Weekly Market Insights

August 14, 2023

Earnings Rise, Prices Fall

Financial Markets

Two out of the three major equity markets fell last week in the midst of positive earnings reports. Historically, August has been a weak month for equities, but there must be a better explanation.

The Dow gained 0.62%, the S&P 500 fell 0.31%, and the NASDAQ fell 1.90%. One week after Fitch downgraded U.S. sovereign debt, Moody's downgraded a number of mid-sized U.S. banks. Economic releases gave mixed signals concerning inflation, which, of course, put the fear of another Fed rate hike in the minds of investors. Both of these factors, as well as the unsettling nature of domestic politics and weakness in China, gave investors reason to pause.

Economics

Relative to the United States, some global economies appear in turmoil. The war in Ukraine shows no sign of slowing, putting further upward pressure on both energy and grain prices, which will continue to adversely affect global inflation. Furthermore, Saudi Arabia's announcement to reduce oil production is another factor driving energy prices higher.

The U.K. continues to grapple with both political and economic turmoil, and the government seemingly does not have a handle on how to address the problems. The western economies face many challenges, both individually and collectively, but we can analyze them and have some confidence that we understand what is happening. Unfortunately, that is not true of China, the most consequential foreign economy of them all.

China is clearly having serious economic issues and, some argue, political ones as well. The greatest challenges for analysts are the lack of regular press briefings with government officials, no minutes of central bank policy meetings, and, most importantly, many doubt the accuracy of released information. An interesting question is, will these economic and political issues morph into social problems? What we do know and have written about many times is that China has massively overbuilt, funded by government debt, particularly in housing.

We have written frequently about two serious economic problems facing China, both related to debt. The first relates to China's exceptional growth in the past being funded by a rapid accumulation of significant debt. The second is China's continued efforts to create a trading empire through The Belt and Road Initiative. The first is collapsing, while the second is losing money at a rapid pace.

Two new economic problems for China have come to light. The first is growing unemployment, particularly among the younger population, which is causing labor unrest. The second and far more serious problem is deflation. Deflation is a serious issue for a number of reasons. Just as inflation can overheat an economy as consumers and businesses move up their purchases in an attempt to beat inflation, consumers and businesses delay purchases when faced with deflation. This accelerates deflation and slows economic growth, a combination that makes it extremely difficult for China to service its government and private debt. Economic historians will tell us this is one of the roadblocks that makes it so difficult for countries to make the leap to higher levels of GDP per capita. Given the difference in challenges, investors should expect Chinese authorities to do the opposite of western central bankers and add stimulus.

Conclusion

The United States continues to move along a positive economic path. Is inflation beaten? Not yet, but the direction is positive. After over a year of persistent rate hikes, the Federal Reserve is now taking a more cautious approach. As we have written, the U.S. equity market has come a long way from the October 2022 low, and markets sometimes need time to pause.

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