Great-West Investments Capital Markets Perspective

Week in Review: August 23rd – 29th

INDEX/ SECURITY	ASSET CLASS	LEVEL (CLOSE)	% CHANGE (THROUGH FRIDAY'S CLOSE) 1 WK.	YTD
Dow Industrials	Lg. Cap Eq.	35,455.80	0.96%	16.70%
S&P 500®	Lg. Cap Eq.	4,509.37	1.52%	20.88%
NASDAQ Comp.	US Equity	15,129.50	2.82%	17.80%
S&P Midcap 400©	Mid-Cap Equity	2,767.06	3.42%	19.96%
Russell 2000®	Sm. Cap Eq.	2,277.15	5.05%	15.08%
Stoxx 50	Europe Eq.	4,190.98	1.05%	17.34%

INDEX/ SECURITY	ASSET CLASS	LEVEL (CLOSE)	% CHANGE (THROUGH FRIDAY'S CLOSE) 1 WK.	YTD
FTSE 100	UK Equity	7,148.01	0.85%	10.64%
Nikkei 225	Japan Equity	27,641.14	2.32%	0.72%
EEM:US	Emkt. Equity	$51.59	4.22%	0.33%
EFA:US	Non-US Equity	$80.70	1.57%	10.55%
UST 10y (yield)	US Treasury	1.31%	+0.05%	0.40%
B/Barc AGG	Fixed Inc.	2,375.18	-0.05%	-0.61%

It was an artful dodge.

Markets had been **hoping for additional clarity coming out of the Federal Reserve's annual offsite at Jackson Hole last week.** What they got instead was an impressive display of the "five D's of dodgeball[1]" by Federal Reserve Chairman Jerome Powell that would've impressed Patches O'Houlihan himself.

It's not that Powell *meant* to be slippery, it's just that there wasn't really all that much he could say that would satisfy the market's need for a better sense of when and how the Fed might begin to taper its asset purchases. **After all, most of the trends that have kept the taper in limbo remained very much on the court**, dodgeballs at the ready: most notably **the delta variant** (which continues to cause a worrying rise in both case growth and hospitalizations worldwide,) but also **progress on unemployment** (which remained positive, but is still a long way from where the Fed would like to see it.) **Until both of those factors start to improve, Powell's Peter LaFleur impression is likely to continue**.

But even if there was no clear signal about when the Fed might step down it's pace of bond purchases, there was also no effort to scale back expectations – increasingly common among market participants – **that the taper will begin before the calendar turns over on New Year's Day**. And then there was this: "(the tapering of bond purchases) will not be intended to carry a direct signal regarding the timing of interest rate lift-off[2]…" That was as clear a signal as we've received so far that even **when the Fed finally *does* decide to quit soaking up $120b in treasury and mortgage debt each month, nobody should interpret that to mean that a dreaded increase in rates is imminent**.

Markets seemed to like that message because stocks – which had mostly been in a holding pattern all week while the Fed enjoyed its virtual confab – had a great day on Friday. Treasuries, too, got some relief: after rising pretty much all week, 10-year yields dropped on Friday after Powell's modestly reassuring message, cutting what would've been a 10 basis-point move higher for the week almost in half as demand for US Treasury debt improved. That's **because Powell's statement seemingly broke the link between tapering and a normalization of rates** that was ultimately behind the

[1] "Dodge, duck, dip, dive and dodge!"
[2] https://www.federalreserve.gov/newsevents/speech/powell20210827a.htm

market's initial reaction to the post-GFC tapering of bond purchases in 2013 – the so-called Taper Tantrum that initially sent both stocks and bonds lower until cooler heads prevailed and equities recovered.

So that was the Fed's big moment.

But what about that other big Fed-fueled controversy, that all this inflation we're seeing is truly temporary? Here, Powell provided perhaps the most detailed breakdown so far outlining why he thinks all this price pressure that businesses and consumers alike are fretting over will go away[3]. Let's call them **"Powell's Five Forces":**

- **Inflation is being driven by a narrow group of things** directly impacted by COVID that will eventually "wash out over time,"
- **Prices in those areas (i.e. used cars) have already started to moderate** as shortages in related areas ease,
- **Wage growth, while rising, has yet to reach levels that would encourage a "wage-price spiral"** seen in previous cycles,
- **Longer-term inflation expectations have moved far less that short-term expectations**, and
- "(G)lobal disinflationary forces" like technology, globalization and demographics remain in play, (an argument which basically breaks down to "**Eh, inflation has been low for as long as we can remember, so it will probably stay low…")**

Is Powell right, or is he going out of his way to justify an easier-than-it-should-be stance ahead of what basically amounts to a pending re-election campaign next year? (**Powell's term as Fed chair expires in February**, and it seems logical that President Biden would be more likely to re-appoint a dovish Jerome than a hawkish one…)

Who knows? I for one am a little skeptical that this kind of horse-trading is really all that common with regard to who does (and doesn't) park their keister in the Fed's most important chair, but **there is little doubt that a President who is trying to spend $4 trillion dollars on a broad-reaching infrastructure plan would probably prefer someone who isn't all that worried about over-inflating the US economy**.

Time will tell. But it's important that for the time being, **businesses and consumers aren't as comfortable as the Fed is with the idea that current inflationary trends are just a COVID-inspired fever dream**. For example, last week's flash **PMIs once again showed that cost burdens faced by businesses across both the manufacturing and services sectors of the US economy have remained at near-record highs**[4]. And it's not just here in the US, either: rising costs got a starring role in Eurozone flash PMIs last week as well[5]. (Incidentally, those same PMIs – as well as last week's regional Feds[6,7], CFNAI[8] and the durable goods report – showed exactly what was expected: growth is robust, but is being led by current output and perhaps already peaking out.)

Consumers aren't so sure that all this will simply go away, either. The University of Michigan released its final read of August consumer sentiment on Friday, with no sign that the collapse in consumer confidence evident in the preliminary estimate two weeks ago was a mere aberration. Instead, the **UofM economists noticed that a widening gap between income received by consumers and the rate of inflation for the stuff they're buying is starting to impact purchasing behavior**. That, plus the persistence of the delta variant, could mean that even if an economic downturn is not imminent, any "emotional impact on spending patterns" wrought by these influences could last for quite a while, just as it did during past non-financial collapses in consumer sentiment like Hurricane Katrina or 9/11[9].

But let's go back and explore that gap that the UofM called out, the one growing between how much consumers are bringing in and how they're spending it. Also on Friday, markets digested the Bureau of Economic Analysis' **income-and-outlays report, which was a little light on the spending side but *way* better than expected in the income side**, where incomes grew by 1.1% month-over-month: about 3x higher than the increase in spending and far ahead of what

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[3] Ibid.
[4] https://www.markiteconomics.com/Public/Home/PressRelease/2ebf3c08ba874510879b6b2976cc98c4
[5] https://www.markiteconomics.com/Public/Home/PressRelease/b3f183b46e7d475994607def220f3835
[6] https:/richmondfed.org/research/regional_economy/surveys_of_business_conditions
[7] https://www.kansascityfed.org/surveys/manufacturing-survey/tenth-district-manufacturing-activity-continued-at-a-strong-pace/
[8] https://www.chicagofed.org/publications/cfnai/index
[9] http://www.sca.isr.umich.edu/

economists had predicted[10]. Both wages and government transfers – now the primary sources of income for US consumers – rose in July, but something notable happened with regard to transfers: **a clear hand-off is beginning to take place between Pandemic Unemployment Compensation (PUC,) and programs such as child tax credit** payments authorized by the America Rescue Plan approved during the early days of the Biden administration. That could become increasingly important when additional unemployment benefits expire for the remaining 25 states during the first week of September.

Finally, the **FDA granted full approval to Pfizer's COVID vaccine** (now unfortunately named COMIRNATY – perhaps the worst and hardest-to-pronounce drug name in modern history…) on Monday[11]. That was followed almost immediately by word that the **Department of Defense planned to make the vaccine mandatory for DoD personnel "soon,"** possibly an indication that **other large organizations might feel similarly emboldened** and require – or at least strongly (even financially) encourage it in the near future[12].

What to Watch This Week: August 30th – September 5th

Notable economic events (Aug. 30 – Sept. 3)

Monday*:* Pending home sales, Dallas Fed

Tuesday: Home prices (x2), Consumer confidence

Wednesday: ADP payrolls, ISM/PMI manufacturing

Thursday: Challenger layoffs, weekly jobless claims, factory orders (July)

Friday: Payrolls, ISM/PMI services/composites

This week will bring an opportunity to see what "continued but insufficient progress" in the jobs market looks like. That is of course a reference to **Friday's payrolls report,** where we will all get a chance to pretend that we're Jerome Powell and guess whether or not the US labor market is healing fast enough to do something as silly as slowing the pace of asset purchases. Economists think the US economy will have created around three-quarters of a million jobs in August when the dust settles, a deceleration from last month's pace but still **robust enough to represent progress**. Once again, the ideal jobs report would be one that shows solid improvement in putting people back to work **without being so robust as to raise the alarm** about an accelerated timetable for Fed action. **Goldilocks is the house, yo…**

As always, Friday's payroll data will be preceded by **ADP**'s own estimate of jobs growth on Wednesday as well as **Challenger layoffs** data on Thursday.

Other key data on tap this week include **final reads on the ISM and PMI data for both manufacturing (on Wednesday,) and services (Friday.)** As before, it's reasonable to expect these numbers to paint a picture of a US economy that is growing, but at a slightly less aggressive pace than in previous months. **The focus will very likely be on prices paid/received** and whether those figures support the Fed's contention that inflation is transitory. Another area of focus could be **whether an ongoing handoff between manufacturing** – which has been extremely strong as output has struggled to catch up with post-COVID demand for actual goods – **and services** (which, while strong, has also remained a little more restrained as a result of the persistence of the delta variant) **has continued**. For what it's worth, there was also evidence in last week's income and outlays report that exactly such a hand-off is taking place.

While we're on the subject of a possible cooling-off of previous demand-led booms, we get a few more reads into the health of the **housing market** this week with Monday's release of pending home sales and Tuesday's home price data from FHFA and S&P/Case-Shiller. Last week's new- and existing home sales data was generally consistent with **a leveling-off of**

[10]https://www.bea.gov/news/2021/personal-income-and-outlays-july-2021
[11] https://www.pfizer.com/news/press-release/press-release-detail/pfizer-biontech-covid-19-vaccine-comirnatyr-receives-full
[12] https://www.defense.gov/Explore/News/Article/Article/2742785/dod-intends-to-mandate-pfizer-vaccine-pentagon-official-says/

demand in the once white-hot US housing market, with this important note from the National Association of Realtors' Lawrence Yun capturing things pretty succinctly[13]: "**Although we shouldn't expect to see home prices drop in the coming months, there is a chance that they will level off as inventory continues to gradually improve**". If that's truly the case, then expect to see evidence in this week's home price reports.

Finally, **Tuesday** will represent a milestone in US/Afghan history as the **deadline for a final withdrawal of US forces** in that troubled country passes. Regardless of how that may (or may not) impact the geopolitical environment or the capital markets that envelop it, I feel compelled to offer **heartfelt condolences and tearful thanks to the families of the 11 US Marines, one US soldier and one US sailor who lost their lives** in the horrendous terror attack in Kabul last week. That, plus the scores of civilian deaths that also occurred during that cowardly attack, are a reminder of exactly how troubled our world remains.

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

[13] https://www.nar.realtor/newsroom/existing-home-sales-climb-2-0-in-july.