First Trust
Monday Morning OUTLOOK

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Volatility and Fear

At the close on Friday, the NASDAQ Composite Index was down 6.1% and the S&P 500 was down 3.5%, from their recent all-time record highs. The 10-year Treasury yield, which was 1.67% as recently as the week of Thanksgiving, was yielding 1.35% at the close on Friday. Oil prices have fallen about 22% from their highs and Bitcoin was down about 28% over this past weekend.

Some investors are worried about the Omicron variant of COVID-19, and maybe further variants to come. But many are concerned about the Federal Reserve speeding-up its pace of tapering quantitative easing, which could set the stage for interest rate hikes in 2022. Meanwhile, the odds of passing President Biden's signature fiscal plan – the so-called Build Back Better proposal – appear to be no better than 50%, down significantly from earlier this year.

What this reminds us of is the "stop-go" Keynesianism of the 1970s, where policymakers would whipsaw between goosing the economy through loose money and extra government spending, then battling the ensuing inflation by tightening monetary policy, slowing the growth of spending, or even by raising taxes. This ping-pong policymaking was not healthy for the stock market: the S&P 500 increased at a 1.6% annual rate in the 1970s as consumer prices rose 7.4%.

In recent weeks, the stock market has decided the economic pain associated with an eventual tightening of fiscal and monetary policy is more likely to come sooner rather than later. Investors realize the budget deficit in the year ahead is likely to be much smaller than the past couple of years, which will be good for the long-run but could be an economic headwind in the near future.

Meanwhile, the Fed meets next week and recent testimony by Fed Chairman Jerome Powell indicates it will likely hasten the pace of tapering. One theory is that the Fed could finish tapering as early as March next year. That's consistent with the futures market for federal funds, which appears to be pricing in two or three rate hikes in 2022 (assuming the rate hikes are 25 basis points each).

We think taking the economic pain earlier rather than later is the better option. The next report on consumer prices arrives on Friday and we are estimating an increase of 0.7% in November. If we're right, that would mean consumer prices are up 6.8% from a year ago, the largest increase for any twelve months since the early 1980s.

The longer the Fed waits to address this, the harder it will be to stop. In the early 1980s, Paul Volcker ended up pushing the federal funds rate to nearly 20%, which caused a brutal set of recessions. Some tightening now, versus more tightening later, would signal wisdom in managing monetary policy.

We also think the economy could handle both a faster taper and earlier rate hikes. Remember, even when it's tapering, the Fed is still expanding its balance sheet, it's just doing so at a slower rate. Meanwhile, with inflation approaching 7%, the "real" (inflation-adjusted) federal funds rate is lower than it ever was in the 1970s.

But mark us down as skeptical about two or three rate hikes in 2022. Policymakers and politicians may be willing, but the flesh is weak. After the last time the Fed finished a tapering operation, back in 2014, it raised rates only when the 10-year Treasury yield was above 2.00%, not below. It's hard seeing the Fed getting aggressive with rates with the 10-year yield south of 2.00% and, right now, we're at about 1.4%. Maybe the Fed will raise once; two or three times seems like a stretch, even if the economy could handle it and inflation suggests more rate hikes are needed.

Sooner or later, though, the US will have to pay a price for COVID era looseness in both money and fiscal policy. For now, we're betting more of the pain comes after 2022.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-7 / 7:30 am	Int'l Trade Balance – Oct	-$66.8 Bil	**-$67.6 Bil**		-$80.9 Bil
7:30 am	Q3 Non-Farm Productivity	-4.9%	**-5.3%**		-5.0%
7:30 am	Q3 Unit Labor Costs	+8.3%	**+8.8%**		+8.3%
2:00 pm	Consumer Credit– Oct	$25.0 Bil	**$20.0 Bil**		$29.9 Bil
12-9 / 7:30 am	Initial Claims – Dec 5	220K	**235K**		222K
12-10 / 7:30 am	CPI – Nov	+0.7%	**+0.7%**		+0.9%
7:30 am	"Core" CPI – Nov	+0.5%	**+0.5%**		+0.6%
9:00 am	U. Mich Consumer Sentiment- Dec	68.0	**68.4**		67.4