1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

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The Market Changes its Signals?

Financial Markets

Equity markets had a rather uneventful holiday-shortened week. The Dow gained 1.78%, the S&P 500 gained 1.53%, while the NASDAQ gained 0.72%. Investors appear to side with those Fed officials who argue it is time to consider a reduction in the size of interest rate increases. This, of course, is very different than a reduction in rates. It brings into question the Fed's view on the strength of the economy, and there are certainly reasons to be concerned.

The yield curve remains inverted. An inverted yield curve simply means short maturity Treasuries yield more than long maturity Treasuries, often a sign of an impending recession. Along with this, the Fed continues to tighten, which almost always puts downward pressure on economic activity.

Quant Insight analysts argue in a recent *Barron's* that credit spreads, the difference between corporate and government bond yields which measures investors' fears about defaults, appear to have been moving the market since October 12th. Investors, of course, remain concerned over inflation, since it is the motivator of the Federal Reserve and the prime determinant of interest rates.

Both Interesting and Important

The midterm elections are over, mostly. The "mostly" refers to the senatorial runoff in Georgia. This will be an interesting event, but it will not change the balance of power in the Senate. Although one might think the political fighting is over, one would be wrong. We now enter a period of important intra-party combat. The end result of these internal battles will be important for future legislation.

As we wrote earlier, investors appear to have moved their concern from the Fed hiking interest rates to the question of whether there is a recession in the near future. What are the signs of a recession? We mentioned two common signals—an inverted yield curve and widening credit spreads. Both are concerning, but we should examine other economic signals.

Are balance sheets stressed? At the moment, both consumer and corporate balance sheets are in good shape. That bodes well for continued spending.

Employment remains strong. Remember, consumption is about 70% of the United States economy. It is unlikely for the U.S. economy to enter a recession with a healthy labor market. There has been legitimate concern over the labor market because of the remarkable series of layoffs, primarily in the technology sector. However, those who are being laid off appear to be getting reemployed. An interesting sidebar is those companies that are laying off employees have seen increased investment, sales, and profits. This tells us two things. One, the layoffs are not due to a slowdown in demand, and, two, the process of a successful transfer of capital for labor may be underway. Improvements in efficiency do not lead to recession. A real concern is the housing market. Data indicates a slowdown is underway. Not surprisingly, higher interest rates are negatively impacting both sales and housing starts. Housing numbers are obviously heavily influenced by affordability. There are two sides of affordability in all purchases—income and price. The important point here is that declining consumer affordability is not a matter of a falling consumer incomes, but of higher finance rates and housing inflation. We would be far more concerned if it were the former.

A lot has been written about supply chains. We wrote in the past that supply chain disruptions are slowly being solved. This leads us to an area that is

vital to all economies—*GLOBALIZATION*. World Trade is vital to the economic wellbeing of all countries. We have written often about this. The world appears to be in a state of flux. This is mostly due to China, but all countries appear to be rethinking how to participate. At the moment, we are not even sure how the United States views the situation. It won't be long before we have a bitter debate in Congress. A quick footnote about trade—if inflation slows and rates decline, the dollar should weaken. This, contrary to some peoples' views, will help the U.S. economy by making products manufactured in the United States less expensive for other countries to buy.

China looms large in the debate about the future of globalization. Their economy and political position are very difficult to predict. Certainly, China is in a difficult position. A lot of information is coming out, and we will be following and writing about it in time.

Conclusion

While there are many moving parts to an economy, it does not appear to us as if a recession is imminent, but may be looming on the horizon. Consumer balance sheets are strong, employment is high, and some members of the Fed are thinking in terms of reducing the size of the next rate hike. Readers should be aware that any single month's CPI report can include statistical noise. For this reason, it is important to remember that one month's report does not make a trend.

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