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CIO Strategy Bulletin

Understanding the Fed: What Tightening Means for Portfolios

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Summary:

- **The Federal Reserve has changed its mind. The Fed is speeding its "exit from easing" and presenting a favorable gradual "return to normal" scenario as likely.**
- **The Fed's actions and forecasts are most consistent with a view that the pandemic and the government's discrete policy response will not engender a long-lasting rise in inflation.**
- **Monthly gains in goods spending have been diminishing ever since the last wave of stimulus in the first quarter of 2021. In our view, the pace of demand is starting to fall back in line with gains in real personal incomes with no new mass stimulus to come. With slower consumer spending coupled with growing imports and production, supply and demand imbalances will gradually close.**
- **The absence of market pressure in long-term yields in the face of the Fed's tightening campaign is notable. Powell remarked that in a low global yield environment, investors are able to take advantage of premium US yields. Combined with expected growth in corporate earnings, this is constructive for further potential gains in equity prices and negative real returns in many bonds.**
- **In the coming months, day-to-day swings in the performance of negatively correlated equity sectors may be extreme. Yet, there are possible clear winners in the environment that we see unfolding. Certain defensive sectors, like Consumer Staples, can benefit from moderating input cost and supply chain normalization. Some "Unstoppable Trends" like Fintech and Health Care can be beneficiaries. And "quality" will matter. This is good for larger firms that can drive EPS growth and dividend payouts. This environment will be tough for profitless firms with high expectations.**

EVEN WITH FED RATE HIKES, THE ECONOMIC OUTLOOK REMAINS POSITIVE…

The Federal Reserve has changed its mind. Chairman Powell communicated the Fed's "exit from easing" and presented a remarkably transparent view of their thinking. The Fed presented a gradual "return to normal" scenario and a nuanced analysis of the risks faced by the economy, especially inflation. Here are some highlights:

Policy actions, Fed Forecasts, and Powell Comments:

- FOMC members expect the US economy to grow 4.0% in 2022 and 2.2% in 2023.
- They expect inflation to fall to 2.6% in 2022 and 2.3% in 2023 (measured by the PCE deflator).
- They see the Fed funds rate at 0.9% at end of 2022, 1.6% at end of 2023 and 2.5% in the "longer run." *In other words, they still expect to raise policy interest rates at the last cycle's "gradual" pace.*
- The Fed accelerated "tapering" (the end of bond purchase to end QE) to March 2022 from June 2022. They also noted that they would have flexibility in the event economic conditions changed.
- While the Fed is wary of upside price risks, Powell continued to note that wage growth to date has not been a significant contributor to inflation. Rather, inflation has resulted from temporary stimulus and "supply barriers" that are unique to the COVID period. In short, the Fed still sees inflation decelerating without additional policies to strongly constrain demand.
- Powell noted that it may not take as long as the last cycle for the Fed to reduce its bond holdings. At some point, this could substantially speed effective tightening, though perhaps not in the year ahead.

Market reaction:

- Markets have vacillated, with investors unsure of how to position for the changing monetary policy and economic outlook. US equities rallied in relief initially. This followed apprehension over the potential for more hawkish steps. Since last Thursday, "defensive" and "value" sectors have outperformed.
- The bond market initially saw yields move little as the Fed maintained its long-term policy rate forecasts but accelerated the time-table for rate hikes by a few months. The US dollar and commodities saw little net change amid generally increased volatility.

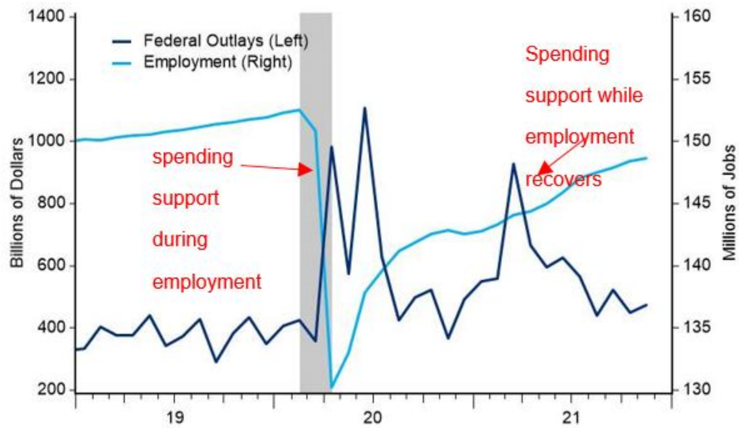
POWELL'S REMARKABLY CANDID TALK ON FED DECISION-MAKING AND DATA

After a month of apprehension, risk assets initially greeted the US Fed's hawkish direction at its December policy meeting with relief. The information and policies presented by the Fed were less dramatic than feared. The Federal Open Market Committee still sees US inflation decelerating *without* strong-handed policies to constrain demand. The preponderance of data suggests FOMC members are right. However, we expect to see a gradual acceleration of underlying inflation when supply-side distortions end. Chairman Powell acknowledged this at great length in his press conference. However, Powell is being fa*r more patient* than inflation hawks would like him to be. The debate on whether current inflation levels are transitory or becoming persistent continues.

FOR NOW, THE FED IS TIGHTENING CAREFULLY

As discussed in our Outlook for 2022, a major feature of the financial and economic environment next year will be the speed and manner by which the Fed tightens. The US, like many other Developed Economies, saw monetary and fiscal policy ease in concert in 2020. This included direct income support to most households. To do this, Fed money printing covered virtually all of the net borrowing in the US. In 2021, this process was repeated, but at a time when the economy was already recovering (see figure 1). A side effect has been a pronounced rise in inflation, led by a phenomenal "stay at home" driven shift in consumer demand for goods at the expense of services. This concentrated demand for scarce products. Inventories vanished, discounting disappeared and substitution demand brought more costly imports to US shores.

Figure 1: US Employment and Federal Spending



Source: Haver as of Dec 15, 2021. Grey areas are recessions.

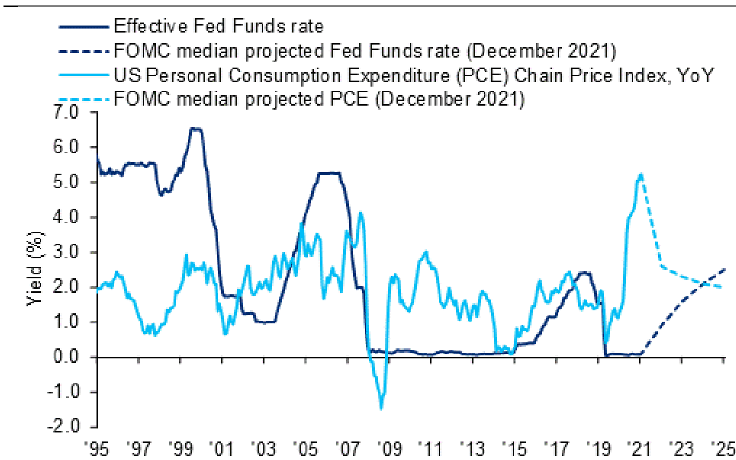
The Fed is now beginning the process of unwinding monetary stimulus as the economy continues to recover. The US Congress, while debating structural spending changes, is not going to repeat any short-term spending plans.

The critical assessment ahead is whether the inflation-generating process is going to create persistent inflation that will require a stronger and more disruptive monetary policy response. Fed Chairman Powell gave a good deal of attention to this issue.

FOMC members forecast a sub-1% policy rate by the end of 2022 with no “money financing” (QE) beyond March. This is monetary tightening, but of modest scope compared to past recoveries (see figure 2). The Fed’s own US growth forecast of 4.0% (above our own 3.5%) with slowing inflation (slightly lower than our view) is evidence that they see no great need to suppress demand sharply.

The Fed’s actions and forecasts are most consistent with a view that the pandemic and the government’s discrete policy response will not engender a long-lasting rise in inflation.

Figure 2: Federal Funds Rate Target, Inflation, Fed Projections



Source: Haver and Federal Reserve Bank, as of Dec 15, 2021. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

AN "ENGINEERED RECESSION" AND ITS INFLATIONARY AFTERMATH

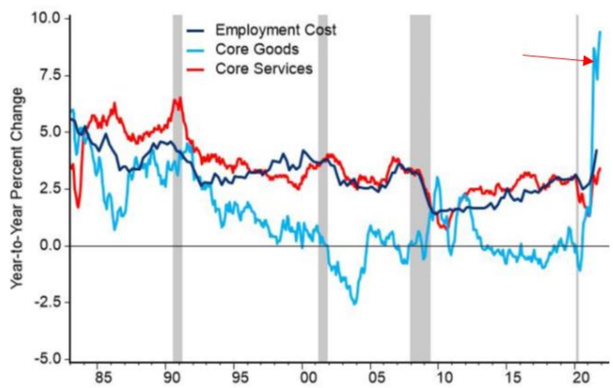
In his press conference, Powell outlined each of the data points that tipped the Fed toward more rapid action, including the US Employment Cost Index, which rose 3.7% in the year through September. The "upward tilt" in wages has accelerated in the pandemic recovery (see figure 3). Strong gains in US employment and a limited rebound in the post-pandemic labor force suggest further wage gains to come.

However, Powell noted that "wage growth has to date not been a significant contributor to inflation." Instead, a shortage of particular products drove 2021's rapid inflation as buying certain goods "at any price" prevailed.

This is consistent with our view that 2020 saw a first-of-its-kind "engineered recession." This was the result of an exogenous shock and deliberate steps to shutter the economy as opposed to typical business cycle excesses. The engineered economic collapse was reversed by massive policy actions in short order.

The nature of Inflation is more complex. Consumer prices generally rise in all periods. Yet, by not repeating the macro stimulus or production shutdowns, the drivers of consumer price spikes will abate.

Figure 3: US Employment Cost Index, Core Goods and Services Prices YoY % change



Source: Haver as of Dec 15, 2021. Grey areas are recessions.

INFLATION REMAINS A REASONABLE CONCERN FOR 2022

Nonetheless, as we discuss in Outlook, the risk of an upward trend in *long-term inflation* is a reasonable concern. This is true even if "the goods side of the economy sorts itself out" as Fed Chairman Powell put it. Thus, the Fed's patience has critics. Inflation hawks see demand persistently outstripping the economy's supply-side capacity.

Who will be proven right?

Supply bottlenecks and demand imbalances will not be erased in an instant. That's certainly true given the Omicron variant and the spike in infections being seen across the world now. Some of the distribution issues that plagued the economy this past winter were in place in 2019, even before COVID hit (please see our CIO bulletin of October 31, 2021). As figure 4 shows, order backlogs and input prices of US producers are just beginning to moderate from acute upward pressures. Yet, early in 2022, we would expect the usual seasonal collapse in holiday merchandise shipments. This should ease pressures on distribution costs (see figure 5). "Late delivery" of seasonal merchandise may, in fact, lead to sharp discounting of many non-essential products. (Get out your credit cards!)

Figure 4: US Purchasing Managers Order Backlogs and Commodity Input Prices Paid

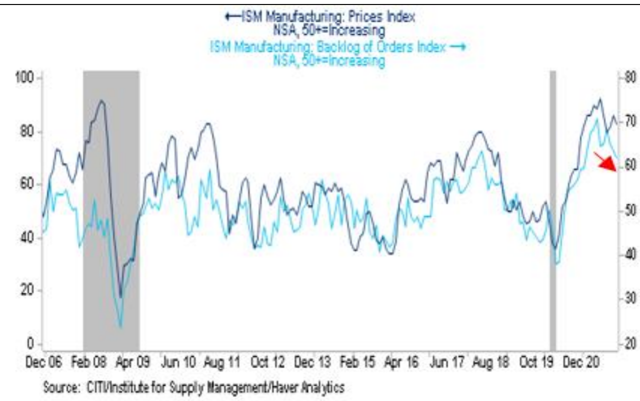
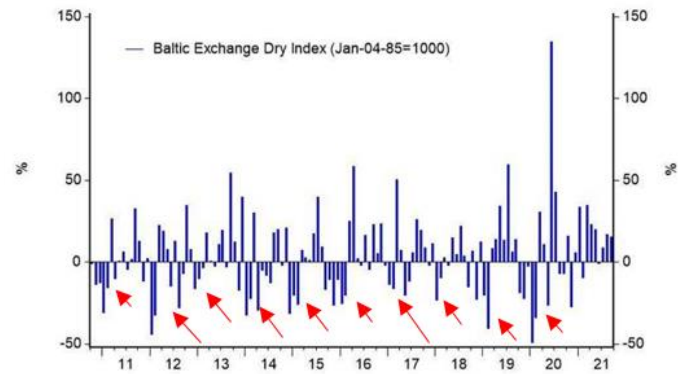


Figure 5: Freight Costs for Overseas Shipping of Dry Goods MoM % Change: Prices Routinely Drop in 1Q Periods



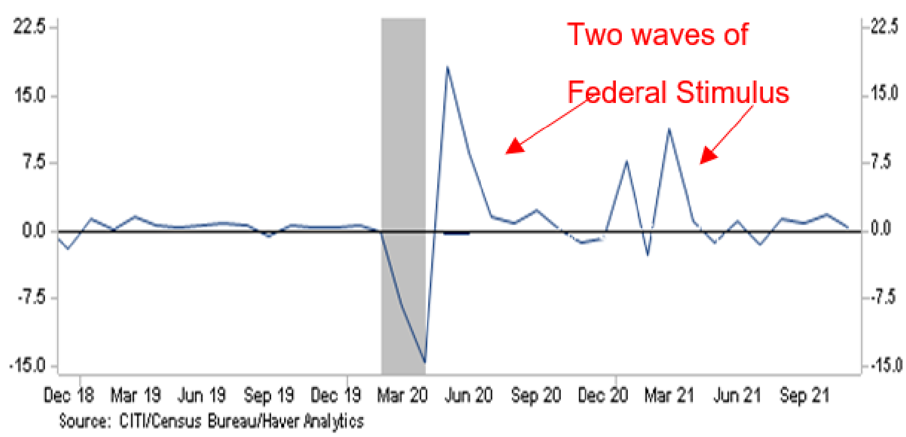
Source: Haver analytics as of December 10, 2021. Grey areas are recessions.

FOLLOW DEMAND, NOT JUST SUPPLY

Cost issues do not inform us about demand. However, the path of US retail sales is telling. Consumer goods spending has been torrid over the past year, up 6.6% in real (unit) terms, and up 15.3% in inflated dollars. The gap between the two measures shows that spending would have been *even stronger* if not for goods shortages. Yet, the monthly gains in goods spending have been diminishing ever since the last wave of stimulus in the first quarter of 2021. In our view, the demand pace is starting to fall back in line with gains in real personal incomes with no new mass stimulus to come. This is before the Fed's recent actions. (see figure 6).

The COVID disruptions to the economy are likely to be extended by Omicron, but with less impact. With each new COVID wave, the impact on personal mobility has diminished (see figure 7). Omicron will likely have some temporary global production and trade impacts. With slower consumer spending coupled with growing imports and production, supply and demand divergences will still gradually close (see figure 8). For a full discussion see our latest [Data Watch publication].

Figure 6: US Retail Sales MoM % Change



Source: Haver as of Dec 15, 2021. Grey areas are recessions.

Figure 7: Global Mobility and COVID Infection Rate

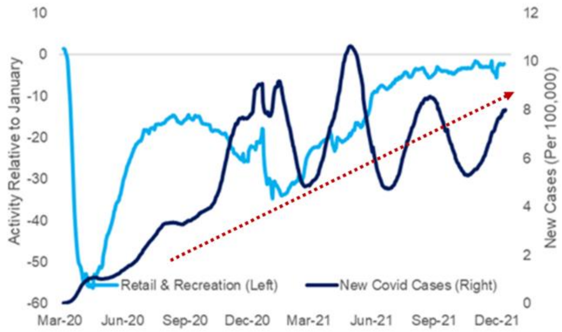
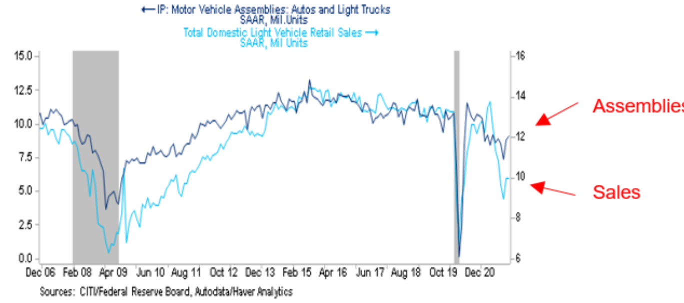


Figure 8: US Light Vehicle Production and Sales



Source: Haver analytics as of December 15, 2021. Grey areas are recessions.

EXPECT MORE FED RESTRAINT OVER TIME

With sufficient evidence that the economy's potential - its "effective" maximum, non-inflationary employment level - is not back to its "healthy" state, Powell said the Fed could take a "methodical approach" to tapering bond purchases. He also said that the Fed could also hold off on rate hikes until the Fed's QE program was complete.

Powell also gave hints of a much less liberal monetary policy setting at some point in the future. In particular, Powell noted that the Fed may take a different approach with regard to the Fed's bond holdings.

In the last cycle, slow growth and sub-par inflation left the Fed with a (subjectively) swollen balance sheet nearly nine years into the expansion. Powell noted that this cycle may argue for a different balance sheet approach.

We see Fed balance sheet reductions – either via the maturation of bonds or sale of holdings – as a substitute way to raise rates. Private capital is needed to replace the Fed and the price of that capital is likely to be higher absent the Fed's own money printing. This poses potential risks for markets.

During 2018, the Fed seemed to take a cavalier approach to Quantitative Tightening (QT), continuing rate hikes and bond reductions at the same time without any historical precedent to measure the dual impact. This eventually drove a 20% reduction in US and global equities. Had the Fed not changed course, this threatened the economic expansion at that time. Notably, however, this came after 9 rate hikes (see figure 9).

WITH THE RIGHT POLICIES, GOOD EQUITY RETURNS ARE POSSIBLE

US equities posted an 11% annualized return across the Fed's tightening cycle of 2014-2018, *inclusive* of the 20% drop at the end of the tightening period, including QT. We are not as optimistic about the level of US equity returns for this current cycle but remain positive due to the likely rise in corporate earnings ahead. Heading into 2022, EPS prospects argue for moderate equity market gains. We also believe the level of pressure the Fed will exert on non-US assets will be less than during the 2014-2016 period. (Please see our November Quadrant for a full discussion).

Figure 9: S&P 500 vs Change in the Fed's Bond Purchases

Figure 10: S&P 500 vs S&P 500 EPS Y/Y% and our Forecast

Source: Haver analytics and Factset of December 10, 2021. Note: Circled area is last period of Fed monetary policy tightening. 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. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

The absence of market pressure in long-term yields in the face of the Fed's tightening campaign is notable. Powell remarked that a low global yield environment – with investors able to take advantage of premium US yields – was one reason for this, and we agree (see figure 11). The massive rise in "excess liquidity" driven by QE is another plausible explanation (see figure 12).

Figure 11: US 10-Year Treasury Note Yield and Other G7

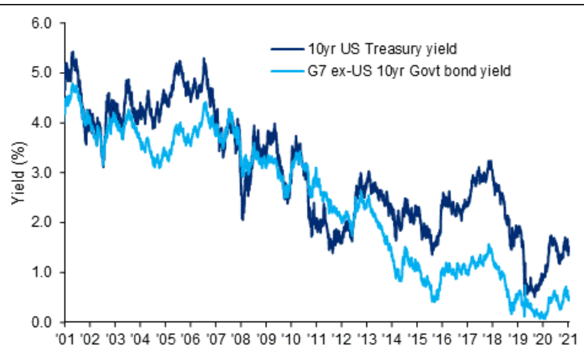


Figure 12: US Bank Holdings of US Treasuries

Source: Haver analytics and Factset of December 10, 2021. Past performance is no guarantee of future results. Real results may vary.

INFLATION IS THE ENEMY OF GROWTH

Markets appear to believe that high inflation is incompatible with expansion. Thus, if inflation does not stabilize at a lower level, the US recovery may terminate early. However, an improvement in supply and a normalization in demand would extend the expansion's longevity. Therefore, lower inflation would be compatible with rising real and nominal long-term yields and a "re-steepening" of the yield curve.

We believe the supply side of the world economy has the potential to recover in 2022. Our expected path to slightly higher nominal and real rates is one of higher confidence in the *longevity* of the expansion. This requires supply and demand to grow at more similar rates in the next two years.

THE LIKELY MARKET ENVIRONMENT

We believe the period of "peak cyclical acceleration" is over. As figure 13 shows, US manufacturing new orders have crested at growth rate that was above 94% of all months since World War II. In the absence of a new recession, the average one-year returns for the S&P 500 following such a peak have been 10.8% (for full discussion see our September Quadrant). During similar periods, defensive industries such as Healthcare and Staples have routinely outperformed cyclicals such as Industrials and Materials.

Though we are wary of highlighting short-term performance, Staples have outperformed the S&P 500 during the recent period when the Fed has hinted at a more definitive tightening cycle (see figure 14). Staples providers have been the most significantly impacted firms by rising commodity input costs, with returns more than 1100 basis points weaker than the S&P 500 in the past 12 months. The recent outperformance of Staples suggests markets sense the end of the input price surge and perhaps the end of the inflation acceleration more broadly.

Figure 13: New Orders vs Industrials/Staples

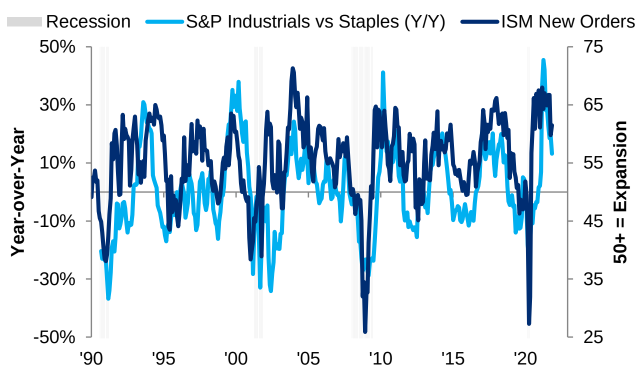
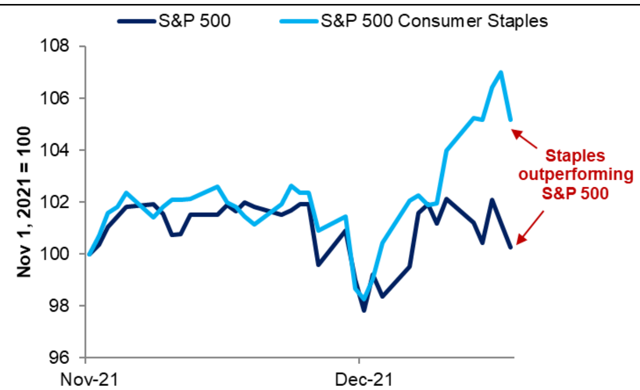


Figure 14: S&P 500 vs S&P 500 Staples (Nov/21 – now)



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EQUITY STRATEGIES FOR THIS ENVIRONMENT

As investors battle with each other over whether the Fed is behind or ahead of the curve in fighting inflation, we expect inconsistent performance in equity themes. Day-to-day swings in the performance of negatively correlated sectors can be extreme. "Secular growth" assets or cyclical "inflation trades" may dominate performance from day to day as we described in our August issue of Quadrant and figure 15). This vacillation may mislead investors into thinking that either trade is the beginning of a run of long-term performance.

However, for 2022 as a whole, we believe that defensive sectors have the potential to outperform. Many of these are noted below. What is quite interesting for investors is that both some "Unstoppable Trends", like Fintech and Health Care are potential beneficiaries, in concert with improvements in defensive shares, like Staples.

Figure 15: Recent Industry Group Correlation to Movements in US Yield Curve

Index	Q1 '21 Performance	Implied YC Sensitivity (% of EPS after 2023)	Correlation to 3m 10y	Rank	
Banks	15%	70%	0.39	1	Potentially outperform when yield curve steepens
Diversified Financials	9%	81%	0.37	2	
Insurance	7%	73%	0.23	3	
Russell Value	11%	81%	0.21	4	
Energy	18%	71%	0.00	5	
Materials	6%	75%	0.08	6	
Capital Goods	9%	84%	0.15	7	
Autos	5%	78%	0.16	8	
Semis	11%	86%	0.09	9	
Transportation	7%	84%	0.09	10	
Global High Dividend	6%	71%	-0.10	11	
Div. Growers	9%	80%	0.04	12	
Telecom Services	4%	75%	-0.07	13	
Media & Entertainment	7%	88%	0.02	14	
Real Estate	6%	82%	-0.33	15	
Consumer Durables & Apparel	2%	86%	0.02	16	
Tech Hardware & Equipment	-2%	85%	0.04	17	
Health Care Equip & Svcs	2%	87%	-0.07	18	
Food & Staples Retailing	0%	86%	-0.01	19	Potentially outperform when yield curve flattens
Pharma Biotech & Life Sc	0%	83%	-0.12	20	
Utilities	1%	82%	-0.36	21	
Consumer Services	5%	91%	-0.10	22	
Retailing	1%	89%	-0.03	23	
Fintech	3%	89%	-0.15	24	
Food Beverage & Tobacco	0%	83%	-0.29	25	
Russell Growth	1%	90%	-0.09	26	
Clean energy	-14%	88%	-0.07	27	
Com & Prof Services	2%	89%	-0.28	28	
HH & Personal Prod	-2%	88%	-0.20	29	
Software & Services	0%	91%	-0.17	30	

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SUITABLE PORTFOLIOS TO WEATHER THIS TRANSITION

The onset of the next phase of the economic cycle – a period of expansion that needs to weather monetary tightening – suggests a shift to quality, income generating assets. While we are fully aware of the value of future growth and innovation, an environment of "scarce financing" will mean success will come less easy for speculative ventures. We believe this is driving the current market dynamic, where dividend growth shares are outperforming, and profitless firms are falling (see figures 16-17).

As we discuss in Outlook, our portfolio asset allocation has shifted to a more defensive posture without retreating into the "fear trade" of owning negative real-yield bonds or cash. We want to retain exposure to long-term growth assets that are changing the world economy, tactically over-weighting "defensive growth and income" assets we find in dividend growth shares across the globe.

Figure 16: Performance by Valuation Category for Russell 3000 Since Fed Chair Powell's Renomination

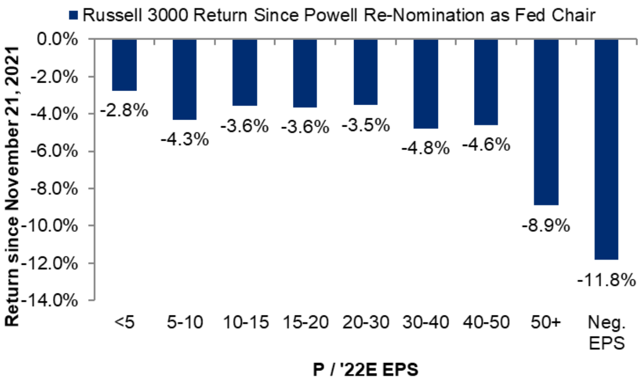
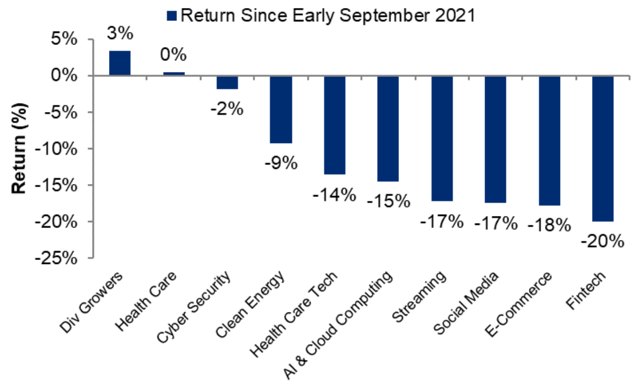


Figure 17: Thematic Performance Since September



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