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2021 3rd Quarter Review: Supply and Delta Variant Challenges

Executive Summary

- Although the delta variant spike put a dent in 3rd quarter growth, **supply of goods and labor are limiting economic growth.**
- **Annualized Real GDP growth slowed from 6.7% in Q2 to 2% in Q3**. Real GDP exceeds the pre-pandemic high by 1.37%. (Data from U.S. Bureau of Economics).
- On an inflation adjusted basis, **Consumer Spending (70% of USA economy) exceeded the pre-pandemic level in Q2 and continued up 0.4% quarter over quarter in Q3 (1.6% annualized).** (Data from U.S. Bureau of Economics).
    - **In spite of the Covid spike, services spending was up 1.9% (quarter over quarter) in Q3; that is 7.84% annualized.** But spending on services still trails the pre-pandemic level by 1.6%.
    - **The main source of slower growth in GDP in Q3 was in Goods spending which was down 2.56% (quarter over quarter) in Q3.** This was impacted by a 17.6% drop in motor vehicles and parts spending because of the shortage of semiconductor chips. **Supply of goods was the issue, not demand.**
- The recovery in the economy beyond the pre-pandemic peak level has been accomplished with employment still lower by four million workers.
    - There are 10.4 million job openings.
    - **Even with a return to the pre-pandemic unemployment rate or better (including the participation rate), jobs gains would be about seven to eight million, still short of meeting the demand for jobs.**
    - **Labor supply is the issue.** Extraordinary solutions are necessary including but not limited to use of automation, expansion of working age range (working beyond age 65), legal immigration, and higher employment participation rates. Higher participation rates become more challenging with the baby boomer generation having reached or reaching age 65 between 2011 and 2029.
- **Measuring the impact on the economy by the delta variant spike is difficult.** But let's say that supply of motor vehicles and parts had been flat with Q2, total consumer spending would have increased 4.7% instead of 1.6%. With consumer spending at 70% of our economy, Q3 real GDP growth would have improved to 4.2% from the actual 2%. **If early expectations of Q3 real GDP growth of 6% were accurate, then the drag of the Covid spike was 1.8% annualized.**
- **Fuel for economic growth persists.**
    - Personal income (excluding transfer payments) rose at an annualized rate of 1.5% in Q3.
    - Money supply rose at an annualized rate of 11.4% in Q3.
    - Transfer payments (stimulus) from the government declined by $1.875 Trillion since Q1, but they still exceed normal levels by $900 Billion. Government stimulus is shrinking but is still exceptional**.**
- **Covid and supply issues have kicked the can of continued economic growth further down the road. We expect good growth in 2022 and 2023**. **Supply, public health, and inflation remain the primary deterrents.**
- **The inflation spike has not yet toned down. With economic demand fuel aplenty, solutions to supply issues are needed.**

Macro-Economic Perspective

- Real GDP grew at a 6.3% annualized rate in Q1 and exceeded the previous peak in GDP that occurred in Q4 2019. Q2 Real GDP grew at an annualized rate of 6.7%, Q3 Real GDP growth was 2% annualized.
- Disposable personal income has risen at an annual rate of 5.47% since the end of 2019. This calculation ignores the blip in transfer payments in Q2 and Q3 in 2020 and Q1 in 2021.
- The savings rate was 13.7% last year, was 20.5% in Q1,10.5% in Q2, and 8.9% in Q3. Prior to the pandemic, the U.S. savings rate was about 7.5%.
- After the massive increase in M2 money supply (cash, checking and savings deposits, money market, mutual funds, and CDs) of 24.2% in the last year ending Q1 2021, M2 growth has slowed to an annualized rate of 9.7% in 2021 through Q3. This annual pace still exceeds the typical Federal Reserve practice of maintaining a 3% to 6% increase in the money supply each year. Source: Federal Reserve Bank of St. Louis.
- The velocity of money (the frequency at which one unit of currency is used to purchase goods and services within a given period of time) continues at a very low level. So far, this has countered the inflationary pressure caused by the massive increase in money supply.
- Household net worth peaked at $111.04T at year end 2019. Since then, it has risen 16.6% to $129.45T at Q1 end, and another 9.5% to $141.7T at Q2 end. It is hitting new records every quarter. Source: Federal Reserve
- Total personal consumption was up 11.3% in the 1st quarter, 4.5% in the 2nd quarter, and 0.4% in the 3rd quarter.
- In early 2021, the incidence of Covid infection had peaked at 437 cases per million (7-day average). Covid deaths over the same period peaked at 8 per million. The delta variant peaked at 331 cases per million (7-day average) and 3 deaths per million (7-day average) in September. Source: NY Times. **As discussed in the Executive Summary, Q3 GDP was more impacted by supply issues than the delta variant spike. Although, some of the labor supply issues were impacted by the fear of Covid. The fear factor appears to be declining**.
  - The Wall Street Journal reported that 9.8 million people did not look for work in May of 2020 because of fear of the pandemic. This number declined to 1.6 million people in September this year.

Key Economic Data Points:

Inflation Readings Still Worrisome

October readings on consumer price inflation were 6.2% for headline inflation and 4.6% for core inflation (excludes volatile food and energy numbers). For September, personal consumption expenditures (PCE) price index was 4.4%, the core reading was 3.6%. The October reading is not reported until 11/24/21. These readings are well above the Federal Reserve's target for inflation between 2% and 2.5%. **Keep in mind the Federal Reserve's new policy of allowing inflation to run above their 2% target. This was put in place in reaction to the difficulty of getting inflation up to the 2% target over the past two plus decades.** They use the PCE core reading to measure inflation.

Expert prognosticators have little agreement on the future path of inflation**.** Some economists are concerned that it will continue at elevated levels. They point to rising consumer expectations for long term inflation. Others, including the Federal Reserve, expect resolutions to the present supply constraints and therefore a return of inflation levels back within the Federal Reserve's targeted window.

The Federal Reserve Bank of Atlanta tracks Sticky inflation (weighted basket of items that change price relatively slowly, such as wages and haircuts) which has trended up this year on a year over year basis from 1.7% to 2.8% and Flexible inflation (weighted basket of items that change price relatively frequently, such as automobiles, gasoline, and hotel rooms), which has trended up this

year on a year over year basis from 1.8% to 13.5%. When the USA struggled with stagflation in the late 1970's and early 1980's, sticky inflation followed flexible inflation up into double digits. This is not happening currently.

DBFM believes that the supply issues will resolve in 2022 with labor supply being the most difficult to resolve. Therefore, inflation will fall back into the Federal Reserve's target range by late 2022 or early 2023.

Longer term we have concerns with low growth and low inflation because of high government debt.

Growth Projections: Macroeconomic projections by the Organization of Economic Cooperation and Development have lowered their projection for economic growth in the USA from 6.9% to 6% for 2021 and raised the forecast for 2022 from 3.6% to 3.9%. For the rest of the world, they lowered their projection for economic growth from 5.8% to 5.7% for 2021 and have left their forecast for 2022 unchanged at 4.5%.

Employment: T**he FED is forecasting a full job recovery with unemployment back down to 3.5% by 2023.** The big unanswerable question remains, what will happen with the employment participation rate? DBFM estimates that the upper end of potential for employment gain is 8 million people. This will be important to curing supply of goods and services bottlenecks that exist now and thereby fending off continued high inflation. **There is evidence that corporations are raising capital investment for automation to help deal with lower employment participation rates since Covid. GDP growth can be achieved via greater employment and/or greater productivity from a given employment level.**

Consumer spending (70% of GDP): Personal consumption expenditures (annualized) exceeded the pre-pandemic peak in June and continued to rise in Q3 this year at a 1.6% annual rate. This growth rate was restrained by the semiconductor supply shortage. The Institute of Supply Management (ISM) reading for service remained elevated in the 3rd quarter, July was 64.4, August was 61.7, and September was 61.9. A reading of 50 is the dividing line between decline and growth. These are exceptionally high numbers.

Manufacturing (11% of GDP): The ISM reading for manufacturing also remains high July through September at 59.5, 59.9, and 61.1, respectively. **The Federal Reserve reported a 4.3% increase in industrial production in the 3rd quarter despite the drop in motor vehicle production. This is the fifth consecutive quarter with a gain of at least 4%.**

Construction (4.1% of GDP): Construction rose 1.4% in Q3 from $1.5522T in Q2 to $1.5736T in Q3. Residential construction is reaching new highs while non-residential and public construction remain below the pre-pandemic peak. Data from the Department of Commerce.

Home sales: National Association of Realtors (NAR) reported that September existing home sales declined 2.3% to 6.29 million seasonally adjusted annual rate from 6.44 million one year ago. New household formation remains a bit above a 1.5 million annualized rate. New construction is keeping pace with new family formation. **But the NAR reports that supply of homes for sale is an extremely low 2.4 months.** Six months' supply is considered a balanced marketplace for buyers and sellers. NAR also reports that **the median price for a single-family home sold in September was $359,700 which is up 13.8% from the year ago level. This data bodes well for construction prospects and home prices. Affordability remains a problem, especially for first time buyers.**

Securities Market Perspective

By the end of the third quarter, a 100% stock portfolio with 20% invested in international was up approximately 14.27% with dividends reinvested. Intermediate term bonds (Barclay's Aggregate Bond Index) were down 1.62%, an improvement from a decline of 3.57% by the end of Q1, and short-term bonds were up 0.09% (Barclays U.S. Gov't Credit 1 to 3 Year Bond Index). It is interesting that bond prices have improved (interest rates down) all the while concerns about inflation abound. There are outside influences keeping bond yields in check (supporting bond prices) such as Federal Reserve massive monthly bond purchases and the existence of $10T in negative yielding bonds outside the USA. Bond markets have a higher I.Q. than equities markets, thereby suggesting concerns about inflation are overdone. Although, we do expect yields to rise (bond prices down) before year-end into a range of 1.75% to 2%.

Valuation Discussion Points:

- By the end of the third quarter, as measured by price to book value, **growth stocks were 163% above their long-term average** of 4.83 at 12.72. **Value stocks were 15.1% above their long-term average** of 2.18 at 2.51.
- At the third quarter end, growth stocks were up 13% and value stocks were up 16.44%.
- Growth recovered some ground in the 3rd quarter with the Covid resurgence, mainly in large cap.
- <u>It is still the case that low interest rates continue to provide cover for higher valuations</u>.
- <u>Growth stock valuations are significantly more threatened by higher inflation and interest rates than Value stocks</u>. We are seeing a trend when Covid cases are spiking, growth investments rally relative to value investments. It seems the expectations are for slower economic growth and less risk of interest rate increases when the threat of Covid is ramping up.
- As of 10/29/21, FactSet reported that with 82% of companies in the S&P 500 beat earnings estimates. Further, they estimated that 3rd quarter earnings were up 33%.
- Going forward, we expect the pace of earnings growth to stay healthy but decline from the 3rd quarter results. **Therefore, we expect future gains in equity prices to come along more grudgingly than they have since the end March 2020.**
- So far, the stock market rise has not created economic excesses. On the other hand, **one does not have to look far to see examples of excessive stock valuations. Tesla stock market valuation exceeded $1 Trillion recently.** If Tesla achieves their production goal of 900,000 cars this year, the value of Tesla will be $1,300,000 per car produced. For comparison, Ford is valued at $18,400 per car produced. GM is valued at $12,650 per car produced. If Tesla were able to sustain a profitability level twice that of Ford's and therefore earn a valuation of $36,000 per car produced, Tesla would have to produce 32,500,000 cars per year to grow into their market valuation. That would account for just over 81% of the cars sold in the USA and China in 2020. **Rivian**, a new electric vehicle manufacturer of pick-up trucks and SUVs recently went public. On the first day of trading, its stock market valuation exceeded that of Ford's by 56%. Rivian has sold 156 vehicles to employees only.
- The Federal Reserve's zero bound interest rate policy continues to force investors to increase risk via investing in stocks and pursuing lower quality bonds. The spread in yields between high yield bonds and Treasuries are at an all-time low. One should be careful in maintaining investments in lowest quality bonds as well as limiting overall exposure to below investment grade bonds.
- Low interest rates are driving investors to stretch for yield. The only bond categories with positive total return this year are high-yield bonds, long-term corporate bonds, and long-term municipal bonds. High quality corporate bonds, U.S. Agency bonds, U.S. Treasury bonds, mortgage-backed bonds, and foreign government bonds all have negative total return this year.
- The value of bonds worldwide with negative yields have shrunk from a value of $16T in Q2 down to $10T presently. That is still a very sizable supply of negative yielding bonds, but certainly a significant reduction.
- In the U.S.A., bond yields have moved more in response to level of threat from Covid than from the threat of higher inflation.
- There are plenty of high-quality and reasonably valued companies with stock dividend yields well in excess of interest rates available in bonds.

Bonds:

- Yields on all types of bonds are being anchored at very low levels by Federal Reserve policy action of holding the Federal Funds rate at nearly 0% and monthly bond purchases. DBFM continues to pursue additional avenues to enable positive bond return and portfolio income in this low interest rate environment. This is becoming a daunting task.
- Interest rates will likely rise a bit before year end as the Federal Reserve has begun winding down their bond purchasing program with a targeted completion in June of 2022. Federal Reserve action to raise rates is not likely until mid to late next year. Avoidance of long-term bonds is the order of the day in the investing world (unless you are chasing yield). High quality intermediate term bonds are in place to counter-balance potential stock market pullbacks. DBFM is maintaining a heavy concentration on shorter term bonds without sacrificing yield.

Wrap up:

- The Services spending portion of Consumer Spending remains the only major economic component that remains below the pre-pandemic peak, by only 1.6%.
- The course of inflation is dependent upon reducing or eliminating supply constraints. Labor supply and semi-conductor supply constraints may offer the greatest challenges to resolve.
- The U.S. is awash in money. High personal savings rates continue and gains in mobility freedom point to strong demand growth to continue.
- Significant gains in U.S. personal wealth are also driving strong demand growth.
- The surge in the Delta variant of Covid serves as a reminder that we have not reached a point where Covid is a moot issue.
- Potential Risks: Inflation forcing the Federal Reserve's hand to clampdown by raising interest rates sooner than planned, tax increases, supply constraints (material and labor) not resolved, or reversal of progress against Covid-19 severe enough to negatively alter supply, mobility, and spending behavior for services.

Please feel free to contact us with any questions, or if you would like to schedule a virtual, face to face, or phone meeting.

Thank you,

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