# Great-West Investments Capital Markets Perspective

## Week in Review: July 12th -18th

| INDEX/ SECURITY | ASSET CLASS | LEVEL (CLOSE) | % CHANGE (THROUGH FRIDAY'S CLOSE) 1 WK. | YTD |
|---|---|---|---|---|
| Dow Industrials | Lg. Cap Eq. | 34,687.58 | -0.52% | 14.17% |
| S&P 500® | Lg. Cap Eq. | 4,327.16 | -0.97% | 16.00% |
| NASDAQ Comp. | US Equity | 14,427.24 | -1.87% | 12.33% |
| S&P Midcap 400© | Mid-Cap Equity | 2,616.96 | -3.31% | 13.45% |
| Russell 2000® | Sm. Cap Eq. | 2,163.24 | -5.12% | 9.33% |
| Stoxx 50 | Europe Eq. | 4,035.77 | -0.79% | 13.00% |

| INDEX/ SECURITY | ASSET CLASS | LEVEL (CLOSE) | % CHANGE (THROUGH FRIDAY'S CLOSE) 1 WK. | YTD |
|---|---|---|---|---|
| FTSE 100 | UK Equity | 7,008.09 | -1.60% | 8.48% |
| Nikkei 225 | Japan Equity | 28,003.08 | 0.22% | 2.04% |
| EEM:US | Emkt. Equity | $53.59 | 0.07% | 4.22% |
| EFA:US | Non-US Equity | $78.32 | -1.56% | 7.29% |
| UST 10y (yield) | US Treasury | 1.29% | -0.07% | +0.38% |
| B/Barc AGG | Fixed Inc. | 2,369.54 | 0.24% | -0.85% |

**Was that a bead of sweat on Chairman Powell's forehead?**

If you've been around markets for a while, one of the things you can probably appreciate is how innovative this thing that all these youngsters are calling "the Internet" really is (or, maybe you've heard them call it "the world wide web." I'm not really sure if there's a difference...) Either way, it used to be that **when the Chairman of the Federal Reserve presented an update to Congress, you had to wait until the next day** to read about it in the newspapers. **But today, you can log on to what this new generation of bitcoin-obsessed Robin Hood account holders is calling *"You Tube"* and watch it in almost real-time**[1].

That's *soooo* much better than waiting 12 hours (or more,) for a filtered version that comes by way of a journalist whose other beat might have once have been street crime or local the wedding scene. For example, when the conversation gets uncomfortable, watching the Fed Chair's semi-annual testimony to lawmakers live and in color allows you to see all the squirming, sweating and prevaricating in real-time. And **even though Chairman Powell did a competent job representing his views, there were still plenty of reasons for him to swea**t.

Take for example **last week's inflation data**. Consumer prices rose 0.6% in June (5.3% year-over-year[2],) an uncomfortably high rate that was **even higher than most analysts were expecting**. The producer price index, released just a day later, was hardly better: it rose 1.0% (+7.3% year-over-year[3],) making it the highest reading since the BLS began calculating it a decade ago. Inflation "doves" were quick to point out that both numbers were **driven at least in part by sectors seeing the biggest snap-back in demand as the economy re-opens** – areas like used cars, car rentals and other travel-related services. Those same analysts also argue that **base effects** – which arise by comparing this year's reflating prices to last year's pandemic-depressed levels – are still artificially pushing inflation higher. **That could mean that all that price pressure will begin to simply evaporate soon**.

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[1] https://www.youtube.com/watch?v=agOrZsyhA7o
[2] https://www.bls.gov/cpi/
[3] https://www.bls.gov/news.release/ppi.nr0.htm

While that could very well be the case, last week's **eye-watering CPI and PPI data** were still enough to put Chairman Powell's repeated reassurances that inflation is temporary back in the spotlight as he testified in front of lawmakers. His response was telling: at a certain point the Fed's official line will "flip" if the numbers don't come down, and that it won't take forever for him to see whether inflation is transitory or not[4]. Translation: **the Fed is fully aware that prices are rising too fast for some market participants' comfort and patience is not unlimited**.

**It's probably unfair to characterize that as a change in Fed thinking** – Powell and many of his friends at the Fed are still fully committed to being as accommodative as possible for as long as possible – but it does at least **acknowledge** a simple truth: **the Fed might still have it wrong with regard to inflation, and at some point they may be forced to admit it**. That would of course put central bankers in an even tighter spot than they're in now and could even force them to do something rash, like normalize policy ahead of schedule.

To be sure, not all the inflation news was bad. In addition to the legitimate caveats above, businesses may also be seeing light at the end of the tunnel: the Atlanta Fed's monthly survey of **business inflation expectations climbed down off their recent highs** and indicated, kind of surprisingly, that businesses might be somewhat less inclined to increase prices than they usually are[5]. That could be great news for inflation at the economy-wide level, but maybe not so great for individual company margins.

As for **the productive side of the economy**, the news was somewhat mixed. **Industrial production and capacity utilization were disappointing** and are still being impacted by a prolonged semiconductor shortage that has continued to cut output in auto manufacturing.[6] On the other hand, the **New York Fed's** monthly survey of manufacturers in its region was **nothing short of a boom**, more than doubling expectations and suggestive of a continued boom in (attempted) hiring[7]. In nearby Philadelphia, the **Philly Fed wasn't quite as upbeat, but still remains elevated**[8]. Both surveys continued to bemoan higher prices and an inability to find workers, including this gem from Philly: 74% of the businesses who responded have increased wages in the last three months, with a many saying that in order to attract workers, they have had to increase wages faster and at a higher rate than they had originally planned.

And then there was the consumer. Retail sales[9] were up a much better-than-expected 0.6%, suggesting that **consumers aren't shy about spending what cash they have,** even if prices are accelerating, stimulus payments are waning and the economic outlook is a little less certain that in was a few months ago. But that report was perhaps even more notable for categories that *declined*: the **COVID-juiced sectors of building materials, sporting goods/hobbies and vehicles slipped in June** – no doubt at least partially in response to price spikes in some of those same goods and services. That gives at least some credibility to the idea that inflation may not be all that persistent as pent-up demand works itself out and rising prices leads to legitimate demand destruction in a few key categories.

But will it last? One question posed (rhetorically) by survey-takers at the University of Michigan is **whether or not consumers will pull in their horns and hold cash as a precaution** against price volatility: "complaints" about rising prices for homes, cars and consumer durables hit an all-time high in the UofM's latest survey, clear evidence that consumers are taking notice of rising prices[10]. Not coincidentally, the July mid-month read on **consumer sentiment index was much lower than expected.** And for what its worth, it's probably fair to ask whether a significant market drawdown – if and when it comes – might be exactly the kind of sentiment-damaging event that causes consumers to tuck in.

Finally, a word about **corporate earnings**. Big banks like JPMorgan, Goldman Sachs, Citigroup and a handful of others kicked off second quarter earnings season last week. **Results so far look pretty good**: low interest rates and anemic loan

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[4] https://www.fxstreet.com; https://www.federalreserve.gov/newsevents/testimony/powell20210714a.htm
[5] https://www.atlantafed.org/research/inflationproject/bie
[6] https://www.federalreserve.gov/releases/g17/current/default.htm
[7] https://www.newyorkfed.org/survey/empire/empiresurvey_overview
[8] https://www.philadelphiafed.org/surveys-and-data/regional-economic-analysis/mbos-2021-07
[9] https://www.census.gov/retail/marts/www/marts_current.pdf
[10] http://www.sca.isr.umich.edu/

volumes are leaving a mark on banks who rely more heavily on old-school deposit-taking-and-lending activity, but those with robust capital market capabilities are doing just fine. The one thing that seemed pretty universal among banks that reported last week was that **the US consumer appears to be in excellent health**: charge-offs are surprisingly low for companies that make consumer loans, while pretty much every bank that reported last week decreased the amount of capital set aside for losses – a tangible vote of confidence in those to whom the banks are ultimately writing the loans. Either way, though, **results weren't compelling enough to catalyze a big market rally**, and financials underperformed the market itself. As we've argued before, **results for the remainder of second quarter earnings season will have to be pretty good to validate current asset prices**, let alone underwrite a continued equity market advance.

# What to Watch This Week: July 19th – 25th

## Notable economic events (July 19th – 23rd)

**Monday**: NAHB housing market index; *earnings: IBM, JBHT*

**Tuesday**: Housing starts/permits; *earnings: NFLX, UAL, PM*

**Wednesday**: *earnings: TXN, CSX, LVS, JNJ*

**Thursday**: Weekly claims, existing home sales, ECB decision; *earnings: AAL, LUV, INTC*

**Friday**: Flash PMIs, Olympic opening ceremonies; *earnings: AXP*

**This week should be comfortably quiet** from a planned economic release perspective, with only housing market data and the flash PMIs to keep us busy. That **should allow earnings to take center stage**, with, among other things, multiple looks at **how the semiconductor business is coping** with the ongoing chip shortage (Texas Instruments reports on Wednesday, followed by Intel on Thursday.) Other large-cap tech companies expected to report this week are IBM (Monday,) and the **first of the FAANGs – Netflix – on Tuesday**.

But for perhaps **the best read-through into what really matters to markets right now, a handful of COVID-relevant companies are set to report** this week including a trio of airlines: United on Tuesday, followed by American Airlines and Southwest on Thursday. Add to that vaccine maker J&J and casino operator Las Vegas Sands, and there's a good chance that **we'll have a better view into how stubbornly high COVID infection rates are impacting areas of the market most exposed** to the pandemic. That could be important given the amount of attention being paid today to the delta variant and efforts to stem its aggressive spread. For example, the City of Los Angeles announced a re-introduction of its indoor mask mandate on Friday,[11] something that is probably helping to spark a moderate decline in both equity markets and bond yields as I write this.

There are also **a few peeks into how supply chains and logistics networks are holding up**. Trucking company JB Hunt reports on Monday, while railroad operator CSX is scheduled to release earnings on Wednesday. While transport-oriented companies **always provide great read-through** into what's going on in the broader economy, their importance **is magnified in the post-COVID climb-out because logistics and supply chains are so central to what seems to be holding back the current expansion**. CSX could be particularly interesting given competitor Kansas City Southern's earnings miss last Friday.

One-off events worth paying attention to include the **ECB's decision on rates** and the pace of asset purchases, scheduled for Thursday. As previously discussed, the ECB made the notable decision last week to adopt a Fed-like inflation targeting model, essentially formalizing what was already assumed to be an *easy-for-as-long-as-we-need-to-be* approach to policy. Comments endorsing that policy will get attention, as will any promises to extend bond purchases further out into the future as delta-strain COVID continues to march across Europe.

And finally, in what could prove to be the biggest test for markets regarding efforts to move beyond COVID, the **Olympic Games will open in Tokyo this Friday**. While the ability to hold the games at all is an impressive (and encouraging) feat, **the**

[11] Bloomberg, 7/16/21

**absence of spectators in the stands** as well as the almost inevitable drum-beat of news reports describing infected athletes who are tragically required to sit it out **will become a surreal reminder to us all that the pandemic isn't quite over**.

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