Weekly Market Insights

November 7, 2022

Markets Fall but Still No Real Message

Financial Markets

United States equity markets closed lower this past week. Despite the decline, there should be some encouragement for equity investors. The Dow Jones closed down 1.40%, the S&P 500 closed down 3.35%, while the NASDAQ closed down 5.65%. Under very few circumstances would anyone feel comforted by these numbers, but three things encourage us—the week-ending rally, the structure of returns, and the lack of panic.

In almost all cases, investors should be comforted when the market performs well on the last trading day of the week. Additionally, taking the week as a whole, the markets did not suffer excessively. We say this because there was an easy reason for investors to feel pessimistic. As most are aware, the Federal Reserve raised interest rates another 75 basis points last week, which was on the higher end of analysts' projections. This could have led to much steeper market declines and a prevention of the Friday rally. Finally, as we look at the distribution of returns and the outperformers, it gives us some comfort about a topic we have discussed several times in the past. It seems, perhaps, that companies investing heavily in existing technology, like those in the Industrials sector, will be the future market leaders. Although this should not be taken as a forecast, it is a very interesting concept and is certainly not out of the realm of possibilities.

Markets remain volatile and investors are nervous. It is difficult to forecast how they will react to the upcoming elections.

Economics

Ryan has done a fine job in laying out last week's economic indicators, which you can find at the end of today's update. It makes no sense for anyone to repeat what he has written, so we will just make a few other observations.

China, of course, is an important topic and seemingly always on the world stage. Along with all of the changes taking place over the past few weeks at the Chinese National Congress, two additional important initiatives have occurred. German Chancellor, Olaf Schultz, is the instigator of both. The newly elected Schultz made his first trip as chancellor to China to meet with President Xi. The trip's obvious purpose was to enlist Xi's help in joining most other nations of the world in warning President Putin against the use of nuclear weapons, tactical or otherwise. In this he succeeded. It was not the most ringing endorsement, but it was an unmistakable one. Most Russia watchers would agree that Putin would be very wise to heed Xi's warning.

Schultz' second initiative was a more subliminal one—establish a relationship with President Xi, and, perhaps, strengthen China's ties with the West. Although we have written unsparingly about President Xi and the direction he is taking China, it would be a great thing for both the East and West to see an easing of tensions. Clearly, at least for the moment, the United States cannot be the primary negotiator of peace.

Both the markets and economic players globally will be closely watching the coming elections. It will be interesting and fun to write about.

Conclusion

Much remains the same. Will the elections bring changes to the status quo? Probably to some degree, but one should not expect market volatility to come to an end. Investors must remember that the dominant player remains the Federal Reserve. The monetary authority will not be abandoning its mandate to control inflation anytime soon.

Weekly Market Insights (cont'd)

Economic Indicator Update

Since the onset of the pandemic, economic indicators have often been contradictory and difficult to interpret. Today, however, the economic data appears to more unanimously point to the same message—economic growth is moderating, inflation is peaking but remains elevated, and the labor market is strong but slowly cooling. Going forward, we will look for these trends to continue but in a more decisive manner, particularly when it comes to inflation and labor market indicators.

The first reading of 3rd quarter GDP growth came in higher than consensus expectations at a 2.6% quarter-over-quarter seasonally adjusted annualized rate. Increases in exports, nonresidential investment, government spending, and consumer spending contributed to the rise. While a positive reading was encouraging after two consecutive quarters of decline, economic growth is on track to moderate from 2021's 5.7% growth. Other popular indicators of economic activity like Industrial Production and various Purchasing Manager Indices (PMIs) have shown definitive signs of moderation as well. While each of the PMI readings are slightly different, they have been unanimously trending lower and all are at or near contractionary levels. With the Federal Reserve aiming to cool economic growth, a slowing but non-contractionary economy is the ideal state.

Headline inflation measures held steady in October, but core readings accelerated from the prior month.[1] While energy, food, and goods prices have largely stabilized, services inflation components have continued to accelerate. Shelter again was a driving factor behind the elevated core readings, accelerating 0.7% for the second consecutive month. With the average 30-year fixed rate mortgage firmly exceeding 7%, housing market weakness is noticeably materializing in housing indicators. Housing Starts fell 8.1% over the course of the month, the NAHB Housing Market Index posted its tenth straight decline, and the S&P Case Shiller Home Price Index has contracted for two consecutive months.

Real time rental data is also showing clear signs of deceleration with Zillow's Observed Rent Index drastically declining for seven consecutive months after peaking in February.[2] Despite weakening housing and rental data, the shelter components within the CPI and PCE inflation gauges act with significant lag time, so elevated readings could persist for some time. In addition to housing, other components of services inflation are dependent on underlying consumer demand. Because consumer demand is fueled by labor market strength, higher unemployment and reduced wage gains may be an unfortunate necessity to temper demand and allow for further inflation improvements to materialize.

October's labor market data indicated continued tightness but signs of cooling. Nonfarm payrolls increased by 261,000, signifying another solid month of job gains, but marks a cooldown from September's 315,000 pace and is the lowest monthly increase since December 2020. Household survey data painted a slightly different picture with the unemployment rate rising 0.2 percentage points to 3.7% and year-over-year average hourly earnings falling 0.3 percentage points to 4.7%. Despite JOLTS job openings once again turning higher after last month's significant decline, the report also showed a decrease in the number people hired and workers who quit their jobs—an early indicator that employers and employees may be preparing for a period of economic weakness. Taken together, this month's employment data points to a strong labor market that is gradually showing signs of cooling. Although significantly higher unemployment and subdued wage gains would be painful to endure,

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[1] October year-over-year inflation readings: CPI: 8.2%, Core CPI: 6.6%, PCE Deflator: 6.2%, Core PCE Deflator: 5.2%.

[2] Clark, Joshua. "Methodology: Zillow Observed Rent Index (ZORI)." Zillow Research. September 17, 2022. https://www.zillow.com/research/methodology-zori-repeat-rent-27092/.

increased labor market slack looks to be an unfortunate consequence of the inflationary environment at hand.

After a brief period of improvement, consumer confidence indicators have stagnated with renewed uncertainty over inflation and financial markets cited as the primary factors. Consumption data was mixed with retail sales coming in flat month-over-month but personal consumption expenditures increasing 0.6% over the same period. After months of consistently strong consumption data, we have started to see some volatility. A potential explanation exists in that mounting inflation is eating into pent-up savings and has started to take its toll on consumers. Spiking levels of credit card borrowing and a recent Federal Reserve study showing a 25% decline in household excess savings since late 2021 give further credence to this idea.[3] One can hope for limited consumer pain as the economy and labor market continue to weaken, but further moderation in consumer demand is a necessity in ebbing the price pressures currently plaguing the economy.

Economic indicators appear to be moving in the right direction, but more decisive and consistent readings are needed. Continued increases in labor market slack along with tempered services inflation remain the areas of focus in the months ahead.

[3] Aladangady, Aditya, David Cho, Laura Feiveson, and Eugenio Pinto. "The Fed - Excess Savings during the COVID-19 Pandemic." Board of Governors of the Federal Reserve System. htps://www.federalreserve.gov/econres/notes/feds-notes/excess-savings-during-the-covid-19-pandemic-20221021.html.

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