3Q21 Economic Summary

The light at the end of the Covid tunnel dimmed a bit during the third quarter. After falling steadily in the spring, U.S. Covid cases began to rise rapidly in July as the highly contagious Delta variant spread across the country. Despite the rising case counts, states resisted reimposing restrictions that could put an undue burden on economic activity. Even so, economic growth is expected to have slowed in the third quarter as supply chain bottlenecks and Delta-induced precautions began to take a toll. Equity markets remained resilient through most of the quarter, but volatility increased in September as the weaker data trends became more apparent. It was a mixed bag for fixed income markets as well. Covid concerns caused Treasuries to rally in July, but rates in the belly of the curve began to back up in August and September as inflation increased and taper anxiety set in.

While economic activity remained solid, third quarter U.S. GDP growth is expected to have slowed from the rapid pace set during the first half of the year. US manufacturing continued to expand, but growth was constrained by parts shortages, rising commodities prices and distribution challenges. Getting finished goods out the door remains a major problem for manufacturers due to record backlogs at ports, trucker shortages, and railyard bottlenecks. Service industry growth also continued at a robust clip but was tempered somewhat by supply constraints and slower consumer spending on travel and leisure as the Delta variant ramped up. Momentum remained positive in the housing market as well, but higher input costs and shortages of raw materials continued to crimp homebuilders' ability to meet demand.

One of the biggest challenges facing all industries was a shortage of labor. Job openings remained near record highs during the quarter as concerns about the Delta variant made some people reluctant to return to work. In addition, given the number of openings, workers are being choosier about which positions they want to take, thus extending the hiring process. Although labor demand remains high, employment growth has begun to lag. Payrolls grew by 1.65 million during the quarter, but most of the increase happened in July. Hiring disappointed in both August and September as workers remained on the sidelines. With labor demand outpacing supply, employers are having to increase pay to attract qualified candidates. The rise in wages combined with all the other pandemic-related supply shortages and distribution bottlenecks have sharply driven up costs for producers. The resultant price increases on everything from food and shelter to cars and household furnishings weighed on consumer sentiment and reduced purchasing power during the quarter.

The US is not alone in its pandemic-related struggles. The International Monetary Fund (IMF) recently cut its world economic outlook, citing supply chain disruptions and rising inflation as constraints on the global recovery. The organization revised down its growth prospects for advanced economies, largely due to slowing growth in the US, Germany and Japan. It also cut its growth outlook for China, reflecting the country's scaling back of public spending as well as the downturn in the country's highly leveraged property sector, which was intensified by developer Evergrande's recent debt crisis. The IMF stated that the risk balance for the global economy is tilted to the downside primarily due to uncertainties surrounding the course of the pandemic and inflation. Although the organization expects inflation to return to its pre-pandemic range for most economies next year, if pandemic-induced supply-demand mismatches continue longer than expected, it could lead "to more sustained price pressures and rising inflation expectations that prompt a faster-than-anticipated monetary normalization in advanced economies."

The Federal Reserve echoed these same concerns at the September FOMC meeting. While participants continued to believe that elevated inflation rates would eventually moderate, they acknowledged that supply disruptions and labor shortages might last longer than expected, which could result in longer and more persistent effects on prices and wages than currently assumed. Although no changes were made to monetary policy, the Fed set the stage to begin tapering asset purchases as soon as November. According to the minutes of the meeting, most Committee members agreed that "substantial further progress" had been met for their goals on inflation and employment. As such, a gradual reduction in the pace of asset purchases was likely and could commence in either mid-November or December. The September dot plot forecast also showed that some participants had pulled forward their expectations for liftoff, with 9 of the 18 FOMC members now projecting at least one rate hike in 2022. When asked about the shift in the dot plot at the post-meeting press conference, Chair Powell reiterated that the criteria for liftoff is more stringent that the criteria for tapering and that liftoff would occur some time after tapering ends. Markets took heed of the Fed's more hawkish tone and began pricing in a rate hike by the end of 2022.

Overall, US economic data continues to point to a sustained recovery; however, supply chain disruptions and the resultant rise in inflation remain a concern. The longer the disruptions last, the more embedded inflation is likely to become, which could impede the outlook for growth.