SMITH AFFILIATED CAPITAL

FIRST QUARTER 2022 INVESTMENT COMMENTARY

Virus Fears, Inflation, and a Possible Policy Mistake Cast a Shadow over 2022

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The Omicron variant is likely to take a greater toll on GDP growth in early 2022 than we previously thought. Omicron is spreading rapidly and widely and is causing some restrictions on activity to be put in place, including self-imposed restrictions. There is some hope that infections from the new variant will produce relatively mild symptoms, but only among those fully vaccinated, including a booster shot. Currently, only 61% of the population has been vaccinated, with just 25% receiving their booster shot. The severity and extent of the pandemic's short-term path are very fluid so we will be watching developments closely over the coming weeks. That said, the economic outlook for 2022, particularly over the first quarter, looks less upbeat than we thought a month or so ago.

What's more, the fiscal stimulus that was such a powerful driver of growth in 2021 will be either nonexistent or morph into a drag in 2022. Senator Joe Manchin dealt what may be a fatal blow to President Biden's climate and social safety net agenda when he said he would not vote for the Build Back Better plan being crafted in the Senate. At the same time, the House passed its $1.8 trillion version of BBB in late November. Manchin has never been an enthusiastic supporter of BBB, citing concerns about the possible impact on inflation, some of the climate provisions, and the short-term nature of many of its components, which he argues masks the true cost of the legislation. There is some chance that BBB can be overhauled to satisfy Manchin's concerns, but at this stage, the chances of passage have dropped considerably.

Although the Build Back Better bill was never meant to be a stimulus, its absence or a deeply scaled-back version will further dilute the contribution of fiscal policy in economic activity this year. The withdrawal of fiscal stimulus will coincide with the accelerated withdrawal of monetary support. The Fed now plans on ending its bond-buying program by March, opening the door for rate hikes soon after that. The Fed's pivot is in response to the rapid acceleration in inflation that has become more persistent and longer-lasting than expected, even as the job market continues to forge ahead. But policy tightening will do little to solve the inflation problem, fueled mostly by pandemic-related labor and goods shortages that Omicron may intensify. Hence, the threat of a policy mistake that could stifle the expansion is not a trivial possibility.

Winding up a Solid Year

It may not feel like it given the resurgence in Covid health concerns, elevated inflation, and heightened financial market volatility, but the U.S. economy is riding high heading into 2022. Unemployment is falling rapidly, people are shopping freely, household balance sheets are solid, and businesses are enjoying record profits. The recovery from the 2020 pandemic recession, the deepest – although shortest – since the Great Depression, has been swifter and more robust than any previous postwar upturns.

But while there is plenty to celebrate about the recovery, the economy has not fully healed, and risks to the outlook loom large. The output level is still 2.5 percent below the pre-pandemic trend; nearly 4 million of the 22.3 million workers that lost jobs in early 2020 are still missing and wages, after being adjusted for inflation, remain below where they were in March 2020. While job growth has been strong, businesses are desperately struggling to fill open positions, as the share of the population in the labor force remains well below its pre-pandemic level. Health concerns, childcare responsibilities, and a wave of early resignations are holding back the labor supply.

Despite these headwinds, the economy is winding up a year of solid growth, with GDP on track to advance by around 5.5 percent. What's more, it is heading into 2022 with solid momentum, as the fourth quarter is expected to grow by an eye-opening annual rate of more than 7 percent. Yet as we noted at the outset, not everything is coming up roses; household sentiment has been sinking dramatically in recent months, with some surveys reporting a negative mindset comparable to recessions. One reason, of course, is the resurgence of Covid, driven by the new Omicron variant. Another is the astonishing revival of inflation, which is running at the strongest pace in 40 years and prodding the Federal Reserve to take corrective action sooner than it had planned just a month ago. Both the intractable health crisis and the hawkish pivot of the central bank cast a dark shadow over the outlook. No one knows how severe the latest Covid wave will be, and many fear that a policy mistake could choke off the expansion. The coming year still looks promising, but the downside risks are rising.

Uncertain Outlook

As the curtain rings down on 2021, the new year offers many promises but is fraught with uncertainty. On the positive side, the fundamentals are solid. Flush with cash from several rounds of stimulus payments, expanded unemployment benefits, and unspent funds that couldn't find outlets due to pandemic restrictions, consumers are in a good position to sustain spending

for a while at a healthy pace. Final figures are not yet in, but holiday sales were strong, limited primarily by a shortage of goods that supply bottlenecks prevented from reaching stores in time for the season.

That said, the stimulus-fueled underpinnings that propelled the most substantial consumer spending increase in 2021 since World War 11 are not sustainable. For one, most of the stimulus checks have already been spent, particularly among lower-income households. For another, pandemic emergency unemployment programs have ended. Unless Congress extends it, so too has the expanded child-care tax credit that gave families up to $300 a month for each child. The last check went out in December, and according to the Census Bureau Household Pulse Survey, 77.4 percent either mostly spent it or used it to pay down debt.

The rapid depletion of tax credit funds reflects the diminished financial reserves among lower-income households and their weakened position to power consumption in the months ahead. More broadly, the personal savings rate, which shot up as high as 34 percent last April, is now down to under 7 percent, in line with pre-covid levels. There is still more than $2 trillion in excess savings from unspent funds sitting in bank accounts, but they are held mainly by wealthier households who tend to retain high savings balances. According to the Federal Reserve's Consumer Expenditures Survey, households in the top 20 percent income bracket only spend two-thirds of their annual incomes. Those in the bottom 40 percent rung spend all of their incomes and then some, meaning they either draw on savings to support spending or go into debt.

Still, the purpose of the massive financial aid disbursed over the past year was to tide people over until the private sector could retake the mantle of growth. That handover is well underway, thanks to a robust job market that is fattening the paychecks of existing workers and restoring most of the ones that were lost during the pandemic. While government transfer payments are rapidly diminishing, labor compensation is making up some of the difference. Since March, wages and salaries have increased by a monthly average of 12 percent from year-earlier levels, while government transfer payments have been cut in half, from $8.1 trillion in March to under $4 trillion in November. Importantly, low-paying industries generate the most significant wage gains, offsetting some of the sting from reduced government transfer payments.

Omicron's Impact Being Felt

Following the vigorous fourth-quarter growth rate, which likely exceeded 7 percent, the economic engine is poised to downshift significantly in the first quarter, when we expect the pace to slow to around 2.5 percent. The signs of a downshift are already highly visible, as Omicron is putting the kibosh on a growing swath of service-sector activity. Vaccine and mask mandates are reinstated in many states; schools are partially closing again, theaters are shutting down shows, airlines are canceling thousands of flights daily, and most importantly, consumers are starting to behave more cautiously. According to data provided by the reservation site, Open Table, bookings at restaurants and bars have slipped markedly in December. The health implications of the Omicron variant are still highly uncertain. But given the variant's apparent greater ability to overcome vaccines and re-infect those that have previously caught Covid, it's not surprising that the peak of the current Covid wave has already surpassed the last peak in August.

Still, it is too early to determine if the economic impact from this variant will be as disruptive as previous ones. Early health data suggest that Omicron produces less severe symptoms than earlier variants. Given this, the government is unlikely to impose lockdown restrictions, given the political backlash that could ensue. The public appears to have developed pandemic fatigue, reluctant to make as many sacrifices as in the past two years. With vaccination rates higher and more tools to combat the virus available, including the promising development of a Covid pill that could swiftly become broadly distributed, there is every reason to hope the damage to the economy could be contained.

Hence, we see a pattern developing similar to the one traced in 2021. In the third quarter of last year, the Delta variant sliced the growth in GDP to 2.3 percent from 6.7 percent in the previous quarter, when the economy was reopening from lockdown, and the recovery was in full swing. We expect Omicron to pose a similar drag on growth in the first quarter, but as was the case last year, once this wave passes, the recovery should rebound. Some health officials believe that the rapid spread of infections indicates that this wave will peak sooner than Delta, pointing to a faster decline in case counts. Even so, the post-Omicron revival will lack the punch that propelled growth in 2021, as its two fundamental tailwinds –fiscal stimulus and a turbocharged easy monetary policy – will morph into headwinds in 2022.

The Fed's Hawkish Pivot

The Fed's pivot to a more hawkish policy at its mid-December FOMC meeting was well telegraphed and had a little disruptive impact on the financial markets, unlike the taper tantrum that roiled the markets in 2013. As widely anticipated, the Fed doubled the pace of QE tapering to $30 billion a month, putting it on course to end QE asset purchases in March 2022. More importantly, Chair Powell clarified in the press conference that he and the FOMC had quickly pivoted to a more hawkish policy stance. Since the November policy meeting, this pivot was based on evidence of faster and more widespread inflation, stronger labor market conditions, and faster wage gains. He pointed out that while the main drivers of the elevated rate of inflation were the pandemic, there is now a broader range of goods and services experiencing rapid price increases.

In line with this view, the Fed revised up its headline personal consumption expenditure (PCE) and core PCE inflation forecasts by a sizeable 0.4 percentage points to 2.6% year-over-year and 2.7%, respectively, in the fourth quarter of 2022. Meanwhile, the unemployment rate estimate was cut by 0.3 percentage points to 3.5%, which is below its long-run potential projection of 4% -- indicative of a tight labor market. The tightness is mainly due to the slow rebound in the labor force participation rate. Workers are reluctant to return to the labor force for various reasons, including health care concerns, childcare responsibilities, and early retirements, reflecting bloated nest eggs fueled by outsized stock market gains and inflated home prices.

It's unclear how long labor participation remains muted, and labor shortages persist. The successive waves of Covid variants are key depressants. The current upsurge in case counts keeps workers away and spurs labor shortages across a broad swath of private industries and the public sector. Staffing at hospitals, subways, nursing homes, and schools is being severely cut back, even as fears of infection discourage healthy people from taking a job. No doubt, when the Omicron threat recedes, workers will return. Still, it's unlikely that the participation rate will return to pre-pandemic levels, if only because of the wave of retirements suppressing the labor force. Hence, perceptions of maximum employment will look very different than they did pre-pandemic. The Fed obviously believes that keeping inflation in check is now more imperative than fostering job growth. That bias shift will probably get stronger in 2022 as the annual rotation of regional bank presidents will usher in more hawkish voting members on the FOMC this year, including Esther George and Loretta Mester.

It's Not the 1970s

The lack of available workers puts upward pressure on wages, but a sustained wage-price spiral stoking inflation, reminiscent of the 1970s, is not in the cards. True, labor has gained more bargaining strength, resulting in some hefty pay raises among low-wage workers. Unions have also flexed their muscle in some high-profile negotiations, providing members with the most significant wage and benefit increases in decades. But the gains follow decades of lagging wages and represent more of a catching up than a portent of recurring bargaining success. Significantly, none of the significant agreements contained COLA's that were prominent features of labor contracts in the 1970s, and union membership as a share of the workforce is half of what it was then.

Admittedly, businesses were readily able to pass on most of the increased labor costs to consumers last year, thanks to beefed-up demand underpinned by massive government transfer payments, elevated savings, and hefty wealth gains. But those underpinnings will not be a driving force in 2022. True, the astonishing global surge in Omicron case counts over the past several weeks will prolong the supply-chain disruptions and shortages that have also driven up inflation. But there are signs that bottlenecks are easing, and businesses are increasingly finding workarounds to obtain supplies, as manifested by shortened delivery times now underway. Factory production has ramped up, and even auto manufacturers have turned out more cars and trucks over the past two months, indicating that the chip shortage that shut down assembly lines earlier in the year is easing.

We expect inflationary pressures to peak out around the spring of 2022 and recede over the second half of the year as the supply of goods and labor continues to meet demand. Assuming Omicron's grip on the nation recedes over the next several months, consumer-purchasing habits will normalize, shifting away from physical goods into services, which should also relieve inflationary pressures. Indeed, when conditions normalize, we may well see sharp price declines on an array of goods, including autos that were in particularly short supply during the pandemic. Notably, households and the fixed income markets expect inflation to recede markedly over the longer term, indicating that consumer buying and wage-setting behavior is not poised to set off a sustained wage-price spiral.

As expectations of Fed rate hikes gained traction over the past several months, short-term rates have staged significant increases even as long-term rates have shown modest changes, leading to a flattening yield curve. At this juncture, the markets are priced for 2.7 rate hikes in 2022, which is fully captured by the upward move in short-term yields. However, the relative stability in the 10-year Treasury yield suggests that bond investors believe the Fed will successfully prevent inflation from getting out of control by bringing about slower growth. From our lens, the risk is that the sustained elevated inflation rate through the early months of 2022 will spur the Fed to move more aggressively than is necessary. The Fed does not have a good track record for bringing about a soft landing for the economy; the task ahead will be particularly challenging amid the myriad crosscurrents it will have to navigate.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market (Barclays TSY Bellwethers)	Yields (%)			Total Return (%)	
	12/31/2020	9/30/2021	12/31/2021	Last Quarter	Last Year
6-Mo. Bill	0.09	0.05	0.18	0.01	0.09
2-Yr. Note	0.12	0.29	0.73	-0.53	-0.57
5-Yr. Note	0.36	0.98	1.26	-0.90	-2.80
10-Yr. Note	0.91	1.52	1.50	0.67	-3.60
30-Yr. Note	1.64	2.08	1.89	4.70	-4.62

Municipal Bonds	Yields (%)			Total Return (%)	
	12/31/2020	9/30/2021	12/31/2021	Last Quarter	Last Year
Barclays GO Bond Index	0.87	0.99	0.97	0.71	1.01
Barclays State GO Bond Index	0.77	0.87	0.86	0.60	0.92
Barclays Local GO Bond Index	0.97	1.10	1.07	0.81	1.10
Barclays Revenue Bond Index	1.22	1.23	1.22	0.79	1.86

Equities	Levels			US $ Terms (%)	
	12/31/2020	9/30/2021	12/31/2021	Last Quarter	Last Year
S&P 500	3756.07	4307.54	4766.11	11.02	28.68
DJIA	30606.48	33843.92	36338.30	7.87	20.95
NIKKEI (Tokyo)	27444.17	29452.66	28791.71	-5.32	-4.42

Commodities	US $			Percent Change (%)	
	12/31/2020	9/30/2021	12/31/2021	Last Quarter	Last Year
COMEX Gold Active Monthly	1895.1	1755	1829	4.22	-3.49
CRB Future Com. Pr. Index*	167.79	228.9221	232.37	1.51	38.49
West Texas Intermediate Crude ($ per bbl.)	48.62	75.03	76.99	2.61	58.35

Currencies	Levels			Percent Change (%)	
	12/31/2020	9/30/2021	12/31/2021	Last Quarter	Last Year
Yen	103.25	111.29	115.08	-3.41%	-11.46%
Sterling	1.3672	1.347	1.353	0.45%	-1.04%
Euro	1.2216	1.158	1.137	-1.81%	-6.93%

Global Bond Markets**	Levels			US Dollar Terms (%)	
	12/31/2020	9/30/2021	12/31/2021	Last Quarter	Last Year
German 10-Yr.Bond	-0.66	-0.32	-0.30	-0.30	-2.80
Japanese 10-Yr.+ Bond	-0.04	0.01	0.00	0.15	0.07
UK 10-Yr.+ Bond	0.14	0.89	0.90	0.44	-4.85
Emerging Market (USD)	3.50	4.22	4.33	-0.52	-1.65

Source: Bloomberg Financial Data
*Thomson Reuters/Jefferies CRB Commodity Excess Return Index
** Global Bonds Represented by Bloomberg Barclays Indices

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