Summary

In an unusually light week for economic data releases, consumer sentiment improved and jobless claims continued to come in at low levels. Bank lending standards have continued to tighten, due to recession fears.

Equities were mixed to lower last week, despite little news. Bonds fell back as interest rates ticked higher. Commodities gained overall, as crude oil prices soared.

Economic Notes

(+) The preliminary **Univ. of Michigan index of consumer sentiment** for February rose by 1.5 points to 66.4, above the median forecast calling for 65.0. This was the highest level in almost a year for the series, with assessments of current conditions improving, while future expectations fell back a bit. Expectations for inflation over the next year rose 0.3% to 4.2%, which was unexpected within a recent downward trend; expectations for the next 5-10 years were unchanged at an elevated 2.9%. Within the anecdotal commentary, worries about potentially rising unemployment pushed consumers to rein in spending expectations a bit, pulling down the mood.

(0) **Initial jobless claims** for the Feb. 4 ending week rose by 13k to 196k, above the median forecast of 190k. Continuing claims for the Jan. 28 week rose by 38k to 1.688 mil., above the 1.660 mil. level expected. Initial claims rose by 9k in CA to lead the way, followed by IL, but there were few other state-by-state extremes. It continues to appear that year-end seasonal adjustment factors are at play, but no major gains in claims have appeared in response to high-profile layoff announcements in tech and related industries. In fact, claims have remained stable at a relatively low level since early 2022.

(-) The Fed's **Senior Loan Officer Opinion Survey** for Q4-2022 showed a continued tightening of lending standards by banks generally, based on lower confidence in the economy. For commercial/industrial loans, a growing number (but only a third) of banks reported slowing demand, but was surpassed by the number of banks tightening standards and widened spreads. To no surprise, this was tied in with less favorable economic conditions and a more uncertain outlook, as well as a reduced tolerance for risk and decreased liquidity. Commercial real estate standards also tightened for the majority of banks, for both construction loans and those backed by multi-family properties; demand for such loans also fell back versus the prior quarter. Residential mortgage standards also tightened to some degree, but this tended to be concentrated on the sub-prime and jumbo segments. (High mortgage rates serve as a tightening influence on its own.) Consumer installment loans in the auto and credit card area also saw lower demand, while banks also tightened standards. (Based on other less-publicized data, existing credit card balances have risen as pandemic funds have started to run low, and car loan delinquencies have been ticking up as well.)

Question of the Week

Where do we stand in the interest rate policy process?

After another quarter-percent rate hike on Feb. 1 to 4.50-4.75%, the Federal Reserve has inched closer toward its self-advertised terminal rate (around 5.00%, give or take 0.25% or so in either direction).

There seems to be a current stand-off between the Fed and markets, which has driven much of this year's stock and bond market sentiment. On one hand, Fed communications remain steadfastly hawkish and point to additional hikes, through formal communications as well as anecdotal comments in speeches and Q&A, despite welcomed signs of 'disinflation,' as they've put it. (This is despite a bit of a mixed message in Chair Powell's last FOMC press conference, where signs of dovishness were peppered in with hawkishness, baffling markets.) Committee members continue to feel that inflation-fighting credibility remains more important than giving any

hints of potential reversal in course. History has shown that central banks have commonly pulled back on tightening before inflation is completely 'beaten'—a lesson that has remained top of mind as they proceed.

On the other hand, financial markets continue to expect the Fed to eventually cave, largely from the assumption of the economy slowing to the point of recession, forcing their hand to reverse course and ease. Higher interest rates also substantially raise the cost of financing U.S. government debt, with principal amounts in the trillions. Over time, larger interest payments could weigh on discretionary budgetary spending elsewhere, potentially lowering economic growth (government spending is a sizeable part of U.S. GDP). Fed funds futures markets have been pointing to a gradually easier policy outcome for some time as well, showing a few months of a pause at the assumed terminal rate, followed by an assumed cut or two starting around late summer or fall. The widespread perception of a 'Fed put' since the financial crisis (and even before, if Alan Greenspan's tenure is included) has stoked the view that central banks are increasingly captive to financial market movements, and can only stomach a certain amount of pain before intervening. Unlike decades ago, when only the wealthier segment of society owned stocks and bonds, the democratization of financial assets through retirement plans and pensions has enlarged the audience for and dependence on risk assets, perhaps pushing these further into the assumed core of the Fed's financial stability mandate. Debate continues about this, with inconclusive answers for official policy.

Overseas, messages have diverged, with the European Central Bank (ECB) raising rates 0.50%, and essentially promising another 0.50% at the next meeting. Conversely, the Bank of England (BOE) also raised 0.50%, but declared that hike to be perhaps the last in the cycle. While inflation has been much more robust in Europe (and a legacy of inflation rising out of control in decades past driving central bank philosophy), economic growth has been weaker at the same time, holding down hawkish impulses. Importantly behind the scenes, other central banks don't share the U.S. Fed's secondary mandate for full employment, so labor markets are not a separate consideration other than financial stability/inflation.

The U.S. treasury yield curve remains sharply inverted, which is a classic indicator of economic cycle change. In fact, the 10y-3m differential has an impressive 8-0 win-loss record of predicting recession since 1968. The average inversion has lasted just over a year, and we're over six months into this one. Inverted curves tend to not last for longer stretches because they don't make economic sense, and don't allow the financial system (bank lending in particular) to function normally by setting price risk appropriately for longer maturity assets. As inversions normalize, it's been normally due to recession, as central banks lower short-term rates, which then fall further than long-term rates—the latter being hinged on longer-term expectations. Yield curves have not tended to exit an inverted state by long-term rates rising faster than short-term rates (the other option), at least in the measured modern era, even though fear of that happening tends to persist, causing some investors to avoid fixed income.

No potential path is guaranteed from a forward-looking timeline. Inflation that remains pesky forces central banks to keep hiking and/or sustain higher rates for a longer stretch of time, even if at a policy pause. Economists have recently been debating which factor will be most important going forward: the ultimate height of the terminal rate reached, how long rates just remain high generally, or both. Since every episode has a different backdrop and inputs, these theories are difficult to test. Keeping a policy pause on for longer is assumed to better help 'wring out' inflation impulses brought on by excess liquidity created during the pandemic. (Quickly falling M2 monetary growth is an example of this in action.) On the positive side, in contrast to much of the last 15 years since the 2008 financial crisis, nominal interest rates are now high enough globally to allow for some later easing, if needed. This contrasts with zero or negative rates in a variety of developed countries not that long ago, which allowed for little policy easing without taking things in an even stranger direction, such as deeper negative rates or further yield curve engineering (as is still occurring in Japan).

Some good news is that central banks could be close to the tightening finish line. As markets tend to be forward-looking, stocks have historically reacted positively for the year after the Fed reaches a terminal rate, as well as for the stretch after inflation reaches a peak. Those two conditions obviously aren't mutually exclusive, but the timing might not be perfectly aligned. For government bonds, rate hikes slowing and eventually stopping removes an obvious price downside tied to duration risk, compared to the uncertainty over long-term rates having much more runway upward. At a policy pause, now higher yields contribute positively to returns, and a rate cut has the potential of carrying through the yield curve and boosting prices—an ideal environment for fixed income. (That type of cycle shift also raises the potential benefits for owning bonds over cash in such an environment.) That also holds true to some degree for corporate bonds, but being watchful of spreads is important, particularly for lower-quality debt if a slowdown is on the horizon and companies experience further financial stress. While rates overall may decline, credit spreads can widen, sometimes negating that positive influence.

Market Notes

Period ending 2/10/2023	1 Week %	YTD %
DJIA	-0.11	2.33
S&P 500	-1.07	6.71
NASDAQ	-2.37	12.05
Russell 2000	-3.34	9.05
MSCI-EAFE	-1.57	7.34
MSCI-EM	-2.40	6.04
Bloomberg U.S. Aggregate	-1.43	1.55

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
2/3/2023	4.70	4.30	3.67	3.53	3.63
2/10/2023	4.79	4.50	3.93	3.74	3.83

U.S. stocks ended lower last week on net, with little meaningful economic news to drive sentiment, although large cap stocks outperformed small cap stocks. Most sectors were little changed on the week, with the exception of energy, which gained almost 5% with higher oil prices, and communications, with fell -6%, led by a poor display by Alphabet/Google in an artificial intelligence demonstration. Real estate also fell back -2% along with higher interest rates.

Earlier week gains were driven by Fed Chair Powell's reiterated remarks about the economy having entered a 'disinflationary' phase, although it didn't fully back away from a hawkish tone if labor conditions remain strong. This was interpreted as positive for a continued wind-down of rate hikes for coming months. (The market obsession with what the Fed is planning is obviously a persistent theme of the past several months.) President Biden's State of the Union address Tues. evening offered little new policy information, although a 'unity' message across the aisle and discussions with House Speaker McCarthy offered hope for a debt ceiling solution before the last minute, to prevent a 2011-like episode. The speech also focused more on domestic economic growth, jobs, and inflation than it did foreign concerns, highlighting what appears to be on the minds of most voters as of late.

Foreign stocks fell back along the same lines as U.S. stocks, with the exception of U.K., which earned a small gain as it was reported that a widely expected recession has again been averted for now with Q4 GDP coming in flat. China slightly underperformed in emerging markets, with negative sentiment surrounding the U.S. shooting down of what was described as a Chinese spy balloon the prior weekend carrying over a bit—as expectations for trade and potential sanctions remain in greater flux. Turkish stocks were the outlier, falling well beyond -

10% after the massive earthquake; natural disasters can be expensive infrastructure rebuilds, especially in emerging nations.

Bonds declined on the week as interest rates ticked higher, with strong labor data and a hawkish Fed weighing on hopes for lower interest rates. Treasuries outperformed corporates slightly, but all were generally down to similar degrees, except for bank loans which earned top honors with no change.

Commodities experienced a positive week, due to gains in energy offsetting declines in industrial metals. Crude oil rose almost 9% on the week to just under $80/barrel, due to the EU's price cap and ban on Russian oil going into effect, as well as Russia's announcement of a 500k/day cut in production (5% of their output). By their own admission, this was intended to punish Western oil markets and maximize their own revenue. However, there is growing skepticism about the effectiveness of sanctions on Russian petroleum, due high demand from nations such as India and China, as well as the mirky nature of 'blended' stock sold globally (i.e. after oil is traded between ships on the high seas, where is no way to tell where it originally came from).

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, Seeking Alpha, 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.