

A study in contrasts: Wall Street and the underlying economy

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17 August 2021

The contrast between the rise of the stock market and the underlying state of the US economy was highlighted on Monday when Wall Street's main index, the S&P 500, reached a level double its low of March 2020 as the initial effects of the COVID-19 pandemic led to chaos in US financial markets.

The new high was recorded despite the debacle in Afghanistan, sharply falling consumer confidence, slowing growth in China and the widening impact of the Delta variant both in the US and internationally.

The markets fell on Tuesday with the S&P 500 having its worst day for a month, falling by 0.7 percent and the Dow dropping by 500 points at one stage, on the back of data which showed a 1.1 percent fall in retail sales in July compared to June.

But with money continuing to pour into the financial system from the Fed the general sentiment appears to be that the Wall Street surge will continue. "I don't think it portends a precipitous drop around the corner. I think it's very temporary," one financial manager told the *Wall Street Journal*.

Fears of worsening conditions in the underlying economy were revealed in the results of the widely watched Michigan consumer confidence survey published at the end of last week.

It showed that the Consumer Sentiment index fell by 13.5 percent from July to August to a level just below the April 2020 low. The University of Michigan (UofM) survey reported that the only faster rates of decline in the Sentiment Index were in April 2020, when it recorded a drop of 19.4 percent and in October 2008, during the global financial crisis, when it dropped 18.1 percent.

"The losses in early August were widespread across income, age, and education subgroups and observed across all regions," according to the survey. Richard Curtin, the UofM economist in charge of the survey called the results "stunning."

It indicates that the Biden administration's economic policies and its claims that the US economy is on the way to recovery could well be going the same way as Afghanistan.

A survey of small businesses conducted by the *Wall Street Journal* showed a fall in sentiment similar to that recorded by the UofM.

It found that small business confidence in August had

dropped to its lowest level since the early spring, largely as a result of the rise in COVID-19 infections due to the more infectious Delta variant.

Some 39 percent of small business owners expected economic conditions in the US to improve in the next 12 months, down from 50 percent in July and 67 percent in March. Reporting on the survey, the *Journal* cited the owner of one small business, an event production company, which reported a flurry of cancellations.

"We were slowly ramping up in anticipation of a robust third and fourth quarter," he said. "You can drop the 'ro' part. It seems like it is just bust."

The resurgence of the pandemic via the Delta variant is also putting a damper on international economic growth, particularly in China.

According to data released by China's National Bureau of Statistics on Monday, the economy slowed in July by more than expected. This was the result of Delta infections as well as flooding due to extreme weather events in parts of the country.

Retail sales in July rose by 8.5 percent in July compared with the same month a year ago and industrial production increased by 6.4 percent. But both these figures were below the level anticipated by economists of 10.9 percent and 7.9 percent respectively.

China has imposed strict travel restrictions in response to an outbreak of the coronavirus that began in the middle of last month in Nanjing. But even before the latest outbreak there were signs that the initial bounce back of the Chinese economy was slowing.

Reporting on the latest data, Fu Linghui, a spokesman for the statistics bureau said; "Growth in some consumer sectors and services slowed." He warned that growth in the second half of the year was likely to be lower than the first six months.

International banks and forecasting agencies are revising down their estimates for Chinese growth. Goldman Sachs, Morgan Stanley and Nomura as well as other investment banks have all reduced their forecasts. The ANZ bank added its voice on Monday when it downgraded its forecast for full year growth from 8.8 percent to 8.3 percent. It pointed to a "broad-based slowdown in domestic activities in July, which suggests that the economy is rapidly losing steam."

Julian Evans-Pritchard, senior economist at Capital Economics, told the *Financial Times* (FT) that in addition to the fall in the growth of retail sales, investment spending and industrial activity that were less sensitive to COVID-19 restrictions were also weaker.

“The drop back in consumption should reverse once the virus situation is brought under control and restrictions are lifted,” he said. “But we think the slowdown elsewhere will deepen over the rest of the year.”

And if there is a slowdown in the rest of the world, it will heavily impact on China as can be seen in the latest figures on exports which showed growth of 19 percent in July as compared with 32 percent in June.

The increasingly complex situation in the global economy is adding to the problems confronting the major central banks as they consider whether they should start to ease or “taper” their support for financial markets.

There appears to be something of a shift among members of the Fed’s governing body towards tapering. In an interview with the FT last week, San Francisco Fed president Mary Daly, regarded as being on the dovish side, said it was “appropriate” to start dialling back accommodation, starting with asset purchases.

“Talking about potentially tapering those later this year or early next year is where I’m at,” she said.

Esther George, the president of the Kansas City Fed, has also indicated that it is time to “transition from extraordinary monetary policy accommodation to more neutral settings.”

The key issue here is inflation and whether this will lead to a push by workers for higher wages. George alluded to this issue, referring to “firm inflation expectations” and a “recovering labour market” as being consistent with Fed objectives that could provide the basis for “bringing asset purchases to an end.”

The question was dealt with more bluntly in remarks by David Kelly, chief global strategist at JPMorgan Asset Management, reported in the FT.

The official Fed position is that the present spike in US inflation is “transitory.” “But there is nothing transitory about wage inflation,” Kelly said, warning that present Fed policies “will trigger higher wages and pressure corporate margins.”

On the other side, there is a fear that such is the dependence of Wall Street on the flow of cheap money from the Fed and the mountain of debt and fictitious capital it sustains that any move to curb it in order to counter inflation and a wages push by workers will set off financial turbulence.

The financial markets will be closely following the remarks by Fed chair Jerome Powell at the annual conclave of central bankers and financial analysts at Jackson Hole, Wyoming at the end of this month which may give some indication of the direction in which the US central bank is heading.

At present the differences, at least as they appear in public, are relatively muted. But that could rapidly change as indicated

by developments in Britain.

In the middle of July, the House of Lords economic affairs committee, which includes former Bank of England governor Mervyn King, issued a scathing report on the Bank of England’s (BoE) quantitative easing (QE) asset purchasing program.

Lord Michael Forsyth, the chair of the committee, said the BoE “has become addicted” to QE using it as the “answer to all the country’s economic problems.”

The report said there were wide perceptions the bank was “using QE mainly to finance the government’s spending priorities” and if these continued to grow “it would lose credibility destroying its ability to control inflation and maintain financial stability.”

BoE governor Andrew Bailey responded testily to the use of the word “addicted” saying it had a “very damaging meaning for many people who are suffering.”

Last week the BoE made a tentative move towards tightening monetary policy when it announced a plan to start reducing its holding of £900 billion worth of government bonds, equivalent to about 40 percent of GDP.

Announcing the policy at a press conference, Bailey said when interest rates reached 0.5 percent the central bank would stop reinvesting the proceeds of bonds it owns and when they reached 1 percent it would consider selling some of them. The process of unwinding QE would proceed on “autopilot” along a “gradual and predictable path.”

But as the FT reported this “breeziness” seemed odd given the “market upheavals” when the Fed sought to reduce its balance sheet in 2013 and 2018. In 2013 the initial move to end QE resulted in a spike in interest rates.

In 2018, when Fed chair Powell indicated further rate rises in 2019 following four rises over the previous 12 months and that the reduction in asset holdings was on “autopilot,” Wall Street responded with a significant fall, recording its worst December since the Depression.



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