Weekly Market Insights

May 18, 2020

The markets follow the Fed

The U.S. equity markets fell this past week. The Dow closed down 2.26%, the S&P 500 fell 2.65% and the NASDAQ decreased 1.17%. Investors were shaken by a grim speech from Federal Reserve Chair Powell and disappointing economic statistical releases, but, as we will point out in a moment, both the degree and manner of the fall are somewhat encouraging.

The Fed

Federal Reserve Chairman Jay Powell spoke this past week and was far more downbeat than in the past. Fed followers will recall Mr. Powell predicting a V shaped recovery just a few weeks ago. His present position is far more grim. He again reassured the nation that the Fed would do everything in its power to help both the financial markets and the economy. Interestingly, he said that that all members of the Federal Open Market Committee[1] rejected going to negative interest rates. He called for a greater effort from the Administration and Congress with more fiscal policy. Investors should expect continued stimulus from the Fed.

Fiscal Policy

Having recently passed the largest fiscal bill in history, the House of Representatives just passed a new stimulus bill of approximately $3 trillion. Both the President and the Senate Majority Leader called it dead on arrival. That should not discourage those looking for more fiscal stimulus. This should be expected, as it happens most of the time. It is more of a political ploy than a rejection of fiscal stimulus. A bill will pass. The only questions are when and how much.

Economic Releases

Last week, we saw more abysmal economic releases, highlighted by worse than anticipated retail sales and unemployment insurance claims data. Retail sales dropped 16.4% in April while initial unemployment claims came in at just under 3 million. Initial claims decreased slightly from the prior week; however, continuing claims continued to climb, albeit only a modest amount. Despite the negative releases, the market's reaction was minimal, as investors seem to have accepted the profound impact of the global lockdown and believe the worst is behind us. The risk, of course, remains that the lasting economic damage caused by the shutdown is not being fully reflected in market expectations. As the U.S. economy begins to reopen, how quickly consumers begin to increase discretionary spending and how infection rates respond to relaxed lockdown orders will likely impact the market's path going forward.

The Budget and Deficit

The rapidly expanding money supply and budget deficit have many investors concerned about the inflationary impact. Both the government and the Fed correctly see no other option and believe the extreme measures are necessary. As we all know, creating a budget is a matter of balancing alternatives. Alas, it becomes far more difficult in an election year, but it remains the same. As we and many economists have written, a budget deficit is not a problem if it grows less than GDP. Of course, today this clearly is not the case. There are many problems the framers of monetary and fiscal policy must try to avoid or minimize. Four come to mind: lower productivity, crowding out, dramatic increase in interest payments long into the future, and less flexibility to respond to future unseen challenges. The first two can be minimized. If fiscal policy is used primarily to advance productive capacity, i.e. roads, ports and education, then it might even advance productivity. Crowding out, in the short run, can be covered by monetary policy. The other two are far more difficult.

Weekly Market Insights (cont'd)

The danger/problem with monetary stimulus is that it has a tendency to increase wealth disparity. This is because it acts primarily through financial markets and the majority of financial assets are held by high income earners. The argument can be made that it increases all IRAs, 401(k)s and pension funds, but that is far less obvious.

The decision comes down to the "greater evil." Take a chance for a real depression now or fight an extreme debt in the future. It is a pretty good bet which way the Administration and Congress will decide.

Encouraging

Earlier we wrote that even with the equity markets losing ground and grim economic indicators, we take some encouragement from last week's activity. If someone would have shown an unbiased investor an advanced notice of the past week's economic releases and a copy of Chairman Powell's speech and followed by asking how much the market would fall, that investor, almost surely, would have guessed far more than 2%.

The other positive is that the market on most days ended the day on an uptrend, even showing a major reversal and overcoming a large loss, ending the day with a gain.

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[1]The Federal Open Market Committee, a committee within the Federal Reserve System, is charged under United States law with overseeing the nation's open market operations. This Federal Reserve committee makes key decisions about interest rates and the growth of the United States money supply.

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Please click here for the Economic Release Calendar - May 2020.