Q3 2021 Economic Outlook

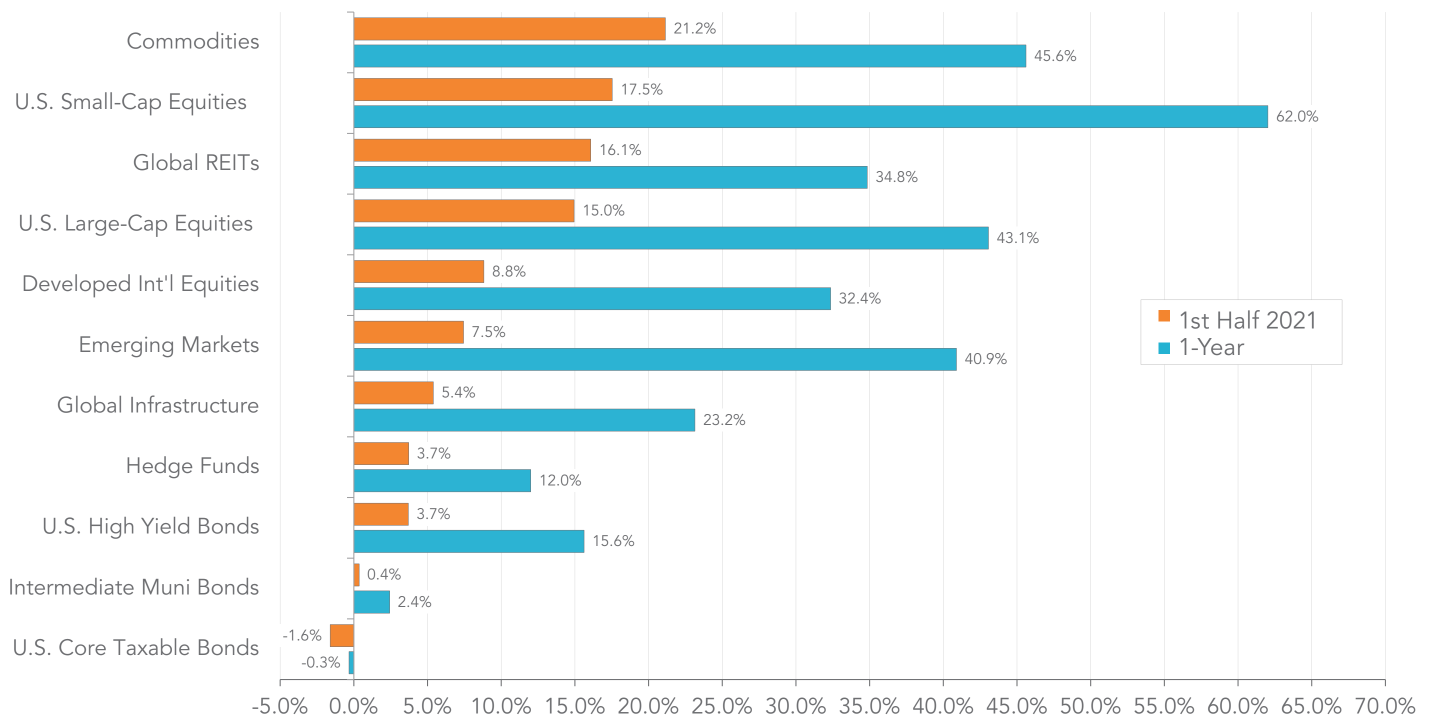
By CIO Gino Perrina & LNWM Investment Strategy & Research

NEARLY FREE MONEY AND ITS CONSEQUENCES

> “The first lesson of economics is scarcity: There is never enough of anything to satisfy all those who want it. The first lesson of politics is to disregard the first lesson of economics.”
>
> **– Thomas Sowell**

There are few, if any, places I can think of that I'd rather be than Seattle in the summer. Those of you fortunate to call the Northwest home know the unbeatable combination of natural beauty and temperate climate we enjoy. This summer has so far been one of the nicest I can remember and the forecast looks like that will continue. The prognosis for the US economic recovery looks equally bright, although much like the triple-digit temperatures we uncharacteristically experienced in June, there are clearly risks of overheating.

The global pandemic caused a collapse in economic activity during 2nd quarter 2020 that was followed by an increasingly strong surge toward year-end. That surge has continued into 2021 as consumer spending has rebounded along with corporate investment, all fanned by the flames of government stimulus and incredibly low interest rates. At the current pace, GDP in the US is set to fully recover to pre-pandemic levels before the end of this year and possibly the 3rd quarter. There is no doubt that economic revival has accelerated into 2021, as we had anticipated. Our year-end portfolio allocation decisions have performed well as a result.



Source of Data: Morningstar, Bloomberg, Hedge Fund Research, ICE Data Services.

THE DEBT DILEMMA

Per usual, however, we are asking ourselves, 'what's next?' Given that we are at an incredible juncture economically, with an unwritten playbook, that question is even more difficult than normal to answer. Strong economic growth has come at a price. As a nation, we are on track to hit a record high debt-to-GDP ratio by the start of October (end of fiscal 2021). By many estimates, the combined monetary and fiscal stimulus applied in the last year was *four times* that of the Global Financial Crisis.

In one of our 2020 quarterly Outlooks, I wrote about the necessity of stimulus but also our concern over rising levels of debt. To some I may sound like a broken record, having said repeatedly over the past year that the US risks a sharp rise in inflation along with violent swings in economic activity if our government fails to control spending and debt monetization. Economic history shows the potential problems that can arise with this trajectory.

Unfortunately, talk of a balanced budget is heard no more. Quite the contrary: nearly $4 trillion in additional federal spending is currently being debated in Congress. I am encouraged by the words of Fed Chairman Powell indicating his willingness to curtail monetary stimulus on signs that inflation is taking hold; this would likely begin with the Fed tapering its $120 billion a month in bond purchases, although no timeline has been set for that.

Somewhat surprisingly, US interest rates (as measured by the yield on 10-year Treasuries) have fallen in the past month to the lows seen back in February, indicating a lack of investor concern about inflation. Without question, there are multiple sides to the inflation argument, but it is definitely a concern at this point, and markets can reprice very quickly while portfolio re-allocation takes much longer.

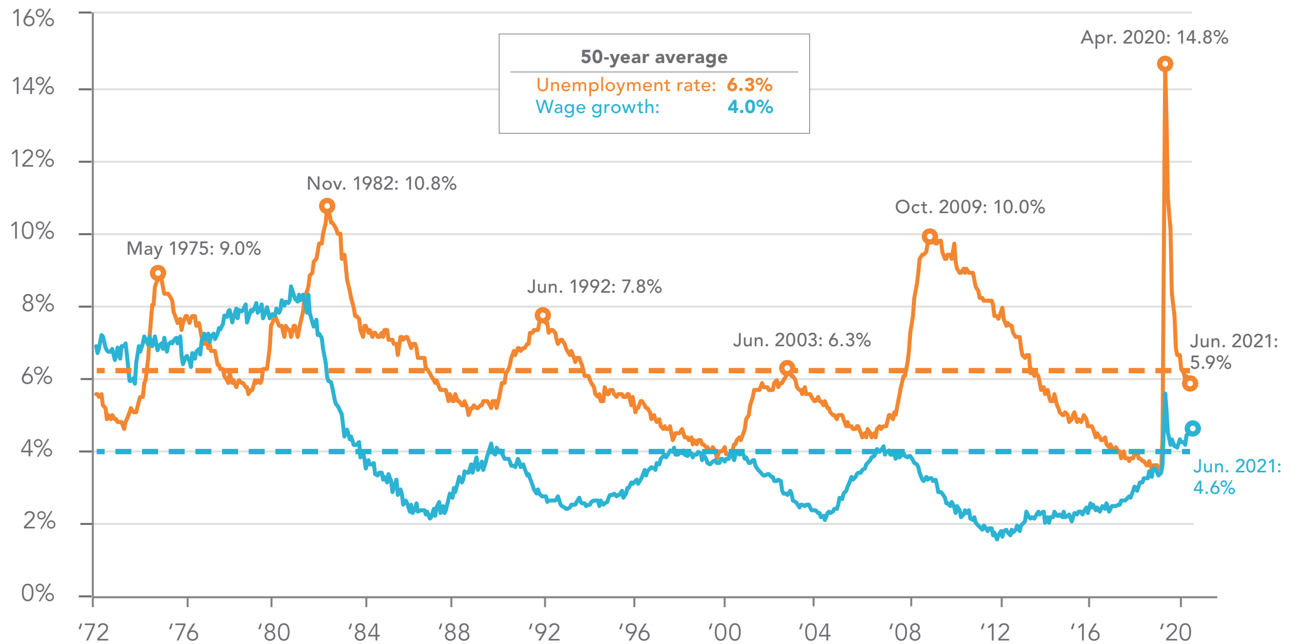
WHAT IS CONCERNING

What we have seen is dramatically higher prices in many commodities, which directly impact consumers and consumer spending. Those who believe inflation will be transitory, including Fed Chair Powell, point to supply/demand imbalances that will correct in time. However, one key component of inflation – wage increases — tend to be "sticky" once initiated. And we are seeing significant wage increases due to strong demand for labor, particularly for lower-wage jobs.

We would argue that a pay raise for lower-wage workers should be welcomed and that these increases are not likely to be transitory. The labor shortage could ease when extended unemployment benefits end in September, but there's not likely to be much slack in what is a very tight job market – a record amount of job openings (9.2 million recently), equivalent to one job per unemployed worker.

Companies can pass on higher operating costs (for raw materials, components, and wages) to consumers by raising prices. And many are doing so (consumer prices were up 5.4% in June 2021 vs. June 2020). But they can do this only up to a certain point. Another corporate profit booster since 2018 – lower taxes — are likely to be less of a tailwind under the Biden administration.

This begs the question I have repeatedly received from clients recently: are equities overvalued? As with 'what's next,' this is something we ask ourselves daily. Earnings reports for S&P 500 companies have certainly been robust so far in 2021 in comparison to the height of the pandemic in spring



Source of Data: BLS, FactSet, J.P. Morgan Asset Management.

2020. However, corporate earnings growth is likely to subside in the second half of the year. US equity markets are up about 15% year-to-date but it has been anything but a predictable path to this point. We've seen various sector and industry rotations, which we would interpret as capital markets struggling to assign valuations. Given current interest rate levels and earnings growth prospects, we think the equity market is fairly valued, but the first half of this year is a reminder of how fickle capital markets can be.

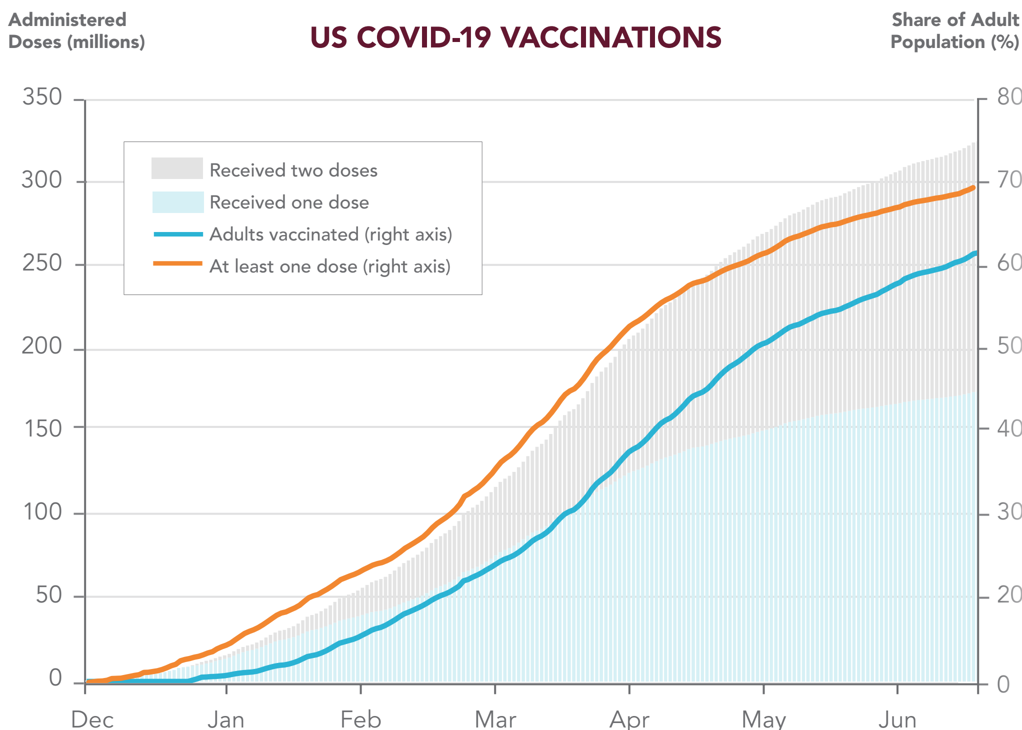
WHAT WE'VE DONE/ARE DOING

During 2020 and its many unique challenges, we made some shifts in portfolio allocations that reflected the changing environment. As I've already mentioned, we believed the fiscal and monetary stimulus being applied globally would trigger an economic rebound, though we could not have foreseen how quickly we are nearing full recovery. In response to that, we made two key changes in LNWM portfolios: 1) increased exposure to equities globally and lowered cash; 2) maintained our focus on fixed-income holdings that have lower sensitivity to rising interest rates.

Both changes have been additive, although the benefit of limiting interest rate risk was somewhat erased starting at the end of the 2nd quarter. Nonetheless, LNWM portfolio performance overall has been robust in the first half of 2021. At this time, no further changes are planned although we are constantly evaluating our positioning. One possible trigger of allocation changes would be significant and sustained increases in Treasury bond yields.

Q3 2021 KEY ECONOMIC DRIVERS

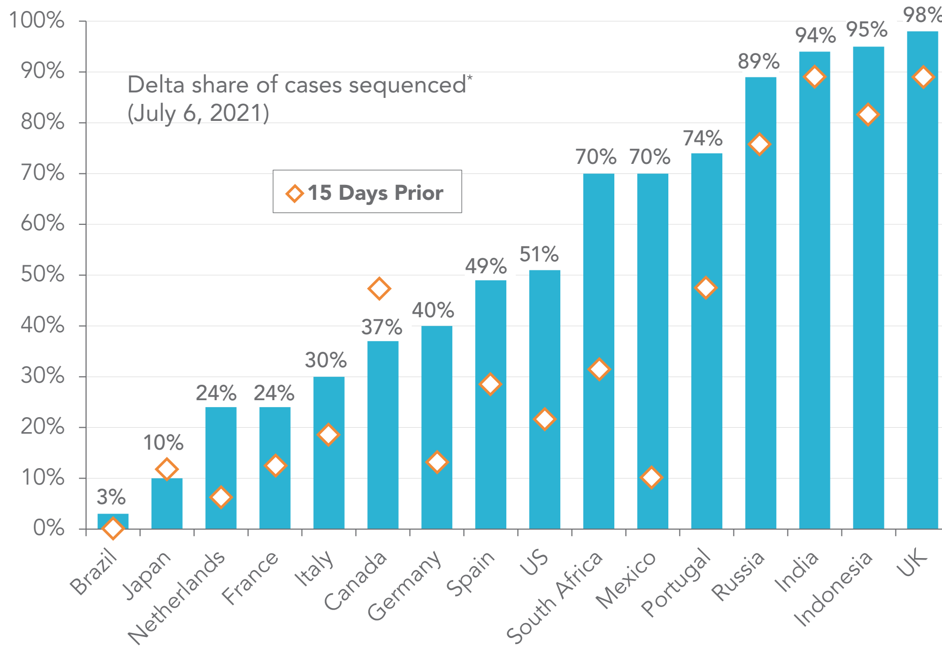
- **Inflation –** We've said enough about inflation and our concerns. However, what is equally important is capital market reaction to hints of higher inflationary pressures. The most recent Consumer Price Index data showed a monthly increase of 0.9%, the highest since 2008 and almost double expectations. Yet, the 10-year US treasury yield was unchanged. Similarly, when Chairman Powell indicated his willingness to reevaluate stimulus measures, market reaction was somewhat muted.
- **Corporate Earnings –** The momentum in corporate earnings growth that began late last year has continued into 2021, with huge increases relative to last year when the economy shut down. This has moved equity prices to record highs. Going forward, we believe equity valuations are dependent on these two things: 1) continued strong earnings growth; and 2) low interest rates. Both of these factors could come under pressure in the coming year.
- **Fiscal/Monetary Policy –** Most Americans have benefitted in some way (and to verifying degrees) from the easy money that has fueled the economic recovery. However, there needs to be a plan for how we move away from the current state. We believe an aging population, a massive amount of savings, foreign demand for US bonds and other structural factors will keep US interest rates relatively low. Yet massive borrowing by the US can only continue if the US dollar retains its status as the world's reserve currency. Admittedly, this is a long-term risk, but investors will begin to question the dollar if US debt becomes burdensome; for instance, if the average interest rate the US pays on its debt is consistently higher than US GDP growth.



Source of Data: Oxford Economics/Haver Analytics.

The US has done a relatively good job vaccinating the population, allowing for broad economic reopening. More than 70% of US adults have had at least one dose but surveys suggest that the majority of those willing to be vaccinated have already started the process. While this might put herd immunity out of reach, it does suggest Covid-19 will be a manageable threat going forward.

THE DELTA VARIANT IS SPREADING RAPIDLY IN MANY COUNTRIES



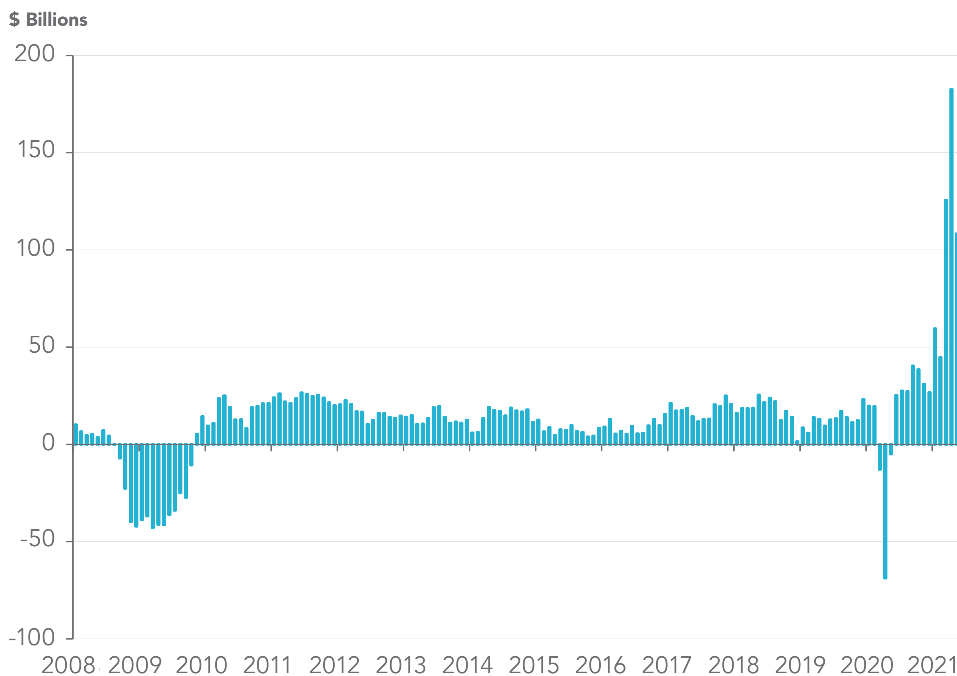
*Sequenced cases are a subset of confirmed cases that are examined more closely and categorized into variants.

Source of Data: Department of Labor, Goldman Sachs Global Investment Research.

The Delta variant of Covid-19 has spread rapidly around the world, with the UK's dramatic increase in new cases indicating the high level of transmission. Delta is forecasted to become the dominant Covid strain around the world in the next few months and is already spreading quickly in the US. While Delta is causing a surge in cases even in countries with high vaccinations rates, both hospitalizations and deaths have been rather modest so far. This gives us reason to believe there won't be extensive new shutdowns.

SURGE IN US RETAIL SALES

Change over past 12 months, seasonally adjusted



Source of Data: FRED, US Census Bureau.

As the US economy reopened, consumers were ready to spend. Retail sales skyrocketed to the highest levels in over a decade driven by government stimulus payments and higher savings. While the impact of stimulus checks and extra unemployment benefits will decrease in the months ahead, consumers will continue to spend, given pent-up demand for services like dining out and travel.

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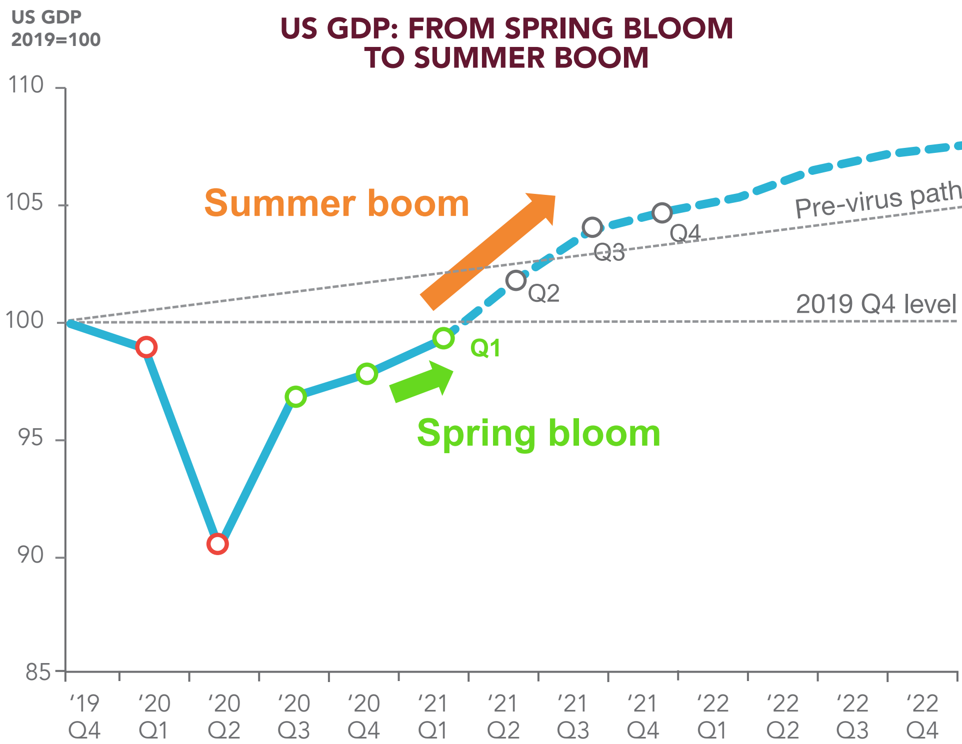
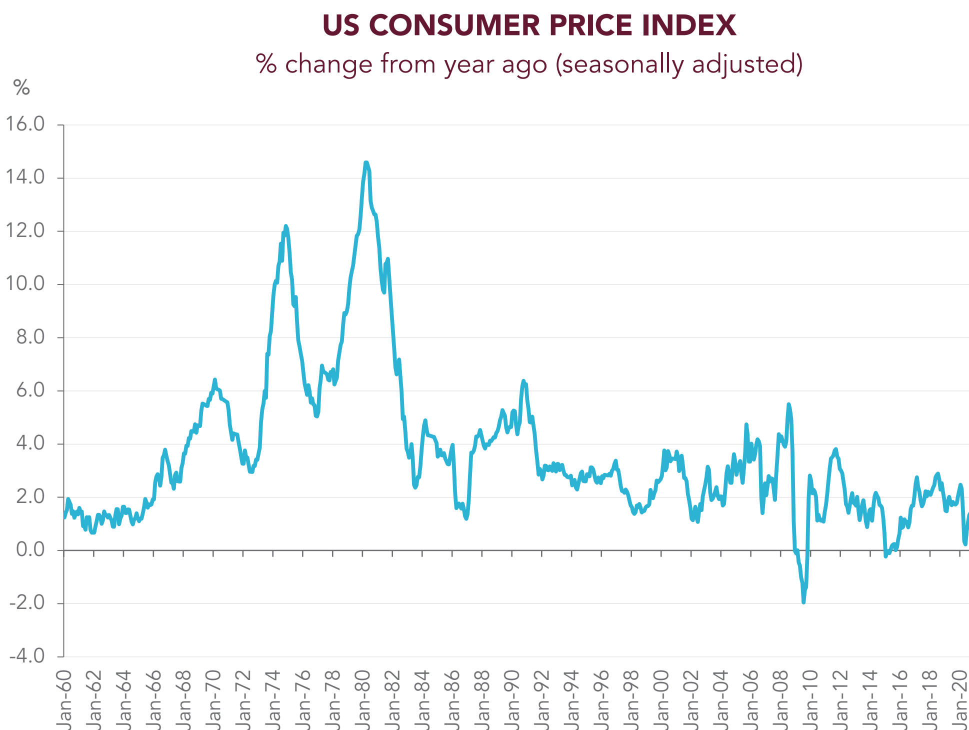


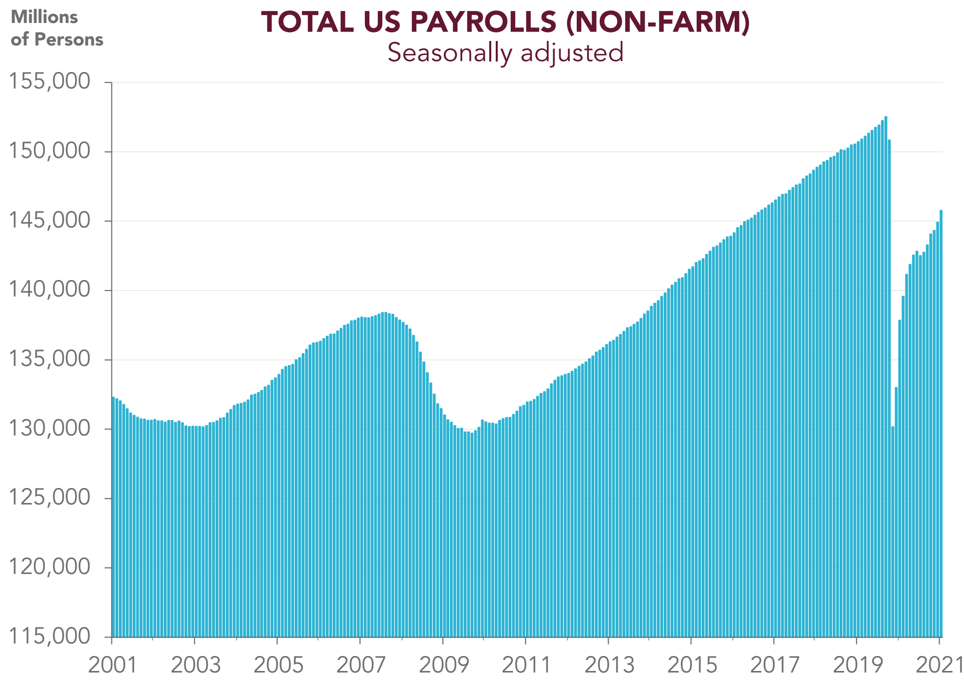
Source of Data: Oxford Economics.

Forecasts for US economic growth anticipate higher than normal expansion throughout this year based on a variety of factors: healthier and more confident consumers with higher savings and unspent stimulus money; and additional government spending to fund programs like infrastructure upgrades and support for families with children. Growth in 2022 should revert to a more normal pace.



Source of Data: FRED, BLS.

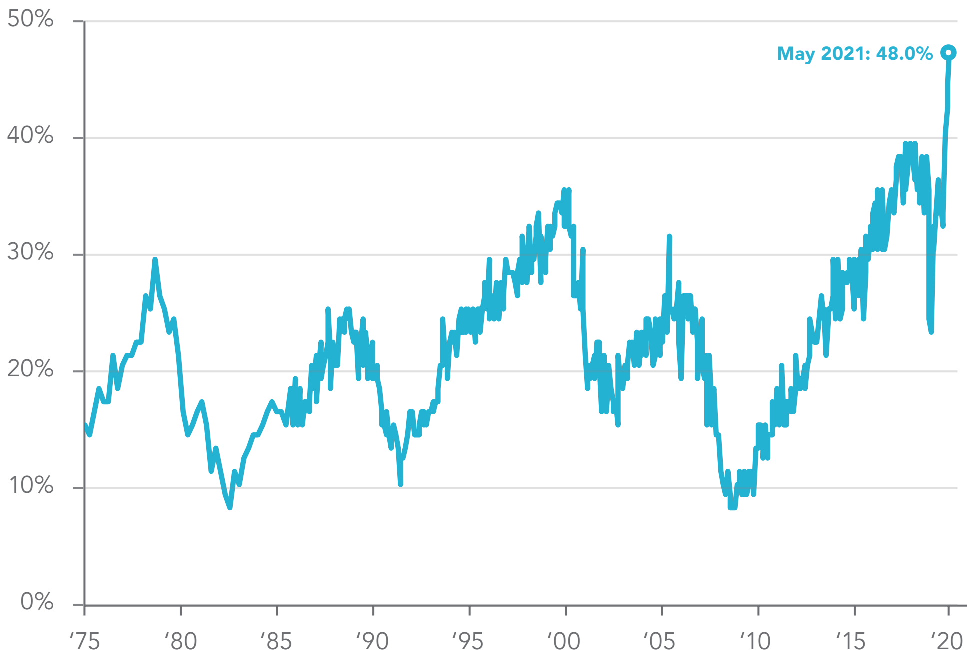
US consumer prices have been rising at an annualized rate of more than 4%, levels last seen in 2008 and 1990; however, increases are far from the peaks hit in the the 1970s. It is important to consider base effects, here: namely that 2021 price growth is relative to last year's stifled economy. Spread out over the last two years through June 2021, the US Consumer Price Index has risen an average of 3% annualized.



Source of Data: FRED, BLS.

The US labor market continues to repair but more slowly over the past few months, and we are still quite far from the strong job market we had prior to the pandemic.

Wages are increasing significantly for low-paying jobs, but it is difficult to gauge how sustainable the upward pressure is. There are now more than 9 million unfilled jobs in the US (a record high) equal to the additional number of people currently unemployed vs. pre-pandemic levels.



Source of Data: Conference Board, National Federation of Independent Business, US Department of Labor, J.P. Morgan Asset Management.

Since companies started aggressively hiring this spring, they have found the process to be extremely difficult as shown in this chart. This has been most apparent in the services sector, where some former employees have shifted to other industries during the pandemic and others continue to collect generous unemployment benefits until September instead of returning to work. This has led to large increases in wages to entice workers back.

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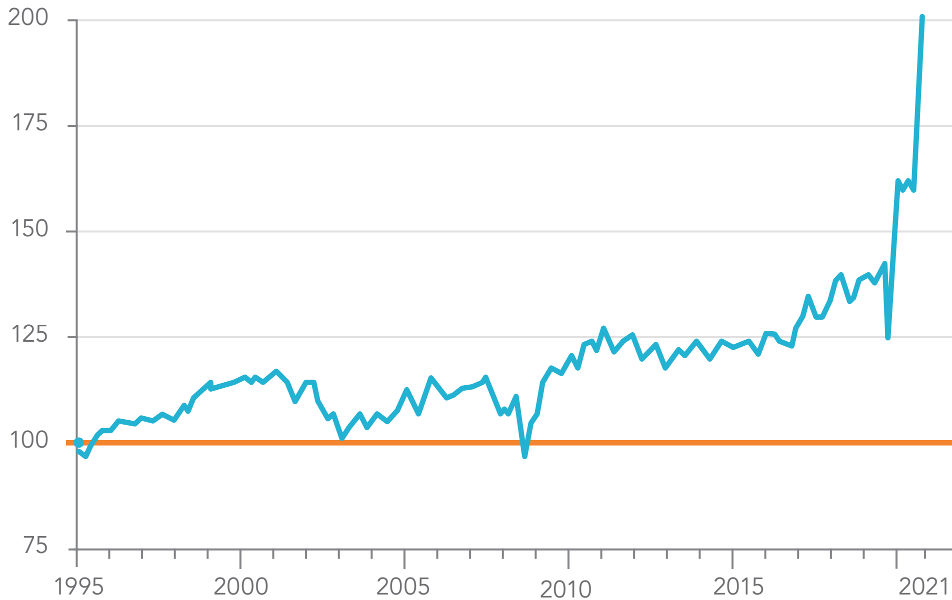
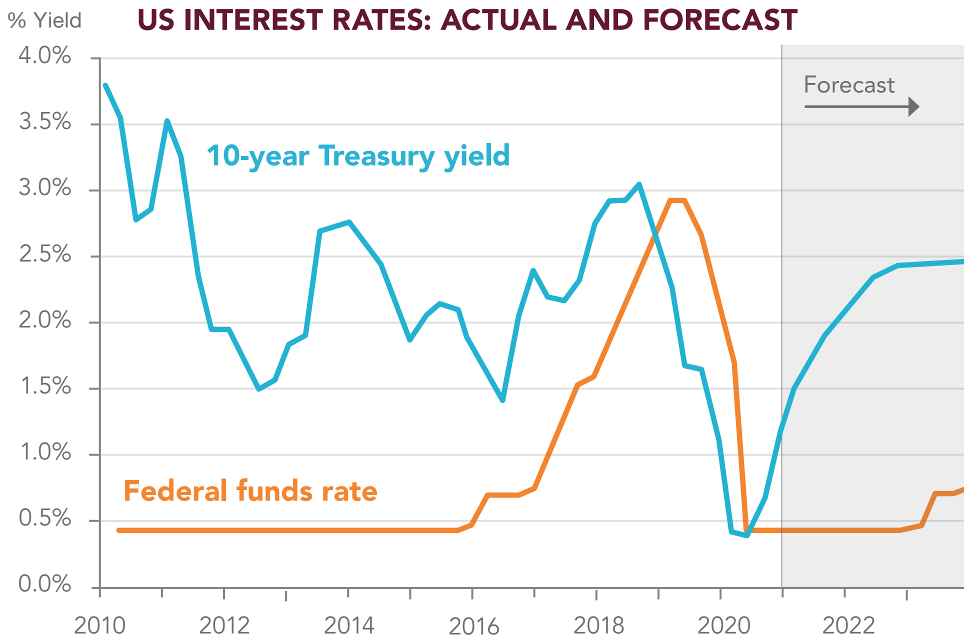


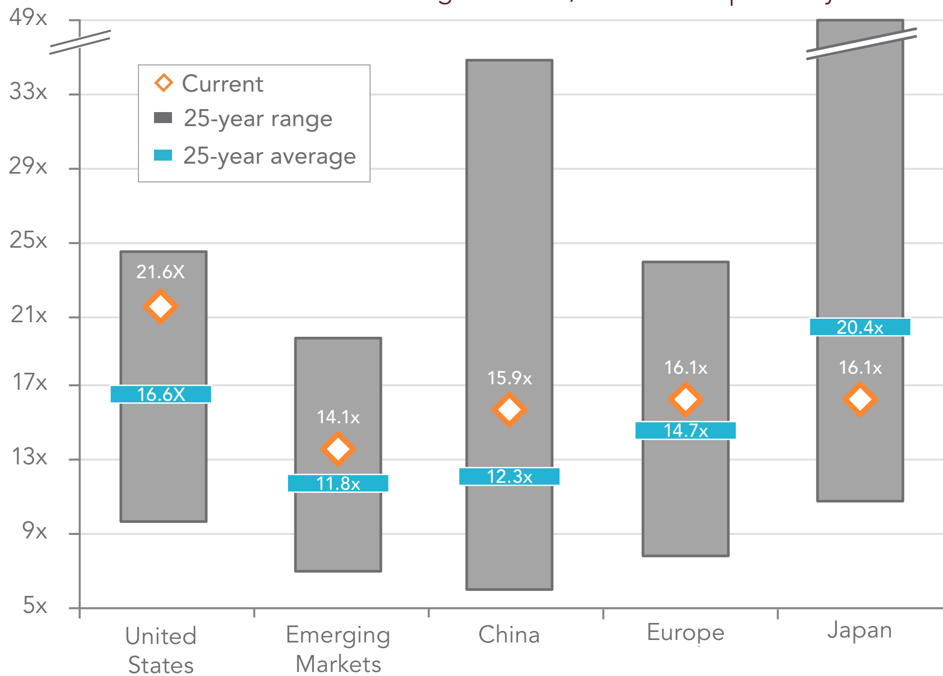
Source of Data: The Economist, Cox Automotive.

Supply shortages have been a significant factor in inflation. In the chart, we see an index measuring the pricing of used cars, which accounts for about 33% of the increase in overall inflation during past year. Demand for new cars is outstripping supply, given the drop in car production during the Covid-19 shutdowns and the inability to now get crucial components such as semiconductors. While the duration of the shortage is uncertain, supply will eventually ramp up to meet demand and this particular pressure on inflation should dissipate eventually.



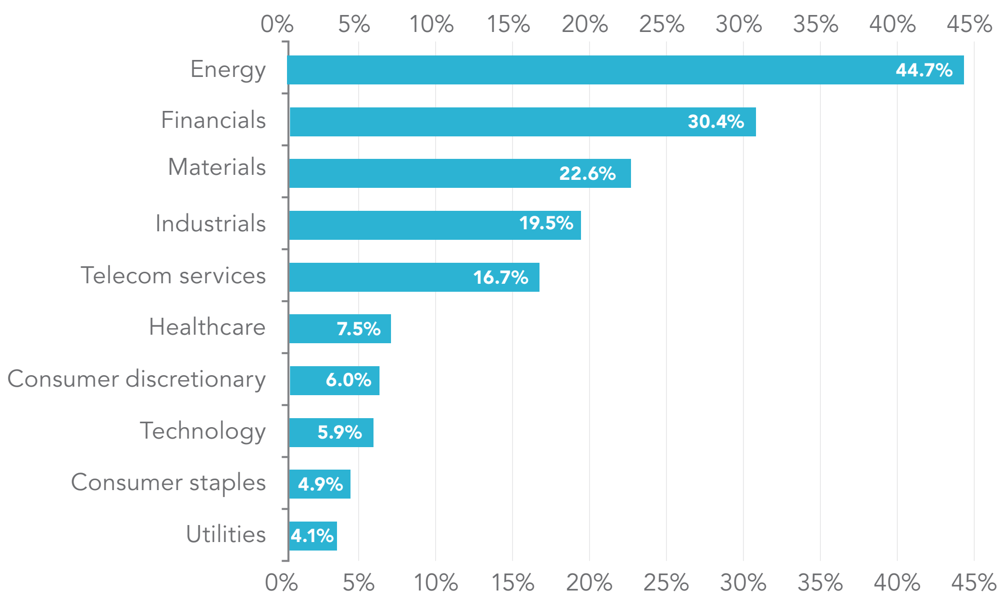
Source of Data: Oxford Economics/Haver Analytics.

Interest rates fell in Q2 2021 as investors reined in concerns about long-term inflation after the Fed telegraphed it would do what is necessary to head it off. US interest rates are likely to resume rising in the second half of the year, but they're not likely to go much above the averages of the past five years, given a global savings glut, aging populations in many developed countries, lower rates abroad, and the Fed continuing to buy billions in bonds each month.



Source of Data: FactSet, MSCI, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

Equity valuations, including price-to-earnings ratios, have increased dramatically since the lows hit in March 2020. Worldwide, we believe valuations appear most reasonable in Europe and in emerging markets, with Asia ex-Japan appearing to have the most compelling opportunities.



Source of Data: BlackRock Investment Institute (BII), with data from Refinitiv Datastream and S&P.

Investors focused on growth stocks, primarily tech, during the pandemic and rotated into cyclicals as economic recovery took hold (materials, energy, industrials, etc.). In the meantime, many high-quality companies with strong balance sheets and cash flows have seen their shares trading at one of the greatest discounts to the overall market in the the last 30 years. Included in this "value" group are utilities and providers of consumer staples.

THE BENEFITS OF DIVERSIFICATION

Total return by asset category relative to a diversified* allocation.

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	YTD 2021	15-Year Annualized Return	15-Year Annualized Volatility#
Best Performance	Global REITs 42.35%	MSCI EM 39.42%	10yr Treas 20.06%	MSCI EM 78.51%	US Small Cap 26.85%	10yr Treas 17.15%	Global REITs 28.65%	US Small Cap 38.82%	Global REITs 15.89%	Muni Bonds 2.45%	US Small Cap 21.31%	MSCI EM 37.28%	Muni Bonds 1.64%	US Large Cap 31.43%	US Large Cap 20.96%	COMM. 21.15%	US Large Cap 10.89%	MSCI EM 21.35%
	MSCI EM 32.14%	COMM. 16.23%	US Bonds 5.24%	Global REITs 38.26%	Global REITs 20.40%	US Bonds 7.84%	MSCI EM 18.22%	US Large Cap 33.11%	US Large Cap 13.24%	US Large Cap 0.92%	US Large Cap 12.05%	MSCI EAFE 25.03%	US Bonds 0.01%	US Small Cap 25.52%	US Small Cap 19.96%	US Small Cap 17.54%	US Small Cap 9.51%	US Small Cap 20.21%
	MSCI EAFE 26.34%	MSCI EAFE 11.17%	Muni Bonds 4.23%	MSCI EAFE 31.78%	MSCI EM 18.88%	Muni Bonds 7.62%	MSCI EAFE 17.32%	MSCI EAFE 22.78%	10yr Treas 10.72%	10yr Treas 0.91%	COMM. 11.77%	US Large Cap 21.69%	10yr Treas -0.03%	Global REITs 23.06%	MSCI EM 18.31%	Global REITs 16.11%	Diversified 6.74%	Global REITs 19.85%
	US Small Cap 18.37%	Diversified 10.91%	Illiquid HF -19.03%	US Large Cap 28.43%	COMM. 16.83%	US Large Cap 1.50%	US Large Cap 16.42%	Diversified 15.60%	US Bonds 5.97%	US Bonds 0.55%	MSCI EM 11.19%	Diversified 17.29%	Global REITs -4.74%	MSCI EAFE 22.01%	Diversified 12.53%	US Large Cap 14.95%	MSCI EM 6.61%	MSCI EAFE 17.37%
	Diversified 17.36%	Illiquid HF 9.95%	Liquid HF -23.25%	Diversified 27.48%	US Large Cap 16.10%	Diversified -3.56%	US Small Cap 16.35%	Illiquid HF 9.14%	US Small Cap 4.89%	Global REITs 0.05%	Diversified 7.11%	US Small Cap 14.65%	Illiquid HF -4.75%	Diversified 19.53%	Illiquid HF 11.83%	Illiquid HF 10.02%	Global REITs 5.32%	COMM. 16.56%
	US Large Cap 15.46%	10yr Treas 9.76%	Diversified -30.77%	US Small Cap 27.17%	Diversified 12.00%	US Small Cap -4.18%	Diversified 12.54%	Liquid HF 6.73%	Muni Bonds 4.66%	MSCI EAFE -0.81%	Illiquid HF 5.46%	Global REITs 11.42%	US Large Cap -4.78%	MSCI EM 18.42%	10yr Treas 10.58%	Diversified 8.96%	Illiquid HF 5.01%	US Large Cap 15.49%
	Illiquid HF 12.89%	US Bonds 6.97%	US Small Cap -33.79%	Illiquid HF 20.01%	Illiquid HF 10.24%	Illiquid HF -5.25%	Illiquid HF 6.37%	Global REITs 4.39%	Diversified 3.79%	Illiquid HF -1.11%	Global REITs 4.99%	Illiquid HF 8.58%	Liquid HF -6.74%	Illiquid HF 10.48%	MSCI EAFE 7.82%	MSCI EAFE 8.83%	10yr Treas 4.74%	Diversified 11.70%
	Liquid HF 9.25%	US Large Cap 5.77%	COMM. -35.65%	COMM. 18.91%	10yr Treas 7.90%	Global REITs -5.82%	US Bonds 4.21%	Muni Bonds -0.32%	Illiquid HF 2.98%	Diversified -2.23%	US Bonds 2.65%	Liquid HF 5.98%	Diversified -7.07%	10yr Treas 8.91%	US Bonds 7.51%	MSCI EM 7.45%	US Bonds 4.43%	10yr Treas 7.03%
	US Bonds 4.33%	Muni Bonds 4.79%	US Large Cap -37.60%	Liquid HF 13.40%	MSCI EAFE 7.75%	Liquid HF -8.88%	10yr Treas 4.18%	US Bonds -2.02%	Liquid HF -0.57%	Liquid HF -3.64%	Liquid HF 2.51%	US Bonds 3.54%	US Small Cap -11.01%	US Bonds 8.72%	Liquid HF 6.80%	Liquid HF 3.73%	MSCI EAFE 4.40%	Illiquid HF 6.60%
	Muni Bonds 3.74%	Liquid HF 4.24%	MSCI EAFE -43.38%	Muni Bonds 7.18%	US Bonds 6.54%	MSCI EAFE -12.14%	Muni Bonds 3.56%	MSCI EM -2.60%	MSCI EM -2.19%	US Small Cap -4.41%	MSCI EAFE 1.00%	Muni Bonds 3.49%	COMM. -11.25%	Liquid HF 8.63%	Muni Bonds 4.23%	Muni Bonds 0.36%	Muni Bonds 3.71%	Liquid HF 5.65%
	COMM. 2.07%	US Small Cap -1.57%	Global REITs -47.72%	US Bonds 5.93%	Liquid HF 5.19%	COMM. -13.32%	Liquid HF 3.51%	10yr Treas -7.83%	MSCI EAFE -4.90%	MSCI EM -14.92%	Muni Bonds -0.10%	10yr Treas 2.07%	MSCI EAFE -13.79%	COMM. 7.69%	COMM. -3.12%	US Bonds -1.60%	Liquid HF 1.16%	US Bonds 3.24%
Worst Performance	10yr Treas 1.36%	Global REITs -6.96%	MSCI EM -53.33%	10yr Treas -9.71%	Muni Bonds 3.13%	MSCI EM -18.42%	COMM. -1.06%	COMM. -9.52%	COMM. -17.01%	COMM. -24.66%	10yr Treas -0.16%	COMM. 1.70%	MSCI EM -14.57%	Muni Bonds 5.63%	Global REITs -8.18%	10yr Treas -4.10%	COMM. -3.00%	Muni Bonds 2.86%
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	YTD 2021	15-Year Annualized	15-Year Annualized

*Diversified asset allocation: 25% U.S. Large Cap Equities; 10% U.S. Bonds; 10% U.S. Municipal Bonds; 13% Hedge Funds (6.5% Absolute Returns, 6.5% Market Directional); 22% Int'l Developed Equities; 5% U.S. Small Cap Equities; 9% Emerging Markets Equities; Global Infrastructure 4%; Commodities 2%

Past performance is no guarantee of future results. Data as of 6/30/2021. Returns are for period and index indicated (see Disclosures page for index definitions). "Diversified Allocation" returns assume monthly rebalancing.

Source of Data: Morningstar, Hedge Fund Research.

The chart above highlights annual returns on a diversified portfolio consisting of the asset classes noted in the footnote, for each year from 2006 to 2021 (as of June 30, 2021). The last two columns show 15- year annualized returns and volatility for the diversified portfolio as well as for the asset classes. The rally in cyclical industries started to wane at the end 2nd quarter 2021, as the Fed calmed inflation worries and the market turned its attention to the resurgence in Covid cases globally driven by the new Delta variant. Falling interest rates caused fixed-income securities to perform slightly better this quarter, recouping some of the losses sustained during the first quarter.

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INDEX DEFINITIONS

US BONDS: Barclays Capital US Aggregate Bond Index – Covers the US Dollar-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS, ABS, and CMBS sectors.

COMMODITIES: Bloomberg Commodity Index - A broadly diversified index of futures contracts intended to be representative of the commodities market. It currently includes 19 commodity futures in seven sectors.

MUNICIPAL BONDS: Barclays Capital Municipal 1-10 Year Index - Tracks the broad market performance of tax-exempt bonds with 1 to 12 years remaining to maturity.

10-YEAR US TREASURY BONDS: BofAML US Treasury Current 10 Year Index – The market value weighted index of public obligations of the US Treasury with maturities of 10 years.

INT'L DEVELOPED EQUITIES: MSCI EAFE Index - A free float-adjusted market-capitalization index that is designed to measure developed market equity performance, excluding the US and Canada. Consists of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

EMERGING MARKETS EQUITIES: MSCI Emerging Markets Index - A free float-adjusted market-capitalization index that is designed to measure equity market performance in the global emerging markets. Consists of the following 25 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

US LARGE CAP EQUITIES: Russell 1000 Index - Measures the performance of the large-cap segment of the US equity universe and represents approximately 92% of the US market.

US SMALL CAP EQUITIES: Russell 2000 Index - Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, representative of the US small-capitalization securities market.

LIQUID HEDGE FUNDS: HFRX Global Hedge Fund Index – A daily-valued index designed to be representative of the overall liquid hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry.

ILLIQUID HEDGE FUNDS: HFRI Fund Weighted Composite Index – A global, monthly-valued, equal-weighted index of over 2,000 single-manager funds that is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies. Constituent funds report monthly net of all fees performance in US dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

GLOBAL REITS: FTSE EPRA/NAREIT Developed Real Estate Index - A measure that tracks the performance of listed real estate companies and REITs worldwide.

DIVERSIFIED PORTFOLIO: 10% US Municipal Bonds; 10% US Core Bonds; 25% US Large Cap Equities; 5% US Small-Cap Equities; 22% Int'l Developed Equities; 9% Emerging Markets Equities; 4% Global Infrastructure; 13% Illuquid Hedge Funds; 2% Commodities.

DISCLOSURE

Diversification does not assure better performance and cannot eliminate the risk of investment losses. There are no guarantees that a diversified portfolio will outperform a non-diversified portfolio. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles, or from economic or political instability in other nations.

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ABOUT THE AUTHOR

Gino Perrina, Ph.D. CFA® served as Chief Investment Officer at Laird Norton Wealth Management (LNWM) from 2015 through mid-July 2021, when he left the firm to return to his roots in institutional investing. As of July 16, 2021, the Chief Investment Officer of LNWM is Ronald G. Albahary, CFA®.

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