

ECONOMIC OUTLOOK

Summary

The recent trend of economic data underwhelming versus expectations has caused the S word - or stagflation - to garner more attention than it typically should. Since there hasn't been true stagflation since the 1970's, here's a quick refresher on the topic: It's a period of elevated inflation during a time of stagnated economic growth and high unemployment. Yes, we are experiencing elevated inflation. But are we truly experiencing high unemployment? After all, there are more jobs available than people to fill those jobs. And how strong is the case to be made for stagnated economic growth?

Following the economic shut downs in 2020, an influx of stimulus cash in consumers' pockets and a fully opened economy were expected to lead the charge toward a banner year for GDP growth in 2021. Things seemed to be going mostly to plan with 6.4% GDP growth in the first quarter and 6.7% growth in the second quarter. However, the emergence of the Delta variant has seemingly allowed pandemic-driven supply chain disruptions to linger on, which is causing both inflation to increase and growth expectations to decrease.

Regardless of where you stand on the transitory nature of inflation, there is no arguing that CPI is currently 5.3% year-over-year through August, with no signs of slowing down in the short term. Although full-year GDP was originally estimated to be 7%+ earlier this year, we didn't manage to exceed that level in either of the first two quarters. Additionally, when factoring in that third quarter expectations have been in decline from 6%+ to their current estimate of 2.3%, according to GDPNow, it remains possible that inflation finishes the year at a higher level than GDP growth. So, perhaps it makes sense why stagflation is working its way back into people's vocabulary.

However, even if the U.S. were to only record 1.5% GDP growth for both Q3 and Q4, overall GDP for 2021 would still be in

excess of 4%, which would be the highest annual level of growth this century. Since GDP is calculated in real terms, it is already adjusted for inflation. Furthermore, GDP growth encompassing the entirety of the pandemic-related shutdowns (June 30, 2019 to June 30, 2021) averaged 2% per annum, which is well within its traditional range. The jury is still out on employment (depending on how you want to frame the argument), but it's difficult to argue that we are currently experiencing stagnated economic growth. No one knows what the future may hold, but it looks like we can avoid using the S word, at least for now.

Positives

An upside surprise in August retail sales (0.7% vs -0.7% est.)

September PMI's (both ISM and Markit) exceeded expectations at already elevated levels

The third revision of 2Q21 GDP was revised slightly higher (6.7%)

Negatives

A big miss in September nonfarm payrolls (194k vs. 500k est)

The labor force participation rate remains muted (61.6%)

Consumer confidence continues its decline (109.3)

EQUITY OUTLOOK

Summary

The month of September lived up to its reputation for being a challenging month for equity markets. The S&P 500 snapped a streak of seven consecutive positive months, declining 4.7% in September. Value stocks held up slightly better than growth stocks with the Russell 1000 Value Index falling 3.5% relative to the Russell 1000 Growth Index's 5.6% decline. Smaller U.S. companies fell, as well as both developed international and emerging market stocks. Energy was the only economic sector in the S&P 500 that finished higher jumping 9.4% fueled by a surge in the underlying commodity prices.

Throughout the year, the stock market has rallied in the face of a number of headwinds yet many of those ongoing concerns were highlighted by pundits as the reason for September's weakness. Issues in Washington, namely the unclear path for an increase in the debt ceiling and the uncertainty regarding further stimulus gave the markets reason to take pause. A quick jump in bond yields during the month also stirred up renewed fears of inflationary pressures. Supply chain and input cost pressures remain challenging for many industries. Beleaguered Chinese real estate developer, Evergrande, also shook markets in September as investors contemplated the potential contagion from the company's missed debt obligations and potential collapse.

Equity markets appeared to take a well-earned breather following the impressive gains throughout 2020. Seven

months of gains in a row is fairly uncommon. Given the lack of investment alternatives, we believe the "buy the dip" mentality will continue. We continue to view any weakness as an attractive entry point for long-term investors.

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?

FIXED INCOME OUTLOOK

Summary

Yields traded in a narrow range for the first three weeks of September as investors looked toward the September 22 meeting of the Federal Open Market Committee (FOMC). Given the weak August payroll report released a few weeks earlier, it was not surprising when the committee opted to delay the announcement of plans to reduce their monthly asset purchases. Through their statement and subsequent press conference, Fed Chairman Powell indicated that the economy had “all but met” the conditions to begin to taper which cemented beliefs that they will officially announce the plans at their early November meeting and systematically reduce the amount of purchases beginning in December.

While their decision and press conference provided little new information, the individual voting member’s forward projections of the overnight rate did change in a material manner. Whereas the median forecast of the group had indicated there would be no rate hikes in 2022 and two hikes likely in 2023, it now shows that half the participants expect a rate increase to happen in 2022. Furthermore, the group now expect that there will be three or four rate hikes in 2023 and possibly the same for 2024.

After the FOMC meeting, interest rates declined modestly as investors apparently appreciated the delay in tapering and that the dot plots were not as aggressive as some had feared. This tranquility was short lived as in the span of the next four days the 10-year yield surged by a whopping 25 basis points (bps). Yields powered higher after the BOE indicated that it is considering raising rates in November to combat inflationary pressures. For the month, the 2-year Treasury note increased by about 7 basis points (bps) to end September at 0.28%. The 5-year and 10-year notes gained about 18 bps to end at 0.97% and 1.49%, respectively. The long end of the curve flattened somewhat as the 30-year bond increased by only 11 bps to end at 2.05%. The blended index of government and corporate bonds returned

-1.07% for the month with the intermediate maturity version delivering -0.57%.

Barring any unforeseen geopolitical or economic event, the Fed is likely to follow through and begin reducing purchases in December. With only four weeks or so until it is announced and few additional weeks before it begins, we still believe that there is room for longer interest rates to move modestly higher into the year’s end. Even so, as the yield approaches the highs reached in March, they might well become too compelling for foreign buyers to ignore. Swiss and German 10-year yields are still negative by about 15 to 20 bps. Japanese and French 10-year bonds are positive but offer less than 20 bps. So as the U.S. rates increase, foreign investors will be increasingly willing to buy U.S. bonds and take the currency risk that is too far out to hedge.

Positives

Foreign buyers should cap yield increases

No taper tantrum as investors are prepared for Fed tapering of purchases

Negatives

Reported inflation levels are reaching the highest in decades

Trade and production bottlenecks are unlikely to ease soon

Unknowns

Democrat’s success in passing tax and spend bill