INVESTMENT STRATEGY OUTLOOK

THE ECONOMY

May 2021

Supply Side Issues Weighing On Growth?

Data for the month of March consistently beat expectations, setting a high bar for the April data. While we expected the overall tone of the April data to remain solid, we nonetheless worried about some undercurrents in the data, specifically supply chain/logistics bottlenecks and building, and broadening, inflation pressures. Though it is still early, in terms of the number of series for which the April data have been reported, what we've seen thus far is consistent with these themes, i.e., the economy continues to recover at a fairly rapid pace but supply side issues are intensifying and could slow down the pace of growth while fueling faster inflation in the months ahead.

The first estimate from the Bureau of Economic Analysis (BEA) shows real GDP grew at an annualized rate of 6.4 percent in Q1 which, with the exception of Q3 2020, is the fastest quarterly growth rate since Q3 2003. Real private domestic demand, or, combined household and business spending, grew at an annualized rate of 10.6 percent in Q1, with consumer spending supported by two rounds of Economic Impact Payments and a recovering labor market, while business investment in equipment, machinery, and intellectual property products remained strong. Still, what jumped out at us the most about the Q1 2021 GDP data was the 4.1 percent annualized increase in the GDP Price Index which, despite being the largest such increase since Q2 1990, drew remarkably little attention. Aside from the simple math – real GDP growth would have been even faster had inflation been lower – we find the jump in the GDP Price Index to be quite relevant, in that it shows broader based inflation pressures building earlier than had been anticipated.

The monthly surveys of the manufacturing and services sectors conducted by the Institute for Supply Management (ISM) embody each of the elements highlighted above, i.e., further expansion, increasingly pressing supply side issues, and intensifying price pressures. Of the combined 36 industry groups represented in the ISM's surveys, 35 reported growth in April, matching March's total. The difference, however, is that the pace of growth slowed in both the manufacturing and services sectors in April, and a common theme of the comments from survey respondents shared by ISM was that shortages of labor and non-labor inputs are hindering their ability to keep pace with strongly growing demand. As such, backlogs of unfilled orders in both the manufacturing and services sectors expanded further in April. Another common theme is that input prices are rising at a rapid pace, with the ISM's measure of input costs at its highest level since mid-2008 in both the manufacturing and services surveys.

The April employment report offered further evidence of supply constraints and building inflation pressures, and somewhat rudely so, we might add. Total nonfarm employment rose by only 266,000 jobs in April, and while in normal times this would be cheered as a strong increase, it fell far, far short of the better than one million jobs we and the consensus forecast expected. While there are, perhaps somewhat fortunately, no official records tracking these things, this is the largest discrepancy between actual and expected numbers we can recall ever seeing – and misses of this magnitude don't come with a simple and tidy explanation. There are indications that firms would have hired more workers in April had they actually been able to do so. Average weekly hours worked rose in April while average hourly earnings jumped by 0.7 percent, with increases across all of the broad industry groups.

The increases in weekly hours and hourly earnings in the leisure and hospitality services industry group were particularly notable. Keep in mind that this is the industry group that stands to benefit the most from increased mobility and further reopening of the economy, and while payrolls in leisure and hospitality services rose by 331,000 jobs in April, this was a much smaller increase than had been anticipated. As such, firms resorted to adding hours – the average workweek in leisure and hospitality services has risen by almost 1.5 hours since February and is easily above pre-pandemic norms – and by increasing wages in an attempt to lure more workers. Average hourly earnings of non-supervisory workers in leisure and hospitality services rose by 2.7 percent in April, easily the largest monthly increase on record.

Supply chain/logistics issues also weighed on hiring in April. Payrolls amongst motor vehicle producers fell by 27,000 jobs in April, as increasing numbers of plants are being idled or run at less than full capacity due to the global shortage of semiconductor chips, and production in other industry groups such as computer and electronics equipment is also being impacted. Moreover, aggregate hours worked in construction fell sharply, which could reflect growing constraints on supplies, such as lumber, that are causing builders to scale back production despite robust demand.

Many are pointing to the surprisingly weak April employment report as a sign that yet more fiscal policy support is needed and that it is too soon for the FOMC to even consider beginning to unwind the considerable degree of monetary accommodation now being provided. We had a different take on the April employment report, instead seeing it as further evidence that labor shortages and supply chain/logistics bottlenecks are beginning to weigh on growth and further stoke inflation pressures. To be sure, one always wants to be careful about drawing sweeping conclusions from a single report. But, when there are consistent signs across an increasing number of data series, arguing that a still-fragile economy warrants further demand-side support becomes increasingly untenable. Demand is clearly not a problem at present, particularly with over $2 trillion in excess saving in the household sector. Instead, the ability to meet demand is a growing issue, in terms of supplies of labor and non-labor inputs. Whether these constraints will ease isn't so much the question as when they will ease. That likely won't happen quickly and, in the interim, there will be implications for both growth and inflation. ▲

Source: BEA; BLS; ISM

STOCKS

Growing Pains Ahead For SMid

Domestic equity indices ended April with sizable year-to-date gains, the S&P 500 higher by 11.8% on a total return basis, while the small-cap Russell 2000 index performed even better, rising 15% in just four months' time. While small caps have bested large and mega-cap stocks year-to-date and post-election, the S&P 500 staged a rally in both an absolute and relative sense over the past month, outperforming the Russell 2000 index by 3.5% during April and providing investors with a glimpse of what may be in the cards over the near-to-intermediate-term. The rally in the Russell 2000 over the past year has been nothing short of impressive with the small-cap index climbing nearly 75% over the trailing year ended April 30. The index also weathered the storm of rising interest rates well, jumping 11.5% from December 31 through February. However, small cap stocks struggled for gains in March and April, with the Russell 2000 rising just 3.5% during that two-month stretch, well short of the S&P 500's 10% gain over the same time frame.

We expect margin pressures from higher commodity prices and wages to impact smaller companies in an outsized way which, along with higher interest rates, could act as a headwind to this cohort of stocks over coming quarters. Since the end of February, investors have taken profits in small and mid-cap (SMid) stocks due to free cash flow concerns, while increasing exposure to mega-cap U.S. multinationals, specifically economically sensitive stocks leveraged to a global economic recovery. A weaker U.S. dollar as inflationary pressures build would benefit U.S.-based exporters on a relative basis as their products would become more competitive in foreign markets; there are more such companies in the S&P 500 than in the Russell 2000. While we remain more constructive on domestic large-cap stocks, as evidenced by our persistent overweight to the S&P 500, substantial tailwinds provided by the economic recovery in the U.S. should offset some of the headwinds from rising costs and margin pressures for small- and mid-cap U.S. stocks, thus, a 'neutral' allocation to SMid remains appropriate in our view.

Beginning in the back-half of March and extending into May, investors

have shifted allocations to position for rising inflation, bidding-up commodities and sending natural resource-related stocks to levels last seen in 2014/2015. Specifically, there has been a bull market in 'things that hurt when you kick them,' such as industrial metals and barrels of crude oil. Alongside the rise in commodities, economically sensitive sectors, specifically, financial services, consumer discretionary, and materials outperformed the S&P 500 during April. Interestingly, while most cyclical industries/sectors performed well throughout April, industrials caught our attention as the sector posted a positive absolute return but lagged the S&P 500 amid concerns surrounding the potential for rising input costs and logistics bottlenecks to persist into the second quarter, perhaps longer. The investment backdrop we anticipate, highlighted by, higher commodity prices, a gradual rise in inflation, and a weaker U.S. dollar driven by an improvement in the economic growth outlook abroad, should, all else being equal, favor domestic large cap stocks and developed markets abroad on a relative basis. While small and mid-cap U.S. companies and emerging markets could tag along for the ride, these are companies and economies that can ill-afford higher input costs as they are often 'price takers' not 'price makers.'

With the bulk of earnings season behind us catalysts for near-term equity upside become more difficult to identify. Investors will likely take their cue from upcoming economic releases, market technicals, and talk of a potential Fed taper, any of which could lead to a bout of volatility. We remain comfortable with our overweight to domestic large cap stocks as well as a neutral allocation relative to our strategic long-term targets to SMid and emerging markets due to a more mixed backdrop for these areas with headwinds and tailwinds netting out, in our view. With the Eurozone preparing to re-open, we have seen renewed interest in European equities. The iShares Euro Stoxx 50 ETF (FEZ) was up 11.4% year-to-date through April, lagging the S&P 500 by less than half of one percent. As has been the case for the past 20 years, developed international markets appear attractively valued relative to domestic large cap stocks, but foreign indices skew toward 'old economy,' economically sensitive sectors and may be poised to perform well on a relative basis as the global economic recovery takes root. Positioning could be another tailwind for international-developed market stocks as investors perennially underexposed to this sub-asset class may be 'forced' to begrudgingly increase exposure. We have funded our domestic large-cap overweight via an underweight to international-developed markets, but we continue to evaluate this position given perhaps the most constructive backdrop for European equities, specifically, that we've seen in decades. ▲

Source: Bloomberg, Factset

BONDS

Inflation, Taper Talk Take Center Stage Into Summer

U.S. Treasury yields presented traders with ample opportunities to make money from either the long or short side throughout April, while offering up little in the way of opportunities for long-term investors to reposition and shorten the duration of their fixed income portfolio, should they so desire. The U.S. 10-year Treasury yield, after ending January, February, and March at a higher level than where it began each month, broke that trend in April, closing the month down 9 basis points at 1.65%. The closely watched 10-year yield has been stuck in a trading range between 1.55% and 1.74% since the start of March and traders, including short-term tactical traders, are likely to continue to key off of those levels until further notice, selling long bonds when the 10-year approaches 1.74% and buying them back around 1.55%. As March wrapped up, the 10-year yield appeared to be on a collision course with the 2% level, but auction results in mid-April were encouraging and indicated robust demand for long-term Treasuries from abroad, stopping the upward climb of long-term yields in its tracks.

While a period of range-bound, relative calm in the Treasury market is most welcome as it has given investors a chance to catch their breath after rates rose in unsettling fashion in January and February, we don't expect it to last much longer. Inflation is the topic du jour with prices of commodities as well as intermediate and finished goods rising along with labor costs over recent months. With inflationary pressures building, chatter has grown louder that perhaps the Federal Open Market Committee (FOMC) could pivot to a less accommodative stance, potentially announcing a reduction, i.e. taper of its $120 billion per month in bond purchases sooner than market participants had previously thought.

The market received mixed messages from FOMC Chair Jerome Powell and Treasury Secretary Janet Yellen as May began. Chair Powell and other FOMC members have, for the most part, been speaking from the same script and have tried to alleviate investor concerns that a taper would be required over the near-term to combat inflation. Secretary Yellen, however, made comments that appeared to be somewhat at odds with the FOMC's 'steady as she goes' stance regarding bond purchases, although she did attempt to walk back her comments in short order, which led to a sigh of relief and some buying in long dated Treasuries. A tapering 'test drive' for markets could come at the Kansas City Federal Reserve's annual Jackson Hole symposium in August, an event that has historically been a popular venue for such announcements. Fixed income investors and traders aren't likely to wait for Jackson Hole to reallocate and position for such an announcement, and the 10-year Treasury yield almost doubling from 1.63% to 3.00% in four months' time during the Taper Tantrum of 2013 will likely be top-of-mind. As Mr. Market often reminds us, however, history may rhyme, but it rarely repeats.

While talk of a taper and inflation could dominate conversations surrounding fixed income allocations into the summer months, our recommended positioning to combat what we see materializing is unchanged. We continue to believe that the path of least resistance for long-term Treasury yields is higher through year-end but making a sizable duration bet is fraught with potential missteps and unforeseen consequences for investors. While we continue to recommend a duration profile below that of our benchmark to reduce interest rate sensitivity, we don't want to be too short as the reduced yield or carry is difficult to replace without taking on significant credit risk. Shorter duration corporate bonds, both investment grade and high yield, are a relatively appealing place to be as taper talk grows louder, inflationary pressures build, and the global economy recovers. We remain underweight Treasuries, but should rates rise sharply due to some combination of taper, faster economic growth, and/or rising inflation, we would expect our portfolio duration to extend to take advantage of higher yields available farther out on the curve, but a more defensive posture remains warranted at present in our view. ▲

Source: Bloomberg, Factset

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