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VIEWPOINT

A Stephens Inc. Economic and Financial Commentary
by Thomas Goho, Ph.D.

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Americans have been living under the Covid -19 cloud now for almost two years. Every aspect of our lives has been touched by Covid, including individual health, business strength and the vigor of the U.S. economy. And the threats from Covid are not yet vanquished.

Also, the U.S. government is facing an extraordinary number of highly uncertain policy issues – policy decisions that will surely affect the country's economic well-being.

Let's examine the health of the U.S. economy, households, businesses and Federal government at the end of 2021. What do these "economic health" findings bode for the major components of the economy?

- Will American consumers have the financial resources to support the economy's growth?
- Will labor markets recover the momentum that existed prior to the Covid outbreak?
- Will businesses be able to maintain their recovery momentum or will labor shortages and supply-chain problems reduce that forward momentum?
- Will governmental policies strengthen or undermine economic growth as Covid waxes and wanes?
- Will Congress increase taxes on corporations and individuals?
- Will Federal Reserve actions support or hinder the current economic expansion?

The range of possible economic outcomes is unusually wide for 2022 just as it was in 2021. Our early 2022 guesses are just guesstimates given the current economic, epidemiological, political and monetary policy uncertainties in the United States and around the world.

Economic Growth

The economy has largely recovered from the paroxysms in the first and second quarters of 2020, when the economy shrank by about one-third and then bounced back by about an equal amount. (See Figure 1.) Since the third quarter of 2020, the American economy has grown between 5% and 6%, which is well above its American long-run growth rate of 2%.

Figure 1:
Real Gross Domestic Product (GDP), Seasonally Adjusted, 2017 to Present.

Source: U.S. Department of Commerce: Bureau of Economic Analysis. "Gross Domestic Product, Third Quarter 2021". December 12, 2021.

Based on current forecasts by various regional Federal Reserve Banks, U.S. economic growth now appears to be trending upward. The Federal Reserve of Atlanta is forecasting 2021 4th quarter growth of between 9% and 10%. A survey of 36 professional forecasters by the Federal Reserve Bank of Philadelphia predict that 4th quarter GDP will grow about 4.6%, with growth for all of 2021 of 5.5%. The wide difference in fourth quarter estimates is not surprising given the continuing uncertainties in the economy.

Best Guess About Economic Growth

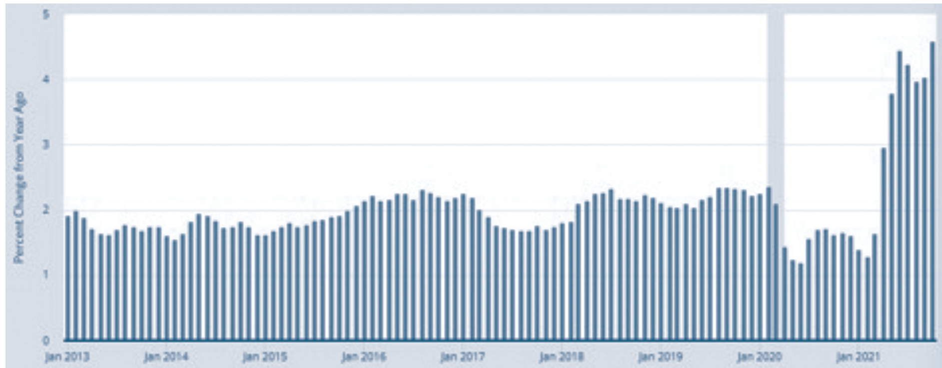
There are 2 points that seem reasonable to make about economic growth, even if it is difficult to produce reliable forecasts:

- Growth in 2021 will be above the long-term trend for U.S. economic growth: roughly 5% in 2021 versus a pre-pandemic average rate of 2%.
- Growth in 2022 and into 2023 will trend downward toward that long-term average, with 2022 about 4%, and 2023 and 2024 growth of 2.0% to 2.5%.

Prices and Inflation

Inflation for almost a decade had been quiescent until the appearance of Covid, but recent strong economic growth is producing concern that this growth will fuel inflationary pressures. The data in recent months has triggered alarms on Wall Street and Main Street. (See Figure 2.) Core inflation which excludes food and energy is higher on a yearly basis by 4.6%, led by an increase in core goods prices of 8.5%. Core prices of services increased 2.9%.

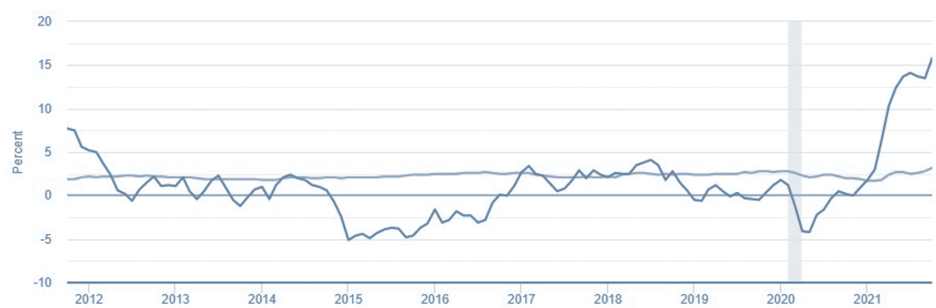
Figure 2:
Core Consumer Price Index (Goods and Services) 2013 to Present.



Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from database on December 9, 2021.

The Federal Reserve of Atlanta analyzes the consumer price index (CPI) in a slightly different way than the Bureau of Labor Statistics. It divides the CPI into those items with prices that have slow and/or infrequent changes. A consumer's telephone bill and homeowner's insurance are examples of items with sticky prices. Goods and services that experience frequent price changes are called flexible prices. Examples of flexible-priced items include agricultural produce and energy. (See Figure 3.)

Figure 3:
Sticky Versus Flexible Consumer Prices in the CPI, 2011 to Present.



Source: Federal Reserve Bank of Atlanta. "Sticky Price CPI". November 12, 2021.

The Federal Reserve of Cleveland estimates that about 70% of CPI prices are sticky and 30% flexible over the long run. What Figure 3 indicates is that sticky prices have indeed remained stable with an annual increase of slightly more than 2%. On the other hand, the flexible prices have risen significantly – the highest rate of increase in over a decade. These flexible prices are up more than 13.5% in the past year.

The preferred measure of Federal Reserve decision makers, the Personal Consumption Expenditures Price Index (PCE), shows a similar inflationary trend. (See Figure 4.) Both total inflation and the core inflation (excluding food and energy) are running at a rate twice the Federal Open Market Committee's (FOMC) target of 2%

Figure 4:
Personal Consumption Expenditures (PCE) Price Index. 2013 to Present.

Source: Federal Reserve Bank of New York: Research and Statistics Group. "U.S. Economy in a Snapshot." November 2021.

The FOMC has indicated that it will tolerate inflation above its target inflation rate for some undefined period. However, based on recent Fed comments it could act to restrain this inflationary outburst. The Fed has indicated that it is curtailing the purchase of government debt as well as agency-backed mortgages, a sign that the Fed will finally end its expansion of the money supply.

Best Guess About Inflation

The trillion-dollar question for financial markets concerns the future trajectory of prices in general and particularly flexible prices. Seventy percent of the CPI is well-behaved, increasing at an annual rate of about 2%, its long run performance. The Federal Reserve Board of Governors and the Federal Open Market Committee in general think that flexible prices will come back to earth in late 2022, or 2023 at the latest. Long-run inflation will return to its average of about 2% (flexible and sticky prices together), according to the Fed.

We at Stephens are not as confident about the trajectory of prices. The pandemic has laid bare some systematic problems in the economy:

- Shortages of skilled and semi-skilled workers in key industries
- Complicated supply chains heavily dependent on erratic government policies both here and abroad
- Logistics problems throughout the supply chain

We think that conservative investors should anticipate that U.S. inflation will increase for the next 12 months at a rate outside the 2% inflation comfort zone of Federal Reserve policymakers, probably 4%. If we are correct, this suggests that the Fed will be forced to expeditiously unwind its monetary easing, thereby forcing interest rates most likely higher and faster than its current statements indicate.

In late 2021 the Fed announced that it began monetary tapering. Don't be fooled by this announcement. The Fed is continuing to increase the size of its balance sheet; the money supply is still increasing. In other words, only the pace of the increase is slowing. This slowing does not constitute real monetary tightening, especially given that the Fed is continuing its commitment to low interest rates.

Federal Reserve policy is a major contributor to the upward move in inflation! It is too slowly coming to this realization, and it remains behind the inflation curve.

U. S. Labor Market Conditions

Economic growth appears to be returning to its normal trajectory after a wild 18 months, but the same cannot be said for labor market conditions. The unemployment rate at 4.2% in November is above the pre-Covid rate of 3.5% but certainly headed in a positive direction. (See Figure 5.) Remember that the unemployment rate peaked at 14.8% in April 2020. The improvement has been dramatic, but the numbers fail to capture the real conditions in labor markets.

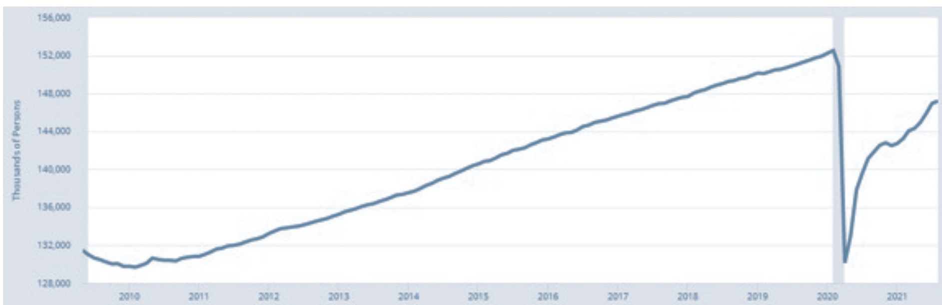
Figure 5:
U.S. Unemployment Rate, Seasonally Adjusted, 2008 to Present.

Note: Shaded areas indicate U.S. recessions.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from database on December 12, 2021.

Total employment is languishing even as the unemployment rate is plunging. There are 4 million fewer workers in late 2021 than there were in February 2020 prior to the onset of Covid. (See Figure 6.) That is 148.3 million workers now compared to 152.5 million in February 2020.

Figure 6:
All Employees, Non-Farm, Seasonally Adjusted (2009 to Present).



Note: Shaded areas indicate U.S. recessions.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from database on December 12, 2021.

In a normal year the American workforce grows by about 2 to 2.5 million workers, propelled by population growth. If Covid had not struck, the workforce would likely be about 156 million instead of today's 148 million. So, in some sense the U.S. economy is short about 8 million workers, not the previously noted 4 million workers.

The reduced labor force is occurring while the potential labor market is growing robustly as measured by number of job openings. (See Figure 7.) In late 2021 there were almost 11 million job openings, the highest numbers ever recorded by the Bureau of Labor Statistics. In late 2021 about 8 million workers were looking for employment. There are more job openings than unemployed individuals looking for positions, a very unusual imbalance between job openings and job seekers.

Evidence of this shortfall in employment is the recent drop in the labor participation, which is the percentage of prime-age workers who are in the labor force. That rate was 63.3% in February 2020 prior to the start of the pandemic. In November 2021 it was 61.8%, a drop of 1.5%, which is a significant drop in a labor force of almost 150 million workers.

One should not jump to the conclusion that everyone seeking employment should have a job because there are more job openings than unemployed workers. In this era of Covid, workers are making decisions about the working conditions they seek, focusing on their personal safety and the safety of their families. Some workers want only remote jobs while employers may be seeking workers for brick-and-mortar locations. The many mismatches between job openings and unemployed workers are not likely to be resolved in the next year or so.

Figure 7:
U.S. Job Openings, 2013 to Present (seasonally adjusted in thousands)

Note: Shaded area indicate U.S. recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from database on December 12, 2021.

Best Guess About Labor Markets

Next year, 2022, will be a strange time for labor markets. Employers will complain about a shortage of qualified workers, and job seekers will remain cautious about accepting jobs that don't meet a wide range of criteria including safety and location. Yet a few outcomes for 2022 and beyond seem likely to materialize:

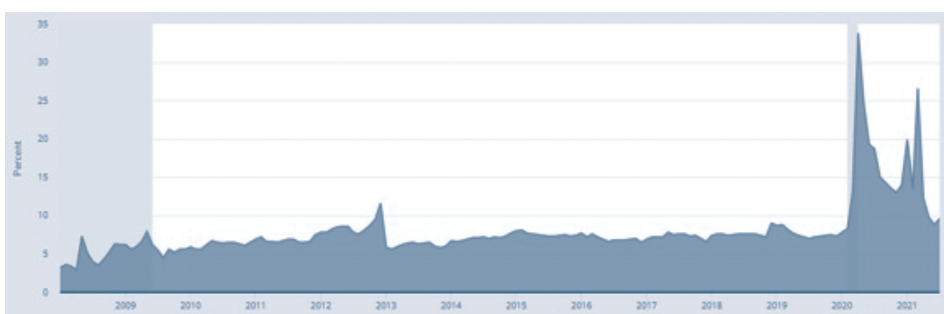
- The unemployment rate will improve with the rate approaching 4.0% by the end of 2022 or early 2023.
- Job openings will remain strong with about 8 to 10 million jobs being available in 2022.
- Employers will be faced with significant wage demands given the unique labor market conditions created by Covid.

Labor market outcomes in 2022 are predicated on no emergence of new and deadlier strains of Covid. However, the recent appearance of the Omicron strain of Covid is already creating doubts about these predictions.

Household Finances

Massive payments from the U.S. government to households during the pandemic contributed to a soaring personal savings rate. (See Figure 8.) These payments to millions of households helped the personal savings rate rise to a record 33.8% of disposable income in 2020. The personal savings rate is expressed as a percentage of disposable personal income. Subsequently the rate has dropped to 8.8%, still higher relative to the recent years, but far below the rate during the height of the pandemic.

Figure 8:
Personal Savings Rate, Seasonally Adjusted, 2008 to Present.

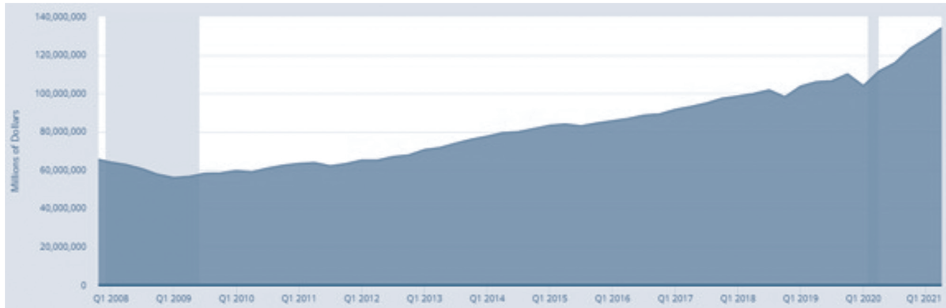


Note: Shaded areas indicate U.S. recessions.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from database on December 13, 2021. (Based on data from U.S. Bureau of Economic Analysis.)

A second important and surprising consequence of the pandemic is the dramatic increase in household net worth. Household net worth soared from $110 trillion in the fourth quarter of 2019 to $134 trillion in mid-2021, a 22% increase in 18 months. (See Figure 9.)

Figure 9:
Household Net Worth, Millions of Dollars, 2008 to Present.



Note: Shaded areas indicate U.S. recessions.

Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from database on December 13, 2021. (Based on data from the Board of Governors of the Federal Reserve System.)

Factors in increasing household net worth were rising housing prices and higher returns on domestic and global stocks.

Let’s review what the Fed did during that 18-month period. The Federal Reserve forced interest rates lower on many financial instruments trading in the economy. Low mortgage rates fostered strong home sales leading to higher home prices, with housing prices up nationally by 14%. Low interest rates on bonds fueled higher bond and stock prices. Stock prices as measured by the S & P 500 index are more than 35% higher than they were at the official start of the pandemic-induced recession of 2020.

Best Guess About Household Finances

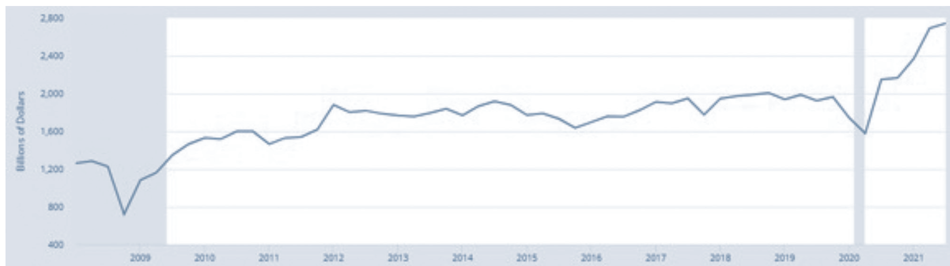
The improvement in household finances was fueled in part by generous stimulus payments from the government. In addition, household wealth benefited from low interest rates. However, government largesse for households and low interest rates are probably over. The coming years are likely to see much more modest improvement in household saving, investments and wealth accumulation.

Occasional headline stories suggest that many households are hurting financially. This headline has been true since household financial data has been collected. Of course not all households benefited equally. But the bottom line is that overall, American households are in a strong financial condition. That strength is likely to continue into 2022, which will fuel strong consumer spending in 2022.

Financial Conditions of American Business

The upheavals in the economy could easily have evoked conclusions that the business sector is in shambles. Some industries, such as restaurants, entertainment, airlines, and cruise lines, did suffer great financial setbacks. However, the American business sector in an aggregate sense remains healthy by most financial metrics. Corporate profits are strong. (See Figure 10.) After a brief pause in 2020, aggregate after-tax business profits are now at a record level of over $ 2.6 trillion.

Figure 10:
Corporate Profits After Taxes, 2008 to Present.

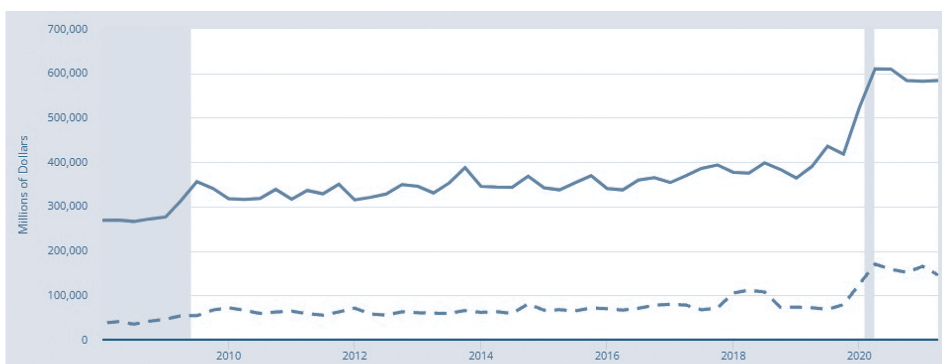


Note: Shaded areas indicate U.S. recessions.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from database on December 13, 2021.

The cash position of many American businesses remains healthy. Corporate caution in capital expenditures during the pandemic combined with strong profits has resulted in healthy cash reserves for many retail trade corporations and manufacturers. (See Figure 11.)

Figure 11:
Cash on Hand and in Banks for All Manufacturing (top line) and Retail Trade (lower line) Corporations, 2008 to Present..



Note: Shaded areas indicate U.S. recessions.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from database on December 13, 2021.

In addition, the amount of debt that American corporations have on balance sheets compared to their market value is at a multi-decade low. (See Figure 12.) Part of this strong debt position can be explained by the relatively high valuation of stocks relative to the amount of debt on corporate books. In addition, firms have been cautious in adding debt during the unsettling conditions of the pandemic.

Figure 12:
Business Debt as a Percent of the Market Value of Corporate Equities, 2008 to Present.

Note: Shaded areas indicate U.S. recessions.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from database on December 14, 2021.

Best Guess About the Financial Health of American Business

The finances of American businesses mirror those of U.S. households. Caution during the recession combined with the low cost of borrowing has left most American firms in a relatively healthy financial position. It may seem counterintuitive, but recessions often reduce the financial strain on businesses:

- lower costs of labor because of a smaller workforce,
- fewer resources tied up in inventory and accounts receivable because sales dropped,
- assistance provided to struggling businesses by various U.S. governmental agencies,
- and lower borrowing costs because Fed monetary policy is very accommodative.

The coming year should see a strong rebound in capital business expenditures prompted by strong demand from households and other businesses. It is reasonable to expect that new business formation will be strong, replacing many businesses that failed during the pandemic in sectors such as hospitality and retail. Recent data indicate that new business formation is at or near record levels. This strong performance will continue in 2022.

Monetary Policy

The U.S. Federal Reserve Bank, its Board of Governors, and the Federal Open Market Committee collectively have been and continue to support an expansionary monetary policy. From the beginning of the financial crisis of 2008-09, the Fed has largely been committed to a very easy monetary policy, with rapid increases in the money supply and unusually low interest rates. Since the start of the 2008 financial crisis, the assets of the Fed have increased ten-fold from $800 billion to $8.7 trillion. (See Figure 13.)

Figure 13:
Total Assets of the Federal Reserve System, in billions of dollars, 2008 to Present.

Note: Shaded areas indicate U.S. recessions.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from Database on December 13, 2021. (Based on data from the Board of Governors of the Federal Reserve System.)

A manifestation of the Fed's monetary largesse is the downward movement of 30-year mortgage rates from 6.5% in 2008 to 3% in late 2021. (See Figure 14.) This decrease in 30-year mortgage rates is against a backdrop of inflation that is largely unchanged over this period. Inflation was running at about 2% for 12 years up to the pandemic.

Now with inflation at 5%, mortgage rates, to the amazement of many economists, are still about 3%. And the Fed continues to purchase mortgage-backed securities thereby holding down mortgage rates.

Figure 14:
30-Year Fixed Rate Mortgage Average in the United States, 2008 to Present.

Note: Shaded areas indicate U.S. recessions.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from Database on December 13, 2021. (Based on data from the Federal National Mortgage Association.)

Indeed, the Federal Reserve has finally begun to "taper" its purchase after 2 rounds of Fed decisions in November and December. Now instead of purchasing $40 billion per month of mortgages, its acquisitions have dropped to $20 billion per month. Instead of $80 billion per month of U.S. Treasury debt, the Fed has cut purchases to $40 billion.

Best Guess About U.S. Monetary Policy

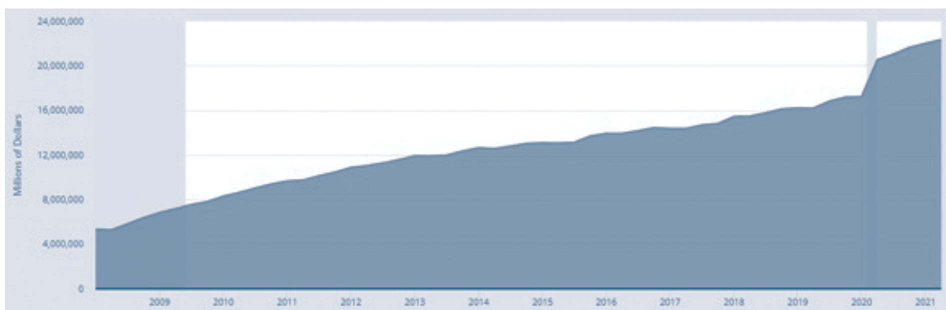
The Federal Reserve is implementing the taper without much enthusiasm. The Board understands the consequences of its loose monetary policy: a strong economic recovery, strong home sales and home prices, and a robust stock and bond market strength.

The Fed really does not want to take away the party punch bowl, but the process is beginning. Such a decision is not popular with many politicians inside the D.C. Beltway. Therefore, investors should not expect truly draconian measures that would slow the economy in the next 6 months. Again, in an about-face, the Fed which was recently not anticipating interest rate increases has now penciled in 3 rate increases in 2022 and 3 more in 2023.

Government Finances

Easy monetary policy has been a boon for the huge increase in government spending and the U.S. debt, particularly since the start of the pandemic. (See Figure 15.) At the beginning of the financial crisis in 2008, the Federal debt held by the public was $9.4 trillion. Today the Federal debt is approaching $23 trillion

Figure 15:
Total Federal Debt Held by the Public, 2008 to Present.

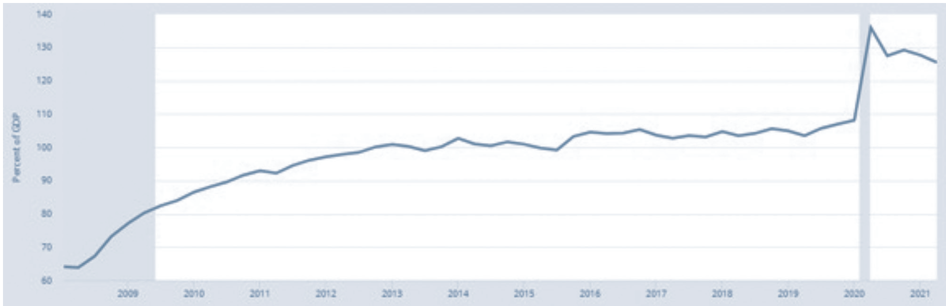


Note: Shaded areas indicate U.S. recessions.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from Database on December 14, 2021. (Based on data from the U.S. Treasury, Fiscal Service.)

One measure of the Federal debt burden for Americans is the size of the total federal debt relative to the U.S. GDP. Most economists view this present ratio of about 125% as outside the bounds of prudent fiscal policy. (See Figure 16.) A high Federal debt imposes an onerous burden on the Federal budget because interest payments absorb a larger and larger share of its revenues.

Figure 16:
Total Federal Debt Held by the Public as a Percent of Gross Domestic Product (GDP), 2008 to Present.



Note: Shaded areas indicate U.S. recessions.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Database (FRED). Extracted from Database on December 14, 2021.

The Federal Reserve, by purchasing a massive amount of the government's debt, has held down interest rates on the Federal debt. This has maintained low interest payments to bondholders, thereby minimizing the burden of the debt on taxpayers, at least temporarily.

Best Guess About Government Finances

The financial condition of the U.S. government is clearly sub-par when compared to the situation even 3 to 5 years ago. But an important point is that global investors have an almost insatiable appetite for U.S. government debt, a fact that will not change for years to come. America will certainly honor its debt in the upcoming decades. The U.S. has the capacity to pay. The bad news for Americans is that the cost of borrowing -- interest rates -- will slowly become prohibitively expensive, driving out important social spending from the Federal budget such as education, health care and infrastructure.

Americans should not be alarmed just yet. Currently, the problem is not dire. The Federal Reserve will continue to inject its "monetary vaccine" to disguise the magnitude of the coming fiscal problem for the American government.

Final Thoughts

For a decade now, the economy has grown at about 2% per year with 2% inflation and unemployment in the range of 4% to 5%.

We at Stephens thought with wise tax and regulatory policies the American economy could grow regularly at about 3% to 3.5% per year, with a modest rate of inflation of about 2% and an unemployment rate under 4%. Such strong growth could be inclusive, helping a wide range of individuals achieve their economic potential: educated and less educated, skilled and unskilled, men and women, and irrespective of racial identity. This strong growth did not materialize except for brief periods because of many misguided tax and regulatory policies.

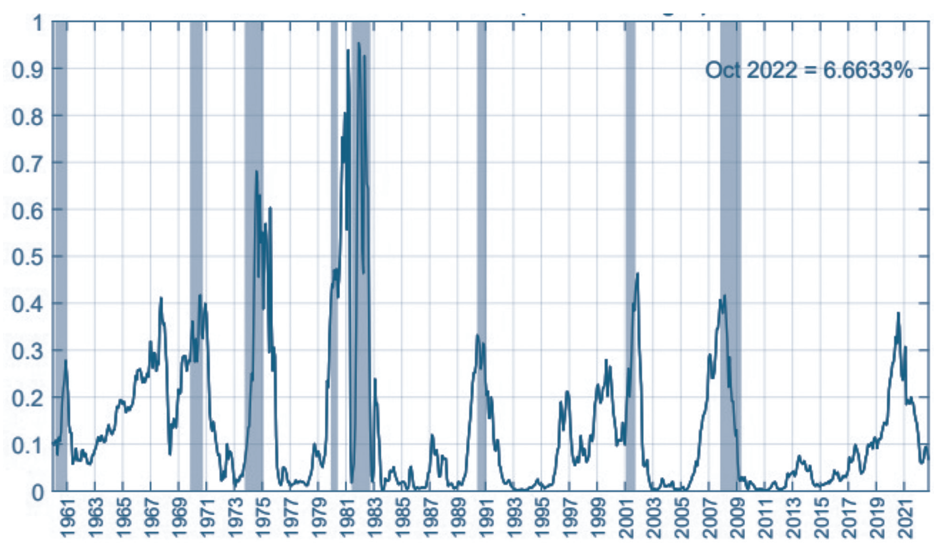
Now the business media is beginning to sound an alarm: stagflation. Stagflation is characterized by almost no growth or negative growth, high unemployment and a high rate of inflation – greater than 5% and possibly more than 10%.

Let us be clear. Stagflation is not yet on the horizon. The economy is facing an uncomfortably high rate of inflation for the next several years: an inflation rate of 3% to 5%. But the U.S. economy should grow strongly for the next 12 to 18 months, a rate greater than 3%. After that period, growth will slowly return to that sub-par rate of 2%. In summary, what's on the horizon for the U.S.:

- Stagflation, no;
- Uncomfortable inflation, yes, but runaway inflation, no;
- Adequate growth, yes;
- Strong labor conditions, yes;
- Recession, no.

The Federal Reserve of New York's model of recession probability places the odds of a recession in the next 12 months at about a 1 in 16 chance. (See Figure 17.) We at Stephens agree with that prediction.

Figure 17:
Probability of U.S. Recession (Predicted by Treasury Spread.)



Source: Federal Reserve Bank of New York: The Research and Statistics Group. "Data and Indicators." November 2021.

Given how volatile the economic and political environments have been over the past two years, it would be foolhardy to ignore the possibility that something could blindside our expectations. We see at least a few sources for possible complications:

- The ongoing effects of more new strains of Covid such as the emergent Omicron strain.
- In turn governments in the U.S. and around the world could move back into a lockdown situation thereby derailing expected growth.
- A massive expansion in the American welfare state.
- Large increases in corporate and individual taxes -- taxes that directly or indirectly hit all Americans, not just those deemed to be wealthy.

In the short term, federal spending could spur consumer spending and economic growth beyond the 12-to-18 months window suggested above. But it would hasten the time frame that global bond buyers would start abandoning the purchase of U.S. government debt instruments.

Massive additional governmental spending is unnecessary for the well-being for most American families. Most American households and businesses are in extraordinarily good condition to support healthy and inclusive growth. The private sector is primed to boost this economy with sustainable growth.

The economy is back on track after a near catastrophe. The biggest economic question for 2022 is in the hands of the Federal Reserve. Will it be able to mitigate its earlier policy missteps without harming this recovery?

The past two years were filled with unexpected and troubling economic events. We are cautiously hopeful that 2022 breaks that pattern.

We wish you and your family a **Happy and Healthy New Year!**

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