Great-West Investments Capital Markets Perspective

Week in Review: January 3rd – 9th

INDEX/ SECURITY	ASSET CLASS	LEVEL (CLOSE)	% CHANGE (THROUGH FRIDAY'S CLOSE) 1 WK.	YTD	INDEX/ SECURITY	ASSET CLASS	LEVEL (CLOSE)	% CHANGE (THROUGH FRIDAY'S CLOSE) 1 WK.	YTD
Dow Industrials	Lg. Cap Eq.	36,231.66	-0.29%	-0.29%	FTSE 100	UK Equity	7,485.28	1.36%	1.36%
S&P 500®	Lg. Cap Eq.	4,677.03	-1.87%	-1.87%	Nikkei 225	Japan Equity	28,478.56	-1.09%	-1.09%
NASDAQ Comp.	US Equity	14,935.90	-4.53%	-4.53%	EEM:US	Emkt. Equity	$48.89	0.08%	0.08%
S&P Midcap 400©	Mid-Cap Equity	2,793.14	-1.72%	-1.72%	EFA:US	Non-US Equity	$78.77	0.11%	0.11%
Russell 2000®	Sm. Cap Eq.	2,179.81	-2.92%	-2.92%	UST 10y (yield)	US Treasury	1.76%	0.25%	0.25%
Stoxx 50	Europe Eq.	4,305.83	0.17%	0.17%	B/Barc AGG	Fixed Inc.	2,319.03	-1.53%	-1.53%

Past performance is not a guarantee of future results. Investing involves risk, including possible loss of principal.

I guess they meant it.

Back on December 15th, the last time the **Federal Reserve's rate-setting body** got together, they **told the world that they would get a little more aggressive with this whole "tightening" thing**. Specifically, Powell and his pals doubled the pace of the so-called taper (the pace at which the Fed is slowing purchases of Treasury- and mortgage bonds,) a scant six weeks after they announced the beginning of the program. That timing was a mild surprise and was widely seen as an indication that **the Fed was taking inflation a little more seriously** than they had previously let on.

But the Fed always keeps some of its cards close to the vest. After each FOMC meeting, the formal announcement issued by the Fed is carefully crafted to communicate only what the Fed wants the markets to hear, and the Chair's post-meeting press conference usually sticks closely to that script. **Absent from those communications is therefore much of the background discussion that took place to justify any action (or inaction) taken by the committee**. To get *that* context, you have to wait three weeks for the release of the **meeting minutes**. **We got those last Wednesday**[1].

If we can trust the note-takers at the Fed (and hopefully they were a little more engaged than I was during my college sociology class…) **the Fed is planning to normalize policy faster and more aggressively than it did** during "the previous normalization episode" (namely, the post-GFC taper and lift-off in 2015.) That's because the **economy is stronger, labor markets are tighter and the Fed's own balance sheet is much larger** than it was back then. That, plus a few technical reasons having to do with the portfolio of assets the Fed has amassed so far during the COVID crisis, suggests that the Fed will work faster and more aggressively to tighten the screws this time around than they did the last. In short, Wednesday's Fed minutes made it clear that the Fed's new stance was **likely to be even more aggressive than was first assumed when it announced its decision on the pace of the taper in mid-December**.

Although declines in the stock market were more orderly than we may have had a right to expect, other areas of the market reacted to the Fed minutes pretty much the way you might've thought: with the gloves now off, US Treasury **rates rose faster** than they have for quite some time and the **yield curve steepened noticeably**. Expectations for **lift-off**

[1] https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20211215.pdf

– the first increase in the Fed Funds rate – **moved forward to March**, with traders now placing the odds of a 25-basis point increase in rates at the March 16th meeting at roughly 70% (just three months ago, the probability of *any* increase at the March 2022 meeting was less than 5%)[2]. Interestingly, some analysts noted that the increase in longer-term yields represented **a vote of confidence in the new, more aggressive Fed**: because the curve steepened and rates rose **without a corresponding increase in so-called break-evens** (a market-based view that captures the difference between ordinary treasury securities and inflation-adjusted ones,) traders seem to be saying the Fed's new stance as inflation-fighter first and jobs-grower second **should allow it to guide the economy back to normal without too much turbulence**[3].

As far as **equity markets** are concerned, **losses were reasonably tame**, at least in aggregate. The **exceptions were mostly among fast-growing stocks** in sectors like technology and communications – namely, those areas where rates matter more and valuations have been most stretched. (One possible explanation for the relationship between interest rates and growth lies in the magic of "discounting math." Think of it this way: if you own a fast-growing but expensive stock, you may have to wait longer for it to pay off. That's fine when rates are low and/or falling, but when they're high and rising, waiting for that growth to materialize can feel even more "expensive" because of all that interest income you might suddenly be foregoing while you're waiting to get paid.) **The net result was a fairly steep 4.5% drop in the Nasdaq Composite Index even while other, more cyclically-oriented areas actually managed *gains***.

Of course, one key to the notion that the Fed might be able to successfully walk the tightrope between too much tightening and too little is a **continuation of the recovery in the US jobs market**. And that, dear reader, was the second-most important piece of information markets got last week: the **US economy created just under 200,000 jobs** in December[4] – a solid figure for sure, but way **less than economists had hoped for**.

It's perhaps telling that **the market didn't really know how to react** to that data when it was released on Friday morning. At first, investors seemed relieved that the jobs-creation engine wasn't running at much above idle because it meant the Fed wouldn't have to get even more aggressive than it already was (a view supported by the market's lack of excitement surrounding Wednesday's better-than-expected ADP payroll print just two days earlier[5].) Markets also seemed to like the **continued decline in the unemployment rate**, which now sits at 3.9% - the lowest rate since February 2020 and within spitting distance of pre-COVID levels, making it seem as if hopes for some kind of Goldilocks-like recovery in jobs was still possible even if the Fed had suddenly "got religion" with regard to inflation.

But as Friday progressed, the mood seemed to sour a little bit and equity markets resumed their decline while rates trekked higher – perhaps in response to **COVID-Omicron news that isn't getting a whole lot better**. Add to that a litany of **PMI-type data[6,7] that suggested growth might be topping out** and there was just enough uncertainty about the outlook for growth (not to mention the upcoming corporate earnings season, which kicks off on Friday,) to keep the pressure on risk markets.

As an aside, from where I sit **Powell's Fed deserves some credit** for its communication policy during the COVID crisis. By doing things like explicitly de-linking a tapering of bond purchases from an increase in rates, **they've avoided a repeat of some of the mistakes that caught the market off guard during the "taper tantrum" in 2013**. That's when markets briefly became convinced that a slowdown in the bond purchase program that had been in place to combat the effects of The Great Recession/Financial Crisis since 2008-09 meant that an increase in rates was imminent. This time, by clearly communicating that tapering and rate increases wouldn't happen simultaneously, the Fed has deftly side-stepped the brief (but violent) equity market freak-out that accompanied that 2013 taper announcement.

[2] Cme.com
[3] Bloomberg, 1/7/22
[4] https://www.bls.gov/news.release/empsit.tn.htm
[5] https://adpemploymentreport.com/2021/December/NER/NER-December-2021.aspx
[6] https://www.markiteconomics.com/Public/Home/PressRelease/51d060f7a3314d1b8bb8d948e035d4c7
[7] https://www.markiteconomics.com/Public/Home/PressRelease/407ef6783b8047b0af4ac0ff226d736e

But that doesn't mean it's necessarily safe to sound the all-clear for markets just yet: even if traders are right and **the Fed can accomplish a normalization of policy without killing growth entirely**, **there will still likely be a period of adjustment** as investors acclimatize themselves to a new reality: an economy that will now have to stand on its own two feet as the Fed turns its full attention to fighting the fires of inflation while fiscal policy remains very much up in the air. And that might be exactly what we're seeing today, as **markets begin the second week of 2022 by extending last week's losses and bidding volatility higher**.

What to Watch This Week: January 10th – 16th

Notable economic events (January 10-14)

Monday: Powell confirmation hearing

Tuesday: NFIB small business confidence

Wednesday: CPI, Atlanta Fed business inflation

Thursday: Weekly jobless claims, PPI

Friday: Bank earnings, retail sales, UofM Consumer Sentiment

Welcome to earnings season! The fun starts Friday, when JPMorgan, Citigroup and Wells Fargo announce results for the fourth quarter and full-year 2021. As always, following the banks will be weeks and weeks of reports from companies of all stripes and flavors, and it's probably no exaggeration to say that this quarter's earnings season **might be the most impactful of the pandemic era**. Wall Street analysts have maintained their perpetually optimistic views, but others aren't so sure: Have **supply chains** really begun to heal? **Will** labor markets and raw materials **costs stabilize** anytime soon? How successful have businesses been at passing through higher costs onto their consumers, and what has it meant for **margins**?

And perhaps most important of all, **will the robust rebound in consumer demand continue**, or is it destined to fade along with official efforts to stimulate our way out of the pandemic? (Incidentally, Friday's retail sales report might hint at that answer, too.) The answers to these and other questions will be known over the next several weeks as earnings season picks up momentum.

But before we get to any of that, **we still have inflation to worry about**. On Wednesday, the Bureau of Labor Statistics will release its first read of **consumer price inflation** for December, and it's expected to be a doozy: economists think the year-over-year increase in headline prices **could reach 7.1%** – the highest that index has been since June of 1982. Ditto for **producer prices, expected to be equally eye-popping** on Thursday. (For a more nuanced and forward-looking view, the Atlanta Fed will release its excellent Business Inflations Expectation survey on Wednesday as well.) Suffice to say inflation remains top-of-mind for just about everyone, even if recent **PMI data has suggested that prices might be coming off the boil**[8]. While it might be too soon to see that in this week's CPI and PPI data, anecdotes suggesting that price pressures were finally relenting was a welcome (and long-awaited) ray of hope after months and months of bad news on prices.

We also get **two important reads on confidence this week**, one from the perspective of small businesses (the NFIB's small business confidence index on Tuesday,) and another from that of consumers (the University of Michigan's preliminary read of consumer sentiment on Friday.) **Confidence has lagged recently**, primarily as a result of COVID, inflation and policy-related wrangling. This week's data will be an opportunity to see if any of those concerns have relented in recent weeks.

Speaking of policy, Fed Chairman Jerome **Powell's re-nomination will be debated** by the Senate Banking Committee on Monday, which could provide a test of the persistence of the more progressive elements of the Senate and the Democratic caucus more generally. Similarly, efforts to pass the **Biden Administration's large spending bill could generate press this week as well**, as discussions move from the size of the bill to various legislative techniques that could allow its passage in spite of stout resistance from a few members of the President's own party. Such political horse-trading doesn't always

[8] Ibid.

matter to markets, but given the enormous potential size of Joe's Big Bill – and the timing of it as other stimulus efforts fade – investors are paying a little more attention than usual this time around.

Source for index data: Bloomberg.com; GWI calculations.

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