Weekly Market Insights

May 2, 2022

A Rough Start To 2022

Financial Markets

With the exception of certain currency markets, most major market indices suffered large declines this past week. It was the culmination of four months where both equity and fixed income markets fell. The reasons for the volatility haven't changed, only their order of importance. Primary factors at play are COVID, war in Ukraine, inflation, money supply, and rising interest rates. We will explore the relationships more deeply in the economics section.

The Dow fell 2.47%, the S&P 500 fell 3.27%, and the NASDAQ fell 3.93%.

Economics

There are several elements to the current inflation dynamic. The onset of the COVID pandemic created an economic crisis, which forced the Federal Reserve to expand the money supply and carry out quantitative easing in response. This infusion of liquidity effectively lowered interest rates and encouraged demand. COVID also created havoc with the work force, lowering the supply of labor, thereby raising wages. The other inflationary effect of the pandemic was to interrupt the smooth operation of supply chains and transportation. Just as COVID was slowing, Russia invaded Ukraine. Other than being a terrible humanitarian tragedy, it reduced the supply of oil, gas, and wheat, adding to inflationary pressures. Seeing this, the Fed decided correctly to raise interest rates in order to combat rising inflation. As anticipatory institutions, financial markets reacted as one might expect and began to decline. Are the markets correct in both anticipating high inflation and the possibility of a Fed overreaction spurring a recession? While this is a legitimate possibility, it is not inevitable. The problem with models in social sciences is that humans don't always behave as the model expects. Today, we will try to point out ways in which the models may not accurately predict the future by highlighting three important factors—the labor force, supply chains, and the Federal Reserve.

As most everyone knows, the supply of labor, as measured by the labor force participation rate,[1] dropped significantly with the advent of COVID. As the pandemic continued, the stimulus checks to families relieved some of the pressure to return to work. As time went on, not all former workers returned to work, however, recent statistics indicate this may be reversing. If this trend continues, the cost of labor should stabilize or even come down.

There is another exciting development in the labor market. I first learned of it on a "60 Minutes" segment, which was devoted to an experiment by IBM with respect to employment. The thesis is simple—not all higher level jobs need a college degree to perform them. IBM has embraced this philosophy, and now other

[1]The labor force participation rate is an estimate of an economy's active workforce. The formula is the number of people ages 16 and older who are employed or actively seeking employment, divided by the total non-institutionalized, civilian working-age population.

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companies are following suit and experimenting with the program as well. The implications of this development could be enormous. First, it gives a large number of Americans a path to higher paying jobs. Next, as these workers leave their previous jobs, it opens the path for lower level employees to take those jobs that have been left vacant. This could encourage higher employment and labor motivation while also fighting income inequality.

Until recently, most Americans barely knew the difference between a supply chain and a bicycle chain. Times of course have drastically changed. Many still don't understand the what and why, but they are now part of the conversation. A strong argument can be made that the supply line problem is a COVID phenomenon. Official reports from companies like Sherwin-Williams, Fastenal, Whirlpool, Johnson & Johnson, and Kimberly-Clark are seeing some improvements or expect to see it in the coming year.[2] If this problem is in fact beginning to moderate, it will have significant implications for the U.S. inflation outlook.

The last point involves the Federal Reserve and will take just a few sentences to explain. They have a difficult job regardless of how the supply chain issues play out. The Fed must reduce the liquidity in the system, while balancing just how much pressure the economy can withstand—a most difficult job.

This is not meant to be a bullish call, but rather to point out how models and logical assumptions can be incorrect or sabotaged by unexpected events or behavior. In this case, there are many assumptions being made.

Conclusion

It is highly unlikely that either of the scenarios will turn out as described above but will most likely be a combination of several potential outcomes. It is no wonder financial markets are as remarkably volatile as they are now. Caution rather than aggression is the road to follow. A positive is that those investors looking for income may be getting their opportunity.

Next week, we will provide an in depth analysis of this past month's economic releases and discuss global economics, including trade deficits and currencies.

[2]Barron's May 2nd 2022, pg. 6, "Supply Woes Signs of Hope"

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