Time for your annual check-up, Mr. Market

Capital markets — and the economy they represent — spent much of 2021 in reasonably good health. But will that remain true this year?

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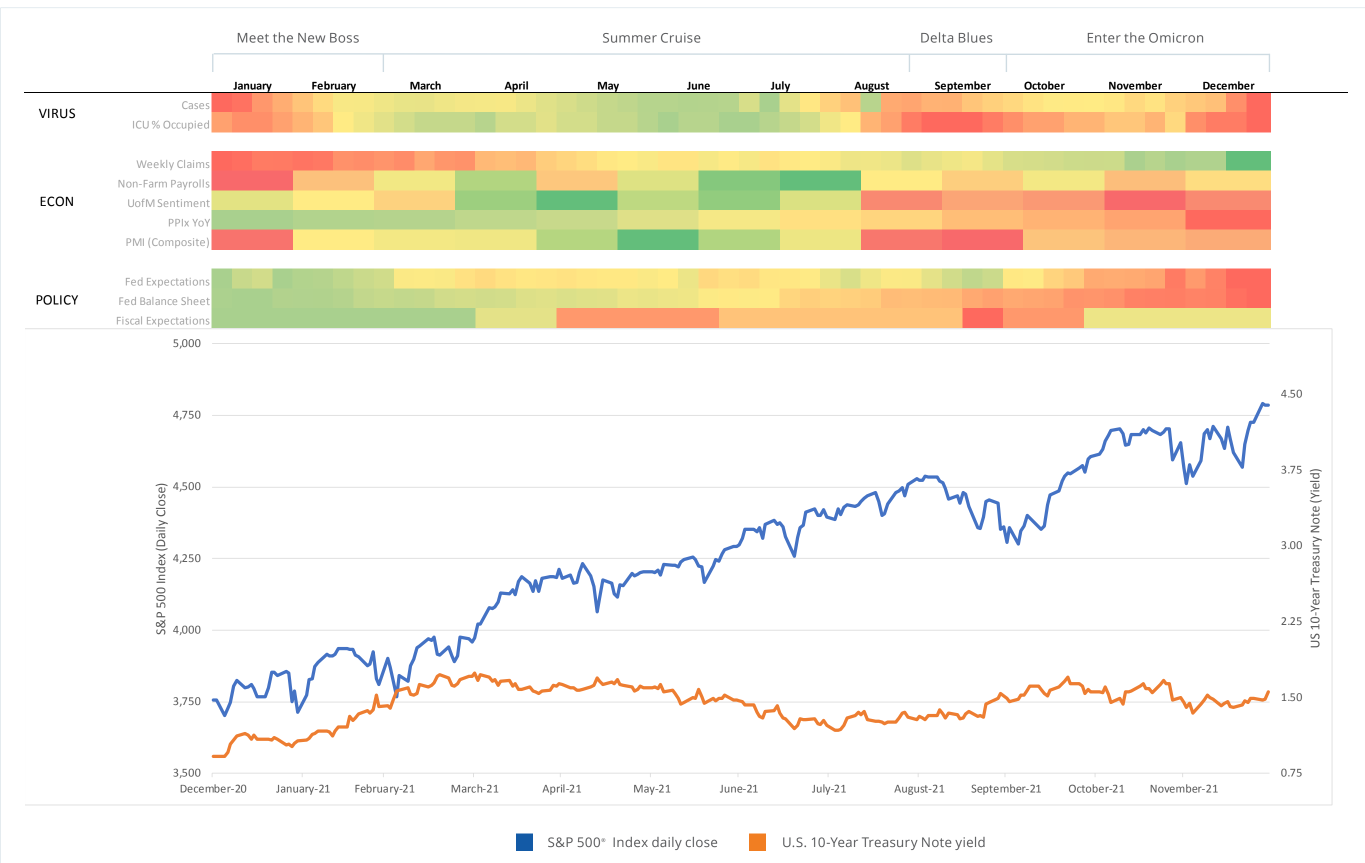
Imagine for a moment that the U.S. economy is a hospital patient (not too much of a stretch, I'm sure, given recent events). Now imagine yourself as the physician in charge of monitoring its health. What metrics would you use to determine whether or not your patient is healthy? It's a debatable proposition, but you could do far worse than using capital market indicators to form the core of your diagnosis. For example, the stock market might represent the economy's heartbeat, and interest rates might be its cholesterol level or rate of respiration.

As any good doctor knows, though, vital signs are only one indication of what's going on inside a patient. Moreover, there is a significant amount of feedback across them: If the heartbeat is too slow, it could cause respiration rates to spike; if cholesterol levels are rising, they will eventually impact the patient's heart rate; and so on. That feedback alone makes reliance on a single indicator dangerous in the extreme. And to complicate things further, the vital signs most indicative of a patient's overall well-being depend to a very significant degree on what currently ails them the most. Monitoring cholesterol levels may not tell you a whole lot about a patient suffering from a broken nose, for example, but it is absolutely critical for a patient in danger of suffering a heart attack.



The same is true for our patient, the U.S. economy. It's one thing to monitor stock market returns or interest rates, but ignoring other vital signs means missing out on data that could be key to assessing the economy's overall health. For better or worse, 2021 made it obvious which indicators to track, and they can be grouped into three broad categories: COVID, economic policy and a handful of macroeconomic variables. In the chart on the previous page, we attempted to capture some of those signals and overlaid them against two of the vital signs to which you are likely most accustomed: the return of the S&P 500® Index and yields on the 10-year U.S. Treasury note.

Now fix your eyes on the top of the chart, where we've color-coded the trend during the last 12 months in each of the 10 variables chronicled here: two that represent the progress of COVID, five designed to capture the overall tone of the economy, and three designed to measure the direction of monetary and fiscal policy. A few things quickly become evident. First, if you look at this handful of indicators collectively, four distinct periods emerge: a period of relative uncertainty early in the year (where reds and yellows are roughly balanced out by a few greens), a long period during the spring and summer when trends were mostly positive (where greens and yellows dominate), another brief period of uncertainty through September, and a decidedly negative turn to close out the year. Let's take a look at each of these four periods.

Phase 1: Meet the new boss (S&P 500 Index: +1.46%, 10-year U.S. Treasury yield: +0.49% to 1.41%)

Equity markets had a hard time getting started during the first two months of 2021, with the S&P 500 ending February only slightly ahead of where it began the year. This was a fairly balanced period when viewed through the lens of our three-factor framework, with a very favorable policy environment balancing out less favorable trends in both the economy and COVID. On the policy front, it was immediately clear that incoming President Joe Biden was in a spending mood and the Fed was still buying Treasury and mortgage bonds hand over fist. Meanwhile, any increase in the federal funds rate was still thought to be a long way off — 2023 at the earliest. But COVID's winter surge wasn't yet over, with case growth and hospitalizations among the highest levels we'd see all year. On the economic front, the job market was still a mess (see inset on page 4), but Purchasing Manager's indices and sentiment were improving. With these three forces more or less battling it out to form a kind of unsteady equilibrium, political headlines grabbed attention, first due to the battle for control of the U.S. Senate (ultimately decided in favor of the Democrats in a dramatic run-off election to decide both of Georgia's seats). With single-party control of both the executive and the legislative branch solidified, pundits began to wonder what that meant for the next four years. Later — and perhaps more profoundly — the Capitol riots in Washington shined a spotlight on a deepening partisan divide that threatened to unravel not just the country's economy but its social fabric as well.

Phase 2: Summer cruise (S&P 500 Index: +19.6%, 10-year U.S. Treasury yield: -0.10% to 1.31%)

By the end of February, COVID seemed to be in full retreat. Businesses most heavily impacted by COVID started looking ahead to a virus-free future, with airlines and cruise operators among those tentatively offering upbeat guidance. The "reopening trade" took hold and stocks took off, adding nearly 20% by the end of August. Consumer sentiment peaked, PMIs accelerated and even the long-suffering jobs market showed tentative signs of improvement. The more pessimistic among us started grumbling about inflation, but price pressures were still months away from peaking. On the policy side of things, President Biden's big fiscal plans were dented by opposition from within his own party, and traders started to openly question the Fed's resolve, but for at least a while things seemed to be on a pretty solid footing.

Phase 3: Delta blues (S&P 500 Index: -4.8%, 10-year U.S. Treasury yield: +0.18% to 1.49%)

With the end of summer came the realization that inflation probably wasn't going away anytime soon. Fed Chairman Jerome Powell's admission that "transitory" was no longer a credible way to describe rising prices was still months away, but markets often sense a shift in the prevailing winds long before it actually occurs, and mounting reports of supply chain stress had convinced them that a change in the weather was inevitable. On the economic front, PMIs remained historically strong but began to suffer from altitude sickness and were having a harder and harder time reaching new heights. Meanwhile, competing visions about how to properly define "infrastructure" created still more turbulence in the fiscal policy realm — even as a federal government shutdown loomed and debate around the debt ceiling raged. But perhaps most impactful of all, the term "delta variant" fully entered the national lexicon after the mutation that first arrived during early summer accelerated case counts, allowing COVID to make a comeback — possibly related to a return to in-person learning at school districts nationwide. Many of the trends established during the early months of the pandemic but temporarily suspended during the salad days of summer reasserted themselves with a vengeance.

Phase 4: "Enter the omicron" (S&P Index: +11.8%, 10-year US Treasury yield: +0.01% to 1.50%)

Of the markets' four moods of 2021, the period covering the last three months of the year is perhaps the most perplexing. The most dramatic development occurred on the day after Thanksgiving with the introduction of the omicron variant — a moniker that makes COVID's latest mutation sound like the lead villain in Marvel movie. Meanwhile, with only one exception — a powerful and long-awaited decline in jobless claims to below pre-pandemic levels — all the variables we've cataloged here remain at or near some of their most concerning levels of the year. For example, the Fed's long-feared taper of asset purchases has begun (and its pace doubled only one month after it was formally announced). Futures traders and the so-called "dot plot" now agree that multiple increases in the fed funds rate will probably occur in 2022 — a stark contrast to the beginning of 2021, when "lift-off" was thought to be a 2023 event. At the same time, the prospects for the president's aggressive fiscal agenda remain very much in limbo. From an economic perspective, it seems increasingly likely that PMIs have peaked, and inflation remains off-the-charts high while consumer sentiment has softened. And yet for all that red, markets have done just fine: Stocks finished the final quarter of the year with a robust gain of almost 12, while 10-year yields hardly moved at all. It's enough to make you wonder if there's something going on inside our patient that these vital signs aren't capturing.

The prognosis: Held for observation

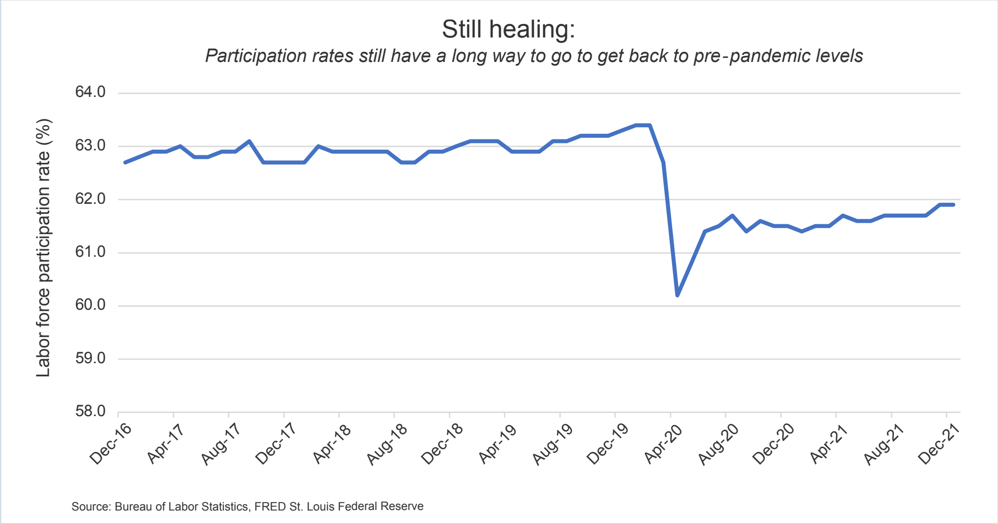
If you're confused by the market's year-end performance in the face of all these headwinds, you're not alone. But on some level, at least some of the market's upbeat tone during the tail end of 2021 might be justified. Take omicron, for example: The increase in confirmed COVID cases has been nothing short of shocking, but so far (knock on wood), symptoms generated by the variant appear less severe than earlier versions. Meanwhile, the labor markets continue to heal, and while it seems increasingly likely that forward-looking indicators like PMIs may have topped out, they remain extremely elevated on a historical basis. As for inflation, at least some of the supply chain stress that created it is finally showing signs of easing. The extent to which that ultimately takes (or doesn't take ...) some of the pressure off prices will be one of the keys to how markets begin 2022.

Another key will be corporate earnings. So far, companies have been extremely successful at navigating the pandemic and its aftermath, boosting earnings consistently and allowing markets to "grow into" what are admittedly stretched valuations. But persistent cost and wage inflation (coupled with an imperfect ability to fully pass those rapidly rising costs onto consumers) could eventually place that growth at risk. It also remains to be seen how businesses, investors and consumers alike will react to a less accommodative Federal Reserve (and the higher interest rates that might entail). All this represents a monumental change from what had begun to feel like accommodation-as-policy since the dawning of the Great Recession more than a decade ago.

So while the U.S. economy isn't exactly languishing in the ICU ward, enough of its vital signs are blinking yellow and red to keep the patient under observation. Either way, here's hoping 2022 will hold only positive surprises. I think we've all earned a break

Rattling chains: How labor market and logistic challenges helped generate inflation in 2021

If 2020 was the year of the COVID-19 pandemic, 2021 can be described as the year of inflation and supply chain disruption. From labor shortages to increasing inflation all the way to supply chain disruption, the year has plagued both consumers and business owners alike. You might think markets would suffer in this environment, but this could not have been further from the truth. The market soared in 2021.

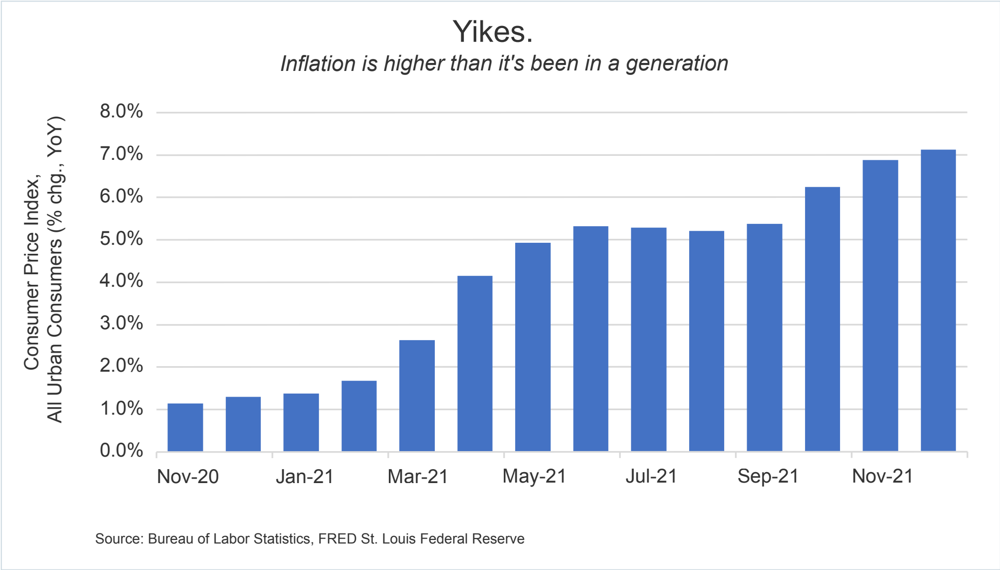


But the market is not the only thing that continues to rise. Prices of many goods and services rose throughout 2021, and there is little to no relief in sight. Of course, one thing driving the increase in prices is the shortage of labor. At the end of September 2021, there was at least one open job for every American seeking employment, with 10.4 million available job openings. There are fewer people working now than before the pandemic began despite a slow and steady improvement during the final months of 2021.

So where have all the workers gone? Many factors may be contributing to the shrinking labor force: reassessed work/life priorities in light of the pandemic, an abundance of savings accumulated (with help from government stimulus checks and rising asset values), looming health concerns and a host of other issues related to COVID and its fallout. One thing is for sure: Workers are now armed with increased leverage and can demand higher wages, which has in turn caused some companies to drastically raise prices. In addition, worker shortages have contributed to trend by disrupting normal production routines and reducing output. As a result, just about everything is in short supply, and if we pair the increased demand for goods with these supply chain problems, we have a real recipe for disaster.

Though the Federal Reserve once thought the increase in inflation would likely be short lived, the central bank now believes a reversal will take longer than originally thought. And they were right: Today, the various measures of inflation stand at their highest levels in decades, and the pressure has been broad based, with increasing costs of energy, food, both new and used vehicles, medical care services, transportation, apparel, and shelter.

For now, consumers have been a bit more willing to pay higher prices — thanks, no doubt, to the huge amounts of federal stimulus received in 2020 and the early months of 2021. Only time will tell if that willingness to pay higher prices will persist — or be replaced by a "buyer's strike" that ultimately saps demand. Worse still might be the emergence of an "inflationary psychology" that reignites inflation even in the absence of some of these pressures.



Either way, as labor and supply shortages begin to resolve, we are hopeful we will see price pressures begin to give way. Still, there is danger of an over-shoot by consumers or policymakers, and with inflation where it is, rate hikes seem like a foregone conclusion in 2022. Though there is hope that labor shortages, supply chain disruptions and inflation will all come to an end, these issues persist and continue to weigh on both consumers and businesses alike.

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