2021 Q3 Economic Recap and Rate Outlook

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

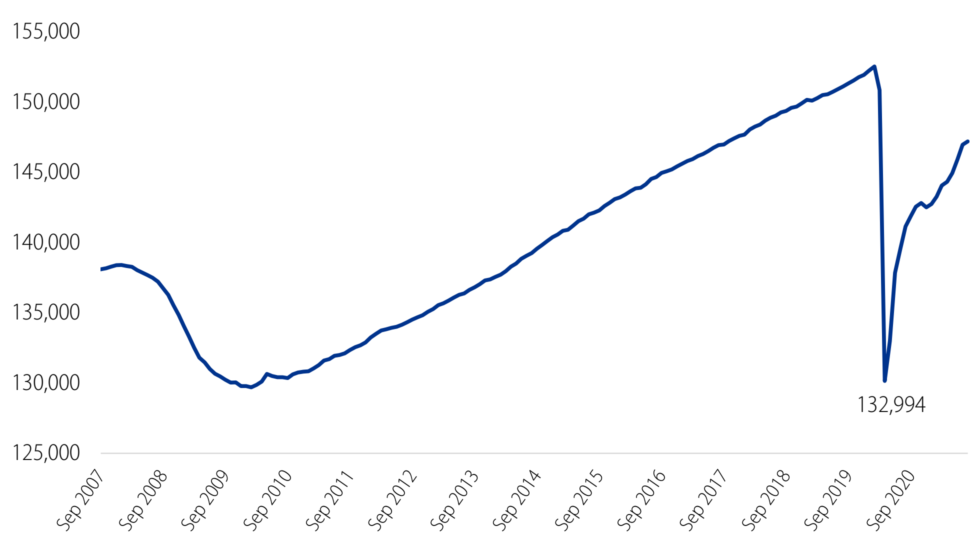
The biggest surprise of the third quarter was the rapid spread of the Delta variant which abruptly reversed a five-month downtrend in new Covid cases. Virus concerns infected growth for much of the quarter, although September showed a steady decline in the spread and some corresponding improvement to the data. The 7-day average of new COVID-19 cases actually peaked at 161k on the first day of September before dropping -55% over the course of the month as another 10 million Americans received their first shot, boosting the total above 210 million, or 65% of the U.S. population. As the virus receded, market focus turned to the mid-month FOMC meeting for indications of when committee members would begin reeling-in some of the Fed's accommodative monetary policy.

Chairman Powell told reporters in the post-meeting press conference on September 22nd that QE asset purchases were expected to wind down by mid-2022. Although an official start date has not been set, tapering will almost certainly begin later this year. The FOMC meeting also brought a fresh "dot plot" that was a bit more aggressive in terms of future interest rate increases. Of course, the Fed's path is subject to change depending on labor market and inflation trends.

Non-farm payrolls, tainted by the latest virus wave, rose by just +235k in August, an unexpected deceleration from the million-plus pace of the previous two months, leaving payrolls 5.3 million below the pre-pandemic total. At first glance, it might appear those jobs are missing, but in reality, it's the workers that are absent.

At first glance, it might appear those jobs are missing, but in reality, it's the workers that are absent.

Total Nonfarm Payrolls (in thousands)



Source: Bureau of Labor Statistics.

Employment website *Indeed.com* reported a 40% increase in job postings since the pre-pandemic level of February 2020. The Labor Department reported a record 10.9 million job openings in the U.S. at the end of July, the equivalent of 1.3 posted jobs for every jobseeker. With federal unemployment benefits ending on September 6th for an estimated 11 million Americans, significant numbers of open positions will be filled in the upcoming months, but the longer term outlook will depend on the pandemic hangover.

Part of this hangover is related to school reopening. A survey from the Census Bureau released last May showed approximately 20% of prime age workers with Pre-K children reported disrupted access to childcare, while the number of Americans homeschooling their kids has doubled over the past year from 2.5 million to 5 million.

The labor shortage has been a problem for years as the number of working-age Americans has been declining since 2018. Covid has convinced millions of older workers already on the verge of retirement (in many cases with pandemic-bolstered household net worth) to exit the workforce early, extracting decades of skill and experience that younger workers can't match. Compounding the problem and draining the labor pool are countless millions unable to pass a drug test. Amazon responded in June by dropping the requirement that delivery drivers be screened for cannabis and believes this action could increase the applicant count by 400%.

Covid has convinced millions of older workers already on the verge of retirement (in many cases with pandemic-bolstered household net worth) to exit the workforce early, extracting decades of skill and experience that younger workers can't match.

The National Federation of Independent Businesses survey for August showed job vacancies at the highest level in series history, and comments from business owners mentioned extreme difficulty finding and retaining workers. A record 41% of small businesses have recently increased worker pay, while 26% plan to raise compensation in the next three months. With such a shallow labor pool, the top business concern has shifted to the *diminished quality of new hires*. An August PricewaterhouseCoopers survey showed 88% of employers were experiencing higher than normal turnover, while two-thirds of workers surveyed were looking for a new job, double the percentage from three months earlier.

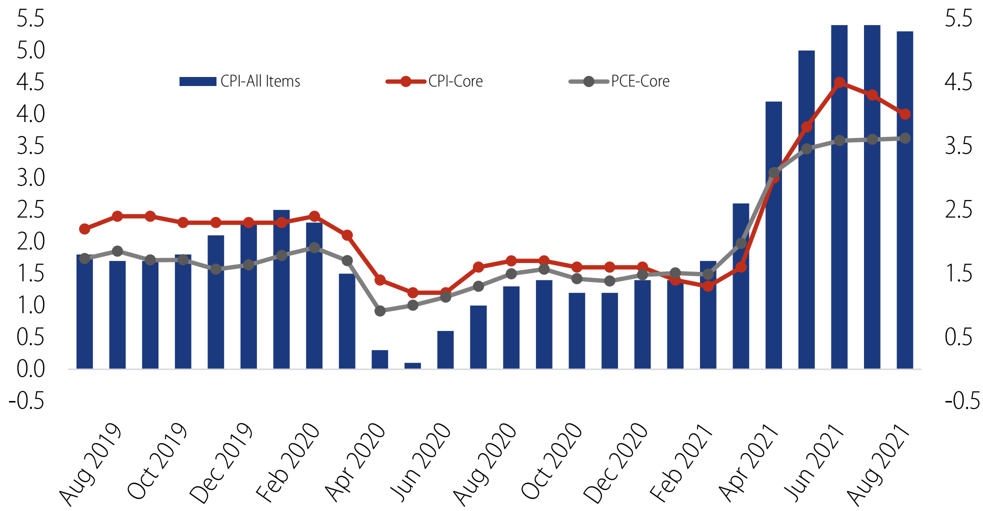
A record 41% of small businesses have recently increased worker pay, while 26% plan to raise compensation in the next three months.

Employers unable to fill open positions and retain workers have the choice of limiting operating hours, which reduces revenue, or providing overtime pay for existing workers, which increases costs. Or both.

Consumers will be paying higher prices for food, clothing and transportation as inflationary pressures remain extremely elevated, well beyond the "transitory period" Fed officials have repeatedly referenced. On a year-over year-basis, headline CPI was up +5.3% in August, down from +5.4% the previous month, while core CPI climbed +4.0% on a year-over-year basis following a +4.3% annual increase in July. The simple fact that the indexes are moving lower may have provided some comfort, but inflation remains stubbornly near thirty-year highs. Core CPI is running at an annualized six-month pace of +6.4%, while the headline is up +7.4%.

The simple fact that the indexes are moving lower may have provided some comfort, but inflation remains stubbornly near thirty-year highs.

Inflation Indicators (Year-Over-Year Percent Change)



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

The underlying reason for the sharp rise in price pressures points squarely to the global pandemic and how economies around the world have responded by adding massive amounts of liquidity. The obvious problem is simply that demand for goods and services far exceeds supply, but in the new Covid-tainted economy, the issue goes much deeper. Consumers in the U.S. have amassed significantly more spending capacity over the past year, at the same time the factories that produce these goods are grappling with a generational labor shortage, Covid infections and ongoing supply chain issues. After the goods have been produced, companies face not only a massive increase in shipping and transportation costs but in many cases lengthy delays in getting goods to market.

After the goods have been produced, companies face not only a massive increase in shipping and transportation costs but in many cases lengthy delays in getting goods to market.

Bloomberg reported that container ship ports around the nation are severely backed up. The Los Angeles-Long Beach port, the ninth largest in the world- responsible for 40% of U.S. container imports and 30% of exports- has seen volume more than double since the before the pandemic. This has resulted in a record 62 ships waiting to dock in September with an average delay of 10 days. Before Covid, it was rare for even a single ship to be waiting offshore. This bottleneck has been costly, not only in terms of dormant labor but also container shipping costs. The Wall Street Journal reported in September that spot container shipping rates from Asia to the West Coast have risen +500% year-over-year and +1,400% over the same period in 2019.

Once unloaded, the cargo faces additional problems with a severe shortage of truck drivers. In 2019, according to the American Trucking Association (ATA), the long-haul trucking industry was already short more than 60,000 drivers. With annual turnover above 90% and the industry recently prohibited from hiring anyone with DUI's or substance abuse charges on their record, the ATA estimates a shortage of 160,000 drivers by 2028. This driver shortage is expected to translate into higher transportation costs and expedited automation.

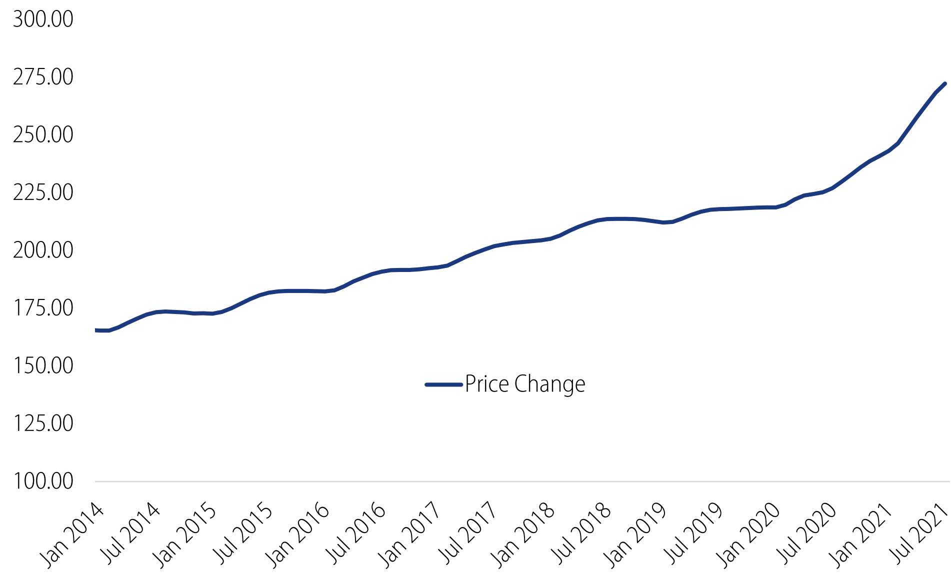
The ATA estimates a shortage of 160,000 drivers by 2028. This driver shortage is expected to translate into higher transportation costs and expedited automation.

Construction costs, on the other hand, may be coming down. Lumber prices have been on a wild ride all year, up over +300% versus pre-Covid prices in May before plunging back near lows for the year by quarter end. The lumber snapback was a classic example of consumers (and homebuilders) balking at sky-high prices until production was able to catch up. Since the beginning of 2020, lumber costs are still up roughly +25%. Material costs have contributed to record home prices, but the housing story remains one of limited supply.

Home sales slowed during the quarter while prices continued to soar as buyers fought over a depleted inventory of available homes. The S&P CoreLogic Case-Shiller 20-city home price index was up an annualized +20% in July. If you step back to July 2019, the index was up just +2% on a year-over-year basis.

The lumber snapback was a classic example of consumers (and homebuilders) balking at sky-high prices until production was able to catch up.

S&P/Case-Shiller Composite 20 Home Price Index



Source: Case-Shiller.

Zillow housing data, which differs from S&P CoreLogic in its timeliness and scope, showed a +17.8% annual price increase in August. This is well above the housing bubble peak of +11.9% in October 2005. The crazy thing about residential inflation is that it hasn't yet been captured in the consumer price index. The recently ended federal eviction moratorium had limited rent increases during much of the pandemic, while higher home prices represented by the owner's equivalent rent (OER) component typically take a while to flow into the index.

According to J.D. Power, the average sales price for a new vehicle was $42,802 in September, up almost +19% year-over-year.

The auto story is similar to the housing story with solid consumer demand overwhelmed by low inventory and high prices. *Edmunds.com* reported U.S. automakers sold just over 1 million vehicles in September, the lowest sales month of the year. Total third quarter unit sales were approximately 3.4 million, down -13% year-over-year and -26% for the quarter. According to *J.D. Power*, the average sales price for a new vehicle was $42,802 in September, up almost +19% year-over-year, while used car prices are up roughly +32%.

The available inventory of new cars in the U.S. is down 70% from the pre-pandemic levels. This has everything to do with the inability to find necessary parts, specifically microchips. The well-documented chip shortage isn't expected to catch up with industry demand until late 2022, according to analysts from *IHS Markit*. Taiwan Semiconductor Manufacturing Co. (TSMC) has promised to increase chip shipments by 20% to 30%, but this looks like a drop in the bucket when considering the thousands of barren dealer lots throughout the country and presumably the world. Eventually, the supply will catch up, but it'll be years. In the meantime, the average age of vehicles on U.S. roads has climbed to a record high of 12.1 years.

The well-documented chip shortage isn't expected to catch up with industry demand until late 2022, according to analysts from IHS Markit.

The Fed is arguably meeting its employment mandate as the jobs themselves have mostly returned, but their mandate for stable inflation is well off the mark. Strong consumer demand paired with rising labor costs, the near-term arrival of higher housing costs in the price indexes, and severely challenged global supply chains indicate inflation could remain extremely elevated well into next year.

As Americans waited on new vehicles and homes, they threw more and more dollars into the stock market. Individuals added a record $16 billion to stocks and ETFs in July and another $13 billion in August; and were promptly rewarded as both the NASDAQ and S&P 500 reached new record highs in early September. After that point, stocks began to sink as the markets turned their attention to an increasingly hawkish Fed and the rising threat of a default on government debt, unless the debt ceiling is raised …for the 88th time since 1959.

Strong consumer demand paired with rising labor costs, the near-term arrival of higher housing costs in the price indexes, and severely challenged global supply chains indicate inflation could remain extremely elevated well into next year.

GOP leaders are balking at the massive amount of proposed new spending under Biden's "Build Back Better" infrastructure plan and forcing the Democrats to use their razor-thin majority to raise the debt ceiling themselves. However, as of quarter end, two blue Senators were holding out *and the clock is ticking*. Treasury Secretary and former Fed Chair Janet Yellen recently warned the Treasury could run out of money on October 18th. She went on to tell congressional leaders that a default on America's debt obligations would be "unthinkable" and "would have absolutely catastrophic economic consequences."

…And that's where the third quarter ends, with retreating Covid cases, an overabundance of job openings, a baffling shortage of workers, stubborn inflationary pressure and shifting Fed policy, all tied up in a tight political knot that could lead to a default on Treasury obligations at a time when the entire world is awash in liquidity.

This massive liquidity continues to put downward pressure on bond yields, which otherwise might be trending much higher. Yields on the long end of the curve moved around quite a bit throughout the quarter but changed surprisingly little from the beginning to the end. In the absence of a severe economic slump, economists see a gradual rise in yields over the next six quarters as the Fed reverses course.

…And that's where the third quarter ends, with retreating covid cases, an overabundance of job openings, a baffling shortage of workers, stubborn inflationary pressure and shifting Fed policy, all tied up in a tight political knot that could lead to a default on Treasury obligations at a time when the entire world is awash in liquidity.

Q3 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	6/30/21	0.00%-0.25%	0.04%	0.07%	0.25%	0.89%	1.47%
High			0.06%	0.07%	0.30%	1.02%	1.53%
Low			0.02%	0.06%	0.17%	0.65%	1.17%
End	9/30/21	0.00%-0.25%	0.03%	0.07%	0.28%	0.97%	1.49%

Source: U.S. Department of the Treasury.

At the moment, the best bet is for a quarter point hike 15 to 18 months from now, but there are a number of influencing factors in play that could alter the timing.

Economic and Interest Rate Outlook

Fed officials recognize that that the need for aggressive monetary policy has passed. The QE taper is likely to begin in December and finish six to nine months later. Only then will the Fed consider an increase in the overnight target rate. At the moment, the best bet is for a quarter point hike 15 to 18 months from now, but there are a number of influencing factors in play that could alter the timing.

The first is payroll growth, which slowed significantly in August but is expected to accelerate between now and year end. Powell has made it clear that the Fed would like to see further progress on the labor front. The number of employed Americans is still 5.3 million short of the pre-pandemic peak, even though the jobs themselves appear to have returned. A reduction in the number of available workers has a corresponding negative effect on GDP growth, unless productivity increases to make up the difference. Consulting firm *Korn Ferry* estimates a global labor shortage of 85 million skilled workers by 2030, suggesting the problem isn't short-term. It also opens the door to increase the pace of automation. All in all, it's hard to reconcile the extreme labor shortage with Powell's lofty goal of bringing the unemployment rate back to the pre-pandemic low point.

All in all, it's hard to reconcile the extreme labor shortage with Powell's lofty goal of bringing the unemployment rate back to the pre-pandemic low point.

The unexpected resignations of Boston Fed president Eric Rosengren and Dallas Fed president Robert Kaplan has further muddied Fed waters. Both are inflation hawks, leaning toward tighter Fed policy, but they could be replaced in the future with more dovish members.

But even the doves are unlikely to believe inflationary pressure will vanish anytime soon. Lean housing and vehicle inventories promise no near-term relief. The University of Michigan Consumer Sentiment survey for September showed the percentage of respondents believing it's a bad time to buy a house has climbed to 66%, identical to the percentage believing it's a bad time to buy a vehicle.

On the other hand, demand for holiday purchases should be the strongest in years, though tardy shoppers will be challenged by empty shelves and a lack of accustomed sale items. A new report by *S&P Global Market Intelligence* warns that companies will face product shortages and higher prices as they attempt to stock up for the holidays, while producers that haven't adapted to the longer lead times for

Demand for holiday purchases should be the strongest in years, though tardy shoppers will be challenged by empty shelves and a lack of accustomed sale items.

shipping may find their goods stuck at sea waiting for an opportunity to dock.

A bright spot for seniors struggling with higher prices is that the annual cost of living adjustment (COLA) for Social Security recipients is likely to be the biggest since 1982. The Senior Citizens League recently estimated the COLA increase for 2022 would be around +6.0%. By comparison, Social Security benefits increased by just +1.3% in 2021.

A bright spot for seniors struggling with higher prices is that the annual cost of living adjustment (COLA) for Social Security recipients is likely to be the biggest since 1982.

The Fed typically cools inflation by ratcheting interest rates higher to slow economic growth, but as monetary policy is set to fade, fiscal policy is on the verge of expanding at an unprecedented pace. A $1.2 trillion infrastructure bill passed the Senate by a 69-30 margin in August but hasn't yet been voted on by the House, while a proposed $3.5 trillion budget reconciliation bill has stalled with no GOP support and just 48 supporters among the Democrats. With bill passage intertwined with the debt ceiling, the United States finds itself in the unthinkable (but still extremely unlikely) position of defaulting on its debt obligations.

Politics are likely to drive the markets in October, adding a big dose of volatility and likely nudging market yields higher. Assuming congressional leaders are able to navigate through this month's political turmoil without causing too much damage, and the next Covid wave isn't too disruptive, GDP growth is actually expected to pick up during the final quarter of 2021. *If lawmakers fail to act in time, all bets are off.*

Politics are likely to drive the markets in October, adding a big dose of volatility and likely nudging market yields higher.