

ECONOMIC OUTLOOK

Summary

A surprise to the upside in the January jobs data has all but assured the Federal Reserve will begin a rate-hiking cycle at its March meeting. The primary motivation for the Fed to increase the overnight rate is to curb the excessive inflation seen throughout the past year. However, the strength in the economy during the same timeframe also warrants rates to move off the zero lower bound.

For example, it is well known that growth in 2021 was buoyed by fiscal and monetary stimulus, but even still, GDP growth for the fourth quarter registered 6.9%, which was the year's largest quarter of growth. This brought full-year GDP up to 5.5% for 2021 – the highest annual level in nearly 40 years. But while the quarterly headline data was certainly positive, the underlying data was a bit weaker. Companies rebuilding depleted inventory accounted for 4.9% of the overall GDP growth and only 2.3% was due to consumer spending. Given how GDP calculations work, inventories are now likely to be a drag on growth in early 2022.

In similarly mixed data, we continue to see signs that growth is expanding in 2022, albeit at a slower rate. For example, ISM Services and ISM Manufacturing PMIs, which measure contraction or expansion in those industries, have been in decline for several months; but both still remain well into expansionary territory. Retail sales also declined in December, however, they remain well above trend from pre-pandemic levels. Additionally, average hourly earnings continue to increase at a rapid rate, yet, factoring inflation in, employees still take home less money.

The Federal Reserve has a dual mandate to maintain maximum employment and stable prices and they are going to use their tools as necessary to achieve those goals. However, throughout the past several months, the market expectation has shifted from roughly two rate hikes in 2022, to potentially eight over the next two years. If growth does slow as expected, it remains to be seen how many rate hikes the market can absorb before the economy is negatively impacted.

Positives

Non-farm payrolls exceeded estimates by nearly 350k, while two month revisions increased by 700k+

The labor force participation rate unexpectedly jumped 0.3% to 62.2%

PPI Final Demand for December came in below expectations (0.2% vs 0.4% est)

Negatives

University of Michigan Consumer Sentiment Index has reached its lowest level in nearly 10 years

Personal income missed expectations (0.3% vs 0.5% est)

Existing home sales missed expectations by 4% (-4.6% vs -0.6% est)

EQUITY OUTLOOK

Summary

As expected, volatility returned in a big way to start 2022. The S&P 500 finished January down 5.2%, though at one point in the month the index was down much more significantly. The closing high to closing low exceeded 9% and we eclipsed the 10% correction territory on an intraday basis. Growth stocks were punished more harshly with the Russell 1000 Growth Index falling 8.6%. The Russell 1000 Value Index held up much better dipping just 2.3%.

Coming into the year, concerns over supply chain disruption, Omicron, inflation and the Fed continue to linger over equity markets. However, January saw heightened concern over Russia's intentions in positioning troops on Ukraine's border. It is unclear if Russia will launch a full-scale invasion and what exactly a response from the West would look like. China is hosting the winter Olympics in Beijing this year. Given the importance of that event and the warming relations between Moscow and Beijing, it is unlikely, in our view, that Putin and Russia will take any action prior to the closing ceremonies on February 20. Still, the market will likely remain focused on this conflict as the month progresses.

Corporate earnings season is now underway. We expect results will generally be strong but forward guidance may be challenging. Supply chain constraints, worker shortages and inflation are impactful for many. Given that, it is unlikely earnings season will single handedly cool the recent volatility.

The markets will likely remain choppy through the first half of this year but it appears we should have more visibility into all of the above concerns as we enter the back half. We believe equity markets should perform well for the balance of the year.

Positives

Equity fundamentals

Oversold conditions in many individual stocks

Negatives

Occasional inflation scares

Supply chain and labor shortages

Unkowns

Russia's intentions with Ukraine

FIXED INCOME OUTLOOK

Summary

It has been a rough start to the year for bond investors following a rare negative return last year. As Omicron fears fade into the background, aggressive Fed action became the new dominate market concern. At their Senate confirmation hearings, both Fed Chairman Powell and Vice Chair-elect Brainard talked tough about the Fed taking the actions necessary to combat current inflationary pressures by tightening monetary policy. Chairman Powell then followed up with even more hawkish talk after the Fed's January meeting of the Federal Open Market Committee (FOMC). Here he stated conditions are different than at the onset of the past tightening cycle in 2015 and the policy will reflect those differences. While emphasizing the committee has made no final decision, he certainly laid the groundwork for a faster pace of rate hikes, the potential of 50 basis point (bps) hikes and that the tapering of the Fed's balance sheet would begin soon after lift-off.

Soon after these comments, most economists and forecasters began to expect at least five rate hikes this year and one firm published there will likely be seven. The front end of the yield curve quickly reflected these revised forecasts with yields moving sharply higher. For the month, the 2-year Treasury note yield increasing by 45 bps to 1.18%. The entire curve moved higher and flatter with the 5-year increasing 35 bps to 1.61% and the 10-year gaining 27 bps to 1.78%. The 30-year bond advanced 20 bps to 2.11%. To add insult to injury, investment-grade credit spreads increased by about 15 bps causing corporate bonds to decline even further in value than comparable maturity Treasury notes. With the rise in rates and the increase in credit spreads, most of the bond market indices experienced one of their top 10 worst monthly returns in the past 30 years.

While we are certainly on board with the Fed moving forward their forecast for rate hikes, both in timing and number, we do not believe they will have the opportunity to increase rates five times this year followed by another four or five times in 2023. Any pull-forward on increases this year will come at the expense of increases next year so the total will likely remain six or seven. And as recently discussed by Chairman Powell and many other Fed officials, we are also in agreement the Fed should start tapering their balance sheet soon after they begin raising the overnight rate. The use of the balance sheet will be an important tool to drain liquidity and manage inflation. Using this tool also reduces the need for more aggressive rate hikes. The curve should steepen somewhat with longer rates increasing.

Positives

Inflationary pressures should ease as employment increases

Economy likely to slow from torrid 2021 pace as fiscal stimulus fades

Short maturity yields reflect aggressive Fed rate policy

Negatives

Foreign demand for U.S. debt could decline as rates rise globally

Declining equity prices could lead to bond sales for rebalancing

Unknowns

Russia's intentions in Ukraine
