INVESTMENT STRATEGY OUTLOOK

ASSET MANAGEMENT

THE ECONOMY

September 2021

Pace of Growth Slows Sharply In August

Ongoing supply chain and logistics bottlenecks and the surge in COVID cases stemming from the Delta variant of the virus acted as stiff headwinds for the U.S. economy in August. The few August data releases that have hit the wires suggest the pace of activity faded sharply during the month, as did consumer confidence. Many forecasters, us included, have scaled down expectations for real GDP growth over the back half of 2021, and the outlook for 2022 remains clouded by uncertainty over how long supply chain and logistics bottlenecks will linger and whether, or to what extent, COVID will remain a source of intermittent disruptions in economic activity. Those who had been waiting for the economy to settle into a post-pandemic new normal will have to keep waiting, unless of course what we're seeing now is that new normal.

Unit motor vehicle sales fell to an annualized rate of 13.057 million units in August which, outside of the early months of the pandemic, is the lowest monthly sales rate in a decade. In keeping with what has become the overriding theme of the economy, the steep decline in motor vehicle sales is more a supply side story than a demand side story. With production still hamstrung by chip shortages and inventories of finished vehicles having been significantly pared down – Wards Intelligence reports that by the end of August inventories were equivalent to less than one month of sales – consumers simply have fewer options, and prices for new vehicles are rising rapidly. The report on motor vehicle sales sets a weak tone for August consumer spending, and a steep decline in spending on consumer durable goods will contribute to a meaningful deceleration in growth in real consumer spending for Q3 as a whole. To that point, our September baseline forecast anticipates real consumer spending will grow at an annualized rate of less than 1.0 percent in Q3 after annualized growth of 11.9 percent in Q2.

While the Institute for Supply Management's (ISM) surveys of the manufacturing and non-manufacturing sectors point to continued expansion, they also suggest the pace of expansion has slowed. Input shortages, shipping delays, and labor supply constraints continue to bite into growth while input prices continue to push higher. Comments from survey respondents reveal not only ongoing frustrations with these supply chain and logistics bottlenecks but also growing uncertainty as to how much longer they will endure. If there is a silver lining here, it is that growing backlogs of unfilled orders will eventually have to be worked down and dwindling inventories of finished goods will eventually have to be built back up. When these imbalances will be rectified, however, remains highly uncertain. The ISM surveys also show that input price increases remain broad based; of the combined 36 industry groups in the ISM surveys, 34 reported paying higher prices for inputs in August. Moreover, input prices have been rising each month for more than a year now, so that even if prices do begin to rise at a slower rate, they are still rising, and each month's increase builds on those that have come before. That is, more broadly, a useful point to keep in mind as some continue to downplay inflation on the grounds that elevated rates of inflation of late are transitory.

Consumers are certainly not downplaying inflation, with higher prices combining with concerns over COVID putting a large dent in consumer confidence in August. The University of Michigan's gauge of consumer sentiment fell sharply in August, falling to its lowest level since December 2011 – even lower than during the initial wave of the pandemic – while the Conference Board's gauge of consumer confidence also logged a sharp decline. Both surveys show consumers' perceptions of conditions for making major purchases, such as motor vehicles, appliances, and home furnishings, have deteriorated sharply, thanks mainly to higher prices. While concerns over COVID seem the bigger driver of the decline in consumer confidence in August, that inflation is factoring into spending decisions should not be overlooked.

The August employment report is further evidence that the pace of economic activity slowed during the month. Total nonfarm employment rose by 235,000 jobs in August, far below expectations. It is worth noting that there is a long history of the initial estimate of August job growth significantly undershooting the final count. For instance, over the past five years, the initial estimate of August job growth has been revised up by an average of 75,000 jobs by the final estimate, and there is no reason to think this year will prove to be an outlier. That, however, is no more than meaningless noise. Of more relevance is that there are signs that rising COVID case counts had an adverse impact on August job growth. The not seasonally adjusted data show sizable declines in employment in retail trade and leisure and hospitality services, in line with various spending and mobility trackers that show consumers pulled back in August amid rising case counts. At the same time, with many firms pushing return to office dates further out – many had anticipated returning after Labor Day – hiring amongst providers of building services and amongst retail and restaurant establishments in close proximity to office clusters was likely also pushed back.

We think it also worth noting that prior estimates of job growth in June and July were revised up by a net 134,000 jobs, making this the second straight month in which the net upward revision for the prior two-month period was over 100,000 jobs. Given the dreaded "August effect" noted above, we'll go out on a limb here and say next month will make it three in a row. At the time of its release, we thought the July employment report was unambiguously strong, and revisions make it even stronger. We do not think the labor market deteriorated as much last month as the August employment report implies. Yet, since many will see the August employment report solely in the context of what it might mean for the FOMC as they deliberate tapering the Fed's monthly asset purchases, we'll say the August data reflect grudging further progress rather than the substantial further progress the FOMC is looking for, thus giving them the latitude to punt on a decision at their September meeting. ▲

Source: Bureau of Economic Analysis; Bureau of Labor Statistics; Institute for Supply Management; The Conference Board; University of Michigan Surveys of Consumers; Wards Intelligence

STOCKS

A September To Remember, Or Forget?

With the bulk of quarterly earnings season in the rearview mirror, one of the bigger blocks in the wall of worry for investors as August began appeared to be seasonality. Historically, the August through mid-October time frame has proven to be a challenging one for investors in domestic stocks. With the benefit of perfect hindsight, however, disciplined investors were well served to ignore the naysayers as August turned out to be a pleasant surprise, with the S&P 500 rising 3% during the month. The Russell 2000 small-cap index climbed 2.2% during August, but again trailed the S&P 500, a familiar monthly pattern since small-cap stocks peaked in mid-March. Despite some bouts of intra-month volatility caused by rising COVID-19 cases in the U.S., investors continued to view any pullback in stocks caused by fears of a U.S. economic slowdown as a buying opportunity. Seemingly weekly rotations between secular growth and cyclical value sectors buoyed headline indices in the process.

Abroad, both developed (MSCI EAFE) and developing (MSCI EM) markets churned out gains of around 1.5% but trailed domestic indices during August. Gains were common across international-developed markets with the MSCI Japan index and the Euro Stoxx 50 index each ending the month higher by 1.9%. In Europe, individual country indices tied to Germany, Italy, and Spain each rose over 1%, while the United Kingdom and France were notable laggards, despite posting positive returns. Within developing markets, volatility in Chinese equities persisted throughout the month as the regulatory regime there remained a moving target, creating trading opportunities for tactical or short-term traders, but the MSCI China ETF (MCHI) ultimately ended the month down just 0.6%. Brazil and South Korea were also notable laggards within the MSCI Emerging Markets index, while India, Mexico, and Taiwan were standouts on the positive side of the ledger.

We remain in a historically challenging seasonal stretch for domestic equities through the first half of October but, as we saw during August, history doesn't have to repeat, or even rhyme, and market action has a propensity to move in the direction that is most confounding to a majority of market participants. While August was a nice surprise, bucking the historical trend of flat/negative returns, September could be poised to live up to its historical billing as a less profitable month for equity investors. With a potential lack of positive corporate catalysts leading up to the Q3 earnings season in mid-October, uncertainty on the monetary policy front and the battle over the

debt ceiling in D.C. could challenge equity returns in September.

Atop our list of concerns entering September is that we're settling into what could be a lean period from a corporate news flow perspective, and with a news vacuum needing to be filled, space that was occupied by positive earnings-related news in August could be replaced by weakening/softer economic data and chatter surrounding policy shifts on a number of fronts in Washington D.C. Earnings beats and upward earnings revisions boosted demand for stocks during July and August, but with a dearth of corporate news on the horizon, equity investors may turn their attention back toward a formidable wall of worry, leading to heightened volatility and to potential profit-taking or risk-off positioning this month.

September is setting up to be a big month in our nation's capital for both the Federal Open Market Committee (FOMC) and Congress. In light of a weaker than expected August nonfarm payrolls report released earlier this month, we're now far less convicted in our belief that the FOMC will announce plans to taper bond purchases later this month. Evidenced by rising stock prices, equity investors appear quite comfortable with the well-telegraphed beginning of the tapering of bond purchases. However, investors will likely focus on Chair Jerome Powell's post-meeting press conference on September 22 for clues as to just how aggressive the FOMC might be given that a number of 'doves' appear to have joined 'hawks' on the Committee in favor of reducing purchases. Traders attempting to front-run the Fed is a tale as old as time, and after stocks rallied during August, a 'sell the rumor' pullback leading up to the FOMC's two-day meeting later this month could be in store. Also, of note, Congress remains at an impasse on raising the debt ceiling, another block in the wall of worry for equity investors. With little movement expected before October, or perhaps November, on this front, uncertainty tied to the debt ceiling could become an overhang, assuming investors finally notice that nothing has been done.

Our expectations for equity market performance in September are tempered for the reasons outlined above, but we don't believe the necessary preconditions (excessive investor optimism/lack of skepticism, offsides/aggressive positioning) are in place to generate a substantial decline during the month. Corporations are flush with cash and are itching to put it to work, evidenced by some sizable acquisitions announced at the start of September – large capital outlays that point toward building confidence on the part of C-suites operating in certain sectors or industries. While corporate confidence may be on the rise, investors have grown increasingly skittish – a positive development, in our view, and perhaps surprisingly, put/call ratios remained elevated as August ended, implying heightened demand for portfolio hedges despite the S&P 500 making a series of all-time highs. While uncertainty related to the economy or potential policy shifts in D.C. may be elevated, this is a market that has turned numerous bears into believers over the past 18 months, and we see few reasons to expect upward price momentum to reverse course in a meaningful way over the next 3-6 months. ▲

Source: Bloomberg, Factset

BONDS

Job Growth, Fed Remain In Focus

The first week of September brought the release of the closely watched August Employment report, which showed that 235,000 jobs were created during the month, well short of the consensus estimate of 725,000. While the headline reading was not at all encouraging, prior estimates of job growth in June and July were revised higher, and the unemployment rate fell to 5.2% - bright spots not to be overlooked. Most notably for fixed income investors, in our view, was the continuation of the trend of sharp month-over-month increases in average hourly earnings. After a nearly 0.4% increase in July, this metric rose 0.6% in August, topping the consensus estimate of a 0.4% uptick, leading to louder voices from those already calling for stagflation amid weakening U.S. economic growth. We believe this to be premature.

Weaker than expected job growth in August could shift the voting balance within the Federal Open Market Committee (FOMC), as 'doves' recently warming to tapering the Fed's monthly asset purchases could walk back that stance and push for a patient approach, relying on incoming data to settle the matter. The FOMC finds itself in an unenviable position. On one hand, if August payrolls had surprised to the upside or at least met the consensus estimate, the FOMC would likely believe it had the necessary cover to announce tapering at its September meeting and begin the process of reducing bond purchases in November or December. But now, with August payrolls falling short of expectations, the resolve of Committee 'doves' that have recently turned publicly 'hawkish' on tapering is set to be tested and the September meeting could turn into a "kick the can down the road" type of event.

While the August payrolls report wasn't as weak as headlines might imply, it remains to be seen how the FOMC will interpret the release and how, if at all, it might alter the Committee's discussions and tapering timeline. The $64,000 question(s) top-of-mind for investors in U.S. Treasuries remains when the FOMC will begin reducing bond purchases and, more importantly, at what pace. Opportunities for the Committee to telegraph its plans in a satisfactory manner and properly prepare markets for what is to come are few and far between this year if they balk at doing so at their September meeting. There is no FOMC meeting in October, and the Committee is unlikely to view mid-December as an optimal time to announce tapering plans given how sparsely trading desks will be staffed, which leaves just the November FOMC meeting. Given persistently 'hot' inflation data and some measure of progress on the labor front, we believe the FOMC should get on with it and announce its tapering timeline this month; however, the August job growth shortfall provides cover to be patient and we wouldn't be at all shocked if the FOMC finds a way to punt until the Committee's November meeting, which would still leave December as possible lift-off.

From a positioning perspective, we remain comfortable with an allocation to fixed income below our strategic long-term target. We continue to expect long-term Treasury yields to trend higher into year-end as the path forward for economic growth becomes clearer and inflationary pressures persist due to a combination of rising wages/jobs growth, and logistics bottlenecks. We continue to recommend a portfolio duration below that of our benchmark to limit interest rate sensitivity/drawdown and prefer short duration investment-grade corporate bonds relative to Treasuries. After a bout of volatility for high yield (HY) corporates in mid-August due to an economic 'growth scare,' the Bloomberg Barclays U.S. High Yield index was again trading at late July levels as September began. Investors appear to expect defaults to remain low for some time to come, providing them with cover to reach for yield and clip a higher coupon than can be sourced from investment-grade credit with the expectation that they can 'buy high and sell higher' down the road, if necessary. High yield defaults should remain near current low levels for quarters to come, but we remain neutral on the asset class relative to our long-term target allocation. Emerging market debt is appealing as a diversification tool and could benefit from rising inflation and a weaker U.S. dollar as well, but exposure must be appropriately sized. ▲

Source: Bloomberg, Factset,

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