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MARKET SIGHT LINES

A Mid-Year Growth Scare

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In our last Sight|Lines, we discussed that we're at a Mid-Year Inflection Point, with economic recovery peaking, markets hitting new highs, and the expectation that the focus will turn to fundamental drivers of economic growth and company earnings. Since then, as investors looked forward, we've experienced volatility tied to increased worries about growth, a growth scare of sorts. Then, for the week ended July 19, 2021, the S&P 500 fell 2.9%, and the 10-year treasury rate fell to 1.19% on that date. People wondered, what's driving these moves? In this week's Sight|Lines, we review some elements of this growth scare, including shifting economic growth, virus variants, inflation worries, and rising global/geopolitical risks.

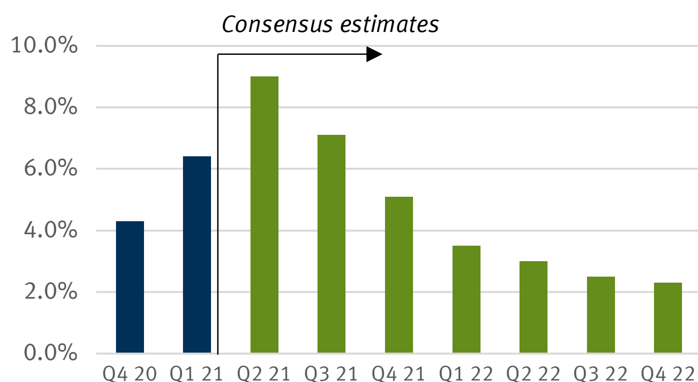
Shifting Economic Growth

Figure 1 again shares the consensus forecast for U.S. real GDP growth for the next two years, showing that growth is expected to remain "above trend" over that period. We also see growth peaking in the second quarter of 2021, with an estimated 9% annualized growth rate.

And China's economy is slowing, with the People's Bank of China surprisingly cutting the bank reserve requirement ratio in order to boost lending.

Economic growth from the pandemic reopening is peaking, and we're headed back to a period of slower growth, a slowdown perhaps amplified by troublesome virus variants.

Figure 1. Real GDP (QoQ% SAAR)



Source: Stifel Investment Strategy via Bloomberg as of July 22, 2021
Quarter-over-quarter (QoQ) Seasonally Adjusted Annual Rate (SAAR)

Virus Variants

People are focused on coronavirus mutations like the delta variant, worried they will force local governments and businesses to slow or reverse the reopenings, dampening economic growth. But the good news? As studies are performed on the delta variant, we're learning that vaccines appear effective. For example, a study in the UK found that two doses of the Pfizer vaccine were effective in protecting 88% of individuals from experiencing symptoms and 96% from hospitalization. So, fortunately, the burden of new cases from this troublesome variant should be manageable, and local governments and businesses should continue their reopening plans.

Inflation Worries

Increased inflation has contributed to the market volatility. CPI was 5.4% for the year ended June, with Core CPI, which excludes food and energy, rose 4.5% over the same period. These consumer prices are under pressure, in

part due to higher costs on the production side. PPI, which measures changes in production costs, has accelerated in recent months due to higher commodity prices, supply chain complications, and challenges hiring skilled workers, which puts upward pressure on wages. PPI was 7.3% for the year ended June, with Core PPI up 5.6% over the same period. The Federal Reserve (Fed) believes this jump in inflation is transitory, meaning inflation will decline to an acceptable level by the end of the year. Investors seem to agree. The 10-year breakeven inflation rate, a market measure of future inflation, sits at 2.3%.

Rising Geopolitical Risks

Before the pandemic, geopolitical risks were very much in focus for investors. And, as we make our way through the pandemic recovery and look forward, these risks are in focus again. For example, we've seen unrest in Colombia and Cuba, and rising tensions between Spain and Morocco and the U.S. and China. Over the last month, President Biden has unified U.S. allies in condemning China's human rights abuses, unfair trading practices, aggressive foreign policy maneuvers, and cyber-espionage. In addition, the U.S. has proposed a *Build Back Better World* initiative to compete with China's *Belt and Road* initiative and issued an advisory to American businesses and individuals operating in Hong Kong.

Interest Rates

The 10-year treasury rate was as high as 1.75% earlier this year, declined to the 1.19% level previously mentioned, and now sits at 1.27%. Investor worries about factors like the delta variant, inflation, and geopolitical risks often result in a "flight to perceived quality," with demand bidding up treasury prices and down treasury yields. A lower 10-year treasury rate may also signal that investors believe the Fed will move more slowly to increase rates, but we think rates will move higher from here. The consensus forecast is for the 10-year treasury to sit at 1.8% at year end, and forward rates signal even higher rates from there. Other things that may push rates higher include stronger global, synchronous growth, and increased issuance of treasury securities to fund higher government spending. Higher rates should coincide with equity market recovery.

Equity Market Recovery

Despite the recent decline, equity markets have since recovered, with the S&P 500, for example, within 1% of its record high. This move is attributable, in part, to early indications that the second quarter earnings season will be positive. With 16% of S&P 500 companies reporting so far, 83% have reported better-than-expected earnings, beating forecasts by a median of 13%. Our outlook remains modestly positive for stocks, with the prospect of increased volatility, and a possible market correction, as we navigate the challenges of this environment.

Conclusion

2021 has been a good year for investors, but we've experienced some market volatility in July, driven by shifting economic growth, virus variants, inflation worries, and rising global/geopolitical risks. Such volatility is common, and the equity market has recovered some. Interest rates remain lower than one might expect, and we see various pressure pushing rates higher from here.

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