Weekly Economic Update—December 13th, 2021

In the 1970s economist Arthur Okun created the so-called "misery index", designed to track the mindset of a nation that during the 1970s was buffeted by high levels of inflation and unemployment, a confluence of events that economists summarily labeled stagflation. Not taking sides as to whether inflation or unemployment was the more important battering ram on public sentiment, Okun just added them together to devise the index. The higher it went, the more miserable people felt, regardless of the cause, and visa versa when the index declined, pulled down by either lower unemployment or inflation – or better still, both.

The 1970s was a particularly trying decade for Americans as the Arab oil boycott and surging oil prices sent the index skyrocketing twice during the period that featured alternating bouts of accelerating inflation and unemployment and occasionally both. At the index peak of 19.9 in mid 1975, inflation was running at 11.8 percent combined with an elevated 8.1 percent unemployment rate. The intense misery level spilled over into early 1980, when the index peaked at an even higher 21.9 percent, thanks to a 14.4 percent inflation rate tethered to a still-elevated 7.8 percent unemployment rate.

Each decade saw the index spike by varying degrees, reflecting a series of catalysts. They included another oil-price surge in the late 1980s leading up to Iraq's invasion of Kuwait and subsequent recession in the early 1990s, the dot-com collapse in the early aughts that led to a mini-spike in the index, and the Great Financial Crisis of 2008, which ignited a more significant increase. But the pandemic-fueled surge in the misery index last year hit a peak that towered over the previous three and rivaled the misery apex reached in the mid-70s and early 1980s. Indeed, last year's spike was much sharper and swifter than any preceding increase, surging from 5.9 to a peak of 15.1 in just one month – from March to April – in contrast to the roughly 3-year span from trough to peak that marked the two increases in the index more than four decades ago.

Clearly, the shock from the pandemic, which abruptly sent the economy into lockdown and drove the unemployment rate to a depression-era high of 14.4 percent last April from a 50-year low of 3.5 percent just two months earlier, was a bolt out of the blue that underpinned the astonishingly swift and sharp rise in the misery index. In contrast to the earlier increases, inflation played no role this time. Indeed, it actually kept the public's misery from intensifying even more, as the pandemic's shockwaves sent many prices plummeting, dragging the annual inflation rate down below 1 percent during the spring. But that was then.

Since the economy reopened, growth and employment have recovered at a swifter pace than previous postwar recoveries, driving the jobless rate down to 4.2 percent in November. Yet, the misery index after dropping for several months never fell to levels consistent with past expansions. Worse, since its brief downward journey, the index has resumed climbing and erased almost half of the decline. At 11.2 in November, the misery index is around the peak levels normally seen during recessions, except for the twin peaks in 1975 and 1980. But whereas declining inflation cushioned the blow from the surge in unemployment on the misery index last year, just the opposite is driving the index higher now. The scourge of inflation, which hit a 39-year high of 6.8 percent in November, has returned with a vengeance and is the main culprit behind the latest increase.

Not surprisingly, the more popular indexes of consumer sentiment – most notably from the surveys compiled by the University of Michigan and the Conference Board – closely, but inversely, track the ups and downs of the misery index. After a brief recovery following the pandemic recession, the Michigan index of household sentiment is currently hovering at recession levels, notwithstanding a modest uptick reported on Friday for early December. Importantly, the sentiment reading has deteriorated far more rapidly than has the misery index, wiping out all of last year's recovery and then some. This relatively greater dive in the sentiment index reflects the many subjective factors that influence household responses to the survey, including the political landscape and particularly now the ongoing concerns over Covid-19, nurtured by the current rebound in case counts.

That said, households blame inflation as the primary reason for their deteriorating sentiment. In the Michigan survey, 76 percent of respondents said that inflation was a bigger problem than unemployment, dwarfing the 21 percent share that thought unemployment was the bigger problem. Given the robust job market and low unemployment rate, that overwhelming perception should be expected. Still, many analysts and economists are scratching their heads, wondering why households are so downbeat when unemployment is historically low and employers are fiercely competing for scarce workers, leading to accelerated wage increases. Fatter paychecks presumably make people happier and willing to tolerate higher prices.

Simply put, the wage increases are still not keeping up with inflation. With November's 6.8 percent increase in consumer prices over the past year outpacing the 4.8 percent increase in average hourly earnings for workers, the purchasing power of worker earnings continue to deteriorate. In inflation-adjusted dollars, average hourly earnings are no higher now than they were in March 2020, having lost 5.2 percent since April of last year. Hence, it is understandable that households feel they need to run faster just to stay in place, which is not a confidence-building dynamic. One gauge of how important real earnings are to households can be gleaned from the latest University of Michigan Survey.

Despite the generally downbeat reading in the overall index, sentiment among households in the lower third of the income spectrum actually rose by a solid 23.6 percent while upper income groups were more pessimistic. This disparity is consistent with the divergence in wage gains that is evolving, with lower-paid workers gaining significantly stronger pay increases than their more richly compensated colleagues. In the leisure and hospitality sector, for example, average hourly earnings increased by 12.3 percent from a year ago, which is well ahead of inflation and more than double the increase for all workers.

To be sure, the critical issue for the economy is how people act not how they feel although the reverse may be true for politicians. From the macro lens, households are responding more to the upbeat job market than to the downbeat sentiment readings or the spike in the misery index. Consumers are spending freely and spurring a vigorous growth rate in the current quarter that should carry over into next year. The misery index lacks some key components, such as excess savings accumulated during the past year from stimulus payments and unspent funds during Covid-era restrictions that are injecting more life into the economy than indicated by the combined trend in employment and inflation.

However, the longer inflation erodes purchasing power, particularly after pandemic-related savings runs out, the greater the risk that consumers will pull back. It's important to note that while inflation is racing ahead at the fastest pace in four decades, household long-run inflation expectations remain in check. Hence, instead of pulling forward purchases to beat price increases – as was the case in the 1970s when labor also demanded, and received, larger wage increases that fueled a wage-price spiral – consumers are more likely to view price increases as a deterrent to spending, particularly if they do not expect to receive corresponding wage increases going forward.

Importantly, the Federal Reserve, like households, now considers inflation to be a bigger problem than unemployment. Unlike the 1970s, the Fed is poised to act earlier to prevent a sustained inflation outbreak and is expected to start pulling in the reins following its upcoming policy meeting on December 14-15. A key concern in the financial markets is whether the Fed is about to make a policy mistake by moving too abruptly. That's the signal being flashed in the bond market, as manifested by a sharp flattening in the yield curve. The stock market, however, appears unperturbed, as neither inflation concerns nor a possible policy overcorrection prevented a solid gain over the past week.

FINANCIAL INDICATORS

INTEREST RATES	Dec 10	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.06	0.06	0.05	0.08
6-month Treasury bill	0.13	0.10	0.07	0.08
3-month LIBOR	0.20	0.18	0.16	0.22
2-year Treasury note	0.66	0.60	0.52	0.11
5-year Treasury note	1.25	1.14	1.23	0.37
10-year Treasury note	1.48	1.36	1.57	0.90
30-year Treasury bond	1.88	1.68	1.93	1.63
30-year fixed mortgage rate	3.10	3.11	2.98	2.71
15-year fixed mortgage rate	2.38	2.39	2.27	2.26
5/1-year adjustable rate	2.45	2.49	2.53	2.79

STOCK MARKET				
Dow Jones Industrial Index	35,970.99	34,580.08	36,100.31	30,046.37
S&P 500	4,712.02	4,538.43	4,682.85	3,663.46
NASDAQ	15,630.60	15,085.47	15,860.96	12,377.87

COMMODITIES				
Gold ($ per troy ounce)	1,783.10	1,785.10	1,867.70	1,842.00
Oil ($ per barrel) - Crude Futures (WTI)	71.96	66.40	80.69	46.04

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Job openings (October) - mlns	11.0	10.6	10.6	10.5
Quit Rate (October) - Percent	2.8	3.0	2.9	2.8
Consumer Credit (October) - $blns	16.9	27.8	13.5	23.6
Consumer Price Index (Nov.) - % change	0.8	0.9	0.4	0.6
Core CPI (November) - % change	0.5	0.6	0.2	0.4