1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

December 5, 2022

An Encouraging but Confusing Week

Financial Markets

United States equity markets had a positive week. Both large and small cap stocks ended the week in positive territory with smaller cap companies leading the pack. The Dow gained 0.24%, the S&P 500 gained 1.13%, and the NASDAQ Composite gained 2.09%. Within the S&P 500, the Communication Services and Consumer Discretionary sectors led the pack while the Energy sector was the laggard. It should come as no surprise that consumer goods companies showed relative strength given the apparent strong seasonal shopping spree. We wrote last week that it appeared investors were turning their fears from continued inflation to recession. Federal Reserve Chairman Powell did nothing to dissuade them. His remarks were a bit dovish, leading investors to believe the next hike will be 50 basis points rather than 75 as in the past. This is good news, but we remind investors that Chairman Powell is implying a slowdown in the increase in interest rates, not a reversal or pivot.

As we write about the Fed and its dual mandates—moderate inflation and maximum employment—investors should keep in mind that monetary policy can only influence the demand side of the economy. The supply side is an equal partner.

Economics

There are a number of interesting issues facing the country. The progress towards peace, or lack thereof, with the Ukrainian war is one. We will happily leave any comments to the military analysts.

We have written a lot about the consumer being the dominant mover of the U.S economy, so it is important to follow both the consumer and the labor markets. Together, they have a large impact on the economy.

There are three important global issues facing the United States which deserve government attention. None of them have a definitive answer, but all warrant our attention. First, how will the U.S. handle trade policy with a divided government? Next, where is China headed? The third, and most speculative, question is, can India be the next China?

In the short period left for the sitting House and Senate, there is a considerable amount to be done as far as trade is concerned. The question is, will Congress even attempt to face these challenges? One important one is the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). This is an important piece of legislation. Both the House and Senate are losing some pro-trade members, and, the president, if he wants it to pass, will have stiff resistance from the progressive left of his own party. President Biden and the legislature may find it easier not to face it. We are skeptical about it passing, and that is a shame. It is interesting that the administration appears unlikely to bring it up, as most of his advisors do favor free trade, Kimberly Clausing being one. She was an early economic advisor to President Biden and wrote an excellent book, not written for specialists, *Open: The Progressive Case for Free Trade, Immigration, and Global Capital.* The book outlines a powerful argument for globalization with safeguards for American workers. It is well worth the read.

China is the second largest economy in the world. Interestingly, as we have written before, it has a very low GDP per capita. Although the country appears rich, many of its citizens are poor. As all who read the news know, China is going through tough times and has some difficult choices to make. Related to this is India, another country with a huge population

that is making an attempt to modernize its economic infrastructure. India is a democracy, and, like China, has a large number of highly educated citizens. We believe India has the capacity to be another China. Next week, we will discuss both in greater detail.

Conclusion

It is difficult to come to any concrete conclusions at the moment. Investors should be pleased by Chairman Powell's remarks. Economic indicators, in our view, suggest lower inflation going forward. However, rather than being sanguine about the economic future, investors should not discount a prolonged period of inflation or a recession.

November Economic Indicator Update

November's economic indicators provided continued evidence of disinflation, particularly amongst core measures. Broad trends seen over the past few months remained in place, with economic growth continuing to moderate, labor market slack slowly materializing, and the consumption indicators showing resilience. As Federal Reserve Chairman Powell stressed in his most recent speech, reducing upward pressure on wages will be paramount for continued progress going forward.

Price gauges showed encouraging signs of disinflation in November, with both headline and core measures decelerating from the prior month.[1] While inflation readings have retreated from highs seen earlier this year, services inflation components have remained elevated. The shelter component has been and continues to be the primary culprit, accelerating 0.8% over the course of the month and accounting for 40% of core CPI in the most recent release. Under the surface, however, there were subtle signs of improvement. The two dominating factors behind the shelter component, owner's equivalent rent and rent of primary residence, actually decelerated month-over-month, but an unusually large 4.9% increase in lodging away from home pushed the overall measure higher. Furthermore, closer to real-time rental data is showing clear signs of deceleration, with Apartment List's National Rent Index[2] reporting the largest single month dip in its history and Zillow's Observed Rent Index[3] declining for an eighth consecutive month. Housing market weakness is also noticeably materializing with housing starts, existing home sales, pending home sales, and housing price indicators all falling over recent months. 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.

U.S. labor market data indicated continued tightness; however, there are signs that increased slack is slowly materializing. Nonfarm payrolls increased by 263,000, faster than expected but a step down from October's upwardly revised 284,000 pace. It is also worth noting that hiring by industry has not been uniform, with employment gains in labor supply-constrained industries like leisure, hospitality, and healthcare overshadowing hiring freezes and layoffs in other industries. The household survey data was mixed, with the unemployment rate holding steady at 3.7% but hourly earnings accelerating 0.6% month-over-month and the labor force participation rate ticking slightly lower to 62.1%. JOLTS job openings declined by 344,000 to 10.3 million, a sign that employers may be slowing their hiring plans, and unemployment claims have been trending higher. While somewhat of a mixed bag, labor market indicators are showing gradual signs of cooling. Continued progress on this front will be crucial for controlling wage gains and further reducing inflationary pressures.

November's consumption-related data suggested continued resilience from U.S. consumers. Retail sales and personal consumption expenditures came in ahead of estimates, increasing 1.3% and 0.8%

[1]November's year-over-year and month-over-month inflation readings: CPI: 7.7%, 0.4%; Core CPI: 6.3%, 0.3%; PCE Deflator: 6.0%, 0.3%; Core PCE Deflator: 5.0%, 0.2%.
[2]Apartment List Research Team. "Apartment List National Rent Report." Apartment List, November 29, 2022. https://www.apartmentlist.com/research/national-rent-data.
[3]"Zillow Observed Rent Index (ZORI)." Zillow Research. December 2, 2022. https://www.zillow.com/research/data/.

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month-over-month, respectively. Furthermore, Black Friday shopping takeaways were largely better than feared, with retailers seeing improved in-store traffic trends along with year-over-year growth in online spending. Despite continued strength in spending metrics, there is building evidence that consumers are coming under increased financial stress. Consumer confidence measures from The Conference Board and Michigan University remain at depressed levels, with increased borrowing costs, inflation concerns, and declining asset levels weighing on sentiment. Furthermore, spiking levels of credit card borrowing and declining savings rates suggest consumers may be extending beyond their means. As we have stated in prior updates, the hope is for limited consumer pain as the economy and labor market continue to weaken, but further moderation in consumer demand may be a necessity in ebbing the current inflationary pressures at hand.

Inflation measures are moving in the right direction, but further labor market slack is needed in order to reduce wage pressures and services inflation components that are keeping price gauges at elevated levels. If disinflation continues and inflation concerns reside, economic growth indicators may increase in importance as market participants attempt to weigh probabilities of a soft landing or recession. Thus far, we have seen definite signs of moderation. While 3rd quarter GDP growth was revised higher to 2.9%, the gain follows two consecutive quarters of negative readings. Additionally, other popular indicators of economic activity like Industrial Production and various Purchasing Manager Indices (PMIs) have moved unanimously lower, sitting at or near contractionary levels. With real-time estimates for 4th quarter GDP calling for 2.8% growth, economic growth appears to be cooling but not yet contracting—the Federal Reserve's hoped-for outcome.

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