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What's in this week's Report:

- Current Market Assumptions (Why Stocks Remain Resilient)
- Why Jobless Claims Jumped Last Week
- Weekly Economic Cheat Sheet: Inflation is the Key This Week (CPI on Wed, PPI on Thurs)
- Weekly Market Preview: Do Stagflation Risks Rise?
- What Can Break The S&P 500 Out of the Current Trading Range?
- Why Wasn't "Bad" Data "Good" for Stocks?

Futures are little changed following a mostly quiet weekend of news as investors digest the "Just Right" jobs report and look ahead to CPI on Wednesday and the start of earnings season on Friday.

Friday's jobs report was "Just Right" with job adds rising 238k vs. (E) 230k and wages gaining 4.2% vs. (E) 4.3% y/y. The report is helping to slightly ease the hard landing worries from last week.

Today should be a mostly quiet day of trading as European markets are closed for the Easter holiday and there are no notable economic reports and just one Fed speaker, Williams at 4:15 p.m. ET, as investors will look ahead to Wednesday's critical CPI report and the start of bank earnings on Friday.

Market	Level	Change	% Change
S&P 500 Futures	4,109.75	-22.25	-0.53%
U.S. Dollar (DXY)	102.4690	0.3770	0.37%
Gold	2,016.20	-10.20	-0.50%
WTI	80.00	-0.70	-0.87%
10 Year	3.365%	-0.018	-0.55%

April 10, 2023

Planning Corner

College funding has never been more complicated for families seeking the best outcome for their children while preserving their financial security. The cost of a "top tier" college or university now exceeds $70,000 per year. While most do not pay the top rate due to scholarships and grants, qualifying for "financial aid" can be a Pyric victory. Most forms of financial aid offered to families are in the form of LOANS, not grants or scholarships.

There are financial aid data tools that each render different results depending on household finances. The FAFSA is the federal version, and the CSS is the private school version.

The rules for the FAFSA will be changing in 2024-2025 in a way that will severely penalize those families with multiple students in college at the same time.

The time to prepare for these changes is IMMEDIATELY!

Let us evaluate your portfolio today!

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Stocks

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

Stocks wavered between gains and losses for most of last week as bad economic data stoked recession fears while Fed officials maintained a hawkish stance on "higher-for-longer" rates policy ahead of the jobs report Friday. The market was closed in observance of Good Friday, but equity futures edged higher in the wake of the BLS release before closing early for the holiday. The S&P 500 ended the short trading week down an incremental 0.10% leaving the index up 6.92% YTD.

The market began last week with tentative gains as a surprise production cut was announced by OPEC+, which sent WTI crude oil futures back to $80/barrel, a multi-month high that prompted multiple warnings from central bankers including the Fed's Bullard as well as the IEA that the spike in oil prices would add upward pressure on already sticky high inflation. The S&P 500 was able to recover from intraday weakness, however, and the index notched a gain of 0.37%.

Stocks gapped higher Tuesday thanks to cooler-than-feared inflation data overseas before a bad miss in the February JOLTS headline (job openings dropped below 10 million for the first time since May 2021) saw markets reprice the odds of a hard landing and both equity markets and Treasury yields declined on the day. Financial news wires were quiet into the afternoon as focus turned to Trump's arraignment, but that did not impact markets and the S&P 500 closed with a loss of 0.58%.

The theme of "bad data is bad for markets" persisted Wednesday as the ADP Employment Report missed estimates, sending the 10-year yield to new 2023 lows while the ISM Services PMI was rather disappointing. The S&P 500 churned lower into the early afternoon before the index stabilized and recovered a good portion of the losses into the close, ending down just 0.25%.

There was effectively no conviction in the markets on Thursday as traders positioned into Friday's jobs report, knowing they wouldn't be able to react to the data until this morning with the stock exchanges being closed for Good Friday. The NYSE notably saw the second lowest volume day of the year. Economically, the Department of Labor released an update regarding a "revision to seasonal adjustment factors" for initial unemployment insurance claims, which meant recent weekly data has been understated by as much as 50K/week in 2023. With the new revision process factored in, jobless claims fell by 18K to a still historically low 228K last week, underscoring tight labor market conditions in the high frequency data set. The S&P rallied into the European close before turning sideways to end Thursday up 0.36%, just above the psychologically important 4,100 level.

Bottom Line

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The S&P 500 was mostly resilient again last week if we consider the barrage of disappointing economic data, which implied the chances of a "hard landing" are higher than previously thought (this was before the weekend news that bank lending dropped the most in two years, something that will undoubtedly weigh on the economy going forward).

That resiliency lies in a series of mostly positive assumptions investors and the market have made including: 1) A dramatically more dovish Fed, as markets are pricing in fed fund futures at 4.00% by year end (reflecting more than 100 bps of cuts from the peak fed funds rate of 5.125%). 2) An economic soft landing. 3) No more fallout from the banking stress and 4) Stable earnings.

That's not an impossible run, but I've been through two dramatic hiking cycles in my career ('99-'00 and '05-'07) and both had similar bouts of optimism, only to see it eventually fade. This time is different in that there was massive stimulus injected into the economy and a decade plus of QE, but my experience tells me these assumptions are aggressive. To use a poker analogy, "inside straights" can happen, but that's not the way to bet. Point being, any material disappointment in any of those assumptions (expected Fed rate cuts, soft/hard landing, bank fallout or earnings declines) will lead to a 5%-ish pullback, and any disappointment in two or more opens up a 10%-ish pullback possibility.

As such, we think the near-term risk/reward at these levels remains unattractive, and we are maintaining our defensive tactical stance. Moreover, we think slowing growth remains the biggest and clearest trend in markets right now, and we want to insulate portfolios from that impact. That was demonstrated last week as defensive sectors handily outperformed as growth concerns grew, and we think that continues as growth slows/

Focus this week will be on inflation and the start of earnings, so if there will be disappointment it'll come from 1) CPI not falling fast enough (and challenging the expected number of rate cuts by year-end) and 2) Earnings possibly falling from the current $225 2023 S&P 500 expectation and $240 2024 expectation.

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

Need-to-Know Economic Data from Last Week

For the first time since the Fed started dramatically hiking rates just over a year ago, the weekly economic data clearly pointed to a slowing of activity, both from a growth, employment and inflation standpoint.

Starting with the jobs report, it fell into our "Just Right" range as job adds were 236k vs. (E) 230k while wages rose 4.2% y/y vs. (E) 4.3% y/y. The unemployment rate dropped to 3.5% but that's not enough, by itself, to make the report "Too Hot." Given the increased anxiety surrounding a hard landing last week, the jobs report will result in some relief as it shows a steady labor market, and this report won't make the Fed more or less likely to hike 25 bps in May. As such, don't be shocked by a relief rally in some of the cyclical sectors today (industrials, financials, materials) although keep in mind the labor market is a lagging indicator and firms only cut hiring *after* the economy has started to slow in earnest.

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Turning to growth, the two key growth reports of each month were released last week, and they both dropped to levels last seen exiting the Great Recession (if we ignore the pandemic spike lows and separate one-month spike low in services PMI). The March ISM Manufacturing PMI fell to 46.3 vs. (E) 47.5, the lowest level since 2009 (ignoring the pandemic spike low in spring 2020). New Orders, the leading indicator in the report, fell to 44.3 vs. (E) 49.0, a very low number and one that indicates more slowing ahead. Meanwhile, the March ISM Services PMI declined to 51.2 vs. (E) 54.5, which is the lowest level since 2010 if we ignore the spring 2020 pandemic spike low and a one-month drop in December 2022. Similar to the manufacturing PMI, New Orders fell to 52.2 vs. the previous 62.0, implying a sudden loss of momentum.

Turning to the price indices in both PMIs, there was positive progress there, as prices for the manufacturing PMI declined to 49.2 vs. the previous 51.2, while the prices in the Services PMI declined to 59.5 from 65.0. Positively, both price indices have finally returned to pre-pandemic levels! However, the concern now is that progress on prices has come too late, because if economic data collapses along with inflation, that won't help stocks (even if the Fed pauses or cuts). Bottom line, one week's data is not conclusive, but the uniformity of the disappointing economic data last week was eye opening, as the weight of rate cuts seems to be finally hitting the economy, and as that occurred concerns about a hard landing rose.

Why Were Jobless Claims Revised Higher?

Weekly jobless claims popped to the highest level since early December last week, rising to 228k vs. (E) 200k, although due to significant seasonal adjustments that was actually a decline from the revised figure of 248k from two weeks ago. According to the Bureau of Labor Statistics, who releases the weekly claims data, the revision occurred because (surprise!) the methodology for calculating seasonal adjustments for jobless claims switched during the pandemic, and that method (which is called additive) may have been chronically understating actual jobless claims. There has now been a switch made to combine the way claims were calculated pre-pandemic (called multiplicative) and during the pandemic (additive) and the result is that, over the past three months or so, claims were revised higher by about 50k across the broad.

What this means to us is that claims have been running between 200k-250k over the past few months. That's higher than what was stated, but practically it's not a gamechanger and even claims between 200k-250k signal a tight labor market. So, this change creates a distinction, but one without a practical difference. The net result is that claims need to move towards, and through, 300k to signal real deterioration in the labor market.

Important Economic Data This Week

For several months we and others have cautioned that inflation needed to fall faster than growth for the Fed to achieve a soft landing and markets to sustainably rally, but last week's soft economic data implied the opposite is happening (growth falling faster than inflation) and if that is confirmed by this week's inflation data, then worries about a hard landing or stagflation will rise and markets will likely get volatile.

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The key report this week is Wednesday's CPI, and while we will have a full "CPI Preview" in tomorrow's Report, the bottom line is that we need to see CPI decline (and preferably come in under expectations) and signal that disinflation has reengaged. Secondary in importance with regards to inflation will be Thursday's PPI and, to an even lesser extent, today's New York Fed Inflation Expectations and Friday's University of Michigan five-year inflation expectations.

Bottom line, if CPI is light this week that will help ease hard landing concerns because markets will become surer the Fed can cut rates later this year. However, the more inflation indicators this week that signal disinflation the better, as the Fed can cut sooner to support growth (if needed) if it has comprehensive data showing inflation is indeed quickly returning to its target. I'm not saying that will happen this week, but if economic data is suddenly rolling over, then investors need inflation to drop quickly and sharply, otherwise stagflation/hard landing become the most likely outcome. And with stocks at these levels that leaves a lot of room for declines.

Finally, we will also get the FOMC minutes from the March meeting this week and markets will be looking for any sign that shows the Fed will hike just once more or, perhaps, not at all. And any hints of those comments will be welcomed by markets (at least short term).

Special Reports and Editorial

What Can Break The S&P 500 Out of the Current Trading Range?

The S&P 500 has stayed broadly rangebound for most of 2023, trading between a low of 3,800-ish and a high of 4,200-ish, but there are looming candidates that could result in a breakout. The near-term catalyst is the CPI report, and the next iteration is coming Wednesday (CPI).

Specifically, markets need to see CPI core fall below 5% and ideally below 3.9%. If we can see real progress on this metric that could result in the S&P 500 breaking out above the current trading range, and the reason is clear.

Improvement will substantially free the Fed up to possibly (and finally) meet market expectations and not only stop hiking rates, but also make plans to cut rates before year-end. That realization, combined with still-defensive positioning amongst investors, could lead to a break above the top end of the range as the market anticipates the Fed cutting rates and an economic "soft landing" coming to fruition.

The other potential catalyst is one that's a bit further off in the future, 2024 S&P 500 earnings. As we and others have pointed out, the S&P 500 is pressing up against the bounds of "reasonable" valuations given $225 2023 S&P 500 earnings. At 4,100, the S&P 500 is trading at an 18X multiple, which is simply very high for an environment of 1) Slowing economic growth, 2) Fed rate hikes and high rates, 3) Geopolitical uncertainty and 4) Banking stress. It's very, very hard for fundamentals to justify the S&P 500 much higher than current levels simply because that view is too optimistic, and valuation is part of the reason the S&P 500 has struggled to rally much above 4,100.

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However, in July (so during the Q2 reporting season), analysts will begin to value stocks and the major indices using 2024 expected S&P 500 earnings, and they are currently sitting at $240/share. Meanwhile, 4,100 is just 17X 2024 earnings, so if those earnings can hold (and granted there's uncertainty there) then by the time July rolls around, investors will be justified in pushing the S&P 500 higher towards 4,300 (which would be an 18X valuation) if there's no deterioration in the current set up.

Here's the point more broadly. The Fed hinting that the next rate hike is likely the last one, combined with no more bank failures has fueled a rally in stocks that, at its core, is being driven by the hope of a less-dovish Fed. However, hope can only get markets so far (at least sustainably) and that's why we've seen the S&P 500 struggle to get much above current levels.

For it to break out, there must be real, tangible progress from key data points to further solidify that the Fed is indeed 1) Not hiking anymore and 2) Rate cut expectations are credible.

If one (or more) of these conditions are met, and we don't see any further macroeconomic deterioration (so no more bank failures, no conflict between Russia/NATO or U.S./China, no sudden collapse of economic data) then we would be inclined to increase stock exposure and get more aggressive on this break out and that means adding additional large-cap growth exposure via TDIV as well as more cyclical exposure (industrials, financials, energy, materials) because at that point a "soft landing" would become much more likely.

However, given the level of uncertainty in the markets we much prefer to have proof inflation is falling and the labor market is normalizing. If neither happens then once again Fed assumptions will be too dovish, and the S&P 500 will not break out of the current range and may well fall back into the lower end of it.

<u>Why Wasn't "Bad" Data "Good" for Stocks?</u>

For much of 2023, stocks have rallied on disappointing economic data, but that was not the case last week as "bad" economic data wasn't "good" for stocks, as markets dropped following the soft JOLTS and Factory Orders reports. The reason for that is twofold.

First, the market already assumes an imminent less-hawkish Fed (that's why we're at 4,100 in the S&P 500). Second, if the economic data suddenly deteriorates, then the Fed will be too late, and we'll get a hard economic landing. Put differently, "bad" economic data is only good for stocks if the market thinks 1) The Fed can get more dovish and 2) That dovishness can be effective in stopping a hard landing.

Looking at JOLTS, if economic data suddenly collapses it won't matter if the Fed doesn't hike in May, because at that point they are too late. Monetary policy works with a lag—we haven't felt the impact of most of the rate hikes yet, so even if the Fed were to start cutting rates in June, it'd be months before it'd have an impact on the economy (if not quarters).

Bottom line, "bad" economic data can still cause a rally in stocks, but for it to work we have to have the S&P 500 trading at a level that doesn't assume an imminent, less-hawkish turn from the Fed (so the S&P 500

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below 4,000 based on rate hikes concerns) and we have to have data that isn't suddenly "bad" and imply that U.S. economic activity is hitting a proverbial cliff. Right now, we have neither, so it'll take either 1) Rate hike expectations to move higher or 2) A moderation of economic data (but not outright collapse) for "bad" economic data to push stocks higher once again.

Jim Noble

Quote of the week:

"There is nothing either good or bad but thinking makes it so."

– William Shakespeare

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