Investment Perspective

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CROSS CURRENTS **July, 2021**

Eighteen months after the pandemic slammed into our shores, most Americans have been able to regain a sense of normalcy. The rapid development and distribution of safe and effective vaccines has allowed communities to reopen. Meanwhile, unprecedented government support served as a financial bridge for many households and businesses while the economy was locked down.

Globally, prospects for economic recovery have brightened, particularly among developed countries whose citizens have had broad access to vaccines. The OECD now forecasts that the world economy will expand by 5.8% in 2021, up significantly from its December outlook. U.S. GDP could grow by around 7% this year, returning to pre-pandemic levels of output.

Delta force

A precondition for economic healing, vaccine deployment has been uneven across nations. But manufacturers will continue to ramp up production and aim to deliver over 10 billion doses this year. That would be sufficient volume to fully inoculate 70% of the world's population — assuming doses reach underserved regions and individuals willingly accept the vaccine.

In the meantime, the race has taken on new urgency with the emergence and spread of the highly contagious Delta variant. The World Health Organization warns that Delta is the "fastest and fittest" strain yet — potentially 60% more transmissible than the Alpha variant, which was already 50% more transmissible than the original strain of COVID-19. It will "pick off" the most vulnerable people, especially in areas with low vaccination rates.

From Sydney to Seoul and Portugal to South Africa, authorities have reinstated lockdown measures. Marking the most visible reaction to the new threat — Olympic organizers just announced that the Games would be held without spectators in the host city Tokyo.

The U.S. could see another spike in cases this summer as one-third of Americans over age 18 have yet to receive a single vaccine dose; in some states, half of adults remain

unvaccinated. For the hesitant, scientific evidence continues to mount: Studies indicate that both the Pfizer-BioNTech and Oxford-AstraZeneca vaccines are more than 90% effective at preventing hospitalizations from the Delta variant. And the Associated Press reported that only 1% of the 18,000 COVID-19 deaths in May related to fully vaccinated patients.

Wave theory

With most of the adult population vaccinated, the economic impact of another wave of U.S. COVID cases should be modest. The key, obviously, will be the extent to which any new restrictions hobble activity. Absent *Shutdown 2.0*, the recovery should continue to have traction. Importantly, consumers and businesses find themselves in much better shape today than they typically have been at the early stages of previous cycles— largely thanks to fiscal and monetary support.

During the depths of the pandemic, consumer spending slumped, particularly for services. At the same time, personal income increased from stimulus payments and enhanced unemployment benefits. Also, many white-collar workers telecommuted, with no hit to their salaries. Households have therefore accumulated $2.5 trillion of excess savings. As the country reopens, some of this cash hoard is being unleashed with a return to restaurants, theaters, sports events, and travel.

In general, corporate balance sheets are also healthy with reasonable debt levels and solid cash positions. Companies will likely boost capex to meet consumer demand and unblock supply chain jams. And the banking sector finds itself in a much stronger position this time around. Many banks over-reserved for credit losses during the recession and are reversing those charges. The Fed's 2021 stress test indicated that all 23 institutions examined had capital "well above" that required to weather a severe downturn. Those banks were given the green light to increase dividends and share repurchases.

Build and repair

The recovery could also receive a boost from stepped-up infrastructure spending. In late June, President Biden announced his support for a "framework" developed by a bipartisan group of 21 senators. Their $1.2 trillion plan calls for $579 billion in new spending focused on roads, bridges, rail, public transit, broadband internet, water and sewer pipes and the power grid.

The group must now sell the proposal to their colleagues. While infrastructure spending may be an issue that enjoys bipartisan support, there are still major differences between and even within both parties over what the spending priorities should be, and over what should be considered "infrastruc-

ture". But if Congress fails to ratify a plan, the administration could hammer one through the budget reconciliation process with a simple majority vote.

Across the pond, the European Union is kicking off a recovery program termed *Next Generation EU.* To be funded by EU-issued bonds, the €750 billion initiative is of similar scale. The funds will be split among all 27 member states in proportion to the damage inflicted by the pandemic. Nations in Southern Europe will receive the largest share of the loans and grants. As with the potential U.S. stimulus plan, NGEU should boost GDP growth over the next few years.

Labor pains

However, there are some bottlenecks that could hold back the recovery. Because of the abundance of job openings, labor market trends that usually occur in a mature expansion when unemployment is low — such as rising wages, people quitting jobs to look for others, companies citing worker shortages — are oddly happening at the beginning of this one.

As of June, total nonfarm employment stood 7 million (4.4%) below pre-pandemic levels. The unemployment rate is 5.9% compared to 3.5% in February 2020. In theory, there should be substantial slack in the labor market. Yet many establishments are struggling to attract workers. A recent National Federation of Independent Business survey indicated a record-high 48% of small business owners reported unfilled job openings.

Much of this gap can be attributed to the reluctance of lower-wage workers to return to work and forego generous unemployment benefits. The $300/week supplemental benefit had been extended until September 6th although some governors have been ending the program early. But that is not the only explanation. A flood of early retirements along with lower immigration has also reduced the labor force. And pandemic-related school closures prompted some parents to leave their jobs and stay home.

I-word

The tight labor market has begun to create wage pressures. Many service-sector firms have had to offer hourly pay above the minimum wage to draw applicants; some have begun offering signing and referral bonuses. But so far, wage growth has been constrained outside of a few lower-wage sectors like leisure and hospitality.

Commodities such as lumber, metals, agricultural products, and semiconductor chips have seen prices explode. For instance, the National Association of Homebuilders reported in April that higher lumber prices had added $36,000 to the average cost of constructing a single-family home. Such price

hikes largely reflect supply shortages that will be reversed in time. Many commodity prices have dropped back sharply over the last several months.

As for consumer prices, in both April and May, core inflation surged at rates not seen since the early 1980s. The figures caught Fed policymakers by surprise, but Chairman Powell maintains that this spike is "transitory". And indeed, much of the recent uptick has stemmed from automobile prices (new, used, and rental cars) where supply has been severely constrained. If one backs out the impact of autos and certain pandemic-impacted services (airfare, hotels, and event admissions), core CPI levels remain below their prior trendline.

Clear for now

The forces driving the inflation uptick stem from supply-side challenges. This situation should be remedied as businesses return to full capacity and rebuild inventories. But higher inflation may prove the greatest structural risk to capital markets over the next several years. Powell and Company have made clear their willingness to accept periods of above-target inflation particularly with the labor market below "maximum employment". The Fed will likely go slow for now; ultimately, rising inflation expectations could force the central bank's hand.

Assuming continued progress against the pandemic, the global economy should expand at a solid pace over the next twelve months. Corporate profits have rebounded sharply but the comparisons become tougher, so the rate of growth will naturally slow. Meanwhile, equity valuations remain somewhat stretched, already reflecting the favorable backdrop.

— Christopher J. Singleton, CFA, Managing Director

July 14, 2021