Slower Growth + Tighter Fed = Still Okay

October 2021

Summary

In the aftermath of the pandemic, both the economy and financial markets continue to strengthen. Unemployment fell to 4.8%, a swift drop from 7.8% just one year ago. The economy snapped back with roughly 6.1% GDP improvement, and the S&P 500 is up 15% through September. The stock market was remarkably calm during this turbulent period, reaching one of the longest rallies without a 5% correction in 20 years. All good things must come to an end, and the stock market saw its first 5% drawdown at the end of September.

Number of days without a 5% correction

~~211~~ 0

The next phase of the recovery is likely to be more difficult as investors assess how much more good news is ahead. There are plenty of risks that could be disruptive to financial markets, but the environment is still positive for stocks. The data from 2021 is so strong that it is almost inevitable that 2022 will look worse by comparison. Economic growth will be slower, but not slow. Monetary policy will be tighter, but not tight. While stocks have had a long run and are somewhat expensive, bond yields are still quite low and have not served as a hedge to equities in the last few years.

Growth Not As Fast, Policy Not As Easy (but not slow, not tight)

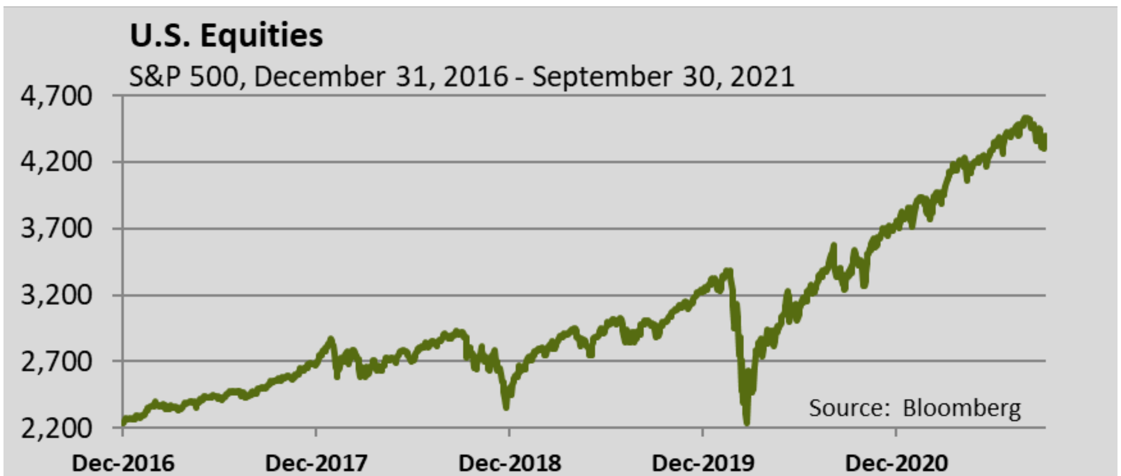
Many economic factors that impact financial markets will change in the next few years. Economic growth will slow in 2022, but the pace of growth is still expected to be strong. Fiscal stimulus will be lower and spread out over time. Easy monetary policy from the Federal Reserve (Fed) will continue, albeit at a lesser pace. Despite these changes, conditions are still conducive to economic growth and financial markets.

	2021	2022	
GDP Growth	6.1%	4.4%	GDP growth is a comparison to prior years. Since 2020 was restricted heavily by the pandemic (-3.4%), a big rebound in 2021 is measured from a low base. If achieved, expectations of 4.4% GDP growth in 2022 would be the highest in over 20 years (excluding 2021). Slower than 2021 is still relatively strong.
Fiscal Stimulus	$1.9T	$0.55T	Emergency fiscal stimulus focused on the pandemic is likely to be replaced by investment in highways, bridges, the power grid, etc. The stimulus passed in March was $1.9T focused on direct payments to be made in 2021. The recently proposed Infrastructure package is an added $550B, which is more of an investment in the future that will be spent over several years.
Fed Rates	0%	0%	The Fed has been clear in its communication about interest rates, indicating that short-term rates are likely to remain unchanged at zero until the end of next year. Plans can change, but monetary policy remains very friendly.
QE	$120B	$120 → $0B	In September, Fed Chairman Powell indicated that tapering of bond purchases "may soon be warranted." This means less quantitative easing (QE), but buying securities is still easing. Currently, the Fed is purchasing $120B of Treasuries and mortgage securities each month. A gradual reduction would likely hit zero by summer. However, even then, zero purchases is still "easy monetary policy" as the Fed will continue to hold $8.5T of securities on its balance sheet.

Source: Bloomberg, Federal Reserve

Summary of Current Positioning

The stock market has not only recovered from the pandemic; it is 30% higher than the pre-pandemic peak. As a result, stocks are expensive when measured by the ratio of price-to-earnings. Perhaps the more important story is that of corporate profits, which were extremely strong over the past year. On the expense side, companies have cut costs significantly, improved productivity, and benefited from low interest rates which lowers the cost of servicing debt. On the revenue side, shortages in many areas have increased corporate pricing power, and a weaker dollar boosted overseas earnings. Corporate profit margins are the highest in over 20 years. While stock valuations are not cheap, the stock market run was not just a result of stocks being "bid up."



There is some risk that the significant stock market advance in 2021 leaves the market ripe for a major correction. This is always a risk when investing in the stock market, but the backdrop for stocks is still very friendly. Most bull markets are ended by the Fed tightening monetary policy. For now, policy makers are maintaining a very market-friendly approach. Even if the Fed moves more quickly than the market anticipates, it will take some time before policy becomes restrictive.

Although stock valuations are high, bonds are also expensive. The yield on a 10-year Treasury is only 1.5%, and most bonds generated negative returns in the first nine months of the year. In recent periods, bonds have not served as an effective hedge to stock market losses and therefore are not a compelling alternative to stocks at this time.

In April, client equity allocations were reduced slightly. After a largely sideways experience in stocks over the summer, the recent pullback in September provided an attractive opportunity to increase allocations to equities. Therefore, client portfolios have been adjusted to the maximum equity allocation. As markets return to a more normal environment and the Fed takes its foot off the gas, market volatility will likely increase. There may be more and larger corrections in the next year, but equity allocations represent a much more attractive risk / reward tradeoff.

Bonds Are No Longer A Hedge To Falling Equities

A relatively standard investment principle is that bonds act as a hedge against falling stock prices. Portfolios can be protected from large drawdowns because positive bond returns can mitigate stock market losses. This is generally true, and clearly bonds are less volatile than stocks.

However, since the pandemic, bonds have not been an effective hedge. There have been 20 drawdowns since the end of the 2008 Financial Crisis. Prior to the pandemic, 14 of the 16 stock market drawdowns saw bonds act as a hedge and provide some degree of buoyancy to portfolios. The major exception was the "Taper Tantrum" in 2013 when investors worried about the Fed's plan to reduce its purchases of Treasuries and mortgage-backed securities.

Start date	End date	S&P 500	Bonds
1/19/2010	2/8/2010	-8.1%	0.5%
4/23/2010	7/2/2010	-16.0%	3.0%
2/18/2011	3/16/2011	-6.4%	1.7%
4/29/2011	6/15/2011	-7.2%	1.6%
7/7/2011	10/3/2011	-18.8%	4.2%
4/2/2012	6/1/2012	-9.9%	2.2%
9/14/2012	11/15/2012	-7.7%	1.2%
5/21/2013	6/24/2013	-5.8%	-3.1%
12/31/2013	2/3/2014	-5.8%	1.9%
9/18/2014	10/15/2014	-7.4%	2.4%
5/21/2015	8/25/2015	-12.4%	0.0%
11/3/2015	2/11/2016	-13.3%	1.9%
1/26/2018	2/8/2018	-10.2%	-1.0%
9/20/2018	12/24/2018	-19.8%	1.6%
4/30/2019	6/3/2019	-6.8%	2.1%
7/26/2019	8/14/2019	-6.1%	2.3%
2/19/2020	3/23/2020	-33.9%	-0.9%
9/2/2020	9/23/2020	-9.6%	-0.3%
10/12/2020	10/30/2020	-7.5%	-0.2%
9/2/2021	10/4/2021	-5.2%	-0.8%

Source: Bloomberg

Since the pandemic, none of the four stock market drawdowns were buffered by bond returns. Even the -34% drawdown at the beginning of the pandemic (March 2020) was accompanied by a -0.9% loss in bond returns.

This change in bond dynamics is likely driven by two factors: 1) extremely low interest rates provide very little cushion to changes in bond price; and 2) rising interest rates may cause stock market drops because they signal tighter borrowing conditions (and since bond prices move inversely to interest rates, bond returns fall as well).

Is Inflation a Concern?

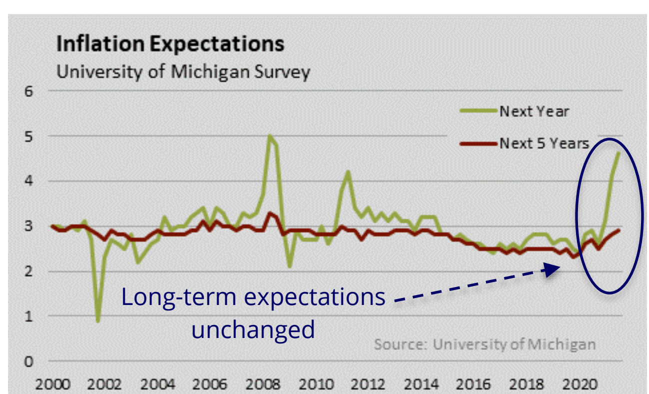
It started with toilet paper and anti-bacterial wipes, but, more recently, shortages of goods like new and used cars, bikes, lumber, and even Christmas trees and chicken tenders have been one of the most visible economic impacts of the pandemic. With limited supply, prices have gone up on many items. The natural concern that follows is whether inflation will soon become a problem. This topic has been in the news frequently this year and will likely continue to garner headlines in the future. While inflation is clearly higher in the short run, it is unlikely to be a problem over time.

First, recent price spikes have occurred mostly due to problems with the supply chain, not because there has been a large increase in demand for certain goods. These higher prices are likely to be temporary ("transitory" is the term the Fed uses). The price of lumber is an interesting example. Prices doubled this spring, and then fell by 70% from the highs in May. Auto prices in the U.S. are up by 22%, but auto production has fallen by 30% so far this year due to chip shortages. Once the supply of computer chips is restored, the pendulum is likely to swing the other way, turning the shortage of cars into an abundance of them.

Second, the Fed and most economists believe that inflation has been too low in recent years. The Fed's stated inflation target is 2% (measured by core PCE). From the end of the financial crisis in 2009 through 2020, core PCE inflation has been well below the Fed's target, averaging 1.6%. Over that same period, inflation never reached 2.5% in any single month and exceeded 2% in only 13 of the 129 months. In fact, the Fed has stated that it wants average inflation to reach 2%, which means that since inflation has been so far under target for 12 years, it should be allowed to exceed 2% for quite some time. Is there a chance that the Fed is not as in control of inflation as it hopes? Yes, clearly, but higher inflation in the short term is both expected and desired.

Third, wages have recovered strongly over the past year. Data from the Atlanta Fed tracking wage growth of individuals demonstrates that recent readings are solidly in-line with the past five years [See chart, below left]. More worrisome inflation would likely be reflected in wages, as seen in the 1970s with the wage-price spiral.

Fourth, longer-term inflation expectations have not changed. While expectations for inflation over a one-year horizon have jumped to their highest level in 20 years, expectations for inflation on a five-year horizon are firmly in line with historical precedent. See chart with data from the University of Michigan Surveys of Consumers, below right.



One Of The Longest Rallies In 20 Years Comes To An End

At the end of September, the S&P 500 saw its first 5% correction in almost a year. Markets have been very tame due to the extraordinary stimulus and ongoing pandemic recovery. The rally lasted 211 trading days (roughly 10.5 months). On average, the stock market encounters a 5% correction every 72 trading days.

Date Streak Ended	Length (Trading Days)	Turn Into 10% Correction
6/12/50	282	Yes
1/3/55	326	No
8/3/59	409	Yes
12/12/61	283	Yes
10/28/63	255	No
5/13/65	369	No
10/9/89	225	Yes
2/2/94	333	No
5/24/96	369	No
2/11/04	219	No
1/26/18	399	Yes
9/2/21	211	???

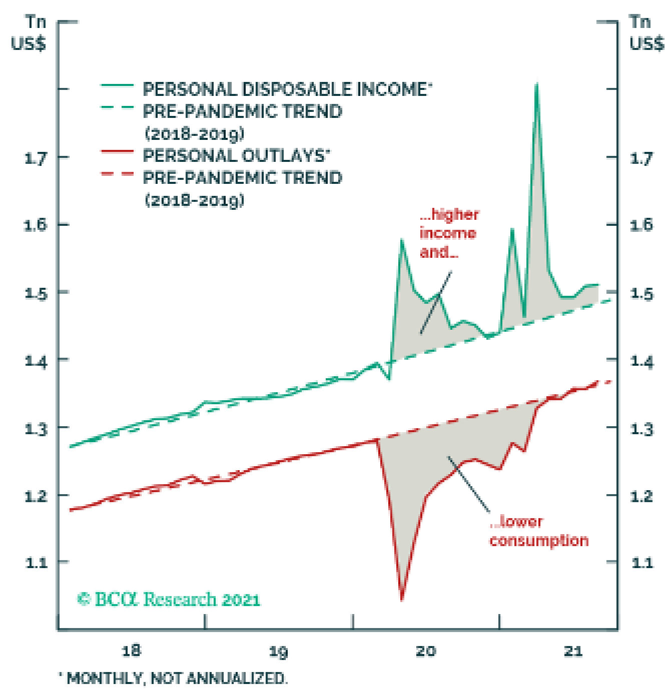
Source: Ned Davis Research

The only two similar periods over the last 20 years were in 2003-2004 during the initial recovery from the Technology Bubble and in 2017-2018 after passage of the Tax Cuts and Job Act (TCJA). However, all good things must come to an end. There is plenty to worry about (see page 6), but uncertainty from the stalled infrastructure bill and concerns over global supply chain problems may have provided the friction to end the rally.

Interestingly, five of the eleven prior streaks went on from a 5% drawdown to hit at least a 10% correction. It is not clear that the current correction is fully over, but the risk of a major bear market seems low. Of the streaks since 1980, those associated with a rising rate environment have tended to have larger drawdowns. The streaks ending in 2004 and 1996 were mild and not associated with any monetary tightening from the Fed. The streaks ending in 2018, 1994 and 1989 ended partially due to Fed policy tightening – both 2018 and 1989 saw double-digit declines while 1994 was just shy of a “correction” at -9%.

Plenty of Dry Powder

While the pandemic-driven recession is over, not all of the stimulus funds have been put to work in the economy. The fiscal stimulus in the U.S. was roughly $5T, a combination of stimulus checks, unemployment insurance benefits, and other direct payments. In most recessions, personal income falls dramatically, but the massive stimulus packages caused personal income (on average) to increase [see chart, right]. At the same time, due to the pandemic, personal spending went down. The gap between the two (shaded gray areas) represents extra cash reserves.



Despite improvements in economic conditions, many consumers remain wary about the situation and, consequently, held on to cash as a precautionary measure. These cash reserves will likely serve as dry powder that will help the economic recovery continue. As consumers gain more confidence in the recovery, increased spending should follow.

Asset Class Returns

Stocks have steadily recovered since March 2020. After falling -34% from peak to trough at the onset of the pandemic, the S&P 500 realized one of the fastest bear market recoveries and reached new highs in September 2020. Through September 2021 the S&P 500 was up 15.9%, and international stocks were up 8.4%. World stocks, which represent the All-Cap World Index (an index intended to comprehensively reflect global stock prices), returned 11.5%. Emerging markets were negative for the first nine months, hurt by new regulations in China and stricter covid protocols.

Asset class	2020	2021 ytd
U.S. stocks	18.4%	15.9%
World stock	16.9%	11.5%
Small cap	19.9%	12.4%
International	7.8%	8.3%
Emerging markets	18.3%	-1.2%
Core bonds	7.5%	-1.6%
Treasuries	8.0%	-2.5%

Source: Bloomberg

Falling interest rates were helpful to bond returns last year since bond prices and interest rates are inversely correlated. But the economic recovery led to modest increases in interest rates, generating negative returns for bonds through September 30. Core bonds, which represent the Barclays Aggregate Bond Index, fell -1.6%. Treasury bonds are more sensitive to interest rates and consequently fell -2.5%.

Risks Abound But Should Be Contained

The current environment appears friendly due to a combination of monetary stimulus, fiscal stimulus, and continued recovery from the pandemic. However, the most damaging bear markets occur from a negative surprise. By definition, it is difficult to predict what surprise will come, but there are a few risks worth monitoring:

- Corporate earnings rebounded swiftly since the 2020 recession. In the second quarter, S&P 500 company earnings reached a record level on a quarterly basis, exceeding the 2019 high by 15%. Such strong results during the pandemic may have set expectations too high for 2022. If earnings falter, it could be disappointing to markets.
- The economic impacts of the pandemic seem to be easing both in the U.S. and around the world. A new strain or major outbreak would be challenging.
- While it appears that inflation is under control, readings are likely to be high over the next year. Significantly higher long-run inflation expectations would be disruptive.
- Interest rates are expected to rise. If rates increase too quickly, financial markets will worry that higher borrowing costs will be too burdensome for individuals, companies, and individuals.
- The pandemic continues to disrupt certain parts of the world economy. China has encountered a coal shortage, and Europe is mired in a natural gas crisis. Other fallout from the pandemic could interrupt the market advance.
- The U.S. averted a crisis over the debt ceiling, but the deadline / limit was only delayed by two months. A renewed standoff in Congress could destabilize the market once again.

Final Thoughts

The post pandemic recovery has been impressive. Both the economy and financial markets saw strong performances so far in 2021. The economy and stock market do not always move in the same direction, and record-high stock prices are notable. It is common to extrapolate current conditions into the future, but 2022 may be very different than 2021. The Fed will still support the economy, but less so. Stimulus from Congress will likely be different (less direct payments, more investment in infrastructure). Tax rates on corporations and individuals may be higher, and borrowing costs are likely to rise. While those factors are all less positive for equities, they are not yet negative.

The stock market ride for the first nine months of the year was almost as smooth as it could get. As this economic cycle matures (slower growth and less stimulus), the stock market will likely deliver lower returns and see more drawdowns. There is still likely room for stocks to generate positive returns, but they are unlikely to match the 15% pace set so far this year.

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