Summary

Economic events for the week included the Federal Reserve raising policy rates another quarter-percent. The January employment situation report came in stronger than expected. However, this was offset by a weakening in ISM manufacturing, consumer confidence, and a deceleration in home prices.

Equities fared positively last week, with positive sentiment around inflation pressures starting to decelerate, as acknowledged by global central banks. Bonds were little changed domestically, but negatively affected by a stronger dollar abroad. Commodities fell back along with pullbacks in energy prices.

Economic Notes

(0) The **FOMC** meeting ended with a 0.25% rate hike, continuing a tightening policy that began in early 2022. A slowing in the pace of hikes was noted as appropriate, as the Fed continues to evaluate the impact of cumulative hikes so far. In the post-meeting press conference, Chair Powell acknowledged that progress has been made and "the disinflationary process has started" in his view, but the job is "not fully done" with "a lot of work left to do." When asked about conditions needed for a potential pause, he remained a bit vague. However, "there won't be a light switch flipped" but it will be based on an "accumulation of evidence" to indicate a more obvious pause point.

Is the Fed still too hawkish since disinflation seems to be in process? It may depend on historical context, with the 1970s being an example of pulling off the brakes too quickly. That seems to be a precedent that the FOMC is closely tied to, with their admitted fears of not doing enough still outweighing a premature exit. This is related to the still-high unpredictability of inflation in the post-pandemic cycle, which has been unlike other traditional business cycles. A key question for the balance of 2023 is which of the two factors is most important: the ultimate terminal rate or the longevity of higher rates generally.

Less related to interest rates, the Fed has been fielding questions about how it plans to directly address climate change. This has been a head-scratcher to some economists, and from the Fed itself, with Chair Powell noting recently that decisions about such policies should be made by elected branches of government, and using monetary or supervisory tools would be 'inappropriate' for such goals (although the Fed maintains several climate committees under its watch, to assess such risks). The tone has been firm, despite pressure from some politicians (and even Fed members) for the Fed to push for a greener path. Is such policy even possible through such a blunt tool as the Fed funds rate? It would likely need to be through some mechanism of 'penalizing' fossil fuel industries by considering them more risky, or 'rewarding' green ones, although some intertwining of the two has made this much more difficult.

(-) The **ISM manufacturing index** for January fell by -1.0 point to 47.4, further into contraction, and below expectations calling for 48.0. This is the lowest level since May 2020. Under the hood, production and new orders both became more contractionary, while employment fell slightly but remained in expansion. Supplier deliveries ticked up, but remained contractionary, showing shorter delivery times in keeping with slowing (less backlog). Prices paid also rose by 5 points, but remained in contraction. This continues a trend of general industrial weakening, although the process appears orderly thus far.

(+) The **ISM services/non-manufacturing index** for January reversed course by rising 6.0 points to an expansionary 55.2, contrary to expectations for a less-meaningful 50.5 and the second-highest monthly improvement since the series' 1997 inception. Gains were seen in most key categories, such as business activity, new orders, employment, and supplier deliveries—with the first two at levels near 60. Prices paid ticked down by a fraction of a point, but remained just under an expansionary 68 reading. Anecdotal commentary noted still-strong demand and cautious optimism going into the new year, with diverging data like this continuing to add uncertainty to the recession expectation.

(-) **Construction spending** fell -0.4% for December, in contrast to expectations of no change, with upward revisions for the prior month. Every segment fell back to a similar degree—public and private, as well as residential and non-residential. Construction cost inflation was unchanged, which represented a net improvement.

(-) The **S&P Case-Shiller home price index** fell -0.5% in November, the fifth straight month, a bit better than the -0.7% consensus estimate. All but 2 of the 20 index cities saw declines, with Detroit leading with a 0.1% rise, while San Francisco and Phoenix led the downturn, each by -1.4%. The year-over-year rate of change decelerated by -1.8% to 6.8%, down over -2% from the peak in June 2022. Expectations for decline remain keyed in on the more extensive urban markets on the two coasts.

(0) The broader **FHFA house price index** declined -0.1% in November, also better than the -0.5% consensus estimate. Across the U.S., price changes were mixed, with West North Central and Middle Atlantic seeing increases, while the more expensive Pacific and Mountain regions were down around -1%. The year-over-year rate of change decelerated by -1.7% to 8.1%.

(-) The Conference Board **index of consumer confidence** for January fell by -1.9 points to 107.1, below expectations calling for no change. While assessments of current conditions showed an increase of over 3 points, expectations for the future fell by over -5 points. The labor differential also improved, with jobs deemed plentiful on net. It appears that ongoing inflation struggles as well as potential recession concerns (both widespread in the news media) continue to weigh on sentiment, while the debt ceiling debate may also play a role.

(+) The government **JOLTS** job openings number for December rose by 572k to 11.012 mil., which was a surprise above an expected decline to 10.300 mil. Gains in openings were most pronounced in hotel/food services (409k) and retail (134k), while declines were largest in information (-107k) and other services (-32k). The job openings rate rose by 0.3% to 6.7%, while the hiring rate ticked up by 0.1% to 4.0%. On the other side, the layoff rate rose a tenth to 1.0%, while the quits rate was unchanged at 2.7%. There appear to be seasonality factors continuing in the JOLTS survey, which could account for up to half of recent monthly opening additions. But as it stands today, there are about two vacancies per every unemployed person.

(-) The **ADP private employment** measure rose by 106k in January, falling short of the 180k expected, and well short of the December rise. This appeared to be due to weather to some degree, such as heavy snow in some regions, as well as extensive flooding in CA. Services jobs rose 109 (95k of which in leisure/hospitality), while goods-producing jobs fell -3k, as a -24k drop in construction was offset by a 23k rise in manufacturing jobs.

(+) **Initial jobless claims** for the Jan. 28 ending week fell by -3k to 183k, well below the 195k median forecast. Continuing claims for the Jan. 21 week declined by -11k to 1.655 mil., below the 1.684 mil. expected. Claims fell mostly in CA, where flooding impacts also waned. While seasonal adjustments continue to influence the results, claims levels overall remain contained.

(+) The employment situation for January came in stronger than expected, keeping the labor market aloft as a primary strong spot in the economy. There were a variety of elaborate seasonal and census-based adjustments, as is common each new year, which causes some to question the accuracy of and assumptions used in government payroll data. The revisions went back two years in this case, but generally pushed employment higher over that period. Regardless, this is considered the government's best effort, although the statistical standard error is acknowledged to be high, which is why later revisions are so common. Perhaps the 'newness' of the release is the most relevant use for markets, which have tended to react dramatically at times to the report on Fridays. In this case, the strength of the jobs number reiterates the Fed's argument that the economy can continue to handle ongoing interest rate hikes, which explains the initial negative reaction of the stock market.

Nonfarm payrolls rose by 517k, sharply beating consensus calling for 188k, and beating the Dec. and Nov. readings (each of which were revised higher from the initial numbers). Payrolls rose in nearly 70% of industries, as leading areas included leisure/hospitality (128k), most of which were in food/drinking places still recovering from pandemic and benefitting from seasonal effects, but still 3% below pre-pandemic levels. Other gains included professional/business services (82k), government (74k, half of which reflected a return of striking education workers in CA), health care (58k), retail (30k), construction (25k), and manufacturing (19k). As one can see from that long list, breadth was quite strong.

The **unemployment rate** ticked down another tenth to 3.4%—below expectations of a rise of a tenth, and, in fact, the lowest rate since 1969. This was despite calls for it to rise a tenth instead, although there was no change to the adjusted labor force participation rate. Per the BLS, labor force participation was noted as still below its Feb. 2020 level, with the household employment measure only rising by 44k after accounting for population control adjustments. The U-6 measure of underemployment ticked up a tenth to 6.6%, in line with most of the second half of 2022.

Average hourly earnings rose 0.3%, on par with expectations and down a tenth from last month's reading after revisions. This took the year-over-year change to 4.4%, on par with expectations, but down a half-percent from last month's trailing pace—seen as a positive for inflation. **Average weekly hours** increased 0.3% to 34.7, in contrast to consensus estimates for a tenth lower.

(0/+) Nonfarm **productivity** for Q4 rose by 3.0% on an annualized basis, exceeding expectations of 2.4%. However, year-over-year productivity decelerated by -0.4% to 1.5%. **Unit labor costs** rose by an annualized 1.1% in Q4, below the anticipated 1.5%, which caused the year-over-over number to decelerate by -0.7% to 4.5%. This was considered welcome news on the inflation front, where labor cost increases have been scrutinized more closely than almost any other metric.

Market Notes

Period ending 2/3/2023	**1 Week %**	**YTD %**
DJIA	-0.15	2.44
S&P 500	1.64	7.86
NASDAQ	3.33	14.77
Russell 2000	3.90	12.81
MSCI-EAFE	0.46	9.05
MSCI-EM	-1.18	8.65
Bloomberg U.S. Aggregate	0.03	3.02

U.S. Treasury Yields	**3 Mo.**	**2 Yr.**	**5 Yr.**	**10 Yr.**	**30 Yr.**
12/31/2022	4.42	4.41	3.99	3.88	3.97
1/27/2023	4.73	4.19	3.62	3.52	3.64
2/3/2023	4.70	4.30	3.67	3.53	3.63

U.S. stocks cheered the FOMC decision, less so for the rate hike but the comments in the post-meeting press conference where Chair Powell pointed out that the beginnings of disinflation were appearing. Markets are always looking for signs of the end of bad phases and potential starts of good phases—even well in advance. This appears to be a capitulation point on the inflation front if current trends continue. Markets were mixed about Friday's employment situation report, as noted earlier. In another piece of technical market news, the S&P's 50-day moving average has surpassed the 200-day moving average for the first time in a few years—this is referred to as a 'golden cross', taken bullishly by some chartists.

By sector, consumer discretionary and communications each gained over 5% as better-than-expected earnings boosted sentiment. Meta Platforms/Facebook was a primary contributor, up over 20% due to a revenue surprise and strongly expressed outlook. By contrast, energy fell over -5% along with a drop in oil prices. Real estate also rose along with more dovish sentiment surrounding future interest rates.

In the busiest week for Q4 earnings, about a third of S&P 500 companies reported, bringing the total reported count to about 50%, per FactSet. Of these reports, about 70% have exceeded estimates on the earnings side and 60% on the revenue side. At this point, the blended earnings growth rate (consisting of already-reported and estimates for the rest) remains at -5.3% for the quarter (compared to -3.3% that was expected at year-end 2022). A variety of private estimates have come in lower, in the -10% range on a year-over-year basis, making FactSet look a bit bullish. Surprises have been led by health care and materials, while communications and consumer discretionary have continued to lag estimates. While expectations for the full calendar year 2022 remain at just over 4% for the broader S&P, full year 2023 expectations have drifted down to 3% (which implies negative earnings growth early in the year followed by a late-year recovery). Very early 2024 earnings estimates have come in at an optimistic 9% for the index, coinciding with the expectation for a potential recession entry and exit having happened by that time. By then, leadership is expected to evolve to today's laggards, including 'growth' communications and consumer discretionary, as well as utilities and tech.

Foreign stocks were little changed in developed markets, as gains in Europe offset minor drops in the U.K. and Japan. Both the ECB and BOE raised policy interest rates by another 0.50% each, but markets remained dovish relative to the U.S. (as policymakers continued to promise further rate hikes), although weaker fundamentals have caused markets to bet on higher chances of policy reversal later in the year. Interestingly, the BOE meetings in particular tend to contain a greater number of dissenting votes than the U.S. FOMC, showing a wider range of opinions about the best course of action.

Stocks fell back sharply in emerging markets, mostly due to a drop in China, as markets reopened after the Lunar New Year holiday. This may have been a 'buy the rumor, sell the news' type of response, as manufacturing numbers moved back from contraction into slight expansion, although real estate conditions remain challenged.

Bonds were little changed last week (despite strong drops in yields during the week before recovering), with the yield continuing to anticipate several more Fed rate hikes, but a potential end in sight. In particular, the 2-year Treasury yield rose over 10 bp as a timeline for the Fed staying at a 'terminal' rate lengthened. Investment-grade and high yield corporates outperformed treasuries, in line with risk-taking in equities. A percent rise in the U.S. dollar punished developed market debt by an equivalent amount, while emerging markets were mixed.

Commodities fell back last week on net, led by lower prices for energy and industrial metals, and hurt by a rise in the dollar. Crude oil fell nearly -8% last week to just over $73/barrel, due to weaker manufacturing results and a stronger U.S. dollar. Natural gas prices continued to correct, by over -15%, after spiking mid-week due to high-but-temporary expected demand from frigid weather in the Eastern U.S.

Have a good week.

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Sources: FocusPoint Solutions, American Association for Individual Investors (AAII), Associated Press, Barclays Capital, Bloomberg, Citigroup, Deutsche Bank, FactSet, Financial Times, First Trust, Goldman Sachs, Invesco, JPMorgan Asset

Management, Marketfield Asset Management, Morgan Stanley, MSCI, Morningstar, Northern Trust, PIMCO, Standard & Poor's, StockCharts.com, The Conference Board, Thomson Reuters, T. Rowe Price, Univ. of Michigan, U.S. Bureau of Economic Analysis, U.S. Federal Reserve, Wall Street Journal, The Washington Post. Index performance is shown as total return, which includes dividends. Performance for the MSCI-EAFE and MSCI-EM indexes is quoted in U.S. Dollar investor terms.

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Notes key: (+) positive/encouraging development, (0) neutral/inconclusive/no net effect, (-) negative/discouraging development.