1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

January 9, 2023

A Remarkable Start!

Financial Markets

It was truly a remarkable start to the New Year, not just for investors. Last week, we watched the astonishing merry-go-round with the Republicans' efforts in selecting a Speaker of the House. This will likely have unhappy economic consequences later this year. More on this in the economic section.

Equity markets fluctuated throughout the week until Friday, when buyers were inspired by a government report, showing that wage growth had decelerated from prior months. That sent investors into a flurry of buying. For the week, the Dow gained 1.46%, the S&P 500 closed up 1.45%, and the NASDAQ gained 0.98%. Those numbers may not seem remarkable at first glance, but much of the gain came on the last trading day. The inspiration stems from the idea that if the slowdown in wage growth is an indication of future economic growth, then perhaps the Federal Reserve can end its tightening of monetary policy sooner than expected. This would be very good news for markets, but we remind investors that it is just one observation.

There are a number of important economic releases coming this week, which will help investors and analysts come to better conclusions of whether the wage growth release was really showing a slowdown or was just an anomaly. However, economic releases may be overshadowed by the start of the corporate earnings season, which begins this Friday.

Economics

This week, Ryan does a review of this past month's economic indicators, so our economic review will be a bit shorter than usual.

We wrote in the beginning about the difficulty the House Republican majority had in selecting a Speaker. The disarray and infighting is not likely to go away soon. Investors and analysts should expect some economic consequences as a result. Most analysts, both economic and political, have pointed them out. We would focus our readers' attention on the debt ceiling and the budget. These are vital to both the economic wellbeing and reputation of the country. In the past, both parties have tread gingerly around these two important areas. Right now, it does not appear that this will continue to be the case. There is of course time to change, but a change in attitude does not appear imminent.

On Monday, the Federal Reserve releases its consumer credit report for November. Investors will be hoping for a slowdown of credit issuance. On Wednesday, the National Mortgage Bankers Association will publish its Market Composite Index measure of applications for the week ending January 6th. Again, investors will be looking for a slowdown.

On Thursday, the Department of Labor reports on Initial Jobless Claims. Also on Thursday, the U.S. Bureau of Labor Statistics releases the Consumer Price Index. All of these releases have enormous implications for inflation and monetary policy decisions. Both the Fed and investors will be very attentive to these releases. It is almost axiomatic that, as these indicators go, so goes the market.

Conclusion

At least for the foreseeable future, financial markets remain in the hands of central bankers. We don't think the Fed will back off the battle against inflation without substantial evidence that inflation is on the wane. This coming week's economic reports, no matter how positive, are unlikely to change the Fed's view. It will take repeated evidence over the coming weeks and months. Investors will frequently try to outguess the Fed, which seldom leads to positive outcomes. We have not changed our view.

Weekly Market Insights (cont'd)

December Economic Indicator Update

We saw further signs of disinflation, slowing economic growth, and gradually improving labor market balance in December. As higher interest rates and slowing demand continue to ease inflation pressures, growth indicators may garner greater attention with interested parties attempting to gauge the timing and severity of a potential recession. The labor market is central to this issue, as a reduction in wage pressures is critical for achieving the next leg lower in inflation, but also a primary source of consumer support. With growth dynamics working in both directions, this is a complicated issue to say the least.

Inflation indices continued to move lower in December, with both headline and core measures decelerating from the prior month.[1] Although the shelter component slowed from November, it once again accounted for nearly half of the core CPI measure's rise. As we have noted previously, despite current housing market weakness, it will take time for declines in housing prices and rental rates to show up in the CPI shelter component. However, more real time data from Zillow and the Federal Reserve Bank of Cleveland provide assurance that this deceleration will, in fact, materialize. The Zillow Observed Rent Index fell 0.4% month-over-month, the largest sequential decline in the seven-year history of the index, and now sits 17.1% below its February peak.[2] Similarly, results from the Cleveland Fed's New Tenant Repeat Rent Index, based only on the leases of tenants who recently moved in, show that year-over-year growth in national rental rates has roughly halved since peaking in June of last year. Historically, this index has led actual CPI by about a year and suggests that the cooldown in the housing market may start to materialize in inflation data in the second half of 2023.[3] Another less-cited inflation gauge provides further reason for optimism. Favored by Fed Chairman Powell, the Core Services CPI, which adjusts for energy and shelter inflation, cooled significantly to 0.1% month-over-month from 0.4% in October and 0.8% in September. Covering prices paid for a wide range of services like healthcare, education, restaurants/bars, haircuts, and more, Powell believes this adjusted measure better captures inflation in the areas of the economy most sensitive to labor costs.[4] While there is more progress to be made, inflation readings are trending in the right direction.

The next leg lower in inflation will be largely dependent on increased labor market slack and the resultant impact on consumer demand. While we continue to see some evidence of a cooling labor market, December's employment data largely suggests that there is more work to be done. Non-farm payrolls increased by 223,000, marking the fifth straight month of declining payroll gains, but is still considered a strong print by historical standards. Additions continue to be bifurcated by industry, with industries like leisure, hospitality, and healthcare making up for hiring slowdowns and cuts in other areas of the economy. Furthermore, despite an improved Labor Force Participation Rate, the Unemployment Rate decreased to 3.5%, matching the lows seen earlier in 2022. A surprising deceleration in Average Hourly Earnings growth with downward revisions to prior months was the most encouraging takeaway from the past Friday's employment report, fueling hopes that the labor-supply demand imbalance is improving. There has also been more anecdotal evidence of slowing demand for labor with companies like Amazon, Salesforce, Vimeo, and Goldman Sachs adding to the growing list of layoff announcements. Additionally, a recent NFIB survey suggests small businesses are dialing back hiring plans, with the percent of businesses planning to add workers declining to the lowest level in almost two years. Still, at over 10.5 million, the ratio of job openings to unemployed sits at nearly 2 to 1. As a reference, pre-pandemic this ratio sat at just above 1. Ultimately, labor market slack has started to show up in economic releases, but more progress is needed.

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[1]December's year-over-year and month-over-month inflation readings: CPI: 7.1%, 0.1%; Core CPI: 6.0%, 0.2%; PCE Deflator: 5.5%, 0.1%; Core PCE Deflator: 4.7%, 0.2%.

[2]"Zillow Observed Rent Index (ZORI)." Zillow Research. December 17, 2022. https://www.zillow.com/research/data/.

[3]Tanzi, Alexandre. "US Rent Inflation Is Slowing Fast in New Index Built by Fed Team." Bloomberg.com. Bloomberg, December 20, 2022. https://www.bloomberg.com/news/articles/2022-12-20/us-rent-inflation-is-significantly-slowing-in-new-index-built-by-fed-team?sref=J9GPLx1B.

[4]Boesler, Matthew. "Powell's 'Most Important' US Inflation Indicator Cools Again." Bloomberg.com. Bloomberg, December 13, 2022. https://www.bloomberg.com/news/articles/2022-12-13/powell-s-most-important-us-inflation-indicator-cools-again?sref=J9GPLx1B.

Weekly Market Insights (cont'd)

Economic growth and consumer-related indicators remain mixed, but we are beginning to see growing signs of weakness. Survey-based consumer confidence indices have been at depressed levels for some time, and, despite recent disinflation-fueled bounces, remain at historically low levels. Similarly, various survey-based economic activity indicators known as PMIs have been trending lower over recent months, and a growing number have now fallen into contraction territory. While survey-based data has shown signs of weakening for some time, hard data capturing actual economic growth and consumption has begun to turn lower as well. Retail Sales declined 0.6% month-over-month, a reversal from the prior month's 1.3% rise, while Personal Consumption Expenditures underwhelmed with a 0.1% increase. On the economic growth front, Durable Goods Orders declined 2.1% month-over-month, and Industrial Production declined 0.2% over the same period. Despite growing signs of weakness, economic growth and consumption trends have remained resilient thus far and are not yet at worrisome levels. Real-time 4th quarter GDP estimates are still calling for 3.8% growth, but we should expect economic growth and consumer demand to continue to slow as the year progresses.

The labor market is central to the competing inflation-growth dynamic. Inflation's next phase lower will likely require further labor market weakness in order to reduce wage pressures, so finding balance is key. Employment metrics have moved in the right direction in recent months, but there is more work to be done.

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