HB RETIREMENT®

FINANCIAL MARKET SNAPSHOT

August 2021

August 16, 2021

US equity and bond markets painted contrasting pictures in July as the S&P 500 hit new all-time highs while US Treasury yields slumped to lows not seen since February. While such a sharp decline in yields would normally imply a significant reduction in the economy's growth outlook, there appears to be a wide range of factors behind the move. For part of the month, fears over raising Covid cases called into question the sustainability of the economic recovery. The primary market narrative was driven by concerns regarding the potential impact of the emerging the delta Covid variant.

Covid Update

On the COVID front, the U.S. saw a resurgence of the virus comparable to what has been observed in the U.K. The U.K. and the Netherlands similarly saw an unexpected surge as the Delta variant spread but both have since seen infection counts drop nearly as quickly as they went up. Of 163 million Americans fully vaccinated as of July 26; there were 6,239 hospitalizations, including 1,263 deaths in people diagnosed with the SARS-CoV-2 infection. In about 25% of cases, patients were asymptomatic, or diagnosis appeared secondary to primary cause of the event. Markets appear to agree with the assessment that the resurgence of the virus, and in particular the prevalence of the highly contagious Delta variant, doesn't pose much of a threat to the broader economy as investors didn't appear to expect new lockdown measures to be put in place.

Additionally, July data showed that the delta Covid variant was significantly more contagious than prior variants and was spreading at accelerating rates, particularly throughout the southern U.S. states. In late June, the United States was at a low point in new Covid, averaging about 10,000 new cases each day. In stark contrast, the U.S. is currently averaging closer to 125,000 per day as of August 15th. Since July 1st, there has been a 700% increase in the week-over-week average of COVID-19 infections in the United States, according to the Centers for Disease Control and Prevention. Moreover, the delta Covid variant has quickly become the dominate strain. At the beginning of July, the delta variant accounted for approximately 52% of all Covid cases. As of August 8th, the CDC reported that the delta variant accounted for approximately 97% of total Covid cases. As a result, New York City recently announced it will require proof of vaccination for indoor activities such as restaurants and gyms, while China imposed new restrictions on travel in a bid to slow a delta-driven outbreak.

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China Concerns

News reports emerged throughout the month that the Chinese government was increasing regulatory activities, particularly in the tech and private education sectors, which added to market uncertainty. U.S.-China tensions escalated after Chinese authorities confirmed reports they would ban the private education industry from making profits. The Chinese government also said that it would punish ride-hailing companies for monopolistic behavior. The Securities and Exchange Commission responded by saying it would stop processing registrations of U.S. IPOs and other sales of securities by Chinese companies. As a result, the Nasdaq Golden Dragon China Index declined 22.0% during July.

Healthy U.S. Economy

However, most of July's macroeconomic data continued to paint the U.S. economy as healthy. The recovery in the labor market picked up pace with 850,000 jobs added in June – the largest monthly gain since last August. Prices paid by U.S. consumers climbed in July at a more moderate pace, though not enough to provide major relief from the cost increases weighing on sentiment and driving policy debate. Inflation, while elevated, has been showing signs of slowing. The core CPI, which excludes the volatile food and energy components, rose 0.3% from the prior month and 4.3% from July 2020. The result fell below economists' consensus forecast for a 0.4% increase and well below June's rise of 0.9%. Sharp decelerations in inflation in select areas of the economy that had seen rapid price increases in the spring helped keep the headline numbers in check.

Consumer confidence as measured by the Conference Board stayed at high levels in July unchanged from previous months, although the University of Michigan consumer confidence figure dropped to a five-month low as consumers cited inflation. The text of the report attributed the fall mainly to an intense reaction (and perhaps an overreaction) to the Delta Covid variant wave, and especially an exasperation that perhaps the pandemic will drag on for years. If that is what's going on, the pessimism might quickly fade as the current wave of Covid infections potentially decline over the next few months.

Moreover, second quarter earnings season also offered reasons for optimism, with 86% of reporting companies beating analyst EPS estimates, compared with 80% for the whole season a year ago. Companies topped revenue estimates 78% of the time, while 10% missed. That compared with 56% and 30% respectively a year ago.

Fixed Income

In the July Federal Reserve (Fed) meeting, the Fed acknowledged that it the economy was making "progress" in-line with its mandate but said that tapering (i.e. slowing the pace of asset purchases) would require additional improvements – particularly in the labor market. It also acknowledged that there was upside risk to the inflation outlook, but retained the view that this would be transitory. Investors have been looking for signals from Federal Reserve members in hopes of gaining some insight as to when the Fed might begin to taper. The market appears to be viewing the Jackson Hole symposium, which takes place in late August, as a potential venue for the Fed to lay out the timing and contours of its expected move to taper the bond-buying program.

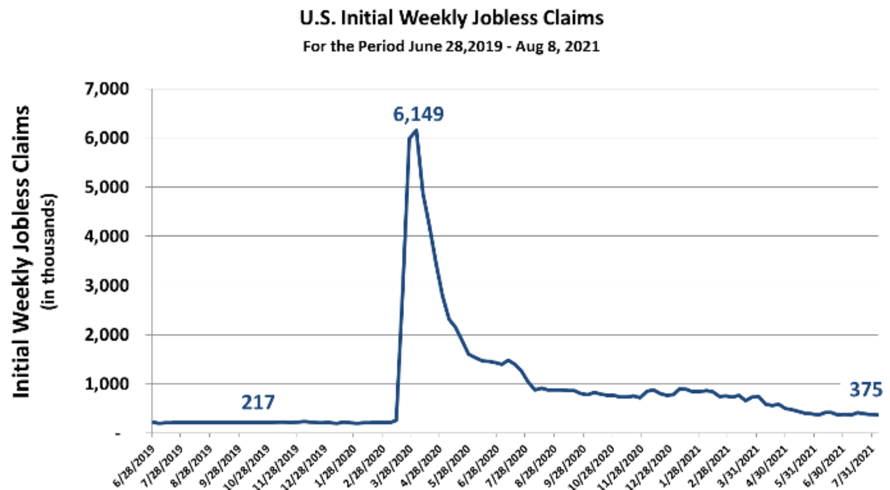
President Biden's infrastructure spending ambitions are one potential catalyst for a move higher in bond yields, although progress remained elusive over the course of the month. Following news that the skeleton of a bipartisan infrastructure bill had been agreed at the end of June, the details of the deal were not been solidified by the end of July. However, after months of negotiation, the Senate recently voted in a filibuster-proof 69-30 to approve a $1 trillion infrastructure framework. The bill orders repairs to crumbling physical infrastructure such as roads and bridges, expansions to broadband internet access, replacement of lead water pipes, financial support for clean energy projects, and improving the weatherization and cybersecurity of vulnerable infrastructure.

Overall, we do not believe that the bond market is sending a negative signal about the health of the economy. While the current level of Treasury yields may appear inconsistent with the strength of the recovery, we expect yields to move marginally higher over the remainder of the year.

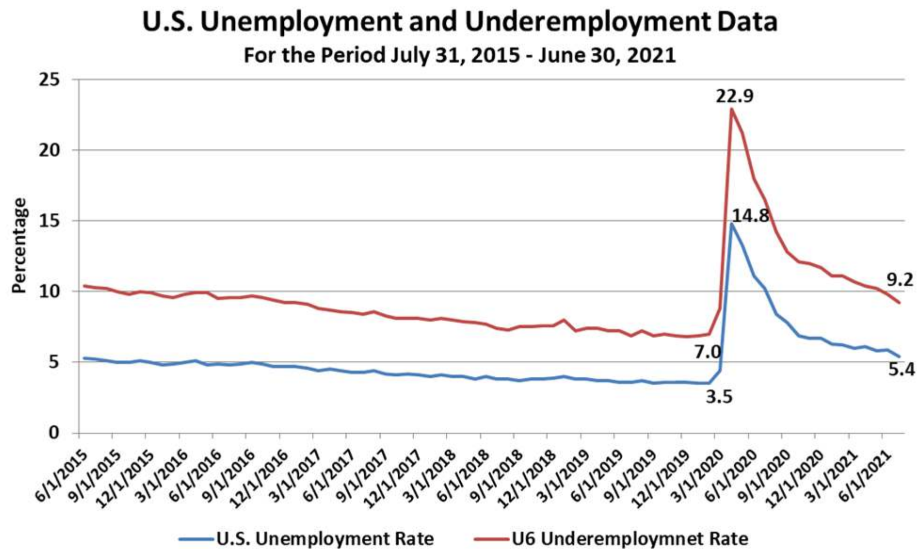
Improving Labor Market Data

The number of job openings in the U.S. economy jumped to 10.1 million open jobs on the final day of June, the report said, up from 9.2 million in May. Despite the unemployment rate remaining above 5% and the U.S. economy being millions of jobs short of pre-pandemic levels, many businesses have reported difficulty finding workers. Nominal wage gains, especially among non-management employees, also points to a tighter labor market. The Labor Department said in Friday's jobs report there were 8.7 million Americans looking for work, meaning there were more open jobs than potential workers. The high level of job openings comes even as some states have ended the extra unemployment benefits that were created during the pandemic in an effort to motivate Americans to return to work. The extra benefits are set to expire for the rest of the country next month.

- Hiring Modestly Above Expectations.
  - Nonfarm payrolls increased 943k in July, following a revised-up gain of 938k in June. The consensus estimate for July was 870k, with a forecast range spanning 350k-1200k. With revisions, total employment gains in May and June were 119k higher than previously reported.
  - Payrolls are 5.7 million below February 2020 levels. The economy lost 22.4 million jobs over the March-April period last year. It has netted 16.7 million since then.



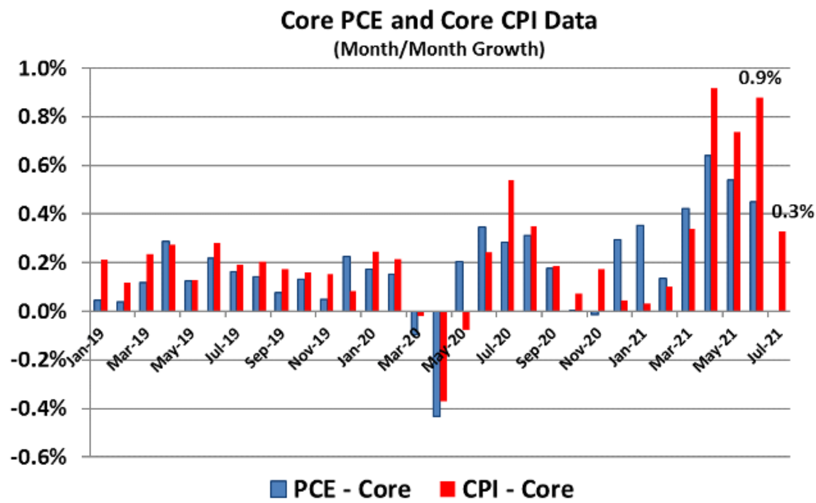
- Private sector employment rose 703k, while state and local education jobs rose by a combined 231k. The pandemic has disrupted typical seasonal hiring and firing patterns, with the increase stemming from fewer-than-normal job cuts during the summer.
  - An encouraging signal of underlying strength came from continued gains in professional and business services (60k), job creation that will need to be sustained to carry the recovery. Within the industry, employment in professional and technical services rose by 43k, and is now 121k above the February 2020 level.
  - Notable job gains occurred in leisure and hospitality (380k), with two-thirds coming in food services and drinking places (253k).
  - Gains in employment were also evident in transportation and warehousing (50k) manufacturing (27k) and a turnaround in construction (11k) despite higher virus cases and worker shortages.
  - The headline was significantly lifted by employment in education, with state and local governments adding a combined 231k. Seasonal patterns were distorted by staffing fluctuations due to the pandemic, with fewer-than-normal job cuts during the summer.



- Unemployment Rate Drops Sharply, Participation Up Slightly.
  - A drop in the unemployment rate to 5.4% (vs. 5.9% prior) came alongside a 0.1 percentage point increase in participation. Adjusted for the overall drop in participation over the course of the pandemic, the jobless rate fell to 7.8% from 8.4% prior.
  - Still, similar declines will be harder to come by provided workers stream back into the labor force in the second half. With augmented unemployment benefits ended in half of U.S. states by early July, as many as 1 million workers will be incentivized to reenter the workforce over the near term.
- On labor force participation, Federal Reserve Chair Jerome Powell's comments at the July press conference indicated the balance of the FOMC will expect constraints to ease. Those include caregiving needs, virus fears and unemployment insurance payments.

Consumer Inflation is U.S. moderates while remaining elevated

Prices paid by U.S. consumers climbed in July at a more moderate pace, though not enough to provide major relief from the cost increases weighing on sentiment and driving policy debate. The consumer price index increased 0.5% from June and 5.4% from a year ago, according to data released by the U.S. Labor Department. The core CPI, which excludes the volatile food and energy components, rose 0.3% from the prior month and 4.3% from July 2020. The result fell below economists' consensus forecast for a 0.4% increase and well below June's rise of 0.9%. Economists often consider core CPI to be a more reliable indicator since it's insulated from the frequent swings in petroleum and food prices.



Source: The U.S. Labor Department

Sharp decelerations in inflation in select areas of the economy that had seen rapid price increases in the spring helped keep the headline numbers in check. Used car and truck prices, which rose rapidly between April and June as Americans looked to vacation, gained just 0.2% in July after a climb of more than 10% in the prior month. The new vehicles index jumped 1.7%. Apparel prices were flat after a 0.7% increase in June, and transportation services prices actually declined after a pop of more than 1% at the end of the second quarter. Airfares and auto insurance costs also declined.

Category	Jan-21	Feb-21	Mar-21	Apr-21	May-21	Jun-21	Jul-21
All Items:	**0.30%**	**0.40%**	**0.60%**	**0.80%**	**0.60%**	**0.90%**	**0.50%**
Food and Beverages	0.10%	0.10%	0.10%	0.40%	0.40%	0.80%	0.70%
Housing	0.00%	0.20%	0.30%	0.50%	0.40%	0.40%	0.40%
Equivalent Rent	0.10%	0.30%	0.20%	0.20%	0.30%	0.30%	0.30%
Apparel	2.20%	-0.70%	-0.30%	0.30%	**1.20%**	0.70%	0.00%
Transportation	1.10%	1.10%	**2.70%**	**2.50%**	**2.10%**	**3.60%**	**0.60%**
Vehicles	-1.00%	-0.30%	0.50%	**4.60%**	**4.00%**	**5.60%**	**0.60%**
Motor Fuel	**7.40%**	**6.40%**	**9.10%**	-1.40%	-0.70%	**2.50%**	**2.40%**
Medical Care	0.40%	0.30%	0.10%	0.10%	-0.10%	-0.10%	0.30%
Educ and Commun	0.00%	0.10%	-0.10%	0.30%	0.30%	0.10%	0.20%
Special Indices:							
Core	**0.00%**	**0.10%**	**0.30%**	**0.90%**	**0.70%**	**0.90%**	**0.30%**
Energy	**3.50%**	**3.90%**	**5.00%**	-0.10%	0.00%	1.50%	1.60%
Services	0.00%	0.30%	0.40%	0.60%	0.40%	0.40%	0.30%

Source: The U.S. Labor Department

Faced with supply constraints and surging demand, businesses are raising prices for goods and services as cost pressures mount. Ongoing challenges including materials shortages, shipping bottlenecks and hiring difficulties will likely continue to put broader upward pressure on prices in the months ahead. At the same time, some of the price surges linked to the economy's reopening are beginning to ebb. In fact, the Labor Department said a smaller gain in the costs of used cars and trucks was a "major factor" in the moderation of the core CPI.

The key takeaway from the report suggests that some easing in the reopening and supply-shortage driven boost to prices, and tentatively suggests that inflation may have peaked. The "transitory" inflation camp – that is, those who view the current surge in inflation as temporary and reversible within the next few months – will take comfort from the retreat of items that have been chief contributors to the surge in inflation, such as used-car prices and airfares. They will argue that such components will most likely detract from inflation in the months ahead.

Substantial Wage inflation, or not-so-subtle wage inflation?

The U.S. labor market recently hit a new milestone. For the first time, average pay in restaurants and supermarkets climbed above $15 an hour. Restaurants, bars, retailers, cleaners and other services had to lay off millions of workers during the pandemic. As they try to scale up quickly, employers are finding it hard to bring workers back unless they raise pay and offer other new benefits. Many laid off workers reassessed what they want to do in their careers, and the additional unemployment payments gave them a financial cushion to search for something different. Overall, nearly 80% of U.S. workers now earn at least $15 an hour, up from 60% in 2014. Job sites and recruiting firms say many job seekers won't even consider jobs that pay less than $15 anymore.

Source: https://www.frbatlanta.org/chcs/wage-growth-tracker.aspx

The chart above reflects the difference in wage growth of high skilled vs. low skilled workers over the past two (2) years. In general, low-skilled jobs are defined as those requiring workers to have no more than a high school education and no more than one year of work experience. By definition, these low-skill tasks cannot be executed remotely, but only at the location where these services are provided. As such, most of these jobs are tied to service industries and incudes a broad category of fields such as lodging, food and drink service, event planning, theme parks and travel & tourism. These segments tended to be the hardest hit during the economic downturn and the disparity in wage growth during the past twelve months reflects that. Consequently, the easier year-over-year comps coupled with the relatively quick economic rebound has resulted in a "wage gap catch-up" for lower skilled workers. Additionally, these lower skilled workers were the most severely impacted during the Covid recession and, as a result, tended to experience significant negative impact to their personal balance sheets.

So what do we believe? First, we acknowledge that there is upward wage pressure within certain segments of the economy but do NOT believe that wage inflation is rampant and systemic throughout the general economy, but rather a function of the economic reopening. And secondly, we believe that the low skilled "wage gap catch-up" will likely be a persistent for the foreseeable future and will likely take the next six to twelve months before it begins to abate.

Implications for Our Portfolios

From a portfolio management perspective, we remain cautiously optimistic on equity capital markets as we progress into the back half of 2021. Expectations for equity market returns in the second half of the year appear to be more muted, with S&P 500 price targets implying mid-single digit returns over the remainder of the year. We believe that this expectation is supported by the potential for sustained earnings growth, driven by the continued reopening of the economy.

We believe that the continuation of a "catch-up" trade into the back half of 2021 is likely, and that value equity could outperform growth equity over this time period. Consequently, we believe that as the economy reopening accelerates in the second half of the year, the rally could broaden to economically sensitive investments that have lagged, including cyclical sectors, small-cap stocks and international equities.

We continue to watch inflation trends very closely, and believe that inflation has both a transitory and a structural component to it. Furthermore, we believe that the transitory causes will begin to abate in the latter half of the year driven by: easy comparables dropping out of the data, supply chain constraints being resolved and the labor market conditions continuing to improve. Consequently, we believe that this expectation supports our preference for equity over fixed income as well as corporate and securitized debt over government debt.

At HB Retirement, we remain committed to our disciplined and repeatable investment process, which is based both on top-down, macro analysis coupled with bottom-up, fundamental research. As such, we intend to follow the data and adjust our outlook and portfolios accordingly. Consequently, at the present time, we are staying the course with regard to the asset allocation—favoring value over growth. Unprecedented times such as these not only validate but mandate a disciplined investment process!

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The MSCI EAFE Index is a free float –adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

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The S&P 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing the major sectors of the U.S. economy.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment grade fixed-rate bond market, including both government and corporate bonds.

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