CETERA® INVESTMENT MANAGEMENT

COMMENTARY

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Summer Volatility Heating Up

- Equity and bond markets waver as risks continue to mount.
- Meanwhile the Fed seems increasingly focused on inflation.
- In uncertain times, diversification remains the best investment strategy.

This summer and the second half of the year could be marked by more market volatility, as investors become less complacent about growing risks and momentum fades. Bond investors have been bidding up bond prices, sending 10-year Treasury yields lower, to under 1.3% (from 1.75% just a few months ago). This could be an ominous sign for the economy and equity investors are starting to take notice. Today, stock markets opened sharply lower as investors are growing more concerned that we could now be seeing peak economic growth and that the reopening trade may be over. Economic data is starting to come in lower than projected as we saw weekly jobless claims unexpectedly rise and a survey to business leaders in the service sector came in weaker than expected with supply and labor shortages. These economic concerns are coupled with the growing worries around the COVID-19 Delta variant which is making its way around the globe.

These worries seem to be mounting at the same time inflation projections are rising. This recovery has been driven in large part by stimulus from Washington and a very accommodative Federal Reserve (Fed). The Fed has a dual mandate to maximize employment and keep prices stable. The Fed has been willing to let inflation or prices rise and focus more on maximizing employment, but if inflation is too hot, they will be forced to raise interest rates and stop buying as many bonds, sending yields higher and putting a lid on economic growth as borrowing costs would become more expensive. In a recent meeting, the Fed noted risks to the outlook for the economy are broadly balanced, but a substantial majority of participants judged that the risks to their inflation projections were “tilted to the upside.”

So, on one hand, investors are concerned about peak economic growth and the Delta variant and on the other hand, investors are worried the Fed will become less accommodative to fight inflation. This is a bit confusing because slower economic growth would generally lead to less inflation. However, there is such a thing called stagflation, which we saw in the 1970s. This is characterized by stagnant economic growth and rising inflation. This is generally caused by an external shock to the economy such as rising oil prices as we saw in the 1970s. The good news is that we don’t see stagflation on the horizon. We do see volatility though as investors weigh the mounting risks to the economy and try to gauge what the Fed will do in the face of inflation. Inflation may or may not end up being merely a temporary side effect from the stimulus pumped into the economy and the supply-side constraints caused by the economy reopening.

The recent volatility is also expected and something we wrote about in our Mid-Year Outlook. Valuations in both stock and bond markets suggest little margin for error in economic data and market expectations and now we are seeing uncertainty grow. A correction is possible as we haven’t seen a pullback in a while. For example, the S&P 500 hasn’t fallen more than 5% since October 2020. Timing corrections is extremely difficult though and often not profitable. A famous investor and author once said, “Far more money has been lost by investors trying to anticipate corrections, than lost in the corrections themselves.”

To reiterate, we continue to anticipate more volatility in the near term. Any disruption to current expectations could be a headwind to stocks, and stock market valuations priced to perfection could amplify this volatility. We may see a stock market correction at some point this year, but we still don’t expect a big sell-off like we saw last spring. We maintain that diversification is the key in this market. In these times, your financial professional can help you stay focused on your long-term risk and return goals and help you with your personalized investment objectives.

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Glossary

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