SMITH AFFILIATED CAPITAL

WEEK OF JANUARY 21, 2022

WEEKLY ECONOMIC COMMENTARY

While the economy may be going through a soft patch, the stock market is enduring more of a rough patch, with the S&P 500 index tumbling nearly 8 percent so far this year, and the tech-laden Nasdaq composite index already in correction territory, having fallen by more than 10 percent from its November high. It's always a fool's errand to try explaining why stock prices move one way or the other, particularly over short periods. For sure, there are occasions when the catalyst is obvious, such as an external shock that heightens investor anxiety and drives them into safe-haven assets, with Treasury securities the usual landing place. The shock of Covid-19 certainly fits that bill, and the recurrent waves of the virus clearly had a disruptive influence on the market over the past two years.

No doubt, the rapidly spreading Omicron variant is having a disruptive influence this month as well. But whereas previous waves of the virus unfolded amid a generally favorable policy and economic backdrop, there are few calming influences to temper investor jitters this time. If anything, market volatility is being amplified by an array of actual and potential shocks that are poised to linger. What's more, investors are finding little refuge in the safety of Treasury securities, as the dive in stock prices has coincided with a sharp rise in market interest rates so far this year. Despite a roughly 10 basis point retreat on Thursday and Friday, the bellwether 10-year Treasury yield has increased by more than 25 basis points over the past three weeks, a move echoed by shorter-maturity issues.

The aberrant yield climb on that erstwhile hedge for anxious stock investors alongside the fall in equity prices reflects the crosscurrents buffeting the markets. Although not precisely an abrupt shock to the system, the inflation surge over the past six months has exceeded expectations, both in its severity and duration, spurring increased speculation that the Federal Reserve would pivot to a tighter monetary policy more quickly than planned at its last meeting. The rapid spread of Omicron and its global reach sustain supply-chain disruptions fueling the inflation fire and driving up interest rates.

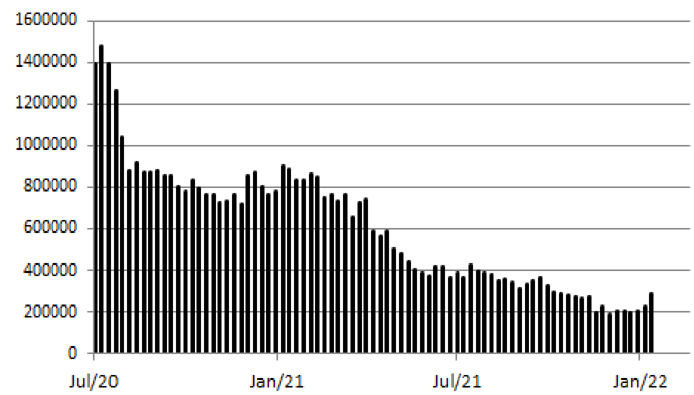
Meanwhile, the inflation surge is morphing into sticker shock for millions of households whose paychecks are not keeping up even as their savings cushion accumulated over two years of generous government transfer payments is rapidly depleting. The soft patch that the economy is expected to endure in the first quarter will primarily reflect the drag from supply-side constraints. But the downside threat to demand from inflation is more than trivial, as consumers may not be as accepting of higher prices as they were last year when fiscal and monetary support was far more accommodating. If inflation continues to outpace wage gains and squeezes household budgets, the drag on real incomes would eventually undercut demand and usher in weaker economic conditions. Alternatively, if outsize price increases stick without cutting into demand, that suggests income growth would be getting a big boost from accelerated wage gains, setting the stage for a wage-price spiral that embeds inflation more firmly in the economic landscape, something that portends higher interest rates and a harsher response from the Fed.

Just how successfully the Fed navigates these crosscurrents is the wild card in the outlook. In recent weeks, the markets have set inflation as the number one problem facing the economy and have increasingly priced in a more hawkish Fed response. This week, there were even whispers that officials might leap-frog the expected 25 basis point rate increase in March with a 50 basis point hike. From our lens, a more tempered response is still the correct approach to the evolving economic and inflation environment. Indeed, there is a growing disconnect between the markets' fixation with inflation and the broadening list of growth downgrades among forecasters for the first quarter. For the most part, these downgrades reflect the weaker handoff to the new year from the softer-than-expected data over the closing months of 2021, including the downbeat retail sales figures for December reported last week.

But there are few signs that activity in January is rebounding. Indeed, high-frequency data indicate that the economy will struggle to eke out any growth at all in the first quarter. According to the Empire State Manufacturing Survey, the index of factory activity in New York plunged by an unsightly 33 points in January, a downturn only partially alleviated by a modest 7.8 point increase in the Philadelphia Manufacturing Survey. Again, the weakness primarily reflects supply constraints and rising costs; importantly, respondents in both surveys expressed optimism that conditions would improve over the next six months. In the here and now, however, sagging activity in the manufacturing and service sectors may be starting to take a toll on the jobs front.

Perhaps the most disconcerting report this week revealed a rise in worker layoffs. For the third week in a row, initial claims for unemployment benefits increased, the longest stretch of weekly increases since last September amid the Delta wave. That said, claims for jobless benefits remain historically low, and the uptick may reflect quirks in seasonal adjustment factors that temporarily elevate the count. But the trend bears watching, particularly on the heels of the markedly slower payroll growth reported for December. With more job openings than job seekers, and workers quitting their jobs at a record pace, businesses are striving to retain staff as long as possible, not laying off workers at the first sign of weakness. Still, if production setbacks continue, either due to delivery delays or consumer defections because of the virus, retaining workers would become more untenable.

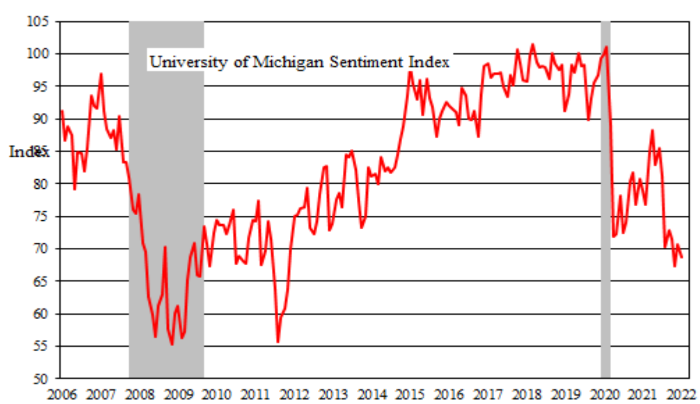
Unemployment Claims Tick Up



Keep in mind that layoffs would take a much more significant toll on demand than was the case in 2020 and 2021 when the purchasing power of unemployed workers was cushioned by enhanced jobless benefits, several rounds of stimulus checks, and expanded childcare payments. Those supports have expired and are not likely to be renewed by a highly polarized Congress, including legislators who firmly believe that the massive financial aid contributed to the inflation problem. This has important implications, particularly for low-wage workers who were the prime beneficiaries of the government transfers and who tend to spend almost every penny of the benefits.

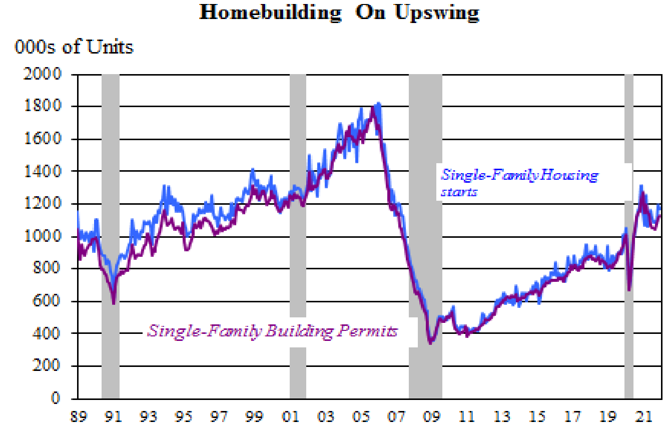
The good news is that this cohort of the labor force is in strong demand and receiving the most significant pay raises. The bad news is that inflation and the withdrawal of fiscal support are putting a bigger dent in their financial well-being than those higher up the income ladder. That's the message conveyed in the latest University of Michigan Survey of households taken in early January. The overall Sentiment Index fell by nearly 2 points to the second-lowest level in the past decade. Significantly, lower-income households felt more downbeat about the economy than upper-income households. A formidable 40 percent of households in the bottom third of incomes reported worsening finances compared to just 20 percent of those in the top third.

That Sinking Feeling



Simply put, income growth will be a far less important source of strength for consumers in the first quarter than last year. And if the stock market's performance so far this month is any indication, the wealth effect on consumption will also be muted. On a positive note, homebuilding activity should fill part of the void left by consumers, as the housing market remains red-hot and stoking a pickup in residential construction outlays. Amid a sparse batch of data released this week, homebuilding activity sounded a distinctly positive note. Housing starts in December came in much more robust than expected, and building permits, a forward-looking indicator of residential construction activity, jumped by 9.1 percent.

Homebuilding On Upswing



The slim inventory of homes for sale amid strong demand is driving up home prices and is encouraging homebuilders to ramp up construction. It remains to be seen if the recent climb in mortgage rates, which closely follows the 10-year Treasury yield, will dampen demand. In the near term, it may actually stimulate home sales if potential buyers decide to jump in before rates go even higher. It's also possible that higher mortgage rates may even free up some supply. Many recent homebuyers opted to keep their old homes and become landlords because exceptionally low mortgage rates kept carrying costs low while rents were accelerating. That equation could change if mortgage rates continue to rise.

Interestingly, last month's strongest segment in residential construction was for multifamily units. This highly volatile sector could easily see a sharp retreat in the coming months. But the fast rise in rents may also be encouraging a pickup in apartment construction that in time would bring on more supply and relieve the upward pressure on rents. This would validate what some industry observers believe – that the cure for high rents is high rents. The same might also apply to the current inflation surge, particularly if the Omicron wave fades in coming weeks and more supply comes on stream.

FINANCIAL INDICATORS				
INTEREST RATES	January 21	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.17%	0.13%	0.05%	0.09%
6-month Treasury bill	0.35	0.29	0.13	0.1
3-month LIBOR	0.26	0.24	0.21	0.23
2-year Treasury note	1.02	0.96	0.66	0.13
5-year Treasury note	1.56	1.56	1.18	0.46
10-year Treasury note	1.76	1.79	1.41	1.11
30-year Treasury bond	2.08	2.13	1.82	1.85
30-year fixed mortgage rate	3.56	3.45	3.12	2.79
15-year fixed mortgage rate	2.79	2.62	2.34	2.23
5/1-year adjustable rate	2.60	2.57	2.45	3.12
STOCK MARKET				
Dow Jones Industrial Index	34265.37	35911.81	35365.44	30996.98
S&P 500	4397.94	4662.85	4620.64	3841.47
NASDAQ	13768.92	14893.75	15169.68	12998.50
Commodities				
Gold ($ per troy ounce)	1836.10	1816.30	1810.10	1839
Oil ($ per barrel) - Crude Futures (WTI)	84.83	84.39	71.18	52.75
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Housing Starts (December) - 000s	1702	1678	1552	1611
Building Permits (December) - 000s	1873	1717	1653	1682
Existing home sales (Decmeber) - 000s	6100	6490	6340	6183