October 2021

Economic Update

A Review of Third Quarter 2021

In retrospect, National Association of Business Economics were a bit too optimistic three months ago when they predicted a historically strong summer. Since that time, third quarter GDP growth projections have been reduced. The group's median forecast is now down to 4.0% growth for the third quarter and 5.6% for the year as a whole.

Many factors have contributed to this GDP growth slowdown, but probably none more than the resurgence of Covid-19. As of this writing, every state apart from California is at high transmission levels per the CDC.

Still, new cases appear to have peaked in early September and have been trending down since that time. Approximately 76% of Americans have now received at least one vaccine shot according to the CDC. While this percentage is lower than many other countries, hopefully it should still be enough to avoid yet another wave in the winter months ahead.

U.S. Economy

Consumer confidence declined precipitously during the last few months as the Covid-19 2nd wave took hold. The monthly University of Michigan Consumer Sentiment survey registered 72.8 in September, which is near pandemic lows. This compares to a relatively high reading of 88.3 in April, and it is still well below the normalized value of 100.0 set in the first quarter of 1966.

In addition to the pandemic, respondents cited concerns about recent inflation. The Consumer Price Index for all Urban Consumers rose 5.3% for the 12 months ending August 2021. The Fed still considers this higher inflation to be transitory, but consumers are more skeptical. Only 18% of respondents to the University of Michigan Consumer Sentiment survey anticipated that their household's near-term income gains would be higher than their expected inflation rate.

Businesses have seen significant supply chain issues of late, which has been a significant contributor to our recent surge in inflation. Covid-related port shutdowns have led to shortages in both parts and finished goods. As a result, the cost of sending a container from Shanghai to Los Angeles has grown more than sixfold as compared to May 2020, according to the Drewry World Container Index. The cost of shipping from Asia to Europe has increased even more than that.

Wage gains have been relatively strong as of late, if not quite keeping up with inflation. According to the Bureau of Labor Statistics, average wages were up 4.3% for the 12 months ending August 2021. On an absolute basis, that is the highest wage growth registered in more than a decade.

Job growth continues to be relatively strong as well. Per the Bureau of Labor Statistics, the U.S. economy added 1.1 million jobs during July, 235,000 in August and 194,000 in September. The total number of unemployed persons is now down to 7.7 million and the unemployment rate is now down to 4.8%. Both numbers are trending in the right direction, but they remain well above the pre-pandemic levels of 5.7 million and 3.5% respectively.

Unlike consumer sentiment, business sentiment continues to be positive. While Markit survey manufacturing PMI fell from 61.1 in August to 60.5 in September, that is still a very strong reading. The services PMI fell from 55.1 to 54.4 over the same period. Readings above 50.0 predict economic expansion.

Business optimism could also be related to strong corporate earnings. Despite the supply chain issues and recent increases in wages, companies have still found a way to raise margins and therefore push increased sales down to the bottom line. Standard and Poor estimates that S&P 500 companies collectively earned a record $175.52 per share of operating earnings during the twelve months ended June 30. In the 2nd quarter alone, operating earnings were up 90% from one year prior.

International Economy

Markit survey PMI results for the Eurozone were comparable to those found in the United States. Eurozone manufacturing PMI fell from 61.4 in August to 58.7 in September. The services PMI fell from 59.0 in August to 56.3 in September. Markit cites supply chain delays and shortages, which have hindered the ability of businesses to satisfy rising consumer demand. Still, on an absolute basis, both surveys indicate that business confidence is very strong.

China reappeared in the news at the end of the quarter, as news of a potential significant default spooked markets for a few days. The issue is at a Chinese company named Evergrande, which is a massive property developer but generally had not been well known outside of China.

There has been a decades-long real estate boom in the Chinese market. However, many properties have been purchased by wealthy investors purely for speculative purposes and are not currently occupied. In fact, according to Rhodium Group, there are 90 million apartments sitting vacant throughout the country today. To put this number in context, that is nearly twice as many total apartments that exist in the entire United States!

The Chinese government is aware of this speculation issue and consequently stepped in last year, announcing limits to the amount of debt that property developers can maintain going forward. Evergrande is having trouble meeting those new limits and now is likely to default. As of this writing it is still unclear whether the Chinese government will provide a bailout for the company or not. Global markets have been a little skittish as a result.

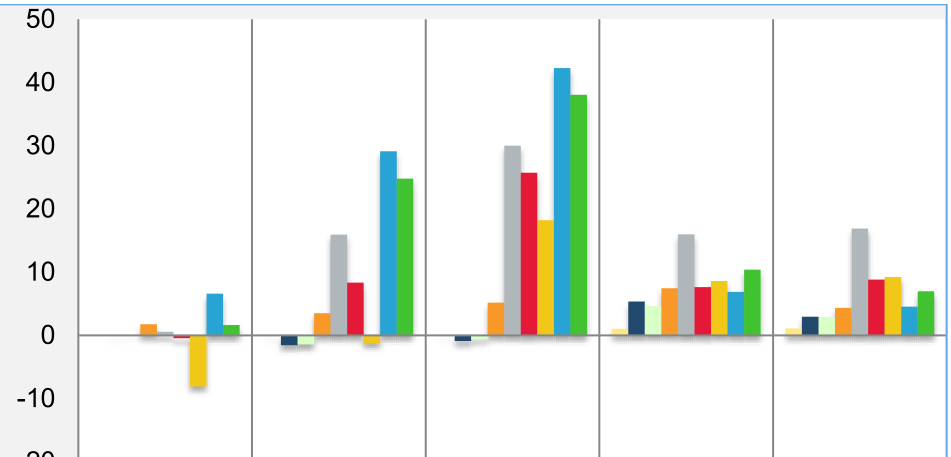
Markets

Developed equity markets had a relatively flat quarter as surging cases slowed down the economic recovery. Markets actually started the quarter strong, but then September erased gains from the two months prior to that. U.S. large-cap equities, as represented by the S&P 500 Index, gained 0.58% during the quarter and are now up 15.92% year-to-date. Developed international equity markets, as represented by the MSCI EAFE Index, finished the quarter down 0.45% but have still gained 8.35% for the year thus far.

Emerging markets had a much poorer quarter, erasing all gains for the previous six months. The MSCI Emerging Markets Index finished the quarter down 8.09% and is now down 1.25% year to date. Recent inflation concerns continue to benefit both real estate and commodities. The Dow Jones UBS Commodity Index and the Wilshire REIT Index have gained 29.13% and 24.79% respectively for the year so far.

Bond indexes were relatively flat as interest rates increased slightly during the quarter. The Barclays U.S. Aggregate Bond Index was up a scant 0.05% for the quarter and is still down 1.55% for the year. The Barclays Global Aggregate Bond Index gained 0.09% during the last three months, but it is still down 1.43% year to date. The Barclays U.S. Inflation-Linked Bond Index, however, has fared better due to increasing expectations for inflation. That index is up 3.51% for the year so far.

Through Sept. 30, 2021



	Quarter-to-Date	Year-to-Date	1-Year	3-Year	5-Year
T-Bills	0.01	0.03	0.06	1.03	1.10
Bloomberg US Agg Bond Index	0.05	-1.55	-0.90	5.36	2.94
Bloomberg Global Agg Bond Index	0.09	-1.43	-0.56	4.64	2.89
Bloomberg US Infl Linked Bond Index	1.75	3.51	5.19	7.45	4.34
S&P 500 Index	0.58	15.92	30.00	15.99	16.90
MSCI EAFE Index	-0.45	8.35	25.73	7.62	8.81
MSCI Emerging Markets Index	-8.09	-1.25	18.20	8.58	9.23
Bloomberg Commodity Index	6.59	29.13	42.29	6.86	4.54
Wilshire REIT Index	1.64	24.79	38.04	10.39	6.97

information. Past performance does not guarantee future results. An investment cannot be made directly in an index. (Refer to the end for index definitions.)

Outlook

The global economic recovery experienced a few hiccups during the last few months, but OECD economists are expecting it to get back on track now that Covid-19 cases are on the decline once again. They are projecting strong growth for both the rest of this year as well as 2022.

Based on Markit PMI survey results, businesses around the world share their optimism. Corporations remain in a very favorable position with strong earnings, good growth prospects and generally healthy balance sheets. Supply chain issues and wage pressures have been managed thus far, and there is no reason to expect them to derail additional corporate earnings records over the next few quarters too. Jobs growth should continue to be strong as well.

On a cautionary note, however, market valuations are still a little stretched after the large gains that we have experienced over the last few years. There are also potential looming corporate tax increases assuming some sort of infrastructure bill comes out congress at some point soon. As always, we recommend a diversified portfolio containing a reasonable amount of equity exposure for any investor with a long enough time horizon.

Bloomberg US Aggregate Bond Index: The Aggregate Bond Index is a broad-based benchmark that measures the investment grade, dollar-denominated, fixed-rate taxable-bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS. The Aggregate rolls up into other Bloomberg flagship indices such as the multi-currency Global Aggregate Index and the Universal Index, which includes high-yield and emerging markets debt. The Aggregate Index was created in 1986, with index history backfilled to Jan. 1, 1976.

Bloomberg Global Aggregate Bond Index: The Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the Aggregate (USD 300mn), the Pan-European Aggregate (EUR 300mn) and the Asian-Pacific Aggregate Index (JPY 35bn). In addition to securities from these three benchmarks (94.0% of the overall Global Aggregate market value as of Dec. 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300mn), Euro-Yen (JPY 25bn), Canadian (USD 300mn equivalent) and Investment Grade 144A (USD 300mn) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized sub-indices by liquidity constraint, sector, quality and maturity. A component of the Multiverse Index, the Global Aggregate Index was created in 1999, with index history backfilled to Jan. 1, 1990.

Bloomberg Global Inflation-Linked Index: The Global Inflation-Linked Index (Series-L) includes securities that offer the potential for protection against inflation as their cash flows are linked to an underlying inflation index. All securities included in the index have to be issued by an investment-grade-rated sovereign in its local currency. The list of eligible currencies is the same set of currencies eligible for inclusion in the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) represents a stand-alone multi-currency index exposed to the real yield curve for each relevant currency. As such, the index does not contribute to the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) was created on Oct. 31, 1997.

S&P 500® Index: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard & Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. The returns presented for the S&P 500 are total returns, including the reinvestment of dividends each month.

MSCI EAFE Index: The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed-market equity performance, excluding the U.S. and Canada. As of April 2002, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI EMF (Emerging Markets Free) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of April 2002, the MSCI EMF Index consisted of the following 26 emerging-market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

Bloomberg Commodity Index: Bloomberg Commodity Index℠ and Bloomberg Commodity Index Total Return℠ the DJ-UBSCI℠ family includes both the BSCI℠, which is calculated on an excess-return basis, and the BSCITR℠, a total return index based on the BSCI℠. The former reflects the return of underlying commodity futures price movements only, while the latter reflects the return on fully collateralized positions in the underlying commodity futures.

Wilshire US REIT Index: Introduced in 1991, the Wilshire REIT index is intended as a broad measure of the performance of publicly traded real estate equity securities. The index is market-capitalization weighted of publicly traded real estate securities, such as Real Estate Investment Trusts (REIT), Real Estate Operating Companies (REOC) and partnerships. The index is composed of companies whose charters are the equity ownership and operation of commercial real estate.

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