

ECONOMIC OUTLOOK

Summary

With the availability of vaccines having increased throughout the year, there has been an expectation that furloughed/laid off employees would come rushing back into the workforce. Initially, this seemed to be confirmed in the March nonfarm payroll report with a 916k increase in jobs that crushed expectations. Unfortunately, since then we have seen two disappointing job reports. During April, there was an expectation that nearly one million workers would be added back to the labor force, yet we only saw a gain of 266k. More recently in May, we missed job-growth expectations by 116k (675k expected vs 559k actual).

While adding 500k+ jobs in one month would have been astounding pre-pandemic, we have now gained 850k less jobs than expected during the past two months. However, this doesn't mean that businesses aren't hiring. Odds are if you drive by your nearest strip mall you will be inundated with "help wanted" signs, and you have likely seen or heard about corporate incentives, such as a bonus after working for a set period of time.

So why are businesses having such a hard time attracting workers? The most common belief is the federal government is inadvertently providing an incentive to remain at home by including a \$300 per week supplement to the unemployment benefit. With higher paying industries mostly either back to work or not having lost jobs initially, a large portion of the remaining unemployed are thought to be low earners in the service sector, and in many cases, it's believed that the extra \$300 benefit per week is providing a higher take-home pay than if they return to work.

It remains to be seen if this is the actual reason why job openings aren't being filled but it does seem logical. So much so that roughly half of the states have now opted out of the federal unemployment programs, therefore eliminating any supplemental unemployment income. However, each state has a different date in which this takes effect, most starting around mid-June.

If this indeed proves to be the reason for the "slow" job growth, we likely won't see the full impact until the payroll report that is released on the first Friday in August due to the timing of the data collected. If this is the case, while there may be "more" discretionary income pumped into the economy over the course of the next few months, we may continue to see some of the bottlenecks in supply chains and a slower reopen on the services side of the economy than initially expected. With businesses needing to pay up to entice workers and the price of labor inputs increasing, it's possible that this could push some of the GDP gains expected during the second and third quarters toward the backend of the year.

Positives

Conference Board U.S. Leading Economic Indicators remain elevated (+1.6%)

ISM Services Index registers its highest level ever recorded (64.0)

First time unemployment claims have hit a post-pandemic low (385k)

Negatives

Unit labor costs exceeded expectations by 2.1% (-0.4% expected vs 1.7% actual)

The labor force participation rate declined month-over-month and also fell short of expectations

Retail sales were flat month-over-month

EQUITY OUTLOOK

Summary

As we anticipated, the equity market rally stalled a bit in May with the S&P closing higher by just 0.7%. The Russell 1000 Value Index rose 2.3% extending the year-to-date outperformance over the Russell 1000 Growth Index which fell 1.4% during the month. The developed international, MSCI EAFE and MSCI Emerging Market indexes rose 3.7% and 1.2% respectively.

With most first quarter earnings in the books, the stock market's muted reaction to strong results may signal that equities are looking for something beyond earnings to set the direction for markets moving forward. The threat of inflation could certainly strike a new tone for equity markets and recent surveys of inflation expectations suggest economists see a widening range of possible outcomes. Inflation is undoubtedly rising as it was specifically referenced in numerous corporate earnings calls this quarter. The big question will be whether inflation is transitory, as the Federal Reserve suggests, or longer lasting and problematic. We likely won't know that answer for many months.

Progress towards an infrastructure spending bill could also be a directional driver for stocks. Some sort of bill has largely been discounted by the market but the specific details regarding the size, support (bipartisan), potential tax offset, etc. will be closely watched. There is little debate that infrastructure has been ignored for too long and requires attention.

As we have mentioned in recent months, it is very likely equity markets will chop along in the near term. Looking out further, the fundamental backdrop continues to present a favorable environment for stocks relative to other major asset classes. Long-term investors should look at pullbacks as buying opportunities.

Positives

Accommodative Federal Reserve and global central bank policy

Lack of return competition from other major asset classes

Reopening of America is gaining steam with few immediate setbacks

Negatives

Stock valuations, by some traditional measures, look relatively stretched

Rising material and labor costs

Unknowns

How long before the threat of inflation forces a reaction by the Fed

Are equity fundamental growth rates peaking

FIXED INCOME OUTLOOK

Summary

Following a terrible first quarter for investment-grade bond investors, Treasury yields moved slightly lower in April and then traded in a very narrow range in May. The bond market seems to have found an equilibrium between those selling due to inflationary concerns and those buying because yields have moved back near pre-pandemic levels. Reallocations from rising equity markets and consistent Fed purchases are also adding support to the market. With consistent Fed messaging, the 2-year Treasury note remained within a basis point of 0.15% all month. The 10-year note traded in a 13 bps range, about one-half the normal range, before closing May about 3 bps lower at 1.59%. The 30-year bond ended about a basis point lower at 2.28%. The Treasury market returned 0.34% for the month.

Corporate bonds delivered better returns even though the average investment-grade bond spread ended May virtually unchanged at 91 basis. The outperformance can be attributed to their higher starting yield along with slightly greater price appreciation as bonds age. Companies also redeemed a significant number of bonds prior to their maturity. The premium companies pays for early redemptions is reflected in the market's return but then the bonds are removed from the indices so their tighter spread is not reflected in the market average. Corporate bonds returned 0.77% for the month with the intermediate maturity subset (1 to 10 years) returning 0.58%. The broad bond market indices delivered positive returns during May. Combined with April's return, the Bloomberg Barclays Intermediate Government/Credit Index has clawed back nearly half of its first quarter's loss and now stands at a year-to-date return of -0.98% at the end of May.

Given that bond investors had to digest the highest inflation reports in more than a decade, it appears that a growing number are believing it to be transitory rather than it becoming embedded in the economy. We are in agreement and also believe that the Fed has good reason to stick with their rate forecast and focus on the data as it comes in rather than what may happen based on models. As we have seen for months, short-term interest rates are unlikely to move more than a handful of bps through the summer. Longer rates may make another push higher but that probably will not happen until we enter the latter part of the year.

Positives

Low volatility in short rates as they remain anchored by Fed policy

Bond inflows as accounts rebalance from equity market gains

Negatives

Highest reported inflation in more than a decade

Large spending bills may increase deficits for years

Unknowns

Geopolitical tensions over the source of COVID-19

Geopolitical tensions over foreign hacking of U.S. computer systems