Summary

Economic news for the week included the FOMC hiking rates by another quarter-percent, raising speculation that this might be for the final time this cycle. The employment situation report came in stronger than expected, with a falling unemployment rate, although other details were less robust. ISM services improved further into expansion, as did ISM manufacturing, although the latter remained in contraction—the mixed results reflect the uncertain prospects for recession (or not).

Equities were mixed, with a decline in the U.S. offset by gains in foreign emerging markets. Bonds fell back, as credit spreads widened. Commodities fell back, notably in energy, largely due to concerns about the economy.

Economic Notes

(0/+) The **FOMC** raised interest rates by 0.25%, as reported earlier in the week, but the most watched-for element was a hint of a future pause—which was included in the statement. This was perhaps best described as a 'dovish hike' to be followed by a 'hawkish pause,' implying the Fed could still raise rates further if inflation remains a threat and it's deemed the economy can handle it. The impact of tighter credit was acknowledged, although the degree can only be measured over time.

Markets turned south during Chair Powell's press conference, when he noted a decision to pause had not been made, and partially due to news released during the meeting of new bank stress (PacWest in CA and Western Alliance of AZ), but also in responding to questions that signaled a lack of clarity about the outlook for rate cuts. While he noted cuts were in the base case for 2023, the opinion differs sharply with market expectations. He noted, though, that the Fed may need to change course if that negative view becomes the correct one, so that assumed lack of conviction (even though any conviction at all at this point would be premature) seemed to pull down sentiment a bit.

(-/0) The **ISM manufacturing index** for April rose by 0.8 of a point to 47.1, surpassing expectations calling for 46.8. In the details, production and new orders gained over a point, but remained in contraction, while employment gained 3 points back into expansion. Prices paid also ticked 4 points higher, back into expansion at 53, while supplier deliveries fell slightly, remaining in contraction. The anecdotal comments reiterated that slowing demand for goods (supply chains for which have strongly improved) have led to a glut in inventories. The overall index remains in contraction, but is above the low from last month, which points to an absence of further deterioration in activity.

(0/+) The **ISM services/non-manufacturing index** for April rose by 0.7 of a point to 51.9, a tenth of a point above expectations. Business activity fell by over -3 points, with employment also falling a bit—but both remaining expansionary. New orders, however, rose an additional 4 points to a strong 56 reading. Supplier deliveries moved higher but remained slightly contractionary. Prices paid ticked up to nearly 60, which reiterated inflationary pressures from the services side. In contrast to manufacturing, services overall remain in expansion. This divergence remains at the crux of why the economy is bordering on the edge between recession and no recession.

(0) **Construction spending** in March rose 0.3%, beating expectations of 0.1% and reversing a drop the prior month. Private non-residential rose a percent, followed by nearly a percent in public residential spending, while private residential fell several tenths in an ongoing negative trend. Interestingly, construction costs fell by over a half-percent in the month, boosting the 'real' spending result. Year-over-year, sectors are surprisingly mixed, with several showing strong gains, such as in manufacturing, transportation, and lodging. Total construction spending is up 4% for the year, just under the rate of inflation, implying negative after-inflation growth. In residential, private single-family spending is down -23%, while multi-family is up 23%—pointing out the ongoing mismatch in activity seen in other data, like starts.

(-) The government **JOLTS** job openings for March fell by -384k to 9.590 mil., the lowest level in two years after peaking last spring, and below expectations for 9.736 mil. (revised up from the original Feb. release). The key declines were in transportation (-144k), professional/business services (-135k), and retail trade (-84k); gains were seen in food/accommodation (75k), which continues to recover from the pandemic. The job openings rate declined by -0.2% to 5.8%, while the hiring rate was unchanged at 4.0%. On the other side, the layoff rate ticked 0.2% higher to 1.2%, while the quits rate fell -0.1% to 2.5%. The jobs-to-workers gap fell significantly but remains wide (between 3 and 4 mil., based on the measurement used). In looking at the other stats, hiring has come down this year, in keeping with past slowdowns, although the overall rate remains stronger, and quits have also come down from the peak. While not an overly weak report, this reiterates the story of labor markets decelerating at the edges.

(+) The **ADP employment report** for April showed private sector jobs rising by 296k, over double the prior month's pace, and surpassing the 150k expected. Services jobs rose 229k, with 154k of that being in the continuing-to-normalize leisure/hospitality segment, and 69k in education/health services. Goods-producing jobs rose 67k, with 53k in construction and 52k in natural resources mining (obviously offset by declines elsewhere).

(0) **Initial jobless claims** for the Apr. 29 ending week rose by 13k to 242k, above the 240k expected, with gains and declines mixed by state. Continuing claims for the Apr. 22 week, on the other hand, fell by -38k to 1.805 mil., well below an expected increase to 1.865 mil. Even though claims are about 20% higher than at year-end, they started from a very low level and remain range-bound.

(+) The employment situation report for April came in far stronger than expected. In short, conditions are generally still strong, but improvements are decelerating. **Nonfarm payrolls** rose by 253k, beating expectations calling for 185k and continuing a string of beating expectations for about a year. However, several prior months were revised down by -149k, which is not insignificant. Private service-producing jobs added 197k, while goods-producing jobs rose by 33k (construction and manufacturing), with industry breadth showing gains in just over half of industries (less than in prior reports). By segment, gains were mostly seen in professional/business services (43k), health care (40k), leisure/hospitality (31k), financial services (23k), and government (23k). Temp jobs fell by -23k, continuing a string of declines and pointing to weakness on the edges of hiring markets. It's assumed that some seasonal factors have also played a role, and the standard error of these monthly reports normally has a factor of +/- 100k, explaining the frequent later revisions and lack of first-release reliability (despite strong market reactions to this report).

The **unemployment rate** fell by a tenth to 3.4%, a level not seen since 1969, in contrast to an expected rise of a tenth. The U-6 underemployment rate fell two-tenths to 6.6%—also hovering near multi-decade lows. The labor force participation rate fell a bit during the month, and included a 139k rise in household employment. **Average hourly earnings** rose 0.5% for the month, above expectations of 0.3%, showing that wage inflation is still present. This equated to a year-over-year increase of 4.4%, up a tenth from the pace of the prior month. The **average workweek** length was flat at 34.4.

Earlier in the week, nonfarm **productivity** fell -2.7% in the preliminary Q1 release, reversing a gain for Q4 2022 and worse than the -2.0% expected. Year-over-year productivity improved by nearly a percent to -0.9%. **Unit labor costs** rose at an annualized rate of 6.3% in Q1, double the Q4 2022 rate, and stronger than the 5.6% increase expected. Year-over-year, labor costs decelerated by a half-percent to 5.8%. Neither was especially good news.

Question of the Week

Where do we stand with the debt ceiling debate?

The $31.4 tril. U.S. debt ceiling remains in sharp focus, with Treasury Secretary Yellen formally notifying Congress via letter that it could be hit as soon as June 1. The actual date has been cloudy, and largely dependent on how much cash the Treasury receives from April tax returns, with amounts far lower than last year. This has sped up the ceiling date as government coffers run dry. Undoubtedly, Yellen's estimate is likely a bit conservative, with the intention of spurring Congress to action, with an impasse between House Speaker McCarthy's bill proposing limitations of Federal spending not being accepted at face value by Senate Democrats or the President. A few options exist from here: (1) a short-term extension for another few months, or to around September, when it could be wrapped up in other budget discussions for 2024 (and likely more disagreement); or (2) some type of compromise acceptable to all parties. There is a formal meeting planned between Congressional leaders and the President on Tues., May 9, which could provide more clarity on where we stand. The ability to hold votes gets a bit trickier soon due to the Congressional schedule moving out of session.

There remain other options the Treasury can use, such as prioritizing payments (interest payments on debt being made first), swapping debt with other government entities (like IOU's) to delay cash flows, and delaying payments to vendors and even recipients of Social Security. The latter is very undesirable, due to the reliance of many on Social Security income (also a bloc with a higher voting participation rate), and potentially backfiring on politicians in a big way. While not acknowledged as a viable option by Yellen, and considered strange, the 'trillion-dollar coin' idea remains alive among some lawmakers. The idea was raised in 2011 and is based on a loophole that treats the minting of precious metals coins differently from normal currency issuance. A coin could be minted, transferred to the Treasury, and then used as new 'money'. Legal opinions about this technique vary, although it certainly falls far outside the spirit of how the precious metals coin rules were obviously intended (geared toward coin collectors/investors, not funding the government).

Another discussion surrounds the 14th amendment of the U.S. Constitution, which states that the "validity of the public debt of the United States, authorized by law...shall not be questioned." Proponents essentially argue that it would be unconstitutional for the government to not pay its debts, regardless of other rules put in place since. In this sense, it's been argued that a debt ceiling itself is unconstitutional. However, it's not clear which parties have the power to circumvent the ceiling. Legal scholars seem to be mixed on this, and a serious challenge would require getting the courts involved, which could be controversial and messy, not to mention likely not quick.

The base case from most economists and strategists is that a U.S. debt default is still unlikely, but even a tiny chance due to such strong disagreement among the parties is unsettling to global markets to say the least, even though risk markets have not appeared to react as badly as if the situation were deemed dire. Treasury markets continue to show this elevated stress, with yields for maturities over the summer having run above comparable debt before or after the key debt ceiling period, although Fed expectations and the current inversion continue to show an unusual yield curve shape.

Per consensus, the most likely scenario continues to appear that a last-minute deal is completed in some form. Congressional members have been given a series of educational presentations from outside experts to show how damaging a default could be for global markets, the status of the dollar, and U.S. projections of power in the world (impacts that might not have been realized, since the background of most members is not finance or economics), which may have also created a mismatch between private voting behavior in the final tally and public messaging on the issue. U.S. treasury bills, notes, and bonds represent the world's 'risk-free' assets, from which all other securities are priced in some way—removing that status by adding the 'risk' back in would be likely very damaging. There are other impacts on markets from treasuries being considered the ideal collateral

for loans, widening the scope of potential trouble. It could affect any entity relying on treasuries as key assets, including banks, insurance companies, as well as other nations.

However, markets react strangely to things, such as in 2011, when U.S. government debt was downgraded by one of the three rating agencies, only to be followed by a rush to buy treasuries. As is the case with the reserve status of the U.S. dollar, there remain no stronger alternatives at this time. The only western nations with debt ceilings are the U.S. and Denmark; it's easy to see why the concept is so unpopular.

Market Notes

Period ending 5/5/2023	1 Week %	YTD %
DJIA	-1.23	2.25
S&P 500	-0.78	8.33
NASDAQ	0.09	17.22
Russell 2000	-0.49	0.40
MSCI-EAFE	0.16	11.70
MSCI-EM	0.51	3.30
Bloomberg U.S. Aggregate	-0.05	3.53

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
4/28/2023	5.10	4.04	3.51	3.44	3.67
5/5/2023	5.26	3.92	3.41	3.44	3.76

U.S. stocks lost ground on the week, despite a strong recovery attempt on Friday after perceived strength in the April employment report. Comments from Fed Chair Powell contradicted market hopes for lower rates soon, in addition to likely angst surrounding the upcoming U.S. government debt limit. By sector, technology led the way with a small gain, led by a strong report from Apple, followed by defensive health care and utilities ended the week flat; laggards included energy down -6% and financials. Real estate was down -1%.

The week began with JPMorgan's takeover of failed First Republic Bank, meaning essentially all deposits and assets were absorbed (however that didn't include bonds or stocks of FRB, the latter of which fell to under $2/share). JPM entered into a loss-sharing agreement with the FDIC for absorbed loans, many of which were the jumbo variety, in keeping with FRB's wealthy clientele. Such outcomes are usually the best-case scenarios for such banks, which creates a smooth experience for customers, while avoiding the more tumultuous ends of Silicon Valley Bank and Signature Bank, where buyers couldn't be found. Later in the week, PacWest Bancorp and Western Alliance, two medium-sized banks in the Western U.S., announced that they were looking at 'strategic options' (which is the new code for trouble).

Per FactSet, about 85% of S&P 500 companies have now reported Q1 quarterly earnings, with nearly 80% having positively surprised. Earnings have since improved from an initial -7% expectation to -2%; however, expectations for Q2 earnings have worsened a percent to -6%. For the full 2023 year, assumed earnings growth is hovering around 1%, implying most hopes are pinned to a recovery in 2024. While profit margins have remained higher than expected (partially due to inflation allowing for stronger pricing), not yet reverted back toward 'normal' levels, as they've been prone to do historically. However, other comments from executives noted 'weak demand' (the Fed has contributed to that), as well as seeking out better 'efficiency,' as well as greater use of 'artificial intelligence' (the latter isn't surprising, as there is a need to offer the view that companies are on top of new trends, even if not necessarily useful today). Stocks have held up relatively well in recent months, with earnings not nearly as bad as the worst fears—however, as it doesn't appear a recession is currently at hand, another quarter or two of earnings results remain at risk of disappointment.

Foreign stocks fared better than U.S. last week, with gains in Japan offsetting flattish results in Europe and the U.K. The ECB raised rates by 0.25% to 3.25%, after several straight half-percent hikes, offering some hope for a slowing in hawkish policy despite President Lagarde's comments to the contrary. Emerging markets saw gains across the board, led by Brazil, Korea, and Taiwan, with China lagging along with manufacturing PMI falling from expansion to contraction.

Bonds fell back last week, largely due to widening spreads for corporates. Concerns over the banking sector remain the primary driver, assumed to raise the broader risks of default (which have been rising, albeit not at an extreme pace). Foreign bonds were mixed, with developed markets helped by a weaker dollar.

Commodities were mixed for the week, with gains in agriculture and precious metals offset by a sharp drop in energy. Crude oil prices fell by over -7% last week to over $71/barrel, along with natural gas dropping by -11%. Despite several catalysts for upward price movement earlier in the week, such as hijacked tankers and falling U.S. inventories, concern over the U.S. banking sector's effects on the economy and lackluster industrial data from China weighed on sentiment.

Have a good week.

Ryan M. Long, CFA
Director of Investments
FocusPoint Solutions, Inc.

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, 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.

The information above has been obtained from sources considered reliable, but no representation is made as to its completeness, accuracy or timeliness. All information and opinions expressed are subject to change without notice. Information provided in this report is not intended to be, and should not be construed as, investment, legal or tax advice; and does not constitute an offer, or a solicitation of any offer, to buy or sell any security, investment or other product. FocusPoint Solutions, Inc. is a registered investment advisor.

Notes key: (+) positive/encouraging development, (0) neutral/inconclusive/no net effect, (-) negative/discouraging development.