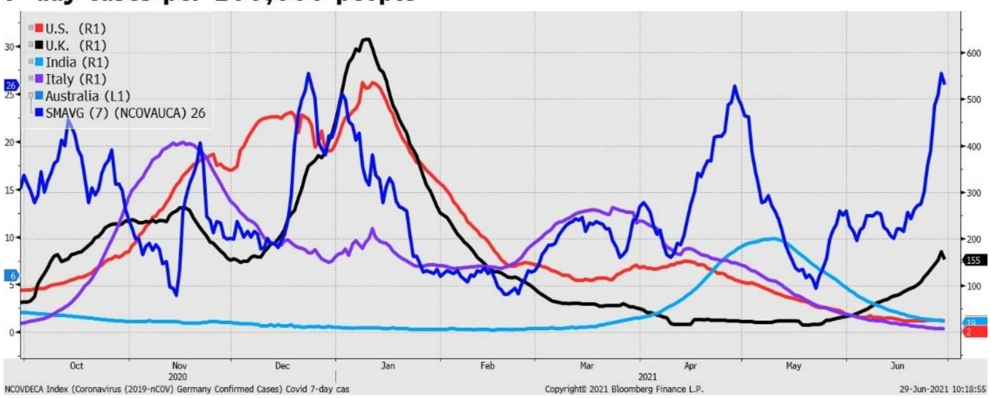
## Economic and Market Update – MIXED SIGNALS (06/30/2021)

## Latest Developments and Economics

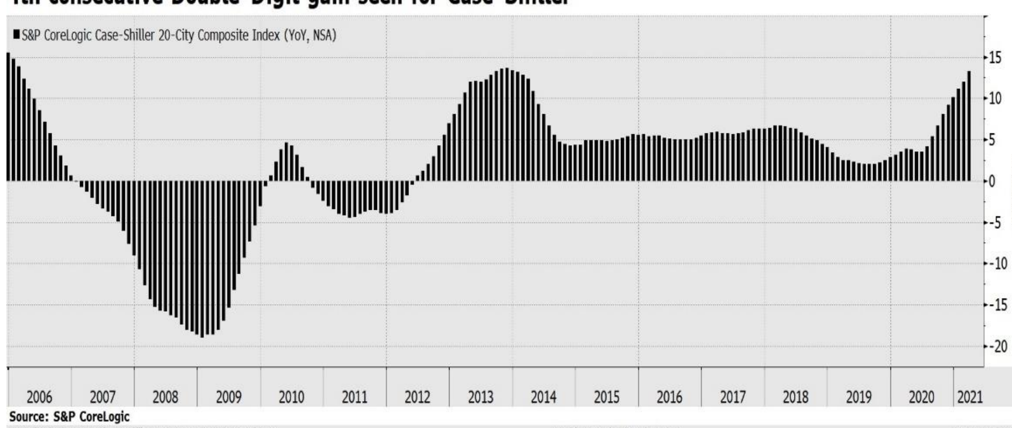
While the United States, and much of the world, continues the process of reopening there have been several items that have been sending mixed signals on the pace. The first is the COVID virus itself. Infections and hospitalizations have fallen and many of the restrictions coming down are allowing life to return to a more normal cadence, but the virus shows some troubling signs. In the U.S. the vaccination rate has slowed and, while low, the cases per day are no longer decreasing. The Delta variant is much more transmissible and creates risk for those unvaccinated. Globally, the virus is following a seasonal pattern of rising cases with half of Australia in lockdown (blue line), Indonesia imposing stricter controls and the U.K. and India still struggling with the variant. It will be something to watch in the U.S. once we enter the Fall season.

**Watching the Curves**
**7-day cases per 100,000 people**



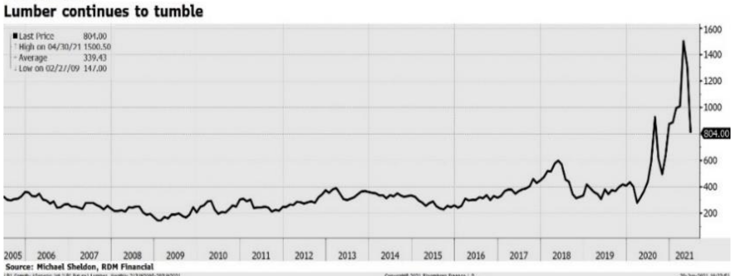

Another mixed signal is housing. Prices continue their march upwards, gaining 14.6% year over year in the latest national reading – the fastest appreciation in 15 years. Median home price is now over $350,000 nationally. However, sales of existing (and new homes) fell for a fourth straight month dropping 0.9%, even with historically low mortgage rates, to an annualized rate of just 5.8 million units. There is a very low inventory of just 1.23 million homes for sale at the end of May.

**Housing Prices Spike Higher**
**4th consecutive Double-Digit gain seen for Case-Shiller**

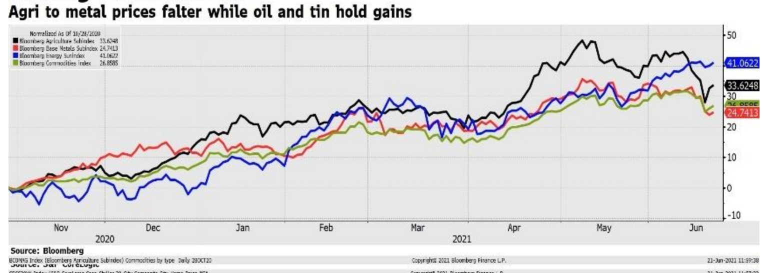



We are also seeing mixed signals in commodity inflation. Lumber, which has contributed to the increase in the cost of new homes, seems to be moderating as are many other commodity sectors while oil continues to climb. Oil hovering near $75 per barrel (up 50% YTD) is the result of an increase in demand due to reopening and a constrained supply. Shale production is down and the oil glut in storage is dwindling but OPEC is expected to increase production in August which will help keep up with increasing demand. Iran may also be allowed to sell more oil. The increase in oil prices has worked its way through

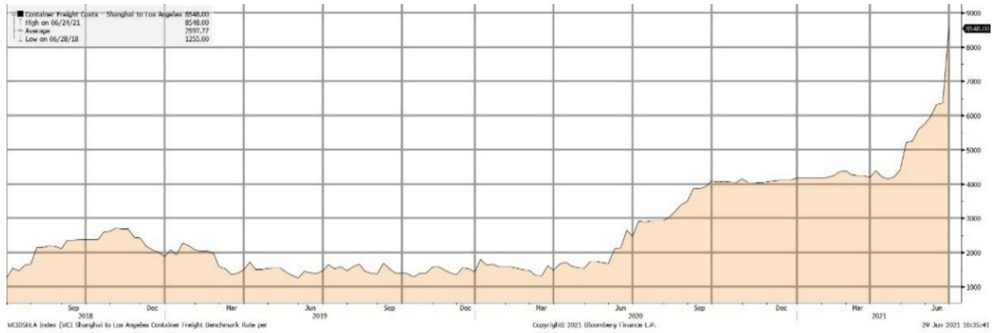
**Timber!**
**Lumber continues to tumble**



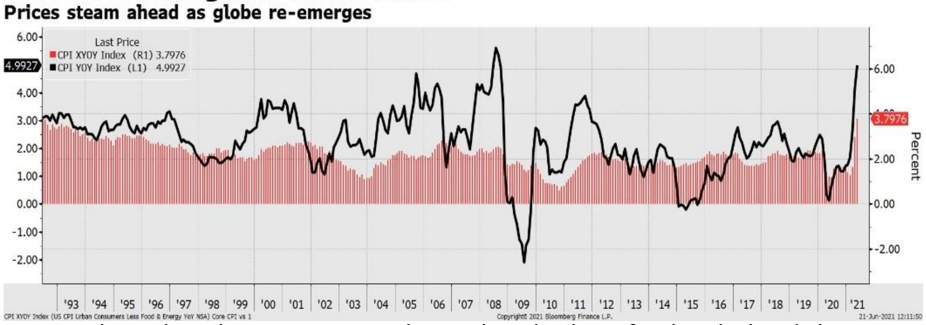

**Cooling Commodities**
**Agri to metal prices falter while oil and tin hold gains**



to the gasoline pump, the airline seat and beyond. The oil prices are another contributing factor to the historic increase in shipping costs. This is also driven by the heavy demand for goods and the restarting of the supply chain. The shipping costs for containers from Shanghai to Los Angeles has increased to over $8,500 per container.

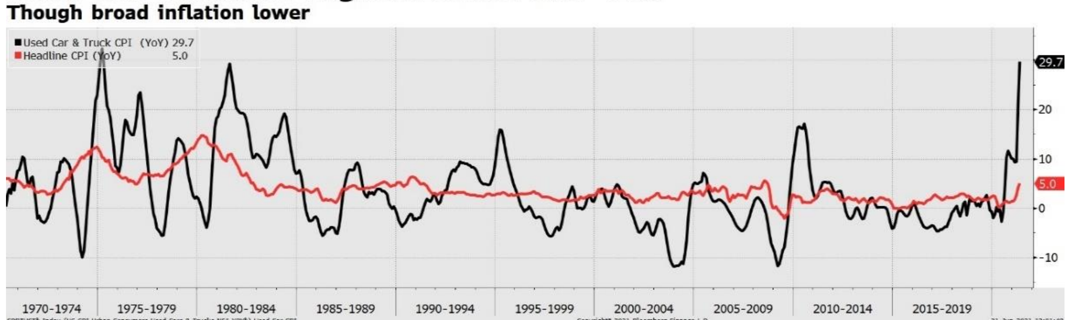


**Core CPI At Highest Since 1992**
**Prices steam ahead as globe re-emerges**

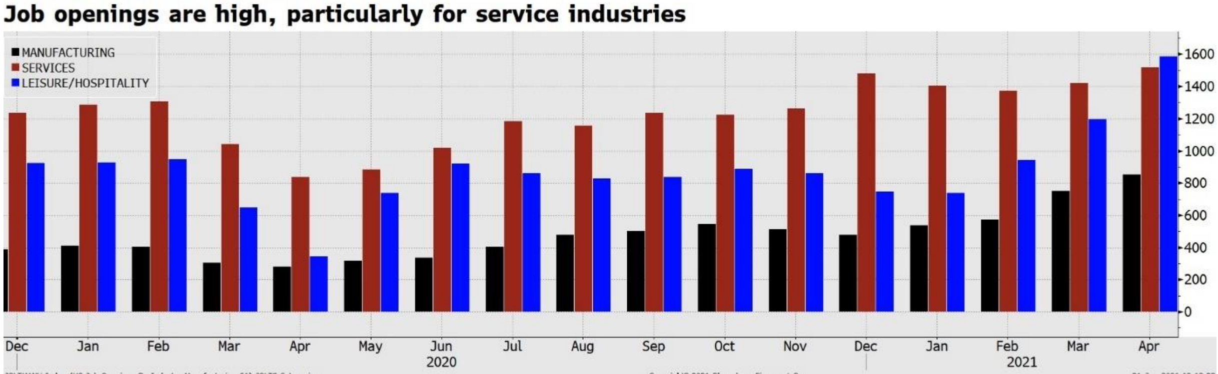



All of this has resulted in several measures of inflation increasing at rates not seen in many years. The most publicized measure, the Consumer Price Index (CPI) came in at 5.0% - the highest since 2008. Even Core CPI (which excludes volatile energy and food prices) increased at 3.8%. Some of this can be attributed to a low base from last year but that doesn't explain all the fast pace. Housing contributed to the CPI increase but, when looking further behind the reported number, one can find that there were several categories that had an outsized impact on the reading. Used vehicles, new vehicles, household furniture, appliances, apparel and airline tickets are among the items increasing quickly. Energy and used vehicles are each up almost 30%, transportation up 11% (airlines and rental cars), natural gas 13%, and apparel over 5%. The only offset was medical costs down 1.9% versus last year. The Federal Reserve believes that most inflationary effects to be temporary. Supply chain problems causing shortages and increasing prices (ie: new cars), creates a real impact on consumers, regardless of length. Another potential inflation trigger is a shortage of labor. The lack of workers is causing employers to lift wages, which is not a temporary effect. Employers continue to add jobs to the point where there are almost 9.3 million jobs open and unfilled in the United States. The mixed signal in labor is the fact that the addition to nonfarm employment has been very underwhelming. If so many jobs are open, and wages are rising, where are the workers? The Biden administration and the Fed are focused on returning jobs to the levels that existed before the pandemic. In February of 2020 there were 152.5 million workers in the U.S. and the latest reading is 145.0 million workers so apparently 7.5 million jobs need to be recovered. This leaves the labor participation rate at 61.7% versus 63.4% before the pandemic.

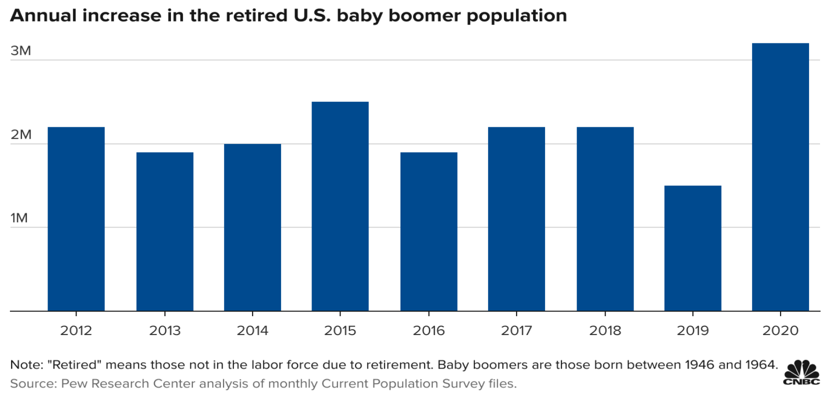
**Used Car Inflation Highest Since the '70s**
**Though broad inflation lower**



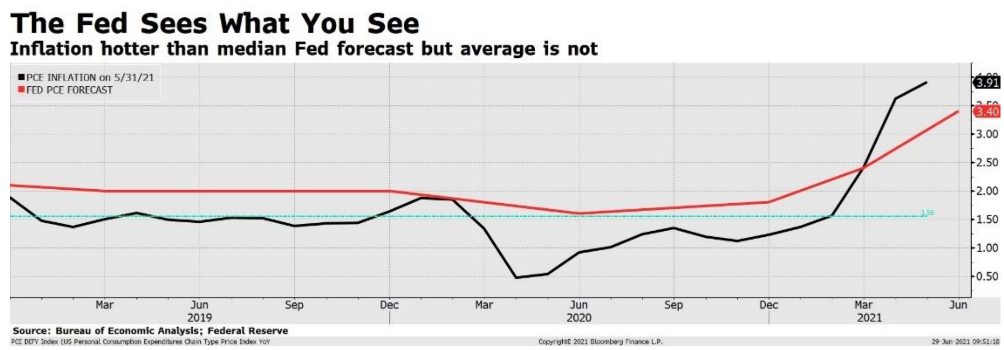

**Where Are The Workers?**
**Job openings are high, particularly for service industries**



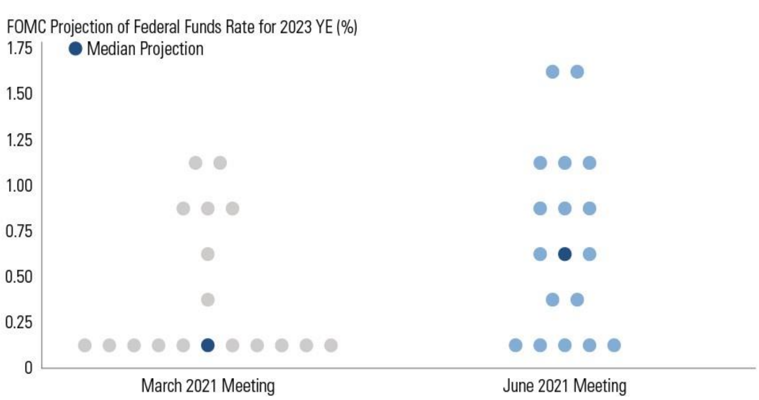
The question is will all those jobs necessarily return? First, it is estimated that between 2.0-2.5 million workers retired during the pandemic. Baby boomers were already in their peak retirement years and the pandemic seems to have accelerated this trend. Second, there could be mismatch in labor skills versus the skills required for open positions or a lack of desire or ability to work. Finally, companies have the option to increase capital expenditures to reduce dependence on labor and not hire as many employees as prior to the pandemic.




There are other measures of price inflation that are signaling similar increases. The Producer Price Index (PPI) was 6.6% in the U.S. – highest since 2010. China had the highest PPI read since 2008. This is important as it is the inflation that producers are experiencing and could make its way into consumer prices eventually. Core Personal Consumption Expenditures (PCE), the Fed's preferred measure of consumer inflation, also rose at 3.4% - highest since 1992.

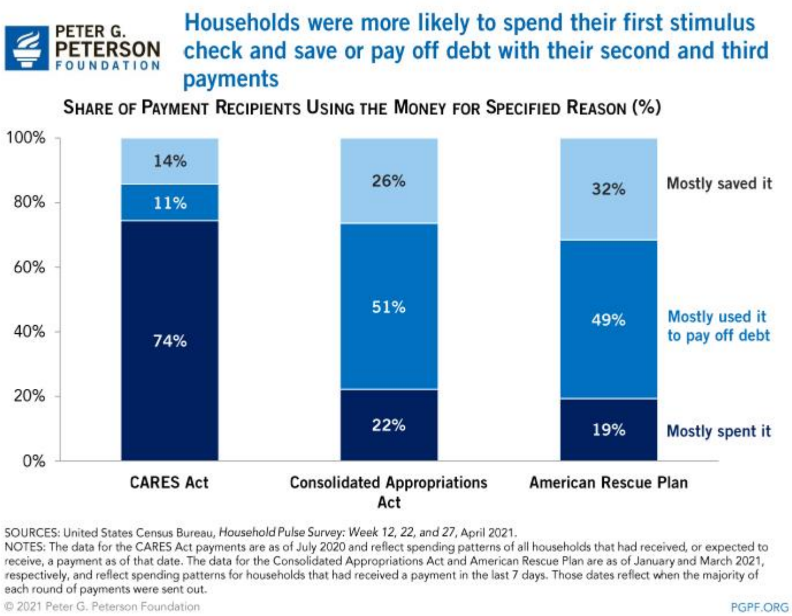



In the June press conference Fed Chair Jerome Powell acknowledged that inflation has "been larger than we expected, and they may turn out to be more persistent than we have expected, but the incoming data are very consistent with the view that these are factors that will wane over time, and inflation will then move down toward our goals – and we'll be monitoring that carefully." The Fed raised its annual expectation of inflation to 3.4% for the year from 2.4% in March. Even though transitory, the Federal Reserve did move up their timing for increasing interest rates. Instead of 2024 the Federal Reserve now expects two rate increases in late 2023. St. Louis Fed President James Bullard went a step further saying that he could see the first-rate increase in 2022 should inflation persist. The larger and longer inflation readings continue, the greater the chance that the Fed would have to take a more extreme action to curtail inflation. The "dot plot", a visual read of where current Fed Governors expect interest rates to be into the future, has moved rather significantly for 2023 since the last meeting in March.




Despite the inflation talk, long interest rates fell after the Fed meeting. The 10-year yield fell below 1.50% and has pretty much stayed there for June. This is a mixed signal as rates would be expected to rise with rising inflation. Currently real yields (yields after inflation) are negative for most maturities – a situation that cannot last indefinitely. This punishes savers as they lose purchasing power with negative real returns and rewards borrowers who repay loans with dollars that are less valuable.

Turning attention to politics we find more mixed messages. After multiple rounds of negotiations, a bipartisan group of Senators agreed on an infrastructure deal that mainly focuses on “hard” infrastructure. The $1.2 trillion deal is to be spent over 8 years and includes $579 billion in new spending. The bill includes $312 billion in transportation (roads, bridges, rail, etc.) and $266 billion in non-transportation infrastructure (broadband, power, water). While the bill does address infrastructure, which both parties support, there are no clear funding sources for the additional spending. No tax increases were included, and the offsets are forecast to come from unused COVID spending and better enforcement of current tax laws (IRS tax gap). Although this is much less than the Biden Administration’s $4.4 trillion total between the two proposed bills President Biden did put his support behind the bipartisan effort. The next day he seemed to have threatened a veto if it did not come with a reconciliation bill for the rest of his proposals but then quickly cleared up any misunderstanding that an implied veto was not his intention. The bill is now moving forward but is still on shaky ground. It still needs to pass the Senate and House. There are some Republicans reluctant to give Biden a win. There is a faction of Democrats who insist on the full proposal and expect a follow up bill to move forward with the remainder of the spending and tax increases (without Republican support). Nancy Pelosi has made comments that the bipartisan infrastructure bill will not go through the House without the follow up bill in tow.

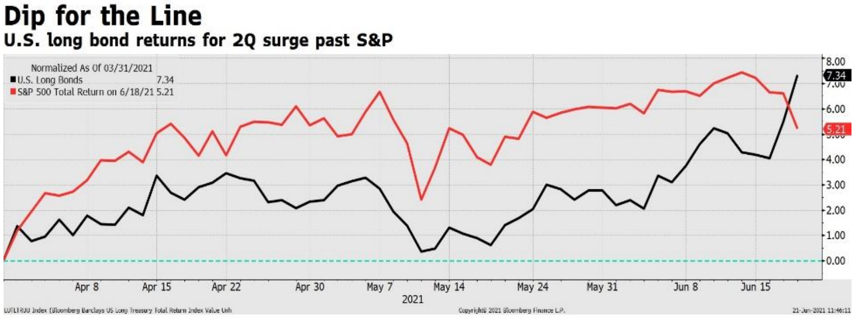



We have also seen some weakness in retail sales which could signal a slowdown in the recovery pace. This could be a result of the stimulus checks to citizens having been fully disbursed. The total of over $860 billion in payments over the three packages is complete. Households have most likely already spent a good portion of the payments but still have savings they can spend in the future. While the $300 weekly supplemental unemployment payments will end by September, new direct payments will start July 15. The advanced child tax credit payments begin with individuals and families under certain income caps who will receive $300/$250 for each child monthly for the rest of 2021. This is an advance on the increased child tax credits of $3,600 for each child under 6 and $3,000 for each child aged 6-17. Finally, inhabitants of some states will also be receiving direct payments from their state governments. States such as California and New Jersey are sending $1,100 and $500 respectively to eligible citizens from surpluses generated by Federal CARES payments to States.

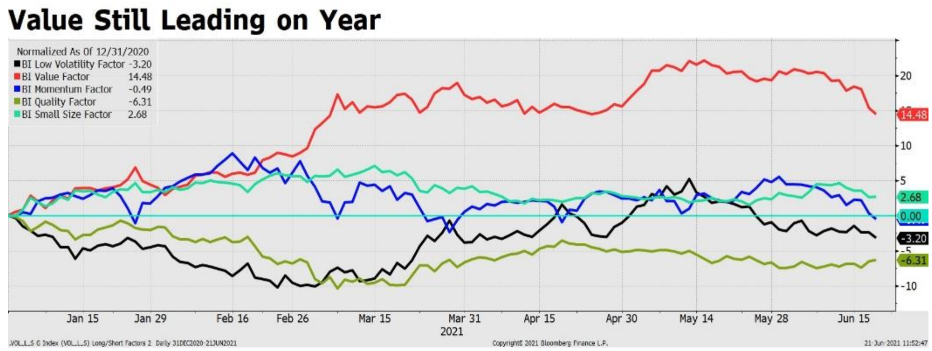
One last item of note at the Federal level is that treasury secretary Janet Yellen has indicated that the debt ceiling, which was suspended during COVID until July 31, 2021, is at risk of being reached in August. If so, the government would not be able to borrow money to pay its obligations unless the ceiling was raised or suspended again. In the past this has created political uncertainty, government shutdowns and disrupted financial markets.


## Financial Markets

The news in major U.S. financial markets was also noteworthy for the messages they suggest. The interest rate reaction to the Fed pulling ahead projected rate increases was unusual. Short term interest rates increased but long-term rates decreased. This caused the yield curve in June (pink line) to be flatter than the yield curve on March 1 (blue line). The shorter-term reaction was expected but the long-dated reaction sends a mixed signal. It is possible that the market does not believe the




inflation story has legs. If it thought inflation was a long-term problem rates should have increased. Also, it is possible that there is slower growth, or a recession, expected in the longer term and interest rates could be lower in the years to come. There are also some technical factors that are creating noise. Among them is the fact that with equity markets rising there is a heavy flow from pension funds into U.S. treasuries and international buyers still see the U.S. as high yield relative to other developed markets sovereign debt. In any event the longer end falling drives the low mortgage rates that are helping to fuel the housing market. The declining yields caused the total return for long-dated bonds to surpass equity returns for June.




The S&P 500 achieve a return of over 14% for the first half of 2021 and set record high price levels during June. The markets did have a hiccup from the Fed's unexpected news of early rate rises but generally recovered those losses quickly. While value stocks still lead growth stocks for the year they have trailed as of late and with a slower reopening expectation growth stocks have recently outperformed. In the short term the valuations of the S&P 500 are supported by corporate earnings estimates. The 2019 Earnings Per Share (EPS) of the S&P 500 was $161 and fell to $139 in 2020. The consensus 2021 EPS is $188 – about a 35% increase. Growth is expected to continue into 2022 where consensus EPS is $210 – another 12% on top of 2021. What we are watching, which could have an impact, is what goes on in Washington. Should regulations, company break-ups and corporate tax increases pass there would need to be a reassessment of the consensus corporate EPS estimates for future years. After such impressive market results for the first half of 2021 the bar is very high for the second half to match and could face a more challenging path.

**Should you have any questions please contact us.**

Image sources: Bloomberg and CNBC unless otherwise noted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