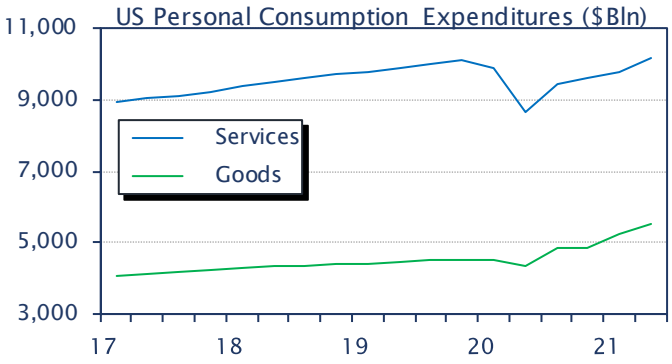
SEPTEMBER 2021

Agincourt
CAPITAL MANAGEMENT, LLC

INVESTMENT UPDATE

Last month we covered some of the more unusual aspects of the current economic recovery, focusing particular attention on employment. Since then, August's US nonfarm payroll figures were released, showing a disappointingly slow pace of new hires. With extended unemployment benefits due to expire in the first week of September, and with an estimated 10 million job openings, it was expected that there would be a surge of folks re-entering the job market, with economists expecting at least 750,000 net jobs added in August; the tally came in at less than 250,000.

To be fair, the labor markets are a well-known lagging indicator of economic strength—most employers will increase the hours of existing employees to every reasonable extent before going to the expense and trouble of making new hires. There are more direct, contemporaneous indicators of economic health than those which measure the labor markets. In this *Update*, we'll look at the Bureau of Economic Analysis' national income figures, including components of US GDP. Even though the data is only updated quarterly, it directly measures US economic output.



Econ 101 tells us that GDP (a country's "gross domestic product") is measured over a period of time, and is equal to "C + I + G + E"; "C" is consumption, "I" is investment, "G" is government expenditures, and "E" is net exports. In the US the biggest component of GDP is "C," personal consumption, which currently makes up approximately 69% of the US economy. Included in personal consumption are goods (24% of US GDP) and services (45%). Historically, when we look at past US recessions, the services component of consumption has been very stable, declining only modestly during downturns, while consumption of goods tends to take a big hit. This makes intuitive sense: In a recession, households pull back on purchases of goods—especially durable goods like automobiles or large appliances—while spending on services, such as utilities, medical expenses, and education, tend to be "stickier" and don't drop off to the same extent.

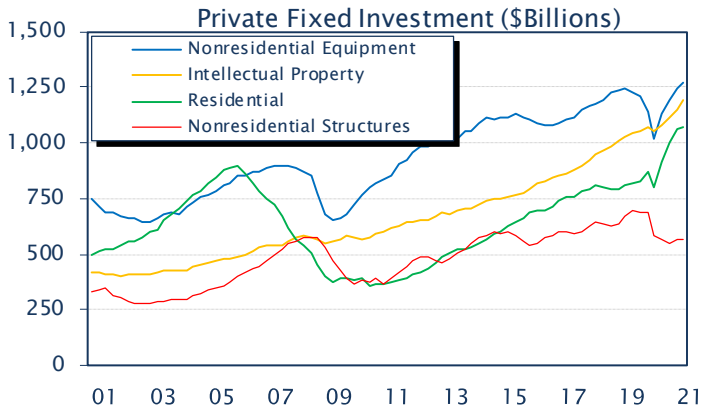
Like many other aspects of the 2020 recession, though, things have been topsy-turvy in this cycle. Last year, as the impact of COVID spread across the US economy, spending on services dropped dramatically, while household spending on goods barely stumbled. As the chart on this page shows, spending on goods only fell by $181 billion from the first quarter to the second quarter of 2020, a 4% decline, compared to a drop of $1.3 trillion, or 14%, for services. It took more than 18 months for spending on services to reach its previous level, while goods purchases rebounded immediately. When we combine the two components, the US economy appears to be back on track, but spending on services remains comparatively low.

Again, this makes sense; COVID severely reduced the demand for health care services, transportation services, recreation, and food service and accommodations, and spending on these categories remains at or below pre-COVID peaks today. Meanwhile, goods consumption is now more than one trillion dollars above pre-COVID highs. With households spending less on vacations, business travel, lodging, restaurants, and entertainment, there was more discretionary income available to spend on goods, including home improvement, computers/electronics, cars, and recreational equipment. In addition, pandemic-related benefit payments boosted US disposable income to a level 9% above the pre-pandemic trend in the first half of 2021, helping to fuel these purchases.

Over time, consumption of services will catch up, relatively speaking, as the growth in goods spending is set to cool, due to both supply and demand considerations. The rise of the Delta COVID variant has slowed the outlook for growth in the second half of 2021, as businesses and households adjust to another period of uncertainty. In the manufacturing sector, the Delta variant is causing ongoing disruptions to the global supply chain, as less developed economies (where both raw materials and many manufactured goods are sourced) are months behind developed nations in vaccinating their populations. US auto sales have fallen to recession-level volumes, not because of declining demand, but because manufacturers are struggling to source vital computer chips and other components due to rolling factory shutdowns in southern Asia. These issues aren't just related to vehicle sales, as many other industries are experiencing manufacturing disruptions, limiting production and curtailing supply.

Meanwhile the heavy demand for goods is likely to cool in the coming months as extended benefit payments are steadily phased out. As mentioned above, the economy has been supported over the past eighteen months by a number of government-sponsored pandemic relief programs, which flowed into households and businesses, peaking earlier this year at an annual run rate of $5 trillion. We could see this impact softened by the reduction in the current high level of household savings rates, as some may dip into their piggy banks in order to offset the loss of supplemental income.

While consumption is the main driving force for economic growth, the remaining 31% of the economy is split fairly evenly between private fixed investment and government expenditures (exports are a net negative, and a small drag on US GDP). Government expenditures are the most stable of the major GDP components, but there's an effort to boost this category in the coming quarters. While the Senate has agreed on a $580 billion infrastructure deal, the House, along with the Biden administration, is working on a $3.5 trillion package. The expectation is that Congress will come up with a compromise bill in the $1.5 trillion range, paid for with roughly $800 billion in new taxes, all spread over a ten-year period. Assuming these numbers are in the ballpark, this would add a few tenths of a percentage point to 2022 GDP growth, with most of that coming late in the year, and a declining positive impact over time.



Private fixed investment, which makes up approximately 17% of US GDP, is a volatile "swing factor" in the US economy, as both households' and businesses' commitment to future investments have varied considerably throughout history. True to form, as the chart on this page shows, there have been very different paths for the components of this group lately. Two of the main components here measure investment in structures, residential (housing and other fixed property), and nonresidential structures. These two have moved in opposite directions over recent months. Residential investment has been the fastest growing component of fixed investment, up 34% from the second quarter of 2020, amid increased demand and relatively short supply in the US housing market. Demand is elevated due to shifting preferences among homebuyers looking for upgrades (or making improvements on their existing homes) to better accommodate working from home and remote learning. Note that this has been a very different pattern from what happened to residential investment when real estate prices crashed in 2007-2009, as this series didn't recover from its 2006 highs until after the pandemic began. At the other end of the scale is nonresidential structures, reflecting the weakened state of commercial property owners (think shopping malls and downtown offices). It's hard to imagine any significant growth in investment in this category in the coming quarters, with the exception of warehouses and data centers. Over the past decade, these two categories paint a very different picture of the US economy, with investment in commercial structures having barely added to economic growth.

The other two categories are intellectual property and nonresidential equipment. Intellectual property investments are split roughly evenly between software (yes, that's considered a "fixed investment") and research and development. In our tech-heavy service economy, it's easy to imagine that this category would be fairly recession-proof, and during the past two downturns (each highly destructive to capital in their own way), this series has grown with near-clockwork precision. Once again, this is in contrast to nonresidential equipment, easily the most cyclical component of private fixed investment. This includes heavy equipment for energy, mining and manufacturing, transportation equipment, and (another weird inclusion) computer hardware.

With the exception of nonresidential structures (a relatively small component), the outlook for private fixed investment is strong. Growth in industrial equipment purchases may be held down for the next few months due to supply chain disruptions, but this is a sector that should benefit from secondary effects if infrastructure spending ramps up in the coming years. As for residential investment, while it's reasonable to assume that the supply-demand imbalance in housing will realign over time, until then money will continue to flow into the construction of new homes. And intellectual property spending, which has grown at a consistent 7% annual rate for the past decade, shows no signs of slowing; steady growth here is the nearest thing to a sure bet, economically speaking, that forecasters can count on.

In short, consumption—the biggest component of US GDP—has been on a tear over the past 18 months, but is set to take a flatter trajectory in the coming months as purchases of goods slow. Some of this will be offset by a rotation into increased consumer spending on services. Meanwhile, government expenditures and private fixed investment should continue to provide steady growth over the next year or two, even if residential investment cools off, as the effects of a modest infrastructure deal begin to contribute to growth.