WEEKLY
Economic Commentary

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Millennium
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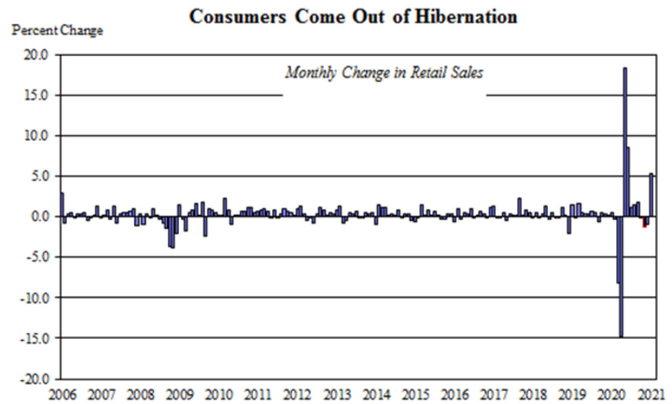
Christmas came late this year for retailers, as Santa sled straight out of Washington and delivered checks to households in January, sending them on to a belated shopping spree. The question is, was it "bad" or "good" Santa that shimmied down the economic chimney? No doubt, many will view the check-bearer as bad Santa, one who is set to become an even bolder stocking-stuffer next month when the government would have him deliver another even larger batch of goodies to an undeserving American public. These critics argue that the largess is more than enough for the needy, and will nourish an overstuffed economy that eventually breaks out into an inflation sweat.

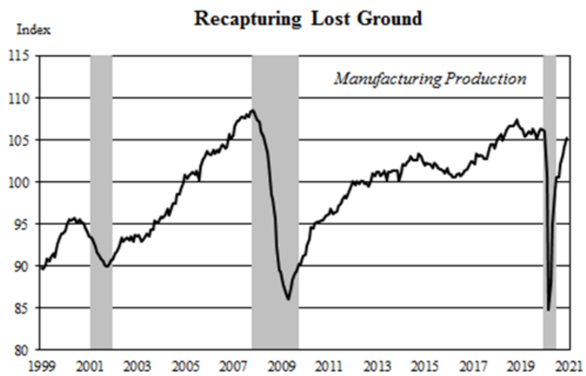
This sentiment is gaining support, but it still echoes Scrooge in this unfolding saga. While the economy is hardly as desperate as Bob Cratchit, it is still struggling to make ends meet. Yes, the $600 checks sent out in early January combined with the extension and additional $100 weekly topoff to unemployment benefits played a key role in turning consumers from dormant into buoyant shoppers last month. But the transformation was a long-time coming, as the January burst in retail sales followed three months of declines that left the economy staggering at the end of last year. It's unclear if this outburst was primarily an expression of relief from many distressed households, who now have a lifeline to carry them through the next few months of pandemic headwinds.

Future research will determine how much of the spending outburst sprung from the less-wealthy households, those who held back late last year because of growing job insecurity and fading government income support. The retail sales report released this week is hardly revealing, as all major categories of sales increased in January. Indeed, the 5.3 percent increase swamped the consensus forecast of roundly 1 percent and was the largest monthly gain in seven months. Take out the outsized snapbacks in April and May when consumers emerged from lockdown bunkers to restock depleted household goods and you would have to go back nearly 10 years to find another monthly increase as large.



As was the case last spring, the easing of business and social restrictions boosted sales at establishments that were most affected by pandemic shutdowns. Restaurants and bars enjoyed a 6.9 percent rebound in customer traffic, although their sales are still languishing nearly 20 percent below pre-Covid levels. Other sectors, however, experienced a full comeback and then some. The biggest gainers, not surprisingly, are those firms selling to consumers who have been stuck in their homes throughout the health crisis. These include online shoppers who have driven sales at nonstore retailers 27.5 percent above pre-Covid levels, punctuated by an 11 percent surge in January. Likewise, households have resumed love affairs with hobbies and books, and are listening to more music, boosting sales in this category 21.6 percent above pre-pandemic levels.

Understandably, factories making these goods are thriving as well. Manufacturing output rose for the fourth consecutive month in January, posting a 1.0 percent increase. With the latest advance, manufacturers have now recovered more than 95 percent of the output losses wrought by the pandemic shutdowns. And like retail sales, the gains have been widely distributed across all major sectors. One key exception being automobiles, where production has been stymied by a shortage of semiconductors, something that continues to bedevil other industries as well and is stirring policy discussions regarding the reliance of such critical components on foreign sources. Together, the strong gains in retail sales and industrial production throws a new, much brighter light, on the economy's early-year performance.



In an astonishing turnabout from late last year, the economy opened 2021 with renewed momentum, spurring an upgraded assessment of the first quarter's outlook. It was only a few short months ago that the risk of a double-dip recession loomed large. That grim prospect, however, has all but vanished as early indicators are tracking a growth rate of over 7 percent for the first quarter. That would represent an acceleration over the previous quarter's 4.0 percent annual rate and set the economy on course to recover pandemic-related output losses by midsummer. Clearly, the $900 billion fiscal stimulus passed in December has played a key role in jump-starting the economy's engine. It is also adding fuel to the controversy regarding how much more stimulus is needed if the economy has regained its footing, or whether bad Santa is overdoing his stay.

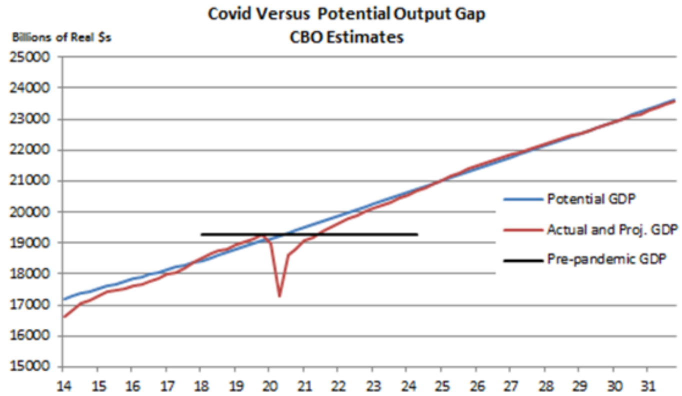
No doubt the surprisingly upbeat start to the year will stoke the controversy and dominate the policy narrative in coming weeks. That said, the Biden administration remains intent on keeping a muscular package in the forefront of congressional deliberations next week. Whether the ultimate bill turns out to be $1.9 trillion or, as we expect, slightly less, its impact will be significant and provide powerful support to the looming mini-boom in activity that is poised to take place over the spring and summer months. To be sure, a major impetus will also be provided by the progress being made on the health front. Case counts are declining precipitously, notwithstanding the emergence of new variants, and the daily doses of vaccinations have risen to 1.7 million, exceeding the government's timetable set last month.

With herd immunity expected by midsummer, the pandemic's grip on the economy should ease considerably, allowing the post-Covid revival in activity to unfold. The question remains, however, as to whether the fiscally-stimulated rebound would drive the economy into inflationary waters, validating critics who believe the proposed size of the American Rescue Plan is overkill. While acknowledging that the upside risks to the outlook has increased, we concur with Treasury Secretary Yellen's assessment that the bigger risk is doing too little rather than too much. For one, the economy is emerging from a historical crisis, much as was the case following the Great Financial Crisis in 2008. A lesson learned from that episode, when policymakers were pressured to limit the size of fiscal stimulus, is that doing too little can hamper recovery by not unshackling the economy from the lingering restraints of the crisis.

For another, the inflation threat that underpins the anti-stimulus argument is just that - a threat that remains far removed from reality. Yes, the bond vigilantes are once again peering through the woodworks, sending long-term Treasury yields to one-year highs. The climb reflects a combination of expected higher inflation as well as stronger growth. But the inflation component, based on the yields spread between Treasury securities and Treasury inflation-protected securities, stands at about 2.20 percent. That's more than double the low reached last March, the depths of the pandemic recession, but hardly an alarming prospect if actual inflation does rise to that level. Indeed, Fed Chair Powell would welcome that threat, as the Federal Reserve has been unsuccessfully striving to lift inflation to its 2 percent target on a sustained basis for years.

Keep in mind that market based inflation expectations also surged coming out of the Great Financial Crisis. The so-called breakeven rate on the 10-year note rose from near zero in 2008 to about 2.50 percent in April 2011 before moving still higher to over 2.60 percent a year later. Of course, that increase in market-based inflation expectations was not matched in reality. Except for a brief period in 2018, the Fed's preferred inflation gauge, the personal consumption deflator has persistently remained below 2 percent since that target was officially adopted in April 2012. In all likelihood, it will rise to the occasion in coming months, as the mini-boom expected over the second quarter allows businesses to restore the deep price cuts made during the pandemic, lifting inflation above 2 percent. We suspect that this time, inflation will remain above the 2 percent threshold, but not break out into an uncontrollable climb.

For that to happen, the economy would need to outperform even upgraded growth expectations and create bottlenecks in both the product and labor markets. What's more, it would need to stoke an increase in inflation expectations among households as well as investors beyond the ranges seen over the past two decades. None of that seems likely in our view. While the output gap created by the pandemic recession should be closed by mid-summer, the economy is still a ways from running at full potential. According to the Congressional Budget Office, that is not expected to occur until 2025. Importantly, the economy's potential output is a flexible target that can be raised if prompted by growing demand for more capacity.



Nor is the labor market anywhere close to full employment, a starting point for upward wage pressures to gain traction. There are still almost 10 million fewer jobs than there were prior to the pandemic, and the labor force participation rate is a full two percentage points below its pre-pandemic level. The drop in participation has fallen disproportionately on women and people of color, who have been the most adversely affected by the health crisis.

There is a reason that the administration's fiscal proposal is called the American Rescue Plan rather than another stimulus. While the overall economy may no longer need to be rescued, major pockets of the population do. This is what "good" Santa does.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

INTEREST RATES	February 19	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.04%	0.05%	0.08%	1.58%
6-month Treasury bill	0.05	0.06	0.09	1.55
3-month LIBOR	0.18	0.20	0.22	1.69
2-year Treasury note	0.10	0.11	0.12	1.42
5-year Treasury note	0.58	0.49	0.43	1.42
10-year Treasury note	1.34	1.21	1.09	1.59
30-year Treasury bond	2.13	2.01	1.85	2.04
30-year fixed mortgage rate	2.81	2.73	2.77	3.47
15-year fixed mortgage rate	2.21	2.19	2.21	2.97
5/1-year adjustable rate	2.77	2.79	2.80	3.28
STOCK MARKET				
Dow Jones Industrial Index	31494.32	31458.40	30996.98	29398.08
S&P 500	3906.71	3934.83	3841.47	3380.16
NASDAQ	13874.96	14095.47	13543.06	9731.18
Commodities				
Gold ($ per troy ounce)	1780.90	1823.60	1853.20	1586.90
Oil ($ per barrel) - Crude Futures (WTI)	59.00	59.69	52.05	52.22

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Retail Sales (January) - % change	5.3	-1.0	-1.3	1.0
Industrial Production (January) - % change	0.9	1.3	0.9	0.8
Capacity Utilization (January) - Percent	75.6	74.9	73.9	73.8
Housing Starts (January) - 000s	1580	1680	1553	1526
Building Permits (January) - 000s	1881	1704	1635	1635
Producer Price Index (January) - % change	1.3	0.3	0.1	0.4

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