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COMMENTARY

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Taper Talk Rattles Stocks

- U.S. equities log their worst week since February on Fed policy concerns.
- The Fed seems to have pivoted from its stance that inflation will be transitory.
- In uncertain times, diversification remains the best investment strategy.

Last week, U.S. equities were lower with the S&P 500 logging its worst week since February after a 1.3% decline on Friday. Equity markets struggled as investors continued to digest the more hawkish-than-expected Federal Open Market Committee (FOMC) meeting and the Federal Reserve (Fed) dot plot that suggested two potential interest rate hikes in 2023. When we laid out our 2021 primary investment themes, we noted mounting risks would be a concern as the economy transitions from an early-cycle to mid-cycle recovery. One specific risk we highlighted is potential inflation and the Fed being too optimistic about its transitory nature. We feel last week was a clear sign that both the Fed and financial markets might be wrong.

When the pandemic-induced recession started last March, the Fed began an unprecedented stimulus package that included cutting interest rates to near zero and implementing a $120B per month treasuries and mortgage-backed securities purchase program. The Fed implemented both policies to help stimulate the economy by keeping borrowing costs low. Despite a recent jump in inflation, Fed members indicated that it would be transitory and therefore not likely to lead to a need to either raise interest rates or reduce these purchases, known as tapering, to reduce price pressures anytime soon. In fact, in early June, New York Fed President John Williams, the usual voice of the Fed consensus perspective, stated “we’re still quite a ways off” from tapering. Unfortunately, at this past week’s FOMC meeting, where interest rate policy is primarily set, the new edition of the Fed's Summary of Economic Projections (SEP) and Fed Chairman Jerome Powell's commentary indicating a potential path toward tapering raised investor concerns. These seemed to be an about-face from Fed statements just a couple of weeks earlier and increased worries that maybe the Fed has underestimated the transitory nature of it. The icing on the cake occurred on Friday when St. Louis Fed President James Bullard seemed to indicate that inflation is more than policymakers expected, making an interest rate hike necessary by late 2022. Friday’s selloff was sharp with all 11 S&P 500 sectors lower on the day.

In general, inflation worries investors. Bond investors demand higher yields to compensate them for inflation’s effect on purchasing power. This impacts equities because higher borrowing costs from rising yields make corporate debt more expensive. Couple higher borrowing costs with widespread shortages of components, materials and freight services along with wage growth at 20-year highs, rising inflation is an important market concern. The Fed knows this and uses interest rate policy to raise interest rates to combat it. However, as we have noted in past commentaries, we continue to see evidence that inflation may not be as transitory as the Fed anticipates and policymakers may need to be a bit more aggressive in their tapering. Though the Fed did not officially announce any tapering plans in their FOMC meeting last week, this may change sooner than later. Our best estimate is that policymakers will provide some sort of warning at their annual Jackson Hole symposium in late August or their September meeting when they next update their dot plots. If inflation continues to prove less transitory than anticipated, expect official tapering to begin early in 2022. Financial markets seem to be geared toward this scenario as we saw a sharp selloff in economically sensitive commodities, a strengthening U.S. dollar, and a flattening yield curve on Friday. All three of these indicate that investors expect a possible shift to a more hawkish interest rate policy than was anticipated.

Equities had a tough week and we anticipate more volatility in the near-term. Any disruption to current expectations could be a headwind to stocks, and stock market valuations priced to perfection could amplify this volatility. We may see a stock market correction at some point this year, but we still don’t expect a big selloff like we saw last spring. We maintain that diversification is the key in this market. In these times, your financial professional can help you stay focused on your long-term risk and return goals and help you with your personalized investment objectives.

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Glossary

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