INVESTMENT STRATEGY OUTLOOK

October 2021

THE ECONOMY

Suddenly Not So Great Expectations

The Bureau of Economic Analysis (BEA) will release their initial estimate of Q3 GDP on October 28, which somehow seems appropriate. Recall that October 28, 1929, the original "Black Monday," is the date most typically associated with the stock market crash of 1929 that helped pave the way for the Great Depression. Okay, that may be a bit too dramatic, and if it helps ease any tensions that a Black Monday reference may trigger, take comfort in the knowledge that October 28 falls on a Thursday this year, not a Monday.

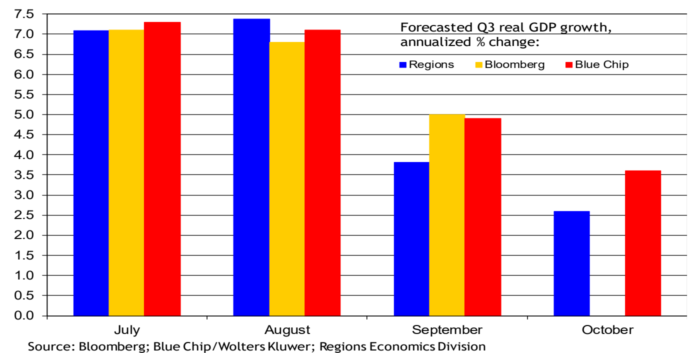
To the extent October 28 seems an appropriate date for the release of the Q3 GDP data, that is simply due to the extent that what were lofty expectations for Q3 real GDP growth as the quarter began were considerably more down to earth by the time Q3 ended. More specifically, as of our July baseline forecast, we anticipated annualized Q3 real GDP growth of 7.1 percent, while our October baseline forecast pegs Q3 growth at just 2.6 percent. As the accompanying chart shows, we were far from alone in building up then knocking down expectations for Q3 growth. Our July forecast matched the consensus in the monthly survey conducted by Bloomberg and fell a bit short of the consensus forecast of 7.3 percent growth in the Blue Chip survey (we participate in both surveys). For a sense of how high expectations were, the average annualized growth rate anticipated in the ten lowest forecasts in the July Blue Chip survey was 5.2 percent.

As a frame of reference, we, as do most of our counterparts, update our forecasts upon the release of the monthly employment report, which typically occurs on the first Friday of any given month, and we adjust our expectations during the month as we process the incoming economic data. We produced our August baseline forecast on August 6, fresh on the heels of the release of the July employment report which showed the economy added 943,000 nonfarm jobs in July while the unemployment rate had fallen from 5.9 percent in June to 5.4 percent in July. So, at the time our August forecast was struck, Q3 still seemed destined for big things, at least in terms of real GDP growth, and our August forecast aligned with the median Bloomberg and Blue Chip forecasts.

Those August forecasts, however, were quickly rendered moot. The surge in COVID-19 cases during the month had an immediate impact on consumer behavior, as various trackers of consumer spending picked up on rapid declines in spending on services such as travel, tourism, dining out, entertainment, and recreation as we moved through August. At the same time, manufacturing and shipping hubs across Asia were shutting down due to rising COVID cases, thus exacerbating supply chain and shipping bottlenecks. To the extent consumers were still willing to spend on goods, increasingly lean inventories became a more binding constraint. For instance, motor vehicle sales fell from 14.7 million units in July to 13.0 million units in August (annual rates), and what really stood out about the decline in sales is that it wasn't until the latter half of August that sales began to tumble due to worsening inventory shortages. Motor vehicle sales fell even further in September, to a rate of 12.2 million units, which not only further dragged down expectations for Q3 growth in consumer spending but also set a weak base for Q4 growth. Though perhaps not to the same degree, we're seeing the same patterns in sales of other consumer durable goods.

By the time September forecasts were struck, it was clear Q3 real GDP growth would fall well short of what had been expected when the quarter began, and those expectations had been dampened even further by time we produced our October forecast, which anticipates Q3 real GDP growth of just

Fading Expectations For Q3 . . . And Beyond?



Source: Bloomberg; Blue Chip/Wolters Kluwer; Regions Economics Division

2.6 percent. Again, we've had plenty of company in downgrading the view of Q3 growth (the October Bloomberg survey was not available at the time of this writing). Though Q3 has ended, we are still processing incoming data for the month of September, including data on new residential construction, new home sales, business investment, net exports, nonfarm business inventories, and consumer spending. As such, there is ample room for the view of Q3 real GDP growth to change further.

Still, even if incoming data put it in a more favorable light, when all is said and done Q3 growth will fall far short of the lofty expectations we and others had for it as the quarter began. The bigger question, however, is what disappointing Q3 growth might mean going forward, particularly in light of ongoing global supply chain and logistics bottlenecks and elevated inflation. Indeed, the combination of listless growth and elevated inflation has raised fears of a return to the stagflation that gripped the U.S. economy over much of the 1970s and early-1980s. To be sure, the past eighteen months have hammered home the lesson of never saying never, but we nonetheless see a bout of stagflation as being unlikely.

One parallel between now and the 1970s is considerable disruption on the supply side of the economy, which during the 1970s largely reflected a series of oil shocks and which at present largely reflects lingering distortions brought on by the pandemic. While these supply side disruptions have contributed to higher inflation, as in the 1970s, current elevated rates of inflation are also a reflection of robust growth in demand, and in that sense the present looks very little like the past. In the household sector, record-high household net worth, significantly above-trend levels of personal saving, and near record-low household debt burdens make a significant and sustained decline in consumer spending unlikely. In the corporate sector, notably wide profit margins and ample amounts of cash on corporate balance sheets make a significant and sustained decline in business investment spending unlikely.

Thus, while supply side constraints will continue to weigh on growth over the next few quarters, there are few worries on the demand side of the economy, making a bout of stagflation unlikely. Indeed, the bigger risk to the economy could be that, even as supply side constraints ultimately ease, supply will still not catch up with demand. Such a scenario poses its own risks, such as faster sustained inflation, but that would still leave us a long way from stagflation. ▲

Source: Bureau of Economic Analysis; Bloomberg; Blue Chip/Wolters

STOCKS

Lofty Earnings Estimates, Rising Treasury Yields Are Hurdles To Clear

From a seasonality perspective, October has historically ushered in more profitable days for equity investors as the 4th quarter of any given calendar year has, on average, been the best of the bunch for the S&P 500. Throughout history, however, October has also developed a reputation for occasionally being quite scary, and we're not just talking about Halloween. The "October effect" is the perception that stocks typically fall during the month, but this is a purely psychological phenomenon as, dating back to 1928, the S&P 500 has ended October higher 58% of the time, and by an average of 4.1%. The belief that October is pre-destined to be a challenging one for equity investors is likely rooted in the fact that October has, not once, but twice, contained a "Black Monday." The first being in 1929 and the second in 1987, with October 19 of 1987 providing the largest single-day decline in the Dow Jones Industrial Average on record at over 22%. While we don't expect this month to be a repeat of '29 or '87, September's challenging backdrop for U.S. equities could stretch into October for two reasons: lofty quarterly earnings expectations and the potential for long-term Treasury yields to move higher into year-end amid stickier inflationary pressures.

On the earnings front, estimates for the 3rd quarter have remained anchored, with the analyst consensus estimate for quarterly S&P 500 earnings sitting at $48.36 on September 30, down just $0.30 since the end of August. This despite some blue-chip companies already posting quarterly results that fell short of estimates, while also lowering or removing forward guidance due

to higher labor costs and/or supply chain bottlenecks. The current backdrop isn't set up for an 'under promise and overdeliver' quarter in our view, and earnings expectations that fail to be met or exceeded could lead to steeper near-term drawdowns. A positioning or sentiment reset, while painful, would be healthy and provide investors with a more appealing opportunity set as we enter a historically positive seasonal stretch from mid-October through December and year-end performance chasing boosts demand for year-to-date 'winners.'

After peaking at 1.74% on March 31, the U.S. 10-year Treasury yield ended each calendar month from April through July lower than the prior month's close, a tailwind for growth stocks. Long-term Treasury yields remained range-bound throughout August, the 10-year yield, specifically, closing between 1.20% and 1.35% on all but a few days during the month – again, a constructive backdrop for growth. However, the supportive interest rate backdrop for growth sectors in place from April through August shifted after the Federal Open Market Committee's (FOMC) September meeting concluded on the 22nd. Post-meeting, FOMC Chair Jerome Powell acknowledged that inflationary pressures would be stickier than expected, leading to fears that the Fed could be 'behind the curve' when it comes to battling inflation.

Fears that persistent inflation could force a faster tapering of bond purchases or potentially pull forward Fed fund rate hikes led to increased short positions in long dated U.S. Treasuries, or bets that yields would rise, which pushed the 10-year U.S. Treasury yield higher by 20 basis points over the final seven trading days of September. The possibility that the FOMC might need to get more aggressive to combat inflation spurred sector rotation to close out the quarter. Investors used information technology as a source of funds and reallocated capital into energy, materials, and financial services to position for persistent inflation or a further rise in long-term Treasury yields. Despite this shift, our portfolios remain balanced between growth and value as economically sensitive sectors may be the place to be near-term as inflation expectations remain elevated, but once Treasury yields/inflation expectations stabilize, growth sectors should once again garner interest as CFO's seeking the biggest productivity bang for their buck will be hard-pressed to find a better place in which to deploy capital.

Outside the U.S., investors are focused on the evolving regulatory backdrop in China, as well as on how the Evergrande situation plays out amid chatter that the Chinese government could force a break-up of the beleaguered real estate developer to prevent economic contagion. Statements such as "China is un-investable" make the contrarian in us question if a bottom is near, but we acknowledge that this situation isn't likely to be resolved soon and remain neutral on emerging market equities as a result. We remain positive on Europe as economic growth expectations are reasonable and indices skew 'cyclical' providing leverage to a global economic recovery. The European Central Bank (ECB) is expected to keep pandemic-era support in place for longer than the FOMC and the Bank of England; however, higher inflation readings out of the Eurozone will test the ECB's ability to remain accommodative. We expect October to be volatile as investors parse earnings releases and digest higher energy prices, but liquidity and economic recovery should propel stocks higher over the coming year and we continue to view pullbacks as buying opportunities. ▲

Source: Bloomberg, Factset, Yardeni Research

BONDS

FOMC To Be Tested Amid Turnover, Leadership Uncertainty

September ended with yields on U.S. Treasury paper maturing at least one-year out moving higher, with the largest month over month increases taking place in the 5- to 10-year portion of the yield curve where yields rose between 18 and 20 basis points during the month. Much of the jump in yields in the belly of the curve appeared to be attributable to FOMC Chair Jerome Powell's comments in the wake of the Committee's September meeting that inflationary pressures had proved less transitory than the Committee originally expected. Market participants were caught off guard as this was a surprising public acknowledgement by the FOMC Chair that the Committee's projections had been wrong, which did little to inspire confidence that the Fed has a complete understanding of what is really going on from an inflation standpoint. The move higher in 5 and 10-year U.S. Treasury yields in late September is a sign that market participants are losing faith that the FOMC is ahead of the curve when it comes to fighting inflation.

Due to this crisis of confidence, investors have taken steps to hedge just in case the Fed is forced to take a more hawkish stance via forward guidance to put downward pressure on long-term Treasury yields or raise the Fed funds rate earlier than is currently anticipated to combat rising prices/inflationary pressures. With inflationary pressures proving more durable than the Committee anticipated while the labor market recovery has been painfully slow in the U.S., the FOMC already had a lot on its plate. But at the end of September, the tough task of balancing price stability with full employment became even more so amid notable turnover within its ranks as two prominent regional Fed Bank Presidents, Dallas President Robert Kaplan and Boston President Eric Rosengren, announced they would retire in short order. Kaplan cited not wanting to be a distraction after his stock trading disclosure called into question his objectivity, and, while Rosengren's disclosure raised similar questions, he cited health-related reasons for stepping aside. Rosengren was slated to become a voter in 2022, but neither was a current voting Committee member.

Within days of the resignations, FOMC Chair Jerome Powell had the misfortune of testifying before Congress, and with questions swirling surrounding trading practices by Fed members and perceived conflicts of interest, the normally cordial and uneventful testimony turned contentious. One Senator, Elizabeth Warren from Massachusetts, went so far as to call Chair Powell "a dangerous man" due to what she perceives to be weakened U.S. banking regulations under his watch, and publicly stated that she would oppose his nomination for a second term as FOMC Chair. Uncertainty surrounding FOMC leadership would be unsettling enough by itself but throw in a stalemate surrounding raising the debt ceiling and passage of the President's proposed budget, and we have a recipe for interest rate volatility to persist.

The backdrop remains a challenging one for fixed income investors as higher quality bonds yield very little while duration, or interest rate sensitivity, is elevated, leaving little room for interest rates to rise before prices decline, potentially generating a negative total return. With inflationary pressures likely to be sustained over coming quarters, preservation of purchasing power takes on even greater importance, and many investors have felt forced to allocate more capital to high yield corporates and other relatively higher yielding bonds to preserve buying power. The desire to reach for yield can be powerful, but we would do so in a measured manner as failure to size exposures appropriately can lead to elevated volatility and deeper drawdowns. We remain underweight Treasuries, overweight shorter duration investment-grade corporate bonds, neutral on high yield corporates, and maintain allocations to asset-backed securities and emerging market debt for diversification. ▲

Source: Bloomberg, Factset

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