Outlook Memorandum

JANUARY 2022

S&P 500:
4766
(As of December 31, 2021)

Inflation Worry Overtakes COVID

Stocks finished 2021 shrugging off uncertainties around surging cases of the Omicron variant and simmering unease with inflation that has proven higher and more persistent than expected. For the year, the S&P 500 delivered a return of 28.7%. The MSCI European Index gained 25.8%, while the MSCI Emerging Market Index was down 2.5%. Notably, Chinese stocks dropped almost 22% as real estate tremors drew attention to severe imbalances accumulated over the past decade. The dollar gained over 6% versus a basket of international currencies, largely reflecting the U.S. economy's more rapid post-pandemic recovery. Commodity prices were mixed, with base metals remaining buoyant even as gold declined about 4%. Energy prices have continued to climb higher reflecting the combination of constrained supply, resurgent demand, and restrictive attitudes toward fossil fuels (oil gained 50%; natural gas 47%).

2022 is off to a weak start as worry over the latest economic disruptions and inflation casts a large cloud over markets. The 10-year treasury yield has already touched 1.9% (from 1.5% at yearend) as inflation and the Fed's hawkish tilt stoke concern over forthcoming policy tightening. Rising yields, in turn, are dragging stocks lower as investors factor in higher discount rates (30-year bonds and richly valued growth companies, where values are disproportionately tied to the future, have been particularly weak). Lingering pandemic related distortions, including Omicron disruptions, expand the range of inflation and policy outcomes that typically surface as the Fed shifts toward tightening. Simply put, there is no textbook precedent for the level of disruption and stimulus over the past two years. Inflation last year was easily three times as high as the Fed would normally tolerate, and the key question is whether the structural forces that contributed to the long period of disinflation (pre-pandemic) have been vanquished by changes in the labor force, emerging stakeholder capitalism, rising wages, and a more progressive policy posture. At stake is not whether the Fed tightens too little or too much, but whether it tightens due to stronger growth (which is preferred) or higher inflation (which risks pushing the economy into recession).

Clearly the normalization process is taking longer and to the extent inflation resolves slowly, the market's trepidation will continue. Easing backlogs, rising inventories, and decelerating income growth immediately prior to Omicron suggest inflation was in the process of breaking, though higher housing costs and energy prices were still seeping into price indices. While Omicron impacts should fade with declining infections, China's approach of targeted lockdowns may stretch out the supply chain impacts. On the demand side, the policy coordination that proved powerful over the past two years is ending as the Fed prepares to tighten and the most stimulative policies, such as channeling cash toward lower income, lower wealth households, fall victim to the ongoing discord in Washington. This transition may mark a step away from directly addressing imbalances (albeit with subtle adjustments, such as a less rigid inflation target) and a return toward conventional policy approaches that are hampered by diminishing multipliers. Given the additional burden of $9 trillion in incremental debt and worsened demographics following the pandemic, this may be directing the economy back to its prior slow growth, disinflationary path. To this point, short-term yields have risen sharply but long-term rates remain squarely defiant of recent inflation readings, suggesting investors are concerned the Fed is now tightening while growth is slowing. Weighing all these factors, we see inflation normalizing throughout 2022 and 2023 without requiring a draconian increase in the Fed's short-term lending rate, leading to an environment that we think will prove supportive for equities.

Omicron infections are a speedbump for the economy. While symptomatic infections are broadly categorized as mild, for most people the experience resembles the flu without the need to seek acute medical care. The sheer magnitude of infections (the confirmed trailing 7-day average infection rate is well above 700,000, and that may represent less than 25% of the actual level of infections) coupled with CDC guidelines is creating a rolling pause in economic activity that is sweeping across the country.

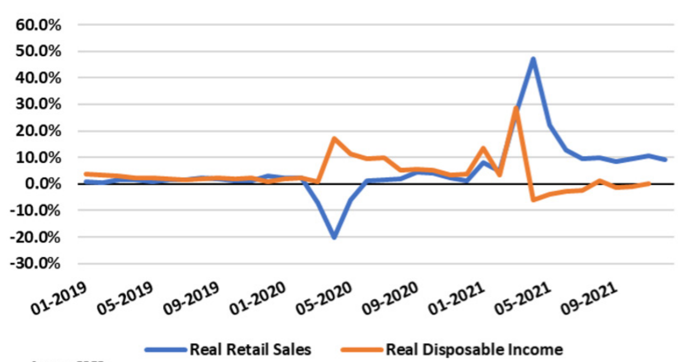
The drag on economic activity should prove transient, judging by the limited reinstatement of restrictions, resilient retail foot traffic, and how quickly infection rates have both risen and then receded in the earliest hit regions (which is the clearest indication that actual infections were far greater than the official tallies). The U.K. is somewhat instructive given that the initial Omicron wave measurably accelerated in mid-December, reaching a peak during the last week of December/first week of January, and is now rapidly declining – and we are seeing a very similar pattern in the northeast.

Sick pay mechanisms mitigate most of the impact on income and demand. The most vulnerable segments such as lower income workers in service industries with less generous or non-existent sick-time benefits are more likely to suffer a reduction in take home pay (and unlike the aftermath of the initial pandemic Congress is not mustering enhanced unemployment or other benefits to fill the gap), which may weigh on consumer spending.

More acutely, supply constraints have resurfaced due to cumulative lost workdays as businesses quickly fall below minimum required staffing levels when employees call in sick. The result is stores adjusting their operating hours, restaurants moving temporarily to takeout only, airlines cancelling flights and offering staff bonus pay to work extra hours – the list of anecdotes is long. In the New York region, which has been at the leading edge of the Omicron wave in the U.S., the Empire Manufacturing Index swung from a level indicating a strong expansion in early December to a level consistent with stalled overall growth in early January. The subcomponents, including hiring and future business conditions, align with our view that Omicron represents a short-term net cooling effect that largely dissipates as the infection rate drops. However, meaningful progress resolving order backlogs now seems likely to extend well into the second quarter.

Fading fiscal stimulus should ease demand-supply imbalances and price pressures. The root of recent inflation stems from asymmetry between the timing and magnitude with which consumers received stimulus compared to how quickly businesses could reopen and expand following lockdowns. Policymakers erred on the side of too much, thus creating several boluses of stimulus in an environment of constrained supply. Per-capita disposable income surged in both 2020 and 2021, both up over 4.5%. A year ago, real incomes were surging almost 32%. With many programs now expiring or simply not renewed (including enhanced unemployment benefits and redirecting the child tax credit into a direct payment), real disposable income growth decelerated sharply into yearend, and turned negative for households lower on the income totem pole despite strong gains in hourly wages.

REAL DISPOSABLE INCOME VS ADVANCE REAL RETAIL SALES



Source: FRED

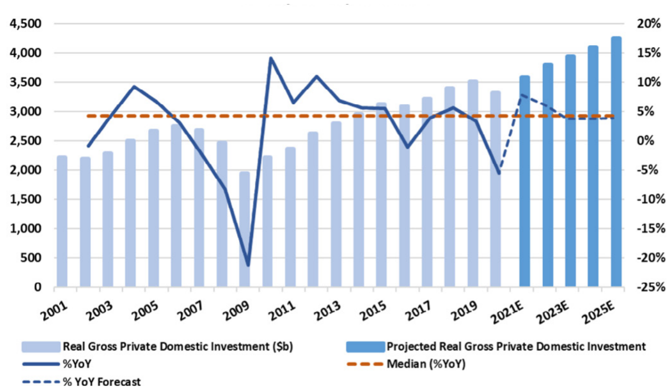
Consumer spending and retail sales closely follow income trends, particularly given that among lower income households (which have the highest propensity to spend additional income), the inflation adjusted excess savings accumulated over the past two years is already back at pre-pandemic levels. Not surprisingly, retail sales softened during December coming in 1.9% lower than November -- though the softness is at least partly attributable to Omicron and the previous pull forward of purchases (retail sales were upbeat in October and November, at +5%, as awareness of supply bottlenecks was used to encourage people to shop early).

Moderating inflation, in turn, should enable ongoing employment and wage growth to translate into real economic gains. Inflation has been more than offsetting strong recent increases in wages and compensation levels for many households – a dynamic that manifests in sagging real disposable income growth, weaker consumer confidence, and declining approval ratings in Washington. On the surface this is stagflation, in which prices and incomes are both rising without any corresponding increase in the standard of living.

To the extent that recent inflation is a function of the one-time stimulus payments during the pandemic, and such programs are not continued, then inflation pressures will begin to ease more noticeably once Omicron impacts fade. In the lead up to yearend, for example, purchasing manager indices for both manufacturing and services remain firmly in "strong expansion territory" but were displaying preliminary signs that the pace of expansion was moderating, which is consistent with the pre-Omicron gradual easing of backlogs that was underway and rising inventories. We also suspect there is an ongoing dynamic where businesses and households shifted from "just in time" ordering/consumption patterns to "just in case" – which combined with fading fiscal stimulus, should support easing price trends ahead.

Even as we see supply and demand each moving back toward a more tenable equilibrium, surveys indicate that hiring intentions remain elevated. Private payrolls, including revisions, increased by close to 6 million jobs during 2021 – including roughly 1.2 million in the fourth quarter even as the economy has moved closer to a full recovery. Over 2 million people have left the workforce over the past two years, largely reflecting accelerated retirements, leaving companies to scramble to find sufficient workers even as the government handed out cash and stimulated demand. As a result, companies have been raising wages to fill open positions amidst robust demand for goods and services, with the latest unemployment rate of 3.9% approaching pre-pandemic levels. Hourly wages are rising at a better than 5% annual rate – a factor that is encouraging workers to bargain for higher compensation and driving the rate in which workers are quitting to record levels. Importantly, we expect 2022 to deliver another 3%-4% gain in wages, supporting consumer spending even in the absence of new stimulus.

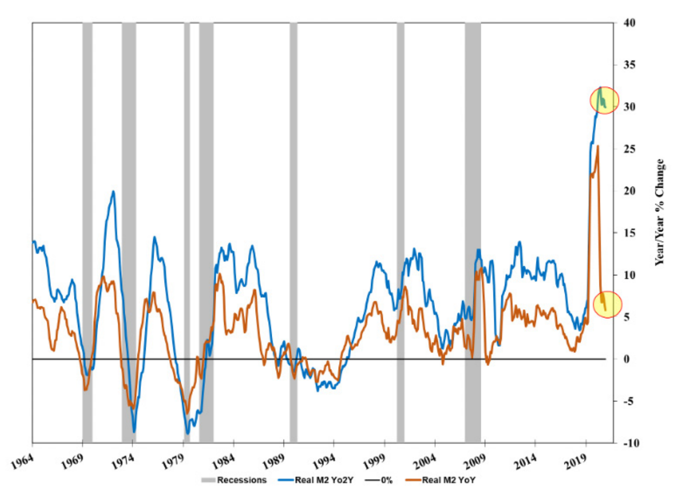
US CAPITAL EXPENDITURES



Source: Bloomberg & Goldman Sachs

Higher wages push businesses to invest. The pandemic's lasting impacts on the economy and the labor force are slowly coming into focus. As many as 2 million workers accelerated their transition into retirement, either reflecting personal assessments of health risks or induced by the abundance of stimulus that filled bank accounts and lifted retirement assets. This dynamic has contributed to hiring difficulties and, thus, supply constraints – an issue exacerbated by policies that simultaneously stimulated demand and probably enabled many workers to delay their return to work. As businesses confront the reality of rising costs – not to mention the uncertainties of persisting geopolitical issues, such as relying on supply chains in China – the benefit of investing in new technology and equipment, relocating supply chains, and adjusting business processes increases. Last year capacity and productivity enhancing investments already began to ramp up. Given the long lead times and complexity associated with many projects, business spending is likely at the beginning of a multi-year upswing that should support employment and productivity. Clear examples include widespread adoption of app-based ordering (and menus) at restaurants, self-driving trucks (as Walmart is experimenting with between some of its stores and its warehouses), and other investments in automation and business processes that boost productivity.

REAL M-2



Normalizing liquidity supports ongoing economic growth and corporate earnings. Inflation hits lower income households hardest, negating recent wage gains and likely causing many to resort to revolving credit balances. This imbalance is highlighted by the reality that wealthier households have generally saved the stimulus handed out over the past two years, while cash balances among the less wealthy are largely back to 2019 levels. Clearly, the economy and investors have just experienced an era of peak liquidity that is now receding. However, concerns that the Fed will need to rapidly tighten policy appear overblown when weighed against the absence of new fiscal stimulus in 2022, which by itself creates a natural drag on liquidity and economic conditions. The implication is that gradual tightening is all that may be needed to move inflation below income growth.

Importantly, both our ACAP Liquidity Index and year over year growth in real M2 money supply suggest that monetary conditions continue to be broadly accommodative, with the monetary policy backdrop normalizing as real M2 growth is already back along its prior trendline. As an artifact from the pandemic, easing bottlenecks should coincide with rising inventories – a dynamic that is apt to pull our ACAP Liquidity Index lower as banks adjust the composition of their balance sheets from securities to loans. At the same time, renewed lending activity, accompanied by easing backlogs and inflation, should provide support for broader growth in real M2 money supply even as the Fed is less accommodative. On balance, this means that overall liquidity should continue to remain highly favorable. This paves the way for the current angst over higher inflation, new disruptions from Omicron, and the typical turbulence that surfaces when policy transitions from accommodative to restrictive postures to subside.

The spike in uncertainty should fade as we move into the second quarter. Futures markets are pricing in four to five rate increases between now and February 2023, 2-3x what was expected as recently as September. This abrupt shift in expectations reflects the deep uncertainty that is weighing on markets, driven by the opposing extremes of inflation (7% last year) and a Fed Funds rate still anchored near zero. With the Fed tightening into an environment of waning demand and increasing supply, inflation is poised to ease progressively throughout the year and moderate expectations for how far the Fed ultimately tightens. Omicron disruptions may provide a pause and allow more rational ordering patterns, which could contribute to perceptions that conditions are weaker over the short-term. At the same time, underlying employment gains, wage increases, and business investment are set to continue as the private sector adapts to the reality of recent retirements. From an investment perspective, we continue to see better relative value in equities based on our view that the emerging tightening cycle will be gentler than investors are prone to fear, and we are shifting toward cyclical and discretionary companies that enjoy better pricing power, particularly those that can benefit from rising wages.

ALEXANDRIACAPITAL

ARLINGTON
1300 17th Street North, Suite 840
Arlington, VA 22209
202-391-0170

NEW YORK CITY
500 7th Avenue, 8th Floor
New York, NY 10018
800-500-4647