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Amadeus Wealth Alternatives
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*In this week's recap: Powell comments spur sell-off on Wall Street.*

# Weekly Economic Update

*Presented by Ed Papier, August 29, 2022*

## THE WEEK ON WALL STREET

A comprehensive sell-off on Friday following comments by Fed Chair Jerome Powell drove stocks to losses for the week.

The Dow Jones Industrial Average tumbled 4.22%, while the Standard & Poor's 500 dropped 4.04%. The Nasdaq Composite index fell 4.44% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, lost 1.10%. [1,2,3]

## UNDER PRESSURE

Stocks dropped on Friday following Powell's remarks reiterating the Fed's inflation-fighting resolve. While his comments did not break new ground, markets reacted severely, perhaps on worries that interest rate hikes may continue into next year.

After starting the week sharply lower on renewed rising interest rates and economic slowdown fears, markets staged a modest turnaround beginning mid-week. Stocks rallied on Thursday, sparked by a revised Gross Domestic Product estimate showing the economy's shrinking less than initially estimated. Thursday's rally also got a boost from regional Federal Reserve Bank presidents, who suggested future rate hikes may be in line with market expectations.

## POWELL AT JACKSON HOLE

In his much-anticipated speech at the Jackson Hole Economic Symposium, Powell unflinchingly reaffirmed the Fed's commitment to raising rates to lower inflation, even if it results in causing pain to individuals and businesses.

Wall Street focused on Powell's presentation in the hope it might provide greater clarity on future Fed direction, though his remarks ultimately went no further than restating past communications. Powell commented, "We are moving our policy stance purposefully to a level that will be sufficiently restrictive to return inflation to two percent." This statement may have put to rest any thoughts that the Fed would soon pivot on rate hikes. [4]

## THE WEEK AHEAD: KEY ECONOMIC DATA

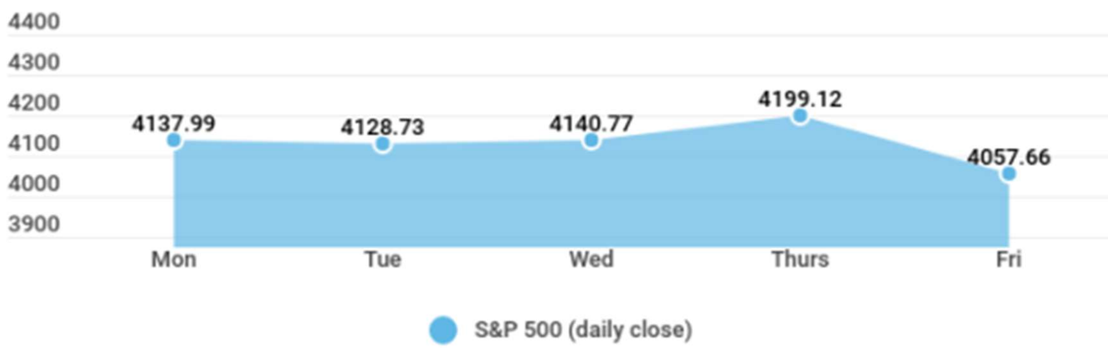
**Tuesday:** Consumer Confidence. Job Openings and Turnover Survey (JOLTS).
**Wednesday:** Automated Data Processing (ADP).
**Thursday:** Jobless Claims. Institute for Supply Management (ISM) Manufacturing Index.
**Friday:** Employment Situation. Factory Orders.

### QUOTE OF THE WEEK

" When you want to help people, you tell them the truth.
When you want to help yourself,
you tell them what they want to hear ."

*THOMAS SOWELL*

| Market Index | Close | Week | Y-T-D |
|---|---|---|---|
| DJIA | 32,283.40 | -4.22% | -11.16% |
| NASDAQ | 12,141.71 | -4.44% | -22.39% |
| MSCI-EAFE | 1,898.45 | -1.10% | -18.73% |
| S&P 500 | 4,057.66 | -4.22% | -11.16% |




| | Treasury | Close | Week | Y-T-D |
|---|---|---|---|---|
| | 10-Year Note | 3.04% | -0.06% | +1.52% |

Sources: The Wall Street Journal, August 26, 2022; Treasury.gov, August 26, 2022
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 19, to Friday, August 26, close. Weekly performance for the MSCI-EAFE is measured from Friday, August 19, open to Thursday, August 25, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

## OF NOTE

Long-term returns are unsustainable - a bold statement that flies in the face of mainstream analysis. It is a true statement that over the very long term, stocks have returned roughly 6% from capital appreciation and 4% from dividends on a nominal basis. However, since inflation has averaged approximately 2.3% over the same period, real returns are closer to 8% annually on average. More precisely, from 1928 to 2021, the market returned 8.48% after inflation.

After more than a decade, many investors have become complacent in expecting elevated rates of return from the financial markets. However, can those expectations continue to be met in the future?

It is likely no surprise that the surge in returns following the Great Financial Crisis resulted from the Fed's repeated monetary interventions and zero interest rate policy. Those actions and fiscal interventions from the government created the most significant financial bubble in history.

The fiscal policies implemented post the pandemic-driven economic shutdown created a surge in demand that further exacerbated an already extended market. Those fiscal interventions led to an unprecedented surge in earnings. However the surge in the M2 money supply is now over. Without further stimulus, earnings must eventually revert to economically sustainable levels.

While the media often states that "stocks are not the economy," it is economic activity that creates corporate revenues and earnings. As such, stocks cannot indefinitely grow faster than the economy over long periods. When stocks deviate from the underlying economy, the eventual resolution is lower stock prices.

Since 1947, earnings per share have grown at 7.72%, while the economy has expanded by 6.35% annually. That close relationship in growth rates is logical given the significant role that consumer spending has in the GDP equation. The slight difference is due to periods where earnings can grow faster than the economy when coming out of recession. However, while nominal stock prices have averaged 9.35% (including dividends), reversions to actual economic growth eventually occur because corporate earnings are a function of consumptive spending, corporate investments, imports, and exports.

The market disconnect from underlying economic activity is due to psychology, hence the entire field of behavioral finance. Successive rounds of monetary interventions have led investors to once again believe " this time is different". Unfortunately, it never is.

While not precise, there is a correlation between economic activity and the rise and fall of equity prices. For example, in 2000 and again in 2008, earnings contracted by 54% and 88%, respectively, as economic growth declined. These contractions occurred despite calls for never-ending earnings growth before both of these contractions.

As earnings disappointed, stock prices adjusted by nearly 50% to realign valuations with weaker than expected current earnings and slower future earnings growth. So while the stock market is once again detached from reality, looking at past earnings contractions suggests it won't be the case for long.

Since stock prices get driven by the psychology of market participants, there can be periods when markets disconnect from fundamentals. However, most important to investors is that fundamentals never play "catch up" to stock prices. According to Kalish Concepts, "The conclusion is clear: this is not sustainable. The market has outperformed historical returns by a wide margin since 2009. Much of this outsized performance came in the 2017 – 2021 period when returns were 2x higher than long-term historical average." The market risk of overly optimistic earnings estimates is high, as are the long-term above-trend returns.

Earlier this year, Jeremy Grantham made headlines with his market outlook. The crux of the article can be summed up as follows: "All 2-sigma equity bubbles in developed countries have broken back to trend. But before they did, a handful went on to become superbubbles of 3-sigma or greater: in the U.S. in 1929 and 2000 and in Japan in 1989. There were also superbubbles in housing in the U.S. in 2006 and Japan in 1989. All five of these superbubbles corrected all the way back to trend with much greater and longer pain than average. Today in the U.S. we are in the fourth superbubble of the last hundred years."

The deviation from long-term growth trends created by the repeated financial interventions by the Federal Reserve, is unsustainable. Unless the Federal Reverse is committed to a never-ending program of zero interest rates and quantitative easing, the eventual reversion of returns to their long-term means is inevitable.

Profit margins and earnings will inevitably return to levels that align with actual economic activity. As Jeremy Grantham once noted: "Profit margins are probably the most mean-reverting series in finance. And if profit margins do not mean-revert, then something has gone badly wrong with capitalism".

Many things can go wrong in the months ahead. While investors cling to the hope the Fed has everything under control, there is a reasonable chance they don't. The next decade could be a disappointment to those with overly optimistic expectations of the stock market. [5]

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CITATIONS:

1. The Wall Street Journal, August 26, 2022
2. The Wall Street Journal, August 26, 2022
3. The Wall Street Journal, August 26, 2022
4. The Wall Street Journal, August 26, 2022
5. realinvestmentadvice.com/long-term-returns-are-unsustainable