

Markets Swing on Omicron Uncertainty and Powell's Take

The short end of the bond market, which takes its cue from expected Fed policy, has swung wildly in recent days as it grapples with persistently high inflation and the sudden emergence of a potentially disruptive new COVID variant.

Moderna CEO Stephane Bancel told the Financial Times yesterday that there is likely to be a material drop in the effectiveness of the vaccination against the Omicron variant relative to the Delta variant. This statement apparently spooked overnight markets. Early this morning, researchers at the University of Oxford offered a less dire opinion saying "despite the appearance of new variants over the past year, vaccines have continued to provide very high levels of protection against severe disease and there is no evidence so far that Omicron is any different."

It's still very early. Clearly, the latest mutation has sparked concern, and concern is enough to potentially slow economic growth. Slower growth means less consumer demand, and less demand suggests less price pressure . . . assuming that Omicron doesn't further delay production, in which case price pressures could rise further.

This morning, Fed Chair Jay Powell and Treasury Secretary Janet Yellen testified in front of the Senate Banking Committee. Both released prepared statements before addressing Congress. Powell's prepared remarks were released late yesterday. On the key issue of inflation, Powell admitted that ". . . factors pushing inflation upward are expected to linger well into 2022." He also said Fed members expect inflation to move lower over the coming year (. . . which sounds a little contradictory). However, the part of Powell's statement that caught the market's attention seemed to be: "The emergence of the Omicron variant poses downside risks to employment and economic activity, and increased uncertainty for inflation. Greater concerns about the virus could reduce people's willingness to work in person, which would slow labor market progress and intensify supply chain disruptions." This sounded really dovish at the time, and implied that the Fed might be a bit more cautious in reeling-in its accommodative policy.

In the actual testimony, much of that dovishness disappeared. Responding to questions from Senate members, Powell said "it is appropriate to discuss wrapping up asset purchases a few months earlier," and indicated this discussion could happen at the FOMC meeting in two weeks. Powell said the threat of persistently higher inflation had increased, but indicated the Fed will adapt and use its tools to make sure it doesn't get entrenched. (This also hints at an earlier taper.) Wrapping up the taper early would open the door for earlier tightening of the overnight funds rate. Powell also agreed it was time to stop describing inflation as "transitory," a worn-out phrase that had been used repeatedly by Powell and other Fed officials for most of this year.

Powell pinned the drop in the labor force participation rate on lingering Covid-19 concerns, and said it will take longer for the labor force to recover. He also noted that

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"we aren't going back to the same economy;" ... although he didn't elaborate on this comment.

Treasury Secretary Yellen focused on the debt limit, saying she "cannot overstate how critical it is that congress address this issue," and "if we do not, we will eviscerate our current recovery." She went on to say that if the debt ceiling wasn't increased, Americans would not receive social security and military checks, and that a recession could follow. Yellen has previously said the Treasury will run out of cash as soon as December 15th, a little over two weeks from now.

Much of Yellen's other comments were upbeat: GDP is now above pre-pandemic levels, unemployment is at its lowest level since the start of the pandemic, and the labor market is set to reach full employment two years earlier than the CBO had estimated. Yellen cautioned that further economic progress is tied to progress on the virus and specifically, the Omicron variant. The Q&A included scattered discussions on components of the proposed infrastructure package, the budget, nominations of Fed officials and supply chains ... which are all linked in one way or another.

Although Omicron has dominated the headlines in recent days, there seems to significant progress being made on the supply side. The Ports of Los Angeles and Long Beach announced yesterday that the two ports have seen a combined 37% decline in aging cargo on the docks since October 25th. There was also good news in the auto sector as monthly U.S. vehicle production increased from 1.06 million units to 1.43 million units in October. Auto production is still down from 2.17 million in January, but the October increase indicates the global chip shortage may have turned a corner.

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Market Indications as of 1:57 P.M. Central Time

DOW	Down 586 to 34,550 (HIGH: 36,432)
NASDAQ	Down 238 to 15,545 (HIGH: 16,057)
S&P 500	Down 68 to 4,587 (HIGH: 4,705)
1-Yr T-bill	current yield 0.21%; opening yield 0.09%
2-Yr T-note	current yield 0.53%; opening yield 0.50%
3-Yr T-note	current yield 0.82%; opening yield 0.79%
5-Yr T-note	current yield 1.15%; opening yield 1.16%
10-Yr T-note	current yield 1.44%; opening yield 1.51%
30-Yr T-bond	current yield 1.78%; opening yield 1.86%

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