How Will the Fed's Shifting Message Impact Markets?

A little over a month ago, the Federal Reserve announced plans to gradually unwind ("taper") their quantitative easing programs. The plans put forward were to trim the monthly bond and mortgage security purchases by $15 billion per month, effectively ending the QE program by June 2022.

By the end of November, however, those plans had changed.

In a testimony to the Senate Banking Committee on November 30th, Federal Reserve Chairman Jerome Powell admitted that "pricing increases have spread much more broadly" than anticipated in the economy, and that the Fed "didn't predict supply-side problems." In other words, inflation is running hotter-than-expected for longer-than-expected, and the Fed is responding by accelerating the taper and potentially setting the stage to raise interest rates on a faster timeline next year.[1]

From an investment standpoint, a more hawkish Federal Reserve is often believed to be problematic. A reduction in monetary stimulus, coupled with rising interest rates, surely cannot be good for stocks, right?

A quick review of recent history can help us address this question. There is only one previous instance of Fed tapering, in 2013, and the stock market endured some short-term selling pressure in the midst of the QE's unwinding. But the selling pressure did not last very long. From the time Ben Bernanke announced QE would be reduced (summer 2013) to the actual end of QE (fall 2014), the S&P 500 went up over +20%.[2]

The Fed then started raising interest rates in December 2015, pushing the fed funds rate from 0.5% in December 2015 all the way up to 2.5% by December 2018. As readers can see from the chart below, Fed tightening during the last bull market caused a few blips and pullbacks, but QE tapers and rate hikes were not powerful enough to prevent the stock market from pushing higher.

The S&P 500 Over the Last Decade

Source: Federal Reserve Bank of St. Louis[3]

I similarly do not expect a shift in the Federal Reserve's current messaging and policy to have a meaningful effect on stocks. The stock market has long known about the Fed's plans to gradually remove monetary policy stimulus, and a slightly accelerated, well-telegraphed timeline for policy changes should not serve as a negative surprise.

In fact, markets may even welcome an accelerated taper – since QE purchases put downward pressure on long-dated U.S. Treasury bond yields, QE is effectively flattening the yield curve and squeezing bank profits in the process. If an accelerated taper allows longer duration bond yields to move higher while short-term interest rates remain close to zero, it could spur more bank lending – a good outcome for the economy.

As for the Fed moving up their timeline for interest rate increases, I think it is important for investors to remember that bull markets tend to end after the Fed's last rate hike – not their first one. As readers can see in the S&P 500 chart above, the U.S. stock market can continue to do well even as the Federal Reserve engages in fed funds rate increases. That process may begin in 2022, but it does not mean the bull market has to end as a result.

Bottom Line for Investors

In my view, the Federal Reserve's shifting message and policy is in response to a *good problem.* In the words of New York Fed President John Williams, the U.S. economy is "roaring back," and supply/demand imbalances are putting pressure on prices. Demand is above pre-pandemic levels, and supply can't keep up. I don't see this as a permanent problem.

Even still, the Fed is probably right to take some action, even if only for optics. A slightly accelerated taper timeline and the possibility of rising rates next year are not likely to move the needle on inflation at all, in my view, and I concurrently don't see much effect of this tightening on the economy or stocks. I've written before that *corporate earnings and economic growth matter more than the Fed,* and I do not think a slight shift in the Fed's messaging and policy will affect either in the coming year.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Wall Street Journal. November 26, 2021. https://www.wsj.com/articles/high-inflation-falling-unemployment-prompted-powells-fed-pivot-11638786601

[2] The Balance. November 9, 2021. https://www.thebalance.com/fed-funds-rate-history-highs-lows-3306135

[3] Fred Economic Data. December 6, 2021. https://fred.stlouisfed.org/series/SP500

Weekly Market Update

Important Market News We Think Worth Considering

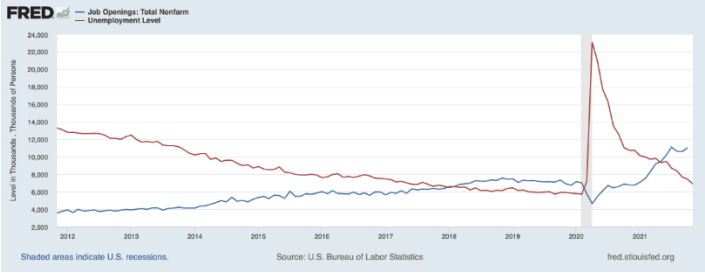
IN FOCUS THIS WEEK

- **Tight U.S. labor market**
- **Omicron's effect on southeast Asia manufacturing**

A Very Tight U.S. Labor Market

Inflation pressures and the pandemic have many Americans feeling as though the economy is not headed in the right direction. But economic fundamentals paint a different picture, which is why there seems to be a 'disconnect' between stock market performance and people's general views on the economy. One case-in-point of an underappreciated, strong economic fundamental: the jobs market. In the U.S., the number of job openings far exceeds the number of unemployed people. According to ZipRecruiter, there are approximately 11 million available jobs in the U.S. versus 6.9 million unemployed people actively looking for work (see chart below). Such a strong labor market largely gives workers leverage – the ability to quit a job and seek a better-paying one, the ability to negotiate higher wages and sign-on bonuses, and the possibility of securing better benefits. Indeed, a recent survey by the Conference Board found that U.S. companies are setting aside an average of 3.9% of total payroll for wage increases in 2022, which is the highest percentage recorded since 2008. The survey also reported that companies are planning to lift salary ranges, both of which should put U.S. households on a path to increase saving and spending in the new year – particularly if inflationary pressures ease.

Below, a chart showing the number of job openings (blue line) compared to unemployed workers (red line).[1]



Source: Federal Reserve Bank of St. Louis[2]

Will Omicron Wreak Havoc on Southeast Asia Manufacturing?

The surge of the Delta variant created problems for Southeast Asia manufacturing hubs, like Vietnam, Malaysia, and Thailand. We covered some of these factory shutdowns in this space and added that these closures were a key part in creating bottlenecks in the supply chain that still exist today. Fortunately, some of the key players in the region – Thailand and Vietnam specifically – have shifted away from aggressive pandemic measures like full shutdowns, instead opting for less restrictive measures that allow the economy to continue producing. These moves have been helped along by rising vaccination rates, which are likely to continue trending higher as more vaccine supply becomes available.[3]

ZACKS INVESTMENT MANAGEMENT, INC.
www.zackspcg.com

[1] Wall Street Journal. December 8, 2021. https://www.wsj.com/articles/giant-gap-persists-between-job-openings-and-available-workers-11638959405?mod=djemRTE_h

[2] Fred Economic Data. December 9, 2021. https://fred.stlouisfed.org/series/JTSJOL#0

[3] Wall Street Journal. December 6, 2021. https://www.wsj.com/articles/supply-chains-in-southeast-asia-are-less-vulnerable-after-delta-driven-disruptions-11638794416?mod=djemRTE_h

DISCLOSURE

Past performance is no guarantee of future results. Inherent in any investment is the potential for loss.

Inherent in any investment is the potential for loss. Zacks Investment Management, Inc. is a wholly-owned subsidiary of Zacks Investment Research. Zacks Investment Management is an independent Registered Investment Advisory firm and acts as an investment manager for individuals and institutions. Zacks Investment Research is a provider of earnings data and other financial data to institutions and to individuals.

This material is being provided for informational purposes only and nothing herein constitutes investment, legal, accounting, or tax advice, or a recommendation to buy, sell or hold a security. Do not act or rely upon the information and opinions given in this document without seeking the services of competent and professional investment, legal, tax, or accounting counsel. Publication and distribution of this document is not intended to create, and the information and opinions contained herein does not constitute, an attorney-client relationship. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors, or markets identified and described were or will be profitable. All information is current as of the date of herein and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole.

Any projections, targets, or estimates in this document are forward looking statements and are based on the firm's research, analysis, and assumptions. Due to rapidly changing market conditions and the complexity of investment decisions, supplemental information and other sources may be required to make informed investment decisions based on your individual investment objectives and suitability specifications. All expressions of opinions are subject to change without notice. Recipients should seek financial advice regarding the appropriateness of investing in any security or investment strategy discussed in this document.

Certain economic and market information contained herein has been obtained from published sources prepared by other parties. Zacks Investment Management does not assume any responsibility for the accuracy or completeness of such information. Further, no third party has assumed responsibility for independently verifying the information contained herein and accordingly no such persons make any representations with respect to the accuracy, completeness or reasonableness of the information provided herein. Unless otherwise indicated, market analysis and conclusions are based upon opinions or assumptions that Zacks Investment Management considers to be reasonable.

Any investment inherently involves a high degree of risk, beyond any specific risks discussed herein.

It is not possible to invest directly in an index. Investors pursuing a strategy similar to an index may experience higher or lower returns, which will be reduced by fees and expenses.