ECONOMIC OUTLOOK

bounty management
unique investment insight

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Delta Dents Spring Optimism With Another Summer Wave

In our last quarterly update, the pandemic seemed to be waning as vaccinations and health measures stemmed the tide. People hung up their masks and breathed a sigh of relief. Then over the summer the Delta variant, a more potent and even more transmittable variant, surprised us all once again. Daily cases in the U.S. that were as low as 11,000 in June, rose to over 175,000 in September. Vaccines are effective against the new variant, but breakthrough infections are possible and the unvaccinated half of the U.S. are extremely vulnerable. By August, indicators in pandemic sensitive sectors, such as restaurants and travel, started to fall. But, unlike March 2020, the economy is not shutting down. The Delta variant may have slowed the pace of the global economic recovery, but will not derail it. Global economic growth has rebounded this year aided by government and central bank support, consumer/business spending, effective vaccines, and the resumption of many economic activities. Even though the economic impact of the Delta variant has so far been relatively mild in countries with high vaccination rates, it has added pressure on global supply chains and costs.

In the U.S., the government and Federal Reserve continue to provide pandemic support. The American Rescue Plan, a $1.9 trillion aid package, has provided $350 billion to state and local governments, over $30 billion in rental and mortgage assistance, and an expanded child tax credit for millions of parents. The Fed is planning on paring back the $120 billion in monthly purchases of Treasuries and mortgages by year-end, but will likely keep rates near 0% into next year. In Europe, the European Central Bank (ECB) is buying €1.85 trillion in bonds to support the economy and keep interest rates low. Globally, there are still over $13 trillion in negative yielding sovereign bonds meaning that investors pay for the privilege of keeping deposits in the bank. Even low yielding U.S. bonds seem relatively attractive since some yield is better than paying the bank.

As we enter the last quarter of the year, we expect more market volatility with rising inflation, supply chain bottlenecks, tight labor markets, the threat of more virus outbreaks, slowing growth rates, and the Federal Reserve/ECB starting to pare back asset purchases. The inflation rate has risen sharply to 5.4% (4.0% excluding food and energy) due to supply disruptions, higher wages and commodity prices, and government spending. The sudden demand spike as Americans bought more goods while slashing spending on services in the middle of a global pandemic has caused ripples along the supply chain. Factory and port closures in Asia and elsewhere due to covid outbreaks have led to long delays and higher costs. The additional costs will eventually find their way to consumers as higher prices and to companies' bottom lines in the form of lower profits. The Fed still believes that higher prices and supply issues are "transitory" - loosely defined as three months to two years - but admits they have already lasted longer than anticipated. In the end, as we have seen over the past 18 months, the economic recovery is heavily dependent on the path of the virus.

U.S. Economy

U.S. GDP grew 6.5% in the second quarter driven by personal spending, exports, and state/local government spending. Although the gain was strong, it was less than most estimates. The numbers are still a bit skewed since the economy collapsed 31.4% in the second quarter of 2020 before bouncing back 33.4% in the subsequent quarter. The economy has now surpassed its pre-pandemic level, but forecasts for 3rd quarter GDP growth have dropped from 7% in June to 3.1% in October due to the impact of the Delta variant, fiscal stimulus waning, and rising prices. After raising their estimates last quarter, the Fed lowered their full year 2021 GDP forecast from 7.0% in June to 5.9% in September and raised the 2022 forecast to 3.8%. The primary driver of U.S. growth over the next year will mirror the improvement in health. The number of cases should continue to decline as the fourth pandemic wave recedes – at least until people head indoors during the colder months.

Consumer and Manufacturing

The Conference Board reported that consumer confidence fell for the third straight month in September as the spread of Covid and inflation concerns weighed on consumers. Meanwhile, the U of Michigan's Consumer Sentiment Index dropped to 71 in September from 85.5 in June and well below February 2020's comparable reading above 100. Bottlenecks in global supply chains made it difficult for businesses to keep up with demand for many goods which resulted in lower inventories. Restocking inventories will take time as Delta has hindered manufacturing and shipping activity in key economies around the world. The ISM Manufacturing Index increased to 61.1 in September, up for a second straight month, although factories experienced longer delays in raw material deliveries and higher prices. Auto sales have recovered from pandemic lows, but production has slowed due to shortages of key parts such as semiconductor chips.

Employment

The U.S. economy created 194,000 jobs in September, the fewest in the past nine months. Nonfarm payrolls grew a revised 366,000 in August, down from 962,000 in July and 1.05 million in June. The unemployment rate is 4.8%, up from 3.5% in February 2020, but down from 14% in April 2020. The participation rate has dropped since the start of the pandemic from 63.3% to 61.6% - this translates to 4.3 million fewer workers. Economists thought that school re-openings, expiring unemployment benefits, and lower Delta cases would raise the number of available workers. The reasons for labor shortages include a lack of affordable daycare, a reduction in immigrant workers, federal relief payments, a trend to become self-employed, fear of Covid, and an acceleration in retirements. The Fed is watching the unemployment rate to decide how long to keep short-term interest rates low so slowing job growth could affect the timing of Fed tightening.

Real Estate

The S&P Case-Shiller Home Price Index rose 19.7% in the year ended in July, the highest annual rate since the index started in 1987. Low inventory is a key factor for the price increase as the number of homes for sale remains below typical levels and has sparked bidding wars for some properties. The strong economic position of high-wage remote workers and low mortgage rates have helped housing demand. Recently, higher prices seem to be slowing the market as some buyers are stepping back. The National Association of Realtors recently reported that existing home sales declined 2% in August from July to 5.88 million homes. That is still well above the 3.9 million sales in May 2020, but down from 6.7 million in October 2020. Data on new single-family homes and housing permits shows a similar downward trend.

World Economy

Europe

The outlook for the European economy looks brighter than expected in spring. Falling numbers of new infections mainly due to progress in vaccinations and virus containment measures, have led Europe to re-open more service sector businesses. Upbeat survey results among consumers and businesses as well as tourism activity suggest that a rebound in consumption is already underway. These positive factors are expected to outweigh the temporary shortages and rising costs in the economy. The forecast for inflation this year and next has also been revised upwards, though inflation is projected to moderate next year. In September, the Organization for Economic Co-operation and Development (OECD) projected euro area growth of 5.3% in 2021 and 4.6% in 2022, with a strong rebound in Europe, the likelihood of additional fiscal support in the U.S., and increased consumption in advanced economies.

Britain's inflation rate hit 3.2% in August, the highest in almost a decade. Expectations for higher inflation in the year ahead rose in September and the Bank of England said the case for raising rates was strengthening. Supply chain and staffing problems continue to worsen since Brexit - there was even panic-buying at gas stations in September caused by a shortage of truck drivers. After shrinking by 1.4% in the first three months of the year, the economy grew by 5.5% in the second quarter with the help of higher consumer spending and an improvement in trade.

China and Emerging Markets

China’s 2021 GDP forecast by the International Monetary Fund was revised down slightly to 8% in October due to tight covid restrictions and a slowdown in property sales and construction activity in the wake of a debt crisis facing real estate giant Evergrande. Efforts to reduce emissions and a shortage in coal supplies caused power outages across China that halted production at factories. Virtually all indicators point to a softening of domestic demand, particularly if energy shortages crimp industrial activity. This could spur a round of at least modest stimulus measures by the end of the year.

The growth forecast for emerging markets was revised down 0.4% to 6.4% by the IMF in October, largely because of lower growth in Asian economies. Growth prospects in India have been downgraded following a severe second Covid wave during the spring. Similar dynamics are seen throughout Asia (e.g., Indonesia, Malaysia, Philippines, Thailand, Vietnam), where recent infection waves are causing a drag on activity. These waves are one reason for the global supply disruptions. In September, the OECD projected 2021 global GDP growth of 5.7% and 4.5% in 2022.

Commodities

Prices for commodities including oil, gas, coal, and agricultural products have surged over the past year leading to higher consumer price inflation. Global commodity prices in July and August this year were about 55% higher than a year earlier. Crude oil has risen 64% to $81 a barrel this year. Prices at the pump are up over $1 in the past twelve months to over $3 a gallon. Even though the number of oil rigs has risen during the past year to 528 in early October, this is about 1,000 rigs below the level of drilling the last time oil prices were this high seven years ago. With the Fed perhaps raising rates sooner than expected, gold finished the quarter down -0.7% for the quarter and -7.3% year-to-date. Global food prices have risen to their highest level in a decade due to strong Chinese demand and harvest setbacks.

Investment Perspective

As we enter the fourth quarter, slowing growth, rising inflation, supply chain snarls, and the pandemic, all threaten to erode consumer/investor confidence and corporate profits. Even though the Delta variant has taken some of the momentum out of the recovery, the economy has firmly rebounded this year. Global GDP has surpassed its pre-pandemic level, but output in mid-2021 was still 3.5% lower than projected before the pandemic. Economist have lowered U.S. GDP growth forecasts for the 3rd quarter from 7.8% in July to 1.4% in October, in part due to the impact of the Delta variant on spending and supply chain issues. Many economists have pushed the recovery into 2022 with the thought that spending and production has been delayed by the virus surge and supply disruptions. The recovery continues, but is not as robust as the first half of the year.

As we have written in the past, stock valuations are high based on most historical measures. With the equity market's strong performance over the past couple of years, the probability of extraordinary equity returns over the next decade diminishes with each leg upward. To justify current equity valuations, one has to believe that economic growth can accelerate forever, companies can maintain profit margins regardless of wages or material costs, and the government can print, borrow and spend endless amounts of money. There is concern that both the Federal Reserve and the ECB will be paring back their asset purchases at the same time over the course of the next year – a key to the market's rise since the financial crisis. As Robert Shiller, the Nobel prize economist, wrote recently, "The prices of stocks, bonds, and real estate, the three major asset classes in the U.S., are all extremely high. In fact, the three have never been this over-priced in modern history." His explanation for the over-valuation of assets includes the Fed setting interest rates near 0% and investor euphoria/over-confidence. He admits that it is impossible to time the markets or predict the date of the correction, but suggests overall risk has increased for longer-term holding periods of a decade or more.

So where does this leave investors? Cash and short-term bond rates are still at or near 0% and the 10-year Treasury note yields about 1.6%. In an economy with 5.4% inflation this translates to negative real (after inflation) rates of return. However, shorter-term bonds, Treasury Inflation Protected Securities, and cash add balance and a measure of safety to an investor's portfolio. Stocks, even with all their volatility, offer investors a chance of earning returns above inflation and preserving purchasing power. With supply chain bottlenecks pushing up material, equipment, and shipping costs as well as a tight labor market raising labor costs, there is concern that profit margins will be squeezed. Sector and stock selection is now even more important. In investment portfolios, we continue to focus on the areas that we feel have relative long-term value and will preserve purchasing power including materials, industrials, energy, and technology. Dividend paying stocks remain a core component. Gold and precious metals offer a form of insurance in a currency that cannot be debased or manufactured out of thin air. As we have done through many market cycles, our focus is to identify attractive investment areas and invest in well-run companies with strong long-term prospects while being mindful of valuation. The recovery will continue to follow the path of the pandemic and we await the day when we can once again leave our masks at the door. We remain patient, thankful, and vigilant.

September 30, 2021
DJIA: 33,843.92
S&P 500: 4,307.54

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.