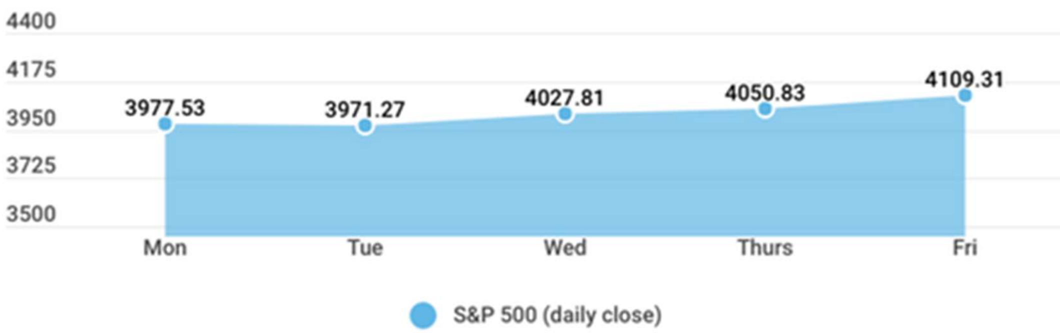
Weekly Economic Update April 3, 2023

Stocks rallied last week on receding fears of a widening banking crisis, led by resurging investor interest in technology and communication services names.

The Dow Jones Industrial Average gained 3.22%, while the Standard & Poor's 500 added 3.48%. The Nasdaq Composite index rose 3.37% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, advanced by 3.34%.[1,2,3]

Market Index	Close	Week	Y-T-D
DJIA	33,274.15	+3.22%	+0.38%
NASDAQ	12,221.91	+3.37%	+16.77%
MSCI-EAFE	2,084.49	+3.34%	+7.23%
S&P 500	4,109.31	+3.48%	+7.03%



	Treasury	Close	Week	Y-T-D
	10-Year Note	3.48%	+0.10%	-0.40%

Sources: The Wall Street Journal, March 31, 2023; Treasury.gov, March 31, 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, March 24, to Friday, March 31 close. Weekly performance for the MSCI-EAFE is measured from Friday, March 24, open to Thursday, March 30, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

Tech Leads Rally

An absence of further bad news in the banking sector made for a good week, with high-quality technology and communication services stocks leading the market. While easing banking worries laid the groundwork for the week's positive gains, growing conviction that Fed rate hikes were ending and positive inflation data out of Europe helped support the renewed enthusiasm for stocks.

Encouraging inflation data on the domestic front on Friday also added to the gathering optimism, igniting further gains to cap a satisfying week for investors.

Inflation Grinds Lower

In an otherwise news-light week, Friday saw the release of February's personal income and outlays report, which provides insight into inflation and consumer expenditures, the dominant contributor to economic growth.

The Personal Consumption Expenditures Price Index (PCE), the Fed's preferred measure of inflation, rose 0.3% for the month, below market expectations and below the prior month's 0.6% jump. The year-over-year increase of 5.0% improved from January's rise of 5.3%. Energy prices declined, partially offsetting increases in food, goods, and services. Personal income rose 0.3%, while consumer spending increased 0.2%.[4]

This Week: Key Economic Data

Monday: Institute for Supply Management (ISM) Manufacturing Index.

Tuesday: Factory Orders. Job Openings and Turnover Survey (JOLTS).

Wednesday: ADP (Automated Data Processing) Employment Report. Institute for Supply Management (ISM) Services Index.

Thursday: Jobless Claims.

Friday: Employment Situation.

"The great tyrannies are always perpetrated in the name of the noblest causes"

– Thomas Paine

Of Note

Americans can expect their wealth to get repeatedly chipped away as the monetary system degrades and requires progressively more intervention by authorities to perpetuate itself.

The recent downfall of two sizable American banks, Silicon Valley Bank (SVB) and First Republic Bank, rattled the financial markets. Investors are now looking to the Federal Reserve to provide relief and within months reverse its policy of raising interest rates. That's after the central bank, together with the Treasury and the Federal Deposit Insurance Corporation (FDIC), already shored up the banking sector, offering special loans and guaranteeing uninsured deposits for the failed banks.

The failures, however, represent a symptom of a broader problem—one the central bank can't fix, according to Daniel Lacalle, fund manager, economist and author. "The problem here is the concept of 'what can be done?'" he said, arguing central bank market interventions intended to smooth over market perturbations tend to simply redistribute the risk and losses—and at the added cost of making the system more fragile in the long run. "Every time they try to solve a bubble with more liquidity injections, they create another bubble," he commented. "What you have to do first is not implement crazy monetary policies."

He was referring to the policy of extremely low interest rates that the Fed maintained for most of the past decade. Lacalle alluded to the Austrian economic theory, which posits that central banks can't set interest rates correctly. When the economy is not doing well, central banks set the rates artificially low in order to "stimulate" the economy. That allows companies to loosen fiscal discipline and makes credit available to projects that would be otherwise too risky to attract capital. When the economy "overheats", the availability of credit outstrips the production capacity of the economy, resulting in inflation and then the central bank raises rates, tightens credit, and the poorly performing risky projects go under.

Because rate hikes take more than a year to fully manifest in the economy, central bankers tend to continue hiking for too long. Excessively high rates then cause the destruction of even viable businesses. Recession ensues. The central bank then tries to cushion the recession blow by dramatically cutting rates, thereby repeating the cycle. “After a decade of excess, of course, there are going to be episodes like SVB and these other regional banks,” Lacalle said.

SVB was the banker of choice for many Silicon Valley tech startups and their venture capital funders that have benefited from the protracted period of loose credit. In just a few years, it grew into one of the 20 largest banks in the country, with some $200 billion in assets. When its investments started to underperform and its stock dropped, clients got cold feet and many moved their money elsewhere, triggering a bank run.

Some economists have argued that the SVB crash was the fault of regulators. The Federal Reserve of San Francisco should have stepped in when it saw warning signs of SVB’s instability, argued the Brookings Institution’s Aaron Klein in a recent commentary.

Lacalle wasn’t convinced. He pointed out that on paper, SVB was following the regulatory mantras.

“You’re hedging your volatile positions in technology and risky ventures, which obviously is your core business—that’s nothing we can do about—and you’re hedging it with long-term treasuries and mortgage-backed securities,” he said. But it was exactly the large treasuries portfolio, which dropped in value due to the Fed’s rate hikes last year, that pushed SVB over the edge.

The Fed’s response to the SVB crisis is a typical example, Klein suggested, of the system’s underlying flaw—a short-term solution with long-term negative implications. Shortly after regulators took over SVB, the Fed, the Treasury, and the FDIC announced that no depositors in the failed banks will lose money, despite most of the deposits being above the FDIC insurance limit of $250,000 per account. Furthermore, to ensure no other banks hit a liquidity crunch because of the value drop in their treasury holdings, the Fed will allow them one year to borrow against those holdings at “par value”—the Fed will de facto pretend the treasuries are worth more than they currently are.

The Fed’s apparent motivation was to forestall runs on other smaller banks. Yet its actions created “an incentive to take even more risk by the next bank,” Lacalle said. “The example of SVB is telling everyone that what they should do is exactly what SVB did because nothing’s going to happen. If things go well, you will make a lot of money and if things go badly, bad luck, but nothing’s going to happen. So what is the incentive to be prudent and to have a prudent level of risk management? Zero.”

Though proponents of the Fed’s move maintain it doesn’t amount to a bailout, that may be a distinction without a difference. If the SVB comes up short of giving its depositors their money back, the FDIC is now on the hook to cover the difference. The agency can draw money from two sources: Fees imposed on banks, which are typically passed on to customers; and government loans, meaning taxpayers.

Moreover, the intervention ingrains the notion that large banks, once again, are getting special treatment. “The moral hazard is enormous,” Lacalle said, noting that while banks are allowed to borrow extra against their treasuries, ordinary bondholders don’t have that option.

A banking system without a central bank would have no centrally controlled interest rate. “If you had a free banking system in which interest rates floated freely, SVB would have never been able to get the balance sheet that it had,” Lacalle said. If the bank wanted to invest in tech startups of uncertain prospects, it would need to pay a risk premium on the necessary capital, discouraging excessive gambles.

While he voiced a preference for such a system, he stopped short of advocating for totally regulation-free banking. Even without the Fed to oversee them, banks would still face liability risks.

Despite his belief that the central banking system inevitably leads to its own collapse, Lacalle doesn’t see that happening anytime soon. “We’re very far away from a breaking point,” he said. The Fed has proven creative in devising various short-term fixes to avoid cascading events that could unravel the system.

“They can do it forever. … It’s only you and I who are going to pay for it in higher inflation, higher debt, lower real wages, lower employment,” Lacalle said, noting that “there’s a lot of perverse incentives to continue doing this…The gradual destruction of the wealth of a nation by monetary policy is something that can take a very, very long time and obviously, there are winners and losers," he said.

What we may see in the near future, however, is another crisis moment. While he said he wouldn't go as far as to declare the whole banking sector bust, he also didn't believe SVB's collapse was "an isolated event…It's always the same. First, you get a small bank, then you get a large bank, then you get a truly scary one. So I think we are not in a situation where you can say, 'Oh, the SVB crisis is over."[5]

Footnotes and Sources

1. The Wall Street Journal, March 31, 2023
2. The Wall Street Journal, March 31, 2023
3. The Wall Street Journal, March 31, 2023
4. CNBC, March 31, 2023
5. theepochtimes.com/Americas-to-bear-burden-of-montary-systems-gradual-deterioration-economist-says_5131784.html?src_src=partner&src_cmp=ZeroHedge

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Please consult your financial professional for additional information.