

Weekly Market Insights

January 3, 2022

An Astonishing Year

Financial Markets

New strains of COVID spreads across the globe, political mayhem takes place, inflation hits new heights, global supply chains struggle, shortages are everywhere, and yet equity markets hit record highs! It has truly been a remarkable year for both the economy and global financial markets. Scholars argue markets are rational. We think this is correct but the argument is they are rational in the long-run. The big contradictions to this remarkable market performance were the Chinese markets, with Hong Kong's Hang Seng index down more than 14% and mainland China's CSI 300 index down more than 5%. Of course, there are very unique political problems that continue to threaten China's economy and markets. More about China in the economic section.

The broad based S&P 500 was led by the energy sector, which remarkably gained nearly 50% along with a more than 40% rise from the real estate sector. Technology, although not the leader this year, was a considerable contributor to market gains. As we wrote in the beginning, these remarkable gains were not restricted to the U.S. Markets were also quite impressive across the Atlantic.

The most interesting, if not the most germane, question is what may follow such a confusing year? No one knows the answer, but we will use the economics section to point out some potential positives and negatives we see for 2022.

International

This year promises to be very interesting with the issues being both multifaceted and global.

Internationally, investors must follow what is occurring in the Ukraine as Russia continues to threaten invasion. We don't have a strong opinion, but, as many texts on security suggest, a falling power is more dangerous than a powerful one.

We put China and Taiwan in a similar category. Although China is indeed a strong and powerful country, we don't see the sense in China moving against Taiwan. Interestingly, China comes up in many ways principally in trade.

Domestically, many political decisions must be made. Coming to any conclusion will be difficult. Ideological differences are wide and unfortunately the United States is headed into mid-term elections this year. Investors should be prepared for some epic battles.

Very important trade issues must be addressed. To this point, there is no clear direction. A lot is being done by Asian countries where China is making strides. The U.S. appears to be viewing from afar. This, we believe, is an error. The United States should be intimately involved in all trade negotiations.

Domestic investment presents a great opportunity. The U.S. has an opportunity to rebuild supply chains, modernize our educational system, and develop a skilled work force. Using technology and creative innovation can make an already hugely productive country much more so. It won't be easy, but it can be done. The most important factor is somehow making our currently divisive political environment more focused and cooperative. This also presumes U.S. companies will look to the

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future for investment opportunities. In the long-run, it should be well worth it for both investors and management teams.

This does not suggest abandoning trade! It merely reiterates Adam Smith and David Ricardo's free trade argument—each country does what it does best and trades those products.

December Economic Update

December's economic indicators were largely positive; however, the Omicron variant remains a significant source of uncertainty for the months ahead. Due to the backward looking nature and lag time associated with economic indicators, potential impacts from the Omicron-fueled resurgence in COVID infections had yet to materialize in this past month's economic releases. While renewed lockdowns do not appear to be in the cards in the U.S., the global surge in infections could exacerbate existing supply chain disruptions, damage consumer confidence, and complicate the labor market recovery.

Inflation pressures persisted in December with the Consumer Price Index increasing 0.8% from the prior month and 6.8% year-over-year. The monthly rise was the result of broad increases in both reopening and core components with gasoline, shelter, food, used cars, and airfares amongst the largest contributors.¹ As we have mentioned in prior reports, inflationary pressures over the past year have been fueled by supply chain constraints, stimulus-fueled demand, labor shortages, and rising wages. As elevated inflation readings persist, inflation expectations become more important to the larger inflation issue. Untethered inflation expectations could lead to a demand for higher wages, resulting in firms raising prices to offset increased input costs, causing workers to expect even higher wages, and so on—a phenomenon known as the wage price spiral. At the moment, inflation expectations do not appear to be

at extreme levels. However, unlike traditional inflation gauges, expectations are very difficult to measure. One measure of inflation expectations from the University of Michigan indicated consumers' one-year outlook for a 4.9% rise in inflation and a 3% annual increase over the next five years. Long-term expectations are generally thought to be a better predictor of consumer behavior, and the five year outlook is not much higher than the average of 2.8% from 2000-2019. The break-even rate measured by the difference between the yield on Treasuries and inflation-indexed bonds (TIPS) is another measure of inflation expectations and point to a similar message. The five-year rate went as high as 3.17% in mid-November, but the ten-year rate rose to just 2.35%, signaling that investors expect a return to pre-pandemic inflation levels over the long-term.² While renewed COVID concerns may intensify supply chain and labor supply issues over the short-term, we ultimately expect these issues to improve and inflationary pressures to diminish over the course of 2022.

The employment situation continues to improve. While November's payrolls disappointed to the downside with 210,000 additions, there were significant upward revisions to prior months and the unemployment rate fell to 4.2%. Furthermore, unemployment claims remain low with both initial and continuing claims now back to pre-pandemic levels. The labor market recovery is even more impressive when looking at improvements over the course of 2021 as a whole. Employers added a record number of jobs this year (6.1 million through November), job openings have surged to over 11 million, and layoffs have fallen to a half-century low.³ The recovery in labor market participation is still underway however, and recent indications from Federal Reserve Chairman Powell are that a full recovery may not happen for some time. Again, the Omicron variant has introduced significant uncertainty to the economy and employment progress may slow over the short-term. Increased infections could renew hesitancy for in-person work, curb hiring, and potentially encourage layoffs. We will

¹ *Consumer Price Index Summary*. (2021, December 10). U.S. Bureau of Labor Statistics. <https://www.bls.gov/news.release/cpi.nr0.htm>

² Timiraos, Nick, Gwynn Guilford. (2021, December 12). *How Do You Feel About Inflation? The Answer Will Help Determine Its Longevity*. Wall Street Journal. https://www.wsj.com/articles/inflation-expectations-federal-reserve-interest-rates-11639352911?mod=latest_headlines

³ Guilford, G., & Mena, B. (2021, December 30). *Strong Labor Market in 2021 Faces Down Omicron Threat*. WSJ. https://www.wsj.com/articles/weekly-jobless-claims-12-30-2021-11640826932?mod=hp_lead_pos1

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watch jobless claims for signs of trouble as the weekly cadence provides for a good early indicator of hiring and trends for the broader economy.

The Conference Board Consumer Confidence and Michigan Consumer Sentiment indices both improved in December but highlighted consumers' concerns over purchasing power in the months ahead. As we pointed out last month, there appears to be a divergence between what consumers are feeling and what they are actually doing. This trend has continued and consumers' spending is increasing even as inflation worries mount. A recent *Financial Times* article reported consumer spending on debit and credit cards at Bank of America increased 20% compared to last year and 28% when compared to the same period in 2019. This compares to average annual growth rates closer to 10% in 2018 and 2019 and far exceeds any contribution from inflation.⁴ Furthermore, while the monthly rise in retail sales came in below consensus expectations, current spending levels are 18.2% higher than November 2020. U.S. consumers have been bolstered by accumulated savings, elevated job openings, rising wages, and appreciated asset levels. Emotional responses to renewed COVID concerns and inflation fears could be

temporarily distorting the survey-based confidence measures, and we will continue to put more weight on what consumers are doing rather than what they are feeling.

Economic indicators were strong this past month, and real time GDP estimates from the Atlanta Fed are pointing to 7.6% annualized 4th quarter growth.⁵ Impacts from the Omicron variant may disrupt economic progress in the short-term, but we remain confident in the longer-term outlook.

Conclusion

Having gone through a litany of possible issues in 2022, we remain positive on equities. We believe inflation is mostly transitory with some important persistent pressures, and the western world's central banks will respond well to the challenges.

Best Wishes for a very healthy and successful 2022!

⁴ *Americans put aside their economic fears to spend again.* (2021, December 11). Financial Times. https://www.ft.com/content/248ef7db-7362-46dd-a50d-260d4e0a1130?accessToken=zwAAAX4RErYQkc8kjvfb2JG3dOIDSYNTgoRMA.MEYCIQDNc4X7yTQlvpUsilttWcaajYleOIAUm7dxHt_1HRVzVQIhAOXuCq0tb4Y-xJMSr37fsxMHII4vDyZQT5lthKWik8tS&sharetype=gift?token=d27e71e4-21c3-45d7-8b3d-f15139fec5b7

⁵ *GDPNow.* (2021, December 23). Federal Reserve Bank of Atlanta. <https://www.atlantafed.org/cqer/research/gdpnow>

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