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SUMMARY

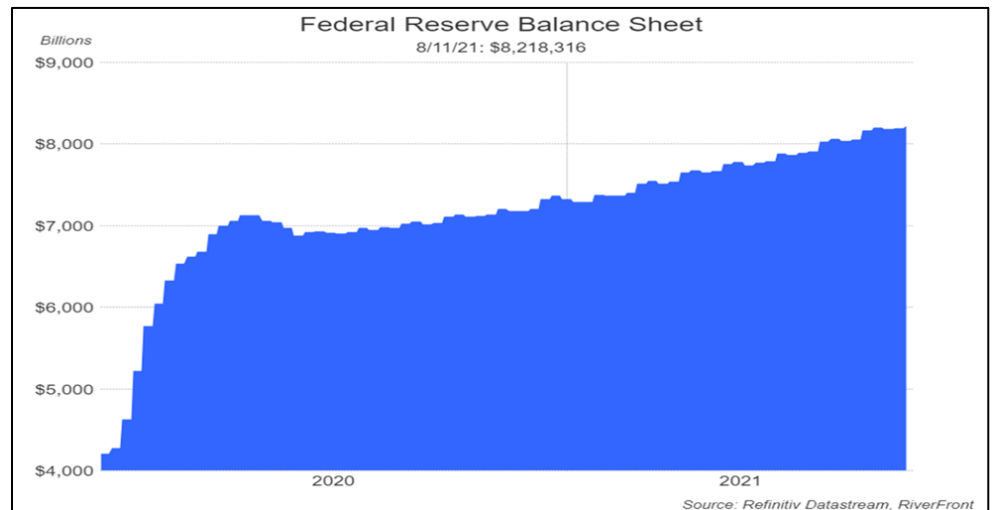
- We believe Jackson Hole may serve as the two-minute warning for the Fed to announce the tapering its Quantitative Easing (QE) purchases.
- The US has a supply issue and not a demand issue, and just needs time for them to balance out, in our view.
- We expect the 10-year Treasury to finish the year in the 1.50%-1.75% range and equity markets to continue to grind higher.

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The Fed's '2-Minute Warning'

What Asset Tapering Means for Markets

The Jackson Hole Economic Symposium begins on August 26th and the three-day event may serve as one of the most important policy events of the year. The Federal Reserve (Fed) will elaborate on its plan for meeting its dual mandate to maximize employment and to provide stable prices by keeping inflation around 2% over time. Since the onset of the pandemic, the Fed has been the backstop for the economy. Their creation of emergency facilities during the early days of the pandemic has helped to keep the economy from repeating the 2008 Great Financial Crisis. To that end, they have added over \$4 trillion to their balance sheet since March 4, 2020, buying bonds and thus keeping long-term interest rates low. The Fed's balance sheet reached an all-time high recently, totaling \$8.2 trillion (see chart below). However, with unemployment approaching 5% and inflation near 3.5% as measured by Core PCE, Jackson Hole may serve as the 'two-minute warning' for the Fed to announce that it is slowing, or 'tapering' as the Fed calls it, the size of its bond purchasing program – known as Quantitative Easing (QE). Importantly, 'tapering asset purchases' is still supportive of bond prices and adds to overall liquidity.

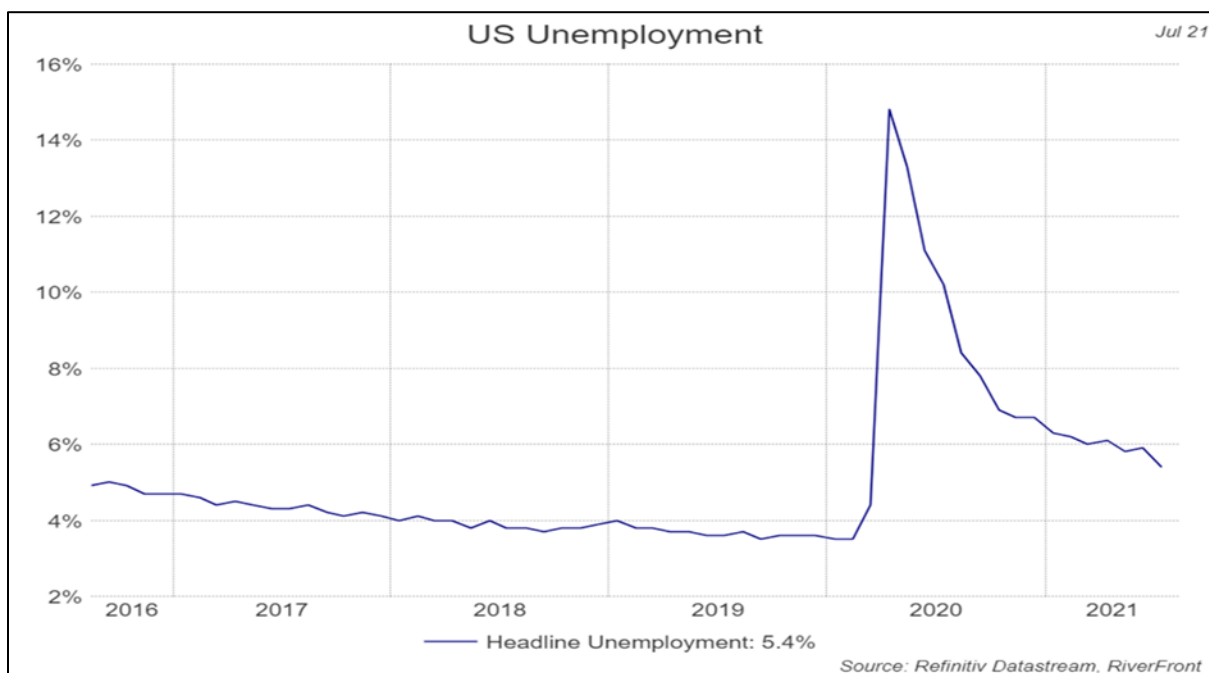


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Examining the Fed's Dual Mandate

Employment:

The recent strength in the labor market is making it harder to argue that the Fed is not well on its way to meeting its employment mandate. Non-farm payroll monthly additions have averaged nearly 617,000 per month thus far this year, with June and July averaging 940,500. The momentum is building and as the extended unemployment benefits expire on September 6th, more workers should enter the workforce. We think this will help to alleviate the labor supply shortage.



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Inflation:

The Fed has projected that inflation will be transitory until the supply-chain is back fully online. Currently core PCE is at 3.5% and headline inflation as measured by CPI is at 5.4%. Given that the Fed has undershot its target for so long, it has stated a willingness to let inflation run hot for short periods of time. Here at RiverFront, we acknowledge that different parts of the economy will experience periodic bouts of inflation over the next 6-9 months. However, we agree with the Fed's view that that the current rate of inflation will subside once temporary COVID related supply disruptions are alleviated.

Fed Outlook: Timing of the Taper

The actions taken by the Fed at the onset of the pandemic were meant to lend support to an economy that was shutting down. Through QE the Fed has driven down interest rates supporting both bank lending and consumer demand. By combining monetary stimulus with fiscal stimulus in the form of transfer payments (stimulus checks), policymakers have helped engineer a historic rebound in the US economy. It is for this reason the US has a supply issue and not a demand issue. We believe a tapering of QE would help to rebalance the supply and demand dynamic.

The Fed has stated many times that it was going to give markets plenty of lead time prior to tapering its QE purchases. Following guidance at Jackson Hole, we believe that the Fed will formally announce its plans to taper at the September FOMC meeting and start tapering in November. The two-month grace-period would honor the Fed's intent of giving the markets ample notice prior to tapering, in our opinion.

What does tapering mean for markets?

Once tapering begins we expect bond yields to rise. For context, we think the ten-year Treasury yield (1.26% as of last Friday) will finish the year in the 1.50% -1.75% range, moving back towards the higher levels seen in March of this year. Since rates hikes are not expected until late 2022/early 2023, continued improvement in earnings should allow equity markets to grind higher. We believe gradual tapering will allow time for the supply of goods and labor to catch up with demand mitigating inflation worries. If yields on the 10-year Treasury remain below 2%, we think the equity market will enjoy a 'goldilocks' environment with growth 'hot enough' to drive earnings, but 'not so hot' to cause a significant rise in interest rates. Therefore, we continue to position our asset allocation portfolios to favor stocks over bonds.

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