ECONOMIC & INVESTMENT PERSPECTIVES

JULY: US GDP GROWTH STRONG, BUT WORRISOME?

Figure 1: 7/31/2021 Returns (source: Bloomberg)

Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	YTD	1YR	Current vs. 52-wk High	Current vs. 52-wk Low
US Aggregate Fixed Income	AGG	1.1%	-0.6%	-0.8%	-2.7%	2.9%
Investment Grade Corp Bonds	LQD	1.4%	-0.4%	0.7%	-2.4%	6.3%
U.S. Treasury Bonds	GOVT	1.2%	-0.8%	-3.1%	-4.2%	3.2%
20+ Year Treasury Bonds	TLT	3.7%	-4.5%	-11.3%	-13.2%	12.3%
Muni Bonds	MUB	0.5%	1.3%	2.6%	-0.4%	2.3%
High Yield	HYG	0.1%	2.7%	7.6%	-0.3%	6.4%
Non-US Corp Bonds	IBND	1.1%	-3.0%	3.0%	-4.6%	4.2%
Emerging Markets Bond LC	EMLC	-0.5%	-4.2%	3.4%	-7.2%	2.5%
Global Equity						
ACWI Global Equity	ACWI	0.9%	13.4%	33.4%	-0.8%	33.0%
United States	VTI	1.7%	17.2%	38.9%	-0.9%	39.2%
International Developed	EFA	0.8%	10.4%	31.1%	-3.2%	30.4%
Emerging Markets	EEM	-6.4%	0.3%	21.0%	-11.5%	22.0%
Global Equity by Region						
United States	VTI	1.7%	17.2%	38.9%	-0.9%	39.2%
Europe	IEUR	1.7%	15.3%	35.1%	-2.7%	38.6%
Asia ex-Japan	AAXJ	-7.1%	-1.7%	18.6%	-14.3%	18.7%
China	MCHI	-13.5%	-11.8%	0.6%	-26.9%	7.7%
Japan	BBJP	-0.5%	0.3%	25.7%	-6.2%	24.8%
Latin America	ILF	-5.8%	2.4%	29.8%	-8.7%	44.0%
US Equity						
US S&P 500	IVV	2.4%	18.1%	36.4%	-0.7%	37.2%
NASDAQ 100 QQQ	QQQ	2.9%	16.5%	37.9%	-1.2%	40.2%
US Large Growth	IWF	3.4%	16.7%	36.5%	-1.3%	38.0%
US Large Value	IWD	0.9%	17.9%	39.1%	-2.1%	40.9%
US Eqwt S&P 500	RSP	1.3%	20.6%	45.1%	-0.6%	47.5%
US Mid Cap	IJH	0.4%	18.0%	46.9%	-2.9%	53.3%
US Small Cap	VTWO	-3.6%	13.2%	51.8%	-5.7%	55.6%

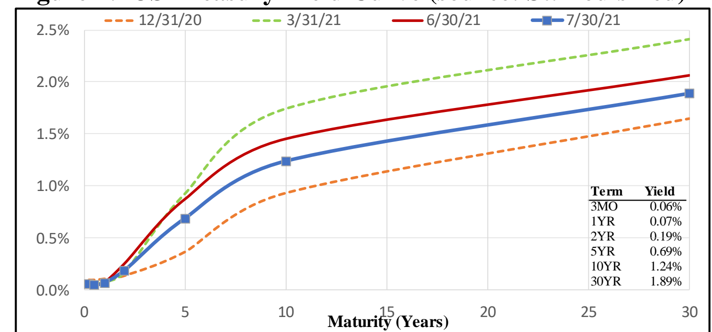
Interest rates declined in July as inflation concerns gave way to worries over economic growth amid rising virus cases and stubbornly stagnant vaccine progress. Global stock returns were mixed with a more defensive tone. Performance highlights for the month and 2021 year-to-date (YTD) are summarized below.

- Bonds: The US Aggregate index (AGG) rose 1.1% this month (-0.6% YTD) as interest rates fell. Long-term Treasuries (TLT) rose 3.7% (-4.5% YTD) while corporate bonds (LQD) were up 1.4% (-0.4% YTD). Non-US bonds (IBND) gained 1.1% (-3.0% YTD); emerging market debt (EMLC) lagged.
- Global equity (ACWI): +0.9% this month (+13.4% for YTD).
- US Equity: The broad market (VTI) rose 1.7% in July (+17.2% YTD). A defensive bias was evident in July as the S&P 500 (IVV +2.4%) out-performed small (VTWO -3.6%) and mid cap stocks (IJH +0.4%), and Growth (IWF +3.4%) out-performed value stocks (IWD +0.9%). Sector leaders included health care, real estate, utilities and technology, while energy and financials logged negative returns for the month.
- Non-US Equity: Developed markets (EFA) gained 0.8% in July (+10.4% in YTD), led higher by European stocks (IEUR), while Japanese stocks (BBJP) fell marginally. Emerging markets (EEM) were down 6.4% (+0.3% YTD), largely due to weakness in China (MCHI), which was -6.4% (+0.3% YTD) after Beijing threatened more regulation of tech companies.

Interest Rates and the Economy

Interest rates declined again this month as slowing growth outweighed inflation concerns. Figure 2 graphs the US yield curve, which plots yields (Y-axis) for various maturities (X-axis) of US Treasuries. Short-term yields remain near zero while long-term rates have moved lower, flattening the curve. The US 10-year bond yield fell from 1.45% to 1.24% in July as the Federal Reserve (Fed) reiterated its accommodative policy. Weaker-than-expected GDP growth (page 2) validated the growth concerns.

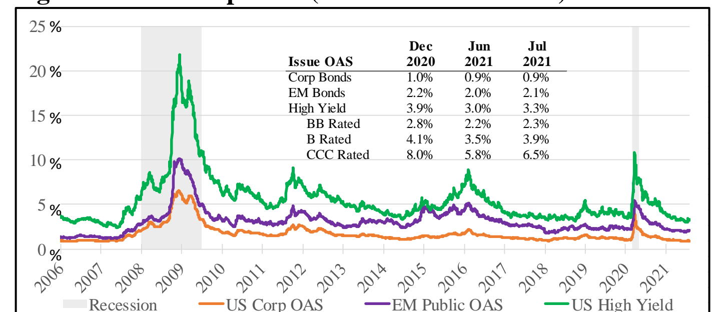
Figure 2: US Treasury Yield Curve (source: St. Louis Fed)



For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between yields and Treasuries of comparable maturities. Low or narrowing spreads signal optimism while high or rising spreads signal fear. Spreads widened marginally this month, confirming the moderate "risk off" tone of the markets.

- Investment grade corporate bond spreads were stable last month at 0.9% versus 1.0% at the 2020 year-end.
- High yield (non-investment grade) spreads widened to +3.3% but are well below year-end spreads of +3.9%. The riskiest bonds (rated CCC & below) yield +6.5% over Treasuries, up from 5.8% last month but below year-end levels of +8.0%.
- Emerging market bond spreads widened slightly to +2.1% this month but are still tighter than at year-end. The stability of these spreads in a declining interest rate environment means that non-U.S. yields have fallen along with those in the U.S.

Figure 3: Credit Spreads (source: St. Louis Fed)

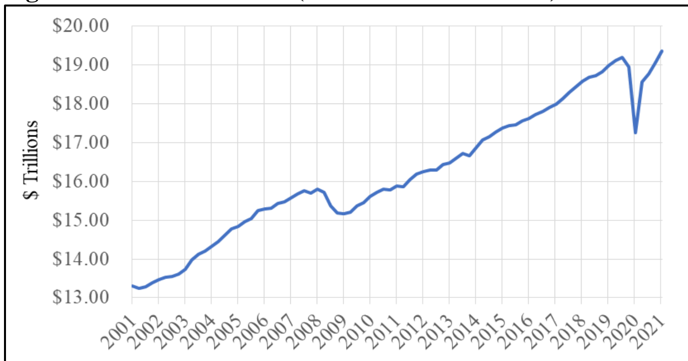


Peak U.S. Real GDP Growth?

The National Bureau of Economic Research (NBER) announced recently that the pandemic-induced economic recession in the U.S. officially ended April 30, 2020, making it the shortest recession on record (two months). That means that the new economic cycle/expansion has been underway for 15 months. Recently, however, the markets have taken on a more defensive tone, likely in anticipation of slowing economic growth amid renewed virus concerns. Despite a strong economic recovery and rising inflation in recent months, both of which should cause interest rates to rise, yields have declined from Q1 highs (see Figure 2 on prior page); bond investors are looking past current data and forecasting lower future growth and inflation. Equity returns have continued to be positive in aggregate, but the rotation underneath has favored defensive market segments (large, quality growth, less volatile sectors like utilities) over more economically-sensitive areas (value and small stocks, energy and financial sectors).

The recovery from last year's recession has been swift. The U.S. Bureau of Economic Analysis (BEA) recently reported that real GDP grew at an annualized pace of 6.5% in the second quarter (Q2). (Note: Real GDP stands for Gross Domestic Product, the value of all final goods and services produced in the US, adjusted for inflation.) This marks the fourth straight quarter of strong growth and a notable milestone: For the first time, the US economy has surpassed its pre-pandemic size (Figure 4).

Figure 4: U.S. Real GDP (source: St. Louis Fed)

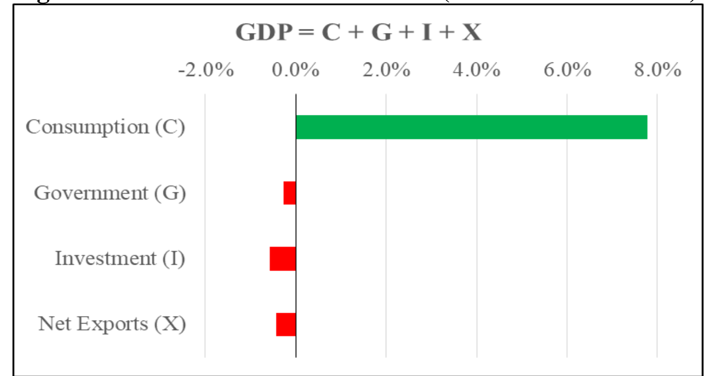


Looking beyond the headline numbers offers some cause for concern. First, while Q2 growth was solidly positive, it fell well short of economists' expectations of over 8% annualized growth. The sources of growth are also instructive. GDP can be subdivided into four major sub-components:

- **Personal Consumption:** 69% of the U.S. economy is powered by the aggregate expenditures of individual consumers.
- **Government expenditures:** 18% of GDP is driven by direct spending by federal, state and local governments. (Note: This does not include the billions of dollars transferred to citizens in the form of relief payments and extended benefits in the wake of the pandemic; these are included under Personal Consumption Expenditures if and when that money is spent.)
- **Private Investment:** 17% of the economic output comes from the expenditures and investment activity of businesses, including construction, equipment, manufacturing and inventories.
- **Net Exports:** The net value of U.S. exports minus imports (trade deficit) is a drag on our economy, currently -4% of GDP.

Figure 5 breaks down the Q2 real GDP growth of 6.5% by contribution from these four major sub-components.

Figure 5: Real Growth Contribution (source: St. Louis Fed)



It is clear that Q2 economic growth in the U.S. was entirely driven by consumer spending; the other three categories were negative contributors to growth in Q2. U.S. consumers have been flush with cash, given the hundreds of billions of dollars in pandemic relief and extended unemployment benefits. These transfer payments have worked exactly as intended: The government put money in consumers' pockets, consumers spent the money, and the economy boomed. In order to keep the economy growing, either the government needs to continue doling out free money, or the other segments of the economy need to ramp up:

- Government expenditures on defense and infrastructure should benefit employment and economic growth.
- Business investment should improve as supply chain disruptions decline over time, increasing U.S. manufacturing and production (e.g. autos and computers as the semiconductor shortage eases) and reversing the drag of inventory drawdowns.
- Net imports are a drag on our economy, but increased economic activity can reduce the trade deficit over time.

Bottom Line

Rhetoric concerning rising inflation, tapering (when the Fed will lessen its influence over interest rates by reducing or eliminating its $120 billion monthly bond purchases, and the debate over massive government spending, debt and deficits misses an uncomfortable truth: The economy is not yet self-sustaining, and it won't be until vaccination rates rise and virus cases fall. The story is similar in other economies around the world as a resurging, mutating virus threatens economic recovery in Europe, Japan, Asia and South America (Figure 6). While we do not expect a repeat of 2020 lockdowns and economic calamity, more time and work will be needed before the Fed, global central banks and governments can scale back monetary and fiscal stimulus. Markets are likely to remain volatile as economic activity, employment, inflation and interest rates seek self-sustaining equilibrium, underscoring the value of a diversified investment portfolio.

Figure 6: Virus Cases (source: www.ourworldindata.org)