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Amadeus Wealth Alternatives
Your Compass to Alternative Investments

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In this week's recap: Stocks advance with hopes of a new stimulus, end the week up, despite no new deal and President Trump's illness.

Weekly Economic Update

Presented by Edward Papier, CIMA® CFF, October 5, 2020

THE WEEK ON WALL STREET

Stocks advanced last week, propelled by hopes that legislators may reach an agreement for a new fiscal stimulus package and optimism generated by a few corporate deal announcements and initial public offerings.

The Dow Jones Industrial Average rose 1.87%, while the Standard & Poor's 500 increased 1.52%. The Nasdaq Composite index gained 1.48% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, advanced 1.56%.[1,2,3]

STOCKS MANAGE GAINS

Stocks ebbed and flowed all week as investors reacted to news that legislators might have reached a compromise for a new round of fiscal stimulus. By Friday afternoon, the negotiations proved unfruitful, though stocks managed to retain some of the gains built up over the course of the week.

Corporate buyout announcements, along with a couple of high profile initial public offerings, helped the overall market while technology stocks enjoyed a good week. Energy stocks continued to lag.

In volatile Friday trading, stocks sagged following a weak employment report and news that President Trump had tested positive for COVID-19 and was later hospitalized. Losses were trimmed later in the day on comments by House Speaker Nancy Pelosi, who suggested an airline aid bill may be in the works.

CONFLICTING EMPLOYMENT DATA

Last week's employment reports and corporate layoff announcements painted a mixed picture of the labor market.

The monthly ADP (Automated Data Processing) report on private sector hiring showed an unexpectedly strong growth of 749,000, while jobless claims remained over 800,000.[4,5]

Continuing jobs claims fell by nearly one million, but there were a number of large companies, including major airlines, that announced layoffs during the week. Friday's employment report showed 661,000 nonfarm payrolls were added in September, dropping the unemployment rate to 7.9%. What appears to be clear, is that the direction remains positive but the pace of progress has eased a bit.[6]

THE WEEK AHEAD: KEY ECONOMIC DATA

Monday: Purchasing Managers Index (PMI) Composite Final. Institute for Supply Management (ISM) Services Index.

Tuesday: Job Openings and Labor Turnover Survey (JOLTS).

Wednesday: Federal Open Market Committee (FOMC) Meeting Minutes.

Thursday: Jobless Claims.

QUOTE OF THE WEEK

"Distortion in the cost of credit is the not-so-remote cause of the aging fires at which the Federal Reserve continues to train its gushing liquidity hoses. But the firemen are the arsonists. It was the Fed's suppression of borrowing costs, and its predictable willingness to cut sort Wall Street's occasional selling squalls, that compromised the U.S. economy's financial integrity"

JAMES GRANT

Market Index	Close	Week	Y-T-D
DJIA	27,682.81	+1.87%	-3.00%
NASDAQ	11,075.02	+1.48%	+23.43%
MSCI-EAFE	1,859.54	+1.56%	-8.71%
S&P 500	3,348.44	+1.52%	+3.64%

	Treasury	Close	Week	Y-T-D
	10-Year Note	0.70%	+0.04%	-1.22%

Sources: The Wall Street Journal, October 2, 2020; Treasury.gov, October 2, 2020
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, September 25, to Friday, October 2, close. Weekly performance for the MSCI-EAFE is measured from Friday, September 25, open to the Thursday, October 1, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

Fed money printing is an exhibition of monetarism, an economic theory most closely associated with

Milton Friedman, winner of the Nobel Memorial Prize in economics in 1976. Its basic idea is that changes in money supply are the most important cause of changes in GDP. A monetarist attempting to fine-tune monetary policy says that if real growth is capped at 4%, the ideal policy is one in which money supply grows at 4%, velocity is constant, and the price level is constant. This produces maximum real growth and zero inflation. It's all fairly simple as long as the velocity of money is constant.

But money velocity is not constant, contrary to Friedman's thesis. Velocity is like a joker in the deck. It's the factor the Fed cannot control. Velocity is psychological. It depends on how an individual feels, about his or her economic prospects. It cannot be controlled by the Fed's printing press. It measures how much money gets spent - from people to businesses. Think of when you tip a waiter. That waiter might use that tip to pay for an Uber. And that Uber driver might pay for fuel with that money. This velocity of money stimulates the economy.

Unfortunately, velocity has been crashing for the past 20 years. From its peak of 2.2 in 1997 (each dollar supported $2.20 of GDP), it fell to 2.0 in 2006 just before the global financial crisis and then crashed to 1.7 in mid-2009 as the crisis hit bottom. The velocity crash did not stop with the market crash. It continued to fall to 1.43 by late 2017, despite the Fed's money printing and zero rate policy (2008–15). Even before the pandemic, it fell to 1.37 in early 2020. It can be expected to fall even further as the new depression drags on. As velocity falls, the economy falls. Money printing is impotent; $7 trillion times zero = zero. There is no economy without velocity.

The bottom line is monetary policy can do very little to stimulate the economy unless the velocity of money increases. And the prospects of that happening aren't great right now. But what about fiscal policy? Can that help get the economy out of depression? Let's take a look...

We're seeing more deficit spending in 2020 than the past several years combined. The government will add more to the national debt this year than all presidents combined from George Washington to Bill Clinton. This spending explosion comes on top of a baseline budget deficit of $1 trillion. Combining the baseline deficit, the approved spending and the expected additional spending brings the total deficit for 2020 to over $3 trillion at the minimum. That added debt will increase the U.S. debt-to-GDP ratio to over 120%. That's the highest in U.S. history and puts the U.S. in the same super-debtor's league as Japan, Greece, Italy and Lebanon.

The idea that deficit spending can stimulate an otherwise stalled economy dates to John Maynard Keynes and his classic work The General Theory of Employment, Interest and Money (1936). Keynes' idea was straightforward. He said that each dollar of government spending could produce more than $1 of growth. When the government spent money (or gave it away), the recipient would spend it on goods or services. Those providers of goods and services would, in turn, pay their wholesalers and suppliers. This would increase the velocity of money. Depending on the exact economic conditions, it might be possible to generate $1.30 of nominal GDP for each $1.00 of deficit spending. This was the famous Keynesian multiplier. To some extent, the deficit would pay for itself in increased output and increased tax revenues.

The problem is
there's strong evidence that the Keynesian multiplier does not exist when debt levels are already too high. In fact, America and the world are inching closer to what economists Carmen Reinhart and Ken Rogoff describe as an indeterminate yet real point where an ever-increasing debt burden triggers creditor revulsion, forcing a debtor nation into austerity, outright default or sky-high interest rates.

Reinhart and Rogoff's research reveals that a 90% debt-to-GDP ratio or higher is not just more of the same debt stimulus. Rather it's what physicists call a critical threshold. The first effect is the Keynesian multiplier falls below 1. A dollar of debt and spending produces less than a dollar of growth. Creditors grow anxious while continuing to buy more debt in a vain hope that policy makers reverse course or growth spontaneously emerges to lower the ratio. This correction doesn't happen. Society is addicted to debt, and the addiction consumes the addict. The endpoint is a rapid collapse of confidence in U.S. debt and the U.S. dollar. This means higher interest rates to attract investor dollars to continue financing the deficits. Of course, higher interest rates mean larger deficits, which makes the debt situation worse. Or the Fed could monetize the debt, yet that's just another path to lost confidence.

The result is another 20 years of slow growth, austerity, financial repression (where interest rates are held below the rate of inflation to gradually extinguish the real value of debt) and an expanding wealth gap. The next two decades of U.S. growth would look like the last two decades in Japan. Not a collapse, just a slow, prolonged stagnation. This is the economic reality we are facing. And neither monetary policy nor fiscal policy will change that.[7]

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Know someone who could use information like this?
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 2, 2020
2. The Wall Street Journal, October 2, 2020
3. The Wall Street Journal, October 2, 2020
4. CNBC, September 30, 2020
5. CNBC, October 1, 2020
6. The Wall Street Journal, October 2, 2020
7. zerohedge.com/economics/weve-reached-endpoint-monetary-and-fiscal-policy-wont-help

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treasury.gov, October 2, 2020