Now’s the time to prepare for the next market sell-off

Kristina Hooper
Chief Global Market Strategist

Weekly Market Compass | July 26 , 2021

Last week, in the midst of a market sell-off that rattled investors, I finished my commentary with one final sentence, “Stay calm, stay diversified, and for those with cash on the sidelines, look for buying opportunities.” After I wrote it, I wondered if the stock market would bounce back before investors had the time to look for buying opportunities. After all, that has been the pattern we have seen for more than a year; any sell-off has quickly been followed by a rush back into the stock market by eager buyers. And so it went this time as well — investors hardly had the chance to blink before the rebound happened. But if you think the summer sell-off that many anticipated has come and gone, I believe you are sorely mistaken. I’m closely watching four headwinds that could trigger another sell-off.

Four headwinds to watch

- **COVID spread.** COVID-19 continues to spread around the world. In Southeast Asia, a region that escaped the severity of previous waves of infection, a number of countries are experiencing a dramatic increase in Delta variant cases, such as Malaysia, Thailand, Indonesia, and even Singapore. The situation has gotten particularly bad in Indonesia, with severe oxygen shortages in Bali and Java. What’s more, given double-digit positivity rates, medical experts are worried that Indonesia could be an ideal breeding ground for more variants of COVID-19. Meanwhile, countries with high vaccination rates are struggling with upticks in cases as well, including the United Kingdom, France, Spain, and Israel. As has widely been reported, the United States is struggling with the Delta variant as unvaccinated parts of the population are seeing a surge in hospitalizations.

  Now the news is not all bad when it comes to COVID-19. After a peak in cases earlier this month, South Africa has finally started to see cases move in the right direction. In the US, White House officials report that vaccinations are actually starting to increase in some of the states where COVID infections are on the rise, such as Arkansas, Florida, Louisiana, Missouri, and Nevada. It seems that a greater effort on the part of elected officials — as well as the disturbing coverage of young people being hospitalized and dying — has helped encourage some reluctant Americans to get vaccinated. However, as we have seen before, any negative COVID headlines can spark jitters in markets.

- **Vaccine effectiveness questioned.** The development of effective vaccines has been critical to the economic turnaround and the strong stock market rally of 2021. So if vaccines were to no longer be very effective in the face of COVID, that could cause a serious case of market nervousness.

The news out of Israel is concerning. Based on national health statistics, researchers have estimated that the Pfizer vaccine was only 39% effective against preventing COVID-19 infection in Israel between June 20 and July 17.1 This is surprising given that, for a time period that overlaps with this period – June 6 through July 3 — the vaccine was estimated to be 64% effective. 1 It is worth noting that there was only a relatively small number of cases included in the study, so it may not be accurate in assessing the effectiveness of the vaccine. However, if this were an accurate estimate, it compares very unfavorably with statistics from earlier in the year; between January and early April, the vaccine was 95% effective in preventing COVID-19 infection. 1 The good news is that thus far, the Pfizer vaccine continues to be more than 90% effective in preventing serious illness.[1]

If vaccine effectiveness really has fallen that substantially, one reason could be that the vaccine's ability to prevent infection may be wearing off. While it would be onerous to have to roll out a booster shot quickly, at least that would mean there is presumably a solution for the lower effectiveness rate. Data should be scrutinized in many countries to get a better sense of vaccine effectiveness. A great experiment is underway in the United Kingdom. COVID-19 related restrictions (masking, social distancing, etc.) were lifted on July 19 despite rising COVID-19 cases fueled by the Delta variant. We will want to follow the situation closely for indications of how well vaccinations have protected UK citizens against the Delta variant.

- **Fed tightening fears.** Then there is the Federal Reserve. We have the Federal Open Market Committee meeting this week — some Fed watchers are anticipating a taper announcement at this meeting, although I think that would be premature (I think it's more likely we get a taper announcement at Jackson Hole). I empathize with Fed Chair Jay Powell as he walks a delicate tightrope — preparing markets for tapering while assuring that the Fed will be very patient and thoughtful as it starts its normalization process. But it's not just this FOMC meeting. Just as "Shark Week" seems to last far more than a week, the summer of "Fedspeak" will continue, and let's face it, any FOMC participant's words can rattle markets — especially as we get closer to the start of normalization.

- **US debt ceiling woes.** One more item that could add summer swoons for the stock market is the impending debt ceiling. In late June, US Treasury Secretary Janet Yellen warned about this issue, as it impacts the ability of the Treasury to issue bonds and pay its bills. Voting on raising the debt ceiling can be politically dangerous for a substantial portion of Congress, adding an extra layer of dysfunction to an already dysfunctional legislative body. While the official expiration date is July 31, we know from recent experience that the government can usually continue to function using "extraordinary measures" until the fall. However, the longer it takes to reach a deal, the greater the potential for volatility.

Of course, sometimes catalysts for market sell-offs can seemingly come out of nowhere or be lurking in the shadows, so the list above is far from complete.

Stay prepared for sell-offs

In other words, be prepared for more sell-offs. Now, that doesn't mean stocks will fare poorly for the rest of the year. Given solid fundamentals and the accommodative monetary and fiscal policy backdrop, I expect the stock market to finish the year higher than where it is today — but there could very well be hiccups along the way. So, in advance of the next sell-off, please keep this simple, familiar advice handy: Stay calm, stay diversified, and for those with cash on the sidelines, keep looking for buying opportunities.

With contributions from Ashley Oerth

Notes

[1]NY Times, "Israeli data suggests possible waning in effectiveness of Pfizer vaccine," July 23, 2021