PORTFOLIO MANAGER INSIGHTS

WEEKLY INVESTOR COMMENTARY | NOVEMBER 10, 2021

Investment Committee

After much anticipation, the Fed has announced that it will begin reducing its monthly asset purchases. Investors have spent months wondering when this process would start given the strong recovery and ongoing market rally. While markets have been taking this in stride, some investors are understandably nervous about what this may mean for their portfolios. Uncertainty around Fed policy is one reason investors ought to maintain a long-term perspective on their investments and financial goals.

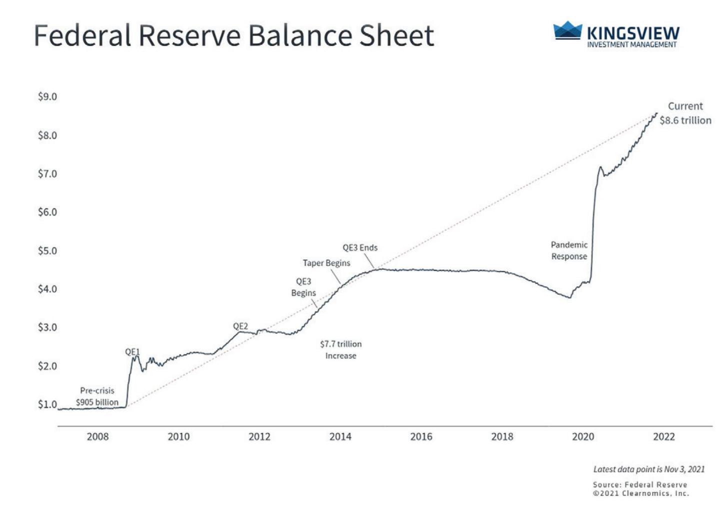
Topics like Fed tapering, rate hikes, the Phillips curve and others can seem complex, but it's important to separate the *how* from the *why*. Mechanically, the Fed's tapering process is simply the first step toward returning to a more "normal" monetary policy. It begins to slow the purchases of Treasury and mortgage-backed securities that began last year as part of the Fed's emergency response to the pandemic, based on its 2008 financial crisis playbook.

The pace of $120 billion per month has caused the Fed's balance sheet to balloon to over $8.6 trillion - significantly larger than the pre-pandemic peak of $4.5 trillion. By reducing these purchases each month beginning in November, the Fed would still be buying bonds through May 2022. This would add up to $420 billion which would push its balance sheet above $9 trillion.

It's important to underscore the fact that the Fed is still buying assets, just at a slower pace. Shrinking its holdings may not happen until much later. After tapering began in 2014, the balance sheet did not begin to shrink until 2018.

While the *how* is quite involved, the motivation for the tapering process is simple: the Fed is refilling the punch bowl at a slower pace before it removes it altogether. This makes sense at a time when emergency stimulus is no longer needed and when monetary policy is arguably playing a smaller role. After all, inflation is rising not necessarily because Fed policy is too loose, but because of strong demand and supply disruptions. The Fed has made it clear that they have little control over these factors.

THE FED IS SLOWING ITS BOND PURCHASES



KEY TAKEAWAYS:

1. **The Fed announced its "tapering" process which simply means that it will slow its bond purchases. Rather than purchasing $120 billion of Treasury and mortgage-backed securities per month, it will reduce this by $15 billion each month beginning in November.**
2. **Even at this pace, the Fed's balance sheet will grow to $9 trillion by the time it ends its asset purchases in mid-2022.**

At the same time, it could still be considered a policy mistake for the Fed to keep financial conditions too easy for too long as inflation heats up, even if they can't directly control the underlying causes. This is especially true at a time when consumers and markets are beginning to expect higher short- and medium-term inflation. The classic runaway inflation scenarios, such as a wage-price spiral, involve an ever-higher expectation of inflation which can become a self-fulfilling prophecy. To stop this, the Fed would have to take dramatic steps.

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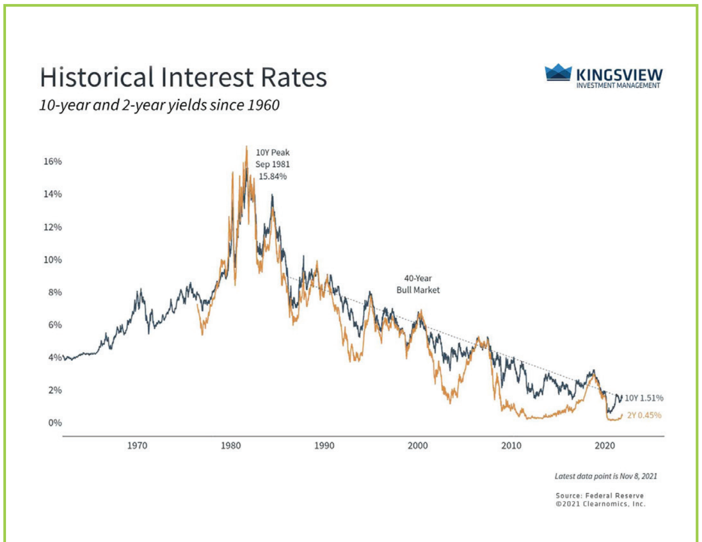
Thus, there are conflicting fears among investors around a) the Fed normalizing then tightening policy, and b) the Fed not tightening enough to combat inflation. Fortunately, the market has taken the shift in Fed policy in stride so far, and history supports this. After endless concerns and some market volatility in 2013, financial markets performed well the rest of the cycle. This occurred despite not only tapering but a shrinking Fed balance sheet and several rate hikes. Ultimately, it was the strong underlying trends in the economy that mattered most.

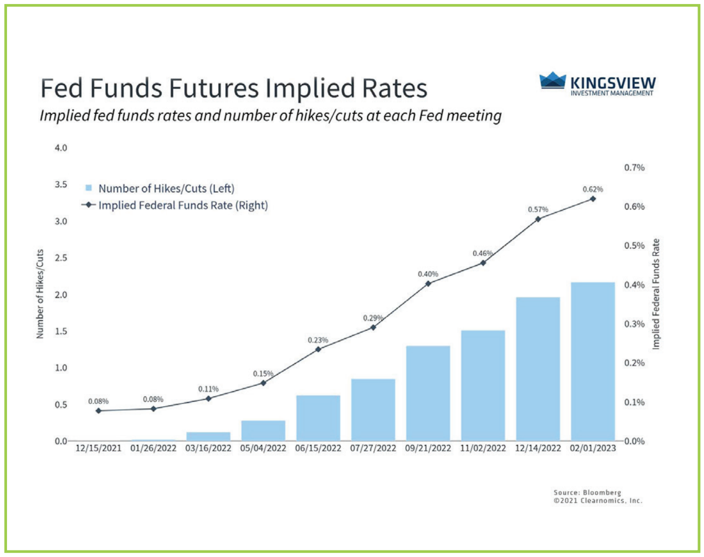
INTEREST RATES ARE RISING IN ANTICIPATION OF FED RATE HIKES



KEY TAKEAWAYS:

1. **Short-term interest rates have been rising. This is because the tapering process is the first step in eventually raising the fed funds rate.**
2. **The Fed has communicated via their Summary of Economic Projections that most officials expect to hike rates once by the end of 2022.**

THE MARKET EXPECTS THE FED TO HIKE RATES FASTER



KEY TAKEAWAYS:

1. **Market-based expectations, on the other hand, have been adjusting upward. At the moment, fed funds futures suggest that there could be at least two rate hikes by the end of 2022.**
2. **Over the past year, the Fed has adjusted its expectations toward the market, not the other way around.**

Similarly, while there are concerns building within the market as the "everything rally" continues, it's unlikely that reduced bond purchases or a few rate hikes will be what derail current trends. Instead, all market cycles have their ups and downs related to growth, profits, interest rates and valuations. Focusing on these factors instead can shed more light on the state of the market than focusing on the Fed alone.

In other words, investors should continue to hold balanced portfolios that match their financial goals, rather than focus too much on when the Fed will finally raise rates one-quarter of one percent.