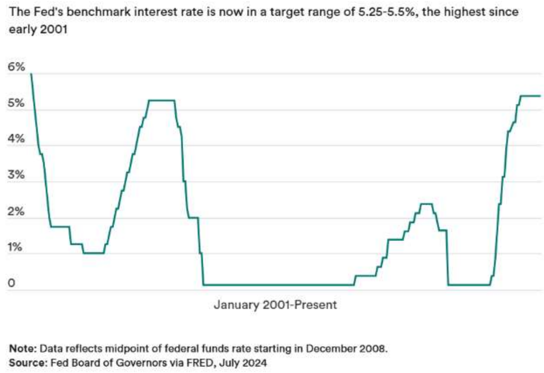
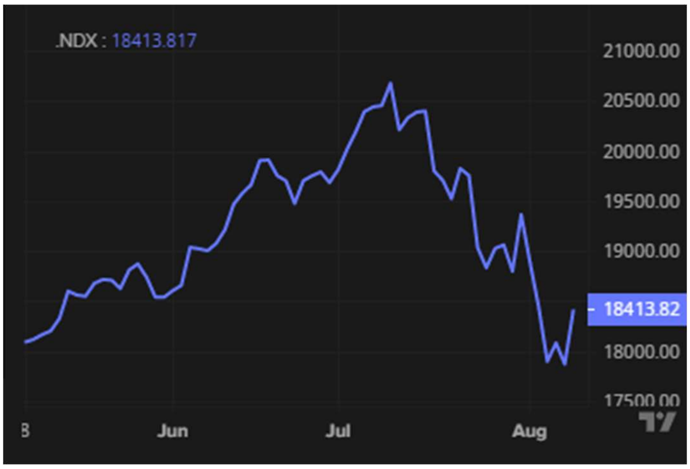
Is inflation under control or will a recession prevail?

Faced with the new collapse of global stock markets, the Federal Reserve just sent a signal to the markets. "The Fed's job is very simple: maximize employment, stabilize prices and maintain financial stability," Chicago Federal Reserve President Austan Goolsbee told CNBC. "We always look ahead, and if conditions start to deteriorate in a way that any of those elements of the production line deteriorate, we will fix it. There is no bad weather. There is just bad clothing. As conditions come, we will respond appropriately," he added.

The Fed has not however explained how it might intervene, but some investors are betting that the Federal Reserve could now call an emergency meeting of its monetary policy arm (FOMC) and bring forward to August the rate cut on the table in September, after Chairman Jerome Powell kept the cost of money unchanged at 5.25-5% for the eighth consecutive time in July, while Europe, Switzerland and even Japan have already started easing. A sudden cut in US rates would be an admission that the US economy is weaker than expected and could slip into recession, as the latest data from the labor market would seem to indicate, with fewer jobs created (114,000, well below expectations) and an unemployment rate that rose to 4.3% in July.



The new collapse on the stock markets began on August 6 in Japan: in Tokyo, the Nikkei 225 index lost 12.4% and the TOPIX index 12.2%. As much as it recovered the following day pretty much the entire ground lost of Monday, this represented the biggest decline since Black Monday in 1987, a crash linked in part to fears about the American economy, but above all to the rise of the yen in recent weeks, which on the one hand slows down the competitiveness of exports of Japanese companies, and on the other forces investors who have borrowed in yen to finance their bets to hastily close positions that have suddenly become unsustainable. Seoul is also in free fall (-8.8%). The sell-off from the East spread to the rest of the world, sending first European stock markets and then Wall Street into the red. In the afternoon, some data on the American economy partly mitigated the losses, which remain heavy.



In Milan, once again the worst performing index, the FTSE MIB index fell 2.26%, with another 15 billion in capitalization burned, bringing the total for the last three sessions to 55 billion. In Paris, the CAC40 lost 1.42%, the Frankfurt DAX 1.82% and the London FTSE 2.04%. The spread between the 10-year BTP and the German Bund remained substantially stable, slipping to 152 basis points from 154 at Friday's close, with a yield that rose slightly to 3.67% from the previous 3.63%, while that of the Bund stood at 2.15%.

Overseas the day was slightly more dramatic. The Nasdaq fell by more than 6% at the opening, the S&P index by 4.7% and the Dow Jones by 2.85%. Then the positive and better than estimated data from the ISM services, the index that measures the performance of the tertiary sector, which rose from 48.8 in June to 51.4 in July, allowed the technology stock index to halve its losses to 3.57%, due to the slumps of Big Tech, with Nvidia down 6%, Apple by 4.32%, Intel by 7.22% and Amazon by 5.25%, after disappointing quarterly results. At the close, the Nasdaq marked -3.43%; the S&P -3.00% (the biggest decline since September 2022) and the Dow Jones -2.60%.

The slowdown of the US economy and the technology bubble, along with the mistakes of the Fed, are among the main causes of the turbulence that is shaking the markets, but Donald Trump immediately tried to exploit the crash on the stock markets to his -electoral- advantage. "The stock markets are collapsing. I told you!!! Kamala has no idea. Biden is fast asleep. All caused by inept American leadership!", wrote the Republican candidate on his platform Truth social on Sunday evening.

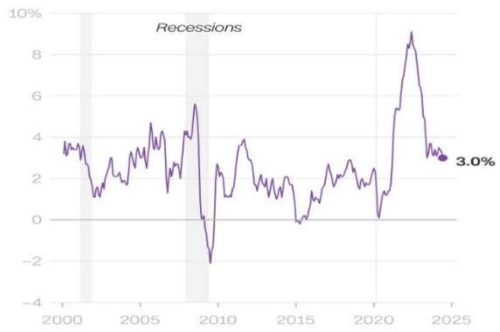
What exactly happened on Friday, August 2? The lesson, in general, is that even very sharp and sudden drops in the indices do not necessarily signal a broader financial crisis or a recession in the west. Much will depend, however, on the degree of indebtedness of the entities that have suffered the greatest losses in recent days and, above all, on the response of central banks in the coming weeks.

One of the main reasons for the stock market crashes in these days is structural. With the enormous growth of American Big Tech in recent years – linked in turn to the inevitable digital revolution, artificial intelligence and the revolution of electric mobility – stock markets have become incredibly concentrated. Never before have so few companies weighed so much on the total capitalization of the world stock markets. Apple, Microsoft, Nvidia, Alphabet (Google), Amazon, Meta (Facebook) and Tesla have a collective capitalization of over 13 trillion dollars. The comparison is inappropriate, but it is a value greater than the entire gross product of a year of the euro area (the third largest economy in the world after the United States and China) and half of the gross product of the United States.

The incredible growth in the stock market value of the seven American Big Tech companies has caused the market to become extremely dependent on them. In particular, on their results published every three months. All the synthetic indices of the world stock markets fluctuate greatly based on the fluctuations of Apple and its sisters. Those seven companies alone are now worth 25% of the market capitalization of the over 2,500 companies listed in the United States. And Wall Street, immediately before the recent crashes, was worth almost 70% of all world markets. It is as if the international financial system were an organism with an extremely large and heavy head in proportion to the rest of the structure; therefore, it is prone to losing its balance when the head swings fearfully .To give an idea: the aggregate market value of the new technological “Seven Sisters”, alone, is almost equal to the value of the entire stock indexes of the other main G7 countries: the stock exchanges of Japan, France, Great Britain and Germany put together. It is inevitable that the fluctuations of the “Seven Sisters” are destined to become earthquakes on the world markets.

The trigger for the crashes came when the quarterly results of some of the new “Seven Sisters” of tech disappointed. In recent days, Amazon’s revenues in the second quarter, for example, came out a little below expectation. As for the most fashionable of Big Tech, the artificial intelligence chipmaker Nvidia, hedge fund Elliott recently declared that its stock is in a “bubble” and its story is “overinflated.” No wonder, then, that a correction in Big Tech has triggered a violent correction in global markets that is more concentrated than ever before.

But the financial key does not explain everything. The landslides have become collapses in the last couple of days as doubts have emerged about the resilience of the American economy. The fact that the number of jobs added in the United States in July (114 thousand) was the second lowest since the beginning of 2021 has scared the markets. This and the increase in the unemployment rate to 4.2% raise fears that the first economy in the world, after defying the force of gravity of rather high official rates, is headed for a recession.



Note: Figures not adjusted for seasonal swings.

Source: US Bureau of Labor Statistics
Graphic: Matt Stiles, CNN

These fears may be overblown. First, a single month of weak job creation does not prove a recession. April was worse (108,000 jobs), then the labor market rebounded. In addition, these are partly temporary job cuts, due to bad weather. And the increase in unemployment seems to be explained not by layoffs but by new immigrants arriving in the United States and other people who are now looking for a job. In short, the Federal Reserve's rates at their highest since 2001 (5.25%-5.50%) are starting to slow the American economy, but the latter still grew by 2.8% in the second quarter at an annualized pace. We are far from a crisis scenario. And we are also far from it because the Fed has ample room to quickly cut rates, if necessary, and restore calm to the markets as well as growth in the economy. But there are two variables: the first is financial. The crashes of recent days have done a lot of harm to some large investors who had taken on a lot of debt to take positions on some stocks like Nvidia. These investors must therefore sell other positions to increase the guarantees to creditors: this will cause, indeed is already causing, a chain reaction of crashes in other investment classes. Without this necessarily being justified by the fundamentals. In essence, there is a lot of speculative behavior that will now weigh on the indices.

The other variable is political: will the stock market crashes weigh on the challenge for the White House between Kamala Harris and Donald Trump? That is not certain. But the markets had already begun to deal with the tax cuts – in deficit – on businesses that Trump promises. And in recent weeks they had risen (also) because of that. Stock market investors, even when they vote for the Democrats, love Trump. They demonstrated this immediately after his election in 2016. Now the fact that the outcome of the November 5 polls is more uncertain is leading to a readjustment of the indices.

My personal take is -generally speaking- that the political variable is just chit-chat to fill in newspaper articles or gimmicks for election purposes. Investors get scared quickly, but they come to reasoning probably even faster, for they know that politics is mostly a big show while it’s companies with their profits that make the world go around and -when sufficiently big and powerful- they dictate policies themselves to the elected representatives.

Marcello Tedeschi, August 6, 2024