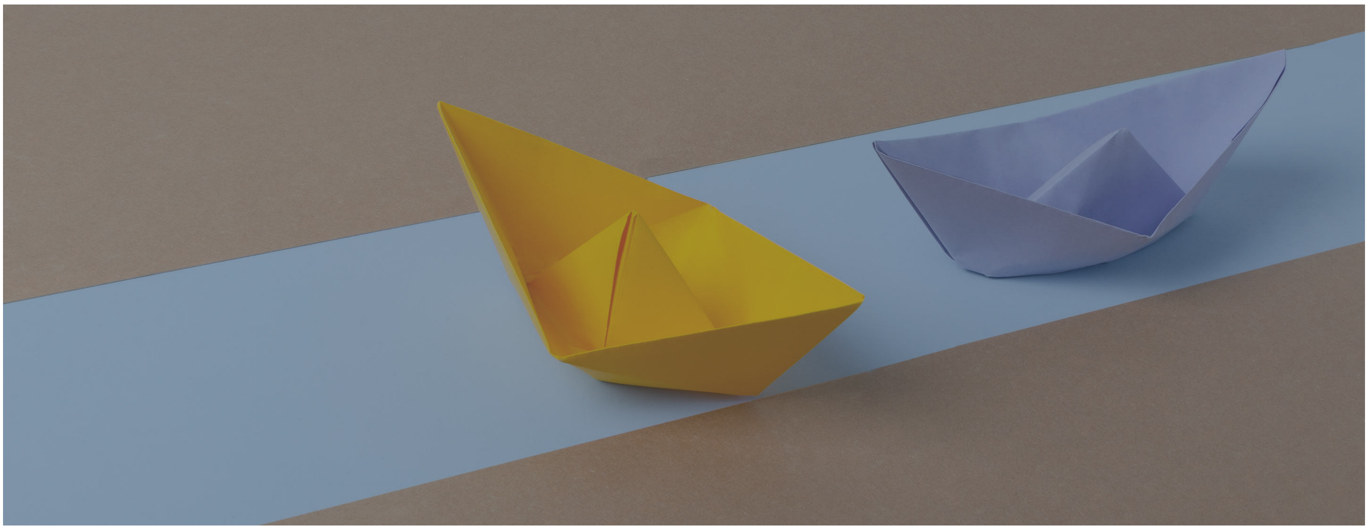


Wednesday, October 20, 2021

No Shortage of Bottlenecks

Recovery momentum within financial markets cooled during the third quarter as investors faced new unknowns and a range of emerging constraints that will shape the next chapter of the global economic recovery.

Recovery momentum within financial markets cooled during the third quarter as investors faced new unknowns and a range of emerging constraints that will shape the next chapter of the global economic recovery.

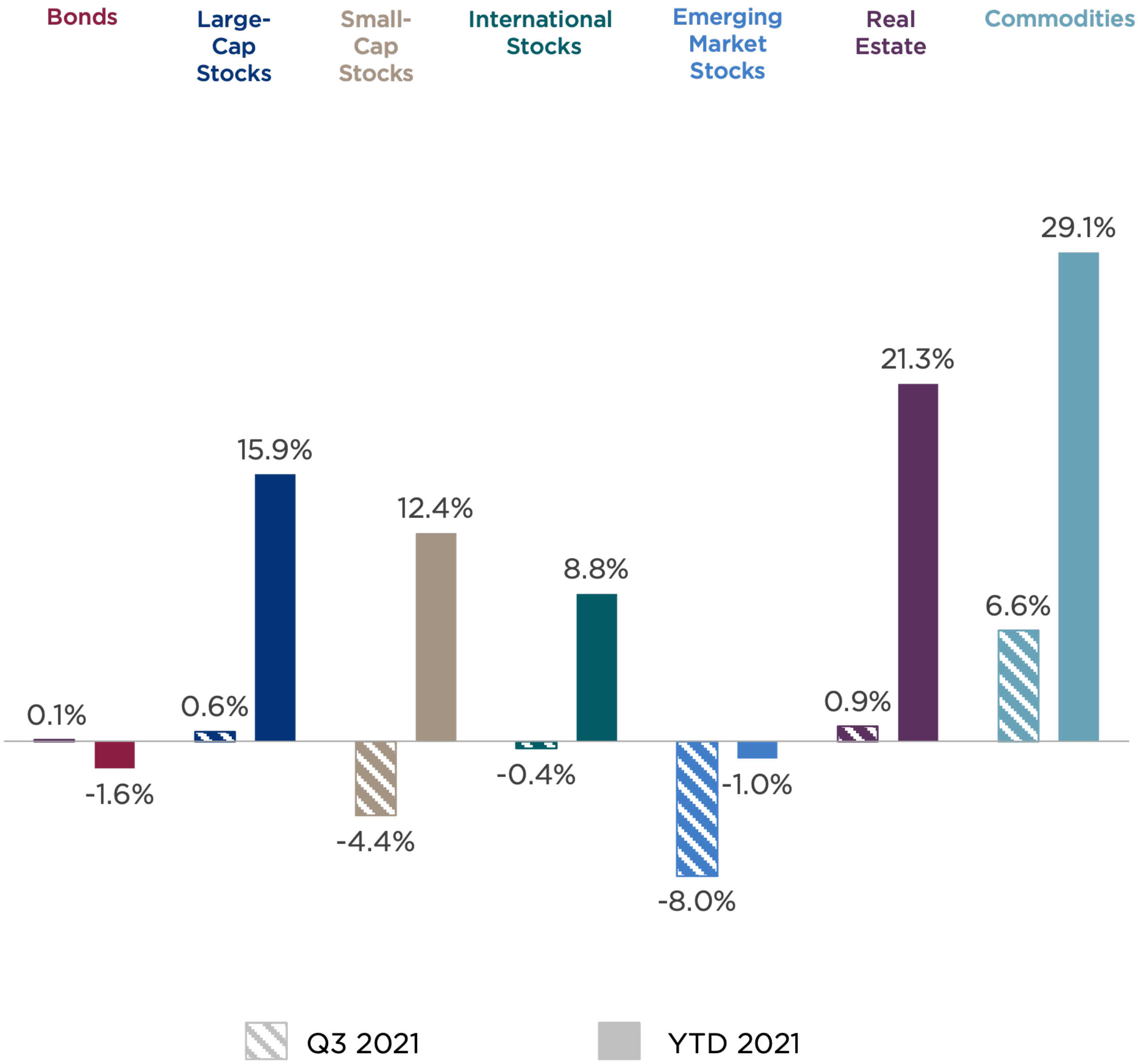
We have written before that restarting a machine as complex as the global economy from its full emergency stop last year would likely involve hiccups. Sure enough, a host of bottlenecks have emerged that now threaten to disrupt the pace of continued growth. At the same time, global political risks are on the rise, creating greater uncertainty around the future business, policy, regulatory, trade, and tax climate.

While the fundamental underpinnings of continued long-term growth remain strong, these questions and constraints may make for rougher seas ahead. In this edition of Investment Strategy, we explore the top concerns and constraints weighing on markets today and what they could mean for investors over the horizon.

Third-Quarter Recap

As shown in Figure One below, after a strong first half of the year, returns for most asset classes were muted during the third quarter. The U.S. continues to lead global equity markets, supported by a host of competitive advantages, including its more dynamic economy, a coordinated policy response, and strong business and household economic fundamentals.

Figure One: Third-Quarter and Year-to-Date Asset Class Returns



Source: Bloomberg. Asset class returns are represented by the following indexes: Bloomberg Barclays U.S. Aggregate Bond Index (U.S. bonds), S&P 500 Index (large-cap stocks), Russell 2000® (small-cap stocks), MSCI EAFE Index (international stocks), MSCI Emerging Market Index (emerging market stocks), Dow Jones U.S. Real Estate Index (real estate), and Bloomberg Commodity Index (commodities).

However, hidden beneath the muted index returns was a considerable amount of choppiness as investors grappled with rapidly changing conditions. This is best seen through the relative performance of mega-cap technology firms—the stalwart, cash-generating machines that flourished during the height of pandemic uncertainty—and smaller, more economically sensitive small-cap value stocks that tend to benefit from broadening economic growth conditions.

We've seen several significant rotations over the course of 2021. From early to mid-summer, the emerging threat of the delta variant raised fears of further restrictions and social distancing, providing a tailwind to mega-cap growth. The tide shifted in September as virus case growth slowed, company earnings surged, and interest rates ticked up, benefitting the smaller banks that comprise a healthy share of the small-cap value category. We expect to see more rotations like these in the months and quarters ahead.

Outside the U.S., we've seen similar rotations, as developed market stocks provided flat results while emerging markets stocks slid by 8 percent amid growing uncertainty within China.

Finally, core U.S. bonds treaded water during the quarter as the yield on the benchmark 10-year Treasury barely budged from July levels. Yet again, there was far more movement than is apparent from the quarter-over-quarter change. Interest rates climbed late in the quarter amid rising inflation fears and early signals of a shift away from the Fed's extraordinary pandemic support programs.

A Range of Constraints

Markets always represent a diverse set of opportunities and risks. Today, the fundamental market opportunity remains the same as in the past year: The worst of the pandemic is behind us, with far less permanent damage to institutions and the economy than initially feared. However, the risks are becoming more evident, as a range of bottlenecks have emerged with the potential to dampen the growth trajectory from here.

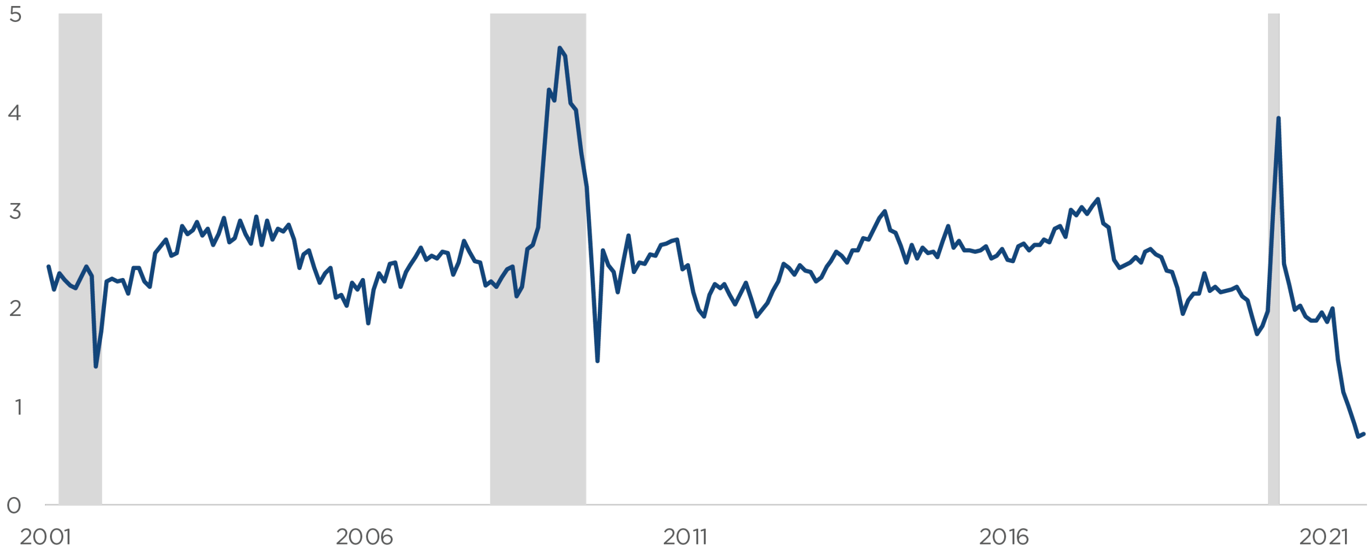
Production and Supply Chain Bottlenecks

Businesses of all types are facing supply chain, production, and logistics challenges. Evidence of these challenges can be seen in bare store shelves, backordered products, empty auto dealer lots, and ultimately, higher prices, as producers struggle to obtain the raw inputs and parts required to make their products. And even when goods are produced, businesses face lengthy delays and escalating prices to deliver those products to their final destinations.

In many ways, these challenges are completely understandable. Aggregate demand for goods was not only maintained during this unique recession but accelerated by massive stimulus and soaring household wealth. Meanwhile, factory shutdowns during the peak of the crisis depleted inventory levels, and lingering staffing and parts shortages have delayed a return to full production.

Perhaps the greatest illustration of supply chain stress can be seen in the auto industry. In this era of ever smarter and more connected vehicles, a global shortage of microchips has led manufacturers to park thousands of mostly completed vehicles in parking lots while they await the chips needed to finish building them. Total auto sales are expected to slump nearly 23 percent in the third quarter, and, as shown in Figure Two, the ratio of available cars in inventory to sales dipped to its lowest level in at least 30 years.[1]

Figure Two: Auto Inventory-to-Sales Ratio

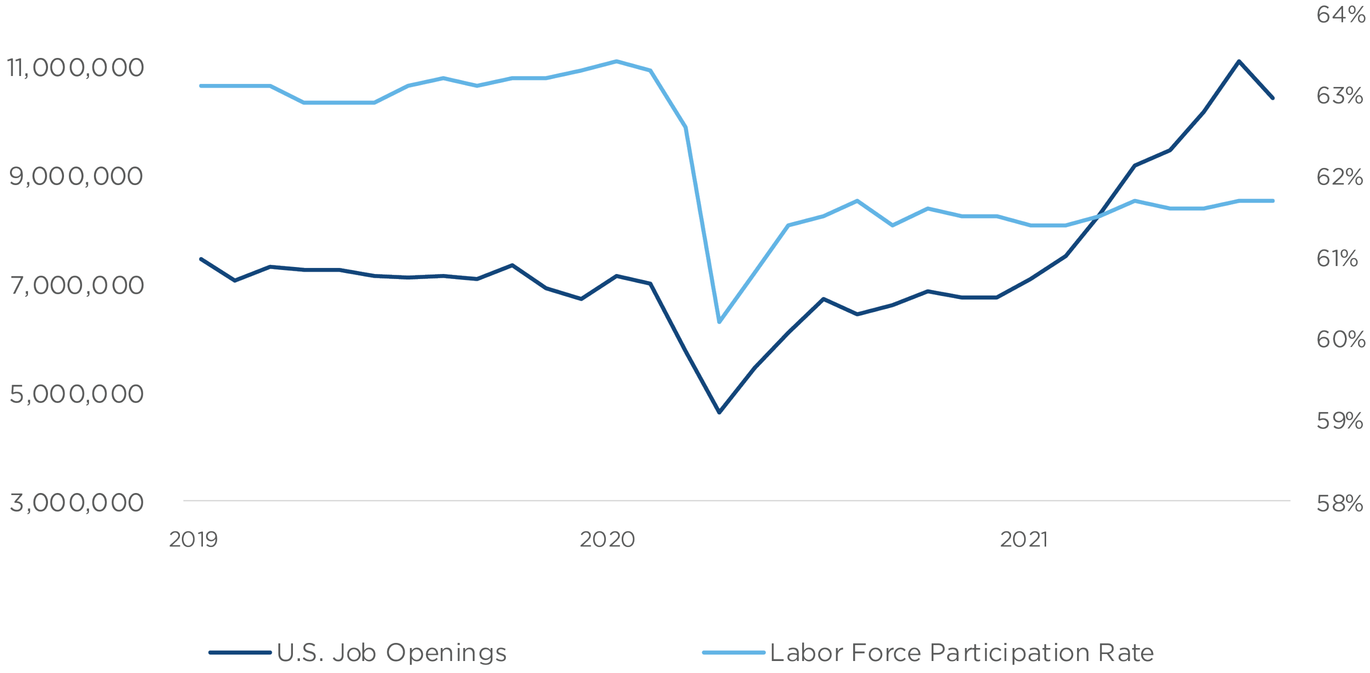


Sources: U.S. Bureau of Economic Analysis, Federal Reserve Bank of St. Louis.

Labor Market Needs Work

Although the U.S. economy continues to add jobs, an ongoing shortage of available workers has slowed the labor market's recovery and has begun to apply upward pressure to wages. The U.S. economy added nearly 200,000 jobs in September, well below expectations—and a far cry from the number of workers needed to meet demand. As shown in Figure Three, the number of U.S. job openings stood at 10.4 million in August, while the labor force participation rate remained stubbornly low as large numbers of workers who left the job market during the pandemic didn't appear to be in a hurry to return—even at higher wage levels.

Figure Three: Job Openings and Labor Force Participation



Sources: U.S. Bureau of Labor Statistics, Federal Reserve Bank of St. Louis

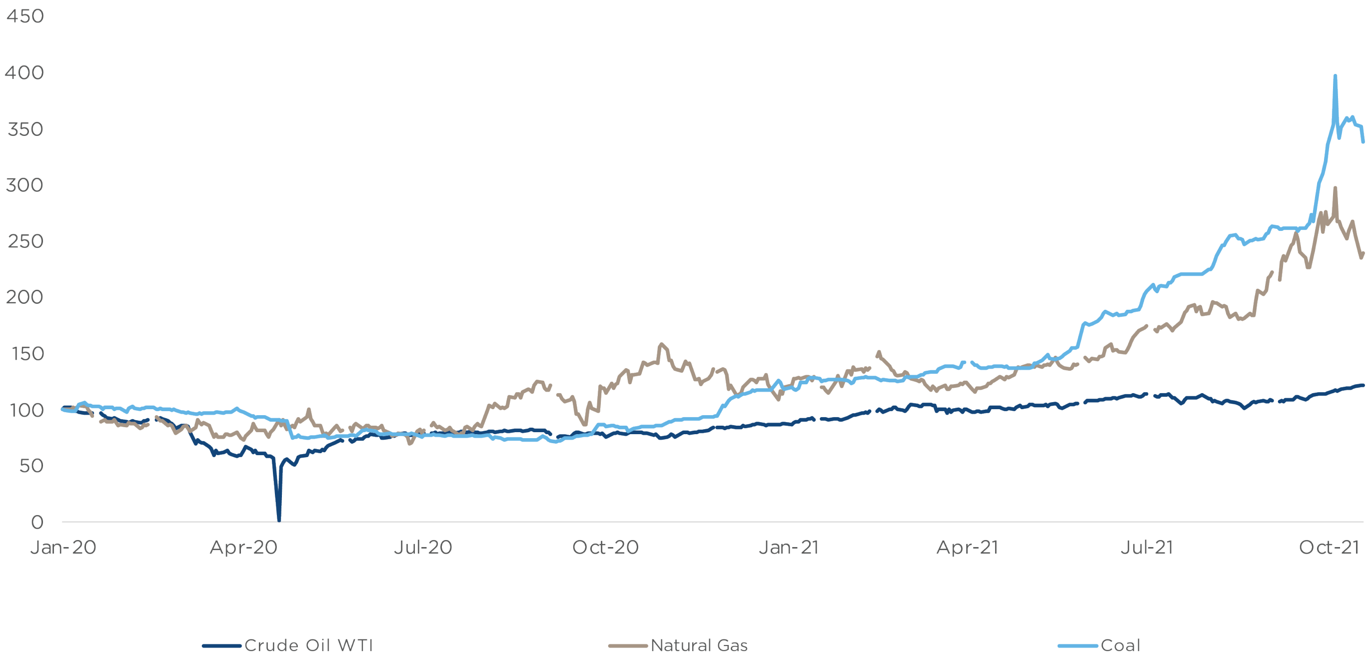
The challenge of finding workers in some industries is acute, pushing wages higher at the fastest pace in decades. While year-over-year wage growth across all private industries has occurred at a rate of 3.5 percent, some service-sector employers hit hardest by the pandemic have seen labor costs rise by nearly twice this rate.

Investors and policymakers alike are keeping a close eye on the labor market. While wage gains are important to raise living standards and help narrow the income gap, they also represent another source of rising costs that could threaten profit margins or drive prices higher. Unlike other business input costs, wage changes tend be one-way, increasing the risk of more persistent inflation. Labor market conditions are also an important guidepost for the timing and pace of actions by the Federal Reserve to begin tapering its extraordinary stimulus policies.

Global Energy Deficit

Another worrisome bottleneck has emerged within global energy markets. Oil prices have reached seven-year highs, natural gas prices briefly spiked to levels not seen since 2008, and coal prices have climbed to record levels.

Figure Four: Oil, Natural Gas, and Coal Prices (indexed to 100 at 1.2.2020)



Source: Bloomberg

Shortages and soaring prices have been driven by both market and political forces. During the pandemic, energy producers slashed output as demand and prices collapsed and may now be reluctant to invest in new production infrastructure amid prospects for regulations that may increase the payback period of their investments. As a result, within the U.S. alone, oil production is almost 2 million barrels per day below 2019 levels.[2]

Global energy shortages are also heavily influenced by geopolitical maneuvering. Europe, for example, relies heavily on natural gas piped in from Russia, especially after an unseasonably calm summer reduced wind power output. However, a contentious approval process for a controversial pipeline project has reduced Russia’s willingness to boost output to meet European demand. Within China, severe shortages of electricity have forced rolling blackouts and factory closures. While Beijing attributes the shortages to its green initiatives, the root cause is also politically influenced, as China slashed purchases of coal from Australia following that country's call for an independent investigation into the origins of COVID-19.

These energy shortages are happening at the worst possible time—as the global economy struggles to return to full speed, and as we enter the colder winter months.

Legislative Logjam

Washington is abuzz with a legislative docket jam-packed with consequential and controversial policy items. Markets breathed a modest sigh of relief when the debt ceiling impasse was broken in early October. Even if the short-term extension sets the stage for an even fiercer battle in January, the recent measure provides lawmakers with room to maneuver as they address three other critical items: a bipartisan infrastructure bill, a larger spending (and tax) package, and a funding agreement to avoid government shutdown.

The reconciliation process will be messy and may contribute to market volatility as the likely winners and losers from the budget battle become clearer. Uncertainty about the future tax environment also makes it difficult for investors and business executives to make decisions. In the coming weeks, we expect to begin to see more concrete details of the tax proposals that will be used to offset some of the costs of the Biden administration's domestic agenda.

Political risks are also rising outside the U.S. In addition to its energy problems, China faces a range of challenges, including a slowing economy, an aging population, and a real estate price bubble that threatens a significant driver of the growth that has occurred over the past decade. Recently, two developments have ratcheted up investor anxiety: China's more provocative posture with Taiwan, and a slate of more aggressive regulatory actions, fines, and penalties against a wide swath of private enterprises as the country pursues its social agenda with renewed vigor. These actions caught many by surprise and reinforce the view of China as a convenient capitalist that reluctantly accepts global ties and outside capital, except when they conflict with Communist Party priorities.

The bottlenecks described above represent sources of friction for the economy—friction that could translate into inflation. Prices paid by consumers in September rose faster than expected, at a year-over-year rate of 5.4 percent, matching the largest annual gain since 2008. Debate continues over whether price increases represent the short-lived costs of reopening as the global economy works through the kinks and bottlenecks described above or a more sticky and problematic inflation threat. However, one thing is clear: The longer and faster that prices move higher, the greater the pressure on the Federal Reserve to begin the gradual process of reversing its ultra-accommodative monetary policy.

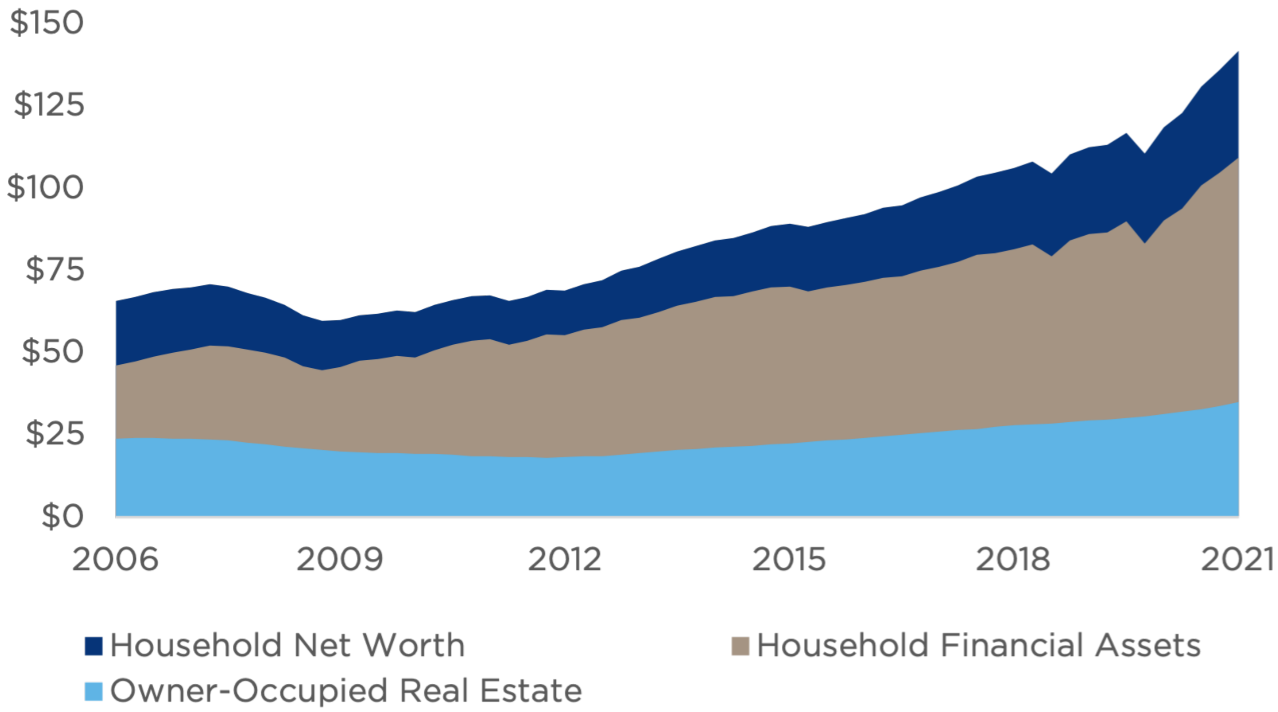
Foundation of Strength

The issues described above have captured their share of financial headlines, but it's important also to remember the level of fundamental economic strength that remains in place as these logjams begin to clear.

Within the U.S., operating earnings of S&P 500 companies rose by an estimated 27 percent in the third quarter (versus a year ago), following staggering 89 percent year-over-year gains last quarter. During the pandemic, corporate revenue collapsed as economic activity came to an abrupt stop, and companies slashed spending every way they could. As revenues rebounded, companies so far have been able to keep a lid on expenses, causing profits to surge. But with price pressures and supply chain problems mounting, how individual companies perform during the next phase will be heavily dependent on their abilities to navigate around roadblocks.

Consumer spending power also remains a potent tailwind. Propelled by soaring stock and real estate markets and stimulus checks, the net worth of U.S. households has reached record highs. As shown in Figure Five, the Federal Reserve estimates that household net worth grew to nearly $142 trillion during the second quarter. Finally, monetary policy remains highly supportive of the business and investment environment. Although the Fed has hinted that continued economic improvement could prompt tapering of its bond-purchase program by year-end, interest rates are likely to remain extremely low for an extended period as it gradually unwinds the extraordinary stimuli deployed during the pandemic.

Figure Five: Household Net Worth (in Trillions)



Source: Federal Reserve

Uncorking the Bottle

Each of the logjams described above could clear quietly, and many of them likely will. But it's possible that some will not, posing threats to corporate profits, consumer behavior, and future growth prospects. Today, investors are eagerly awaiting the start of the third quarter earnings season for more clues on how individual companies are faring against these challenges.

Although the global economy has passed the peak recovery stage, our view is that conditions remain in place for continued economic expansion as constraints begin to ease. During this next phase of the recovery, we expect markets to be shaped more by fundamental forces than tidal swells of stimulus and liquidity. Such changes in market regimes can be volatile. During choppy seas, long-term investors should focus on the elements within their control that can serve as anchors to windward, including their savings rate, portfolio diversification, and time horizon.

---

[1] Edmunds, "New Car Sales Are Plummeting Because Automakers Can't Make Enough Cars"
[2] U.S. Department of Energy

Author(s)

Michael J. Vogelzang, CFA®

https://www.captrust.com/people/michael-j-vogelzang-cfa/

Sam Kirby, CFA®

https://www.captrust.com/people/sam-kirby/