A Return to More Normal Times

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Over the past 18 months, the United States and the global economy have struggled with COVID-19. The lockdown, put in place to stem the spread of the virus, allowed health care systems to prepare. In addition, the lockdown provided time and resources for vaccines that are lowering the number of cases. However, the domestic lockdown resulted in the worst quarterly decline in U.S. gross domestic product (GDP) on record, as well as the largest yearly decline since the end of World War II.

Over the past few weeks, conversations with clients and investment committees have focused on inflation and the job market. They are connected, given the current economic environment.

Vaccination Trends

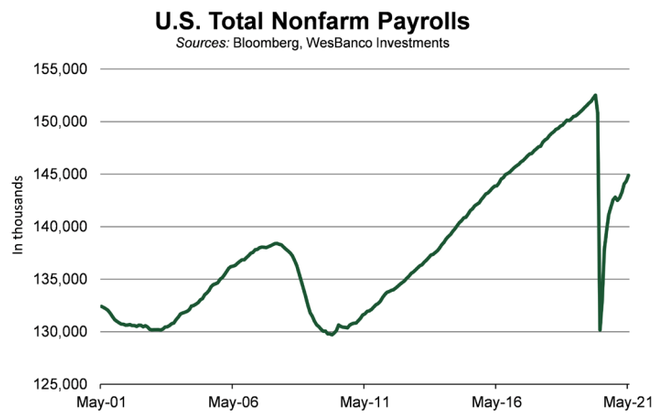
As of June 22th, nearly 65.4% of the U.S. adult population has received one dose of the COVID-19 vaccine. At the state level, there is a wide range of vaccination rates. Vermont leads with 84.4% of its adult population receiving one dose. Currently, there are four states with adult vaccination rates below 50%: Wyoming (48.7%), Louisiana (47.8%), Alabama (49.1%) and Mississippi (45.5%). Those older than 65 are marching closer to herd immunity. Nearly 77% of the U.S. population greater than 65 is fully vaccinated, with 87.3% receiving at least one dose. Experts have varying opinions on the level necessary to achieve herd immunity. It is believed that between 70% and 90% are needed to protect the community and slow the spread of COVID-19. Many states have targeted an 80% vaccination rate.

Restrictions, vaccinations and improved hygiene efforts have lowered overall COVID-19 cases in the U.S. The 7-day average of new cases has dropped to 10,350, or readings not reported since March 2020. The number of new cases peaked in January 2021 with 310,285. As vaccinations have slowed, many states have started sweepstakes, or prize giveaways, to promote vaccines. With unused federal coronavirus relief funds, Ohio is giving away a weekly prize of $1 million and college scholarships. Private companies are even getting involved. Some are offering a year of free groceries, vacations and tickets to sporting events. Following Ohio's announcement, vaccinations increased by 6% among people 30 and 74 years old. This suggests sweepstakes may help with herd immunity.

Hiring Trends

Unemployment measures created after the lockdown support spending; however, they may foster a reluctance to return to work. The two-step stimulus implemented in December and March has led to strong demand. But, in recent months, hiring and the labor market have disappointed.

The April consensus estimate called for one million in total new nonfarm payrolls; however, only 266,000 jobs were added. In the following month, it was estimated that nearly 675,000 jobs would be created. Once again, the actual number disappointed. Just 559,000 jobs were created in May. Under normal conditions, an average of 400,000 new jobs added each month would suggest a solid labor market. However, total nonfarm payrolls are still below the prior peak by 7.6 million. Year-to-date, U.S. employers have added 2.4 million jobs. At the current pace, the U.S. labor market will fully recover by mid-2022.



To entice workers, several states are ending supplemental weekly benefits. As of June 30th, 22 states will end enhanced benefits, with another three to follow in July. Many of these states already have unemployment rates below the national average. The change in policy is meant to bring workers back to the labor force. The average maximum unemployment benefit is about $23 per hour; the jobs available likely have a lower hourly wage. However, with prior stimulus payments and elevated savings, spending should remain robust.

We expected to see improvement in continuing claims. Over the past several weeks, U.S. continuing jobless claims have remained near 3.5 million. This stands in sharp contrast to the record of 23.1 million in June 2020. A year prior to the pandemic, continuing claims averaged at 1.7 million per month. In the prior recession, continuing claims reached a peak of 6.6 million.

We see signs of accelerating improvement in the labor market. At the start of 2021, U.S. initial jobless claims remained close to one million filings. More recently, that figure fell to 376,000, well below the near-term peak of 6.1 million. The long-term average for initial jobless claims is 363,000, or nearly on par with current readings.

However, prior to the pandemic, the U.S. experienced its best job market in nearly 50 years. Unemployment stood at 3.5%. Initial jobless claims were close to 200,000, and the median duration was 20 weeks. Current readings, while improving, suggest full employment remains several quarters away.

Job Openings and Firings

However, there are several "green shoots" in different labor market readings. The Job Openings and Labor Turnover Survey, or JOLTS, suggests we are closer to full recovery than nonfarm payrolls would imply. The U.S. labor market has always been dynamic.

There are millions of layoffs and quits each month, and millions of hires offset them. The net result is the monthly change in nonfarm payrolls, announced on the first Friday of every month. In the most recent report, there were 6.075 million hires and 3.952 million quits.

Generally, people leave jobs when they are confident they will find another. Or, they already have one lined up. During the 2008-09 recession, national quits dropped to 1.55 million, compared to the 20-year average of 2.66 million. In April 2021, quits jumped to 3.95 million. In the strong labor market of 2019, quits averaged 3.51 million. The San Francisco Federal Reserve believes people are quitting their jobs because more skilled positions are available.

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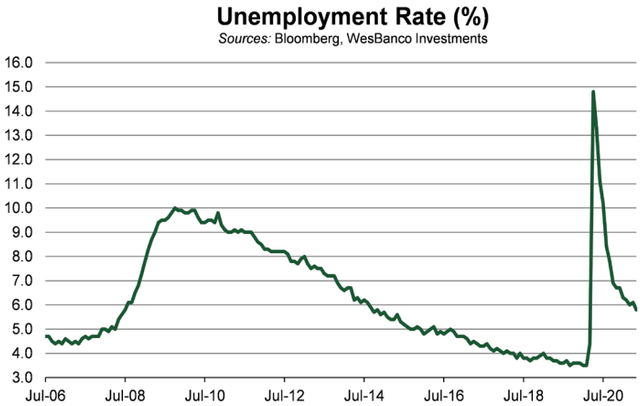
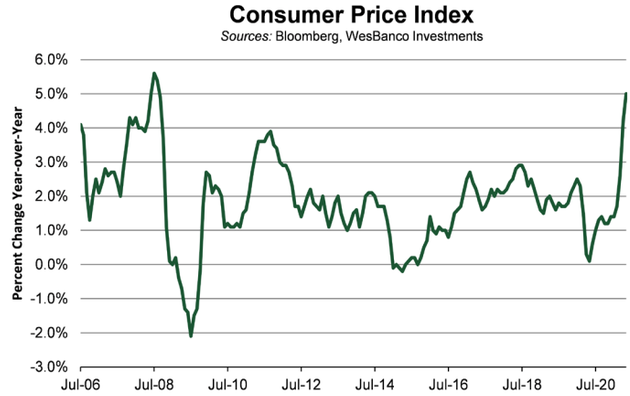
Economic Outlook (Cont'd from pg. 1)

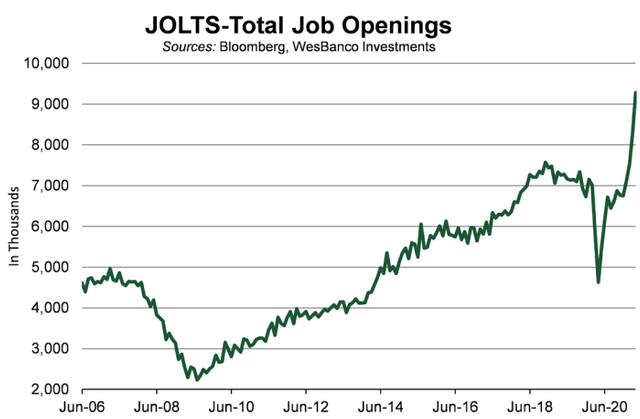




Should their thesis hold true, it signals a tight labor market — not one that is years away from full employment. From the employer perspective, it is generally cheaper to hire someone that is unemployed than someone who is already working. For the employee, competition for their skills generally brings higher pay, better hours or benefits, or signing bonuses.

The total number of job openings support the labor market. Generally, job openings fall in a recession, and rise in a recovery. In this recovery, economic activity has picked right up where it left off. Examples include the housing market, retail sales and manufacturing activity. In April, the JOLTS report showed a total number of job openings of 9.29 million. This exceeds the prior cycle peak by 66%.

Despite higher unemployment, key labor readings suggest the labor market is close to full employment.



Inflation Concerns

Inflation is on everyone's mind. The Federal Reserve says elevated readings are "transitory," or expected to be brief. In their view, the lockdown temporarily drove prices down a year ago, as activity recovered. Then, prices followed upward, and now year-over-year comparisons are extremely difficult. For example, in May 2020, airline fares, as measured by the Consumer Price Index (CPI), fell 28.5% on a year-over-year basis. During the lockdown, airline fares fell on a year-over-year basis for 13 consecutive months. In May 2021, airline fares rose by 24.1% compared to the prior year. These readings pushed the May Consumer Price Index (CPI) up 5.0% compared to the prior year, its biggest jump since 2008. The year-over-year comparisons will become easier in July. At that time, we will see if inflation is "transitory" or persistent.

The Federal Reserve maintains a dual mandate for full employment and price stability. That said, it worries a tight labor market will lead to wage inflation.

Interest Rates Outlook

Though the Federal Reserve believes recent inflation is transitory, it maintains a focus on long-term inflation expectations. Federal Reserve Chairman Jerome Powell acknowledged that the economy has improved. Now, future Federal Reserve meetings may contain discussion about reducing bond purchases. For the time being, though, the Federal Reserve will keep buying $120 billion in Treasury and mortgage securities per month. Chairman Powell has made it clear that the Federal Reserve will only reduce bond purchases after it provides notice "as far in advance as possible." We expect such notice by this Fall, with a reduction by the beginning of 2022, maybe sooner.

We focus on the "dot plot," or forecasts from policymakers, when it comes to short-term rates. For 2022, seven Federal Reserve policymakers are now in favor of at least a 25-basis point rate increase. Previously, there were four policymakers. For 2023, 13 of 18 policymakers support an increase. The "median dot" suggests the Federal Reserve will raise rates twice (for a total of 0.50%) in 2023.

Summary

The economic recovery within the U.S. is well underway. Vaccination rates are above other well-developed countries, while the supply of vaccines outstrips demand. As vaccination levels move closer to 70%, easement of restrictions will likely accelerate. This should release pent-up demand into services and push the U.S. economy back above prior cycle peaks. This will likely put further pressure on the labor market. As the competition for labor intensifies, wages will likely increase. On a year-to-date basis, the average hourly earnings for all employees have increased by 3.4%, slightly above the long-term average of 2.7%. Should this trend continue, it may result in higher inflation.

Former Federal Reserve officials believed inflation and unemployment had a stable and inverse relationship. Stated another way, as unemployment dropped, inflation increased by a similar amount. However, as the economy recovered from the 2008-09 recession, inflation never consistently moved above a targeted range. Reviewing the current economic data, we believe a certain amount of inflation is transitory; however, a portion of higher prices will remain as the economy improves.

The consensus view suggests the U.S economy will expand at its fastest rate in nearly 40 years.

Uneven hiring, which we expect for the rest of the year, may result in increased volatility within equity and fixed-income markets. However, the Federal Reserve will remain accommodative until the labor market reaches full employment. It will likely keep a lid on interest rates until late 2022. At that point, the recovery will be two years old, and the economy will be well positioned for higher rates.

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