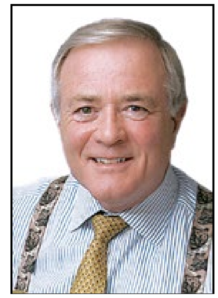
DJC

THE DAILY JOURNAL OF COMMERCE, PORTLAND, OREGON



William Rutherford

OP-ED: After spectacular October, market stumbles … before recent rally

Published Nov 11, 2022

This year has been difficult for all asset classes, especially equity securities. After a bad start, the stock market worsened through the summer, reaching new lows and panic among some market participants. A washout would have been good for the market, wiping out remaining excesses, but the market fell just short, despite striking a new low for the year.

Then came October, which is normally a not-so-good month for the market. It got a boost with the best October in years. Those who quit the market before October missed a big uptick. Volatility continued, with the market experiencing wide swings – some days by as many as 1,000 points in a trading day.

What is the cause of all the volatility? Inflation. Federal Reserve Chairman Jerome Powell and the board governors are intent on breaking inflation. They have made their intention clear, which has spooked the markets. Because of their continued, aggressive interest rate increases, we are likely to experience a recession.

The Fed is striving for a “soft landing” – i.e., no recession, but rather a cooling-off of demand. On the current path, a hard landing is likely. The market does not like the possibility of a hard landing, and so it fluctuates widely as it tries to parse each likely alternative.

The economy appears to be strong – too strong for the Fed. In the recent jobs report, employers added 261,000 positions in October, many more than forecast. While that may appear to be good news for some, it is not good news for a Fed that wants to see the economy slowing. In a bad-news scenario, the Fed took comfort in an uptick in the unemployment rate to 3.7 percent.

After the report was issued, however, Chairman Powell gave a hawkish news conference that left the recent market rally on life support. Yet the Dow remains 11 percent above its Sept. 30 closing low. The markets are pricing in a 75-basis-points increase in interest rates in December.

Chairman Powell continues to make clear that he wants to break the back of inflation, which means higher interest rates and a slowing economy. Investors should take note of the Fed intentions.

Other central banks around the world are raising interest rates to keep pace with the U.S. Fed’s inflation fight. The Fed’s tactic of raising rates to fight inflation has a side consequence of strengthening the dollar. Higher U.S. rates means the dollar is a better place to invest and so increases the demand for dollars. As the dollar increases in value, investors pull their money from other currencies to buy dollars, making other currencies weaker.

Since many contracts around the world are priced in dollars, when its value fluctuates, there are winners and losers. One such category is holders of debts that are due in dollars. This could mean contracts for commodities such as oil or borrowing in U.S. dollar-denominated debt. Since oil contracts are usually denominated in U.S. dollars, it becomes harder for countries and companies with currencies weakening against the dollar to pay those contracts. Similarly, for those who have debts in U.S. dollars, it becomes harder to pay those debts. Emerging market governments often borrow in dollars but find repayment difficult as their local currency becomes less valuable. Might we then see an emerging market country default on its obligations? It is possible, and even likely.

In an inflationary environment, U.S. exports become more expensive to foreign buyers. This causes them to look for other sources, even as the strong dollar, the world's reserve currency, raises the cost of products worldwide, thus fueling more inflation.

Markets add another piece to the puzzle: The elections fill in the blanks a bit. Now that the elections are over, it is easier to see what kind of economic policy the government may follow. It provides a clue as to whether we will have tighter or looser monetary policy and what kind of fiscal policy we will follow.

What about national security? As of this writing, not all election outcomes are clear. Still open is who will control Congress: the Democrats or the Republicans? Their economic policies are different, so market reaction will be different. If the Democrats have a clear majority, look for more easy money and inflation. If the Republicans do, look for a more tight-fisted economic policy; an effort to change the course of inflation, but a less robust economy. Either way, good luck.

William Rutherford is the founder and portfolio manager of Portland-based Rutherford Investment Management. Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com. Information herein is from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. Investment involves risk and may result in losses.