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Pandemic recovery:

Normalizing policy and market risks

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The United States Federal Reserve (Fed) is faced with continued challenges as it seeks to manage both the cyclical and structural economic fallout from the pandemic and move beyond its ultra-accommodative policies. Fed Chair Jerome Powell indicated at the most recent Federal Open Market Committee (FOMC) meeting a desire to shift away from the central bank's bond purchases by the middle of 2022, suggesting an end to quantitative easing in the near future. For investors, the shift toward policy normalization indicates a slightly more challenging environment ahead and therefore a need for more selective portfolio allocation.

Tapering is becoming a more likely reality.

The Fed is likely to start tapering asset purchases before year-end and complete it by mid-2022 – Fed Chair Jerome Powell offered the timeline for tapering at the September FOMC meeting. Speculation remains about when policy rates will rise, which the Fed has tied to further considerable progress on its maximum employment goal. Of course, the timing of rate liftoff could be delayed if there's a resurgence of virus variants or a severe economic slowdown, but it's fair to assume that the beginning of tapering may be a sign that rate hikes are not as far off as some have expected.

Labor supply continues to be impacted by a variety of factors.

Although there may be an increase in labor supply as unemployment benefits expire and children return to in-person schooling, the breakdown of returning workers and recovering participation rates shows that retirements have increased by more than would be expected from normal aging patterns. This may be a sign that there are structural issues impacting the labor supply. The fact that labor participation could remain depressed should be a point of concern for the Fed, and Chair Powell has recently acknowledged that further progress toward its labor market goal is required before they can consider fed funds rate increases. The Fed will be looking to see progress by early next year, with less emphasis on payroll numbers and more focus on participation.

Uncertainty around inflation expectations remains.

Inflation continues to be a point of concern for many, even as long-term inflation expectations stay anchored around the 2% level. Policymakers and investors generally agree that once supply chain issues are resolved, inflation pressures should ease. However, if transitory shocks are prolonged or repeated, inflation expectations will become de-anchored, and broad-based inflation will become more persistent. Policymakers are also concerned about wage inflation, particularly as commentary from CEOs suggest higher wages are posing a threat to company margins. So far, the U.S. employment cost index and the Fed's favored Atlanta Wage Growth Tracker point to little evidence of wage increases that might portend unwelcome inflation, and productivity gains through the pandemic suggest that the effect of restricted labor on costs has not been too troublesome.

If inflation does prove to be more persistent and economic activity starts to struggle under the weight of higher prices, the Fed will face a tough dilemma: Raise rates to fight inflation and inadvertently hurt activity when it's already struggling, or restart asset purchases to insulate activity, but inadvertently boost inflation further. This trade-off would be unfamiliar territory for many investors, and that uncertainty would be disruptive for risk assets.

Rate liftoff and the reaction of the bond markets.

Chair Powell has made the point that there's no mechanical link between the timing of tapering and the timing of liftoff. Interestingly, yields had stayed very low in recent months despite tapering being just a few months away. While this was potentially a sign of the Fed's communication success, factors such as the Delta outbreak, slowing economic growth, and slower treasury issuance, combined with easy global liquidity conditions and the permanent presence of the U.S. significant savings glut, are contributing to the low yields.

The most recent "dot plot," which measures policymakers' expectations for where interest rates are heading, projected the federal funds rate to be 1.75% by the end of 2024, indicating three rate hikes in 2023 and another three in 2024. After a kneejerk rally, U.S. treasurys have recently sold off sharply as investors digest that the Fed is finally taking steps towards policy normalization.

Federal debt levels can be managed, for now.

With the Biden Administration's infrastructure plan and the potential for tax hikes in the foreseeable future, the fiscal state of governments is becoming increasingly relevant for investors. The U.S. has a lot of so-called "fiscal space" because of its borrowing capacity, depth of financial markets, and economic strength. With the low-rate environment and real interest rates on government debt being negative, public spending can be easily rationalized. However, at some point, the interest payments on U.S. debt will become a more significant chunk of the government's budget, and tough choices will have to be made to service the debt load. In the near term, however, with interest rates so low, interest payments are manageable but something to keep an eye on.

The recent boon in home prices is different from the runup to the GFC.

While the prolonged spike in home prices might feel similar to what was experienced in 2004–2007, it's different in at least two ways:

- First, the quality of the mortgages underlying the purchases is much higher, the mortgage industry is healthier, and the banks are stronger and better capitalized.
- Second, and more fundamental to the market itself, there's been a significant shift in the types of housing people want.

For example, when people determined that they could work from home during the pandemic, the demand for housing in the suburbs surged. However, as the inventory of unsold and available housing is very low (a compounding problem of both a demographics shift and new home construction slowing during the pandemic), many homebuyers are forced into bidding wars, driving prices higher. The Fed is paying close attention to housing prices—it's part of their mandate to worry about financial stability—but this is a very different phenomenon than what transpired before the Global Financial Crisis.

The Evergrande crisis is not China's Lehman moment.

Some headlines have compared Evergrande to Lehman Brothers, but there are very few parallels, other than a big company that is in financial trouble. China has much more control over its financial system than the U.S. and is closely monitoring the Evergrande situation—and more broadly the real estate markets in China—which are an important part of their economy. However, since they are a state capitalist system, China can intervene quickly to take action against large market movements.

Policymakers face a moral hazard dilemma: They want to punish reckless speculative behavior, but they're very sensitive to the need to avoid the wider financial and economic risks posed by a collapse of Evergrande. As a result, the Chinese government will likely negotiate with stakeholders to take some loss, but not enough for a disorderly exit, preventing it from becoming a systemic issue. If regulators can break the self-reinforcing feedback loops between developers and banks, the channels of financial risk will not spiral out of control.

Implications for investors.

With the inflation goal fully met, the Federal Reserve is finally turning its attention to policy normalization. Given that market-based measures of inflation expectations are still anchored and other measurements suggest a limited threat of wage inflation, rate hikes are likely a long way off.

While this should be a source of comfort for investors, concerns are growing that inflation will be more persistent than expected and higher prices will eventually weigh on economic activity. Angst over how the Fed might respond to such a dilemma has contributed to both the recent bond market sell-off and to equity market weakness. Add in the Chinese government facing its own policy dilemma, and market risks are perhaps greater than they have been since last year. Against the current backdrop, managers with the ability to be more selective, more focused on quality and certainly, more nimble, should be in high demand.

Risk considerations

Investing involves risk, including possible loss of principal. Fixed-income investments are subject to interest rate risk; as interest rates rise their value will decline. Past performance is no guarantee of future results. International and global investing involves greater risks such as currency fluctuations, political/social instability and differing accounting standards.

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