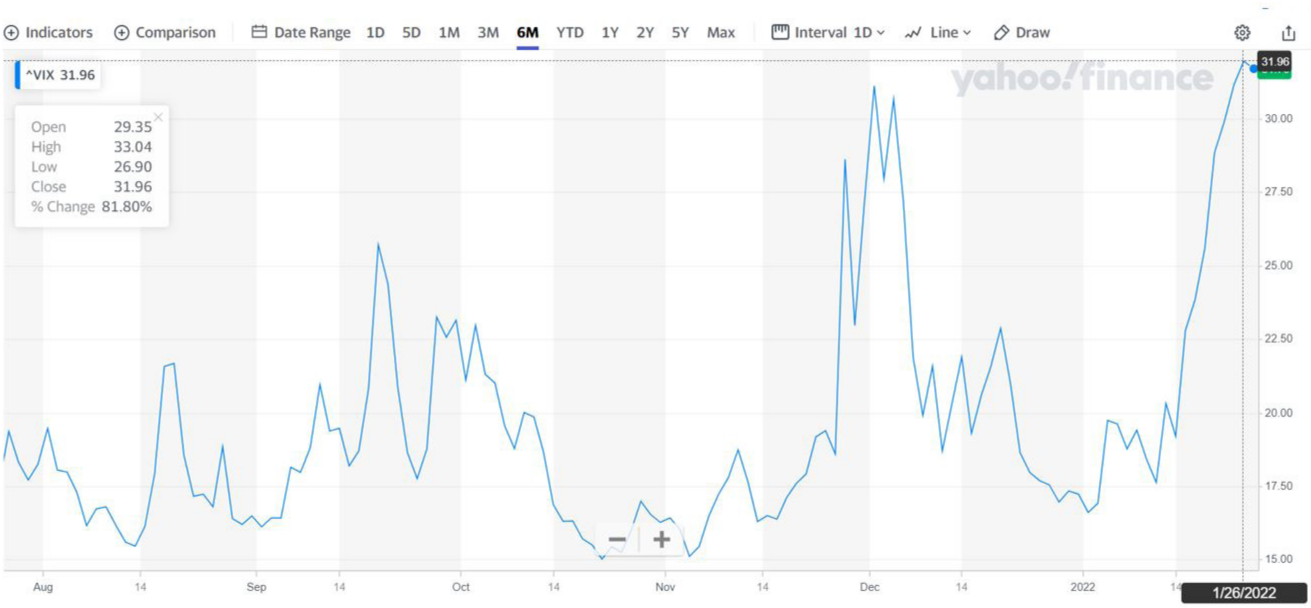
Week in Review

Friday, January 28th, 2022

1. Volatility has Spiked Year-to-Date

Notable in the markets this week has been the high level of volatility in the equity indices which have seen several large intraday swings. Volatility has risen to a high level on concerns about Federal Reserve monetary policy and concerns about the potential for slower economic growth prospectively.



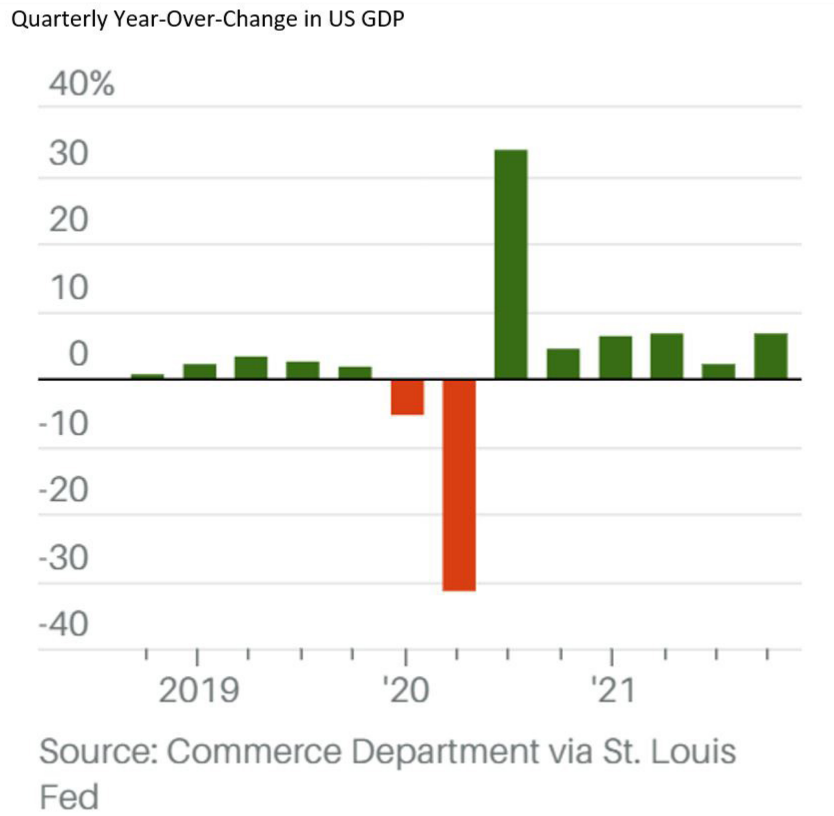
Source: Yahoo Finance

The current level of volatility is similar in magnitude to the spike associated with the announcement of the Omicron strain of COVID in late November. Volatility tends to spike during periods of unexpected change. The spike associated with Omicron was quickly overcome as the strain, while contagious, was found to be less severe overall. Interestingly, the explanation for the current spike is less clear as it has been apparent for some time that the Federal Reserve would be raising rates soon to combat inflation. The likely explanation is heightened fear that the Federal Reserve will tighten policy much more quickly and aggressively than previously perceived and will be less likely to come to the rescue of the equity markets if the economic and employment data is otherwise strong.

Volatility does not tend to remain at such elevated levels as it does presently. It is possible that the concerns about the Federal Reserve have already peaked. As concerns do ultimately ease, it is likely the markets will settle into a more settled period reflecting the underlying trajectory of long-term growth for companies and the normalized level of long-term interest rates which will determine reasonable valuation multiples.

2. Strong Economic Growth to Finish 2021

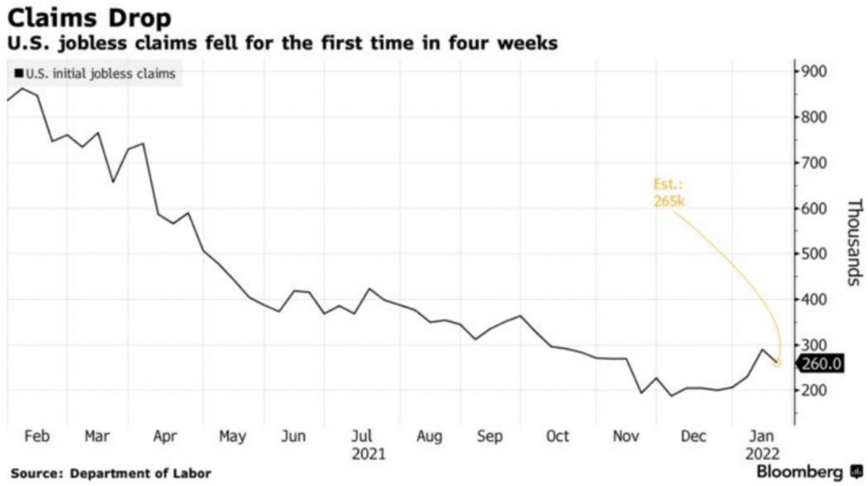
The latest Gross Domestic Product (GDP) data released for the fourth quarter of 2021 came in at 6.9% and surpassed expectations of 5.5.%. The growth level also showed acceleration from the third quarter of 2021 despite the probable impact of Omicron.



Economic growth for 2021 saw a strong rebound with the full year rate coming in at 5.7% versus a contraction of 3.4% for 2020. The fourth quarter came in particularly strong helped by strong consumer spending. Other drivers of growth were the replenishment of company inventories which had been drawn down earlier in the year as reopening demand soared.

While GDP growth in the fourth quarter was helped by increased volumes, the GDP price index rose a significant 6.5%. This suggests the impact that higher prices are having on nominal economic growth as a reaction to inflation. So far, demand remains positive despite the inflationary environment.

Other data released this week included initial jobless claims. Initial unemployment claims totaled 260,000 in the week ending January 22, down 30,000 from the prior week period and the first weekly decline in the past month.

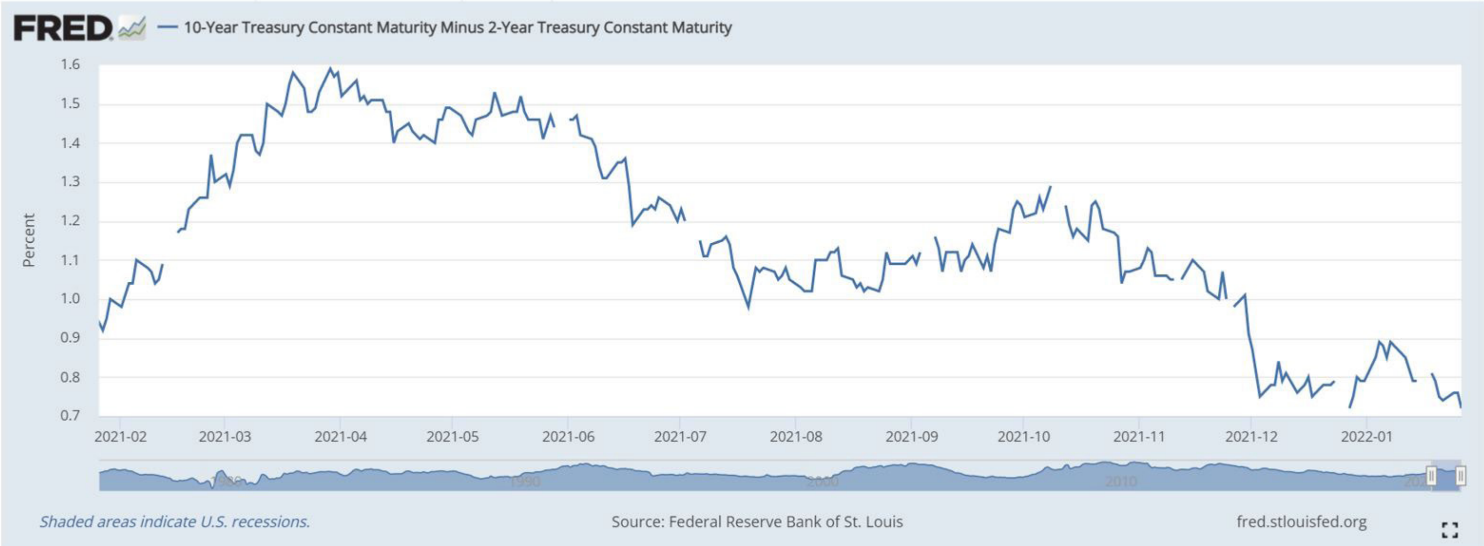


Overall economic and employment data corroborates that the US economy remains in a strong recovery period.

3. Federal Reserve Confirms it's on Track to Tighten

Federal Reserve Chairman spoke this week and confirmed that the Fed expects to commence its plan to move steadily away from the accommodative stance enacted as a response to the pandemic. The Chairman acknowledged that inflation remains well above target and, while the economy is still recovering, he would not expect tightening policy to be harmful to the economy and job market as both are quite strong.

Chairman Powell indicated that the Fed would remain nimble and guided by data. The data this week should be seen as supportive of the Fed's position. However, the market may be a little less certain about the implications of longer-term higher rates. The primary concern is that economic growth may slow. Consistent with this concern is a flattening of the yield curve.



The delta between the 10-year treasury and the 2-year treasury has notably declined over the past month as the 2-year rate has moved up much faster than the 10-year rate. The delta is still positive and from a historical perspective not yet indicative of a pending recession which typically is proceeded by a negative delta or inverted curve.

Thinking Ahead

Recent data still supports economic growth and strong employment. The market, though, is likely responding to good news as supportive of tighter monetary policy causing concern about the trajectory of economic growth. The balance between policy and economic fundamentals will continue to be important to navigate the elevated volatility in the market with a focus on longer-term positioning.

Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.