Weekly Market Insights

December 7, 2021

Markets are volatile. Transitions are difficult!

Financial Markets

This past week, equity markets were exceptionally volatile. There were a number of reasons for this. The first is well known—the resurgence of COVID-19 with the Omicron variant. At this point, we have no definitive knowledge about the seriousness, so we must wait and see.

The Dow fell 0.91% for the week, the S&P 500 fell 1.22%, and the NASDAQ fell 2.62%. Those numbers, though relatively large, don't adequately describe this past week's volatility. As you will read in Ryan's discussion about economic indicators, there is some confusion in finding a coherent theme in this past month's reports. It's likely that there are other powerful factors at work. Three interesting issues that appear to be overhangs for investors are the speed and power of the shift from monetary to fiscal stimulus, elevated inflation and its duration, and the impact short-term traders may have on market volatility.

Economic Indicators

November's economic indicators were encouraging, although recent developments with the Omicron variant have introduced uncertainty for the months ahead. While not uniformly positive, labor market releases were promising and consumer demand has proved resilient in the face of rising prices. The fear is that a significant increase in infections could derail recent economic progress and increase inflation pressures.

Inflation measures remain elevated relative to historical norms and above the Fed's 2% target. The headline Consumer Price Index was reported at a 6.2% year-over-year pace while the PCE Index came in at 5%. More volatile components, such as energy, used cars, and food, are still significant contributors to record headline numbers; however, some of the core inflation components like shelter have recovered to pre-pandemic levels and have started to turn higher. This is reflected in higher overall core inflation numbers, with the core PCE rising 4.1% from the prior year. Furthermore, labor supply shortages have led to firms offering higher wages, further increasing inflationary pressures. However, higher wages only become problematic when unit labor costs exceed labor productivity. Since the onset of the pandemic, productivity gains have generally outpaced unit labor costs, but this reversed in the most recent quarter. While a single report does not necessarily dictate the future trend, this relationship bears watching in the months ahead. Easing supply chain constraints should help to decrease cost pressures going forward with Federal Reserve forecasters seeing inflation starting to abate towards the second half of next year. The Omicron variant has further clouded the inflation picture, however, presenting both upside and downside risks. As the world learns more about the new variant, the inflation issue should become clearer.

November saw positive developments on the employment front. October's payroll gain was strong with 546,000 additions and, while November's report disappointed to the downside, there were significant upward revisions to prior months. Additionally, the unemployment rate fell substantially to 4.2% from 4.5%, and weekly unemployment claims declined to the lowest level since 1969. The most encouraging news came with a reported increase in participation rate to 61.6%. While still 1.5 percentage points below pre-pandemic levels, the participation rate has been at a standstill since partially recovering from the April 2020 bottom of 60.2%. Insufficient labor supply has been an

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often-cited headwind for businesses across the country and a contributor to inflation worries, so if participation continues to improve it will be a major positive for the economy as a whole. While employment still has not returned to pre-pandemic levels, research from the St. Louis Fed suggests the labor market may be tighter than it appears due to substantial early retirements. Furthermore, if higher inflation persists, a decline in real wages may encourage more people to seek employment. At this point, the labor market has taken major strides in its recovery, and we look to be closer to full employment than previously thought. It is important to remember that these releases capture periods before the Omicron variant had been discovered, and, as alluded to earlier, there could be potential downside risks should a surge in infections result in layoffs and reduce peoples' willingness to work.

The Conference Board Consumer Confidence and Michigan Consumer Sentiment indices have remained at depressed levels following steep declines this past summer in response to concerns over inflation and the Delta variant. Despite seemingly low levels of consumer confidence, consumption indicators have continued to rise. Retail sales increased 1.7% from the prior month and personal consumption expenditures increased 1.3%. While we would like to see confidence measures rise, there is a clear divergence between what consumers are feeling and what they are actually doing.

Economic indicators were strong this past month, and real time GDP estimates from the Atlanta Fed suggest a 4th quarter bounce. Despite non-linear improvement, the labor market looks to be healing and rising inflation has not yet deterred U.S. consumers from spending. However, the new COVID variant introduces a heightened level of uncertainty and could negatively impact economic progress in the months ahead.

Economics

Other than the Omicron variant, investors' primary fear is the Federal Reserve potentially withdrawing monetary stimulus too quickly in an effort to avoid hyperinflation. That concern may well be overblown. There are a number of reasons we feel this way. We remain in the camp that today's inflation is transitory and will abate in 2022. In this case, inflation is heavily influenced by the much written about supply chain problems. Although very troublesome, these are temporary and are expected to eventually be resolved. The fascinating part of the inflation scare is that it is coming from two different philosophies. First is the pure monetarist angle that argues that "inflation is always and everywhere a monetary phenomenon."[1] The second argues that excessive government spending creates its own demand leading to inflation. Neither appears to be the case. In our view, the monetarist argument fails. Friedman agreed that there must be some excess demand to spur inflation. Demand will be strong, but as supply chains rehabilitate the increased supply will begin to hold down prices. The other argument that government spending will create excess demand fails because government spending stimulates the economy by creating more efficient infrastructure. The failure of both arguments leads us to believe the current level of inflation will likely not be sustained.

Another fear is that by taking its foot off the monetary accelerator, the Fed may cause an economic slowdown. We feel this is unlikely, and the reason is clear—a substitution factor. As we allude to in the title, there will be a transition from monetary to fiscal stimulus which will further encourage demand.

All of this happening at the same time is very unusual, perhaps even unique. It is no secret that investors fear uncertainty. These are clearly uncertain times, making investors nervous. This positive case is dependent on a relatively smooth transition. All of you who have followed economics know this is not guaranteed. We feel the odds are for a reasonable transition, but we will be following these events very closely.

[1] Milton Friedman and Anna Schwartz

Conclusion

There will almost certainly be a lot of volatility and exciting headlines throughout the remainder of the year and into 2022. We remain positive on the U.S. economy. Even so, there will undoubtedly be bumps in the road. This is not the time for investors to panic.

"If you can keep your wits about you while all others are losing theirs, and blaming you… The world will be yours and everything in it, what's more, you'll be a man, my son."[2]

[2]Rudyard Kipling

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