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OUTLOOKS

September 2021

ECONOMIC OUTLOOK

Summary

Fresh off the disappointing August jobs report, is a good time to point out that for as strong as the economic growth has been year-to-date, much of the U.S. economic data has been coming in below expectations since mid-June. Since that time, the Citi Economic Surprise Index for the U.S. (which has a positive value when economic data is stronger than expected and a negative value when it is worse than expected) has dropped by more than 100 points (+56.6 to -54.0).

For example, just these past few weeks we have seen disappointing reports (relative to expectations) in many areas, including the following: regional fed manufacturing indexes (Richmond, Dallas, Empire), consumer confidence, small business optimism, Markit PMIs, various housing statistics (starts, new home sales, pending home sales, etc.), retail sales, productivity, consumption, and, of course, jobs.

It is important to point out this phenomenon is not isolated to the United States. During the same time frame, Citi's Economic Surprise Index for other countries has also either dropped substantially or remained materially negative. For example, the index for the Eurozone has dropped by nearly 150 points (+125.4 to -22.2), and China's index currently sits at -51.2. Citi's aggregation of all "major economies" fell by 120 points (+92.9 to -28.7).

While this may seem alarming, let's keep perspective. Many of these data points remain very elevated. PMIs are hovering near or above 60, which are levels not frequently seen. Retail sales are roughly 17.5% higher in total than they were pre-pandemic. Other data points, such as the regional fed manufacturing indexes, remain above their '10-'19 ten-year averages. All of this is in spite of labor shortages, supply chain issues and a spike in COVID cases due to the delta variant.

Economic impact payments, or stimulus checks, have been the driver behind much of the growth that we have seen this year. So expectations should soften as their effects begin to fade from the economy. But even as the stimulus effect fades, the hope is that the economy can continue to grow organically, albeit at a more tempered pace.

Positives

Personal income continues to increase month-over-month (1.1% vs 0.3%)

Factory orders remain strong (1.5% vs 1.0%)

Continuing jobless claims hit a new post pandemic low (2.748MM)

Negatives

August nonfarm payrolls came in much lower than expectations (235k vs 733k)

Retail sales ex autos and gas missed expectations (-0.7% vs -0.1%)

NFIB Small Business Optimism hit its lowest level in the past 5 months (99.7)

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EQUITY OUTLOOK

Summary

The S&P 500 rose 3.0% in August, marking the seventh consecutive month the benchmark finished in positive territory. Returns for the month by equity region, size and style were tightly bunched. The developed international, MSCI EAFE Index was up 1.8%. The MSCI Emerging Market Index added 2.6%. The Russell 2000 Index of small companies climbed 2.2% while the Russell Midcap Index gained 2.5%. The Russell 1000 Growth Index did outperform the Russell 1000 Value climbing 3.7% and 2.0% respectively.

The path of least resistance for equity markets has been higher and there is no particular evidence that is going to end soon. Stocks have had a magnitude of excuses for which they could have paused or retreated. COVID-19 is hardly under control with the Delta variant raging in many areas but the market has been unfazed. The endurance of inflation pressures are still being debated and yet the market pushes forward. Dovish comments from the Federal Reserve's Jackson Hole meeting last month likely helped cool inflation concerns. Investors have yawned off the threat of tax increases, discussions of which have recently been silenced. Even the poorly executed withdrawal from Afghanistan did little to curtail the market's momentum.

As we close out the summer and turn to autumn, it's important to note that September has historically been a challenging month for the stock markets. It's difficult to envision, though, that statistical reminder is likely to derail this freight train.

Positives

The rate environment should remain accommodative for equities

Few attractive alternatives to investing in equity markets

Negatives

Stock valuations, by some traditional measures, look relatively stretched

Many economic data points are decelerating, possibly temporarily

Unknowns

COVID-19 vaccine efficacy diminishing over time? Are boosters needed?

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OUTLOOKS

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FIXED INCOME OUTLOOK

Summary

Traditionally fixed income investors have focused on economic growth and the associated level of inflation for guidance as to the appropriate level of interest rates.Today's markets are different. Following the pandemic-led recession, the economy quickly rebounded with the rate of growth averaging more than 12% over the past year. With bottlenecks in many supply chains and a shortage of workers, inflation is near the highest experienced in almost four decades by most measures. Yet, bond yields remained in a relatively stable range over the past two months. In August, the 2-year Treasury note yield increased by about 3 basis points (bps) to end at 0.21%. The 10-year note rose nearly 9 bps to end at 1.31%. Corporate bond credit spreads ended nearly unchanged for the month. After a string of four months with positive returns, Treasury notes and investment-grade corporate bonds experienced modest declines with the blended index returning -0.20%.

There is no explicit or implied guarantee that Treasury bonds or corporate bonds should deliver a yield higher than the rate of inflation. Because they traditionally have, many investors believe it to be some sort of divine right. Even suggesting otherwise could be considered market heresy to generationally-seasoned investors. We believe the market is beginning to question that steadfast relationship. We believe that the future path of the overnight rate and supply/demand fundamentals are proving to be the only metrics that matter in determining the future direction of interest rates.

We do believe the overnight rate will rise in the future but not likely until 2023. When the Fed does begin to increase it, the economy will likely be slowing and struggling with difficult year-over-year comparisons. Two to four rate hikes might be all that can be accomplished this cycle, regardless of inflationary levels. Additionally, demand for fixed income investments is likely to remain strong even after the Fed slows and eventually ends its balance sheet purchases. As equity markets advance and investors rebalance their risk, a wave of capital is unleashed that finds its way back into bonds regardless of the prevailing yield levels. We believe that trillions of dollars have or are going to be reallocated into bonds.

We expect that yields could rise modestly into the fall but temporary spikes higher will be met with incremental buying which will cap their advance. Credit spreads offer little relative value based on history, but in a low-rate environment, investors demand should keep spreads low.

Positives

- Investor rebalancing as equity markets make new highs
- Investors are fully prepared for Fed tapering of QE purchases

Negatives

- Reported inflation levels are reaching the highest in decades
- Trade bottlenecks and labor shortages unlikely to ease soon

Unknowns

- Success of massive ($3.5T) spending proposal in Washington
- Longevity and impact of Delta and other variants

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