1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

October 10, 2022

China, the Economy, and the Fed

We would like to start this week's update by extending a congratulations to former Federal Reserve Chairman Ben Bernanke on receiving the Nobel Prize in Economics. Well deserved!

Financial Markets

United States financial markets continued to suffer from extreme volatility this past week. Investors can be excused for creating this volatility. Markets face confusion and unknowns both domestic and global. *The Economist* had a very apt title in one of their articles this week, "What Next?"

U.S. equity markets traded down sharply on Friday but still ended the week positive. The Dow Jones closed up 1.99%, the S&P 500 closed up 1.51%, and the NASDAQ closed up 0.73%. The dominant fear for investors was higher interest rates, although the economic releases could be considered mixed. For instance, jobs data appeared to suggest the economy was slowing, but other data showed increasing growth. Investors can be forgiven for being a bit more Chicken Little than Pollyanna. As they read the news, they see crises in the Ukraine, high domestic and global inflation, and a very fractious midterm election. China is also entering its 20th National Congress on October 16th, which may be disturbing both economically and security wise. Finally, the remarkable strength of the U.S. dollar is causing strain in the currency exchange markets. Given the wide variety of global challenges, unusual volatility may remain for quite some time.

Economics

There are a lot of questions facing investors, government officials, and, perhaps most importantly, members of the Federal Reserve Open Market Committee (FOMC). We listed some of the more pressing concerns earlier. One we didn't mention, but is nevertheless very important to the market, is the beginning of earnings season.

We have written much about both China and Ukraine. There is much more to write about, but we will leave them to next week.

The discussion about the remarkable strength of the dollar is quite interesting. Its strength reflects many things. Among them are expectations of lower domestic inflation, a stable economy, a responsible central bank, and a sound political base. It should help strengthen the balance of payments of its trading partners.

Both the Fed and investors will be watching corporate earnings announcements very closely for signs of a slowdown and inflationary pressures.

As everyone is aware, the price of energy is vitally important to inflation and elected officials. This leads to a very interesting and important question. Why do the Saudis sanction a cutting of production right before the November midterm U.S. elections? It is a very interesting question and unlikely to be forgotten soon.

Conclusion

At the moment, it is difficult to be certain about any answers to the questions we laid out. It is likely that volatility will remain well above normal for some time. The Fed is not going to give up the ghost in its fight against inflation, so we expect higher funds rates for the foreseeable future. It is far too early to say how much higher. Our view is that the labor market will continue to ease, but not dramatically.

We strongly recommend readers pay close attention to the Chinese Communist Party's convention starting October 16. It has the potential to be one of, if not the most, important events of not just this year but the next few years.

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September Economic Indicator Update

Economic indicators continue to signal a slowing economy, but not drastically so. Inflation has been and remains a focal point, but disjointed economic data is clouding the outlook. While there have been encouraging signs of disinflation, further labor market slack will be needed in order to relieve service-oriented price pressures and achieve the next leg lower towards price stability.

Headline inflation measures cooled slightly in August, but core readings accelerated from the prior month.[1] While goods and commodities prices have largely declined to normalized levels, the diverging core and headline measures reflect continued stickiness in services inflation. Shelter was a driving factor behind the elevated core readings, accelerating 0.7% month-over-month and 6.2% year-over-year—the largest monthly increase since 1991. The impact of mortgage rates rising to levels last seen in 2007 has already manifested itself in weaker housing data, but there are reasons to believe elevated shelter prices could persist for some time. Home prices are starting from very elevated levels, and, while slowly improving, housing inventories are still historically low. Furthermore, recent research findings from the Federal Reserve Bank of San Francisco suggest higher levels of remote work may be driving increased demand for housing, resulting in higher prices and rental rates. With around 30% of work still being performed at home compared to 5% pre-pandemic, the current elevated demand environment may be slow to subside.[2] Ultimately, demand for services, rents, and housing are reliant on consumers' willingness and ability to pay, which is largely dependent on labor market strength. For this reason, reduced demand for labor and more subdued wage increases are needed in order for further inflation improvements to materialize.

September's jobs data was contradictory, but, generally indicated that labor market tightness is slowly easing. JOLTS job openings declined by more than 1 million to just over 10 million total openings, and Challenger Gray layoffs have come in higher than the previous year for four months in a row. Furthermore, anecdotal evidence has been supportive of reduced labor demand with restaurants like Chipotle and Starbucks reporting improved hiring and staffing levels, and more and more companies are announcing job cuts or reduced hiring plans. Friday's employment report pushed back against this theme to some extent. While growth slowed to 263,000, job additions came in higher than anticipated, the unemployment rate unexpectedly declined to 3.5%, and the labor force participation rate dropped slightly to 62.3%. While the market reaction to the report was decisively negative, employment gains have shown clear signs of moderation in recent months, trending well below 2022's monthly average of 440,000 and 2021's average of 560,000. Notably, September's wage growth held steady with the prior month, and the year-over-year rate declined to 5%. Although hoping for weaker employment data seems paradoxical, and there is a human element to consider, increased labor market slack and controlled wage gains are central to inflation's path lower.

Consumer confidence indicators improved slightly last month, reaffirming August's decisive trend change after months of readings near historical lows. Inflation concerns continue to dissipate, with consumers feeling support from a strong labor market. This disinflationary theme materialized in inflation expectations with five year forward expectations falling to 2.7%, breaking below the 2.9% to 3.1% range that has held since January 2021. After softer consumption and spending data in August, September's metrics came in a stronger. Retail sales increased 0.3% and personal spending rose 0.4% from the prior month. Improved consumer confidence levels are a welcome sign

[1]September year-over-year inflation readings: CPI: 8.3%, Core CPI: 6.3%, PCE Deflator: 6.2%, Core PCE Deflator: 4.9%.
[2]Kmetz, Augustus, Johannes Wieland, and John Mondragon. "Remote Work and Housing Demand." San Francisco Fed. Federal Reserve Bank of San Francisco, September 26, 2022. https://www.frbsf.org/economic-research/publications/economic-letter/2022/september/remote-work-and-housing-demand//

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pushing back against recessionary fears, but further moderation in consumer demand is needed for service oriented price pressures to ease.

Inflation continues to show signs of improvement, although the next move lower may be more difficult to achieve. Reaching price stability will likely require increased unemployment and a sustained period of below-trend economic growth. Popular indicators of economic activity, like Industrial Production, GDP growth, and various Purchasing Manager Indices (PMIs), have shown definitive signs of moderation, and, while there has been growing indications of increased labor market slack, further consistency is needed. For now, the Federal Reserve's goal for a soft landing remains intact, but the window for a non-recessionary outcome continues to narrow.

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