Summary

Economic data for the holiday-shortened week included mixed regional manufacturing results and housing data, higher jobless claims, but continued gains in the index of leading indicators.

U.S. equity markets, especially the Nasdaq-heavy group of technology stocks, fell back near or into correction territory. Foreign stocks fared slightly better than U.S., although also in the negative. Bonds were mixed, based on risk level. Commodities gained a bit on net, along with continued tight supplies in crude oil markets.

Economic Notes

(-) The **Empire manufacturing index** for January fell by a dramatic -32.6 points to a contractionary -0.7 level, well below the median forecast of 25.0. Under the hood, new orders fell back by the largest amount, into contractionary territory; on the other hand, shipments and employment fell back but remained in expansion. Prices paid and delivery times fell, implying that logistical conditions were slowly improving. Unsurprisingly, it appeared the spread of the omicron variant played a key role in the pullback in sentiment during the month. On the positive side, expected business conditions six months out only fell by a point to remain at a solid expansionary level of 35, confirming the omicron thesis.

(+) The **Philly Fed manufacturing index**, on the other hand, rose by 7.8 points to 23.2, compared to a forecasted slighter gain to 19.0. Shipments and new orders both rose by several points, to further expansionary levels; however, employment fell back by -8 points, although remained solidly in expansion. Prices paid rose again, to very strong levels reflecting underlying inflation pressures, while prices received and delivery times each eased a bit. On another positive note, assessments of business conditions six months out rose by nearly 10 points, further into expansionary territory of just below 30—similar to the New York survey.

(-) **Existing home sales** for December declined by -4.6% to a seasonally-adjusted annualized level of 6.180 mil. units. This reversed the gain from the prior month, and fell short of the median forecast of a -0.6% decline expected. Single-family home sales fell by -4%, while condos/co-ops declined -7%. Sales fell in every region, led by -6% drops in the West and South. Overall, it appears the lack of supply again held back sales activity, noted by a 20-year low months' supply reading of 1.8. The median sales price rose about a percent for the month and 16% over the past year to $358,000. The NAR noted these dynamics in their commentary, referencing a lack of housing supply continuing to be unable to satisfy high demand, although price growth rates have decelerated a bit from earlier in the year.

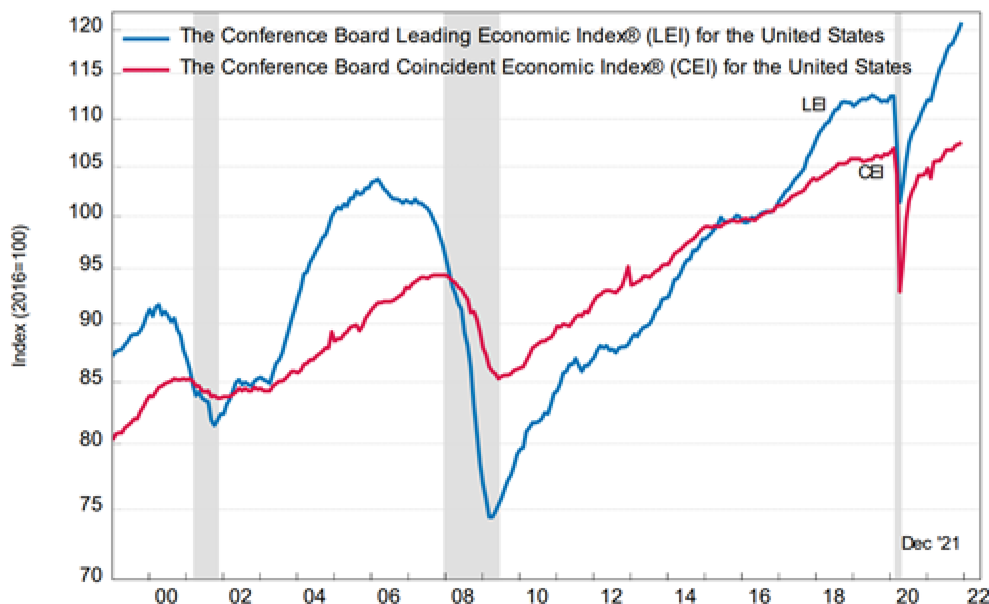
(+) **Housing starts** rose by 1.4% in December to a seasonally-adjusted annualized rate of 1.702 mil. units, beating expectations of a -1.7% decline. The gain was led by multi-family, up 11%, while single-family starts fell back by -2%. Regionally, the Midwest and Northeast experienced the strongest gains, up 20-40%, while the West saw a -14% decline in the month. Interestingly, over the past year, single-family starts are down -11%, while multi-family experienced growth of 53%—an indication of the resurgence in apartments (and which can see the tendency of overbuilding in 'good' times). **Building permits** rose 9.1% for the month, which far exceeded the median forecast of -0.8%. Multi-family led here as well, with gains of over 20%, while single-family rose by 2%. Northeast permits rose over 110% for the month, followed by the Midwest up 22%, with a West decline of -10%. Warmer than average weather during the month likely provided a tailwind to the stronger results for these metrics. While recent periods have seen starts rise above the estimated need of about 1.5 mil. new single-family units per year (accounting for scrappage, etc.), finding skilled labor remains a problem, especially so if it's being directed toward multi-family projects, which can offer more immediate bang for the buck.

(-) The **NAHB housing market** index for January fell back by a point to 83. This was below expectations of no change, but remained among the higher readings of the series' history over the last 35 years. Current sales

were unchanged, while future sales and prospective buyer traffic fell back by several points. Regionally, the Northeast experienced the most severe decline, while the West saw a minor gain for the month.

(+) The Conference Board's **index of leading economic indicators** for December rose by 0.8%, extending a series of strong monthly gains for Q4 2021. In the single month, eight of the ten components made a positive contribution, led by building permits, lower jobless claims, and the interest rate spread; the sole detractors were consumer business sentiment and unchanged weekly manufacturing hours. The coincident and lagging indicators also rose, by 0.2% and 0.1%, respectively. For the second half of 2021, the LEI increased at an annualized rate of 8.1%, a strong showing, but down from the 9.0% annualized pace seen in the first half of 2021.

The positivity is expected to fade a bit moving into Q1 2022, according to the opinion of The Conference Board, due to the headwinds of the omicron variant, labor shortages, and inflation. However, overall economic growth is expected to remain strong in 2022, with a low risk of recession (that being one of the main uses of the indicator).



Source: The Conference Board. Shaded areas indicate recessions, as defined by the NBER.

(-) **Initial jobless claims** for the Jan. 15 ending week rose by 55k to 286k, above expectations for a minor drop to 225k. **Continuing claims** for the Jan. 8 week rose by 84k to 1.635 mil., above the 1.563 mil. expected by consensus. It appears that seasonal effects could still be playing a role, but effects from the omicron variant may be as well, with a trend toward higher claims in manufacturing states.

Question of the Week

How have stocks performed historically under rising interest rates?

The short answer is better than many would expect, but it depends on the regime and other events happening at the time.

Where does the fear of rates originate? Aside from the more restrictive financing costs for businesses and consumers, rising rates and/or changing Fed policy can provide a shorter-term jolt to risk assets, largely due to the impact of higher discount rates pulling down the modeled fair values for income-producing assets. In the

past decade, the mere removal of extremely accommodative policies, in an effort to get back to some sort of normal (conditions not requiring emergency measures) signified a form of 'tightening'.

For the most part, central banks and markets elevate interest rates in response to stronger economic growth and/or inflation—each of which needs to be cooled from overheated levels. As stronger economic growth has historically coincided with positive corporate earnings growth, decent equity returns in these environments isn't that surprising. Inflation is another matter. Beyond a certain level, sustained high inflation can be perceived as more of a headwind. This is not only due to higher interest rates that are assumed to accompany inflation, and lower fair valuations due to present value of money effects, but also the tangible effects of rising costs of wages and goods inputs, which lower corporate profits. As long as the effects of growth outweigh the negatives of higher costs, positive stock results make sense.

However, as the business cycle matures, and economic growth begins to wane, an economy can become more sensitive to inflation and rate effects. This raises another fear about rising rates—in that a central bank will make a policy error and hike too much, pushing the economy into recession. On the positive side, such slowing can prompt central banks to pause rate hikes and/or begin a reversal if this slide starts to occur (and they act accordingly). Recessions have tended to be far worse for earnings growth (and equity prices) than any rising rates (which occur during stronger economies). This data will no doubt be closely watched by the Fed this year, as central banks tend to avoid tightening into a weakening environment. Still-elevated inflation remains the wildcard, something the Fed feels compelled to react to the longer it persists from merely 'transitory' status.

As you can see from the tables below, rising interest rates and/or a tightening Fed haven't necessarily meant doom and gloom for the stock market. Keep in mind, though, that all returns are regime-dependent, with different underlying growth rates, base interest rates, and inflation. (Note that Fed movements prior to the last few decades were much less transparent than they are today; at times before 1979, target rates weren't always announced. Markets seem to be have become more skittish in recent years in keeping with the high level of communication about rate movements.)

S&P 500 Returns When 10y Treasury Yield Rises by > 1%

Rising Rates Start	Rising Rates End	10y Treasury Yield Start	10y Treasury Yield End	Months	S&P Price Return %	Change in 10yT Yield %	Trailing 12m CPI % at Start
12/26/1962	8/29/1966	3.79	5.51	44	18.3	1.7	1.3
3/16/1967	12/29/1969	4.45	8.05	34	1.3	3.6	2.8
3/23/1971	9/16/1975	5.38	8.59	54	(18.1)	3.2	4.7
12/30/1976	9/30/1981	6.80	15.84	57	8.7	9.0	4.9
5/4/1983	5/30/1984	10.12	13.99	13	(7.9)	3.9	3.6
8/29/1986	10/16/1987	6.95	10.23	14	11.8	3.3	1.6
10/15/1993	11/7/1994	5.19	8.05	13	(1.4)	2.9	2.8
1/19/1996	7/8/1996	5.54	7.05	6	6.7	1.5	2.7
10/5/1998	1/21/2000	4.16	6.79	16	45.8	2.6	1.5
6/13/2003	6/28/2006	3.13	5.25	37	26.0	2.1	2.1
12/30/2008	4/5/2010	2.11	4.01	15	33.3	1.9	0.1
7/24/2012	12/31/2013	1.44	3.04	17	38.1	1.6	1.4
7/8/2016	10/5/2018	1.37	3.23	27	35.5	1.9	0.8
3/9/2020	3/31/2021	0.54	1.74	13	44.6	1.2	1.5
Average				26	17.3	2.9	2.3
Median				16	15.0	2.4	1.9
% Positive				-	79	-	-

Source: FocusPoint Solutions calculations, Yahoo Finance, Bloomberg, LPL, Federal Reserve. Treasury yield used is Fed DGS10.

S&P 500 Index Price Return After The First Fed Rate Hike				
Date of First Hike	Return Next 3m %	Return Next 6m %	Return Next 12m %	Trailing 12m CPI % at Start Mo
8/7/1980	6.5	4.2	6.9	12.9
12/22/1981	(8.6)	(13.0)	12.6	8.9
12/21/1982	9.1	22.0	18.0	3.8
12/16/1986	15.3	20.6	(0.8)	1.1
3/29/1988	3.5	3.7	12.4	3.9
2/4/1994	(3.9)	(2.4)	1.9	2.5
3/25/1997	12.7	18.9	39.6	2.8
6/30/1999	(6.6)	6.7	6.0	2.0
6/30/2004	(2.3)	6.4	4.4	3.3
12/16/2015	(2.2)	0.2	8.9	0.7
Average	2.3	6.7	11.0	4.2
Median	0.6	5.3	7.9	3.1
% Positive	50	80	90	100
Sources: FocusPoint Solutions calculations, Yahoo Finance, Federal Reserve, The Balance.				

In these types of environments, cyclical 'value' stocks have often appeared more attractive than 'growth' stocks with lower yields—which can see elevated valuations due to low interest rate inputs. Additionally, floating rate assets obviously have seen greater investor interest, as they benefit from the 'float' higher in yields. Ironically, traditional bonds themselves eventually become more attractive, since longer-term returns are so heavily reliant on starting yields—so higher starting yields mean better return potential.

Market Notes

Period ending 1/21/2022	1 Week (%)	YTD (%)
DJIA	-4.55	-5.63
S&P 500	-5.67	-7.66
NASDAQ	-7.55	-11.98
Russell 2000	-8.07	-11.44
MSCI-EAFE	-2.08	-2.19
MSCI-EM	-1.04	1.03
Bloomberg U.S. Aggregate	0.05	-1.77

U.S. Treasury Yields	3 Mo.	2 Yr.	5 Yr.	10 Yr.	30 Yr.
12/31/2021	0.06	0.73	1.26	1.52	1.90
1/14/2022	0.13	0.99	1.55	1.78	2.12
1/21/2022	0.17	1.01	1.54	1.75	2.07

U.S. stocks started the week on a weaker note, with interest rates ticking higher and causing further concern for investors. From peak levels in December 2021 peak, the tech-heavy Nasdaq index and Russell 2000 small cap indexes have reached beyond correction territory at over -10%. However, the more diversified S&P 500 has not yet reached that -10% mark. The technology sector (about 30% of the S&P's market cap weight) has been responsible for roughly half of the absolute return decline so far in 2020. (It's important to note that almost every calendar year or two features at least one -10% stock price drop, and U.S. markets have been arguably overdue.)

Every sector was in the red last week, led by consumer discretionary (-8%) and technology, but also financials. Defensives consumer staples and utilities fared far better, with minimal losses, as expected. Real estate fell back around -3%, which outperformed many other segments. Popular stock Netflix was hit particularly hard (down -20%), with a decline in subscriber growth, as pandemic concerns (and at-home TV watching) appeared to wane. With the price of the stock appearing quite high by a variety of metrics, such a drawdown wasn't unexpected, but a jarring reminder of the easy earnings gains of 2021 now behind us. Aside from interest rate and inflation concerns, Russian activity at the Ukrainian border has raised geopolitical uncertainty, as have continued high Covid omicron case rates.

Earnings for Q4 are beginning to roll in, with mixed results. Aside from the Netflix disappointment noted above, several financial firms also disappointed earlier in the week. However, while overall growth remains above-average, cautionary management guidance on several earnings calls about the future growth have been another catalyst for weakening sentiment—rising interest rates have fueled this negative tone in recent weeks. Compared to a robust 2021, a more tempered 2022 was largely expected, although the Covid omicron variant doesn't seem to have overly worsened conditions. Per FactSet, Q4 year-over-year growth is expected to run at just under 22% (which remains robust historically). Hard-to-beat base effects (from a bad 2020) and supply chain issues have pulled down expectations, although the common 'underpromise early and overdeliver later' tendency for earnings reports can be common. In short, fundamental conditions remain strong, but not as much so as last year. Markets can overreact to times of change more than they do absolute levels.

While also negative, foreign stocks held up better than U.S. stocks last week, in part due to different monetary policy timelines and lower valuations. It was expected that the ECB will follow in line with the U.S. Fed and raise policy rates, although later in the year. However, the ECB's response has been more dovish, with mixed opinions on the committee it appears. Japanese markets were hampered by several regions placed under additional emergency measures in response to omicron, and dovish central bank language. Emerging markets were mixed, with stronger sentiment in Brazil and China, along with a cut in interest rates for the latter; Russian stocks plummeted again with tensions with Ukraine remaining high and possible sanctions on the horizon.

U.S. bonds were mixed, with longer-term treasuries faring positively, in line with risk-off sentiment, although the 10-year treasury briefly reached 1.9% before falling back. High yield and bank loan prices declined. Developed market bonds fell back in keeping with a stronger dollar, while emerging market bonds interestingly fared positively—counter to a tendency to act as a risk-off asset.

Commodities gained last week to a minimal degree, with increases in all major sub-groups, led by agricultural prices. The price of crude oil rose by over a percent to just above $85/barrel, offsetting an over-10% decline in natural gas prices due to higher supplies. As often happens in these scenarios, oil price estimates for coming months have risen (to $100/barrel or more in some cases); however, estimates in the middle of such periods often tend to end up being inaccurate. Factors keeping oil prices high include supply, with little spare capacity remaining, and OPEC nations not feeling an immediate need to ramp up further production. Demand is also continuing to improve, due to the omicron variant's less severe nature resulting in shorter lockdowns and an anticipated faster return to higher activity levels and mobility. Oil production and distribution assets are difficult to turn on and off quickly, causing demand/supply mismatches that can move prices in unforeseen

directions quickly. As an example of this unanticipated speed, the early 2020 negative -$37/barrel futures price comes to mind, when oil literally couldn't be given away fast enough, but times have changed.

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, 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.