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In this week's recap: Stocks extend last week's rally, despite a major disappointment in the tech sector.

Weekly Economic Update

Presented by Ed Papier, February 7, 2022

THE WEEK ON WALL STREET

Stocks managed to gain ground last week as investors turned their focus to corporate earnings.

The Dow Jones Industrial Average rose 1.05%, while the Standard & Poor's 500 gained 1.55%. The Nasdaq Composite index picked up 2.38% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, tacked on 2.73%. [1,2,3]

EARNINGS IN FOCUS

At the start of the week, stocks extended the previous week's rally with some high-growth companies leading the move higher. Strong company profits fueled the market the middle of the week, until an earnings disappointment from a mega-cap company took investors by surprise. The earnings miss deflated sentiment as it heightened worries of what it may portend for other technology companies yet to report. These anxieties led to a sell-off that reverberated across the market.

Subsequent earnings beats from several technology and social media names, and an above-consensus rise in new payrolls on Friday, helped the market close with week with a solid gain.

OMICRON AND UNEMPLOYMENT

A string of employment reports pointed to a generally healthy labor market, despite the Omicron surge late last year. The Job Openings and Turnover Survey (JOLTS) showed a hiring slowdown, with near-record high job openings and worker resignations. The ADP (Automated Data Processing) employment report saw private payrolls shrink by 301,000. That was the first monthly decline since December 2020. [4,5]

More encouragingly, initial jobless claims declined, while continuing jobless claims reached their lowest level since 1973. A strong January employment report showed 467,000 jobs added during the month, with upward revisions to previously released November and December. [6,7]

THE WEEK AHEAD: KEY ECONOMIC DATA

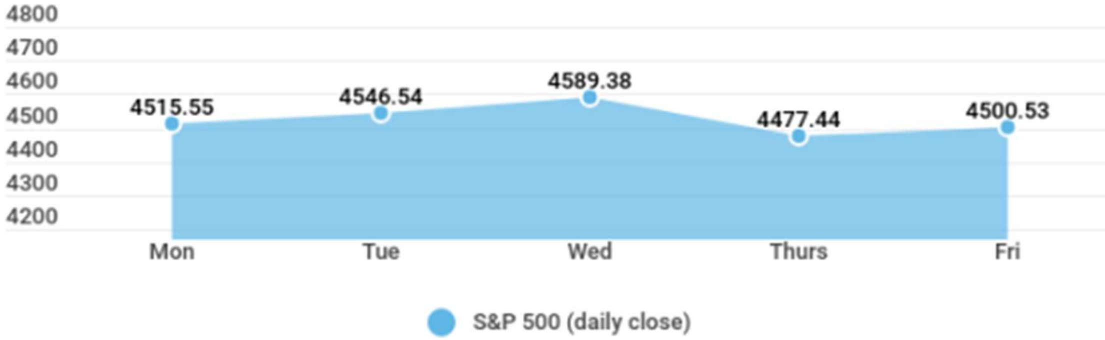
Thursday: Consumer Price Index (CPI). Jobless Claims.
Friday: Consumer Sentiment.

QUOTE OF THE WEEK

"I won't tell you that the world matters nothing, or the world's voice, or the voice of society. They matter a good deal. They matter far too much. But there are moments when one has to choose between living one's own life, fully, entirely, completely—or dragging out some false, shallow, degrading existence that the world in its hypocrisy demands. You have that moment now. Choose!"

OSCAR WILDE

Market Index	Close	Week	Y-T-D
DJIA	35,089.74	+1.05%	-3.44%
NASDAQ	14,098.01	+2.38%	-9.89%
MSCI-EAFE	2,261.69	+2.73%	-3.18%
S&P 500	4,500.53	+1.55%	-5.57%



	Treasury	Close	Week	Y-T-D
	10-Year Note	1.93%	+0.15%	+0.41%

Sources: The Wall Street Journal, February 4, 2022; Treasury.gov, February 4, 2022
Weekly performance for the Dow Jones Industrial Average, Standard & Poor's 500 Index, and NASDAQ Composite Index is measured from the close of trading on Friday, January 28, to Friday, February 4, close. Weekly performance for the MSCI-EAFE is measured from Friday, January 28, open to Thursday, February 3, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

Rising inflation in the United States and around the world is forcing investors to assess the likely effects on both "risky" assets (generally stocks) and "safe" assets (such as US Treasury bonds). The traditional investment advice is to allocate wealth according to the 60/40 Rule: 60% of one's portfolio should be in higher-return but more volatile stocks, and 40% should be in lower-return, lower-volatility bonds. The rationale is that stocks and bond prices are usually negatively correlated (when one goes up, the other goes down), so this mix will balance a portfolio's risks and returns.

During a "risk-on period," when investors are optimistic, stock prices and bond yields will rise and bond prices will fall, resulting in a market loss for bonds; and during a risk-off period, when investors are pessimistic, prices and yields will follow an inverse pattern. Similarly, when the economy is booming, stock prices and bond yields tend to rise while bond prices fall, whereas in a recession, the reverse is true.

But the negative correlation between stock and bond prices presupposes low inflation. When inflation rises, returns on bonds become negative, because rising yields, led by higher inflation expectations, will reduce their market price. Consider that any 100-basis-point increase in long-term bond yields leads to a 10% fall in the market price – a sharp loss. Owing to higher inflation and inflation expectations, bond yields have risen and the overall return on long bonds reached -5% in 2021.

Over the past three decades, bonds have offered a negative overall yearly return only a few times. The decline of inflation rates from double-digit levels to very low single digits produced a long bull market in bonds; yields fell and returns on bonds were highly positive as their price rose. The past 30 years thus have contrasted sharply with the stagflationary 1970s, when bond yields skyrocketed alongside higher inflation, leading to massive market losses for bonds.

But inflation is also bad for stocks, because it triggers higher interest rates – both in nominal and real terms. Thus, as inflation rises, the correlation between stock and bond prices turns from negative to positive. Higher inflation leads to losses on both stocks and bonds, as happened in the 1970s. By 1982, the S&P 500 price-to-earnings was eight, whereas today it is above 30.

More recent examples also show that equities are hurt when bond yields rise in response to higher inflation or the expectation that higher inflation will lead to monetary-policy tightening. Even most of the much-touted tech and growth stocks aren't immune to an increase in long-term interest rates, because these are "long-duration" assets whose dividends lie further in the future, making them more sensitive to a higher discount factor (long-term bond yields). In September 2021, when ten-year Treasury yields rose a mere 22 basis points, stocks fell by 5-7% (and the fall was greater in the tech-heavy Nasdaq than in the S&P 500).

This pattern has extended into 2022. A modest 30-basis-point increase in bond yields has triggered a correction (when total market capitalization falls by at least 10%) in the Nasdaq and a near-correction in the S&P 500. If inflation were to remain well above the US Federal Reserve's target rate of 2% – even if it falls modestly from its current high levels – long-term bond yields would go much higher, and equity prices could end up in bear country (a fall of 20% or more).

More to the point, if inflation continues to be higher than it was over the past few decades (the "Great Moderation"), a 60/40 portfolio would induce massive losses. The task for investors, then, is to figure out another way to hedge the 40% of their portfolio that is in bonds.

There are a number of options for hedging a traditional 60/40 portfolio. The first is to invest in inflation-indexed bonds or in short-term government bonds whose yields reprice rapidly in response to higher inflation. The second option is to invest in gold and other precious metals whose prices tend to rise when inflation is higher (gold is also a good hedge against the kinds of political and geopolitical risks that may hit the world in the next few years). Other non-correlated asset classes one might consider include: Private debt, private equity and real estate on a primary and secondary basis, equipment and aircraft leasing, direct and co-investments, early and stage venture, direct secondaries, options trading (to hedge long positions), multi-alternative, General Partner interests, litigation finance, energy and other special situations.

The optimal combination of short-term bonds, gold, and real estate will change over time and in complex ways depending on macro, policy, and market conditions. Yes, some analysts argue that oil and energy – together with some other commodities – can also be a good hedge against inflation. But this issue is complex. In the 1970s, it was higher oil prices that caused inflation, not the other way around. And given the current pressure to move away from oil and fossil fuels, demand in those sectors may soon reach a peak.

While the right portfolio mix can be debated, this much is clear: sovereign wealth funds, pension funds, endowments, foundations, family offices, and individuals following the 60/40 rule should start to think about diversifying their holdings to hedge against rising inflation. [8]

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The Dow Jones Industrial Average is an unmanaged index that is generally considered representative of large-capitalization companies on the U.S. stock market. Nasdaq Composite is an index of the common stocks and similar securities listed on the NASDAQ stock market and is considered a broad indicator of the performance of technology and growth companies. The MSCI EAFE Index was created by Morgan Stanley Capital International (MSCI) and serves as a benchmark of the performance of major international equity markets, as represented by 21 major MSCI indexes from Europe, Australia, and Southeast Asia. The S&P 500 Composite Index is an unmanaged group of securities that are considered to be representative of the stock market in general.
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