

The financial markets are ending the year on a roller-coaster ride, and the road ahead is not likely to get much smoother. After shedding about 3 percent early in the week, as health, inflation and policy concerns raised the anxiety level among investors, stocks came roaring back later in the period, with the S&P 500 index racing to a new record high at the end of the week. Interest rates, meanwhile, stayed on the path in effect since the Fed announced its pivot to a more hawkish policy last week, with short-term yields sustaining an upward move against a mostly stable bond yield, resulting in a flattening yield curve. At 0.70 percent, the 2-year Treasury yield is the highest since February 2020, while the 10-year yield, at 1.49 percent, is virtually unchanged from its June level.

To be sure, trading was exceptionally light this week and is expected to remain that way until investors return from the holiday break at the start of 2022. When they do, it will be interesting to see where the collective mindset will send market prices. Clearly, events on the health front are evolving at rapid speed, and perceptions of how the new Omicron variant will impact the economy could change on the dime. The latest news is mixed, with new cases in the U.S. already surging past the Delta-driven peak in August, but apparently carrying milder symptoms. Encouragingly, new Covid pills developed by Merck And Pfizer are about to hit the market, which would certainly make the pandemic a more manageable virus and less life-threatening in the public's mind, returning a sense of normalcy to everyday life.

That said, as we get ready to bid 2021 farewell and embrace a new year, the strong momentum that began the fourth quarter is hitting a speed bump, thanks in good part to the resurgence of Covid cases. Consumer spending, the economy's main growth driver, cooled down in November following a torrid increase in October. We got a firm inkling of this pattern with the cooler retail sales data reported for the month last week; on Thursday, the Commerce Department's more comprehensive report on personal consumption confirmed the slowdown. Overall, consumer spending increased by a moderate 0.6 percent in November, led by a strong advance in outlays for services, which are mostly excluded from the retail sales data.

Importantly, as was the case with retail sales, the entire gain in personal outlays last month reflected higher prices. Real personal spending was flat, following a solid 0.7 percent gain in October. Again, some of the weakness can be attributed to consumers pulling forward holiday purchases into October to avoid product shortages. But that behavior does not apply to services, which provide value when consumed and usually cannot be purchased for a later gift. Hence, real outlays for services actually rose 0.5 percent in November, led by spending on recreational services (+1.2 %) and hotels (+0.6%)

Indeed, the rotation in purchases away from goods into services was expected to unfold as health conditions improved and households became less fearful of social gatherings. That pattern played out as the Delta-led surge in Covid cases unwound in September and October before the Omicron variant took hold in late November. The data for that month only partially reflected the impact of Omicron, which did not become a headline issue until the few weeks. Hence, we suspect that the rotation into services will be set back in December, as the rapid spread of Omicron takes its toll. The rollback in a broad swath of services is well underway, as postponements and cancellations are rampant for theaters, sporting events and restaurant bookings.

On the other side of the household ledger, personal incomes also cooled in November, advancing by a very moderate 0.4 percent, led by a 0.5 percent increase in wages and salaries. The increase in worker earnings was the smallest in four months, and reflected the slowdown in jobs growth reported three weeks ago. Worse, the modest income gain fell further behind the price increases households faced last month. Hence,

real disposable incomes fell for the fourth consecutive month, slipping by 0.2 percent in November. To finance their spending, households had to dig deeper into savings, as the personal savings rate fell to 6.9 percent, from 7.1 percent in October.

The decline the savings rate – the lowest since July 2019 – is dramatic compared to the near 34 percent that prevailed in April, following the last stimulus check sent out in March. To be sure, there is still more than \$2 trillion of the savings accumulated over the past year from stimulus checks, expanded unemployment benefits and unspent funds during lockdowns that is sitting in household accounts. Those funds should give the economy a boost in 2022 as they are drawn down and enter the spending stream. But how much of a boost is unclear. Lower income households already spent most of the funds on essentials – food, rent, debt and childcare, among other items – so it's doubtful they have much discretionary funds left over to fuel growth next year.

Conversely, those higher up the income ladder hold most of the excess savings, but the question is how much of it will find its way into the spending stream. For sure, when the health situation improves and people re-engage in social activities, the demand for services will rebound with the help of these discretionary funds. But the further up the income ladder you go, where the bulk of the excess savings is concentrated, the spending response is likely to be much more muted. High-net worth individuals tend to retain much of their increased wealth, and most of the unspent funds on services that were accumulated over the past year should remain on the books. That said, this income segment will also be the main drivers behind the revival in service spending in 2022 as wealthier consumers return to theaters, concerts and other in-person discretionary activities that Omicron is currently discouraging.

But the ongoing surge in case counts is clearly casting a shadow over the near-term outlook. The slowdown in consumer spending last month together with current signs of a pullback in many activities, has taken some steam out of the momentum heading into next year. Growth in the fourth quarter is still tracking a healthy annual pace of around 7 percent, thanks to the strong start at the beginning of the period. But the economy is poised to hit a soft patch in the first quarter, when we expect the advance in GDP to slow to 2.5 percent. And that assumes the Omicron variant is brought under control within the next few months and does not cause widespread restrictions, either voluntary or government-imposed, on business activity.

Importantly, even as the virus-induced slowdown is unfolding, inflation continues to accelerate and complicate the task of the Federal Reserve. The inflation gauge that the Fed monitors to reach its 2 percent target, the personal consumption deflator, increased by 5.7 percent in November from a year ago, the fastest since 1982. This measure runs a bit lower than the consumer price index, which rose by 6.8 percent according to the previous week's release, but it is still well above the Fed's target. The core PCE deflator, which strips out volatile food and energy prices, is also running hot, increasing by 4.7 percent, about a percentage point below the core CPI but still the fastest pace since 1989.

The Fed will be navigating a delicate balance in 2022, striving to keep inflation in check while sustaining the recovery in the job market. At its last policy meeting, it shifted priorities, from promoting job growth to restraining inflation. The Fed's pivot indicates that it plans to wind down its bond-buying program by March and lift rates in May for the first time since December 2018, followed by two more rate hikes in 2022. The financial markets are fully on board with that strategy, pricing in three rate increases during the year. However, there is a creeping sense among bond investors that the Fed may make a policy mistake and tighten policy too far, choking off the recovery.

Indeed, the flattening of the yield curve, with long-term rates tilting down over the past several weeks reflects the growing perception that growth will weaken following the Fed's planned rate hikes. However, the yield curve is still positive, indicating that bond investors are not fearing a recession – yet. Conversely, the stock market's latest rally suggest a much more bullish outcome, perceiving the Fed's strategy as timely and well suited to bring inflation under control while prolonging the expansion. This is not the first time that the stock and bond markets have been at odds regarding future prospects. From our lens, the course of the pandemic poses a greater risk to the economy than the prospect of a policy mistake.

FINANCIAL INDICATORS

INTEREST RATES	Dec 23	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.08	0.05	0.06	0.09
6-month Treasury bill	0.17	0.13	0.09	0.09
3-month LIBOR	0.21	0.21	0.18	0.25
2-year Treasury note	0.69	0.63	0.50	0.13
5-year Treasury note	1.25	1.17	1.17	0.37
10-year Treasury note	1.49	1.41	1.48	0.94
30-year Treasury bond	1.91	1.81	1.83	1.66
30-year fixed mortgage rate	3.05	3.12	3.10	2.66
15-year fixed mortgage rate	2.30	2.34	2.42	2.19
5/1-year adjustable rate	2.37	2.45	2.47	2.79

STOCK MARKET				
Dow Jones Industrial Index	35,950.56	35,365.44	34,899.34	30,199.87
S&P 500	4,725.79	4,620.64	4,594.62	3,703.06
NASDAQ	15,653.37	15,169.68	15,491.66	12,804.73

COMMODITIES				
Gold (\$ per troy ounce)	1,810.10	1,799.20	1,792.30	1,875.00
Oil (\$ per barrel) - Crude Futures (WTI)	73.76	70.34	68.17	47.73

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Personal Income (November) - % change	0.4	0.5	-1.0	0.3
Personal Spending (November) - % change	0.6	1.4	0.6	0.8
Savings Rate (November) - Percent	6.9	7.1	8.1	8.7
New Home Sales (November) - 000s	744	662	723	697
Existing Home Sales (November) - 000s	6,460	6,340	6,290	6,140
Durable Goods Orders (November) - % chg	2.5	0.1	-0.4	0.8

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