WEEK OF FEBRUARY 18, 2022

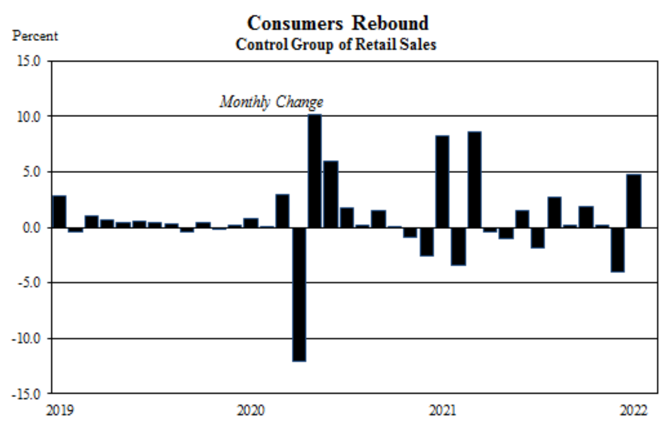
WEEKLY ECONOMIC COMMENTARY

One of the major challenges policymakers face is to separate substance from noise when making important decisions. With so many disruptive events coursing through the economy and financial markets in recent months – including the ongoing Russian/Ukrainian imbroglio -- that effort has been particularly tricky. To be sure, some events initially appear like noise but turn into substance. The pandemic-related supply disruptions that ignited skyrocketing inflation are a case in point. Originally thought to be transitory – i.e., noise – it has stayed around much longer than expected. Not surprisingly, its evolution has also altered the trajectory of policy thinking. For some time -- too long in the eyes of many – the Fed remained patient, believing the first phase of the inflation surge was mostly noise that would quiet down as case counts, i.e., the decibel level, ran its course.

That thinking, however, has now been shelved. While case counts in the U.S. are rapidly falling, the Covid-19 tentacles have touched so many sectors of the economy that their inflationary effects will live on over the foreseeable future. Hence, the Fed decided that it can no longer look the other way as the pandemic remnants of accelerating wages, product and labor shortages, de-globalization, and lingering health-related issues threaten to become firmly embedded in the economic landscape. Fed officials realize that substantive measures are needed to curb what is now a substantive influence exerting upward pressure on inflation. The only decision now is how far do they need to go to correct a potentially explosive situation.

Just as the pandemic's influence evolves, so too is the Fed's thinking. The minutes of the Fed's January 25-26 policy meeting, released this week, revealed increasing anxiety among policymakers that inflation could get out of control. The overall sense of the meeting was that the central bank was prepared to move more aggressively than had previously been thought if inflation continued to exceed expectations. The meeting was held before the eye-opening consumer price report for January was released last week, so that feeling of angst may well have increased. Indeed, the financial markets are fully priced for a rate hike at the next meeting in mid-March, which we now believe will be of the half-point variety followed by quarter-point increases in each of the following meetings this year.

That said, nothing is written in stone, and the trajectory of rate increases could well change if the facts on the ground change. As chair Powell noted, the Fed needs to be humble and nimble when making policy decisions and rely on incoming data to guide its actions. The data so far this year have unambiguously pointed towards a more hawkish stance, revealing far more strength in economic activity and higher inflation than expected. Job growth is booming; wage increases are accelerating and encompassing a broader spectrum of the workforce, and, importantly, the inflation spiral has yet to peak, much to the chagrin of Fed officials. While the economy is going through a soft patch, thanks mainly to the growth-suppressing effects of the Omicron variant, recent data indicate that the sluggishness will be short-lived, and activity is poised for a vibrant spring revival.



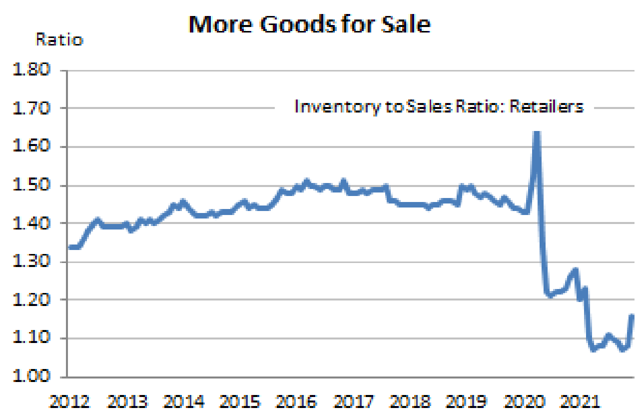
Indeed, this week's key report imparts a decidedly upside risk to the weak consensus growth forecast for the first quarter. The economy's main growth driver, consumers, went on a vigorous spending spree at the start of the year. In January, retail sales surged by 3.8 percent, far more potent than the 2 percent consensus forecast. What's more, households spent on almost everything, although Omicron did deter consumers from visiting restaurants and bars. Sales at eating and drinking places slumped for the second consecutive month, falling by 0.9 percent. But what people saved on restaurant meals, they spent profusely on items purchased online, as sales at non-store retailers, mostly Internet shopping, surged by 14.5 percent. That was the most substantial gain among major retail sectors, but consumers spread their purchases widely, with sales for motor vehicles (+5.7%) and furniture and home furnishings (+7.2%) among the standouts. Significantly, the core group of sales, which excludes autos, building materials, and gasoline that feeds directly into the GDP calculations, leaped by an impressive 4.8 percent, the strongest since March of 2020, when government stimulus checks bloated household bank accounts.

But revised figures also show that the spending slump in December – when Omicron case counts rapidly increased – was more profound than previously estimated. Core retail sales now show a 4.0 percent drop instead of the previous 3.1 percent decline for the month. Hence, the economy started the year on a lower level, which dilutes the growth boost to the first quarter provided by the strong January reading. Although the vibrant retail sales last month tilt the growth forecast for the quarter to the upside, more confirmation is needed before an upgrade is justified. One month does not make a trend, and since the latest sales report follows a sharp downward revision the previous month, a wait-and-see posture is warranted. With so many crosscurrents buffeting households, it is fair to question how durable the January strength in consumer spending will turn out to be.

Keep in mind that some powerful tailwinds underpinned retail sales in January. The strong growth in jobs ranks high on the list, and there is every reason to believe that positive influence will remain in effect. Meanwhile, the strong demand for workers amid labor shortages indicates that companies will grant heftier paychecks to employees as long as they can absorb the higher labor costs by posting higher prices or through productivity gains. So far, the pass-through option has prevailed, stoking the Fed's concern over inflation and raising fears of a wage-price spiral. It's unclear if companies have yet been able to extract productivity gains from workers. If anything, productivity will likely suffer in the first quarter, as job growth and hours worked are on track to handily outpace the increase in GDP.

But while labor conditions should continue to provide solid support, consumer spending also received a boost in January from sources that are not sustainable. The last childcare payment was made in December, and although most of it was spent that month, some spilled over into January. None will be available going forward, as there is not enough support in Congress to renew that fiscal aid, at least for now. Likewise, households came into the month with healthy bank accounts, reinforced by two years of generous government transfer payments that padded savings. Households have steadily tapped into those reserves in recent months, and their financial cushion has been substantially depleted.

Finally, January retail sales may have been boosted by delayed purchases, reflecting product shortages in December exacerbated by pandemic-related bottlenecks at ports as well as factory shutdowns overseas from the rise in outbreaks. According to multiple retail sources, gift card sales in November and December were substantially more robust than usual for those months, likely used for January purchases. A gift card is not counted as a sale until it is cashed in. To be fair, the inventory shortage no doubt contributed to the slump in retail sales in December, as consumers had fewer goods to buy. Conversely, businesses had made some progress rebuilding their inventories by the end of the month, which may well have imparted strength to sales in January. Inventories of cars and parts increased by an outsize 6.8 percent in December, which helped auto sales in January. Take out autos, and the gain in retail sales in January shrinks from 3.8% to 3.3%.



The Fed will not have time before its March 15-16 meeting to gain a better sense of consumer spending trends, as the next retail sales report will come out after the meeting. However, it will have another month of data on jobs and consumer inflation, which should justify a half-point increase in the Federal funds rate that may coincide with an announcement of further tightening, including the start of balance sheet shrinkage. Beyond that, things get a bit murkier. At this juncture, it appears that the Fed is more concerned about inflation than either households or the financial markets, where inflation over the medium and longer run is expected to recede quite dramatically from current levels. A more than trivial fear in the market is that the Fed will go too far to curb inflation and bring the economy to its knees.

That perception has its roots in the past record of Fed inflation-fighting efforts, as the central bank has a poor history of curbing inflation without causing a recession. The task this time is made more challenging because monetary policy affects demand and has little ability to alleviate supply shortages, which is a major catalyst stoking inflation pressures. For sure, there is room to take some steam out of demand before inflicting much economic damage, and a series of well-communicated gradual rate hikes can accomplish that without disrupting the financial markets. A key to success will be how quickly supply shortages clear up, both in the product and labor markets, which would significantly reinforce the Fed's inflation-fighting efforts and reduce the risk of overkill.

The good news is that supply logjams are already easing, as manifested by the inventory rebuilding, and the pandemic's grip on the economy is loosening. Case counts and hospitalization rates are falling rapidly, and government restrictions are being lifted nationwide. The latter should shift help on the inflation front by shifting consumer purchases away from goods, where shortages are most acute, to services. At the same time, reduced health concerns help expand labor supply, relieving wage pressures. According to the Census Bureau, the number of people forced to stay out of work because of sickness or having to care for someone who was sick fell by about a million over the past month – from 8.8 million to 7.7 million.

FINANCIAL INDICATORS				
INTEREST RATES	February 18	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.35%	0.17%	0.17%	0.04%
6-month Treasury bill	0.63	0.35	0.35	0.06
3-month LIBOR	0.48	0.26	0.26	0.19
2-year Treasury note	1.47	1.02	1.02	0.11
5-year Treasury note	1.82	1.56	1.56	0.59
10-year Treasury note	1.93	1.76	1.76	1.34
30-year Treasury bond	2.25	2.08	2.08	2.14
30-year fixed mortgage rate	3.92	3.56	3.56	2.81
15-year fixed mortgage rate	3.15	2.79	2.79	2.21
5/1-year adjustable rate	2.98	2.60	2.60	2.77
STOCK MARKET				
Dow Jones Industrial Index	34079.18	34265.37	34265.37	30932.37
S&P 500	4348.87	4397.94	4397.94	3811.15
NASDAQ	13548.07	13768.92	13768.92	13874.46
Commodities				
Gold ($ per troy ounce)	1900.80	1836.10	1836.10	1786.2
Oil ($ per barrel) - Crude Futures (WTI)	91.66	84.83	84.83	60.17
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Retail Sales (January) - % change	3.8	-2.5	0.7	0.9
Industrial Production (Janury) - % change	1.4	-0.1	0.9	0.4
Capacity Utilization (Jaunary) - Percent	77.6	77.6	77.7	76.4
Producer Price Index (January) - % change	1.0	0.4	0.9	0.7
Housing Starts (January) - 000s of units	1638	1708	1703	1621
Building Permits (January) - 000s of units	1899	1885	1717	1744