



WEEKLY

Economic Commentary

September 24, 2021



Millennium
CORPORATE CREDIT UNION

This week featured a remarkable string of policy-makers prepping anyone within earshot that something not too cheerful was about to take place. The Federal Reserve signaled that it was poised to start removing its emergency support for the economy, the White House directed Federal agencies to prepare for a possible government shutdown, and the Chinese government issued a warning that the nation's largest real estate developer may default on its debt. Unless you're a golfer, all of this teeing up should be a source of extreme angst, particularly in the financial markets where uncertainty is a time-honored catalyst for turmoil. Perhaps the best explanation for the benign response of investors to this swirl of events is that they sent the Delta variant into the background, at least for a while.

Indeed, despite Friday's modest setback, the stock market handily shrugged off the trifecta of ominous messaging, as the S&P 500 overcame an early week stumble and posted its strongest daily gain since July on Thursday, a day after the Fed announced its intention to start closing the monetary spigot. For the week, the index tacked on a modest increase. Bond yields also moved higher, with the bellwether 10-year Treasury yield hitting a near three-month high of 1.46 percent on Friday. It may seem counter-intuitive for stocks to react positively to a more hawkish Fed policy. But after months of fretting over the Delta threat to the economy, investors appear to be cheered - and in sympathy with - the Fed's more upbeat view of economic prospects that justify its plan to reduce monetary support. No doubt, additional signs the spread of the Delta variant has peaked also buoyed investor spirits.

At the rate-setting FOMC meeting this week, the Fed gave the strongest signal yet that it is satisfied with the progress made towards meeting its employment and inflation goals and, hence, the time to start removing emergency support to the economy is drawing close. A formal announcement that it will start tapering its asset purchases is expected at the November 2-3 policy meeting. In their updated projections, Fed officials expect inflation to be higher and the unemployment rate lower at the end of this year than under the previous set of pro-

jections made in June. And while the emergence of the Delta variant cut GDP growth estimates for this year relative to the June forecast, the economy is projected to grow a half percentage point faster next year than thought three months ago. In light of this upgraded growth and inflation outlook, the projected interest-rate lift-off has been pulled forward, with 9 Fed officials now expecting the first rate hike next year compared to 7 in June.

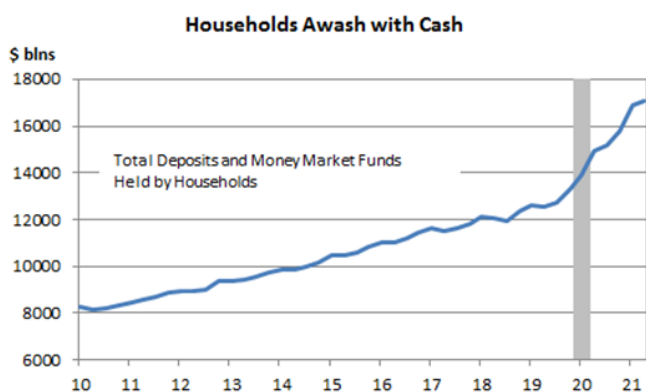
Economic Projections of the Federal Reserve: September 22, 2021

Variable	Median 1				
	2021	2022	2023	2024	Longer run
Change in real GDP	5.9	3.8	2.5	2.0	1.8
June projection	7.0	3.3	2.4		1.8
Unemployment rate	4.8	3.8	3.5	3.5	4.0
June projection	4.5	3.8	3.5		4.0
PCE inflation	4.2	2.2	2.2	2.1	2.0
June projection	3.4	2.1	2.2		2.0
Core PCE inflation ⁴	3.7	2.3	2.2	2.1	
June projection	3.0	2.1	2.1		
Memo: Projected appropriate policy path					
Federal funds rate	0.1	0.3	1.0	1.8	2.5
June projection	0.1	0.1	0.6		2.5

In his post-meeting press conference, Chair Powell indicated that the next jobs report for September only had to be "reasonably good" for the Fed to go ahead with its plans. Since the September report comes on the heels of much weaker job gains in August than expected, it remains to be seen what constitutes a "reasonably good" increase in September. We note that the October jobs report will be released just two days after the November 2-3 FOMC meeting, so the risk of a weak reading that would put the taper decision in a negative light can't be ignored. Importantly, the Fed may not have to run that risk if a potential debt ceiling crisis forces it to scuttle the decision amid the financial turmoil that would surely follow such a calamity.

From our lens, the Fed's projected rate lift-off is a bit too hasty in light of formidable headwinds that could restrain activity next year, as well as the uncertainty surrounding the economy's main growth drivers. With regards to the latter, the massive fiscal stimulus that has powered the recovery through the pandemic has ended, and the economy faces a significant drag from the loss of government

transfers next year. This fiscal cliff should be offset by the ongoing increase in labor compensation underpinned by healthy job growth. But key to the economy's growth prospects next year will be the extent to which households draw on their copious savings from the unspent funds during the pandemic. According to the latest Federal Reserve data, household holdings of liquid assets surged by more than \$3 trillion between the first quarter of 2020 and the second quarter of this year.



Most of that accumulation wound up in the hands of wealthier individuals who have a higher propensity to save than those lower down the income ladder. Still, a good portion of the buildup reflects funds that were not spent during the pandemic, either because of enforced lockdowns or health fears that discouraged people from spending on services. As the health crisis ebbs and the reluctance to spend on in-person service sector activities fades, we suspect that wealthier individuals will be keen to return to these activities, drawing on the unspent funds they built up over the past 18 months. We estimate that more than \$2 trillion of excess savings has been socked away during this period, and the return of these funds to the spending stream would clearly impart a sizeable boost to the economy next year.

However, it's unclear just how much of the savings build-up will be retained instead of spent. Following the financial crisis in 2008, households turned exceptionally frugal, spending the next four

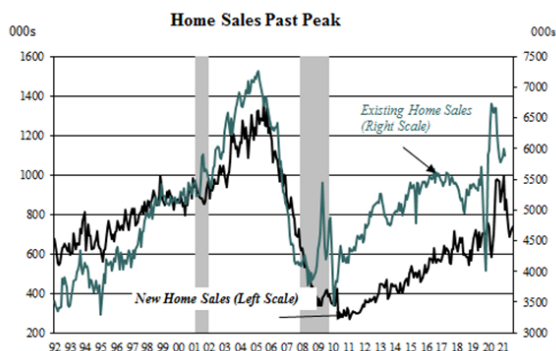
years building up their savings rate, which eventually peaked at 11.6 percent in December 2012, up from 3.2 percent in January 2008. Over the ensuing eight years leading up to the pandemic, the 7.2 percent average savings rate stood more than 2 percentage points higher than the average over the dozen years prior to the financial crisis. After two external shocks in recent memory that resulted in steep job losses, it would not be surprising if wealthier households decided to keep a healthier cushion of savings than otherwise to guard against future adversity.

It's important to note that Fed officials reported a greater than usual amount of uncertainty regarding their growth and inflation forecast, so the expected timing of rate lift-off is highly susceptible to change. We expect the first hike to take place in early 2023, reflecting the array of headwinds that looms in 2022. Keep in mind too that there is an open seat for a Federal Reserve Governor that President Biden may fill with someone who has a more dovish bias than the nine members expecting to hike rates in 2022. One thing is clear: no rate increase will take place until the Fed completes the tapering process, which Powell indicated would be around the middle of next year.

The ability of Chair Powell to delink the timing of rate increases from the tapering of asset purchases is a market departure from the muddled messaging that led to the "taper tantrum" in 2013. What's more, it would be a stretch to describe this week's FOMC meeting as a shift to a hawkish policy, which many commentators have done. While monthly purchases of Treasury and mortgage-backed securities are expected to be reduced by \$15 billion a month (\$10 billion in Treasuries and \$5 billion in mortgages), the Fed's balance sheet will still be growing each month through the middle of next year. Hence, there will be no withdrawal of liquidity from the banking system that would ordinarily be associated with a tightening of monetary policy.

Interestingly, when the tapering of asset purchases actually began in December 2013, long-term interest rates embarked on an extended decline that lasted until the summer of 2016. By the end

of the period, the 10-year Treasury yield had fallen by roughly 50 percent from the December 2013 level. That pattern is not expected this time, as the inflation environment is much different than it was then, when lingering deflation fears were still prevalent. Nor could the recent uptick in bond yields be considered a tantrum by any stretch. That said, it remains to be seen how much further rates could increase before it starts rattling the rate-sensitive housing sector, where home sales have been on a declining trend this year, despite a modest increase in new home transactions in August.



To be sure, the weakening sales trend is more a reflection of limited supply than soft demand. If anything, the pandemic has strengthened the demand for homes, particularly for bigger spaces out of highly dense urban areas to accommodate remote work. That trend has started to reverse as more offices are reopening and workers are returning. Still, surging home prices have pushed many first-time home buyers out of the market, and the prospect of higher mortgage rates, which closely tracks the 10-year Treasury rate, would be another headwind for the housing market, and overall economy, to overcome.

KEY FINANCIAL & ECONOMIC INDICATORS

FINANCIAL INDICATORS

	September 24	Week Ago	Month Ago	Year Ago
INTEREST RATES				
3-month Treasury bill	0.04%	0.04%	0.05%	0.10%
6-month Treasury bill	0.08	0.05	0.05	0.11
3-month LIBOR	0.13	0.12	0.12	0.23
2-year Treasury note	0.28	0.22	0.20	0.12
5-year Treasury note	0.95	0.86	0.80	0.26
10-year Treasury note	1.46	1.37	1.31	0.66
30-year Treasury bond	1.99	1.91	1.92	1.40
30-year fixed mortgage rate	2.88	2.86	2.87	2.90
15-year fixed mortgage rate	2.15	2.12	2.17	2.40
5/1-year adjustable rate	2.43	2.51	2.42	2.90
STOCK MARKET				
Dow Jones Industrial Index	34798.00	34584.88	35455.80	27173.96
S&P 500	4455.48	4432.99	4509.37	3298.46
NASDAQ	15047.70	15043.97	15129.50	10913.56
Commodities				
Gold (\$ per troy ounce)	1750.60	1753.90	1820.90	1859.70
Oil (\$ per barrel) - Crude Futures (WTI)	73.95	71.96	68.68	39.78

ECONOMIC INDICATORS

	Latest	Previous	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
	Month/Quarter	Month/Quarter		
Housing Starts (August) - 000s	1615	1554	1657	1610
Building Permits (August) - 000s	1728	1630	1594	1687
Existing Home Sales (August) - 000s	5880	6000	5870	5898
New Home Sales (August) - 000s	740	729	685	759

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