GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—June 21st, 2021

The Fed's policy meeting took center stage this week, as a modest shift in policy guidance stoked a frenzy of speculation in the financial markets. The key takeaway is that the central bank adapted a somewhat less dovish stance, moving up its expected rate lift-off to 2023. After a brief knee-jerk reaction, bond investors decided that the Fed's move was both prudent and justified, and yields tumbled.

Still, the reasons for the decline in bond yields are unclear. Despite the recent burst of inflation, the bond market's inflation gauges have declined significantly in recent weeks. Likewise, household longer-term inflation expectations remain well anchored.

While inflation risks have increased, thanks to resurging demand and supply restraints that may last longer than expected, we don't expect an uncontrolled inflation spiral. Structural disinflationary forces should regain their dominance once pandemic-related disruptions fade. Supply constraints are already starting to ease and pent-up demand is not open-ended.

You would hardly call it a tantrum, more like a mild pique by bond investors in response to the Fed's expected shift to a less dovish stance. At the FOMC meeting this week, Fed officials shortened the runway for an expected rate lift-off, as the median forecast for the first increase was pulled forward into 2023, with 13 of the 18 committee members expecting at least one hike during the year. In its previous quarterly forecast in March, only 5 of the 18 participants expected a rate increase that soon. The shift caused a predictable knee-jerk reaction in the bond market, as the 10-year Treasury yield spiked 12 basis points to 1.59 percent immediately following the release of the post-meeting policy statement. However, the miffed response dissipated as quickly as it emerged, as the entire increase was erased later in the week. Shorter-term yields, which are more sensitive to Fed policy shifts, did post sustained and sizeable increases following the meeting, resulting in a significant flattening of the yield curve.

Not surprisingly, the Fed's actions as well as the market's reaction have generated a host of explanations from commentators. Most agree that the subtle shift to a less dovish stance was timely and appropriate, given the changed landscape since the March meeting and the Fed's revised outlook for growth and inflation. Simply put, the economy has shown more strength and inflation has escalated faster than the central bank expected three months ago. With the outlook for both growth and inflation revised higher for 2021, Fed officials justifiably expect to lift rates sooner than later. Where opinions differ is over the market's reaction and whether the initial response is a harbinger for the rest of the year.

The reasons for the abrupt reversal of bond yields are particularly unclear. Is it that the Fed has built up an enormous amount of credibility among bond investors that it has the tools and ability to prevent an undesirable increase in inflation? That's clearly the message conveyed by Fed Chair Powell in his post-meeting press conference. The pulling forward of expected rate hikes could have quelled some fears that the Fed was falling behind the inflation curve. Alternatively, the reflation trade may already have run its course and the Fed's actions merely reinforced a trend that is already underway. This notion, of course, conflicts with the burst of inflation seen in the latest data on consumer and producer prices, which are increasing at the fastest pace in decades.

But the sharp run-up in commodity prices has been arrested and they are now on astonishing freefall. Lumber, copper, steel, agricultural products and some other base metal prices have tumbled by double-digits in recent weeks. To be sure, commodity prices tend to be volatile and are not the main source of sustained inflation on the consumer level, which is influenced primarily by labor costs and inflation expectations. Neither has broken out to any meaningful extent. Labor shortages are creating some wage

HEADQUARTERS:
2188 SW Park Place Suite 100
Portland OR 97205

pressures as demand for workers is outpacing supply. The Fed expects that mismatch to dissipate over time, as the pandemic-related restraints on labor supply should fade and bring workers off the sidelines.

And while there has been a spike in household short-term inflation expectations, long-term expectations remain well anchored. For the latter to pick up on a sustained basis – which would worry the Fed – a different dynamic in the wage-price cycle would need to emerge. Workers would demand – and get – higher wages to compensate for expected prices increases, and employers would grant the raises knowing that they could pass on the higher costs to consumers. As workers strive to stay ahead of price increases, a vicious wage-price cycle is set in motion, amplified by spiraling inflation expectations.

However, that is hardly the case now. While wage growth has picked up, workers are far from staying ahead of the game. Indeed, real average hourly earnings for all workers are declining, with the June reading off nearly 3 percent from a year ago. Nor have inflation expectations seeped into the mind-set of bond investors. The spread between yields on normal Treasury securities and inflation-indexed securities has narrowed significantly in recent weeks, with the 10-year breakeven rate staging the steepest decline this week since April 2020. Some technical factors are arguably skewing spreads, but a decline of this magnitude would not occur if inflation expectations were tracking higher.

The benign attitude towards inflation in the financial markets, as well as among households, aligns with the Fed's thinking that once pandemic-related dislocations are ironed out over coming months, structural disinflation forces such as globalization, demographic changes and productivity-enhancing technological advances, will once again come into play and inflation will recede towards its 2 percent target. We concur with that sentiment but also believe that inflation will stay somewhat higher for longer than the Fed thinks. Clearly, with the unprecedented volume of fiscal stimulus boosting household income and an enormous amount of purchasing power still residing in savings, the resurgence in demand could well be extended and turn out to be stronger than the Fed expects.

Meanwhile, supply chain bottlenecks and constraints on labor may take longer to unwind, thus stretching out the mismatch between demand and supply. The reticence of workers to fill more of the record 9.3 million job openings could last longer, reflecting lingering health concerns, child care requirements until schools reopen in the fall and the financial disincentive to a job search afforded by generous unemployment benefits. What's more, the pool of potential workers on the sidelines may be considerably less than thought, thanks to a wave of early retirements among baby boomers whose financial resources have been greatly swollen by surging housing and stock prices. It may take steeper wage increases than otherwise to lure these aging workers off the sidelines and back to the workforce.

Although the upside risks to inflation has increased, we do not believe that a sustained inflation spiral is in the cards. For one, the productivity resurgence underway is likely to continue, thanks to a more efficient workforce, a strong investment cycle and surging business formation in highly productive industries. These influences should get a boost from the American Jobs Plan that would upgrade the nation's infrastructure. For another, the revival in demand is bringing more capacity online that should ease some of the pressure on prices. Case in point is the auto industry, where production has been shackled by a shortage of semiconductor chips. In May, total auto and truck assemblies increased by 1 million over the previous month. Indeed, total manufacturing output rose by a solid 0.9 percent last month and has recovered 98.5 percent of the pandemic losses incurred last year.

It's also important to note that the resurgence in demand is not open-ended, despite the formidable amount of purchasing power from elevated savings and sturdy hiring gains expected over the balance of the year. The impact from the last round of stimulus payments that bloated bank accounts will fade in coming months, and enhanced unemployment benefits is scheduled to expire in September; half of the states have already exited the program, so millions of households are already facing a fiscal cliff. The torrid demand for goods that homebound consumers gobbled up during the pandemic is already starting to fizzle as the economy reopens and people venture outdoors to partake in long-denied services. The latest retail sales report highlighted this rotation in shopping preferences.

While total sales fell by a disappointing 1.3 percent in May, it is important to note that most retail sales are for goods – appliances, building material, hobbies, books, furnishings – all items that were devoured during the pandemic. These purchases all took a dive last month. However, the few service establishments included in the retail report did quite well, most notably bars and restaurants where sales have surged in recent months and have now surpassed pre-pandemic levels. A more comprehensive report on consumer purchases will be released with the personal income and spending release later this month; we suspect it will show that services more than made up for the decline in goods purchases. That said, pent-up demand for services, like that for goods, is not open ended. As more workers come off the sidelines later this year to fill job openings, the mismatch between demand and supply will lessen and ease the upward pressure on prices.

FINANCIAL INDICATORS

INTEREST RATES	June 18	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.05	0.03	0.01	0.15
6-month Treasury bill	0.06	0.04	0.03	0.17
3-month LIBOR	0.13	0.12	0.15	0.31
2-year Treasury note	0.25	0.17	0.15	0.19
5-year Treasury note	0.87	0.74	0.82	0.33
10-year Treasury note	1.44	1.45	1.62	0.70
30-year Treasury bond	2.02	2.14	2.32	1.47
30-year fixed mortgage rate	2.93	2.96	3.00	3.13
15-year fixed mortgage rate	2.24	2.23	2.29	2.58
5/1-year adjustable rate	2.52	2.55	2.59	3.09
STOCK MARKET				
Dow Jones Industrial Index	33,290.08	34,479.60	34,207.84	25,871.46
S&P 500	4,166.45	4,247.44	4,155.86	3,097.74
NASDAQ	14,030.38	14,069.42	1,347.99	9,946.13
COMMODITIES				
Gold ($ per troy ounce)	1,763.90	1,879.50	1,881.80	1,734.75
Oil ($ per barrel) - Crude Futures (WTI)	71.50	70.78	63.88	38.35

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Retail Sales (May) - % change	-1.3	0.9	11.3	2.4
Industrial Production (May) - % change	0.8	0.1	2.6	0.5
Capacity Utilization (May) - Percent	75.2	74.6	74.6	74.4
Housing Starts (May) - 000s	1,572	1,517	1,725	1,591
Building Permits (May) - 000s	1,681	1,733	1,755	1,756

HEADQUARTERS:
2188 SW Park Place Suite 100
Portland OR 97205