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MACROCOSM

Reflections on a Boom Year

Wednesday, December 29, 2021

Donald Luskin

Was it good for you too?

Thank you being a TrendMacro client, and a friend. As always, we will publish our year-ahead outlook in the first week of January. Today we will look back on the 657 research reports and videos we will have produced in 2021. But this won't take long. The starting point is our January 2021 outlook report (see "A Boom in 2021… But What Could Make It Bust?" January 4, 2021).

- *We called for an economic boom in 2021*, standing on the shoulders of our outside-the-box call for a V-shaped recovery, made in April 2020, the darkest days of the pandemic lockdowns. We told clients we could see real US GDP growth as high as 10%. The third quarter was ruined by the arrival of the Covid Delta variant, but as of this writing it looks like growth for the whole year is going to come in close to 6%.
- *We said the Covid vaccines would be effective at curbing case-growth, as the population quickly achieved herd immunity.* That was wrong.
- *We said there would be no more draconian lockdowns, no matter what the progression of the virus turned out to be.* That was right in terms of large-footprint government-imposed restrictions. But it was wrong in the sense that individuals nevertheless pulled back from economic activity and remobilization in the third quarter during the Delta variant wave.
- *We called for excellent performance by US equities, despite their strong rally in 2020.* We told clients to expect a 30% total return for the S&P 500, and as of this writing it looks like we pretty much hit it on the nose.
- *We called for a substantial back-up in long-term yields.* Versus the US 10-year Treasury yield of 0.91% at the end of 2020, finishing 2021 at 1.51% is substantial enough to cause a 3% total return loss for bondholders. But at the year's high for yields in March, we expected them to move higher still, and they didn't.
- *We called for outperformance by "value" over "growth" as the laggard industries in the economy re-opened.* For large-cap stocks, that was the right call for almost the whole first half of 2021, but in the back half it more than reversed itself. But for mid- and small-cap stocks, "value" strongly outperformed "growth" over the entire year.

Update to strategic view

US MACRO, US STOCKS, US BONDS, FEDERAL RESERVE, OIL: We correctly anticipated a boom, but we didn't attain the 10% real US GDP growth we'd talked about, thanks to the arrival of the Delta variant in Q3. We said no matter what the virus did, there would be no more lockdowns and the economy would continue to re-open. Our call for a 30% total return for the S&P 500 was spot-on. We were wrong that value would outperform growth – at least in large-cap, but in mid- and small-cap value strongly outperformed. We were correct that the 10-year yield would back up, but were wrong in March, at the top, when we expected it would rise further. We were right that there would be few policy wins for Biden, and no tax-hikes. We were right that inflation would emerge, and so far markets agree with our call that it will be transitory. We thought the Fed would be more dovish, but as policy has changed, we have been correct that it would have no market impact. We were correct that oil prices would rise, but that there would be no "super-cycle."

[Strategy dashboard]

- Those assessments are based on standard index definitions of "value" and "growth" that don't capture all the relevant recovery dynamics. We told clients specifically that energy and financials, two deep-value sectors, would outperform, and indeed they did – the first and third best-performing sectors this year, respectively. Similarly, we said other nations' stock markets would catch up to US performance, having lagged significantly in 2020. The US was the second-best performing major equity market this year, but France did better still, and Italy, India, Germany and the UK were very close behind.
- _As the year unfolded, we correctly recognized the five 5%-plus corrections that developed in equity markets – that is, we correctly called them mere corrections._ On the one day this year when the US equity risk premium rose just microscopically above its post-Global Financial Crisis mean, in the Omicron panic after Thanksgiving, we called for buying the dip. In April, when the ERP reached its narrowest post-GFC level, we correctly avoided calling for a tactical asset allocation move out of stocks and into bonds. Instead, we recognized a secular "regime change" in the ERP, reflecting the unique nature of the post-pandemic boom and the Fed's official abandonment of its erroneous Phillips Curve framework.
- _We called for the Joseph R. Biden administration to accomplish only few policy victories, and no tax-hikes._ We wrongly predicted that the Republicans would retain narrow Senate control, expecting that the GOP would hold at least one of the two Georgia seats up for grabs in January. But we said, either way, that the Democrats would lack either a mandate or an effective governing majority. We said in January, even before concrete proposals were made, that no tax-hikes could be enacted – and as of year-end, that's the way it has turned out.
- The administration's only victories were February's party-line American Recovery Plan Act (the third emergency Covid relief bill) and the bipartisan Infrastructure and Jobs Act. The latter was a Trojan Horse that, as we explained while it was happening, doomed further tax-and-spend initiatives by pulling out the components most attractive to swing-voters.
- _We predicted the Biden administration would not undo former President Donald J. Trump's tariffs on China, nor related non-tariff measures._ Though Biden could have done so with the stroke of a pen, he did nothing.
- _We predicted the Biden administration would not get a new nuclear deal with Iran._ We were right. However, early in the year, we became wrongly concerned that a deal was coming.
- _We said oil prices were too low at year end 2020, and that they would rise as demand returned._ That was correct. Mid-year, while many commodities analysts were calling for an inflationary super-cycle in oil prices, and production was recovering only grudgingly in the US, we correctly called for OPEC+ to gradually increase supply and contain prices.
- _We predicted there would be a surge of reported inflation due to base-effects and supply-demand mismatches, and that it would be_

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[About us]

transitory. We were very right about the reported inflation part, and its causes. It remains to be seen whether it is transitory, but as of year-end, market-implied expectations agree with us that it is.

- *We said Jerome Powell would be renominated as Fed chair.* He has been.
- *We said the Fed would do little or nothing to remove policy accommodation*. We weren't sufficiently hawkish in terms of policy changes, but we were correct in terms of market impact – which has been none. Specifically, we didn't think tapering of asset purchases would come this year, but as the hints started to come out, we correctly said there would be no tantrum. We have also been surprised by the speed at which markets have come to expect lift-off from the near-zero funds rate as soon as the May 2022 FOMC. Looking back on it, none of this should have surprised us. After all, we're the ones calling for an economic boom. We should have expected that the Fed would track it with matching policy changes.

Bottom line

We correctly anticipated a boom, but we didn't attain the 10% real US GDP growth we'd talked about, thanks to the arrival of the Delta variant in Q3. We said no matter what the virus did, there would be no more lockdowns and the economy would continue to re-open. Our call for a 30% total return for the S&P 500 was spot-on. We were wrong that value would outperform growth – at least in large-cap, but in mid- and small-cap value strongly outperformed. We were correct that the 10-year yield would back up, but were wrong in March, at the top, when we expected it would rise further. We were right that there would be few policy wins for Biden, and no tax-hikes. We were right that inflation would emerge, and so far markets agree with our call that it will be transitory. We thought the Fed would be more dovish, but as policy has changed, we have been correct that it would have no market impact. We were correct that oil prices would rise, but that there would be no "super-cycle."