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Turn Out the Lights, the Party's Over

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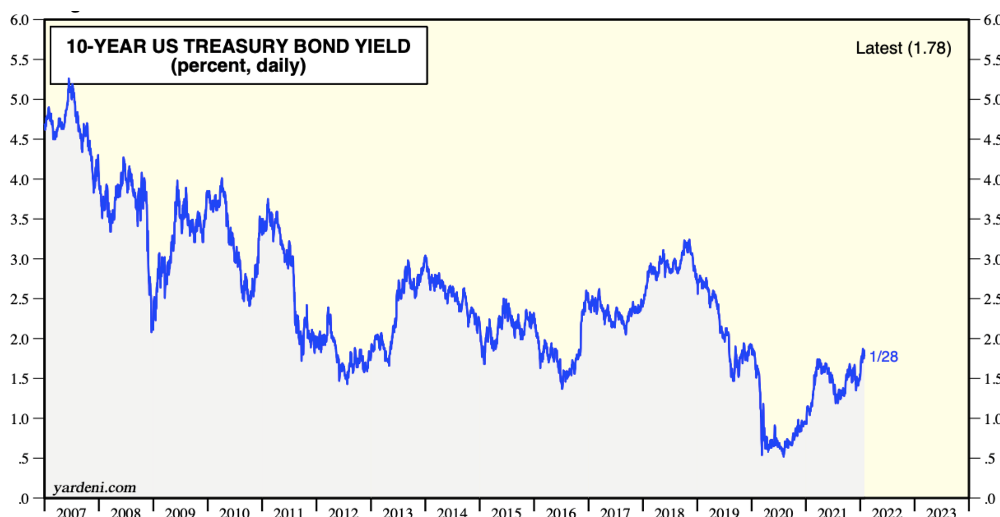
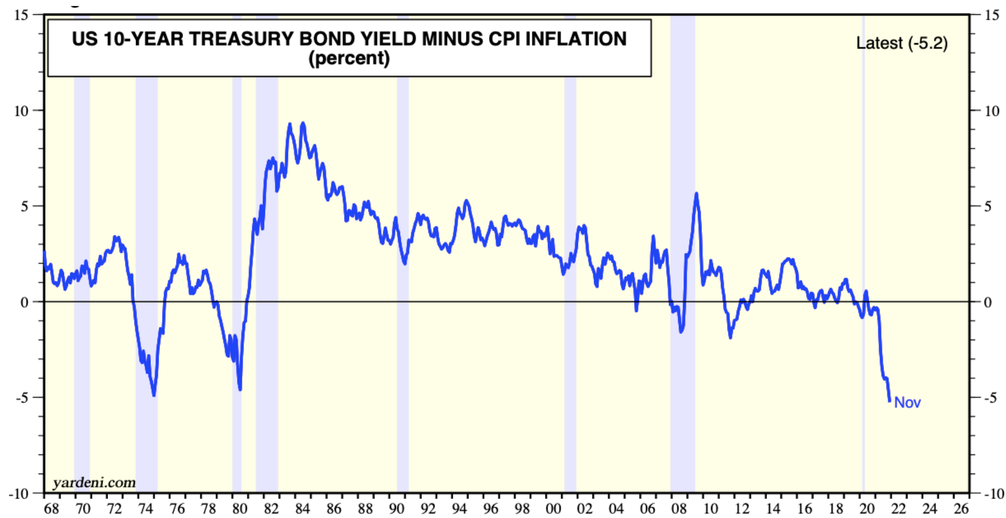
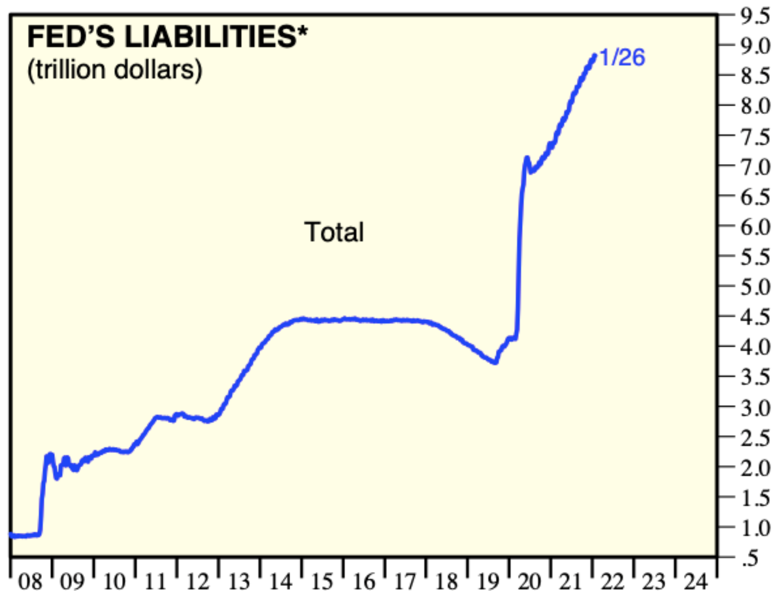
We have frequently likened the Federal Reserve's ultra-easy monetary policy to an out-of-control party. The boys of Animal House would be proud of our crazy Uncle Fed's partying ways. *Money for nothing* has been blaring out of the speakers at the Sigma Delta Fed house ever since the pandemic started. The inflation police have finally shown up and their message is clear, "turn out the lights, the party's over".

After lowering the Fed Funds rate to zero, Uncle Fed still wanted to party on. Quantitative easing became the new policy tool of choice. The Fed purchased all sorts of bonds and pumped even more money into the economy, while also artificially lowering long-term interest rates. 10-Year Treasury Yields were pushed all the way down to .5% before recently rebounding to 1.78%, a yield level that is still significantly below where it would historically trade relative to inflation.

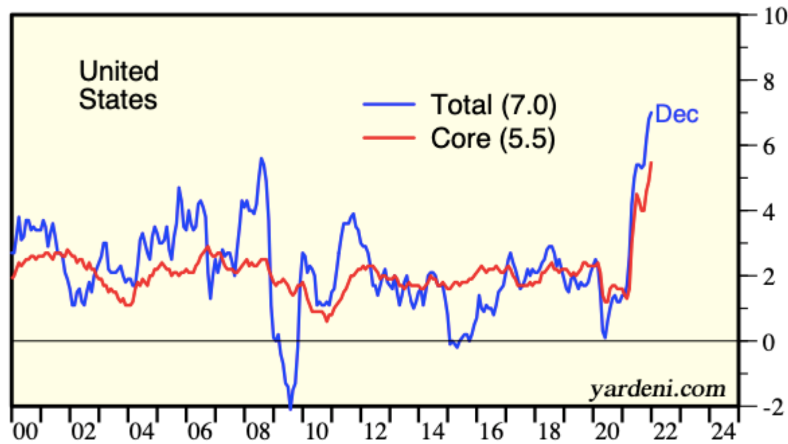




Just when we thought things couldn't get wilder, Auntie T. joined the party. Together, the Fed and Treasury undertook the unprecedented practice of directly mailing people money. Importantly, this money wasn't extra money produced from budget surpluses. It didn't actually exist. It was created through expanding balance sheet liabilities. Modern Monetary Theory (MMT) was no longer a theory, it very much became real.

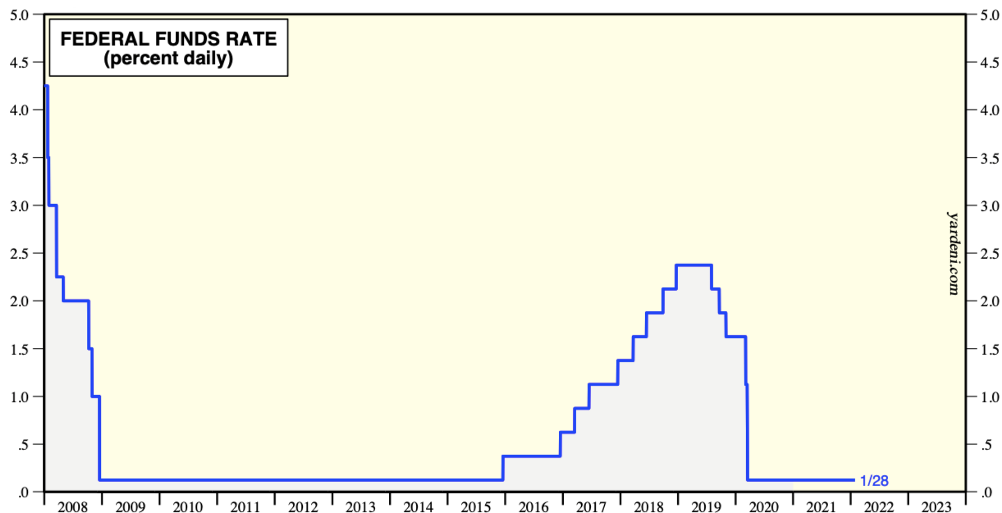


Not surprisingly deficits expanded, consumer demand spiked, supply couldn't keep up with demand, and the eventual result was inflation. Too many dollars chasing too few goods.



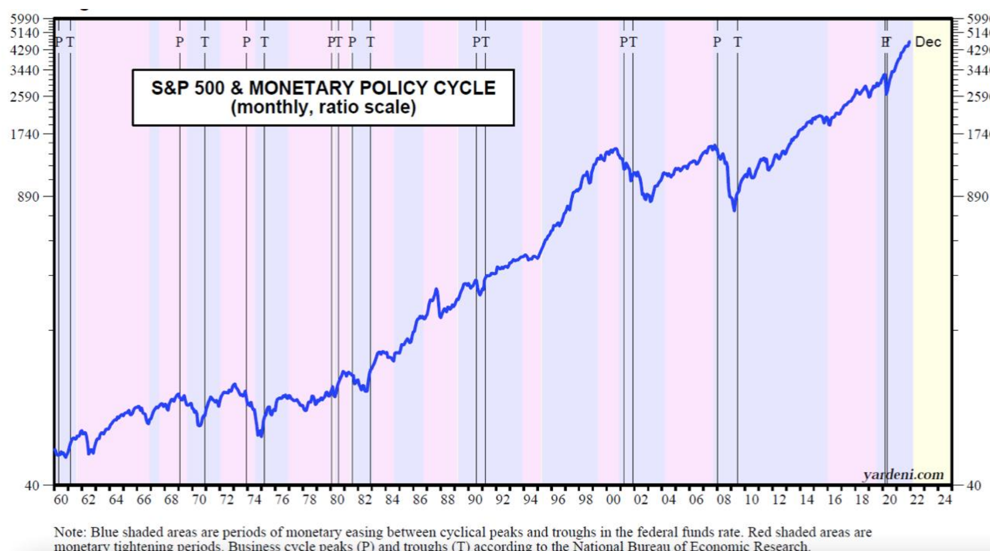
Over the last 2 years, Fed Chair Powell has repeatedly warned of ending the Fed's ultra-easy monetary policy. Markets and politicians would respond by throwing a taper tantrum and The Fed would back off their threats of tighter monetary policy. According to the Fed's minutes, these reactions never factored into the Fed's decision-making. Rather, concerns about the virus and its economic impact drove their decision-making. So, what's different this time? A cynic might suggest being recently reappointed to a 4-year term as Fed Chair allows for a monetary policy that is more independent of political pressure. Others argue it is far easier to back off threats of tightening when inflation is low, not at 40-year highs. Either way, Fed Chair Powell has made it clear, the party is over.

On January 5th the Fed released its minutes of the December 14-15 FOMC meeting. The minutes expressed a more hawkish view on inflation than investors expected. Mid-January's Fed meeting was followed by Fed Chair Powell's usual press conference. He signaled he is going to hike the Fed Funds rate during their next scheduled meeting in Mid-March. An increase of 50bps (1/2 percent) is a likely scenario.

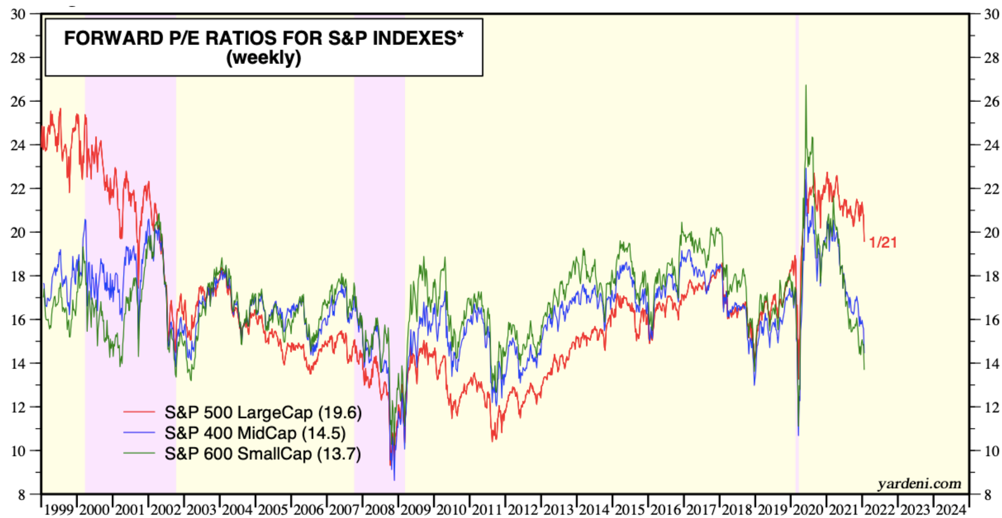


The Fed also signaled an end to quantitative easing, the practice of purchasing bonds in the open marketplace. The details are yet to be specified, but the plan is to shrink the Fed's balance sheet by halting the purchase of bonds while also letting the bonds on the Fed's balance sheet mature and roll off. Once again, the message is clear, this liquidity has ended.

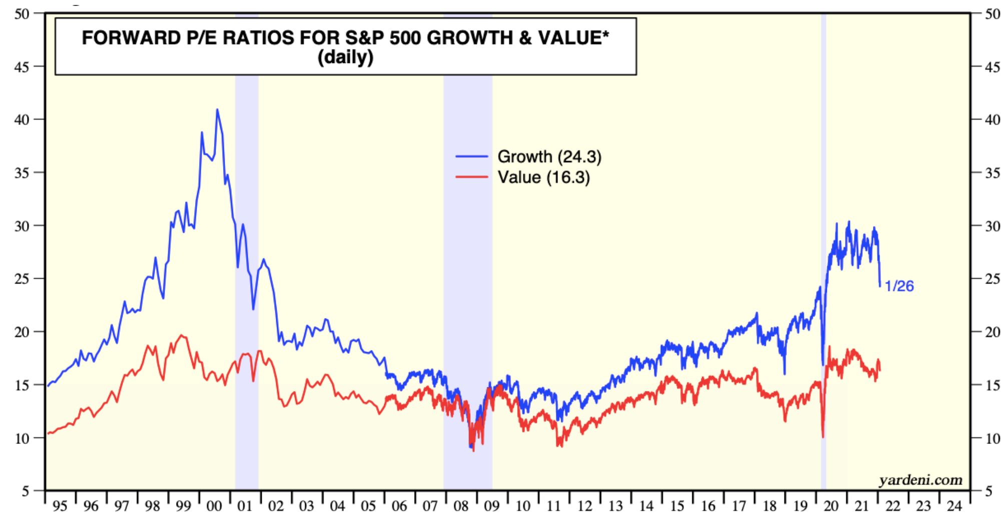
Understandably, stock markets have responded by selling off while also displaying impressively high intra-day volatility. Even the most seasoned stock investors are feeling a case of whiplash. Many stock investors are getting out of Dodge. We are tempted to join them, and likely will in the not-too-distant future. However, history tells us it's not quite time to run and hide just yet. During these initial tightening phases stocks tend to do okay, albeit with much more volatility. It's not until the economic impact of tighter monetary policy takes hold that we should run for the hills. Historically, the S&P 500 has continued to appreciate during periods of monetary tightening until a recession is imminent.



Our theme during this liquidity party has been to ride the wave. *Beta* (systematic stock exposure) has been an investor's best friend. Stocks have risen over 100% from their pandemic lows and investors that did not maintain stock exposure during this period cost themselves dearly. Going into 2022 our expectations were for positive, albeit far more modest, stock market returns along with higher volatility. At least we got the volatility part right. We are not yet giving up on our return expectations. We are however changing our *Beta* theme to an *Alpha* theme. This means we will be much more active in the trading of your portfolios. As evidenced recently, we will use market sell-offs to add equity exposure and market rallies to decrease equity exposure. We are also actively reallocating from the more expensive Large Cap Stocks into less expensive Small and Mid-Cap Stocks.



Additionally, we continue to tilt portfolios from pricier Growth Stocks into less expensive Value Stocks. During the Beta theme, higher valuations were justified. We no longer believe that the higher multiples associated with Large Cap Stocks and Growth Stocks are justified in a rising interest rate and inflationary environment. Higher inflation and higher interest rates lower the present value of future earnings. This is referred to as a higher discount rate.



In summary, we are transitioning investment environments. Investors should expect to see considerably more trading activity in their portfolios. We believe this is the best way to add value during this new phase where our expectations are for stocks to move mostly sideways with a slight upward bias. We are not yet bearish, that too may change soon.

Actively yours,

The Mommaerts Mahaney Team

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Mommaerts Mahaney Financial Services, Inc. provides advisory services through ERTS Wealth Advisors, LLC, a registered investment advisor.
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