Overview

The Covid-19 (COVID) induced supply and demand imbalance intensified during the quarter pushing inflation and economic growth estimates to levels not seen in decades. With state economies reopening, demand climbed sharply and projections peg second-quarter 2021 economic growth at 9-10% and full-year 2021 growth at 7-8%. Due to the widespread labor shortages and supply bottlenecks, companies across the nation struggled to fill open positions and keep pace with demand. Prices at the consumer and producer levels rose sharply over the past year prompting the Federal Reserve to upwardly revise 2021 inflation projections from 2.4% to 3.4%.

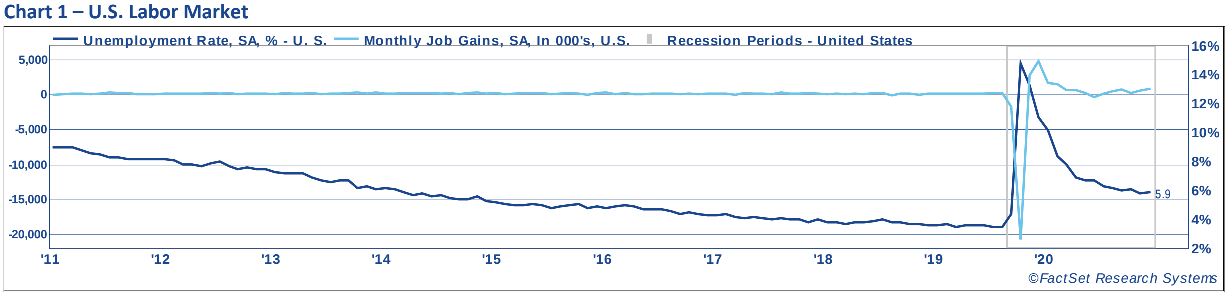
Early in the quarter, stock and bond markets reacted rather negatively to the higher inflation rates but subsequently took them in stride advancing as the quarter progressed, judging credible the Federal Reserve's contention that inflation will indeed be transitory. The COVID era has so far been a very wild ride. Going forward, the ride should be tamer as COVID vaccinations and familiarity help to lower levels of economic uncertainty but the ride is still going to be bumpy with some unexpected turns.

Labor Market

Since the onset of COVID, the skill of making reasonably consistent accurate forecasts and estimates has often proven rather difficult and the labor market is a perfect example of such difficulty. This is due to the lack of any comparable precedent and the extreme complexity and intricacies of how people and businesses have responded to COVID and related restrictions and policies.

April and May saw actual monthly job gains come in much lower than forecasted while June came in higher than expected. Factors attributable to the higher expectations were sharply rising vaccination levels, declining COVID infection rates, significantly lower weekly initial jobless claims trends, strong economic growth as state and local economies rolled-back most restrictions, and just the sheer number of jobs available to fill.

Chart 1 – U.S. Labor Market



According to the Bureau of Labor Statistics Job Openings and Labor Turnover (JOLT) report, job openings in April reached a record level of 9.3 million. This record job openings level is slightly below the 9.8 million people who are reported as unemployed. The JOLT report cited large job opening increases throughout the U.S. in a variety of industries including construction, manufacturing, retail, transportation, professional services, financial services, health care, and leisure and hospitality.

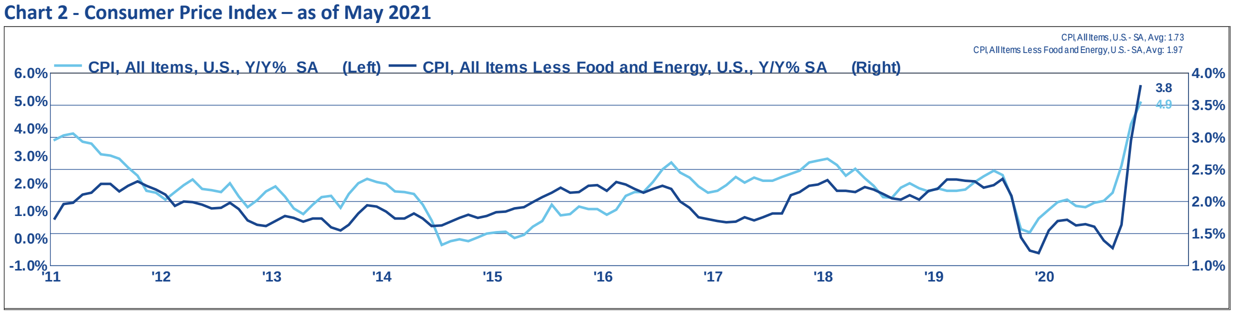
With so many businesses and industries desperate to find workers to fill open positions, why have the pace of job gains been so weak? Many argue Federal pandemic assistance payments incentivize workers to stay home. Others point to closed schools or daycare centers forcing parents to stay home. Just plain fear of contracting COVID could be another deterrent. Some argue the supply chain bottlenecks are stalling production and idling workers. Many jobs may not be coming back at all as some businesses are turning to technological innovations to replace workers. Another factor could be that industries that benefitted substantially from COVID could be shedding jobs.

The Federal Reserve expects the labor market to strengthen over the next year which should expand production, reduce the supply bottlenecks, and lower inflation rates to their long-term target rate of 2%. Given weekly initial jobless claims have fallen so dramatically over the past few months and that monthly job gains have been muted, it makes sense for the labor market to strengthen over the coming months. Much of these anticipated gains will depend on whether the Federal pandemic assistance payments expire in September and COVID infection rates remain low. What is not so clear is if inflation rates will be transitory and indeed trend to the 2% target or remain elevated.

Inflation

According to the U.S. Department of Labor's Consumer Price Index (CPI) report, core inflation in April rose 0.9%, which was the highest monthly reading since April 1982. Moreover, the National Federation of Independent Business (NFIB) May Small Business Optimism Survey indicated that 40% of small businesses are raising prices, which is the highest reading since 1981. Over the past couple of quarters, business and consumer surveys have acknowledged rising price pressure and their near-term expectations are for these pressures to persist.

Chart 2 - Consumer Price Index – as of May 2021



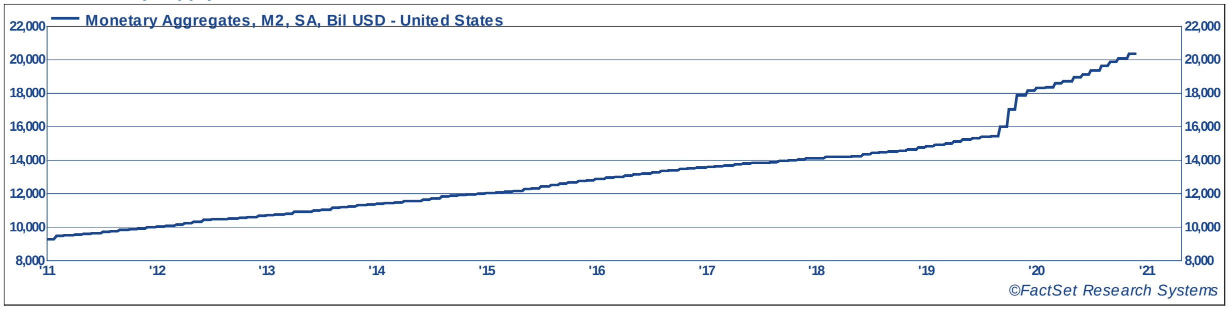
The Federal Reserve acknowledges inflation will be rising near term as they recently significantly raised their 2021 inflation projection to 3.4% from 2.4%, a 42% increase. However, they contend the rise in inflation rates will be short lived as the majority of the increase is concentrated in a few industries and once supply chain bottlenecks are resolved, inflation pressures will recede. One sign transitory inflation is already taking shape are lumber prices, which have fallen some 35% from their recent peak. Many economists agree with the Federal Reserve's transitory inflation forecast.

Yet, there are many economists in the prolonged inflation camp. They agree with the Federal Reserve that the supply chain bottlenecks should subside along with the higher near-term inflation (5%-7% y/y) caused by the supply and demand imbalance. However, these prolonged inflation campers contend the trillions of dollars being funneled into the economy will lead to lingering inflation rates of 3-4% for the next couple of years. Their concern is the inflation train has already left the station.

Their contention is that the enormous growth in the money supply since March 2020 (+32.1%) will lead to demand outpacing supply or more dollars chasing fewer goods. Retail sales figures provide a good indication of this "chase" as even with millions of people still unemployed, the nominal level of retail sales in May 2021 of $620.2 billion is 17.7% higher than the January 2020 nominal level of $526.9 billion.

Fiscal policy provided the support to sustain consumption demand during the pandemic. Moreover, savings rates soared during the pandemic due to limited services so there is the potential for a large amount of additional spending, the timing of which is uncertain.

Chart 3 – Money Supply



The verdict on the rate of inflation will play out over the next few quarters, but the fact is inflation has moved higher. As a result of higher inflation and projected strong economic growth, the Federal Reserve shot the proverbial arrow across the bow at their recent FOMC meeting and the capital market reaction was one of indifference.

Capital Markets

Early last quarter, stock markets reacted rather negatively to the higher inflation rates but subsequently took them in stride advancing as the quarter progressed, judging credible the Federal Reserve's contention that inflation will indeed be transitory and the fact that underlying economic fundamentals are solid with a red-hot housing market, strong manufacturing and service activity, monthly job and retail sales gains, stable business and consumer confidence, and very strong corporate earnings.

Table 1 – Stock Index Total Returns as of 6/30/2021

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
S&P 400	-1.02	3.64	17.59	53.24	13.17	14.29	12.40
Russell 2000	1.94	4.29	17.54	62.03	13.52	16.47	12.34
S&P 500	2.33	8.55	15.25	40.79	18.67	17.65	14.84
Dow Jones Industrial	0.02	5.08	13.79	36.34	15.02	16.66	13.50
NASDAQ	5.55	9.68	12.92	45.23	25.72	25.80	19.32
MSCI Developed	-1.13	5.17	8.83	32.35	8.27	10.28	5.89
MSCI Emerging	0.17	5.05	7.45	40.90	11.27	13.03	4.28

Due to higher inflation rates and much stronger economic growth, the shift in tone from the June Federal Reserve FOMC meeting moved undeniably hawkish as the Summary of Economic Projection's "dot plot" showed more policymakers in favor of raising short-term rates once in 2022 and twice in 2023, and they began initial debate on the tapering of bond purchases, although the likelihood of any actual tapering won't happen until early-to-mid 2022.

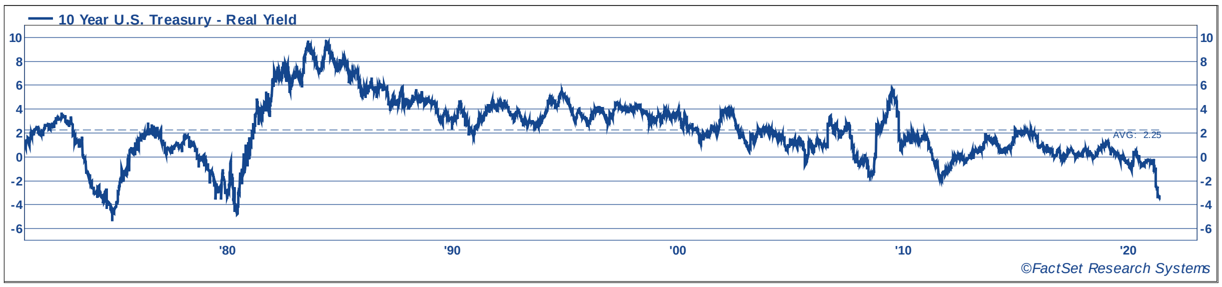
Bond vigilantes are stumped by the reaction of the bond market to higher inflation rates and stronger economic growth. Instead of bond yields rising on the news, they actually fell and the yield curve flattened. Last quarter, the yield on the 10-year treasury bond fell from 1.74% to 1.45%, which drove bond returns higher.

Table 2 – Bond Index Total Returns as of 6/30/2021

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Barclays High Yield	1.34	2.74	3.62	15.37	7.45	7.48	6.66
Barclays Municipal	0.27	1.42	1.06	4.17	5.10	3.25	4.28
Barclays Inter Gov't/Credit	0.20	0.98	-0.90	0.19	4.70	2.63	2.76
Barclays Aggregate	0.70	1.83	-1.60	-0.33	5.34	3.03	3.39

Real interest rates, which are nominal interest rates less the rate of inflation, have turned decidedly negative. The real yield on the 10-year treasury stands -3.34%. Historically, real interest rates average +2.3% above the rate of inflation.

Chart 4 – U.S. Real Interest Rates



With yields moving lower in the face of higher inflation, is this an indication of pending economic weakness for historically the bond market has been a harbinger of economic trends? A recession is not likely but some growth has been front loaded along with some financial pain being back loaded and these factors could crimp the pace of economic expansion.

With an economy that is forecasted to grow 7-8% in 2021, rising inflation, strong money supply growth, the Fed on the verge of beginning to taper bond purchases, and explosive growth in debt levels, how long can historic and artificially low interest rates remain? Not for much longer. The Fed continues to back themselves into a shrinking corner space with the accommodative policies of bond purchases and a near zero target rate. Ultimately, the only way out is for some market pain. Their dual mandate is price stability and maximum employment. They are being patient and “waiting” for employment levels to approach pre-pandemic levels. Fun fact, it is evident millions of jobs are available, perhaps people just need to go back to work.

The COVID era has so far been a very wild ride. Going forward, the ride should be tamer as COVID vaccinations and familiarity help to lower levels of economic uncertainty but the ride is still going to be quite bumpy with some unforeseen turns.

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Sources: FactSet, U.S. Department of Labor, Bureau of Labor Statistics, Federal Reserve, National Federation of Independent Business, and U.S Census Bureau