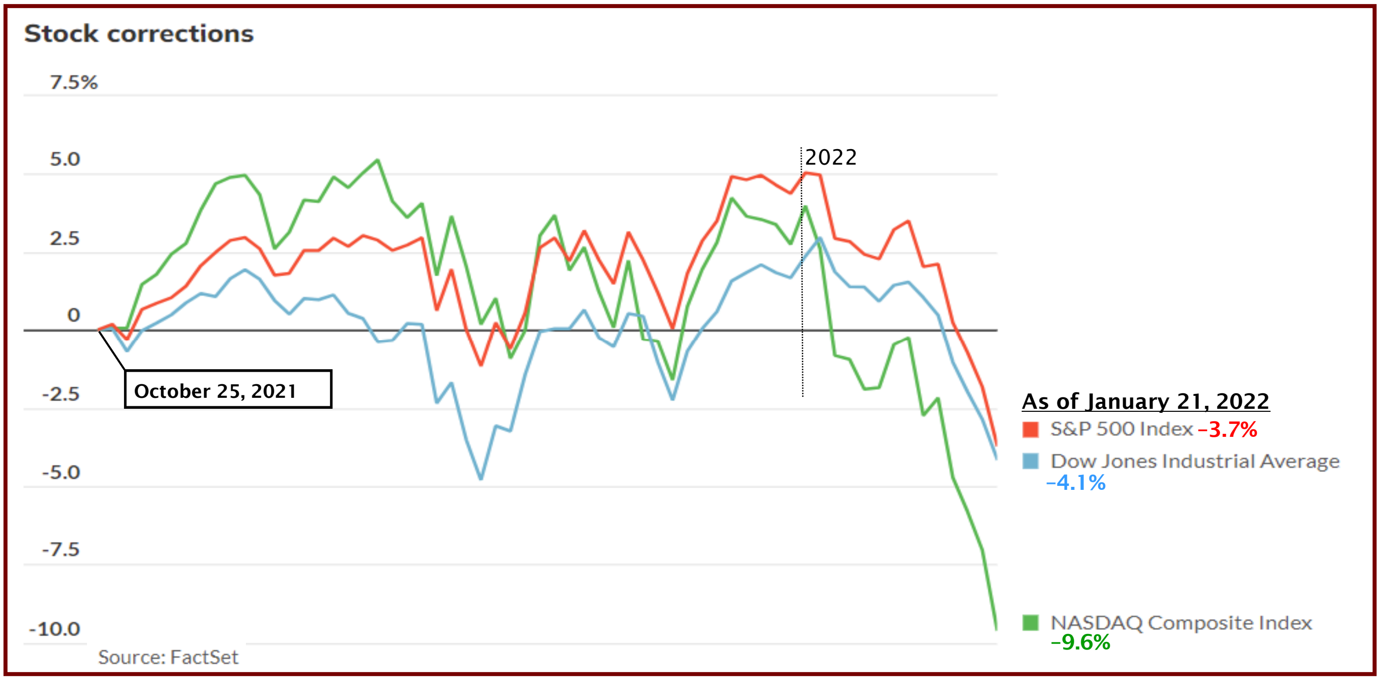
MARKETS RECALIBRATE TO INFLATION & THE FED

Since the year began, equity valuations have declined and terms such as "market noise," "pull-back," "correction," "bear market," and "plunge" are finding their way into the headlines. Terms of art like these may be useful for folks tasked with covering the events of the day, but because they're all backward looking in nature, they're not particularly helpful to the portfolio decision-making process. Here's how the major U.S. stock indices stood as of late January. (**Better news begins on page 7.**)



The question is whether recent declines in equity valuations will persist, intensify, or reverse. Of course, no one knows, but here are a few of my thoughts on the matter.

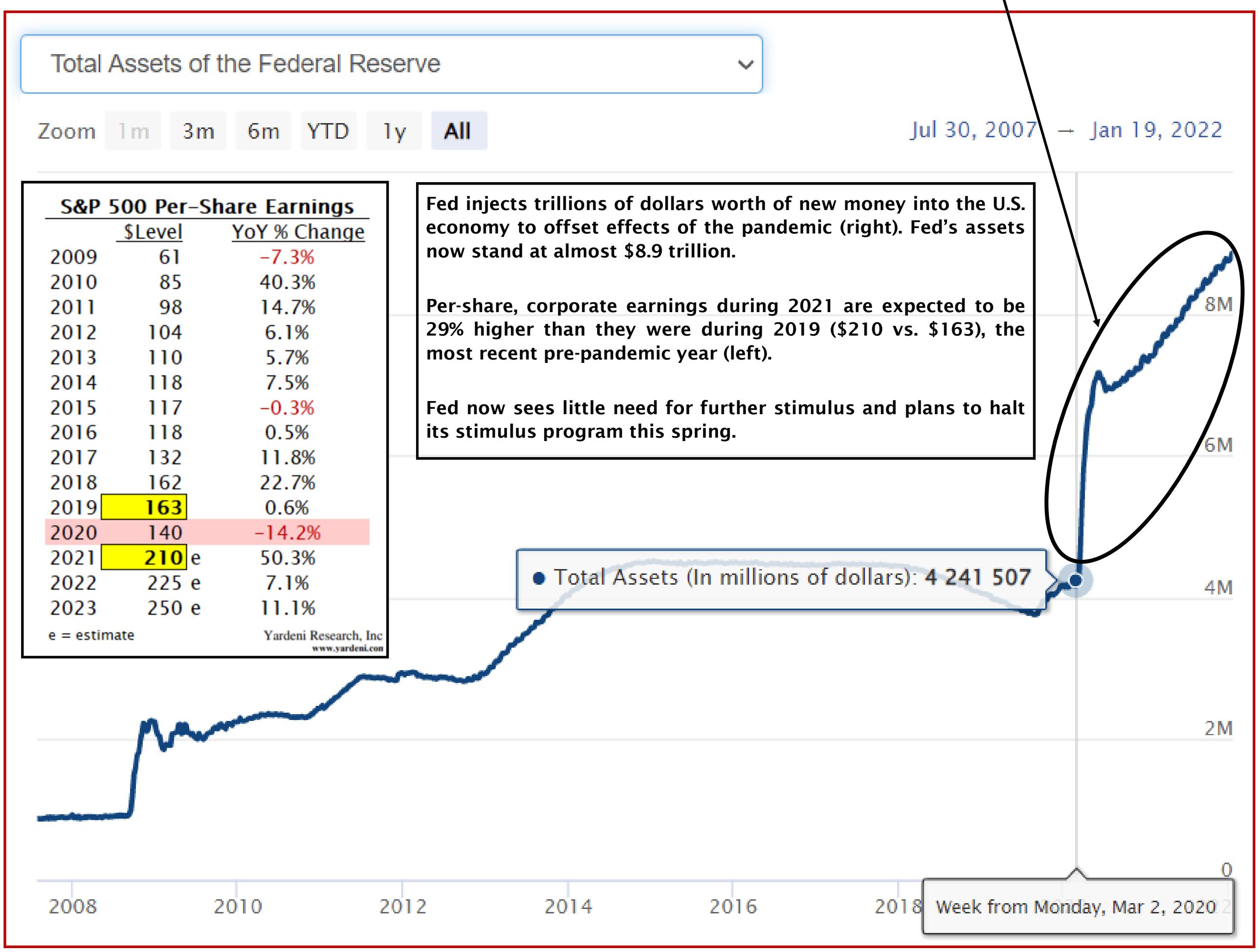
FEDERAL RESERVE TRANSITIONING AWAY FROM STIMULUS

To avoid burying the "*lede"* (a spell-check surprise), I'll say upfront that although it seems clear that economic growth is slowing, I don't interpret the recent downdraft as a signal that the U.S. economy is falling apart. Instead, I think investors are digesting the ramifications of the Federal Reserve's transition away from economic stimulus to a neutral policy stance the Fed expects to achieve in March and, later this year, to actual policy tightening. Fears of persistently high inflation may also be weighing on investors' collective psyche. I'll use the rest of this space to examine these things a bit.

FED'S FIRST STEP IS TO END ITS STIMULUS PROGRAM …

By design, the Federal Reserve is the one entity that creates new money when it writes a check. For everyone else, the money backing that newly written check must *already* exist, or the check will bounce. Roughly speaking, when the Fed judges business conditions as being too slow or when our economy is harmed by some event or disaster, the Fed is apt to inject fresh funds into the economy to stimulate the system to a higher level of activity. When the Fed writes those checks to inject money into the economy it must necessarily buy something which is, typically, various types of bonds. When it does, the assets on its balance sheet increase commensurately.

As you can see in the following image, the Fed's assets stood at about $4.2 trillion at the onset of the pandemic versus almost $8.9 trillion now which means the Fed has stimulated the U.S. economy to the tune of $4.7 trillion … more than doubling the assets on its balance sheet since early 2020 (circled). This is the DNA of inflation.



S&P 500 Per-Share Earnings

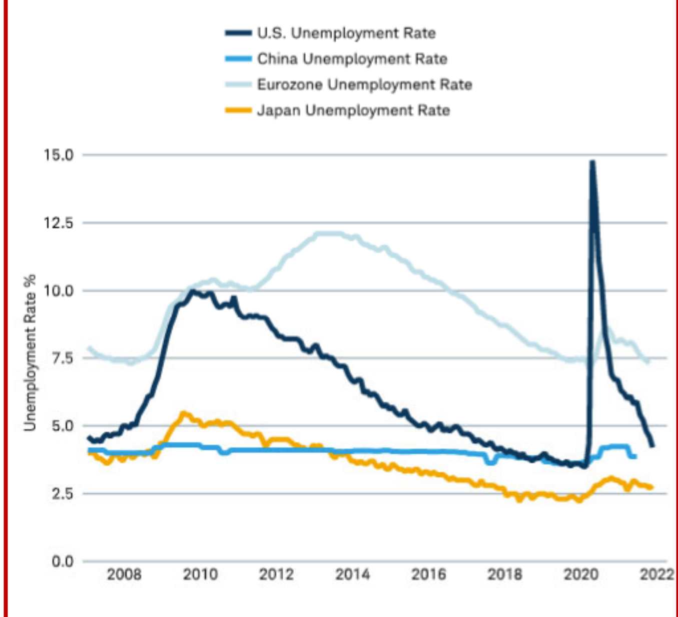
	$Level	YoY % Change
2009	61	-7.3%
2010	85	40.3%
2011	98	14.7%
2012	104	6.1%
2013	110	5.7%
2014	118	7.5%
2015	117	-0.3%
2016	118	0.5%
2017	132	11.8%
2018	162	22.7%
2019	163	0.6%
2020	140	-14.2%
2021	210 e	50.3%
2022	225 e	7.1%
2023	250 e	11.1%

e = estimate Yardeni Research, Inc www.yardeni.com

BECAUSE IT BELIEVES THE U.S. ECONOMY NO LONGER NEEDS IT

During most of 2021, the Fed had been injecting about $120 billion per month into the U.S. economy and, as you can see in the previous image, the Fed had taken even more dramatic action immediately after the onset of the pandemic. Corporate earnings have not only returned to their pre-pandemic levels, Yardeni Research expects corporate earnings in 2021 to usurp them by a stout 29%.

As you can see in the next image on the left, the Fed has fairly well achieved its objective of reducing the rate of unemployment to pre-pandemic levels and leading economic indicators suggest that the U.S. economy is now settling in to a more sustainable level of growth, as shown on the right.



Source: Charles Schwab, MacroBond as of 12/31/2021.

Bars represent National Bureau of Economic Research defined recession periods.
Source: Bloomberg, MacroBond as of 1/6/2022

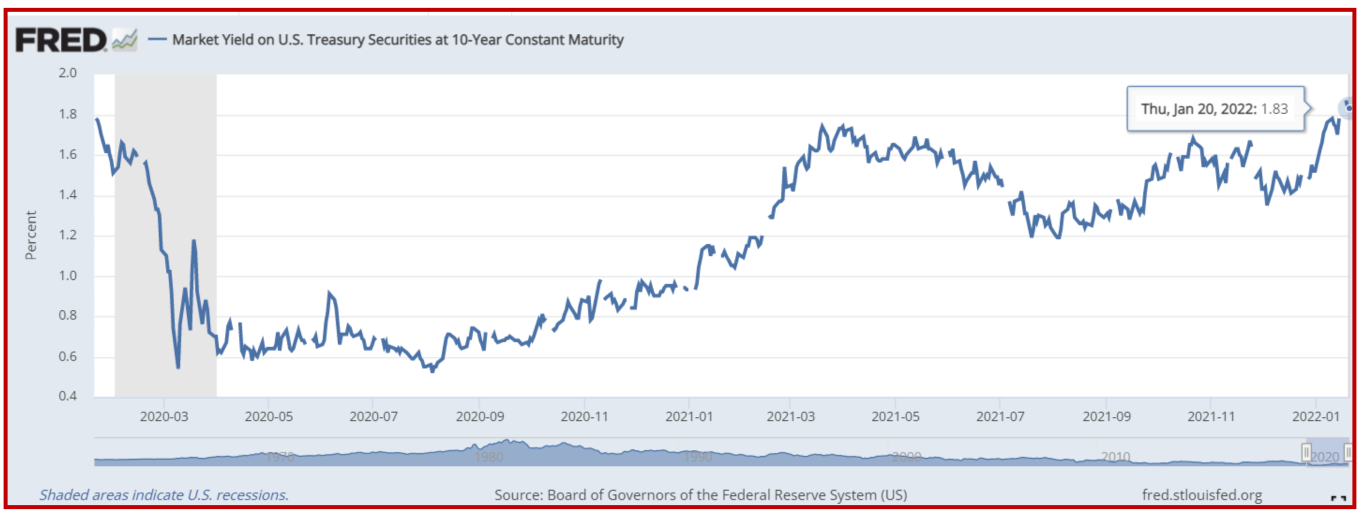
After signaling for months now that the Fed intends to "taper" the rate at which it had been injecting stimulus into the economy, the Fed has more recently signaled its intention to conclude its stimulus effort by March rather than by summer. This means investors must now reacclimate to an environment where asset prices are not skewed higher simply as a result of ongoing Fed stimulus. Policy transitions are always apt to trigger market volatility, but the Fed is apparently now of the opinion that the risks posed by further stimulus and inflation outweigh the risk of halting further stimulus.

EXPECTED INTEREST RATE HIKES CONTRIBUTE TO VOLATILITY

In addition to bringing its stimulus efforts to a halt, the Fed has long signaled that it eventually intended to target an increase in a key interest rate (the federal funds rate). More recently, the Fed has signaled that it would begin raising that rate this year. This matters because higher interest rates tend to act as a retardant to economic activity. Although the Fed's aim is to thwart inflation, the usual byproduct of higher rates is a reduction in loan demand, money supply, and economic activity that will, hopefully, also reduce the rate inflation. Again, the only reason the Fed intends to raise rates is because the Fed now sees the downside risks from inflation as exceeding any risks posed by higher rates and somewhat slower economic activity.

TREASURY YIELDS HAVE RISEN IN ANTICIPATION OF FED ACTION

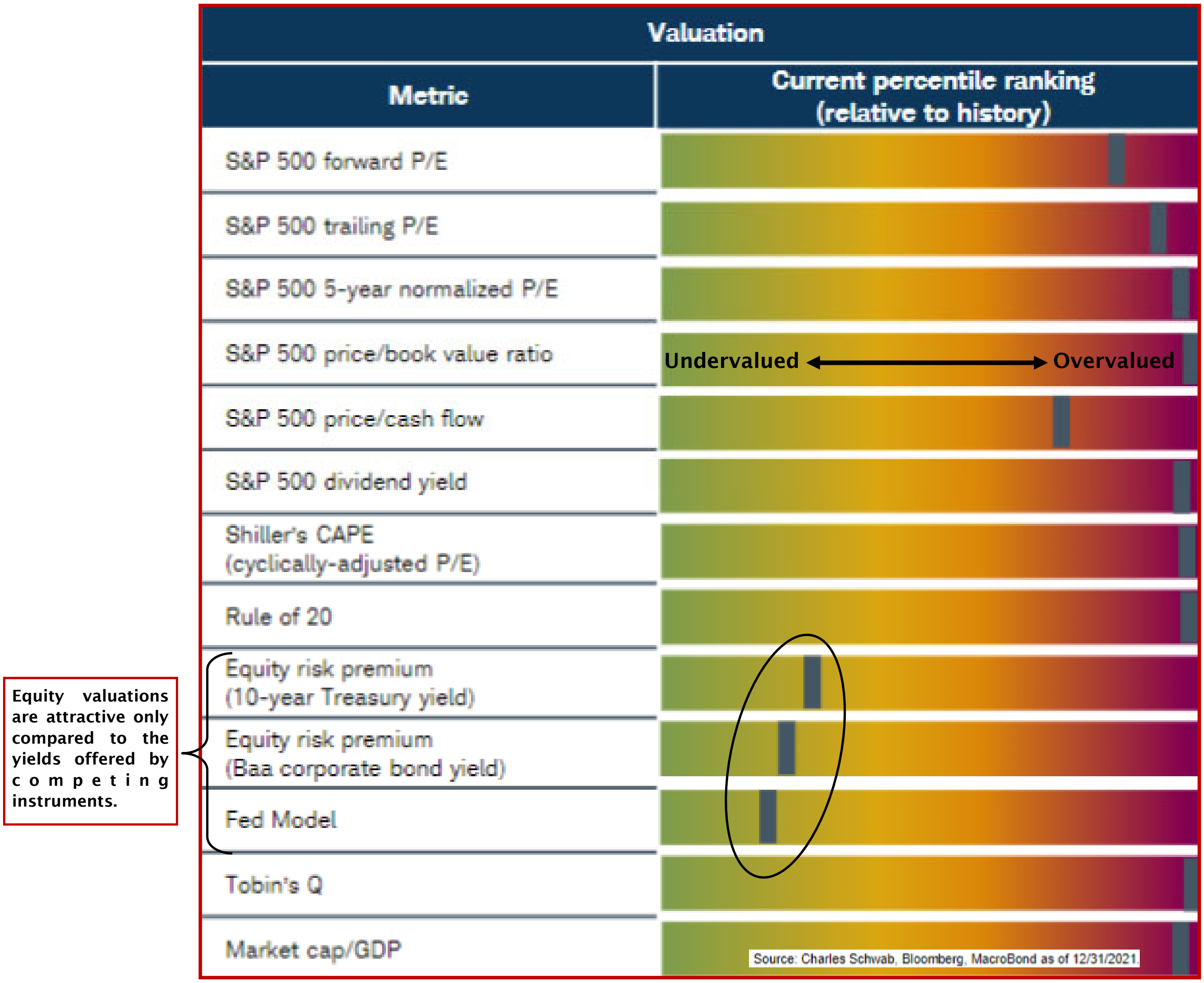
Rising yields are welcome news for income-seeking investors, but they also place downward pressure on most asset values, including equities. Anticipating rising rates, or perhaps rising inflation, the yield on Treasury notes maturing in 10 years has now eclipsed its pre-pandemic level when it stood below 1.8%.



EQUITIES LOSE A BIT OF THEIR YIELD ADVANTAGE

You may recall the following image from my previous note which grades the relative attractiveness of equities using a variety of metrics. Although most indicators continue to suggest equities remain overvalued, this image is premised on data that predates January's equity slide, so the valuation grades shown here may portray equities as being somewhat *more* overvalued than they currently are.

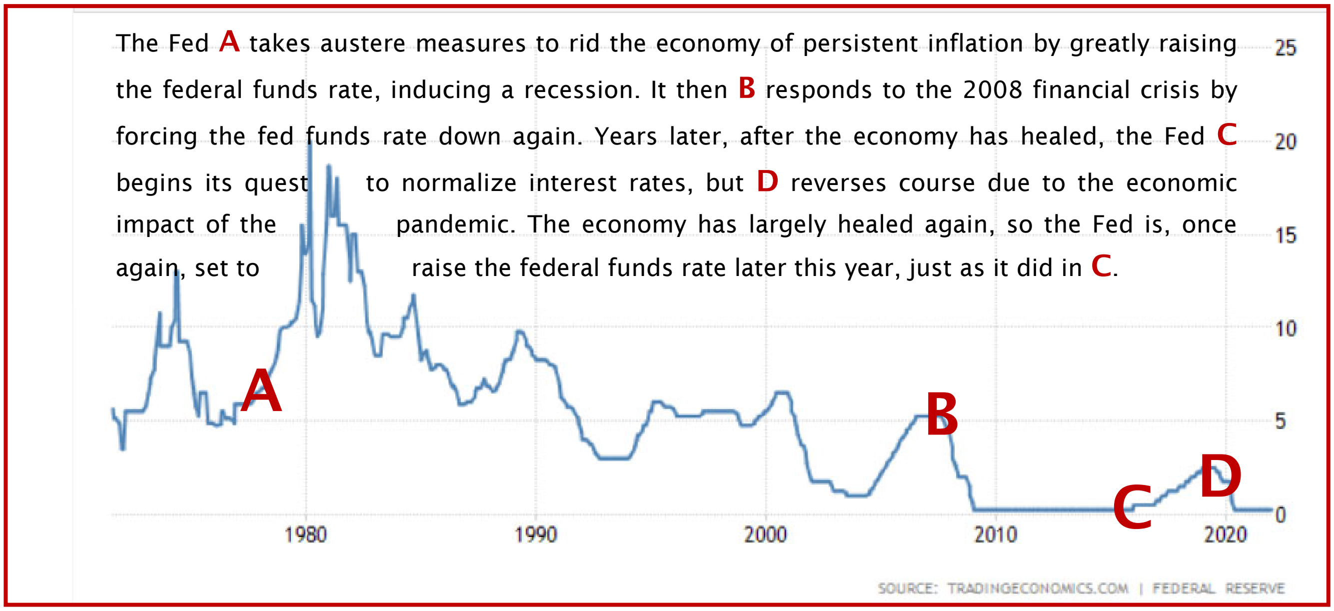
However, the yields on Treasury notes and other income-producing instruments that compete for investor dollars have also increased a bit since the data in this image was assembled which might then result in equities being portrayed as being somewhat *less* overvalued than they now are. Therefore, the relative attractiveness of equities versus a few months ago might be a push.



FED NOW EXPECTS TO RAISE RATES <u>THIS</u> YEAR, NOT NEXT

When the Fed raises interest rates, it reduces loan demand, the money supply, business activity and, hopefully, inflation which is its real goal. Months ago, the Fed indicated it may begin raising rates in 2023 or 2024, but because inflation has surged and because the Fed does not want to allow it to become entrenched, the Fed is set to act sooner.

When the Fed raises rates, it usually does so by intervening in the market in which banks borrow and lend among themselves, i.e., the federal funds market. Here's a look at the rates in that market over the past half century and where we are now.



RATES MAY REMAIN RELATIVELY LOW DESPITE HIKES

The Fed recently estimated that the Federal Funds rate might reach 0.9% by the end of 2022, 1.6% at the end of 2023, and 2.1% at the end of 2024. However, Goldman Sachs went on record in late January as expecting the Fed to raise the federal funds target rate four times this year (one more than the Fed suggested), and it thinks more rate hikes are possible if inflation does not subside as much as the Fed hopes.

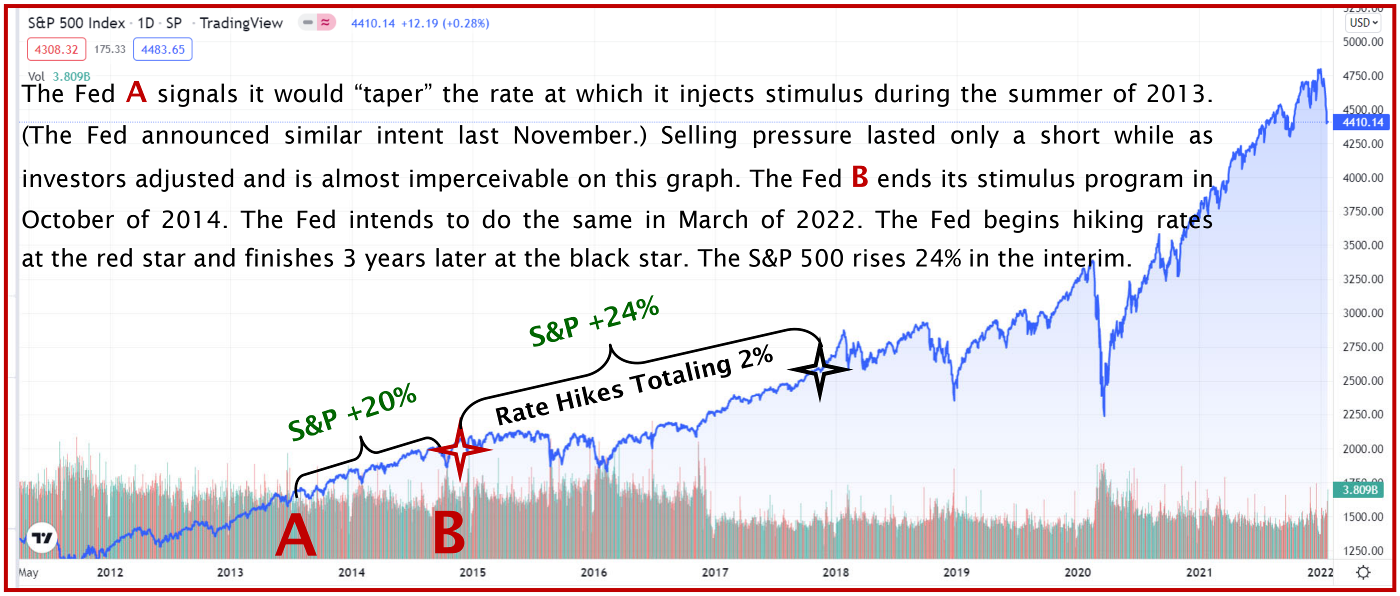
The federal funds target rate currently stands at .25% which, by historical standards, is extremely low. If history is a guide, the magnitude of each rate hike implemented by the Fed may be only .25%. If so, and if Goldman Sachs is correct, the federal funds rate at year end might then be 1.25% rather than .9% which is still low by historical norms.

FED MAY BEGIN REVERSING STIMULUS THIS SUMMER

Goldman Sachs thinks the Fed might begin removing some of that $4.7 trillion worth of stimulus from the economy at a rate of about $100 billion per month this July and continue on that path for a couple years. Since low interest rates and Fed stimulus tend to push asset prices higher, might the converse also be true? A similar situation arose in 2013, so let's see what history shows.

SO FAR, HISTORY IS ON OUR SIDE

2013 is the only previous instance of which I'm aware where the Fed tapered its stimulus effort prior to reversing course to remove stimulus. Remember, March is expected to be the point where the Fed is neither adding nor reducing stimulus (to be "policy neutral"), and July is the point at which Goldman Sachs thinks the Fed will begin removing stimulus and/or raising interest rates.



The Fed started raising the federal funds rate in December of 2015 (red star) which is about where we might be this summer and pushed it from 0.5% to 2.5% over the next three years (black star). **Despite regular rate hikes over this time, the S&P 500 still rose by about 24%. History is an imperfect predictor of the future, but the only other time we've been through this, equity investors who remained invested did ok.**

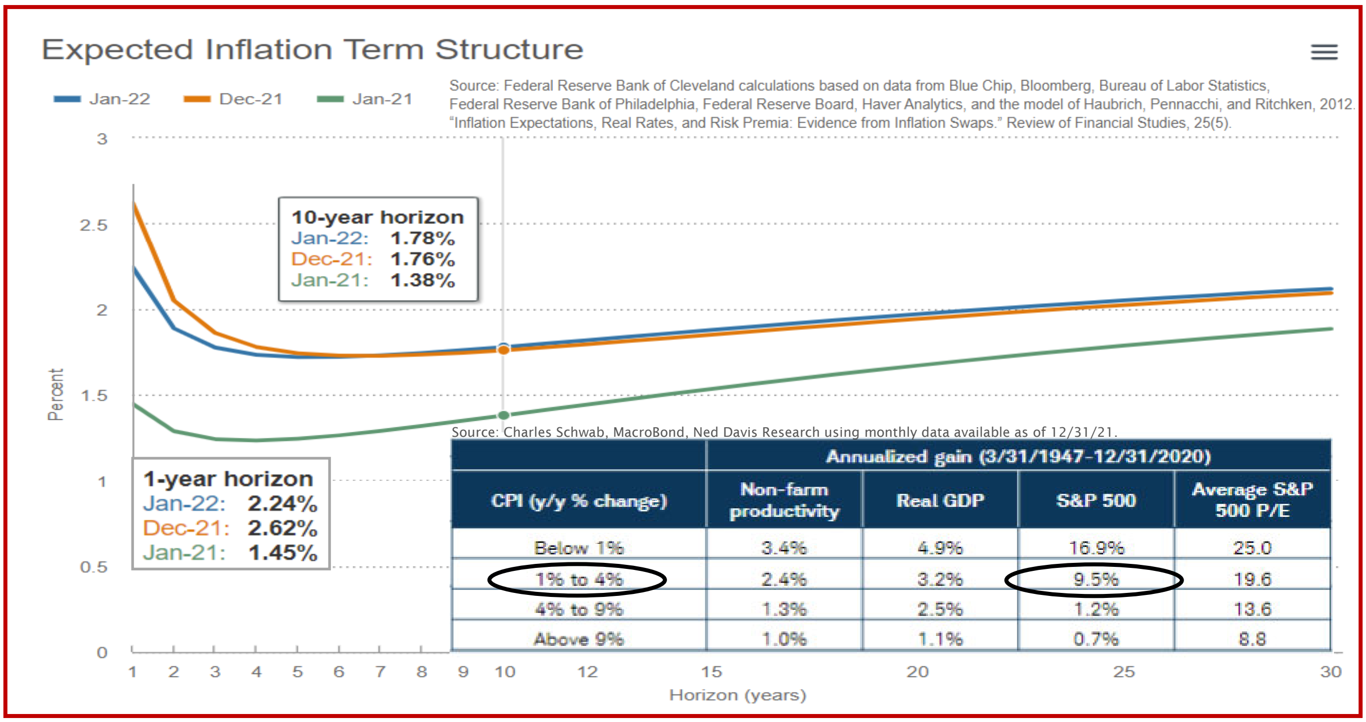
FED'S INFLATION ESTIMATE REMAINS SURPRISINGLY BENIGN

I've already mentioned that inflation spiked to about 7% last year. There has been a lot of conjecture as to whether inflation will become entrenched in our economy and plenty of that conjecture has come directly from the Fed. My sense is that investors are expecting inflation to persist at rates that significantly exceed the 2% inflation target the Fed pursued before the pandemic began. The Federal Reserve Bank of Cleveland utilizes a predictive model to estimate future inflation rates within the U.S., so let's have a look at that.

Despite the fact we've just come off a year where inflation was 3½ times the Fed's usual target, the Fed continues to expect inflation to settle down to levels that would be considered low by most any standard. Versus its estimate in December, the Fed's 1-year inflation estimate has actually declined from 2.62% to 2.24% and its 10-year estimate remains well below it's previous, 2% target, although it has risen a bit since last January. Importantly, these figures are nowhere near recent inflation levels.

BENIGN INFLATION MAY ALLOW FOR DECENT EQUITY RETURNS

If the Fed's inflation estimates turn out to be accurate enough to fall somewhere within the range I've circled below, historical data suggests equities could continue to produce non-trivial returns (also circled).



	Annualized gain (3/31/1947-12/31/2020)			
CPI (y/y % change)	Non-farm productivity	Real GDP	S&P 500	Average S&P 500 P/E
Below 1%	3.4%	4.9%	16.9%	25.0
1% to 4%	2.4%	3.2%	9.5%	19.6
4% to 9%	1.3%	2.5%	1.2%	13.6
Above 9%	1.0%	1.1%	0.7%	8.8

To finish, I'll leave you with some consensus, average annual return estimates for equities, bonds and cash equivalents for the next decade and I'll immediately contrast them to the actual annualized returns achieved over the preceding 5 decades. These estimates are courtesy of Charles Schwab and are as of the end of 2021: Large U.S. Stocks (6.6% projected/10.7% historical); Small U.S. Stocks (7.1%/10.8%); Large International Stocks (6.5%/8.7%); U.S. Bonds (1.7%/7.4%), and Cash (1.3%/4.7%).

I do think we're entering an environment of lower returns. We'll see. — Glenn Wessel