Week in Review

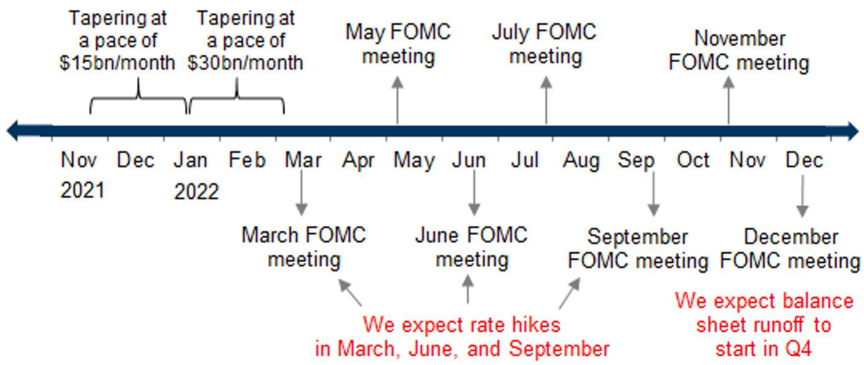
Friday, December 17th, 2021

1. The Federal Reserve Accelerates the Taper

Acknowledging that inflation is proving to be much higher and persistent, Federal Reserve Chairman Powell announced on Wednesday a doubling of the rate of reduction in its monthly asset purchases. The Chairman also laid the path for a more aggressive timeline and cycle for rate increases.

The following chart from Goldman Sachs Investment Research illustrates the new view on the taper timeline with asset purchases being completed in March with the first rate hike to commence then or shortly thereafter. The forecast number of rate hikes in 2022 also moves from the previous two to three by year-end.

Timeline for Tapering, Rate Hikes, and Balance Sheet Runoff, GS Forecast

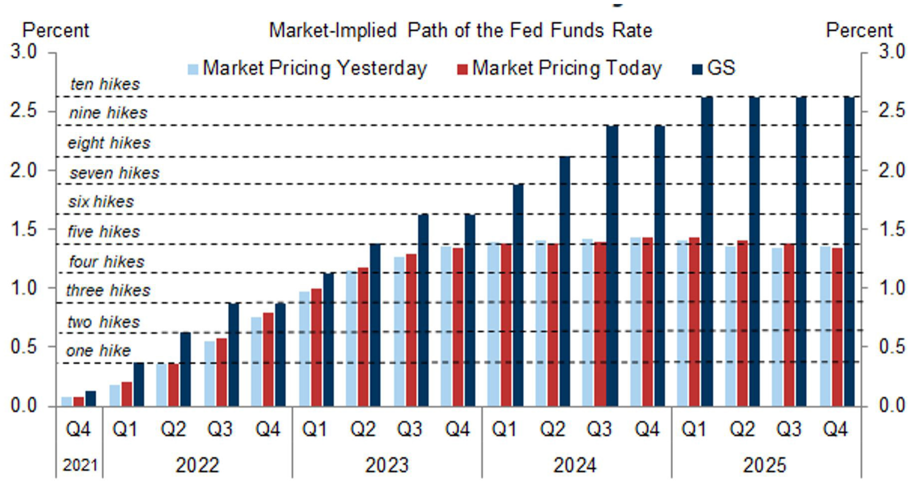


Source: Goldman Sachs Global Investment Research

The market appears to have been prepared for the acceleration of the tapering. Initially, the market response was neutral to positive as commentary by the Federal Reserve Chairman was no more hawkish than expected and likely deemed a necessary step given the high level of inflation in the current environment.

Views on the longer-term trend for fiscal policy, however, is more uncertain with Goldman Sachs Investment Research suggesting that the coming year's cycle for rate increases may give way to further rate increases, which could push the Fed Fund's rate to levels above the pre-COVID level of 1.55% and well above the average realized since the financial crisis nearly 15 years ago.

This expectation is not universally accepted as consensus at this time, as seen in long-dated treasuries yielding well below Goldman Sachs' forecast. However, the potential for the trend for the Federal Funds rate to exceed that observed in the past decade may help explain the contraction of price to earnings multiples for premium priced stocks and the recent resurgence in the value versus growth stock positioning discussion.

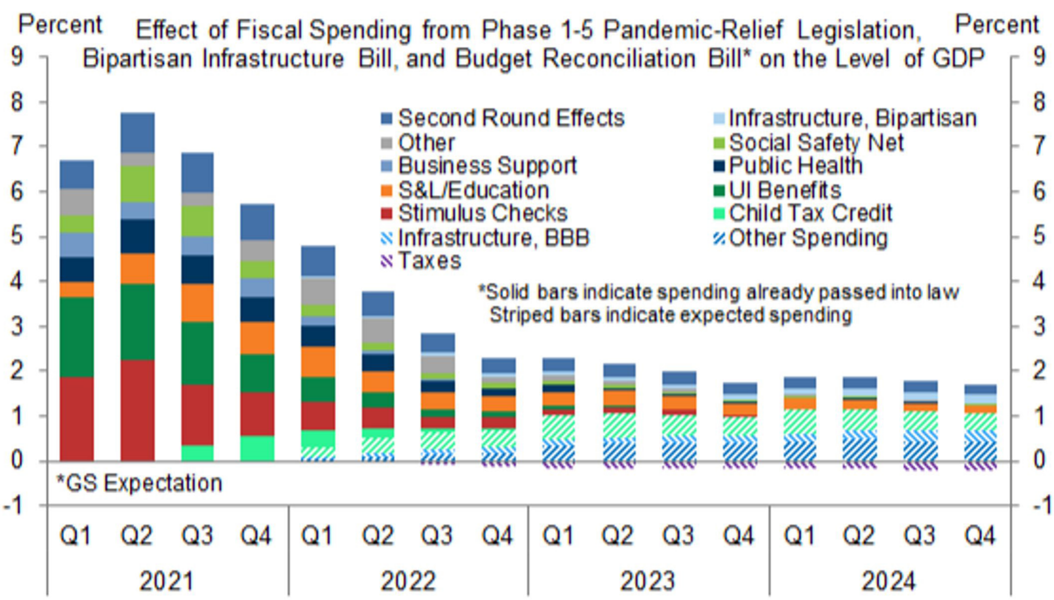


Source: Goldman Sachs Global Investment Research

While the final level of rates is unknown, a sustained higher level for the Federal Funds rate will likely have an impact on both the fixed income and equity valuations as markets adjust to higher risk-free rates, higher discount rates, and lower terminal values.

2. Fiscal Policy Also Faces Significant Headwinds

At the same time that the Federal Reserve is looking to tighten monetary policy, unprecedented fiscal support enacted as a response to the COVID pandemic will be rapidly declining. The ultimate level of fiscal support moving forward may vary depending upon the progress of the Build Back Better (BBB) plan, but even with its potential passage, the level of fiscal support will be nearly two-thirds lower in the coming years than during this past year.



The exceptional level of fiscal support provided through programs such as stimulus checks to consumers and businesses undoubtedly played an important role in offsetting the negative effects of the COVID pandemic. Moving forward, the economy will be more dependent upon the private sector to drive growth. While the private sector looks poised to play this role, uncertainties such as Omicron, inflation, and supply chain constraints pose risk.

Thinking Ahead

As we head into the end of the year, the landscape for monetary and fiscal policy both look set to embark on a different cycle in 2022. The likely outcome is that the markets will need to look increasingly at internal business fundamentals and financial returns to drive value creation. We have confidence that high-quality businesses are up to this challenge.

Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.