Summary

On a holiday-shortened week, economic data for the week included the ISM services index strengthening, and mixed results for jobless claims.

Global equity markets gained last week, as central bank actions and member comments solidified a commitment to fighting inflation without overly damaging the global economy, in addition to inflation pressures themselves cooling. Bonds were mixed, with treasuries down due to higher rates, and high yield seeing gains. Commodities were mixed, with energy falling back due to natural gas prices, while crude oil was little changed.

Economic Notes

(+) The **ISM services/non-manufacturing index** for August ticked up 0.2 of a point to 56.9, above the median forecast calling for 55.3. Under the surface, business activity and new orders were up a point or more, further into expansionary territory; employment rose over a point, and rose back from contraction into expansion. Prices paid and supplier deliveries continued to fall back gradually, although both remained at elevated levels (prices more so than deliveries). This continued improvement is another example of continued economic expansion, as opposed to contraction.

(0) **Initial jobless claims** for the Sep. 3 ending week fell by -6k to 222k, below the expected increase to 235k. **Continuing claims** for the Aug. 27 week, on the other hand, rose by 36k to 1.473 mil., above the consensus expectation calling for 1.438 mil. Initial claims were mixed by state, with continued gains in MA, while MI saw the largest declines. Overall, however, the ratio of unemployed to total available workers remains tempered, in keeping with strong labor markets.

(0) The Fed's **Beige Book**, which documents anecdotes from the various regional Federal Reserve banks during July and August, noted that activity was largely unchanged on net over the period. This included some districts reporting slight to modest growth while others saw slight to modest softening. While discretionary spending has pulled back a bit, as did auto sales, in favor of food and essentials, leisure/tourism has solidly picked up. Manufacturing has shown growth, although labor shortages and supply chain shortages weighed on activity. Real estate activity also softened to a greater degree, strained by higher financing rates. Employment continued to rise at a modest to moderate pace, however. Regarding inflation, prices remained elevated, but most districts saw a degree of moderation in the rate of increase, which was a positive. Overall, while there appeared to be some loosening in supply constraints, the outlook for economic growth remained weaker than prior periods this year.

Question of the Week

Now that the summer 'slow' season is nearly over, what's on the radar?

Labor Day indeed signifies the Wall Street 'New Year' for financial markets, with attention already turning from the current year for the most part, and toward Q4 and 2023. There are several headline items worth watching that may drive sentiment and potential volatility in coming months.

- Inflation. There has been progress, with a deceleration in the pace of increase in areas such as used cars, which had been a problem. Lower oil prices helps the headline number the most, and supply disruptions in global trade are slowly improving. Goods inflation is now morphing into higher services inflation, so we are not past the problem. Additionally, from a formal CPI standpoint, shelter inflation (from both higher rents and home prices, the latter of which have only recently begun to slow) is an expected upward force on prices. While the worst may be over, levels may remain above the 2% target

for a few years potentially. Even if that's the case, 3-4% on a year-over-year basis would be a welcome change compared to the more consumer-damaging 8-9%. It's noteworthy that historical 12-month inflation has been far higher than the 2% Fed target—4.0% over the past 50 years, and 3.2% since the CPI's creation in 1913.

- Federal Reserve. The probability of rate increases has picked up a bit, with expectations for a 0.50% move in Sept. now having evolved to 0.75%. The robust language and pace of the Fed have been notable in recent public comments. They've announced the specific focus being reducing inflation (through dampening economic demand, the only factor they can control), even if this causes consumer 'pain'. Whether that remains true if the economy falls into recession remains to be seen, but for now, we can take this at face value.
- Interest rates. Short-term rates follow Federal Reserve policy, and these have unsurprisingly been rising steadily. However, long-term rate predictions aren't quite as easy—these follow economic growth and inflation expectations, which have tended to regress to the mean. As such, recent treasury yields look less dramatic when considering an expected inflation drop towards normal levels (even if levels remain higher than target for up to a few years) and economic growth drifting back to trend levels around 2%-ish. A key question markets are trying to determine: what is the Fed's terminal rate? In recent weeks, estimates have risen from around 3.50% to more like 4.00%. After rates reach that level, it's possible the Fed stays put for a time, if policy is assumed to be tight enough as to not cause undue economic damage but also allow inflation to gradually ease to a natural rate. However, another pervasive view is that the Fed 'breaks' the economy through fast rate hikes, and will need to cut rates at some point in 2023. The good news for discouraged bond investors is that higher rates raise expected returns for bonds, which tend to track starting yields. (Just for example, 4.00% policy + 1.50% investment-grade corporate spread = 5.50% return, which is around the long-term average for bonds.)
- Economic growth/recession odds. Activity has been slipping, with two straight quarters of negative growth, although this hasn't been defined as an official recession. However, indicators are mixed, with manufacturing and services sentiment remaining expansionary, and labor markets strong, although consumer debt is rising along with higher wages. Economists aren't known for making outright recession calls outright, but the consensus is rising for the coming year, and close to a near certainty over the next two years. At best, growth isn't expected to turn sharply positive in coming quarters. Of course, this matters as GDP growth translates into assumptions about corporate earnings.
- Earnings. Through Q2, earnings growth has come in at over 5%, a surprisingly persistent result considering the economic weakening. A risk for Q3 and Q4 is that, in keeping with traditional recessions, earnings could decline by -10% up to -30%. Lower earnings could subsequently pressure stock valuations and prices, so additional market volatility this fall (even testing prior lows) wouldn't be a surprise. Market timing isn't advised, though, as recessions haven't been great times to abandon equities (results during recessions themselves have been mixed), but stock prices have tended to find a bottom and start recovering well before recessions end.
- European energy environment. This includes the announcement (partially a surprise, partially not) of the Russian Nord Stream pipeline closure. Several nations have ramped up, or are in the process of ramping up, LNG capabilities for winter, but there will be pressure on both residential and industrial usage. While it appears the probabilities of a European recession have moved sharply higher (and higher than chances in the U.S.) largely due to these effects, the depth and severity remain in question. Valuations in European equities already largely discount this negativity, with the MSCI Europe index P/E just above 10x—a level in line with recessions.
- China. Another round of selected pandemic lockdowns has pressured sentiment. As it stands, weaker growth has prompted fiscal stimulus. However, the government has been careful to not overdo it, particularly in segments such as real estate where a careful balance between not propping up asset bubbles, bailing out troubled developers, and satisfying disgruntled homebuyers is playing out.
- Covid. This wildcard isn't done yet, especially with an ongoing threat of new lockdowns in China, although the situation has dramatically improved from that of two years ago. While the medical

component has evolved into an endemic stage, impacts persist in supply chains, travel, and real estate, such as office and retail properties. Some of the still-lagging areas may improve steadily, while others could be more persistent—requiring market assumptions to adapt.

- Seasonality/Technicals. We hesitate to put too much emphasis on these factors, as they aren't always consistent from one year to the next. The S&P had retraced upward about 50% of the first half's -23% correction, but wasn't able to break above the technically-significant 200-day moving average. (Prices trading above that mark are seen as bullish from a momentum standpoint, although it's possible investors care about that timeline only because it seems others care about it.) Since 1925, September has been the worst-performing and most volatile month for equity markets (in fact, the only month with a net negative return). However, the 4th quarter of each calendar year has been the best-performing quarter, even if it contains bouts of volatility from time to time (October has been notorious for drama).
- US mid-term elections. These can be a source of volatility, but it has tended to be short-lived, with stronger later-year stock market recoveries common. The incumbent President's party has often lost Congressional seats, although, as we've seen for decades, the party in charge isn't really that important for stock returns (contrary to popular belief).

Market Notes

Period ending 9/9/2022	1 Week (%)	YTD (%)
DJIA	2.72	-10.16
S&P 500	3.68	-13.72
NASDAQ	4.15	-22.15
Russell 2000	4.07	-15.39
MSCI-EAFE	0.89	-19.52
MSCI-EM	-0.13	-19.42
Bloomberg U.S. Aggregate	-0.70	-11.56

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
9/2/2022	2.94	3.40	3.30	3.20	3.35
9/9/2022	3.08	3.56	3.45	3.33	3.47

U.S. stocks gained ground last week, in a reversal of recent negativity, led by lower energy prices and well-accepted Fed comments about the ability to achieve a soft landing. Every sector was in positive territory, led by most cyclical consumer discretionary and materials, each up over 5%. Energy lagged, up less than a percent. Real estate also gained several percent, despite higher longer-term interest rates, which have been a headwind for the group.

Foreign stocks came in a bit behind U.S. stocks, with Europe and the U.K. several percent higher, while gains in Japan and emerging markets were more tempered. More solidified plans by several European nations (such as household energy cost caps in the U.K.) in handling the energy crisis resulting from gas shortages appeared to improve sentiment. The magnitude of some fiscal aid is approaching or exceeding that of the Covid response. The ECB raised interest rates by 0.75% on Thurs., which, coupled with hawkish language, has raised expectations for further hikes later in the year. Chinese producer price inflation fell unexpectedly, which helped global sentiment later in the week.

U.S. treasury bonds fell back last week, as higher rates in Europe translated to higher U.S. rates—in a bit of a reversal of the usual pattern. Investment-grade corporates were little-changed, while high yield and floating rate bank loans were strongly positive, in keeping with equity sentiment. Foreign bonds were mixed, with higher rates hurting developed market bonds, while a weaker dollar boosted emerging markets.

Commodities were mixed last week, with agriculture and industrial metals gaining several percent, while energy prices pulled back. The price of crude oil was little changed on the week, ending at just under $87/barrel; natural gas prices corrected by nearly -10%. Extreme dynamics continue to dominate gas markets, with an undersupply in the U.S. caused by hot weather usages and an outage at a key plant accounting for a fifth of total exports, while Europe is obviously affected by the Russian pipe shutdown. Perhaps amazingly, European efforts to pre-fill inventory ahead of winter have been successful, but price pressures persist, resulting in government policy actions.

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.