

With both conventions now in the rear view mirror, the markets' attention will shift from the race for the White House to the Halls of Congress, where legislators need to forge a pandemic relief bill before they leave on the campaign trail. Simply put, the window of opportunity to get a bill passed is narrowing, even as the need for renewed fiscal support is growing. That might not seem obvious in the recent spate of economic data, which do not depict an economy that is falling off a cliff. Consumers continue to spend, stronger orders for durable goods is spurring production and housing activity is roaring ahead. But these bullish indicators are still riding the coat tails of the fiscal stimulus passed in the spring, and that fuel is quickly running out.

Fed chairman Jerome Powell added his voice in support of more Federal aid in his appearance this week at the annual Jackson Hole symposium. For sure, that was not the main thrust of his keynote address, wherein he formalized the new framework for monetary policy that has been under review for the past 18 months. Going forward, the Fed will put more emphasis on achieving maximum employment ahead of price stability. The shift in emphasis is long overdue given the yearslong evidence that low unemployment has not stoked an upsurge in inflation. The takeaway from the new framework is that the Fed is willing to let the economy run hot and keep unemployment as low as possible while letting inflation rise moderately above its 2 percent target for a while.

From a market perspective, the Fed's revised long-term strategy means that interest rates will remain at rock-bottom levels for the foreseeable future. In the past, the Fed would start raising rates to preemptively stave off higher inflation when the unemployment rate fell below a level deemed consistent with a noninflationary environment. Now the Fed will wait for inflation to rise above 2 percent before pulling the trigger; the duration of the lag would depend on how long inflation remained below the 2 percent target and how deep was the shortfall. Since the 2 percent target was officially announced in 2012, inflation has persistently undershot the mark, reaching it only briefly in 2018. From our lens, the Fed will not raise rates from the near zero bound for at least the next several years.

To be sure, the Fed only controls short-term rates, while yields in the bond market are greatly driven by investor expectations. If those expectations drive rates higher than the Fed thinks is compatible with its employment objectives, it could directly intervene, employing a so-called "yield control" strategy. Fed officials are not ready to include such a strategy in their policy toolbox, but it is something that has been considered and could well be employed down the road. Interestingly, even as the Fed is bemoaning the stubbornly low inflation, bond market investors are expecting inflation to rise, as reflected in a key market inflation gauge, the breakeven rate. However, the increase is coming off an extremely low base hit in March, when the arrival of the coronavirus sent the economy into the steepest downturn since the Great Depression. Even after a more than 1 percentage point rise in the breakeven rate, market expectations of inflation still hover well under 2 percent.

No doubt, the longer the Fed keeps its foot on the monetary accelerator, the greater the odds that inflation hawks will emerge from the woodworks. But the unprecedented expansion in the money supply in all its forms since the pandemic struck has been more than offset by a historic plunge in the velocity of money. Simply put, the money created is not being spent, and as long as there is no velocity there can be no inflation. Instead of entering the spending stream, the copious volume of new money is flowing into Treasury securities, other financial assets, such as stocks, or being channeled by households into higher savings accounts. Inflation hawks will argue that this vast amount of liquidity will eventually be unleashed and launch

a virulent outbreak in inflation. But the Fed believes that the task of lifting inflation from its stubbornly low level is more challenging than sopping up the excess liquidity that might stoke inflation.

We concur with that assessment, as the influence of monetary policy on inflation has been greatly diluted by the onset of other forces in recent decades, including globalization, technology, weaker labor unions and changing demographics. The upsurge in market-based inflation expectations reflects the reopening of business in the U.S. that allowed growth to snap back and defuse deflationary fears that had festered during the early stage of Covid-19. Meanwhile, the concerns on Main Street center more on tenuous job prospects than on losing purchasing power to higher inflation. That bias is clearly manifested in the Conference Board's latest consumer confidence survey, which revealed a drop in confidence to the lowest level in more than six years in August.

The sagging mind-set of consumers includes a gloomier assessment of present conditions as well as deteriorating expectations of future conditions. Importantly, the more downbeat mood reflects increasing anxiety about the job market and, by extension, income prospects. The share of respondents who said that jobs were plentiful fell to 21.2 percent, less than half the pre-pandemic share of 46.5 percent in February. Meanwhile, the share saying that jobs were hard to get jumped to 25.2 percent from 13.9 percent over the same period. President Trump will have a hard time convincing voters that the job market is stronger now than when he took office. Not only are there 7 million fewer workers on payrolls than was the case in January 2017, but the disparity in consumer assessments of the job market is the most negative since November 2015.

Thanks to the massive fiscal stimulus provided under the CARES act in the spring, the devastating 22 million job losses in March and April did not result in an even greater downturn in consumer spending than actually occurred in the second quarter. The \$600 weekly supplement to unemployment benefits plus the stimulus payment of up to \$1200 to households greatly cushioned the decline and spearheaded the vigorous spending rebound in May and June. But with the supplemental payments expiring at the end of last month, the deterioration in household perceptions of the job market may have more of a negative impact on spending than the boost provided by the rebound in hiring over the past three months.

As it is, both actual hiring and spending are slowing. More than 1 million workers applied for unemployment benefits in the week ending August 22. That was the second consecutive week new filings topped the 1 million mark after briefly dipping below it to 971 thousand in the week ending August 8. The slight uptick may be the tip of the iceberg, as real time data suggest that layoffs are rising and job listings are at best flattening out or at worst declining again. It will be a close call, but the August employment report due out next Friday could possibly show a decline in payrolls following three consecutive monthly gains, which recouped about 40 percent of the March/April job losses. The 1.8 million increase in jobs in July was less than half the 4.8 million gain posted in June.

Meanwhile, consumers are pulling in their horns. Personal consumption increased 1.9 percent in July, markedly slower than the 6.2 percent and 8.6 percent increases in the previous two months. Even so, the spending gain exceeded the increase in personal income, which rose by a tepid 0.4 percent, despite a decent 1.4 percent increase in wages and salaries. The reason for the difference: federal support for incomes fell, but mostly for good reason, as the steep decline in unemployment that month translated into lower payouts for jobless benefits. To finance the consumption increase, households had to dip into savings, which pulled the savings rate down from an elevated 19.2 percent to a still historically high 17.8 percent.

Hence, households in the aggregate still have a huge cushion of savings to draw on to finance purchases. The question is, will they? Keep in mind that people with the highest savings rate are generally in the upper income brackets, whose spending propensities have been curtailed by lockdown restrictions. With many of those restrictions lifted over the past month, they now have more purchasing options and will likely dip into their savings to finance them. But for the vast majority of middle-income households, their propensity to save is influenced by the emerging economic backdrop. Clearly, the cushion built up in recent months

reflected a desire to boost precautionary savings in the face of the roiling health crisis and the pandemic recession it brought about.

With Covid-19 still very much a headwind, job and income prospects looking less promising and heightened uncertainty over whether fiscal relief will be forthcoming, there is every reason to believe that middle-income households will retain a high level of precautionary savings, which suggests more cautious spending in coming months. For households on the lower rungs of the income ladder, the future is more dire as their spending habits are directly linked to job growth and government support payments should the job market continue to weaken. Consumer spending is the economy's main engine of growth, and without additional fuel from a fiscal relief package its performance will surely suffer over the fall and winter months.

FINANCIAL INDICATORS

INTEREST RATES	August 28	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.11	0.09	0.10	1.99
6-month Treasury bill	0.11	0.12	0.11	1.88
3-month LIBOR	0.25	0.26	0.25	2.13
2-year Treasury note	0.16	0.17	0.11	1.51
5-year Treasury note	0.26	0.26	0.21	1.39
10-year Treasury note	0.72	0.64	0.54	1.50
30-year Treasury bond	1.50	1.34	1.20	1.96
30-year fixed mortgage rate	2.91	2.99	2.99	3.58
15-year fixed mortgage rate	2.46	2.54	2.51	3.06
5/1-year adjustable rate	2.91	2.91	2.94	3.31

STOCK MARKET				
Dow Jones Industrial Index	28,653.87	27,930.39	26,428.32	26,403.28
S&P 500	3,508.01	3,397.16	3,271.12	2,926.46
NASDAQ	11,695.63	11,311.80	10,745.27	7,962.88

COMMODITIES				
Gold (\$ per troy ounce)	1,972.60	1,945.20	1,991.90	1,529.20
Oil (\$ per barrel) - Crude Futures (WTI)	42.93	42.27	40.44	55.16

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Home Sales (July) - 000s	901	791	687	713
Durable Goods Orders (July) - % change	11.2	7.7	15.0	0.0
Nondefense Capital Goods Orders (% chg.)	1.9	4.3	1.5	-0.1
Consumer Confidence Index (August)	84.8	91.7	98.3	94.2
Personal Income (July) - % change	0.0	-1.0	-4.2	1.0
Personal Consumption (July) - % change	1.9	6.2	8.6	-0.5

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