Amadeus Wealth Alternatives 411 Hackensack Ave. Ste. 200, Hackensack, NJ 07601 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: Cooling inflation brings market gains.

Weekly Economic Update

Presented by Ed Papier, November 14, 2022

THE WEEK ON WALL STREET

A cooling inflation number ignited a powerful rally on Thursday, sending stocks to strong gains for the week.

The Dow Jones Industrial Average gained 4.15%, while the Standard & Poor's 500 added 5.90%. The Nasdaq Composite index rose 8.10% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, picked up 5.72%. [1,2,3]

STOCKS SURGE

A lower-than-expected inflation report triggered the biggest one-day stock market gain in more than two years as the news raised investors' hopes that the Fed might consider easing the pace of future rate hikes. The day's gains were pronounced in the hard-hit technology sector, as the tech-heavy Nasdaq added 7.35%. [4]

Stocks initially rallied to start the week, but gave up some of the gains on Wednesday following a muddy and indecisive outcome to the midterms. Friday saw stocks build on their gains to close out an exceptional week.

INFLATION MODERATES

Consumer prices rose slower in October, increasing 0.4% for the month and 7.7% from 12 months ago. Both numbers were below market expectations of 0.6% and 7.9%. The core CPI (excludes energy and food sectors) rose a more modest 0.3% on a monthly basis and 6.3% from a year ago. [5]

The deceleration in prices was mainly attributable to price declines in used cars (-2.4%), apparel (-0.7%), and medical care services (-0.6%). Despite the progress, inflation remains well above the Fed's 2% target rate. A look behind the numbers shows that October's 7.7% CPI was fueled by the largest monthly jump in shelter costs since 1990 (+0.8%). Shelter costs account for one-third of the CPI. Energy was up 1.8%, while food costs rose 0.6% for the month. [6]

THE WEEK AHEAD: KEY ECONOMIC DATA

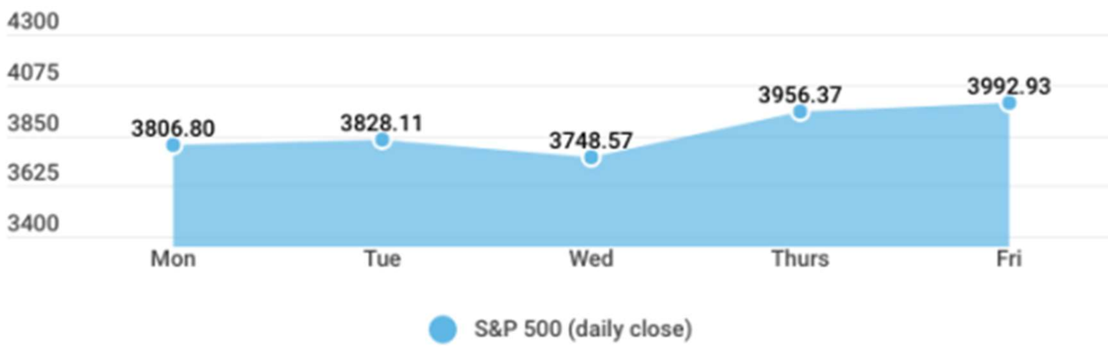
Tuesday: Producer Price Index (PPI).
Wednesday: Retail Sales. Industrial Production.
Thursday: Housing Starts. Jobless Claims.
Friday: Existing Home Sales. Index of Leading Economic Indicators.

QUOTE OF THE WEEK

An error does not become truth by reason of multiplied propagation, nor does truth become error because nobody sees it. Truth stands, even if there be no public support.
It is self-sustained.

MAHATMA GANDHI

Market Index	Close	Week	Y-T-D
DJIA	33,747.86	+4.15%	-7.13%
NASDAQ	11,323.33	+8.10%	-27.62%
MSCI-EAFE	1,871.56	+5.72%	-19.88%
S&P 500	3,992.93	+5.90%	-16.22%



	Treasury	Close	Week	Y-T-D
	10-Year Note	3.82%	-0.35%	+2.30%

Sources: The Wall Street Journal, November 11, 2022; Treasury.gov, November 10, 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, November 4, to Friday, November 11, close. Weekly performance for the MSCI-EAFE is measured from Friday, November 4, open to Thursday, November 10, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

The Federal Reserve's next crisis is already brewing. Unlike 2008, where subprime mortgages froze counter-party trading in the credit markets as Lehman Brothers failed, in 2022, it might just be the $27 trillion Treasury market.

When historians review 2022, many will remember it as a year when nothing worked. Throughout the year, surging interest rates, the Russian invasion of Ukraine, soaring energy costs, inflation running at the highest levels in 40 years, and the extraction of liquidity from stocks and bonds whipsawed markets violently. Since 1980, bonds have been the de facto hedge against risk. However, in 2022, bonds have suffered the worst drawdown in more than 100 years, with a 60/40 stock and bond portfolio returning a despairing -34.4 percent.

The drawdown in bonds is the most important. The credit market is the "lifeblood" of the economy. Today, more than ever, the functioning of the economy requires ever-increasing levels of debt. From corporations issuing debt for stock buybacks and operations to consumers leveraging up to sustain their standard of living. The federal government requires continuing debt issuance to fund spending programs because it requires the entirety of tax revenue to pay for social welfare and interest on the debt.

Debt issuance is not a problem as long as interest rates remain low enough to sustain consumption and that there is a buyer for the debt. The problem comes when interest rates rise. Higher rates reduce the number of willing borrowers, and debt buyers balk at falling prices. The latter is the most important. When debt buyers evaporate, the ability to issue debt to fund spending becomes increasingly problematic. Treasury Secretary Janet Yellen recently made a point in this regard: "We are worried about a loss of adequate liquidity in the [bond] market," she said. The problem is that outstanding Treasury debt has expanded by $7 trillion since 2019. However, at the same time, the major financial institutions that act as the primary dealers are unwilling to serve as the net buyers. One of the primary reasons for this is that for the past decade, the banks and brokerages had a willing buyer to which they could offload Treasurys: the Federal Reserve.

Today, the Federal Reserve is no longer acting as a willing buyer. Consequently, the primary dealers are unwilling to buy because no other party wants the bonds. As a function, the liquidity of the Treasury market continues to evaporate. Robert Burgess, the executive editor of Bloomberg Opinion, summed it up nicely: "The word *crisis* is not hyperbole. Liquidity is quickly evaporating. Volatility is soaring. Once unthinkable, even demand at the government's debt auctions is becoming a concern. Conditions are so worrisome that Treasury Secretary Janet Yellen took the unusual step Wednesday of expressing concern about a potential breakdown in trading, saying after a speech in Washington that her department is 'worried about a loss of adequate liquidity' in the $23.7 trillion market for U.S. government securities. Make no mistake: if the Treasury market seizes up, the global economy and financial system will have much bigger problems than elevated inflation."

This isn't the first time this has happened. Each time the Federal Reserve previously hiked rates, tried to stop quantitative easing, or both, a crisis event occurred, requiring an immediate response by the Federal Reserve to provide an accommodative policy.

All this is coming as Bloomberg News reports that the biggest, most powerful buyers of Treasurys—from Japanese pensions and life insurers to foreign governments and U.S. commercial banks—are all pulling back at the same time. 'We need to find a new marginal buyer of Treasuries as central banks and banks overall are exiting stage left," according to Bloomberg.

While there are actual warning signs of fragility in the financial markets, they are not enough to force the Federal Reserve to change monetary policy. The Fed noted as much in the minutes of its recent meeting. "Several participants noted that, particularly in the current highly uncertain global economic and financial environment, it would be important to calibrate the pace of further policy tightening with the aim of mitigating the risk of significant adverse effects on the economic outlook."

While the Fed is aware of the risk, history suggests the crisis levels necessary for a monetary policy change remain in the distance. Unfortunately, history is riddled with monetary policy mistakes where the Federal Reserve over-tightened. As the markets rebel against quantitative tightening, the Fed will eventually acquiesce to the selling deluge. The destruction of the "wealth effect" threatens the functioning of both equity and credit markets.

The Fed's primary threat remains an economic or credit crisis. History is clear that the Fed's current actions are once again behind the curve. Each rate hike puts the Fed closer to the unwanted "event horizon"—beyond which events can't be controlled. "What should be most concerning to the Fed and the Treasury Department is deteriorating demand at U.S. debt auctions. A key measure called the bid-to-cover ratio at a recent government offering of in benchmark 10-year notes was more than one standard deviation below the average for the last year," reported Bloomberg News.

When the lag effect of monetary policy collides with accelerating economic weakness, the Fed will realize its mistake. A crisis in the Treasury market is likely much greater than the Fed realizes. [7]

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

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Please feel free to send us their contact information via phone or email. (Don't worry – we'll request their permission before adding them to our mailing list.)

CITATIONS:

1. The Wall Street Journal, November 11, 2022
2. The Wall Street Journal, November 11, 2022
3. The Wall Street Journal, November 11, 2022
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6. CNBC, November 10, 2022
7. theepochtimes.com/the-treasury-market-is-the-feds-next-crisis_4816951.html