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Enduring: Perspectives for the Fourth Quarter

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The word *enduring* has been a common theme in 2021. On one hand, because the pandemic has endured much longer than any of us would have hoped. On the other hand, we've seen Americans and people around the world valiantly endure this difficult period, irrespective of the challenges that we have all faced.

As we enter the home stretch of 2021, we chose the acronym ENDURING to capture the factors and storylines that have the greatest potential to influence the economy and investment markets. Each letter represents a critical topic, ranging from the Economy to Global Population.

E - Economy
N - Nation of Interest: China
D - Debt
U - Unemployment
R - Rates
I - Inflation
N - News
G - Global Population

What follows is our perspective on each of these topics.

Economy

Gross Domestic Product (GDP) growth continues to move in the right direction, albeit at a slower pace in the most recently completed quarter. The first release of economic data for the third quarter was announced yesterday, showing that the U.S. economy grew by 2.0%, dampened by the Delta variant of COVID-19 and supply chain disruptions.[1] By contrast, GDP grew at a historically accelerated annual rate of 6.3% in the first quarter and 6.7% in the second quarter[2], fueled by three key drivers of consumer spending: government stimulus, widespread business re-openings, and rising vaccination rates.

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[1] The Wall Street Journal, *U.S. Economy Slowed in Third Quarter on Delta Surge, Supply Crunch* (link)

[2] The Wall Street Journal, *Consumers Ramped Up Spending in August as Inflation Remained Elevated* (link)

Those consumer spending drivers faded from July to September, while two additional factors arose to further dampen GDP growth: a surge in COVID-19 cases and deepening supply chain bottlenecks.

As it relates to the economy, we expect that COVID-19 and lingering supply chain issues will continue to create some headwinds to robust growth. However, overall, we are comfortable with the pace of progress that we see in key economic figures. We will continue to monitor this closely in the coming weeks and months.

Nation of Interest: China

There is a lot of political discord in Washington D.C. right now. One of the few topics where there is bipartisan agreement is the notion that China is a formidable nation, whose national interests are at times at odds with ours. This topic goes beyond interesting national security developments, such as the U.S. selling nuclear submarines to Australia. As it relates to investment markets, the most pressing matter is whether U.S. / China relations have the potential to spur a selective economic decoupling.

What does that mean? For decades, the economies of our two nations have been closely connected: the U.S. is the largest purchaser of Chinese export goods, and China is the third-largest purchaser of U.S. export goods. In 2020 alone, $559 billion in goods traded between our economies.[3] China is currently working through a variety of internal domestic challenges including a highly leveraged real estate market, as well as a massive energy crisis which led to imposed widespread blackouts earlier in October.

Increased political tensions between our countries have the potential to reduce trade Sino-American trade. There is also the potential for supply chains to be re-worked, including U.S. companies sourcing more materials domestically, where input costs are higher. These higher costs would likely be passed along to consumers, and may serve to exacerbate the inflationary pressures we will discuss later in this journal.

Debt

In the second quarter of 2021, U.S. public debt stood at $28.5 trillion.[4] This compares to an annualized GDP pace in the second quarter of $22.7 trillion.[5] That means debt to GDP is approximately 128%! Important to note: this debt figure does *not* include the unfunded liabilities associated with Social Security and Medicare.

U.S. public debt to GDP hasn't been this high since just after the end of WWII.[6] However, there are Modern Monetary Theorists who question whether sovereign debt matters at all — citing that the US Treasury can simply print money to resolve short- or long-term debt issues. My answer to that question is: how can it not matter?

[3] Office of the United States Trade Representative, The People's Republic of China (link)

[4] U.S. Department of the Treasury, *Federal Debt: Total Public Debt* (link)

[5] Bureau of Economic Analysis, *Gross Domestic Product, Second Quarter 2021 (Advance Estimate) and Annual Update* (link)

[6] The Balance, *US National Debt by Year* (link)

We will likely see legislation passed shortly that will have meaningful impact on the federal budget. As always, there will be winners and losers. Infrastructure, social safety net expansion, and a patchwork of revenue generators — also known as taxes — will be part of the bill. Even assuming we all agree on the priorities identified in the legislation, unless there is sufficient revenue to cover the expenses, this will result in a further increase of our national debt.

Unemployment

At the height of the pandemic, we saw U.S. unemployment reach 14.8%.[7] Today, unemployment has returned to near pre-pandemic levels. On October 8th, we learned that total nonfarm payroll employment rose by 194,000 in September, and the unemployment rate fell by 0.4% to 4.8%.[8] Notable job gains occurred in leisure and hospitality, professional and business services, retail trade, transportation, and warehousing.

In recent months, we have seen a vast improvement in the unemployment rate. However, there are still millions of people who are out of work who were employed prior to the pandemic. The work is not yet done as it relates to unemployment, though we remain cautiously optimistic about the pace and trajectory of the U.S. labor market.

Rates

Rates are one of the greatest driving factors in determining if asset prices are likely to move up or down. When interest rates move down, besides reducing borrowing costs, it increases the value at which bonds are trading. At the same time, lower rates provide the justification and basis for investors to pay higher multiples for equities.

Today, interest rates are moving higher. The question remains: how much higher will they move and on what timeline will this move occur? If rates rise dramatically, it could create a headwind to current valuations built into the equity markets. Central banks around the world have expressed an interest in gradually tightening monetary policy, but it remains to be seen exactly what that shift will look like.

At the time of this publication, the yield on the U.S. 10 Year Treasury Note is 1.57%. This is well above the yield of 0.58% seen in March of 2020, but still at the lower end of the 1.50% to 3.00% range that was observed in 2018 and 2019, prior to the pandemic.[9]

Inflation

Federal Reserve policy is governed by two objectives: the pursuit of an "average" 2% inflation rate (to provide price stability within the economy) and achieving "maximum" employment. There has been good progress made on unemployment in recent quarters, but inflation remains a challenge: the Labor Department reported that the consumer price index rose by 0.4% in September, bringing the year-over-

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[7] The Wall Street Journal, *Broader Unemployment Rate Hits 14.8%* (link)

[8] U.S. Bureau of Labor Statistic, Employment Situation Summary, October 8 (link)

[9] CNBC, *U.S. 10 Year Treasury* (link)

year increase to 5.4%.[10] Clearly, this is well above the Fed's quoted target. While some of this is certainly due to the "base effect" caused by reopening from lockdowns, it is an open question as to when and by how much this will moderate.

As we've noted in previous Gerry's Journals, the Fed faces the question of whether this inflation is transitory (a short-term inflationary period that has resulted from the COVID-19 pandemic) or if it is more systemic (an inflationary period that is more persistent).

In an effort to curb inflation, the Fed may begin tightening monetary policy (reducing its ongoing bond purchases) as early as next month. This, in turn, will likely pave the way for the Fed to raise interest rates. As we've noted previously, we will be watching the pace and magnitude of any rate changes closely, since interest rates will influence both inflation and asset valuations.

News

According to the Pew Research Center, 53% of Americans get their news on social media "often" or "sometimes," and 36% of Americans *regularly* get their news from Facebook.[11] And while almost every piece of news has *some* degree of editorial overlay, there are "news" stories circulating on social media that are cut from whole cloth. We expect to hear more about this in the coming weeks, months, and years, and feel that disinformation (from all segments of the ideological and political spectrum) is one of the great challenges facing our nation and the globe.

Just this week, a new FCC director was nominated. Her name is Jessica Rosenworcel, and she is from West Hartford, CT.[12] We expect to hear more about the restoration of net neutrality rules and how we collectively interpret Rule 230 of the 1996 Communications Decency Act (which largely exempts telecommunication companies and website owners from being held liable for their users' published content[13]).

This isn't just a conversation about free speech, which does have its limits. The internet and social media have provided us with the good (e-commerce, greater access to information, and new forms of self-expression), the bad (false narratives, bullying, body shaming, and echo chambers, which disproportionately impact children and more fragile members of our society), and the ugly (the proliferation of hate groups and platforms that facilitate their formation and proliferation). Right now, we believe a more holistic regulatory and legal framework is needed that preserves the "good" while curtailing the "bad" and "ugly" components of social media and the digital ecosystem.

While there are clearly social issues here to address, there is also an investment impact. Which companies stand to benefit, and which companies will lose favor as a result of a shifting social or regulatory

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[10] The Wall Street Journal, *Accelerating Inflation Spreads Through the Economy* (link)

[11] Pew Research Center, *News Use Across Social Media Platforms in 2020* (link)

[12] Hartford Courant, *West Hartford native nominated by President Joe Biden to be first female FCC chairwoman* (link)

[13] AP Explains: *The rule that made the internet* (link)

environment? This is a dynamic, and rapidly evolving topic, which we will continue to evaluate moving forward.

Global Population

The world's population is expected to grow by 2.5 billion people over the next few decades. What percent of that growth do you think will come from the U.S., Canada, Europe, and Japan? The answer is around 4% or 100 million people. This insight was shared with us by David Bridges, Senior Geopolitical Advisor at Fidelity Investments, on a recent webinar produced by GYL Financial Synergies.

The remaining 96% of this growth will largely come from Emerging and Frontier Markets: India, Indonesia, and Africa, to name a few. As we've covered in previous editions of Gerry's Journals, population growth can be a key driver of GDP growth which, in turn, supports growth in capital markets. As investors, it can be natural to have a "hometown bias" when building a sophisticated investment portfolio. In other words, to favor U.S. companies over international companies.

However, we know the U.S. doesn't have a monopoly on the development of brilliant ideas, companies, and ways of doing business, and the data shared by David Bridges is just another reminder of why it is prudent to incorporate international emerging market exposure within a broadly diversified portfolio.

Closing Thoughts

We understand that it is a dynamic and challenging time in the world, but we will endure. As always, our team remains committed to helping you achieve your financial objectives, both short- and long-term. If you'd like to discuss anything shared in this journal or your wealth management strategy, we invite you to connect with your Wealth Advisor.

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