

**WEEKLY ECONOMIC COMMENTARY**  
A BREAK IN INFLATION EXPECTATIONS

You could hardly call it a pivot, much less a U-turn, but the Federal Reserve has added a bit more nuance to its policy stance, a shading that has thrown commentators into a speculative frenzy this week. The springboard for all the fuss was the release of the minutes from the April 27-28 policy meeting. Recall, the summary statement delivered after that confab highlighted the Fed’s firm commitment to keep its foot on the monetary pedal for the foreseeable future, meaning that rates would remain at near zero and bond purchases would remain at current levels until the labor market reaches maximum and inclusive employment and inflation rises to 2 percent for a period of time.

Chairman Powell reaffirmed that commitment at the post-meeting press conference, albeit he acknowledged that a stronger-than-expected recovery had gotten underway and Fed officials had upgraded their economic outlook. Still, he felt that the recovery was uneven and incomplete, even as the pandemic posed downside risks that required careful monitoring. He also noted that the expected acceleration in inflation is not something to worry about, as it would likely reflect transitory factors. The key take-away from that meeting: The Fed is still not even “thinking about thinking about” easing its foot off the pedal.

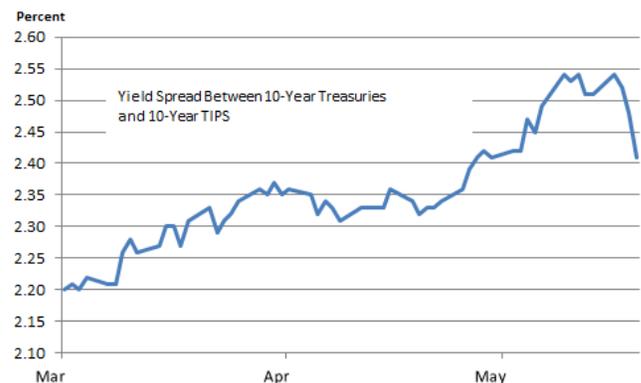
Well, it turns out some officials were thinking about it after all. According to the minutes of the meeting released with the usual three-week lag this week, a number of them thought “If the economy continued to make rapid progress toward the Committee’s goals, it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases”. On balance, the Fed retained a dovish message, concerned more about the incomplete recovery in the labor market than the expected acceleration in inflation, which it believes is being stoked by transitory forces. Still it recognizes the tail risk that inflation could be stickier than expected, reflecting lingering supply chain disruptions in the goods sector and a tidal wave of pent-up demand that puts upward pressure on prices for services.

From our lens, the “at some point” will take place at the August annual Jackson Hole symposium when Chair Powell will publicly unveil plans as to when, and under what conditions, the Fed would start slowing the pace of asset purchases. The timing of the announcement should not spur the “taper tantrum” that sent bond yields surging in 2013 when the Fed shocked the markets by announcing it would soon start unwinding its asset purchase program. For one, there will be no similar shock effect, as the Fed has nimbly laid bare its intentions for some time, punctuated by the much-discussed suggestive phrase in the minutes.

For another, the markets are far from displeased by the prospect of tapering. For months as the recovery gained traction and inflationary pressures built up, a growing segment in the bond market became concerned that the Fed was falling behind the inflation curve. That growing sentiment appears to have stalled, at least temporarily. The steep rise in market-based measures of inflation expectations came to an abrupt halt following the release of the minutes this week, with the 10-year breakeven rate falling to a three-week low on Thursday. To be sure, bond investors have flip-flopped on expectations several times over the past year, so heightened inflation concerns could well upend market psychology again in coming months.

Importantly, while investors appear to have digested the ugly inflation data for April released last week, the transitory forces stoking inflation will be reaching their peak impact over the late spring and summer months. The economy is more fully reopening week after week, more than 60 percent of the population have received at least one vaccine shot, Covid-19 case counts are plunging and stimulus payments as well as enhanced unemployment benefits are bloating household bank accounts. Hence, consumers have the wherewithal and motivation to unleash pent-up demand, although consumption patterns are poised to shift from goods to services. Meanwhile, companies are struggling to keep up with demand due to supply-chain disruptions and difficulty in finding qualified workers to fill open positions.

**A Break In Market Inflation Expectations**



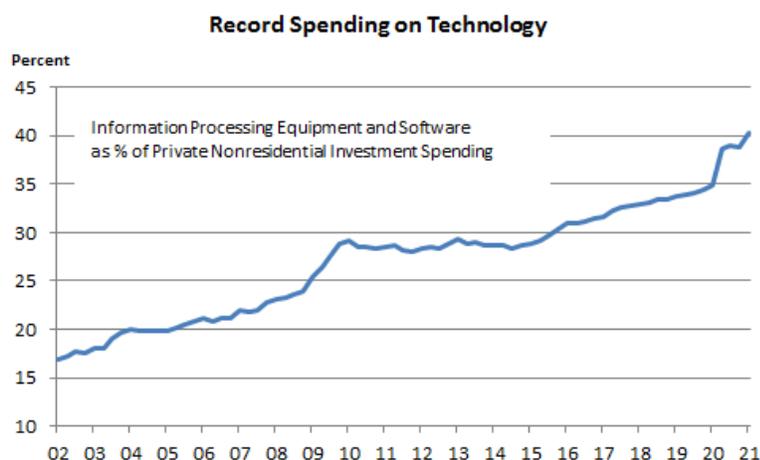
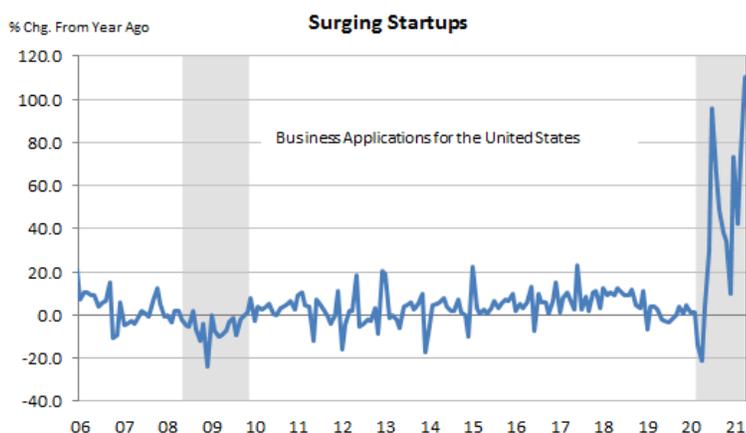
That said, it is important not to conflate the prospect of a Fed tapering its asset purchases with a tightening of monetary policy. The Fed will still be expanding its balance sheet, although at a reduced pace, and has not changed its intention to keep short-term rates at near zero at least through the end of 2023. Simply put, policy will still be highly accommodative as it navigates an uncertain post-pandemic economic landscape. While we believe that short-term inflationary pressures and robust growth will prompt a rate hike in 2023, we also expect inflation to peak this year and recede towards the Fed’s 2 percent target in 2022 and beyond.

One reason is that the pandemic has prompted U.S. companies to become more efficient, controlling costs by producing more with less. For example, the U.S. economy is generating about as much in the way of goods and services as it was prior to the pandemic but with 8.2 million fewer workers. Part of this increased productivity reflects changes in the composition in the work force, i.e., the least productive workers were the first to be laid off during the pandemic and are the last to be rehired as the economy reopens. Another positive contribution may also be related to the changed nature of the workplace; several studies indicate that working from home has turned out to be more productive than working at the office.

But a time-honored driver of productivity is technology, allowing companies to automate processes via more sophisticated computers, software, robotics and advanced telecommunications methods, among others. The embrace of new technologies has waxed and waned over the years, depending on the cost of labor, profitability and shifting economic prospects. But the pace has accelerated during the pandemic; in the first quarter of this year, the proportion of private investment spending devoted to technology hit a record of over 40 percent. This trend should receive further impetus from a number of catalysts, including President Biden’s infrastructure spending proposal, the increased costs of hiring low-paid workers, and growing pressure on U.S. companies to return production from overseas, spurring construction of cutting edge factories.

Another incentive to step up spending on productivity-enhancing equipment and software is simply the declining growth in the labor force. Baby boomers are retiring and leaving the workforce, immigration has slowed considerably in recent years and population growth is stalling out. What’s more, it may be that large companies are losing workers to start-ups, which are exploding in number. According to Commerce Department figures, new applications for businesses more than doubled in April from a year ago, a trend that has persisted throughout the pandemic. The notion that this is a typical development during recessions as workers who lose jobs become entrepreneurs is refuted by the experience during the last recession, which saw a decline in business applications.

We suspect that the explosion in business applications underway reflects to some extent the massive government transfer payments over the past year that provided laid-off workers and would-be entrepreneurs with the financial cushion and confidence to take risks associated with start-ups. And unlike the Great Recession when the housing collapse vaporized the home equity of millions of Americans, the housing market has thrived during the pandemic, providing homeowners with trillions of dollars of additional housing equity and vital collateral to draw on to start a business.



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FINANCIAL INDICATORS				
INTEREST RATES	May 21	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.00%	0.00%	0.02%	0.11%
6-month Treasury bill	0.01	0.03	0.04	0.142
3-month LIBOR	0.15	0.16	0.18	0.39
2-year Treasury note	0.15	0.15	0.16	0.147
5-year Treasury note	0.82	0.81	0.86	0.31
10-year Treasury note	1.62	1.63	1.63	0.62
30-year Treasury bond	2.32	2.34	2.31	1.29
30-year fixed mortgage rate	3.00	2.94	2.97	3.24
15-year fixed mortgage rate	2.29	2.26	2.29	2.7
5/1-year adjustable rate	2.59	2.59	2.83	3.17
STOCK MARKET				
Dow Jones Industrial Index	34207.84	-0.43	0.43	42.66
S&P 500	4155.86	-0.39	-0.28	43.21
NASDAQ	13470.99	0.33	-3.35	46.22
COMMODITIES				
Gold (\$ per troy ounce)	1881.25	2.05	4.88	8.93
Oil (\$ per barrel) - Crude Futures (WTI)	63.58	-2.72	3.77	71.10
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/Quarters Ago	Average-Past Six Months/Quarters
Housing Starts (April) - 000s	1569	1733	1447	1598
Building Permits (April) - 000s	1760	1755	1726	1763
Existing Home Sales (April) - mlns	5.85	6.01	6.24	6.33

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