

WEEKLY

Economic Commentary

March 5, 2021

The financial markets continue to sound a down-beat note, sending stock and bond prices tumbling and spurring a quest for answers by investors. Only a strong rally on Friday kept the S&P 500 index from retreating for the third consecutive week, which would have matched the longest losing streak since last September. As it is, the setback over the previous two weeks left the index just 2.3 percent above the level at the start of the year, erasing more than half of the 4.8 percent gain registered over the first six weeks. As dispiriting as that is to stock investors, the pain has been more acutely felt in the bond market. There, yields have climbed steadily since the start of the year, tacking on more than a half-percent to the 10-year Treasury note by the end of this week. At 1.56 percent, this bellwether yield is more than three times higher than its historic low reached last August.

Not surprisingly, the speed and magnitude of the climb in bond yields have stoked speculation over how the Federal Reserve might react. With five Fed governors on the dock to speak publicly this week, there was plenty of opportunity to provide the markets with some guidance as to possible responses. That opportunity, however, came and went, leaving investors with as many questions as answers by the end of the week. Reflecting the lack of direction forthcoming from the Fed, Chair Powell noted on Thursday that while the increase in bond yields caught his attention, the move was not disruptive enough to warrant a response.

From our lens, this makes sense. For sure, the surge in the 10-year Treasury yield was more abrupt than anything seen in years. But it's important to put the move in the context of the rapid pace of unfolding developments. The economy is emerging from a devastating pandemic-induced shock, which vaporized more than 20 million jobs in the span of two months and resulted in the steepest contraction in activity since the 1930s. The existential threat from the health crisis wrought havoc in the financial markets, sending bond yields to all-time lows and the stock market into a deep correction. Stocks have since recovered all of their losses and then some as the combination of massive fiscal support and rapid progress in

developing a vaccine restored investor confidence that the economy would fully recover over time. Indeed, the torrid rebound in stock prices, notwithstanding the recent setbacks, has led many to wonder if the market has gone too far.

Likewise, the bond market has echoed the descent and recovery in the health crisis and, hence, perceptions of the economy. However, despite all the hoopla surrounding the climb in long-term rates, the 10-year Treasury yield has only returned to its pre-pandemic level, sitting almost precisely where it was in mid-February of last year. It should come as no surprise therefore that Chair Powell is confirming the Fed's intention to stay the course, keeping its short-term policy rate at near zero and retaining bond purchases at its current pace of \$120 billion a month until it is convinced the economy is back to full employment and inflation has risen to its 2 percent target on a sustained basis.

The pattern of yield moves in recent weeks fully reflects the Fed's intentions as well as unfolding economic developments. Clearly, the climb in long-term yields indicates that bond investors believe the economy is on the recovery path and inflation risks are rising. But while bond yields have surged since the start of the year, short-term rates have not. The two-year Treasury yield, which is a time-honored gauge of Fed expectations has barely moved for almost a year and is actually a tad lower than where it stood in mid-November. In other words, the Fed's credibility remains intact, as investors fully believe that it will stick to its guns until its goals are achieved. That said, Fed officials are keeping a watchful eye on market developments. While Powell reiterated his intention to stay the course, he also noted that if market gyrations threaten to undermine the achievement of those goals, some action would be taken. Implicit in this message is that the Fed would lean against an increase in bond yields if it thought financial conditions were tightening too much and threaten the recovery in the job market.

So far, however, there is little sign that the jobs recovery is faltering. If anything, it is proceeding faster than most expected. Friday's employment report put an exclamation point on that observation. In February,

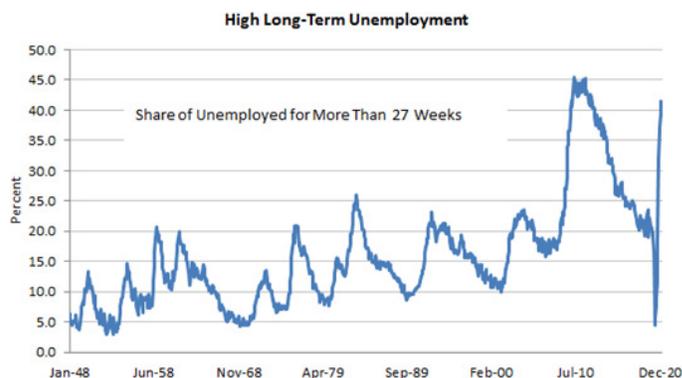
nonfarm payrolls surged by 379 thousand, well ahead of consensus expectations, and the initial estimate for January was revised up from a 49 thousand gain to 166 thousand. If not for the loss of government jobs, the increase would have been even stronger. Private payrolls jumped by 465 thousand. The increases were broadly based, with 57 percent of industries expanding payrolls, up from 48.4 percent in January. Bad weather appears to have held back the headline gain to some extent; construction payrolls, for example, fell by 41 thousand, which is at odds with the outsized strength in home-building activity.

As we noted above, the evolving strength in the economy is a reopening story, and that certainly applies to the job market. Many states eased business restrictions in February, which benefited the service sector more than the goods sector. The discrepancy shows up in the numbers. Service sector employment grew by 513 thousand while jobs in the goods-producing industries fell by 48 thousand following a 13 thousand loss in January. This is consistent with the reopening of the economy, as consumption patterns shifted away from goods to services. The main benefactor of this shift was the leisure and hospitality sector. As consumers flocked to newly reopened bars and restaurants, these business owners put out the hiring sign. Overall, employment in the leisure and hospitality sector surged by 355 thousand last month, accounting for 70 percent of increased service-sector hiring.

Also, on the positive side, the unemployment rate slipped another fraction, falling 0.1 percent to 6.2 percent. Workers got raises as well; average hourly earnings increased 0.2 percent in February and are up 5.3 percent over the past year. But the good news should not be overstated. Beneath the headline figures a host of misgivings looms large. For one, the unemployment rate is undercounting millions of workers who dropped out of the labor force. The labor force participation rate remained at a woefully low 61.7 percent, which is lowest since the 1970s. Adjusted for these dropouts and other factors, the unemployment rate would be over 9.0 percent. Indeed, the Labor Department's own broader gauge

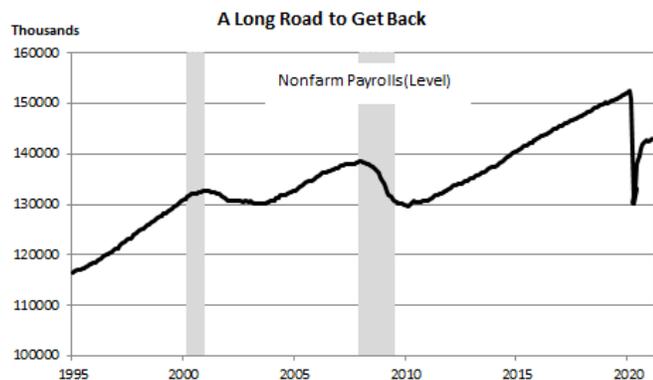
of underemployment, the U6 rate that includes workers in part-time positions who would prefer full-time jobs, as well as other marginally attached workers to the labor force, stands at a high 11.1 percent.

Meanwhile, although the ranks of the unemployed are shrinking, those who are out of jobs are remaining on the sidelines longer. The share of unemployed workers that have been searching for a job for more than 27 weeks increased to 41.5 percent, the highest level since June 2012. The longer a worker remains jobless, the lower are the odds that he or she will find a position. Job skills erode over time, a long stretch of joblessness impairs physical and mental health and discouraged job seekers eventually drop out of the labor force. This is the segment of the workforce that the Fed is intent on bringing off the sidelines and has so far not participated in the jobs recovery.



Indeed, despite the recovery of 12.9 million jobs over the past ten months, there are still 9.4 million fewer workers drawing paychecks than there were prior to the pandemic. We expect that there will be a burst of hiring over the summer as the economy enjoys a growth spurt, which will lead to about 7 million jobs being created over the course of the year. As impressive as that prospect is, it would still leave a shortfall of over 2 million jobs to make up by the end of 2021. Hence, it will be sometime in 2022 before all those job losses are recouped, not counting new entrants to the labor force that will also be competing for jobs. Put another way, the Fed is correct in its view that the job market is far from

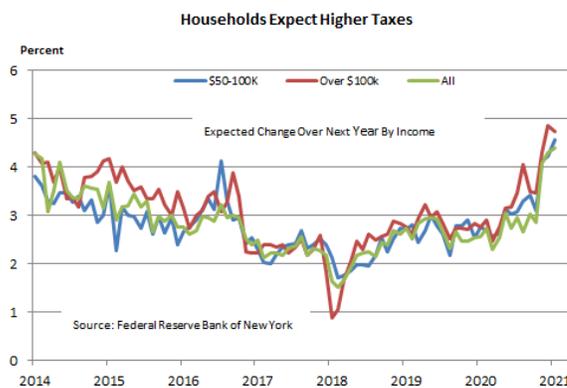
healed, lending heft to its commitment to retain an ultra easy policy until that goal is reached.



But what about the massive fiscal support yet to come on stream on the heels of the stimulus already propping up economic activity? No doubt, the \$1.9 trillion fiscal measure that will become law in coming days will add considerable muscle to the growth engine. Critics argue that there is already a considerable amount of fuel in the pipeline, as households accumulated nearly \$2 trillion of unspent funds into savings during the pandemic. The concern is that the unleashing of these funds to satisfy pent-up demand together with pending fiscal stimulus will send the economy into overdrive, stoking the much-feared inflation flare-up that is being priced into the bond market.

While the risk of stronger growth and inflation than desired has clearly increased, we caution that some of the influences behind this prospect may be overstated. The high savings rate, for example, may not be as big a source of consumption strength as thought. That would be the case if households decide to immediately relinquish these funds into the spending stream as soon as purchasing options become more available when the economy fully reopens. But there are reasons to believe that savings will remain well above normal levels for a while. One reason: Households realize that there is no free lunch and the massive fiscal intervention that is propping up the economy will require higher taxes down the road. According to the latest New York Federal Reserve's survey of consumer expectations,

households expect their tax burdens to increase over the next year and may well be socking away funds for that purpose.



Interestingly, most of the accumulated savings over the past year has been concentrated among wealthier individuals. They are the ones, in turn, who are expected to flood restaurants, book rooms at hotels, return to gyms, go to the theater and plan expensive trips when these service sector activities become widely accessible. But it is also these individuals who are putting aside funds for higher taxes, funds that will not be available for spending purposes. Hence, the high savings rate may reflect more advanced planning than potential firepower to rev up the economy.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

	March 5	Week Ago	Month Ago	Year Ago
INTEREST RATES				
3-month Treasury bill	0.04%	0.04%	0.03%	1.29%
6-month Treasury bill	0.07	0.06	0.05	1.13
3-month LIBOR	0.18	0.19	0.19	1.58
2-year Treasury note	0.14	0.12	0.11	0.94
5-year Treasury note	0.80	0.73	0.47	0.94
10-year Treasury note	1.56	1.44	1.17	1.17
30-year Treasury bond	2.30	2.14	1.97	1.69
30-year fixed mortgage rate	3.02	2.97	2.73	3.45
15-year fixed mortgage rate	2.34	2.34	2.21	2.95
5/1-year adjustable rate	2.73	2.99	2.81	3.20
STOCK MARKET				
Dow Jones Industrial Index	31496.30	30932.37	31148.24	25409.36
S&P 500	3841.94	3811.15	3886.83	2954.22
NASDAQ	12920.15	13192.35	13856.30	8567.37
Commodities				
Gold (\$ per troy ounce)	1698.60	1733.20	1815.20	1580.00
Oil (\$ per barrel) - Crude Futures (WTI)	66.73	61.63	57.07	45.24

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
ISM Manufacturing Index (February)	60.8	58.7	60.5	58.7
ISM Non-Manufacturing Index (February)	55.3	58.7	57.7	57.0
Nonfarm Payrolls (February) - 000s	379	164	-306	317
Unemployment Rate (February) - Percent	6.2	6.3	6.7	6.8

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