Financial Markets This Week

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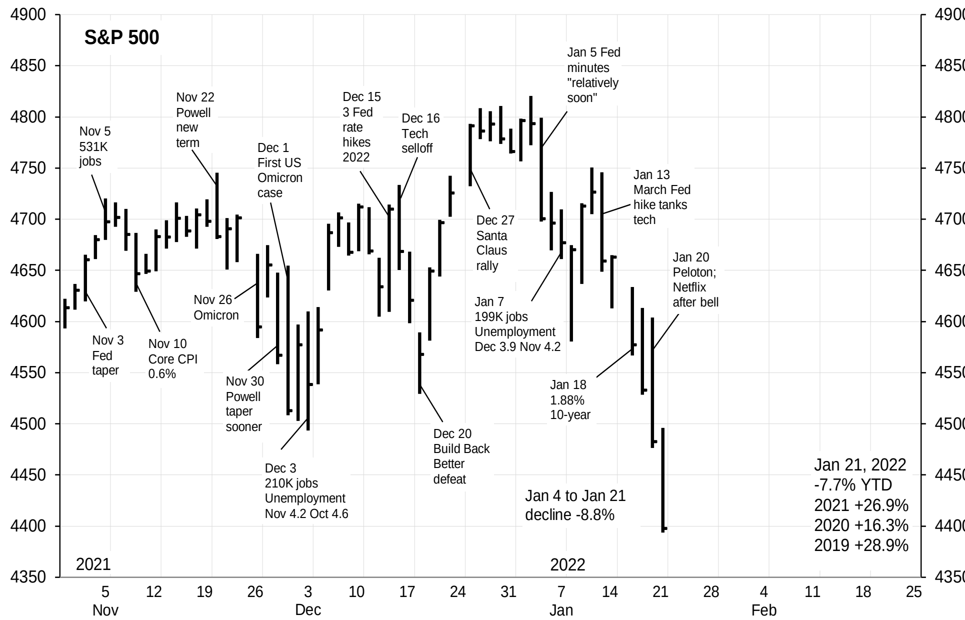
WHY DO STOCKS FALL?

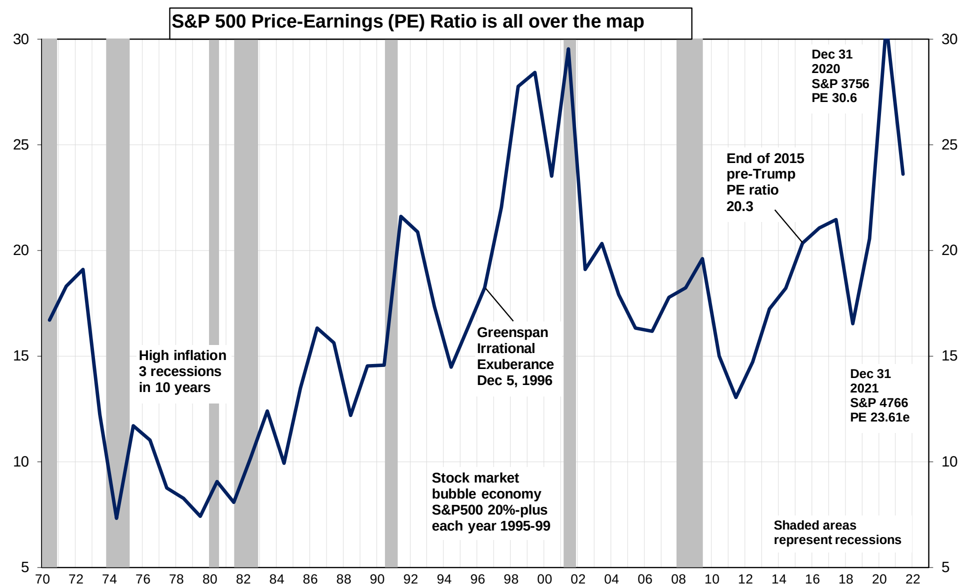


It's only three weeks into 2022, and the decline in the stock market is already making us wonder if it will be one of those years. Since the stock market recovery from the scary pandemic losses (35.4% hitting bottom March 23, 2020), this is only the second time stocks have pulled back so far from record highs. Near the close on Friday, the S&P 500 was down as much as 8.8% from January 4, 2022's record high. The worst pullback in the stock market since the pandemic crash recovery was in September 2020 when the S&P 500 fell 10.6% from a record high. The September 2020 drop was tech stocks related as well, although the losses this year are more Federal Reserve rate hike related and what that will do to technology companies. Stocks weren't prepared for Fed rate hikes coming relatively soon; then hearing a week later Fed officials in unison saying a March 2022 first hike (to all of 0.50%) was likely; then bond yields got to 1.90% earlier this week; and then Thursday's company news from Peloton and Netflix caused the market to stumble perhaps. The selling accelerated shortly after noon on Thursday certainly.

Why do stocks fall? Why do birds sing, why do frogs croak. Investors, traders, speculators cannot help themselves. Selling is always a mix of news and technicals on the charts, 200 day moving averages breaking and the like, which at some point gets panicky, especially ahead of a weekend. It takes a lot to keep stocks down for the entire year though. The table here looks back over the last three decades. Eight out of thirty years were down. And there hasn't always been a need to rush out to put money to work and buy the dip. You aren't always missing out. If you bought the S&P 500 1,469.25 top of the internet stock bubble at the end of 1999, you still had a chance to shove all your chips in at 2012's close of 1,426.19… thirteen years later.

Eight Down Years for Stocks in the Last Thirty Years				
Event 1	1990	330.22	-6.6	Recession hits the S&P 500, Oil (Iraq invades Kuwait)
Event 2	1994	459.27	-1.5	Fed announces big rate hikes from 3.0% to 5.5%
Event 3	2000	1,320.28	-10.1	Fed hikes to 6.5%
Event 4	2001	1,148.08	-13.0	Recession, 9/11, Fed cuts rates to 1.75%
Event 5	2002	879.82	-23.4	WorldCom, Fed rate cut to 1.25%, Iraq war slowdown
Event 6	2008	903.25	-38.5	Recession, no argument there, Lehman bankruptcy
Event 7	2015	2,043.94	-0.7	1,000 point flash crash, Oil, China, World growth
Event 8	2018	2,506.85	-6.2	Fed, Federal Govt shutdown, Oil, China (trade) war
Event 9	2022	4,397.94	-7.7	Fed, bond yields, tech stocks, Omicron slows economy

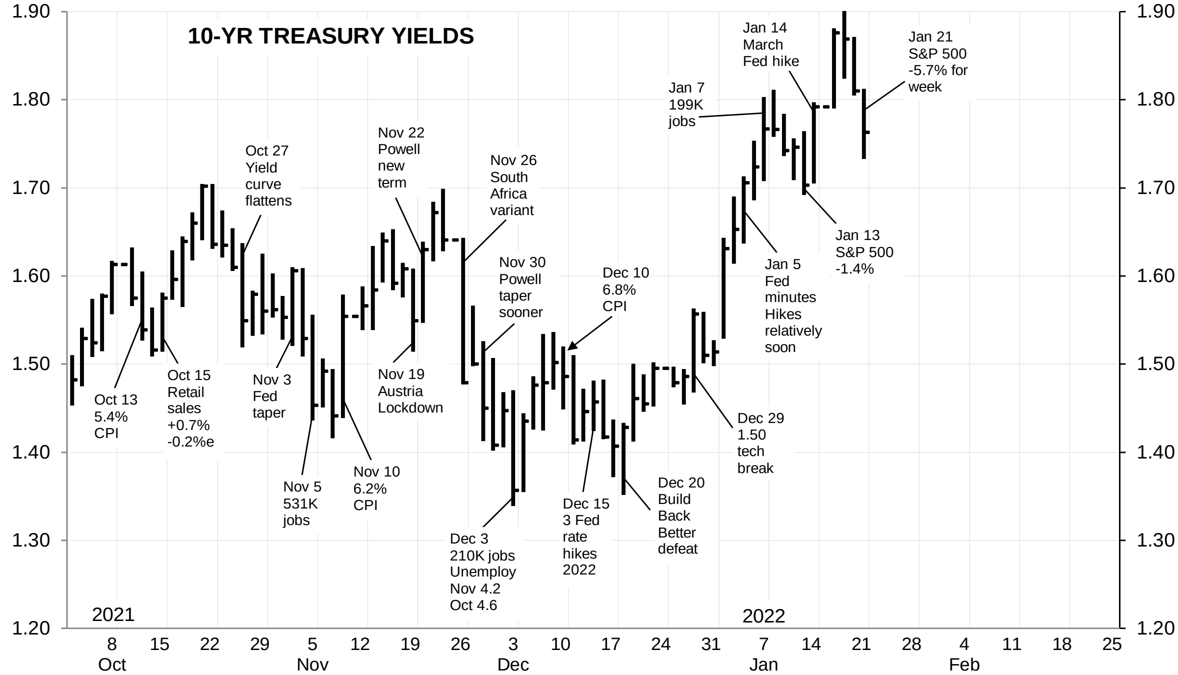
Eight years out of thirty call it. There were fundamental reasons for selling each year: the Federal Reserve took away the punch bowl and lifted rates, there were three recessions, and other miscellaneous reasons. We can look back calmly after the turbulence has passed and stamp some reasons on the stock market drops. Real-time is different if you are watching the panic and listening to the financial news networks. The year-to-date decline for 2022 at Friday's close is 7.7% which would add to the history books if it sticks. A 7.7% decline is worse than a 6.2% drop in 2018 as the Fed pushed its interest rate to 2.5% (it is 0.25% right now), there was a Federal government shutdown, a trade war with China. A 7.7% decline is also worse than the 6.6% drop in 1990 when the economy went over the cliff into a recession as oil prices spiked when Iraq invaded Kuwait.



The market crashed 5.7% this week. It might be early yet to expect any help from Fed Chair Powell although he seems to stay up late often with his risk management approach, the pluses/minuses written in columns on a yellow legal pad when things get gnarly. Back in January 2019 he signaled the Fed could be patient with those three more 25 bps rate hikes in 2019 after raising rates to 2.5%, the peak as it turned out, at the December meeting. It might be early yet as the drop in stocks in December 2018 was 20.2% at the worst point versus only 8.8% today. There was news like a Federal government shutdown to contend with at the end of 2018, but Fed officials continued to note for a while the disconnect between the positive news on the economy and what the leading indicator of the stock market had to say about the future. The morning Powell said they could be patient 4:45, January 4, 2019, nonfarm payroll employment rose 312K Powell noted.

If it is too early for the Fed to ride to the rescue there's always big tech earnings coming next week. It looks like Q4 2021 corporate earnings are running 30+% higher than Q4 2020 which would be positive as long as there are not too many downgrades to company expectations for Q1 2022. The S&P 500 PE ratio came back down to an estimated 23.61 at the end of 2021 despite the big jump in the index. We are not sure how anyone knew companies would make that much money coming out of the pandemic, but if operating earnings stick where they are, the PE ratio is 21.14 at Friday's close.

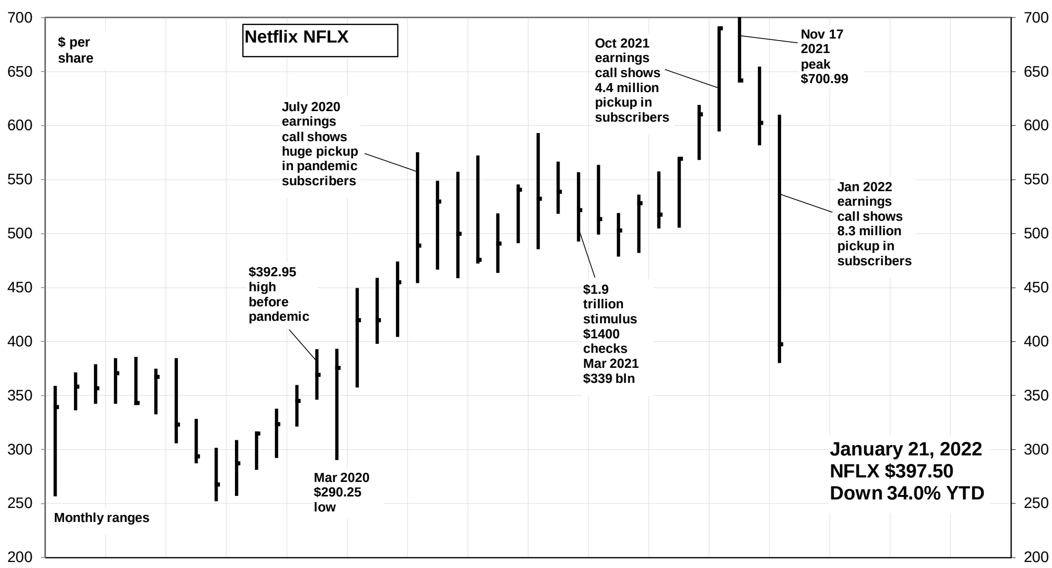
INTEREST RATES



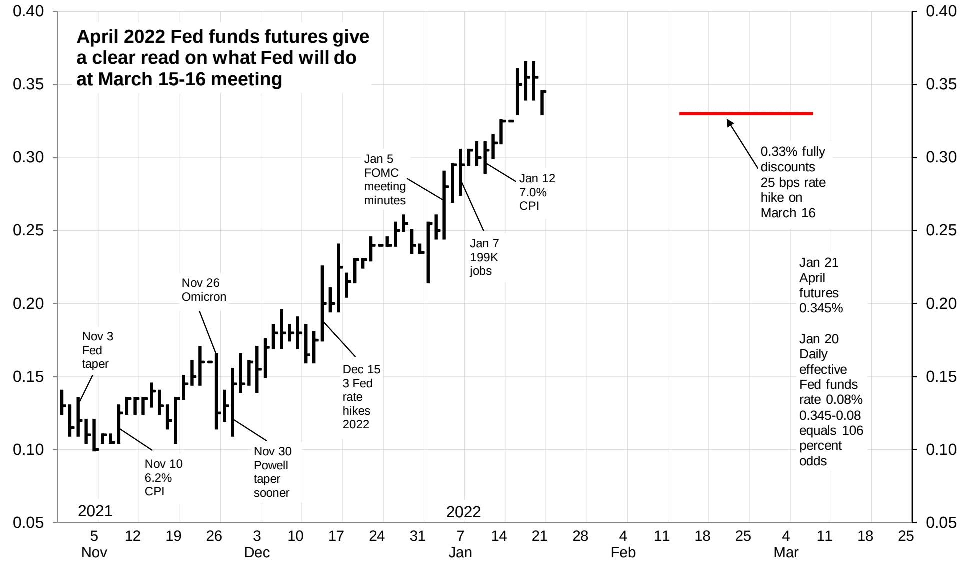
A see-saw this week's trading. Higher bond yields brought stocks down at the start, and by the end of the week, sharply lower stocks brought yields back down. It was the worst stock market rout since September 2020. 10-year Treasury yields closed at 1.76% on Friday after being as high as 1.90% on Wednesday. Fed officials aren't saying anything because of the blackout ahead of next week's meeting. We like the bond yield rally, but we don't trust the Fed to push rates quickly to 2.5% like they did at the end of 2018 because of all the criticism they received for that move. Even with inflation as high as it is. Economic growth looks already like it is slowing in the first quarter. Stay tuned.

Netflix NFLX drops 21.8% Friday after earnings

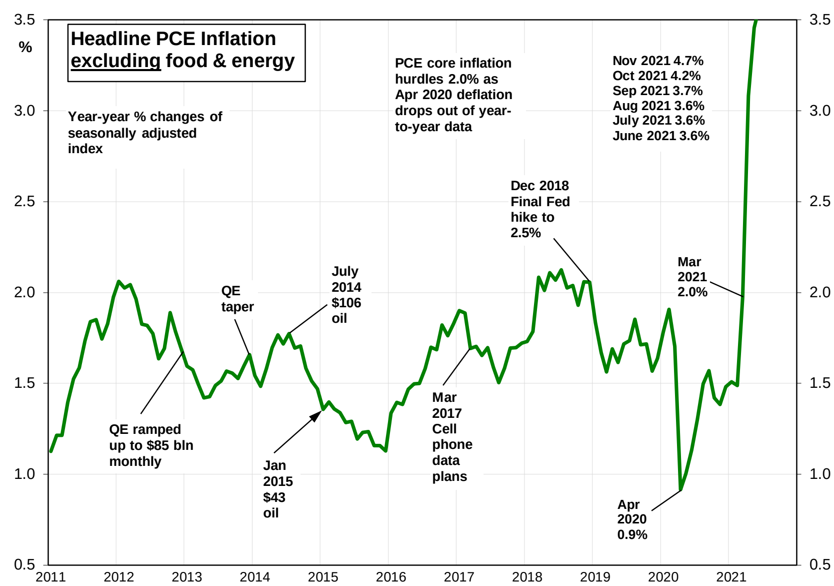
Netflix tumbled on Friday after releasing earnings on Thursday after the bell. New subscribers looked strong at 8.3 million in Q4 2021 (15.8 million during Q1 2020 pandemic), but the company forecast just 1.3 million in Q1 2022. The shareholder letter talked of costs and competition, and last week of course they raised their prices. Check your bill. Earlier in the day on Thursday, the market got a reminder of the pandemic stay-at-home days nearing the end with Peloton suspending production.



FEDERAL RESERVE POLICY



The Fed meets on January 25-26, 2022 to consider its monetary policy. There are no forecasts, but Powell will present an opening statement and take questions from the press for an hour. What does market volatility mean for the outlook? The Fed is purchasing $40 billion U.S. government securities for the month ending February 11, down from $80 billion before tapering was announced on November 3. After February 11, it buys $20 billion for a month and then that's it. No more Treasury purchases that adds liquidity that makes the stock market keep setting record highs. Powell will also get asked about balance sheet reduction. Some participants at the December meeting wanted to have the security holdings be mostly Treasuries. This is the same as last time, but they are saying to reinvest "principal from agency MBS into Treasury securities relatively soon or letting agency MBS run off the balance sheet faster than Treasury securities." There is some understanding of what reducing Treasury securities holdings will do, but it is not known what selling off the $2.6 trillion of MBS would do. Seems like it might send mortgage yields higher relative to Treasury yields, which could be a problem for the housing market, slow economic growth faster than anticipated etc.



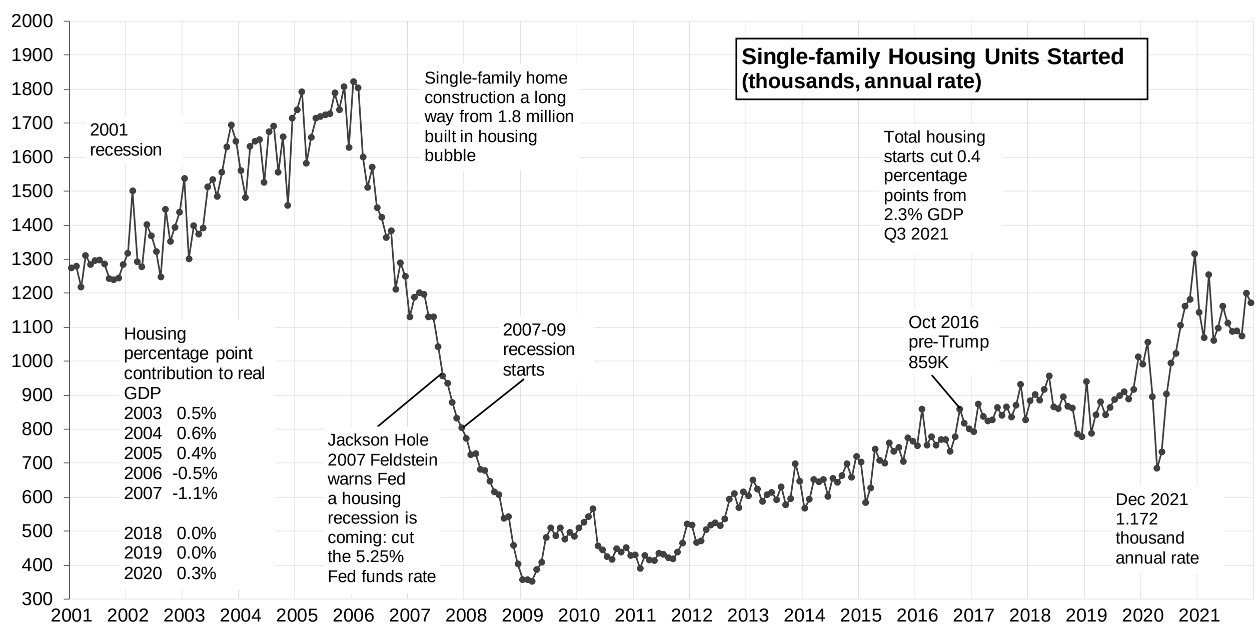
CPI inflation is 7.0% in December, but the Fed's preferred measure is PCE inflation that comes out on Friday, January 28. Core PCE inflation was much less at 4.7% year-year in November. In terms of inflation-fight optics, the year-on-year core PCE inflation rate may drift up until the March 2022 report. If inflation stops increasing, it may keep the Fed's interest rate hikes measured this year as long as the stock market turbulence doesn't make Powell want to be patient again. If they go and hike rates the first time in March, it seems like a once a quarter pace would be appropriate again for a while, like they did the last time in 2016 through 2018. This would put the Fed funds rate at 1.25% at the final December 2022 meeting.

OTHER ECONOMIC NEWS

Residential housing permits jump this month in Philly (Wednesday)

Breaking economy news. Residential housing construction data. Permits rose 9.1% to a 1.873 million annual rate in December. Starts rose 1.4% to a 1.702 million annual rate in December. The housing permits data jumped due to some forthcoming real estate tax changes in 2022 that affects building permits in Philadelphia. The housing starts increase, slight as it was, is driven by a double-digit jump in multi-family starts as single family starts fell 2.3% with big wide swings offsetting each other around the country. Single family starts up 11.1% in the Northeast, and up 50.8% in the Midwest, but these were offset by declines in the bigger markets out West (-14.6%) and the South (-8.2%). It was a confusing year for residential housing construction where new supply is desperately needed, and the big erratic changes in the final month of 2021 did little to clarify the picture.

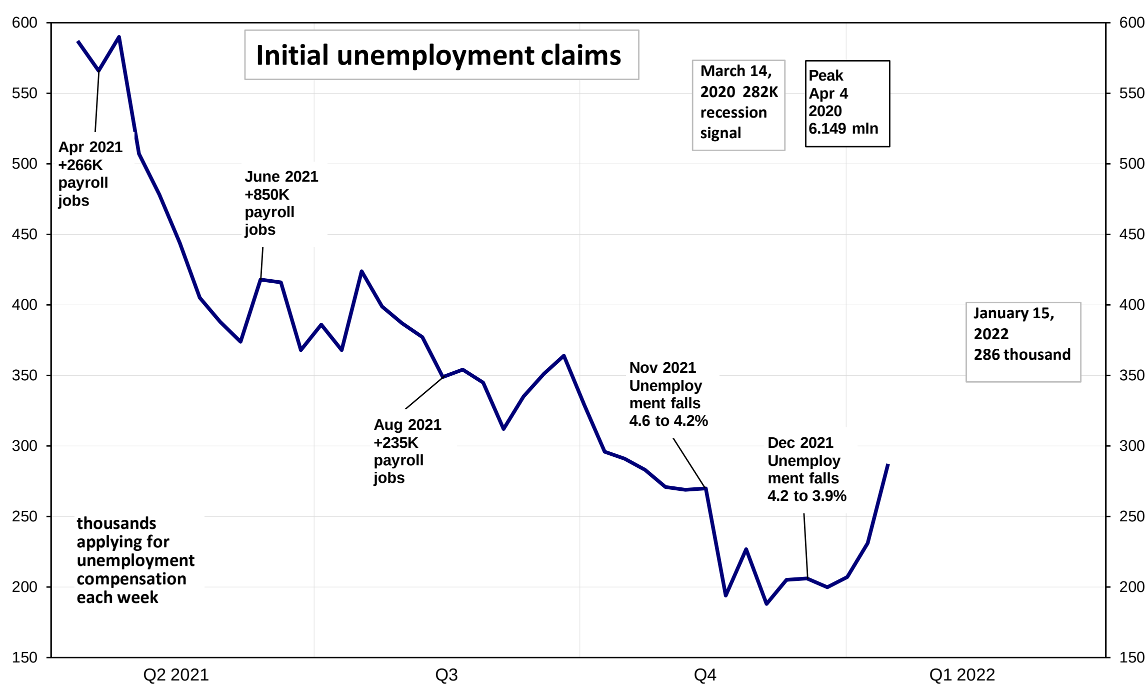
Net, net, residential housing construction is missing out on the economic demand boom that is occurring in many other sectors of the economy, and with mortgage rates already rising with several Federal Reserve interest rate hikes cocked and ready, this year is likely to be sideways at best for residential home builders. It will be interesting to see if higher mortgage rates cool the housing bubble in prices because the lack of new supply will likely remain the dominant trend for another year. There is a shortage of affordable homes across America and there is nothing in the pipeline to suggest more new homes are on the way. Residential housing construction has been a drag on real GDP spending in the second and third quarters last year, and although starts improved at the end of the fourth quarter of 2021, new construction will not add much if at all to the economy for the quarter. Stay tuned. Story developing.



Jobless claims going wrong way and don't support aggressive Fed action on inflation (Thursday 8am ET)

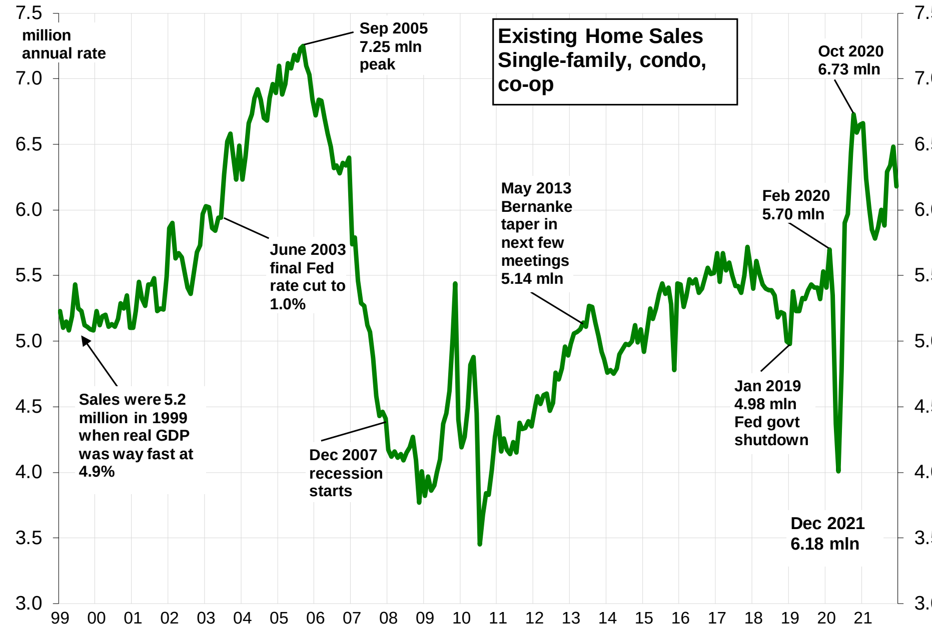
Breaking economy news. Jobless claims are going the wrong way and do not support an aggressive move by the Federal Reserve to rein in inflation. Blame the weather or blame the spread of the Omicron virus, but until first-time jobless claims come back down to earth, the economy cannot be given a clean bill of health. There were storm clouds on the outlook horizon after last week's elevated reading of joblessness, and now the sky has grown even darker after today's report. 286,000 new applicants for unemployment benefits in the January 15 week, 231 thousand in the January 8 week, and 207 thousand in the January 1 week which is essentially the last week of 2021 because of the New Year's holiday. Job layoffs have risen enough this year to signal a recession which is very hard to believe, so we expect it is something more to do with faulty seasonal factors that cannot take account of the winter storms, and/or the spread of the Omicron virus that has led to some temporary layoffs.

Net, net, the markets got a warning shot fired across the bow of the economy today from a jump in first-time filings for jobless benefits which is the traditional early signal that the economy is inches away from going over the cliff and down into the black hole of recession. Perhaps the Omicron virus has shut down more American businesses and kept shoppers away from the mall more than we thought. The reports that new Omicron cases are peaking counts as good news that leads us to hope that job layoffs are also peaking. Stay tuned. Story developing. Today's jobless claims data are a big surprise and we hope it is temporary, winter storm related perhaps, regardless of the reason though, the higher layoffs are a cautionary tale for the economy where despite inflation pressures, the Federal Reserve will have to proceed with their interest rate hikes at a measured pace. No surprises please. The economy may be slowing down more than previously believed.

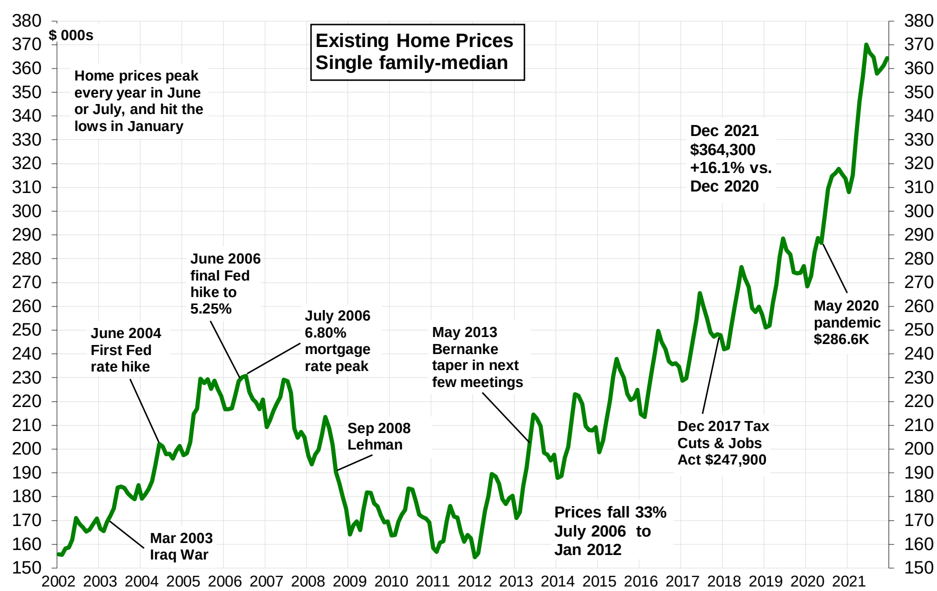


Existing Home Sales are down, bubble in prices continues (Thursday 10am ET)

Breaking economy news. Existing home sales fell 4.6% in December to 6.18 million at an annual rate. The South and West fell about 6 percent this month, and sales in the Northeast and Midwest were down about 1%. The same story. The pandemic stay-at-home economy required a home, and home sales peaked at 6.73 million in October 2020. Sales are not the real story in today's report. Everyone wants to know what is going to happen to the cost of the roof over their heads.



Let's see home prices in that 7.0% December CPI report are rising 3.8%. Not in my town. Maybe the Bureau of Labor Statistics (BLS) didn't see this report. Existing home prices are going up faster than they did in the housing bubble years that peaked almost to the day the Federal Reserve lifted its policy rate to the peak of 5.25% in June 2006. Mortgage rates were 6.8% in July 2006 at the peak. Will higher interest rates burst the housing price bubble again? 30 year mortgage rates were 3.56% this week, and would go close to 5% this time around if the Fed pushes the Fed funds rate to 2.25% which their forecasts say they will do by the end of 2023. That's off in the future which is of course highly uncertain, so keep bidding up home prices. Everyone else is. Nationwide, the increase in December 2021 is 16.1%. There are starting to be some regional differences with the South up 20.3% year-to-year, the Northeast only up 6.0% and the Midwest +10.0% and the West +7.9%. Just like the internet says: everyone is moving to Texas and Florida. We forgot. As we said earlier, home prices are going up faster than the housing bubble years over a decade ago. During the housing bubble in the early 2000s, nationwide home prices never rose faster than 10 percent year-over-year. At least until late in the game, in the middle of 2005. Stay tuned. Watch here where the world goes next.



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