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ECONOMIC UPDATE

FIRST QUARTER 2021

Quarterly Key Points

- After slowing considerably during the winter months amid a record surge in infection rates and the ensuing activity restrictions, measures of economic activity are now signaling a robust rebound in 2021 fueled by pent up consumer demand, fiscal stimulus, and vaccine optimism.
- COVID-19 vaccine distribution has accelerated with ~62 million people, or 18.8% of the population, in the U.S. now fully vaccinated. Importantly, vaccine eligibility restrictions have largely been removed, meaning that any individual wanting to get vaccinated can now do so, subject to availability.
- As anticipated, the Government approved the $1.9 trillion American Rescue Plan Act of 2021 in early March. No sooner did the ink dry on that emergency stimulus bill than talk of a massive infrastructure spending plan began circulating.
- With bank accounts already awash with cash and with another round of stimulus taking hold, consumer spending appears poised for a strong rebound in March and beyond. Measures of business activity suggest that both manufacturing and services are preparing to meet the pending surge in consumer demand.
- Core inflation forecasts are now running close to 2% by the end of the year, and there is growing debate about whether inflation will be short-term and transient or long-term and sustainable. With the market pricing in stronger economic growth and inflation, it comes as little surprise that the yield curve steepened considerably during the quarter.

Our View

- Armed with plenty of spending cash, confident consumers will embrace “normal” activities, particularly as vaccination rates improve and pandemic restrictions are removed. The labor market should continue to improve, but lingering unemployment is a concern, with many jobs permanently lost.
- With considerably stronger economic growth now expected, unanticipated changes in the size and timing of Government and central bank support could trigger volatility in risk assets. As such, we are taking an opportunistic and patient approach to investment across sectors. Portfolios are currently positioned with slightly higher liquidity to protect against downside risks and to provide “dry powder” for attractive purchases.

FIRST QUARTER 2021 – LET THERE BE LIGHT!

After slowing considerably during the winter months amid a record surge in infection rates and the ensuing restrictions, measures of economic activity are now signaling a robust rebound in 2021 fueled by pent up consumer demand, fiscal stimulus, and vaccine optimism. Fourth quarter GDP was revised up to a 4.3% q/q annualized pace, signaling a slightly stronger end to the year than previously thought, and leaving 2020 GDP down 3.5% on the year. Looking ahead, quarterly GDP projections indicate accelerating output that could grow by 8%-10% q/q annualized by mid-year, with full-year GDP growth projections in the 6%-7% range for 2021 versus earlier estimates in the 4%-5% range.

At the end of last year we wrote that fast tracked vaccines provided a light at the end of the dark tunnel of record COVID-19 infections and related lockdown restrictions. Despite early logistical challenges, vaccine distribution has improved and over 167 million doses have been administered in the United States so far, including 62 million people who are fully vaccinated and more than 75% of the population over 65-years of age that have received at least one dose (CDC data as of April 5th). So much progress has been made over the last several months that vaccine eligibility restrictions have been removed, subject to availability. Lockdown restrictions are being lifted and activity is accelerating just in time for warm spring weather. As a sign of things to come, TSA checkpoint numbers tracking daily traveler volume in the U.S. averaged ~1.4 million per day over the last 10 days of March, versus only 695k and 843k per day averages during 3Q and 4Q 2020 respectively.

Still, considerable work remains in order to reach herd immunity as only 18.8% of the total population has been fully vaccinated. Furthermore, public health leaders continue to advise caution and diligence, warning that relaxing safety protocols and rapidly spreading variants will be problematic. Indeed, several dozen states are seeing rapidly rising infection rates that rival those seen in early January, drawing some to conclude that a fourth wave of infections has begun. The race is on between public health efforts to inoculate the rest of the population and the virus/its variants spreading rapidly through a pandemic fatigued population. Throw in a healthy dose of vaccine hesitancy and the path forward may have a few speed bumps along the way.

There were also several pieces of unfinished political business at the end of the year, including congressional certification of the Electoral College votes, the inauguration of the president-elect, and the hotly contested Georgia runoff election. Although the first two items have historically been uneventful, forgone conclusions, the events of early January showed that nothing can be taken for granted. The Georgia runoff election resulted in both Senate seats going to Democrats, resulting in a Democrat-controlled Congress and paving the way for elevated fiscal spending. It is worth noting, and not surprising, that the Federal budget deficit reached a whopping $3.1 trillion dollars for the fiscal year ended September 30, 2020, while the rolling 12-month budget deficit at the end of March represented 16.4% of last year’s GDP. Total U.S. Government debt outstanding stands at $27 trillion, representing ~130% of GDP. The intent here is not to judge the Government’s actions during a global pandemic, but rather to highlight that the bill has been considerable. Going forward, the Biden administration’s spending plans will include healthy tax increases that will not go uncontested.

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GOVERNMENT & CENTRAL BANK UPDATE

Following the heavily debated $900 billion fiscal stimulus package that passed in late December, the new administration wasted no time passing an additional round of stimulus. The $1.9 trillion American Rescue Plan Act of 2021 that passed in early March includes direct payments of $1,400 to eligible individuals, an extension of the previously existing $300 weekly unemployment supplement, an increased child tax credit, vaccine distribution assistance, and a $350 billion provision for state and local government assistance. No sooner did the ink dry on that emergency stimulus bill than talk of a massive infrastructure spending plan began circulating. The proposal, referred to as the American Jobs Plan, involves $2.2 trillion in spending over the next eight years on items such as transportation infrastructure, green energy and EV, broadband expansion, job training, manufacturing, housing, drinking water, and elderly care. The plan would be paid for through increased taxes and, as a result, it will face considerable Republican resistance.

Since enacting unlimited QE at the onset of the pandemic, the Federal Reserve has purchased ~$3.0 trillion in Treasury securities and ~$1.8 trillion in Agency MBS (gross of paydowns). The Fed kept its policy rate unchanged throughout the quarter, while published forecasts indicate that rates will likely remain near zero for at least the next several years. However, there is growing debate about whether inflation will be short-term and transient versus long-term and sustainable, and how soon inflationary forces will be at odds with the Fed's current accommodative policy stance. Since moving to a flexible average inflation targeting (FAIT) framework last year, the Fed has made no bones about its intention to let inflation run hot in order to achieve its desired level of inflation; a goal that has been elusive for the last decade. Even as rates were selling off throughout the quarter - at times rather dramatically - the Fed held fast to its message, keeping the policy rate anchored at zero and giving no indication of an end to the current pace of asset purchases.

The recent shift to FAIT gives the Fed plenty of breathing room to be patient; however, as the market continues to price in stronger economic growth and accelerating inflation, the Fed's commitment will likely be tested. Those who recall the "taper tantrum" in 2013 know that unexpected changes in policy direction can result in violent market adjustments. We are now on new ground, however, and there are many unanswered questions. How long will the Fed allow core inflation to run above 2%? What is its pain threshold? How sensitive is it going to be to the market's long-term inflation expectations? At present, the market expects the policy rate to remain at zero until sometime in 2023 and the asset purchase program to begin tapering early next year.

INTEREST RATES, INFLATION & HOUSING

With the short-end of the curve firmly anchored at ~0.15%, reflecting Fed policy commitments, and the market pricing in stronger economic growth and accelerating inflation, it comes as little surprise that the yield curve steepened considerably during the first quarter. 2s-10s steepened ~80 bps with 10-year and 30-year Treasury rates ending at 1.74% and 2.41% respectively in March. Considering the aforementioned inflationary pressures, 5-year and 10-year break-even inflation rates rose to 2.60% and 2.37%, the highest levels since 2008 and 2013 respectively (Figure 1).

FIGURE 1: 5-YEAR AND 10-YEAR U.S. TIPS BREAKEVEN RATES[1]

Meanwhile, actual measures of inflation remain muted. Headline CPI steadily increased by 0.3% m/m in January and 0.4% m/m in February, while core CPI increased

[1]Source: Bloomberg

by a lackluster 0.0% m/m and 0.1% m/m during the same time periods. Measured year-over-year, headline and core inflation are currently running at only 1.7% and 1.3% respectively, well below Fed target levels. Many are looking at producer price inflation (PPI) as a harbinger of things to come. Fueled primarily by commodity price increases, core PPI is already running at 2.5% y/y in February after large increases of 1.2% m/m and 0.2% m/m in January and February respectively. Notably, for the next several quarters, year-over-year inflation measurements are expected to increase in rapid fashion as a result of base effect comparisons to depressed inflation levels during the early months of the pandemic. Nevertheless, the massive wave of consumer spending on the horizon, lean inventories, and rising commodity prices have core consumer inflation forecasts running something closer to 2% by the end of the year.

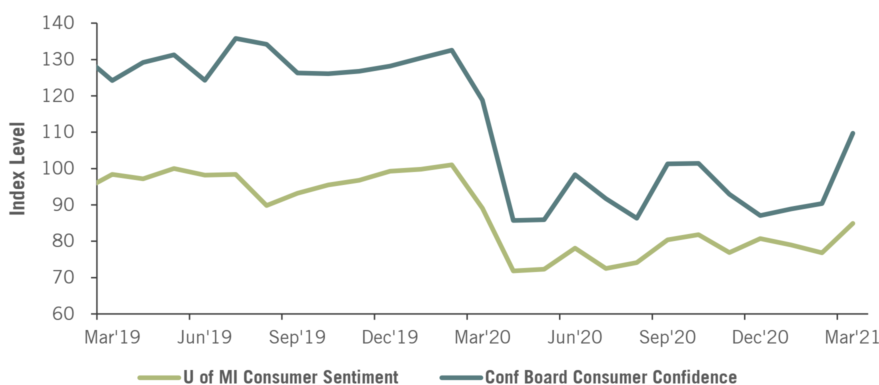
30-year mortgage rates rose ~50 bps to 3.17% by the end of the quarter in concert with the broader sell-off in interest rates. Nevertheless, pandemic related shifts in demand coupled with tight housing supply and confident consumers flush with cash continue to power the hottest housing market since before the GFC. With home prices up by 11% y/y in January and mortgage rates on the rise, affordability could become a constraint for many would-be home buyers. New home sales and existing home sales dropped by 18.2% m/m and 6.6% m/m respectively in February, more likely the result of bad weather than affordability issues. Meanwhile, the supply of new homes is unlikely to change the supply-demand situation in a meaningful way over the near-term, as skyrocketing materials costs, illustrated by the Price Producer Index for Lumber & Plywood, make the price point of new construction less tenable. All totaled, it appears the summer moving season will be strong and the next few quarters should provide clarity regarding the path for the housing market.

LABOR MARKET RECOVERY AND ROBUST CONSUMER DEMAND...BUT CAN SUPPLY KEEP UP?

The unemployment rate fell to 6.0% by the end of the quarter after the economy added 916k jobs in March. Additionally, strong upward revisions to non-farm payrolls in January and February, to 233k and 468k respectively, were a welcome surprise after initial estimates indicated a stalling out of the labor recovery during the winter virus surge. Sub-components of other economic indicators, like the ISM Manufacturing Employment Index which increased to 59.6 in February, also point to a strong trend in hiring. Nevertheless, weekly unemployment claims stubbornly remain in the 700k per week range while ongoing claims are stuck at 3.8 million. Furthermore, the total employment level is still 7.8 million jobs lower than it was pre-pandemic (~70% of lost jobs have been recovered).

Following three monthly declines, retail sales advanced by 7.6% m/m in January, reflecting the $900 billion stimulus package taking hold, before falling back by 3.0% m/m in February as a result of harsh winter weather. The University of Michigan Consumer Sentiment Index jumped to 84.9 in March from 76.8 in February, marking the largest month-over-month increase and the highest measurement since the onset of the pandemic, while the Conference Board Consumer Confidence Index increased by 19.3 points to 109.7 in March, the largest one month increase since 2003 (Figure 2). With bank accounts awash with cash, yet another round of stimulus checks adding fuel to the fire, employment improving, and confidence running high, consumer spending appears poised for a strong rebound in March and beyond. The amount of money

FIGURE 2: UNIVERSITY OF MICHIGAN CONSUMER SENTIMENT AND CONFERENCE BOARD CONSUMER CONFIDENCE[2]



[2]Source: Bloomberg

burning a hole in consumers' pockets cannot be overstated. By some measures, excess savings in consumer accounts amounts to between $1.5 and $2 trillion dollars. All this cash represents a tinder box of consumer demand, set to ignite as vaccines take hold and restrictions are lifted.

Measures of business activity suggest that both manufacturing and services are ramping up to meet the pending surge in consumer demand. The ISM Manufacturing Index, the ISM Services Index, and the ISM Report on New Business Orders Index came in at 64.7, 63.7, and 68.0 respectively in March, marking not only the highest levels since the onset of the pandemic but also the highest levels in decades. Sub-indices like the ISM Backlog of Orders Index, which reached 67.5 in March (the highest reading on record), suggest that manufacturers are still playing catch up, while the ISM Manufacturing Prices Paid Index (85.6 in March) indicates that manufacturing cost pressures are mounting consistent with the PPI commentary above. Meanwhile, retail inventories are also struggling to keep pace, growing at -0.3% m/m and 0.0% m/m in January and February respectively. Industrial production and capacity utilization measures took a small step backward in February as well, largely the result of severe winter weather that gripped the country and shut down a number of states in the South. In summary, all of these measures suggest that while the sector is getting healthier and ripe for growth, businesses may be a bit behind the curve, feeding the narrative that higher inflation could be right around the corner.

LOOKING AHEAD

Buoyed by ongoing support from the Government and the Fed, and vaccine distribution that has finally gained traction, the economy is ready for launch. Armed with plenty of spending cash, confident consumers will embrace "normal" activities, particularly as vaccination rates improve and pandemic restrictions are removed. This will be particularly beneficial for travel, hospitality, leisure, and retail sectors. As always, unemployment will be a key variable to watch. The labor market should continue to improve, but lingering unemployment is a concern, with many jobs permanently lost.

The evolution of core inflation and, more importantly, the Fed's response to it pose the biggest questions for the market over the remainder of the year. With considerably stronger economic growth now expected, unanticipated changes in the size and timing of Government and central bank support could trigger volatility in risk assets. More specifically, the Fed's commitment to providing exceptionally easy monetary policy could be tested as the market prices accelerating growth and inflation over the coming year. Furthermore, the path of the virus and its variants, the speed of vaccine distribution, and public acceptance all remain potential sources of volatility. As such, we are taking an opportunistic and patient approach to investment across sectors. Portfolios are currently positioned with slightly higher liquidity to protect against downside risks and to provide "dry powder" for attractive purchases down the road.

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