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ECONOMIC UPDATE

SECOND QUARTER 2021

Quarterly Key Points

- The economy has accelerated considerably, fueled by pent-up consumer demand and the removal of COVID-19 restrictions. With virtually all measures of economic activity signaling a robust rebound for the remainder of the year, 2Q21 GDP is expected to increase at a 10%-11% q/q annualized pace with full-year GDP growth projections in the 6%-7% range.
- As expected, the Federal Reserve kept its policy rate unchanged throughout the quarter; however, published inflation forecasts and expected future rate hike messaging turned slightly hawkish in June. The market expects a formal announcement of QE tapering at the September meeting with implementation in early 2022.
- In a partial reversal of first quarter's steepening, the curve flattened considerably in 2Q21. 2s vs. 10s flattened 36 bps reflecting the Fed's more hawkish tone. Not surprisingly, long-term break-even inflation rates also compressed.
- Retail sales are 18% higher than February 2020, indicating that consumers continue to spend at an elevated rate, but the labor market recovery since early spring has been somewhat underwhelming. The housing market remains red hot, buoyed by low mortgage rates, tight supply, and strong demand.
- Businesses are expanding rapidly, but elevated consumer demand and supply chain bottlenecks are accelerating inflation in the near term, sparking a debate about whether inflationary pressures will be transitory or persistent.

Our View

- Released from COVID-19 restrictions, U.S. consumers will continue to embrace "normal" summer activities. Not surprisingly, labor markets, particularly employment in the travel, hospitality, and leisure sectors, have seen rapid improvement, but not at a pace that will regain the job deficit any time soon. The evolution of core inflation, and what it means for central bank policy, will remain in sharp focus for the remainder of the year.
- The Fed has an uphill battle to successfully execute an exit strategy from its unprecedented pandemic response. Policy risk is high, and the market's sensitivity to unwanted changes may trigger renewed volatility. As such, portfolios continue to be positioned with slightly higher liquidity to protect against downside risks and to provide "dry powder" for opportunistic purchases.

2Q2021 – UNTETHERED CONSUMERS AS PANDEMIC RESTRICTIONS LIFTED

Taking a moment to reflect, the second quarter of 2020 – the depths of the COVID-19 pandemic - will undoubtedly go down as one of the worst economic time periods on record. Fast forward to today, the economy has accelerated considerably, fueled by pent-up consumer demand and the removal of activity restrictions. With virtually all measures of economic activity signaling a robust rebound for the remainder of the year, and after growing at a 6.4% q/q annualized pace in 1Q21, 2Q GDP is expected to increase at a 10%-11% q/q annualized pace. Furthermore, full-year GDP growth projections are in the 6%-7% range and forecasts for 2022 are generally in the 3%-5% range, signaling the stage is set for strong growth to sustain into the foreseeable future. What a difference a year makes!

Historic efforts to stimulate the economy and the remarkably fast development of vaccines have borne fruit, resulting in a complete untethering of consumers. By mid-May, following the administration of several hundred million COVID-19 vaccine doses in the U.S., the CDC announced sweeping changes to activity restrictions, most notably those involving mask wearing and social distancing. To date, over 325 million doses have been given with more than 150 million individuals fully vaccinated. Notably, approximately 58% of the over-18 and 79% of the over-65 populations are now fully vaccinated in the U.S. (CDC data as of July 5th https://covid.cdc.gov/covid-data-tracker/#vaccinations). While heard immunity may not be achieved, the decision to relax restrictions appears to coincide with the most vulnerable populations largely being inoculated, the removal of vaccine eligibility restrictions, and the overwhelming evidence of vaccine efficacy. Public health leaders continue to advise caution and diligence, however, warning that the risk of infection remains elevated, particularly for unvaccinated individuals. Additionally, vaccine boosters may eventually become necessary, as the exact duration of protection provided from the current dose is largely unknown. So, while things clearly have improved, we are not out of the woods just yet.

GOVERNMENT & FEDERAL RESERVE STILL IN STIMULUS MODE

After alleviating considerable financial stress for millions of Americans during the pandemic, a number of financial relief programs (e.g. expanded unemployment benefits, foreclosure/eviction moratoriums, and federal student loan payment deferral programs) have already expired or are scheduled to expire in the coming months. However, there is considerable debate about how expirations will impact unemployment and housing. Some posit that the expiration of these programs will force the employment situation to improve by removing disincentives to find work. On the other hand, advocates for continuing the programs highlight a lopsided recovery along socioeconomic lines. Still others connect the dots to explain constrained housing supply as partially the result of the foreclosure moratorium. Considering the current political impetus to remain accommodative, it seems likely that portions of these programs will get extended, like the FHFA's recent extension of the foreclosure moratorium until July 31st, perhaps on a more targeted basis. Meanwhile, Congress continues to debate a substantial infrastructure spending plan, referred to as the American Jobs Plan. Initially sized at $2.2 trillion over eight years, the plan details have toggled back and forth between Democrats and Republicans since its original proposal in March. The most current bi-partisan version comes in at $1.2 trillion with a heavy focus on

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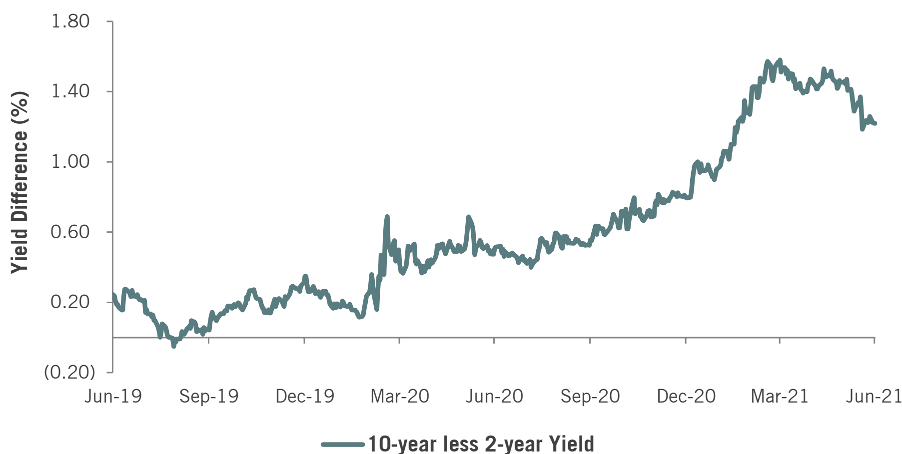
physical infrastructure spending. As with previous versions, Democrats want the plan to be paid for through increased taxes and, as a result, it is receiving considerable push back from Republicans.

As expected, the Federal Reserve kept its policy rate unchanged throughout the quarter; however, published inflation forecasts and expected future rate hike messaging turned slightly hawkish in June, with the median "dot" indicating multiple rate hikes in 2023. While many have noted that the dot plot should be taken with a considerable grain of salt, it is noteworthy in that it signals an increasing number of Fed members have moved up the timing of rate increases and are considering rising inflation in their projections. Although the FOMC statement made no mention of asset purchase tapering, Fed Chair Powell indicated the potential for taper discussions in the not too distant future. The market expects a formal announcement of QE tapering at the September meeting with implementation in early 2022.

Regarding the path forward, we have the monetary policy playbook from the last ten years as a guide. If the Fed follows the same pattern, it will taper asset purchases to the point where its balance sheet is no longer expanding *before* raising the policy rate. Removing too many pieces of the monetary policy puzzle all at once distorts the picture, so it is prudent to peel back the layers of accommodation one at a time. Only after successful fed funds liftoff and subsequent evidence that the economy can manage on its own will the Fed allow its balance sheet to runoff by ceasing to reinvest paydowns. Unfortunately, history doesn't bode well for the Fed's ability to unwind unconventional monetary policy. To our knowledge, no modern central bank has been able to successfully fully unwind a QE program. Considering the Fed's balance sheet is fast approaching $8 trillion, it would seem to be an even more difficult task than it was back in 2014 with a balance sheet half that size. Although the Fed tapered net asset purchases to zero by the end of 2014, it didn't raise the fed funds rate until December 2015 and "quantitative tightening" didn't start until the end of 2017. Importantly, even though the economy was growing at nearly a 4% annualized pace on the back of the 2017 tax cuts, the combination of balance sheet reduction and a 2.5% policy rate led the market to a breaking point only a year later. The Fed reversed course starting December 2018 after equity markets dropped nearly 20% over the final quarter of that year.

FIGURE 1: U.S. TREASURY CURVE STEEPNESS[1]



After years of gorging on cheap financing, we question the market's ability to tolerate higher rates and "normalized" monetary policy as signaled by recent history, and some form of unconventional monetary policy may be here to stay. Indeed, the bond market may already be sending that message. In a partial reversal of the first quarter's steepening, the Treasury yield curve flattened considerably in 2Q21. Prescient of the Fed's forthcoming comments, the 10-year Treasury was grinding lower by mid-May, falling from 1.74% to 1.47% to end the quarter. The 2-year Treasury yield rose by about 0.10%, settling in at 0.25% at the end of June. Putting it together, 2s vs. 10s flattened 36 basis points (0.36%), reflecting the Fed's hawkish tone (Figure 1). Not surprisingly, long-term break-even inflation rates also compressed down to 2.34% from a post-pandemic high of nearly 2.60% in early May, while 10-year real interest rates rallied back down to -.90% during the same timeframe.

[1]Source: Bloomberg

RETURN TO NORMAL UNDERWAY; BOTTLENECKS/CONSTRAINTS REMAIN

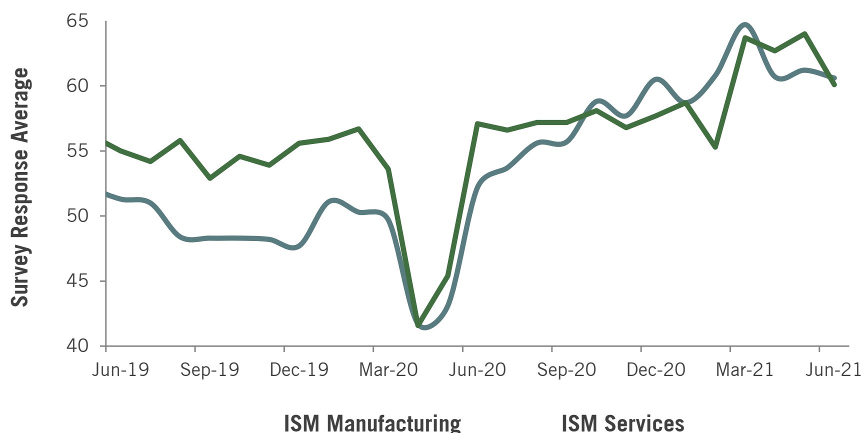
Armed with accumulated excess savings (i.e. under-spending on certain activities during the pandemic) and untethered from activity restrictions, consumers are increasingly back on the move, traveling and dining out as evidenced by the daily average TSA checkpoint throughput which broke above 2 million passengers on June 30th for the first time in 15 months. Consumer confidence has generally been on an upward trend and retail sales have displayed a strong correlation to government stimulus, rising rapidly in January and March (7.6% m/m and 11.3% m/m respectively) while increasing by a more subdued 0.9% in April and falling by 1.3% in May. Importantly, sales are 18% higher than February 2020, indicating that consumers continue to spend at an elevated rate despite month-to-month percent change noise.

The housing market remains red hot, buoyed by low mortgage rates, tight supply, and strong demand. After rising to approximately 3.20% in late March, mortgage rates have come back down to 3.00%. Although there has been an increase in listings and new construction activity, housing supply remains tight. New home supply has bounced up to 5 months from a low of 3.5 months last fall, while existing homes are barely up to 2.5 months of supply from a low of 2 months. This resulted in home price appreciation of 14.9% y/y in April. While leading indicators of housing activity have slowed to pre-pandemic levels, largely due to a lack of supply, the run up in home prices has effectively priced out many potential buyers, limiting purchase activity to some degree (buyer burnout). Although annualized sales measures remain elevated historically, new home sales and existing home sales have dropped by 23% and 13% respectively since January.

With the economic flood gates open, a commensurate rebound in employment has been expected; however, the labor market recovery since early spring has been somewhat underwhelming. A downward revision to March non-farm payrolls was followed by two months of below survey numbers, with only 269k and 583k jobs added in April and May respectively. The June payroll number was stronger than expected, with 850k jobs added, but unfortunately the unemployment rate edged up to 5.9% after falling to 5.8% the month prior. The ISM Manufacturing Employment Index decreased by nearly 10 points during the quarter, to 49.9, suggesting that hiring has slowed, perhaps due to difficulty attracting workers. Headlines about worker shortages present a conundrum as weekly new unemployment claims and ongoing claims remain elevated. With total employment levels still approximately 7 million jobs lower than pre-pandemic levels, narratives involving the incentives of continued government support, workers being hesitant to return to work, persistent childcare limitations, and early retirements abound.

Businesses are expanding rapidly in an attempt to meet consumer demand. After reaching the highest level since the early 1980s in March, the ISM Manufacturing Index leveled off at 60.6 in June. Meanwhile, the ISM Services Index reached 64.0 in May, marking the highest reading on record (going back to the mid-1990s) before falling back to 60.1 to end the quarter (Figure 2). The ISM Report on New Business Orders Index has averaged a 65.3 since August of last year, and reached 66.0 in June. Inventory measurements present an interesting mixed picture: retail inventories have struggled to keep pace with demand, having gained back only 25% of the reduction seen during the early months of the pandemic (91% of the pre-pandemic level), while wholesale inventories have shot up to 105% of the pre-pandemic level, gaining back 3x what was lost. While supply chain bottlenecks certainly exist, these observations

FIGURE 2: ISM MANUFACTURING AND SERVICES[2]



[2]Source: Bloomberg

suggest they may not persist.

INFLATION HEATING UP BUT NOT PROBLEMATIC...YET

Elevated consumer demand and supply chain bottlenecks are accelerating inflation in the near term, leading to an ongoing debate about whether inflationary pressures will be transitory or persistent. Notably, core CPI rose by 0.9% m/m in April, the largest one-month increase since 1982, before rising by an additional 0.7% m/m in May. As with many measures, year-over-year inflation readings are distorted due to base effects, but for illustrative purposes, headline and core CPI are running at 5.0% and 3.8% y/y respectively. Primarily the result of elevated commodity prices, production bottlenecks, and rising labor costs, core PPI remains elevated, rising by 0.7% m/m in each of March, April, and May.

Forecasts generally call for core inflation in the 2.5% range by the end of the year, falling back to closer to 2.0% in 2022. 5-year and 10-year break-even inflation rates ended the quarter at 2.50% and 2.34% respectively, while the 5Y-5Y forward break even inflation rate has settled in at only 2.18%. Importantly, these rates do not imply problematic inflation on the horizon, suggesting the market has thus far agreed with the Fed's assessment that current inflationary pressures will likely pass. Further, by design, the Fed's new Flexible Average Inflation Targeting (FAIT) framework provides breathing room to let inflation run hot; however, this is an unprecedented time and exactly how high the Fed will comfortably let inflation run is unknown. Last quarter, we posed several questions regarding FAIT: 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? While the answers remain to be seen, the hawkish pivot in the June FOMC meeting suggests the Fed is more likely to capitulate to inflationary pressures and, judging by the market's reaction, perhaps sooner than previously expected.

LOOKING AHEAD

Released from COVID-19 restrictions, U.S. consumers will continue to embrace "normal" summer activities including vacations, dining out, and in-person shopping. Not surprisingly, labor markets, particularly employment in the travel, hospitality, and leisure sectors, have seen rapid improvement, but not at a pace that will regain the job deficit any time soon. There exists some disconnect between labor supply and demand that may need to be resolved before the Fed can claim victory on its full employment mandate. The evolution of core inflation, and what it means for central bank policy, will remain in sharp focus for the remainder of the year. Indeed, the Fed has an uphill battle to successfully execute an exit strategy from its unprecedented pandemic policy response. Its more hawkish message in June reverberated through capital markets, triggering a rally in rates, a flatter yield curve, and relatively subdued inflation expectations. Policy risk is high, and the market's sensitivity to unwanted changes may trigger renewed volatility. As such, portfolios continue to be positioned with slightly higher liquidity to protect against downside risks and to provide "dry powder" for opportunistic purchases.

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