# WEEKLY
## Economic Commentary

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Millennium
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As advertised, the economy is going through a rough patch before the widely expected improvement sets in. What is not known is how rough the patch will turn out to be and how long it will last. The answers to those questions will depend almost entirely on how the health crisis evolves and how government officials respond. Developments on the health front are not very encouraging; cases of the virus, hospitalization and death rates continue to set daily records even as the rollout of Covid-19 vaccines is proceeding far too slowly to stem this distressing trend. Understandably, a number of states are imposing tighter restrictions on social behavior and business operations. This confluence of events is adding to downward pressure on economic activity.

But all is not gloom and doom on either the health or government fronts. While the vaccine rollout is proceeding at a slower pace than expected, reflecting shortcomings in distribution and manufacturing, it is gradually covering more of the population. A third vaccine from Johnson and Johnson is likely to hit the market soon, boosting supply and enhancing the prospect that most of the population will be inoculated by mid-year, bringing the nation closer to herd immunity. When that milestone is reached, the prospect for the economy will also brighten considerably.

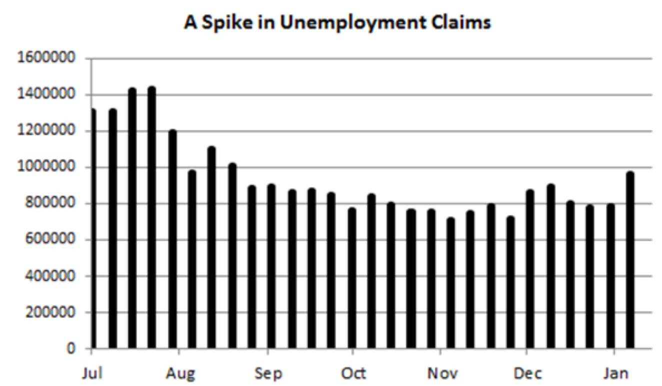
And while state and local governments are battening down the hatches to curb infections, the incoming Biden administration is pulling out all stops to deal with the health crisis and cushion the economy from its growth-damaging effects. The president-elect announced a $1.9 trillion coronavirus relief bill on Thursday, which would be more than double the stimulus provided under the Economic Recovery Act following the Great Financial Crisis during the Obama-Biden administration. The package contains wide-ranging measures of support, including $70 billion targeted for the vaccine campaign and Covid testing. There should be little resistance from Congress on the bill's components aimed at pulling the nation out of the grip of the pandemic, but other elements are likely to find a less receptive audience in a still highly-polarized Congress.

That said, the ever-worsening health crisis and dismal incoming reports that portray a sinking economic ship should bolster more bipartisan support for economic relief than otherwise. No doubt, some lawmakers will object to the additional stimulus checks sent to households ($1400 on top of the $600 approved in the December relief package) as well as the expanded unemployment benefits, reasoning that household finances in the aggregate are in good shape and unemployed workers should not receive more income than they were earning in previous jobs, as happened for many with the enhanced jobless benefits provided by the $2 trillion coronavirus relief bill passed last March. But that argument, which received support over the summer when the economy was rebounding from the pandemic recession, should attract fewer proponents now for a number of reasons.

For starters, even as the economy emerged briskly from the recession over the spring and summer and more than half of the 22 million laid-off workers regained their jobs, the recovery hardly lifted all ships. While growing wealth and income inequality has been well documented over the past several decades the trend has garnered particular attention over the past ten months, as a booming stock market has bestowed trillions of additional wealth to well-off individuals, and higher-paid workers able to work remotely from home retained their jobs. Conversely, the recession and pandemic took the biggest toll on less skilled, lower-paid workers who hold very little, if any, stocks and comprise the bulk of the 10 million people who still have not recovered the jobs lost at the height of the recession. These individuals occupy the right leg of the K-shaped recovery that has come to define the current cycle.

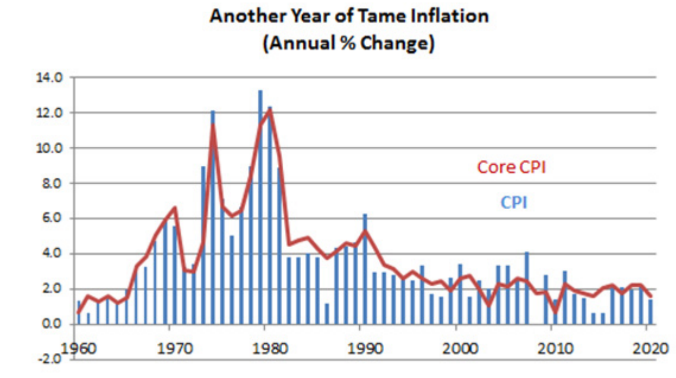
Indeed, Fed Governor Lael Brainard aptly noted this week that "unemployment is likely above 20 percent for workers in the bottom wage quartile while it has fallen below 5 percent for workers in the top wage quartile." Her comment reaffirmed the Fed's commitment to retain an easy monetary policy until the economy is once again generating enough jobs on a sustained basis to bring back these disadvantaged workers. Despite a flurry of concern in the financial markets that the combination of aggressive fiscal and monetary stimulus would stoke higher inflation and spur the Fed to reverse course sooner rather than later, Fed chairman Jerome Powell nixed that notion in an online forum this week, stating that this is not the time to even consider pulling in the reins.

The Fed chief has ample reasons to stay the course. Seven consecutive months of job growth came to an abrupt halt in December, as the economy shed 140 thousand jobs during the month. By all accounts, employment prospects are not improving in January. Not only are job listings continuing to slump, layoffs are spiking once again. The Labor Department reported that first-time claims for regular state unemployment benefits surged by 181 thousand to 965 thousand in the first full week of January, the highest since August. With cases of the virus accelerating and broadening throughout the nation, more states are imposing business restrictions that will sustain the increase in layoffs. If nothing else, the dire near-term outlook for job-searchers, particularly among lower-paid service workers that are most impacted by renewed business closures, should undercut objections to expanded jobless benefits included in Biden's proposed fiscal package. According to the latest Census Bureau's Weekly Pulse Survey, an outsized 75 percent of small businesses have experienced large or moderate negative effects from the pandemic in the January 4-10 week.




What's more, the Fed is amply justified in downplaying inflation concerns. True, some technical issues will likely push inflation above the central bank's 2 percent target some time this spring, as annual comparisons with pandemic-depressed price data from a year-earlier will pump up the inflation rate. But once the base effects drop out of the calculation, inflation should recede below that threshold and stay there for at least another year or two. For sure, no inflation impulse is expected to come from the labor cost side, as it will take years to remove all of the slack in the labor market. Not only are payrolls about 10 million below pre-pandemic levels, the labor force participation rate has fallen to where it stood in the 1970s.

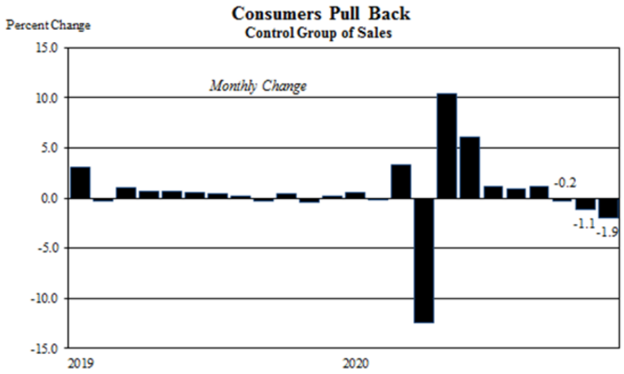
Meanwhile, actual inflation remains extremely tame, ending last year on a soft note. The headline consumer price index did increase by a buoyant 0.4 percent, double the November increase, thanks to a jump in energy and food prices. Strip out those volatile components and the picture changes dramatically. The core CPI eked out a slim 0.1 percent increase and ended the year 1.6 percent higher than its year-earlier level. The headline CPI, even with December's uptick, also punctuated a year of tame inflation, rising 1.4 percent during 2020. That's the lowest annual headline inflation rate in five years. The inflation measure that the Fed uses for its 2 percent target, the personal consumption deflator, runs cooler than the CPI and won't be released until later this month. That is expected to end the year at a very benign 1.2 percent pace.




Keep in mind that under the Fed's new flexible inflation targeting regime, it will tolerate an inflation rate above 2 percent for some time before it starts to discard its turbocharged easy policy. For one, inflation has been below the target for so long that it would take more than a brief period of 2 percent-plus inflation to lift inflation expectations and bring the average up to

2 percent. Importantly, the Fed has abandoned the principle of moving proactively when unemployment falls below certain thresholds, which has guided policy in the past. The experience over the past decade has convinced Fed officials that unemployment can fall to as low as 3.5 percent without generating inflationary pressures. The official unemployment rate is currently at 6.7 percent, but the broader underemployment rate is much higher, hovering near double digits. Fed chair Powell has reiterated time and again that he would like to see the job market run hotter than allowed to in the past to bring disenfranchised workers back to the labor force.

But the economy is a long way from running hot. For it to even start percolating, the main growth driver, consumers, would need to open their wallets much wider than they currently are. Thanks to business restrictions, a rampaging health crisis and the financial squeeze on lower-income households bearing the brunt of the recent layoffs, they are doing just the opposite. In December for the third consecutive month, sales at retail establishments fell, this time by 0.7 percent following a 1.4 percent slide in November. Hence, the torrid third quarter rebound in personal consumption is now a distant memory; the holiday-laden fourth quarter turned out to be more somber than cheerful, as consumers ended the year making fewer purchases at a wide range of retail establishments. In December, sales fell in seven of




the thirteen major retail categories, with the strongest performance turned in by gasoline stations, reflecting higher prices at the pump. But the control group of sales, which excludes volatile nonfood categories like autos, gasoline and building materials and enters directly into the GDP calculations, suffered a steeper drop than headline sales, tumbling 1.9 percent in December.

Again, this is the rough patch the economy is currently struggling with as the pandemic's grip on the economy tightens. We suspect the vise will continue to squeeze life out of the economy this month, making for a distressingly weak opening chapter to the year. But the bleak winter should usher in a much brighter spring and summer as progress towards ending the health crisis picks up speed, easing restrictions on business and social behavior. At that juncture, the economy will have plenty of fiscal ammunition, which, combined with pent-up demand from foregone spending will unleash a mini-boom over the second and third quarters. That will not restore all of the ground lost during the pandemic, but the economy should once again be functioning normally and eating steadily into the shortfall.

# KEY FINANCIAL & ECONOMIC INDICATORS

## FINANCIAL INDICATORS

| INTEREST RATES | January 15 | Week Ago | Month Ago | Year Ago |
|---|---|---|---|---|
| 3-month Treasury bill | 0.09% | 0.09% | 0.08% | 1.55% |
| 6-month Treasury bill | 0.10 | 0.09 | 0.11 | 1.56 |
| 3-month LIBOR | 0.23 | 0.22 | 0.24 | 1.83 |
| 2-year Treasury note | 0.12 | 0.14 | 0.12 | 1.58 |
| 5-year Treasury note | 0.45 | 0.48 | 0.38 | 1.63 |
| 10-year Treasury note | 1.09 | 1.12 | 0.95 | 1.83 |
| 30-year Treasury bond | 1.84 | 1.88 | 1.69 | 2.29 |
| | | | | |
| 30-year fixed mortgage rate | 2.79 | 2.65 | 2.67 | 3.65 |
| 15-year fixed mortgage rate | 2.23 | 2.16 | 2.21 | 3.09 |
| 5/1-year adjustable rate | 3.12 | 2.75 | 2.79 | 3.39 |
| | | | | |
| **STOCK MARKET** | | | | |
| Dow Jones Industrial Index | 30814.26 | 31097.97 | 30179.05 | 29348.10 |
| S&P 500 | 3768.25 | 3824.68 | 3709.41 | 3329.62 |
| NASDAQ | 12998.50 | 13201.98 | 12755.64 | 9388.94 |
| | | | | |
| **Commodities** | | | | |
| Gold ($ per troy ounce) | 1826.10 | 1849.70 | 1886.40 | 1556.70 |
| Oil ($ per barrel) - Crude Futures (WTI) | 52.12 | 52.73 | 49.06 | 58.71 |

## ECONOMIC INDICATORS

| | Latest Month/Quarter | Previous Month/Quarter | Two-Months/ Quarters Ago | Average-Past 6 Months or Quarters |
|---|---|---|---|---|
| Consumer Price Index (December) - % change | 0.4 | 0.2 | 0.0 | 0.3 |
| Core CPI (December) - % change | 0.1 | 0.2 | 0.0 | 0.3 |
| Retail Sales (December) - % change | -1 | -1 | 0 | 0 |
| Industrial Production (December) - % change | 1.6 | 0.5 | 1.0 | 1.3 |

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