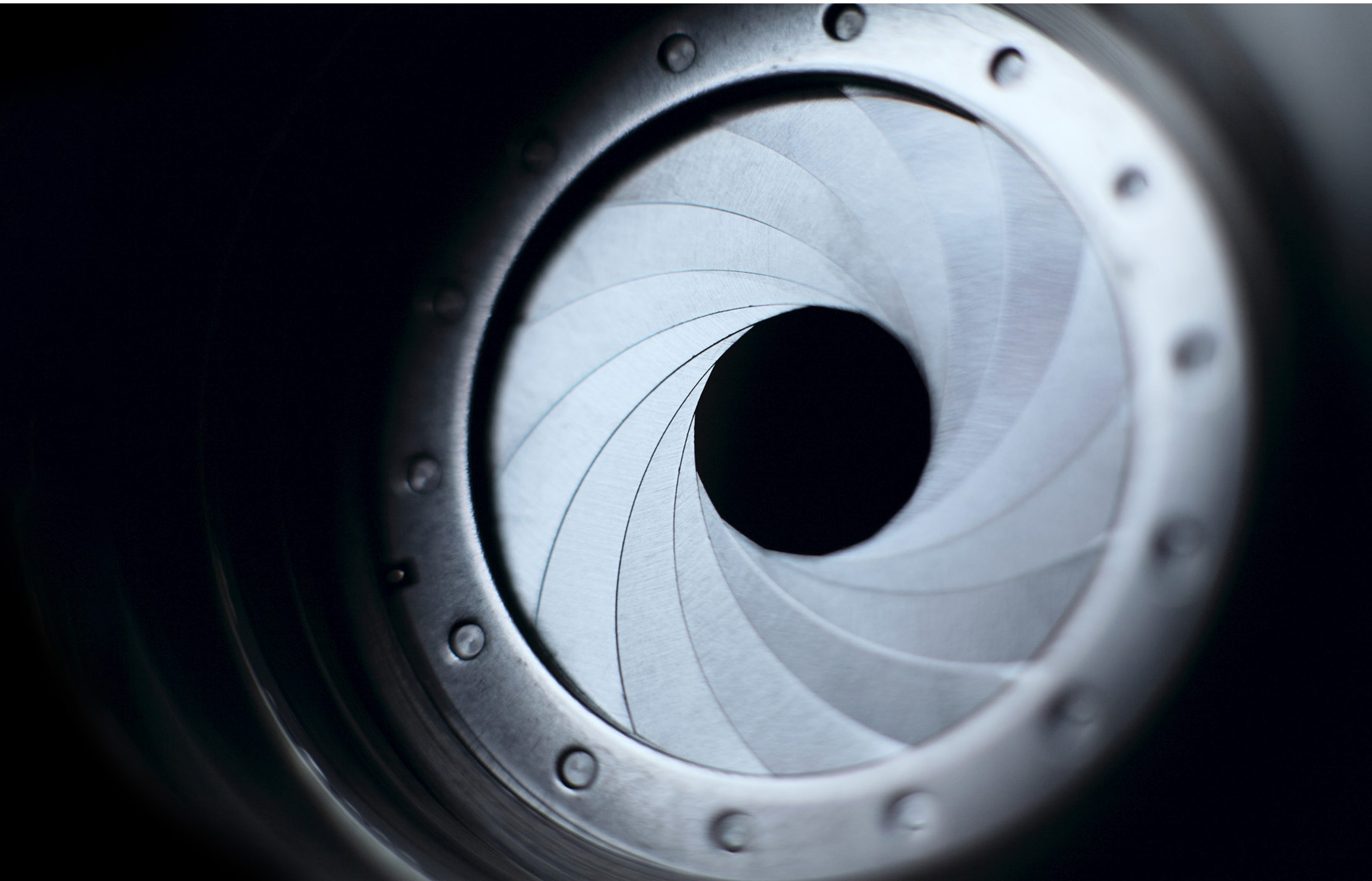
FS INVESTMENTS®

Q3 2021 Economic outlook

Zooming in on inflation

Q3 is shaping up to be a collision course of the economy, policy and markets. Inflation data will be in focus, feeding into expectations of when the Fed will begin its inevitable swing toward tightening. Equity markets have remained sensitive to interest rates and yield curve dynamics, all of which stand to shift rapidly as our economy continues this unprecedented recovery.



Lara Rhame

Chief U.S. Economist, Managing Director, FS Investments

Lara is Chief U.S. Economist and Managing Director on the Investment Research team at FS Investments, where she analyzes developments in the global and U.S. economies and financial markets. Her fresh take on macroeconomic issues helps to inform and develop the firm's long-term views on the economy, investment trends and issues facing investors. Lara is committed to the Philadelphia community and serves on the boards of the Economy League of Greater Philadelphia, Hyperion Bank and Starr Garden Park.

Learn more

Read more from Lara Rhame

Sign up to receive our latest Insights articles

Read our analysis

- Inflation »
- Wages »
- Labor market »
- Commodities »
- Housing »
- Fed policy »
- Credit markets »
- Equities »
- 2022 »

FS Investment Solutions, LLC 201 Rouse Boulevard, Philadelphia, PA 19112
www.fsinvestmentsolutions.com 877-628-8575 Member FINRA/SIPC

OUTLOOK-MACRO-Q32021

Investment Research

Robert Hoffman, CFA
Managing Director

Lara Rhame
Chief U.S. Economist
Managing Director

Andrew Korz
Director

Kara O'Halloran, CFA
Director

Contact
research@fsinvestments.com

Dear Reader,

There is enormous focus on getting back to normal as the world reopens from the pandemic this quarter. When I look ahead, I see a different landscape than what is in the rearview mirror. Across generations, geographies and industries, a great reassessment is underway to determine how to keep the best of the seismic changes of the pandemic and make the whole system better. We feel this as investors. We want to keep what's gone right and improve upon it.

At home, many of us are rethinking our priorities for our families and businesses after this extraordinary period. While optimism in the air, let's not be too quick to rush back to where we were. I am eager to see the new directions we take in the coming year.

From my family to yours, I wish you a healthy summer.

My best,

Lara Rhame
Chief U.S. Economist
Managing Director

Q3 is shaping up to be a collision course of the economy, policy and markets. Data watching will become a full-time sport, with inflation, wage, commodity and employment data all feeding into expectations of when the Fed will begin its inevitable swing toward tightening. Equity markets have remained sensitive to interest rates and yield curve dynamics, all of which stand to shift rapidly as our economy continues this unprecedented recovery.

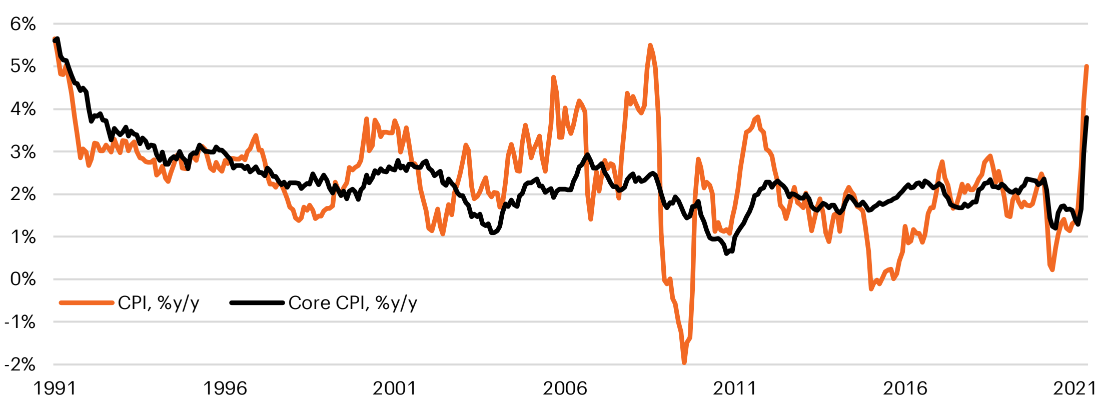
Key takeaways

- Inflation data will be an overarching focus in Q3, including distortions from the 2020 shutdown, wage data and inflation expectations.
- The Fed has made a hawkish pivot and faces the complicated task of communicating timing to markets.
- Strong market fundamentals will likely continue in Q3, but the trajectory of this extraordinary cycle is changing in ways that could challenge investors into 2022.

All eyes on inflation

Inflation is dominating the economic discussion, and with good reason. We expect this to only intensify in the coming quarter. Inflation surged in Q2 in large part due to base effects in the year-over-year calculation as the sharp price declines of 2020 led to an offsetting price jump. Still, the headline was shocking: Consumer prices rose 5.0% year over year in May, the highest in 13 years. Core CPI, which excludes food and energy, hit 3.8% y/y, the highest since 1992.

Consumer prices surged in Q2



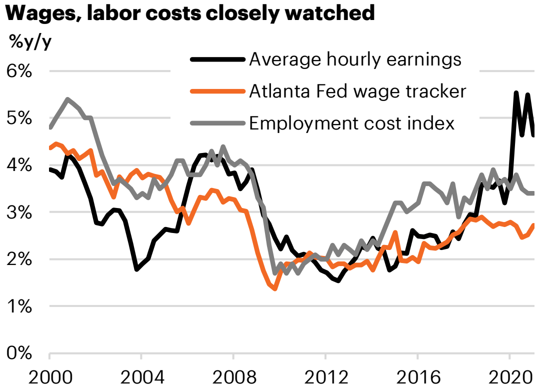
Source: Bureau of Labor Statistics, as of June 16, 2021.

Is rising inflation technical, transitory or will it turn into a sustained trend of quickening price acceleration? A close look at the data shows offsetting trends and distortions, and the outlook is far from clear. We examine whether **inflation is hot or not**, and what clearly looks technical versus what price increases have intensified during the early recovery. From here, the details will be even more important, even though the headline year-over-year rate is expected to ease.

Inflation is a much bigger topic than just consumer prices. Wages, input prices, commodity prices and inflation expectations are all part of this vital economic concept and will churn around markets to influence policymakers and investors.

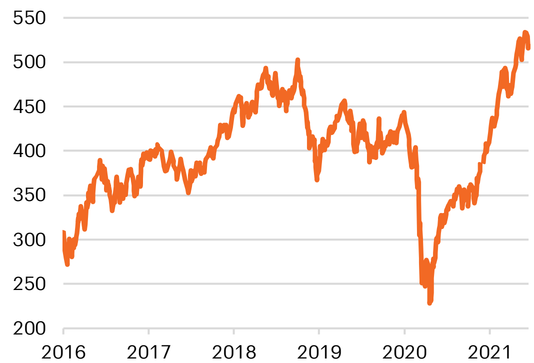
CPI often gets the bulk of the headlines, but we are laser focused on **wages**. Wages are the other side of the inflation coin, and for decades rising wages were a key driver of inflationary cycles that triggered Fed rate hike cycles. In the 2009–2020 expansion, however, the wage push inflation model broke down. Despite an unemployment rate at a 50-year low—the unemployment rate was 3.5% in January 2020—wage pressure was virtually nonexistent.

Wages, labor costs closely watched



Source: Bureau of Labor Statistics, Federal Reserve Bank of Atlanta, as of June 16, 2021.

S&P GSCI



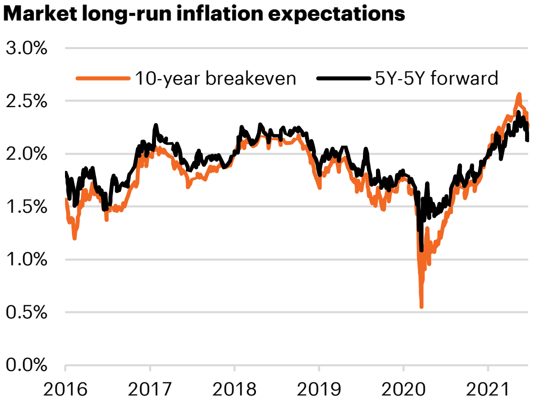
Source: Bloomberg Finance, L.P., as of June 16, 2021.

There is evidence, however, that wages are rising. A look at wages so far in 2021 shows that lower-paying jobs, most notably retail, leisure & hospitality and transportation, are experiencing significantly higher wages. 2020 is still causing significant data distortions, raising the importance of Q3 data to decipher the new trend in wages. Anecdotally, companies express the need to compete for workers with increased wages or other compensation. It bears repeating that this business cycle is unprecedented, and the nature of wage inflation in the early part of this expansion bucks the trend of the prior four expansions.

Commodity prices are also stoking inflation fears, as the surge in commodity price inflation since the beginning of the pandemic has been another overarching theme. The production processes for energy, grains and lumber are vastly different, but there is a common thread running through these sectors. Often producers misjudged the implications of the pandemic and planned to cut supply, only for global demand to return much sooner and stronger than expected. We break down each sector and their recent trends.

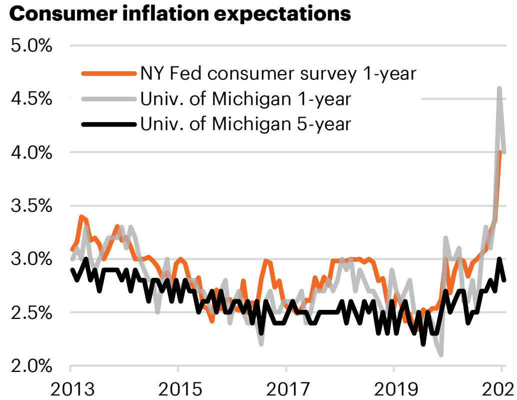
Expectations of where inflation is heading are also important to assessing the inflationary threat. Inflation is more than just a current reading. It is an uptrend of rising prices that leads people and businesses to expect higher prices in the future, thereby demanding higher wages and reinforcing the upward inflationary trajectory.

Market long-run inflation expectations



Source: Bloomberg Finance, L.P., as of June 16, 2021.

Consumer inflation expectations



Source: Federal Reserve Bank of New York, University of Michigan, as of June 16, 2021.

Markets have their own view of where inflation is going, which we can extrapolate from forward rates and inflation-adjusted bond pricing. Market measures have shown inflation expectations recovering alongside the robust economic rebound and then extending to reach a multiyear high as signs of inflation continued to intensify. More recently, however, the market greeted the recent May CPI print with a shrug. Inflation expectations have settled around 2.25%, close to the long-run average of the last decade, leaving us to conclude that markets are not overly concerned about runaway inflation at this time.

Consumers, however, are taking notice. Here again, policymakers keep a close eye on where consumers expect inflation to go, because that can lead directly to wage expectations. The University of Michigan survey shows 1-year inflation expectations spiked in May 2021 as gasoline and other commodity prices jumped. (One-year expectations, it should be noted, are highly correlated to commodity prices.) The 5-year time frame also shows households are bracing for higher prices, but that increase has been more modest.

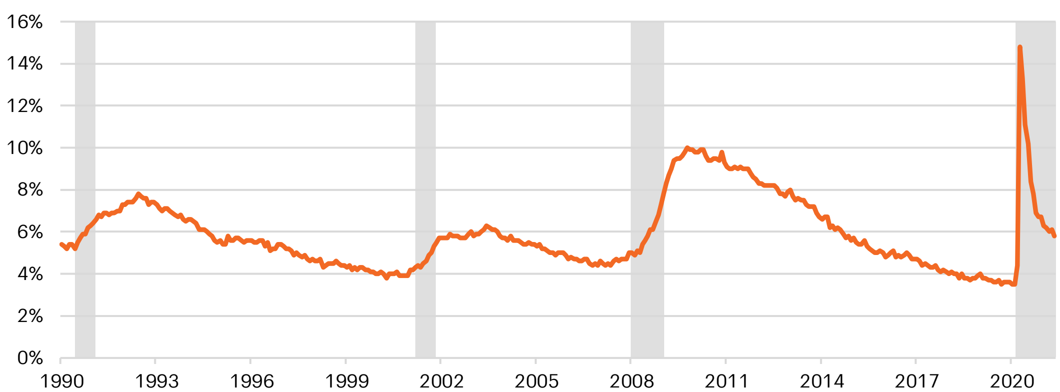
All of this may feel like it is adding up to a perfect storm of inflationary pressures, particularly over the next year. Indeed, we expect a mini-cycle where inflation pressures continue as the economy works through supply disruptions in the face of strong demand. But over the long term, powerful disinflationary pressures remain at play. Globalization will continue to push goods prices lower. Demographics and lower potential growth are also structural forces keeping inflation low.

In Q3, inflation data will continue to steal the spotlight, and looming uncertainty will likely keep policy expectations shifting rapidly.

A business cycle like no other: The labor market and housing

It is a common refrain: that this economic cycle has been unprecedented. In this cycle, crushing job losses were front-loaded to the start of the recession. Now, with growth surging, the demand for labor is one of the overarching features of this young recovery. Yet so far, the recovery in employment is far from complete. Over 7 million people remain out of work, and another 3.5 million have dropped out of the workforce entirely. And yet job openings have soared, with over 9 million positions advertised and unfilled.

Unemployment rate

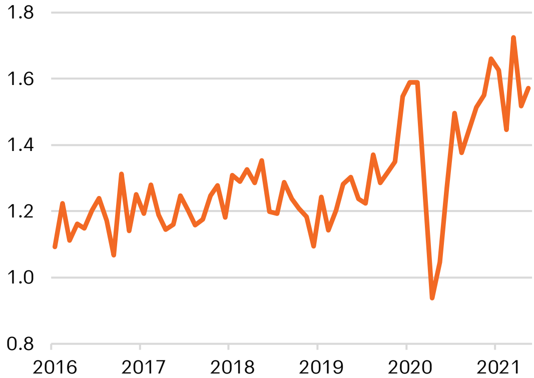


Source: Bureau of Labor Statistics, NBER, as of June 16, 2021. Shaded areas represent NBER-dated recessions.

The **labor supply-demand mismatch** is rooted in causes that may not resolve quickly. The available pool of labor has changed. Geographic migration, shifting preferences of remote work, rising retirement and people needing or choosing to exit the workforce to caregive all point to a slower and more uneven recovery. We discuss the many positives of the strong labor market, but also dive into how a rapid drop in the traditional U-3 measure of inflation could muddy the waters further for Fed policymakers.

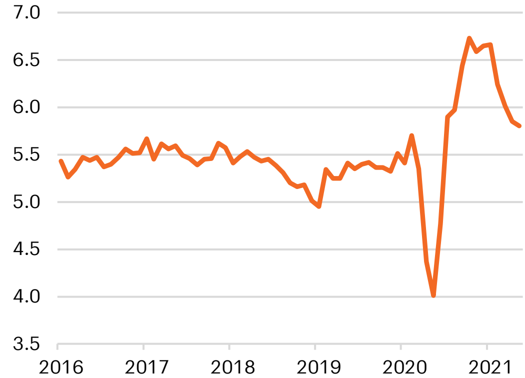
The **housing market** has also heated to a boil during this recession. The story of the residential housing boom truly draws from virtually every aspect of the pandemic economy. We dissect demand-side factors, supply-side constraints, and note some early, tentative signs of normalization. Existing home sales have already slowed, and buyers are now beginning to balk at current valuations. Importantly, skyrocketing prices have brought back memories of the mid-2000s. But we don't see a similar "bubble" forming; low interest rates have kept housing affordability in line with the last 10 years.

Housing starts, millions



Source: U.S. Census Bureau, as of June 18, 2021.

Existing home sales, millions

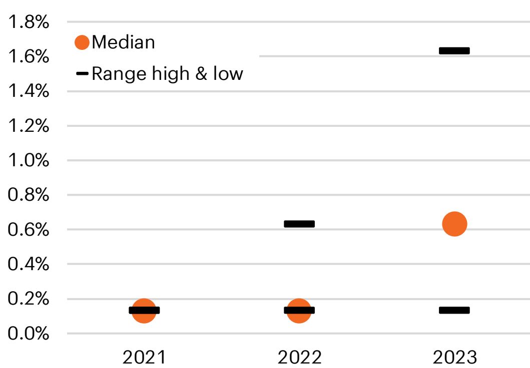


Source: U.S. Census Bureau, as of June 18, 2021.

Fed policy takes a hawkish turn

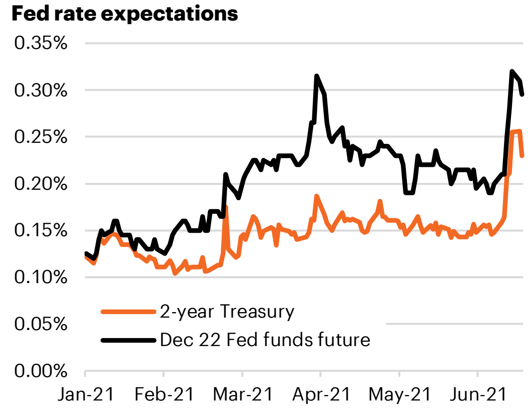
Here we go! At the June 16–17 meeting, the FOMC unexpectedly released a "dot plot" rate projection with a median expectation of two 25 bps rate hikes by the end of 2023. In the following days, Fed speakers filled the airwaves to put context behind what is an increasing divergence of forecasts among the FOMC. Before a rate hike, however, the Fed will look to taper its asset purchases, a step which now looks likely to begin in Q4 2021.

Fed "dot plot" rate projections



Source: Federal Reserve, Summary of Economic Projections, as of June 16, 2021.

Fed rate expectations



Source: Bloomberg Finance, L.P., as of June 21, 2021.

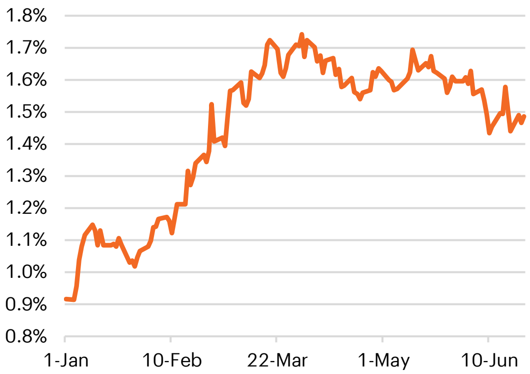
But the Fed now faces a problem of long-run goals that are in direct contrast to short-term data trends, and we expect Q3 to be filled with rapidly shifting policy expectations that spark volatility in interest rates. The prospect of a Fed rate hike is often challenging for markets to navigate.

Financial market impact of inflation, growth and shifting policy

Strong growth and currently accommodative Fed policy continue to support financial markets, even in the face of possible inflation and a swing toward eventual Fed tightening. Treasury yields rose significantly in Q1 as vaccine distribution and another fiscal stimulus package reinforced the strong economic rebound at the end of 2020. But in Q2, core long-term yields have eased. This retracement in yields was concurrent with the blockbuster CPI inflation data releases—another example of markets shrugging off the long-term implications of short-term inflation.

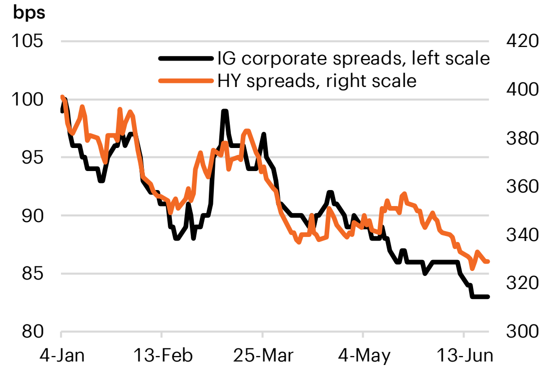
Treasury yields may remain rangebound in the coming quarter. U.S. economic growth is expected to remain strong but has likely peaked. The hawkish Fed pivot has flattened the yield curve, pushing up 2- and 3-year yields while the 10-year fell after the release of the updated dot plot. Fed policy will continue to be an important driver of yield curve dynamics. After all, the Fed has not yet gotten specific about the timing or speed of tapering asset purchases.

10-year Treasury yields



Source: Bloomberg Finance, L.P., as of June 22, 2021.

Credit spreads reflect positive fundamentals



Source: Bloomberg Finance, L.P., ICE BofAML U.S. Corporate Index, ICE BofAML High Yield Index, as of June 23, 2021.

Credit markets are enjoying the ride. The low interest rate environment has mired traditional fixed income in negative territory. The Bloomberg Barclays U.S. Aggregate Bond Index (Barclays Agg) is down -1.6% year to date as of June 21, 2021, and investment grade bonds have struggled to generate returns despite a robust fundamental backdrop. Sub-investment grade credit and leveraged loans, on the other hand, have had a solid first half of the year.

Where do we go from here? Spreads are tight, leading some investors to automatically assume a correction is imminent. We detail key corporate metrics we are watching but remain mindful of historic periods where spreads remained tight for years. The main risks to our credit outlook revolve around inflation and interest rates, and we are watchful should Fed tapering cause benchmark long-term interest rates to rise sharply or unexpectedly.

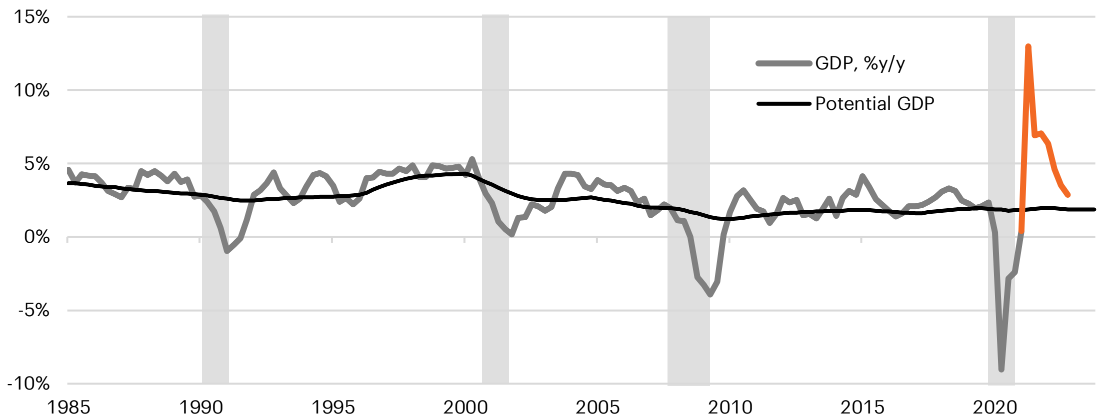
Finally, **equities** are also benefiting from a fundamental backdrop that is largely positive. While the S&P 500 continues to hit new highs, the pace of gains has moderated in Q2 and the dominance of thematic trades has worn off. Valuations, while not exorbitant compared to bond yields, are not cheap. In Q3, we see the market moving toward a more mid-cycle stance, with positive implications for quality vs. high-beta stocks.

An early look at 2022 and beyond

As we near the midpoint of 2021, it is time to start focusing on next year. The near-total shutdown, the surging recovery, waves of fiscal stimulus and the reorientation of large swaths of our workforce have resulted in an economic cycle like no other. The Fed expects growth in 2021 to be 7.0% and 3.3% in 2022.[1] Remember, Fed Chair Jerome Powell's tenure ends in 2022, and it is uncertain whether he will be reappointed. This could further increase uncertainty around the Fed's policy trajectory.

2022 is shaping up to be a **year of deceleration**. This is not a pessimistic forecast: Earnings and GDP are expected to maintain growth levels well above pre-COVID trends. But deceleration can be an uncomfortable place for markets. The U.S. economy is still subject to the gravitational pull of its underlying potential growth. The next act of this economic cycle may be more normal than we could imagine.

GDP growth is expected to return to potential



Source: U.S. Congressional Budget Office, Bureau of Economic Analysis, NBER, Bloomberg Finance, L.P., as of June 16, 2021.
Note: Potential GDP is an estimate from the U.S. Congressional Budget Office. The orange line represents the Bloomberg consensus GDP estimate.
Shaded areas represent NBER-dated recessions. 2020 recession end is for illustrative purposes. The NBER has not stated that the current recession has ended.

1 FOMC Economic Projections, June 16–17, 2021. Reflects the median GDP projection.

Inflation: Hot or not?

Key takeaways

- It is all about inflation in Q3, and CPI hit a 13-year high of 5.0% y/y in May 2021.
- The inflation debate is rightly heated: Some inflation is clearly transitory, while other price pressures may not dissipate quickly.
- Owner's equivalent rent may have finally bottomed, which could add to inflation in Q3 and beyond.

We expect inflation data and shifting inflation expectations to dominate headlines in Q3, and with good reason. We predicted a technical bounce in inflation in Q2 as "base effects" from the acute COVID price declines fall out of the year-over-year calculation. But bottlenecks, changes in demand and rising input prices all acted to push CPI to 5.0% y/y in May, the highest since 2008.

An active and important debate has now developed over whether the Q2 surge in inflation is transitory (this is the Fed's narrative) or will be sustained beyond the easing of pandemic-related supply disruptions. There are strong arguments on both sides, which will make data watching in Q3 an action-packed activity.

Several categories driving inflation higher in Q2 clearly reflect this technical base effect. Airline, hotel and energy prices—which together are 8.6% of the CPI index—plunged in March, April and May of last year. As the economy has reopened, these prices reflect an unwinding of the similarly acute price decline of a year ago. Airfares fell -28.5% y/y in May 2020 and are up 24.1% y/y in May 2021.

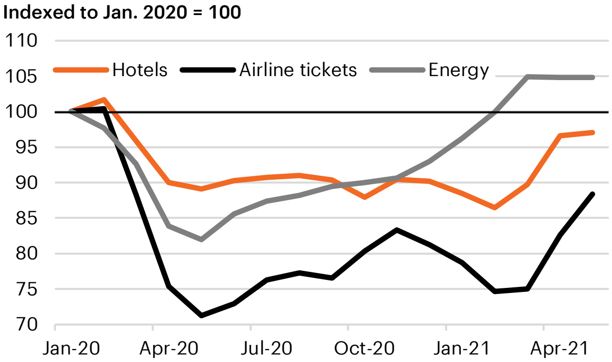
Other categories, however, are showing price acceleration that intensified during the pandemic and has yet to slow. Food out of home, which is about half of household food costs, accelerated during the pandemic, has not slowed and increasingly may be fueled by higher wage costs. New car prices have risen as strong demand ran headlong into supply-chain disruptions that reduced auto production. The resulting pivot to buy used cars and trucks pushed these prices to double-digit monthly increases in April and May and alone account for one-third of the CPI monthly gain.

Used car prices are often used as the prime example of transitory. Indeed, it is unlikely that used cars will maintain this pace of inflation. But there are few indications right now that high demand is fading or price pressures are easing. In other words, how much time constitutes "transitory" is also up for debate.

Owners' equivalent rent (OER) looms as the largest category within consumer prices. OER is meant to capture the monthly cost of housing and largely reflects the cost of rent. During the pandemic, the migration out of high-rent cities to less costly locations (or in some cases, back to the childhood bedroom) caused OER to fall and dragged CPI down with it. Before the pandemic, OER was regularly above 3% y/y, but slid throughout the past year to a low of 1.46% y/y in February 2021.

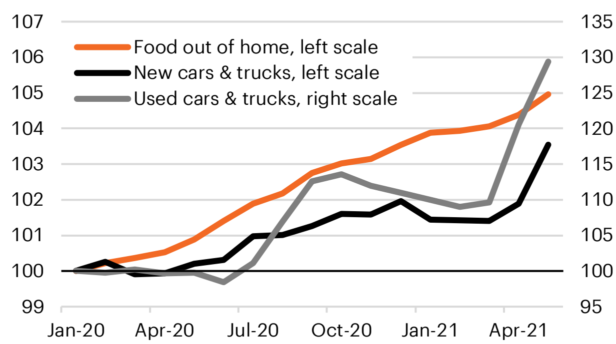
Looking ahead, the debate over the nature of this mini-cycle of inflation will continue over the summer. Markets, for their part, currently tacitly agree with the Fed that inflation will likely be only transitory. But consumer prices are only one piece of the puzzle. Inflation in wages and commodity prices are important components that need to be closely watched as well.

Prices recover after sharp COVID declines
Indexed to Jan. 2020 = 100



Source: Bureau of Labor Statistics, FS Investments, as of June 16, 2021.

Prices accelerated during pandemic
Indexed to Jan. 2020 = 100



Source: Bureau of Labor Statistics, FS Investments, as of June 16, 2021.

Wages: Significant acceleration in 2021

Key takeaways

- Wages are a critical, and recently overshadowed, component of inflation.
- This cycle is seeing early signs of wage pressure, a highly unique feature.
- Wage data has been heavily distorted by the pandemic; Q3 will be closely watched as the numbers normalize.

Wages are critical to the inflation outlook, and while markets and investors tend to focus on CPI, wage data in Q3 will give better guidance about possible inflationary pressures. So far in 2021, there are early signs that wages are rising, which would be a unique feature of this expansion.

Data in the coming months will be even more critical because annual wage data remains distorted from the labor market turmoil of the pandemic. In April 2020, when the economy shed 20.7 million jobs, average hourly earnings actually rose 8.2% y/y. Almost half of these layoffs were in the leisure & hospitality and retail trade sectors—two categories with lower wages.

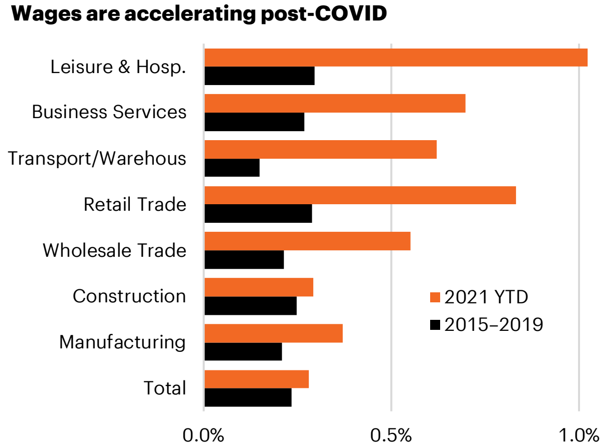
As the economy reopens more fully and leisure & hospitality employment recovers, wage trends in this sector will be critical. Certainly, anecdotal evidence indicates labor costs are moving higher in a variety of industries. News of labor shortages, wage increases and signing bonuses are widespread. Amazon, the country's second-largest retailer, announced $1,000 signing bonuses for new hires. This is not included in average hourly earnings but would show up in other employment cost measures.

Historically, wage pressure has been one of the most important drivers of inflation and therefore monetary policy. This held true for most modern business cycles into the early 2000s, as rising wages would squeeze margins, causing companies to raise prices and driving up the two big measures of consumer inflation, CPI and the PCE deflator. The latter, of course, is the Fed's target measure of inflation.

This broke down in the 2009–2020 expansion. Wages were slow to rise in that expansion but eventually started moving higher in 2013, reaching over 3.5% y/y. Yet companies did not pass along these wage increases to consumers, and the PCE deflator averaged only 1.4% over the same time frame. Now, even if wage inflation rises, the Fed has indicated it wants to see if this feeds through to broader inflationary measures before reacting.

The current business cycle also stands alone because of unprecedented wage trends. A typical business cycle sees wages fall after the recession ends, usually bottoming several years into the new expansion. The entire profile of the labor market disruption during this remarkable recession has been counter to historic trends. Should the tight labor market and surging growth cause wages to rise early in the expansion, it would put even more pressure on Fed policymakers to navigate their desire to let prices "run hot." Q3 wage data will have important implications for inflation expectations, markets and Fed policy.

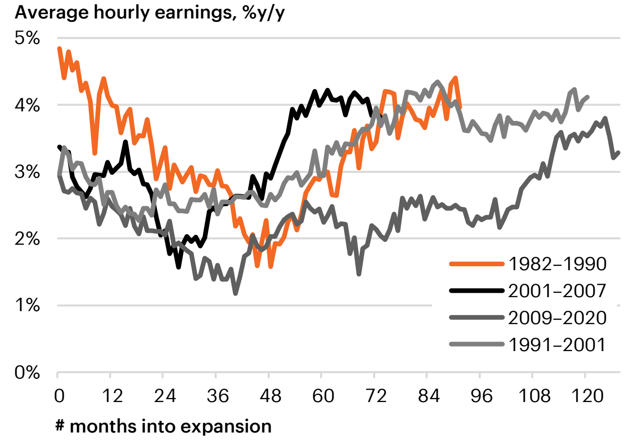
Wages are accelerating post-COVID



Source: BLS, FS Investments, as of June 16, 2021.
Note: Average 2015–2019 vs. Jan–May 2021 hourly earnings monthly gains. 2020 excluded because of significant distortions.

Wages typically fall early in expansions

Average hourly earnings, %y/y



Source: BLS, NBER, FS Investments, as of June 16, 2021.

Labor market: Supply-demand mismatch to persist

Key takeaways

- The labor market recovery continues but is far from complete.
- The pool of available labor has shifted due to preferences, geography and early retirement.
- Labor supply remains a key ingredient for GDP growth later in 2021.

The job recovery has been strong but remains incomplete. There are 7.3 million fewer jobs in our economy than before the pandemic, with almost a third of these in the retail and leisure & hospitality sectors. Increasingly, the simplistic goal of "bringing all those jobs back" seems harder to attain.

The available pool of labor has changed. Many pundits were quick to compare the 2020 labor market disruption to a hurricane, whereby significant unemployment would quickly and fully reverse upon post-pandemic reopening. We have instead been more cautious. Geographic migration, shifting preferences of remote work, rising retirement and people needing or choosing to exit the workforce to care for children at home all point to a slower, more uneven recovery going forward.

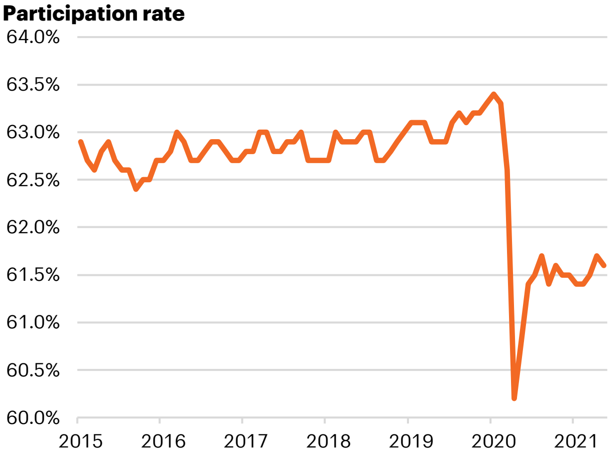
The participation rate remains stubbornly low, most recently at 61.6% in May 2021. In addition to people who are still unemployed, 3.5 million people have simply left the workforce. An acceleration in retirement has occurred during the pandemic. Retirements were already on an uptrend given the demographics of the aging baby boomers, but the percentage of the population that is retired jumped to 19.5% in April 2021, up from 18.6% pre-COVID.

There are reasons to expect the participation rate will improve somewhat. The expiration of supplemental unemployment benefits may cause people to look for a job in the fall. Currently, households have a cash savings stockpile, but as that dwindles, some people may need to re-enter the workforce. Finally, with almost every school system hoping to fully reopen in the fall, some caregivers may plan on returning to work.

A tight labor market is clearly good news for households and has helped boost consumer confidence. But for the macroeconomy, the labor supply-demand mismatch is a serious hurdle. At the end of the day, our economy's ability to grow still depends largely on how many workers are can bring into the workforce.

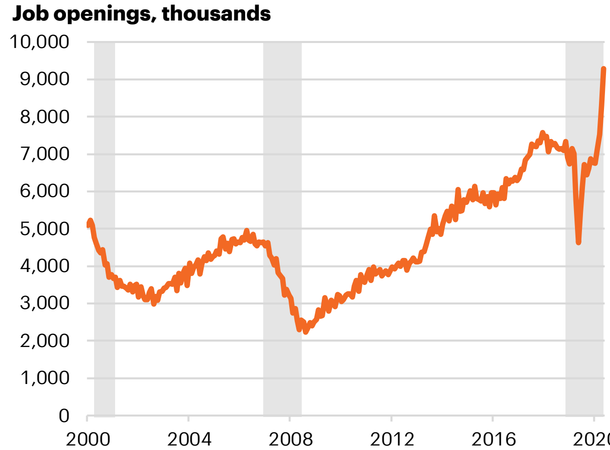
These labor dynamics could muddy the waters for the Fed as well. The nature of this nascent economic expansion is extraordinary in that the labor shortage is happening right at the outset of the recovery. This is unique. Historically, job openings and wage pressures are mid- to late-cycle phenomena. The traditional U-3 jobless rate will look low because it automatically leaves out people who have left the workforce. Like inflation, it could be another example of data that may cause markets to prematurely price in the need for a Fed rate hike.

Participation rate



Source: Bureau of Labor Statistics, as of June 16, 2021.

Job openings, thousands



Source: Bureau of Labor Statistics, NBER, as of June 16, 2021. Shaded areas represent NBER-dated recessions.

Commodities: Stoking inflation fires

Key takeaways
- Commodity prices have surged since 2020.
- Oil prices have eclipsed pre-pandemic levels as supply remains constrained.
- From metals to grains, the spike in input prices has stoked fears of eventual impacts on consumer prices.

The surge in commodity prices since the onset of the pandemic has been among the most captivating themes for economists. While the production processes for energy, grains and lumber are vastly different, there is a common thread running through each that explains the price surge. Like many of us, producers misjudged the economic impact of the pandemic and planned to cut supply to deal with plunging demand. Instead, global demand for many commodities has surged, leaving the supply side to play catch-up. As crucial inputs to the global production chain, the durability of commodity price increases will play a crucial role in determining the eventual direction of consumer price inflation.

Energy

WTI crude prices recently rallied past $70/bbl for the first time since late 2018, spurred on by rebounding energy demand and a cautious approach from the world's top producers. OPEC+ plans to return only a fraction of its COVID-era supply cuts to the market in the coming months, giving oil prices the green light to march higher as the summer travel season heats up. U.S. gasoline prices have recently risen above $3.00/gallon for the first time since 2014.

Agriculture

Prices of key agricultural commodities like soybeans and corn have soared 59% and 55%, respectively, since mid-2020, stoking fears of food price inflation. Supply of grains was interrupted at the onset of the pandemic as farmers expected demand, especially from crop-based fuels, to plunge. Instead, a massive uptick in demand from China, along with recovering biofuel demand and poor weather in many crop-growing regions, combined to create a perfect storm for grains prices.

Metals

Markets saw prices for industrial metals soar as massive fiscal stimulus stoked a global manufacturing rebound. Copper prices rose 81% from May 2020 to May 2021, while the price of iron ore, which is used to produce steel, gained 47%. Surging demand from China, the world's leading consumer of copper and producer of steel, has sustained near-record prices in 2021. However, China is stepping up its bid to control inflationary pressures—including releasing metals stockpiles—paving the way for an interesting Q3.

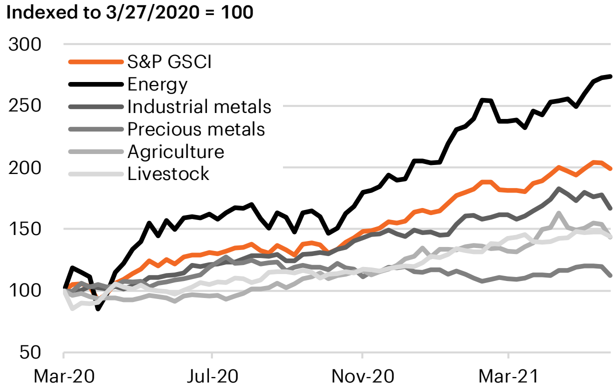
Lumber

The price of lumber, everyone's favorite commodity in 2021, climbed fourfold from May 2020 to early May 2021, sending shockwaves through the U.S. homebuilding industry. Sawmills reduced production amid the pandemic and have been slow to build out capacity. Between reduced supply and surging construction and renovation demand, the value of lumber skyrocketed. Prices have fallen materially since but remain double pre-COVID levels.

Gold

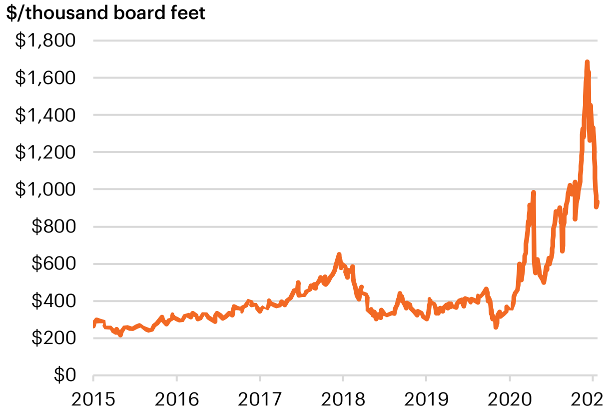
As a haven asset, gold has struggled in 2021 amid rising interest rates. Essentially a bet on the direction of real interest rates, gold will be a popular vehicle for laying wagers on Fed policy for the rest of the year.

Hot commodities
Commodity performance since late-March lows
Indexed to 3/27/2020 = 100



Source: Bloomberg Finance, L.P., S&P GSCI, as of June 18, 2021.

Lumber prices
$/thousand board feet



Source: Bloomberg Finance, L.P., as of June 18, 2021.

Housing: The crossroads of the COVID economy

Key takeaways

- Demand has recently cooled but should remain strong as interest rates remain low.
- Supply constraints could be easing, although higher input prices will remain for some time.
- Skyrocketing prices brought back memories of the mid-2000s, but we expect a modest renormalization driven by fundamentals.

The hallmark of the COVID economy has been the housing boom, as it is a story that draws from virtually every aspect of the pandemic. The policy response to COVID slashed interest rates. Demand surged as the population moved, and supply was constrained first by the shutdowns, then by both labor and input shortages. All of this helped lead to surging house prices, which have triggered bad memories of the mid-2000s.

Housing has always been hyper-sensitive to interest rates, and the Fed's policy response to the pandemic drove mortgage rates under 3% for the first time ever. Even now, rates have moved up only modestly and remain well below pre-COVID levels. This meant that as the population faced an unprecedented pandemic and considered how to quickly adjust, housing demand skyrocketed. There has been a wave of first-time homeowners, a national migration to out of cities to suburbs, exurbs and other locales with lower cost of living. There has also been a surge of interest in second homes and investment properties; 15% of purchase mortgage applications in February were for second/investment properties, roughly double pre-COVID levels.

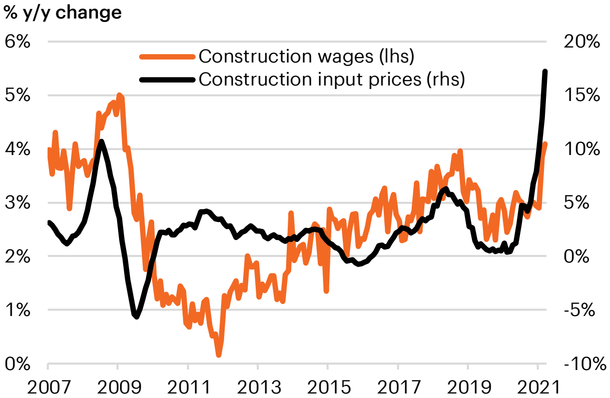
The pandemic heavily affected the supply side of housing as well, helping to push prices higher. Compared to other markets, a shortfall in housing supply takes longer to correct. This was exacerbated by a sharp drop in new home construction as the pandemic hit in April 2020. In December, less than two months' supply of homes were available for sale. The supply of new homes has been affected by surging input prices and scarcity of labor. Lumber prices, as discussed in the commodities section, more than quadrupled from May 2020 to May 2021, and prices for many other inputs have risen as well.

The result has been a market that appears slightly crazy by almost any standard. An index from the FHFA shows prices up nearly 13% y/y, the highest since the late 1970s. Competition for homes has been fierce, as 88% of listed homes sold in April were on the market for less than one month, versus an average of around 40% over the past decade.

But despite the sharp increase in housing prices, rock-bottom mortgage rates have kept the median monthly payment below 15% of median family income, around average for the past decade.

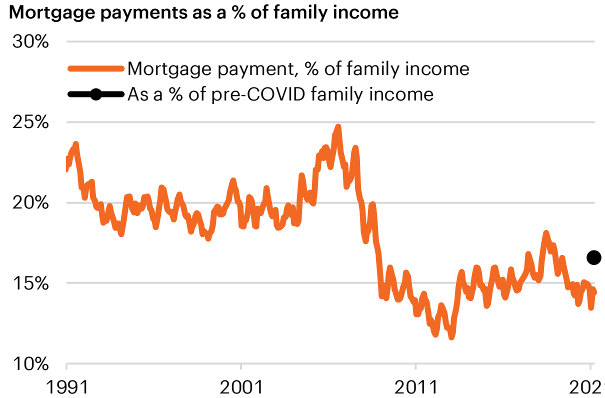
The proportion of those aged 25–34 is expected to peak at 14.2% in 2021 before declining as younger millennials enter their prime household formation years. While pandemic "shock" factors may continue to exert force on prices for the rest of 2021, we believe secular factors like demographics, interest rates and the availability of land for builders will once again be the primary drivers of home prices.

Construction costs have soared
% y/y change



Source: Bureau of Labor Statistics, as of May 31, 2021.

Housing affordability
Mortgage payments as a % of family income



Source: National Association of Realtors, as of March 31, 2021.

Fed policy: Let’s talk it through

Key takeaways

- The Fed turned unexpectedly hawkish in Q2.
- Communicating short-run trends vs. long-run goals will be complicated for the Fed and markets.
- Risks of a policy misstep are rising quickly.

The Fed took an unexpectedly hawkish turn in Q2 when the median rate forecast included two rate hikes in 2023 in the June FOMC Economic Projections. This has completely upended the monetary policy discussion, which is so central to interest rates and market sentiment. Within the FOMC, there is now a wide divergence of forecasts, which will make for crowded airwaves over the summer as Fed speakers weigh in on inflation, growth and policy expectations.

Right now, the Fed faces a problem of long-run goals in contrast to short-term concerns and data. The Fed underwent a large framework review in 2020 to address the fact that inflation had been chronically low for decades, only to find themselves having to defend their new policy of average inflation targeting in the face of rising inflation.

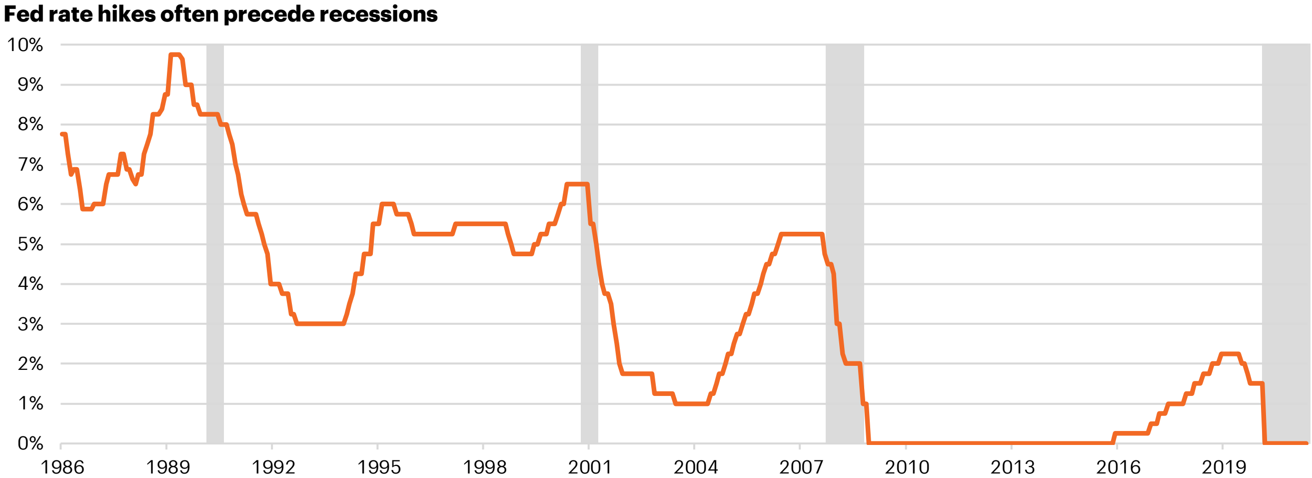
While the Fed maintains dual goals of full employment and inflation averaging 2%, Fed Chair Powell has made clear the Fed is prioritizing employment. Yet, with the sluggish participation rate, unemployment may continue to fall quickly. The Fed made a clear policy misstep in 2017–2018 by raising rates to preempt inflation. This may seem like ancient history given where our economy is now, but it nonetheless dented Fed credibility.

The first step along the road to tightening is to taper asset purchases. Currently, the Fed is purchasing $80 billion of Treasury securities and $40 billion of mortgage-backed securities a month. Winding this down will be a necessary precursor to raising rates. And yet the Fed so far has indicated that it is only starting to talk about talking about when it will downshift asset purchases. In other words, the taper has yet to begin, but suddenly the timing is looking more like Q4 2021. All of this results in fertile ground for miscommunication.

It is important to appreciate that Fed rate hikes have preceded every recession over the past 50 years. This is not to be an alarmist: U.S. economic growth is strong and our expansion has just begun. A recession is not visible in our forecast horizon. But there is a strong argument to be made that there is no hurry to raise rates. The Fed typically adds accommodation to the economy for the first several years into a new expansion. Clearly this recovery is unique, and growth, employment and financial markets have recovered at lightning speed. Still, rate hikes are not a risk-free proposition.

Despite June’s noteworthy shift in forecasts, it is important to note that the dot plot reflects a range of estimates that can and do change frequently. This is particularly true in the two-year horizon. While neither we—nor most of the FOMC—expect a rate hike for the next several years, the conversation has begun. That alone is enough to inject uncertainty and volatility into markets.

Fed rate hikes often precede recessions



Source: Federal Reserve, NBER, as of June 16, 2021. Shaded areas represent NBER-dated recessions.

Credit markets: Enjoying the ride

Key takeaways

- Declining long-term rates boosted core fixed income in Q2 after its poor showing during the first quarter.
- HY bonds and senior secured loans have each posted a solid first half of 2021 in what has become an eerily predictable year.
- Spreads across markets are tight. Returns in Q3 will be primarily driven by income.

Core fixed income enjoyed a respite from its year-to-date declines during the second quarter. After posting its worst quarter since 1981 in Q1, the Barclays Agg has risen steadily since late March as long-term interest rates have drifted lower. These gains have not fully offset the losses that sharp interest rate spikes caused early in the year, and both the Agg and investment grade corporates remain down -1.6% and -1.13% year to date, respectively.

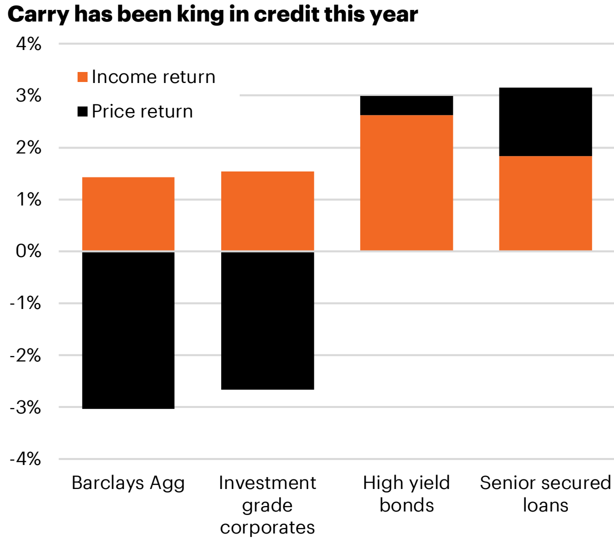
Sub-investment grade credit, on the other hand, has had a solid first half of 2021 with high yield bonds up 2.99% and senior secured loans up 3.15% as of June 18. Both markets have been eerily predictable, as they are on track to post an annual return roughly equal to each market's yield to maturity entering 2021. At the risk of overusing a word that was so in vogue 18 months ago, that makes today's environment unprecedented. Only five times in the past 34 years has the previous year-end yield to maturity been a predictor of the following year's return by 2% or less.

The economic backdrop remains very favorable for risk assets going forward despite our forecast for growth to decelerate from Q2's robust rate. Default rates have plummeted and fundamentals continue to improve. Corporate leverage has declined but remains higher than pre-COVID levels. We expect leverage to remain higher in this cycle due to the robust new issuance we've seen. Low interest rates have created an extremely favorable financing environment with low debt service costs. For that reason, we'll instead be closely watching interest coverage stats as a way to gauge companies' ability to satisfy their debt obligations. These figures also improved last quarter.

Many dynamics and indicators suggest that we have moved to a mid-cycle environment, meaning returns will likely be driven predominantly by income (carry), with some opportunity for active credit selection. Spreads remain tight across the credit spectrum, with investment grade and HY spreads nearing our year-end forecast. It is important to remember that tight spreads do not beget imminently wider spreads. In the years leading up to the Global Financial Crisis, spreads remained "tight" in each market for over two years without major fluctuations in either direction.

The main risks to our outlook revolve around inflation and interest rates. Further spikes in long-term interest rates would send core fixed income down sharply, like we saw in Q1. Unexpected rate spikes could weigh on sentiment broadly throughout markets again, causing some interim volatility in sub-investment grade credit as well. That said, historically rising rates have tended to be a positive long-term catalyst for credit markets. Overall, we see few catalysts to deter us from believing that credit markets will finish the year largely as they started. Given their relatively higher yield and historic insensitivity to interest rates, we think this environment favors sub-investment grade credit over investment grade fixed income.

Carry has been king in credit this year



Source: Bloomberg Barclays U.S. Aggregate Bond Index, ICE BofAML U.S. Corporate Index, ICE BofAML U.S. High Yield Index, S&P/LSTA Senior Secured Loan Index, as of June 18, 2021.

Equities: A head-spinning cycle

Key takeaways

- The equity market cycle, like the economy, is progressing at an intense pace.
- Margins expanded as companies took advantage of operating leverage but could come under pressure from input costs.
- Valuations, while not cheap, remain reasonable given low interest rates.

The fundamental backdrop for global equities continues to be largely positive, with many countries approaching widespread vaccination and economies moving toward something resembling normalcy. Markets, especially in the U.S., largely grasped this positive outcome and priced it in during Q1. While the S&P 500 continues to hit new highs, the pace of gains has moderated and the dominance of thematic trades has worn off. With the market searching for catalysts, we believe Q3 will be more about alpha than beta.

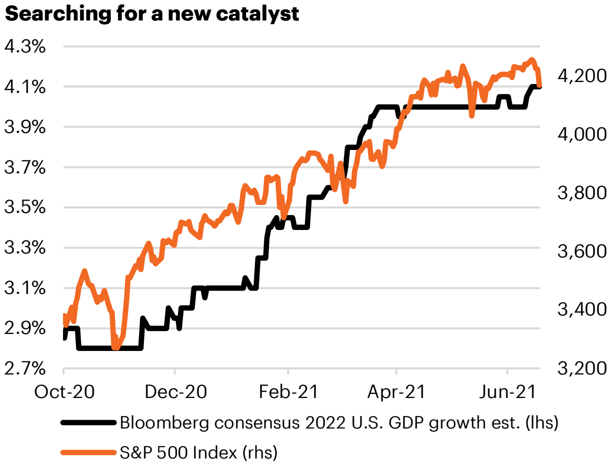
After being driven by two distinct macro trades for much of the past year—the tech/growth trade in mid-2020, followed by the cyclical trade post-vaccine announcement—markets have been decidedly less theme-driven in recent months. We view this as a natural progression toward a more mid-cycle environment. While it may seem early to be talking about mid-cycle, note the remarkable speed with which this market cycle is developing—forward earnings estimates eclipsed their pre-crisis high in just 16 months, a full year faster than any other U.S. recession since 1980.

Fundamentals continue to look robust amid surging economic growth. S&P 500 EPS grew 46% y/y in Q1, driven by strong revenue growth and record profit margins of 13.5%. Analysts continue to revise their EPS forecasts upward; expectations are for 2021 and 2022 EPS to be 12% and 26%, respectively. This is above 2019 levels, a remarkable data point considering the carnage at the outset of the bear market and the scale of the economic disruption. Still, momentum likely peaked at some point in Q2. Markets will have to get comfortable with a form of deceleration, even if growth is still above trend.

In the U.S., focus in Q3 will continue to be on inflation and the Federal Reserve's reaction to it. From a fundamental standpoint, companies were able to expand profit margins to record levels in Q1 thanks to significant operating leverage. Their ability to sustain those margins will be in part dictated by growth of input prices and wages, and firms' ability to pass on price increases to consumers. With revenue growth strong, rising costs will be among the top concerns for equity investors.

Ultimately, while we still see the growth/policy cocktail as supportive for global equities for the rest of this year, the "more beta is better" market that has dominated post-vaccine announcement is unlikely to continue. Valuations, while not exorbitant compared to bond yields, are not cheap either. In the U.S., we see the move toward a more mid-cycle stance as generally positive for quality vs. high-beta stocks. Outside the U.S., we still see early-cycle opportunities in Europe and certain emerging markets, while China's tightening has made investing there challenging.

Searching for a new catalyst



Source: Bloomberg Finance, L.P., as of June 18, 2021.

Valuations not exorbitant

12-mo. trailing FCF yield minus 10-year Treasury yield

Source: Bloomberg Finance, L.P., as of June 18, 2021.

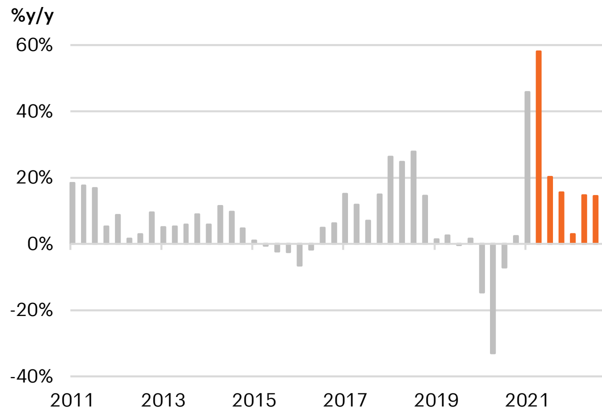
2022: A year of deceleration

Key takeaways
- Q3 will likely start a broad trend of deceleration that will extend into 2022.
- GDP and earnings growth are likely to remain far above historic trends, but the pace of growth will ebb.
- Monetary policy support will also likely slide as QE is tapered ahead of a future rate hike.

Growth in 2021 is expected to be a blockbuster. The median Fed projection for 2021 GDP growth is 7.0%, the highest in since 1978. The high-water mark for that growth, however, is already likely behind us. The final dose of fiscal stimulus that hit the economy at the end of Q1 likely propelled Q2 GDP to double digits. But in the second half of 2021 and throughout 2022, the pace of growth will likely decelerate.

This should not be confused with a pessimistic forecast. Growth in 2022 is expected to be strong by historic measures. The Fed projects 3.3% growth, while the consensus is 4.1%. Either outcome would be far above most estimates of our underlying potential trend growth rate. When the dust from this economic cycle finally settles, this core concept of potential growth will come back into focus. Labor force growth is expected to slow further in coming years. Productivity bounced during the pandemic, but a new era of higher productivity will take years to prove out and as yet is far from clear.

Earnings growth forecast to slow

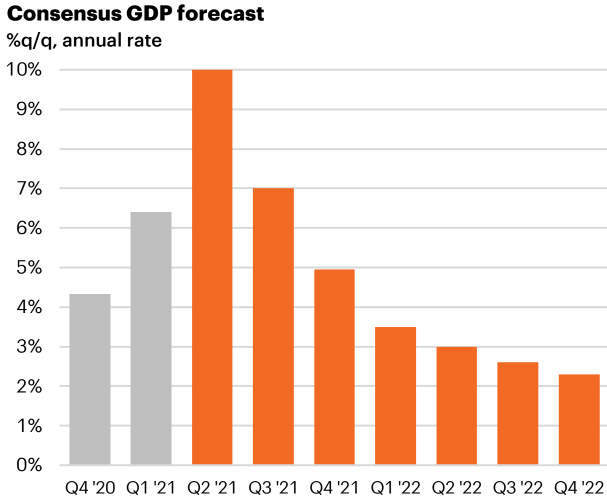


Source: Bloomberg Finance, L.P., as of June 16, 2021. Projection represents Bloomberg consensus forecast of S&P 500 earnings growth.

The tailwinds driving our economy to such spectacular performance have also supported earnings. Massive fiscal stimulus has helped households weather the storm of the pandemic, and consumption has been a powerhouse for growth. How fast GDP and revenue growth slow will depend in part on how households manage their stockpile of savings going forward.

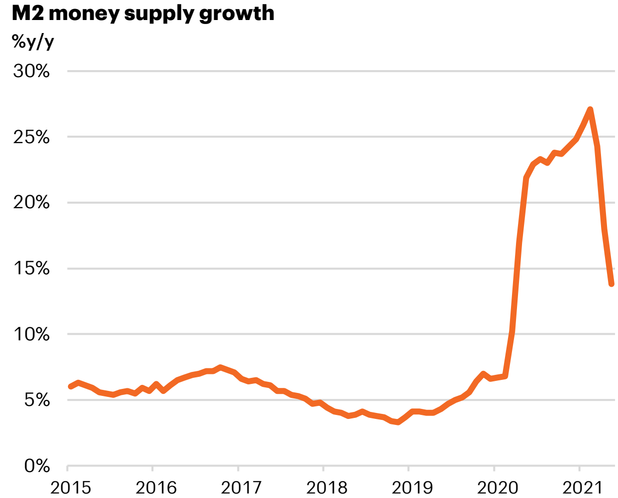
We also expect tailwinds from policy to slowly abate. We've given significant airtime to the Fed's hawkish pivot and tapering of QE could come as soon as Q4 2021. Much uncertainty still surrounds a potential infrastructure package, which would be a positive for GDP. The timing and size of new stimulus, however, would be unlikely to arrest the coming quarters of deceleration.

Consensus GDP forecast



Source: Bureau of Economic Analysis, FS Investments, Bloomberg Finance, L.P., as of June 16, 2021. Forecasts (in orange) reflect Bloomberg consensus forecasts.

M2 money supply growth



Source: Federal Reserve, FS Investments, as of June 16, 2021.