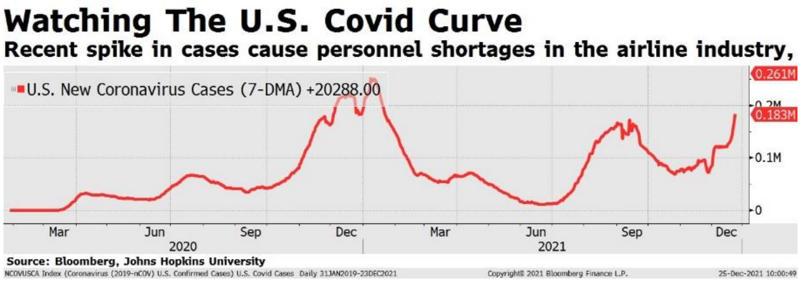
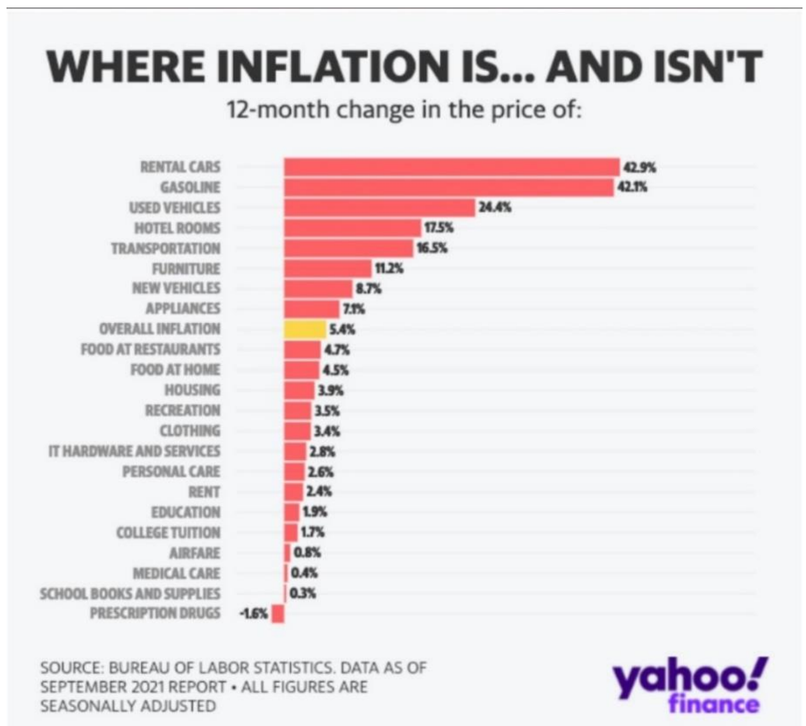
Courier Capital, LLC
Registered Investment Adviser
An affiliate of Five Star Bank

Economic and Market Update – THE GREAT UNWIND (12/31/2021)

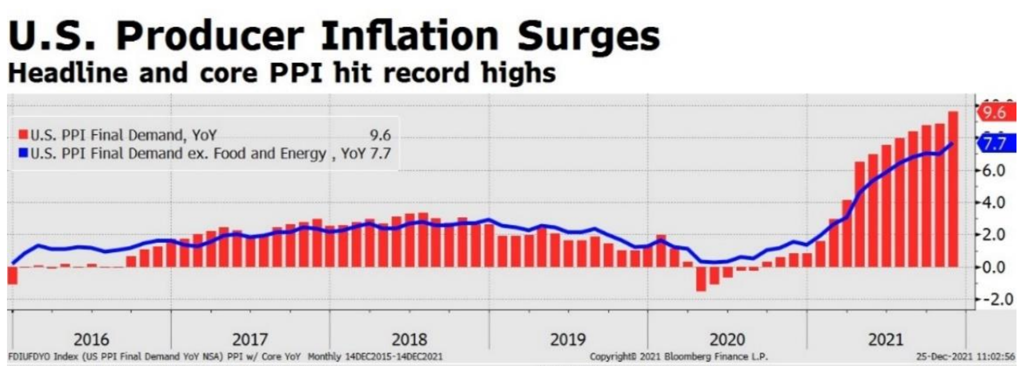
Latest Developments and Economics



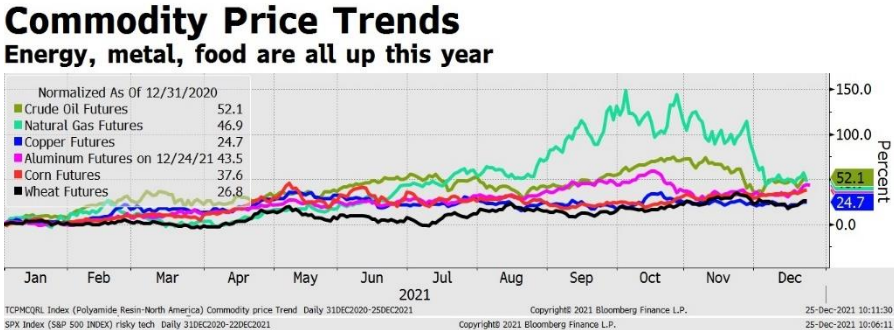
While the Omicron variant of the virus is taking over cases and rapidly spreading, the initial indications are that it is less virulent than Delta. This realization has caused some of the panic surrounding the potential for reverting to widespread lockdowns to subside. This idea received some additional support when the CDC reduced recommended isolation time from 10 days to 5 days for people with asymptomatic cases (followed by 5 days of wearing masks). Despite the positive news COVID is still having an impact by delaying the recovery of supply chain disruptions and shortages. One needs to look no further than the number of cancelled flights over the Christmas and New Year's holiday due to flight crew positivity rates to see an example.

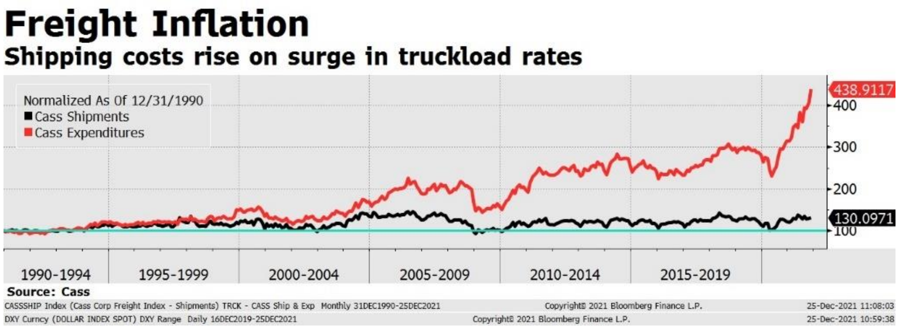


The supply chain issues, along with strong demand, have contributed to inflation so far continuing to increase – in all its measures. The latest Consumer Price Index (CPI) was 6.8% year-over-year and core (excluding food and energy) rose to 4.9% - the highest level since 1991. The Personal Consumption Expenditures (the Fed's preferred measure) came in at 5.73% year-over-year with core PCE at 4.68%. While inflation numbers have been deeper, longer and now broader than expected many still point to eventual inflation pressure reduction as the supply chain recovers given that much of the inflation in driven by a few extraordinary items. However, almost all categories are higher than the stated 2.0% overall target.

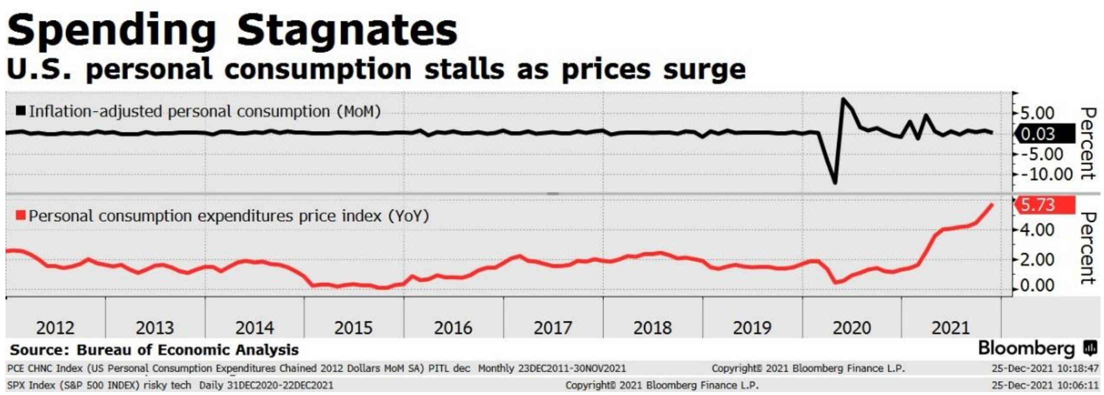


Even the Producer Price Index (PPI) monthly reading jumped by an annualized 9.6% which resulted in a year-over-year of 5.60% and core at 4.52%. The PPI measures inflation of input costs experienced by manufacturers. Essentially, this is inflation that will potentially get passed on to consumers in the form of higher prices of goods.



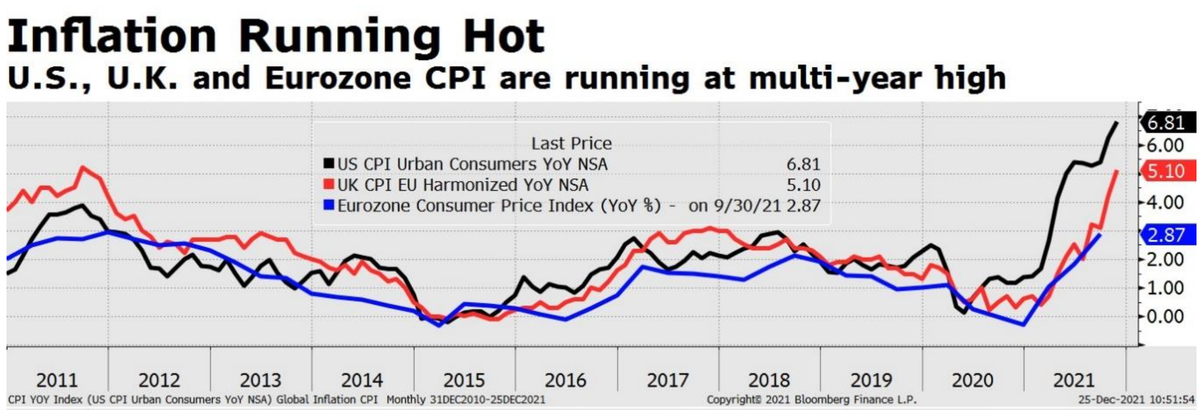


Much of the reason for the PPI increase includes not only the cost of labor, which has risen substantially, but the cost of raw materials and shipping as well. Almost all commodity categories are up significantly this year. This includes energy (oil and natural gas), industrial metals (copper and aluminum) and agricultural (corn, wheat). Even lumber, which spiked early, is rising again after settling back earlier this year. The cost of shipping has also risen dramatically due to the freight issues in the Pacific and elsewhere. The chart shows that actual number of shipments have not really changed much but the expenditures on freight are up significantly – especially in the last year.



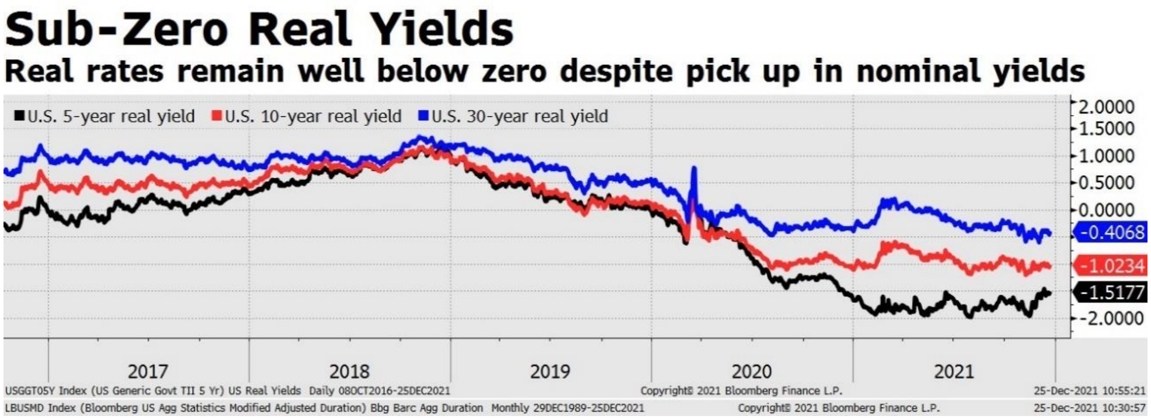
Inflation is also starting to have an impact on aggregate consumer spending as well. Last month we saw that consumer confidence was starting to wane. As those feelings turn more cautious, we are now seeing the results of those feelings as lower spending. The chart shows that while consumers spent about 5.7% more money, after inflation real spending barely budged. As a reminder the consumer is responsible for about two-thirds of Gross Domestic Product (GDP). GDP grows with productivity improvements and increases in working-age population.

The latest data on U.S. population growth was not encouraging. Over the last year the United States population is estimated to have increased by 392,665 people or, 0.1%. This is the lowest absolute number since 1900 and the lowest percentage rate since the founding of the nation according to the U.S. Census Bureau. Reasons given were COVID, low birth rates and low levels of immigration.



The U.S. isn't alone in this continuing inflation issue. As the chart to the right shows multi-year high rates of inflation are currently present in the United Kingdom and the Eurozone countries as well.

Inflation data has pressured the Fed to not only give up the 'transitory' description of higher inflation but has prompted them to take a more aggressive stance. They announced a doubling of the unwinding of $120 billion monthly bond purchases from the $15 billion in November and December to $30 billion starting in January. At this new pace they will be no longer buying bonds by March 2022, but they will still be left with nearly $8.8 trillion of bonds on their balance sheet which will also unwind very slowly. As far as interest rate hikes go, the Fed has signaled that they will start after March and are projecting three interest rate hikes in 2022, followed by another three in 2023 and two more in 2024. If they follow through with this path, at 0.25% per hike, that would leave overnight interest rates in the 2.00-2.25% range in 2024. The Federal Reserve needed to show some action towards inflation and stiffen monetary policy or risk credibility in the financial markets. Another reason they had to act was due to the real cost of borrowing. After considering recent inflation, the real cost of debt is less than zero – which is a condition that cannot persist indefinitely. Basically, borrowers are encouraged to take on debt as they are essentially benefiting by repaying in less valuable dollars. In fact, as defined by the two conditions above of negative real interest rates and an enormous Federal Reserve balance sheet, monetary policy is looser now than it was in 2020. The Fed had to act decisively, and they could not use the labor situation as cover any longer to keep rates low.

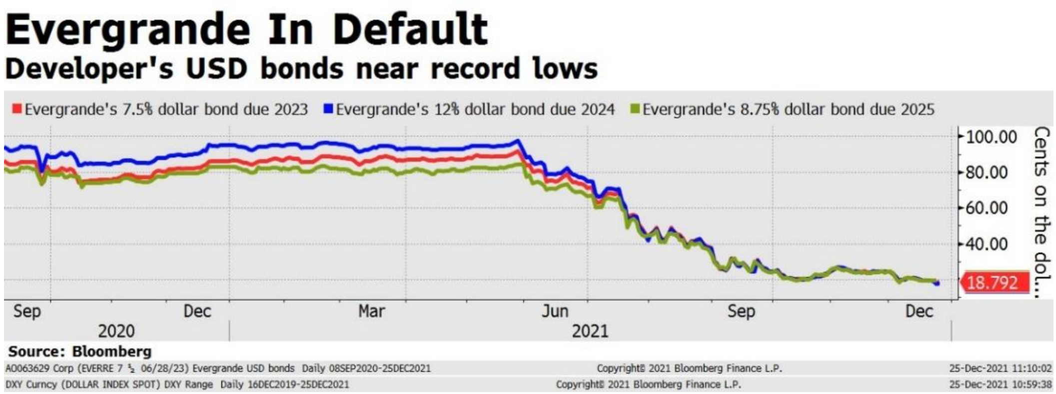


There have been some recent developments on federal government fiscal policy. The $1.75 trillion 'Build Back Better' bill looks to be on hold at least until early 2022. The current version has been blocked since Senator Joe Manchin came out on national television indicating that, although he has tried for five months, he cannot support the current version on this plan. He asserts that the true cost of the plan is $4.5 trillion if everything that is temporary is made permanent and that the nation cannot afford the additional debt and resulting further inflation given major geopolitical risks facing the country. There are other reasons he gives for his lack of support, but this leaves the bill without the 50 votes necessary to pass through reconciliation, and far short of the 60 to pass by normal channels, into law. There is a narrow path and short window forward for the bill which will require renegotiation into something smaller (or parts of it piecemeal) before mid-term elections.

Congress did address two looming deadlines that were fast approaching. On December 3rd a federal government shutdown was averted when the president signed into law a continuing resolution that will fund the federal government through February 2022. Furthermore, they addressed the debt ceiling through increasing the debt limit by $2.5 trillion. This Democrat-led initiative narrowly passed the Senate (50-49) and should push the next debt ceiling discussion beyond the mid-term elections.

There are also a few items of note internationally. One of the more pressing issues is the significant Russian military buildup along the Ukrainian border. Ukraine is interested in joining NATO and Russia would be threatened by a NATO presence in what was a buffer country for them. The United States has warned that there would be dire consequences if Russia invaded Ukraine, but Putin may be testing this administration and NATO in general with these provocative actions. Talks between Biden and Putin are scheduled to be held in January. Iran continues to further its uranium enrichment towards weapons grade and does not seem too interested in resuming talks with the United States or in updating the last nuclear agreements.

China's internal changes continue down a path of more central control and away from some of the capitalist ideas recently permitted. The friction with the United States and China continues as well. The Biden administration has, for the most part, continued the same posturing with China that the last administration had taken – strategic competition. The strain is both from an economic and political/military perspective. China continues to build up its military and desires to increase military bases across the region. The goal is to assert sovereignty over former lands which include South Korea, Philippines and especially Taiwan. In addition, the zero-tolerance policy regarding COVID has meant continuing Chinese shutdowns which impact the supply chain. The chip industry once again made this warning this past week. The U.S. wants to move towards a more secure, redundant supply chain, which may include onshoring critical supply chain elements in the future. China is also still experiencing growth issues. This past Q3 saw year-over-year growth of 4.9%, a significant drop from the Q2 GDP growth of 7.9% and below targeted annual growth of 6.0%. This was caused by COVID, supply chain issues, power shortage and a significant dependence on the real estate industry. The response by the Chinese government was to cut interest rates for the first time since April 2020 – a significant divergence from other global central bank actions. The troubles with Evergrande mentioned in previous letters has not improved. The chance of bond default is still high, and the company's bonds are trading at about $0.19 per dollar reflecting the significant risk that is perceived by markets.

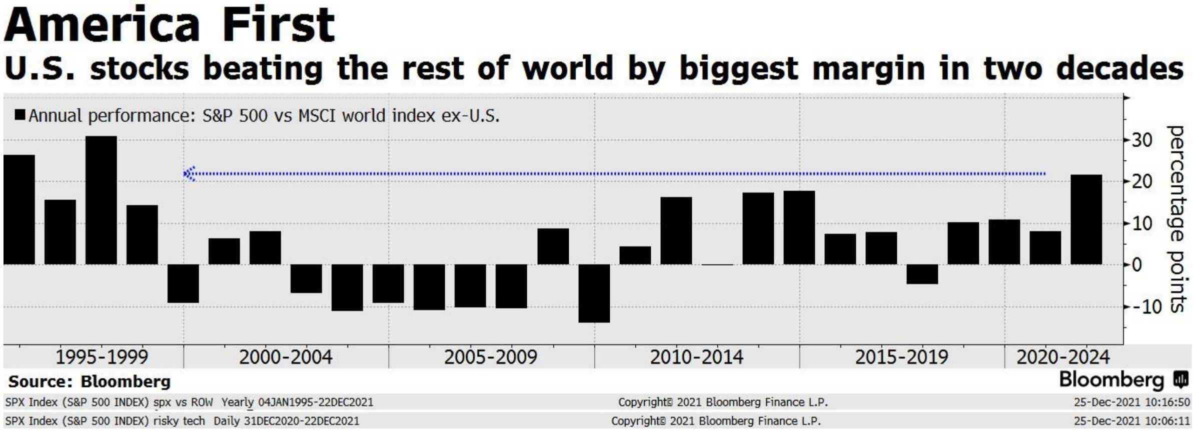


Looking forward to 2022 below are some of the significant items that will shape the year in capital markets:

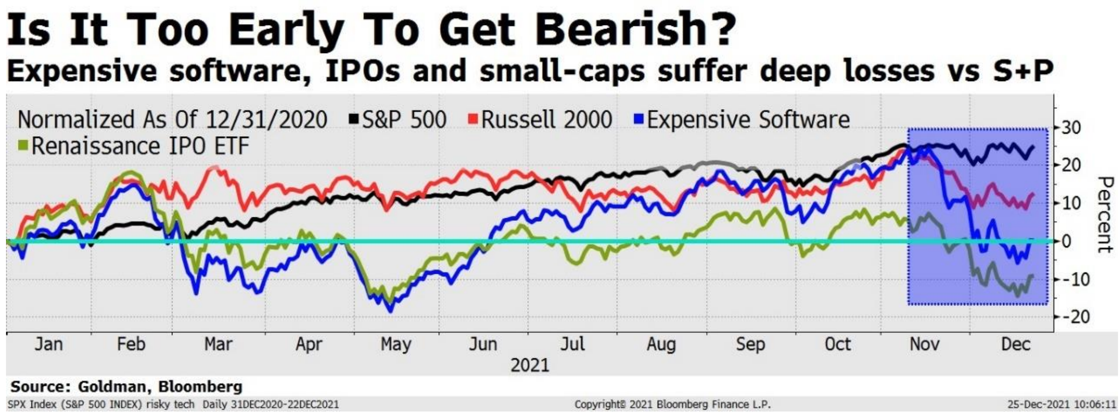
- The pace and duration of above trend inflation in the U.S. and globally.
- The resulting path of tapering and interest rate increases in the U.S.
- The progress against COVID 19 variants globally.
- The continued progress on unemployment and worker shortages in the U.S.
- The behavior of the consumer and their propensity to spend in 2022.
- Revenue growth and company margins as impacted by inflationary costs.
- Build Back Better bill disposition and mid-term elections late in the year.
- Geopolitical developments (especially Russia, China and Iran).

Financial Markets

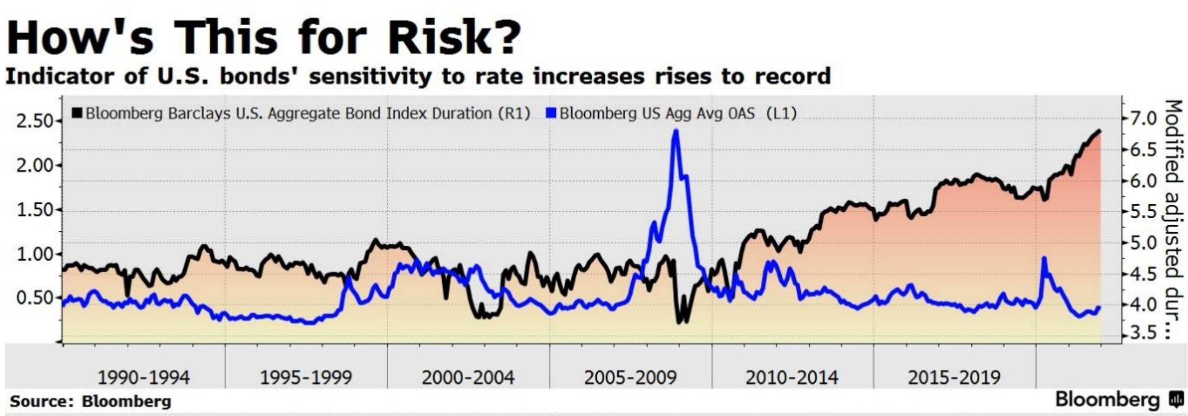
The S&P 500 had another year of double digit returns, which results in above historical average of 10% in five out of the last six years (2018 being the lone negative return). Furthermore, the index set 70 all-time high records in 2021. The last quarter was a bit of a rougher ride as news of inflation, the more aggressive Fed position and the Omicron variant caused volatility in the last months of the year. This has put the S&P 500 in a unique position among other world stock market returns and even among other domestic equity asset classes.



Since 2010 the S&P 500 has beaten the rest of the world in equity returns in all but two years. This past year was the greatest magnitude of return differential since 1997.

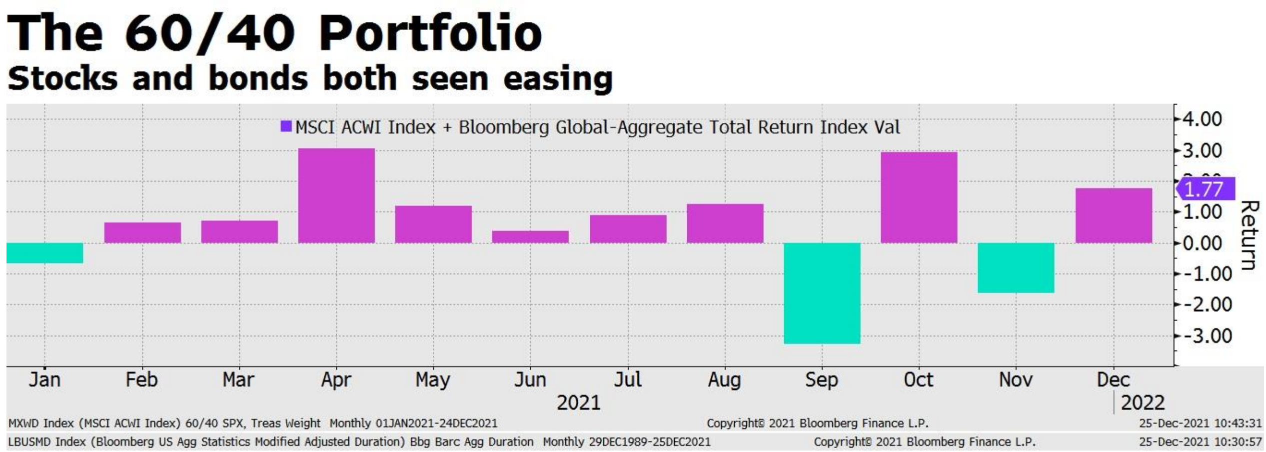


The S&P 500 also has outperformed U.S. small company stocks as well as certain hot sectors (software) and IPO's this year by a significant margin. Much of this can be attributed to the constitution of the S&P 500 as being heavily tilted to Information Technology. Also contributing was the significant amount of monetary/fiscal stimulus over the last couple years and growth in company earnings in the United States. A handful of dominant stocks continue to carry the index. Apple's market value just crossed $3 trillion – which is more than the annual GDP of countries like France, India, Italy and UK. Since the S&P 500 long-term average is 10% the recent significant performance over the average means that, from a purely mathematical perspective, expectations of future returns should be tempered in order to return to that long-term average. This also means that international equities and small cap equities should also perform better relative to the S&P 500 as well.



In U.S. fixed income markets the Fed has sent a very strong signal that, should conditions persist, we are entering a period of interest rate increases. This never bodes well for fixed income investments but there may be a bit more vulnerability in the current bond market. The Barclay's Aggregate bond index (the S&P 500 of bonds) has increased its duration (economic maturity) significantly over the past couple years (beyond 6.5 years on the chart) and bonds have become even more expensive as defined by the spread (additional yield over treasuries - blue line). The sum of all this means that bond prices will most likely react very sharply with interest rate increases as the risk has increased (duration) and there is little price cushion (spread). The fact that the current 10-year Treasury bond yield hasn't moved much in anticipation of rate increases and still sits around 1.50% is a bit baffling.

The projected rate increases have caught the attention of the currency markets. In anticipation of those rate increases the dollar has strengthened recently. While this is good for U.S. consumers buying foreign goods, it creates a currency headwind for U.S. companies selling goods abroad.



In sum, well-diversified global moderate portfolios have had another good year of returns as both stocks and bonds have contributed to positive returns. Given the issues facing the economy and markets in 2022 it seems prudent to expect that both equities and fixed income may not repeat the recent returns they have generated over the past few years.

<u>WISHING YOU A VERY HAPPY, HEALTHY AND PROPSEROUS 2022!</u>

Should you have any questions please contact us.

Image sources: Bloomberg and CNBC unless otherwise noted

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