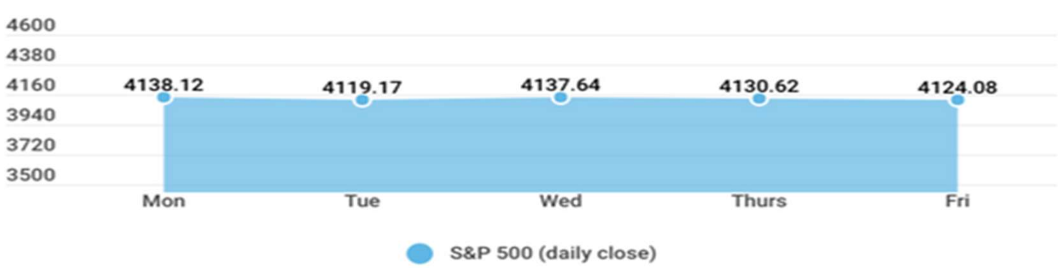
Weekly Economic Update May 15, 2023

Stocks were mixed last week as good inflation news was offset by mounting debt ceiling concerns and rekindled regional banking fears.

The Dow Jones Industrial Average lost 1.11%, while the Standard & Poor's 500 slipped 0.29%. The Nasdaq Composite index rose 0.40% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, fell 0.67%.[1,2,3]

Market Index	Close	Week	Y-T-D
DJIA	33,300.62	-1.11%	+0.46%
NASDAQ	12,284.74	+0.40%	+17.37%
MSCI-EAFE	2,130.19	-0.67%	+9.58%
S&P 500	4,124.08	-0.29%	+7.41%



	Treasury	Close	Week	Y-T-D
	10-Year Note	3.47%	+0.03%	-0.41%

Sources: The Wall Street Journal, May 12, 2023; Treasury.gov, May 12, 2023
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, May 5, to Friday, May 12 close. Weekly performance for the MSCI-EAFE is measured from Friday, May 5, open to Thursday, May 11 close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

Uncertainty Weighs on Stocks

The week got off to a quiet start as investors waited on April's two key inflation reports scheduled for release on Wednesday and Thursday. When consumer prices rose less than forecasted, stocks broke out of their lethargy and moved higher. Stocks also got a boost on Wednesday afternoon from comments from the White House, hinting at an opening for negotiation on the debt ceiling.

Despite a substantial cooling in producer price increases, stocks turned mixed on Thursday amid a disappointing earnings report from a Dow Industrial component and new data that reignited investor anxiety over regional banks' financial health. Stocks ended the week the way they began, largely drifting in an otherwise directionless fashion.

Inflation Pressures Ease

Consumer prices rose 4.9% year-over-year, the tenth consecutive month that the headline inflation rate has declined. This was a slight improvement over March's 12-month increase of 5.0%. April's monthly inflation rate was 0.4 percent, above March's 0.1 percent rise. April's increase was driven by higher housing, gasoline, and used car costs.[4]

Inflation progress extended into wholesale prices, which rose 0.2% in April–below the consensus forecast of a 0.3% rise. For the last twelve months, producer prices increased 2.3%, an improvement from last month's 2.7% year-over-year gain and the lowest recording since January 2021.[5]

This Week: Key Economic Data

Tuesday: Retail Sales. Industrial Production.

Wednesday: Housing Starts.

Thursday: Existing Home Sales. Index of Leading Economic Indicators. Jobless Claims.

"Much of the social history of the Western world, over the past three decades, has been a history of replacing what worked with what sounded good."

– Thomas Sowell

Of Note

The US economy and its financial system operate under the implicit belief that the Federal Reserve controls the direction of the economy and finance. This belief isn't in Fed influence, it's in Fed control: that the Fed can reverse a stock market decline on a dime, it can reverse a recession, it can do "whatever it takes" to keep markets stable and expansive.

The history of the past 30 years seems to support this belief. Every time a financial crisis has manifested, the Fed has "saved the day" with some new policy extreme, changing the rules, jacking up its balance sheet 10-fold, and so on.

The flaw in this confidence in Fed control is the three speculative bubbles that have inflated and burst in the era of Fed Control, 1995 to the present. These bubbles could not have inflated without a "dovish" Fed pushing interest rates down and juicing the financial system with liquidity / credit. Since all speculative bubbles eventually burst, the Fed is forced into "rescue mode" which requires ever more extreme manipulation, rather, intervention, to stabilize the bubble bursting and inflate the next bubble.

What few entertain as a possibility is the Fed is losing control of the economy and finance for systemic reasons that have nothing to do with Fed Policy per se. In other words, it's not a "Fed policy error" that brings the system down, it's much larger forces: diminishing returns and second order effects.

The immediate effect of new Fed policy extremes is strong, much like a new drug has an immediate effect. But as the drug is injected again and again, it loses its efficacy. In medicine this is a biological process; in finance, it's a psychological process as participants habituate to every new Fed policy extreme and count on its 1) permanence and 2) continued efficacy.

For example, the Fed's trick of lowering bond yields / interest rates. Participants can confidently increase their exposure to risk to insane levels and dispense with hedges because they're confident the Fed will drop interest rates back to zero if the stock market falters.

This confidence in the efficacy of Fed policies can be understood as a buffer, providing resilience and a backstop ("the Fed Put") to any financial / economic instability. Participants stop panicking the moment the Fed announces a new dovish policy, even if the policy has limited effect on real-world conditions. The decline of real-world efficacy is masked by the instant euphoria of participants, who have come to count on the Fed's actions resolving crises literally overnight.

The decay of diminishing returns occurs under the radar. Few understand all the Fed's actions (reverse repos, etc.) or the scale of these operations, or their efficacy in terms of correcting dis-equilibrium / instabilities in the real-world economy and markets.

While participants continue to believe these buffers will always protect the system from hazard, the buffers have eroded. The next Fed "save" fails, revealing the buffers have collapsed. Put another way, the Fed has lost control.

Every new Fed policy extreme generates second order effects which unleash unintended consequences. The prime example is moral hazard, the belief that risk can be taken on to boost speculative gains without suffering any consequences of that risk blowing up.

Since participants believe the Fed will slash interest rates back to zero as soon as markets swoon, they increase their gambles based on that confidence. Any debt taken on today can be rolled over into lower rates in the future, so there's no limit on risk or credit expansion. The riskiest possible expansions of credit--to fund stock buybacks, acquisitions of competitors, etc.--are greenlighted based on the confidence that the Fed will always push interest rates back toward zero as soon as conditions wobble.

This confidence sets up a feedback loop in which Fed policies push participants to extremes of risk and debt that guarantee speculative bubbles inflate and then burst, demanding fresh Fed policy extremes. In other words, the Fed has created a doom-loop in which the most insane risk is transformed into a "safe bet" based on the expectation of a Fed "save."

But what if the Fed is unable to push policies to new extremes due to systemic constraints? What if policies that worked like magic before no longer work this time around due to diminishing returns / collapse of buffers?

What if the Fed cannot reverse the doom-loop of second order effects its previous policy extremes have generated? These outcomes don't seem farfetched to anyone who studies systems dynamics. Rather, they seem inevitable and predictable.

What if the Fed has already lost control but nobody dares question the confidence in Fed omnipotence? It's not the Fed policy extremes that work the magic, after all; it's the confidence of participants that resolves the bubble bursting crisis.

Those who look at systems dynamics have solid reasons for seeing this third massive Everything Bubble as the last bubble. When this bubble bursts, there will be no fourth or fifth bubble, there will only be rubble.[6]

Footnotes and Sources

1. The Wall Street Journal, May 12, 2023
2. The Wall Street Journal, May 12, 2023
3. The Wall Street Journal, May 12, 2023
4. The Wall Street Journal, May 10, 2023.
5. CNBC, May 11, 2023
6. zerohedge.com/markets/what-if-fed-has-lost-control

Investing involves risks, and investment decisions should be based on your own goals, time horizon, and tolerance for risk. The return and principal value of investments will fluctuate as market conditions change. When sold, investments may be worth more or less than their original cost.

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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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