Situation analysis

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Substantial progress on jobs and prices brings Federal Reserve changes to asset purchase program

Key takeaways

- The U.S. Federal Reserve (Fed) maintained low interest rates but announced it will begin reducing its monthly asset purchase program this month and plan to conclude purchases in June 2022.
- Fed Chairman Jerome Powell expressed patience on rate hikes despite investors pricing in relatively aggressive interest rate hikes in 2022.
- Today's announcement is consistent with our positive outlook on the economy and diversified portfolios. Policymakers retain significant flexibility to slow or speed up policy normalization as economic data evolves.

The Federal Reserve (Fed) maintained accommodative monetary policy of low interest rates following the conclusion of its regularly scheduled two-day meeting and announced gradual asset purchase reductions (tapering). The Fed plans to reduce the $120 billion per month asset purchases of Treasuries and agency mortgage-backed securities by $15 billion per month, starting in November and concluding in June 2022. The Fed believes employment and prices have met their goals for substantial further progress to begin tapering the asset purchases.

However, the debate around how quickly the Fed will increase interest rates overshadowed the highly anticipated tapering announcement. Bond market prices imply more than two interest rate hikes in the second half of 2022 and two more in 2023, a faster pace than Fed member surveys indicated at their last meeting. Our positive outlook for diversified portfolios remains intact based on economic reopening progress and supportive corporate fundamentals. Elevated inflationary pressure resulting from supply chain problems and worker shortages along with COVID-19 impacts on the pace of the economic recovery remain key risks to our view.

Global stocks were up prior to the announcement and rose further on the lack of any major surprises combined with still-easy monetary policy. The S&P 500 Index representing larger U.S. companies, the Russell Midcap Index representing mid-sized companies and the Russell 2000 Index of small companies all hit new all-time highs today. Treasury yields increased slightly for longer maturities, although shorter-term bond yields were little changed after the Fed's announcement. The 10-year Treasury bond currently yields 1.59 percent, up from 0.92 percent at the beginning of the year but down from the 2021 high near 1.76 percent in March.

Concluding bond purchases by June 2022 would provide the Fed significant optionality to increase interest rates as soon as July 2022 if conditions warrant, though we don't anticipate such an aggressive trajectory unless we see significant further labor market progress and/or inflationary pressures remain uncomfortably high. The official statement from the Fed's two-day meeting stated, "Inflation is elevated, largely reflecting factors that are expected to be transitory." In response to a question around expectations of two rate hikes currently priced into bond markets for 2022, Chairman Jerome Powell said, "We think we can be patient" with respect to interest rate hikes.

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Powell's four-year term expires in February, which increases policy uncertainty considering no announcement yet from President Biden on who he will nominate for the role. Odds from PredictIt strongly favor Powell, seen as a pragmatic leader who led the Fed's rapid and aggressive response to capital market convulsions in March 2020. We would anticipate odds of 2022 rate hikes would fall considerably if President Biden surprises markets by nominating Lael Brainard. President Biden noted yesterday he will make an announcement "fairly quickly."

Our investment outlook remains "glass half-full" regarding the forward prospects for diversified portfolios. Rising corporate earnings, continued reopening progress and accommodative central banks support our near-term outlook. Ongoing supply chain problems and a slow labor market recovery, both of which contribute to uncomfortably high and persistent inflation, remain risks to our view. We continue to encourage investors to retain a multi-year, multi-cycle perspective, being mindful of recent events but focusing on two key investment horizons: First, the current reopening activity around the globe and countries' variable speeds and glidepaths as they emerge and second, the steady state that follows and how sustainable growth may be throughout that second horizon.

As always, we value your trust and are here to help in any way we can. Please do not hesitate to let us know if we can help address your unique financial situation or be of assistance.