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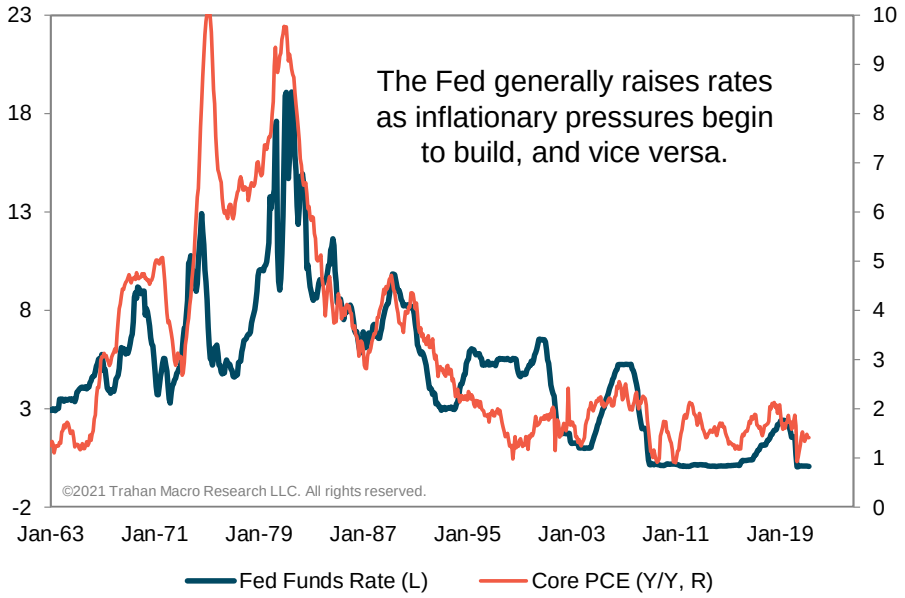
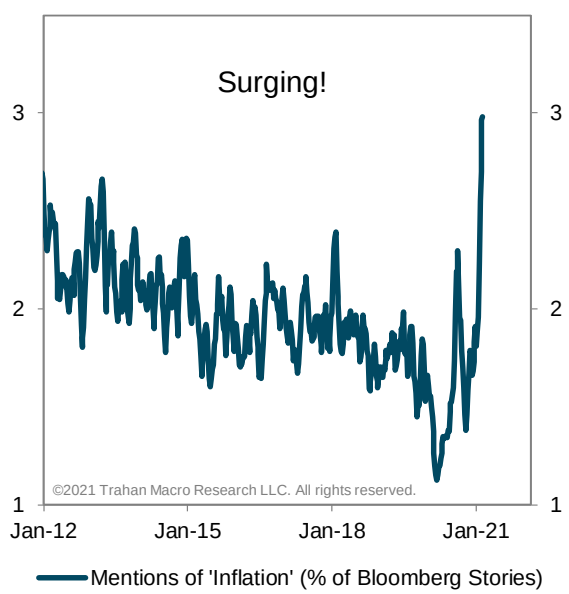
The Fed Trade Nobody Is Writing About (Part Deux!)

One aspect of this economic downturn that feels different from recent memory is the amount of capacity that has been eliminated. Every recession sees some closures but this one feels more like the experience described in textbooks with hints of Schumpeter's creative destruction. It is generally understood that this reduction in capacity combined with an increase in demand is what results in inflationary pressures during economic recoveries. In essence, don't be freaked out by inflation; it is doing what it is supposed to do given the rebound in place. The Fed should also "do what it is supposed to do" and eventually react to this inflation.

Fed Policy And Inflation Are Intrinsically Linked



Inflation Dominates Headlines



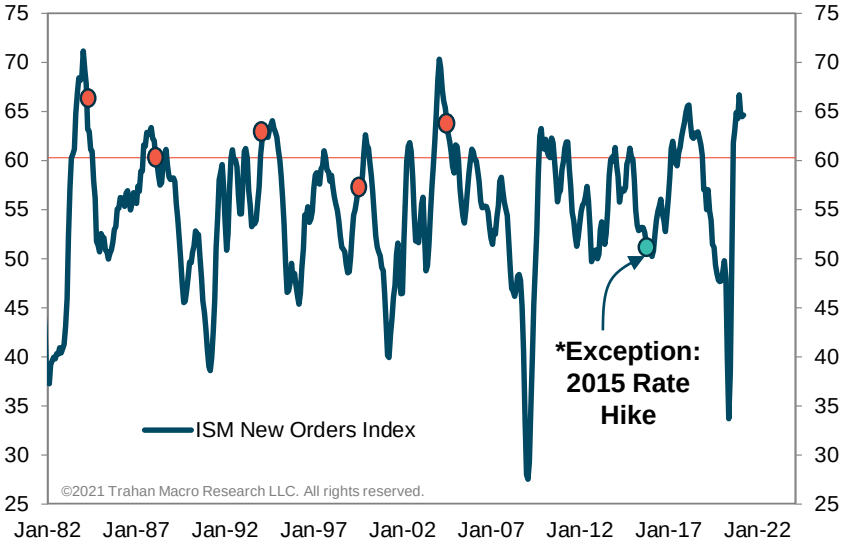
It seems clear to us that the Fed will eventually be forced off the sidelines. Surely, managing a mandate that promotes employment while also containing inflation is challenging with this much stimulus in the pipeline. That said, gauges of Fed policy, like the Taylor Rule, argue that the Fed should already be raising rates. The Taylor Rule is not a perfect tool, but it does help quantify the Fed's dilemma. On page 8, we use a Bloomberg function that allows us to plug estimates into the Taylor Rule equation. Simply using consensus figures for employment and inflation in 2021-22 illustrates just how much pressure the Fed could be facing ahead.

The point here is that Fed rate hikes are almost inevitable, and that line of thinking seems to be gaining ground. What is less clear, however, is how to profit from these events. Consensus views Growth stocks as the best vehicle for the so-called "Fed Trade". Rather, we argue that this is based on a misunderstanding of history and see low-duration stocks as the better alternative for the Fed Trade in 2021. Time will tell which is correct of course. As always, your feedback is greatly appreciated. Best, Francois

Fed Tightening And Growth Stocks … Demystified

The belief that Growth stocks do well when the Fed is raising rates is more coincidence than causality. What we mean here is that the Fed tends to first raise official rates when LEIs (ISM New Orders in the chart below) are at or near a peak for the cycle. This happens to be the point in the equity cycle in which Growth stocks typically begin to outperform. So, this is not a causal relationship – it is just a function of timing. Leadership would be different IF the Fed first raised rates at a different point in the cycle.

First Rate Hike Usually Occurs Near A Cycle Peak*



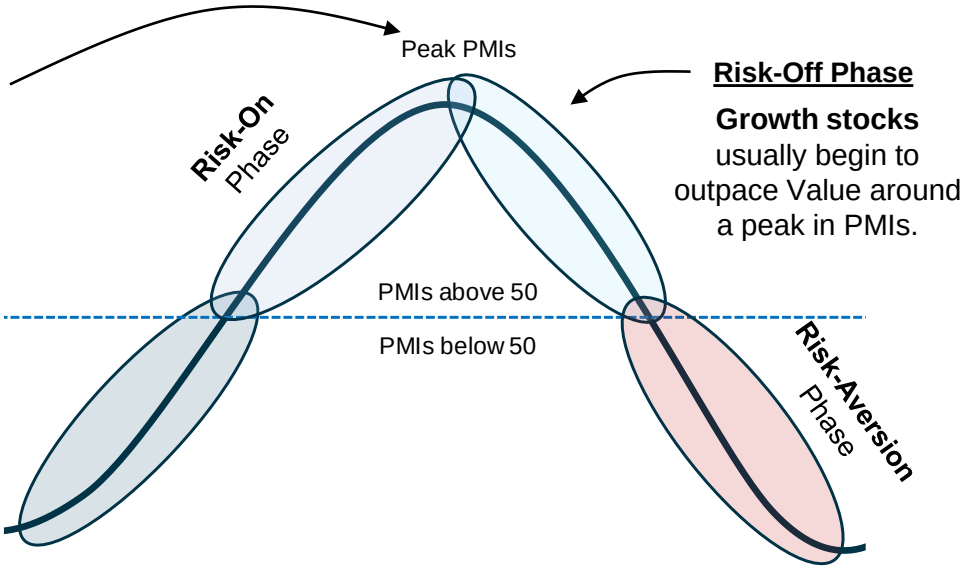
2015 Rate Hike Had Different Timing

Beginning of Fed Tightening	ISM New Orders Index
Mar-84	67.8
Mar-88	59.6
Feb-94	62.1
Jun-99	57.1
Jun-04	64.2
Dec-15	**50.9**

The one time in the last 40 years when the Fed's first rate hike occurred at a different point in the cycle resulted in very different leadership in the equity market. Indeed, the Fed's first rate hike in December of 2015 occurred with the ISM New Orders Index near a low and just about to rebound. Interestingly enough, it is Value and cyclicals that outperformed following the beginning of that tightening cycle.

Fed Tightening And The Cycle:

- The Fed generally raises rates well into a recovery;
- Rate cuts/hikes have an indirect impact on equity leadership, but are **not the cause** for rotations;
- Growth stocks tend to gain traction around peaks in the cycle;
- The performance of Growth stocks is a function of the cycle; NOT the Fed's actions.

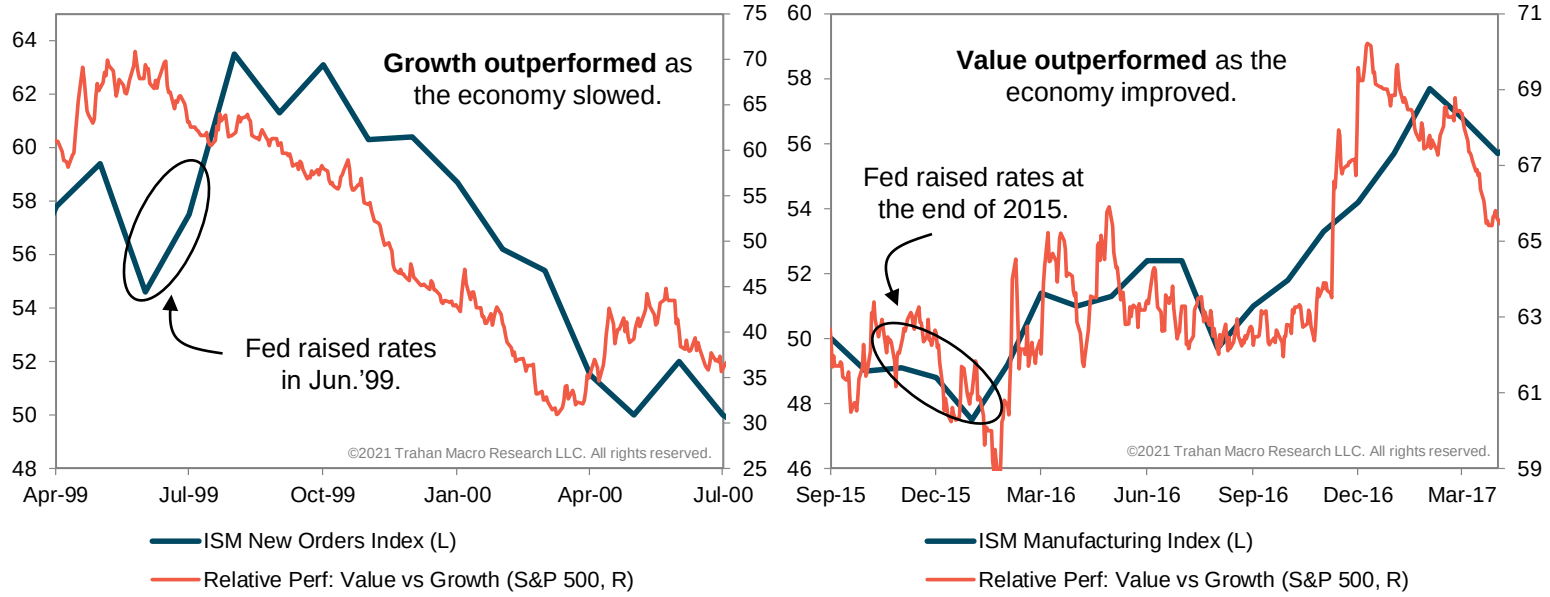


The confusion comes from the near identical timing of that first Fed rate hike across several cycles. This pattern got investors used to associating Fed tightening with Growth leadership. The causality, however, has to do with the data and where it is pointing. It's not about Fed tightening as much as it is about whether one expects LEIs to deteriorate or not. Gauges of policy argue this is not likely in the cards in 2021.

The Real Driver Of Equity Leadership In Fed Tightening (The Cycle)

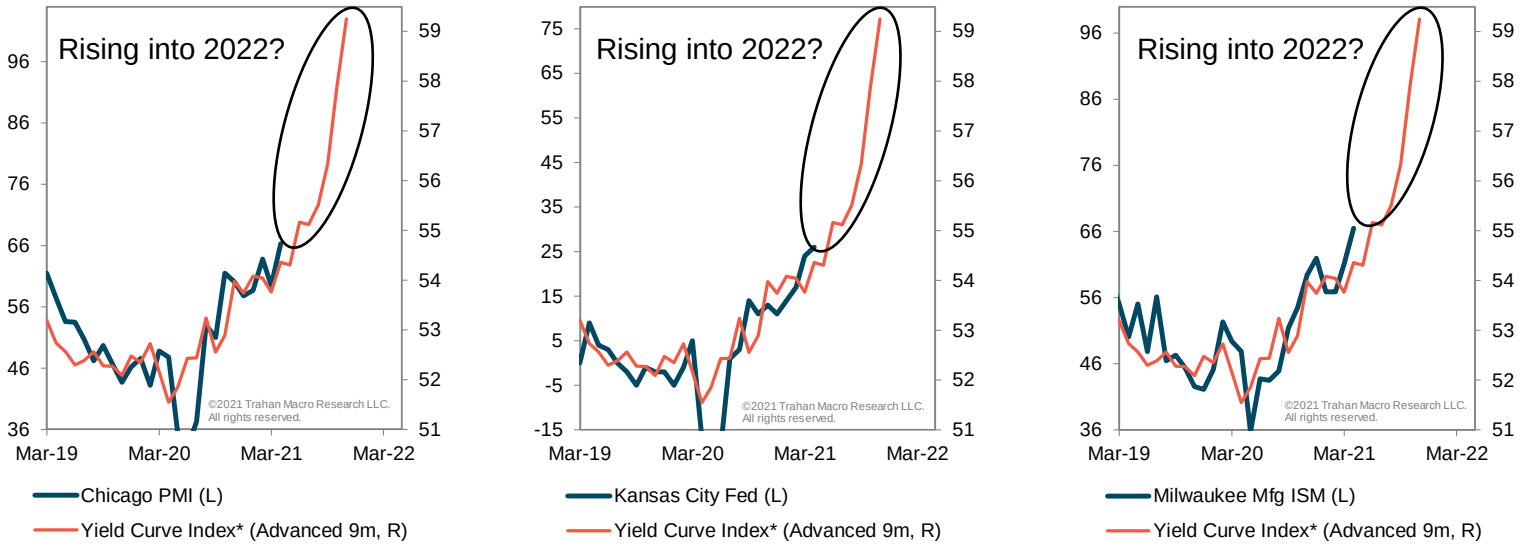
Perhaps the best illustration of the difference in timing of that first rate hike is to look at two episodes side by side. On the left, we see the Fed tightening cycle of 1999-2000. The first Fed rate hike occurred in June of 1999, just as the ISM New Orders Index was about to embark on an extended decline. Needless to say, what followed was Growth leadership as investors flocked toward stable investments. Conversely, the Fed's first rate hike in December of 2015 happened just one month before the cycle trough in the ISM as it was about to rebound and Value stocks led that charge.

Value Stocks Outpaced Growth Stocks Following A Rate Hike In The Last Tightening Cycle



The point of the two charts above is to show that leadership in the wake of that first Fed rate hike hinges on whether the data will improve or deteriorate. Believing that it's just about Fed tightening is arguing against logic and evidence. What we can debate, however, is whether the data does improve from here. After all, the ISM New Orders Index, like most PMIs, sits near cycle highs. While intuition would argue that LEIs are likely to slow from here, proxies of policy argue otherwise. Worded differently, stimulus in the pipeline suggests that a true cycle peak in the data is still several quarters away. While Growth leadership will inevitably take hold at some stage, it is probably more of a 2022 story than a 2021 story.

The Yield Curve Argues The Peak In PMIs Is Still Several Quarters Away



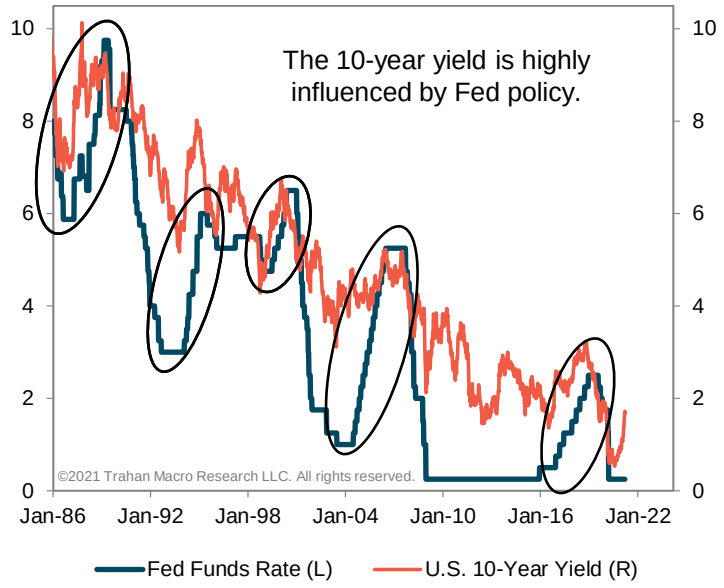
The One Constant In Fed Tightening Is Higher Bond Yields

While there are all sorts of beliefs when it comes to Fed tightening and equities, most don't hold up to the test of historical backtesting. *Buy Growth stocks, three steps and a stumble* and a bunch of other idioms prove to be inconsistent when tested properly. One feature of past tightening cycles that is absolutely consistent, however, is the influence of higher yields. Yields were up in each of the five tightening cycles and, as the table below shows, by an average of almost 200 bps. This is the pathway that influences equities the most, in our opinion. Yields are what you must be mindful of when it comes to Fed tightening.

Yields Were UP In Every Single Fed Tightening Cycle Of The Past 40 Years

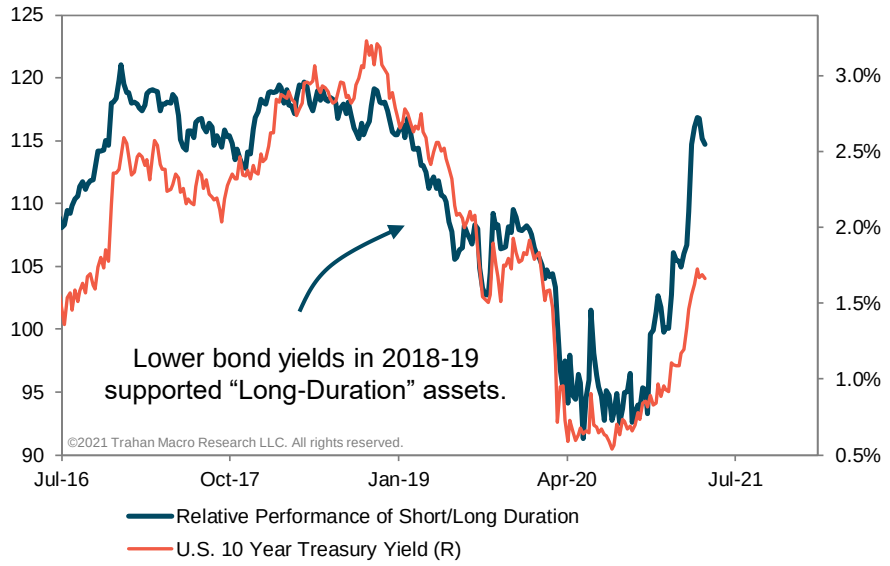
Tightening Cycle	Δ 10-Year Yield
1987-89	1.37
1993-94	2.83
1999-00	2.04
2004-06	1.37
2016-18	1.82
Average	*1.88*

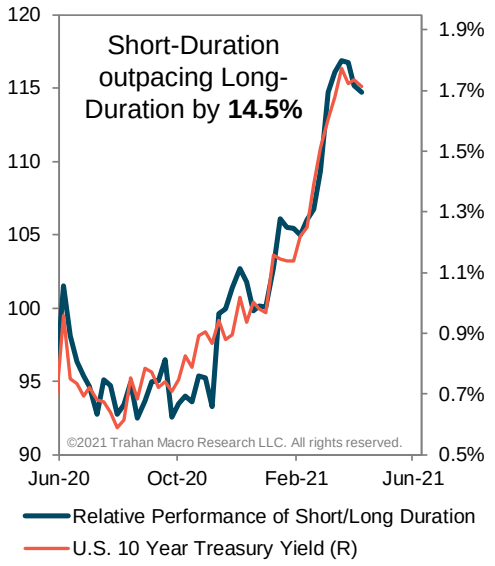
The FFR And The 10Yr Closely Correlated



When we mention yields, the first thing that people think about is Utilities or Financials. Surely, those sectors are influenced by the direction in yields. That said, with valuations so high for the equity market, there is another aspect of the influence of bonds that we have to consider, and that is in regard to what it might do to leadership *WITHIN* sectors. As the chart below reveals, yields have probably had a greater influence on S&P 500 leadership trends in 2021 than any other variable or factor. The reality is that high-flying Growth stocks with lofty equity duration values appear allergic to higher yields.

The Fed's Actions, Via Bond Yields, Driving S&P 500 Leadership

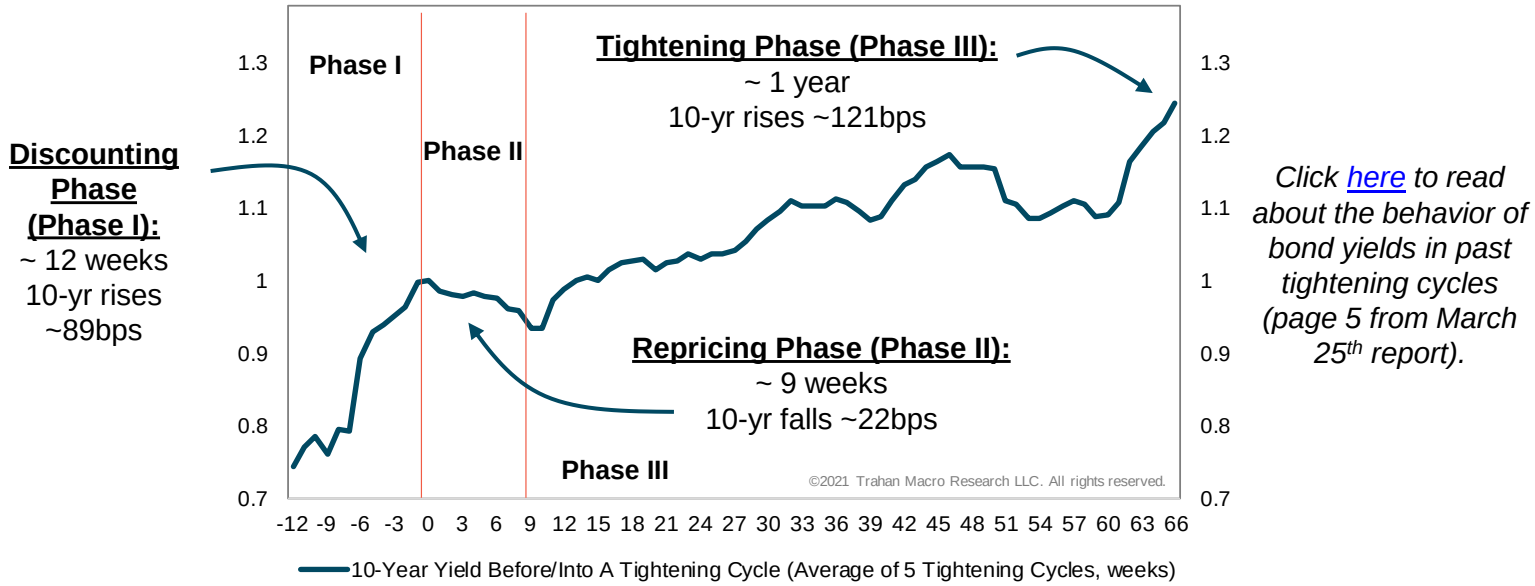




The "Fed Trade" To Dominate Headlines For Years To Come?

Maybe "years to come" is too long? The point is that it seems inevitable to us that the Fed has to raise rates, even when using their own framework, and those cycles tend to last for quite some time. In essence, this is likely to be part of the conversation for the foreseeable future. The chart below is from our report a few weeks back that showed a consistent rise in bond yields in past Fed tightening cycles. We believe that we are in the first phase of this historical pattern. Wall Street opinions are always early on this debate but the recent rise in bond yields is sending a clear message here.

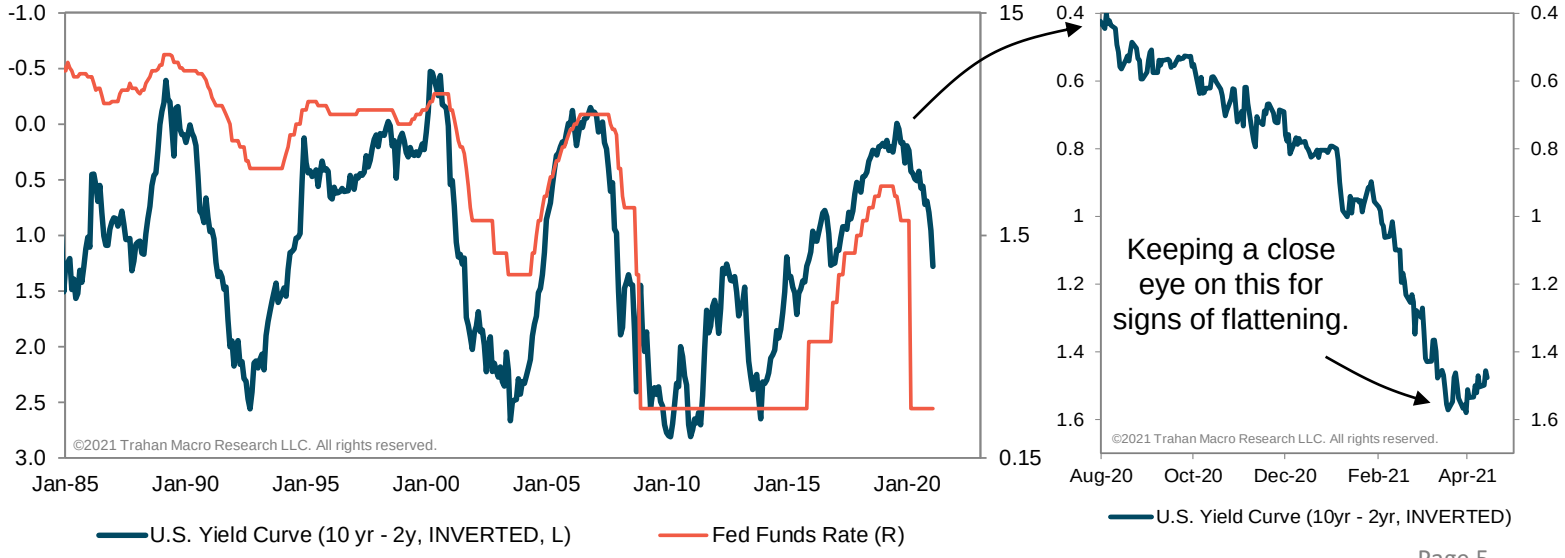
The Typical Rise In Yields In Past Fed Tightening Cycles



Click here to read about the behavior of bond yields in past tightening cycles (page 5 from March 25th report).

Yes, it's true, our industry tends to call for Fed action more quickly than the Fed typically reacts. The difference is we have opinions, while Fed officials have a mandate. Still, we know that markets have begun to price in an eventual hike and that the start date is moving forward. If we wanted to be exact, we would say that the official start to Phase 1 is when the yield curve begins to flatten, which has yet to occur. The "glass half full" voice in me says that recent changes in the term structure are the beginning of this process. Admittedly, I am looking for this to happen so I might be a bit biased. More importantly, the yield curve is what we are following to get a sense that this process is moving along.

The Beginning Of The Tightening Trade Officially Starts When The Yield Curve Starts Flattening



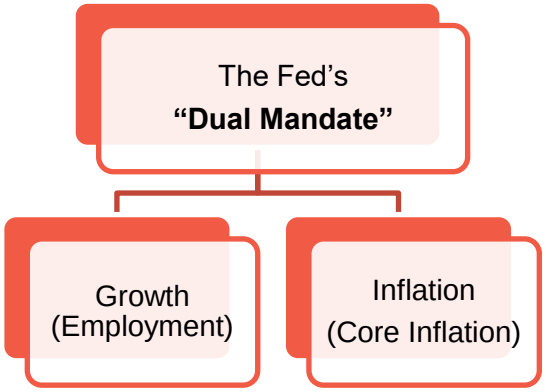
The Fed Will Ultimately Do What Its Mandate Dictates

The "Fed debate" on Wall Street has almost always proven futile. It does not really matter what we think, what matters is what the Fed thinks. The best way to get at this is by trying to understand policy via the Fed's mandate. While the Fed mandate has three official components to it, historically the Fed focuses mostly on two of these: employment and inflation. A glance at the minutes of almost every Fed meeting in recent decades reveals that the debate typically centers on one of these series or the other (or both!). The key in a recovery is to balance the need for full employment with growing inflationary pressures. The tricky part in THIS recovery is figuring out how stimulus and less capacity will influence the debate.

The Federal Reserve's "Dual Mandate": The Evolution of an Idea

Since 1977, the Federal Reserve has operated under a mandate from Congress to **"promote effectively the goals of maximum employment, stable prices, and moderate long term interest rates"—what is now commonly referred to as the Fed's "dual mandate."** The idea that the Fed should pursue multiple goals can be traced back to at least the 1940s, however, with shifting emphasis on which objective should be paramount.

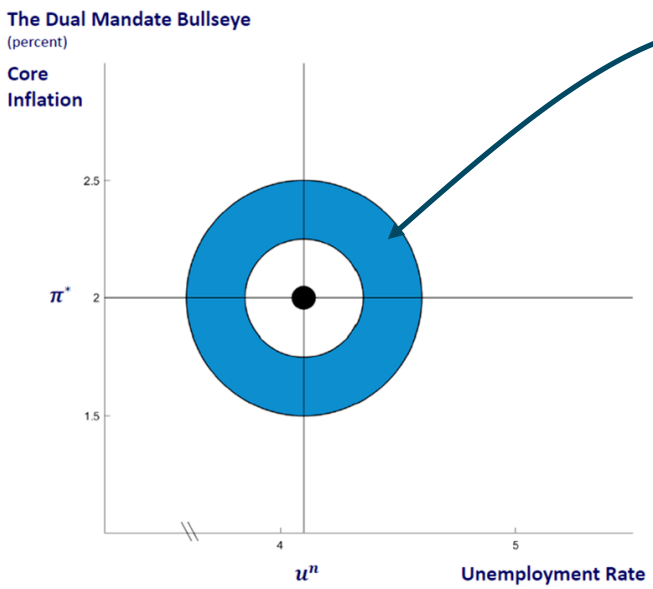
By Aaron Steelman, Richmond Fed, December 2011
The Federal Reserve's "Dual Mandate": The Evolution of an Idea



These are two major influences for inflation:

1. Economic Activity
2. Labor Markets

The Fed's Dual Mandate: Growth And Inflation



The Federal Reserve's Dual Mandate - Federal Reserve Bank of Chicago

"The monetary policy goals of the Federal Reserve are to foster economic conditions that achieve both stable prices and maximum sustainable employment."

It's easy, of course, to take shots at Fed officials from the sidelines (I am guilty of this across my career). It's not always so easy to figure out what the right thing to do is. Surely, the Fed has made plenty of mistakes and this is not an absolution, merely a recognition that it can be complicated to figure out what to do when you have two variables moving in opposite directions in the midst of a recovery. This is sometimes referred to as a bull's eye, but the simpler term is to call it a moving target.

The Case For Rate Hikes Using The Fed's Own Mandate

One helpful tool for understanding Fed policy is the Taylor Rule (TR). While it is not helpful at gauging the level of the fed funds rate (FFR), it is helpful for seeing whether pressure is lessening or intensifying for the Fed, using their own mandate. Indeed, the TR merely quantifies the two key series of the Fed's mandate. It currently sits at around 2%, so well above the FFR. More importantly, it has been rising steadily and being pushed higher by accelerating inflation and a declining unemployment rate. The way we would interpret the TR at this time is that it shows pressure building on Fed officials to tighten policy.

What Is The Taylor Rule?

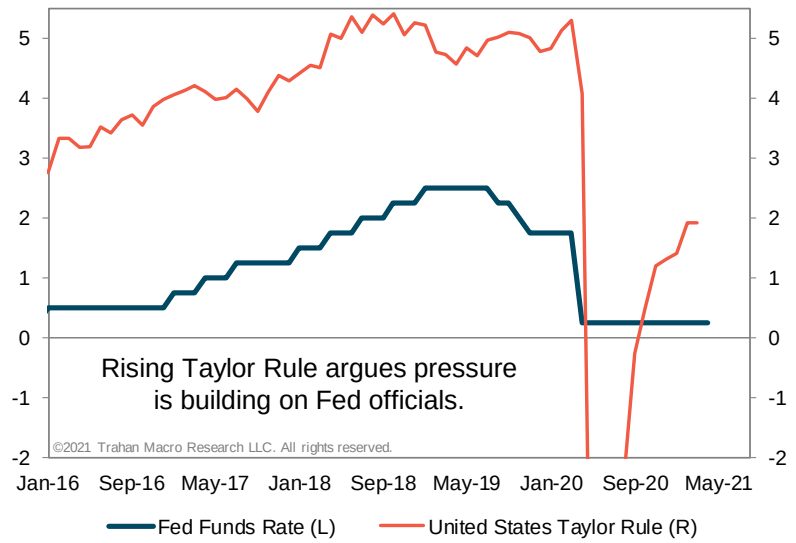
Original 1993 Paper by John Taylor

- Developed by John Taylor (Stanford Economist) and published in 1993;
- Designed as a framework for how the Fed should set monetary policy;
- Has done a consistent job at illustrating how monetary policy has been conducted across time.

How Is The Taylor Rule Calculated?

$$r = p + .5y + .5(p - 2) + 2$$

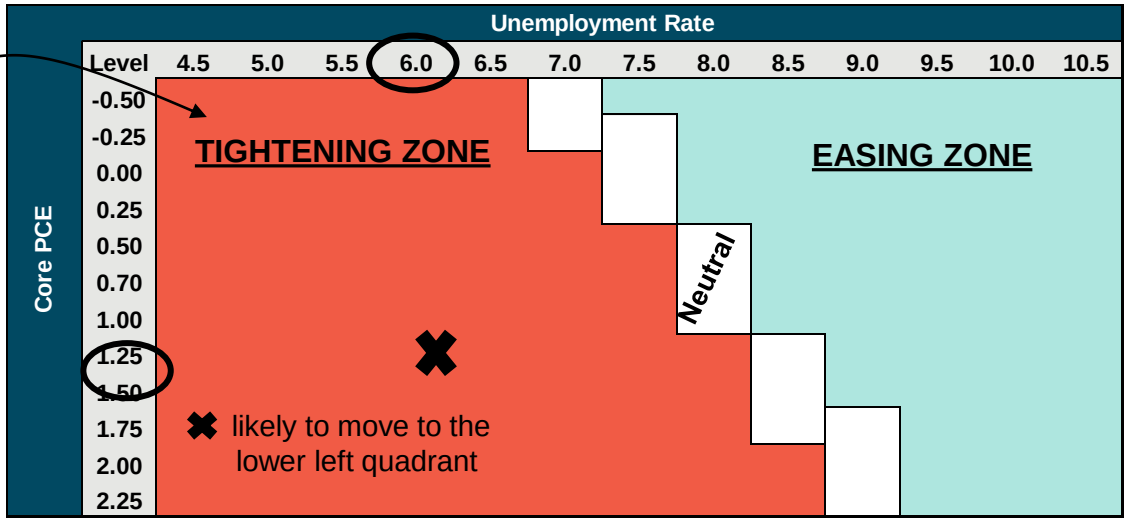
Taylor Rule: A Gauge Of The Fed's Mandate



A literal interpretation of the TR would argue the Fed should already be raising rates. In reality though, the Fed does not react to every monthly data point so the FFR is far less volatile than the TR across history. It's helpful to know that the TR is higher than the FFR but it does not really tell us much. It tells us the Fed should be debating tightening rather than easing and that is indeed what is happening at the Fed. Our preferred way of using the TR is to try and figure out where it is likely to go in the near future in order to gauge the likeliest direction of the Fed debate. In the early stages of an economic recovery, it seems clear that employment conditions will improve and sadly, that inflation will accelerate. In essence, both variables are likely to lift the "Taylor-Rule Implied FFR" in the coming quarters.

TR Illustrates The Trade-Off Between Unemployment And Inflation

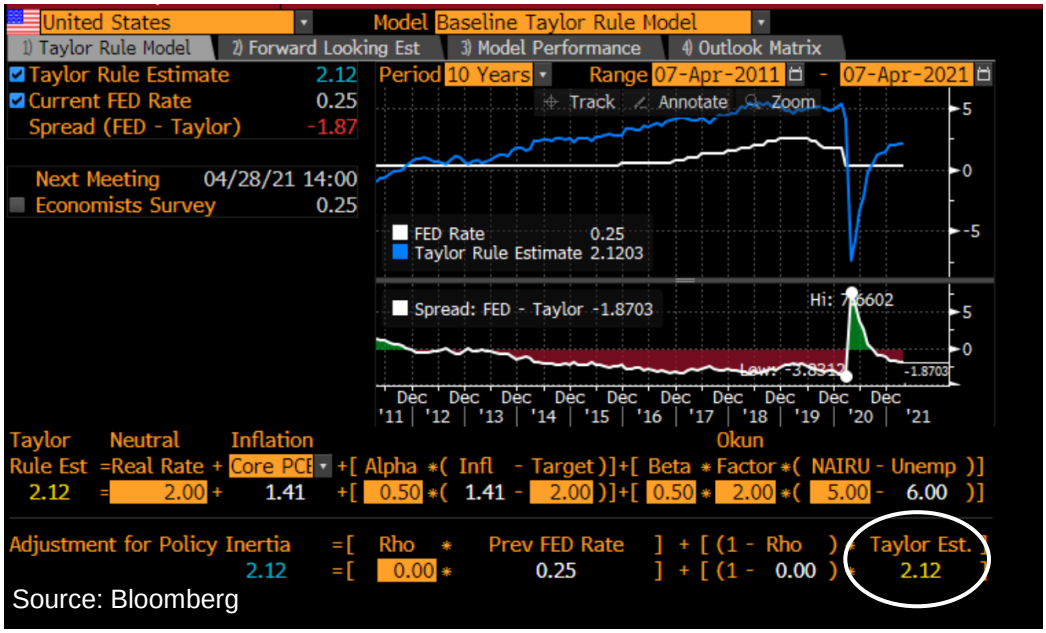
The TR level suggests the Fed should be debating tightening. A move to the lower right quadrant would point to a growing case for rate hikes.

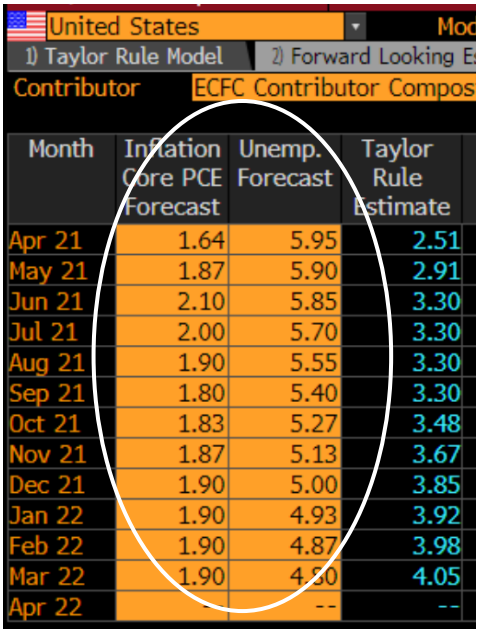


Consensus Sees Growing Pressure On The Fed To Raise Rates

The most helpful aspect of the TR is being able to plug in our estimates and see what it argues for official rates down the road vs where we are today. Bloomberg has a function that allows users to do this automatically without having to do the calculations themselves. We find this tool extremely helpful because it allows us to quantify the Fed's mandate and how it will likely evolve across time.

You Can Use Your Own Forecasts In The TR Using This Bloomberg Function: TAYL [GO]

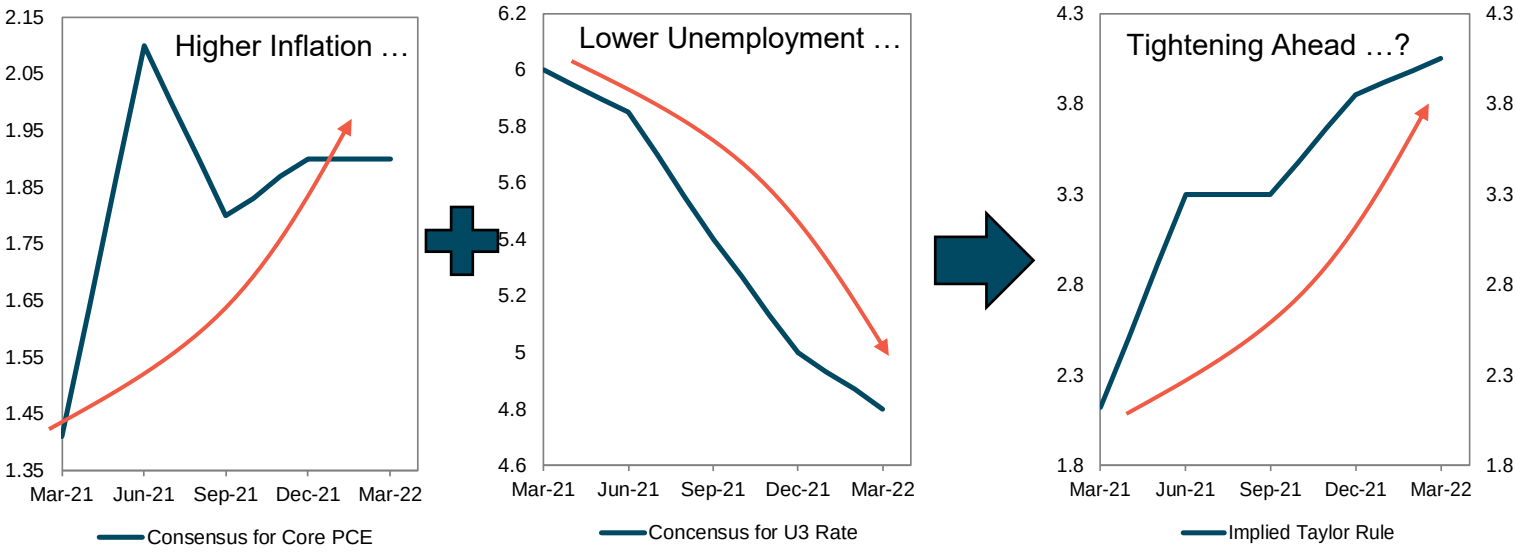




Month	Inflation Core PCE Forecast	Unemp. Forecast	Taylor Rule Estimate
Apr 21	1.64	5.95	2.51
May 21	1.87	5.90	2.91
Jun 21	2.10	5.85	3.30
Jul 21	2.00	5.70	3.30
Aug 21	1.90	5.55	3.30
Sep 21	1.80	5.40	3.30
Oct 21	1.83	5.27	3.48
Nov 21	1.87	5.13	3.67
Dec 21	1.90	5.00	3.85
Jan 22	1.90	4.93	3.92
Feb 22	1.90	4.87	3.98
Mar 22	1.90	4.80	4.05
Apr 22		--	--

I think most readers of our work know that we expect the recovery to be surprisingly strong. Regardless, the more conservative consensus figures of economists for the unemployment rate and core inflation reveal that the implied fed funds rate in the TR would nearly double in the coming year. We interpret this as a sign of tremendous pressure ahead for the Fed to raise rates.

<u>Consensus</u> On Employment And Inflation Would DOUBLE The TR Implied Fed Funds Rate

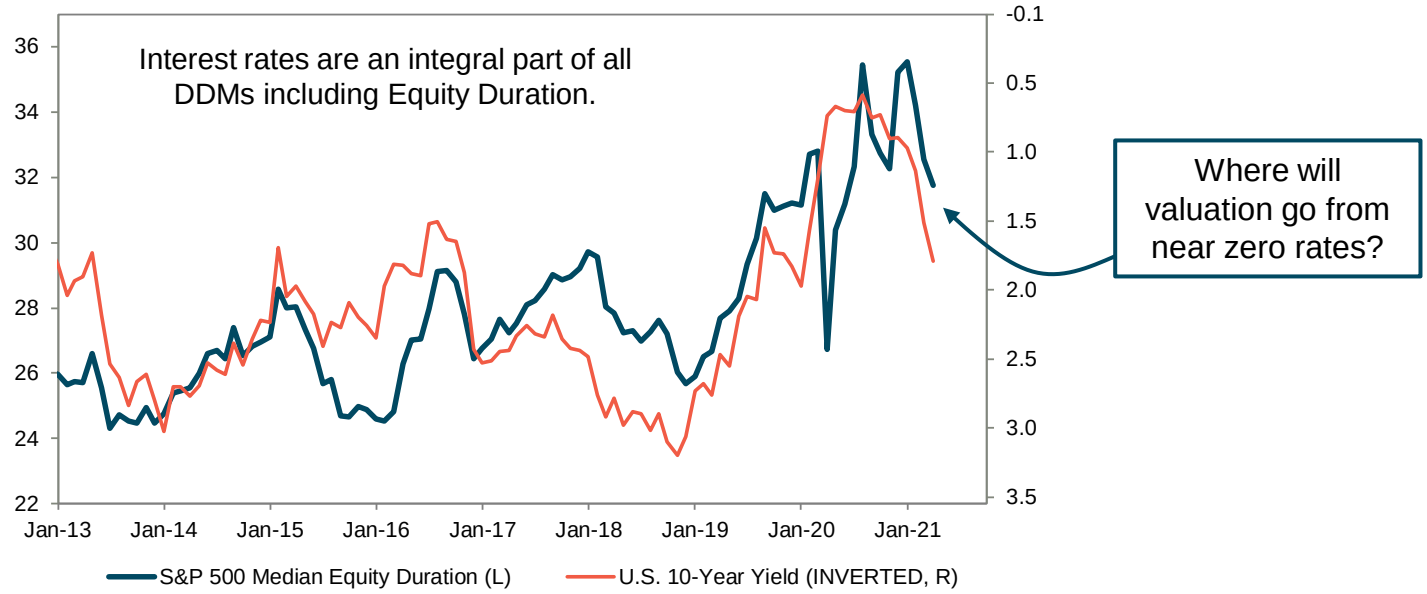


Many discard the TR as an antiquated tool because it no longer lines up with the level of the fed funds rate. This is true. Regardless, it is very helpful at quantifying the Fed's mandate and for understanding the likely direction of the Fed debate. In this case, the case for rate hikes will likely intensify dramatically.

Influence Of Rates On Stocks Greater Than It Has Been In Decades

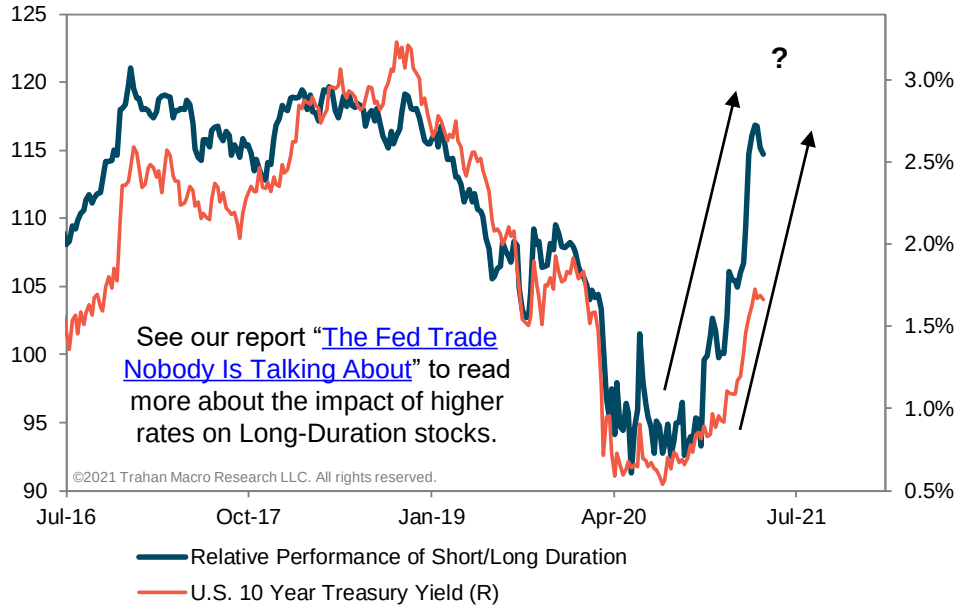
Bond yields have always played an important role in our framework. Over the years, we have primarily used interest rates to forecast the likely trajectory of LEIs ahead. More recently, however, rates have had a growing influence on valuation in the market. The chart below highlights the close correlation between rates and the S&P 500's overall valuation, according to Equity Duration. This should not be surprising, of course, since rates are at the heart of dividend discount models (DDMs). Still, the inverse relationship between yields and equity duration has been exceptionally tight of late. Unsurprisingly, perhaps, the historical decline in rates in the last two years has been met by a historical surge in valuation.

S&P 500 Valuation Closely Tied To Interest Rate Trends

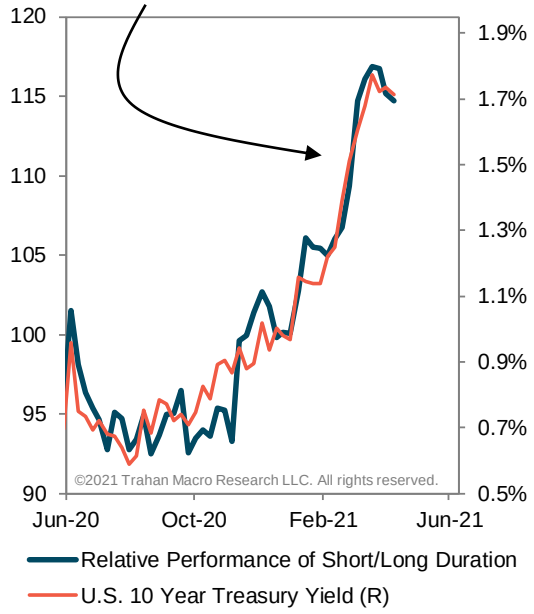


Now a lot of folks talk about rates and valuation and we like to avoid consensus topics when possible. We will surely monitor this situation, but our recent focus has been on what rates might do to the VERY popular Growth trade. This year, the rise in interest rates has put pressure on Long-Duration stocks (mainly Growth stocks) and we've seen Short-Duration stocks lead the charge. We covered this in our report a few weeks ago. What we wanted to do this week was try to zone in on ***where this relationship is most impactful.***

Bond Yields' ENORMOUS Influence On Stock Selection



Leadership All About Bonds



Where Are Rates Having The Biggest Impact On Stock Selection?

We know that rates are having a large impact on leadership trends in the S&P 500. Surely, there must be some sectors where the influence is greatest and others where it is weakest? Actually, there are four sectors in which the relative performance of Short-Duration to Long-Duration stocks exhibit an even higher correlation to rates than that of the overall market. Most of these were intuitive (i.e., cyclicals), though interestingly REITs also had a strong correlation. Meanwhile, three sectors showed little correlations. These are sectors where we would not expect yields to have an impact on stock selection.

The Influence Of Yields On Stock Picking

68% of the S&P 500's market cap has an Equity Duration greater than the index median.

Short/Long Duration & U.S. 10YR	
Sector	Correlation
Discretionary	**0.87**
Real Estate	**0.82**
Financials	**0.77**
Industrials	**0.75**
S&P 500	**0.67**
Tech	**0.55**
Staples	**0.42**
Telecom	**0.29**
Utilities	**0.25**
Materials	**0.03**
Health Care	**-0.46**
Energy	**-0.58**

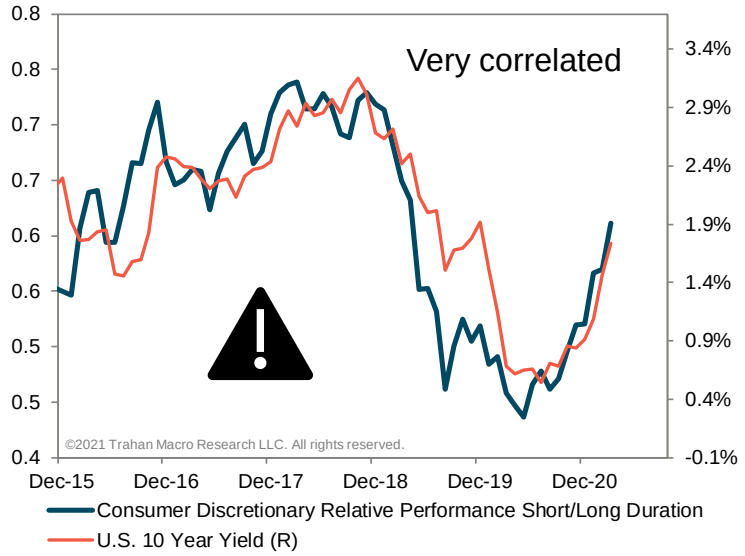
Bond yields a CRITICAL variable for stock selection in these sectors

Bond yields a KEY influence for stock selection in these sectors

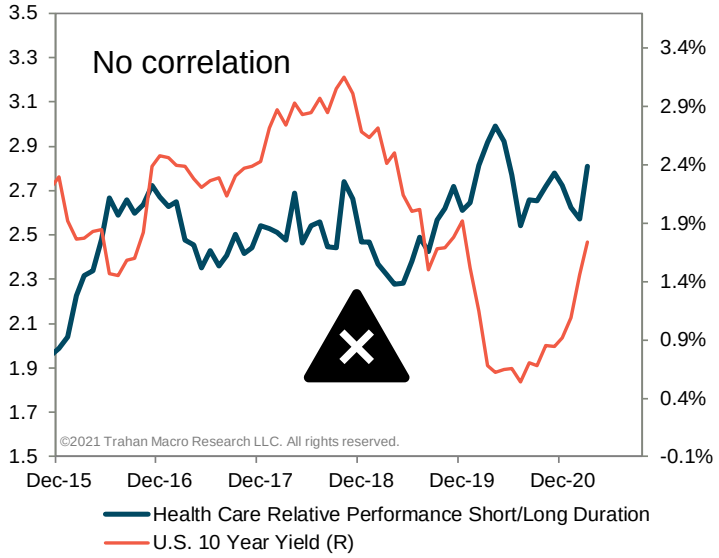
Bond yields an INCONSISTENT factor for stock selection in these sectors

The exercise reveals that it's unwise to pick stocks within some sectors without an understanding of bond yields and where they might be headed. The influence for sectors like Consumer Discretionary or Industrials is significant. Conversely, investors will have to look elsewhere for influential variables for Materials, Energy or Health Care as bond yields have no significant influence. Interestingly, this exercise proved that this analysis cannot be done superficially. For example, we all know that bond yields are VERY important for the Utilities sector, but they have little influence on stock picking WITHIN the sector.

Rates Matter MORE Within Discretionary



Rates Do NOT Matter Within Health Care



The Fed Trade Where It Matters Most: S&P 500 "Short-Duration" Screen

The abbreviated screen below focuses on the four sectors that exhibit the highest correlations between Equity Duration within the sector and bond yields (i.e., sectors where leadership is ***most sensitive*** to rates). These are Discretionary, Real Estate, Financials, and Industrials. It shows a partial list of names that have the shortest equity duration, in other words, the stocks that should be the ***least*** sensitive to rising rates within these sectors, and therefore the most attractive in terms of stock selection. Please email us at quant@trahanmacroresearch.com for the full screen or other S&P and Russell Indices.

S&P 500 Equity Duration Stock Screen

TRAHAN MACRO RESEARCH

Universe: S&P 500

Calculations As Of: 4/12/2021

Lower Quintiles Rank Better

(1 = Short Duration, 5 = Long Duration)

Ticker	Name	Equity Duration	Equity Duration Rank	Price	Market Cap	Style	Industry
Consumer Discretionary							
TJX	TJX Companies Inc	31.4	2	$ 69.52	83839.0	Value	Specialty Retail
F	Ford Motor Company	26.8	1	$ 12.38	49411.0	Value	Automobiles
APTV	Aptiv PLC	29.7	2	$ 143.15	38716.7	Core	Auto Components
DHI	D.R. Horton, Inc.	30.0	2	$ 93.75	34097.0	Core	Household Durables
LEN	Lennar Corporation Class A	22.0	1	$ 104.86	32117.1	Value	Household Durables
BBY	Best Buy Co., Inc.	22.7	1	$ 121.56	30395.5	Core	Specialty Retail
DLTR	Dollar Tree, Inc.	31.4	2	$ 117.04	27319.6	Value	Multiline Retail
Real Estate							
DLR	Digital Realty Trust, Inc.	31.4	2	$ 143.52	40346.5	Value	REITs
WELL	Welltower, Inc.	27.2	1	$ 75.39	31466.5	Value	REITs
EQR	Equity Residential	29.8	2	$ 71.78	27744.5	Value	REITs
CBRE	CBRE Group, Inc. Class A	28.5	2	$ 80.98	27233.7	Value	Real Estate Mgmt. & Development
AVB	AvalonBay Communities, Inc.	28.8	2	$ 187.12	26122.8	Value	REITs
O	Realty Income Corporation	30.9	2	$ 65.67	24527.8	Value	REITs
ARE	Alexandria Real Estate Equities, Ir	30.6	2	$ 168.96	23095.6	Value	REITs
Financials							
BRK.B	Berkshire Hathaway Inc. Class B	19.5	1	$ 267.93	615281.4	Value	Diversified Financial Services
SCHW	Charles Schwab Corporation	8.7	1	$ 67.71	127646.5	Value	Capital Markets
BLK	BlackRock, Inc.	30.7	2	$ 807.98	123325.1	Core	Capital Markets
AXP	American Express Company	26.3	1	$ 147.57	118560.8	Value	Consumer Finance
CME	CME Group Inc. Class A	27.8	1	$ 204.70	73498.8	Value	Capital Markets
CB	Chubb Limited	21.5	1	$ 160.94	72439.9	Value	Insurance
PGR	Progressive Corporation	28.0	1	$ 96.43	56426.3	Core	Insurance
Industrials							
JCI	Johnson Controls International plc	27.6	1	$ 62.03	44678.5	Value	Building Products
LHX	L3Harris Technologies Inc	25.4	1	$ 209.59	43084.5	Core	Aerospace & Defense
PCAR	PACCAR Inc	28.1	1	$ 95.29	33078.5	Value	Machinery
FTV	Fortive Corp.	26.0	1	$ 73.56	24868.6	Value	Machinery
IR	Ingersoll Rand Inc.	23.7	1	$ 50.15	21085.8	Value	Machinery
WAB	Westinghouse Air Brake Technolo	23.1	1	$ 80.81	15264.7	Value	Machinery
TXT	Textron Inc.	24.5	1	$ 58.43	13259.2	Value	Aerospace & Defense

Full list is available for clients of Trahan Macro Research. E-mail us at quant@trahanmacroresearch.com if you would like to receive the full stock screen.