Welcome to the "Not Enough" Economy

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For the most part, the COVID-19 experience has played out as predicted for the U.S. economy and stock market. GDP growth took a massive hit in second quarter 2020 and rebounded dramatically over the following year. The stock market has mirrored that performance. If anything, we would argue that both have bested expectations. That being said, the first half of the year still showed how fickle markets can be.

During the COVID shutdown, the "work from home" trade and more defensive stocks dominated the markets. This led to outperformance of large-cap companies over small-cap, growth over value, and domestic over international. We also saw interest rates decline as economic growth was questioned and deflation became a concern. However, once the vaccines were introduced in November, there was a massive "re-opening" trade, or a move toward more economically sensitive stocks. All the previous outperforming trends reversed. We even saw interest rates move back up rather quickly, peaking recently in late March.

While most areas of the market continued to make progress, the second quarter saw a swing back toward those COVID-favored names. We saw the S&P 500 gain 8% for the quarter, pushing year-to-date returns to near 15%. Small cap stocks and ex-U.S. indices finished the quarter up about 5%. The stellar first quarter for small caps leaves that index up 17% for the year as international finished up around 9%. While there were pockets of strength in the energy and financial space, value trailed growth for the quarter by about 7%. The decline in interest rates during the quarter also helped ease a difficult year for bonds. That index finished the quarter up 1.8%, but still down almost -2% for the year.

As mentioned, the economy and markets are progressing from COVID much as we have anticipated. Historically, when most economies struggle, it is from a demand problem. This recovery does not seem to have a demand issue. In fact, if anything is holding it back now it is a lack of supply. The post-pandemic economy is taking shape as one in which there is not enough – not enough housing, not enough workers, not enough cars, lumber, semiconductors, chlorine, pretty much everything… except toilet paper. These shortages are producing conditions not experienced in several generations. Following are our thoughts about a couple of those conditions that seem top of mind: employment and inflation.

The Labor Market

We're all experiencing it. The economy opened back up, and we're finally able to go shopping and out to eat. When we do, we find two things missing: stocked shelves and employees. Help wanted signs are in every window, often advertising surprisingly high hourly pay. We think, "Where was this when I was a teenager?"

We all know what happened after COVID last year. Everyone was sent home and according to the Labor Department, approximately 22.2 million jobs were lost. The unemployment rate hit 15%. Most of those jobs were of the lower wage variety concentrated in the public facing retail, travel and hospitality sectors.

Over the course of the year, the unemployment rate was driven back down to 5.9% as 15 million of those jobs have been recovered. Economists have been ringing their hands over the continued difficulty in getting the remaining 7.2 million people back to work. There is much speculation on their hesitancy.

Probably the most common cited reason is the enhanced unemployment benefits available through the COVID policies passed by Congress. Generally, these benefits equate to a 40-hour work week at $15 an hour. For those working in jobs paying less, it is reasonable to assume they would postpone employment as long as they could. Many Governors held this opinion and in May had their states opt out of the programs. By cutting the benefits, they assumed local employment would return more quickly. The early results have not been as expected. It appears the problem is much more nuanced.

Recent surveys by the jobs site Indeed.com suggest that COVID is still the main factor keeping the unemployed from returning to the workforce. Job seekers want to see greater vaccination rates among their co-workers and customers. They still fear contracting the virus and passing it to family members.

Many other reasons were cited as well. Urgency seems to have been diminished thanks to the financial cushions created by both reduced spending and stimulus payments received throughout the pandemic. Many families have learned to live on one spouse's salary. Others claim a mismatch exists in job skills employers are looking for versus what they believe is required to perform the job. Childcare is also an ongoing problem. With schools out of session, many summer camps cancelled, and reduced day-care availability, many workers just cannot leave home.

Our small business owning clients have given us another interesting reason. Many of their former employees found themselves accepting jobs after graduation (high school or college) out of necessity. This was not where they intended to be, but where they ended up. In many cases, they were good jobs, and over the next 5, 10, 15 years the jobs became careers. COVID gave them a break and the ability to "pivot." Finally, they had an opportunity to seek the careers they originally wanted. Many are also going back to school. Often, the original jobs were in the hospitality sector or public facing. Understandably, these individuals would like to explore other opportunities. This likely explains the difficulties retail and restaurants are having finding workers.

For some more seasoned workers, the Great Recession had forced them to stay in the workforce, rebuilding their retirement accounts. They were also in "comfortable" positions that were hard to give up. With the COVID break, many have seen glimpses of non-working life. Additionally, unexpectedly strong 401K balances and house values have given them the confidence to finally retire. Pulling all these different workers back into the labor force is proving more difficult and displays changing dynamics. Overall, the labor market appears to be much more complicated than just unemployment benefits.

Inflation

Lumber and used car prices have been the poster children for post-COVID inflation fears. For lumber, the pandemic sent construction demand soaring while shutting down most production. The result was a parabolic move in price from about $300 (per 1000 board feet) to almost $1800 earlier this year. With a shortage of semiconductor chips slowing

production of new cars and trucks, used vehicles have become scarce commodities. Prices have soared, up 30% to 50% over the last year.

Other data shows significant upward pressure on prices as demand for goods and services exceeds supply. June's release of the CPI inflation index revealed a surge of 5.4%, the largest move since 2008. The print was broad-based but included large increases in several components that have COVID related supply/demand imbalances. For example, gas prices are up substantially from last year's "no travel" summer. Rents, calculated from currently high home prices, are a large, elevated component. Lastly, higher travel prices from airfares and hotel rooms contributed. Of course, higher wages also played a part.

Like lumber and autos, we have found ourselves with "not enough" of most goods due to both demand and limited production, resulting in higher prices across the board. However, "high prices are the cure for high prices" and are now weakening demand just as production starts to come back online. For example, lumber prices have tumbled from the $1800 area to now below $600. June was also the first month this year to see used car prices reverse. We are likely at peak economic activity as re-opening the economy and trillions in stimulus collide. We expect this to diminish in coming quarters.

The ongoing debate in financial markets is whether these price moves are sustainable or transitory. We, along with the Fed, lean towards transitory. Over time, we expect better supply/demand balances and prices to retreat. We continue to watch other metrics. Measures of inflation expectations remain well anchored. Money velocity, a technical way of tracking how quickly money is spent over time, does not indicate lasting inflation.

However, we do not believe we can be completely complacent about inflation. Inflationary headwinds could persist. After decades of globalization keeping prices low, the world appears to be moving in the other direction. Demographics are also shifting in developed countries in ways that promote inflation. Lastly, e-commerce is maturing and might not be able to drive prices much lower.

Outlook

While our short and intermediate-term economic outlook is optimistic, our investment outlook remains somewhat guarded. A great deal of good news is already reflected in current stock prices. We have near-term concerns regarding the Delta variant of COVID and the stagnation in vaccination rates at home and abroad. Should this variant take hold, the recovery could be weakened. The Federal Reserve, busy with inflation and unemployment, must continually convince the markets everything is under control.

Putting it all together, we look for the second half of the year to continue the momentum of the first half. This should lift financial markets gradually higher, but it would not surprise us to see more turbulence as investors digest incremental data and news.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us and stay safe and well.

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