

ECONOMIC OUTLOOK

Summary

The topic de jour when discussing anything related to the economy has been inflation. It has become so prevalent that not only is it being discussed by investment professionals and at the Federal Open Market Committee (FOMC) meetings, it may have also been a topic of conversation at Thanksgiving dinner while indulging on a more expensive plate of turkey with family and friends. But sadly, since the Fed retired “transitory” from their vernacular just a few days after the holiday, we were deprived of the opportunity to express thankfulness about the end of the great “transitory versus permanent” inflation debate.

With inflation being discussed at length, the recent strength and momentum of the economy are easily overlooked. Initial unemployment claims dropped to levels not seen since before the pandemic (222k), and the underemployment rate continues to decline — now sitting within just 1% of its all-time low (7.8%). The labor force participation rate jumped higher to 61.8%, and the unemployment rate dropped to 4.2%, which are also the highest and lowest levels, respectively, since the pandemic started. While the labor force participation rate remains lower than its historical levels, the case can be made that the economy is close to reaching full employment.

But the strength hasn't been limited to jobs. The ISM Service PMI hit an all-time high of 69.1, while ISM Manufacturing remained robust at 61.1. Even inflation-adjusted (real) data looks impressive. Demand remains solid with consumer spending up 0.7% month-over-month and GDPNow (Atlanta Fed) tracking 4Q GDP at 9.7%.

With such strong supporting data, it is unfortunate that all of the recent positive economic momentum has been overshadowed by the news of the Omicron COVID variant in late November. Rather than focusing on the tangible data and strength in the economy, many may now be experiencing representative bias, with fears of further economic lockdowns and slowdowns for a strain that is seemingly more transmissible, yet reportedly milder, than previous strains. Time will tell whether Omicron will become the new dominant strain and how impactful it will be but until then, the economy appears to be on solid footing.

Positives

Already strong retail sales (1.7% vs 1.4% estimated MoM) are even stronger when stripping out autos

Housing had a blowout month with pending home sales up (7.5% vs 1.0% estimated MoM)

Continuing unemployment claims fell below 2MM for the first time since the pandemic started

Negatives

CPI came in higher than expectations (0.9% vs. 0.6% estimated MoM) causing inflation further concerns

The Michigan Consumer Sentiment Index hit its lowest level in 10 years (67.4%)

The headline non-farm payroll numbers disappointed, missing by 340k

EQUITY OUTLOOK

Summary

Equity markets continued to march higher in November until a couple of late-month scares moved the stocks into negative territory. Omicron, a new COVID-19 variant derived from South Africa, created a new wave of uncertainty that rippled throughout capital markets. Additionally, Chairman Powell's testimony that the Federal Reserve may get more aggressive in response to inflationary pressures also caught investors flat footed. When the dust settled, the S&P 500 closed the month down 0.7%.

The threat of a new variant also resulted in relatively uneven returns across different equity segments. Growth stocks outperformed value with the Russell 1000 Growth index rising 0.6% and the Russell 1000 Value falling 3.5%. Economic sectors like finance and energy, which had seen impressive gains this year as economic conditions improved fell 5.7% and 5.2% respectively in November. Conversely, technology and consumer discretionary stocks rose 4.3% and 2.0% during the month.

We believe the equity market's response to events in late November was likely an overreaction. Early indications appear to show Omicron produces milder cases with hospitalization less likely. Regardless, vaccines are readily available and society appears to be learning to live alongside the virus. Jerome Powell's comments were likely an attempt to appease

politicians whose constituents are concerned about inflation. Volatility may persist for a brief period but markets will eventually stabilize as concerns dissipate. Stock valuations are reasonable especially considering the impressive earnings growth experienced in the last several quarters and expectations for earnings moving forward. With the lack of investment alternatives, we continue to believe equities represent an attractive alternative for long-term investors.

Positives

Equity fundamentals

Accommodative Federal Reserve

Negatives

Occasional inflation scares

Supply chain and labor shortages

Unkowns

Omicron impact

FIXED INCOME OUTLOOK

Summary

Interest rates were fairly volatile during November as the yield on the 10-year U.S. Treasury note dropped by about 10 basis points (bps) early in the month leading into the release of the strong October payroll report. It then rose by more than 20 bps peaking just before Thanksgiving, only to give up most of that gain on Black Friday as news of weak retail sales and the concern about the Omicron variant fueled a flight to safety. The risk-off sentiment sent the 10-year yield to close at 1.44%, 11 bps lower for the month and the lowest monthly close since August. Corporate bonds experienced the same overall risk aversion but the timing was uniquely different. Investment-grade credit spreads moved sharply wider at the same time yields rose following the payroll report and then stayed about 25 bps higher for the remainder of the month.

Seemingly unrelated to those markets, the 2-year note experienced similar volatility but then closed November at 0.57%, about 7 bps higher for the month. Despite the factors influencing longer rates lower and credit spreads wider, the move in the 2-year reflects investors' beliefs the Fed will act more aggressively by increasing the overnight rate three times in 2022 instead of the previously forecasted once or twice.

At the recently conducted semi-annual testimony to the chambers of congress, Fed Chairman Powell acknowledged inflationary pressures are likely to persist longer than expected and the use of the word "transitory" is no longer accurate. He also disclosed there will be significant discussions at this month's meeting of the Federal Open Market Committee (FOMC) about accelerating the pace of the reductions in asset purchases. Instead of tapering purchases by \$15 billion per month over an eight month period, many participants have indicated they would prefer to reduce purchases by twice that amount and stop purchases all together sometime in the spring.

We believe asset purchases (known as quantitative easing) and the expansion of currency in circulation has a lot more influence on the rate of inflation than small changes in the overnight rate. Because of this, we are encouraged by the idea of a faster tapering. Once finished, the Fed and markets can clearly focus on the timing of increases in the overnight rate but we suspect they will not happen as aggressively as the markets are currently forecasting. The decline in 10-year yields in the face of reduced Fed buying likely indicates investors are increasingly believing this as well. We were hopeful longer maturity yields could trend towards new yearly highs but now believe they will struggle to reach the 1.75% level experienced in March.

Positives

Foreign buying continues as the dollar remains resilient

Short maturity yields already reflect aggressive Fed rate policy

Negatives

Reported inflation levels are likely to remain uncomfortably high well into 2022

Additional federal spending plans would necessitate additional deficit borrowing

Unknowns

The future of Biden's Build Back Better agenda

The degree to which inflation and bottlenecks are transitory or permanent
