MARKET REVIEW AND OUTLOOK

Second Quarter 2021

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Market Review

Market style factors reversed course during the second quarter, as small-cap value stocks fell behind their large-cap growth counterparts. Falling discount rates and concerns about the Federal Reserve (Fed) prematurely slowing down the economy due to inflationary concerns may have contributed to this shift toward defensive growth and away from cyclical value stocks during the second quarter. Fears of runaway inflation also helped real estate investment trusts (REITs). Moreover, malls and shopping centers have avoided mass defaults because banks have been willing to rework loans.

Within fixed income, higher inflation expectations amid still-ample monetary support spurred Treasury inflation-protected securities (TIPS) and high yield, respectively, to outperform the broader Bloomberg Barclays U.S. Aggregate Bond Index. On the other hand, with the Fed keeping the fed funds rate anchored, short-term bonds lagged the broader fixed-income market.

Outlook

When it comes to inflation, we currently face short-term and long-term effects. Here we discuss some of those "transitory" effects as well as some that could be more lasting.

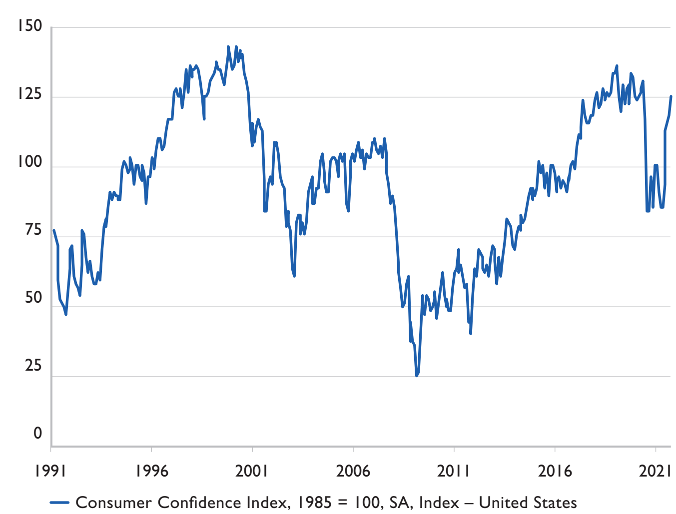
Short-Term Inflation Impacts

Some of the recent run-up in inflation was driven by demand dynamics that may have been transitory. The stay-at-home conditions induced by the pandemic shifted consumers' consumption to products and electronic gadgets and away from entertainment and travel. This unexpected surge in demand for physical goods over services along with incidents like the Suez Canal blockage have contributed to rising inflation. While some impacts may be transitory, others will have more lasting effects on inflation.

Demand

Extraordinary assistance from the federal government boosted consumer confidence.

Figure 1 - Consumer Confidence Index

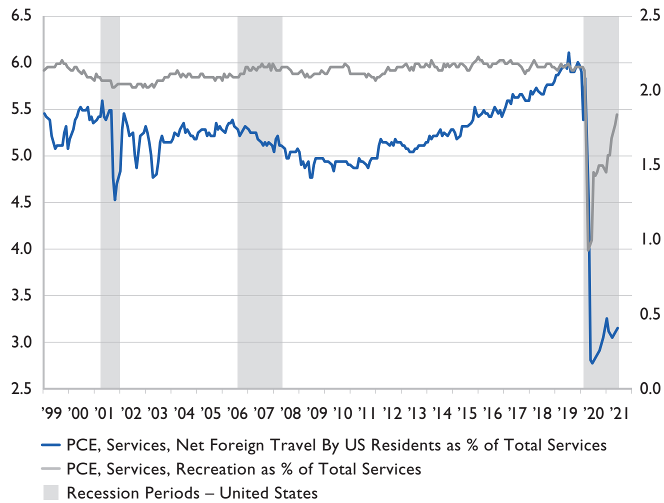


Source: FactSet

Performance data quoted represents past performance, which does not guarantee future results.

During 2020's statewide lockdowns, consumers could no longer spend on services such as entertainment and international travel.

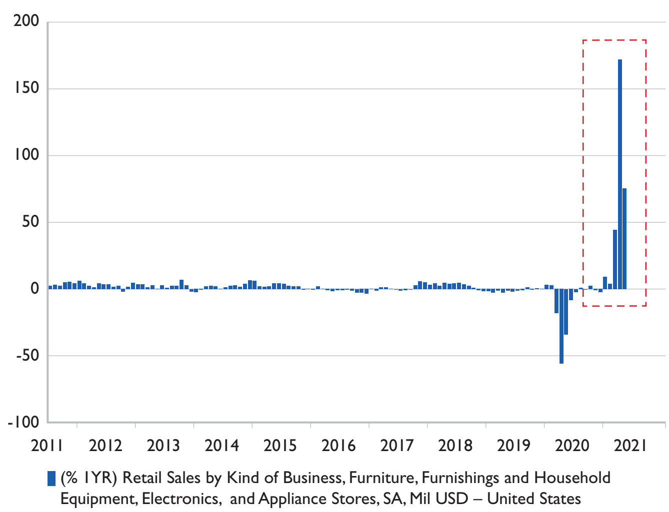
Figure 2 - Personal Consumption Expenditure for Travel and Recreation



Source: FactSet

As they acclimated to the work-from-home lifestyle, consumers rushed to buy furnishings and electronics to improve the quality of the time spent at their residences.

Figure 3 - Sales of Furniture and Household Equipment



Source: FactSet

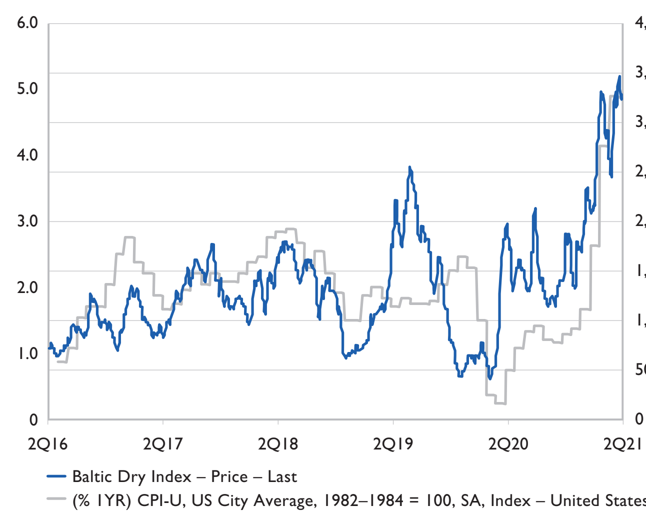
Shipping

The surge in demand is made evident by the rise in shipment activity. For instance, the Port of Los Angeles processed more than one million container units in the month of May, setting a record for and marking the tenth consecutive month of year-over-year increases.

The congestion is more jammed than Los Angeles freeways during rush hour, as some vessels have been forced to wait up to five days just to dock. It has been reported that it could take an additional 10 days or more to unload shipments from ships to trains to their final destinations.

Shipping costs (as measured by the Baltic Dry Index) also have climbed higher in recent periods. For example, the Drewry World Container Index showed shipping costs to the U.S. from China have surged 229% in a year to roughly $10,000. In comparison, the average cost from Shanghai to Los Angeles was less than $1,800 per container from 2011 to March 2020. As is often the case, businesses passed these higher costs to customers, causing goods prices, and thus inflation, to jump higher.

Figure 4 - Baltic Dry Index vs. Consumer Price Index



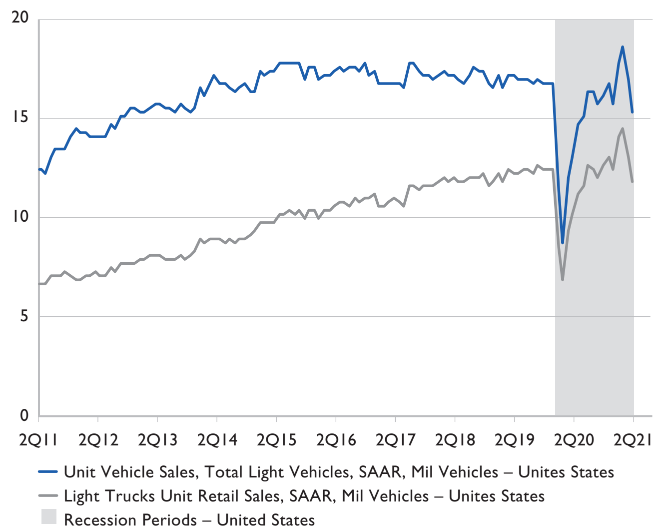
Source: FactSet

As logistics clear up, shipping costs will likely normalize, meaning that this inflationary pressure should be temporary.

Supply-Chain Bottlenecks

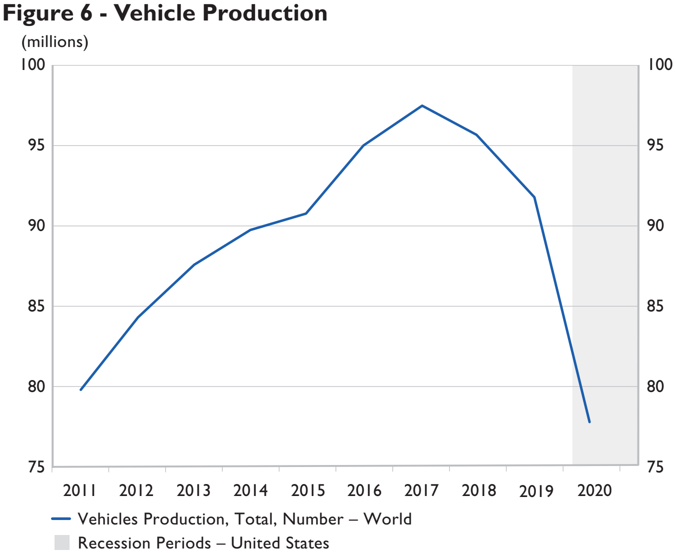
Despite a strong recovery in auto demand (particularly for trucks, SUVs, and vans), car production has plunged due to a shortage of semiconductor chips.

Figure 5 - Vehicle Sales



Source: FactSet

Figure 6 - Vehicle Production

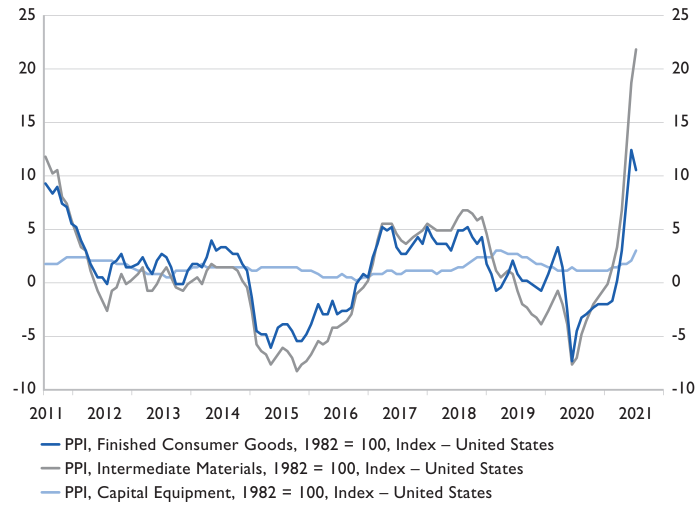


Source: FactSet

As indicated earlier, the semiconductor chip shortage stemmed from the surge in purchases of electronics and home appliances. This is an example of how one industry can disrupt multiple sectors of the economy.

Supply-chain bottlenecks that disrupt supply can keep inflation heading higher, as producers are seeing their input costs rise.

Figure 7 - Change in Price Over Time

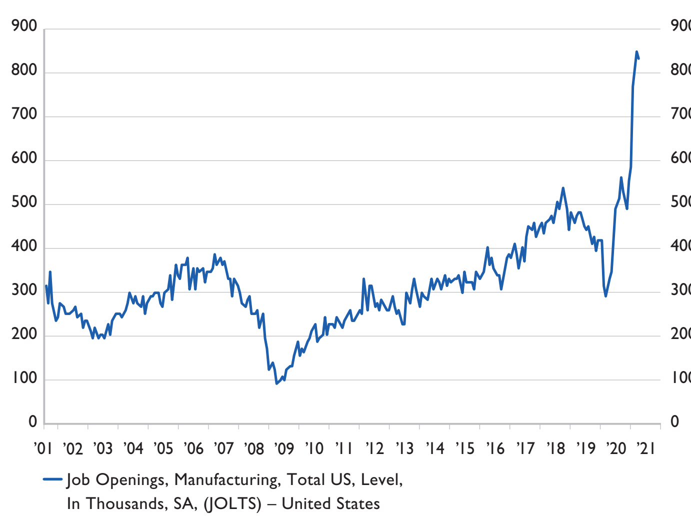


Source: FactSet

Although the Fed generally believes that these inflationary pressures remain transitory, supply-chain disruptions continue to keep prices inflated. Demand outstripping supply and labor shortages are contributing to rising cost pressures.

While the manufacturing industry recovered many of the lost jobs from the pandemic, a surge in manufacturing job openings illustrates the difficulty filling those spots.

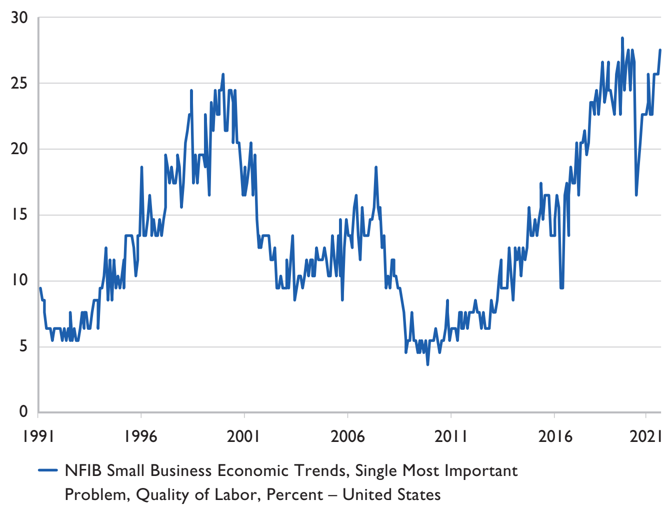
Figure 8 - Open Jobs in Manufacturing



Source: FactSet.

A skills gap may keep this mismatch lasting for a few years as manufacturers have found filling these positions difficult. As was the case prior to the pandemic, more than a quarter of small businesses surveyed by the National Federation of Independent Business (NFIB) have identified "Quality of Labor" as the single most important problem.

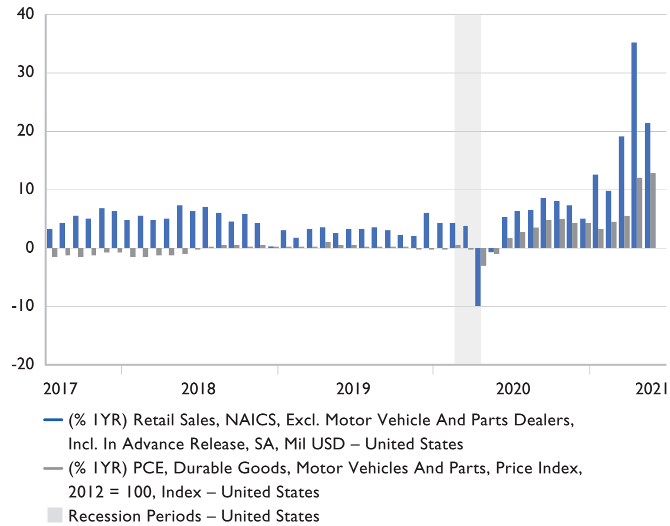
Figure 9 - Quality of Labor as a Problem



Source: FactSet

This means employers likely will need to increase compensation to attract potential hires. In general, wage inflation must occur in order to attract enough workers to allow production to run at optimal capacity. Otherwise, the labor shortage will remain a challenge for businesses that would otherwise be losing out on potential revenue. In other words, as long as demand outstrips available goods, inflation will continue creeping higher. This is particularly true for auto prices as the economy continues to reopen and individuals resume their normal driving patterns.

Figure 10 - Sales of Motor Vehicles and Parts



Source: FactSet

Labor

Businesses are beginning to raise income and compensation to attract workers. Whether this trend will continue, as expanded unemployment benefits expire by September, remains to be seen.

Figure 11 - Percent Change of Average Hourly Earnings

Source: FactSet

While some supply-chain bottlenecks may be transitory, persistent factors such as rising wage inflation and demand exceeding supply could lead to higher overall inflation. This is especially true if businesses anticipate that consumers, whose savings swelled during the pandemic, have the ability to absorb higher prices. With higher earnings expectations leaving little room for margin compression, raising prices is the rational alternative for many manufacturers.

Conclusion

Evidence shows that companies face margin pressures from multiple sources. The rising consumer price index also indicates that producers have been passing along some of the costs to consumers. The questions remain as to how much more costs can companies absorb, and will shipping costs determine how much inflation is passed onto consumers?

During the pandemic, American consumers bought electronics such as smartphones and laptops as well as other home products, which all contributed to the congestion in the global supply chain. The lockdowns spiked demand while simultaneously slowing production. The logjam in supply chains could improve when people begin to once again shift their disposable income spending to services such as travel and entertainment. Some of these trends are just now beginning to emerge.

Still, back-to-school and holiday shopping seasons likely will keep the ports busy, as cargo traffic volume is unlikely to ease until sometime next year. Until supply chains return to normal, shipping costs may stay elevated and keep inflation above-trend during the next few quarters. If the Fed shifts its current outlook and deems inflation concerning and persistent rather than transitory, then it likely would lead to correction across riskier assets, especially cyclical stocks and credit. Conversely, if inflation abates, these same assets could resume their rallies.

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