Updated Fed Policy Outlook for 2022

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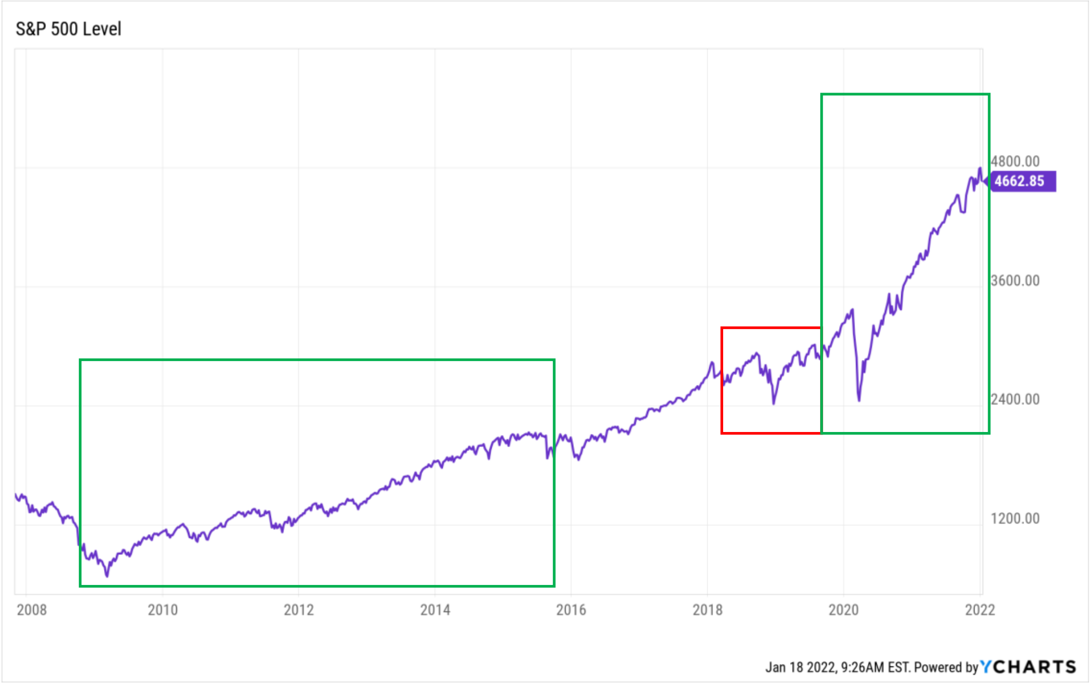
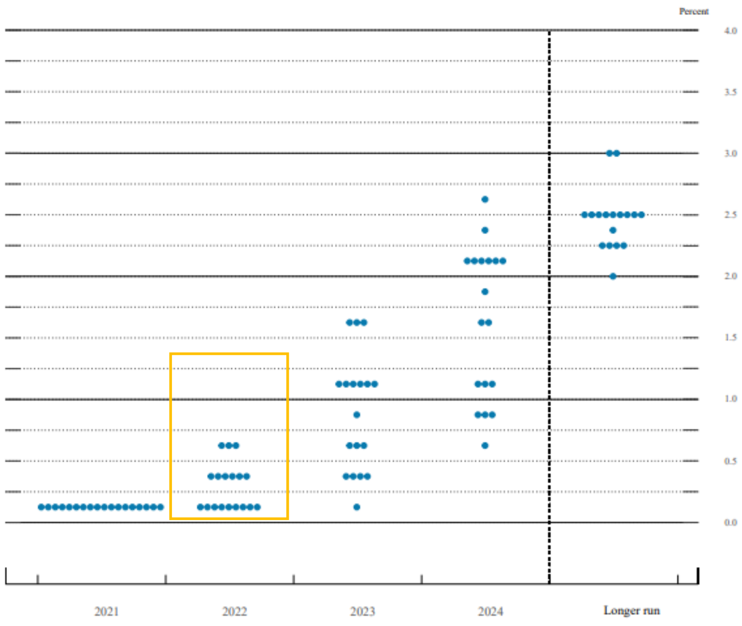
Fed Policy - It Matters A Lot to Markets



Fed Policy Outlook Has Changed Drastically Over the Past Three Months

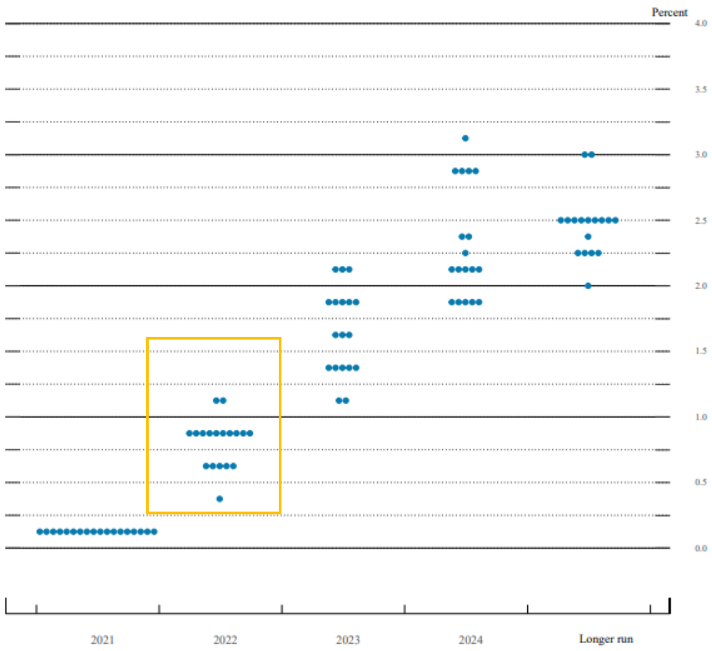
In September, median "dot" showed one rate hike, barely.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate

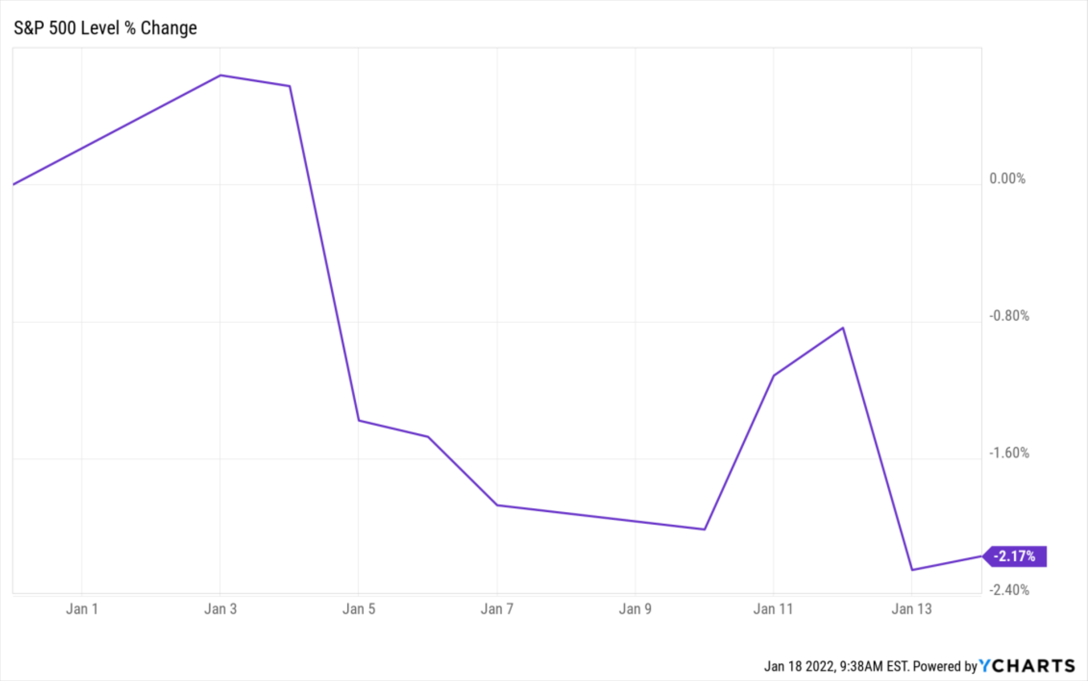


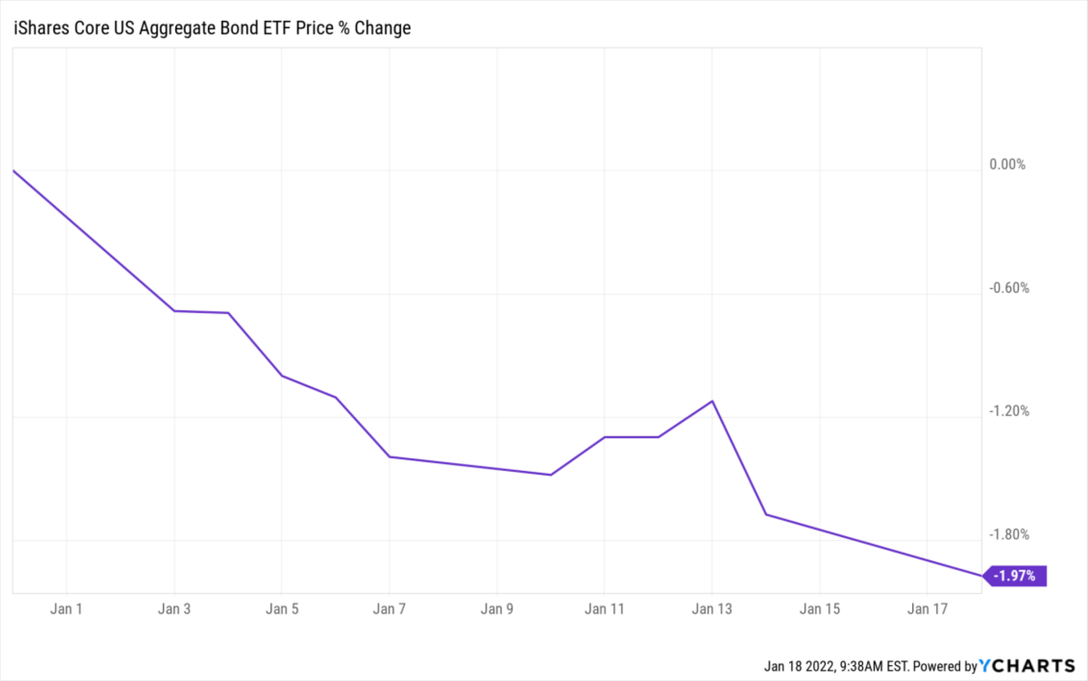
In December, media dot showed three rate hikes, and in March it will likely be four.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



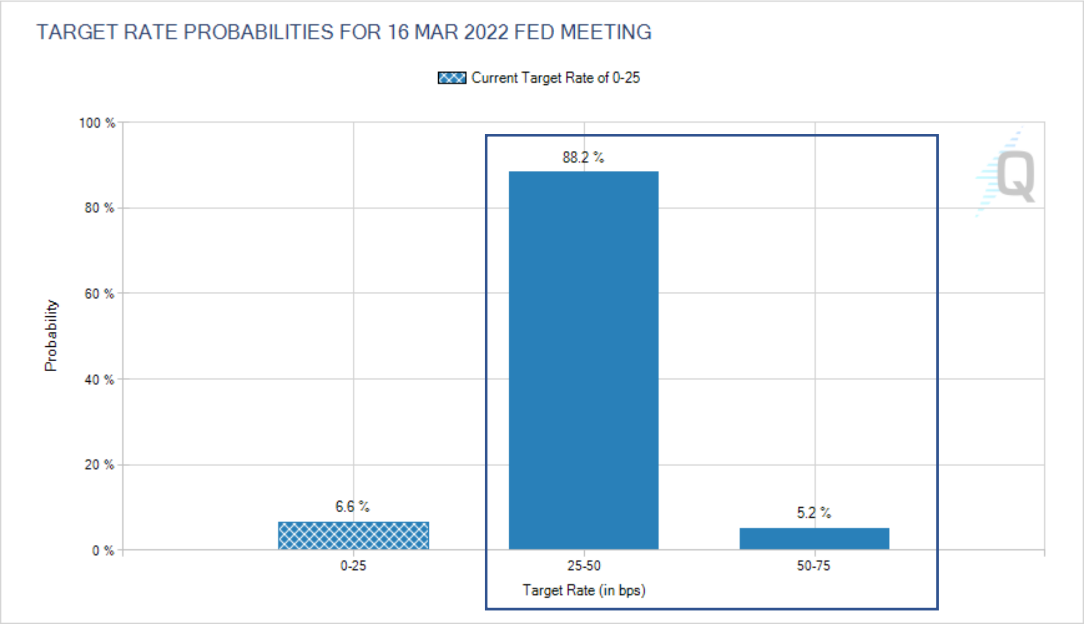
This Shift in Fed Policy Has Impacted Markets



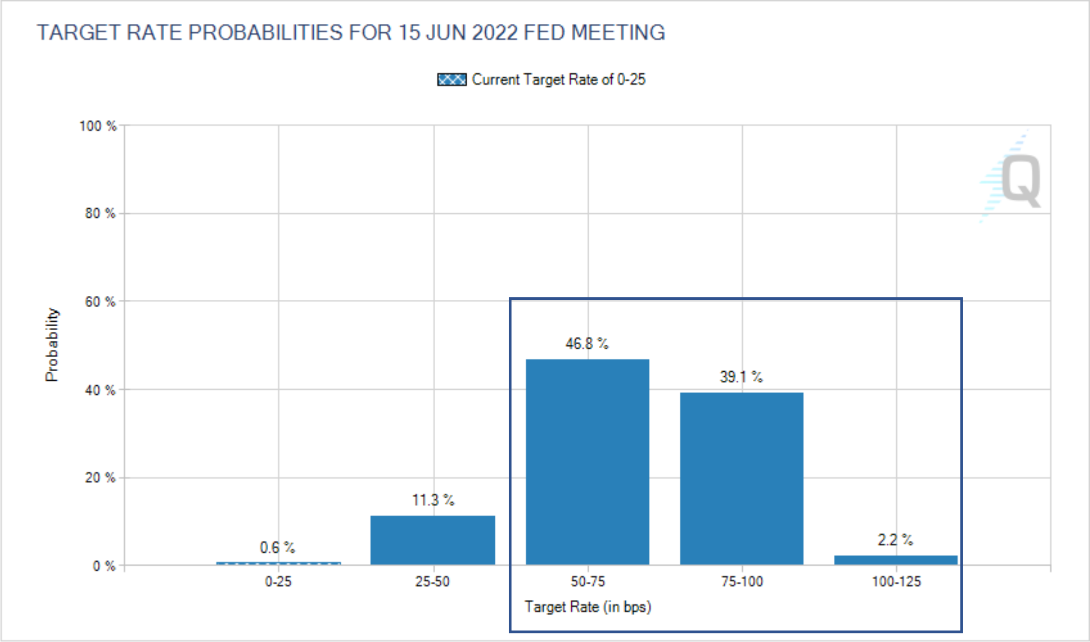


What's Expected Going Forward – Watch Fed Fund Futures

A 25 bp March Rate Hike Is A 93% Probability

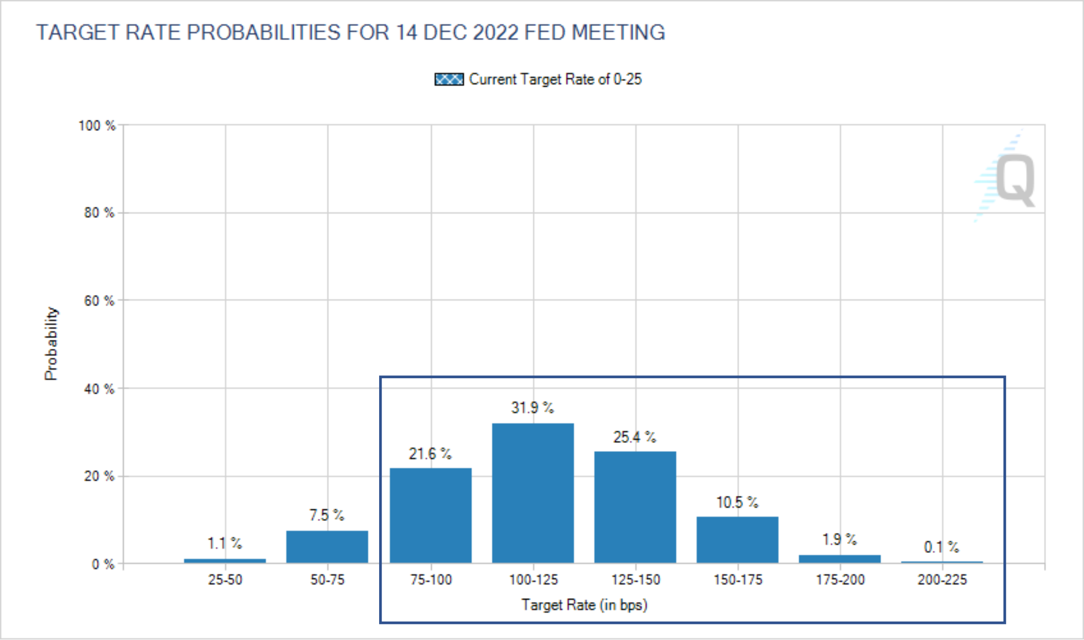


Another Rate Hike At or Before the June Meeting is a more than an 85% Probability.

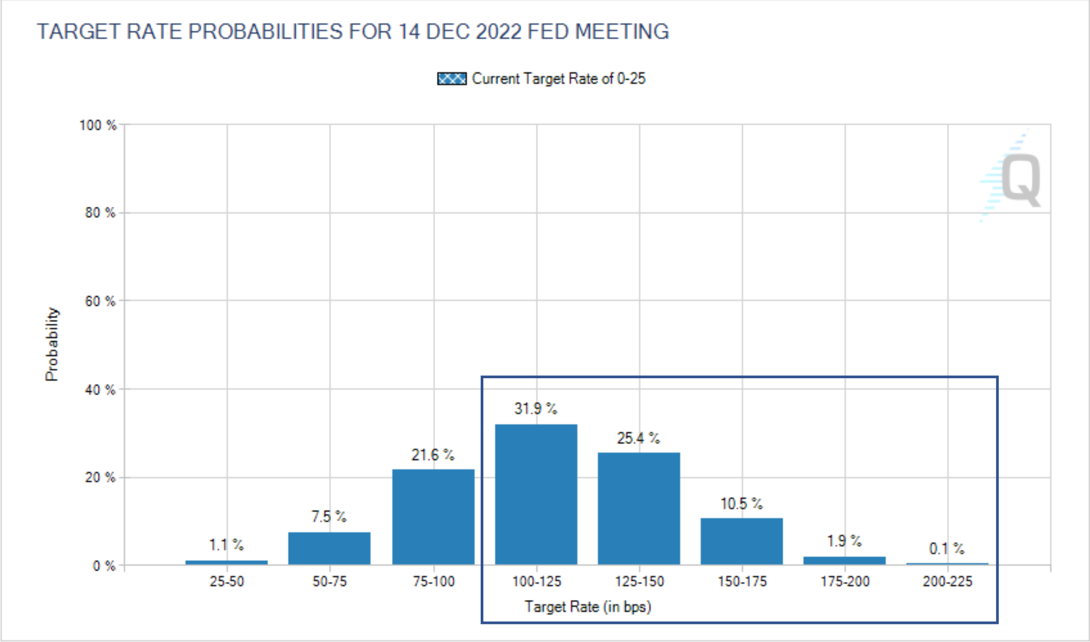


What's Expected Going Forward – Watch Fed Fund Futures

Another rate hike by September is a more than 75% probability.



A fourth rate hike in December is more than a 70% probability, while a fifth hike is a 35% probability.



What Would Constitute a Positive of Negative Surprise from the Fed Going Forward?

Positive Surprise

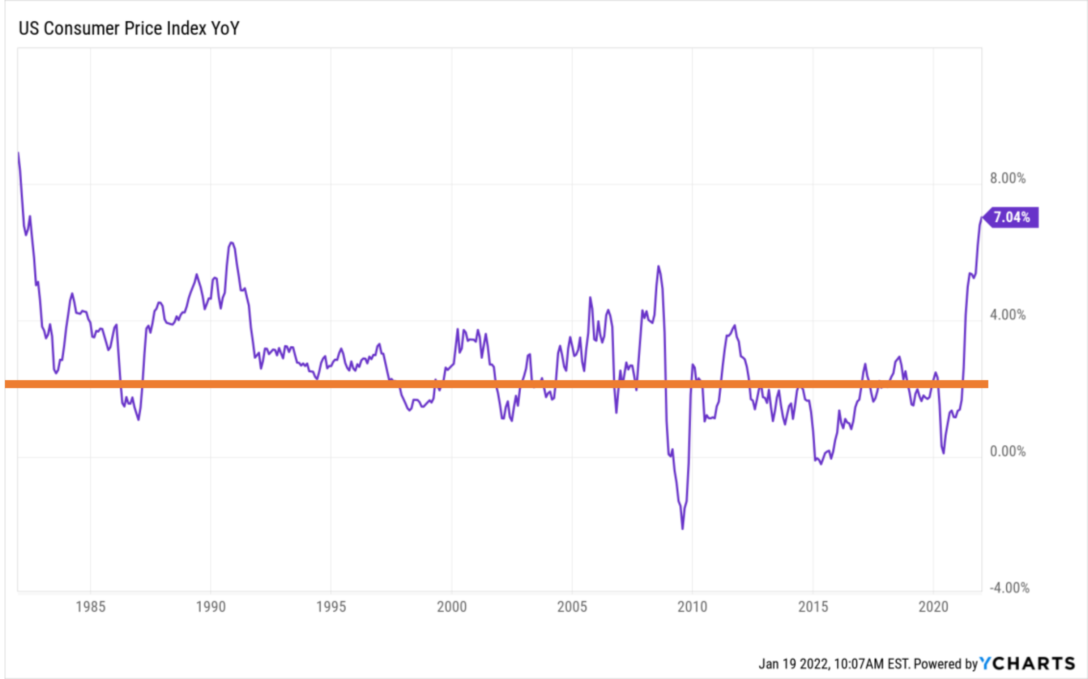
- A positive surprise would be one that implies the Fed might hike rates less than currently expected. That means less than four rate hikes in 2022.
- This would help markets stabilize and especially put a tailwind on tech/Nasdaq.

Negative Surprise

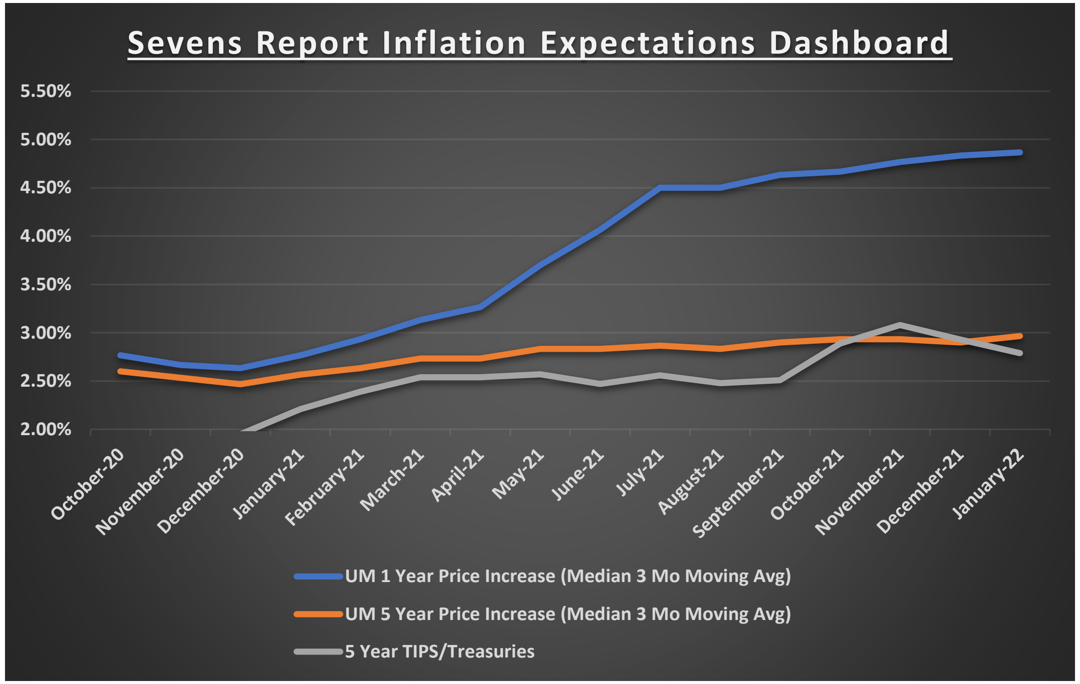
- Candidate 1: Fed officials open the door to five rate hikes this year (possibly via March dots).
- Candidate 2: Balance sheet reduction (this is the major negative surprise we need to watch for).
  - Asset Sales? This is a wildcard to watch (and would be a big negative).

What is the Key Variable To Determine Future Fed Policy: Inflation (not Economic Growth).

Key Inflation Metric #1: CPI



Key Inflation Metric #2: Inflation Expectations.



What Is the 10's-2's Spread Saying Now? Watch 0.73%. A definitive break requires more defensive positioning.

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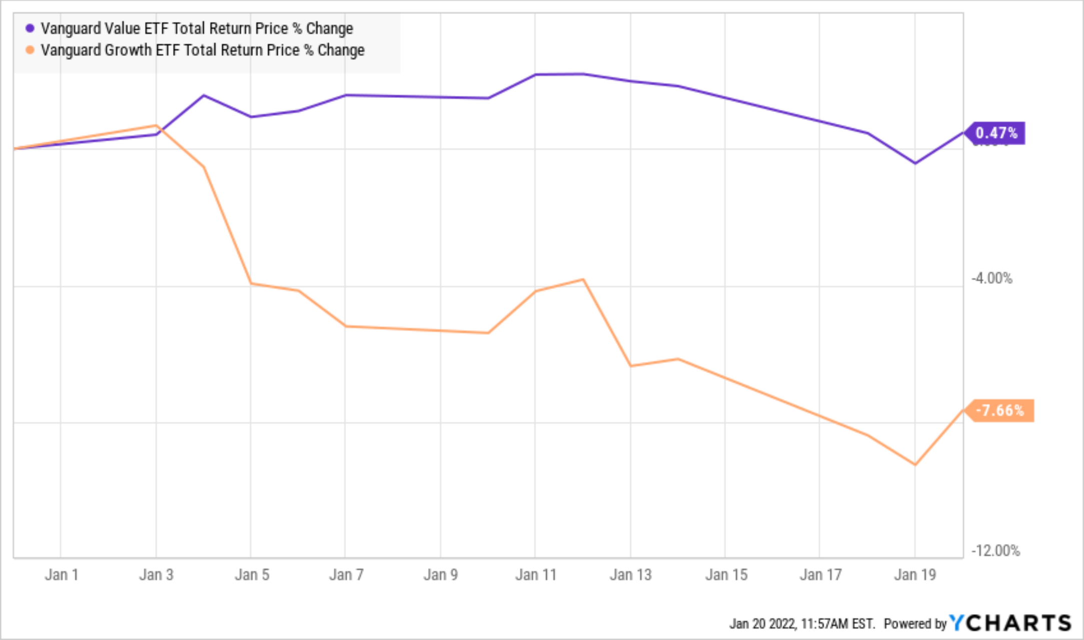
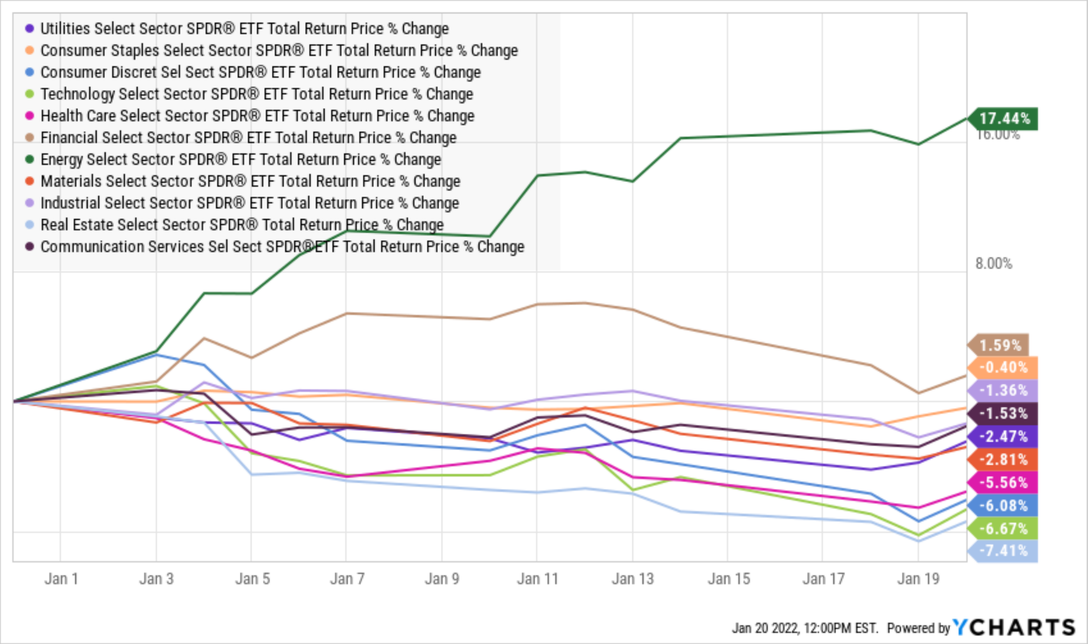
Outlook for Growth/Value, Cyclicals and Defensives

Value vs. Growth



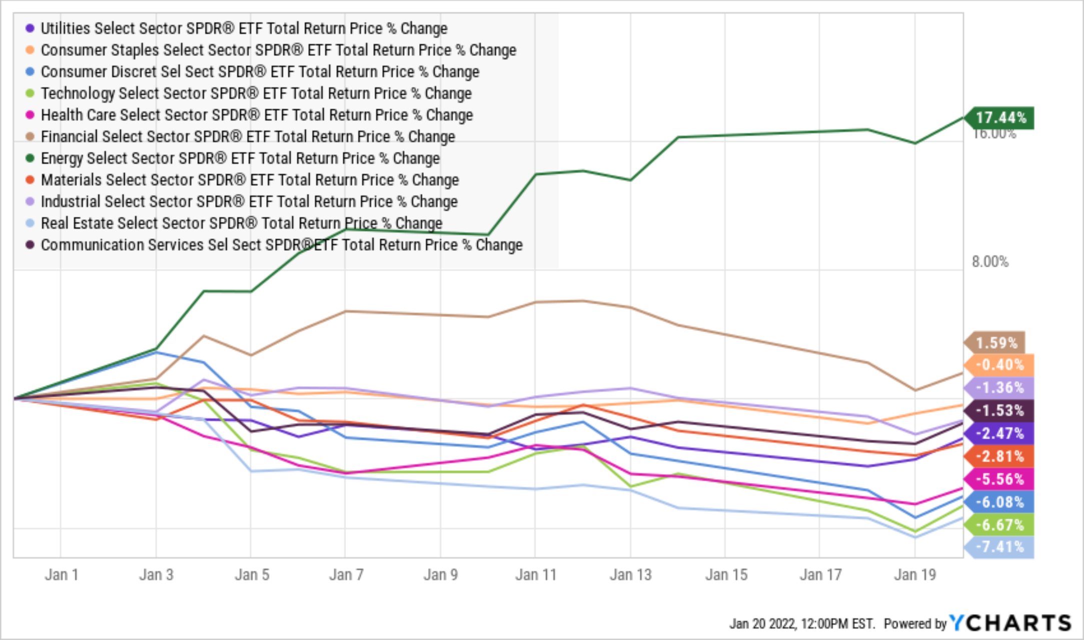
Sector Performance



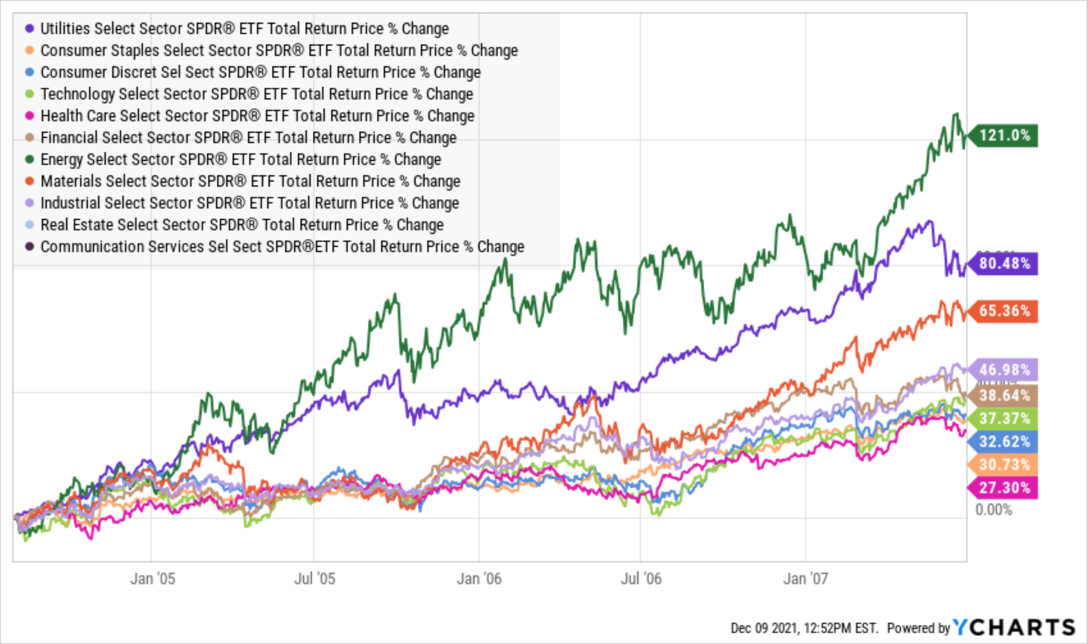
SEVENS REPORT

Outlook for Growth/Value, Cyclicals and Defensives

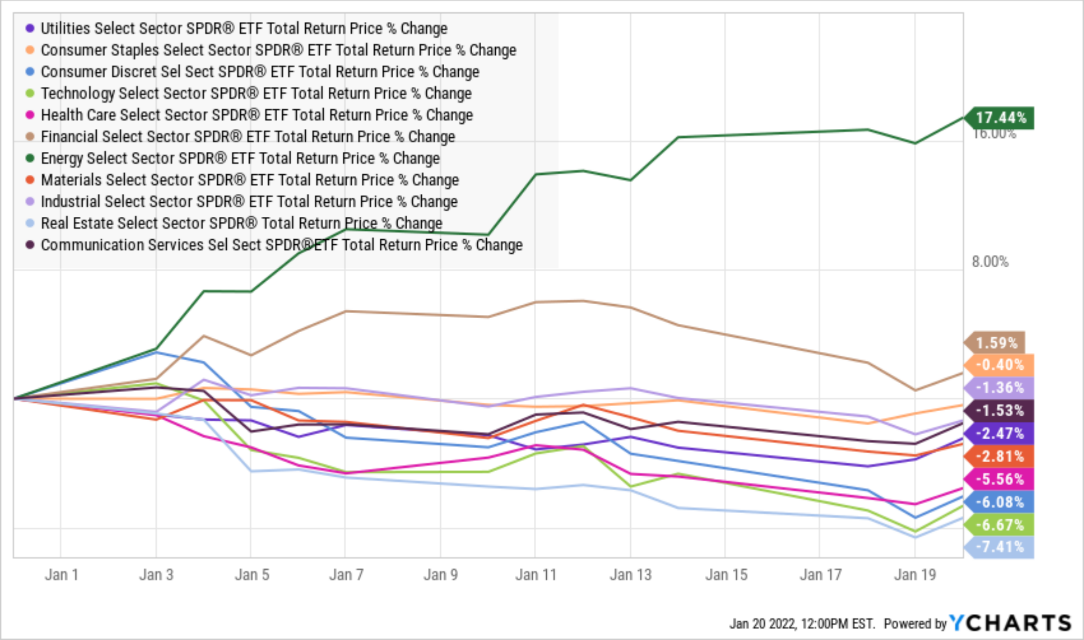
Sector Performance 2022 YTD



Sector Performance ‘03-’07 Rate Hike Cycle



Performance of Cyclical and Defensive Sectors



Sector	Forward P/E	YTD Performance
XLE	11.6X	17.4%
XLF	15.0X	1.59%
XLV	16.7X	-5.56%
XLB	17.1X	-2.81%
XLC	19.9X	-1.53%
XLU	20.3X	-2.47%
SPY	21.1X	-4.89%
XLP	21.9X	-0.40%
XLK	27.0X	-6.67%
XLY	30.6X	-6.08%

Takeaways

- The Fed is the major medium-term influence on stocks. Rates are rising and that will pressure the market multiple (the question is by how much – the more rate hikes, the more pressure).
- A positive Fed surprise is Powell backing off of four hikes at next week's FOMC Meeting.
- A negative Fed surprise is Powell implying possibly five rate hikes.
- A very negative surprise is Powell hinting at balance sheet reduction.
- A very, very negative surprise is Powell hinting at asset sales.
- It's early in the year, but lower multiple sectors are outperforming both on an absolute and relative basis. Defensive sectors (XLU/XLP) aren't "cheap" but there is investor demand due to volatility. Cyclical sectors (energy, materials, financials) are also outperforming.
- Tactically, we think a mix of all three (low multiple, defensive and cyclicals) is a tactical strategy that can outperform, especially if we see a slowing of economic activity.