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Economic and Market Outlook

December 31, 2021

It's the End of the World as We Know It

"The speed of communication, the speed of information transfer, the cheapness of communication, the ease of moving things around the world are a difference in kind as well as degree."

- Paul A. Volcker, Former Federal Reserve Chairman (1979-1987)

Section I. Volatility

The quote above by Paul Volcker from the 1980s speaks to the fact that every day the amount of information available becomes greater. From news outlets providing their opinions instead of just news, to the internet doing the same, we are subjected to that information 24 hours a day, seven days a week. 50 years ago people just got information on the 6 o'clock evening news or the daily newspaper. The stock market reacts quickly in the short term to headlines. As long term investors, we need to do our best to focus on earnings and economic trends in an attempt to not let the emotions volatility creates influence our decisions.

The market historically has had three 5% corrections and one 10% correction a year on average. Through September, however, we had not experienced any 5% corrections this year. This is no longer the case as we have had two 5% corrections since our last report. Yet at no time did our long term economic indicators signal a need to change course.

Once again we want to emphasize the power of large numbers, or in this case a lack of power. A 300 point move in the Dow Jones Industrial Average (DJIA) does not carry the same weight as it did 10 years ago. At that time the DJIA was at 12,107.74, meaning a 300 point move was 2.48%. Today that same 300 point move is only 0.83%.

Hearing moves of such large numbers still catches investors' attention, however, when put in the proper perspective, such a move reflects normal volatility.

Section II. Inflation

The readings for inflation have continued to increase. Currently the Consumer Price Index (CPI) is 6.8% on an annual basis, and core CPI, which excludes food and energy, is at 4.9%. This is well above the Federal Reserve's 2% target. While the pandemic has dragged on, consumers have spent some of their savings that they accumulated during the lockdown. This created some transitory inflation. Chart #1 is the personal savings rate for the U.S. After averaging about 7% from 2000 to 2019, it peaked in April 2020 at 33.7%, right after the beginning of the Covid-19 lockdowns. The reading for November 2021 is down to 7.3% meaning this pressure on inflation should begin to ease.

Paul Volcker is the last Fed Chair to have to deal with double digit inflation and the second part of his quote is prescient in this case. The "ease" with which goods move around the world has been greatly impaired. The Federal Reserve probably chose the wrong word when they termed inflation "transitory" because that led people to believe it would only last a few months. Most of the inflation we are experiencing is a mismatch of supply and demand caused mainly by Covid-19 fears and lockdowns. Factories shutdown causing a shortage of semiconductors, food stuffs, lumber etc. At the same time consumers flush with cash increase demand for these same goods. Manufacturing is complicated and factories can't just start up on a dime.

Wages continue to rise in an effort to lure people out of unemployment. These wage increases will not roll back and it is unsure how much further they will need to rise. The other problem for now is that rent increases due to increased home prices normally take 18 months to be reflected in the inflation numbers.

Other areas will eventually prove to be transitory but will take longer to work out than the Federal Reserve originally expected. Semiconductor chip shortages affect many parts of the economy from vehicles to technology. The Omicron variant is still keeping people from returning to work and bringing production to full capacity at factories creating shortages for many goods. In addition, the lack of enough longshoremen and truck drivers is exacerbating the supply shortage.

The key concern for inflation is persistent price hikes. The good news is that Industrial Production plus Productivity gains thanks to technology will eventually lead to disinflation. That is why we believe inflation will not be a long term problem but it will last longer than Federal Reserve first believed. Some of the current elevated inflation rate is transitory, based on supply chain shortages. Inflation due to wage hikes is appearing to stick for the long term.

Section III. <u>The Federal Reserve and Interest Rates</u>

Because of inflation the financial media has become more focused on interest rates. We have been spoiled by ultra-low rates during the pandemic. Historically, rising interest rates accompany a strengthening economy. In addition, the ultra-low rates we have experienced have hurt savers and retirees.

The Federal Reserve announced that they are about to adjust monetary policy. Federal Reserve Chairman Jerome Powell stated at his latest press conference that the committee is going to start tapering the bond purchases quicker than originally expected. As of November, the Fed added liquidity to the economy by purchasing $120 billion a month in government and mortgage backed bonds. It is estimated that there is still an additional $240 billion of bonds to be purchased while tapering. In other words, they are still adding liquidity through March, but at a slower pace. In addition, Powell has made it clear that there will be no rate hikes while tapering is ongoing. The 10-year Treasury yield remains around 1.5%. This is also a reflection that long term inflation expectations are not elevated.

We still believe the rise in rates is coming but it will happen slowly. Historically, the stock market will climb until a third rate hike. After that, things can get bumpy if they have to continue to fight inflation. A 2.5% 10-year Treasury note yield is still very low historically and there other factors that still exist that should limit the climb moving forward. Japan has been a net seller of U.S. Treasuries for the last 5 years. Japan may become a net buyer of U.S. Treasuries because of the eventual rise in rates. This is because the eventual rise in the 10-year bond yield combined with currency hedging costs collapsing makes the U.S. 10-year bond much more attractive to Japan.

In addition, rates in most European 10 year bonds remain low, making the U.S. 10 year bond more attractive to international investors. The U.K. 10 year yields 0.92%. The German 10 year yields -0.25%. France 10 year yields 0.12%. Italian 10 year yields 1.12%. Swiss 10 year yields -0.17%. This compares to our 1.50% 10 year yield.

Section IV. <u>The Recession Model</u>

As we have discussed in past reports, earnings and the economy are the true long term influences on the stock market. Recessions are the major reason we experience corrections of more than 10%. Corrections of less than 10% are just part of normal volatility and can happen multiple times each year.

We have developed what we view as a recession indicator which tracks 5 data sets on a monthly basis. If 3 of the 5 indicators are negative <u>and</u> the S&P 500 is below its 40 week moving average, it is a very strong indication that a recession is near or may already be underway.

Indicator number one compares the current monthly unemployment rate to its 12 month moving average. As of November, the unemployment rate was 4.2% and the 12 month moving average was 5.6%. By being below the moving average this indicator is positive.

Indicator number two is represented in Chart #2. This represents the year over year percentage change of Advance Real Retail and Food Service Sales. This is one method to measure the strength of the consumer. As you can see, the Covid-19 shut down had a major effect on this index in early 2020. Re-opening is also having a major effect. This indicator bottomed in April 2020 at -20.2% and had recent high of 45.2% in April 2021. Currently the reading is 10.6% for November, so this indicator is positive. Any reading above 0 is positive. The reading is also normalizing which should relieve some inflation pressure.

Indicator number three is represented in Chart #3. This shows the year over year change in Industrial Production. This indicator bottomed in April 2020 at -16.3%. This indicator is positive and moderating. It currently sits at 5.3% for November 2021.

For indicator number four (Chart #4), we look at Total Nonfarm Payrolls divided by the Civilian Labor Force Level on a year over year percentage change basis. This indicator has moderated because of the difficulty companies are having hiring in the last couple of months caused by the Delta and Omicron variants and stands at 3.09%. A zero reading represents neutral therefore this indicator is still positive.

Indicator number five (Chart #5) represents the Average Weekly Hours of Production and Nonsupervisory Employees-Manufacturing on a year over year percentage basis. Once again, this indicator bottomed back in April 2020 at -7.69%.

Currently the reading is only 0.0%, so this indicator is neutral and reflects how the Delta and Omicron variants have elongated the economic recovery in the last few months.

Currently four of the five indicators are positive and the S&P 500 Index is 5.75% above its forty week moving average. As long as the S&P 500 is above its forty week moving average this model does not give any recession warning signs. It is worth noting that the spread of the Index over the moving average has decreased.

The above indicators are only updated on a monthly basis. To offset this situation we also track two other indicators. They are both indicators that are updated more frequently (on a weekly or daily basis) and we consider them as early recession indicators. Both are somewhat volatile so we track three month moving averages.

The first one is the Aruoba-Diebold-Scotti Business Conditions Index which is updated on a daily basis and published by the Philadelphia Federal Reserve. The 91 day moving average, after pulling back since the last report to 0.05, has rebounded and sits at 0.49. The divining line for entering and exiting recessions is -0.8.

The second indicator for recessions is the Chicago Fed Business Activity Index. It is reported weekly and the divining line for entering recessions is -0.7. The three month moving average slightly weakened and sits at 0.37.

In summary, the two "early warning signs" are not predicting recession at this time, but have weakened slightly in the last three months.

Section V. <u>Market Psychology</u>

For decades we have measured market psychology using price and volume data in the short and long term from the Dow Jones Industrial Average as well as a 17 week moving average of advancing and declining stocks on the New York Stock Exchange.

Currently most of the price/volume indicators remain positive, but 3 of the 12 are starting to flash yellow. This could be indicating that some short term correction is ahead in the 5% range. Once again, these are normal and part of market volatility.

Our advance/decline line has dipped slightly below 50%. Our model that measures the first and second derivative on price and volume remains positive. We have developed this model to recognize patterns and spot buy and sell signals from reviewing years of historical data.

Section VI. Covid-19 and the Omicron Variant

Omicron so far seems to be more contagious but not nearly as fatalas previous variants, especially if vaccinated. Remember that vaccines are meant to mute the effect of the virus, not completely immunize you. Merck and Pfizer are both receiving approval for an anti-viral pill to take after you contract Covid-19. While the Delta and Omicron variants caused the economic recovery to pause, it is our belief that the recovery remains on track and should regain momentum in the coming months. Whether it comes from vaccines, anti-viral pills or herd immunity, lockdowns no longer seem to be in our future. Once again the media spews a lot of sensational reports about the few breakthrough cases, not about the millions safe because of vaccination.

Section VII. The Economy

Indexes that measure manufacturing data have continued to have strong readings. The Philly Fed Manufacturing Index hit a nearly 50 year high in April, with a reading of 50.2 (0 is the line for growth or contraction). The reading for December 2021 was a still positive 15.4. The Empire Manufacturing Index hit a high in July of 43 (0). December's still strong reading was 31.9. The national ISM manufacturing index remained elevated at 61.1% in November and the ISM services index is at 69.1% (above 50 is considered growth, above 55 is considered exceptional growth). You can see the service sector quickly passing the growth in manufacturing, and lowering the unemployment rate. Multiple Wall Street and Federal Reserve predictions for GDP have been lowered because of the Omicron variant for 2021. GDPNow currently estimates GDP at 7.2% annualized for the fourth quarter.

Section VIII. Conclusion

As Mr. Volcker pointed out, the world continues to evolve and change constantly. Thus it is continually the end of the world as we know it as technology advances and Covid-19 mutates. But we still feel fine about our positions and will continue to monitor our indicators on the lookout for changes of significance.

We wish all a joyous and safe Holiday season and a prosperous New Year!

Scott B. Williams, CFA, CFP
Kent Stone

Chart #1

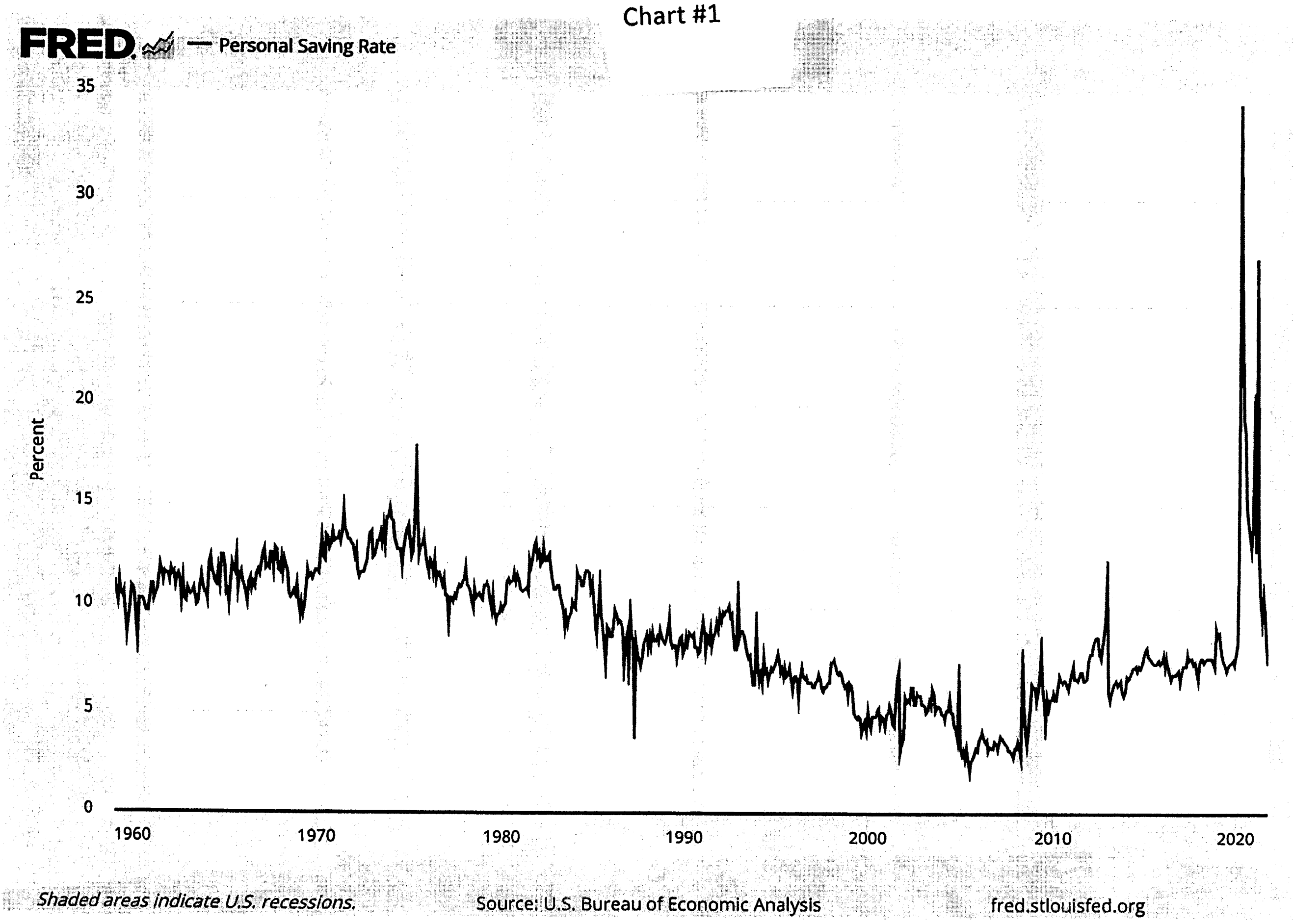


Chart #2

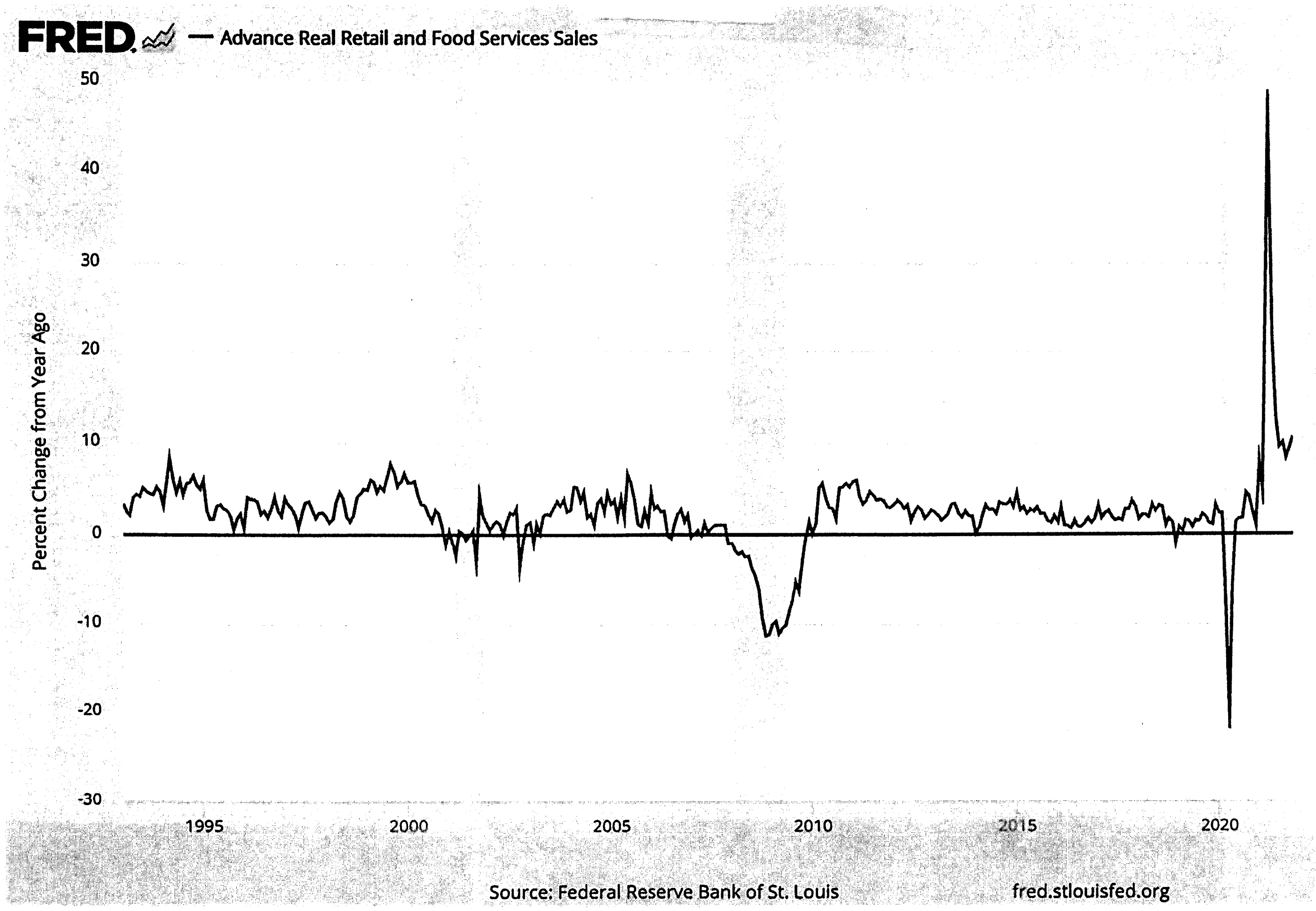


Chart #3

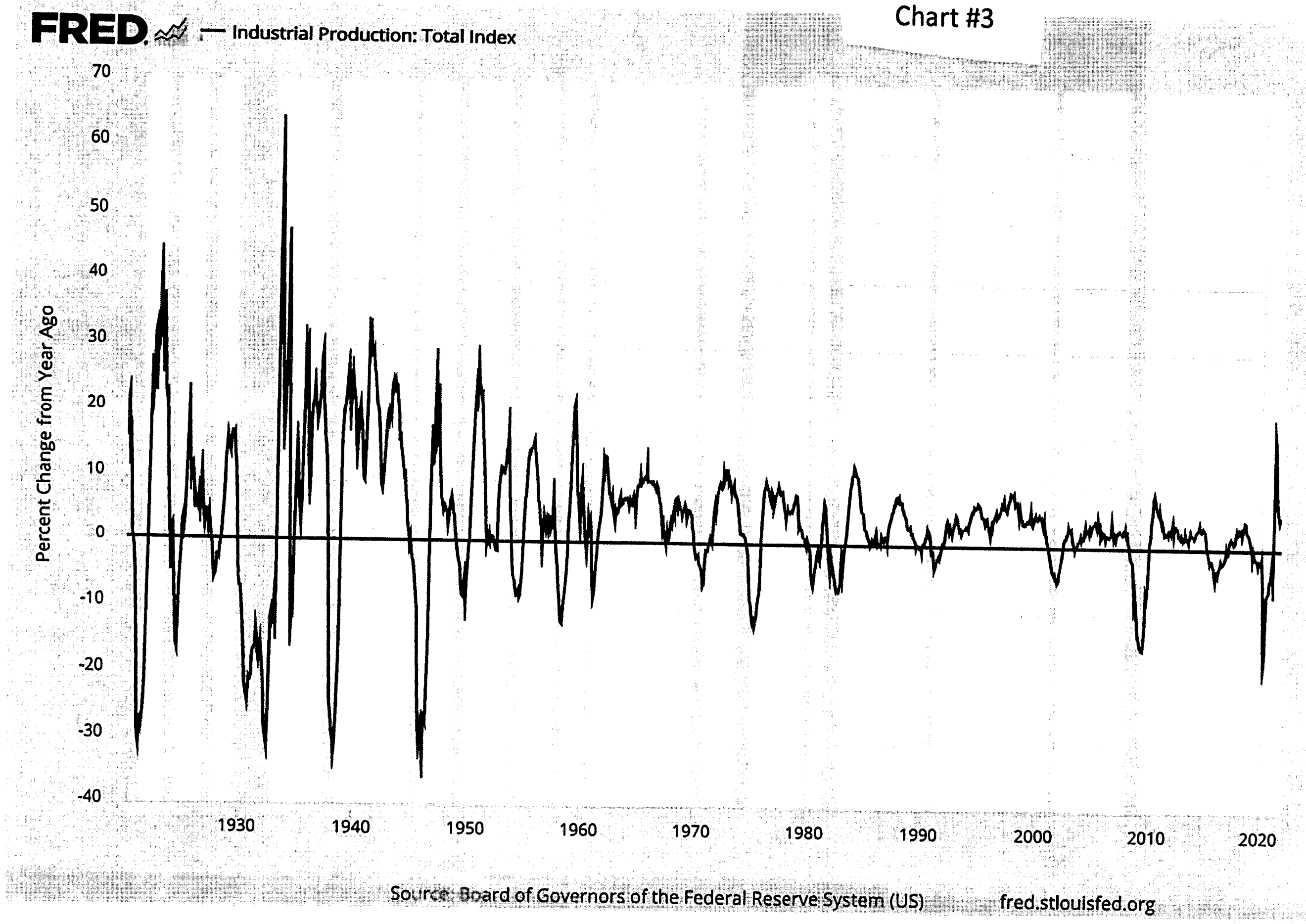
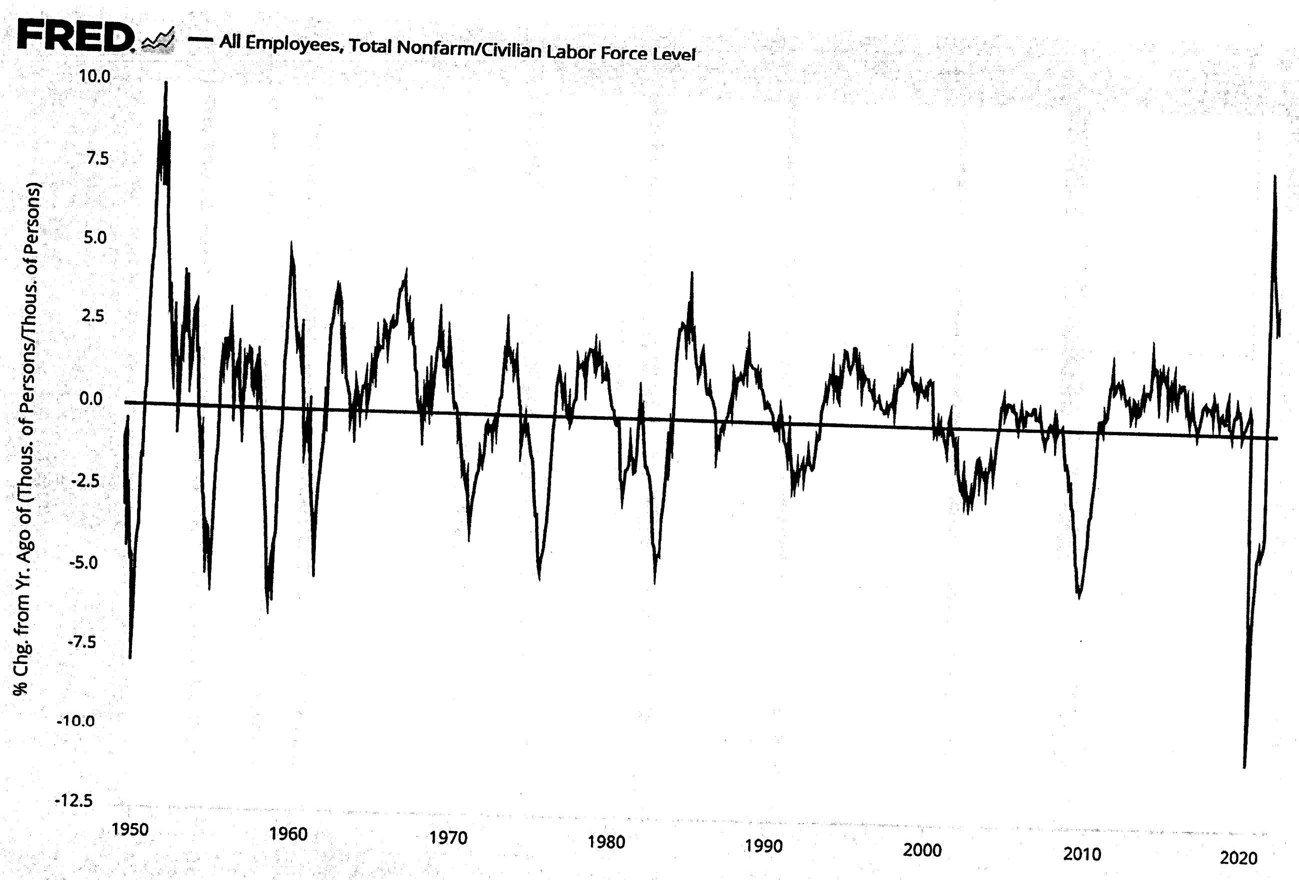


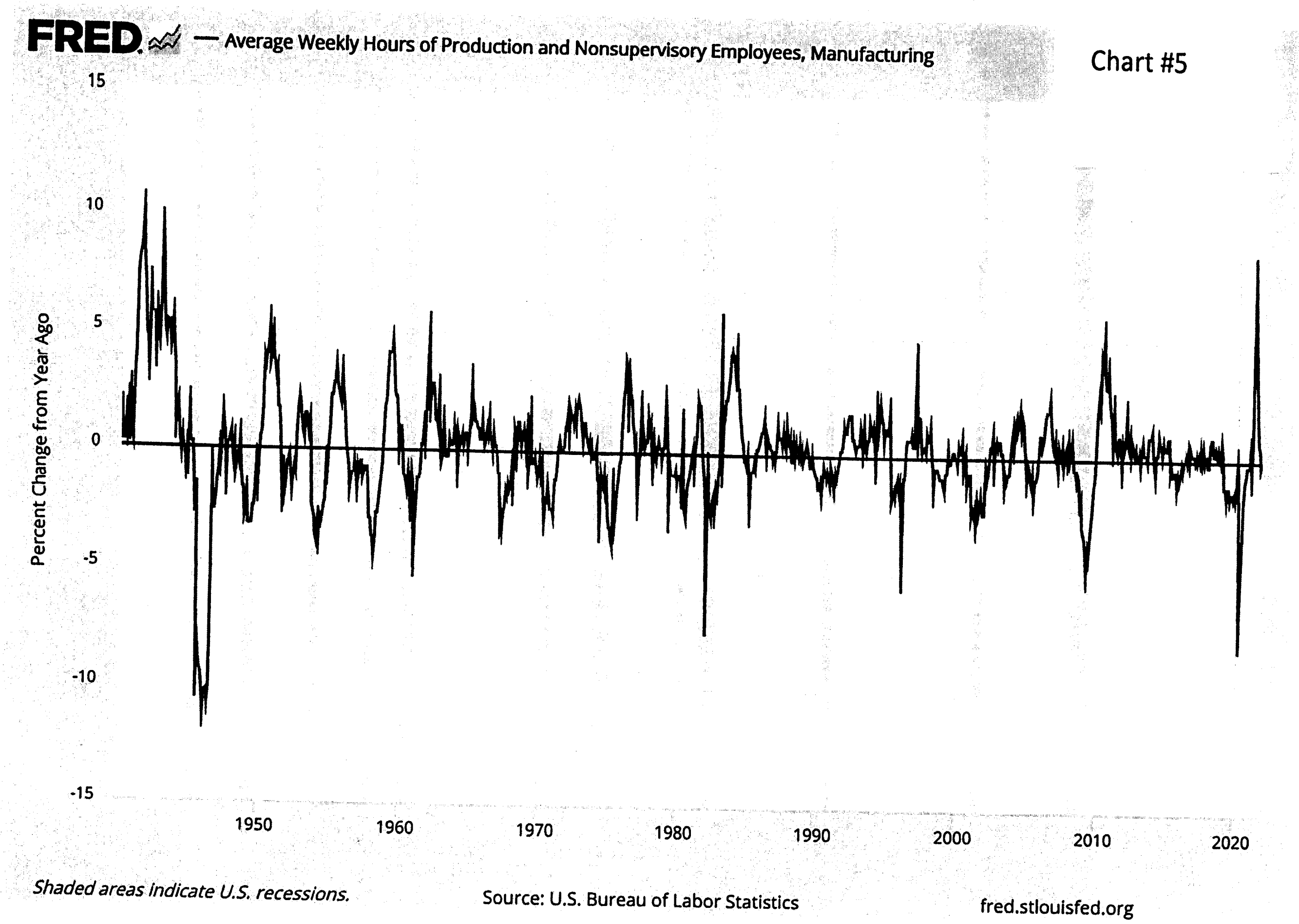
Chart #4



Shaded areas indicate U.S. recessions.

Source: U.S. Bureau of Labor Statistics

Chart #5


FRED
— Average Weekly Hours of Production and Nonsupervisory Employees, Manufacturing
Percent Change from Year Ago
15
10
5
0
-5
-10
-15
1950
1960
1970
1980
1990
2000
2010
2020
Shaded areas indicate U.S. recessions.
Source: U.S. Bureau of Labor Statistics
fred.stlouisfed.org