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A Swift Rebound Then a Gradual Slowdown

The economic recovery reached some important milestones recently. The S&P 500 has doubled its level from its pandemic low. This marks the fastest bull market doubling since World War II, taking just 354 trading days, a milestone that historically takes more than 1,000 trading days to reach. After growing at a 6.5% annual rate in the second quarter, real GDP is now 0.8% larger than it was at its previous peak just prior to the pandemic.



Of course, just getting back to where we were before the pandemic hit is a low bar to pass. Obviously, GDP would have grown much faster if the pandemic had not occurred, and the economy clearly still has some ways to go before it is fully pieced back together. Unfortunately, the pace of the recovery has already begun to slow. Second quarter GDP growth, despite being the fastest year-over-year pace in 70 years, missed expectations, with most estimates projecting growth between 8% and 10%. Corporate earnings were stellar in the second quarter, but the consensus among most analysts is that earnings growth has peaked. Retail sales decreased unexpectedly in July, and the most recent reading of the University of Michigan's consumer sentiment index showed a dramatic plummet, with sentiment falling to the lowest level of the pandemic-era.

This is not to say we expect economic contraction or a full-blown recession anytime soon. The decline in retail sales is part of a broader trend of American consumers shifting away from purchasing goods and toward spending money on services as the economy reopens. The recent raft of disappointing economic data—particularly consumer sentiment—can be partly attributed to fears about the Delta variant causing Covid numbers to surge in many parts of the country. In fact, historically, the consumer sentiment index is a contrary indicator, and when readings fall to the bottom quintile, over the next 12 months, the S&P 500 average returns of 11%. Unfortunately, the current moment is likely to buck the historical trend.

As Growth Slows, Uncertainty Grows

Much of the record-breaking growth we have seen recently is due to a year's worth of pent-up consumer demand, fueled by massive government stimulus spending. What we have



seen has been an economic sugar high that is already beginning to fade. Beyond headline figures like GDP and jobs numbers, which are lagging indicators and can tell us only where the economy was, a raft of leading and coincident indicators, which tell us where the economy is heading, are signaling a clear deceleration in growth.

The Economic Cycle Research Institute's (ECRI) U.S. Coincident Index, which combines broad measures of economic output, em-

ployment, income, and sales data, indicates that the economy's growth is slowing. According to the index, the U.S. economy's growth rate, after having peaked at nearly 20% in March, had fallen to 5% in June. ECRI's analysis suggests that growth will continue to slow in the coming months. Worryingly, ECRI's analysis also shows a strong correlation between slowdowns in economic growth and the risk of serious stock market correction. Since 2010, every stock market pullback of at least 10% on the S&P 500 began when the growth cycle was in the type of downturn we currently are. Considering that an upturn in the growth cycle led ECRI to call last year's stock market rally much sooner than most economists, the organization's track record is quite reliable.

Risks on the Horizon

The likelihood of a double-digit correction in the near-to-mid term is growing. We have long been concerned that the stock market's sky-high valuations and frenzied speculation may be setting the stage for a large correction. The quarter's stellar earnings reports went a long way toward justifying many stocks' inflated prices. However, even with some of the most expensive valuations in history, stock issuances are continuing at a frenetic pace, blowing past previous records set during the run up to the dotcom bubble. The popularity of special purpose acquisition companies (SPACs) is evidence of rampant speculation that does not look to be cooling. The first six months of 2021 saw more capital raised via SPACs than in the previous 20 years combined. It is not just SPACs and IPOs, however, as even established companies are issuing stock at a record pace.

It is important to keep in mind that because they are quantifiable in nature, stock valuations are considered to be a fundamental metric, but they also serve as an indicator of sentiment. The previous valuation records were set during the late 1990's, when euphoria was abundant. Citigroup's panic/euphoria model, which tracks current market sentiment, has hit levels not seen since the period before the 1999/2000 crash. We are currently in the longest period of ebullient readings without a major market correction since the dotcom boom, and analysts are growing increasingly convinced that something will give.

While history never repeats exactly, conditions are right for a major correction, and now is the time to prepare. Luckily, the staggered nature of the global economic recovery means the eventual slowdown will also be staggered. While growth in the U.S. has likely already peaked, growth in Europe is not expected to peak until later in the year, because much of the region has not yet fully reopened and the European Central Bank is still in the process of coordinating a potentially massive economic stimulus package. As other regions catch up with vaccine distribution and economic reopening, there is ample opportunity for diversification to guard against a more volatile U.S. stock market. As growth slows and earnings become choppy, uncertainty will grow, and the U.S. stock market will be more vulnerable to a major pullback. The catalyst for such a pullback could be anything from geopolitical fallout from Afghanistan, a vaccine-resistant variant of Covid, or simply a raft of disappointing economic news, but the most immediate threats are inflation and the Federal Reserve's response to changing economic conditions.

The Fed: Making the Right Moves at the Wrong Time?

Inflation has been a hot topic in recent months, with the consumer price index growing by leaps and bounds at levels not seen in decades. The Fed is maintaining their stance that this is transitory in nature, and inflationary pressure will subside once the economy works through pandemic-related supply and labor issues. While we agree that fears about the type of runaway hyperinflation seen in the 1970's are overstated, the Fed may be understating the threat and ignoring the cyclical nature of inflation. ECRI's U.S. Future Inflation Gauge remains in an upswing, which suggests that inflationary pressure will persist even after supply chain issues are addressed.



Investors, for the most part, seem less concerned about inflation itself than the Fed's response to it. In the face of a surging economy and shortages of labor and supplies, the yield curve has unexpectedly flattened. Signals out of the bond market suggest that investors see a bigger risk in the Fed stepping in too soon, preemptively raising rates to cool off the economy and potentially triggering a recession instead. With slowing growth, the Fed is likely to maintain its dovish stance and hold off on increasing rates until the second half of next year at the soonest, which should calm investors, but the Fed may have already missed the ideal window to begin normalizing policies. The Fed has two criteria that determine when it will move: inflation that consistently surpasses its 2% target and full employment. Arguably, inflation has already surpassed this target, and with the labor force dramatically smaller than prior to the pandemic, the Fed's metric for full employment may be woefully outdated. Worryingly, if economic growth slows faster than expected, the Fed will have very few tools left to combat it.

While the Fed's stance on interest rates is unlikely to change any time soon, the end of quantitative easing will likely be here soon. The bond-buying policy was enacted last year to ensure liquidity last year, but with the crisis largely behind us, the program has outlived its usefulness. The monthly purchase of \$40 billion of mortgage-backed securities seems particularly unnecessary, doing little more than adding fuel to an already red hot housing market. We expect the Fed to signal later this year that it intends to begin tapering off asset purchases in the first quarter of next year. This has the potential to roil the bond markets, like it did during the so-called "taper tantrums" that occurred in 2013 when the Fed moved to normalize policies they enacted during the Great Recession. While the potential for turmoil is there, the move has been so well telegraphed and long expected that it is unlikely to cause much of a stir.



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