Summary

Economic data included no revisions in the still-negative Q2 U.S. GDP report. Durable goods fell back, as did home prices in several national indexes. Consumer confidence measures were mixed, while jobless claims improved.

Global equity markets fell back again, as investor moods were dampened by continued corporate negativity and higher interest rates, with financial concerns in the U.K. a key catalyst. Bonds declined as yields rose across much of the treasury curve. Commodities were mixed with crude oil prices ending slightly higher for the week.

Economic Notes

(-/0) The third and final Q2 U.S. **GDP** report showed no change from the prior estimate, staying at a contractionary -0.6%. A positive was that consumer spending was revised upward, offsetting a drop in exports. When looking at industries, the leading contributors to the decrease were cyclical groups including construction and nondurable goods manufacturing (such as chemical products), which accounted for -1.5% of the total GDP percentage contribution. On the positive side, contributors were health care/social assistance (led by hospitals), professional/scientific/technical services, real estate/rental/leasing, and accommodation/food services. The core PCE price index rose at an annualized 4.7% for Q2, three-tenths higher than the prior report, with stronger impacts from food services/accommodations, motor vehicles/parts, and transportation.

Based on the Atlanta Fed's GDPNow measure, growth expectations for Q3 have bounced around the 0.0-2.0% range for the past several months before rising to 2.4% in the latest estimate. The Blue Chip survey economist consensus has remained just above 1.0%, with a range of 0.0-2.5%. Despite the negative actual results of Q1 and Q2, there still seems to be a hesitancy in calling the current environment a recession. Though, odds of a recession in the next year (and especially two years) seem to remain better than half in the mainstream economist community.

(0) **Personal income** for August rose by 0.3%, a bit stronger than forecast and driven by wage/salary income, ending in a year-over-year gain of 8%. **Personal spending** rose by 0.4%, but under the surface was a broad split between goods (which fell -0.5%) and services (which gained 0.8%), in a continuation of the latter's post-pandemic repair (both groups were up a similar 8% on a trailing 12-month basis). The personal saving rate remained stable at 3.5%. The PCE inflation measure rose by 0.3% on a headline basis, while core PCE increased by 0.6%. Year-over-year, this equated to headline and core PCE changes of 6.2% and 4.9%, respectively.

(0) **Durable goods orders** for August fell back by -0.2%, slightly better than the -0.3% expected. Removing transportation (commercial aircraft down almost -20%) turned the decline into a positive 0.2%, while core capital goods orders was an even stronger 1.3% gain. These were led by gains in electrical equipment, computers/electronics, metals, and machinery. Core capital goods shipments rose by 0.3%, on par with expectations.

(-) The **S&P Case-Shiller home price index** declined by -0.4% in July, compared to an expected gain of 0.2%. Prices rose in only 8 of the 20 cities, led by gains in Miami and Charlotte of up to a percent, while San Francisco, Seattle, and San Diego declined by over 2% each. On a year-over-year basis, the pace of national price growth decelerated by -2.6% to a still-robust 16.1%.

(-) The broader and less urban-focused **FHFA house price index** fell -0.6% in July, which disappointed relative to an expected no change. Of the nine national regions, eight showed declines, led by -1% or more in the Pacific and New England segments. The year-over-year pace of chance decelerated by -2.4% to 13.9%. It's possible financial markets took these numbers negatively, assuming that the Fed might be tightening too fast and causing negative side effects in real estate markets. But, markets (and the Fed) can't have it both ways. If rates rise sharply, real estate softening is historically-common outcome. Mortgage rates continued rising, to 7% last week, with uncertain impacts on potential homebuyers.

(+) **New home sales** in August rose by 28.8% to a seasonally-adjusted annualized rate of 685k units, sharply higher than the -2.2% consensus decline. Every region saw an increase, led by the South (106k) and West (28k). The median new home price came in at $436,800, down a dramatic -6% from July's level. The months' supply inventory level fell from 10.4 to 8.1. Homes 'under construction' continue to remain the largest category, but both 'not started' and 'completed' have gained ground in recent months on the edges.

(-) **Pending home sales** fell back by -2.0% in August, slightly beyond the -1.5% consensus forecast. Regionally, the West saw a slight gain, but all other segments saw declines for the month. Year-over-year, pending sales have fallen by -23%. This points to lower existing home sales results in upcoming months.

(+) The **Conference Board index of consumer confidence** for September rose by 4.4 points to 108.0, beating forecasts calling for 104.6. Assessments of present conditions and expectations for the future rose at similar rates, and the labor differential rose to a slightly lesser degree.

(-) The final Sept. **Univ. of Michigan index of consumer sentiment** number declined by -0.9 of a point to 58.6, disappointing relative to the unchanged reading expected. Compared to the initial report, assessments of current conditions actually rose by nearly a point, while future expectations fell back by two points. Inflation expectations, however, continued to remain stable. For the coming year, these were revised up a tenth to 4.7%, but for the next 5-10 years, they ticked down by another tenth to 2.7%. Anecdotal commentary noted concern about the economy during the month (along with high media coverage of recession risks), as well as ongoing uncertainty over inflation (despite that not affecting the survey results all that badly).

(+) **Initial jobless claims** for the Sep. 24 ending week fell by -16k to 193k, below the 215k median forecast. **Continuing claims** for the Sep. 17 week fell by -29k to 1.347 mil., below the 1.385 mil. consensus estimate. Initial claims fell sharply in MI (-10k), reversing a spike the week prior, and were mixed in a variety of other states. Overall, levels remained low, consistent with a strong labor market with little signs of radical improvement nor deterioration.

Market Notes

Period ending 9/30/2022	**1 Week (%)**	**YTD (%)**
DJIA	-2.92	-19.72
S&P 500	-2.88	-23.87
NASDAQ	-2.68	-32.00
Russell 2000	-0.82	-25.10
MSCI-EAFE	-1.35	-27.09
MSCI-EM	-3.26	-27.16
Bloomberg U.S. Aggregate	-0.99	-14.61

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
9/23/2022	3.24	4.20	3.96	3.69	3.61
9/30/2022	3.33	4.22	4.06	3.83	3.79

U.S. stocks fell back again last week, and September ended negatively—true to historical form, unfortunately. In addition to financial turmoil in England (discussed below) carrying over to other developed nations, explosions that damaged the Nord Stream European gas pipeline, and a hurricane making landfall in Florida added the potential for disruptions. By sector, only energy ended with a gain (2%), while utilities suffered the most (-9%), on higher interest rates and perceived hurricane effects. Real estate also lost -4%, in keeping with most other sectors. Negative feedback from Apple and Nike in regard to upcoming global slowing were closely-responded to by investors.

The Dow finally reached -20% bear market territory last week, to join the S&P and NASDAQ, although that index is generally irrelevant from the standpoint of broader stocks (better measured by the S&P). But, it tends to be mentioned in the mainstream media frequently due to its century-plus historical legacy. Interestingly, the VIX index (which is the implied standard deviation on the S&P 500 based on options pricing) has risen relatively gradually. After trading between 20-30 most of the past few months, it's again approaching 35. On the positive side, from a contrarian standpoint, high VIX levels have provided decent equity buying opportunities over the following 12- and 24-month periods. This is not saying this fall's volatility has ended—both October outright and the lead-up to mid-term elections have provided historical uncertainty. However, the three months of Q4 have been historically the most positive for equities.

From the S&P 500 peak of 4797 on Jan. 3, prices are now down -25%. This is right about the median market decline level seen before recessions since World War II. So, the perpetual question being asked by markets is: where is the bottom? As usual, markets are trying to sort out a variety of potential scenarios. Investor sentiment, inflation, and geopolitics may still carry the near-term, but earnings become more important on a multi-quarter basis. With the economy in transition, markets are sorting out a variety of more realistic to less realistic scenarios. These are just examples to show how the inputs involved change the assumptions

- In a sample hypothetical worst case, 2022 estimated S&P earnings of $225 fall by -10% in 2023 to $203. Applying a deep recession-like 12x P/E ratio results in an index level of ~2430. (This would be a total peak-to-trough drop of -49%, and a further decline of -32% from Friday's close.) As that total drawdown severity is nearly on par with the 2008 financial crisis (over -50%), this appears extreme, more in line with a multi-decade structural bear market. For what it's worth, it isn't in the base case of most mainstream strategists. However, these types of calculations are instructive, particularly in light of periodic financial advertisements on the sensational side claiming: 'Stocks set to fall by 90%!'
- In a middle-of-the-road scenario, conservatively implying 0% earnings growth for 2023 (which assumes a recessionary earnings drop as well as recovery), and a reversion to a long-term average 15x P/E, results in a level of 3375. This is -6% below Friday's close, and a -30% total drop from peak. So, this path would be slightly worse than the median historical precedent.
- In a better-case scenario, using FactSet's median estimate of 8% earnings growth for 2023 (to ~$243), and a still-optimistic 16x-17x P/E, the S&P target rises to ~4000. This is 12% above the current level, although still down -16% from the peak. Assuming we enter recession, markets could start to look further out into 2024, with stock pricing based on implied earnings recovery post-recession. This could push prices higher in advance of the actual fundamental improvement, which wouldn't be all that unusual.

Foreign stocks in Europe and the U.K. fared better than domestic stocks, helped by a weaker dollar, while emerging markets fared worse, although results were country-specific. The episode in the U.K. was an unusual wrinkle during the week. To combat economic slowing and high energy prices, the new Truss administration announced a substantial fiscal expansion with energy subsidies and tax cuts (although spending was not reduced in kind, increasing the fiscal deficit sharply). This was rebuked by the IMF, and resulted in a dramatic weakening of the pound and debt sell-off as interest rates rose sharply, causing nearly a -25% drop in long-term bond prices in short order. This was made even more real for potential British homebuyers, as mortgage lenders withdrew from the market due to a lack of clarity about rates, and not wanting to be left holding the bag. Pension plan asset-liability conditions had also deteriorated quickly and severely, which prompted government action. This included the Bank of England announcing temporary asset purchases of long-dated bonds (which pulled yields back down by a about a percent within a trading day, almost reversing the prior price decline). In keeping with this policy, the October beginning of U.K. quantitative tightening has been postponed a month. While the government was praised for the short-term response to restore stability, it has been criticized for the ill-planned fiscal plan that started the whole debacle. The Bloomberg European Financial Conditions Index fell to -3.5 standard deviations below normal, in line somewhere between Covid and the Eurocrisis (the U.S. index fell to -1.5 standard deviations below normal, last seen in early 2019).

If this sounds circular and confusing, those events reflect the new reality of the global central bank tightrope. This is a hoped-for balance between wanting rates higher to fight inflation, but not enough all at once to disrupt financial funding markets and market expectations. The Russia-Ukraine conflict is directly related to this, with government pressure to assist citizens being the result of slower economic growth, due to higher energy prices, starting with Russian energy dependence and cut-off of regional supply. By contrast, the U.S. has the benefit of sponsoring the world's reserve currency, as well as the largest and most liquid treasury bond market, which has lowered the risk of similar events on this side of the pond. The U.S. is also far more energy self-sufficient, with no reliance on Russia; in fact, American LNG has been shipped to Europe to quickly shore up their winter supplies, albeit the ocean being a cumbersome transportation method. This does highlight the difficulty in making the transition between quantitative easing (which England has essentially implemented again for now) and quantitative tightening (which is the removal of such market-stabilizing purchases). For the U.K. and possibly other developed nations, a possible scenario is that this removal of 15 years' worth of monetary easing may end up being more gradual, and thus take far longer, than initially expected to reduce the chances of such surprises.

U.S. bonds fell back again as interest rates continued higher. Government outperformed corporates, with the bellwether 10-year treasury temporarily reaching 4% for the first time since 2008, as longer bonds have ticked upward to reflect the new assumptions of a higher Federal Reserve terminal rate. However, in keeping with sentiment from the Bank of England's actions, long treasuries fell back by over a quarter-percent—the largest single-day change since 2009—as investors sought out the safety of these bonds. This higher rate level has also increased the curve inversion between the 10y-2y, while the 10y-3m segment remains positive. These differences reflect the differing economic signals pointing to either recession or no recession. Foreign bonds fell back most notably in emerging market debt, which declined several percent as credit spreads widened.

Commodities were mixed on the week, with gains in energy and precious metals offset by a minor decline in industrial metals. The price of crude oil rose roughly a percent on net to just over $79/barrel, despite a back-and-forth week. OPEC has considered production cuts, which were balanced with recession concerns that have steadily lowered expectations for energy demand.

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.