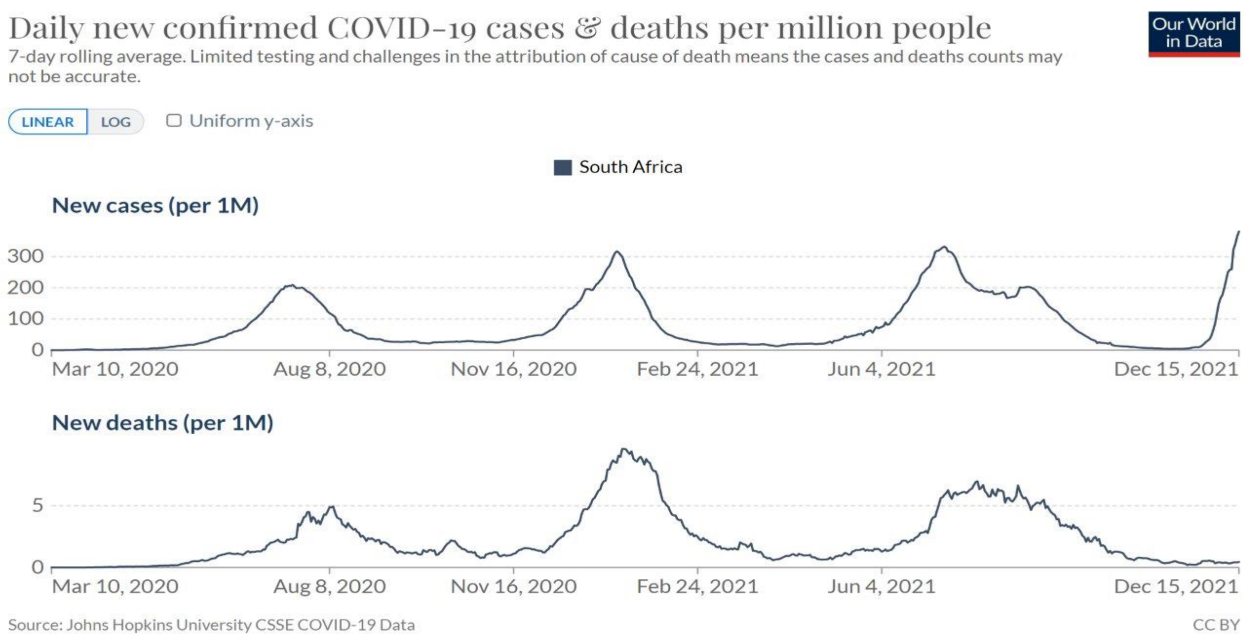
## COVID's Omicron Variant

With so much still to be learned about the Omicron variant, investors decided to sell first and ask questions later. The S&P 500 fell 5% from an intraday high of 4,744 on November 22nd to an intraday low of 4,495 on December 3rd, while the benchmark 10-year Treasury yield declined from 1.70% to 1.33% during this "flight to safety."

We've seen this play before, as the emergence of the Delta variant drove stock prices lower, only to rally as uncertainty faded. So far, it appears that each strain of the virus is less lethal than the one that preceded it, and few deaths have been reported due to Omicron (chart, below). But the latest variant's




ability to spread far more rapidly than either of its predecessors has already resulted in governments imposing new travel restrictions, which, among other consequences, threatens to worsen the supply chain disruptions that have plagued our economic re-opening. School districts and campuses are closing again in some areas. Masking requirements are being increasingly reinstated, and sporting events and gatherings are being canceled. Worker shortages could persist awhile longer if people remain unable or unwilling to return to work. Goldman Sachs has cut its 2022 GDP growth projection from 4.2% to 3.8% in response to Omicron, although we would question the utility of a single point estimate in such a fluid situation. The broader point is that we should be mindful of the risks COVID still presents to us collectively, even as the health risks to us as individuals lessen with each new variant. Aside from increasing worry over potential Federal Reserve policy errors, the pandemic remains the greatest threat to the economy for the foreseeable future.

**Jobs and the Economy**

Non-farm payrolls advanced at a disappointing pace in November, as the economy added only 210,000 jobs versus the 550,000 that analysts were expecting. But as has consistently been the case in prior months, the headline number masks much of the underlying strength in the labor market. There were upward revisions of 82,000 jobs to the two previous months' reports. And the employment gains reported from the household survey, which measures new workers, not new jobs, showed an increase of 1.1-million. The unemployment rate fell to a new COVID era low of 4.2%.

Initial jobless claims, which are those claims filed immediately after a separation from employment, remain at multi-decade lows. The most recent jobless report shows the 4-week moving average of initial claims to be just over 203,000, the lowest level since 1969. This number is particularly stunning when you consider that the U.S. civilian labor force has more than doubled in the last 50 years. Job openings remain at near-record levels, and consumer confidence readings are stabilizing, despite the onset of the Omicron variant.

Elsewhere, retail sales are holding steady at a level well above the pre-COVID trend, and industrial production continues to recover toward its pre-pandemic growth path. Despite the supply shortages that have challenged much of the manufacturing sector, overall production remains strong and is now less than 2% below its pre-COVID growth path. The most recent ISM manufacturing data are indicative of an economy growing at a real rate of 5%, well above the recently lowered Goldman Sachs estimate.

**Interest Rates and the Federal Reserve**

After months of assurances that heightened inflation levels were "transitory", Federal Reserve Chairman Powell has acknowledged that it was time to retire that word. Transitory always seemed to be a curious term anyway – in the end, everything is transitory.

Consumer price inflation rose by 6.8% over the twelve months ending in November. Excluding food and energy, the prices of which tend to be more volatile, inflation rose 4.9%, the highest level in more than 30 years. The Fed has now clearly shifted its focus away from supporting employment gains to attempting to prevent inflation from becoming entrenched at an elevated level.

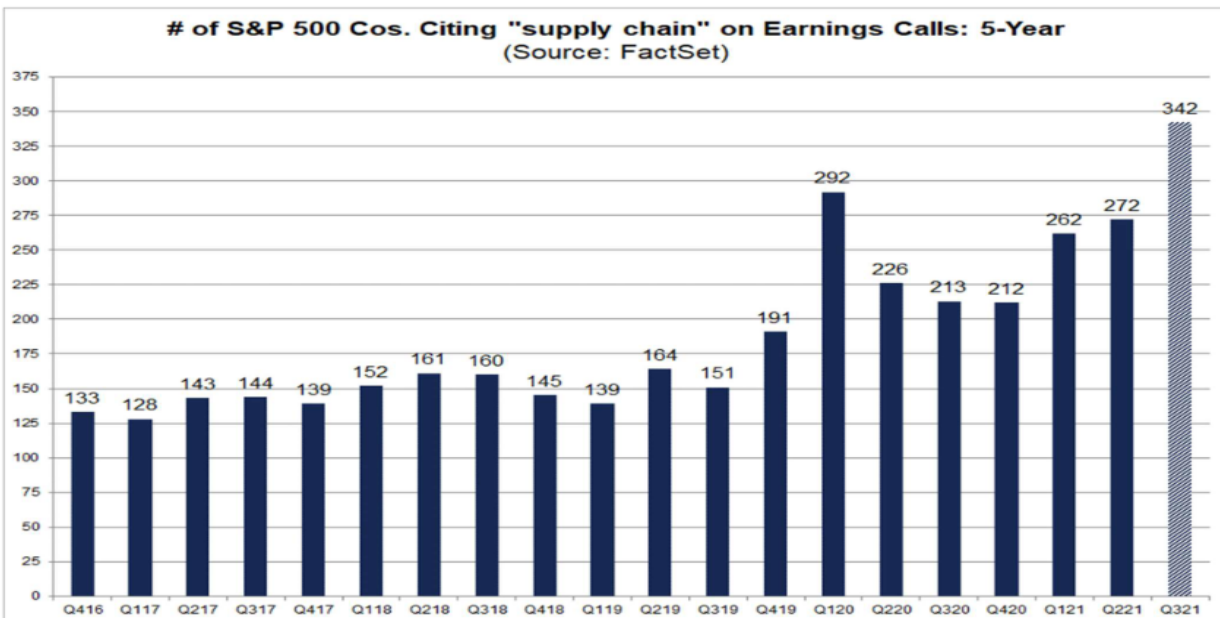
As we pointed out in the previous *Outlook*, most analyses have cited supply shortages as the main reason for the uptick in inflation as the economy re-opened from the 2020 shutdown, but demand factors are in play as well. Both nominal GDP growth and incomes have advanced above their pre-COVID growth paths as a result of unprecedented levels of fiscal stimulus and Fed policies that were much more accommodative than in past cycles. Positive labor market momentum and an additional $4.5-trillion in spendable savings above the pre-COVID trend are likely to continue to fuel demand even as the Fed begins to gradually withdraw its support. The crucial question is whether the Fed, having dismissed inflation as a concern throughout the recovery period, is now behind the curve and will be forced to move too aggressively to accomplish its goal of controlling inflation without plunging the economy back into recession.

A month ago, the markets were expecting one interest rate hike late next year, and a series of gradual rate increases over the 2023-24 time frame. Now, the consensus is that the Fed will increase rates three times in 2022 and at least four times in 2023, with more to possibly follow after that. The Fed has reinforced these expectations by announcing that it will accelerate its tapering of asset purchases, setting the stage for rate increases to begin earlier than previously forecast.

The optimistic view is that the Fed has a greater margin for error than is generally thought in the current situation.  With incomes, earnings and nominal GDP growth indicators strong and "real" interest deeply negative, the Fed has plenty of hiking leeway before it risks sending the economy into another downturn.  By that view, inflation will remain elevated in 2022, but a level below 3% in 2023 will seem plausible as the economy slows, but doesn't stall.  The negative view is that the Fed waited too long, and more aggressive tightening will be required than would have been necessary otherwise.  It's a fine line to tread, but the Fed's change in focus is a necessary first step.

**The Stock Market**

Supply shocks and rising input costs have so far not affected corporate earnings.  A whopping 82% of S&P 500 companies reported earnings results that exceeded expectations, with the average positive surprise of 10% above estimates.  However, it should be noted that more companies lowered guidance for the future than raised them, and the number of companies citing supply chain concerns in their commentary has increased in each successive quarter this year, and accelerated in the most recent quarter.




By all traditional measures, equity investors have had a remarkable run over these last 21 months.  The S&P 500 Index has risen 23% so far this year, and is 106% above its March 2020 low.  The S&P 500 posted new record highs in every month in 2021, joining 2014 as the only other year when this has occurred.  Gravitation to the mean, alone, would suggest that investors should lower their expectations for the next couple years.  But even apart from COVID uncertainty and Fed policy concerns, the ongoing narrowing of market breadth is a key near-term risk to the market.  Fewer and fewer stocks are participating in the market's rise.

We have commented repeatedly in past Outlooks that market returns are being increasingly driven by a handful of stocks whose large market capitalizations disproportionately affect the index.  While the stock market is commonly measured by the S&P 500 Index, which is market-cap weighted, one must increasingly look to the 500 stocks that make up the Index to get a true reading on the market.

Goldman Sachs has calculated that 51% of the S&P 500's return since April has been concentrated in just 5 stocks: Microsoft, Alphabet, Apple, Nvidia, and Tesla, whose share prices have risen a weighted average of 38% from the end of April through the end of November. The S&P 500 is up 8.2% during the same time, while an equal-weighted S&P 500 Index is up less than 3%! The market cap weighting of the 10 largest stocks in the S&P 500 has increased in each of the last 7 years and now accounts for 31% of the Index, the highest concentration since 1980. While the Index has not experienced a correction of more than 5% from any high in more than 15 months, the average stock in the S&P 500 is currently 13% below its 52-week high.

The offset, of course, is that while the outperformance of the mega cap growth stocks has masked much of the weakness in the rest of the market, it has also inflated what investors perceive to be an overvalued market. The S&P 500 Index currently trades at more than 21 times forward earnings estimates, well above historical norms. But the 5 stocks noted above that have driven most of the market returns throughout 2021 now trade at a weighted average of 48 times earnings. The equal-weighted average multiple for the 500 stocks that comprise the index is less than 17 times earnings, in line with historical norms and reasonable given the current economic and interest rate environment.

Still, narrowing breadth has often – but not always - been an indicator of near-term weakness in the market. When combined with the potential economic drag of Omicron, heightened Fed policy concerns and the increasingly cautious guidance regarding 2022 earnings, investors should be cautious about chasing market returns at these levels.

In closing, and as another challenging, but rewarding, year draws to a close, we take this opportunity to express again our gratitude for your business and for your trust. We wish you a happy and healthy holiday season, and look forward to working with you in 2022 and beyond.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