1919 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

January 22, 2024

Inflation Fears Recede!

Financial Markets

United States Equity markets closed the week in record territory. The S&P 500 ended up 1.17%, the Dow Industrials up 0.72%, while the NASDAQ closed up 2.26%. We are in the beginning of earnings season, and, although earnings have been alright, CEO's have been muted in discussing prospects for the year ahead. The question is, what is driving the market to new highs? The answer is probably a number of things, as we shall see in the economics section. Earnings have been good for the most part, but it is still early, and over the next two weeks there will be plenty of reports for investors to analyze. We will be paying close attention, not to just the level of earnings reported, but, to each company's view of the future. That being said, the leading driver of the market remains the Fed's intentions and how they will affect the economy.

Economics

Investors appear less concerned about just how many times the Fed will cut rates this year and are content to see inflation coming down, assuming rates will follow. The real economy, as opposed to the monetary side, is holding up well. Economic activity is slowing but currently remains far from recessionary territory. This, of course, makes life much easier for the Federal Reserve. One of the most encouraging announcements this past week was the University of Michigan's survey results showing that consumers are getting more confident that inflation is receding.

The European Union remains in slow recovery mode, continuing to lag the United States. One problem is Germany. Normally the EU's driving force, the country is in a prolonged economic slowdown. The U.K. appears stalled. It is in political turmoil, and it is difficult to imagine the U.K. making substantial economic advances without first making political progress.

The war in the Middle East has damaged an already economically weak area of the globe. Many of the Middle Eastern countries are dependent on trade through the Red Sea, making the recent interference with trade in the region very harmful. As readers are well aware, Red Sea trade has slowed, putting these mostly poor countries in even more difficult positions. This, unfortunately, does nothing but make dictators more secure in their leadership positions.

China continues to show economic weakness. The population is both aging and declining, resulting from a combination of economic fear and the residual effect of Mao's "One Child" policy. As always, ensuring the accuracy of China's economic reporting is difficult at best.

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Yield Curve Update

Yields bounced higher this past week, fueled by both monetary and fiscal policy developments. Shorter-dated yields rose more than yields on the long end, with the 2-year increasing 24 basis points and the 10-year increasing 18 basis points from the prior week. As a result, the 2 year/10-year yield curve inversion increased by 6 basis points to -20.

On the monetary policy front, stronger than expected economic data and comments from Federal Reserve officials led to a market repricing for the probability of future rate cuts. Retail Sales, Industrial Production, Housing Starts, Consumer Sentiment, and Unemployment Claims all came in stronger than expected, leading to the rising belief that 2023's above-trend growth and tight labor market dynamics may continue into 2024. Additionally, Fed governors Bostic and Waller pushed back against the timeline for rate cuts and the idea that the fight against inflation has already been won. Influenced by these developments, the market is now pricing in a 40% chance of rate cuts in March, down from 70% the week prior.

On the fiscal policy side, worries over the U.S. government's rising debt load and continued political infighting in Congress contributed to the rise in longer-term yields. For much of the last year, the U.S. Treasury has been able to finance its debt by issuing shorter-dated T-Bills, but, as bills start to reach the upper end of the Treasury's limits, longer-term debt will likely need to be issued. With Congress considering more deficit-driven fiscal policy measures, concerns over a rising supply of the Treasury's longer-dated notes and bonds and an associated liquidity drain pressured yields higher. It's also worth mentioning that, despite Congress passing legislation that will extend government funding into March, the passage does nothing to alleviate the U.S. government's high debt levels, Congress' struggle to agree on full-year funding measures, and the likelihood of continued deficit-driven fiscal policy in the future.

Together, these policy developments, along with growing inflationary risks associated with renewed supply chain disruptions in the Red Sea, pushed rates higher.

Conclusion

Of all the economically developed countries, the United States appears to be in a position to continue to lead. The Fed has done an excellent job reining in inflation without triggering a recession, and there is no indication that a trend change is imminent. The pandemic-inspired supply chain problems have been largely sorted out, and the new structure appears to be sounder. We will cover more about supply chains at a later date. So, what concerns us? Politics, of course! We are just beginning, and the primary season has become as acrimonious as we have ever seen. Just when things seem headed in the right direction, the U.S. is entering a campaign where, under the best intentions, opponents must declare impending disaster. So, it is possible that the oft-repeated quote in Walt Kelly's *Pogo*, "We have met the enemy and he is us" may not be as humorous as we would like!

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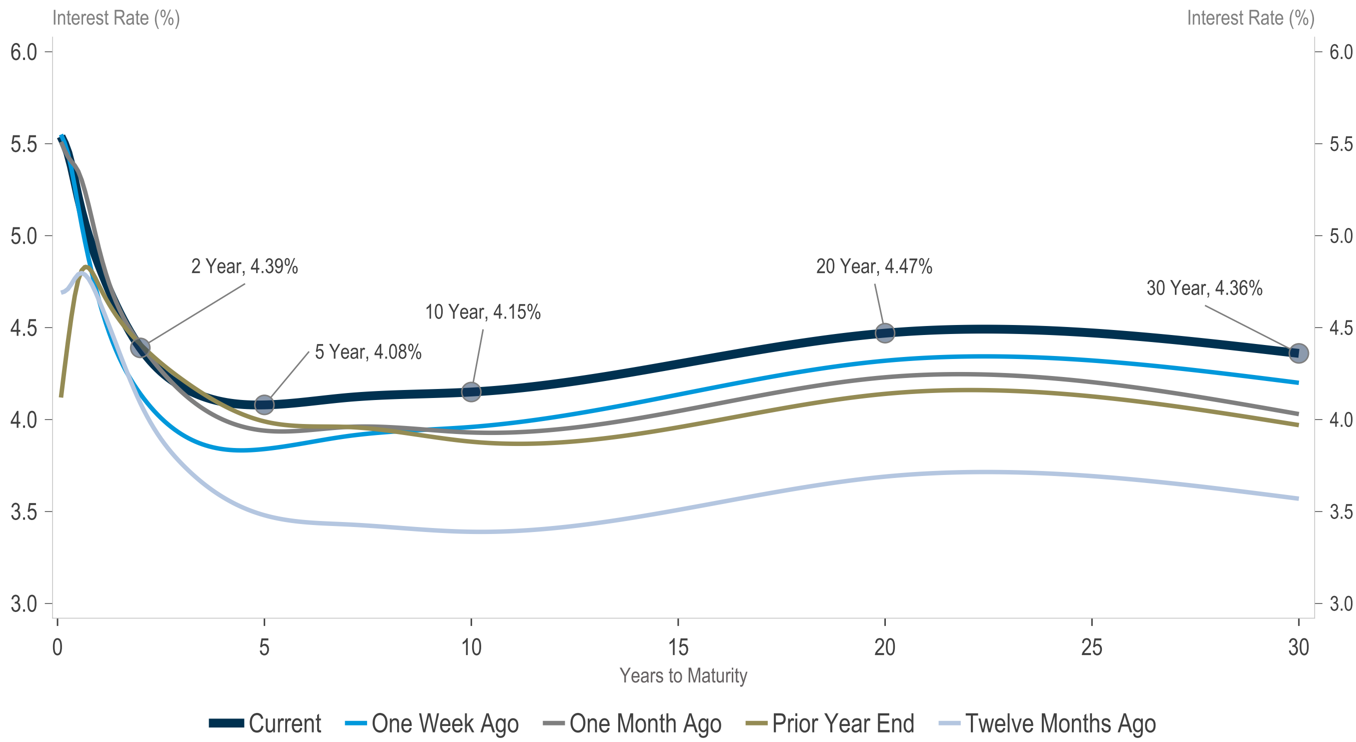
Yield Curve

Interest Rates for U.S. Treasury Securities by Maturity Date



U.S. Department of Treasury, Daily Treasury Bill Rates Data
Data as of 1/19/24

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