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Viewpoint

October 2021

ASSET MANAGEMENT | WHITE PAPER

2022 Outlook: Economy Recovering, But Beware of Heavy Regulatory Hand

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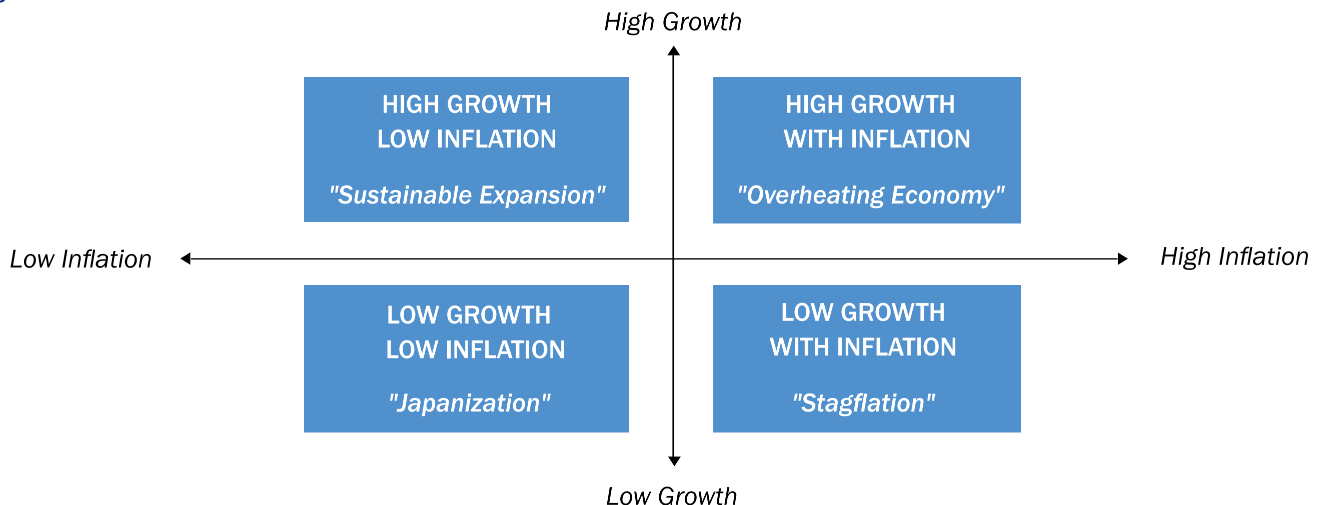
Insurers looking ahead into 2022 are likely to be concerned about an economic and investment environment that offers a lot of uncertainty. There are new highs in stocks, cycle lows in bond yields and spreads, recurring waves of virus variants, central banks in apparent disarray, and political turmoil everywhere. However, despite all these danger signs, we are guardedly optimistic that the current recovery will continue well into the new year.

2021 has been a transition year. Reflation, i.e., the building back from the 2020 depression, was good in Q1. Inflation, the big fear in Q2 and Q3, threatens to be bad. Across the globe we see a transition from a goods recovery to a services recovery, with the United States and China leading the way.

What's next? Do we maintain growth or face stagnation? And either way, is it with or without the scourge of high inflation? (See Figure 1.)

Figure 1 Growth-Inflation Matrix



Prepared by Conning, Inc. Source: Conning, Inc.

Many are reading the "up" cards (i.e., the current facts) that show some economic growth indicators slowing while inflation is rising. The Delta variant has prompted mask mandates to re-emerge in some areas and returning to school is challenged too; it's logical that the mood of the consumer has been dampened. Further, stress in the Chinese property sector highlighted by default concerns regarding Evergrande threatens global stability. However, we should look at a few of the "down" cards (i.e., unresolved areas of concern).

We believe the rollover from recovery to expansion in the U.S. is well established, built on strong pre-pandemic fundamentals, fueled by substantial central bank support and lavish government spending. Roughly 70% of economic activity in the U.S. is consumer spending. While the U.S. consumer pulled back some over the summer,[1] most recent data show that Delta is nearing its peak.[2] Employment data continues to improve[3] and supply chains appear to us to be on the mend. We expect the slower third quarter growth will prove to be temporary.

Fiscal Spending: Beyond the Necessary?

After long-standing requests from central bankers for fiscal help, the Biden administration is definitely complying, rolling out several significant spending bills running anywhere from $3.5 to $5 trillion. This is being called "stimulus" but the "down" cards here may be the unintended consequences. And we expect there will be many, given that the final bill appears likely to be between 5,000 and 10,000 pages of mandates, taxes, and regulations.

A number of market observers have expressed concerns with all this spending, but beyond inflation Conning's concern is the crushing of incentives and stifling of production. In the end, that may kill the recovery as on the margin it discourages very productive people from producing more and less productive people from improving.

Yet the spending continues, with calls for more.

Paying for It All at the Cost of Growth

What could break the cycle? Perhaps figuring out how to pay for it. The flip side of spending in terms of fiscal policy is taxation. Some observers say the current proposals amount to the biggest tax increase in more than 50 years; regardless, they don't appear to us to be pro-growth.

Some policymakers who subscribe to Modern Monetary Theory (MMT) believe the central bank should be able to support all the spending we need through monetary policy. But the world's central bankers appear confused, oscillating between easing and tightening as they try to decide which is faster: growth in virus variants or economic activity. The U.S. Federal Reserve itself is not immune from the opinion split: about half a dozen of FOMC voting members see no rate increases through 2023, another half dozen expect to raise rates up to four times by then, and the remainder expect one or two.[4]

Two old sayings combine to form a powerful deflationary force in the economy: "necessity is the mother of invention" and "practice makes perfect." We think production will do what production always does when demand spikes (absent government interference): expand, build back, and repair itself to meet it. The need for new and better processes can spur innovation and creativity such as the advances that led to the recent U.S. energy independence. The incentives and competition of the free market make us better and better at those advances, lowering their costs and improving their efficiencies.

Regulatory Role May Decide Recovery's Strength

That "government interference" part, however, is a significant qualifier given this administration's regulatory proclivities. Conning believes the likelihood of many policy changes is reduced by the current divided government along with President Biden's falling approval numbers in national polls, so the momentum we've built will likely carry us through with good growth into 2022. But the threat of slowing the expansion still looms, as regulatory burdens are not transitory. Does that mean "stagflation"?

Stagflation is stagnant growth with high concurrent consumer price inflation. We think we will continue to have good growth, so stagnation is not the base case. But stagflation has an evil twin, what some have called "Japanization" given the two lost decades of Japan's economy – long-term economic stagnation without inflation despite expansionary monetary and fiscal policies.

In the U.S. we now see increasing regulation, especially in energy, banking, and climate-targeted mandates, proposals for higher taxes, and "free money" via MMT. If, thanks to these policy developments, we don't sustain the recovery, we think the near-term risk feels more like Japanization than stagflation.

We have, and we expect to continue to have, a robust recovery from the economic doldrums of 2020, but needless to say, rerouting $3.5 to $5 trillion in taxes from the private sector to the government can easily derail it. Should some version of the massive spending, tax, and regulatory bill make it through the House, only two Democratic senators, each from the largely Republican states of Arizona and West Virginia, would stand in its way. It bears watching but, for now, we think there's a good chance to continue our sustainable expansion that will support current market valuations.

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Footnotes:

[1] Bureau of Economic Analysis, U.S. Department of Commerce (2021), "Personal Income and Outlays, August 2021," News Release dated October 1, 2021, https://www.bea.gov/news/2021/personal-income-and-outlays-august-2021

[2] Centers for Disease Control and Prevention, "COVID Data Tracker Weekly Review," October 15, 2021, https://www.cdc.gov/coronavirus/2019-ncov/covid-data/covidview/index.html

[3] U.S. Department of Labor, Bureau of Labor Statistics, "The Employment Situation – September 2021" News Release, October 8, 2021, https://www.bls.gov/news.release/empsit.nr0.htm

[4] Source: The Board of Governors of the Federal Reserve System, FOMC Projections materials, accessible version, Sept. 22, 2021, Figure 3.E., "Distribution of participants' judgments of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate, 2021-24 and over the longer run," https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20210922.htm

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