THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – OCTOBER 2021

U.S. Markets and Economy

October often gives U.S. stocks a Halloween fright—but not this month. All the unpleasantness of September was wiped out by a strong October rally that took the leading indices to new all-time highs. The rally continued in the first few days of November, with the Dow plowing through 36,000, the S&P 500 breaking above 4,600, and the NASDAQ soaring to new highs above 15,500. This time, everybody joined the party: the Russell 2000, a broad index of smaller stocks that had lagged the big-cap stocks all year, finally pushed above the 2,400 level at the start of November for a new all-time high.

The statement issued on November 3 by the Federal Open Market Committee (FOMC) summarized the good news: the economy is continuing to recover, the virus infection rate is dropping as the economy continues to reopen, and the Fed is commencing a much-anticipated tapering of its quantitative easing (QE4) monthly purchase of long-term securities. The previous time the Fed began a taper, stocks sold off in a "taper tantrum," so this time the Fed made sure everyone knew when the taper was starting and how gradual it would be. The result? No selloff. The Fed will reduce its monthly purchases by $15 billion each month, which will end the program next summer. Fed Chairman Jerome Powell has also stated the Fed will increase interest rates very gradually after that. This is catnip for traders who love low interest rates, and the Fed's predictions suggest that in real terms, after subtracting inflation, real short-term *and* long-term interest rates will remain below zero. Combine this benign monetary environment with soaring corporate profits and you have a recipe for a continued bull market in stocks.

Economic news has been more mixed, however: real gross domestic product (GDP) in the third quarter (July–September) only grew at a 2% annual rate, a sharp slowdown from the summer's red-hot pace. But part of this slowdown is a result of a surge in virus infections that peaked in late-September and has fallen sharply since. Fourth quarter GDP should show a rebound. Unemployment has dropped below 5%, and the Fed and many economists believe it can drop to 4% or even lower (it was as low as 3.5% just before the pandemic hit the U.S.). If the Fed is correct that inflation is elevated for transitory reasons, the FOMC can continue to drive the economy forward to meet its other objective in its dual mandate: "maximum employment growth consistent with price stability."

The fly in the ointment is indeed the rate of inflation. By the Fed's favorite measure, core PCE (the personal consumption expenditure deflator, excluding food and energy), prices are rising at about 3.6% at an annual rate. This is well above the Fed's old target of 2%, but the Fed's new target is probably a *range* of 1% –3%, which is how many other central banks target inflation. The argument for a return to 2% inflation (the middle of the range) is based on the belief that supply chain bottlenecks will be resolved in the next six months. If this turns out to be too optimistic, the Fed may be forced to raise interest rates sooner to cool off inflation, but such a move would jeopardize the return to full employment. This potential dilemma is a mild version of what the Feds faced in the 1970s and early 1980s, when the economy fell into recession while inflation soared to double digits. Thus, all of Wall Street will be parsing the data on these bottlenecks, and bad news could lead to short-term selloffs.

While the Fed has a sensible plan for monetary policy, the same cannot be said for fiscal policy. President Biden and Democratic leaders in Congress were able to pass the bipartisan infrastructure bill, but the final outcome of the so-called human infrastructure bill is unclear. Even more concerning is a rerun of the debt-ceiling fiasco in December, as any form of U.S. default on its debt would have negative repercussions worldwide.

World Markets and Economy

Europe followed the U.S. higher, with Britain still the laggard as it battled COVID-19, Brexit, and supply chain problems. The STOXX Europe 600 did gain more than 4% for the month, finishing at an all-time record, although this index has badly trailed the U.S. for some time. Since 2000, the STOXX Europe 600 is up only 20%, while the S&P 500 tripled over the same time period. Germany also managed a 4% gain, even though the Merkel era is ending.

Japan's Nikkei 225 index fell for the month, as political uncertainty peaked before the parliamentary election called by new Prime Minister Koshida. But on October 31, Koshida's Liberal Democratic Party (LDP) maintained its majority when the votes were counted, and the Nikkei soared on November 1, wiping out the losses for October. Stock traders now expect the LDP will introduce more spending initiatives to spur the Japanese economy, which has not fully recovered from COVID-19 even though the pace of vaccinations has been strong. Chinese stocks were weak as fears of a real-estate meltdown continued. Although troubled real-estate giant Evergrande made some overdue debt payments, more trouble looms in 2022 when the company has even larger payments due.

Outlook

Economic growth should speed up for the rest of the year, with monetary policy remaining very stimulative. Add in rising corporate profits and the bull market has the fuel to continue its run. Bumps in the road could appear if supply chain bottlenecks do not ease or if Congress allows the U.S. to default. But, for the long run, stocks are still the best asset to hold.

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