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TAILWINDS

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DECEMBER 2020

FED FACES NEW CHALLENGES IN 2021 (Q&A)

When it comes to Fed actions in the latter half of 2020, how would you grade the Fed's response <u>and</u> its ability to effectively communicate to both the markets and the public how it plans to steer the economy past the current recession?

Grade A. We gave the Fed passing marks in the first half of the year and see no reason to change now. While the hard work was accomplished earlier in the year (getting markets functioning again), the second half required the fortitude to not only stick to the plan (and not upset global capital markets) but to remain independent in light of November's Presidential election. On both counts, we would give the Fed stellar marks with a grade of A.

In Jerome Powell's late spring remarks, market participants were handed a roadmap. And despite all the whiplash throughout the year, nothing was said or done to deviate from these policies – thus giving the markets and the economy the comfort and ability to go about their daily business without undue interference from unwanted, unneeded, and unexpected government policy.

Is Jerome Powell likely to be reappointed as Fed chair in 2022? Why do think President-Elect Biden will or will not reappoint Powell?

Most likely. At this time, it appears that President Biden will reappoint Jerome Powell, but we retain the right to change our mind as the event is not yet within our investment landscape or timeline. Specifically, the decision may hinge on the outcome of the Georgia Senate races which have the potential to directly affect any additional fiscal stimulus – allowing investors to reassess after the first 100 days of the President-elect.

Consistent with the Fed's guidance that rates will hold at near-zero "until labor market conditions have reached levels consistent with the Federal Open Market Committee's (FOMC) assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time," what is your current base case for how soon the Fed will be able to start lifting rates again?

2024. This was our forecast earlier this year (in May) and the incoming data thus far has done nothing to persuade us to deviate from it. Data in the months ahead, however, may cause us to readjust that forecast. The outcome in Georgia may determine the size and scope of fiscal stimulus in 2021. A Democratic sweep could boost the size of any stimulus which in turn may increase not only economic activity but consumer spending, inflation, and ultimately longer-term interest rates. The overriding risk would be if the Fed is forced to raise interest rates sooner than previously projected.

Why did we originally think 2024 was an appropriate timeline? There are several ways we arrive at the same conclusion. First, we can let history be our guide. After the 1990 and 2001 recessions, it took about 2.5 years from the end of the recession for the Fed to begin raising rates. The Great Recession, on the other hand, was deeper than those previous two, and therefore took considerably longer (around 6.5 years) for the Fed to start lifting rates. If this recession were to end in Q4, then 2-3 years would take us out to Q1-Q2 of 2023. Considering we're experiencing a GDP decline that's much more severe than the Great Recession, perhaps it will take longer. We're not quite ready, however, to make a 2027 type of forecast.

Alternatively, we can look at it through the dual mandate lens. A material move upward in rates would only occur after a material increase in inflation combined with a material decrease in unemployment. But with falling wages, falling rents, and low energy prices all keeping a lid on inflation, monetary policy should be benign for a very long time.

Finally, we can simply look to the yield curve. A move in the Fed Funds will likely be put off until the Ten-Year Treasury yield is north of 2.00%—a level that appears to still be a long way off.

With the growing possibility that an effective vaccine could be distributed to the broader public by 2021, some economists have predicted that we could see a "supercharged" economy next year, amid a strong reopening and a confident consumer. How likely, if at all, do you find this scenario and what would this mean for the economy, inflation, employment and the Fed?

Very Likely. We need to distinguish two different scenarios that could play out in 2021 and beyond. One is the 'back to normal' scenario and this outcome is very likely as the world over will ignite to satisfy the huge swath of pent up energy and delayed activity that has affected so many areas. This should dramatically fuel the economy, raise employment, and lift inflation, as many metrics get back to normal. However, we must remember what 'back to normal' was in our pre-Covid environment. With tax cuts, low interest rates, and a 50-year low in unemployment, the then-normal inflation rate was near 2%. We believe we can get back to these levels. But many are assuming a different scenario—one with persistent and pervasive inflation for years to come. We do not yet see this playing out. Yes, there will be a shock and boost to the system as we get back to normal, but we see this as a one-time event rather than a continual upward spiral in prices for years to come.

Do you expect that the FOMC will, at any point, adjust the composition of its bond purchases for the primary purpose of stimulating economic growth (thus looking more like a traditional Q.E. program)? Why and how soon, if at all, do you expect it could be implemented.

No. To clarify, "no" as in not in the near future. The Fed will allow the economy to reopen and will monitor the bounce back. If the economy fully recovers (Nike Swoosh) then we wouldn't expect any Fed adjustment. However, if the recovery looks more like a cup and handle (with a flat horizontal handle) then we would expect the Fed to stimulate growth in some way.

What themes and development(s) regarding Fed policy do you think will be most important to keep an eye on in 2021?

The 'back to normal' trade will lift interest rates back to a more normal level. While many analysts suggest longer-term rates for 2021 will stay below 1.50%, we're hesitant to assume this as a given. The challenge then becomes whether the Federal Reserve can avoid overreacting.

To draw a simple analogy from Sesame Street: anyone with kids will recall the recurring segments where a child would be given four objects (three of them similar and one quite different) as the "one of these things is not like the other" song plays and the child decides which one doesn't belong. Let's apply the same approach to Wall Street in analyzing the prospects for 2021. Consider the following as we approach the end of a tumultuous 2020:

1. Large Cap stocks (S&P 500) are at an all-time high;
2. Small Cap Stocks (Russell 2000) are at an all-time high;
3. Gold (and Bitcoin) both hit all-time highs this year;
4. Even Japan is at a 24-year high for U.S. investors; but
5. Nominal yields on 10-year Treasury Bonds have barely budged off their all-time lows set back in March—and are even lower when adjusted for inflation.

Which one of these assets is not like the other? Interest rates are headed north in 2021; moving back to a more normal range (perhaps even above 1.50% which few analysts are predicting and therefore few investors are prepared for). However, the move should not be viewed as a perpetual unwind and instead, a return to normalcy. The challenge will be for the Fed to not overreact to this move higher in longer-term interest rates by raising shorter-term interest rates. That action would not only signal a changing policy but introduce an increased risk to the ongoing recovery heading into 2022.