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Fourth Quarter Outlook 2021

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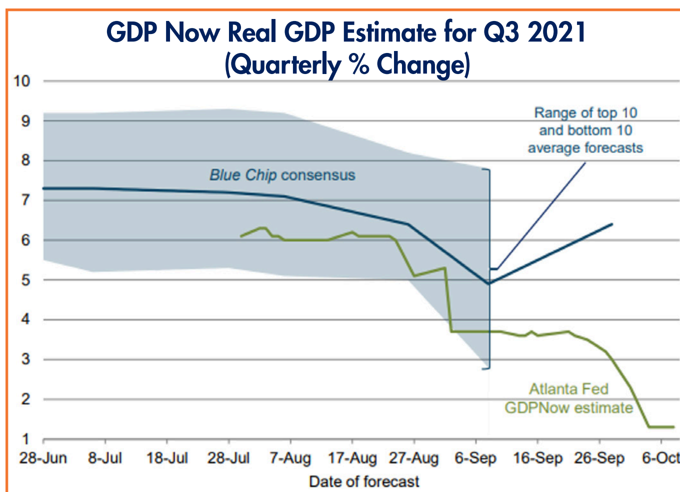
Economists Further Lowered Their 2021 Forecasts with the Delta Variant Third Quarter Spread

The Variant Likely Peaked, Fourth Quarter Should Show Mini-Cyclical Rebound

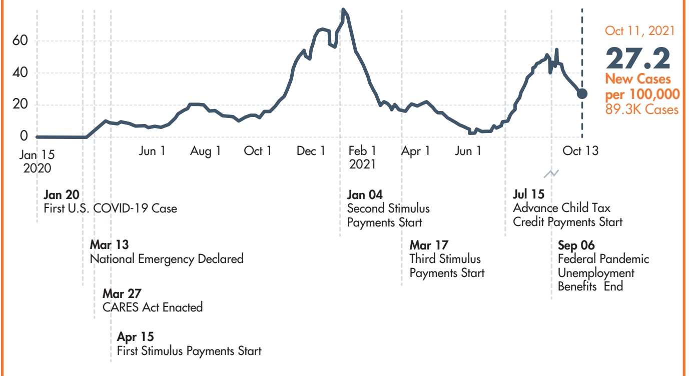
Many economists reduced their 2021 economic forecasts to reflect the Delta variant impact. Much of their reductions reflected their downward revision of third quarter forecasts (see Figure 1). Looking forward, the Delta variant seems to be peaking (see Figure 2). Fourth quarter economic activity should show improving momentum. With that, it seems likely the economy will experience a mini-cyclical recovery to the benefit of so-called value/cyclical stocks.



(FIGURE 1) Source: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 avaerage forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

Daily Reported COVID-19 Cases

In the **United States,** on **October 11, 2021,** there were **27.2** newly reported COVID-19 cases per 100,000 people.



(FIGURE 2) Source: New York Times, Johns Hopkins Coronavirus Resource Center, Centers for Disease Control and Prevention (CDC)

Fed Tapering, Reducing Securities Purchases

Modest Impact on the Economy
Monetary Policy Remains Accomodative

Each month the Fed increases its holdings of Treasury and agency mortgage-backed securities by at least $120 billion. In its September meeting, the Federal Open Market Committee (FOMC) stated it looks to moderate its pace of asset purchases "soon", tapering likely no later than year end. The Fed will likely taper its asset purchases by $15-20 billion monthly and end incremental purchases by the middle of 2022. In a $20 plus trillion economy, eliminating these incremental purchases would likely show little impact on growth and remain accommodative.

Admittedly, so-called tapering by the Fed would concern investors by moving monetary policy closer to a Fed funds rate hike.

Potential Changes in Fed Membership in 2022 Could Affect Speed of Hiking Funds Rate

If Inflation Runs Hotter, a Fed Funds Rate Increase will Likely Happen Sooner

Potential changes in Federal Reserve Board leadership next year could importantly influence the speed of rate increases. President Biden will shortly determine whether to reappoint the Fed Chair and two vice-chairs. In the case of Chair Powell, his term as Chair ends in February and most still expect renomination despite some Senate opposition. The two vice-chairs of the Fed will not be reappointed. Therefore, these two plus an already empty seat on the seven member Fed Board of Governors, will likely be filled next year by President Biden. In addition, two regional Fed Bank presidents also resigned. In appointing new board members, the President will emphasis a more diverse dovish board. A more dovish board may push out a Fed funds rate increase at least 18 months off into the future. However, if inflation runs hotter than expected, the Fed may face the need to quickly curb the rise with rate increases. Will a more dovish Fed move as quickly as may be required?

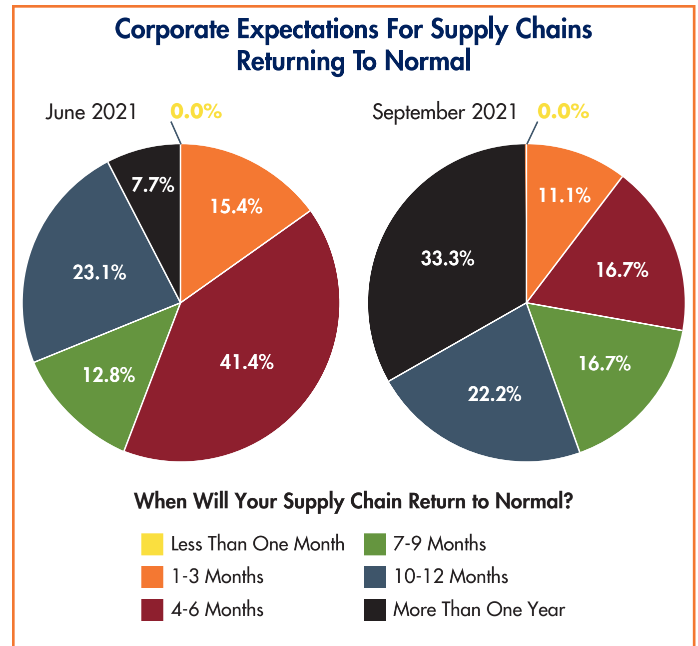
Goods Inflation Shot Up With Low Product Inventories

As Delta Variant Lessens, Consumers Will Likely Shift Spending to Services – Moderating Goods Inflation as That Change Occurs

With the onslaught of Covid-19 early in 2020, businesses sharply reduced their inventories in expectation of a deep recession. With the same economic concerns, Congress passed a series of massive pandemic income replacement programs totaling over $5 trillion—equal to 25% of annual GDP. The combination of these actions resulted in accelerated demand producing product shortages with the low inventories. Not surprisingly, prices shot up for selective products. With both the full impact of stimulus programs and the Delta variant fading, consumers will likely shift their spending to services from goods. With this shift, the Fed expects this inflationary spike will likely prove transitory—admittedly an undefined time period.

Product Shipping Delays Could Lengthen Transitory Inflation

Speedily refilling inventories will prove key to meeting the Fed's expectation for "largely transitory inflation." Once again Covid will play an important role in determining whether inventories can be rapidly rebuilt to relieve shortages. Shipping products represents one friction point as Asian air and ship ports close periodically due to outbreaks of Covid. At the same time, a lack of sufficient workers and equipment in this country results in ships backed up waiting to enter jammed U.S. ports. Figure 3 shows corporate expectations for the persistence of supply chain disruptions.

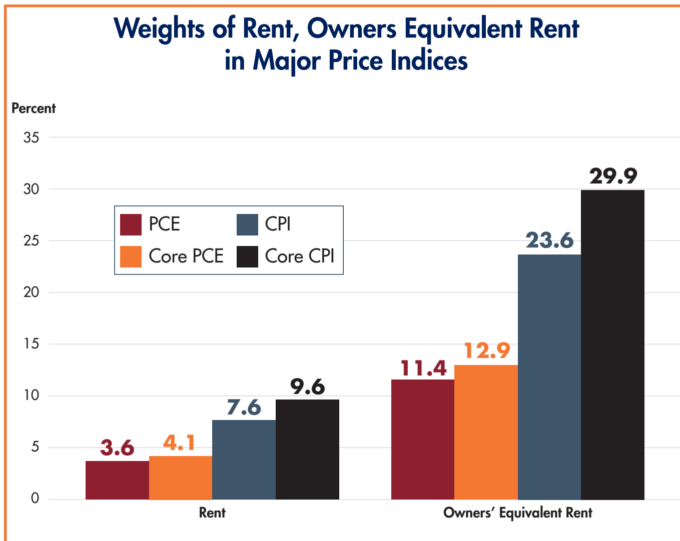


(FIGURE 3) Source: Federal Reserve Bank of Dallas Texas Retail Outlook Survey. Note: 38 responses. This question was posed to those currently experiencing any supply-chain disruption delays. These calculations exclude respondents that answered "not sure," which represented 4.9% of such responses in June '21 and 5.3% of responses in Sep '21.

Shelter Cost Inflation

Sticky, Important Weightings in CPI and PCE

The other important open inflation question, one that will prove stickier, will be the outlook for shelter costs–rent and owners' equivalent rent (OER)–the amount of rent equivalent to the cost of home ownership. Figure 4 shows the shelter weightings in the Consumer Price Index (CPI) and the price index for Personal Consumption Expenditures (PCE).



(FIGURE 4) NOTES: PCE refers to the personal consumption expenditures price index; CPI refers to the Consumer Price Index. Core measures exclude food and energy.
SOURCES: Bureau of Economic Analysis; Bureau of Labor Statistics, Federal Reserve Bank of Dallas

Investors Should Remain Wary of Impact of Shelter Cost Increases on CPI and PCE

Sticky Impact, Not Transitory

The lag effect of heavily weighted shelter costs in the CPI as well as the PCE could offset potentially ebbing transitory inflation and importantly, prove stickier. The Dallas Fed forecasts rent inflation will shoot up to nearly 7% by year end 2023; that increase would prove to be the highest increase in more than 30 years. Rent increases would not likely prove transitory. In our view, despite the Fed's mantra, investors need to remain wary that inflation will prove higher and last longer. The key question, if this proves correct, is how rapidly the Fed will respond and to what degree.

Fourth Quarter Congressional Actions Could Impact Taxes in 2022 and Beyond

With 2021 moving into the final quarter, the political whirl in Washington will likely produce some important outcomes that will impact 2022 and, as importantly, the years beyond. Congress will likely spend a good portion of the final quarter of 2021 considering a traditional infrastructure bill—already passed by the Senate—as well as a second infrastructure bill covering a broad list of social programs. Important to investors as well, will be how high corporate tax rates will be raised to help fund these programs. Based on current expectations, higher corporate tax rates could reduce 2022 S&P 500 earnings by approximately 5%. With a corporate tax rate increase and economists looking for GDP growth to slow to under 4% by year-end 2022, investment strategists expect S&P earnings will likely show mid-single digit range growth next year. Without likely strong earnings growth in 2022, better stock market performance will depend on higher price/earnings valuations.

The Eve of an Election Year, Debt Ceiling Could Prove More Difficult to Resolve

Congress kicked the debt ceiling can down the road to December 3rd. Congress will then face two weeks before the holidays to raise the debt ceiling or face default. With the 2022 election year then just over the horizon, we will likely see a round of Emmy award-winning year-end political theatrics before any possible resolution could result. Most long-time Washington observers expect Congress to pass a higher debt ceiling. However, investors need to be alert with the deep political split and Congress warily looking into the election year that easy outcome seems less certain.

Political Discord in Election Year

May Lead to Unfriendly Countries Taking Advantage of U.S. Distractions

It seems hard to contemplate but 2022 could be a year that investors see even greater political acrimony between and within the parties than experienced this year. The odds favor little achievements in Washington. However, investors need to be concerned that less friendly countries will take advantage of our capitol "instability" to create international incidents.

Investment Conclusions

Fixed Income and Alternatives

In our view, inflation will likely prove higher and last longer than the Fed expects. Nonetheless, interest rates will remain historically low for some time – no matter whether moving up or down. With inflation materially higher than interest rates, this combination results in negative real interest rates, inflation less nominal interest rates, for fixed

income investors. Therefore, with both low nominal and negative real interest rates, fixed-income investments remain unattractive and should only be used to protect capital. For that portion of the portfolio historically committed to fixed income securities, investors should primarily focus on a diversified group of alternative investments.

Increased Market Volatility

Investors face the last part of 2021 with continued question marks. These include the Covid spillover impact on profit margins, the resulting in greater uncertainty for the 2022 economic outlook, and higher tax rates that could diminish next year's corporate earnings outlook. These will likely produce greater market volatility between now and year end, particularly if the Covid spillover produces a greater impact on profit margins then currently forecasted.

Mini-Cyclical Rally

The Delta Variant slowed third-quarter economic expansion, but its influence will likely diminish as vaccines, and importantly booster shots, seem ready to provide

appropriate protection. Such protection will enable consumers to prudently go on with their lives. Sizeable untapped consumer savings and growing employment levels will help drive the economic expansion further. As the variant becomes less of a factor, inventory rebuilding will likely speed up again as supply chain bottlenecks begin to open up. Later in the year, as the economy regains greater momentum—experiencing a mini-cyclical expansion–so-called value/cyclical stocks will prove a prime benefactor.

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The S&P 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies by market value, the index is widely regarded as the best single gauge of large-cap U.S. equities.

The Russell 1000 Value Index measures the performance of those companies in the Russell 1000 Index with lower price-to-book ratios and lower forecasted growth values. The Index is calculated on a total return basis with dividends reinvested and is not assessed a management fee. It is not possible to invest directly in an index.

The Russell 2000 index is an index measuring the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

The Russell 2500 Index is a broad index, featuring 2,500 stocks that cover the small- and mid-cap market capitalizations. The Russell 2500 is a market cap-weighted index that includes the smallest 2,500 companies covered in the Russell 3000 universe of United States-based listed equities.

The MSCI World Index captures large and mid-cap representation across 23 Developed Markets (D.M.) countries. With 1,633 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index is an equity index which captures large and mid-cap representation across 21 Developed Markets countries around the world, excluding the U.S. and Canada. With 920 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (E.M.) countries. With 1,125 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. An index is a portfolio of specific securities, the performance of which is often used as a benchmark in judging the relative performance to certain asset classes. Indexes are unmanaged portfolios and investors cannot invest directly in an index. An index does not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown. Past performance is not a guarantee of future results.

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