

*In this Q4 recap: U.S. economy confronts a new COVID-19 variant amid continuing inflation and supply chain bottlenecks. Europe institutes new social restrictions in response to a surge in Delta and Omicron variant infections. Investors turn cautious as uncertainties increase.*

# Quarterly Economic Update

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*A review of Q4 2021, Presented by DSA Financial Group*

## THE QUARTER IN BRIEF

The stock market kicked off the fourth quarter with a powerful rally in October and added to those gains into November until investors were blindsided by news of the emergence of a new COVID-19 variant, Omicron, and testimony by Fed Chair Jerome Powell that escalating inflation and an improving labor market warranted consideration of an acceleration of its bond purchase tapering plans.

Markets, as a rule, do not like surprises and uncertainty and the combination of a new variant and a suddenly more hawkish Fed sent stocks into a skid that largely erased the November's accumulated gains. Market reaction to the Omicron news was exacerbated by when the news hit--on Black Friday, a day that typically provides less liquidity since many investors and traders are on holiday.

Investors soon learned the contours of what a more hawkish monetary policy would look like. In its mid-December meeting, the Federal Open Market Committee (FOMC) announced plans to speed up its bond purchase tapering schedule and signaled that, once tapering is concluded in March 2022, up to three rate hikes may follow.

Markets settled down into the final weeks of the quarter as early indications suggested that Omicron's health impact was less severe than the Delta variant. Relieved that its economic consequences may be less than initially feared, reinvigorated investors jumped back into the market, pushing stocks higher into the end of December and capping a strong year of performance.

Corporate profits for the third quarter were solid. Eighty-two percent of the companies comprising the Standard & Poor's 500 Index reported earnings above Wall Street analysts' expectations, posting an average earnings growth rate of 39.8% in the third quarter. This earnings momentum is anticipated for the fourth quarter, with an earnings growth forecast of 20.9%, which, if realized, will mark a historical high watermark in corporate profits.<sup>1</sup>

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## THE U.S. ECONOMY

After a Delta variant-induced slowdown in the third quarter, signs are pointing to a strong economic rebound in the fourth quarter and solid growth into 2022. Though the official economic growth rate for the fourth quarter won't be reported until January's Gross Domestic Product (GDP) report, according to the Federal Reserve Bank of Atlanta, which tracks economic data in real time, their model is indicating a 7.2% annualized real rate of Q4 GDP growth.<sup>2</sup>

This economic rebound overcame several headwinds, including accelerating inflation, supply chain bottlenecks, a labor shortage, and a pending pivot toward monetary normalization.

The labor market evidenced considerable recovery as initial jobless claims fell steadily, while the unemployment rate shrank to 4.2% in November, even as some 600,000 Americans entered the labor market and the labor participation rate rose to pre-pandemic levels.<sup>3</sup>

The nation's manufacturing sector gathered momentum in the fourth quarter. The Institute for Supply Management (ISM) Manufacturing Index rose in November for the eighteenth straight month, with the trend pointing toward a faster acceleration in that growth.<sup>4</sup>

Looking ahead, one survey of economists conducted by the Federal Reserve Bank of Philadelphia shows a median forecast of 3.9% in GDP growth in 2022, with stronger growth in the first half of the year and a moderating expansion in the final two quarters.<sup>5</sup>

Especially noteworthy is the American consumer, the primary driver of economic growth. Americans have stockpiled \$2.3 trillion of excess savings (i.e., savings above pre-pandemic levels), providing a strong underpinning to fuel future economic activity.<sup>6</sup>

While the economic outlook appears positive, headwinds exist.

The economic impact of Omicron is difficult to estimate. For now, it appears unlikely to lead to widespread lockdowns, but it may pose the potential to prune economic growth at the margins.

Perhaps the most concerning potential financial risk is inflation, which has persisted at an elevated rate for longer than the Fed expected. November's Consumer Price Index (CPI) provided little comfort, as prices jumped at a rate not seen in nearly forty years, rising 6.8% year-over-year. It was the sixth consecutive month that inflation exceeded 5%.<sup>7</sup>

Shaky consumer confidence is another possible risk. Though consumers may be flush with excess savings, spending requires consumers to be confident about their personal situations and the economy. In the University of Michigan's November consumer sentiment survey, Americans expressed less optimism than at any time since the credit crisis years, largely due to rising inflation and perceived government inaction to address it.<sup>8</sup>

While additional risks may present further challenges, the overall expectation, nevertheless, is for continued economic expansion in the near- to intermediate-term.

## GLOBAL ECONOMIC HEALTH

The economic outlook in European Union (EU) countries remains encouraging despite the rise in Delta and Omicron variant infections and instances of some countries, e.g., Austria and Germany, instituting fresh economic restrictions. Maintaining this economic growth momentum has been primarily a result of continued progress in the region's vaccination efforts. As a consequence, the EU economy is projected to grow by 5.0% for the full year 2021 and by 4.3% in 2022. Domestic demand and an improving labor market are expected to drive this economic improvement, but inflation, ongoing supply chain bottlenecks, and the Omicron variant are the main risk factors that could upend this otherwise strong forecast.<sup>9</sup>

The Bank of England is less sanguine about the prospects for the United Kingdom's economic growth going forward. While GDP growth in 2021 is expected to be a very healthy 7.0%, the estimated growth rate for the fourth quarter was shaved due to supply chain disruptions. For 2022, the U.K.'s central bank is forecasting a 5.0% expansion in GDP. Similar to other countries, continuing supply chain problems, inflation, and the spread of COVID-19 represent risks to the U.K. economy in the months ahead.<sup>10</sup>

Economic growth in China slowed considerably in the latter part of 2021. In fact, GDP growth in the third quarter (+4.9%) was the slowest growth rate in a year, and materially lower than the second quarter growth rate of 7.9%. Economic growth is expected to further decelerate in the fourth quarter and remain weak into the first half of 2022. There are a variety of factors that are weighing on China's economy, including its zero-COVID policy, power shortages, massive debts held by property developers, and the drag of government regulation on private sector businesses.<sup>11</sup>

The Bank of Japan shaved its forecast for economic growth in 2021 from 3.8% to 3.4%, but raised its estimate for GDP expansion in 2022 to 2.9%, up from 2.7%, citing the effects of COVID-19 infections and the expectation that the Japanese economy would rebound as the COVID-19 overhang wanes.<sup>12</sup>

The MSCI-EAFE Index, which tracks developed overseas markets, rose 2.40% in Q4, while emerging markets, as measured by the MSCI-EM (Emerging Markets) Index, fell 1.68%.<sup>13</sup>

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#### TIP OF THE QUARTER



*Consider ramping up your college savings with rewards programs. There are credit cards and online shopping programs available that can allow you to direct a steady stream of rebates toward your education fund.*

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#### LOOKING BACK, LOOKING FORWARD

Investors enjoyed robust stock market returns in 2021. It was a performance that had less to do with P/E ratio (Price-to-Earnings) expansion – the market P/E actually came off its high – and more a result of strong earnings growth.

One overlooked feature of the stock market's 2021 performance was the successive waves of rotational corrections. From the view of major indices, stocks enjoyed a steady rise throughout the year without a correction (i.e., a decline of 10%-20%), suggesting a generally stable, even placid, stock market.

However, beneath this smooth ascent were periods of volatility for specific industry groups. For example, as of November 26, while the year-to-date return on the S&P 500 was 22%, 92% of its

constituent stocks experienced at least a 10% decline from their YTD highs, with an average drawdown of 18%. Similarly, the technology-heavy NASDAQ Composite, which was up by 20%, saw 89% of stocks with a drawdown of at least 10% and an average retreat from YTD highs of 40%.<sup>14</sup>

In other words, while the major market indices did not experience a correction, most stocks comprising these indices suffered corrections at some time during the year.

It is unrealistic to expect a repeat of the 2021's outsized gains, but the consensus of Wall Street analysts is one of modest price gains in 2022 amid continued economic growth and low, though rising, interest rates.

While the market may be affected by multiple "known unknowns," e.g., geopolitical flare-ups, trade frictions, or inflation, there are several key ones worth highlighting.

The Federal Reserve began to pivot toward monetary normalization, announcing in December an acceleration of bond tapering and the possibility of up to three interest rate hikes. Markets expected this, so this may already be priced in. However, if the Fed finds itself behind the inflation curve and needs to increase the number of rate hikes or accelerate their pace, it may unsettle investors.

Corporate earnings growth is anticipated to moderate in 2022. This is to be expected considering the rate of economic expansion will likely slow and its comparative period, 2021, established such a high bar.

That said, 4Q 2021 earnings (reported in 1Q 2022) is forecast to grow by 20.9%, which, if that materializes, means 2021 full-year earnings growth will be 45.0%. For 2022 Wall Street analysts are projecting an 8.8% jump in corporate profits. This is a substantial come-down, but it represents healthy growth from a high watermark. Should companies exceed these expectations, it may help support higher valuations.<sup>15</sup>

Another important market influence may be a slowdown in China's economy. A deceleration in the growth of the world's second largest economy may translate into lower consumption of imported consumer goods or production of manufactured goods, representing a potential risk to the global economy.

Possible rate hikes, higher inflation, and moderating economic growth may sound like a recipe for a tepid stock market, but history tells us that stocks are more likely to rise in a rising interest rate environment and during periods of moderate economic deceleration. While past performance is not a guarantee of future returns, it suggests that markets may advance under less-than-optimal circumstances.<sup>16</sup>

| <b>MARKET INDEX</b> | <b>12/31 Close</b> | <b>Q4 % CHANGE</b> | <b>Y-T-D % CHANGE</b> |
|---------------------|--------------------|--------------------|-----------------------|
| DJIA                | 36,338.30          | +7.37%             | +18.73%               |
| NASDAQ              | 15,644.97          | +8.28%             | +21.39%               |
| S&P 500             | 4766.18            | +10.65%            | +26.89%               |

| <b>BOND YIELD</b> | <b>12/31 RATE</b> | <b>1 MO AGO</b> | <b>1 YR AGO</b> |
|-------------------|-------------------|-----------------|-----------------|
| 10 YR TREASURY    | 1.51%             | 1.44%           | 0.92%           |

Sources: Wall Street Journal, December 31, 2021, Treasury.gov (Bond Yield)

The market indexes discussed are unmanaged and generally considered representative of their respective markets. Individuals cannot directly invest in unmanaged indexes. Past performance does not guarantee future results. U.S. Treasury Notes are guaranteed by the federal government as to the timely payment of principal and interest. However, if you sell a Treasury Note prior to maturity, it may be worth more or less than the original price paid

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which all other metals trade. The CAC-40 Index is a narrow-based, modified capitalization-weighted index of 40 companies listed on the Paris Bourse. The DAX 30 is a Blue Chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange. The FTSE 100 Index is a share index of the 100 most highly capitalized companies listed on the London Stock Exchange. BSE Sensex or Bombay Stock Exchange Sensitivity Index is a value-weighted index composed of 30 stocks that started January 1, 1986. Nikkei 225 (Ticker: ^N225) is a stock market index for the Tokyo Stock Exchange (TSE). The Nikkei average is the most watched index of Asian stocks. The Hang Seng Index is a free float-adjusted market capitalization-weighted stock market index that is the main indicator of the overall market performance in Hong Kong. The All Ordinaries (XAO) is considered a total market barometer for the Australian stock market and contains the 500 largest ASX-listed companies by way of market capitalization. The SSE Composite Index is an index of all stocks (A shares and B shares) that are traded at the Shanghai Stock Exchange. The S&P/TSX Composite Index is an index of the stock (equity) prices of the largest companies on the Toronto Stock Exchange (TSX) as measured by market capitalization. The MSCI Emerging Markets Index is a float-adjusted market capitalization index consisting of indices in more than 25 emerging economies. The MSCI World Index is a free-float weighted equity index that includes developed world markets and does not include emerging markets. The CBOE Volatility Index<sup>®</sup> is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. The S&P SmallCap 600<sup>®</sup> measures the small-cap segment of the U.S. equity market. The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index. Additional risks are associated with international investing, such as currency fluctuations, political and economic instability and differences in accounting standards. This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. MarketingPro, Inc. is not affiliated with any person or firm that may be providing this information to you. The publisher is not engaged in rendering legal, accounting or other professional services. If assistance is needed, the reader is advised to engage the services of a competent professional.

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