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OP-ED: U.S. market turbulence looming

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In spite of rising numbers of virus cases and threats of interest rate increases fueled by inflation, the market has powered forward. For the first time in five years, the S&P 500 outperformed the Nasdaq. The S&P in 2021 posted a 26.89 percent gain.

Still, the virus has been disruptive in various sectors of the economy. Especially hard hit were travel, leisure and entertainment. Technology companies benefited, as businesses sought to operate more efficiently.

The world appears to be having difficulty vanquishing the COVID-19 viruses, and as soon as we get an upper hand, a new strain crops up. Perhaps that is to be the way of the future. A knockout blow appears to be elusive.

The mutating virus also is causing problems for logistics and planning, and thus cost increases. Prices for many things are going up. For a long time, the Federal Reserve considered those price increases as transitory, but the board eventually capitulated and decided to raise interest rates to counter inflationary pressures. The market does not like inflation, but it doesn't like higher interest rates either.

The Federal Reserve previously raised interest rates late in 2018, in the waning days of the longest-lasting economic expansion in U.S. history. It didn't take long for the Fed to rethink its increases, and it was forced to roll back the benchmark rate all the way to zero, as the economy went into a shocking tailspin. So, are we to see a repeat of the prior experience? Some people think the Fed can tighten things multiple times before the economy suffers. So far, the markets have been holding up. The coming rate increase has been well telegraphed, so it will be no surprise – and the rate increase will bring the benchmark rate up to only 0.25-0.5 percent.

The Fed has telegraphed two 0.25 percent rate hikes before the end of the year. Current Fed fund rates point to a 60 percent likelihood of tightening in March and a 61 percent likelihood of additional hikes by the end of the year. Although the anticipated hike in the near term is reflected in the current market, will the subsequent hikes bring troubles?

According to the Fed, it is responding to inflationary pressures, which by some measures are the fastest in nearly 40 years. The Fed has concluded that the trend is no longer “transitory.” So the question is: Can the Fed engineer a soft landing? It has been tried before but rarely successfully. In the soft landing scenario, the Fed gets it just right and demand eases a bit, in a “Goldilocks adjustment.” However, the danger is that inflation persists and rises even more than the Fed anticipates, prompting an even more aggressive Fed response. According to Mohamed El-Erian, chief economic adviser at Allianz, the question is: When does the Fed lose its nerve?

Bond yields have stayed largely in check despite expectations for rate hikes. But a market response to these increases could take the benchmark 10-year Treasury to around 2 percent this year. Is the economy strong enough to withstand the rate increase? Perhaps a correction comes in the second half of the year, as rate increases continue. Markets are coming off a long period of declining real interest rates. This long period of declining rates has allowed stocks to break free from economic fundamentals allowing price-earnings ratios to expand. The period of declining rates is ending, and real rates are likely to rise; this shift will change market leadership and perhaps unleash more volatility.

In addition, the Fed will likely taper its bond purchases, which could slow the economy further as liquidity is removed from the financial sector.

Buckle up for what appears to be a period of market turbulence and continue a disciplined investment process. Do not get spooked by the turbulence. As we used to say in the Army: “Hang loose, remain flexible and continue the mission.” It was good advice then and now.

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