Outlook Memorandum

OCTOBER 2021

S&P 500:
4307

This Is What GROWTH Feels Like

Investors have enjoyed a string of strong monthly gains since the initial pandemic trough. That is, until this past September when the S&P 500 fell 4.7% – a clear departure from recent experience that reversed most of the gains the market posted during July and August. For the quarter, the S&P 500 finished with a 0.6% return. Emerging markets dropped about 8% during the quarter, partly reflecting strength in the dollar (+2%) as markets digested tremors in China's property sector, evolving Fed and ECB rate policy, and heightened uncertainty amid the escalating discord in Washington. Japanese stocks stood out, gaining 4.8% for the quarter while most other markets (including bonds) offered relatively muted results (in the range of +/- 1%). Energy markets were a clear standout as natural gas prices surged as much as 60% and oil climbed 4.5%, largely reflecting supply constraints amidst unwavering demand.

September's pullback came as investors assessed risks posed by a waning stimulus backdrop, coupled with escalating gridlock in D.C. and the emergence of potential risks emanating out of China. The acute urgency for short-term stimulus no longer exists with the economy advancing at the fastest pace in four decades and markets on firm footing. Businesses are struggling to keep up with resurgent demand, pushing wages higher and delivering additional adrenaline, risks doing nothing more than fueling more durable inflation and disruption in the supply side of the economy. For investors, the reality of reduced fiscal stimulus and an end of the Fed's monthly bond purchases requires a change in mindset: away from the rising tide that was lifting all boats, to a mindset that incorporates risks in a more balanced manner. The key question is how much of the current economic strength (demand, inflation, wages, and supply bottlenecks) is self-sustaining as opposed to an artifact of policy over the past eighteen months. Amidst this uncertainty, contention over raising the debt ceiling threatened to introduce an unexpected drag on economic activity.

Policy transitions and the emergence of new sources of risks create uncertainty for markets, even in the presence of a strong underlying economy. This is particularly true now. Weekly jobless claims recently fell below 300,000 and the private sector is adding jobs at a healthy pace. Pandemic supports are rolling off, but wages and incomes are rising at a ~10% pace. Those gains, if sustained, represent a permanent unexpected shift higher in the lifetime earnings for many households and stands to be a more significant driver of economic activity than one-off stimulus checks. Whether coincidence or consequence, stronger growth in household hourly earnings may represent a critical departure from the preferred policy algorithm of the past 40 years, which prioritized business profitability as the primary mechanism for promoting employment and prosperity. The implication is that the growth multiplier on future stimulus may be moving higher after a prolonged period of increasing impotence. To this point, recasting the child tax credit as a direct payment finally put money in the hands of households that need it most. Inflation, while currently high, is poised to ease gradually as severe bottlenecks are resolved; and on a longer-term basis, the rise in business investment (which stagnated during the growth recession) portends higher worker productivity, more income gains, and downward pressure on future inflation. All this is not to say a new golden age is upon us. Global stimulus following the pandemic obscured economic challenges under a

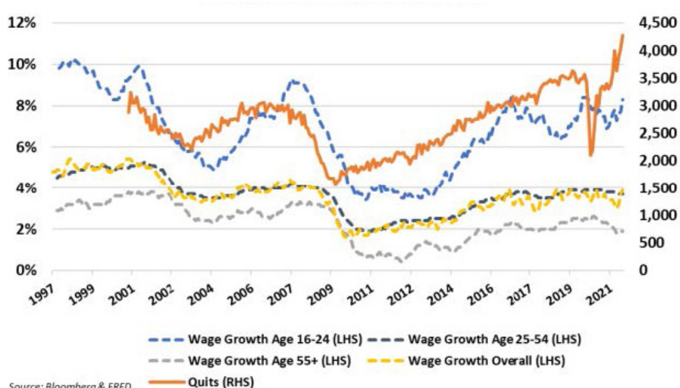
sea of liquidity – and those risks are becoming important again. However, the economy emerging now may be on track to deliver higher real growth and rising real interest rates over the next several years with positive implications for equities broadly as the gap between nominal GDP and bond yields widens to record levels.

The economy is cyclically strong. Investors renewed preoccupation with upcoming adjustments with the Fed's interest rate policy, inflation pressure that is receding a bit more slowly than expected, and a nervous view toward rising wages are overshadowing an economy that is navigating the lingering vestiges of the pandemic reopen while creating jobs and above trend income growth. A clear policy goal has been restoring pre-pandemic employment conditions – particularly given the unevenness with which the shutdown and restrictions affected lower income, hourly workers (particularly in service industries) as compared to higher income, salaried workers. For most pundits, that goal has been interpreted to mean restoring employment levels to about 165 million people and a jobless rate below 4%. While disruptions have prompted changes in how people live and work, what is becoming clear is that as many as 3.2 million people have left the workforce – with the greatest impact among individuals 65 and older. The decision to stop working may simply reflect an accelerated retirement date, a decision that the risk of exposure to infection is not worth the extra income, or lasting displacements caused by business closures. The over-65 segment may be very slow to return to work, especially since time away contributes to diminished earnings potential if they return to work – and their short time until retirement may not be sufficient incentive to invest in new skills (with the rewards coming later).

The result has been a shortage of workers and a measurable acceleration in wage growth as businesses offer raises, bonuses, and other perks in their scramble to re-staff operations. Wage gains have been particularly pronounced among the younger, less skilled, hourly workforce – in fact, wage gains in this segment are outpacing gains among higher income workers. Hourly earnings are up almost 9.8% compared to last year, and comfortably above 2019 levels. Moreover, new jobs are being added at a healthy pace – much more so than market pundits may quibble about. The private sector, for example, added an estimated 1.2 million jobs in the third quarter. While interpreting year-over-year comparisons is challenging given the distortions that the pandemic created in the data (seasonal hiring associated with summer vacations, back to school, and the holidays have all been jumbled by the significant shift in purchasing patterns), the average work week has been extending longer. In fact, the increase in the average work week during September was equivalent to an addition of ~900k extra jobs beyond what was indicated in the employment report.

US WAGE GROWTH BY AGE AND QUITS

Importantly, infections are definitively trending lower, once again, after the Delta variant delivered what was arguably the fourth wave of infections. After hitting a recent peak



Source: Bloomberg & FRED

of as many as 180,000 daily infections, that rate has now dropped below 65,000. With highly effective results from Merck's oral COVID treatment recently announced and multiple other oral treatments on track to report efficacy results in the months ahead, the path toward a more muted virus impact on health and the economy is starting to come into focus (in addition to the prospect of extending vaccinations to younger segments and making booster shots available). Furthermore, it is still too early to discern what the true impact of children returning to school will be on the future employment environment for businesses and job seekers.

Liquidity conditions are far from restrictive. Transitions from easing cycles to tightening cycles, no matter how spread out, seem to bring temporary bouts of angst as investors reawaken their awareness of market risks. The current environment is no different, even though measures of overall liquidity in the financial system exceed historical measures (particularly at points of transition). Real M2

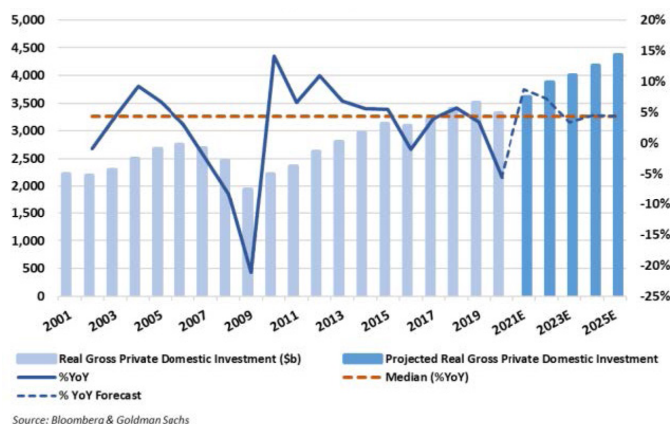
money supply remains near a four-decade high relative to real GDP, though the year-over-year growth rate has decelerated sharply and is approaching historically normal levels of growth. Still, the Fed has expanded the money supply by over $1.7 trillion year to date – which represents the highest annual amount in history. The Fed's real short-term interest rate, meanwhile, has been trending lower over the past six months as inflation measures have moved higher; and while investors fret over looming policy changes at the Fed and the prospect of a more prolonged period of higher inflation owing to businesses offering raises…overlaying these two dynamics highlights that the Fed is on course to become increasingly stimulative on a real interest rate level.

Real money supply, however, only tells part of the story. Households remain flush with excess cash accumulated largely from pandemic stimulus programs (and from forgone expenses related to vacations, eating out, commuting expenses, and other artificial spending constraints created by the pandemic). Whereas that excess spending may not necessarily all flow back into the economy, it is nonetheless underpinning the pent-up demand that is driving robust bookings in the travel and leisure industries. Notably, our ACAP Liquidity Index continues to inch higher. This contrasts with normalizing growth in real M2 money supply and reflects several dynamics that stand to encourage underlying economic growth. While banks have been reporting relatively tepid loan demand in recent quarters, they are flush with cash and highly liquid short-term securities portfolios – in short, banks have a large and growing capacity to lend (and the fact that lending is far more profitable than holding cash is a strong incentive for the banks to expand their loan books). At the same time, higher inflation is prompting a steepening in the yield curve (which widens the profitability of each loan) and incentivizing businesses to make investments and expand operations to take advantage of robust demand and capture the spread between input costs and rising prices (and to offset wage gains through productivity enhancing initiatives). We suspect that part of the tepid loan demand reflects distortions created by the pandemic – namely, many households and businesses still have excess cash levels earning near zero rates of return (which depresses the need for borrowing), while supply chain spasms created by parts shortages and shipping delays (there are more than 60 ships waiting off the port of Long Beach, CA to be unloaded) have constrained the ability for businesses to replenish inventory (in other words, businesses are running at exceptionally low inventory levels which is not only causing disruptions in supply chains, but adding to cash balances….rather than building inventories, which is a large use of cash).

The inversion of policy, namely promoting broader income growth as the primary mechanism for supporting business profitability is taking root. The pandemic, by sheer happenstance, accelerated the shift toward prioritizing income growth by placing significant constraints on businesses and workers while the government response created an enhanced, albeit temporary, safety net. The result has been a shortage of people willing to work, which in turn is prompting businesses to offer significantly higher wages. Recent employment reports have revealed workers are quitting jobs at record rates (see chart on previous page), with the number surging over four million. At first pass, quitting sounds like a problem for the economy – but it is a clear sign that workers are confident in their ability to obtain more attractive jobs (pay and work conditions). At the same time, fiscal policy has been pivoting as evidenced by the reconfiguration of the child tax credit (which significantly expanded the ranks of families receiving this benefit) and the numerous provisions in the pending infrastructure and reconciliation bills. While large bills always contain contentious provisions, these bills stand to promote domestic work (infrastructure) and make key health, childcare, and work-oriented services more affordable.

Interestingly, we may already be seeing some flow through from higher income levels. Business investment has been growing, and now sits at a fifteen year high relative to GDP (chart below). Wages, even adjusted for recent inflation, are still above where they were in 2019 (especially in lower wage brackets) – which should continue to encourage business investment. Importantly, this trend is emerging overseas: in China, President Xi is promoting 'common prosperity'; in the U.K., Prime Minister Johnson is promoting 'leveling'; and in Japan, Fumio Kishida is promoting redistribution and an 'income-doubling plan.'

US CAPITAL EXPENDITURES



The real economy may be in the early stages of diverging from the financial economy. As we have highlighted before, the preferred policy algorithm of the past forty years has focused on protecting business profitability as the primary mechanism for promoting employment and prosperity. The effectiveness of such a trickle-down approach has waned, as evidenced by rising debt levels, trade imbalances, and growing wealth/income inequality. Aging demographics and economic policies among our trading partners have also contributed, but intuitively an extra dollar in the hands of the wealthy is less stimulative than an extra dollar in the hands of the unwealthy. In fact, this dynamic may underpin the relative constrained domestic business investment in recent decades. Going forward, growing consumption should entice corporations to increase capacity even if interest rates inch higher. This dynamic suggests the Fed can reduce liquidity without impacting the real economy to the same extent as was the case over the past decade when markets and the economy were more closely tied together given the large amounts of leverage across households and corporations (household leverage is at the lowest level in 45 years).

Looking forward, the transition from a stimulus driven economy to a self-sustaining one creates uncertainty. The global economy remains influx as it reorients to a post-pandemic world where both consumers and businesses are still adapting to the realities of living with an endemic virus. That said, we believe the underlying economic momentum can bridge the gap forming from the roll-off of pandemic era policy measures. Inflation and supply chain disruptions are a wildcard, but we believe these pressures should start waning as we move into 2022, particularly as increased capital investment leads to more capacity. The result is an environment where the Fed is unlikely to raise interest rates rapidly, disrupting growth in the economy.

In terms of asset allocations, we continue to be constructive on equities and increasingly cautious on bonds given the negative real rates of return across the interest rate curve. Specifically, we remain underweight long duration bonds and strategic around credit given the general decline in lending standards. In equities we see potential for more volatility in pandemic beneficiaries where growth may slow as the economy fully reopens and high-flying stocks where valuations may be more susceptible to modest changes in interest rates given that most of their value is determined by cashflows further out in the future, similar to the way longer duration bonds are more sensitive to changes in interest rates (although increased business investment is a significant long-term tail wind to their growth). That said, we continue to favor strong cashflow companies while remaining mindful of the runup in valuations across very high-quality growth businesses.

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