

As the curtain rises on the new year, it's notable that 2022 is the year of the tiger, an animal known for its assertive, unpredictable, and energetic qualities. Barely a week in, these attributes are already dominating the news cycle and roiling the financial markets. To be sure, 2021 was the year of the ox, a lumbering creature that hardly reflects the swirl of rapid-fire events that unfolded during the year. It may yet turn out that the Fed in cohorts with health professionals will tame the tiger allowing a more tranquil economic environment to unfold over the year.

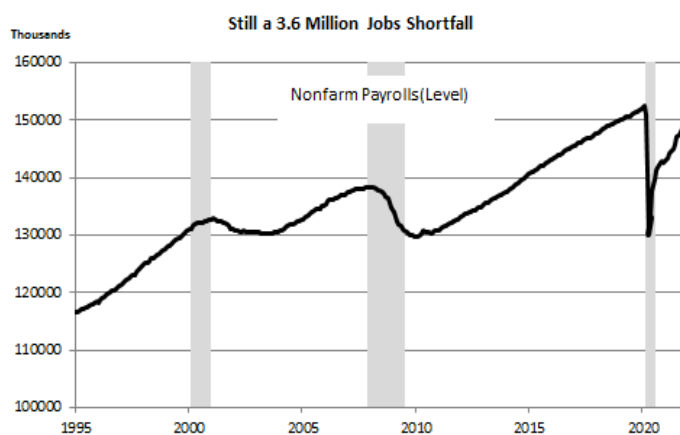
But developments over the opening week suggest that a more eventful than languid outcome is in store for the period immediately ahead. Recall that the financial markets reacted with aplomb in November when the Fed unveiled details of its plan to start unwinding monetary support. The plan was well telegraphed and favorably received in the markets, as it raised hopes that policymakers were getting ahead of the inflation curve and poised to guide the economy onto a soft landing. At the time, Delta was also unwinding so that the economy would not only be in a better position to withstand a tightening policy, but the pandemic-related forces driving up inflation would also recede, making the Fed's task manageable.

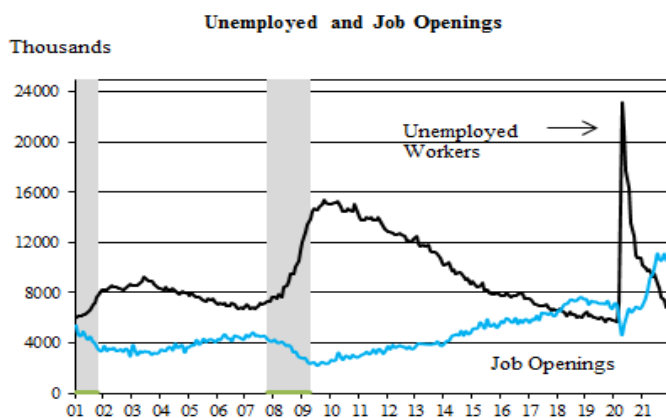
That was then. Covid took on a new mutation in December, and the Omicron variant has since surpassed Delta as the driving force propelling caseloads to record levels. Instead of receding, health fears are again on the rise and threatening to slow the recovery even as it aggravates the supply shortages underpinning the abrupt climb in inflation. That unholy confluence of events is, understandably, complicating the Fed's mission of reining in inflation while keeping the recovery on track. At its December policy meeting, officials decided that controlling inflation was a more immediate concern. They opted to reduce asset purchases at a swifter pace and hinted at earlier and steeper rate increases this year. That hawkish pivot was amplified this week, as the minutes of that meeting revealed an even stronger bias towards tightening conditions than indicated in the summary statement released on the day of the meeting.

As a result, the markets are now bracing for an earlier rate hike, moving it up from May to March, followed by two more over the course of the year, and for the Fed to start reducing its balance sheets shortly after the tapering of asset purchases is completed in March. As expected, the combination of persistently high inflation and a more hawkish Fed policy is taking a toll on the bond market, where the bellwether 10-year Treasury yield increased by a sharp 26 basis point increase since the start of the year, ending the week at 1.77 percent, the highest in nearly two years. Interestingly, the reaction in the bond market is the mirror image of the move following the November policy meeting, when the 10-year yield tumbled by 30 basis points between late November and early December. The conflicting responses to the Fed's evolving policy stance reflect shifting investor perceptions over whether policymakers can bring about that elusive soft landing.

That said, the economic news this week validates the Fed's hawkish tilt, as the inflationary embers are still burning bright and the job market continues to run hot. True, the headline reading in the December employment report, released Friday, looks soft on the surface. Nonfarm payrolls rose by a much smaller than expected 199 thousand during the month, a significant shortfall relative to the consensus expectation of a 450 thousand gain. But revisions to the previous two months added 141 thousand more jobs than originally estimated, and December's initial disappointing estimate still punctuates a year of record job growth totaling 6.4 million. Despite that chart-topping annual gain, there are still 3.6 million fewer jobholders compared to the pre-pandemic level in February 2020.

Notably, that shortfall does not reflect weak hiring demand. Businesses are struggling to find workers and their efforts are akin to squeezing water out of a stone. At the end of November, there were a near-record 10.6 million job openings, which exceeded the number of unemployed workers by 53 percent, a gap that has never been wider. Meanwhile, workers are quitting their jobs in droves, as a record 4.5 million turned in their resignations in November. Simply put, it is not the demand for workers but supply that's holding back job growth. The labor force participation rate, at 61.9 percent, didn't budge in December and still remains well below the 63.3 percent pre-pandemic level.





The Labor Department reported that Covid did not keep more people out of the labor force last month than in previous months. Still, the surveys of businesses and households took place in the week of December 12, before the Omicron case count began its astonishing climb. The good news is that the latest wave is not causing as many restrictions on business activity as earlier ones, and symptoms are so far turning out to be much milder. The bad news is that it is spreading faster and is likely to produce as many restraints on the labor supply as earlier episodes. School closings are not as pervasive as before, but they are sporadic and leave millions of parents unable to commit to a job search due to childcare responsibilities. Even mild symptoms prevent workers from showing up on the job, derailing train and subway service and aggravating the labor

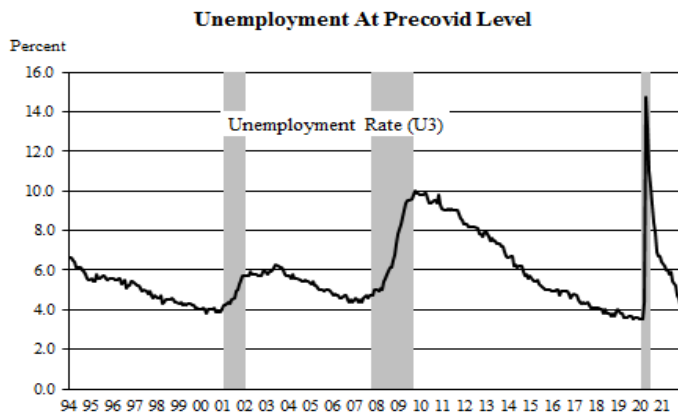
shortages in the hospitality sector, particularly at restaurants and bars.

These restraints will ease as case counts once again dwindle; indeed, many health professionals believe that Omicron will peak out faster than the Delta variant, if only because of its more rapid spread. Moreover, vaccination rates are climbing, and patients are recovering faster with milder symptoms, indicating that Omicron will be less disruptive to economic activity than earlier variants. But a significant restraint on the labor force may become more permanent even after the health crisis ends. Simply put, the population is aging, and so too is the labor force, with ever more workers moving into the early retirement stage of life. And whether it's the result of healthier balance sheets, thanks to a decade of burgeoning stock portfolios, or a rethinking of life/work balance following nearly two years of a life-threatening pandemic, more of that age cohort are leaving the labor force.

Since the onset of the pandemic in February 2020, 782 thousand workers age 55 or older have left the labor force, accounting for 34 percent of the overall workforce decline of 2.2 million. That's a significantly larger share than the 23 percent weight of this group in the labor force. No doubt, some of these older workers may decide to return under certain circumstances. Their nest eggs may run out, they may get bored, or they may be lured back to the job market by attractive pay packages. It's unlikely, however, that returning seniors would offset the aging process that is sending ever-larger waves into retirement.

In other words, the labor force may be closer to full employment than implied by the shortfall in payrolls relative to pre-pandemic levels. Not too long ago, analysts dismissed the low unemployment rate as overstating job market tightness because it didn't capture the large pool of workers on the sidelines that refused to join the labor force for a variety of reasons. That argument is less compelling now. Even as the payroll increase slowed dramatically in December, the unemployment rate fell to 3.9 percent, the lowest since February 2020. Earlier on, more importance would have been given to the weak payroll growth than the low unemployment rate. This time, the reverse might be true.

We suspect there is more room for the unemployment rate to fall, but companies will have to pay more to entice workers to the fold. During the year before the pandemic, when the unemployment rate fell below 4 percent, average hourly earnings increased at a 3 – 3.5 percent annual rate. Now they are increasing between 4 ½ and 5 percent, with December showing a 4.7 percent gain compared to a year ago. Significantly, low-wage workers are driving the acceleration, particularly in industries where labor shortages are most acute. Leisure and hospitality workers saw their average hourly earnings increase 14.1 percent from a year ago in December.



With health concerns likely to restrain labor supply for at least a few more months, upward wage pressures should persist and prompt employers to raise prices, keeping the inflation rate elevated and sustaining the Fed's increasingly hawkish stance. However, there are signs that bottlenecks are easing in the product markets, as reflected in reduced delivery waits for supplies among small businesses, and relief from the virus in coming months should release more labor supply, easing upward wage pressure. Hence, we expect inflation to peak out some time in the spring and allow the Fed to stay on a path of gradual tightening rather than forced into an abrupt growth-killing stance. While the first rate hike is still expected to take place in May, the odds of an earlier move in March have increased. However, if financial conditions tighten enough via a stock market correction or a sharp upward move in bond yields, that would mitigate the need for an earlier rate hike.

FINANCIAL INDICATORS				
INTEREST RATES	January 7	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.10%	0.06%	0.06%	0.08%
6-month Treasury bill	0.12	0.19	0.13	0.09
3-month LIBOR	0.23	0.21	0.20	0.22
2-year Treasury note	0.84	0.73	0.66	0.14
5-year Treasury note	1.50	1.26	1.25	0.49
10-year Treasury note	1.77	1.52	1.48	1.13
30-year Treasury bond	2.12	1.90	1.88	1.87
30-year fixed mortgage rate	3.23	3.11	3.10	2.65
15-year fixed mortgage rate	2.43	2.33	2.38	2.16
5/1-year adjustable rate	2.41	2.41	2.45	2.75
STOCK MARKET				
Dow Jones Industrial Index	36231.66	36338.30	35970.99	30814.26
S&P 500	4677.03	4766.18	4712.02	3768.25
NASDAQ	14935.90	15644.97	15630.60	13201.98
Commodities				
Gold (\$ per troy ounce)	1796.70	1828.60	1783.10	1862.9
Oil (\$ per barrel) - Crude Futures (WTI)	78.95	76.10	71.31	50.09
ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
ISM Manufacturing Index (December)	58.7	61.1	60.8	60.2
ISM Services Index (December)	62.0	69.1	66.7	64.3
Nonfarm Payrolls (December) - 000s	199	249	648	508
Unemployment Rate (December) - Percent	3.9	4.2	4.6	4.7
Average Hourly Earnings (Dec.) - % change	0.6	0.4	0.6	0.5

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