Summary

In a shortened week, economic data included weaker results for retail sales, industrial production, and some regional manufacturing activity. Housing sales and starts continued to decline; on the other hand, homebuilder sentiment surprisingly improved.

Global equities were mixed to higher last week, due to mixed economic data, but also increased signs of falling inflation and optimism over China's reopening. Bonds ticked higher as interest rates fell back along most of the yield curve. Commodities also rose with expected higher demand in coming months.

Economic Notes

(-) **Retail sales** for December fell by -1.1%, a bit below the median forecast calling for -0.9%, and included negative revisions for recent months. Removing the more volatile components (autos, gasoline, building materials), sales fell a more tempered -0.7%, but still about twice the decline expected. The differential was due to a -5% drop in gasoline station sales, with autos also down; however, building materials sales rose a bit. Within core, furniture/home furnishings and non-store/online retail each fell as well. Also note that retail sales are reported on a nominal basis, with 'real' after-inflation results coming in even more negatively when the effects of higher inflation are accounted for. That translates a 6% year-over-year nominal gain in retail sales back down toward zero or even slightly negative. In recent weeks, retail sales have been heavily skewed by Nov. and Dec. holiday shopping, and reflecting seasonality adjustments which can sometimes veer off-track, especially since the pandemic extremes. Future months should provide more clarity on the recent downturn, although positive shifts in consumer spending away from retail goods towards services may take away some of the sting from this particular number.

(-) **Industrial production** in December fell by -0.7%, well below the -0.1% median forecast, and represented the worst month in the last twelve. It was led lower by manufacturing production, down over -1%, which included a drop in auto production, with business equipment down even further. In other key groups, mining production fell nearly -1% as well, offset by a 4% rise in utilities, which is largely based on monthly weather conditions (cold temps and need for heating). **Capacity utilization** fell by -0.6% to 78.8%. While auto production was down due to planned outages for Nov. and Dec., overall production declines reflect a trend of continued weaker economic data.

(-) The **Empire State Manufacturing Survey** fell a dramatic -21.7 points to -32.9 in January, further into contraction (where zero represents neutral). This was the lowest level since mid-2020 and, in fact, was the 5th worst single-month reading in the history of the survey. This downturn was led by a drop in new orders and shipments, into contraction, employment declining and just barely expansionary, while inventories ticked higher. Prices paid also slowed, continuing a recent trend of improvement. From the standpoint of looking six months ahead, firms expected little improvement in business conditions. While only a single survey, this reflects slowing conditions ahead, although assessments of business conditions six months out rose over a point to an expansionary level of 8.

(-/0) The **Philadelphia manufacturing index** rose by 4.8 points in January to a still-contractionary -8.9, better than the -11.0 median forecast. Underlying strength was seen in employment and shipments, each of which rose back into expansion, as well as new orders, which improved to a slightly less negative place. Prices paid also fell back by nearly -12 points to a far less expansionary condition than what has been seen over the past year. Interestingly, expectations for business conditions six months out rose by 6 points back into an expansionary level. In answering the anecdotal question asked of respondents, labor and other costs were expected to grow more slowly in 2023 compared to 2022, which may explain some of the optimism.

(+) The **Producer Price Index** for December declined by -0.5% on a headline level, well slower than the expected -0.1%. Core PPI, removing food and energy, rose by 0.1%, which was about half the increase expected. Under the hood, energy prices falling -8% played a key role (in fact, a -13% drop in gasoline prices was the primary contributor for the month), as did food at -1%, while segments such as medical care rose by 0.2%. Year-over-year, headline and core PPI decelerated to rates of 6.2% and 5.5%, respectively, continuing a string of declines from a peak in March 2022. By grouping, goods prices have risen 8%, while services are up 5%, in keeping with supply chain dynamics still repairing. The overall deceleration is certainly welcome news, with a likely carryover to CPI. However, the improvement has taken far longer than expected, now coinciding with deteriorating economic data, making the Fed's balancing act even more challenging.

(0/-) **Existing home sales** in December fell by -1.5% to a seasonally-adjusted rate of 4.02 mil. units, slightly better than the expected decline of -3.4% and better than last month's sharp drop. However, it represented the 11th straight month of declines. Single-family units fell by just over -1%, while condos/co-ops fell -5% on the month. Regionally, the West fared best with a flat reading, while the South fell by -2%. Year-over-year, existing sales were down -34%, while for the 2022 calendar year, sales fell by -18% from the prior year, as higher financing rates took a rising toll over time. The median sales price decelerated to $366,900, a 2% gain over the last 12 months, and down -4% from peak levels earlier in 2022. The months' supply fell -0.4 to 2.9 for the month, remaining tight.

(0/-) **Housing starts** for December fell back by -1.4% to a seasonally-adjusted annualized rate of 1.382 mil. units, which was stronger than the expected -4.8% decline. The divergence was mostly based on the 11% rise in single-family starts (the first gain in four months), in contrast to the -19% decline in multi-family. Regionally, the Northeast saw a sharp rise of over 130%, while the Midwest fell by nearly -40%—late in the year, such shifts can be weather-related. Over the past 12 months, starts remain down -22%, with a deeper drop in single-family offset by slightly less negativity in multi-family. **Building permits** fell by -1.6%, in contrast to the expected 1.0% increase for the month. Faring oppositely to starts, single-family permit activity fell back by -7%, while multi-family rose by 5%. Year-over-year, permits are down -35%, in another reflection of the housing downturn led by rising financing rates. In terms of multi-family units being built, however, volumes are nearing a 50-year high.

(+) The **NAHB housing market index** for January rose by 4 points, beating expectations for no change, and representing the first rise in a year. All three categories of current, future, and expected sales rose by several points, with current sales leading the way. All four national regions also saw gains, led by the South and West. This provides some hope for homebuilding activity, perhaps related to interest rates pulling back a bit (by over -1%) in recent weeks from highs.

(0) **Initial jobless claims** for the Jan. 14 ending week declined by -15k to 190k, well below the expected rise to 214k. Continuing claims for the Jan. 7 week rose by 17k to 1.647 mil., but below the 1.655 mil. expected. Claims were very little changed by state, with overall levels remaining low and affected by year-end seasonal factors.

Question of the Week

How much does the debt limit debate this year matter to investors?

The newsworthy announcement last week from U.S. Treasury Secretary Yellen was that the U.S. debt limit of $31.4 tril. had been officially reached. However, despite the ominous headlines, this limit doesn't suddenly stop government payment activity, but rather kickstarts the Treasury's planned 'extraordinary measures' that allow outgoing payments to continue. It does mean that the Treasury is on 'borrowed time' so to speak, until Congress votes to raise the debt ceiling. This could be contentious, if the 1995 and 2011 debt ceiling debates serve as a template. In the latter 2011 episode, drawn-out negotiations caused S&P to lower their U.S. credit rating from the coveted AAA to AA+, where it's remained ever since. (Moody's and Fitch kept their ratings at the top tier.)

At the same time, the debt ceiling has been raised over 100 times since World War II, so the situation is far from unusual.

Some have called for permanent eradication of the limit to prevent these episodic debates, claiming that, since payments are simply fulfilling earlier agreed-upon promises, it's merely a logistical hurdle. However, in today's charged environment, House Republicans may call for spending reductions to allow a limit increase to get through. While the exact number of months that extraordinary measures can be used is dependent on tax revenues received through April, June has been indicated as a preliminary deadline. If conditions remain unsettled by then, even further measures may have to take place, such as prioritizing of and/or delaying of some payments. Talk of issuing a platinum 'trillion dollar coin' again resurfaced, which would take advantage of a loophole about metal bullion, but that hasn't gone anywhere the last several times it was mentioned over the last ten years. The primary concern is outright default (or even a seeming disregard about default) of interest payments on U.S. treasury debt. It wouldn't be surprising to see the next several months filled with rhetoric, although most policymakers appear to agree that actual or technical default is a critical line to avoid crossing. Political outcomes are difficult to put a probabilistic weighting on, with chances of a default not being zero—but then again, they never have been zero. This is despite U.S. treasury debt referred to in markets as being 'risk-free', but that really means 'risk-free' compared to everything else available.

Despite policy disagreements over the years, and how challenging it can be for investors to ignore these in real time, with 24-hour news, politics and economics/financial markets haven't been strongly related to each other over the long-term. Throughout decades of changing Presidential administrations and compositions of Congress, economic growth, company fundamentals, and interest rates have proven to be far more important drivers of investment results. The U.S. government (as well as other world governments) have acted in seemingly dysfunctional ways from time to time, and even for long stretches. But, absent policies that affect investment assets, such as an extreme increase in tax rates or being on the losing end of a world war, for example, economic factors have mattered far more.

It might seem obvious that U.S. government debt should behave poorly in these types of events, as it would be expected for interest rates to rise and prices to drop, in keeping with higher perceived credit risk. That pattern has been common in emerging markets. However, with U.S. debt, that trade has not been obvious. In fact, during the 2011 debt-ceiling crisis, investors rushed away from riskier assets and ironically toward U.S. treasuries, driving up their prices, which was contrary to what many experts predicted—considering that 'U.S. credit' was at risk. This is for a variety of reasons, both tangible and intangible, including predictable rule of law, military capabilities, sizable natural resources, land, and material wealth, and relative self-sufficiency in industrial and food production. It also reflected the view that politics were the problem, not a regime change or ability to pay due to unfavorable currency fluctuations or the price of certain commodity exports. U.S. stocks fared poorly during the 2011 crisis, falling into -10% to -15% correction territory that summer, but recovered in the following 12 months. So, reacting to today's uncertainty by selling U.S. assets is not an obvious solution.

Investors adopting a diversified global asset allocation approach are inherently more insulated from conditions affecting a single region or source of volatility. Focusing on a variety of asset classes around the world as opposed to just a few (like the U.S. economy or U.S. government alone) is a key reason such portfolios are built in this way and have offered return enhancement and/or risk reduction over time. At the same time, global portfolios still tend to contain some weighting of U.S. government bonds, which continue to be thought of as the highest-rated debt in the world, and tend to be sought out as safe havens during times of market volatility (per the 2011 example). Aside from government bonds, corporate bonds and stocks are driven by company prospects, such as earnings growth and valuation fundamentals, operating in private markets outside what the U.S. or other governments are doing. Portfolio allocations to foreign stocks and bonds provide diversified exposure to activity in other economies and their associated revenue streams, including those with higher potential growth than in the U.S. Foreign stocks being underpriced represents an especially good opportunity currently, with conditions in Europe not proving to be as bad as feared, and China's reopening bringing hope for stronger growth not only domestically, but also carried into improved global growth. Otherwise, assets like

commodities are positively correlated to inflation and geopolitical stress, and have provided non-correlation benefits when paired with other traditional portfolio components (as we have seen over the past few years).

All that said, headline news events can certainly drive short-term market movements, so seeing more day-to-day volatility wouldn't be surprising. In fact, it should probably be expected, with this debate coupled with a slowing economy and continued uncertainty about inflation. On the positive side, having witnessed the 11th-hour negotiations of 2011 and concern that began to surround U.S. creditworthiness, there appears to be a greater realization today of the reputational damage that such rhetoric can cause outside the Washington political sphere. Financial markets have traditionally been forward-looking, so once a crisis passes, it might be forgotten just as fast as markets seek out the next wall of worry to climb.

Market Notes

Period ending 1/20/2023	1 Week %	YTD %
DJIA	-2.66	0.78
S&P 500	-0.65	3.55
NASDAQ	0.55	6.47
Russell 2000	-1.04	6.06
MSCI-EAFE	0.01	7.05
MSCI-EM	0.63	8.39
Bloomberg U.S. Aggregate	0.15	2.89

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
1/13/2023	4.67	4.22	3.60	3.49	3.61
1/20/2023	4.72	4.14	3.56	3.48	3.66

U.S. stocks were mixed last week, with offsetting weaker economic reports and improved producer inflation readings. Sentiment mid-week took a turn downhill due to lower retail sales and industrial production numbers, as well as a large layoff announcement from Microsoft and Google. Thus far, layoff announcements have been concentrated in the tech industry, but markets appear to be awaiting a broader spread. Labor market erosion seems to be one of the key factors the Fed is anticipating in finding a fed funds rate peak. Sector results were oddly mixed, with communications (mostly Alphabet/Google), technology, and energy leading the way; industrials fared worst, along with normally defensive consumer staples and utilities. Real estate also fell back by nearly a percent.

Foreign stocks were mixed to higher last week with optimism over the impact of China's reopening on global markets, tempered with comments from the ECB that rate hikes will continue. Most directly, the central bank warned financial markets about being too dovish. Overall, in the last few months, conditions in Europe have been better than first feared (helped by a warmer winter, with less need for natural gas), which has led to a rally in non-dollar currencies and outperformance regardless by international stocks. This is another reminder that stocks look to the future, rather than the past. Chinese stocks have been a surprise this year, with double-digit returns thus far as the reopening has proceeded faster than many expected, with hopes for far improved economic growth this year. The Lunar New Year holiday, beginning Jan. 22 and lasting two weeks, consists of substantial vacations and travel, which could exacerbate the Covid spread situation, but also stronger consumer spending.

Bonds showed slightly positive results last week as yields ticked a bit lower across the board, other than for the shortest and longest maturities. Investment-grade corporates outperformed, due to their yield spread, while high yield fell back. Foreign bonds, especially in emerging markets, gained sharply, with optimism about the China reopening winning out over recession fears.

Commodities rose in all major segments, led by energy and industrial metals. Crude oil prices gained over 2% to just under $82/barrel, due a lower U.S. rig count last week as well as continued expectations for demand to rise from China's reopening. Natural gas, on the other hand, fell back another -5% as a continued warmer-than-expected winter weighed on expected demand. This has been most noticeable in Europe, enough to cause doubt about the odds about a potential recession. Considering the tensions on the brink of action between Russia and Ukraine a year ago, a crash in natural gas prices was among the least likely of predictions.

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, National Association of Realtors, 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.