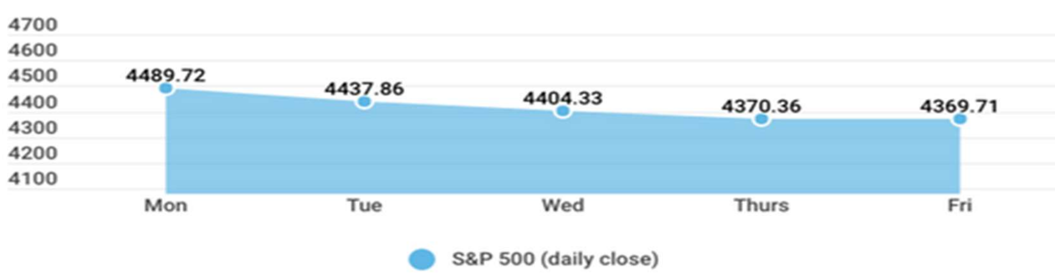
WEEKLY ECONOMIC UPDATE AUG. 21, 2023

Stocks extended their August declines last week as higher yields and weak economic data out of China soured investor sentiment.

The Dow Jones Industrial Average lost 2.21%, while the Standard & Poor's 500 retreated 2.11%. The Nasdaq Composite index backtracked 2.59% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, slumped 2.83%.[1,2,3]

Market Index	Close	Week	Y-T-D
DJIA	34,500.66	-2.21%	+4.08%
NASDAQ	13,290.78	-2.59%	+26.98%
MSCI-EAFE	2,068.98	-2.83%	+6.43%
S&P 500	4,369.71	-2.11%	+13.81%



	Treasury	Close	Week	Y-T-D
	10-Year Note	4.26%	+0.10%	+0.38%

Sources: The Wall Street Journal, August 18, 2023; Treasury.gov, August 18, 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, August 11, to Friday, August 18 close. Weekly performance for the MSCI-EAFE is measured from Friday, August 11, open to Thursday, August 17 close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

Stocks Wilt

Rising bond yields, driven primarily by strong economic data and the release of the minutes from July's Federal Open Market Committee (FOMC) meeting that pointed toward Fed officials' potential need to raise rates further, weighed on stocks throughout the week.

In a week of light trading typical of August, stocks were additionally buffeted by a string of economic data that painted a flailing economic recovery in China and warnings of potential downgrades of dozens of U.S. banks by Fitch, a credit-rating agency.

After the 10-year Treasury yield rose to its highest level since October 2022 on Thursday, yields eased on Friday, helping to arrest the week's downward trend.[4]

Retail Sales Surprise

Retail sales jumped 0.7% in July, the fourth-consecutive month of increasing consumer spending on goods. The report supported the growing narrative that the U.S. may be able to avoid a recession in the near term. The strong spending data, supported by a robust labor market, also may have placed the Fed in a more difficult position in trying to bring inflation down to its target rate without more rate hikes.[5]

Consumer spending was higher in most categories, including bars and restaurants, grocery and hardware stores, and back-to-school items like books and clothing. Sales of autos and electronics fell, a possible consequence of higher borrowing costs.[5]

This Week: Key Economic Data

Tuesday: Existing Home Sales.

Wednesday: Purchasing Managers' Index (PMI) Composite Flash. New Home Sales.

Thursday: Durable Goods Orders. Jobless Claims.

“Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one.”

– Charles Mackay

Of Note

At the end of July, 2023, the financial rating agency Fitch announced that it was downgrading the sovereign debt of the United States. The stock market tumbled. The bond market tumbled. Talking heads talked. But what does the downgrade really mean?

In the aftermath of the Fitch announcement, many pundits solemnly intoned their opinion that “the United States will never default on its debt” or something similar. Is this claim true?

That depends to some extent on how you interpret the claim. Consider that there are three types of default and that it is unlikely the United States will default in two of the senses. In the third sense, we will see that not only is it likely that the US will default, it’s almost guaranteed. We’ll also see that the United States federal government has, in the past, defaulted on its sovereign debt.

Sovereign debt is debt issued by a so-called sovereign entity. Originally, this was a king, and technically in kingdoms like the United Kingdom, government borrowing is borrowing by “the crown,” meaning the king.

We don’t have to look deeply into history to find many, and repeated, examples of sovereigns defaulting. For example, Fitch reports 14 separate sovereign defaults since 2020! Among those defaulting have been Ukraine, Argentina and Ecuador. So, the mere fact that the US federal debt is sovereign debt certainly does not tell us that it cannot default.

What does it mean for a bond to default? In general, the term default means failing to meet a stated obligation. In the context of most non-sovereign bonds, there are two general types of default: money defaults, and non-money defaults.

When most talking heads talk about the US government defaulting on its bonds, they are implicitly referring to a money default. A money default occurs when the obligor (e.g. the US Treasury) fails to make a scheduled payment in full and on time.

Money defaults can occur for two basic reasons: inability to pay, or unwillingness to pay. In some contexts, a borrower has the ability to pay, but chooses instead to default. Usually, such a voluntary money default would be part of a negotiating strategy, or a strategy to position oneself for bankruptcy. Bankruptcy is the legal process for adjudicating the various conflicting claims on a borrower who cannot pay all the claims in full. For the legal bankruptcy process to work, however, all the parties must submit to the jurisdiction of the court. In the case of private bankruptcies within a single country, this is usually not an issue.

However, there is no well-established or accepted such process for nations or sovereigns that cannot meet their obligations. As messy, costly and inefficient as the bankruptcy process is, the process, and the associated law, gives at least some idea to the various parties regarding what can be expected if the borrower does default.

But an orderly, or semi-orderly, restructuring of the US federal obligations through the bankruptcy process is not a possible outcome. While it might make sense for the US government to voluntarily admit that it has more debt than it can service over the long run, and take appropriate steps, that seems unlikely to happen in the foreseeable future. In other words, voluntary money default seems extremely improbable.

In most private debt and non-sovereign (e.g. state and local) debt, there is a contract between the borrower and lender. Those contracts, or bond indentures, may contain clauses, called covenants, that require the borrower to meet certain tests from time to time. For example, a corporate borrower may be restricted from allowing total debt to exceed a certain percentage of revenue, or assets, or something like that. When such covenants exist, and a borrower violates a covenant, the borrower can be in default even if the borrower never misses a payment. Such covenants, however, do not apply to US federal debt.

For borrowers like the US government and select other governments around the world that borrow mostly in the currency that it can print, including the Japanese, Chinese, and UK governments, there is a third option. We'll call it Fiat Default.

The US government can print dollars. It can, therefore, simply create, out of thin air, essentially any quantity of dollars that it decides to. This ability to print money means that it is unlikely that the US will ever (at least in the foreseeable future) face a situation in which it is unable to meet its obligations to pay interest or principal on the debt.

However, that same ability virtually guarantees that such debt will be paid with dollars that are worth less than before. This process of repayment with worth-less dollars is not recognized by most economists as default, though it is hard to classify it as anything else. Official US government statistics show that cumulative inflation since 2020 has amounted to about 20%. In other words, what cost a dollar in 2020 would now cost about $1.20.

So someone who lent the US government $1000 in 2020, and gets that $1000 back now, actually receives money worth only about $833. Yes, they got interest, but that interest was supposed to compensate them for not having the use of the money. And the interest rate in 2020 was close to zero anyway.

If you lend me $1000, and I pay you back only $833, you would be entirely justified in believing that I had defaulted. But that inflation-default is standard operating procedure for the US government. And it has been so ever since 1933. In that year, the government explicitly defaulted by reneging on its commitment to repay loans in gold. Before 1933, the dollar was defined as a certain weight of gold.

The government knowingly and intentionally defaulted on that promise. And since then, the US government has consistently spent more than it takes in from all forms of revenue, making up the difference by borrowing and printing money. That intentional policy of fiat money finance is why we have inflation.

In the short to medium term, we have seen the highs for inflation. A recession is likely however, and the government will respond to such a recession with yet more money printing, which will cause inflation to revive and return, possibly at even higher levels than were seen in the past two years.[6]

Footnotes and Sources

1. The Wall Street Journal, August 18, 2023
2. The Wall Street Journal, August 18, 2023
3. The Wall Street Journal, August 18, 2023
4. CNBC, August 18, 2023
5. The Wall Street Journal, August 15, 2023
6. Content of an email received from Roger Silk, Sterling Foundation Management LLC: https://www.sterlingfoundations.com/

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.

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