Weekly Market Insights

March 14, 2022

Confusion remains supreme

Equity Markets

As everyone in the investing world knows, volatility has been extraordinarily high. It was elevated before the Ukraine crisis, but has now risen to levels seldom seen. Not only are we experiencing large day to day fluctuations, but intraday volatility has been high as well. Although it may seem like an inviting trading opportunity to some, it is clearly treacherous territory.

Investors are well aware that the short-term trajectory for equities appears to be lower, and there are several themes vying for the title of lead cause—our view is the war, inflation, and the Fed, in that order. The war is not in our bailiwick, while the Fed and inflation are so interrelated that we can treat them as a single topic. We think that the Federal Reserve's Open Market Committee (FOMC) meeting this week will not disturb investors. It is expected that they will raise interest rates 0.25%. Inflation is a far different story for many reasons. We will discuss this more in the economics section.

This week's performance: the Dow fell by -1.89%, the S&P 500 declined by -2.88%, and NASDAQ dropped by -3.53%. Not surprisingly, the Energy sector was the only one to end the week in positive territory, while consumer goods trailed all sectors.

Economics

There are many theories suggesting reasons the inflation we see now is not temporary. The most popular among investors is purely monetary. The case is that the Federal Reserve overstepped when combatting the most recent recession and kept the monetary spigots on far too long. Monetary theorists would tell us that this action alone produces inflation and that the Fed would eventually have to step hard on the brakes, potentially leading to an economic slowdown.

The second theory is that the world is facing a labor shortage. Over the past forty years or so, as underdeveloped countries began to advance economically, they brought a huge number of formerly unemployed workers into the labor force, keeping prices low. This swell in the global work force is coming to an end, which could result in rising labor costs and provide upward pressure on inflation. The third reason is very similar to the second, except the shrinking labor force phenomenon is also occurring in the developed world. Since the pandemic, we have seen a steady reduction of the labor supply.

All of the theories we laid out appear plausible, but they are all uncertain. The monetarist argument is a sound one and follows accepted economic principles, but it is by no means a sure bet. It appears to us as herculean to think that the labor forces in all developing economies are reaching their limit. Asia certainly is advancing rapidly, but clearly has more room to grow. Furthermore, Africa, South America, and Central America are still very much in the developing stage.

The argument that the labor supply in the U.S. is shrinking is far from an accepted theory. It most likely is a lingering reaction to the pandemic and will continue to recover.

If the shrinking labor supply is actually the main reason behind elevated inflation, it doesn't necessarily mean inflation will be long-term. This is an argument we have made in the past. The industrial world may be entering a second industrial revolution. As labor becomes scarce and labor costs rise, businesses will accelerate the substitution of capital (technology) for labor, holding prices in check or even driving them down. This, of course, could create its own problems, which we will write about in the future.

Conclusion

Unfortunately, there isn't a firm answer to the questions above. Time, of course, will reveal the answer. We outlined a number of potential economic problems that may or may not be impediments to future growth, but there are also problems that we are still recovering from—the traumas of COVID and supply chains. These remain real problems, but they are more mundane, and we have more confidence that they will be solved sooner rather than later.

While short-term volatility is elevated, we continue to be focused on our clients' strategic goals and objectives.

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