

The Commerce Department closed the books on the second quarter, releasing its first estimate of GDP for the period and the all-important report on household income and spending for June. As expected, the economy turned in a robust performance, powered by a muscular pace of consumer and business outlays. Since the results were generally in line with expectations and reflected past events, they had little impact on the financial markets. Instead, investors turned their attention to monetary and fiscal policy developments and, more importantly, to the disturbing upsurge in Covid cases.

All eyes on this week's FOMC meeting were focused on whether the Fed would provide guidance as to when it would start removing its turbo-charged support for the economy. No one expected it to hint at raising rates, which Fed Chairman Powell stated was still a ways off. But given the dramatic upturn in inflation and steamier pace of economic activity, many commentators expected the Fed to indicate when it would start reducing its asset purchases, which it already stated was a precondition before rate increases would begin. No such guidance was given. While Chair Powell acknowledged that progress towards meeting the Fed's employment and inflation goals has occurred, it was not enough to move up the timetable to withdraw support.

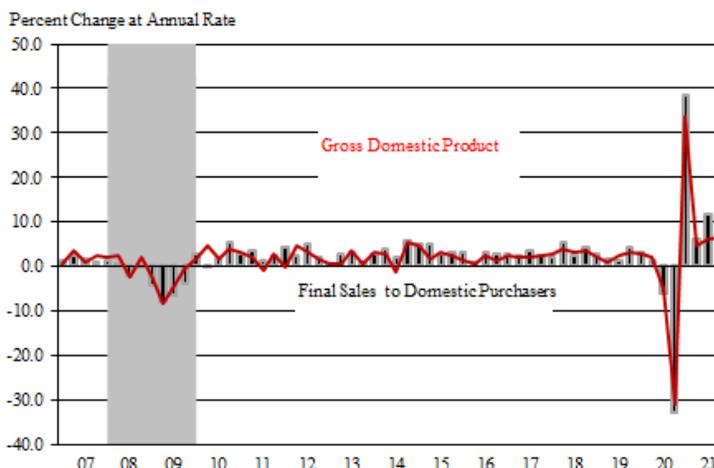
For the most part, the Fed's message landed on the financial markets with a thud, as a wait-and-see sentiment appears to be the prevailing view among investors. That makes sense considering all the uncertainties regarding inflation and the economy's path over the next several months amid the spreading Delta variant of the virus. However, a more definitive tone was sounded on the fiscal front as the \$1 trillion infrastructure bill received a critical procedural vote in the Senate, heightening the prospect of full Senate approval. As welcome as the bipartisan effort would be, the road ahead is fraught with partisan acrimony as Congress is poised to grapple with lifting the debt ceiling and a pending \$3.5 trillion spending bill on social programs.

With Congress no longer deliberating over pandemic-related stimulus measures, fiscal policy will be shaped more by political than economic influences in the future. Just the opposite is the case with monetary policy, of course, as the economy's direction will have a decisive influence on the Fed's next move in the coming months. The economy still has considerable momentum from our lens, pointing to another solid, albeit less vigorous, performance in the current quarter than in the just-completed one. The 6.5% annual growth rate in GDP posted in the second quarter fell slightly below expectations, but the shortfall was primarily due to the inability of businesses to restock inventories fast enough to accommodate surging demand.

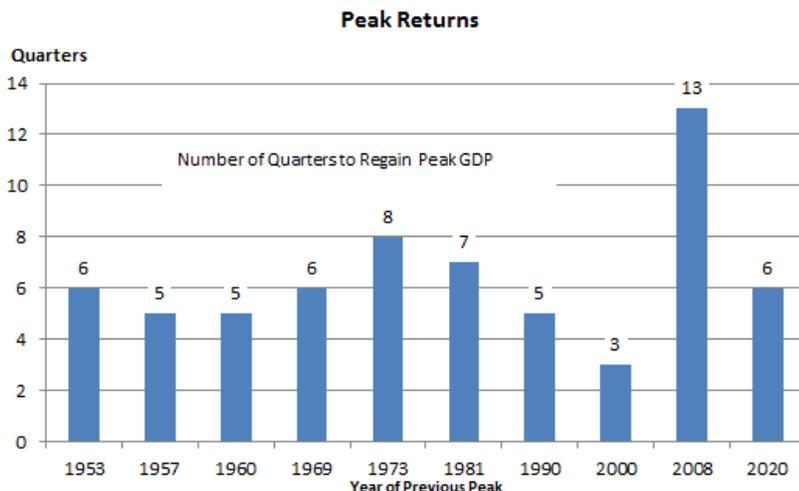
That slowdown in inventory accumulations, which reflected supply restraints as much as anything else, subtracted 1.1% from the GDP growth rate. Another 0.4% drag came from the trade side, as the strength of consumer demand pulled in more imports than domestic producers could supply. Hence, while GDP increased by 6.5%, final sales to domestic purchases – a better gauge of demand – boosted by a much heftier 9.9%. The disparity in growth between domestic demand and output was even greater in the first quarter when the 6.3% advance in GDP trailed the increase in final sales to domestic purchases by a whopping 5.5%.

As noted, consumers were the driving force behind the stellar GDP advance, as the unleashing of pent-up demands amid a reopening economy underpinned the strongest pace of personal consumption since 1952. The gain would likely have been even more substantial if not for the scarce supply of cars on dealer lots restraining auto sales. Likewise, supply restraints also hampered activity in the housing sector, as residential outlays contracted by 9.8% during the second quarter. Still, the 6.5% increase in GDP followed a lofty 6.3% increase in the first quarter, marking the most robust back-to-back quarterly gains since the early 1980s.

GDP Stronger Than It Looks

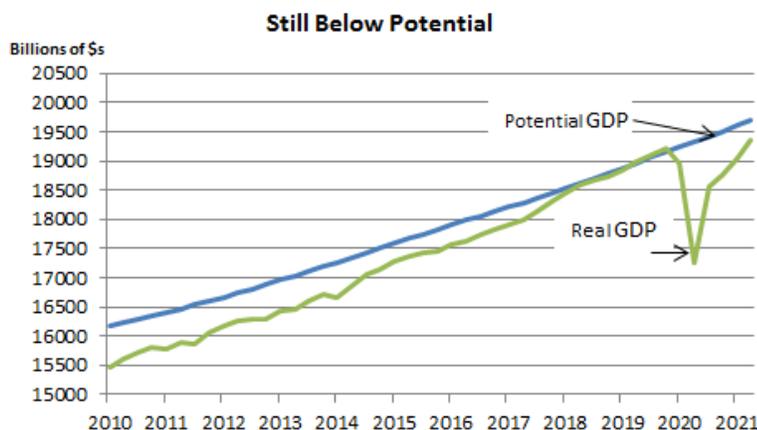


Significantly, the rapid first-half growth lifted the level of GDP above its pre-Covid level. In turn, it underscored the attention-getting headlines that the economy has recovered all of its pandemic-related output losses, leading some to laud this as a V-shaped recovery. As important as that development may seem, we have to point out that there is nothing special about how fast the economy returned to its previous peak. To be sure, the lag has been much shorter than the recovery following the Great Recession, when it took 13 quarters for output to recover its losses. But that cycle included 6 recession quarters – the longest stretch of any postwar downturn – compared to just one this time, which made it the shortest on record. Even with the longer period of growth since the pandemic, the economy's return to its pre-Covid peak merely matches the average of the previous nine recoveries.



What's more, the recovery speed should be measured against where output would be at full capacity had the pandemic never occurred. Compared to this measure of potential GDP, which the Congressional Budget Office estimated in January 2020, output is still almost 2 percent below its limit. Combine that with the 6.8 million missing jobs relative to the pre-Covid level, and it's understandable why Fed Chair Powell believes the recovery still has a ways to go before the economy returns to full health. It also influences the Fed's view that intensifying price pressures now underway will unwind as supply continues to expand and pent-up demand fades.

We concur with that view but caution that prices will remain under pressure for a while as it will take time for supply restraints to ease and demand to taper off. For example, in the auto industry, the shortage of computer chips – a critical component in the production process – is expected to extend well into next year. Meanwhile, service providers, particularly in the hospitality sector, continue to scramble for workers; reports abound of restaurants and other retail establishments either shutting down or reducing the hours they stay open because of a labor shortage. On the demand side, elevated pent-up savings, healthy balance sheets, strong job prospects, and lingering fiscal support will keep consumers in a spending mood at least through the summer months.



As we move further into the second half, however, these supports will start to ease. Indeed, households have already reached deeply into their copious savings to finance purchases. Personal consumption increased by a respectable 1.0 percent in June, which outstripped the slight 0.1% increase in personal incomes. As a result, the savings rate fell to 9.4%, the lowest since February 2020 and down from 26.9% as recently as March. That's still well above pre-Covid levels, which averaged 7.6 percent in 2019, but the liquidity cushion is rapidly deflating. Importantly, so too is the income boost from fiscal stimulus. One of the more dissonant features of the second quarter's GDP report is that real consumer spending surged by an 11.8 percent annual rate even as real disposable incomes plunged by 30.6 percent, reflecting the steep decline in government transfer payments.

No doubt, the plunge in government transfers is not a big deal as long as rising labor compensation offsets the void. With the shortage of labor putting workers in the driver's seat, wage growth is picking up, a trend we expect to continue, although at a slower pace over the remainder of this year and next. The Fed hopes that the more attractive pay packages will lure workers off the sidelines and relieve the labor shortage in many industries, particularly in the service sector. However, worker pay is only one factor that will influence employment gains in the coming months. The other elephant in the room is the spread of the Delta variant, which threatens to keep schools shut, prod state and local governments to re-impose restrictions, and stoke health fears among workers and consumers that would suppress the labor supply and discourage in-person shopping.

While those disturbing growth-dampening events are not imminent, they are gaining increasing attention in the financial markets, most notably among bond investors, contributing to the surprising persistence of low bond yields. However, one positive development on the health front is that vaccination rates are starting to creep up again, increasing by about 20% over the last two weeks after several months of declines. Whether that reflects the surge in virus cases or the more aggressive pleas by government officials urging people to get vaccinated is unclear. But the closer the nation gets to herd immunity, the better the chance the recovery will retain its momentum.

FINANCIAL INDICATORS				
INTEREST RATES	July 30	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.05%	0.05%	0.04%	0.09%
6-month Treasury bill	0.06	0.05	0.05	0.1
3-month LIBOR	0.13	0.13	0.14	0.25
2-year Treasury note	0.19	0.21	0.24	0.11
5-year Treasury note	0.70	0.72	0.86	0.21
10-year Treasury note	1.23	1.28	1.44	0.55
30-year Treasury bond	1.89	1.92	2.05	1.2
30-year Fixed Mortgage rate	2.80	2.78	2.98	2.99
15-year Fixed Mortgage rate	2.10	2.28	2.26	2.51
5/1-year Adjustable rate	2.45	2.49	2.54	2.94
STOCK MARKET				
Dow Jones Industrial Index	34935.47	35061.55	34786.35	26428.32
S&P 500	4395.26	4411.79	4352.34	3271.12
NASDAQ	14672.68	14836.99	14639.43	10745.273
COMMODITIES				
Gold (\$ per troy ounce)	1817.10	1801.90	1788.200	1964.9
Oil (\$ per barrel) - Crude Futures (WTI)	73.70	72.95	75.08	40.69
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/Quarters Ago	Average-Past Six Months or Quarters
Real GDP (Q2), % change, Saar	6.5	6.3	4.5	2.5
Durable Goods Orders (June) - % change	0.8	3.2	-0.7	1.4
New Home Sales (June) - 000s	676	724	785	812
Personal Income (June) - % change	0.1	-2.2	-13.6	1.3
Personal Consumption (June) - % change	1.0	-0.1	1.1	1.6
Personal Savings Rate (June) - Percent	9.4	10.3	12.7	15.6

Disclaimer: This publication contains the current opinions of the manager and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Such opinions are subject to change without notice. This publication is distributed for education purposes only. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Forecasts are based on proprietary research and should not be interpreted as an offer or solicitation, nor the purchase or sale of any financial instrument. No part of this publication may be reproduced in any form, or referred to in any publication, without the express written permission of Smith Affiliated Capital Corp.