Jobs and the Economy

The global supply chain bottlenecks that have increased prices for consumers and created growing uncertainty over the pace of our economic recovery are likely to persist for longer than formerly expected.

Automakers had hoped that chip shortages would be mostly behind them by now. But the surge in new COVID cases, especially in Southeast Asia where many of the chip manufacturers are located, has created a worsening problem that has forced manufacturers to close most of their North American plants.

Home builders are reporting missing home deliveries due to a lack of raw materials and a tight labor market, and retailers are warning holiday shoppers that goods may not reach the shelves in time for Christmas. Growing levels of congestion at major ports around the world and a serious lack of truck drivers are creating bottlenecks all along the transportation lines, delaying deliveries for retailers and manufacturers.

The International Monetary Fund (IMF) has downgraded its 2021 U.S. growth forecast by a full percentage point, the most for any major economy, citing supply chain disruptions and weakening consumption, which itself is driven by supply chain bottlenecks and the lack of inventory. Moody's has lowered its growth forecasts for both 2021 and 2022, citing "supply chain disruptions that are now showing up at every corner." Moody's also warned of more dark clouds ahead due to the challenge of "harmonizing the rules and regulations by which transport workers move in and out of ports and hubs around the world." The cultural and logistical differences in how countries are forced to fight the spread of COVID has resulted in the lack of a cohesive global approach to transporting goods.

Another disappointing employment report for September seemed to confirm the growing fears of an economy that was losing momentum. Payroll growth missed expectations by a substantial margin, with an increase of just 194,000 jobs vs. a consensus forecast of 500,000. But here, as in prior months' reports, there are more positive indicators that do not show up in the headline numbers. For example, jobs data for the prior two months was revised upward by 169,000, and private sector jobs rose by 317,000 with upward revisions to July and August numbers. Also, the household survey, from which the unemployment rate is calculated, showed a 526,000 rise in employment, in line with expectations for the second consecutive month. The unemployment rate itself fell to 4.8% from 5.2% in August and 5.4% in July. As we pointed out last month, the headline payroll survey counts the number of jobs, while the household survey counts the number of workers, including agricultural workers, the self-employed and workers in private households.

There was positive news with respect to incomes, as average hourly earnings rose 0.6% and hours worked rose 0.8%. The product of those is a proxy for income, which rose 1.45% in September, the biggest advance in more than a year. Initial jobless claims, a leading indicator of future jobs growth, fell below 300,000 for the week ending October 9th, the lowest level of the post-COVID era.

Inflation

It has become common practice to focus on supply chain disruptions as the sole cause of the inflationary pressures we are experiencing. While supply factors are certainly the primary cause, demand factors are at play here as well. Total spending in the U.S. economy has grown more than 17% over the last four quarters, as a historically high savings rate has combined with pent up demand in an economy that is trying to re-open. Aggregate demand is already back to its pre-COVID growth path, and future demand growth above the economy's sustainable growth rate would likely result in price inflation that is more persistent than the Fed (and most analysts) had previously expected.

St. Louis Fed President James Bullard, in a recent virtual presentation, said that this year's surge in inflation, which all central bankers had until recently viewed as temporary, may well persist in a strong U.S. economy and a tightening labor market. In typical Fed-speak, he said "While I do think there is some probability that this will naturally dissipate over the next six months, I wouldn't say that's such a strong case that we can count on it."

We are left to wonder, then, exactly how much of a probability is "some" probability, and the best we can say at this point is that it's not enough to count on. But the change in tone would indicate that the risk that the "persistent" case will prevail over the "dissipating" case is growing, and it is a risk that we are increasingly focused on.

Interest Rates and the Federal Reserve

The Federal Reserve has announced that it intends to begin to taper its purchases of securities before this year is over. This does not mean an end to quantitative easing, as the Fed's balance sheet will continue to expand - just at a slower pace. The prospect of tapering has raised concerns that that Fed may misplay the tapering process, leading to market volatility. However, the Federal Reserve has indicated that its actions will be gradual and dependent on market conditions.

Interest rates have moved higher throughout the year, with the yield on the 2-year U.S. Treasury rising to 0.34% from 0.13% at the end of 2020. The yield on the 10-year U.S. Treasury has risen to 1.60% from 0.93% over the same time period. The resulting spread in the 10-year vs the 2-year has risen from 80 basis points to 126 basis points, indicating that expectations for GDP growth and inflation have increased since the beginning of the year.

The Fed has two basic mandates: to achieve full employment and control inflation. The U.S. labor market continues to improve, even if unevenly as evidenced by the mixed September jobs report. The inflation pressures the U.S. faces are primarily – but not totally - related to supply disruptions, which we are increasingly convinced will persist well into 2022. The path ahead for the Federal Reserve is to navigate its tapering process while taking into account changing economic and financial market conditions, and to judge when best to raise short-term interest rates to stabilize demand in an over-heated economy. Given the current political climate, the continuing threat COVID places on the pace of our recovery, and the ongoing unevenness in the labor market recovery, there is a growing concern that the Fed may find itself behind the curve, and will maintain its dovish policies longer than warranted, thereby risking entrenched inflationary pressures unrelated to current transitory pressures brought about by supply disruptions.

The Stock Market

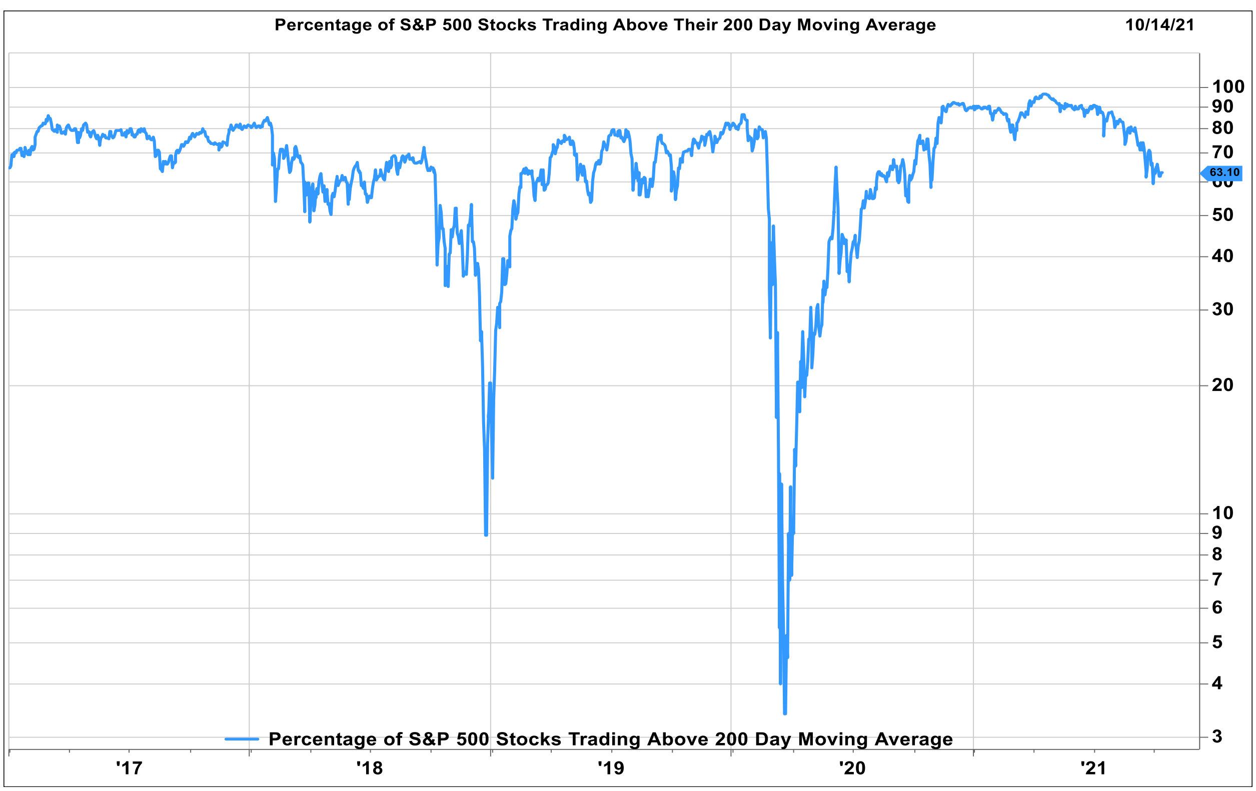
The quarterly earnings reporting season has begun with major banks like JP Morgan, Citigroup and Bank of America reporting results that exceeded expectations. However, we will be watching with more interest the reports of companies more exposed to supply bottlenecks and labor shortages such as such as retailers, home builders, manufacturers and transportation companies.

Companies have been reporting positive earnings surprises at a record rate throughout the year, and S&P 500 consensus estimates for 2021 earnings are now 22% higher than they were last year at this time. Estimates for 2022 earnings have risen 15% above where they were a year ago.

At some point in every market cycle, expectations overshoot on the upside and reality inevitably sets in. It is unclear whether rising expectations have adequately factored in persistent supply bottlenecks and rising costs in raw materials, including energy. Morgan Stanley strategists say they don't believe supply chain problems have been factored into the market's earnings expectations, and there could be some unpleasant surprises if they are right.

As we pointed out last month, the S&P 500 has more than doubled in the last 18 months, with just a single decline during that time of more than 10%. A growing number of analysts have been saying that we are overdue for another correction, citing high valuations in the face of mounting concerns over inflation, supply interruptions, COVID variants and Washington's version of The Squid Game over raising the debt ceiling or risking default. Perhaps a series of negative earnings surprises in some economically sensitive sectors will provide a catalyst for the correction that many analysts are predicting. But we think that such fears really miss the point, because corrections have already occurred in many sectors of the market that have not shown up in the Index, itself. At the bottom of the market weakness in September, the S&P 500 had fallen 6% from its high at the beginning of the month. But the average stock in the S&P 500 had declined more than 12% from its high. This is why most investors' portfolios, including ours, underperformed their benchmarks in September.

Technically, the market is showing signs of losing momentum. The percent of stocks trading above their 200-day moving average has been steadily declining since the first quarter. At this indicator's peak in



March, more than 95% of the S&P stocks were trading above their moving averages; that number has fallen steadily to near 60% today. The fact that fewer than 40% of stocks are trading above their 50-day moving average portends further weakness ahead.

Despite the concerns expressed here, we have not moved to lower our equity exposure, although we have re-allocated some funds out of technology and other high multiple sectors into areas that enjoy more favorable valuations. Corrections are a normal and healthy part of the market cycle, whether they are evidenced by a broad decline in the market averages or are experienced as part a normal rotation among market sectors. The odds of anything more damaging remain slim, however, given the Fed's current policies and the lack of any serious financial bubbles.

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