AndCo's Monthly Market Update

December 2021

THE ECONOMY

" It's a very slow process – two steps forward, one step back – but I'm inching in the right direction" – Rob Reiner

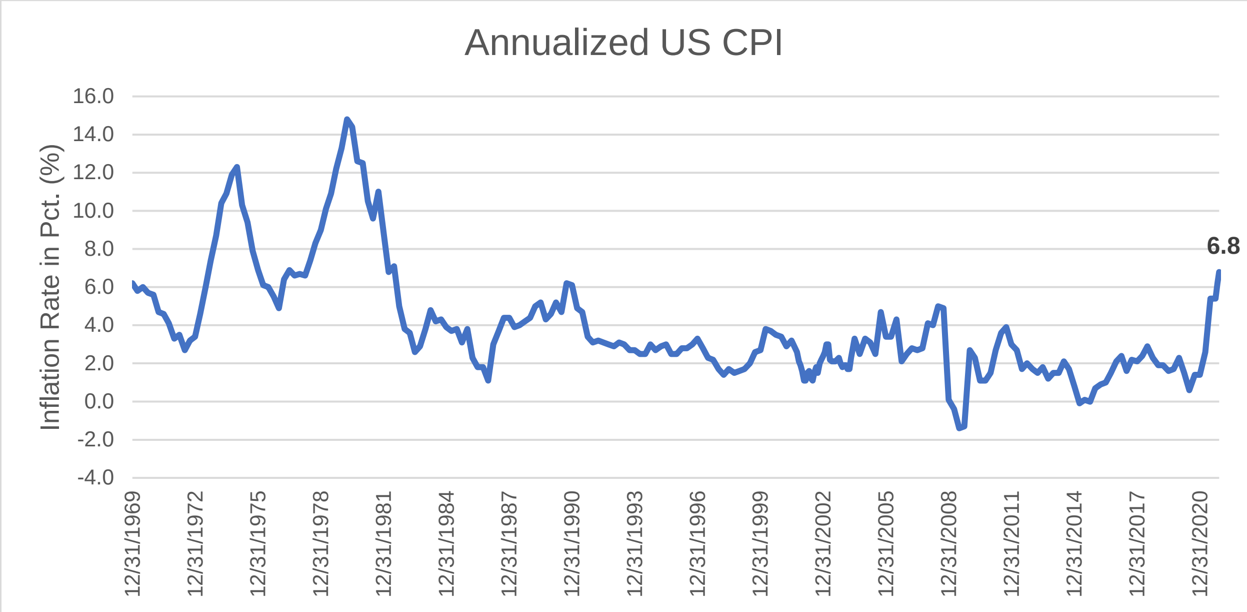
Just as soon as we thought the risks associated with the pandemic were dissipating and the economy was poised for further growth, a new variant of the Covid-19 virus (Omicron) emerged. Reports began appearing during the month that a new variant of the virus had been discovered in South Africa.[1] While early tests have showed that Omicron is more contagious than previous versions, observed results reveal that the symptoms are less medically severe relative to the Delta variant that emerged earlier this year.[2] Fortunately, the incidence of infection so far has been skewed towards those countries with high effective vaccination rates which should bode well for keeping the incidences of hospitalizations low.[3] To combat the rise in cases, countries like Austria, Belgium and the Netherlands recently renewed their policy of restricted travel and social interaction.[4] While restrictions are likely to negatively impact global economic growth in the near-term, from the table below we can see that based on current forecasts, future economic growth expectations remain on solid footing.[5]

Country	2020	2021	2022	2023
United States	-3.4%	5.5%	3.9%	2.7%
Eurozone	-6.5%	5.1%	4.4%	2.4%
China	2.3%	8.0%	4.9%	4.9%
Japan	-4.7%	1.9%	2.3%	1.2%
World	-3.3%	5.7%	4.2%	3.7%

Source: S&P Global as of November 30th, 2021

Overall, US economic data was mixed during the month. We continue to monitor the health of the labor market closely given the potential impacts on consumer spending and sentiment. For the month, payrolls grew by 210,000, far below consensus expectations.[6] Despite this, the US unemployment rate fell to 4.2% during the month, down from 4.6% in October.[7] Importantly, the supply of labor is beginning to increase as people re-enter the workforce. As evidence, the labor force grew by 594,000 during the period which resulted in the labor force participation rate increasing to 61.8% from 61.6% in November.[8] One area of concern remains wage growth, which grew by 4.8% year-over-year in November. Despite the strong rate of growth, wages continue to trail the recent sharp rise in US inflation.[9] In the event that inflation does not moderate, or wages do not keep pace, workers could potentially fall further behind as the cost of goods and services outstrips their income gains.

In a surprise reversal, the Federal Reserve Bank (the Fed) Chairman Jerome Powell told Congress during his recent testimony that, "it's probably a good time to retire that word – transitory."[10] For the better part of a year, the Fed had insisted that rising inflation was, in fact, not permanent, and would likely revert to the long-term trend of roughly 2%. Psychologists often refer to this as cognitive dissonance, or the stress that is felt when someone holds two conflicting viewpoints. In the case of the Fed, prior to Powell's testimony, it stated that inflation, despite massive money printing and fiscal stimulus, was transitory and not persistent. Yet, given their access to economic information, Fed members had to be acutely aware of the significant rise the prices of goods and services. As evidence, we can see in the chart below, inflation rose by 0.8% in November to a 6.8% annualized rate.[11] According to the Bureau of Labor statistics, this is the fastest pace of inflation since 1982.[12] The concern moving forward is that to correct its misread on inflationary pressures, the Fed will seek to drain liquidity from the economy by tapering its bond purchase program and begin the process of raising interest rates. While interest rates remain historically low, a sudden rise in the cost of borrowing has the potential to stall further economic growth.

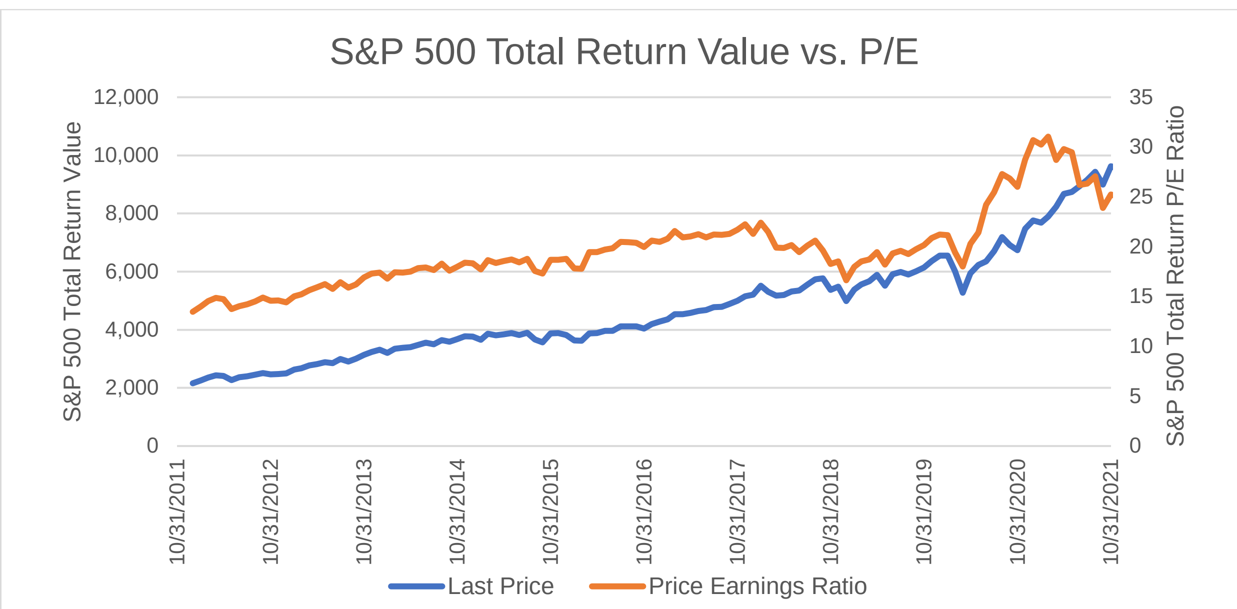


Source: Bloomberg as of December 10th, 2021

Other data points we monitor such as the ISM Services Index and the ISM Manufacturing PMI exhibited solid expansion during the month.[13] Both indicators showed that new orders and manufacturing expanded during the period despite continued constraints resulting from the disruption in the supply chain. Notwithstanding accelerating inflation, consumer sentiment rose during the month with the University of Michigan Consumer Sentiment Index posting a reading of 70.4, up from 67.4.[14] The implications here are important, particularly in the heart of the Christmas shopping season. The National Retail Federation is projecting that Holiday spending could grow between 8.5% to 10.5% over 2020, smashing the previous record for annual growth.[15] Finally, real estate continues to shine with the Case-Shiller US National Home Price Index rising by roughly 1.2% during the month, and 19.5% annualized.[16] Real estate has benefited significantly from the Fed's loose monetary policy keeping mortgage rates low. Moving forward, as interest rates begin to normalize, the pace of increase in home prices should revert to their long-term mean growth rates. It will be interesting to watch how consumers adapt to the new environment and if they adjust their spending habits accordingly.

EQUITIES

Domestic equity markets were broadly lower across market capitalizations and styles with only the Russell 1000 Growth Index posting a positive return for the month. For the month, the S&P 500 Total Return Index declined by -0.69% bringing the yearly return to 23.18%.[17] In addition to contending with uncertainty related to Omicron, markets were negatively impacted by the announcement that Evergrande, the largest real estate property developer was in default on its outstanding debt. The result of these events was a marked increase in overall volatility with the CBOE Volatility Index (VIX), which moved to its highest level since February.[18] Despite the declines during the month, equity valuations remain high by historical standards with the S&P 500 Price Earnings Ratio registering above 25.0.[19]

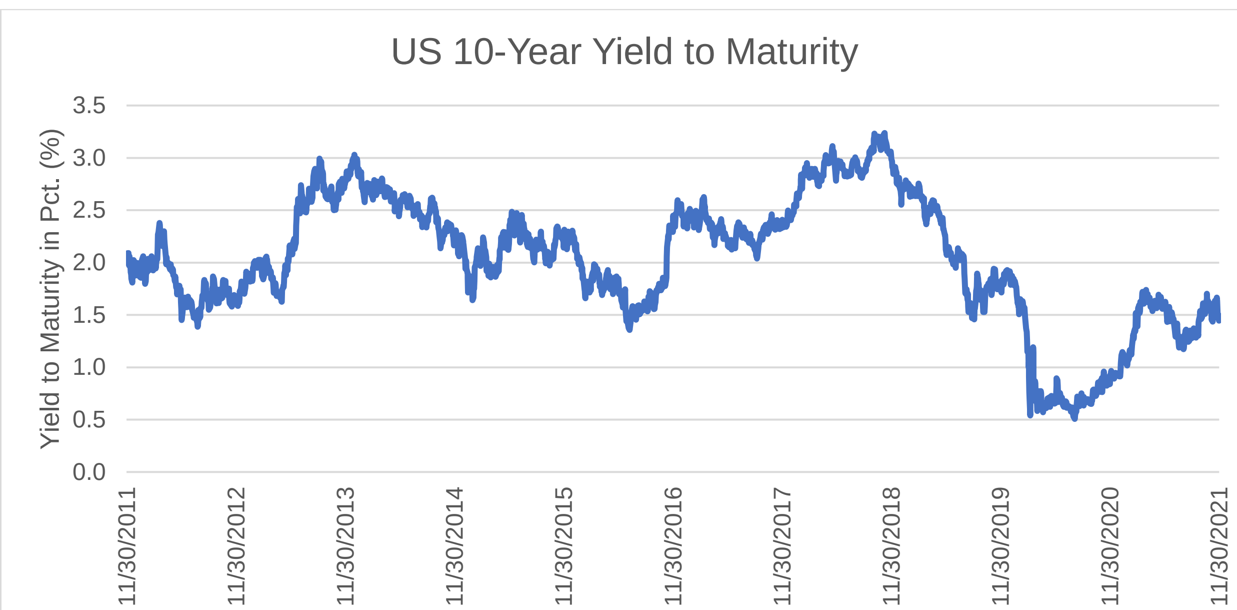


Source: Bloomberg as of November 30th, 2021

Overseas, both international developed and emerging equity markets came under considerable pressure during the month with the MSCI EAFE Index falling by -4.65% while the MSCI Emerging Markets Index fell by -4.08%, respectively.[20] As previously stated, many European countries reinstituted restrictions to arrest the pandemic and emerging markets didn't fare much better with the Omicron variant discovery in South Africa. However, the biggest story impacting foreign markets was the default by Evergrande. Given the importance of real estate to the broader Chinese economy, and the fact that the company is seen by some as "too big to fail," the announcement caught many investors off guard despite being widely anticipated by the market.

FIXED INCOME

US fixed income returns were mixed for the month with higher quality bonds outperforming lower quality issues. The Bloomberg US Aggregate Bond Index rose 0.30% while the Bloomberg US Corporate High Yield Index declined by -0.97% for the month.[21] While the increased equity market volatility was a significant factor in the overall performance of fixed income for the month, the Fed's capitulating pivot on inflation, and the resulting rise in rate increase expectations, drove the market. Following Powell's testimony and the rapid rise in US inflation, expectations are that the Fed will attempt to end its bond purchase program sooner than expected.[22] Despite the change to a much more hawkish approach, US Treasury yields declined during the period with the US 10-Year Treasury bond closing at 1.40%, down from a yield of 1.55% from October.[23]



Source: Bloomberg, November 30th, 2021

APPENDIX

1. https://www.who.int/news/item/28-11-2021-update-on-omicron
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