GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—May 17th, 2021

The specter of inflation is once again rearing its head and garnering most of the attention in the financial markets. To be sure, it's not as if its noisy entrance came out of the blue. For months the economic community and policy makers have been warning anyone within earshot that price increases would accelerate as the economy reopens and unleashes a tidal wave of pent-up demand that overwhelms supply. Against this mighty demand backdrop, fueled by massive fiscal stimulus, companies are able to restore prices that had been deeply cut during the worst of the pandemic, and muster enough power to pass higher labor and input costs on to consumers.

Still, the magnitude of the price increases reported for April this week far exceeded expectations and briefly rattled the financial markets. For its part, the Fed remains unmoved by what it still considers a transitory spike in inflation that will recede once supply catches up with demand and bottlenecks are cleared up. The question is, how long will it take for this dynamic to play out? The longer it takes, the greater the odds that inflation expectations would increase and lead to a self-perpetuating rise in actual inflation, forcing the Fed to move sooner rather than later. From our lens, the robust economic expansion now unfolding will likely prompt the Fed to lift rates about a year sooner than it predicted at its March policy meeting (starting in late 2022) but we don't see inflation or inflation expectations spiraling out of control.

Granted the headline spike in consumer prices last month was truly frightening. The overall consumer prices index surged 0.8 percent and the core CPI, which excludes volatile food and energy items, jumped 0.9 percent. You would have to go back to April 1982 to find a larger monthly increase in the core index. On a year-over-year basis, the increases are just as hair-raising. The overall CPI jumped 4.2 percent and the core rose 3.0 percent, the strongest 12-month increase since 1996. Both readings are significantly above the Fed's 2 percent inflation target, as will the Fed's key gauge it monitors – the consumer price deflator – when it is released later this month.

But a look under the hood of the April consumer price report reveals a less alarming set of details, one that is consistent with transitory forces related to a rebooting economy. Further, 40 percent of the core CPI increase, for example, came from an eye-opening 10 percent increase in used car and truck prices. This outsized contribution is clearly a product of temporary forces related to pandemic disruptions. Rental car companies have to rebuild fleets that they sharply downsized last year when lockdown restrictions crushed travel. Meanwhile, the supply of new cars has been restrained by the shortage of semiconductor chips, which is impeding production, and used cars are being held off the market by owners who are avoiding public transit for health reasons and are driving to work. Additionally, with lockdown restrictions being lifted, Americans are starting to travel more, opting for local destinations within driving distance.

But people are also taking longer trips that involve flying and leaving their homes for vacation destinations. Hence, airfares jumped 10.2 percent and hotel and motel prices increased by a record 8.8 percent. With warmer weather, more time is being devoted to recreational activities, imparting a lift to recreational service prices and motor vehicle insurance. Despite these outsized increases, many of these service providers have not fully restored prices to levels that prevailed before the pandemic. Hotel prices are still 6 percent below their pre-pandemic level and airfares are a whopping 18 percent below where they were in February 2020. The catch-up phase is just beginning; amid a strong recovery in demand and lagging supply over the balance of the year, the sectors that have been punished the most during the pandemic will be the most aggressive in raising prices to recoup lost revenues.

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While this will sustain pressure on the Fed from some quarters to move before it falls too far behind the curve, we doubt it will gain traction with policymakers or the financial markets. Indeed, bond investors showed only a modest reaction to the CPI report even as they displayed a strong appetite for government securities, enthusiastically gobbling up the Treasury's $41 billion offering of 10-year notes this week. Meanwhile, stocks rebounded strongly on Thursday and Friday, clawing back a chunk of the debilitating losses suffered earlier in the week, driven by rising inflation fears. On Main Street, inflation expectations did pick up, as reflected in the preliminary University of Michigan Consumer Sentiment Index for early May. While the steepest increase was in near-term inflation expectations, household expectations for inflation out to 5-10 years jumped to above 3 percent, the highest in more than a decade.

The Fed pays particular attention to household inflation expectations. If they become unmoored, with households expecting to get higher wages and pay higher prices down the road, that would set in motion the self-perpetuating inflation spiral that prompts the Fed to correct. But we doubt the latest reading of the household survey is enough to sway the Fed from its current course. The spike in inflation expectations that occurred in March 2011 was also in response to a temporary surge in prices coming out of the Great Recession, which quickly faded and just as swiftly took the air out of inflation expectations. Importantly, the survey noted that households expect inflation to outpace incomes going forward, which is not a recipe that encourages a shift to a strong buy-in-advance behavior. Indeed, the spike in prices last month drove real worker earnings 3.5 percent below the year-earlier level, the steepest annual decline in more than 40 years.

If heightened inflation expectations spurs households to pull spending forward, it certainly didn't work in April. In another report that missed expectations – a familiar occurrence so far this month – consumers spent less at retail stores last month than expected. Following a stunning 10.7 percent increase in March, retail sales were essentially flat in April, a softer reading than the consensus expectation of a 1 percent gain. The control group of sales, which excludes food, autos, gasoline and building materials, that enters into the GDP calculations, fared even worse, falling by 1.5 percent. The setback reflected weaker purchases of most discretionary goods, including clothing, sporting goods and furniture; even that stalwart category, online sales, slipped 0.6 percent during the month.

That said, it's foolhardy to think that consumers are about to go into hibernation. Last month's slippage should be viewed more as a breather than a shift in behavior. Keep in mind that the spending surge in the previous month was bloated by the stimulus checks that reached household bank accounts in March. In fact, that month's increase was revised up from an original estimate of 9.8 percent to 10.7 percent, an upward adjustment that just about accounts for the 1 percent downside miss in the April retail report. Simply put, retail sales last month landed about where they were expected after the March revision is taken into account. More to the point, the seeds for a resumption of torrid spending in coming months are firmly in place.

For one, households still have plenty of firepower in reserve from the stimulus checks and other generous transfer payments. Over the past year, they have accumulated more than $2 trillion in excess savings, as pandemic restrictions severely limited spending opportunities even as most middle and high earners continued to draw paychecks. For another, the reopening process is hopping onto a speedier track as Covid cases continue to dwindle and vaccinations are reaching a broader segment of the population, including adolescents. The CDC announced a major easing of restrictions on social gatherings this week, foreshadowing an upsurge in attendance at concerts, stadiums as well as restaurants. We still expect households to deliver the strongest spending increase this year since 1946.

That said, consumers will not be dipping into an unlimited pool of funds that would sustain a supercharged pace of spending beyond the next several months. Keep in mind that wealthier households hold most of those excess savings, and it is unclear how much of it they will actually spend as opposed to building up wealth. As for those generous government transfer payments, the enhanced unemployment benefits are scheduled to expire in September and 11 states are already unilaterally opting out of the program, cutting off the $300 weekly supplement for unemployed workers in those states. The goal of these opt-out states is to incentivize workers to resume a job search, which they believe is being discouraged by the generous benefits.

Hence, after a spending binge in the summer and fall that satisfies pent-up demand, consumer-spending growth should downshift markedly by the fourth quarter and return to a trend-like pace next year. That pattern together with expectations that more supply will come online dovetails with the Fed's view that the inflation upsurge is temporary. While we agree that the economy will cool later this year and keep inflation under control, it will do so at a higher level of activity and less spare capacity than the Fed expects, prompting an earlier move to tap on the brakes than it currently envisions.

FINANCIAL INDICATORS

INTEREST RATES	May 14	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.01	0.02	0.02	0.12
6-month Treasury bill	0.03	0.03	0.04	0.15
3-month LIBOR	0.16	0.16	0.19	0.43
2-year Treasury note	0.15	0.15	0.16	0.16
5-year Treasury note	0.81	0.78	0.83	0.31
10-year Treasury note	1.63	1.57	1.58	0.64
30-year Treasury bond	2.35	2.28	2.28	1.32
30-year fixed mortgage rate	2.94	2.96	3.04	3.28
15-year fixed mortgage rate	2.26	2.30	2.35	2.72
5/1-year adjustable rate	2.59	2.70	2.80	3.18
STOCK MARKET				
Dow Jones Industrial Index	34,382.13	34,777.76	34,200.67	23,685.42
S&P 500	4,173.85	4,232.60	4,185.47	2,863.70
NASDAQ	13,429.98	13,752.34	14,052.34	9,014.56
COMMODITIES				
Gold ($ per troy ounce)	1,843.80	1,832.00	1,777.30	1,735.35
Oil ($ per barrel) - Crude Futures (WTI)	65.51	64.84	63.07	26.40

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer Price Index (April) - % change	0.8	0.6	0.4	0.4
Core CPI (April) - % change	0.9	0.3	0.1	0.3
Producer Price Index (April) - % change	0.6	1.0	0.5	0.6
Retail Sales (April) - % change	0.0	10.7	-2.9	2.1
Industrial Production (April) % change	0.7	2.4	-3.5	0.4