MACRO REVIEW & OUTLOOK

AS THE PANDEMIC RECOVERY PEAKED LAST QUARTER, KEY DRIVERS OF JANUARY'S SHIFT IN SENTIMENT WERE ALREADY PRESENT.

Markets ended the second pandemic year on a high note. Buoyed by a bounce back in US GDP growth in Q4 and continued strong earnings, equities notched up new record highs. Unemployment dropped rapidly, reaching below 4 percent in the US. Travel picked up over the holiday-intensive quarter, even as news emerged from South Africa of a new Covid variant. Many Americans hoped that the reopening of theaters, some offices, and businesses would allow for a more normal 2022. They were wrong.

It did not take long for the mood to sour in the new year. Dangers to the 2022 outlook were already evident in Q4. Behind the good cheer, five broad themes emerged: 1) earlier and maybe more abrupt US monetary tightening; 2) rising inflation; 3) a shifting labor market; 4) a growth slowdown in China, with consequent monetary easing; and 5) the continued cloud of Covid-19. And overlaid on all of these themes is the impact on global sentiment of geopolitical tensions, notably Russia's increasing threat to Ukraine.

Persistent high inflation in October and November finally triggered an unambiguous shift in tone from the world's most important central bank late in the quarter. In mid-December, the Federal Reserve indicated an earlier and steeper tightening of monetary policy. The message seemed to sink in only in January, when Fed minutes from December showed central bankers thinking ahead to shrinking the Fed's balance sheet, as well as raising interest rates. The news that consumer prices rose last year at a pace not seen since 1982 has only reinforced expectations of tightening. Inflation pressures are also evident across the Atlantic, with unexpectedly high December readings in both the UK and Europe. Markets are on edge to see what the Fed decides in its first policy meeting of 2022 on January 26. In the meantime, equity markets plunged into correction territory this year and forecasters, including the IMF, are marking down global growth.

Geopolitical tensions that have been front and center this month also began in Q4, as Russia massed troops on its borders with Ukraine and issued a list of demands to the US and NATO allies that challenge the post-Cold War order in Europe. Concerns about China's turn towards more state control, less freedom for private enterprise, and less openness to the West continued in Q4, as did worries about the impact on growth in the world's second largest economy of the widening crisis in its over-indebted property sector.

But perhaps the most important cloud hanging over 2022 from last year: a sudden resurgence of Covid infections with the extra-contagious Omicron variant sweeping across the world after it was identified in November. Daily infection rates in the US and elsewhere shot up to the highest levels since the pandemic began. Just as it has for the past two years, the new Coronavirus shifted expectations and upset plans for work, school, and life more generally.

While markets greeted the new year with a thumbs down, investors should not despair. The global economy is set to continue to grow, albeit at a slower pace than hoped, dented by both Omicron and tightening money. There is some hope that a new policy approach to what remains the biggest "known

unknown"– Covid-19 – will emerge in 2022. In the US, there is growing acceptance that a gradual return to pre-pandemic normal may not be realistic. The next best option would be a considered plan – and timely actions – for living with the virus. Better protective masks and access to testing is now part of the US plan. Further medical advances that will help are already in the pipeline. Innovation remains a key strength for the US – and for investors.

FIVE BROAD THEMES FROM Q4 2021 THAT WILL DEFINE 2022

1. *Turning to tightening – the Fed begins to move.*

Sometimes, the economy is driven by outside shocks, with policymakers mostly in reactive mode. After two years dominated by twists and turns of the Covid-19 pandemic, 2022 will see central bankers in the driver's seat. How well they manage the shift away from extraordinary stimulus – with the virus still hovering and its economic impact uncertain – will be key for the global economy this year. While some major central banks are still holding off from tightening (and in China, policy is moving in the opposite direction, towards easing), the Federal Reserve has now made its intentions clear, as Chair Jerome Powell characterized the threat from inflation as "severe". It is Fed actions that matter for global liquidity.

The shift towards tightening in developed markets began in earnest in Q4 2021. First came moves from some smaller central banks. Then the Bank of England surprised markets in December with a 15 bps rise in its policy rate – the first since rates were slashed in the face of the pandemic in March 2020. More importantly for the global economy, Powell finally signaled rising concern about inflation when he had his first chance to speak to Congress days after being renominated as Fed Chair. By its mid-December meeting, the mood of the FOMC had changed decisively. The central bankers projected three rate increases in 2022 and an earlier end to the asset purchases that had fed nearly $4.5 trillion of liquidity into the economy since March 2020.

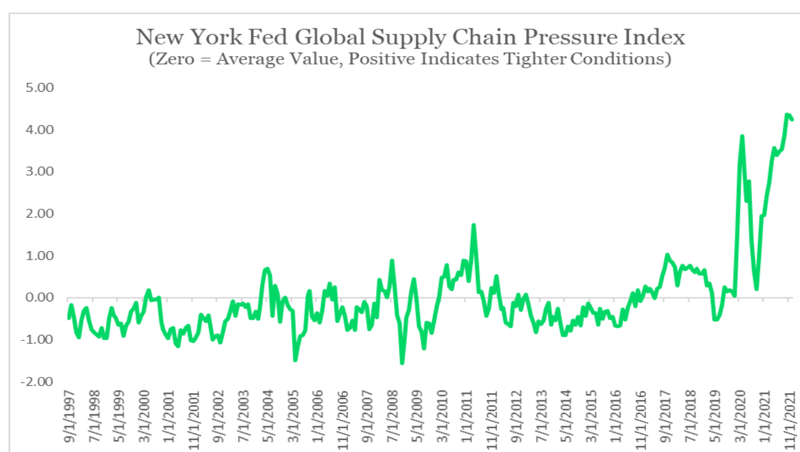
There is a good chance that we may, instead, see four rate rises this year, as the Fed struggles to get inflation under control. And watch for the impact on liquidity and financial markets of balance sheet contraction, now clearly in the Fed's sights. Economists believe that interest rates are the most effective monetary policy tool to guide the economy, impacting demand – and therefore prices – directly. Under this reasoning, quantitative easing through asset purchases is seen as useful for its impact on the longer-term rates that central banks do not directly control, in circumstances with little or no room left to cut short-term rates further. For investors in financial markets, however, the Fed's actions are watched for a more direct impact on liquidity and financial asset prices. Chair Powell understands this. He and his

colleagues may not react to a market correction from the rich valuations of 2021, but they do not want to shock markets into a downward spiral. They will move cautiously and communicate carefully.

2. Inflation: from transitory to …?

As US inflation took off in 2021, analysts were initially divided about whether the Fed was right to consider price pressures "transitory" and stay focused on the still-weak labor market that fell short of its "maximum employment" goal. Most economists, on both right and left, had supported the stimulus packages – fiscal and monetary – put in place to combat the pandemic-induced recession. Even the few who called out the inflationary risks from fiscal policy, notably former Treasury Secretary Lawrence Summers, did not anticipate the supply bottlenecks that hindered production last year and collided with a pandemic run-up in spending and demand for goods.

As the year went on, the evidence built that inflation was both faster and more persistent than most had expected. By Q4, price increases had spread beyond the initial sectors affected by pandemic shortages to cover broad items, including food and shelter. Supply chain problems worsened as ships circled outside major US ports, unable to dock and unload, truck drivers were in short supply, and – importantly – the zero Covid stance by China and other Asian producers led to unpredictable shortfalls in production. At the same time, demand in the West shifted to goods as spending on services was constricted by health fears and pandemic lockdowns.



Debate continues about whether demand pressures or supply shortages are to blame for today's inflation, and what is the best historical analogy to consider. In a recent [interview with RockCreek CEO Afsaneh](

Beschloss that was the keynote of the Council on Foreign Relations' Stephen C. Freidheim Symposium on International Economics, Cecilia Rouse, Chair of the President's Council of Economic Advisers (CEA), suggested that the period after World War II – when production switched from wartime to peacetime – was a better model than the energy crisis-triggered stagflation of the 1970s. "What that tells us is that we will get through this," Chair Rouse said, acknowledging that one historical lesson is that it may take some time; however, "as supply and demand moderate, we will get back to healthy rates of inflation."

Rouse also noted that supply bottlenecks – for example at US ports – are noticeable, in part, because of unusual demand pressures. Although there are blockages, as the ships with full cargoes floating outside ports demonstrate, the volume of goods moved through US ports in recent months has been higher than ever. As we discussed late last year, today's inflation reflects both supply limitations and demand push. In 2021, inflation accelerated sharply in Europe as well as in the US. But the 7 percent rise in US consumer prices during the year was considerably higher than the 5 percent recorded in Europe. That likely reflects the bigger fiscal push to American demand in 2020/2021.

A puzzle remains, however, that will matter for the trajectory of prices – and policy – in 2022: why did it seem so hard for central banks to push inflation up to target before the pandemic, and why were forecasters so wrong last year?

As inflation lingered below target in the pre-pandemic period, many central bankers feared that their ability to manage the economy and guide price stability – defined as 2 percent annual inflation – was diminishing. With inflation below 2 percent, interest rates would get closer to the zero bound, limiting room for maneuver to support the economy. Concern about the ineffectiveness of policy in the face of too-low inflation preoccupied officials, particularly as financial asset prices boomed, wages lagged, and inequality grew. Such concerns helped fuel the Fed's 2020 shift to targeting average inflation, with a permissive approach to above-target price increases that it expected would easily reverse or slow. Was it fiscal expansion, after all, that "cured" inflation? If so, as pandemic-era spending winds down, will the fiscal pull back already underway in the US support the Fed as it wrestles the genie back into the bottle?

3. Not your father's labor market: pandemic changes may be here to stay.

The pandemic has changed attitudes and behavior towards work. Some of those changes will unwind as the fear of infection ebbs. But this will take time. Meanwhile, measures of the labor market need to be rethought, along with policies to support those who want to work but have been unable to find a suitable job that allows them the flexibility to take care of themselves and their families.

On the first issue, it is increasingly clear that indications of labor shortages from metrics such as job vacancies and quits are telling us more about the state of the labor market than the traditional payroll numbers. New research from Jason Furman and William Powell III shows that vacancies and quits are empirically a stronger predictor of core CPI. Data from smaller firms and businesses may also be more telling than that from bigger employers who provide higher wages and more benefits that attract workers.

Inflation hawks worry about a wage-price spiral. It is true that if wages chase price increases, and firms then raise both wages and prices, the Fed will have a harder time curbing inflation. But average rises in wages and prices do not tell the whole story. One bright side of recent recorded increases in hourly average earnings is that those at the lower end of the pay scale in the US – in more marginal service jobs – have seen bigger pay rises than those at the top. Less bright is the fact that lower income families have also experienced worse inflation as they spend more of their incomes on items such as food and gas, where prices climbed most in 2021.

As we have pointed out in previous letters, and our partner the Equality Fund detailed in their annual report, Covid had a disproportionate impact on working conditions for women, who shoulder most of the burden of caring for children and elderly relatives, and the vulnerable, who are more likely to become dangerously sick if they are infected. More flexibility, more support for childcare, and tolerance for remote work will all help bring workers back into the labor force. Are companies listening?

4. *China: distancing or decoupling, the world's second largest economy is carving out a different way forward.*

What happens in China, the world's second largest economy, matters for global growth. And, once again, the experience in Q4 is a good guide to what to expect in 2022.

For 2021 overall, China's GDP growth rebounded to 8 percent, much faster than 2020's pandemic low of just over 2 percent. But much of last year's improvement came in the early part of the year, before the woes of property giant Evergrande spilled into public view, and renewed outbreaks of Covid led to further drastic lockdowns in some major cities. As foreign investors are only too aware, growth and confidence were also hit by an unexpected government shift in mid-year to tighter regulation of several previously fast-growing sectors – notably education, tech, and consumer. In Q4, exports were strong, reflecting the appetite for goods in the developed world. But this was not enough to offset disappointing consumption and retail sales, leaving growth in the quarter at just 4 percent compared to a year earlier. Look for a similar pattern this year. Both the zero Covid policy that has constrained production and demand and the

regulatory shift that began last year are set to continue and will likely hold GDP growth down to between 4 and 5 percent.

China's market remains most important for its Asian neighbors, who contribute inputs into many goods made in China, and for commodity exporters who feed Chinese consumers – quite literally – and provide raw materials to power growth. Domestically, companies will have to adjust to President Xi's call for "common prosperity", making sure to stay in favor with Beijing in order to thrive. This may hold down overall Chinese growth and dampen enthusiasm for consumer technology firms that grew into world beaters like Alibaba and Tencent. But China is more than the top five tech stocks. The level of dispersion seen in 2021 between domestic stocks and offshore listings suggests that there are opportunities. Moreover, China's leaders will not allow a financial crisis to develop that could spill over into global markets and are already taking steps to bolster domestic demand, with a mid-January cut in interest rates. As the US tightens, looser policy in China could be another factor in currency markets.

5. Covid – here to stay, learning to manage.

In the middle of Q4, just as the Delta wave was subsiding, the new Omicron variant swept across the world, including to countries in Asia that had prided themselves on successful pursuit of a "zero Covid" policy. The virus penetrated the defenses of millions who were vaccinated, strained hospital resources, and is now leading to increased hospitalizations and deaths, mostly among the millions still unvaccinated.

When Omicron first hit, it was tempting to believe that the global economy could weather the surge without much damage. The variant seemed to lead to milder disease, especially among those vaccinated. But two factors were underestimated: First, the extreme contagiousness of the virus has led to so many falling sick that workplace disruption from absenteeism is far outpacing that in earlier waves. And while hospitalizations and death rates are lower in relation to the number of infections, they have soared in absolute numbers, making a slower start to 2022 in the US and elsewhere now likely. Indeed, the International Monetary Fund delayed the release of its new forecasts until yesterday to take account of the impact of Omicron. Second, the continued attempt to achieve zero Covid by China, particularly in view of the February Beijing Olympics and the Party Congress in October, means that supply bottlenecks will continue well into this year. Factories, apartment blocks, and indeed whole cities, can be locked down when just a handful of Covid cases are found.

There is a glimmer of hope for the future, however. We may be getting closer to living with the virus being endemic – causing new infections but not at a scale or intensity that makes businesses, schools,

and normal life close down. It is a good sign that, in the US and Europe, governments removed blanket travel restrictions put in place in the immediate aftermath of Omicron. Instead, they are focusing on mitigating spread with an expansion of testing, continued encouragement of vaccination and boosting, and support for medical advances that will make treatment cheaper and more available.