INVESTMENT STRATEGY OUTLOOK

THE ECONOMY

June 2021

Supply Side Issues Weigh On Growth, Feed Price Pressures

An increasingly common theme of the recent economic data is the growing imbalance between the supply side of the economy and the demand side. Thanks to an unprecedented degree of fiscal and monetary policy support, greater numbers of people being vaccinated against the COVID-19 virus, and the lifting of remaining restrictions on economic activity, the demand side of the economy is notably robust. The supply side of the economy, not so much. Shortages of labor and non-labor inputs and shipping bottlenecks are driving up costs to producers and acting as a drag on output growth. In short, the issue at present is not the lack of demand, it is the inability of goods producers and services providers to keep pace with demand. Perhaps the best summary of the opportunities and challenges facing many firms across a wide range of industry groups comes from a respondent to the Institute for Supply Management's (ISM) May survey of the manufacturing sector: "demand is strong, but what good is that if you cannot get the materials to produce your finished goods?"

While perhaps the most telling comment, other respondents to the ISM's surveys of the manufacturing and non-manufacturing sectors expressed similar sentiments. Order books amongst producers of goods and services providers are expanding faster than firms can fill them, as shortages of materials, shipping delays, and labor supply constraints are acting as increasing drags on production. The ISM's May survey of the manufacturing sector showed the index of supplier delivery times rose to its highest level since April 1974, and suppliers themselves are increasingly constrained by lack of capacity and labor supply issues. The ISM's surveys show non-labor input price pressures continue to intensify; of the combined 36 industry groups represented in the ISM's surveys of the manufacturing and non-manufacturing sectors, 35 reported paying higher prices for inputs in May after all 36 reported paying higher prices in both March and April.

The story in the labor market is also one of supply side issues feeding price, or, in this case, wage pressures. Granted, that may seem at odds with the May employment report, which showed total nonfarm employment rose by 559,000 jobs in May. To be sure, it says a lot about the world as it now is that nonfarm payrolls rising by 559,000 jobs in one month is seen as a disappointment when in more normal times job growth of that magnitude would not even have been imaginable. Be that as it may, this is now the second month in a row that we are left to try and explain a much smaller than expected increase in nonfarm payrolls (April's gain was 278,000 jobs, far less than expectations of around one million jobs). It is worth noting that, in cases such as motor vehicle production, input shortages are curbing production to the point that firms have put workers on furlough until supply chains are functioning more smoothly, which is weighing on nonfarm payrolls.

Still, it wasn't unreasonable to expect that further reopening of the economy, increasing numbers of people being vaccinated, and strong growth in consumer and business demand would prompt much larger job gains in April and May than we actually saw, particularly given that the Bureau of Labor Statistics shows roughly eight million open jobs. Against that backdrop, the decline in labor force participation in May is even more striking, and with that decline that there are now more than 3.5 million fewer people in the labor force than there were prior to the pandemic. There are several factors weighing on labor supply at present. Inclusive of the supplemental benefits being paid by the federal government, the level of unemployment insurance benefits is for many recipients who had previously worked in lower-wage industry groups equal to or greater than their labor earnings, making not working a rational choice. While the supplemental benefit payments are slated to expire in September, a number of states – 25 so far – have announced they are withdrawing from the program, with supplemental benefits in these states ending over June and July.

Coming months will help assess the role these supplemental benefits are playing in labor supply constraints, but they are hardly the only factor. For instance, labor force participation amongst females has fallen significantly over the course of the pandemic, as females have shouldered a larger share of the burdens of day care and at-home schooling. To the extent this is a factor, this constraint should ease considerably in the fall with the start of the new school year and what presumably will be a higher level of day care services than is now available. It could also be that those whose previous jobs are no longer there due to their former employer having gone out of business either do not have the skills required to land a new job or are held back by mobility constraints (i.e., being either unable or unwilling to move), such that landing a job is more difficult. Finally, there are those who out of concern for their health simply do not yet feel comfortable returning to a physical work environment. Regardless of the causes, labor supply constraints are holding down job growth while fueling upward pressure on wages of workers across all skill levels and industry groups. When coupled with demand for labor running hot, labor supply constraints are pushing up wages at a rate that would otherwise seem at odds with the remaining degree of labor market slack.

Rapidly rising input costs, labor costs, and shipping costs are feeding inflation pressures in the broader economy, as is apparent in the most recent readings on the Consumer Price Index. While these topics will surely be discussed at this month's FOMC meeting, Committee members continue to message that they see supply chain/logistics bottlenecks and labor supply shortages and, in turn, growing inflation pressures, as transitory. As such, they are not yet prepared to begin mapping out a plan for tapering the Fed's monthly asset purchases and are nowhere near being prepared to begin increasing the Fed funds rate. So far, market-based measures of inflation expectations seem largely aligned with the FOMC's view, but survey-based measures show consumers expecting significantly faster inflation. At some point, something has to give, but when that will be and what that will be remain to be seen. ▲

Source: BLS; ISM

STOCKS

Economic Clouds Parting Across The Pond

In recent months, we have highlighted our belief that the outlook for developed markets abroad was improving, particularly in Europe, and this more positive stance spurred us to increase exposure to foreign developed stocks as May wrapped up and June began. Every investment decision brings potential opportunity costs, but after three years we no longer believe that the scales are tipped in our favor by remaining 'underweight' foreign developed market stocks. Our 'underweight' to international developed markets funded our 'overweight' to domestic large cap stocks (S&P 500), but after the S&P 500 outperformed the MSCI EAFE index by nearly 10% annualized over the past three years, we view this as an opportune time to level set and move back to strategic 'neutral' across equity sub-classes. We had been 'underweight' developed market stocks abroad relative to our long-term strategic target since June of 2018 and shifted to an even more sizable underweight position in February of 2019. Our 'underweight' to developed market stocks abroad had been rooted in our belief that the Eurozone faced headwinds on a number of fronts, many of which have since subsided or turned into tailwinds of late, leaving us with a more constructive outlook on international developed market stocks broadly.

Europe was already in the throes of economic malaise leading up to the Brexit vote in 2016, driven by an aging population, a lack of fiscal support, and excessively tight regulation. Uncertainty tied to contentious Brexit negotiations ongoing since 2016's referendum, and the likelihood that trade relations with the United States, a primary export market, would be tested as President Trump levied tariffs on a broad swath of European goods made an already bad situation even worse. Brexit talks up to that point appeared to leave the door open for countries other than the United Kingdom to attempt to break free from the European Union (EU), calling into question the bloc's future. Investors hate uncertainty, and Brexit generated plenty for a half-decade, allowing allocators to remain perpetually under exposed to European stocks with little fear of potentially

missing out on substantial equity upside. On the heels of last November's Presidential election, the prospect of the Biden Administration removing or reducing tariffs on goods imported from Europe generated buying interest in developed markets abroad, and capital inflows have continued as Brexit was finally completed with little fanfare in January as the United Kingdom and European Union came to terms on the separation, removing yet another overhang.

After a decade of accommodative monetary policy in the aftermath of the Global Financial Crisis generated few tangible or durable positive results on the continent, more creative stimulus measures were essential to move the economic needle as low interest rates and bond purchases alone failed to spur growth and/or inflation. We were far from optimistic that fiscal spending would materialize given Germany's well-earned reputation for saving and loathing debt. Without Germany's backing, any fiscal stimulus package was certain to fail. The onset of the COVID-19 pandemic required lockdowns and quarantines across the Eurozone, providing Germany with the necessary cover to break from nearly a century of fiscal austerity and loosen the purse strings, allowing the EU to potentially spend its way to the 'other side' of the pandemic. This was a watershed event and indicative of how dire the situation on the continent had become. The 'other side' is where the Eurozone and the U.S. now find themselves as they relax travel restrictions and social distancing standards, just in time for tourists to travel and spend during the crucial summer months.

Domestically, large-cap multinationals are positioned to benefit from a weaker U.S. dollar as 20% of revenues for U.S. companies were generated overseas in 2020, despite headwinds on the trade front and lockdowns or quarantines persisting across Europe, and that number could rise over the back-half of 2021 as tariffs are reduced and demand from abroad recovers. Domestic SMid could face headwinds from rising wages and higher commodity prices but leverage to a U.S. economic recovery would benefit small caps should economic growth surprise to the upside and inflationary pressures subside. International developed market stocks carry relatively attractive valuations and reasonable earnings growth expectations, while investors and allocators, broadly speaking, remain under exposed to this cohort of stocks, setting up a potentially low risk scenario as optimism builds surrounding the global economic recovery. Emerging markets would benefit from a weaker U.S. dollar making commodities more affordable; however, a lack of widespread vaccine availability throughout the developing world is cause for pause. Commodity producing developing economies such as Brazil and Russia have seen their equity markets perform well year-to-date, but tech-reliant countries in Asia are the straw that stirs the drink within the MSCI Emerging Markets index. With China, South Korea, and Taiwan 65% of the MSCI EM index, higher interest rates could pressure earnings multiples and weigh on emerging market returns. ▲

Source: Bloomberg, Factset

BONDS

A High Stakes Summer Ahead For The FOMC

In the first week of June, the Federal Reserve announced its intention to wind down the Secondary Market Corporate Credit Facility (SMCCF), a program set up in March of 2020 as an emergency lending vehicle, by the end of 2021. At the end of April, the SMCCF held $13.7B in individual corporate bonds and exchange traded funds (ETFs) holding corporate credit. Based upon its size alone, the sale of securities held won't be market moving; however, the message this move sends, that the Fed will no longer be there as buyer of last resort for these bonds, could still spur some repositioning within corporate bonds into year-end. History will likely view the winding down of the SMCCF as being just the first in a series of crucial steps required for the Fed/Treasury to extricate itself from crisis-era accommodative policies.

After the SMCCF announcement, our best guess remains that the Fed will announce a high-level framework and/or timeline for how it plans to taper bond purchases to the masses at the St. Louis Fed's annual Jackson Hole meeting in August. However, chatter is making the rounds that FOMC Chair Jerome Powell will initiate discussions surrounding tapering purchases at the Committee's regularly scheduled two-day meeting June 15-16. The stakes will be high as a tapering plan is communicated to market participants and we expect volatility in rates and choppy trading in credit as the meeting approaches.

Calls for the Federal Open Market Committee (FOMC) to taper it's current $120B per month in bond purchases have grown louder over recent months as the U.S. economy appears to be on a more sustainable path toward robust economic growth while measures of inflation have been running 'hot.' The FOMC is currently slated to buy some $80B of Treasuries per month and $40B of mortgage-backed securities (MBS), while also reinvesting proceeds from maturing holdings. Those in the FOMC in favor of tapering sooner rather than later argue that, at a minimum, the FOMC should end purchases of MBS as housing demand has significantly outpaced supply over the past year in many markets and affordability has quickly become a much bigger concern for those on 'bubble watch' for froth in asset prices.

Prices for new construction and existing homes, as well as home furnishings, lumber, copper, and wages for tradesmen have gone parabolic over the past year. But rising prices, as well as a shortage of land available upon which to construct new single-family structures, have started to weigh on housing demand as mortgage applications for purchase fell in both April and May. Even amid recent housing market strength, the Fed has struggled to source the $40B per month in mortgage-backed securities it has committed to buy, falling short of that mark in recent months, which strongly suggest that it would be appropriate for the FOMC to begin tapering. In short, tapering purchases of MBS appears to be the lowest-hanging fruit and is a way to ease into the process without upsetting the applecart too much.

The opportunity set within fixed income holds little appeal to us and we enter June tactically 'underweight' bonds relative to our strategic target. We expect bond returns to fall short of our long-term capital market expectations over the next 12-24 months, while volatility could surprise to the upside. Bonds still have a place in a diversified portfolio, but on a real, or after inflation basis we expect a challenging backdrop over the coming years. We maintain a preference for domestic investment-grade bonds, specifically shorter duration corporate issues relative to U.S. Treasuries and international sovereign bonds, and continue to recommend a portfolio duration slightly below that of the Bloomberg Barclays Aggregate in an effort to reduce interest rate sensitivity and/or drawdown should long-term Treasury yields rise as we expect. Some exposure to long dated Treasuries could be beneficial should volatility across asset classes rise. Diversification remains a fixed income investor's best friend. ▲

Source: Bloomberg, Factset

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