

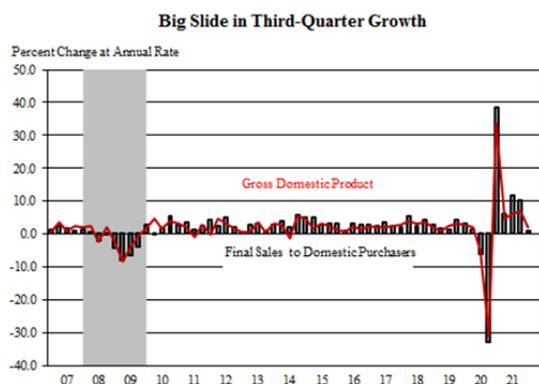
WEEKLY

Economic Commentary

October 29, 2021

As advertised, the economy hit a severe speed bump in the third quarter, as growth in GDP slowed to a 2.0 percent annual rate from a robust 6.7 percent in the second quarter. While the pullback was sharper than the consensus expectation of a 2.7 percent growth rate, many thought it could have been much worse; the Atlanta Federal Reserve GDP tracking model had it as low as 0.2 percent just days before the Commerce Department released its report on Thursday. To be sure, the range of forecasts was exceptionally wide, with some economists among Blue Chip forecasters expecting growth to come in at almost 6 percent.

Needless to say, the Delta variant weighed heavily on the economy during the period. Surging case counts early in the summer curtailed spending on services, even as it amplified supply pressures, preventing factories, wholesalers and retailers from getting enough goods that consumers want. The auto sector, hampered by the inability to obtain computer chips for production, is the poster child for these supply shortages, as the slim inventories of vehicles on dealer lots sent motor vehicles sales into a deep nosedive, which contributed importantly to the eye-opening 26.2 percent plunge in durable goods spending during the period. But no major spending category in the private sector performed better in the third quarter than in the second. Personal consumption, business investment, residential outlays and exports were all weaker. Final sales to domestic customers increased by a meager 1.1 percent, down from a 10.1 percent advance in the second quarter.



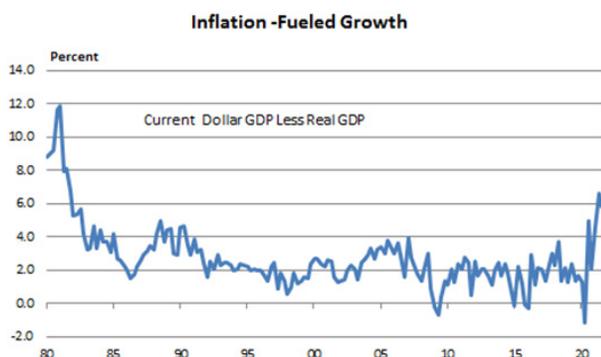
That said, it would be a mistake to put too much importance on the abrupt turn of events between the second and third quarters. Just as the economy’s performance over the first half of the year was artificially boosted by several rounds of government transfer payments and the reopening from Covid-induced restraints, the third quarter was artificially depressed by the reemergence of public health fears linked to the Delta variant and supply-chain disruptions. These catalysts on both ends of the ledger are losing clout and they should have much less of an impact going forward. The last government stimulus payment went out in March and the accumulated savings from unspent funds during the pandemic is rapidly depleting. Meanwhile, the pandemic’s grip on the economy is steadily easing, as case counts have fallen by nearly 50 percent since September 1.

The supply-chain snarls are likely to take longer to unwind, but that too should ease during 2022 and expand the availability of goods to consumers. In fact, business inventory investment actually increased in the third quarter, suggesting that households won’t be facing bare shelves during the upcoming holiday shopping season. They may not get precisely the goods they want, but other options to purchase should be available.

The National Retail Federation is predicting gangbuster sales growth this season, exceeding last year’s increase by about 50 percent. And with Delta cases plummeting, spending on services should also revive. People are already returning to restaurants and booking more flights for vacations and family visits. Meanwhile, the reopening of schools along with diminishing health fears should spur parents to rejoin the workforce, alleviating the shortage of labor.

Keep in mind, too, that the 2 percent growth rate in the just completed quarter is not terribly grim compared to the 2.3 percent average quarterly pace in the 20 years prior to the onset of Covid. Looked at from another perspective, the economy’s performance last quarter could be viewed as highly successful. True, real GDP growth plunged by 70 percent compared to the second quarter. But in

current dollar terms, the setback was far less. In fact, the 7.8 percent growth rate in nominal GDP during the period was stronger than any quarter of the ten-year expansion leading up to the pandemic. Hence, the spending spigot was wide open last quarter, but businesses reaped more of the revenue stream while consumers got less bang for the buck. The gap between the nominal and real GDP growth rate last quarter was just a shade under the second quarter, which was the widest since the early 1980s.

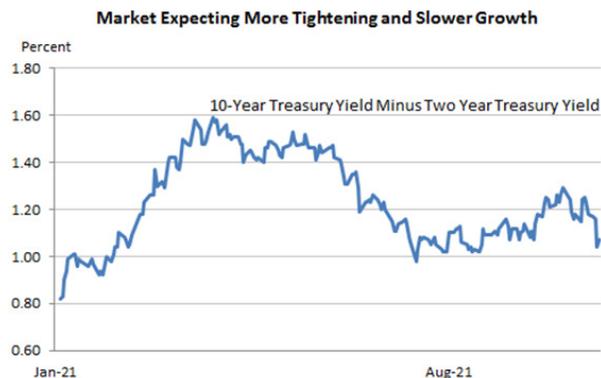


Simply put, businesses gained a good deal of pricing power over the past six months, cushioning the blow to profits from the shortage of goods they had available to see. More than anything, this demand/supply mismatch lit a fire under inflation, propelling consumer prices up by the fastest pace since the early 1990s. From our lens, price pressures will remain elevated through early next year, owing to ongoing supply disruptions that are taking longer to resolve than previously thought, rising labor costs and the lingering boost to household purchasing power from pandemic-related savings. Collectively, these influences should enable businesses to retain a degree of pricing power, allowing them to pass most cost increases onto consumers.

The persistence of inflation has put the Federal Reserve in the cross hairs, prompting it to speed up its plan to withdraw support for the economy. At its policy meeting next week, the Fed is expected to flesh out the details regarding when it will start and how fast it will proceed with reducing its purchases of government-backed securities, currently at \$120 a month. We expect it to begin the tapering process

in November and slice \$15 billion from its monthly purchases. That would bring an end to the emergency additions to its portfolio in eight months, after which the door would be open for rate hikes. At its last FOMC meeting in September, Fed officials expected to start raising its main policy rate in December of next year.

However, the stubborn persistence of high inflation has made investors and traders much less patient. The financial markets are pricing in more than two full rate hikes next year as well as an increased risk that the Fed will make a policy mistake by tightening too rapidly thereafter. A key measure pointing to that mistake is the spread between the 10-year and 2-year Treasury yield. The 2-year yield is closely linked to market expectations of Fed policy changes while the 10-year yield reflects expectations of growth and longer-term inflation. Since the beginning of the month, the 2-year yield has increased much faster than the 10-year yield, resulting in a sharp narrowing in the spread between the two. Hence, market participants believe that the Fed's rate hikes will slow growth and bring down inflation in the later years.



We believe investors are expecting a more aggressive Fed response -- and weaker economic performance -- than will actually occur. That said, while the yield curve has flattened somewhat this month, it is a far cry from inverting, wherein the 2-year yield exceeds that of the 10-year security. A yield inversion is a time-honored indicator the economy is poised to fall into a recession, most likely due to an overly aggressive Fed tightening. In the current

circumstance, nothing could be further from the case. Rather than moving too aggressively, the Fed is steadfastly adhering to the premise that the forces propping up inflation will soon fade. Although Fed chair Powell acknowledges that inflation has remained elevated longer than expected and that the upside risks going forward have increased, he continues to believe the current surge in inflation is “transitory” and will unwind next year as the post-pandemic economy normalizes.

We agree with that view for a number of reasons. For one, the recent strengthening of business pricing power has its limits. To some extent, consumers have accepted higher prices because of their stronger financial positions, including the excess savings from unspent funds during the pandemic that was fattened by generous government transfer payments. But more than 11 million people were cut off from the emergency programs providing enhanced unemployment benefits earlier this month, and households are drawing down those excess savings. In the September personal income and spending report released on Friday, the personal savings rate had dwindled to 7.5 percent from the 26.6 percent in March, when the last stimulus payment went into bank accounts. The 7.5 percent rate does not provide a much fatter financial cushion than the 7.1 percent average rate in the 10 years prior to the pandemic.

What’s more, consumer resistance towards higher prices is already showing up in many places - for homes, cars and college admissions, among others. There is little sign that households are pulling purchases forward to beat higher prices, although some are doing so to avoid being caught short of desired goods during the holidays. Importantly, a more aggressive tightening policy than the Fed currently plans would do little to ease the supply shortages that are the primary catalyst behind the inflation surge. By tightening financial conditions just enough to take some air out of demand, the Fed would be buying time for supply to catch up.

Finally, fears that the sharp rise in labor costs will lead to a wage-price inflation spiral are overblown, in our view. The shortage of workers that is behind

the wage spike should ease in the coming year for a number of reasons, including diminished health fears (assuming another variant of the coronavirus does not emerge), the return of working parents as schools reopen, reduced incentives to delay a job search because of generous government assistance, and the depletion of excess savings that will encourage workers to seek a paycheck to support spending.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

	October 29	Week Ago	Month Ago	Year Ago
INTEREST RATES				
3-month Treasury bill	0.06%	0.06%	0.04%	0.09%
6-month Treasury bill	0.06	0.07	0.05	0.11
3-month LIBOR	0.13	0.12	0.13	0.21
2-year Treasury note	0.50	0.46	0.27	0.14
5-year Treasury note	1.19	1.20	0.93	0.38
10-year Treasury note	1.56	1.64	1.46	0.88
30-year Treasury bond	1.93	2.08	2.03	1.65
30-year fixed mortgage rate	3.14	3.09	3.01	2.81
15-year fixed mortgage rate	2.37	2.33	2.28	2.32
5/1-year adjustable rate	2.56	2.54	2.48	2.88
STOCK MARKET				
Dow Jones Industrial Index	35819.56	35677.02	34326.46	26501.60
S&P 500	4605.38	4544.90	4357.04	3269.96
NASDAQ	15498.39	15090.20	14566.70	10911.59
Commodities				
Gold (\$ per troy ounce)	1785.00	1793.10	1761.30	1881.85
Oil (\$ per barrel) - Crude Futures (WTI)	83.22	83.98	75.75	37.32

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Durable Goods Orders (September) - % change	-0.4	1.3	0.5	0.8
Consumer Confidence Index (October)	113.8	109.8	115.2	118.8
GDP (3rd Quarter) - % change. Saar	2.0	6.7	6.3	3.7
Personal Income (September) - % change	-1.0	0.2	1.1	-2.6
Savings Rate (September) - Percent	7.5	9.2	9.9	9.7

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