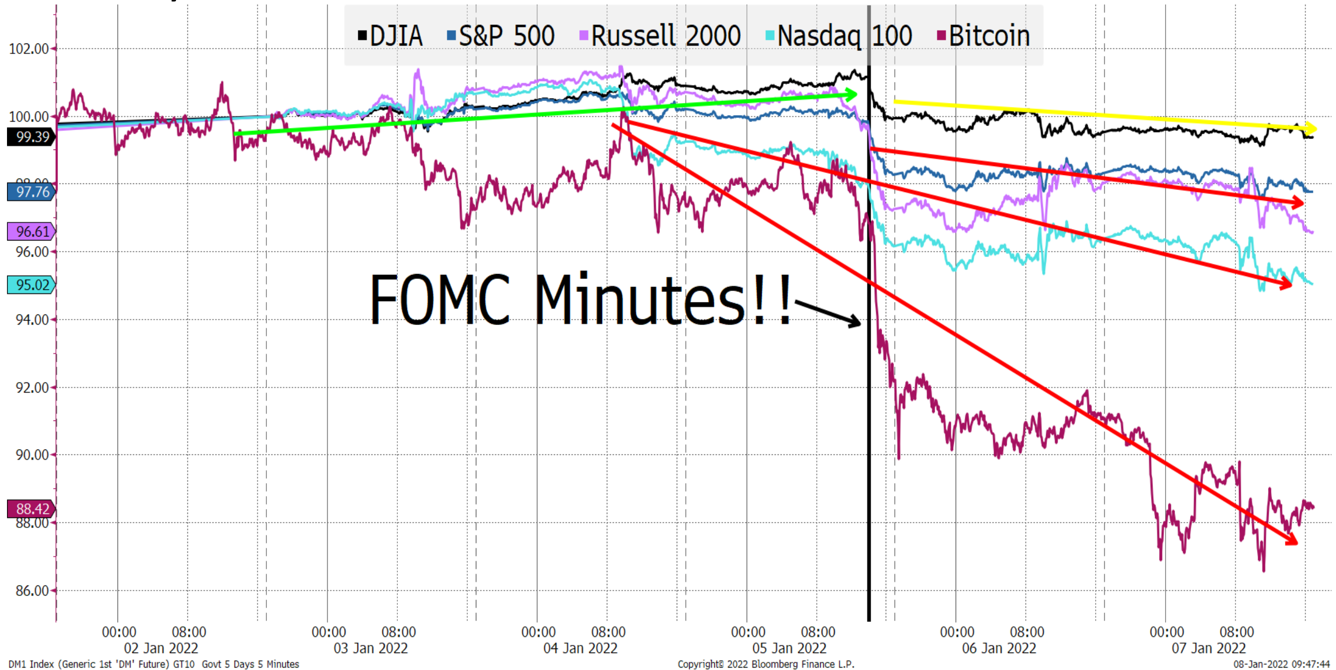
How the Year Changed in Minutes

We came into this year looking for the FOMO and TINA assets to underperform (The 2022 Outlook).

That outlook got a huge boost when the Federal Reserve released their minutes on Wednesday at 2pm.

An Unusually Clear Chart



The year was more or less meandering along with some outperformance from the Dow and S&P 500 and some weakness in the Nasdaq 100 and Bitcoin. That meandering shifted dramatically with the release of the FOMC minutes and in my estimation, the market hasn't traded as well since then (the bounces seem weak and almost artificial, while the selling seems relentless and motivated). We addressed some of this briefly in FEAR published Thursday, but will expand on this today as we prepare for what should be another volatile week.

The Minutes

First, let's start with my understanding of the FOMC Minutes. These are not minutes in the sense that someone is scrambling to write down all that is said at the meeting so it can be released at some later date as a transcript. **FOMC Minutes are a policy tool in their own right**.

The minutes are done after the meeting. They are carefully reviewed. They can be used to reinforce a message they tried to send (if they think that the market didn't understand it properly) or to correct a message that they think the market misunderstood. These minutes, as I understand them, can be influenced by data and information that has come out since the meeting itself (probably not a lot, but the potential is there).

So, these minutes as I use them, are not just a reflection of what went on, but are a guide to nudge the markets in a direction that they already expected us to be moving in.

The clear takeaways from the minutes were:

- **Anyone, including me, who was thinking "one-ish" hikes must seriously reconsider that view**, not only because of the minutes, but also because the minutes have been supported by various Fed Speakers, at least in terms of pounding the table on rate hikes. **I think that the hikes aren't that important in the grand scheme of things**. Basically, hikes were already priced in, and the naysayers all know that hiking has a higher hurdle than messing with the balance sheet.
- **Anyone, including me, who thought that balance sheet reduction was a next year issue needs to rethink that view.** This, to me, was the big news of the day. For many of us who had difficulty understanding why taper started so late (market conditions felt pretty darn good long before taper started) now has to consider that not only would we stop buying bonds (finally), but we might let the balance sheet shrink!

If QE helped risk assets (and I think it helped immensely), then QT, even if just run-off (without selling), could hurt risk assets. The markets are always pricing things in ahead of time and this has started to get priced in (and likely has more to go).

The Fed could clarify that the minutes (and some additional speakers) have again been misinterpreted and they didn't really mean balance sheet reduction. Markets would then breathe a sigh of relief.

Having said that, I've viewed balance sheet size as an easier tool for the Fed to use, so **my base case is now**:

- One hike, likely at the March meeting. I'd be less surprised, now, to see the first hike at the January meeting, than the May meeting.
- Then talk about slowing or stopping reinvestment. I still cannot imagine them actually selling, but they might put a cap on how much it can run down in any given month (this seems to be on the table).
- Beyond that is anybody's guess, and we will work through some thoughts, but risk assets are going to derive their price action from the level of QT for the coming weeks as markets ascertain what was meant (and rate hikes don't help that either).

Video Killed the Radio Star and Politicians Killed the Fed

The one thing that has changed in the past few weeks is that inflation is now consistently in mainstream media headlines, and it is one of the **hottest political topics out there**. I strongly believe that the Fed has been as politically independent as possible (something critical given their role and importance to the economy). However, it does seem like politicians, from the president on down, likely have some influence (it seems like it would be naïve to believe otherwise, given how important the subject has become).

Politicians have been contorting all sorts of data to downplay inflation. Some have used it as an excuse to attack businesses. Others just seem to misdirect our attention with strange or vague statements. In any case, the president has made his view on inflation quite clear and certainly seems to be sending marching orders out to squelch it as much as possible.

I am not diminishing the impact felt by the poorest people in this country, where inflation has the potential to erode their quality of life, but:

- **Average hourly earnings are up 4.7% year on year** (up 0.4% in November and 0.6% in December).
- **According to JOLTS**, the number of job openings remains well above ten million (there are three million MORE job openings than before the pandemic, which if those get filled, would take us back to as many people employed as before the pandemic). The "quit" rate is the highest since they started tracking that data, which is indicative of a very strong labor market.
- **Anecdotally, people complain about the ability to hire.**
- My outlook, based partly on the potential to get some form of stimulus, but much more heavily based on onshoring or supply chain repatriation, means that jobs should continue to be created.

If jobs were difficult to get or if pay was trailing inflation heavily, then I would be scared of inflation, but as I wrote in Inflation, Like Greed, is Good, that is NOT the current story. We have excellent job opportunities, rising pay, and **whether it is infrastructure spending, building out sustainable energy, or creating more dependable supply chains, there will be big benefits to be reaped down the road** including the realistic belief that things like renewable energy will be deflationary once it reaches sufficient scale.

Additionally, I am not sure how raising rates helps supply chain driven inflation? How does the U.S. raising rates make China produce more, ship it to us, and get it offloaded?

Even if fighting inflation is the right step, I'm struggling to see how much it helps the current causes of inflation.

Those most hurt should be protected and helped as much as possible given the drivers of inflation, the ultimate benefits of inflation, and the need to build out so much in parallel, but that protection seems better suited coming from D.C. rather than from the Fed.

I am extremely worried that we are addressing the wrong issues with the wrong tools because this has become a game of political soundbites rather than political solutions.

Underperforming in a Weak Market

When I look at sectors, industries, and asset classes I remain incredibly comfortable with the outlook from last week (with the exception of rates which we will deal with in a moment).

I just think that the relative performance will occur in a weak overall market rather than in one of decent strength.

Repricing Credit Not Rethinking Credit Risk

Credit spreads widened this week, but are still tighter than in early December.

I continue to expect credit to perform decently this year (not a lot of room for tightening, but widening should be contained).

While I got bullish on high yield in early December (at levels only slightly cheaper than now), I'd hold off on adding as I think that we can see some more weakness.

Markets need to price in what is the appropriate spread for any given level of credit risk now that the central banks have shifted to being far less accommodative (far sooner than previously expected).

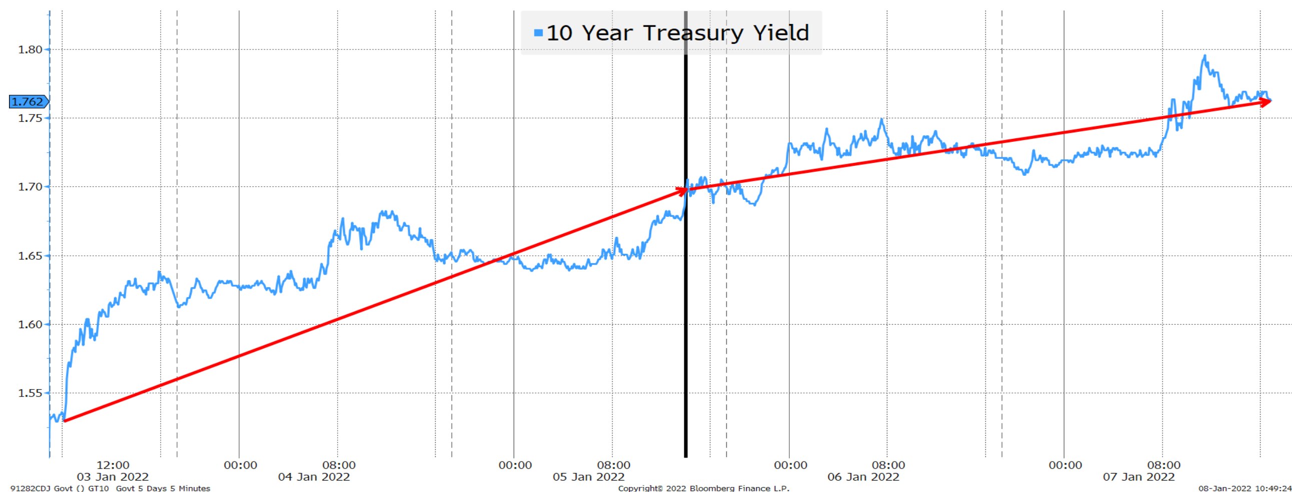
That is very different from needing to price in that credit risk itself is rising.

I think that the economy itself will do well enough (even with a more hawkish Fed) and credit risk will not change materially. Most companies have such a large buffer between what they are earning and what they need to pay on the debt front that any change in that relationship is not going to be big enough to call into question credit worthiness. I just think (in fitting with relative performance occurring in a weak tape) that people will demand to get paid slightly more for the same level of risk.

Which Brings us to Rates

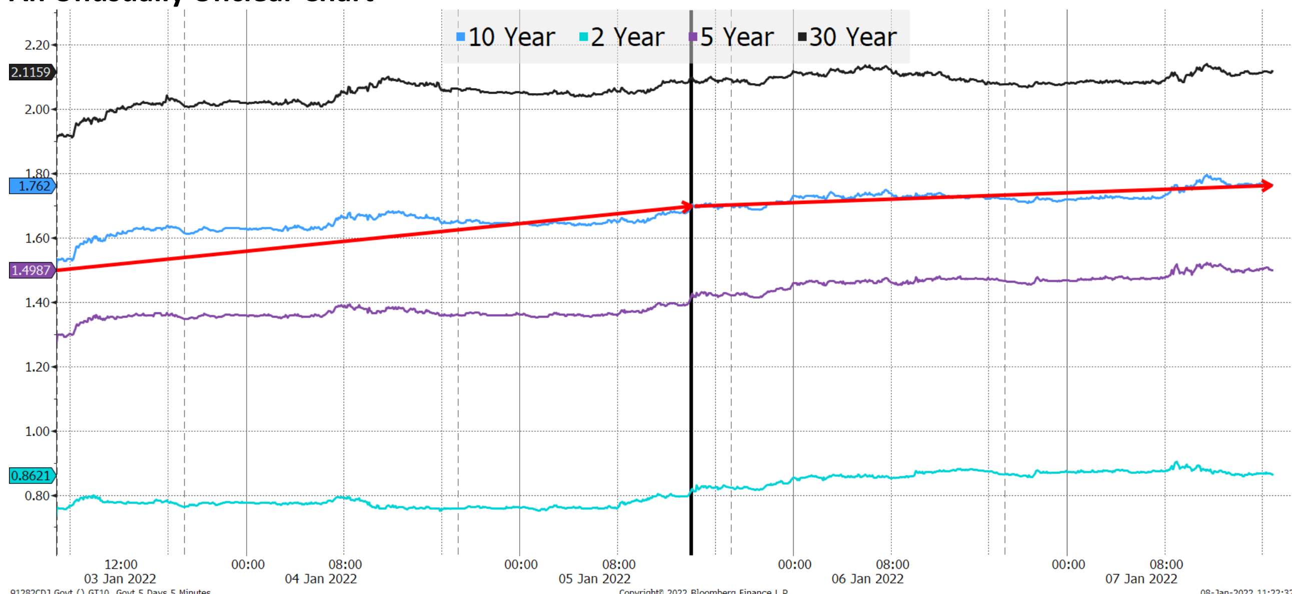
It seems ironic (**or maybe I'm just being stupid**) that for much of the past 12 months we have had to lead with rates because they have been such a driving force in every other market, but today I am looking at them last. It feels ironic (**or again, maybe it is just me being stupid**) that the Fed's decision to not buy Treasuries seems to impact other markets more than the Treasury market.

In any case, I will end today with rates.



The 10-year Treasury yield jumped from 1.5% to 1.76% over the course of the week. What is interesting is that most of the damage was done prior to the minutes! Also, unlike risk assets, which finished the week at or near their lows, Treasuries finished with a bit of strength.

An Unusually Unclear Chart



We started this T-Report with a very clear chart, here an event occurred, and the reaction and implications seem obvious. Rates just didn't exhibit that. The best I can make out is that it was a largely parallel shift in the yield curve, with rates moving higher across the board, and most of the price action was done before the minutes. There was some steepening of yield curves, but many curves (like 5s vs 10s) **hit their steepest point on Tuesday**!

I must admit that **10s vs 30s** isn't part of the yield curve I fixate on, but not only did that hit its steepest level on Tuesday, but it **finished the week flatter**!

If the QE narrative was all that was at work, then why would we see 30s outperform? Shouldn't the long-end bear the brunt of less Fed buying? Maybe it is more hikes, but then why did the 2-year move so little?

I think that given the lack of a clear story in rates (at least from curve shapes) and the fact that most of the move occurred ahead of the minutes, what we are seeing here is some knee-jerk reaction and bad positioning.

Yes, the higher 10-year yield probably helped push stocks lower, but that narrative is probably overplayed.

Risk-Off?

We've had the QE trade (where everything does better). We've also had the QT trade that maybe appeared for a few moments (where everything does worse, but that trade tends to be short lived, at least recently). We did get some good "risk-on" moments, which was more of what I was looking for when thinking Treasury yields would go higher and be supportive of the sectors and industries that I liked (and they held up remarkably well last week given how quickly yields moved higher).

As we come into this week, I think we get:

- Underperformance in TINA/FOMO/Complexity, however you want to define it.
- Outperformance in simplicity/value/dividends/reopening/travel/logistics/onshoring.
- This will occur in a "risk-off" environment where equities and all risk assets will struggle and rates, especially at the long end, will do well (yes, I like owning Treasuries here).

Sure, futures could open solidly on Sunday and we can always look forward to another Turnaround Tuesday, but unless the Fed pulls back, Omicron slows rapidly, or DC looks like they can get policy done rather than just creating more soundbites, I'm uncomfortable with risk here and wouldn't bet on any of those caveats too heavily!

In any case, 2022 is off with a bang and we will all have to work hard to navigate it!

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