

ECONOMIC OUTLOOK

Summary

Many seem to think the inflationary pressures the economy has been experiencing derive more from bottlenecks and disruptions in the supply chain than other factors. From a scarcity of raw materials to port congestion and labor shortages, there is a logical belief that these pressures will abate as the pandemic winds down, or as we learn to live with COVID. However, it may require a shift in pandemic-related spending habits, rather than the end of the pandemic itself, to truly provide needed supply chain relief.

Following the economic shut downs at the onset of the pandemic, we saw a tectonic shift in consumer spending habits. While much of the service sector remained closed, many of the funds that would have traditionally been earmarked for services found their way into either debt reduction and savings, or goods and manufacturing. This shift from a services-based economy toward goods was exacerbated by government transfer payments (stimulus, supplemental unemployment benefits, etc.), which actually put some in a better financial place during the recession than prior to it. Many consumers were awash in cash, with few places to spend.

This unexpected increase in demand toward goods caught manufacturers flat footed and playing catch up throughout the pandemic. The ISM Manufacturing PMI data has come in close to or above 60 for all of 2021, meaning manufacturing is expanding at a rapid pace. That's a level that's not often reached, especially for sustained periods of time. Supplier delivery times seemed to start improving just prior to the wave of the Delta variant but have since slowed considerably. While having more workers in factories and truck drivers to deliver final products, for example, will certainly help, what will relieve supply chains most at this point is likely a decrease in the demand for which most businesses just weren't prepared.

In October, we saw the biggest drop in ISM Manufacturing New Orders (66.0 to 59.7) since the onset of the pandemic and the biggest increase in ISM Services New Orders since the first quarter of 2021 (pre-Delta variant). Hopefully this is a sign the economy is beginning the process of reverting to its traditional service base, and the demand for goods might soon be reduced. However, with the holiday season quickly approaching and record sales expected, the decrease in demand to a level needed to alleviate supply chain pressures is unlikely to occur until 2022.

Positives

Inflation (via Core PCE) has shown signs of moderating for three consecutive months

Initial jobless claims continue to decline and are nearing pre-pandemic levels

PMI's remain elevated with ISM Services hitting an all-time high (66.7)

Negatives

Third quarter GDP trailed estimates (2.0% actual vs 2.6% estimated)

ISM supplier delivery times have gotten slower for three consecutive months (52.5)

After three months of declines, the ISM Prices Paid survey climbed (85.7)

EQUITY OUTLOOK

Summary

It didn't take long for equity markets to recover from the September slump. The S&P rose 7.0% in October more than offsetting the losses from the previous month and closing at a fresh 52-week high. The "buy the dip" mantra that has been persistent for the last several years appears to remain in effect. Stocks do not appear as if they want to stay down for any extended period of time.

Many of the issues that caused concerns in September have moderated to a degree just a month later. Washington is still dysfunctional but the market appears to be content that gridlock there will result in fewer radical changes. Fewer changes often make the waters easier for businesses to navigate. Additionally, a handful of companies are beginning to hint at slow improvements regarding supply chain bottlenecks. This issue will remain with us for many months to come but any sign of progress is welcome.

Perhaps the reason the stock market has been so resilient is we remain in a goldilocks situation as far as equity markets are concerned. The Fed has signaled their intent to begin tapering asset purchases this month, yet they continue to make the distinction that tapering is a separate decision from a rate liftoff. Weeks into the current reporting season, corporate earnings continue to show upward momentum which has been making market valuations look more reasonable. Additionally, corporations are still able to borrow at very reasonable levels to finance new opportunities.

As we look to close out 2021, equity markets appear to be set for a continued move higher. Holiday spending has already begun and things are shaping up nicely for a Santa Clause rally. We expect this momentum to carry forward into 2022. There certainly will be setbacks from time to time but we continue to believe long-term investors will be rewarded for an allocation to equities.

Positives

Earnings growth remains positive

COVID cases in the U.S. continue to trend lower

Accommodative Federal Reserve

Negatives

Higher inflation signals may spook markets from time to time

Several industries will likely continue to struggle with supply constraints and labor shortages

FIXED INCOME OUTLOOK

Summary

With the Fed's path to tapering bond purchases all but etched in stone following the September meeting of the Federal Open Market Committee (FOMC), the timing of "lift-off" from the current zero interest rate policy (ZIRP) was all that was left for Fed watchers and market traders to ponder in October. Focusing on elevated inflation pressures and a series of solid economic reports, investors moved forward their expectation for a first-rate hike into mid-2022. While not impacting T-bill and 1-year yields much, this "tightening tantrum" resulted in a fairly unusual shift in the yield curve as 2-year, 3-year and 5-year yields increased by 22 to 24 basis points (bps). Discounting back these yields we can calculate the bond market is now pricing for two rate increases in 2022, beginning as early as June, and three increases in 2023. To justify the 5-year Treasury note at a yield of 1.18%, there also needs to be two additional rate increases in 2023.

The curve movement is somewhat unusual in that bonds with maturities longer than seven years increased much less and past ten years, yields actually declined. The 10-year increased by a modest 7 bps to 1.55% and the 30-year bond yield declined by 11 bps to end at 1.93%. The drop in long yields likely reflects the investor's beliefs the Fed will follow this path of rapid rate increases until it eventually leads the economy to the brink of the next recession. Given little change in credit spreads, the monthly return from intermediate-maturity Treasury and corporate bonds were similar at -0.57% and -0.55%, respectively. With yields declining, the long maturity sectors of the market delivered solid monthly returns of 1.86% for Treasury bonds and 1.50% for investment-grade corporate bonds.

There is merit in the belief Treasury yields should reflect the linked path of the overnight rate, especially for maturities of five years and less. But forecasting the economy and inflation many years into the future is somewhere in between an inexact science and an exercise in futility. Projecting what the

Fed will do with that information adds even another level of complexity. That said, we can look at past experiences and apply current biases and influences that might alter what traditionally has been done. The repetitive history of the Fed causing recessions combined with dovish leadership, federal budget constraints and their new policy framework lead us to believe the Fed will allow rates to remain lower than what they would have in the past. We do not believe the Fed will be as aggressive as the market is currently expecting and interest rates inside of five years are not likely to move much higher anytime soon. The curve can steepen and longer maturity yields can increase from current levels if more investors come to believe the Fed will error on the side of dovish cautiousness, like we do.

Positives

Foreign interest in U.S. debt will increase as yields rise

Short maturity bonds reflect an overly aggressive Fed rate policy

Negatives

Reported inflation levels are reaching the highest in decades

Markets will have to absorb more debt as the Fed reduces purchases

Unknowns

The future of Biden's Build Back Better agenda

The degree to which inflation and bottlenecks are transitory or permanent
