Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

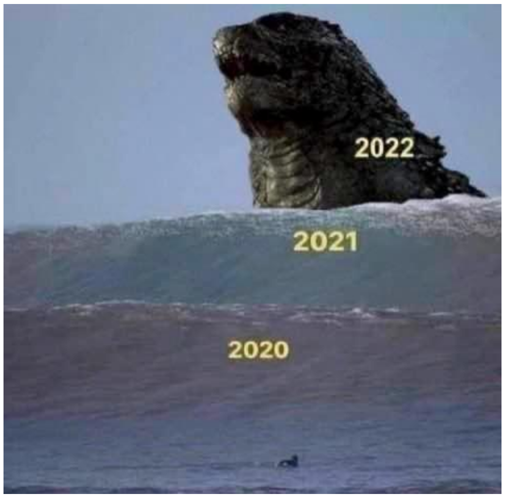
MACROCOSM

Boom On…

Tuesday, January 4, 2022

Donald Luskin

Sour sentiment and surprisingly normal valuations set the stage for another strong year.



We enter 2022 with 48% of Americans calling the boom year of 2021 "poor," rating it the worst in the history of the polling other than 2020. 29% think 2022 will be "poor" as well. In terms of the economy and the markets, 2021 is going to be hard to beat, and we likely won't, as the post-pandemic boom settles toward a steady state. But *2022 will be a continuation of 2021's boom* (see "Reflections on a Boom Year" December 29, 2021), *with the global economy continuing to both re-open from the pandemic lockdowns and gain productivity by adopting the new technologies and new methods learned under the lash of necessity. With sentiment where it appears to be, surprises will be on the upside*.

OMICRON AND THE PANDEMIC *At the end of the day, the markets and the economy don't care about the coronavirus – they just care about the way consumers, firms and governments will react to it.*

- *Our core prediction on this remains that the era of lockdowns is substantially over*. Everyone knows they didn't succeed in containing the pandemic, and no one is willing to try them again – at least nowhere near the scale of 2020 – and cause another global depression for no purpose (see "Let It Go, Let It Rip" August 4, 2021).

- *Nevertheless, cautious or scared individuals can pull back from economic activity voluntarily. We think the fact that the TrendMacro Social Distancing Index has made new lows – indicating the best-ever levels of*

Update to strategic view

US MACRO, US STOCKS, US BONDS, FEDERAL RESERVE, OIL: Gloomy sentiment sets the stage for another boom year in which all surprises will be on the upside. The Omicron case-wave may have already crested, if South Africa is a template. Its low virulence is minimizing panic and acting as an impromptu vaccine. There will be no more draconian lockdowns, or significant consumer withdrawal from economic activity. Equity valuations, according to our ERP model, begin 2022 precisely where they began 2021. This year forward earnings upgrade momentum is well above average, but not at last year's extraordinary pace, pointing to an above-average year for stocks, but not a repeat of last year's stellar returns. A low bar is set for this earnings season, when sufficient surprises could reignite a new upgrade cycle. The curve is discounting Fed lift-off at the May FOMC meeting. If growth and labor market recovery continue as they have, which we expect, lift-off won't be tightening, but only an appropriate policy adjustment. But we…

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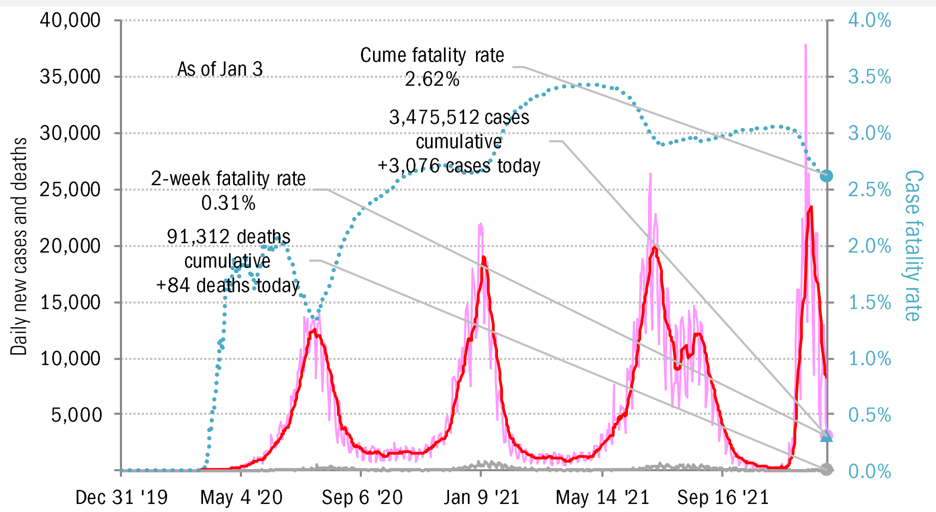
<u>remobilization of the US economy since the 2020 lockdowns, despite the Omicron case-wave of the last month – shows that individuals are as "over it" as governments</u> (see ["Video: What you're not hearing about Omicron and the most important chart in economics"]() December 27, 2021).

- This is enabled by the fact that Omicron, while leading to the worst-ever number of new cases seen in the pandemic, is causing relatively few hospitalizations or deaths – just as we predicted for it at the very beginning (see "Video: What you're not hearing about the Omicron variant" November 28, 2021).
- *<u>And Omicron may prove to be a more effective vaccine than the vaccines. At the cost of producing mostly just mild illness, it seems that</u>* *it is effective at immunizing people against Delta and other variants*.
- If we had to venture a guess as to where the pandemic is going, we will just remind you that we already pointed out that the Omicron case-wave quickly crested and reversed in South Africa, where it all started (please see the chart below, and see "Video: Three things you aren't hearing about the Omicron variant, one month later" December 22, 2021). It's still early days, but it's looking like that has set a pattern for other nations, including the US – if we had to place bets, we'd say we've seen the worst.

Covid in South Africa



Source: Johns Hopkins, TrendMacro calculations

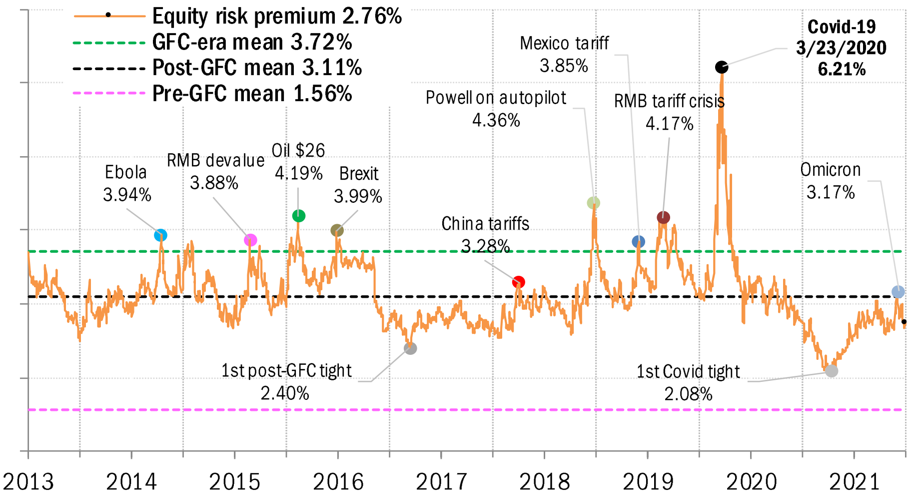
EQUITIES AND VALUATIONS 2021's 28.7% S&P 500 total return is a high bar for 2022, especially given the conventional wisdom that valuations are already rich. *<u>But the reality is that valuations, at least valuations relative to bonds as expressed in our S&P 500 equity risk premium model, are starting this year virtually exactly where they were a year ago – literally just a 1 bp difference</u>* (please see the chart on the next page).

[Continued from first page]

…expect statistical inflation rates to cool, and perhaps even briefly reverse, so the FOMC might wait as an insurance policy, in which case we would expect only two hikes this year. Oil prices are key, having been a major contributor to current inflation levels; that contribution will wane, as we expect oil will be flat to lower this year. Long-term yields will drift higher, but we don't expect a growth-damaging back-up. Democrats might continue to push Build Back Better, but we believe it is now too damaged to survive. The GOP will take back the House and likely the Senate in the midterms, ending BBB definitively. The cessation of child tax credits is not a fiscal cliff depriving the economy of consumption power, but rather the end of an economic distortion that has crippled the supply-side by incentivizing workers at the margin to withhold their labor in the face of abundant job openings.

[Strategy Dashboard home]

S&P 500 equity risk premium after recovery from the Global Financial Crisis



Source: Various, TrendMacro calculations

- ERP-based valuations for stocks got downright cheap a month ago, in the sharp correction following the emergence of the Omicron variant. Well, "cheap" in the sense that the ERP moved – for one day – slightly above the post-GFC mean. The ERP is reliably mean-reverting, but we don't think that's the relevant mean any more – so we said "buy the dip" (see "Video: What you're not hearing about the Omicron variant" November 28, 2021) and have marked the day with a new dot in the ERP chart (again, please see the chart above). We continue to believe there has been a "regime change" that has shifted the mean lower (see "Regime Change for the Equity Risk Premium?" April 19, 2021), which implies that *values even slightly above the post-GFC mean represent relative undervaluation of equities*.
- Now, with the ERP narrower, equities are not as undervalued as they were a month ago – but we think they are still somewhat undervalued relative to bonds.
- Furthermore, even though the ERP is right where it was a year ago, the forward earnings growth wave – and earnings season upside surprise wave – that were in motion then (see "Earnings Versus the Bubble" May 26, 2021) are now significantly moderated.
- The annualized month-over-month forward earnings growth rate is now about 21% -- well above the historical average of about 11%, but far below the sometimes triple-digit values we were seeing last year. All else equal, *this points to a well above-average year for US equities – say, something like a total return of 20% – even if it falls somewhat short of last year's outsized total returns. As re-opening continues, we expect another year of confusing growth/value relationships, made difficult by the dominating presence of just a few very large companies in the "growth" category. We expect another good year for value industry groups such as finance and energy, and catch-up from non-US markets whose economies have not so far re-opened as much as the US has.*

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Dallas TX
214 550 2121
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

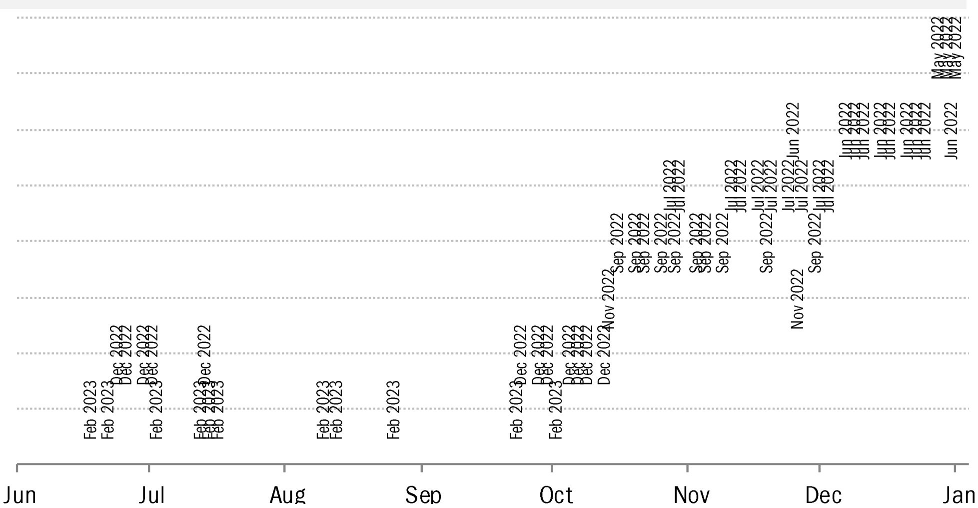
[About us]

- *<u>We can't rule out that moderating earnings growth expectations are too pessimistic, and that all they really mean is a lowering of the bar for actual earnings.</u>* We will know in a week or two if this earnings season will be one of the surprises to the upside we are expecting, in which case it would re-ignite a more rapid upgrade rate.
- Long-term Treasury yields are another component of the ERP. Rising yields last year narrowed the ERP somewhat, making equities less relatively attractive. We'll comment more on yield expectations in 2022 momentarily, but for now we'll just say that we don't see them as a dominating headwind.

WILL INFLATION BE TRANSITORY, AND WILL THE FED TIGHTEN?
<u>No, but the Fed will lift off from the near-zero funds rate</u>. Assuming the economy continues to boom – as it continues to remobilize after the Covid lockdowns and enjoys the productivity gains earned during the crisis – then lift-off would simply track the natural rate of interest higher (see "'Hawkish Powell'? Not a Chance." December 1, 2021). That is different than tightening, which is when policy rates move higher without an associated improvement in the economy.

- Already, once Q4-2021 is reported, we expect we will see that real GDP grew 5.7% over the year, ending it 3.3% higher than the prior pre-pandemic high. The unemployment rate will likely fall to, or below, its low pre-pandemic levels by the March jobs report (see "On the November Jobs Report" December 3, 2021). *<u>Tapering asset purchases will be complete by then, setting the stage for lift-off at the May 4, 2022 FOMC meeting – which the money-market curve now fully expects (please see the chart below</u>*). We're happy enough going along with that consensus, but if anything we would take the over – we expect Fed Chair Jerome Powell will be comfortably reconfirmed by then, and that inflation data will have started to moderate. *<u>We wouldn't be surprised at all to see the</u>*

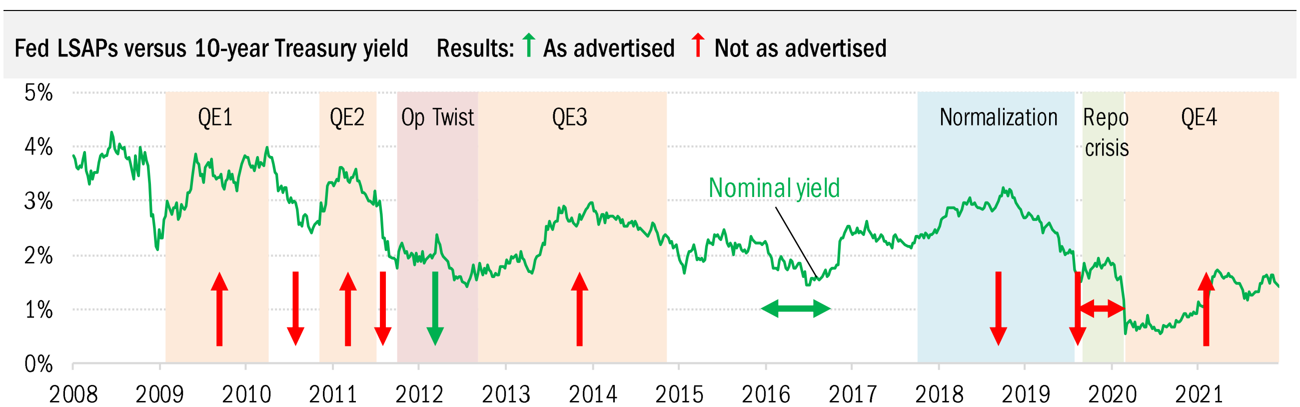
Futures-implied FOMC meeting of lift-off from near-zero funds rate



Source: Bloomberg, TrendMacro calculations

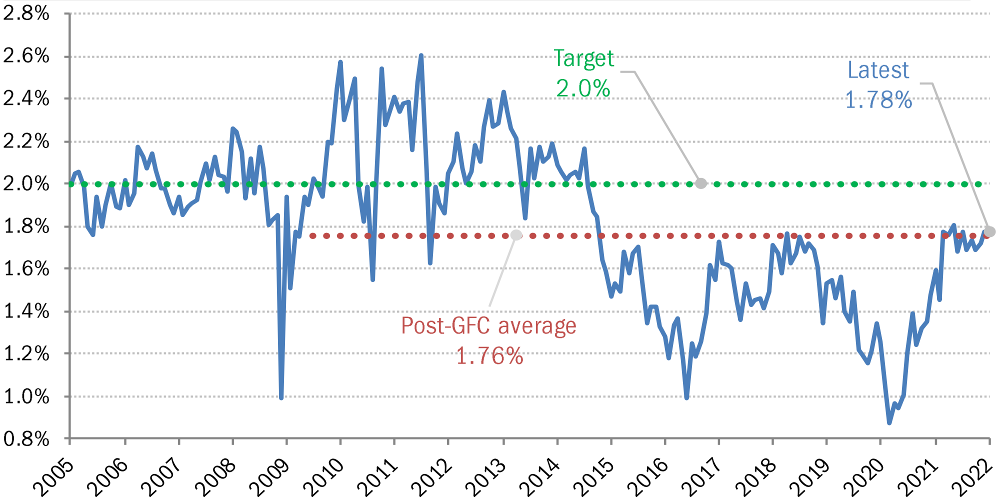
Powell Fed wait a meeting or two as an "insurance policy." Markets are looking for three hikes this year – we wouldn't be surprised by only two.

- That said, we think no insurance will be necessary. Lift-off, understood in the context of tracking growth, not tightening, even if it comes in May, is not growth-unfriendly. Indeed, to fail to lift off under those circumstances would make the Fed increasingly, and inappropriately, accommodative.
- *And remember, because a May lift-off is already completely discounted in the money-market curve, it is as though it has already happened. We're not seeing any tantrums.*
- *The risk here is that the Fed makes what we think would be a huge policy error – by moving faster and more aggressively than we're anticipating, by actually tightening – if it runs out of patience with inflation, and tries to quell it, even though its origins were never monetary to begin with* (see, among many, "Is Inflation Still 'Transitory'?" October 13, 2021). *We see this as highly unlikely, because we still read Powell as very squared away on the true nature of the inflation blip we're seeing now, even if the specific word "transitory" has to be shelved for political optics* (see "On the December FOMC" December 15, 2021).
- *In our baseline 2022 – taper concludes in March, lift-off in May or June, two or at most three hikes, economic growth in a somewhat moderating boom – we don't see the curve-flattening that the consensus seems to be worried about.*
- Again, the short-end has already done what it's going to do consistent with these policy expectations. And we think long yields are still too low for our moderating boom scenario. We're not looking for a scary-big back-up, nothing that would put too big a dent in the equity risk premium – after all, history has no example of a sharp back-up following termination (or even reversal) of Fed asset purchase programs (please see the chart below). *The governing dynamics will be the interplay of a waning atmosphere of caution on the one hand, pushing yields higher, and an ongoing global savings glut keeping a lid on them. What would be the highest 10-year yield you'd see in that kind of world – 2.5% perhaps?*
- By the way, we don't assign a big role in determining yields this



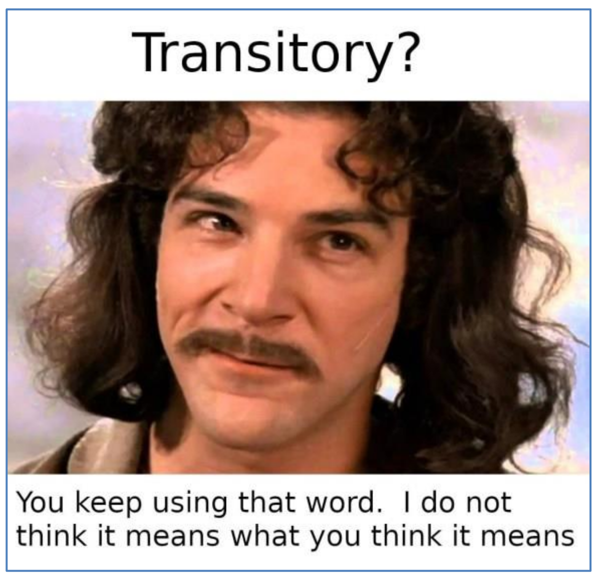
Source: Bloomberg, TrendMacro calculations year to waning panic about inflation not being transitory. The inflation component in US Treasuries has never panicked about inflation to begin with (please see the chart below).

Five-year five-years forward TIPS breakeven (downward adjusted 50 bp for PCE basis)



Source: Bloomberg, TrendMacro calculations

- *<u>The risk to this forecast is on the downside. We can't rule out that inflation might prove to be more than transitory, that is, it might actually reverse to some extent. Simply the cessation of continuing inflation in a few key categories – especially motor fuels and motor vehicles – should easily bring overall inflation back to target.</u>* For instance, for motor fuels to repeat their year-over-year contribution to today's alarmingly high CPI inflation, oil would have to go to \$160 per barrel. That *could* happen but it's *not going to* happen. All oil has to do is stay unchanged for a year and inflation comes down by something like 160 bp.



- *<u>Indeed, unchanged to slightly lower is our baseline forecast for the oil price, with global inventories right where OPEC+ wants them, where the cartel can gradually release capacious excess capacity to meet recovering demand.</u>*
- *<u>If motor fuels, motor vehicles and other categories where prices have been inflamed in the post-pandemic recovery actually reverse their gains, we could be looking at CPI prints that appear to be downright deflationary. Maybe the Treasury market would look through that, as it has looked through inflation all along – but maybe not. It's certainly not a world in which yields would get away to the upside.</u>*

POLITICS, POLICY AND THE FISCAL CLIFF As we predicted would happen, a "no" from Senator Joseph Manchin III (D-WV) seems to have killed the Build Back Better Act (see: "Video: at you're not hearing about... BBB RIP" December 20, 2021). If we were advising President Joseph R. Biden Jr., we'd tell him he should let this unpopular exercise in over-reach fade away and be forgotten as soon as possible – for his own sake. But our intuition is that he, or at least his party, imagines that their interests are best served by soldiering forward on it, to be seen as "doing something." *So as long as Democrats have even tenuous control of Congress, it can still come back in some modified form – a variant, if you will. But like Omicron, any BBB variant that has any chance of getting past Manchin, Kyrsten Sinema (D-AZ) or their equivalents in the House, will be not very virulent.*

- *The worst policy errors – raising the marginal corporate income tax rate, or the personal capital gains tax rate – have already been definitively killed by Sinema, and are highly unlikely to come back no matter what else happens.*
- Manchin has clearly exposed the budget chicanery in the House version of the bill, which fantastically posits that spending programs will sunset after one or just a few years (thus disguising their true cost). To fit BBB – with honest budget accounting – into a bill small enough to get by Manchin and other moderates will require the Democrats to do the impossible: to agree among themselves on only a tiny subset of the spending programs now in the bill, and throw all the rest overboard. That's too many sacred cows to be sacrificed. The performative politicians making up the Democrats' progressive wing will find it more personally profitable to *not* settle for half a loaf, but rather to walk away from the bill, vilify Manchin and other blockers, and go into their safe-district primaries advertising their ideological purity.

- The restoration of the deductibility of state and local taxes will be a particular sticking point. Key Democratic moderates in the House insist on it, yet progressives – especially Bernie Sanders (D-VT) are opposed to it as a sop to the rich. Any concession to deductibility both makes the budget-balancing math harder and alienates progressives.
- Finally, a vote for BBB by any Democratic moderate gets more expensive and risky every day, as the midterm elections approach (now just ten months away). Moderates who might vote for BBB will have to defend themselves in swing districts where BBB is unpopular and will have to endure attacks by well-funded

Republican opponents who will hold them accountable for it. We are highly confident that the GOP will take control of the House, and reasonably confident that they will take the Senate. It doesn't have to be the red wave that some of our friends on the right are talking about – indeed, if inflation subsides and the economy continues to improve as we expect, it may not be. But the Democrats' margins of control are so narrow, even a wavelet will do it. And all it takes is one chamber, and then BBB will officially be dead and gone.

- *We tend to focus on the risk to markets of higher tax rates, especially on corporations or on capital gains, that might have eventuated if BBB had passed. But some clients are just as worried about a "fiscal cliff" caused by BBB not passing – specifically, the year-end 2021 expiration of refundable child credits that had acted effectively as stimulus payments through most of 2021.*
- First, as proposed, the cost of continuing the child credits would entail massive tax increase on firms and individuals – so even if they were continued, whatever stimulative effect they had this year when they were not tax-funded could not be repeated.
- That aside, we acknowledge that these payments, amounting in some cases to many thousands of dollars to multi-child families with below-median incomes, contributed to the ability of those households to consume last year. But much of that extra income appears to have been saved. And its economic benefit on the demand-side came at an offsetting cost on the supply-side. At the margin, workers found themselves with the wherewithal to stay out of the labor market, leading to a record drop in labor force participation and a record jump in unfulfilled demand for workers. *After a certain point, no amount of demand-side stimulus can drive growth when the supply-side is labor-constrained from further production. Indeed, this is one of the key bottlenecks that has led to the supply-demand mismatches that have fueled transitory inflation. It is not a fiscal cliff if a non-worker stops receiving government payments, provided he can quickly get a job that replaces that lost income – and it enables otherwise impossible production at the same time. No, that is not a fiscal cliff: it is a pathway out of economic distortion and towards equilibrium*.

Bottom line

Gloomy sentiment sets the stage for another boom year in which all surprises will be on the upside. The Omicron case-wave may have already crested, if South Africa is a template. Its low virulence is minimizing panic and acting as an impromptu vaccine. There will be no more draconian lockdowns, or significant consumer withdrawal from economic activity. Equity valuations, according to our ERP model, begin 2022 precisely where they began 2021. This year forward earnings upgrade momentum is well above average, but not at last year's extraordinary pace, pointing to an above-average year for stocks, but not a repeat of last year's stellar returns. A low bar is set for this earnings season, when sufficient surprises could reignite a new upgrade cycle. The curve is discounting Fed lift-off at the May FOMC meeting. If growth and labor market recovery continue as they have, which we expect, lift-off won't be tightening, but only an appropriate policy adjustment. But we expect statistical inflation rates to cool, and perhaps even briefly reverse, so the FOMC might wait as an insurance policy, in which case we would expect only two hikes this year. Oil prices are key, having been a major contributor to current inflation levels; that contribution will wane, as we expect oil will be flat to lower this year. Long-term yields will drift higher, but we don't expect a growth-damaging back-up. Democrats might continue to push Build Back Better, but we believe it is now too damaged to survive. The GOP will take back the House and likely the Senate in the midterms, ending BBB definitively. The cessation of child tax credits is not a fiscal cliff depriving the economy of consumption power, but rather the end of an economic distortion that has crippled the supply-side by incentivizing workers at the margin to withhold their labor in the face of abundant job openings.