

Episode 21

# Lara Rhame's top 10 macro ideas for 2022

As 2022 approaches, we walk through Chief U.S. Economist Lara Rhame's 10 big macro ideas for next year.

Kara O'Halloran (00:06):

Welcome back to FireSide a podcast from FS Investments. My name's Kara O'Halloran, I'm a Director on our Investment Research team here, and it is the most wonderful time of the year, and I'm not talking about the holiday season, November and December may mean Thanksgiving and then the start of the holidays to most people, but for anyone working in financial markets, it is year ahead outlook time. Here at FS, we have plenty of content coming your way to keep you all busy for the rest of the year and get you prepped for 2022. And I am so excited to kick things off with what is always one of my favorite pieces of the year and our clients' favorite pieces as well, our chief economist, Lara Rhame's 10 for '22. So, her top 10 calls for next year. Lara is here with me today to walk through what she is closely watching for 2022. Lara, welcome.

Lara Rhame (00:53):

Thank you. Is it already that time of year? It's just snuck up on me.

Kara O'Halloran (00:57):

I know we say it every year, "I can't believe it's the end of the year," but really this year I can't believe it's the end of the year.

Lara Rhame (01:05):

I know.

Kara O'Halloran (01:05):

It's crazy. I think about 2021, we started in lockdowns, we had the vaccines, we had this vaccine euphoria and the reopening, and then Delta came and Omicron, and maybe we'll learn how to say that in 2022.

Lara Rhame (01:17):

Right. Supply chain disruptions.

Kara O'Halloran (01:18):

Yeah, exactly. We still have strong economic growth and markets are still making all-time highs. They're trading near all-time highs today.

Lara Rhame (01:26):

But interest rates haven't gone anywhere.

Kara O'Halloran (01:28):

Exactly.

Lara Rhame (01:28):

They're pretty much back where they were at the beginning of the year.

Kara O'Halloran (01:30):

Yep. But big topic of conversations still and commodities had a big run for a while. There was no shortage of things to talk about last year. It was a good time to watch a podcast.

Lara Rhame (01:41):

That must be why it seems like we're just right here again, thinking about that, the coming year.

Kara O'Halloran (01:44):

Exactly. But I think we can all agree that there was one topic that dominated everything. You can guess it, inflation.

Lara Rhame (01:52):

Yes.

Kara O'Halloran (01:53):

So, Lara, I think the big question is, are we going to be talking about inflation this much next year?

Lara Rhame (01:59):

At least for the first half of the year, I absolutely think that they will be. And that's really because inflation I now sort of divide into three key drivers. One are those reopening stocks, that's really what pushed inflation up in the beginning of 2021. I mean, reopening categories, when you have an 80% decline in airline tickets, even if they rise sort of a small amount, it looks like a tremendous inflationary year on your gain. That's really what we kind of got in the second quarter of 2021.

Lara Rhame (02:36):

But now, we're seeing inflation coming from this huge demand shift into goods, which has collided with supply chain disruption, so higher demand, lower supply is meant really increasing prices. And then, wage pressure is clearly causing the cost of services to rise for households. So, all of these things continue to bubble up as well as big question marks on the commodity front. And all of that means that even if we get some of these drivers of inflation moderating in the beginning of the year, we're still going to be seeing these 6%, maybe even 7% year-on-year inflation rates over the first quarter. So, headlines that really, we have not experienced since the 1980s.

Kara O'Halloran (03:30):

Wow. So, what is your end-of-year forecast for inflation? What do you think about after the first half of the year?

Lara Rhame (03:36):

Yeah, I mean, you look at some things which have really... Energy, oil prices doubling over the course of 2021, drove, right now is driving about a third of our year-on-year inflationary gain. And when we think about where oil prices are going, they're even in November, in right now where we sit in December, they're already off significantly, those peaks. With global growth forecasts where they are, it's likely that energy prices will continue to come down and at least moderate.

Lara Rhame (04:12):

So, this is a good example of things that I think towards the end of the year will start to bring inflation back down from these acute levels, but we may still be around 3%, for example, that's significantly higher than we were before the pandemic. So, end of 2022 forecast is for the fourth quarter to see inflation of 3% year on year, but that is still about a percent higher than the 2% we were seeing before the pandemic started. It's bigger. It's more impactful than it sounds.

Kara O'Halloran (04:47):

Absolutely. I mean, we've talked about on this podcast before just how detrimental to portfolios, just that, what doesn't sound like a lot of inflation, especially when we're seeing numbers over six, like you said, maybe even over seven, and so 3% really still can have a big impact on portfolios on both the equity side and the bond side, on the relationship between the two. So, I think, even as inflation, if it starts to leave the headlines a little bit, or if it's not as dominant in the headlines, really important to remember that it is still impacting everything or portfolios I should say.

Lara Rhame (05:22):

Yeah, yeah. No, I mean, I think that's exactly right. And you think about everything from real wage gains, that is going to also continue to really, I think, be a really significant focus in the coming year. The fact that higher inflation is impacting consumer sentiment. We have different measures of consumer sentiment. Some are more sensitive to inflation, but those measures show consumer sentiment lower now than at any point during the pandemic. So, it's not like we're just robots thinking about inflation in terms of our finances. Inflation, especially when it's coming from food and energy, is something that impacts every single household. And it will, I think, have economic impact well beyond just whatever year-on-year price level you're thinking of.

Kara O'Halloran (06:09):

Right. So, it's hard to talk about inflation without then bringing up the fed, which I think probably takes spot number two in terms of what we've been really closely watching and really talking about for the last year. The Fed has started to taper their asset purchases. We're recording on December 9th, so we heard from Chair Powell last week, we may have even, by the time this episode comes out, may have heard from him again. But the Fed is considering accelerating the timing of their taper, which many in markets took to mean that rate hikes could be coming sooner than anticipated. You think right now we're kind of oscillating between pricing in two and three rate hikes next year, which thinking back to the summer, thinking back to August, I think markets were thinking maybe one rate hike. So, things really changed quickly there. So, what are you thinking the Fed is going to do next year?

Lara Rhame (07:00):

So, my expectation is the Fed will raise rates twice next year. And that is a little lower to your point than what markets are pricing in, which ebbs and flows with data. But right now is very close to three rate hikes next year. And I would say five rate hikes over the next two years. So, markets, I think, really expect the Fed not only to raise rates, but to get traction and really embark on a more lengthy rate hike cycle.

Lara Rhame (07:32):

When I think about the step one, which is the taper, the Fed has worked to speed this up because I think they want to have maximum flexibility. And I think it's a mistake to assume that just because they want to get the taper over faster, they necessarily want to raise rates at the next meeting. By that I mean, if the taper now is expected to end in March and just for everybody out there listening, with the pandemic, the Fed engaged in quantitative easing, they

purchased a lot of assets as a way to further support the economy when rates are at zero. And they're withdrawing that additional quantitative or monetary support to financial markets in the economy.

Lara Rhame (08:24):

So, this next step after that would be to raise rates if they want to continue to tighten monetary conditions, tighten economic conditions, lower demand, and get ahead of inflation. And I think the final word for me is that we need to realize that the Fed will probably not go on autopilot in the same way that we have seen in past cycles. The economic outlook is still uncertain enough and inflation is coming from places like supply chain disruptions, as an example, that won't necessarily be fixed by raising rates or slowing down demand. So, all that's to say, outlook is for two rate hikes, but we still need to listen for signals about timing and be proactive about not assuming anything's on autopilot.

Kara O'Halloran (09:21):

Mm-hmm (affirmative). That's a good point. So, often when people think about a Fed rate hike or rate hike cycle, they kind of instantly assume that the long end of the yield curve is also going to increase, that long-term rates are going to rise, obviously the Fed is controlling the short-term rates. But I think you have different... Data shows us something different. So, Lara, what are your thoughts on long-term interest rates next year, given your outlook for two Fed rate hikes?

Lara Rhame (09:48):

Yes, I refer to this as the Myth Busting second...of the-

Kara O'Halloran (09:51):

We had an episode on that. We love Myth Busting here on the FireSide Podcast.

Lara Rhame (09:54):

The Myth Busting portion of our podcast today.

Kara O'Halloran (09:56):

I love it. It's our new segment.

Lara Rhame (09:59):

Which is that I often hear people talk about the Fed raising rates and won't long-term interest rates start going up? And exactly to your point, long-term interest rates often kind of stay where they are. And long-term rates have been really range-bound for the past year. And that was our expectation a year ago. And looking ahead, I think we're still in a very sort of sideways pattern there. And Fed rate hikes will not change that. I expect... We wrote a lot about how, when inflation is higher, it doesn't necessarily mean long rates will rise.

Lara Rhame (10:36):

Similarly, when the Fed raises short-term interest rates or the Fed funds rate, it does not necessarily mean that long-term rates will rise. And in fact, they almost always stay flat to even lower slightly. My personal expectation is for rates, in the first half of next year, the 10-year, to stay between one and a half and two. And we could see rates in the second half of next year from two to two and a half.

Lara Rhame (11:07):

And interestingly, that is not probably coming from Fed rate hikes. It's maybe coming from the fact that China right now is actually easing monetary policy to stimulate their economy. I think that actually might be one of the factors that raises US interest rates so high.

Kara O'Halloran (11:26):

Walk me through that dynamic.

Lara Rhame (11:28):

That may seem like it came out of left field, but bear with me. Globally, interest rates are so low and in the developed world, yield curves are flat to negative or inverted in the first part of the yield curve. So, you really have had a situation now for several years where global growth, and I think we can all agree that as goes China, so goes the rest of global growth to a very significant degree, ends up being reflected in the US yield curve.

Lara Rhame (12:08):

And there's actually a fabulous graph. That's one of my favorites that I've included in the 10 for '22 that shows that Chinese monetary stimulus is a great leading indicator of the US 10-year yield. So, we saw that in the middle of last year, when China tightened rates, US yields actually fell on the back of that over time, that ended up coming to fruition, I think, we may very well see that reverse course as the US and Chinese monetary cycles continue to diverge.

Kara O'Halloran (12:44):

That's so interesting. And not something that I think we often talk about-

Lara Rhame (12:49):

No.

Kara O'Halloran (12:49):

... or I hear talk about often. So, speaking of growth, we talked about global growth a little bit, let's refocus on US growth for next year. Headline, what are you thinking for 2022?

Lara Rhame (13:01):

So, 2022, I think we get growth around 3% for the full year. Remember, 2020 was like the worst year for growth, and 2021 was the best year. And now, we sort of end up muddling in the middle. And I think by the end of 2022, we may end up with growth, my expectation is to find ourselves back around 2% GDP in the third and fourth quarter of next year, similar to where we were before the pandemic. And I think, we get there because, for households, income growth starts looking an awful lot like wage growth. And we really need to remember that while we may see companies reporting higher nominal sales or nominal revenue, that is one of the problems with inflation, nominal growth looks very different from real growth.

Kara O'Halloran (13:58):

And not something that we've had to differentiate much for the last decades.

Lara Rhame (14:02):

Yeah. It takes different mental gymnastics when you're adding up growth.

Kara O'Halloran (14:06):

Right.

Lara Rhame (14:06):

Yep.

Kara O'Halloran (14:07):

So, okay. So, I want to go even more macro, take a macro view of the macro economy, if you will. But we talked about things that you're watching closely, and we talked about inflation and the Fed and growth, but I want to know more broadly, what are some of the headwinds and tailwinds that you see that could impact all of this or any of this?

Lara Rhame (14:31):

Sure. Well, and that's important to think about, because we still have really opposing forces pulling on our economy and you do kind of end up with this tug of war, which is why I'm going with that sort of middle ground, muddling through concept for growth of next year. We have the really powerful gravitational pull of our potential growth, of weak labor force growth. When we think about our economy and the fact that we've recovered a lot from the pandemic, but what are we still missing? It's the recovery in services. Those are the jobs that are missing. But those jobs are some of the lowest productivity jobs out there.

Lara Rhame (15:14):

So, if we bring all those jobs back, it's actually could imply some fairly weak productivity growth next year. And I think that's the gravitational pull that ends up, maybe not as an exact headwind, but certainly can cause our momentum to really flag. But on the other side, you still have a healthy household sector. You have a strong household balance sheet. I think there is room for households to lever up there, that could help offset some of the dwindling savings from the really massive fiscal stimulus that we got through end of 2020 and early 2021. So, consumer confidence remains really critical to watch. But I think as the year progresses, we go from growth of around 4% more towards growth around 2%.

Kara O'Halloran (16:09):

All right. So, let's wrap it up with a rapid-fire round. Okay?

Lara Rhame (16:15):

Got it.

Kara O'Halloran (16:16):

Like quick answers. What is your highest conviction idea?

Lara Rhame (16:21):

That I think interest rates are going to stay where they are, bear flattening.

Kara O'Halloran (16:26):

What did you want to put on your outlook that you left off?

Lara Rhame (16:29):

Oh, that's a tough one. Because I was already fighting for space. I mean, it's really tough. I think, I didn't mention the midterm elections and all the policy uncertainty that brings, tax policy, trade policy. I didn't mention the residential housing market, which has been on fire throughout the pandemic, starting to cool, but Fed's raising rates, really makes you wonder where that's sort of if it just comes to a gradual decline or something more abrupt.

Kara O'Halloran (16:58):

Okay. What's the sleeper hit that we're going to talk about next year that's not inflation?

Lara Rhame (17:04):

I think the focus towards the end of next year really turns back on growth and productivity.  
Yeah.

Kara O'Halloran (17:10):

How far behind are you on your Christmas shopping?

Lara Rhame (17:14):

Here's the problem.

Kara O'Halloran (17:14):

I haven't started.

Lara Rhame (17:16):

Here's the problem, my family, me, my husband, and one of my daughters, we're all have birthdays right around the holidays. So, it's not just holiday shopping. It's birthday shopping as well. I mean, it's double duty.

Kara O'Halloran (17:26):

Yeah, you got a twofer there.

Lara Rhame (17:29):

Brutal.

Kara O'Halloran (17:29):

On that, I will let you go so that you can go hit the stores.

Lara Rhame (17:33):

Good luck to us.

Kara O'Halloran (17:34):

Yeah. Right? Oh, well, Lara, thank you so much for joining me as always your chart book, the 10 for '22 is available along with the rest of our 2022 outlook content on [fsinvestments.com](https://fsinvestments.com) and very excited to bring you back in 2022 to start it all over again.

Lara Rhame (17:52):

Absolutely. Look forward to it.

Kara O'Halloran (17:53):

All right. Thanks. This podcast is brought to you by FS Investments. If you found this helpful, subscribe to get new episodes as soon as they're available.