BULL & BEAR BULLETIN

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Monetary Policy Turning More Hawkish

The Federal Reserve Open Market Committee projections that came out of the December meeting showed participants preparing to respond to the threat of higher price instability, which may have resulted from extraordinary fiscal measures during the COVID-19 crisis combined with supply side constraints appearing globally in key markets. The core (excluding food and energy) Personal Consumption Expenditures Price Index registered a 4.1% change from a year ago. The Federal Reserve has a target of 2% for this measure meaning that the current price environment is elevated relative to their desired policy outcome. The headline number, which includes the impact of food and energy prices, is currently hotter than the core measure and is now running 5% year-over-year.

There has been significant debate around the nature of the inflation environment. Some believe it is due to cyclical forces emanating from the COVID-19 disruptions and resulting economic cycle downturn and rapid recovery. Others seem to believe that the onset of a higher price environment is becoming structural and secular in nature with expectations for future inflation anchoring at higher levels than seen in the past decade. It does appear that with further gains in energy and industrial metals prices being elusive for the time being, some of the argument around a sustained level of 5%, 6% or 7% type of price increases may not happen. After a few more months, the vector could be lower for these inflation numbers as we move into the second half of next year. In short, inflation may become more subdued.

This does not mean that when considering the disruptions to the labor supply and other supply side constraint issues within the production function for goods and services, that we won't necessarily settle into a world where inflation is sustainably running in the range of 2% to 4% for a while, which would be elevated relative to what was experienced during the post 2008 Global Financial Crisis decade.

Coming back to the Federal Reserve, we can consider what their reaction post meeting may be and that would lead us into considering possible market reactions. The projection for the Federal Funds Rate in the longer run is in the 2% to 3% range as of the December meeting. This longer run outlook was unchanged from September's projections. What did change was the pace of tapering bond purchases and the pace of potential rate hikes in 2022 and 2023. This outcome appeared to already be priced into markets and the longer run outlook for where interest rates will end after a hiking cycle remained unchanged. The market reaction to the meeting may be classified as neutral to mildly positive for equity and bond market stability.

The bulls will argue that the economic growth and labor picture will remain robust. Inflationary pressures will not build to such levels that the Fed will be forced to act more aggressively threatening a more robust economy and market buoyancy. In this vein, one would look forward to a few good years of mid-cycle growth and constructive markets.

The bears will argue that inflationary pressures and expectations will not remain anchored and will not fade from current intensity and that this will shorten the growth and market cycle as the Fed is forced to act more aggressively. In this case, one would look towards a mid-cycle expansion but perhaps anticipate elevated volatility and seek quality and mildly defensive risk assets should it end a bit sooner than anticipated.

Of course, what may come may not be so binary this go around with outcomes in between becoming a reality across different industry groups and sectors. Certain corridors of corporate America and global industry in general may display resilient and adaptable business models that can maintain value creation under challenging conditions.

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