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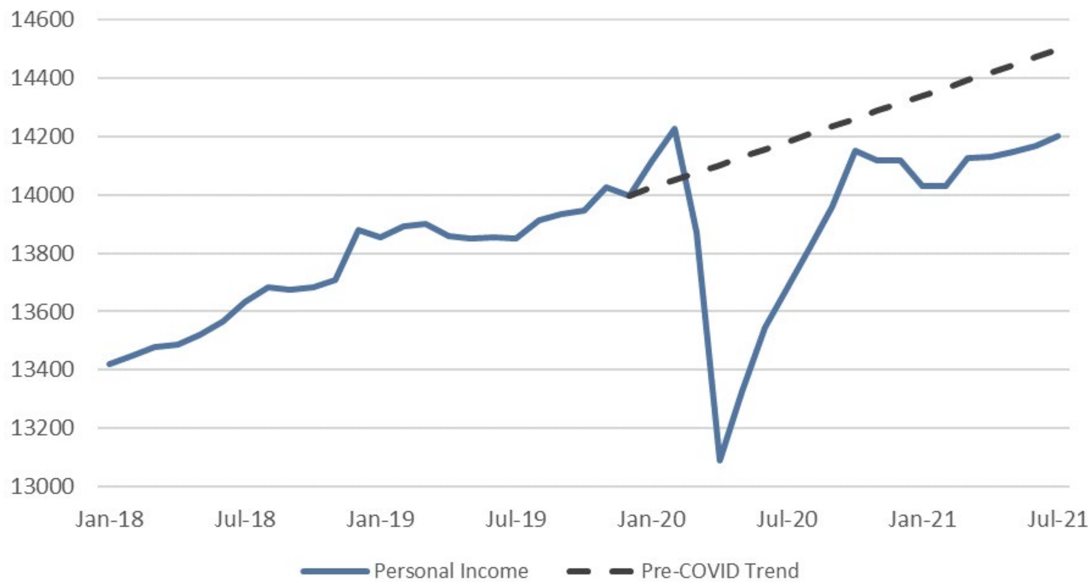
QUARTERLY UPDATE
October 4, 2021

MARKET COMMENTARY

Fig. 1: Additional labor market gains are necessary to push personal income back to trend
Real Personal Income (Billions)



Sources: Bloomberg, Mill Creek

We enter the fourth quarter of 2021 facing a very different set of circumstances than have characterized the investment landscape since mid-2020. As monetary and fiscal stimulus dissipate, investment markets will increasingly be reliant on organic economic growth to push through several upcoming headwinds. While we remain constructive on risk assets, we believe investors will likely face a more normal — more volatile — path forward.

What are those headwinds?

Fiscal policy: COVID-related fiscal support has effectively ended. Fiscal drag will reduce US GDP growth by -0.7% in Q4 and -2.3% for calendar year 2022.

Monetary policy: The slow process of removing accommodation has begun. The Fed all but announced that the tapering of asset purchases will begin in November and conclude mid-2022. The first Fed Funds hike is likely to occur near the end of 2022.

Consumer demand: Consumer expenditures comprise 70% of the US economy. Inflation-adjusted expenditures on goods have increased 15% since 2019 —driving much of the rapid economic growth we've experienced over the last year and a half. However, we've seen a 4.3% decline in inflation-adjusted spending on goods since April. Consumption of services will need to continue growing to offset the reduction in spending on goods.

Higher interest rates: Higher rates are unlikely to be a hurdle for corporate investment decisions (the current yield on a 10-year inflation-adjusted Treasury Note is -0.85% per year), but higher rates will negatively impact asset values unless future cash flows grow sufficiently to offset the higher discount rate. This effect is particularly impactful for "long-duration" risk assets, like young high-growth companies.

Personal income: Personal income including government support (e.g. enhanced unemployment benefits) remains 3-4% above the pre-COVD trend, but personal income ex transfer payments remain 2% below the pre-COVD trend (Fig. 1). We need to continue to see good job growth through the balance of 2021 and into 2022 to make up the gap.

Higher taxes: Households and corporations are likely to see tax burdens increase in 2022.

The US economy and investment markets, as they stand today, can manage these economic headwinds. Due to rising investment markets and the large government-to-household fiscal transfers of the last 18 months, households have about $15 trillion of "excess wealth" above the pre-COVID trend that will continue to support consumption if we hit a slow patch. Corporations are also in a very strong financial position and have seen profits increase 36% since 2019. However, the economy, and markets, will be less resilient until we (hopefully) reach full employment sometime near the end of 2022.

Those who follow our weekly missives know that we've been unflinchingly bullish since last fall when it became clear to us that vaccinations plus government stimulus were going to lead to historically high NGDP growth in 2021. Our message today isn't bearish, but pragmatic. We're now on the other side of that growth surge. The margin of safety is diminishing, and we should set expectations accordingly.

QUICK LINKS

- House View Summary
- Q3'21 Macroeconomic Outlook
- Q3'21 Equity Outlook
- Q3'21 Fixed Income Outlook
- Q3'21 Private Equity Outlook

This week's contributor: Michael Crook, CAIA

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