GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—November 15th, 2021

Inflation dominated the news cycle this week, and it's likely to garner even more attention in coming months. That's clearly not what the financial markets or the Federal Reserve thought would be the most pressing economic issue a few months ago when the Delta variant was stifling economic activity and Capitol Hill was at an impasse over raising the debt ceiling and advancing the administration's key legislative proposals. True, the inflation genie had popped out the bottle during the spring and the widespread view then was that it would likely get worse for a while due to pandemic-related supply disruptions amid a stimulus-fueled rebound in demand.

But the consensus of private forecasts as well as the Federal Reserve firmly believed that the inflation spike would start to dissipate as the calendar turned to 2022. The feeling was that the ebbing of the pandemic would allow supply snarls to clear up and correct the imbalance between supply and demand, thus easing price pressures. While the pandemic's grip on the economy is clearly ebbing, inflationary pressures are hardly on the cusp of fading. As this week's consumer price data starkly reveals the inflation fires are burning hotter, stoking fears among investors and uncertainty over the Fed's well-telegraphed strategy of guiding the economy through the transition phase by gently reducing its massive bond-buying program. But as the former heavyweight champ Mike Tyson famously said, "everyone has a plan until they get punched in the mouth."

Inflation is certainly delivering a more severe and lasting blow to the economy than most had thought likely over the summer. The headline consumer price index shot up by 0.9 percent in October, more than double the September rate and lifting the annual rate to a 30-year high of 6.2 percent. While soaring oil and food prices are having a mighty influence, the accelerated increase in prices is broadly based. The core consumer price index, which excludes food and energy prices, increased by a heady 0.6 percent during the month, boosting the annual rate to 4.6 percent, the fastest since 1991. These readings far outpaced expectations and reversed the promising month-over-month slowing trend seen over the July-September period.

Not surprisingly, the outsize inflation pickup has raised speculation over the prospective path of monetary policy as well as the fate of the administration's ambitious 'Build Back Better' spending bill. A growing chorus of economists are sounding a more urgent note, prodding the Fed to speed up its planned reduction of asset purchases and pull forward its projected interest-rate liftoff date. At this juncture, chair Powell is sticking with the gradual plan outlined at the last policy meeting and in subsequent public comments, retaining the belief that this inflation spike is transitory and will unwind as economic conditions normalize. However, he also cautioned that the Fed stands ready to move more swiftly if inflation appears to be gaining more traction than anticipated.

Meanwhile, the fate of the administration's $1.75 trillion spending bill is coming under fire from inflation hawks that claim the government has already fanned the inflation fires with its massive $1.9 trillion rescue package passed in March, which they believe unreasonably fueled demand amid ongoing supply shortages. Their assertion could further weaken support for the bill from some key moderate Democrats in Congress who expressed concerns over the impact a bill of that size would have on the deficit. With reinforcements from the inflation camp, they now have an additional argument for a scaled-back version of the bill. From our lens, the legislation would have a only a minimal inflationary impact next year, as the expiring stimulus from pandemic relief programs would just about offset the demand boost from the spending bill.

That said, there is no denying that inflation has become a bigger headache for policy makers than expected and that the pain will linger beyond earlier predictions. We believe that price pressures will intensify further in coming months and not peak out until the second quarter, when more supply comes on stream, labor shortages ease and excess savings from pandemic relief funds are depleted, sapping strength from household demand. It's quite possible that the Fed's patience would run out more quickly if inflation continues to escalate in coming months, prodding it to speed up its tapering process and raise rates sooner rather than later. Several wild cards make it difficult to judge the Fed's prospective course of action. President Biden will have three open positions on the Federal Reserve Board to fill next year, and a decision as to whether to reappoint or replace the current chair, Jerome Powell, is pending. The new mix of Fed Governors may or may not retain a more dovish bias in policy decisions.

Another wild card is the behavior of the bond market should inflation continue to run hotter than expected. Historically, such an occurrence has brought out the bond vigilantes who, fearing that the Fed is falling behind the inflation curve, drive up long term yields to prod the Fed into a tightening stance. Thus far, the bond market has been relatively calm in the face of the inflation surge and the Fed's patient approach. The bellwether 10-year Treasury yield has increased by more than half percent from its mid-summer low and break-even rates, which track inflation expectations, have also risen. But the increases have been contained and hardly point to runaway inflation. The Treasury yield has backed down from the 1.71 percent peak hit on October 21, ending this week at under 1.60 percent despite the string of bad inflation news during the period.

What complicates the Fed's task is that it has little power over key catalysts behind the inflation surge, namely supply restraints stemming from factory shutdowns overseas, a shortage of chips for auto production, clogged ports, a paucity of truck drivers to transport goods to and from warehouses, as well as a general labor shortage. A more rapid withdrawal of monetary support would not ease these restraints even as it might slow the jobs recovery. The Fed is keenly aware that there are still more than 4 million jobs yet to be recovered of the 22.3 million that were wiped out by the pandemic last year. True, companies are having trouble luring many of these workers off the sidelines, creating fierce competition that is driving up wages, particularly for lower-paid workers. But the wage increases for most workers are still lagging inflation, leaving them with less purchasing power than before the pandemic.

Hence, the Fed must navigate a delicate balancing act, nurturing a jobs recovery that still has a ways to go before reaching full employment while keeping inflation in check so that wage gains are not more than offset by rising prices. Not coincidentally, the Fed's pivot to a less accommodative policy is occurring alongside a corresponding increase in public angst over inflation. As is the case with most trends, some sectors are hurt more than others by the inflation pickup this year. Large firms, for example, are able to absorb higher labor and input costs better than smaller firms, and are better equipped to cope with supply shortages. With regards to the latter, it was reported this week that Amazon, Home Depot, Walmart and several other giant corporations have chartered their own cargo ships to circumvent the container shortage that is preventing other firms from accessing the imported goods they need for the upcoming holiday shopping season. The shortage of goods and labor along with rising costs are the main culprits behind the plunge in small business optimism in recent months.

Likewise, inflation is taking a severe toll on household sentiment. On Friday, the University of Michigan reported that its sentiment index fell sharply in early November, falling to its lowest level in a decade. Households are mainly chagrined with the ineffectiveness of government policies in dealing with inflation, which is wiping out nominal income gains achieved in the workplace. Half of the families in the survey expected their real incomes to fall next year, which is not a good omen for future spending. On the positive side, the inflation upsurge has not had a meaningful impact on inflation expectations. Household expectations for the next year did creep up 0.1 percent to 4.9 percent, but surging gasoline prices typically boost short-term inflation expectations. But inflation expectations over the next five to ten years held steady at 2.9 percent.

Importantly, the stability of the long-term gauge indicates that inflationary expectations have not become unanchored, which is an encouraging observation for the Fed. That, together with household expectations of declining real incomes next year, reduces the threat that consumers are poised to accelerate purchases to avoid higher prices in the future. If anything, higher prices are proving to be more of a deterrent than an accelerant to consumption. That said, healthy balance sheets, elevated savings and a robust jobs recovery should support a solid increase in spending in coming months, despite higher prices, before tapering off next year as these demand boosters unwind. Simply put, the risk that inflationary pressures will prod the Fed into an earlier and more abrupt shift away from an accommodative policy has clearly increased. But contained inflation expectations together with a receptive bond market give it some time to stick with its current strategy at least for several more months.

FINANCIAL INDICATORS

INTEREST RATES	Nov 12	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.05	0.06	0.05	0.09
6-month Treasury bill	0.07	0.08	0.06	0.10
3-month LIBOR	0.16	0.14	0.12	0.22
2-year Treasury note	0.52	0.40	0.40	0.17
5-year Treasury note	1.23	1.06	1.13	0.41
10-year Treasury note	1.57	1.45	1.57	0.89
30-year Treasury bond	1.93	1.89	2.04	1.65
30-year fixed mortgage rate	2.98	3.09	3.05	2.84
15-year fixed mortgage rate	2.27	2.35	2.30	2.34
5/1-year adjustable rate	2.53	2.54	2.55	3.11
STOCK MARKET				
Dow Jones Industrial Index	36,100.31	36,327.95	35,294.76	29,479.81
S&P 500	4,682.85	4,697.43	4,471.37	3,585.15
NASDAQ	15,860.96	15,971.59	14,897.34	11,829.29
COMMODITIES				
Gold ($ per troy ounce)	1,867.70	1,819.50	1,768.10	1,890.90
Oil ($ per barrel) - Crude Futures (WTI)	80.69	81.42	82.66	40.66

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer Price Index (October) - % change	0.9	0.4	0.3	0.6
Core CPI (October) - % change	0.6	0.2	0.1	0.5
Producer Price Index (October) - % change	0.6	0.5	0.7	0.7
Small Business Optimism Index (October)	98.2	99.1	100.1	99.9

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