WHY US ECONOMIC GROWTH COULD SURPRISE ON THE UPSIDE

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All the relevant boxes are checked for a robust capital goods cycle to unfold over the next several years. Corporate sector finances are solid with record cash positions and extremely rapid growth in company earnings. Manufacturing capacity has expanded only modestly in recent years, and the capital stock is at an advanced age. Most importantly, the cost of labor is virtually assured of rising rapidly in coming years, easily exceeding the cost of capital. With the benefit of rapid technological innovation, business firms will be incentivized to substitute capital equipment and software for labor, boosting the pace of capital formation.

Summary and Major Conclusions:

- The tone of world financial markets changed noticeably in the middle of May as investor confidence in the economic outlook abruptly deteriorated, triggering a massive flight to safety.
- The primary catalyst for this marked shift in investor psychology was evidence of deterioration in public health conditions as the highly infectious Delta variant of COVID-19 rapidly became the dominant strain, resulting in a surge in infections.
- In addition to the pandemic, two other factors weighed on investor confidence: Widespread reports of supply chain disruptions that were undermining the economic recovery; and sharp increases in consumer inflation, as some companies used their pricing power to pass along input cost increases to customers.
- An examination of underlying fundamental trends leads to the conclusion that these impediments to economic growth are temporary, and that the US economy will surprise on the upside over the next one to two years.
- Although public health conditions will continue to ebb and flow in coming months, it seems reasonable to assume that the economic impact of COVID-19 will gradually weaken with the passage of time.
- The current very disappointing pace of US vaccinations could give way to a sharp increase in inoculations as the dominant mRNA vaccines receive full FDA approval and as businesses, universities, state governments, and municipalities implement vaccine mandates.
- The emergence of something akin to herd immunity early next year would be a game changer for the outlook for economic growth, as a combination of rising vaccinations and natural infections steadily increases the population's resistance to the virus.
- Consumer spending should remain strong for the next four quarters, at a minimum, sparked by continued healthy job creation, accelerating growth in wages, and accommodative financial conditions. Spending should also benefit as pent-up demand built during the lockdown is unleashed.
- The powerful rebound in the US manufacturing sector over the past six months could be a prelude to an extended period of healthy and sustained growth. The events of recent years have culminated in a strong desire by US manufacturers to develop a "built in America" mindset.
- Business investment spending should benefit from an expected strong growth in worker compensation. With the benefit of rapid technological innovation, companies will be incentivized to substitute equipment and software for labor, reinforcing the growth of spending on capital formation.

- Despite recent signs of slower growth, residential construction remains in a multi-year boom. The construction cycle will not end until housing starts are sustained at a sufficient pace to satisfy the level of underlying demand, which is supported by rapid growth in first-time home buyers and record-low inventories.

- Continued recovery in the labor market will be a powerful catalyst for strong growth in spending and output. Employment data clearly show that the demand for labor is robust but that hiring has lagged because of supply constraints.

- The mismatch between supply and demand has resulted in the largest shortage of workers in decades, especially for skilled workers with a college degree. This shortage could persist for several years, implying strong upward pressure on wages in 2022 and 2023.

- There are several major risks to the growth outlook: An inability to contain the pandemic; persistent supply chain disruptions that continue to undermine output and spending; mounting evidence that the recent surge in inflation is not transitory, causing the Fed to slam on the brakes; and a sustained rise in bond yields.

- Widespread economic uncertainty implies that safe-haven assets will remain in high demand. A decisive shift in equity market leadership in favor of cyclical stocks is unlikely to commence until there is convincing evidence that the current temporary forces undermining the economic expansion have begun to fade.

The tone of world financial markets has changed noticeably since the middle of May as investor confidence in the economic outlook has darkened, triggering a massive flight to safety. The primary catalyst for this marked shift in investor psychology was evidence of deterioration in public health conditions as the highly transmissible Delta variant of COVID-19 rapidly became the dominant strain, triggering a surge in infections.

Risk-Off: As measured from the middle of May, the market yield on ten-year US Treasury bonds plunged from a peak of 1.7% to a low of 1.1% at the end of July. The ***real yield*** on government bonds fell to a ***negative 1.2%***, the lowest level ever recorded in the 250-year history of the US Treasury market. Equity market leadership shifted from value to growth stocks: Growth stocks appreciated by 15% while value stocks ***declined*** by 1% over that period. Small-cap stocks also posted negative returns. The US dollar rose by 5%.

Risk-On: *These market returns were a mirror image of those during the early months of this year*. The yield on government bonds rose from 0.9% at the end of 2020 to a high of 1.7% in May, while value stocks outperformed growth stocks. From December 31 through May 15, the value stock index rallied by more than 15%, massively outdistancing the 2% gain in the growth stock index. Small-cap stocks performed best through the end of May with a total return of nearly 20%.

Shortages and Inflation: In addition to the pandemic, two other factors have weighed on investor confidence prompting a flight to quality: (1) Widespread reports of supply chain disruptions that were undermining the economic recovery; and (2) Sharp increases in consumer inflation, as some companies used their pricing power to pass along input cost increases to customers. The core Consumer Price Index (CPI) jumped from only 1.3% in February to 4.3% in July (annual rate).

Underlying Trends: An examination of underlying fundamental trends leads to the conclusion that these impediments to economic growth are temporary, and that the US economy will surprise on the upside over the next one to two years. The following is an analysis of major sources of economic growth that should contribute to a faster rate of GDP growth than currently anticipated by financial markets.

PUBLIC HEALTH CONDITIONS

Although public health conditions will continue to ebb and flow in coming months, it seems reasonable to assume that the economic impact of COVID-19 will ***gradually*** weaken with the passage of time. The current very disappointing pace of US vaccinations could give way to a sharp increase in inoculations as the two mRNA vaccines receive full FDA approval and as businesses, universities, hospitals, state governments, and municipalities implement vaccine mandates.

There are also new vaccines under review — for booster shots and for children under the age of 12 — while Merck's antiviral drug Molnupiravir is scheduled to complete phase three trials in October. Many credible medical experts expect the current fourth wave of the pandemic to peak within the next several months, paving the way for a resumption of reopening initiatives.

The approach of something akin to herd immunity early next year would be a game changer for the outlook for healthy and sustained economic growth, as a combination of cumulative vaccinations and natural infections continue to grow in number. The primary risk to the outlook is the emergence of new variants that are more virulent and resistant to current vaccines.

PERSONAL CONSUMPTION

The economic recovery has been powered primarily by a boom in consumer spending, initially driven by massive government income-support programs but more recently by traditional textbook forces: A strong recovery in employment and healthy increases in wage and salary income. Household spending should remain strong for the next four quarters, at a minimum, sparked by continued healthy job creation, accelerating growth in wages, and accommodative financial conditions.

Future spending will also benefit as pent-up demand created during the lockdown is unleashed. The personal savings rate remains 50% above the long-term average and should return to normal along with a full recovery in both the manufacturing and service sectors. Sales of autos and appliances continue to be constrained by shortages in components but should eventually recover as supply chains are normalized. In short, the consumer-led economic recovery will dominate 2021 but the economy will evolve into a more broadly based expansion with a rebound in the manufacturing and capital goods sectors in 2022 and 2023.

MANUFACTURING REVIVAL

The powerful rebound in the US manufacturing sector over the past six months could be a prelude to an extended period of healthy and sustained growth. The events of recent years have culminated in a strong desire by both US manufacturers and the government to develop a "built in America" mindset. There are several megatrends that have led to this shift in emphasis:

- The sudden emergence of painful tariff wars in the last decade raised business awareness of the need for safe and secure access to materials and components
- Escalating geopolitical tensions between the US and China have reduced the appeal of China as a destination for direct investment
- The disruption in global supply chains caused by the pandemic exposed the risks to domestic producers of dependence upon foreign sources for vital components
- Congressional passage of the Biden administration's infrastructure initiative would greatly reinforce the incentives to invest in the US

Manufacturing capacity in the US has not increased since China's entrance into the World Trade Organization (WTO) in 2001 — as US industrial companies repeatedly made the decision to shift production from domestic locations to China. There are substantive reasons to expect that this process will reverse direction over the next decade.

BUSINESS CAPITAL INVESTMENT

All the relevant boxes are checked for a robust capital goods cycle to unfold over the next several years. Corporate sector finances are solid with record cash positions and extremely rapid growth in company earnings and cash flow, while the cost of capital is extremely low. Manufacturing capacity has expanded only modestly in recent years, and the capital stock is at an advanced age.

Most importantly, the cost of labor is virtually assured of rising rapidly in coming years, easily exceeding the cost of capital. *With the benefit of rapid technological innovation, business firms will be incentivized to substitute capital equipment for labor, boosting the pace of capital formation*. I expect both manufacturing and capital spending to increase as a share of GDP over the next three years.

RESIDENTIAL CONSTRUCTION

Residential construction remains in a multi-year boom that will not end until there is an adequate supply of housing units to satisfy underlying demand. Housing completions collapsed following the real estate bust in 2007, resulting in a steep decline in construction and a massive shortfall in housing units. There are currently only 1.25 million existing homes for sale nationwide, down 20% from June of last year and near an all-time low.

Construction has entered a temporary slowdown phase because of bottlenecks in labor and building materials. However, growth should resume in 2022: Currently at 1.65 million units, housing starts could rise to 1.85 million in 2022 and close to two million in 2023. The all-time peak was 2.25 million starts in early 2006. The construction cycle will not end until housing starts are sustained at an elevated pace sufficient to satisfy the level of underlying demand, as the millennial generation enters the prime homebuying years.

LABOR MARKET RECOVERY

Continued recovery in the labor market will be a powerful catalyst for strong growth in spending and output. The housing market will also benefit as the economy transitions to full employment. Of the cumulative 22 million jobs destroyed during the pandemic, 16.5 million have been recovered, meaning that employment remains 5.5 million below its pre-pandemic peak early last year. The level of nonfarm payrolls should return to its peak of 152.5 million during the summer of next year. My forecast assumes net job creation of six million this year followed by another four million in 2022.

Employment data clearly show that the demand for labor is robust but that hiring has lagged because of supply constraints. Job openings nationwide posted in June rose to a record ten million. The mismatch between supply and demand has resulted in the largest shortage of workers in decades, especially for skilled workers with a college degree.

This shortage could persist for several years, implying strong upward pressure on wages in 2022 and 2023. Currently increasing at an annual rate of 4.5%, average hourly earnings could rise to 5% to 6%. The combination of healthy job creation and rising wages should result in robust growth in consumer spending over the next 12 months.

RISKS TO ECONOMIC GROWTH

There are four major risks to the outlook for economic growth. Each of these risks is linked either directly or indirectly to the coronavirus:

- An inability to contain the spread of COVID-19 because of lagging vaccinations, failure to adhere to safety measures, and/or the emergence of new highly contagious variants that are resistant to current mRNA vaccines.
- Lingering supply chain interruptions extending beyond yearend, resulting in persistent disruptions to spending and output.
- Mounting evidence that the current spike in inflation is not transitory, causing the Federal Reserve to tighten monetary policy aggressively.
- A sustained rise in government bond yields triggering a spike in borrowing costs for households, businesses, and governments.

INVESTMENT CONCLUSION

Lingering investor concerns over the pace and sustainability of the economic expansion should result in continued relative strength in safe-haven assets such as government bonds and high-quality growth stocks. The corollary is that reopening stocks and economically sensitive sectors will lag. A decisive shift in leadership in favor of cyclical stocks is unlikely to commence until there is convincing evidence that the current temporary forces undermining the economic expansion have begun to fade. Greater investor conviction in a robust and sustained business expansion should spark a market shift toward risk assets.

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Bloomberg Barclays US Aggregate Bond Index: is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. Investors frequently use the index as a stand-in for measuring the performance of the US bond market.

Dow Jones Industrial Average: is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

MSCI World Excluding US Equity Index: is a stock market index comprising of non-U.S. stocks from 23 developed markets and 26 emerging markets. The index is calculated with a methodology that focuses on liquidity, investability, and replicability.

NASDAQ: is an American stock exchange at One Liberty Plaza in New York City. It is ranked second on the list of stock exchanges by market capitalization of shares traded, behind the New York Stock.

Russell 2000 Index: is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

Russell 3000 Growth Index: is a market capitalization-weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The index is used to provide a gauge of the performance of growth stocks in the United States.

Russell 3000 Value Index: : is a market-capitalization weighted equity index maintained by the Russell Investment Group and based on the Russell 3000 Index, which measures how U.S. stocks in the equity value segment perform by including only value stocks.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

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