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In this week's recap: Economy slows; Stocks retreat.

Weekly Economic Update

Presented by Ed Papier, May 2, 2022

THE WEEK ON WALL STREET

On Friday, a sharp sell-off sent major stock market indices into negative territory for the week, capping a volatile close to April.

The Dow Jones Industrial Average declined 2.47%, while the Standard & Poor's 500 tumbled 3.27%. The Nasdaq Composite index dropped 3.93% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, fell 3.33%. [1,2,3]

STOCKS SLIDE

Trading was volatile in the final week of April as investors struggled with the crosscurrents of global economic growth anxieties stemming from widening COVID-related lockdowns in China and a fresh batch of corporate earnings reports.

Monday set the tone for the week. Stocks staged an intraday reversal, wiping out a deep morning decline to end the day higher. After broad losses on Tuesday and a choppy session on Wednesday, stocks mounted a powerful rally Thursday thanks to positive corporate earnings reports, overcoming a disappointing first-quarter Gross Domestic Product report. Stocks could not sustain Thursday's momentum, as Friday witnessed a broad-based retreat to cement another week of losses.

ECONOMY CONTRACTS

Following the torrid 6.9% annualized GDP growth rate in the fourth quarter, economists had expected economic growth to moderate to about a one-percent gain in the first quarter. Instead, the economy shrank at an annualized rate of 1.4%, dented by a slowdown in inventory investment by businesses, a jump in the trade deficit, and a decline in defense spending.

Consumer spending held up, rising 2.7%, though the gain was amid higher prices. Some economists expect the economy to resume its expansion for the remainder of the year, which may be one reason investors shrugged off the negative surprise. [4]

THE WEEK AHEAD: KEY ECONOMIC DATA

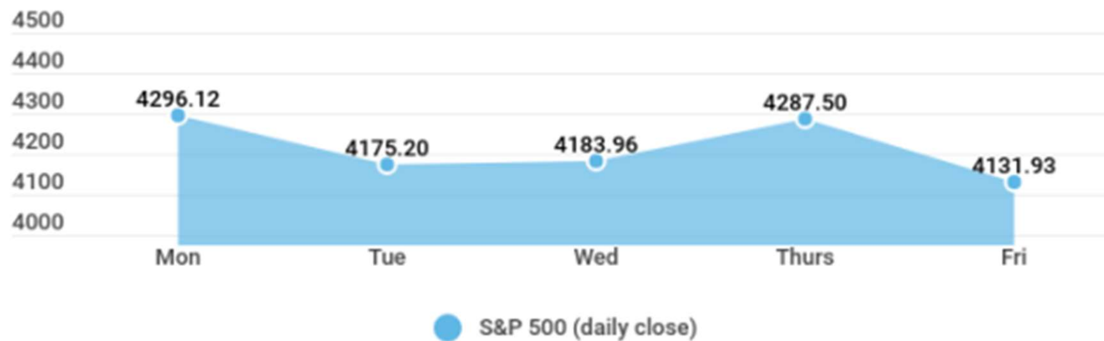
Monday: Institute for Supply Management (ISM) Manufacturing Index.
Tuesday: Factory Orders. Job Openings and Turnover Survey (JOLTS).
Wednesday: Federal Open Market Committee (FOMC) Announcement. Automated Data Processing (ADP) Employment Report. Institute for Supply Management (ISM) Services Index.
Thursday: Jobless Claims.
Friday: Employment Situation.

QUOTE OF THE WEEK

"Freedom is the right to tell people what they do not want to hear"

George Orwell

Market Index	Close	Week	Y-T-D
DJIA	32,977.21	-2.47%	-9.25%
NASDAQ	12,334.64	-3.93%	-21.16%
MSCI-EAFE	2,012.60	-3.33%	-13.85%
S&P 500	4,131.93	-3.27%	-13.31%



	Treasury	Close	Week	Y-T-D
	10-Year Note	2.89%	-0.01%	+1.37%

Sources: The Wall Street Journal, April 29, 2022; Treasury.gov, April 29, 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, April 22, to Friday, April 29, close. Weekly performance for the MSCI-EAFE is measured from Friday, April 22, open to Thursday, April 28, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

One of the hardest leadership challenges is knowing when to change plans. Is what you *could* do better than what you *are* doing? Certainty is impossible. At some point, though, good leaders recognize their plans aren't going well and start looking for better ones. The Federal Reserve is there, not the Fed's current policy dilemma, rather, the Fed itself; its very existence, structure, and goals. They need a complete restructuring because the Fed isn't accomplishing what we all need it to. Worse, it is causing problems we could do without. Fed officials are largely responsible for the cycles of bubbles, booms, and busts over the last 30 years. Further, they share some of the blame for the growing divisions and tribalism in our society. Much of it springs from the wealth disparity they aided and abetted.

The Fed has painted itself into a corner. All the options are bad and getting worse. While the current Federal Reserve will increasingly inject itself into the economy and make things worse, its leaders do so with the best of intentions because they believe their own dogma. The reasons it is in this position are no mystery. Indeed, this is all inherent in the Federal Reserve system's design. It is trying to do things it shouldn't be attempting. The only real solution is a wholesale redesign and reconstruction. What we have today isn't working and the time has come to amend the Federal Reserve Act and change its purposes and authorities.

As lender of last resort, a central bank stands ready to always loan a commercial bank enough cash to repay depositors. This doesn't always mean the bank is in trouble. Money flows in and out every day and sometimes gets unbalanced. In the US, "federal funds" are available overnight to fill these gaps, for which banks pay interest at the federal funds rate, the amount of which is set by the Federal Open Market Committee (FOMC).

This rate has grown far beyond the limited purpose of simply enhancing bank liquidity. It has become the benchmark for everything. The entire global economy now hinges on a price subjectively determined by a committee of a) politically appointed Governors and b) regional Fed presidents selected by boards who represent their region's commercial banks. Unlike other prices, it isn't a function of supply and demand. The rate can be as high or as low as the committee wants. The FOMC members set the rate at whatever they think will achieve what they believe are good economic goals. But that has economic consequences.

It all seems so logical when they explain it. But the reality is that we have been through multiple bubbles brought about by ever-lower interest rates in an effort to avoid recessions and improve employment (laudable goals to be sure) and in recent years a new tool: quantitative easing (QE).

The Federal Reserve Act gives the Fed a "dual mandate." It is required to promote both full employment and price stability. Unfortunately, its monetary policy tools have at best a distant influence on employment. Creating the conditions that let businesses create jobs is really a fiscal and regulatory function. Congress and the president should be doing that part. The Fed should arguably only be focused on price stability.

Fed proponents point to a correlation between Federal Reserve efforts and unemployment, however the connection represents correlation without causation. Jobs are created when entrepreneurs recognize business opportunities and need workers to achieve them.

As for price stability, the Fed defines "stability" as inflation averaging 2% yearly. That's not stability. A 2% inflation rate will, over a typical worker's lifetime, consume a large part of the buying power of their savings and leave them anything but "stable."

Moreover, the Fed hasn't produced consistent price stability despite its many tools. Inflation was well below target for most of the last decade (based on the Fed's own benchmarks, though consumers certainly saw higher inflation in their living costs). Now inflation is far above their target. The Fed's choice to keep rates low and continue massive QE is having serious side effects.

There are interest rates and "real" interest rates (nominal interest rates minus the inflation rate), which account for the fact the currency with which a borrower repays may have changed value before repayment was due. The Fed is now taking this to extremes, as former Morgan Stanley Asia chair Stephen Roach explained explained: "Consider the math: The inflation rate as measured by the Consumer Price Index reached 7% in December 2021. With the nominal federal funds rate effectively at zero, that translates into a real funds rate (the preferred metric for assessing the efficacy of monetary policy) of -7%. That is a record low."

What federal funds rate should it target to address the most likely inflation rate 12–18 months from now? No one has a clue, including the Fed and the financial markets.

A -7% real interest rate is simply bizarre. It means anyone who can borrow at the fed funds rate, or close to it, is effectively being paid to take on more debt. And not just paid but paid *well* , plus whatever return they can generate with the borrowed money. This is partly why so many asset prices are so bubble-like today.

How did the Fed act in 2008? They sprayed money in all directions, charged practically nothing for it, and accepted almost anything as collateral. Not surprisingly, the banks took to this largesse like bees to honey. Taking it away from them has proved very difficult. We now find ourselves in an era of speculation about what will happen when interest rates are raised.

This can't continue. The Federal Reserve and its peers need to get back to old style, boring central banking and stop trying to micromanage the entire economy. The mere attempt generates yet more problems. The free money environment they've created makes every other challenge worse.

So what should be done? Abolish the dual mandate and have the Fed focus squarely on inflation. That will be easier if full employment isn't on their plate As noted above, the link between low interest rates and employment is tenuous, if it exists at all.

Further, 2% inflation should be seen as high. The Fed should be leaning into inflation (tightening monetary policy) at 2% inflation and ease policy when inflation is at 1% or lower. Period. It goes without saying that we need better inflation tracking tools as well.

The Federal Reserve should not be this all-powerful "manager" of the economy. Further, the Fed has even taken on a third unwritten mandate, that of "financial stability," which really means stock market stability. The low rates that keep the stock market happy also financialized the entire economy. It is now cheaper to buy your competition than to actually compete. Private equity has evolved the way it has because low rates make it possible to buy good businesses. Add cheap leverage and over time the sector will produce well-above-market returns. None of these returns are available to the bottom 80% of the population, meaning the rich get richer. The financialization of the economy has been one of the greatest ills brought about by a loose monetary policy.

Jeremy Grantham recently commented: "Perhaps the most important longer-term negative of these three bubbles, compressed into 25 years, has been a sustained pressure increasing inequality: to participate in the upside of an asset bubble you need to own some assets and the poorer quarter of the public owns almost nothing. The top 1%, in contrast, own more than one-third of all assets. And we can measure the rapid increase in inequality since 1997, which has left the U.S. as the least equal of all rich countries and, even more shockingly, with the lowest level of economic mobility, even worse than that of the U.K., at whom we used to laugh a few decades back for its social and economic rigidity."

The economy can manage itself, with a few rules, of course. We just need stable money, a stable economic environment, and an honest, reliable banking system. A great deal of the Fed's activity has nothing to do with what should be its core mission. As bureaucracies do, it has grown too powerful and invented new reasons to justify its existence.

This is a serendipitous time to begin this discussion, with pushback against authorities across the spectrum "speaking down" to the hoi polloi. We live in a time of dueling experts, with one group of experts wanting to censor others or drown out alternative, competing ideas.

The Fed is part of that system, led by a group of people who believe they know better how to manage a $20 trillion economy than businesses and consumers themselves. They have created all sorts of unintended consequences, none of which they assume responsibility for, because their theories tell them that what they are doing is correct and those consequences are caused by something else. They are like Plato's philosopher kings. "Trust us, we know how to run your lives."

That's not any one person's fault, nor is it a partisan political thing. Getting us into this mess was a long-term bipartisan comedy of well-intentioned errors. Finding a solution is more important than pinning blame. We have to start somewhere and now is the time. [5]

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CITATIONS:

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