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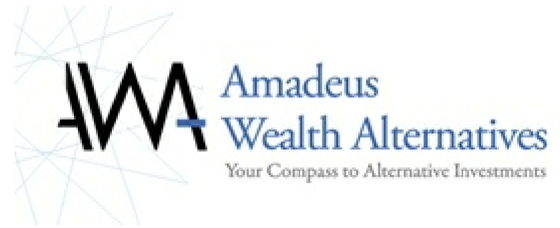

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In this week's recap: Hawkish Fed sees bonds higher and stocks retreat.

Weekly Economic Update

Presented by Ed Papier, January 10, 2022

THE WEEK ON WALL STREET

A jump in yields sparked by a more aggressive sounding Federal Reserve sent the market lower to start the new year.

The Dow Jones Industrial Average fell 0.29%, while the Standard & Poor's 500 declined 1.87%. The Nasdaq Composite index was hardest hit, dropping 4.53% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, slipped 0.55%.[1,2,3]

THE TECH WRECK

The perception of a more hawkish Fed put a hard stop to the year's positive start and pushed bond yields higher and stocks into a broad retreat.

Technology and other high-valuation shares were particularly hard hit by rising yields. Even the larger-capitalization technology companies with strong cash flows and profits were damaged. As yields trend higher, investors are questioning if these companies can lead the market in 2022. Fueling this decline was a four-day sell-off of technology companies by hedge funds that, in dollar terms, represented the highest level in more than ten years. Stocks continued to struggle into the final trading day, unsettled by a renewed climb in yields and an ambiguous employment report.[4]

THE FED'S SURPRISE

Minutes of December's Federal Open Market Committee (FOMC) meeting were released last week and it revealed a more hawkish Fed than investors had been expecting. One surprise was that the first hike in interest rates could occur as early as March. Another, and perhaps more consequential, surprise was the idea of beginning a "balance sheet run-off" by the Fed following the first hike in the federal funds rate.[5]

A balance sheet run-off means that maturing bonds won't be replaced with new bonds, the result of

which is a smaller Fed balance sheet. Many investors view this step as removing liquidity from the system, a departure from market expectations that the balance sheet would remain flat during the Fed's pivot to monetary normalization.

THE WEEK AHEAD: KEY ECONOMIC DATA

Wednesday: Consumer Price Index (CPI).

Thursday: Jobless Claims. Producer Price Index (PPI).

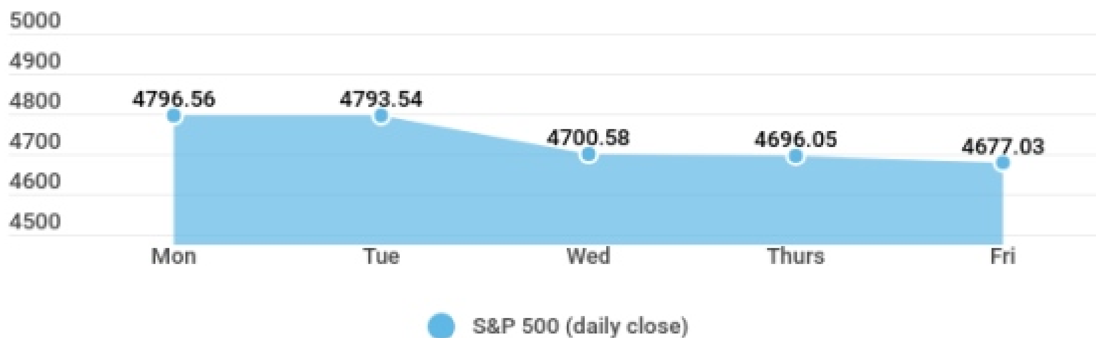
Friday: Retail Sales. Industrial Production. University of Michigan Consumer Sentiment Survey.

QUOTE OF THE WEEK

"One does not become enlightened by imagining figures of light, but by making the darkness conscious."

CARL JUNG

Market Index	Close	Week	Y-T-D
DJIA	36,231.66	-0.29%	-0.29%
NASDAQ	14,935.90	-4.53%	-4.53%
MSCI-EAFE	2,323.20	-0.55%	-0.55%
S&P 500	4,677.03	-1.87%	-1.87%



	Treasury	Close	Week	Y-T-D
	10-Year Note	1.76%	+0.24%	+0.24%

Sources: The Wall Street Journal, January 7, 2022; Treasury.gov, January 7, 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, December 31, to Friday, January 7, close. Weekly performance for the MSCI-EAFE is measured from Friday, December 31, open to Thursday, January 6, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

In its semi-annual Financial Stability Report, the Fed issued a stock market warning as elevated valuations are causing markets to be "vulnerable to significant declines". To wit:

Prices of risky assets generally increased since the previous report, and, in some markets, prices are high compared with expected cash flows. House prices have increased rapidly since May, continuing to outstrip increases in rent. Nevertheless, despite rising housing valuations, little evidence exists of deteriorating credit standards or highly leveraged investment activity in the housing market. ***Asset prices remain vulnerable to significant declines should investor risk sentiment deteriorate, progress on containing the virus disappoint, or the economic recovery stall.***

Is the Fed's stock market warning justified? The Fed is stating that valuations, as the prices of "risky" assets keep rising, make the stock market continually more vulnerable to a crash. What could cause asset prices to crash? The Fed notes specifically:

- *Another surge, or variant, of the COVID virus*
- *A stalling of the economic recovery*
- *Investor "risk-sentiment" deteriorates*

Given that Fed interventions boosted the stock market and investor sentiment, the withdrawal of that support could be problematic. The high correlation between the financial markets and the Federal Reserve interventions is all you need to know to navigate the market.

There is little doubt that risk assets are surging higher, driven by speculative investor confidence. That speculation appears throughout the market, from record call options to meme stocks surging in price (shares of a company that have gained a cult-like following online and through social media platforms). But it's not just the retail investor piling into stocks, but even professional managers are now *"all in"* the equity risk pool.

Of course, such speculative appetite is no surprise as the Fed's monetary policy created the Pavlovian response to risk-taking. Given the amount of liquidity thrown at the stock market, the Fed should take responsibility for investors' irrational exuberance.

Valuations are extreme by virtually every measure. "Across most asset classes, valuation measures are high relative to historical norms. Since the May 2021 Financial Stability Report, equity prices rose further." – *Federal Reserve*

The description of valuations by the Fed is somewhat misleading. When saying something is high relative to historical norms, its meaning gets lost without some context. In this case, the context best comes from historical charts of various valuation measures.

The most obvious is the Shiller CAPE ratio which takes current prices divided by 10-years of earnings. This method smooths out the volatility of earnings that can occur on an annual basis. At 40x trailing earnings, current valuations were only marginally higher at the peak of the market in 1999.

A look at market capitalization to the economy also gives you some sense of the excess in markets. Given that earnings and revenue come from economic activity, the market cannot outgrow the economy long term. Lastly, price-to-sales (what happens at the top line of the income statement) is also exceedingly stretched. While stock prices can advance, earnings are ultimately a function of economic growth and sales. Therefore, when excesses occur, an eventual reversion must, and will, occur. The only question is the timing and the catalyst.[6]

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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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CITATIONS:

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2. The Wall Street Journal, January 7, 2022
3. The Wall Street Journal, January 7, 2022
4. CNBC, January 6, 2022
5. The Wall Street Journal, January 5, 2022
6. realinvestmentadvice.com/fed-issues-stock-market-warning-as-valuations-surge/