SMITH AFFILIATED CAPITAL

WEEKLY ECONOMIC COMMENTARY

WEEK OF NOVEMBER 26, 2021

In this holiday-shortened week, there was plenty of data to be thankful for, a significant event that had been a long time coming, and market-shattering health news on Friday that obliterated the post-thanksgiving holiday cheer. With regards to the long-awaited event, President Biden, after much deliberation, has re-appointed Chairman Powell for another four-year term, opting for continuity at the helm of the Federal Reserve. Biden tapped Fed Governor Brainard for Vice-Chair, replacing Richard Clarida, who is not likely to get re-appointed to a full 14-year governorship term since he was appointed by President Trump.

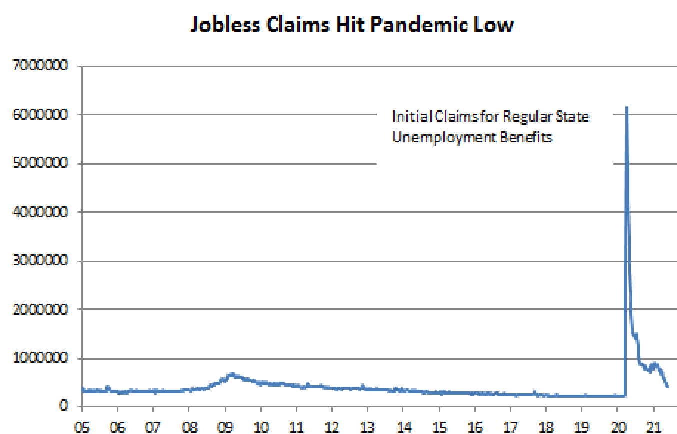
Powell has done an excellent job leading the FOMC through the Covid crisis. Financial markets should be comforted by his re-nomination. Despite being too hawkish in 2018, he transitioned into a moderately dovish leader focused on ensuring a broad and inclusive labor market recovery. He enjoys strong bipartisan support within Congress, notwithstanding the more progressive members such as Senator Warren arguing to replace Powell with Fed Governor Brainard. Previously Warren criticized Powell for acting to "make our banking system less safe, and that makes [him] a dangerous man to head up the Fed." Elevating Governor Brainard to Vice-Chair should help quell some of the progressive discontent with the re-appointment of Powell as Chair.

Lael Brainard has been a powerful voice against the deregulation of financial institutions, dissenting against the easing of rules covering banks' capital buffers and liquidity provisions under the Trump administration. She is also seen as someone who would focus on the impact of climate change on the financial system's stability and be open to the Fed adopting a digital currency. Tapping Brainard as Vice-Chair confirms our view that the current Vice-Chair Clarida is not likely to be re-appointed to a full 14-year governor term. Clarida joined the Federal Reserve in September 2018 as he filled an unexpired term ending January 31, 2022. Despite doing a superb job spearheading the Fed's review of its policy framework and contributing key monetary policy and market insights to the FOMC, we suspected that Clarida would not be re-appointed since he was named by former President Trump.

As such, Powell now can nominate three new Fed governors to the FOMC, including the next Vice Chair of Supervision, who will likely reverse the loosening of bank regulations that unfolded under the Trump Administration – thus being tougher on banks and Wall Street. Overall, the nominations will likely tilt the Board of Governors more dovish as policymakers will place a high priority on promoting broad-based and inclusive employment gains. With the Democrats in control of the Senate, we expect swift confirmation by the Senate of all nominees.

But despite the more dovish slant in the Fed's prospective composition next year, the pressure to pivot more quickly away from its turbocharged easy policy in effect over the last 18 months is building. Importantly, policymakers are already tilting towards that way of thinking. According to the minutes of the last FOMC meeting on November 2-3 released this week, Fed officials "judged that inflation pressures could take longer to subside than they had previously assessed." Moreover, they noted that price increases were unfolding more broadly. Simply put, the tone of the minutes reflected a heightened concern about the upside risks to inflation. Given the pre-Thanksgiving feast of robust economic data released this week, we now believe the Fed will accelerate the pace of tapering its asset purchases, finishing the job by the end of April instead of June. As a result, the door would be open to an earlier rate increase than the current forecast of a December hike.

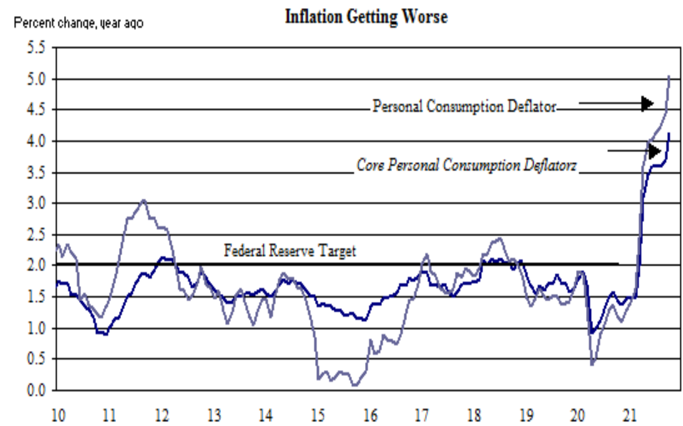
Indeed, the week's basket of economic news starkly confirmed that the economy is ending the year on a hotter streak than expected a month or so ago. The job market continues to tighten, with companies aggressively striving to hold on to workers. That is amply illustrated by the ongoing plunge in claims for unemployment benefits. In the latest week, initial claims for jobless benefits fell below pre-pandemic levels, falling to the lowest seasonally adjusted level since 1969. No doubt, the outsized drop reflects some quirky statistical adjustments, as claims actually rose 18 thousand, or 8 percent, before being adjusted for seasonality. Still, given the various reports of labor shortages and the solid seasonal hiring by major chain stores and delivery services heading into the holiday shopping season, there is little question that layoffs are being held to a minimum.



Companies are holding on to staff as much as possible because demand for goods and services remains red-hot. Last week's retail sales report revealing a more substantial than expected gain for retailers in October was amplified by this week's more comprehensive personal income and spending report, which includes

purchases of services and goods sold chiefly at retail establishments. Total personal consumption increased by a robust 1.3 percent in October, the strongest in seven months, lifting the annual gain to 12 percent. As was the case for retail sales, inflation accounted for a big chunk of the increase. But real personal spending still increased by a solid 0.7 percent.

Notably, the Fed's preferred inflation gauge contained in the personal income and spending report underscores the growing pressure on policymakers to pivot away from its easy policy sooner rather than later. The personal consumption deflator and the stripped-down core PCE deflator, which excludes volatile food and energy prices, both increased at the fastest annual rate since the early 1990s in October. The headline deflator rose 5.0 percent over the past year, while the core deflator gained 4.1 percent. Both are well above the Fed's target of 2 percent inflation over time, and neither is expected to drift down to that target until at least late next year. However, we do expect price increases to peak sometime in the first quarter and gradually slow over the year.



Until Friday, the financial markets were moving faster than the Fed towards a more hawkish response to inflation, pricing in as many as three rate increases next year, with liftoff pulled forward to as early as April. Heightened inflation expectations, as well as upgraded growth forecasts, also lifted bond yields, with the bellwether 10-year Treasury yield rising to over 1.70 percent on Wednesday from 1.55 percent at the end of last week. Early in the month, just before the three-week run of strong economic and inflation data spewed out of Washington's data mills, the Treasury yield stood at 1.44 percent. Yields further down the maturity spectrum, which are more sensitive to Fed policy shifts, rose even faster, resulting in a flattening yield curve.

Interestingly, while the minutes of the FOMC minutes revealed a more hawkish pivot among policymakers, Fed officials still expressed deep concerns over the path of Covid and most preferred to remain patient until the health situation comes into clearer focus. Indeed, Fed staffers and "a few participants mentioned an upsurge in COVID-19 cases during the coming winter or an emergence of new virus strains as possibilities that, if they were realized, would damp economic activity." The meeting took place during the first week of November, but the concerns expressed then could not have been more prescient, as news of a rapidly spreading new variant in South Africa sent tremors through the global financial markets on Friday.

To be sure, trading on Friday was truncated by the holiday, and price action tends to be more volatile amid light trading. But the moves in the equity and debt markets on Black Friday were eye-opening, with all three major stock indexes suffering their worst declines of the year. Meanwhile, all of the growth and policy expectations that had been driving bond yields sharply higher throughout the week experienced a 180-degree turnaround, with the 10-year Treasury yield plunging to 1.48 percent on Friday. Likewise, some commodity prices also got crushed, with crude oil prices plunging by an astonishing $10 on the final day of the week to just over $68 a barrel.

It remains to be seen if this new health shock has staying power when trading returns to full strength next week. The World Health Organization (WHO) is sending out alarming messages about the newly discovered variant, and dozens of countries are already imposing travel restrictions to and from South Africa. Keep in mind that infection rates from the Delta variant have been rising rapidly in Europe, and some countries have already responded with restrictive measures. Austria, for example, announced a hard 10-day lockdown. If this leads to broader restrictions and lockdowns, the economic outlook could change dramatically, as would investor expectations regarding profits and inflation. The good news is that health officials in the U.S. still believe that the uptake of vaccination rates and a better-equipped medical toolkit to cope with Covid's effects should minimize the negative impact of the new variant among Americans. But they also admit that there is not enough data or studies to validate that belief fully. At this point, there are more questions than answers, so odds are the markets will remain highly skittish in the coming weeks.

FINANCIAL INDICATORS				
INTEREST RATES	November 26	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.06%	0.05%	0.06%	0.09%
6-month Treasury bill	0.09	0.06	0.06	0.1
3-month LIBOR	0.18	0.16	0.13	0.22
2-year Treasury note	0.50	0.52	0.50	0.16
5-year Treasury note	1.17	1.22	1.19	0.37
10-year Treasury note	1.48	1.55	1.56	0.84
30-year Treasury bond	1.83	1.91	1.93	1.57
30-year fixed mortgage rate	3.10	3.10	3.14	2.72
15-year fixed mortgage rate	2.42	2.39	2.37	2.28
5/1-year adjustable rate	2.47	2.49	2.56	3.16
STOCK MARKET				
Dow Jones Industrial Index	34899.34	35601.98	35819.56	29910.37
S&P 500	4594.62	4697.96	4605.38	3638.35
NASDAQ	15491.66	16057.44	15498.39	12205.85
Commodities				
Gold ($ per troy ounce)	1792.30	1848.50	1785.00	1779.3
Oil ($ per barrel) - Crude Futures (WTI)	68.17	76.11	83.22	44.40
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Personal Income (October) - % change	0.5	-1.0	0.3	-0.1
Personal Consumption (October) - % change	1.3	0.6	1.1	0.7
Savings Rate (October) - % change	7.3	8.2	9.9	9.3
Durable Goods Orders (October) - % change	-0.5	-0.4	1.3	0.8
New Home Sales (October) - 000s	745	742	693	717
Existing Home Sales (October) - 000s	6340	6290	5880	6027

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