2Q21 Economic Summary

As vaccinations increased and Covid risk declined, Americans were eager to return to pre-pandemic life during the second quarter. Business re-openings broadened and the US economy boomed. Equity markets hit new highs driven by stronger-than-expected economic growth, accommodative monetary policy and robust corporate earnings. Despite the improved economic outlook and signs of rising inflation, the yield curve flattened during the quarter. Shorter-term Treasury yields rose while longer-term Treasury yields fell as markets became more convinced that the Fed is serious about inflation and is willing to decrease accommodation sooner-than-expected to keep it from becoming embedded.

After a strong start to the year, US economic growth accelerated rapidly during the second quarter as parts of the economy most impacted by the pandemic began to fully reopen. Service-oriented businesses saw a huge surge in demand as Americans craving a return to normalcy flocked to restaurants, bars, hotels and gyms. US manufacturing also continued to expand at a solid pace despite global supply chain disruptions that raised input prices and reduced production capabilities. Labor shortages also hampered the return to full capacity. While payrolls remain below pre-pandemic levels, the gap is closing as businesses recall workers and try to fill open positions in an effort to keep pace with the rise in demand. With job openings and quit rates at all-time highs, the competition to attract qualified candidates is stiff, forcing many employers to increase pay. Home builders cited a lack of skilled workers combined with supply shortages and high materials prices as reasons why they cannot keep pace with housing demand. The lack of supply pushed new and existing home prices to record highs, forcing many first-time homebuyers out of the market and resulting in a decline in home sales. Despite these growing pains, the US economy was red-hot during the quarter, with some economists predicting that 2Q21 GDP growth could be as high as 10%.

While the US economy is roaring, the global growth recovery is somewhat uneven as countries with less access to effective COVID vaccines are still battling the virus. Pandemic-related restrictions remain in place in many countries and a growing number are having to tighten restrictions further due to outbreaks from the highly infectious Delta variant. While the IMF projects global growth to rebound robustly this year, it expects smaller improvements in emerging economies versus their developed peers. In addition to concerns about the evolution of the pandemic and progress on vaccines, the IMF cited inflation as a risk to the global economic outlook. Surging commodity prices, rising wages and supply chain bottlenecks are not only impacting prices in the US but also in other developed countries, including Canada, the UK, the EU and China. While the IMF believes that the runup in prices is temporary, it warned that if inflation proves more persistent than expected it could lead to a sharp tightening of global financial conditions. The IMF continued to urge countries to maintain accommodative monetary policies but advised the need to closely monitor inflation and financial stability risks.

While the Fed remains committed to doing its part to support growth, the tone coming out of the June FOMC meeting was noticeably less dovish than prior meetings. Rising inflation was on the Fed's radar as the Committee acknowledged that recent price increases were larger than anticipated, resulting in a marked increase in the Fed's median 2021 Core PCE forecast which rose from 2.2% in March to 3.0% in June. Despite the upward revision, Fed members continued to attribute much of the inflation increase to transitory factors, citing production bottlenecks and supply constraints as the primary drivers behind the runup in prices. They believe these pressures will dissipate as the surge from pent-up demand subsides and economic conditions normalize. In addition to revising up its inflation forecast, the Fed increased its expectations for the growth outlook, raising the median 2021 US GDP forecast up to a whopping 7.0%. Robust gains in consumer spending and business investment combined with continued improvements in the labor market led to the upgraded forecast.

Given the rapid pace of the recovery and the increase in inflation, some Committee members believe that the Fed's goals for the economy may be met somewhat earlier than they had projected. As a result, the date of liftoff was pulled forward in the June dot plot forecast. The majority of Fed members now expect two interest rate increases in 2023, up from zero at the March meeting. In addition, although the Fed left the pace of quantitative easing unchanged, there were nascent discussions on tapering. According to the meeting minutes, participants agreed to begin discussing their plans for adjusting the path and composition of asset purchases at upcoming meetings. In his post-meeting press conference, Chair Powell made it clear that "reaching the standard for substantial forward progress is still a ways off," but progress is being made and the tapering discussion has begun. He reiterated that the Fed will provide advance notice before announcing any decisions on changes to the asset purchase program. Chair Powell also downplayed the change in the dot plot forecast saying "these projections do not represent a committee decision or plan, and no one knows with any certainty where the economy will be a couple years from now." Despite Chair Powell's efforts to explain the Fed's process, markets were caught off guard by the meeting's more hawkish tone. Shorter-term Treasury yields rose to reflect the projected faster-than-anticipated pace of tightening while yields on the longer-end of the curve fell as inflation expectations declined.

Thus far 2021 is setting up to be a stellar year for US economic growth, but with vaccination rates plateauing and the Delta variant on the rise, we're not out of the woods yet. The US must continue to keep the virus in check or economic momentum could begin to backslide.