Chemung Canal Trust Company and Capital Bank, a division of Chemung Canal Trust Company

# Investment Outlook - July 2021

## Jobs and the Economy

Employment gains accelerated for the second consecutive month in June with the economy adding 850,000 jobs, far more than economists were expecting. There were modest upward revisions to the prior two months' reports, as well. It was the biggest monthly employment gain since August 2020, when the economy added 1.6-million jobs.

Despite the generally positive report, there were some oddities that pointed to ongoing unevenness in the labor market recovery. The unemployment rate edged up to 5.9% from May's level of 5.8%, as more than 150,000 people re-joined the labor force and were unable to find work. Both wages and hours worked grew at a slower pace than in May.

In all, it remains a job market that is out of balance. Employers are struggling to attract and retain staff as the economy continues to improve, while many workers remain unready to return to work. The number of job openings outpaced hiring by almost 400,000 positions in May, alone. Some are quick to attribute this disparity entirely to generous pandemic-era jobless benefits providing a disincentive to work, but evidence suggests that this is a factor only at the margins. A total of 26 states have announced an early end to pandemic-era benefits, and according to The Economist Intelligence Unit, data from those states shows that their announcements have not spurred their residents to return to their jobs in greater numbers. More likely, continued fear of infection, lack of child care and in-person schooling, and the lingering dislocations caused by the economic shutdown are the major factors in the gap between job openings and hiring. There is also the reality that it is easier and quicker to lay off workers than it is to re-hire them.

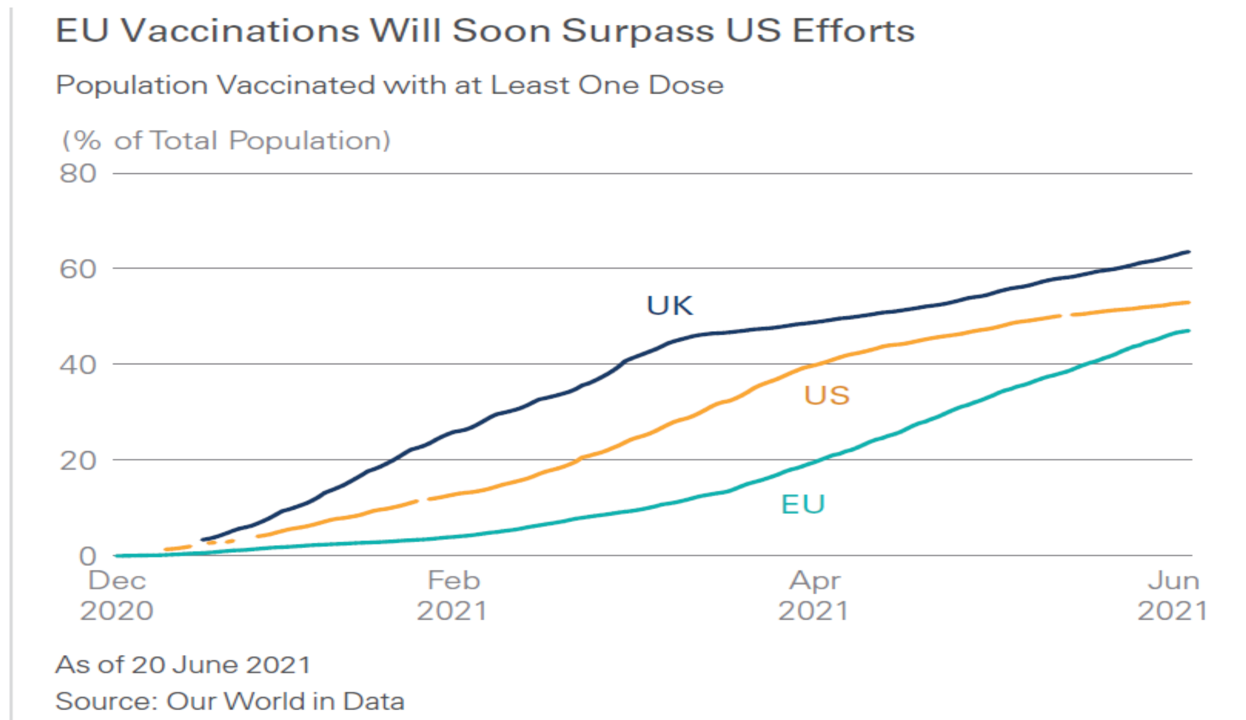
More than 22-million jobs were lost in the first two months of the pandemic. Fourteen months later, there are still 7-million fewer people working than in February 2020. If job gains continue at the average pace of the last three months, we will not return to pre-pandemic employment levels until September 2022. While headline unemployment stands at 5.9%, a research piece by Lazard Asset Management points out that when adding back in the people who have dropped out of the labor force altogether, the unofficial unemployment rate is closer to 8.6%.

Despite the slower than expected recovery in the job market, there are good reasons to think that the reports will improve in the coming months as children return to in-person schooling, supply chain disruptions are ironed out, and more of our population becomes immunized.

## COVID-19 Update

In the second quarter, 26% of all adults received at least one shot of a vaccine, bringing the total percentage of Americans who have received one dose or more to 53%, and the fully vaccinated percentage of our population to 45%. When you add in the number of people with acquired immunity from having been already infected, the U.S. population has achieved significant immunity to COVID-19, though at a level well below the President's target of having 70% of all adults vaccinated by July 4th. The pace of daily vaccinations has declined from more than 4-million doses per day in April to just 1-million in June, suggesting that the 70% target won't be achieved until well into the 3rd quarter, if then. By

comparison, the European Union (EU) has rapidly accelerated its vaccination programs, and is on pace to surpass the U.S. in the percent of its population that has been vaccinated before the 3rd quarter is over.




Still, the progress that has been made in the U.S. has resulted in the number of daily cases declining from more than 200,000 in January to fewer than 15,000 in June. Over the same period, the number of deaths has declined from more than 4,000 to fewer than 300. Most states have rescinded mask mandates and lifted COVID-related restrictions, spurring increasing demand for services, particularly restaurants, bars and domestic travel. More than 40% of the new jobs in the June report were in those sectors.

The best that we can say is that we are continuing to move inexorably back to normality, but normality may not necessarily mean familiarity. Changing patterns of behavior and consumption as a result of our experiences these last sixteen months are creating unknowns that are not predictable in their effects on the economy or the financial markets.

**Inflation**

As one news article has suggested, perhaps our key inflation metric, the Consumer Price Index (CPI), should be redubbed the Car Price Index.

The CPI climbed to a 13-year high in May, with prices up 5% compared to the same period last year. But fully one-third of that increase was due solely to the price of used cars. According to Edmunds, the average used car price is up 27% from a year ago, due to pent-up demand and limited supply. While one would expect that the demand for cars would rapidly increase in an economy emerging from an economic shutdown and awash in household savings, the simultaneous lack of inventory is the result of a perfect

storm of supply chain disruptions and rental car companies having sold a significant part of their fleets last year to survive the pandemic as demand came to a near halt. Now, with the dramatic rebound in travel, rental car companies are facing a shortage of cars to rent and aren't selling what they have. At the same time, new car inventories are low due to a shortage of computer chips, driving up the prices of both new and used cars.

Apart from autos, the bulk of the inflation so far has come from what's known as the Flexible Price CPI, a subset of goods and services included in the CPI that change price very frequently, and which tend to be most sensitive to supply trends rather than increases in demand. They are therefore less predictive of future inflation. The capacity utilization rate has risen to 75% from 63% in April 2020, evidencing that production is coming back online and price increases in these sectors should begin to moderate. By contrast, prices that tend to stick and portend future inflation, such as rent, education and medical services, have barely moved at all.

When we are considering price increases in cars, transportation, lumber, semiconductors, or any number of other inputs into the headline inflation readings that are sensitive to supply related issues, we need to consider the specific market explanations for these price changes, as well as the "base effects" due to the economic situation one year ago when the prices for these products were falling due to the pandemic. The numbers seem higher because they are being compared to the depressed levels of 2020. We expect that such comparisons will normalize within a relatively short period of time. The market-specific factors behind the current round of price increases, whether owing to extraordinary measures taken during the pandemic or resulting from its aftermath, may continue to create short term inflationary pressures over the next couple of years as supply chain kinks are worked out.

**Interest Rates and the Federal Reserve**

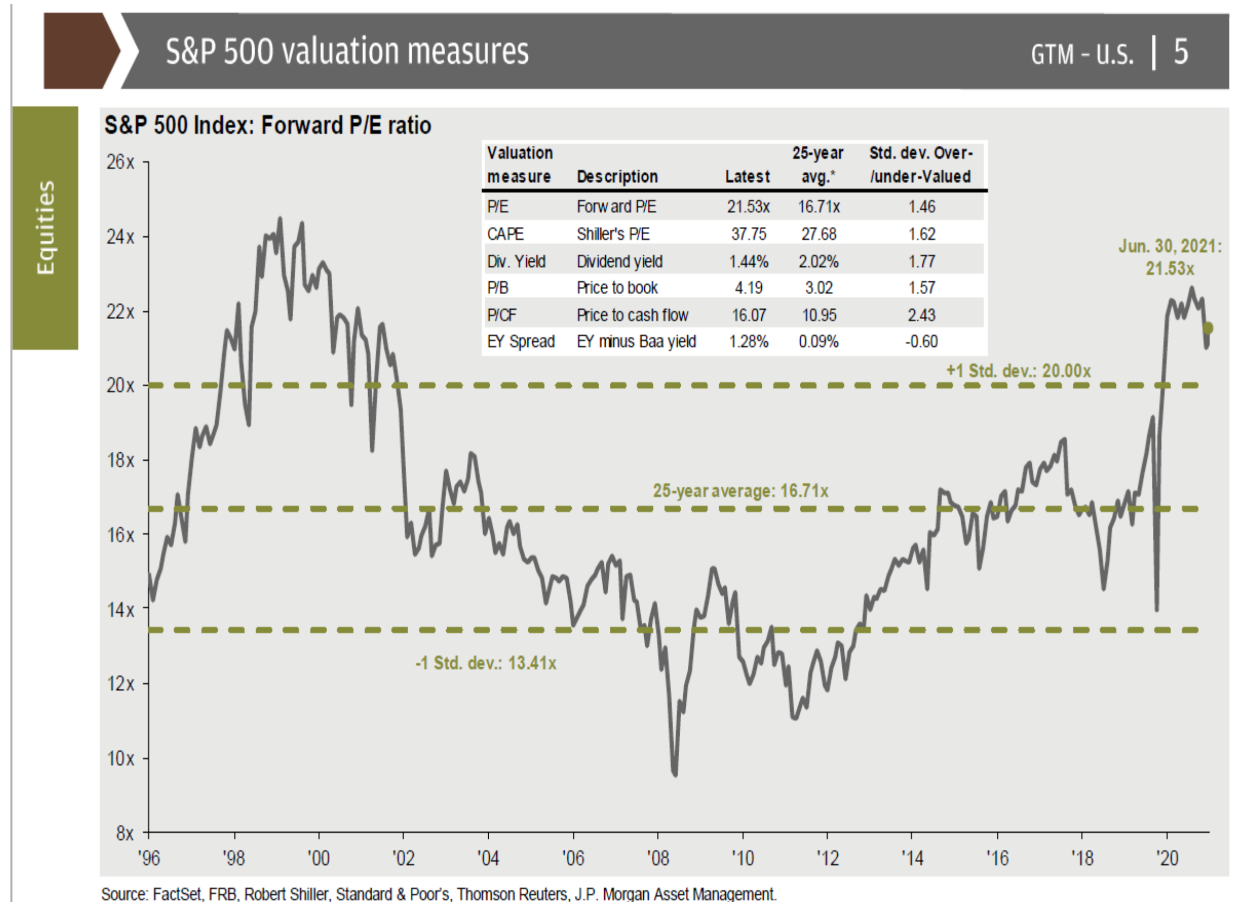
Transient inflation and slack in the labor market should continue to support the Fed's near 0% policy through late 2022 or early 2023. However, it is becoming more widely assumed that a rapidly improving economy will result in a slowing of the Fed's bond purchase program. Based on the minutes from the Fed's April meeting, "a number of participants suggested that if the economy continued to make rapid progress toward the Committee's goals, it might be appropriate at some point in upcoming meetings to discuss a plan for adjusting the pace of asset purchases."

One perplexing recent development has been the fall in the 10-year Treasury yield to 1.37% from its March level of 1.74%, even as inflation and growth expectations continue to rise. Perhaps the continued weakness in the labor statistics is putting a lid on rates, or the number of positive surprises in the economic data has moderated. Whatever the cause, the current yield is well above January's level, and we expect that long term rates will break out of their trading range to the upside and approach 2%-2.25% as the year goes on.

**The Stock Market**

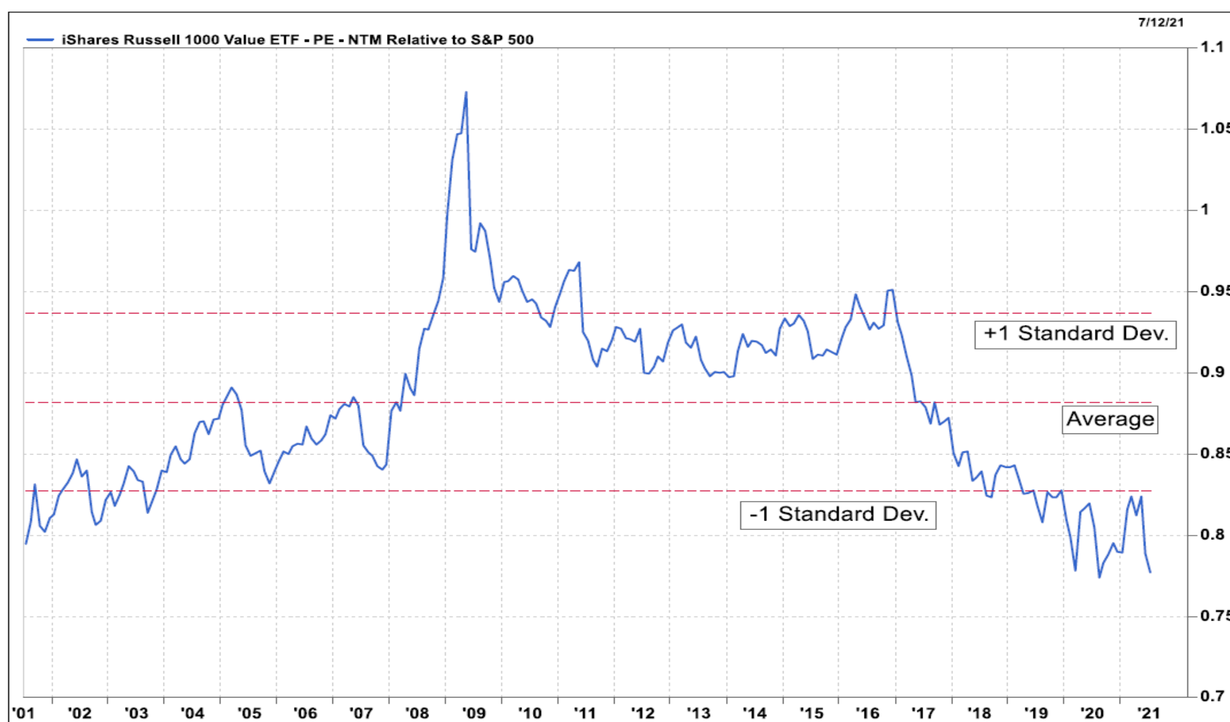
The market's rotation into the cyclical/value sectors of the market, which began last October, took a pause in June as interest rates fell and traders sensed that the rate of economic growth may be peaking. This caused a "re-rotation" back into the higher multiple, "growthier" names that drove the market in the early stages of the market's recovery from the 2020 lows. While the Russell 1000 Value ETF has declined 1% since the end of May, the 5 largest stocks in the S&P 500 (Apple, Microsoft, Google, Amazon, and Facebook) were up 13% as a group, driving the market's valuation even further above historical norms.

The price/sales ratios for both the S&P 500 and the NASDAQ 100 are now more than 30% above their peaks of the last cycle, and the market's forward price/earnings ratio is nearly 1.5 standard deviations above its average of the last 25 years. The chart, below, also shows a valuation measure known as Shiller's P/E, which measures the market's current price relative to the average of the last ten years of earnings, adjusted for inflation. That ratio, and all of the other more commonly used valuation measures such as forward P/E, dividend yield, price/book and price/cash flow, are indicative of an equity market that is richly valued when compared to its 25-year average.




| Valuation measure | Description | Latest | 25-year avg.* | Std. dev. Over-/under-Valued |
|---|---|---|---|---|
| P/E | Forward P/E | 21.53x | 16.71x | 1.46 |
| CAPE | Shiller's P/E | 37.75 | 27.68 | 1.62 |
| Div. Yield | Dividend yield | 1.44% | 2.02% | 1.77 |
| P/B | Price to book | 4.19 | 3.02 | 1.57 |
| P/CF | Price to cash flow | 16.07 | 10.95 | 2.43 |
| EY Spread | EY minus Baa yield | 1.28% | 0.09% | -0.60 |

As we have pointed out in the past, high current valuations should indicate lower expected *future* returns, but are poor predictors of near term performance. Stocks can – and often do – remain over-valued for extended periods of time. This is an even greater possibility in the current environment, with the Fed pumping liquidity into the system and the returns from competing asset classes relatively unattractive. But those areas of the market that are most extended will also be the most vulnerable if inflation proves to be more persistent than we expect, or if interest rates rise or the Fed moves to drain liquidity from the system. So we are at a strange crossroads in the market, where valuations are too high to recommend new commitments and the fundamentals are already discounted in the prices, but the technicals are too strong to recommend lightening up.




The good news is that stock-pickers can still find value in this market, and "value" stocks are more under-valued relative to the market (chart, above) than at any time in the last 20 years. These stocks are largely concentrated in the industrial, financial, materials and energy sectors which are more leveraged to an improving economy, and are relatively less sensitive to changes in interest rates, so we are comfortable maintaining our over-weights in these areas. So long as the economic recovery proves to be durable, we think these areas will again outperform, while their low relative valuations provide a measure of downside protection.

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