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INVESTMENT COMMENTARY

The Expansion is Poised to Enter a Slower, Less Inflationary, Phase

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The U.S. economy is past its fastest growth phase, but like a marathoner, it still has plenty in reserve to continue the run. Until the Delta variant reared its ugly head, it was thought that conditions would have returned to normal by now, setting the stage for a robust second-half sprint that carried the momentum into 2022. The expansion still has legs, but instead of a sprint, its pace is downshifting to a jog. The unwelcome revival of the fourth stage of Covid-19, spurred by the Delta variant, created a headwind that has taken some steam out of the growth engine.

After posting a robust 6.6 percent growth rate in the second quarter, the economy likely advanced at a more sobering 3 percent pace or less in the just-concluded third quarter. That's still respectable compared to the long-term trend, but far less than what policymakers hoped would unfold as the pandemic loosened its grip on the economy. Of course, government officials did not anticipate the resumption of rising case counts over the summer that put the kibosh on activity. Renewed health fears once again altered household behavior and spurred another round of business and government restrictions, although not as stringent as those imposed at the height of the pandemic last year. Still, consumers cut back spending during the summer, and job growth slowed dramatically in August.

Needless to say, the economy's performance going forward rests heavily with the path of the virus. The good news is that case counts seem to be peaking, albeit at high levels, and vaccination rates are still grudgingly climbing, as the rapid increase in Covid related deaths has persuaded more unvaccinated people to get inoculated. What's more, an expanding list of businesses, prodded by President Biden's mandate that all companies with more than 100 employees get vaccinated or tested, should accelerate the trend. Assuming the health crisis continues to ebb, the third-quarter slowdown in activity should not be the beginning of the end of the expansion. The fundamentals underpinning the economy remain solid, setting the stage for a rebound in the fourth quarter and continued growth next year.

Consumers Take a Step Back

Households took a breather over the summer following a torrid spending spree in the second quarter when personal consumption leaped by 12 percent. How much of the pullback reflected the impact of the Delta variant is unclear. Still, the outright spending decline in July occurred alongside the rapid increase in case counts that undoubtedly prompted many consumers to forsake going to restaurants, bars, and shopping malls where in-person gathering heightens the risk of infection.

Still, households are learning to live with the virus, and the July pullback turned out to be more of a hiccup than a retreat as spending bounced back in August. Rising virus fears may be curtailing some household activities, but, unlike the first wave of Covid-19, they are not stopping consumers from shopping. The major difference this time, aside from a better tolerance of the virus, is that household purchasing power has been dramatically enhanced by the $2 trillion in government transfer payments received since December and the nearly $6 trillion since the onset of the pandemic. These payments more than offset the job-related income losses caused by Covid-19.

Indeed, a lack of consumer demand has not impeded growth this year. The larger issue has been supply constraints, which continue to be the biggest drag on the economy. Simply put, companies have been unable to stock their shelves with enough merchandise to satisfy customer needs. Globalization with all its virtues is the primary culprit, as goods made in factories thousands of miles away need to be shipped to the U.S., either to provide the parts necessary to complete production or to be resold in the retail market. But the pandemic has taken as big, if not bigger, toll on overseas producers as it has here. The shutdown of ports and factories abroad has disrupted global supply chains and caused a severe shortage of goods in the U.S. The auto industry is a glaring example of this disruption, as the inability of producers to obtain much-needed computer chips, made primarily in Taiwan, has stifled auto production and vaporized the inventory of cars for sale.

Lingering Supply Restraints Will Impede Growth

The shortage of supplies – raw materials, component parts, and labor – will continue to stifle activity through various channels for some time to come. Manufacturing supply chains are facing historic levels of stress. The ISM Manufacturing index's supplier deliveries component – a widely followed measure of supply-chain pressure – points to the sharpest deterioration in vendor performance since the 1970s. ISM Services also points to rising stress in the services sector. Firms frequently cite difficulties with transportation, production capacity, high input costs, and hiring as reasons for worsening performance.

Strain is the harshest on the transportation front. Total ocean-borne cargo volumes received at U.S. ports stood near historic highs in July and were up 20% from pre-Covid levels. Longshore worker shortages and berthing space constraints have caused a monumental backlog of ships waiting to dock at U.S. ports. In late September, a near-record 53 ships waited to unload at Los Angeles and Long Beach, the two largest U.S. ports, which together receive 35% of U.S. goods imports. As a result, shipping costs have surged; the benchmark Harper Petersen shipping rate index is up more than 400% since Covid's onset.

And delays extend beyond seaports. The trucking industry (which moves about 75% of U.S. freight across the country) transported near-record volumes of shipments in July that stood 15% above pre-Covid levels. Aside from Covid-related challenges, a chronic driver shortage has also prevented a more robust response in truck freight-carrying capacity. After arriving by cargo ship, a shipment must wait nearly two weeks before it starts its journey to its destination, up from 3-4 days before Covid.

Air cargo load factors also stand well above their long-term average and early-2020 levels. Meanwhile, total railcar freight volumes are relatively steady. However, they're weighed down by a structural decline in coal shipments (25% of railcar freight loads) as the economy shifts toward environmentally-friendly energy sources. The confluence of these headwinds is stalling the inventory rebuild. Business cycle upturns typically coincide with inventory restocking, but the Covid crisis has decidedly broken that relationship. While production is thriving, inventories haven't gained traction, constricting activity down the production chain and leaving many businesses with excessively low inventories.

Supply-chain headwinds are unlikely to ease in the near term. But we see a light at the end of the tunnel – current challenges will not be indefinite. As vaccination rates rise in the U.S. and overseas and demand slowly returns to pre-pandemic patterns, transportation logjams will clear, input costs will normalize, and production and hiring challenges will recede. In other words, easing supply-side constraints, rising capital investment, and demand normalizing to pre-pandemic patterns will allow firms to clear the significant backlog of orders built up in the past 18 months. That said, supply-chain headwinds should weigh on activity until at least the second half of 2022. What's more, disruptions in specific sectors – such as the semiconductor chip shortage's impact on automobile production – could last into 2023.

The Drag from Fading Fiscal and Monetary Support

The supply restraints amid a stimulus-fueled surge in demand constitute the perfect storm to ignite an upsurge in inflation. Predictably, the inflation rate has spiked to levels not seen in decades, which is prompting the Fed to start unwinding its turbo-charged easy policy. At its last FOMC meeting, Fed officials all but confirmed that it is poised to begin tapering its asset purchases from the $120 billion monthly pace in effect over the past 18 months, perhaps as early as November. Fed officials also accelerated the lift-off date for its policy rate, pulling forward the expected first increase from 2023 into 2022.

We concur with the timing of the tapering but believe that the Fed may be too hasty in expecting to lift rates in 2022. While it is important to keep inflationary expectations in check and maintain credibility, which the tapering process will accomplish, we believe that there are too many headwinds and external risks to justify a rate hike soon after the tapering process completes in mid-2022. It's important to remember that the powerful unleashing of demand since the onset of the pandemic has been driven primarily by the unprecedented volume of government transfer payments, both in the form of direct stimulus checks and expanded jobless benefits. Those payments have mostly run out, and this year's fiscal thrust will morph into a significant fiscal drag in 2022.

To be sure, Congress is now contemplating further stimulus in the form of two bills – the $1.2 trillion infrastructure bill and the $3.5 trillion social-policy and climate bill (the reconciliation bill). While there is bipartisan support for the infrastructure package, the larger reconciliation bill, assuming the moderate and progressive wing of the Democratic Party can reach a compromise, is likely to be watered down considerably, perhaps to under $2 trillion. Even so, the next round of government outlays will be very different from the nearly $6 trillion passed over the past 18 months. The two pieces of legislation will be spread out over ten years, which would impart a much smaller stimulus in 2021 and 2022 than the headline number suggests. Indeed, we estimate that the two pieces of legislation combined would boost growth by about 0.5 percent in 2022, while the expiration of past stimulus measures will constitute a 6.5 percent drag on growth. Indeed, the fiscal cliff facing households is already starting to bite; real disposable incomes fell 0.3 percent in August and probably slid more deeply in September, as expanded unemployment benefits vanished for millions of people.

Peak Inflation Doesn't Mean a Fire is Burning

In all likelihood, inflation has peaked with the headline PCE deflator firming to 4.3 percent in August from a year ago– the highest since 1991 – and core inflation holding steady at 3.6% – the highest since the early 1990s. With supply gradually catching up to demand and base effects fading out, we expect inflation to cool in the coming quarters. However, price pressures will remain sticky, with core PCE inflation running around 3% into 2022.

From our lens, the US economy is unlikely to experience an inflation regime shift –i.e., shifting into a high-inflation regime (persistently above 5%). But after a decade of glacial price rises in the wake of the financial crisis, it will experience a prolonged period of warm inflation above the Fed's 2% target. The stickiness will initially reflect post-Covid supply-and-demand imbalances, but from 2022 onward, it will mirror sustained economic and labor market strength.

That said, spiraling inflation is highly unlikely. While business pricing power is near record-highs, we believe an inflationary psychology is unlikely to settle in. Instead, we observe that faster price increases are eroding demand, which in turn is leading to cooler inflation. While slim inventories are crimping car sales, the industry reports a decided decline in demand as well, as higher prices turn off many customers. Indeed, the latest surveys show that the surge in car prices has driven consumer sentiment regarding vehicle buying conditions to the lowest in nearly 40 years. A similar pattern – scarce supply but receding demand due to high prices – can be seen in the housing market, where sales have fallen off a cliff this year.

Similarly, while lower-paying jobs are getting unprecedented wage growth, we believe this reflects a one-time releveling of low wages rather than a permanent shift in workers' bargaining power. Evidence doesn't point to a change in the trade-off between unemployment and wages, nor in wage and inflation links. The unemployment rate remains well above pre-Covid levels, and more than 5 million jobs remain unrecovered from the huge pandemic losses last year. With the economy expected to grow above-trend in coming quarters while inflation recedes, stagflation is nothing more than a misguided perception. The Fed's credibility in not tolerating runaway price increases should help anchor long-run inflation expectations; meanwhile, demographics, globalization, and technology should keep exerting structural downward pressure on inflation.

Downside Risks Loom Large

Although we expect growth to rebound from its third-quarter lull as the health situation improves and job growth picks up, the economy faces several downside risks that could still derail the expansion or at least slow it down. As noted, the fiscal cliff from the loss of transfer payments is a formidable headwind that will be overcome only if certain assumptions come to pass. Aside from the modest boost expected from the two new bills now being considered in Congress, households are sitting on more than $2.5 trillion of unspent funds built up throughout the pandemic. Policy makers and forecasters, including us, believe that the main impetus to consumption next year will derive from the drawdown of these savings to normal levels.

Currently, the personal savings rate stands at 9.4 percent, down considerably from the 26.6 percent nearby peak reached in March following the last government stimulus payment. However, there are several reasons to believe that households will retain an elevated savings rate, much less draw it down to the average pre-Covid level of 7.2 percent that prevailed in the ten years after the financial crisis. For one, wealthier individuals who have a higher propensity to save than those down the income ladder hold the bulk of the savings, and this cohort has little need to tap into these funds to finance purchases.

Lower and middle-income households who managed to build up a savings cushion from the transfer payments may well decide to keep more of it than otherwise. Following three significant shocks over the last two decades that threw millions of workers out of jobs and the still-high level of anxiety over the path of Covid-19, there is likely to be a strong preference to maintain a healthier financial cushion to guard against future adversity. What's more, nearly 60 percent of U.S. households hold common stock, either directly or through retirement accounts, and the link between stock prices and confidence has strengthened in recent years. Hence, the risk of a deep market correction and the wealth destruction that would ensue could well take a bigger bite out of consumer spending than in the past.

Finally, the risk of an unprecedented fiscal mishap cannot be ignored. We believe that Congress will come to its senses and lift the debt ceiling before the October 18 deadline. Still, there is a nontrivial chance that the impasse will last longer and result in a confidence-shattering calamity. Likewise, we expect that the administration will ultimately get a watered-down reconciliation bill enacted. However, failure to do so this year would doom its prospects, as it's unlikely that anything could be accomplished in 2022 when legislators will be preoccupied with mid-term elections. Should the two significant pieces of legislation fail to see the light of day, the fiscal cliff that is already weighing on growth would become even steeper.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market (Barclays TSY Bellwethers)	Yields (%) 9/30/2020	Yields (%) 6/30/2021	Yields (%) 9/30/2021	Total Return (%) Last Quarter	Total Return (%) Last Year
6-Mo. Bill	0.11	0.05	0.05	0.02	0.11
2-Yr. Note	0.12	0.25	0.29	0.10	0.00
5-Yr. Note	0.27	0.88	0.98	-0.15	-2.14
10-Yr. Note	0.68	1.45	1.52	-0.07	-6.07
30-Yr. Note	1.45	2.07	2.08	0.39	-12.71

Municipal Bonds	Yields (%) 9/30/2020	Yields (%) 6/30/2021	Yields (%) 9/30/2021	Total Return (%) Last Quarter	Total Return (%) Last Year
Barclays GO Bond Index	1.07	0.87	0.99	-0.25	1.82
Barclays State GO Bond Index	0.98	0.75	0.87	-0.26	1.75
Barclays Local GO Bond Index	1.16	0.98	1.10	-0.24	1.88
Barclays Revenue Bond Index	1.51	1.11	1.23	-0.29	3.20

Equities	Levels 9/30/2020	Levels 6/30/2021	Levels 9/30/2021	US $ Terms (%) Last Quarter	US $ Terms (%) Last Year
S&P 500	3363	4297.5	407.54	-0.58	29.98
DJIA	27781.7	34502.51	33843.92	-1.46	24.15
NIKKEI (Tokyo)	23185.12	28791.53	29452.66	2.57	22.14

Commodities	US $ 9/30/2020	US $ 6/30/2021	US $ 9/30/2021	Percent Change (%) Last Quarter	Percent Change (%) Last Year
COMEX Gold Active Monthly	1887.5	1771.6	1755	-0.94	-7.02
CRB Future Com. Pr. Index*	148.5066	213.853	228.9221	7.05	54.15
West Texas Intermediate Crude ($ per bbl.)	40.22	73.47	75.03	2.12	86.55

Currencies	Levels 9/30/2020	Levels 6/30/2021	Levels 9/30/2021	Percent Change (%) Last Quarter	Percent Change (%) Last Year
Yen	105.48	111.11	111.29	-0.16%	-5.51%
Sterling	1.292	1.383	1.347	-2.60%	4.26%
Euro	1.1721	1.186	1.158	-2.36%	-1.20%

Global Bond Markets**	Levels 9/30/2020	Levels 6/30/2021	Levels 9/30/2021	US Dollar Terms (%) Last Quarter	US Dollar Terms (%) Last Year
German 10-Yr.Bond	-0.61	-0.37	-0.32	-2.58	-3.43
Japanese 10-Yr.+ Bond	-0.04	0.00	0.01	-0.55	-5.48
UK 10-Yr.+ Bond	0.10	0.66	0.89	-3.89	-0.89
Emerging Market (USD)	4.09	3.85	4.22	-0.55	3.31

Source: Bloomberg Financial Data
*Thomson Reuters/Jefferies CRB Commodity Excess Return Index
** Global Bonds Represented by Bloomberg Barclays Indices