ECONOMIC & INVESTMENT PERSPECTIVES

NOVEMBER: OMICRON SPOOKS STOCKS

Figure 1: 11/30/2021 Returns (source: Bloomberg)
Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	YTD	1YR	Current vs. 52-wk High	Current vs. 52-wk Low
US Aggregate Fixed Income	AGG	0.3%	-1.4%	-1.3%	-3.1%	1.4%
Investment Grade Corp Bonds	LQD	-0.1%	-1.8%	-1.7%	-3.9%	4.0%
U.S. Treasury Bonds	GOVT	0.6%	-1.5%	-2.2%	-3.2%	2.2%
20+ Year Treasury Bonds	TLT	2.8%	-2.6%	-3.8%	-5.6%	13.8%
Muni Bonds	MUB	0.7%	1.0%	1.7%	-1.2%	1.3%
High Yield	HYG	-1.2%	1.4%	3.4%	-2.9%	0.4%
Non-US Corp Bonds	IBND	-1.8%	-8.8%	-6.3%	-10.4%	1.3%
Emerging Markets Bond LC	EMLC	-2.8%	-10.8%	-7.6%	-15.0%	1.0%
Global Equity						
ACWI Global Equity	ACWI	-2.3%	14.2%	19.6%	-4.3%	18.1%
United States	VTI	-1.5%	21.1%	26.7%	-4.2%	25.8%
International Developed	EFA	-4.5%	6.8%	12.1%	-6.6%	9.6%
Emerging Markets	EEM	-4.1%	-5.1%	1.7%	-16.2%	1.0%
Global Equity by Region						
United States	VTI	-1.5%	21.1%	26.7%	-4.2%	25.8%
Europe	IEUR	-4.7%	11.1%	16.6%	-6.6%	13.8%
Asia ex-Japan	AAXJ	-3.5%	-6.8%	-0.9%	-18.7%	1.0%
China	MCHI	-5.8%	-19.3%	-17.5%	-33.2%	1.0%
Japan	BBJP	-3.2%	-1.1%	4.2%	-10.6%	3.1%
Latin America	ILF	-5.1%	-18.0%	-7.6%	-26.8%	1.2%
US Equity						
US S&P 500	IVV	-0.7%	23.1%	27.8%	-3.8%	26.9%
NASDAQ 100 QQQ	QQQ	2.0%	26.0%	32.1%	-3.6%	33.6%
US Large Growth	IWF	0.6%	24.9%	30.4%	-3.9%	32.2%
US Large Value	IWD	-3.6%	17.5%	21.9%	-5.4%	20.1%
US Eqwt S&P 500	RSP	-2.6%	21.8%	26.8%	-5.7%	25.5%
US Mid Cap	IJH	-3.0%	18.6%	26.3%	-7.5%	25.0%
US Small Cap	VTWO	-4.2%	12.3%	22.0%	-10.6%	21.3%

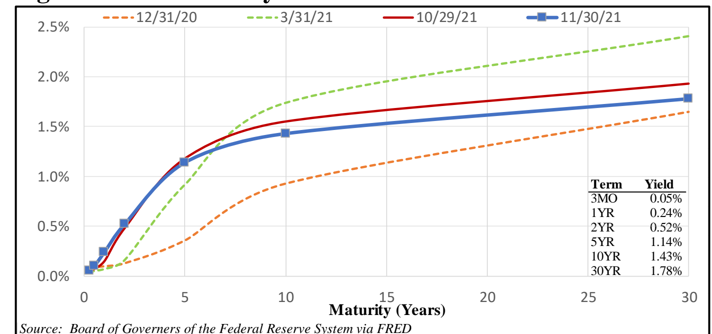
After notching new highs earlier in the month, stocks sold off aggressively to post negative returns for the month. Concerns over a new virus variant (Omicron) sparked the selloff, which was exacerbated by Fed Chair Powell's comments on inflation and the potential for tightening monetary policy. Performance highlights for November and year-to-date (YTD) are summarized below.

- Bonds: The US Aggregate index (AGG) ended the month up 0.3% (-1.4% YTD) as interest rates fell. Long-term Treasuries (TLT) rose 2.8% (-2.6% YTD), but corporate bonds (LQD) lost 0.1% (-1.8% YTD). Non-US bonds (IBND and EMLC) lagged materially, under-performing as the dollar strengthened.
- Global equity (ACWI): -2.3% in November (+14.2% YTD).
- US Equity: The broad market (VTI) fell 1.5% this month (+21.1% YTD). The S&P 500 lost 0.7% (+23.1% YTD), out-performing small caps (VTWO), which fell 4.2% (+12.3% YTD). Only two sectors posted gains this month (Technology and Consumer Discretionary) as investors fled to the perceived safety of large, growth-oriented stocks as interest rates declined (increasing the value of future earnings). Growth stocks (IWF) rose for the month and leads value (IWD) over longer periods.
- Non-US Equity: Developed markets (EFA) lost 4.5% (+6.8% YTD), led lower by European stocks (IEUR -4.7%). Emerging markets (EEM) lost 4.1% (-5.1% YTD) with weakness across the board; Russian stocks (RSX) fell 11.6% as the price of oil (Russia's main export) tumbled from $84 to $66 per barrel.

Interest Rates and the Economy

Figure 2 graphs the US yield curve, which plots yields (Y-axis) for various maturities (X-axis) of US Treasuries. Short-term yields remain near zero but rose marginally with the increasing likelihood of Fed rate hikes sooner rather than later to combat inflation. Long-term yields declined, reflecting fears of slowing economic growth amid renewed virus concerns and the potential impact of tighter Fed policy. The 10-year bond yield rose as high as 1.67% mid-month but ended November at 1.43%.

Figure 2: US Treasury Yield Curve

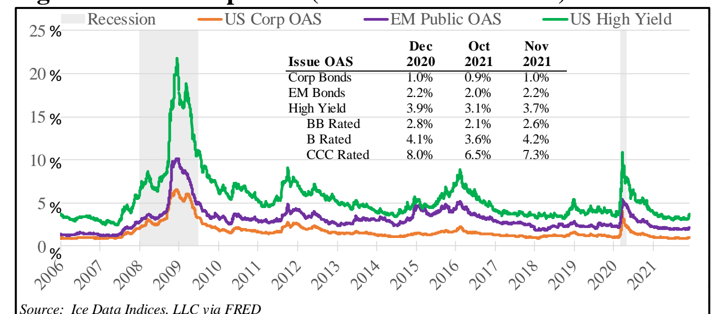


Source: Board of Governers of the Federal Reserve System via FRED

For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between yields and Treasuries of comparable maturities. Low or narrowing spreads signal optimism while high or rising spreads signal fear. Spreads widened in November reflecting the risk-averse market tone but remain near historic lows.

- Investment grade corporate bond spreads rose to 1.0% this month, comparable to 2020 year-end levels.
- High yield (non-investment grade) spreads widened to +3.7% but are still below year-end spreads of +3.9%. The riskiest bonds (rated CCC & below) now yield +7.3% over Treasuries, up versus last month but below 2020 year-end levels of +8.0%.
- Emerging market bond spreads widened to +2.2% and are comparable to year-end levels. Though credit spreads have been relatively stable, non-U.S. bonds have under-performed US bonds due to the strength of the U.S. dollar.

Figure 3: Credit Spreads (source: St. Louis Fed)



Source: Ice Data Indices, LLC via FRED

Fed Uncertainty: Inflation vs. Employment

Markets turned decidedly negative in the final days of November as news broke regarding the new Omicron variant of the COVID-19 virus. Very little is known about this strain (transmissibility, severity, vaccine efficacy), but investors were clearly spooked, just as they were when the Delta variant surfaced earlier in the year. Markets sold off aggressively then recovered somewhat before diving again on the last day of the month in response to Fed Chair Powell's comments as he testified before the Senate Banking Committee. As if the Fed's job was not difficult enough, given the mixed signals coming from the employment and inflation components of their dual mandate (to promote full employment and maintain price stability), the new virus variant poses new risk and uncertainty as they wind down their monthly bond purchases ("tapering") and consider raising interest rates to combat inflation. Figure 4 below illustrates various ETF and market returns for two distinct periods in November: pre-Omicron (Nov. 1-24) and post-Omicron (Nov. 25-30, just three trading days).

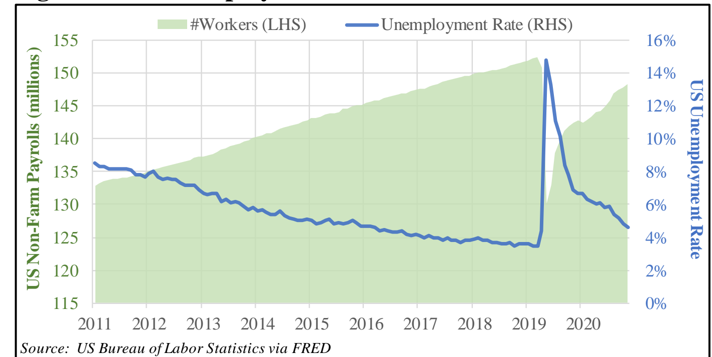
Figure 4: November ETF Returns (source Bloomberg)

Bonds	ETF	Nov. 1-24	Nov. 25-30	Nov. 1-30
US Aggregate Fixed Income	AGG	-0.7%	0.9%	0.3%
Non-US Corp Bonds	IBND	-3.0%	1.2%	-1.8%
Emerging Markets Bond LC	EMLC	-3.0%	0.2%	-2.8%
Global Equity				
ACWI Global Equity	ACWI	0.6%	-2.9%	-2.3%
United States	VTI	1.8%	-3.2%	-1.5%
Europe	IEUR	-2.3%	-2.5%	-4.7%
Asia ex-Japan	AAXJ	-0.4%	-3.1%	-3.5%
Japan	BBJP	0.2%	-3.5%	-3.2%
Latin America	ILF	-2.2%	-3.1%	-5.1%
US Equity				
US S&P 500	IVV	2.2%	-2.9%	-0.7%
NASDAQ 100 QQQ	QQQ	3.3%	-1.2%	2.0%
US Mid Cap	IJH	2.8%	-5.7%	-3.0%
US Small Cap	VTWO	1.6%	-5.6%	-4.2%
Commodities & Currency				
Bloomberg Commodity Index	DJP	-0.4%	-8.3%	-8.7%
Gold ETF	GLD	0.3%	-1.0%	-0.7%
Crude Oil ETN	OIL	-1.5%	-14.8%	-16.1%
US Dollar	na	1.9%	0.1%	2.0%

Before Thanksgiving, bonds were down as interest rates moved higher and the dollar strengthened. Non-US stocks were struggling, especially in Europe amid rising virus concerns (pre-Omicron); U.S. stocks, however, were setting new all-time highs amid generally good economic news and stabilizing energy prices. After Thanksgiving, global markets moved swiftly in a more synchronized manner with bonds up (as interest rates fell) and stocks down across the board. Riskier equity segments (small and mid-cap stocks) fell nearly 6%, while ultra-large tech-oriented stocks (which dominate QQQ) fared better. After trading over $84 per barrel, oil prices had begun to decline early in the month but then dropped nearly 15% to $66 per barrel with new worries about economic growth and supply chain disruptions.

In Fed Chair Powell's testimony on Capitol Hill, he suggested that the FOMC will consider accelerating the wind-down of monthly bond purchases, possibly completing the process by March instead of mid-2022 as previously announced. Given his comments about lingering inflation, investors interpreted this as paving the way for interest rate hikes sooner than originally thought. To date, the Fed has seemed more concerned about employment, viewing elevated inflation as "transitory" as strong, stimulus-driven demand temporarily out-paces supply while the global economy restarts. His testimony implies a pivot toward inflation uncertainty even as the labor market has not yet fully recovered. Figure 5 illustrates the employment component of the Fed's dual mandate. Unemployment has improved dramatically, declining to 4.6% after spiking in the early phase of the pandemic, but the labor force (number of people who are employed or seeking jobs) has not yet recovered to pre-pandemic levels. The U.S. has added 5.8 million jobs in 2021 alone, but the labor force is still 4.2 million less than in February, 2020, likely due to lingering health and logistical concerns (like child care).

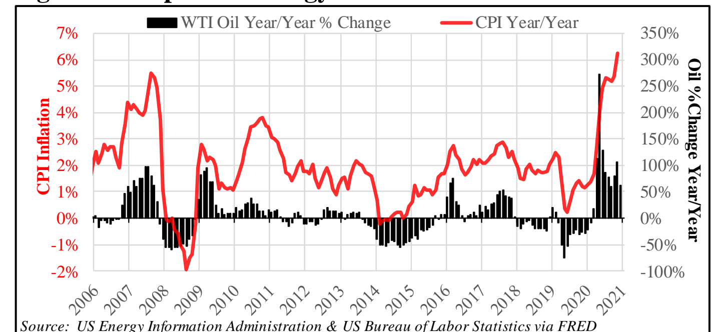
Figure 5: U.S. Employment Data



Source: US Bureau of Labor Statistics via FRED

The new variant could increase inflationary pressures by causing further supply chain disruptions and by forcing employers to increase wages to entice workers back into the job market. Exactly what the Fed can do about that is unclear, but the energy markets may be doing some of their work for them. Figure 6 illustrates the significant impact that rising (falling) energy prices have on the pace of inflation (deflation). The price of oil rose from less than $20 in early 2020 to more than $84, driving higher inflation. If oil prices remain at current levels or decline further, inflation will most likely decline as well, similar to 2008-9, 2015 and 2020.

Figure 6: Impact of Energy Prices on U.S. Inflation



Source: US Energy Information Administration & US Bureau of Labor Statistics via FRED

Bottom Line

The post-Thanksgiving market swoon is a reminder of how interconnected global economies and markets are, especially in the pandemic era. Markets are digesting the more rapid removal of monetary stimulus (Fed asset purchases and low interest rates) amid heightened virus uncertainty. The coming days and weeks will be critical as researchers learn more about Omicron and its potential impact on the economy (or lack thereof). What we do know is that vaccination rates must increase in the U.S. and around the world if we hope to avoid the same negative economic and market cycle every time a new variant emerges. Markets are likely to remain volatile as economic activity, inflation and interest rates seek self-sustaining equilibrium, underscoring the value of a diversified portfolio that over-weights liquid inflation hedges (equity, emerging markets, commodities).

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