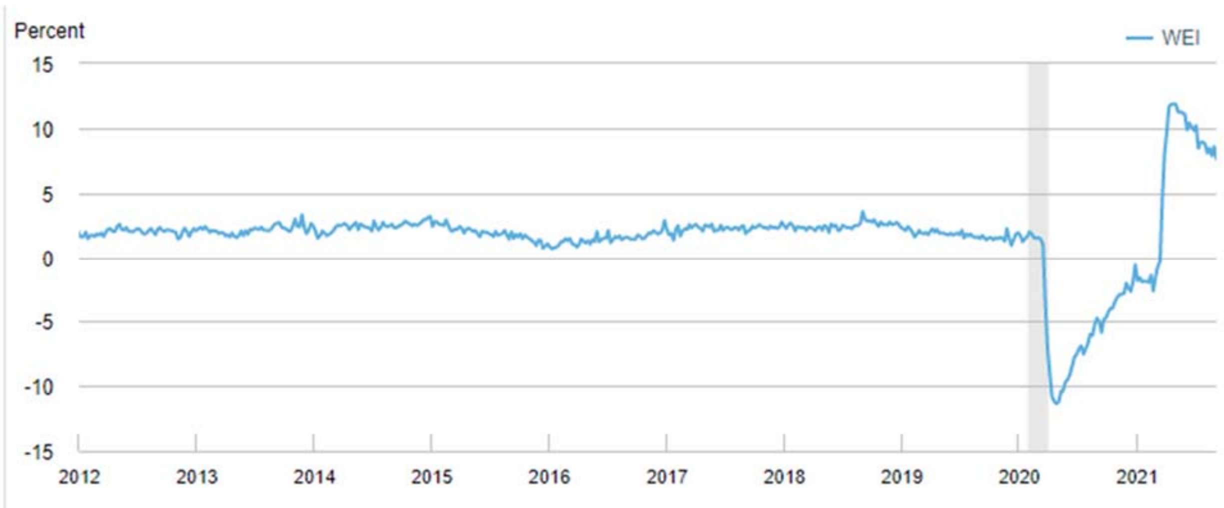
ECONOMIC REVIEW

October 2021

Growth Remains Strong, But Is Slowing: The economy continues to rebound strongly this year, although growth has slowed recently due to the resurgence in COVID cases. GDP in the second quarter recovered to above pre-pandemic levels and is expected to grow 6% for the year, more than making up for last year's 3.4% decline.

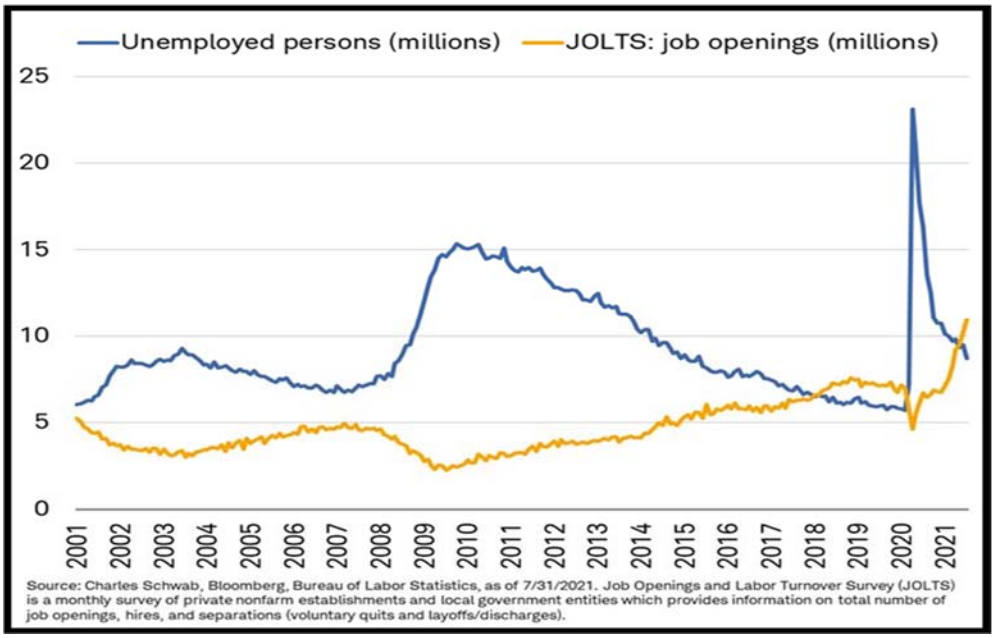
This weekly economic indicator from the Federal Reserve Bank of New York shows how the sharp economic rebound from earlier this year is softening, though still strong.



Source: Federal Reserve Bank of New York. Authors' calculations based on data from Haver Analytics, Redbook Research, Rasmussen Reports, the American Association of Railroads, and Booth Financial Consulting.

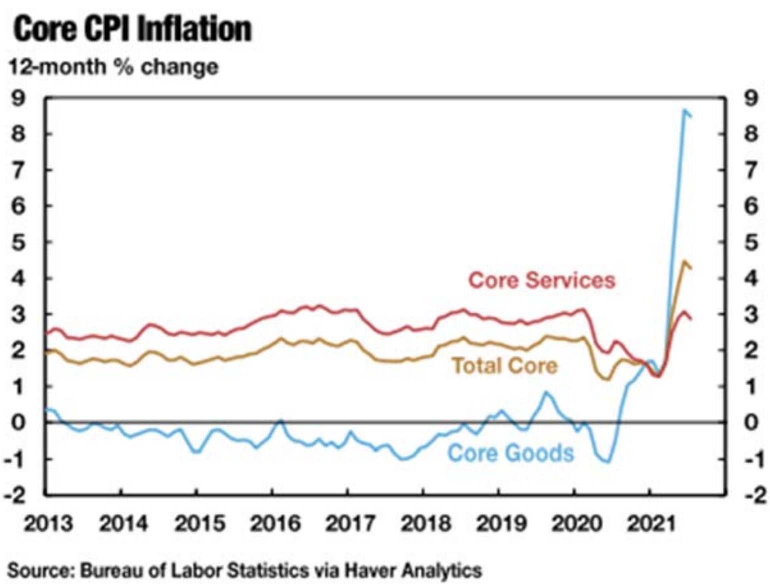
Earnings Are Booming: Corporate earnings are proving to be much more volatile than GDP. Following last year's 22% decline, earnings are expected to bounce back strongly with growth of more than 60% in 2021, followed by 10% growth in 2022. This year's earnings growth results from strong revenue growth of 15% and sharply improving profit margins. Operating profit margins recently increased to 13.1% from 8.6% a year ago, an increase of about 50%. Not only has earnings growth been impressive, but also companies are beating earnings expectations at a record pace. More than 85% of the 500 largest companies have beaten both earnings and revenue expectations over the past quarter.

Job Market Remains Challenging: Recent job growth data was disappointing. Though jobs exist, it has been difficult for companies to find candidates to hire. There are now 11 million job openings, the most since the government began tracking this metric 20 years ago. Also indicating a very tight labor market, there are fewer than 1 unemployed person per job opening.



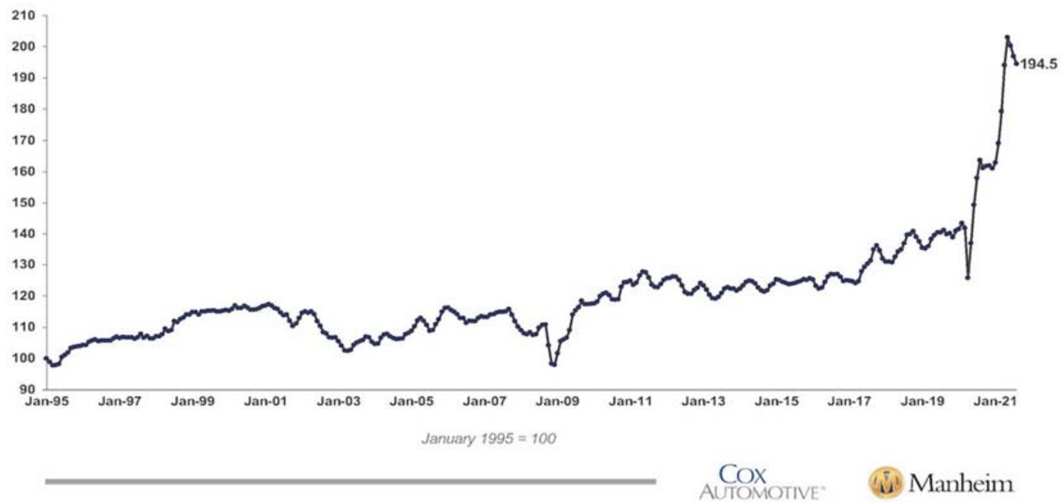
Only about half of those people who left the workforce when COVID began have returned, as measured by the labor force participation rate. This rate measures the percentage of people who are not working and not actively seeking employment. Due to the termination of extra unemployment benefits, we should find out shortly whether these conditions are temporary and people plan to return to work, or whether the trends might be longer-lasting.

<u>Inflation Remains High:</u> Inflation continues to run much hotter than it has in many years, although it is showing signs of cooling off slightly. As shown below, most of the recent inflation has been driven by goods, rather than services. Core CPI (Consumer Price Index) has risen 4.3% over the past 12 months, while core goods prices have risen 8.5%. The consensus forecast for overall inflation is 4.3% for 2021, followed by 3.0% in 2022.



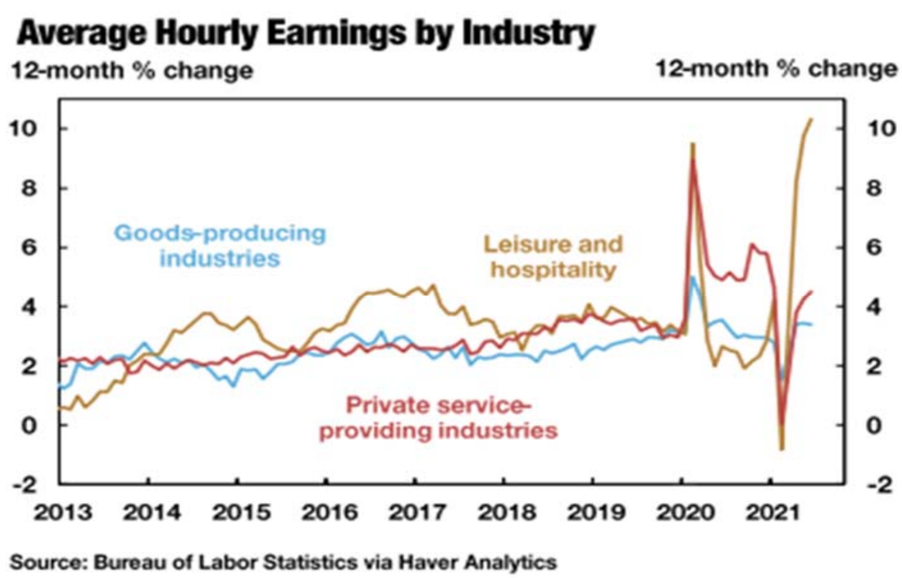
Product shortages, particularly in semiconductors, have driven much of the goods inflation. While manufacturers globally have been impacted, the used car sector has been most visibly affected. As shown below, used car prices have risen dramatically as chip shortages have made new cars harder to come by. These high prices are likely unsustainable, and prices are showing signs of beginning to cool down.

Used Car Price Index



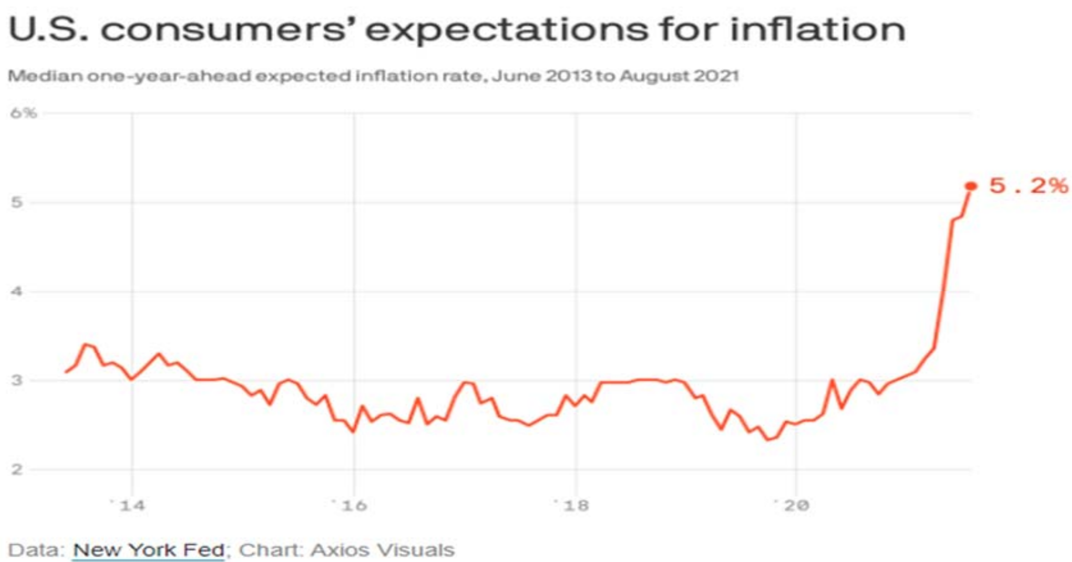
Other sectors that had seen price surges have already retreated. Lumber prices, which had risen 5-fold in about a year, recently fully returned to pre-COVID levels.

<u>Wages Are Rising</u>: The tight labor market is leading to wage pressures, particularly in the leisure and hospitality industry where the average hourly earnings have risen more than 10% over the past year, compared with 4.3% growth in average hourly earnings for the overall labor market.



Not surprisingly, industries that have seen higher rates of employees leaving have experienced higher wage growth. Some of these labor market trends likely will prove temporary and some may prove permanent.

<u>Is Inflation a Temporary or Longer-Term Issue?</u> It remains unclear where inflation is heading in a post-COVID world, but longer-term behavior changes and price pressures are building. Much of what causes inflation is psychology, meaning that consumer expectations of inflation can lead to inflation-causing behavior. More fiscal stimulus and government spending also could lead to higher inflation but could be offset by structural headwinds such as demographics and high debt levels.



While product shortages may be expected to ease up over time, the process is taking longer than expected. Businesses have been operating on a "just in time" inventory model for years, with very lean inventory management. As companies work to increase inventories to meet demand, they may need to increase manufacturing capacity. Companies also may need to bring some manufacturing back to their home countries to become less dependent on facilities in other countries. These changes are likely to take years and require significant capital outlays, and may lead to increased costs over the longer term. Also, companies may be reacting to component shortages by double-ordering, something we witnessed late in the dot-com boom twenty years ago. Thus, this period of product shortages could be followed by a period of excess inventories.

We will be watching these trends closely, as the implications could be significant. The Federal Reserve could raise interest rates sooner than expected, bond yields could increase, and corporate profit margins could decline from all-time highs as input costs rise. Value stocks and international stocks could benefit most from inflation, while high-valuation stocks, such as technology, could be most vulnerable.