

2021 Q2 Economic Recap and Rate Outlook

The U.S. economy accelerated in the spring months as COVID-19 slowed to a crawl and consumer demand for goods and services surged. The story of the quarter was a supply-demand imbalance in everything from housing and automobiles...to jobs. The rebalancing process in the post-covid era has been hamstrung by extreme shortages as a large portion of a slumbering global economy emerges from the virus fog at the same time, demanding goods that haven't been produced.

According to CDC data, the 7-day moving average of new U.S. virus cases at the end of June was just 10,400, down from 70,700 when the quarter began and just a fraction of the 250,000 peak in early January. The percentage of the adult population in the U.S. with at least one vaccine dose had climbed to 66.5% by quarter end, but more importantly nearly 75% of the 50-and-older crowd had received at least one shot. This group had accounted for 95% of the nation's covid deaths.

New infections are fast disappearing despite steadfast pushback from a large portion of the population. In a recent Associated Press-NORC Center for Public Affairs Research poll, 34% of unvaccinated adults indicated they would "definitely" not get a shot, while 27% said they "probably" wouldn't. The hard pass resulted in an oversupply of time-sensitive vaccines, which led the Biden Administration to pledge 80 million excess doses to nations still struggling with the spread.

In mid-May, the CDC announced it was finally safe for the fully-vaccinated to set face masks aside, while leaving specific decisions to the individual states. A handful were already ignoring federal guidelines, but the CDC announcement resulted in a majority of states dropping mask mandates within weeks. This all's-clear whistle didn't actually make much difference, as most Americans were already out, making summer plans and trying to spend dollars accumulating for the better part of a year.

One of the more remarkable tales of the pandemic has been the financial health of the nation as a whole. The Federal Reserve reported the net wealth of U.S. households increased by a staggering \$13.5 trillion last year, the biggest increase in three decades of recordkeeping. The *Wall Street Journal* (WSJ) pointed out the sharp contrast with 2008 when U.S. households lost \$8 trillion. The fact that GDP growth was so anemic following "the Great Recession" was a reflection of that lost wealth and a massive hangover from the housing bubble.

The current path forward is considerably less bumpy, while at the same time more uneven as the majority of pandemic wealth accrued to homeowners and stockholders. The stock market has been steadily climbing since the November election with the S&P 500 up almost +45% year-over-year. The pandemic housing story has been told many times. There hasn't been nearly enough supply on the market to meet demand, sending home values skyrocketing. The S&P CoreLogic Case-Shiller 20-city home price index rose +14.8% year-over-year in the most recent

Scott McIntyre, CFA
HilltopSecurities Asset Management
Senior Portfolio Manager
Managing Director
512.481.2009
scott.mcintyre@hilltopsecurities.com

Greg Warner, CTP
HilltopSecurities Asset Management
Senior Portfolio Manager
Director
512.481.2012
greg.warner@hilltopsecurities.com

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April report. The biggest gain in 33 years of record keeping absolutely crushed the +2.5% pre-covid increase from 2019.

Unfortunately, only about 65% of Americans are homeowners and just 55% own stock according to a recent Gallup poll, so the wealth gap further widened. From a purely economic standpoint, this doesn't bode well for future growth.

For the time being, the vast majority of Americans, whether from stock market and home value gains, or stimulus checks and unemployment benefits, have had the capacity to spend for a while. And what wasn't spent, was saved. The personal savings rate has fluctuated wildly due to government stimulus checks but was 12.4% as of May, more than twice the savings rate at the end of the previous recession. The Conference Board measure of consumer confidence for June indicated 10.7% of Americans surveyed plan to buy an automobile within the next six months. These folks are likely to find limited choices and very few bargains. Research firm J.D. Power reported 75% of all new vehicles sold were at or above sticker price in June, more than double the pre-pandemic average. The average price for a new vehicle in May according to Kelley Blue Book was a record \$41,263, up +5.4% year-over-year. The average listing price for a used car climbed to a record \$24,414 in mid-June, up a staggering +25% from the same time period a year earlier.

There simply aren't enough cars and trucks to meet buyer demand, and this problem won't be fixed anytime soon. Time Magazine reported the typical automobile requires more than a thousand microchips. When the pandemic hit last year, people limited their driving, auto sales plunged, manufacturers canceled chip orders and chipmakers shifted output to meet surging demand for laptops, tablets and webcams. Although vehicle demand has roared back, it's impossible to simply flip the production switch back on. The microchip process takes nearly three months from start to finish, and only 12% of chips are produced domestically. This is a prime example of a supply chain we don't control.

To fix this, the Senate passed a \$52 billion bipartisan bill in June to increase U.S. semiconductor production, but new facilities will take years to build. Between now and then, countries and products will be jockeying for whatever chips are available. As a result, the global auto industry expects to slash production by -4.6% when dealer inventories are already extremely light and demand is through the roof. It's estimated the total industry cost of the lost output will top \$100 billion in 2021.

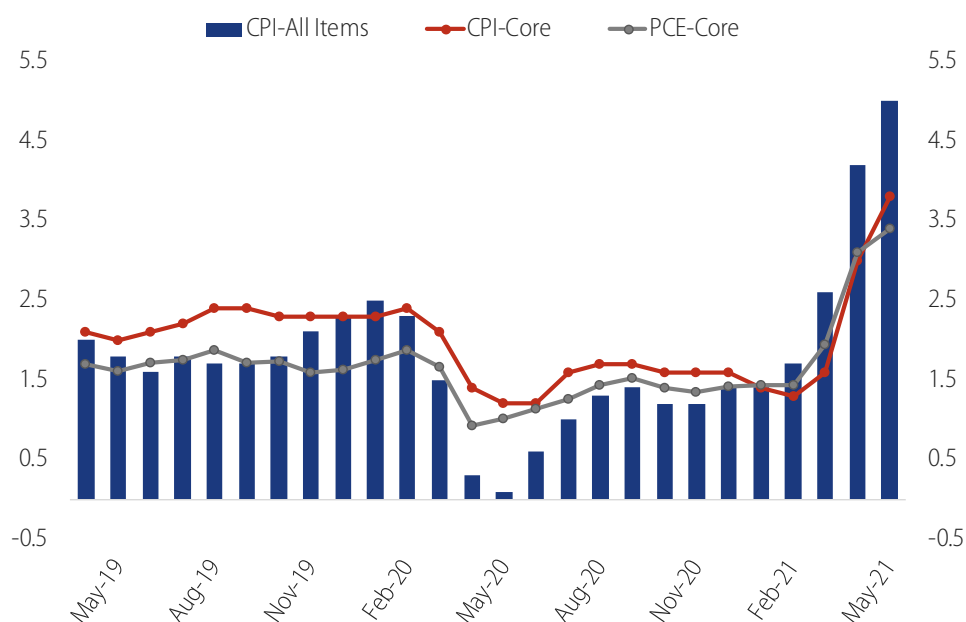
Inflationary pressure will be squarely in the spotlight for the remainder of the year and will play a major role in how long the Fed can maintain its extremely accommodative policy stance. Everyone knew year-over-year prices would jump in the spring due to the well-telegraphed "base effect." On cue, headline CPI rose +5.0% year-over-year in May, a 13-year high, while core CPI was up +3.8%, the highest in 29 years. The Fed's preferred measure, core PCE, weighed in at +3.4% year-over-year in May, also a 29-year high.

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Inflation Indicators (Year-Over-Year Percent Change)



Source: Bureau of Labor Statistics and Bureau of Economic Analysis.

As expected, the biggest increases were in transportation, travel and lodging, and restaurants and drinking establishments. All of these were sectors that were largely dormant during the depth of the 2020 shutdown and have since awoken. What wasn't widely expected was when business picked up, sidelined employees were slow to return. This forced desperate employers, particularly in low-paying service industries, to offer higher pay, bonuses, tuition reimbursement and other incentives to lure in workers.

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The most obvious explanation for why vacant positions weren't being filled was that federal benefits enacted under the CARES Act had given unemployed workers a safety net with higher pay through Labor Day. But this narrative didn't tell the whole story as there are countless reasons many haven't returned to work. Early retirement is probably the most significant and permanent of these as twice the expected number of Americans have retired in the 15 months since the pandemic began, extracting 1.2 million workers from the labor force. A more temporary reason is that tens of millions of kids are still out of school. Summer camps and daycare centers have reopened their doors, and although it's too early to get even a rough count, tales of lengthy waiting lists indicate capacity is still limited. This suggests many parents may be homebound until schools open.

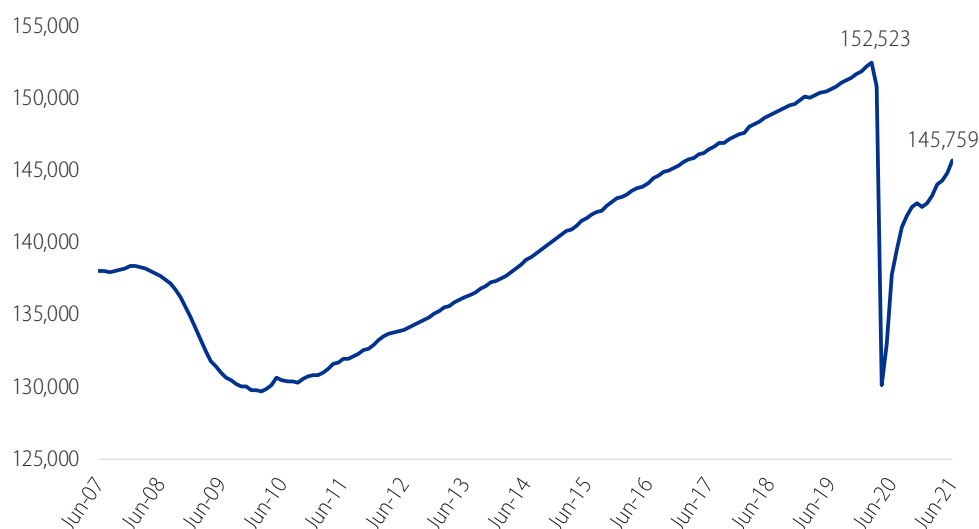
The base effect will gradually fade, but shortages of materials and labor promise to keep prices high for much of the year. When looking at prices over just the last three months (which should factor out the base effect) headline CPI was increasing at a surprisingly hot +6.9% annualized pace in May, while core CPI was rising +5.2%, well above the Fed's +2.0% flexible target. The concern is, over time people begin to expect prices to be higher in the future, which becomes a self-fulfilling prophesy. Fed officials are paying attention, but not particularly worried. Instead, the Fed is focused on returning to full employment.

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Exactly what full employment means in a post-pandemic world is far from clear. June payrolls rose by 850k but remain nearly 6.8 million below the February 2020 count. Payroll gains of a million per month for the remainder of the year would still leave a shortfall. And, at the point when all the lost jobs have returned, net job creation over a two-year period will essentially be zero. Having said that, there is still a lot of work to be done.

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Total Nonfarm Payrolls (in thousands)



Source: Bureau of Labor Statistics

Home sales have slowed in recent months as a lack of available inventory squeezes out buyers on the margin. If homebuilders can find enough skilled labor (a big if) and lumber prices continue to normalize, starts and permits should rise in coming months, and new construction should increase available supply. Several economists have mentioned that the strange pandemic housing boom represents an acceleration of intended future purchases. If this is the case, discouraged buyers could find better opportunities early next year when supply rises and rabid demand falls.

At the June FOMC meeting, Fed members finally granted some relief to the short end by making two technical adjustments.

Market yields on the extreme short end were at, or near record lows for much of the quarter, with six- and 12-month Treasury bills dropping to 0.01% and 0.03% respectively in mid-May. Three-month bill yields and overnight repo traded *below zero*, forcing local government investment pools and money market funds (straining with record balances) to slash fees just to keep daily rates positive. At the June FOMC meeting, Fed members finally granted some relief to the short end by making two technical adjustments. They increased both interest on excess reserves (IOER) and the reverse repurchase rate by 5 basis points, creating some breathing room while maintaining easy policy.

The June FOMC meeting was also notable because of a largely unexpected change in the "dot plot." The number of committee members forecasting at least one increase in the overnight funds rate next year climbed from four to seven, while 13 of 18 Fed officials now envision at least one hike in 2023, up from seven at the March meeting.

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Of these 13 members, seven see at least two hikes in 2023. Powell cautioned that these rate projections do not represent a plan or a consensus, but the short end took notice as the two-year Treasury yield climbed to 0.29% and the three-year to 0.49%, both nearly triple 2021 lows.

Q2 Interest Rates

		Fed Funds	3 mo. T-bill	12 mo. T-bill	2 yr. T-note	5 yr. T-note	10 yr. T-note
Last	3/31/21	0.00%-0.25%	0.01%	0.05%	0.16%	0.94%	1.74%
High			0.04%	0.08%	0.27%	0.98%	1.72%
Low			0.00%	0.03%	0.14%	0.71%	1.43%
End	6/30/21	0.00%-0.25%	0.04%	0.07%	0.25%	0.89%	1.47%

Source: U.S. Department of the Treasury.

Economic and Interest Rate Outlook

Third quarter data will be closely watched. The expectation is that growth will slow in the absence of government stimulus and that inflationary pressures will retreat. The fact that market yields on the long end are well below first quarter highs indicates investors are on board with the inflation outlook.

The initial second quarter annualized GDP readings won't be released for another month, but the Atlanta Fed's GDPNow measure was +8.6% as of July 1st, and the June Bloomberg economists survey showed an average forecast of +8.9%. If GDP came in at +7% for all of 2021, it would be the strongest annual growth rate in 37 years, and if growth reached +8%, it would be the strongest expansion since 1951. Before tapping the brakes, the Fed will consider that the U.S. economy *contracted* last year and net job gains over the last 15 months are down 6.8 million, so there's considerable lost ground to make up. They'll also recognize that current growth has been fueled by extreme government spending, and most of that support is scheduled to end soon.

Federal student loans payments were deferred and interest stopped accruing last spring. This relief, provided to approximately 42 million Americans, will expire on Oct. 1, 2021. Both eviction and foreclosure moratoriums were just extended another month but are now expected to expire on July 31st. An estimated 2.3 million homeowners and 6.2 million renters (approximately one in seven) were behind on their payments in March according to a Harvard University housing report. Congress has provided tens of billions in government support to renters and homeowners which should take care of most delinquent payments, but going forward, there will be bills to pay that promise to restrain discretionary spending.

Price pressure should moderate as supply catches up with demand, but there are big pockets of more persistent inflation that will disproportionately affect lower income earners: rent and gasoline. The average pump price ended the quarter at a

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seven-year high, while apartment rental prices have soared +9.2% during the first six months of 2021. Both of these will weigh heavily on consumers on the margin.

Fed members are mostly on the same policy page, although there are a few prominent hawks. Dallas Fed President Robert Kaplan told the WSJ it will soon be time to pare back on QE purchases, and St. Louis Fed President James Bullard told a CNBC audience that the Fed might consider an interest-rate hike as soon as late 2022, a comment echoed days later by Boston Fed President Eric Rosengren. Contrarians always take centerstage, but the majority of Fed officials still expect the first rate hike no sooner than mid-2023. And long before that first hike, the FOMC will reduce asset purchases and stop reinvestment of principal and interest payments.

If by then GDP has returned to a more moderate pace and inflation has slipped back below target, the urgency may have passed, allowing the Fed to maintain easy policy for longer. In December 2008, the last time the Fed cut to zero, it took seven years before the first quarter point increase and then another full year before they tightened again. Although controlling debt service costs isn't a Fed mandate, the national debt has almost tripled since 2008, so any rate hikes will have an immediate and significant impact on the nation's debt service costs.

A continuation of the historic recovery seems certain for the next several quarters, but as government support fades, expect growth to moderate over time. The June Bloomberg survey indicates both an average Q4 2022 GDP forecast of +2.3% and average core PCE at +2.1%. If these cooler forecasts prove accurate, the initial hike in the overnight funds rate could be postponed to late 2023 or beyond.

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