For most of the past dozen years, American stock markets have marched steadily higher, no matter what obstacles may have stood in their way. There have been minor stumbles here and there, to be sure, and Covid caused history’s shortest bear market last year; but smooth out the squiggles (Chart 1 uses monthly data, for example) and the market’s relentless climb has been inexorable. Even the bear market now looks like nothing more than a minor interruption.

The occasional stumbles came from various political or economic challenges that have cropped up over the years: the debt ceiling debacle of 2011, the taper tantrum of 2013, an oil price crash in 2015, and so on. In every instance – including the Covid pandemic – investors suffered from momentary jitters before regaining their confidence; economic growth and corporate earnings have ultimately justified the mojo.

In that context, the past couple of weeks have given investors a half-dozen serious concerns, any one of which conceivably could have been sufficient to trigger a shudder:

- Covid hasn’t gone away. If anything, the Delta variant is scarier and more pernicious than anything we have seen since the pandemic began. It has infected far more people than earlier strains, and even vaccinated people are at risk of catching or transmitting it. Mask mandates have been imposed (again), and even voluntary changes in behavior can collectively dampen economic activity.
• Federal fiscal support for people and organizations sidelined by Covid has effectively ended. Enhanced unemployment benefits expired earlier this month, and most other CARES and ARP programs have likewise disappeared. No matter how it’s sugarcoated, removing more than $3 trillion of stimulus is a contractionary policy choice.

• Congress may fail to enact any infrastructure legislation. The Democrats are blaming Republican obstructionism, but it’s Democratic infighting that is more likely to derail both the bipartisan “hard” infrastructure bill and the Democratic “soft” bill as well.

• Congress may also fail to raise the debt ceiling. If it does, the economic consequences may not be as “catastrophic” as Treasury Secretary Janet Yellen warned in a recent Wall Street Journal op-ed, but it surely won’t be pretty. One can argue whether the U.S. even needs a debt ceiling, since the Treasury markets can effectively discipline the federal government’s borrowing behavior. Still, the ceiling exists and Republicans are playing with fire by threatening to kill legislation that would raise it.

• The Federal Reserve has its own opportunities to spook the markets. Even after this week’s Fed meeting and press conference, investors are still nervous that the central bank may raise interest rates or reduce its purchases of Treasury bonds and mortgages too soon or too quickly. Higher interest rates translate to lower P/E multiples and therefore lower stock prices.

• In the real economy, the private sector has its own problems. Companies across many industries have been complaining that production inputs – workers, commodities, and intermediate goods like semiconductors – are harder to find and increasingly expensive. Investors don’t yet know just how severely this supply chain constriction will affect third-quarter earnings when companies begin to report their profits next month.

• Half a world away, China’s economy has been slowing, leading investors to worry about its growing debt burden. In particular, Evergrande – China’s second largest real estate company – was reportedly on the verge of defaulting on two large loan payments this month. Investors on Monday seized on the notion that a possible Evergrande default would be China’s “Lehman moment” that would send Asia’s stock markets into a tailspin with the U.S. possibly caught in its wake.

These stories have all been evolving over the past few months, even as stock markets continued to climb the wall of worry. The immediacy of Evergrande’s possible default triggered the recent slide in equity prices, but the chart-reading wizards on Wall Street have been warning for months that leadership is getting narrow, that volatility was beginning to increase, and that support levels were looking shaky. Earlier this week, it looked as if this might be the moment that a second bear market in two years might begin.

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1 Republicans have also threatened to block a continuing resolution to fund the federal government beyond September 30th. This is political theater that won’t have any long-term impact on the economy; after all, similar tactics shut down the federal government on three occasions during the Trump presidency, to no long-term ill effect.
It was a false alarm. President Biden summoned key members of Congress to rebuke them for their internecine squabbling about the two infrastructure bills; whether he will be successful in corralling his own party will ultimately be an important test of his presidency, but for now the markets have gotten the message that the President is deeply and personally involved in bringing the twin infrastructure bills to fruition. And across the Pacific, the People’s Bank of China has apparently discreetly arranged for Evergrande’s debt payment to be “resolved.”

Back in Washington, the Federal Reserve wrapped up its two-day meeting yesterday in a way that extended Chair Jerome Powell’s remarkable tightrope-walking record. In the central bank’s official statement and at the press conference that followed it, Mr. Powell clearly signaled that the Fed will begin tapering its bond purchases and raising interest rates sooner than previously expected. Chart 2 shows the new “dot plot,” indicating each Fed governor’s current expectation for overnight interest rates over the next few years (including a first look at 2024). The clear message is that rates will steadily rise back toward normalized levels.

Further, a comparison with the dot plot from the Fed’s June meeting is also instructive. Three months ago, only five governors expected the fed funds rate to top 1% by year-end 2023; today that has almost doubled to nine. The average of the 2023 dot plots jumped about 20 basis points since the last meeting, from 0.7% to 0.9%. In other words, the Fed now expects three or four quarter-point hikes by the end of 2023, one more hike than the group had thought just three months ago.
Typically, when the Fed promises to take away the punch bowl, investors turn sour and the party dissipates; but this week, not only weren’t the markets spooked by this threat of tighter money, they liked it. Investors bid up the prices of stocks, while bond prices held fairly steady immediately after the announcement and press conference. Sweet dreams are made of this. Who am I to disagree? Fed futures contracts – the best way to infer market expectations, by comparing yields on Treasury debt of varying maturities – suggest that the markets were already anticipating the Fed to tighten more quickly: traders breathed a sigh of relief that the Fed acted prudently, neither too lax nor too tight.

There are still many reasons stock prices could turn south quickly. If bad news is to come, the most likely source is Congress. Four big items top the legislative agenda in the next few weeks: passing a continuing resolution to fund the government past September 30; raising the debt ceiling so the Treasury can avoid defaulting on its obligations; enacting a $1 trillion bipartisan infrastructure bill; and using the reconciliation process to deliver President Biden’s Building Back Better (soft infrastructure) bill.

Of these, the debt ceiling looms most menacingly. The probability of Republicans blocking this legislation is quite low, but it’s not zero. The consequences of failure would be severe to the value of the dollar, to the role of the dollar in global markets, and to America’s political standing among the world’s industrial nations. The bond markets have mostly ignored this potential black swan, and they are probably right to do so; it seems inconceivable that not even a single Republican would support legislation to keep the Treasury afloat.

Outside the Beltway, the economy is still feeling its way out of the pandemic. GDP growth has slowed markedly in the September quarter, to about 3% from the 6.6% reported for the June quarter. Companies only reopen once, whether it’s Disneyland welcoming tourists, restaurants inviting diners back indoors, or professional services firms asking employees to return to the office. Each of these reopenings represented a discontinuous jump in economic activity that can’t be repeated. As fewer businesses have yet to reopen, this discontinuous boost necessarily is fading, and the emergence of the Delta variant slowed the process further. Seen in that light, 3% annualized growth from June to September is an impressive demonstration of the economy’s fundamental strength.

The same holds true for corporate profits. Earnings growth is slowing, but most market watchers still anticipate 20% gains in the September and December quarters, despite being compared against much stronger year-ago periods. Balance sheets are the healthiest they have been in many years, as many companies jumped on low interest rates to refinance debt and extend maturities.

Consumers are in great shape, too. According to work done by Empirical Research Partners, household savings expanded by about $2 trillion during the pandemic. That’s because spending on services (travel, dining, recreation, etc.) plunged while government support (unemployment insurance, stimulus checks, PPP loans, etc.) skyrocketed. The sharp increase in retail sales during the pandemic was made possible by this huge increase in consumers’ spending power.

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2 Or, better yet, eliminating it entirely and letting financial markets dictate Uncle Sam’s borrowing capacity.
Consumers still have plenty of dry powder to use for future spending, too. Of the $2 trillion net increase in savings, ERP estimates that about 40% to 45% belongs to consumers in the bottom 60% of incomes. This group of consumers collectively has a higher propensity to spend rather than save, suggesting that the economy has plenty of room for continued growth as consumers at all income levels gradually resume their old habits.

The burden remains on the bears. Despite all the widely known reasons that stocks could go down – Covid, China, Congress, inflation, labor shortages, supply chain problems, poor technical market indicators, and more – they haven’t. Investors, it seems, have a fundamental faith that the economy is resilient and that corporate profits can continue to expand. With the weight of history and current data both on their side, the bulls still seem to have the upper hand, and that’s how we continue to position our clients’ portfolios.