MARKET UPDATE

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I. The Past Week

A. Markets

1. Stocks: DJIA +1.46%; **S&P +1.45%**; Nasdaq +.98%
2. UST Yields: 3-month: 4.67% (+25 bps); 2-year: 4.24% (-17 bps); **10-yr: 3.55%** (-33 bps)
    a. The 3-month / 10-year is inverted by 112 bps (the most in many years)
    b. The 2-yr / 10-yr inversion flattened a bit
3. WTIC $74.95 (**-8.1%**)
4. USD +.4% (but dropped 1.1% on Friday)

B. The Main Events from the Week

1. The release of the **FOMC minutes**
2. The **employment report**
3. The **ISM services** (non-manufacturing) survey

C. The Big Picture

1. The **FOMC minutes** indicated that the Fed is not satisfied with the recent slowdown in inflation. In addition, they are bothered by optimism in the stock market.
2. The employment report revealed a 50+ year low unemployment rate (if you take the unemployment rate out three decimal places), but the market liked the **slowdown in wage inflation** (4.6% YoY, down from 5.1%) and the slight uptick in the participation rate.
3. The slowdown in wage inflation at the same time that employment is so strong led investors to believe that the Fed will be able to stop raising rates sooner than previously thought. This resulted in **lower long-term yields and higher stock prices**.
4. US stocks had their best day in more than a month as traders speculated that a slowdown in wage growth will keep the Fed from having to intensify its battle against inflation.
    a. The market had a positive reaction to the jobs report after falling with seven of the prior eight reports.
    b. **Value beat growth** last week by 2%. Investors may be less pessimistic about the economy. The ISM services survey contracted for the first time since May 2020.
    c. Similar to what we saw several times last year, we might have reached really high levels of pessimism and it didn't take much to start a rally.
5. **Questions** that remain:
    a. Can wage growth continue to slow at record-low levels of unemployment?
    b. How much does wage inflation have to slow in order for the Fed to become less aggressive?
    c. Are we headed to a soft landing or a recession?
    (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg)

D. Soft Landing?

1. Investors got a **growing-but-slowing labor market**, a tick-up in **participation**, and a **deceleration in wage gains**.
    a. If job growth can continue without fueling a wage-price spiral, maybe the economy doesn't need a recession.
2. **Fed funds futures** pricing implies a peak in rates by spring, then cuts in the back half of 2023. This is very different than the **FOMC's dot plot**.
3. Thursday is the **CPI report**. The inflation rate is expected to fall to 6.5% YoY (from 7.1% in November). (Barron's)

E. Earnings

1. S&P 500 companies are **expected to report their first losing quarter since 2020**. EPS are expected to decline 2.2% YoY to $53.87, after 4.4% growth in Q3 and 8.4% in Q2.
    a. At the start of 2022, analysts expected 14.1% YoY growth for Q4.
2. By **sector**:
    a. The energy and industrial sectors are expected to be outliers – EPS +65% and +43% YoY
    b. Materials are expected to drop 22% as input prices have decreased
    c. Communication services are expected to drop 21% due to lower ad spending and continued streaming losses at many media companies
    d. Consumer discretionary is expected to drop 15%
    e. Tech earnings are supposed to decline 9% as wage costs balloon at many software companies, enterprise demand slows, and semiconductors remain in a downturn.
3. **Revenue** is forecast to increase 4.1% YoY in Q4 and 11.2% for all of 2022 (to $13.8T).
    a. The fact that sales are rising but earnings are falling is a sign that **margins have peaked.**
4. Current estimates would bring **2022 EPS to $219.80**, up 5.6% for the year.
5. The **bottom-up** consensus is for EPS to grow 4.4% in **2023**. The **top-down** calls for a 2.7% decline to $214.
    a. The difference is in profit margins. Strategists see them getting squeezed by rising wages and higher interest costs, even as the prices they charge customers moderate. This is consistent with the Fed's view that some elements of inflation are sticky and will take time (and economic pain) to bring down. (Barron's)

II. The Fed

A. Key Ideas from the FOMC Minutes

1. The Fed believes that **tighter financial conditions** (higher borrowing costs and lower stock prices) are necessary in order to lower inflation. (WSJ)
    a. "An unwarranted easing in financial conditions, especially if driven by a misperception by the public of how" the Fed will react to economic developments "would complicate the committee's effort to restore price stability."
2. The FOMC still **hasn't seen enough progress in ending inflation**. (WSJ)
    a. Minutes said that officials in the last month "stressed that it would take substantially more evidence of progress to be confident that inflation was on a sustained downward path."
3. There are many **downside risks** to the economy. (Bloomberg)
    a. "The sluggish growth in real private domestic spending expected over the next year, a subdued global economic outlook, and persistently tight financial conditions were seen as tilting the risks to the downside around the baseline projection for real economic activity."

B. Issues to Consider

1. SEP vs. Fed funds futures
2. How high will the FOMC have to raise rates?
3. How long will rates have to stay there?
4. Can the economy just slow down or do we need a recession? (Bloomberg)

C. The Fed Faces Another "Conundrum"

1. In 2006, Fed Chair Greenspan famously referred to the situation where the FOMC was raising the Fed funds rate but longer-term yields were dropping, as a **conundrum**.
2. So as the Fed raises rates now, **why is the 10-year yield dropping**?
    a. Belief that the Fed will get inflation under control. Or…
    b. Belief that the Fed will go too far and push the economy into recession. (Bloomberg)

D. Former NY Fed Pres. Dudley Says That the FOMC Faces Risks

1. **Economic growth** could be more persistent than expected. There will be greater defense spending, more discretionary spending, and higher Social Security payments.
2. The current **neutral rate may be higher** than 2.5%. Inflation could push that up. There could be more demand for investment (automation) and the Fed's balance sheet is still very accommodative (~$8.5T).
3. **Market participants** may be overly excited by the drop in goods inflation. The real worry is **wage inflation affecting the price of services**. (Bloomberg)

E. Comments by Former Fed Chair Greenspan

1. A **recession is the most likely outcome** at this time. While the last two monthly inflation reports did show a deceleration in the rate of prices increases, prices are still increasing.
   a. Wage increases, and by extension employment, still need to soften for a pullback in inflation to be anything more than transitory.
2. The Fed must be a moderating force on animal spirits. **If the economy is based on creative destruction, you have to have some recessions**.
3. The long and variable lags with which Fed policy impacts the economy can be impacted by many factors. One is the **resilience of the domestic consumer**.
4. The risk of lowering rates too soon is that inflation flares up again. It could also impact Fed credibility as the purveyor of stable prices. (advisorscapital.com)

F. Minneapolis Fed Pres. Kashkari

1. We hear of labor shortages, but **real wages are still declining**. Workers' share of GDP is falling.
2. Current inflation is like "**surge pricing**." Higher prices can lower demand and bring out more supply (if the supply is available…e.g., more Uber cars).
   a. We've seen prices soar, corporate profits climb, and income for workers increase, but not as much as prices.
3. We rely too much on the Phillips curve and unemployment gaps and changes in inflation expectations. These models only allow for high inflation if a tight labor market has nonlinear effects or expectations become unanchored. (Medium)

G. Richmond Fed Pres. Barkin – We've Learned by Talking with Constituents

1. By talking to constituents, we learned that:
   a. Lower-income consumers are being squeezed much more.
   b. The labor market has stayed tight as employers are reluctant to let go of employees that they took so long to find. Workers are facing challenges, including: escalating cost of gas, housing and child care costs.
2. What we'll try to figure out in 2023:
   a. *Is inflation calming?* Are consumers slowing spending? Are supply issues resolving? What are business leaders' attitudes toward pricing? How are consumers reacting to higher prices?
   b. *Is the labor market cooling?* Will we see layoffs spread beyond housing and tech? Will those on the sidelines finally come back into the workforce? Will compensation increases continue, or slow?
   c. *Are we headed for a recession?* Businesses seem to have pulled out and updated their recession playbooks. What happens next? Do they turn the pages in the book, or return it to the shelf?
   d. *How much of the pandemic economy sticks around?* Do the sectors that benefitted from COVID-19 (e.g., recreational goods) get a permanent boost? How will commercial centers evolve in the context of hybrid work? (Richmond Fed)

III. The Economy

A. Goldilocks Jobs Report

1. The jobs report increased the hope that the Fed can tame inflation without widespread job losses. The economy added **223K jobs** and wage growth slowed to **4.6% YoY**.
    a. Average hourly earnings rose **.3%** (and the prior month was revised down).
2. The unemployment rate fell to **3.5%.**
3. An **uptick in participation** (to 62.3%) paired with the slowdown in wage growth suggest some of the tightness in the labor market is starting to unwind.
4. The **average workweek** dropped from 34.5 to 34.3.
5. There are pockets of weakness in the labor market, particularly in tech and real estate.
6. Separately, the **ISM Services index** contracted in December (49.6), for the first time since May 2020. The ISM's measure of services employment shrank for the second time in three months, with respondents noting trouble filling positions and also restraining hiring due to economic concerns. (Bloomberg)

B. Larry Summers – We're Headed to Recession

1. **All major reductions in inflation** in the past 70 years have been associated with recessions. The **Sahm Rule** demonstrates that whenever unemployment rises by more than half-a-percent within a year, it goes on to rise by 2%.
2. Refinancing is going to be more expensive. Profits will be hurt as excess savings are depleted. At that point, workers will be released.
3. Just like goods inflation was transitory, as bottlenecks ease and prices return to normal, there will be **transitory deflationary forces** impacting the statistics. There is no basis for assuming that we are winning the war against inflation unless wages decline (or productivity increases). (Washington Post)

C. IMF – We're Headed to a Tough Year

1. IMF Managing Director Kristalina Georgieva warned that the **global economy faces "a tough year, tougher than the year we leave behind."**
2. She said that "we expect one-third of the world economy to be in recession." She said that the three big economies (US, EU, China) are all slowing simultaneously.(Bloomberg)

D. What is Going on with Retirements?

1. The **Beveridge Curve** has moved. This is the tradeoff between vacancies (Y-axis) and unemployment (X-axis). Lower unemployment means higher vacancies. Since Covid, vacancy rates have surged and people haven't returned to the labor force. This has pushed wages higher.
    a. The curve has shirted outward meaning that the **labor market has become less efficient at matching** unemployed workers with vacant jobs. This may be the loss of 50+-year-olds and they may be harder to replace.
2. **Maybe the numbers are just wrong**. The Philadelphia Fed summed up final revisions to jobs data for Q2 by state and found that only 10,500 net new jobs had been added, while the US current employment statistics estimated 1.047MM jobs over the period.(Bloomberg)

E. Other Assorted Data

1. In the last SEP, no participants anticipated that the Fed would be lowering rates in 2023.
2. Wages for workers who stayed at their jobs were up **5.5%** in November YoY. This was just **3.7%** in January 2022. Employees who changed companies, job duties or occupations saw a **7.7%** gain. (WSJ)
3. Going into Friday's jobs report, employers said that they added 2.7MM jobs in the past six months. Households put the number at only 12,000. These two measures tend to diverge in the months prior to a recession. They diverge over marginal workers – people with weak labor force attachment, nontraditional jobs and tenuous employment. These are the first people affected by a downturn. (Bloomberg)
    a. Note: the BLS revised all of these numbers in December and the discrepancy is gone! (I'm not sure if that makes me feel better or worse.)

IV. Politics

A. McCarthy's Election as Speaker Increases Risk of Debt Crisis

1. One of the main demands that McCarthy agreed to was to **use the nation's debt limit to try to force deep cuts in the federal budget**. The issue will come to a head sometime after July 1 when the $31T debt ceiling will need to be raised to prevent a default on debt payments.
    a. The commitment that spending cuts will be tied to any increase in the debt ceiling will be opposed by the Democratic-controlled Senate and Pres. Biden.
2. McCarthy also committed to fashioning a fiscal 2024 budget resolution that caps spending at 2022 levels.
3. In addition, it will take just one lawmaker to call for an immediate no-confidence vote in the speaker. Democrats had raised the threshold to a majority when they controlled the House.
4. The **Holman Rule** would bring back the ability to propose amendments to appropriations bills to **cut the salaries of specific federal workers** or funding for specific programs. (Bloomberg)

B. Social Security

1. Social Security will only be able to pay **76%** of its promised benefits by 2033 if nothing changes. Nearly **2/3** of beneficiaries age 65 and older receive **50%** or more of their total income from Social Security checks. For **one-third** of elderly beneficiaries, Social Security provides **90%** of their income.
2. Two different alternatives to fixing benefits:
    a. Increase the payroll tax from **12.4% to 15.87%** would solve the problem for 75 years.
    b. **Remove the earnings cap** (like was done with Medicare in 1994) and this would solve the problem for 35 years (Bloomberg)