**Philequity Corner (November 15, 2021)**
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## Climbing a wall of worry

Last Monday, November 8, the four major US indices all closed at fresh record highs with the S&P at 4,702, the Dow at 36,432, the Nasdaq at 15,982 and the Russell 2000 at 2,443. These new all-time highs were achieved despite the prevalence of various risks such as coronavirus cases brought about by the delta variant, surging commodity prices, a global energy crunch, China's regulatory crackdown, and widespread supply bottlenecks. The stock market remains resilient even as it climbs a wall of worry. The S&P 500 is now up 24.7% year-to-date while the Nasdaq, Euro Stoxx 50, and Topix are up 23.1%, 22.9%, and 13.1% ytd, respectively.

## Inflation, fastest pace in 31 years

However, the US bull run was halted by the extraordinary spike in inflation. The US consumer price index (CPI) rose 6.2% YoY in October, the fastest pace since December 1990. Higher prices were seen for energy, vehicle, food, and shelter, thus raising the concern that inflation is now becoming more broad-based. In its recent statement, the Fed said that "Inflation is elevated, largely reflecting factors that are expected to be transitory." Nonetheless, Treasury Secretary Janet Yellen believes that elevated inflation will not persist beyond 2022. Yellen emphasized that the Fed will not allow a repeat of 1970s-style price increases when US inflation reached double-digit levels.

## Fed's Financial Stability Report

Aside from the sharp rise in inflation, the Fed is carefully monitoring the development of various risks. In its comprehensive 77-page Financial Stability Report, the Fed identified and discussed several near-term events or scenarios that can interact with vulnerabilities in the financial system. We enumerate some of these risks and vulnerabilities below.

1. Lofty valuation levels that are above historical standards for various asset classes
2. Vulnerability of businesses and household borrowers to the expiry of government support programs and uncertainty over the pandemic
3. Leverage in the financial sector
4. Funding risks in money market funds, open-end mutual funds, and stablecoins
5. New COVID-19 variants and a potential worsening of the public health situation
6. A sharp rise in interest rates that could slow the pace of the recovery
7. Adverse developments in emerging markets spurred by a sharp tightening of financial conditions
8. Fallout from China's regulatory tightening
9. Stress in China's property market and potential spillovers to the US
10. A slower-than-expected recovery in Europe
11. Fading fiscal stimulus that can weigh on economic growth
12. Escalation of tensions between the US and China

## Retail traders move markets

The Fed devoted a special section to discuss the growing impact of retail traders and social media on the stock market. The prolonged lockdowns and work-from-home arrangements during the pandemic has sparked an extraordinary growth in retail trading. The rise of retail trading has been evident among younger investors who are more willing to take on risk and use more leverage. This was accompanied by the wide use of open social media platforms such as Reddit forums where retail traders can congregate and exchange information. According to the Fed, discussion in the social media can amplify the information flow among retail investors, but it can also increase the "noise" in the retail community.

In a previous article, we talked about the popularity of stock broker Robinhood and its impact to the stock market (see *Robinhood rattles markets*, February 8, 2021). Robinhood created a big retail following by eliminating commissions and by utilizing a user-friendly mobile trading platform which gamified trading for its millennial users. Retail brokers such as Robinhood provide easy access not only to equities, but also to leverage that can be used for trading volatile products such as options and cryptocurrencies. We have witnessed episodes of extreme volatility induced by meme stocks which were pushed by an army of online retail traders. These episodes were short-lived and did not have a lasting impact on the broad market. However, these events illustrate that the growing power of retail traders and the bigger influence of social media both bear watching.

## A recovery fraught with risks

The higher-than-expected US inflation in October raised the prospect of Fed rate hikes and interrupted the ascent of global equities. It remains to be seen whether inflation will end up being transitory or if it will become more persistent. In any case, central bankers around the world are closely watching the inflation picture and are ready to act if necessary. In fact, some central banks have already raised their benchmark rates.

Meanwhile, national governments have intervened to address the supply bottlenecks that have been caused by the surge in demand brought by the worldwide reopening. The vaccine rollout in many countries and the availability of COVID-19 treatment pills should support the recovery of the global economy from the pandemic. The Fed has identified several vulnerabilities in its latest Financial Stability Report. Nonetheless, it is reassuring to know that the central bank is actively monitoring these risks and is ready to take action if any of these materialize. Experienced asset managers are cognizant of these risks, but the stock market continues to move higher as it climbs a wall of worry.

*Philequity Management is the fund manager of the leading mutual funds in the Philippines. Visit www.philequity.net to learn more about Philequity's managed funds or to view previous articles. For inquiries or to send feedback, please call (02) 8250-8700 or email ask@philequity.net.*