

Summary

Economic data for the week included consumer price inflation coming in still higher relative to history and the Fed's target, but at a slower pace than last month. The widely-anticipated mid-term elections resulted in a likely divided government, although vote counts were still ongoing by the end of the week. Consumer confidence again fell back, while jobless claims were little changed.

Global equity markets experienced a strong week, buoyed by the positive CPI inflation surprise, with foreign stocks especially benefitting from a drop in the value of the dollar. Bonds also fared well as long-term interest rates pulled back. Commodities were mixed, with crude oil lower and metals higher.

Economic Notes

(0/+) The **consumer price index** for October showed an increase of 0.4% on a headline level (vs. the 0.6% rise expected), and 0.3% for core when removing food and energy (vs. consensus of 0.5%). Within the report for the month, energy commodity prices rose 4.4%, followed by food up 0.6%, although only in meats and grains, reiterating strong inflation impulses in those key consumer areas. In other products, gains were seen in new car prices (0.4%) and hotel rooms (4.9%), which were offset by used cars falling back sharply (-2.4%), apparel (-0.7%), medical care services (-0.6%), and airline fares (-1.1%). Shelter prices rose 0.8%, the biggest one month increase in over 30 years, remaining under the influence of higher rents and owners' equivalent rent, based on still-high house prices.

The trailing 12-month CPI results came in at 7.7% and 6.3%, for headline and core, respectively. The headline differential was driven by energy prices having risen 18% during the year. Both year-over-year headline and core represented a deceleration from the prior month's pace of 8.2% and 6.6% last month (explaining why this was taken so positively by markets). Although inflation overall still remains uncomfortably high, the movement lower represents good news.

There had been some preliminary signs that certain inflation components are cooling, including lower used car auction prices, consumer goods, and asking rents in some commercial property segments (as offices remain challenged). The supply-chain risk continues, as long as China continues a zero-Covid policy, but an increasing focus on vaccinations (especially the elderly) and potential post-Communist party meeting evolution in policy to boost growth may ease that risk into 2023. The demand side of inflation has also come down, as it's tied to economic growth and monetary policy, which has become significantly tighter along in keeping with higher borrowing rates. However, none of these individual components respond quickly, with Atlanta Fed flexible inflation higher but decelerating, while sticky price inflation has flattened after rising for several months.

(-) The preliminary November **Univ. of Michigan index of consumer sentiment** fell by -5.2 points to 54.7, below the expected minor decline to 59.5. Assessments of current conditions fell by nearly -8 points, while expectations for the future were only down a few points. Inflation expectations ticked up a tenth of a point for the coming year to 5.1% as well as for the next 5-10 years to 3.0%. It appeared that buying conditions for durable goods decreased by the greatest amount, which resulted in a weakness in sentiment across all demographic groups in the survey.

(0) **Initial jobless claims** for the Nov. 5 ending week rose by 7k to 225k, just above the 220k forecast. **Continuing claims** for the Oct. 29 week rose by 6k to 1.493 mil., compared to the 1.492 mil. consensus forecast. Initial claims were pushed higher by CA, KY, and TX, tempered by declines in a variety of states. Despite a slight uptick, overall claims levels remain low.

(-) The Fed's **Senior Loan Officer Opinion Survey** for Q3 reported weaker demand and tighter lending standards generally. In commercial and industrial, 39% of banks tightened standards, up from 24% in Q2, with

similar patterns for smaller firms. This included a third of banks widening loan rate spreads, more than a doubling from the prior quarter. In line, demand for loans also dropped. These all go along with generally more cautious behavior from banks when recession odds rise. Importantly, banks noted that internal conditions, such as weaker capital positions or liquidity, were not a cause for the caution. Unsurprisingly, the rationale for the majority of banks was a more uncertain and less favorable economic outlook, as well as lower tolerance for risk and industry-specific issues.

Commercial real estate loans saw tightening to an even greater degree in the quarter, accompanying by a fall in demand. The tightening was led by the more cyclical segment of construction/development, with multi-family residential slightly less affected. Residential mortgage loans saw mixed results, with tightening for most loans, including jumbo and subprime, while others were less affected. Consumer installment loan supply fell, with greater scrutiny of credit card applications. Auto loan demand fell, which is not surprising considering higher inflation-driven auto costs. Ultimately, rising recession risks tend to raise sensitivity to potential consumer defaults, with credit card balances having risen in recent months.

Question of the Week

Has the mid-term election changed anything for markets?

The elections last week ended up inconclusive so far, with slow vote counts continuing in several states. Current estimates continue to point to a slim Republican majority in the House, and a more conclusive outcome of the Senate staying in Democratic hands, coupled with another Georgia run-off set for early December. A Republican House win would result in divided government, which was widely expected (as only five seats were needed), but this hasn't been officially called, due to the large number of close races. Regardless, an assumed 'red wave' didn't end up materializing, with margins far tighter than seen via pre-election polling. The lack of clarity held back a potential market rally, albeit having it saved by the better inflation data.

What does this mean for markets? While results continue to be sorted out, market reaction tends to be hinged on: (1) the removal of uncertainty from the election itself and potential big surprises (like a Democratic sweep), and (2) the higher likelihood of divided government, with the Republicans taking the House being the only necessary piece. Specifically, near-term market worries are focused on corporate taxes, fiscal spending, and regulation, which were all assumed to be at risk of moving higher were Congress to stay in its current configuration.

A swap in party control has been common in mid-terms, particularly if the underlying economy is seen as vulnerable and the President has a low approval rating. The Democrats have actually fared better in the 2022 mid-terms than perhaps any incumbent party in the last 40 years. Economic slowing has been a key focus for voters historically ('It's the economy, stupid'), which always seems to surprise campaign managers by dominating other newsworthy items. Though, today's unique inflation problem piled on secondary fuel, as did a variety of social issues and candidate ideologies/backgrounds. In contrast to the last two years under Democratic control, a split-party outcome raises the probability of gridlock and lowers chances of more controversial and partisan legislation being passed, notably the mentioned tax hikes and/or large spending packages, as we saw over the last term. However, a Democratic Senate still retains power for nominations and other items. In this sense, markets have viewed periods of 'stalemate' positively. This would give a temporary respite until 2024 Presidential campaign discussion begins, as well as debt ceiling debates likely to come up in mid-2023, which could again be contentious (with 2011 notable for a negative market response).

There would be financial advisory implications here as well, as a split Congress could lower the chances of new legislation banning items like back-door Roth IRAs, capping of 'mega-IRA' balances (and requiring withdrawals of excess accumulations), etc. However, there is still two-party support for some initiatives to plug policy loopholes and raise tax revenue, so all may not be dead. There has been broad support for strengthening

retirement savings, whether that translates into higher contribution limits or product adjustments. More critical and controversial items like entitlement reform remain a ‘third rail’, so do not appear on the front burner at this point. The greatest two-party support continues to exist in areas of domestic reshoring (semiconductors and other manufacturing) and other domestic supply initiatives in response to shortages seen during the pandemic. A continued tough stance on China has also been supported by both sides of the aisle, in one of the rare areas of bipartisan agreement.

As an example of the sense of post-election relief investors have felt historically, JPMorgan compiled data for the immediate 200 trading days around mid-term elections over the last 40 years. About half of the 100-day periods before Election Day were flattish or negative, while 9 out of 10 100-day stretches afterward have been positive. This is only based on history, of course, and future results are never assumed. Most importantly, though, it points to how politics (and most other new) has little bearing on longer-term financial market outcomes. More important fundamental drivers are interest rates (for bonds) and earnings growth (for stocks).

Market Notes

Period ending 11/11/2022	1 Week (%)	YTD (%)
DJIA	4.22	-5.51
S&P 500	5.93	-15.08
NASDAQ	8.11	-27.13
Russell 2000	4.64	-15.19
MSCI-EAFE	8.42	-15.73
MSCI-EM	5.74	-22.11
Bloomberg U.S. Aggregate	2.29	-14.10

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
11/4/2022	4.21	4.66	4.33	4.17	4.27
11/11/2022	4.28	4.34	3.95	3.82	4.03

U.S. stocks continued a volatile fall week, with inputs driven by Tuesday’s mid-term election results (which took some time to tabulate and with results not as conclusive for a divided government as some had hoped) and Thursday’s consumer price index reading, which showed some improvement downward on a trailing 12-month basis. These are two items that financial markets have been waiting for clarity on and better news about, with uncertainty always being closely tied to volatility. That the latter would fuel a positive market response was not a huge surprise. Additionally, and perhaps even more importantly, a member of the Fed noted that 4.5% might be an appropriate place for a pause in rate hikes, which goes along with the lower inflation reading. With the current fed funds rate at 3.75-4.00%, that’s not far away. The sharp Thursday gain was the best single day in over two years.

By sector, growth stocks saw a strong rebound last week, led by technology and communications, up 9-10% each. Speculation was the winning approach last week, with technology firms with no profits outperforming higher quality companies. Defensive sectors health care and utilities came in last, but still rose over a percent for the week. Real estate rallied by over 7% along with interest rates falling back.

A peripheral source of volatility was the collapse of the FTX cryptocurrency exchange, despite being a darling company not long ago. It appears a potential mishandling of customer funds and company direct investments in crypto were to blame. Cryptocurrency volatility has the potential to bleed over into traditional asset classes, if not only for the fact of the volatility itself, with Bitcoin down nearly -80% from peak levels last year. Sadly, anecdotal reports note that pandemic stimulus payments were a source of some (or a lot) of the crypto

speculation, although well-known institutions also provided FTX capital. This was real money that has now evaporated, and calls for crypto regulation have intensified.

Foreign stocks also experienced gains, to an even larger degree on net, due to a drop in the U.S. dollar, which directly raised foreign equity returns. Europe and Japan saw the strongest response, followed by emerging markets and the U.K. On a local currency level, stronger-than-expected earnings helped European markets, although U.K. economic growth showed a Q3 decline of -0.2%, but was slightly better than expected. Emerging markets were led by Taiwan and South Korea, which outpaced China as Covid cases rose again, which offset a -10% drop in Brazil due to higher inflation reading.

U.S. bonds experienced one of their stronger weeks in years, as long-term interest rates fell back sharply upon the tempered inflation news. Most bond categories fared similarly, from treasuries to high yield. Foreign bonds outshined domestic with the U.S. dollar weakening by -4% on the week, pushing developed and emerging market debt higher by equivalent amounts.

U.S. treasury bond issuance has fallen off dramatically in 2021 and 2022, which has kept overall supply low, resulting in potentially less impact from the Fed's QT, and strong investor demand. This is particularly true from foreign buyers, where U.S. bonds provide high safety and higher yields than other sovereign alternatives. This investor demand has served to keep prices high and yields lower than they may otherwise would be. This can also exacerbate the inverted shape of the treasury yield curve, holding down 10y yields, while the Fed-driven 3m rate has continued to rise.

Commodities fell back on the week, as weakness in energy offset higher prices for industrial and precious metals—the latter likely helped by the weaker dollar. The price of crude oil fell by -4% to \$89/barrel, along with a pullback in natural gas prices. Industrial metals have more recently benefitted from rumors of China moving away from zero-Covid policies eventually, in addition to low stockpiles. Gold has come back more recently, with the strong U.S. dollar flattening to moving downward a bit, as well as the crypto volatility.

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.