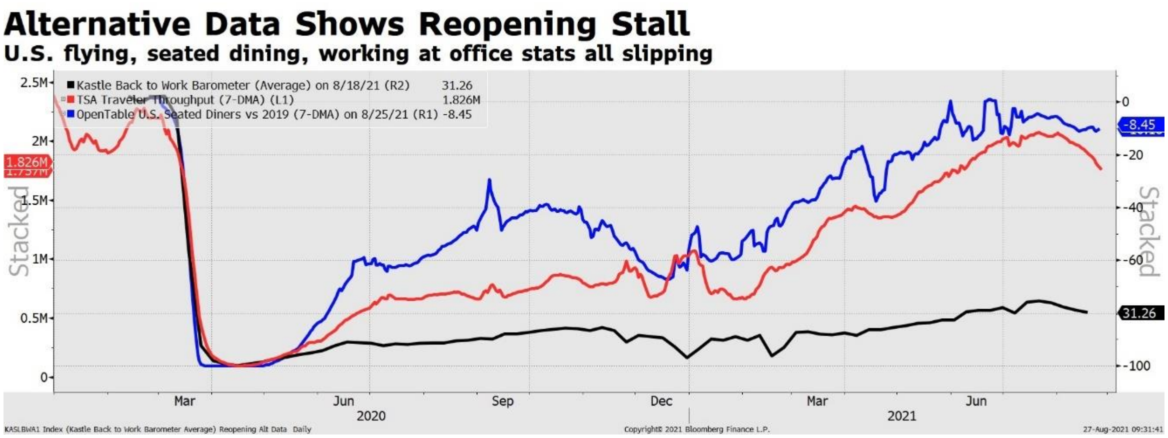
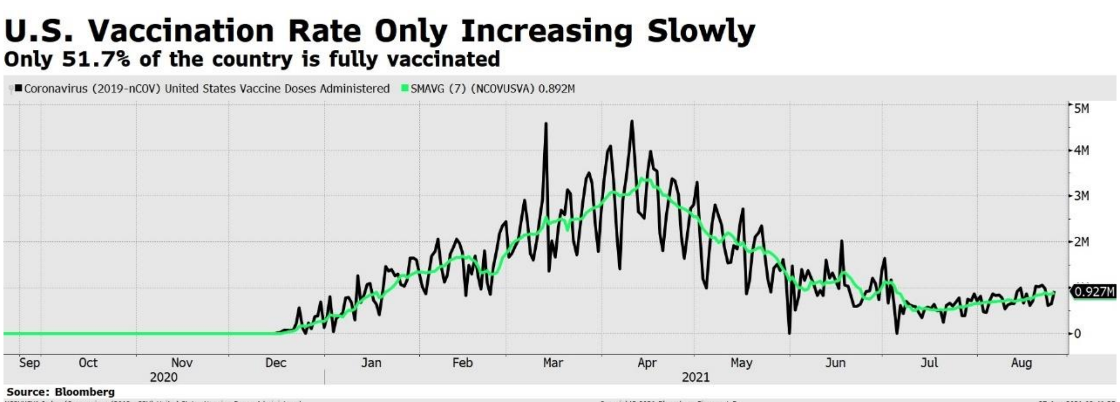
Courier Capital, LLC
Registered Investment Adviser
An affiliate of Five Star Bank

Economic and Market Update – LOSING STEAM (08/31/2021)

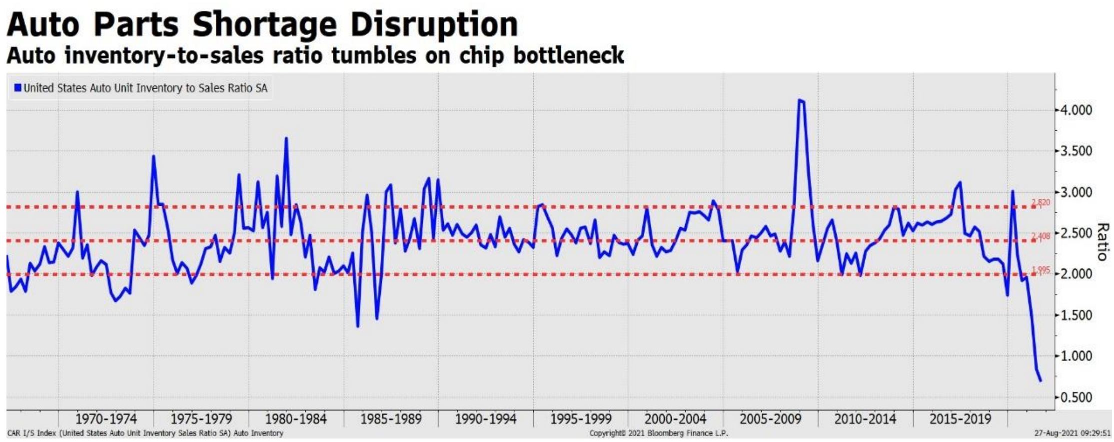
Latest Developments and Economics

Recent data points have indicated that the economic recovery in the United States continues but is losing some steam relative to the pace set earlier this year. While that was expected at some point it may be surprising to some that it happened so quickly. First, we have seen reopening activities slow down as measured by return to work at office, travel and restaurant visitation. Furthermore, recent economic data supports this as well. Retail sales fell 1.1% in July and durable goods orders slowed (though impacted by slowing aircraft orders). Housing purchases have slowed. Most concerning is that the University of Michigan's consumer sentiment index dropped to a reading of 70.2 (where 81.3 was expected) from last month's 81.2. This is the lowest level of this index since 2011 and a drop this large (13.4%) is rare. This does not necessarily follow that the economy is due for a downturn, but it does indicate that consumers are less confident about current and future prospects. This sudden drop in confidence may be coming from health concerns resulting from a new wave of Delta-fueled COVID cases and hospitalizations, new mask requirements and limitations as well as significant increases in the prices of many consumer-orientated goods and services. Many see the source of the health-related concerns coming from the slowdown in U.S. adults completing their vaccination program. The early rate of between 3-4 million vaccines per day has fallen to less than 1 million. As of the end of August just over half the population is fully vaccinated.

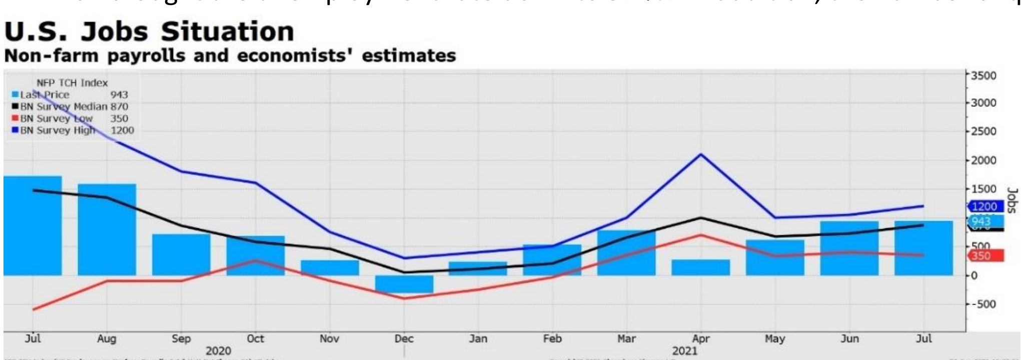




In addition to the health concerns the recent increase in inflation has also weighed on the minds of consumers. The headline inflation, as defined by the Consumer Price Index (CPI), was up 5.4% over the last 12 months. The most significant increases were in items very visible to the consumer including gasoline, utilities, used cars - all up significant double digits. Food away from home, transportation services and apparel are also up over 4% each. Core CPI, which is less volatile food and energy, was still up 4.3%. The Fed chair Jerome Powell reiterated at Jackson Hole that he still believes much of the inflation trends are "transitory", due to temporary circumstances such as shortages, and will lose steam (ex: the historic auto parts shortage). If both the health concerns and the inflation are temporary, then consumer sentiment can turn positive very quickly as conditions stabilize.



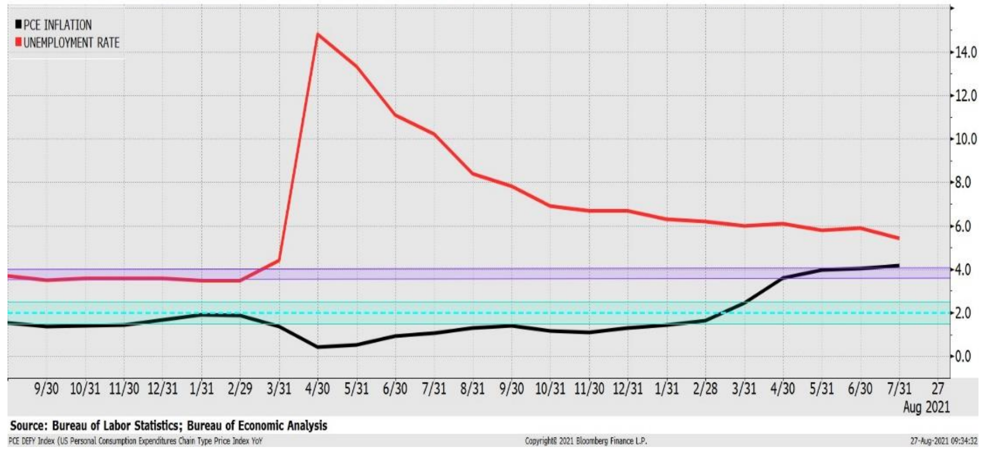
There has been very good news on the job and unemployment front. Last month there were 943,000 jobs added in the U.S. which brought the unemployment rate down to 5.4%. In addition, the number of quits increased (a sign of labor confidence) and there are currently over 10 million jobs waiting to be filled in the country. The Federal Reserve estimates that about 5 million of the 6 million jobs still lost since the pandemic are in the service industries. Having more jobs open than people currently looking is a catalyst for upward wage pressure, which is inflationary. In addition, the significant rise in housing costs has not made its full impact on inflation data yet. In fact, there is growing dissention among Federal Reserve regional presidents that the inflation we are currently experiencing may not be as benign and temporary as Chairman Powell believes. About 5 non-voting regional presidents have come out strongly in favor of beginning to reduce the extreme accommodation in keeping rates low.



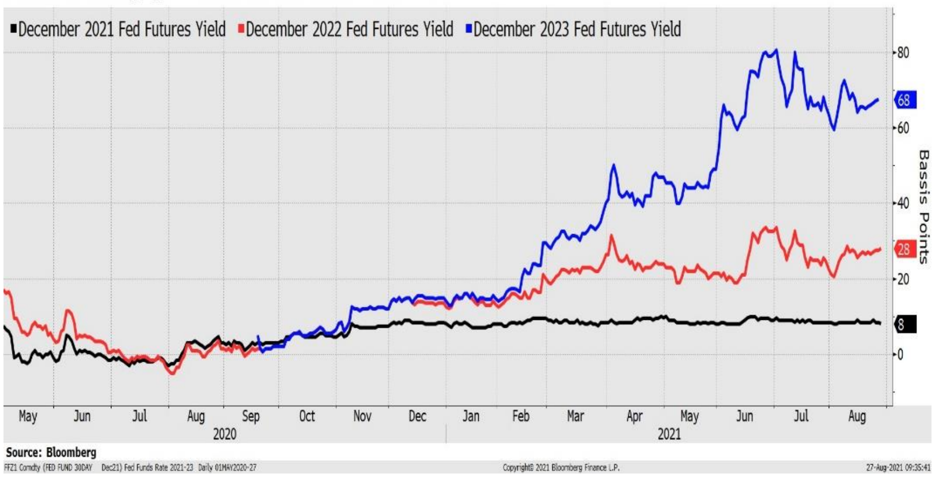
At the post Jackson Hole press conference on Friday 08/27 Chairman Powell stated that we have achieved “substantial progress” on the inflation goal but that there was a long way to go on the jobs front. Given the focus on jobs he reiterated his current plan that tapering of the $120 billion-dollar monthly bond purchases since June of 2020 will begin to wind down later this year (possibly putting upward pressure on rates) but an official rate increase is still some ways off.

Not Quite There

Inflation is averaging above the Fed's target, but unemployment is still high



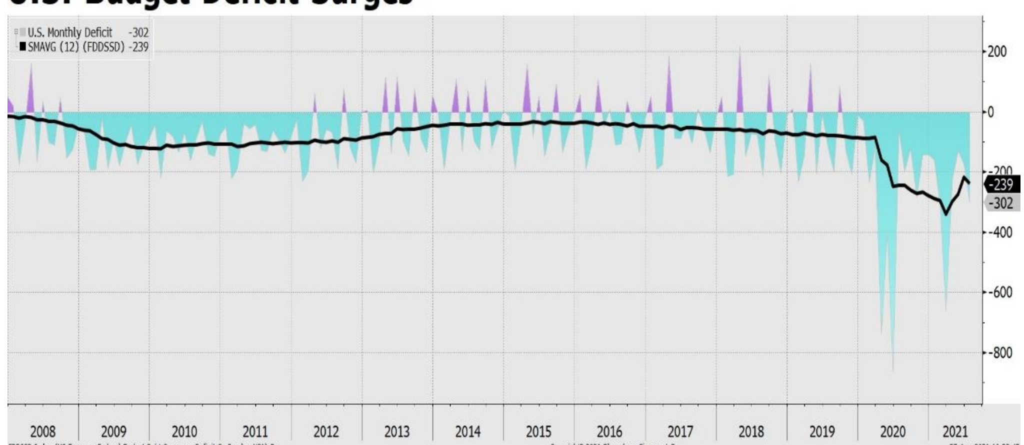
Fed Hike(s) Priced in for 2023



If, however, inflation overstays its welcome, or increases further, that may prompt a larger response from the Federal Reserve to contain the inflation threat. Current futures markets, where people are taking sides with their money, seem to indicate that the rise in rates could be rather quick. While the black line anticipates rates staying where they are the rest of this year the expectation is 0.25% increase in short-term rates by December 2022 (red line) and then another 0.40% from there by December 2023 (blue line). This expectation has been moving up quickly since about April of this year.

In addition, Congress has moved forward with consideration of the Biden Administration’s $3.5 trillion social spending plan through reconciliation along with the bipartisan $1.0 trillion traditional infrastructure plan. Historically, deficit spending of this magnitude (averaging $239 billion per month) also puts upward pressure on inflation and interest rates. These bills will most likely not come to vote in Congress until mid-September when both chambers return from recess.

U.S. Budget Deficit Surges



Geopolitical events have been dominated by the retreat and withdrawal of the United States from Afghanistan. While this has very significant human and political implications we are focusing on any potential geopolitical and economic repercussions. Some developments to watch are:

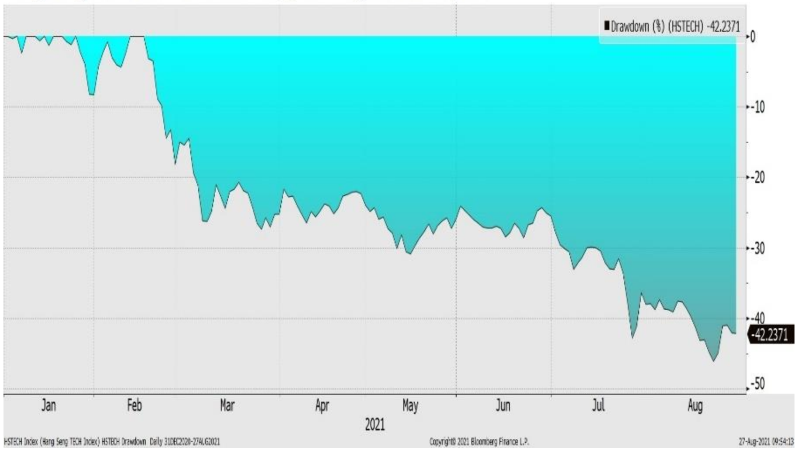
- a potential increase in terrorism (which we have unfortunately already experienced)
- regional instability (the situation is complicated between the Taliban and ISIS who are not friendly with each other as well as neighboring countries such as Pakistan, India, Iran and China)
- reaction and response from allies (Israel and Taiwan have become a little more nervous about U.S. commitment)

Each of these items has the potential to disrupt trade or cause business and consumers to be more cautious.

The other international activity lies in China with their focus on increasing the regulatory environment and it is impacting technology companies the most. In a continued theme of "common prosperity" they have addressed data privacy laws and personal information to protect citizens and cut down on what they say is widespread fraud. As China is a one-party system, they can enact these laws much faster than most western democracies. They have continued this month with the passing of data privacy laws to protect personal information, similar to Europe's GDPR but much stricter. They are aimed at stopping the collection of data by big technology companies. This would also prohibit overseas (i.e.: U.S.) stock listings for companies in China that manage sensitive individual data. The reaction to the new laws over the past few months has been swift. The Hang Seng (Hong Kong's stock index) has dropped close to 50% from its high and Tencent (a very large Chinese tech company with social media, messaging and video games) has declined significantly. There may be more to come.

Drop and Give Me Fifty!

Hang Seng Tech Index drawdown approaching 50% from peak

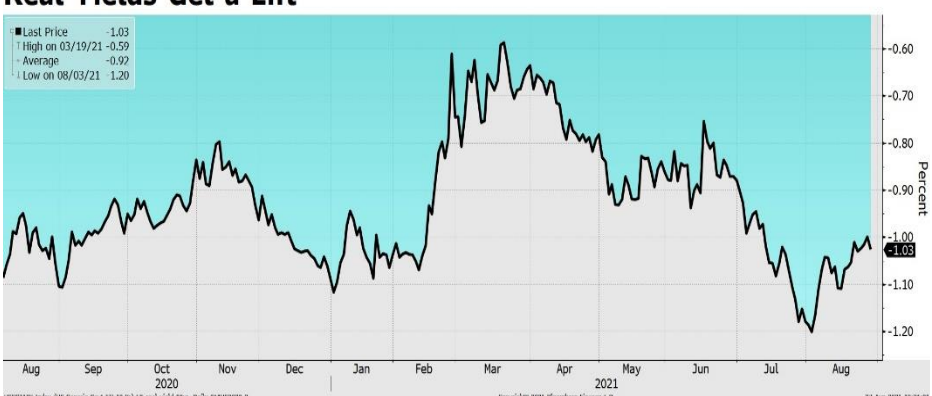


Tencent Valuations Near Eight-Year Low

Stock's blended 12-month forward P/E ratio falls

Financial Markets

Real Yields Get a Lift

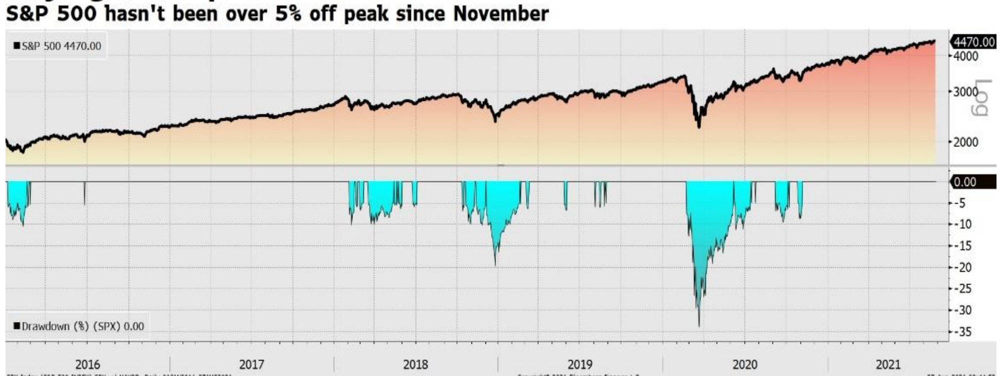


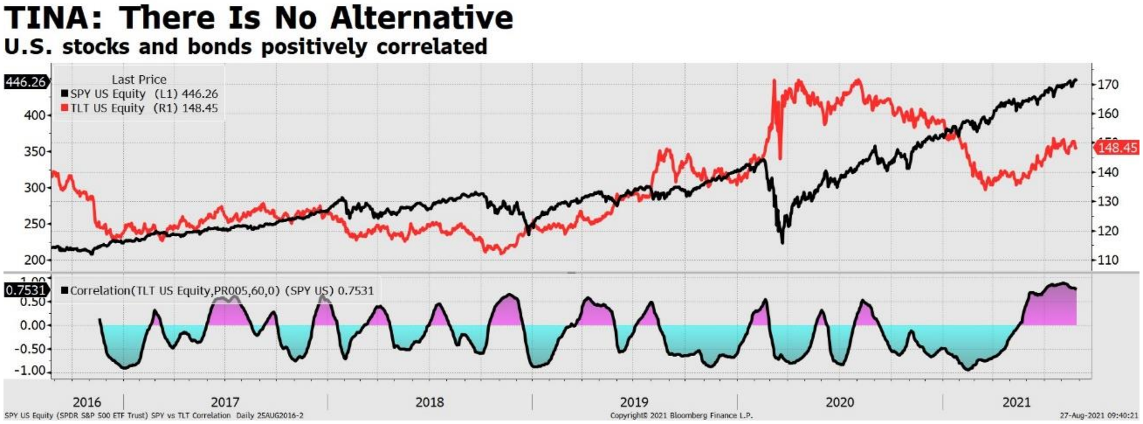
Despite expectations of the Federal Reserve beginning to discuss tapering, the 10 Year Treasury yield backed up to about 1.25% before starting to move past 1.30% late in the month. This non-reaction in yields, coupled with higher than trend inflation, has meant that real yields (i.e.: after inflation) are still significantly negative – to the tune of about 1.20%. That means you lose 1.20% of purchasing power by purchasing the bonds – even though your dollar return is positive. This can have a significant impact on savers if it continues too long. Large cap equities in the U.S. however have not lost any steam this year. There has not been a 5% retreat in the S&P 500 since November of 2020.

Despite the rise in the general index there has been quite a bit of churn underneath. There has been rotation in the reopening and the stay-at-home stocks during the year. Even though the S&P 500 has set over 50 new records this year about a third of stocks in the index are more than 10% below their 52-week highs.

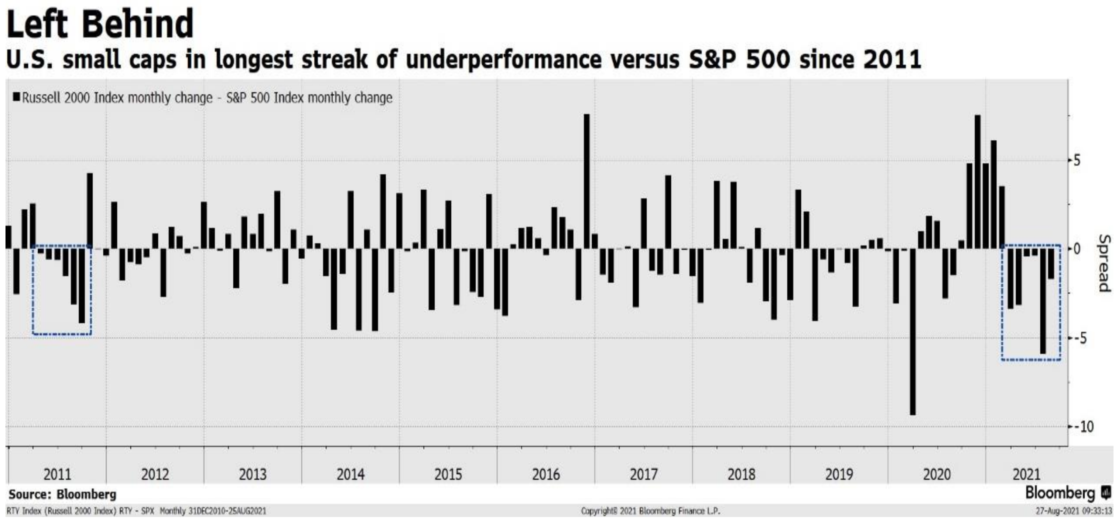
Buying the Dip

S&P 500 hasn't been over 5% off peak since November

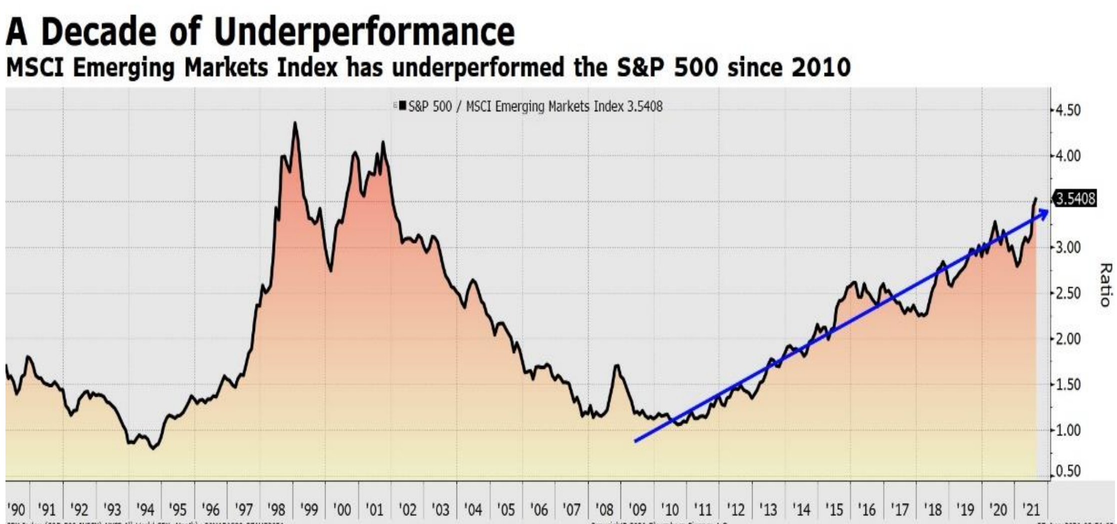




This is mainly because there have not been many investment alternatives readily available except equities given the low (and falling) bond yields. In fact, rising equities and declining yields this year has meant that bonds and stocks have moved in the same direction (positively correlated) in 2021. Usually, bonds provide portfolio diversification because they generally move in the opposite direction of stocks in the long-term. During periods like this, when they move together, portfolios rise because of both asset classes but, if correlation stays positive there could be a period where they move down together as well.



Not all equity classes have had the same experience as the S&P 500 this year. Beyond U.S. Large Cap equities many other equity classes are between 5% and 10% below their 52-week highs. Also, these are highs that were reached several months ago. Looking at small cap U.S. equities they have had the longest underperformance to the S&P 500 since 2001 – not because they have fallen but mainly because the S&P 500 continues to rise. The same can be said of developed international and emerging market equities. In fact, the emerging markets have the best fundamentals for long-term growth but have lagged the S&P since 2010. Some of this lately is the China impact that was mentioned above. It is in these other equity asset classes that we may look to find value.



Should you have any questions please contact us.

Image sources: Bloomberg and CNBC unless otherwise noted

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