Weekly Market Insights

July 27, 2020

Markets take a break and the future of the dollar

The Markets

U.S. equity markets ended this past week lower, losing earlier gains. The Dow fell 0.76%, the S&P 500 fell 0.28% and the NASDAQ fell 1.33%. Technology stocks led the decline. Perhaps this retreat should not be a surprise, as the technology sector has performed so well over the past few months and the market had been on a three-week winning streak. The motivation for the weak market was the increase in both infections and deaths from the pandemic. There had been an apparent complacency among some investors about the progress of the pandemic, but that was dampened by last week's reports. European markets have picked up steam for a number of reasons. They appear to have gained more control over the coronavirus than the United States and have come to an agreement on monetary and fiscal policy. More about that later.

The Economy

The economy remains remarkably strong given the circumstances. It is slowly reopening and some employees are going back to work. Unemployment reports have been encouraging, but looking at the raw numbers in isolation, an observer would be forgiven if they thought the future was bleak. The hero on the white horse for the moment, Federal Reserve Chair Jay Powell, rode to the rescue, flooding the system with liquidity while the government stepped in aggressively with fiscal stimulus. Interestingly, a large part of the fiscal stimulus, income substitutes, was not spent, as savings rates increased dramatically. This added savings means the consumer is able to continue to spend. Even with the increased savings, consumer spending has been remarkably resilient.

The extraordinary levels of government debt used to finance the added liquidity and fiscal policy extensions, although needed and laudable, will have to be dealt with at a later time. We have written in the past that this does not appear to be a danger for the economy in the next twelve months or so, but it is important to try to look into the future. The most important and obvious bellwether for a deteriorating economy is the strength of its currency. This is particularly important for the United States. Since the end of World War I, and particularly the Bretton Woods Agreement in 1944, the U.S. dollar has been the world's most important currency. If the dollar lost its primacy, it could and almost assuredly would lead to a chaotic economic environment.

What, historically, have been the reasons a currency falls out of favor? High uncontrolled inflation, lack of a strong central bank and political turmoil. High inflation in this case would be caused by an overabundance of money in the system when the economy is near capacity. This particular point is what worries most analysts, and it worries us to a degree, but some exercising of economic wisdom by the Federal Reserve and Congress can alleviate this problem. The Fed should, as soon as appropriate, start to withdraw liquidity from the system while the administration and Congress should slowly work to lower the government debt burden through revenue and spending management. It will be important for these programs to move slowly, but just starting them will give the world economies confidence in the U.S. dollar. An important leg of this three-legged stool, the President, Congress and the Federal Reserve, is the Fed and its independence. Fed independence must be guarded. It concerns us that the President has nominated, and the Senate Banking Committee has approved, the nomination of Judy Shelton as a board member of the Federal Reserve Bank. We, as almost all economists, view this as a dangerous nomination. Ms. Shelton has, in the past and continues to voice, very unorthodox opinions. For example, she has advocated going back to the gold standard, while at the same time wants to incorporate Modern Monetary Theory (MMT) into policy. Unfortunately, the gold standard and MMT are mutually exclusive, and she has called for the dissolving of the Federal Reserve System.

Europe

We wrote earlier in this paper about Europe. The euro, along with the economy and equity prices, are on the rise. Europe has done some very good things. They appear to be controlling the pandemic better than we have in the United States. The government in Brussels has apparently made significant progress in consolidating bond issuance and distributing aid to the less fortunate countries, meaning funds flowing north to south. All this is good except it is not as concrete as it may seem. The north - south divide remains very powerful, and there are clauses in the agreement that appear to allow some countries to bow out. A very important point to remember is the government in Brussels is not the last word. Each country has its own government which often is at odds with Brussels.

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