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Nationwide Economics

Economic & Financial Markets Monthly Review

August 2021

Recovery ends and expansion begins, blunted by supply chain problems and the Delta variant

What's happening and why in the economy and financial markets

Economic Review

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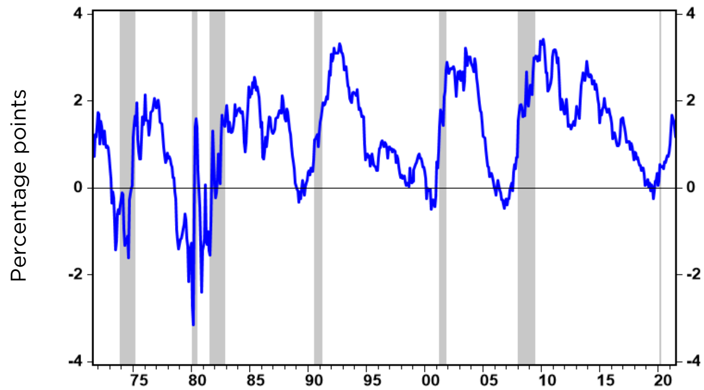
Business Cycle Update

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, however, suggesting that there is still 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 Update

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



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

One of the best predictors of an economic downturn is a fully inverted yield curve, when short-term 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 But the new world of the COVID-19 pandemic and government responses to the virus superseded the usual recession rules early last year.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 dipped recently to the lowest level since February, but at around 125 bps it remains above the long-term average and suggests continued growth ahead.

Economic Review

The recovery is over; the expansion has begun

The economy had a consistent theme in July: solid data that could have been even stronger but for persistent supply-side constraints in both materials and labor. Real GDP and nonfarm payrolls experienced rarely-seen growth, but GDP gains were below expectations and payrolls continued to be limited by stagnant labor force participation. Moreover, while strong growth continued in the manufacturing sector, the ISM survey slipped to a six-month low. Even the service sector, where the ISM survey rose to an all-time high, was held back by supply-side limitations.

Rapid growth for real GDP in the second quarter
Real GDP grew by a rapid 6.5 percent (annualized) in the second quarter, the fourth-highest reading since the turn of the century. Despite this strength, growth was held back by a decline in government spending, net exports (as the U.S. expanded more quickly than most of the rest of the world), and a large drop in inventories caused by a combination of supply chain issues and high consumer demand. On the other hand, core GDP growth (which removes the impacts of trade, inventories, and government) grew at a rapid rate of 9.9 percent. As expected, consumer demand proved to be the biggest contributor to economic growth, with personal consumption expenditures rising by 11.8 percent, while business fixed investment grew at an impressive rate of 8.0 percent. The level of GDP is now higher than it was before the COVID recession, implying that the recovery phase has been completed, and the expansion has begun.

Going forward, while supply chain issues are expected to persist for some time, inventory drawdowns are unlikely to detract from growth in the second half of the year since the level is already so low. Despite supply constraints, and although COVID could still produce some speed bumps, very strong demand is expected to continue and should lead to GDP growth of over 6.0 percent for the year.

Another impressive employment report
Nonfarm payrolls grew by an impressive 943,000 in July, the second straight month over 900,000 after upward revisions to June (May was also revised higher). Industries most effected by the pandemic continue to lead the way with strong gains in transportation, education and health services, and especially leisure and hospitality. Government payrolls also saw the largest increase since August 2020, likely due to hiring activity by school districts as they prepare for mostly-in-person instruction starting as soon as this month.

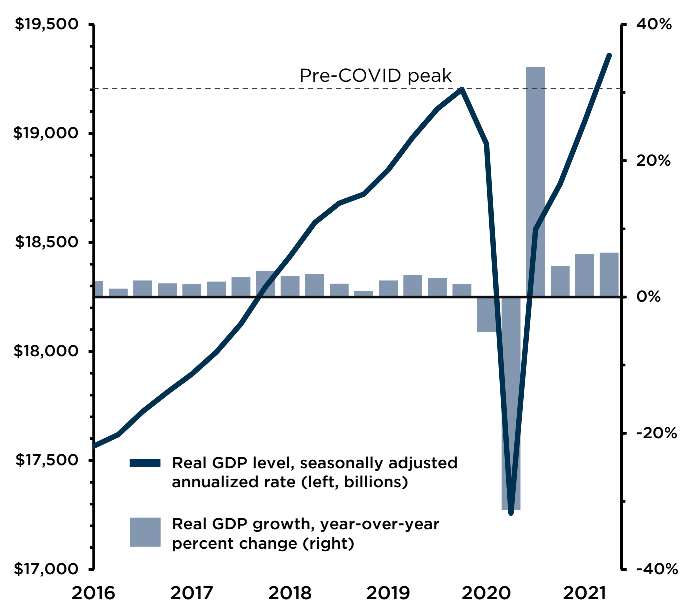
The U-3 unemployment rate fell by 0.5 percentage points — its largest drop since October — to 5.4 percent, the lowest mark since the onset of the pandemic. Although it remains much higher than the 50-year low seen just prior to the pandemic, it is encouraging to see a large drop in unemployment after it had remained relatively stagnant in the first half of the year.

July's job growth beat expectations, but it could have been even larger if not for continued sluggish growth in labor supply. The labor force participation rate ticked up in July, but has remained in a narrow, below-average range (between 61.4 and 61.7 percent) for the past 14 months. We think it's likely that a return to full-time in-person schooling, a pickup in vaccinations, and the coming end to all special unemployment insurance benefits will provide greater incentives to re-enter the workforce. While the job gains seen in the last two months are likely unsustainably high, these possible increases in labor supply could help to keep growth elevated for some time — especially as job openings jumped to their highest level ever in June.

ISMs diverge, but strong growth continues for both
The Institute for Supply Management (ISM) manufacturing index remained at a level suggesting strong growth but missed expectations and fell to a six-month low for July. On the other hand, the services index bucked the trend and climbed to an all-time high. Although they headed in different directions, the story is similar for both: high demand is driving rapid growth which is being held back by supply constraints. Growth in supplier delays, input prices, and the backlog of orders remain very high for both (the price index for services climbed to the highest level since 2005).

Respondents to both surveys supported the contrast between demand and supply. They consistently noted both strong sales and continued struggles with supply chains. While the employment index for both surveys moved higher, survey responses still noted difficulty in filling open positions — as the NFIB survey continues to show for small firms.

Real GDP at a record high



Sources: Bureau of Economic Analysis; Haver Analytics

Financial Markets Review

Stocks up and rates down

The yield on the ten-year U.S. Treasury note nosedived in July while the S&P 500 Index posted yet another gain. Since peaking at the end of the first quarter, the benchmark note yield dropped by more than 50 basis points (although it has edged higher again since the strong July employment report). Robust earnings and plentiful liquidity moved broad equity index prices higher despite another jump in inflation. Looking ahead, the further rise in earnings expectations for the third quarter should be positive for equity markets.

A move to less than 1.20 percent again

July subtracted more than 20 basis points (bps) from the U.S. Treasury ten-year note yield, finishing the month at 1.22 percent — and falling as low as 1.19 percent within the month. This is an often-seen seasonal pattern, with sharp note price gains (and concomitant yield declines) in July 2019, 2011, and 2010 when the yield dropped by more than 40 basis points in each of those months. These bond price rallies have tended to be followed by seasonal declines (and yield increases) in August, as seen so far this month.

June's increase in the yield on the two-year and five-year U.S. Treasury notes reversed last month. Anticipation had been building for the FOMC to start tapering asset purchases, signaling a reduction in monetary stimulus. But a sharp rise in new COVID cases and a moderation in inflation expectations dampened that outlook, lowering the two-year yield to under 20 bps and five-year below 70 bps.

The ten-two spread slipped to as low as 1.02 percent in early August, down by nearly 60 bps over the last four months. Typically, a wider spread shows optimism over the economy's prospects. Today, Fed purchases, rising case counts, and expectations of lower Treasury issuance are muddying the waters. In addition, a significant yield drop disrupts portfolios that try to mitigate interest rate risk, encouraging investors to purchase more longer-term paper — and driving longer-term yields (and spreads) even lower.

Shooting past expectations

The second-quarter earnings season was a hit with investors. Nearly nine in ten of the S&P 500 companies that have reported earnings beat expectations, easily surpassing the average. Year-over-year revenue gains are more than 23 percent, a record since at least 2008. Inflation has had little impact on profit margins, roughly in line with the first quarter. Prospects are bright with expectations for third-quarter profits rising in July,

On March 23, 2020, the S&P 500 index fell below 2,200. As this report was being written in mid-August, it is trading around record levels at around 4,460, with 100 more points added in July alone — an increase of nearly 2.4 percent. Continued strong performance bodes well for the economy and is generating significant wealth for households. Smaller-cap companies, however, struggled to keep pace with their larger brethren. Energy and financial components hampered both mid-cap and small-cap indices.

Equities in developed countries rose in July, the fifth monthly gain this year. Global economic prospects are brightening with manufacturing activity brisk in key export countries. Surprisingly, most of these markets are still below their 2007 highs. Healthy gains in service activities suggest the impact of the COVID-19 outbreak is dissipating. The outlook is encouraging, with the potential for finally hitting new all-time highs as the global expansion takes hold.

The cost of a barrel of oil retreated at the end of July as new production goals eased supply concerns. OPEC+ compromised with the UAE, which had made significant capital investments. Relief has not shown up at the gasoline pumps, however, to the chagrin of consumers. Persistently hot temperatures caused strong electricity demand last month, pushing natural gas prices above $4.00 MMBtu for the first time since late 2018. Supply constraints are likely to continue into the winter, putting more energy cost strain on households.

But in good news for builders, the benchmark lumber price fell to under $600 per 1,000 board feet — a round trip from late October. Lower input costs and optimistic consumers could be a catalyst for more building. Prices in the agricultural complex were mixed in July, pushed up by drought concerns and down by export demand fears. Still, on a year-over-year basis, strong price gains reflect a healthy recovery from the COVID-19 shock.

In July, the dollar meandered as global trade networks struggled. While the global economic recovery could put pressure on the greenback, potential tightening and higher interest rates by the Fed in advance of other central banks could move the dollar in the other direction.

Asset Class Performance	1-month	6-months	12-months
S&P Composite 500 Index	2.38%	19.19%	36.45%
S&P Midcap 400 Index	0.34%	16.25%	46.99%
S&P Smallcap 600 Index	-2.39%	13.48%	56.95%
EAFE[1]	0.76%	11.18%	30.86%
U.S. Dollar Index[2]	0.08%	-0.15%	-3.83%
CRB Commodity Index[3]	1.12%	22.64%	48.83%
Intermediate Treasuries[4]	0.78%	-0.13%	-0.74%
Long Treasuries[5]	3.65%	-0.99%	-11.08%
Investment-grade Corporate Bonds[6]	1.37%	1.39%	1.42%

Total returns represented as of 7/31/21

[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

The Outlook

Latest COVID surge a modest headwind

After receding noticeably in the late spring and early summer, the new COVID infection rate has spiked again. The case count rose by an average of more than 42,000 per day in July, up from 13,350 in June, and continued to pick up steam in early August (climbing to more than 100,000 per day). The pandemic is again rising as a near-term downside risk to the economy.

COVID impacts have diminished

As Federal Reserve Chair Jerome Powell noted in his post-FOMC press conference late last month, however, successive COVID spikes have had diminishing effects on economic activity. While the first wave last spring fueled a record contraction in real GDP and a loss of more than 20 million nonfarm payroll jobs, for example, the economy wobbled only modestly during the much larger surge in cases in the winter.

Economy remains open

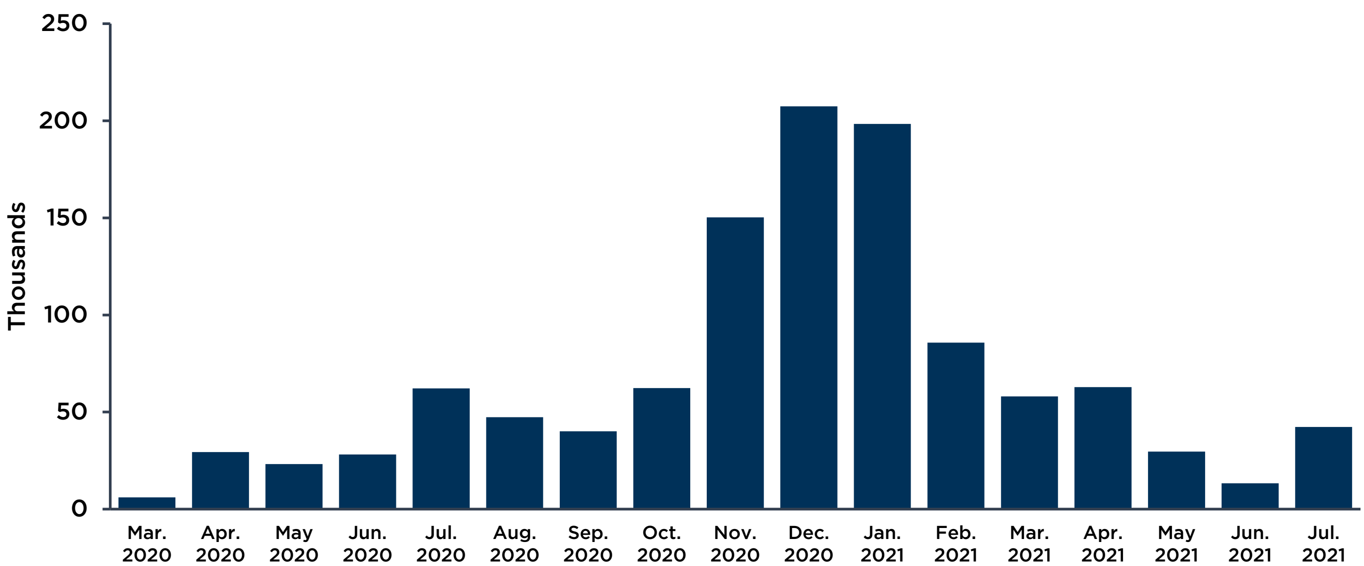
This trend, of course, is largely a function of the evolution of the government's response as the pandemic has evolved. The strict lockdowns that were broadly implemented soon after COVID arrived in the U.S. have been gradually rescinded to the point that all 50 states have now fully reopened even as some have reinstituted indoor mask mandates. It should come as little surprise, then, that the economy has continued to perform well despite the jump in the case count of late. Recent data on employment, manufacturing activity, and confidence all suggest that any impact to this point has been extremely limited. Moreover, the Delta variant of COVID, despite being far more transmissible than previous versions, appears to be far less serious to the more than 50 percent of vaccinated persons in the U.S.

Momentum reflects upside risks

This economic resilience owes in large part to the feedback loops that continue to strengthen in the wake of the initial lifting of business restrictions more than a year ago. Since the recession ended last spring, nonfarm payrolls have bounced back by 16.7 million, personal spending has moved higher by close to a third, and earnings at the largest U.S. public companies have soared by nearly 90 percent. Far from sputtering in the absence of fiscal stimulus checks and the curtailment of unemployment benefits, this expansion is still gathering steam. The upshot is that the bar is set increasingly high for COVID or any other exogenous shock to derail it.

It is reasonable to expect some ripples in the months ahead should the pandemic continue to trend in the wrong direction — there have already been hints of slight pullbacks in air travel, hotel occupancy, and restaurant activity — but there are few signs pointing to a more dire outcome. The recent data flow should also reduce concerns over how the economy might fare should the virus prove to be endemic as some health experts now fear. COVID could well become a recurring structural headwind, one that may marginally alter the growth rate periodically without materially changing the overarching narrative. For now, the ongoing spike in cases represents a developing downside risk that is still overwhelmed by the upside momentum.

Average Daily New COVID-19 Cases in the U.S.

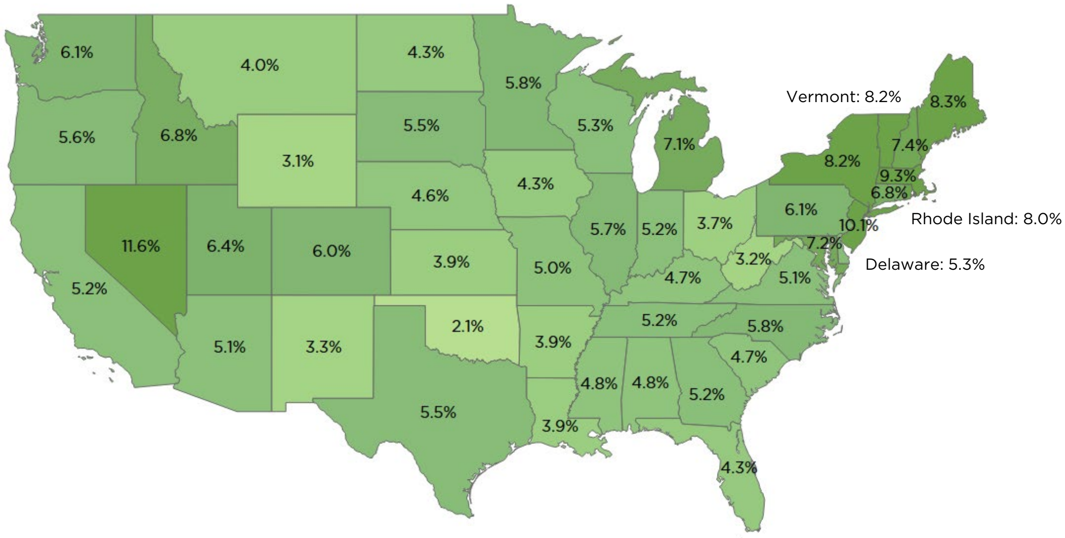


Sources: Johns Hopkins University

Charts & Commentaries

Solid job gains in most states over the past year

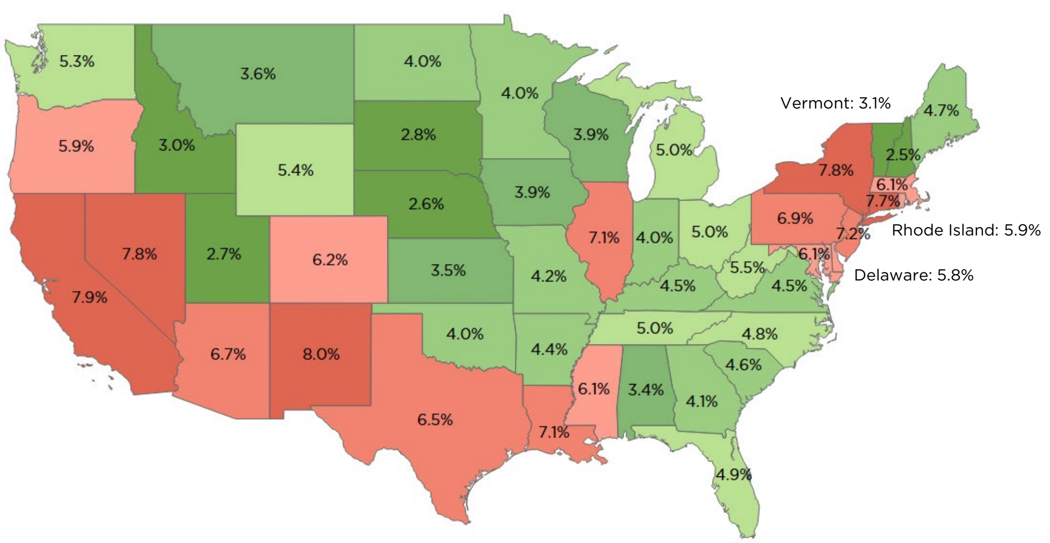
- Over the past 12 months, national payrolls climbed by nearly 6.0 percent as the recovery ensued — paced at the state level by double-digit gains in Nevada and New Jersey with increases above 8.0 percent in many New England states.
- Job growth over the past year was a little slower in the middle of the country where there were relatively fewer job losses during last year's downturn.



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

State unemployment rates still trending downward

- Unemployment readings in the middle of the country have mostly dropped to pre-COVID levels, with 11 states at-or-below 4.0 percent in the Intermountain West and Great Plains regions (plus Vermont, New Hampshire, Alabama, and Indiana).
- But multiple states still have unemployment rates well above their pre-COVID norms, with six states above 7.5 percent in June (including Hawaii not shown).

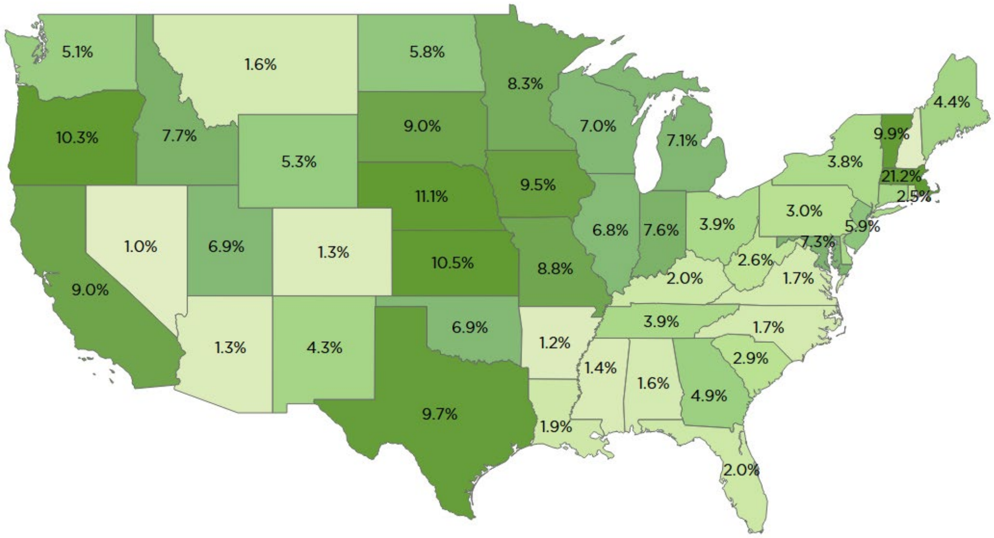


Sources: Bureau of Labor Statistics; Haver Analytics
Civilian unemployment rate, June 2021

Charts & Commentaries

Farmland values are up sharply in many agricultural states

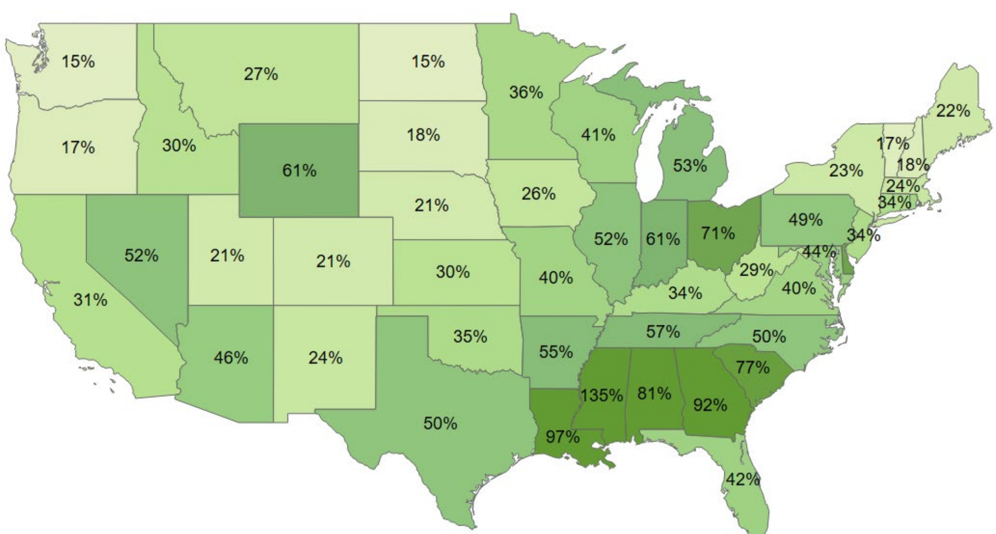
- Farm real estate values rose at-or-near double-digit rates across the Corn Belt and Upper Great Plains as prices for many crops (including corn, soybean, and wheat) climbed this year.
- The boom in home construction over the past year also increased demand for cropland, driving up values in many states but most sharply in several Western states.



Sources: USDA; Haver Analytics
Annual change in farm real estate value per acre, 2021

Business formations have accelerated after the pandemic

- High-propensity business applications are up in every state during 2021 compared with the pre-COVID period — led regionally by strong gains throughout the South and in much of the Midwest (plus Wyoming and Nevada).
- This suggests that businesses are being formed in these areas to replace firms that closed during the pandemic and to take advantage of growing consumer demand, especially in the hardest hit service sector industries.

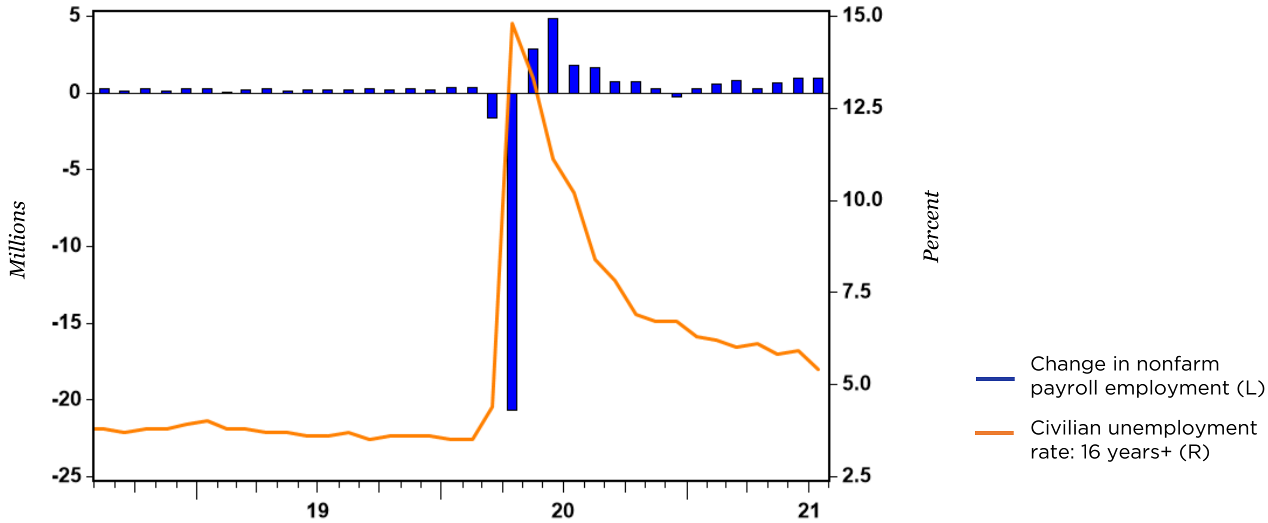


Sources: Census Bureau; Haver Analytics
High-propensity business applications: Average for 2021 (through June) versus average from 2018-19

Charts & Commentaries

Further strong job gains for July

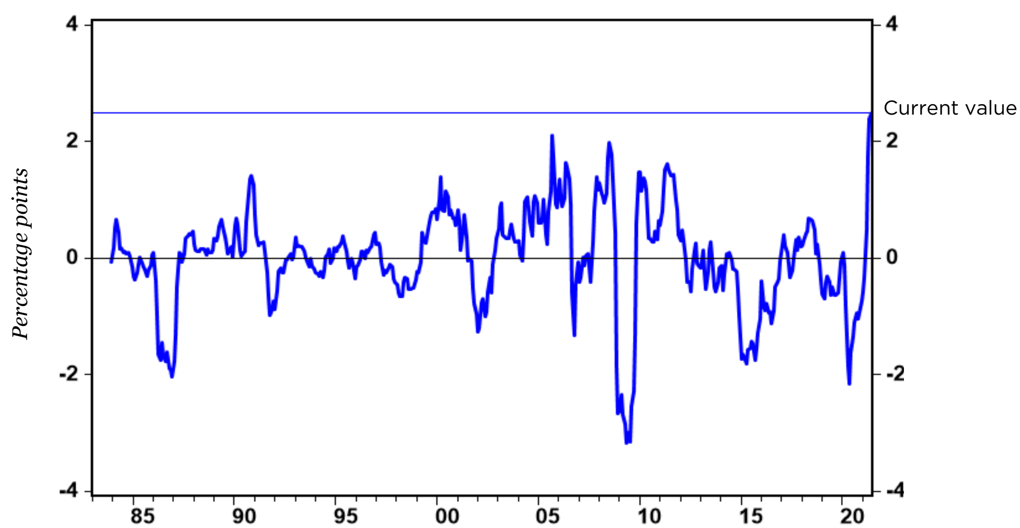
- Nonfarm payrolls grew by a strong 943,000 for July, led again by service sector industries and back-to-school hiring by local districts. With upward revisions to May and June, the economy added nearly 2.5 million jobs over the past three months.
- The U-3 unemployment rate dropped to 5.4 percent for July, the lowest level since April 2020 and the sharpest monthly decline since last October. Labor force participation remains low, however, as many workers have not reentered the workforce.



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

Outliers continue to drive the inflation spike

- The Cleveland Fed's trimmed-mean inflation measure showed a more moderate 2.9 percent increase over the past year compared with 5.4 percent for the consumer price index (CPI) — the widest monthly gap in the history of the series.
- This suggests that the recent jump in the CPI is mostly from a more limited group of industries impacted by supply chain problems (e.g., autos, lumber) rather than across the board sharp price increases.

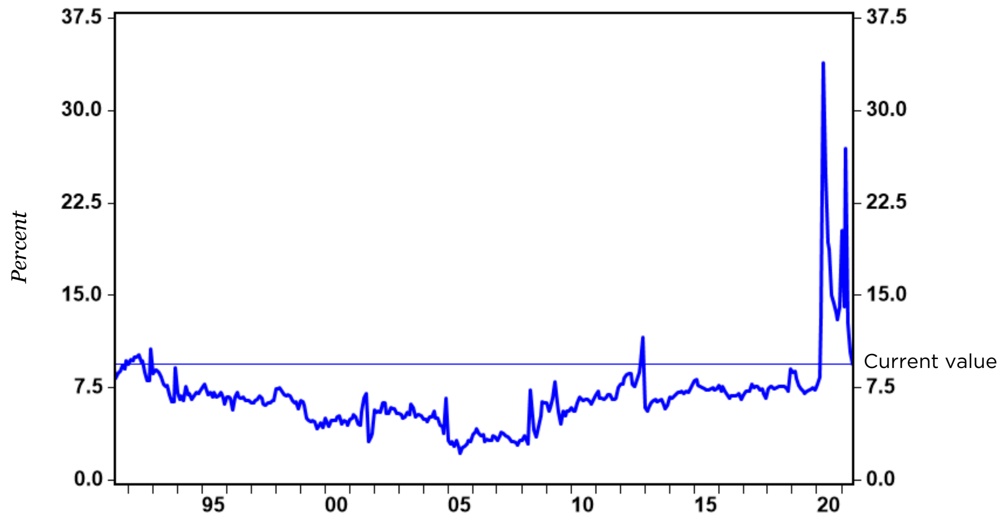


Sources: BLS; FRB Cleveland; Haver Analytics
Difference between the 12-month change in the CPI and Cleveland Fed's trimmed-mean CPI, June 2021

Charts & Commentaries

Household savings a continued source of consumer spending power

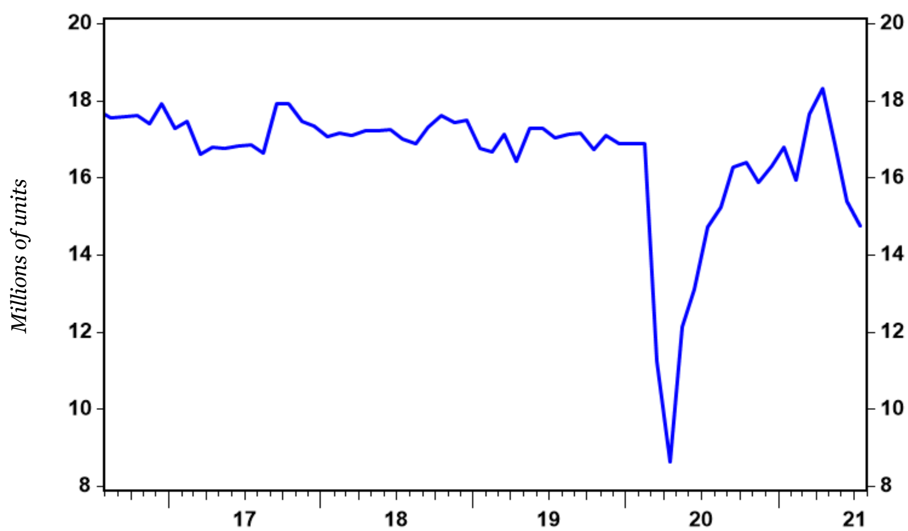
- The personal saving rate, although down from recent peaks, remained elevated in June at 9.4 percent of disposable personal income — above the long-term median of 7.2 percent.
- Above-average savings — in addition to record household net worth, strong job/income growth, and still low interest rates — should add a further boost to consumer spending over the rest of this year and into 2022.



Sources: BEA; Haver Analytics
Personal saving as a percentage of disposable personal income, June 2021

Supply constraints hit auto sales

- After peaking in April at the highest sales pace since 2005, light vehicles sales have dropped sharply through July as production has been significantly hampered by an ongoing shortage of microchips – a product of COVID-caused supply chain disruptions.
- Microchips are expected to be in greater supply soon, but a continued lack of available inventory at dealers could limit sales growth in the second half of the year.



Sources: BEA; Haver Analytics
Light vehicle sales, July 2021

Forecast

Nationwide Economics Forecast

As of August 2021	Actual		Estimate	Forecast			
	2019	2020	2021	2022	2023	2024	2025
Real GDP [1]	2.2%	-3.4%	6.2%	4.7%	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%	4.5%	2.5%	2.5%	2.6%	2.7%
Total Home Sales [3,7]	6.03	6.46	6.76	6.65	6.30	6.00	5.85
S&P/Case-Shiller Home Price Index [9]	3.7%	10.3%	11.2%	6.1%	4.6%	3.8%	3.2%
Light Vehicle Sales [3,7]	16.9	14.5	16.5	17.0	16.6	16.4	16.2
Federal Funds Rate [2,4,6]	1.50%	0.00%	0.00%	0.00%	0.25%	0.50%	0.75%
1-Year Treasury Note [2,4]	1.59%	0.10%	0.05%	0.10%	0.50%	0.70%	0.90%
5-Year Treasury Note [2,4]	1.69%	0.36%	0.90%	1.10%	1.30%	1.50%	1.70%
10-Year Treasury Note [2,4]	1.92%	0.93%	1.75%	2.00%	2.15%	2.30%	2.45%
30-Year Fixed-Rate Mortgage [2,4]	3.74%	2.67%	3.20%	3.40%	3.55%	3.70%	3.85%
Money Market Funds [2,8]	1.55%	0.47%	0.14%	0.14%	0.22%	0.48%	0.74%

[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

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

Major forecast changes from last month:

1) Real GDP growth, although still strong, was slower than expected during the second quarter — reducing the projected growth for all of 2021 modestly. This would still be the fastest year for the economy since 1984. Some spending impacted by the Delta variant in the second half of 2021 may be shifted into 2022, lifting forecasted growth for next year to 4.7 percent.
2) Consumer inflation remained hotter than expected through June as COVID impacts linger in many industries. As a result, year-over-over CPI readings should remain elevated into 2022, increasing our year-end projection to 4.5 percent for 2021. We still expect inflation to cool off in 2022, slowing back towards the long-term trend (albeit a bit faster than pre-COVID).
3) Supply constraints for auto production and the continued lack of homes for sale slowed sales activity for both sectors in the second quarter. We have lowered our sales projections for home and autos for 2021 modestly from last month — although activity should remain above-average through 2022 in response to strong demand fundamentals.

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