Weekly Market Insights

October 17, 2022

Gloom from the IMF and a Wild Ride in the Markets

Financial Markets

U.S. financial markets took investors on a wild roller coaster ride this past week. United States equity market performance finished mixed. The Dow closed up 1.15%, the S&P 500 down 1.55%, while the NASDAQ closed down 3.11%.

The end of the week was rather remarkable. On Thursday, equities started in the red after September's higher than expected inflation release, but reversed course and closed with a gain of 2.6%.[1] A sharp reversal came on Friday, losing all Thursday's gains and more. Of course, all of this did not occur in a vacuum. As we wrote in the heading, there were plenty of disturbing news stories, and analysts were waiting for the news from China's Communist Party Congress which occurred over the weekend. At present, the primary issues weighing on investors' minds are inflation, the Federal Reserve, and interest rates.

Interestingly, *Barron's* magazine points out in a recent article that swings in markets often, but not always, signal the end of the downturn.

Economics

There is little doubt now that the Federal Reserve is committed to staying the course and defeating inflation, which, of course, means keeping rates higher than originally expected by most investors. This is standard monetary policy with which most monetary analysts would agree. A problem arises because these actions do not occur in a vacuum. We would hate for this to sound like a tutorial, but it is imperative that readers understand the underlying economics at play. Tighter monetary policy leads to higher interest rates. Higher interest rates increase borrowing costs, which leads to decreased spending, and the domestic economy slows in response. This is exactly what the Federal Reserve wants. Higher interest rates will also change the competitive nature of the U.S. economy. An unintended consequence is what will happen internationally. The currency market reacts by making the U.S. dollar more attractive, so the dollar becomes more expensive relative to other currencies. This is a particularly difficult situation for many developing economies. The reason is they often borrow in U.S. dollars, then convert those dollars into their local currencies. When the dollar becomes more expensive against their currency, it becomes far more expensive for those countries to repay their debt.

There are also cross-border spillovers with the developed economies. Not only is inflation high, and in many cases rising, but demand is also weakening, and higher interest rates are inclined to further dampen demand. So, central banks are walking the thin line between subduing inflation and creating a recession.

We have been writing about the weakening of the Chinese economy and the October 16th Communist Party Congress meeting for a while. Information is now being released, and we will issue a report soon.

Conclusion

Investors should expect continued volatility for some time. The Fed is determined to defeat inflation, so elevated interest rates will remain for the foreseeable future.

[1] The S&P 500 closed with a gain of 2.6% from the prior day's close.

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