

WEEKLY

Economic Commentary

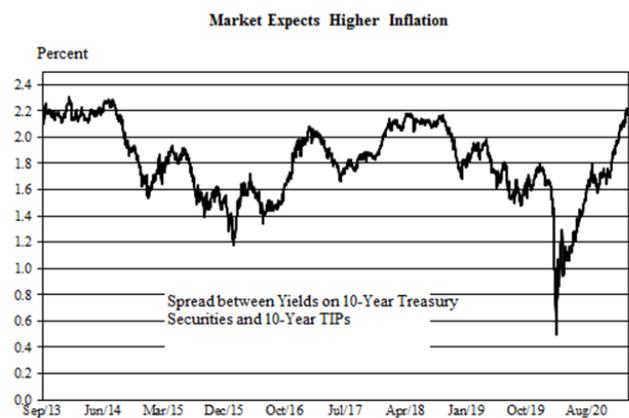
February 12, 2021

As the debate over whether the proposed \$1.9 trillion fiscal stimulus is too much or too little continues to rage, the administration has the upper hand and appears intent on pushing through as much of that package as it can. To be sure, Congress is currently embroiled in the impeachment trial, which is sucking all of the legislative energy out of the Senate. That said, President Biden has indicated reluctance to compromise on certain issues that had been thought to be on the bargaining table, such as reducing the size and/or income limits of the planned \$1400 direct payments to households. The votes have yet to be counted, and there still could be enough of a pushback in Congress that would result in meaningful changes to the American Rescue Plan; but it now appears that the fiscal stimulus will carry somewhat more punch than thought a few weeks ago.

Not surprisingly, as that prospect becomes more likely so too will critics more vehemently argue that the massive size of the stimulus, on top of the \$900 billion passed in December, will bring unwelcome consequences for the U.S. economy. The most problematic risk is that it would stoke more demand than the economy can potentially accommodate without igniting an inflation outbreak. After all, the fiscal package alone exceeds the so-called output gap, the space between what the economy can potentially produce when it is at full employment and production is running at full capacity, and the goods and services that it is currently generating. But while the math seems valid, advocates for the administration's agenda question its underlying assumptions, which are drawn from historical relationships that may no longer be relevant. They also question whether the math itself rests on faulty measurements, such as what constitutes full employment and potential output, which have shown more flexibility over the years than economists thought possible.

From our lens, the economy is poised for a significant rebound in the second and third quarters, thanks not only to the boost from fiscal stimulus but also the firepower from the vast cushion of savings that households accumulated during the pandemic, which can be used to satisfy pent-up demand, as

well as significant progress on the health front. The rebound in demand will no doubt run into bottlenecks that will put upward pressure on prices and lift inflation above the ranges seen in recent years. Investors have been pricing in that prospect for several weeks, as loftier inflation expectations have contributed to a significant increase in bond yields. The bellwether 10-year Treasury yield broke above 1 percent in January for the first time in eight months, and is currently hovering around a one-year high of 1.20 percent. Meanwhile, real yields have hardly budged, so the spread between the two - the so-called breakeven rate - has widened, confirming the increase in market-based inflation expectations.



Importantly, however, the climb in inflation expectations has yet to be validated in real time. As reported this week, consumer prices remained as tame as they have been throughout the past decade. The headline consumer price index did spike by 0.3 percent in January, the sharpest in six months, owing primarily to higher prices for gasoline. Excluding volatile fuel and food prices, however, the core CPI was flat during the month, and up just 1.3 percent over the past year. That's precisely where it has been for most of the past two decades. But we are only a few short months away from the one-year anniversary of the onset of the pandemic, when rigid lockdown restrictions and business closures sent demand for services off a cliff and, with it, prices, particularly for such things as airlines, hotels, amusement parks and other forms of leisure activity. Compared to those depressed levels, prices on a wide range of services - as well as some goods, such as apparel, which

fell out of favor as people were shut in their homes - will suddenly explode and send the inflation rate sharply higher.

Fed officials are keenly aware of that looming inflation blip but are willing to tolerate it for a period of time before easing up on the monetary accelerator. The consensus view, both inside and outside the Fed, is that once these base effects are in the rear view mirror, the inflation rate will stabilize around levels that the Fed feels comfortable with. We concur with that assessment, although recognize the upside risks that might occur if the combination of fiscal stimulus, the easing of the health crisis and elevated savings ignites a much stronger rebound in economic activity than is currently envisioned. Our sense, however, is that the economy's growth engine will not be overly revved up by these influences.

Keep in mind that as large as the fiscal stimulus is on paper, it does not translate into a dollar for dollar increase in economic activity. Studies of the stimulus provided by the Cares Act last March show that a considerable fraction of households used their direct checks to bulk up savings accounts or pay down debt. A similar pattern is likely to occur this time as well. Indeed, a recent survey financed by Bloomberg revealed that an even larger fraction of households would put their stimulus checks into savings than was the case last spring. What's more, while upper income households accounted for most of the saving increase last year, the latest survey indicates that a larger fraction of lower income people would also save a portion of their checks this time. While this suggests that the fiscal stimulus will not deliver as big of a near-term bang to the economy, it also indicates that it might have a more enduring effect, as the savings will filter into the spending stream over a period of time.

And that might be key to the sustainability of the recovery once the health crisis is over, as the job market faces major challenges from the wounds left over from the pandemic. Even with the 55 percent recovery of the jobs lost during the pandemic, there are still about 10 million fewer workers collecting paychecks than there were last February. That's a steep hill to climb, which will become even more

of a hurdle the longer these workers remain on the sidelines. The trend is not encouraging, as the share of long-term unemployment, those out of a job for at least six months, has climbed to nearly 40 percent, the highest since late 2012. As these workers languish on the sidelines, the harder it is for them to return to the workforce.

The struggle is becoming ever more apparent. In the early months of the recovery last spring, laid-off workers were quickly rehired as virus cases receded and lockdown restrictions were eased. The job-finding rate, the share of workers that were able to find a job a month after being unemployed, surged to the highest level in at least 30 years. But that rehiring binge soon faded as the pandemic's grip on the economy tightened in the fall and chilled the jobs recovery. Even as payrolls continued to expand, albeit at a slower pace, and layoffs receded, as reflected in declining claims for unemployment benefits, the job-finding rate plunged to four-year lows. No doubt, the demand for workers will rebound as the health crisis and lockdown restrictions ease, but the National Restaurant Association estimates that more than 100 thousand restaurants have already closed their doors due to Covid-19 and tens of thousands of other small businesses have fallen by the wayside. The small business optimism index compiled by the National Federation of Independent businesses has fallen sharply over the past three months, erasing 70 percent of the gains made over the previous six months. With fewer jobs to return to, the post-pandemic rehiring is not likely to be as swift or as robust as was the case last spring.



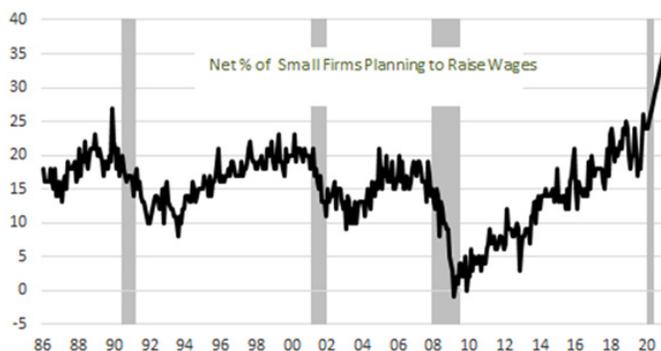
Hence, the pending fiscal aid would provide a critical lifeline for the millions of workers left behind. Eight months into the post-pandemic recovery, there were still 366 thousand fewer job openings in December than in February according to the Labor Department's JOLTS survey, and more than 4 million less than the number of job searchers. High-frequency data indicate that job postings have recovered further in January, returning to pre-pandemic levels. But how many of those jobs will go unfilled because they require skills that unemployed workers don't have? The accelerated pace of vaccine distribution, for example, is spurring a sharp increase in demand for pharmacists, a position that a laid-off restaurant worker is ill equipped to handle.

Interestingly, the mismatch between job listings and available workers may be underpinning an unusual dynamic in the small business community. Although as a group sentiment has turned bleak, the share of firms planning to raise wages in coming months has soared to the highest level in the history of the series. This may reflect the strong influence of firms that face labor shortages, such as the pharmacies, as well as expectations of a hike in the minimum wage, which is a component of Biden's American Rescue Plan. If these firms can pass the increased labor costs on to consumers it would add another impetus to inflation. The NFIB survey indicates that small businesses have regained the pricing power that was decimated during the pandemic, but the share of firms planning to increase prices has not risen above pre-pandemic levels.

Odds are, neither small nor large firms will enjoy unfettered pricing power as the economy recovers from the pandemic over the coming year. Inflation should pick up, as noted earlier, but after the transitory surge in the spring and summer, price increases should stabilize at a modestly higher pace than seen over the past decade. But the seeds for a sustained acceleration are not in place. Bond investors may be pricing in a pick up in long-term inflation, but households are not and they are the ones that will decide if businesses can make big price increases stick. While pockets of the labor force may enjoy increased bargaining power, it is highly unlikely that it will spread among the broader workforce. With a shortfall of 10 million jobs still to recover and job searchers far outnumbering job listings, workers are hardly in a position of strength to demand higher wages. Without the nurturing influence of strong wage gains and escalating inflation expectations, the prospect of a sustained acceleration in inflation seems remote.

As long as inflation remains under control and the job market has huge gaps to fill, both the Federal Reserve and the administration will continue to push for aggressive growth-boosting policies. There are more hands involved in the fiscal process, so the eventual muscle that Washington provides to jump-start the economy's engine may fall short of what the Administration wants. But whether it turns out to be \$1.9 trillion or \$1.3 trillion, the fiscal impetus will be substantial and necessary, not only to juice the growth rate but also to encompass a broad spectrum of the population, including those who otherwise would be left behind.

Luring Workers With Higher Pay



KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

	February 12	Week Ago	Month Ago	Year Ago
INTEREST RATES				
3-month Treasury bill	0.05%	0.03%	0.09%	1.57%
6-month Treasury bill	0.06	0.05	0.10	1.57
3-month LIBOR	0.20	0.19	0.23	1.73
2-year Treasury note	0.11	0.11	0.12	1.40
5-year Treasury note	0.49	0.47	0.45	1.41
10-year Treasury note	1.21	1.17	1.09	1.58
30-year Treasury bond	2.01	1.97	1.84	2.05
30-year fixed mortgage rate	2.73	2.73	2.79	3.45
15-year fixed mortgage rate	2.19	2.21	2.23	2.97
5/1-year adjustable rate	2.79	2.81	3.12	3.32
STOCK MARKET				
Dow Jones Industrial Index	31458.40	31148.24	30814.26	29102.51
S&P 500	3934.83	3886.83	3768.25	3327.71
NASDAQ	14095.47	13856.30	12998.50	9520.51
Commodities				
Gold (\$ per troy ounce)	1823.60	1815.20	1826.10	1573.90
Oil (\$ per barrel) - Crude Futures (WTI)	59.69	57.07	52.12	50.34

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Consumer Price Index (January) - % change	0.3	0.2	0.2	0.2
Core CPI (January) - % change	0.0	0.0	0.2	0.1

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