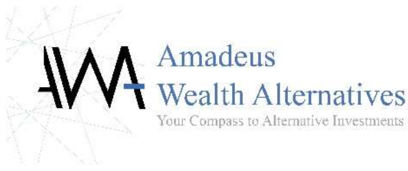


WEEKLY ECONOMIC UPDATE DEC. 16, 2024

Stocks finished the week mixed, bookending losses around midweek gains as investors digested fresh inflation data. The Standard & Poor's 500 Index slipped 0.64 percent, while the Nasdaq Composite Index ticked up 0.34 percent. The Dow Jones Industrial Average dropped 1.82 percent. The MSCI EAFE Index, which tracks developed overseas stock markets, slid 1.48 percent.[1,2]

Up and Down Week

Stocks fell broadly over the first part of the week. Leading chipmakers who produce semiconductors for artificial intelligence applications were under pressure after Chinese regulators announced an antimonopoly investigation.[3] Investors breathed a sigh of relief Wednesday morning following news that consumer inflation in November was in line with expectations. Mega-cap tech stocks led the rally, with the Nasdaq closing above 20,000 for the first time. Meanwhile, the Dow fell as healthcare stocks came under pressure.[4]

Stocks remained in the trading range for the rest of the week on mild concerns about Thursday's warmer-than-expected wholesale inflation report and a spending slowdown among lower-income consumers. The Dow registered its worst losing streak since 2020.[5,6,7]

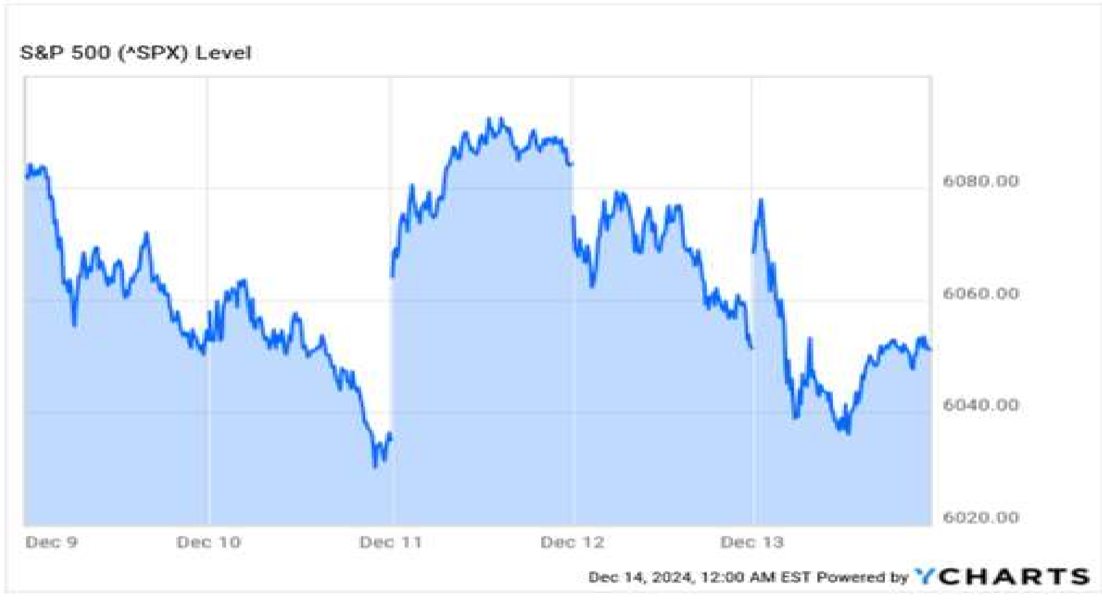
YCHARTS

Weekly Market Insights (WMI)

Major Index Return Summary

Name	1M TR	YTD TR	1Y TR	5Yr TR
Dow Jones Industrial Average	0.28%	18.66%	22.28%	72.92%
MSCI EAFE	2.09%	7.80%	12.51%	36.60%
Nasdaq Composite	3.32%	33.50%	37.94%	137.5%
S&P 500	1.27%	28.54%	32.13%	106.7%

S&P 500 Daily Close



10-Year Note Review

Indicator Name Date	Latest Value	1M Ago 3M Ago 1Y Ago	1M Change 3M Change 1Y Change
10 Year Treasury Rate 12/13/24	4.40%	4.44% 3.66% 4.04%	-0.90% ▼ 20.22% ▲ 8.91% ▲

Final Fed Meeting of 2024

The consumer price index ticked up to 2.7 percent on an annualized basis in November, as expected. The market's rally following the news reflected investor relief that inflation met expectations and that the increase from the prior month was slight.

Those two factors may reinforce the belief that the Fed would follow through with the December rate adjustment, which it penciled in back in September. The bellwether inflation measure was the last critical data point before the Fed's two-day meeting, scheduled to end on December 18.[8]

This Week: Key Economic Data

Tuesday: Federal Open Market Committee (FOMC) Meeting Begins. Retail Sales. Industrial Production. Business Inventories.

Wednesday: Housing Starts and Permits. FOMC Announcement. Fed Chair Press Conference.

Thursday: Gross Domestic Product. Existing Home Sales. Weekly Jobless Claims.

Friday: Personal Income and Outlays. Consumer Sentiment.

Quote of the Week

"It is forbidden to kill; therefore all murderers are punished unless they kill in large numbers and to the sound of trumpets".

– Voltaire

In recent years, the transmission mechanism of monetary policy—the intricate process through which central bank actions impact the economy—has undergone significant changes, notably as global debt levels have surged. With governments around the world carrying heavier debt burdens, the impact of rising interest rates on the economy has shifted in ways that policymakers must grapple with. This complex situation underscores the need for a deeper understanding of the economic dynamics. One of the most pressing issues is the effect of increasing interest payments on government debt, reshaping how central banks think about and implement monetary policy.

Historically, central banks have used interest rates as their primary tool to influence economic activity. When inflation is high, or the economy is overheating, central banks raise interest rates to cool demand by making borrowing more expensive. Conversely, when the economy is sluggish, they

lower rates to stimulate spending and investment by making credit cheaper.

This process works through several channels:

1. Interest rates: higher rates increase the borrowing costs for businesses and consumers, reducing spending and investment, and vice versa.
2. Wealth effect: changes in interest rates affect asset prices, which influence household wealth and, in turn, consumer spending.
3. Exchange rates: higher interest rates can attract foreign capital, strengthen the domestic currency, and impact trade balances.

However, with unprecedented levels of government debt, the traditional transmission of monetary policy is becoming increasingly complicated.

Now that government debt is at historically high levels, the impact of interest rate changes reverberates more strongly through fiscal channels. Rising interest rates affect private borrowers and significantly increase the cost of servicing government debt. This creates a feedback loop between monetary and fiscal policy, which may ultimately constrain the central bank’s ability to use its tools as freely as it did in the past.

As interest rates rise, governments must allocate more of their budgets to debt servicing costs. This presents a significant dilemma: higher interest payments can crowd out

other forms of government spending, such as infrastructure investments, social programs, or healthcare. In countries with very high debt-to-GDP ratios, such as the United States, Japan, and several European nations, the cost of debt servicing has become a substantial part of the national budget.

The US net interest expense is on track to be the second largest outlay, second only to Social Security. Perhaps this is why Japan, with its 250% debt to GDP, has been so slow to raise interest rates.

This increase in government spending on interest payments due to rising rates means two things:

1. Constrained fiscal policy: governments may have less room to maneuver when it comes to fiscal stimulus, as a larger proportion of their revenue goes towards interest payments. This could limit the effectiveness of countercyclical fiscal measures in future recessions.
2. Political pressure on central banks: central banks may face political pressure to keep interest rates low to help reduce the government's borrowing costs. This creates a risk of 'fiscal dominance', where the need to manage government debt trumps the central bank's focus on controlling inflation.

The rising cost of government debt can also significantly dampen economic growth. As governments are forced to spend more on debt servicing, they may cut back on productive investments that drive long-term economic

growth. The gravity of the situation is a cause for concern. Additionally, higher interest rates can squeeze private-sector borrowing, especially for small businesses and consumers, leading to lower levels of economic activity overall.

A central bank's traditional objective is to manage inflation and stabilize the economy. However, with high debt levels, central bankers must now also consider the fiscal implications of their actions. Raising interest rates aggressively to combat inflation could potentially destabilize public finances, especially if governments are already struggling with large deficits and high debt loads.

For example, a country with high debt that faces rising interest rates may see its credit rating downgraded, leading to higher borrowing costs and a vicious cycle of debt accumulation. Central banks may be forced to adopt a more cautious approach to tightening monetary policy, even when inflation rises, to avoid exacerbating fiscal pressures. This caution could lead to a situation of 'fiscal dominance', where the central bank's ability to control inflation is compromised by political pressure to keep interest rates low for the government's benefit, highlighting the potential risks to inflation control when central bank independence is threatened.

Another significant shift in the transmission mechanism is that high debt levels have led to greater uncertainty about how quickly or effectively monetary policy actions translate into economic outcomes and through which channel—monetary or fiscal.

Consider a scenario where a central bank hesitates to raise rates due to concerns over government debt. In this case, inflation could persist at high levels, diminishing purchasing power and undermining the efficacy of future policy interventions. This erosion of the central bank's control over inflation due to 'fiscal dominance' could result in less effective future policy interventions, highlighting the enduring impact of high debt levels on the economy.

The US economy, along with others, is approaching a critical juncture, with the upcoming election potentially serving as a catalyst. Despite being in the fourth year of economic expansion and with unemployment at or near all-time lows, current deficit levels mirror those seen during recessionary periods.

When the next economic downturn arrives, the government may find itself in a precarious situation. Will it be able to respond with a Keynesian splurge given the current levels of debt and deficits? If the new administration fails to curb spending, the market may force austerity measures on the government. Fearing this outcome, the government will likely have to tighten fiscal spending, potentially leading to an economic slowdown.

This dynamic has made life increasingly difficult for investors, and they should remain cautious. With interest rates starting to move lower on the back of rate cuts and valuations looking stretched with still relatively flat curves, fixed income is at risk of yields moving materially steeper as

investors lose confidence or central banks respond to an economic slowdown.

Worryingly, politicians seem more concerned about people eating dogs and cats over the pending fiscal crisis. Perhaps investors will continue turning to alternative assets and gold which is known to protect against inflation, currency devaluation and geopolitical risk, which seems to be rising by the day.[9]

Footnotes and Sources

1. The Wall Street Journal, December 13, 2024
2. Investing.com, December 13, 2024
3. CNBC.com, December 10, 2024
4. The Wall Street Journal, December 11, 2024
5. The Wall Street Journal, December 12, 2024
6. CNBC.com, December 13, 2024
7. The Wall Street Journal, December 13, 2024
8. The Wall Street Journal, December 11, 2024
9. zerohedge.com/markets/economic-juggling-complexities-monetary-policy-amid-soaring-debt

Investing involves risks, and investment decisions should be based on your own goals, time horizon, and tolerance for risk. The return and principal value of investments will fluctuate as market conditions change. When sold, investments may be worth more or less than their original cost. Any forecasts or forward-looking statements are based on assumptions, may not materialize, and are subject to revision without notice. The market indexes discussed are unmanaged, and generally, considered representative of their respective markets. Index performance is not indicative of the past performance of a particular investment. Indexes do not incur management fees, costs, and expenses. Individuals cannot directly invest in unmanaged indexes. Past performance does not guarantee future results. The Dow Jones Industrial Average is an unmanaged index that is generally considered representative of large-capitalization companies on the U.S. stock market. Nasdaq Composite is an index of the common stocks and similar securities listed on the NASDAQ stock market and is considered a broad indicator of the performance of technology and growth companies. The MSCI EAFE Index was created by Morgan Stanley Capital International (MSCI) and serves as a benchmark of the performance of major international equity markets, as represented by 21 major MSCI indexes from Europe, Australia, and Southeast Asia. The S&P 500 Composite Index is an unmanaged group of securities that are considered to be representative of the stock market in general. U.S. Treasury Notes are guaranteed by the federal government as to the timely payment of principal and interest. However, if you sell a Treasury Note prior to maturity, it may be worth more or less than the original price paid. Fixed income investments are subject to various risks including changes in interest rates, credit quality, inflation risk, market valuations, prepayments, corporate events, tax ramifications and other factors. International investments carry additional risks, which include differences in financial reporting standards, currency exchange rates, political risks unique to a specific country, foreign taxes and regulations, and the potential for illiquid markets. These factors may result in greater share price volatility. Please consult your financial professional for additional information. This content is developed from sources believed to provide accurate information. The information in this material is not intended as tax or legal advice. Please consult legal or tax professionals for specific information regarding your individual situation. This material was developed and produced by FMG Suite to provide information on a topic that may be of interest. FMG is not affiliated with the named representative, financial professional, Registered Investment Advisor, Broker-Dealer, nor state- or SEC-registered investment advisory firm. The opinions expressed and material provided are for general information, and they should not be considered a solicitation for the purchase or sale of any security.
Copyright 2024 FMG Suite.