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CIO Strategy Bulletin

THE RATIONAL MR. POWELL

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SUMMARY

- It was a tumultuous week in markets, with investors on edge, worrying how far central banks will go to stamp out inflation. Since January 3, the S&P 500 index has sunk 8% while the Nasdaq is down 12%.
- The Fed's signaling its intention to raise interest rates and reduce its balance sheet simultaneously has already resulted in a true, effective tightening of monetary policy in early 2022.
- Yet, we believe this isn't a typical inflationary period. The torrent of monetary, fiscal stimulus and COVID-driven supply distortions over the past two years caused major supply-demand imbalances and labor market distortions.
- We also believe policymakers have little choice but to accept the one-off rise in consumer prices that resulted from COVID stimulus and temporary – albeit lingering – supply/demand imbalances. And in our view, policymakers will understand that hurting consumer demand won't solve current challenges.
- What are the considerations for portfolios now? The early 2022 reckoning in stock markets has been concentrated in equities with the highest valuations. As such, we prefer to limit allocations in US growth equities to established, profitable firms. Our largest allocation and largest sector overweights are global dividend growth equities and healthcare, respectively.
- For the immediate outlook, we're looking outside the US: the valuation for *most* of the world's individual shares look nothing like the highest fliers on the Nasdaq. Non-US shares across all regions trade at a mere 13X expected 2022 EPS.
- While not offering a "good yield," the recent rise in rates means investment grade securities are becoming a potentially compelling low-risk asset for us in portfolio construction.

A TINY BIT OF PANIC

Inflation, interest rates and the Fed have put fear back into markets. So has the Russia-NATO standoff over Ukraine and oil prices rising to 2014 levels. Since January 3rd, the S&P is down 8%, the Nasdaq is down 12% and nearly 20% of Nasdaq issues have hit new 52-week lows. Headline US inflation reached 40-year highs with a 7% rise over the year through December. The Fed has radically changed course (see our bulletin of December 19, 2021 [Understanding the Fed](#)) by planning both rate hikes and balance sheet reductions to shrink lending and slow consumer demand.

Looking backwards, it has been 21 months since either the S&P or Nasdaq had a decline of 10%. Normally, we experience declines of 5% 3x per year and a decline of 10% once a year. So, this correction is, in a sense, long overdue. But looking unemotionally at historical norms does not capture the panicky tone of the market today.

As we wrote in [“Fear and Loathing of Inflation” on November 14, 2021](#), inflation has a visceral impact on consumers and investors. It is driving a wedge between the improving state of labor markets and consumer confidence, which is weakening even as the economy continues to grow.

For over a decade, we have gotten used to a benign level of inflation, under 2.5% per year since 2011. So, when that annual rate quadrupled in December to 7%, people began to wonder if the 15% peak inflation rate of the 1980s was possible again.

Persistent inflation is a complicated problem for the Federal Reserve and policymakers. A cycle of rising wages and prices would require more radical action. In the 1960s and '70s workers expected to be paid more year after year, with prices for everything rising in concert. The Fed was then in the habit of “accommodating” this with increasing the money supply every year. This was only broken by radical tightening steps and deliberate US recessions in 1980 and 1982.

SCARCE PRODUCTS, NOT WAGES, DROVE INFLATION IN 2021

The flood of liquidity that policymakers used to overcome a literal shutdown of the global economy was unprecedented. Spending and distortions in the economy of this scale were last seen in WWII (see figure 1). First, production and consumption were deliberately crushed. Then, a broad, stimulus-induced recovery commenced. But with the pandemic reshaping the economy, consumer demand focused on goods at the expense of services. This drove the demand for goods to unprecedented levels, bidding up prices as goods became scarce (see figures 2-3).

Figure 1: Disruptions in Production Have Been of a Scale Unseen Since WWII

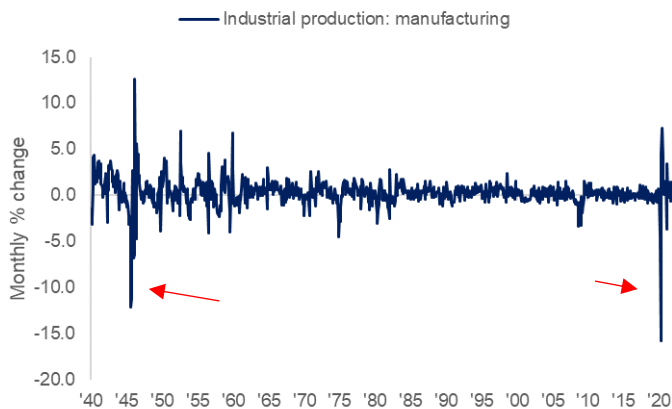
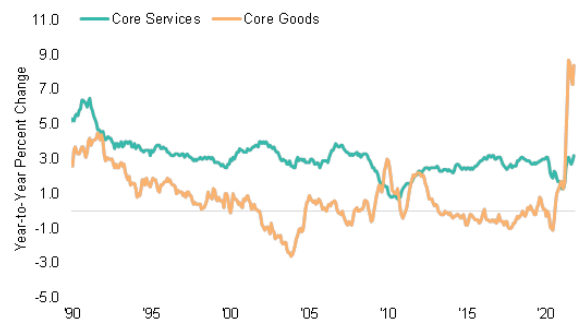


Figure 2: Scarce Products, Not Wages Drove Inflation in the Past Year



Source: Haver analytics as of January 22, 2022.

Figure 3: US Employment Cost Index and Consumer Price Index Y/Y%

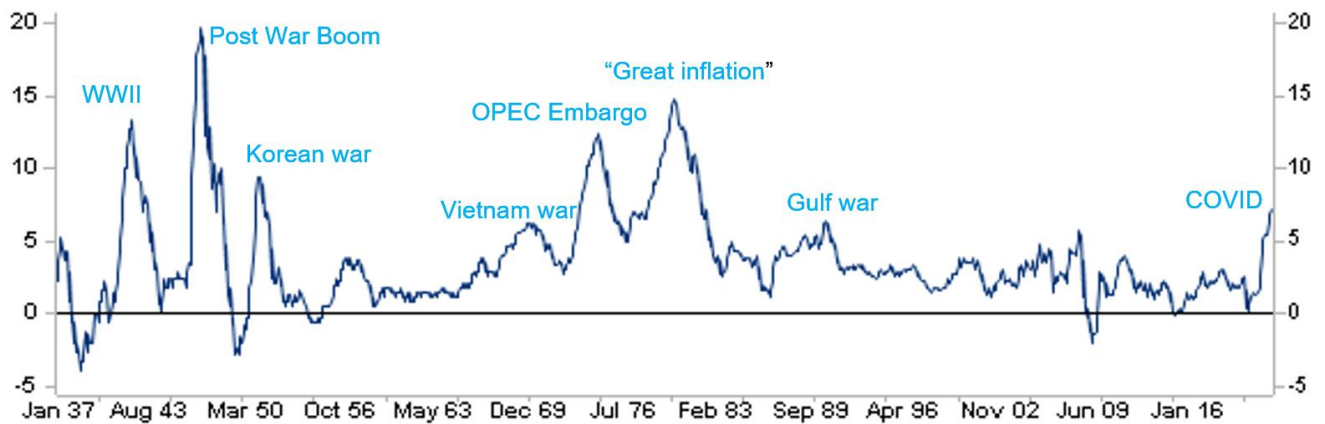


Source: Haver Analytics, Bureau of Labor Statistics as of January 22, 2022.

The pandemic itself warped the economy by changing the availability and mobility of workers, leading to manufacturing and supply chain disruptions in what was a “just in time” global manufacturing ecosystem. Businesses adapted by spending more to meet that demand, boosting goods imports by 18% and expenditures despite international shipping costs nearly tripling.

In short, this was anything but a typical cycle and, therefore, this is anything but “typical inflation” (see Figure 4.)

Figure 4: US Consumer Price Index Y/Y% Change and Historic Transitions



Source: Haver Analytics, Bureau of Labor Statistics as of January 22, 2022.

A RATIONAL FED REALIZES ITS LIMITATIONS

With macro stimulus largely in the rear-view mirror, policymakers should see that inducing a collapse in demand would do nothing to solve many of the present inflation-induced challenges. “Excess demand” for certain goods at the expense of services is not addressable with monetary policy. Even more clearly, Omicron’s impact on global and local supply chains cannot be fixed with tightening macroeconomic policies.

WHY EXPECT RATIONALITY?

We believe Fed policymakers have little choice but to accept the one-off rise in consumer prices that resulted from COVID stimulus and temporary – albeit lingering – supply/demand imbalances. We also believe that policymakers will recognize that inducing a collapse in demand will do nothing to solve the present inflation challenge. Here’s why:

- Fiscal policymakers have already eliminated almost all COVID stimulus.
- There is tangible progress toward supply recovery, both in components and in transport.
- Covid is likely to abate, and the future severity of the disease will, too. The demand balance between goods and services expenditures will slowly return to normal.
- A severe tightening that sinks the recovery in employment will do little to improve the supply/demand imbalance and represents an unacceptable sacrifice.

Therefore, it seems unlikely to us that the Fed will clamp down hard enough to completely reverse the crisis-induced easing. Unlike the historic choice made in 1981 to force a recession in the fight against double-digit inflation, we believe the Fed **will not** choose to (or need to) sacrifice the present US economic recovery to force inflation down. In fact, we expect Fed members to confirm this view in future comments as the policy-making Federal Open Market Committee meets later this week.

THE DATA SUPPORTS THE FED MOVING CAUTIOUSLY

EMPLOYMENT DATA

While no one should expect a full return to pre-COVID economic norms, COVID has left massive and temporary distortions to product demand and labor markets. Despite both a sharp drop and subsequent recovery in 2020, two million jobs were lost in the US in the past two years while four million workers are missing from the labor force (see figures 5-6). This explains the Covid-related spike in wages given the temporary shortage of workers.

Figure 5: US Employment Level Still 2 Million Lower Than Two Years Ago

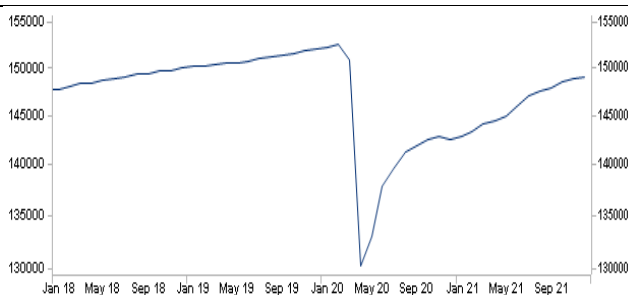
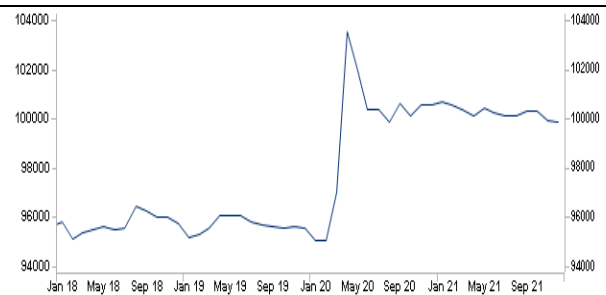


Figure 6: Four Million Have Yet to Return to the Labor Force



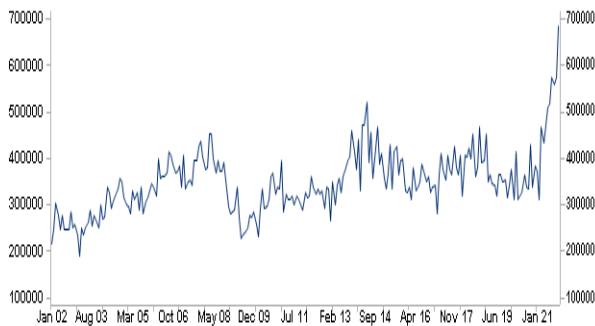
Source: Haver Analytics as of January 21, 2022. Figure 1 shows US employment level. Figure 2 shows US persons not in the labor force (16+ years).

SUPPLY CHAIN NORMALIZING, KEY COMPONENTS ARRIVING

In normal times, it often takes time for supply to catch up with demand. In the case of semiconductors, people have forgotten that there was already a shortage in 2019. The 2018 tariffs imposed by the US on China restricted the availability of raw materials for chips, such as silicon and reactor tubes. Then, Japan implemented export restrictions on Korean semiconductor manufacturers on chemicals produced by Japan vital to chipmaking. So, a semiconductor shortage was already in place in December of 2019 driving prices higher.

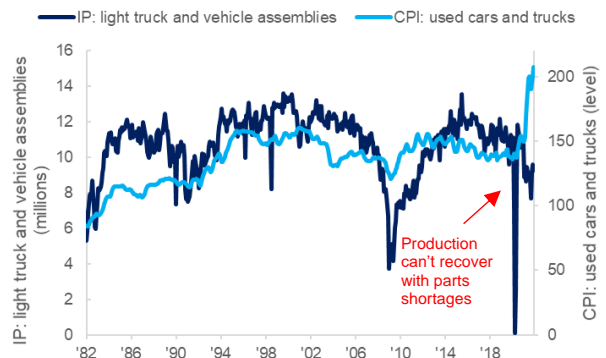
Now, in 2022, even in the face of extraordinary demand for semiconductors caused by Covid, US semiconductor component imports are surging. This increased supply should help the US autos industry, among others, begin to ramp up production. Thus, we expect that the availability of new cars will rise, ultimately correcting the largest spike in used car and truck prices in history (see figures 7-8).

Figure 7: US Semiconductor Imports from Taiwan



Source: Haver Analytics as of January 21, 2022.

Figure 8: Used Vehicle Prices vs New Vehicle Production



MORE SHIPS, MORE OIL

US ports are now showing significant progress working through the backlog of container shipments (see figure 9). And while we can contemplate new disruptions or shocks, the pace at which global oil supplies are recovering is well in excess of the 3.2% growth rate Citi expects crude oil consumption to grow in 2022-2023 (see figure 10).

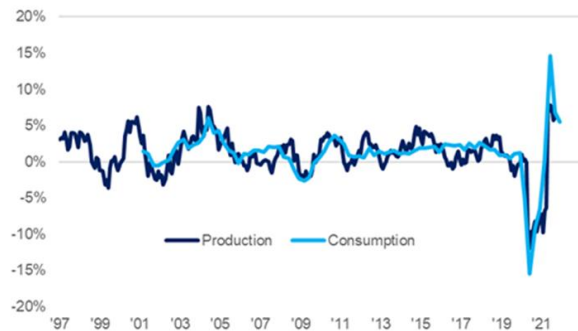
In our view, higher profits in the oil patch seem highly likely to restore higher production levels, and hence bring down the oil price over the coming year. This will tame headline inflation and improve the sense of well-being for consumers.

Figure 9: Easing Supply Bottlenecks from Asia: Container Vessels in Port of Los Angeles



Source: Haver Analytics as of January 21, 2022.

Figure 10: Global Crude Oil Consumption and Production year-on-year %



PORTFOLIO IMPLICATIONS

Both equities and bonds have fallen together in value in the new year. The combined bond and stock market selloff in the past three weeks suggests limits to the extent of further interest rate pressures generally.

EQUITIES

As we discussed in last week’s bulletin ([CIO Bulletin - Tech vs Fed](#)), the early 2022 stock market reckoning has been concentrated in equities with the highest valuations (see figure 11). With a year or more of monetary tightening ahead, we don’t expect speculative froth to return (see figure 12).

We would prefer to limit allocations in US growth equities to established, profitable firms. Our largest allocation and largest sector over-weights are global dividend growth equities and healthcare, respectively. However, “interest rate victims” in the present selloff include the strongest technological franchises in payments, fintech and cybersecurity. We see the selloffs in select equities as a buying opportunity for long-term investors.

Figure 11: Russell 3000 Returns by Valuation Band

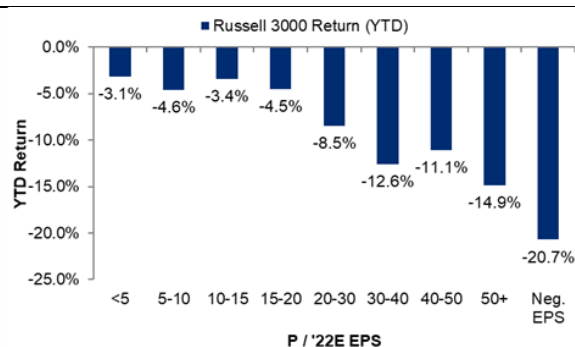
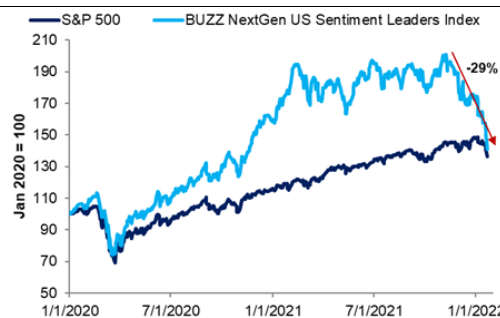


Figure 12: Shares of Firms With Strongest Backing on Social Media Posts vs S&P 500



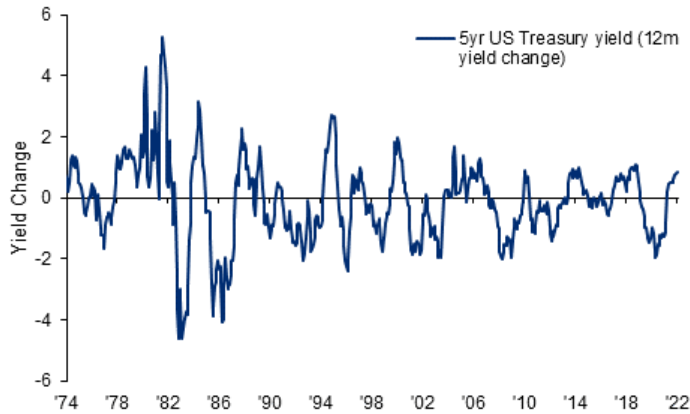
Source: Haver analytics as of January 7, 2022. Note: Figure 12 - The Buzz/NextGen US Sentiment Leaders Index dropped 29% since late 2021 to come more in line with S&P 500 index levels. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

FIXED INCOME

The Fed’s communication on future short-term policy rates - and revelation that it intends to tighten monetary policy with its balance sheet at the same time - has resulted in a true, effective tightening of monetary policy in early 2022. Notably, US Treasury five-year note yields have risen 120 basis points over the past year. That represents the *majority* of the rate rise seen in any past tightening cycle, excluding those managed by 1980s inflation-slayer Paul Volcker (see figure 13).

While far from a “good yield,” the rise in rates means that investment grade securities are becoming a more compelling low-risk asset for us in portfolio construction. This is particularly so if the Fed’s quantitative tightening actually short-circuits a more dramatic rise in policy interest rates.

Figure 13: US Treasury 5-Year Note Yield 12-Month Difference



Source: Haver Analytic as of January 22, 2022.

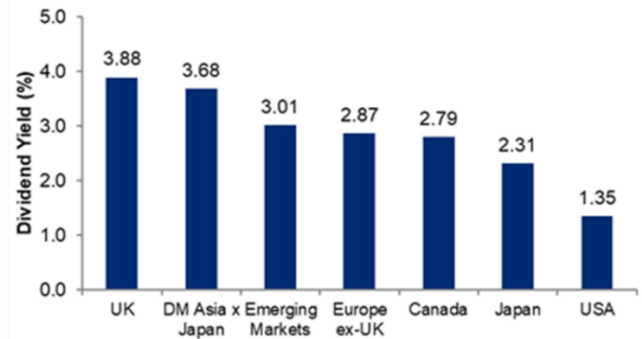
THINK GLOBALLY

Given recent market volatility, we take comfort in the fact that the valuation for *most* of the world’s individual shares look nothing like the highest fliers on the US’s Nasdaq. As Figure 14 shows, **non-US shares across all regions trade at a mere 13X expected 2022 EPS**. They also trade with premium immediate dividend yields (see Figure 15). This includes markets with notable macro-economic risks, but contrasting policies to the US, such as the European Union. There, monetary policy remains in “slowing easing mode” this year. It also includes China, where both fiscal and monetary easing are beginning to turn far more growth-friendly as policymakers start to stem an unacceptably weak growth rate (See figure 16).

Figure 14: US Growth, Value, and non-US Valuations



Figure 15: Regional Dividend yields



Source: Haver analytics as of January 7, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Figure 16: MSCI China forward PE is more than 40% below that of US even after the little outperformance in 2022 so far. We see this gap narrowing with additional policy support in China



Source: Bloomberg, as of 17 Jan 2022

CONCLUSIONS

Investors were treated to a rapid recovery from the COVID swoon in 2020. They now face the likely first equity market correction of the recovery as policymakers appropriately discontinue stimulus when the economy doesn't call for it. At the same time, we expect the Fed to confirm that risking the expansion is not in their game plan.

We are not among the chorus of bears who claim stimulus is the sole story of the bull market. While we expect lower equity returns going forward, we believe that the surge in corporate profits is and will be the key driver of markets. We see slower gains in EPS this year and next.

A sharp change in the pace of macro policy easing – both fiscal and monetary – does represent a change in the market environment. Firms with a good story - but in need of cash to merely survive - should not be an investor's priority. Meanwhile, we don't fear for the valuation of most of the world's profitable companies.

In the end, we expect that the Fed will act rationally to normalize its policies without crushing a nascent recovery. Perhaps the markets will look back at the Fed's moves in December as prescient. By announcing its intention to use both rate hikes and balance sheet reductions to tame inflation, it may already have achieved some of its objectives in spite of its limited ability to tame Covid-driven inflation.

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