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In this week's recap: Passage of infrastructure bill in Senate boosts DJIA and S&P; Nasdaq stays flat.

Weekly Economic Update

Presented by Ed Papier, August 16, 2021

THE WEEK ON WALL STREET

Looking past inflation figures and Delta variant trends, stocks last week found a way to climb higher and set fresh record highs in the process.

The Dow Jones Industrial Average rose 0.87%, while the Standard & Poor's 500 advanced 0.71%. The Nasdaq Composite index was flat (-0.09%) for the week. The MSCI EAFE index, which tracks developed overseas stock markets, gained 0.77%. [1,2,3]

QUIETLY CLIMBING

Stocks moved higher amid relatively light trading last week. After initially retreating under the weight of Delta variant updates, stocks grinded higher, catalyzed by the Senate's passage of a $1 trillion infrastructure bill.

Two themes emerged last week. The first was that inflation assumed a less threatening profile. The most recent Consumer Price Index report showed some moderation in consumer price increases, while investors appeared to interpret a hotter-than-expected Producer Price Index report as the peak in this inflation cycle.

Also worth noting were comments by multiple Federal Reserve Bank regional presidents suggesting that the time for tapering (i.e., ending the Fed's bond purchases) was nearing, with one intimating that tapering could start as early as October. [4]

INFLATION REPORTS

Consumer prices climbed at their fastest rate since August 2008, rising 5.4% year-over-year. But this elevated rate was expected by most economists. The core inflation rate (excludes the more volatile food and energy prices) came in 4.3% higher, substantially lower than anticipated. This deceleration in core inflation was largely attributed to a slowdown in price increases in used cars and apparel. [5]
More unsettling was the following day's Producer Price Index (PPI). The PPI, which can be an indicator of future consumer prices, came in at the highest rate since tracking began, surging 7.8%. [6]

THE WEEK AHEAD: KEY ECONOMIC DATA

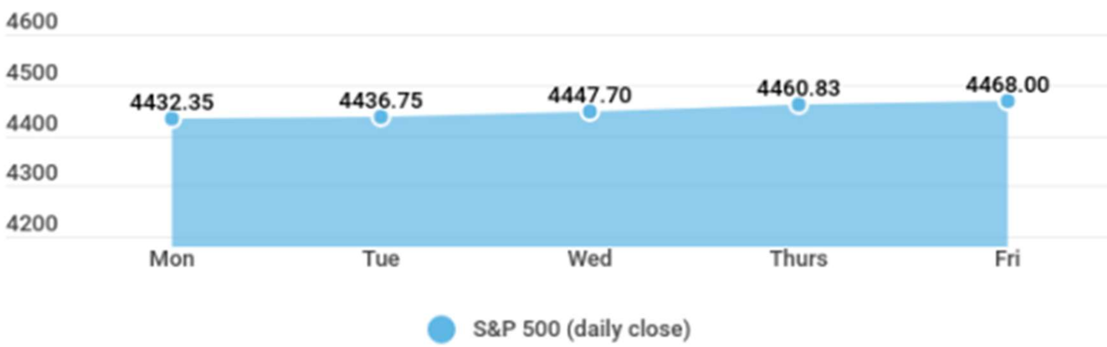
Tuesday: Retail Sales. Industrial Production.
Wednesday: Housing Starts. FOMC (Federal Open Market Committee) Minutes.
Thursday: Jobless Claims. Index of Leading Economic Indicators.

QUOTE OF THE WEEK

"They who can give up essential liberty to obtain a little temporary safety deserve neither liberty nor safety"

BENJAMIN FRANKLIN

Market Index	Close	Week	Y-T-D
DJIA	35,515.38	+0.87%	+16.04%
NASDAQ	14,822.90	-0.09%	+15.01%
MSCI-EAFE	2,362.81	+0.77%	+10.02%
S&P 500	4,468.00	+0.71%	+18.95%



	Treasury	Close	Week	Y-T-D
	10-Year Note	1.29%	-0.02%	+0.36%

Sources: The Wall Street Journal, August 13, 2021; Treasury.gov, August 13, 2021
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, August 6, to Friday, August 13, close. Weekly performance for the MSCI-EAFE is measured from Friday, August 6, open to Thursday, August 12, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

"Years of ultra-loose fiscal and monetary policies have put the global economy on track for a slow-motion train wreck in the coming years. When the crash comes, the stagflation of the 1970s will be combined with the spiraling debt crises of the post-2008 era, leaving major central banks in an impossible position"… Nouriel Roubini

Today's extremely loose monetary and fiscal policies, when combined with a number of negative supply shocks, could result in 1970s-style stagflation (high inflation alongside a recession). In fact, the risk today is even bigger than it was then.

Conversely, during the 2007-08 financial crisis, high debt ratios (private and public) caused a severe debt crisis – as housing bubbles burst – but the ensuing recession led to low inflation, if not outright deflation. Owing to the credit crunch, there was a macro shock to aggregate demand, whereas the risks today are on the supply side.

We are thus left with the worst of both the stagflationary 1970s and the 2007-10 period. Debt ratios are much higher than in the 1970s, and a mix of loose economic policies and negative supply shocks threatens to fuel inflation rather than deflation, setting the stage for the mother of stagflationary debt crises over the next few years.

For now, loose monetary and fiscal policies will continue to fuel asset and credit bubbles, propelling a slow-motion train wreck. The warning signs are already apparent in today's high price-to-earnings ratios, low equity risk premia, inflated housing and tech assets, and the irrational exuberance surrounding special purpose acquisition companies (SPACs), the crypto sector, high-yield corporate debt, collateralized loan obligations, private equity, meme stocks, and runaway retail day trading. At some point, this boom will culminate in a Minsky moment (a sudden loss of confidence), and tighter monetary policies will trigger a bust and crash.

But in the meantime, the same loose policies that are feeding asset bubbles will continue to drive consumer price inflation, creating the conditions for stagflation whenever the next negative supply shocks arrive. Such shocks could follow from renewed protectionism; demographic aging in advanced and emerging economies; immigration restrictions in advanced economies; the reshoring of manufacturing to high-cost regions; or the balkanization of global supply chains.
More broadly, the Sino-American decoupling threatens to fragment the global economy at a time when climate change and the COVID-19 pandemic are pushing national governments toward deeper self-reliance. Add to this the impact on production of increasingly frequent cyber-attacks on critical infrastructure and the social and political backlash against inequality, and the recipe for macroeconomic disruption is complete.

Making matters worse, central banks have effectively lost their independence, because they have been given little choice but to monetize massive fiscal deficits to forestall a debt crisis. With both public and private debts having soared, they are in a debt trap. As inflation rises over the next few years, central banks will face a dilemma. If they start phasing out unconventional policies and raising policy rates to fight inflation, they will risk triggering a massive debt crisis and severe recession; but if they maintain a loose monetary policy, they will risk double-digit inflation – and deep stagflation when the next negative supply shocks emerge.

But even in the second scenario, policymakers would not be able to prevent a debt crisis. While nominal government fixed-rate debt in advanced economies can be partly wiped out by unexpected inflation (as happened in the 1970s), emerging-market debts denominated in foreign currency would not be. Many of these governments would need to default and restructure their debts.

When former Fed Chair Paul Volcker hiked rates to tackle inflation in 1980-82, the result was a severe double-dip recession in the United States and a debt crisis and lost decade for Latin America. But now that global debt ratios are almost three times higher than in the early 1970s, any anti-inflationary policy would lead to a depression, rather than a severe recession.

Under these conditions, central banks will be damned if they do and damned if they don't, and many governments will be semi-insolvent and thus unable to bail out banks, corporations, and households.

As matters stand, this slow-motion train wreck looks unavoidable. The Fed's recent pivot from an ultra-dovish to a mostly dovish stance changes nothing. The Fed has been in a debt trap at least since December 2018, when a stock- and credit-market crash forced it to reverse its policy tightening a full year before COVID-19 struck. With inflation rising and stagflationary shocks looming, it is now even more ensnared.

So, too, are the European Central Bank, the Bank of Japan, and the Bank of England. The stagflation of the 1970s will soon meet the debt crises of the post-2008 period. The question is not if but when. [7]

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Please feel free to send us their contact information via phone or email. (Don't worry – we'll request their permission before adding them to our mailing list.)

CITATIONS:

1. The Wall Street Journal, August 13, 2021
2. The Wall Street Journal, August 13, 2021
3. The Wall Street Journal, August 13, 2021
4. The Wall Street Journal, August 11, 2021
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7. project-syndicate.org/commentary/stagflation-debt-crisis-2020s-by-nouriel-roubini-2021-06?utm_source=project-syndicate.org&utm_medium=email&utm_campaign=authnote&