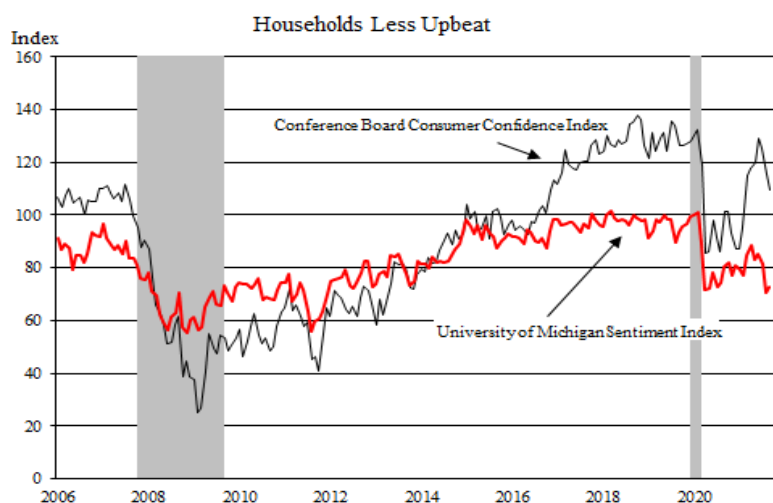


As the calendar turns to a new month, all we can say is good riddance to September. The just-completed month delivered some of the most awful news of the year, leaving the Biden administration as well as investors with severe headaches. Stocks turned in their worst performance since March 2020, with the S&P 500 tumbling by nearly 5 percent, with the deepest slide saved for the final week when the swirl of unfortunate events coalesced into a firestorm. Not surprisingly, the muddled events on Capitol Hill, the proximate cause of the administration's angst, topped the list and continue to weigh heavily on the financial markets.

The last-minute agreement to pass a bill that funds the government **through December 3** avoids a government shutdown that would have occurred at midnight at the end of that forgettable month. But the clock is still ticking on several other issues that will keep tempers in Congress inflamed and the markets on tenterhooks. The most dire threat surrounds the debt ceiling imbroglio, which, if not resolved **by October 18**, would, according to Treasury Secretary Yellen, have catastrophic consequences for the U.S. economy, resulting in a deep recession and a financial crisis. Few expect Congress to fail to lift the debt ceiling before that happens. Still, the more prolonged partisan bickering over the issue continues, the greater the turmoil in the financial markets will be. The Democrats want a bipartisan vote on lifting the debt ceiling, but Republicans want Democrats to lift it themselves, refusing to endorse the spendthrift proclivities embodied in their proposed bills.

Regarding the latter, the \$1 trillion infrastructure bill passed by the Senate remains stalemated in the House, as the progressive wing of the Democratic Party is battling with its moderate members over the size and scope of the larger \$3.5 trillion social policy and climate bill. The moderates want to shrink it, and the progressives threaten to block the infrastructure bill unless they get a commitment on the larger package. The uncertain outcome puts the Biden administration's agenda in peril and challenges the president's campaign assertions that he can effectively work with Congress to get things done. On Friday, House leaders were still quibbling over when to put the infrastructure bill up for a vote.

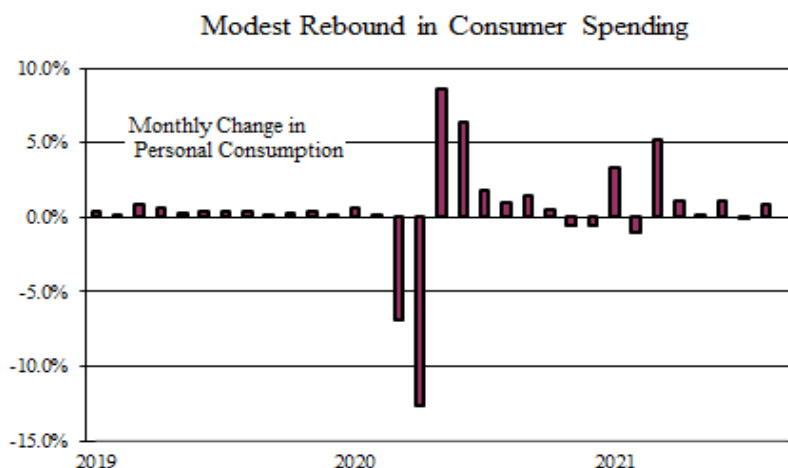
This week, the political drama overshadowed health and economic news, which essentially provided a mixed bag of results. On the negative side, households – the economy's main growth driver – continue to display high anxiety over the spread of the Delta variant. In September, the confidence readings of both the Conference Board and the University of Michigan stood considerably below their nearby peaks in June. The downbeat mindset of households is undercutting their buying plans. Escalating inflation along with the deteriorating health crisis is weighing on consumers as well. The downshift in household spirits aligns with their pullback in spending over the summer.



Indeed, after a stellar 12 percent annualized increase during the second quarter, consumer spending is tracking a tepid gain of less than 1 percent in the current quarter. That prospective pullback would put a severe dent in the economy's overall growth rate, which we expect to slow from last quarter's 6.7 percent pace to 1.5 percent in the third. But the slowdown, as stark as it is, is by no means the beginning of the end of the expansion. That might be the case if the resurgent pandemic – the primary cause of the current slowdown – were to worsen in the months ahead. The good news is that the light at the end of the tunnel is shining brighter.

Not only are case counts ebbing, but the pace of inoculations is also picking up. Vaccine hesitancy is still a roadblock to herd immunity; however, the imposition of mandates from Washington, local governments, and businesses is having a dramatic effect in prodding people to get their shots. As vaccination rates continue to trend higher, the growth-retarding impact of the pandemic should be curtailed. Consumers who pulled back social activities during the summer as health fears flared up will return to the more open behavior that propelled the robust consumption gains during the second quarter. Indeed, the stirrings of a comeback are already on the radar.

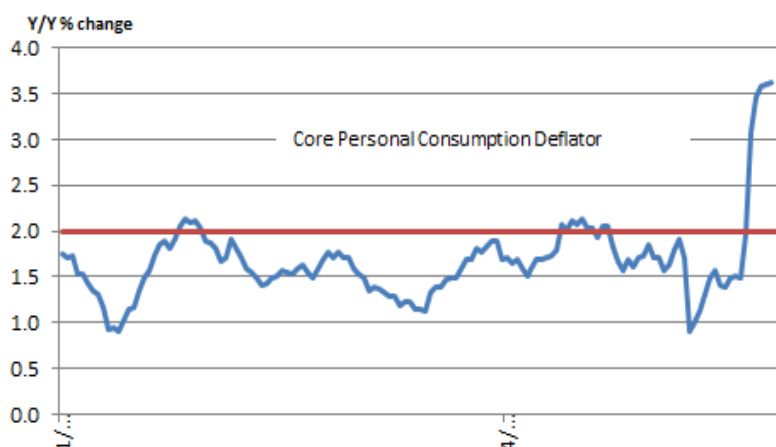
On Friday, the Commerce Department reported that consumer spending increased by a respectable 0.8 percent in August following a downwardly revised 0.1 percent decline in July. Notably, the August rebound occurred despite the worsening trend in virus cases that month, indicating that the pandemic's grip on the economy was already loosening. Simply put, households are responding to pandemic fatigue and are learning to live with the virus. Now that promising signs on the health front are proliferating, households will likely become even more emboldened to resume normal behavior. We suspect that an even more substantial spending gain will be seen in September. High-frequency data from reservation sites like Open Table, the Transportation Authority, and credit card vendors indicate that people are returning to restaurants, increasing debt purchases, and traveling more.



Hence, the stage is set for a robust spending increase in the fourth quarter, punctuating the most substantial annual increase for personal consumption since 1946. No doubt that will put more pressure on the Federal Reserve to speed up its plans to remove support for the economy. The pressure could intensify further if the current inflation spike turns steeper and becomes more entrenched than the Fed expects. On this score, the inflation gauge that the Fed monitors threw off mixed messages in the latest income and spending report. The headline personal consumption deflator firmed up a bit in August, rising 4.3 percent from a year ago, up 0.1 percent from July. But the annual increase in the core PCE deflator held steady at 3.6 percent for the third consecutive month.

Clearly, both measures are running considerably above the Fed's target of 2 percent over time. As hinted by the stabilizing core inflation rate, the good news is that peak inflation may be behind us. As confirmed by Fed chair Powell this week, the bad news is that inflation may linger at higher levels for a longer period than the Fed had earlier thought. That said, Powell attributed the persistent overshoot to supply-chain disruptions, which show little sign of

Inflation Still Elevated But Stabilizing



easing. If anything, pandemic-related shutdowns of factories in Vietnam that were widely reported this week impede the inventory rebuilding process of a broad swath of U.S. retailers, particularly sellers of apparel and other goods that rely on imports from those factories. The plight of the auto industry to obtain much-needed chips from overseas to build cars also remains bleak.

The conundrum for the Fed is that its policy decisions do not influence the forces responsible for the supply constraints that are primarily driving up inflation. However, what they do influence is demand, and the urgency to suppress it by withdrawing monetary support is a matter of debate. The doves arguing for a sustained accommodative policy point to the millions of jobs that are still missing since the

onset of the pandemic; in their eyes, demand-suppressing decisions should be postponed until those jobs are recovered. What's more, they note, correctly, that the massive fiscal support that has underpinned demand throughout the pandemic is ending, and that support will transform into a severe fiscal drag next year. Hence, economic headwinds are already in place without the reinforcement of a less supportive Fed policy.

The hawks, however, point to the formidable tailwinds that are poised to deliver another year of solid growth in 2022, adding fuel to the inflation fire. Labor demand remains in high gear, with the search for workers exceeding the supply of labor. That combination, in turn, is driving up labor costs and wages, which puts pressure on businesses to raise prices and provides workers with the wherewithal to accept higher prices. There is more than enough anecdotal evidence to verify the former, as numerous business surveys indicate that businesses plan to lift prices to cover rising labor costs. But the acceptance of higher prices by consumers is far from entrenched. Households are reeling from sticker shock from the surge in car prices, contributing to a steep pullback in auto sales. A similar response can be seen in the housing market, where many first-time buyers are priced out of the house search. Surveys of inflation expectations indicate that households expect higher inflation over the near term – i.e., one year out – but a return to lower inflation in later years.

That's the perception that underscores the Fed's current plan and one with which we concur. The current inflation spiral is driven mainly by supply constraints that will linger well into next year and keep inflation elevated at least through the first half of 2022. While the Fed cannot alter that prospect by reducing its asset purchases, neither should the withdrawal of support pose much of a threat to demand. Elevated savings of households together with expected solid job growth in the coming months should provide consumers with sufficient firepower to sustain spending. But the shift to a less dovish policy would help keep inflation expectations in check an important goal of the Federal Reserve.

FINANCIAL INDICATORS				
INTEREST RATES	October 1	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.04%	0.04%	0.05%	0.09%
6-month Treasury bill	0.05	0.08	0.05	0.11
3-month LIBOR	0.13	0.13	0.12	0.23
2-year Treasury note	0.07	0.28	0.21	0.13
5-year Treasury note	0.93	0.95	0.78	0.28
10-year Treasury note	1.46	1.46	1.33	0.70
30-year Treasury bond	2.03	1.99	1.95	1.48
30-year fixed mortgage rate	3.01	2.88	2.87	2.88
15-year fixed mortgage rate	2.28	2.15	2.18	2.36
5/1-year adjustable rate	2.48	2.43	2.43	2.90
STOCK MARKET				
Dow Jones Industrial Index	34326.46	34798.00	35369.09	27682.81
S&P 500	4357.04	4455.48	4535.43	3348.44
NASDAQ	14566.70	15047.70	15363.52	11075.02
Commodities				
Gold (\$ per troy ounce)	1761.30	1750.60	1830.60	1903.05
Oil (\$ per barrel) - Crude Futures (WTI)	75.75	73.95	69.26	38.99
ECONOMIC INDICATOR				
	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Durable Goods Orders (Aug) - % chg	1.8	0.5	0.8	1.1
Consumer Confidence Index (September)	109.3	115.2	125.1	119.3
Personal Income (August) - % change	0.2	1.1	0.2	-2.9
Personal Consumption (August) - % change	0.8	-0.1	1.1	0.6

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