MJM INVESTMENT ADVISORS, INC.

2022 Investment Outlook

Game Changer

“There’s a real risk now, I believe, that inflation may be more persistent.”

– Federal Reserve Chair Jerome Powell

"It may become warranted to increase the federal funds rate sooner or at a faster pace than participants had earlier anticipated. Some participants also noted that it could be appropriate to begin to reduce the size of the Federal Reserve's balance sheet relatively soon after beginning to raise the federal funds rate. Some participants judged that a less accommodative future stance of policy would likely be warranted and that the Committee should convey a strong commitment to address elevated inflation pressures."

– December Meeting Minutes of the Federal Open Market Committee

"The sensitivity of assets to a tightening is bigger than the sensitivity of the economy,"

– Jason Rotenberg – Bridgewater Associates

For over a decade, global central banks led by the U.S. Federal Reserve (Fed) have maintained ultra-accommodative monetary policies to support the global economy. When the C-19 pandemic hit in early 2020, the Fed had to pull out all the stops to offset the negative effects of the pandemic. It quickly implemented ultra-accommodative policies by buying $120 billion a month of Treasury and mortgage-backed bonds and cutting interest rates to 0%. Starting in the summer of 2020 and throughout 2021, the U.S. economy staged an impressive economic rebound. The potent mix of recovering demand, stressed supply chains, and $7 trillion of monetary and fiscal stimulus led to rising and elevated inflation levels throughout 2021. The Producer Price Index rose 9.7% during 2021, the highest annual increase on record. The Fed’s message to financial markets was that inflation was transitory and would eventually decline even as inflation rose and became a bigger problem as the year progressed. It was only after persistent and rising levels of monthly inflation that the Fed finally relented and Chairman Powell announced the Fed would alter its monetary policy path. Starting in November, the Fed tapered its QE related bond buying by $15 billion a month and at its December meeting the Fed announced it was increasing the pace of QE tapering by $30 billion a month and would end the QE program by March.

Before the global pandemic, the U.S. economy experienced weak inflation over the previous decade, something that was a continual concern of the Fed. Weak inflation came with below average economic growth no matter what central banks did to try and stimulate economic activity. That all changed in March 2020 with the onset of the Covid-19 pandemic, which forced fiscal and monetary authorities to act in a very aggressive manner. The U.S. government pumped over $3 trillion of deficit spending into the U.S. economy and the Fed cut interest rates to zero and instituted Quantitative Easing of over $4 trillion of bond buying. The pandemic caused massive shifts in society and consumer activity, as work-from-home trends and consumer durable goods spending exploded while consumer services and employment associated with it plunged. Global outsourcing and supply chains became dysfunctional as C-19 negatively impacted goods production while fiscal stimulus spending accelerated demand. The just-in-time inventory and global outsourcing mentality of the past twenty years couldn’t handle the change.

Starting in early 2021, prices began to rise as supplies were constrained and demand accelerated and product shortages became common. The next chart shows how prices for goods surged higher during 2021. The latest data shows goods price increases may have peaked but now services prices are escalating.

Source: Bloomberg

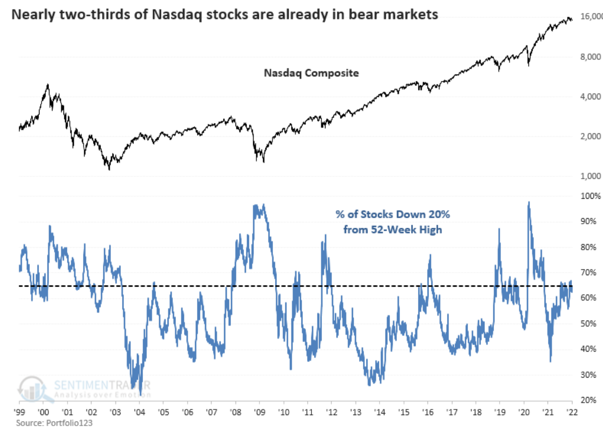
Major changes in the labor force also began to impact labor supply and C-19 waves caused production slowdowns. Many retirement age people dropped out of the workforce (appr 3.5 million >55), parents were forced to stay at home given school shutdowns and remote learning, and businesses were having trouble filling positions. The unemployment rate dropped throughout 2021 and then wage gains began to accelerate as employers raised wages to incentivize workers to come off of the sidelines. The Fed continued on with its ultra-accommodative policies even as the evidence mounted that inflation was becoming more problematic.

By the end of 2021, headline CPI hit 7% and wage gains were coming in hotter than expected at just under 5% for the trailing 12 months. The Fed finally changed its tune late in 2021, announcing plans to taper bond buying under its QE program and end QE by March. The Fed also indicated interest rate increases could start sooner rather than later. The Fed December meeting minutes released in the first week of January showed a surprising degree of concern on the part more members of the FOMC that inflation was a growing problem and having a negative impact on more Americans. There was some acknowledgement in the meeting minutes that the Fed may need to act more expeditiously.

Since the Global Financial Crisis of 2008, investors have become accustomed to the Fed having their back and being overly willing to supply and maintain accommodative monetary policy conditions. This setup (known as the Fed put) has had a significant positive impact on rising financial markets and created rich valuations for most financial assets. The Fed was able to maintain its position because inflation was never a threat but 2021 was a game changer in that regard. The Fed has had to acknowledge its outlook for transitory inflation was wrong and it now needs to reverse course and wind down its ultra-accommodative monetary policies to help bring inflation back down towards its 2% annual target. As a result, 2022 is going to be a much different and challenging environment than investors have come to expect for some time. The change in the Fed's position is a game changer.

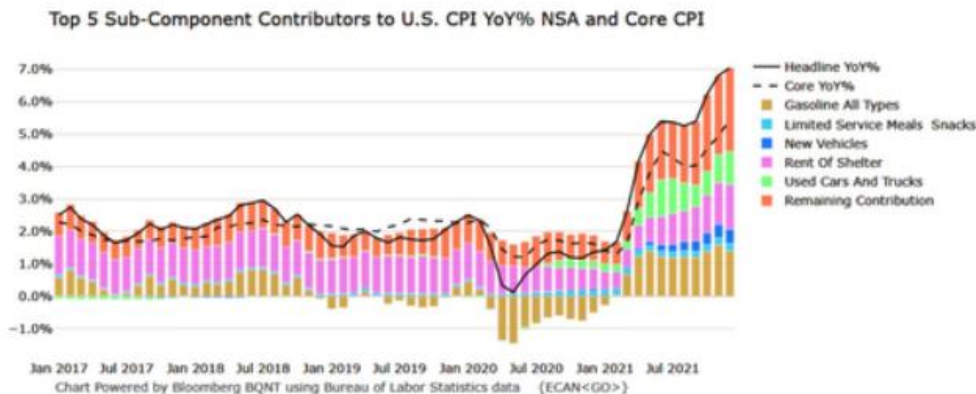
2021 marked the 3rd consecutive year that the broad U.S. stock market returned above 20%, which is significantly above the long-term (since 1934 or 88 years) annualized return profile of nearly 11% per year.

However, 2021 was also a deceiving year because even though the S&P 500 Index returned +28.7%, the average stock returned much less and the returns for the broad stock market were heavily dominated by a narrow subset of the largest stocks. Small cap stocks as measured by the Russell 2000 Index returned only +14.8%. Small caps peaked early in 2021 and then declined for the rest of the year, even as the broad market continued to rise. The next chart of the Nasdaq Composite shows that over 60% of Nasdaq stocks had declined 20% from their 52-week high by the end of 2021 even as the index made new highs.



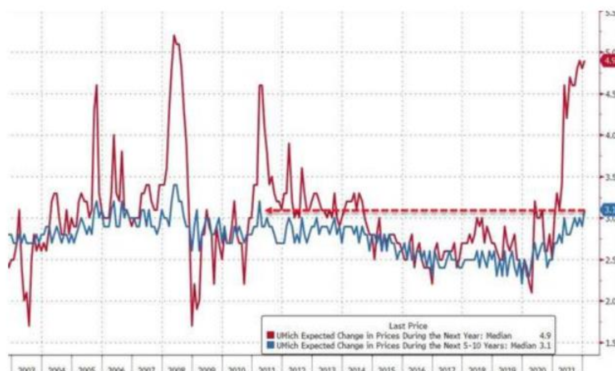
Emerging markets fared worse as the MSCI EM Index ended 2021 with a -2.5% return or nearly 32% less than the S&P 500 Index return. As the year progressed, investors stayed invested in the stock market but rotated their positioning to get more defensive by the end of the year.

Strong stock market returns for an extended period of time tend to distort investor expectations and create a sense of complacency that elevated returns are the norm. The game is changing and 2022 should be more of a reality reset than most investors expect. The most important factor that will influence financial markets performance in 2022 is the rate of inflation and whether it remains above expectations. If inflation remains persistent, it will force the Fed to raise interest rates either faster or more frequently than the market expects. The current Wall Street consensus forecast is for inflation to decline to 3.3% in 2022, still well above the Fed's 2% annual inflation target. The annual headline inflation rate at the start of 2022 is 7% and core CPI is at 5.5%, the highest levels since 1982. The next chart breaks down the CPI by its components and shows the dramatic move higher in inflation over the course of 2021.



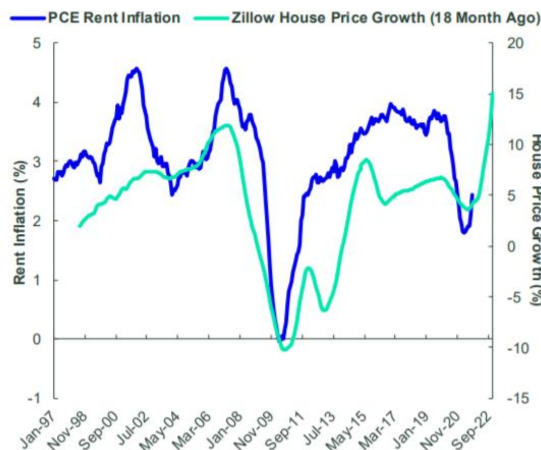
Source: Bloomberg

The latest University of Michigan Consumer Survey for December showed consumers expect inflation to be 4.9% in 2022. The chart below shows how consumer inflation expectations rose throughout 2021 (red line) and how longer term inflation expectations (blue line) are also rising. In addition, the latest NFIB survey of small businesses showed that 22% of small business owners said inflation is their top concern, the highest reading in 41 years. What makes it more difficult for the Fed is when consumer and business inflation expectations are well above its own forecasts. It indicates the Fed is behind the curve and needs to act to bring future inflation expectations back under control.

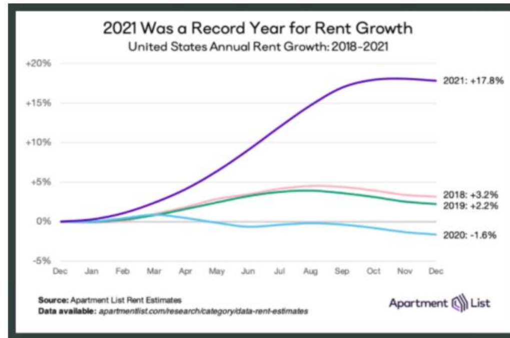


Source: Bloomberg

It is highly unlikely that the headline CPI level will remain at its current 7% profile and will moderate over 2022 but how much it moderates will be a major factor for 2022. One key component of the Consumer Price Index (CPI) is the owner's rent equivalent reading, which makes up a very large portion of CPI at 23% plus there is another 7% related to another housing related inflation gauge called Rent of Primary Residency. For most of 2021, housing related inflation in the CPI calculation was much lower than headline inflation and in stark contrast to the large rise in housing prices nationally, with many markets seeing over 20% price increases. Housing price increases tend to lead rent increases by about 18 months. The chart below shows that PCE Rent inflation has only begun to turn higher and this component of CPI should have more upward pressure as we move through 2022. This makes intuitive sense in that rental contracts are set annually and as leases hit their annual renewal then landlords raise rents based on current market conditions.



2021 showed this trend is already firmly in place as the next chart of annual rent increases for the past four years indicates.



Wage growth represents another important source of inflation. The U.S. is in a tight labor market with the unemployment rate now at 3.9% (it was 3.5% just prior to the start of the C-19 pandemic) and where the number of jobs available exceed the number of unemployed workers. Virtually everywhere you look businesses are short workers and have Now Hiring signs posted. Employers posted 10.6 million job openings in November, the six straight month the figure topped 10 million. This figure compares to 6.9 million unemployed people across the U.S, meaning there are 1.5 unfilled jobs per unemployed person. Another eye-opening data point is the number of workers voluntarily quitting their jobs, which surpassed 4.5M in December, an all-time record. This unusual labor market setup has been heavily impacted by the number of workers job hopping to increase wages combined with the number of people still on the sidelines due to the impact of C-19 on their lives. What this means in practice is that employers are being forced to outbid each other to attract workers, especially in the minimum or low wage job categories, which account for 20% of the labor force.

It is highly likely that wage pressures will continue in 2022 until the labor supply/demand imbalance improves. The next chart shows how wage inflation is accelerating and after a long period of low wage increases. Wage growth is now just getting back to 2008 levels before the Global Financial Crisis hit. The annualized wage gains in the December Non-Farm Payrolls report came in at +4.7%, the highest reading going back to 2000. It is important to note that this wage gain level is still below the CPI, which means that the average worker is experiencing negative real wage growth given elevated inflation levels.

The combination of rent and wage increases means inflation should remain well above the Fed's 2% annual target during 2022 and should remain above 3% for most of the year. If that happens, the Fed is likely to remain on its path of monetary policy tightening. Once QE is finished in March, the Fed is likely to end its Zero Interest Rate Policy and start to raise the Fed Funds rate shortly thereafter. The December Fed meeting minutes released during the first week of January indicated the FOMC also discussed reducing the size of the Fed's balance sheet. This news spooked financial markets, with stocks heading lower and bond yields surging higher.

The next chart from Goldman Sachs using U.S. Federal Reserve data shows how higher inflation expectations have become more embedded into market expectations. The implied probability that CPI will exceed 3% rose dramatically throughout 2021 while expectations of low inflation have plummeted. More than any specific inflation datapoint, when expectations for higher inflation become more ingrained into society, the Fed's job become more difficult and it is likely to act to counter those expectations. Remember the Fed has a Congressional directed, dual mandate towards full employment and controlled inflation. The full employment test has been met. The Fed's annual inflation target is 2% and the actual inflation level today is much higher. The December University of Michigan Consumer Survey showed 25% of respondents cited the negative impact of inflation on their standards of living. The Biden Administration has no doubt made it clear to Chairman Powell that this situation must be addressed.

Source: FED

Another game changer for 2022 is that inflation is forcing the Fed to withdraw monetary support just as the C-19 Omicron variant is negatively impacting economic activity. Omicron cases started soaring globally in mid-December and new U.S. weekly cases were over 1,000,000 in early January, exceeding the prior peak experienced in January 2021 by a staggering amount. According to former FDA Commissioner Dr. Scott Gottlieb, the Omicron variant wave should peak in a few weeks and be close to ending by the end of February. The good news is Omicron is less deadly than either Delta or prior variants even though it is much more transmittable. However, the more transmittable nature of Omicron has more negative consequences for near-term economic activity as a larger number of people quarantine. Businesses and state and local governments are implementing restrictions again (New Year's Eve was a bust) and this will cause consumer and business activity to decline and first quarter real GDP growth to be weaker than expected. Employment data like average hours worked are declining due to service businesses like restaurants having to shut down or limit capacity again. An example of negative economic impact of Omicron is the number of Americans dining in-person in restaurants was 28% below pre-pandemic levels

for the week ending December 28th, according to data from OpenTable. The decline reflects the biggest drop since April 2021 when the Delta variant was prominent.

Another issue will be the extension of the global supply chain disruptions as key manufacturing countries like China shut down economic activity to contain Omicron and this will lead to supply constraints being extended further into the future. China completely shut down the city of Xi'an (population 13 million!) to control a C-19 outbreak. Semiconductors including memory chips are one area that have been a major problem and improving supply will be pushed out even further into the future. Global auto production is just one example of how supply chain disruptions are negatively impacting sales. U.S. auto sales in December were at an annualized 12.7 million level and there were about 2 million additional autos that would have sold in 2021 if it weren't for component shortages. Both new and used car inventories in the U.S. are at record lows and prices have risen significantly, adding to the inflationary pressures felt by many Americans.

All that being said, as we have seen in previous C-19 variant waves, as cases peak and then recede, economic activity rebounds quickly and economic growth in the future catches up. Before Omicron, first quarter real GDP forecasts for the U.S. were in the 5%-6% range. Now, first quarter real GDP growth estimates have been cut to 1.5% to 2.0% but second and third quarter real GDP growth rates increased to near 7% in anticipation of the catch-up effect as the Omicron wave recedes, restrictions ease, and economic activity recovers.

Slowing economic growth combined with the Fed reducing its accommodative policies to try to rein in inflation will serve as a double negative and most likely create more headwinds early in the year for financial markets. However, if Omicron serves to be an important turning point in changing C-19 from a pandemic to an endemic, then this near-term economic slowdown will quickly be forgotten.

A key question for 2022 is what may alter the ongoing path of rising asset prices and above average stock market returns? Two factors may play a major role as the year plays out. The first is short-term interest rates. The Fed and other major central banks have suppressed short-term interest rates since the 2008 Global Financial Crisis. The Fed was steadily increasing interest rates during 2018 until financial markets had a major tizzy fit and stocks declined by over 20% during the fourth quarter of that year. Starting in January 2019, the Fed backed off on further interest rate increases and began to cut interest rates once again, which lead to a major move higher in U.S. stocks. When the C-19 pandemic hit in early 2020, the Fed cut interest rates by 1.5% to 0% and has held them there since.

The next table breaks down the past 88 years of annual stock returns (since 1934) into periods of rising and falling short interest rates and calculates the geometric mean return during those periods. The data shows that periods of declining interest rates have a more positive impact on stock returns than periods of rising interest rates by a fairly wide margin of nearly 7% annually. In other words, more tailwinds occur for stocks when short-term interest rates are falling and more headwinds occur when short-term interest rates are rising. For the past three years when short-term interest rates were falling or at zero, U.S. stocks returned an average of 26% per year.

	Number	Average Return
Years With Falling Short Term Interest Rates	38	14.61%
Years With Rising Short Term Interest Rates	45	7.72%
Total Years*	88	10.99%

* There were four years with unchanged rates; the first year in the study (1934) was excluded since we did not have 1933 rate data

Source: Seeking Alpha - Ploutos

The Fed made important changes to its monetary policy plans at the past several meetings. It's Quantitative Easing policy is being wound down (tapering) faster and is now expected to end in March. This will remove an important liquidity driver to financial assets. In addition, barring some material decline in the economy, and given elevated inflation levels, the Fed is most likely to begin raising interest rates immediately after QE ends. Today, the Fed Funds (the short-term interest rate controlled by the Fed) futures market indicates there will be three 0.25% interest rate increases in 2022. The market environment will change from a period of falling short-term interest rates to one of rising short-term interest rates. Historically, this has meant more headwinds to stock returns.

A second factor that may take on more importance this year is price volatility. One of the major benefits of ultra-accommodative central bank policies has been extended periods of below average price volatility. Investors have become accustomed (addicted) to the central banks using monetary policy as a means to support economies during the past 12 years. A whole generation of investors has become programmed to believe the Fed won't hesitate to step in to support financial markets when adverse events happen. The policy actions of the Fed to the C-19 pandemic are the most recent example justifying this belief. With investors living in a world of the Fed being everyone's wing man, financial market volatility has been suppressed since normal corrections don't play out as they have in the past and are also much shorter in duration. This was evident in 2021, when the S&P 500 Index made 77 new highs, exceeding the prior annual record of 70 new highs in 1954. There was only one 5% correction during 2021. As the Fed withdraws its policy accommodation stance, higher price volatility and more frequent or larger market corrections are more likely to occur.

The difference in stock returns during periods of decreasing and increasing price volatility is significant. The table below shows the geometric mean difference over the past 88 years with the annual return spread of 14.7%. The withdrawal of Fed liquidity support from the economy via the combination of the end of QE and interest rate increases will most likely lead to increased price volatility in the stock market and with it comes a higher probability of lower returns.

	Number	Average Return
Decreasing Volatility Years	49	17.84%
Increasing Volatility Years	38	3.13%
Total Years*	88	10.99%

Source: Seeking Alpha - Ploutos

Summary

2002 should be a game changer, as the transition from a period of ultra-accommodative monetary policies to one where the Fed withdraws monetary policy support in response to elevated inflation levels has begun. How inflation plays out during 2022 will determine the pace and level of Fed tightening, which in turn will have a major influence on how financial assets perform this year. After three straight years of stock returns that were substantially above the long-term average, and with financial asset valuations trading at elevated levels, investors should expect a more challenging investment environment in the year ahead.

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January 15, 2022

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