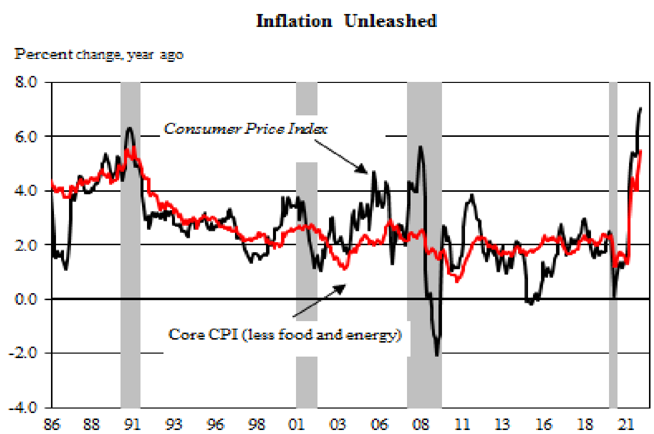
WEEKLY ECONOMIC COMMENTARY

Inflation continues to dominate the headlines, overshadowing mounting geopolitical tensions, disturbing health news, ongoing dysfunction on Capitol Hill, growing odds of steeper rate hikes, and even the NFL playoffs that began over the weekend. Unlike the weather, however, those in charge are not just talking about it but poised to do something about it. In particular, Federal Reserve officials are all on the same page, something that's not always been the case in recent years. No longer are some policymakers more concerned about an incomplete jobs recovery at the expense of elevated inflation that, until recently, was considered transitory and primed to recede along with pandemic-related disruptions that were thought to underpin it. As articulated by Chair Powell at his Senate confirmation hearings this week, taming inflation is an essential step needed to extend the life of the expansion and keep the job-creating engine firing on all cylinders.

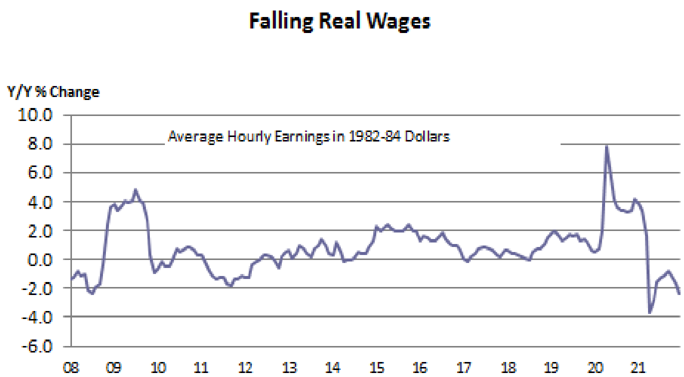
But while the objective is clear and accorded widespread acclaim, the means of achieving it remains unsettled. While all officials agree that it's time to start removing monetary support, some want to move faster than others. The market is pricing in the first rate hike in March, a few months ahead of the implied liftoff from the Fed's projections made in December, which included three hikes this year. At least two policymakers commented this week that they are open to an increase in March, which along with four rate hikes this year, is what we are currently forecasting. There may still be 3.6 million jobs that have not been recovered from the 22.4 million laid off at the height of the pandemic last March and April. But the pool of available workers that can be brought back to the workforce has shrunk for various reasons, including early retirements, childcare responsibilities, and health concerns. The Fed understandably believes that the risk in terms of higher inflation outweighs the rewards of squeezing more labor out of this shrunken pool.

This week's inflation reports further cemented that risk/reward balance. Although the outcomes revealed in the consumer and wholesale price releases were about as expected, they still hammered home the idea that inflation has reached eye-opening levels, posing a threat to the Fed's inflation-fighting credibility and an increasing political liability to the administration. The consumer price index increased 7 percent in December from a year ago, the highest since 1982, while the core CPI that excludes volatile energy and food prices increased by 5.5 percent, the highest since 1991. The pipeline feeding into consumer prices does not offer much encouragement. Prices on the wholesale level also staged a remarkable annual increase, with the producer price index surging by a record 9.7 percent over the past year.



Just as disturbing as these sky-high inflation readings is the speed with which we have come to this point. The consumer price index took only 20 months to climb from a near-zero (0.2 percent) annual rate in April 2020 to 7 percent in December. This head-spinning upturn far outpaced the 41-month climb from a trough to an inflation peak in May 1980 or the 28 months of rising inflation before the previous high was hit in December 1974. Indeed, the current episode is the speediest since the early 1950s, when inflation raced to a peak in April 1951 over an equally short period of 20 months. Some compare the current episode with the one in the early 1950s because the latter was underpinned by a tight labor market and sharply rising wages that drove up prices. But the unemployment rate in 1951 plunged to 3.1 percent, much lower than the current 3.9 percent, and the bargaining power of labor was greatly enhanced by union muscle. More than 25 percent of the workforce belonged to a union in the early 1950s compared to 11 percent now and only 6 percent in the private sector.

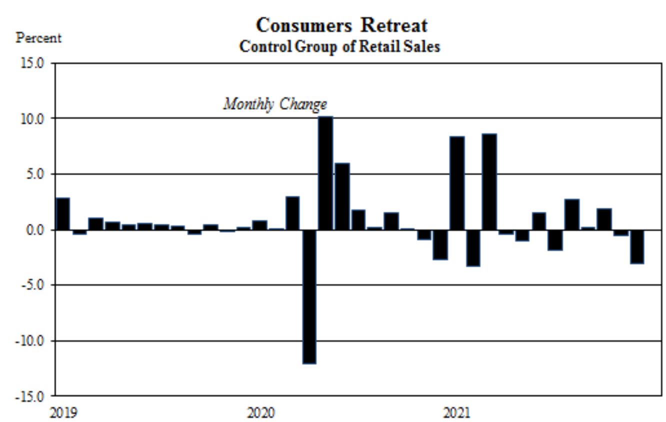
That said, the ever-tightening labor market, amplified by the shrinking labor pool noted earlier, is driving up wages and feeding through into higher prices. Like the CPI, the increase in workers' average hourly earnings raced up from a 0.3 percent annual rate last April to 4.7 percent this December. That's a quick turnaround, spurred by faster wage increases for low-wage workers but not fast enough to keep up with rising prices. After adjusting for inflation, worker earnings are still 2.4 percent lower than a year ago. The good news is that workers are making incremental progress, as real earnings increased in December from November for the first time in four months. Non-management workers are doing a bit better, as their hourly earnings increased by 1 percent more than for all private-sector workers over the past year.



The longer wage growth continues to accelerate, and employers can pass higher labor costs onto consumers, the greater are the odds that a wage-price spiral would gain traction, making life more difficult for the Fed. While the risk of that prospect has increased, it remains unlikely in our view. One reason is the speed with which the inflation spike has unfolded. Following more than three decades of subdued inflation, punctuated by periods of powerful deflationary forces, the current episode is still too short to make much of a dent in inflationary expectations. There is scant evidence that households are pulling forward purchases to beat higher prices, and businesses are more concerned about the impact rising input costs will have on their bottom lines. The financial markets have yet to price in higher inflation over the longer term, as the 10-year inflation breakeven rate in the Treasury market remains within the 2 – 2.50 percent range in effect over most of the past decade.

Nor should worries that a red-hot economy will fan the inflation fires and become more entrenched. That might have been the case a few months ago when the economy was on track to close out the year on a galloping growth rate, widely expected to top a 7 percent annual rate in the fourth quarter. That ambitious perception has all but vanished, as recent data prompted forecasters to lower their sights considerably. To be sure, earlier in the quarter it was thought that Covid-19 was being licked, and the return of normal behavior together with an arsenal of unspent funds from the pandemic and stimulus payments would fuel the economy's growth engine and provide solid momentum heading into 2022. But the optimistic assumption regarding the pandemic was upended by the emergence of a new variant, Omicron, extending the supply-side constraints contributing to inflation even as it undercuts confidence and household behavior.

Hence, the economy ended 2021 with a whimper rather than a blast, its footing looking shaky as the new year begins. The most striking evidence of the languid close to the year can be seen in Friday's retail sales report. Consumer spending is the main cylinder that drives the growth engine, and it sputtered severely over the final two months of 2021. Following a slim 0.2 percent increase in November, total sales slumped by 1.9 percent in December. And that's in current dollars, including the much higher prices consumers paid for these goods. Adjusted for inflation, the volume of goods sold tumbled by an even steeper 2.4 percent. Nor was it just a few items that consumers shunned last month. The weakness was across the board, as 12 of the 14 major categories of sales posted declines, led by a surprising 8.7 percent plunge in online purchases.



Notably, the control group of sales, excluding gasoline, autos, and building materials, which feeds directly into personal consumption in the GDP calculation, fell by an outsize 3.5 percent following a downward revised 1.5 percent drop in November. That's the first back-to-back decline in over a year and indicates that the fourth-quarter growth in GDP will come in weaker than the 6.5 percent pace we estimated prior to the retail sales report. Keep in mind that what still seems like a formidable growth rate was front-loaded, as most of the strength occurred in October. The slowing pace evident in November and December translates into a considerable loss of momentum heading into 2022.

To be sure, the bleaker late-year reading on consumers must be tempered by the fact that many likely pulled forward holiday purchases to October in anticipation of supply shortages. We also wonder how much of the weakness in sales simply reflected the inability of retailers to find workers. Reports abound of stores restricting hours of operations because of staff shortages. According to the December jobs report, payrolls in the retail sector declined last month, even as workers logged an average of 31.4 hours a week, the highest in more than six years. This is another sign that workers were being stretched as much as possible to keep the doors open.

We suspect that labor shortages will persist until Omicron runs its course, easing health concerns and childcare responsibilities that keep potential job seekers out of the workforce. At the same time, the new variant is stifling demand for in-person activities, such as dining out, and restricting travel and tourism. Hotel occupancy rates are down to 45.4 percent, 14.5 percent below pre-pandemic levels, and seated dinners and reservations are down nearly 30 percent, according to OpenTable. Hence, the economy is not getting much of a boost in January, setting the stage for another soft patch in the first quarter when growth could be cut in half relative to the fourth quarter. With that backdrop and inflation expected to remain elevated, the Fed will face some tough choices as winter turns to spring.

The good news is that many health officials expect Omicron to fade as quickly as it flared up, opening the door to a swift rebound in activity in the second quarter. Whether the soft patch in the first quarter turns out to be too soft for the Fed's comfort and prompts it to postpone rate hikes remains to be seen. One noteworthy aspect of the speedier termination of asset purchases decided last month is that it gives the Fed more flexibility in its policy decisions at an earlier date. Given the myriad crosscurrents that will be playing out over the first quarter, that flexibility will be a handy addition to the Fed's toolbox.

FINANCIAL INDICATORS				
INTEREST RATES	January 14	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.13%	0.10%	0.05%	0.09%
6-month Treasury bill	0.29	0.12	0.13	0.1
3-month LIBOR	0.24	0.23	0.21	0.23
2-year Treasury note	0.96	0.84	0.66	0.13
5-year Treasury note	1.56	1.50	1.18	0.46
10-year Treasury note	1.79	1.77	1.41	1.11
30-year Treasury bond	2.13	2.12	1.82	1.85
30-year fixed mortgage rate	3.45	3.23	3.12	2.79
15-year fixed mortgage rate	2.62	2.43	2.34	2.23
5/1-year adjustable rate	2.57	2.41	2.45	3.12
STOCK MARKET				
Dow Jones Industrial Index	35911.81	36231.66	35365.44	30996.98
S&P 500	4662.85	4677.03	4620.64	3841.47
NASDAQ	14893.75	14935.90	15169.68	12998.50
Commodities				
Gold ($ per troy ounce)	1816.30	1796.70	1810.10	1839
Oil ($ per barrel) - Crude Futures (WTI)	84.39	78.95	71.18	52.75
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer Price Index (December) - % chg	0.5	0.8	0.9	0.6
Core CPI (December) - % change	0.6	0.5	0.6	0.4
Producer Price Index (December) - % chg	0.2	1.0	0.6	0.7
Retail Sales (December) - % change	-1.9	0.2	1.8	0.0
Industrial Production (December) - % chg	-0.1	0.7	1.2	0.2