PACIFIC LIFE
MARKET insights
RETIREMENT SOLUTIONS DIVISION
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A WILD MARKET RIDE

Market volatility has been a constant this year. Should we be worried?

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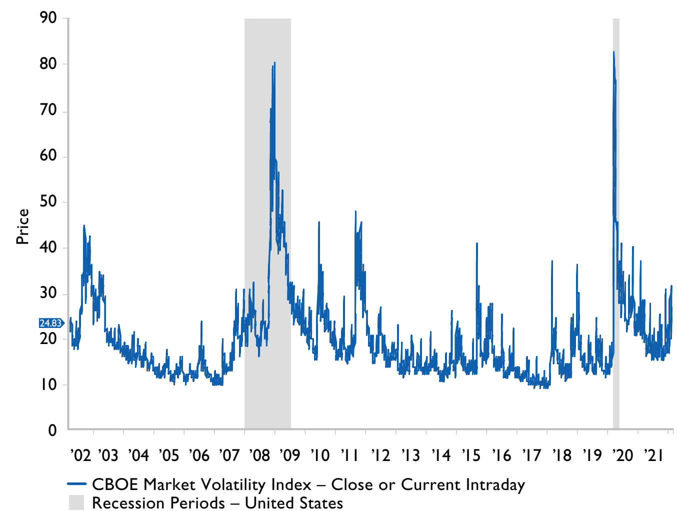
Key Takeaways

- From a historical perspective, the current market volatility isn't unusual.
- The "Fear Index" suggests a bear market isn't imminent.
- Worry over interest-rate hikes is a root cause of the market jitters.
- The backdrop for economic growth remains relatively robust, despite various headwinds.
- The big question: How will the Federal Reserve (Fed) show its promised nimbleness in keeping the economy strong?

A long list of concerns has contributed to the rough market environment this year, including expectations for interest-rate hikes, rising inflation, labor shortages, waning fiscal stimulus, continuing COVID-19 threats, geopolitical tensions, and elevated stock-price multiples. Stock prices have been slumping for the first time in recent memory, and market swings in January were wild. In just one day last month, the Dow Jones Industrial Average fell and gained more than 1,000 points.

Although a 1,000-plus daily swing sounds overwhelming, the Chicago Board Options Exchange (CBOE) market volatility index (VIX or, informally, the "Fear Index") has been much higher in the past. The VIX has yet to suggest we're even close to a bear market.

Figure 1: The "Fear Index" Doesn't Suggest an Imminent Bear Market



Source: FactSet

Bear markets (a drop of 20% or more in the stock market) typically come amid an outright recession and concurrent slump in corporate profits—conditions that haven't arisen yet. On the other hand, stock-market corrections (a drop of at least 10%) are normal and tend to happen every couple years or so, and impulsive reactions to headlines don't justify panic selling out of stocks. The market fluctuations we're experiencing this year are rather typical. What was much more unusual was the calm and steady market ascent in 2021, fueled largely by an overwhelming amount of stimulus that pumped cheap money into the economy.

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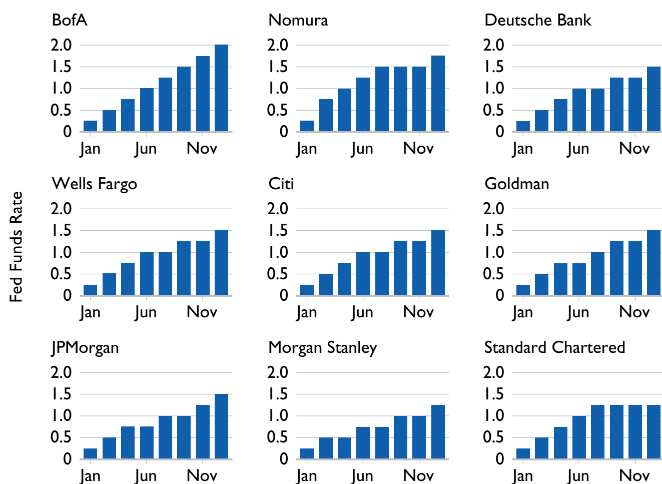
Stock-market performance may have been brutal in January, but it shouldn't sound an alarm given that the S&P 500® index has closed down at least 1% for the day nearly 450 times since the Great Recession of 2008.

Causes for Market Volatility

Expectations of more aggressive interest-rate hikes by the Federal Reserve have caused much of the market turbulence. Fed Board Chair Jerome Powell has recently changed his tone from expectations of "gradual" and "measured" rate hikes to the need to make "nimble" moves, which fueled concerns that easy money from the central bank was no longer guaranteed.

Since the Fed's January meeting, economists have started to revise their 2022 forecasts for interest-rate hikes. Some, such as Bank of America, believe the Fed will raise rates seven times this year, suggesting the central bank may have been well behind the curve in tightening monetary policy to address the acceleration in inflation. Nevertheless, Wall Street seems split on how many hikes will come this year.

Figure 2: Economists Are Split on the Number and Size of Rate Hikes in 2022



Source: Bloomberg

As the Fed pivots toward tightening monetary policy, markets may continue to experience further volatility. While many agree that a rate hike in March is a near certainty, questions regarding timing and magnitude of hikes thereafter remain uncertain—and if there's one thing the markets do not like, it's uncertainty.

The Fed has provided little forward guidance on the likely path of the federal funds rate, partly because of the lack of clarity about the economic outlook and inflation. It is not in the interest of the Fed to surprise the market, as the markets are currently pricing about 125 basis points of rate hikes this year. It also is likely that the Fed will telegraph future rate hikes as it has done for its expected hike in March, as well as for the balance-sheet runoff, which is expected to start only after the Fed initiates its rate hikes. This suggests that the balance-sheet normalization will happen after the March meeting.

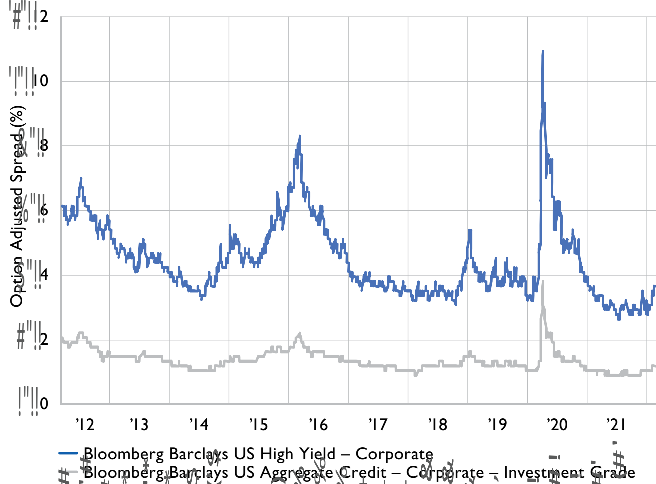
Russia-Ukraine War

While the war in Ukraine is not expected to have a significant and direct impact on the U.S. economy, geopolitical events like this can cause market volatility to rise. In this particular case, commodity prices are expected to rise given that Russia is a major exporter of oil and gas, while Ukraine is an exporter of wheat. This conflict exacerbates the global inflation problem many countries are struggling to address. The Fed and other central banks will have to gauge how this conflict will impact inflation and growth, which will ultimately determine how hawkish they can be.

Fundamentals Matter

Regardless of how the market responds to rate hikes, it does not change the fact that the fundamental backdrop for economic growth remains relatively robust. Even if the most aggressive interest-rate forecast comes to fruition, the federal funds rate would be only at around 2% by the end of the year. Even with these hikes, we still would be in a relatively low-rate environment. Additionally, bond markets have yet to indicate an imminent problem, which is implied by the comparatively low credit spreads despite the recent stock-market volatility.

Figure 3: Despite Stock-Market Volatility, Credit Spreads Remain Low



Source: FactSet

Congestion and Inflation

Besides interest-rate hikes, what also may help bring down the rate of inflation? Fixing pandemic-impacted supply chains. It's possible that this congestion will be largely alleviated as consumers pivot from goods purchases to services such as traveling. After going on a spending spree on goods earlier in the pandemic, consumers appear to be taking a break as supply-chain disruptions have led to rising prices and stimulus funds have dwindled.

Figure 4: Consumer Spending on Goods Has Dropped Dramatically

Source: FactSet

Pent-up demand for services should recover as the economy fully reopens after the omicron variant outbreak. As consumer spending moves away from goods to services, some of the inflationary pressure on goods may diminish.

We are already seeing significant relief in the supply-chain congestion. According to Barrons, the number of containers sitting idly at the Port of Los Angeles has dropped 40% since early November. In fact, container shipping costs have fallen dramatically from their recent highs, which could suggest that inflation on goods may follow. Perhaps inflation will become transitory after all.

Figure 5: Shipping Costs Have Plunged but Not Inflation

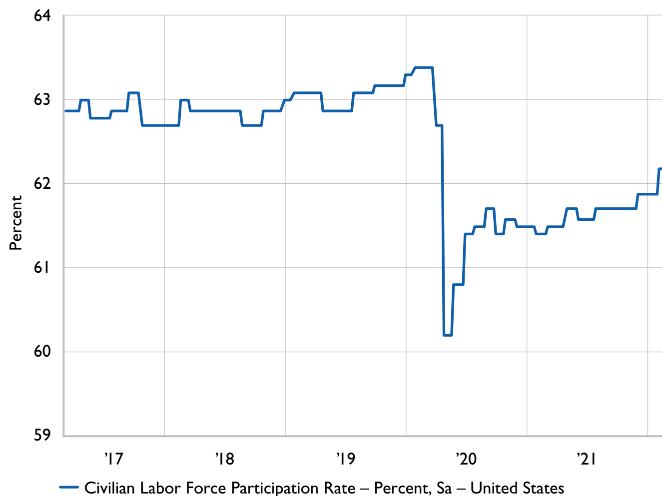
Source: FactSet

Ready for Aggressive Rate Hikes?

Although unemployment levels remain tight, the economy still has yet to normalize from the pandemic. Despite recent improvement, supply chains continue to be disrupted mainly due to the major shortage of workers. Businesses still struggle to get people back to work despite the reopening and unemployment benefits coming to an end.

It should be noted that unemployment appears tight because some people still choose not to return to the labor force. Labor participation has yet to recover from the effects of the pandemic, which could be due to various reasons.

Figure 6: Labor Participation Still Hasn't Recovere**d**



Source: FactSet

The path of the pandemic remains a primary risk to the economic outlook. The pandemic continues to slow the recovery of the supply-chain network due to lockdowns in China and Southeast Asia, which have kept prices elevated.

The bottom line: With all this complexity weighing on a jittery market, let's see if the Fed will be nimble enough to recognize whether aggressive hikes are needed.

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