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*In this week's recap: Plenty of treats for Wall Street this week.*

## Weekly Economic Update

*Presented by Ed Papier, October 31, 2022*

### THE WEEK ON WALL STREET

Stocks overcame poor earnings results from some of America's largest companies to post gains last week as investors cheered positive earnings surprises, easing inflation and a rebound in economic growth.

The Dow Jones Industrial Average rose 5.72%, while the Standard & Poor's 500 advanced 3.95%. The Nasdaq Composite index added 2.24% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, gained 4.89%. <sup>1,2,3</sup>

### A "SPOOK-TACULAR" WEEK

Some mega-cap technology companies were under pressure last week on weak earnings and tepid fourth-quarter guidance. They reported multiple headwinds, including declining advertising revenues, loose expense control, and a slowdown in cloud growth.

Meanwhile, positive earnings surprises from "old economy" companies powered markets higher. This market bifurcation was evident in the divergence in the performance of the Dow Industrials and the Nasdaq. The S&P 500 posted a substantial gain despite its disproportionate weighting of mega-cap stocks, which helped illustrate the power of the rally. Momentum accelerated into Friday, aided by an easing in inflation and a solid third-quarter Gross Domestic Product (GDP) report.

### ECONOMIC GROWTH EXCEEDS EXPECTATIONS

After two straight quarters of negative economic growth, the initial estimate of the third quarter's GDP came in at a solid 2.6%, exceeding economists' 2.3% estimate. The surprising economic performance was largely attributable to an increase in exports, which narrowed the trade deficit, a development that may not repeat going forward. <sup>4</sup>

Particularly encouraging was the personal consumption expenditure price index, a report used by the Fed to track inflation. It increased 4.2%, well below the 7.3% jump from a quarter ago. <sup>5</sup>

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## THE WEEK AHEAD: KEY ECONOMIC DATA

**Tuesday:** Institute for Supply Management (ISM) Manufacturing Index. Job Openings and Labor Turnover Survey (JOLTS).

**Wednesday:** Federal Open Market Committee (FOMC) Announcement. Automated Data Processing (ADP) Employment Report.

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

**Friday:** Employment Situation.

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## QUOTE OF THE WEEK

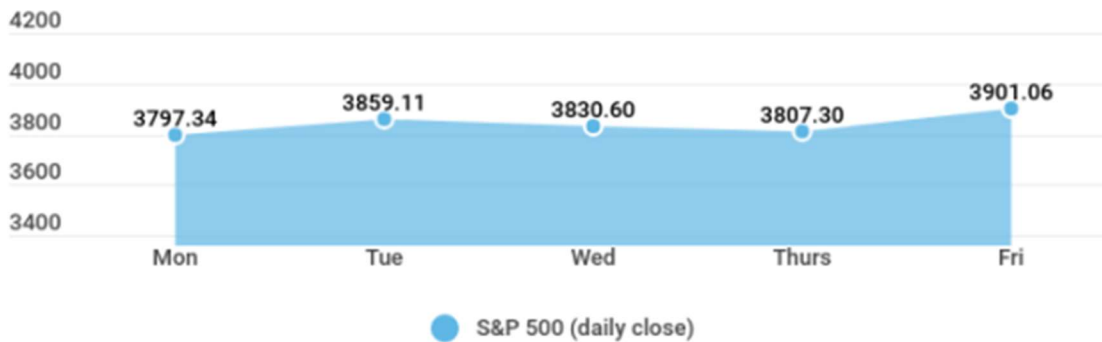


*"Crisis is the rallying cry of the tyrant"*

JAMES MADISON

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Market Index	Close	Week	Y-T-D
DJIA	32,861.80	+5.72%	-9.57%
NASDAQ	11,102.45	+2.24%	-29.04%
MSCI-EAFE	1,761.76	+4.89%	-24.58%
S&P 500	3,901.06	+3.95%	-18.15%



	Treasury	Close	Week	Y-T-D
	10-Year Note	4.01%	-0.20%	+2.49%

Sources: The Wall Street Journal, October 28, 2022; Treasury.gov, October 28, 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 21, to Friday, October 28, close. Weekly performance for the MSCI-EAFE is measured from Friday, October 21, open to Thursday, October 27, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

## OF NOTE

The U.S. treasury bond market has tumbled this year. That's no surprise. Between the Federal Reserve's interest rate hikes and quantitative tightening, 10-year treasury yields have increased from 1.6 percent to more than 4.0 percent year to date (bond yields have an inverse relationship with bond prices).

But this doesn't feel like a regular bond bear market. While the bond market appears calm on the surface, increasingly there's talk of a "liquidity crisis" brewing from too many forces acting in union. In other words, a functioning market—no matter which direction it is going—needs both active buyers and sellers. Today's market has been whipsawing, with extremely low liquidity (meaning very, very few buyers at any price) and high volatility. And that could be bad news not just for the treasury bond market but for other financial markets as well.

Earlier this month, U.S. Treasury Secretary Janet Yellen expressed concern that she was "worried about a loss of adequate liquidity." On Oct. 20, Yellen's staff even asked the Treasury Bond Auction Committee (a consortium of investment banks that run bond auctions) if the U.S. Treasury should begin buying some less-liquid bonds to provide liquidity. That's an unusual and concerning request.

The ICE BAML MOVE Index, the de facto measure of bond market volatility, is at its highest since the middle of 2009—the thick of the last financial crisis. Yields on both two and five-year bonds are at multi-decade highs.

Let's quickly examine what has been happening. Liquidity has been declining ever since the Fed began raising interest rates. The Fed's ending quantitative easing—buying of bonds—and starting of quantitative tightening, has worsened liquidity by taking out one of the market's biggest purchasers of bonds. More interest rate hikes are expected to come.

The U.S. dollar will continue to strengthen as the Fed increases rates to battle inflation. That will cause other countries to intervene and defend their currencies. To do so, they will need to sell U.S. treasury bonds, adding more downward pressure to bond prices.

In a vacuum, these moves all make sense individually. But all of these selling activities converging at once could likely seize up the bond market. Remember, a sale can only occur between two willing parties. It's unclear who will do the buying.

The Financial Times also pointed out a little-known market structure problem that has yet to be tested. "Previously, the primary dealers (i.e. big banks) kept the treasuries market liquid in a crisis by acting as market makers. But after 2008, a string of regulatory reforms made it expensive to play this role," the financial paper noted in an Oct. 20 report. "As a result, primary dealers' transactions are now just 2 percent of the market, down from 14 percent in 2008."

In a note to clients, Bank of America analysts say bond market liquidity is "fragile and vulnerable to shock." There are a lot of risks facing the markets today: Persistent inflation, continued interest rate hikes, the U.S. and global economy, geopolitical challenges in Europe (Russia/Ukraine) and East Asia (China), and their impacts on businesses, employment, and ultimately the financial markets.

The surging dollar is also threatening a traditional source of demand for U.S.-denominated assets. Sovereign wealth funds and foreign pension funds have historically been big buyers of U.S. assets, both equities and bonds. But the bear market in both of these asset classes, coupled with a very strong dollar, has dampened foreign demand. Foreign countries now need to sell U.S. dollar-denominated assets to defend their currencies. This is another under-the-radar source of liquidity drying up.

At almost \$24 trillion, the U.S. treasury bond market is huge. But if this market seizes up and freezes, the consequences could be wide-ranging and hard to prepare for. <sup>6</sup>

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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.)

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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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