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Amadeus Wealth Alternatives
Your Compass to Alternative Investments

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In this week's recap: Inflation takes center stage.

Weekly Economic Update

Presented by Ed Papier, May 16, 2022

THE WEEK ON WALL STREET

In a volatile trading week, stocks extended their losses as economic growth and inflation concerns soured investor sentiment.

The Dow Jones Industrial Average dropped 2.14%, while the Standard & Poor's 500 lost 2.41%. The Nasdaq Composite index fell 2.80% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, slumped 3.21%. [1,2,3]

A TURBULENT WEEK

Inflation moved to center stage last week with the release of April's Consumer Price Index (CPI) and the Producer Price Index. Both numbers came near their 40-year highs but were lower than March's year-over-year numbers. The results heightened investor anxiety about future Fed monetary tightening and its impact on economic growth.

In recent weeks, technology stocks have borne the brunt of the downdraft as investors lightened up on risk exposures, with some of the mega-cap tech names getting swept up in the selling pressure. Cooling import price increases buoyed spirits on Friday, helping spark a rally that reduced the week's losses.

INFLATION STAYS HOT

Investors were greeted with a mixed CPI report, looking for signs that inflation may be cooling. Year-over-year costs rose 8.3%, slower than the previous month but faster than consensus estimates.

Excluding food and energy, core inflation climbed 6.2%. Buried beneath the headline number was a 5.1% yearly increase in shelter costs, the most significant increase since 1991. Shelter costs account for one-third of the CPI. [4]

Inflation has been a weight on markets all year. Investors are concerned that the persistence of higher prices may tip the economy into recession as increased spending on essential needs crimps consumers' spending power.

THE WEEK AHEAD: KEY ECONOMIC DATA

Tuesday: Retail Sales. Industrial Production.

Wednesday: Housing Starts.

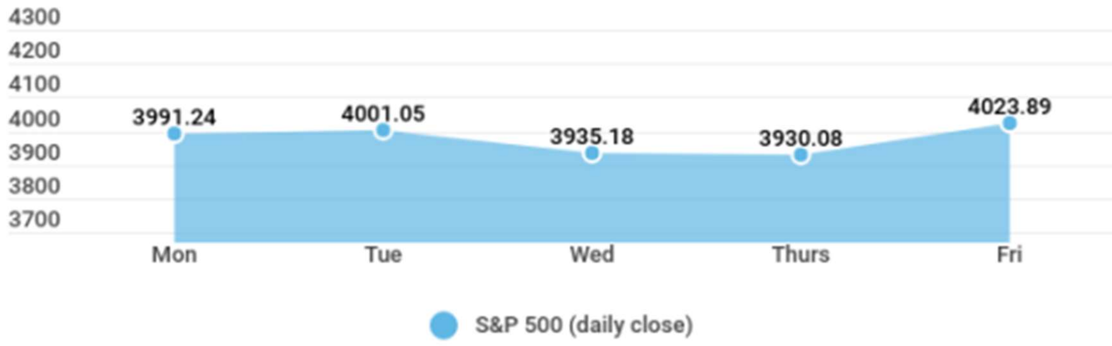
Thursday: Existing Home Sales. Jobless Claims. Index of Leading Economic Indicators. .

QUOTE OF THE WEEK

"Thinking is difficult. That's why most people judge."

CARL JUNG

Market Index	Close	Week	Y-T-D
DJIA	32,196.66	-2.14%	-11.40%
NASDAQ	11,805.00	-2.80%	-24.54%
MSCI-EAFE	1,909.42	-3.21%	-18.26%
S&P 500	4,023.89	-2.41%	-15.57%



	Treasury	Close	Week	Y-T-D
	10-Year Note	2.93%	-0.19%	+1.41%

Sources: The Wall Street Journal, May 13, 2022; Treasury.gov, May 13, 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, May 6, to Friday, May 13, close. Weekly performance for the MSCI-EAFE is measured from Friday, May 6, open to Thursday, May 12, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

Settling wreckage from the past with realities of the present can be difficult and painful. "If you do the crime, you must do the time."

When it comes to financial markets and the economy, this can take many forms. Some of the most common include bankruptcy, shuttered businesses, and collapsing share prices.

Last week Federal Reserve Chair Jay Powell and the Federal Open Market Committee Meeting (FOMC) raised the federal funds rate 50 basis points. This marked the first 50 basis point rate hike since 2000. It is part of the Fed's initial efforts to settle up on wreckage from the past.

The world has changed markedly over the last 22 years. Certainly, the economy and financial markets have become twisted and warped. Without the proper perspective everything from the price of a gallon of gas to the price of a house is muddled and confused.

The main culprit, no doubt, is quantitative easing (QE) and zero interest rate policy (ZIRP) employed by the Fed. The troubles financial markets and the economy are now facing are the direct result of decades of Fed market intervention. The main purpose of these interventions has been to artificially suppress interest rates.

Ultra-low interest rates have the effect of robbing from the future. They pull consumption forward and mask business failures. They also reward risk takers while hurting savers.

After expanding its balance sheet by over $8 trillion over the last 14 years the Fed has produced raging consumer price inflation. The official inflation rate, as measured by the consumer price index, is now increasing at an annual rate of 8.5 percent – a 40 year high. The unofficial inflation rate is likely over 17 percent.

Wage earners, savers, retirees on fixed incomes, and everyone except the most upper crust are getting ravaged. The inflation tax is draining their savings, depressing their real wages, and reducing their standard of living.

The Fed, using backwards looking data, kept interest rates too low for too long. The consequences are nothing short of disastrous. Financial assets, like stocks, bonds, and real estate, were simultaneously inflated to mega bubbles. This rewarded wealthy asset holders. But what goes up must come down. The reckoning of financial assets has only just begun.

For example, the S&P 500 is off to its worst start in 83 years. Over the first four months of 2022 the S&P 500 is down 13.7 percent. As context, the S&P 500 started the year down 17.3 percent in 1939 and 28.2 percent in 1932. Year to date the NASDAQ is down roughly 20 percent, losing 13 percent in April alone.

At the same time, U.S. gross domestic product (GDP) shrank by 1.4 percent during the first-quarter of 2022. The economy is contracting and may already be in a recession. We won't officially know until second-quarter GDP data is reported, as a recession is generally considered a decline in GDP over two consecutive quarters. In the interim, the massive stock, bond, and real estate bubbles that the Fed puffed up have a long way to fall. The stock market's grinding its way into a bear market.

More importantly, the 10-Year Treasury yield has doubled to roughly 3 percent over the last 6-months. And the real estate market appears to be cracking.

Normally, a bear market and a recession come towards the end of an interest rate hiking cycle, not the beginning. But because the Fed held interest rates too low for too long, and took a blow torch to consumer prices, it now must hike rates in the face of a declining stock market and contracting economy.

Because the Fed didn't realize it was stimulating consumer price inflation until it was completely out of control, it has a giant mess on its hands. And, at this point, it doesn't appear to have the fortitude to clean things up. The Fed is deeply behind the curve and has a lot of catching up to do. This means it may have to hike rates much higher than most people are expecting – even as the economy and financial markets are in full meltdown.

When considering Fed policy it is not enough to consider just the federal funds rate. Inflation must also be considered in relation to the federal funds rate. If inflation and the rate of inflation is higher and rising faster than interest rates, Fed policy is still inflationary.

In March, the Fed increased the federal funds rate by 0.25 percent. Last week it hiked the federal funds rate another 0.5 percent, bring it to a target range of 0.75 to 1 percent. Yet, in March alone, the CPI increased 1.2 percent (April CPI will be released next week).

So while the Fed has hiked interest rates 0.75 percent since March it is still falling behind the inflation rate curve. It's an ugly place to be. And will only get uglier, as the economy stagnates and inflation intensifies.

If the Fed was really serious about fighting inflation it would have hiked interest rates by at least 1.5 percent. Yet it didn't. Thus Wall Street celebrated with the S&P 500 and NASDAQ both jumping 3 percent following the FOMC statement on Wednesday.

Alas, this stock market ecstasy may be brief. The idea that the Fed can contain inflation without provoking a recession is a fantasy. The crimes committed are too substantial. One way or another, wreckage from the past must be settled up. And get this: We're all the collateral. [5]

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CITATIONS:

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4. CNBC, May 11, 2022
5. economicprism.com/settling-wreckage-from-the-past/#more-8118