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In this week's recap: Wall Street flips the script, enjoys a rally.

Weekly Economic Update

Presented by Ed Papier, October 24, 2022

THE WEEK ON WALL STREET

A positive start to a new earnings season and late-week hopes for a near-term easing in Fed rate hikes lifted investors' spirits and powered stocks to gains for the week.

The Dow Jones Industrial Average jumped 4.89%, while the Standard & Poor's 500 advanced 4.74%. The Nasdaq Composite index added 5.22% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, gained 1.66%. [1,2,3]

EARNINGS, FED SPARK RALLY

The stock market narrative shifted last week from Fed interest rate hikes (a persistent drag on investor sentiment) to corporate earnings, which boosted investor enthusiasm with better-than-expected results. Stocks surged in the first two days of trading on the strength of positive earnings surprises, aided by a modest pullback in bond yields and news that the U.K. was scrapping its tax cut plans.

Mid-week, stocks surrendered some gains on a stronger U.S. dollar and rising bond yields. But on Friday, comments by a Fed official that hinted at a possible relaxation in Fed rate hikes sent stocks soaring to close out a good week.

BETTER THAN EXPECTED

Investors were approaching the new earnings season with a fair amount of trepidation amid an environment of higher interest rates and a slowing economy. The concern has been that poor earnings may drag stock prices lower from current levels.

Early earnings results have provided investors with mostly positive surprises. With 88 companies comprising the S&P 500 index reporting, 75% reported profits above analysts' expectations, well above the 66% long-term average. [4]

THE WEEK AHEAD: KEY ECONOMIC DATA

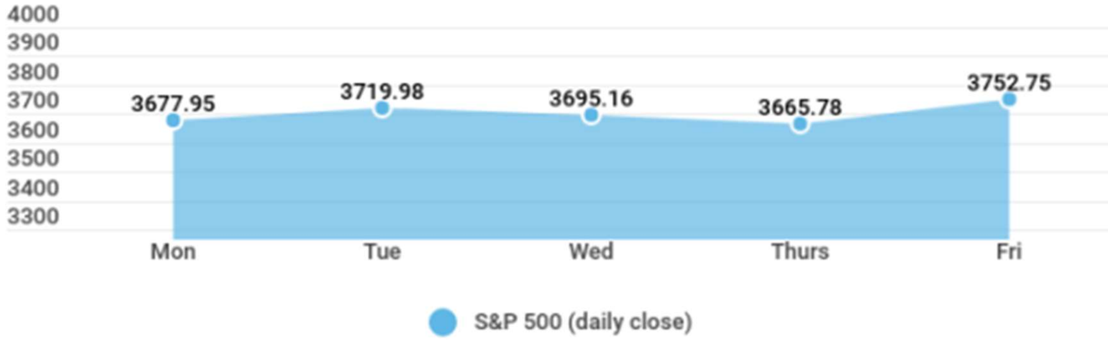
Monday: Purchasing Managers' Index (PMI) Composite.
Tuesday: Consumer Confidence.
Wednesday: New Home Sales.
Thursday: Jobless Claims. Durable Goods Sales. Gross Domestic Product (GDP).

QUOTE OF THE WEEK

"You must always be willing to truly consider evidence that contradicts your beliefs and admit the possibility you may be wrong."

ANONYMOUS

Market Index	Close	Week	Y-T-D
DJIA	31,082.56	+4.89%	-14.46%
NASDAQ	10,859.72	+5.22%	-30.59%
MSCI-EAFE	1,698.33	+1.66%	-27.30%
S&P 500	3,752.75	+4.74%	-21.26%



	Treasury	Close	Week	Y-T-D
	10-Year Note	4.21%	+0.21%	+2.69%

Sources: The Wall Street Journal, October 21, 2022; Treasury.gov, October 21, 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, October 14, to Friday, October 21, close. Weekly performance for the MSCI-EAFE is measured from Friday, October 14, open to Thursday, October 20, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

Federal Reserve rate hikes will add trillions to the national debt, according to an analysis by the Committee for a Responsible Federal Budget (CFRB). The Fed delivered another 75-basis point rate-hike during its September FOMC meeting and made it clear that rates will be 'higher for longer' to fight persistently high inflation. According to the CFRB, rate hikes will add another $2.1 trillion to the national debt over the next decade.

The debt currently stands at $30.9 trillion. Every increase in interest rate raises the federal government's interest expense. So far in fiscal 2022, the US Treasury has paid $471 billion to fund the government's interest payments. To put that number into context, at this point in fiscal 2021 the Treasury's interest expense stood at $356 billion. That represents a 30% year-over-year increase.

Interest expense ranks as the sixth largest budget expense category, about $250 billion below Medicare. If interest rates remain elevated or continue rising, interest expenses could climb rapidly into the top three federal expenses.

According to the Congressional Budget Office, this is exactly what will happen. It projects interest payments will triple from nearly $400 billion in fiscal 2022 to $1.2 trillion in 2032. But it gets worse than that. The CBO made this estimate in May and interest rates are already higher than those used in its analysis.

In a statement to Fox Business, the CFRB concedes that rate hikes are necessary in this inflationary environment. It places the onus on the federal government to get its spending under control.
"Policymakers can help the Fed by limiting the need for rate hikes with fiscal policy that pushes inflation in the right direction. That means not enacting legislation and executive orders like student loan forgiveness that have ballooned deficits and only made demand pressures worse."

Even with pandemic-era spending programs expiring, the federal government continues to spend about half-a-trillion dollars every single month. In August alone, the administration spent another $523.3 billion. That brought total spending for fiscal 2022 to just over $5.35 trillion.

There is no indication spending will slow anytime soon. While federal outlays have fallen compared to last year as pandemic programs wound down, the US government is still handing out COVID stimulus and has asked for more. Congress recently pushed through another massive spending bill. Meanwhile, the US continues to shower money on Ukraine and other countries around the world. And we haven't begun to see the impact of student loan forgiveness.

A paper published by the Kansas City Federal Reserve Bank acknowledged that the central bank can't slay inflation unless the US government gets its spending under control. In a nutshell, the authors argue that the Fed can't control inflation alone. US government fiscal policy contributes to inflationary pressure and makes it impossible for the Fed to do its job.

"Trend inflation is fully controlled by the monetary authority only when public debt can be successfully stabilized by credible future fiscal plans. When the fiscal authority is not perceived as fully responsible for covering the existing fiscal imbalances, the private sector expects that inflation will rise to ensure sustainability of national debt. As a result, a large fiscal imbalance combined with a weakening fiscal credibility may lead trend inflation to drift away from the long-run target chosen by the monetary authority."

According to the Peter Peterson Foundation, "As interest rates rise and the nation's debt grows, it will become even more expensive to borrow in the future. Congresses and presidents of both parties, over many years, have avoided making hard choices about our budget and failed to put it on a sustainable path. It is vital for lawmakers to take action on the growing debt to ensure a stable economic future."

Interest expense isn't the only problem the Fed's inflation fight creates for the US government. Along with raising rates, the Fed is shrinking its balance sheet. That means it's not buying Treasury bonds. The federal government needs the central bank to continue buying Treasuries in order to prop up the market and enable its borrowing. Without the Fed's intervention in the bond market, prices will tank, driving interest rates on US debt even higher.

Something has to give. The Fed can't simultaneously fight inflation and prop up Uncle Sam's spending spree. Either the government will have to cut spending, or the Fed will have to keep creating money out of thin air in order to monetize the debt. You can decide which scenario you find more likely. [5]

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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, October 21, 2022
2. The Wall Street Journal, October 21, 2022
3. The Wall Street Journal, October 21, 2022
4. Refinitiv, October 20, 2022
5. zerohedge.com/markets/fed-rate-hikes-will-add-trillions-national-debt