# THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – AUGUST 2021

**U.S. Markets and Economy**

August was another good month. U.S. stock indices all rose for the month, with the S&P 500 plowing right through 4,500 after a brief hiccup mid-month. What is even more impressive is that the S&P 500 has not had even a 5% pullback all year, during which time it has risen more than 20%—and this is on top of massive gains in the last eight months of 2020. The NASDAQ soared above 15,000, and the Dow Jones Industrial Average, the relative laggard, managed to hold above 35,000. The Russell 2000 index of smaller stocks also rejoined the party with a gain of almost 5% for the month, but this index has still not broken through its high set in March of this year.

News on the economy and corporate profits was also good. Although hiring gains were smaller in August (reported in early September), employment continues to grow, and the unemployment rate continues to tick down (reaching 5.2%). Corporate profits have soared as GDP has grown: GDP growth in the second quarter was a strong 6.6% (revised data), and economists estimate that the third quarter (July–September) will show a still-good but slower rate of real growth of 4%–6%. The expected slowdown, which has already appeared in the monthly employment numbers, reflects the resurgence of the Delta variant of the virus, which has pushed the U.S. case rate back to levels not seen since the winter peak before the spread of vaccination. The rise in cases, hospitalizations, and deaths has slowed the reopening process, strained medical resources in a number of states, and led to more restrictions on activities in many areas.

The spread of the highly transmissible Delta variant has also played havoc with supply chains around the world, which has created shortages in key areas, like semiconductors, and driven up shipping costs and shipping times. These disruptions have led to increases in the rate of inflation, whether measured by the consumer price index (CPI) or the broader personal consumption expenditures (PCE) deflator. Even the core PCE deflator (with food and energy stripped out), has been rising at a 3.5% pace. This rise in inflation was initially welcomed by the Federal Open Market Committee (FOMC), as its "target" of 2% inflation was undershot for many years. Now that the Fed is aiming for 2% inflation on average, some months above 2% are just fine as long as price increases settle back down to 2% in the long run. The path of economic growth and inflation will be the key determinant of future FOMC policy. Right now, the Fed and many

economists believe that much of the inflation "blip" is temporary, reflecting both "base effects" (prices were temporarily depressed last summer) and the supply disruptions created by the reopening of the economy.

Both stock traders and bond traders have bought into the Fed's forecast, simultaneously pushing up both stock prices and long-term bond prices. Stock prices would probably lose some steam if the FOMC were preparing to tighten monetary policy to keep inflation in check. In fact, the FOMC and Jerome Powell have said they have no plans to increase short-term interest rates for some time, and the Fed has not even started to reduce its $120 billion per month of quantitative easing (QE4). Powell and most FOMC members want to see the economy at full employment before they even begin to tighten. The strength in bonds, with the U.S. 10-year Treasury yield remaining around 1.3%, also suggests the rise in inflation is temporary.

**World Markets and Economy**

European economic growth has been less impressive than in the U.S., but growth rates picked up in the second quarter. Overall, European GDP should grow by 4%–6% annualized, with some countries, like Italy and Spain, growing much faster and others, like Germany, plodding along at a slower pace. The spread of the virus and the effects of supply disruptions have held back growth, as in the U.S. The STOXX Europe 600 index gained almost 2% for the month, and the gains among countries tended to mirror their economic growth rates. Italy was up close to 3% for the month (and up more than 19% so far this year), and Spain was also up close to 3% for a year-to-date gain of almost 30%. Germany gained about 2% for a more modest year-to-date gain of 15.5%.

Japan did manage to pull off a spectator-free Olympics, but the overall economic impact of the games was of course disappointing. Relief that the outcome was not even worse led to a "relief rally" of almost 3% for the month, but the Japanese Nikkei 225 index has managed a gain of only 6.5% for the year so far. Japanese stocks have been held back by weak economic growth, with second quarter GDP growing at an annual rate of only 1.3%. Japan is struggling with a record number of virus infections, which has partially shut down Tokyo and other areas. The vaccination rate there also lags behind the U.S. and Europe.

**Outlook**

Continued economic growth, surging corporate profits, and the prospect of continued monetary stimulus means that U.S. stocks can extend their gains. The major risks are if the Delta virus exerts (or even newer variants exert) a larger drag on economic growth or if inflation refuses to subside, which could spark a change in Fed policy. Short-term traders can create short-term selloffs just on rumors of either event, but long-term investors have earned their stripes riding out these brief squalls.

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