Global supply chain shock

Re-decoupling of the U.S. market and economy?

Feng Yuqing: Although most of the indicators point to a healthy economy, if it is not very strong, people begin to question the state of the economy. When the Fed raises interest rates rapidly, it will easily lead to market volatility.

Updated at 18:15 on February 8, 2022 FT Chinese website columnist **Feng Yuqing**

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Under the prospect of a strong interest rate hike by the Federal Reserve, the first month of 2022 can be said to be erratic and bleak for the U.S. stock market, with undercurrents surging.

The S&P 500 fell 7.0% in January, with 10 of 11 sectors and 80% of their sub-sectors in decline. There is a saying on Wall Street, "As in January, so in a year,"

according to The Stock Trader's Almanac, since 1950, every time the market fell in January, there has been a bear market, or a continuation of the original bear market, or 10 % down or flat, except last year. Against this backdrop, coupled with the highest inflationary pressures in 40 years and the Fed's determination to raise interest rates, the stock market decline to start 2022 portends a difficult and challenging year for investors. Just on February 3, Facebook tumbled, losing more than $230 billion in market value, the largest one-day drop in the history of a U.S. company, and the Dow Jones Industrial Average fell more than 500 points, and the market was in shock.

Still, Niall H. O'Malley, founder of Blue Point Investment Management, remains confident about the future. Niall, who just made an investment at the end of January, believes the market needs such a period of recalibration after the wild bull market of 2020 and 2021. The key question going forward is whether the U.S. economy is strong enough to offset the pullback from 3-4 Fed rate hikes.

The U.S. economy grew much faster than expected in the fourth quarter of last year, with annualized GDP growth reaching 6.9%, thanks to a surge in inventories and consumer spending. Economists had expected an increase of 5.5%. This also brings the U.S. GDP to 5.7% for the full year of 2021. On the employment front, data from the Labor Department on Friday showed that U.S. payrolls rose sharply by 467,000 in January, with the unemployment rate at 4%, still a historically low level. At the same time, although the U.S. inflation rate has reached the highest level in nearly 40 years, the strength of the economy and the Fed’s interest rate hike expectations have caused the dollar index to rise by 7% in 2021, the best performance since 2015.

While many of the factors driving high growth in 2021 - including reopenings, fiscal and monetary stimulus, and vaccinations - will disappear, The Conference Board's economic index shows that the uptrend in GDP by the end of 2021 will continue to expand into the spring, although the first quarter is due to Omicron The ravages may slow to 2.2%, but full-year 2022 GDP will grow by 3.5%, well above the pre-coronavirus growth trend.

JPMorgan's Business Leaders Outlook, released in January, surveyed U.S. small and medium-sized business leaders' expectations for the coming year. Of these, 83%

are optimistic about the outlook for the next 12 months, and 70% say their business has recovered or exceeded pre-pandemic profitability. 90% of respondents expect their business to grow by 2022. None of the respondents said they were afraid of going out of business. In fact, the typical signs of expansion plans -- capital spending and credit demand -- are both expected to rise sharply from a year ago.

Ataman Ozyildirim, senior director at The Conference Board, told me that the major economic indicators are showing strong fundamentals and consumer spending has recovered. The real estate market has been doing well. Despite the volatility in the stock market, things are looking pretty good from last year's overall trend. In terms of the underlying cyclical dynamics of the expansion, the U.S. economy is in a good position. Of course, there are always headwinds in economic development, and the most likely storm at present comes from the Fed's interest rate hike.

Fed Chairman Powell changed his dovish view at the Fed meeting last Wednesday, emphasizing the possibility of raising interest rates at every FOMA meeting starting in March. Powell has previously insisted that inflation is temporary, but the US 12 The monthly core CPI has reached its highest level in 30 years, and in the face of huge inflationary pressure, Powell has turned into a hawkish stance, and he has not even ruled out the possibility of raising interest rates by 50 basis points at a time. Previously, the market generally expected the Federal Reserve to raise interest rates 3-4 times this year. Now this expectation has increased. The latest report from Bank of America shows that it may raise interest rates 7 times.

And in the face of an already $8 trillion balance sheet, the Fed will halt its $120 billion in bond purchases since the pandemic in March. At the same time, it will begin to shrink the balance sheet later this year, and steadily withdraw the easing policy in 2022. In an interview with Bloomberg on Tuesday, February 1, Philadelphia Fed President Patrick Harker said he supports four rate hikes this year of 25 basis points each, but currently disapproves of a 50 basis point increase unless inflation spikes.

The Fed is indeed somewhat passive in controlling the inflation curve. They have unprecedented balance sheets and essentially zero federal benchmark interest rates. The inflation rate in December last year was 7%, which resulted in a real federal benchmark rate of -7%.

"Even in 1975 and 1980, the real federal benchmark interest rate was not this low, and we still have a long way to go from -7% to the level needed to curb inflation," said Steve Roach, a well-known American economist. I said, "The Fed is raising rates more often than they and the market expect, potentially slowing economic growth. And shrinking the balance sheet is taking out excess liquidity and should cause a bigger impact on the market." Influence."

The Fed's dual responsibility is to maintain price stability and maintain employment levels. At present, the employment level has reached 4%, and inflation is already the core task of the Fed.

"The Fed's job is not to support the market, and if the market goes down that's the result of the Fed's actions, it's hard for investors, but that's not part of the Fed's job," Steve Roach said.

So will the Fed's fiscal tightening policy affect the normal development of the economy? Could an otherwise healthy economy be in trouble with a rapid rate hike?

Powell emphasized that the Fed's policy has been adapting to the changing situation, and he is pleased with the resilience of the U.S. economy and will continue to adjust policies based on U.S. economic data.

“The Fed certainly doesn’t want to plunge the economy into recession,” Sam Stovall, chief investment officer at CFRA Research, told me. “They want to strike a balance between raising interest rates to keep inflation in check and keeping the economy going.”

On February 1, Bridgewater Associates, the world's top hedge fund, said in its 2022 economic outlook that while asset markets may be more sensitive to interest rate hikes than in the past, the real economy may actually be less sensitive to tightening. But Bridgewater also stressed that investors may have underestimated the need for the Fed and other central banks to "aggressively" tighten monetary policy to fight inflation, which would pose "significant risks" to the market.

In 2020, the U.S. economy fell off a cliff due to the epidemic, but due to fiscal stimulus and a large amount of liquidity injected by the Federal Reserve, the U.S. stock market rose sharply, basically disengaging from the real economy. So now that

the U.S. economy is relatively healthy, will the market fall sharply in the future, so that the asymmetry between the stock market and the real economy will reappear?

"It's not impossible. It's happened in the past. In 2018, when the U.S. economy was good, the Fed's rapid tightening policy sent the stock market down nearly 20%." Yung-Yu Ma, chief investment officer at BMO Wealth Management Tell me, “But I think the challenge right now is that while the economy is stable, the fiscal stimulus is fading, the Fed is raising rates, and growth doesn’t look likely to accelerate. Then there’s the potential for markets to get stuck in a good economy.”

With the Federal Reserve likely to be in tightening mode for the next two years, Yung-Yu Ma believes investors are trying to figure out how to adjust the price of assets now, because trying to predict the far future and making investment decisions today is not easy. And, while the economy's fundamentals are good, some new data suggest it's not that strong. The Purchasing Managers Index, which measures activity in manufacturing and services, fell to 50.8 in January from 57 in December, hitting an 18-month low in January due to Omicron's impact.

While the vast majority of indicators point to a healthy economy, as long as it's not very strong, people start to question the state of the economy, which can easily lead to market volatility as the Fed prepares to raise rates quickly.

"If everyone thinks the economy is good, why is the market down so much?" Sam Stovall said.

Amy Zhang, executive vice president of Fred Alger Management and star fund manager of small and mid-cap stocks, believes that the macro economy plays a decisive role in this situation, and the rise and fall of many stocks is somewhat disconnected from the company's fundamentals. The Alger Small Cap Focus Fund, managed by Amy, ranked No. 1 among small cap stocks in the United States in 2018, and she is ready to take this opportunity to choose some stocks with good value for money.

However, most of the investment circles around Amy believe that Omicron is likely to subside in the spring. The market has generally expected that the frequency of Fed

rate hikes will be 3-4 times, and the 2%-3% economic growth market in the United States will also bring a very large amount to the market. chance.

"I feel like it's dark before dawn," Amy told me.

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