James Wealth Management

Volatility, Now What?

The market began in 2022 with much volatility, which is very concerning. When someone is afraid or worried about an event, the best way to counteract that fear is to learn about what is happening and take advantage of the opportunities the worry presents. First, let us define some of the buzzwords in the media.

We have been hearing about inflation for some time, but now the media is starting to mention stagflation.

This is a combination of two words, inflation, and stagnation. Inflation is rising prices measured by the Consumer Price Index. The Consumer Price Index is a basket of goods and services economists use to show price changes over a period of time. Stagnation means low economic growth. Gross Domestic Product (GDP) counts all the output generated within a country's borders. We commonly hear comments about how much GDP has grown or declined over a certain period.

A declining GDP is an indicator of low economic growth. A high unemployment rate is also a sign of low economic growth. If the economy does not grow, companies start laying off workers, causing the unemployment rate to go up. Stagflation is a double whammy of rising prices and low economic growth. This is a concern because we do not want high unemployment in conjunction with rising prices. The last time we had stagflation was in the 1970s. Let us compare the 1970s to today to help us understand how the times are the same or different.

	December 1974	June 2022
Consumer Price Index	12.3%	8.6%
Unemployment Rate	7.2%	3.6%
Gross Domestic Product	-1.9%	3.5%
Misery Index (CPI + Unemployment)	19.5	12.2

When we look at this data, we can see that inflation, judging by the Consumer Price Index (CPI), is lower than it was in the 1970s but the highest it has been since 1981. We should not downplay the pain of inflation we are experiencing! Undoubtedly, inflation is real and painful, but the causes are different.

In the 70s, a few contributing factors to inflation were our spending on the Vietnam War, President Johnson's war on poverty, President Nixon's choice to remove us from the gold standard, and OPEC's oil embargo in 1973. Today we are experiencing supply chain bottlenecks, pent-up demand as we come out of the pandemic, and labor shortages.

Speaking of labor shortages, let us compare the unemployment rate. The unemployment rate in the 70s was double what it is today. Today's low unemployment rate signals economic growth.

We can see this signal is correct because GDP also grew 3.5% in the last 12 months. In the 1970s, the economy was shrinking, not growing, and as a result, we had a high unemployment rate for that period. The question on everyone's mind right now is whether the economy will continue to grow. In June, the Fed raised interest rates by an unprecedented 0.75%.

That is the most significant single increase in interest rates since 1994. The Fed was initially expected to raise rates by 0.50%. However, the May CPI was very high and consumer expectations for inflation increased. This caused the Fed to act more aggressively than anticipated. In normal times, the Fed hikes by 0.25%. Economists are now predicting a hard landing, or a recession, for the economy because of the change in Fed policy. The Fed was hoping to avoid causing a recession, but they felt they had to act to stop inflation.

How do rising interest rates cause a recession? When interest rates are rising, it becomes more expensive for people and companies to borrow money. Individuals will not buy as many products because it will be costly to use a loan. They will also be more likely to live within their means. In fact, the consumer might choose to save their money because interest rates on their savings account are high. These activities would cause prices to fall because people are not buying products—a precursor to a recession. The same can be said for companies. A company could choose not to expand its business due to the rising borrowing costs.

If companies are not expanding, they are not hiring, which could increase unemployment. If consumers are not spending and companies are not expanding, prices will not grow as much. This is how the Fed combats inflation but at the same time causes a recession. Can you start to see why the market has had volatility?

The last item in the chart to explore is the Misery Index, often quoted in the media. The Misery Index adds the inflation rate to the unemployment rate. The higher the index, the more miserable people are because they do not have jobs, and inflation is high. In 1974, the Misery Index was 19.5; today, it is 12.2. While we are somewhat miserable, we are not as miserable as we were during the last bout of stagflation. By these metrics, we are not yet in a period of stagflation. However, economists are keeping an eye on how the increased gas prices are hurting the economy.

Now that we have made you miserable, what can you do to improve your situation? In this environment, we would recommend buying companies on sale, utilizing dollar cost averaging to take advantage of lower stock prices, converting to a Roth IRA, postponing large purchases and mortgages, paying off your variable rate credit cards, and living off cash until markets rebound.

Are you still concerned?

We can help determine your ability to withstand market volatility, review your accounts, and provide you with potential options to help improve your situation. We want to help you become successful on your financial journey.