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CIO Strategy Bulletin

The Market Loses the Fed's Tailwinds

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Summary

- **Every time the Fed meets, announcements are made about how it views the condition of the US economy and its upcoming challenges.**
- **Fed members have long believed that the extraordinary "easy money" policies that bolstered markets and supported the economy through the Covid-19 pandemic would end and that short-term interest rates would rise in 2022. However, last month, they discussed reducing the Fed's balance sheet in addition to rate hikes.**
- **We see an inherent contradiction in the Fed's dual policy views and choices. Using bond runoffs as a source of economic and inflation restraint would presumably limit the absolute number of rate hikes needed, thus resulting in reductions in yields across the curve. Yet, the Fed would also raise rates at the same time.**
- **Using multiple policy tools to tighten for just the second time in history adds to macro policy uncertainty and takes some unneeded risks with the nascent recovery. Compared to its recent caution and concern for the growth outlook, the Fed now appears overconfident.**
- **Our focus, therefore, must remain on the economy itself and corporate profits, in particular. Profits in the last decade meant positive returns even when the Fed did not provide support. We think the same will be true going forward. However, the overall profit gains of 2022-2023 will be significantly slower than 2021.**
- **The current market environment has led to significant underperformance of the least profitable and most speculative companies, some of which may never deliver on the market's high hopes for their future earnings.**
- **Areas like payments – a subsegment of fintech – as well as certain firms within our clean energy and cyber security themes have fallen to much more reasonable valuations on a growth-adjusted basis.**
- **Investors will face short-term risks while the Fed calibrates its policies for the benefit of the economy at large. That said, we do not fear that the US central bank has already undermined the recovery. Economic progress and positive returns have historically coexisted well into tightening cycles.**
- **Herein, we present our considerations for portfolios at this turning point in Fed policy.**

PRELUDE: WHEN THE FED MEETS, MARKETS LISTEN

Every time the Fed meets, announcements are made about how it views the condition of the US economy and its upcoming challenges. The Fed sometimes adjusts its policies to address specific issues or signals to markets when future changes to policies may occur, depending upon how market conditions unfold. In times of crisis, like this pandemic, the Fed's announcements take on much greater importance. In fact, at this very moment, the Fed is THE paramount barometer of the economy's future as it faces unprecedented challenges. The Fed is the rudder for the economy, delivering the support it needs for market liquidity and credit availability, ensuring the proper functioning of financial markets and prioritizing which risks require the most attention.

Three weeks after each Fed meeting, its meeting minutes are issued. These minutes are made public so that interested parties can understand the thinking of the Fed's staff, meeting participants and voting members. The minutes are where analysts focus their attention, to see how the "tea leaves" are changing, where the views of its members are coalescing or diverging. It was in these minutes that the "big news" hit this past week.

THE BOND MARKET MAY SOON BE NEEDING Your MONEY

The Fed members now believe that the extraordinary "easy money" policies that bolstered markets and supported the economy through the Covid-19 pandemic are no longer necessary. The threat of sustained inflation, as the US jobs market nears what it views as "maximum" employment, has taken center stage. While always cryptic, the minutes suggested that almost all of the Fed's members believe that it should both raise rates AND initiate a reduction in the bond holdings it built up during the pandemic. Just a month earlier as reflected in the minutes of the November 3rd meeting, the members took more of a "wait and see" approach to these same issues, but now the tone had shifted toward a "ready to act" stance.

The rapid shift in tone and the rapid-fire timing of likely future Fed actions was unusual.

READY, SET…. UNDO?

While the Fed's policymaking committee kept its benchmark interest rate near zero, they expect up to three quarter-percentage point increases during 2022, two more hikes in 2023 and two more in 2024. The fed funds futures market pricing indicates about a 2-to-1 chance that the first hike will come in March, three months earlier than previously expected. The good news in all this is that the Fed believes the US economy in 2022 is strong and resilient. The bad news is that they think inflation may pose a greater risk to the long-term health of the economy than the pandemic.

Fed Chairman Powell set off a "gut check" in financial markets on December 15th of last year. At that time, he noted that the economic and inflation outlook for 2022 was quite different from the past cycle. He therefore argued that the process of "normalizing" the Fed's balance sheet might take place at a faster pace than the "long delay" of the previous cycle.

Their idea to "get the balance sheet down" (what is called "quantitative tightening") is intended to wean the economy off its reliance on the Fed for the creation of credit. When the Fed buys bonds, it eliminates the need for private market participants (savers) to do so, allowing capital to flow into new credit issuance by others (bond issues or loans).

Financial markets in the first week of 2022 faced a rerun of Powell's December message. Yet, just as the Fed was warning markets that may shrink its bond portfolio, it was *adding* to its holdings. By the end of the first quarter 2022, the Fed's bond holdings will be about $100 billion larger than they are now ($8.3 trillion).

What unsettled markets – and unsettles us – is the use of two Fed tools at once and the possibility that this could create unintended, negative consequences. The Fed's policy rates will go up, and the central bank will not only stop "buying bonds," but will actually allow bonds to mature without reinvestment or even sell bonds, reducing its holdings (the credit it provides) outright.

THE MARKETS LOSE THEIR TAILWIND

The unwinding of the Fed's macro stimulus has both *less conventional and less predictable* elements. As we discussed in our bulletin of December 19, the US Federal Reserve believes it can achieve a slowing of inflation to 2.6% this year while real GDP grows 4.0%. It expects this positive growth and inflation combination while its key policy rate moves up by just 0.75 percentage point over the course of the year[1]. What the Fed did not reveal in its indicators is the future expected size of its bond portfolio – the credit the Fed provides to borrowers.

Increases in rates and a reduction in bond holdings – at some uncertain pace and future date – creates dual restraints that may magnify one another. We worry that the Fed may begin such a "quantitative tightening" policy beginning sometime this year. Though it may act very gradually, a reduction in the central bank's bond holdings forces others to lend with scarce rather than limitless resources. This reduces the capacity for debt financing in the economy (see figure 1). Raising short-term interest rates at the same time would provide a building hurdle for economic growth.

Figure 1: Fed bond holdings of US Treasuries and mortgage related securities vs total US corporate debt outstanding

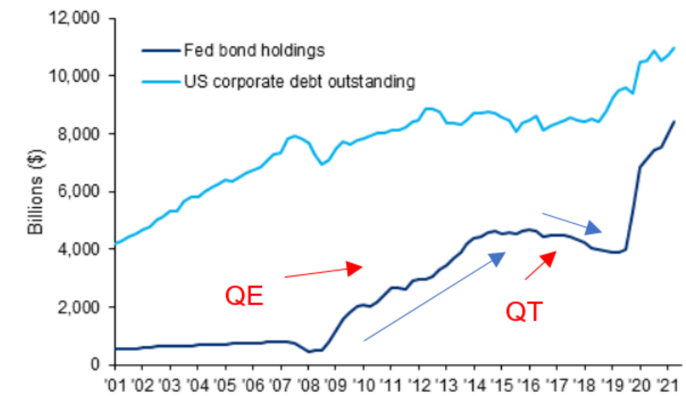
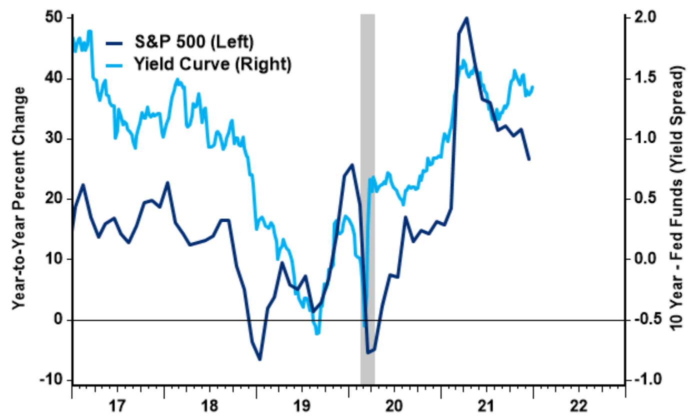


Figure 2: US Treasury Yield Curve (10-year Less Fed funds Rate) Vs S&P 500 Year-to-Year Percent Change



Source: Haver analytics as of January 7, 2022. Note: Shaded region is recession. 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.

2017 AND 2018 REDUX?

In the present situation, the Fed's own growth and inflation forecasts for 2022 and beyond suggest they see no need to "clobber" the US economy with tighter monetary policy to achieve their policy goals. Yet, "many" participants judged that the appropriate pace of balance sheet runoff could be "faster than it was during the previous normalization episode." Therefore, we remain concerned that the Fed does not see the powerful effect it can exert on financial markets with asset purchases and redemptions.

2018 provides an example of what can happen when the Fed errs.

[1] It revealed this in its December 15th, 2021 Summary of Economic Projections (SEP), which includes the forecasts of all Federal Open Market Committee participants from Fed Governors to regional Presidents. This "Fed consensus" is different from Board of Governors staff economic projections.

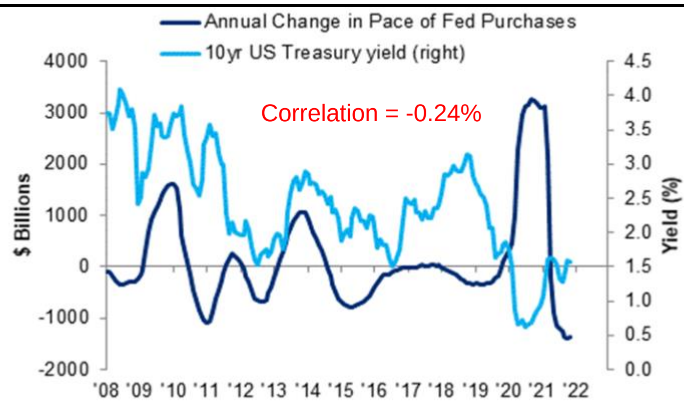
In 2017, then Fed Chair Janet Yellen said the slow reduction of the Fed's bond portfolio would be like "watching paint dry." Continuing the policy into 2018, current Fed Chair Jay Powell described a process of combined rate hikes with balance sheet reductions as on "autopilot."
However, it was not so tranquil for financial markets as the US yield curve inverted under the weight of nine rate hikes and a $600 billion reduction in Fed lending. US equities fell as much as 20% in 4Q 2018 as markets anticipated a policy-induced recession before the Fed reversed course (see figure 2). A recession was avoided and share prices rebounded, but not without a significant short-term market decline.

WE SAY, "BEWARE UNCONVENTIONAL POLICY"

The yield on US Treasuries is a reflection of the overall stance of monetary policy on financial conditions. In fact, the Fed's purchases have had little influence on bond yields (see figure 3). In periods in which Fed bond purchases have succeeded in improving growth expectations, yields have risen rather than fallen.

In the Fed's minutes and statements describing its long-run policy goals, the Fed hopes to return to policies of using adjustments in short-term interest rates as its primary policy tool. In our view, if the Fed indeed wants to return to conventional monetary policy, it should avoid the extra uncertainty created with overlapping restraint. Using bond runoffs as a source of economic and inflation restraint would presumably limit the absolute number of rate hikes needed, thus resulting in reductions in yields across the curve. This is where we see an inherent contradiction in the Fed's dual policy views and choices. To move away from the era of QE and QT, it would be best to stop using QE and QT.

Figure 3: US 10-Year Treasury Yield vs 12-Month Change in Fed Bond Purchases



Source: Haver analytics as of January 7, 2022.

SILVER LININGS AND STRATEGY

Fortunately, as the Fed noted, the economic outlook is indeed stronger than in the early, fragile years of the last recovery. US dollar holders and most investors would not be well served if the Fed were to ignore its responsibility to stabilize US inflation at low levels. While we noted that the Fed has the power to crush growth and bond yields if its mis-calibrates, the US growth outlook has been strong enough in early 2022 that the yield curve has steepened even as the Fed appears poised for a more hawkish turn in fighting inflation (see figures 4-5).

Equity markets have taken a blow from greater Fed policy uncertainty in the first week of 2022. However, we continue to believe the economic expansion has the endurance to outlast both the pandemic and a threatening rise in inflation. The latest news on leading indicators of inflation points in the direction of subsiding cost pressures. This provides incentives for policymakers to move patiently and deliberately (see figures 6-7).

Figure 4: US Real GDP and Employment Level

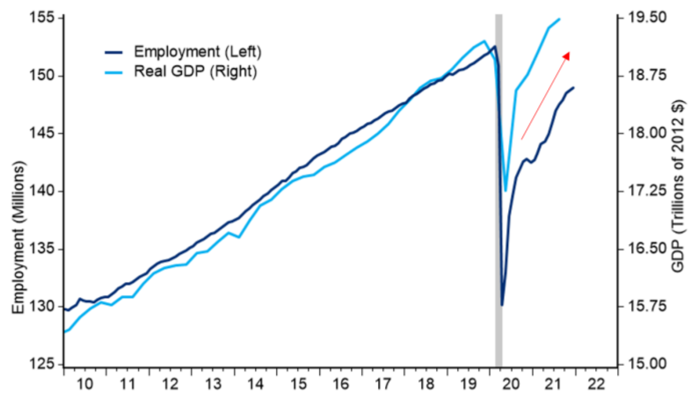
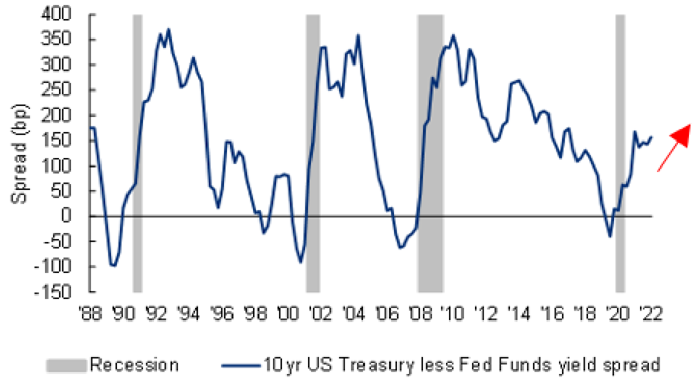


Figure 5: US Treasury Yield Curve (Daily)



Source: Haver analytics as of January 7, 2022. Note: Shaded regions are recessions.

Figure 6: Dry Goods Global Shipping Rates

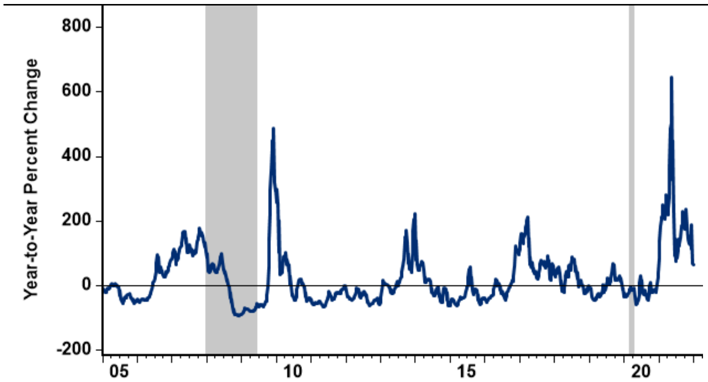
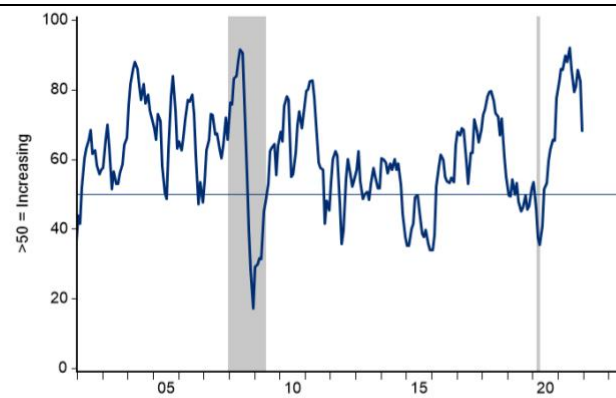


Figure 7: US ISM Manufacturing Input Prices Paid



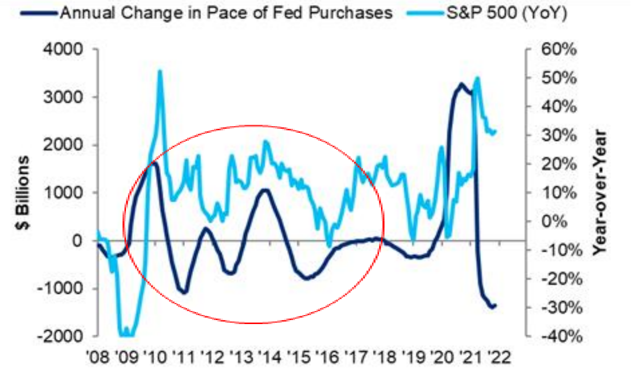
Source: Haver analytics as of January 7, 2022. Note: Shaded regions are recessions.

IN THE END, THE REAL ECONOMY MATTERS MOST

The real economy is far from a “bit player” in generating income, output, and financial returns (see figures 8 and 9). Throughout the period of unconventional US monetary policy during the past 12 years, share prices moved more closely in line with anticipated corporate profits than Fed policy actions. Ultimately, equity returns over annual periods were in line with the profits subsequently delivered by firms (we expect EPS gains in the high single digits in 2022-2023, much slower than 2021). Changes in bond purchases by the Fed can influence the economy and help explain returns, but rising profits in the last decade meant positive returns even when the Fed did not provide support.

Figure 8: S&P 500 vs EPS (including CGWI Forecast for 2022 EPS)

Figure 9: S&P 500 Y/Y% change vs annual change in Fed bond purchases



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PORTFOLIO CONSIDERATIONS AMIDST THIS POLICY UNCERTAINTY

We reiterate our strategy of favoring higher quality, larger and more profitable firms in equity holdings, preferably in less cyclical industries (please see figure 10 and our Outlook 2022 for discussion.) Our single-largest equity allocation is the healthcare sector, with traditionally "defensive growth" characteristics. In addition, we've aligned 10% of total medium-risk portfolios (including both equities or bonds) to consistent dividend growers. These are firms that are *currently* and sufficiently profitable to seek to return greater cash to shareholders in the form of a *growing* yield. Taken together, these equity holdings are less volatile than broader markets during corrections.

In addition to bond yield pressures and yield curve steepening, the strongest trend seen in financial markets in the young 2022 has *not* been weakness in firms most aligned to economic expansion, but rather in those with the highest valuations with their prospects tied mostly to promises of the future (see figure 11-13).

As these shares drop in price, we see future opportunities building amid the carnage. As we outlined in Outlook 2022, we believe certain "unstoppable trends" are likely to experience growth at a much faster rate than the global economy in the coming decade. Firms with exposure to trends like fintech, cyber security, clean energy, and health care technology should enjoy strong and sustainable profits growth as these trends play out. These fundamental growth drivers will actually lead valuations to fall "organically" over the coming years as many of these companies mature and grow profits. We therefore believe core portfolios with a long time horizon should establish and maintain allocations to these trends, adding to positions when markets overreact.

We do not believe, however, that all growth stocks face the same recovery prospects. The current market environment, characterized by a less accommodative Fed and an apparent end to ever-easy monetary support, has led to significant underperformance of the least profitable and most speculative companies, some of which may never deliver on the market's high hopes for their future earnings. Choosing where and when to buy the dip in growth requires an analysis of current valuations relative to expected growth (see figure 14). Areas like payments – a subsegment of fintech – as well as certain firms within our clean energy and cyber security themes have fallen to much more reasonable valuations on a growth-adjusted basis. Certain post-pandemic winners in the electric vehicle, "web 3.0", and small cap biotech space could face bleaker near-term prospects.

To the extent that rates continue to rise from here, it is difficult to "call the bottom" in growth at this point, and we advise against market timing in any event. For clients interested in building positions in our preferred themes, we see an opportunity to exploit elevated volatility in these unstoppable trends, a strategy which can boost portfolio income while enabling investors to accumulate positions if volatility persists in the short-run (see figure 15).

Figure 10: US Small Cap Shares vs Large Consumer Staples

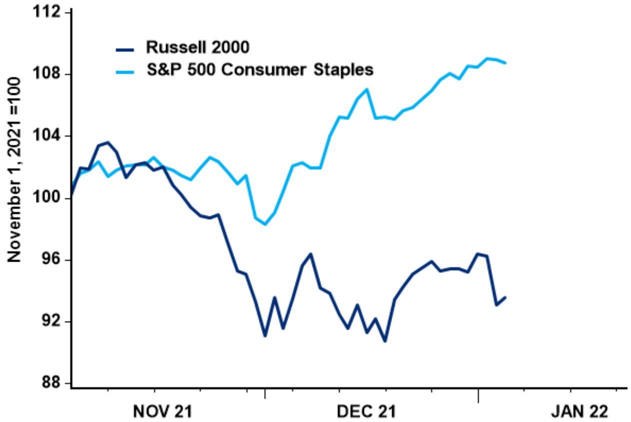

Figure 11: US Equity Performance 2022 by Valuation Group

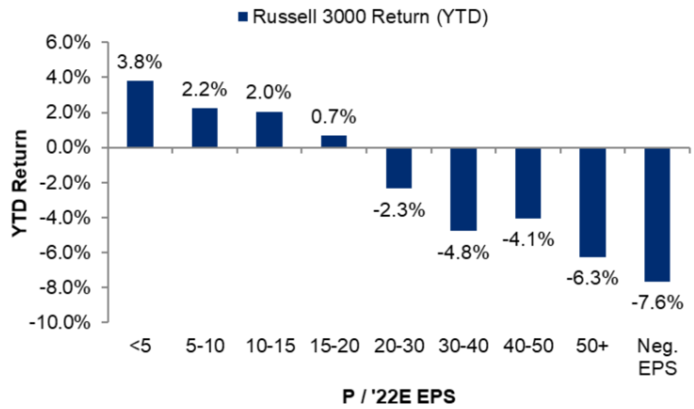

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Figure 12: NYSE Composite Index and Breadth of Advancers vs Decliners

Figure 13: Nasdaq Composite Index and Breadth of Advancers vs Decliners

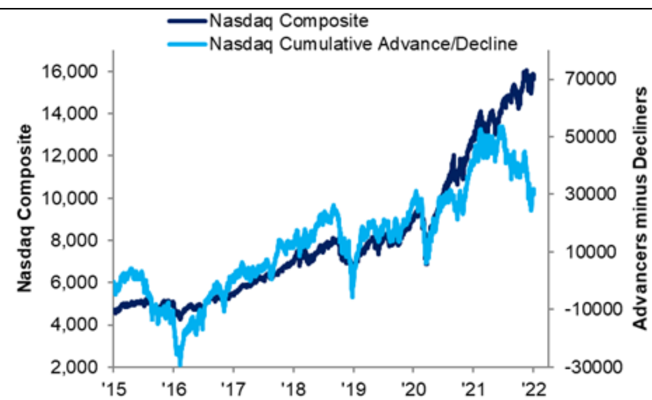

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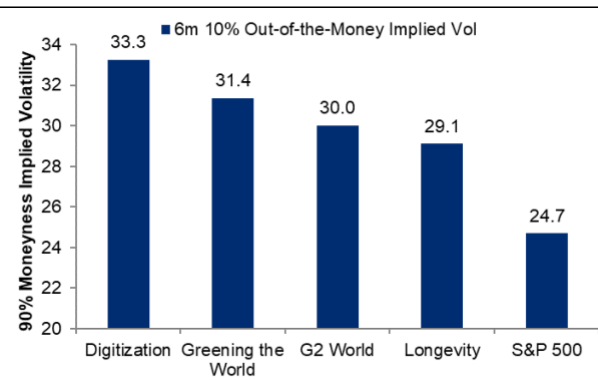
Figure 14: Secular growth valuations relative to expected growth

Theme	Fwd P/E	Fwd P/S	5 Yr Avg EPS Growth (%)	PEG Ratio
Payments	24.1	3.8	25%	0.97
Clean Energy	22.7	2.3	18%	1.28
Fintech	31.5	5.9	21%	1.48
E-Commerce	28.9	1.6	23%	1.26
Cyber Security	35.0	3.9	16%	2.23
Metaverse	36.5	5.9	14%	2.53
AI & Cloud Computing	54.1	6.4	20%	2.75
Social Media	34.7	4.1	8%	4.31
Health Care Tech	210.3	4.8	15%	13.61

Figure 15: Exploiting volatility on unstoppable trends



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CONCLUSION

Even after Chairman Powell's December remarks, it has surprised us that the Fed seems willing to experiment with unconventional and overlapping monetary actions to "normalize" policy in an "abnormal" economic environment, particularly so soon. Doing so creates additional monetary policy uncertainty even by the Fed's own admission.

Investors will face short-term risks while the Fed calibrates its policies for the benefit of the economy at large. That said, we do not fear that the US central bank has already undermined the recovery. Economic progress and positive returns have historically coexisted well into tightening cycles.

DISCLOSURES