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The Shifting Economy

Consumers, Capex, Inflation, the Fed, and Markets

All data as of May 31, 2021, unless otherwise noted.

An inauspicious start

January 5, 2015

Luke joins Wilmington Trust as Chief Economist

May 2, 2015

"Any company that has an economist certainly has one employee too many."

~ Warren Buffett

Criticism of economics in the world of finance

1. Gross Domestic Product (GDP) and equity performance have a negative correlation
2. Markets hit inflection points *before* the overall economy

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Contents

Consumers

Capex

Inflation

Federal Reserve

Markets

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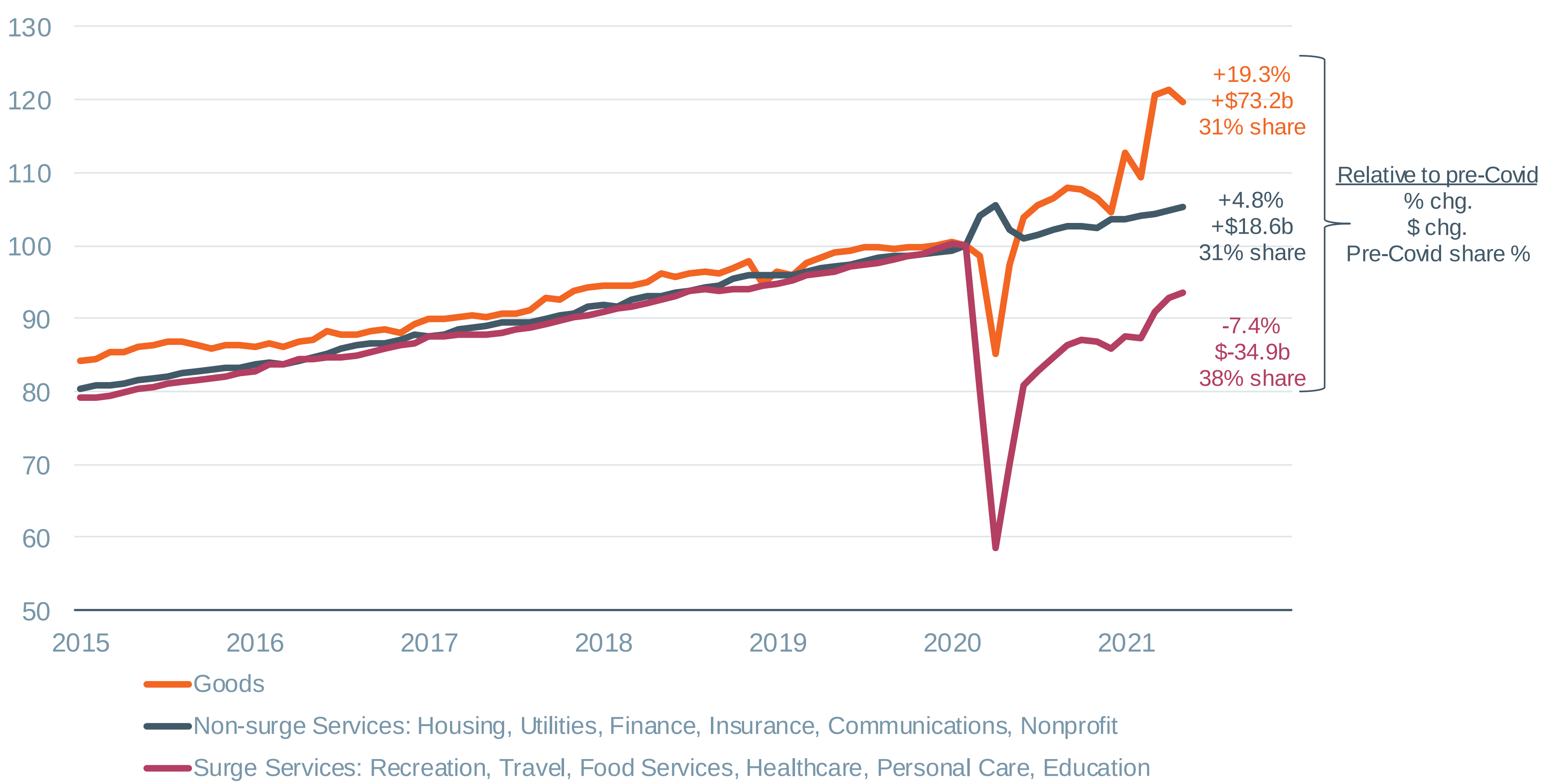
Section 1 Consumers

Consumer spending – Shifting from goods to services

Spending on goods surged in the pandemic, driven by lockdowns and fiscal stimulus. With widespread vaccinations and the removal of restrictions, consumers have started to cut back their spending on goods while spending on services is increasing. We expect this to continue.

Consumer spending (Index, Feb 2020 = 100)



Data as of May 31, 2021. Sources: Bureau of Economic Analysis, WTIA.
We define "surge" service spending as categories we expect to accelerate as pandemic mitigations continue to be lifted.

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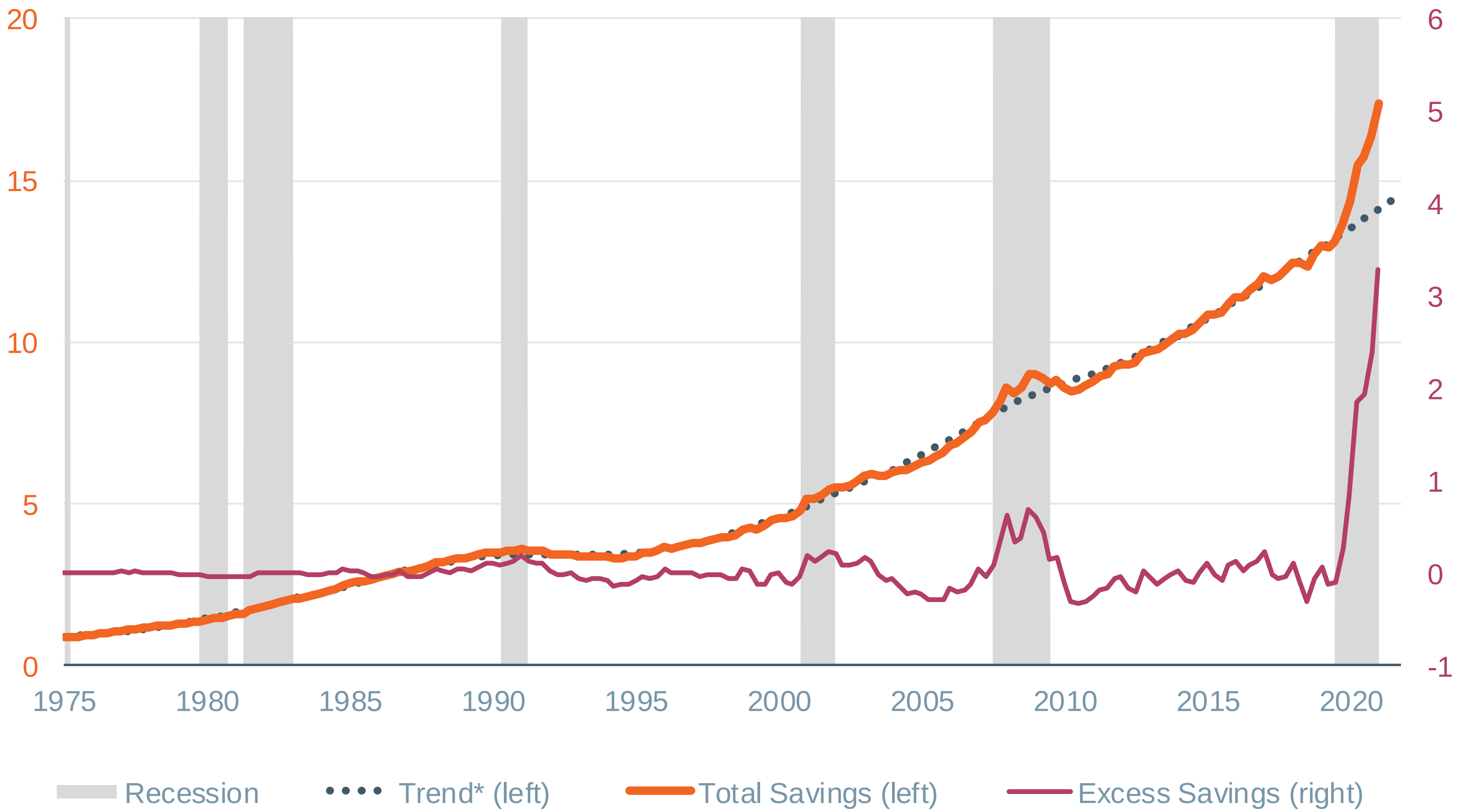
Consumer savings – Unprecedented levels

U.S. households have in aggregate saved $3.1 trillion above the pre-pandemic trend. Savings piled up due to lack of spending on services such as travel, vacations, and entertainment due to mitigations, and were fueled higher by stimulus checks. We expect these savings to help push overall spending higher in 2021 and 2022.

Household deposits in Checking, Savings, and Money Market accounts ($ trillions)



Data as of May 31, 2021. Sources: Federal Reserve, WTIA.

*Trend is established using a Hodrick-Prescott (HP) filter on the Savings data using the period shown. The HP filter refers to a data-smoothing technique. The HP filter is commonly applied during analysis to remove short-term fluctuations associated with the business cycle. Removal of these short-term fluctuations reveals long-term trends. This can help with economic or other forecasting associated with the business cycle.

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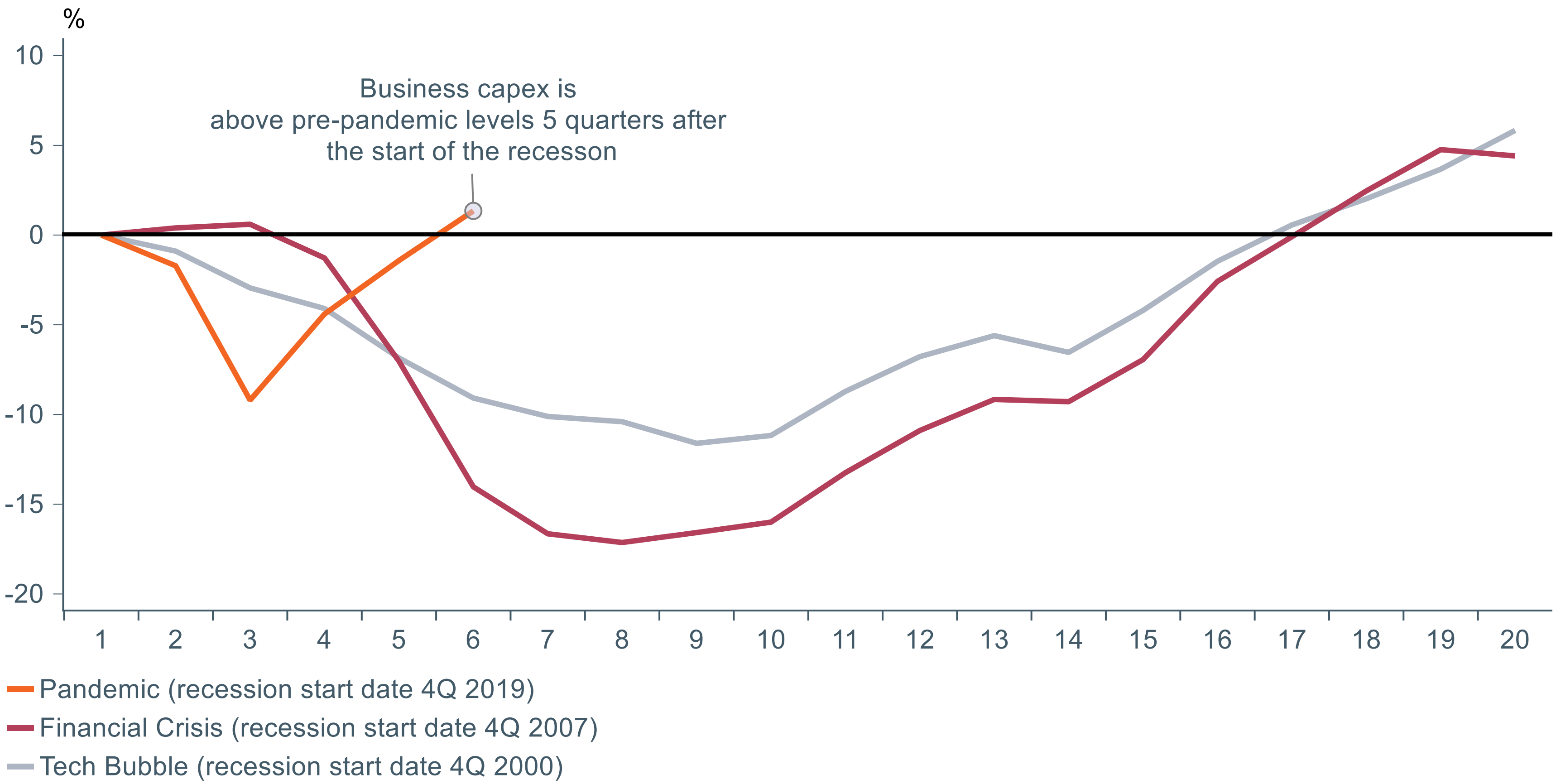
Section 2 Capex

Capital Expenditures – The rebound has been swift

Business capital expenditures (capex) is already slightly above pre-COVID levels as of 1Q 2021, just five quarters since the start of the recession (compared to an average of 11 quarters in the recessions since 1957).

Business Capex (cumulative % change in the quarters after the start of recessions)



Data as of May 31, 2021. Sources: Macrobond, Bureau of Economic Analysis.

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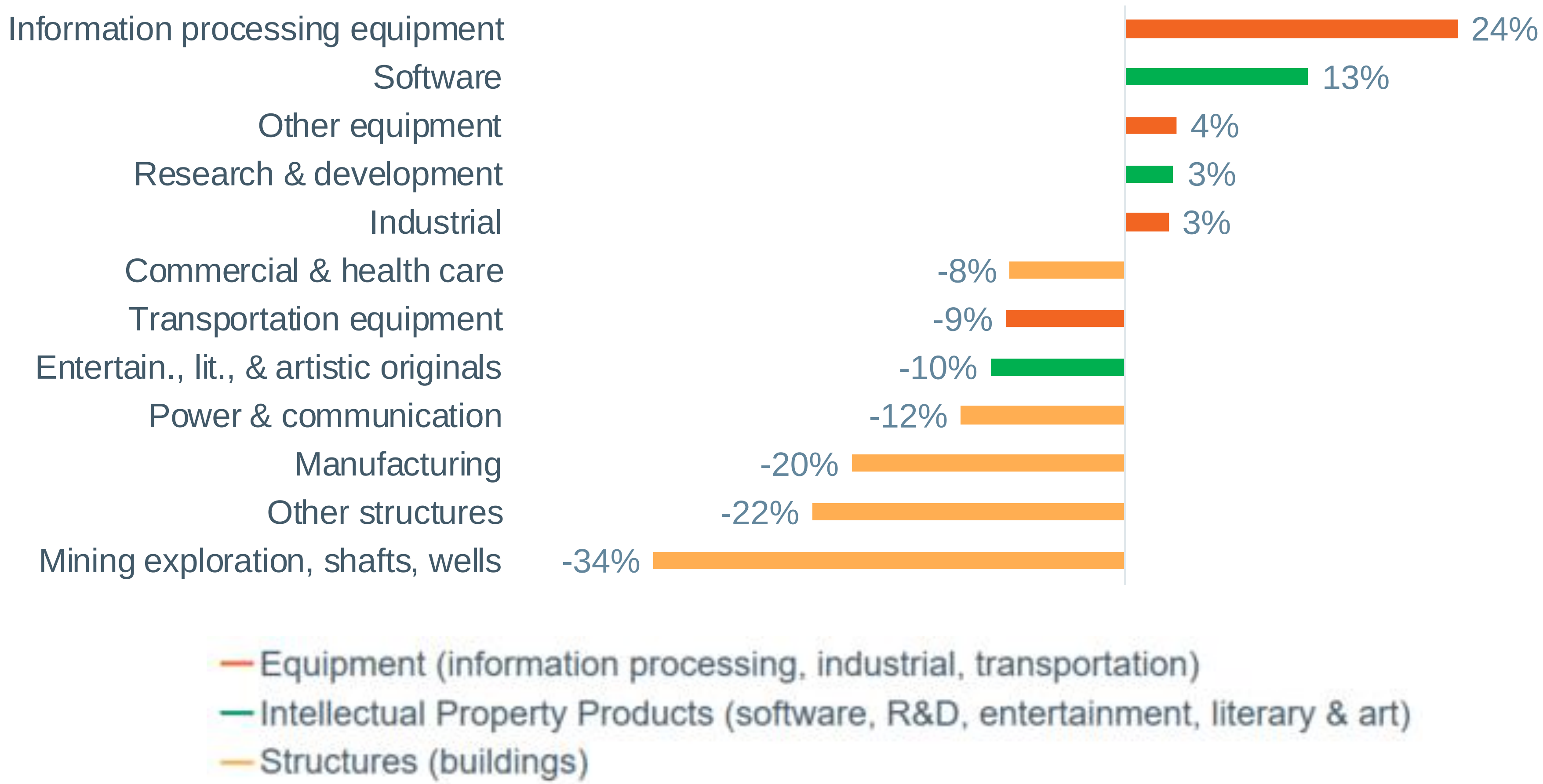
Capital Expenditures – Technology is king

Business capex has been led by spending on information processing equipment and software as firms rely on technology to adapt to the pandemic environment and increase efficiency.

Subcomponents of Business Capex (% change from 4Q 2019 to 1Q 2021)



Data as of May 31, 2021. Sources: Macrobond, Bureau of Economic Analysis

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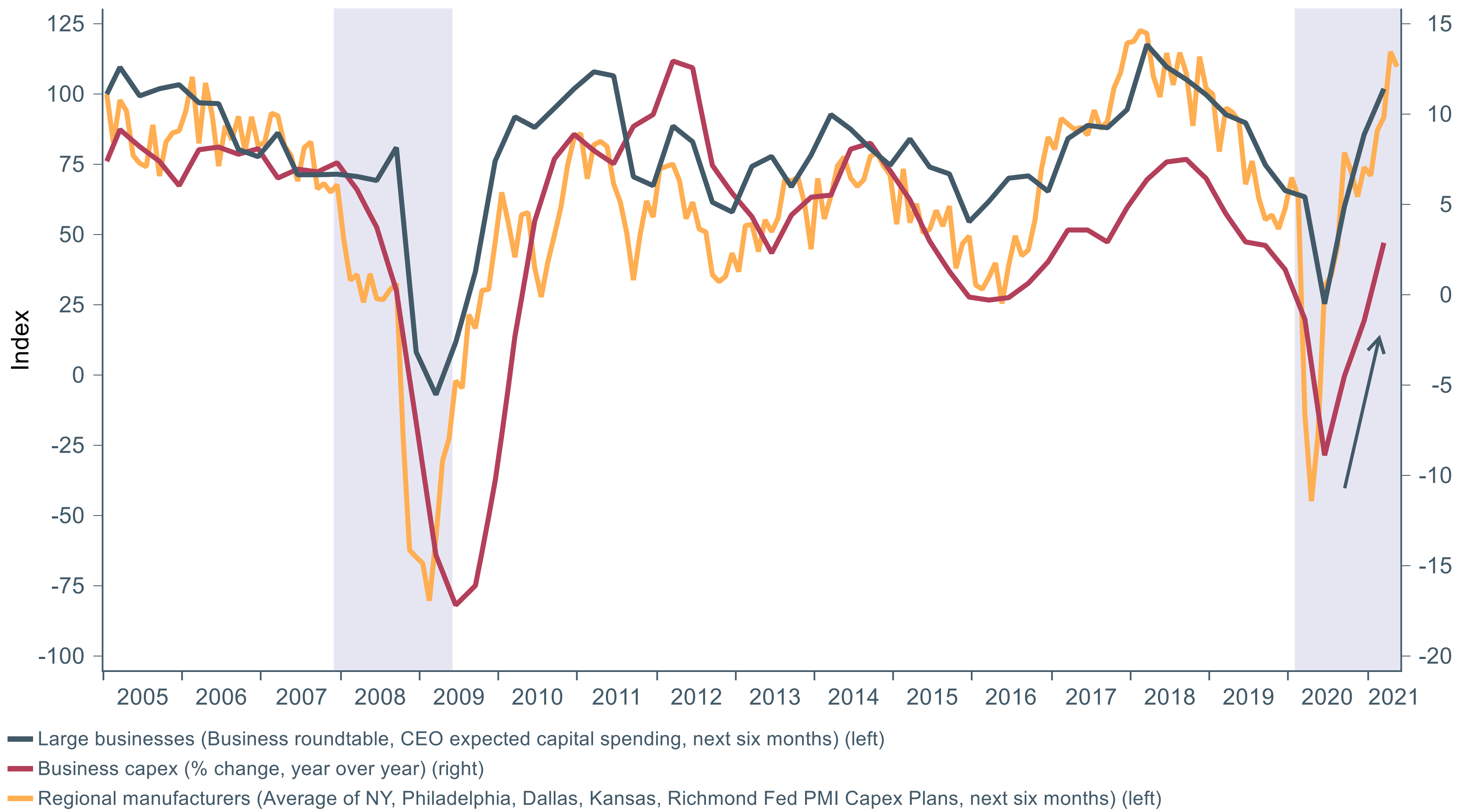
Capital Expenditures – Signs Point to Continued Growth

Firms have already accelerated capital spending, and we expect it to continue. Surveys indicate that large companies and manufacturing firms expect to increase capital expenditures in the months ahead.

U.S. business capital spending, manufacturer, and large-business capex plan



Data as of May 31, 2021. Sources: Macrobond, Bureau of Economic Analysis, WTIA.

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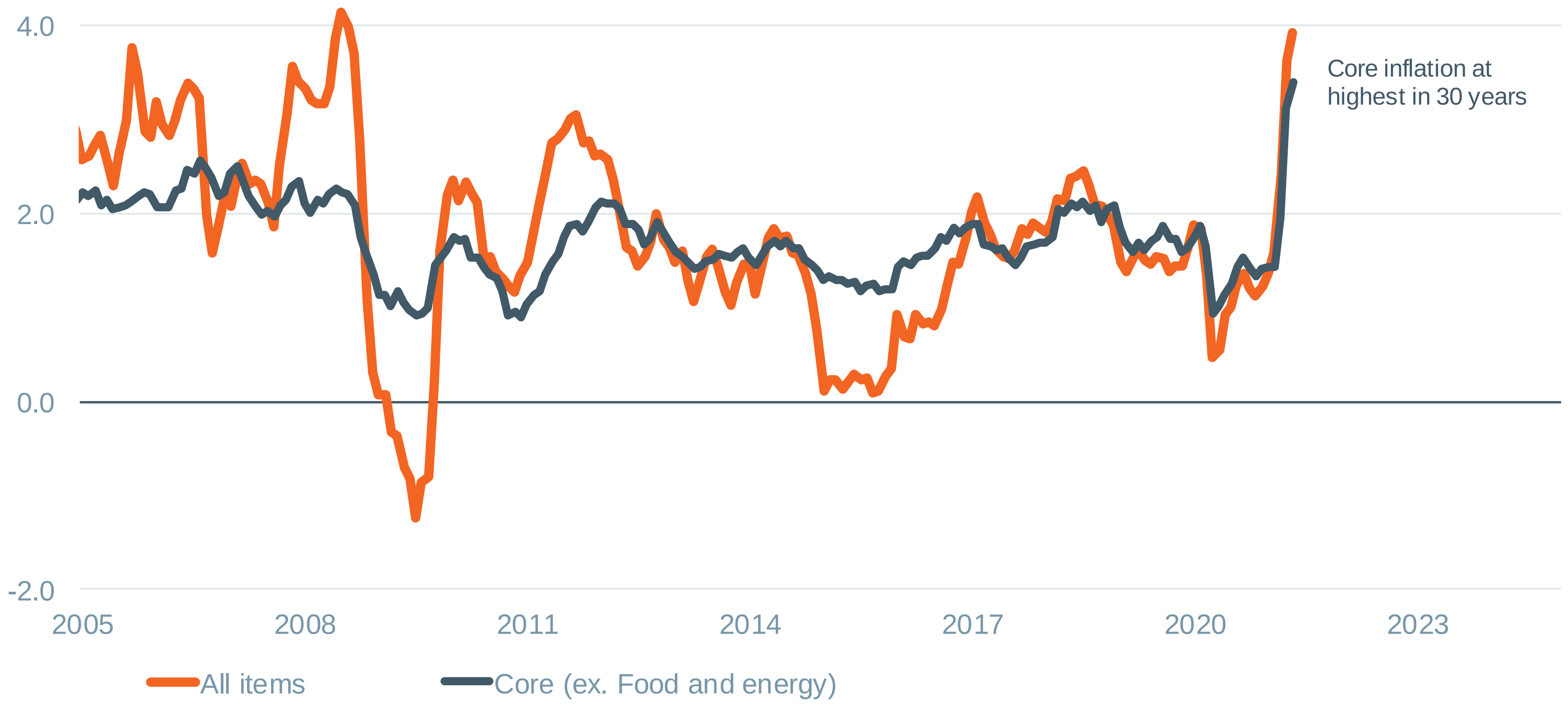
Section 3 Inflation

Current Inflation – Recent surge has drawn attention

The recent surge was driven partially by base effects as year-over-year comparisons in March, April, and May 2021 are to the corresponding months in 2020 when the economy was shut down and prices of many goods and services collapsed.

Personal Consumption Expenditure Price Index (% chg. y/y)



Data as of May 31, 2021. Sources: Macrobond, Bureau of Economic Analysis, WTIA.

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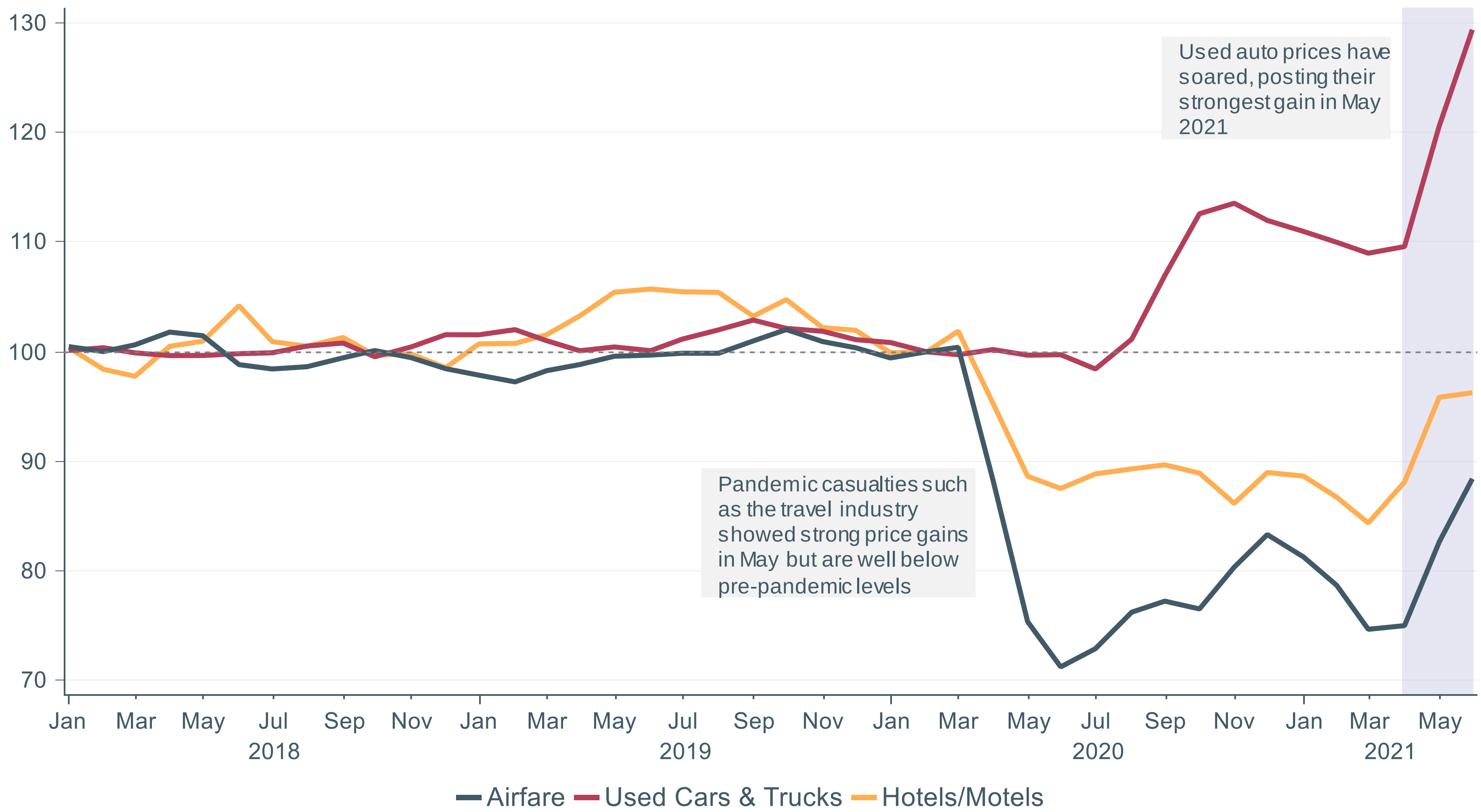
Current Inflation – Expected to ease after recent surge

Some of the recent acceleration is not from base effects but from true accelerations in April and May. We expect the 2021 acceleration in inflation to be transitory, and for price increases to slow as we move into 2022 as base effects, one-off impacts, and supply bottlenecks abate.

Price indices for select Consumer Price Index (CPI) components (February 2020=100)



Data as of May 31, 2021. Sources: Bureau of Labor Statistics, WTIA.

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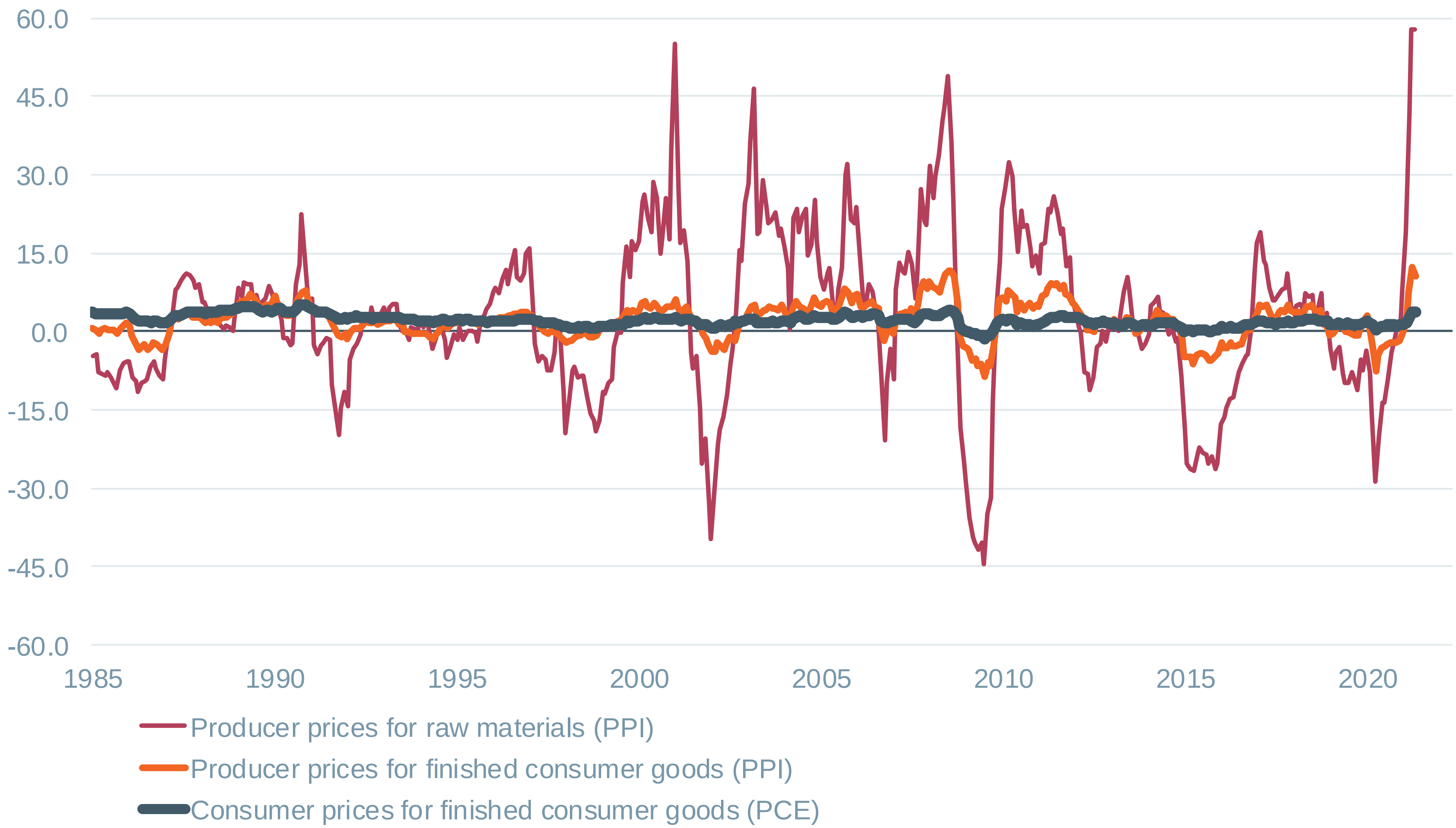
Current Inflation – The familiar commodity cycle

Prices of raw materials are up 58% year-over-year (y/y) but have started to ease and in some cases, fall. Our analysis* shows a tight relationship on the pass-through to consumers. About 15% of raw materials price changes flow through to intermediate costs and only 40% of those are passed on to consumers.

Producer and Consumer Prices of Goods (% chg. y/y)



Data as of May 31, 2021. Sources: Macrobond, Bureau of Economic Analysis. *Regression analysis of historical data for the time frame shown

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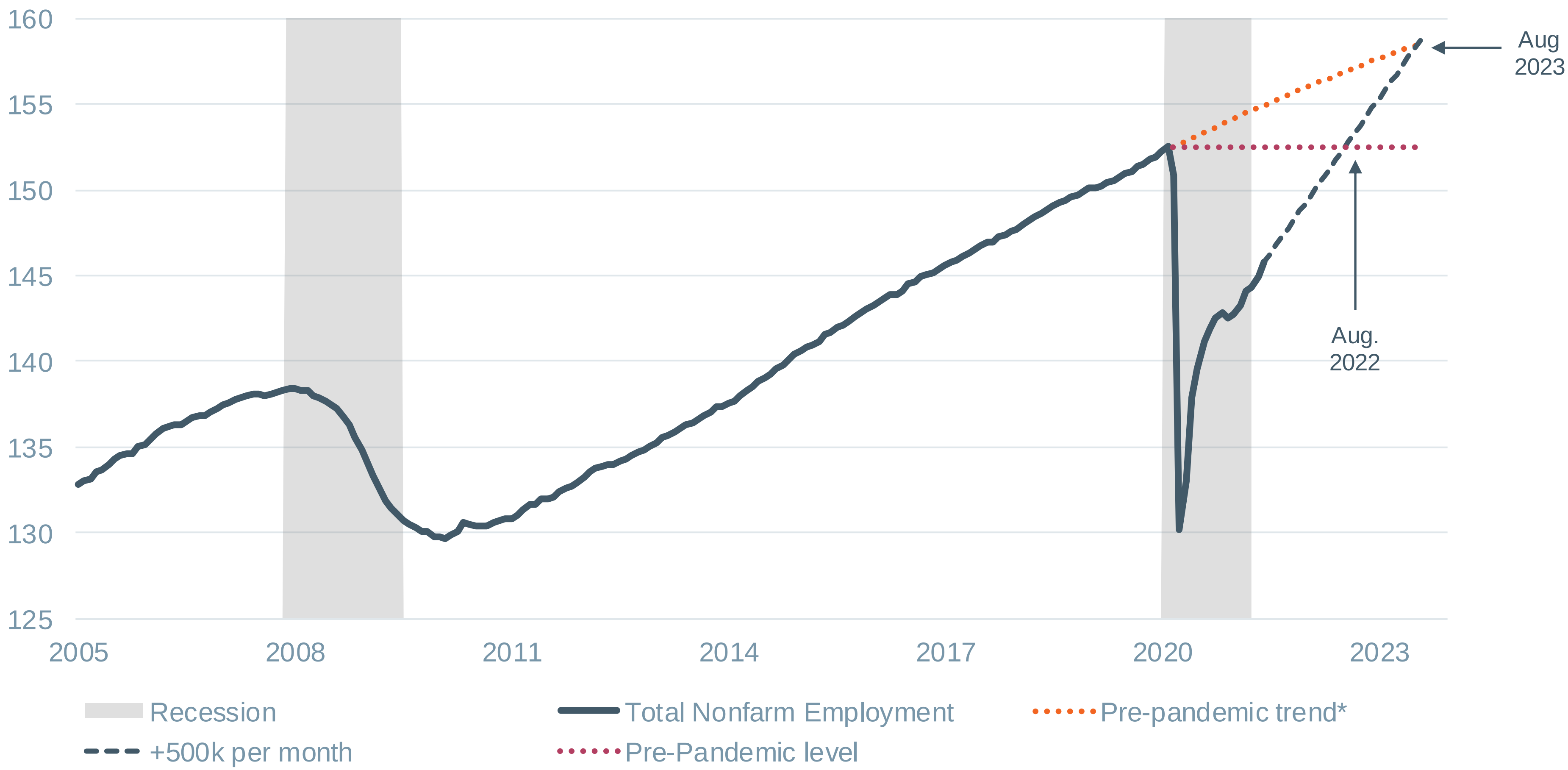
Section 4 Federal Reserve

Recovery of Labor Market - Jobs

There are many possible definitions of a full recovery of the labor market from the standpoint of jobs. Returning to the pre-pandemic level of jobs would take until August 2022 if employers added 500,000 per month. A higher hurdle would be the pre-pandemic trend*, which would take until August 2023 at that rate.

U.S. Nonfarm Jobs (millions)



Data as of May 31, 2021. Sources: Macrobond, Bureau of Economic Analysis.
*Job growth typically slows late in an economic cycle. Growth in the previous cycle peaked at 2% y/y in 2014-15 and slowed to 1.4% just before the pandemic. Here we assume a continued slowing to 1% by mid-2023.

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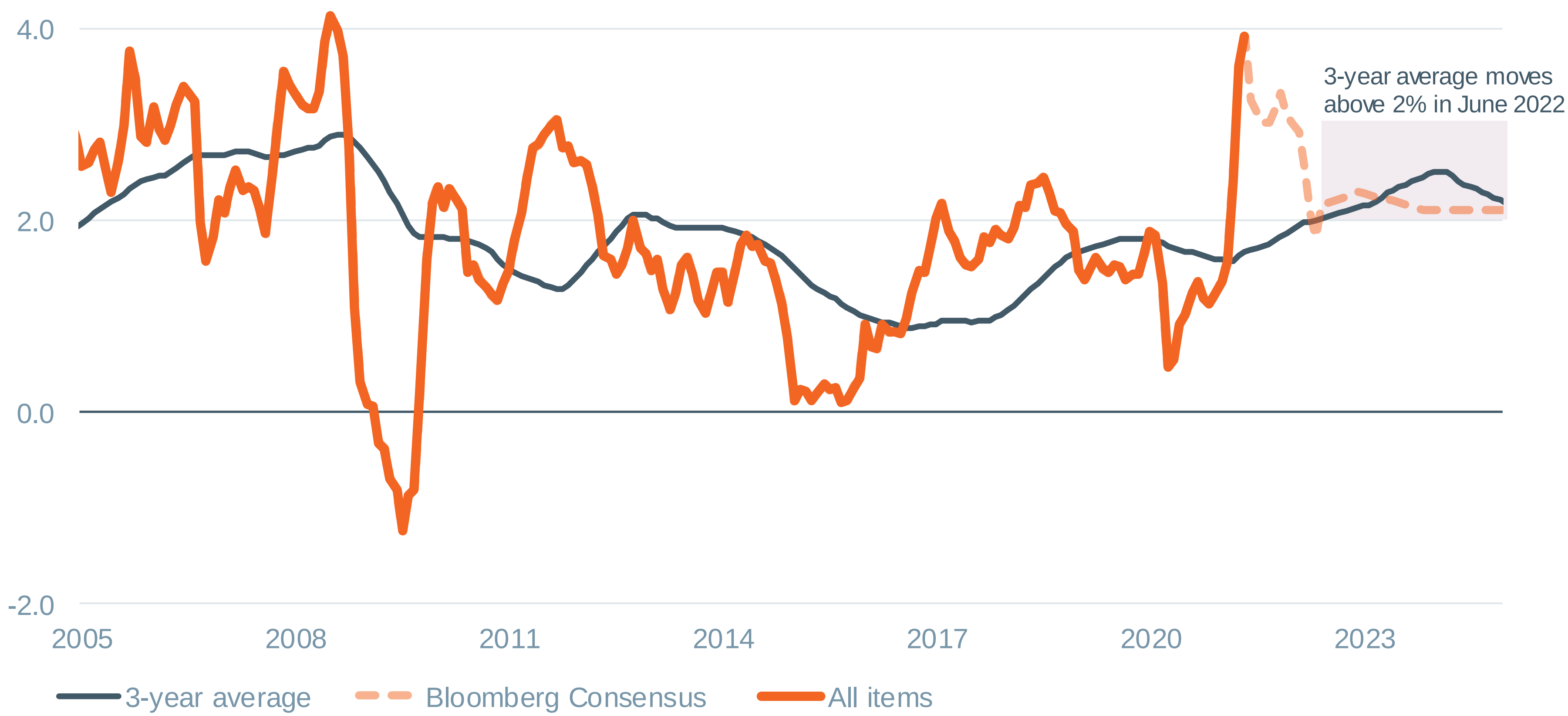
Current Inflation – Crossing the 2% threshold

In their new operating strategy, the Fed wants to see inflation "moderately above 2 percent for some time so that inflation average 2 percent over time." When asked about the time frame for the average, the Fed has been silent. By our calculations, if inflation follows the Bloomberg Consensus of 3.2% and 2.1% y/y in 2021 and 2022, respectively, then a trailing 3-year "look back" would cross the 2% threshold in mid-2022.

Personal Consumption Expenditure Price Index (% chg. y/y)



Data as of May 31, 2021. Sources: Macrobond, Bureau of Economic Analysis.

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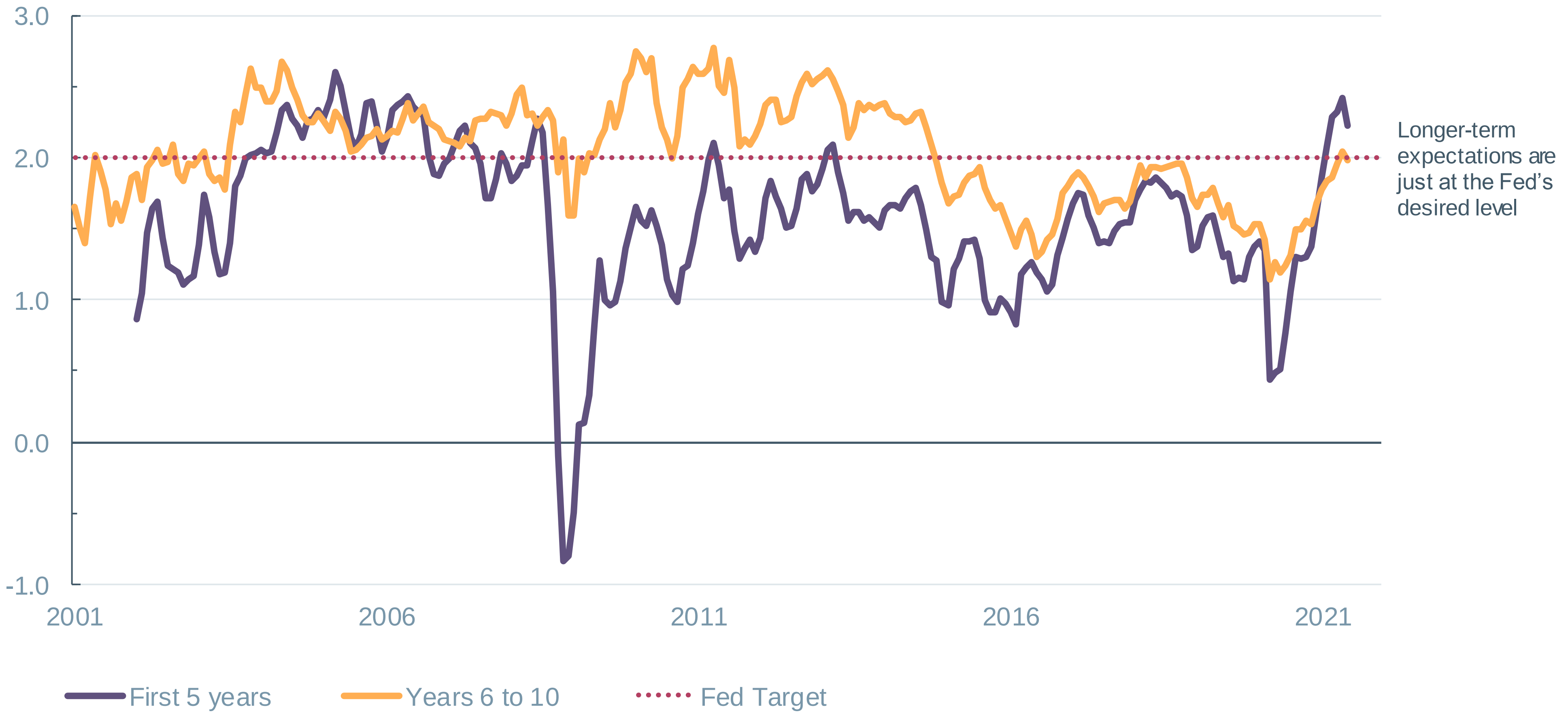
Expected Inflation – Still in check

The Fed wants to see "longer-term inflation expectations well-anchored at 2 percent." Breakeven inflation rates on Treasury Inflation Protected Securities (TIPS) are helpful indicators of the bond market's implicit inflation forecast. But TIPS are in terms of CPI inflation, which runs higher than the Fed's preferred personal consumption expenditures (PCE) measure of inflation. We adjust* TIPS breakevens and find expectations have just recently returned to the Fed's target.

TIPS Breakeven Rates adjusted from CPI to PCE terms (%)



Data as of May 31, 2021. Sources: Macrobond, Bureau of Economic Analysis, Bloomberg, WTIA.
*We adjust by calculating the average difference in CPI and PCE inflation for the 10-year period from 2009 to 2019 and subtracting that value from the TIPS breakeven rates reported by Bloomberg.

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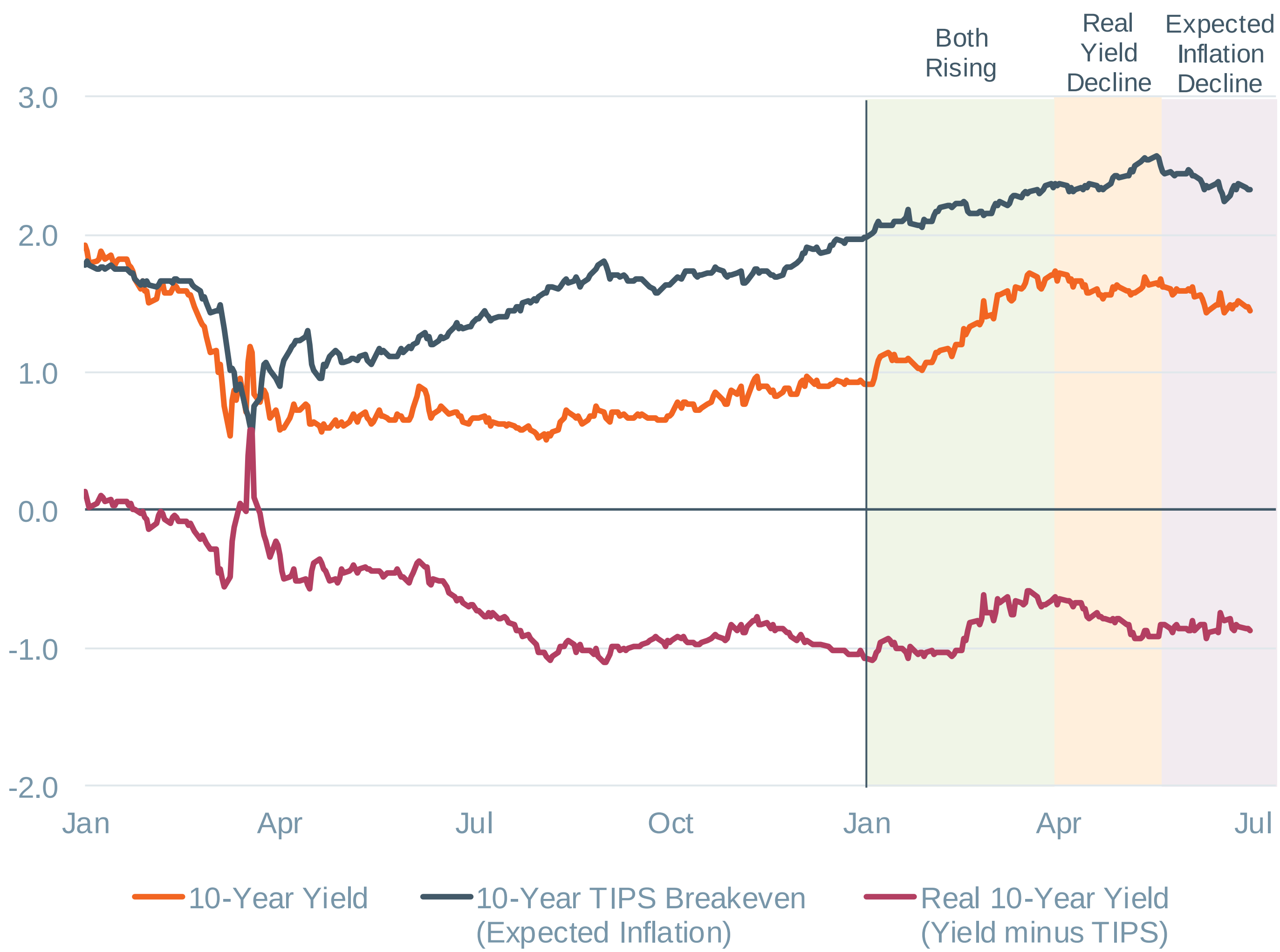
Section 5 Markets

Interest rates – Breaking down the 10-year yield

The 10-year yield surged from 0.9% at the start of 2021 to a peak of 1.74% at the end of March and has since drifted down to 1.45% as of June 30, 2021. We break the yield into inflation compensation and the real yield. In Q1 both were rising, followed by a period of decline in real yield then a decline in expected inflation.

U.S. 10-year Treasury (%)



Data as of May 31, 2021. Sources: Macrobond, Bureau of Economic Analysis.

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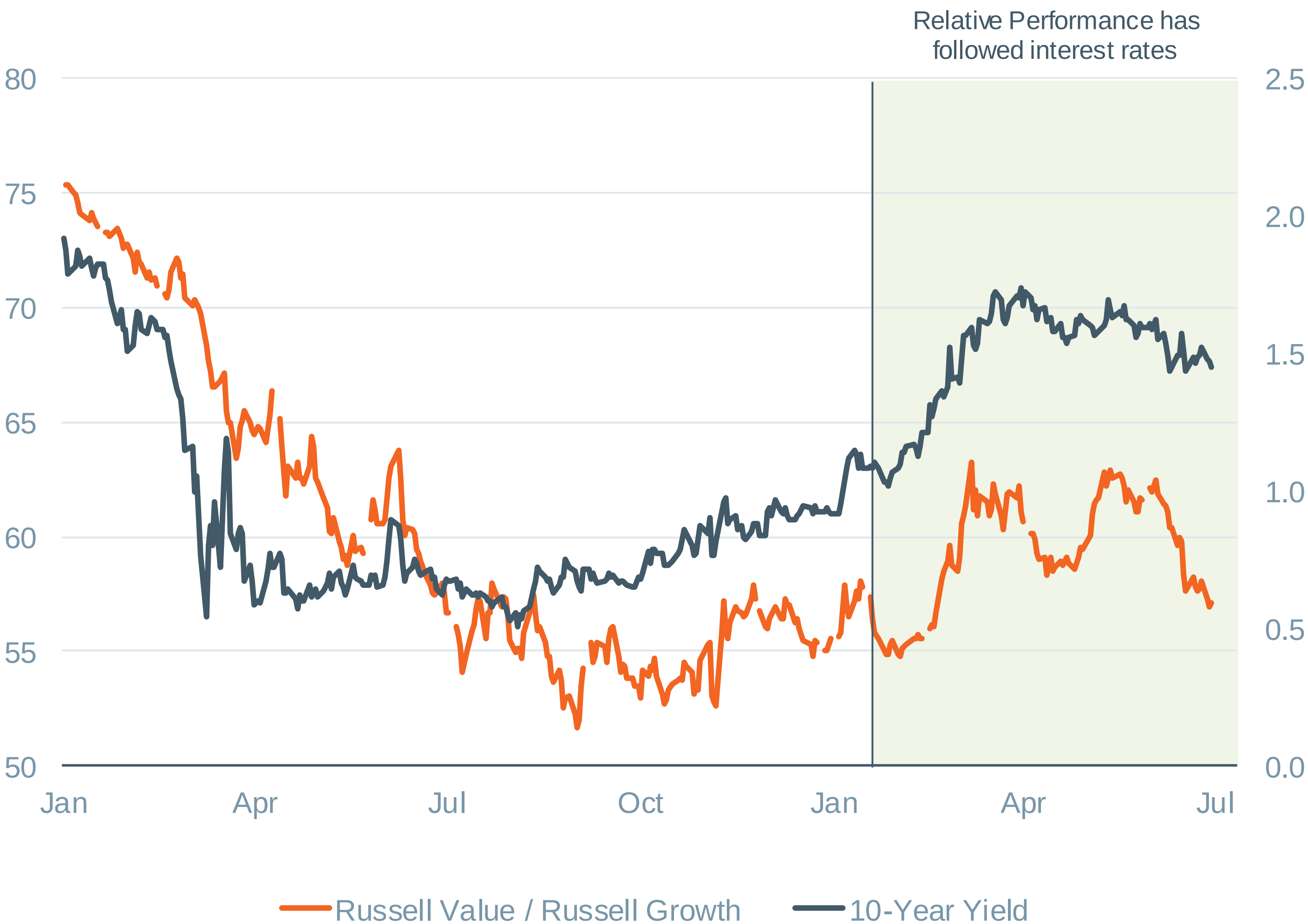
Equity Styles – Growth vs. Value

The relative performance of Value and Growth equities has tracked closely with interest rates since the start of the pandemic. The Value index generally outperformed the Growth index when interest rates when interest rates were rising.

Relative performance of Value and Growth Equities (ratio) and Interest Rates (%)



Data as of May 31, 2021. Sources: Macrobond, Bureau of Economic Analysis.

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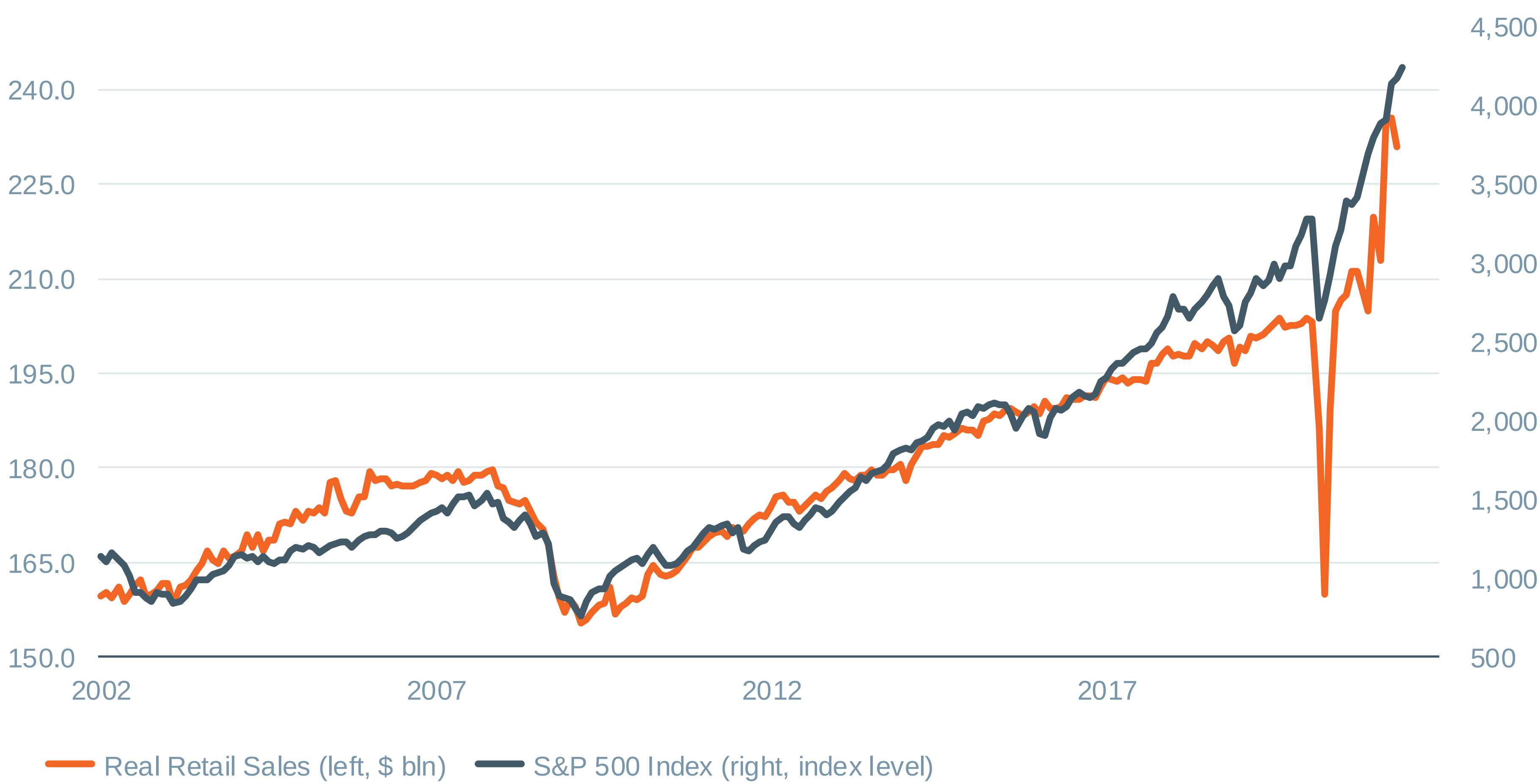
Section 6 Back to Mr. Buffett

Economics and Markets

The strongest connection between macroeconomic data and financial market data is through consumer spending. Real retail sales* is highly correlated with large cap U.S. equities.

Real Retail Sales and Large Cap Equity



Data as of June 30, 2021. Sources: U.S. Census Bureau, Bureau of Labor Statistics, Bloomberg, WTIA.
*We calculate real retail sales by dividing the overall figure reported by Census and divide by the Consumer Price Index reported by the Bureau of Labor Statistics

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Expertise In

- Economics
- Monetary policy

Luke is Chief Economist and Head of Economics, Asset Allocation & Quantitative Services for Wilmington Trust Investment Advisors (WTIA), a part of the M&T Bank family. Luke is also a member of WTIA's Investment Committee.

Prior to joining Wilmington Trust in 2015, Luke was an officer and economic advisor with the Federal Reserve Bank of Philadelphia. Earlier in his career, Luke worked as a senior economist at IHS Global Insight (now IHS Markit) and as an economist for the U.S. Department of Housing and Urban Development.

Luke holds a Ph.D. in economics from Temple University and a bachelor's degree in economics and history from James Madison University. He is a former adjunct faculty member at Temple University and formerly served on the board of directors of the Pennsylvania Economic Association. In addition, Luke is former president of the Philadelphia Council for Business Economics, a chapter of the National Association for Business Economics.

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The term Russell 1000 Value Index refers to a composite of large and mid-cap companies located in the United States that also exhibit a value probability. The Russell 1000 Value is published and maintained by FTSE Russell.

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