



Meet With Us

Market Commentary: A Santa Claus Rally

MARKET COMMENTARY December 17, 2021



Sign Up for our Newsletter

CIO [Rob Edel](#) analyzes the state of the markets; including the unpredictability of the markets, the implications of a new variant and the harsh reality about inflation.

By [Rob Edel](#), *Chief Investment Officer*

[View commentary in PDF format](#)

View the [Nicola Wealth Investment Portfolio Returns: November 2021](#)

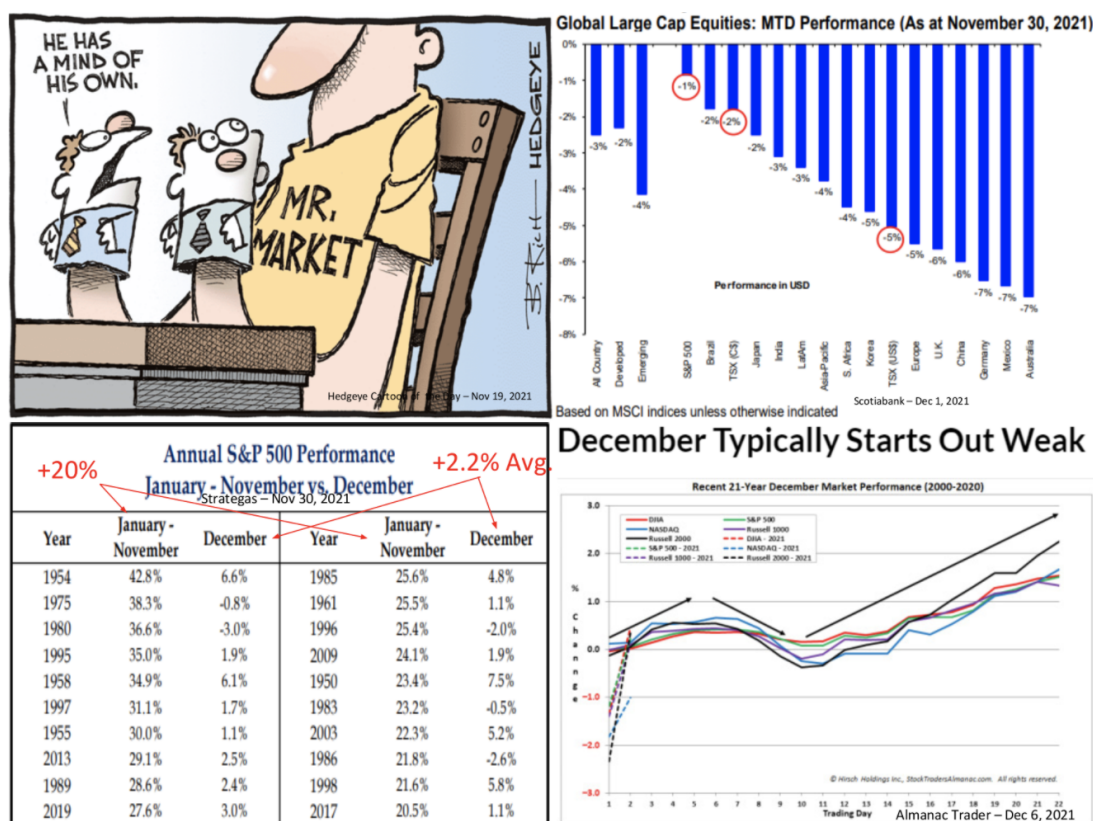
Highlights this Month

- [Pressure mounts as a new variant emerges.](#)
- [The critical factor commanding investor attention in the New Year.](#)
- [Relief on the horizon?](#)
- [Keeping workers on the sidelines.](#)
- [What's a President to do?](#)
- [A weaker market than headlines indicate.](#)

November in Review

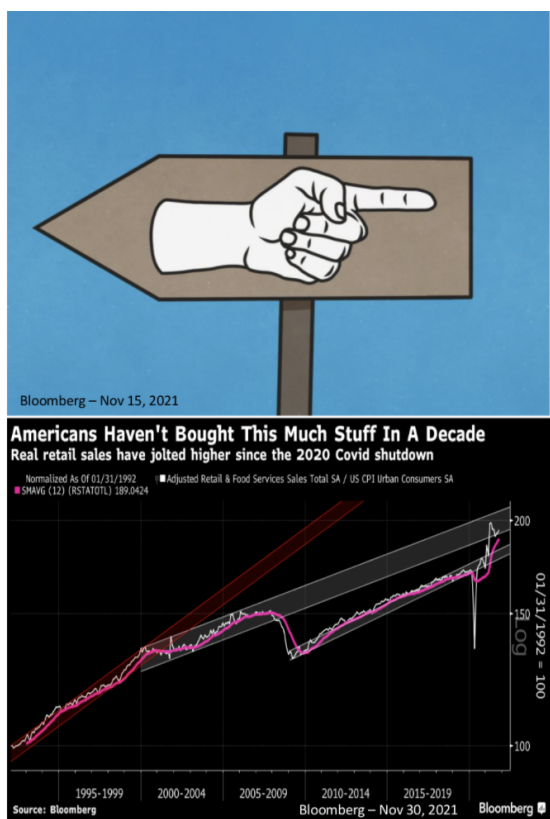
After a remarkable run of consistency, markets now appear to be on a more unpredictable path. A weak September was followed by a strong rebound in October, only to see equities decline again in November, with S&P/TSX -1.8% (-4.9% in US dollar terms) and the S&P 500 -0.70% (US dollar terms). Despite the weak showing in November, history would appear to favour a rebound in December.

While the last month of the year can get off to a slow start, Business Insider indicates that a nice Santa Claus rally has historically resulted in December delivering the best stock returns of the year. Also, historically speaking, working for a December rebound are the weak returns presented in November. Strategas reports that since 1950, the S&P 500 has only ever recorded negative returns in December three times following declines in November. On average, the S&P 500 has increased 1.5% in December, but following a poor November showing, the S&P 500 has historically increased 2.7% on average. The opposite has been the case for year-to-date performance, meaning strong returns have historically translated into positive December returns. Since 1950, the S&P 500 has recorded returns above 20% for the first 11 months of the year on twenty occasions. December returns on average during those twenty years have been up 2.2%. With the S&P 500 -0.7% in November and +23.2% year to date, positive returns in December are anticipated.

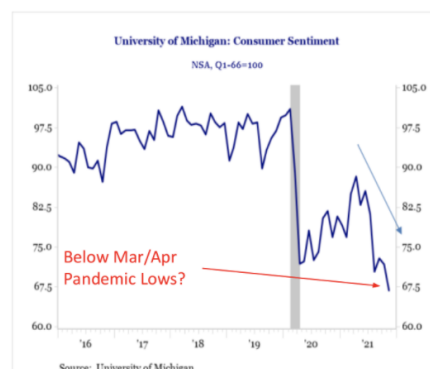


The pandemic market has shown a remarkable ability to do the opposite of what investors expect, proving to be unpredictable. Case in point, the University of Michigan Consumer Sentiment index has been on a steep downward path since the beginning of May, actually falling below levels experienced during the depths of the pandemic last March/April. Based on deteriorating consumer sentiment it would be reasonable to expect consumer sales to be suffering a similar fate. Quite the opposite, however, as retail sales & foodservice have experienced a near uninterrupted recovery since last Spring, suffering no apparent fallout from declining consumer views on the economy. Consumption has been so strong that retail and food service sales growth are now back to levels on par with pre-financial crisis trend lines. It is a matter of watching

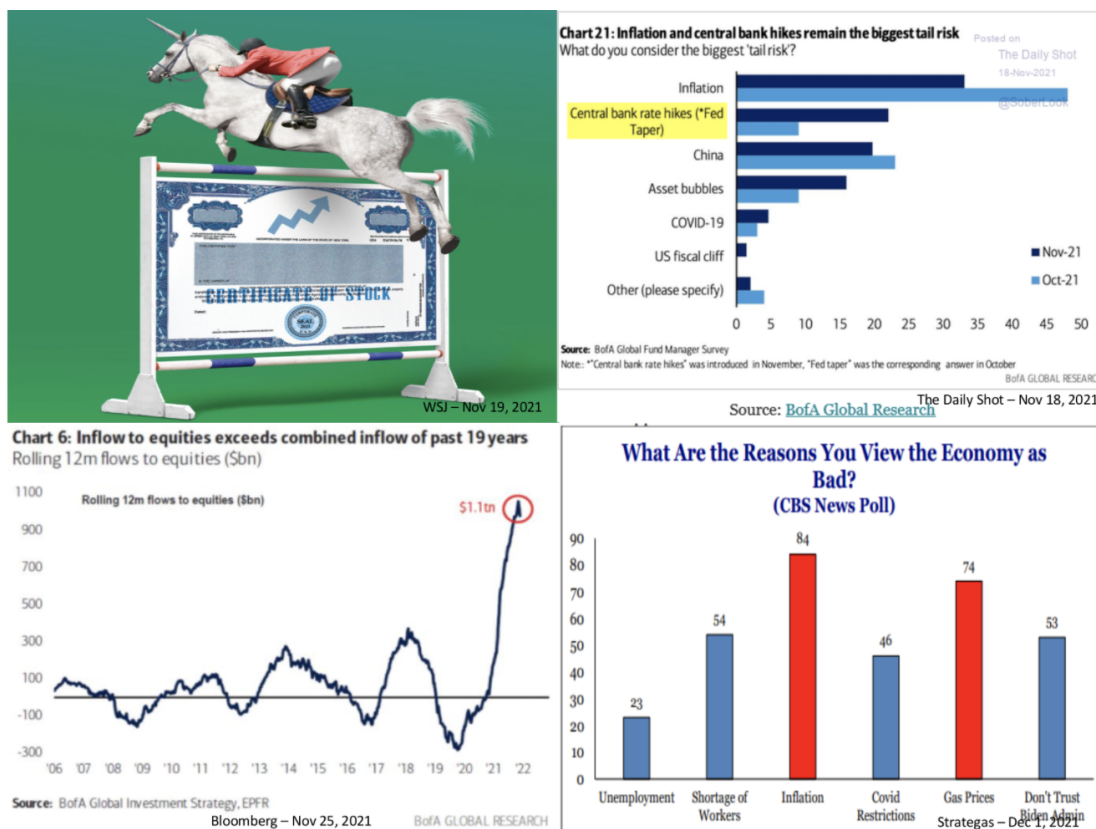
what consumers do rather than what they say. But why are they talking down the economy? Does this foreshadow lower spending in the future?



CONSUMER SENTIMENT NOT REFLECTING WHAT U.S. CONSUMERS ARE DOING



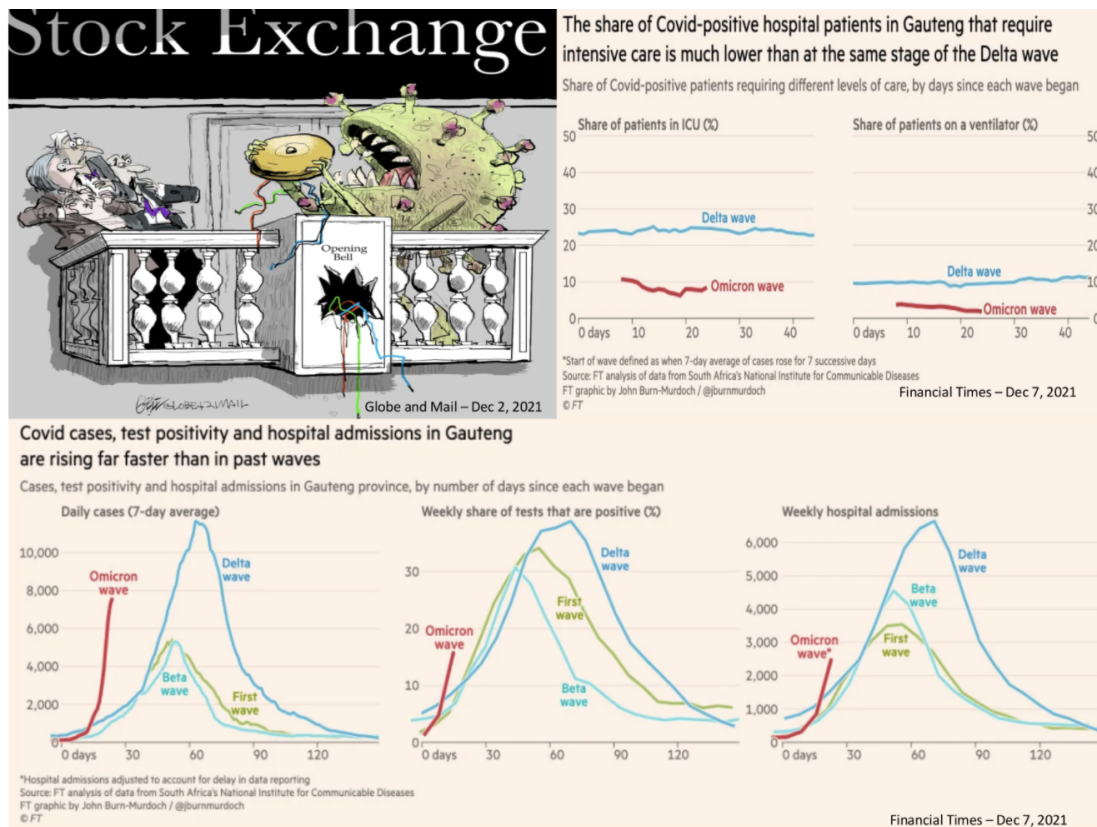
A recent CBS News poll shed some light on why Americans may be so pessimistic in their views. For the first time in 25 years, voters are more concerned about inflation and gas prices, and Strategas reports that these are the main reasons they possess a negative view of the economy. Investors maintain a similar view. Recent findings from a survey of Fund Managers by the Bank of America cite inflation and central bank rate hikes as the most considerable tail risks. The market has been on an extraordinary run and has justifiably attracted investor interest. Further research by Bank of America indicates that equity inflows have totalled \$1.1 trillion over the past 12 months, higher than the combined flows of the past 19 years! However, higher inflation and the prospect of tighter monetary conditions will present a hurdle for investors to clear when it comes to returns next year, which is why we plan to spend the rest of this commentary discussing just that, with one caveat. Survey results from the Bank of America back up the belief that the market has moved on from the pandemic, showing minimal tail risk associated with COVID-19. However, with the emergence of a new variant, omicron, we are compelled to revisit our beliefs and re-examine the risk that the pandemic may still hold for investors.



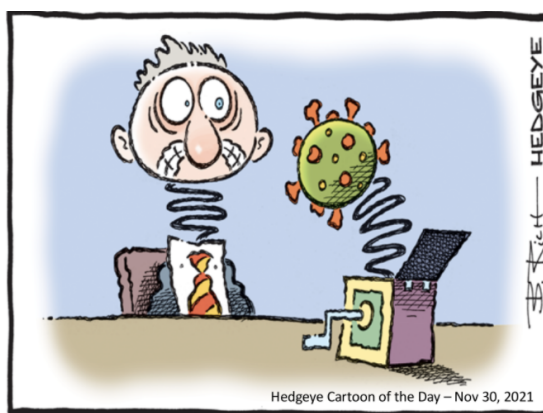
Pressure mounts as a new variant emerges.

Risk assets came under pressure in early December as news poured out of South Africa about a new COVID-19 variant of concern containing a large number of mutations. While data is still being collected and analyzed, the number of mutations to the virus' spike protein has many concerned that the omicron variant will be able to evade vaccines as well as re-infect those who have already acquired natural immunity. Given the rapid increase in new cases in South Africa, it is also suspected that the new variant is more transmissible than the delta variant. If this is confirmed, it could mean that the omicron variant would quickly gain dominance in a world where no one has immunity. Yet, there is optimistic evidence that omicron may be less virulent and cause milder symptoms if any at all.

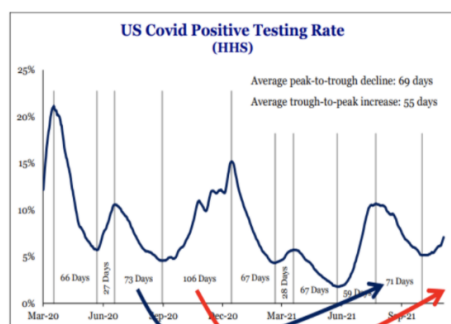
In the same region of South Africa where COVID-19 cases are spiking higher than previous waves of the virus, the percentage of patients in the intensive care unit or on a ventilator are much lower than experienced with the delta wave. If this is the case, and omicron causes only mild illness, a more transmissible and dominant omicron variant could help the world reach herd immunity much faster while bringing an end to the pandemic sooner than expected.



Even if the data confirms that omicron is more transmissible but less virulent, the sheer number of new cases may mean more people getting sick. Regardless of the new variant, lower seasonal temperatures mean cases are destined to trend higher. According to Goldman Sachs, Canada was one of several economies singled out as having a high relative risk due to the winter impact of COVID-19, mainly due to low temperatures. We still believe markets have largely moved on and that factors other than the pandemic will be what investors focus on in 2022, but we admit COVID-19 has had a history of doing the unexpected.



OMICRON OR NOT, US IS HEADING INTO THE TOUGHEST SEASONAL PART OF THE COVID CALENDAR



Strategas – Dec 1, 2021

Exhibit 2: Lower Temperatures and Faster Virus Spread

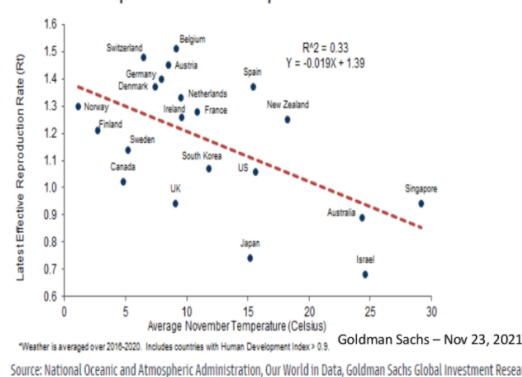
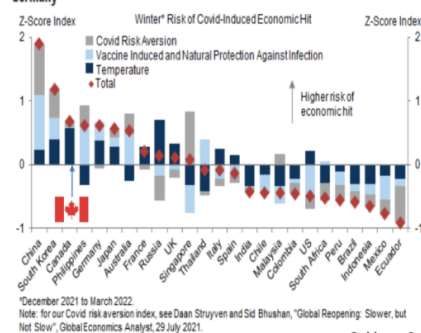
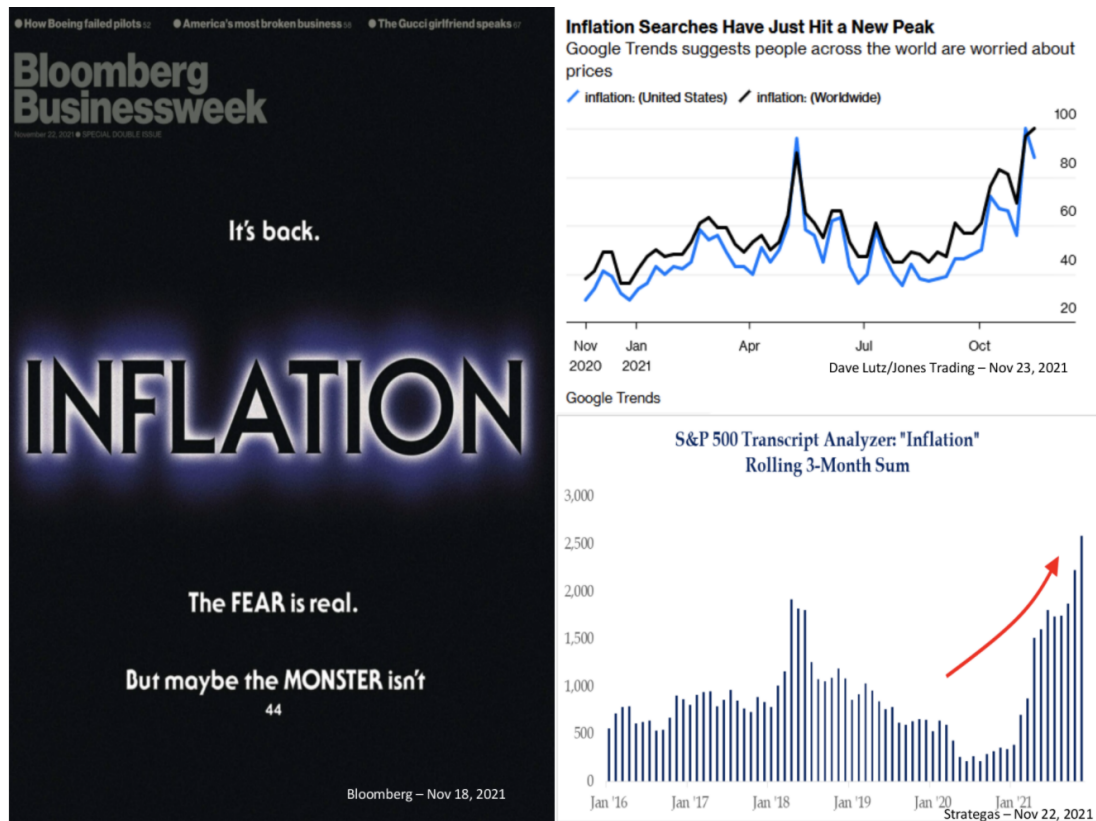


Exhibit 6: Relatively Higher Winter Risk of Covid-Induced Economic Hits in China, South Korea, Canada, and Germany

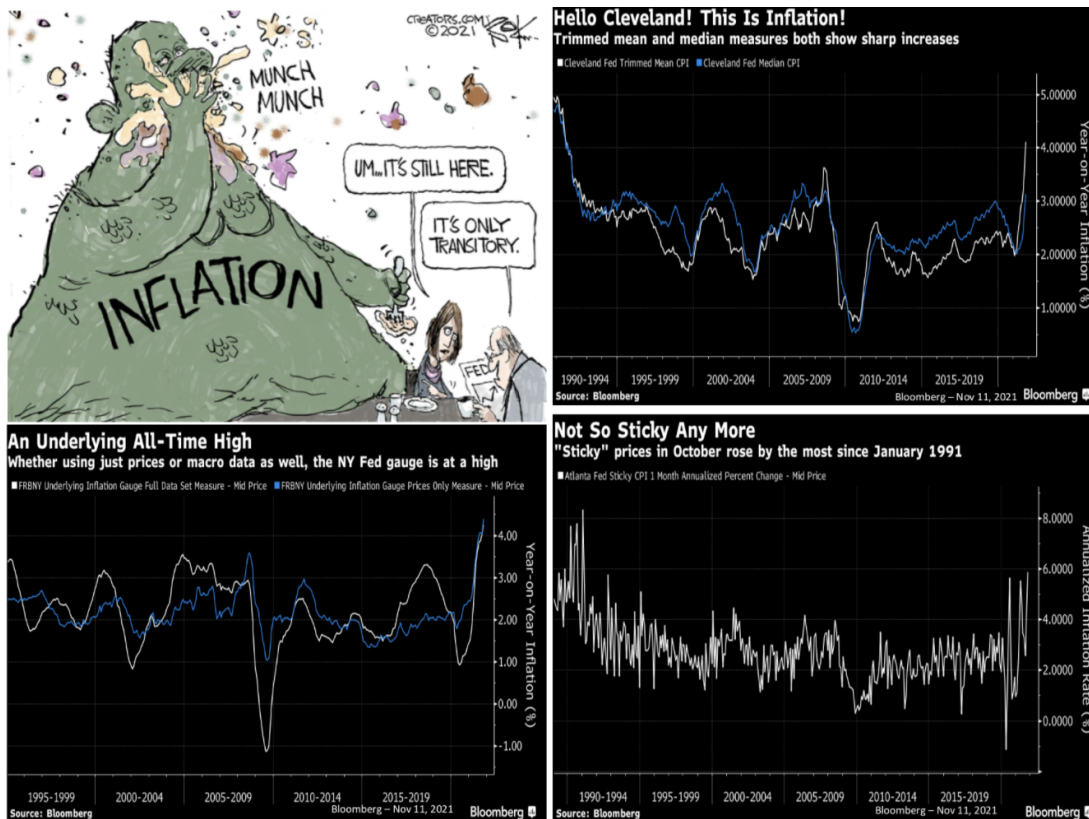


The critical factor commanding investor attention in the New Year.

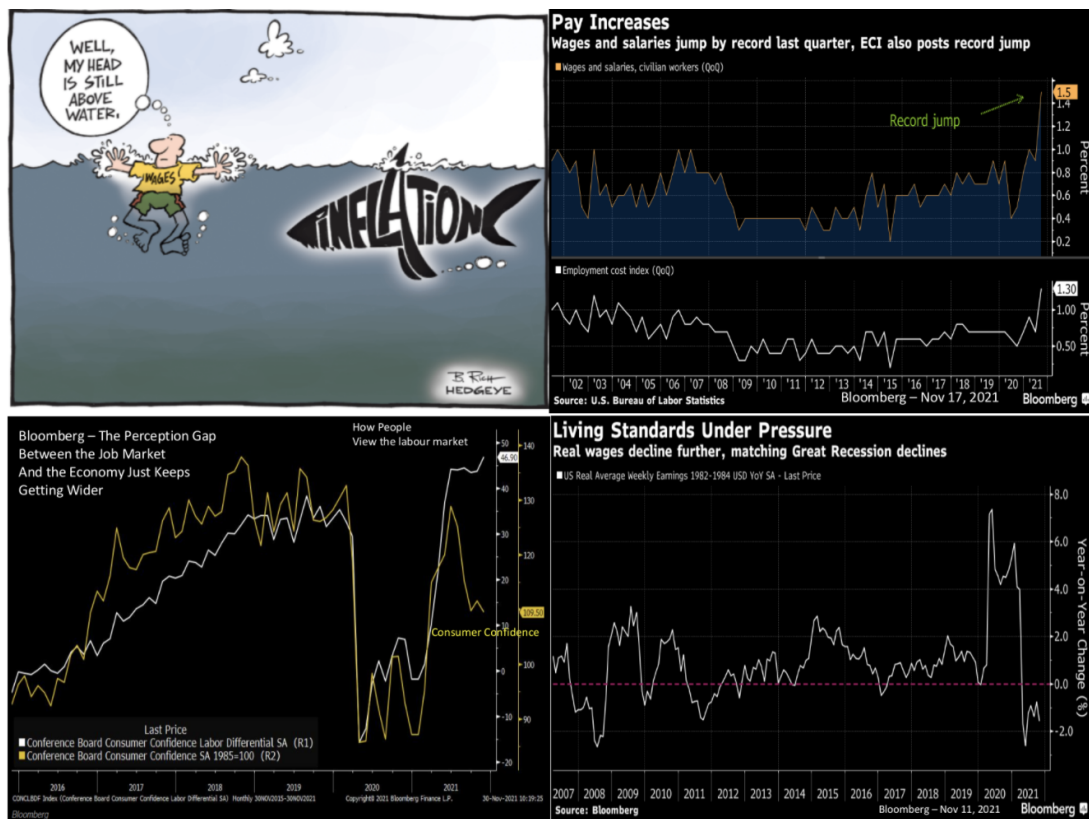
If not the pandemic, what will command investor attention in 2022 and potentially move markets? Inflation tops the list and the headlines. Not only does the volume of searches on Google referencing inflation worldwide suggest that people are worried about inflation, but Factset reports that the spike in references to inflation during S&P 500 company quarterly earnings conference calls suggests corporate America is also concerned.



Based on the inflation rate released for October, the concern is warranted as inflation begins to look less and less transitory. The New York Federal Reserve's underlying inflation gauge reached a new high in October, and the Cleveland Federal Reserve's trimmed mean and median measures both showed sharp increases. Bridgewater believes underlying inflation in November would have been closer to 8-9% if the rapid rises in both rent and home prices were included. According to ShadowStats.com, if the consumer price index was calculated using the same methodology used in 1980, inflation would be closer to 15% in October rather than just over 6%.

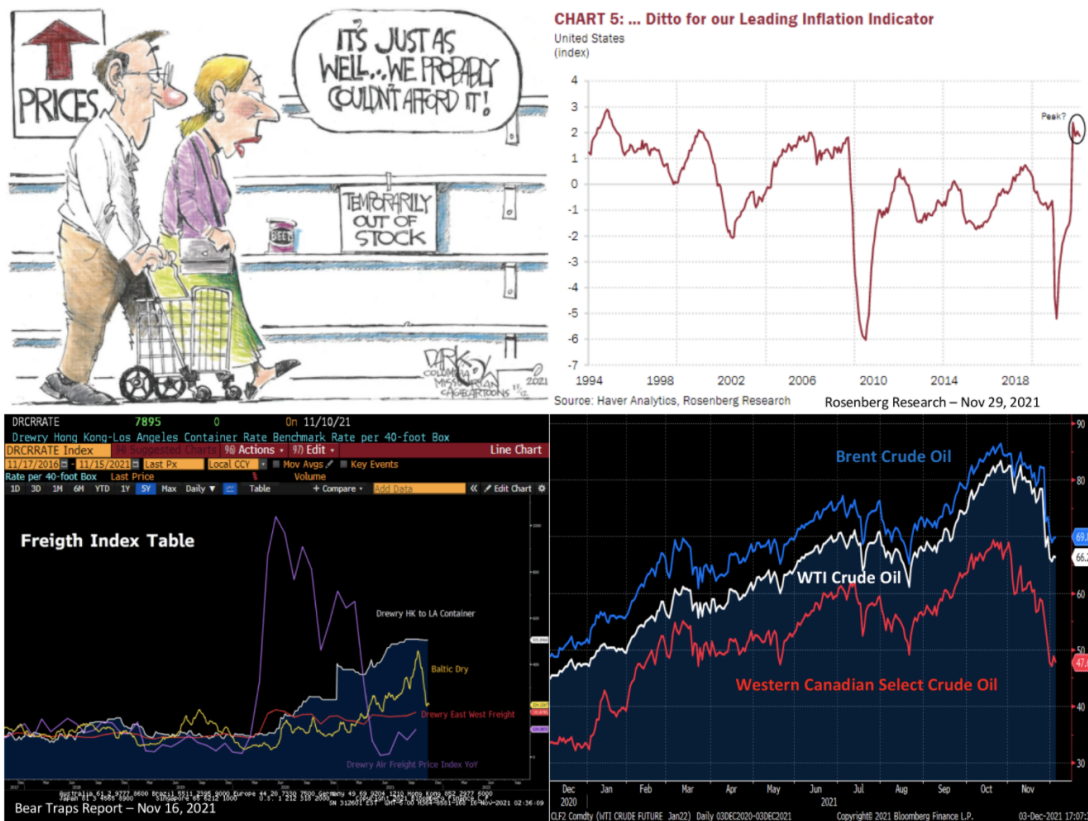


For workers, higher inflation can be good if it means higher wages, but if consumer prices increase above wages then workers lose ground while real wages decline. That is exactly what has been happening, with American living standards under pressure as real wage growth declines have matched those of the great recession. It is one of the reasons consumer confidence has begun to decline. There is normally a fairly tight relationship between consumer confidence and people's perception of the strength of the labour market. Lately, a gap has started to form, with people still viewing the job market favourably but consumer confidence falling. Eventually, this gap will need to close, and if inflation keeps eroding workers' standard of living, it will not be because consumer confidence increases.



Relief on the horizon?

Some relief might be on the horizon, however. Rosenberg Research's leading inflation indicator has recently shown some signs of peaking, and oil and freight prices have started to normalize. While the debate on whether inflation is transitory or persistent will continue to rage on a while longer, supply disruption likely will not. Eventually, the prices of goods impacted by supply chain issues will start to normalize.



Whether this means inflation itself will normalize back to pre-pandemic levels is a tough call and likely to weigh on investors well into 2022. As pointed out on a recent Goldman Sachs chart, inflation remains very uncertain over the next few years. A survey of Professional Forecasters by the Federal Reserve of Philadelphia shows that the experts have been consistently wrong in assuming inflation would normalize in three to six months. November forecasts still indicate inflation should stabilize around 2.5% by late next year. For the most part, financial markets tend to agree. 5-Year Breakeven Rates spiked to over 3% last month, but 10-Year Breakeven Rates were much more subdued. The markets have never really bought into the notion of inflation spiralling out of control. Similar to oil and freight rates, both the 5- and 10-Year Breakeven Rates have also started to roll over.

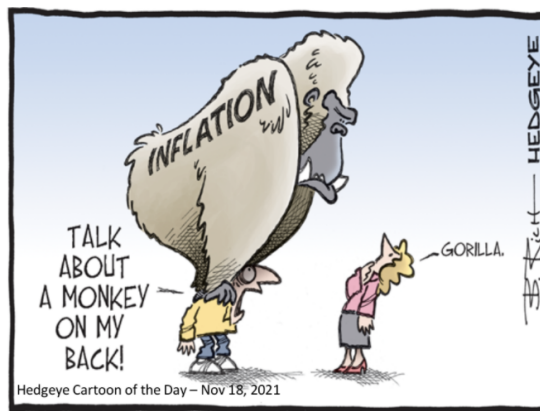
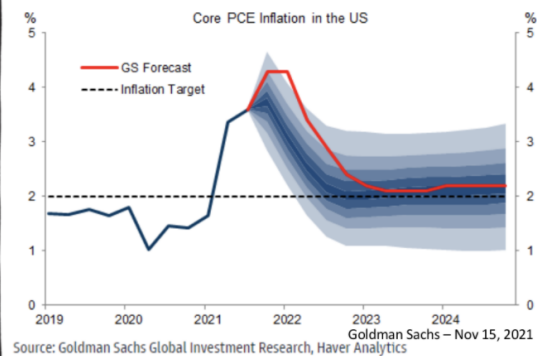


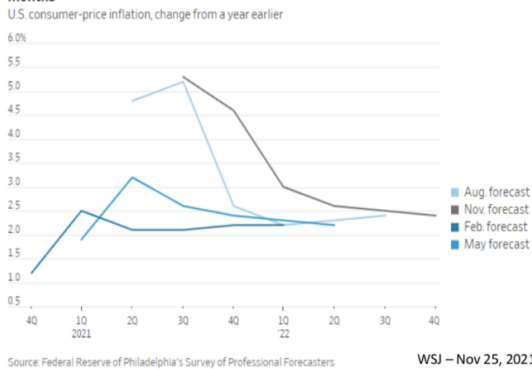
Exhibit 8: High inflation uncertainty



Inflation Expectations
A sharp retreat from peaks for five and 10-year breakevens



Professional analysts have kept assuming that inflation would normalize in three to six months

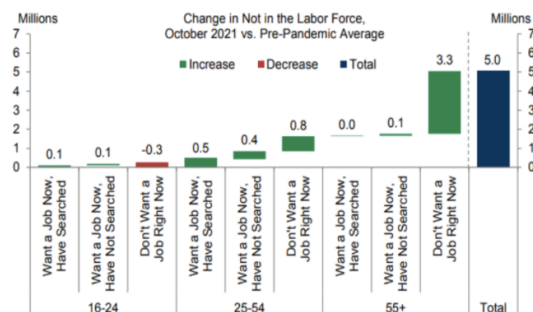


Employment and wage growth will play a significant role in determining whether financial markets and professional forecasters are right about inflation returning to pre-pandemic levels next year. Currently, there are more jobs than workers and the cause is not very clear. Goldman Sachs estimates 5 million workers have exited the labour force, with a majority falling in the 55 years and older demographic. According to Rosenberg Research, labour participation rates in the 55 years and older age group have declined more than any other demographic, particularly for men. The most common explanation for older workers remaining unemployed, Goldman Sachs finds, is that they do not want a job at the moment, meaning they are not even looking. Which indicates they have the financial means to step away, at least for a period.



WSJ – Nov 25, 2021

Exhibit 1: The Majority of Labor Force Exits Since the Start of the Pandemic Reflect Older Workers Who Don't Want a Job Right Now

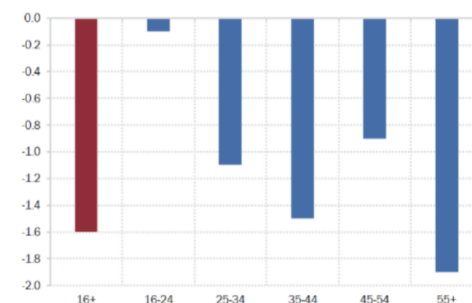


Source: US Bureau of Labor Statistics, Goldman Sachs Global Investment Research

Goldman Sachs – Nov 12, 2021

CHART 8: 55+ Age Group Has Seen Largest Decline in the "Part Rate"

United States: Labor participation rate by age group
(change since January 2020, percentage points)

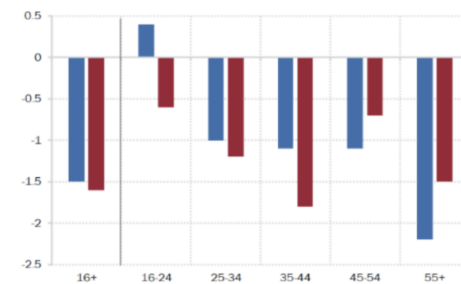


Source: Haver Analytics, Rosenberg Research

Rosenberg Research – Dec 8, 2021

CHART 9: Decline in Participation Rate Differs Across Gender and Age Group

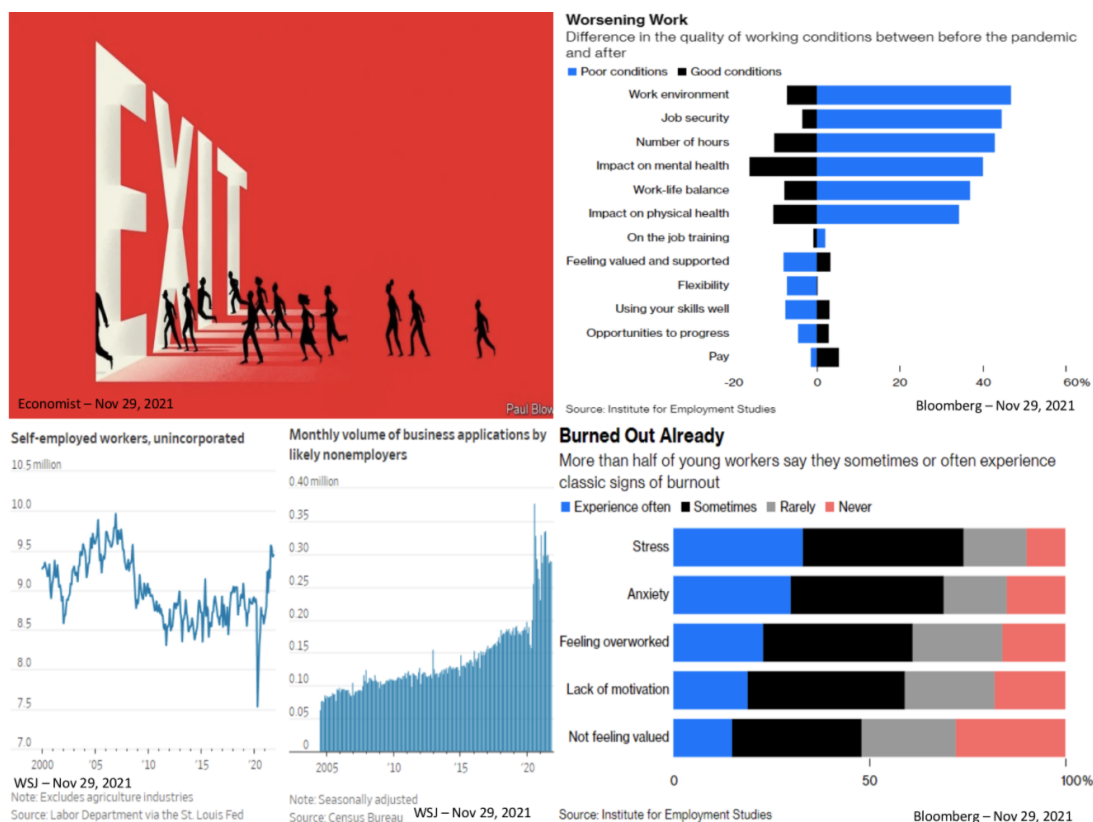
United States
(red bars; female labor participation rate by age group; change since January 2020, percentage points)
(blue bars; male labor participation rate by age group; change since January 2020, percentage points)



Source: Haver Analytics, Rosenberg Research

Rosenberg Research – Dec 8, 2021

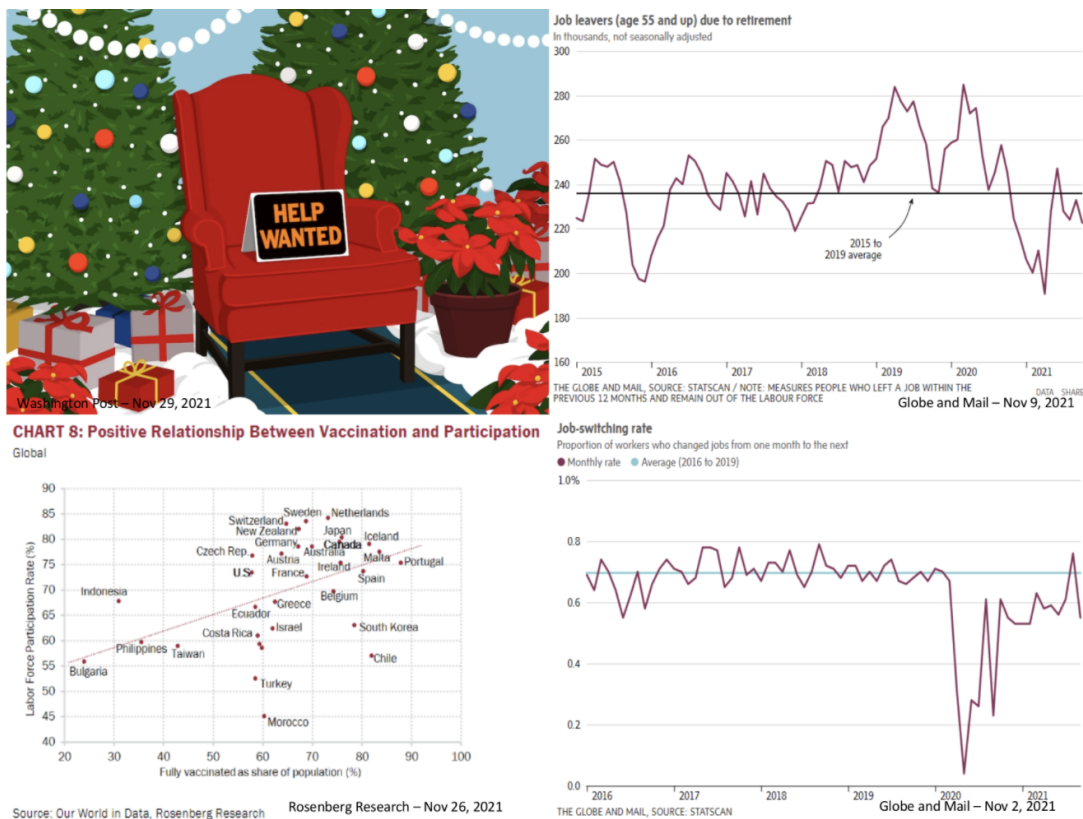
On the opposite end of the spectrum, the younger Generation Z workers, aged 16 to 25, have not experienced the same decline in labour participation rates, likely because they do not have the financial means, but they certainly would like to. A survey done by the Health Foundation and Institution for Employment Studies in Britain found that 16-to-25-year-olds are reporting a significant decline in the quality of working conditions compared to before the pandemic, and more than half report showing signs of burnout. Many workers leaving jobs in the US are choosing to work for themselves. In fact, the number of self-employed workers increased by 500,000 during the pandemic, which was the highest since the start of the financial crisis in 2008. Year-to-date through October, the Census Bureau reports 4.54 million new business applications were filed (up 56% from the same period in 2019), which is the highest on record dating back to 2004. It appears that Americans are growing tired of "working for the man" and regard self-employment as more appealing.



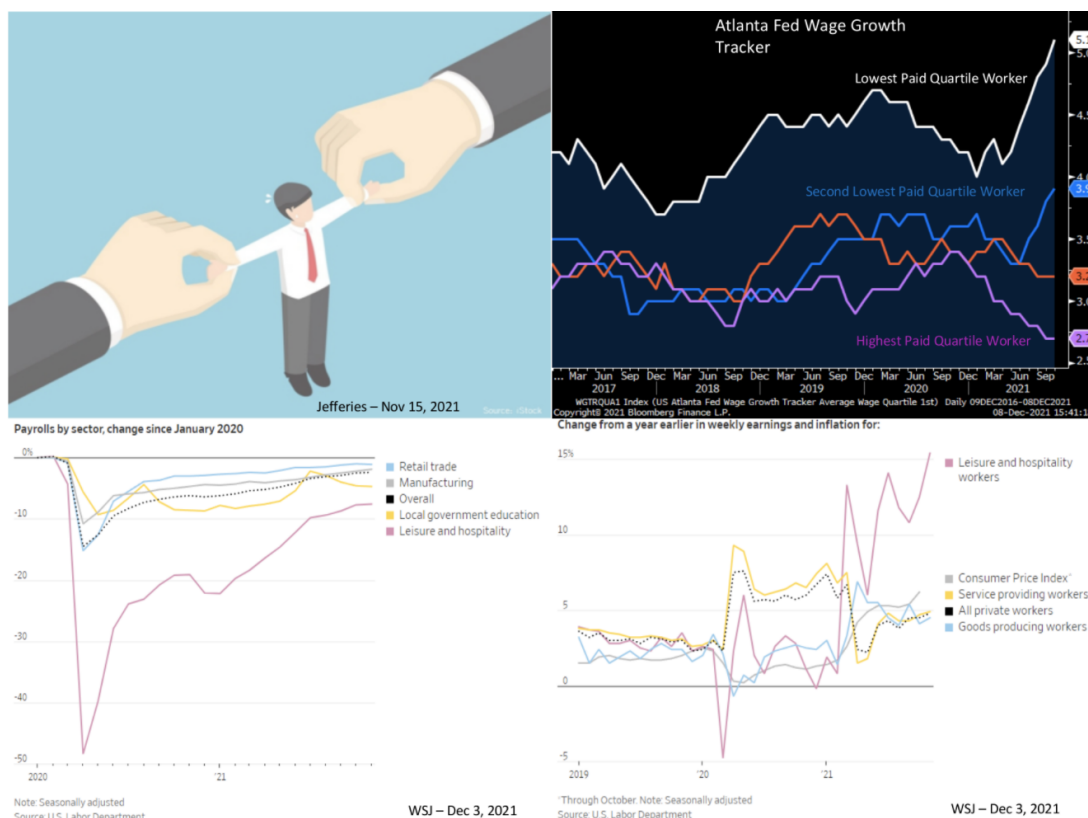
Keeping workers on the sidelines.

COVID-19 is playing a role in keeping workers on the sidelines, as evidenced by the difficulty that businesses are having in hiring Santas this holiday season. Older gentlemen with “bellies like a bowl full of jelly” being exposed to the potentially unvaccinated and contagious masses check many boxes when it comes to COVID-19 risks.

According to a recent Washington Post article, the median wage of a Santa-for-hire normally commands \$30 an hour, but the going rate is currently \$150 an hour or more. As pointed out by Rosenberg Research, countries with higher vaccination rates tend to also have higher labour participation rates and have seen their workforce return to pre-pandemic levels faster. Canada, for example, has higher vaccination rates than the US and has not experienced the same great resignation phenomenon. Retirement levels are at or below the 2015 to 2019 average, as is the number of workers changing jobs.



The unknown remains to be; how much of what we see in the job market is due to COVID-19 and if it will revert to pre-pandemic norms, or if this reflects a permanent change which could cause a much tighter labour market and higher wages. Wages have already started to increase, but the most increases are in the sectors hardest hit during the lockdowns, such as leisure and hospitality. After receiving government support during the lockdowns, some workers are re-evaluating their future in jobs that many deem not so desirable. The hours are not that great, and neither is the pay, so many are taking their time looking for alternatives before returning to work (if they ever do). They likely have some savings left over from the government unemployment supplements, but once it runs out, will they go back? The good news is that employers are trying to lure them back with fatter paychecks. According to the Atlanta Fed's wage growth tracker, the lowest-paid quartile of workers has seen a spike higher in wages, helping narrow the gap with higher-earning workers.

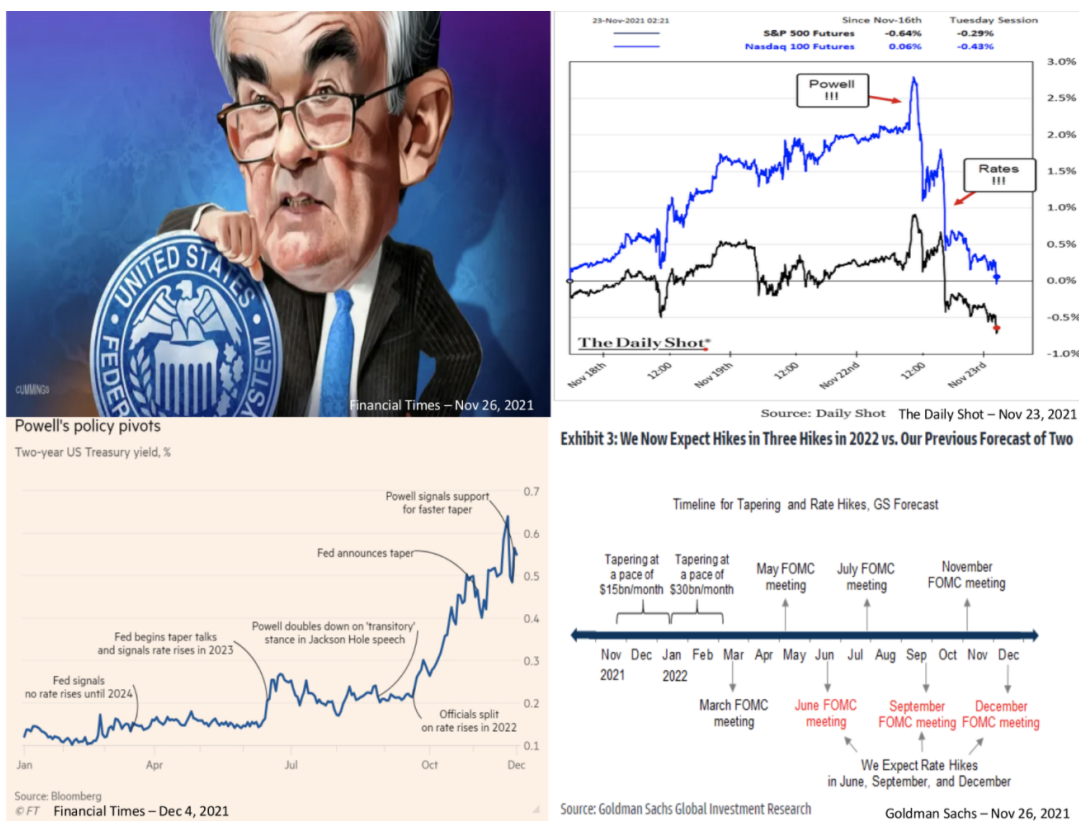


What's a President to do?

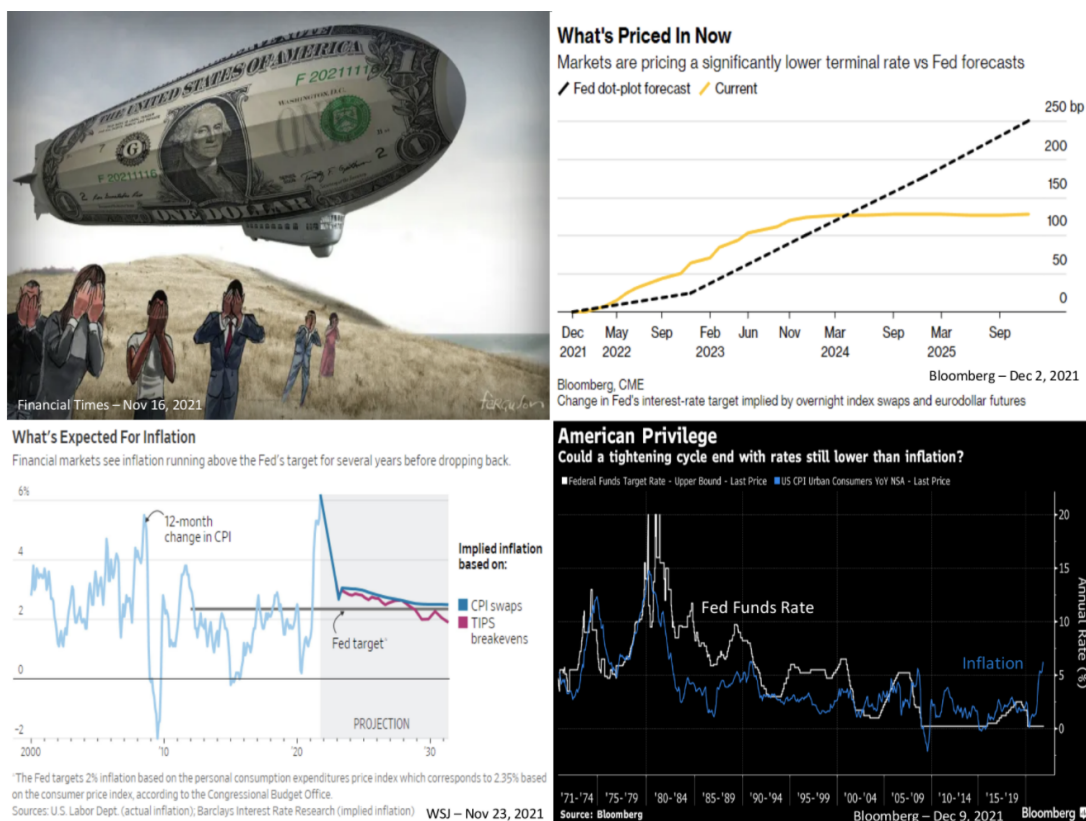
And here is where it gets tricky for the Federal Reserve. Inflation is moving higher, which is particularly bad for lower-income consumers, but at the same time, strong job demand is helping elevate wage growth for low-wage earners. President Biden is being pressured by moderate Democrats, like West Virginia Senator Joe Manchin, to do more about inflation. Manchin worries more government spending will cause inflation to move even higher, and as a result, is threatening to withhold support for Biden's Build Back Better social spending program. At the same time, progressive Democrats want even more spending and are happy with loose monetary policies stoking a hot economy to heat up even more to increase wages for lower-income workers. They think Jay Powell as Chairman of the Fed is okay, but easy money advocate Lael Brainard would be even better. What's a President to do? Last month, Biden re-appointed Powell as Chairman but tapped Lael Brainard as Vice-Chairperson. It was a bone thrown to both the moderates and the progressives.

Soon after being re-appointed, Powell pivoted towards tightening monetary policy by suggesting to drop the term transitory when referring to inflation and conceding that the schedule to taper the Fed's quantitative easing program could be accelerated. Biden needs Manchin's vote, and Chairman Powell looks to be doing what he can to help Biden get it. In the bond market, 2-year yields have been moving higher since early October as it became evident that higher inflation would compel the Fed to tighten monetary policy. The reaction in the stock market has been more nuanced. Equities initially rallied when Powell was re-appointed, as he is viewed as more vigilant in ensuring inflation would not become unhinged, but then sold off over concerns that vigilance might result in higher yields.

Given Powell's recent pivot, Goldman Sachs now sees the Fed completing the tapering prices by March and announcing the first-rate hike at the June FOMC meeting. Goldman believes that the Fed will raise rates three times next year. Goldman Sachs' forecast is headline-grabbing, but presumably a bit aggressive. Powell's gone to great lengths to disassociate tapering with rate hikes, and he may wait longer in announcing liftoff. Regardless, what will ultimately matter more to the market is not when the Fed starts raising rates but by how much they raise them.



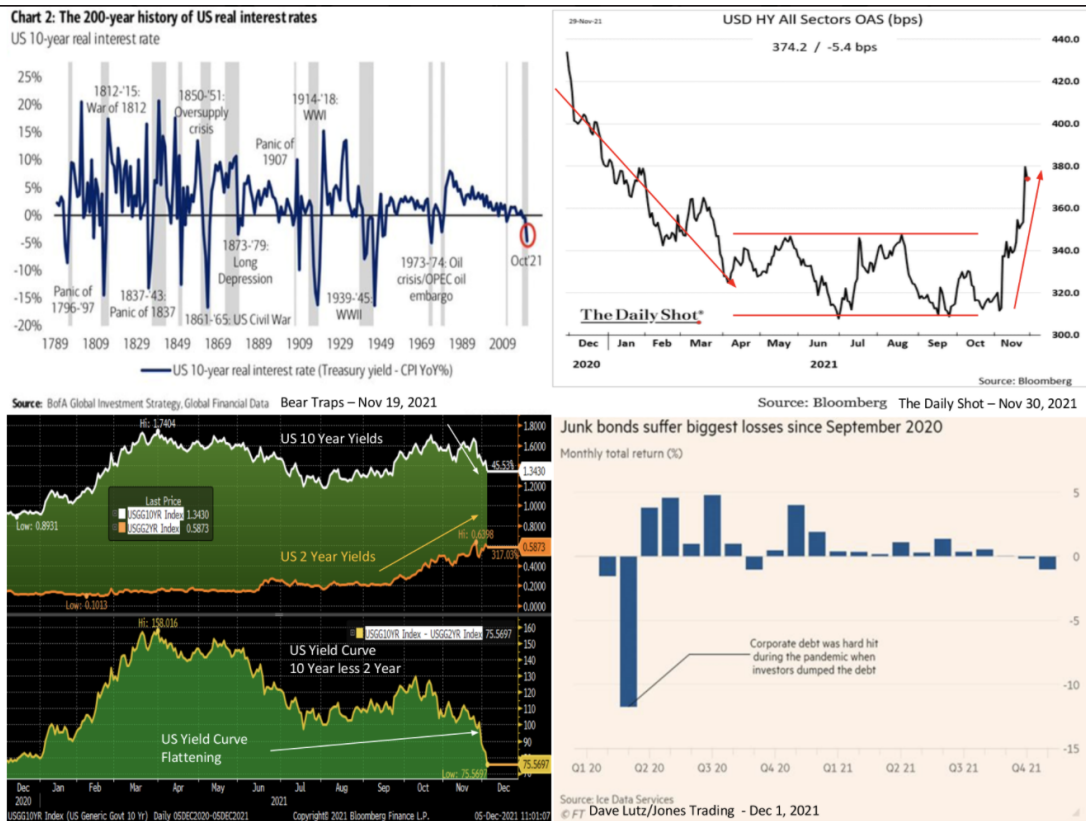
According to the Fed dot plot forecast, which shows the average future forecast for all the Federal Reserve policymakers, Chairman Powell and the bunch see rates going up to 2.5%. However, financial markets think 1.25% will be where rates will land once the Fed finishes tightening. Who is correct will likely come down to the future direction of inflation and the US dollar. Financial Markets see inflation running above the Fed's target rate for several years before starting to recede to 2% or below. With inflation currently running above 6% and overnight rates at the zero bound, real Fed funds have rarely been this negative. Real rates will move higher as inflation recedes and the fed funds rate moves higher, but if the Fed can keep rates lower than inflation, such that real Fed funds are negative, it would make servicing America's massive debt a whole lot more manageable. The burden of letting inflation rise too far above rates, however, would fall squarely on the shoulders of the dollar which would lose lustre and purchasing power in the eyes of foreign capital.



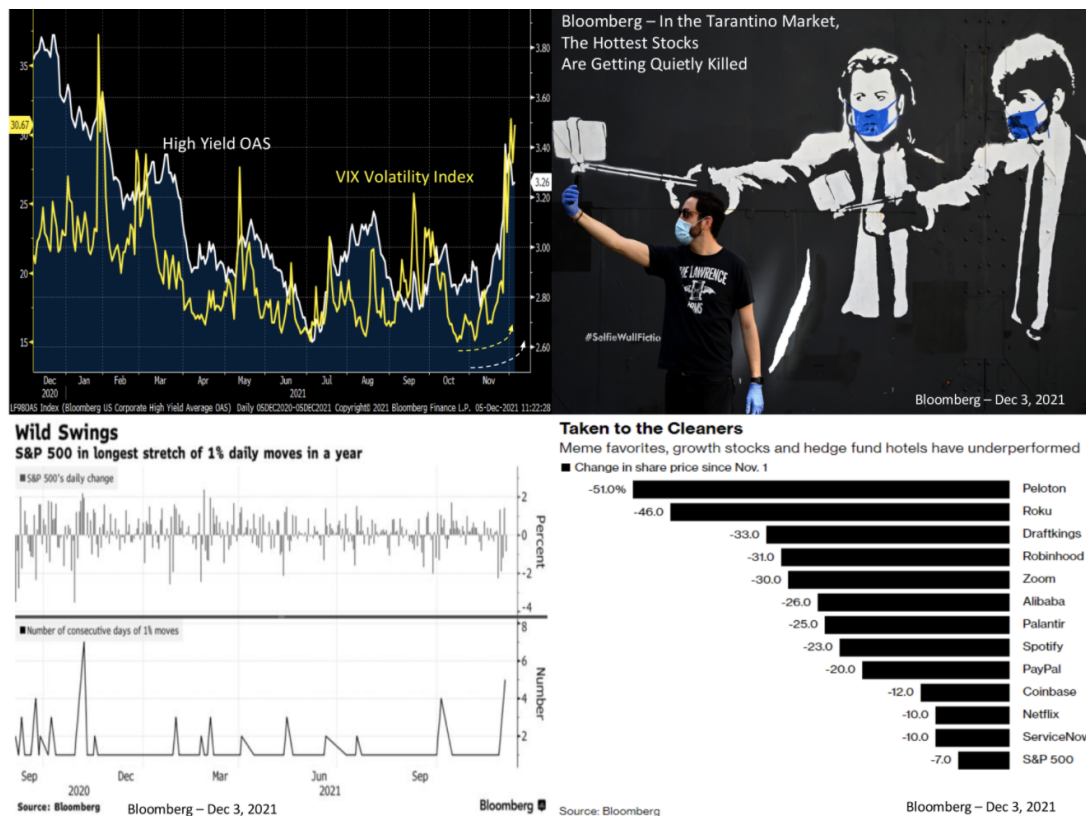
Real 10-year yields have also receded to levels rarely seen before, at least not since World War II. In fact, while 2-year nominal yields were rising last month, 10-year rates were falling, thus flattening the yield curve. A steepening yield curve is a sign of a strengthening economy, which is what we would expect when inflation is strong. A flatter yield curve is more of a vote of non-confidence in the economy and shows that the market believes the Fed's tightening cycle will be a short one. If the yield curve inverts with 2-year rates above 10-year rates, it is a sign a recession is brewing.

A weaker market than headlines indicate.

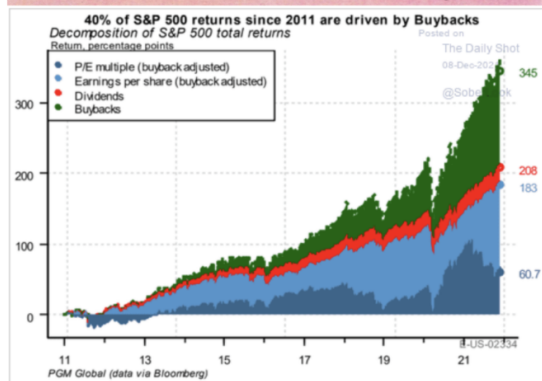
The credit market also started to signal some caution last month. After falling earlier in the year, credit spreads have been incredibly stable before suddenly spiking higher in November, with junk bonds recording their biggest losses since September of last year. While the market believes higher inflation will drive short-term rates higher, the economy is sensitive to higher rates and the Fed risks making a policy mistake if they raise rates too aggressively. Now keep in mind, while the yield curve flattened, it did not invert. And while credit spreads are widening, they are still extremely low. These are potential early warning signs, not imminent harbingers of a coming deflationary crash.



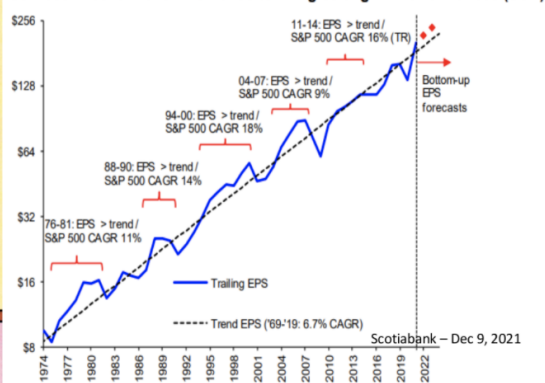
The underlying damage of rates potentially moving higher could also be seen in equity markets, especially beneath the surface. As high yield credit spreads increased, so did equity price volatility, with the VIX moving up to levels not seen since earlier in the year. While it has become rare to see the S&P 500 move up or down more than 1% during a single trading session, in early December the S&P 500 strung together five such days in a row for the first time in a year. In what one Bloomberg article characterized as the Tarantino Market, many of the market's hottest stocks this year are getting quietly killed and taken to the cleaners (or were they killed and the traders called the cleaners?). Some of the pullback is a reversal of the stay-at-home premium that they attracted during the pandemic, but the prospect of higher interest rates is dampening the enthusiasm for highly valued companies, and the market is weaker than the headline returns indicate.



Higher rates will put pressure on equity valuations, but it doesn't mean stocks can't continue to go up. According to Scotiabank, above-trend earnings tend to bring strong total returns, and earnings are expected to continue to be above trend. According to the Bureau of Economic Analysis, over the past two quarters, US businesses have posted their highest profit margins since 1950. Corporate America is flush with cash and buying back their own stock has been a favourite way to spend it over the years. According to PGM Global, since 2011, the price to earnings multiple has accounted for only 18% of S&P 500 return, while earnings drove 35% and buybacks 40%. Higher rates and lower valuations will likely be a headwind for returns next year, but they are not the only game in town when it comes to what drives equity returns.

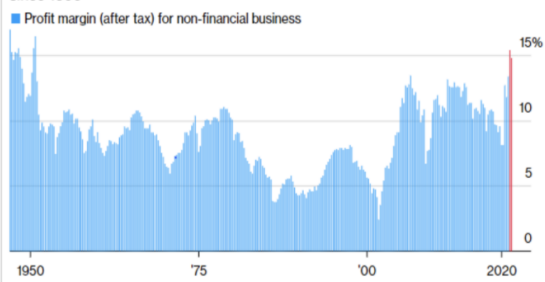


S&P 500: Above Trend EPS Tends to Bring Strong TR Performances (USD)



Raking It In

In the last two quarters, U.S. business has posted its widest profit margins since 1950



Source: Bureau of Economic Analysis
 Note: Margin = seasonally adjusted profits as share of gross value added by non-financial corporate business.
 Bloomberg - Nov 30, 2021

While 2021 has been a tough year for humanity, with the pandemic and extreme weather events continuing to take both a physical and emotional toll, the market has fared rather well. Based on last month's market action, however, some headwinds might be forming for next year. The market is pricing in little chance of a recession and economic data has been coming in stronger than expected since September, but declining consumer confidence gives us pause. Consumer confidence and stock prices usually move in the same direction, and lately, they have not. Higher inflation and tighter monetary policy would be a headwind for market liquidity and valuations. Strong earnings should keep the market moving forward, but there will be less room for error, especially if inflation remains persistent. We are optimistic that humanity will have a better year in 2022, but we are not as sure about the markets. Go long humanity, short the market? 2022 is still looking positive, but we expect increased volatility.



Disclaimer

This material contains the current opinions of the author and such opinions are subject to change without notice. This material is distributed for informational purposes only. Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information presented here has been obtained from sources believed to be reliable, but not guaranteed. Nicola Wealth is registered as a Portfolio Manager, Exempt Market Dealer, and Investment Fund Manager with the required provincial securities commissions. All values sourced through Bloomberg.

Related Articles

Market Commentary: A Santa Claus Rally

CIO Rob Edel analyzes the state of the markets; including the unpredictability of the markets, the implications of a new variant and the harsh reality [...]

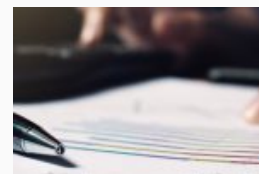
December 17, 2021



MARKET COMMENTARY

Nicola Wealth Portfolio Results – October 2021

Returns for the Nicola Core Portfolio Fund were +1.2% in the month of October. The Nicola Core Portfolio Fund is managed using similar weights as our [...]



November 16, 2021

MARKET COMMENTARY

Market Commentary: Ready to Wave the White Flag

CIO Rob Edel analyzes the state of the markets; including monetary and fiscal policy, Biden's crashing approval ratings, whether inflation is persistent or transitory, and [...]



November 16, 2021

MARKET COMMENTARY

Market Commentary: What No One Tells You About Stagflation

CIO Rob Edel explores the state of the markets; including inflation and unemployment rates, China's influence, and the concerns of stagflation, in this edition of [...]



October 19, 2021

MARKET COMMENTARY

Nicola Wealth Portfolio Results – September 2021

Returns for the Nicola Core Portfolio Fund were +0.3% in the month of September. The Nicola Core Portfolio Fund is managed using similar weights as [...]



October 19, 2021

MARKET COMMENTARY

Subscribe

Sign up to receive Nicola Wealth's insights on wealth planning and investing

[Sign Up](#)
[Home](#)
[Investing](#)
[Planning](#)
[News](#)
[About Us](#)
[Our Team](#)
[Nicola Wealth Gives Back](#)
[Client Stories](#)
[Meet With Us](#)
[Careers](#)
[Contact Us](#)



©Copyright 2021 Nicola Wealth. [Terms and Conditions](#) | [Privacy & Legal](#) | [Legal](#)

