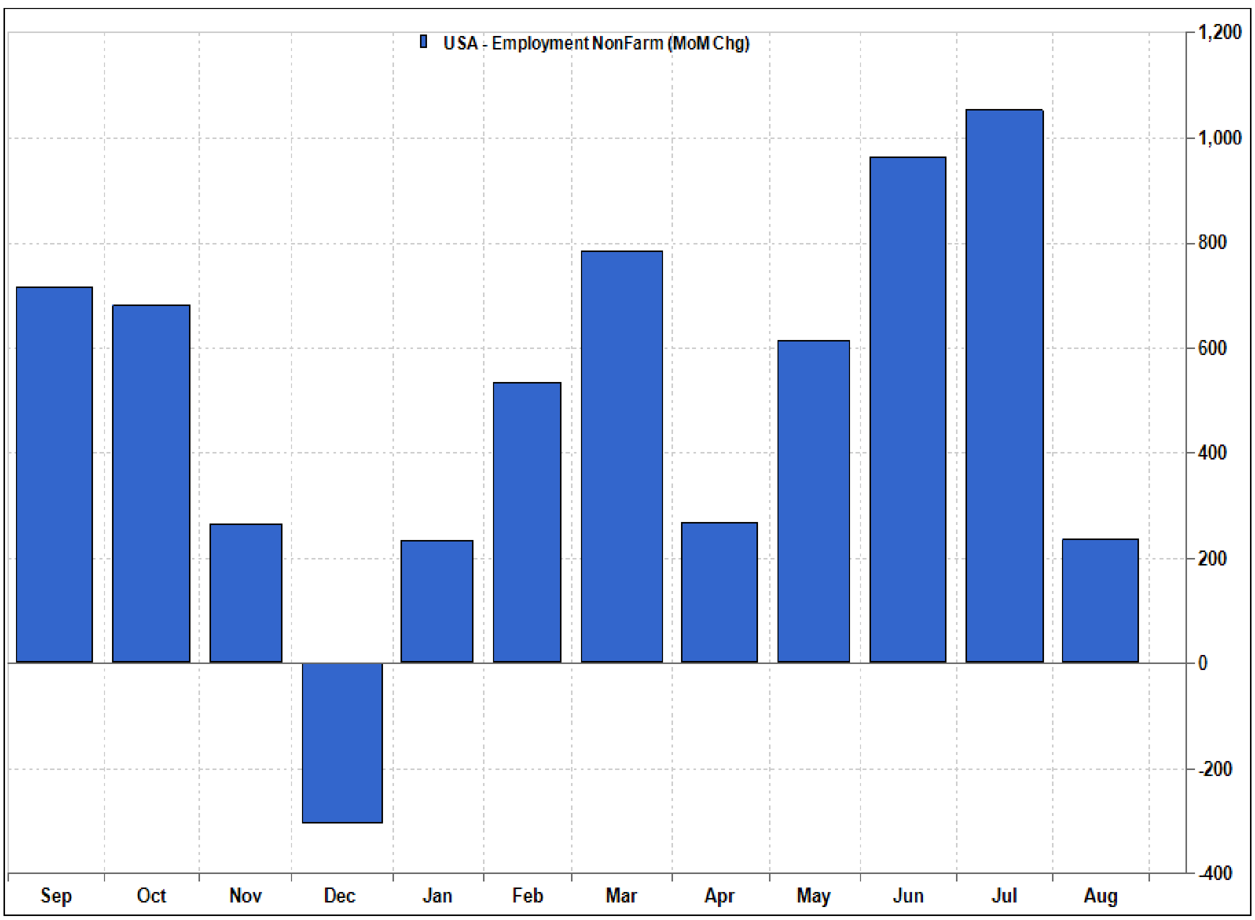
Chemung Canal Trust Company and Capital Bank, a division of Chemung Canal Trust Company

Investment Outlook - September 2021

Jobs and the Economy

August’s non-farm payrolls rose by a much weaker than expected 235,000 jobs, the smallest gain in seven months and far below the Bloomberg consensus which was expecting more than 700,000 new jobs during the month. While the disappointing report created negative headlines and much over-reaction from the ubiquitous cable news talking heads, it would be a mistake to attach too much importance to a single monthly report.

To begin with, monthly jobs reports are historical, not predictive. They tell us what has already happened, not what is happening now or what is likely to happen in the future. Also, employment data has been understandably volatile as we have emerged from last year’s COVID related shutdown (chart, below). And August has historically been an unpredictable month, with seasonal factors such as vacations, furloughs due to factory re-tooling and back-to-school activities all affecting the data.



It should be pointed out that there are actually two employment surveys, which generally move in the same direction over time but often differ widely in any given month. The payroll survey, upon which the headline data is based, estimates the nation's employment by surveying about 400,000 business establishments. The Bureau of Labor Statistics (BLS) then revises the data to estimate total U.S. payroll employment. The household survey, however, which is not as widely reported, estimates the level of employment by surveying 60,000 households. The two surveys differ in concept as well as scope. While the payroll survey counts the number of jobs, the household survey counts the number of workers. While the payroll survey covers only wage and salary workers on non-farm payrolls, the household survey covers those workers, as well as agricultural workers, the self-employed, and workers in private households. Some economists argue that the payroll survey tends to undercount workers in the early stages of an economic rebound, as it focuses on a fixed set of businesses and misses jobs being created by new, start-up businesses.

The August household survey, in contrast to the disappointing payroll survey, indicated that the economy added a solid 509,000 jobs during the month, following a powerful gain over more than a million new jobs in July. It also showed that while COVID sensitive sectors such as leisure & hospitality and retailing weakened, the manufacturing sector continued its strong recovery. Other indicators more predictive of future trends such as initial jobless claims continued to show improvement, and job openings are at record highs. The unemployment rate is derived from the household survey, and it fell to a cycle low of 5.2% in August.

We expect that payroll gains will re-accelerate as we move into the fall, with school re-openings easing childcare constraints. We would also expect the sectors most affected by COVID to rebound as the Delta wave peaks, as it appears to be doing, and the ranks of the unvaccinated grow thinner.

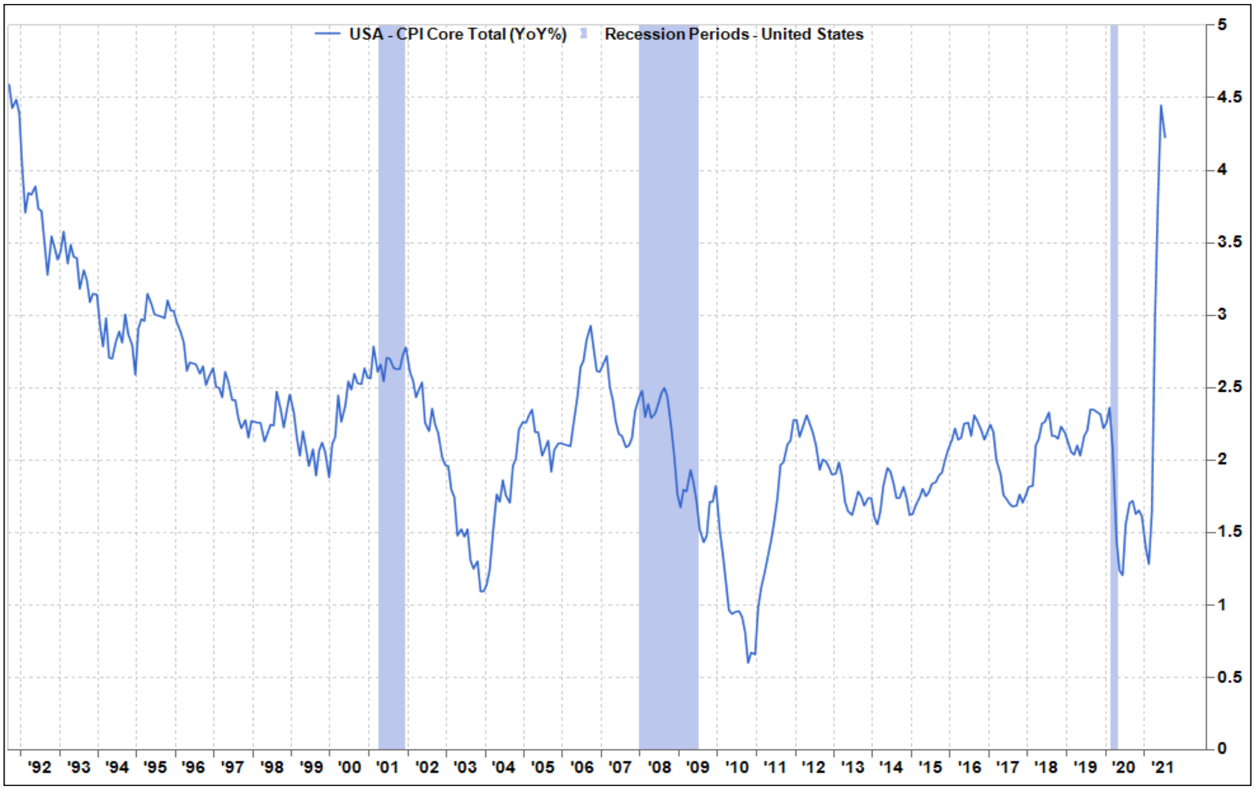
Elsewhere, momentum in the manufacturing sector continued in August, as the ISM Manufacturing Index rose to 59.9 from 59.5 in July. A reading above 50 is indicative of a manufacturing economy that is expanding. The forward-looking New Orders Index, which has been highly correlated to capital spending and corporate earnings growth rates, rose to 66.7 in August from 64.9 in July. According to research provided by MKM Partners, whose guidance has proved to be consistently reliable, current ISM data is consistent with an economy growing at an above trend 6% real growth rate, and a 8-10% nominal growth rate. Such rapid growth, along with a tightening labor market and ongoing supply chain interruptions, should continue to exert upward pressure on inflation for the foreseeable future, but we do not expect any of these conditions to be problematic long term. Sustainable real GDP growth is limited to the growth of the work force plus productivity gains, and will thus eventually revert back to the 2%-2.5% we experienced in the last cycle, and the economy will work through its supply chain issues over time.

Inflation

The Core Producer Price Index (PPI) has risen from its pre-pandemic peak of 1.6% in January 2020 to a 7-year high of 6.1%. The core Consumer Price Index (CPI) rose from its pre-pandemic peak of 2.4% to 4.5% in June 2021, before easing to 4.3% in July. And the core Personal Consumption Expenditure (PCE) Index, the Fed's preferred measure of inflation, has risen to a 30-year high of 3.5%, up from its pre-pandemic peak of 1.9%. The current core PCE reading is well above the Fed's much-discussed long-term target of 2%, and it is important to note that the so-called "base effects" caused by comparisons to the low levels of April-June of 2020 are no longer relevant – and inflation numbers are still rising.

Chairman Powell acknowledged in July that "inflation has increased notably, and will likely remain elevated in coming months before moderating." The operative word in Powell's statement would seem to be "months", as in not years. And "elevated" is a fairly relative term. For example, crude oil prices today have risen to around $70/barrel, more than 4 times the pandemic low of $17 in April 2020, and significantly above the pre-pandemic level of $50. But coming out of the Great Recession of 2008-09, oil prices spiked from below $40/bbl to above $110/bbl, and remained elevated above $80/bbl for the first 5 years of the longest economic expansion in our history.

For now, we cannot make a case opposing the Fed's assurance that inflation is not a long term concern, as we believe that temporary supply interruptions are conspiring to drive up prices as we emerge from an unprecedented economic calamity. But we also note that the current inflation readings are higher than in all past early cycle periods over the last 30 years (chart, below), so we will remain watchful.



Interest Rates and the Federal Reserve

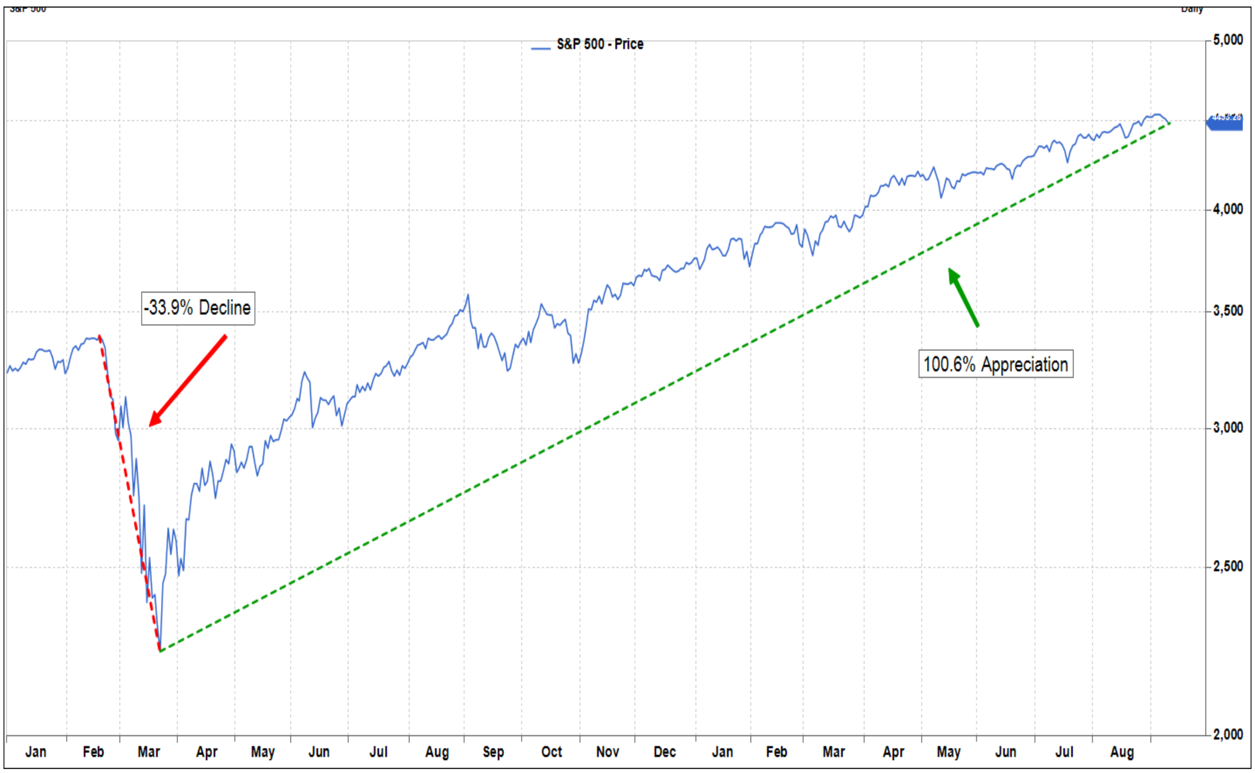
At the Federal Reserve's much anticipated annual monetary symposium last month, Chairman Powell noted the ongoing recovery in the labor market and reiterated his optimistic view that core inflation will eventually revert back to the Fed's long term price stability goal. He stated that it might be appropriate for the Fed to begin reducing (tapering) the pace of asset purchases later this year, and the consensus is that such an announcement could come as soon as the November Federal Open Market Committee (FOMC) meeting. Importantly, Powell emphasized that this step was not intended to signal an imminent increase in interest rates, and the financial markets generally applauded his speech. The S&P 500 Index rallied to a new high in the wake of his remarks, and the 10-year Treasury fell from 1.36% to 1.31%.

Some thought that Powell might actually announce a tapering plan at the symposium, but waiting until November buys the Fed two more months of data on the course of the Delta variant, as well as time to review the September jobs report, which will be released on October 8th. The September report will be the first report to reflect the ending of Federal unemployment assistance in all of the states.

A Fed tapering of its asset purchases does not mean that it is removing liquidity from the system; it is merely providing liquidity at a slower pace. The Fed could reduce its purchases by $10-billion per month, and still expand its balance sheet by almost $800-billion over the next year. This represents liquid spendable or investable assets at a level unseen outside of world wars.

The Stock Market

The Standard & Poor's 500 Index has more than doubled from its March 2020 low, and now rests 33% above its pre-pandemic high. The stunning rise over the last 18 months has come with just a single decline of more than 10% from any new high, and that was more than a year ago.



Any number of catalysts in recent weeks could have sent stock prices tumbling from these elevated levels, but none have. The market rose in the face of adverse events in Afghanistan and China. A surging Delta variant slowed office re-openings and disrupted the travel, leisure and retail sectors, but the threat to the broader economy appears to be limited. General Motors announced the closure of most of its plants in the U.S. due to persistent chip shortages related to a Delta outbreak in South Korea, but the market was unconcerned. Supply shortages are causing headaches and rising prices for both consumers and producers, but investors are confident that the global economy will work through them. The Fed's comments that Fed balance sheet tapering is all but certain this year sent stocks higher.

S&P 500 companies exceeded earnings and revenue expectations by the most on record in the second quarter, and earnings rose by double digits (16.9%) for an unprecedented 5th straight quarter. Earnings estimate revisions keep going up, and 2022 expectations are now 16% above what they were a year ago. Strong earnings, gushing liquidity even after the Fed taper begins, expectations that we will not see a Fed rate hike until late 2022 at the earliest, and trillions more in fiscal stimulus before the 2022 midterms are enough to offset current concerns over supply interruptions, Delta surge, rising geopolitical concerns, or valuations.

As we have pointed out in the past, while high current valuations negatively impact expected *future* returns, they are poor predictors of near term performance. This is especially relevant in an environment like we have presently, with the Fed pumping liquidity into the system and expected returns from competing asset classes are relatively unattractive. But we also need to acknowledge that current valuations are not what they seem to be.

The S&P 500 currently trade at a price/earnings multiple of more than 21 times forward 12-months earnings. But the Index, as we have often said, is weighted by market cap, and its largest seven companies now account for an outsized 27% of the Index. Those seven – Apple, Microsoft, Amazon, Facebook, Google, Tesla, and Nvidia – trade at a weighted multiple of more than 38 times forward earnings. Nvidia trades at more than 50 times forward earnings, and Tesla's current price/earnings multiple is 114! If we remove the distortion caused by the high valuations of some of these large companies by equal-weighting the Index, we find that the S&P trades at a more reasonable 18 times

earnings - not cheap, but reasonable given the current low interest rate environment. If we were to remove these seven from the equation altogether, we would find more than enough value in the rest of the market to remain fully invested.

There are still any number of near term concerns to keep the pundits busy. Congress will be pushing forward on budget reconciliation, infrastructure and the debt ceiling, all of which promises to be messy.

Jerome Powell's term as Fed Chairman is up in early 2022, and then the midterm elections will loom. Longer term, the Fed – whoever chairs it – will be charged with leading the economy back to normality (whatever that may be), and earnings and GDP will fall back to their sustainable growth paths. But those events are beyond the market's current discounting horizon. For now, the opportunity cost of bearishness is simply too high.

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