Amadeus Wealth Alternatives 1345 Ave. of the Americas 2nd Fl., New York, NY 10105 www.amadeuswealth.com

Amadeus Wealth Alternatives
Your Compass to Alternative Investments

212-697-3930

Edward Papier, CIMA®, CFF

ep@amadeuswealth.com

In this week's recap: Upbeat feelings boost the stock market, with America reopening ahead of Memorial Day.

Weekly Economic Update

Presented by Ed Papier, May 31, 2021

THE WEEK ON WALL STREET

Optimism over the economic reopening and renewed enthusiasm for technology and other high-growth companies powered the stock market higher last week.

The Dow Jones Industrial Average rose 0.94%, while the Standard & Poor's 500 climbed 1.16%. The Nasdaq Composite index led, picking up 2.06%. The MSCI EAFE index, which tracks developed overseas stock markets, added 0.46%.[1,2,3]

SOLID GAINS

Stock rallied on renewed confidence in the economic recovery, lower inflation worries, and rising comfort with Fed officials talking about the potential for easing of its monthly bond purchases. Technology, communication services, and reopening stocks were among the market leaders.

Investor sentiment was buoyed late in the week by an encouraging jobless claims number and the unveiling of a Republican infrastructure proposal. A somewhat hotter-than-expected inflation indicator on Friday did nothing to dampen optimism as stocks added to their gains ahead of the three-day Memorial Day weekend.[4,5]

JOBLESS CLAIMS REACH PANDEMIC LOWS

In a sign of further recovery in the labor market, the number of initial jobless claims fell to a pandemic low, continuing the downward trend in worker layoffs. New jobless claims totaled 406,000 for the week, well below the pandemic high of nearly 1.5 million, though still above the 2019 weekly average of 218,000.[5]

FINAL THOUGHTS

The history of Memorial Day extends back to the Civil War when it was referred to as Decoration Day. We join all Americans in honoring those who died in the performance of their military service to protect the freedoms we enjoy today. These were remarkably brave men and women whose sacrifice will never be forgotten.

THE WEEK AHEAD: KEY ECONOMIC DATA

Tuesday: Institute for Supply Management (ISM) Manufacturing Index.

Wednesday: Automated Data Processing (ADP) Employment Report.

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

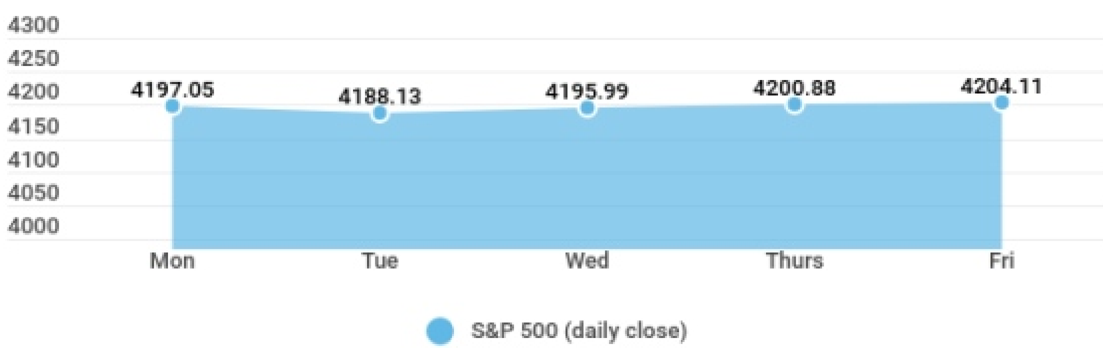
Friday: Employment Situation. Factory Orders.

QUOTE OF THE WEEK

"The closest thing to eternal life I've seen on the earth is a government agency"

RONALD REAGAN

Market Index	Close	Week	Y-T-D
DJIA	34,529.45	+0.94%	+12.82%
NASDAQ	13,748.74	+2.06%	+6.68%
MSCI-EAFE	2,325.27	+0.46%	+8.28%
S&P 500	4,204.11	+1.16%	+11.93%



	Treasury	Close	Week	Y-T-D
	10-Year Note	1.58%	-0.05%	+0.65%

Sources: The Wall Street Journal, May 28, 2021; Treasury.gov, May 28, 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, May 21, to Friday, May 28, close. Weekly performance for the MSCI-EAFE is measured from Friday, May 21, open to Thursday, May 27, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

The repurchase agreement, or "repo," market is an obscure but important part of the financial system that has drawn increasing attention lately. Last Monday, the Fed revealed that the amount of overnight reserves parked at the Fed rose by another $26 billion to $394.9 billion which was the 5th highest in history, up $186 billion in one week and the highest non-quarter end reverse repo (RRP) usage ever. The repo market allows financial institutions that own lots of securities (e.g. banks, broker-dealers, hedge funds) to borrow cheaply and allows parties with lots of spare cash (e.g. money market mutual funds) to earn a small return on that cash without much risk, because securities, often U.S. Treasury securities, serve as collateral. The Federal Reserve uses repos and reverse repos to conduct monetary policy. When the Fed buys securities from a seller who agrees to repurchase them, it is injecting reserves into the financial system. Conversely, when the Fed sells securities with an agreement to repurchase, it is draining reserves from the system. Since the crisis, reverse repos have taken on new importance as a monetary policy tool. Reserves are the amount of cash banks hold – either currency in their vaults or on deposit at the Fed. The Fed sets a minimum level of reserves; anything over the minimum is called "excess reserves." Banks can and often do lend excess reserves in the repo market.

Why does this matter? Three reasons:

1. The Fed is taking Treasuries out of the market through QE purchases and putting them right back in via the RRP.
2. The heavy use of the overnight RRP facility tells us that foreign banks too are now chock-full of reserves.
3. Banks don't have the balance sheet to warehouse any more reserves.

Not only do these actions impair the proper functioning of the repo market which is rapidly running out of collateral and is forced to unwind what it just got from the Fed back to the Fed, it also means that while the Fed still has plenty of assets to monetize courtesy of the Treasury's breakneck debt issuance spree, the banks that end up holding the resulting excess reserves are running out of space and are forced to park these brand new reserves right back with the Fed in the form of the overnight RRP. In short, the US financial system is starting to groan at every incremental new reserve created by the Fed's Quantitative Easing (QE), and considering that there is at least $1 trillion more in QE to go, even with tapering, things could get interesting.

Much more than any flip-flopping commentary from the Fed, these actions confirm we are approaching a critical moment when the Fed will no longer be able to conduct $120 billion in QE every month, since sooner or later someone will figure out that the Fed is buying up hundreds of billions in securities only to turn around and repo out the resulting reserves each and every day, which amounts to outright debt monetization with potentially serious consequences for yields and the US dollar.

As for the immediate market implications they are perhaps even more ominous: either the Fed will have to hike the interest rate on excess reserves or rates will soon go negative. Worse, with the Fed still planning to do at least $1 trillion in QE even assuming a December taper, and potentially as much as $2 trillion based on the latest just released Fed "forecast", there is simply no place to park all of these reserves. And while the Fed pretends it can continue business as usual for years to come, the repo market is not only cracking but banks, full to the gills with inert reserves and which increase by $30 billion every week, are balking at even a penny of additional liquidity. How the Fed will continue to monetize debt then, when the repo system is now out of collateral, is anyone's guess.[6]

Ed Papier may be reached at 2126973930 or ep@amadeuswealth.com
www.amadeuswealth.com

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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:

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4. CNBC.com, May 28, 2021
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