Financial Markets This Week

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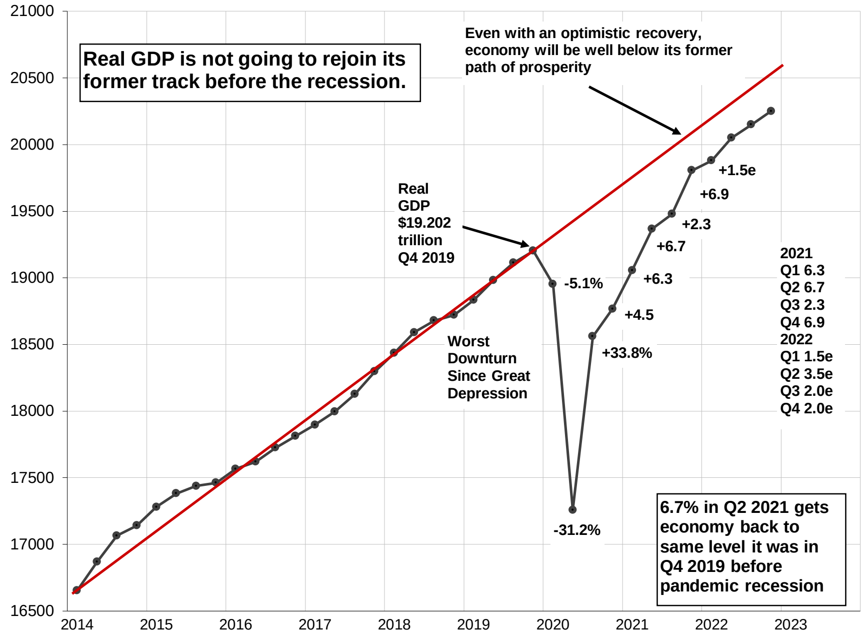
ECONOMY LEAVES 2021 WITH QUESTIONABLE STRENGTH

Breaking economy news Thursday morning. Initial unemployment claims fell 30 thousand to 260 thousand in the January 22 week. Jobless claims have come back down, but are still too high to make the call on whether the economy is out of the woods or not. Also reported was the first look at fourth quarter GDP. Real economic growth jumped 6.9% in Q4 2021, a rebound from 2.3% in Q3 2021, where the average of 4.6% in last year's second half is a better indication of the economy's run rate last year. The strong finish to 2021's record recovery year is welcome, but the surge in fourth quarter growth is already quickly fading early in 2022 and it's not just due to the spread of the Omicron virus. Washington measures to bolster the economy are yesterday's story with the Federal Reserve halting its QE purchases this quarter and the advanced child care tax credit monies no longer being doled out to millions of Americans every month.



Even the 6.9% growth isn't what it appears to be with 4.9 percentage points due to rising inventory levels which hopefully were planned. Also worrying is that business investment in new equipment was nothing to write home about for a second quarter in a row. Exports added 2.4 percentage points to growth, but at the same time America's demand for imports erased 2.4 percentage points from growth showing the U.S. still isn't winning the trade war with the world. Consumer spending is normal at 3.3%. We wouldn't expect a huge lift once people start going out to bars and restaurants more frequently again.

	Q3 20	Q4 20	Q1 21	Q2 21	Q3 21	Q4 21p
REAL GDP	33.8	4.5	6.3	6.7	2.3	6.9
REAL CONSUMPTION	41.4	3.4	11.4	12.0	2.0	3.3
CONSUMPTION	25.5	2.3	7.4	7.9	1.4	2.3
Durables	5.5	0.1	3.5	1.0	-2.5	0.1
Nondurables	4.4	-0.2	2.2	2.0	0.3	0.0
Services	15.6	2.3	1.8	4.9	3.6	2.1
INVESTMENT	11.7	4.0	-0.4	-0.7	2.1	5.2
Business Plant	-0.5	-0.2	0.1	-0.1	-0.1	-0.3
& Equipment and	2.7	1.3	0.8	0.7	-0.1	0.1
Intellectual Property	0.5	0.5	0.8	0.6	0.5	0.5
Homes	2.2	1.3	0.6	-0.6	-0.4	0.0
Inventories	6.8	1.1	-2.6	-1.3	2.2	4.9
EXPORTS	4.6	2.1	-0.3	0.8	-0.6	2.4
IMPORTS	-7.9	-3.7	-1.3	-1.0	-0.7	-2.4
GOVERNMENT	-0.2	-0.1	0.8	-0.4	0.2	-0.5
Federal defense	0.1	0.2	-0.3	0.0	-0.1	-0.2
Fed nondefense	-0.4	-0.4	1.0	-0.3	-0.3	0.0
State and local	0.1	0.1	0.0	0.0	0.5	-0.2

Below line: Percentage point contributions to Q4 2021 6.9% real GDP
Second estimate for Q4 is Thursday, February 24

The economy is strong today with 6.9% growth, but all bets on growth continuing to bring prosperity to millions of jobless Americans are off in 2022 as the Federal government and the Federal Reserve pull the plug on the emergency stimulus provided during the pandemic. Policymakers can only fight a war on one front at a time and with inflation raging out of control, the focus will shift to measures meant to slow demand, and slower economic growth means fewer new jobs.

Growth in the first quarter got revised by many economists after Friday data on real consumption purchases from the personal income report. The question is whether there will be growth as consumer spending fell in November and December which doesn't look virus related. So at the moment, real consumer spending rose 3.3% in Q4 2021, but is falling 3.0% in Q1 2022 unless there is additional spending in January, February, and March. We forecast +1.5% real GDP in Q1 2022, but growth is a close call. Finally we would note that business investment in equipment slowed in the second half of the year. Our monthly proxy for business investment is nondefense capital goods orders ex-aircraft and these nominal orders ran 8.0% in Q3 2021 and 8.7% in Q3 2021. Equipment in the GDP accounts were much weaker. Computers were strong, but transportation equipment, like cars and light trucks, fell sharply. Farm machinery seems to be weak as well.

Fed Chair Powell has it all wrong about a return to strong economic growth being dependent on the virus. The economy is set to slow as it leaves the recovery phase powered by pent up demand and moves into the mature balanced trend-based growth phase. Normal economies do not advance at 2021's 5.7% rate of growth. It is an anomaly due largely to the rebound from the economy's sharp 3.4% pandemic recession decline in 2020. The economy will return to a normal speed, certainly of less than 2.5%, in the months to come especially as the rollout of the Federal Reserve's own policies is designed to slow growth and fight the fires of inflation. Fed policymakers will have to be extremely careful at threading the needle when they raise interest rates to slow the economy this year as every other Federal Reserve in history has raised interest rates too high and brought the economy crashing back down.

Equipment spending slows second half of 2021, computers/software remain strong — Real Percent Changes Annualized

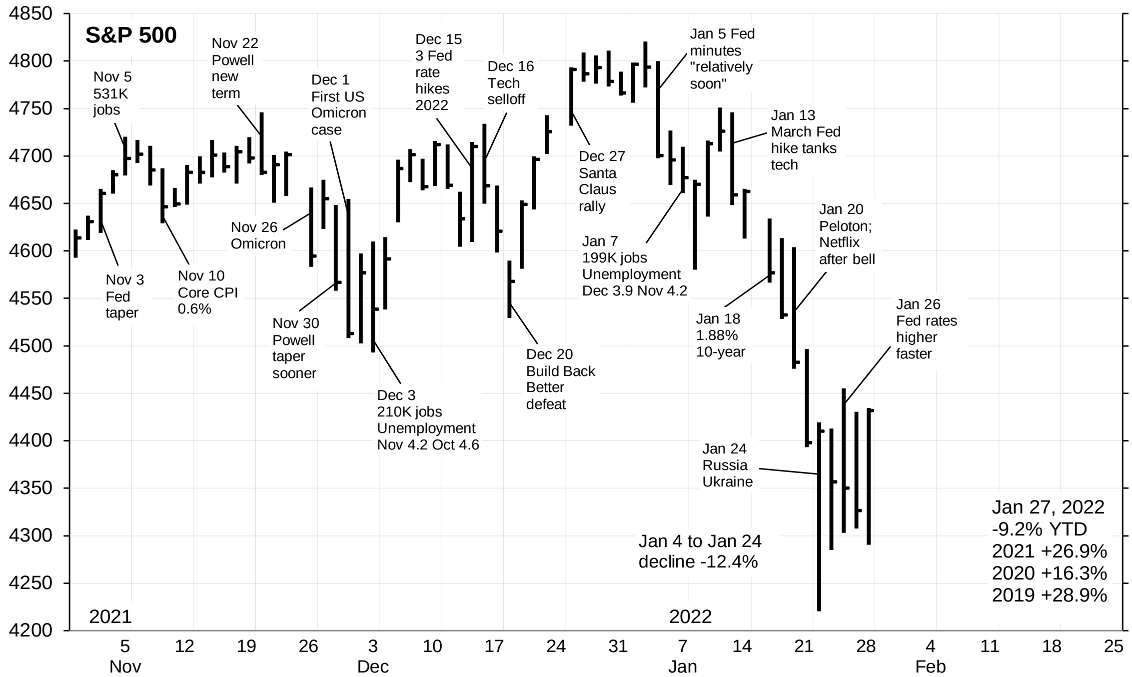
$BLN Nominal GDP expenditures	Q4 17	YOY%	Q4 18	YOY%	Q4 19	YOY%	Q4 20	YOY%	Q4 21	YOY%	Q1 20	Q2 21	Q3 21	Q4 21
Core Durable goods orders *	63,714	7.3	65,430	2.7	65,292	-0.2	70,603	8.1	78,972	11.9	11.9	19.1	8.0	8.7
EQUIPMENT	1152.0	6.7	1224.2	6.3	1210.3	-1.1	1197.5	-1.1	1300.6	8.6	14.1	12.1	-2.3	0.8
Information processing equipment	382.1	8.2	390.6	2.2	390.2	-0.1	447.3	14.6	488.5	9.2	26.0	-7.8	-1.4	24.7
Computers	108.2	10.0	119.2	10.2	118.9	-0.3	138.9	16.8	155.5	12.0	45.1	-35.8	12.2	35.6
Other processing equipment 1	273.9	7.5	271.4	-0.9	271.3	0.0	308.5	13.7	333.0	7.9	18.0	8.5	-6.7	20.0
Industrial equipment	231.7	8.1	250.1	7.9	247.8	-0.9	253.4	2.3	310.8	22.7	7.2	32.9	6.6	15.2
Transportation equipment	303.7	4.9	325.2	7.1	307.4	-5.5	217.1	-29.4	203.6	-6.2	7.6	52.1	-16.3	-38.2
Other equipment 2	234.5	5.3	258.3	10.1	264.8	2.5	279.7	5.6	297.7	6.4	7.6	3.3	-0.6	-11.2
INTELLECTUAL PROPERTY	897.0	6.4	987.7	10.1	1057.0	7.0	1112.9	5.3	1250.2	12.3	15.6	12.5	9.1	10.6
Software	376.2	8.5	412.8	9.7	439.1	6.4	466.0	6.1	526.9	13.1	26.4	14.1	9.3	12.7
Research & Development (R&D)	433.8	5.2	483.7	11.5	524.3	8.4	561.3	7.1	621.1	10.7	9.7	11.2	7.2	6.7
Entertainment, literary, artistic	87.0	3.9	91.2	4.8	93.6	2.6	85.6	-8.5	102.2	19.4	0.0	12.2	21.0	24.2

1 Communication, medical, photocopy, office and accounting equipment; nonmedical instruments

2 Furniture; agriculture, construction, mining/oilfield, and service industry machinery; electrical equipment

* Nondefense capital goods orders ex-aircraft $mln: monthly proxy for business investment spending (not in GDP report)

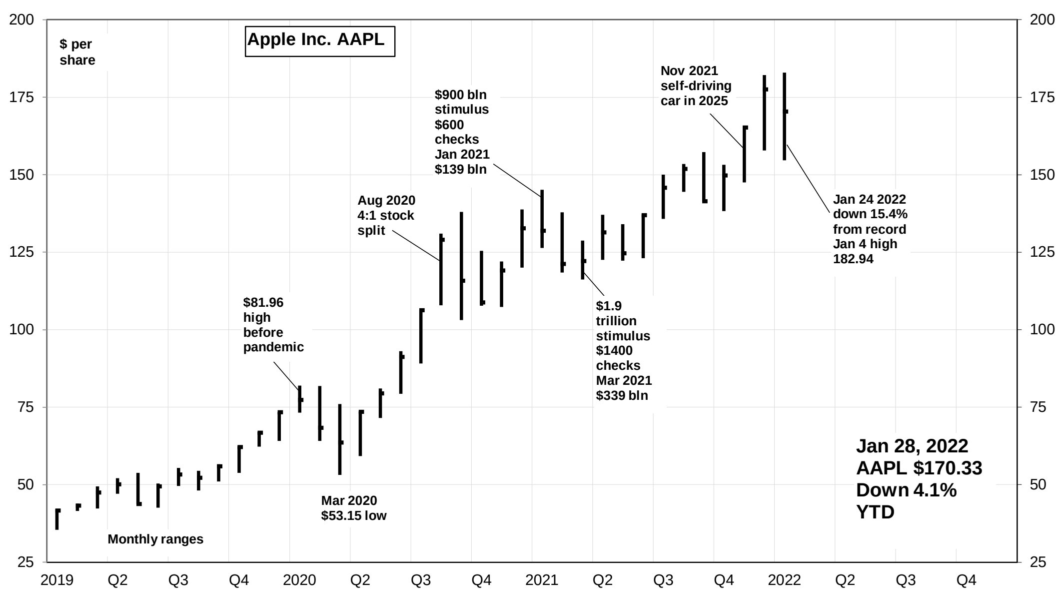
INTEREST RATES



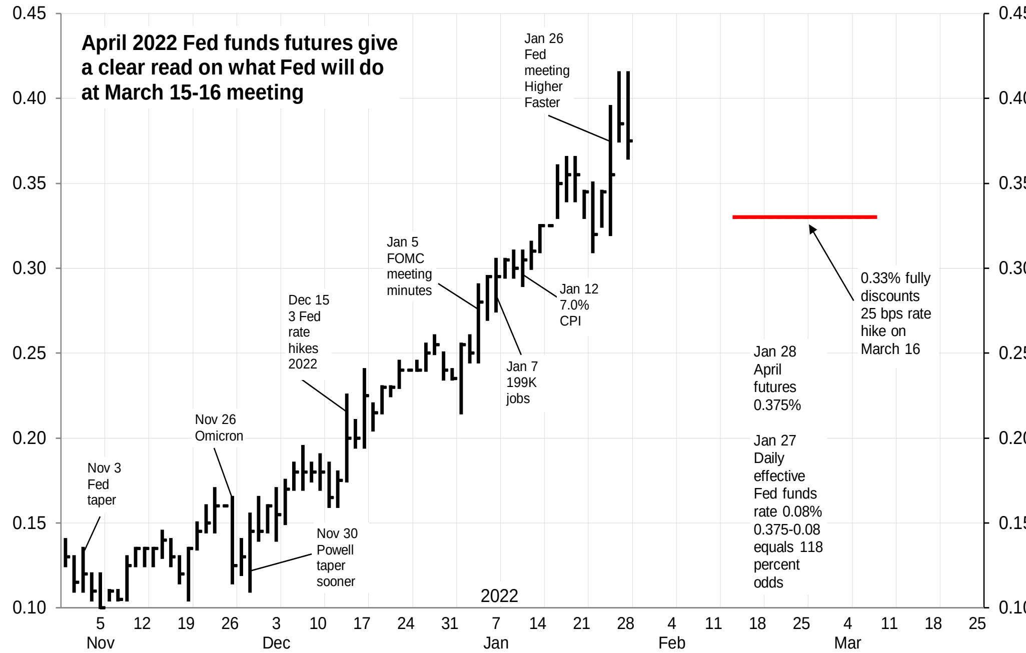
12.4% loss for the S&P 500 from the January 4 record high was hit on Monday. Selling for Russia Ukraine reasons, there was an options expiration on Friday… anyway it was still off 10.9% Friday morning before the day's 2.4% rally took hold. Stocks were up ahead of the Fed's announcement on Wednesday, but lost it on Powell's faster and higher rates theme that the market thought it heard at the press conference. Bond yields more complicated with the Fed's news flattening the yield curve. 10-year Treasury yields were about 1.78% at 2pm ET Wednesday before the Fed and rose as high as 1.88% by the end of the day, closing Friday at 1.77%. Fed March 16 decision date long way away.

Apple AAPL jumps 7.0% Friday after earnings after bell Thursday

We thought the company might eventually slow down, problems perhaps with China sales or iPhone sales, but we're economists here and even ignored our own purchase of an iPhone last quarter as a measure of extraordinary demand. No real forward guidance again besides fewer supply constraints and solid year-year growth expected this quarter. Q1 2022 revenues up 11.2%, if last year's pattern holds, following the Q4 2021 record holiday sales quarter of $123.9 billion with $71.6 billion iPhones.



FEDERAL RESERVE POLICY



The Fed met on January 25-26, 2022 to consider its monetary policy. Bond yields went up on the 2pm ET press statement saying appropriate soon, meaning the March meeting. Yields kept drifting higher and maybe moving higher at a faster pace on Powell's first question. He said no decisions have been made on the rates path this year, but then he looked down and largely read something suggesting he was prepared ahead of time for the rates question and wanted to get the message right: "So more to your question 9:10, we know that the economy is in a very different place than it was when we began raising rates in 2015. Specifically, the economy is now much stronger. The labor market is far stronger. Inflation is running well above our 2 percent target, much higher than it was at that time. And these differences are likely to have important implications for the appropriate pace of policy adjustments. Beyond that, we haven't made any decisions." This comment more or less is why the market thinks interest rates will move higher and faster than before the meeting. Some primary Government securities dealers think the Fed will raise rates at every meeting this year, seven more, which based on our fingers-counting puts the Fed funds rate at 2.0% at the end of the year. Yikes. Doesn't sound advisable. Hey, but that was the pace in 2004-2006. Dealers were emboldened by Powell saying at the press conference, "I think there's quite a bit more room to raise interest rates without threatening the labor market." It was either that comment or dealers want their customers to hedge against rising interest rates. Come on. Make a trade.

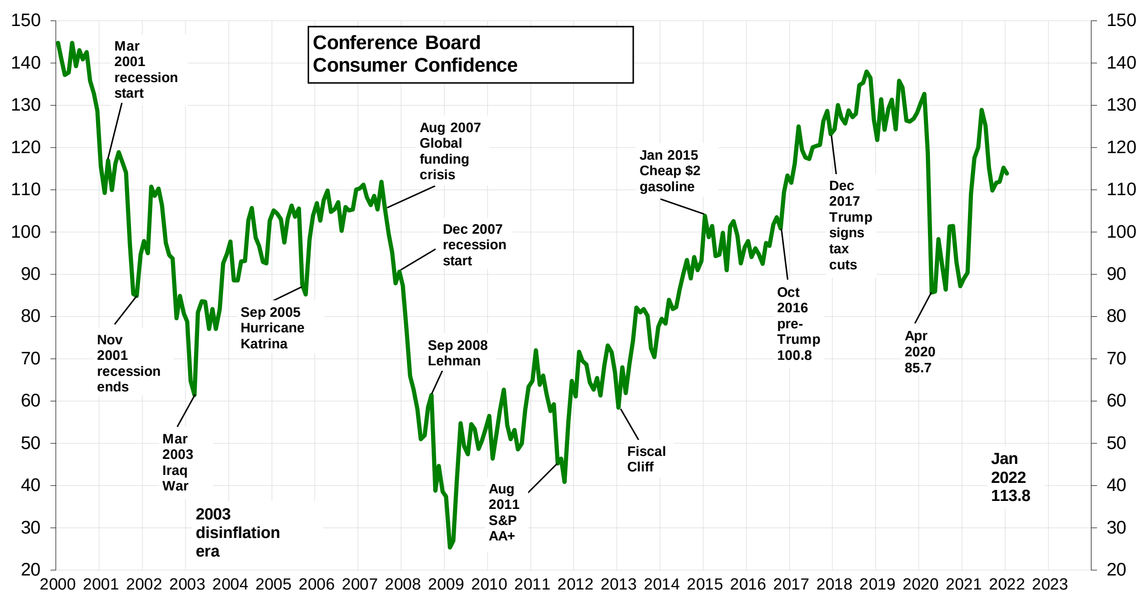
It is easy to forget that on January 1 this year, most of the market wasn't thinking a first rate hike in March was a strong possibility, but now it is in the statement and Powell in Q&A said most participants thought March. If they go in March, then they are probably going every other meeting again (4 X annually) like last time which means a Fed funds rate of 1.25% at the end of the year, which is different from the 3 rate hikes in 2022 that were in their December meeting forecasts. This means to us that the 2-year Treasury note needs to be 1.25% to reflect that one-year yields at the end of 2022 will also be 1.25% after four rate hikes now. At 2pm ET on Wednesday before the Fed press statement the 2-year yield was more like just 1.03%. The 2-year yield closed at 1.15% on Wednesday and went as high as 1.21% in Asia and Europe trading that night. The 2-year note closed Friday at 1.16%. Rates need to take a rest after causing mayhem this year. We will never forgive them for helping to send our S&P 500 stocks down as much as 12.4 percent from the highs of the year on Monday this week. Sit down and rest, markets. Rest. Like we tell the dog.

OTHER ECONOMIC NEWS

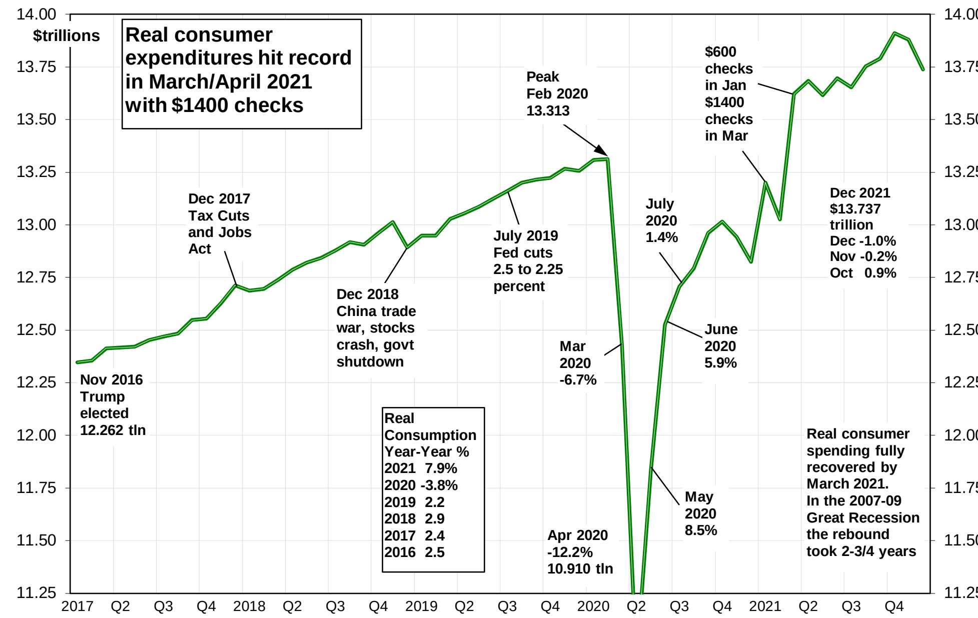
Consumer confidence okay today, but tomorrow… (Tuesday)

Breaking economy news. Consumer confidence fell slightly in January to 113.8 from 115.2 in December. Consumers are feeling better about the outlook than they were in late summer due to the Delta variant and the first case of the new Omicron virus in the U.S. on December 1 hasn't shaken confidence much if at all. The consumer says the labor market isn't as favorable as it was, at least in the future, where fewer jobs are expected to be available. The confidence reading today suggests consumers will continue to spend the dollars needed to help the economy grow, but the future may be less favorable as Wall Street is sending shivers down the spines of many investors and consumers alike. Consumer confidence is okay today, but tomorrow is likely to be a different story.

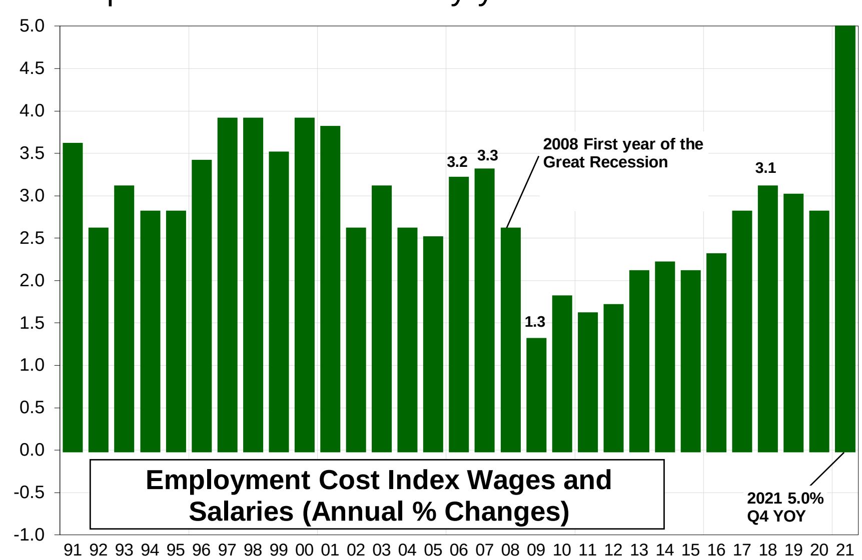
Net, net, consumer confidence remains high for now, but the latest reading is likely to be the calm before the storm given the turbulence in financial markets the last two weeks. This confidence survey famously is said to focus more on the economy and jobs market, but we don't remember consumer confidence remaining high for long historically when Wall Street is in a tailspin. Consumers already think business conditions will not be as positive six months from now before the stock market tumbled. The cutoff date for the survey was January 19 when the S&P 500 closed down 4.9% year-to-date. Stocks were down as much as 11.4% year-to-date yesterday during the wildest trading session in years. One thing the stock market collapse does is create uncertainty about the economic outlook and an adjustment in the public's expectations will likely spillover to consumer confidence.



Wages are up, priming the pump on inflation (Friday)

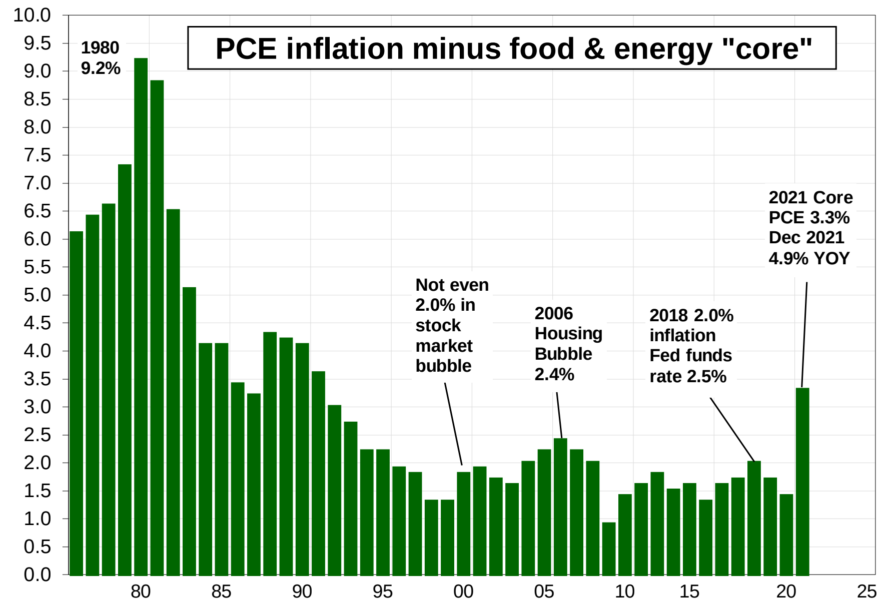


Breaking economy news. Personal income is up, but it isn't going to be enough to buy the sky-prices on those store-bought goods if you can find them. Let's see wages and salaries are up 4.5% the last year, but PCE inflation is up 5.8% the last year, and core consumer goods minus food & energy are up 4.9% the last year. There is a labor shortage in the country plain and simple and it is sending worker wages soaring to new heights. The Employment Cost Index jumped 1.0% in the fourth quarter of 2021 and is 4.0% higher than the year before. Wages and salaries rose 1.1% in the fourth quarter and are 4.5% more than last year. It's not all good news as the term in economics called money illusion is back. There's more money in your wallets and purses but because of the inflation, your money buys less than it used to. No one wants to go back to the 80s, but the economy is. Can stagflation from an overly aggressive Fed be next? The Federal Reserve let its guard down and now they risk it all by saying they might have to move faster and higher on interest rates. Make no mistake about it, central bankers are seeking to slow economic growth which isn't going to be a good thing for Americans if job opportunities and wealth building investments vanish overnight. Make no mistake about it, Fed officials want mortgage rates to go up and make it more expensive to borrow to buy your dream house. For the economy, maybe the dream is over.



If the consumer is two-thirds of the economy, the economy is in trouble this year where durable and nondurable goods purchases were down in both November and December which was before the first U.S. case of Omicron was discovered on December 1. And the sharp rise in positive cases didn't start until a couple of days before Christmas so we doubt Omicron is the reason for a slowdown in economic growth. Real consumer spending rose 3.3% in the fourth quarter, but because of the steep drop at the end of last year, real consumer spending this year is starting off the first quarter from December's depressed level with a shocking decline of 3.0%. Given 4.9 percentage points of real GDP's Q4 2021 6.9% gain was inventory rebuilding, it will be a miracle if we see any economic growth at all in the first quarter.

Net, net, wages are up and priming the pump on inflation pressures creating a dangerous wage-price spiral that is going to be hard to reverse. One of the reasons the Federal Reserve is planning for faster and higher interest rates is because wages and salaries are going up faster and higher than anyone would have predicted. There is a labor shortage out there and that is fueling the fire of inflation as headhunters scour the country to fill the slots for workers that companies demand. The reason there is nothing on the store shelves is that there is no one to put the goods out on the store shelves.



The wage-price spiral is back big time with the economy getting absolutely clobbered by a rise in inflation that just won't stop. It was just Wednesday at the Fed meeting press conference that Powell said he thought that inflation was slightly worse than it was in December, and now today's one-two punch of more consumer inflation and higher ECI wages shows inflation is worse yet again. No wonder Powell made a thinly veiled attempt to jawbone markets saying the economy was stronger with more inflation than the last time the Fed attempted a rates liftoff in 2015 implying stronger medicine of faster higher interest rates might be required to rein in the economy this time around. Stay tuned. With no growth this quarter and the first of many Fed rate hikes in March, we are doomed.

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