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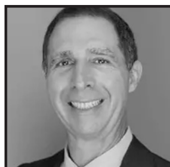
First Quarter 2022 Outlook

January, 2022



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Covid Variants Lower Forecast Confidence

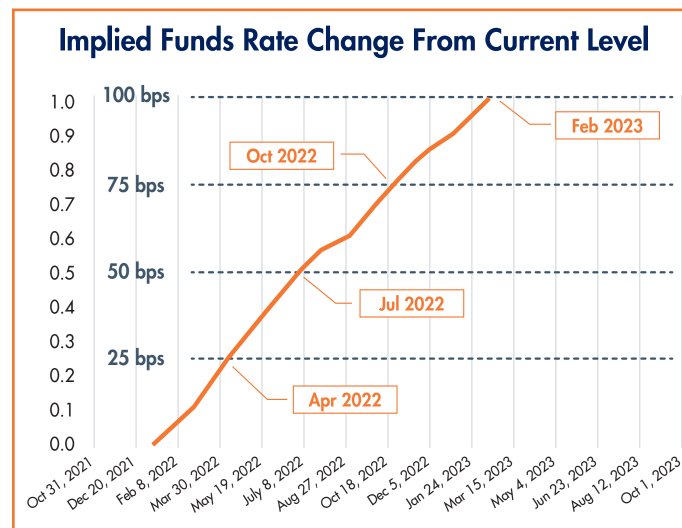
Greater Market Volatility

Americans entered 2021 with the hope that miracle of vaccines would lead to an "end" to Covid as a major concern. A year later, with Omicron spreading rapidly, albeit a milder variant, that hope remains unanswered. The economic outlook for 2022 and its future path depends, in part, on the likelihood of unpredictable breakouts of new Covid strains. Such uncertainties will predictably produce greater volatility in financial and commodity markets.

Fed Rate Liftoff, Real Rates Still Remain Negative

Only a Limited Restraint on Economic Growth

The Federal Reserve will likely accelerate both liftoff (increasing its funds rate), and tapering, ending incremental purchases to its balance sheet of government and agency mortgage debt. Investors currently expect four 25 bps funds rate increases over the next 12 months (see Figure 1). No doubt, interest costs on $29 trillion of federal government debt will ultimately limit how high the Fed can raise rates. Therefore, even if nominal funds increase by 1% over the next twelve months, at current levels of inflation, real rates (nominal rates less inflation) will still remain at historically negative levels. Those negative real rates will continue to offer incentives for businesses to borrow and earn attractive levels of returns – assuming the economic outlook remains positive. That being the case, negative real interest rates, likely across the interest rate curve, will not materially constrain corporate investments early in the rate hiking cycle.

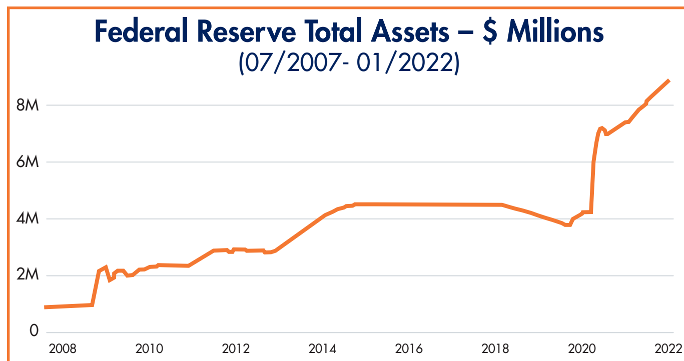


(FIGURE 1) Source: The Daily Shot

Greater Chance For Policy Errors

Since the beginning of 2020, the Fed more than doubled its balance sheet size from $4.2 trillion to $8.8 trillion (see Figure 2). By first not incrementally purchasing new treasury debt each month, and then later, reducing its treasury holdings, the Fed puts additional pressure on debt markets to absorb the issuance of new treasury debt leading to higher rates. The Fed's reversal of these two key monetary policies, nearly at the same time, greatly

increases chances for error, adding to the likelihood for greater financial market volatility.

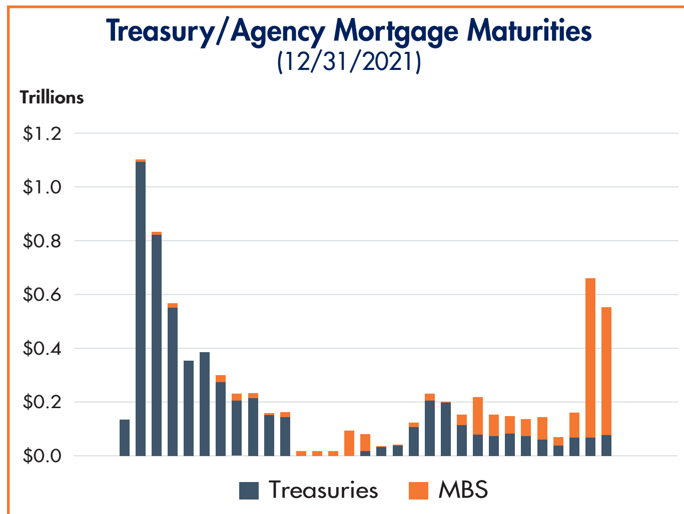


(FIGURE 2) Source: Board of Governors of the Federal Reserve System

Fed's Runoff will also Attempt to Steepen Yield Curve

Not Easy To Pull Off

With the shorter average maturity weightings of the Fed's treasury holdings, the runoff could prove faster than in 2018 (see Figure 3). The Fed's normalization policies will also attempt to steepen the yield curve by reducing its mix of longer dated treasuries – in part to avoid an inverted yield curve – short-term rates higher than long-term rates. Steepening the yield curve will work to the advantage of financial industry companies.

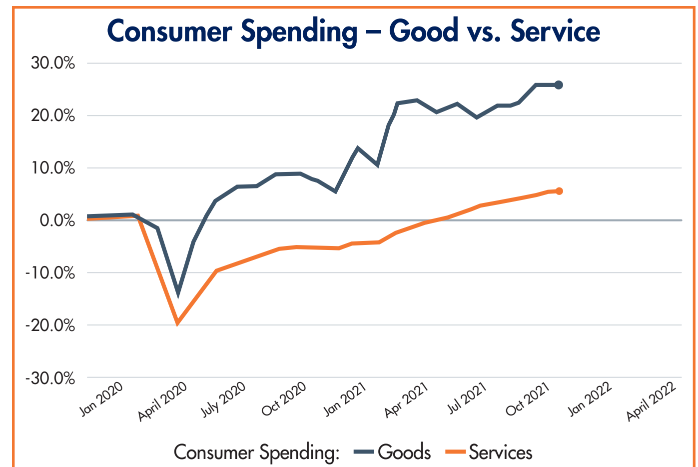


(FIGURE 3) Source: Schwab Economic Research, Bloomberg, Federal Reserve

Inflation Stew, Initially Demand Driven

Choke Supply Chains Piled on Inflationary Pressures

Congress passed three income replacement acts during 2020-21 sending out over $5 trillion in checks, 25% of GDP. At the same time, Covid lockdowns limited consumers spending to principally goods rather than services, and spend they did (see Figure 4). Exploding goods demand choked supply chains cooking the inflation stew the Fed now seeks to cool down.

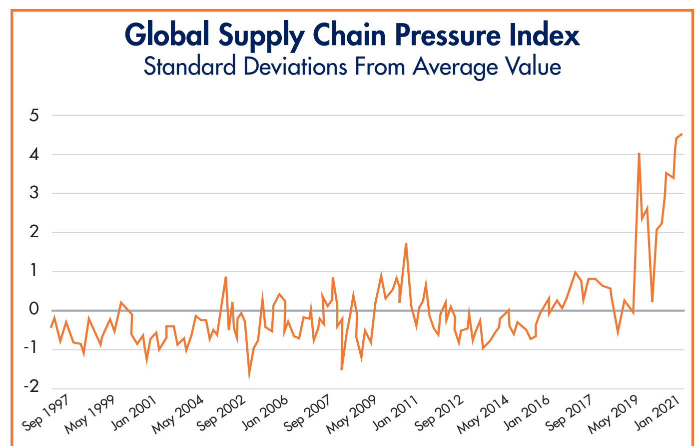


(FIGURE 4) Source: The Daily Shot

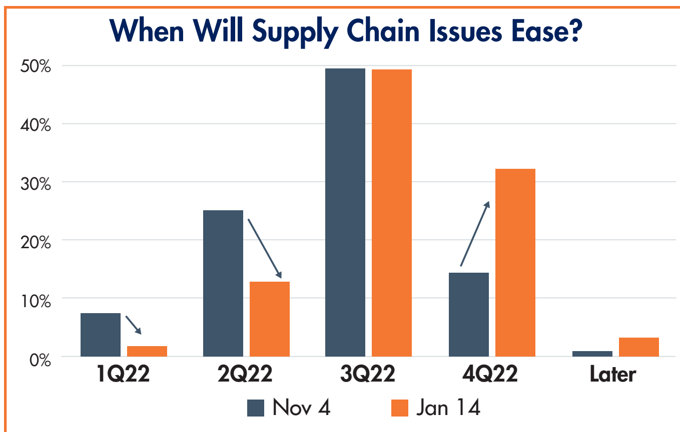
Inflation Could Moderate Around Mid-Year, Demand Pressures Weaken

Risk Higher Wage Costs

Optimistically, inflation may begin moderating around mid-year or shortly thereafter. This possibility reflects both absence of fiscal policy stimulus and "hoped for" supply chain loosening – now still backed up (see Figures 5 and 6). With the probability of supply chains loosening, inventories could rebuild from their current historic low inventory to sales ratios. Consensus economic forecasts call for inflation to moderate about mid-year or shortly thereafter – the risk to that forecast may come from wage pressures.



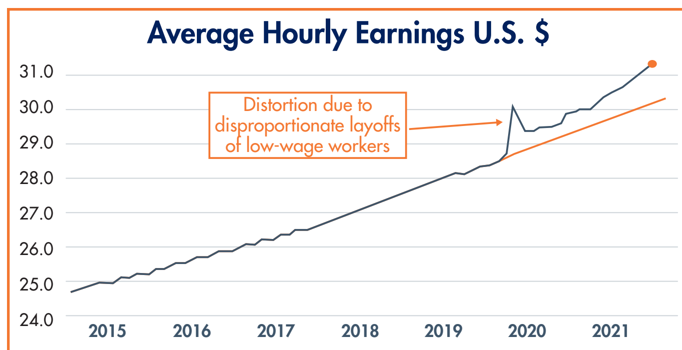
(FIGURE 5) Source: Federal Reserve Bank of New York



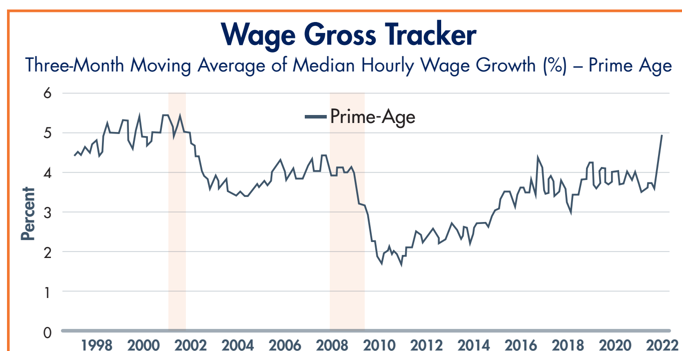
(FIGURE 6) Source: Evercore ISI Research, Daily SHot

Wage Pressures Key Risk to Moderating Inflation Forecasts

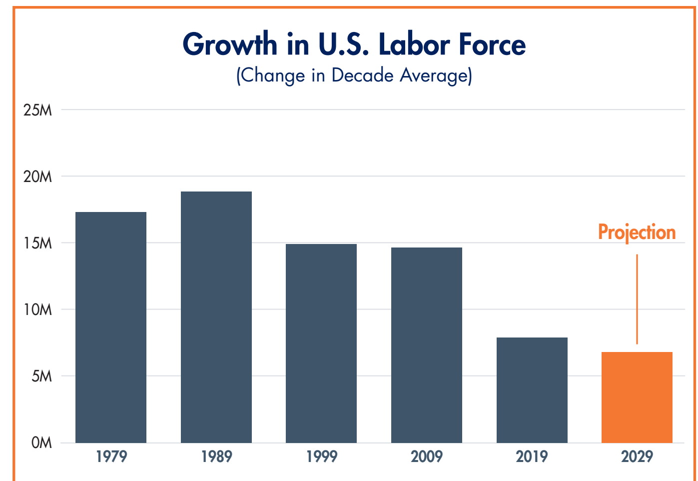
Whether tight labor markets result in longer-term wage pressures will likely determine if inflationary forces diminish longer-term. (see Figures 7 and 8). Demographic changes and increased retirements in this decade will result in the slowest labor force growth in over fifty years (see Figure 9). If this labor shortage produces wage pressures, higher service sector inflation may prove longer lasting than most economists currently expect. With that possibility, labor-intense companies, such as services, will likely prove less attractive investments.



(FIGURE 7) Source: The Daily Shot



(FIGURE 8) Source: Federal Reserve Bank of Atlanta, The Daily Shot



(FIGURE 9) Source: Bureau of Labor Statistics, Bloomberg

Labor Force Shortages Shift Focus to Greater Productivity Improvement Using New Tools and Systems

Adapting to the growing labor shortage will require businesses to make a greater substitution of capital for labor. The United States seems far behind in adopting automation to do just that. To illustrate, according to *Geopolitical Futures,* Germany operates 7.6 robots per 1,000 workers compared to 1.5 robots per 1,000 workers in this country. The pandemic brought and will bring about significant operating changes for businesses. The result should enable businesses to both offset slower labor force growth and improve productivity. Labor shortages will speed up applications of big data to reduce staffing and improve productivity.

Investment Conclusions

Equities

Despite slower first quarter growth, economists continue to look for U.S. GDP growth to reach 3-4% in 2022. This compares to an estimated 5-6% last year. With the Fed raising interest rates and the likelihood of additional Covid variants, this year's forecast may prove optimistic. At the same time, the cyclical recovery will likely continue into the first part of the liftoff cycle. Increasing wage pressures reduces investment attractiveness of labor intense companies particularly in selected service industry groups. At the same time, tight labor availability and the resulting higher labor costs will work to the advantage of capital goods suppliers. Substituting capital for labor will improve both the productivity and profitability particularly of service-oriented companies. Adding to the attractiveness of capital goods suppliers, recent global supply chain interruptions could see

greater investment in North American production facilities. Last year showed the strongest growth in capital investments since the 1940s – this should continue. Economic forecasts calling for slower GDP growth later in 2022 also fit in with the attractiveness of capital goods companies as late cycle stocks. With the Fed attempting to steepen the yield curve, financials should also prove attractive. Further on in the year, if liftoff continues and the economy begins to slow, defensive stocks will likely receive increased focus. Higher rates continue to create difficulties for the so called FAANG stocks – big cap American technology companies. For investors with longer-term horizons, their current difficulties should provide attractive investment opportunities. These companies certainly exhibit characteristics of quality companies – including strong balance sheets and consistent long-term above average growth.

Fixed Income and Alternatives

Whether inflation proves higher and lasts longer or not, interest rates will remain historically low for some time. With inflation materially higher than nominal interest rates, this combination results in negative real interest rates (inflation less nominal interest rates) for fixed income investors. Therefore, with both low nominal and negative real interest rates, fixed-income investments remain unattractive and should only be used to protect capital. For that portion of the portfolio historically committed to fixed income securities, investors should primarily focus on a diversified group of alternative investments.

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The S&P 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies by market value, the index is widely regarded as the best single gauge of large-cap U.S. equities.

The Russell 1000 Value Index measures the performance of those companies in the Russell 1000 Index with lower price-to-book ratios and lower forecasted growth values. The Index is calculated on a total return basis with dividends reinvested and is not assessed a management fee. It is not possible to invest directly in an index.

The Russell 2000 index is an index measuring the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

The Russell 2500 Index is a broad index, featuring 2,500 stocks that cover the small- and mid-cap market capitalizations. The Russell 2500 is a market cap-weighted index that includes the smallest 2,500 companies covered in the Russell 3000 universe of United States-based listed equities.

The MSCI World Index captures large and mid-cap representation across 23 Developed Markets (D.M.) countries. With 1,633 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index is an equity index which captures large and mid-cap representation across 21 Developed Markets countries around the world, excluding the U.S. and Canada. With 920 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (E.M.) countries. With 1,125 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. An index is a portfolio of specific securities, the performance of which is often used as a benchmark in judging the relative performance to certain asset classes. Indexes are unmanaged portfolios and investors cannot invest directly in an index. An index does not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown. Past performance is not a guarantee of future results.

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