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SUMMARY

- We believe the Fed is becoming less accommodative as it embarks on normalizing interest rates.
- The flattening yield curve shows that the Fed is no longer quite as aligned with investors, in our view.
- We have reduced our equity exposure in our Advantage portfolios to a more 'neutral' level.

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The Fed Outlook is Changing

Investors May Not Be 'Fighting the Fed', But It May Feel Like It for A While

While the headlines are focused on Russia's invasion of Ukraine, we think that the most important factor for the stock market will be assessing the pace and magnitude of the Federal Reserve (Fed) tightening. As the days approach the Fed's March 16th meeting, the debate regarding the outcome of that meeting intensifies. While much of the debate has surrounded whether the Fed would raise the Fed Funds Rate 25 or 50 basis points, here at RiverFront we are having a different debate. Our debate focuses on whether the Fed is still on the investor's side once they begin to raise interest rates. We internally all agree that the Fed is becoming less accommodative as it embarks on normalizing interest rates, however, the debate is about when to move our 'Don't Fight the Fed' indicator light from yellow to red. Accordingly, we reduced equity exposure in the portfolios last week to align with our tactical view. Our portfolios still favor domestic equities relative to international equities as developed markets face inflation concerns.

Our last tactical update was discussed in the December 13, 2021 Weekly View, *Looking Through the Windshield*, just days before the Fed met and pulled the tapering of its bond buying forward. At the time of the tactical publication, we concluded that the Fed would be on investor's side until interest rate hikes began to impact economic growth. Thus, the 'Don't Fight the Fed' rule was given the green light. However, the one thing that we have learned in the financial industry is that we must re-evaluate conclusions when the facts change, and much has changed since December 13.

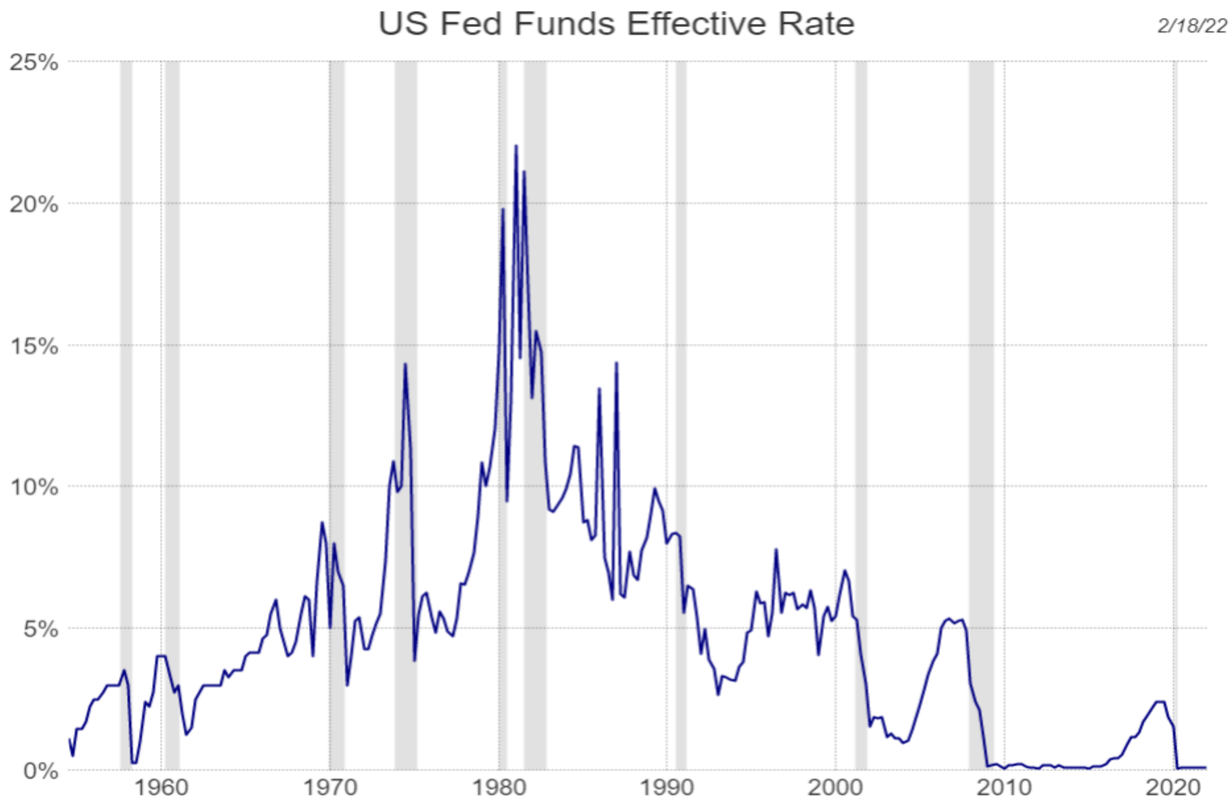
In reviewing our tactical rule of 'Don't Fight the Fed' we give a green light when we think the Fed is fully committed to stimulating growth. We consider it yellow when Fed policy is in transition and red when they are seeking to slow growth to combat inflation. Here is how we see the transition in the current cycle:

"Don't Fight the Fed" signaled a Green Light to RiverFront when...

- The Fed lowered the Fed Funds rate by 1.50% down to zero in 2020 (see chart, below) to combat the initial impact from the COVID-19 pandemic. The Fed implemented bond buying through quantitative easing (QE) of $120 billion per month of Treasuries and Mortgage-Backed Securities (MBS). Additionally, the Fed created liquidity facilities to backstop financial markets such as commercial paper, money markets, primary and secondary corporate bonds, primary broker dealers, main street lending, municipals, paycheck protection and asset backed securities.

- The removal of liquidity facility backstops occurred but monthly QE Of $120 billion per month continued.

- The Fed used the reverse repo market to manage excess liquidity in the banking system, but then began to taper QE in November 2021 by $10 billion Treasuries and $5 billion MBS per month.



Source: Refinitiv DataStream, RiverFront. Chart shown for illustrative purposes only.

"Don't Fight the Fed" signaled a Yellow Light to RiverFront when...

- The Fed reduced QE further by doubling the pace of tapering at its December 15th,2021 Federal Open Market Committee (FOMC) meeting to $20 billion Treasuries and $10 billion MBS per month.
- The Fed forecast and comments became more hawkish, with the speed of rate hikes potentially increasing.
- The Fed planned to finish tapering in March 2022.

Don't Fight the Fed will signal a Red Light to RiverFront if...

- The Fed raises the Fed Funds Rate at a rapid pace and inflation persists at an unacceptable level.
- The Fed continues to raise fed funds to normalize interest rates and begins Quantitative Tightening (QT) by reducing its $8.8 trillion balance sheet.

We have always acknowledged that the 'Don't Fight the Fed' tactical rule is qualitative and thus is more art than science when determining the current state. After reviewing all that the Fed has done over the last two years, we can say with certainty that the next two years will be very different. The initial lift-off of interest rate hikes will be immediately felt in the economy as lending rates will move higher. Higher borrowing costs tend to slow economic growth, and when coupled with core inflation that is 4% over the Fed's target, we believe this will lead to more aggressive tightening. Furthermore, with a balance-sheet that has grown to over $8.8 trillion, the Fed will inevitably have to tighten monetary policy further by either selling or letting securities mature, in addition to rate hikes. Furthermore, the yield curve, as represented by the yield differential between the 2-year and 10-year Treasury has continued to narrow, currently stands at only 41 basis points. The flattening yield curve indicates to us that the Fed is no longer quite as aligned with investors as last year and the market is implying slower growth. The dynamics laid out above would cause RiverFront to conclude that the Fed will no longer be on investors' side if the Fed hikes rates rapidly and thus will be a flashing "yellow light about to turn red".

It is important for investors to remember that our 'tactical rules' are not implemented in isolation, so despite the Fed removing its accommodation to investors 'Don't Fight the Trend' and 'Beware of the Crowd at Extremes' both have green lights and the combination of the two are indicating a positive signal, in our view. However, since the Fed is such an important component of the three rules, we believe our positioning should be neutral over the next three months. Hence, we reduced equity exposure in the portfolios last week to align with our tactical view. We remain positive on equity markets over the next 12-18 months since we believe that the Fed will succeed in engineering a policy transition that will not cause a recession. Our portfolios still favor domestic equities relative to international equities as developed markets face inflation concerns.

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The comments above refer generally to financial markets and not RiverFront portfolios or any related performance. Opinions expressed are current as of the date shown and are subject to change. Past performance is not indicative of future results and diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. An investment cannot be made directly in an index.

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All charts shown for illustrative purposes only. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.
In a rising interest rate environment, the value of fixed-income securities generally declines.

A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security. (bps = 1/100th of 1%)

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero).

Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

Quantitative easing (QE) is a form of unconventional monetary policy in which a central bank purchases longer-term securities from the open market in order to increase the money supply and encourage lending and investment.

Don't Fight the Fed – 'Supportive' means the Fed's monetary policy regarding inflation and employment is in what we believe based on our analysis to be the investors' best interest; 'Against' means the Fed's monetary policy, in our view, is going against the investors' best interest; 'Neutral' means the Fed's monetary policy is neither supportive nor against the investors' best interest in our view. Don't Fight the Trend – Terms correlate to the 200-day moving average as it relates to the equity indexes: 'Positive' means that the trend is rising, 'Flat' means the trend is flat, 'Negative' means the trend is falling. Beware the Crowd at Extremes – Terms correlate to the NDR Crowd Sentiment Poll and its measurement of Extreme Optimism (Bearish), Neutral, or Extreme Pessimism (Bullish).

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