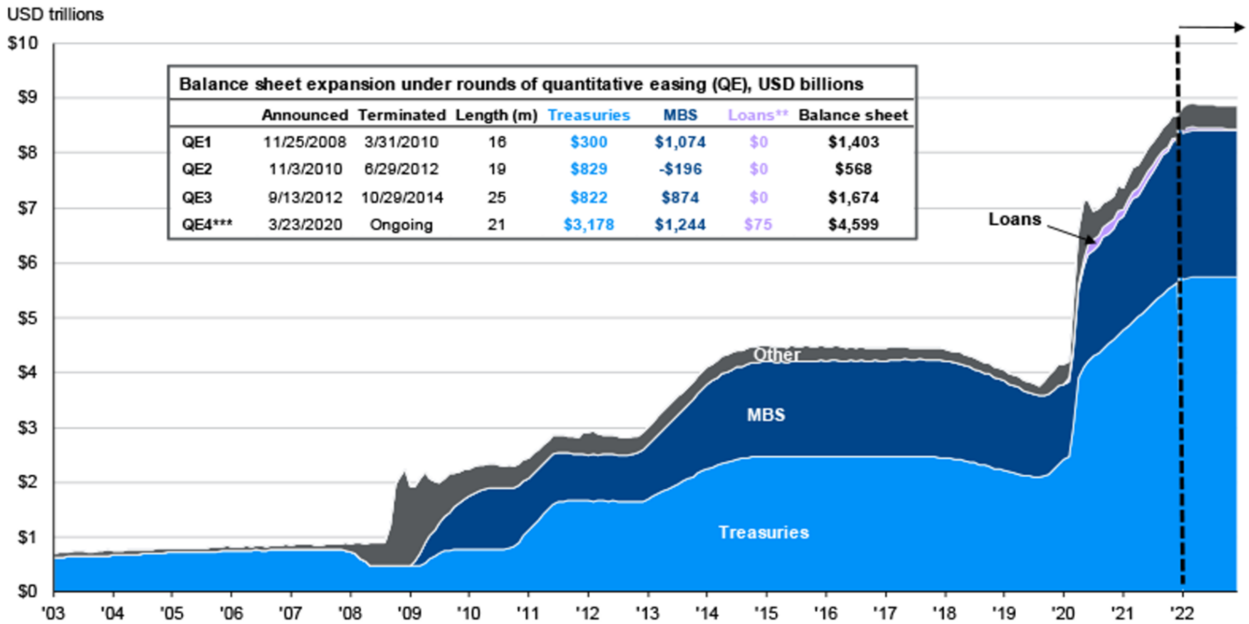
A HAWKISH SENTIMENT

At the start of 2021, we said we "got a feeling '21 is going to be a good year" (see The Who's rock opera, "Tommy"). Specifically, we noted that continued low interest rates and an expanding economy powered by a Covid recovery would bode well for the equities markets. It was a "good year", as the S&P 500 index finished 2021 up 26.9% and is up 47.5% since year-end 2019 despite the pandemic. Additionally, the index saw 70 record closes in 2021, which is the most in a year since 1995[i]. There were brief setbacks to certain parts of the market throughout the year, mostly related to Covid impacts, Federal Reserve policy, legislation from D.C., and changes in Treasury yields. Inequitable vaccine distribution across the world, as well as spread of new Covid variants, disrupted supply chains and logistics operations, negatively impacting company earnings. The Build Back Better Act was not passed in the Senate, pressuring shares of companies expected to benefit from proposed government spending. Each time the yield on the 10-year Treasury rose (as it continues to do these first few weeks of 2022), technology and other high multiple stocks came under pressure. Lastly, the prevailing economic story of the year, that inflation continues to rise, led the Fed to finally abandon the "transitory" label in November. With consumers bolstered by Congressional stimulus and the Fed's "easy money" policies propping up the market, the economic opening continued, and the markets hit new highs.

The consumer price index ("CPI"), which measures what consumers pay for goods and services, rose 7.0% in December year-over-year, marking the fastest rate of inflation since 1982. The producer price index ("PPI"), which measures prices paid by producers of goods and services, rose 9.7% in December, which is the highest year-over-year gain on record. Few economists predicted this acceleration in prices a year ago, and it far exceeds the Fed's long-term target of 2.0%. The imbalance of supply and demand, as well as a decline in the labor force participation rate, are prominent economic impacts caused by the pandemic that caused the surge in inflation last year. Most notably, the price of gasoline increased 49.6%, as demand for travel returned after months of restrictions and lock downs. The price of consumer goods hit record levels across new vehicles (+11.8%), used vehicles (+37.3%), household furnishings (+7.4%), and apparel (+5.8%), as factory shutdowns and shipping bottlenecks stalled production, but consumer demand for those products remained strong. The price of food at home and in restaurants also increased 6.5% and 6.0%, respectively, while the price of meat/poultry/fish increased 12.5%. Lastly, housing costs steadily increased each month, jumping 4.1% for the year. Given housing costs now account for more than 30% of CPI, these bear watching as primary contributors to inflation in 2022. With the labor force participation rate decreasing to 61.9%, which is 1.5% below pre-pandemic levels, a shrinking workforce created significant wage inflation across many industries. Several million people have yet to return to work as many have quit and are now looking for higher pay and/or a more flexible work environment, while some took early retirement and others face obstacles like issues with childcare. The persistent labor shortage, as well as broadening inflation in the CPI beyond energy, food, and consumer goods, suggests higher prices may persist in 2022[ii].

At the Federal Reserve's policy meeting in December, the central bank announced the pace of tapering (*i.e.,* reducing net bond purchases) would be doubled to $30B per month, and interest rate projections were updated to reflect three hikes in the Fed funds rate in 2022. While this "hawkish" sentiment signaled a near end to the pandemic-era easy money policies, the Fed is still projected to purchase $60B of bonds in January and $30B in February with interest rates near zero, despite inflation levels near forty-year highs. The acceleration in tapering is technically not a pivot to tightening, just a less accommodative policy. As the market loves certainty, equities rallied into year-end 2021 given the Fed's clear plan and optimism of economic progress. After the Fed's meeting minutes were released on January 5, however, the details spurred an aggressive sell off in the equities markets. Several Fed officials not only supported an accelerated end to bond purchasing, but also a quicker increase to the Fed funds rate, and most notably, to be more aggressive in reducing the Fed's balance sheet. As shown below, the Fed's nearly $9T balance sheet more than doubled in size since March 2020, and this period of "QE" (quantitative easing) far surpassed the immediate monetary stimulus in the Great Recession[iii]. The Fed did not detail a timeline for a runoff, meaning a reduction in its holdings by letting bonds mature, but the meeting minutes revealed a pivot to more "hawkish" policies should be expected.

The Federal Reserve balance sheet



Balance sheet expansion under rounds of quantitative easing (QE), USD billions

	Announced	Terminated	Length (m)	Treasuries	MBS	Loans**	Balance sheet
QE1	11/25/2008	3/31/2010	16	$300	$1,074	$0	$1,403
QE2	11/3/2010	6/29/2012	19	$829	-$196	$0	$568
QE3	9/13/2012	10/29/2014	25	$822	$874	$0	$1,674
QE4***	3/23/2020	Ongoing	21	$3,178	$1,244	$75	$4,599

Although there was no playbook on how to handle the economic fallout of a pandemic, it appears that Congress and the Fed were too supportive for too long with pandemic stimulus, fueling greater demand for certain goods and leading to exuberance in "risk on" investments. Both factors supported a market in an unprecedented environment, allowing the S&P 500 to avoid a 10% correction in more than 90 trading weeks (compared to an average of every 34 weeks)[iv]. Given the inflationary impact on consumers and producers, there is an urgency for the Fed to "catch up" with tighter monetary policy, and market participants will be seeking clarification of next actions after its upcoming January meeting. Heightened market volatility is likely as shorter-term Treasury yields rise in anticipation of accelerated increases to the Fed funds rate. It's important to note that rising yields are typically indicative of the market's confidence in economic growth, however, rising yields can depress valuation multiples and increase borrowing costs for companies, thus negatively impacting both valuations and earnings. At the same time, companies will continue to face earnings pressure from rising costs on inputs and wages. This market environment may not be positive for some pockets of the market in the short-term, like higher multiple technology stocks, but may be positive for others, like financial stocks, which tend to benefit in a rising rate environment. This speaks to the importance of maintaining portfolio diversification as it is impossible to time market dynamics. While a potential market pullback isn't particularly comforting, this may create investable opportunities in certain sectors that could benefit from a market "reset" following the prolonged accommodative monetary and fiscal policy of the past two years.

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[i] Dow Jones Market Data
[ii] Bureau of Labor Statistics
[iii] J.P. Morgan Asset Management
[iv] Northern Trust, Bloomberg