2021 Q4 Economic Recap and Rate Outlook

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The fourth quarter began amid a fast-retreating Delta variant case count and ended in the midst of sky-rocketing cases of *Omicron*, a highly contagious variant that didn't appear in the U.S. until December 1st. Just four weeks later it represented 60% of all new coronavirus cases, and by year end the daily case count had exceeded the previous peak from last January. In response, the Biden administration announced an additional 10,000 testing sites, 500 million at-home tests made available in January and the deployment of military medical personnel to assist overburdened doctors and nurses.

Fortunately, 73% of Americans *over the age of 18* were fully-vaccinated by year-end and 36% had received a booster dose according to CDC data. Although breakthrough cases have spiked, the new strain seems to be significantly less severe, which buffered the negative economic impact and allowed the U.S. economy to accelerate in the final quarter of a wildly uneven year.

Before the December virus surge, the story of the quarter was the continued rise in inflationary pressure. Elevated prices during the summer months were expected to be *transitory*, and Fed officials were prepared to allow inflation to run above the historical +2.0% target "for some time" while the economy healed. Supply chain disruptions destroyed that plan, and early holiday spending drove up demand. The result was the highest year-over-year inflation readings in nearly four decades. Headline CPI was rising at an alarming +6.8% annual pace in November, the highest since 1982, while headline PCE showed a +5.7% increase from a year ago, the biggest annual gain since 1983.

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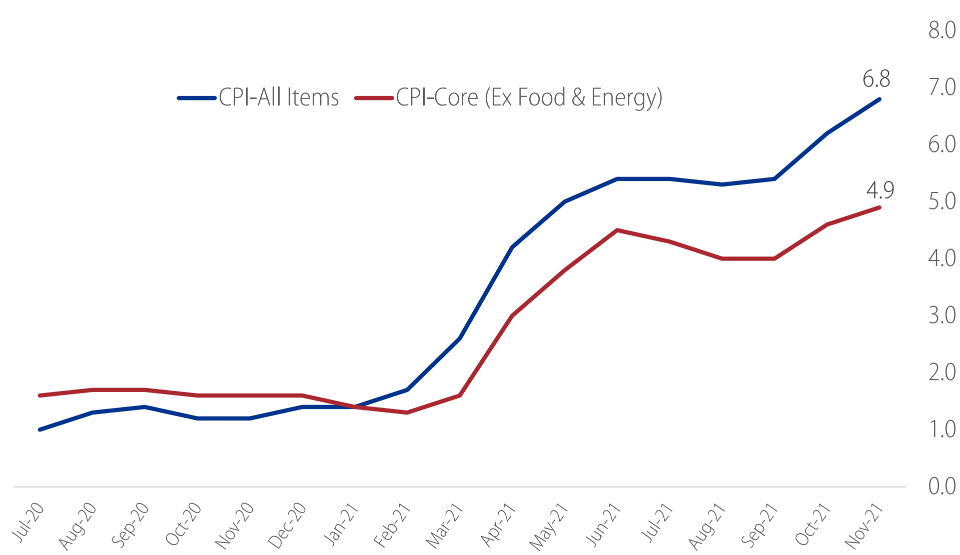
Consumer Price Index (Year-over-Year Percent Change)



Source: Bureau of Labor Statistics.

The Fed's focus during much of the pandemic had been a return to full employment. There was little question that employers *wanted to hire workers* as job openings climbed back above 11 million in October. However, nonfarm payroll gains averaged just +378k from September through November, leaving total payrolls four million short of the pre-pandemic count. In October, the number of job openings exceeded the number of unemployed Americans by the most on record. The unemployment rate dropped to a pandemic low of 4.2% in November, although market surveys, job postings and seemingly millions of help-wanted signs suggest an even tighter labor market.

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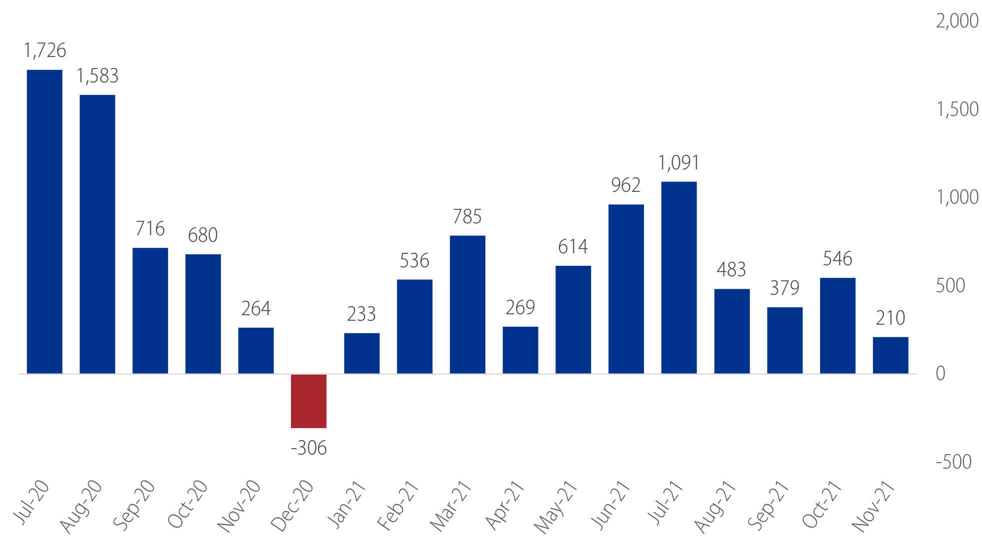
Total Nonfarm Payrolls (in thousands)



Source: Bureau of Labor Statistics.

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The running list of reasons for why labor market participation is hovering near a 40-year low includes various combinations of COVID concerns, early retirement, burnout, and childcare issues. A recent survey by the National Federation of Independent Business showed 49% of small companies were unable to fill their open positions. Further compounding the problem for all employers is a record number of people leaving their jobs. The "quits rate" climbed to 4.4 million in September, the highest level seen in 21 years of recordkeeping.

Obviously, employers are being forced to pay more to attract and retain workers and this practice is expected to continue. The Conference Board Salary Increase Survey for November indicated 2022 salary increases will be the highest since 2008. To remain competitive and combat a 150% annual turnover rate in the industry, national fast food restaurants are accelerating their automation plans. McDonald's announced it would be adding additional self-order kiosks to 1,000 locations each quarter in 2022 and announced a partnership with IBM in December to automate drive-through ordering across the nation. Hyundai Robotics is pairing with KFC to develop chicken-cooking robots, while Grubhub plans to use food-delivery robots at college campuses. Domino's began testing its self-driving pizza delivery vehicles last spring.

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The bond market lost patience with the Fed's employment fixation early in the quarter and short yields moved sharply higher. Fed Chairman Powell announced the start of the much-anticipated taper at the November FOMC meeting and indicated new QE asset purchases would end within six months. Six weeks later, Fed officials, having digested much of the too-hot November inflation data and concluding that labor market conditions were *strong enough*, announced a doubling of the taper pace, opening the door for rate hikes as soon as March. FOMC members also made a hawkish adjustment to the "dot plot," which now shows three rate hikes for 2022, another three for 2023, and two more in 2025. Whether this actually comes to pass will depend on inflation expectations and the future path of the unpredictable coronavirus. For the time being, Fed officials have clawed back a degree of credibility by abandoning the worn-out "transitory" phrase and acknowledging immediate inflation concerns.

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By the end of December, the bond market had priced-in three 25 basis point increases in the overnight funds rate, essentially matching the dot plot.

Q4 Interest Rates

		Fed Funds	3 mo. T-bill	12 mo. T-bill	2 yr. T-note	5 yr. T-note	10 yr. T-note
Last	9/30/21	0.00%-0.25%	0.03%	0.07%	0.28%	0.97%	1.49%
High			0.06%	0.38%	0.75%	1.34%	1.70%
Low			0.02%	0.07%	0.26%	0.93%	1.34%
End	12/31/21	0.00%-0.25%	0.03%	0.38%	0.73%	1.26%	1.51%

Source: U.S. Department of the Treasury.

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While the Fed began the taper process and signaled that tightening was around the corner, Democrats passed Biden's $1.2 trillion infrastructure package and began debating the trimmed-down $1.75 trillion "Build Back Better" social infrastructure spending plan. Many lawmakers, including West Virginia Senator Joe Manchin, believed the plan, in its current form, would increase both consumer prices and the national debt. By year end, the bill was essentially dead.

Unless the BBB plan is rewritten to Manchin's liking, the expanded child tax credit that provided an average of $444 per month to 36 million families will have ended in mid-December. In the absence of additional stimulus payments and a fast-dwindling savings rate, millions of Americans may be forced back into the labor market in the coming months. With BBB on ice, hope for any student loan forgiveness is also on hold. In the meantime, the administration extended the pause on student loan payments until May 1st, which doesn't make a whole lot of sense considering degreed workers currently make about 75% more than non-degreed workers, and the unemployment rate for college graduates was just 2.4% in November. Future relief for student debt burdens may have to take a different form to gain further traction.

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The quarter ended on a few positive notes. The equity market continued to climb with the S&P 500 logging its 70th record close in 2021; Mastercard's SpendingPulse report indicating the biggest annual increase in holiday spending in 17 years; and Senate Democrats passing a $2.5 trillion increase in the debt ceiling, which should push the next political sideshow out beyond the 2022 election.

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Economic and Interest Rate Outlook

The economic outlook, despite the recent virus surge, is bright. Much of this optimism is based on the idea that the effects of the latest variant seem quite mild and are unlikely to result in any widespread business closures. The case count may be soaring, but the number of hospitalizations and deaths, at this point, is far below the peak from last January. However, that doesn't mean businesses weren't impacted. More than 10,000 flights were canceled in and out of the U.S. in the week between Christmas and New Year's Eve due primarily to airline COVID related staffing issues.

While the latest COVID wave moves toward a likely crest over the next couple weeks, considerable progress continues to be made on the therapeutics stage. Before Christmas, the Food and Drug Administration approved both Pfizer and Merck antiviral pills for limited emergency use to treat mild to moderate COVID-19. Pfizer's Paxlovid has shown 90% efficacy in preventing hospitalizations and deaths in high-risk patients. Eric Topol, director of the Scripps Research Translational Institute, in an editorial for the Guardian, said Paxlovid has the potential to change the face of the pandemic and urged bold measures to rapidly scale up production.

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The job market stands to benefit tremendously as COVID is better contained and Americans feel more comfortable returning to their normal lives. As mentioned earlier, the lack of government stimulus payments, for better or worse, is likely to result in an increased number of workers returning to the labor force.

In theory, more workers would translate to greater production, and greater production means replenished supply. There's still an enormous amount of pent-up consumer demand. Besides the obvious need for automobiles, houses and gaming consoles, consumers are anxious to spend some of the nation's record household wealth on dining, travel, and leisure-time activities. It may take a while, but business will always find a way to meet ongoing demand.

Overall inflationary pressure is likely nearing its peak, although housing costs, which make a significant contribution to CPI, are expected to move higher in 2022 before retreating. Demand typically fades in the first quarter, giving businesses the opportunity to restock. Signs that the goods bottleneck is finally clearing is a huge plus for supply. The Ports of Los Angeles and Long Beach indicated that the number of containers lingering on marine terminals has been cut in half since October 25th when the ports announced a daily fee would be imposed on cargo sitting on the dock for 10 days or more. So far, the mere threat of a late fee has done the trick as the implementation date itself has been delayed through January.

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If Fed officials are true to their word, new QE asset purchases will almost certainly wrap up in March. Best guess is that liftoff for rate tightening will be announced at the May FOMC meeting and the first hike will take place in mid-June. Central banks in England, Canada and Australia have also indicated multiple rate increases for next year.

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The December Bloomberg survey of 70 U.S. economists shows GDP slowing from a median quarterly annualized rate of +6.6% in the fourth quarter of 2021 to +3.4% a year later, and the annualized CPI rate cooling from +6.6% to +2.8% over the same 12-month period. The survey also shows a median unemployment rate of 3.6% at the end of 2022, just above the December FOMC forecast of 3.5%.

There are a number of major wildcards in play for next year. Democrats will redraft and attempt to pass a revised version of Biden's Build Back Better, and the mid-term elections could bring a shift in power as narrow Democratic leads in both the House and Senate are vulnerable. And, flying mostly under the radar are several open Federal Reserve Board seats waiting to be filled in early 2022. A more dovish composition of voting members could shift the FOMC's balance and reduce the number of rate hikes in 2022.

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If the last two years have taught us anything, it's that forecasts mean very little. The Fed will begin raising rates in 2022, but the expected series of hikes as outlined in the dot plot and forecasted by the nation's economists will be dependent on how the new year unfolds. At this point, there's reason and appetite for optimism.