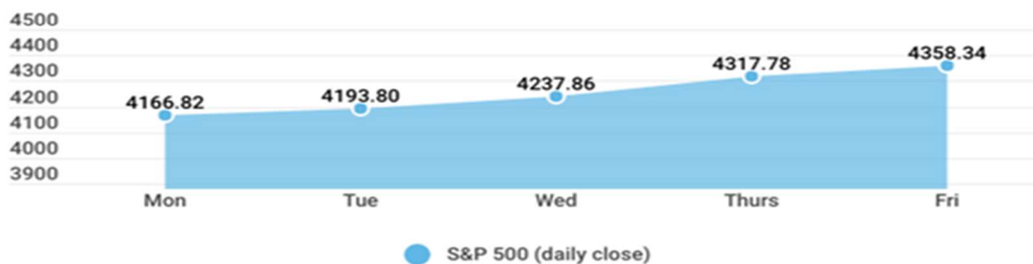
WEEKLY ECONOMIC UPDATE NOV. 6, 2023

Stocks ripped higher last week on a dramatic retreat in bond yields triggered by easing inflation and a slowing labor market.

The Dow Jones Industrial Average jumped 5.07%, while the Standard & Poor's 500 surged 5.85%. The Nasdaq Composite index rocketed 6.61% higher for the week. The MSCI EAFE index, which tracks developed overseas stock markets, gained 3.12%.[1,2,3]

Market Index	Close	Week	Y-T-D
DJIA	34,061.32	+5.07%	+2.76%
NASDAQ	13,478.28	+6.61%	+28.78%
MSCI-EAFE	2,006.05	+3.12%	+3.20%
S&P 500	4,358.34	+5.85%	+13.51%



	Treasury	Close	Week	Y-T-D
	10-Year Note	4.57%	-0.27%	+0.69%

Sources: The Wall Street Journal, November 3, 2023; Treasury.gov, November 3, 2023
Weekly performance for the Dow Jones Industrial Average, Standard & Poor's 500 Index, and NASDAQ Composite Index is measured from the close of trading on Friday, October 27, to Friday, November 3 close. Weekly performance for the MSCI-EAFE is measured from Friday, October 27 open to Thursday, November 2 close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

Stocks Rise

Stocks jumped higher right from the start of the week, shaking off the prior week's sell-off. The combination on Wednesday of the Fed's decision to keep rates unchanged, which accompanied dovish comments from Fed Chair Powell, and a reassuring Treasury announcement on future bond sales, sparked a third straight day of gains. Slight employment gains and weak manufacturing data provided an additional impetus.

The rally continued on Thursday following a sharp drop in bond yields that was driven, in part, by substantial productivity gains and decelerating wage growth. When Friday's monthly employment report was lighter than forecast, yields pulled back further, and stocks added to their week's gains.

Signs of Labor Cooling

Last week's employment data showed potential for a cooling labor market after many months of confounding economists' expectations. The first sign was a lower-than-expected growth in new private sector jobs in October, as reported by Automated Data Processing (ADP), which showed a gain of 113,000 new jobs versus a forecast of 130,000, while job openings were little changed.[4]

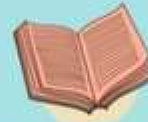
Initial and continuing jobless claims also rose, exceeding consensus estimates. On Friday, the government's monthly employment report further confirmed a potentially cooling employment picture, showing an October slowdown in hiring (150,000 new jobs versus September's revised gain of 297,000) and an uptick in the unemployment rate to 3.9%.[5]

This Week: Key Economic Data

Thursday: Jobless Claims.

Friday: Consumer Sentiment.

Quote of the Week



"The first panacea of a mismanaged nation is inflation of the currency, the second is war. Both bring temporary prosperity, both bring a permanent ruin. But both are the refuge of political and economic opportunists."

– Ernest Hemingway

Of Note

The US Federal Reserve's efforts to quell inflation have sent long-term interest rates to their highest level in a generation, putting a lot of stress on banks, companies and anyone looking to finance a new home. How long will this go on? Judging from the sheer volume of long-term debt securities that the Fed still needs to unload, likely at least a couple more years.

For more than a year, the Fed has been shrinking its holdings of Treasuries and mortgage-backed securities at a rate of about $75 billion a month. This process, known as quantitative tightening, gradually reduces the amount of excess cash reserves in the banking system. The aim is to reach a level of reserves adequate to ensure that banks can satisfy their customers' variable demands for cash and meet regulatory liquidity requirements.

The last time the Fed embarked on quantitative tightening, in 2018 and 2019, it went a bit too far. The supply of reserves fell below what banks required, triggering a scramble for cash that sent short-term interest rates spiking and destabilized the repo market, where banks, hedge funds and others borrow money against Treasury and mortgage-backed securities.

The Fed was forced to step in with emergency liquidity — an experience that it doesn't want to repeat.

This time around, the Fed's starting point is much higher. Its holdings of long-term debt securities exceed $7 trillion, compared with $4 trillion in 2018. Reserves in the banking system stand at about 12% of gross domestic product, up from 7% in September 2019. If one assumes — consistent with the most recent report on the Fed's open market operations — that 8% of GDP would be a suitable cushion of reserves, and that the Fed won't slow the rate of quantitative tightening until reserves fall to 10% of GDP, there's still a long way to go.

The shrinkage is likely to proceed even if the economy slows and the Fed needs to ease. The federal funds rate is its primary tool of monetary policy: It employs the balance sheet only when short-term rates are pinned near the zero lower bound. With the target rate currently above 5%, the central bank has plenty of room for maneuver without resorting to altering the path of quantitative tightening. So it should proceed on autopilot — about as exciting as "watching paint dry," as Janet Yellen once remarked.

There's also a new complicating factor: the Fed's reverse repo facility, where money market mutual funds and others have parked some $1.5 trillion, at interest rates exceeding 5%. As quantitative tightening continues, cash will migrate from the Fed's facility to other repo markets in pursuit of higher rates, increasing the supply of reserves. About $1 trillion has already moved over the past year, even as the Fed has shrunk its balance sheet by $800 billion, resulting in a net addition of $200 billion in reserves.

So when will quantitative tightening end? Assuming an annual runoff rate of $900 billion, nominal GDP growth of 4% and reverse repo balances declining to zero, reserves should reach the initial target of 10% of GDP in about two years. At that point, the Fed will slow the run-off pace as it assesses what constitutes an appropriate reserve buffer.

There three main repercussions. The first will be upward pressure on long-term interest rates and on the bond term premium — the added yield investors demand to lend for longer. Second, higher term premiums will tighten financial conditions, allowing the Fed to keep interest rates lower than it otherwise would (as Dallas Fed President Lorie Logan implied in a recent speech). Finally, by increasing the volume of securities that market participants must absorb and finance, quantitative tightening will risk further turbulence in the Treasury market. Currently, the supply of Treasuries is expanding by nearly 10% of GDP ($900 billion in Fed runoff plus a federal budget deficit of $1.7 trillion), potentially straining the balance sheets of the dealers at the center of the market.

It’s possible that serious dysfunction in the Treasury market could cause the Fed to relent. Barring that, quantitative tightening should proceed unabated, and this should put upward pressure on long-term interest rates until at least late 2025.[6]

Footnotes and Sources

1. The Wall Street Journal, November 3, 2023.
2. The Wall Street Journal, November 3, 2023.
3. The Wall Street Journal, November 3, 2023.
4. CNBC, November 2, 2023.
5. The Wall Street Journal, November 3, 2023.
6. washingtonpost.com/business/2023/10/18/the-fed-has-a-lot-of-quantitative-tightening-to-do/68d18eb0-6da1-11ee-b01a-f593caa04363_story.html

Investing involves risks, and investment decisions should be based on your own goals, time horizon, and tolerance for risk. The return and principal value of investments will fluctuate as market conditions change. When sold, investments may be worth more or less than their original cost.
The forecasts or forward-looking statements are based on assumptions, may not materialize, and are subject to revision without notice.
The market indexes discussed are unmanaged, and generally, considered representative of their respective markets. Index performance is not indicative of the past performance of a particular investment. Indexes do not incur management fees, costs, and expenses. Individuals cannot directly invest in unmanaged indexes. Past performance does not guarantee future results.
The Dow Jones Industrial Average is an unmanaged index that is generally considered representative of large-capitalization companies on the U.S. stock market. Nasdaq Composite is an index of the common stocks and similar securities listed on the NASDAQ stock market and is considered a broad indicator of the performance of technology and growth companies. The MSCI EAFE Index was created by Morgan Stanley Capital International (MSCI) and serves as a benchmark of the performance of major international equity markets, as represented by 21 major MSCI indexes from Europe, Australia, and Southeast Asia. The S&P 500 Composite Index is an unmanaged group of securities that are considered to be representative of the stock market in general.
U.S. Treasury Notes are guaranteed by the federal government as to the timely payment of principal and interest. However, if you sell a Treasury Note prior to maturity, it may be worth more or less than the original price paid. Fixed income investments are subject to various risks including changes in interest rates, credit quality, inflation risk, market valuations, prepayments, corporate events, tax ramifications and other factors.
International investments carry additional risks, which include differences in financial reporting standards, currency exchange rates, political risks unique to a specific country, foreign taxes and regulations, and the potential for illiquid markets. These factors may result in greater share price volatility.
Please consult your financial professional for additional information.
This content is developed from sources believed to be providing accurate information. The information in this material is not intended as tax or legal advice. Please consult legal or tax professionals for specific information regarding your individual situation. This material was developed and produced by FMG Suite to provide information on a topic that may be of interest. FMG is not affiliated with the named representative, financial professional, Registered Investment Advisor, Broker-Dealer, nor state- or SEC-registered investment advisory firm. The opinions expressed and material provided are for general information, and they should not be considered a solicitation for the purchase or sale of any security.
Copyright 2023 FMG Suite.