

Weekly Economic Update—August 30th, 2021

The Jackson Hole symposium, featuring the highly-anticipated address by Fed Chairman Powell, was the main event in the financial markets this week, but rapidly unfolding geopolitical and health developments stole the headlines and may ultimately render Powell's message moot. That said, the markets were braced for any indication as to when, and under what circumstance, would the Fed begin to taper its asset purchases, setting in motion the unwinding of emergency support for the economy in effect for the past 18 months. To no surprise, the chairman was noncommittal about the timing but strongly suggested that tapering could begin by the end of the year.

The explosive events in Afghanistan, while garnering most of the headlines this week, should have little, if any, bearing on the economy or monetary policy, but they could deflect attention on Capitol Hill away from important fiscal matters, including the administration's \$4.1 trillion spending bills and requisite lifting of the debt-ceiling, which could have a disruptive impact on the financial markets. If the American exit is completed by the end of the month with no additional casualties, as the White House hopes, that unsettling prospect would be pushed to the side. As of Friday, geopolitical fears were still front and center, highlighted by the desperate efforts to get remaining Americans and allies out of the beleaguered nation safely.

But the end date for the unfolding health crisis is more uncertain, and its fate does have a direct bearing on the economy. Paced by the Delta variant, infection rates have soared over the summer, with case counts returning more than half way back to the peak levels reached over the winter. Hospitalizations and deaths are also rising at uncomfortable rates and attention-getting breakthrough cases may be impeding efforts to inoculate people who are wary about the vaccine's benefits. One bit of good news is that the surge in cases appears to be slowing, as the 7-day moving average, as tracked by the CDC, has leveled off at around the 140 thousand mark over the past six weeks. However, a spurt in the daily case count at the end of the period to over 160 thousand is not a positive omen.

The uncertain path of the Delta-induced surge in Covid-19, as well as its economic impact, is the wild card in the Fed's decision as to when the tapering of asset purchases would get underway. From our lens, the economy has more than enough firepower to plow through the Delta headwinds and remain on a solid growth track over the remainder of the year. A robust job market that is fattening worker paychecks, elevated savings, healthy balance sheets and ongoing fiscal support, thanks to a fresh round of child care tax credits, should keep households in a spending mood. For sure, consumers received ample income support in July, as personal incomes rose by a formidable 1.1 percent, the strongest in six months. Importantly, most of the gain was organic, coming from fatter paychecks linked to job growth. The 1.0 percent increase in wages and salaries last month was the strongest since last November.

The question is, how much of the income gains will enter the spending stream? This is where the Delta variant muddies the waters, as it could derail the reopening of the economy that is facilitating the return of service sector activity. So far, it has not had much of an impact on incoming data. Consumers continued to rev up their spending on services in July, particularly on recreational activities and restaurants and hotels, which more than offset a slump in goods purchases. Overall, personal spending on goods and services increased by a modest 0.3 percent in July following a torrid 1.1 percent advance in June.

However, while it was the fifth consecutive monthly increase, the July gain was less than half the monthly increases seen during the second quarter. Keep in mind too that the Delta surge gained considerable momentum in August, so the July data does not fully capture the adverse impact on household behavior that has since taken place. Restaurants have come under tighter restrictions, people are rethinking vacation

plans, many events—outdoors and indoors – have been cancelled, and businesses are postponing return-to-office policies, hurting vendors and mom-and-pop establishments that rely on sales to office workers. What's more, inflation wiped out all of the gain in consumer spending last month, as real personal consumption slipped by 0.1 percent.

With the Covid-induced barriers to spending, consumers will provide less oomph to the economy's growth engine over the balance of the year than they did in the second quarter, when real outlays surged by an outsized 11.9 percent annual rate, driving a 6.6 percent GDP growth rate. But they will not go into hibernation as long as the job market remains strong, as we expect, and sustain a solid pace of income growth. Delta may cause consumers to postpone some spending, but that will push more income into savings, creating an additional cushion for future purchases. That pattern already appeared in July as the savings rate increased from 8.8 percent to 9.6 percent, reversing three months of declines.

Importantly, the economy should receive additional support from business capital spending. For one, worker shortages that are contributing to steeper pay raises are prodding companies to invest in more labor-saving equipment and software. For another, corporations have hoards of cash on balance sheets, thanks in good part to surging profits. Not only did corporate operating profits advance by \$235 billion in the second quarter – nearly double the \$124 billion increase in the first quarter – but profit margins hit an all-time high, hitting 18 cents per dollar of output for nonfinancial corporations. Simply put, escalating labor and material costs have so far not crimped the earnings capability of businesses, which have retained more than enough pricing power to cover cost increases. Indeed, the 6.1 percent increase in the core personal consumption deflator in the second quarter handily outpaced the 3.2 annual increase in the employment cost index for private industry workers.

To be sure, the combination of stimulus-fueled consumer demand combined with supply constraints underpinned the pricing power that corporations were able to galvanize since the onset of the pandemic. How long they can retain that power is the question dividing the inflation hawks and doves. For some Fed officials, the time to start unwinding monetary support to diffuse some of that power has already arrived. This week alone, three regional Fed presidents publicly voiced their support to immediately start the tapering of asset purchases. None are voting members of the policy-setting committee this year, so the trigger is not likely to be pulled at the upcoming September 21-22 meeting. Two of them will become voting members next year, however, which heightens the odds that if the tapering process doesn't begin later this year, it will early in 2022.

As noted, Chair Powell in his Jackson Hole speech on Friday appeared receptive to starting the tapering before the end of this year. But he remained less concerned about an inflation spiral than his hawkish colleagues and reaffirmed his view that the inflation surge this year is mostly transitory, linked to pandemic-related forces that will soon abate. We concur with that assessment, as we expect wage pressures to ease as the labor supply expands in coming months and the goods critical to production also become more available. Some commodity prices, such as for lumber, have already plummeted from the peaks reached earlier in the year and manufacturing output is ramping up even as demand is leveling off due to the Delta surge.

On the surface, the latest inflation data remain concerning, with the personal consumption deflators – both the core and overall – coming in well above the Fed's 2 percent target at 3.6 and 4.2 percent year-over-year respectively in July. But the monthly increases were the smallest in six months, indicating that the peak inflation rates are now behind us, although we expect them to remain sticky above 2 percent for the foreseeable future. The good news for seniors is that the recent spike in inflation will provide them with the largest COLA boost in their social security benefits since 1984. The precise increase will not be determined until two more months of price data are available, but something in the range of 5 to 6 percent seems likely. That would be a considerable step-up from the 1.3 percent COLA increase seniors received last year.

FINANCIAL INDICATORS

INTEREST RATES	Aug 27	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.05	0.05	0.05	0.10
6-month Treasury bill	0.05	0.05	0.06	0.11
3-month LIBOR	0.12	0.13	0.13	0.25
2-year Treasury note	0.20	0.23	0.19	0.14
5-year Treasury note	0.80	0.78	0.70	0.28
10-year Treasury note	1.31	1.26	1.23	0.74
30-year Treasury bond	1.92	1.87	1.89	1.52
30-year fixed mortgage rate	2.87	2.86	2.80	2.91
15-year fixed mortgage rate	2.17	2.16	2.10	2.46
5/1-year adjustable rate	2.42	2.43	2.45	2.91

STOCK MARKET				
Dow Jones Industrial Index	35,455.80	35,120.08	34,935.47	28,653.87
S&P 500	4,509.37	4,441.67	4,395.26	3,508.01
NASDAQ	15,129.50	14,714.66	14,672.68	11,695.63

COMMODITIES				
Gold (\$ per troy ounce)	1,820.90	1,782.90	1,817.10	1,957.35
Oil (\$ per barrel) - Crude Futures (WTI)	68.68	62.25	73.70	42.93

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Home Sales (July) - 000s	708	701	720	770
Existing Home Sales (July) -- 000s	5,990	5,870	5,780	5,957
Durable Goods Orders (July) - % change	-0.1	0.8	3.2	0.1
Personal Income (July) - % change	1.1	0.2	-2.1	-0.1
Personal Spending (July) - % change	0.3	0.2	0.2	0.3
Personal Savings Rate (July) Percent	9.6	8.8	9.8	13.4

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