

ECONOMIC OUTLOOK

Summary

Inflation is still viewed by the Fed as transitory, or temporary, and there is no doubt we experienced inflation during the second quarter. Nominal GDP during Q2 grew at an annualized pace of 13.0% - an enormous amount historically. However, inflation accounted for roughly 6.5% of the gain, causing real GDP to register growth at 6.5% (missing estimates by roughly 2%).

Digging further into the data, consumer spending accounted for roughly 7.8% of real growth, which was more than the overall level of GDP for the quarter. This can happen because inventories detracted -1.1% from GDP, indicating that supply can't keep up with demand. Of course, there are other components that either contributed to or detracted from GDP but this is more evidence that consumer demand remains strong, and supply chain issues and bottlenecks continue to negatively impact the economy.

The consensus belief has been that as vaccine availability increased across the globe and additional unemployment benefits in the U.S. expired, some of these bottlenecks would begin to dissipate. The economy only recently began to fully open back up, and we are once again facing the potential re-imposition of restrictions (e.g., mask mandates, proof of vaccination, etc.) due to the surge in COVID variants, particularly Delta. It appears that the labor force participation rate will continue to be impacted by health concerns, child-care availability and any potential extension of additional unemployment benefits.

So what does all this mean? Although early estimates from GDPNow (via the Atlanta Fed) show 6.1% real growth in Q3, there might be a much wider range of outcomes, or "fatter tails," than normal. It appears that the bond markets are beginning to price in some of the tail risk, while equities remain relatively strong. Time will tell which is right.

Positives

Service and manufacturing PMIs remain very elevated for both ISM and Markit surveys

Retail sales ex auto and gas month-over-month beat expectations (1.1% vs 0.5% est)

NFIB small business optimism is approaching pre-pandemic levels (102.5)

Negatives

Continuing jobless claims have flat lined for multiple weeks (currently 3,269k)

Producer Price Index (PPI) ex food and energy were higher than expected (1.0% vs 0.5% est)

New home sales month-over-month were drastically lower than expectations (-6.6% vs 3.5% est)

EQUITY OUTLOOK

Summary

The S&P 500 climbed 2.4% in July with equity markets responding positively to improving economic conditions. Growth and value styles both rallied over the month, though the Russell 1000 Growth Index's 3.3% advance outpaced the 0.8% increase of the Russell 1000 Value Index. Sector performance was a bit scattered. Health care and real estate led the way with 4.9% and 4.4% returns respectively. Energy and financials have both been strong performing sectors year-to-date, though both lost some ground in July. Energy stocks fell 8.3% while financials dipped 0.4%. Looking abroad, the developed international MSCI EAFE Index rose 0.8%. Meanwhile, the MSCI Emerging Markets Index fell 6.7%.

Equity markets appear poised to extend the rally they've enjoyed since the depths of the pandemic induced lockdowns. Threats of new virus variants and fear of inflation will continue to spook markets over the coming months. Thus far, dips in stocks have been quickly reversed as investors have seen these as buying opportunities, given the lack of attractive investment alternatives. There is very little reason to expect this trend won't continue. Corporate earnings results have been outstanding and the healthy fundamental backdrop remains intact. We continue to believe the long-term outlook for equities is strong.

Positives

Accommodative Federal Reserve and global central bank policy

Attractive return potential relative to other asset classes

Negatives

Delta variant delays reopenings

Stock valuations may seem stretched

Rising material and labor costs

Unknowns

How long before the Fed responds to inflation

Are equity fundamental growth rates peaking

FIXED INCOME OUTLOOK

Summary

Despite two quarters of 6%+ economic growth and three months of more than 800,000 non-farm payroll gains, interest rates fell sharply in July as the Delta variant threw a wrench in the reopening story. Ironically, the resurgence of the virus means that backlogs and bottlenecks are likely to persist longer and that the inflationary impact of the reopening will stick around longer as well. With a 7.3% year-over-year increase in producer prices and a 5.4% increase in consumer prices, the markets are clearly looking through the current environment and believe in the Fed's outlook: that inflationary pressures are temporary, as is the burst in economic activity, and that there is no reason to fear that overnight rates will move sharply higher anytime soon. A drop in money market futures has also corroborated this decline in forward expectations of the overnight rate.

So while the lift-off from the current zero-bound interest rate policy is now expected to happen in early to mid-2023, the ability to raise rates is less than many previously believed. Current market pricing is consistent with our outlook that the Fed will have a difficult time moving the overnight rate much above 1% because the year-over-year comparisons of the economy will be very tough and we may actually be back in a period of very slow growth. Continuing with rate hikes in that scenario will be difficult for the Fed to justify.

In July, the 2-year Treasury note yield declined almost 7 basis points (bps) to end at 0.18%. The yield on the 10-year note dropped about 25 bps to end at 1.22%. Intraday on July 20, it declined to 1.12%, which is a technically important 50% retracement from the August 2020 low of 0.50% to the March 31 high of 1.74%. The overall Treasury market delivered a solid return of 1.36% for the month. Intermediate Treasuries returned 0.78% for the month and now have an annual return of -0.38%.

After three consecutive months of superior performance, corporate bonds delivered nearly identical returns during July with the full index up 1.37% and the intermediate index 0.79%. Given the strong performance earlier in the year, investment-grade corporate bond returns have turned positive for the year with gains of 0.08% for the full maturity spectrum and 0.26% for the intermediate maturity subset.

Given the aforementioned difficulties in achieving rate hikes, we believe that a 2-year yield near, or slightly below 25 bps is about right. The curve should steepen with longer rates gradually increasing but they are unlikely to reach the March quarter-end high of 1.75% before the end of the year.

Positives

Institutional rebalancing as equity markets make new highs

Investors now prepared for Fed tapering of QE purchases

Negatives

Delayed opening could lead to higher inflation

Massive spending proposal in Washington will require additional bond issuance

Unknowns

Longevity of Delta variant
