Outlook Memorandum

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Stocks and bonds posted strong gains in the second quarter, benefiting from an economic acceleration fast enough to deliver on the widely anticipated surge in corporate profits…but moderate enough to assuage concern that reopening amid unprecedented fiscal and monetary stimulus would cause inflation to spiral higher. Technology stocks and interest rate sensitive assets performed well, while enthusiasm for cyclical and reopening stocks waned as the economy fell short of maintaining March's frantic pace of hiring. The S&P 500 gained 8.6%, bringing its first half performance to about 15.2%. The bond market gained broadly, with the Barclay's Agg increasing 2% as the yield on the benchmark 10-year Treasury bond declined from a high of 1.74% at the end of March to 1.47% at June's end. Europe and other developed markets gained almost 5%-7% during the quarter, while emerging markets rose a more modest 4%. While commodity shortages are persisting, bottlenecks are easing. Lumber prices, for example, are 60% off their recent peak while metals prices have been stable more recently.

Policymakers are pushing hard to overcome the income, wealth, and job inequities exacerbated by the pandemic. These efforts are promoting the economic recovery, but also aim at broadening participation in long-term growth and prosperity. While the economy's reopening and cyclical acceleration is firmly underway, uneven monthly data and the delta variant may stoke uncertainty. Still, job growth and wage gains amidst strong demand assures the recovery is not in danger of stalling out any time soon. Monetary policy remains accommodative and liquidity abundant, while tepid loan demand provides the Fed cushion to stay the course and reduces the risk of a premature tightening. Importantly, the drivers of recently higher inflation are more likely temporary (substantially tied to used vehicle prices, rent, and travel & leisure).

Whereas policy generally prioritized business profitability as the primary mechanism for promoting employment and prosperity in years past, new approaches are beginning to take hold. Highlighting this point is the transformation of the child tax credit into a payment, which significantly expands the number of lower income households receiving this important benefit. To the extent child tax payments become permanent and future bills also favor lower income households, federal spending may enjoy a higher economic multiplier than in years past and provide an attractive reason for new business investment (revenue/profit opportunities rather than just a lower cost of financing). However, overcoming the resistance presented by an aging population (and a workforce that is now barely growing), high debt levels, and structural imbalances that sustain our trade deficit will take time and be no easy feat.

The implication for investors is the concern over recent inflation readings should ease as the reopening progresses – a view that is taking hold in the bond market as yields pull back from recent highs. At the same time, the pace of economic growth is awakening animal spirits that should promote a reinforcing cycle of renewed loan growth and business investment, especially given persistent fiscal stimulus and highly accommodative monetary policy. The delta variant provides a cautionary note, but infections are more concentrated among the younger and unvaccinated. While valuations largely reflect a positive view, the bias remains higher in markets and we continue to see opportunity among cyclical names, particularly those with sustained pricing power that stand to benefit from the longer-term emergence of persistent hourly wage growth. In terms of bonds, we remain focused on shorter, higher quality maturities.

Policymakers are walking a tight rope. On the one hand, the unprecedented quantity of stimulus risks overheating the economy; on the other hand, the inevitable step-down in ongoing stimulus, combined with very high debt levels and aging demographic trends, risks exacerbating the low-growth and disinflationary environment that plagued the economy leading up to the pandemic. A key investor concern is the tail risk of a replay of the 1970s, in which rising price levels became self-reinforcing and simultaneously constrained business profits, pressured employment, and lowered the present value of future earnings as interest rates rose.

Reopening dynamics have investors straddling the line. Rising vaccinations, falling infections, and additional fiscal stimulus propelled the economy to a 6% growth rate in the first quarter – a pace that is estimated to have accelerated to 9% in the second quarter (its fastest quarterly expansion since the early 1980s). While policymakers have succeeded in energizing consumer spending, businesses have struggled to keep pace. Hiring under normal circumstances is a time-consuming process, but in the context of sizable segments of the population not yet ready to return to work (reflecting a variety of pandemic related reasons) businesses have struggled to fill open positions. The result is a demand/supply mismatch, which has manifested in higher price levels – particularly in areas more acutely affected by challenges enticing people back to work (such as travel and leisure).

June prices rose at a scorching 5.4% annualized clip (and higher than expected). A jump in prices for used cars and trucks accounted for a third of the recent inflation jump, a dynamic that also occurred in April and May (and early 2020). Used vehicle prices are not typically a source of inflation as manufacturing/new auto prices typically dictate resale values. Travel and leisure also contributed to the hot reading due to the unleashing of pent-up demand amidst the logistical challenges of resuming operations.

While hourly wages are rising at a faster pace as the economy reopens (including many positions receiving hiring bonuses), the foundation for lasting inflation is more complex. To this point, recent data suggests the stimulus infused demand surge may already be dissipating. Used vehicle prices inched back in the latest reading (and semiconductor shortages that constrained auto manufacturing is easing), while the cadence of monthly retail sales growth looks more normal in May and June after spiking higher in March and April.

Supply bottlenecks, particularly for services, should continue easing in the coming months as people return to work in greater numbers, reflecting the attraction of higher wages and coinciding with the winding-down of pandemic benefits and a return to in-person school. Further, delta variant infections should work to moderate the impacts of pent-up demand and stimulus-charged spending.

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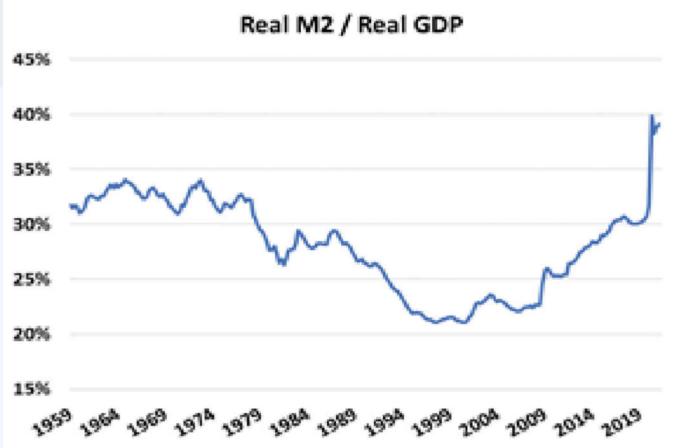
Lasting changes in inflation drivers may emerge more slowly. A lesson from the 1970s is that the roots of inflation stretched back to policy maneuvers in the early 1960s when the Fed and Congress coordinated to implement mutually expansive policies – not unlike what is occurring today. There are important differences, however – as the 1970s began, policymakers were raising taxes and discouraging business investment, which exacerbated inflation trends, while demographic trends, a less globalized economy, lower debt levels, and resource constraints were contributing factors. But despite four decades of study the underlying forces that give rise to persistent inflation remain poorly understood, creating uncertainty with respect to the implications of recent wage gains, changes in fiscal policy, aging populations, and addressing imbalances (trade, deficits, debt).

Policy is highly accommodative, supporting a potent cyclical acceleration for the economy. The Fed has expanded its balance sheet by $4 trillion compared to pre-pandemic levels, in the process helping to underwrite expansive fiscal policy (such as stimulus checks and PPP loans) and directly injecting substantial cash into the economy. A lot of that cash has been redeployed into other investments and spending, but a large portion can still be committed to productive use. Real M-2 money supply is up $1.7 trillion since the end of 2019, and the Fed's $120 billion of monthly Treasury and mortgage

purchases represent a push on real money supply growth that exceeds the economy's sustainable real growth rate. Simply put, liquidity is being pressured higher. (Note that in the past we focused on real M-1, which is a narrower definition of cash in the financial system that can be readily mobilized for spending and investment. The Fed recently updated its definition of M-1 to include savings deposits, which makes the current comparison to historical M-1 lumpy and more analogous to the historical M-2 definition.)

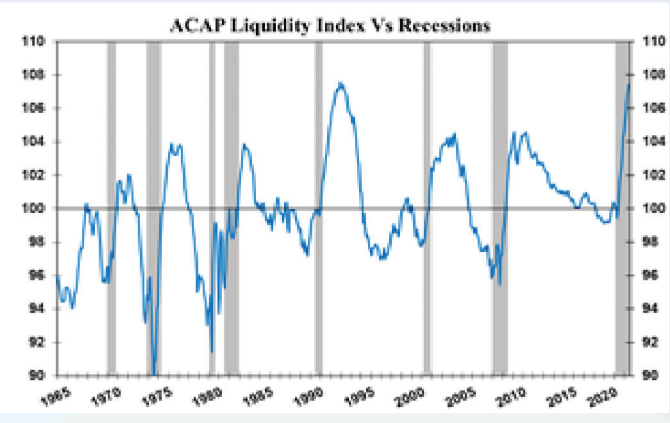


The Fed's actions have produced exceptionally low interest rates across credit markets, with tight spreads providing support for real estate values and corporate bond issuance. Low/unattractive yields and the abundance of liquidity have also forced people to allocate more toward stocks and other assets. Still, the ratio of real M-2 to real GDP (see chart above) is at its highest levels since the 1960s, and the pending question is the degree to which lending accelerates and creates a pro-inflationary impulse in response to the rapid reopening of the economy, generous rounds of stimulus, and additional spending bills working their way through Congress.

Thus far, loan originations have been sluggish – as expected when restrictions were in full effect but persisting in the second quarter with the biggest banks largely reporting lower average loan balances (shrinking at 2% to 6% annual rates). This suggests the money multiplier is currently declining despite an accelerating economy. (To the extent that banks lend money that has been deposited, those funds return to the banks as new deposits – thus expanding the money supply organically as a function of normal economic activity.) Weak demand for loans, however, may simply be a matter of timing in which excess fiscal stimulus has temporarily crowded out the need for credit.

Our ACAP Liquidity Index shows capacity for lending across the financial system is at its highest level in the past 45 years. This state of elevated liquidity reflects the expanding pool of deposits and highly liquid securities relative to shrinking loan balances on bank balance sheets. Simply put, banks are swamped with excess liquidity that is restraining profitability – creating pressure to lend. With monthly new business formation clocking in 50%-60% above pre-pandemic levels, a return to positive loan growth may emerge in the months ahead as the bolus of prior stimulus funds are depleted.

Economic growth is expanding. Hiring picked up significantly in June, after initially downshifting in April and May from March's torrid pace. The scramble to hire, particularly within the travel and leisure industries as the rollback of restrictions unleashed a wave of pent-up demand, has prompted rising wages (with many hourly employees receiving hiring bonuses). Hiring in July through September may be strong as well, particularly as pandemic-era benefits wane, children return to in-person learning, and higher wages tempt workers back into the labor force. Both the demand and supply recovery is on display as TSA throughput rapidly approaches 2019 levels as airlines restore capacity amid high demand.



Consumer spending should remain strong. Cumulative stimulus policies produced an additional $2.5 trillion in household savings (above what normally would have been expected). At the same time, redirecting the child tax credit to a monthly payment (poised to become permanent) is extending this federal child support to millions of low-income families that heretofore did not qualify due to a lack of material taxable income. This money will largely be spent, in contrast to traditional income tax cuts where the stimulative impact is hampered by a high propensity to save. While the infrastructure

bill is slimmed down from its original ambitions, it still adds $500 billion of spending over baseline (spread over 10 years) and the Democrats' $3.5 trillion reconciliation bill, even if eventually downsized, provides a source of consistent demand for an extended period (especially to the extent it too, like the child tax credit becoming a direct payment, is more targeted toward lifting prosperity among lower income households). Taken together, annualized GDP has already exceeded its pre-pandemic peak and is on pace to surpass its pre-COVID trend by yearend.

The eventual pace of Fed tightening should still support the economy. Thus far markets are taking in stride indications that voting members of the Fed are pulling forward their individual expectations for when 'tapering' and interest rate hikes will begin. Part of investors' ease reflects Chairman Powell's credibility and the large residual unemployment due to the pandemic. Importantly, the pace of future policy tightening is likely to proceed cautiously – and to the extent recent wage gains are durable and new approaches to fiscal policy take hold, more persistent inflation trends at 2% or slightly higher still gives the Fed room to increase rates without necessarily being less accommodative (real Fed Funds stays negative based on current inflation forecasts and initial tightening).

The backdrop is favorable, but the infection rate remains uncertain. The delta variant is now the dominant strain, and large swaths of the domestic population (not to mention many countries) remain unvaccinated – providing a large pool for incubating the next variant. While we have learned a lot about treatment over the past 12 months, persistent and rising case counts remain a source of angst for markets and may threaten to derail some of the benefits we have seen from reopening the economy (for example, California just reinstated a requirement to wear masks indoors). The prospect that booster shots can be delivered, if needed, and preserve functional protection from infection is an important contributor to the market's calmness (as is the ability to tweak the mRNA to address more directly new variants).

While there remains a fair bit of uncertainty thanks to the unprecedented year we have just completed, we are cautiously optimistic. Valuations are high, but the economy is performing with cyclical strength unseen in decades. The drivers of recent inflation should moderate, even as monetary and fiscal stimulus remains highly supportive and recent wage gains translate into higher consumer spending. While markets will continue to focus on inflation, overcoming the multiple headwinds responsible for the disinflationary environment that has dominated investor thinking will take time. From an investment perspective, we continue to shift toward cyclical companies that enjoy better pricing power, particularly those that can benefit from rising wages. On bonds, low yields and tight spreads leaves little reason to accept risk – and as such, our focus remains on high quality, short-term maturity issues.

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