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A Powell Play: Investment Implications of the Fed's Policy

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Summary

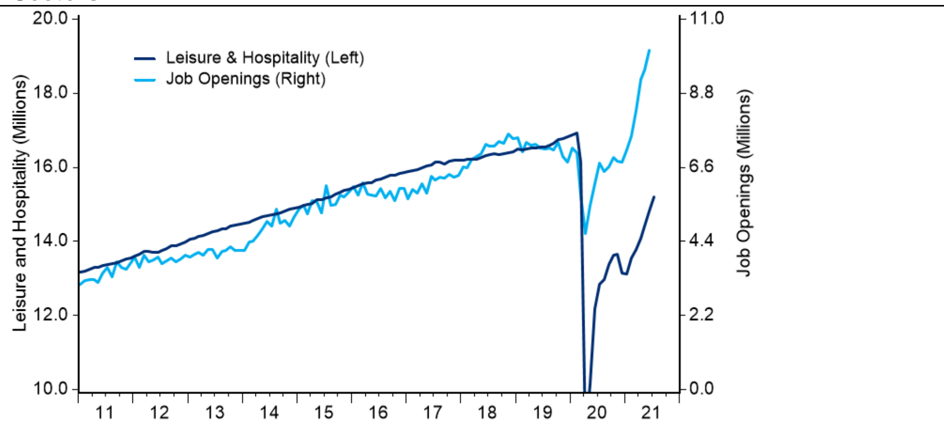
- The Fed Chair, Jerome Powell is focused on achieving "maximum" employment while downplaying long-lasting inflation risk. His speech generated an "everything rally" on Friday where nearly every financial asset did well. Deeper into a market recovery, such inclusive rallies are likely to become increasingly rare.
- Powell emphasized the Fed's overarching commitment to a deeper economic recovery. Given that the Fed is a major driver of the monetary policy underpinning broader employment and economic growth, the normalization of Fed interventions requires a gentle balancing act much like getting a patient out of the ICU. On the one hand, a rapid withdrawal of Fed support could cause asset market declines that would raise the cost of capital and weaken confidence in the recovery. On the other, too much stimulus can be inflationary and counterproductive. Slowing the Fed's financing pace to zero should take most or all of the coming 12 months.
- Looking ahead, how the markets judge any view changes (and thus policy changes) on the part of the Fed will significantly determine the relative performance of certain equity market groups. Movements in the US yield curve are consistent with outperformance and underperformance of industries with very different short- and long-run growth characteristics. We outline the sectors most impacted in this Bulletin.
- We agree Powell's arguments that COVID has generated some very large industry distortions that have caused some consumer prices to jump discretely. Nonetheless, the Fed's approach suggests some rebound in inflation-linked assets in the near-term.

What A Short, Strange Trip It's Been

A year-and-a-half after the pandemic crushed the global economy, we have experienced both the most severe economic disruption and the most rapid recovery ever. Even so, conditions in the US and the world remain unusually uneven. 4.3 million jobs in the US have been created in 2021 alone. Some sectors, like suburban housing, are in an unsustainable boom. Yet, the most impacted sectors of the economy are deeply depressed compared with the pre-COVID period. In

leisure and hospitality, employment is still 10% below 2019 levels. Even after 80% of those jobs were recovered, the present level would still be history's largest net decline for the sector (see Figure 1). Such is "economic divergence"

Figure 1: US Leisure and Hospitality Employment vs Job Openings in All Other Sectors



Source: Haver as of August 20, 2021.

Powell's Conundrum

You can only have one first priority. Drive employment and save the economy or crush inflation and save the economy? That's the essence of what Jerome Powell said at the Fed's annual Jackson Hole symposium "Macroeconomic Policy in an Uneven Economy".

Powell's choice was not an easy one. And the economic and health backdrop is unprecedented. The current economic recovery is underpinned by the Fed's easy money policy. Certain areas of employment within the uneven economy remains highly "at risk" due to COVID's unpredictable resurgence and trajectory. At the same moment, the pricing distortions across many parts of the economy are profound and worrisome. US inflation appears rampant and controlling it remains a Congressional mandate for the Fed.

Here Is What Powell Said

"If a central bank tightens policy in response to factors that turn out to be temporary, the main policy effects are likely to arrive after the need has passed. …Today, with substantial slack remaining in the labor market and the pandemic continuing, such a mistake could be particularly harmful."

He then addressed historical precedent:

"History also teaches … that central banks cannot take for granted that inflation due to transitory factors will fade…the (Fed) would certainly respond … to assure that inflation runs at levels that are consistent with our goal.

Powell's Decisive Response

"We have much ground to cover to reach maximum employment, and time will tell whether we have reached 2 percent inflation on a sustainable basis."

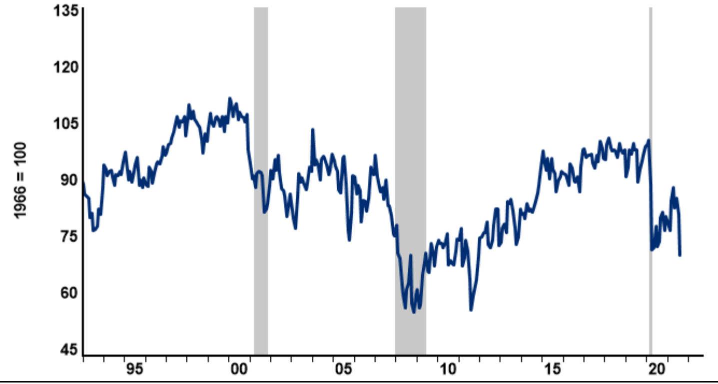
Powell's Thinking

Powell determined that the greater risk to the economy is getting everyone back to work. He was clear in his belief that the inflation in the economy was temporary and directly associated with the pandemic's impact on everything from supply chains to the shift to "work from home" for millions.

Of the US job gains in 2021, a full 47% have come from leisure and hospitality. This source of strength is very much in question as COVID vaccines will not be a panacea (see Figure 2). Americans thought the pandemic would end cleanly, which would lead to a "return to the old normal." That view was too optimistic. The prospect of continued masking and COVID booster shots sank a key measure of US consumer confidence by nearly 14% in August (see Figure 3).

Figure 2: Vaccination as a Panacea is the Latest COVID Myth to Fail

Figure 3: US Consumer Sentiment



Source: Haver Analytics as of August 20, 2021.

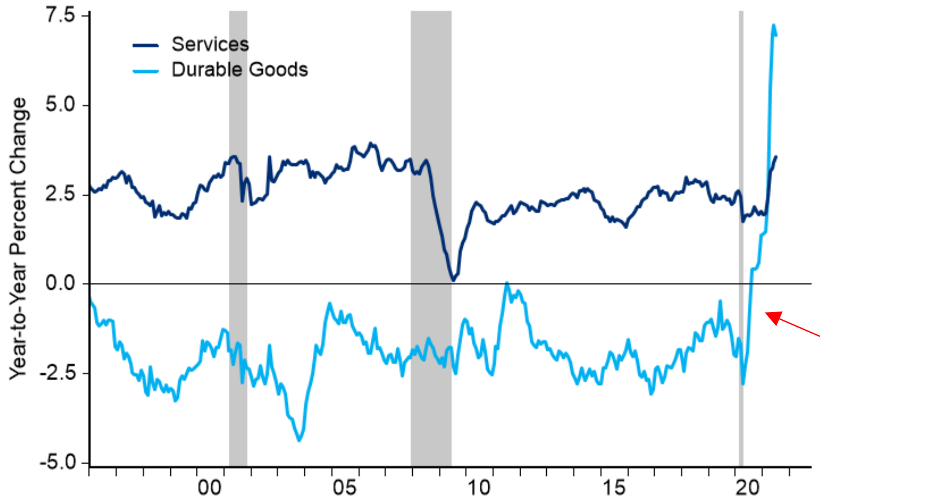
Powell also knows that growth in the US and world economy has to slow from the recent pace. The US economy grew at a 6.4% annualized rate in the first half of 2021. Most developed economies have recovered at a similar pace. And while the "runway" for future economic growth is still quite long, these are unsustainable GDP growth rates. When economies grow faster than their underlying resources, a slowdown in the *pace* of growth is merely a question of *when*, not if.

The Distortions

With a labor force that has shrunk by 3.2 million since COVID struck (and an adult population that has grown by 1.5 million) a good deal of today's labor shortages reflect a distorted economy that still has "much ground to cover" to reach maximum employment. Powell argued strenuously – and, in our view, effectively – that the current sources of inflation in the COVID-bound economy are unlikely to be persistent (see Figure 4).

For example, used cars, which are the greatest single contributor to the rise in core US inflation, are hardly an industry of the future. Prior to COVID, highly competitive markets and a permanent shift of consumer purchases to services allowed consumer durables prices to deflate for more than two decades. These conditions haven't been permanently reversed, in our view.

Figure 4: US Consumer Durable Goods Inflation vs Services Inflation: 25 Years of Deflation in Hard Goods Such as Used Autos



Source: Haver as of August 20, 2021.

The Fed's Blunt Instrument: Monetary Policy

As a backdrop for understanding the theme of this year's Jackson Hole meeting, one needs to understand the effects and limitations of monetary policy. Monetary policy cannot, with any accuracy, address industry specific problems, such as those driven by changing consumer preferences. Fiscal policy – such as targeted industry bailouts for airlines as an example – can be more directive.

In practice, most US *and* global macroeconomic policy steps have been designed to stimulate broad economic activity rather than shelter particular segments of the economy in the present crisis. Overall, the government and the Fed have provided "hyper stimulus" for some growing parts of the economy and insufficient support for narrow parts of the economy that can only fully recover when the pandemic ends.

There are pressures on Powell from outside the Fed to set policy with only the weakest sectors in mind. Similarly, there are ongoing pressures for the Fed to address particular social goals over which it has no relevant tools or authority.

The Fed pulled out all the stops to support the economy during the crisis. At present, the US central bank is easing at an unsustainable pace for the long-term by financing $120 billion in credit per month with newly-minted money (see Figure 5). This generally forces private lenders to take greater risk while expanding the absolute supply of credit to the economy at a lower interest rate level.

Reversing Fed policy – returning to normal – requires a gentle balancing act much like getting a patient out of the ICU. On the one hand, a rapid withdrawal of Fed support could cause asset market declines that would raise the cost of capital and weaken confidence in the recovery. On the other, too much stimulus can be inflationary and counterproductive. Slowing the Fed's financing pace to zero should take most or all of the coming 12 months. During most of that time COVID risks will linger for the US economy while other forms of macroeconomic policy support, like special unemployment benefits, are set to end (see Figure 6).

Figure 5: Federal Reserve Credit (Bond and Loan Assets)

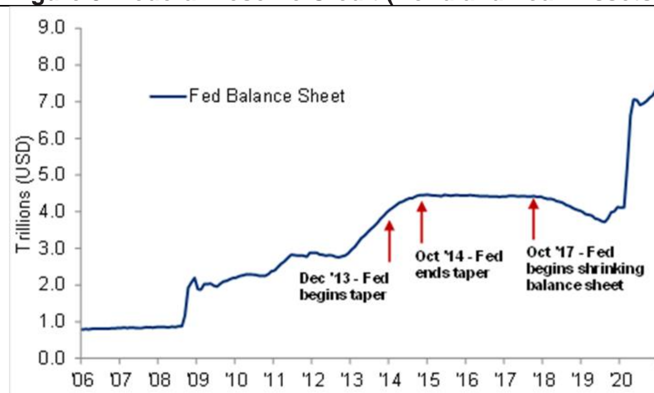
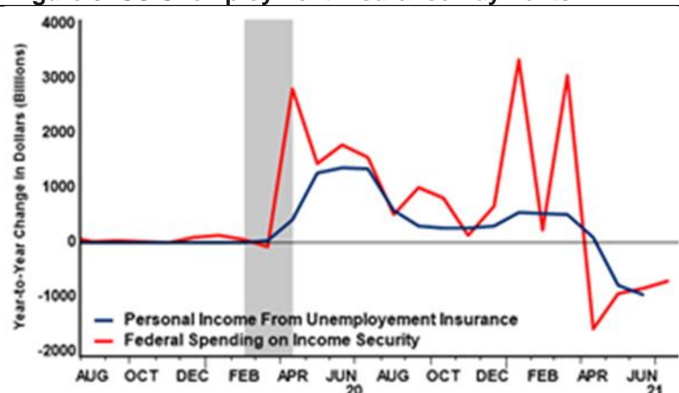


Figure 6: US Unemployment Insurance Payments



Source: Haver Analytics as of August 20, 2021.

The Impact of Powell's Decision

Powell's emphasis on "maximum" employment while minimizing long-term inflation risks should reinvigorate "inflation trades" over the near-term, in our view. These are investments geared toward unit price increases (shortages) rather than innovation and growth. For example, a commodities futures contract represents merely the price of a standard, simple product, not the volume of the product produced. Real growth, on the other hand, is generally associated with technological advances and improving living standards.

We expect that the bond market will view Powell's bias toward growth and slow withdrawal of stimulus as mildly "inflationary," with the US yield curve steepening in response. Yield curve steepening and growth accommodation are positives for most cyclical assets, including Financials. When increased demand for long-term loans raises the term structure of interest rates, banks capture a somewhat greater profit in their lending. Higher commodity prices would be a corresponding signal. And in the event that there was a "hard stop" to the delta-variant spread in the US, the Fed would certainly be viewed as overly accommodative.

In the event that Powell's "glide path" becomes viewed as "tight" - constraining economic recovery - long-term yields will fall. A flattening yield curve would be the result. In that environment, assets with highly durable "stand out" growth rates would tend to outperform.

How "The Curve" Impacts Share Prices

The table in figure 7 provides a sensitivity analysis of various global industry group share prices to movements in the US yield curve. These are ranked by recent performance and their correlation to yield curve movements over the past five years. Assuming current prices equate to the sum of discounted of future cash flows, a move higher in interest rates may reduce the present value of expected EPS several years into the future. We expect that significant gyrations in the relative performance for the most sensitive and least sensitive groups are likely to come in the months ahead as markets are swayed by their assessments of the future Fed policies.

Figure 7: Groups and Styles Share Price Performance, Correlation to Movements in the US Yield Curve

Index	Q1 '21 Performance	Implied YC Sensitivity (% of EPS after 2023)	Correlation to 3m10y	Rank	
Banks	15%	70%	0.39	1	↑ Outperform when yield curve steepens
Energy	18%	71%	0.00	2	
Diversified Financials	9%	81%	0.37	3	
Autos	5%	78%	0.16	4	
Capital Goods	9%	84%	0.15	5	
Insurance	7%	73%	0.23	6	
Materials	6%	75%	0.08	7	
Real Estate	6%	82%	-0.33	8	
Russell Value	11%	81%	0.21	9	
Global High Dividend	6%	71%	-0.10	10	
Semis	11%	86%	0.09	11	
Telecommunication Services	4%	75%	-0.07	12	
Consumer Durables & Apparel	2%	86%	0.02	13	
Div. Growers	9%	83%	0.04	14	
Media & Entertainment	7%	88%	0.02	15	
Transportation	7%	84%	0.09	16	
Consumer Services	5%	91%	-0.10	17	Outperform when yield curve flattens ↓
Food Beverage & Tobacco	0%	83%	-0.29	18	
Health Care Equip & Svcs	2%	87%	-0.07	19	
Com & Prof Services	2%	89%	-0.28	20	
Food & Staples Retailing	0%	86%	-0.01	21	
Pharma Biotech & Life Sc	0%	83%	-0.12	22	
Utilities	1%	82%	-0.36	23	
HH & Personal Prod	-2%	88%	-0.20	24	
Tech Hardware & Equipment	-2%	85%	0.04	25	
Retailing	1%	89%	-0.03	26	
Fintech	3%	89%	-0.15	27	
Software & Services	0%	91%	-0.17	28	
Russell Growth	1%	90%	-0.09	29	
Clean energy	-14%	88%	-0.07	30	

Source: Bloomberg, Factset, and Haver as of August 27, 2021. Note: Using MSCI AC World Industry Groups and the following thematic indices: S&P Global Clean Energy Index, S&P Dividend Aristocrats, MSCI World High Dividend, Factset Global Fintech Index. Implied discount rate sensitivity is calculated as the share of each index price not reflected in 2021-2023 EPS.. 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. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events

Here is just one example of performance divergences ahead. We see little room for Financials and Fintech, Energy and Alternative Energy to rally at the same time (see Figures 8-9). As Figure 7 also shows, their performance historically has been quite negatively or lowly correlated to each other.

Figure 8: US Small Cap Banks, Fintech and S&P 500

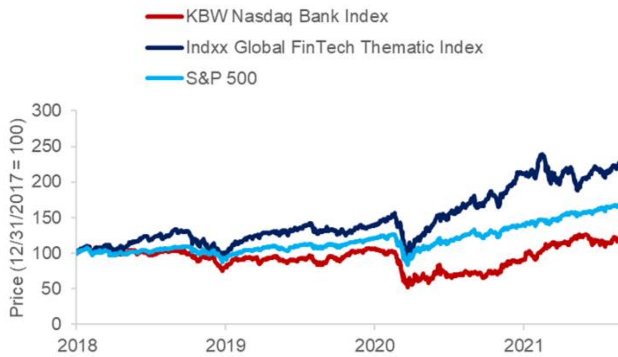
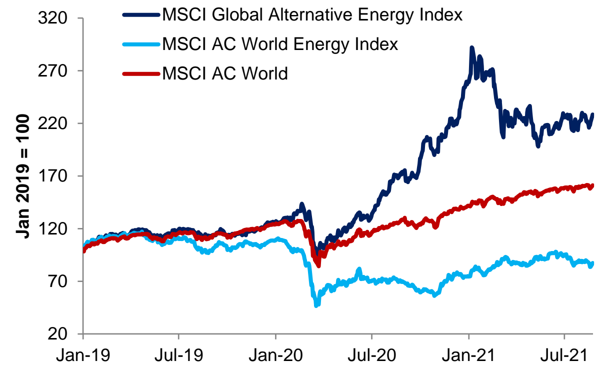


Figure 9: Global Energy Sector vs Alternative Energy and S&P 500



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Powell Play Portfolio Implications

After a doubling of US equities from the exaggerated low point of March 2020, we don't expect that every asset will be a "winner" as they were on Friday, post Powell's speech and he helped remind investors why avoiding all risk in a portfolio is a mistake.

As the 18-month recovery has transpired, we have boosted and then gradually reduced our exposure to "recovery" assets in discretionary portfolios, most recently shifting a larger share of our asset allocation to equities aligned to the drivers of long-term returns, rather than those merely "rebounding" from an economic dislocation.

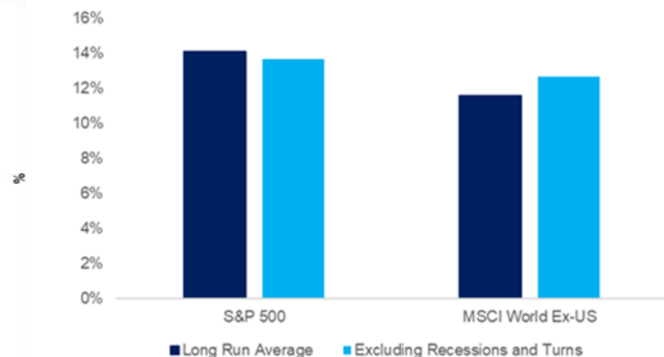
While further cyclical recovery may be ahead and cyclical "inflation trades" may be re-invigorated in coming months, the deeply depressed conditions of 1H 2020 are history, as are the initial rapid returns associated with economic recovery. Inflation will likely be somewhat higher in the decade ahead than in the one past. However, the past year's unique and COVID-driven price pressures are not representative of the future.

As Figure 7 shows, "dividend growers" show little bias toward a steeper or flatter yield curve. For many reasons, this makes them an allocation of "high quality" element of diversified core portfolios for the long run (please see our last *Quadrant* for discussion).

And staying invested is essential, even after recurring collapse and rebound periods. The data overwhelmingly suggests that sustained rewards can be potentially earned by those investing in human progress for the long run (see Figures 10-11).

Figure 10: Recessions/Recoveries Drive the Big Swings Down and Up…

Figure 11: …But "Mid-Cycle" Equity Returns Are Roughly the Same as Long-Term Returns



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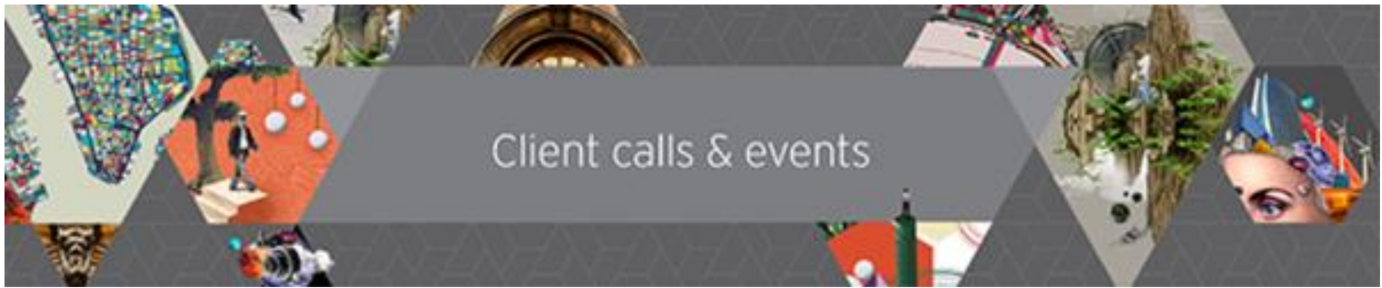
Beware Negative Real Rates

Even after a sharp recovery in the valuation of equities, the bond market remains richer than it was prior to the COVID shock. Nominal yields may gradually climb and would likely spike more notably if-and-when the COVID pandemic truly ends. This will cause mark-to-market losses of at least modest scope for long-duration bonds. Unlike the equity market – when firms earnings and revenues can be nominally inflated – today's 1.35% yield for 10-year notes remains well below the Fed's humble inflation target.

In the past decade, US cash – even without the world's lowest interest rates - lost 12% of its purchasing power. In the coming decade, we estimate a real loss of 17% even as the Fed may begin to "normalize" interest rates gradually in 2023.



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