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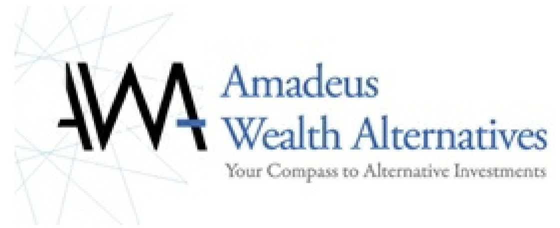

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In this week's recap: Volatile week ends on rebound.

Weekly Economic Update

Presented by Ed Papier, January 31, 2022

THE WEEK ON WALL STREET

An exceptionally volatile week, marked by wide intraday price swings, whipsawed investors with stocks ending higher following a surge to the upside on the final trading day of the week.

The Dow Jones Industrial Average rose 1.34%, while the Standard & Poor's 500 gained 0.77%. The Nasdaq Composite index ended flat (+0.01%) for the week. The MSCI EAFE index, which tracks developed overseas stock markets, declined 3.54%.[1,2,3]

MARKET VOLATILITY

Rising bond yields, Federal Reserve uncertainty, and escalating tensions on the Ukrainian-Russian border unsettled markets all week. The week opened with two successive days of deep early losses that were erased by furious, late-afternoon rebounds. The following two-trading sessions that started with strong gains that evaporated with late-session selling.

The most dramatic session was Monday, in which stocks ended slightly higher after hitting intraday lows that saw the NASDAQ fall 4.9%, the Dow shed 1,115 points, and the S&P 500 moved into correction territory. Technology was at the epicenter of the volatility all week as rate fears weighed on sector. Stocks rebounded strongly on Friday, managing to conclude a week on an upbeat note.[4]

FED READIES MARKET FOR RATE HIKES

Last week's meeting of the Federal Open Market Committee (FOMC) left rates unchanged, though officials signaled short-term rates would likely be raised at its next meeting in March. As expected, the Fed also approved one last round of bond purchases, bringing quantitative easing to an end by March.[5]

Left a bit more nebulous were details on the pace and timing of reducing the Fed's balance sheet, a

lingering worry of some investors. But Fed Chair Powell indicated that shrinking the Fed's asset holdings may occur at a faster rate than in past periods of balance-sheet reductions, such as in 2014 and 2017.[6]

THE WEEK AHEAD: KEY ECONOMIC DATA

Tuesday: ISM (Institute for Supply Management) Manufacturing Index. JOLTS (Job Openings and Labor Turnover Survey).

Wednesday: ADP (Automated Data Processing) Employment Report.

Thursday: Factory Orders. Jobless Claims. ISM (Institute for Supply Management) Services Index.

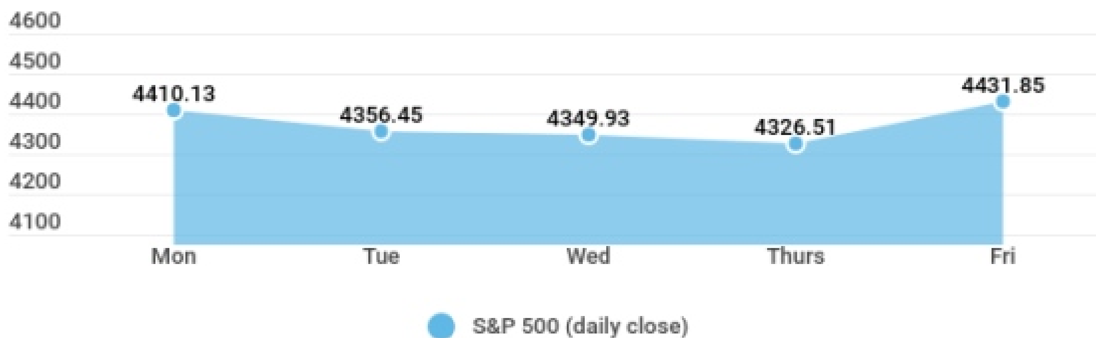
Friday: Employment Situation.

QUOTE OF THE WEEK

"Everything that irritates us about others can lead us to an understanding of ourselves."

CARL JUNG

Market Index	Close	Week	Y-T-D
DJIA	34,725.47	+1.34%	-4.44%
NASDAQ	13,770.57	+0.01%	-11.98%
MSCI-EAFE	2,203.51	-3.54%	-5.67%
S&P 500	4,431.85	+0.77%	-7.01%



	Treasury	Close	Week	Y-T-D
	10-Year Note	1.78%	+0.03%	+0.26%

10-Year Note	1.78%	+0.03%	+0.26%

Sources: The Wall Street Journal, January 28, 2022; Treasury.gov, January 28, 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 21, to Friday, January 28, close. Weekly performance for the MSCI-EAFE is measured from Friday, January 21, open to Thursday, January 27, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

Despite dips and disruptions from new variants of COVID-19, 2021 turned out to be a relatively positive year for economies and markets in most parts of the world. Growth rose above its potential after the severe recession of 2020, and financial markets recovered robustly. This was especially the case in the United States, where stock markets reached new highs, owing partly to the US Federal Reserve's ultra-loose monetary policy (though central banks in other advanced economies pursued radically accommodative policies of their own).

But 2022 may be more difficult. The pandemic is not over. Omicron may not be as virulent as previous variants – particularly in highly vaccinated advanced economies – but it is much more contagious, which means that hospitalizations will remain high. The resulting uncertainty and risk aversion will suppress demand and exacerbate supply-chain bottlenecks.

Together with excess savings, pent-up demand, and loose monetary and fiscal policies, those bottlenecks fueled inflation in 2021. Many of the central bankers who insisted that the inflationary surge was transitory have now conceded that it will persist. With varying degrees of urgency, they are planning to phase out unconventional monetary policies such as quantitative easing, so that they can start to normalize interest rates.

Central banks' resolve will be tested as policy-rate hikes lead to shocks in the bond, credit, and stock markets. With such a massive build-up of private and public debt, markets may not be able to digest higher borrowing costs. If there is a tantrum, central banks would find themselves in a debt trap and probably would reverse course. That would make an upward shift in inflation expectations likely, with inflation becoming endemic.

The next year also brings mounting geopolitical and systemic risks. On the geopolitical front, there are three major threats to watch. First, Russia is preparing to invade Ukraine, and it remains to be seen whether negotiations on a new regional security regime can prevent escalation of the threat. Although US President Joe Biden has promised more military aid for Ukraine and threatened harsher sanctions against Russia, he also has made clear that the US will not intervene directly to defend Ukraine against an attack. But the Russian economy has become more resilient to sanctions than it was in the past, so such threats may not dissuade Russian President Vladimir Putin. After all, some Western sanctions – such as a move to block the Nord Stream 2 gas pipeline – could even exacerbate Europe's own energy shortages.

Second, the Sino-American cold war is getting colder. China increasing its military pressure on Taiwan and in the South China Sea (where many territorial disputes are brewing), and the broader decoupling between the Chinese and US economies, is accelerating. This development will have stagflationary consequences over time.

Third, Iran is now a threshold nuclear state. It has been rapidly enriching uranium to near-weapons grade, and the negotiations over a new or refurbished nuclear agreement have gone nowhere. As a result, Israel is openly considering strikes against Iranian nuclear facilities. Were that to happen, the stagflationary consequences would likely be worse than the oil-related geopolitical shocks of 1973 and 1979.

The new year also brings several systemic concerns. In 2021, heatwaves, fires, droughts, hurricanes, floods, typhoons, and other disasters laid bare the real-world implications of climate change. Making matters worse, the aggressive push to decarbonize the economy is leading to underinvestment in fossil-fuel capacity before there is a sufficient supply of renewable energy. This dynamic will generate much higher energy prices over time. Moreover, climate refugee flows toward the US, Europe, and other advanced economies will surge just as those countries are shutting their borders.

Against this background, political dysfunction is increasing in both advanced economies and emerging markets. The US midterm elections may offer a preview of the full-blown constitutional crisis – if not outright political violence – that could follow the presidential vote in 2024. The US is experiencing near-unprecedented levels of partisan polarization, gridlock, and radicalization, all of which poses a serious systemic risk.

Populist parties (of both the far right and the far left) are growing stronger around the world, even in regions like Latin America, where populism has a disastrous history. Peru and Chile both elected radical leftist leaders in 2021, Brazil and Colombia may follow suit in 2022, and Argentina and Venezuela will remain on a path to financial ruin. Interest-rate normalization by the Fed and other major central banks could cause financial shocks in these and other fragile emerging markets such as Turkey and Lebanon, not to mention the many developing countries with debt ratios that are already unsustainable.

Despite recent declines, public and private equity remain expensive (with above-average price-to-earnings ratios); real-estate prices (both housing and rent) are high in the US and many other economies; and there is still a craze around meme stocks, crypto assets, and SPACs (special purpose acquisition companies). Government bond yields remain ultra-low, and credit spreads – both high-yield and high-grade – have been compressed, owing partly to direct and indirect support from central banks.

As long as central banks were in unconventional policy mode, the party could keep going. But the asset and credit bubbles may deflate in 2022 when policy normalization starts. Moreover, inflation, slower growth, and geopolitical and systemic risks could create the conditions for a market correction in 2022. Come what may, investors are likely to remain on the edge of their seats for most of the year.[7]

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CITATIONS:

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