

## WEEKLY ECONOMIC COMMENTARY

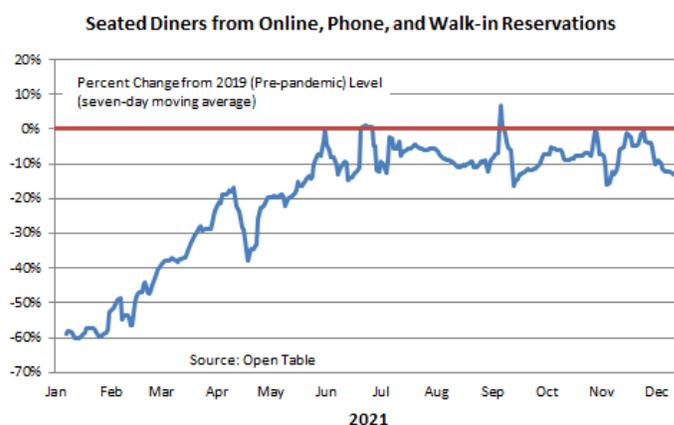
Anyone who has followed the financial markets for a time knows that they often behave like children, reacting churlishly when they don't get what they want and giddy with joy when they do. This week was a prime example of the latter, as the Federal Reserve delivered what it promised, and investors' initial reaction was one of unbridled joy. On Wednesday, stock prices surged following the Fed's much-anticipated announcement that it will speed up the pace it plans to withdraw support for the economy. The decision at the two-day policy-setting meeting was amply telegraphed in advance by Chair Powell and a host of other Fed officials who understandably have become alarmed by the speed, breadth, and persistence of an inflation upsurge no longer viewed as transitory.

Hence, the Fed decided to slash bond purchases at double the pace it had announced just a month ago, upping the monthly haircuts to \$30 billion from \$15 billion while also planning to ramp up expected rate hikes over the next several years. It now projects three rate increases in 2022, another three in 2023, and two in 2024, lifting the key policy rate from the current near-zero to 2.1 percent. The faster wind-down of purchases, assuming it is sustained, means that the pandemic era emergency bond-buying program will end by next March, opening the door for the first rate hike about three months earlier than previously indicated. The markets are fully pricing the liftoff to take place in May.

The intriguing issue is why the markets reacted favorably to such a hawkish pivot from the central bank. Higher rates are usually a recipe for slower growth and smaller profits. Powell suggested as good an answer as any, pointing to the fact that taming the inflation dragon would lengthen the life of the expansion, setting the stage for a more profitable cycle over the longer run. There is, of course, the risk that the Fed may go too far and choke off the expansion prematurely. The Fed does not have a sterling record of bringing about a soft landing for the economy on this score. That said, the markets' bigger concern in recent weeks as inflation skyrocketed was that policy was in danger of falling behind the curve, and harsher growth-stifling measures would need to be taken later on to bring it under control.

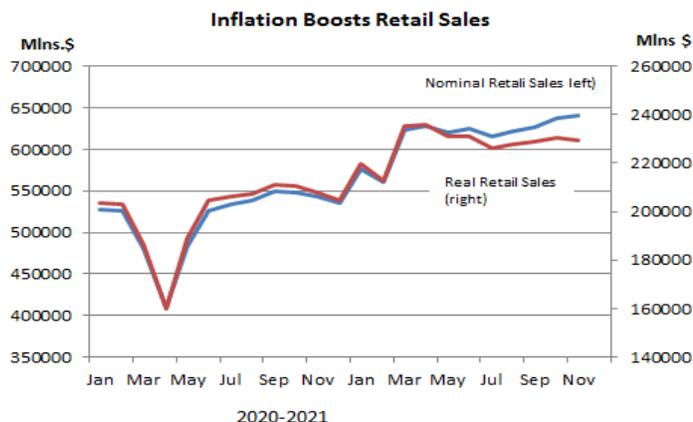
But just as children soon get bored with new toys, the markets love affair with the Fed's announcement dissolved almost as quickly as it appeared. Stocks tanked later in the week, wiping out all of the earlier gains and then some. Since Friday was a triple-witching day when stock options, index options, and index futures all expire at once – a quarterly event that typically stokes a good deal of volatility – it's unclear how much of the late-week dive reflects noise rather than substance. But the concern that the resurgence of a familiar enemy may outflank the Fed in its battle against inflation, namely the ominous spread of the Omicron variant, is injecting a note of pessimism in the markets. Cases of the virus in the U.S. have increased by more than 50 percent over the past two weeks, and hospitalization rates are up by a third, raising fears that the economy could once again fall victim to the health crisis.

To be sure, it will take a while to get a clearer picture of how serious the latest wave will turn out to be and how much damage to the economy it will cause. Government officials insist that lockdowns are not in the cards, but restrictions are already being put in place in broad swaths of the nation. Mask requirements and vaccine mandates are ramping up. More businesses are telling employees not to come to the office, concerts and theaters are canceling shows, and sporting events are being disrupted. The revival of the service sector is very much at risk if households once again refrain from participating in social events, including dining out and other activities where the threat of infection looms large. Since news of the spread of the Omicron variant garnered headlines in recent weeks, restaurant bookings have slipped, as data provided by Open Table indicates.



On a broader scale, the pullback in consumer purchases reported by retailers last month is worrisome. Retail sales increased by a slim 0.3 percent in November, less than half the expected gain. The so-called control group of sales – which excludes autos, gasoline, and building materials that feed directly into personal spending in the GDP accounts – actually declined for the first time in four months. The weakness is even more pronounced when sales are adjusted for prices, which increased at more than double that of dollar sales last month. After adjusting for inflation, retail sales actually fell by 0.5 percent in November.

The surprising weakness of retail sales last month should not derail the momentum building before Covid’s resurgence. For one, it comes on the heels of a robust sales increase in October, which was revised up from 1.6 percent to 1.8 percent. Hence, consumers may have responded to widespread reports of potential goods shortages and decided to shop for Christmas presents a month earlier than planned.



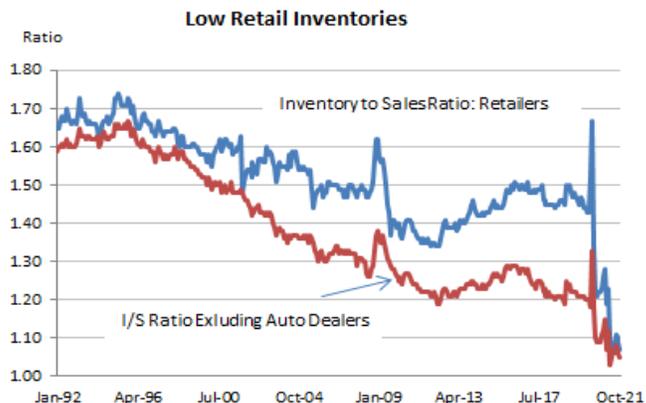
Indeed, the usual gift-giving items, such as electronics and appliances, suffered the weakest sales last month, but that followed an exceptionally strong increase in October. Taken together, the average increase in sales over the two months still looks healthy. It points to a solid holiday shopping season, albeit one that may not measure up to the blockbuster prospect that retailers had hoped for earlier in the fall.

The weaker than expected sales in November could reflect a lack of supply as much as a demand pullback. Heading into November, retail stocks were the lowest on record relative to sales. Auto dealers are particularly hard-pressed to fill their lots with vehicles, thanks to the semiconductor shortage crippling auto production. But the restocking hurdles extend throughout the retail

sector, as the inventory/sales ratio excluding auto dealers also hovered around all-time lows in October. The good news is that there are signs that the supply-chain disruptions behind the shortages are starting to ease. The bad news is that the Omicron-driven surge of the virus is spreading rapidly overseas, threatening to stifle production at factories that provide U.S. businesses with much-needed supplies.

To be sure, the Fed was well aware of the upsurge in virus case counts when it held its policy meeting this week. Chair Powell acknowledged that the worsening health situation might have put a dent in hiring in November when payrolls grew significantly less than expected. That didn’t dissuade Fed officials from seeing inflation as the primary threat to the economy over the near term. Powell noted that people are learning to live with the virus, suggesting that the current wave should not deliver as severe a blow to activity as earlier ones. Widespread reports by health officials that Omicron has less severe effects than the Delta or earlier versions of the virus seem to support that view.

Indeed, the focus on inflation received another dose of validation this week, as producer prices surged by a record 9.6 percent in November from a year ago. The eye-opening surge in wholesale prices follows the attention-getting spike in consumer prices reported last week and confirms the sustained inflation pressure in the pipeline that will translate into at least another several months of elevated consumer price readings. We expect consumer inflation to peak sometime in the first quarter of next year, as supply bottlenecks continue to ease and demand starts to fade along with the waning of fiscal support.



With the fate of the President’s \$1.8 trillion Social Spending and Climate bill looking ever-more fragile, the economy could receive an even smaller fiscal boost next year than thought. As it is, the failure to garner enough votes in the Senate for the bill is likely to doom its prospects for passage this year. Whether it passes next year remains to be seen. There is a better chance that it either gets scaled back to gain the support of all Democrats or falls by the wayside entirely if a compromise can’t be reached. While the fiscal battle will take center stage in the coming months, the major drama will come from the Federal Reserve as it strives to navigate the economy through pandemic headwinds while keeping inflation in check.

FINANCIAL INDICATORS				
INTEREST RATES	December 17	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.05%	0.06%	0.05%	0.08%
6-month Treasury bill	0.13	0.13	0.06	0.09
3-month LIBOR	0.21	0.20	0.16	0.24
2-year Treasury note	0.63	0.66	0.52	0.13
5-year Treasury note	1.17	1.25	1.22	0.39
10-year Treasury note	1.41	1.48	1.55	0.95
30-year Treasury bond	1.81	1.88	1.91	1.7
30-year fixed mortgage rate	3.12	3.10	3.10	2.67
15-year fixed mortgage rate	2.34	2.38	2.39	2.21
5/1-year adjustable rate	2.45	2.45	2.49	2.79
STOCK MARKET				
Dow Jones Industrial Index	35365.44	35970.99	35601.98	30179.05
S&P 500	4620.64	4712.02	4697.96	3709.41
NASDAQ	15169.68	15630.60	16057.44	12755.64
Commodities				
Gold (\$ per troy ounce)	1799.20	1783.10	1848.50	1879.75
Oil (\$ per barrel) - Crude Futures (WTI)	70.34	71.96	76.11	47.97
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Retail Sales (November) - % change	0.3	1.8	0.7	0.5
Industrial Production (November) - % chg.	0.5	1.7	-1.0	0.4
Capacity Utilization (November) - Percent	76.8	76.5	75.3	76.1
Housing Starts (November) - 000s	1679	1502	1550	1587
Building Permits (November) - 000s	1712	1653	1586	1649
Producer Price Index (November) - % chg	0.8	0.6	0.6	0.7

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