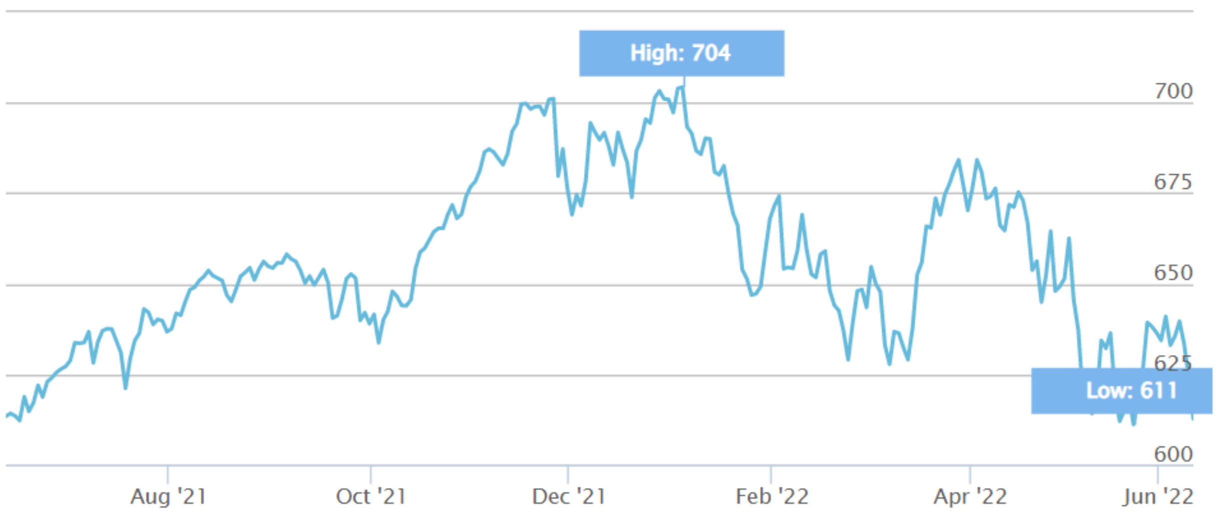
THE WORLD ECONOMY. BLEEDING FROM HUNDREDS OF CUTS BUT NO AMUPATIONS YET.

The ECB (European Central Bank) which is the most dilatory and cowardly of the major Central Banks, alongside the Bank of Japan, finally announced it was going to raise its borrowing rate to 0%. Shortly thereafter the CPI in the USA came in above expectations fuelling expectations of faster and bigger intervention by the FED. Markets around the world tanked.

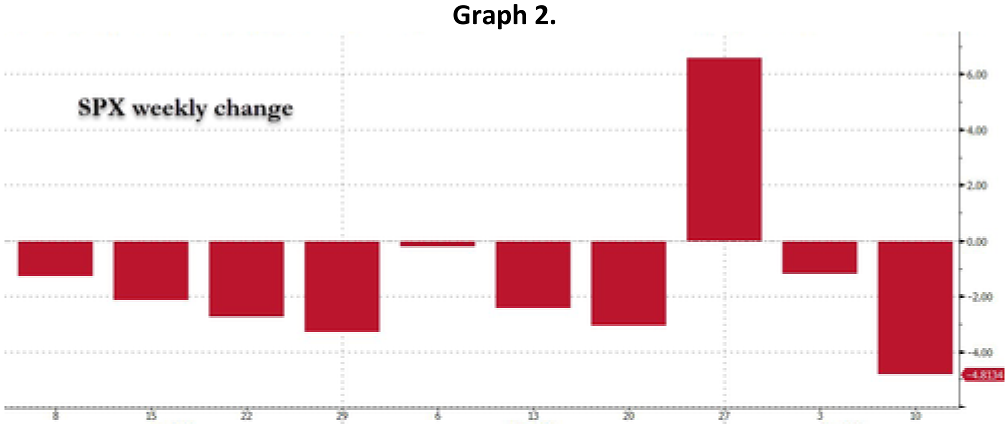
This fall was captured by the best gauge of share markets in the developed economies. *"The STOXX® Global 1800 Index contains 600 European, 600 American and 600 Asia/Pacific region stocks represented by the STOXX® Europe 600 Index, the STOXX® North America 600 Index and the STOXX® Asia/Pacific 600 Index."* The index fell by 3.21% by the end of the week back to 313 just short of its low of 311 for the year.

Graph 1.



The S&P500 also fell for the week making this the 10th weekly fall in the last 11 weeks, the highest frequency of falls since the Great Depression 90 years ago.

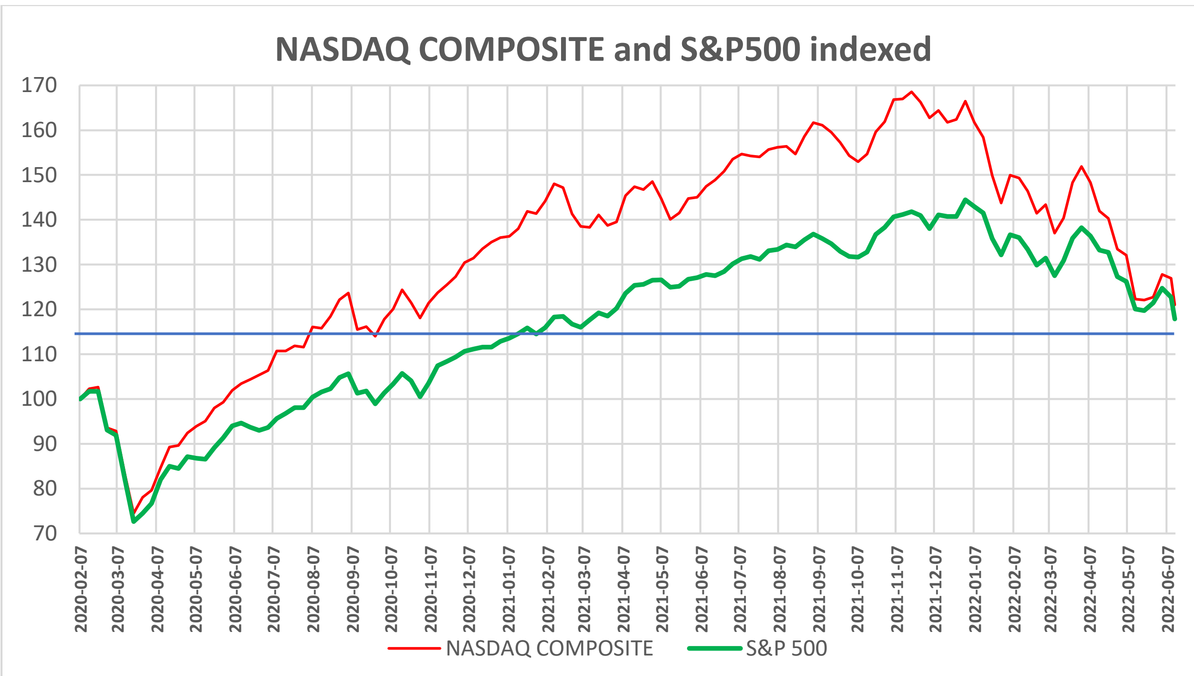
Graph 2.



(Source: Bloomberg)

In Graph 3 I have plotted weekly indexes for both the Nasdaq Composite and S&P500. Given the falls on Monday I have extended it. As of Monday the Nasdaq is down 33% and the S&P 500 is down by 22% from their 52-week peaks. Both are in Bear territory, the S&P just, but the Nasdaq deep. To fall 33% or by a third, the Nasdaq would have had to have risen by 50% previously. That is a better estimate of the losses for share values this year which now amount to over $10 trillion or half the value of annual GDP. Adjusted for inflation the two indexes would have to fall to 115 to match the first quarter in 2020. They are getting close to that figure; another weekly fall will move the real price of shares close to pre-pandemic levels. However, given that Monday's fall was fuelled by rumours of a 0.75% rate hike, which is so unlikely it amounts to market manipulation, the week may not end up down, unless retail sales fall significantly.

Graph 3.

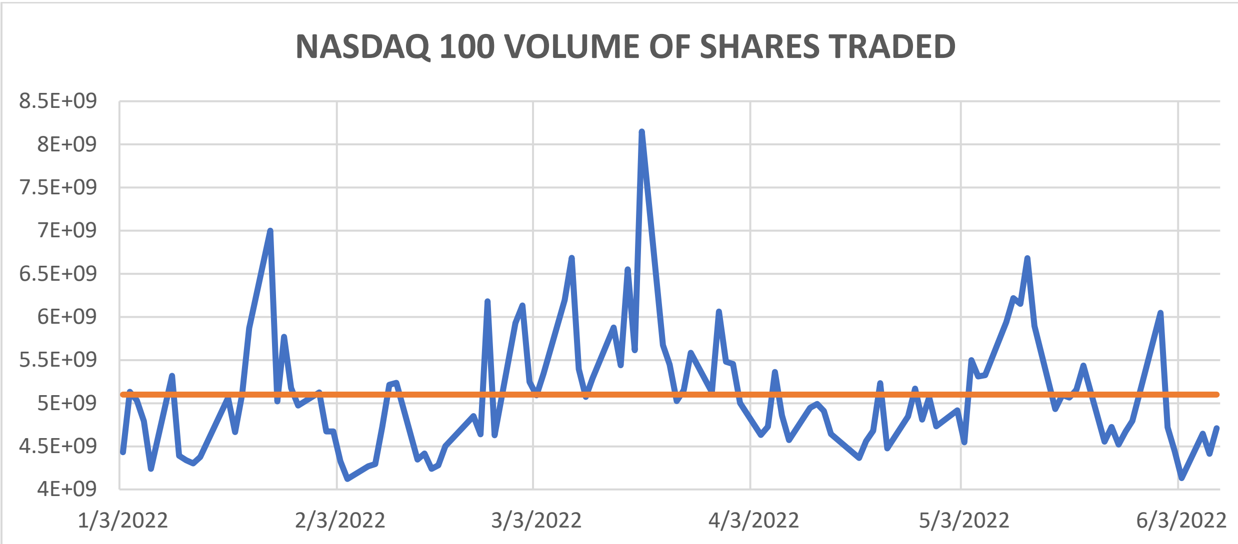


(Source: FRED Tables NASDAQCOM and S&P500)

Volatility on the Stock markets are severe and destroying confidence. This is a function of illiquid markets, as the Financial Times points out in an article *'Liquidity is terrible': Poor Trading Conditions Fuel Wall Street Tumult" "Liquidity across US markets is now at its worst level since the early days of the pandemic in 2020, according to investors and big US banks who say money managers are struggling to execute trades without affecting prices. Relatively small deals worth just $50mn could knock the price or prompt a rally in exchange traded funds and index futures contracts that typically trade hands without causing major ripples, said Michael Edwards, deputy chief investment officer of hedge fund Weiss Multi-Strategy Advisers."* Illiquid markets can be compared to a rabbit caught in the headlights. At some point the rabbit is run over, that's when real panic emerges, that is when there is a rush for the exits as capitulation sets in. We have not reached that point yet, but it came close on Monday when volume rose.

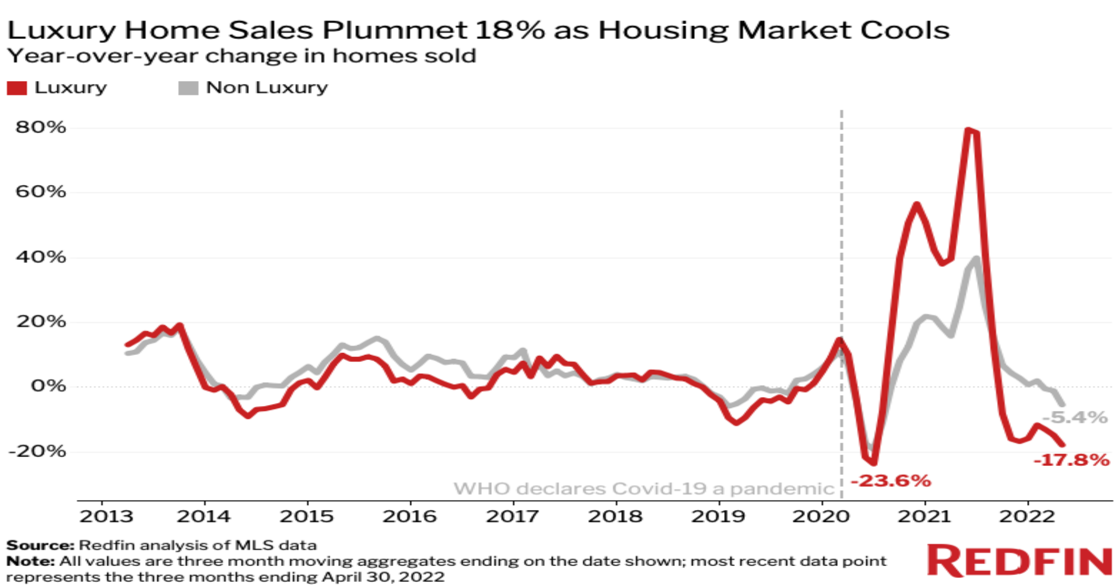
In the meantime as any boxer will admit, being pummelled over time can be very damaging in itself. On Monday the volume of shares traded rose sharply as did the breadth of the falls. That is indicative of rising panic for the first time. Graph 4 extends to Friday last week, and it shows that over the course of the year, there were only four volume spikes and each time the market settled down. NasdaqTrader.com

Graph 4.

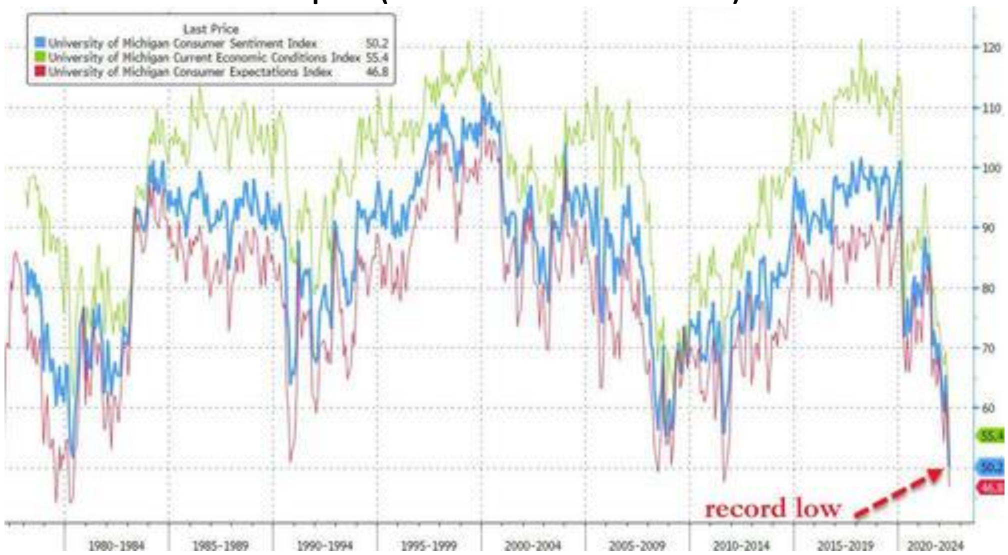


The losses on the stock market are now having an effect on the wealthy. In my last posting on the US economy I reported that there was no evidence from luxury goods manufacturers of a significant fall in their sales over the first quarter of this year. Now there is. Monthly rentals in the Hamptons, playground for the New York Bankers, have fallen from an average last year of $70,000 to a mere $40,000 this summer. REDFIN reports in April that the sales of luxury homes fell sharply though they remain elevated. (See Graph 5 below). Last Friday the University of Michigan published its report on Consumer Sentiment. The preliminary June data collapsed from 58.4 to 50.2, its lowest ever reading and well below the expectation of a 58.1 read. (See Graph 6) In addition, the measure of expectations decreased to 46.8 from 55.2. Finally intentions to buy large ticket items remained at record lows even in higher income groups.

Graph 5.



Graph 6. (UMich Consumer Sentiment)



Bloomberg

Rates for 30-year mortgages have broken through the 6% barrier, a level last seen prior to the 2008 crash which was sparked by sub-prime lending. Although the issuance of sub-prime mortgages is far less this time round, the size of the overall housing market relative to GDP is larger, so any correction in the housing market will be profound. It is already affecting personal consumption as refinancing mortgages which tend to boost spending have now fallen by 75% compared to last year.

Of course a fall in spending is always associated with a rise in inventories as I pointed out in my last post on the US economy. All that needs to be added is April's preliminary wholesale inventories data released last week, which rose 2.2% on top of an upwardly revised 2.7% in March. This brings the annual increase in inventories to 23.4%. Rising inventories raised the sales to inventory back to 1.25 or back to mid-2018 levels. The sharp rise in inventories is bad news for producers especially in China.

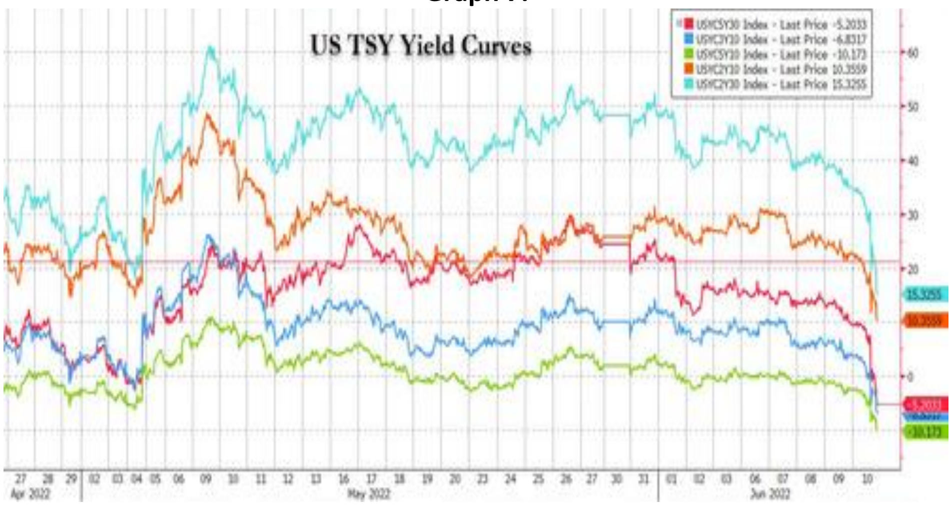
The Bond Market.

Alongside the housing market the bond market is increasingly stressed, and it is likely that we have a pair of black swans in the making.

As a result of the Consumer Price Index surprising on the upside side primarily due to runaway energy and food prices, and strangely auto prices, the pundits were erasing their previous forecasts and pencilling in ten rate rises by the FED. Even the possibility of a 0.75% rise was resurrected. As a result, the 2-year yield rose above 3.0% for the first time since 2018 while the spreads between short term and long term shrank once again. This is shown by the sharp dives in spreads over the last week. The 5-year and 10-year yield inverted by the close on Friday while the 10-year and 2-year inverted briefly on Monday. Despite this harbinger of recession, the majority of Wall Street experts, as well as polls of Chief Financial Officers, still maintained that a recession, though likely, will not occur before 2023.

However, should retail sales for May due to be released on Wednesday contract, then GDPNow's forecast for second quarter GDP growth will turn negative. And what is true for May is true for June, thus falling consumption adds up to recession now, not in 2023.

Graph 7.



Bloomberg.

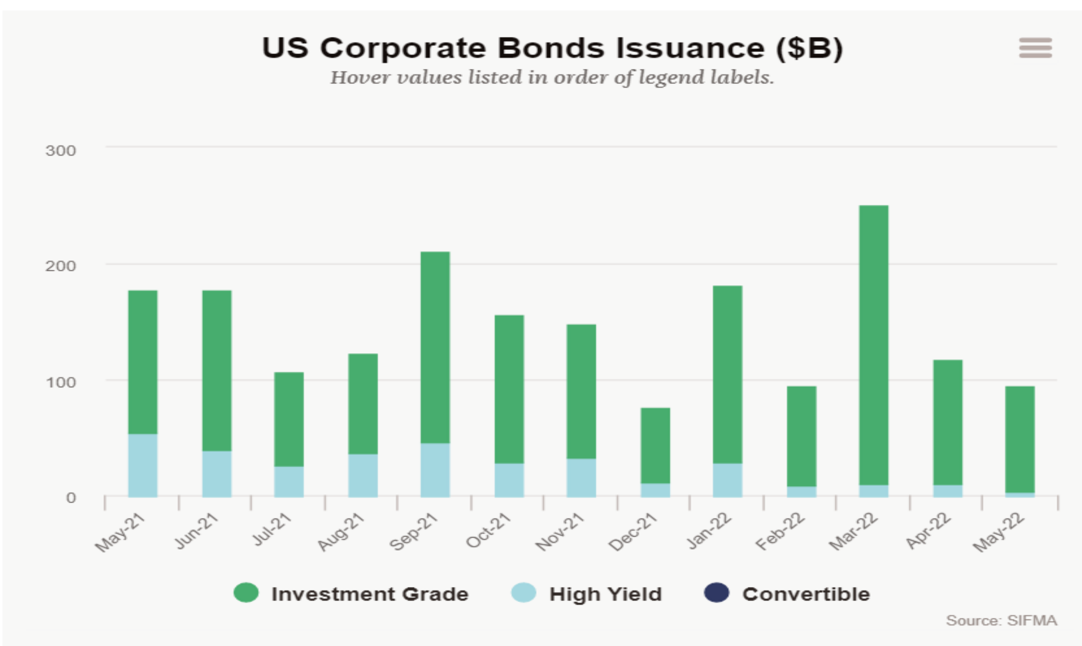
SIFMA's latest report issued on the 9th June covering May's bond market showed the bond market seriously impaired with high yield issuance frozen. (See Graph 8 below.) The amount of bonds outstanding adjusted for inflation is down, showing fewer bonds are being issued compared to bonds being retired.

YTD statistics include:

- *Issuance (as of May) $737.8 billion, -23.2% Y/Y*
- *Trading (as of May) $40.3 billion ADV, -4.1% Y/Y*
- *Outstanding (as of 1Q22) $10.0 trillion, +2.5% Y/Y*
- *Issuance of Mortgage-Backed Securities (as of May) $1,170.7 billion, -45.1% Y/Y*
- *Issuance Asset Backed Securities (as of May) $134,009.3 million, -38.6% Y/Y*

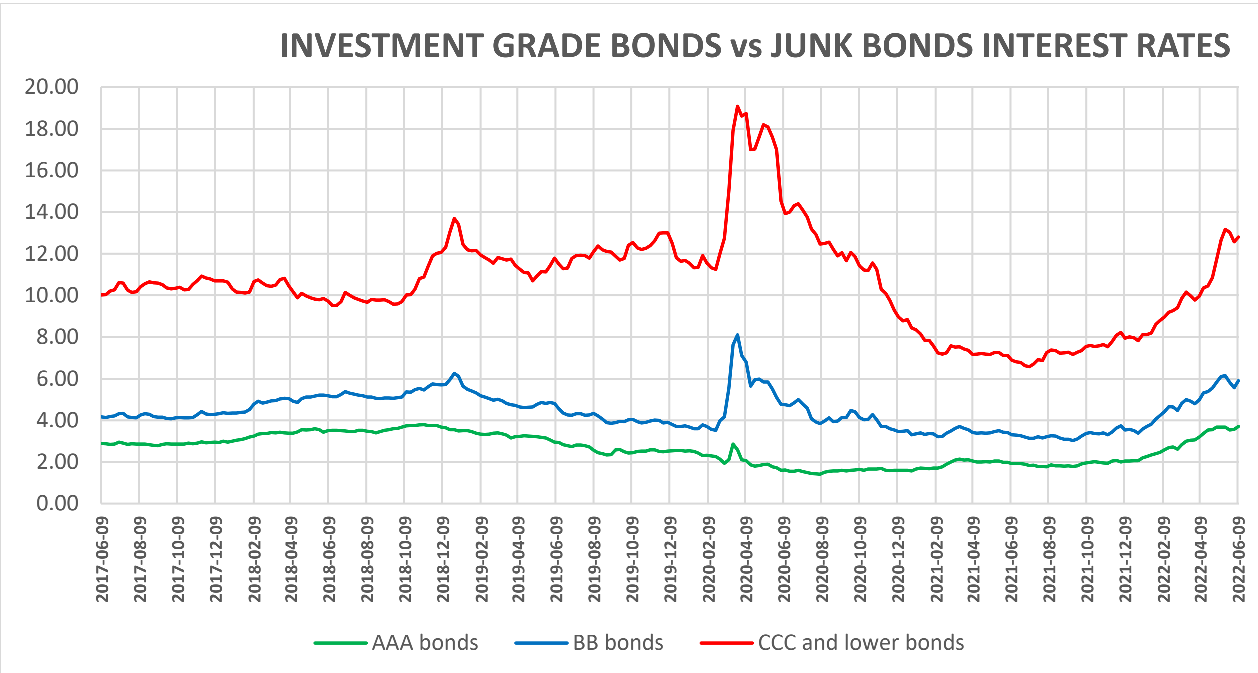
SIFMA

Graph 8.



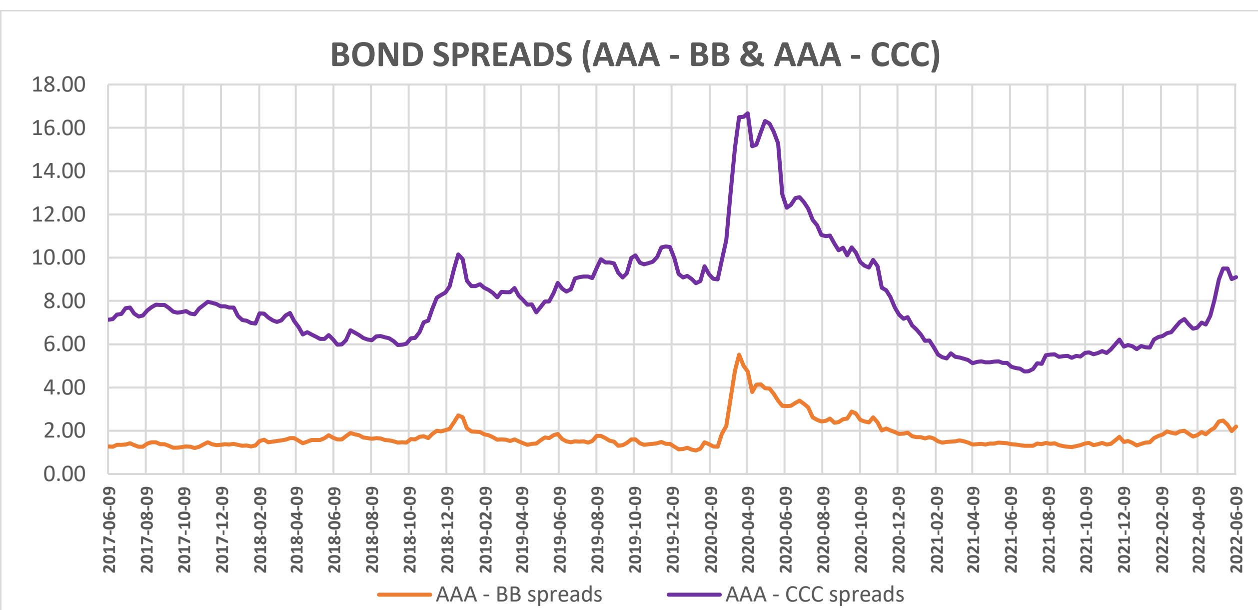
While there is little evidence of large-scale insolvencies the new risk-off environment, driven by higher interest rates, has resulted in a widening of the spreads between top grade investment bonds and junk bonds. However, as the two graphs below show, while interest rates have overtaken 2019 levels the spreads are still somewhat narrower.

Graph 9.



(Source: FRED Tables BAMLH0A1HYBBEY [BB], BAMLH0A3HYCEY[CCC], BAMLC0A1CAAAEY [AAA])

Graph 10.



Europe & Japan.

The announcement by the European Central Bank (ECB) that it will raise interest rates for the first time in July by a miserly 0.25% has stressed the European markets. It has driven up interest rates in the more indebted countries like Spain and Italy. This explains why the ECB is so reluctant to push up interest rates even in the face of galloping inflation. Because the EU has fewer fiscal levers compared to the USA it is more reliant on monetary policy to prop up the diverse economies which make up the EU particularly the countries sharing a common currency.

Graph 11.

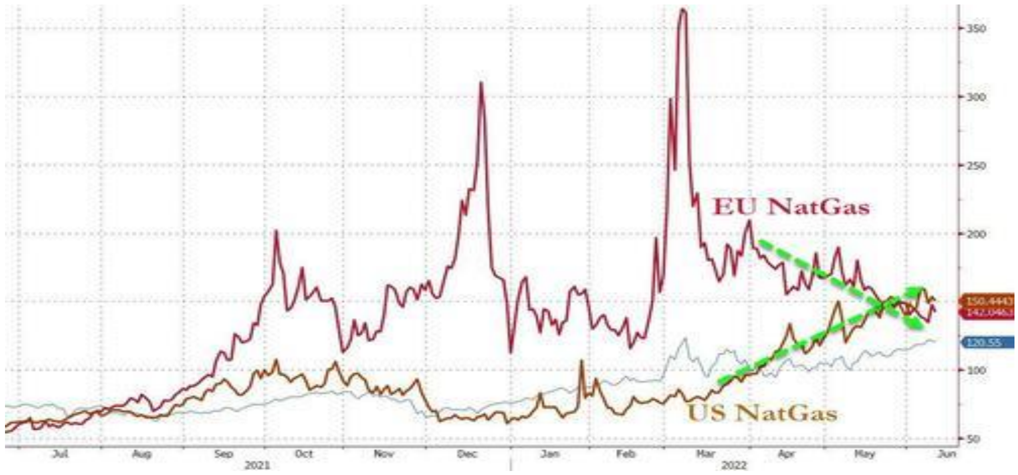
Bloomberg

Despite the ECB's hesitancy, German 10-year yields broke through 1.5% for the first time since 2014 as Germany competed with rising US rates. This rise in interest rates, the war in Ukraine and sentiment weighs on the economy. In the final quarter of 2021 the German economy contracted by 0.3% only to rise by 0.2% in the first quarter of 2022. It is likely to contract once again this quarter.

Of interest is the fact that due to exports of LNG and hot weather, prices for gas in the USA rose higher than those in the EU. (See Graph 11 below)

Japan remains the basket case. Desperate to prevent a rise in interest rates the Bank of Japan is in overdrive buying up Bonds. The price, a collapse in the exchange rate of the Yen. "*The dollar-yen pair just touched 135.00 for the first time since February 2002 and is now within 0.01% of their highest levels seen since October 1998."* The BOJ is alone amongst major Central Banks in refusing to raise interest rates. Even its neighbour, the Bank of Korea has done so. It is unlikely that the BOJ will be able to hold out indefinitely as a Yen crisis is building and a weak Yen imports inflation.

Graph 12.



Conclusion.

There is no conclusion to this article. This is the first part of a two-part article, the second part will be published at the end of the week once the data on retail sales is in.

Brian Green, 13th June 2023.