Rodney's Take

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The Known Unknowns Hurting Stocks

Inflation is running hot, wages aren't keeping up, tech earnings are slowing down, and rates are walking higher. Those are the things we know, and because the equity markets are forward-looking, it makes sense that these things largely are priced into stocks. And yet we're still waking up to sharp volatility and ugly down days. Welcome to the world of the known unknowns.

The Fed raised rates last week and created a glide path for reducing its balance sheet. The bump from a range of 0.25%–0.50% to 0.75%–1.00% was telegraphed well in advance, and everyone knows how to evaluate higher overnight rates. Prime rate and other lending rates will move higher, short-term financing will be more expensive, and a subset of consumers who buy on credit won't be able to purchase as much as they could before. As for the shrinking balance sheet, that's a bit trickier.

I've noted before that we have exactly one data point to use when forecasting how this will play out, the Fed's balance sheet reduction in 2018–2019, and even that was a bit different. Leading up to that period, then-Chair Yellen said that shrinking the balance sheet should be like watching paint dry, implying that it should be a slow, modest program that didn't affect the markets. Whether the operation led to the market volatility in late 2018 is up for debate, but the Fed soon reversed course after letting just $750 billion roll off over the course of more than a year. This time, the Fed will be aggressive, as it plans to reduce the balance sheet by $47.5 billion in June and July and then by $95 billion per month after that, which adds up to more than $1 trillion per year. No one knows exactly how stocks will react as the Fed quickly drains liquidity from the bond market.

As Western nations ban Russian exports and cut off Russian banks from the financial world, we're making the decision to suffer through commodity shortages at home to inflict pain inside Russia and to cut off some of that country's funding. The shortages will show up as inflation, which doesn't fall equally across populations. Notice that I wrote "will show up," because the shortages haven't happened yet, especially in the soft commodities, such as wheat. Countries from Brazil to Egypt are making emergency plans for wheat, fertilizer, and palm oil. The shortages will go well beyond natural gas and oil and likely won't end soon.

Russia has used thousands of precision-guided munitions and has lost dozens of aircraft, none of which can be replaced without Western technology. As the Russian military runs out of such hardware, Putin likely will use less-sophisticated weaponry, which will lead to more civilian deaths and greater Western resolve to ostracize the nation.

And then there's China. Because China stockpiles commodities, controls prices, and currently has severe lockdowns in place, we can't know in advance what effects inflation and rebounding domestic demand will have on the Chinese economy and its exports. The lack of visibility or a working model of how this will play out leaves investors looking for any sign as to what lies ahead.

Any one of these variables—Fed balance sheet run off, Russian invasion, severe Chinese COVID lockdowns—would give equity investors fits. The fact that they're happening at the same time is turning a potentially volatile investing environment into something that could be much worse: a market rout.

It might not happen. International bond investors might snap up U.S. debt quickly enough to stop rates from zooming higher, we might arrive at a diplomatic solution with Russia and avoid the worst of the global shortages ahead, and China might ease its COVID restrictions at such a pace as to not cause widespread economic harm. That's the problem with known unknowns. We can't be sure what will happen. For now, we'll stick with our short list of mostly income-producing investments and wait for the economic clouds to part a bit before making our next move. In today's environment, cash definitely is a friend.

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Got a question or comment? You can contact us at info@hsdent.com.