Economic & Financial Markets

Monthly Review

December 2021

Supply, transportation, and labor constraints boost inflation, but economic data bring holiday cheer

Concerns remain, but growth has picked up from the third-quarter lull

Omicron and the Fed shake financial markets

Rate liftoff in 2022 becoming more likely

Nationwide®
is on your side

In this issue

Produced by Nationwide Economics

David W. Berson, Ph.D., CBE
SVP & Chief Economist

Bryan Jordan, CFA
Deputy Chief Economist

Ben Ayers, MS
Senior Economist

Dan Hadden, CFA
Financial Markets Economist

Scott Murray, CFA
Financial Markets Economist

Daniel Vielhaber, MA
Economist

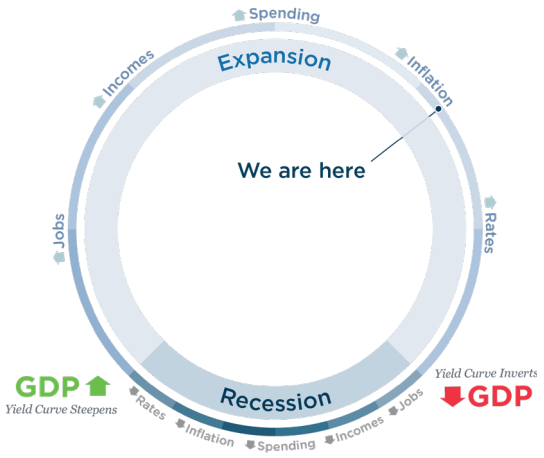
Jayne Rinehart
Senior Executive Secretary

Brian Kirk
Communications Consultant

Economic Update

Business Cycle

As of November 2021



The Covid-19 recession was officially the shortest on record — lasting only for the two months ending in April 2020. Since then, rapid economic growth has boosted the level of real GDP above the pre-Covid peak — transforming the recovery to an expansion.

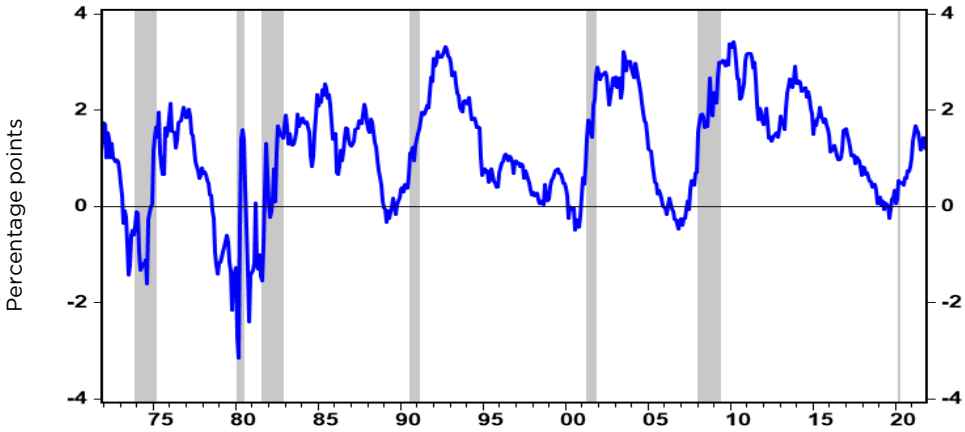
Covid-caused supply chain, transportation, and labor supply issues have slowed growth and pushed inflation higher in recent months. But with demand strong (especially from consumers) and the supply side issues beginning to subside, growth is already picking up again while inflation should slowly subside next year. Still, inflation is likely to remain higher than in the pre-Covid period, given where the economy is in the business cycle.

Yield Curve

Spread between 10-year and 1-year U.S. Treasury yields

One of the best predictors of an economic downturn is a fully inverted yield curve, when short-term interest rates are above long-term rates for a sustained period. But the new world of the Covid-19 pandemic and government responses to the virus superseded the usual recession rules early last year.

The spread between 10-year and 1-year Treasury note yields fell in November (and early December) in anticipation of Fed rate hikes and growth concerns from the Omicron variant. At this point, however, the spread is not low enough be considered a recession warning.



Sources: Bureau of Labor Statistics; Haver Analytics
Shaded areas depict recessionary periods

Concerns remain, but growth has picked up from the third-quarter lull

Despite lingering concerns coming from continued supply chain disruptions and rising inflation, plus new concerns stemming from the Omicron variant, economic data were strong for November. Although the payroll employment gains were disappointing, the details in the jobs report were much more encouraging. Consumers continue to spend, despite reduced sentiment, while business surveys show that both manufacturing and services continue to grow strongly — with services at a record high.

Encouraging details in the employment report

Nonfarm payrolls grew by only 210,000 for November (market estimates were for 575,000), but upward revisions totaling 82,000 were added to October and September's figures. Moreover, the details of the report were encouraging. The household survey showed a drop in the unemployment rate to 4.2 percent — the lowest level since before the pandemic — despite a rise in the labor force participation rate. A dramatic rise in civilian employment of 1.14 million was responsible for the decline in the unemployment rate, and the disconnect between civilian employment and payrolls suggests a reasonable chance of upward revisions to November's payroll number.

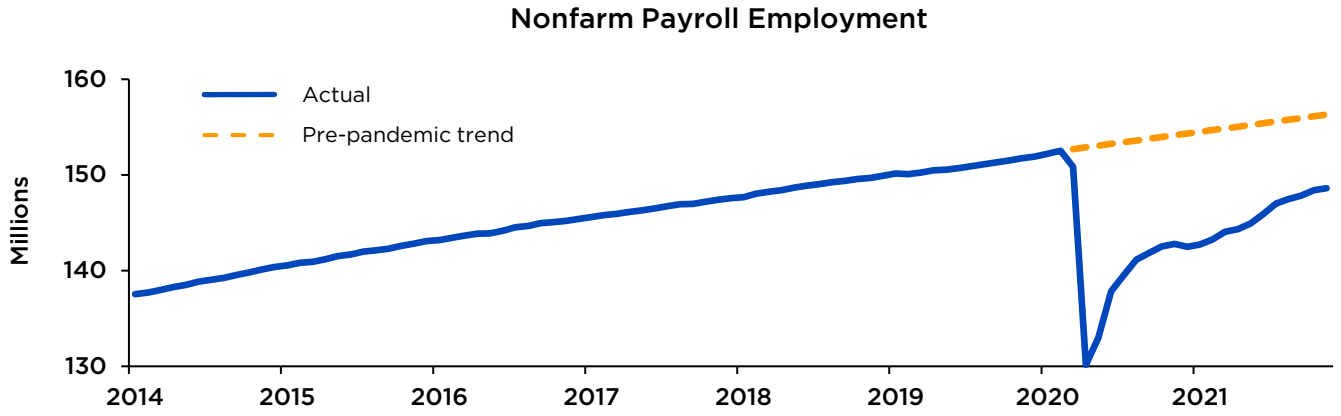
On balance, these data are positive for the labor market. It appears that workers entering the labor force are having very little trouble finding jobs, as evidenced by the simultaneous jump in the labor force and drop in unemployment. Still, while rising to the highest level since March 2020, the November labor force participation rate of 61.8 percent remains well below the pre-Covid trend (over 63 percent). Additionally, while payrolls are now only about four million below the prior peak from February 2020, they remain roughly eight million below where they could have been if employment had kept growing at its prior trend from the last peak. Continued growth in labor force participation will likely be needed to approach a new employment peak in the next several years. In the absence of that, however, low unemployment rates will imply tighter labor markets than in the past.

Consumers concerned, but continue to spend

There is a disconnect between consumer sentiment/confidence surveys and consumer spending. The consumer confidence index fell for November to its lowest level since February, while the consumer sentiment index dropped to its lowest level in a decade. The main concern is inflation, with many complaining of declining living standards and anticipated cutbacks in spending due to rising prices. Despite these concerns, however, consumer spending has been very strong, and the October data show particularly strong growth in spending on goods (helped by a modest pickup in auto sales, as some supply constraints are loosening). Furthermore, despite high motor fuel prices, car travel has remained strong and airport passenger throughput has recovered to pre-pandemic levels. It's possible that the concerns expressed by consumers will show up in behaviors in coming months or that the Omicron or other future Covid variants could offer additional speed bumps, but current readings suggest that consumers are contributing strongly to growth in the fourth quarter.

ISM services index climbs to a record high

November's ISM manufacturing index reading was up modestly from the prior month and consistent with strong sector growth. Gains were seen in new orders, production, and employment (the fastest since April for the latter two), while supplier delays and input price indices both edged down (but remained very high). The ISM services index had a more significant increase, climbing to its highest level on record (data back to 1997), breaking the record set a month earlier. The increase was aided by a new record for the business activity component, while new orders matched their record from October. While not setting records, supplier delays, input prices, and the backlog of orders all remain very high from a historical perspective. Taken together, the manufacturing and services readings are consistent with the view that economic growth has picked up significantly from the third-quarter slowdown, but supply chains remain a substantial hindrance to growth and an accelerant to inflation



Source: Bureau of Labor Statistics

Omicron and the Fed shake financial markets

After rising to record highs, Omicron shook equity markets after Thanksgiving, causing the third worst daily decline this year and the second monthly pullback. The yield curve flattened substantially as Fed tightening fears pushed up short-term rates and growth fears pushed long-term rates down. But the broad decline in commodity prices may provide some relief to manufacturers and consumers. Still, Fed policymakers admitted that elevated inflation may persist well into 2022 — retiring the term "transitory."

Markets focus on Omicron

The arrival of a new strain of Covid dampened the expectation of a December equity market rally. Just a week before Thanksgiving, the S&P 500 hit an all-time high, more than 100 percent higher than last March's Covid low. With just days left in the month, a tenth monthly gain seemed assured. But Omicron fears gripped the equity market, and the S&P 500 declined by nearly 70 basis points in November. While this seems large, it is small as monthly declines go, even outside of recessions. For example, since the end of the Covid recession, there have been four monthly downturns that exceeded November's drop.

Omicron may prove to have little impact on either the economy or financial markets other than in the very short run. Still, its domination of the headlines suggests that while the unforeseen risks over the longer term are skewed decidedly to the upside, illustrated by technological breakthroughs, policy innovation, etc., surprises over the shorter term are generally more negative.

Rates rocked by the Fed and Omicron

The yield on the U.S. Treasury 10-year note climbed steadily in November until Omicron fears dropped the rate back to nearly 1.50 percent (and to as low as 1.35 percent in early December). The expectation of a faster Fed taper and speculation that the Fed may hike short-term rates sooner and by more next year caused investors to reduce long-term Treasury positions in anticipation of slower economic growth. In addition, inflation seemed more persistent, also dampening the outlook for sustained economic growth.

November marked the fourth time in the last eight months that the yield on the 10-year note topped 1.65 percent (the days before Thanksgiving). In none of these occurrences did the rate exceed this year's 1.75 percent high, recorded at the end of March. At the same time, the recent low of 1.35 percent (on December 3) was the lowest since September 23 — and at no time since the first week of the year did it drop below 1.00 percent.

Unlike long-term rates, short-term rates rose in response to heightened expectations for Fed hike rates. The 1-year Treasury note yield, which averaged around 8 basis points (bps) for much of the year, rose above 30 bps in early December — the highest level since the start of the pandemic. The rise in short-term rates and decline in long-term rates has reduced the ten-one yield spread to its lowest level since earlier this year. This yield spread has been an excellent leading indicator of economic downturns historically, with recessions almost always occurring after this spread turns negative. At around 120 bps at the end of November (and a tad lower in early December), this indicator is still far from signaling a downturn.

Concerns about the Omicron variant and central bank tightening caused the price of oil to fall last month, as markets looked for slower worldwide growth and thus oil demand, and the decline continued into early December. OPEC+ confirmed its commitment to modestly more production each month, even though several countries announced dispersals from their strategic petroleum reserves in an attempt to lower crude oil prices.

Over the last six months, the broad lowering of commodity prices showed that some healing was occurring in worldwide supply chains. The Commodity Research Bureau's (CRB) spot commodity index has declined in three of the past four months. But the rise in commodity prices was so big after the Covid recession, that the CRB index at the end of November was still up by nearly 32 percent from a year earlier and by almost 40 percent from January 2020.

Asset Class Performance

Total returns represented as of November 30, 2021

	1-month	6-months	12-months
S&P Composite 500 Index	-0.69%	9.38%	27.92%
S&P Midcap 400 Index	-2.94%	-0.07%	26.47%
S&P Smallcap 600 Index	-2.29%	-1.48%	31.42%
EAFE[1]	-4.64%	-3.68%	11.28%
U.S. Dollar Index[2]	1.79%	5.07%	2.78%
CRB Commodity Index[3]	-1.22%	2.86%	31.70%
Intermediate Treasuries[4]	0.26%	-0.39%	-1.43%
Long Treasuries[5]	2.65%	8.81%	-4.41%
Investment-grade Corporate Bonds[6]	0.06%	1.94%	-0.53%

[1] Index measuring equity performance of developed markets outside of the U.S. and Canada

[2] Federal Reserve trade-weighted broad currency index

[3] Commodity Research Bureau; CRB spot index

[4] Index of 1-year to 10-year Treasury notes

[5] Index of 10-year and longer Treasury notes and bonds

[6] Index of U.S. investment-grade corporate bonds

Sources: Bloomberg; Haver Analytics

Rate liftoff in 2022 becoming more likely

In recent congressional testimony, Federal Reserve Chair Jerome Powell said that the risk of persistently higher inflation has increased and that policymakers will soon consider speeding up the pace of asset purchase reduction as a result. These comments were Powell's most hawkish of the cycle to date and hint not only at an accelerated wind down of the Fed's quantitative easing program, but also at an expedited launch of the next federal funds rate hike cycle.

Labor market, inflation fueling Fed rhetoric

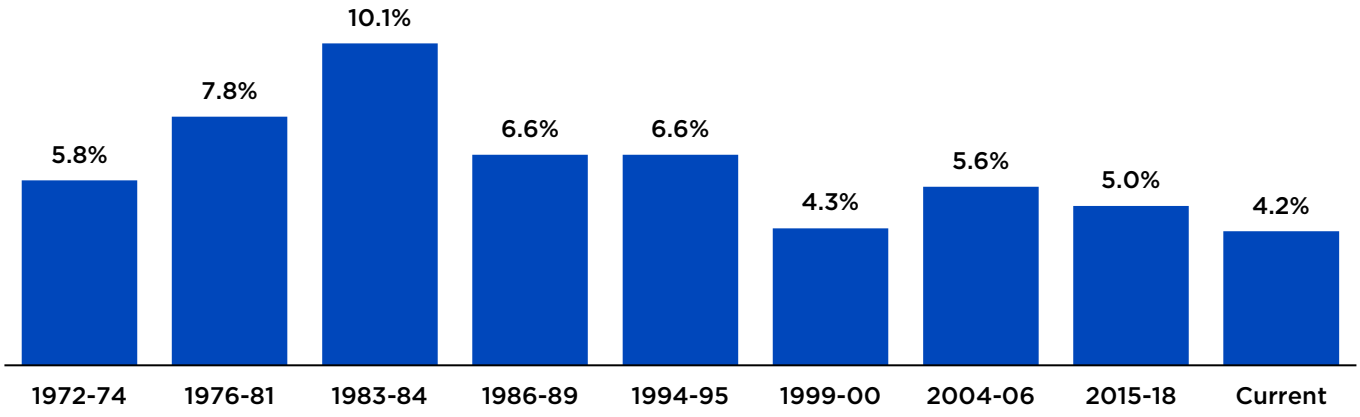
The Fed chair's change of tone is understandable considering the rapidly tightening labor market and the spike in the inflation rate. The jobless rate is now lower than at the outset of any rate hike cycle in the last five decades while the annual change in the consumer price index has shot up to its highest level since the early 1990s. Moreover, price pressures have broadened in recent months while inflation expectations have climbed. Fed rhetoric has not coincidentally taken on a more hawkish bent, punctuated by Powell's pivot. The Fed's posture tends to evolve only slowly, suggesting that the bar is set high for now for a swing back in the dovish direction. The probability of the launch of new tightening cycle in 2022 is rising.

Tightening still likely to be slow and steady

At the same time, however, there is still a case to be made for a measured removal of accommodation. Powell's more aggressive language of late comes ironically just as at least some elements of the transitory inflation story that he has been promoting throughout this year have started to fall into place. There have been indications that the semiconductor shortage has started to ease, for example, a development that helped to drive automobile output to one of its largest increases on record in October. Businesses are restocking — inventories are currently advancing at their fastest four-month pace in more than a decade — and commodity prices in aggregate have started to recede. Even labor supply has bumped higher, albeit at a halting pace thus far. These trends are all in their early stages and none are likely to play out particularly quickly or smoothly going forward, but they lend credence to the view that inflation has been driven higher in part by idiosyncratic factors and should soon diminish to some degree as society continues to normalize. They also speak to the difficulty in assessing the underlying economic trend given the pandemic's impact on the data. For these reasons, as well as a desire not to short-circuit the recovery in the labor market, it is likely that the Fed will move cautiously in lifting benchmark rates even as it now appears more willing to start sooner rather than later.

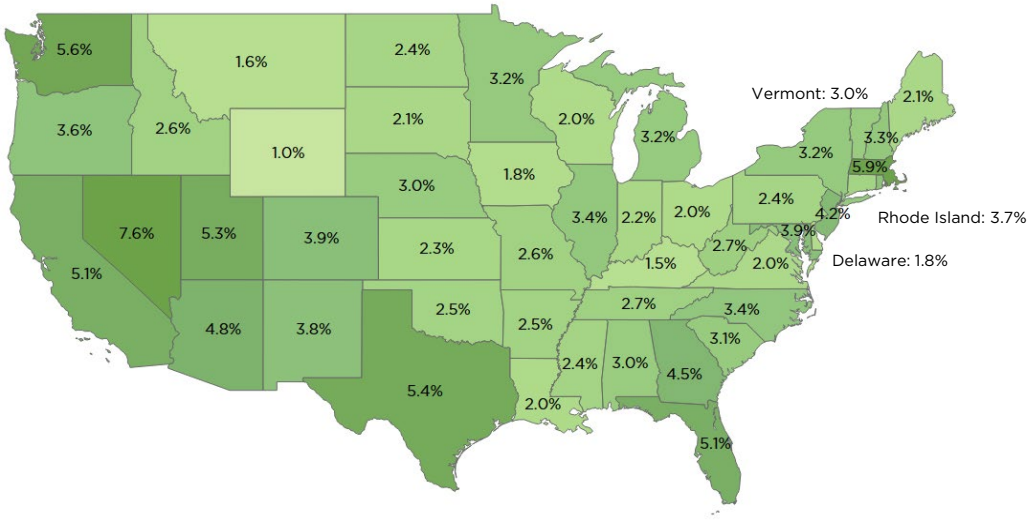
Our updated forecast calls for one 25 basis point rate hike next year (likely in the second half of 2022) and three moves of the same magnitude in 2023. This would be a bit faster than the pace at the outset of the 2015-18 cycle, but very gradual by long-term historical standards. The process by which this expansion will come to an end may soon be underway, but, like those in other recent cycles, it is unlikely to reach its conclusion quickly.

The Unemployment Rate at the Outset of Federal Reserve Tightening Cycles



Sources: Bureau of Labor Statistics, Federal Reserve Board of Governors

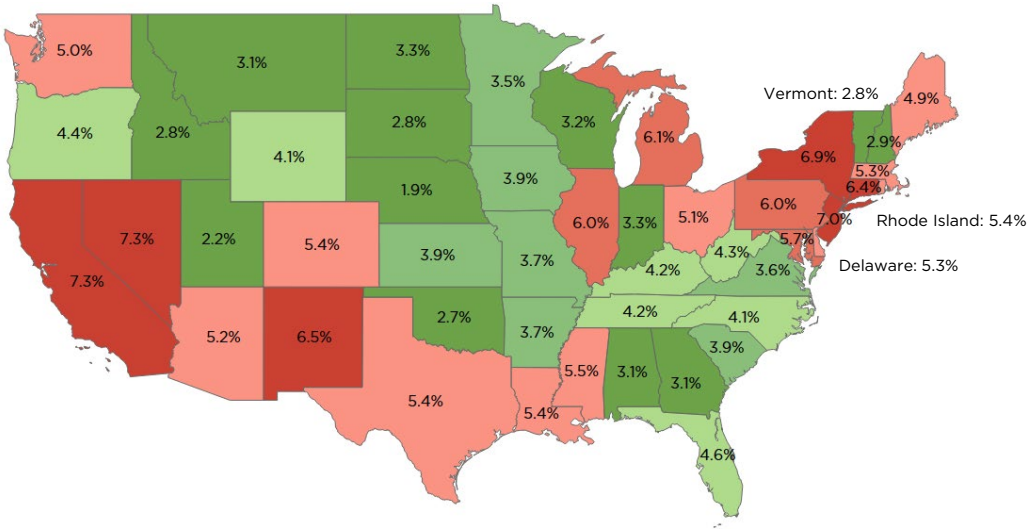
Solid job gains in most states over the past year



- Over the past 12 months, job gains were strongest in the West, Southwest, and Southeast regions — led by Nevada, Texas, and Washington (plus Massachusetts) with increases above 5.0 percent.
- Job growth over the past year was relatively slower across the middle of the country, although in most states the annual employment gain was at-or-above the long-term average.

Sources: Bureau of Labor Statistics; Haver Analytics
Twelve-month growth rate in nonfarm payroll employment, October 2021

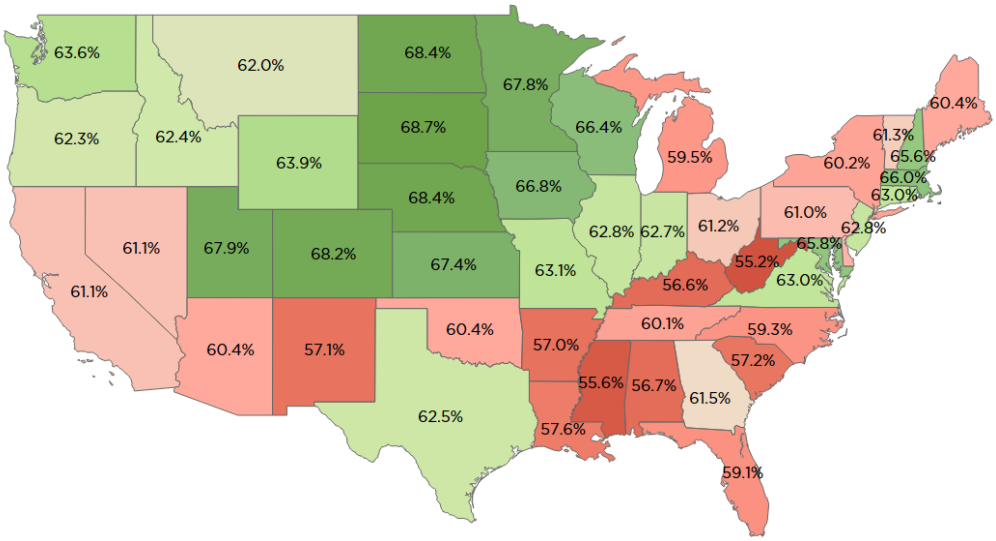
More states reaching pre-Covid lows for unemployment rate



- The unemployment rates in 19 states have dropped below 4.0 percent – a very low level – while several additional states are slightly above that level as labor markets tighten across the country.
- But a few states still have unemployment rates well above their pre-Covid averages, led by California, Nevada, and New Jersey above 7.0 percent (with a smattering of additional states just below that level).

Sources: Bureau of Labor Statistics; Haver Analytics
Civilian unemployment rate, October 2021

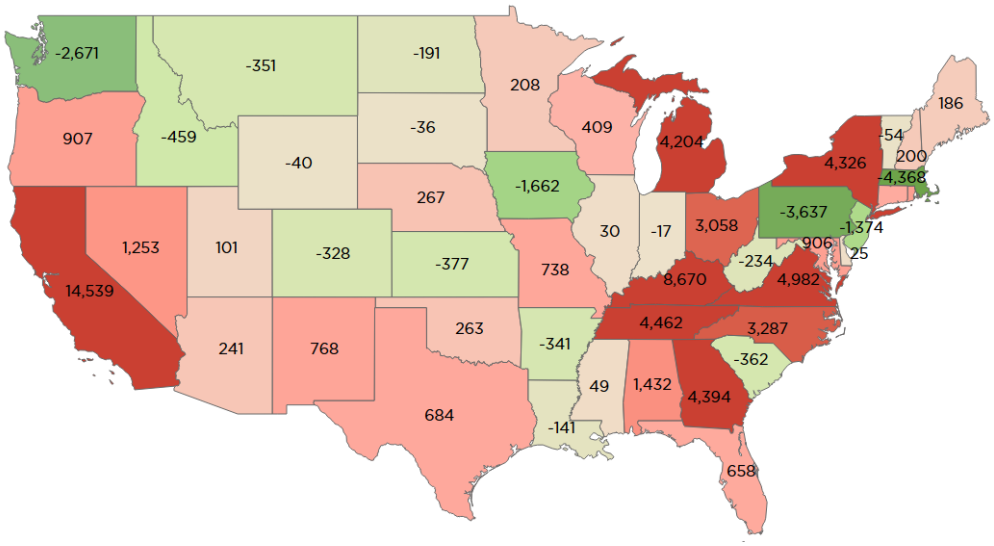
Low labor participation rates are adding to labor shortages



- The national labor force participation rate – although rising, was only 61.6 percent in October, still nearly two percentage points below the level from February 2020.
- At a state level, lower participation rates in much of the Southeast and Southwest regions as well as in highly populous California and New York are holding down the national figure.

Sources: Bureau of Labor Statistics; Haver Analytics
Labor force participation rate relative to national, October 2021

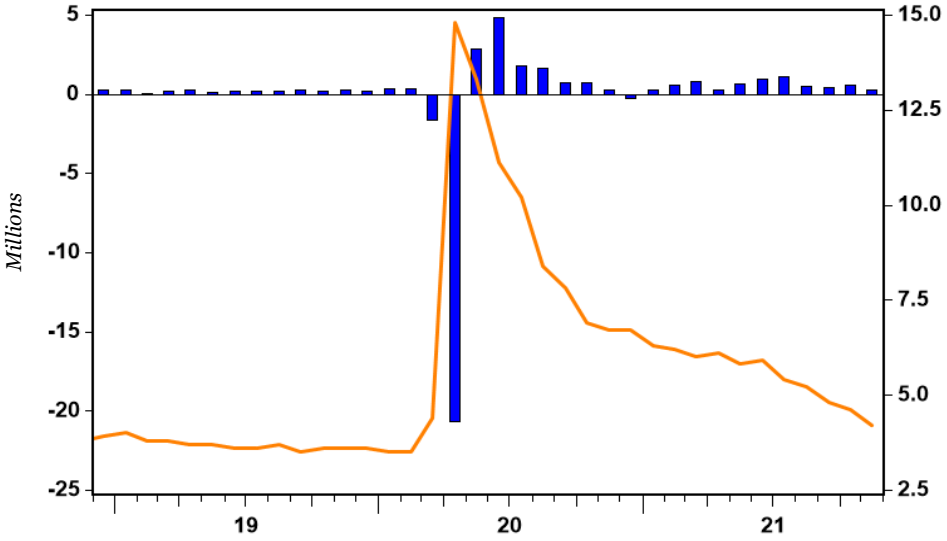
Jobless claims near normal or better in more states



- Average initial jobless claims for November were below the levels from the same period during 2019 in 18 states (and modestly above in a few more) as labor markets tighten further.
- There are a few states where jobless claims remain higher than pre-Covid averages, including California, Kentucky, and Virginia among others — mostly in states with higher unemployment rates.

Sources: Department of Labor; Haver Analytics
Initial jobless claims, weekly average November 2021 vs. November 2019

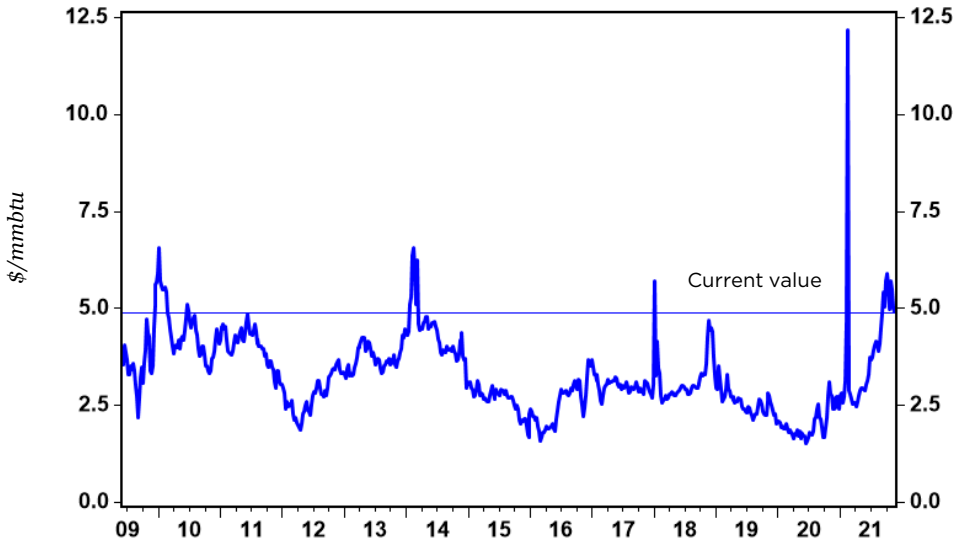
Slower hiring for November but the trend remains strong



- Nonfarm payrolls grew by a weaker 210,000 for October. Still, when including upward revisions to September and October, job growth has averaged a solid 378,000 over the past three months.
- The U-3 unemployment rate fell to 4.2 percent for November while the broader U-6 rate dropped to 7.8 percent, pandemic lows for both – even with a rise in the labor force participation rate.

Sources: Bureau of Labor Statistics; Haver Analytics
Monthly change in nonfarm payroll employment; level of the civilian U-3 unemployment rate, November 2021

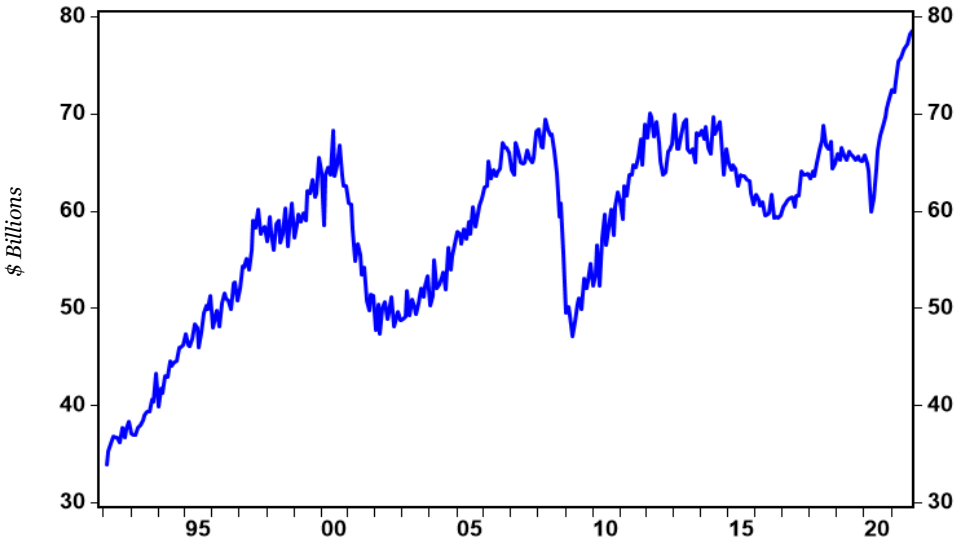
Higher heating costs have pushed inflation higher – will it continue?



- Although down from recent highs, natural gas prices were still near the highest levels over the past decade in late November and could add to heating costs this winter.
- If sustained, these higher natural gas prices could place additional upward pressure on consumer inflation measures in coming months.
- But (positively) natural gas prices have dropped to the lowest levels since the summer in recent weeks – hopefully holding down heating price hikes.

Sources: Energy Information Administration; Haver Analytics
Natural gas price, Henry Hub; November 26, 2021

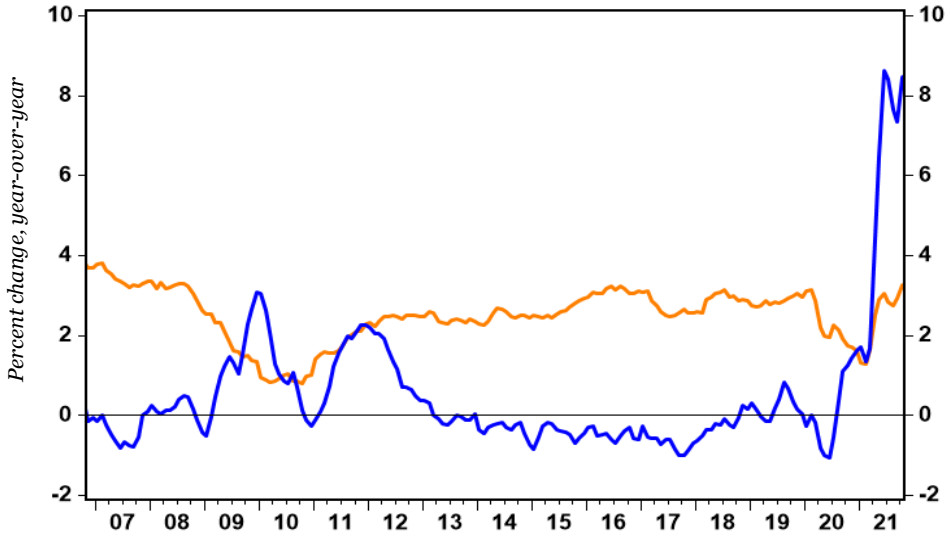
Demand for manufactured goods has surged



Sources: Census Bureau; Haver Analytics
Nondefense capital goods orders, excluding aircraft, October 2021

- Core capital goods orders have climbed to record levels this year as consumer purchases have shifted from services to goods during the pandemic.
- The sharp rise in demand combined with lingering pandemic constraints on supply and transportation systems have significantly stressed global supply chains while raising prices for many goods.

Rising goods prices have been mostly responsible for higher core inflation



Sources: BLS; Haver Analytics; October 2021

- A spike in prices for goods has driven much of the increase in the 12-month change in the core CPI (excluding food and energy) this year, which rose to a 30-year high of 4.6 percent in October.
- Goods inflation is expected to slow as supply chains heal but services inflation (especially for housing and rent costs) could accelerate to keep core inflation above-trend for some time.

Commodities less food and energy

Services less energy

Forecast from Nationwide Economics

As of December 2021	Actual		Estimate	Forecast			
	2019	2020	2021	2022	2023	2024	2025
Real GDP [1]	2.2%	-3.4%	5.7%	4.5%	2.5%	2.0%	1.8%
Unemployment Rate [2,7]	3.7%	8.1%	5.4%	4.1%	3.6%	3.6%	3.7%
Inflation (CPI) [5]	2.0%	1.2%	6.5%	3.3%	2.3%	2.6%	2.7%
Total Home Sales [3,7]	6.03	6.47	6.93	6.85	6.60	6.25	6.00
S&P/Case-Shiller Home Price Index [9]	3.7%	10.3%	18.9%	8.9%	4.6%	3.8%	3.2%
Light Vehicle Sales [3,7]	16.9	14.5	15.1	16.8	17.1	16.5	16.3
Federal Funds Rate [2,4,6]	1.50%	0.00%	0.00%	0.25%	1.00%	1.50%	2.00%
1-Year Treasury Note [2,4]	1.59%	0.10%	0.30%	0.50%	1.20%	1.65%	2.10%
5-Year Treasury Note [2,4]	1.69%	0.36%	1.25%	1.60%	2.00%	2.40%	2.75%
10-Year Treasury Note [2,4]	1.92%	0.93%	1.55%	1.90%	2.30%	2.60%	2.90%
30-Year Fixed-Rate Mortgage [2,4]	3.74%	2.67%	3.10%	3.50%	3.95%	4.30%	4.60%
Money Market Funds [2,8]	1.55%	0.47%	0.14%	0.22%	0.86%	1.42%	1.91%

Major forecast changes from last month

- In response to faster inflation and signs that the labor market has tightened significantly, the Federal Reserve looks increasingly likely to tighten monetary policy in 2022 rather than holding off until 2023. We now expect at least one 25 basis point increase in the federal funds rate by the end of 2022 following by hikes totaling 75 bps in 2023.
- Monthly inflation continues to run hot in response to higher energy costs and supply chain disruptions. We have boosted our projections for consumer price inflation for both 2021 and 2022 as faster readings are expected to last longer. Inflation is projected to decelerate over 2022, but to a still above-trend pace of 3.3 percent.
- Long-term interest rates should climb modestly over 2022 and 2023 in response to faster inflation and the start of Fed tightening. But given their lower starting point at the end of 2021, the year-end estimates for coming years are slightly below the prior forecast — keeping the outlook relatively 'lower for longer' despite rising future rates.

[1] Percent change year-to-year
[2] Percent
[3] Million units
[4] Year end
[5] Percent change Q4-to-Q4
[6] Target rate, lower limit
[7] Year average
[8] Annual return
[9] Percent change Dec-to-Dec
[a] Actual

Sources: Haver Analytics (actuals); Nationwide Economics (estimates and forecasts); except Money Market Funds (all data from Nationwide Economics)

NFM-11356AO.3