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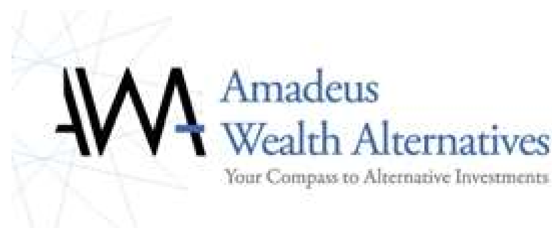

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In this week's recap: Fed talks turkey on lower rates, boosting markets.

Weekly Economic Update

Presented by Ed Papier, November 28, 2022

THE WEEK ON WALL STREET

Growing optimism that the Fed may be ready to ease future interest rate hikes sent stocks higher in a quiet trading week.

The Dow Jones Industrial Average gained 1.78%, while the Standard & Poor's 500 added 1.53%. The Nasdaq Composite index improved 0.72% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, advanced 2.33%. [1,2,3]

STOCKS RALLY

In light holiday-week trading, stocks rallied as investors grew more hopeful of a slowdown in a future rate hike. The release of the minutes from the early November meeting of the Federal Open Market Committee (FOMC) fed investors' optimism. Fed officials suggested such easing may be coming soon.

Investor sentiment was also lifted by unexpectedly strong retailer earnings, upside surprises in new economic data, and a better-than-expected consumer sentiment reading. Investors looked past the continuing Covid-related challenges that have stymied China's economic recovery and its attendant implications for global growth.

EASING IN THE OFFING?

The Fed meeting minutes, released before the Thanksgiving holiday, showed that most Fed officials felt a slowing in interest rate increases would be appropriate. The minutes also suggested that such a

deceleration in rate hikes may begin with December's meeting with a 50 basis point hike rather than a fifth consecutive boost of 75 basis points. [4]

The primary reasons for slowing the pace of rate hikes were the growing risk that the Fed may increase rates beyond what was required to reduce inflation to its two percent target and signs that inflation pressures were easing. [5]

THE WEEK AHEAD: KEY ECONOMIC DATA

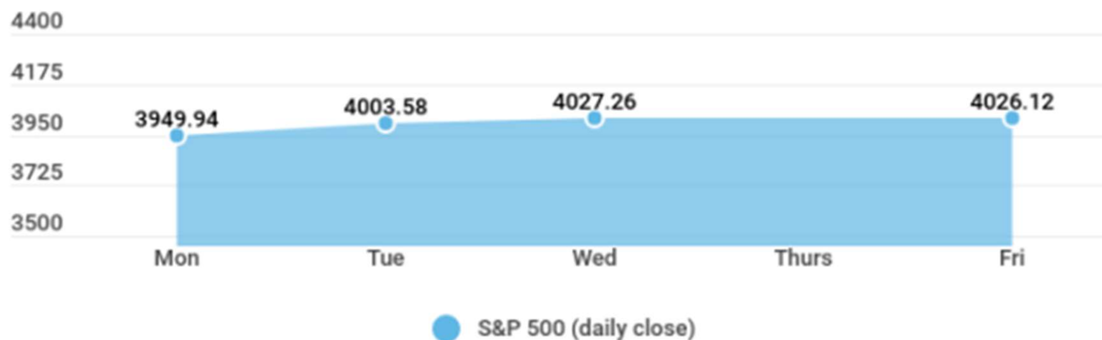
Tuesday: Consumer Confidence.
Wednesday: Gross Domestic Product (GDP). Automated Data Processing (ADP) Employment Report. Jobs Openings and Labor Turnover Survey (JOLTS).
Thursday: Jobless Claims. Purchasing Managers' Index (PMI) Manufacturing.
Friday: Employment Situation.

QUOTE OF THE WEEK

"Let's retell the FTX story using entities of the U.S. government. The Treasury is like FTX, issuing tokens that it calls bonds. The Fed is like Alameda Research, taking these tokens on its balance sheet to try to support their price. You're going to say, "Wait. The Fed is issuing its own tokens, called money. The analogy does not hold." But Quantitative Easing did not work by issuing money. Instead, the Fed borrowed from banks, by paying interest on reserves and doing "reverse repos." Just like Alameda Research, it took a levered position in Treasury tokens. Now the Fed is bankrupt. It has to be bailed out by the Treasury (you and me). Unlike FTX, the Treasury can still get away with issuing tokens."

Mathew Crawford

Market Index	Close	Week	Y-T-D
DJIA	34,347.03	+1.78%	-5.48%
NASDAQ	11,226.36	+0.72%	-28.24%
MSCI-EAFE	1,967.08	+2.33%	-15.80%
S&P 500	4,026.12	+1.53%	-15.53%



	Treasury	Close	Week	Y-T-D
	10-Year Note	3.69%	-0.13%	+2.17%

Sources: The Wall Street Journal, November 25, 2022; Treasury.gov, November 25, 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 18, to Friday, November 25, close. Weekly performance for the MSCI-EAFE is measured from Friday, November 18, open to Thursday, November 24, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

Interest rate hikes get most of the attention as the Federal Reserve fights inflation, but balance sheet reduction is arguably more important. And it's not going well.

Since the Fed stopped buying Treasuries and started letting bonds fall off its books as they mature, the bond market has experienced increasing volatility and liquidity problems.

In fact, there is already talk about the possibility of the central bank abandoning quantitative tightening. Since the Fed launched its first quantitative easing (QE) program in the wake of the 2008 financial crisis, it has purchased more than $8 trillion in US Treasury bonds and mortgage-backed securities.

In effect, the Fed monetized trillions of dollars in government debt, first in the wake of '08 and then again during the pandemic. Through various QE programs, the Fed bought bonds with money created out of thin air, creating an artificial demand for Treasuries. Central bank bond buying holds the price up and keeps bond yields artificially low. This allows the US government to sell more bonds than it could without the Fed's intervention. Without the Fed's involvement in the bond market, Uncle Sam would have a hard time maintaining its borrowing and spending policies. Interest rates would rise too high to make further borrowing tenable.

That's beginning to happen today. When the Fed started quantitative tightening, the artificial demand it created disappeared. As a result, bond prices tanked, and interest rates spiked. This is not a good scenario for a US government with more than $31 trillion in debt.

As the Fed runs QE, the new money that it creates to buy bonds finds its way into the economy. This is the definition of inflation. The only way the Fed can tackle inflation is to stop creating money and remove the excess it created from the economy. Quantitative tightening (QT) is a key part of this process. If the Fed was really serious about fighting inflation, it would not only let maturing bonds roll off its balance sheet, but it would also sell Treasuries into the open market. This would shrink the Fed balance sheet and pull excess dollars out of the economy. But the central bankers know they can't do that without collapsing the Treasury market.

In May, the Fed announced a QT program as CPI began to climb. According to the plan, the Fed is supposed to be reducing the balance sheet by $95 billion a month. This is up from $47.5 billion before September. Based on the Fed plan, it would take over seven years for the central bank to reduce the balance sheet to pre-pandemic levels. And it's even falling short of that goal. To date, the Fed has only succeeded in meeting or exceeding its goal one time (August) in six months.

But even this tepid QT program is causing problems in the Treasury market. According to a recent *Reuters* report, "The US Federal Reserve's ongoing balance sheet drawdown has exacerbated low liquidity and high volatility in the $20-trillion US Treasury debt market, raising questions on whether the Fed needs to re-think this strategy."

One bond analyst told *Reuters* that the volatility could force the Fed to pivot back to QE. " *It is certainly conceivable that, if bond volatility continues to rise, we could see a repeat of March 2020. The Fed will be forced to end its QT and buy a large amount of Treasury securities."*

A key indicator that investors track is the liquidity premium of on-the-run Treasuries, or new issues, compared with off-the-runs, which are older Treasuries representing the majority of total outstanding debt, but make up only about 25% of daily trading volume. On-the-run Treasuries typically command a premium over off-the-runs in times of market stress. BCA Research data showed that 10-year on-the-run premiums over their off-the-run counterpart are at their widest since at least 2015. Morgan Stanley in a research note said that off-the-run liquidity is most impaired in U.S. 10-year notes, followed by 20-year and 30-year bonds, as well as five-year notes.

The only thing the Fed can do to alleviate the problem is to go back to buying bonds. If the market starts to collapse, that's almost certainly the path it will take. One analyst summed up the conundrum facing the Fed, suggesting the Fed can't simultaneously fight inflation and run quantitative easing. UBS economists said the Fed may be forced to end QT by the middle of 2023. This is not good news for those expecting the Fed to win the inflation fight. Going back to QE literally means a return to inflation. [6]

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The forecasts or forward-looking statements are based on assumptions, may not materialize, and are subject to revision without notice.
The market indexes discussed are unmanaged, and generally, considered representative of their respective markets. Index performance is not indicative of the past performance of a particular investment. Indexes do not incur management fees, costs, and expenses. Individuals cannot directly invest in unmanaged indexes. Past performance does not guarantee future results.
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:

1. The Wall Street Journal, November 25, 2022
2. The Wall Street Journal, November 25, 2022
3. The Wall Street Journal, November 25, 2022
4. The Wall Street Journal, November 23, 2022
5. The Wall Street Journal, November 23, 2022
6. zerohedge.com/markets/treasury-market-liquidity-volatility-problems-could-derail-fed-balance-sheet-reduction