2021 3rd Quarter Economic Update

Unfortunately, the economic outlook has changed from my last economic update. A few months ago, the outlook was optimistic, and it seemed we were on the road to a strong recovery. No one can tell the future consistently and accurately, so we must adapt and adjust as the outlook changes.

One significant change-the delta variant is causing more infections, hospitalizations, and deaths. This will be our third wave of infections. These waves cause uncertainty regarding the economy and markets.

The economy is losing momentum, consumers are pulling back, employers are slowing their hiring, and businesses have to try and adjust and adapt to new, changing health requirements.

There are also concerns about the debt ceiling that has to be approved by the Senate and Congress. Tapering of government bond purchases is also a concern.

There are now concerns about a debt default by the second-largest real estate developer in China. More about this in the GDP section.

Covid

Most financial media focuses on covid because it's understood that the economy is dependent on covid's outlook. In last month's market update, I provided three scenarios:

1. The delta variant peaks and falls, similar to Great Britain. This would be the best scenario and could lead to a strong recovery.

2. Covid is a global problem and spreads quickly. Most of the world is not vaccinated, so covid may be with us for a while, and we have to learn to live with it. This could slow the global and U.S. economic recovery.

3. The variant continues to mutate and becomes more contagious, and evades vaccines becoming more deadly. This is the worst scenario for the world.

If you can tell me what scenario (there could be more, but the financial media focuses on the above three) will happen, we would have an idea of the prospects for the economy.

Here are the latest covid numbers from the week of September 13:

The Latest Numbers

63.4% of the U.S. population have had at least one vaccine dose

54.1% of people in the U.S. are fully vaccinated

171,350 new U.S. cases recorded yesterday

2,678 deaths in the U.S. recorded yesterday

666,627 total U.S. deaths

4,661,153 total deaths world-wide

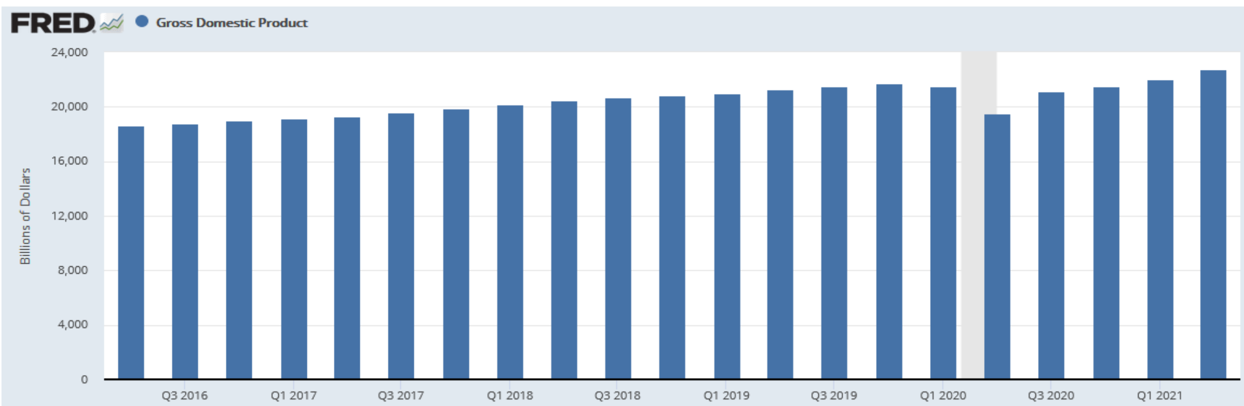
Source: WSJ

The list of numbers no longer includes those that have been infected. There are over 40 million people who have had the virus. If we included these people, we would be closer to 70%. From what I've read, health experts believe that those infected would have better protection if they had at least one shot of a vaccine.

GDP

At the beginning of the year, GDP was expected to grow above 4% for 2021. The economy was picking up steam, and economists were talking about GDP growth of about 6%. There are many signs that the economy is slowing. Consensus GDP forecasts will probably not be out until October. We can expect it to be lowered to 4%.

Below is a five-year chart for GDP:

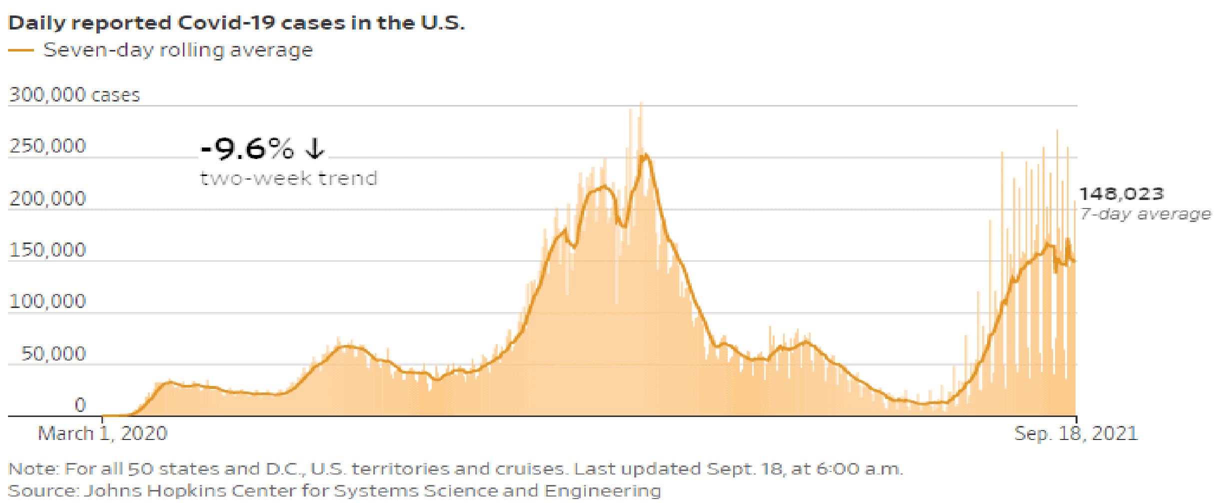


Source: Federal Reserve Economic Data

There was steady but slow growth from 2016 to 2019. Covid caused the U.S. to go into a short but deep recession.

In 2020, U.S. and global central banks provided trillions of dollars of liquidity into the financial markets. U.S. lawmakers provided aid and support to help works, small businesses, and many other entities to help them get to the other side of the health and financial crisis.

Let's look at the covid spikes and review the impact on the economy.

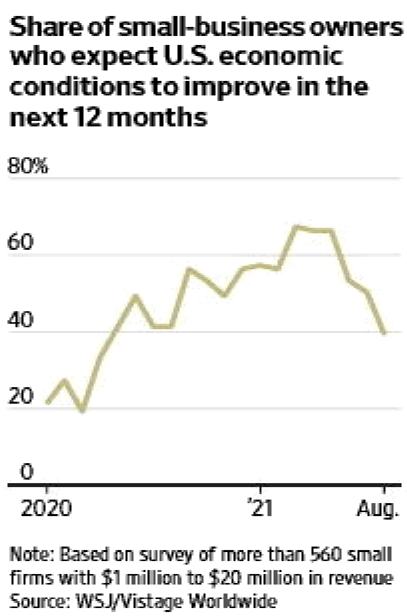


The economy went into a recession in the first wave, primarily due to the uncertainty of the virus and the lack of a vaccine and treatments and the closing of many public and private organizations.

The second wave during the winter did not slow the economy down. The economy probably had enough momentum to avoid a double-dip recession in this wave of infections.

Some analysts are concerned that the eviction moratorium ended, and we may see some landlords struggle with their mortgages, and we could see more homeless families.

Covid is also impacting small businesses:



Small business confidence was improving, but covid is creating uncertainty among consumers and businesses.

China's Debt Problem

It looks like China's 2nd largest real estate developer may default on some of its debt. Some analysts compare this to the real estate bubble bursting in 2007 that led to the Great Recession. It's not a good comparison. Wall Street firms sold sub-prime loans all over the world. When mortgage holders defaulted on their mortgages, it created a global financial crisis. The exposure by U.S. investors to the Chinese developer is small.

What happened in China has been predicted for years. Everyone knew that China borrowed too much money that went into real estate.

China's growth will probably slow, and thus global growth will likely be slower. This could slow U.S. growth.

This is another event, trend that must be monitored.

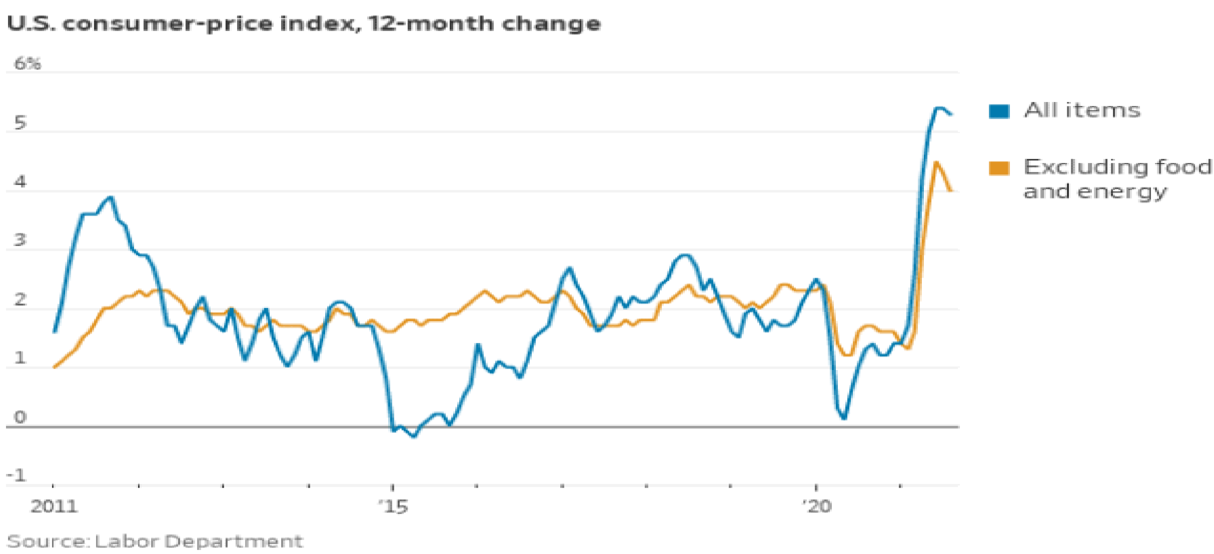
Higher taxes?

The Democrats are trying to pass a $3.5 trillion for human infracture investing. To pay for the spending, they are proposing tax hikes. The prospects for passing the house and Senate are bleak, so I will hold my analysis till something is passed.

CPI, Interest Rates

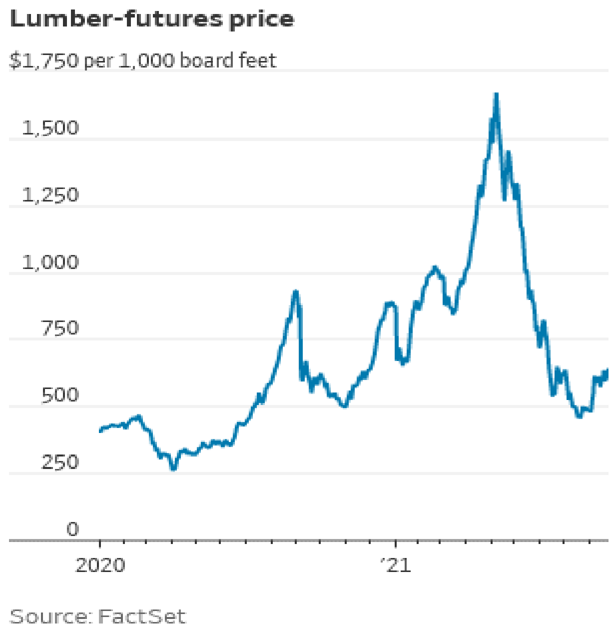
Inflation

There is a debate among economists and investors on whether the current high inflation will be transitory or sustained. Much of the inflation is due to one-time effects. The global reopening is causing increased demand with supply constraints, especially with supply chain disruptions worldwide.

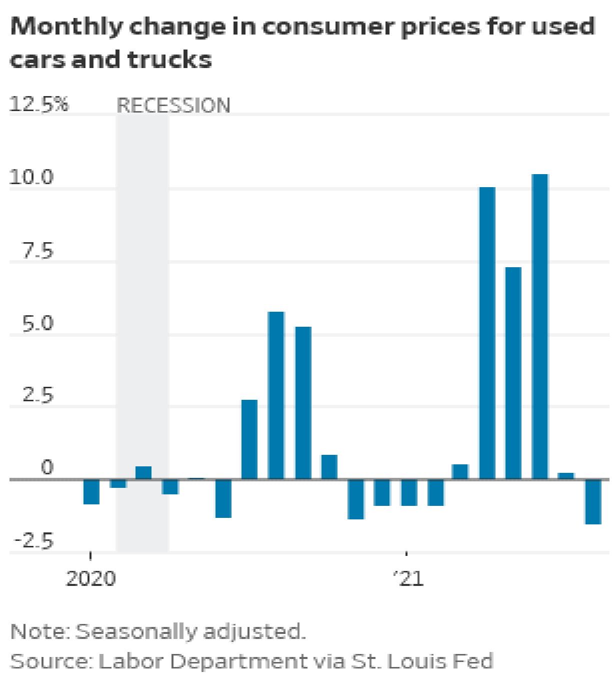


The chart shows the spike in inflation. Now we see a minor reversal of the spike.

We are starting to see a reversal in some prices. Last year that was lots of reports of skyrocketing lumber prices. Fortunately, we see a reversal in lumber prices:

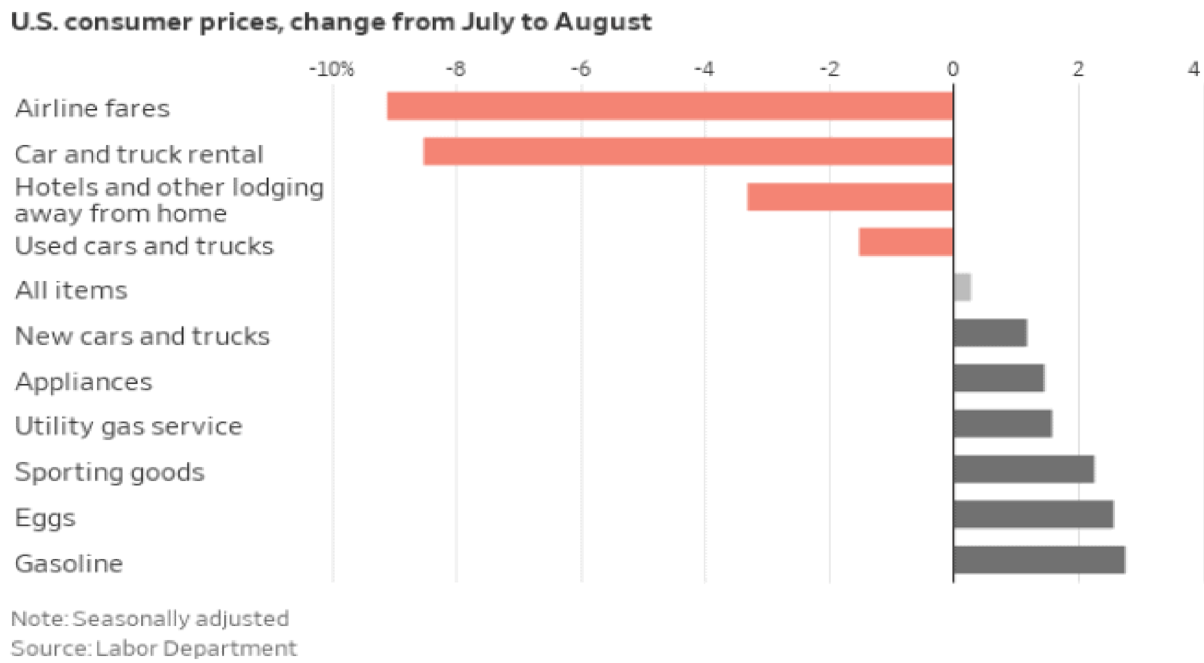


As most of us know, most newer cars are loaded with technology. A critical component of these technologies is semiconductors. There is a global shortage of semiconductors, and without semiconductors, car manufactures have had to close down some of their production. Consumers have had to buy used cars. As demand for used cars surged, so did used car prices.



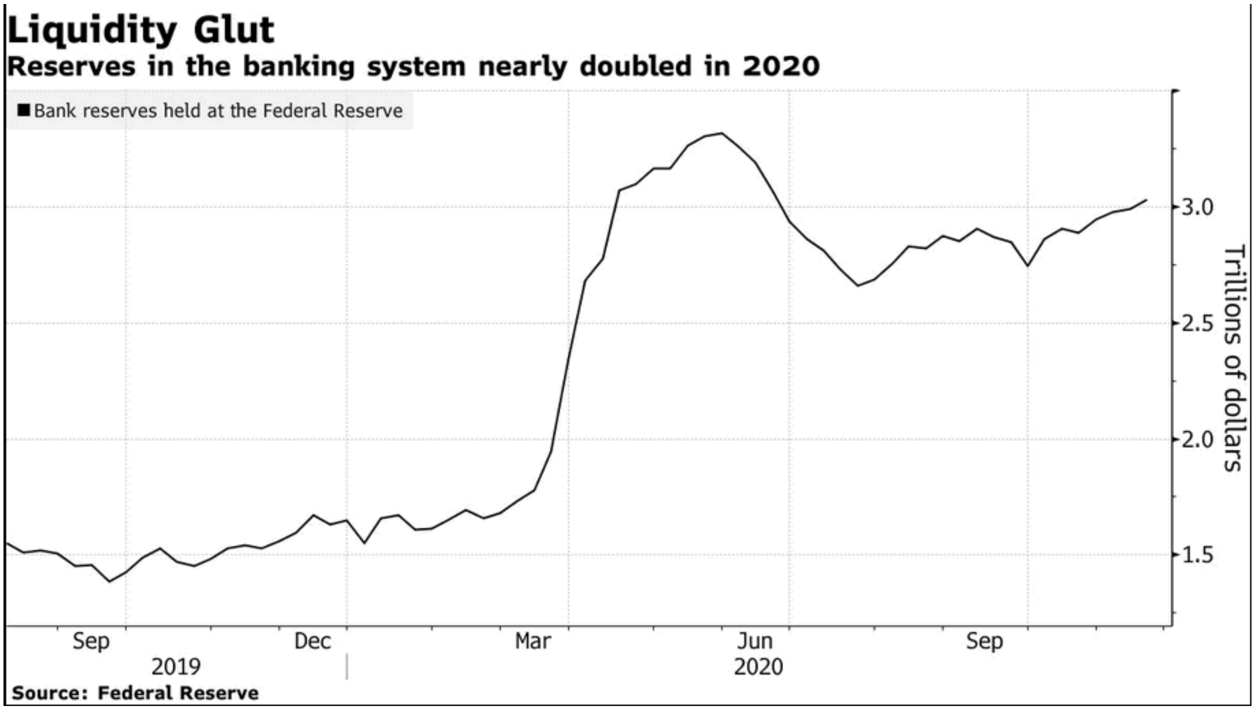
After the surge in prices, we now see a reversal of the spike.

Some of the inflation in the components that were rising are now reversing:



Gasoline has the highest price increase. Gas prices are seasonal. We usually see gas prices fall during winter when there is less driving/traveling. Prices typically rise during the summer driving season. Prices can spike during the hurricane season that ends in November.

In the past, when there is too much liquidity from the Fed in the banking system, and the banks lent the money out, it can cause inflation. Too many dollars chasing too few goods.



The liquidity in the banking system is not being lent out. If banks start lowering their lending standards and loaning out money, this can cause inflation. This has not happened since the Great Recession that began in 2008. The "velocity" of money is low and is not causing inflation.

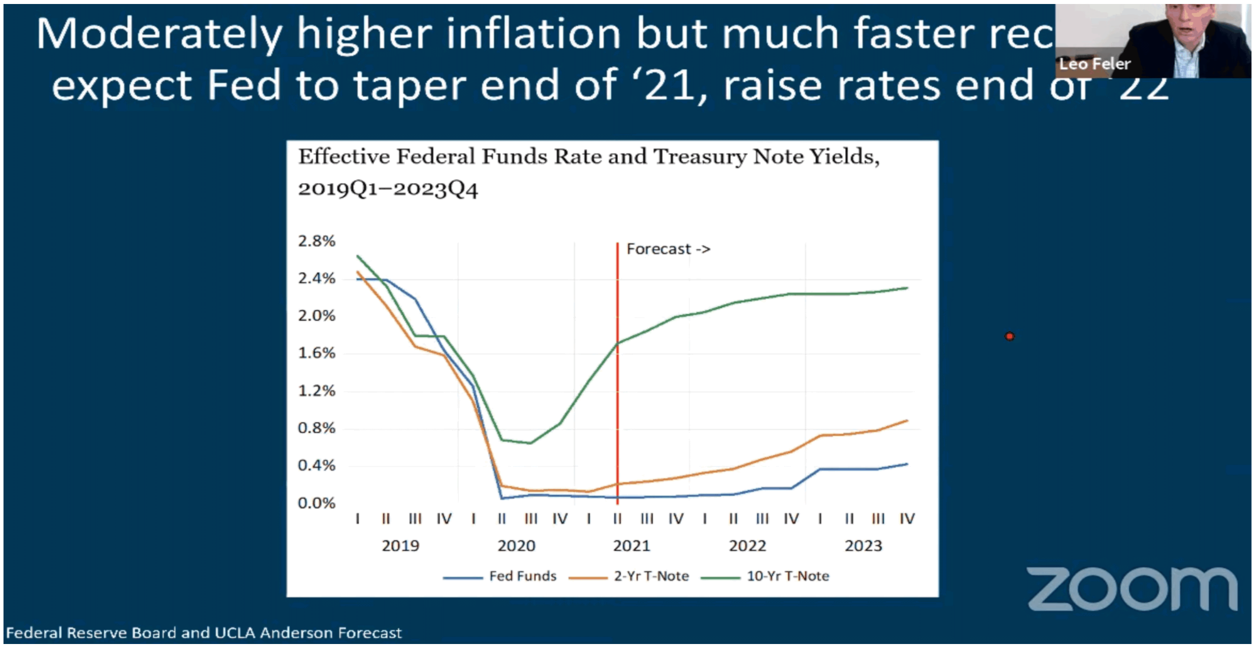
Interest Rates

The bond markets don't believe there will be higher inflation. Below is a 3-year chart of the 10-year Treasury:

Typically bond yields reflect inflation, as investors need to be paid at least the rate of inflation to protect the buying power of an investment dollar. According to the inflation chart at the start of this section, inflation is about 4%. The 10-year interest rate is about 1.4%, way below the current rate of inflation. Admittedly, bonds have had low yields because of quantitative easing (bond-buying by the Fed) going back to 2008. If the bond market believed there would be significant inflation, yields would move much higher.

The Fed's quantitative easing program currently buys $120 billion a month of mostly treasury and government agency debt. Investors and economists have tried to guess when the Fed may end its quantitative easing, otherwise known as "tapering." In a recent Federal Reserve press conference, Fed Chair Powell stated tapering may start by the end of this year and may end mid-year 2022. It's also expected that the Fed may begin raising the Fed Funds rate by the end of 2022 or early 2023.

Quantitative easing has helped keep long-term rates low, as shown by the above chart. What could happen to bond rates when all the buying ends? According to the UCLA Business School and their economists, forecasters see rates rising in 2022, 2023:



UCLA forecasters see the 10-Year Treasury about 2.4% by 2023.

Forecasts can be wrong, and no one can accurately predict the future. Because inflation and interest rates are so important, we must monitor these forecasts for their adjustments up or down.

Inflation and interest rates are critical to the economy and markets. I keep a sharp focus on both.

Briefly, low inflation and interest rates help the economy and asset valuation and vice versa.

The Fed has said they want to keep interest low until they reach full employment and are willing to tolerate some inflation.

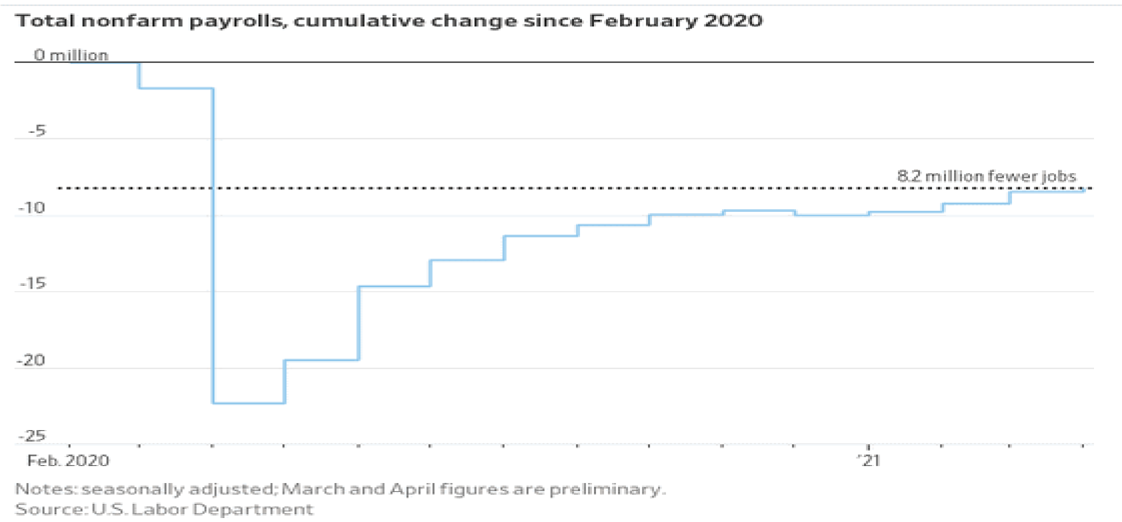
Employment and Consumer

It's essential to focus on the consumer because the consumer is about 70% of the economy.

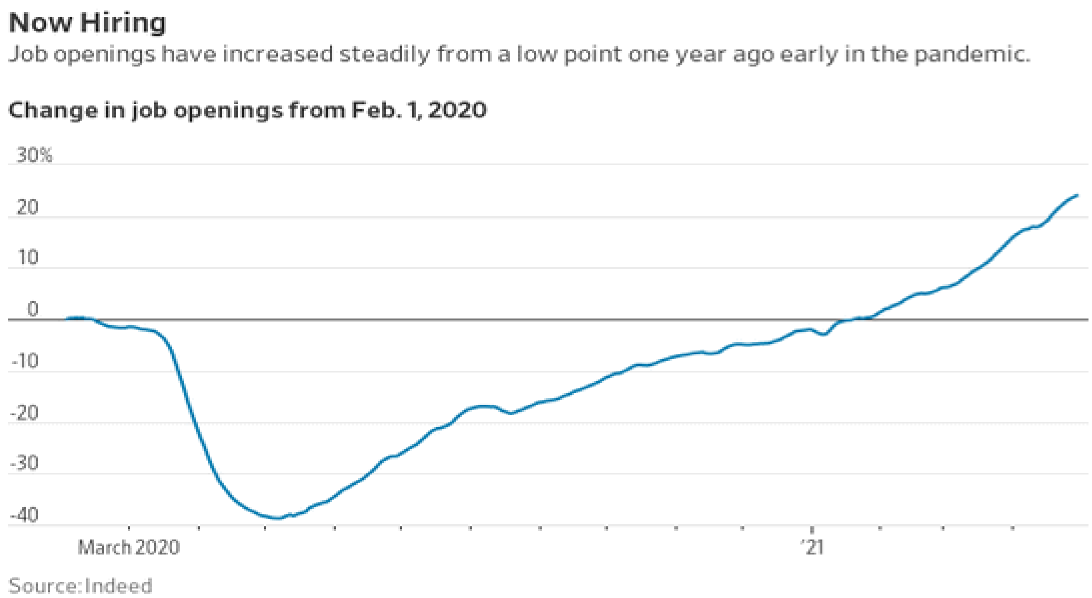
Employment

I've been monitoring the economy for decades, and I've never seen the employment picture so mixed. Some components of the employment picture are positive, and some are concerning.

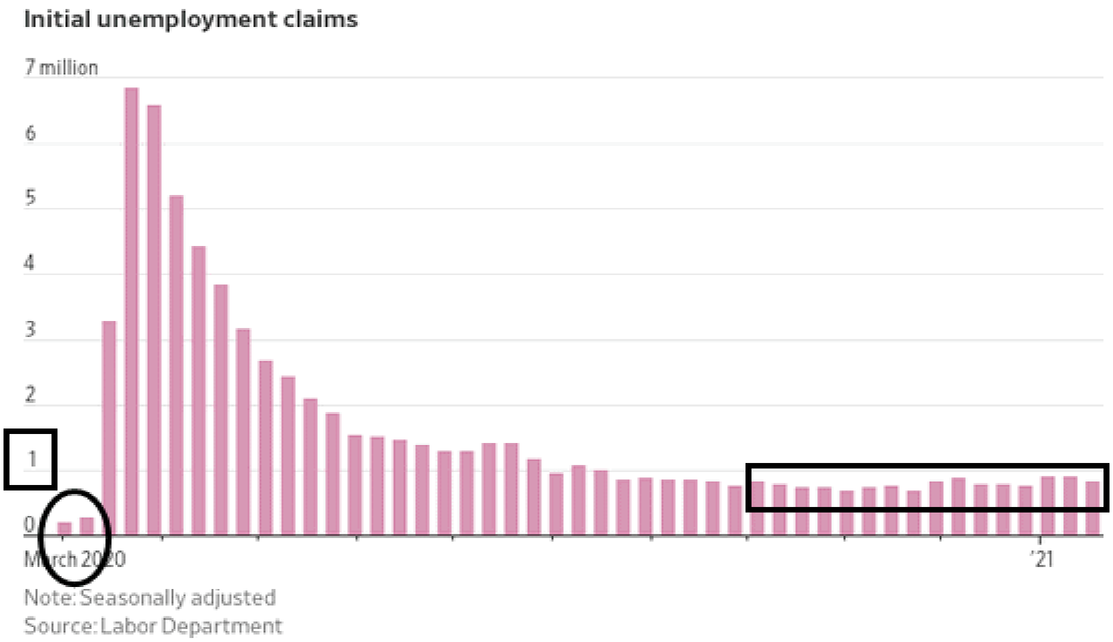
There are about 8.2 million unemployed, higher than the amount before the pandemic.



Also, there are more jobs than applicants frustrating employers:

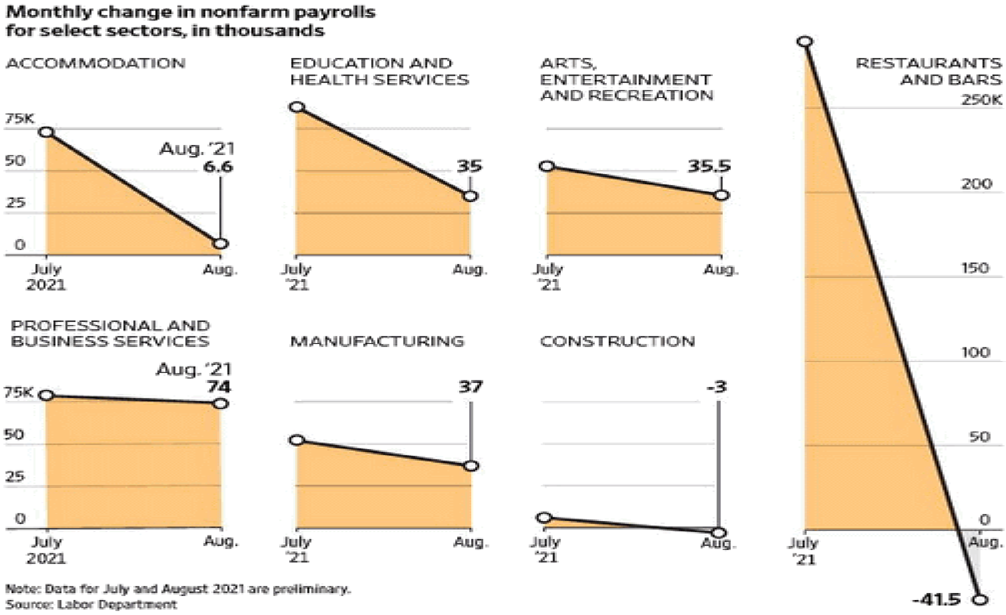


Making the employment picture worse is the third wave of infections for the U.S. Unemployment claims were coming down. Now we see unemployment claims rising again because consumers are pulling back in eating out and shopping at malls and brick and mortar stores.



The third wave of infections is impacting the employment picture. The circled months of the chart show the level of unemployment claims before the pandemic. Unemployment claims skyrocketed at the start of the pandemic, but there was steady progress in bringing down the claims. Claims have been rising slightly the last few months.

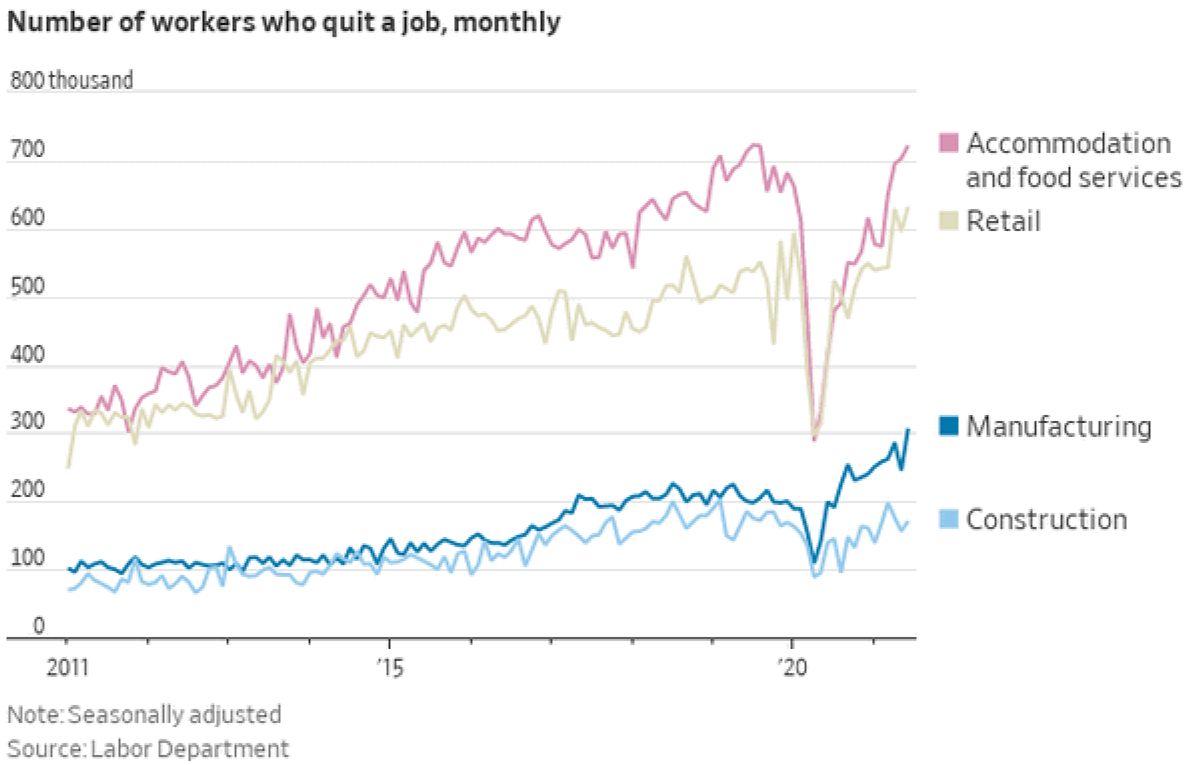
Below is a chart showing where the job losses are occurring:



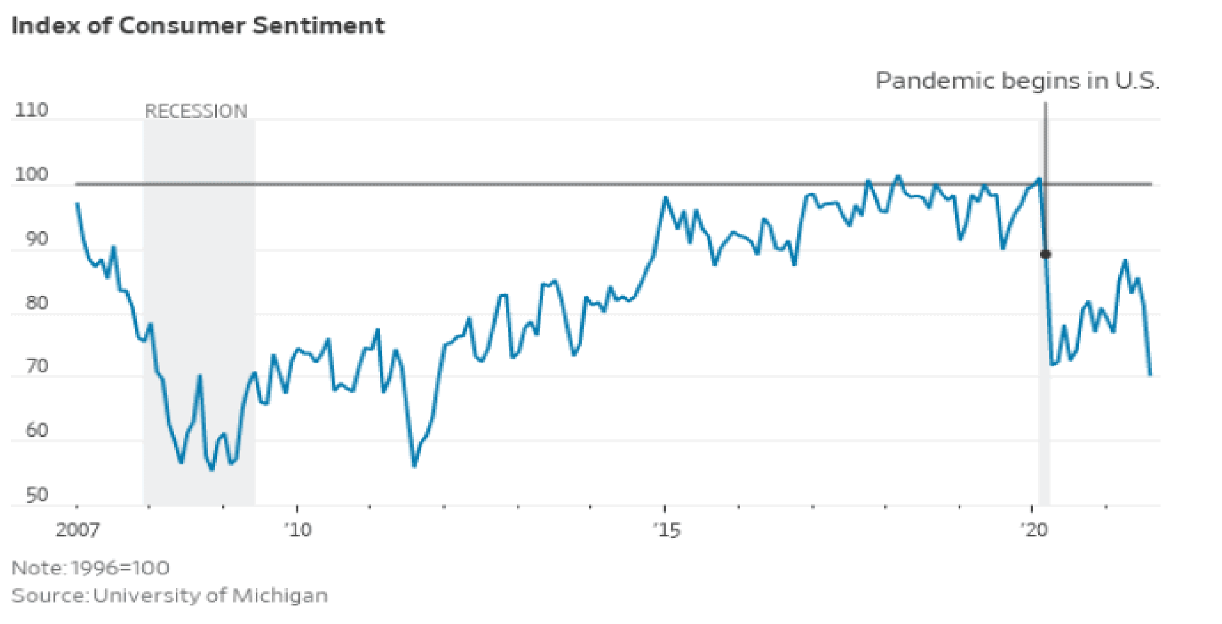
As expected, restaurants, bars, and hotels saw the largest drops in employment. Education and health services also had large drops.

One of the peculiar employment trends is the high "quit rate." By definition, the quit rate is the number of workers who are quitting their jobs:

Workers in hotels, restaurants, and retail have the highest quit rates:



In the financial press, a word you come across is "reassess." Workers are reassessing their jobs/careers: some workers are looking at other job options; some took courses to qualify for better-paying jobs with more benefits and job security; there is quite a bit of data and stories showing workers close to retirement are deciding to retire early.



Covid, Afghanistan, the border crisis is adding to the uncertainty and lower consumer confidence. Usually, lower confidence leads to lower consumer spending.

We see slower retail sales:

Retail sales improved to above pre-pandemic levels. We are now seeing a slowing in retail sales.

Summary and Conclusion

- As I've been writing about for the last 1 1/2 years, covid is the key to the economy and markets. Unfortunately, we're in our 3rd wave of infections. The world is behind in vaccinations, the virus can continue to mutate, and some health experts believe covid will be with us for a while, and we will have to learn to live with it. Hopefully, this outlook is too pessimistic.

- Even though inflation has recently spiked, we see a reversal in prices that were rising, there is little velocity of money, and the bond market is not reflecting higher inflation. Some economists see interest rates rising after tapering next year and in 2023.

  The level of inflation and interest rates are critical to the economy and markets. I will continue to monitor the trends of inflation and interest rates.

- The employment picture is mixed with plenty of job openings, but we see high quit rates, especially in areas of the economy where employers are begging for workers.

- We are seeing lower consumer and small business confidence.

- A few months ago, most investors and analysts were optimistic about the economy and markets. But, covid, China, the debt ceiling, potential higher taxes… may cause the global and U.S. economy to slow, and this could lead to more volatility and lower market returns.

I remain bullish because we are in the early phases of the economic and market cycle. Also, my clients and myself are invested mostly in dividend-paying stocks that are undervalued to fairly valued. We don’t need high growth rates to do well.