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In this week's recap: The White House signs COVID-19 fiscal relief bill into law; the economy reacted positively.

Weekly Economic Update

Presented by Ed Papier, March 15, 2021

THE WEEK ON WALL STREET

Stocks touched new record highs last week as bond yields steadied, a fiscal relief bill was signed into law, and confidence in a strong economic recovery grew.

The Dow Jones Industrial Average gained 4.07%, while the Standard & Poor's 500 tacked on 2.64%. The Nasdaq Composite index rose 3.09% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, gained 3.01%.[1,2,3]

DOW 32,000

Stocks marched higher as bond yields leveled off and the $1.9 trillion stimulus bill moved through the legislative process. A muted inflation number and a better-than-expected jobless claims report evidenced an improving economy absent an attendant rise in inflation.[4]

The technology sector was particularly volatile, with the NASDAQ Composite falling into correction territory to start the week as investors rotated into cyclical opportunities.

Technology rebounded strongly as bond yields stabilized and bargain hunters purchased tech names at reduced prices. The bounceback propelled the S&P 500 to a record high, while the reopening trade drove the Dow Industrials above 32,000 for the first time.[5,6]

The week ended on a mixed note, with the Dow and S&P 500 adding to their record closes and the NASDAQ Composite trimming its weekly gain.

TREASURY AUCTIONS

Treasury auctions to finance federal spending are usually staid affairs, but investor trepidation was high ahead of last week's auctions of 10-year and 30-year Treasuries. Investors were concerned that lukewarm demand amid a huge supply had the potential to drive yields higher and take the pressure on stock prices lower.

As it turned out, Wednesday's auction of 10-year Notes was received with adequate demand, helped by a tame February inflation number and strong overseas interest. The following day's 30-year auction also went relatively smoothly, though the auction yield was 36.2 basis points higher than last month's auction. Despite $120 billion of federal debt issuance last week, yields steadied, easing investors' interest rate concerns for the moment.[7]

THE WEEK AHEAD: KEY ECONOMIC DATA

Tuesday: Retail Sales. Industrial Production.

Wednesday: Housing Starts. Federal Open Market Committee (FOMC) Meeting Announcement.

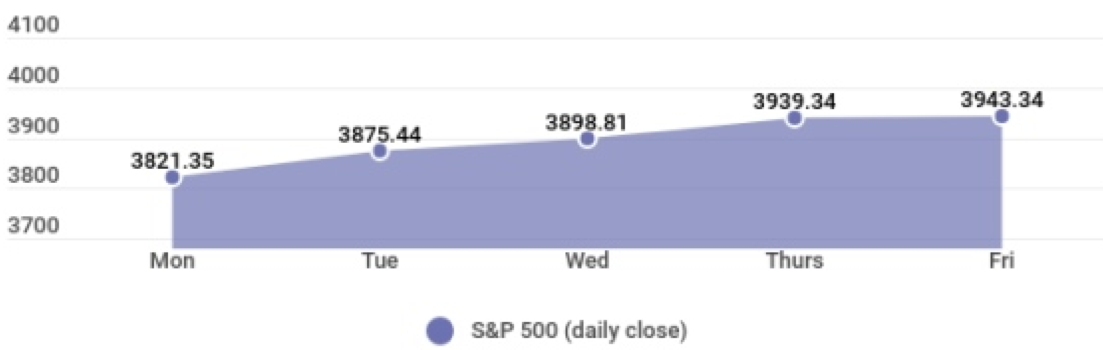
Thursday: Jobless Claims. Index of Leading Economic Indicators.

QUOTE OF THE WEEK

"Unless someone like you cares a whole awful lot. Nothing is going to get better. It's not."

Dr. SEUSS

Market Index	Close	Week	Y-T-D
DJIA	32,778.64	+4.07%	+7.10%
NASDAQ	13,319.86	+3.09%	+3.35%
MSCI-EAFE	2,220.46	+3.01%	+3.40%
S&P 500	3,943.34	+2.64%	+4.99%



	Treasury	Close	Week	Y-T-D
	10-Year Note	1.64%	+0.8%	+0.71%

Sources: The Wall Street Journal, March 12, 2021; Treasury.gov, March 12, 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, March 5, to Friday, March 12, close. Weekly performance for the MSCI-EAFE is measured from Friday, March 5, open to Thursday, March 11, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

There has been a rising concern as of late about surging inflation as the Government injects more stimulus into the economy. While it seems logical, the reality will be quite different as weak economic growth rates force the Fed to monetize the entirety of future debt issuances. Debt monetization is the practice of a government borrowing money from the central bank, which, in the process of buying the debt, creates new money. It is one of the practices often informally referred to as 'printing money'. This practice allows a government to finance its deficit without creating money directly—which is prohibited in many countries—and also without increasing debt to private parties. Generally considered dangerous because it risks creating runaway inflation, various forms of debt monetization have occurred as part of national responses to the Covid-19 pandemic and other crises over the past decade.

The Federal Reserve is well aware of the problem with debt monetization and explains why they have been quick to reduce rates and increase bond purchases. Such is the case because higher rates spread through the economy like a virus, a "rate virus". In an economy that requires $5 of debt to create $1 of economic growth, changes to interest rates have an immediate impact on consumption and growth.

- An increase in rates curtails growth as it slows consumption.
- As of October, the Fed had $7.02 trillion in liabilities and $39.2 billion in capital. A sharp rise in rates will dramatically impair their balance sheet.
- Rising interest rates will immediately slow the housing market. People buy payments, not houses, and rising rates mean higher payments.
- An increase in rates means higher borrowing costs and lower profit margins for corporations.
- Stock valuations have been elevated due to low rates. Higher rates exacerbate the valuation problem for equities.
- The negative impact on the massive derivatives market could lead to another credit crisis as rate-spread derivatives go bust.
- As rates increase, so do the variable rate interest payments on credit cards. With the consumer already impacted by stagnant wages, under-employment, and high living costs, a rise in debt payments would further curtail disposable incomes.
- Rising defaults on debt service will negatively impact banks that are still not adequately capitalized and still burdened by massive bad debt levels.
- The deficit/GDP ratio will surge as borrowing costs rise sharply.

In an economy supported by debt, rates must remain low. Therefore, the Federal Reserve has no choice but to monetize as much debt issuance as is needed to keep rates from substantially rising. Unfortunately, higher levels of debt continue to retard economic growth keeping the Fed trapped in a debt cycle as hopes of "growth" remain elusive. The current 5-year average inflation-adjusted growth rate is just 1.64%, a far cry from the 4.79% real growth rate in the '80s.

It is hard to overstate the degree to which psychology drives an economy's shift to deflation. When the prevailing economic mood in a nation changes from optimism to pessimism, participants change. Creditors, debtors, investors, producers, and consumers all change their primary orientation from expansion to conservation.

These behaviors reduce the velocity of money, which puts downward pressure on prices. Recall the velocity of money is important for measuring the rate at which money in circulation is used for purchasing goods and services. Velocity is useful in gauging the health and vitality of the economy. High money velocity is usually associated with a healthy, expanding economy. Low money velocity is usually associated with recessions and contractions. In each monetary policy intervention, the velocity of money has slowed along with the breadth and strength of economic activity. Money velocity has already been slowing for years, a classic warning sign that deflation is impending. Now, thanks to the virus-related lockdowns, money velocity has begun to collapse. As widespread pessimism takes hold, expect it to fall even further.

While the Federal Reserve keeps wanting higher inflation rates, which should correspond with economic growth, its policy actions continue to work to the contrary. In theory, their actions should lead to higher inflation as low rates spur consumption and investment. However, a signature characteristic of a "liquidity trap" is when injections of cash into the private banking system by a central bank fail to stimulate economic growth. A liquidity trap occurs when people hoard cash because they expect adverse events. Signature characteristics of a liquidity trap are short-term interest rates remain near zero.

The Federal Reserve has no real options unless they are willing to allow the system to reset painfully. Unfortunately, given we now have a decade of experience of watching monetary experiments only succeed in creating a massive "wealth gap," maybe we should consider an alternative. Ultimately, the Federal Reserve and the Administration will have to face hard choices to extricate the economy from the current "liquidity trap". However, history shows that political leadership never makes hard choices until those choices get forced upon them. We continue to "hope" we can grow our way out of our debt problem, but "hope" has never been a functional strategy for fixing problems.[8]

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Please feel free to send us their contact information via phone or email. (Don't worry – we'll request their permission before adding them to our mailing list.)

CITATIONS:

1. The Wall Street Journal, March 12, 2021
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