Economic & Market Perspectives

Fall 2021

The fall season brings with it shorter days, cooler temperatures, falling leaves, and of course, the time-honored tradition of Halloween – children everywhere will be exclaiming: "trick or treat!"

The end of the third quarter was certainly no treat for investors as September was a tumultuous month for financial markets. Investors are most likely wondering what is in store for them in the month of October and beyond --- "tricks" or "treats"? There are concerns about the Delta variant of Covid-19, higher inflation, labor shortages, supply-chain disruptions, higher interest rates, and slowing economic growth. At the same time, the economy is growing, albeit at a slowing pace, and the risk-on trade continues to drive markets higher.

The Economy

The Federal Reserve has indicated that the path of the economy is dependent upon the course of the virus, including progress on vaccinations.

The Delta variant of Covid-19 has driven the most recent surge in new cases, hospitalizations, and deaths related to Covid-19 – the so-called "third wave". After peaking in January, the number of new reported cases of Covid-19 declined to just under 12,000 daily in June, but that number shot up to a high of 161,000 in early September, based on the seven-day moving average, according to the Centers for Disease Prevention and Control (CDC). However, it appears that the number of new cases and hospitalizations related to Covid-19 may have peaked. Recent data shows that new cases and hospitalization in the U.S. are trending down, and daily deaths related to Covid-19, which lag reported cases, are leveling off.

Vaccination rates are increasing and millions have acquired natural immunity. Over 55% of the U.S. population is fully vaccinated, and for the most vulnerable segment of the population, ages 65 and older, 83% are fully vaccinated, according to the CDC. In addition, there have been over 43 million reported cases of Covid-19 in the U.S. since the onset of the pandemic; in other words, about 13% of the U.S. population has acquired natural immunity. This percentage is likely higher, since the number of new cases is probably underreported. And the Food and Drug Administration is reviewing data submitted by Pfizer to clear its Covid-19 vaccine for use in children ages 5 to 11. All of this should help control the spread and mitigate both the human and economic impact of Covid-19 in the future.

Economic growth in the first half of 2021 was strong, but the pace of economic growth appears to be slowing. Real Gross Domestic Product (GDP) growth increased at an annualized rate of over 6% in the first and second quarters of this year. Growth has been driven by a surge in consumer spending despite consumers expressing concern about the Delta variant and higher inflation.

While the U.S. economy is expanding, the pace of expansion is slowing as manufacturers and service-oriented businesses struggle with shortages of labor, supplies, and materials, according to recent surveys from the Institution of Supply Management and IHS Markit. Economists are revising down their estimates for third quarter real GDP growth from 6.8% in August to 5.0% in September, according to a monthly survey from Bloomberg. And the Atlanta Fed's GDPNow estimate for third quarter real GDP growth is 2.3% as of October 1, which is down significantly from its initial forecast of 6.1% on July 30.

Consumers are losing confidence as the Delta variant and inflation weigh on consumer optimism. The Conference Board's consumer confidence index recently hit a 7-month low in September, and the University of Michigan consumer sentiment reading for the same month is close to a 10-year low.

Two measures of inflation, the Consumer Price Index (CPI) and the Personal Consumption Price (PCE) Index, the Fed's preferred measure, are at their highest levels in thirty years. The CPI rate of inflation for the 12 month ended in August was 5.3%, and the PCE price index for the same period was 4.3%. These inflation numbers are well above the Fed's long-term inflation target of 2%.

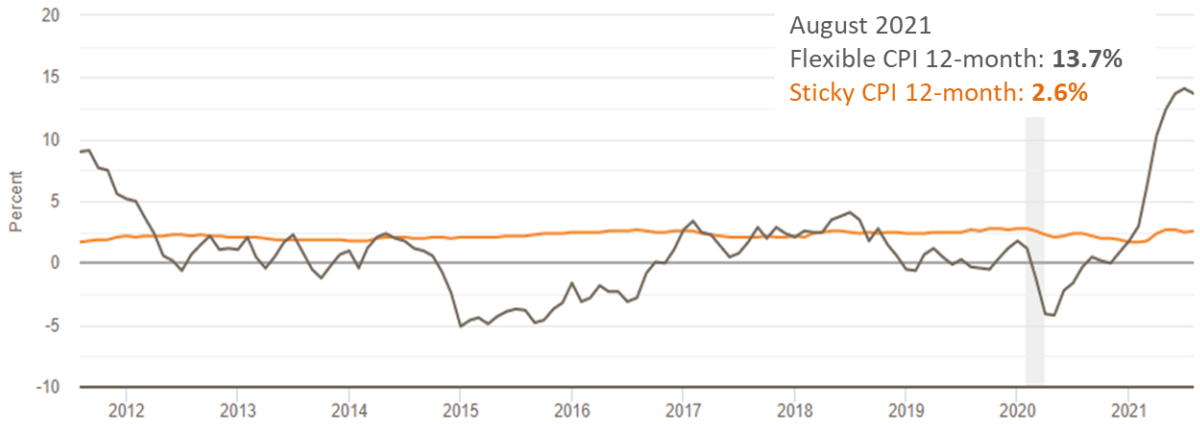
Businesses are also concerned about inflation. The number of S&P 500 companies citing "inflation" on their second quarter earnings calls is 224 – a 10-year high according to FactSet.

The Fed has assured us that while inflation may be higher and last longer than they anticipated, it is transitory. Measures of expected inflation appear to support the Fed's view on inflation. The Aruoba Term Structure of Inflation Expectations, which is based on surveys of economists, shows inflation trending between 2.2% and 2.3% over the next 3 months to 10 years as of September. And the 5-Year, 5-Year Forward Inflation Expectation Rate – a measure of expected inflation (on average) over the five-year period that begins five years from now – is running between 2.1% and 2.3% over the past three months.

The Atlanta Fed tracks inflation, as measured by the Consumer Price Index (CPI), in terms of "flexible CPI" and "sticky CPI" – see Chart 1. According to an article by Michael Bryan and Brent Meyer, about 70 percent of CPI is composed of sticky-price goods and 30 percent of flexible-price goods. Some items that make up the CPI change prices frequently (flexible CPI), while others are slow to change (sticky CPI). And sticky prices appear to incorporate expectations about future inflation to a greater degree than prices that change on a frequent basis.

About half of the flexible-price CPI consists of food and energy goods, with the remainder being largely autos, apparel, and lodging away from home. Sticky-price CPI includes many service-based categories, including medical services, education, and personal care services, as well as most of the housing categories. As the chart indicates, the recent spike in flexible CPI has been significant (up 13.7% for the 12-months ending in August). As a result, flexible CPI has been a key factor in the rise in headline CPI. For example, used car prices leaped at least 7.3% for three months in a row before rising just 0.2% in July, and airline tickets, fuel, and service businesses also counted for much of the recent overshoot, according to MarketWatch.

Chart 1 – Flexible versus Sticky CPI



Source: Federal Reserve Bank of Atlanta. Note: gray bar indicates period of recession

In addition to inflation, business are facing challenges from labor shortages and supply-chain disruptions. Half of small business owners report that supply-chain disruptions are having a significant impact on their business, and over one-quarter (27%) of small employers are currently experiencing a significant staffing shortage and, as a result, a loss of sales opportunities, according to a recent survey by the National Federation of Independent Business.

The labor market continues to improve and demand for labor is strong. Job gains averaged 750,000 per month over the past three months but slowed in August. The U.S. added just 235,000 jobs in August as leisure and hospitality hiring slowed. Despite the slowing of hiring activity, layoffs are trending down. Weekly jobless claims have fallen fairly steadily since hitting 424,000 in mid-July, and the 4-week moving average for unemployment claims was 340,000 at the end of September. The unemployment rate is 5.2% (8.4 million unemployed persons), which probably understates the shortfall in employment as the labor market participation rate has not moved up from the low rates that have persisted for most of the past year. Job openings hit a record high of 10.9 million in July, the fifth straight all-time monthly high, indicating strong demand for labor.

Projected earnings growth rates for companies in the S&P 500 are decelerating but still look solid. Analysts project earnings to grow close to 43% in 2021 and just under 10% in 2022, according to FactSet. And analysts and companies have been much more optimistic than normal in their estimate revisions and earnings outlooks for the third quarter. Analysts will be closely monitoring earnings guidance to see if costs related to higher inflation, labor shortages, and supply-chain disruptions negatively impact profit margins in the fourth quarter and beyond. For example, companies such as FedEx, Nike, Costco, and Bed Bath & Beyond recently lowered their outlook for profits and revenue to account for the higher costs and delays associated with labor shortages and supply-chain challenges.

Fiscal and Monetary Policy

As September came to a close, Congress had failed to come to agreement on pending legislation, a $1.2 trillion bipartisan infrastructure bill, passed by the Senate, and a $3.5 trillion budget reconciliation bill, focused on "soft" infrastructure. The progressive wing of the Democrats in the House of Representatives did not want to vote to approve the $1.2 trillion bill until after the $3.5 trillion bill is passed by the Senate.

Meanwhile, moderate Democrats in the Senate are concerned about the size and scope of the $3.5 trillion bill, especially its potential impact on inflation. There are also questions about the need for this amount of additional fiscal stimulus given the strength of the economy. There are also concerns about the large amounts of deficit spending and growing debt, which is currently close to 100% of GDP and projected to grow to 107% of GDP in 2031.

Senator Joe Manchin of West Virginia has indicated that his topline for the budget reconciliation bill is $1.5 trillion, and he will not support anything above it. A series of late September negotiations, including a plea by President Biden, failed to resolve the issues holding up this legislation. Congressional leadership has extended the deadline for resolving this impasse.

To help offset the $3.5 trillion in new spending, House Democrats have proposed tax increases to raise an estimated $2 trillion. The proposal includes increasing the tax rate on long-term capital gains and dividends to 25% from 20%; increasing the top marginal income rate for individuals to 39.6% from 37%, (which does not include a separate 3.8% tax on top earners and a separate 3% tax above $5 million); and increasing the corporate tax rate to 26.5% from 21% -- according to The Wall Street Journal. Senator Manchin has expressed concern about raising taxes on businesses and indicated that he would not want to see a corporate tax rate above 25%

And if this was not enough to work through, Congress is also dealing with continuing to fund the government while addressing the debt ceiling.

In comparison to the political wrangling associated with fiscal policy, the process around monetary policy seems relatively mundane. The Federal Reserve's interest rate-setting committee, the Federal Open Market Committee (FOMC), met in mid-September and signaled it would start to reduce bond buying as soon as November – currently, the Fed is purchasing $80 billion in Treasurys and $40 billion in mortgage backed securities each month – and possibly begin to raise interest rates next year. Fed Chair Jerome Powell acknowledged in a statement that "we've achieved substantial further progress toward our goals of inflation and maximum employment. And for inflation we appear to have achieved more than significant progress."

The Fed also updated its economic projections for 2021 (from June) to reflect the effects of the Delta variant and supply constraints. The Fed lowered its projected change in real GDP for 2021 to 5.9% from 7.0%, raised its projected unemployment rate to 4.8% from 4.5%, and raised its projected rate of inflation to 4.2% from 3.4%. The Fed also revised its projections for the federal funds rate for 2022 to 0.3% (from 0.1% in June) and for 2023 to 1.0% (from 0.6% in June).

Financial Markets

September spooked investors. Many market-watchers noted that the S&P 500 had not experienced a correction of 5% or more since last October, and indicated that the market was overdue for a pullback. They also pointed out that the month of September is historically the worst month in terms of stock market performance. When you combine this with anxiety about the Delta variant, concerns that inflation may last longer than expected, signs that the U.S economy may be slowing, high stock valuations, and a potentially more hawkish Fed, it is not surprising that all three major indexes were lower for the month. The ongoing political wrangling in Washington did not help.

The S&P 500 fell 4.8% in September, its largest monthly decline since March 2020. Plus, we finally got that "pullback" as the S&P 500 dropped 5.1% from its record high of 4356 on September 2. The Dow Jones Industrial Average lost 4.3% for September, while the Nasdaq dropped 5.3%.

For the quarter, the S&P 500 ended up with a slim 0.2% gain, marking its sixth consecutive quarter of gains. Both the Nasdaq and Dow finished the period lower, marking their first quarterly losses since the first three months of 2020. The economically sensitive small-cap Russell 2000 fell 4.6%.

Overseas, the pan-continental Stoxx Europe 600 benchmark finished in positive territory for the quarter, advancing 0.4%.

Indexes in Asia posted mixed results for the quarter. Japan's Nikkei Stock 225 gained 2.3%, while China's Shanghai Composite shed 0.6% and Hong Kong's Hang Seng plunged 14.8%. Concerns over a slowdown in Chinese growth, especially in its property sector, weighed on global sentiment.

In bond markets, the yield on 10-year U.S. Treasury notes closed the quarter at 1.52%, up from 1.45% at the end of the prior quarter. Yields have fallen back from their closing high of 1.74% at the end of March but are still up from a low of 0.93% in the beginning of January. The expectation for rate increases and higher inflation has led to some selling pressure for government bonds. Yields and prices move inversely.

Oil and commodities prices rose for the quarter. Nymex Crude rose 2.1% and the Bloomberg Commodity Index gained 6.6% on increased demand from the global economic recovery.

The CBOE Volatility Index or VIX, also known as the "fear" index, jumped 41% for the quarter as more downside risks to the recovery are surfacing.

For Select Market Returns, see Chart 2.

Chart 2 – Select Market Returns

10-Yr Treasury Yield 7 bps*	Bitcoin 25.3%	Bloomberg Barclays U.S Aggregate Bond Index 0.1%	Cboe Volatility Index (VIX) 40.8%
Comex Gold -0.9%	Dow Jones Industrial Average -1.9%	MSCI Emerging Markets Index -8.2%	Nasdaq Composite -0.4%
Nikkei 225 2.3%	Refinitiv/Core Commodity CRB Index 4.5%	Russell 2000 -4.6%	S&P 500 0.2%
STOXX Europe 600 0.4%	Shanghai Composite -0.6%	U.S. Dollar Index 2.4%	WTI Crude oil (per barrel) 2.1%

6/30/21 - 9/30/21 *Change in percentage (note: bond prices move inversely to yields)

Sources: The Wall Street Journal; Morningstar; Coinbase Bitcoin retrieved from FRED, Federal Reserve Bank of St. Louis

Investment Strategy

As we look to the fourth quarter and beyond, we see the opportunity for more treats than tricks and have a risk-on tilt in our investment strategies. We continue to overweight equites and inflation hedges and underweight bonds.

We expect to see more volatility in equity markets, as we move to a mid-cycle recovery. Solid economic and earnings growth, although decelerating, supports our overweight to U.S. stocks. We favor economically sensitive small cap stocks. We have a slight overweight to large cap value, which has higher exposure to financials, industrials, and energy sectors. These sectors should benefit as the economy continues to recover.

We are underweight developed and developing markets. International stocks have favorable valuation discounts versus U.S. stocks and are positioned well for a cyclical recovery, but we are maintaining our U.S. stock bias. Emerging market economies are lagging developed economies in terms of vaccination rates and projected rate of economic growth, and concerns about an economic slowdown in China and recent regulatory crackdowns are weighing negatively on sentiment.

Rising inflation expectations and potential back up in yields limit the attractiveness of bonds. We are significantly underweight core bonds (e.g., Treasurys, mortgage-backed securities, corporates, and agencies). Within our core bond allocation, we are underweight duration to help mitigate interest rate risk. We have tactical positions in non-core bonds (e.g., floating rate bonds, preferred securities, and short-term high yield bonds), which help add some yield. We are underweight cash as anchored short-

term interest rates and rising make cash returns unattractive.

We have a tactical overweight to inflation hedges. Inflation-linked bonds help hedge against inflation risk. REITs, or real estate investment trusts, are benefitting from reaccelerating demand and relatively low interest rates. And the post-pandemic recovery, potentially weaker dollar, and rising inflation are supportive our allocation to commodities.

For more on our strategic allocation and tactical allocation, including over- and under-weights, see next page.

The Investment Strategy Team

PeoplesBank Wealth Management – Strategic and Tactical Allocation *

	Asset Class	Strategic (%)	Over/Underweight (%)	Tactical (%)
Equities	U.S. Stocks	32	7	39
	International Developed Stocks	22	-4	18
	Emerging Market Stocks	6	-2	4
Fixed Income	Core Bonds	38	-13	25
	Non-Core Bonds	0	7	7
	Cash Equivalents	2	-1	1
Inflation Hedges	Inflation-Linked Bonds	0	1	1
	Real Estate-related securities	0	3	3
	Commodity-related securities	0	2	2

*As of October 2021

Investment Process

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

The ISC is responsible for developing both the strategic (long-term) and tactical (short-term) asset allocations for Wealth Management's investment management and trust relationships. The ISC is comprised of the senior members of the Wealth Management team. The ISC 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 additional information regarding PBWM's investment process, please call or send an email to your relationship or investment officer.

Sources: Barron's, Bloomberg, Centers for Disease Control and Prevention (CDC), Factset, MarketWatch, Morningstar, Federal Reserve, and The Wall Street Journal; "Are Some Prices in the CPI More Forward Looking than Others? We Think So" (Michael F. Bryan and Brent Meyer).