

# WEEKLY

Economic Commentary

March 19, 2021

For years following the inflationary spiral of the 1970s, the Federal Reserve's biggest challenge was to convince the public and financial markets of its inflation-fighting credibility. The journey to success was long and painful, starting with a harsh growth-stifling turn of the credit screws by the Volcker led Fed in the late 1970s and early 1980s, which sent the economy into a deep recession but broke the back of the inflation spiral. That initial breakthrough enabled subsequent Fed regimes to take less extreme measures to control inflation. But to establish and maintain credibility they felt the need to preemptively act to nip inflation in the bud when underlying conditions, such as low unemployment, pointed to a pick-up in price pressures. By the early 2000s, however, the Fed could safely exclaim "mission accomplished"; not only had it brought inflation down to levels last seen in the 1960s, but it thoroughly anchored inflation expectations, convincing households and the financial markets that it would forever keep the inflation genie bottled up.

In fact, the Fed may have gotten more than it bargained for. In recent years, just the opposite challenge has bedeviled Fed officials, trying to convince the markets that not only would it allow the genie to open the lid, but wants it to roam around for a while. Despite several rounds of unprecedented monetary stimulus since the Great Financial Crisis, their efforts have mostly been in vain. Not only has inflation remained too dormant over the past two decades, but so too have inflationary expectations. To a large extent, the fault lies with the Fed as it continued to respond to conventional portents of higher inflation. For example, it embarked on a three-year rate-hiking campaign in late 2015 when the unemployment rate fell to 5.0 percent, then considered the lowest rate compatible with stable inflation. Yet, the rate hikes continued despite no evidence of an inflation outbreak.

Acknowledging the folly of those preemptive strikes, the Fed recently overhauled its policy framework, promising not to pull the rate trigger until it sees the whites in inflation eyes. Rather than bolstering its inflation-fighting credibility, it is now striving to establish its reflationary bona fides. Since last year, Fed officials have stated time and again that it wants

to see the job market return to full employment and would allow inflation to exceed its 2 percent target for a while without spurring a rate hike. That commitment was reiterated at this week's meeting in which the median forecast of the 18 Fed officials on the policy committee is for no change in the federal funds rate through 2023 even as they expect the unemployment rate to fall to 3.5 percent and inflation to rise above its 2 percent target. The reaffirmation of this dovish stance may or may not be getting through to investors, depending on how you interpret recent market moves.

Following the Fed's meeting, long-term interest rates continued on their astonishing upward trend, with the bellwether 10-year yield hitting 1.75 percent at one point, up 20 basis points from a month earlier and from under 1 percent at the start of the year. But long-term interest rates as well as the shape of the yield curve reflect investor expectations of several forces, including inflation, economic growth, future rate changes by the Fed and uncertainty regarding all of the above, commonly referred to as the term premium. It is unclear how much each of these components is contributing to the surge in bond yields. Some believe that rising inflation expectations are having a major impact while others expect that the Fed will once again blink as the economy picks up steam, prompting it to hike rates sooner than it states.

No doubt, all of the influences cited above are contributing to the upward move. From our lens, the first rate hike will come a bit sooner than the Fed expects, sometime early in 2023 as the economy returns to full health and an inflation rate slightly above the Fed's 2 percent target is sustained. Importantly, however, we do not envision an overheated economy that would ignite an uncontrollable inflation outbreak and send long-term interest rates sky-high. Indeed, we expect that one of the more distinguishing trends in the bond market seen over the past forty years will remain firmly intact.

Since Volcker broke the back of inflation in the early 1980s, every cyclical peak in long-term rates has been lower than the previous peak. For that trend to be derailed, the 10-year Treasury yield would need

to climb to the 3.25 percent peak reached in October 2018 from its current level of slightly over 1.70 percent. While that's clearly not out of the question, it would require a steamier economy and inflation than we envision over the next several years. What's more, while the Fed has opened the door to higher inflation, it is not likely to give it free reign once its dual mandate of full employment and 2 percent inflation has been met for a period of time. It is being patient and tolerant before pulling the rate trigger, but it won't sacrifice the anti-inflation credibility so painfully gained over the past forty years.



To be sure, even as the Fed committed to keeping rates at near zero for the foreseeable future, it significantly upgraded its near-term growth and employment forecast for 2021 relative to the previous quarterly outlook presented at the December meeting. The FOMC now expects a GDP growth of 6.5 percent this year, 2.3 percent stronger than expected in December, and the unemployment rate to dip to 4.5 percent compared to its earlier estimate of 5.0 percent. The Fed also bumped up its inflation forecast to 2.4 percent from 2.0 percent. Critically, though, the growth and inflation spikes this year are deemed to be transitory, as both are projected to subside in 2022 and thereafter, virtually matching the forecast made last December.

The stronger forecast for 2021 comes as no surprise, as the previous outlook was made before the American Rescue Plan with its \$1.9 trillion growth-boosting stimulus was enacted and the vaccine rollout to combat Covid-19 still hadn't begun. The fire lit by these two catalysts has revved up the economy's

growth engine far quicker and stronger than hoped. Recall that in the waning weeks of 2020, the general view was that fiscal stimulus proposed by the administration would be scaled back due to congressional resistance; instead, the Democrats got all they asked for via the budget reconciliation procedure. Importantly, the vaccine distribution has progressed far more rapidly than most health officials projected, allowing broader swaths of the economy to reopen sooner than expected.

Economic Projections of the Federal Reserve: March 2021				
Variable	Median <sup>1</sup>			
	2021	2022	2023	Longer run
Change in real GDP	6.5	3.3	2.2	1.8
December projection	4.2	3.2	2.4	1.8
Unemployment rate	4.5	3.9	3.5	4.0
December projection	5.0	4.2	3.7	4.1
PCE inflation	2.4	2.0	2.1	2.0
December projection	1.8	1.9	2.0	2.0
Core PCE inflation <sup>4</sup>	2.2	2.0	2.1	
December projection	1.8	1.9	2.0	
Memo: Projected appropriate policy path				
Federal funds rate	0.1	0.1	0.1	2.5
December projection	0.1	0.1	0.1	2.5

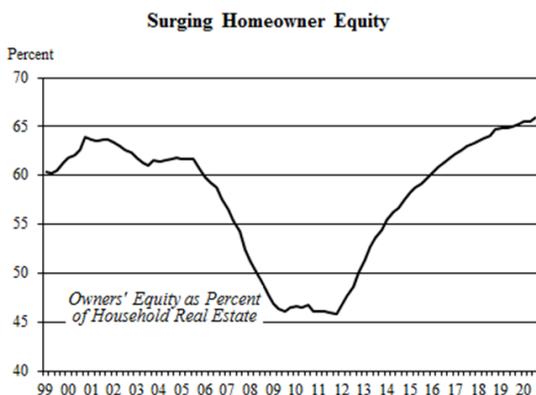
That cocktail of fiscal stimulus, rapid progress on the health front and a turbocharged monetary policy set the stage for a powerful start to the year in sharp contrast to earlier fears that the economy would stumble out of the starting gate, perhaps suffering a contraction in the first quarter. Instead, most economic reports have exceeded expectations over the first two months of the year, notwithstanding a weather-related setback in retail sales and production last month. But those setbacks follow upward revisions in January, leaving the economy on pace for a robust 6-7 percent growth rate for the first quarter. With warm weather approaching, more than half the adult population expected to be vaccinated this spring, and the impetus from the American Rescue Plan now underway, we expect momentum to accelerate in the second and third quarter, resulting in a torrid growth rate of about 7 percent this year, the strongest in nearly 40 years.

In addition to the aforementioned catalysts driving growth, another potentially huge impetus lies in the wings, as households have accumulated nearly \$2 trillion of savings during the pandemic, reflecting funds that weren't spent because of business closures

as well as the direct stimulus payments from the Cares Act passed last spring. Meanwhile, households have built up a formidable cushion of savings in another form - housing equity. Thanks to surging home prices over the past year, homeowners enjoyed a \$1.65 trillion increase in housing equity in 2020, including more than \$650 billion in the last quarter alone. Their equity stake in homes surged to a 30-year high of just under 66 percent at the end of the year.

To be sure, that represents a formidable amount of purchasing power in the wings. However, it is not likely to translate into an equal amount of spending

over the last decade that have vaporized millions of jobs in a short time, many households will likely prefer to keep a higher level of precautionary savings than otherwise, just in case.



power. Homeowners could tap into their housing equity through refinancing, as was the case during the ill-fated housing boom that ultimately ended in a veil of tears for millions of households when the housing market collapsed in 2008. But mirroring the rise in Treasury yields, mortgage rates have also increased significantly this year, making refinancing much less attractive to homeowners. What's more, there are compelling reasons to believe that Americans will retain higher savings than normal going forward.

For one, most of the savings accumulated over the past year has padded the financial resources of wealthier households, who have a lower propensity to spend than people further down the income ladder. For another, wealthier individuals spend more on services than goods, and the forgone spending on many services cannot be made up. It's impossible to make up for a year's worth of lost haircuts or dinners at restaurants. Finally, following two major shocks

# KEY FINANCIAL & ECONOMIC INDICATORS

## FINANCIAL INDICATORS

	March 19	Week Ago	Month Ago	Year Ago
<b>INTEREST RATES</b>				
3-month Treasury bill	0.02%	0.04%	0.04%	0.28%
6-month Treasury bill	0.02	0.05	0.06	0.38
3-month LIBOR	0.19	0.18	0.19	0.74
2-year Treasury note	0.16	0.15	0.12	0.51
5-year Treasury note	0.89	0.84	0.73	0.72
10-year Treasury note	1.73	1.63	1.44	0.98
30-year Treasury bond	2.44	2.39	2.14	1.55
30-year fixed mortgage rate	3.09	3.05	2.97	3.36
15-year fixed mortgage rate	2.40	2.37	2.34	2.77
5/1-year adjustable rate	2.79	2.77	2.99	3.01
<b>STOCK MARKET</b>				
Dow Jones Industrial Index	32627.97	32778.04	30932.37	23185.62
S&P 500	3913.10	3943.34	3811.15	2711.02
NASDAQ	13215.24	13319.86	13192.35	7874.88
<b>Commodities</b>				
Gold (\$ per troy ounce)	1744.90	1722.90	1733.20	1576.40
Oil (\$ per barrel) - Crude Futures (WTI)	61.46	65.60	61.63	32.97

## ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Retail Sales (February) - % change	-3.0	7.6	-1.3	0.6
Industrial Production (February) - % change	-2.2	1.1	1.0	0.3
Housing Starts (February) - 000s	1421	1584	1670	1533
Building Permits (February) - 000s	1682	1886	1704	1666

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