Weekly Markets Commentary

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Stocks Look to Regroup Following A Shaky Start to the New Year

The ongoing bond market adjustment to the threat of tighter monetary policy accelerated last week, as yields jumped at the start of trading in the new year. The expectation of higher rates was reinforced during the week, first by the minutes of the Fed's December meeting, followed by the solid December jobs report. The yield on the U.S. ten-year note surged 25 basis points higher on the week to 1.76 percent, its highest in two years, dating back to just prior to the onset of the pandemic. The bond market adjustment began in September when the Fed first hinted at tapering. Back then the ten-year note was yielding 1.30 percent. The more Fed sensitive two-year note has climbed from 0.20 to 0.86 percent since September, after rising 14 basis points last week. For the week, the Bloomberg Barclays U.S. Aggregate Bond index fell 1.5 percent.

The rise in bond yields is also unnerving the longer-duration parts of the equity market, primarily technology stocks, where elevated valuations are justified by the expectation of future earnings. The Nasdaq Composite tumbled 4.5 percent last week. In contrast, the Dow Jones Industrial average was down only 0.3 percent. At the other end of the spectrum from technology were the financial stocks, where prices soared higher by 5.4 percent, as the rise in yields makes lending and other services more profitable.

The Fed Takes a More Hawkish Stance; First Rate Hike Could Come As Early As March

The Fed minutes reinforced the hawkish shift at the Federal Open Market Committee (FOMC) meeting. The meeting discussion raised the possibility of a faster rate hike cycle this time, as well as the possibility of an earlier start to reducing the balance sheet. And the Fed did accelerate the pace of tapering so that it now concludes in March, clearing the way for a possible first rate hike at the March meeting. The Fed has believed for some time, dating back to last fall, that its inflation mandate has been achieved, but that it wanted to see more progress toward full employment. And while the growth in non-farm payrolls over the last two months has been disappointing, the unemployment rate has now fallen to 3.9 percent, the lowest since the 3.5 percent rate in February, 2020, just before it soared to 14.7 in April.

The CME FedWatch tool now ascribes a 70 percent chance to a rate hike in March. Last week, those odds were 50/50, and one month ago were one in three. And the odds are only slightly higher that we will see three rate hikes this year and not four.

Omicron Provides Surprises, But May Not Be As Economically Disruptive As Feared

The prevailing sentiment seems to be that the Omicron variant will not be as economically disruptive as feared. In South Africa, the surge in the seven-day rolling average of Omicron infections intensified over a roughly 30-day period, peaking in mid-December, followed by a precipitous decline over the past three weeks. In the UK, where the outbreak lagged by several weeks, a similar pattern may be close to unfolding. A December surge of similar length to South Africa's may be in the process of peaking. For the pattern to hold, new cases must now begin to decline sharply. If they do, it would suggest that a similar pattern might be in store for the U.S., leading to a pre-Omicron infection rate by late February or so. Of course, this virus has provided plenty of surprises.

Fourth Quarter Earnings Start This Week; Bond Investors Will Closely Watch This Week's CPI Report

Somewhat lost in the shuffle of interest rates and Covid infections is the start this week of fourth quarter earnings season. According to Factset, earnings are expected to grow by 21.7 percent, up slightly from the start of the quarter. If that turns out to be the actual growth rate, then earnings for all of 2021 will have grown by 45 percent. Earnings growth is expected to slow to 9.4 percent next year. JP Morgan Chase, Citigroup and Wells Fargo start things off on Friday.

Beyond earnings, this week's economic calendar is quite full. Bond investors will be watching the December CPI report on Wednesday with trepidation. The year-over-year headline rate is expected to climb to 7.0 percent, its highest since 1982. The core rate is expected to climb 5.4 percent, its highest since 1990. December retail sales are expected to be held back by both Omicron fears and supply chain problems, especially for automobile manufacturers. Industrial production is expected to rise modestly, while consumer sentiment is believed to have edged lower.

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There are risks associated with **fixed-income** investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, **bond** prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

A **10-year Treasury note** is a debt obligation issued by the United States government that matures in 10 years.

The CME Group's Fedwatch Tool calculates the unconditional probability that the Fed would hike, cut, or keep the federal funds rate steady during a given FOMC meeting. These calculations are based on the CME Group's 30-Day Federal Funds Futures.

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