

Weekly Market Insights

August 15, 2022

Expectations are everything

Financial Markets

Equity markets experienced a second strong weekly rally, separated by a mildly soft but still positive week. An inspiration for investors was a surprisingly good inflation report. The Consumer Price Index rose 8.5%. While an 8.5% inflation rate is nothing to write home about, it is better than the prior month's 9.1%. It appears as if inflation is moving in the right direction, which leads us to our title. Investors buy and sell on expectations. For much of this year, financial markets have trended lower because investors feared elevated inflation would lead to higher interest rates and, perhaps, a Fed policy-induced recession in the future. As bad economic news persisted, it was hard to know the direction of the economy, so markets were being priced with no strong sense of where things would end. When in doubt, investors are bearish and markets fall. There remain mixed signals of where the economy and interest rates are headed, but last week's better than expected inflation report and the Fed's strong anti-inflation message may have convinced investors that, although still a problem, inflation may be on the way down. This has allowed market participants' expectations to improve and price lower inflation into the market.

As we wrote earlier, it was an excellent week for financial markets. The Dow rose 2.92%, the S&P 500 rose 3.26%, while the NASDAQ rose 3.08%. It was a good week indeed, but we remind investors that expectations are fickle and can change rapidly.

Economics

Earlier, we wrote about the surprisingly positive inflation report released last week. That clearly was the most written about economic news, but there were other noteworthy items from this past week. One central bank diverged from the rest, employment statistics remained surprisingly strong, the first shipments of grain sailed out of Ukraine, and tensions between China and Taiwan continued.

We have written quite a bit about central banks and their role in the global economy. There is not much to add except that they, with the notable exception of China, are now on the same path. The U.S. Federal Reserve is clearly the most aggressive with monetary tightening, with Ms. Lagarde and the ECB catching up. This is certainly a positive.

U.S. employment gains remain somewhat of a mystery. They remain strong when other indicators suggest the gains should moderate. Normally, strong employment gains are warmly greeted. However, when the labor market is already tight like it is now, continued strong employment gains will lead to higher wages, which fuel higher inflation.

The first cargo ship loaded with grain has left Ukraine. Clearly, this is good news. Some have argued that increased shipments of energy fuels and wheat will not significantly reduce inflation

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numbers. That is true, but it misses the point. Food and energy are vital to people's wellbeing and those are the items that mean the most to families and what is most visible to them. So, just because they are not reflected in the core CPI measure does not mean they go unnoticed and are unimportant to consumers.

China is vying with Russia for the role of the most bellicose nation. Happily, China's aggressiveness has not turned to violence as it has with Russia, and there are no troops on the ground fighting. China is a far different country than Russia, but, as we wrote last week, both feel as if they have been wronged by the West. China is far wealthier than Russia and is a more important part of the global economy, which makes it a more complex country to deal with. Chinese manufactured products cover the globe, whereas, outside of energy and wheat, Russia is not an important part of the global economy. Russia has a huge economic problem in fighting a much smaller country in Ukraine. China,

although far larger than Taiwan, would face a far stronger opponent and one with alliances with many strong countries.

China is far less wealthy than people realize, and the economy has problems, both in economic and diplomatic relations, which may make it more dangerous and more likely to be militarily aggressive.

Conclusion

While we believe there has been progress in the fight against inflation, and believe it is positive that the Fed and their counterparts in major Western nations have joined the fray in aligning their monetary policies, it would be folly to say inflation is defeated and all is well. There remains much to be concerned about. It will take plenty of discipline, and hopefully cooperation, to get the global economy back on track. To paraphrase John Donne, no country is an island.¹ This is truer today than ever before.

¹"No man is an island entire of itself; every man is a piece of the continent, a part of the main; if a clod be washed away by the sea, Europe is the less, as well as if a promontory were, as well as any manner of thy friends or of thine own were; any man's death diminishes me, because I am involved in mankind."

Michael Olin Clark
Senior Advisor
moclark@1919ic.com

Ryan Schutte, CFA, CFP*
Investment Associate
rschutte@1919ic.com

Abigail McKenna
Senior Portfolio Associate
amckenna@1919ic.com

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