Week in Review

Friday, July 16th, 2021

1. Labor Market Dynamics Targeted by The Federal Reserve

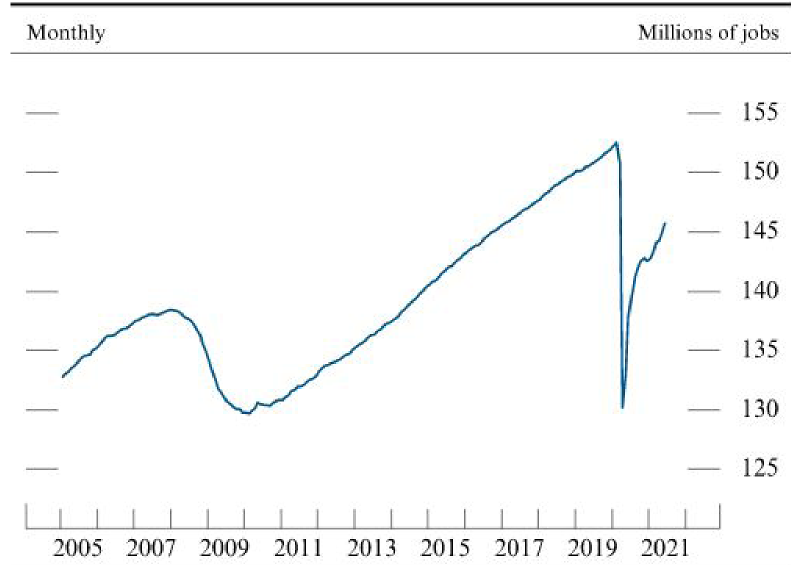
The Federal Reserves Monetary Policy Report was released this past week and Chairman Powell spent two days testifying to Congress. The Chairman continued to push back on worries about a reacceleration in inflation and that the Federal Reserve (Fed) would continue to stand by its current monetary policies until further substantial progress was realized in the economy. The Fed's key measure for progress in the economy continues to be employment.

The Fed's position on employment is that despite the substantial improvement in the labor market, payroll employment increased by 3.2 million jobs in the first half of 2021, that employment remains below its pre-pandemic level.

The Fed also noted that while the unemployment rate has declined 0.8 percentage points in the first half of the year to 5.9% in June, it remains above its pre-pandemic level. The Fed believes that the unemployment rate understates the shortfall in employment as factors related to the pandemic linger impacting the labor force participation rate. These factors include potential workers' concern about safety in the workplace, caregiving demands, a surge in retirements, and expanded unemployment insurance.

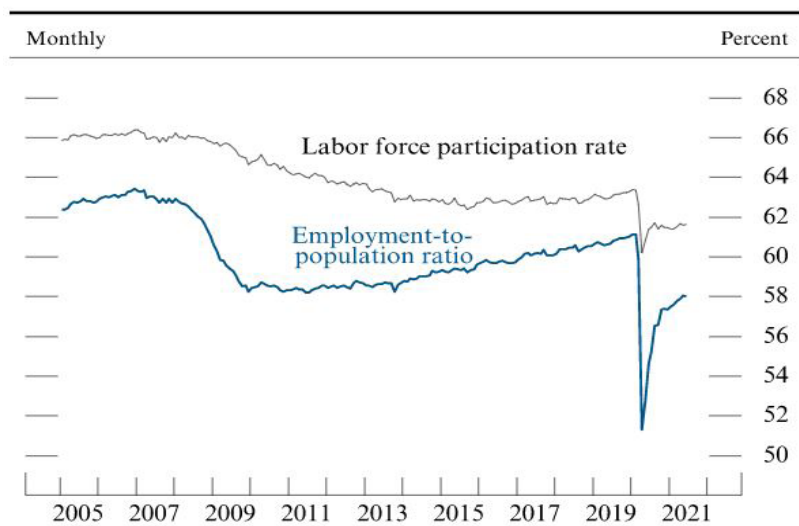
The Fed believes that many of the factors constraining the labor force should gradually abate in the coming months, but they want to continue to monitor the data before changing policy.

Non-Farm Payroll Employment



NOTE: The data extend through June 2021.
SOURCE: Bureau of Labor Statistics via Haver Analytics.
Source: Bureau of Labor Statistics via Haver Analytics

Labor Force Participation Rate and Employment-to-Population Ratio



NOTE: The labor force participation rate and the employment-to-population ratio are percentages of the population aged 16 and over and extend through June 2021.
SOURCE: Bureau of Labor Statistics via Haver Analytics.

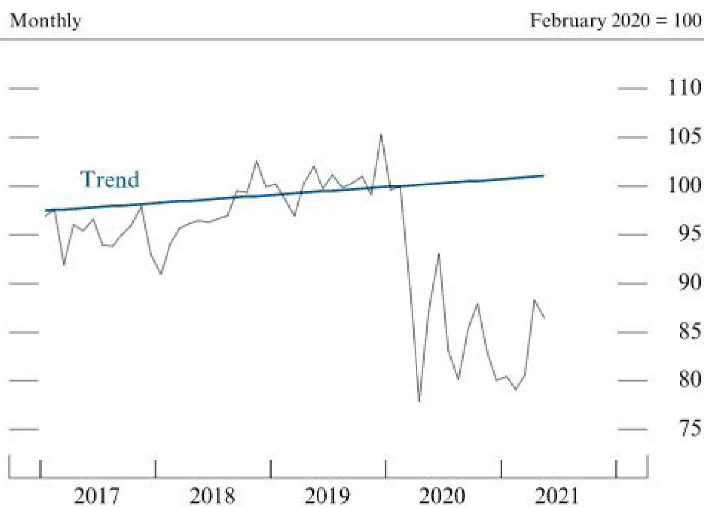
Source: Bureau of Labor Statistics via Haver Analytics

2. The Federal Reserve Is Still Subdued About Inflation Risk Longer Term

The consumer price index rose 5.4% in June from a year ago, coming in above economists' expectations, indicating continued inflationary pressures. However, The Federal Reserve Monetary Policy Report and Chairman Powell's comments to Congress made the case that many of the recent inflationary drivers are likely temporary, boosted by returning demand for services and supply bottlenecks for manufacturing.

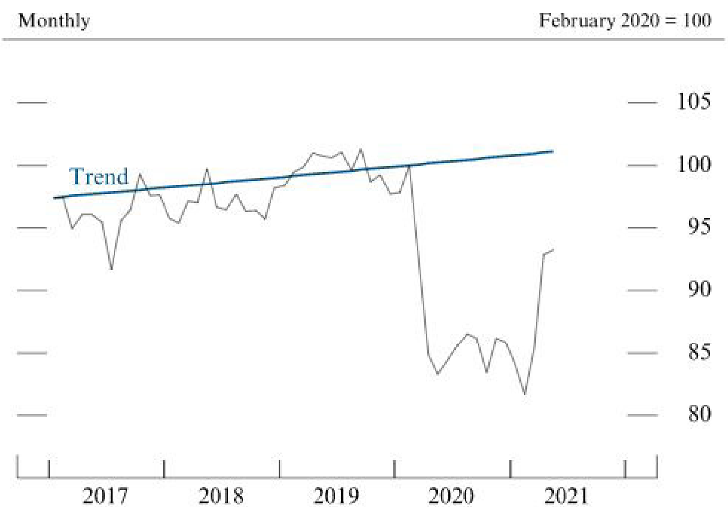
In terms of demand for services, the Fed report cited airline fares and hotel accommodation room rates as examples of returning demand pushing prices up rapidly after falling during the pandemic last year.

Airline Fares



Source: Bureau of Labor Statistics via Haver Analytics

Hotel Accommodations

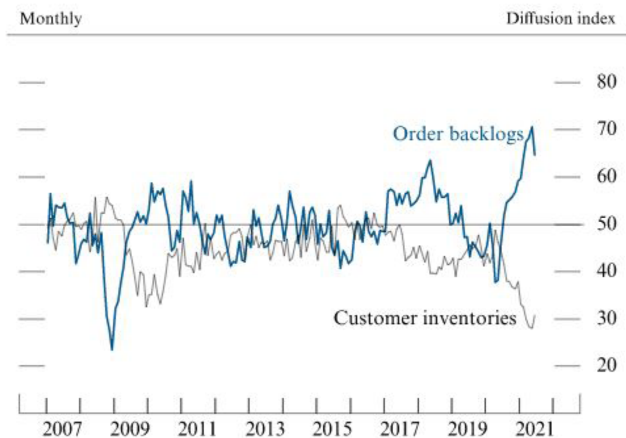


NOTE: Trend is calculated from February 2017 to February 2020.

The Fed report noted that an important part of the rise was driven by the surge in demand from the reopening, but that the initial surge in the growth rate should abate. The report also acknowledged that wage gains, especially in the leisure and hospitality sector and in other service industries that have relatively low average wages, are likely responsible for some of the increase in prices and perhaps may be more sticky going forward.

The Fed report also cited that strong U.S. demand for goods has been faced with a manufacturing and supply chain not able to keep pace. When the pandemic began, many manufacturers sharply curtailed production in expectation of a long downturn, drawn-out recovery, and safety concerns for their employees. However, the pause in demand and recovery occurred much sooner and stronger than had been anticipated, resulting in a scramble for workers and materials to fill the new orders. These shortages have put pressure on prices and led to record order backlogs at the same time inventories are near record lows.

Customer Inventories and Order Backlogs

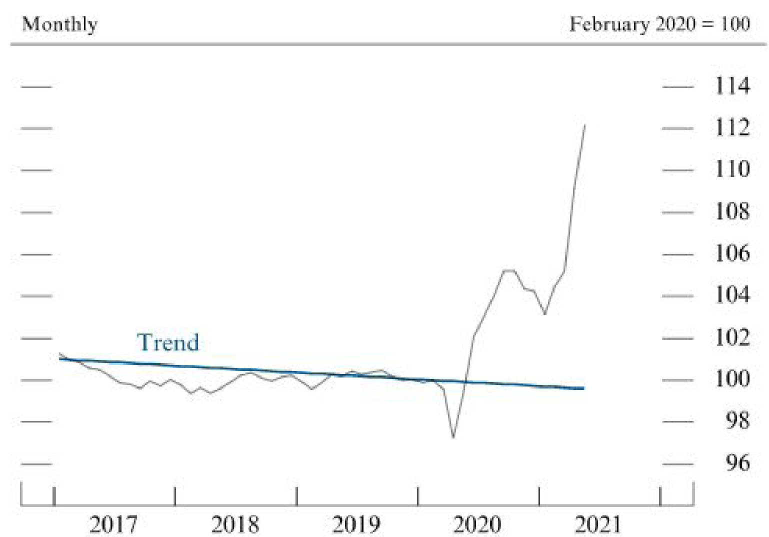


NOTE: The data extend through June 2021.

Source: Bureau of Labor Statistics via Haver Analytics

In particular, the Fed highlighted the automotive industry and its outsized impact on recent inflation. The automotive industry has reported shortages of critical components such as semiconductors which resulted in curtailed new production at the same time demand from households and rental car companies picked up and has been strong. This has caused prices for motor vehicles, particularly used vehicles, to jump and achieve levels well above pre-pandemic trends. The price rise for the motor vehicle sector has accounted for almost one-third of the increase in personal consumption expenditures (PCE) during the second quarter.

Motor Vehicle Pricing

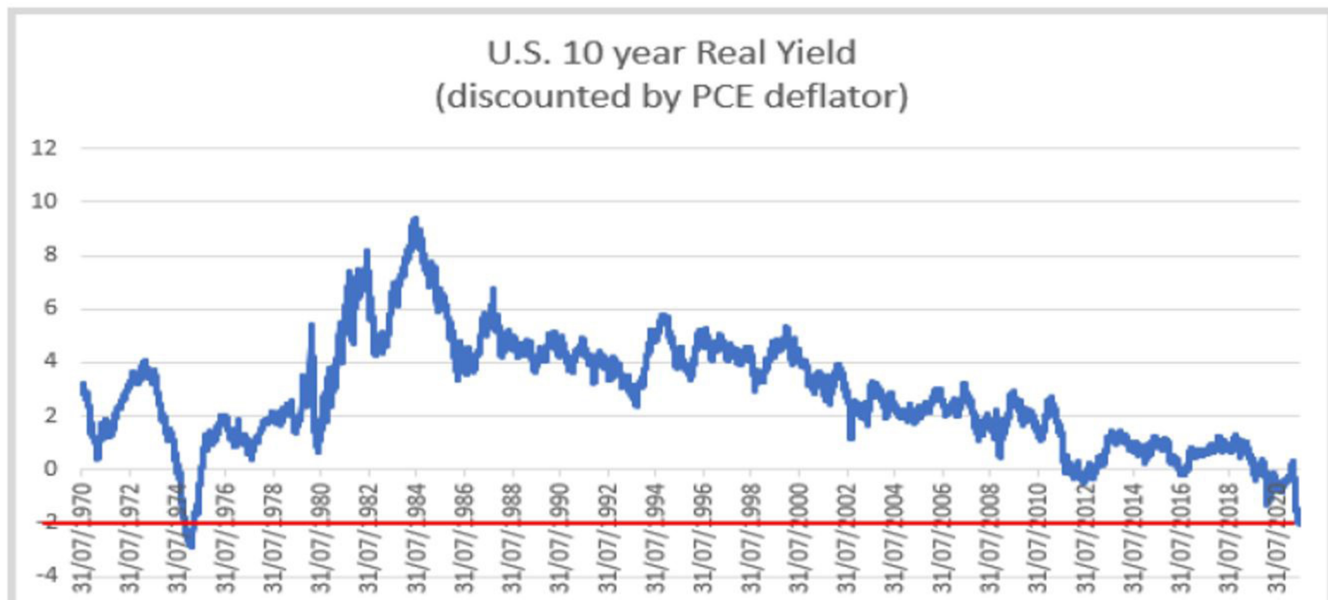


Source: Bureau of Labor Statistics via Haver Analytics

The Fed believes that as producers and supply chains work through the surge in demand, bottlenecks and production levels that supply and demand should become better aligned, and inflation will move down toward their longer-term 2% goal.

3. Real Rates of Return at Historical Low Levels

Given the recent uptick in longer-term inflation expectations, albeit below the recent short-term high figures of the past few months, coupled with the decline in longer-term treasury rates, real rates of return have hit historical lows not seen since the early 1970s. This is well illustrated in the following chart of the 10-Year Treasury Real Yield which is derived from the yield of the 10-Year Treasury less the personal consumption expenditure index (PCE Index) also known as the deflator.



Source: MacroStrategy Partnership

This level of return suggests that at least in the near term, holding long-term U.S. Treasuries and lower risk fixed income more broadly may result in a decline in purchasing power over time. This concern leads to greater assumption of risk to achieve a return in excess of inflation. This trend could be countered by tighter monetary policy by the Fed with expectant higher yields on long-term treasuries but at the risk of slowing economic growth.

Thinking Ahead

As reiterated this past week, the Fed is erring on the side of stimulating economic activity to achieve a fully recovered economy, as measured by employment, and less concerned about what they see as temporary inflationary pressures while the demand and supply balance post the pandemic equilibrates at a more normative level. This is causing some distortions in the investment landscape such as negative real interest rates and asset flows into higher-risk investments offset by the underlying strength in the economy.

Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.

The information contained herein is for informational purposes only, is not personalized investment advice and should not be construed as a recommendation to purchase or sell any particular security, sector or strategy to any individual person or entity. The decision to review or consider the purchase or sale of any security, sector or strategy mentioned should not be undertaken without consideration of your personal financial information, investment objectives and risk tolerance with your financial professional. Past performance should not be considered as an indicator of future results.

Investment Advice offered through Pallas Capital Advisors LLC, a registered investment advisor.