Today's Market

The Fed Just Crashed The Market's Party

Jan. 06, 2022 3:56 PM ET | ACTV, AFMC, AFSM... | 10 Comments | 8 Likes

Summary

- The FOMC minutes showed that the Fed is even more hawkish than previously thought.
- That has sent yields surging higher.
- With earnings growth slowing, the S&P 500 is the most expensive in modern times.

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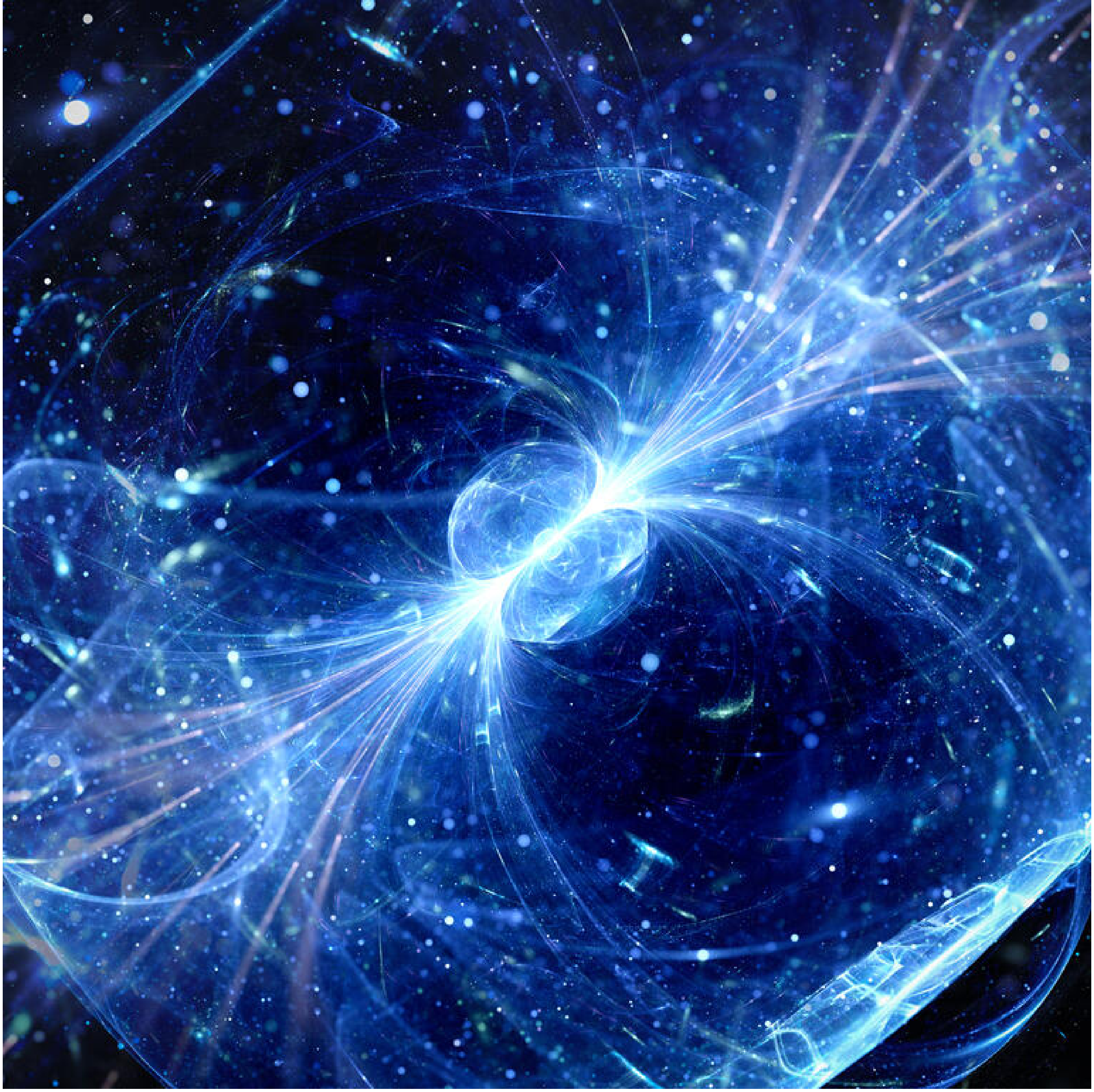

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Stocks fell sharply following the release of the Fed minutes from the December FOMC meeting. It seems that the Santa Claus rally proved not to last as expected, with the Nasdaq composite giving back nearly all of its gains from Dec. 21. The S&P 500 has fared a little bit better, giving back half of its gains to this point.

The FOMC minutes noted that the Fed plans to reduce the balance sheet size shortly after the first rate hike. That would be much sooner than many expected, adding another wrinkle to a changing macro backdrop in 2022.

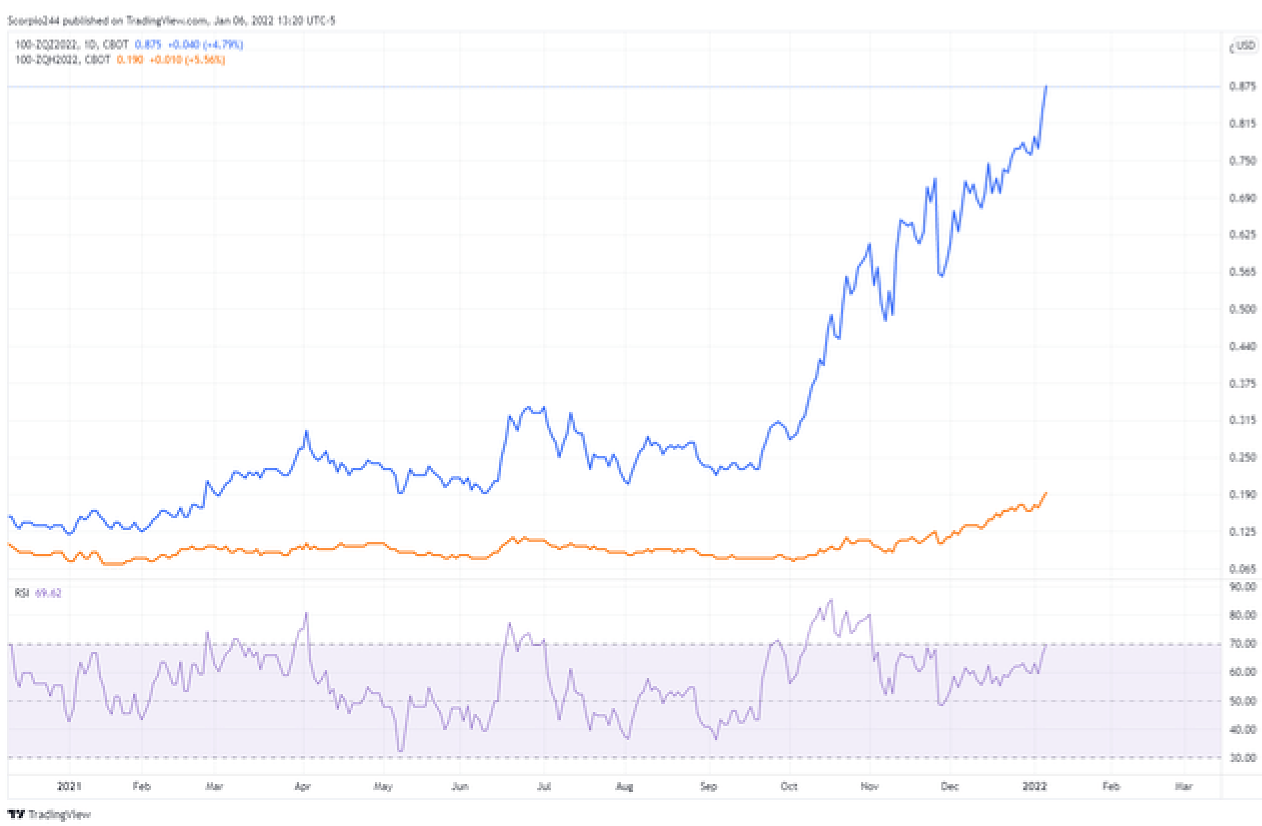
Next week, the most significant risk comes on Jan. 11, when Powell will go before the Senate for his confirmation hearing. It's not likely that Powell will suddenly become dovish and try to walk back the commentary from the minutes.

If anything, he's likely to reaffirm the hawkish tone of the minutes and most certainly will be asked by a senator or even two about what the Fed plans to do with the balance sheet. It seems like the perfect opportunity for him to discuss reducing the balance sheet and perhaps any methods discussed amongst the FOMC participants.

Yields Rocket Higher

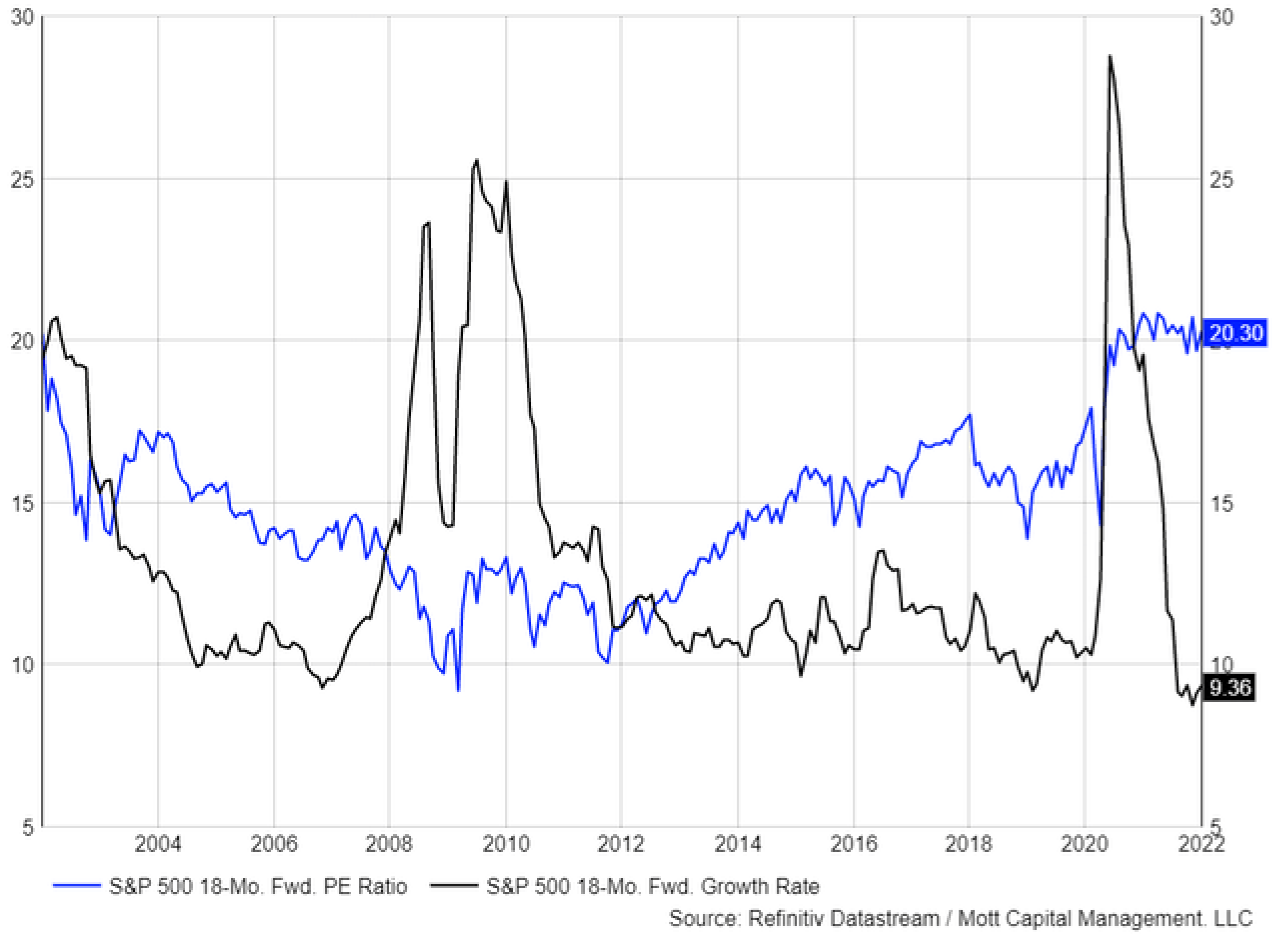
This hawkish tone from the Fed has sent a shockwave through the bond market, with yields moving sharply higher, especially on the front of the curve, and the two-year yield now trading at 88 bps. Worse, especially for the growth/technology trade, real yields, or TIP rates, have surged dramatically higher. The 5-Yr TIP is yielding a rate of -1.32% as of January 6, up from -1.6% on Jan. 5.

Additionally, the Fed Fund Futures for December 2022 is now at 87.5 basis point, suggesting a full three rates hikes for the year. Meanwhile, the futures for March 2022 are currently trading at 19 basis points, reflecting the possibility of the first-rate hike.



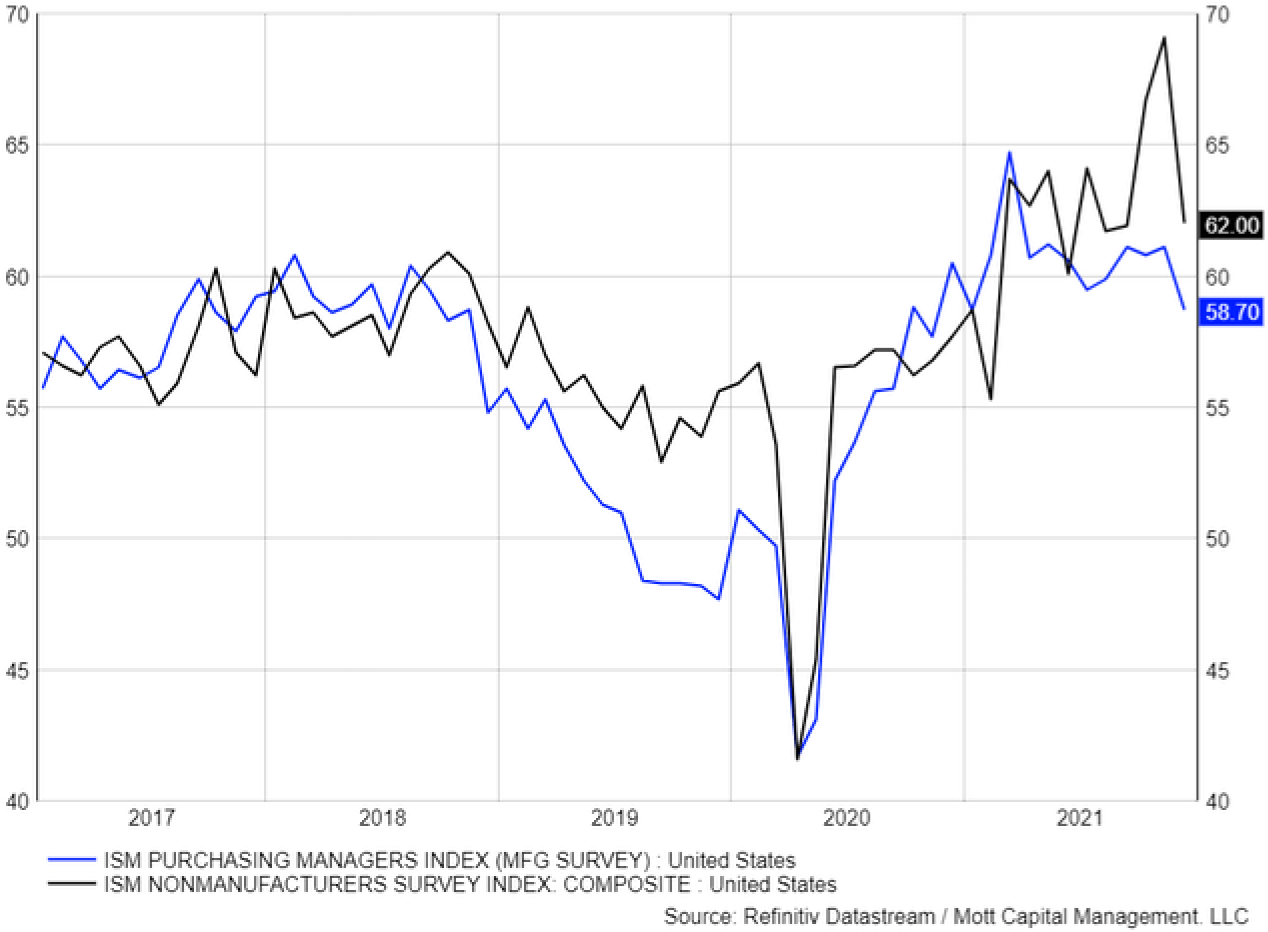
Multiple Compression

Rising rates, tighter monetary policy, and the balance sheet reduction are not suitable for stocks or the multiples that investors pay. It brings the most central question - how will the stock market hold on to the high PE multiple that every sell-side analyst has used to achieve their S&P 500 targets for 2022? Higher rates will make it more challenging to maintain the high earnings multiples currently priced into the market. The S&P 500 is still trading at 20.3 times its next 18-months earnings estimates, higher than where it was in early October. It's also much higher than its previous highs over the last 10 years.

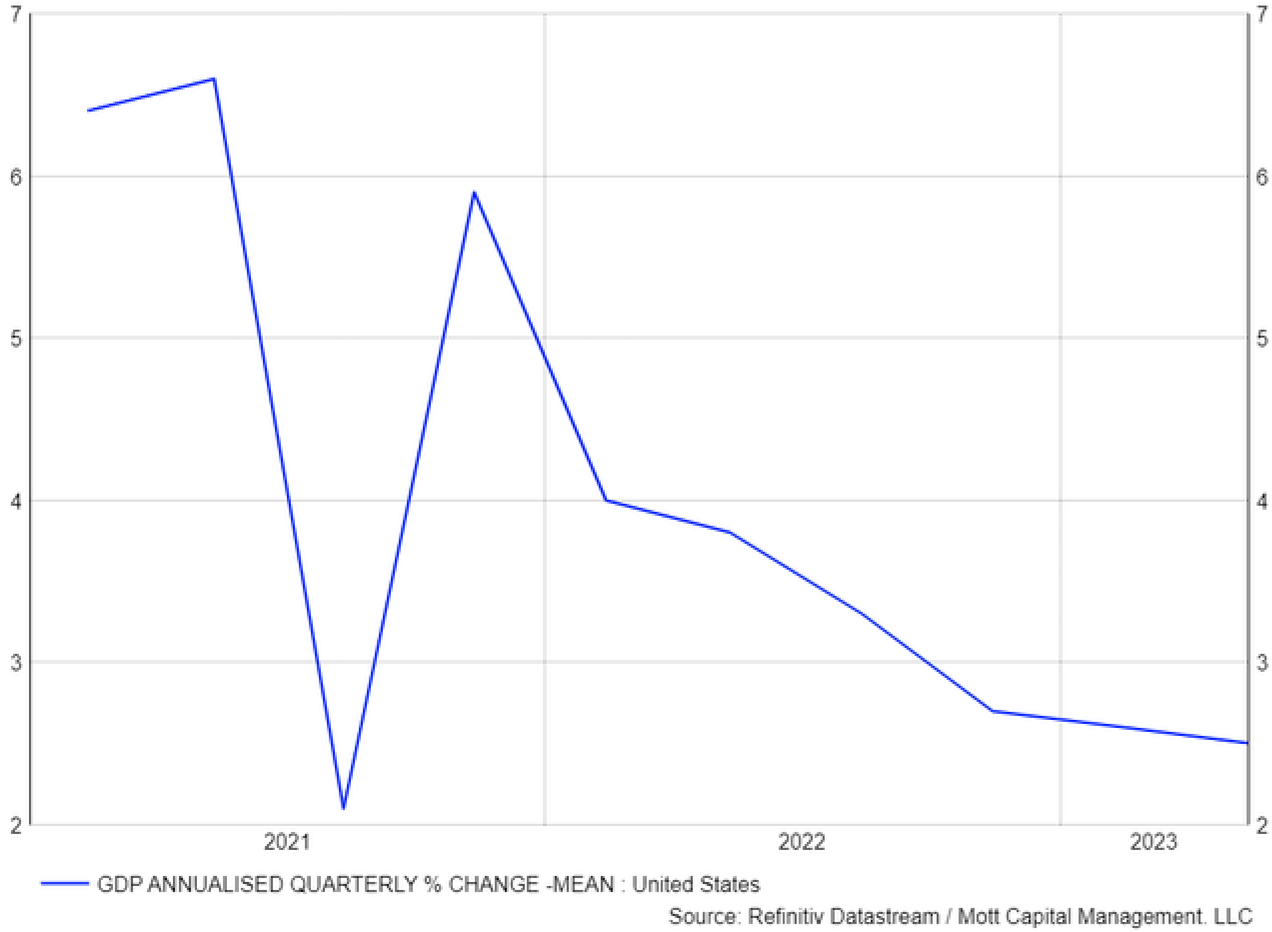


Now that earnings growth is forecast to rise by just 9.4% over the next 18 months, the valuation on the S&P 500 has gotten even more extreme. The index now has a PEG ratio for the next 18 months of 2.2. That's the highest valuation for the index since 1985. Historically, since 2010 the PEG ratio has typically peaked in a range of 1.5 to 1.7. That would imply the S&P 500 has a PE Ratio of around 14 to 16.

With earnings expected to climb to $231 over the next 18 and a PE ratio of 14 to 16, the S&P 500 would trade in a range of 3,250 to 3,700. Of course, that's assuming that earnings estimates don't fall. What makes everything more treacherous is that the Fed tightens monetary policy when there are clear signs of slowing in the economy. Yes, the Atlanta Fed GDPNow model is forecasting fourth quarter growth of 6.7%, but that's down from a more than 9% reading at the beginning of December. On top of that, the latest ISM manufacturing and non-manufacturing data missed expectations by a lot and were down month-over-month, and trends suggest further slowing to come. The Fed will be tightening monetary policy into an economy seeing slower growth.



The most recent polls from Reuters show that expectations are for GDP growth to slow to 4.0% in the first and second quarter of 2022 and then slow to 3.3% and 2.5%, respectively, in the third and fourth quarters. It seems clear that with the Fed on a mission to tame inflation and a more hawkish stance, those GDP estimates will need to reduce over time.



None of this seems to be suitable for the equity market and is likely to lead to a lot of turbulence in the weeks ahead as the market tries to digest the news of how the path the Fed is most likely to take.

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