1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

February 14, 2022

A Cold Wind from the North

Financial Markets

U.S. financial markets suffered another week of confusion. Monday through Wednesday equities advanced. Although improving COVID trends initially served as a tailwind for stocks, investors had to deal with Thursday's Consumer Price Index report which indicated the highest rate of inflation in 40 years. Markets declined in response. Investors also got more concerned about the increasing possibility of Russia invading Ukraine. Still, the crowning moment was when James Bullard[1] delivered his thoughts concerning inflation and what the Federal Reserve should do in response. He suggested that the Fed's first move should be a 50 basis[2] point increase rather than 25 and advocated for a more aggressive tightening posture for the remainder of the year. Investors should remember that Mr. Bullard is the President of the St. Louis Fed which has been the home of more conservative monetary policy research. It is unlikely that all Federal Reserve presidents feel this strongly about rate increases. James Bullard's comments, along with the inflation report and increasing prospects of hostilities in Ukraine, changed the emotional tide and equity markets turned south.

The Dow closed down 1.00% for the week, the S&P down 1.82%, and the NASDAQ down 2.18%. The yield on the 10-year Treasury rose above 2.00% for the first time since July of 2019.

The Economy

As we wrote earlier, inflation appears to be one of the main drivers of concern. Higher inflation means higher prices, and, at a certain point, inflation has the potential to change consumer behavior. The most recent Michigan Consumer Sentiment Index fell significantly from 67.2 to 61.7. Lower consumer confidence is of considerable concern to economists because it can lead to lower consumer spending and a slowdown in the economy.

The Fed is trying to perform a balancing act to bring down inflation while avoiding a recession—a difficult task indeed. In the past, we have written quite a bit about monetary and fiscal policy. If the two work together, good things can happen. Well thought out fiscal policy can offset the recessionary impact of tightening monetary policy while limiting any powerful inflationary pressures. Congress and the President must be careful while drafting legislation, selecting only those policies that truly help the economy like improving railroads, harbors, and education. These types of projects should be welcomed. Interestingly, when many of these initiatives were proposed, it was not the first time. They were clearly stated in Mr. Trump's economic plan when he ran the first time.

An apparent positive in the fight against inflation is the prospect of a recovering labor force. Government labor statistics are indicating that labor supply may be returning. This would relieve wage pressures and help reduce inflation. Supply chain issues also look to be improving, albeit at a slow pace. Still, this is another positive argument against higher inflation.

China

When anyone is seriously analyzing the future of the global economy, whether it be trade, production, growth, or any other measure, China is the elephant in the room. It is hard to remember any paper we have written where China has not been a topic of discussion. It is a very difficult country and economy to analyze. First, because its government is secretive. Second, there are serious doubts about the accuracy of their published economic statistics.

[1]James Bullard is the president of the Federal Reserve Bank of St. Louis.
[2]A basis point is one hundredth of a percent.

Weekly Market Insights (cont'd)

China views itself as a wronged country, even more so a country with a stolen empire. All countries that have fallen from grace live with a romantic but false sense of nostalgia. There is no denying that China was a very large and rich empire. The empire began to crumble with the ascendance of the Empress Dowager Cixi (1835-1908). This led to what the Chinese refer to as the "Age of Humiliation." After the Second World War, there were two competing armies fighting to control China—one led by Chiang-Kai-shek, the other Mao-Zedong. Of course, we all know who won. Mao led China through three decades of self-imposed isolation and extreme economic hardship. When he died in 1976, power shifted to Deng Xiaoping who led China from late 1978 to 1989. He dramatically changed China's economy with a greater acceptance of capitalistic policies. China grew rapidly into an economic powerhouse and remarkably reduced poverty as a result. The country remained on that path until the ascendency of Xi Jinping. When Mr. Xi came to power, many China scholars believed he would accelerate China's acceptance of a modified version of capitalism. Nothing could be further from the truth. He reversed China's "capitalism with Chinese characteristics," curtailed personal freedoms, increased government intrusion, and expanded the role of State Owned Enterprises (SOE).

This is not the picture of a country that one can have great faith in. All of this argues that the United States and the West would be wise to reduce their dependence on China and improve the resilience of their supply chains. When trying to analyze China it is important to remember that, yes, economic success is important, but there is far more at stake for President Xi and China—national pride and the restitution of the Chinese empire may trump economic motivations.

Conclusion

At the moment, there are too many moving parts to be overwhelmingly confident with any short-term predictions. We remain in the camp that the Fed will not be as aggressive as Mr. Bullard suggested, and we agree with those who argue that the labor force will continue to recover. Furthermore, we think that Congress will eventually reach an agreement, and some limited form of fiscal stimulus will pass. We remain positive on the United States economy but a little less so in Europe. If hostilities do occur in Ukraine, they will impact the European economy far more than the U.S.

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