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In this week's recap: Markets react to dim forecast, 2Q reports.

Weekly Economic Update

Presented by Ed Papier, July 25, 2022

THE WEEK ON WALL STREET

Stocks rallied last week as investor spirits lifted thanks to a better-than-expected start to the second-quarter earnings season.

The Dow Jones Industrial Average gained 1.95%, while the Standard & Poor's 500 added 2.55%. The Nasdaq Composite index jumped 3.33% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, advanced 3.54%. [1,2,3]

EARNINGS PROPEL STOCKS

Earnings season kicked off last week, with major banks reporting second-quarter results. While their results were mixed, they appeared to indicate that consumers and businesses remained reasonably healthy–a perspective that helped erase some negative sentiment overhanging the market.

As the week progressed, stocks gained momentum as earnings results poured in from different sectors of the economy, showing that businesses were navigating higher inflation and slowing growth better than investors feared. Technology and other gloomier sectors were among the market's best performers for the week. A few disappointing corporate reports and a weak economic report sent stocks lower to close out a solid week.

CRACKS IN THE FOUNDATION

Data released last week indicated more trouble in the housing market. The latest monthly homebuilder sentiment survey showed the single largest monthly drop in its 37-year history, except for April 2020. The sentiment report preceded a drop in June housing starts and issued building permits. Housing starts declined for the second month, falling 2.0% and surprising economists who had expected an increase. [4,5]

Housing weakness made itself known through a 5.4% month-over-month decline in June's existing home sales, representing the slowest pace since June 2020. Increasing prices and higher mortgage rates demonstrated drags on buyer demand. [6]

THE WEEK AHEAD: KEY ECONOMIC DATA

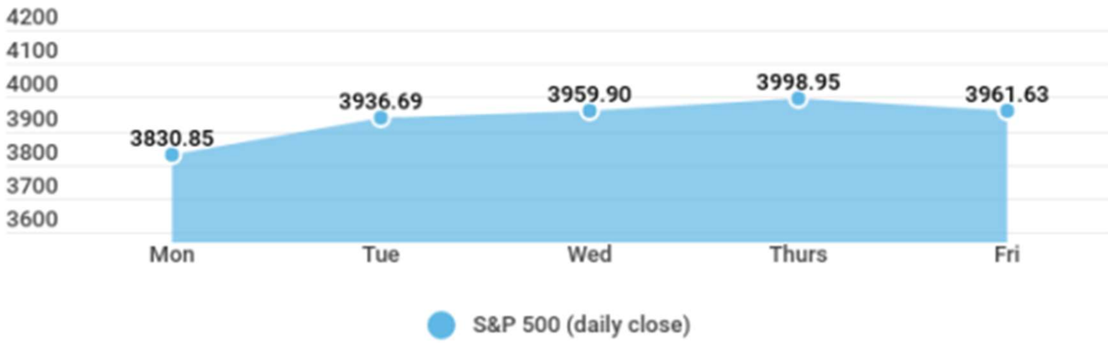
Tuesday: New Home Sales.
Wednesday: FOMC Announcement. Durable Goods Orders.
Thursday: Gross Domestic Product (GDP). Jobless Claims.

QUOTE OF THE WEEK

"The secret of liberty lies in educating people, whereas the secret of tyranny is in keeping them ignorant."

Maximilien Robespierre

Market Index	Close	Week	Y-T-D
DJIA	31,899.29	+1.95%	-12.22%
NASDAQ	11,834.11	+3.33%	-24.36%
MSCI-EAFE	1,881.36	+3.54%	-19.46%
S&P 500	3,961.63	+2.55%	-16.88%



	Treasury	Close	Week	Y-T-D
	10-Year Note	2.77%	-0.16%	+1.25%

Sources: The Wall Street Journal, July 22, 2022; Treasury.gov, July 22, 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, July 15, to Friday, July 22, close. Weekly performance for the MSCI-EAFE is measured from Friday, July 15, open to Thursday, July 21, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

Interest rates represent the price of money, and they are the most important prices in all of capitalism. They have an enormous impact on banks, the real estate market, and the auto industry. It's hard to think of a business that interest rates don't affect in some meaningful way.

Today, we are on the cusp of a rare paradigm shift in interest rates. Such changes take decades—or even generations—to occur. But when they do, the financial implications are profound. Interest rates rise and fall through decades-long cycles. That makes sense, as debt is naturally cyclical. It allows people to consume more than they produce now. But it also forces them to produce more than they consume later to pay it off.

Interest rates last peaked in 1981 at over 15%. Then, they fell for 39 years and bottomed in July 2020 at around 0.62%. The long-term average is 5.6%. Since the bottom in 2020, yields have gone up more than 5x. This reflects a significant shift, and we are now likely at the very beginning of a new, long-term uptrend in interest rates.

Currently the 10-year Treasury is yielding around 3.2%. That's still far below the long-term historical average of approximately 5.6%. It's also not even in the ballpark of the US government's dubious official inflation rate of 8.6%, which is undoubtedly understated. In other words, interest rates have a lot of room to go up.

Remember, interest rates are the price of money. They are the most important prices in all of capitalism. Yet they're controlled by a group of central planners at the Federal Reserve and not set by the market like any other price. It's strange that many people thoughtlessly accept this as "normal." In reality, the Fed is engaged in massive price-fixing, and nobody seems to care.

While the Fed exercises undue influence over interest rates, other significant factors are at play here. And they all point to higher interest rates. Together, they're ushering in a once-in-a-generation shift that is both unstoppable and imminent.

Aside from the Federal Reserve, the US government's federal budget has enormous influence over interest rates. That's because when the government spends more than it brings in from taxes, it issues debt (i.e., Treasuries) to make up the difference. And now that Congress has normalized multi-trillion-dollar federal spending deficits, that means an avalanche of new Treasuries to finance them, but who will buy all this paper?

Historically, there has been a vast foreign appetite for Treasuries. But not anymore. In the wake of Russia's invasion of Ukraine, the US government has launched its most aggressive sanctions campaign ever. As part of this effort, the US government seized the US dollar reserves of the Russian central bank—the accumulated savings of the nation. It was a stunning illustration of the dollar's political risk. The US government can seize another sovereign country's dollar reserves at the flip of a switch.

The Wall Street Journal, in an article titled "If Russian Currency Reserves Aren't Really Money, the World Is in for a Shock," noted: "Sanctions have shown that currency reserves accumulated by central banks can be taken away. With China taking note, this may reshape geopolitics, economic management and even the international role of the U.S. dollar."

China is one of the largest holders of US Treasuries, and it indeed took note of what happened to Russia. It's probably a big reason Beijing cut its Treasury holdings to a 12-year low. Even US allies, like Japan, have also cut their Treasury holdings. There are numerous other examples. But it's clear the world isn't hungry for US debt right now.

The Russia sanctions episode is a reason foreigners and other Treasury holders, may start to question the US' willingness to meet its debt obligations. That would drive demand for higher yields to account for the added risk.

Usually, the Federal Reserve would help the federal government finance its deficits by creating trillions of new currency units to buy Treasuries. But with inflation spiraling out of control and the Fed desperately tightening, it is not in a position to come to the rescue this time.

To summarize, here are the five reasons to expect higher interest rates:

1. Inflation is out of control. Even the government's official inflation statistics—which understate the situation—are far above current interest rates.
2. The federal government must issue a flood of new Treasuries to finance multi-trillion-dollar deficits—which are here to stay.
3. Sanctions are eroding confidence in the US financial system.
4. Foreigners aren't buying as many Treasuries.
5. The Fed is tightening.

When you connect all the dots, it is clear we are starting a new long-term cycle, with rising interest rates and a bear market in bonds. That will have enormous implications for the economy and the stock market. We will likely see incredible volatility in the financial markets as thousands of businesses that had become accustomed to easy money and artificially low interest rates go bankrupt owing to the inability to service their debt at the inevitable higher rates coming our way. [7]

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CITATIONS:

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