1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

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The return of volatility and questions about China

Equity Markets

The ink hadn't dried on last week's piece saying that perhaps it was possible that volatility had slowed, when we got one of the market's most volatile weeks of the year. What happened and why?

All major U.S. equity markets declined. The Dow fell 1.11%, the S&P 500 fell 0.59%, and the NASDAQ fell 0.73%. Investors can take some comfort knowing that markets rallied and recouped some of their losses from earlier in the week. Of course, the question is why did the decline occur? Three reasons seem apparent to us—the concern about the Fed changing course on asset purchases, the increase in COVID infections, and the slowdown in China. As we will discuss, our view is that some of these concerns are overblown.

The Economy

Overall, United States economic statistics remain positive. Over the course of an economic expansion, the path of economic statistics will vary. This is to be expected. Investors must be careful not to overreact. In modern markets, traders can move markets, but these movements are temporary, and long-term investors are wise not to follow suit. The most important of the earlier mentioned concerns, in our view, is the advance of the Delta variant and Fed posture.

The spread of the Delta variant is a danger to the economy. We will continue with our policy of not predicting medical outcomes.

The most important question is, what about the Fed? Will there be a policy change, and how will it affect the economy and markets? This has become paramount since the last Fed meeting when it was suggested that the Fed might begin to taper[1] if the economy continues to improve. We don't think this should frighten investors.

The Fed appears to imply, or, indeed, says that they will continue to fuel the economy if it appears to be losing strength. Second, if the economy continues to accelerate, and the Fed does taper, they have achieved their goal. There is plenty of liquidity in the system. We should remember there are over $2 trillion in non-required reserves held by the Federal Reserve on behalf of commercial banks. One likely result of tapering is an increase in interest rates. For a number of reasons, this may be a positive. Abnormally low rates can encourage high risk investing which creates its own problems.

The United States is facing a rapidly growing number of retirees. This is occurring when traditional defined benefit pension funds are almost a relic of a bygone age and are replaced by defined contribution plans such as IRA's, 401-Ks, 403-Bs, and savings. Historically, investment-grade bonds have been used to produce income in retirement. In an exceptionally low-interest rate period, retirees are faced with a difficult choice. Accept a much lower income return, or invest in riskier instruments.

In our view, there is little evidence that the economy is in danger of recession, but monetary policy does not exist in a vacuum. Fiscal stimulus from the infrastructure bill appears to be on its way, effectively substituting one form of stimulus for another.

When investors are trying to predict where the Federal Reserve is going or what their motives are, they should remember the three mandates for monetary policy: full employment, stable prices, and moderate long-term interest rates. The Fed is highly unlikely to abandon any.

The odds of slipping into a recession appear to be slim, although investors should remember that the rate of economic growth will slow as the recovery continues, and market corrections will occur.

[1]Tapering is a term used to describe the process of gradually stopping asset purchases when there is no predefined end date or amount. Tapering does not involve the outright sale of Treasuries or agency MBS by the Fed—it only means reducing purchases to zero.

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