1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

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A strong economy, equities take a breather and the U.S. leads the way

Equities

U.S. equity markets took a breather this past week. They did this in the face of strong economic releases. Advances of COVID-19 overseas, particularly in India, negatively impacted stock prices. Although equities did decline, they remained well ahead of the game for April.

Economic Indicators

As a reminder, readers should be taking into consideration that the global economy is coming out of a steep decline when reviewing economic statistics. Economic reports were convincingly positive in April. Steady vaccine rollouts and improving COVID-19 trends domestically has encouraged consumer mobility and business reopenings. This has led to expectations for a rapid pickup in economic activity, leading some to fear that a period of uncontrollable inflation will follow.

GDP grew 6.4% over the first quarter of 2021 with the personal consumption component contributing the most to growth. Depressed inventory levels detracted significantly from GDP, however, a decline in inventories may suggest a large ramp up in production is on the horizon. Despite several quarters of strong growth since the 2020 lockdown, GDP is still below pre-pandemic levels. With the expectation for continued strong growth numbers in 2021, we expect this gap to narrow significantly by year end.

Retail sales increased 9.8% in March, coming in meaningfully higher than consensus expectations and February's 2.7% decline. Notably, clothing stores and restaurants saw double-digit increases in sales. Personal income and consumption measures also experienced month-over-month surges, increasing 21.1% and 4.2%, respectively. The BEA[1] attributed the increases largely to the disbursement of $1,400 stimulus checks in March and found that spending was strongest at restaurants and bars within the services sector. While March's income and spending surge was stimulus-fueled, there is still plenty of dry powder amongst consumers with the personal savings rate elevated at 27.6%.

The labor market recovery has picked up steam following March's strong employment report. Employers added 916 thousand jobs and expectations are for another 930 thousand additions in April. Unemployment claims dropped decisively in the beginning of the month and continued to trend lower in the following weeks to levels unseen since March of last year. Despite these recent improvements, there is still significant slack in the labor market. Unemployment claims are elevated relative to historical averages and just recently dropped below the peak seen during the 2007-2008 Financial Crisis. Furthermore, the unemployment rate remains 2.5 percentage points above its pre-pandemic level, 4 million more Americans are unemployed, and labor force participation is still nearly 2 percentage points below its rate in February 2020.

Consumer confidence and sentiment data turned definitively positive last month and signaled further improvements in April's releases. The Conference Board Consumer Confidence index rose sharply to the highest level since February of last year, with most of the improvement stemming from the current conditions component. The Michigan Consumer Sentiment index reported similar results.

[1]Bureau of Economic Analysis.

Interestingly, the surge in the current economic conditions component relative to expectations is the opposite of what typically occurs during recoveries. This may be attributable to the unprecedented stimulus measures rolled out in recent months paired with continued uncertainty regarding life after COVID. Notably, half of all consumers expect declines in unemployment in the months ahead—the highest level ever recorded. Overall, the data supports strength in consumer spending going forward, but drawdowns of savings may be gradual as longer term confidence continues to recover.

Inflation has been the hot topic as of late, and will only garner more attention as the pace of the recovery accelerates. While the two most well-known inflation gauges, the core CPI and PCE indexes,[2] remain below the Fed's 2% target, there are some signs of building price pressures under the surface. For example, within the CPI, the shelter component has ticked higher in each month of 2021. Given its relatively large weighting in the overall CPI calculation, this is something to watch closely. Inflationary pressures are also apparent within the manufacturing sector. April's Producer Price Index (PPI) reading increased 3.1% year-over-year, and the most recent manufacturing PMI pointed to higher input costs due to supplier shortages and rises in transportation fees.[3] Furthermore, according to an NFIB survey, the number of small businesses planning price increases over the next three months is at the highest level since 2008. The same survey also signaled that employers are struggling to fill open positions and are willing to boost pay as an added incentive.[4] More to this this point, the U.S. Employment Cost Index rose 0.9% over the first quarter of 2021 and stayed relatively stable over the past year. This is surprising because typically there is downward pressure on wages during recessions. Wage growth should not be viewed negatively as long as it is accompanied by productivity gains.

The most recent Federal Reserve Beige Book characterized the state of the U.S. economy as accelerating to a "moderate pace," however, economic indicators are painting a different picture. The inflationary pressures we are seeing at the moment look to be temporary rather than persisting, but as economic activity continues to accelerate, the inflation question will only grow in importance.

Economics

As reported earlier, April's economic indicators show a rapidly growing economy. There is little evidence that the U.S. recovery is in any jeopardy. Although there are clear signs of upward pressures in some markets, we don't feel there is a danger of an inflationary spiral, at least in our forecastable future. The U.S. economy appears to be in a very positive position for the next year or so. The other concern is the economy slipping back into recession. Neither appears to be a danger.

We are encouraged by the latest FOMC (Federal Open Market Committee) report.[5] The opening line should give comfort to those who fear a return to recession or slow growth.

"The Federal Reserve is committed to using its full range of tools to support the U.S. economy in this challenging time, thereby promoting its maximum employment and stable price stability goals." We all know the FOMC is going to promote growth, but it is reassuring to see stability prominently displayed. This is important because there is legitimate concern among investors that the combination of aggressive government spending and rapid monetary growth will produce serious inflationary pressures.

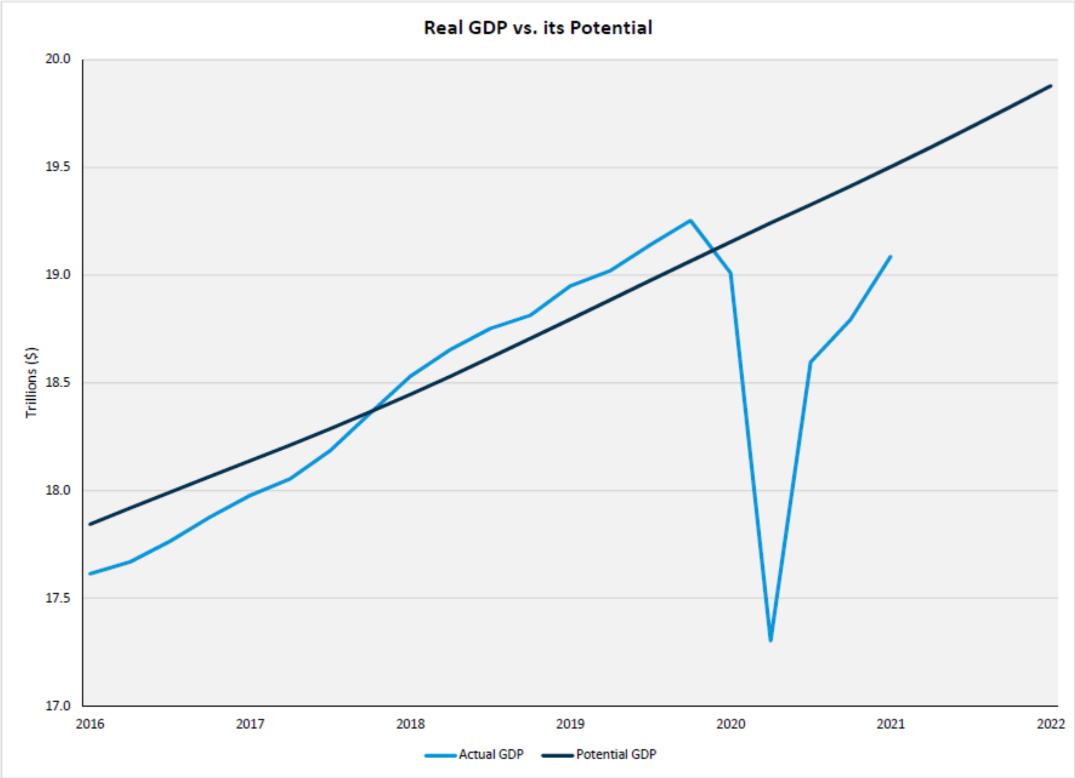
We have written about the exceptionally large fiscal packages in the past few weeks. We feel that spending on infrastructure and education are a positive, as both add to productivity gains in the

[2]The core measures exclude food and energy.
[3]IHS Markit. 2021. "IHS Markit Flash U.S. Composite PMI." https://www.markiteconomics.com/Public/Release/PressReleases.
[4]Dunkleberg, William C., and Holly Wade. 2021. "NFIB Small Business Economic Trends." National Federation of Independent Businesses. https://www.nfib.com/foundations/research-center/.
[5]April 28, 2021.

intermediate and long run. Also, increased consumption combined with low interest rates will encourage business investment. It appears likely that residential investment will slow, relieving some pressure on already low interest rates and encourage more business investment.

There is plenty of economic slack in the E.U. and parts of Asia. This idle capacity can relieve U.S. price pressure. Clearly, this will add to the U.S. trade deficit, but as the economies of these countries start to gain strength, they will be importing more to relieve some of that pressure. In any case, as we have often written, trade deficits are not a serious problem.

Having said that, investors should expect to see growing price pressures, but they should be temporary. In the United States, upward pressure on various markets such as labor, commodities, etc., should be temporary. The E.U. will take longer to gain strength. If we are correct, it is likely that any chance of global economic tightness leading to a serious inflationary cycle followed by monetary tightening is well into the future. Our final point about why we appear complacent about inflation is the actual and potential GDP gap. Looking at the enclosed chart, readers can see that there is a gap between potential and actual GDP. It is unlikely to have a serious bout of inflation until they are much closer. As shown in the chart, even when actual exceeded potential, inflation was absent. But investors should expect continued volatility. In economics and investing there is no such thing as a straight line.



Sources: U.S. Bureau of Economics and U.S. Congressional Budget Office

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