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*In this week's recap: Weakness in tech and high-growth stocks leads to a rocky week;
Yellen and Powell signal optimism.*

Weekly Economic Update

Presented by Ed Papier, March 29, 2021

THE WEEK ON WALL STREET

A rocky week with wide price swings led to mixed results for stocks last week, as investors grappled with anxieties over economic growth and weakness in technology and other high-growth stocks. The Dow Jones Industrial Average added 1.36%, while the Standard & Poor's 500 gained 1.57%. The Nasdaq Composite index fell 0.58% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, slipped 1.67%. ^{1,2,3}

STOCKS CHURN

After a promising start to the week, stocks turned negative on mounting concerns about economic growth in Europe, with broad losses in energy, cyclicals, and technology.

Though bond yields backed off their highs and Secretary of the Treasury Janet Yellen and Fed Chair Jerome Powell both struck an optimistic tone on the economy, stocks posted back-to-back losses on Tuesday and Wednesday.

Thursday trading was emblematic of the week's volatile action. The S&P 500 dropped nearly one percent earlier in the day following Powell's comment about the Fed eventually rolling back its bond purchase program, then rallied to close with a 0.5% gain. ⁴

Stocks rallied into the Friday close, pushing the Dow and S&P 500 into positive territory and paring the losses on the Nasdaq Composite.

TECH REMAINS UNDER PRESSURE

The losses in technology and other high-growth stocks in recent weeks have largely been attributed to the sharp and rapid rise in bond yields.

So, it was both interesting and a bit confounding that last week saw yields pull back, and rather than helping support these companies' stock prices, many technology stocks continued to decline. The failure to rally on lower yields may be pointing to other reasons for their price weakness. Some are concerned about current prices, and believe there may be better growth opportunities in more fairly-valued companies. The "fear of missing out" that propelled investors to pile into these stocks over the last twelve months appears to have moderated.

THE WEEK AHEAD: KEY ECONOMIC DATA

Tuesday: Consumer Confidence.

Wednesday: ADP (Automated Data Processing) Employment Report.

Thursday: Jobless Claims. ISM (Institute for Supply Management) Manufacturing Index.

Friday: Employment Situation Report.

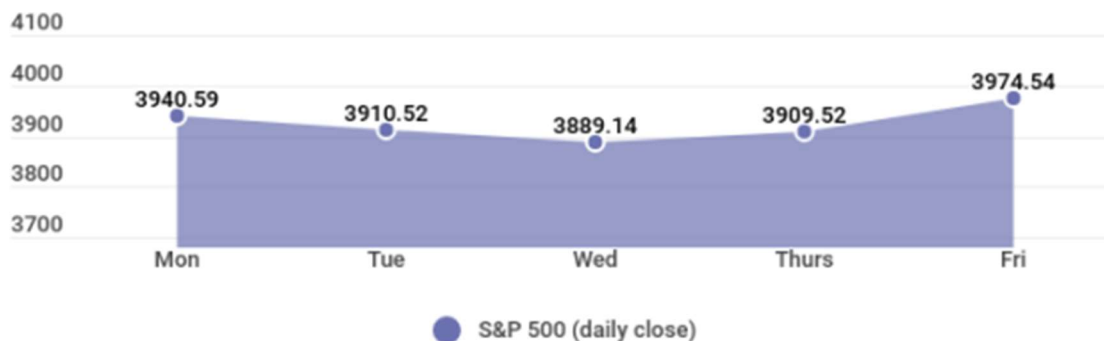
QUOTE OF THE WEEK



"Here in America, we are descended in blood and in spirit from revolutionists and rebels – men and women who dare to dissent from accepted doctrine. As their heirs, may we never confuse honest dissent with disloyal subversion."

DWIGHT D. EISENHOWER

| Market Index | Close | Week | Y-T-D |
|--------------|-----------|--------|--------|
| DJIA | 33,072.88 | +1.36% | +8.06% |
| NASDAQ | 13,138.72 | -0.58% | +1.94% |
| MSCI-EAFE | 2,194.08 | -1.67% | +2.17% |
| S&P 500 | 3,974.54 | +1.57% | +5.82% |



| | Treasury | Close | Week | Y-T-D |
|--|--------------|-------|--------|--------|
| | 10-Year Note | 1.67% | -0.07% | +0.74% |

Sources: The Wall Street Journal, March 26, 2021; Treasury.gov, March 26, 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 19, to Friday, March 26, close. Weekly performance for the MSCI-EAFE is measured from Friday, March 19, open to Thursday, March 25, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

Central banks have artificially depressed sovereign bond yields for years. Now, a small rise in yields can cause a massive market slump that evolves into a financial crisis.

Quantitative easing was designed as a tool to provide liquidity to a scared market and benefit from exceptionally attractive valuations of the lowest-risk assets, sovereign bonds. Central banks would cut rates and purchase these high-quality, low-risk assets from banks, thus allowing financial entities to lend more to businesses and families and strengthen confidence in the economy. Once financial conditions improved, central banks would reduce their balance sheet and normalize policy. This result never happened.

Central banks started purchasing sovereign bonds at rock-bottom valuations and continued buying them when they went from being underpriced to massively overpriced, regardless of the state of the economy, maintaining purchases in growth periods. This led to the European Central Bank purchasing sovereign bonds even when government bonds were enjoying negative real and nominal yields in their issuances. Bond yields became so low that the gap between bond prices and the reality of risk and solvency of the issuer widened to extreme levels. Southern Europe sovereign bonds "traded" at all-time high prices and historic-low yields despite worsening deficits and weaker economic conditions.

The Federal Reserve did the same. Throughout the growth periods, Yellen and Powell continued with aggressive asset purchases and low rates, bringing the 10-year sovereign bond yield to an abnormal level for a growing or recovering economy.

What happens when the central bank makes the highest-quality and lowest-risk asset extremely expensive? Since the perception of risk becomes clouded, savers take more and more risk for lower yields in other assets, driving investors to take too much risk in equities and other bonds because the central bank is manipulating the most important risk signal: rates.

Interest rates are the price of risk. Eternally and artificially depressed rates create bubbles and the roots of the next crisis.

Central banks tell us that rates are low because the market demands them. However, they will not allow rates to float freely and when bond yields rise with a mild bounce in inflation expectations, central banks immediately step up purchases and manipulate the yield curve, which shows that such excuse is a fallacy.

A mild increase of US 10-year bond yields to 2%, a more than logical move considering inflation expectations and the recovery of the economy, may cause a financial crisis not because of this modest rise, but because of the massive level of risk built in the economy from the prior artificial depression of those yields. A small bounce in yields would simply collapse the massive deck of cards of risk built into the economy when rates were manipulated down at any cost.

What mainstream economists call a "rate tantrum", where rates go up and markets go down as investors unwind "risk-on" bets, is in reality a "rate hangover", waking up from a binge drinking fest of disproportionately low rates for too long. The worst is that rates are so abnormally low anyway and risky bets so high that even a set of dovish messages from central banks cannot prevent a correction.

Why? A 2% yield in the US 10-year bond would generate a massive outflow of capital from emerging markets, driving their bond yields to unsustainable levels because in the past years these economies have been accustomed to believing that twin deficits and massive imbalances are the way to go.

This outflow would not just happen in emerging markets. The riskiest assets, high yield bonds and cyclical equities, as well as those sectors that benefitted the most from low rates and high liquidity, technology, would suffer together. This reaction would make it impossible to hide from an abrupt market correction because the correlation built in the past ten years is simply too high. Falling tech stocks will be accompanied by falling value stocks.

More worrisome is that most consensus comments are that central banks should accelerate financial repression to avoid a market slump. Instead of paying attention to the risks built in the past decade due to abnormal rates and bond valuations, instead of raising the alarm on the numerous bubbles we can see in markets, many pundits are actually asking central banks to inflate the bubble further at any cost.

However, this time it may not work because inflation is actually rising, and rates could rise even with central bank dovish policies and financial repression. There is no problem with a 2% US 10-year bond yield in normal conditions of a growing economy with 2% inflation. There are a lot of problems when entire markets have based their valuations on inflationary policies. The risk of a financial crisis does not come from rising bond yields. The risk of a financial crisis was created by lowering bond yields to unrealistic and unjustifiable levels in the first place. ⁵

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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:

1. The Wall Street Journal, March 26, 2021
2. The Wall Street Journal, March 26, 2021
3. The Wall Street Journal, March 26, 2021
4. CNBC, March 25, 2021
5. [zerohedge.com/markets/how-small-rise-bond-yields-may-create-financial-crisis](https://www.zerohedge.com/markets/how-small-rise-bond-yields-may-create-financial-crisis)