Congress Asset
Management Company

# Economic and Market Outlook

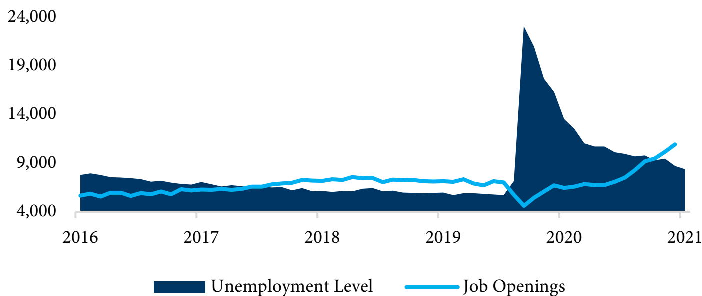
*Fourth Quarter 2021*

We enter the 4th quarter of 2021 at an inflection point. For most of this year, the financial markets were calm as the stock market rose, ignoring the economic lull that accompanied the rise of the Delta variant. At the same time, the yield on the U.S. 10 Year Treasury fell to about 1.25% in mid-August. Now, however, the financial markets are reassessing the outlook for inflation and growth. Market interest rates have risen faster than many expected, tempering stock gains and clouding the outlook. Increased volatility should continue as the global economy re-emerges from the pandemic induced restrictions, disrupting normal trade and economic patterns.

There is little doubt that the U.S. economy is expanding at an elevated rate. Demand for goods and services remains robust supported by strong consumer trends. This is unlikely to end soon as job opportunities remain plentiful, wages are increasing, and consumer net worth remains elevated. Re-establishing a pattern first seen in 2018-2019, the nearly 11 million available jobs outnumber the close to 9 million officially unemployed. Work is available and pay is increasing.

**Job Openings & Unemployment Level**

*August 2021 (in thousands)*

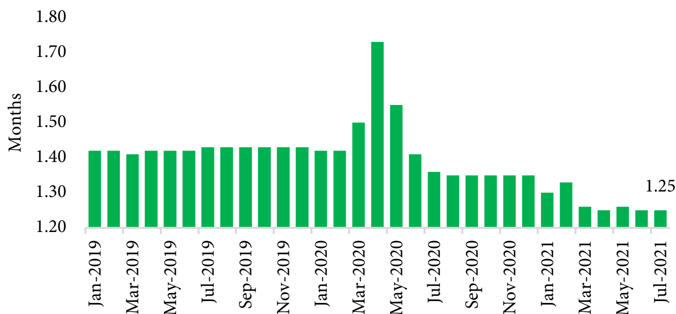



Source: U.S. Bureau of Labor Statistics

Trends for businesses and other organizations are also accelerating. The business inventory to sales ratio has fallen to less than 1.3 months. Replenishment to a more appropriate 1.4 to 1.5 months will take time, adding to demand pressures as companies re-stock.

**Total Business: Inventories to Sales Ratio**

*2Q 2021*



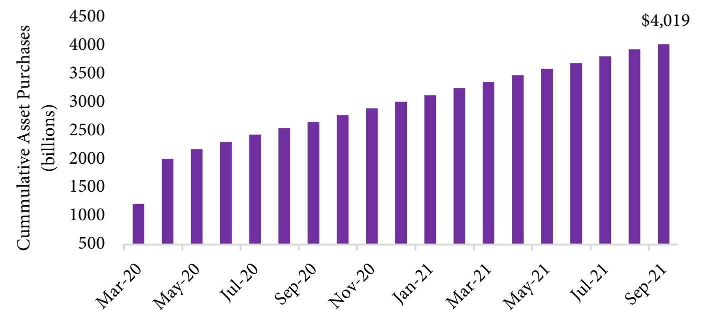

Source: U.S. Census Bureau

The U.S.'s spending spree has been ongoing for over a year. The breadth and depth of demand, coming on the heels of the initial pandemic shutdown, has overwhelmed supply chains. Twenty percent of all imports enter via the ports of Long Beach and Los Angeles where upward of 60 cargo ships await to unload goods. Shipping costs have skyrocketed and delays abound.

Supply chain constraints are one element adding to inflation fears. Employment costs continue to rise as help wanted signs proliferate at restaurants, hotels, medical facilities, and schools. The Federal Reserve Bank (Fed) has noticed. The Fed played an important role over the past 18 months by lowering short term interest rates and purchasing over $4T of fixed income securities. These actions helped alleviate and shorten the economic pain of the pandemic, but if extended too long could exacerbate inflationary pressures. Late in September, the Fed signaled it will curtail its asset purchases beginning in November, tacitly acknowledging that August's 5% CPI reading was too high.

**Fed Asset Purchases (Treasury & Mortgage Backed Securities)**

*March 2020 to Sept. 2021*




Sources: Bloomberg, Federal Reserve Bank of New York

Inflation and supply issues are also surfacing in Europe and China. Notably, oil and natural gas prices have spiked with natural gas up five-fold over the past year. Some of the price rises will likely prove temporary, but energy investments have shifted to renewable sources like wind and solar. Especially in the U.S., there are few new carbon energy projects. As global growth solidifies, demand for carbon-based energy sources will re-appear, helping to set a floor for oil and natural gas prices, one higher than we have become accustomed to.

As the financial markets grapple with inflation, Washington appears to be in a state of suspended animation. The most immediate concern remains the federal debt ceiling, which if not raised or suspended by October 18, will prohibit most federal expenditures. Congress is highly unlikely to let that happen as the Democrats have the votes to remedy this issue by themselves. But the prospect that a U.S. default could happen is tempering investor's risk appetite and affecting both stock and bond prices.

In addition, Washington continues to struggle with a $1 trillion bi-partisan infrastructure bill and the far more ambitious $3.5 trillion American Families Plan. As currently envisioned, the American

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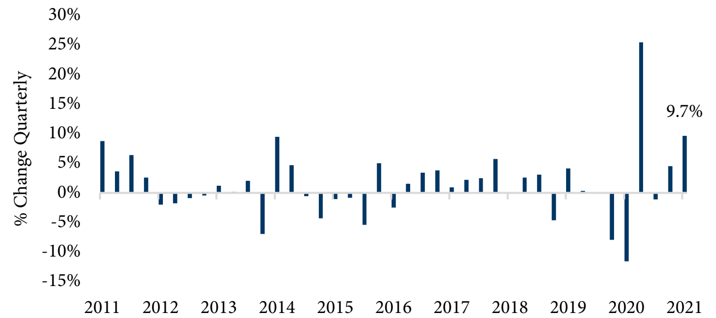
Families Plan would raise taxes, increase transfer payments, and enlarge the recipient class to include upper middle-class taxpayers. A slimmer plan could offer opportunities and assistance to those in need without the inflationary pressures the full plan would present to an economy already running close to capacity.

Fears that inflation is becoming systemic, similar to the 1970's, have risen. The Fed and others espouse a different view- that current inflation trends are transitory. The truth probably lies somewhere in the middle. Inflation will likely be higher than it has been, but not at the destructive level seen five decades ago. Many of the deflationary forces introduced to the economy since the 1980's should continue to suppress deleterious inflation.

For example, advancements in technology such as software and advanced machinery continues to foster better efficiency and productivity. Remote working offers flexibility and improves living standards. Globalization, embodied by the acceptance of China into the World Trade Organization in 2001, opened new trading routes, driving down prices. Global trade routes are now more disparate, a further check on costs while fostering development in other parts of the world. The Fed's September announcement itself should reassure inflation hawks that the central bank has not abandoned its price stability mandate.

A fall chill has descended on the financial markets. This is understandable given the positive returns over the past year and Washington's uncertain fiscal path. The economy is strong, however, and consumers and businesses will continue to spend until demand is satiated. Corporate profits, recently measured at +9%, should continue to grow and be supportive to stock prices over the next year. Bond returns may be more challenged as interest rates find a new equilibrium but offer stability and the promise of marginally higher income as we approach year end.

**Corporate Profits**
**(After Tax with Inventory Valuation Adjustment & Capital Consumption Adjustment) *2011-2021***




Source: Source: U.S. Bureau of Economic Analysis

**Investment Oversight Committee**
**Daniel A. Lagan, CFA, President & CIO**

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