Summary

In a holiday-shortened week, economic releases included the mixed results of ISM manufacturing falling further into contraction, while ISM services rose further into expansion. The employment situation report showed positive jobs growth, but at a slower rate than expected, to cap a week of mixed labor data generally.

Equities fell globally last week, with expectations for more hawkish central bank policy and associated higher interest rates for longer, following not-terrible economic data. Bonds fell back along with higher assumed rates. Commodities were up slightly, led by production cuts in crude oil that boosted prices.

Economic Notes

(-) The **ISM manufacturing index** for June fell by -0.9 of a point to 46.0, below the expected slight improvement to 47.1. New orders improved by several points, but remained in contraction, while production and employment each fell a few points, further into contraction. Prices paid fell by another -2 points further into a contractionary 42 level, which was positive news from an inflation improvement standpoint. Supplier deliveries and lead times for materials also declined for the month. This all continues to point to general slowing in the manufacturing sector, which has some self-fulfilling tendencies, as survey respondents noted economic slowing and slower customer demand as key concerns.

(+) The **ISM services/non-manufacturing index** in June rose by 3.6 points to 53.9, further into expansion, and above the median forecast of 51.2. The underlying components were similarly strong, with gains in business activity, new orders, and employment, all moving further into expansion. In fact, all but three of the 18 industry sectors showed growth. Prices paid fell by -2 points, still expansionary at 54, showing inflationary impulses for services (largely labor) not seen to the same degree in goods production. While manufacturing activity has definitely shown slowing, services has remained robust. These two key measures have tended to act in unison during past economic cycles, so the current divergence is unusual. Either services sees a change in course and deteriorates (which would likely coincide with a broader-based recession), or manufacturing turns back upward to accompany services in the 'soft landing' expansion scenario. This remains a month-to-month situation in terms of clarity.

(+/0) **Construction spending** rose 0.9% in May, twice the pace of the prior month (which had been sharply revised down), exceeding the 0.6% level expected. Within the details, private residential activity rose over 2% to lead the way, as did public residential by a percent. Non-residential spending was flat to down in both public and private segments. Construction costs actually fell back by a half-percent in May, resulting in even stronger 'real' spending. This is in contrast to much of the past year, of course, but a positive direction nonetheless.

(+) The **ADP private employment survey** for June showed a gain of 497k, well above the 225k expected by consensus, and the 267k of last month. Services jobs rose 373k, with a rise of 232k in leisure/hospitality leading the way. Goods-producing jobs gained 124k, with construction jobs gaining 97k. In recent years, June has been heavily affected by seasonal factors, which have created more of a distortion than in other months.

(-) The **JOLTs government job openings** report for May showed a drop of -496k to 9.824 mil., below the median forecast of 9.900 mil., but also included a revision higher of 217k for the prior month. Gains were seen in professional/business services (94k) and education (45k), but were offset by health care/social assistance (-285k), finance/insurance (-139k), and retail (-125k). The rate of job openings fell by -0.3% to 5.9%, while the hiring rate rose a tenth to 4.0%. On the departure side, the layoff rate was flat at 1.0%, while the quits rate ticked up 0.2% to 2.6%. There appeared to be especially low response rates for this survey lately, while the general view is a slight deterioration in labor market conditions. Though, based on overall ratios of openings to unemployment and payrolls, conditions generally remain tight.

(0) **Initial jobless claims** for the Jul. 1 ending week rose by 12k to 248k, just above the 245k forecast. Continuing claims for the Jun. 24 week, on the other hand, fell by -13k to 1.720 mil., well below the rise to 1.737 mil. expected. The largest gains in claims were seen in MI, NY, and OH, while TX and NJ saw declines. Changes in the recent week appeared due to layoffs in education services (summer break) as well as manufacturing (such as automotive, likely due to retooling). Seasonal adjustments remain an issue, as do the potential for fraudulent claims in a few states, but standard measures of claims have steadily risen from levels of a year ago.

(0) The employment situation report for June came in a little lighter than expectations, which is in keeping with other indicators of labor markets slowing at the fringes. It also helped perhaps lower the high probability of a Fed rate hike in July and onward. **Nonfarm payrolls** rose by 209k for the month, below the 225k expected and the strong pace of the prior month; revisions for prior months taken down by -110k. Gains were strongest in in government (60k), health care/social assistance (65k), and construction (23k). Leisure/hospitality jobs rose 21k—a slower pace than in recent months in this still-recovering sector. On the negative side, retail jobs declined (-11k), while the bulk of other segments were little changed. Interestingly, only 6 out of 10 industries saw payroll growth, which is the second-weakest level of breadth in the post-pandemic period. An important element of this report is the large standard deviation in results, and high likelihood of later revisions. While markets often react to the initial report upon release, it’s largely as it relates to expected impact on Federal Reserve policy.

The **unemployment rate** fell a tenth to 3.6%, similar to expectations. The U-6 underemployment rate continued to grind higher by 0.2% to 6.9%, with the labor force participation rate little changed. **Average hourly earnings** rose 0.4%, a tenth above consensus. On a year-over-year basis, earnings were up 4.4%, at the same pace as the prior month, although the trailing 3-month moving average was a few tenths higher than that, and staying a bit robust. The **average workweek length** ticked up a tenth from the prior month at 34.4.

(0) The June **FOMC meeting minutes** showed that ‘almost all’ participants were on board with the committee’s decision to pause rate hikes. However, it appeared ‘some’ members had been leaning towards another 0.25% hike, as inflation continues to run at a level deemed ‘unacceptably high,’ and downward improvement far slower than expected. The compromise appeared to be a pause to gather more information about the cumulative effects of tightening thus far, before proceeding further. Interestingly, the FOMC also continued to expect a mild recession looking ahead (likely in Q4-2023 or Q1-2024), although there seemed to be nearly equal chances of avoiding one, as banking stresses had ‘receded.’

Again, there were no real surprises here, but the commentary points to higher chances of further rate hikes in 2023. Several members are clearly uncomfortable with current inflation levels, and feel more needs to be done, especially now that the banking stresses of the spring have not morphed into a deeper crisis. That said, ‘cumulative effects’ of rate hikes aren’t a small thing. Total rate increases of 5% over the past year have tightened financial conditions significantly, and the effects on the banking sector have led to further constraints in credit availability and much higher cost for firms needing funding. Any problems related to this may not surface immediately, but can intensify quickly in more distressed credit-laden sectors if other dominos happen to fall, such as economic growth taking a turn downward.

Market Notes

Period ending 7/7/2023	**1 Week %**	**YTD %**
DJIA	-1.91	2.94
S&P 500	-1.11	15.59
NASDAQ	-0.91	31.12
Russell 2000	-1.26	6.73
MSCI-EAFE	-2.04	9.39
MSCI-EM	-0.63	4.22
Bloomberg U.S. Aggregate	-1.30	0.77

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
6/30/2023	5.43	4.87	4.13	3.81	3.85
7/7/2023	5.46	4.94	4.35	4.06	4.05

U.S. stocks fell back generally last week, as decent economic news continued to perpetuate an assumed hawkish Fed policy lasting longer than expected, with further rate hikes. Stocks declined sharply on Thurs. specifically as strong labor market data (ADP and claims) highlighted these expectations. This was particularly true in light of somewhat hawkish Fed minutes from June, where further hikes were debated to a greater degree than was previously assumed. Nearly every sector was down for the week, led by health care, materials, and technology. Health care appeared to be negatively affected by disappointing trial results for a new lung cancer drug from AstraZeneca. Utilities and communications suffered least, with minimal changes for the week. Real estate gained a fraction of a percent, interestingly, despite a rise in interest rates.

Earnings season for Q2 begins next week, which may provide more clarity on the underlying health of firms, with FactSet predicting a -7% drop in the quarter, and a slight deterioration in revenue growth. Within the index, expected double-digit 12-month earnings gains in consumer discretionary and communications are assumed to be offset by dramatic downward reversals in energy, materials, and health care. For what it's worth, the earnings decline is expected to be short-lived, with Q3 earnings growth flattish, full-year 2023 growth just under a percent, and full-year 2024 growth up 12%. Of course, these are all preliminary figures, but tend to price in a peak slowdown mid-year, with a recovery towards year-end. The near-term focus remains on profit margins (which have deteriorated with inflation but remain historically high), stresses from credit contraction, consumer spending rates, and potential developments and usage of AI as a productivity input to growth models.

Foreign stocks fell to a greater degree than domestic, led by declines in Europe and the U.K., due to continued concern over the hawkishness of future central bank policy, weak industrial production results in Germany, and house price/mortgage pressures in England. On the other hand, Japan and emerging markets experienced minimal declines. EM was helped by a small gain in China, with manufacturing and services numbers declining but remaining in expansion.

Bonds fell back last week as interest rates moved higher—all in keeping with the more hawkish Fed policy sentiment. Senior bank loans fared best, with a minimal decline, due to their floating rate nature. Corporates in general fared slightly worse, as credit spreads widened a bit. Foreign bonds also fell back, despite the helpful influence of a weaker dollar.

Commodities generally saw gains for the week, led by energy. Crude oil rose nearly 5% last week to $74/barrel, due to signals of some tightening in supply, and announced production cuts by Saudi Arabia and Russia. This offset a -8% drop in natural gas prices, as U.S. temperatures moderated a bit from extreme heat.

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, 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.

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