WEEKLY
Economic Commentary

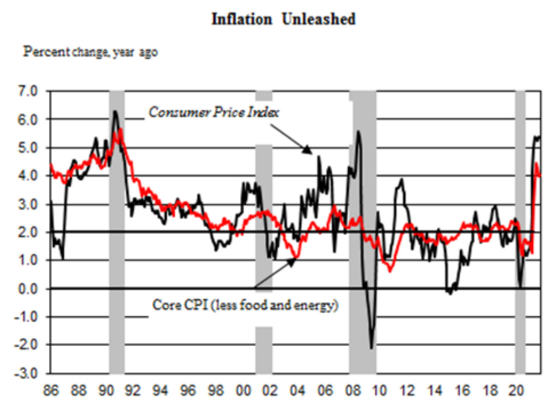
October 15, 2021

Millennium
CORPORATE CREDIT UNION

This week was all about inflation, supply disruptions and worker shortages, spurring as many questions as answers regarding the path of the economy, monetary policy and the role of Washington. One question that no longer needs answering is whether the inflation upsurge now underway is driven by transitory forces that is on the cusp of fully unwinding. While we don't believe a sustained cycle of higher inflation is poised to occur, nor do we think that a return to the pre-Covid environment of lowflation is in the cards, at least in the foreseeable future. The sparks igniting the current inflation surge will simmer for a while and sustain a faster pace of price increases than we've seen during most of this century. But they will gradually burn out over the next several months; once the sizzle is removed, a low burner will keep inflation running modestly hotter than has been the case in the pre-pandemic era.

As the myriad headlines have made strikingly clear this week, the main culprit behind the inflation upsurge - and the one that will keep it running hot for longer - is the pandemic related supply shortages that show few signs of easing. Closed factories overseas due to the virus and adverse weather are keeping much-needed parts from being produced, clogged ports are preventing ships from offloading wares, too few truck drivers are preventing goods from being delivered to warehouses and stores, and a broad swath of companies are losing sales because of a shortage of workers. While demand has cooled from the red-hot pace in the spring and early summer, it is still outpacing the increase in supply, a time-honored confluence that drives up prices.

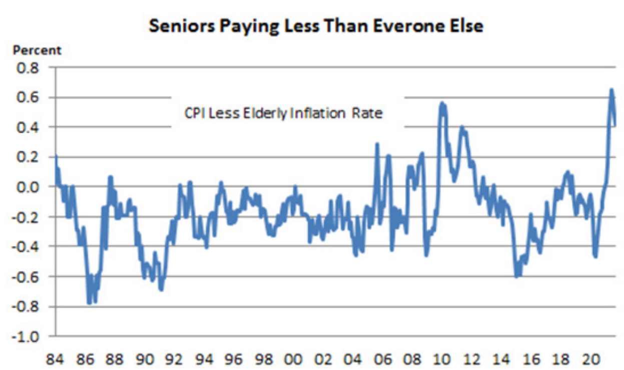
With the demand and supply mismatch firmly in place, the September report on consumer prices released this week, which revealed another month of accelerating inflation, raised few eyebrows. The headline consumer price index rose 0.4 percent from August, lifting the index 5.4 percent above its year-earlier level. That reverses the 0.1 percent dip in August and returns the annual inflation rate to the hottest pace in 13 years reached in both June and July. As was the case back in 2008, surging oil prices are once again a key factor driving up inflation. But back then, the core inflation rate, which excludes volatile food and energy prices, was running at 2.5 percent. Now it is at 4.0 percent, reflecting inflation's impact on a broader basket of goods and services.



Importantly, the financial market took the still-hot inflation report in stride, as stock prices staged an impressive rally following its release on Wednesday and the bellwether 10-year Treasury yield receded from its four-month peak reached earlier in the week. The benign response suggests that investors believe the Fed's plan to start reducing monetary support in coming months will prevent runaway inflation but not stifle the economic expansion. Just as households and businesses are learning to live with the pandemic, so too might investors be more accepting of a future with somewhat higher inflation.

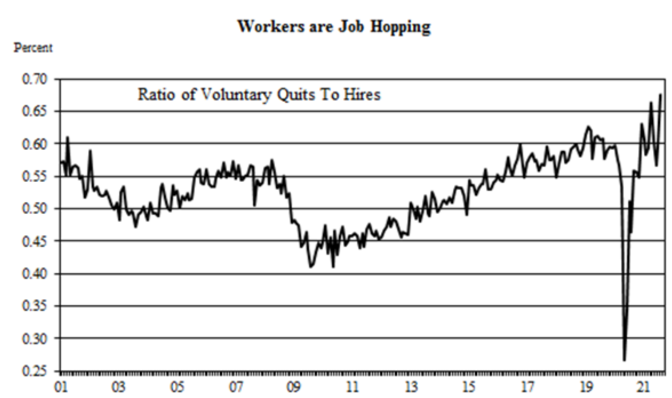
The elevated inflation rate over the past year has brought good news to at least one segment of the population: the elderly collecting social security benefits. These benefits receive annual cost of living adjustments linked to the increase in consumer prices, and the outsized increase in the CPI over the past year is resulting in the largest COLA adjustment - 5.9 percent - in forty years. This is good news for a rapidly expanding age group, particularly among those that have had to rely on skimpy interest receipts on deposits and fixed income securities over the past decade. Indeed, the elderly may be getting a better deal from the COLA increase than the rest of the population, whose purchasing power has been more deeply eroded by inflation.

The Labor Department compiles an experimental price index for Americans aged 62 and older. Like prices in general, the elderly inflation rate has picked up considerably this year, rising to 5.0 percent in September from a year ago, up from 1.4 percent at the end of last year. However, the overall CPI has increased more steeply, rising to 5.4 percent from the same 1.4 percent last December. Hence, inflation has robbed more purchasing power from the general population than from the elderly this year. Indeed, overall inflation has outpaced elderly inflation for six consecutive months, the longest stretch in nearly 10 years, thanks in good part to slower price increases for medical care. For most of the period the index covers going back to 1984, the elderly population has been victimized by a higher inflation rate than the overall population.



In contrast to seniors, inflation has deeply eroded the purchasing power of the working class this year, erasing much of the gains made during the pre-Covid expansion. In each of the last six months, the annual increase in the CPI has outstripped the increase in average hourly earnings for all private sector employees, leaving inflation- adjusted earnings nearly 1 percent lower in September than a year ago. However, the inflation/earnings gap is closing, having narrowed from 3.7 percent in April. What's more, the monthly increase in worker earnings topped the inflation rate in September for the first time since February. Simply put, the labor shortage that is contributing to higher inflation also underpins the faster pace of wage increases now underway. At the current pace of the two trends, the gain in worker pay will soon overtake the annual inflation rate.

Indeed, the increased bargaining power of labor is directly linked to the increased competition for workers, which continues to intensify. True, companies have picked up hiring and are filling more open positions; according to the Labor Department's August JOLTs survey, the number of unfilled jobs declined to 10.4 million from the record 11.1 million in July. The problem is, workers are quitting at a faster rate. In August, more workers quit their jobs relative to new hires than any time on record. Hence, companies have to offer bigger pay packages not only to attract new workers, but also to keep existing workers from leaving. This is a recipe for faster wage gains down the road, a decided plus for household purchasing power that is losing the income support from the massive government transfer payments over the past 18 months.



The question is, how fast will labor compensation increase and how much of the increase will flow through into higher prices, sustaining the inflation cycle? Clearly, if a wage-price cycle gains traction, the consequences for the economy would be dire, as the Fed would need to abruptly step on the brakes, sending the economy into a recession. While that is always a possibility, we don't believe it is likely to occur. For one, the shortage of workers is not open ended, as it is in good part tied to the pandemic. New case counts have declined dramatically so far this month and higher vaccination rates point to a continuation of this trend over the winter. This should enable more schools to reopen, allowing parents to return to the workforce, and diminish health fears that are keeping many people from seeking jobs. As the supply of workers increase, the fierce competition to fill open positions should likewise abate.

For another, companies can offset some of the increase in wages by boosting productivity. Since the onset of the pandemic, nonfarm productivity has increased by almost 3.0 percent, about 50 percent above its long-term trend. In the first half of this year, it increased by 3.2 percent, more than offsetting the increase in labor compensation. Hence, unit labor costs actually declined by 0.8 percent compared to the first half of last year. No doubt, as the supply of workers increases, particularly in the more labor-intensive service sector, productivity gains will slow. And with the fastest wage gains accruing to low-wage, less-skilled workers, unit labor costs should pick up, putting more pressure on employers to raise prices.

However, it is unclear if companies can make much steeper price increases stick. For that to happen, inflationary expectations would need to ramp up and add fuel to the wage-price cycle. Workers would then demand bigger pay raises in anticipation of higher inflation and companies would grant the increases, expecting to pass them on to consumers in the form of higher prices. But long-term inflation expectations have remained well anchored according to recent surveys. The University of Michigan Consumer Sentiment survey released on Friday showed that household inflation expectations over the next 5-10 years actually declined from 3.0 percent to 2.8 percent in early October.

That said, inflation expectations over the next year continued to increase, which is an understandable response to the current inflation spike. Importantly, the price increases are not deterring consumers from making purchases, as retail sales in September staged a stronger increase than expected, advancing by a solid 0.7 percent. Households still have firepower from unspent funds during the pandemic and leftover savings from government transfer payments. Armed with these financial resources, healthier balance sheets and growing optimism over job prospects, consumers should remain in a festive shopping mood heading into the holidays. Odds are, they will also have to pay higher prices for the many goods that will be in short supply during the holiday season. By next year, however, the supply bottlenecks should ease up - both in the labor and product markets - allowing inflation to cool from its red-hot pace to more of a simmer.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

INTEREST RATES	October 15	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.05%	0.04%	0.04%	0.11%
6-month Treasury bill	0.06	0.05	0.05	0.12
3-month LIBOR	0.12	0.13	0.12	0.22
2-year Treasury note	0.40	0.27	0.22	0.14
5-year Treasury note	1.13	0.93	0.86	0.32
10-year Treasury note	1.57	1.46	1.37	0.76
30-year Treasury bond	2.04	2.03	1.91	1.52
30-year fixed mortgage rate	3.05	3.01	2.86	2.81
15-year fixed mortgage rate	2.30	2.28	2.12	2.35
5/1-year adjustable rate	2.55	2.48	2.51	2.90
STOCK MARKET				
Dow Jones Industrial Index	35294.76	34326.46	34584.88	28606.31
S&P 500	4471.37	4357.04	4432.99	3483.81
NASDAQ	14897.34	14566.70	15043.97	11671.56
Commodities				
Gold ($ per troy ounce)	1768.10	1761.30	1753.90	1905.05
Oil ($ per barrel) - Crude Futures (WTI)	82.66	75.75	71.96	40.33

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Consumer Price Index (September) - % change	0.4	0.3	0.5	0.6
Core CPI (excluding food & energy) - % change	0.2	0.1	0.3	0.5
Producer Price Index (September) - % change	0.5	0.7	1.0	0.8
Retail Sales (September) - % change	0.7	0.9	-1.6	0.1

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