Wealth Advisory Market Update

December 2, 2021

Market Update

Volatility is the key word to describe the markets this past week. We saw both the equity and fixed income markets react to two separate events, the news surrounding the omicron variant of the coronavirus and the comments of Federal Reserve Chairman Jerome Powell. We'll address each in turn. First, the omicron variant was detected in South Africa last week and has since spread to more than two dozen other countries. Over the last two years, other variants also mutated from the original virus, but this one is different in a couple of ways. Based on the data gathered so far, omicron has more mutations of the spike protein which may lead to a higher chance of it evading current vaccines and possibly reinfecting those that have already had Covid-19. The scientific community is still in the data collecting stage and currently does not have a clear answer if this is the case or not. Markets do not like uncertainty which is all we have at the moment. Because of this, we have seen the re-opening stocks take a beating to the downside, led by airlines, financials, hospitality and leisure companies. We have also seen a rally in yields in the US as investors began to trade into more safe haven assets.

Since we are still in the infancy of the understanding of this new variant it is impossible for us to make a call on whether or not this will continue to impact markets. As data continues to come out, we will be following it very closely. There are multiple scenarios of how this could affect markets over the longer term. Downside in equity markets could be seen if:

- The virus is able to evade current antibodies and spread more rapidly through the global population
- The virus is more severe than variants that preceded it
- Transmissibility is higher than previous variants

If we see these scenarios come into play, global leaders may begin to restrict travel even more and institute lockdowns once again. If this happens another recession for the Global economy is a real possibility. Supply chain disruption could get even worse. This will lead to more strain on prices which in turn could drive inflation up even more. A combination of these events could lead to 70's-style Stagflation. Stagflation is defined as higher inflation with slower economic growth which, as you can imagine, is not a good mix. On the flip side, equity markets may not be affected at all if:

- The virus is less severe than previous variants as the data collected so far seems to indicate
- This variant does not become the dominant strain and overtake the Alpha and Delta variants
- The effectiveness of vaccines and natural immunity of previously-infected people remains high.

In these instances, we should see an ongoing recovery in economic growth across the globe as the current supply chain disruptions get resolved. We should also see an increase in consumer confidence as inflation begins to subside.

A second reason for the recent uptick in volatility, which we believe is the real cause of the current risk off sentiment, is because of the comments made by Federal Reserve Chairman Jerome Powell at Tuesday's senate testimony. He stated that it was time to retire the word transitory regarding inflation. This was not a revelation to us, as we have maintained our opinion that inflation will be stickier than what the Fed is currently predicting. Powell also stated that the threat of persistently higher inflation has grown and the Federal Reserve would likely begin the tapering of QE purchases a few months sooner. If this happens, it may also move up the timeline for a new rate hike cycle. These comments rocked the markets, moving yields on the front end of the curve up dramatically, while also flattening the curve even further. This flattening suggests the bond market is pricing in a policy error.

In our view, the fixed income markets usually represent the smartest thinking in the room. Meaning the shape of the U.S. Treasury curve is usually a very good indicator of what to expect from economic growth going forward. When the long end of the yield curve moves down as the short end moves higher, this is the market pricing in a faster pace of rate hikes which could lead to slower economic growth in the future. The market is pricing it this way because participants believe it will be a policy

error by the Federal Reserve to raise short term rates into a slowing economy, which, in the end, may push the US into a recession. This has led to a pick up in volatility in the equity markets. Higher rates and slower growth do not bode well for the stock market, especially the high-flying tech sector, which already seems overpriced from a fundamental standpoint.

We have seen the Federal Reserve back track on multiple occasions, and should be open to this possibility as well. The most recent instance was in December 2018. At that time, the Fed was in the middle of a rate hike cycle, lifting the Fed Funds rate from 0% to 2.5%. During the 4th quarter of 2018, it became apparent that the US economy was beginning to rapidly slow. At that December meeting, Chairman Powell stated that current monetary policy was on autopilot. Meaning that the rate hikes would continue into 2019 until normalization was reached. After he made these comments, the bond market began to price in a policy error and the yield curve inverted in May 2019. However, the bigger move was in the Equity markets. They fell over 11% in the month of December 2018. In the end, the Federal Reserve walked back its auto-pilot statements and we did not see another rate hike.

This same scenario could play out if a market correction of that magnitude happens again. It is important to note, interest rates are essentially at 0%, so in essence, the Fed has no dry powder when it comes to lowering rates unless we see a Negative Interest Rate Policy (NIRP). We do not believe this will be the case. We believe the most likely path is that the Fed may restart its bond buying program again.

We believe volatility will remain high through the end of the 2021. We do remain positive on value/quality over growth stocks because of the fundamental and economic backdrop. We have started to add duration to our fixed income portfolios while only sticking to high credit names. As more information comes out, we will have a better idea on what to expect going forward and will adjust our thinking if the data points us in a different direction.

We will continue to navigate this changing environment as adeptly as possible. As always, we at AMB thank you for your support and for allowing us to partner with you in reaching your financial goals.

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