# MONDAY MATTERS

NOBLE PLANNING

James K. Noble CFP® CLU®

What's in this week's Report:

- Weekly Market Preview:  Do the Banks Stabilize?
- Weekly Economic Cheat Sheet:  Key Inflation Data on Friday
- Dynamics Between Stocks, Bonds, and the Economy Have Changed Since Covid
- Dow Theory & Managing Risk Reward in Stocks
- Is the More-Dovish-Than-Expected Fed Decision A Bullish Gamechanger? No. Here's Why
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Futures are modestly higher following the successful merger of Silicon Valley Bank over the weekend.

First Citizens agreed to buy much of Silicon Valley Bank's assets, and that resolution combined with larger deposit insurance chatter is helping stocks to rally this morning.

Economically, the only notable report overnight was the German Ifo Business Expectations and it was better than expected at 91.2 vs. (E) 88.0.

Today the focus will remain on the banks and as has been the case, Frist Republic is the key – resolution for that bank remains the next step towards broader stability in the banking sector.  Economically, today we get the Dallas Fed Manufacturing Index (E: -13.5) and have one Fed speaker, Jefferson at 5:00 p.m. ET, but neither should move markets.

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 4,028.75 | 27.50 | 0.69% |
| U.S. Dollar (DXY) | 103.0530 | -0.0630 | -0.06% |
| Gold | 1,975.40 | -26.30 | -1.31% |
| WTI | 70.70 | 1.44 | 2.08% |
| 10 Year | 3.500% | 0.122 | 3.60% |

## March 27, 2023

### Planning Corner

This week's edition will touch on DOW Theory and the indicators that can give guidance to future market trends. Here is a brief summary of the iconic creation of Charles Dow, the founder of the Wall Street Journal and market legend.

The stock market is composed of companies representing different industry groups, or sectors.  The highs and lows of the DOW Industrial Average and the DOW Transportation Average are used to confirm a bullish or bearish trend in the overall stock market.  This measure is used to help forecast rising or falling markets.

The research that goes into this newsletter evaluates DOW indicators in relation to DOW Theory on a weekly basis.  This week the DOW trends are outlined in detail, with a possible confirmation of a new bullish trend.

Long term investors who have been watching the market may be rewarded for their patience.  Let us evaluate your portfolio today!

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## Stocks

The volatile rollercoaster in markets continued last week as stocks rallied into the March Fed meeting amid stabilizing price action in banks only to reverse some of those gains in the back half of the week thanks to renewed concerns about the global financial system. The S&P 500 gained 1.39% on the week and now is up 3.42% YTD.

Stocks started the week with a solid rally last Monday as investors received the government-brokered takeover of Credit Suisse by UBS relatively well, while a coordinated effort by several of the world's largest central banks aimed at shoring up currency markets bolstered confidence in the global financial system. More heavy price action in the banks, however, limited the gains which left the S&P 500 to end higher by a modest 0.89%.

Equities powered higher on Tuesday on the back of reports that U.S. officials, including those from the Treasury Department, were exploring ways to guarantee all bank deposits for a certain period of time to help restore broad confidence in the system (this was later reiterated by Treasury Secretary Yellen). News that JPM was spearheading an effort by several major banks to keep FRC from failing sent the banking sector higher by 5%, which saw the S&P 500 climb 1.30% to reclaim 4,000.

Stocks churned sideways Wednesday morning before the Fed but then there were whipsaw moves across asset classes after the statement hit the wires and during Powell's press conference. The market had received the Fed decision and suggestion that a policy pause was looming well, but Yellen, speaking separately before Congress, poured cold water on the rally when she pushed back on reports from earlier in the week that the Treasury and FDIC were considering an expansion of current deposit insurance parameters. That saw stocks reverse sharply and the S&P 500 closed down 1.65%.

Stocks recovered a portion of the losses at the open on Thursday as several more policy rate hikes by overseas central banks were taken in stride as rates markets were universally pricing in peak rates and rising odds of rate cuts later in the year. The S&P 500 peaked into the European close before weakness in bank stocks began to drag the broader market lower (KBE hit new 52-week lows). A language change in Yellen's prepared remarks for her continued testimony before Congress that said she was prepared to take "additional deposit actions if warranted" saw the S&P rebound out of negative territory and end the day with a modest 0.30% gain.

Concerns about the banking sectors flared up again early Friday, this time in Europe, as DB shares plunged more than 10% amid a spike in the bank's CDS while UBS fell as much as 7% after a downgrade from Jeffries and news of a U.S. government probe into the bank. The Fed's Bullard made some hawkish comments about still seeing a terminal rate of 5.625%, which weighed on sentiment but it was positive news out of an emergency meeting of the Financial Stability Oversight Council that helped the market stabilize and grind higher into the close. The S&P 500 gained 0.56% on Friday to end a volatile week.




*<u>Inflation Is the Biggest Market Threat</u>*

Stocks have now posted back-to-back weekly gains mostly thanks to an aggressively dovish shift in Fed policy expectations (again) following last week's Fed decision that signaled an imminent end to the rate hiking cycle. But volatility remained elevated, driven by heavy price action in the banking sector amid shaky confidence in the global financial system.

Last week, we pointed out four catalysts for the week and the outcomes of those catalysts were mixed. First, bank stocks fell to new 52-week lows amid conflicting commentary out of Yellen regarding deposit insurance. Despite a bounce on Friday, the heavy price action in banks remains a headwind for stocks and will be until the sector shows meaningful signs of stabilizing.

The second was deposit insurance. Initially, reports that U.S. officials were exploring ways to increase FDIC insurance limits was well received. Then Yellen pushed back on that idea Wednesday afternoon. The Treasury Secretary then changed course again on Thursday and Friday, but ultimately there was no material progress towards higher deposit insurance coverage and that uncertainty will remain a headwind for risk assets in the near term.

Third, the Fed decision was received positively as rates markets aggressively priced in not only an end to the rate hiking cycle, but also multiple rate cuts by year-end. The fact that the Fed left the door open to more rate hikes if data warrants was a fairly overlooked negative component of the Fed decision leaving the catalyst as an only mild positive for markets. Finally, geopolitical tensions between the U.S. and China regarding Russia never really flared up while Trump was not arrested as many expected. That left geopolitics to be a limited influence on the markets last week.

Bottom line, a Fed pause is positive for stocks and other risk assets but the familiar, rapid repricing of less-hawkish policy expectations presents the risk of another major disappointment from Powell and Co. It now will take just one hot inflation print to pin the Fed between a proverbial "rock and a hard place," as policy makers would face the decision of either continuing the fight against inflation with aggressive policy or risk sending the global financial system into another crisis. Additionally, with banks hitting new 52-week lows last week, we can't rule out more headwinds from the financial sector as confidence in the system remains low and notably fragile.

## <u>Economic Data (What You Need to Know in Plain English)</u>

***<u>Need-to-Know Economic Data from Last Week</u>***

The economic calendar was pretty thin last week, which left investors focused on the March FOMC meeting and Powell's presser, both of which were largely dovish versus expectations and well-received by markets (Wednesday's Fed-fueled gains were derailed by Yellen pouring cold water on the idea of increasing deposit insurance levels). The economic data we did receive was mostly strong and to some degree "too hot," which raises the risk that the market is once again getting ahead of itself with dovish money flows.

Beginning with the Fed decision, the FOMC largely met market expectations as they proceeded with a 25-basis-point hike and made no changes to the "dot plot" from December, which showed the fed funds rate at 5.125% at the end of 2023. The key change in the statement was in the third paragraph as policy makers removed the language regarding "ongoing increases" in the policy hike and replaced it with "some additional policy firming may be appropriate." In the past, this has been the Fed's way of signaling an imminent end to the current rate hiking cycle. Importantly, the Fed also acknowledged the recent banking turmoil, indicating that it would result in "tighter credit conditions for households and businesses" and that it would weigh on economic activity, hiring and inflation.

Bottom line for the Fed, the March decision was slightly more dovish than expected and policy makers struck a cautious tone regarding the threat of a banking crisis, which sent policy rate expectations plummeting and Treasuries surging higher with yields falling to multi-month lows into the end of the week. As previously mentioned, the risk to this market reaction is that inflation and growth remain stronger than anticipated and the Fed is forced to move forward with additional rate hikes, offering another volatility shock to markets.

To that point, economic data was strong across the board last week as Existing Home Sales for February came in well-above estimates with a monthly jump of 14.5% (E: +4.25) as home buyers were quick to capitalize on the pullback in mortgage rates. New Home Sales, meanwhile, edged up from a lower-revised January print, narrowly missing estimates, but held steady near pre-Covid levels above 600K. So housing data is appearing to stabilize, at least this month. Jobless claims came in at 191K vs. (E) 195K, underscoring the still very resilient state of the labor market, a trend the Fed is continuing to try to break with policy actions (they want to see a return towards 300K/week). Durable Goods Orders for February had a weak headline of -1.0% vs. (E) +1.5%, and that was from a lower-revised January reading of -5.0% which was initially -4.5%.

The Core Capital Goods figure within the release, which is a proxy for business investment, held up well at 0.2%, only moderating slightly from January's 0.3% reading. At this point, there is no evidence of a meaningful drop-off in business spending recently. Friday's Composite Flash PMI report was likely the most important economic release of the week and it came in hot with the headline jumping out of contraction territory to a reading of 50.2, an eight-month high, led by strength in the service sector as the Services PMI rose to 53.8 vs. (E) 50.3, up from 50.1 in February. Importantly, the "output charges," which measures selling prices rose sharply at the quickest pace since October and the increases were realized in both the manufacturing and services sectors. Bottom line, none of the data last week was consistent with a slowing economy or acceleration lower in inflation pressures and that leaves the risk of a hawkish Fed reaction in the months ahead elevated.

***<u>Important Economic Data This Week</u>***

We will get new data on the housing market with the S&P Case-Shiller FHFA Home Price Indexes due out on Tuesday as well as the March Consumer Confidence release. Pending Home Sales is due Wednesday followed by the second revision to Q4 GDP and initial jobless claims on Thursday. Friday will bring the most important data of the week as the Core PCE figure within the February Personal Incomes and Outlays report will hit before the market opens and then the University of Michigan's Consumer Sentiment report for March will be released at the top of the 10:00 a.m. hour. Bottom line, the banking turmoil, which spread to Europe late last week, has been a dominant influence on markets and the related contagion fears served to compound the dovish reaction to the Fed signaling an imminent pause in rate hikes. But growth data is rebounding and inflation readings remain stubbornly buoyant right now, which puts the Fed in a very difficult version of a Catch-22 scenario.

On the one hand, there is a very real threat of another banking crisis, which, if things escalate, would result in a collapse in confidence in the financial system and very likely severely negative reverberations across global markets. That is something the Fed would almost certainly want to ease policy into to help shore up the system. On the other hand, economic data has been running hot and inflation remains stubbornly high at more than double the Fed's mandated target of 2%. If that continues, the Fed would be forced to continue tightening policy or risk another bout of stop-go policy actions amid historically high inflation. So this week, it will be very important for risk assets to see a drop off in the Core PCE data and consumer inflation expectations on Friday as well as easing growth measures in the other data points. Otherwise, stagflation fears will surge and that would be decidedly negative for stocks and to a lesser degree bonds.

## Special Reports and Editorial

**Dynamics Between Stocks, Bonds, and the Economy Have Changed Since Covid**

Looking at the last three notable yield curve inversions that took place in 2000, 2006-2007, and 2019, and analyzing the subsequent moves in stocks, bonds, and the state of the economy, a clear trend emerges. In these instances from recent history, which were all importantly contained within a period of low inflation and a multi-decade bull market in bonds, Treasury yields repeatedly peaked a matter of years prior to the economy falling into a recession. Fast forward to today and rates have just recently retreated from their cycle peaks within the last few months leading some to believe the economy may have more room to run before facing the threat of a recession. That is why we wanted to do a deeper dive into the history of, and correlations between, yield curve inversions, the economy, stocks and bonds.

To reiterate, yield curve inversions have consistently and accurately forecasted recessions in every phase of post-war market history, regardless of whether the general, long-term trend in rates was upward or downward sloping. But that latter factor does make a difference in the timing of certain market developments surrounding recessions. And because inflation is historically elevated, we want to be clear that the latest yield curve inversion is likely to be very different from the yield curve inversion periods that preceded the dot-com bubble, GFC, or Covid. As such, using those time periods as a guide would likely be detrimental to investment decision making.

Going further back in history to a time of elevated inflation and a bear market in bonds, something that many of those working on Wall Street today have never experienced, we see a very different timing dynamic between turning points in equity and bond markets and their relation to the economic cycle than we have seen since the turn of the millennium. And because high inflation is a major influence on markets again for the first time in decades, we wanted to look back to the 1970s and 1980s as that time period will very likely provide better context and insight into what to expect in the months, quarters, and years ahead.

Starting with inflation, the Consumer Price Index in the U.S. pushed 15% on an annual basis in the early 1980s, which is considerably higher than the 9.1% annualized CPI reading from last June, but still much more comparable to any time frame since the early 1990s up until present day, when it comes to broad price pressures in the economy.

Looking to the yield curve, the 10s-2s spread was notably inverted for much of the late 70s and early 80s, which correctly forecasted two recessions in the U.S., the first in 1980 and the second spanning from the summer of 1981 until Q4, 1982. Not surprisingly, from November 1980 until August 1982 the S&P 500 was in a well-defined bear market that saw the index decline by 30% peak-to-trough.

In the Treasury market, the 10-year yield put in two notable peaks during this time frame, both instances being in the front half of the two aforementioned recessions that occurred in the early 1980s (the 1980 peak yield was 13.65% and the 1981 peak was a staggering 15.84%). Note this is in stark contrast to the 10-year peaks that occurred well before recessions took hold between the mid-1990s and 2020.

The 10s-2s spread didn't sustainably stabilize in positive territory until early August 1982, which very interestingly corresponds with the S&P 500's cycle lows of just 102.20. In the early 80s, sharp counter-trend spikes in the 10s-2s spread, like we saw in the wake of the SVB collapse, preceded bouts of intense selling in equity markets. So, the recent spike in the 10s-2s may very well be a similar warning sign for more volatility ahead.

Bottom line, we are not saying "it's different this time," but the current market dynamics much more closely resemble the market backdrop of the late 70s and early 80s, which means three things: 1) We need to be weary of sizeable moves in the yield curve (like the one that just occurred) as potential warnings signs for more broad market volatility. 2) Yields are more likely to peak during recessions as opposed to before them when inflation is a major market factor, so it should not be assumed Treasuries have already peaked (unless of course we are already in a recession). 3) During periods of elevated inflation, stocks typically don't bottom until the 10s-2s spread has recovered and maintained positive territory, which suggests the October lows are not likely the final lows of this current bear market in equities.

**Dow Theory & Managing Risk Reward in Stocks**

Dow Theory, which was created by the founder of the Wall Street Journal and market legend Charles Dow, has been around for well over a century. And while a slew of different variations and time frame practices of the "investing system" have emerged over the decades, the original strategy continues to offer great insight into the primary trend of the broader equity markets and can offer significant benefits for risk management in long-term investing.

As a quick refresher, there are six basic tenets of Dow Theory, but the main concepts are that price discounts everything. The market has three trends and three phases, and the averages must confirm each other and volume must confirm the averages, and trends remain in place until decisive reversal signals are elected.

We monitor Dow Theory on a weekly time frame as we believe that is the best time frame to serve our subscriber base; fast enough to catch the bulk of major trends, but slow enough to avoid frequent reversals or "head fakes." In its simplest definition, respective sets of higher highs and higher lows in both the Dow Jones Industrial Average and Dow Jones Transportation Average, amid rising volume, confirm an uptrend or bull market in the stock market. Conversely, a respective set of lower highs and lower lows in the two averages, amid rising volume, confirm a downtrend or bear market.

In recent years, Dow Theory studied on a weekly time frame has offered bearish signals that helped investors avoid the bulk of the dot-com bubble and the GFC declines. Furthermore, bullish signals helped guide investors back into equities early on in the subsequent bull markets that followed those two early 2000s bears. The strategy admittedly offered some intermediate bearish signals that some would argue were false or wrong in 2015 and 2018, but in both instances, periods of relatively intense volatility were avoided and bullish signals ultimately followed. Covid was a bit of an anomaly, but importantly, there was no bearish signal from Dow Theory, so those following the system objectively were able to avoid making panicked decisions to liquidate holdings during the extreme market volatility of early 2020.

*<u>What Is the Current Dow Theory Call?</u>*

During the first week of May 2022, a lower low in the DJIA was the final development to fall into place to elect a bearish Dow Theory signal following a break down in the Transports about a month prior. The S&P 500 opened the following week at 4,123, which was less than 15% below the early 2022 all-time high of 4,818. For those who repositioned portfolios at that time, a meaningful portion of the 27% peak-to-trough drawdown in the S&P 500 was avoided, which is a big deal when considering long-term capital preservation goals.

Furthermore, at the August 2022 peak rebound in stocks, the S&P 500 only managed to move 4% beyond the early May "sell signal" level from Dow Theory, but only after the index had fallen another 11%+ through the June lows. Stated differently, the bearish Dow Theory signal from early May helped avoid an additional 11% loss over the subsequent six weeks while the forfeited upside since the bearish signal has been just 4%. I don't know many investors who view risking 11% to make 4% as favorable, so the latest sell signal from Dow Theory has been valuable.

*<u>How Far Is Dow Theory from Turning Bullish?</u>*

Actually, not very far, but it is important to remember the Dow Theory tenet that trends remain in place until they're decisively reversed by confirming signals and rising volume. The price action in the Dow Transports has improved since the late-Q3 lows with the index establishing a set of higher lows through the turn of the year and most recently a new higher high in February.

The Dow Jones Industrial Average, however, is a different story as it recovered off of the late-September lows to hit new highs in late 2022, but a higher low was never established in the process (because it was a pretty straight-line relief rally). That means that if we see a higher low than the late-September weekly closing low of 28,725.51 in the DJIA, preferably confirmed by another new high above the high weekly close of 34,429.88 from December, and barring any negative developments in the Transports a bullish signal will be elected. These two market extremes in the Dow Jones should be closely watched as we navigate this uncertain market backdrop.

**Is the More-Dovish-Than-Expected Fed Decision A Bullish Gamechanger? No. Here's Why**

The Fed hiked rates 25 basis points, but for the first time since the hiking cycle began a year ago, signaled the end of rate hikes is near (or already upon us) and markets initially cheered that change. However, the bigger issue for this market remains unchanged from the start of 2023, namely that what will determine the next 10%-15% in the S&P 500 isn't whether the Fed hikes 25 bps more, but instead whether we get a hard or soft economic landing. As such, we don't see the Fed's signal of a looming end to rate hikes sustainably bullish.

First, the Fed signaled that the end of rate hikes is likely near, but they didn't guarantee it. Point being, if CPI stays near 6% between now and the May meeting (something unlikely but possible) and the bank crisis is contained, don't be shocked if the Fed signals more rate hikes are to come. As we and others have said since the start of the year, the Fed will follow the data. The regional banking crisis hasn't changed that fact. Bottom line, the Fed is likely done or almost done with rate hikes, but it'll be up to the economic and inflation data (and it's not a guarantee).

Second, the FOMC statement shouldn't have been viewed as a material positive, namely because the Fed signaled that the regional banking crisis will put downward pressure on the economy (and also inflation). Prior to SVB and SBNY failing, the Fed had a very difficult task of sticking a soft economic landing. That task has become even more difficult with the regional banking stress. The fact that it might make the Fed stop after 50 bps of hikes in 2023 (or 75 bps if they hike in May) isn't a good thing. It's the equivalent of hoping your arm is broken as opposed to bruised so you can get heavier pain killers. Yes, it may provide more immediate relief, but it presents a much bigger problem!

Bottom line, the key issue for the markets in 2023 has been, and remains, whether we get a "soft landing" or "hard landing" ("no landing" is looking increasingly unlikely). The Fed signaling a potential end in sight for rate hikes is a positive in general (that has to happen at some point for pressure on multiples to ease) but if they are ending rate hikes because economic risks are too great, that's not a reason to buy stocks.

Stepping back, this market reminds me more and more of the early 2000s, where stresses emerged and growth slowed, but by then Fed rate cuts were too little, too late. I hope I am wrong and the Fed nails the soft landing, but the regional banking crisis only makes that task more difficult (and that's assuming it doesn't get worse). Because we think economic growth, not whether the Fed hikes another 25 bps or more, is the key driver of the next material move in markets, we remain cautious and conservative in positioning.

Looking forward, economic data remains the key. If the data rolls over in the next month or so and points to a quick loss of economic momentum, that will not be positive for the economy or markets and we should expect material downside in stocks, and we will be watching intently for any signs of that occurring. The next key economic reports are the ISM PMIs and jobs report (both the first week of April) but at this point every economic report is important because determining whether it's a hard of soft landing will be the key to outperforming in 2023, and we're committed to helping you do that.

Jim Noble

*Quote of the week:*

*"Cultivate 12 people who love you, because they are worth more than 12 million people who like you."*

*- Kevin Kelly, from 103 bits of advice I wish I had known*


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