Economic & Market Perspectives
July 2021

A summer of freedom

As we close out the second quarter of 2021, celebrating our nation's Declaration of Independence 245 years ago, there is no doubt the freedom we celebrate this summer will look and feel a lot different than last year.

The COVID-19 pandemic forced the nation to put Independence Day celebrations on hold last summer, which meant there were no parades, no fireworks, and no gatherings with friends and family. President Joe Biden said recently that he hoped this summer would be very different from last year's and called for "a summer of freedom. A summer of joy. A summer of get-togethers and celebrations. An all-American summer that this country deserves after a long, long, dark winter that we've all endured." And by all accounts, this summer appears to be very different.

More vaccinations and easing pandemic restrictions are leading us down what the Biden Administration refers to as the "path to normal", characterized in part by a burst in economic activity and optimism. But with this optimism, there are growing concerns about inflation. All of this, of course, impacts market action and how we position our portfolios.

Path to normal

As we noted in April's *Economic & Market Perspectives*, the Federal Reserve has indicated that "the path of the economy will depend significantly on the course of the virus, including progress on vaccinations".

In May, President Joe Biden set a target to get 70% of Americans vaccinated with at least one dose of COVID-19 vaccine by July and another goal of having 160 million Americans fully vaccinated by Independence Day. Vaccination numbers have fallen off in recent weeks, and the percentage and total number vaccinated fell short of Biden's goal.

Nevertheless, the U.S. has made significant progress in combating COVID-19. According to data from the Centers for Disease Prevention and Control (CDC), 54% of the total US population or 180 million people have received at least one dose of a vaccine and about 46% or 154 million are fully vaccinated as of June 29. Although there are worries about the highly transmissible Delta variant, it appears that fully vaccinated people have a high degree of protection against it.

COVID-19 cases, hospitalizations, and deaths have come down significantly from peak levels in January and restrictions have been eased nationwide. The economy is expanding rapidly as more Americans return to work and other "normal" activities.

Economic optimism

At its most recent rate-setting meeting in June, the Federal Reserve noted that the progress on vaccinations is reducing the effects of the COVID-19 crisis on the economy. This progress combined with massive government spending, near-zero short-term interest rates, and continued bond-buying from the Fed has supercharged the U.S. economy.

The Biden Administration has proposed a $6 trillion budget for the fiscal year starting October 1, which includes the $2.3 trillion American Jobs Plan focusing on infrastructure and the $1.8 trillion American Families Plan, which includes universal preschool and free community college. Biden and a group of centrist Senators agreed to a roughly $1 trillion infrastructure plan, securing a bipartisan deal that lawmakers and the White House are attempting to move through Congress along with a broader package supported by Democrats.

The Federal Reserve recently increased their projections for real Gross Domestic Product (GDP) growth in 2021 from 6.5% to 7% and inflation from 2.4% to 3.2%. The 7% annualized growth rate for the year would be the fastest pace since 1984.

Despite forecasting a surging economy and higher levels of inflation, the Federal Reserve remains committed to maintaining an accommodative monetary policy stance. The Fed also recently indicated that it plans to keep the federal funds rate near zero but Fed officials signaled they may begin raising the benchmark rate by the end of 2023, sooner than they anticipated in March. The Fed also began talking about tapering, reducing the up to $120 billion in monthly purchases of Treasury and mortgage-backed securities.

The Bureau of Economic Analysis estimates that the U.S. economy grew at a rapid 6.4% annual pace in the first quarter of 2021, and the estimate for real GDP growth in the second quarter is 7.8%, according to the Atlanta Fed's GDPNow model (as of July 1).

The labor market is slowly recovering. The number of workers filing for initial jobless claims has dropped by more than a third since late April, and new applications for unemployment benefits declined to a new pandemic low of 364,000 in the week ending June 26, according to the Labor Department. While the jobless claims numbers are trending in the right direction, they are still well above the 2019 weekly average of 218,000.

Despite the progress on weekly jobless claims, the U.S. added a modest 559,000 new jobs in May, after creating a revised 278,000 new jobs in April, even with millions still unemployed. This is somewhat perplexing given the record number of job openings, 9.3 million in April, according to the Labor Department's Job Openings and Labor Turnover Survey.

Inflation concerns

With the economic recovery, we are seeing signs of inflation. While the IHS Markit manufacturing and services PMI (flash) surveys showed the U.S economy grew rapidly in June, shortages of labor and supplies are raising costs for businesses and adding to rising inflation. The National Federation of Independent Businesses small-business index fell for the first time this year over growing labor and inflation worries.

Rising inflation has to do, in part, with so-called "base effects", which refers to the comparison of current price-levels to a period when the pandemic and its related restrictions put significant downward pressure on prices – consumers were not spending on certain goods or services, including travel and leisure activities. For example, the price of retail gasoline (regular, all formulations) was $2.08 per gallon in June 2020 and $3.06 per gallon in June 2021, according to the U.S. Energy Information Administration.

As the economy reopens, supply is having trouble keeping up with pent-up demand. As a result, we are seeing shortages, for example, with used cars, computer chips, and workers.

The Fed's Beige Book (a summary on current economic conditions in the various Fed districts) recently noted that overall price pressures increased further since the last report with selling prices increasing moderately, while input costs rose more briskly. In addition, the University of Michigan's Surveys of Consumers report showed that year-ahead inflation expectations rose to 4.6% in May.

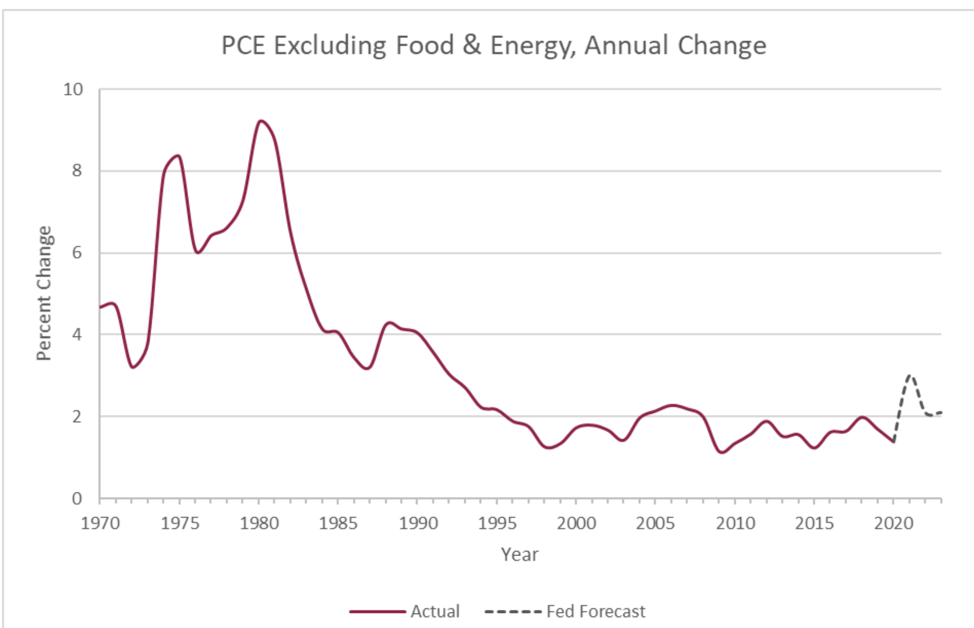
The core rate of inflation (also known as core CPI), which excludes volatile food and energy, increased 0.7% in May and the 12-month rate climbed to 3.8%, a 29-year high. The core Personal Consumer Expenditures (PCE) price index – the Fed's preferred measure of inflation – moved up 0.5% in May, and the 12-month rate climbed to 3.4%, the biggest increase since 1992.

The rate of inflation is now close to double the Federal Reserve's 2% target, but Fed officials, including Fed Chair Jerome Powell, insist prices will ease next year as the economy gets back to normal, people return to work, and widespread shortages of labor and supplies fade over time.

The forces that have helped keep U.S. inflation low and stable for about three decades – an aging population, increased globalization, technological advancements, diminished bargaining power for workers, and energy independence – are still key factors. Plus, inflation expectations have been anchored around 2% for decades. See Chart #1

Chair Powell has said that it is highly unlikely that inflation will rise to levels seen in the 1970s but acknowledged significant uncertainty as the economy reopens.

Chart #1



Source: FRED, Federal Reserve Bank of St. Louis. Note: 2021-2023 is Federal Reserve Forecast

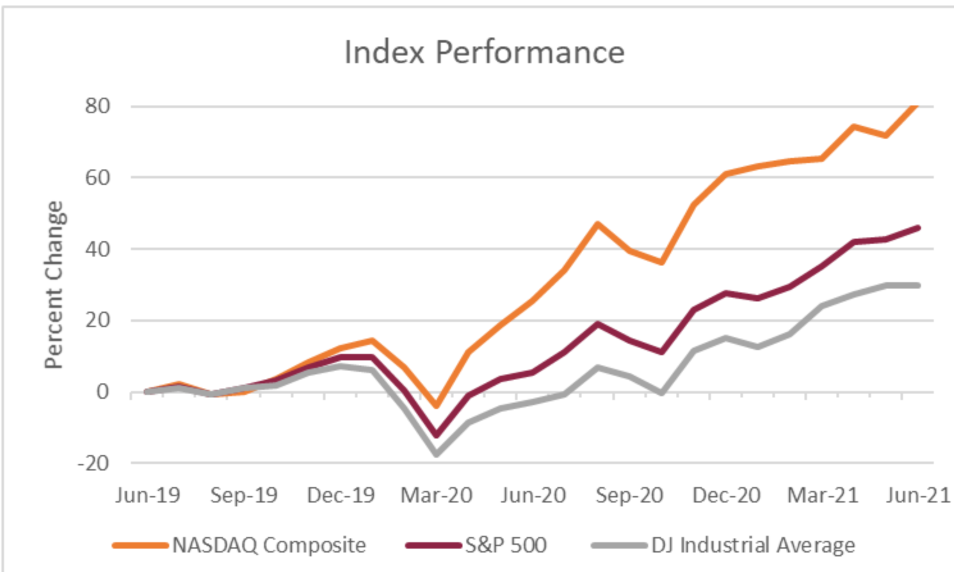
Market action

U.S. stocks posted impressive gains in the second quarter as the economy returned closer to normal and have logged double-digit gains for the first half of the year.

For the quarter, the Dow Jones Industrial Average gained 4.6%, the S&P 500 jumped 8.2%, and the Nasdaq Composite surged 9.5%. According to The Wall Street Journal, the Dow Industrials and the S&P 500 recorded their fifth consecutive quarter of gains, the largest such streak since a nine-quarter stretch that lasted through 2017. See Chart #2. The economically sensitive small-cap Russell 2000 advanced 4.1% for the second quarter.

For the first half of the year, the S&P 500 rose 14.4%, while the Nasdaq Composite gained 12.5% and the Russell 2000 index advanced 17%.

Chart #2
U.S. stocks have recorded five consecutive quarters of gains, their longest such streak since 2017.



Source: Morningstar; The Wall Street Journal.

Overseas, the pan-continental Stoxx Europe 600 benchmark climbed 0.2% in the second quarter.

Asian markets were mixed for the quarter. Japan's Nikkei Stock 225 lost 1.3%, while Hong Kong's Hang Seng rose 1.6% and China's Shanghai Composite moved up 4.3%.

The yield on the 10-year U.S. Treasury note is sending a different signal about the prospects for longer-term growth, indicating it may not be as strong as anticipated, even with higher inflation levels. The benchmark note ended the second quarter with a yield of 1.443%, which is down from the closing high of 1.749% in late March but still up from a low of 0.915% in early January. Note: bond yields and prices move in opposite directions.

In commodities markets, Nymex crude oil gained 24.2% and Comex gold was up 3.3%, while the Bloomberg Commodity index rose 13.3% in the second quarter.

The WSJ Dollar Index ended the quarter down 0.7%, but the index is up 2.4% since the beginning of the year.

Portfolio positioning

Given the progress on vaccinations, outlook for economic and earnings growth*, and potential for higher inflation, at least in the near future, we continue to favor equities over fixed income and have a tactical overweight to inflation hedges.

> * S&P 500 companies are expected to report earnings growth of 35% for calendar year 2021, and analysts' bottom-up price target for the S&P 500 is 4785, which is 11% above its June 30 closing price, according to Factset.

In April, the Investment Strategy Committee (ISC) reduced exposure to growth equities and increased exposure to value equities across the U.S. large and mid-cap as well as international developed large cap asset classes, which gives us an almost equal-weighting to growth and value in our total return portfolio strategies. This will increase our cyclical exposure as the U.S. and global economies bounce back from the pandemic-driven restrictions.

In May, the ISC reduced U.S. large cap and increased our allocation to more economically sensitive mid- and small-cap equities, and the ISC added an allocation to mid-cap value. The ISC also increased international developed large cap equity exposure and reduced our allocation to emerging markets. International developed markets have greater exposure to cyclical sectors than emerging markets equities, which should be beneficial as the global economy recovers, especially over the next 6-12 months. And, the ISC decreased the core bond allocation within our portfolio strategies and increased non-core bonds, specifically floating rate bonds. Overall, the allocation to equities, fixed income, and inflation hedges** remains unchanged from April.

> ** With the increased focus on inflation, we have grouped inflation-linked bonds and real estate- and commodity-related securities under "Inflation Hedges".

For more on our positioning and asset class views, see next page.

PeoplesBank Wealth Management – Asset Class Views

Asset Class	PBWM Positioning*	Notes
Equities	**Neutral**	
U.S. stocks	Overweight	Monetary policy, fiscal stimulus, continued vaccination progress, and strong economic data support overweight to U.S. stocks. We favor more economically sensitive small and mid-cap stocks, and we have a slight overweight to large cap value.
Developed international stocks	Underweight	The Eurozone economy should begin rebounding at a faster pace in the second half of 2021, and we favor international small cap stocks as global economy recovers.
Emerging market stocks	Underweight	Emerging markets could benefit from US dollar weakness and strong global growth, but Europe has greater exposure to a cyclical recovery.
Fixed Income	**Underweight**	
Core bonds	Underweight	Rising yields and inflation expectations limit attractiveness of core bonds.
Non-core bonds	Overweight	Adding yield and limiting interest rate risk with tactical positions in short-term HY bonds, preferred securities, and floating rate bonds.
Cash equivalents	Underweight	Anchored short-term yields and rising inflation expectations make cash returns unattractive.
Inflation Hedges	**Overweight**	
Inflation-linked bonds	Overweight	Useful diversifier and inflation hedge in low yield environment.
Real estate-related securities	Overweight	REITS should benefit from reaccelerating demand and low interest rates.
Commodity-related securities	Overweight	Post-pandemic recovery, weaker dollar, and stronger inflation support allocation to commodities.

**Relative to PeoplesBank Wealth Management's (PBWM's) strategic benchmark as of June 2021*

Investment Process

PeoplesBank Wealth Management's asset allocation process develops both long-term (strategic) and shorter-term (tactical) recommendations. The strategic recommendations are based upon how the Investment Strategy Committee believes investment portfolios should be positioned in a generally neutral market environment over the next ten years. The tactical recommendations are meant to highlight opportunities over the next one to two years where the Committee sees either increased opportunity or risk.

The Wealth Management Investment Strategy Committee (ISC) is responsible for establishing and updating both the strategic (long-term) and tactical (short-term) asset allocation for Wealth Management's investment management and trust relationships. The committee is comprised of the senior members of the Wealth Management team. The committee is also responsible for monitoring and updating strategies, managers, and funds within client portfolios. The ISC meets monthly. If you have any questions or would like to discuss PeoplesBank Wealth Management's outlook further, please call or send an email to your relationship or investment officer.

References: Barron's, Centers for Disease Control and Prevention (CDC), Factset, MarketWatch, The Federal Reserve, The Wall Street Journal, and U.S. Energy Information Administration.