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What's in this week's Report:

- How Positive is the Restart of Disinflation?
- Weekly Market Preview: Regional Bank Earnings This Week (Do They Ease Contagion Concerns?)
- Weekly Economic Cheat Sheet: First Look at April Economic Activity
- Market Multiple Table: April Update
- Yield Curve Analysis "Policy Spread" Update

Futures are little changed following a quiet weekend of news as investors await key regional bank earnings this week.

The only notable economic report this morning was Italian CPI, which fell –0.4% vs. (E) -0.3% and further implied that global disinflation has restarted (which is a positive).

Today we get the first look at April economic activity via the Empire Manufacturing Survey (E: -18.3) and markets will want to see stability (so not a continued steep drop). We also get the latest look at housing via the Housing Market Index (E: 45).

Additionally, regional bank earnings start and their commentary on deposits and "Held to Maturity" securities will be especially important. Some reports we're watching today include: SCHW ($0.90), GNTY ($0.69), MTB ($3.98), JBHT ($2.05).

Market	Level	Change	% Change
S&P 500 Futures	4,166.75	3.00	0.07%
U.S. Dollar (DXY)	101.7010	0.1490	0.15%
Gold	2,018.00	2.20	0.11%
WTI	81.99	-0.53	-0.64%
10 Year	3.560%	0.038	1.09%

April 17, 2023

Planning Corner

Tax season concludes this Tuesday, April 18. For many people these deadlines are a burden.

Do you know how much of your income went to taxes last year? Most people have no idea. Financial planning is the foundation of taking control of your life. Contributions to traditional 401(k) and IRA accounts can reduce your current tax burden modestly, but what is the consequence of this act over your lifetime?

Consider the following: You make a $10,000 contribution and are in the 22% tax bracket you "saved" $2,200 in current tax. After 30 years assuming 5% gain you have $43,220 and will pay $9,510 in taxes at the 22% rate leaving an after-tax net of $33,710.

A ROTH contribution of $8,800 (after-tax equivalent) growing at 5% for 30 years grows to $38,030 TAX-FREE. Schedule your tax planning strategy session today!

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Stocks

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

Stocks posted modest gains last week as investors digested the Goldilocks March jobs report and multiple inflation releases that showed easing price pressures. Combined, the data rekindled hopes for a soft economic landing, helping the S&P 500 advance 0.79% on the week and leaving the index up 7.77% YTD.

Equities gapped lower last Monday as investors digested the March jobs report, which was released the previous Friday (Good Friday) when markets were closed. An upward revision to the World Bank's 2023 global growth forecast and an increase to 4.7% (4.2% previously) in the NY Fed's one-year consumer inflation expectations weighed modestly on sentiment early but the S&P 500 held above Friday's lows and recovered to end the day with a gain of 0.10% as focus turned to CPI.

The market was almost perfectly unchanged on Tuesday as Chinese inflation undershot estimates while the IMF's 2023 global growth forecast was more cautious that the WB's, easing some hawkish central bank policy fears. Commentary out of the Fed's Williams was favorable as he downplayed systemic risks to the banking system while Goolsbee said the Fed needs to "exercise caution" with future rate hikes as trader attention increasingly zeroed in on Wednesday's CPI.

Stocks initially rallied Wednesday as a headline CPI was much cooler than expected but an uptick in the core figure kept the market from extending early gains. The Fed minutes release in the afternoon did not offer any material surprises, but oil prices broke out to new YTD highs in the wake of the CPI release and that prompted both the IEA and officials from the ECB to warn that higher oil prices would put upward pressure on inflation and stocks turned lower, with the S&P 500 down 0.41%.

On Thursday, both headline and core PPI figures posted monthly declines while jobless claims climbed higher adding to recently improving hopes that a hard landing would be avoided. The S&P 500 melted higher over the course of the day before settling within a few points of the psychological 4,150 level, up 1.33% on the day.

Stocks rallied to fresh two-month highs to start Friday, as big bank earnings came in better than expected and underscored resilience in the nation's financial sector while Core Retail Sales data were not as bad as feared. The UM Consumer Sentiment index included a hot one-yar inflation expectation number, which rose to 4.6% vs. (E) 3.7%, which poured some cold water on the rally. Comments from the Fed's Waller and Bostic resulted in rising odds of a May rate hike and that saw stocks turn lower. However, the S&P 500 rebounded to close with only a modest 0.21% loss on the session.

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Bottom Line

Markets started last week with hard landing and stagflation concerns but thanks mostly to the drop in CPI and PPI, those concerns eased and stocks logged a solid rally on the week. And to be sure, the restart of broad disinflation is a positive, as headline CPI and PPI both fell sharply, and numerous inflation indicators are now approaching pre-pandemic levels.

That drop in headline inflation readings emboldened investors who have embraced the "hike/pause/pivot/cut" Fed script that is the underpinning of this multi-week rally. However, what last week's data did not do is close the concerningly wide gap between those "hike/pause/pivot/cut" expectations, and the economic data and Fed speak reality that is directly refuting those expectations.

Now, to be fair, more times than not the market is right on Fed expectations, as the market is pricing in what it thinks will happen with the data while the Fed mostly speaks on what is happening right now. So it's wrong to say these market expectations for a hike/pause/pivot/cut are unreasonable, although I do obviously think they are aggressive and leave a lot of room for disappointment (and we saw a hint of that on Friday via the pop in inflation expectations, which is why stocks dropped).

To that point, we should all expect this Fed expectations pendulum to swing back and forth (between optimism and pessimism) over the coming months, as it has since the Fed started hiking in 2022. That's because we won't know if the hike/pause/pivot/cut thesis is right until we see core CPI and assess how deep the economic slowdown will be.

What we do know now is that the economy is slowing. The data we've seen in the past two weeks has been remarkably clear, including Friday's soft retail sales report. In uncertain markets such as this, it's helpful to find the clearest trend and follow it. Right now amidst Fed and inflation uncertainty, it is certain that the economy is slowing. The only questions are how quickly and how much does it slow.

However, if the current risks in the market persist, which include Fed expectations being incorrect (no pivot or cut), inflation staying too high, an economic hard landing, more banking stress, geopolitical flare ups, then more conservative positioning cushions portfolios from any steep decline (say more than 10%).

Bottom line, markets remain resilient and that matters, but that resiliency is based on this aggressive idea of a Fed hike/pause/pivot/cut strategy and an only gradual slowing of economic growth (not a hard landing). Those outcomes are possible, but the market remains aggressive in its expectations, and we continue to worry that leaves stocks open to near-term disappointment, and the possibility of a 5%-10% air-pocket, so we'd continue to use rallies like this one to ensure exposure and volatility are where everyone is comfortable, as at 4,200 the S&P 500 has priced in a lot of good "things" happening, and if they don't, stocks will drop.

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

Need-to-Know Economic Data from Last Week

A drop in key inflation metrics eased stagflation worries in the markets and boosted the idea of a looming Fed pause, pivot and cut later in the year, and that helped offset more disappointing economic data that implies economic growth is slowing.

Inflation was in focus last week and the data must be taken in the context of a market that wants to focus on anything that reinforces the Fed pause/pivot/cut narrative, and both CPI and PPI gave the market some hope. Headline CPI dropped sharply to 5.0%, below estimates of 5.2% and sharply lower than the 6% February reading. Similarly, PPI fell 2.7% from 3.0%, the lowest reading since early 2021. On a headline basis, both reports show disinflation (the decline in inflation) had restarted after stalling for February and March, and that's positive.

However, the more important parts of the inflation report, core CPI and core PPI, were less positive. Core CPI actually rose to 5.6% from 5.5% y/y, while core PPI rose 3.6% vs. (E) 3.1%. That matters, because it's well known what's pushed inflation stats lower over the past six months has been a drop in goods prices, as supply chains have normalized and commodity prices have eased. However, the key inflation statistic the Fed is watching remains services inflation, and so called "super core" inflation, which is core CPI minus housing, stayed buoyant and rose 0.4%.

Bottom line, if we were to look at last week's inflation data agnostically, it was a mixed bag, as clearly headline inflation is declining (a good thing), but the key parts of inflation that can make it so sticky, services inflation, remained buoyant. And while last week's data doesn't make a Fed hike and pause less likely in May, it doesn't make it that much more likely, either (and it does nothing to reinforce the hopes of two or three rate cuts later in 2023).

Looking at growth data, it clearly pointed to slowing economic growth. The key report was Friday's Retail Sales, and in March that fell -1% vs. (E) -0.4% and rose just 2.9% y/y vs. (E) 5.0%. The more important "control" group, which is retail sales less autos, gasoline and building supplies, declined -0.8% vs. (E) -0.3%, implying that consumer spending is starting to ease. Other data last week implied a similar message (slowing growth) as jobless claims ticked higher to 239k (low but moving higher) while the manufacturing sub index in the Industrial Production report declined -0.5% vs. (E) -0.1%.

Bottom line, last week's data implied a resumption in the decline in inflation and more slowing growth. Market bulls will see this as proof of an increased chance of a soft landing (and they may well be right and that's why stocks rallied). But it's also important to point out that the data last week did not reinforce the idea of looming Fed rate cuts, and as such there remains a wide gap between Fed and economic expectations, and the current reality.

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Important Economic Data This Week

This week's data will give us additional insight into the hard-landing/soft landing debate, as we will get the first set of data points from April and markets need to see stability in the data to ward off hard-landing worries.

The key report this week is Friday's flash composite PMIs, which are the first major data point for April. The March reading was 52.3 and markets will want to see stability in that data (a mild easing would be welcomed, but not a sharp drop off or jump). Prior to Friday's flash PMI, we'll get the first looks at regional manufacturing activity via the Empire Manufacturing Survey (today) and Philly Fed (Thursday). Empire took a dive in March at -24.1 while Philly wasn't far behind at -23.1, so a bounce back in both would be welcomed. On inflation, the price indices will be watched and declines are needed, because if the headlines are high this week and the price indices bounce back, it'll stoke stagflation concerns.

Finally, on Thursday we get jobless claims and thanks to the revisions of two weeks ago, the numbers are drifting higher towards 300k. A move towards or through 250k this week would be welcomed by the market as a normalizing labor market is needed for the Fed to meet the market's current pause/pivot/cut expectation.

Special Reports and Editorial

Market Multiple Table: April Update

The changes to this month's Market Multiple Table very clearly show how hope and expectations have driven stocks higher, as the improvement in the MMT in the past month didn't come from any "hard" data points, but instead from more subjective influences on the markets, namely the regional bank crisis and Fed rate expectations.

We saw improvement in both of those situations. First, there have been no more bank failures and some stability has returned to the regional banks, and that's a legitimate short-term improvement. Second, in reaction to the banking stress, the market has adopted dovish expectations for the Fed, including multiple rate cuts before year-end. Those two changes are the biggest and most positive in the MMT this month, and they explain why the S&P 500 is trading above 4,100.

However, I again want to stress those are subjective improvements. Yes, no more banks have failed, but there's no clear proof to tell us this crisis is over. And yes, the bank stress will likely make the Fed less hawkish, but the market's expectations for rate cuts stand in glaring contradiction to what the Fed is saying. Now, that doesn't mean these assumptions are necessarily incorrect, but I do want to point out they are subjective and not based on something concrete.

Looking at the more concrete market influences (inflation, labor market, economic growth) there was no real improvement. And in fact, there was mild deterioration over the past month although that could change later this morning if CPI comes in light.

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A Game of Multiples (Updated 4/11/2023)			
Market Influence	**Current Situation**	**Things Get Better If...**	**Things Get Worse If...**
Regional Bank Stress	No more banks have failed and there's relative stability in the industry, although stresses remain.	There continue to be no more bank failures and earnings commentary from banks is positive.	Stresses increase and another bank (FRC, PACW) fails, reintroducing financial crisis concerns.
Rate Hike Expectations	The market is pricing in one more hike (to 5.125%) and a year-end fed funds rate of 4.25%.	The Fed confirms just one more hike and hints at possible rate cuts later in 2023.	The Fed hikes 25 bps and leaves the door open to additional hikes.
Inflation	Headline CPI should start to decline but Core CPI will also have to drop to imply disinflation has restarted.	Core CPI falls below expectations and gets close to 5.0% y/y.	CPI is firm or higher than expectations, especially core CPI.
Labor Market	The March jobs report and other labor market indicators was "Just Right" and implied some small slowing of activity but not a collapse.	Labor market indicators gradually deteriorate, implying a return to normalcy in the labor market.	Labor market indicators bounce back from recent weakness, implying still-tight labor conditions (and wage inflation pressures).
Economic Growth	Economic data has started to point towards a "hard landing" although it's not definitive at this point.	Economic data remains stable and implies some slowing, but not a collapse.	Economic data rolls over further, increasing hard landing worries.
Expected 2023 S&P 500 EPS	**$225**	**$240**	**$215**
Multiple	16.5X-17.5X	17.5X-18.5X	15X-16X
S&P 500 Range	3,713-3,937	4,200-4,440	3,225-3,440
S&P 500 Target (Midpoint)	3,825	4,320	3,333
Change from today	-7.0%	5.1%	-19%

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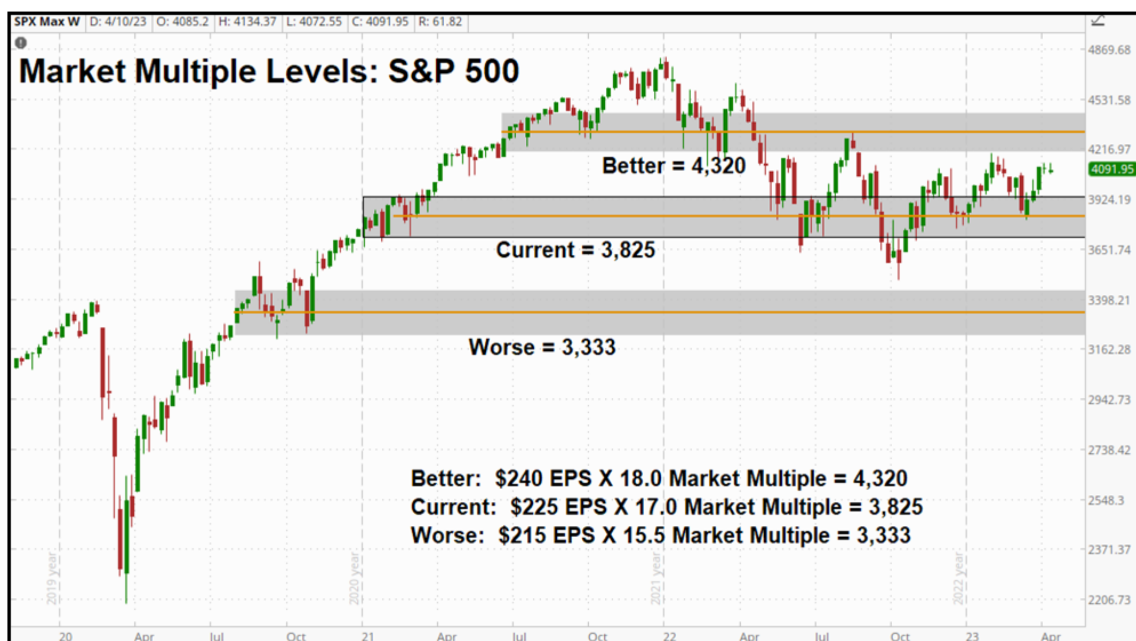
For now, the MMT very clearly illustrates a market that has rallied on expectations of good things happening in the future, while the actual events of the present have been, at best, neutral, if not mildly negative (as stagflation risk has risen).

Current Situation: Regional bank stability, dovish Fed expectations, still-elevated inflation, mild deterioration in the labor market and slowing growth. As mentioned, the current market environment largely reflects the divide between what the market thinks/wants to happen (stable banks and less-hawkish Fed) and what is actually happening (inflation sticky, growth slowing). As long as the market's "wants" come true, then current levels of the S&P 500 are justified. But if they do not come true, then markets are over their skis by at least 5%.

Things Get Better If: Regional bank stress subsides, the Fed confirms dovish expectations, Core CPI drops towards 5.0%, the labor market deteriorates and economic growth gradually moderates. This situation would confirm the market's positive hopes about the banks and the Fed, and add to it disinflation and a normalizing economy and labor market—and in effect deliver the soft landing everyone wants. In this environment, stocks should rally hard, and rightly so as multiples and earnings should rise. If this environment were confirmed it would signal the end of this bear market, as this environment is Goldilocks for stocks and bonds.



Things Get Worse If: Regional bank risks re-emerge, the Fed hikes 25 bps in May and signals more hikes are coming, Core CPI stays sticky or, ever worse, disinflation reverses and the labor market and economic growth remain resilient. This would truly be a worst-case scenario for stocks and it'd dash the hopes of investors that have underpinned the recent rally, and open up the possibility of a substantial decline in stocks. This environment would be stagflation with the added stress of regional bank failures with a Fed

powerless to help. 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 if contagion gets a lot worse. This is pretty much a nightmare scenario for stocks.

Bottom Line

As mentioned, the MMT clearly shows the rally in March in stocks and bonds has been driven by expectations, not actual hard improvement. That doesn't mean it's wrong (the expectations could be accurate) but it does leave this market open to disappointment, and on that disappointment a 5% air pocket in stock shouldn't surprise

Yield Curve Analysis "Policy Spread" Update

In December, we took a deep dive into the yield curve and analyzed just about every different combination of duration spreads between Treasury yields. It has become fairly common knowledge in the investment world that an inversion between the 10s-2s spread is a time-tested recession indicator, and even though some analysts and investors are declaring that "it's different this time," we are not in that camp and still expect a recession to occur in the months or quarters ahead. The biggest question for markets regarding the economy remains whether it is a shallow and relatively short-lived recession (soft landing) that markets are able to weather fairly well or a deep and painful one (hard landing) that results in sharp equity market losses and broader turmoil across financial markets. The answer to that question remains to be seen.

While we were doing our historical yield curve analysis, one interesting thing we discovered within the shorter duration end of the curve was that the spread between the 2-Year yield and the 3-Month yield consistently offered a signal of its own, not for a looming recession, but for Fed policy expectations. For that reason we refer to the 2Yr-3Month spread as the "policy spread."

The policy spread inverted back in December, at which point we first made you aware of the development. The 2Yr-3Month has since been falling deeper into inversion offering an increasingly convicted signal that rate cuts are indeed looming. Interestingly, the policy spread was on the brink of un-inverting in early March as it reached -1 basis point before the banking turmoil exploded. That sent the spread tumbling back to new cycle lows below -100 basis points. For reference, the policy spread never got much below -60 basis points in 2007/2008 and bottomed at an even -100 bps in early 2001. Yesterday, the 2Yr-3Month fell to a new cycle low of -114 basis points, which was also a record low in our data set looking back to 1995.

Looking at history, it is possible for the policy spread to remain inverted for over a year before the Fed cuts rates. But typically we found that it was a matter of months, more precisely between one and nine months before the Fed began cutting rates. As is the case with the rest of the curve, when the duration spreads start to steepen materially back towards positive territory, things are likely about to get ugly for the economy or the financial system, or both. As such, we will continue to look for a sharp move higher in the policy spread indicating a market that is anticipating aggressive rate cuts.

Jim Noble

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Quote of the week:

“Be kind whenever possible. It is always possible.” —The 14th Dalai Lama.

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