GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—August 9th, 2021

Amazon is the latest among several high-profile firms to push back return-to-office plans for its corporate workers, highlighting the disruptive impact the surge in Covid cases is having on the labor market. But while the spread of the Delta variant is creating turmoil in the job market, it has yet to slow the growth in corporate hiring. That was clearly evident in the latest jobs report released on Friday. If anything, the reopening of the economy continues to generate a huge demand for labor, and many companies still cannot find enough workers to fill positions. Among small businesses, for example, a record 49 percent of owners have at least one unfilled job opening, according to the National Federation of Independent Businesses.

More broadly, the economy added an above-consensus 943 thousand net new jobs in July; what's more, another 113 thousand were added to the original estimates for May and June, resulting in a remarkable 2.5 million increase in payrolls over the past three months. The hiring binge took a big chunk out of unemployment, as the jobless rate plunged 0.5 percent, from 5.9 percent to 5.4 percent. There's still a ways to go before it returns to the 3.5 percent pre-pandemic rate, but the current unemployment rate is a far cry from the 14.8 percent hit during the worst stage of the pandemic last April. Encouragingly, the biggest declines were among minority groups, Blacks and Hispanics, where the jobless rate fell by 1.0 and 0.8 percent. That said, the rate in both groups, at 8.2 and 6.6 percent remains well above the 5.4 percent national rate.

Clearly, the latest jobs report contains more positive than negative news. The job increases in July were broad based, with 67.5 percent of industries expanding payrolls, led by a 659 thousand increase in service sector jobs. Indeed, the services sector remains a key engine of job growth, as businesses continue to benefit from the wider reopening of the economy and massive pent-up demand from consumers. Over half of the job creation was again concentrated in the leisure & hospitality sector, which recouped another 380 thousand jobs and has added a cumulative 1.093 million jobs over the past three months. The advance was mostly driven by a 253 thousand increase in employment at food and drinking places, while employment in the entertainment & recreation sector rose 53 thousand, reflecting strong hiring at gambling venues, sporting facilities and amusement parks.

Overall, the employment recovery in the hard-hit leisure and hospitality sector has made significant progress. As of July, the sector has recovered 80 percent of the job losses caused by the pandemic, although the shortfall would be larger when accounting for all the jobs that would have been created absent the pandemic. That said, if the pace of job creation over the past three months were to continue, the leisure and hospitality sector would recoup all of its pandemic-related losses by year-end. The robust demand for workers in this sector strikes an important note because it is here that the difficulty of filling position is the greatest and where most low-paying jobs prevail. Importantly, many believe that generous unemployment benefits are discouraging workers from taking low-paying jobs and is a key reason for the labor shortage facing leisure and hospitality companies.

It's unclear if the early exit of about half the states from the Federal enhanced benefits program motivated workers to take jobs. Early evidence suggest that it has not, although we will be getting more details when individual states report on employment changes in a few weeks. But one thing is clear: the labor shortage is driving up worker pay and hours in low wage sectors. Whereas average hourly earnings for all workers increased by a solid 0.4 percent last month and 4.0 percent over the past year, the increase for leisure and hospitality workers soared. In July, their earnings increased by a torrid 1.4 percent over the previous month and by an astonishing 13 percent over the past year. What's more, the surge is not just a one-month

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phenomenon; earnings for this group have been on a tear for the last three months, increasing by an annual rate of over 20 percent during the period.

Importantly, the more lucrative pay packages are starting to draw workers off the sidelines. In July 216 thousand individuals entered the labor force, lifting the labor force participation rate 0.1 percent to 61.7 percent. While that's up from a recent low of 61.4 percent in February, the share of the population either holding a job or looking for work is still well below the 63.4 percent pre-pandemic level and hovering near the lowest levels since the early 1970s, when women accounted for a much smaller fraction of the labor force. Simply put, constraints on the labor force persist, reflecting health concerns, childcare responsibilities and, perhaps, generous unemployment benefits. These constraints will not vanish right away and we suspect that ongoing labor shortages will continue to put upward pressure on wages at least over the next several months.

So far, investors are not showing much anxiety over the climb in labor costs, as the stock market continued to rally after Friday's jobs report. One possible reason: corporate earnings are handily beating expectations despite the rise in input costs, not only from labor but from expenses related to shipping, supplies and other components that go into the production process. To some extent, the increase in costs is not leading to a margin squeeze because companies are able to pass the increases on to consumers in the form of higher prices. But companies have also uncovered ways to boost productivity during the pandemic, which gives them room to lift wages without hurting the bottom line.

The ability to sustain productivity advances will become increasingly important over the coming year. Consumers have accepted higher prices in recent months largely because they are sitting on bloated financial resources, i.e., the elevated savings accumulated over a year of enforced spending restraints as well as the copious government stimulus payments received since the onset of the pandemic. But those inflation bulwarks are quickly running out. Households have already tapped deeply into their savings to finance purchases in recent months, enhanced jobless benefits are about to expire for everyone in September, and government stimulus payments are no longer padding bank accounts. As these demand boosters fall by the wayside, companies will be hard-put to make price increases stick, which underscores our view that the spiraling inflation seen this year will lose momentum next year.

And while we expect labor constraints to persist for a while longer, they too should ease as the year progresses and take some steam out of building wage pressures. Schools are reopening, relieving working parents of child care responsibilities, vaccination rate have started to ramp up again, thanks to beefed-up government efforts to make vaccines more accessible and offering incentives to defuse vaccine hesitancy. Meanwhile, a broader swath of private companies is mandating inoculations among workers and, like governments, are offering incentives, such as paid leave for time needed to get vaccinated; some are offering bonuses as well. More people are also being motivated as they see that the surge in Covid cases is particularly widespread among the unvaccinated segment of the population.

As noted, there are hardly any blemishes in the latest jobs report, which points to a healthy and sustained recovery as the economy continues to reopen. And while the stock market continues to rally, the bond market views the same forces that adds muscle to growth and profits as an indicator of higher interest rates. Indeed, much of the discussion following the jobs report centered on what the Federal Reserve's next move might be. The general view is that the surprising strength in the labor market will push up the timetable for the Fed to start unwinding its turbo-charged easy policy. Bond yields moved significantly higher on Friday, as the 10-year Treasury yield rebounded from a midweek low of 1.12 percent to end the week at 1.31 percent.

From our lens, the July jobs report does increase the odds of an earlier move by the Fed than thought a few weeks ago, a change supported by recent hawkish comments of a few Fed officials this week, including Vice-Chairman Clarida. We caution however, that the surveys providing the July employment data were taken before the surge in Covid cases took hold later in the month. In recent weeks, the Delta variant has clearly taken center stage and is having a meaningful influence in several states. Some have already re-

imposed mask mandates and are allowing certain businesses to stay open only for vaccinated customers. Hence, we doubt that the Fed would make any outright announcement of a change in policy until it sees the next employment report, which will give a clearer picture of how the increase in virus cases is impacting the job market. Keep in mind that even with the stellar increase in payrolls over the past three months, there are still 5.8 million fewer jobs than there were just prior to the pandemic.

Simply put, the highly contagious Delta variant casts a shadow on the labor market recovery, threatening to slow the return of workers still on the sidelines due to child care issues or health concerns. The upsurge in case counts comes just as the vast government income supports that sustained the economy throughout the pandemic is vanishing. Hence, the recovery props are now shifting from the public to the private sector, with the strength of the job market and worker compensation representing critical driving forces. Assuming the Delta variant does not force renewed containment measures that locked down the economy last spring, the labor market recovery should continue and underpin healthy job gains over the balance of the year. If that turns out to be the case, the Fed should start removing its support early next year, beginning with a tapering off of its monthly bond purchases. However, we do not expect the Fed to start raising short-term rates from their near-zero levels until at least late 2022 or early 2023.

FINANCIAL INDICATORS

INTEREST RATES	Aug 6	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.06	0.05	0.05	0.10
6-month Treasury bill	0.06	0.06	0.05	0.12
3-month LIBOR	0.13	0.13	0.12	0.24
2-year Treasury note	0.22	0.19	0.22	0.13
5-year Treasury note	0.77	0.70	0.79	0.23
10-year Treasury note	1.31	1.23	1.36	0.57
30-year Treasury bond	1.95	1.89	1.99	1.23
30-year fixed mortgage rate	2.77	2.80	2.90	2.88
15-year fixed mortgage rate	2.10	2.10	2.20	2.44
5/1-year adjustable rate	2.40	2.45	2.52	2.90

STOCK MARKET				
Dow Jones Industrial Index	35,208.51	34,935.47	34,870.16	27,433.48
S&P 500	4,436.52	4,395.26	4,369.55	3,351.28
NASDAQ	14,835.76	14,672.68	14,701.92	11,010.98

COMMODITIES				
Gold ($ per troy ounce)	1,762.00	1,817.10	1,808.80	2,031.15
Oil ($ per barrel) - Crude Futures (WTI)	68.08	73.70	74.67	41.57

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
ISM Manufacturing Index (July)	59.5	60.6	61.2	61.3
ISM Services Index (July)	64.1	60.1	64.0	61.7
Nonfarm Payrolls (July) - 000s	943	938	614	681
Unemployment Rate (July) - Percent	5.4	5.9	5.8	5.9
Average Hourly Earnings (July) - % change	0.4	0.4	0.5	0.3

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