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What's in this week's Report:

- The Three Assumptions Supporting Stocks
- Weekly Economic Cheat Sheet (All About Inflation and Growth)
- Weekly Market Preview: Can Stocks Continue to Ignore Rising Bond Yields?
- Why Haven't Rising Yields Caused A Bigger Pullback?
- Hard Landing, Soft Landing or No Landing?
- Market Multiple Table February Update

Futures are little changed following a mostly quiet weekend of news as markets look ahead to tomorrow's CPI report.

The only notable economic report overnight was better than expected growth and inflation updates from the European Commission, which now sees EU growth rising 0.9% this year (up from 0.3%) and inflation at 5.6% (down from the previous 6.1%). These revised estimates are helping to bolster the "No Landing" economic scenario.

Markets should mostly be in a holding pattern today as the CPI report looms tomorrow morning, but there are two notable events on the calendar to watch: New York Fed Inflation Expectations (One Year: 5.0%, Five-Year: 2.4%) and one Fed speaker: Bowman (8:00 a.m. ET). If inflation expectations are higher than before or Bowman is hawkish, that could mildly pressure stocks.
stocks.

Market	Level	Change	% Change
S&P 500 Futures	4,107.00	7.25	0.19%
U.S. Dollar (DXY)	103.6260	-0.0040	-0.00%
Gold	1,867.70	-6.80	-0.36%
WTI	78.92	-0.80	-1.00%
10 Year	3.745	0.002	0.06%

February 6, 2023

Planning Corner

In the past two years new legislation has produced unprecedented changes in the American retirement system for individuals, business owners and plan administrators. If you are not aware of these changes, then you may not be optimizing retirement for you, your beneficiaries. If you are a business owner, you have multiple obligations to consider.

The Secure Act 2.0 was passed in 2022 and has had immediate and lasting impact for beneficiaries of qualified plans already.

New tax provisions provide opportunities for legacy planning to mitigate the impact of tax burden for beneficiaries.

The benefits of ROTH provisions for IRA and 401(k) plan contributions makes it even more important to conduct a tax analysis of your retirement.

Call to schedule an appointment.

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Stocks

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

After enjoying solid gains through the end of January and early February, stocks pulled back last week amid a rise in yields and a stronger dollar as there was a hawkish shift in Fed policy expectations. The S&P 500 fell 1.11% on the week and is up 6.54% YTD.

At the start of last week, stocks traded with a heavy tone as the shockingly strong January jobs report, and its potential implications for Fed policy, continued to be assessed while geopolitical tensions rose given the Chinese surveillance balloon debacle. The Fed's Bostic reiterated that he anticipates two rate hikes this year, which kept pressure on stocks. The S&P 500 closed down 0.61%.

Trading was quiet and choppy ahead of Powell's interview with Bloomberg on Tuesday, but that changed in a big way once he began to speak. Stocks initially rallied as Powell noted disinflationary trends are taking hold, but a huge tail in the Treasury's 3-Year Note auction saw the major indexes fall to session lows. Powell later was quoted saying, "it may be different this time" to which traders flipped into risk-on mode and the S&P roared back to close higher by 1.29%.

Stocks gave back some of Tuesday's gains on Wednesday amid more consistently hawkish commentary from regional Fed presidents as well as an unexpected increase in the Manheim Used Vehicle Index, which rekindled worries about 1970s-style "stop-start inflation" trends. A strong 10-Year Treasury Note auction helped ease the pain but the S&P 500 still lost 1.11%.

On Thursday, stocks gapped higher at the open after German CPI undershot estimates, easing some of the uncertainty about inflation trends while solid earnings from DIS bolstered optimism about the health of the U.S. consumer. But the hawkish Fed speak continued with Barkin and a report from the AAII that sentiment among retail investors (typically viewed as a contrarian indicator) had turned bullish for the first time in 10 months. The rollercoaster of Treasury auctions continued with a very soft 30-Year auction in the early afternoon and that saw equities fall to new lows into the close. The S&P 500 declined 0.88%.

Stocks gapped lower at the open on Friday as Russia announced a planned oil production cut which sent both oil prices and yields higher. The former raised concerns about inflation while the latter was an indication of more hawkish money flows. The S&P 500 closed a gap back to Thursday's close before turning back lower as traders digested an uptick in consumer inflation expectations within the University of Michigan's Consumer Sentiment report.

The odds that the fed funds rate is above 5% at yearend notably jumped from just 10% coming into the week to over 45% Friday. Stocks were able to hold the morning lows and churned higher into the afternoon with the S&P 500 gaining a modest 0.22%.

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Data Really Is the Key to This Market

Stocks declined last week thanks to signs of stickier-than-expected inflation and hawkish commentary from regional Fed presidents. But considering the surge in bond yields over the past week, the declines in stocks could have been a lot worse.

Consider: Markets have dramatically altered their Fed rate hike expectations over the past six trading days, as terminal fed funds expectations are now over 5% (up more than 25 basis points from before the jobs report) while year-end fed funds is just under 5% (up basically 50 basis points from the lows after Powell's presser).

In 2022, a move of that size would have caused a sharp, intense pullback in stocks (like we saw in June and late August). But it caused just a mild pullback in stocks last week and that resiliency must be respected. As far as "why" stocks are resilient, there are three main factors. First, the market thinks the end of Fed rate hikes are in sight, with one or two more hikes coming before the pause. Second, economic growth remains strong, so it's emboldened markets to hope the economy can withstand rates at or near current levels (i.e. the no-landing scenario). Third, the market believes inflation will continue to decline (consistent disinflation).

So, in order for stocks to stay resilient, these three assumptions need to remain in place, otherwise concerns about a hard landing will resurface, and stocks will drop. Specifically, that means this week markets need to see, in order of importance:

1) Stable price data starting with tomorrow's CPI report and followed by the price indices in the Empire and Philly Fed manufacturing surveys. There is a risk inflation bounces back given other data, and if it's a decent bounce it will likely create more volatility.

2) Stable economic growth, via Retail Sales and Empire/Philly Fed surveys. Again, the market is resilient because it thinks the economy can withstand rates at current levels and the data this week needs to reinforce that message.

3) Not-hawkish Fed speak from Fed leadership. Regional presidents (Bullard, Kashkari, Bostic, etc.) can sound hawkish but they aren't in charge. However, if Brainard of Powell hints that rates need to go higher than 5.125%, that will be a fresh headwind.

The macro backdrop has positively changed from 2022 and that's reflected in the market's resilience in 2023. But that resilient nature is based off these key assumptions and they need to be reinforced for stocks to solidify the YTD gains. If the data implies one (or more) of these assumptions are false, then a 5% pullback (or more) shouldn't be a surprise.

I appreciate the recent outperformance of growth/value but until there's more clarity on just how likely each of these market assumptions are, I prefer to maintain tactical overweights towards value, defensive sectors, and minimum volatility ETFs, simply because I believe the downside in this market on disappointment remains larger than the upside on any surprises.

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

Need to Know Econ from Last Week

There were only three notable economic reports last week but two of the three hinted that inflation pressures may be mildly bouncing, while the third pointed to a still very tight labor market, and these reports contributed to the weakness in stocks last week.

Starting with the inflation data, there have been some anecdotal signs that inflation pressures may be bouncing near term (specifically the European CPIs and the price indices in the ISM PMIs) and there was more evidence of that last week as the Manheim Used Vehicle Value Index rose for the first time in months, while the University of Michigan Inflation Expectations Survey saw a small increase in one-year inflation expectations to 4.2% from 3.9% while the five-year expectations remained at 2.9% (where they've been for the past three months).

Neither of those numbers imply inflation is making a strong comeback, but they do hint that the rapid disinflation we've seen over the past several months may be easing, and while inflation is still clearly declining, it may be entering more of a "stair step" decline phase than a straight line down, and that realization may result in some disappointment in markets, if it's proven out.

The other notable economic report was weekly jobless claims, which rose slightly to 196k vs. (E) 192k, but that number remains far, far too low to imply there's balance in the labor market. Last week's data hinted at the no-landing scenario as anecdotal inflation metrics were firm while jobless claims remained low.

Important Economic Data This Week

We said in last Friday's report that economic growth data and inflation had become even more important than before, because solid growth data and disinflation have allowed stocks to (mostly) weather a sharp and sudden spike in bond yields, and the inflation and growth data will need to continue to decline and stay resilient (relatively speaking) to continue to support stocks.

That makes tomorrow's CPI report again the most important economic report of the month, **and none of us should be surprised if this number is hotter than expected**. There have been several anecdotal inflation indicators including the Manheim Used Vehicle Value Index and the price indices in the ISM Manufacturing and Services PMI that implied price pressures may have bounced back after several months of disinflation, and that may well show up in tomorrow's CPI report. Hopefully that isn't the case, and even if it happens it doesn't mean that inflation isn't still declining—it is, just not in a straight line. Markets need an inflation number that meets or comes under expectations (especially for Core CPI) otherwise pressure on stocks will increase.

Beyond CPI, we get several important growth updates this week, starting with the first look at February economic data via the Empire Manufacturing Index (Wednesday) and Philly Fed (Thursday). Markets will

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want to see stability in this data especially given the rise in bond yields. Additionally, declines in the price indices will be welcomed, while any increase in prices will only further fears that the pace of disinflation is easing.

The next most important growth update comes via February Retail Sales (out Wednesday). Consumer spending powers the U.S. economy but it also supports services inflation. However, the support it gives for the economy far outweighs any upward pressure on inflation, so the market will want to see stability in the data. Point being, an ugly retail sales report likely won't be good for stocks because it might make the Fed less hawkish (it probably won't regardless). Instead, it'll just increase the chances of an economic hard landing, and as such likely increase the headwinds on stocks amidst higher rates.

Other notable economic data this week includes Industrial Production and Capacity Utilization (which will give us hard data on the state of manufacturing) and weekly jobless claims (which need to trend higher in the coming weeks).

Bottom line, even despite the small pullback from the recent highs, stocks have withstood a sharp jump in yields and increase in rate hike expectations very well. For that to continue we'll need to see inflation not bounce back and economic growth remain resilient. If the data this week shows that, then stocks can stay resilient despite higher yields. If it doesn't, then we should not be surprised if the S&P 500 trades below 4,000.

Special Reports and Editorial

Why Haven't Rising Yields Caused A Bigger Pullback?

During the first month of the year, one of the oddities of the markets was the massive gap between what the Fed said it was going to do on rates (raise to 5.125% and stay there for the foreseeable future) and what the market expectations were for rates (a peak of 4.875%, and two, maybe three, rate cuts by year end), and how that gap closed was supposed to be a defining factor of the first quarter.

Well, that gap did close over the past week, as market expectations now have peak fed funds above 5% (acknowledging that the Fed will hike twice more) and year-end fed funds right around 4.875% (pricing in one rate hike later in the year).

The closing of that expectations gap can be seen through the sharp jump in Treasury yields. Eight days ago (five trading days ago) the 2-year Treasury yield hit a near-four-month low of 4.07%. On Thursday, it hit a near-three-month high at 4.49%. That's a 42-basis-point jump in five trading days!

Similarly, the 10-year Treasury yield sat at 3.4%, again near a three-month low. On Thursday, it hit 3.65%, a 25-basis-point jump in five trading days! During that period, the S&P 500 is down just 1.75%, which is much less than we'd expect given every time we saw a yield spike in 2022 stocks got hit very, very hard.

So, why aren't stocks dropping more in response to the spike in yields? There are two main reasons.

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First, as usual, it has to do with *why* the market is making moves. Yields are spiked because economic growth, specifically the jobs report and the ISM Services PMI, were much stronger than expected. That implies the economy is much stronger than expected, and if that's the case, then the economy should be able to better withstand higher rates (at least in the near term).

Second, the stronger-than-expected jobs report and services PMI were successful in getting market expectations to match what the Fed previously said. But the Fed has not come out and officially implied they will have to raise rates *more* than previously forecasted—so the Fed isn't getting any more hawkish than was already expected (it's just the market is finally acknowledging what was previously said).

Those two factors have combined to keep the decline in stocks relatively mild, especially given the solid YTD rally. Looking forward, there are two events that could remove these supports from the markets and ensure that further increases in yields *do* pressure stocks.

1. Economic growth rolls over. As mentioned, yields are rising because growth has been stronger than expected and as such, the economy can better handle the higher rates. However, if the jobs report is a mirage and gets revised heavily, or other metrics of economic data begin to drop sharply, then markets will begin to fear a hard landing because the Fed simply isn't cutting rates anytime soon. Bottom line, for stocks to keep most of the YTD gains, economic growth needs to stay strong.

2. Inflation can't meaningfully rebound. The Fed hasn't become any more hawkish than it was back in December (it's just the market now believes them thanks to the data). However, if inflation bounces back and stops falling, then the Fed could get incrementally more hawkish and terminal fed funds could rise to 5.375% or higher (Bostic mentioned 6% earlier this week). In that instance, the Fed would be getting incrementally more hawkish, peak Fed hawkishness will not have been achieved, and I'd expect a sharp decline in the S&P 500 led by tech/growth.

Looking forward that means the key data points we need to watch are (in order of importance): 1) CPI on Tuesday, 2) Retail Sales on Wednesday, 3) Empire Manufacturing on Wednesday, and 4) Philly Fed on Thursday.

For stocks to remain buoyant in the face of rising rates, we need to see 1) CPI not show a rebound in prices and 2) Important economic readings show stability. If we get the opposite, we need to prep for more volatility.

Hard Landing, Soft Landing or No Landing?

The market loves analogies, and the latest analogy to define trading has been likening the economy to a plane the Fed is piloting, with rate hikes forcing the economic plane onto the ground via a "soft landing" (the most positive outcome) or a "hard landing" (the most negative). But in light of Friday's strong jobs data, there's another landing we must consider: "No landing."

Essentially, what "no landing" means is that the economy does not come in for a landing, that it stays strong and we do not see growth meaningfully slow. What this would look like is data rebounding: Job adds staying

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strong, service measures of the economy staying in expansion territory, and manufacturing and housing bouncing back in the coming months.

So, what would a no landing mean for markets? The most important takeaway from this scenario is that numerous additional Fed rate hikes would come back on the table. That would then bring us back to a 2022 situation, where markets again begin to price in an ever-higher terminal fed funds rate, which should weigh on stocks and bonds in the future. Additionally, a no landing ultimately just delays, but does not avoid, the hard vs. soft landing debate. The reason why is the Fed will keep raising rates until it feels confident that growth is slowing and that it won't put upward pressure on inflation.

No Landing vs. Soft Landing vs. Hard Landing

	Goldilocks Translation	Unemployment Rate	Economic Growth	Inflation	Fed Funds	Impact on S&P 500?	What Outperforms: Value or Growth?
No Landing	Too Hot	Stays Very Low < 4%	Stays Strong	Levels Off	Year-end Fed Funds > 5.125%	Negative. "Don't Fight Fed." 3,500-4,000 in the S&P 500.	Value (higher rates weigh on growth)
Soft Landing	Just Right	Rises Modestly (4%-5%)	Slows, But Only Slightly and Not As Bad As Inflation	Keeps Declining (Core CPI < 5% in 1H '23)	Year-end Fed Funds 4.875% - 5.125%	Positive. Rally Into Mid-to-Upper 4,000s Possible in S&P 500.	Growth (falling rates, but stable growth)
Hard Landing	Too Cold	Rises Sharply > 5%	Drops Sharply, Faster Than Inflation	Falls But Not As Fast As Growth	Year-end Fed Funds < 4.875%	Very Negative. 3,300-3,800 in the S&P 500.	Value (more defensive sectors)

Bottom line, a no landing would not be a sustainable positive because it just ultimately delays that point where 1) We get to peak hawkishness and 2) The market can reasonably expect the Fed to pivot to a more supportive stance for the economy.

Stepping back, this market has become more confusing for investors thanks to last week's surprisingly not-hawkish FOMC decision and the hotter-than-expected economic data. And whether we're headed for a soft, hard, or no landing is as uncertain as ever.

To help understand this situation, I've included this table of each scenario and what it would mean for unemployment, growth, inflation, fed funds, the S&P 500, and growth vs. value. I will cut and paste this table onto my board at work to serve as a guide as the data comes out over the coming weeks and I encourage you to do the same.

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Market Multiple Table February Update

The February Market Multiple Table acknowledges the increased changes of “No Landing” in the near term via the continued decline in inflation, the surprisingly resilient economic data, and the fact that Powell didn’t hint at taking rates above the 5.125% terminal rate. The result of all that was to slightly increase the market multiple to 17X-18X from the previous 16.5X-17.5X.

Practically, that increases the range at which the S&P 500 is fundamentally supported, but it’s not enough to justify the YTD rally and despite the improvement in the MMT the overarching message is the same from last month: The market is fundamentally overvalued at current levels.

Positively, the intensity of that overvaluation has been fundamentals 1) Haven’t improved *that* much since the start of the year and 2) A lot of that improvement is based on resilient labor market data, which is positive in that it implies the economy is stronger than feared, but it’s negative in that it’ll eventually embolden the Fed to hike rates more if there’s not a return to balance soon.

Looking at the market influences of the MMT, there was one notable change at the bottom that I’ll cover in a minute, but in general the MMT reflects the reality that economic data is driving markets. To that point, the most important current market influences remain: Inflation, Labor Market, and Economic Growth. The one change in market influences comes at the bottom, where Fed rate hikes has been replaced by rate hike expectations.

Here’s why I made that change. The market *still* isn’t listening to what the Fed is saying about rate hikes. The only reason that market-based rate hike expectations have risen is because the data has been so hot it’s making the market believe the Fed. Point being, if the data rolls over, rate hike expectations will fall again—regardless of what the Fed says. So, it’s about the data.

Bottom line, the MMT reflects the increased likely hood of a near-term “No Landing” and that resulted in a mild increase in the fair value range. But it’s still not enough to justify the rally in the S&P 500 and the fact remains this market is vulnerable to disappointment, **especially if it comes from hotter-than-expected inflation readings, or disappointing economic growth.**

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A Game of Multiples (Updated 2/9/2023)			
Market Influence	**Current Situation**	**Things Get Better If...**	**Things Get Worse If...**
Inflation	The disinflation process has started, but it must continue if we are going to see the peak of Fed rate hikes in the coming months.	Disinflation accelerates and we see price indices continue to drop over the next month.	Price indices stabilize or bounce back, implying the disinflation process will be choppy and lengthy.
Labor Market	January's jobs report was incredibly strong and the labor market remains tight, although wages are declining.	Wage increases continue to moderate and we see the unemployment rate start to rise.	Labor market metrics remain very tight and wage gains start to reaccelerate.
Economic Growth	Data is pointing to "No Landing" where the economy remains resilient and potentially invites more rate hikes to cool demand.	Growth moderates towards a soft landing.	Economic data rolls over hard and worries about a hard landing rise.
Rate Hike Expectations	The market expects year-end fed funds to be between 4.875% - 5.125%.	Economic data moderates and market expectations shift to 4.875%.	Economic data stays strong and market expectations rise above 5.125%.
Expected 2023 S&P 500 EPS	**$225**	**$235**	**$215**
Multiple	17X-18X	18.5X	15X-16X
S&P 500 Range	3,825—4,050	4,230-4,348	3,225-3,440
S&P 500 Target (Midpoint)	3,938	4,289	3,333
Change from today	-4.3%	4.2%	-19%

Current Situation: Mild Improvement Thanks to Solid Data and Declining Inflation. The Current Situation reflects the reduced (but not eliminated) chances of a near-term hard economic landing, and that's why the current multiple was slightly increased. But it's only a slight increase because none of the improvements in the data

were definitive. We could easily see this improvement reversed in the coming months, so while there was an improvement, this remains a fluid situation.

Things Get Better If: Core CPI Drops, Labor Market Metrics Deteriorate (including jobless claims), Economic Data Moderates but Doesn't Collapse, and the Fed Telegraphs a 25-bps Rate Hike in March and Then a Pause (implying the terminal rate won't be above 5%).

This situation would pave the way for a potential end to this market decline/bear market and that would result in the S&P 500 justifiably trading well above 4,000 (towards our near-term technical target of 4,300 and probably higher on momentum). But while this would clearly be an extension of positives that occurred in January and arguably make the outlook for stocks the best it's been in over a year, we should not expect stocks to move close to the old highs, and there's one clear reason: The economy will still be at risk of a material slowdown. That will keep multiples under levels from 2021. While this outcome may not get the S&P 500 to new highs, it would imply the bottom in stocks is "in."

Things Get Worse If: Core CPI Doesn't Drop Further (or rises), Labor Market Metrics Remain Resilient (including jobless claims), Economic Data Starts to Collapse (implying a recession) and Fed Leadership (Powell or Brainard) Starts to Threaten Fed Funds Above 5.125%. Markets simply can't sustainably rally until we get to "peak hawkishness," and in this outcome markets would aggressively price in a hard landing (so 15X-16X multiple) with downside risks to earnings, economic growth and financial stability. Given the optimism that's been priced into markets so far in 2023, this outcome would lead to a painful decline of at least 10% in short order.

The S&P at 3,300 should be thought of as a "worst case," but given market momentum a technical-driven violation of that level can't be ruled out. And given the recent rally, that means downside of 15%-20% from here. While the outlook for markets has turned more optimistic, I want to stress that this outcome is not impossible and we need to remain vigilant to the risks to stocks and bonds.

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