Weekly Market Insights

January 10, 2022

High volatility, a way of life

Financial Markets

The first week of the New Year just continued the pattern established in 2021—high volatility. The first trading day of the year ended positively, but rest of the week was a downhill ride. The Dow closed down 0.29%, the S&P 500 down 1.87%, and NASDAQ down 4.53%. There were plenty of reasons for investors to be concerned. COVID remains prominent, there were some discouraging economic releases, discomforting global relations continue, and, of course, the Fed!

COVID-19, as we repeat all too often, is a real unknown. There are some interesting things occurring in the market that we feel adds to market volatility. We have written in the past about market structure, particularly the popularity of meme stocks and funds that trade in great size among retail and short-term oriented investors. These funds interestingly can attack whole sectors. When this occurs, many other market participants back away, creating a buy side vacuum. Economics 101 tells us that a lot of supply and little demand creates downward pressure on prices. This past week we observed this in the high flying tech sector. This is disconcerting to say the least but is not too destructive. These types of moves often self-correct but also take time. COVID is a problem that we cannot predict, and, while we think the aforementioned changes in market structure are difficult to deal with, they ultimately can be. In our economics section, we discuss some erratic economic indicators and monetary policy.

Economics

As we wrote earlier, some economic releases look discouraging, and, at best, they are confusing. Investors appear to be reacting to each release independently rather than as a whole with a long-term perspective. There are plenty of contradictions, but, in our view, the indicators paint a far more sanguine picture than the bears believe. No one should be surprised that there are strong differences among analysts. We think an interesting question is, why are the indicators acting out of character?

The answer may very well lie in the nature of this unique cycle. Economic cycles follow patterns, and they are most often caused by imbalances. There is an order to the progress and regress of an economic cycle—expansion, peak growth, and slowdown. In the words of every analyst who has been wrong, this time may be different. This cycle was interrupted by an outside force in the COVID pandemic. As a result, all the phases that comprise an economic cycle did not have an opportunity to play out but were halted in mid-cycle. Therefore, this recovery is far choppier than normal, which makes it hard to follow.

We think the recovery will continue, perhaps in a choppy fashion, but will expand nonetheless. This leads us to the Fed.

As we wrote last week, we remain in the camp that the current bout of inflation is transitory. It most likely will take longer to normalize than many hoped, but we believe it will eventually trend towards the Fed's goal of 2%. The current fear by many is that the Fed will tighten too quickly and choke off the recovery. The other camp believes it is too late and inflation will run away.

The inflation that we are facing at the moment comes from excess demand paired with insufficient supply, which is different from previous cycles. In past cycles, the Fed has had to tighten sharply to combat inflation, leading to an economic slowdown. "The Fed takes the punch bowl away from the party."[1] But, of course, this is not a normal cycle. There is plenty of demand, but supply is artificially restrained. Remember, supply chain and transportation hub problems have persisted. Once they start to be solved, half of the equation changes and pressure on prices should begin to ease.

For those who worry that the Fed will tighten too fast and too much, we offer some reassurance. It will take quite a while to absorb the excess liquidity in the system, and there is $2 trillion in excess reserves held at the Fed which can come out at any time. Furthermore, the Fed is not bound to tightening. If they see a problem, they can reverse at any time.

Conclusion

Markets will continue to be volatile for the foreseeable future, and there will be as many predictions about both the economy and the markets as there are analysts. We urge investors not to overreact. That is the most dangerous move to make.

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