BLOG POST
A Dark Winter?
12/02/2021

Omicron has arrived and is quickly spreading, sending global markets into panic and free fall. Are we approaching a dark winter for the economy and market? This was predicted last year, but both the markets and economy remained resilient in the face of the latest strain of the coronavirus that year. Mutating viruses are not uncommon, but the early response to Omicron feels very different. Countries are closing their borders over fears that the virus will rage as it did in March 2020. Stocks were lower by 2% or 3% globally when the new strain was identified in South Africa. Oil and other commodities were crushed under the weight of expectations of a return to global lockdowns just as travel was normalizing and returning to 2019 levels.

While Sunday morning talking heads discuss the ‘perpetual pandemic,’ the real risk is whether or not the global economy will be derailed by government health policies. It seems almost a certainty that the complex supply chain issues wracking key industries will be further weakened by new restrictions. A dark winter, however, might present a great buying opportunity for equities just as April 2020 did for investors. The concern that the Fed, and other Central Banks, were going to start the process of removing excess liquidity through bond buying, and gasp, consider rate hikes, will likely be taken off the table. Generally speaking, certain varieties of the “Fed to the rescue” trade worked well in early 2020 and may again in 2022.

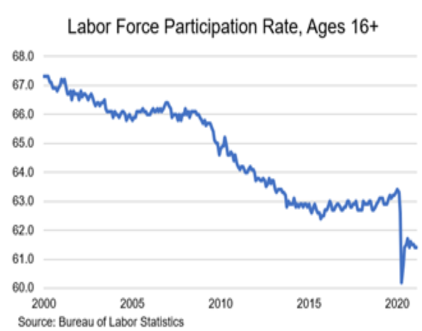
The economy today is far more vulnerable than most of the sell side analysts suggest. We face multiple risks that could result in a recession: a dramatically slowing China as their real estate and debt bubbles begin to burst, inflation at multi-decade highs forcing the Fed’s hand to tighten monetary policy, and political dysfunction that could result debt defaults and policy uncertainty if we go back into lockdowns.

The China risk is a global risk, as a slowdown will create lowered demand for Europe and higher interest rates in the West. The credit markets appeared to have weathered the Evergrande fallout, but the magnitude of the problem is much greater than Japan faced decades ago and still has not recovered from.

The Fed will certainly respond to the Omicron threat and the Treasury futures indicate that. The first rate hike in the U.S. was forecast for June 2022, but was instantly pushed back to September when news of Omicron hit. The Bank of England was poised to hike in December and that has been pushed to February, according to futures, and the ECB currently shows no chance of a rate hike for all of 2022. The policy response from Central Bankers is likely the least of our worries -- they will almost always favor policy accommodation regardless of the risk of long term inflation.

The political risk in the U.S. is very different than in early 2020 when Trump was still in office and the GOP controlled the Senate. Some almost have the feeling that Biden is a lame duck President just one year into his Administration. The Democrats are divided between Progressives and Moderates, making it quite easy for Republicans to score political points. Current polls suggest an overwhelming win for the GOP in the midterm elections and a likelihood that the GOP will control the House and Senate in the last two years of the Administration. It is likely that the political left is going to have to compromise on many issues just to get the debt ceiling passed and avoid a debt default on their watch, even though they currently control the White House, Senate, and House.

At the end of the day, virtually all recessions are the result of a reduction of spending by consumers. Supply chain issues lead to deferred spending, but when a fall in demand occurs we experience a recession. A look at the current Labor Participation Rate from the Bureau of Labor Statistics reveals a significant problem for which there may no longer be a political solution. The government responded to the lockdowns of 2020 with unprecedented stimulus to pay people when the companies they worked for were forced to close. That appears very unlikely to repeat given the challenges that created for small businesses facing massive labor shortages. As the chart suggests, the labor participation rate had been falling for decades but looked to be recovering around 2016 before falling off a COVID cliff in 2020. After a rebound, we have begun to move lower -- a bad sign for businesses in desperate need of workers.



Some expect the markets to be fully reliant on the Fed to come to the rescue to avoid the next Bear Market in equities in 2022.