CITY NATIONAL ROCHDALE
AN RBC/CITY NATIONAL COMPANY

JUNE 22, 2021

On the Radar

FAQS ON THE MARKETS AND ECONOMY

Should investors be worried about tapering?

Fed stimulus has been a powerful source of fuel for the recovery in stock prices over the past year, and a transition to less policy support is bound to bring some anxiety to markets. However, given our outlook for multiyear expansion and above-average economic growth, we don't think it will be a major headwind for equities.

The experience following the 2013 "Taper Tantrum" is informative. After then-Fed Chairman Ben Bernanke caught investors by surprise signaling plans for a gradual reductions in asset purchases, the S&P 500 underwent a 5.8% pullback that lasted 23 days.

Markets subsequently stabilized as the economic recovery continued to gain traction and investors grew increasingly comfortable with the idea of a less supportive Fed. Indeed, from the time Bernanke announced QE would be reduced in May of 2013 until the QE finally ended in October of 2014, the S&P 500 increased over 20%.

Tapering will be only the first step on what will be a long path toward monetary policy normalization, and eventual interest rate hikes are still likely two years away. But it should be reassuring that policymakers believe the economy is starting to move beyond the COVID-19 crisis and will need less of a helping hand. If tapering occurs, then the economy is strengthening, and that should be good for earnings and for equities.

In the meantime, we suspect officials have learned their lessons from 2013 and intend to be as clear as possible about the Fed's expectations in order to avoid sending any mixed messages to markets.

S&P 500

Source: Federal Reserve Bank of St. Louis.

Investors can also take comfort in the fact that periods leading up to the initial policy-rate increase have historically been very favorable for equities. Since 1990, the S&P 500 has averaged a total return of 18% during the two years preceding the Fed's first rate hike.

KEY QUESTIONS

Is the Fed going to be raising interest rates in 2023?

Why are retail sales falling despite households having so much money?

Is the Fed going to be raising interest rates in 2023?

That was the headline of many articles, but forecasting interest changes is a little more complicated than a simple headline.

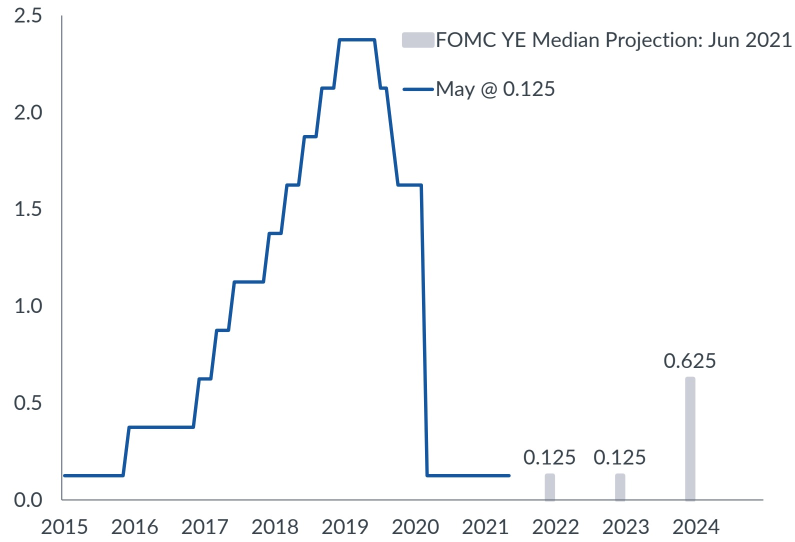
Once a quarter, the Fed forecasts GDP, unemployment rate, inflation, and the federal funds rate. At their meeting last week, the 18 members had an extensive range in votes regarding the federal funds rate. Five members thought there would be no change in interest rates, and two members thought the rate would move up to 1.625%; the remaining votes were distributed between those levels.

The vote does not mean the Fed is planning to raise interest rates in 2023; it tells us that some members think rates should increase by then.

Powell says take this with "a grain of salt." First, 2023 is a few years away, and a lot will happen before we get there.

Second, monetary policy decisions tend to be guided by senior Fed members (chairman, vice chairman, and president of the New York Fed), not an average of all the voting and non-voting members.

Federal Funds Rate & FOMC Projections (%)



Source: Bureau of Labor Statistics as of June 2021.

Why are retail sales falling despite households having so much money?

Last month, retail sales declined by 1.3% month over month, but they are up 28.1% year over year.

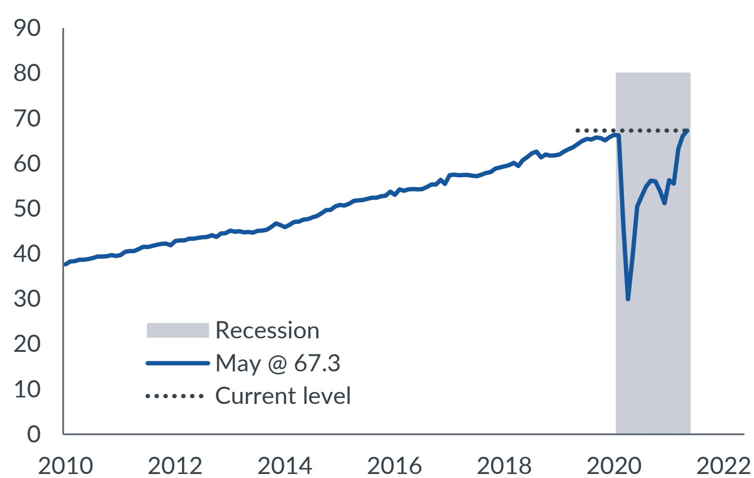
Retail sales generally measure the sale of goods, not services. Since the pandemic started, households have spent an increasing amount of money on goods (Pelotons, Big Green Eggs, home improvement products, etc.). They have not spent much money on services, due to social distancing requirements.

That is beginning to reverse. With the economy reopening, consumers are now clearly rotating out of durable goods into nondurable goods and services, which generally does not show up in the retail sales report. The weakness in May's retail sales was concentrated in building materials (-5.9%), vehicles (-3.7%) and electronics (-3.4%). Yet restaurant sales are now above the pre-recession peak as consumers are starting to venture out (see chart).

To fuel future spending, households have built up "extra" savings of more than $2.5 trillion compared to the average savings of 2019. That will give them plenty of money to spend in the future.

Retail Sales: Restaurant Sales

$, billions, seasonally adjusted annual rate



Source: U.S. Census Bureau as of May 2021.

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