Wentz Weekly

December 20, 2021

Resetting Expectations

Since the market lows last March, the S&P 500 and NASDAQ have gained a staggering 116% and 144% respectively, one of the strongest and fastest recoveries ever experienced. Minus some occasional volatility, the market seems to have gone up in a straight line since the bottom. However, it is important as we head into 2022 the need to reset those expectations as the market environment will be drastically different. The supply chain issues, bottlenecks, inflationary pressures, labor shortages, rising interest rates, mid-term elections, and continued waves of covid are all issues we believe we will continue to see in 2022. With all these issues, the Fed faces a conundrum – increase rates in an environment where growth is expected to slow. The Fed may be too late to act, and as we look forward will feel the need to raise rates to combat the rising inflationary pressures and tight labor market that is much closer to its 2019 levels. This means a rising risk for stagflation – an environment which represents slow economic growth combined with high inflation, initially seen in the 1970s.

What this means for investment portfolios is lower returns. With interest rates rising, we expect no return from the fixed income markets (prices decline in a rising interest rate environment). With growth slowing and investors already giving stocks a premium valuation due to low interest rates and expected growth throughout 2021, we see stock returns as being more muted, especially in comparison to returns over the past two years. The stimulus that has driven the recovery will essentially stop by the end of the first quarter. Americans saw the last advance payments of the child tax credit in December and those with student loans will be forced to begin payments again after the forbearance ends January 31st, both equaling an estimated $26 billion less that Americans will have to spend. In addition, the Fed will no longer be purchasing securities and the government will issue more debt after raising the debt ceiling, creating more supply and less demand in the Treasury market. The story is much different than 2021 and why resetting expectations is needed. We expect much more volatility and lower growth in equities but continue to favor the asset class, particularly those that pay dividends.

The December Fed meeting gave a much more hawkish stance on monetary policy. First, the Fed announced an acceleration to its taper timeline, doubling the pace in which it will reduce its monthly asset purchases. At this schedule, quantitative easing will end by March. Second, the Fed pulled forward its expectations on interest rate increases, with the "dot plot" showing the average Fed member sees three rate increases in 2022 with a rate of 0.9% by year end (up from 0% now), and 1.6% by 2023. The longer-term/terminal rate remains at 2.5%, but how fast we get there has changed. During the press conference, Chair Powell said "after March that we can raise interest rates as and when appropriate." Last, the Fed removed language around the inflation goal and gave a more upbeat view on the labor market. Powell admitted inflation has become more persistent and "the risk of higher inflation becoming entrenched has increased," while focusing a lot on the quits rate in the labor market which suggests the labor market is very tight. The next new discussion and argument will be when does the Fed begin its balance sheet runoff (start reducing the size of its balance sheet – in other words when does it start getting rid of all the bonds it bought over the past 18 months). Treasury yields move higher along the curve especially on the short end, resulting in a flatter yield curve. Interestingly, stocks moved higher likely because investors cheered the news the Fed would fight higher inflation and reduce the risk of stagflation. However that was short lived as the markets finished the week on a weak note.

The Fed was not the only Central Bank meeting last week, several others held their own policy meetings with the message close to the Fed's. The Bank of England made the biggest move, unexpectedly deciding to raise its key interest rate by 0.25% from its record low level of 0%. Its Governor said the reason is because monetary policy will not solve supply-side problems but it was forced to act due to the risk to higher medium-term inflation and inflation expectations. The European Central Bank and Bank of Japan both remain very accommodative but announced plans to scale back their emergency asset purchase programs that were implemented at the onset of the pandemic. However, the ECB said it remains flexible and hinted at expanding its normal bond purchases, indicating interest rate hikes are much further off than the rest of the world.

Speaking of inflation, producers are seeing the prices they pay that make the good we use increase at the highest pace ever. Wholesale prices, measured by the producer price index rose 0.8% in November, higher than the 0.5% increase expected, with core prices up 0.7% in the month, also higher than expected. Compared to a year ago the index was 9.6% higher for the highest ever recorded and accelerating from the 8.8% rate in October. Core prices were 6.9% higher from a year ago, accelerating from 6.3% in October. Producer prices are sometimes an indicator on what inflation will look like on the consumer level.

U.S. retail sales rose 0.3% in November, down from October's strong 1.8% increase, and lower than the 0.8% increase expected. Compared to a year ago retail sales are 18.2% higher, accelerating from October's 16.3% increase. When accounting for inflation on a real basis retail sales fell 0.5%, after accounting for a 0.8% increase in prices per the consumer price index. Excluding gas and auto sales, which both tend to be more volatile categories, retail sales were up just 0.2%. Categories seeing lower sales included department stores down 5.4%, electronics and appliances down 4.6%, and health/personal care down 0.6%. All other categories were higher with gas seeing a 1.7% increase followed by sporting goods store at 1.3%. Online sales were flat in the month and lower than the y/y rate at 12.1%. The report is another indication Americans chose to start holiday shopping earlier and over a wider period.

Company News

- Harley-Davidson said it will spin off LiveWire, its all-electric motorcycle business, into a separate public company through a SPAC deal which will have a $1.8 billion enterprise value. Harley-Davidson will retain a 74% stake in the new company.
- FedEx crushed earnings expectations reflecting what the company said was "very strong demand and pricing environment." Labor costs were higher but the company said headwinds seen over the past several quarters are beginning to fade and it saw the most job applicants ever.
- Pfizer said it is acquiring Arena Pharmaceuticals for $100/share in an all-cash transaction valued at approximately $6.7 billion. Arena is working on treatments for several immune-inflammatory diseases.

The Week Ahead

It will be a holiday shortened trading week this week with the markets closed on Friday in observance of Christmas. The economic calendar will remain busy this week until then. On Wednesday the third revision on third quarter GDP as well as the Conference Board's survey of consumer confidence are released. The week will also include a couple housing indicators including existing home sales on Wednesday and new home sales on Thursday. Elsewhere on Thursday we will see an update on weekly jobless claims, durable goods orders, consumer sentiment survey from the University of Michigan, and the monthly personal income and outlays report which includes the PCE price index, the Fed's preferred measure of inflation. The corporate calendar will be light but there are several notable earnings reports including Carnival, Nike, and Micron on Monday, Rite Aid, General Mills, and Blackberry on Tuesday, and CarMax and Paychex on Wednesday. We hope everyone has a Merry Christmas!

The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market. The Dow Jones Industrial Average (DJIA), commonly known as "The Dow" is an index representing 30 stock of companies maintained and reviewed by the editors of the Wall Street Journal. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represent approximately 8% of the total market capitalization of the Russell 3000 Index. The NASDAQ composite is an unmanaged index of securities traded on the NASDAQ system. Every investor's situation is unique and you should consider your investment goals, risk tolerance and time horizon before making any investment. Information contained herein was received from sources believed to be reliable, but accuracy is not guaranteed. Information provided is general in nature and is not a complete statement of all information necessary for making an investment decision and is not a recommendation or a solicitation to buy or sell any security. Investing always involves risk and you may incur a profit or loss. Keep in mind that individuals cannot invest directly in any index. Past performance does not guarantee future results. There is no assurance these trends will continue, or forecasts will occur. Opinions expressed in the attached article are those of the author and are not necessarily those of Raymond James. All opinions are as of this date and are subject to change without notice.