Weekly Market Insights

June 21, 2022

Where to Now?

Financial Markets

Financial markets around the globe suffered persistent losses this past week. In the United States, the Dow fell 4.79%, the S&P fell 5.79%, and the NASDAQ fell 4.78%. The markets haven't seen this kind of behavior in a long time. Internally, sector performance was all in the red, with the least damaged being Consumer Staples, which was down 4.24%, followed by Health Care, Communication Services, Financials, and Information Technology. Energy brought up the rear falling 17.16%.

These losses didn't come out of the blue. There was considerable disconcerting information, beginning with the generally expected 0.75% interest rate hike by the Federal Reserve. If this wasn't enough to frighten investors, economic statistics released by the government indicated a possible economic slowdown, and there continues to be no indication of a de-escalation of the war in Ukraine. With all of the above on investors' minds, the market's performance doesn't seem all that surprising.

The extraordinary volatility we are seeing now brings market structure to mind. With the advent of so many new types of funds and strategies, some of which are very large in size, do markets react faster than in the past?

Economics

There is a lot of economic news for investors to ponder. Most of it is confusing at best, contradictory at worst.

Inflation continues to be disturbingly high, which, of course, keeps the Federal Reserve stepping on the monetary brakes. However, Fed economists must account for the inflation we are seeing in food and energy. These components fall out of the "core" measure of inflation that the Fed focuses on because they are unlikely to respond to monetary policy prescriptions. Reason being, it is not a problem of too much demand, but is instead a supply problem made worse by the war in Ukraine. Rapidly rising wages are a traditional cause of inflation. That is clearly within the Fed's bailiwick and should respond to monetary policy action. The Fed, however, must take into account the very unusual path of the wage price spiral. We are still facing the problem of insufficient labor supply. To my knowledge, no one has a great explanation of why this problem has persisted, but, as COVID began to slow, workers did not return to work as expected. This, of course, caused excess demand for workers, forcing businesses to raise prices to offset higher wages. There is now statistical evidence that suggests this interesting phenomena may be ending. Specifically, if economic growth cools, demand for labor should slow, which will put downward pressure on wages. If this comes to fruition, there may be relief in wage growth.

As the Fed raises interest rates, it has important global consequences. Higher interest rates in the United States relative to other countries makes the dollar stronger. This makes foreign goods cheaper and leads to higher imports and a larger trade deficit. Some believe a less expensive dollar and an expanding trade deficit is a sign of national weakness. This is, of course, a fallacy. Most often, it is merely the sign of a well working global economy. So, as the regulator of the world's most important currency, the Federal Reserve must keep global balance in mind as it tries to manage inflation.

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Conclusion

Today's note may seem very disconcerting, but it should not be, really. When the economy overheats and the Fed begins to hike interest rates in order to control inflation, it is always frightening to investors, business leaders, and consumers. This time, there are two more unpredictable dynamics that make it more distressing—COVID and the Ukraine war. The COVID situation appears to be improving as an economic problem. Alas, the war in Ukraine has not improved and is a great unknown. If the energy supply starts to improve, and wheat reaches consumers, the economic difficulties will be much easier to solve.

The current environment can lead to great opportunities. The global economy is in need of modernization, particularly a modernization of trade regulation. Countries like the United States have an opportunity to improve infrastructure and correct some outdated problems. Perhaps a Bretton Woods meeting aimed at trade rather than monetary policy could be organized.

Any or all of these will take time, but the world's most influential countries must come to grips with the seemingly global political angst.

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