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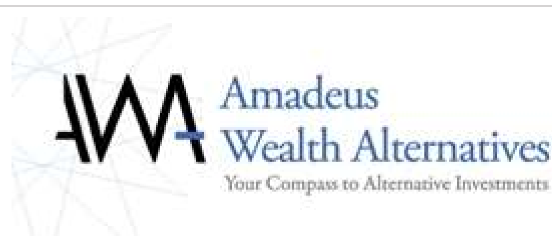

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In this week's recap: The Fed signals interest rate hikes.

Weekly Economic Update

Presented by Ed Papier, June 21, 2021

THE WEEK ON WALL STREET

New messaging from the Federal Reserve on interest rates and inflation last week led to a broad retreat in stock prices.

The Dow Jones Industrial Average dropped 3.45% while the Standard & Poor's 500 lost 1.91%. The Nasdaq Composite index slipped 0.28% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, fell 0.64%. [1,2,3]

UNSETTLED MARKETS

The Federal Reserve's announcement on Wednesday that interest rate hikes may likely occur sooner than expected and that it had underestimated the pace of inflation unsettled investors. The hardest hit groups were cyclical stocks, like energy, materials, and industrials, as well as financials and consumer staples. [4]

Losses accelerated into the week's close on comments by St. Louis Fed President James Bullard that the first rate hike could be as soon as 2022.

The bond yield curve flattened, as short-term interest rates rose in anticipation of rising rates and longer-term rates declined, reflecting a view of an eventual economic slowdown.

THE FED'S SURPRISE

Last week's FOMC meeting announcement took investors by surprise as the Fed indicated that two rate hikes in 2023 were likely. It was as recent as March that the Fed had signaled that rates would remain unchanged until 2024. [4]

The Fed also raised its inflation expectations to 3.4%, up from its March projection of 2.4%, though it continues to believe that price increases will be transitory in nature. [5]

The Fed provided no indication of when and by how much it might begin tapering its monthly bond purchase program. [6]

THE WEEK AHEAD: KEY ECONOMIC DATA

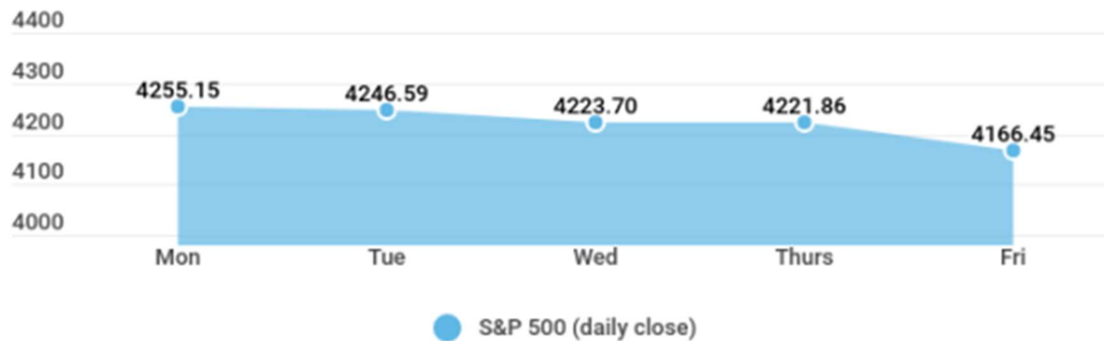
Tuesday: Existing Home Sales.
Wednesday: PMI (Purchasing Managers Index) Composite Flash. New Home Sales.
Thursday: GDP (Gross Domestic Product). Durable Goods Orders. Jobless Claims.
Friday: Consumer Sentiment.

QUOTE OF THE WEEK

"Everything that irritates us about others can lead us to an understanding of ourselves"

CARL JUNG

Market Index	Close	Week	Y-T-D
DJIA	33,290.08	-3.45%	+8.77%
NASDAQ	14,030.38	-0.28%	+8.86%
MSCI-EAFE	2,350.34	-0.64%	+9.44%
S&P 500	4,166.45	-1.91%	+10.93%



S&P 500 (daily close)

	Treasury	Close	Week	Y-T-D
	10-Year Note	1.44%	-0.03%	+0.51%

Sources: The Wall Street Journal, June 18, 2021; Treasury.gov, June 18, 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, June 11, to Friday, June 18, close. Weekly performance for the MSCI-EAFE is measured from Friday, June 11, open to Thursday, June 17, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

Just like in 2000, proponents claim "this time it's different." Back then, the claim was that since the Internet would be growing for decades, dot-com stocks could go to the moon and beyond. The claim the Internet would continue growing was sound, but the prediction that this growth would drive stock valuations into a never-ending bubble was unsound. Once again, we hear reasonable-sounding claims being used to support predictions of a never-ending rise in stock valuations.

Despite all the assurances to the contrary, all bubbles pop because they are based on human emotions. We attempt to rationalize them by invoking the real world, but the reality is speculative manias are manifestations of human emotions and the feedback of running in a herd of social animals.

In the "Glorious Thirty" years of the postwar era of broad-based prosperity, financial assets as a percentage of Gross Domestic Product (GDP) were around 3 times GDP. This ratio increased with every one of the three bubbles since the mid-1990s: the dot-com bubble in 1999-2000 (Fed Bubble #1) , the subprime bubble in 2007-08 (Fed Bubble #2) and now the Everything Bubble of 2020-21 (Fed Bubble #3). Financial assets are now 6 times the size of the "real economy" (GDP), an extreme beyond all previous extremes. This observation reflects the dominance of financial assets based on extreme expansions of debt, leverage and speculation.

The chart of S&P 500 stocks above their 200-day moving average has been pegged to the upper boundary for weeks, far longer than the extremes reached in previous manias. The red warning light of extremes in sentiment, valuation, etc. can flash for quite some time, but as noted over the years, speculative bubbles often display symmetry: those that spike higher tend to collapse in a mirror-image of the manic rise. This symmetry isn't perfect, of course, just as correlations are rarely if ever perfect, but as a generality, bubbles tend to display symmetry as manic greed slips into doubt and then cascades into panic.

There are seven factors to keep in mind that may intensify reversals and risks:

1) The dominance of ETFs (exchange-traded funds) and index funds. As money pours into these passive funds, the funds buy whatever stocks are in the ETF or index. Good, bad and indifferent stocks in each ETF or index are purchased without any assessment of their relative value. When owners sell, the process is reversed: every stock in the ETF or index is automatically sold to fund the redemption. This leads to "the baby being thrown out with the bathwater" as the best performing companies get sold off with the dregs in the ETF or index.

2) The reliance of bubbles on borrowed money (margin debt) and leverage: 2X and 3X leveraged ETFs and a variety of financialization tricks to increase leverage and thus gains. When assets that have been leveraged reverse even modestly, the losses are quickly consequential, and the "solution" is to liquidate every leveraged asset before the position is wiped out. Selling begets selling, and this is the self-reinforcing feedback of crashes.

3) The decline of short interest to all-time lows. Put another way, the number of speculators who have an incentive to buy shares in a decline is near all-time lows, so the only buyers in a real decline will be "buy the dip" players who will soon be wiped out if the decline continues.

4) The narrowing of the speculative universe into a few assets. This factor creates an extreme dependency on the few rocketships to keep soaring lest the entire ETF / index fund world collapse.

5) The potential for the Covid varients to spread globally beyond current expectations. Such an expansion could trigger a global slowdown / recession.

6) Fiscal and monetary stimulus suffer from diminishing returns and declining money velocity suggests returns can fall off a cliff.

7) The dominance of algorithm-driven trading (*algos, trading bots, etc.*), which appear to be mostly programmed to be momentum / trend-following. If these programs are withdrawn to avoid high volatility, the liquidity the market depends on to maintain stability may dry up, increasing the odds of the market going bidless, i.e. buyers vanish and prices crash.

When the warning light is flashing red, it's prudent to have a capital preservation strategy in place. [7]

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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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2. The Wall Street Journal, June 18, 2021
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