19/19 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

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A U.S. Downgrade and Markets Slump

Financial Markets

This past week saw both the debt and equity markets declined. The Dow fell 1.11%, the S&P 500 fell 2.27%, and the NASDAQ Composite fell 2.85%. Before last week's decline, the S&P 500 had risen 28% from its October low. As you will see in the Economic Indicator Update, the economy appears to be in relatively good shape, but a number of disconcerting announcements occurred that spooked investors. There was an announcement by Fitch that they downgraded their credit rating of U.S. government debt to AA+ from AAA. Additionally, there was a swift rise in Treasury yields during the week. This occurred on the heels of the market rally which resulted in significant profit taking.

Economics

Important events are occurring in three of the major global economies—the United States, Europe, and China.

In the United States, there are three things to focus on this week. 1) The trajectory of the U.S. economy and its impact on Federal Reserve monetary policy decisions going forward. 2) The Fitch rating downgrade. 3) The sudden jump in Treasury yields.

Looking abroad, the big questions are whether the European economy is going to wane again and whether China is falling into economic and political turmoil.

The United States economy, as you will read in the indicators section below, appears to be slowing but at a manageable rate. This gradual slowing plays into the Fed's hands. No one of course knows the future, but if the economy continues at this pace, a soft landing is not out of the question. This leads us to ask two questions. Why the sudden jump in treasury rates and what will be the effects of the Fitch downgrade?

The Fitch rating change is based on a number of arguments, some obvious and factual, others conjecture. In any case, what they say is important. Fitch points out the large and growing budget deficit, fiscal weakening over the next three years, and an erosion of governance. This refers to the reoccurring debt limit standoffs that have become common over the past two decades. They also predict a recession in the fourth quarter of this year or the first quarter 2024. This last point is conjecture, and, if a recession does not occur, would it change their view? In any case, it is a shot across the bow. All of the above can be handled, and the simplest first step would be for Congress to realize the damage done by fiscal posturing and come to a better accommodation. Fitch points out an important danger.

So, why the sudden jump in Treasury yields? Perhaps it is the realization that there will be an extremely large increase in U.S. government bond issuance. In other words, higher yields are just the result of supply and demand dynamics.

Interestingly, foreign exchange markets hardly reacted. The U.S. dollar is in no way in danger of losing its place as the preferred currency globally, and the Federal Reserve remains the dominant central bank.

Europe started to combat inflation much later than the United States, so it is reasonable that their recovery should also come later. Also, they face complications of not having coordinated fiscal policies. We will cover more on Europe next week.

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We write about China frequently for a number of reasons. It is a very large and important economy and it is changing both politically and economically. Additionally, it is secretive and its reports are often questionable. We have written at some length about the changes at the Peoples Bank of China (PBoC), and now there has been a somewhat mysterious change of leadership at the head of the Foreign Service, the equivalent of the U.S. Secretary of State. What we do know is that the Chinese economy is weakening. Debt has fueled much of China's past growth with the government spending on building bridges, railways, and housing. There is high youth unemployment, inflationary pressure, a prolonged housing market slowdown, and serious debt problems stemming from poor mortgage lending and failures of the "Belt and Road" initiative. It appears to many that, under Xi, China is turning inwards. We don't look to China to spur global economic growth as it has in the past.

Conclusion

Despite the Fitch downgrade and all the legitimate economic problems it pointed out, the United States remains the dominant economy in the world. Does the country face problems? Yes, both economic and political. But the problems Fitch points out are solvable. Having said that, investors should bear in mind that the equity market has advanced a long way from the October bottom. After a powerful move, markets often need time to rest.

Interested readers should watch for Thursday's Consumer Price Index report from the Bureau of Labor Statistics (BLS). Expectations are for a 3.3% year-over-year rise in inflation, marking an acceleration from last month's 3.0% rate. On Friday, the BLS reports the Producer Price Index, which is expected to increase just 0.70% from a year earlier.

Economic Indicator Update

For several months now, economic indicators have pointed to positive economic momentum, resilient consumer demand, and continued disinflation. July's economic indicators suggested much of the same. This surprising strength in the U.S. economy has resulted in pushed out recession timelines and increased optimism for a soft landing scenario. However, with estimates calling for an uptick in inflation readings next month, the risk of even tighter monetary policy remains. Given the Fed's unwavering commitment to reining in inflation and the delayed impact associated with interest rate hikes, we continue to expect economic headwinds to materialize in the months ahead.

Inflation Indicators

Inflation indicators experienced another month of disinflationary data, with the PCE Deflator Index confirming an encouraging CPI report earlier in July. However, while the decline in headline inflation measures has been relatively swift, core measures have proven to be stickier. Stripped of more volatile price components like food and energy, core measures are thought to provide a better representation of more persistent underlying inflationary pressures in the economy. With Core CPI and Core PCE still in the 4-5% range and expectations for a reacceleration in inflation measures next month, continued disinflation, at least in the magnitude of we have experienced over the last year, may be harder to come by.

- Both the headline PCE Deflator and the Core PCE Deflator increased 0.2% in June, in line with consensus and 0.1 points below May's 0.3% pace.
- Looking at year-over-year growth rates, the headline PCE Deflator decelerated to 3.0% from 3.8% in May, while the core measure decelerated to 4.1% from 4.6%.

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- The Employment Cost Index (ECI) decelerated 0.2 percentage points to 1.0% in the 2nd quarter. The Federal Reserve has referenced the ECI as one of their preferred gauges for wage inflation.
- Unit Labor Cost growth also slowed, increasing 1.6% quarter-over-quarter, down from 3.3% in the 1st quarter.
- Michigan Consumer Sentiment Survey inflation expectations were unchanged from June's reading, coming in at 3.0%. This measure of inflation expectations has been remarkably stable, falling within the narrow range of 2.9% to 3.1% for 23 of the last 24 months. By this metric, inflation expectations appear anchored.

Labor Market Indicators

July's employment indicators cooled slightly from the prior month and continue to point to a tight but gradually normalizing labor market. Despite improvements, labor demand still far exceeds labor supply, which has led to sustained tightness and upward pressure on wages. The Fed continues to point to the labor supply-demand imbalance as a primary driver of inflation, particularly in the services sector, making continued normalization crucial in achieving their 2% inflation mandate.

- Nonfarm payrolls increased 187,000 in July, missing consensus estimates calling for 200,000 additions. Payrolls for the prior two months were revised lower by a combined 49,000.
- Temporary employment continued to trend lower, falling 22,000 from the prior month and 205,000 since its peak in March of 2022.
- The Unemployment Rate declined to 3.5% from 3.6% but remains above the low of 3.4% achieved in April.
- The Labor Force Participation rate held steady at 62.6% for the fourth month in a row.
- Another measure of participation, the Prime Age Employment-to-Population Ratio came in at a level of 80.9%, continuing to hold above the February 2020 level of 80.5%. This ratio focuses on the proportion of employed people in their "prime working years" (25-54 years old). The fact that this metric has recovered its pre-pandemic highs, while the Labor Force Participation Rate has not, highlights the relatively larger proportion of the 55+ population that has not reentered the labor force.
- JOLTS job openings fell by 34,000 in June to 9.6 million. While down from the record 12 million openings in March of 2022, this metric remains well above pre-pandemic levels of 6.7 million and the 5.8 million unemployed.

Consumer-Related Indicators

Consumer-oriented indicators continued to exhibit strength, with both consumer spending and confidence measures rising month-over-month. Commentary from Consumer Sentiment surveys pointed to continued disinflation and employment stability as key drivers for the improvement in sentiment. The influence of inflation and employment on consumer health should come as no surprise given the outsized impact both factors have on future monetary policy and the overall economy.

- Retail Sales increased 0.2% in June, a step down from May's upwardly revised 0.5% pace. June's reading marked the third straight monthly rise in sales.
- Personal Consumption Expenditures increased 0.5% month-over-month, accelerating from May's 0.2% growth.
- The Conference Board Consumer Confidence Index advanced 6.3% in July, with both the Present Situation and Expectations sub-indices contributing to the rise. Importantly, the Expectations Index climbed well above the level of 80 that historically has signaled a recession within the next year.

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- The Michigan Consumer Sentiment Index rose for the second straight month, surging 11% from June and reaching its most favorable level since October 2021. Overall, the rise in sentiment was attributable to lower inflation and stability in the labor markets. However, sentiment for lower-income consumers fell due to anticipation of lower real wages in the future.

Economic Growth Indicators

With GDP growth in the first two quarters of 2023 coming in at 2.0% and 2.4%, respectively, U.S. economic growth has proven to be unexpectedly stable. This surprising strength has been largely fueled by consumers, supported by strong wage growth and a tight labor market. Despite higher than expected overall growth, not all has been equal under the surface, with the services sector making up for a struggling manufacturing sector. However, we are seeing early signs of stabilization in manufacturing PMIs, potentially providing a tailwind for growth in the months ahead.

- The first preliminary reading for 2nd quarter GDP growth came in at 2.4%, above consensus estimates calling for 1.5% growth and the prior quarter's 2.0% rise. Consumer spending cooled relative to the prior quarter, but sharply higher business investment helped drive the quarter-over-quarter acceleration.
- Industrial Production declined 0.5% in June, below expectations for a flat reading but in line with May's 0.5% decline.
- Durable Goods Orders increased 4.6% month-over-month, significantly higher than consensus estimates calling for 0.5% growth and the prior month's 2.0% advance.
- The ISM Manufacturing PMI increased 0.4 points to 46.4 in July. The New Orders sub-index, a leading indicator for demand, increased to 47.3 from 45.6 in the prior month.
- The ISM Services PMI declined 1.2 points to 52.7, below the prior month's reading of 53.9 but still in expansion territory.

Economic indicators have demonstrated surprising strength for several months now, and, with the Atlanta Fed's real-time GDP estimate calling for 3.9% growth in the 3rd quarter, expectations are for this resilience to continue. However, with economists expecting inflation readings to reaccelerate next month, the risk of tighter monetary policy and a consequent slowdown in economic activity remains.

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