GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—September 13th, 2021

With the Delta variant generating ever-more uncertainty into the growth outlook investors may be poised to take some risk off the table. Indeed that appeared to be the case this week, as stock prices fell for five consecutive days, posting its first weekly decline in three weeks. What's more, the underlying reasons for a more risk-averse mindset remains firmly in place..

The potential drag on economic activity and, hence, profits from the dispiriting surge in the Delta variant is, of course, the primary risk to stock as well as investors in speculative-grade bonds. Since case counts have hopped on to a sharply rising trajectory at the beginning of the summer, various gauges of business conditions have softened, prompting widespread downgrades to the growth outlook over the remainder of the year. Fewer people are eating out, booking flights or purchasing tickets for recreational activities, such as concerts, movies, theaters and other crowd-gathering events than in the spring. Hence, the boost from the resurging service sector that propelled the solid gain in GDP during the second quarter is fading, confirming that the peak growth in the expansion is behind us.

That said, the tough government-mandated and business restrictions that locked down the economy during the initial phase of the pandemic last year are not likely to recur. Delta may be more contagious than Covid's initial variant, but it is unfolding in an economic environment that is better equipped to handle it. Vaccination rates, while still stubbornly below herd thresholds, are ramping up and are about to get another push from a fresh round of government mandates that could potentially inoculate an additional 100 million arms. Health professionals armed with more than a year's experience with Covid under their belts, now have more effective medical tools to limit its effects. Hence, the U.S., like most other nations, is learning live with the pandemic that many experts believe is nearing an inflection point.

But while government and business restrictions should be less onerous, the Delta variant is causing growth-retarding behavioral changes among consumers and workers whose lingering effects remain uncertain. The pullback from social activities noted above is already having a palpable effect on personal consumption, the economy's main growth driver. But just as consumers unleashed a torrent of demand for social services during the spring when virus case counts withered away, they should do so again following the ebbing of the Delta surge, whenever that may be. However, it has become readily apparent that it is not a lack of demand that is posing the greatest risk to the economy's growth prospects but a shortage of supply, both of products and labor.

The product shortage reflects the constraints coming from a wide array of sources, including shipping bottlenecks and plant shutdowns overseas linked to the pandemic. The inability of domestic producers to obtain needed parts and materials has stifled production in the U.S. with the auto industry particularly victimized by a lack of semiconductor chips to complete the assembly of motor vehicles. The shortfall of output relative to demand is the main catalyst behind the inflation spike seen this year, as the biggest price increases have been for products hampered by supply constraints, with a particularly large contribution coming from motor vehicle prices. But a broad swath of producers have incurred huge cost increases from imported goods, as shipping costs have increased tenfold since the onset of the pandemic.

The cost pressures in the pipeline that will feed into consumer prices continued to press higher in August, as producer price inflation hit a fresh record during the month. The headline PPI rose 8.3 percent compared to a year earlier, up from 7.7 percent in July and more than four times faster than the prepandemic pace. The good news is that the monthly gains are slowing, with the 0.7 percent increase over July a step down from the 1.0 percent increases in each of the previous two months. That's still an outsized increase but the

core PPI, a more reliable barometer of underlying price pressures, slowed to a 0.3 percent advance from 0.9 percent in July and is the slowest increase so far this year.

The production curbs – and inflation pressures – from supply-chain constraints and shipping bottlenecks should wane in coming months and into 2022 as more capacity is brought on stream and pent-up demand levels off. To be sure, the run-up in prices this year has been greater than expected and is pushing the Federal Reserve as well as other central banks closer to tapering its monetary support. The ECB has already announced its intention to reduce the pace of bond purchases in the fourth quarter, and the U.S. Fed is expected to provide guidance as to when it will follow suit either at its upcoming policy meeting this month or in November. We expect the Fed to start tapering in 2022, although refrain from lifting rates until the following year.

But even as supply and demand for goods and services comes into a better balance, inflation pressure from another source – labor costs, the largest expense item for businesses – is just gaining traction. And unlike the expected easing of supply constraints as the gears of production normalize, rising labor costs may well linger even as the economy slows. That's because the labor shortage which is crimping operations throughout the economy, but most notably in the service sector, is not something that will dissipate overnight. The current staffing difficulties of businesses, both large and small, is as bad as it gets. At the end of July, unfilled job positions stood at a record 10.2 million, which towered over the 6.8 million of new hires and exceeded the 9.8 million workers classified as unemployed.

No doubt, a good part of the shortfall is linked to the pandemic, as health fears are keeping many workers on the sidelines. As vaccination rates continue to increase and Delta case counts recede, this deterrent should also fade. To the extent that enhanced unemployment benefits have discouraged workers from taking a job, that too will fall by the wayside as the Federal emergency programs providing those benefits expire this month. But that still leaves a large contingent who will only return to the workforce if their pay packages justify the effort. Simply put, the pandemic-related labor shortage has strengthened the bargaining position of workers, resulting in larger wage increases, particularly for low-paid workers, and an accelerated rate of voluntary quits, as understaffed firms are keen to lure workers away from their existing jobs with a more lucrative pay package.

Indeed, a recent New York Federal Reserve study found that the so-called reservation wage – the minimum wage that would prod a worker to switch jobs – jumped to $68954 in July from $64226 a year ago, which is nearly double the average percent earnings increase for all private sector workers. The fact that the quit rate in the private sector hit an all time high in August suggests that more and more firms are willing to pay the price to attract these workers. It also indicates that unless these workers boost productivity, the hiring firms will either have to absorb higher costs – and accept lower profits to retain sales – or pass them on to customers in the form of higher prices.

The same New York Fed study also portends a longer-lasting issue that would suppress the growth in the labor force beyond the next year or two: More Americans are expecting to retire at a younger age than in the past. In the July survey, the Fed found that only 50.1 percent of respondents expect to work beyond the age of 62, the lowest share since the survey began in 2014. Importantly, the steepest drop-off occurs among older workers, those 45 and over, of which only 46.6 percent expect to work beyond 62 compared to 53.5 percent when the survey began. That age threshold is not far off for a sizeable fraction of the workforce, as 66.6 million or fully 43.5 percent of employed workers are over the age of 45.

Interestingly, the prospective compositional shift to a younger workforce could accelerate the increase in labor costs. Not only does the increase in early retirements exacerbate labor shortages, thus putting upward pressure on overall wages, the younger cohort of the working-age population is getting significantly stronger wage increases than their older colleagues. According to the Atlanta Fed wage tracker, workers in the 16-24 age group that have been in the same job over the past year received a median wage increase of 9.5 percent, the highest in two decades. That's nearly three times larger than the median increase for all

workers. Significantly, wages for older workers – those over 55 – only increased by 1.9 percent, which may be influencing early retirement decisions.

We suspect, however, that older workers are pulling forward retirement plans more out of satisfaction with their nest eggs than out of dissatisfaction with working conditions. Should the eye-opening appreciation in stock portfolios in recent years melt under a severe market correction, those expectations could easily change. Meanwhile, the Fed is tasked with navigating the economy through a challenging economic and health environment, one that features slowing growth amid a resurging virus and upward wage pressure exacerbated by worker shortages.

FINANCIAL INDICATORS

INTEREST RATES	Sep 10	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.05	0.05	0.06	0.11
6-month Treasury bill	0.06	0.05	0.05	0.12
3-month LIBOR	0.11	0.12	0.12	0.25
2-year Treasury note	0.22	0.21	0.21	0.13
5-year Treasury note	0.81	0.78	0.78	0.26
10-year Treasury note	1.34	1.33	1.29	0.67
30-year Treasury bond	1.93	1.95	1.93	1.42
30-year fixed mortgage rate	2.88	2.87	2.87	2.86
15-year fixed mortgage rate	2.19	2.18	2.15	2.37
5/1-year adjustable rate	2.42	2.43	2.44	3.11
STOCK MARKET				
Dow Jones Industrial Index	34,607.72	35,369.09	35,515.38	27,665.64
S&P 500	4,458.58	4,535.43	4,468.00	3,340.97
NASDAQ	15,115.49	15,363.52	14,822.90	10,853.55
COMMODITIES				
Gold ($ per troy ounce)	1,788.20	1,830.60	1,779.80	1,947.40
Oil ($ per barrel) - Crude Futures (WTI)	69.71	69.26	68.88	37.38

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Job Openings (July) - mlns	10.9	10.2	9.5	9.3
Voluntary Quits (July) - mlns	4.0	3.9	3.6	3.7
Consumer Credit (July) - $blns	17.0	37.9	0.5	24.6
Producer Price Index (August) - % change	0.7	1.0	1.0	0.8

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