ALPHA SOURCES

JANUARY 31, 2022

WHERE IS THE FED PUT?

Financial markets have a tendency to gravitate towards the same narratives over and over, a bit like a good script writer who knows, obviously, that the hero always has to save the cat in the first scene. Core and headline Inflation have soared, and the Fed, as the perennial first mover among the major central banks—curiously flanked by its trusty squire the BOE—is now determined to kill it with rate hikes and QT, having recently abandoned all hope it being ‘transitory’.

Cue new scene, and we are witnessing a torrent of forecasters tripping over each other to proclaim that they now think the federales will lift the Fed funds rate by five, six, or even seven, times this year, not to mention shrink its balance sheet by $1T. Markets have been blissfully ignoring the threat of monetary policy tightening, until now. As I type global equities are down 5-to-10% month-to-date in January, and the yield curve is flatter. What comes next?

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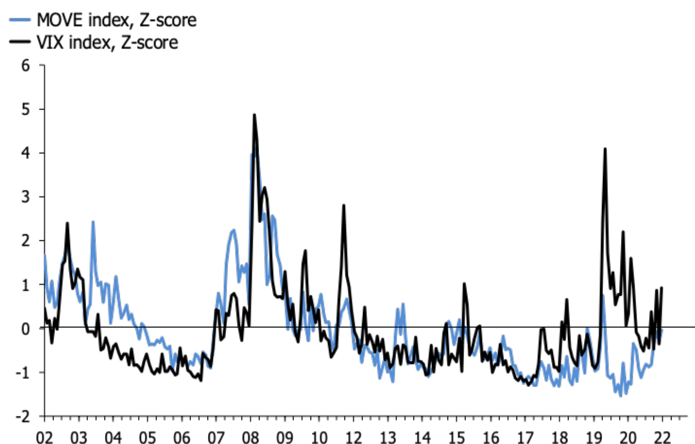
In the traditional script, the Fed does indeed save the cat, mainly by folding like a cheap suit in the face of rising market volatility. Is this time different? It could be. This week has been dominated by a discussion market participants will be familiar with; the strike price of the Fed put. For the uninitiated, this is the threshold at which the FOMC will step in and support markets. It is most often expressed as a percentage-point loss, beyond which further downside are intolerable for policymakers.

So, where is it? I don't know, but it seems clear that market participants believe it is a good deal lower than 10%, which, if true, means that last week's strong close is a sell. Bloomberg's Cameron Crise recently made the general point that *"Inflation has lowered the strike price of the Fed put ... and unless growth expectations deteriorate enough to raise it again, risky assets are going to have to learn to deal with an "unfriendly" Fed."*

I think this is an accurate observation, and it puts markets in a vice. If the economy improves further, it will be interpreted as a source of inflation risk, and if, as Cameron suggests, growth expectations deteriorate, this presumably hurts earnings.

Other observers concur. Bridgewater hit the tapes last week with the observation that it would take a 20% drop in the S&P 500 before the Fed steps in. In a note, HSBC said

fig. 01 / Vol is still rising... - **fig. 02** / ...and the curve is flattening



that; “the strike price of the "Fed put" appears much lower than in the last few years”.

Taking this story at face value, equities are headed for a bear market, and there is nothing policymakers either can, or will, do about it.

With that as an initial condition. I’d focus on two sources of upside. **First**, earnings matter, more than ever. Remember, the idea is that higher inflation—and in the fact that the Fed has to tighten policy sharply to fight it—is a multiple-crushing exercise.

This is obviously a problem for an equity market where valuations have been pushing records for a long time. Anecdotally, it seems to me that the main victims of the sell-off so far have been firms with either no earnings, or earnings far out in the future. This makes sense. It also means that stock pickers should be able to do well, unless of course policy tightening drives the economy into recession.

For the market as a whole, though, it’s worth remembering that earnings have done really well in a post-virus context. The MSCI World is now trading at a forward P/E of 18, down from a peak of 25 at end of 2020. The trailing P/E is 21, down from a high of 33 in February last year, with earnings up 73% over the same period. These valuations are high, but they’re a lot better than a year ago, and this is because of a rebound in earnings.

fig. 03 / Goods PPI will soon fall - **fig. 04** / …but services inflation remains sticky

The challenge now is that aggregate earnings growth almost surely is now slowing, but individual stocks and sectors could do quite well. If the ability to deliver earnings is paramount, it suggests that the traditional recommendation to shun growth equities in an environment of higher inflation could be a bit too simplistic. This is to say, large-cap tech could well be one of the best bets on sustained strong earnings growth.

In addition, as Jon Turek pointed out, to the extent that the Fed is now an aggressive inflation fighter, it could well support growth stocks, presumably by flattening the yield curve. You could also follow my advice, and buy both.

Secondly, it's worth noting the most obvious upside of them all; lower inflation, slower wage growth, and a rebound in the labour supply, mainly in the US. The first is less outlandish than it sounds. After all, US headline inflation won't stay at 7% forever, and as it eases, it's likely that the most aggressive assumptions for Fed tightening will have to be revisited. I hold this to be true even if the pre-virus days of Goldilocks is now ever. **The first test for this thesis will be this week's nonfarm payroll numbers, where I'd comfortably bet that markets would rally in the event of a jump in the labour force participation rate.** This is because it would signal that the Fed has a bit more room to breathe than initially assumed.

In the meantime, I am confident that financial markets will remain preoccupied with the question posed last week; where is the Fed's put?

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