1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

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Markets end the week on a volatile note, the month's economic indicators and a new business paradigm!

Equity Markets

Equity markets ended the week on an up note, but Friday's gain was not enough to overcome the losses sustained earlier in the week. The Dow closed down 1.35%, the S&P 500 was down 2.20%, and the NASDAQ closed down 3.19%. The culprits remained the same two that have bothered investors for some time—COVID and uncertainty about the spending bills and what the Fed will do. Alas, there are no real answers to either. Although the Fed tells us what they think, their actions are always predicated on the strength of the economy.

Economics

Since Ryan Schutte, CFA, Investment Associate, has a review of some important economic indicators in the "September Economic Update" section, we will take advantage of his efforts, take a flight of fancy, and discuss a possible future. You will notice indicators are unusually inconsistent, and this is one reason equity markets remain volatile. Investors may be confused by this inconsistency, but should remember that the recession did not arrive through the normal channels. This may have altered the way businesses conduct their operations. We believe it is possible that there is a paradigm shift. Clearly, this is not a sure thing, but it is certainly possible. If this is true, it has important implications for markets. In any case, it is a very interesting thought to explore.

We have recently written a bit about this shift and a lot has to do with supply chain management and the dominant theme of the future, technology. The use of high tech in production, the substitution of capital for labor, diminishes the advantage that lesser developed countries have had in the past. This does not put an end to foreign-based supply lines, but there may be fewer and dispersed over more countries. If this should occur, it could be a boost to U.S. growth, but it wouldn't come without a cost. Substituting capital for labor is a positive for the economy in a macro sense, but will cost jobs in the short run. There are ways to ease the pain. We have written about them extensively, but a new program has come about and was recently highlighted on the television news show 60 Minutes. IBM created an initiative to help offset the problem many American companies face—not enough qualified candidates to fill many of their jobs. Rather than have a college degree as the barrier to entry, they are interviewing talented high school graduates, and setting up training programs for entry into management and technical positions. Programs like this will go a long way in solving underemployment, wage disparity, and unfilled jobs.

None of this is a sure thing. It will take cooperation between the private sector and government. Corporations will have to make the financial commitment to spend on technological advances, and government must facilitate this process by spending on infrastructure.

September Economic Update

The pace of the U.S. economic recovery slowed in recent months, as negative impacts from the Delta variant, continued supply chain constraints, and shortages dented reopening momentum from the spring and early summer.

The Federal Reserve continues to communicate that inflation is transitory, although we are seeing that transitory may turn out to be longer than initially expected. Inflation readings remain elevated but are starting to ease as more volatile components like used cars, hotels, and airfares are moving closer to historical norms. The most recent core CPI measure came in at 4.0%—below July's 4.5% print but still significantly higher than the Fed's flexible 2% inflation target. So far, inflation has been tied to reopening sectors, but we are watching core inflation components like housing and wages for signs of sustained increases. Housing's impact on inflation, measured by rents and owner's equivalent rent[1], are tame but have gradually increased throughout the year. Inflation expectations, not just realized inflation, plays an important role in the overall inflation picture. One measure of inflation expectations from the New York Fed has turned higher with consumers' expectations for the coming 1- and 3-year inflation were 5.2% and 4%, respectively.[2] Still, alternate inflation measures designed to be less volatile than traditional gauges that are also thought to better incorporate future inflation expectations offer some reassurance. The Cleveland Fed's median CPI, the Dallas Fed's trimmed-mean PCE price index, and the Atlanta Fed's Sticky-Price CPI are good examples with readings of 2.4%, 2.0%, and 2.6%, respectively.

GDP growth for the 2nd quarter was revised higher to a real annualized rate of 6.7%; however, expectations for 3rd quarter growth continue to trend lower. To this point, forecasts from the Atlanta Fed's real time estimate of GDP growth began the quarter above 6% and now sit at 3.2%. The forecast uses economic reports that have already been released, so the estimate declined as weaker data was incorporated. Much of this plays into the peak growth story that has dominated headlines as of late. The Fed tapering discussion and heightened complications surrounding the potential for additional fiscal stimulus from an infrastructure bill further complicate the issue.

However, with COVID cases again trending lower, continued vaccinations occurring throughout the U.S., and an improving labor market, the hope is that any unrealized 3rd quarter growth will not be lost but pushed into future quarters and spread over a longer period of time.

After back to back months of nearly 1 million payroll additions, August's payroll number disappointed to the downside with 235,000 jobs added over the course of the month. Not all labor market news was negative, however, with the unemployment rate declining to 5.2% from 5.4% in the prior month. Furthermore, weekly unemployment claims data remains close to pandemic lows and jobs remain plentiful with over 10 million openings reported in the most recent JOLTS data. NFIB Small Business surveys continue to report a record number of firms having difficulty finding new workers with owners citing unqualified applicants and labor quality as the primary reasons for unfilled positions. It is clear that persisting frictions like childcare, business uncertainty due to COVID, and a mismatch between the skills workers have and skills needed by employers are weighing on the labor market recovery. Expectations are for a 500,000 payroll gain in September. A number close to or higher than this may indicate that the labor market is regaining its footing.

The U.S. consumer has remained resilient despite inflationary pressures and renewed COVID concerns. Retail sales increased 0.7% over the course of the month while personal consumption expenditures increased 0.8%. Both releases beat consensus expectations. Personal incomes also rose, increasing 0.2% in September. While the most recent surge in COVID cases appears to have peaked in the U.S., the

[1]Owners' equivalent rent (OER) measures how much money a property owner would have to pay in rent to be equivalent to their cost of ownership.
[2]"Inflation Expectations Continue to Move Up," Survey of Consumer Expectations. Federal Reserve Bank of New York. https://www.newyorkfed.org/microeconomics/sce#/inflexp-1.

Weekly Market Insights (cont'd)

fear is that higher prices, COVID concerns, and continued labor market struggles will begin to weigh on consumer confidence, translating into lower consumption and overall economic growth. The latest Consumer Confidence report indeed dipped lower; however, commentary in the report suggests some of the decline may be attributable to an emotional response stemming from the spread of Delta variant just as many believed the pandemic was coming to an end. Generally, short-term outlooks for incomes, businesses, and jobs worsened and spending intentions for big ticket items like homes, cars, and major appliances fell. Despite falling nearly 20 points from June's peak, the Consumer Confidence measure remains elevated relative to historical levels and high enough to support further economic growth in the near-term.

It is important to remember that many economic indicators are backward looking and reflect a period when COVID cases were on the rise from the Delta variant. New cases are once again trending lower in the United States and vaccinations are increasing, so we may see more positive reports in the months ahead. As has been the case throughout the pandemic, economic progress going forward will be heavily dependent on the COVID situation.

Conclusion

Although a review of the economy indicates its growth rate may be slowing, that should not be of great concern for investors at this time. The economy could not continue to grow on its previous path. The magnitude of the post-COVID rebound was not expected to persist. As for inflation, we agree with Chairman Powell that it is temporary. Why? Because of the nature of the recession. As the recession began to retreat, consumption increased much faster than production. Producers could not catch up, because COVID kept workers at home, not because productive facilities were not there. As workers return, many price pressures should dissipate as COVID recedes.

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