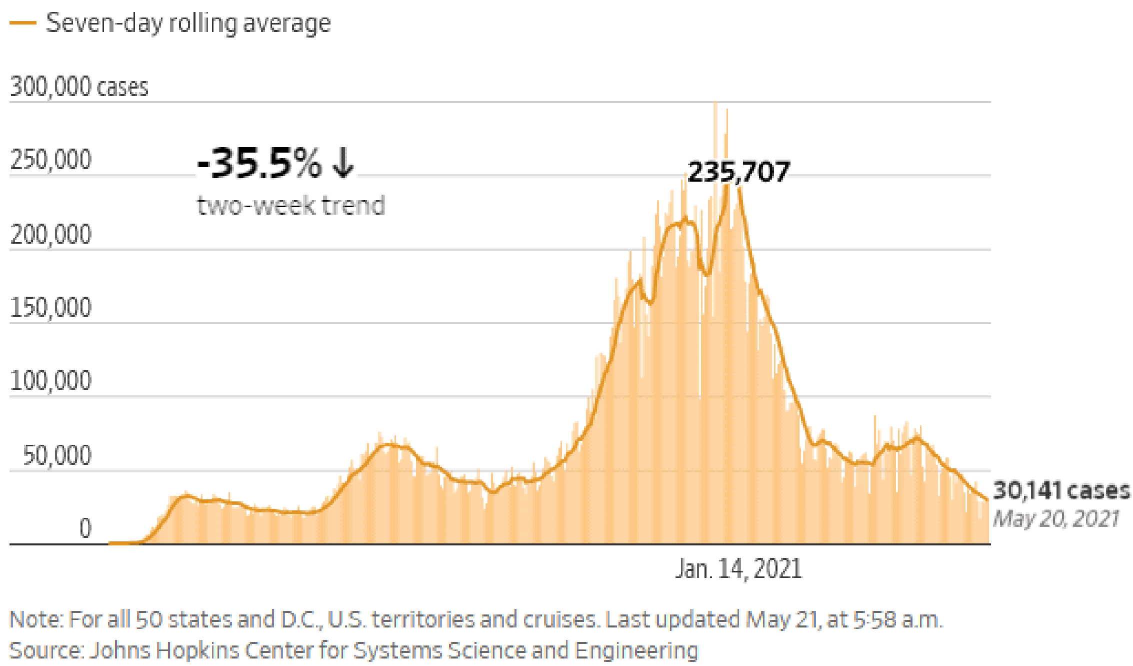
2021 2ND Quarter Economic Update

Most economists, analysts forecasted the economy would start to recover this summer once the covid vaccines get us close to herd immunity. There are many signs that this economy has started a strong recovery before summer.

Consumers, businesses, investors, analysts, economists are all concerned about inflation. In this Update, I will focus on inflation. In a nutshell: limited supply, strong demand equals inflation. Are current inflation trends sustainable or are they transitory?

Covid 19

As I've been writing about for the past year, the key to the economy is beating the virus.



Fortunately, the trend for infections has come down dramatically. Below is some current key covid data

The Latest Numbers

290,724,607 vaccine doses given so far in the U.S.

27,525 new U.S. cases recorded yesterday

1,338 deaths in the U.S. recorded yesterday

593,293 total U.S. deaths

33,218,607 total confirmed cases in the U.S.

169,021,406 confirmed cases world-wide, and 3,512,719 deaths

Sources: Johns Hopkins University as of 6:30 a.m. ET; Vaccination figures from the Centers for Disease Control and Prevention.

It’s too bad that the healthcare industry didn’t follow up and make sure those that got the first shot, got the second shot. If this happened we would be at herd immunity.

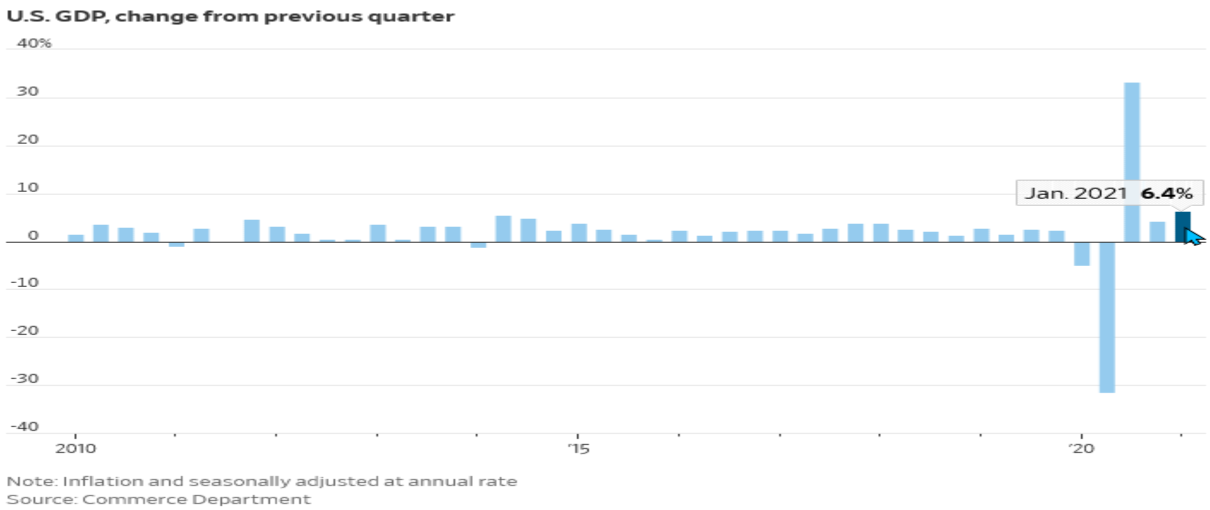
Total confirmed cases are around 33 million and many of these people had some of the antibodies and so should be ok. This number is probably understated because testing was so bad early when the infections started.

Vaccinated (290 million) plus confirmed cases (some of the confirmed case people probably got the vaccine). So we should be at or very close to herd immunity.

Memorial Day could be a test. If we don’t get a spike in infections especially from the variants from India, Brazil… The next test will be in the fall when much of the country has to go indoors where infections can spread more easily.

GDP Key Components of the Economy: Consumers, Housing

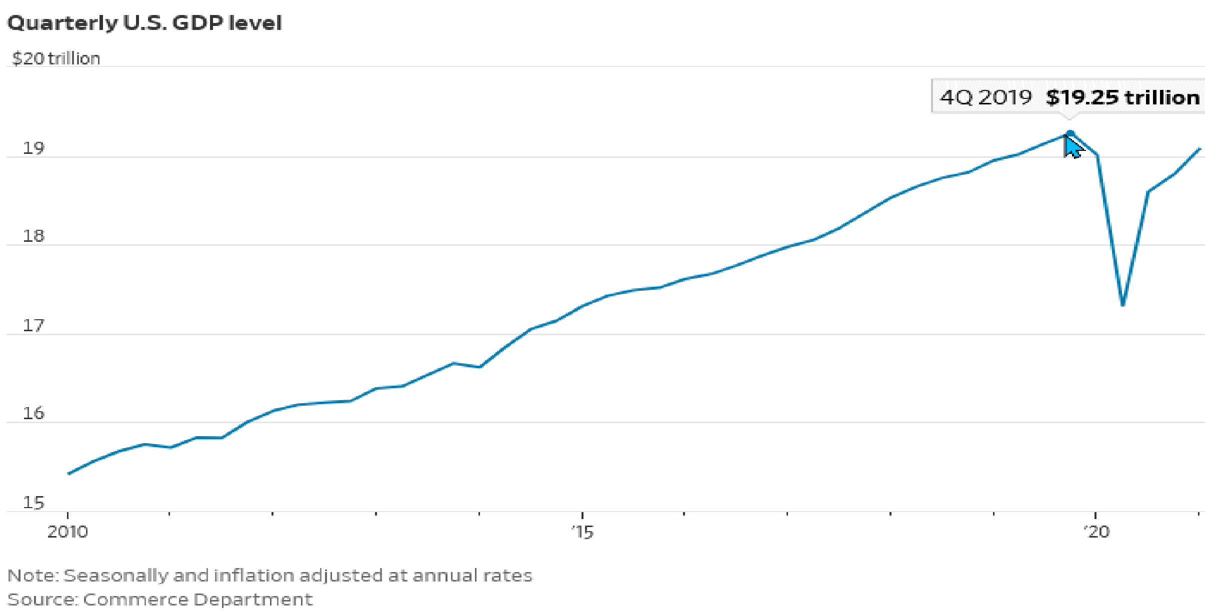
Below is a graph that shows the trend of GDP growth:



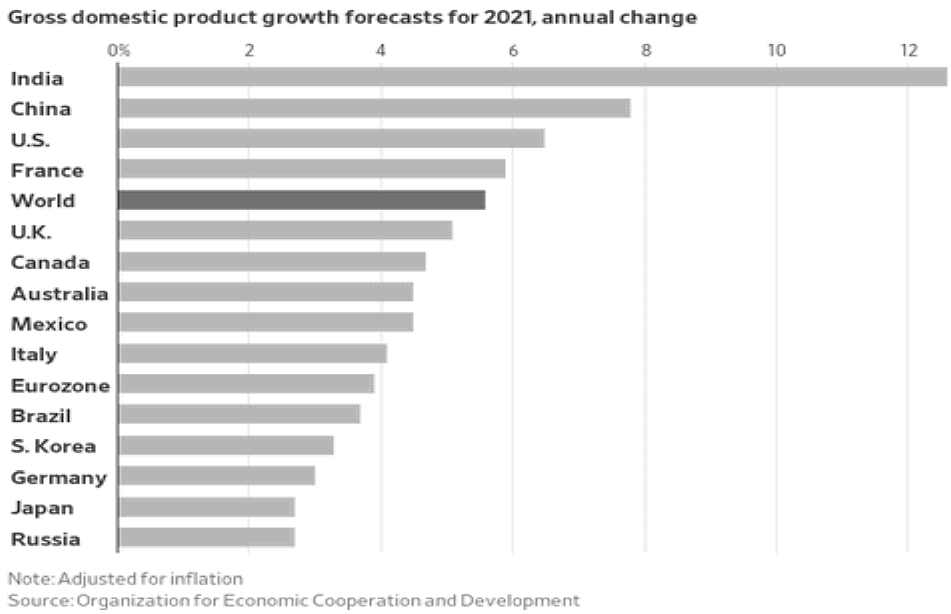
The chart shows explosive growth for our economy. It's the most during the period covered in the graph.

The average growth rate for the past 12 years is slightly above 2%. The chart below shows we have about a $19 trillion economy, the largest in the world. The law of large numbers will probably mean we will probably slow down to the 2% level. A growth rate of 6% would be an increase of about $1.2 trillion, an amount greater than most country GDPs in the world. A growth rate above 5% for our economy is not sustainable.

Even though growth is strong, we are not at pre-pandemic levels yet:

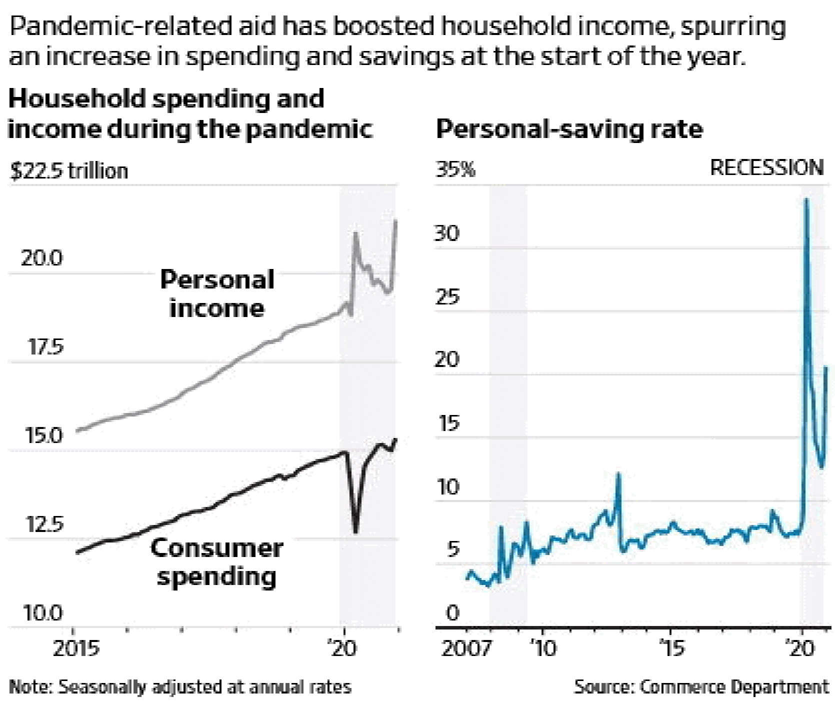


The global economy should also recover this year with good growth:



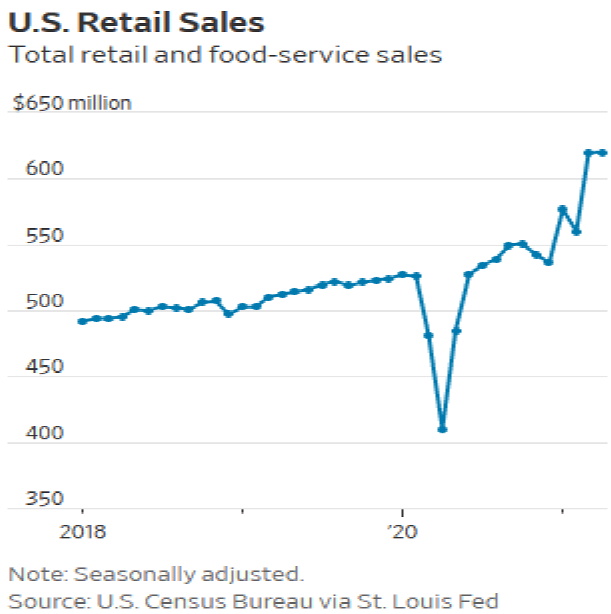
The Consumer

The charts below show how government aid, support, and stimulus checks have helped savings rates, income, and spending.

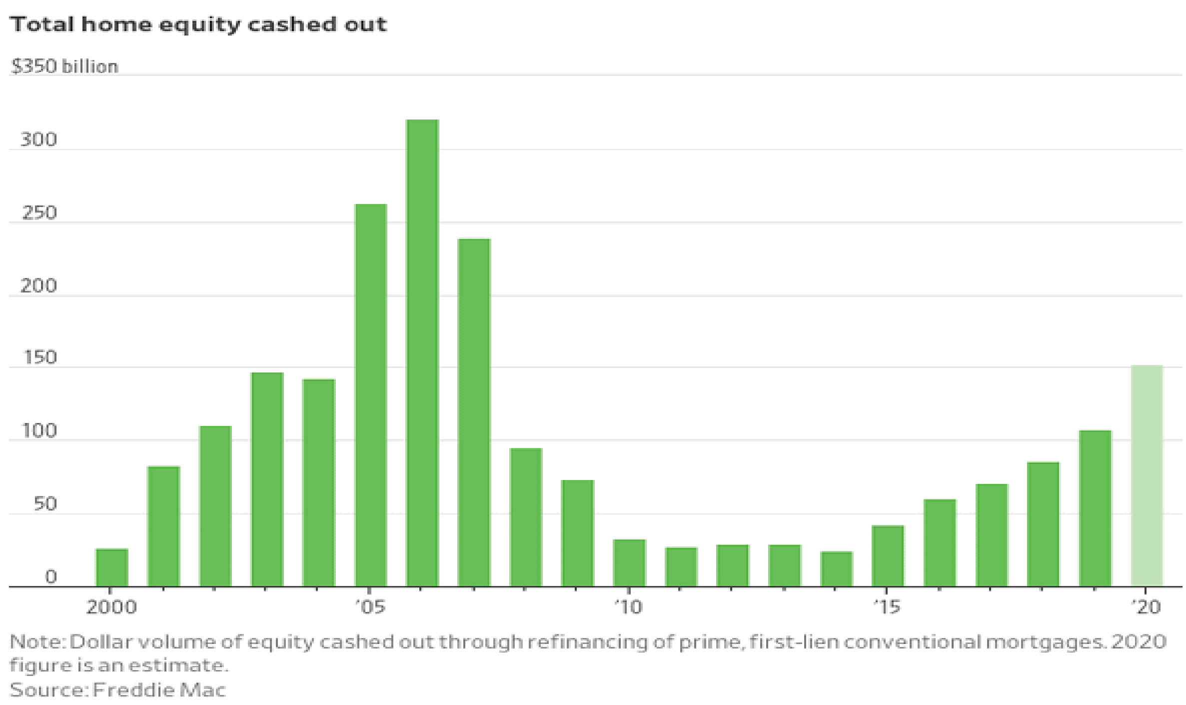


The chart shows personal income and the savings rate dip once stimulus checks were spent and the extra support from covid unemployment benefits ended toward the end of 2020. The extra unemployment benefits were reinstated.

Because of all the aid and stimulus money, retail sales are above pre-pandemic levels.



Another variable helping the consumer is mortgage, equity cashouts

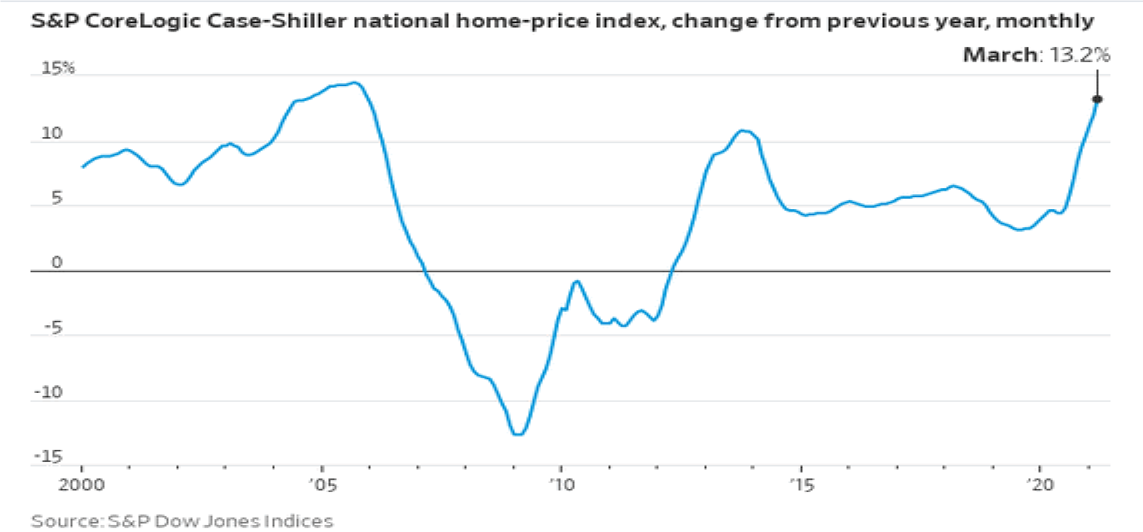


More about these mortgage cash outs below. It seems most of these mortgages went to borrowers with high credit scores.

Housing

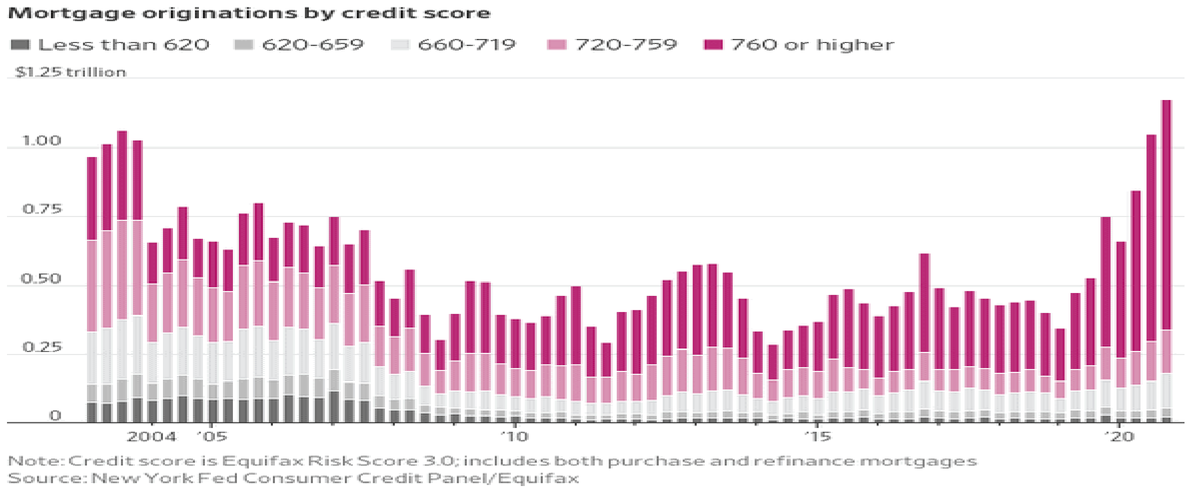
Housing has been a bright spot in our economic recovery. The strong housing market is starting to moderate.

Housing prices have bounced back strongly. Higher prices for homes and the markets increases the wealth effect that normally leads to higher consumer spending.



During the pandemic, new home sales dropped to a low of about 300,000 homes. That has recovered to around 1 million new homes sold. Because of higher interest rates, higher home prices, and low new and existing housing inventories, we can see new home sales are starting to level off.

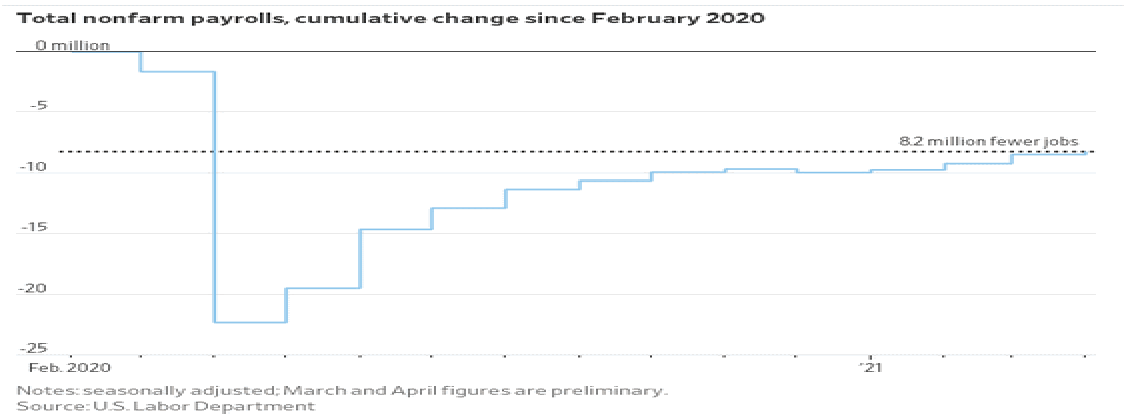
Below is a chart that shows mortgage lending trends for about the last 20 years. Lately, most of the mortgages went to borrowers with high credit scores. This means current borrowers are probably more affluent with better-paying jobs leaving behind many potential buyers with less means.



Again, with higher interest rates, higher prices, and lower housing inventory, potential buyers are expected to be fewer.

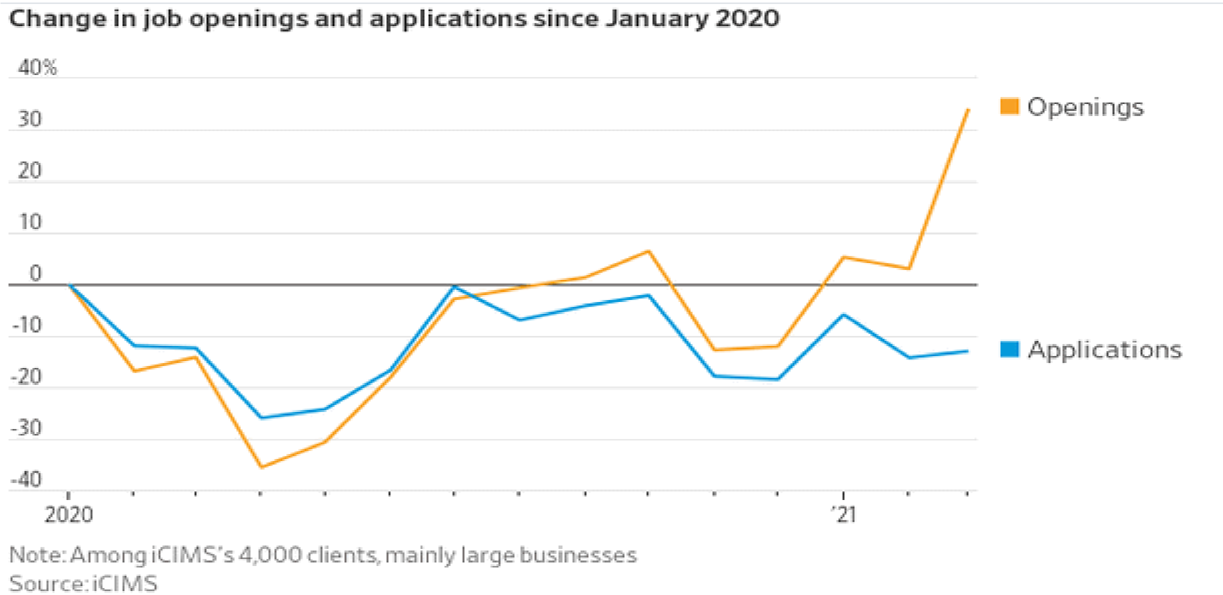
Labor

Jobs creation has surged higher, but we are still aways from full employment. There are about 8 million people that are unemployed and are part of the unemployed looking for work.



Employers are complaining that they can't find workers. This was true before the pandemic. Below is a chart that shows before the pandemic there were more job openings than jobs. Much of it was due to skill gaps. Workers don't have the skills needed for the jobs of today.

Currently, job openings are much higher than potential employees.



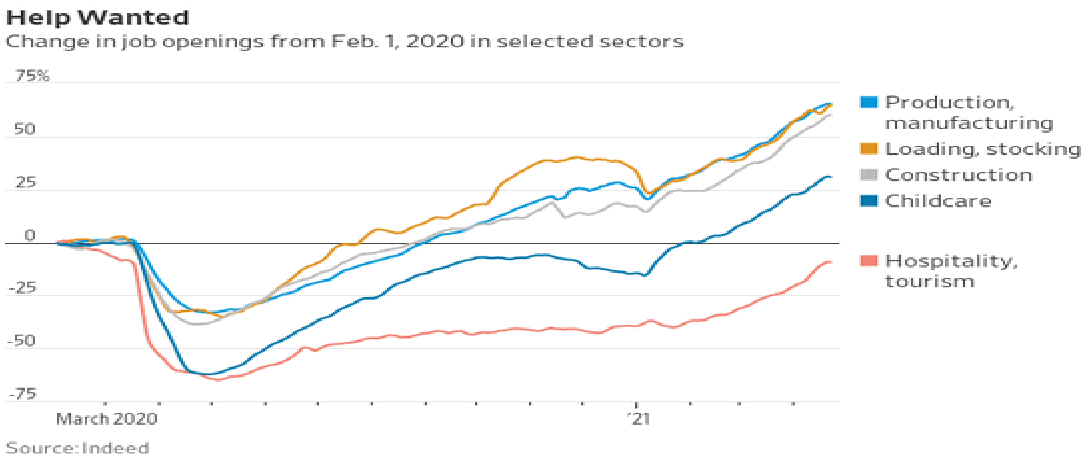
There are many reasons for the scramble for new hires:

- Similar to many products and services – currently demand is much stronger than supplies, especially for labor.
- Some workers changed industries, especially to warehousing and logistics
- Some became gig workers for companies like Uber, Grub Hub, or they started businesses
- Some of the job openings deal with the public. Some of these potential workers live in multi-generational homes, they have to be more careful and not bring the virus home so some of these workers are reluctant to go back or take jobs dealing with the public.
- Many jobs dealing with the public have had to stay closed or have limited capacity, leaving many in these types of jobs unemployed or are working part-time.
- Some schools are not open, so some parents have to stay home and teach and care for their children. This is especially true for women.
- Some employers believe that most of the unemployed don't want to work because of the extra $300 a week they get from unemployment. A study was done by the San Francisco Federal Reserve and found that 1 out of 7, about 14%, are declining job offers because they can make more money staying home.

  The extra unemployment pay is scheduled to end in September.

- Some older workers are deciding to retire early

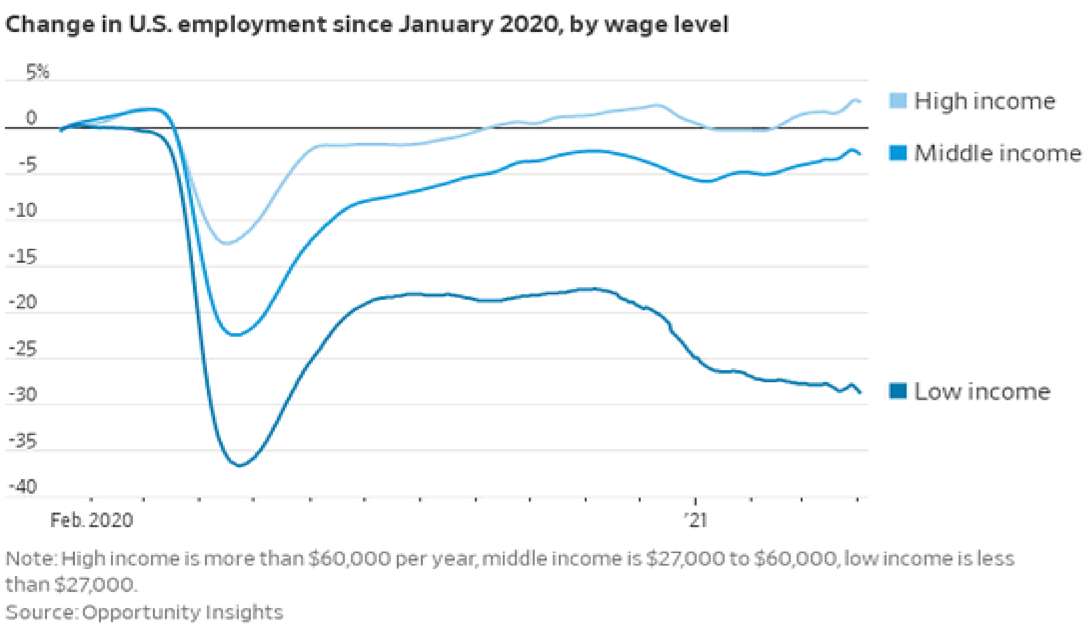
The chart below shows the industries, jobs that have the most openings/demand:



Again, some of these jobs are not being filled because of a job skills gap, especially in production and manufacturing.

The pandemic has highlighted the struggles of the poor not only in the U.S. but around the world. Poor countries and people are getting infected more and are struggling even more financially.

Below is a chart that shows low-income workers have had the lowest employment changes. Again, this has to do with low-income people who tend to work with the public (restaurants, retail, personal services), and those businesses have had to lockdown, open, and lockdown again or partially open. Unemployment in these businesses remains high.

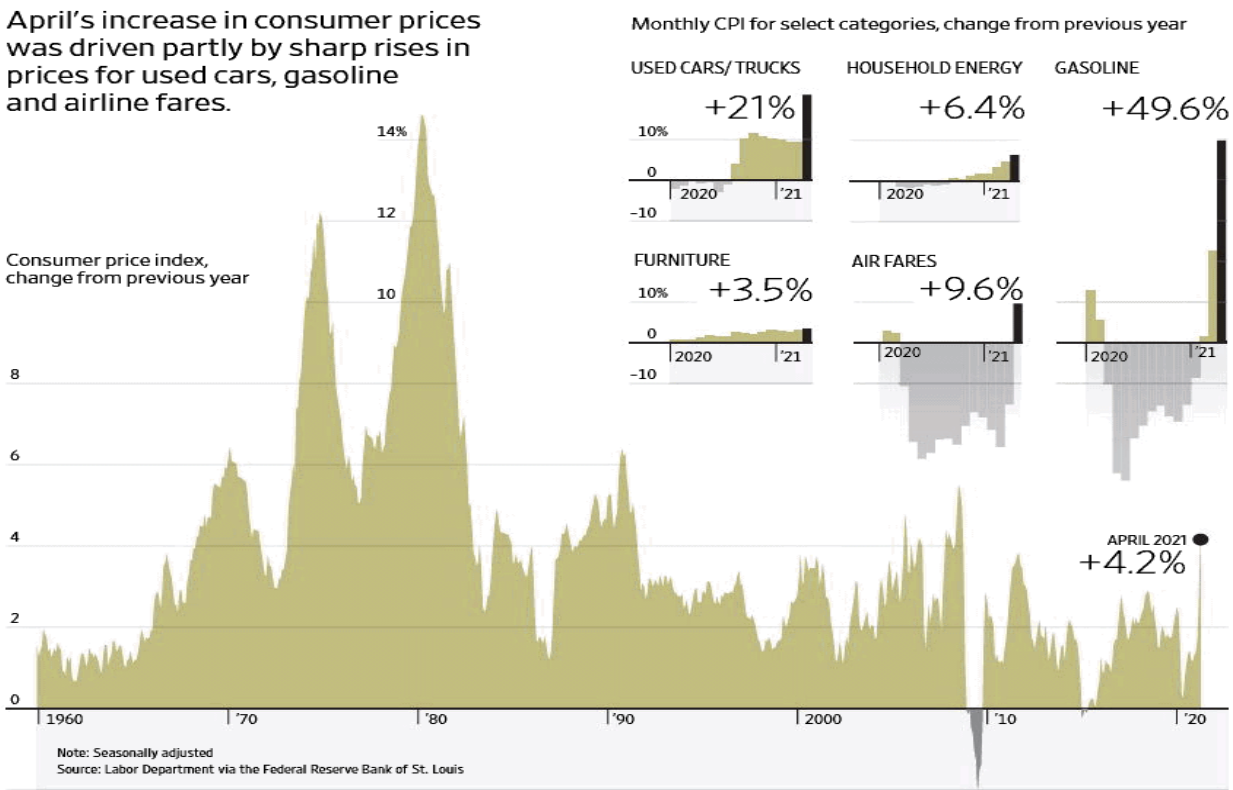


The lockdowns have hit lower-income workers the most.

The plight of poor people is a recurring theme with this administration and is impacting inflation, and interest rates strategies.

Inflation & Interest Rates

Below is a chart that shows long-term and current inflation trends:

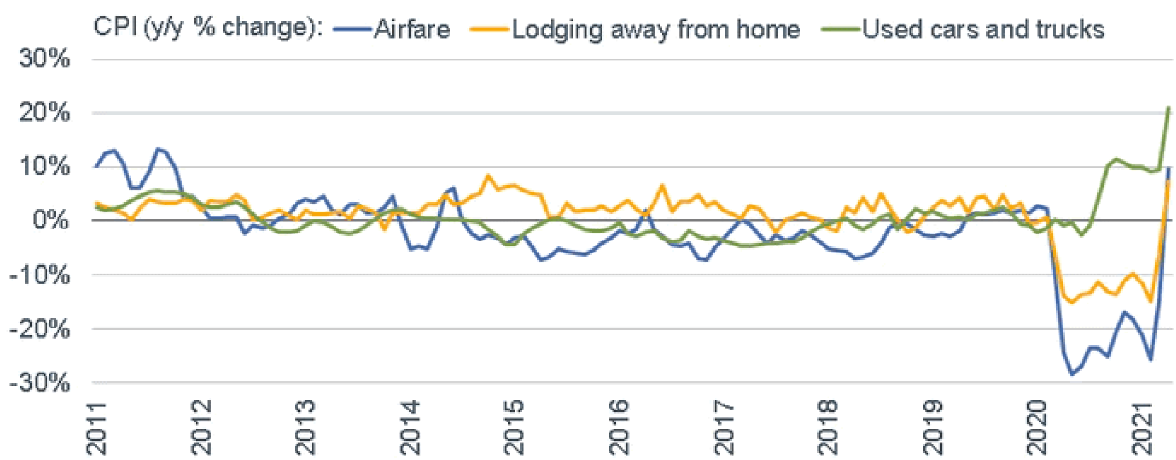


Inflation was bad in the 1970s due to oil embargos and oil supply disruptions from the Middle East and bad monetary policies. Inflation has averaged slightly above 2% for the last ten years. April's inflation reading spiked to 4.2%, the consensus forecast was 3.8%.

I've written several articles about the importance of inflation and interest rates on the economy, markets, and stocks. Briefly, for markets and stocks, many valuation models (capital asset pricing model, discounted cash flows, P/Es adjusted to inflation) include interest rates as one of the important variables in valuation calculations. When rates rise valuations normally fall and vice versa. If you would like a copy of these reports, feel free to email me.

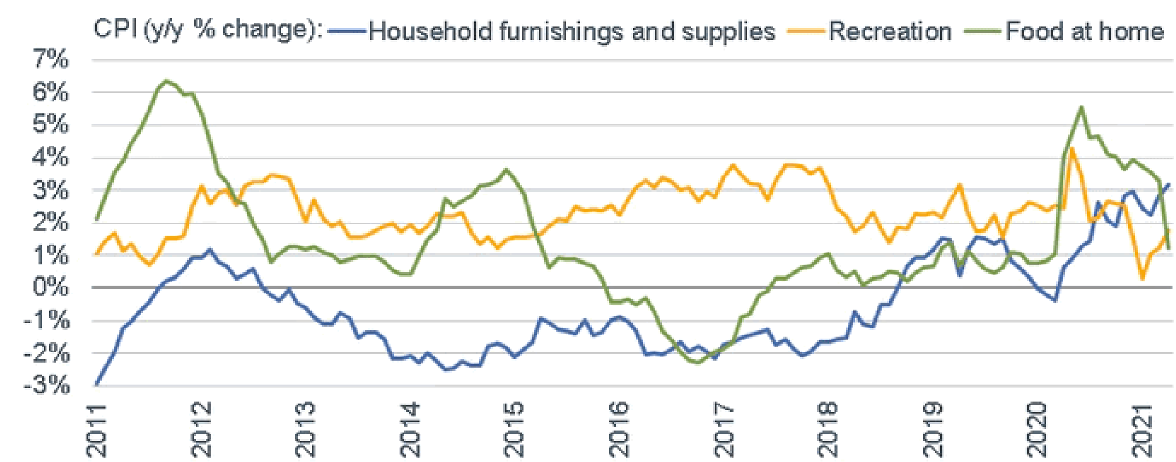
The first chart below shows where prices are spiking. The second chart shows where prices are falling or are moderate. Inflation is happening in the areas of the economy where demand/supply shortages are stronger than expected.

Surging CPI Categories



Source: Charles Schwab, Bloomberg, Bureau of Labor Statistics, as of 4/30/2021.

Benign CPI Categories



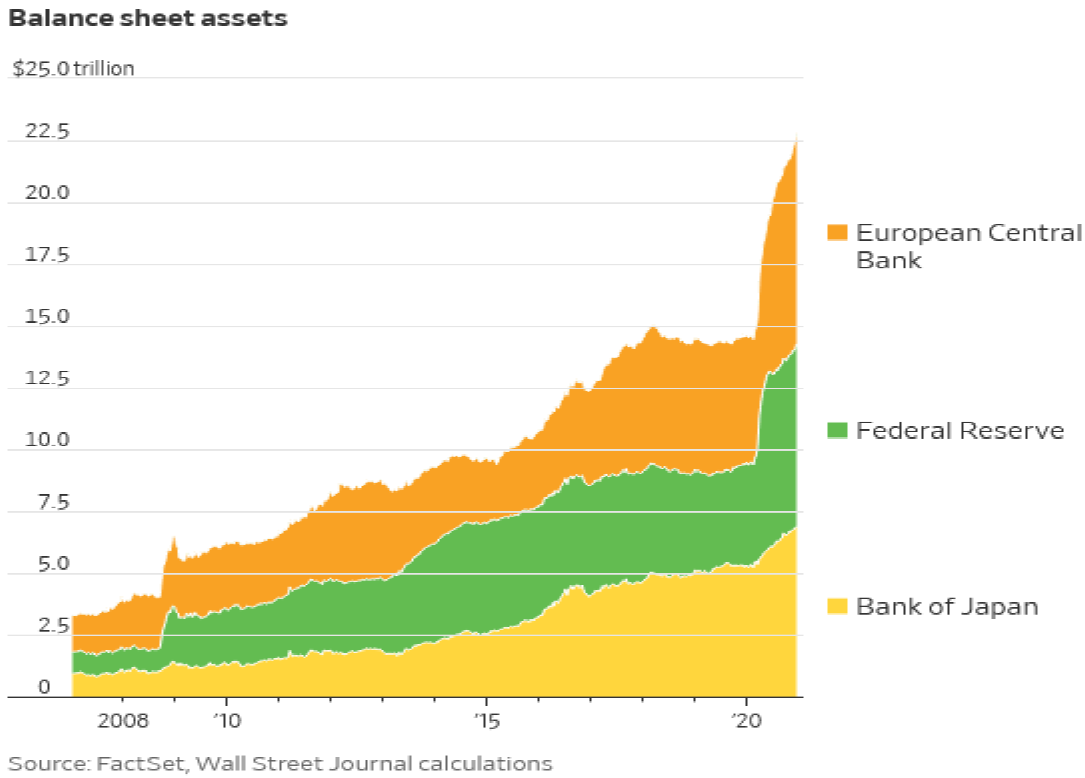
Source: Charles Schwab, Bloomberg, Bureau of Labor Statistics, as of 4/30/2021.

Below are the cases for sustained inflation or inflation will be transitory.

The Case for Sustained Iflation

There are two basic types of inflation: demand-pull and cost-push inflation. Unfortunately, we currently have both. The GDP chart on page 3 shows a strong recovery, which means strong economic activity and demand. The strong demand is causing shortages from lumber, copper, microchips, beef, chicken, labor …. The shortages are causing price increases that lead to higher input costs for many goods so now we have some cost-push inflation.

Some of the strong demand is coming from all the liquidity provided by global central banks:



According to the above chart, central banks have increased their balance sheets from around $15 trillion to about $22 trillion. Too many dollars chasing too few goods.

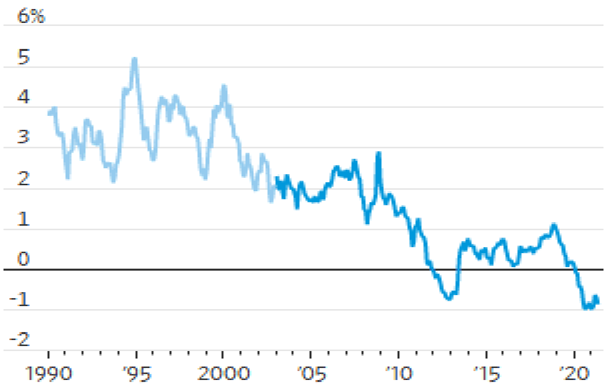
The Federal Reserve continues to buy about $120 billion a month of government and agency debt keeping long-term interest rates low.

One of the reasons why inflation has remained low is because businesses were reluctant to raise prices for fear of losing market share. They were willing to accept lower profit margins. It's different this time, input prices are so high, most businesses are willing to raise prices since most are planning to raise prices. There is not a fear of losing market share to competitors.

There is also inflation in the debt and equity markets:

Money is Dirt Cheap

Inflation-adjusted 10-year Treasury yield



Note: 10-year Treasury yield minus 12-month change in consumer price index excluding food and energy before 2003, 10 year inflation-indexed Treasury yield thereafter

Source: Federal Reserve Bank of St. Louis

Rates remain ultra-low helping businesses with borrowing for growth and consumers buying big-ticket items.

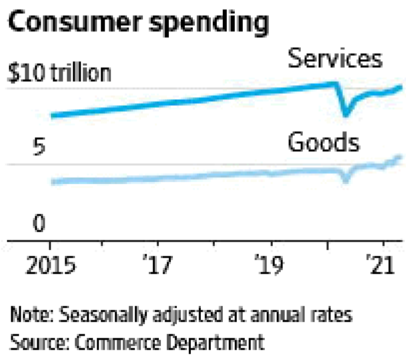
There is inflation in bonds. Normally the 10-year paid about a 3% premium above inflation. The 10-year no longer pays at least the rate of inflation.

Stocks are also inflated. The historical P/E average is about 16. It is currently above 20, stock and market prices are inflated.

As I wrote about in the labor section, labor demand is high for certain industries. It's a mixed bag if these labor cost increases will be sustained. There is high turnover in some of these jobs, so the next group of hires could be hired at lower wages when labor demand pressures subside.

Lawmakers have sent $800 billion in covid relief payments to households. Another $700 billion in additional unemployment benefits is helping workers. All this cash is helping consumer balance sheets and is increasing spending.

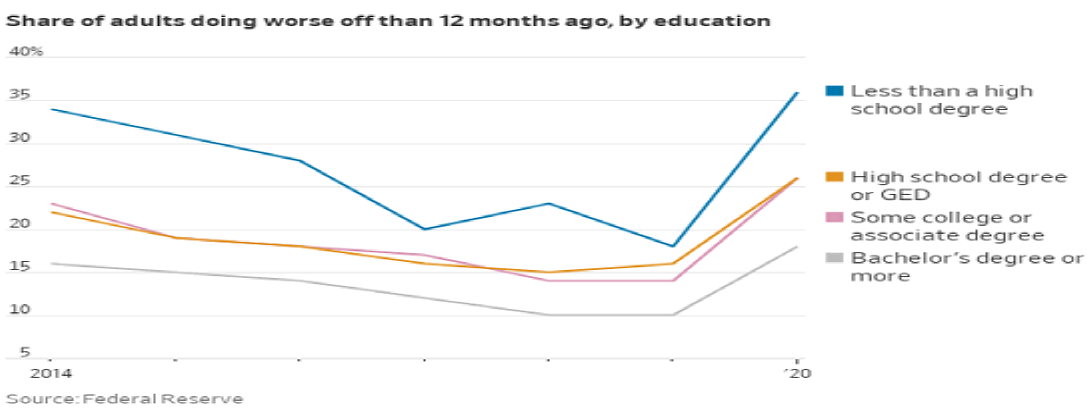
During the pandemic, consumers were still able to shop online. It's expected that services, travel will see strong demand as the economy opens up:



Goods spending has surpassed pre-pandemic levels. Because of the lock-down of many services, they remain below pre-pandemic levels. Services are expected to see strong demand as the economy opens up.

I've written several times that this administration, the Fed, and the Treasury are all willing to let the economy heat up. Inflation will creep up and interest rates may stay low until those that want a job can find one.

Here is another chart that shows that lower-income workers continue to be left behind:



Many of these workers work in low-skilled jobs with low pay and benefits. Again, the Fed, Treasury, and this administration want to keep interest rates low and the economy strong to help all workers.

All the liquidity provided by central banks and aid, support, and stimulus from lawmakers is creating a strong recovery. We are now seeing strong demand and supply shortages.

The Current Inflation Trend Is Transitory?

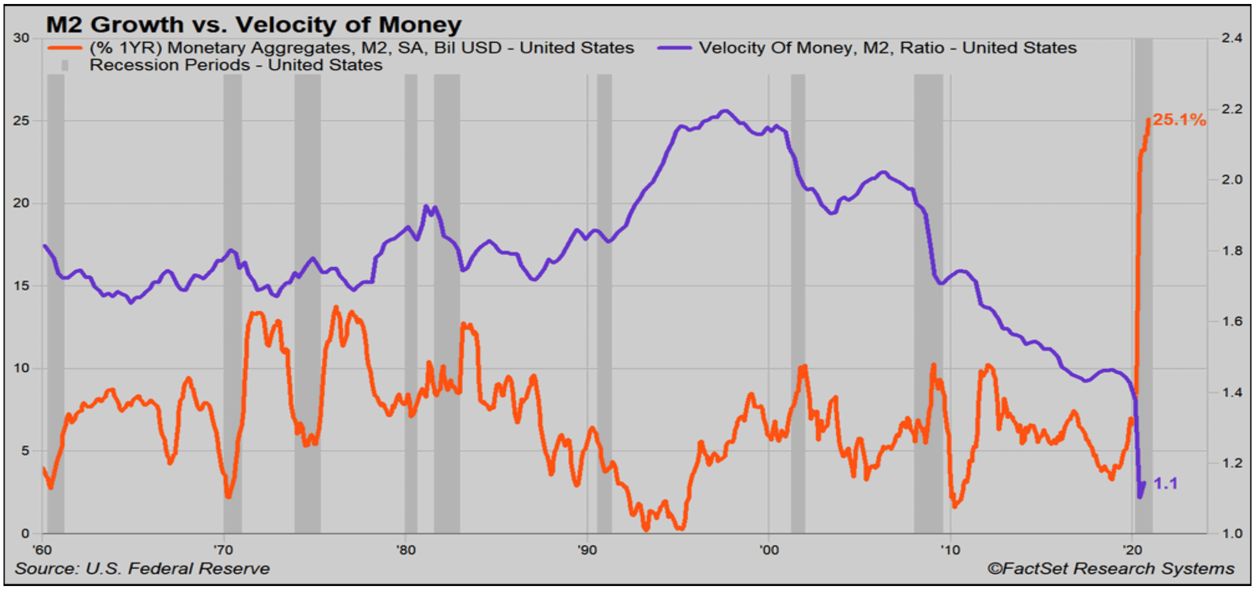
The Wall Street Journal does an economic survey from close to 80 economists from around the world from academia and different industries. Below is the consensus and sample from these economists:

WSJ Economic Survey April 2021	CPI (Year-over-Year Percent Change)			
Organization:	June 2021	Dec 2021	Dec 2022	Dec 2023
National Association of Manufacturers	3.2	2.7	2.5	2.5
Naroff Economics LLC	3.7	3.1	1.9	2.3
MacroEcon Global Advisors				
CoreLogic	3.0	2.0	1.8	2.0
TD Securities	3.2	2.2	2.1	
Stifel, Nicoulas and Company, Inc.				
BMO Capital Markets	3.1	2.5	2.1	2.3
IHS Markit	2.9	2.0	1.5	2.0
Ameriprise Financial	3.7	3.2	2.2	2.0
Point Loma Nazarene University	3.2	2.7	2.4	2.4
St. Mary's University College of Arts, Huma	2.0	2.5	3.0	3.0
North Carolina A&T State University Willie	1.8	1.7	1.6	1.7
Deutsche Bank Securities, Inc.	3.3	2.6	2.2	2.3
Pantheon Macroeconomics				
Decision Economics Inc.	2.5	2.3	2.2	2.5
EconForecaster LLC	2.5	2.6	2.0	1.7
University of Central Florida	3.1	2.7	2.5	2.2
SS Economics				
Amherst Pierpont Securities	3.5	3.2	2.8	2.7
Economic Analysis Associates Inc.	2.8	3.1	2.8	2.5
JPMorgan	3.7	2.9	2.2	
Credit Suisse	3.3	2.8		
American Chemistry Council	3.8	3.3	2.8	3.3
Grant Thornton	3.2	2.3	1.7	2.1
Northern Trust	3.1	2.4	1.9	2.0
UC Riverside School of Business Center for	3.5	3.1	2.4	3.0
Wilmington Trust Investment Advisors				
Credit Agricole CIB	3.3	2.7	2.1	
Eaton Corp.	3.3	2.8	2.4	2.4
HSBC Securities				
First Trust Advisors LP	3.0	2.7	3.5	
Wrightside Advisors				
National Association of Realtors	2.2	2.9	3.5	3.4
Morgan Stanley	2.5	1.7	2.7	
April	**3.01**	**2.58**	**2.27**	**2.34**

The consensus inflation forecast is about 3% for this year but falls to the 2.3% area by the end of 2023.

In this sample, the highest inflation forecast is 3.7% (not shown were two forecasts at 3.8%). Two of these forecasters do see inflation peaking this year and going lower going forward. These economists should understand the economy and inflation better than most of us. According to these forecasts, inflation is expected to be transitory.

I included the chart below in my 2021 Economic Outlook.



Here is what I wrote in my Outlook:

"The orange trendline shows the money supply growing, especially during recessions. Notice how high money supply growth grew after 2010 and is exploding now, but the velocity of money, blue trendline, has crashed meaning businesses, consumers don't want money, even when it's cheap and abundant. In other words, all the liquidity from the Fed is barely being spent. Low economic activity from all the liquidity is not creating inflation."

The trend of a low velocity of money is expected to continue. This means inflationary pressures from a velocity of money will probably not happen. Too many dollars have not been chasing too few goods.

Normally high prices lead to less demand that leads to less supply and demand. This normally leads to a supply-demand equilibrium.

Again, GDP is growing at a 6.4% rate in the 1st quarter of 2021. Is this sustainable? Most economists agree it won't. Below is the GDP consensus forecast and a sample of forecasts from the WSJ survey of economists.

WSJ Economic Survey April 2021	GDP (Annual 4Q/4Q)		
Organization:	Full Year 2021	Full Year 2022	Full Year 2023
MacroEcon Global Advisors			
CoreLogic	6.6	2.7	2.1
TD Securities	5.6	2.5	
Stifel, Nicoulas and Company, Inc.			
BMO Capital Markets	7.0	2.9	2.4
IHS Markit	6.6	2.7	2.1
Ameriprise Financial	6.6	3.5	2.6
Point Loma Nazarene University	6.8	3.5	2.4
St. Mary's University College of Arts, Huma	4.0	2.3	2.0
North Carolina A&T State University Willie	4.0	2.2	2.0
Deutsche Bank Securities, Inc.	7.6	2.9	2.2
Pantheon Macroeconomics			
Decision Economics Inc.	6.3	5.0	3.5
EconForecaster LLC	5.3	3.5	3.1
University of Central Florida	5.4	2.8	2.6
SS Economics			
Amherst Pierpont Securities	7.8	3.2	2.6
Economic Analysis Associates Inc.	3.9	2.9	2.7
JPMorgan	6.4	2.8	
Credit Suisse	7.6	3.0	
American Chemistry Council	6.5	3.3	2.5
Grant Thornton	7.2	2.4	2.2
Northern Trust	7.7	2.8	2.0
UC Riverside School of Business Center for	9.4	3.4	1.3
Wilmington Trust Investment Advisors			
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Eaton Corp.	6.2	4.0	2.8
HSBC Securities			
First Trust Advisors LP	6.0	2.5	
Wrightside Advisors			
National Association of Realtors	4.2	2.8	2.5
Morgan Stanley	8.1	2.8	
April	**6.41**	**3.21**	**2.39**

A 6.4% growth rate is not sustainable with a $20 trillion economy. The slower growth should help supply and demand achieve equilibrium.

Lastly, the Fed could eventually come to the rescue if inflation gets out of hand. The best cure, raise rates, the cost of money to slow down the economy to relieve inflationary pressures. They've done this many times in the past.

Summary and Conclusion

- We are seeing the beginnings of a strong recovery

- The strong recovery is due to: getting close to herd immunity and the reopening of the economy: liquidity from central banks; support, aid, and stimulus from lawmakers; pent-up demand due to on-again, off-again lockdowns, especially for services

- The strong recovery means strong demand when supplies are being overwhelmed, especially for lumber, copper, homes, certain food staples, labor…. This is causing some inflationary pressures and concerns from consumers, economists, the administration, and investors.

- Rising and high inflation and interest rates are bad for the economy, consumers and investors. Low-interest rates and inflation are good for the economy and investors. Contact me if you would like to receive my reports on the importance of inflation and interest rates to the economy and investments.

- The case for a sustained inflation trend include: all the liquidity, cash from the Fed and lawmakers, businesses are willing to raise prices, strong demand and supply shortages, the Fed is willing to let the economy run hot with inflation to make sure that all who want a job can find one.

- The case for transitory inflation include: most economists believe inflation will come down in the next few years; supply and demand will transition to equilibrium, the velocity of money has been low for about the last 20 years, the Fed can always raise interest rates to slow down the economy and inflationary pressures.

- No one can predict the future and what will happen to inflation, but I'm closer to most economists who are forecasting that inflation will be transitory.

As usual, I will keep an eagle eye on inflation, the Fed, and interest rate trends.