GALLIARD
Capital Management, LLC
ARCHITECTS OF INVESTMENT SOLUTIONS

# ECONOMIC UPDATE

THIRD QUARTER 2021

October 7, 2021

### Quarterly Key Points

- GDP grew 6.7% q/q annualized in 2Q21, well below expectations that were initially 10%-11% q/q annualized. Although still robust, GDP forecasts for the remainder of the year have been revised downward. Currently, 3Q GDP is expected to be 4.0%-5.0% q/q annualized while full year 2021 GDP is expected to be 5.5%-6.0%.
- The debt ceiling debate is back as members of Congress conflate previous spending commitments with the current budget in a standoff that threatens to push the Treasury's ability to pay U.S. Government obligations to the brink by mid/late October.
- The Fed kept its policy rate unchanged throughout the quarter; however, it all but committed to QE tapering later this year. Actual inflation started to recede late in the quarter, suggesting that core inflation has peaked. However, it appears increasingly likely that some elements of inflation will remain elevated.
- Ongoing discussions about vaccine efficacy, "breakthrough" infections, booster shots, and inflation are beginning to weigh on consumer confidence. Consumer preferences have shifted between services and goods with the ebb and flow of the virus, but overall consumers continue to spend at an elevated rate.
- Business activity continues to be robust, particularly in manufacturing. Nevertheless, supply chain bottlenecks and labor shortages are preventing a full return to normal.

### Our View

- GDP will continue to grow at an accelerated pace, albeit slower than previously expected, driven by labor market strength, wage growth, and consumer demand. The COVID Delta variant appears to be peaking, but we could experience a seasonal uptick. A reduced appetite for restrictions and the installed base of inoculations should help limit the economic impact of any subsequent waves of infection.
- Unprecedented stimulus since the onset of the pandemic has led to distorted short-run equilibriums, as highlighted by ongoing supply chain bottlenecks and labor shortages. The transition to new long-run equilibriums could be bumpy, increasing the risk of a policy error. Uncertainty persists and, as such, portfolios remain positioned with slightly higher liquidity to protect against downside risks and to provide "dry powder" for opportunistic purchases.

## 3Q21 – DELTA VARIANT DAMPENS OUTLOOK

Our last quarterly write-up centered on an untethered U.S. consumer, increasingly protected by vaccines, armed with a wall of cash stemming from Government stimulus and excess savings that would unleash double digit GDP growth in 2Q21. Unfortunately, COVID-19 had another trick up its sleeve in the form of the Delta variant. Following the administration of several hundred million vaccine doses in the spring, daily new COVID cases plummeted to roughly 12,000 by early June, the lowest since the onset of the pandemic, per CDC data. At approximately the same time, the World Health Organization began warning of a new "variant of interest" that was sweeping through various countries in Europe and Asia, referred to as the Delta variant. Early measurements suggested that Delta was even more transmissible than earlier forms of COVID, increasingly infecting a younger population and even those who had been vaccinated. Using recent pandemic history as a guide, it didn't take long before Delta had become the dominant strain of COVID in the U.S. By September, daily new cases reached 190,000 with some regional geographies experiencing infection rates that surpassed the previous pandemic high point.

For now, the Delta wave appears to have peaked, with daily new cases falling precipitously since mid-September; however, it serves as a stark reminder of the uncertainty involved with a global pandemic and brings with it a host of new questions. With millions of infections proliferating globally, mutations are increasingly likely, possibly yielding even more infectious or perhaps vaccine resistant strains. How successful are new mRNA vaccines at protecting against new variants and are booster shots going to be necessary to prolong protections in place? How will infection rates change with the seasons as people in the Northern Hemisphere increasingly move indoors during the winter? How will the school year progress and what will this mean for previously scheduled "return to office" plans?

Clearly, the Delta variant took some steam out of the broader recovery during the summer: GDP grew 6.7% q/q annualized in 2Q21, well below expectations that were initially 10%-11% q/q annualized. Although still robust, GDP forecasts for the remainder of the year have been revised downward due to supply chain bottlenecks, inflation concerns, and the continued drag from Delta. Currently, 3Q GDP growth is expected to be 4.0%-5.0% q/q annualized, while full year 2021 GDP is expected to be 5.5%-6.0% (previously estimated to be around 7%).

## GOVERNMENT DEBT CEILING TAKES CENTER STAGE

The debt ceiling debate is back, front and center, as members of Congress conflate previous spending commitments with the current budget in a standoff that threatens to push the Treasury's ability to pay U.S. Government obligations to the brink by mid/late October. If not raised, this could theoretically lead to a U.S. Government default. Although few believe the Government will miss debt payments, it is hard not to reflect on the market disruption and credit rating downgrade by S&P that happened in 2011 when Congress argued to within a few days of default. In today's polarized political environment, brace yourself! Also at stake are a $3.5 trillion reconciliation budget package that defines the Democratic agenda and the $1.2 trillion bi-partisan American Jobs Plan that already passed through the Senate in August. In late September, Congress passed a stopgap budget extension that averted a Government shutdown. This is a temporary resolution that merely extends the previous budget until December 3rd.

800 LaSalle Avenue, Suite 1400
Minneapolis, MN 55402-2054
**www.galliard.com** 800-717-1617

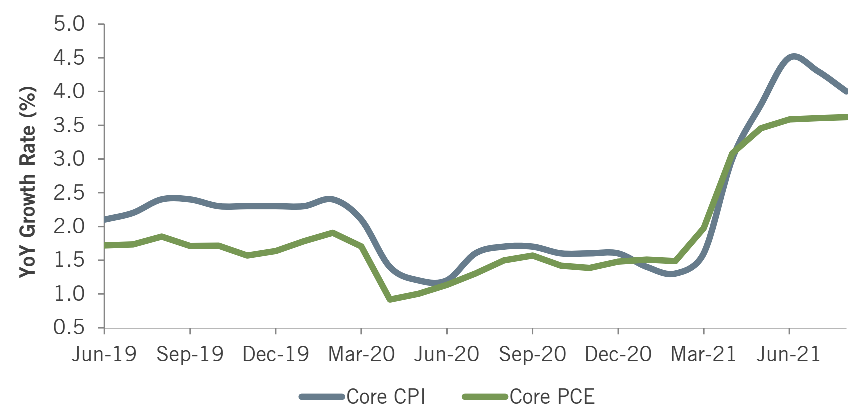
On September 9th, President Biden announced a COVID vaccine mandate requiring companies with more than 100 employees to require proof of vaccination or weekly testing for all employees. This also applies to all federal workers and contractors. It goes without saying that this mandate is highly controversial, pitting personal liberty against public health. As highlighted in a recent Wall Street Journal article (The Long History of Vaccine Mandates in America, 9/18/21), this debate is nothing new in the U.S.; however, the Biden mandate is perhaps the widest sweeping directive to date. Meanwhile, a number of pandemic related financial assistance and payment relief programs have been allowed to expire. Federal Pandemic Unemployment Compensation (FPUC) expired on September 6th and the foreclosure moratorium expired on September 30th. The eviction moratorium, originally part of the CARES Act and subsequently extended by the CDC via the Department of Health & Human Services, failed to extend on July 1st after the Supreme Court ruled that Congress would need to legislate any extensions. A suspension of Federal student loan payments has been extended until January 31, 2022. This is said to be the final extension of that deferral program, granted specifically to give borrowers time to prepare for making payments again.

## CENTRAL BANK STARTS TALKING ABOUT TAPERING

The Federal Reserve kept its policy rate unchanged at both the July and September meetings as expected; however, it all but committed to QE tapering later this year, subject to reasonable employment gains over the next few months. During the press conference, Fed Chair Powell indicated that substantial further progress regarding labor and inflation mandates had "all but been met," suggesting that policy action is at hand. Specifically, the Fed is expected to formally announce tapering in November and wrap up net asset purchases by mid-2022. Notably, this would be an accelerated pace relative to the previous taper initiated in late 2013, with monthly revisions to asset purchases. Since enacting unlimited QE at the onset of the pandemic, the Fed has purchased ~$3.8 trillion in Treasury securities and ~$2.5 trillion in Agency MBS (gross of paydowns), and its balance sheet has ballooned to ~$8.4 trillion.

Over the last two quarters, the timeline for policy action has compressed considerably. In addition to the aforementioned taper announcement moving up to November (earlier expectations were for tapering to start in 2022), the most recent Summary of Economic Projections (SEP) suggests nine FOMC members (half) now see potential for increasing the fed funds rate in 2022, compared with only three in March and seven in June. While we have noted that the SEP dot plot should be taken with a considerable grain of salt, it is noteworthy in that it signals an increasing number of Fed members are considering persistent rising inflation in their outlooks. This was reiterated by Powell, as he highlighted that inflation expectations slightly above 2% are consistent with the new FAIT framework. From the most recent SEP, the Fed expects PCE core inflation to fall to 2.3% in 2022 and to 2.1% over the next several years, GDP to grow 5.9% in 2021 (full year) and 3.8% in 2022, and unemployment to fall to 4.8% by year end 2021 and 3.8% by year end 2022.

**FIGURE 1:** CORE CPI VS. CORE PCE[1]




Actual inflation started to recede late in the quarter (Figure 1). Core CPI increased by 0.3% m/m in July and only 0.1% m/m in August, below expectations for two months in a row. This lies in stark contrast to core CPI prints of 0.9% m/m in April, 0.7% m/m in May, and 0.9% m/m in June - three of the highest monthly increases since 1982. The sharp turnaround suggests that core inflation has peaked; however, it appears increasingly likely that some elements of inflation will remain elevated. Consensus suggests that "re-opening" inflation caused by a wave of pent-up demand will subside, particularly as consumer demand shifts from goods to services; however, inflation related to supply bottlenecks and labor shortages could persist. Alternative Fed measures of core inflation like the Cleveland Fed Median CPI, the Cleveland Fed Trimmed Mean CPI, and the Atlanta Fed

[1]Source: Bloomberg

Sticky CPI 12-Month are measuring 2.4%, 3.2%, and 2.6% y/y respectively. Furthermore, core PPI remains elevated. These measures are consistent with market expectations, reflected in the 5-year, 5-year forward break-even inflation rate of 2.53% and the 10-year break-even inflation rate of 2.38% at quarter end.

At first glance, the yield curve didn't change much quarter-over-quarter; however, there was considerable change throughout the quarter. The 10-year Treasury ground all the way down to 1.17% by early August and 2s vs. 10s flattened 37 bps, primarily reflecting COVID Delta variant fears. By mid-September, the 10-year had sold off to 1.30% and 2s vs. 10s had steepened by 21 bps, reflecting an anticipated taper message at the Fed meeting. Post-September Fed, 2s vs. 10s steepened another 15 bps while the 10-year sold off almost 20 bps to end the quarter at 1.49% - almost exactly where it started. Notably, the recent selloff and steepening has been almost entirely realized in real rates, with breakeven inflation anchored in the 2.3% to 2.4% range.

## CONSUMER CONFIDENCE WANES; BUSINESSES STILL PLAYING CATCH-UP

Ongoing discussions about vaccine efficacy, "breakthrough" infections, booster shots, and inflation are beginning to weigh on consumer confidence. After trending upward throughout the spring, eventually reaching a post pandemic high of 88.3 in April, the University of Michigan Consumer Sentiment Index registered only 72.8 in September after dipping to a pandemic low of 70.3 in August (Figure 2). Month-over-month changes in retail sales have bounced around as a result, up 0.9% m/m in June, down 1.8% m/m in July, and up 0.7% m/m in August. However, overall retail sales were ~15% higher y/y in August and ~18% higher than February 2020, indicating that consumers continue to spend at an elevated rate.

Consumer preferences have shifted between services and goods with the ebb and flow of the virus, as evidenced by the U.S. Goods Spending as a Percentage of Personal Consumption Expenditures measure produced by the BEA, largely reflecting the lack of various services during the pandemic. For example, the percentage of goods spending increased from 31% of total PCE pre-pandemic to nearly 36% of PCE last spring as restaurants, travel, and entertainment were largely closed for business. Following the rollout of vaccines and subsequent relaxation of activity restrictions, goods spending abruptly fell back down to ~34% of total PCE by July reflecting pent-up consumer demand for entertainment, travel, and dining out. A similar pattern can be observed in the TSA checkpoint data on total air travelers in the U.S. The point is, when consumers have money, they will spend - exactly where they spend will shift with the availability of goods and services. The significant shift into more goods spending during the pandemic has driven global supply chain issues, labor market disconnects, and resulting inflation (more on that below).

Overall, the labor market continues to gain strength. Better than expected job growth yielded 962k and 1.053 million jobs added in June and July respectively, but August followed with a disappointing miss, with just 235k jobs added versus an expectation of 706k. The recent volatility in job creation is primarily related to the impact of the COVID Delta variant on services industries like restaurants and leisure/hospitality, both of which drove considerable job growth throughout the spring and early summer. Notably, monthly nonfarm payroll numbers have been revised upward in every month except one through July. Still, behind the growing strength, the labor market presents an ongoing conundrum. Despite an unprecedented 11 million job openings, the labor force participation rate remains below pre-pandemic levels at 61.7%, total employment is still 5.5 million jobs lower than pre-pandemic levels, and the unemployment rate is still elevated at 5.2%. Employees are also quitting their jobs

**FIGURE 2:** UNIVERSITY OF MICHIGAN CONSUMER SENTIMENT[2]


[2]Source: Bloomberg

at an elevated rate, indicated by the JOLTS U.S. Quits Rate Index which, at 2.7% as of July, is at the highest level in the time series going back over 20 years. Clearly, there are fewer workers in the labor force now than there were pre-pandemic, possibly due to early retirements, virus fears, Government support, or even lack of child care. Whatever the reason(s) may be, the labor force is constrained and average hourly earnings accelerated by 0.6% m/m and 4.3% y/y in August.

Fueled by 30-year mortgage rates below 3% throughout the quarter, tight supply, and consumers awash with cash, home prices charged ahead at a blistering pace of nearly 20% in July. Existing home sales of 5.9 million units annualized remain elevated while existing home supply of below 3 months remains historically low. However, new home sales (740k units annualized) have fallen back to pre-pandemic levels as has new home supply, which has rebounded to 6 months. Leading indicators of housing activity have resumed an upward trend after slowing in late summer and the housing market remains red hot.

Businesses continue to expand in an attempt to meet consumer demand, particularly in manufacturing. After reaching the highest level since the early 1980s in March, the ISM Manufacturing PMI Index leveled off in the 60-61 range. The most recent measure of 61.1 in September and the ISM Report on New Business Orders Index at 66.7 mark some of the highest business activity measures in the last 20 years. The same can be said for the ISM Services PMI Index, which, at 61.9 in September, remains near the highest reading on record. Furthermore, both industrial production and capacity utilization are back to pre-pandemic levels. Nevertheless, supply chain bottlenecks and labor shortages are preventing a full return to normal, as evidenced by retail inventories shrinking in every month since March and the NFIB Small Business Job Openings Hard to Fill Index reaching an all-time high of 50 in August. This clearly demonstrates the aforementioned labor shortages, as half of small businesses in the NFIB survey responded that they had open positions that they were unable to fill in the current period.

## LOOKING AHEAD

GDP will continue to grow at a robust pace, albeit slower than previously expected, driven primarily by labor market strength, wage growth, and consumer demand. While the COVID Delta variant appears to be peaking, we could experience a seasonal uptick in daily infections as we head into the winter months in the Northern Hemisphere. However, a reduced appetite for restrictions and the installed base of inoculations should help limit the economic impact of any subsequent waves of infection. Unprecedented stimulus since the onset of the pandemic, both fiscal and monetary, has led to distorted short-run equilibriums, as highlighted by ongoing supply chain bottlenecks and labor shortages. The transition to new long-run equilibriums could be bumpy, leading to increased risk of a policy error. Specifically, monetary policy will need to strike a delicate balance between sticky sources of inflationary pressures and an incomplete labor market recovery. Furthermore, the pending debt ceiling issue has the potential to increase volatility and perhaps derail the Fed's well telegraphed plans. Uncertainty persists and, as such, portfolios remain positioned with slightly higher liquidity to protect against downside risks and to provide "dry powder" for opportunistic purchases.