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ECONOMIC UPDATE

FOURTH QUARTER 2021

January 6, 2022

Quarterly Key Points

- GDP grew at a 2.3% q/q annualized pace in 3Q21, underwhelming expectations that had been revised lower throughout the back half of the year. The delta variant of COVID-19 was clearly a drag on consumption; however, supply chain bottlenecks, labor market constraints, inflation concerns, and the fading impact of Government stimulus were significant influences as well.
- The Fed revised its taper plan in December such that net asset purchases will end in the spring, several months earlier than previously scheduled. The market now expects three rate hikes in 2022. As the market re-priced inflation fundamentals and a hawkish monetary policy response, the curve reshaped considerably during the quarter.
- Despite an unprecedented 10-11 million job openings over the past six months, the labor force participation rate remains below pre-pandemic levels and total employment is still 3.6 million jobs lower than pre-pandemic.
- Earlier in the fall, consumer spending held up well, but then November came in at only 0.3% versus expectations of 0.8% with supply chain issues to blame. Home prices charged higher by 18.4% y/y in October. 30-year mortgage rates remained near 3.10% throughout the quarter while existing home supply has been squeezed back down to only two months.
- Business activity continues to be strong; however, supply chain issues and labor shortages remain problematic. After hovering near the highest level in the past 20 years for most of 2021, the ISM Manufacturing PMI Index dipped to 58.7 in December from 61.1 in November.

Our View

- The omicron variant provides yet another stark reminder of the ongoing risks involved with a global pandemic. Nevertheless, GDP will continue to grow at a healthy pace fueled by consumer demand, labor market strength, and wage gains. Elevated inflation, supply chain bottlenecks, and labor market frictions will continue to be obstacles along the path forward.
- Short-run equilibriums remain distorted and the transition to new long-run equilibriums could be bumpy, setting the stage for a potential policy error. Given continued uncertainty, portfolios remain positioned with slightly higher liquidity to protect against downside risks; this also provides flexibility and "dry powder" for opportunistic purchases in the year ahead.

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4Q21 – OMICRON BLURS THE ECONOMIC OUTLOOK

By early fall, at the time of our last quarterly write-up, the wave of COVID-19 delta variant infections was fading, and the biggest market concerns revolved around ongoing supply chain bottlenecks and the potential impact on the upcoming holiday season. Of course, with the colder weather approaching, the possibility of yet another spike in COVID infections seemed reasonable. Right on cue - and just in time for Thanksgiving - the World Health Organization warned of yet another new "variant of interest" that emerged in South Africa, referred to as the omicron variant. Fast forward to the end of the year, highly contagious omicron has spread like wildfire around the globe. At an average of 550,000 new cases per day in the U.S., this current virus wave dwarfs all of the previous waves by multiples (per CDC data). Putting this in perspective, the initial wave of infections at the onset of the pandemic peaked at 31,000 average daily new cases in April 2020. Daily average cases peaked at ~250k in January 2021 and the delta variant spike reached a daily average of ~160k new cases in September 2021.

Although omicron is more transmissible than previous COVID variants, thus far it appears to cause severe disease less frequently. Nevertheless, a lower incidence of severe disease on the high number of new infections has pushed medical capacity to the brink once again. Even testing has become constrained, with many testing sites reporting hours-long waiting lines and stores reporting at-home test kits in short supply or unavailable. Unfortunately, epidemiologists expect things to get worse over the coming weeks, as infections will continue to increase following the busy holiday season and the return to school for millions of students. Like delta, omicron serves as another reminder of the uncertainty involved with a global pandemic, but some see a potential silver lining on the horizon. Could the emergence of omicron signal a new phase in the evolution of COVID? Will the fast spreading variant flame out, and leave in its wake something far less severe? Will vaccine boosters provide protection, and what about natural immunity across variants? Only time will tell. For now, activity will likely get curtailed as quarantines exacerbate labor shortages, vacation plans get deferred, school systems resort to online teaching, and return to office plans get further delayed.

GDP grew at a 2.3% q/q annualized pace in 3Q21, underwhelming expectations that had consistently been revised lower through the back half of the year. The delta variant of COVID-19 was clearly a drag on consumption throughout the fall; however, supply chain bottlenecks, labor market constraints, inflation concerns, and the fading impact of Government stimulus were significant influences as well. Buffered by considerable excess savings and robust wage gains, consumer spending remained strong. Nevertheless, headwinds persist as inflation remains elevated and it will take some time for shortages to abate. Confidence intervals remain wide, but currently 4Q GDP is expected to be 6.0%-6.5% q/q annualized while full year 2021 GDP is expected to be 5.5%-6.0%. Looking ahead to next year, 2022 GDP growth is forecast to be in the 3.0%-4.0% range.

GOVERNMENT AND CENTRAL BANK UPDATE

The debt ceiling was successfully increased by $2.5 trillion in mid-December, avoiding a Government default. After months of wrangling, a separate agreement negotiated between party leaders allowed for an increase in the debt limit with a simple majority rather than the 60 votes typically required for major legislation. This one-time deal has drawn considerable criticism from Republicans, who had used the debt ceiling to negotiate other pending legislation. Importantly for Democrats, the debt limit increase provides borrowing room into 2023, thus pushing the next round of negotiations past the 2022 mid-term elections. Meanwhile, Congress successfully passed the $1.2

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trillion Infrastructure Investment & Jobs Act in November, while the $2.2 trillion Build Back Better Act stalled out in December and still needs Senate approval. Regarding pandemic related payment relief programs, the suspension of federal student loan payments that had been extended until January 31, 2022 has now been extended until May 1, 2022. The additional extension was granted to allow more time for borrowers to prepare for resumption of payments.

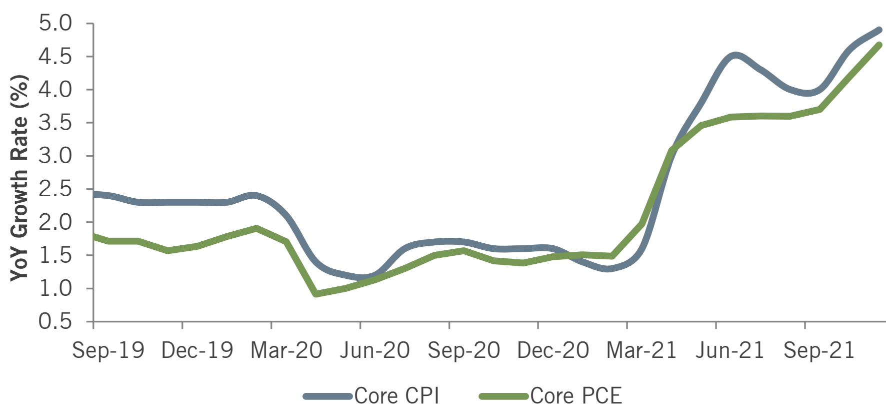
In November, the federal Occupational Safety and Health Administration (OSHA) formally announced a COVID-19 vaccine mandate requiring companies with more than 100 employees, as well as all federal workers and contractors, to implement proof of vaccine or weekly testing measures for all employees. As the federal agency overseeing workplace safety, OSHA is merely enforcing the mandate as outlined by President Biden in September. The mandate is highly controversial, pitting personal liberty against public health, and its application has been delayed by multiple legal battles. Lawsuits looking to stop the mandate claim it does not have Congressional approval and that OSHA acting on behalf of the executive branch lacks the constitutional authority to enforce it. The Supreme Court is scheduled to hear the case on January 7th.

As expected, the Fed kept rates unchanged at its November meeting and formally announced a QE tapering plan to wrap up net asset purchases by mid-2022. Starting in November, Treasury purchases were reduced by $10 billion per month and Agency MBS purchases by $5 billion per month, such that net purchases would be zero in eight months (mid 2022). However, at its December meeting, after the highest inflation prints in nearly 40 years, the Fed decided to accelerate the taper by reducing its purchases of Treasury securities by $20 billion per month and Agency MBS by $10 billion per month starting in January. The accelerated taper schedule will conclude in March, three months earlier than originally expected. The market now expects three interest rate hikes in 2022, to begin soon after the taper is complete. Indeed, the most recent Summary of Economic Projections (SEP), released at the December meeting, now indicates that 17 of 18 FOMC members project at least two rate increases in 2022, with 12 of 18 members projecting at least three rate increases over the next year. Finally, after some speculation about potential replacements, Jerome Powell will remain Fed Chair for another four year term.

INFLATION NO LONGER TRANSITORY

Headline CPI increased by 6.8% y/y in November, the highest rate of inflation since 1982, while core CPI increased by 4.9% y/y, the highest since 1991. Similarly, headline PCE increased by 5.7% y/y in November while core PCE increased by 4.7% y/y, the highest readings since 1982 and 1983 respectively (Figure 1). On a month-over-month basis, all of these measures are near pandemic highs after briefly dipping lower during 3Q. Furthermore, alternative Fed measures of core inflation like the Cleveland Fed Median CPI, the Cleveland Fed Trimmed Mean CPI, and the Atlanta Fed Sticky CPI 12-Month are at 3.5%, 4.6%, and 3.4% y/y respectively, while core PPI also remains elevated. This reversal of monthly measures and the highest year-over-year inflation readings in 40 years suggest that core inflation may be stickier than previously expected by the Fed. Indeed, in his Congressional testimony at the end of November, Fed Chair Powell stated, "it's probably a good time to retire the word transitory," and the reference was subsequently removed from the December FOMC statement. Although the 5-year break-even inflation rate is elevated at almost 3%, the 5Y-5Y forward break-even inflation rate remains firmly anchored at 2.25%, suggesting that the market believes the Fed will act aggressively enough to keep inflation at bay.

FIGURE 1: CORE CPI VS. CORE PCE[1]



[1]Source: Bloomberg

As the market re-priced inflation fundamentals and a hawkish monetary policy response, the yield curve reshaped considerably during the quarter. The 2-year Treasury yield increased by 45 bps (0.45%), reflecting expected rate increases, while the 10-year Treasury yield increased by only a couple of bps, such that 2s vs. 10s flattened by 43 bps. Meanwhile, 10-year real yields fell by 21 bps to (1.10%) and long-term inflation expectations settled at around 2.60% by the end of the year. Over the year, the shape of the yield curve was remarkably unchanged (2s vs. 10s flatter by only 6 bps). Nominal Treasury yields moved higher but real yields were virtually unchanged, leaving break-even inflation wider for the year.

SHORTAGES TEMPER ECONOMIC RECOVERY

Job growth has been lackluster, missing expectations in three of the last four months. Most recently, the November job report showed only 210k jobs added versus expectations of 543k. Even after upward revisions, August and September job growth still missed initial estimates by a considerable margin. Regardless, unemployment has ground down to 4.2%, primarily due to subdued labor force participation, a phenomenon that has drawn considerable attention. Despite an unprecedented 10-11 million job openings over the past six months, the labor force participation rate remains below pre-pandemic levels at 61.8% and total employment is still 3.6 million jobs lower than pre-pandemic. A plethora of narratives attempt to explain why there are fewer workers in the labor force now, such as early retirements, virus fears, Government support, child care, vaccine mandates, and even a re-evaluation of work-life balance. Employees are also quitting their jobs at an elevated rate, as indicated by the U.S. Quits Rate Index at 3.0%, the highest rate in the time series going back over 20 years. A shrinking labor force coupled with record job openings resulted in strong average hourly earnings growth of 0.3% m/m and 4.8% y/y in November following 0.4% m/m and 4.8% y/y increases in October.

Considering the new wave of COVID omicron infections and the 40-year high inflation readings, it comes as little surprise that the University of Michigan Consumer Sentiment Index dipped to a new pandemic low of 67.4 in November. Earlier in the fall, consumer spending held up as evidenced by month-over-month changes in retail sales of 0.7% and 1.8% in September and October respectively, but then November sales rose only 0.3% versus expectations of 0.8%. A similar pattern can be observed in the U.S. Personal Consumption Expenditures Index which increased 0.6% m/m, 1.4% m/m, and 0.6% m/m in September, October, and November respectively. Although the relatively large spike in October followed by a subdued print in November may indicate front-loaded holiday spending in anticipation of supply chain issues, it is hard to deny that omicron and inflation are taking a toll. After accounting for inflation, real personal consumption growth was flat in November. Furthermore, taking inflation into account may ultimately show that real holiday spending was underwhelming at best. Still, keeping things in perspective, overall retail sales are ~22% higher than February 2020, indicating that consumers continue to spend at an elevated rate.

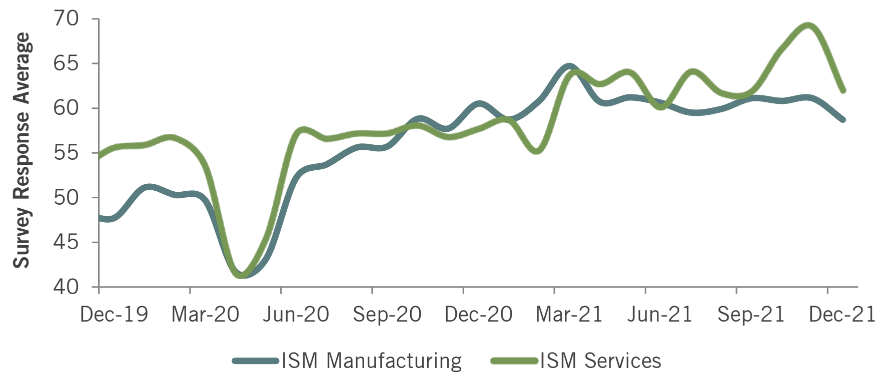
Home prices charged higher by 18.4% y/y in October, marking 11 straight months of double digit year-over-year growth. Notably, however, the month-over-month growth rate has fallen to 0.8% in October from a high of over 2% last spring. Fueled by 30-year mortgage rates that remained around 3.10% throughout the quarter, existing home sales are back up to 6.5 million units annualized while existing home supply has fallen back to only two months after increasing slightly in late summer. On the other hand, new home sales at 744k units annualized have fallen back to pre-pandemic levels, as has new home supply which has rebounded to 6+ months. Leading indicators of housing activity (such as pending home sales and the MBA purchase index) have continued on an upward trend after slowing in late summer; however, with the typically slower winter months upon us and omicron raging, it is reasonable to expect slightly more subdued housing market numbers in the near term.

Business activity remains strong, but supply chain issues and labor shortages continue to be problematic. After hovering near the highest level in the past 20 years for most of 2021, the ISM Manufacturing PMI Index dipped to 58.7 in December from 61.1 in November. The most recent ISM Manufacturing Report on New Business Orders Index at 60.4 is still robust, but less so than the average reading of ~66 between August 2020 and September 2021. Meanwhile, the ISM Services PMI Index reading of 69.1 in November marked the highest point in the series' history before falling back to a still-elevated 62 in December (Figure 2). Both industrial production and capacity utilization

[2]Source: Bloomberg

are back on track after dipping slightly in August and September. Importantly, both of these measures are back to pre-pandemic levels. Retail inventories also appear to have gained some traction, increasing by a whopping 2.0% m/m in November. Nevertheless, labor shortages remain a stumbling block to a full return to normal for businesses. The NFIB Small Business Job Openings Hard to Fill Index has been hovering near 50% since late last spring. This means half of small businesses in the NFIB survey responded that they had open positions that they were unable to fill in the current period. Putting that in perspective, this reading was more like 30%-40% in the years preceding the pandemic.

FIGURE 2: ISM MANUFACTURING AND SERVICES[2]



LOOKING AHEAD

GDP will continue to grow at a healthy pace fueled by consumer demand, labor market strength, and wage gains; however, short-term fluctuations in economic activity remain beholden to the evolution of COVID-19. Shifting public health policies and "pandemic burnout" regarding restrictions will continue to play out against the backdrop of the virus ebb and flow. The omicron variant provides yet another stark reminder of the ongoing risks involved with a global pandemic. Elevated inflation, supply chain bottlenecks, and labor market frictions will also continue to hamper a full return to "normal". Short-run equilibriums remain distorted and the transition to new long-run equilibriums could be bumpy. As such, the environment is ripe for a potential policy error - specifically, monetary policy will need to combat persistent, elevated inflation without squelching the economic recovery. Given continued uncertainty, portfolios remain positioned with slightly higher liquidity to protect against downside risks; this also provides flexibility and "dry powder" for opportunistic purchases in the year ahead.

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