ECONOMIC OUTLOOK

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unique investment insight

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The Federal Reserve Pivots To Combat Inflation

Although we are in the midst of Omicron, the latest Covid variant, the outlook for the global economy is cautiously optimistic with progress on vaccinations and ample government support. The world is exhausted after two years of fighting the pandemic, but the virus still drives the economy and policy responses. With the recent spread of the more contagious Omicron, some countries have restricted travel and activities. Supply constraints are an issue - China, home to a third of global manufacturing, still has a zero-Covid policy and has closed ports and cities at any sign of an outbreak. However, while Omicron may slow the economic rebound, it will likely not stop it. Despite the risks posed by Omicron, there is hope with treatments and vaccines providing protection from serious illness and death. Even with supply disruptions, the economy continues to expand with rising employment and wages, surging home values, and higher prices.

The debate now is whether or not the inflation increase is permanent or temporary. Strong demand, restricted supply, a tight labor market, and higher commodity prices have ignited inflation with December's consumer price index (CPI) at 7.0% and core inflation (excluding energy and food) at 5.5%. The Federal Reserve has contributed to inflation by stoking asset appreciation in areas such as real estate and equities with quantitative easing and 0% interest rates over the past decade, while the government has spent trillions to aid the economy during the pandemic. Global central banks, including the European Central Bank (ECB) and the Bank of Japan, are still purchasing sovereign debt and keeping rates low or negative. Some economists believe that the recent inflation spike is permanent and may spiral out of control if the Fed does not aggressively raise rates. In an effort to curb inflation, the Fed reversed course in December and decided to wind down additional purchases of Treasuries and mortgage securities by March 2022 and raise interest rates during the year.

The other side of the argument is the rise in inflation is likely temporary and tolerable in the short-term. Many economists believe the supply/demand squeeze is due to pandemic bottlenecks that will clear over time and that price increases will moderate. As production expands to meet demand and more people return to the work force, wage pressures will ease and supply constraints will wane. Normal consumption patterns will re-emerge as the pandemic fades – consumer spending will swing from goods to services as consumers start to spend more on entertainment, travel, and restaurant meals. The bond market also expects the inflation rate to moderate to the pre-pandemic trend of low growth and low inflation with long-term Treasury rates at about 2.2%, in-line with the Fed's long-term target. Although inflation is currently higher, the macro forces of aging demographics, debt, globalization, and technology for the past few decades are deflationary. The transitory inflation proponents feel that this type of bottleneck inflation will eventually re-balance as higher prices create an incentive to increase production and supply with opportunities for profit.

U.S. Economy

The U.S. economy is set to continue growing in 2022 though at a slower pace. U.S. third quarter 2021 GDP rose at a 2.3% rate and the latest Atlanta Fed projection for the fourth quarter is 5.0%. Although growth was positive in the 3rd and 4th quarters, the rates are below the first half of the year which averaged 6.5%. Similar to Delta, the Omicron variant is also likely to have a negative short-term impact on GDP in 2022. The Personal Consumption Expenditure (PCE) index excluding food and energy, rose 4.7% in November. This is the Fed's preferred benchmark for inflation and although lower than the 7.0% CPI rate, it is above the Fed's inflation target of 2.0%. Inflation will likely be above the benchmark for the next year. As we have seen in the past, there will be market volatility depending on the effect of the virus on consumer spending as well as the market's reaction to higher commodity prices, supply-chain congestion, and the Fed's rate tightening. The Federal Reserve's December forecast for GDP growth in 2022 was 4.0%, up from 3.8% in September.

Consumer and Manufacturing

Consumer spending fell 1.9% in December with the onset of Omicron and as holiday spending was pulled into earlier months due to consumer fear of limited supply of some goods. At the same time, the December Conference Board Consumer Confidence Index showed expectations for the future improved based on consumers' short-term outlook for income, business, and labor market conditions. The percentage of consumers planning to purchase homes, automobiles, major appliances, and vacations over the next six months all increased. Looking ahead to 2022, both confidence and consumer spending will continue to face headwinds from rising prices and the Omicron surge. The U.S. manufacturing sector remains supply constrained, but demand and sentiment are strong. The Manufacturing PMI registered 58.7% in December with indications of improvements in labor availability and supplier deliveries.

Employment

The domestic employment environment is in better shape than it was a year ago, though still far from full strength. The U.S. economy added 199,000 jobs in December and 249,000 in November, well below the 546,000 jobs created in October and the consensus forecast of 400,000 jobs. The unemployment rate dropped three-tenths of a percent to 3.9%. The number of unemployed persons fell to 6.3 million in December - still about 20% above pre-pandemic levels. Average hourly earnings rose 4.7% from the prior year. Job gains occurred in professional and business services, transportation and warehousing, construction, and manufacturing. In the coming months, employment growth may also be suppressed by Omicron. Data suggests a dearth of workers and high turnover, not a lack of demand, is part of the reason hiring has slowed.

Real Estate

House prices in the U.S. have been inflated by historically low interest rates, limited supply, and increased consumer savings. The U.S. housing market has contributed to the economic recovery though some of the statistics have fallen from recent highs. Home sales are booming - homes sat on the market over the summer for an average of about a week vs. three weeks a year earlier. Construction for single family homes rose 11.8% in November to a seasonally adjusted 1.68 million homes. Demand is especially strong for entry-level existing homes in smaller interior markets with limited inventory. Although house price growth is slowing, support for housing remains strong with low unemployment and rising wages. Millennials are reaching peak age as first-time homebuyers and inventory remained tight in the last quarter of 2021.

World Economy

Europe

After a strong rebound in 2021 with GDP growth estimated at 5.0%, economic activity in the euro area is projected to expand by 4.3% in 2022 according to the Organization for Economic Co-operation and Development (OECD). Growth is supported by strong consumption and government support. Monetary policy is set to remain largely accommodative with the ECB still "very unlikely" to raise interest rates in 2022. Unemployment is projected to decline to close to pre-crisis levels. Similar to the U.S., supply chain bottlenecks and the rebound in energy prices are pushing up inflation. Consumer prices in December were about 5% higher than a year earlier. Even though energy prices rose at a slower pace, food prices rose 4.6% in December from 1.9% in November. Assuming the absence of sustained wage pressures, analysts expect eurozone inflation to moderate by the end of 2022.

Britain's economic outlook is cloudy due to high infection rates from Omicron and renewed government restrictions. Even though GDP is projected to fall in the first part of 2022, the economy is recovering with vaccines and government support. Output is projected to rise by 6.9% in 2021, with growth moderating to 4.7% in 2022. Unemployment is currently 4.2% and continues to decline. Inflation continues to increase due to higher energy and commodity prices and continuing supply shortages. Since inflation pressures are mounting due to rising energy prices and labor shortages, the Bank of England is projected to tighten policy.

Japan

Japan's government approved a nearly $500 billion economic package in November to support recovery from the pandemic including payments to most families and some smaller companies. Japan's new Prime Minister Fumio Kishida is trying to jump start the economy after GDP fell -3.5% in the 3rd quarter, the second contraction in three quarters. Significant progress in vaccination and falling rates of infection are now supporting the resumption of stronger consumption growth as supply chain disruptions are resolved. As a result, the economy is projected to grow by 1.8% in 2021 and 3.4% in 2022.

China

Chinese growth reached 8.1% in 2021, but may slow to about 5% in 2022 according to the OECD. The swift recovery, driven by strong exports as overseas' economies re-opened, stalled in the second half of 2021. A large real estate company (Evergrande) defaulted on debt payments which has shaken confidence and weakened real estate investment, an important engine of growth. Consumption growth is stable, but the pandemic will likely be a near-term headwind to Chinese demand. Initial findings suggest that two doses of the Sinovac vaccine are inadequate in protecting against Omicron. Given China's zero-tolerance policy, new restrictions are likely to be enacted to limit the virus's spread. In December, the OECD projected 2021 global GDP growth of 5.6% and 4.5% in 2022.

Commodities

Oil marched higher during 2021 with Brent crude prices climbing more than 50% to $78 a barrel. Demand lifted prices as the global economy recovered while OPEC and Russia kept supply in balance. Drivers are feeling the pinch with prices rising from $2.25 a gallon late in 2020 to about $3.29 at year-end according to AAA. Demand continues to snap back to pre-pandemic levels and analysts predict Omicron will only briefly slow demand. Gold fell 3.5% in 2021, dragged down by expectations that the Fed will raise rates. Precious metals still offer protection against swings in stocks and a safe haven in times of geo-political stress.

Investment Perspective

Despite the pandemic and issues ranging from inflation to climate change, the markets continued their upward trajectory in 2021. With stock market returns above average recently, we must be careful not to extrapolate the past few years too far into the future. Given that the markets rose quickly on the back of Federal Reserve stimulus, trillions in government pandemic aid, and vaccines, investors should have realistic expectations going forward. Many investment firms and analysts forecast equity returns of 2% to 4% over the next ten years based on the current high market valuations. In the short-term, equities are facing a number of headwinds including Omicron, rising inflation and wages, labor shortages, supply chain constraints, and slowing U.S. growth. Higher profits will help valuations, but longer-term, earnings tend to grow with the overall economy. The Federal Reserve is also set to taper purchases of Treasuries and mortgages by March and then raise interest rates in an effort to stem inflation.

Even with all the challenges, there are several bright spots in the economy. Interest rates remain historically low even as the Fed moves to raise rates. Housing sales are strong with the help of low mortgage rates and a firm job market. Corporate profits for 2021 were robust even with higher employee wages and costs. Earnings for the S&P 500 for the 4Q2021 are projected to grow more than 20% for the fourth straight quarter and analysts forecast growth of 8% to 10% in 2022. GDP is expected to continue growing albeit at a slower pace. According to the Conference Board, consumer confidence remains high as consumers expect the economic expansion to continue despite the headwinds of higher prices and the pandemic winter surge. Lastly, investors feel that the Federal Reserve will not raise rates too much for fear of a market downturn. As we experienced in late 2018, the Fed raised rates to 2.25% then reversed course when stock and commodity markets wobbled.

So where do we go from here? Cash and short-term interest rates remain near 0% and have negative real (after inflation) yields. Even the 10-year Treasury at a 1.7% rate generates a current negative real yield after inflation. Although cash and bonds have little in the way of income, they still offer stability and help act as a buffer during drops in the stock market. Despite elevated valuations, the pandemic, and volatility, equity markets still have the monetary policy support of global central banks plus the additional trillions in government spending for pandemic aid. For sectors, we favor materials, industrials, energy, technology, and healthcare. We look for companies that have the ability to raise prices or cut costs to offset inflation. Dividends remain an important component of total return. Precious metals offer a store of value during times of instability and money printing. In a volatile global environment, we remain focused on our long-term objective of finding well-run, high-quality companies with strong financials at reasonable valuations in areas that offer growth. In times of rising inflation, investors need to be aware of preserving purchasing power and the eroding effect of inflation. At the moment, the Fed and global central banks are in a bit of a bind - they can aid businesses and consumers with lower interest rates, but they cannot solve supply shortages or a public health crisis. In a positive sign, unless new, more dangerous variants emerge, the pandemic should progressively become less of a factor in global economic outcomes. We remain patient, thankful, and vigilant.

December 31, 2021
DJIA: 36,338.30
S&P 500: 4,766.18

About Bounty Management

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If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.

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