

Consumers are getting an early start to their holiday shopping, as sales at retailers were considerably stronger than expected in October. It remains to be seen if households pulled forward purchases that normally would take place in November and December, or if the strong October reading is a sign that holiday sales will be particularly festive this year. A lot is at stake, as the strength or weakness of consumer spending will go a long way towards determining the resilience of inflation and how vigorously the Fed will fight the inflation battle.

A narrative some economists accept is that the cure for high prices is high prices. That is, at some point price increases are a deterrent to consumer spending, as they put ever-expensive goods out of reach for budget-constrained households. The ensuing cutback in demand, in turn, prompts sellers to cut prices or at least slow the increases to lure back customers. The basic message conveyed by this narrative is that policy meddling is not required to restore price stability, as market forces will eventually do the job.

This laissez-faire approach to the inflation cycle rarely plays out in real time as it involves patience on the part of policymakers, which carries many risks, and ignores other influences that might short-circuit the desired response by consumers. Instead of deterring spending, accelerating inflation can set in motion a feedback loop that prompts workers to demand bigger wages to keep up with rising prices. Employers, in turn, are willing to accede to worker demands if they are confident in their ability to cover the increased labor costs by raising prices. This chicken-and-egg process (a.k.a., a wage-price, or price-wage spiral) can continue until the Fed or some external shock breaks the cycle.

While the current inflation cycle has elements of this process, it fails to fit the mold in some important respects. Workers are getting bigger pay raises and the rise in labor costs is putting pressure on companies to raise prices. But wage growth has lagged the increase in consumer prices throughout this inflation cycle and yet demand has held up. Personal consumption drove a healthy rebound in GDP during the third quarter and, as noted at the outset, the fourth quarter is starting off on a strong footing. Retail sales rose by a stronger than expected 1.3 percent in October, outpacing inflation by a considerable margin. The control group of sales, which feeds directly into the GDP calculation, also increased by a sturdy 0.7 percent during the month, pointing to upside risks to fourth-quarter growth prospects.

With consumer spending still vibrant despite the fall in real wages, it's clear that demand is deriving some strength from other sources. Among possible candidates, the excess savings accumulated from unspent funds and generous government transfer payments during the pandemic stand out. By some calculations, about \$1.5 trillion above what otherwise would be available were still sitting on household balance sheets in the third quarter. That wealth increment encouraged consumers to spend a larger fraction of their paychecks than they normally would, as manifested by the precipitous decline in the personal savings rate to 3.1 percent in September – the lowest since 2007 – from 7.5 percent at the start of the year.

In addition to spending more of their paychecks, households also took on an enormous amount of debt to sustain purchases. The New York Federal Reserve reported this week that outstanding consumer debt increased by \$351 billion in the third quarter, the largest dollar increase since 2007. Importantly, credit-card debt increased by 15 percent over the past year, the largest advance in more than twenty years. That combination of reduced savings and increased borrowing filled the gap between income and spending growth this year and fueled the excess demand that underpinned much of the inflation spiral.

The question is, how much fuel is still in the tank? If the October increase in retail sales is any indication, the needle is far from empty. But the growth engine is poised to sputter as the income supplements driving

consumption are losing traction. True, there's still an ample amount of excess savings on household balance sheets; but the total has been cut in half over the past year and it's highly likely that the remaining balance resides mostly with wealthier households, who have a lower propensity to spend. Likewise, people with more discretionary incomes no doubt upped their use of credit cards to finance travel and other services that were denied them during the pandemic. This cohort should have little trouble handling the increased debt burden.

But it's also probable that lower- and middle-income families were forced to use credit cards more extensively to purchase gasoline and food, which take up a much larger share of budgets than richer households and whose prices have paced the inflation upsurge. And while prices of gasoline and food have eased in recent months, the cost of borrowing against these and other purchases have increased sharply. Credit card rates are highly responsive to the spike in short-term rates that the Federal Reserve has engineered since March. The Fed reports data on these rates with a considerable lag, but the latest data point for August, 16.3 percent, had already topped the peak for this series that begins in 1994. Since August, short-term rates have spiked by another 1.5 percentage points.

It's fair to say that the spike in financing costs will deter consumer borrowing and, to the extent debt is needed to finance purchases, take some steam out of spending. Simply put, future spending will more closely align with income growth. That, in turn, is where the rubber meets the road. The premise that high prices is a cure for inflation is more credible if there is not enough juice in demand to make price increases stick. Deprived of the income supplements – savings and borrowing – labor income must accelerate to provide that juice or price increases would need to slow. It's no coincidence that the Federal Reserve is keenly focused on labor market trends and worried that a hot job market will nourish the inflation cycle. Highlighting this point, Kansas City Fed President Esther George commented in the Wall Street Journal this week that "I'm looking at a labor market that is so tight, I don't know how you continue to bring this level of inflation down without having some real slowing..."

Other Fed officials have chimed in with the same stringent warning in recent days, supporting the widespread view that more rate hikes are on the way. The surprising strength in retail sales this week only buttressed that prospect. That said, the October burst in spending may have had some artificial help, as Amazon held its second Prime Day sales event during the month, contributing to a hefty 1.2 percent increase in online sales. What's more, California doled out almost \$5 billion in one-time tax refunds to 17.2 million taxpayers in the state, with some families getting checks of as much as \$1050.

From our lens, inflation is destined to slow considerably next year, thanks to the further easing up of supply-chain related product shortages as well as a cooling off in demand induced by the Fed's aggressive rate-hiking campaign. The risk is that by overly focusing on the job market to keep wages in check, the Fed will inflict more pain on the economy than is necessary. We expect a mild recession next year, but if some Fed hawks get their way – St Louis President Bullard opined this week that rates might have to rise to the 5 – 7 percent range to curb inflation – the severity of the recession could be much more severe.

## FINANCIAL INDICATORS

INTEREST RATES	Nov 18	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.23	4.17	3.99	0.05
6-month Treasury bill	4.63	4.54	4.44	0.06
3-month LIBOR	4.67	4.65	4.32	0.16
2-year Treasury note	4.46	4.32	4.50	0.52
5-year Treasury note	4.01	3.95	4.35	1.22
10-year Treasury note	3.78	3.82	4.23	1.54
30-year Treasury bond	3.89	4.06	4.34	1.91
30-year fixed mortgage rate	6.61	7.08	6.94	3.10
15-year fixed mortgage rate	5.98	6.38	6.23	2.39
5/1-year adjustable rate	6.06	5.95	5.81	2.53

STOCK MARKET				
Dow Jones Industrial Index	33,745.69	33,747.86	31,082.56	35,601.98
S&P 500	3,965.34	3,992.93	3,752.75	4,697.96
NASDAQ	11,146.06	11,323.33	10,859.72	16,057.44

COMMODITIES				
Gold (\$ per troy ounce)	1,752.60	1,774.20	1,662.50	1,848.50
Oil (\$ per barrel) - Crude Futures (WTI)	80.11	88.86	85.14	78.99

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/Quarters Ago	Average-Past Six Months or Quarters
Housing Starts (October) - 000s	1,425	1,488	1,508	1,489
Building Permits (October) - 000s	1,526	1,564	1,542	1,618
Retail Sales (October) - % change	1.3	0.0	0.7	0.5
Industrial Production (October) - % change	-0.1	0.1	-0.1	0.1
Producer Price Index (October) - % change	0.2	0.2	-0.1	0.3

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