Great-West Investments Capital Markets Perspective

Week in Review: February 12th – 21st

INDEX/ SECURITY	ASSET CLASS	LEVEL (CLOSE)	% CHANGE (THROUGH FRIDAY'S CLOSE) 1 WK.	YTD
Dow Industrials	Lg. Cap Eq.	31,494.30	0.11%	3.66%
S&P 500®	Lg. Cap Eq.	3,906.71	-0.71%	4.73%
NASDAQ Comp.	US Equity	13,874.50	-1.57%	8.03%
Russell 2000®	Sm. Cap Eq.	2,260.68	-0.99%	14.55%
Stoxx 50	Europe Eq.	3,704.54	0.24%	3.72%

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FTSE 100	UK Equity	6,624.54	0.52%	2.53%
Nikkei 225	Japan Equity	30,156.03	1.69%	9.38%
EEM:US	Emkt. Equity	$57.51	-0.50%	11.84%
EFA:US	Non-US Equity	$76.25	-0.08%	4.45%
UST 10y (yield)	US Treasury	1.34%	+0.13%	0.43%
B/Barc AGG	Fixed Inc.	2,349.07	-0.57%	-1.71%

For capital markets, good news is sometimes *bad* news.

We're not quite there yet, but **last week was interesting because the economic news was generally pretty upbeat, but markets were mixed to lower**. Usually when this kind of reversal of fortunes starts to happen, it's because things are about to change – most often on the policy front. The logic runs like this: here in the waning days of the COVID pandemic, times are mostly good and getting better, thanks in large part to an extremely accommodative Federal Reserve and helping after helping of generous fiscal stimulus. **If the virus is truly on its way out and the economy is really on the mend, then we may not need all that support anymore**. To borrow a phrase from an earlier era, the Fed (as well as the *Feds* – plural…) might be planning to take the punchbowl away sooner rather than later.

Let's be clear: Chairman Powell and most of his cronies at the Fed still take every opportunity to reassure markets that they don't plan to take their collective foot off the gas anytime soon. And, the next round of trillion-dollar stimulus isn't really a matter of "if," but instead of "how much, and how soon?" **If an accommodative Fed and a spend-happy federal government are the two pillars supporting capital markets, rest assured that neither appear to be going away anytime soon**.

On the other hand, markets have a habit of looking as far into the future as they possibly can, and **recent events have given at least some participants reason to be skeptical that this fountain of liquidity will continue to gush forever**. The biggest boogeyman today is **the potential for a big acceleration in inflation**, which could force the Fed's hand sooner rather than later given its mandate as the nation's preeminent inflation-fighter. (As an aside, last week's higher-than expected producer price index (PPI) print probably gave true skeptics a real case of heartburn – more about that later.)

But for now, let's just be happy and take inventory of last week's positive data. **By far the best news was Wednesday's 5.3% spike in retail spending for January**[1]. The census bureau tracks at least 17 different types of businesses as part of its release, and each and every one saw gains relative to last month. Perhaps even more impressive is that January represented the burst of consumerism that we've been waiting for: after three months of fairly big disappointments,

[1] https://www.census.gov/retail/marts/www/marts_current.pdf

December's stimulus (and the promise of more to come in the near future,) combined forces with a reasonably successful vaccination effort to force consumers to open their wallets a little wider.

Next on the roster of strong economic data was a **very strong US Flash purchasing managers' index (PMI**,) which rose to nearly a six-year high behind continued strength in manufacturing and a surprisingly robust environment for services providers[2]. Interestingly, most of that strength came from domestic demand as export conditions softened a little while other regions continued to battle the pandemic with lockdown efforts of their own. (For confirmation, Eurozone Flash PMIs – also released on Friday – remain clearly in contractionary territory, at 48.1 overall[3].)

Meanwhile, strength in the US PMI data was **also confirmed by better-than-expected regional manufacturing data** from the Federal Reserve Banks of New York and Philadelphia, both of which continue to paint a picture of a manufacturing industry in rebound mode[4,5]. **That left little for pessimists to grab onto, at least as far as the manufacturing sector is concerned**.

News was also decent on the housing front, where a persistent rise in mortgage rates and near-parabolic prices have recently threatened to defuse a boomlet in housing that has been in evidence for many months. But last week, two data releases did their part to bolster confidence at least in the near-term: the **National Association of Home Builder's builder sentiment survey** advanced from its already-elevated levels (economists generally expected it to stall or remain flat,) suggesting that demand trends remain intact despite rising rates, and the number of **building permits** spiked to an seasonally-adjusted annual rate of 1.88 million – **more than 22% higher than year-ago levels**[6]. That could prove crucial, because a persistent lack of housing inventory is the main driver of accelerating home prices – perhaps the biggest threat to the ongoing boom in housing.

That said, **if you want to find reasons to be pessimistic in spite of all this rosiness, you can find a few buried deeper in the data**. First, the strong housing data had a few "yeah, buts," hiding just under the surface, including a slightly weaker-than-expected performance by housing starts (perhaps a function of lousy weather?) as well as a softening in the NAHB's more forward-looking components. In terms of the **PMI and regional Fed data**, they **were just about universal in pointing out that businesses are struggling with the same old inflationary problems** that we've been talking about for months: namely, **input costs are soaring.**

As if on cue, last week's **producer price index release came in well ahead of expectations** on both the headline and on the core[7] last week. Of course, that line is what has the pessimists all worked up in the first place: if inflation gets out of control, the Fed (and the Feds,) will have no choice but to re-think their accommodative stance and begin peeling it back. However, consumer- and producer price index data are likely to remain quite volatile as **the numbers start to "lap" 2020's unusually weak COVID-infected data** (these are the so-called "base effects" that you may have been reading about,) and at least for now, optimists are still able to credibly explain away even the PMI-based evidence of price acceleration by pointing out that **supply chains are still being pressured by pandemic-related disruptions that could eventually prove temporary**. That, plus a fair amount of **labor market slack** (reinforced by a disappointing weekly claims figure last Thursday[8],) are keeping the inflation hounds at bay for now.

So where does this leave us? We have an **economy that is humming on (almost) all cylinders**, and **policymakers are still manning the pumps**, pushing all the liquidity they can into the tank even as the economy recovers. That's without question a recipe for economic reflation. But what the market seems to be struggling with is deciding **at what point *re*flation becomes *in*flation. And when that happens, how will those same policymakers respond?** Will the pumps suddenly stop, or

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[2] https://www.markiteconomics.com/Public/Home/PressRelease/3047d652f486442181de65d5a64306c5
[3] https://www.markiteconomics.com/Public/Home/PressRelease/7ce91c47edea474b995d9a5bb59d1182.
[4] https://www.newyorkfed.org/medialibrary/media/survey/empire/empire2021/esms_2021_02.pdf?la=en
[5] https://www.philadelphiafed.org/surveys-and-data/regional-economic-analysis/mbos-2021-02
[6] https://www.census.gov/construction/nrc/pdf/newresconst.pdf.
[7] https://www.bls.gov/news.release/pdf/ppi.pdf
[8] https://www.dol.gov/ui/data.pdf

will the flow of liquidity taper from a tsunami, to a torrent, then to a trickle before finally drying up completely? **That, as much as anything, could be what drives markets for the remainder of 2021**.

What to Watch This Week: February 22nd – 26th

Notable economic events (February 22-26)

Monday: Leading Economic Indicators, Chicago Fed National Activity Index

Tuesday: Consumer confidence, house prices (2x), Richmond Fed, Powell testifies to Senate

Wednesday: Powell testifies to House, New home sales

Thursday: Initial Jobless Claims, durable goods orders, pending home sales, KC Fed

Friday: UofM consumer sentiment, personal income/outlays

I argued above that the pace of accommodation could set the tone for the rest of 2021. If that's really the case, then Fed Chairman **Jerome Powell's semi-annual field trip to Congress** could shed some light on what lies ahead. Powell will testify before the Senate Banking Committee on Tuesday, then reprise the whole thing on Wednesday in front of the House Financial Services Committee.

There's **no reason to expect any change in tone** during his prepared remarks: Powell will very likely tell lawmakers once again that the Fed is using all its tools to stimulate the economy and that they should keep doing the same by continuing to toss stimulus checks our way. But senators and representatives will also get the chance to question Powell, and **those willing to read between the lines might glean some insight beyond the stock responses that Powell has been delivering for months**.

In terms of scheduled data, this week's **pair of consumer confidence surveys** could be the most interesting things on tap. Part of the irony of the last week's January retail sales blow-out release is that it occurred just when consumer sentiment seemed to be softening (witness the University of Michigan's weak mid-month report two Fridays ago.) This week, the UofM will update that report just a few days after the Conference Board's similar report on Tuesday. **If January's retail sales report are to prove to be anything other than a "one and done," renewed strength in these surveys is pretty important**.

Friday's personal income and outlays report could be similarly important as a cross-check to recent strength in retail sales. **Incomes should show a clear surge as a result of recent stimulus payments**, but that's unlikely to catch anyone off guard, meaning a big upside print is probably not the positive surprise markets might be hoping for. Instead**, the real question for Friday's release will be how willing consumers were to spend that largesse** – the most aggressive stimulus payments in the world won't do much to stoke economic activity if consumers simply stuff the cash in a mattress, as they seemed willing to do early on in the pandemic when savings rates spiked to 33%.[9]

Finally, **housing data will once again capture some attention** as we get two home price releases on Tuesday, new home sales on Wednesday and pending home sales on Friday. As discussed above, the housing market was the first (and perhaps most powerful) sector to rebound as the pandemic started to wane, but challenges like higher prices and rising mortgage rates are starting to bite. In my view, housing markets rank just a spot or two below the potential for corrosive inflation as the biggest things to keep an eye on over the next several months.

Source for index data: Bloomberg.com; GWI calculations.

[9] BEA, FRED St. Louis Federal Reserve