Economic Outlook

The U.S. economy has had its foot on the gas pedal since its sustainable reopening that began this past spring, with economic growth forecasts consistently revised higher amid elevated consumer confidence and improving activity metrics.

Given the resilient macroeconomic backdrop, the equity market was full speed ahead as the S&P 500 notched its seventh consecutive month of positive returns in August.

However, given the multitude of critical economic, political, and monetary policy events this month, this near-term gridlock should not lead to a premature end to the bull market. Rather, strong fundamentals suggest that patience will see the economy and equity market regain their speed as we go into 2022.

The fundamental factors supporting the continuation of the bull market far outweigh the short-term risks.

First, the Federal Reserve (Fed) confirmed an above-trend economic growth for the year ahead as it raised its 2022 GDP forecast from 3.3% to 3.8%.

Second, the streak of above-average earnings growth should continue through next year, with the projection of 15% earnings growth nearly double the average over the last 15 years.

Third, equity valuations, albeit high from a historical perspective, remain attractive relative to bonds.

And finally, companies are continuing to engage in shareholder-friendly actions.

At the Jackson Hole Symposium, Fed Chairman Powell continued to be transparent as he announced that economic conditions warranted the tapering of asset purchases, likely before year end.

Investors immediately looked to the September Federal Open Market Committee (FOMC) meeting for additional guidance and clarity.

As expected, the Fed continued to exercise caution due to the Delta variant and reiterated the definition between tapering and tightening (e.g., raising interest rates), an incredibly important distinction for markets to embrace.

Regardless of whether the official tapering announcement comes in November, as anticipated, with the first reduction in December, it is important to remember that the current pace of purchases is for emergency-use only and that an accommodative Fed will continue to be a tailwind even as quantitative easing is dialed back.

Senate Republicans strongly oppose the Democrats' proposed legislation that would tie the debt ceiling increase with emergency funding for natural disasters and Afghan refugees.

But as partisan as politics have become, cooler heads are expected to prevail and avoid a government shutdown and the first ever debt default.
It is important to dismiss the myth that a hostile government shutdown would result in a dramatic decline in equities.

Since 1980, there have been 15 shutdowns, with the median shutdown lasting a mere three days and while the S&P 500 declines in the week preceding the closure, the S&P index has rallied over 3%, on average, in the 30 trading days following.

The Delta variant temporarily slowed economic momentum, but limited shutdowns prevented a repeat of the catastrophic decline experienced last year.

While the Fed lowered its 2021 GDP projection for the first time in a year, the economy is still on pace for the best year of growth since 1984 as progress indicators remain elevated even during this surge.

The S&P 500 flirted with its first 5% pullback in more than 10 months in September, which would have ended the second longest stretch over the last 25 years.

While the equity market rebounded and quickly erased most of the decline, we continue to exercise caution in the near term, especially as we enter the seasonally weakest part of the year.

However, given continued robust economic growth and no signs of a recession, our bias is to hold existing equity exposure or add opportunistically on weakness.

It is important to avoid panic selling for two key reasons. First, we are currently in a seasonally weak period, which is followed by the seasonally strongest time of year, mid-October through year end.
And second, it historically takes 2 months to recover from a 5-10% pullback and ill-timed decisions can be detrimental to a portfolio.

In summary: The Federal Open Market Committee signaled that, if the economy continues to progress, a moderation in the pace of asset purchases may soon be warranted and would be most likely announced at the November policy meeting.

Officials have lowered their expectations of 2021 GDP growth to 5.9% versus 7.0% in June and raised their inflation forecasts to 4.3% versus 3.4% in June. They expect inflation to fall back to 2.2% in 2022 and 2023.

While the Fed is far from raising short-term interest rates, expectations of lift-off were moved forward.

Finally, politics are having a lesser-than-normal effect on markets, and we would note that the lack of a market reaction could prolong the politicking, as previous market pressure has been a forcing mechanism on Congress to resolve disputes.