

WEEKLY

Economic Commentary

March 12, 2021

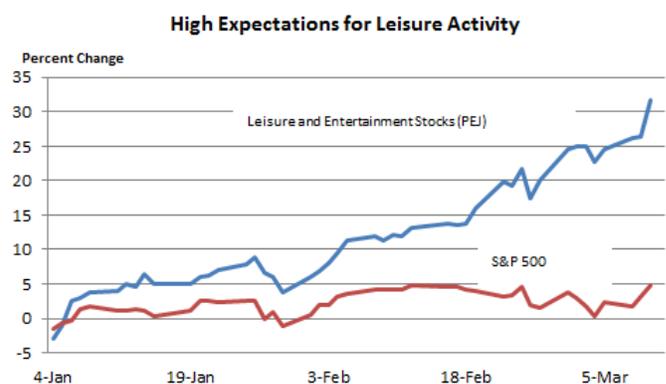
The inflation story got a bit more complicated this week, amplifying the cognitive dissonance resonating through the financial markets. Bond investors, the most visible protagonists behind the increase in inflationary expectations, continued to nudge yields higher, with the bellwether 10-year note yield, at 1.63 percent, reaching the highest level in over a year at week's end. Meanwhile, hard inflation data have yet to validate heightened inflation expectations in the market. Aside from surging energy prices, consumer price inflation was relatively tame in February, as price increases for most goods and services remained well within the ranges seen in recent years. The core consumer price index edged up by a slim 0.1 percent in February and the increase over the past year actually slipped from 1.4 percent to 1.3 percent.

Interestingly, one outlier in the consumer price report for last month was the 0.6 percent jump in recreational prices. Except for an aberrational spike in May 2020, that equaled the steepest monthly increase since July 1996. In every previous incident, recreational prices quickly reversed course, plunging in the following month, highlighting the volatile nature of these prices. There's a good chance, however, that the increase this time will be sustained for a while, pacing the inflation pick-up expected over the spring and summer months. With an increasing number of states lifting restrictions - Texas and Mississippi completely reopened their economies this week - service providers will see a rush of customers, enabling them to restore prices from depressed levels. At the height of the pandemic last spring, the price index for recreational services suffered the steepest decline in more than a decade.

As the virus case count continues to decline and vaccine distribution accelerates, the reopening process will spread more widely, spurring consumers to once again return to restaurants, gyms and other in-person venues, including concerts, theaters and movie houses. Importantly, households will be armed with a formidable amount of purchasing power to satisfy their pent-up demand for these services. The \$1.9 trillion Covid relief bill signed by President Biden this week sends \$1400 checks to most adults, bolsters unemployment benefits

by \$300 a week and provides funds for child care expenses as well as other forms of income support for American families. Additionally, when more purchasing options become available, they will spur households to tap into the more than \$1 1/2 trillion of unspent funds that piled up in savings accounts over the past year.

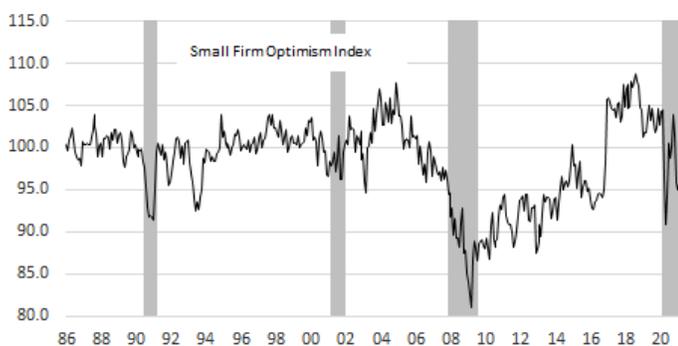
The unleashing of all this purchasing power should enable service providers to regain the pricing power lost during the pandemic. When compared to the depressed prices of a year ago, the annual inflation rate will surge for a period of time until those so-called base effects are removed from the calendar later in the year. But the service sector will still have some catching up to do and will be the main catalyst stoking the economy's growth engine throughout the year. That shift in cylinders driving the economy - from purchases of goods to services - is reflected in the stock market, where prices of companies in the leisure and hospitality sphere have handily outperformed the overall market this year. Conversely, the tech companies that have thrived during the pandemic - as shut-in consumers turned to online activities, boosting the likes of Zoom and video game providers, and funneled most of their purchases remotely through Amazon and other web-based vendors - have seen their stocks languish in recent weeks.



The reopening of the economy is particularly good news for smaller firms that depend on in-person customer transactions. That said, business owners are still reeling from the effects of the winter surge in the virus that prompted states to reimpose restrictions. Their heightened anxiety was reflected

in the small business optimism index compiled by the National Federation of Independent Businesses, which plunged from October through January of this year. As restrictions started to ease in February, the mind-set of small business owners perked up a tad, although the overall optimism index remained well below its pre-pandemic level. In February, the index rose from 95.0 to 95.8, but has a long way to go before returning to the 104.5 level of a year earlier.

Small Firms Still Downbeat

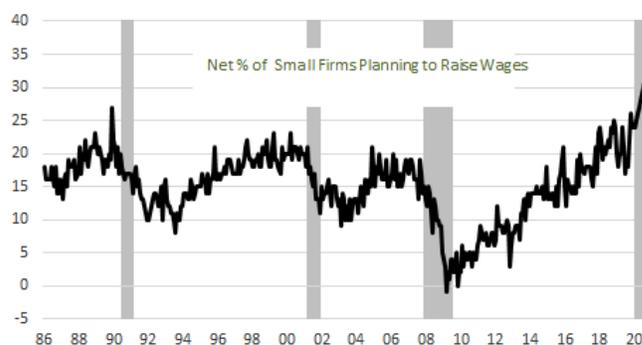


But the details of the NFIB survey align with the inflation theme that is likely to unfold in coming months. As business restrictions ease and customers flock back to stores, owners will need more workers to man cash registers, stock inventory, sell their products, serve customers at bars and restaurants, and manage operations. That drive is well underway, as reflected in the rebound in jobs last month, particularly among small businesses in the leisure and hospitality sector. Even with the surge in job growth, small businesses are finding it ever-more difficult to fill positions. According to the NFIB survey, 40 percent of businesses had at least one job opening they could not fill, the highest share in the history of the survey.

Not surprisingly, businesses will need to offer more attractive pay packages to fill these positions. That imperative, in turn, was strikingly evident in February, as a record 36 percent of businesses planned to hike compensation to lure workers and retain existing staff. No doubt, some of the planned increase reflects the increase in minimum wages being mandated

by a growing number of states. As well, these firms are competing for the same workers that are being recruited by larger well-funded companies, such as Amazon, Target and Walmart, all of which have announced higher minimum wages for their employees in recent months. Indeed, while the administration's push for a \$15 minimum wage has stalled in Congress, the above-mentioned as well as other large firms have already announced they will meet that minimum threshold for workers.

Luring Workers With Higher Pay



To be sure, many small firms believe they can cover the increased cost of labor by increasing prices. In fact, the highest share of firms in more than a dozen years are planning to raise prices, something that would reinforce the upward inflation pressure expected over the spring and summer months. Nor is it just labor that is poised to squeeze costs; small firms are also footing higher prices for goods, as the unleashing of pent-up demand will overwhelm supply for a time. Still, labor accounts for the lion's share of business expenses, and higher wages will represent the biggest source of upward pressure on costs.

To many inflation worriers, the dynamics unfolding on the wage and jobs front reinforce the broader influences that they believe will lead to an unwelcome inflation outbreak in coming years. With \$5 trillion of fiscal stimulus enacted over the past year already in the pipeline and a monetary policy that is committed to keeping short-term borrowing costs at rock bottom levels for the foreseeable future, the seeds for an overheated economy laced with inflation have been planted. Adherents to this view point to the fact that

the economy is already firmly on the road to recovery, and the policy thrust would only hasten the inevitable timetable for corrective anti-inflation action that would send the economy back into a recession.

No doubt, the risk that inflation rises to an unwelcome pace has increased, as have the odds the economy will enter a stronger growth phase than expected by policymakers. But just as there is much fuel for growth in the pipeline, so too is there considerable slack in the product and labor markets to absorb the prospective increase in output and employment. The upcoming surge in pent-up demand and rebound in hiring is highly anticipated by monetary officials. But instead of ruing that prospect, they are welcoming it as a much-needed remedy for the economic and social pain wrought by the pandemic.

Keep in mind that the fastest growing sector facilitated by the lifting of Covid restrictions - leisure and hospitality - hardly reached the limits of capacity. The pandemic vaporized 8.2 million jobs in this sector last March and April, nearly 50 percent of the workforce that existed in February 2020. Since then, 4.8 million jobs have been recovered, including 355 thousand in February, which still leaves nearly 4 1/2 million workers in this sector on the sidelines. Many of them will never return, as a sizeable fraction of companies, mostly small businesses, have closed their doors for good and many others are still struggling with Covid caps that limit operations.

Meanwhile, there are self-correcting forces that will short-circuit a sustained inflation outbreak. Businesses have learned to operate with fewer workers during the pandemic, embracing productivity-enhancing technology, and they will likely resist workers' demand for much higher wages by turning more to labor-saving methods of operations. Meanwhile, households have become accustomed to slowly rising prices following decades of low inflation, and are just as likely to resist price increases that are out of their comfort zone. Inflation expectations remain well anchored and would only become unmoored if a virulent wage-price cycle accommodated by lax monetary policy that underpinned spiraling inflation in the 1970s took root. Those conditions are far from present, and are not likely to surface anytime soon.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

	March 12	Week Ago	Month Ago	Year Ago
INTEREST RATES				
3-month Treasury bill	0.04%	0.04%	0.05%	0.47%
6-month Treasury bill	0.05	0.07	0.06	0.41
3-month LIBOR	0.18	0.18	0.20	1.00
2-year Treasury note	0.15	0.14	0.11	0.53
5-year Treasury note	0.84	0.80	0.49	0.61
10-year Treasury note	1.63	1.56	1.21	0.77
30-year Treasury bond	2.39	2.30	2.01	1.29
30-year fixed mortgage rate	3.05	3.02	2.73	3.29
15-year fixed mortgage rate	2.37	2.34	2.19	2.79
5/1-year adjustable rate	2.77	2.73	2.79	3.18
STOCK MARKET				
Dow Jones Industrial Index	32778.04	31496.30	31458.40	25864.78
S&P 500	3943.34	3841.94	3934.83	2972.37
NASDAQ	13319.86	12920.15	14095.47	8575.62
Commodities				
Gold (\$ per troy ounce)	1722.90	1698.60	1823.60	1674.20
Oil (\$ per barrel) - Crude Futures (WTI)	65.60	66.73	59.69	41.57

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Consumer Price Index (February) - % change	0.4	0.3	0.2	0.2
Core CPI (February) - % change	0.1	0.0	0.0	0.1
Small Business Optimism Index (February)	95.8	95.0	95.9	99.4

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