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ARCHITECTS OF INVESTMENT SOLUTIONS

ECONOMIC UPDATE

FIRST QUARTER 2022

April 5, 2022

Quarterly Key Points

- GDP growth rebounded to a 6.9% q/q annualized pace in 4Q21, exceeding expectations despite the effects of the omicron variant on consumption. Although pandemic restrictions have largely been removed, clearing the path for increased economic activity, the highest inflation in 40 years will weigh on real output.
- The Fed increased the policy rate by 25 bps at its March meeting and signaled that quantitative tightening would commence in the near future. With inflation accelerating, many believe the Fed will remove accommodative monetary policy more aggressively than previously thought. The curve continued to reshape during the quarter as the market re-priced inflation fundamentals and an increasingly hawkish Fed tone.
- Headline and core inflation measures remain elevated, reaching the highest levels in decades. Still, the 5Y-5Y forward break-even inflation rate remains firmly anchored at 2.4%, suggesting that the market believes the Fed will act aggressively enough to squelch the inflation bubble. The labor market remains strong, with job growth handily exceeding expectations in recent months.
- After the omicron variant surge and supply chain bottlenecks effectively curtailed holiday spending, consumer activity picked back up during the quarter. However, consumer sentiment plummeted in March. Manufacturing and services activity remain strong with measures solidly in expansionary territory, but levels have fallen from the historic highs realized in 2021.
- Mortgage rates are on the rise, commensurate with the broader sell-off in interest rates, and home prices continue to climb higher. With elevated home prices and mortgage financing getting more expensive with each passing week, homebuyer affordability is starting to suffer and some measures of housing activity are starting to slip.

Our View

- With COVID retreating for the moment, the path is clear for continued economic recovery fueled by consumer demand, labor market strength, and wage gains; however, risks abound and the taxing effect of elevated inflation will limit the upside in real terms.
- Sustained inflationary pressure has resulted in a compressed timeline for monetary policy action, and the market is bracing for the Fed to remove accommodative monetary policy more aggressively than previously thought. Liquidity in capital markets has been reduced, presenting both risks and attractive opportunities. While we look to add high quality spread product, we remain cognizant of the potential for unintended consequences of large monetary policy and geopolitical shifts.

1Q2022 – COVID CONCERNS ABATE WHILE UKRAINE/RUSSIA CONFLICT MOVES FRONT AND CENTER

The highly infectious omicron variant of COVID-19 drove the 7-day moving average of daily new infections to more than 800,000 in January, surpassing all previous waves of the virus by an order of magnitude. Several individual days in January registered over 1 million new infections in the U.S. (January 10 had 1.259 million and January 24 had 1.011 million), per CDC data. Thankfully, the omicron variant generally causes less severe disease than its predecessors and, by the end of January, the tide seemed to be turning with daily infections falling rapidly. Since mid-March, the 7-day moving average infection rate has hovered in the 30,000 range. Looking back over the past two years, cumulative global infections are closing in on 490 million, with more than 6 million deaths worldwide.

By early March, many remaining COVID restrictions were being removed in rapid fashion. Most notably, CDC masking recommendations changed, resulting in the removal of masking requirements in many schools and municipalities across the country. At present, masking requirements for some forms of public transportation and air travel in the U.S. remain; however, multiple European jurisdictions/airlines have already removed mask requirements for air travel. Major airlines in the U.S. are lobbying the Government to remove the masking requirement and the current CDC mandate comes up for review in mid-April. As a sign of things continuing to improve, the 7-day moving average of TSA Checkpoint Total Travelers has been above 2.0 million since mid-March as millions of travelers embrace spring break. The most recent 7-day moving average readings of 2.1 million travelers is only slightly less than the 2.2 million traveler per-day average in the weeks leading up to the onset of the pandemic back in March 2020.

With COVID concerns fading to the background somewhat, rising geopolitical tensions in Europe took center stage during the quarter. Russia invaded Ukraine on February 24th following a months-long buildup of troops along the border. Being careful not to escalate with a nuclear superpower, the U.S. and its allies have responded with unprecedented economic sanctions against Russia in an attempt to end what has become the largest conflict in Europe since World War II. The impacts of the conflict and the sanctions have reverberated through financial and commodity markets, most notably in energy and food prices. Oil spiked to $120 per barrel in the weeks following the initial invasion, but has since fallen back to $100 per barrel. Meanwhile, wheat prices jumped to $14 per bushel in late February before winding up at $10 per bushel at the end of the quarter. The immediate effects have been inflationary, but the full-scope of consequences of this conflict, both intended and unintended, will be felt for years to come.

GDP growth rebounded to a 6.9% q/q annualized pace in 4Q21, exceeding expectations despite the effects of the omicron variant on consumption. The Citi Economic Surprise Index is back in positive territory after dipping negative at the start of the year, indicating that broad economic measures are robust. Although pandemic restrictions have largely been removed, clearing the path for increased economic activity, the highest inflation in 40 years will weigh on real output. Furthermore, headwinds persist as labor market frictions, supply chain issues, and geopolitical risks abound. As a result, economic forecasts for the remainder of the year have been revised lower. Estimates for 1Q GDP are in the 0.5%-1.5% q/q annualized range and full-year 2022 GDP growth estimates are in the 3.0%-3.5% range.

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GOVERNMENT AND CENTRAL BANK UPDATE

After passing the House in November 2021, the $2.2 trillion Build Back Better Act stalled out and failed to get approval from the Senate. The Act seems to have withered on the vine, and there are currently no initiatives in place to revive it. In late March, the White House released a $5.7 trillion 2023 budget plan that, coincidentally, includes items previously proposed in the Build Back Better Act. The budget also proposes hefty tax changes in order to reduce the budget deficit after the massive pandemic related spending spree. Proposed tax changes include an increase for upper income brackets and increased corporate taxes; both would be a partial reversal of the Trump tax reforms.

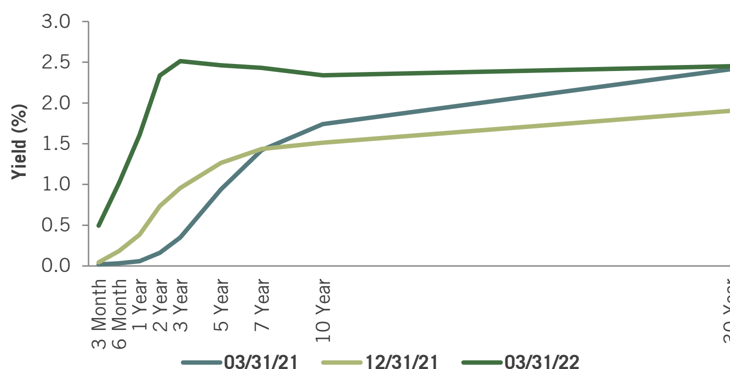
In January, the U.S. Supreme Court struck down the highly controversial COVID vaccine mandate announced by OSHA last November. As the federal agency overseeing workplace safety, OSHA was enforcing the mandate as initially outlined by President Biden last September. Recall that the mandate would have required companies with more than 100 employees, as well as all federal workers and contractors, to require proof of vaccine or weekly testing for all employees. Ultimately, the Supreme Court ruled that OSHA acting on behalf of the executive branch alone lacked the constitutional authority to enforce the mandate without congressional approval. Notably, the Supreme Court's ruling does allow for vaccine mandates for the healthcare industry.

Sustained inflationary pressure has resulted in a compressed timeline for monetary policy action, and the market is bracing for the Fed to remove accommodative monetary policy more aggressively than previously thought. The Fed left rates unchanged at its January meeting and kept the previously accelerated QE taper plan on track for completion in March. Recall that at the December meeting, the FOMC announced an accelerated plan that cut the taper schedule in half, thus clearing the way for quantitative tightening (QT) to commence soon after increasing the policy rate. Furthermore, the Summary of Economic Projections (SEP), released at the December meeting indicated that FOMC members projected 2-3 rate increases in 2022. Fast forward to the March meeting, the Fed raised the policy rate by 25 bps and the updated SEP now indicates that the FOMC intends to raise rates six more times in 2022 (at each remaining policy meeting).

There was considerable debate leading up to the March meeting about the possibility of a "shock and awe" 50 bps move to get things started. Indeed, one FOMC member did vote for a 50 bps hike in March and the median dot plot suggests that several FOMC members will push for accelerated hikes at some point. Chair Powell and several other FOMC members have already indicated that the Fed will increase rates more quickly if necessary. However, the Fed did not begin QT at the March meeting as had been speculated. Rather, the FOMC statement indicated, "the Committee expects to begin reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities at a coming meeting." Finally, the FOMC statement specifically called out the conflict in Ukraine and the uncertainty that it creates.

The yield curve continued to reshape during the quarter as the market re-priced inflation fundamentals and an increasingly hawkish Fed tone. The 2-year Treasury sold off by 161 bps (1.61%), while the 10-year Treasury sold off by 83 bps (0.83%), such that 2s vs. 10s ended the quarter essentially flat. Notably, 2s vs. 10s has been inverted since the end of March (Figure 1). Meanwhile, 10-year real rates sold off by another 65 bps to -0.45% and long-term inflation expectations settled in around 2.8%. Long-term inflation break-evens approached 3.0% in late March, the highest on record since the TIPS market started in 1998.

FIGURE 1: U.S. TREASURY YIELD CURVE[1]



[1]Source: Bloomberg

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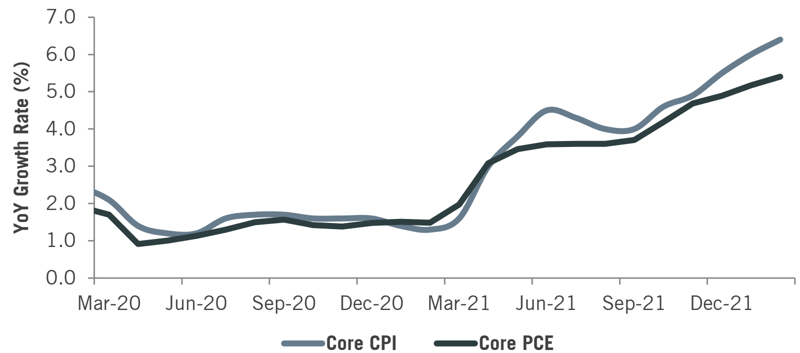
INFLATION TAKING A BITE OUT OF STILL SOLID ECONOMIC RECOVERY

Headline CPI increased by 7.9% y/y and 0.8% m/m in February, while core CPI increased by 6.4% y/y and 0.5% m/m. These readings mark the highest rates of inflation since 1982. Similarly, headline PCE increased by 6.0% y/y in January and 6.4% y/y in February, also the highest since 1982, while core PCE increased by 5.2% y/y in January and 5.4% y/y in February, the highest since 1983 (Figure 2). 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 measuring 4.6%, 5.7%, and 4.5% y/y respectively, while core PPI came in at record setting levels of 8.5% y/y and 8.4% y/y in January and February respectively. The 5-year and 10-year break-even inflation rates of ~3.4% and ~2.8% are close to the highest measures on record since the inception of the TIPS market in the late 1990s. Still, the 5Y-5Y forward break-even inflation rate remains firmly anchored at 2.4%, suggesting that the market believes the Fed will act aggressively enough to squelch the inflation bubble.

FIGURE 2: CORE CPI VS CORE PCE[2]



Meanwhile, the labor market has been strong, as job growth handily exceeded expectations in January and February, with 504k and 750k jobs added respectively. March saw another 431k jobs added, just slightly below expectations; however, consistent upward revisions going all the way back to October indicate the labor market is even stronger than previously thought. As a result, the measured unemployment rate fell to 3.6% in March. Further, annual revisions by the Bureau of Labor Statistics resulted in a considerable jump in the labor force in the first quarter. As it stands, the labor force participation rate moved up to 62.4% in March and total employment in the U.S. is now only about 400k jobs less than pre-pandemic levels. Initial unemployment claims fell to 187k in the third week of March, the lowest since September 1969, while continuing claims are down to 1.3 million, the lowest since January 1970. Taking all of that into consideration, there are still approximately 11 million job openings and the quits rate continues to hover near 3.0%, suggesting that structural labor frictions may persist for some time. As one would expect, nominal hourly earnings remained elevated at 5.4% y/y in January, 5.2% y/y in February, and 5.6% y/y in March. Real hourly earnings on the other hand, have suffered the ill effects of elevated inflation since spring of 2021. The most recent readings in January and February came in at -1.9% y/y and -2.5% y/y respectively.

After a curtailed holiday spending season as a result of the omicron variant surge and supply chain bottlenecks, retail sales came in at 4.9% m/m and 0.3% m/m in January and February respectively. The U.S. Personal Consumption Expenditures Index followed a similar pattern with 2.7% m/m and 0.2% m/m increases in January and February. With inflation running hot, the University of Michigan Consumer Sentiment Index slipped to just 59.4 in March, the lowest reading since 2011. Interestingly, the personal savings rate of 6.3% in February marks the lowest savings rate as a percent of disposable income since 2013, suggesting that the aforementioned wage gains may not be enough to support continued spending, forcing consumers to dip into savings.

The ISM manufacturing and services indices have fallen from the historic highs realized in 2021; however, both remain solidly in expansionary territory. The ISM Manufacturing PMI came in at 57.6 in January, 58.6 in February, and 57.1 in March, while the ISM Services PMI measured 59.9 in January, 56.5 in February, and 58.3 in March. Industrial production at 103.6 and capacity utilization at 77.6% in February have both surpassed pre-pandemic levels, marking the highest points since 2019. The ISM Manufacturing Report on Business New Orders slipped to 53.8 in March, down from 61.7 in February, signaling that supply chain issues, labor shortages, and inflation may be taking a toll on business spending. Similarly, durable goods orders fell by 2.1% in February, marking the largest month-over-month drop since the early days of the pandemic.

[2]Source: Bloomberg

Not surprisingly, mortgage rates are on the rise, commensurate with the broader sell-off in interest rates. The Freddie Mac Weekly Survey rate has increased 156 bps year-to-date, ending the quarter at 4.67%. This marks the highest 30-year mortgage rate since December 2018. Although still relatively low in a historical sense, a mortgage rate approaching 5% looks high relative to the roughly 3% average for the past two years. Nevertheless, home prices climbed higher, registering another whopping 18.6% y/y increase in December and 19.1% y/y increase in January. With elevated home prices and mortgage financing getting more expensive with each passing week, homebuyer affordability is starting to suffer and some measures of housing activity are starting to slip. Leading indicators of housing activity like the U.S. Pending Home Sales Index and the MBA U.S. Purchase Index have been falling for the past several months, as have annualized home sales. Existing home sales dropped back to a 6 million unit annualized pace in February while new home sales fell precipitously during the past few months, to a 772k annualized pace.

LOOKING AHEAD

With COVID retreating for the moment, the path is clear for continued economic recovery fueled by consumer demand, labor market strength, and wage gains; however, risks abound and the taxing effect of elevated inflation will limit the upside in real terms. Furthermore, the monetary policy response required to tame inflation could eventually tip the economy into recession, an idea that the market has started to entertain as signaled by recent yield curve reshaping. Shifting geopolitics and the situation in Ukraine add another layer of uncertainty that is relatively unanalyzable away from the visible human impacts.

Sustained inflationary pressure has resulted in a compressed timeline for monetary policy action, and the market is bracing for the Fed to remove accommodative monetary policy more aggressively than previously thought. Liquidity in capital markets has been reduced, presenting both risks and attractive opportunities. While we are actively reducing elevated liquidity positioning in favor of adding high quality spread product at attractive valuations, we remain cognizant of the likelihood of unintended consequences resulting from significant monetary policy action and persistent geopolitical tensions.

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