James K. Noble CFP® CLU®

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What's in this week's Report:

- Is Conflicting Data Signaling a Shift in the Economy?
- Weekly Market Preview: Earnings Take Center Stage (Lots of Key Reports This Week)
- Weekly Economic Cheat Sheet: Is Disinflation Continuing? (Key Inflation Stats on Friday)
- Why Won't Stocks Drop Part I: Sentiment
- Why Won't Stocks Drop Part II: The Economy
- VIX Just Hit a 52-Week Low: What That Means for Stocks
- The Debt Ceiling Is Now Starting to Impact Markets

Futures are slightly lower following a quiet weekend of news as markets look ahead to key earnings reports and economic data this week.

Economically, the only notable report was German IFO Business Expectations, which slightly beat estimates.

Debt ceiling headlines will increase this week as Republicans try to pass a debt ceiling bill, and if it fails to pass that will increase debt ceiling anxiety in the markets.

Today there is only one economic report, Chicago Fed National Activity Index (E: -0.02), and barring a major surprise that shouldn't move markets.

Focus then will be on earnings, and especially the First Republic results after the close (estimates are $0.72/share). Markets will want to see stability from what's viewed as one of the most vulnerable regional banks. Other notable earnings today also include KO ($0.65) and WHR ($2.44) which will give us insight into consumer spending.

Market	Level	Change	% Change
S&P 500 Futures	4,154.75	-2.00	-0.05%
U.S. Dollar (DXY)	101.6260	-0.1960	-0.19
Gold	1,993.00	2.50	0.13%
WTI	77.58	-0.29	-0.37%
10 Year	3.536%	-0.036	-1.02%

Planning Corner

The Debt Ceiling is upon us again, seemingly to re-enact the battle of wills in 2011 and again, briefly in 2013. If you do not remember these events or look at this as political theater you may wish to re-visit this period of history with a new perspective.

Let's first explore the first Debt Debacle from 2011. When the government began using "extraordinary measures" to continue to pay its bills on May 16 until the agreement was reached on August 2 the S&P 5oo declined -6%. In addition Standard & Poors downgraded U.S. sovereign debt on notch from AAA.

Virtually all of the pundits will tell you that is unthinkable the U.S. would ever default on its debt. That does not preclude the brinksmanship politics that exacerbate market uncertainty.

In the long run these pockets of volatility blend together as we see them in the rear view mirror, but the threat to the current market should not be discounted.

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Stocks

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

Stocks largely churned sideways last week as investors assessed Q1 earnings reports, mixed economic data, and a still-hawkish tone from Fed officials. The S&P 500 dipped 0.10% on the week and is up 7.66% YTD.

Equities began the week with an early rally last Monday thanks to a very strong Empire State Manufacturing release, but subsequent hawkish money flows saw the market begin to retreat over the course of the day as 2-Year yields tested one-month highs. A notable drop in oil prices helped ease inflation concerns after the Nymex close and the S&P 500 squeezed up to session highs, ending with a modest gain of 0.33%.

Equities gapped up to fresh two-month highs on Tuesday morning after strong Chinese Retail Sales data helped Q1 GDP handily top estimates, however hawkish Fed speak from St. Louis Fed President Bullard, who discussed a terminal rate upwards of 5.75%, poured cold water on the rally and sent yields higher. The S&P 500 stabilized into the afternoon and churned sideways to eke out a modest gain of 0.09%.

Hawkish money flows continued on Wednesday after more elevated inflation data out of Europe and that weighed on stocks in early trade. But strong components to MS's Q1 earnings and a profit-beat by IBM helped sentiment improve. The Fed's Beige Book release in the afternoon carried a more cautious tone and some of the hawkish money flows eased allowing the S&P 500 to rebound back towards 4,150, a level that the index closed within 5 points of for a third day in a row with an incremental loss of 0.01%.

Stocks came for sale Thursday as earnings and guidance from several big "tech-focused" companies including TSLA, NOK, FFIV, and TSMC weighed on the broader market. AXP's bad loan reserves also came in more than 10% above estimates, raising concerns about the health of the U.S. consumer and T's free cash flow came in at just 1/3rd of estimates, which sent the stock down 10%. Economic data was mostly disappointing with the Philly Fed Survey falling to the lowest levels since the depths of the pandemic while jobless claims topped estimates. That helped stocks recover into the afternoon, but the market came for sale again on hawkish comments from the Fed's Mester and the S&P 500 ended down 0.60%.

The market was choppy and volatile in morning trade Friday as investors digested a relatively solid Composite PMI Flash in the U.S., which largely tracked the good PMI data points in Europe from the pre-market. Yields turned higher and stocks dropped to new lows for the week before the sideways price action that dominated markets all week resumed into the middle of the day. The S&P 500 ended higher by 0.09%, and near session highs.

Is Conflicting Data Signaling a Shift in the Economy?

The number of mixed signals in this market has been elevated since the pandemic, but it's gotten worse over the past few weeks (and especially last week). It's almost as if the same data is looking at two different economies. Certain reports imply solid growth (Empire and Flash PMIs), while others signal a sharp slowdown is occurring (Philly and leading indicators). Some earnings commentary talks about a resilient economy

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(materials companies such as NUE), while others warn of a looming intense slowdown (CDW). Headline inflation is falling, but core inflation is stable (if not rising). Fed officials are committed to hiking rates in May and are openly saying there will be no cuts this year, yet the market has two to three cuts priced in.

In my experience, this level of divergence in the data and other reliable market indicators usually comes at a "turn" in the economy (or markets). Some reports are looking at the current economy (fine growth) while others are looking at the coming economy (slowing growth). And since this economy is still solidly in growth mode, my concern remains the "turn" will be towards no growth (or more likely) a contraction.

Now, that concern aside, the resilient nature of stocks must still be respected. There was a lot of potentially negative news last week, yet markets only modestly declined. Again, we think bearish sentiment, hope for Fed rate cuts and hope for a soft landing are supporting the market, and while we are concerned that won't last, for now it must be respected.

Bottom line, the conflicting signals from data, earnings, Fed speak, inflation, etc. only reinforce our concern the economy is "turning," and as such we continue to want to be positioned for slower growth ahead. And if the soft landing happens and we get "immaculate disinflation" (dropping inflation without any economic slowdown) then we're still long equities, and while they might relatively lag, they'll still rally with the market.

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

Need-to-Know Economic Data from Last Week

Economic data last week provided fodder for both the bulls and the bears, with three notable reports last week. One was very bad (hard landing), one was surprisingly good (soft landing) and one was in the middle! Starting with the most important report from last week, the April flash composite PMI, it beat expectations as the composite PMI stayed above 50, rising to 53.5 vs. (E) 52.8 while the manufacturing and services sub-indices were also above 50 and hear expectations at 50.4 and 53.7 respectively. That headline is positive, as it implies the economy is quickly losing momentum, but at the same time isn't running "Too Hot." However, along with better growth came an uptick in inflation, as all the price indices rose by solid amounts (about four points), and if that's accurate, then the "hike/pause/pivot/cut" script will come under attack in the coming weeks.

Turning to the regional manufacturing surveys (Empire and Philly), they provided conflicting signals. Empire Manufacturing (which covers the New York/tri-state area) saw a large rebound while Philly Fed (the mid-Atlantic region) saw extreme weakness. To that point, Empire manufacturing surged to 10.8 vs. (E) -18.4 for the first positive reading since November. New Orders were also impressive, jumping to 25.7 vs. the previous -21.7. As mentioned, Philly Fed showed the total opposite, as the headline plunged to -31.3, the worst reading since March 2009 (ignoring the pandemic spike low). New Orders were still solidly negative

at -22 vs. the previous -28. Now, these are volatile readings, but this level of disagreement is very unusual, and a sign the economy is in flux.

The one area of agreement in the two manufacturing surveys was in prices, which showed solid declines (which is in contradiction to the national flash PMI). Prices Paid fell to 33 from 41.9 in Empire and plunged to 8.2 from 23.5 in Philly. Prices Received collapsed to -3.3 in Philly from 7.9, while they edged up slightly in Empire to 23.7 from 22.9. The price indices do show a retreat in prices, which is a positive. The key then is which growth survey is right. If Empire is right, it's a soft landing (and higher asset prices). If Philly is right, it's a hard landing (sharply lower prices ahead).

Conflicting data is to be expected ahead of any significant "turn" in the economy (for better or for worse). And we should brace for more conflicting data in the weeks ahead as the economy absorbs the impact of last year's dramatic rate hikes. The key during volatile times like this is to not get too hung up on any one month's data, and instead focus on the trend, and the trend is clear: The U.S. economy is losing momentum. How much it loses remains to be seen, but growth is slowing, it's just a question of by how much.

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

Next week is the next big week of economic data as it contains the "big three" monthly economic reports (ISM manufacturing PMI, services PMI and jobs report), but there are still some notable inflation and growth reports this week that will shed more light on the state of inflation and growth.

The key report this week is the Core PCE Price Index, which is released on Friday. The most important development in the inflation data this month has been the emerging gap between headline inflation, which is falling quickly, and core inflation, which is staying buoyant (and in some cases, rising). So, for Friday's data, the key will very much be the Core PCE Price Index. That's the Fed preferred measure of inflation, and if the Fed is going to meet the "hike/pause/pivot/cut" market expectations, we need to see that core PCE Price Index stay flat a minimum (so 4.6% y/y), and ideally drop (at or below 4.5% y/y).

Turning to growth, the notable data this week comes Wednesday and Thursday via the Durable Goods report (Wed), Advanced Q1 GDP (Thurs) and jobless claims. Starting with Durables, we've seen some slight weakness in business spending and investment lately, and it'll be interesting to see if businesses are further curtailing large expenditures amidst future economic uncertainty. If we see a big drop in Durable Goods spending, that's likely a sign companies are bracing for a slowdown. Turing to GDP, this will be the first look at Q1 growth and markets are expecting around 2.0% growth, and if the number misses that estimate it'll increase hard landing chatter (although as we and others have said many times, GDP isn't a particularly useful statistic for investing purposes, although the financial media watches it and so must we). Finally, on jobless claims, they are ticking higher and if we see a further move above 250k and towards 300k that will signal some deterioration in the labor market (which investors should embrace as it'll help the Fed pause after the May rate hike).

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For all the noise in the markets, hard landing vs. soft landing remains the key question for stocks and bonds. And while next week is a big week for data, there are important updates coming in the next few days that will shed further light on the state of inflation and growth.

Special Reports and Editorial

Why Won't Stocks Drop Part I: Sentiment

Stocks have proven very resilient so far in 2023, as the S&P 500 is decidedly positive for the year despite multiple additional Fed rate hikes, a stall in disinflation in February, zero geopolitical progress (and even some deterioration with U.S./China relations on the lows) and the biggest bank failures since the financial crisis. And while anticipation of the Fed's "hike/pause/pivot/cut" is a major factor in these resilient markets, sentiment has also played an important role, because so many people came in 2023 bearish and the lack of a market decline is creating a reversal of that opinion and supporting stocks.

To that point, long-term readers of this publication will recognize the term "pain trade." That's a trading term used to explain this simple truth: The goal of the market is to extract the most amount of pain from the greatest number of people. Practically, that means when everyone's bullish, the pain trade is lower. When everyone is bearish, the pain trade is higher. As such, the pain trade has been higher for all of 2023 and that's helping support stocks despite decidedly mixed fundamentals (and mixed is being generous).

Identifying the direction of the pain trade is best done by watching markets every day, but popular sentiment indicators can offer insight into the direction of the pain trade. Case in point, at the start of the year, major sentiment indicators (we watch the Fear/Greed index, AAII Investor Sentiment and Investors Intelligence Advisor Sentiment Index) were pointing towards very pessimistic outlooks.

	1 week ago	1 month ago	1 year ago
CNN Fear/Greed Index	58	28	39
AAII Bulls/Bears Sentiment Index	-2%	-28%	-32%
Investors Intelligence Advisor Sentiment	24.40%	12.50%	-10%

But that general caution became supercharged into outright bearishness following the bank failures in mid-March. One month ago, the CNN Fear/Greed Index was at 28, which put it deeply in the "Fear" category and only three points away from "Extreme Fear." The AAII Bulls/Bears Sentiment Index was -28%, a reading so negative it's usually a buying signal. Finally, the Investors Intelligence Advisor Sentiment Survey was just 12.5%, not an outright bearish signal but one that clearly signaled caution. That wide expectation of looming calamity, and the fact that it hasn't come to fruition yet, has been a material contributor to equity resilience, because it's made the pain trade higher as investors waiting for a decline that never occurred, and who are now chasing stocks higher as they remain resilient.

However, recently sentiment has turned much more positive, and that implies the pain trade may be

starting to turn lower. The CNN Fear/Greed Index registered 58 most recently, a reading very solidly in the "Greed" category. The AAII Bulls/Bears Sentiment index was -8.4%, still exhibiting caution but much more of a "neutral" stance, while the advisor Bulls/Bears ratio rose to 24.4, very close to the 30 reading that implies a pullback is becoming likely.

Bottom line, sentiment matters in the near term, and extreme bearish sentiment following the banking failures has helped this stock rally continue. However, sentiment has improved substantially. So while we're not yet at levels I'd consider a caution signal, we're not very far away, either. Going forward we'll be watching sentiment indicators closely, especially the AAII Bulls/Bears Sentiment Index and the Investors Intelligence Bulls/Bears ratios as both are close to levels that would imply the "pain trade" is turning back lower.

Why Won't Stocks Drop Part II: The Economy

Future economic uncertainty is keeping stocks resilient.

Now, it may seem odd to say that "economic uncertainty" would be something that's supporting stocks, as it's usually the opposite. But the uncertainty I'm referring to has to do with how bad the coming economic slowdown will be, because this is a unique time and if ever there's been a legitimate chance for a very mild recession, it's now, and it's all because of the pandemic stimulus and tight jobs market.

To illustrate this, I first want to revisit the last two material economic slowdowns that have caused bear markets: The tech bubble burst of 2000 and the housing crisis of 2007. In both instances, there were asset bubbles that temporarily inflated people's wealth, as the value of the stock market and home prices respectively created paper gains and gave birth to new industries to support these bubbles.

But when the bubbles burst, two things happened. First, the fledgling industries that were created to support the bubbles were destroyed, resulting in a large jump in unemployment (which is obviously bad for economic growth). Second, the paper wealth that helped fuel consumer spending was erased, as the value of people's stocks and home prices collapsed, essentially destroying a lot of their net worth and resulting in a drop in economic activity. However, none of that has happened this time.

The post-pandemic economic expansion was not driven by an asset bubble that ultimately collapsed. It was driven by government directives that essentially prevented people from spending money on discretionary items, while at the same time literally unleashing a tidal wave of actual cash on the economy via direct stimulus payments or PPP loans that ended up being direct stimulus. Consider...

· The S&P 500 is up 25% from January 2020.

· The Case-Shiller National Home Price Index is up 38.12% from January 2020.

· Wages (found in the Employment Report) have risen 53.5% since January 2020.

· Pandemic stimulus across 476 million payments totaled more than $814 billion deposits into

consumers accounts.

· According to a Yahoo Finance article, 90% of the $770 billion PPP loans have been completely or partially forgiven, injecting additional stimulus into the economy.

What makes this so different is that the cash the government handed out won't collapse in value like tech stocks did in 2000 or houses did in 2007. There's no bubble burst (yet) that's weighing on the economy, because in the end the "wealth creating event" in this cycle wasn't asset appreciation, it was literally money mailed to the populous—and they don't have to give it back (in the vast majority of cases).

Let me put it a different, more personal way. In your social circle, do you know anyone who is worse off financially today than they were before the pandemic? I'll guess the vast majority of the answers to that question is "no."

Unlike the tech stock bubble or housing bubble, this stimulus didn't lose value. It was money that's either been saved or spent. That's what makes this different from 2000 and 2007, and it's why there's a legitimate argument that even despite such aggressive Fed rate hikes, economic growth might not slow as much as one would expect. Now, a few caveats to these points.

First, I appreciate that there have been some economic losers since the pandemic. Inflation is a long-term wealth destroyer, and it's particularly hard on low-income people. Additionally, young people have been quasi left behind, because surging inflation has left many of them unable to afford first homes and saddled them with massive college or auto debt. So, I'm not trying to imply everyone's better off. But from a macroeconomic standpoint, the most productive contributors to the economy (middle-aged people) are better off than before the pandemic, and that's why there's so much uncertainty regarding how bad the slowdown will be.

Second, as you can guess, I'm skeptical that we will avoid a material economic slowdown, mostly because of signals in the bond market. I think that the laws of economics, which say dramatic rate increases lead to real recessions, are still valid. However, I do think the massive pandemic stimulus has succeeded in delaying that slowdown, simply because consumers have more money to work through before they change behavior. It'll only be when that behavior changes that we'll see unemployment rise, and that's when the real slowdown will begin (I believe we've started that process).

Additionally, I think there remains the risk of a bubble bursting in the fixed income space and that's more because of the speed of the rate hikes than anything else. From a high level, giving banks and the financial sector essentially free money for over a decade, and then jacking rates to levels last seen in the 1990s in less than 10 months, will likely result in financial stress and I think we've seen the beginnings of that via SVB and SBNY. I would also be very, very surprised if they were the only two banks that have trouble in the end, although to be clear, I don't think the stress will be as bad as the financial crisis. However, keep in mind there were nearly six months of relative calm between Bear

Stearns and Lehman, so things can fester under the surface for a while.

Bottom line, the bond market and my experience tell me that Fed rate hikes end up causing a meaningful economic slowdown (how bad remains to be seen), but I do think the historic injection of stimulus has delayed the onset and does cloud what would otherwise be a straightforward outcome (rate hikes = recession). Until we get more compelling data that the economy is materially slowing, we can expect investors to remain optimistic about a "shallow" recession or soft landing.

VIX Just Hit a 52-Week Low: What That Means for Stocks

We have been discussing the CBOE Volatility Index, or VIX, more frequently over the last 12 months because certain dynamics of the typically inverse relationship between the market's "fear gauge" and the S&P 500 changed.

We noted in the early innings of the 2022 bear market that the lower lows in the S&P 500 were no longer coinciding with higher highs in the VIX. Lower stock prices and a higher VIX is a relationship that is typical in bull market conditions as hedging activity picks up meaningfully when stocks are driven lower by short-selling speculators (typically these are short-lived, headline-driven pullbacks, hence the use of options as a hedge and not liquidation by institutional money).

The most logical reason behind the change in market dynamics in early 2022 was that institutional investors, who typically employ more sophisticated hedging strategies that include options, started selling their long-time-horizon equity holdings and simultaneously began to abandon their associated hedges as they were no longer needed.

As a refresher, the VIX is calculated with inputs from options prices on the S&P 500, so *ceteris paribus*, more bids in the options market would mean a higher VIX while more supply, or offers in the options markets, would mean a lower VIX. The institutional selling of options hedges was most likely responsible for the sluggish price action in the widely followed but often misunderstood VIX in 2022.

Fast forward to last week, and the VIX is trading at the lowest levels since the S&P 500 hit its standing all-time high in the early days of 2022 (just over 4,818). So we took a dive back into history to further analyze how the VIX performed in market conditions similar to today. Here is what we found.

The single, most-dominant market dynamic right now is the deeply inverted yield curve, so we looked back to periods in history when the yield curve was inverted, the economy was on the brink of, or actually in, a recession, and stocks were either in, or falling into, a bear market. Since the VIX was first published in real time in 1993, we are only left with three examples to work with but the findings are importantly consistent over all three.

In early 2000, the 10s-2s yield curve spread inverted and later that year stocks began to meaningfully rollover as the dot-com bubble began to burst. The VIX was volatile over this period but importantly

hit 52-week lows in March 2002, just like we saw this VIX do this week. It wasn't until the VIX became "overbought" on the weekly time frame, via an RSI reading over 70 in July 2002 that the S&P 500 began the bottoming process, putting in cycle lows later that year.

In early 2005, the 10s-2s again inverted and it remained in backwardation through early 2007. In late 2006, the VIX hit a fresh 52-week low. In the following quarters, the VIX became "overbought" twice on the weekly time frame, the first time in summer 2007 when stocks were near the record highs, and the second in late 2008, just months before the market found a bottom from the GFC turmoil in March 2009.

The 10s-2s briefly inverted in 2019 ahead of the short-lived but historically deep Covid-19 pandemic recession. In November 2019, the VIX closed at a new 52-week low. The VIX became overbought in January on its way to new highs and again in March as the stock market was on the brink of putting in a bottom for the historic year that was 2020.

Today, we are looking at the yield curve hovering just above its deepest inversion since the early 1980s while the VIX is sitting on fresh 52-week lows and obviously nowhere near overbought levels on the weekly time frame, a development that preceded all three of the major market bottoms in the "VIX era" of market history. That suggests we remain in a "calm before the storm" holding period and until we see the VIX reach overbought territory on the weekly chart (via the RSI indicator), among multiple other developments of course, it will be hard to believe the market is poised to casually cruise towards new record highs from here (i.e. the bottom of this bear market is not in).

<u>The Debt Ceiling Is Now Starting to Impact Markets</u>

We have not covered the looming debt ceiling battle in Washington simply because it was too far away, and more pressing issues such as disinflation, economic growth and Fed rate hike expectations were the main drivers of markets. However, that's starting to change as the looming debt ceiling battle is now beginning to impact markets.

We can see that via recent movement in the 1-month and 3-month Treasury bill yields. For background, currently the market expects the debt ceiling to be reached sometime in June. That's between a 1-month Treasury (which redeems in May) and a 3-month Treasury (which expires in July, after the debt ceiling will have been reached).

Since April 3, we've seen the yield on the 1-month Treasury bill fall from 4.7% to 3.9%, as investors have shunned near-term Treasury bills that might get caught up in the debt ceiling fight. Conversely, the 3-month Treasury bill yield has risen from 4.9% to 5.2% since April 3, as investors have sold that debt as it will be subject to potential increased volatility as the debt ceiling fight comes to a head.

Neither one of these moves are material at the moment, but they are a sign that the debt ceiling is coming into the market's view, and if past is prologue that will inject some substantial short-term

volatility into the markets. Rest assured we will be covering the debt ceiling battle as it heats up, so we can best navigate any volatility and keep a clear distinction between short-term Washington gamesmanship, and any potential long-term damage to portfolios.

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Quote of the week:

"To believe yourself brave is to be brave; it is the one only essential thing." —Personal Recollections of Joan of Arc

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