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What's in this week's Report:

- Has the Fed Reached Peak Hawkishness?
- Weekly Market Preview: Will Powell Sound Hawkish on Tuesday?
- Weekly Economic Cheat Sheet: Key inflation data Tuesday and Friday.
- Why Did Stocks Rally So Hard After Powell's Presser?
- FOMC Statement & Press Conference
- EIA Data Takeaways and Oil Update

Futures are moderately lower mostly on follow through selling from Friday's hot jobs report.

The Chinese spy balloon drama dominated weekend headlines but it's unlikely to materially alter U.S./China relations and as such shouldn't be an influence on markets.

Rate expectations rose over the weekend following Friday's jobs report, with markets now pricing in a terminal Fed Funds rate of 4.75% and that's the main reason stocks are lower this morning.

Today there are no notable economic reports and no Fed speakers, so the focus will remain on yields and rate expectations and if they continue to climb, that will weigh on stocks.

Market	Level	Change	% Change
S&P 500 Futures	4,114.75	-31.75	-0.77%
U.S. Dollar (DXY)	103.2340	0.3190	0.31%
Gold	1,884.00	7.40	0.39%
WTI	74.29	0.90	1.23%
10 Year	3.625%	0.093	2.63%

February 6, 2023

How to read the Weekly Market Update

The purpose of this newsletter is to provide continuous context of the major economic issues facing investors. Each weekly report highlights the activities of the previous week, and what to expect in the upcoming week.

Investors face multiple risks that impact both short- and long-term investment decisions. Economic concepts such as Dow Theory, monetary policy, geopolitical risks, inflation, energy policy, commodities and currency movements are addressed each week in the context of highlighted data points.

We use this data to help make investment decisions, however this document should not be interpreted as investment advice. Advisory services offered through NPA Asset Management, LLC a registered investment advisor.

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Stocks

Last Week (Needed Context as We Start a New Week)

Last week was a rollercoaster ride in markets as early week losses gave way to a huge rally in the wake of the Fed decision before disappointing tech earnings poured cold water on the gains into the weekend. The S&P 500 gained 1.62% on the week and is now up 7.73% YTD.

U.S. stocks declined to start last week with the major indexes tracking European bourses lower on the back of some stagflationary economic data out of the Eurozone. Equities rebounded solidly on Tuesday as the U.S. Employment Cost Index came in at 1.0% vs. (E) 1.1%, easing some concerns about inflation and the market rallied on positioning money flows as the Fed decision came into focus. The S&P 500 gained 1.46% on the day.

On Wednesday, stocks surged following Powell's press conference as he failed to meaningfully push back on the market's increasingly dovish policy bets of late. The less-hawkish reaction by rates markets saw the S&P 500 rally 1.05%, ending at the best levels since August.

The rally continued in a big way on Thursday thanks to economic data that supported the case for a soft landing (the sharp slowdown in Unit Labor Costs) while big tech was bid up in sympathy with META shares, which jumped more than 20% on good earnings and guidance. The S&P 500 squeezed up towards 4,200 before ending off the highs with a gain of 1.47%.

Stocks gapped lower at the open on Friday and yields ripped higher on the back of a very strong January jobs report that saw the unemployment rate drop to a multi-decade low while earnings from tech giants AAPL, AMZN, and GOOGL disappointed late Thursday. Stocks were quick to stabilize in early trade, however, and the market rebounded into the late morning following a shockingly strong ISM Services Index release. Stocks rolled over in the afternoon as the dollar and yields both continued to rip higher with terminal rate expectations. The S&P 500 ended near session lows, down 1.04%.

Has Peak Hawkishness Finally Been Achieved?

That's the logical question I asked myself when I sat down to produce this analysis. Peak hawkishness has been one of our "Three Keys to a Bottom" since I introduced them back in May, and I've consistently said it's the most important key to a bottom. And, if we take Powell's press conference on its face, the answer is "Yes," peak hawkishness has been achieved.

I say that because starting in early 2023, market expectations of Fed policy and the Fed's own words on future policy started to massively diverge. Following Powell's press conference, there was nearly a 100-bps difference between where the Fed said fed funds would end 2023 (5.125%) and where the market expects it to end 2023 (less than 4.375%, although that estimate rose slightly following the jobs report).

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Powell did nothing in his presser to get the market to respect the Fed's words. If anything he basically implied that the Fed was getting less hawkish. If that stays the case, then the bottom for this market is likely "in" and going forward dips are to be bought and the larger the dip, the more aggressive the buying should be. However, while I hope that's the case, I think we should refrain from popping the champagne just yet, and here's why.

First, Powell has a long history of sounding one way in a speech only to correct it at a later time. Recent examples of this include the less-hawkish July FOMC press conference, followed by the hawkish Jackson Hole speech in August and the less-hawkish Brookings speech in late November followed by the hawkish December FOMC press conference. But I can list numerous examples beyond the short term, and in reality this has been a quasi-hallmark of Powell's chairmanship. That matters, because Powell speaks Tuesday, and especially given the jobs report, don't be shocked if he pushes back hard against the market reaction. If he does not, that's a very strong sign we are at peak hawkishness.

Second, it won't really matter if we've reached peak hawkishness if we're headed for an economic hard landing, because stocks absolutely will drop from current levels in that instance. They may not take out the October low, but we'll easily be looking at a 10%-plus pullback on a hard landing, regardless of whether the Fed pauses. So, we need the data to continue to point towards a soft landing, so the data remains very important regardless of whether Powell pushes back the market's less-hawkish interpretation.

Third, inflation has to keep falling otherwise we will have to brace for the possibility of a 1970's style start/stop Fed rate hike campaign, and that would be the absolute worst-case scenario for stocks and bonds. Here's why this matters. Inflation is falling but it's nowhere close to the Fed's target. The labor market has made zero progress towards better balance. For sustainable, long-term economic growth (which feeds higher stock prices over the longer term) an economy must have 1) Low Inflation and 2) Healthy labor markets. If the Fed gets to peak hawkishness before either is achieved, it'll continue to squeeze margins for businesses and earnings will decline (bad for stocks). Additionally, investors will build in higher inflation expectations, which will make inflation worse (self-fulfilling prophecy). Finally, the Fed will have to come back at some point and hike rates again, and now we've got the 1970s and a possibly lost decade in equity and bond returns. Point being, the data still matters and inflation has to keep falling.

I appreciate the strength in growth and tech so far this year, but we have to understand a lot of this rally has been predicated on the idea of lower global bond yields. That's likely going to happen, but I think the tech/growth space has gotten ahead of itself in pricing it in, and the important part is why it happens. Is it happening because the Fed/ECB/BOE are getting less hawkish and we have a soft landing? If that's the case, then tech/growth/high beta will continue to handily outperform. Conversely, are yields falling because growth is collapsing and we're headed for a hard landing? If that's the case, growth/tech/high beta will underperform while defensives and value outperform.

At this point, I'm not convinced it's the former (I'll admit it's looking more likely through the first month of the year, but I think that's a bit early to declare). So, at the risk of missing out on some upside, I'm going to

continue to favor defensive sectors, value and minimum-volatility ETFs until it becomes clearer to me that 1) Rates are actually declining (they bounced pretty hard Friday), 2) And that it's a decline being driven by a less-hawkish Fed and soft landing, not a hard economic landing and looming recession.

Certainly, some will disagree with that assessment, but I personally would prefer to give up a bit more of the 18% outperformance of value over growth we've seen over the past year to be sure I'm not walking into a trap by allocating back heavily into tech and growth. However, I certainly appreciate the opposite side of that trade. To me, the facts just don't support it—at least not yet.

Economic Data (What You Need to Know in Plain English)

Need to Know Econ from Last Week

The key event from last week was the FOMC decision, and more specifically Powell's press conference. Put directly, Powell failed to rein in the market's expectations for just one more rate hike in March and two-to-three rate cuts by year end, and the failure to rebuff those expectations (which are in direct contradiction to what the Fed has said for months) sparked a strong rally led by tech and growth on Wednesday and Thursday. Bottom line, for the first time since 2021, central banks hinted at becoming less hawkish in the future, and markets took that signal and ran with it.

Looking at last week's economic data, there was a lot of it and it was important. The highlight from last week was Friday's jobs report and it was a gigantic beat. Job adds rose a massive 517k and the previous two months numbers were revised higher by 71k. The Household Survey, which had been giving a diverging signal from the headline jobs report, showed an explosion of jobs added in January: 894k! The unemployment rate dropped further to 3.4%. The only "not hot" part of this report was the wage data, as wages rose 0.3% (met expectations) and 4.4% y/y (also meeting expectations and down from previous months).

The market sold off on the number initially, but not nearly as much as you'd think and there are two reasons why. First, the labor market hasn't seen any progress towards returning to the balance that Powell said was needed, yet Powell was less hawkish anyway last Wednesday. So, does the labor market cooling really matter for the Fed? It's a legitimate question. Second, the wage data is cooling. Three separate reports last week showed wage pressures were easing: Unit Labor Costs (1.1% vs. (E) 1.5%), Employment Cost Index (1.0% vs. (E) 1.1%) and wages (4.4% from 4.9%). If all the Fed cares about is wage pressures easing (and not more balance in the labor market) then they are largely getting what they want, although there's work to be done.

As for growth data from last week, it was mixed (at best). The ISM Manufacturing PMI fell to 47.4 vs. (E) 48.0, and New Orders, the leading indicator in the report, dropped to 42.5 from 45.1. Both readings are the lowest since the Financial Crisis (if we ignore the pandemic spikes down). Prices, meanwhile, rose to 44.5 from 39.4 and that echoed other goods inflation readings that showed a bounce back in prices in Europe

(Spanish CPI, French CPI, Euro Zone PPI). The ISM Services PMI bounced back solidly to 55.2 vs. (E) 50.4 and up from the previous 49.2 while New Orders, the leading indicator in the report, surged to 60.4 rising 15.2 in January! Prices declined as well, but only barely to 67.8 from 68.1. That remains far above pre-pandemic levels and speaks to concerns about the "stickiness" of service inflation.

Important Economic Data This Week

Powell speaks tomorrow at the Economic Club of Washington, and while the specifics of his speech aren't yet known, he will have the opportunity to either confirm or refute the less-hawkish interpretation of his press conference.

Turning back to the data, we will get notable updates on inflation expectations via the New York Fed (tomorrow) and the University of Michigan (Friday) and markets will want to see those longer-term expectations (five year) continue to drift lower. Away from inflation, the other notable data point is weekly jobless claims (Thursday).

Barring any surprises from Powell, this week should be one of digestion of last week's data, but further declines in inflation expectations will be a welcomed sign by the market and incrementally strengthen market expectations that there's only one rate hike left, and rate cuts coming later this year.

Special Reports and Editorial

Why Did Stocks Rally So Hard After Powell's Presser?

Put simply, markets rallied because Fed Chair Powell refused to reiterate that terminal fed funds will get above 5%, and that there will not be rate cuts in 2023. Now, that might seem confusing because there were sound bites from Powell that sounded hawkish, including stating that the Fed will raise rates "a couple more" times (which seems to get fed funds to 5.125%).

But we have to remember this: The market does not believe what the Fed is saying. It doesn't when the Fed says the terminal rate will be 5.125% and it doesn't believe the Fed when it says there won't be any rate cuts. Powell did nothing to make the market believe the Fed, and because of that the market simply doesn't believe them even more now—and that is why stocks rallied.

The practical impact of Powell's comments was to further cement less-hawkish expectations, and we know that because 1) Stocks rallied, 2) The dollar dropped sharply and 3) The 2-year Treasury yield collapsed.

Was This a Bullish Gamechanger?

No, because Powell didn't tell us anything the market didn't already assume, he just strengthened the market's existing less-hawkish opinion. However, while that's not enough to ignite material upside from here, it does reduce the downside in this market (as long as there are no major surprises from the data).

Given positioning and the likely continued decline in yields, we should expect near-term continued outperformance from tech and growth. And on momentum, the S&P 500 could rally towards 4,200.

Really all Powell did last week was confirm what the market already expected, namely that the Fed is not as hawkish as it said it was in December, that the terminal rate may not go above 5% and that we may get rate cuts in 2023. The most immediate impact of Powell's comments was to better support the YTD gains and reduce the intensity of any pullback (now maybe 5%ish, not 10%ish). Yet as far as the Fed meeting sparking a sustainable move higher from here, that remains unlikely near term.

First, the data remains key. If growth rolls over hard or inflation spikes back (like we saw in Spain/France) then markets will factor in more earnings losses or dial back "less-hawkish expectations."

Second, whether stocks extend the rally or pull back is still much more dependent on the outcome of a soft landing or hard landing. Last week's data implied a hard landing, but it was ignored because of the Fed. That will only last so long, and market history is very clear on this subject: A materially slowing economy amidst rate hike pauses or rate cuts usually results in lower stock prices. Point being, we should not "root" for a materially slowing economy and dovish Fed. Instead, we should root for a stable economy (or slightly slowing) and less-hawkish Fed.

FOMC Statement & Press Conference

The FOMC raised interest rates 25 bps as expected.

Takeaway

The Fed did not change its forward guidance in Wednesday's statement, nor did it signal a pause in rate hikes is coming, but it did make a few small changes to acknowledge progress on inflation and that it's nearing the end of the rate hike cycle, and this "glass half full" market seized on those changes and rallied slightly before the Fed Chair press conference.

Starting with the obvious, the Fed did not materially change its sentence on forward guidance, as it again stated that the Committee "anticipates that ongoing increases in the target rate will be appropriate." So, that was a disappointment vs. expectations.

However, it did make an important change to signal they are getting closer to the end of the rate hike campaign. Specifically, the Fed changed wording from, "In determining the pace of future increases," to "In determining the extent of future increases." That's important because the Fed is essentially saying that it is now considering when to end rate hikes, not just how quickly they will rise. That does not mean the Fed is signaling they are about to pause, but it is a notable change that confirms we're not too far from the end of rate hikes (likely two more).

Turning to Powell's press conference, it was much more dovish than expected and sparked a substantial dovish move across assets. Broadly, markets were concerned that Powell would come out and reiterate the

5.125% terminal estimate from the December dots. He did not. Instead, he basically hedged on that outcome, stating that it was still possible, but it was also possible rates don't get to that point if the data turns. Similarly, he stated that he didn't believe rate cuts would occur in 2023, but if inflation fell faster than expected they were possible.

In essence, Powell had the opportunity to reiterate to markets that the Fed was serious about a 5% terminal rate, and he very much did the opposite: He basically validated the market's disbelief over the Fed's targets, which the market took as dovish. And the market moves were clear, and stocks surged with growth and tech outperforming while the dollar dropped sharply (and came close to breaking 100) while bond yields dropped, with the 2-year yield falling slightly less than the 10-year yield.

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