MONDAY MATTERS

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What's in this week's Report:

- Now What? Updated Market Outlook
- Weekly Market Preview: Will Yields Keep Rising?
- Are Junk Bonds Signaling an Imminent Recession? No
- The Equity Risk Premium at 2007 Levels
- EIA Data Takeaways and Oil Update

Futures are modestly higher on a bounce back from last week's losses following a generally quiet weekend of news.

Economic data was sparse and the only notable report was EU M3 money supply, which rose less than expected (3.5% vs. (E) 3.9%).

Geopolitically, fears are easing that China will send arms to Russia (concerns about this weighed on stocks late last week and an easing of them is helping futures rally).

Today the focus will remain on economic data and the two notable reports are Durable Goods (E: -4.0%) and Pending Home Sales (E: 1.0%). While neither should be a major market mover, markets will want to see stable data (so reports that don't imply growth is too strong, or too weak). We also get one Fed speaker, Jefferson (10:30 a.m. ET).

Market	Level	Change	% Change
S&P 500 Futures	4,008.50	32.75	0.82%
U.S. Dollar (DXY)	104.9800	-0.2340	-0.22%
Gold	1,820.00	2.90	0.16%
WTI	76.21	-0.11	-0.14%
10 Year	3.904%	-0.045	-1.13%

February 27, 2023

Planning Corner

Financial news media was buzzing with conclusions based on the latest **Fidelity Investments** data report on retirement account balances. Bloomberg reported that "The average 401(k) account balance lost about a fifth of its value in 2022, tumbling to $103,900 from $130,700" (Bloomberg, 2/23/2023).

In a second article, Bloomberg quotes its own **MLIV Pulse survey**, asking how much is needed to "retire comfortably". Before you hear their survey result, you need to know that this is a survey of international investors and financial professionals. This weekly international investor survey reported that the answer is $3 to $5 million. (Bloomberg, 2/21/2023).

These numbers just don't add up. Don't be deterred by these contradictions, find out how you to make the most out of your own retirement with an individual review.

Call to schedule an appointment.

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Stocks

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

Stocks continued to decline last week amid increasingly hawkish Fed policy expectations while economic data pointed towards stagflationary trends emerging and retail earnings disappointed. The S&P 500 fell 2.67% on the week and is now up just 3.40% YTD.

Equities began the holiday-shortened trading week with steady selling last Tuesday following the President's Day break as yields and the dollar continued to power higher amid rising terminal rate expectations. Composite PMI Flash data were strong in both Europe and the U.S., which bolstered bets that the Fed would raise rates higher than previously thought and keep them there for longer. The dollar strength and rising yields persisted, keeping consistent pressure on the S&P 500 until the index closed down an even 2.00%.

Stocks attempted to stabilize on Wednesday as the Fed's Bullard largely echoed other recent Fed commentary suggesting he believes the terminal rate will be 5.375%, which is no higher than feared. But the release of the February FOMC minutes in the afternoon revealed the decision to raise rates 25 basis points was not unanimous and some policymakers preferred a 50 bps, which saw stocks roll over. The S&P 500 ended down 0.16%.

Equities rebounded Thursday, but only after the major indexes hit fresh one-month lows as investors weighed a stagflationary Q4 GDP print and hotter-than-expected inflation release in the Eurozone against strong earnings out of chip-giant NVDA. JPM's Dimon also made some encouraging comments midday, which helped the S&P 500 notch a gain of 0.53%.

In what has become a familiar occurrence lately, stocks gapped lower at the opening bell Friday. Global equities were already trading with a cautious tone due to more soft growth data out of Germany but the market extended losses on the back of a hotter-than-expected Core PCE print (4.7% vs. E: 4.3% y/y), which is the Fed's traditionally preferred measure of inflation. Stocks quickly fell to one-month lows after the opening bell but the selling pressure eased after the University of Michigan's Consumer Sentiment release showed little change in inflation expectations on both one- and five-year time frames. That saw Treasuries stabilize and stocks were able to claw back some of the early losses over the course of the day amid mostly quiet news flow. The S&P fell another 1.05% on the session.

Now What? Updated Market Outlook

Stocks dropped to a one-month low last week and the reasons for the weakness couldn't be clearer: Disinflation has slowed materially and as a result the market is increasing Fed rate hike expectations, which is causing Treasury yields to surge and that's pressuring stocks. To that point, stocks and bonds rallied in

January on the ideas that 1) Inflation was declining (or disinflation), 2) The Fed was almost done with rate hikes and 3) There wouldn't be a hard economic landing. Two of those three ideas have been refuted via the data of the past three weeks, and that's why stocks have given back more than half of the YTD gains.

Broadly speaking, for these declines to stop markets need to see data that shows inflation is again dropping and, in turn, the Fed is getting close to ending rate hikes. Until that happens, we should expect continued pressure on both stocks and bonds.

From a strategy standpoint, over the past several weeks we have pushed back against the budding optimism among investors that the Fed was close to done with rate hikes and the battle against inflation was close to being won. The basis for that pushback was simple. Since the start of this hiking cycle a year ago, the market has consistently been too eager in pricing in an end to Fed rate hikes, taking any hint of a drop in inflation or slowing growth and extrapolating it out to be some catalyst that will cause the Fed to back off. **That expectation has been wrong every single time (including most recently) and it won't happen until the Fed sees more progress on inflation.**

As such, we've remained defensive and skeptical about rallies that took the S&P 500 out of what we considered "Fair Value" (3,825-4,050 based on the February Market Multiple Table).

Now, it's important that my skepticism towards the early rally not be confused with me being a perma-bear. I'm not! I'm far from it. There have been some important positives in the markets over the past several months: 1) Economic activity remains resilient, 2) Earnings have held up better than investors feared (at least so far), 3) Disinflation is occurring and the peak in inflation is behind us. and 4) The Fed is much closer to an end to rate hikes than a beginning. While those positives have occurred, investors remain far too eager to extrapolate one data point to imply an imminent end to Fed rate hikes and an economic soft landing and as long as that remains the case, I'll remain skeptical of rallies above fair value.

That said, the S&P 500 has fallen into the upper end of what I consider "fair value." As such, if investors found themselves underinvested and with major "Fear of Missing Out" when the S&P 500 was above 4,100, now is likely a solid time to <u>begin to slowly increase exposure to stocks (and longer-dated bonds).</u> I say that for this simple reason: Economic data has turned against the market (slower disinflation and strong growth) but that can easily change back and if/when it does, the rally will resume. I don't expect it to happen this week (next week is the next big week of data) and I'm by no means saying the bottom is definitively in. However, any good analyst must make allowances for the other scenario occurring too, and the truth is there are positives occurring in the market, and a rally is not an impossible scenario.

Given the current setup, we continue to advocate for any equity allocations to go towards defensive sectors and value. The worst-case scenario for stocks is a recession that crushes growth and earnings. In that outcome, defensive sectors will likely handily outperform, and they should keep losses manageable. If/when a soft landing becomes more likely, we'll happily abandon value and defensives and embrace growth and tech, but we are not yet at peak Fed hawkishness and as such, I am wary of rising yields that will pressure growth and tech as it's done for 15 months now.

Bottom line, stocks and bonds can bounce back but they need the following: 1) Signs of a resumption in the drop in inflation, 2) Stable economic growth (not too good or too bad) and 3) Fed rate hike expectations to stop rising. When that happens, stocks can rally, but until it does, we'll remain defensive and cautious.

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

Need to Know Econ from Last Week

Markets came into last week concerned about a slowing (or reversal) in the trend of disinflation and rising expectations for Fed rate hikes, and the data last week made those concerns worse. The key number from last week was Friday's Core PCE Price Index and it showed a reversal in disinflation trends. The Core PCE Price Index rose 0.6% vs. (E) 0.4% m/m and 4.7% vs. (E) 4.3% y/y. What made these numbers so disappointing was that the monthly and headline readings were increased over the previous month, implying the trend in disinflation didn't just slow, it reversed!

Now, one number doesn't negate the reams of inflation data that shows inflation pressures have eased over the past several months, and the trend in inflation is lower. But this report does imply the pace of that decline has slowed materially, and it may well take inflation much longer than hoped to return to some acceptable level that allows the Fed to stop rate hikes.

As for other reports last week, the February Flash Composite PMIs showed an economy that's resilient. Both the manufacturing (47.8 vs. (E) 47.3) and the services (50.5 vs. (E) 47.2) showed stronger-than-expected activity, and the services PMI was especially notable as that's the portion of the economy the Fed is trying to slow to ease inflation pressures—and that's not the type of progress the Fed will want to see.

On employment, the data remained strong. Weekly jobless claims remained below 200k at 190k, a level that's much too low for a Fed that's looking to ease wage pressures by returning the labor market to a better sense of balance. So, the economic data last week clearly showed that the trend in disinflation has slowed and may be temporarily reversing, and that's causing rate hike expectations and bond yields to rise and it's pressuring stocks, just like it did in 2022. For the rally to resume, markets will need to see new proof that disinflation is reaccelerating and growth is cooling (but not collapsing).

Important Economic Data This Week

Given the hotter-than-expected Core PCE Price Index (and the CPI report before that) the market is craving more inflation data, but it'll have to wait until next week for that as most of the important reports this week focus on economic growth. Broadly speaking, given the high inflation metrics, markets will want to see stability from the important growth reports this week, so that they aren't so good they stoke additional inflation (and rate hike) concerns, and aren't so bad that they spike stagflation concerns (because inflation isn't falling nearly as fast as people had hoped).

The key reports this week are the March ISM Manufacturing and Services PMIs, out Wednesday and Friday, respectively. These are two of the most important monthly economic reports, and markets will want to see stability, as a very strong number will be as much as an additional negative for stocks as a very weak number. The price indices will also be watched closely, as they were firm in the flash PMIs and if we get a decline in the headline PMIs and a bounce back in the price indices, that will increase concerns about a bounce back in inflation. Conversely, in-line headline reports with a further drop in price indices (especially services PMI) will help support stocks and bonds.

The other remaining reports this week include Durable Goods and Pending Home Sales (today) and weekly jobless claims (Thursday) and the outlook is the same: Bulls will want stable data that implies the economy isn't too strong or suddenly weak, while reports far from the consensus in either direction will either spark inflation or stagflation worries (and pressure stocks). To stabilize, stocks need to see 1) Lower price data and 2) Stable-but-not-spectacular economic growth. If the ISM PMIs signal that this week, then markets can bounce.

Special Reports and Editorial

Are Junk Bonds Signaling an Imminent Recession? No

It's often said, and I believe, that the bond market is the "smart market" and that's one of the reasons I focus on bonds every day in this report, because what's happening in bonds can give clues about what's going to happen in stocks and the economy.

To that point, I and others have been consistently pointing out, for over a year, that the yield curve is loudly warning of an imminent economic contraction. But the yield curve isn't the only measure of future economic growth the bond market produces, and like most economic indicators right now, the bond market also is providing some mixed messages about future growth.

I say that because another measure of the bond market's expectations for economic growth is the Baa Treasury bond yield spread. What this spread measures is the difference in the yield between "high yield" (junk) debt and the yield on the 10-year Treasury. Here's how this indicator works.

When the market expects a stable economy (so not major contraction) the difference between junk bond yields and Treasuries will shrink, and that's because investors aggressively buy junk debt (pushing yields lower) for the higher yield because they aren't scared about principal or default, because the economy is good.

However, when bond investors are worried about economic growth, the opposite happens. The difference (or spread) between Baa bond yields and the 10-year Treasury yield widens sharply. That occurs because bond investors aggressively sell junk bonds (sending their yields higher) while piling into Treasuries (sending those yields lower) as investors are no longer willing to take a higher risk for higher reward. Think of it like the economic tide going out, and in that instance, investors <u>will</u> worry about principal payments and defaults for the riskier corporations (the high-yield market).

<u>What's It Saying Now?</u> It's saying that there isn't an imminent recession! The Baa/10-Year Treasury spread *is* well off the highs of 2.36% it hit in July and is currently trading at 1.89%. That's not the level we'd expect if the bond market was worried about an imminent growth slowdown. In fact, the junk bond spread is saying the opposite of the yield curve: It's saying that there's no imminent drop in economic growth coming (at least not to the level where bond investors are concerned about principal or defaults).

So, how can this gap exist? Well, as usual, there are reasons. First, inflation is very high and that's supporting all yields. Inflation is the sworn enemy of bonds as it destroys returns. High inflation could well prompt bond investors to go out on the risk curve to find an adequate inflation-adjusted yield, and since economic growth isn't showing any definitive signs of rolling over, there's no reason to exit junk bonds and lose the yield.

Second, any coming economic slowdown may not be that bad. The junk bond spread could be signaling the "soft landing," meaning not big enough to warrant existing the high yields in junk debt for the safety and lower returns of Treasuries.

Third, QE (and QT) could be influencing the spreads. This is a general thought, but the bottom line is that the bond market has become distorted because of the massive amounts of QE over the past decade plus. Now, with Quantitative Easing over, the Treasury market has lost a material buyer, the Fed. That means that Treasury yields may be drifting higher than they otherwise would have as the market adjusts to the absence of such a large buyer. Practically, that means Treasury yields may be rising faster than otherwise expected, and that could help keep the Baa/10-year Treasury yield spread more muted than before.

<u>What's It All Mean?</u> If we just look at the facts, then this spread is signaling a clear message: The Fed has not tightened enough, yet, to get the corporate bond market materially worried about an imminent recession. Now, that means that if the Fed stops relatively soon, then a soft landing may well be more likely than the consensus might think. However, if the Fed does not stop soon, and views this metric as another signal that it hasn't slowed the economy enough yet, then that will increase the chances the Fed does keep hiking and we get an ultimate hard landing.

<u>How Do We Play It?</u> Essentially, that comes down to whether you're more in the soft landing or hard landing camp. If you think: 1) The Fed is almost done, 2) The U.S. economy is more resilient than expected, 3) Corporate earnings are more resilient than expected and 4) Inflation will continue to decline, then the small spread between junk debt yields and 10-year Treasury yields is a signal to buy stocks (and growth over value and tech over defensives) and buy high-yield debt to take advantage of still very good yields.

However, if you think: 1) The Fed isn't almost done and we've got another 50-75 bps of tightening, 2) The U.S. economy isn't as resilient as it seems and it'll continue to slow as previous rate hikes bite, 3) Corporate earnings will continue to bleed lower and 4) Inflation will remain sticky above the Fed's 2% target, then this is a great buying opportunity in long-dated Treasuries, because they've been sold lately on the hotter-than-expected economic data. It's also a buying opportunity in value and defensive stocks and an opportunity to reduce positions in tech given the YTD bounce.

What Do I think? The number of mixed messages coming from various market indicators is extremely high. The yield curve screams recession while the Baa/Treasury spread says "soft landing." Every day I hear about planned layoffs and hiring freezes, yet the jobs report shows huge job adds while JOLTS are near record highs and jobless claims simply won't rise. Most corporations are warning about tougher days ahead, yet earnings estimates remain surprisingly buoyant.

In the end, I am of the opinion that the economy is stronger than was appreciated by the Fed or the bond markets, and that the Fed will keep hiking rates beyond current market expectations, which will cause a real economic contraction.

But like both material economic slowdowns I've been a part of in my career ('00-'03 and '07-'09) it will take longer to materialize than anyone thinks possible, including people like me who have been through it and think we're making accommodations for it taking longer than we think. It'll still take longer!

The Equity Risk Premium at 2007 Levels

With volatility picking up over the course of the last week amid increasingly hawkish Fed chatter and stubbornly resilient economic data that has combined to result in a meaningful rise in yields, it is a good time to revisit the concept of "equity risk premium."

The equity risk premium equation is essentially a way to measure how expensive stocks are relative to bonds to quantify the excess return that can be expected for taking additional risk in the equity markets versus the risk-free Treasury market.

In contrast to our monthly Market Multiple Table, which provides target ranges based on expected multiples and EPS estimates given different fundamental scenarios, equity risk premium measures the current earnings yield of the broader stock market against a benchmark "risk-free" rate, typically the 10-Year Treasury Note yield.

To calculate the earnings yield, we simply flip the P/E ratio equation upside down. Using the figures from our most current MMT table we have a consensus estimate of $225/share for 2023 S&P 500 earnings. Using the S&P 500 settlement on Feb. 17 of 4,080, we get an earnings yield of 5.51%.

Then to calculate the equity risk premium (aka the current additional return an investor can expect from broad equity market allocations versus bonds), we then subtract the 10-Year Treasury Note yield from the Feb. 17 close, which was 3.82%, from the earnings premium of 5.51% to get an equity risk premium of just 1.69%. That is the lowest reading since 2007.

So, even though stocks began the week roughly 15% below the all-time highs reached in early 2022, the S&P

500 isn't cheap when running cross-asset analysis. In fact, the broad-based index is currently as expensive as it has been in 16 years relative to bond markets. And stepping back to look at the numbers, shorter-duration Treasuries yielding well beyond 4% are rather appealing given the economic uncertainties on the horizon and historically accurate warning signals from the yield curve.

Considering that our research last week pointed out the elevated odds that we see, at a minimum, a retest of the October lows (if not an outright break lower) in the event of a recession, allocating to Treasuries should be considered a sound play, especially for risk-averse clients prioritizing capital preservation.

Jim Noble

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James K. Noble CFP® CLU®

James K. Noble CFP® CLU®

Investment Advisory Representative (IAR), NPA Asset Management

CERTIFIED FINANCIAL PLANNER™ Practitioner since 2011

Providing financial planning, brokerage services, estate planning, and fiduciary investment management for individuals and families.

Contact:

jnoble@nationwideplanning.com

YouTube

The Retirement Channel with Jim Noble CFP(R)

(201) 350 - 8461

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