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COMMENTARY

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Growing Concerns Around Delta Variant Rattle Markets

- Equities sell off on Delta variant concerns.
- Though the Delta variant is a risk, it is a low risk to the economy and markets.
- Instead, we see greater risks around the economy peaking and high valuations.

Global equities began the week with a selloff on concerns that the rebound in Covid-19 cases could weigh on consumer sentiment and lead to a slowdown in economic growth. While the Delta variant is a market risk, at this time, we consider it a low market risk. Instead, as we have noted throughout this year, our bigger market concerns center around peak economic growth, rising inflation and a slowdown in the Chinese economy. As investors weigh these threats to the current high valuations in both the stock and bond markets, we expect volatility levels to rise.

Today, stock markets opened sharply lower as investors are growing more concerned that we could now be seeing peak economic growth and that the reopening trade may be over. Though we consider it a low risk at this time, the Delta variant is still a concern to the financial markets as evidenced by the investor response today. Increasing Covid-19 cases raise the possibility that governments worldwide may respond by imposing restrictions that may derail the current global recovery. Though there could be an economic impact, we don't think it will be as bad as previous waves since consumers have learned to adjust to virus restrictions. Furthermore, while there seems to be a rise in so-called "breakthrough cases," or vaccinated people who have tested positive for the virus, indications suggests that Covid-19 is a low risk to the vaccinated population. For example, the evidence so far suggests that vaccines have greatly reduced both hospitalizations and deaths caused by it. But with all this said, markets remain concerned that consumer spending patterns and labor market dynamics may be influenced by the new surge in cases. Even if fully vaccinated people face a reduced risk, domestically here in the U.S. only about half of the population is fully vaccinated and vaccinated people may adjust their behavior.

We continue to feel that the bigger risks to the markets are peak economic growth, rising inflation and a slowing Chinese economy. As the economy progresses through the current recovery, expect to see slowing rates of change in economic data as the easy year-over-year comparisons roll off. While this is a normal transition in any recovery, given the extremes of this cycle, comparisons may deteriorate more swiftly than anticipated. We also remain concerned that inflation may be less transitory than the Fed suggests, forcing central bank officials to raise interest rates faster than markets anticipate. Lastly, we are seeing more evidence that China, whose economy was one of the first to exit the pandemic-led recession last year, is starting to slow and could further add to investor worries.

We expect the second half of the year to be marked by more market volatility, as investors become less complacent about these growing risks and momentum fades. Bond investors have been bidding up bond prices, sending 10-year Treasury yields lower, to under 1.2% (from 1.75% just a few months ago). This could be an ominous sign for the economy and equity investors are starting to take notice. Valuations in both stock and bond markets suggest little margin for error in economic data and market expectations and now we are seeing uncertainty grow. Fears are compounded by the recent weakening in market breadth in the past month and reopening sectors have lagged the broader market. Both these happenings suggest a less healthy stock market and increases the chances of a potential market correction.

To reiterate, we continue to anticipate more volatility in the near term. Any disruption to current expectations could be a headwind to stocks, and stock market valuations priced to perfection could amplify this volatility. We may see a stock market correction at some point this year, but we still don't expect a big sell-off like we saw last spring. We maintain that diversification is the key in this market. In these times, your financial professional can help you stay focused on your long-term risk and return goals and help you with your personalized investment objectives.

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