ECONOMIC OUTLOOK

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unique investment insight

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Inflation Angst
Overheating Economy or Transitory Surge?

As the pandemic subsides in the U.S., it is a relief to see a brighter economic outlook. The turnaround has been swift with the rollout of multiple vaccines and substantial government support. Within a few months, the U.S. economy has swung from depressed prices and high unemployment to supply shortages and rising prices that are fueling fears of inflation. In June, the Bureau of Labor Statistics' inflation rate rose by 5.4% compared with a year ago, the largest increase since the 2008 financial crisis. Core personal consumption expenditures, excluding food and energy, rose by 3.4% in May, the most in nearly three decades. Outside the U.S., prospects for a lasting global recovery are improving with global GDP forecast to expand 5.6%, helped by the deployment of vaccines and government support. However, Covid continues to spread with more transmittable variants and many countries have very limited vaccine supply. World trade is benefiting from the U.S. rebound, but trade is constrained by global virus outbreaks, supply bottlenecks, and travel restrictions.

Some economists are concerned that the U.S. may have over-compensated for the pandemic with $5 trillion in government aid, including the $2.2 trillion CARES Act and the $1.9 trillion American Rescue Plan Act, along with over $4 trillion in Federal Reserve support. Larry Summers, a former U.S. Treasury Secretary, has for the past decade supported additional stimulus, but now believes the Fed is misreading the economy and creating "dangerous complacency" in financial markets. In this view, there is a risk of sustained high inflation as the fiscal and monetary taps remain wide open – the Fed has rates near 0% and continues to buy $120 billion per month in securities along with trillions in additional government aid. The risk is the economy overheats, with higher wages, asset price inflation, and excessive debt. These economists argue we are at a tipping point where over-stimulated demand, artificially created by government and Fed support, will lead to higher wages and rising prices that will force the Fed to raise rates to fend off incipient run-away inflation.

The Fed's response to this argument is that employment and GDP are still below pre-pandemic levels and the economy can withstand a short bout of inflation over its 2% target. Chairman Powell believes a bit of inflation is manageable and signals the economy is healing and expanding. Any spike in inflation is likely transitory - loosely defined as one quarter to a year or more - driven by the re-opening of the economy, government stimulus, increases in oil prices, and supply bottlenecks. The economy is far from full employment and the number of jobs is still seven million below pre-pandemic levels. Economic data is choppy due to the pandemic and the free-fall in GDP in 2020, and a true inflation reading will likely take time. The Cleveland Fed's median CPI, a measure that omits large outliers, is rising at a much more subdued 2.1%. Interest rates on longer-term bonds remain low at about 2%. Unfortunately, research shows that neither the bond market nor economists have the ability to predict future inflation despite their confident pronouncements.

U.S. Economy

The U.S. recovery is being driven by higher consumer spending, housing, and manufacturing. The Commerce Department reported that first quarter GDP rose 6.4%. Last year in the second quarter, GDP contracted by 31.4% (annualized) followed by a +33.4% rebound in the third quarter. Personal consumption expenditures grew 11% in the first quarter. Business investment, a key to ensuring a robust recovery, rose 11.7% in the first quarter as companies became more confident in the recovery and ramped up orders for computers, machinery, and software. Business spending is now higher than its pre-pandemic peak. Looking ahead, forecasters expect second quarter GDP to expand by 8% to 9%. Fed officials, citing an improved economic outlook due to vaccines, raised their 2021 GDP forecast from 6.5% in March to 7.0% at their June meeting and left the 2022 forecast unchanged at 3.3%.

Consumer and Manufacturing

As the U.S. moves toward a full recovery, consumers have shifted spending from goods to services. Overall spending was flat in May as consumers cut back on purchases of big-ticket items and rotated more of their money toward in-person services. Retail sales declined 1.3% in May after two strong months of sales. Spending rebounded on in-person services such as travel, entertainment, and dining. This spring shaped up to be a solid one for spending with April expenditures upwardly revised to 0.9%. Overall spending in May was well above pre-pandemic levels, with spending on goods up nearly 20% from February 2020. Manufacturing continued to expand in May. The May Manufacturing PMI registered its twelfth consecutive month of growth. The New Orders index rose to 67 (readings over 50 indicate expansion) with a large backlog of orders. Manufacturing growth potential has been limited by wide-scale shortages of materials, strain on the global supply chain, rising commodity prices, and worker shortages.

Employment

The U.S. economy added 850,000 jobs in June and 583,000 jobs in May as the labor market heated up. The unemployment rate rose to 5.9% from 5.8% according to the Labor Department as more Americans joined the labor force. The increase in jobs was the strongest since last August and job openings were a record 9.2 million. Despite the latest gains, the U.S. still has about seven million fewer jobs than in February 2020, the month before the pandemic shut down much of the economy. Employment gains were led by sectors such as leisure, hospitality, healthcare, and manufacturing. The labor force participation rate remains a low 61.6%, compared to the historical average of 65%. Recently, the Labor Department reported that 385,000 people filed initial unemployment claims, down from 500,000 a month earlier. Though trending in the right direction, the data indicates that the employment environment is still under stress.

Real Estate

Home prices in May rose nearly 24% over May 2020. The National Association of Realtors reported that the median existing home price was over $350,000. According to the National Association of Home Builders (NAHB), the median price for a newly built home is now $374,400, up 18% over last year. The NAHB estimates that higher lumber costs alone are increasing new home prices by $36,000 on average. Housing demand continues to be supported by low interest rates and solid demand in suburbs and exurbs. Housing starts rose 3.6% in May from April, but building is constrained by land supply and construction costs. Price increases are leading to a decrease in the number of home sales with May recording a -5.9% decline in sales.

World Economy

Europe

The rebound in Europe is taking more time than in the U.S. due to the delay in procuring vaccines. While the vaccination rollout has gradually gathered pace, substantial pressure on health systems remained in the spring, which forced many countries to reimpose containment measures. Euro area output declined in the first quarter of 2021, with lower consumption and service sector activity due to restrictions. As cases drop and measures are lifted, economic growth is projected to rebound strongly in the second half of this year. With inflation set to remain below the ECB objective by the end of 2022, monetary policy should remain accommodative. Likewise, national fiscal policies should remain supportive until the recovery has gained momentum. Unemployment is projected to decline to pre-crisis levels by year-end 2022. In June, the Organization for Economic Co-operation and Development (OECD) projected euro area growth of 4.3% in 2021 and 4.4% in 2022, boosted by consumer spending, considerable fiscal support, and exports, notably to the U.S.

After the U.K. suffered its largest GDP drop in three centuries in 2020 (-9.9%), forecasters see strong growth of 7.2% in 2021 and 5.5% in 2022, as a large share of the population is already vaccinated. According to the OECD, the U.K., despite the forecast for its fastest growth in decades, faces deeper economic troubles than other G7 economies due to its battle with Covid and exit from the EU. Increased border costs following the exit from the EU will continue to weigh on foreign trade. GDP is expected to return to its pre-pandemic level in early 2022 with a rebound in consumption as pandemic restrictions are lifted.

China and Emerging Markets

Robust growth is expected to continue in China, with GDP rising by around 8.5% this year and 5.8% in 2022. First quarter growth was 2.4% following double-digit rates in the preceding three quarters. The hardest hit industries, such as accommodation and travel, rebounded quickly. Investment and exports will remain robust as infrastructure projects restart and foreign demand recovers. Monetary policy remains accommodative, but some fiscal policy support is being withdrawn this year and credit growth is moderating. Progress in rebalancing the economy from industrial production and investment to domestic consumption has been interrupted by the pandemic, but should resume as the vaccination rollout gains pace. Significant financial risks remain, particularly from elevated corporate sector debt.

In emerging markets, vaccination rates are extremely low (less than 5%) due to a lack of supply. In developing economies such as India, Brazil, Indonesia, and many nations in Africa, a slow vaccination rollout, a resurgence of the virus, and renewed lockdowns are denting any recovery. The International Monetary Fund projects 2021 global GDP growth of 6.0% and 4.4% in 2022.

Commodities

The pandemic caused an historic decline in global oil demand in 2020, but not a lasting one. In the absence of major changes in policy or behavior, global oil demand will return to pre-pandemic levels in 2022. With a recovering global economy and a weakening dollar, oil rallied in 2021 with Brent trading back above $73, up over 50% this year. Growth in oil supply will be a fraction of expected demand growth in 2021 unless OPEC discord leads to a free for all. Producers are cautious and trying to keep the market in balance and avoid surpluses as the economy recovers. With the Fed perhaps raising rates sooner than expected, gold finished the quarter down 6.5% for the year and -0.14% over the past year.

Investment Perspective

The U.S. has made a remarkable recovery from a tragic pandemic that has claimed over 600,000 lives. Currently, over half of the population is fully vaccinated and both cases and deaths have fallen precipitously. Government aid and easy monetary conditions along with receding cases have provided a substantial boost to the economy. Many economists forecast 7%+ growth in 2021, the highest in a generation. Earnings estimates have also been revised upward. Second quarter forecasts call for a 64% increase over last year's crisis low – this is also 8% over second quarter 2019 earnings. Earnings estimates may be low – in the first quarter, forecasts were for 16% growth, but the actual number was 58%. So far, we have seen a swifter recovery than the recession in 2008 in terms of jobs, consumer spending, housing, and loan delinquencies.

As economic activity heats up, price inflation is increasing due to rising input and labor costs, as well as demand for goods/services that exceeds supply. Part of this is due to supply constraints that have caused shortages of everything from semi-conductor chips to bicycles. Supply chains are global with parts sourced from all over the world. For example, bicycles have parts from as many as 50 different suppliers that are manufactured around the world including France (tires), Japan (gears), and China (frames/components). There have been multiple breaks in the global supply chain since last year. As an example, a Covid outbreak in June in the southern China port of Yantian forced authorities to shut it down. Shipping companies estimate there are 350,000 loaded containers on docks that will take weeks or months to clear and may even affect the Christmas season. Labor scarcity has also been an issue with blame aimed at expanded unemployment benefits, lack of child care, health concerns, low wages, lower labor participation, and immigration/travel restrictions that have reduced the number of visas by 54%, or nearly five million, from 2019.

With inflation running hotter, a focus on profit margins and businesses' ability to raise prices is increasingly important for investors. Since bonds and cash offer meager or 0% returns - negative after accounting for inflation – stocks, even with all their volatility, still offer the best hope for any gains. There is of course no guarantee that this will continue. Equities are at the high-end of traditional valuation measures including price/earnings and price/revenue with extraordinary returns increasingly unlikely. As we have seen in the past decade, markets can stay over-valued for extended periods. The markets since the financial crisis have had Federal Reserve and global central bank support with trillions in asset purchases and low or negative interest rates. In addition, due to the pandemic, there was an additional $5 trillion in government aid. For equities, we favor materials, industrials, energy, and technology. Dividend paying companies remain an important part of the portfolio. Precious metals are attractive as a currency that cannot be debased by endless money printing. The inflationary surge is a reflection of the rebound from last year's low levels and bottlenecks that will clear as restrictions ease and more of the world is vaccinated. We have already seen inflation in asset prices over the past decade (e.g., housing and stocks) and now with an inkling of broader price inflation, investors have the additional concern of preserving purchasing power. As these trends unfold, we will as always remain vigilant.

June 30, 2021
DJIA: 34,502.51
S&P 500: 4,297.50

About Bounty Management
Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.

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