The Family Office at Synovus

Empowering enterprising families to thrive. Together.

Economic and Investment Outlook For 2nd Half 2021

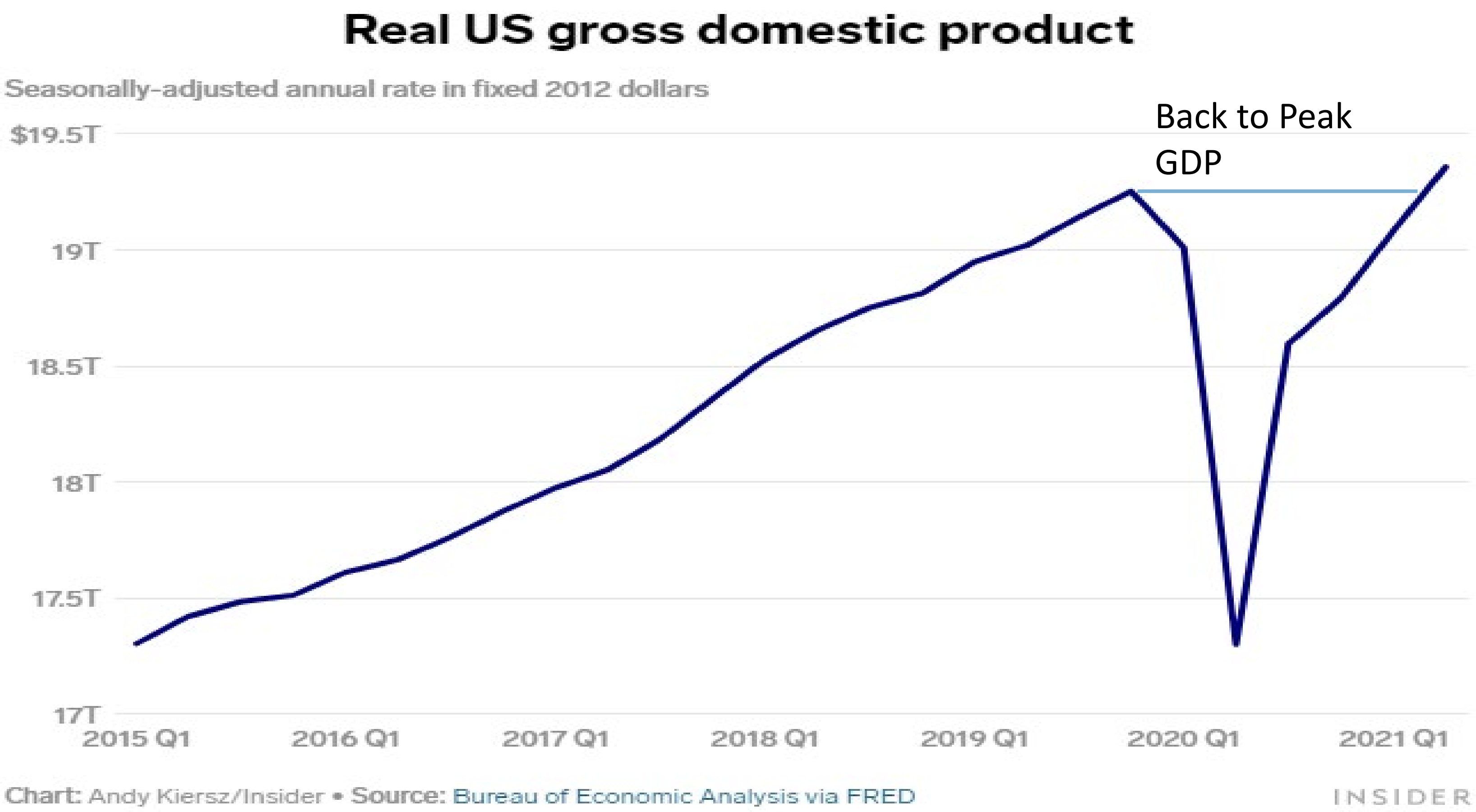
Over half of the U.S. has been vaccinated, and the reopening of the economy is in full swing. With holdouts and the Delta variant becoming the prevalent strain, more uncertainty and volatility have worked their way back into markets. First and Second quarter Real GDP increased at about a 6.5% annualized rate, and inflation picked up more than expected. The U.S. economy regained the full GDP decline from the first half of 2020 a little more quickly than expected due to a swift vaccine roll-out and record stimulus. Strong GDP growth and higher inflation were anticipated for the first half of 2021, but estimates for the second half of 2021 and beyond have become less certain. Inflation has gone up 5.4% over the past year with core prices (*e.g.*, food and energy) up 4.5%. We see both GDP growth and inflation moderating in the second half of the year.

While the U.S. economy is closer to being open fully, challenges continue in travel and entertainment industries, including demand and hiring. In most of the economy, we see full employment in higher earning job categories, while those earning less than $27,000 per year are well below 2019 levels. Filling jobs is still hard for lower-paying positions in restaurants and hotels. This is partially due to unemployment benefits being better than the working wage and partially due to workers not being comfortable working in close proximity to customers who may or may not be vaccinated. While some states have already dropped the extra unemployment benefits, the program will come to an end in September for the rest. In the fourth quarter, we will learn if unemployment will revert to where it was pre-Covid, or if permanent damage has been done that will keep the participation rate down.

It was pretty much a given that the economic loss from Covid would be made up in 2021 with the massive amount of fiscal and monetary policy that had been unleashed. The big question outstanding is what does growth look like going forward as things return to normal? We are left with historically low rates and historically record high debt. With over a decade of living with QE and other monetary tools to keep the economy growing, many believe it is now time for rates to move higher with a return to normal monetary policy. We continue to be in the camp of lower rates for a longer period of time, and we are likely to see financial repression for the foreseeable future. U.S. stocks are primed for record earnings but have been pushed to record valuations. Low interest rates and higher inflation should present an opportunity for selective assets to move higher. We are likely to see companies with pricing power do well, while those who can't pass on higher input costs struggle.

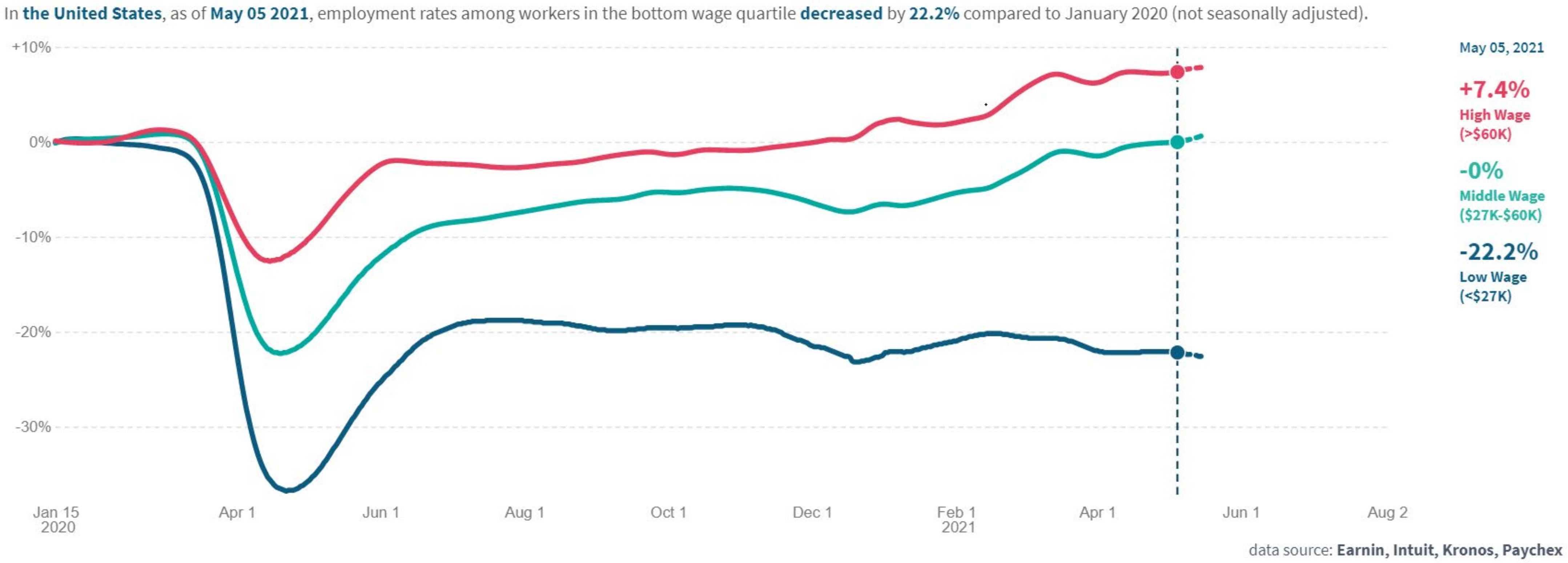
Back to Peak GDP

Real GDP returned to its prior peak in the 2nd quarter of 2021 thanks in part to a quick vaccine roll-out.



Employment Recovery

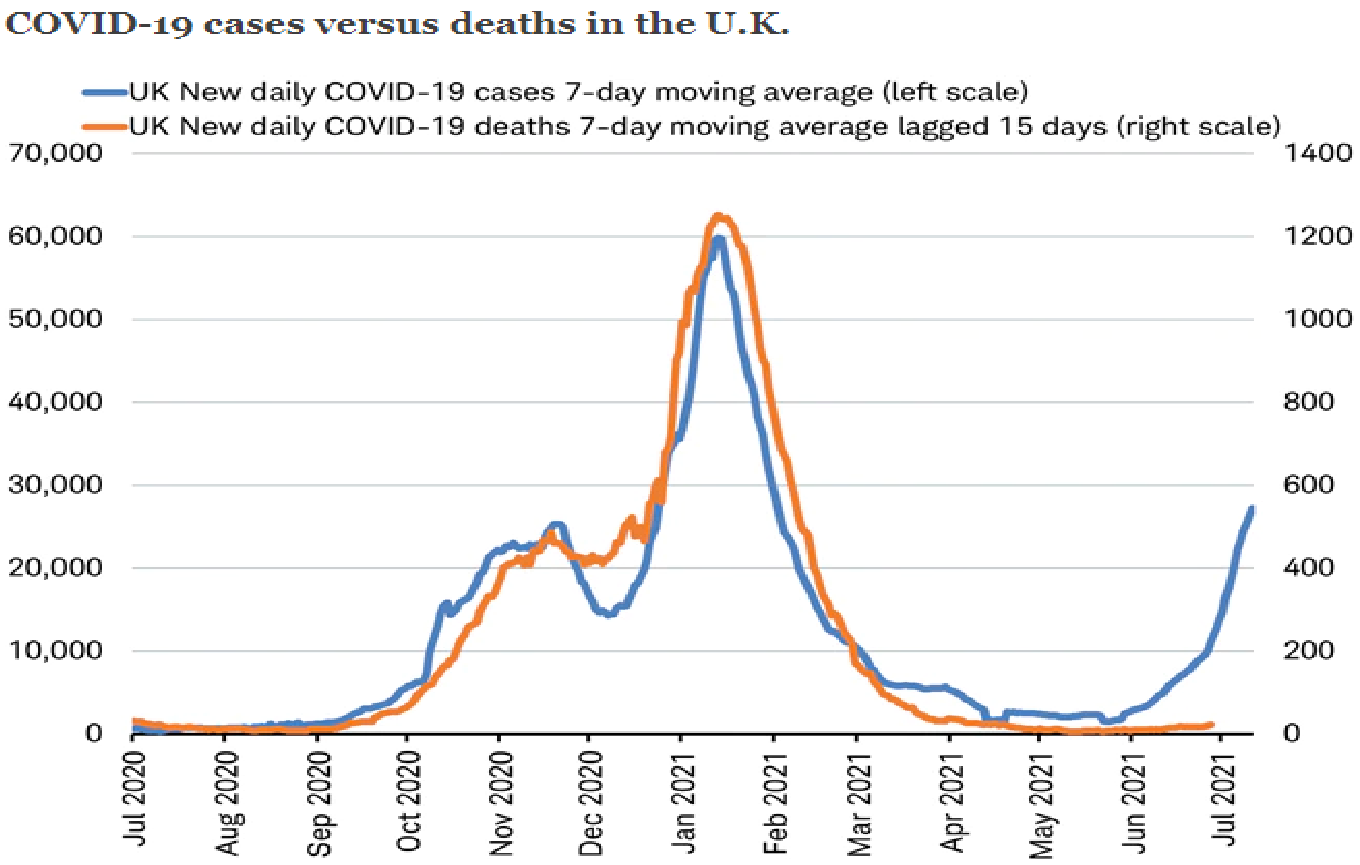
Employment for the highest wage-earners has increased, with middle-wage employment fully recovered. Low-wage employment is still off over 20%.



Source: Tracktherecovery.org

Delta Variant

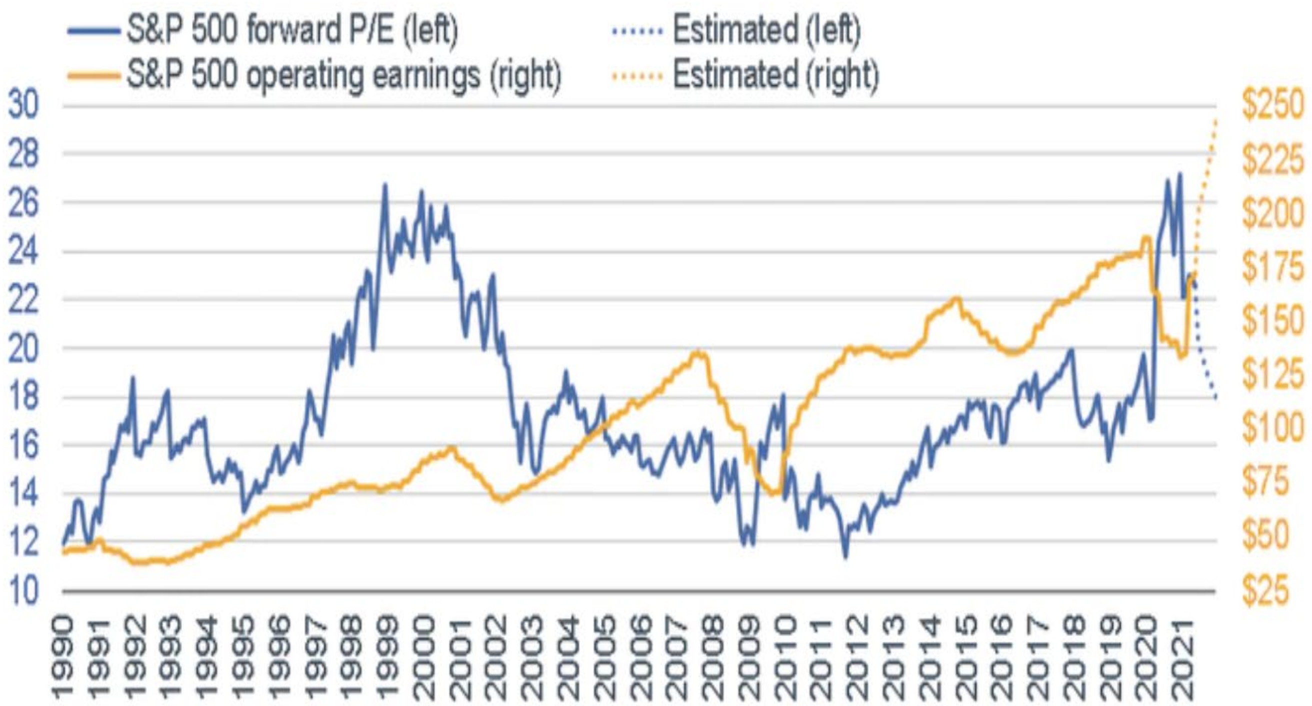
While the Delta variant has led to a significant rise in Covid cases, the experience from the U.K. is that it is significantly less lethal. This may lead to a delay in full economic opening, but we are not likely to go back to strict lockdowns.



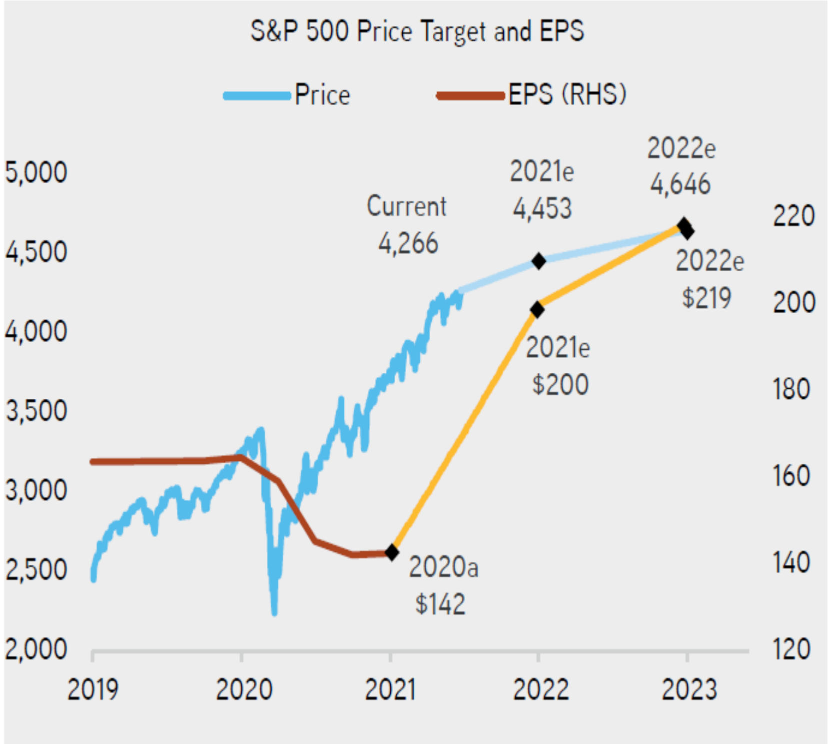
Source: Charles Schwab, Bloomberg data as of 7/12/2021.

Equity Earnings

Estimates for S&P 500 earnings are expected to exceed $200 per share in 2021 and $220 per share in 2022. If that plays out, there is still room to move higher if interest rates are to remain low.



Source: Schwab



Data as at June 28, 2021. Source: S&P 500, KKR Global Macro & Asset Allocation analysis.

Growth

While most recessions are different in their own way, the recession of 2020 was unprecedent in many ways. This recession was due to the voluntary shut down of the global economy to fight a pandemic. Massive amounts of liquidity and stimulus were injected to help smooth the downturn, while technology allowed for higher wage-earners to continue to work from home. While working from home, they did something that is unusual during a recession, they purchased significantly more durable goods than they ever have (exercise equipment, furniture, lawn and garden supplies, boats, RV's, *etc.*). In typical recessions, durable goods get hit hard but then help lead the next recovery. The part of the economy that suffered the most makes up about 4% of GDP (Travel, Restaurants, Live Entertainment). While consumers will defer purchases on a car or furniture, it's hard to make back travel and eating out. As David Rosenberg of Rosenberg Research mentions in a recent piece, "We've never before seen a recovery hinging on restaurants, theme parks and hotels." With so much durable goods purchases being pulled forward, we are not likely to get the same type of recovery we normally do.

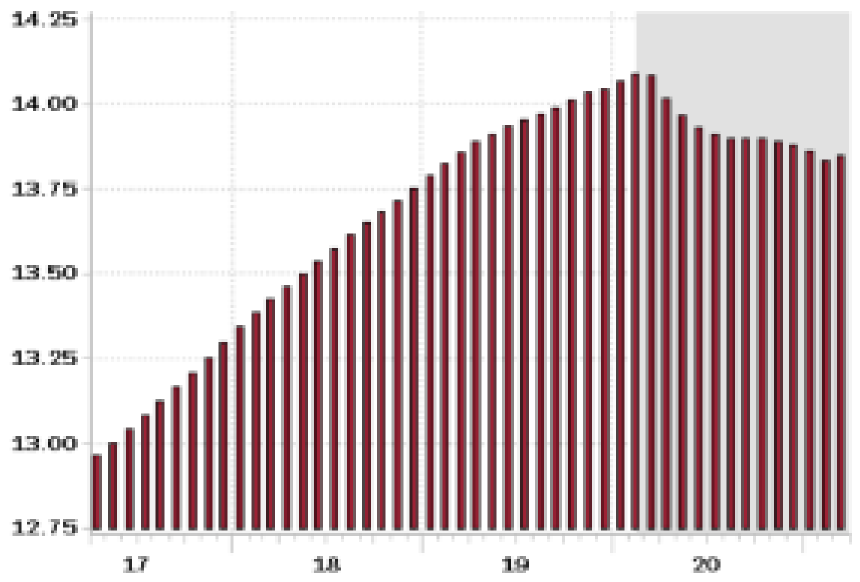
We see GDP moderating, but still ending the year up 6%-6.5%. Beyond 2021 and the first half of 2022, GDP will likely revert to the 2%-2.5% range.

Source: ^ rosenbergresearch.com "No New Eras" May 2021

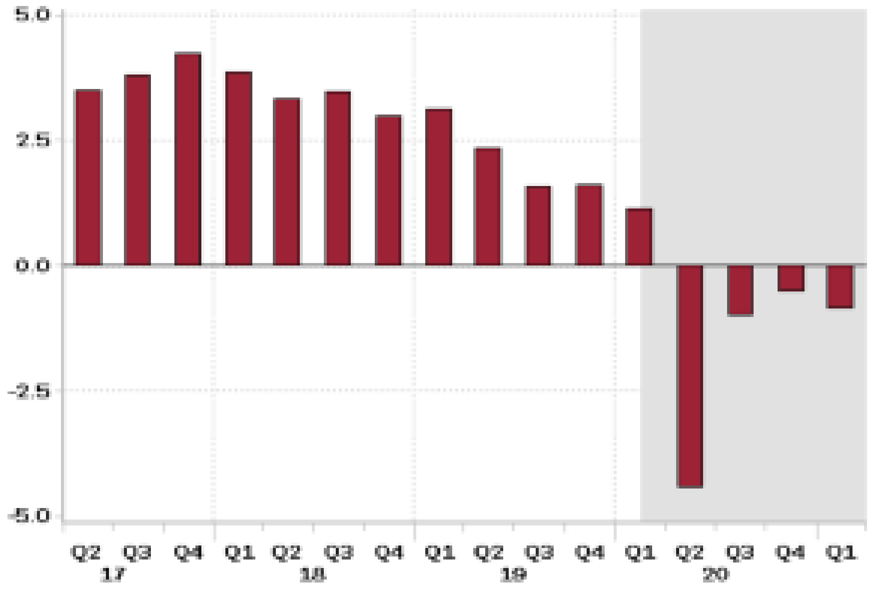
Personal Income

While household income is up significantly, it has been because of government transfer payments (stimulus checks). Under the surface, real personal income has declined. How will consumers react with less government help?

United States: Real Personal Income
Excluding Current Transfer Receipts
(12-month moving average; $ trillions; SAAR)



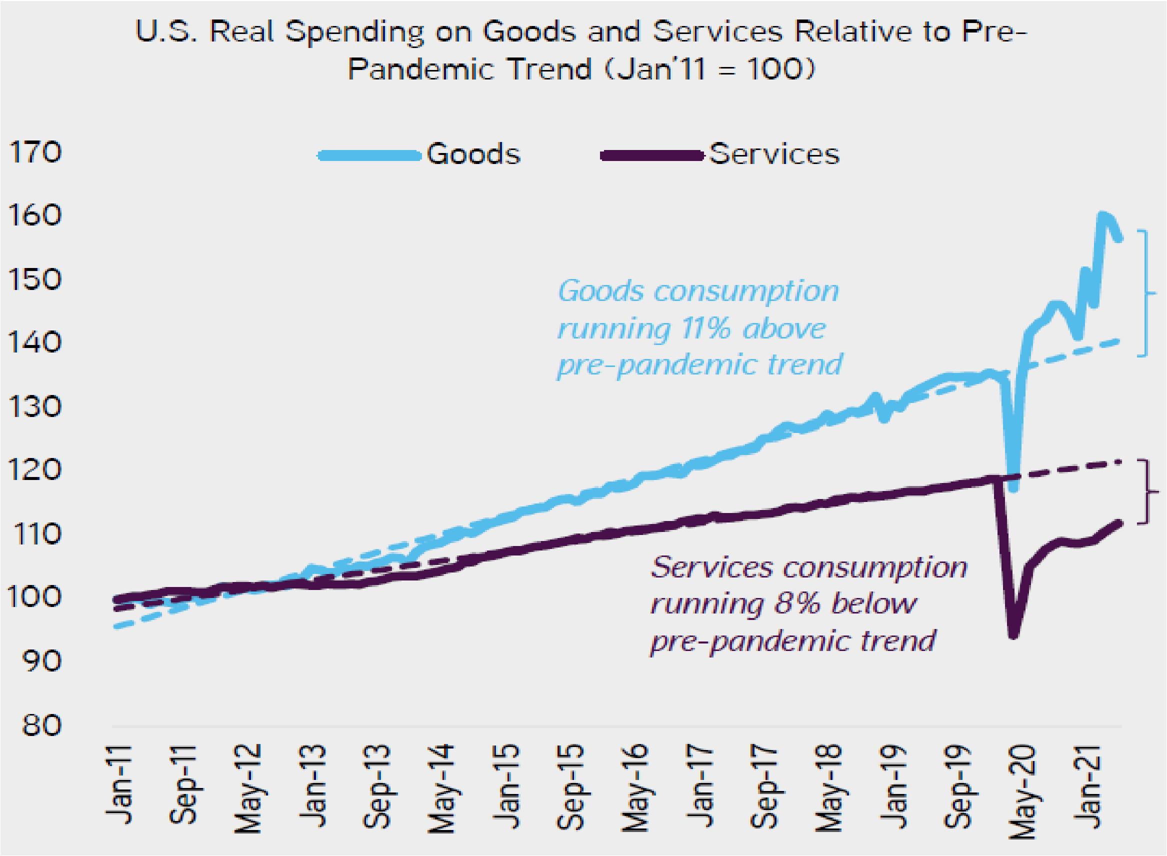
United States: Real Personal Income
Excluding Current Transfer Receipts
(year-over-year percent change)



Source: Rosenberg Research

Goods vs. Services

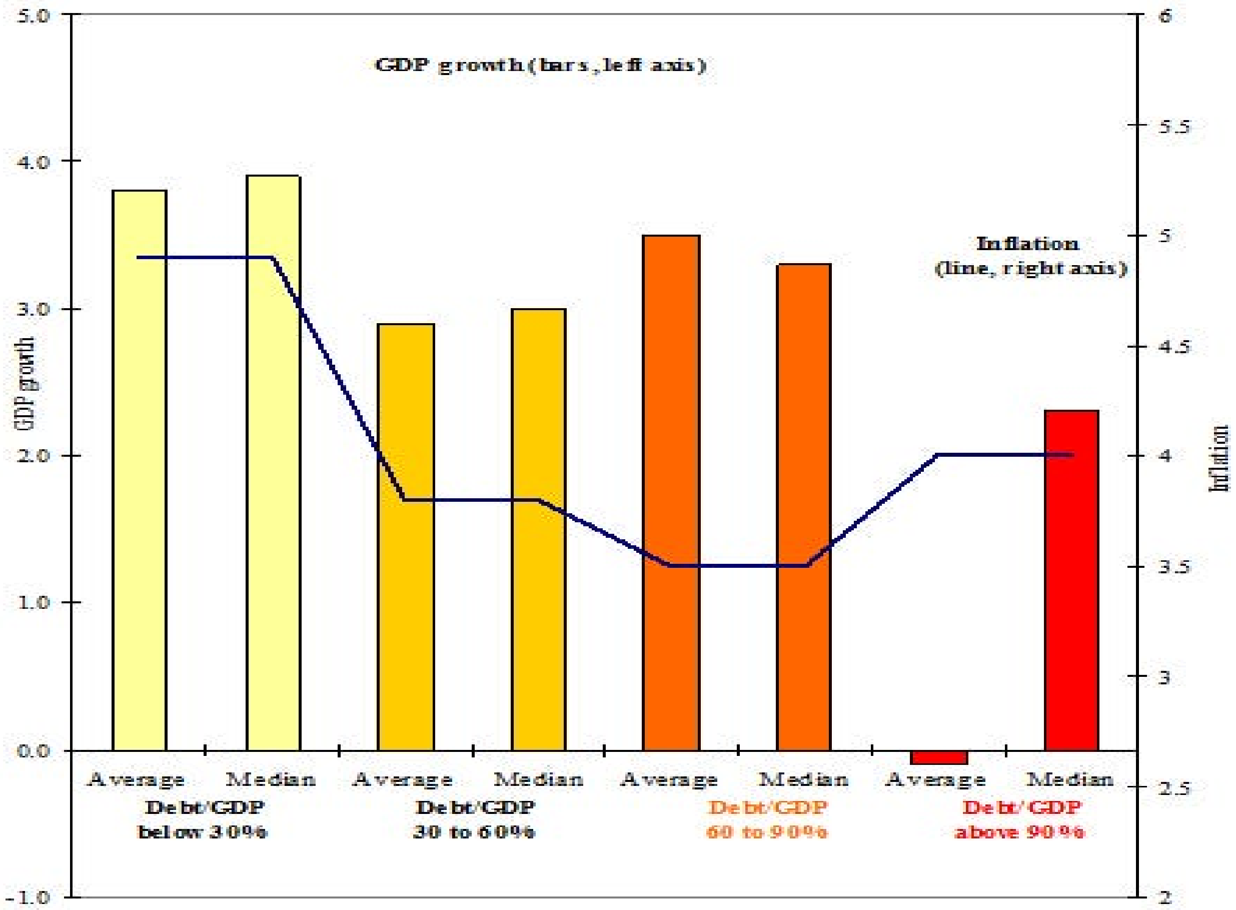
While goods consumption is above pre-pandemic trend, services consumption is still running below trend. It remains to be seen how much services consumption can be made up in a year. How many vacations can one cram into a year to make up for the lost ones?



Data as at July 13, 2021. Source: BEA, BLS, Federal Reserve, Haver Analytics.

Inflation and Interest Rates

As U.S. Debt to GDP goes above 100%, the likelihood of lower growth and higher inflation increases. When Debt/GDP is over 90%, GDP growth is 2.5% or less with inflation running around 4%.



Source: Carmen Reinhart and Kenneth Rogoff

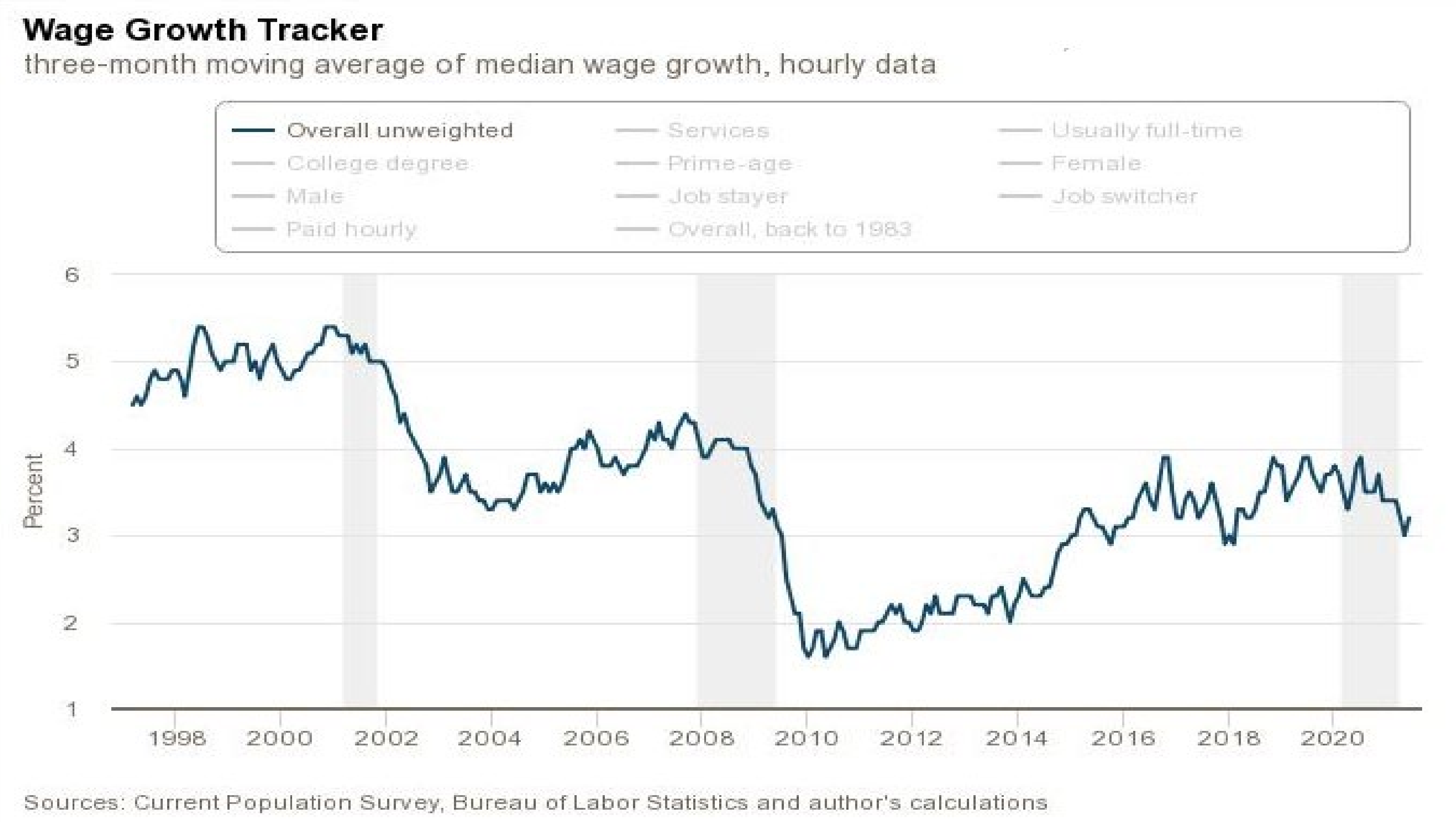
Inflation and Interest Rates

As expected, inflation picked up significantly compared to a pandemic-weakened 2020. While higher levels were expected, the 5.4% increase in June was higher than consensus. Much debate has been going on around transitory versus sustained inflation. While material prices and goods shortages developed due to the disruption in the supply chain, most supply chain issues will be resolved. China has not brought on supply as quickly as in the past, but there are incentives for companies to balance supply with demand. While many commodity price increases will be moderated, it is not likely that they will go down as well. What we are likely to see is a shift to higher prices that tend to stick longer than in the past**. Inflation is likely to be between 2.5%-2.8% over the next couple of years.**

Few, if any, strategists predicted that inflation would spike to over 5% and that the 10-Year U.S. Treasury would yield less than 1.5%. Most investors believe that interest rates must go higher if inflation goes higher. History has proven otherwise. In a period of high Debt/GDP and low economic growth we have typically seen interest rates below the growth in Nominal GDP (before subtracting inflation). With rates at historically low levels, the servicing cost of U.S. Debt is lower than in previous periods. The U.S. has an incentive to keep rates below expected GDP growth and to generate a higher level of inflation. This will keep the Debt/GDP level from moving too far above the level to comfortably service interest payments. With monetary policy likely done in regards to generating economic growth, we expect to hear more talks of fiscal policy as the only way to jumpstart growth post Covid. The rationale is that more Government spending is needed to offset the decline in credit creation by banks. In the current environment there is less concern about crowding out the private sector. Product infrastructure has the ability to generate some additional growth, but the U.S. needs more productivity and likely a higher working population to generate meaningful long-term growth. **We continue to expect the U.S. 10 Year Treasury to stay under 2% for the rest of the year.**

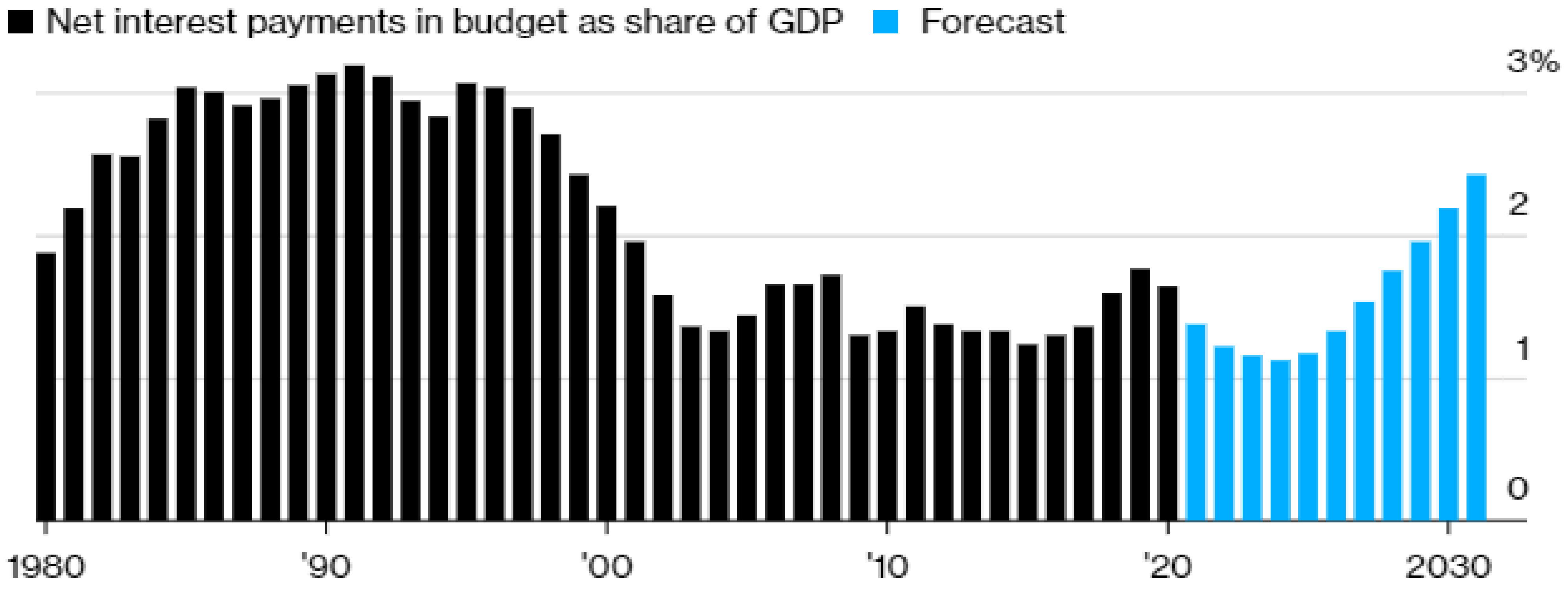
Wage Growth

Inflationary pressures typically arise from strong increases in wages. So far, we haven't seen major gains, but as benefits begin to phase out and more workers come back into the employment pool, we will see if wage pressures emerge.



Debt Servicing

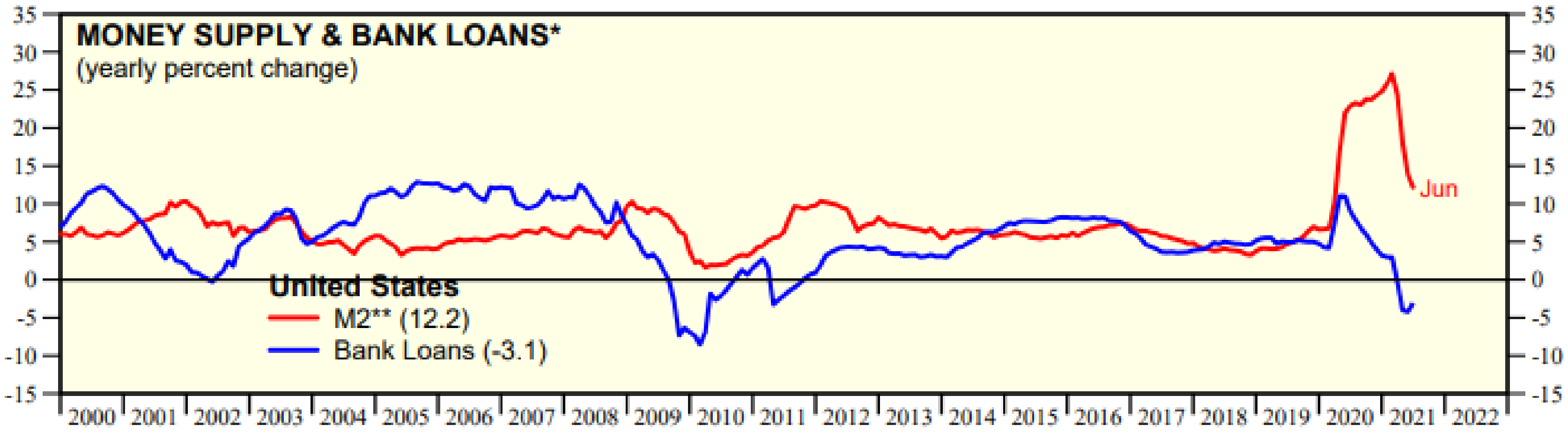
While much attention is paid to Debt/GDP, what is really important is the ability to service debt. Due to historically low interest rates the U.S. is able to service a Debt/GDP that is higher than in the past. Some estimates are as high as 150% to 200% before becoming problematic. Japan is above 250%.



Source: Congressional Budget Office
Note: Fiscal years

Money Supply and Credit

The money supply in the U.S. has grown dramatically, but it has not translated into growth in credit through the banks. Over $1Tn in excess deposits has been going back to the Fed in exchange for safe yield versus going into the economy in the form of credit.



Portfolio Positioning

- With accommodative global monetary policy and the willingness of governments to take on more debt financed fiscal stimulus, we continue to see opportunities in equities relative to fixed income. We are likely to see more dispersion from higher inflation translating into higher input costs for some and higher margins for others. Cyclical stocks, such as Industrials, materials and consumer discretionary paired with secular growth names in technology should see a favorable environment. Consumer staples and companies that are labor intensive will experience more headwinds.
- We continue to be overweight international stocks that are relatively cheaper than domestic stocks. Europe and Japan have lagged the U.S. in the speed of stimulus but are likely to catch up in the next year.
- We have added exposure to strategies that are highly correlated to inflation and increases in commodity prices within our hedge funds. The mining industry has received little capital for capex while the demand for metals continues to increase to accommodate the transition away from fossil fuels and less carbon.
- Within fixed income we are still focused on building out client portfolios targeting a 4-5 year duration. We continue to be conservative focusing on high quality municipal bonds, investment grade corporate bonds, U.S. Treasuries as the core and adding some active tactical strategies on the periphery. High Yield bonds offer little additional return for the risk, as spreads are at ten-year lows.

Disclosures

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