Economic & Financial Markets

Monthly Review

October 2021

The expansion hits a bump in the road as supply constraints linger

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Tapering is not tightening

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In this issue

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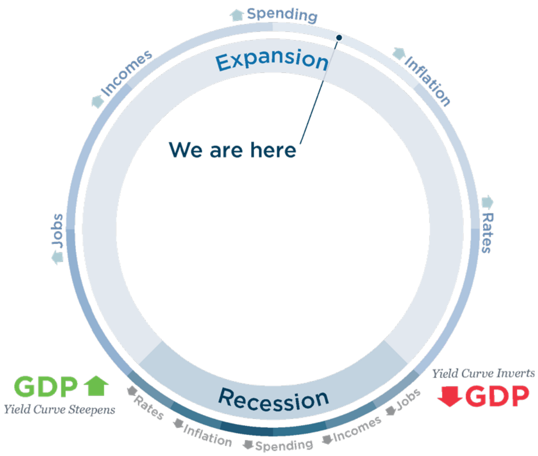
Economic Update

Business Cycle

As of September 2021



The COVID-19 recession was officially the shortest on record — lasting only for the two months ending in April 2020. Since then, the economy has seen perhaps the fastest recovery ever, with the level of real GDP now above the pre-Covid peak.

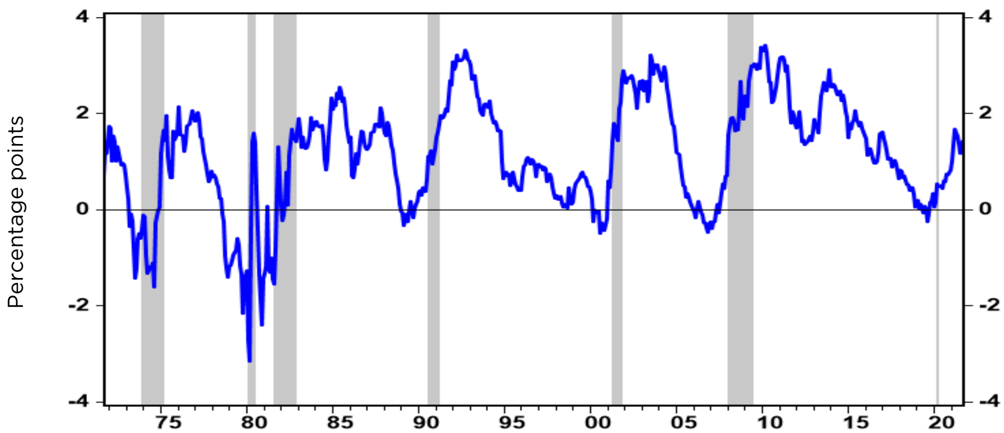
There is still lots of room to be made up with labor and capacity utilization suggesting that there is enough of an output gap that the economy should be able to grow at an above-trend pace for at least another year. Moreover, this gap should allow inflation to move lower once supply chains have healed over the next year.

Yield Curve

Spread between 10-year and 1-year U.S. Treasury yields

One of the best predictors of an economic downturn is a fully inverted yield curve, when short-term interest rates are above long-term rates for a sustained period. But the new world of the Covid-19 pandemic and government responses to the virus superseded the usual recession rules early last year.

The yield spread between 10-year and 1-year Treasury notes has moved upward to the highest level since early June — remaining above the long-term average and suggesting continued growth ahead.



Sources: Bureau of Labor Statistics; Haver Analytics
Shaded areas depict recessionary periods

Growth slowdown deepens amid extreme supply chain disruptions

The deceleration of economic activity looks deeper than previous estimates as the economy continues to be held back by supplier delays and labor shortages. Nonfarm payrolls disappointed again (although the overall employment report wasn't actually weak), almost certainly due to a lack of workers rather than firms lowering their demand. Moreover, supply chain issues are holding back manufacturing and services production (although both sectors continue to show growth). Consumers have shown resilience through the Delta surge but cannot fully offset the negative supply chain impacts holding back overall economic growth.

Nonfarm payrolls disappoint; labor force shrinks

Nonfarm payrolls grew by 194,000 in September, missing expectations by a wide margin. Much of the miss came from a large decline in local government (especially education) jobs; private sector jobs were much closer to projections. It's possible that further effects from the Delta variant can be seen in the leisure and hospitality sector, which added only 74,000 jobs in September and has added just above 110,000 over the last two months after averaging roughly 350,000 for the previous six months. It's more likely, however, that weaker hiring in most industries is more due to a lack of qualified applicants than reduced labor demand. There were 10.4 million job openings at the end of August, the second highest total on record (behind July).

Positive news from the jobs report came in the form of upward revisions to August and July's payroll numbers, amounting to an additional 169,000 jobs. Additionally, the household survey showed an increase of 526,000 employed persons. This dropped the headline unemployment rate to 4.8 percent, marking the first time that unemployment has been below five percent since the beginning of the pandemic.

While we expect stronger job gains in coming months, the labor market will continue to fall short of its potential until supply picks up. Until then, an increasingly tight labor market should lead to faster wage gains, which are already up 4.6 percent over the last year, and lower unemployment rates.

Struggling supply chains hold back ISMs

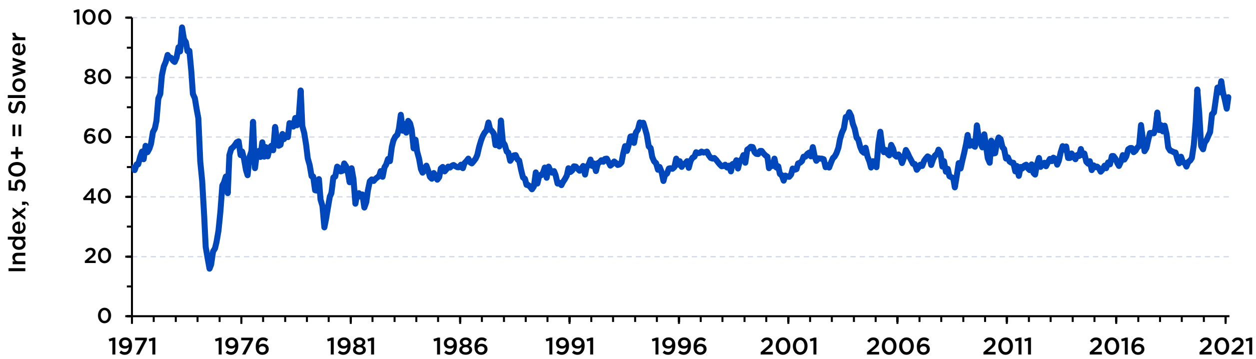
The Institute for Supply Management (ISM) manufacturing and services indices both surprised to the upside for September showing modestly faster growth in both sectors. Demand measures continue to be strong, with growth in new orders for manufacturing flat but remaining elevated, while readings on new orders and business activity on the services side picked up. Labor supply continues to be a constraint, particularly for manufacturing which saw employment barely edge into expansion territory after slipping below 50 for August. Likely as a result of too few workers, total manufacturing production cooled to its slowest level since last June.

Reported supplier delays in both sectors continued to run at near-record levels for September, showing the effects of supply chains in disarray. This has led to an increasing backlog of orders and rising prices. Respondents to both surveys consistently noted supply shortages, lengthening lead times for materials, and difficulty hiring enough workers (due to few applicants).

Consumers show resiliency

Consumer activity was solid for August even during the peak of the Delta variant surge. Outside of a large decline in auto sales (which is tied to the microchip shortage rather than struggling demand), retail sales saw their fastest growth since March. The consumer confidence index, which declined for a third straight month in September, indicated that growth expectations and spending intentions continue to be negatively affected by Delta, but this has yet to filter into consumer behavior. Overall economic growth likely slowed significantly in the third quarter, but consumer spending appears to be holding up. Slower – but still above trend – growth, appears to be more a function of disrupted supply chains and a shortage of labor supply, rather than a decline in underlying demand.

Supplier delays near the highest level since the 1970s



Source: Institute for Supply Management/Haver Analytics

Another down September for equity markets

The S&P 500 Index retreated by almost five percent in September, ending its seven-month positive streak and repeating a calendar phobia. A rise in Covid case counts and persistent supply bottlenecks weighed on investor sentiment. Energy prices surged, further hampering supply chains, pushing up gasoline prices, and signaling higher heating costs in the upcoming winter. Fed Chair Jerome Powell hinted that an announcement on tapering could happen soon, lifting interest rates and slightly steepening the yield curve. Moreover, additional fiscal stimulus and the debt ceiling remained embroiled in a contentious political debate.

Strong 2021 for equities despite setback

Equity declines in September are typical. Since 1927, only 45 percent of Septembers have achieved positive performance in the S&P 500, a sharp contrast to the 60 percent uptick for all months. But based on historical averages, this slump may not last long, with 75 percent of Decembers achieving positive returns.

September's setback was only a minor dent in 2021's impressive rally. While the S&P 500 Index ended the third quarter only about ten points higher than the second quarter's finish, it was up by more than 500 points from the end of last year. The breadth of the market is another positive sign, with 82 percent of names positive so far this year — the third highest reading this century. But, as a cautionary note, more than half of the stocks in the index are ten percent below their mid-year highs.

The energy sector was on fire in September, adding more than nine percent last month and was the only positive category in the index. The benchmark WTI crude price finished above $80 per barrel for the first time since 2014, and natural gas topped $5, an eleven-year high. Shut-ins of Gulf oil wells caused by recent tropical storms and fear of another La Niña winter are blamed for the sharp rise in gas futures. Both Europe and U.S. gas production are struggling to keep up with renewed economic growth and a drop in renewable output. All this at a time when electricity demand has been brisk and natural gas inventories remain dangerously low at well under their five-year average.

The U.S. dollar has benefited from the rally in crude oil prices. Strong U.S. economic growth and export demand have helped the currency return to levels not seen since last September. A stable dollar and high U.S. interest rates compared with other major countries pushed foreign holdings of U.S. Treasuries to a record high in July. The largest international holder, Japan, purchased more that month bringing their position to $1.3 trillion, the highest level ever. The ever-growing U.S. debt has yet to scare away foreign investors.

Higher relative yields

The U.S. 10-year Treasury note yield finished September at almost 1.50 percent, an uptick of 18 basis points over the month and, as with the S&P 500 Index, there was little change from the end of the second quarter. The yield on the two-year note rose slightly, lagging longer maturities and modestly steepening the yield curve. Still, the two-year yield topped 30 basis points as October began, the highest rate since March 2020. Fixed income investors likely sense a change in monetary policy ahead as the odds of interest rate hikes occurring sooner have climbed.

Yields on European sovereign debt also rose, perhaps suggesting stronger economic growth. The yield on the 10-year German bund climbed above -25 basis points at the end of September, a significant increase from the recent -45 bps level. For the 10-year U.K. gilt, the rate crossed the one percent milestone as October began, a more than two-year high. Higher rates across Europe show the recovery is taking hold, good news for the global economy.

A temporary agreement has pushed a potential debt ceiling breach back to early December. This removes some near-term risk for equities, but long-term Treasury yields continue to move higher in anticipation of the actual tapering of quantitative easing (QE). In mid-October, they climbed to the highest levels since early June.

Asset Class Performance

Total returns represented as of September 30, 2021

	1-month	6-months	12-months
S&P Composite 500 Index	-4.65%	9.18%	30.01%
S&P Midcap 400 Index	-3.97%	1.81%	43.68%
S&P Smallcap 600 Index	-2.43%	1.54%	57.64%
EAFE[1]	-3.19%	3.30%	22.96%
U.S. Dollar Index[2]	1.39%	1.94%	-0.70%
CRB Commodity Index[3]	-1.05%	9.29%	36.40%
Intermediate Treasuries[4]	-0.61%	0.62%	-1.38%
Long Treasuries[5]	-2.86%	6.96%	-10.27%
Investment-grade Corporate Bonds[6]	-1.05%	3.54%	1.74%

[1] Index measuring equity performance of developed markets outside of the U.S. and Canada

[2] Federal Reserve trade-weighted broad currency index

[3] Commodity Research Bureau; CRB spot index

[4] Index of 1-year to 10-year Treasury notes

[5] Index of 10-year and longer Treasury notes and bonds

[6] Index of U.S. investment-grade corporate bonds

Sources: Bloomberg; Haver Analytics

Tapering is not tightening

Perhaps no story has captivated financial markets in 2021 quite as much as the Federal Reserve's movement toward reducing the size of its quantitative easing (QE) program. Monetary policymakers were steadfast for much of this year that the economic conditions required for a tapering of this program had not yet been met, but the tone has changed considerably in recent months. The statement released after the Federal Open Market Committee (FOMC) meeting on September 22, for example, indicated that "a moderation in the pace of asset purchases may soon be warranted," a point that was underscored by Chair Jerome Powell in the subsequent press conference. Barring a significant shift in the outlook, a taper announcement is likely to be soon forthcoming.

Economy grew strongly during the last taper

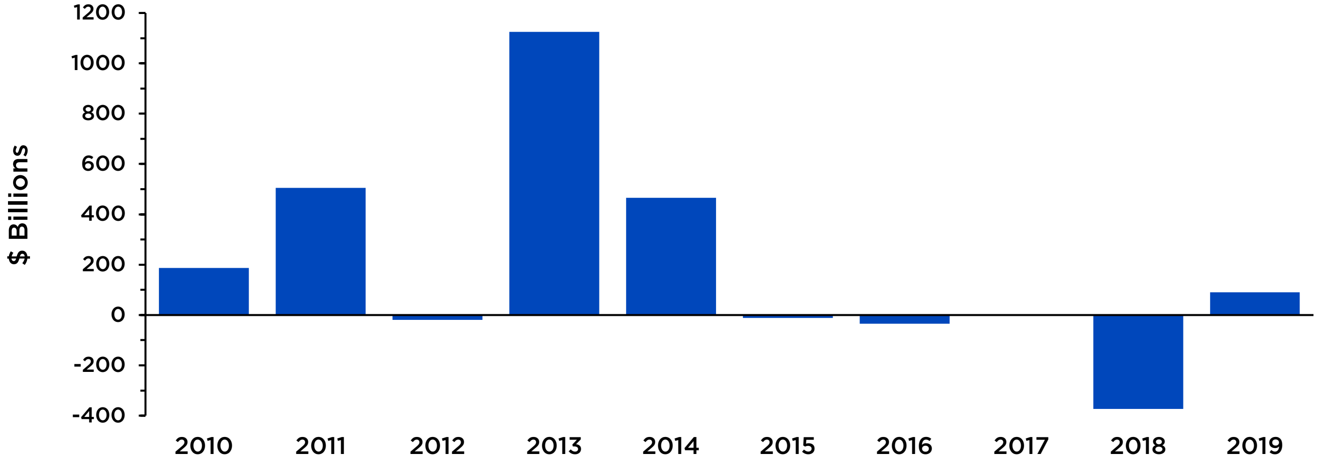
It should be stressed, however, that tapering is not tightening and that the impending downshift in QE only begins what promises to be a very gradual process toward a more restrictive policy stance. The impact of the Fed's last pullback in bond buying is illustrative. As QE was wound down across the first ten months of 2014, the Fed's balance sheet still expanded by more than $400 billion and the economy continued to expand at a healthy clip. After slipping early in the year due to harsh winter weather, in fact, real GDP growth turned in its strongest back-to-back quarters in more than a decade in mid-2014 while the unemployment rate was *en route* to one of its largest annual declines in decades. The financial markets were also relatively calm during this period, as the S&P 500 advanced at a healthy pace throughout 2014 (but with its largest setback of the year just as the taper was ending), while long-term interest rates fell.

A long process

The taper in 2014 was also just the first step in a multi-year transition away an accommodative stance. The Fed went on to begin lifting the federal funds target in late 2015 but moved slowly enough over the subsequent years that policy, as proxied by the shape of the yield curve, didn't turn restrictive until 2019. And given policymakers' own forecasts, a similar path appears likely in this cycle. Specifically, FOMC officials collectively expect the federal funds target rate to rise over the next three years to just 1.8 percent, a level that would very likely still leave the yield curve positively sloped. It is a good bet, then, that policy will remain supportive not only in 2022, but for several more years thereafter. Moreover, it is to be expected that any ripples in the economy or financial markets, such as a soft patch in real GDP growth or a correction in equity prices, would further draw out what is already a very cautious timeline.

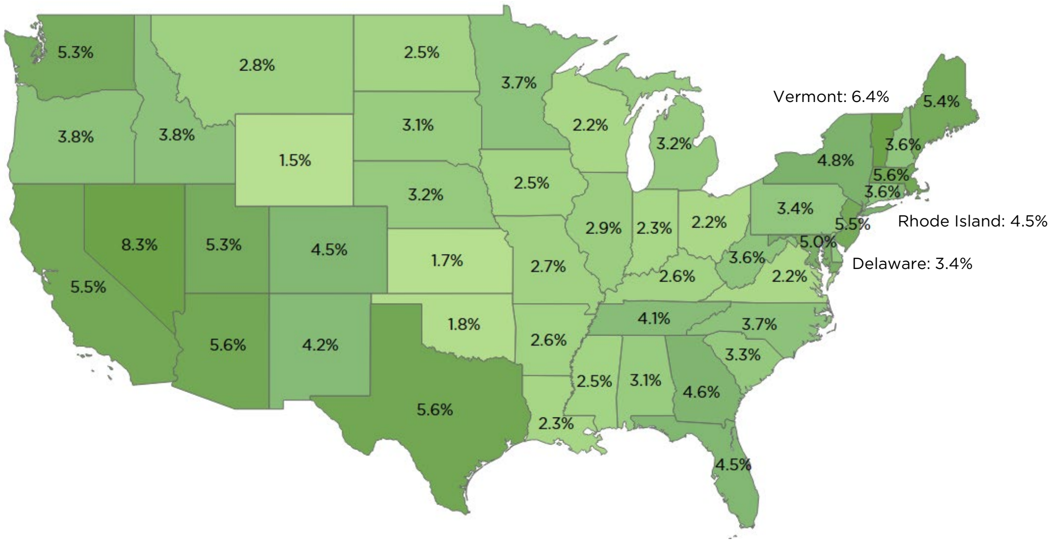
It is worth remembering that the Fed significantly overestimated the degree to which it would tighten at the outset of the last cycle, forecasting after the conclusion of the taper that the fed funds rate would rise to nearly 4.0 percent by the end of 2017. But the benchmark rate reached just 1.5 percent by that date and peaked at 2.5 percent before a renewed easing cycle began in 2019. The current easing cycle may be ending, but as recent history shows, this is far from a signpost that monetary restraint is imminent.

Yearly Changes in Assets on the Federal Reserve Balance Sheet



Source: Federal Reserve Board of Governors

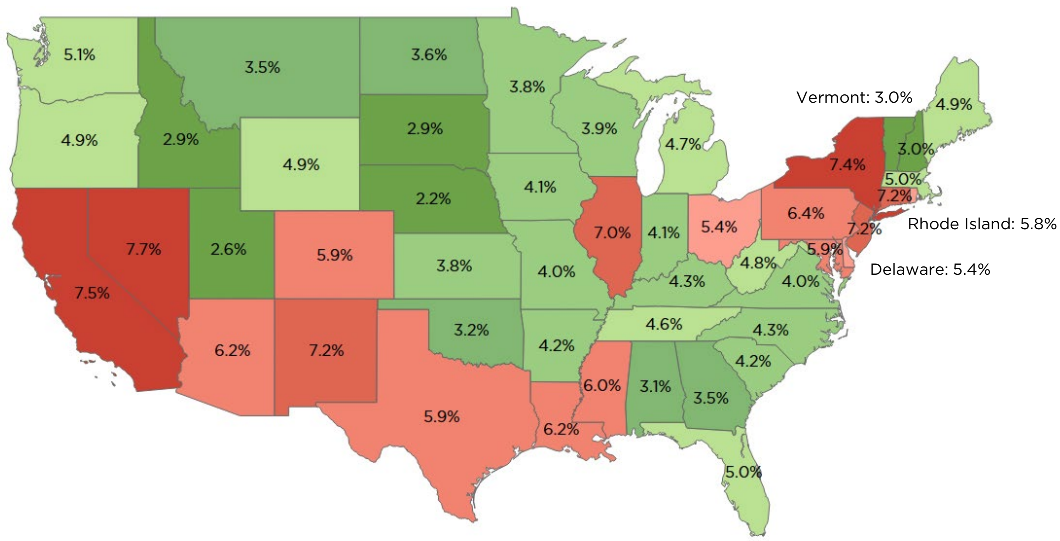
Solid job gains in most states over the past year



Sources: Bureau of Labor Statistics; Haver Analytics
Twelve-month growth rate in nonfarm payroll employment, August 2021

- Over the past 12 months, national payrolls climbed by 4.3 percent — paced at the state level by gains above 8.0 percent in Hawaii (not shown) and Nevada, with many other states also above 5.0 percent growth.
- Job growth over the past year was relatively slower across the middle of the country where there were fewer job losses during last year's downturn.

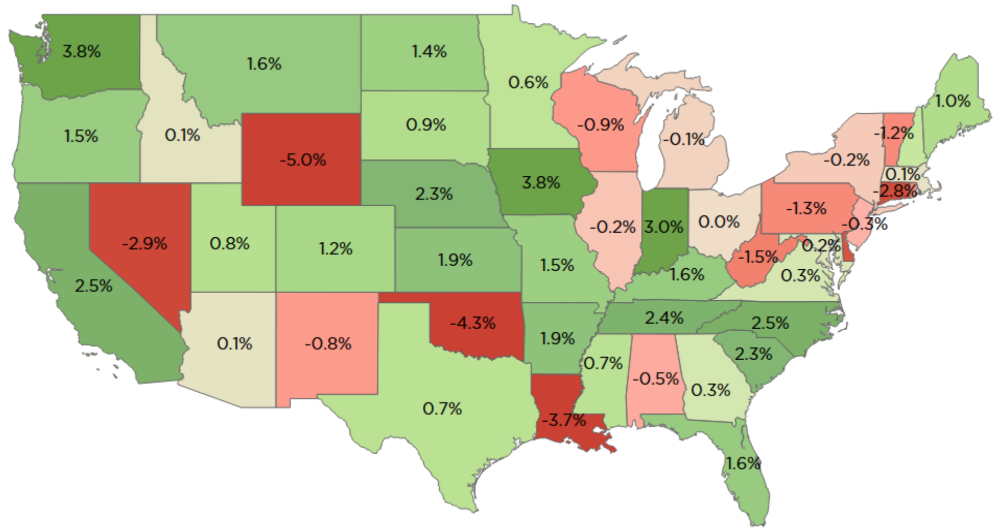
State unemployment rates trending downward



Sources: Bureau of Labor Statistics; Haver Analytics
Civilian unemployment rate, August 2021

- Unemployment readings in the middle of the country have mostly dropped to pre-Covid levels, with 10 states below 4.0 percent in the Intermountain West and Great Plains regions (plus Vermont, New Hampshire, Alabama, and Georgia).
- But several states still have unemployment rates well above their pre-Covid averages, with eight states at-or-above 7.0 percent (including Hawaii not shown).

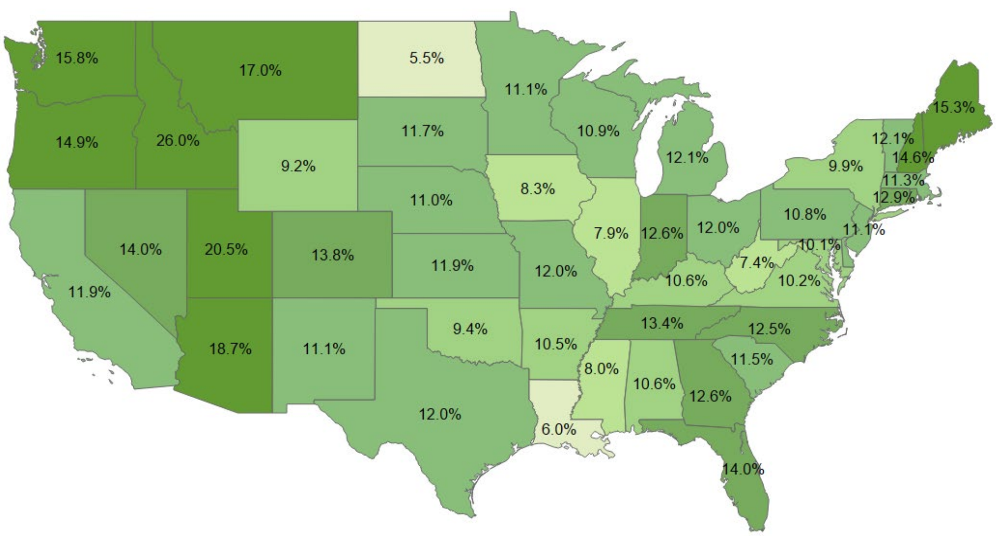
Real GDP is above the pre-Covid peak in many states



Sources: Bureau of Economic Analysis; Haver Analytics
Gross state product relative to pre-Covid peak, 2021Q2

- After a strong first half of 2021, 30 states have surpassed their pre-Covid peaks for economic output, lead by strong growth in Washington, Iowa, and Indiana.
- While several more states were just shy of their prior peaks, a few remained well-below pre-COVID levels — led by declines of 5.0 percent or more in Hawaii and Alaska (not shown), as well as in Wyoming.

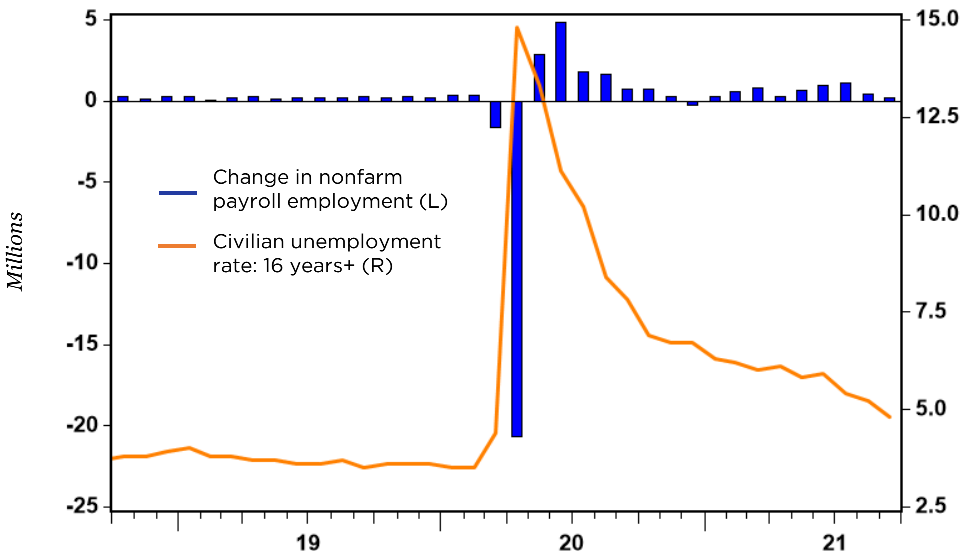
House price gains accelerated further across the country



Sources: Federal Housing Finance Agency (FHFA); Haver Analytics
Four-quarter change in the FHFA House Price Index, 2021Q2

- The hottest housing markets in the country continue to be in suburban and exurban areas around cities in the West — driving annual house price gains above 20 percent in Idaho and Utah.
- Even the slowest annual state increases as of 2021Q2 in North Dakota and Louisiana are still above the long-term trend as homebuyer demand remains strong despite near record low supply of homes for sale.

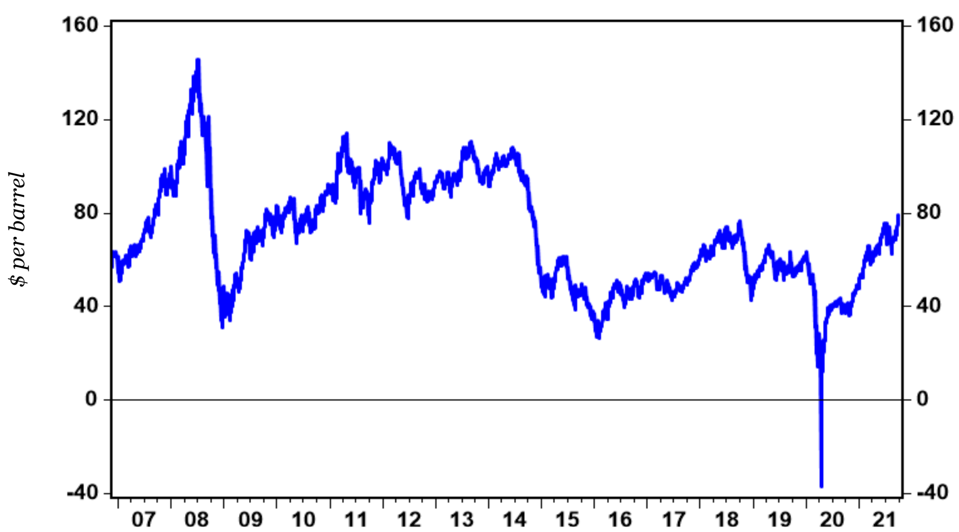
Weaker hiring for September



Sources: Bureau of Labor Statistics; Haver Analytics
Monthly change in nonfarm payroll employment; level of the civilian U-3 unemployment rate, September 2021

- Nonfarm payrolls grew by only 194,000 for September; although private payrolls climbed by a stronger 317,000. There were also upward revisions to July and August with an average of 550,000 in gains over the past three months.
- The U-3 unemployment rate fell to 4.8 percent for September (the lowest level since March 2020) as labor market conditions continue to tighten with demand for workers high.

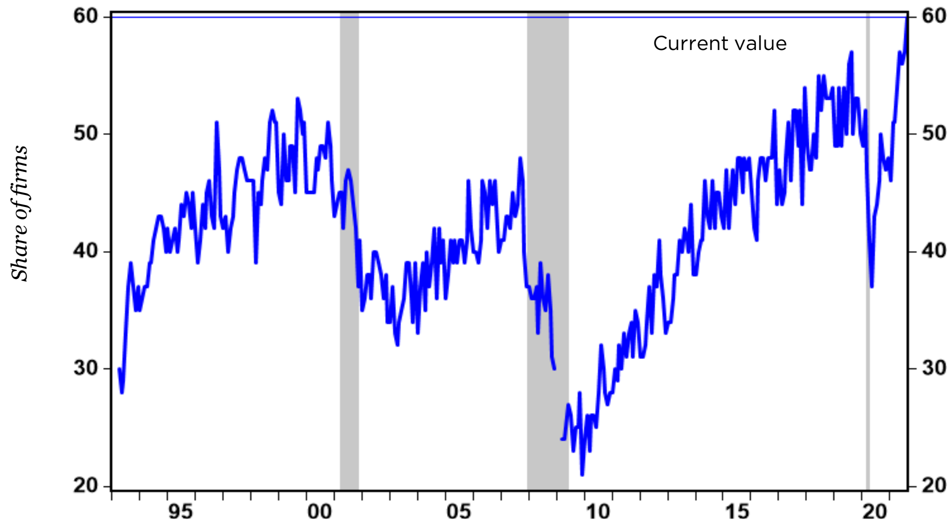
Rising energy prices helping to drive up inflation



Sources: Wall Street Journal; Haver Analytics
West Texas Intermediate spot price, October 5, 2021

- The price of the benchmark WTI crude oil topped $80 per barrel for the first time since November 2014 (nearly double from a year ago). This has occurred as global demand for oil has sharpy increased during the economic recovery and as renewable energy" sources have temporarily diminished.
- While supply chain outliers continue to be a primary driver of the spike in inflation this year, higher energy costs have contributed to the building inflationary pressure across the economy, too.

Lack of workers a further constraint for the business sector recovery



Sources: National Federation of Independent Business; Haver Analytics; Shaded areas depict recessionary periods
Businesses with few or no qualified applicants for job openings, August 2021

- A record 60 percent of small businesses reported few or no qualified workers for job openings in August.
- Labor supply shortages are most acute for the service sector (especially for restaurants and health care) and are expected to limit the rebound in activity in these areas despite rising consumer demand.

Many potential workers remain out of the labor force

Sources: Bureau of Labor Statistics (BLS); Haver Analytics
Labor force participation rate, September 2021

- The labor force participation rate has been little changed in more than a year (and is still well-below pre-Covid levels) as many workers remain of the labor force despite record levels of job openings and rising wages.
- More workers are expected to reenter the workforce in coming months, driven by in-person schooling, falling Covid cases, the ending of special federal government unemployment benefits, and higher pay, but the labor market could remain tight for some time.

Forecast
from Nationwide Economics

As of October 2021	Actual 2019	Actual 2020	Estimate 2021	Forecast 2022	Forecast 2023	Forecast 2024	Forecast 2025
Real GDP [1]	2.2%	-3.4%	5.6%	4.5%	2.5%	2.0%	1.8%
Unemployment Rate [2,7]	3.7%	8.1%	5.5%	4.3%	3.8%	3.7%	3.9%
Inflation (CPI) [5]	2.0%	1.2%	5.6%	2.9%	2.4%	2.6%	2.7%
Total Home Sales [3,7]	6.03	6.46	6.75	6.70	6.40	6.10	5.85
S&P/Case-Shiller Home Price Index [9]	3.7%	10.3%	16.1%	7.9%	4.6%	3.8%	3.2%
Light Vehicle Sales [3,7]	16.9	14.5	15.1	16.8	17.1	16.5	16.3
Federal Funds Rate [2,4,6]	1.50%	0.00%	0.00%	0.00%	0.50%	1.00%	1.50%
1-Year Treasury Note [2,4]	1.59%	0.10%	0.10%	0.14%	0.70%	1.15%	1.60%
5-Year Treasury Note [2,4]	1.69%	0.36%	1.05%	1.15%	1.50%	1.85%	2.10%
10-Year Treasury Note [2,4]	1.92%	0.93%	1.65%	2.00%	2.30%	2.60%	2.90%
30-Year Fixed-Rate Mortgage [2,4]	3.74%	2.67%	3.05%	3.40%	3.65%	3.90%	4.15%
Money Market Funds [2,8]	1.55%	0.47%	0.14%	0.14%	0.32%	0.82%	1.32%

Major forecast changes from last month

- Economic growth has decelerated in the second half of 2021 in response to Delta impacts on consumer behavior and continued supply chain disruptions. As a result, projected growth for 2021 and 2022 is slightly slower than in the previous forecast, although still well-above trend.
- Global supply chain disruptions have shown little improvement in recent months, helping to push up expected year-end consumer price index inflation readings to 5.6 percent. These disruptions, although likely diminishing, are projected to extend through the first half of 2022 and maybe beyond — causing inflation readings to run hotter than previously expected over that period.
- Consistent with a slightly faster inflation outlook and the unemployment rate nearing pre-Covid levels by the end of 2022, we now expect 50 basis points of Fed tightening in each of 2023, 2024, and 2025 (up from 25 basis points in prior forecasts) — bringing the federal funds rate up to 1.5 percent by the end of 2025. Combined with the end of Fed purchases of longer-dated Treasury securities by the middle of next year, this pushes long-term interest rates up by more than previously expected.

[1] Percent change year-to-year
[2] Percent
[3] Million units
[4] Year end
[5] Percent change Q4-to-Q4
[6] Target rate, lower limit
[7] Year average
[8] Annual return
[9] Percent change Dec-to-Dec
[a] Actual

Sources: Haver Analytics (actuals); Nationwide Economics (estimates and forecasts); except Money Market Funds (all data from Nationwide Economics)

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