Investment Insights

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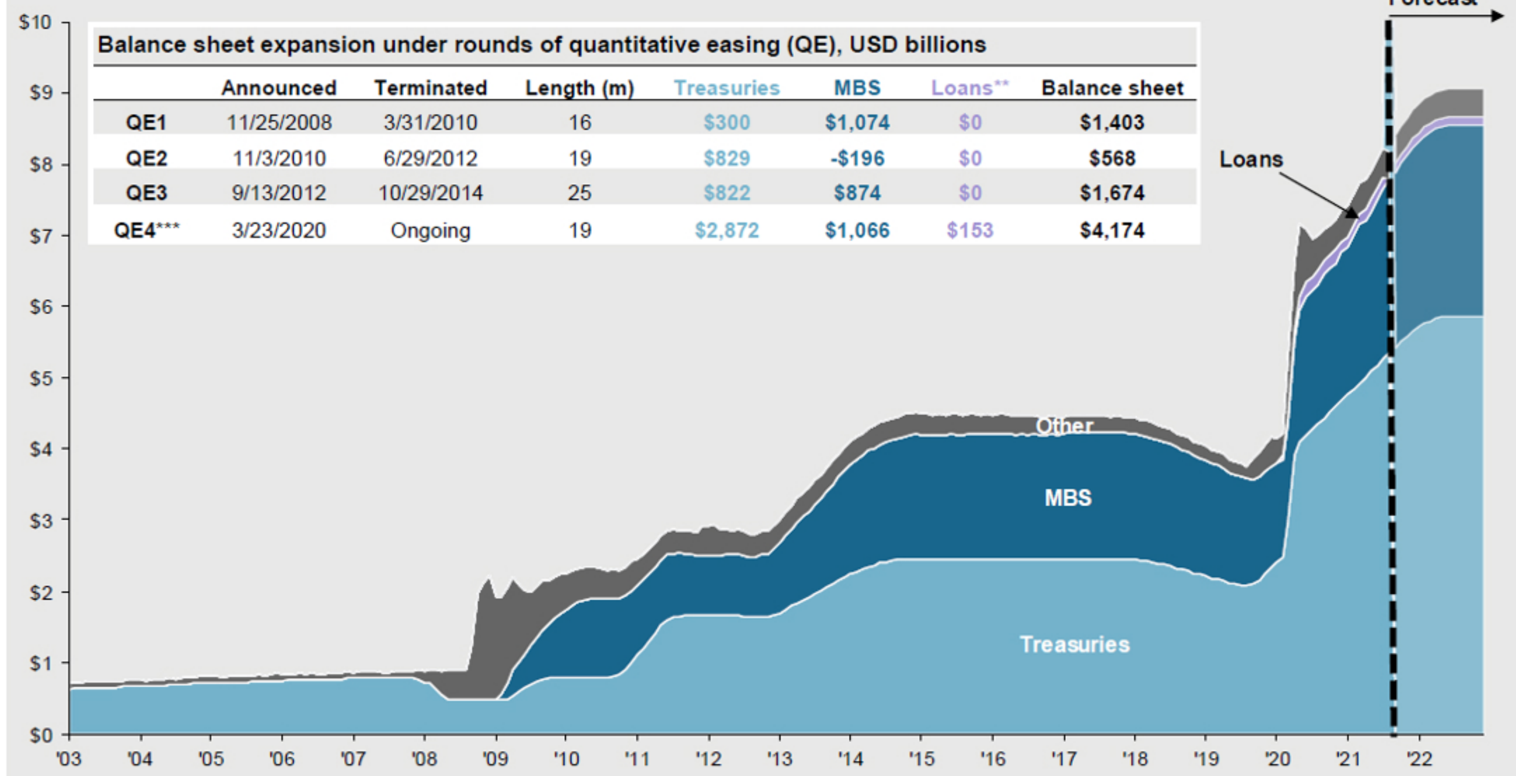
SIERRA MUTUAL FUNDS | OCEAN PARK ASSET MANAGEMENT

The Fed Makes a Move, but Is It Too Late?

The U.S. Federal Reserve (the "Fed") has played a large role in stabilizing both financial markets and the economy since the financial crisis years ago. In fact, the Fed has kept its short-term lending rate near zero two-thirds of the time since late 2008. In addition, the Fed bought over $3 trillion of Treasuries and mortgages during the Financial Crisis to keep borrowing costs low. More recently, the Fed has bought an additional $4 trillion of Treasuries and mortgages since early 2020.



Balance sheet expansion under rounds of quantitative easing (QE), USD billions

	Announced	Terminated	Length (m)	Treasuries	MBS	Loans**	Balance sheet
QE1	11/25/2008	3/31/2010	16	$300	$1,074	$0	$1,403
QE2	11/3/2010	6/29/2012	19	$829	-$196	$0	$568
QE3	9/13/2012	10/29/2014	25	$822	$874	$0	$1,674
QE4***	3/23/2020	Ongoing	19	$2,872	$1,066	$153	$4,174

Source: FactSet, Federal Reserve, J.P. Morgan Investment Bank, J.P. Morgan Asset Management.
Currently, the balance sheet contains $5.4tn in Treasuries and $2.5tn in MBS. *The end balance sheet forecast assumes the Federal Reserve maintains its current pace of purchases of Treasuries and MBS through at least November 2021 as suggested in the September 2021 FOMC meeting. **Loans include liquidity and credit extended through corporate credit facilities established in March 2020. Other includes primary, secondary and seasonal loans, repurchase agreements, foreign currency reserves and maiden lane securities. ***QE4 is ongoing and the expansion figures are as of the most recent Wednesday close as reported by the Federal Reserve. Forecasts are not a reliable indicator of future performance. Forecasts, projections and other forward-looking statements are based upon current beliefs and expectations. They are for illustrative purposes only and serve as an indication of what may occur. Given the inherent uncertainties and risks associated with forecasts, projections or other forward-looking statements, actual events, results or performance may differ materially from those reflected or contemplated.
Guide to the Markets – U.S. Data are as of September 30, 2021.

Fed Board members, including Chairman Powell, initially believed that the high rates of inflation seen in the past six months were temporary, driven primarily by short-term global supply chain issues. This made sense since global economies have reopened to a large extent after last year's near complete shutdown.

Chairman Powell and other forecasters were counting on a 'Goldilocks' situation, where inflation quickly fell back to 2-3%, allowing the Fed Board to take their time, gradually reducing the high levels of support. For example, the Fed recently announced that it will reduce its monthly purchases of Treasuries and mortgage bonds later in November, with further reductions spread over many months.

Unfortunately, October's Consumer Price Index release showed that year-over-year inflation isn't just high, but at the highest level in 30 years. Consumers aren't the only ones paying higher prices. In fact, businesses saw the wholesale prices they pay rise a record 8.6% year-over-year in October.

The continued surge in inflation has led both the Fed and markets to now expect two increases in the Fed Funds rates next year.

The Fed will have to walk a tightrope to quickly move back to 'normal interest rates' without disrupting economic growth. Inflation expectations at the beginning of the year were right at the Fed's target of 2%. Inflation fears increased in the second quarter as consumer price inflation picked up. But investors now expect inflation to be near 3% for the next five years, as measured by Treasury Inflation Protected bonds.

Inflation expectations have jumped from 2% at the beginning of the year to almost 3%.

Source: YCharts

The indices shown are for informational purposes only and are not reflective of any investment. It is not possible to invest an index. The data shown does not reflect or compare features of an actual investment, such as its objectives, costs and expenses, liquidity, safety, guarantees or insurance, fluctuation of principal or return, or tax features. Past performance is no guarantee of future results.

Employment growth picked up in October but at a cost- hourly wages increased almost 5% from the prior year. Higher wages boost consumer demand, which is good, but also lead companies to raise prices well above the Fed's 2% inflation target to maintain their profitability.

Finally, the U.S. isn't the only country seeing rising prices. Germany's wholesale prices increased 13% year-over-year in October. China's producer prices jumped 13.5% from the prior year, boosted in part due to high energy prices and a shortage of containers. Since the U.S. has large trade deficits with both of these countries, their rising prices will further boost our inflation.

The Fed seems to be between a rock and a hard place. Inflationary expectations have already risen well above the Fed's target before the Fed started reducing its stimulus. The Fed has two choices. Double down on their bet that the current high levels of inflation are temporary, by continuing to avoid aggressive rate hikes. Or become more aggressive in raising rates and hope that inflation falls without a significant economic slowdown or recession. Our best hope seems to be that global supply chains heal rapidly, allowing inflation to slow significantly, as previously expected.

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Doug Loeffler is Executive Vice President of Investment Management at Sierra Mutual Funds & Ocean Park Asset Management. He provides research, analysis, and support for the investment activities of the organization and appears on behalf of the firm in the financial press.

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