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Research Commentary | US

Macro Musings

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- **A bipartisan infrastructure bill moved closer to reality this week, brightening the mood on Wall Street and lifting stock prices to another record. Should it pass the full Congress – a big if – the increased fiscal spending would give medium and longer-term growth prospects a considerable boost, a plus for profits and stock prices.**
- **The week's economic reports provided little reason for the Fed to alter its timetable for shifting to a less accommodative policy. A key inflation gauge it follows did spurt above the 2 percent target again, but that overshoot is expected to linger until pandemic related influences subside.**
- **A key determinant of when the Fed moves will be the performance of the job market. The Fed is allowing the economy to run hotter than it would have in the past, aiming to bring sidelined, mostly marginal, workers back to the labor force. But that pool of potential workers may be smaller than thought, thanks to a wave of early retirements. Some of the retirees may come back if the job market is hot enough, but the muscular boost to 401(k) plans over the past year may keep a larger fraction of senior workers on the golf course than anticipated.**

The heightened prospects that a bipartisan infrastructure bill will see the light of day brightened the mood of investors this week. To be sure, the $ 1.2 trillion package cobbled together by a group of 10 Senate Republicans and Democrats is far less than what president Biden campaigned on, much less the broader $2.2 trillion plan he put on the table in March. But the rare spirit of bipartisanship that emerged this week is a welcome departure from the tension-filled congressional backdrop in recent years that produced more acrimony than cooperation amid a highly polarized Capitol Hill.

The additional fiscal spending – which Democrats hope to augment with another more comprehensive and progressive-leaning bill through the reconciliation process – adds heft to growth prospects over the medium and longer term. More growth translates into stronger profits, which clearly cheers stock investors and provided a spark for a late-week rally, lifting the S&P 500 to another record high this week. Importantly, since the spending is spread out over an eight-year period, it should not stoke an increase in inflation expectations, which are currently being roiled by pandemic-related forces. Fed Chair Powell reiterated his view before Congress this week that he expects these transitory forces to fade as the economy normalizes later this year and next.

The fiscal news overshadowed a mixed bag of data this week, with the housing market

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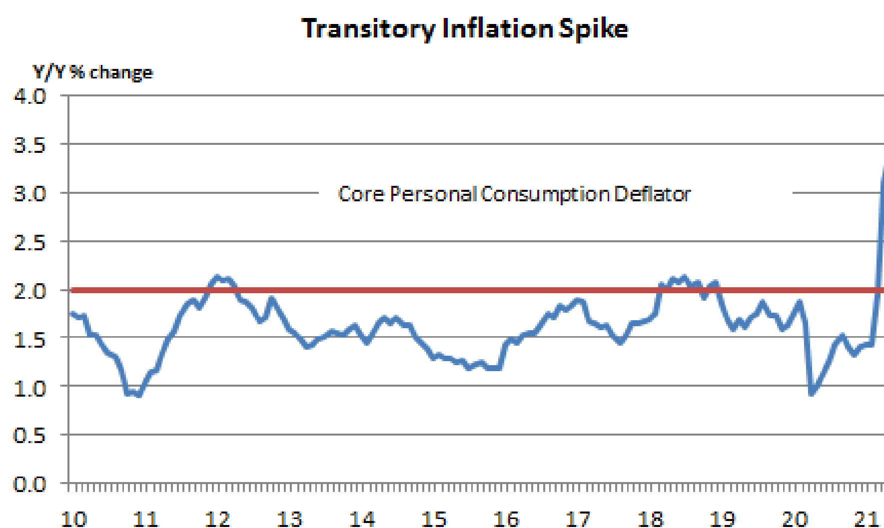
continuing to struggle, business investment showing ever more vigor and the economy's main growth driver, consumers, taking somewhat of a breather. The latest reports provided little reason for the Fed to alter its timetable for shifting to a less accommodative policy. A key inflation gauge it follows, the core personal consumption deflator, continues to run hotter than the 2 percent target, increasing 3.4 percent in May from a year earlier, up from 3.1 percent in April. But an overshoot is expected to linger as the post-pandemic surge in demand exceeds supply, although how long the Fed would tolerate that condition remains unclear.



A critical influence will be the performance of the job market, where numerous inconsistencies muddy the picture. Recent gains in payrolls have been underwhelming, but the shortfall mostly reflects the difficulty of getting workers off the sidelines. We expect the barriers to steadily diminish in coming months as schools reopen, expanded unemployment benefits expire, and higher wages encourages recalcitrant workers to accept job offers. To the extent that health concerns are keeping workers away, that too should ebb as vaccination coverage continues to expand and cases of the virus fall. A major caveat of course is that the variants coming from overseas do not become more prevalent in the U.S., something that, along with stubborn vaccine hesitancy, is deeply concerning to health officials.

Since it overhauled its policy framework last year, the Fed is willing to let inflation run hotter than it would in the past to compensate for years in which it ran consistently below 2 percent. How long it would allow an overshoot is uncertain; but a key objective is to avoid a proactive tightening that would stifle the recovery before the job market returns to full health. The challenge is to determine when that point is reached. One complicating factor is the millions of workers that have dropped out of the labor force during the pandemic. The Fed believes most of them want a job and it's important to keep the growth engine humming until they return. One reference point it monitors is the labor force participation rate. At 61.6 percent, it still is considerably below the prepandemic level of 63.4 percent, a shortfall that translates into 3.5 million fewer workers.

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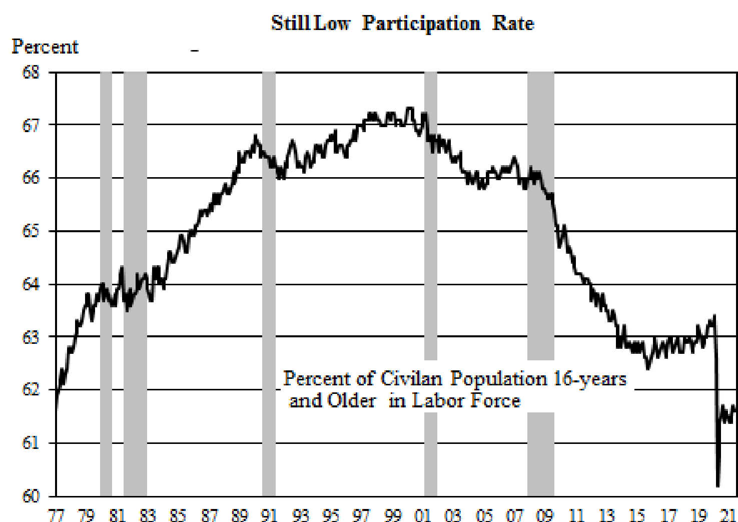

But since the pandemic began, 2.5 million workers have retired, a much higher rate than seen prior to the pandemic. A considerable portion of this group took early retirement, and some of them may have done so involuntarily, pushed out by the lack of job opportunities. No doubt, a hotter job market would encourage these workers to resume the job search. But the Fed runs the risk of stoking inflation if it strives to bring back workers who voluntarily left the labor force and plan to stay permanently on the golf course. Put another way, the Fed may be seeking to lift the participation rate to an unrealistic level, resulting in an easy policy that remains in effect for too long.

The question is, why would more people than usual voluntarily be taking early retirement? One likely reason is that ageing baby boomers are entering their golden years with considerably stronger balance sheets than they expected, thanks to surging asset prices and lower debt burdens. For sure, a broad swath of the population has enjoyed improved financial conditions in recent years. Over the past year alone household net worth increased by an astonishing $25.6 trillion, or 23 percent, including nearly $5 trillion in the first quarter according to Federal Reserve data. That trend continued into the second quarter, as stock prices are tracking a gain of around 8 percent for the period and home values continued to surge.

However, wealthy households with the fattest portfolios reaped the biggest gains, and it's unlikely that their appreciated assets greatly affected retirement decisions. That said, it's important to remember that older households hold more wealth than younger ones, and the improved balance sheets of senior workers may well have tipped them over into retirement. And whereas stock holdings are highly concentrated among wealthier households, housing is the largest asset holding for those lower on the income and wealth ladder. Here too, older Americans tend to have more housing equity than younger individuals, and the surge in property values over the past year provided them with a more comfortable financial cushion – and incentive – to retire on.

Finally, most workers, including those in low-paying jobs, participate in a retirement plan. Here the improvement over the past year has been even more remarkable. According to the Federal Reserve data, assets in defined contribution plans, mostly 401(k)s, surged by 34 percent over the past year, exceeding the gain in the broader measure of net worth by the widest margin in at least a decade. It's not a stretch to believe that some senior workers feel they have enough to retire on a few years before their planned exit from the labor force. Historically, when people retire there is only a slim chance they return to work.

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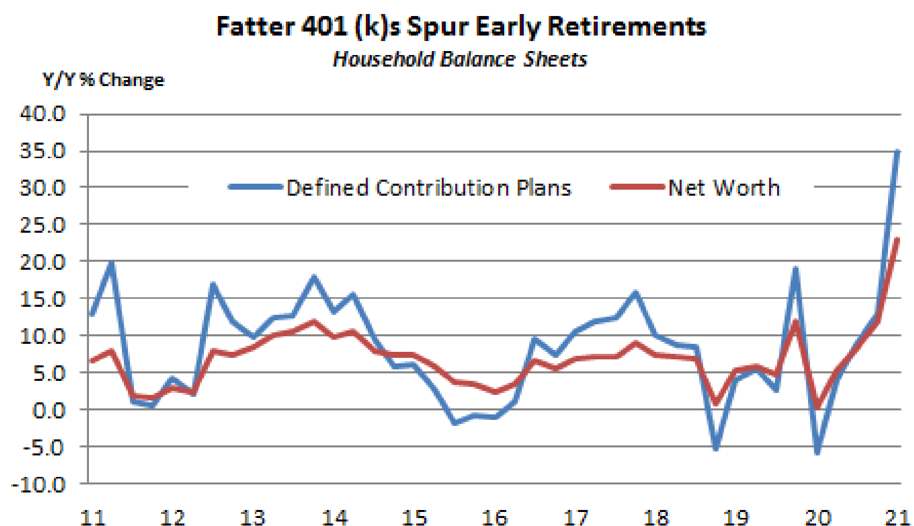
When they do, it's usually because their retirement funds ran out more quickly than anticipated. The outsized gain in retirement accounts over the past year reduces that threat even as it may likely have spurred a wave of early retirements.



I If more people than thought opt to permanently stay out of the labor market, the potential supply of workers is correspondingly reduced. With a lower labor force participation rate, conditions in the job market would tighten faster than otherwise, leading to swifter upward pressure on wages and, hence, price pressures. Clearly, this is something the Fed will have to closely monitor in coming months. As pandemic-related barriers suppressing the labor supply continue to fall more workers will be coming off the sidelines, pointing to a pick-up in job growth over the balance of the year. However, there are a record 9.3 million job openings, and companies may have to compete for a smaller pool of available workers that results in greater labor cost pressures than the Fed expects.

From our lens, the Fed will be facing a higher and stickier inflation environment later this year and in 2021 than it currently envisions. We do not expect inflation to get out of control, as stronger productivity, globalization and demographic trends are powerful offsets, and inflation expectations remain well anchored. However, the Fed will likely have to start pulling in the reins sooner than it currently plans, particularly if the labor market heals faster than anticipated.

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