John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday October 19, 2022

There was a recent political poll that caught my attention. It was a survey among Latinos, asking their opinion for the coming mid-term elections. The result was a surprise. In the past Latinos generally voted for Democrats. But not this time. A majority said they preferred Republicans. The reason for the change is that Latinos do not like socialism and will not vote for a socialist. I find this to be very encouraging. Latinos know all about socialism and how it destroys lives. They have personal experience or have learned from relatives who suffered under a socialist regime. Hopefully this will spread, and we will see a broad-based rejection of socialism.

Inflation is another factor that is bothering voters and investors. The September report that the CPI rose 8.2% year over year while down slightly from August, core inflation, excluding energy and food, rose 6.6% - the biggest annual rise in prices since August 1982. That is a sign that inflation is becoming entrenched in the overall economy.

The members of the Federal Reserve are determined to bring the rate of inflation down. Writing for the Wall Street Journal's October 13 issue, Justin Lahart said: "The Federal Reserve's big rate increases are raising the risks that it will overshoot."

An overshoot would result in a hard landing for the economy. Justin goes on to explain: "But the problem with raising rates by so much at each meeting is that it doesn't give the Fed much time to gauge what its past rate increases have done. Monetary policy works with variable lags, affecting some parts of the economy, such as the housing market, rather quickly, and others, such as the labor market more slowly. And indeed, the housing market has gotten slammed, but the labor market is only now showing signs of loosening up a bit. So it might be that policy is already restrictive enough to cool down the economy, and inflation, as much as policy makers want, but by the time they figure that out they might have raised rates a whole lot more.

One thing that complicates the Fed's policy decisions is that the rates it sets aren't all that is at play here. At 3.125%, the midpoint of its target range on overnight rates is still well short of the 5.25% target that came before the recession that started in 2007. But the rate on a 30-year fixed mortgage, at 6.67%, is back to 2007 levels, which is probably at least due to the Fed's reducing its holdings of Treasury agency debt and mortgage-backed securities.

A sticking point is that lowering the magnitude of rate increases might be taken by investors as a sign the Fed is about to stop raising rates, or even reverse course and start cutting. In such a situation, long-term rates might fall, and stocks might shoot up sharply, easing U.S. financial conditions to the point that the Fed feels compelled to step up the pace of increases again. Of course the reason that investors might conclude that a moderation in rate increases was a prelude to pause is that in the past the Fed has often overshot on rate increases, said it would slow down, and then cut.

Getting off what Evercore ISI strategists are calling the "hamster wheel" of three-quarter point rate increases will be difficult. A possible solution, they suggest, would be for the Fed to try to move the conversation from how much it will raise rates at any given meeting to the ultimate level it expects to bring rates to. That might allow policy makers to raise rates more gradually, gauge how past rate increases are filtering into the economy hopefully, not breaking too many things."

At the moment the Fed is on the “hamster wheel” three-quarter percent per meeting rate hikes. And that is giving some economists the basis for their hard landing predictions.

Mitch, from Zacks investment management thinks that a soft landing is never-the-less the likely outcome.

“With the Federal Reserve engaged in a bold monetary tightening campaign, many pundits and economists are debating whether the economy is headed for a “hard” or “soft” landing. In the post-World War II era, there have been three soft landings following a Fed rate hike campaign – 1965, 1984, and 1994. The difference between then and now, however, is that the Fed was trying to prevent inflation previously, versus its efforts today to reduce already high inflation.[1]

The inflation setup is a key differentiator. But I still think there’s a strong case for a soft landing in the current environment. The Fed needs inflation to come down, and to get there its main objectives are to slow GDP growth to around 2% or less, to bring some balance back into the too-tight labor markets, and to slow wage growth.

I think it’s possible to accomplish all three with a mild recession, not a severe one.

On the economic growth front, we’ve already seen softening GDP figures with earnings and earnings estimates coming down, signaling that the Federal Reserve and other global central bank measures are having at least some effect in reducing demand in the global economy. S&P 500 profit margins have also peaked, which generally implies an economic slowdown is underway or nearby. In the US housing market, 30-year fixed mortgage rates have shot past 6%, which has resulted in seven straight months of declines in existing home sales. Permits for future homebuilding have also plummeted to levels last seen in the spring of 2020.

Regarding the rebalancing of supply and demand in the labor market, the optimistic view is that the Fed could theoretically achieve this goal by reducing the number of job openings instead of slowing the economy to the point of triggering layoffs. August employment data showed an early sign of this possibility, with total job openings falling by 10% to 10.1 million. This figure still far exceeds the 6 million unemployed people looking for work (red line), so the real task here is closing the gap between the two. One month's worth of data does not make a trend, but the 10% dip in job openings seems to be a meaningful step in the right direction.

September payrolls showed some further signs of cooling in the labor markets. Employers added 263,000 jobs in the month, which is a strong figure but notably smaller than the August increase of 315,000 and the 400,000 average gain over the first six months of 2022. Hourly wage growth was 5.0%, which is lower than August's 5.2% gain and marked the slowest pace of increase since December 2021. Somewhat problematically, however, was that the number of people in the labor force fell, which brought the unemployment rate down to 3.5%. More labor is needed to ease wage pressures.

Other factors supporting an economic soft landing are strong fundamentals in the private sector and for households. The private sector has shown few signs that leverage is becoming an issue, and banks continue to report strong financial conditions. Households have spent down a decent portion of accumulated savings following the pandemic, but there is still approximately $1 trillion of net excess savings on balance sheets. The legacy of low-interest rates is also keeping debt service costs historically low for a majority of Americans.

I think the next few months will start to show evidence that inflation pressures are easing, which should start to initiate conversations at the Fed about where the peak in interest rates may fall. On the inflation front, rents are falling month-over-month in many major markets, commodities are at a seven-month low and trading far from peaks, retail inventories are elevated which is forcing many retailers to cut prices, container freight rates are falling sharply, and the US ISM Manufacturing Prices Paid Index is currently at 51.70—down -36.33% from a year ago. All of these factors point to reduced inflationary pressure in the months ahead."

The bottom line for investors is that holding on to stocks is still the best strategy.

I will have the next market review and update for you one week from today on Wednesday, October 26, 2022.

All the best,

John Dessauer