

The U.S. is shaking off the COVID restraints. The domestic economy is roaring driven by pent up consumer demand, continued low interest rates, and government stimulus. Demand is outpacing supply stretching the economy at the seams and raising concerns that a supply shock could bring inflation. We are in the early stages of what is likely to be an extended economic expansion, one that is more robust and broader than recent expansions.

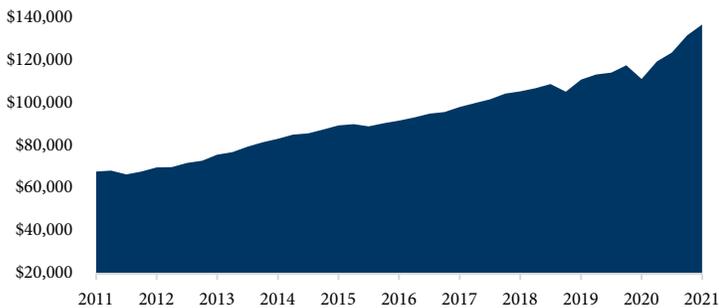
Financial and commodity markets largely reflected the heightened growth outlook. The S&P 500 returned approximately 8.5% in the second quarter and has increased more than 15% this year, driven more by industrial, financial, and materials companies than by technology companies. Many commodities prices continued this year's run, although they have come off the boil lately. Bonds rallied, relieving inflation concerns for now. The U.S. Treasury 10-year Note yield fell from 1.75% to near 1.50% at quarter end.

The end of pandemic induced restrictions is unleashing economic forces not seen since the end of World War II. Exuberance is palpable. People enjoy socializing without masks! Sporting events draw spectators and flights draw passengers. Rush hour and vacation traffic again snarl roadways.

There are at least three strong pillars supporting this expansion: a strong consumer, a long-delayed capex cycle, and government spending. The fiscal stimulus should not be discounted as it topped 15% of GDP in 2020 and should total over 10% in 2021. A further \$1.2 trillion is expected to be approved this summer. Fiscal programs enacted during the pandemic largely worked to stabilize American workers and families. New programs will further enhance spending but seem to be motivated, at least in part, to meet political objectives.

Consumers remain the primary economic force spending about 19% more in May than a year ago. Consumers' willingness to spend is matched by ability and confidence. Compensation was up close to 10% from last year and consumer net worth is at a record high.

U.S. Household Net Worth 2021 (in billions\$)



Source: Board of Governors of the Federal Reserve System, Households and Nonprofit Organizations; Net Worth, Federal Reserve Bank of St. Louis

Sales are likely held back by supply constraints. Manufacturers are struggling to produce enough product to satiate demand. The entire supply chain is challenged, exhibited by the well-publicized semi-conductor shortage. Goldman Sachs estimates that the semi-conductor shortage affects 169 industries ranging from automobiles to kitchen appliances and electronic devices, but the problem is far

larger than one component. The U.S. does not have enough willing workers. From truck drivers to waitstaff, capacity is limited by worker availability.

In this regard, some readings of the work force are misleading. The unemployment rate remains elevated and employment stands about 7 million below pre-pandemic levels. However, the Bureau of Economic Activity's April report was full of positive readings including a record 9 million jobs available. Close to 4 million people voluntarily quit their jobs in April, a record high that reflects a bullish outlook for wages and job advancement. Similarly, involuntary separations were 1%, a record low. The reluctance of some to work should wane as pandemic inspired payments expire and child-care capacity returns.

Job Openings & Job Quits April 2021 (in thousands)



Source: U.S. Bureau of Labor Statistics, Federal Reserve Bank of St. Louis

Corporate America is responding to the dearth of workers. After a year of retrenchment, companies are investing to meet demand. Enticed by ultra-low interest rates, companies have re-capitalized their balance sheets, are awash in cash, and have reduced interest obligations. The Institute of Supply Management's and the Philadelphia Federal Reserve Bank's May surveys indicate that much of these funds will be spent on capital equipment and supply chain infrastructure to alleviate current backlogs and meet future demand. This "capex" cycle appears to have legs and should help realign productive resources for today's economy. A similar story is likely to play out in Europe and Japan.

There is little chance, in our view, that the economy falters here. Corporate earnings should grow double digits and even state and local governments are flush with cash. The major economic risk is inflation. Long dormant, measures of inflation are rising. The Federal Reserve Board's (Fed) preferred measure of inflation, the core PCE deflator, measured 3.4% in May. The Fed targets an "average" inflation rate of 2%. While the latest reading is significantly higher than the 2% target, the Fed suggests that conditions driving the elevated rate are transitory and will dissipate as supply constraints recede. Investors should hope that the Fed's words speak louder than their actions.

In the past, notably the late 1970's-1980's, the Fed raised short term interest rates to break inflation's back. Now the Fed is trying to manage inflation by professing their vigilance while maintaining

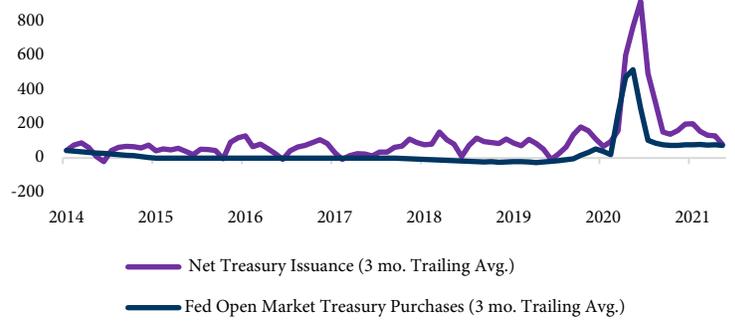
policies intended to push inflation higher – targeting a federal funds interest rate of 0% to 0.25% and purchasing \$120 billion of treasuries and mortgage securities per month. Recently, the Fed’s purchasing of Treasuries has equaled issuance, helping keep long interest rates depressed. Interest rates will likely rise before the Fed begins tapering its asset purchases, perhaps early next year.

As we move past the pandemic and the associated lockdowns, important social and economic questions remain. We used our strong economic position to finance the myriad of programs to support our country. In doing so, we increased our debt to levels not seen since World War II. The upward trajectory is unsustainable and pushes pandemic costs to future generations. How we assess these costs is becoming increasingly important to the markets. Debt remediation is likely to include higher taxes. The structure and form of any tax increases will affect economic growth and inflation. There is no simple fix and so far Congress has largely avoided the issue.

The immediate risk is that our economy is growing faster than its potential which may cause systemic inflationary pressures. Stocks will likely outperform bonds in this environment, however volatility is likely to increase for most asset classes as investors digest the growth/inflation paradigm.

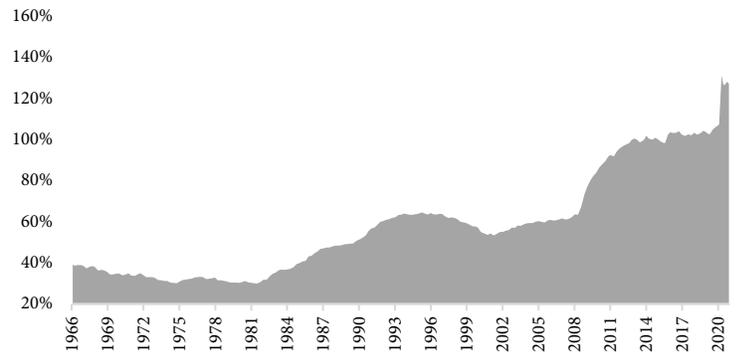
Net Treasury Issuance and Fed’s Open Market Treasury Purchases

May 2021



Sources: Bloomberg, Federal Reserve Bank of New York

Total Debt as a % of GDP January 2021



Source: U.S. Office of Management and Budget and Federal Reserve Bank of St. Louis, Federal Debt: Total Public Debt as % of Gross Domestic Product, Federal Reserve Bank of St. Louis

Investment Oversight Committee
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