

Weekly Economic Update—April 12th, 2021

The fire under economy's growth engine has been ignited and the flames should burn brightly for months to come. By the end of this week, the IRS will have distributed nearly \$400 billion of stimulus checks to 156 million Americans as part of the \$1.9 trillion American Rescue Plan enacted last month. That's quite a match, which should keep the embers of consumer spending hot through the spring and summer season and underpin a double-digit growth rate in GDP during the second quarter. The harsh winter storms that dented economic activity in February are fast becoming a memory even as brighter skies are lighting up the economic landscape.

Clearly, the ramped up pace of vaccinations – with about a third of the population having received at least one dose – has played a key role in the economy's improved performance. Virtually all 50 states have eased business restrictions to varying degrees and the reopening process is gaining traction by the day. Helped by warmer weather, bars and restaurants are greeting a torrent of returning customers, with many reporting trouble finding workers to serve food and drinks. The good news is that these mostly low-wage workers who suffered the most during the pandemic are receiving better pay packages for their services. The bad news is that the reopening of the services sector, as evidenced by the surge to a record high in the ISM index of services activity for March, is being accompanied by a rising case count of new infections.

Indeed, the race between vaccinations and variants is afoot and drawing ever more attention in the financial markets and among policy makers. Fed chair Powell reiterated his concern this week that the pandemic is far from over and still poses a risk to the recovery. He also reaffirmed the sentiment conveyed in the March policy meeting, for which the minutes were released this week, that the economy has made substantial progress but is still a ways from being completely healed. Until the millions of workers sidelined by the pandemic are brought back to the workforce and inflation rises to 2 percent on a sustained basis, the Fed plans on keeping short-term rates anchored at near zero at least through the end of 2023. His dovish comments along with recent tame inflation readings short-circuited, at least temporarily, the steady rise in bond yields in recent months. After rising to 1.75 percent two weeks ago – up from under 1 percent at the start of the year and the highest level since the start of the pandemic – the bellwether 10-year Treasury yield has leveled off and slipped to under 1.70 percent this week.

That said, the Fed's commitment should be tested in coming months as the economy's growth engine revs up and demand outpaces supply for a while. This imbalance will lead to bottlenecks and aggravate supply shortages that are already a pressing problem in more than a handful of industries. Commodity prices have surged in recent months and production bottlenecks are appearing. Two major automakers – GM and Ford – have been forced to shut down plants in the U.S. due to a global shortage of semiconductors. That will amplify the already slim inventories of motor vehicles on dealer lots and drive auto prices higher. The latest report on wholesale prices, released on Friday, only adds to the anxiety of inflation worriers, as the producer price index in March increased at the fastest annual rate since September 2011.

To be sure, the annual rate is skewed upward by the easy comparison with year-earlier prices that were severely depressed when the pandemic struck. But while these so-called base effects will continue to distort year-over-year comparisons for several more months, the ongoing underlying pressures are also palpable. Both the headline and the core producer price index posted sizeable increases of 1.0 and 0.6 percent respectively from February. Despite these near-term price pressures, neither the markets nor the Fed appear overly concerned. As noted, the bond market remained calm even after the producer price report was released, with the 10 year yield ending the week at 1.66 percent, and Fed officials continue to maintain

a dovish posture, believing that once pent-up demand subsides and supply grows into demand later in the year, the inflation rate will likewise recede back towards 2 percent.

We concur with that assessment. The risk of course is that the enormous fiscal firepower combined with the vast pool of unspent savings accumulated over the past year will generate more demand than expected and send the economy into overdrive. That, in turn, risks prodding the Fed to overcorrect and stifle the expansion, repeating the policy mishaps that have frequently occurred in the postwar years. However, the Fed is well aware of those mishaps as well as the powerful disinflationary forces that have become entrenched in the economy over the past several decades. Hence, it has explicitly overhauled its policy framework to avoid making those mistakes. It will take more than a few months or even quarters of above trend growth and inflation before the Fed moves to tighten the credit screws.

Still, Alfred E. Neuman is not on the Federal Reserve Board so a “what me worry” attitude is not likely to persist forever. With fiscal policy still pump-priming the economy and poised to unload more ammunition in coming years, the ramifications of such a massive amount of stimulus must be closely monitored. While inflation expectations are still anchored around 2 percent, it is unclear how patient the financial markets and households would be if the economy generates more growth and inflation later this year and in early 2022 than is generally expected. Should inflation expectations become unmoored and set in motion a self-fulfilling prophecy of stronger wage and price increases, the Fed would have no choice but to abandon its commitment to low rates sooner rather than later.

From our lens, the Fed will likely pull the rate-hiking trigger in the latter half of 2023, as inflation should remain comfortably above its 2 % target and significant progress towards the goal of maximum and inclusive employment will have been achieved. That said, we don't expect inflation to spiral out of control nor should the economy go into overdrive next year. Indeed, the combination of gently rising interest rates, an expansion in the economy's productive capacity and fading impetus from three rounds of stimulus checks to households should rein in both growth and inflation next year. Hence, after a blockbuster growth rate of 7.2 percent this year, we expect GDP to downshift to 3.4 percent in 2022 and consumer price inflation to recede back towards a longer-term trend of 2.0 percent.

The risk as noted earlier is that the firepower from fiscal stimulus already coursing through the economy turns out to be more explosive than expected, leading to speedier growth and a stronger inflation outbreak. While there are clearly upside risks to the forecast, we caution against overestimating the fiscal thrust from the latest round of stimulus payments, which some prominent commentators view as overkill. The \$1.9 trillion American Rescue plan enacted in March included the payment of \$1400 checks to most Americans, representing the third and largest of the lump sum payments sent out over the past year. The fear is that with the job market cranking up and generating millions of additional paychecks to households who are sitting on nearly \$2 trillion of accumulated savings over the past year, the impetus from the latest round of checks would fuel a spending surge that propels the economy into overdrive.

Most of those checks are already on household balance sheets and will no doubt contribute to the spending binge we expect over the spring and summer months as the economy continues to reopen. But actual purchases should fall far short of the purchasing power gained by households, repeating the pattern seen in the previous two rounds of stimulus checks. That prospect was revealed in the New York Fed's latest survey of consumer expectations, released this week. How households plan on using the checks are expected to remain fairly close to the first two rounds. But the most noteworthy difference is that an even higher percentage is expected to be saved – 41.6 percent versus 37.1 percent in the previous round and 36.4 percent from the funds received under the Cares Act last year.

Simply put, households expect to spend only a small fraction of the latest payment – 24.7 percent – and use the rest to pay down debt or further pad savings accounts. That prospective behavior is consistent with our view that households will desire to keep savings at a historically elevated level for a variety of reasons. After two major shocks over the past decade – the financial crisis and the pandemic – that vaporized millions of jobs and upended financial planning, households are understandably inclined to maintain a higher level

of precautionary savings. For another, upper income households are aware that there is no free lunch and are probably earmarking some savings for the higher taxes that will be needed to finance the ambitious spending plans of the administration. That propensity should get a further boost as the White House presses ahead with its \$2.3 trillion infrastructure plan, some version of which should be passed later this year.

Meanwhile, demographics may also encourage households to maintain higher savings than otherwise. People are living longer and will need a more muscular retirement package to carry them over their golden years. Finally, the pandemic is far from over; the accelerated spread of new variants may well stoke fears of another economic setback that could once again send workers to the unemployment lines. That unsettling prospect is a powerful disincentive to engage in profligate spending behavior.

FINANCIAL INDICATORS

INTEREST RATES	April 9	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.02	0.02	0.04	0.25
6-month Treasury bill	0.04	0.04	0.06	0.24
3-month LIBOR	0.19	0.20	0.19	1.37
2-year Treasury note	0.15	0.19	0.14	0.23
5-year Treasury note	0.87	0.98	0.85	0.41
10-year Treasury note	1.66	1.72	1.64	0.73
30-year Treasury bond	2.33	2.36	2.40	1.35
30-year fixed mortgage rate	3.13	3.18	3.05	3.33
15-year fixed mortgage rate	2.42	2.45	2.38	2.77
5/1-year adjustable rate	2.92	2.84	2.77	3.40

STOCK MARKET				
Dow Jones Industrial Index	33,800.60	33,153.21	32,778.64	23,719.37
S&P 500	4,128.80	4,019.87	3,943.34	2,789.82
NASDAQ	13,900.80	13,480.11	13,319.86	8,153.57

COMMODITIES				
Gold (\$ per troy ounce)	1,743.70	1,730.30	1,704.80	1,680.65
Oil (\$ per barrel) - Crude Futures (WTI)	59.37	61.24	65.02	24.41

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
ISM Non-Manufacturing Index (March)	63.7	55.3	58.7	58.1
Consumer Credit (February) - \$ billions	27.6	0.1	9.1	9.1
Producer Price Index (March) - % change	1.0	0.5	1.3	0.6

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