Q3 2021 | Capital Markets Outlook

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Fed's hawkish pivot shouldn't stoke inflation fears

Various financial media outlets and Wall Street firms described the announcement following the Fed's June 16 meeting as a hawkish surprise. We saw it instead as nothing more than a tempest in a teapot. The update of the "dots" (the Summary of Economic Projections) from the Fed's March meeting shows seven members now expect the liftoff of interest rates from the zero lower bound by the end of 2022. This compares with four members previously. Five members still do not expect liftoff until the end of 2023 — a time frame hardly anyone could seriously describe as hawkish.

Fed needs more data

We believe there is still not enough information available to Fed officials for them to determine whether (and how quickly) the labor force participation rate might improve into the fourth quarter of 2021. At the news conference following the meeting, Chair Powell declined to answer a direct question about what specifically would constitute "substantial further progress," saying "it would not be appropriate for me to lay out particular numbers that do or do not qualify."* The disconnect between high job openings and high unemployment (which economists plot on the Beveridge Curve) has been blamed on many factors. As we have written previously, continued

Asset allocations

Shading in the table indicates the change from the previous quarter

	Underweight	Neutral	Overweight
EQUITY			●
U.S. large cap		●	
U.S. small cap			●
U.S. value			●
U.S. growth		●	
Europe			●
Japan			●
Emerging markets			●
FIXED INCOME		●	
U.S. government		●	
U.S. investment-grade corporates		●	
U.S. mortgage-backed			●
U.S. floating-rate bank loans		●	
U.S. high yield			●
Non-U.S. developed country		●	
Emerging markets	●		
COMMODITIES			●
CASH		●	

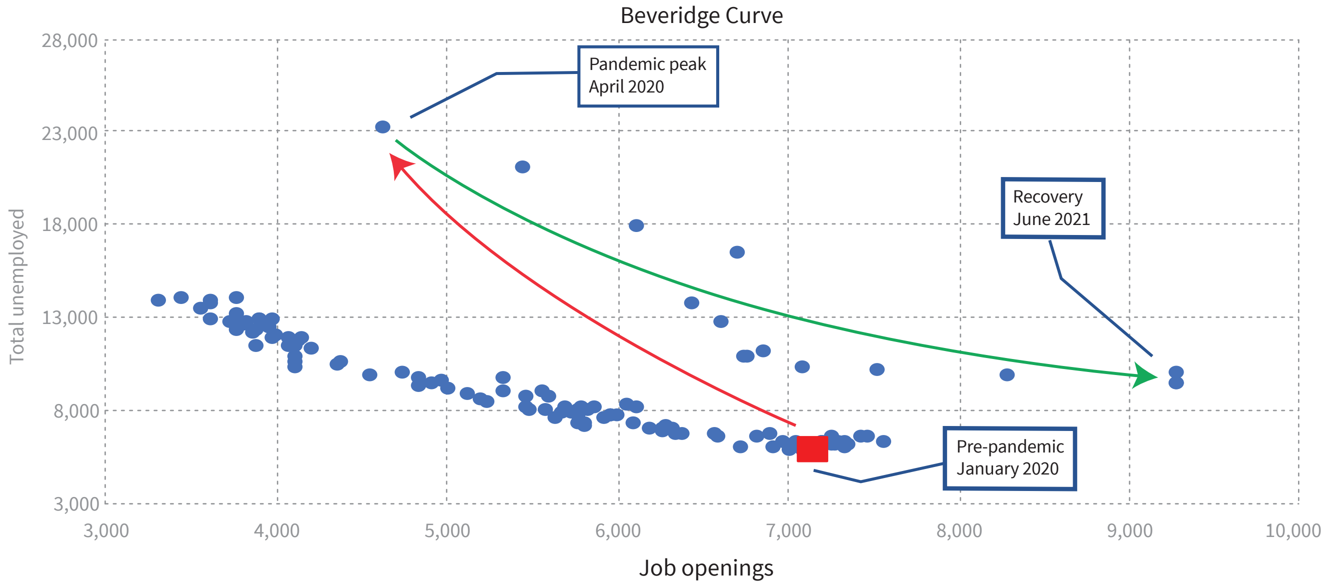
Currency strategy

U.S. dollar versus	Favor other	Neutral	Favor dollar
€ Euro		●	
£ Pound	●	○	
¥ Yen		○	●

* Source: federalreserve.gov, transcript of Chair Powell's Press Conference, June 16, 2021.

Jobs go unfilled as workers stay on the sidelines

Job openings and labor turnover survey and unemployment in thousands, 6/30/2011–6/30/2021



Source: Bureau of Labor Statistics. Red dot represents the beginning of 2020.

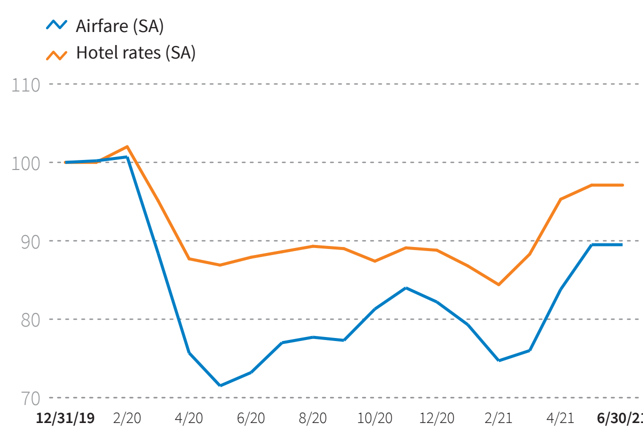
pandemic-related healthcare concerns, lack of access to childcare, and enhanced unemployment insurance benefits are all likely playing some role. It will take several more months until these labor market frictions abate.

Inflation is short term

We continue to agree with the Fed that current upward pressure on inflation is likely to be transitory. As we progress further into the third quarter, we will move past the worst of the base effects (comparisons with 2020) that we had warned about last quarter. In addition, the largest contributors to the rise in recent inflation readings involve sectors of the economy most sensitive to reopening and the removal of mobility restrictions, such as airfare and hotel rates. Used car prices continue to surprise to the upside, but here too we see early evidence that they should start to roll over later in the year. Supply chain issues continue to roil auto production, as manufacturers prioritize scarce semiconductors for use in higher-margin luxury models. Shifting this product mix on assembly lines has exacerbated the upward price pressure on cheaper used cars at a time when the age of the average U.S. car is running close to all-time highs.

Service prices are rebounding to pre-pandemic levels

Indexed prices, December 2019=100



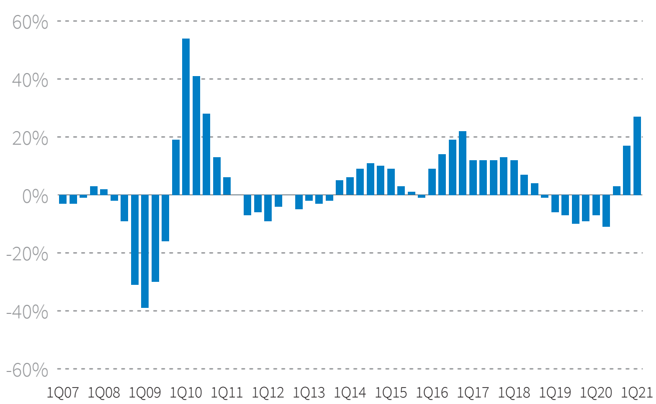
Sources: Bureau of Labor Statistics; Bloomberg.

Semiconductor shortage is cyclical

Putnam's Assistant Director of Equity Research, Andrew O'Brien, CFA, who covers semiconductor companies, believes the current industry shortage is more of a typical boom/bust cycle rather than the result of the pandemic or U.S./China trade tensions. In his view, 2019 was a cyclical "down" year for semi revenues. It was a period of inventory burn coupled with falling production that left the industry wrong-footed when goods consumption recovered strongly in the second half of 2020, driven by fiscal stimulus. However, we might be at another inflection point. We already have strong evidence that as mobility recovers globally, consumers have begun to shift spending from goods to services.

Semiconductors are following a normal cyclical revenue pattern

Y/Y analog revenue growth — TXN, ADI, MXIM, NXPI, 1Q07–1Q21



Source: Putnam (assembled from company reports). TXN is Texas Instruments, ADI is Analog Devices, MXIM is Maxim Integrated Products, and NXPI is NXP Semiconductors.

Too small to lift inflation

Demand for consumer electronics like PCs and tablets, which benefited from work-from-home trends, is starting to roll over. Similarly, smartphone sales have started feeling the effects as China has tightened credit conditions. As this demand slackens, it will free up some capacity for semiconductor makers to refocus their manufacturing to the areas that need it most, like autos. It is also important to highlight that the semiconductors at issue are analog/logic chips and microcontroller units that cost less than one dollar each. (Yes, you read that correctly: one dollar.) It's difficult to make a structural "cost push" inflation argument when the supply chain bottlenecks involve parts whose costs are measured in pennies. And though it may take longer than expected for these bottlenecks to clear, as Andrew O'Brien says, "Ultimately, supply will catch up with demand. It always does."

Taken together, all of this leaves us of the view that not much has changed over the past several months.

- The macroeconomic growth backdrop is still extraordinarily strong, even if the rate of change might be a bit lower in the second half of the year.
- The policy backdrop with respect to both monetary and fiscal support in the G-10 is still enormously stimulative.
- Even if we are past "peak stimulus," money supply growth in developed market economies provides ample liquidity to fuel performance of financial assets.
- Corporate earnings have continued to beat estimates at a historically high rate, even as those forward estimates continue to get revised higher on almost a daily basis.
- Many analysts may continue to underappreciate a nominal growth "boom" since we haven't experienced one for a very long time.

We therefore continue to express a reflationary and rotational tilt to our multi-asset portfolios.

From a directional perspective, we remain

- Overweight commodities
- Overweight equities
- Overweight credit
- Slightly underweight duration

These "beta" positions also continue to be supplemented with a posture within the equity market that emphasizes areas that are more levered to global growth and tend to be on the cheaper side:

- Overweight U.S. small caps and value stocks
- Overweight developed markets outside the United States
- Overweight emerging markets

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