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JANUARY 2022 MONTHLY ECONOMIC COMMENTARY by Colton Krueger, Investment Analyst

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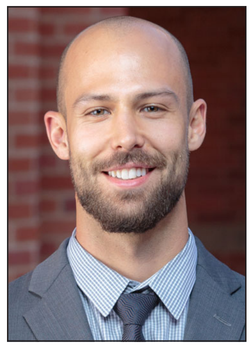
We enter the new year with an incredibly strong economy that's propelling growth, but along with this growth is the highest inflation experienced in a generation. The pace of economic growth and inflation has surprised everyone, including the Federal Reserve, and this new environment is causing the Fed to transition from one of monetary accommodation to potentially monetary constriction in record time.



This change in Federal Reserve policy is first due to the recovery in the labor market. In December's labor report, the unemployment rate fell to 3.9%, the lowest level since February 2020. We've reached pre-pandemic unemployment rate levels despite having 3.6 million fewer jobs. This is due to a significant drop in labor participation, which sits at 61.9% compared to 63.3% in February 2020. With such a small labor pool, businesses are struggling to find workers. There are a near-record 10.6 million jobs openings, which exceeds the number of unemployed workers by 53%. This lower labor participation is likely a new reality. Many people who exited the workforce took early retirement, others have reevaluated their life priorities, and the strong housing and stock markets are giving people confidence that they may not need to work. The Fed previously thought as a children went back to school and fiscal stimulus ran out, that we would see people re-enter the workforce. However, there's now recognition that we likely won't see participation increase meaningfully in the short-term, and therefore, the labor market is near full employment.

Since we are near full employment, Fed officials are now shifting their priorities to reigning in inflation. In November, the Fed began tapering its asset purchases, and at that time they signaled they would conclude their asset purchase program by March 2022. They also communicated that sometime after the conclusion of the program, they would begin raising interest rates. However, since November, the labor market has tightened, and inflation has increased faster than anticipated. The market is now bracing for a rate hike in March along with two more rate hikes this year. Even more surprising, details from December's Fed minutes revealed that the Fed is already discussing reducing its balance sheet. During the last cycle, the Fed stopped its asset purchases in 2014, but did not begin reducing its balance sheet until 2017.

The Fed's quick pivot to a more hawkish stance is due to more persistent and widespread inflation. In December, the Consumer Price Index increased at a rate of 7% annually and Core Inflation, which excludes food and energy, increased 5.5% annually. A year ago, the Fed's outlook for inflation in 2021 was 2.6%; clearly the Fed did not anticipate such an inflationary environment. Additionally, there doesn't seem to be any short-term catalysts to curb inflation. As I mentioned, the labor market remains tight, which will continue to put upward pressure on wages. The supply chain disruptions have not abated, and the Omicron variant threatens to prolong the disruption. Finally, as we enter the new year, companies are evaluating their pricing strategies and will likely continue to put through price increases.

The recognition that inflation may be more prolonged, and the change in the Fed's strategy is causing huge moves in the bond market. In last month, the yield on the 2-year Treasury note has risen over 15 basis points to 0.90, the highest rate since early 2020. A year ago, the 2-year note was 0.11 bps. In the last month, the 10-year note has increased from 1.48 to nearly 1.80 basis points. A year ago, the 10-year note was 1.08 basis points. In the last year yields have increased and the shape of the curve has flattened. This trend is expected to continue; however, we are still far away from a yield curve inversion.

The Fed's signal to begin fighting inflation reflects the strength of our economy and the quickness of the recovery. Across the board, we see strength in the labor marketing, consumer demand, and in housing. It will be important to watch if the Fed becomes too restrictive and reigns in the economy too aggressively, but we are still a long way from this point. A reflationary environment with strong demand is usually good for businesses and corporate earnings. Inflation is certainly something to be feared long-term, but for now the economy is on strong footing as we begin 2022.

ECONOMIC CHARTS