

Weekly Economic Update—July 19th, 2021

Definition of transitory

1: of brief duration: TEMPORARY

//the transitory nature of earthly joy

2: tending to pass away: not persistent

OK. So if even Merriam- Webster can't be more specific regarding the duration of "transitory" isn't it time to cut the Fed chairman some slack? And what's with the "earthly joy" reference? In the scheme of things, it suggests the Fed chief's material pleasures lasts only as long as inflation remains well behaved. In all fairness, no one really knows when an event morphs from transitory to permanent. To inflation hawks, the past several months seem almost like a lifetime, and only swift corrective measures would prevent inflation from becoming permanently embedded in the economic landscape. To inflation doves, the recent period is merely a hiccup following two decades of low inflation that will soon be stifled when pandemic-related forces run their course.

From our lens, neither the alarm bells of the hawks nor the complacency of the doves are warranted. For sure, the inflation readings over the past four months are enough to scare the pants off the casual observer. Consumer prices during that period rose at the fastest pace since the early 1980s, according to this week's government report, which conjures up memories of a regrettable episode. What's more, the pace appears to be accelerating, with the 0.9 percent increase in the headline consumer price index in June equaling the strongest monthly gain since June 2008. Over the past year, the CPI has increased by 5.4 percent, the strongest annual gain in 13 years.

With increases of this magnitude, the Fed's patience is being seriously challenged. That said, while Chair Powell admits the latest inflation burst has exceeded expectations, he still believes it is being driven by transitory forces related to a reopening economy dealing with myriad restraints on labor and supply-chain dislocations. Restraints on labor supply should gradually abate as virus fears ease, generous unemployment benefits are cut off and schools reopen, relieving the child-care burden on working parents. Likewise, as producers ramp up output, supply should gradually expand to meet demand, easing upward price pressures. Distortions related to supply restraints were clearly evident in the latest consumer price report, particularly in the auto sector where production is hobbled by the lack of computer chips. Spiraling prices of used autos accounted for 40 percent of the increase in the core consumer price index last month.

So far, the financial markets remain in sync with the Fed's sanguine view. Inflation fears have clearly not gripped the mindset of bond investors, as yields have receded markedly in recent weeks and breakeven rates that reflect inflation expectations have also narrowed. It's unclear how long this benign inflation perception will last, but a growing body of evidence does suggest the worst is behind us. For sure, the calendar or so-called base effects are about to make the annual gains look less alarming, as the steep price discounts recorded during the height of the pandemic last spring fall out of the calculations. And as the dislocations that are driving up prices in specific sectors, such as autos, get resolved, the outliers that are skewing the price indexes higher should also ease.

The Federal Reserve Bank of Cleveland has compiled an index that excludes these outliers (a trimmed price index) as well as one that tracks prices of expenditure items that fall in the middle of the pack (the

median CPI), which are more reflective of inflation trends. The recent movement in these indexes gives some comfort to the Fed's view that underlying inflation is not as worrisome as the official consumer price index suggests, although they too are creeping up. The trimmed price index increased 2.9 percent from a year ago, up from 2.6 percent in May, marking the fifth consecutive increase in the annual rate. While that's well above the Fed's 2 percent long-run target, it's a pace the Fed can live with for a while until pandemic-related influences unwind.

But how long would the Fed tolerate an above-target rate to persist, and how would it respond if the upward move accelerates further? In his semi-annual Congressional testimony this week, Powell indicated that a clearer picture of inflation trends would come into focus over the next six months or so. Importantly, he noted that if it appears inflation were becoming more firmly embedded in the economy and in expectations, the Fed has the tools to slow it down and would not hesitate to put them to use. That said, he also cautioned that the labor market is far from healed and the risk of choking off the jobs recovery outweighs the inflation threat.

This less dovish but still accommodative message appears to be resonating with investors, as it implies that the Fed is neither falling behind the inflation curve nor about to prematurely stifle the recovery. In light of the economic crosscurrents seen in recent weeks, walking that fine line is highly appropriate. Households, for example, are losing one lifeline while gaining another. The expanded Federal unemployment benefits that helped sustain spending for unemployed workers are scheduled to expire in a few months, and more than half the states have already exited the program, cutting off benefits for about 3 million people. Conversely, families of more than 60 million children up to age 17 started receiving child tax credits in their bank accounts this week, averaging just over \$400 a week, which just about equals the weekly top-off in jobless benefits that are vanishing.

Just how this fiscal give-and-take affects consumer spending over the balance of the year remains to be seen; but this key growth driver is continuing to power the economy forward, thanks to the copious savings accumulated from delayed purchases during the pandemic, healthy balance sheets fueled by rising asset values, and rebounding employment that is lifting labor compensation. After taking a breather in May, consumers reopened their wallets and purses in June, spending more at retail outlets than widely expected. Retail sales jumped 0.6 percent last month, much stronger than the consensus forecast of a 0.4 percent decline. As expected, consumers continue to revamp their spending priorities, turning more to services – travel, dining out and other outdoor activities denied to them during the pandemic – over the goods purchases that dominated spending behavior when stuck indoors.

Still, they didn't skimp on goods purchases, as they spent more on electronics and appliances, clothing and general merchandise. In contrast, spending on autos contracted, reflecting the aforementioned shortage of vehicles available to purchase. The control group of sales that excludes food services, autos, building materials and gasoline, which enters directly into the GDP accounts, increased by a healthy 1.1 percent. Government transfer payments provided less heft to spending in recent months than they did earlier in the year, but personal consumption still held up well in the second quarter. We expect consumers to stage the strongest increase in consumption this year than anytime since the end of WW II.

That said, the muscular performance will be heavily front-loaded as spending growth should taper off over the second half of the year. For one, consumers will have satisfied much of their pent-up demand by the fourth quarter. For another, households have already drawn on their elevated savings to finance purchases, and are likely to retain a higher balance of precautionary savings than normal going forward. Finally, broad swaths of consumers may have trouble keeping up with the higher prices seen in recent months. Indeed, inflation has handily outpaced income gains, as real workers earnings are falling at the steepest pace since the 1980s.

This may become more of an issue sooner than expected, as the University of Michigan July survey of household sentiment, released on Friday, reveals that consumers are deeply concerned about rising prices of autos, homes and other big-ticket items. Aside from economic considerations, the emergence of the

Delta variant poses another downside risk to consumer behavior. Although still quite low, case counts have been rising in the U.S., particularly in states with low vaccination rates. While we do not expect governments to impose restrictions that would impair activity, it's possible that a further spread of the variant could inflame health fears and undermine household confidence.

FINANCIAL INDICATORS

INTEREST RATES	July 16	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.05	0.05	0.05	0.11
6-month Treasury bill	0.05	0.05	0.06	0.13
3-month LIBOR	0.13	0.12	0.13	0.27
2-year Treasury note	0.24	0.22	0.25	0.14
5-year Treasury note	0.78	0.79	0.87	0.29
10-year Treasury note	1.29	1.36	1.44	0.64
30-year Treasury bond	1.92	1.99	2.02	1.33
30-year fixed mortgage rate	2.88	2.90	2.93	2.98
15-year fixed mortgage rate	2.22	2.20	2.24	2.48
5/1-year adjustable rate	2.47	2.52	2.52	3.06

STOCK MARKET				
Dow Jones Industrial Index	34,687.85	34,870.16	33,290.08	26,671.95
S&P 500	4,327.16	4,369.55	4,166.45	3,224.73
NASDAQ	14,427.24	14,701.92	14,030.38	10,503.19

COMMODITIES				
Gold (\$ per troy ounce)	1,812.10	1,808.80	1,763.90	1,807.35
Oil (\$ per barrel) - Crude Futures (WTI)	71.42	74.67	71.50	40.57

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer Price Index (June) - % change	0.9	0.6	0.8	0.8
Core CPI (June) - % change	0.9	0.7	0.9	0.5
Producer Price index (June) - % change	1.0	0.8	0.6	0.8
Industrial Production (June) - % change	0.4	0.7	0.0	0.3
Capacity Utilization (June) - Percent	75.4	75.1	74.6	74.5
Retail Sales (June) - % change	0.6	-1.7	0.9	2.6

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