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Investment Insights Monthly

From The Desk of Bill Hornbarger, Chief Investment Officer September 2021

Ruminations on Monetary Policy

According to the 11th edition of *The Fed Explained: What the Central Bank Does*, the Federal Reserve performs five functions to "promote the effective operation of the U.S. economy and, more generally, to serve the public interest." All five functions are important to the operation of the U.S. financial system, but of particular interest to investors is the Fed's oversight and implementation of monetary policy.

The Federal Open Market Committee is the group within the Federal Reserve System that sets monetary policy and makes all the decisions around the appropriate stance and implementation. The FOMC has two congressionally mandated goals of "maximum employment and price stability." To date, there is no explicitly stated definition of what full employment is while the Fed feels that a 2% inflation rate (measured by the annual change in the price index for personal consumption expenditures) over the longer term is consistent with the price stability mandate. Recently the Fed clarified that the 2% level is not a target but an average rate, meaning that following a period when inflation has been below the 2% target, the Fed will be comfortable with it being above 2% for a period.

The Fed has a variety of tools available to it as it pursues these goals. The one that most investors are familiar with is the target federal funds rate (the rate at which depository institutions lend to each other). As an additional policy tool, the FOMC also uses forward guidance (rhetoric) about its policy rate to influence expectations about the future course of monetary policy. In addition, the FOMC sometimes leans on balance sheet policy, where it adjusts the size and composition of the Federal Reserve's asset holdings, to assist with market functioning and help foster accommodative financial conditions.

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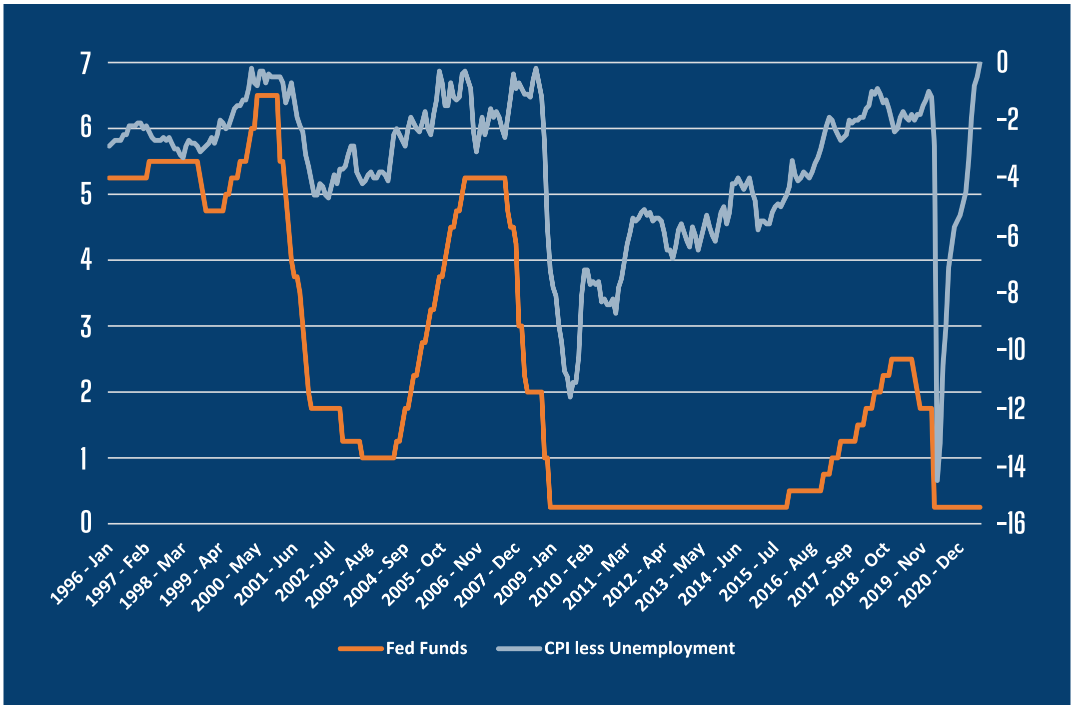
Monetary policy most directly impacts the current and expected path of short-term interest rates which then affects overall financial conditions, including longer-term interest rates, stock prices, and even the value of the U.S. currency. These in turn influence spending, investments, and production through the economy.

It will come as no surprise that monetary policy is currently extraordinarily "easy" or stimulative and has been for the entire period following the Global Financial Crisis. For most of that time, the target Fed funds rate has been below the rate of inflation and at/near the lower limit of 0%. The Fed did start to normalize policy in late 2015, increasing the rate to 2.25% over several years, but the forced recession and economic interruption following Covid-19 has again resulted in a 0% Fed rate, a record low negative real (inflation adjusted) Fed funds rate, and a continuation of the Fed's bond buying program (currently $120 billion per month). Post Covid, fiscal policy has also been extraordinarily stimulative.

Is this policy stance justified? Much of the recent economic data would argue it isn't, as the economy reopened to a wave of pent-up demand. The Fed is responding by openly communicating that it is discussing the tapering of its monthly bond purchases, although no schedule has been communicated yet in acknowledgement of the uncertainty of the current environment and whether recent levels of activity are sustainable.

Here are two very simple charts that show monetary policy (as represented by the Fed funds rate) versus time series economic data. The first combines the Fed's dual mandates of inflation and employment and compares them to the level of Fed funds. It is clear to see the swift rebound from the 2020 shutdowns.

Consumer Price Index Less Unemployment Rate Versus Fed Funds Rate



Source: Haver Analytics

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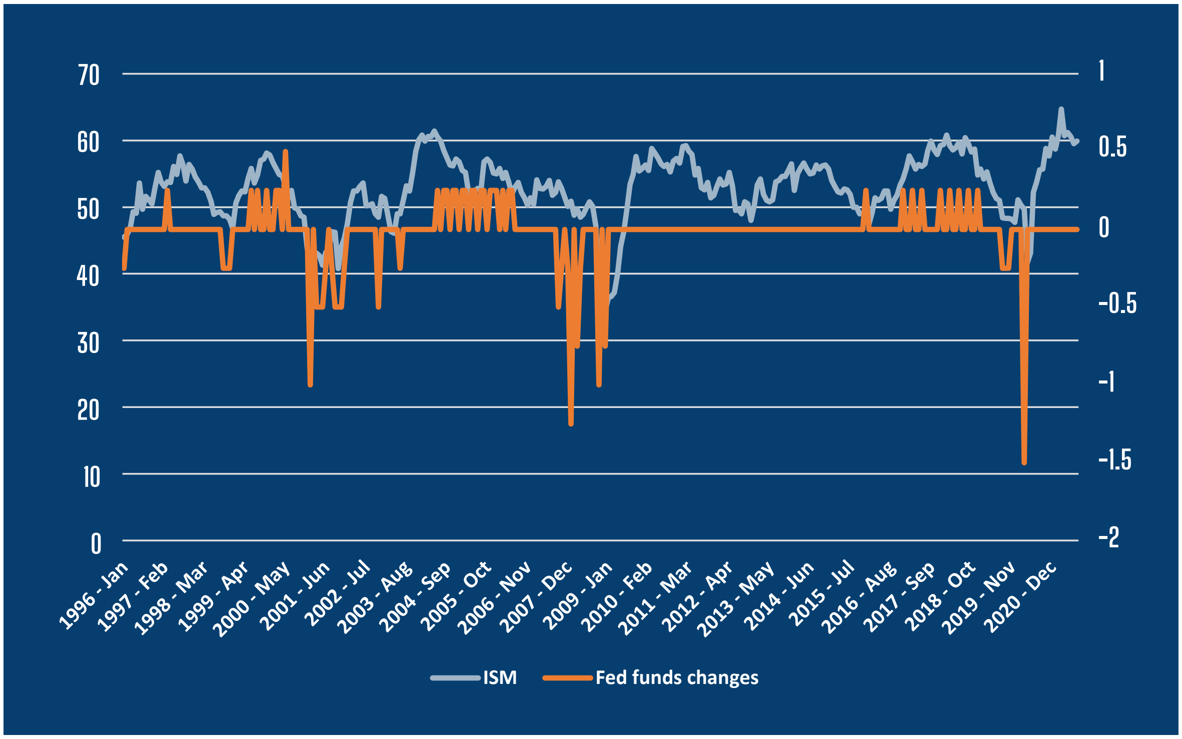
The second chart shows manufacturing as measured by the Institute for Supply Management versus the Fed funds rate. That measure has been in a zone consistent with monetary policy tightening (above 55) for 13 consecutive months. By no means are we suggesting that the manufacturing sector drives monetary policy, but the pattern has been relatively consistent through the years.

Institute for Supply Management Versus Changes in Fed Funds Rate



Source: Haver Analytics

In our opinion, it is appropriate for the Fed to be communicating to the market that it is contemplating changes to the current monetary policy stance. At the same time, it is important to note that those changes don't necessarily mean "tightening" but reversing some of the extraordinary measures currently in place. Moving towards a more normal stance will be a multi-step, multi-year process with the first step being a tapering of the Fed's asset purchase program. In our opinion, the Fed will likely begin tapering its asset purchase program later this year or in early 2022 with additional guidance and clarity expected at upcoming fall meetings. We expect the Fed to be very transparent, cautious, and incremental in its approach to tapering and would suggest any actual increase in rates is likely a late 2022 or 2023 event. With that in mind, we would suggest that in and of itself, monetary policy will remain a tailwind for risk assets. That doesn't necessarily translate to gains but certainly provides us some comfort that monetary policy could act as a floor under equity prices, in the event of a market event.

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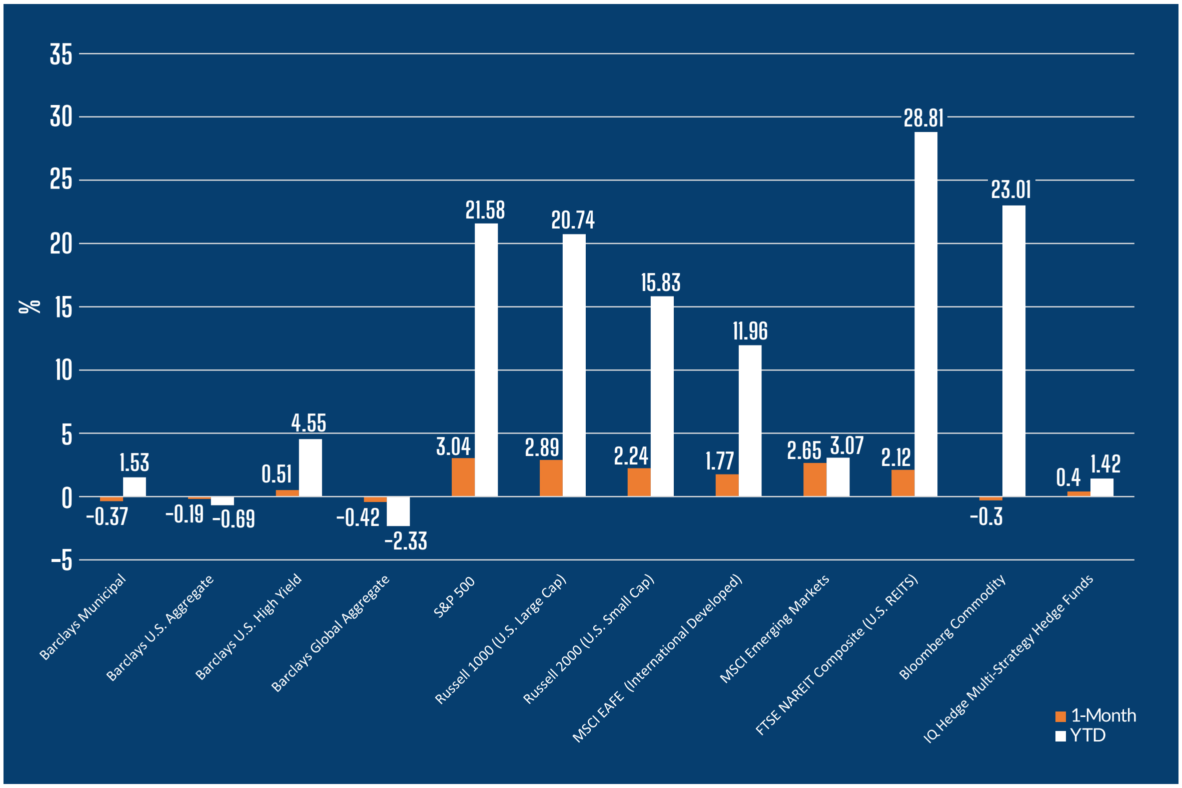
Asset Class Returns as of August 31, 2021

Comparing Recent Month and Year-to-Date Total Returns



Source: Morningstar

Fixed Income

- Treasury/sovereign yields trended higher in August, putting pressure on performance from core fixed income and municipal bonds.
- After widening in July, credit spreads tightened modestly last month. High yield, loans, and emerging market debt all posted solid gains.

Equities

- U.S. equities posted solid gains in August led by growth/tech stocks and large caps.
- Large cap stocks beat small caps and growth trounced value within large cap equities.
- Within small caps, value outperformed growth during August.
- Non-U.S. developed equities lagged U.S. equities last month with particular weakness in Europe. Japan performed well. USD strength was a headwind for developed markets.
- Similar to the U.S., international growth outperformed value, but unlike the U.S., small caps beat large caps.
- Emerging markets rebounded and finally outpaced developed markets outside the U.S. EM Asia and EM Eastern Europe led the way in terms of performance.

Real Assets

- Real assets continue to perform well as inflation concerns persist and economic activity remains relatively robust.
- Strong domestic REIT performance was again helped by surging lease costs in the apartment space. Foreign real estate was also strong for the month.
- The commodity basket was down slightly for the month but is still up more than 23% for the year. Natural gas, sugar, and cocoa were the biggest gainers in August with corn, cattle, and copper among the laggards.

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August 31, 2021	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Barclays U.S. Treasury Bill 1-3 Month	0.00%	0.01%	0.03%	0.06%	1.16%	1.10%	0.58%
Barclays Municipal	-0.37%	0.46%	1.53%	3.40%	5.09%	3.30%	4.05%
BBgBarc U.S. Govt/Credit Intermediate	0.00%	0.17%	0.17%	0.39%	2.88%	1.93%	1.46%
Barclays U.S. Aggregate	-0.19%	0.93%	-0.69%	-0.08%	5.43%	3.11%	3.18%
Barclays U.S. High Yield	0.51%	0.90%	4.55%	10.14%	7.11%	6.66%	7.07%
S&P/LSTA Leveraged Loan	0.47%	0.46%	3.76%	8.39%	4.16%	4.63%	4.89%
Barclays Global Aggregate	-0.42%	0.91%	-2.33%	0.52%	4.56%	2.47%	1.81%
JPM GBI EM Global Diversified	0.77%	0.34%	-3.05%	4.14%	5.78%	3.18%	0.36%
U.S. Equity Indices							
DJ Industrial Average	1.50%	2.86%	17.04%	26.77%	13.33%	16.58%	14.51%
S&P 500	3.04%	5.49%	21.58%	31.17%	18.07%	18.02%	16.34%
NASDAQ Composite (Price)	4.00%	5.21%	18.40%	29.59%	23.46%	23.96%	19.45%
Russell 1000	2.89%	5.03%	20.74%	32.25%	18.42%	18.24%	16.40%
Russell 1000 Growth	3.74%	7.16%	21.08%	28.53%	24.60%	24.35%	19.45%
Russell 1000 Value	1.98%	2.80%	20.32%	36.44%	11.45%	11.68%	13.03%
Russell Mid Cap	2.54%	3.33%	20.12%	41.24%	15.58%	15.40%	14.84%
Russell 2500	2.27%	0.48%	17.53%	45.87%	13.09%	15.10%	14.32%
Russell 2000	2.24%	-1.45%	15.83%	47.08%	10.75%	14.38%	13.62%
Russell 2000 Growth	1.82%	-1.89%	6.92%	35.61%	12.27%	16.58%	14.78%
Russell 2000 Value	2.68%	-1.00%	25.43%	59.49%	8.41%	11.66%	12.14%
Non-U.S. Equity Indices							
MSCI World	2.52%	4.38%	18.29%	30.33%	15.56%	15.44%	12.76%
MSCI ACWI	2.53%	3.27%	16.24%	29.18%	14.91%	14.88%	11.86%
MSCI ACWI Ex-U.S.	1.92%	0.27%	9.74%	25.37%	9.86%	10.43%	7.05%
MSCI EAFE	1.77%	2.55%	11.96%	26.65%	9.50%	10.24%	7.83%
MSCI EAFE Growth	2.36%	4.13%	11.49%	25.33%	13.71%	13.04%	9.63%
MSCI EAFE Value	1.14%	0.91%	12.12%	27.66%	4.98%	7.17%	5.87%
MSCI Europe	1.52%	3.41%	16.11%	29.84%	10.33%	10.75%	8.06%
MSCI Japan	3.08%	1.77%	3.25%	20.36%	8.04%	9.49%	8.20%
MSCI AC Asia	2.59%	-2.88%	1.67%	18.76%	9.57%	10.82%	8.02%
MSCI EAFE Small Cap	2.90%	4.66%	14.39%	33.27%	10.51%	12.25%	10.31%
MSCI ACWI Ex-U.S. Small Cap	2.34%	3.18%	16.05%	35.99%	11.44%	11.92%	8.72%
MSCI Emerging Markets	2.65%	-4.20%	3.07%	21.49%	10.25%	10.80%	5.22%
MSCI EM Asia	2.68%	-5.59%	0.21%	17.86%	11.28%	12.33%	7.86%
MSCI China	0.01%	-13.81%	-12.18%	-5.00%	7.42%	10.97%	7.47%
MSCI EM Eastern Europe	4.35%	4.49%	23.42%	38.66%	13.86%	14.70%	3.31%
MSCI EM Latin America	0.85%	-3.23%	5.50%	35.08%	4.20%	4.26%	-1.60%
MSCI EM Small Cap	1.23%	-0.05%	19.90%	44.27%	13.01%	10.86%	5.91%
MSCI Frontier Markets	2.52%	2.25%	17.79%	31.99%	10.66%	10.14%	6.75%
Hedge Fund Indices							
IQ Hedge Long/Short	1.57%	3.07%	7.97%	16.03%	8.72%	7.46%	--
IQ Hedge Multi-Strategy	0.40%	-0.18%	1.42%	5.79%	4.17%	3.77%	3.65%
Real Assets Indices							
FTSE NAREIT Composite	2.12%	6.23%	28.81%	36.72%	12.52%	9.30%	11.22%
Alerian MLP	-2.31%	-8.48%	35.31%	54.80%	-5.76%	-2.64%	0.48%
Bloomberg Commodity	-0.30%	1.54%	23.01%	31.00%	5.82%	4.17%	-4.67%
S&P Global Infrastructure	1.81%	2.81%	8.36%	20.91%	6.81%	6.60%	7.38%
Other							
Oil Price Brent Crude	-4.38%	-2.85%	40.91%	61.20%	-1.94%	9.18%	-4.43%
CBOE Market Volitility (VIX)	-11.24%	2.27%	-28.84%	-38.70%	7.98%	3.82%	-6.47%

Source: Morningstar

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