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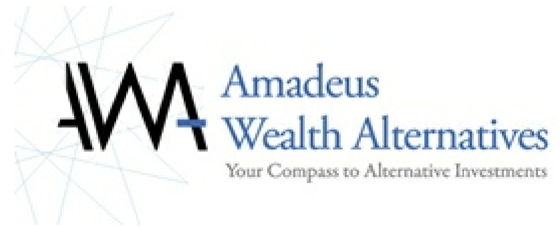

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In this week's recap: Markets overcome reaction to latest Delta variant news.

Weekly Economic Update

Presented by Ed Papier, July 26, 2021

THE WEEK ON WALL STREET

Overcoming a COVID-related economic growth scare, stocks moved higher amid a week of strong corporate earnings reports.

The Dow Jones Industrial Average rose 1.08%, while the Standard & Poor's 500 gained 1.96%. The Nasdaq Composite index soared 2.84% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, dipped 0.20%.[1,2,3]

DELTA VARIANT HEAD FAKE

Stocks staged a broad retreat on Monday as traders worried about the adverse economic implications of growing Delta variant infections. Economically sensitive sectors, such as energy, financials, industrials, and materials, absorbed the brunt of Monday's sell-off.

But the markets did a quick about face, posting four-consecutive days of gains and leaving the three major averages with fresh record highs.[4]

The sharp reversal may be attributable to a "buy on the dip" investor mentality, the absence of investment alternatives to stocks in this low interest rate environment, and massive financial liquidity. Stocks were also lifted by a healthy kick-off to the second quarter earnings season.

STRONG START

The earnings season moved into full swing last week, and the results exceeded the market's high expectations.

Of the 120 companies in the S&P 500 index that have reported as of Friday, July 23, 89% of them beat the Street's earnings-per-share estimates by, on average, 20.6%. Financials and Consumer Discretionary sectors provided the biggest earnings surprises (+28.9% and +24.5%, respectively), while Materials and Utilities delivered the smallest positive surprises (+5.3% and +2.5%,

respectively).

These earnings beats are leading Wall Street analysts to raise earnings estimates for 3Q 2021 through 1Q 2022.[5]

FINAL THOUGHT

The National Bureau of Economic Research said last week that the pandemic-induced recession ended in April 2020, officially lasting two months and making it the shortest recession in U.S. history.[6]

THE WEEK AHEAD: KEY ECONOMIC DATA

Monday: New Home Sales.

Tuesday: Consumer Confidence. Durable Goods Orders.

Wednesday: FOMC (Federal Open Market Committee) Announcement.

Thursday: GDP (Gross Domestic Product). Jobless Claims.

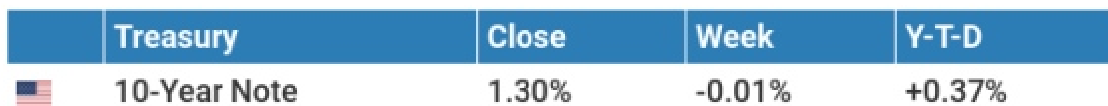
QUOTE OF THE WEEK

"Awareness of ignorance is the beginning of wisdom"

SOCRATES

Market Index	Close	Week	Y-T-D
DJIA	35,061.55	+1.08%	+14.56%
NASDAQ	14,836.99	+2.84%	+15.12%
MSCI-EAFE	2,298.19	-0.20%	+7.02%
S&P 500	4,411.79	+1.96%	+17.46

S&P 500 (daily close)



	Treasury	Close	Week	Y-T-D
	10-Year Note	1.30%	-0.01%	+0.37%

Sources: The Wall Street Journal, July 23, 2021; Treasury.gov, July 23, 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, July 16, to Friday, July 23, close. Weekly performance for the MSCI-EAFE is measured from Friday, July 16, open to Thursday, July 22, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

One of the biggest risks to the world's financial health is the $1.2 quadrillion derivatives market (financial instruments valued according to the changes in price of other financial instruments). The indirect nature of a derivative obligation - the fact that its value is determined by reference to something outside of itself - renders it unusually complex and inherently unstable because it is subject to variables beyond the control of the parties to the contract. They are complex, unregulated, and ought to be of concern to world leaders since their notional value is 20 times the size of the world economy. But traders rule the roost -- and as much as risk managers and regulators might want to limit that risk, they lack the power or knowledge to do so.

A quadrillion is a big number: 1,000 times a trillion. Yet according to one of the world's leading derivatives experts, Paul Wilmott, who holds a doctorate in applied mathematics from Oxford University, $1.2 quadrillion is the so-called notional value of the worldwide derivatives market. To put that in perspective, the world's annual gross domestic product is between $50 trillion and $60 trillion.

To understand the concept of "notional value," it's useful to have an example. Let's say you borrow $1 million to buy an apartment and the interest rate on that loan gets reset every six months. Meanwhile, you turn around and rent that apartment out at a monthly fixed rate. If all your expenses including interest are less than the rent, you make money. But if the interest and expenses get bigger than the rent, you lose.

You might be able to hedge this risk of a spike in interest rates by swapping that variable rate of interest for a fixed one. To do that you'd need to find a counterparty who has an asset with a fixed rate of return who believed that interest rates were going to fall and was willing to swap his fixed rate for your variable one.

The actual cash amount of the interest rates swaps might be 1% of the $1 million debt, while that $1 million is the "notional" amount. Applying that same 1% to the $1.2 quadrillion derivatives market would leave a cash amount of the derivatives market of $12 trillion -- far smaller, but still 20% of the world economy.

How big is the risk to the world economy from these derivatives? According to Wilmott, it's impossible to know unless you understand the details of the derivatives contracts. But since they're unregulated and likely to remain so, it is hard to gauge the risk.

But Wilmott gives an example of an over-the-counter "customized" derivative that could be very risky indeed, and could also put its practitioners in a position of what he called "moral hazard." Suppose Bank 1 (B1) and Bank 2 (B2) decide to hedge against the risk that Bank 3 (B3) and Bank 4 (B4) might fail to repay their debt to B1 and B2. To guard against that, B1 and B2 might hedge the risk through derivatives.

In so doing, B1 and B2 might buy a credit default swap (CDS) on B3 and B4 debt. The CDS would pay B1 and B2 if B3 and B4 failed to repay their loan. B1 and B2 might also bet on the decline in shares of B3 and B4 through a short sale.

At that point, any action that B1 and B2 might take to boost the odds that B3 and B4 might default would increase the value of their derivatives. That possibility might tempt B1 and B2 to take actions that would boost the odds of failure for B3 and B4. This this kind of behavior, in which hedge funds pulled their money out of banks whose stock they were shorting, may have contributed to the failures of Bear Stearns and Lehman Brothers. Derivatives can create in the buyer of protection (the insured) a strong economic incentive to see the borrower fail; in many cases, a default produces the highest possible payout and highest rate of return for the buyer of credit insurance. It's also the sort of conduct that makes it extremely difficult to estimate the risk of the derivatives market.

Moreover, because the volume of credit default swaps can dwarf the amount of a company's outstanding debt, the derivatives market, rather than direct lenders, can determine the fate of a debtor. Accordingly, Wilmott believes derivatives represent a risk of unknown proportions.[7]

Rather than complying with the derivatives regulations imposed under the Dodd-Frank financial reform legislation of 2010, the Wall Street mega banks have moved much of their interest rate derivatives trading to their foreign subsidiaries that fall outside of U.S. regulatory reach. This is known as regulatory arbitrage: seeking the most lightly regulated jurisdiction to ply what many consider to be dangerous trading activity. Consequently, regulators are in an even less tenable position to assess the risks of derivatives. If regulators don't understand the risks in derivatives, chances are great that Congress does not understand them either.[8]

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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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CITATIONS:

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