WEEKLY

Economic Commentary

August 20, 2021

Millennium
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The calendar says that we are smack in the middle of the "dog days of August", but there's nothing languid about the barrage of conflicting influences buffeting the economic landscape. To be sure, the swirl of events for which we have hard data primarily took place in July. But the catalyst for much of the turmoil - the upsurge in Covid case counts, led by the Delta variant - just about assures that things got even more complex this month. In keeping with climactic metaphors, it's fair to say that Delta is throwing a chill on the overheating fears so rampant a few weeks ago.

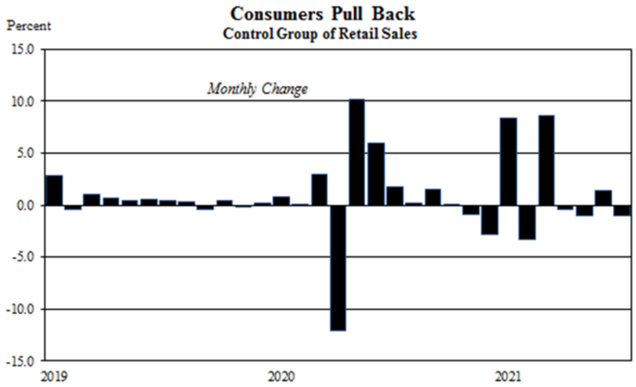
The Fed is no stranger to these sorts of upheavals and it will need to be as nimble as possible to steer the economy through a highly uncertain terrain in coming months. At its last policy meeting in late July, the Delta variant had not reached the full gale force that is now blowing in and stirring the economic pot. Hence, the narrative at that meeting, as detailed in the minutes released this week, was more heavily influenced by positive trends that were unfolding at the time, highlighted by the consensus view that progress had been made towards meeting the Fed's maximum employment and stable inflation goals. Encouraged by that trend, most Fed officials felt that the time to start withdrawing support for the economy was drawing closer, a process that would begin by tapering monthly purchases of government-backed securities.

That said, the presence of Delta was certainly on the radar screen at the time of the meeting, which injected a note of caution into the proceedings. Chairman Powell alluded to the uncertain impact of the spreading virus on economic prospects, and he is probably fretting even more at this point. Still, we suspect that the tapering process is still on the near-term calendar, and a firmer start date could be announced at the September 21-22 FOMC meeting. The Chairman may give some advance notice of the announcement at the Jackson Hole Symposium this coming week, where he will be the keynote speaker. From our lens, the tapering process is likely to start early next year, but it could well be pushed forward into late this year.

The key question, of course, is whether the upsurge in coronavirus cases this month will put a damper on the "progress" that encouraged Fed officials at the last policy meeting. Equally important is whether it would short-circuit the "substantial further progress" that needs to occur before tapering could get underway. Since the July 27-28 policy confab, case counts have increased by nearly 50 percent, reaching levels last seen in late January. That's the bad news. The qualified good news is that the cases are far less severe than the earlier ones, resulting in fewer hospitalizations and deaths. What's more, vaccination rates are ramping up, with 1 million doses given on Thursday alone - the most in nearly two months - and booster shots are on the way. Simply put, the adverse turn in the pandemic should not prompt health and government officials to issue the harsh restrictions on business and social activities that sent the economy reeling last year.

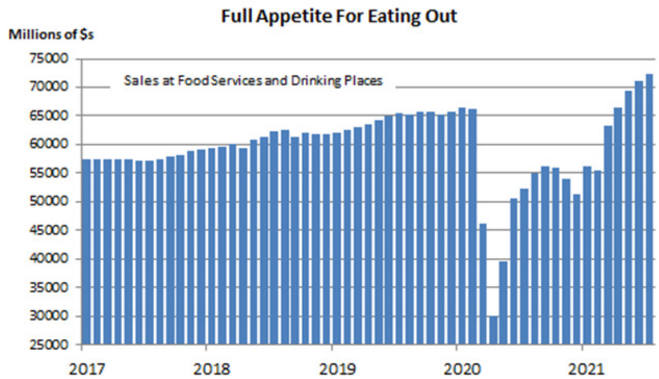
But some growth-dampening barriers are going up in many states, such as requiring proof of inoculation in a broad swath of indoor activities - restaurants, gyms and entertainment venues, among others - which could crimp the revival in services that is now powering the economy's growth engine. The Delta variant is also taking a toll on household confidence, as reflected in the plunge in sentiment in early August reported by the University of Michigan last week. That plunge comes on the heels of a robust jobs report in July and amid ongoing fierce competition for workers by companies struggling to fill a record number of unfilled positions.

Given the solid job market and the fact that households are awash in cash, thanks to massive government transfer payments, the stage should be set for an outsized increase in consumer spending. But this is where the conflicting influences noted earlier are muddying the economic waters. Instead of unleashing a torrent of demand, consumers zipped up their wallets and purses for goods in July, sending retail sales tumbling by a much deeper than expected 1.1 percent during the month. The core group of sales, which excludes autos, building materials and gasoline that enters into the GDP calculation, also fell by 1.0 percent. True, it would be misleading to characterize the pullback as the start of a weakening trend in consumer spending. For one, it followed a strong sales increase in June, including an upwardly revised 1.4 percent gain in the control group of sales. For another, most retail sales are for goods that consumers have loaded up with during the pandemic, having been denied access to most services during the height of the health crisis.

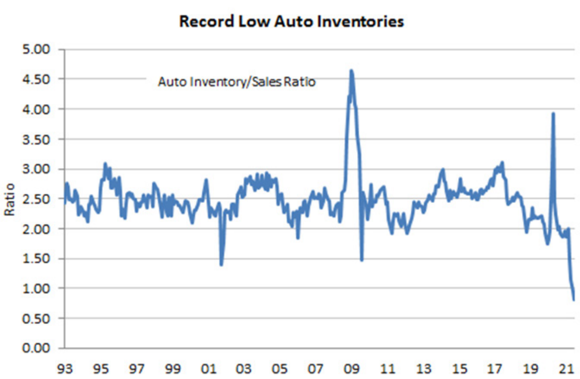


Hence, the retail sales report does not capture the rotation in consumer spending, from goods to services, that is now underway. The sliver of spending on services included in the retail sales report amply illustrates this shift in consumer spending preferences. Restaurants and bars, for example, constitute the only category to see sales increase for five consecutive months, including a 1.7 percent increase in July. Among the other increases, the strongest was for gasoline sales, which posted a 2.4 percent gain. But that reflected another rise in prices at the pump as much as miles traveled. If people are driving more, it is probably pumping up sales for services more than for goods, which can readily be purchased at home via the Internet. But e-commerce sales also took it on the chin last month, falling by 3.1 percent. That may be because Amazon moved up its prime-day sales event to June from July, but online sales declined in two of the past three months, so there may be something more organic going on.

We expect consumers to keep spending at a healthy pace in coming months, led by the ongoing revival in demand for services. While households may have their fill of goods, it's important to note that sales of merchandise are being suppressed by supply constraints as well as softening demand. This is particu-



larly the case for motor vehicles, as the shortage of computer chips is stifling production and resulting in exceptionally lean inventories on dealer lots. The latest data on auto inventories is for June; supply may have expanded in July thanks to a solid 11.2 percent increase in auto production - the strongest in a year - according to that month's industrial production report released this week. But the chip shortage remains acute, prompting Toyota to announce that it is slashing output by 40-60 percent in North America.



Not coincidentally, Toyota blamed the latest plant shutdowns on fresh outbreaks of Covid-19 in Asia, which caused chip manufacturers there to close down operations. This further indicates that the global supply chain disruptions caused by the pandemic is far from over. Nor is the shortage of chips the only culprit causing supply constraints. Ships are clogging ports around the world, resulting in delivery delays for parts and supplies for a wide variety of products. On a positive note, domestic production is ramping up. In addition to the increase in auto assemblies last month, manufacturers in general increased production by a solid 1.4 percent, led by a 2.4 percent increase in durable goods. Even excluding the outsized contribution from auto assemblies, manufacturing output staged a healthy 0.7 percent increase last month.

We expect output to continue to advance at a healthy clip and steadily narrow the gap between supply and demand. The latest manufacturing survey by the Institute of Supply Management shows that the supplier deliveries index slipped in July from its record peak reached two months earlier, but is still the fifth highest on record. Assuming the Delta outbreak doesn't worsen materially and further disrupt the supply chain, the easing of supply pressures should continue. That, in turn, would also take some pressure off prices, giving the Federal Reserve more time to assess the impact the Delta variant is having on demand.

As worrisome as the upsurge in covid cases is, it's unlikely to stifle the recovery for reasons noted earlier - ramped up vaccination rates, less severe symptoms among the afflicted and a determination by government officials to keep the economy open. The wild card is the public's response to the rising case counts. High-frequency data suggest that people are dining less frequently, as reflected in bookings recorded by OpenTable, and rethinking traveling plans. The Transportation Security Agency (TSA) monitors checkpoint travel numbers, and the latest data (for August 19) shows that the number of passengers trails the corresponding period in 2019 (pre-pandemic) by 23.2 percent. On August 1, just before the current upsurge in Covid cases, the shortfall was a slimmer 16.7 percent.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

INTEREST RATES	August 20	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.05%	0.06%	0.05%	0.10%
6-month Treasury bill	0.05	0.05	0.05	0.12
3-month LIBOR	0.13	0.12	0.13	0.26
2-year Treasury note	0.23	0.21	0.21	0.16
5-year Treasury note	0.78	0.78	0.72	0.27
10-year Treasury note	1.26	1.29	1.28	0.64
30-year Treasury bond	1.87	1.93	1.92	1.35
30-year fixed mortgage rate	2.86	2.87	2.78	2.99
15-year fixed mortgage rate	2.16	2.15	2.28	2.54
5/1-year adjustable rate	2.43	2.44	2.49	2.91
STOCK MARKET				
Dow Jones Industrial Index	35120.08	35515.38	35061.55	27930.33
S&P 500	4441.67	4468.00	4411.79	3397.16
NASDAQ	14714.66	14822.90	14836.99	11311.80
Commodities				
Gold ($ per troy ounce)	1782.90	1779.80	1801.90	1924.35
Oil ($ per barrel) - Crude Futures (WTI)	62.25	68.88	72.95	42.73

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Retail Sales (July) - % change	-1.1	0.7	-1.4	1.3
Industrial Production (July) - % change	0.9	0.2	0.8	0.3
Capacity Utilization (July) - Percent	76.4	75.4	75.3	74.8
Housing Starts (July) - 000s	1534	1650	1594	1577
Building Permits (July) - 000s	1635	1594	1683	1688
Inventory/Sales Ratio (June)	1.25	1.26	1.25	1.28

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