

## Making Sense of the Fed's Pivot

*Michael A. Tyler, CFA, Chief Investment Officer*

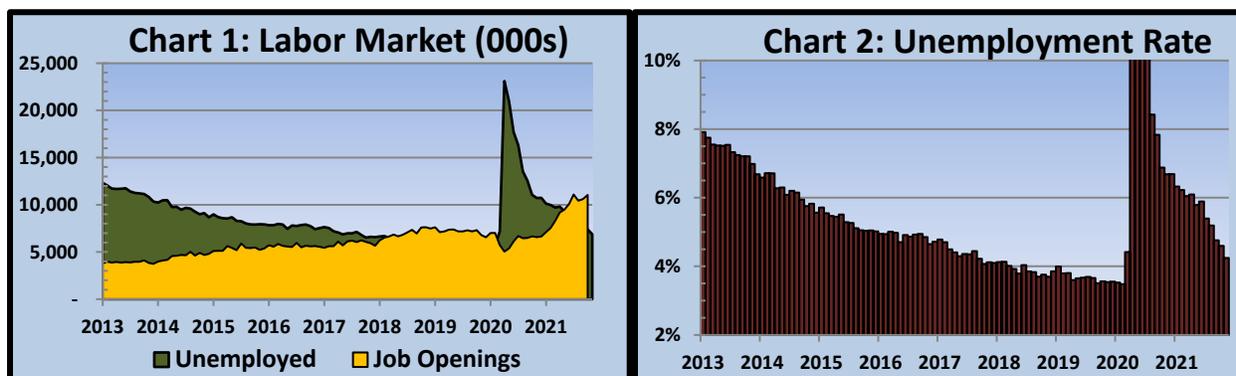
*December 17, 2021*

It looks as though Federal Reserve Chair Jerome Powell may have found his way safely down from his tightrope.<sup>1</sup> In recent months, the Fed has been forced to steer a very narrow course, aware that inflation was rising sharply but unable (or unwilling) to do much in response out of fear that tighter monetary policy would hamstring the fragile economic recovery – yet officials have also been concerned that doing too little could lead to an inflationary spiral not seen since the 1970s. This week the Fed turned sharply hawkish.

The latest economic data have been very, very good to Mr. Powell. Most measures of economic activity – purchasing managers indexes, sales figures, durable goods orders, and the like – have turned upward as Americans have gotten back to work (and play); we are finally spending the massive liquidity that has amassed in our bank accounts. Concurrently, some of the supply chain problems that have exacerbated product shortages have begun to ameliorate, although this problem is far from solved.

The one recent sour note was the disappointing report that only 210,000 new jobs were created in November, less than half of the 500,000 anticipated by many economists. Blame that one on faulty Wall Street forecasts and possibly on suspect data from surveys conducted around the Thanksgiving holiday; I suspect that the final numbers will be stronger than the initial reading.

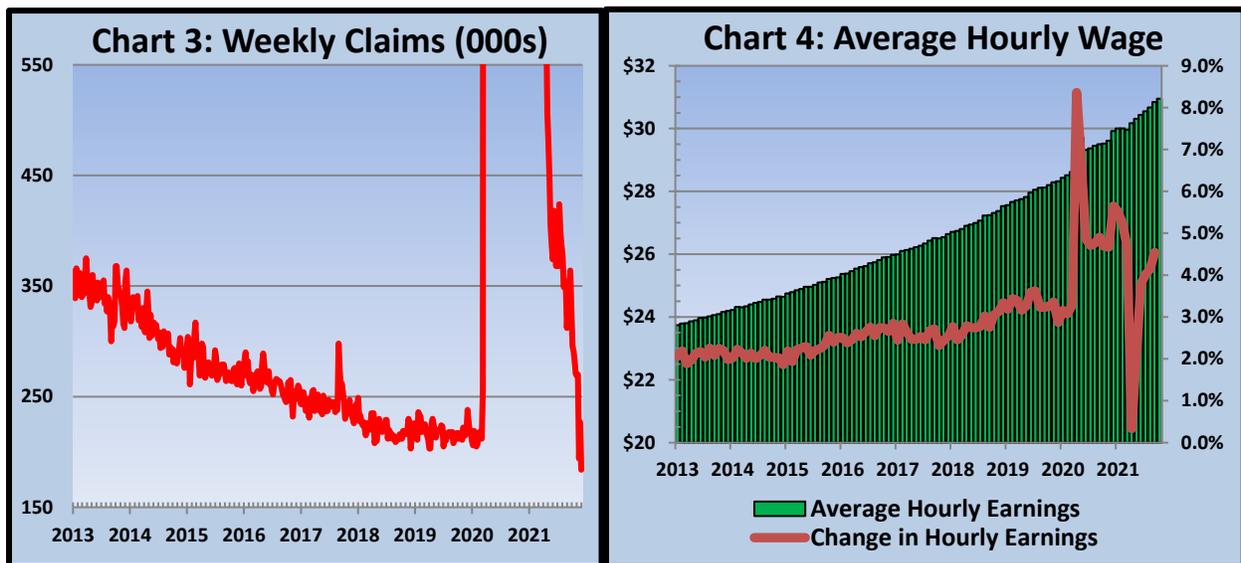
Beyond that one headline number, the other jobs data has been impressively strong: Labor force participation (the percentage of Americans either working or looking for work) perked up to 61.8%, the best reading since the pandemic began. Employers have more than 11 million job postings open, while fewer than seven million Americans are unemployed (Chart 1). The unemployment rate has fallen to 4.2% (Chart 2).



Source (both charts): Labor Department, Bureau of Labor Statistics

<sup>1</sup> See "Powell's High-Wire Act – Tyler's Version," November 24, 2021.

Indeed, last week the Labor Department reported that initial unemployment claims fell to 184,000 (Chart 3); that’s the lowest figure since the summer of 1969,<sup>2</sup> when the U.S. population was only about 202 million compared with over 330 million today. It’s a tight labor market, and workers have the leverage. Hourly wages continue to creep up, rising 4.8% from a year ago (Chart 4). Although the economy has 3.9 million fewer jobs than it supported before the pandemic began, the unemployment data in Charts 3 and 4 suggest that the labor market has effectively resumed its pre-pandemic trajectory in recent months; in other words, it has fully recovered from the pandemic disruptions. If this is so, then the 3.9 million “missing” jobs represent both productivity gains (more output from fewer people) and a pickup in early retirements among late-career workers.



Source: Labor Department, Employment and Training Administration (left); Bureau of Labor Statistics (right)

In the three months since the Fed’s previous policy meeting, the economy has clearly strengthened. Back in September, the Delta virus had punctured the pandemic recovery, as GDP growth fell from 6% in the first six months of 2021 to 2% for the third quarter. Since then, rising vaccination and booster rates lit a fire, and we think fourth-quarter GDP growth will again top 5%. So far, the Omicron virus has had little effect on economic activity; its milder symptoms have not led to surges in hospitalizations, nor to any serious economic restrictions in the U.S.

Global supply chains remain a mess, however, and companies continue to have difficulty satisfying demand for their products. That has led to a meaningful pickup in inflation, from 5.4% when the Fed met in September to 6.8% today. Not only that, but Mr. Powell reported earlier this week that the Fed no longer sees high inflation readings as “transitory.”

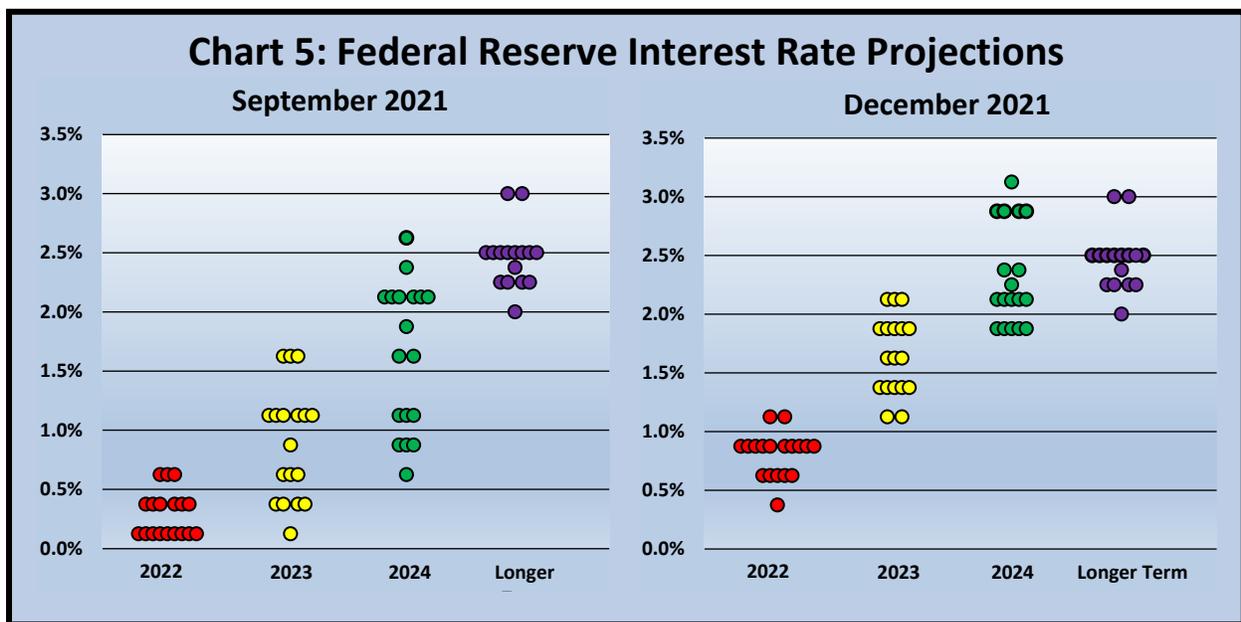
<sup>2</sup> The Canadian rocker Bryan Adams was nine years old in the “Summer of ’69,” when “I got my first real six string / bought it at the five and dime / played it ‘til my fingers bled.” Jerome Powell, another noted guitarist, was 16 that summer; it’s unknown whether he was more interested in practicing his chords or reading up on the economy’s rising inflation and falling unemployment numbers. As for me, I was begging my parents to let me attend Woodstock (they didn’t) and occasionally playing hooky to watch the Miracle Mets overtake the Cubs on their way to the World Series. Lifelong passions begin early.

Faced with rising inflation, robust consumer demand for products and services, supply shortages, and a tight labor market, the Fed had no choice: It *had* to pivot to a more hawkish policy. The central bank took two important steps in that direction this week: First, it accelerated its timetable for reducing bond market support, indicating that it will wrap up its bond-buying (“quantitative easing”) program by next March instead of next June; second, it said that it will likely start raising short-term interest rates next spring rather than much later in the year.

The accelerated tapering process was well telegraphed to investors, primarily through Mr. Powell’s testimony to Congress last month. By reducing its bond purchases, the Fed is gradually tipping the supply-demand balance in the bond market toward sellers, which in theory would drive long-term bond prices down and yields up. Higher long-term yields could then translate into more expensive business loans, home mortgages, and other forms of debt. The process would – again, in theory – also begin to siphon some money out of the economy, gradually dimming inflationary pressures.

Theory doesn’t always hold up in the real world, however. Based on legislation already enacted, the U.S. government’s fiscal stimulus in 2022 will be trillions of dollars lower than it was this year, meaning that the government will need to borrow less money next year. Lower supply of new Treasury bonds will likely offset the Fed’s lower demand to buy them, so the actual impact of the accelerated taper isn’t likely to move rates very much – it may just act to keep long-term yields from falling even further (and bond prices from rising even faster) than they already have.

This may be why the Fed has pivoted to the short end of the yield curve, as represented by the overnight fed funds interest rate. The magnitude of the Fed’s pivot can be seen in Chart 5, which shows the central bank’s “dot plot” projection of fed funds rates as of September (on the left) and this week (on the right). Each dot represents one Fed Open Market Committee participant’s view of the level of the overnight Fed Funds rate at a given point in time.



Source: Federal Reserve

Even in September, the Fed was convinced that interest rates would need to move higher, but there was little agreement about how quickly. Today, the Fed has coalesced around a tightening regime that is both sooner and steeper than it had considered just three months ago. By year-end 2022, for example, all but three committee members expected in September that the overnight rate would remain under 0.5%; today, the group nearly unanimously sees rates above that level. That's the difference between one or two quarter-point hikes (the September view) and three or four hikes (the current view).

The Fed's hawkish turn has legs into 2023 and beyond, too. The median expectation for 2023 has jumped from 0.875% to 1.625%, i.e., from a cumulative total of three hikes to seven over the next two years. For 2024, the median rate forecast has likewise soared to 2.25% from 1.625%. Just to drive home the point, the Fed also rescinded its prior guidance that it would view inflation over sustained periods of time; no longer will it let inflation run hot to offset prior cold periods.

Higher interest rates normally translate into lower price/earnings ratios and therefore into lower stock prices. Higher rates make it costlier to borrow, which reduces incentives to invest in productive capacity; they act as a brake on economic growth. Higher rates also offer investors less risky ways to earn income, which would be expected to draw money away from the stock market and into the bond market. So it was perhaps rather surprising to see the stock market spurt higher when the Fed's statement was released Wednesday afternoon.

I think there are some reasonable explanations for the stock market's counterintuitive initial response to the Fed's more hawkish tilt:

- No more overhang. Now that the Fed has made its intentions clear, investors don't have to worry about not knowing what the bank would do, or when. Interest rate futures had already been indicating that Wall Street traders expected three hikes in 2022, more than the Fed itself had suggested heretofore; now, the Fed has aligned its forecast with what the bond markets were already telling us. Certainty and alignment breed confidence.
- No change to the ceiling. The *one* commonality between the September and December dot plots is the "longer term" projection; despite moving faster, the Fed hasn't raised its view of the long-term level of interest rates, which underpins many investors' calculations of stock valuations.
- Lower risk of an inflationary spiral. Much of Wall Street was worried that the Fed would wait too long to act against persistently higher prices. Many of today's grizzled veterans, after all, were scarred for life as young cubs in the catastrophic inflationary spiral of the late 1970s; seeing the Fed take a firmly hawkish step seemed reassuring.
- A clear runway for earnings growth. Companies are reporting that they have not seen any falloff in demand as they have raised prices, leading to positive revenue surprises and big positive earnings upgrades across many industries. Stocks have proved once again that they are a strong bulwark against moderate inflation, and the Fed's pivot helps ensure that the CPI will be moderate rather than severe.

- FOMO and TINA. As interest rates and long-term bond yields begin to rise, prices of debt instruments are likely to fall – and from very high levels, since interest rates are still near historic lows. If investors flee the bond market, “there is no alternative” (TINA) to stocks; if for no other reason than “fear of missing out” (FOMO), investors may start shifting money from bonds into stocks. While stocks may not be cheap at 22 times year-ahead earnings, they are still nowhere near historically high valuations, and they are supported by rising earnings and dividends. Wall Street is betting, in effect, that earnings will go up faster than P/E ratios will come down, netting out to positive price movement.

In the coming weeks, we will be publishing our outlook for 2022, including our forecasts for the stock and bond markets. At the moment, neither stocks nor bonds offer compellingly attractive returns, but we are not in uncharted waters. For now, we remain fully invested, with a tilt toward equities; even though stock investors have retreated a bit in the past two days, we still think the market’s initial enthusiasm for the Fed’s pivot was the right call.

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