Weekly Market Commentary
October 25, 2021

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The odds still favor a festive holiday shopping season, as households are flush with cash, jobs are plentiful, wages are rising at a solid clip and debt loads are manageable, thanks to low rates, refinancings, and growing incomes. But as the season draws closer, the Grinch is lurking ever so prominently, threatening to withhold a basket full of stocking stuffers for consumers of all ages. The culprit, of course, is not the cynical grump created by Dr. Seuss, but rather the supply shortages wrought by the even more menacing pandemic-related constraints.

At last count, nearly 100 container ships were anchored off the ports of Los Angeles and Long Beach unable to offload their wares, a backlog that is more than 10 times greater than normal. A full accounting of what's on those ships is unavailable, but it stands to reason that a good portion consists of goods that are destined to go into inventory earmarked for Christmas sales. President Biden is trying his best to be the good Samaritan to save the holidays by prompting the ports to stay open 24/7. But then he still needs to mobilize enough workers to offload the merchandise and truck drivers to transport them to warehouses, which may or may not be open in the middle of the night. Even then, the president could do nothing to reopen shuttered factories in Covid-stricken Vietnam or ramp up production of computer chips in Taiwan to ease a severe shortage that is putting the brakes on auto output in the U.S.

No doubt, the Delta variant curbed demand in the third quarter and contributed to slower growth in GDP, which we estimate came in at a dismal 0.9 percent annual rate, a steep falloff from the 6.7 percent pace in the second quarter. While we expect demand to rebound in the current quarter and contribute to faster growth, the extent of the pick-up will depend on the supply available to accommodate customers. If stores and warehouses don't have enough goods, sales would be lost, resulting in unsatisfied demand. And if there are fewer goods to sell, companies may well decide they do not need as many workers, potentially putting a crimp on hiring. That's not the case now, as employers are still desperately trying to fill more than 10 million open positions. But the longer goods are in short supply, preventing businesses from restocking exceptionally lean inventories, the greater the downside risk to holiday sales, as well as the economy's performance in the current quarter.

The counterpoint to this downside risk to growth is the upside risk to inflation that the demand/supply mismatch suggests. That risk has already become a reality as consumer prices are rising at the fastest pace since the early 1990s. Until recently, the inflation surge raised few alarms, as policy makers and the financial markets firmly believed that the supply-chain snarls would soon clear up and the post pandemic surge in demand would abate, relieving price pressures by next year. But that complacency is withering on the vine, as Federal Reserve officials are expressing more concern that inflation could persist beyond what was deemed acceptable earlier in the year. Their concern is shared in the bond market, which is pricing in significantly higher inflation as well as a swifter Federal Reserve response than a few months ago.

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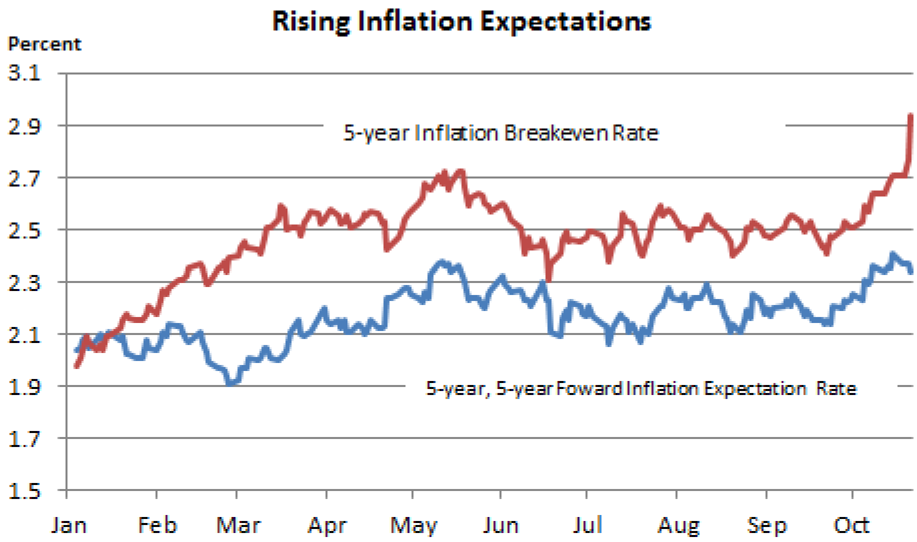
The Fed's plan to start removing monetary support was announced at the September policy meeting, but the futures market is already expecting more rate increases next year than the one quarter-point hike projected at the FOMC meeting. Meanwhile, the bond market is priced for the highest inflation in decades, with the 10-year breakeven rate hitting the highest level since 2006 and the 5-year breakeven rate surging to a new record. Despite these dramatic moves, however, neither measure is expecting inflation to exceed 3 percent, which is hardly an inflation regime shift in our view. What's more, the bond market is not totally convinced in the staying power of inflation. Another market inflation gauge, the five-year, five year forward expected inflation rate indicates that the market expects inflation to be lower from 2026 to 2031 than over the next five years.

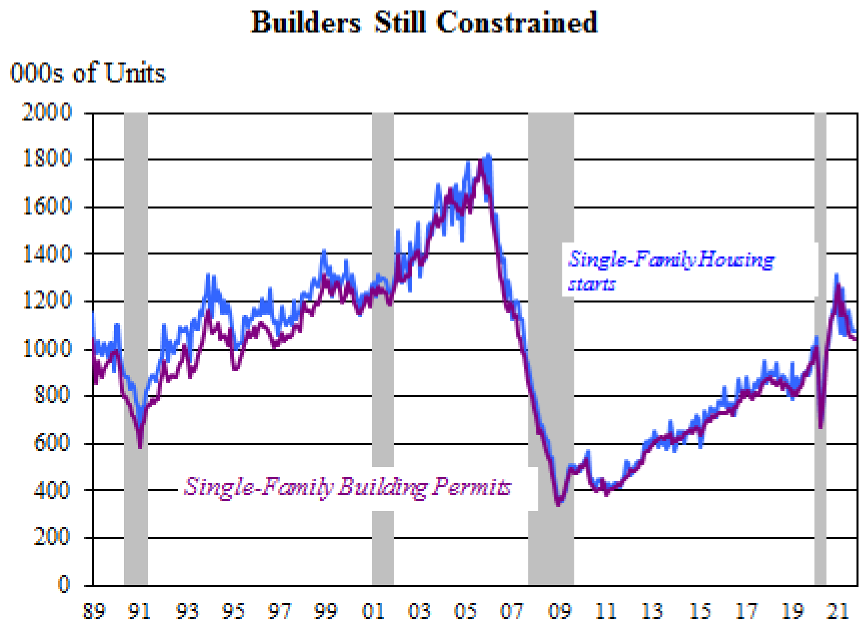


Until this year, that relationship has usually been the reverse, as investors expect inflation to be higher the further out over time. But on Wednesday, the five-year forward rate indicated that inflation would decline by 0.6 percent over the last five years of the 10-year time span. That's the steepest projected decline ever recorded for this series going back to 2003. Hence, either investors expect the Fed to keep inflation under control over the long term or for the economy to slow dramatically in the out years, something that might result from an overly vigilant anti-inflation monetary policy. From our lens, market perceptions are overly hawkish about Fed policy. We believe that only one rate hike will be needed in 2022, and that will not occur until the final month of the year.

While the upside risk to inflation has increased given the persistence of supply-chain constraints, we expect that the forces currently amplifying price pressures will wane in 2022 and beyond. With case counts of the virus falling dramatically and vaccine rates ramping up, health concerns that have kept many people from looking for jobs will ease in coming months, relieving the labor shortage and upward pressure on wages. And while wage growth has accelerated, so too has the increase in productivity, enabling companies to absorb higher labor costs without having to raise prices as much. Indeed, although hourly labor compensation in the nonfarm business sector increased by 2.0 percent in the year through the second quarter, unit labor costs rose only 0.2 percent. Small wonder that corporate profits have more than held their own, underpinning the bullish sentiment fueling the rally in stocks. We expect solid productivity growth next year as well.

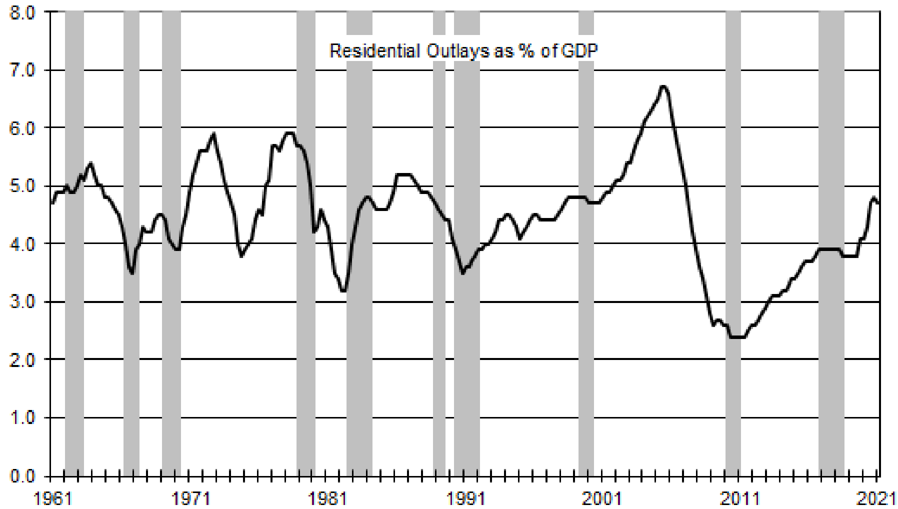
Nor will the clogged ports keeping vessels at bay remain an indefinite constraint on supply, although delays on Christmas gifts still loom large. President Biden hinted that he would use the National Guard to help unload the containers and drive trucks to warehouses if necessary. Some high-profile companies are seeking alternative modes of delivering goods to customers, including railroads, airfreight and even buying their own ships. And as the pandemic hopefully continues to fade, household buying preferences will shift from physical goods to services. That will ease the mismatch between demand and supply for the myriad products that consumers purchased when the virus forced them to stay in their homes. Hence, factories in Taiwan can ramp up production of semiconductor chips for the auto industry using the chip-making resources previously designed for electronic gear, such as phones, computers, TVs and VR systems.

One industry that continues to cope with formidable supply restraints is housing, as builders face rising commodity prices, a lack of building lots and a shortage of workers. Except perhaps for autos, no other industry faces as much unfilled demand as the residential sector, highlighted by the surge in home prices over the past year. Things are not getting much better. Despite ongoing solid demand for housing, builders started 1.1 percent fewer homes in the third quarter than in the second, when starts also contracted. The third quarter ended on a down note, as starts in September fell 1.6 percent, and building permits – an indicator of future construction – slipped by an even steeper 7.7 percent.



We suspect that the declining trend will level off in the current quarter and residential outlays will stage a modest increase, reversing two quarters in which they were a drag on GDP. The performance of the housing sector has some significance. Following the housing collapse in 2007-09, the influence of the residential sector on the overall economy dwindled considerably. By 2010, residential outlays accounted for 2.4 percent of GDP, a record low and less than half the 6.7 percent peak set during the speculative housing boom of 2005. During a long dreary period following the housing collapse, builders had to compete with a flood of distressed sales by homeowners defaulting on their mortgages, which took years to work off.

Housingn Regains Importance



It’s been a long grind back. But a decade of low mortgage rates, an expanding economy and a return to financial health of households sparked a turnaround that is now reinforced by the pandemic-related surge in housing demand from buyers looking for larger living spaces to accommodate remote working, and to move out of densely populated urban areas. As a result, the share of residential outlays in the economy climbed back to 4.7 percent this year, which is actually a tad above the 4.5 percent average of the past 60 years. This is a trend that will likely continue in a post pandemic world, assuming that a broad swath of first-time buyers is not shoved out of the market by skyrocketing home prices. That, again, hinges in no small part on the easing of supply constraints, which are impeding construction activity and, hence, an expansion of the supply of homes for sale.