THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – NOVEMBER 2021

U.S. Markets and Economy

An old Wall Street adage says, “The Bears get Thanksgiving; the Bulls get Christmas.” In November 2021, it was the day after Thanksgiving that the Bears took a swipe at the Bulls. The selloff that day, and another soon after, wiped out the month’s gains in just a few days. The Dow Jones Industrial Average was hit hardest, but the S&P 500 and the NASDAQ Composite indices also lost most—if not all—of their gains for the month. These declines, which were partially reversed in the beginning of December, were a stark reminder to long-term investors that the road to financial security is never smooth.

The post-Thanksgiving pothole can be explained with one word: Omicron. News of a new COVID variant spreading around the world shattered the consensus that the battle against the virus was slowly being won as more of the world’s population got their jabs. What we still don’t know is how transmissible the new variant is, how deadly it will be, or how much protection current vaccines will provide against it. These uncertainties encouraged Wall Street’s short-term traders to do their dance: “When in danger, when in doubt, run in circles, scream and shout.” What is probable, based on preliminary data, is that Omicron is more transmissible, but less deadly, than Delta and that the vaccinated will still be (mostly) protected. Even more importantly, the mRNA vaccines, our best weapon against the virus, can be quickly tweaked to account for the Omicron mutations. Boosters may therefore be in our future for some time, much as annual flu shots have been for years.

U.S. stocks are also in thrall to the Federal Reserve and monetary policy: relief that Jerome Powell was renominated by President Biden for a new four-year term as Chairman of the Board of Governors was offset by growing concerns that the Federal Open Market Committee (FOMC) will taper its quantitative easing program faster than the original timeline set out at its November meeting. A faster taper (which could be confirmed at the December meeting) would clear the way for several increases in short-term rates in 2022. The Fed will likely ease off the monetary accelerator for good reason: the economy is moving closer to full employment, with the November unemployment rate dropping to 4.2% and fourth-quarter real GDP growth likely to be strong at an annualized rate of 5%. At the same time, the supply-chain bottlenecks in the world

economy cannot not be resolved quickly, leading to shortages of key materials and price increases for many products.

U.S. inflation is now running at a bit more than 4% by the Fed's key measure (the core PCE price index) and even faster when measured by the consumer price index (CPI). Inflation measures are likely to get worse in the next few months even without the Omicron variant. Because the Fed's dual mandate is to keep inflation low while moving the economy toward full employment, it is prudent at this juncture for the Fed to make monetary policy a bit less expansionary. Although Wall Street traders may overreact to such a plan, clearer heads will point out that monetary policy will still be very expansionary, as even several increases in the fed funds rate in 2022 will mean that real short- and long-term interest rates will remain below zero. For example, if inflation were to fall back to 2%, the center of the Fed's target range of 1%– 3%, a fed funds rate of 0.5% in 2022 would still mean the real fed funds rate was -1.5%. With the 30-year Treasury currently yielding 1.6%, 2% inflation would also make that real long-term interest rate negative too. And, of course, if inflation runs a little hotter than 2%, which is likely, real interest rate will be even more negative.

History also shows that the stock market can rise even when interest rates are rising, and the current economic recovery appears strong enough to easily withstand rising rates. An extra economic push should come from fiscal policy; now that the $1 trillion infrastructure plan has been passed, Congress is inching closer to passing a stripped-down version of Biden's Build Back Better plan, which will also be stimulative fiscal policy. With American households still sitting on trillions of dollars of extra savings, consumption demand should also power the economy forward. This growth can also keep corporate profits rising, which provides further support for stock prices.

World Markets and Economy

European stock indexes tracked the U.S. in November, rising early in the month and then falling enough late in the month to wipe out gains. The broad EUROSTOXX 600 index fell about 3% for the month, although the index is still up 17% for the year. This solid performance has not been matched by England or Germany, whose stock indices are only up 12% for the year. The British still face a host of Brexit and supply-chain bottlenecks, and the Germans have been hurt by manufacturing and export weakness. The French have done much better, with the CAC 40 index up 24% for the year. French economic activity has risen faster than elsewhere on the continent, as the end of lockdowns has led to a surge in consumer spending. The Spanish, on the other hand, have continued to lag behind the rest of Europe. The International Monetary Fund (IMF) recently cut its GDP forecast for Spain, and the country's unemployment rate remains very high at 14%. Spanish stocks are up only 4% for the year.

Asian stocks have done even worse. Japan is still struggling with the Delta variant, and economic growth again turned negative in the third quarter. Monetary and fiscal policy have continued to be very expansionary, but the Nikkei 225 stock average has managed to gain only 2% for the year. Hong Kong has fared badly as the Chinese continue to throttle economic and political freedoms there. The Hang Seng index is down 14% for the year. South Korea has also been hurt by the steadily rising economic and political tensions between the U.S. and China. The Kospi index is up only 4% for the year.

Outlook

Economic growth and corporate profits should be strong in the fourth quarter, even as the Fed begins to ease off the monetary accelerator just a bit. The bull market thus has more room to run in 2022. Expect more bumps in the road, however, as short-term traders (over)react to news on the COVID and interest rate fronts. For long-term investors, stocks are still the best asset to hold.

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