2021

Q4 Update - October

# Equipment Leasing & Finance U.S. Economic Outlook

EQUIPMENT LEASING & FINANCE FOUNDATION

Your Eye on the Future

# EQUIPMENT LEASING & FINANCE ECONOMIC OUTLOOK

October 2021


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## Key Trends to Monitor

Public Health Situation

Fiscal Policy Uncertainty

Inflation

# EXECUTIVE SUMMARY

**Equipment and Software Investment:** E&S investment rose again in Q2 and is well above its pre-pandemic level. Business investment has remained strong despite emerging headwinds in the economy, though these headwinds could begin to weigh on investment later this year.

**Momentum Monitor:** Momentum monitor readings are now above the long-term average in all 12 verticals tracked by the Foundation's Momentum Monitors, though several verticals have begun to show signs of deceleration as broader economic activity slows.

**Manufacturing Sector:** The manufacturing sector continues to face historically high levels of demand, although growth decelerated over the last quarter. Meanwhile, U.S. industrial output has been constrained by ongoing supply chain shortages and high input prices.

**Small Businesses:** Business prospects for Main Street have been tempered somewhat since the beginning of the summer as a resurgence of COVID-19 has reduced consumer mobility, spending, and confidence. Small businesses are also contending with labor shortages, supply chain delays, and inflationary pressures. However, firms are better equipped to manage these headwinds than they were last year thanks to healthy lending activity and a slow but steady rise in vaccination rates.

**Fed Policy:** Federal Reserve officials largely maintain that ongoing inflationary pressures are mostly temporary. However, officials have signaled that the Fed is ready to begin "tapering" its asset purchases soon, which would translate to tighter financial conditions.

**U.S. Economy:** America reopened for business this spring and early summer as vaccination rates rose and infections slowed. However, the spread of the Delta variant has dampened activity in some areas and has likely slowed economic growth significantly in Q3. Consumer confidence took a hit as people grew less comfortable with in-person activity, and business confidence has been dinged by inflationary pressures and supply chain issues. On the positive side, consumers have accumulated significant savings over the pandemic that should provide a financial cushion, for now. Factors to watch for the rest-of-year outlook include concerns of persistently high inflation, uncertainty surrounding fiscal policy, the potential for tighter financial conditions that could impact equity markets, and the trajectory of the pandemic.

## 2021 Annual Projections

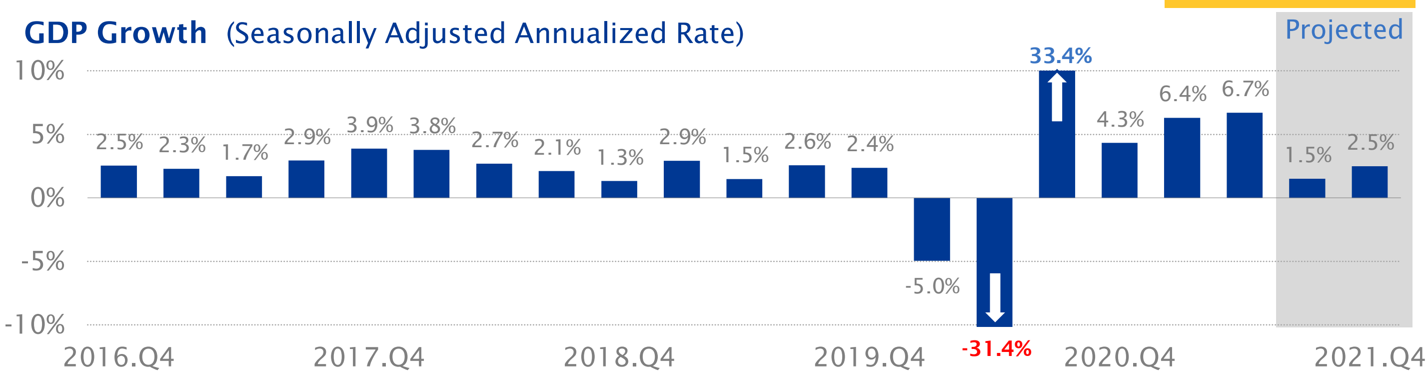
**5.3%**
*GDP Growth*

**13.2%**
*E&S Investment Growth*

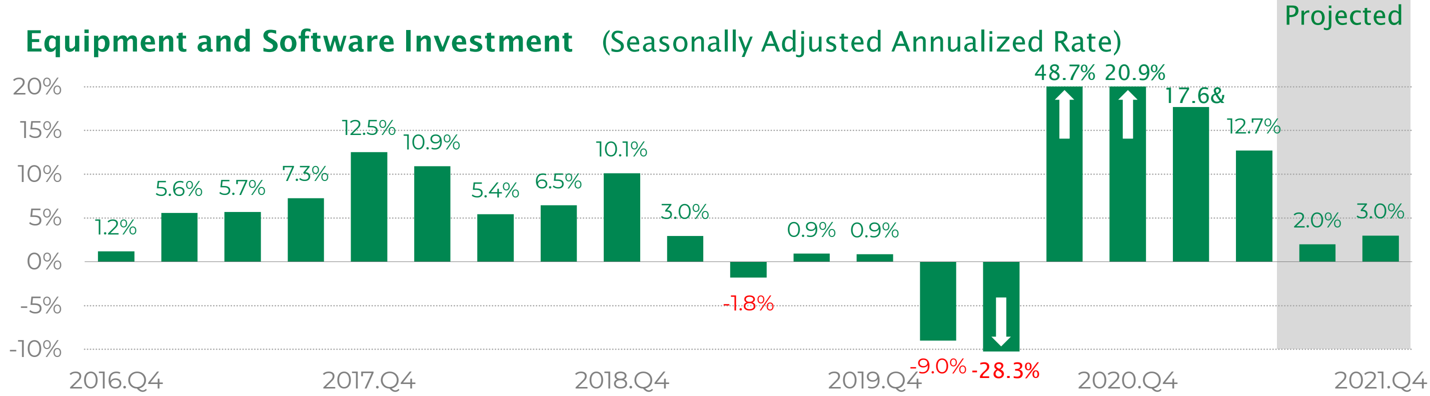
**4.2%**
*Inflation*

**0 bp**
*Change in Fed Funds Rate from Current Range*

**GDP Growth** (Seasonally Adjusted Annualized Rate)




**Equipment and Software Investment** (Seasonally Adjusted Annualized Rate)




Source: U.S. Bureau of Economic Analysis; Keybridge LLC

# MOMENTUM MONITORS

## Sectoral Performance

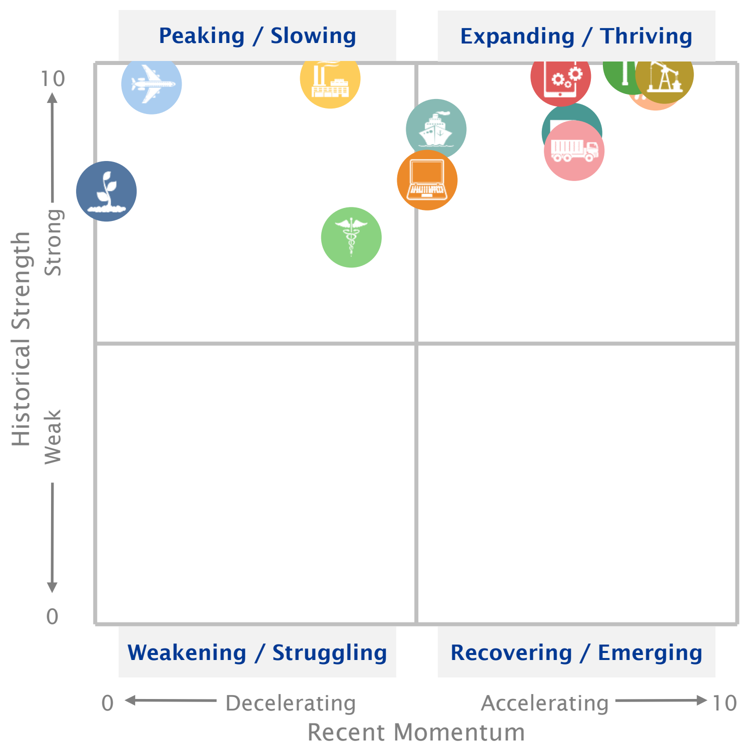
### E&S investment growth surge continues in Q4

Equipment and Software investment jumped 12.7% (annualized) in Q2 2021, the fourth straight quarter of double-digit growth.

Of the 12 investment verticals tracked by the Foundation, nine saw investment rise in the second quarter while three saw investment weaken. Seven verticals experienced double-digit investment growth, including Other Industrial Equipment, Construction Machinery, Mining & Oilfield Machinery, Aircraft, Ships & Boats, Trucks, and Software.

Looking ahead, eight verticals are showing signs of accelerating investment, according to the Foundation's Equipment & Software Momentum Monitors. Four other verticals are showing signs of peaking, though investment growth should remain healthy in these sectors over the next six months. Though economic activity has slowed due to the Delta variant, robust industrial sector demand should support growth in most equipment verticals for the rest of the year.

### Momentum Monitor Sector Matrix




For more information on how to interpret the Momentum Monitor, please refer to the Appendix B (p. 14). A full breakdown of each industry vertical is available at *https://www.leasefoundation.org/industry-resources/momentum-monitor/*

## Movements to Monitor

| Equipment Vertical | Q2 Investment Growth Q/Q | Q2 Investment Growth Y/Y | Next 6 Months | Short-Term Outlook |
|---|---|---|---|---|
| **Agricultural Machinery** | -1% | +26% | ▲ | Though agricultural machinery investment has eased somewhat from the levels seen early this year, investment remains near a multiyear high. High crop prices should support investment into 2022. |
| **Construction Machinery** | +17% | +31% | ▲ | Construction machinery investment growth jumped again in Q2 thanks to sustained demand in the residential construction market. Growth is expected to remain elevated in the near term. |
| **Mining & Oilfield** | +10% | +3% | ▲ | Mining & oilfield investment growth continues to accelerate thanks to multiyear-high oil prices and expectations of a sustained recovery in oil demand. |
| **Trucks** | +35% | 61% | ▲ | Trucks investment growth has benefitted from strong demand for shipping capacity. Investment growth is expected to remain strong in the fourth quarter of 2022 and beyond. |

## Credit Supply

### Credit supply loosened somewhat in Q2

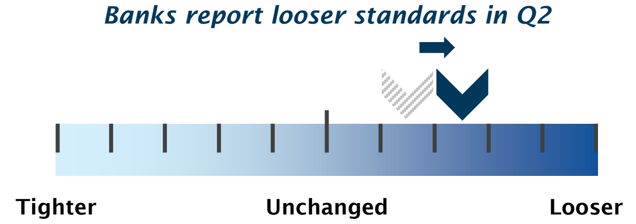
Many banks appear to have transitioned from a "wait and see" approach to a more accommodative lending posture in the second quarter, bolstered by record low delinquencies.

- Overall, lending standards for C&I loans were basically unchanged for 65-75% of banks. For loans to large- and middle-market firms, a net 32% of banks reported easing lending standards, while for loans to smaller firms a net 26% of banks reported easing standards.
- Lending standards also eased for commercial real estate ("CRE") loans. A net 7.1% of banks reported loosening standards for construction and land development loans in Q2, a marked change from Q1 during which a net 14% *tightened* standards.

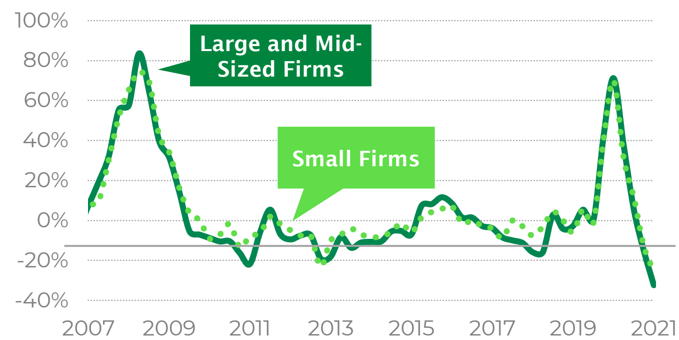
For consumers, credit conditions eased significantly in Q2.

- A net 19% of banks reported easing standards on auto loans, while a net 37% reported easing standards on credit cards.
- Meanwhile, standards eased or were unchanged for all categories of residential real estate (RRE) loans, with the exception of subprime loans, which tightened on net.

**Net Change in Credit Supply Conditions**
*Fed Senior Loan Officer Survey*

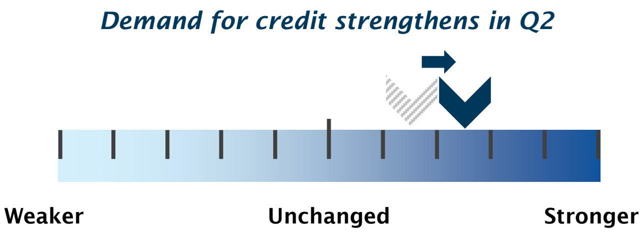



**Tightening Standards on C&I Loans**
*Percent of Respondents*

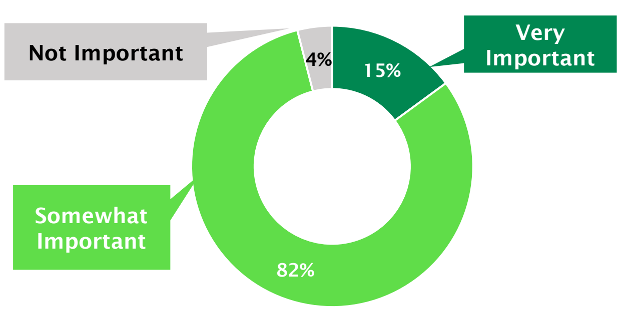



Source: Federal Reserve Senior Loan Officer Survey

**Net Change in Credit Demand Conditions**
Fed Senior Loan Officer Survey




**"Customer Inventory Financing Needs" Driving Stronger Demand**
*Percent of Respondents*




Source: Federal Reserve Senior Loan Officer Survey

## Credit Demand

### Demand shows signs of recovery

Demand for business loans was mixed in Q2.

- On net, 7.0% of banks reported stronger C&I loan demand among medium & large firms in the second quarter, while a net 7.4% reported stronger demand among small firms. Of those reporting stronger demand, the most-cited reason was "increased customer inventory financing needs" (see chart)
- As for CRE loans, a net share of banks now reports stronger demand for the first time since the onset of the pandemic, particularly for construction and land development loans.

Among households, credit demand mostly strengthen.

- A net 12% of banks on net reported stronger demand for GSE-eligible RRE loans in Q2, up slightly from Q1.
- Meanwhile, on net, 27% of banks reported stronger auto loan demand and 32% reported stronger demand for credit card loans — both sharp increases from Q1.

# KEY FINANCIAL INDICATORS

## Consumer Finances

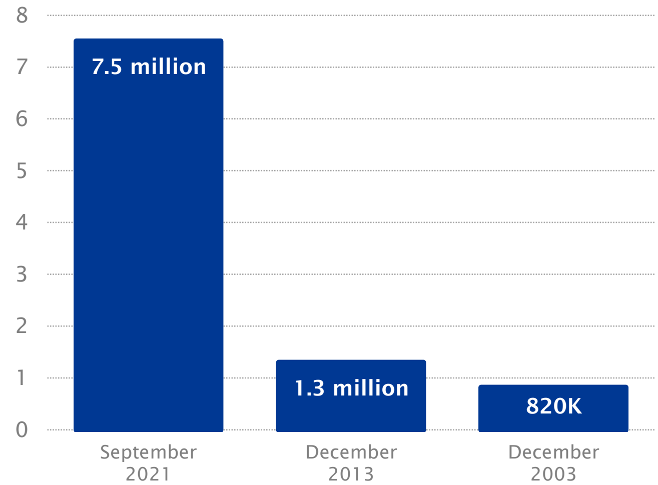
### Financial stress still muted as support ends

Federal relief efforts have kept consumer stress low. However, now that most federal support programs have expired, stress may begin to rise over the next 12 months.

- Bankruptcies are still historically low; just 30,533 consumer bankruptcies were filed in August, 17% below the already-low 2020 number.
- Credit card charge-offs and delinquencies both decreased in Q2. Delinquencies fell by 0.7pp while charge-offs fell by 0.6pp to their lowest level in decades, according to the New York Fed and St. Louis Fed.
- However, 7.5 million people lost benefits in September as federal UI programs ended, far exceeding the number who lost benefits the last two times recession-era federal UI extensions expired *(see chart)*.

All told, consumer financial stress appears likely to increase in the months ahead. However, the volume of federal relief spending over the last 18 months, along with the ongoing recovery in labor markets, should prevent a sharp uptick.

**Federal UI Recipients Losing Benefits after Federal Recession-Era Programs End**
*Millions*




Source: The Century Foundation, Department of Labor

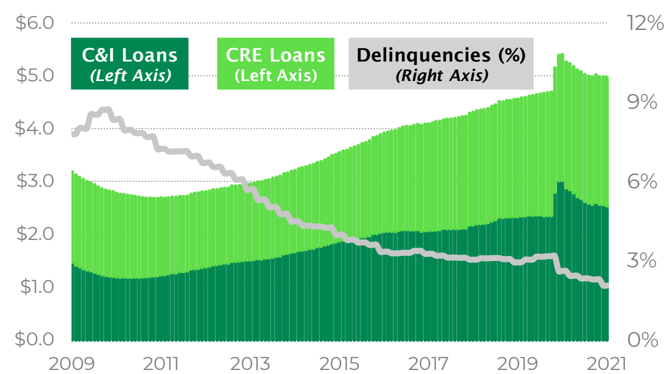
## Business Finances

### Financial stress falling in hard-hit industries

Financial stress among businesses continues to decline thanks to easing business restrictions and recovering consumer demand, particularly in sectors that were hardest-hit by the pandemic.

- After reaching historically high levels last spring, both C&I and CRE loan volumes fell slightly but remain above pre-pandemic levels.
- Meanwhile, delinquencies have eased further in 2021, reaching yet another all-time low in the second quarter.
- Similarly, the Trepp CMBS Special Servicing Rate fell for the eleventh consecutive month in August. Servicing rates improved in four of the five major property types, and industry researchers expect further improvements in the commercial mortgage-backed securities market.

**Business Loan Volume**
$ Trillions




Source: Federal Reserve Board

## Fed Policy Corner

### FOMC still optimistic about inflation outlook

- The Fed continues to expect higher inflation in 2021 due to pandemic-related factors but predicts inflation will fall and moderately exceed 2% in 2022.
- Short-term interest rates remain near zero. However, the FOMC is expected to announce the start of asset-purchase "tapering," resulting in tighter conditions.
- Further clouding the outlook is the looming expiration of Jerome Powell's term as Fed chair. Most Fed watchers expect him to be reappointed, though calls to replace him are growing, from both sides of the aisle.

> "The price increases we've seen have been widespread…taking out food, shelter, energy and used cars/trucks (a standard BLS series), prices are above trend and rising faster than trend."
>
> — Jason Furman, Former Chair, National Economic Council

> "Concern is tempered by a number of factors that suggest that these elevated readings are likely to prove temporary."
>
> — Jerome Powell, Fed Chairman

# Main Street Outlook

## Activity easing, but risk of protracted downturn is low

While small business prospects were improving earlier in the year, a surge in COVID-19 infections has led to reduced consumer mobility, spending, and confidence (see p. 11). As a result, Main Street business conditions are deteriorating. According to the August WSJ/Vistage survey, 22% of small businesses said their business had already been impacted by the surge in Delta variant infections, and another 22% expected future impacts.

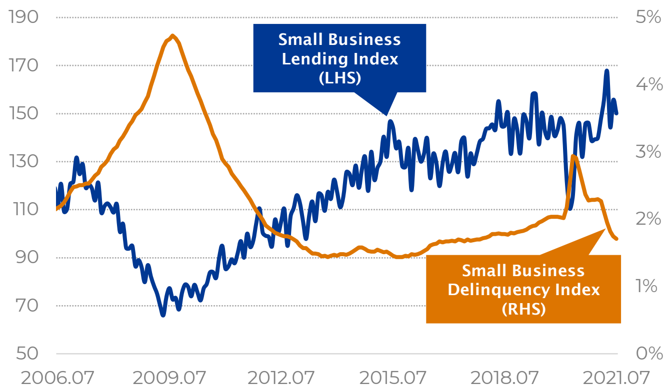
Further, prolonged losses following last year's downturn have had an acute impact on firms' bottom lines. A Goldman Sachs survey highlights how many small firms have been affected: 44% of respondents said they have cash reserves that will last less than three months.

These and other factors are weighing on small business confidence and revenues. Per the WSJ/Vistage survey, only about 40% of small firms expect the economy to grow over the next year — a pandemic-era low — as owners wrestle with labor shortages, rising costs, and supply chain issues.

- According to the National Federation of Independent Businesses, a record 50% of small business owners said they had unfilled positions in August, with 91% of those respondents reporting difficulties finding qualified candidates.
- Hourly wage growth in the August Paychex IHS Small Business Employment Watch reached the highest level in over a decade. Meanwhile, weekly earnings among nonsupervisory leisure and hospitality workers have risen 15% over the last year.
- In the Q3 CNBC/Momentive Small Business Survey, over half of owners said they are encountering supply chain disruptions and 70% said they were seeing a rise in supply costs.
- The Census Bureau's Small Business Pulse Survey showed that, as of mid-September, 25% of small businesses were reporting weaker revenues over the prior week, the highest reading since early March (see chart at bottom).

**Equifax Small Business Lending & Delinquency Index**

*Index of small business loan volume (Jan 2006 = 100) & % of Loans Delinquent*




Source: Equifax

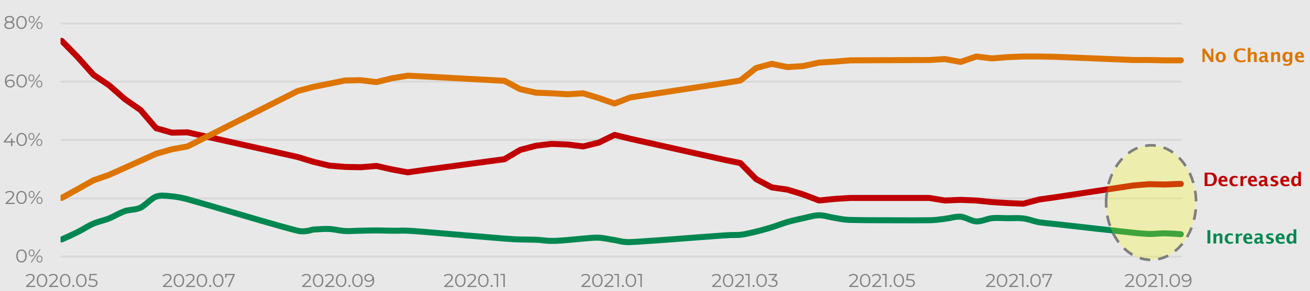
Though these headwinds are clearly presenting issues for Main Street, the overall outlook is still improved compared to the onset of the pandemic and last winter's spike in infections.

- First, small business lending activity remains healthy, and delinquency rates are low per Equifax (see chart above).
- Second, the reopening of in-person schools and expiration of federally-enhanced unemployment benefits could bring more workers back to the labor market and ease hiring pressures, at least somewhat.
- Finally, a relatively successful vaccine campaign in the United States, combined with some degree of natural immunity caused by prior infections, means that consumers are more comfortable, on average, with patronizing businesses in person than they were last year.

All told, Main Street economic activity has slowed — largely due to the Delta variant — following strong growth earlier this year, and things could erode further if COVID-19 cases surge again this winter. However, a protracted small business downturn appears unlikely at present.

# Small Business Revenue Starting to Feel the Pinch, Again

*In the last week, did this business have a change in revenue, not including financial assistance/loans?*




Source: Census Bureau Small Business Pulse Survey

## MLFI-25

### NBV remains on track, despite bottlenecks

ELFA's Monthly Leasing and Finance Index (MLFI-25) fell to $8.5 billion in August but is up 21% compared to August 2020 and is up 10% year-to-date. The 3-month moving average rose a modest 1.4% in August and is up 15% compared to a year ago (see chart). While the industry has bounced back from the recession, supply chain delays and other pandemic-related concerns are presenting significant challenges for many firms.

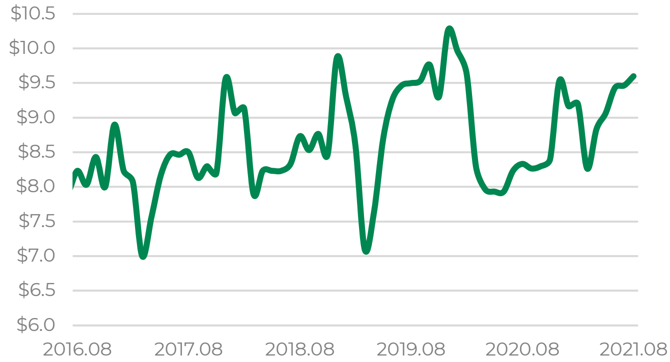
Portfolio performance was a mixed bag. Receivables over 30 days were 1.8 percent, down from 1.9 percent the previous month and down from 2.4 percent in August 2020. Charge-offs were 0.23 percent, up 5bp compared to the previous month but significantly below the 0.75 percent reading from last August.

Total credit approvals were mostly unchanged, edging down to 76.3% in August from 76.5% in July.

The total headcount of equipment finance companies was 14% below year-ago levels, continuing to reflect significant downsizing at an MLFI reporting company.

**MLFI-25 New Business Volume**

*Billions, 3-month moving average*



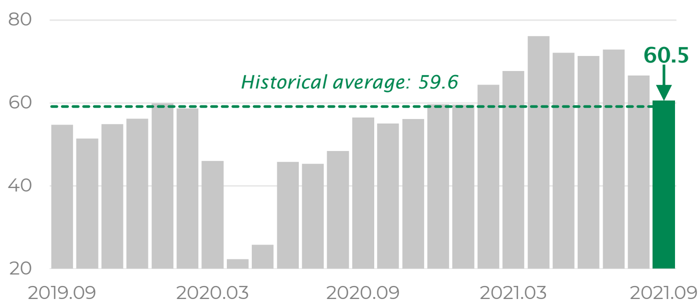

Source: ELFA

"August data show some softness in equipment demand resulting from a mix of summer doldrums, continued supply chain disruptions and lingering pandemic-related woes. Business optimism, which peaked earlier in the summer, also has waned somewhat. However, compared to where the economy and equipment finance business were a year ago...August new business volume is wholly acceptable."

— Ralph Petta, President and CEO, ELFA

## MCI-EFI

### Industry confidence falls due supply chain disruptions and labor shortages




Source: ELFF

"There is great interest in capital expansion in the industries we serve. Supply chain issues continue to delay equipment and the completion of projects. We will see this continue into next year and it will have an impact on when transactions end up on the books."

— Michael Romanowski, President, Farm Credit Leasing

In September, the Monthly Confidence Index for the Equipment Finance Industry (MCI-EFI) fell 6.1 points to 60.5, the lowest level since January.

- Overall, just 18% of respondents expect business conditions to improve over the next four months, down sharply from 36% in August. Meanwhile, 3.6% believe business conditions will worsen — the first time any survey respondent has expressed this concern since April.
- 29% expect to hire more employees over the next four months, down from 36% in August. More positively, no respondent expects to hire fewer employees.
- Meanwhile, there was an increase in expectations for access capital to fund equipment acquisitions in the next four months. 32% expect "more" access to capital, 68% expect the "same" access to capital, and no one expects "less" access.

# Manufacturing Focus

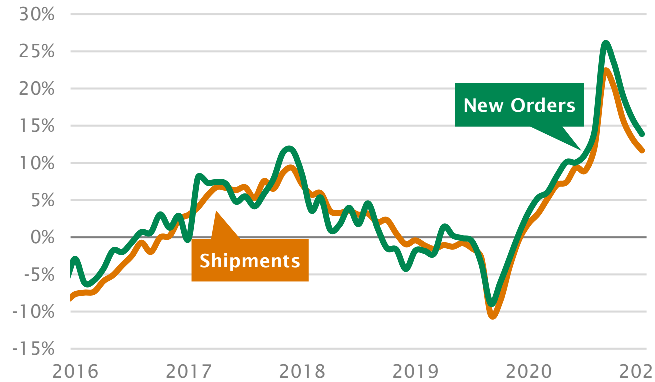
## New orders and shipments growth decelerate but remain elevated

In August, growth in both shipments and new orders of core capital goods decelerated again. However, both metrics remains elevated (*see chart*), and the level of both orders and shipments are still at all-time highs.

- New orders for nondefense, non-aircraft capital goods (a leading indicator of industry performance) rose 0.6% in August and were up 14% compared to last year.
- Shipments of nondefense capital goods excluding aircraft (a concurrent indicator of industry performance) increased 0.8% in August and are up 12% Y/Y.

Business investment should remain strong as the economic rebound continues, though the heady growth rates of early 2021 are unlikely to continue.

**Shipments vs. New Orders of Core Capital Goods**
*Year-on-year percent change*




Source: Census Bureau

## Industrial production gains in August

Industrial Production rose 0.4 point to 101.6 in August and has now eclipsed its February 2020 pre-pandemic level.

- Consumer goods, business equipment, business supplies, and materials production all improved in August.
- Industrial production for consumer durables edged up 0.2pp, driven by home electronics. Appliances, furniture, and carpeting production each slipped.
- Business equipment production increased 0.5% in August following a 3.5% increase a month earlier. Major gains were seen in transit and information processing equipment.
- Despite a dip in August, machinery production is nearly 10 percentage points above year-ago levels (see chart).

**Industrial Production: Machinery**
*Seasonally adjusted*

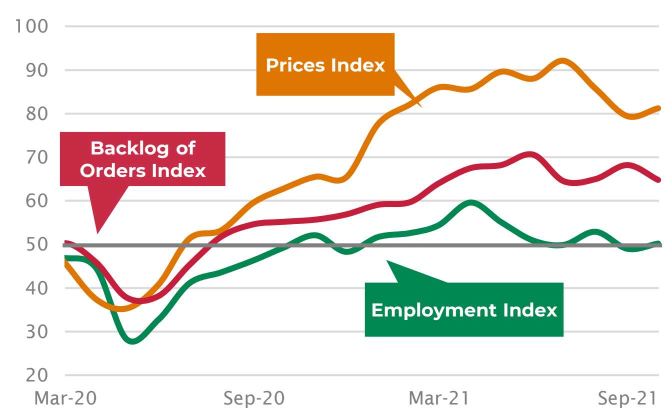

Source: Federal Reserve Board of Governors, G17 report

## Factories continue to face production constraints

The ISM Manufacturing Index rose to 61.1 in September, signaling solid growth. However, U.S. manufacturers still face significant cost pressures that are weighing on the outlook.

- Factories are struggling to hire workers. The Census Bureau reports that there were 889,000 unfilled manufacturing jobs in July, a record since the series began in 2000.
- Though some prices (e.g., lumber) have declined to near pre-pandemic levels, prices for other commodities, such as copper and aluminum, remain high and show few signs of easing.
- Manufacturers' unfilled orders of durable goods excluding transportation rose past an earlier series high in August, caused by ongoing supply chain shortages.

**Manufacturing PMI Indices**
*Above 50 = expansion*




Source: Institute for Supply Management

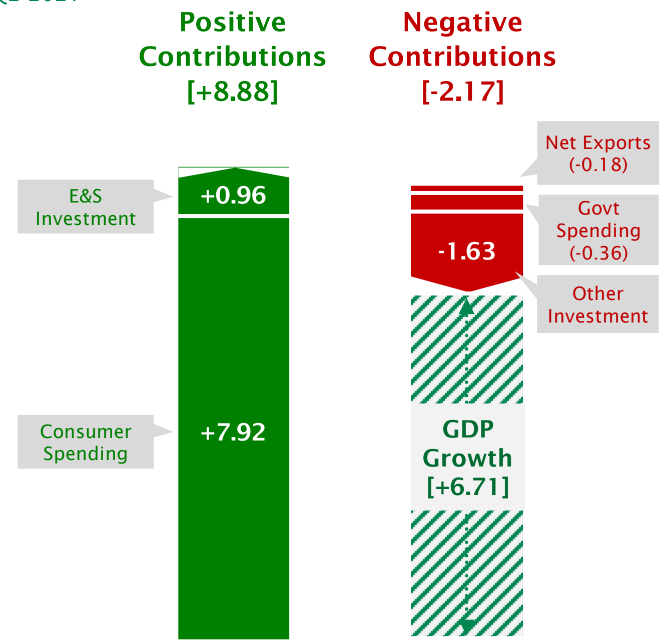
# State of the U.S. Economy

## Economy expands at 6.7% rate in Q2

The U.S. economy expanded at a robust 6.7% (revised) annualized rate in Q2, about the same pace as in Q1. GDP has now eclipsed its level from the end of 2019, just before the pandemic began.

- **Consumer spending**, the economy's largest component, rose 12.0% (annualized) in Q2. Spending growth was broad-based, with double-digit growth across services, durable goods, and nondurable goods.
- **Equipment and software (E&S) investment**, a subset of overall business investment and the lifeblood of the equipment finance industry, jumped 13% following its 18% growth in Q1.
- **Net exports** made another negative contribution to GDP in Q2 thanks to weak demand for U.S. exports.
- **Government spending** fell at a 2.0% rate in Q2, coinciding with some states opting out of federal unemployment insurance programs.
- **Other investment** fell in Q2 thanks to declines in residential investment, nonresidential structures investment, and private inventories.

**Contributions to GDP Growth**
*Q2 2021*




Source: Bureau of Economic Analysis (BEA)

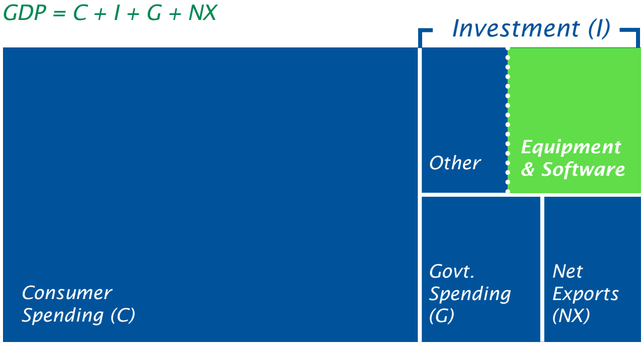
## After summer spending surge, new challenges arrive

With the arrival of a highly effective vaccine and many consumers eager to resume quasi-normal economic activity, the economy boomed in Q2 and the first few weeks of Q3. COVID-19 cases were at a manageable level, resulting in a sharp increase in consumer confidence as people were more willing to dine out, shop in person, and socialize as they had before the pandemic, Many employers began planning for a full return to the office, and the end of the pandemic appeared to be in sight.

However, optimism eased as the Delta variant spread. Infections rose across the country, but the brunt of the new wave was borne by the least-vaccinated states, and it quickly became clear that the deteriorating public health situation was weighing on consumer confidence and economic activity. Inflation concerns also began to weigh on the outlook for consumer spending, and supply chain woes grew ever more problematic.

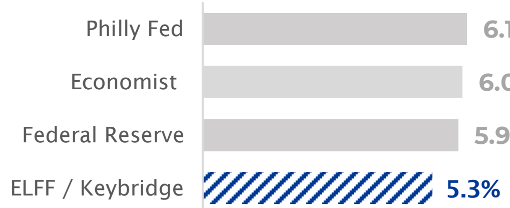
Despite these headwinds, the outlook is more optimistic than it was headed into last winter. Financial stress is historically low, as many consumers have amassed savings over the last year. Businesses continues to invest even as supply chain issues and hiring difficulties persist in some industries. Looking ahead, the virus's trajectory this fall and winter and its effect on consumer mobility will be critical. Inflation and fiscal policy negotiations in Congress are also key uncertainties to monitor.

**Composition of Gross Domestic Product (GDP)**
*GDP = C + I + G + NX*




Source: Keybridge LLC, based on BEA data

**2021 Growth Forecasts**



## Consumer Financial Cushion

### Savings and spending trends suggest substantial pent-up demand

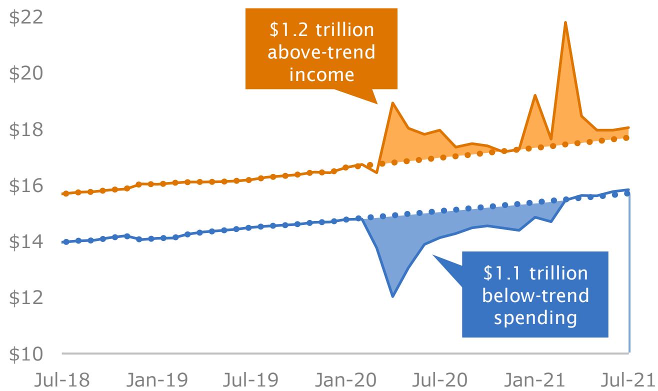
Consumers are on solid financial ground and have accumulated significant savings during the pandemic thanks to foregone spending and government support measures like stimulus checks and UI programs. With higher incomes and lower spending compared to prior years, consumers now have roughly $2.3 trillion in "dry powder" or pent-up spending power (see chart). Similarly, the Federal Reserve reports that U.S. household wealth jumped to a record $141.7 trillion at the end of June, driven by the red-hot housing market and stock market gains.

This financial cushion is buoying consumers as relief measures like the foreclosure and eviction moratoria end. Similarly, even though Black Knight reports that 1.6 million borrowers remain in mortgage forbearance programs, a wave of foreclosures has not yet materialized and seems unlikely to do so, as the recent surge in home prices means that most borrowers now have more equity in their homes. This financial cushion also means that when the pandemic ebbs, consumers may once again unleash strong levels of spending that will boost the economy and job growth.

In sum: most consumers are in solid financial shape and should avoid bankruptcy and foreclosure for the time being, though.

**Income and Spending Compared to Pre-COVID Trends**

*Trillions of Nominal Dollars, Annualized Rate*




Source: U.S. Bureau of Economic Analysis. Based on framework by Jason Furman.

> "Consumers have built up a substantial financial cushion during the pandemic, which is the exact opposite of how things normally play out during and after a recession."
>
> — Dr. Robert Wescott, President, Keybridge

## Labor Demand

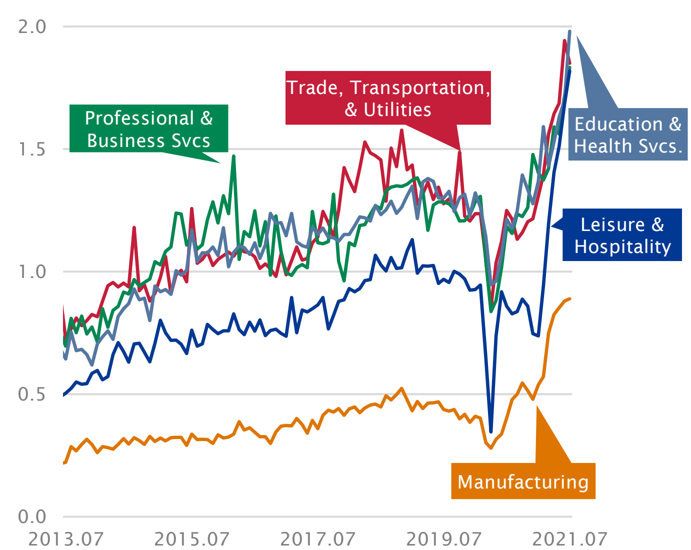
### Historic hiring demand provides opportunities for workers

The economic recovery has produced a broad-based surge in demand for workers. In July, job openings hit a series high of 10.9 million according to the Bureau of Labor Statistics. Unsurprisingly, openings were particularly strong in leisure & hospitality, trade, transportation & utilities, and education & health services (*see chart*). Hiring demand is especially strong among small businesses : a net 32% of small firms plan to hire in the next three months according to NFIB, the largest share ever. Further, 50% of small firms have job openings that they are not able to fill right now.

Though demand for labor is robust, hiring has not been as strong as expected, suggesting a significant supply-demand mismatch. Workers are using this to their advantage, often negotiating better pay and more flexible working conditions. Indeed, according to the BLS employment report, between August and September average weekly earnings for private nonfarm workers increased by 1.2%, and on an annual basis average weekly employee earnings was up 4.6% in September. By comparison, average weekly earnings were growing at around 3% Y/Y prior to the pandemic.

**Job Openings by Select Industry**

*Millions SA*




Source: BLS

## Consumer Mobility Stalls

### Resurgence of pandemic puts damper on consumers

Over the summer, consumer mobility nearly reached pre-pandemic levels. However, the pandemic's resurgence has discouraged some consumers from shopping and recreating in-person according to Google retail and recreation mobility data (see chart). Similarly, TSA passenger volume, which had risen this summer to the highest level since the onset of the pandemic, has fallen back in recent weeks. Reduced mobility is translating into weaker spending: BEA's weekly consumer spending estimates show that spending has slowed in lockstep with consumer mobility.

Though the Delta variant is clearly a headwind to mobility and spending, there are several factors that suggest that the potential downturn in spending won't be as severe as the slowdown that occurred last winter.

- Retail sales are far above pre-pandemic levels. According to Opportunity Insights, card transaction data measuring retail sales shows that spending is still more than 15% above the pre-pandemic baseline.
- The Visa Spending Momentum Index tells a similar story. Though the August SMI was down 2.9pp M/M, Visa expects U.S. consumer spending to expand at its fastest pace in years, even amidst the slowdown in retail and recreation mobility.

However, should the public health situation worsen further as winter sets in, there is concern that spending weakness could spread to other sectors – especially now that income support measures have largely expired.

**Google Mobility: Retail and Recreation**

*% relative to pre-pandemic baseline, 7-day moving average*


Source: Google

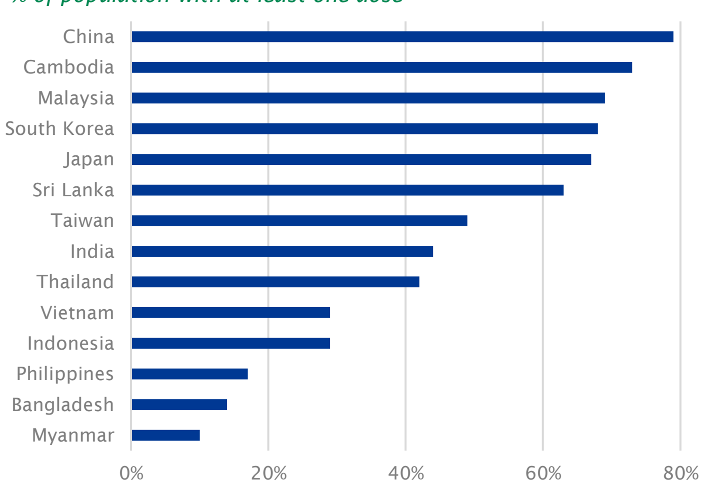
## Supply Chain Pressures

### Asian supply chain constraints drive U.S. prices higher

U.S. car manufacturers have been in the news is recent weeks, with parking lots full of nearly finished automobiles missing semiconductors due to supply chain shortages. According to the WSJ, it's not just the automobile industry that is feeling the supply chain pinch.

**Vaccination Rates in East Asian Countries**

*% of population with at least one dose*




Source: Our World in Data

In Malaysia, where migrant workers have been restricted from traveling because of COVID, palm oil and tin production has slowed dramatically. In Vietnam, coffee production has stalled because of lockdowns and high transmission rates. Other countries producing raw goods are experiencing similar struggles. As of mid-September, all East-Asian countries except for Bangladesh and Nepal had some degree of workplace restrictions. Low vaccination rates *(see chart)* are leading to lockdowns which, in turn, are disrupting supply chains and driving up global prices.

Port closures are also disrupting supply chains. A large port near Shenzen, China was shut down in May because of an outbreak, slowing operations for several weeks. Disruptions of this kind have sent shockwaves through supply chains, and the delays have led to increased cargo ship congestion at U.S. ports. According to the Marine Exchange of Southern California, the Los Angeles port is so congested it could take over a week to dock. Further, when congestion peaked earlier this year in Q1, it led to large numbers of cancelled sailings in Q2 — this story is playing out again, driving cargo prices higher. According to NYT, two years ago to transport goods from Asia to the U.S., a 40-foot container cost less than $2,000. Today, it costs as much as $25,000 — and that price does not guarantee an on-time delivery.

## Fiscal Policy Uncertainty

### Spending bills in limbo as debt ceiling looms

Congress found itself in a familiar position in September: embroiled in several rancorous debates on a laundry list of spending and budget items, all of which come with serious economic, financial, and geopolitical ramifications.

- On the positive side, Congress averted two potential crises in October. First, a partial government shutdown was avoided via a stopgap spending bill that expires in December. Second, Congress also managed to avoid an even worse calamity: a bipartisan group of senators passed a bill that raised the federal debt limit to ensure that the federal government would not default in mid-October.
- However, both measures are temporary, and Congress will have to address them again later this year. The consequences of a default would be particularly severe.
- Elsewhere, Democrats continue to debate the best approach to passing an infrastructure bill (which already passed the Senate with bipartisan support) and a massive social spending bill. Both bills would boost economic growth in 2022 and beyond, but the proposed $3.5 trillion price tag of the social spending bill has sparked concerns among moderate Democrats. Ultimately, the bill's price tag will need to be pared back to pass.

## Inflation Concerns

### Higher inflation likely to persist in 2022

As Congress debates a historic set of spending measures, concerns that higher inflation will persist have intensified. According to the latest NY Fed Survey of Consumer Expectations, the median one-year ahead expected rate of inflation was 5.2%, while the median three-year ahead rate was 4.0% — both series highs, and well above the Fed's 2% target. Households' rising inflation expectations appear to be well-founded: per NFIB, the net share of Main Street businesses that raised prices over the last three months rose to 49% in August, by far the highest share since the 1980s.

However, rising prices are not unique to small firms, or the U.S. economy. Prices are increasing around the world thanks to higher energy and food prices, record-high shipping costs, labor constraints, and other supply chain bottlenecks. These factors are showing few signs of easing in the near term and in some cases will stretch well into 2022.

All told, the longer it takes for COVID-related economic disruptions to work their way through the economy, the more likely it is that higher inflation will be here to stay. Though it is not yet clear how long these factors will impact U.S. consumers and businesses, the question of whether high inflation would be temporary or persist has clearly shifted toward persist, at least for the next six months.

## Pandemic Trajectory

### Has the U.S. finally turned the corner?

Though the Delta variant has produced some "breakthrough" infections in the fully vaccinated population, vaccines have succeeded in limiting serious illness and death and have helped trigger a strong economic rebound this year. Around two-thirds of Americans have received at least one dose, and this number continues to slowly rise.

However, it is not yet clear whether vaccination progress to date, combined with natural immunity, will prevent a new wave this winter. There are several factors that may lead to heightened transmission rates this winter, including:

- Colder weather leads to more indoor activity (particularly in northern states), increasing the risk of transmission.
- Most schools have returned to in-person learning and mask requirements vary by locality. Until a vaccine is available for children under 12, family members of school-aged children will be at higher risk (though approval for children ages 5-11 is expected this fall).
- Policymakers are reluctant to reimpose operating restrictions in many parts of the country.
- Heightened mobility compared to last winter and pent-up demand for travel and family visits.

If a new wave materializes, consumer confidence and economic activity will likely suffer, as occurred last year.

## Monetary Policy

### Fed tightening and risks from abroad

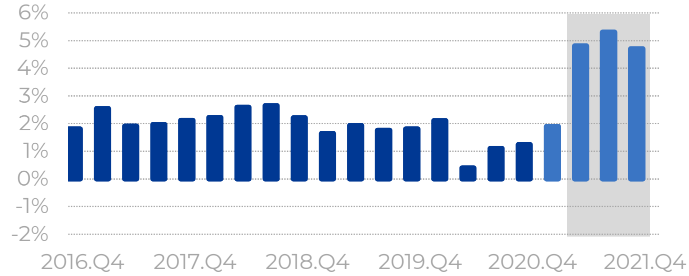
Concerns about inflation and financial market excess have led Fed watchers to expect a slow but steady return to tighter monetary policy conditions, starting with the Fed "tapering" its asset purchases — potentially as early as this November. Though this development is widely expected, tighter monetary conditions will, all else equal, be a negative for financial markets that have seen some of the frothiest valuations ever in recent months. One measure, the Shiller Cyclically Adjusted Price-Earnings Ratio, currently sits at its highest level (38), since the Dot-Com Bubble.

The prospect of tighter monetary conditions comes at a time of financial market volatility, much of which can be explained by substantial weakness in the Chinese housing sector and debt markets. If further turbulence in China continues to weigh on equity market valuations, there is a real risk of a pullback in stock prices, business confidence, and consumer sentiment. Indeed, the University of Michigan's Consumer Sentiment Index currently sits at its lowest point in nearly a decade amid worries of inflation and the pandemic, and additional hits to consumer sentiment could lead to even more market volatility.

### Real GDP Growth (% SAAR)

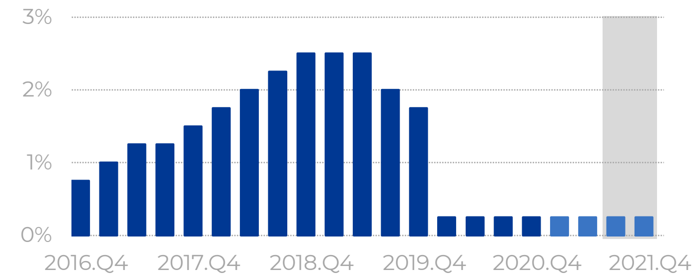

Source: Bureau of Economic Analysis; Keybridge LLC

### CPI Inflation (year-on-year %)




Source: Bureau of Labor Statistics; Keybridge LLC

### Fed Funds Target (upper bound, end of period)

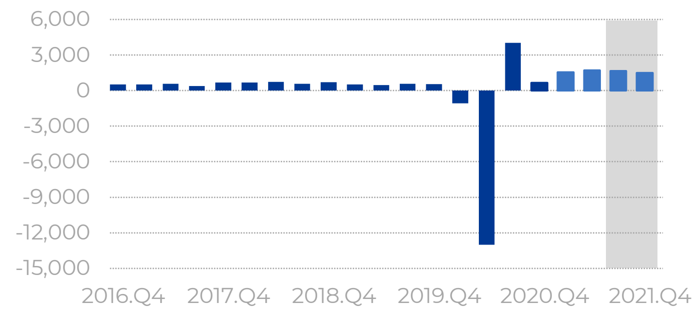



Source: Federal Reserve Board of Governors; Keybridge LLC

### Real E&S Investment Growth (% SAAR)


Source: Bureau of Economic Analysis; Keybridge LLC

### Total Payroll Growth (thousands)




Source: Bureau of Labor Statistics; Keybridge LLC

| INDICATOR, | 2019 | 2020 | 2021 QUARTERLY ESTIMATES | | | | 2021e |
|---|---|---|---|---|---|---|---|
| | | | Q1 | Q2 | Q3e | Q4e | |
| *Real GDP (SAAR %)* | *2.2%* | *-3.5%* | 6.3% | 6.7% | 1.5% | 2.5% | **5.3%** |
| *Real Investment in Equipment & Software (SAAR %)* | *3.5%* | *-2.1%* | 17.6% | 12.7% | 2.0% | 3.0% | **13.2%** |
| *Inflation (year-on-year %)* | *1.8%* | *1.2%* | 1.9% | 4.8% | 5.3% | 4.7% | **4.2%** |
| *Federal Funds Target Rate (upper bound, end of period)* | *1.75%* | *0.25%* | 0.25% | 0.25% | 0.25% | 0.25% | **0.25%** |
| *Total Payroll Growth (thousands)* | *2,011* | *-9,416* | 1,554 | 1,845 | 1,651 | 1,500 | **6,550** |

Note: SAAR% refers to the annualized rate of change in seasonally adjusted data from one quarter to the next, which is the Bureau of Economic Analysis' standard method for reporting growth in the national accounts data.

## About the Momentum Monitor

Business leaders require actionable forward-looking intelligence to make strategic decisions. Accordingly, the Foundation commissioned Keybridge LLC to develop a series of custom leading indicators for the equipment sector. The Foundation-Keybridge Equipment & Software Investment Momentum Monitor consists of indices for 12 equipment and software investment verticals. These indices are designed to identify turning points in their respective investment cycles with a 3–6-month lead time.

The Momentum Monitor is based on Keybridge's extensive research which shows that not all movements in economic data are reliable signals of future economic trends. Keybridge has operationalized its research by constructing indices, each comprised of between 10 to 20 high-frequency indicators. These indicators undergo rigorous testing to determine the optimal thresholds at which their short-term fluctuations are economically meaningful. In simpler terms, the Momentum Monitor sifts out the "noise" in the data and identifies the dominant trends. As a result, each Momentum Monitor index is statistically optimized to signal turning points in the investment cycle without giving false readings of shifts in momentum.

## How to Read the Momentum Monitor

The Momentum Monitor Matrix summarizes the current values of each of the 12 Equipment & Software Investment Momentum Indices based on two factors: Recent Momentum (x-axis) and Historical Strength (y-axis):

- "Recent Momentum" indicates a vertical's recent acceleration or deceleration in the past month relative to its average movement during the previous 3 months. Ratings closer to "0" indicate rapid deceleration, while ratings near "10" represent rapid acceleration.
- "Historical Strength" reflects a vertical's strength in the past month relative to its typical level since 1999. Ratings closer to "0" represent an indicator that is weaker than average, while ratings closer to "10" represent an indicator that is stronger than average.

The matrix consists of four quadrants based on readings for each vertical's recent momentum and historical strength. If a vertical falls in the top-left quadrant, its momentum reading is higher than average, but positive movement has slowed (and perhaps reversed) in recent months — suggesting that investment levels may fall over the next 1-2 quarters. Verticals in the bottom-right quadrant, however, have momentum readings that are below average, but recent movement shows promise — suggesting that investment levels may rise over the next 1-2 quarters.