MACRO MUSINGS

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The Fed Makes Its Move

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SUMMARY

- The **macro**cast™ score suggests a recessionary bear market is still unlikely, but the defensive position of **micro**cast™ reaffirms our expectation that the market volatility is not yet behind us.
- The Federal Reserve raised interest rates for the first time since 2018. It was the first of what is expected to be several rate hikes in 2022, as the central bank looks to tamp down inflation while maintaining the strong job market. Chairman Jerome Powell has shifted to a more aggressive tone and is signaling the Fed will no longer wait for inflation to improve on its own.
- The market registered four consecutive days of 1% gains last week. Similar moves have historically led to strong future returns. While price studies such as this can help frame current data and inform potential outcomes, there are key differences between this occurrence and previous instances that suggest this time may not be as positive.

THE FED RAISED RATES
FOR THE FIRST TIME SINCE 2018

Last week, the Federal Reserve raised the Fed Funds rate by .25%. It was the first increase in four years and the start of a new tightening cycle that could see 7 or 8 more rate increases, representing an additional 1.5-2% by the end of the year, based on the latest market forecast (from the Daily Shot):

The increase was perhaps the least surprising rate hike in history. The only uncertainty was whether rates would rise by .25% or .50%. Geopolitical turmoil ultimately drove the Fed to take a more conservative approach in starting the tightening cycle, but that does not mean they will take a cautious approach going forward. A .50% increase is on the table when the Fed meets again in May.

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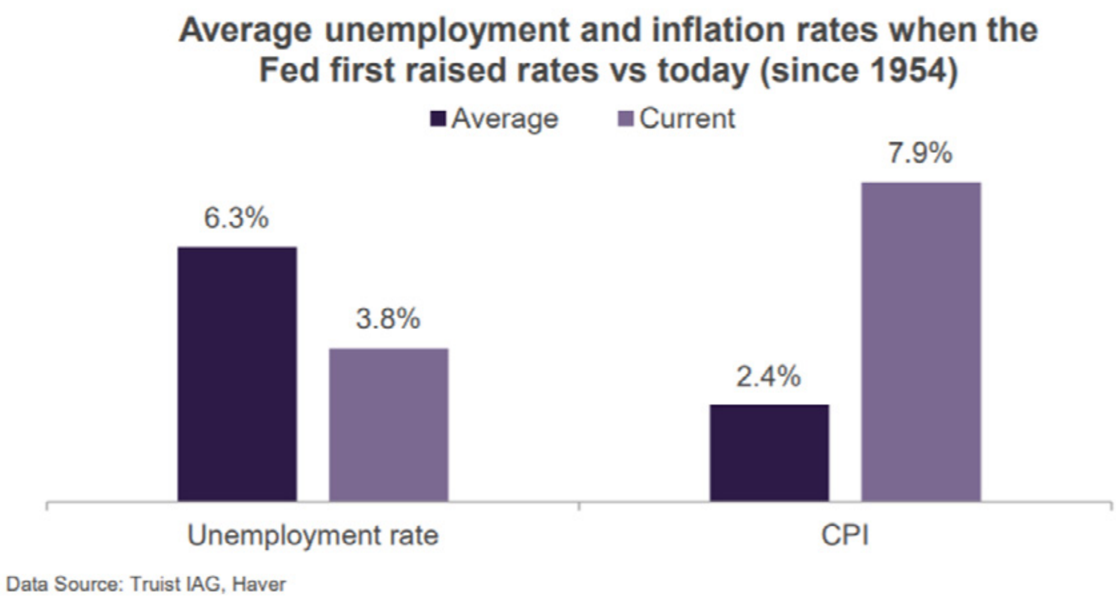
THE FED'S DUAL MANDATE SUGGESTS
THE RATE HIKE WAS LONG OVERDUE

The Fed has two main objectives: maintain full employment and achieve price stability. While job growth has been a success story over the past two years, the same can't be said for price stability, with multiple measures of inflation at 40-year highs.

The following chart shows just how accommodating or "dovish" monetary policy has been. Historically, the first interest rate increase occurred when the unemployment rate was around 6% and when inflation was between 2% and 3% (from Truist):



Today, we have unemployment near-decade lows and inflation at multi-decade highs. While the uncertainty around the trajectory of Covid lasted much longer than many expected, it is remarkable that the Fed waited this long to raise rates, given the strength of the recovery.

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INFLATION IS THE PROBLEM
THAT WILL NOT GO AWAY

Inflation remains a problem. We have written about the view that inflation would be "transitory," but the term has lost all meaning at this point. While we still expect a peak in year-over-year inflation in the coming months, the timeline for when it returns to more acceptable levels remains highly uncertain.

Multiple factors have caused inflation to remain stubbornly high, including:

1. **Higher commodity prices** - Further exacerbated by the conflict in Europe.
2. **Continued supply chain issues** – Manufacturers are not able to keep up with demand.
3. **Missing workers** – Still too many job openings and not enough employees.
4. **Housing prices** – Higher home prices are leading to higher rents, which is a big contributor to core inflation. While housing starts are up, there is still not enough to meet current demand.

All of the above point directly to supply-side issues. This is not the same problem we saw after the Great Financial Crisis, where it was a lack of demand that led to a sluggish recovery. This time, the economy is strong, but there isn't enough oil, there aren't enough homes, and there aren't enough workers, putting upward pressure on inflation as demand exceeds supply.

This is at the heart of the Fed's challenge. As inflation continues to persist, the Fed is shifting its focus away from the labor market and relinquishing their wait-and-see approach to inflation. In a recent speech (click here for the full transcript), Chairman Powell laid out his thinking on what went wrong with inflation forecasts:

> *Many forecasters, including FOMC participants, had been expecting inflation to cool in the second half of last year, as the economy started going back to normal after vaccines became widely available.[3] Expectations were that the supply-side damage would begin to heal. Schools would reopen—freeing parents to return to work—and labor supply would begin bouncing back, kinks in supply chains would begin resolving, and consumption would start rotating back to services, all of which could reduce price pressures. While schools are open, none of the other expectations has been fully met. Part of the reason may be that, contrary to expectations, COVID has not gone away with the arrival of vaccines. In fact, we are now headed once again into more COVID-related supply disruptions from*

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China. It continues to seem likely that hoped-for supply-side healing will come over time as the world ultimately settles into some new normal, but the timing and scope of that relief are highly uncertain. In the meantime, as we set policy, we will be looking to actual progress on these issues and not assuming significant near-term supply-side relief.

The last sentence is key. The Fed will be looking for clear signals that inflation is truly retreating instead of making assumptions like they did last year. They will raise rates until inflation retreats.

The biggest risk with this approach is two-fold. First, inflation is a lagging indicator, meaning it reflects where the economy was 6-9 months ago. So, the high inflation seen now is more of a reflection of the economic conditions last summer. Second, if the Fed continues to raise rates while waiting for clear signs of inflation returning to normal 2-3% levels, they may very well hike us right into a recession.

To be clear, we are not there yet. Our indicators do not point to a recession in 2022. Households with much stronger finances may be able to withstand Fed tightening better than they could in the past. But one thing is for certain: we have not seen this level of Fed hawkishness in many years and must adjust to this new reality with an open mind.

THE POST FED HIKE RALLY **IS UNIQUE IN ITS STRENGTH**

While market performance around Fed meetings is always volatile, the S&P 500 managed to gain around 6% last week and registered four consecutive days of 1%+ performance.

This sort of market strength is rare. It is only the fifth time it has happened since 1950:

4 Strong Days Like We Just Saw Are Rare, But Quite Bullish

S&P 500 Index Returns After Four Consecutive 1% Gains

		S&P 500 Index Return			
Date	4-Day Return	1 Month	3 Month	6 Month	12 Month
6/1/1970	12.3%	-6.6%	5.2%	10.4%	28.0%
10/14/1974	12.2%	1.3%	-1.5%	18.6%	23.0%
10/11/1982	10.2%	6.4%	9.2%	15.4%	27.0%
11/5/2020	7.4%	5.2%	11.5%	18.7%	33.8%
3/18/2022	6.9%	?	?	?	?
	Average	1.6%	6.1%	15.8%	28.0%
	Median	3.2%	7.2%	17.0%	27.5%
	% Positive	75.0%	75.0%	100.0%	100.0%

Source: LPL Research, FactSet 03/18/2022 (1950 - Current)
All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.
The modern design of the S&P 500 Index was first launched in 1957. Performance before then incorporates the performance of its predecessor index, the S&P 90.

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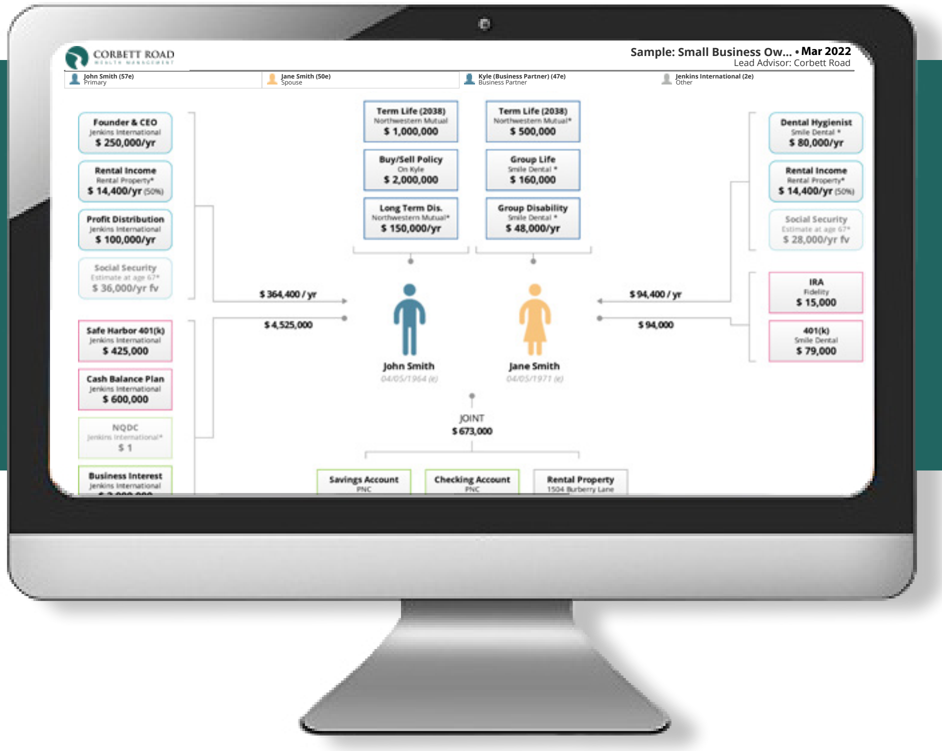
The table shows encouraging performance from previous examples. In all four instances, the market was higher a year later, with strong average returns.

While the study is positive, there are two main reasons to be cautious:

1. A sample size of 4 is limited.
2. In three of the four previous triggers, the market was exiting a recession and major bear market. Although we just had a correction, stocks have not suffered the way they did in the other examples.

The most recent example triggered during the last presidential election. The drawdown then was comparable to the current decline, with a 10% drop in the market driven by political uncertainty. However, the Fed was still providing massive amounts of liquidity, and although the market had surged since the bottom in March 2020, stocks were still trading below their pre-Covid highs. We would be (pleasantly) surprised if we saw similar strong returns going forward.

In summary, the Fed has started their rate hiking cycle and shifted their focus away from jobs to fighting inflation. The Chairman has explicitly stated the Fed will look at actual inflation statistics and will not stop raising rates until inflation moves back toward their 2% target. The market seemed to anticipate this shift, and stocks have rallied since. **macro**cast™ is still positive, but the score remains lower than average, and **micro**cast™ is recommending a defensive posture. We continue to expect slower growth and a volatile market in the months ahead.



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