MID-CONTINENT CAPITAL

CONSILIUM*

Volume 49 ~ January 2022

*advice; judgment; resolution; wisdom

A Market and Economy in Transition in 2022

We have commented previously on the Federal Reserve's remarkable and unprecedented efforts to support the financial system and the economy since the onset of the Covid-19 pandemic. A key component of their plan included what ultimately became a $120 billion-a-month bond-buying program intended to inject liquidity into the system and keep long-term interest rates low. Over the course of the program, the Fed nearly doubled the size of its balance sheet to $8.7 trillion.

The Fed has long promised that this program would be temporary and would be gradually scaled back (i.e., "tapered") to zero when economic circumstances warranted it. Last month, the Fed announced it would follow through on that pledge, reducing its bond purchases in stages, with an expectation that the program would end as soon as March. The Fed has also signaled that the natural subsequent step, to raise short-term interest rates above zero, would only occur after the bond-buying ended. Market speculation has quickly shifted to the timing and extent of such potential rate increases.

There is a widespread narrative that "if the Fed's not easing, it's tightening" and that the new policy is therefore negative for the markets. We believe this binary view is wrong: even after the Fed stops adding to its bond portfolio – and even after it has raised rates a time or two – monetary policy will not be "tight" in any sense of the word. Further, history shows that raising rates per se is not problematic. If rates are being lifted when the economy is strong and growing, the market typically will look beyond it. But if rates are rising when the economy is already faltering, the Fed risks the kind of "overshoot" that has pressured the market historically. We believe the first scenario is in play at this time; we are a long way from concerning ourselves about the second.

Just as the Fed is planning a return to "normal" policy, the economy should look much more "normal" by this time next year, in several respects. First, inflation has been higher than almost anyone expected this year, but the most important factors driving the increase from roughly 2% to 7% will almost certainly be less powerful in 2022 (those being new and used car prices, gasoline prices, and housing). As supply chain bottlenecks ease and demand for goods becomes sated, inflation is poised to be cooler, and perhaps significantly so, a year from today.

Second, coming off the Covid-19 lows in the spring of 2020, we have seen boom-like conditions in the economy generally, and dramatic percentage gains in profits across many sectors, but especially in technology. These extraordinary conditions have set up a period just ahead of us when year-over-year sales and earnings comparisons are going to be difficult for many companies, particularly for those that actually benefited from the pandemic. These "denominator effects" overstated how great business was in the last year and will likely understate performance in 2022.

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Notwithstanding the current surge in Covid cases, we believe that by early 2023 we will be through this transition period and the broad economy will be operating similarly to how it was at the end of 2019: growing moderately, with relatively low inflation. The markets seem to agree; bond yields have not risen to validate concerns about inflation, and companies that traditionally do well when growth moderates (such as consumer staples and utilities) are at all-time highs.

Growth is indeed set to slow from a torrid pace in the technology sector, which due to its size has (and will have) a large impact on the performance of the major stock market indexes. The gigantic, globally dominant, hugely profitable companies in this sector have enjoyed massive gains over the last 18 months, and it would be completely within reason that they might consolidate and digest those gains for some time. Most of these companies have earned the right to a "wide berth" and such an outcome would not be an opportunity to sell. It's generally "business as usual" in most other sectors.

In the last issue of *Consilium* we asserted that stocks may not be cheap, but neither were they overpriced *in relation to prevailing interest rates*. But if rates rise very sharply in response to the change in Fed policy, stock valuations are likely to correct. Further, if the Fed ignores signals from the market and raises rates too far, too quickly, choking off the economy and causing a recession, valuations and earnings are likely to decline simultaneously. This is the more traditional way business cycles and bull markets end. Fortunately, either scenario will take time to unfold and provide ample time to prepare; and neither is currently the most likely outcome.

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On behalf of the entire team at Mid-Continent Capital, please accept our best wishes for a happy, healthy, prosperous, and *normal* New Year!

Sources: Federal Reserve System, Statista

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