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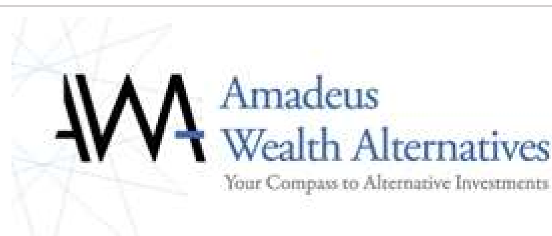

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In this week's recap: Pre-holiday markets see no rebound.

Weekly Economic Update

Presented by Ed Papier, July 4, 2022

THE WEEK ON WALL STREET

Stocks turned lower as a quiet news week offered investors little fresh visibility into the market overhangs of economic slowdown and inflation.

The Dow Jones Industrial Average dipped 1.28%, while the Standard & Poor's 500 fell 2.21%. The Nasdaq Composite index dropped 4.13%. The MSCI EAFE index, which tracks developed overseas stock markets, lost 1.49%. [1,2,3]

REBOUND FIZZLES

Stocks struggled last week amid poor market liquidity typical of the summer months and a news vacuum ahead of the second-quarter earnings reports. Investors also appeared to be anticipating guidance at the July Federal Open Market Committee meeting. What little news there was proved generally disappointing. A steep decline in consumer confidence preceded Fed Chair Powell's acknowledgment that inflation may persist.

Stocks stumbled after a profit warning from a high-end retailer, which highlighted recession risks. The sentiment suffered from a 4.7% increase in the core personal consumption expenditures index, which is the Fed's preferred measure of inflation. It remained near levels not seen since the 1980s. [4]

CONSUMER CONFIDENCE WANES

The Conference Board's Consumer Confidence Index declined to its lowest level since February 2021, falling from 103.2 in May to 98.7 in June (1985=100). While consumers' assessment of current conditions slipped only marginally, their short-term outlook for income, business, and labor market conditions eroded substantially, touching its lowest level since March 2013. [5]

This rising pessimism about the short-term outlook was especially notable in consumers' assessment of financial prospects, with 15.9% expecting their incomes to increase (down from 17.9% in May) and a growing share of individuals expecting their incomes to decrease (15.2% in June vs. 14.5% in May). [6]

THE WEEK AHEAD: KEY ECONOMIC DATA

Tuesday: Factory Orders.

Wednesday: Federal Open Market Committee (FOMC) Meeting Minutes. Job Openings and Labor Turnover Survey (JOLTS). Institute for Supply Management (ISM) Services Index.

Thursday: Automated Data Processing (ADP) Employment Report. Jobless Claims.

Friday: Employment Situation.

QUOTE OF THE WEEK

"That, maybe, is the one and only thing that can guarantee us of a good outcome of the entire process — which is a necessary process, I think. This crisis is not meaningless.

It's not meaningless. It's a process in which society can give birth to something new, something much better than exists up until now."

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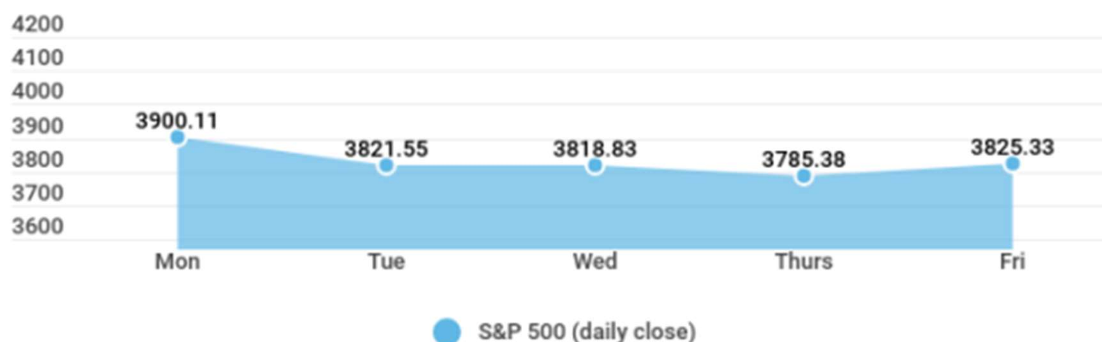
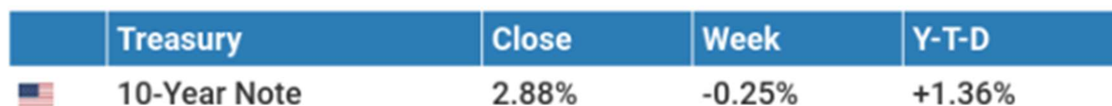
Market Index	Close	Week	Y-T-D
DJIA	31,097.26	-1.28%	-14.42%
NASDAQ	11,127.85	-4.13%	-28.87%
MSCI-EAFE	1,846.28	-1.49%	-20.97%
S&P 500	3,825.33	-2.21%	-19.74%





	Treasury	Close	Week	Y-T-D
	10-Year Note	2.88%	-0.25%	+1.36%

Sources: The Wall Street Journal, July 1, 2022; Treasury.gov, July 1, 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, June 24, to Friday, July 1, close. Weekly performance for the MSCI-EAFE is measured from Friday, June 24, open to Thursday, June 30, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

In late November 2008, then Federal Reserve Chairman Ben Bernanke committed a *fait accompli* . Bernanke, a Great Depression history buff of the highest academic pedigree, gazed back 80-years, observed several credit market parallels, and then made a preconceived diagnosis. He picked up his desktop copy of *A Monetary History of the United States* , by Milton Friedman and Anna Schwartz, turned to the chapter on the Great Depression, and got to work inflating the money supply.

Bernanke first let the quantitative easing (QE) genie out of the bottle with the purchase of $600 billion in mortgage-backed securities and Treasury notes. He bought them with digital monetary credits created out of thin air. By March 2009, Bernanke had run up the Fed's balance sheet from $900 billion

to $1.75 trillion. Then, over the next five years, he ballooned it out to $4.5 trillion. All the while believing he was preventing the Great Depression Part Deux.

Did it never occur to Bernanke he was merely postposing a much-needed financial liquidation and rebalancing? Or that his actions were further distorting the economy and setting it up for an even greater bust? When the day came to straighten things out Bernanke was gone. Janet Yellen, now Treasury Secretary, was tasked with contracting the Fed's $4.5 trillion balance sheet eight years after the Great Recession officially ended.

Jamie Dimon, CEO of JPMorgan Chase & Company, advised caution at the time. Speaking at a conference in Paris on Tuesday, July 11, 2017, Dimon remarked:

"We've never had QE like this before, we've never had unwinding like this before. Obviously, that should say something to you about the risk that might mean, because we've never lived with it before…When quantitative tightening (QT) happens of size or substance, it could be a little more disruptive than people think. We act like we know exactly how it's going to happen, and we don't."

On Wednesday, September 20, 2017, as the Fed was gearing up for QT, Fed Chair Janet Yellen attempted to clarify how the Fed was going to go about it. Following the two-day FOMC meeting, the Fed issued its customary statement. Therein, it mentioned that balance sheet normalization would be initiated in October of that year. The referenced implementation note outlined how the Fed would contract its balance sheet:

"Effective in October 2017, the Committee directs the [Open Market] Desk to roll over at auction the amount of principal payments from the Federal Reserve's holdings of Treasury securities maturing during each calendar month that exceeds $6 billion, and to reinvest in agency mortgage-backed securities the amount of principal payments from the Federal Reserve's holdings of agency debt and agency mortgage-backed securities received during each calendar month that exceeds $4 billion."

Moreover, the Fed identified plans to increase this initial $10 billion balance sheet contraction every three months by increments of $10 billion until they reach $50 billion per month. Then it planned to let it ride until back to normal; though, it was never clear what normal was.

Using a back of the napkin calculation, starting with the initial October 2017 $10 billion reduction then incrementally increasing the reduction by $10 billion each quarter until hitting $50 billion per month, and then contracting by $50 billion a month from there, it would have taken 78-months for the Fed to get its balance sheet back to $900 billion (i.e. roughly where it was before Bernanke's *fait accompli*). Thus, in March 2024, monetary policy would have been back to normal. That was the master plan, at least. But the master plan was an epic failure.

QT was abruptly terminated and reversed in September 2019 – after just 24 months – with the Fed's balance sheet at $3.7 trillion. Initially, the Fed's reversal was triggered to provide the liquidity needed to cover repo-madness.

If you recall, sometime between the night of September 16 and the morning of September 17, 2019, the overnight repurchase agreement (repo) rate hit 10 percent. Short-term liquidity markets essentially broke. Before long, the Fed was supplying hundreds of billion in credit every night to keep credit markets flowing.

Soon after, this was grossly overwhelmed by the coronavirus panic. The Fed subsequently expanded its balance sheet by $5 trillion. A good part of this took place between March and June 2020. By the end of May 2022, the Fed's balance sheet was over $8.9 trillion. And consumer price inflation was at a 40-year high.

This painful account was provided for several reasons. First, to point out that the world does not operate according to the plans and contrivances of central planners. Second, to provide context for what the Fed says it is doing and what will actually happen.

On June 1, 2022, the Jay Powell Chaired Fed initiated QT Part Deux. The master plan this time around was for the Fed to reduce its holdings of Treasury notes and mortgage-backed securities by a combined $47.5 billion per month for the first three months. By September, the total amount to be reduced will go up to $95 billion a month.

According to the Wells Fargo Investment Institute's calculations, the Fed's balance sheet could shrink by almost $1.5 trillion by the end of 2023, taking it down to around $7.5 trillion. What are the odds the Fed contracts its balance sheet to $7.5 trillion by the end of 2023? We'll bet dollars to doughnuts this never happens.

Fed normalization policies are doomed to fail. To put things in perspective, it took 24 months for the Fed to reduce its balance sheet by $800 billion between October 2017 and September 2019 (in the wake of a $3.5 trillion expansion). And this QT program was abruptly ended in repo-madness.

Now it plans to extinguish nearly double the 'assets' in 19 months. Something's bound to break. You can damn near count on it. We know how QT ends. At the very least, interest rates will rise. Asset prices – like bonds, stocks, and real estate – will fall. Credit will contract, yanking the thin rug the economy's resting upon right out from under it. GDP will decrease. Unemployment will increase in the face of declining labor participation. Numerous cities and several states will go bankrupt. California will dry up and slide into the Pacific Ocean. And once again, the Fed will abruptly reverse course…and systematically debase your money, your time, and your life. [7]

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