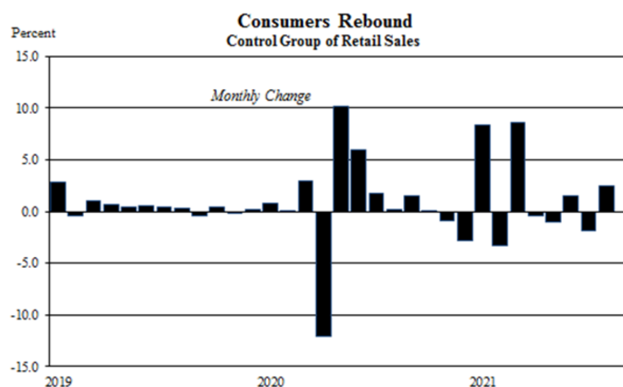
September 17, 2021

Just a few short months ago, before the onset of the summer's heat wave, the general view among economists was that by now the pandemic would be in the rear-view mirror and the economy would be back to normal. That was then. With the virus rearing its ugly head for the fourth time, spurred by the Delta variant, there is nothing normal in the way the economy is behaving. The torrid rebound in activity during the spring and early summer as Covid went into retreat has lost considerable momentum heading into the fall; rising case counts took the steam out of consumer spending, stoked health fears among workers, keeping many from returning to jobs, and quashed hopeful expectations of revived sales among small businesses that rely on returning office workers to keep them afloat. Meanwhile, the pandemic-related supply constraints that clogged the wheels of production may now take longer to unwind.

The headwinds from the persistent health crisis has cut deeply into the third quarter's growth prospects, as we expect GDP to advance at less than half the second-quarter's vigorous 6.6 percent annual rate. But while the growth trajectory is bending, it is not breaking. The economy still has considerable support to power it forward. After a third-quarter hiatus, growth should pick-up in the winter and retain solid momentum next year as well. The Delta variant that sent the economy onto a slower growth path appears to have crested, as case counts are leveling off and vaccination rates continue to climb. Booster shots are on the way, which should stop the virus from gaining traction among the most vulnerable groups and slow its spread through the general population.

Importantly, the economy continues to be powered by solid fundamentals. True, the wide-open fiscal spigot that short-circuited the pandemic recession last year and provided the income juice that jump-started a powerful revival in consumer spending is closing. But households retain a good deal of savings from the government's largesse that has yet to be spent. And while the resurgence in job growth took a hit in August, coming in well below expectations, companies are still hiring, with the major restraint being a shortage of workers to fill a record 10.2 million open positions. Hence, rising labor compensation is offsetting the loss of government income support. What's more, the biggest wage gains are occurring among low-paid workers who tend to spend every penny of their paychecks, thus providing more bang for the buck in terms of consumer spending.

Simply put, the economy's fate is in the hands of consumers. If you look at their mind-set things look awfully dire. The latest University of Michigan survey suggests that households are about to go into hibernation. Their spirits, according to the University's sentiment index for early September, hover barely above the 10-year lows reached in August and buying plans for big-ticket items, particularly cars, have sunk to a record low. But history shows that households do not always act as they feel, and their current behavior appears to reflect that disparity. Despite their glum mood, retail sales in August were stronger than expected, posting a solid 0.7 percent advance that flipped the consensus forecast of a 0.8 percent decline.



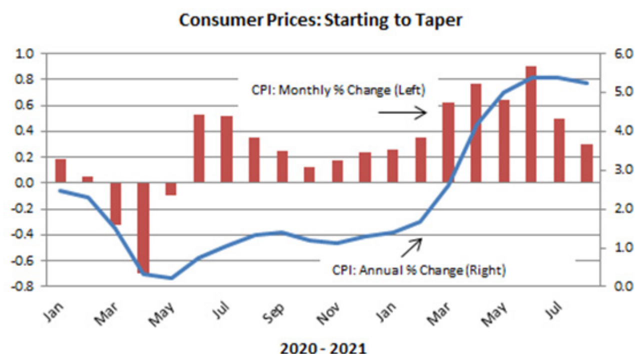
To be sure, the gain comes on the heels of downwardly revised sales for June and July, and not all retailers shared in the increase. But the 3.8 percent slide in auto sales was the biggest drag on retail sales last month, a setback that primarily reflected the slim inventory of vehicles available for sale, thanks to the computer chip shortage that is crimping auto production. Excluding autos, sales rose a healthier 1.8 percent. Indeed, the core group of sales that excludes autos, gasoline and building materials, which is a good proxy for consumer goods purchases

in the GDP accounts, rose by a robust 2.5 percent last month. That is the strongest increase since March, when the disbursal of stimulus checks bloated sales by 8.6 percent.

Otherwise, the August pattern of retail sales reflected the conflicting forces that are influencing household behavior. The reopening of schools has returned a sense of normalcy to life, prompting increases in clothing and department store sales. Conversely, products that were heavily purchased when remote learning and restrictions that kept people at home weakened in August, including sales of electronics (-3.1 percent) and the group consisting of sporting goods, hobbies, musical instruments and books (-2.7 percent). While the curtailment of remote learning may have crimped computer sales last month, it did not dissuade consumers from using them to shop online; sales at nonstore retailers, mainly e-commerce purchases, spiked by 5.3 percent. Not surprisingly, the rapid spread of the Delta variant is discouraging people from going to restaurants and bars, where sales in August did not increase for the first time in six months.

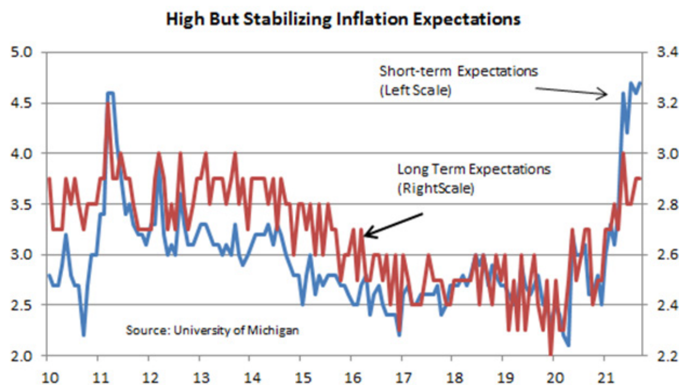
Looking ahead, we expect consumers to remain in a shopping mood leading up to the holidays despite their gloomy mindset. As noted, there are signs that the virus is peaking and a turn for the better would clearly brighten household spirits and encourage a return to in-person activities. The combination of elevated savings and rising labor compensation should provide enough purchasing power to make for a decent shopping season, assuming the goods are available to satisfy customer needs. On that score, widespread media reports of looming product shortages due to supply-chain disruptions could prompt consumers to accelerate their holiday purchases, imparting a bigger boost to pre-holiday sales at the expense of actual holiday sales.

Such a development might put more upward pressure on prices, as companies struggle to keep up with demand. We suspect, however, that the spike in inflation in recent months is already dampening some purchases, particularly for autos, and it is unlikely that consumers would accept further outsized price increases. As it is, the inflation surge appears to have reached an inflection point. The consumer price index rose 5.3 percent in August from a year ago, a slight slowdown from the 5.4 percent increase registered in each of the previous two months. Likewise, the annual increase in the core CPI that strips out volatile food and energy prices, slipped to 4.0 percent from 4.3 percent and 4.5 percent in July and June, respectively. More impressively, the monthly increments turned sharply lower, with the headline CPI slowing to 0.3 percent in August from 0.5 percent in July and the core CPI fading from a 0.3 percent increase to a slim 0.1 percent. The headline increase was the weakest since January and the 0.1 percent increase in the core CPI was very much in line with the increases seen in the 20 years prior to the pandemic.



Clearly, the economy has not returned to the tame inflation environment that prevailed prior to the pandemic. Nor has there been any reversal in the rise in inflation expectations over the past year. The above-mentioned Michigan survey notes that households expect an inflation rate of 4.7 percent over the next year compared to 2.6 percent last September, while expected inflation over the next 5-10 years crept up to 2.9 percent from 2.7 percent. The good news is that both measures have stabilized in recent months, with the 1-year expected rate hovering around 4.7 percent since July and the longer-term expected rate is a shade lower than the 3.0 percent peak hit in May. The stable readings for the longer-term measures of inflation expectations is particularly encouraging to the Federal Reserve, as it validates its belief that the recent spike in inflation reflects transitory forces linked to the pandemic and

reopening economy that will soon abate.



We concur with that assessment and note that less than a third of the goods and services in the consumer price index accounted for more than 90 percent of the inflation acceleration in the three months leading up to the August slowdown. For the most part, prices for those items were driven up by pandemic-related forces and the reopening of the economy. For example, hotels, airlines, restaurants, rental car companies and other businesses that suffered a steep decline in demand early in the pandemic were forced to slash prices. As the economy reopened in the spring, these establishments swiftly restored prices to normal levels, which amplified the year-over-year increase. At the same time, auto prices surged due to the aforementioned production cut-backs related to chip shortages, which prevented dealers from stocking enough inventory to meet demand.

Importantly, the slowdown in the inflation rate during August reflected the reversal of many of those spikes during the spring. Airline fares fell 9.1 percent, hotel prices dipped 3.3 percent, rental car prices fell by 8.5 percent and used car prices declined by 1.5 percent. We suspect that this churning of prices will continue to unfold as the Delta variant wends its way to its conclusion and its effects on consumer behavior dissipates. That said, the virus is not taking nearly as big a toll on the businesses that were so deeply impacted last year, and their prices should likewise hold up better. High frequency data tracking credit card usage indicates that people are still spending freely at dining establishments and on other discretionary items so far in September.

Hence, while the Fed has to be encouraged by the latest inflation readings, we expect it will still forge ahead with its plan to start reducing asset purchases early next year. While inflation has probably peaked, it will recede gradually and remain above the Fed's 2 percent target for the foreseeable future, thanks to ongoing supply constraints amid still-healthy demand and rising labor costs. A formal announcement as to when the tapering would begin could come at the upcoming policy meeting next week or the one in November. One cautionary note, however, is that the tapering could be delayed if the debt-ceiling imbroglio is not resolved by early October and creates turmoil in the financial markets.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

INTEREST RATES	September 17	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.04%	0.05%	0.05%	0.10%
6-month Treasury bill	0.05	0.06	0.05	0.12
3-month LIBOR	0.12	0.11	0.13	0.23
2-year Treasury note	0.22	0.22	0.23	0.14
5-year Treasury note	0.86	0.81	0.78	0.29
10-year Treasury note	1.37	1.34	1.26	0.70
30-year Treasury bond	1.91	1.93	1.87	1.45
30-year fixed mortgage rate	2.86	2.88	2.86	2.87
15-year fixed mortgage rate	2.12	2.19	2.16	2.35
5/1-year adjustable rate	2.51	2.42	2.43	2.96
STOCK MARKET				
Dow Jones Industrial Index	34584.88	34607.72	35120.08	27657.42
S&P 500	4432.99	4458.58	4441.67	3319.47
NASDAQ	15043.97	15115.49	14714.66	10793.28
Commodities				
Gold ($ per troy ounce)	1753.90	1788.20	1782.90	1950.85
Oil ($ per barrel) - Crude Futures (WTI)	71.96	69.71	62.25	39.55

ECONOMIC INDICATORS

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Retail Sales (August) - % change	0.7	-1.8	0.9	1.8
Core Retail Sales (August) - % change	2.5	-1.9	1.5	1.5
Consumer Price Index (August) - % change	0.3	0.5	0.9	0.6
Core CPI (August) - % change	0.1	0.3	0.9	0.6
Industrial Production (August) - % change	0.4	0.8	0.5	0.9

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