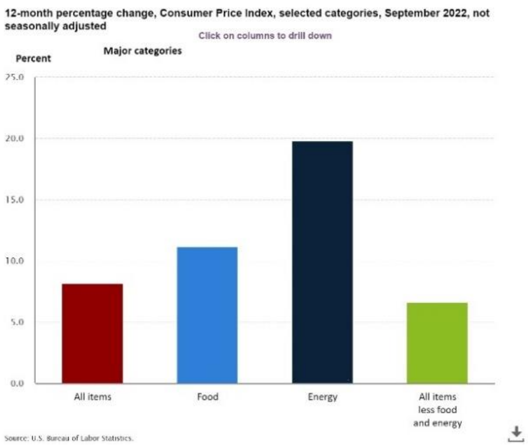
Courier Capital, LLC
Registered Investment Adviser
An affiliate of Five Star Bank

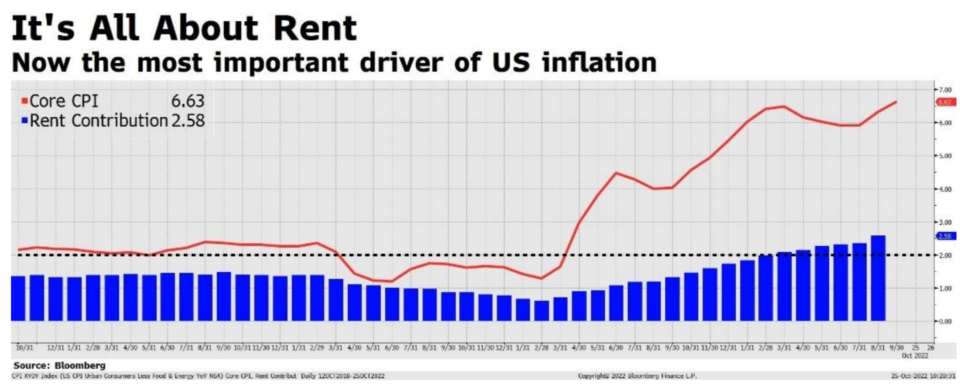
Economic and Market Update – A WAITING GAME (10/31/2022)

Latest Developments and Economics

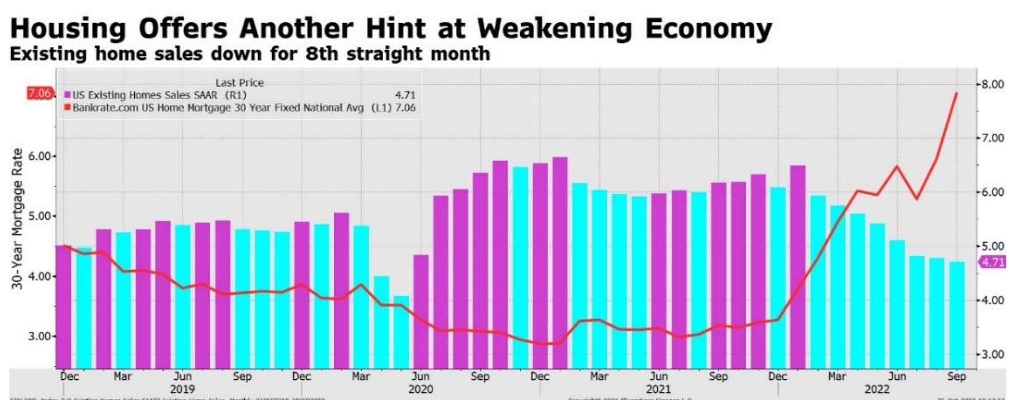
The developments in October did not do much to determine a direction of the economy so we remain in a waiting game. We are waiting for inflation to start to cool. We are waiting to see when the Federal Reserve comes off their torrid pace of interest rate increases. We are waiting to see how the economy responds. We are waiting to see the results of the mid-term elections. Finally, we are waiting to see the developments in geopolitical events – especially the war in the Ukraine.



Inflation remains persistent with a Consumer Price Index (CPI) reading of 8.2% over the last 12 months. Energy at 19.8% and Food at 11.2% were major contributors to the headline number. The remaining items (shelter, apparel, commodities) increased about 6.6% while transportation services increased 14.6%. The high level was confirmed with the PCE measure of inflation increasing 6.2% and core PCE 5.1%.



Shelter, which makes up almost a third of CPI, has been a significant contributor to the inflation readings. That is one area of the economy which has slowed significantly.



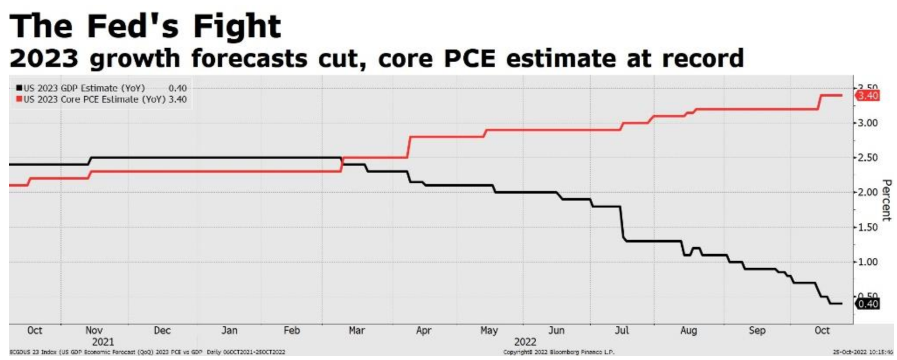
As mortgage rates have increased home sales were quick to decline. Mortgage rates for a typical 30-year fixed-rate at the beginning of 2022 were about 3.25% while 10 months later they are over 7.0% (highest rate since April 2002). Pending sales of existing homes fell 10.2% in September and over 30% year-over-year. As a result, average home prices are coming down. They are down 2.4% from June to August but still up 13.1% over the last year and up 42% since the beginning of the pandemic. While the decline isn't great for homeowners it is good news for starting to bring down the rate of inflation.

In energy OPEC announced a DECLINE in oil production of 2 million barrels per day. While not helping with energy price declines, the announcement may not be as impactful on pricing as it seems since OPEN was not meeting production goals before that announcement. Oil prices in financial markets did not move much on the news.

Even though housing is declining rapidly jobs and consumers remain strong. The labor market is still tight with 10 million jobs open and wages continue to increase. Compensation costs went up 5.0% from September 2021 to September 2022. Worker increases remain below inflation, but the increase is hitting corporate bottom lines. Moreover, the consumer continues to spend.

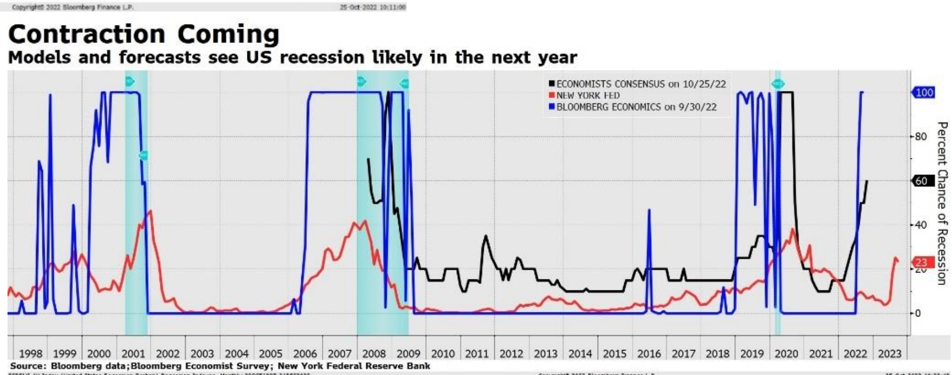
Retails sales did decline recently but only marginally and, when you consider inflation, people are still spending more. Given the pace of interest rate increases it was expected that consumer spending, outside of housing, would fall quicker. This has led Brian Moynihan, CEO of Bank of America, to comment about consumer spending that "You're seeing a mitigation in the rate of growth, not a slowdown. Not negative growth."

Finally, the first read on Q3 GDP was 2.6% annualized rate. That is the first positive reading this year (after -0.6% and -1.6% for Q1 and Q2) and puts the U.S. economy about flat for the year. The growth came from a one-time narrowing of the trade deficit (exports) by 2.7%, which is not expected to repeat. A strong reading would be bad news for inflation but, looking behind the headline number still shows a U.S. economy which is slowing and should contribute to bringing down the rate of inflation. This leaves the Fed in a tight spot – they feel the need to continue to raise interest rates to slow the economy and inflation and the result is the that estimated growth rate of the economy continues to decline.

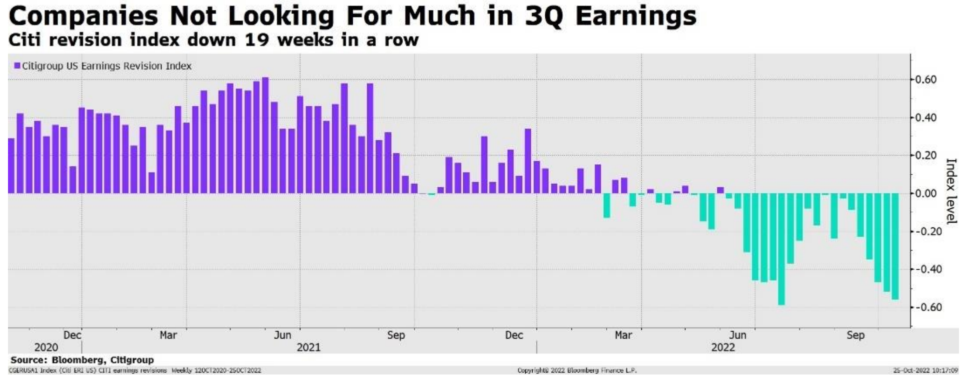


It is fully expected that the Fed will continue with a sixth consecutive rate increase in early November and the fourth in a row of 0.75%. This will bring the upper end of the range to 4.00%. There is one more meeting this year in December with expectations of either 0.75% or 0.50%. Even the lower rate would put us at 4.50% and the market expects a terminal rate of about 5.0%. If true, this would mean that most of the rate increases are behind us after December, but they could stay high until inflation is considered beaten.

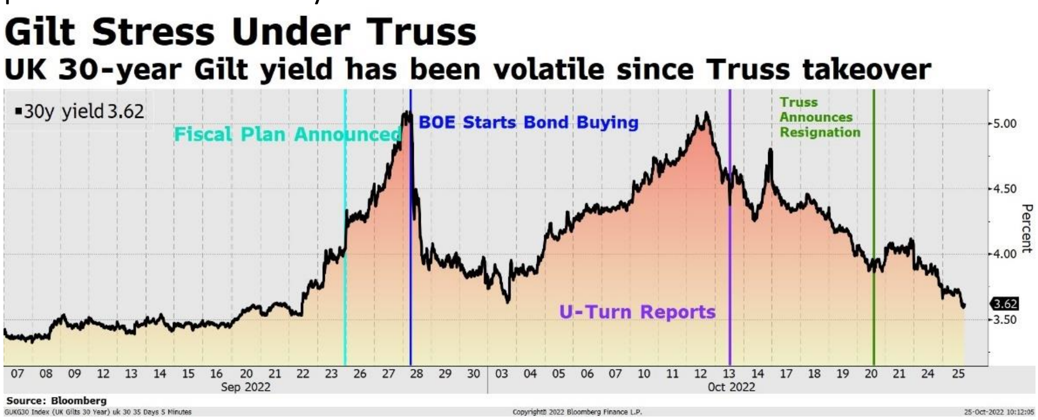
While news on the inflation front and interest rate outlook seems promising the chance of a U.S. recession in 2023 still looms. The underlying economic demand in the latest GDP data was weak.



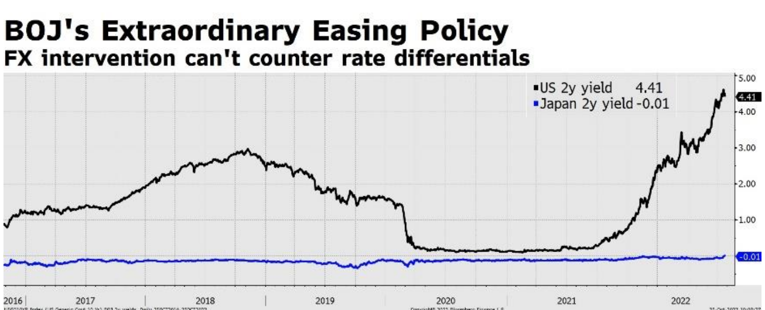
One other concern is the impact of inflation and a strong dollar on company earnings. So far, the Q3 earnings have been rather mixed with energy and financials performing well but technology companies having issues with Amazon, Microsoft, Meta and Alphabet (Google) all missing revenue and profit estimates. Net profitability of S&P 500 companies continues to fall and could be in store for a fifth consecutive decline. This assumes a quarterly profit margin of 12.0%, which is still higher than the five-year average of 11.3%. Earnings estimates are following the latest trend and are falling commensurately.



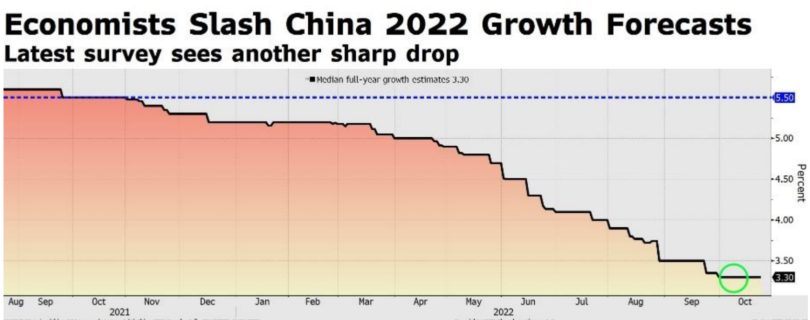
There have been more significant developments on the international front. First, the U.K. is still working to stabilize. The economic turmoil initiated by Prime Minister Liz Truss's plan to stimulate the economy with tax cuts while inflation was at multi-decade highs came to an end with her resignation. Her plan was for a 45 billion-pound tax cut over five years. This caused a massive sell-off in U.K. assets and dropped the British pound to $1.03 – the lowest value ever against the U.S. dollar. In addition, the turmoil in the government bonds (Gilts) caused the Bank of England to step in and purchase British government bonds to the tune of 65 Billion pounds to stabilize interest rates. The resignation came despite the reversal of her tax plan and the firing of her Finance Minister, Kwasi Kwarteng, after support from her party collapsed. Her resignation after 45 days makes her the shortest-serving Prime Minister in British history. In a relatively smooth transition Rishi Sunak was elected to take over the Prime Minister position after other potential candidates dropped out. Sunak did run against Truss and warned about her economic plan. He was a former hedge fund manager and his election seems to have settled markets.



In Japan the central bank elected to keep interest rates where they are currently. Their 10-year yield is capped at 0.25%. While most developed economy central banks are raising rates to fight inflation Japanese rates have remained low. The differential between interest rates in Japan versus the rest of the developed world has wreaked havoc on the Yen. It now takes about 150 Yen to purchase 1 US Dollar – an exchange rate not seen since 1987. In turn Japanese officials have confirmed that they have acted to support the Yen by spending $19.7 billion to purchase Yen-denominated assets. Pressure is on Japanese policy-makers to raise interest rates or risk further devaluation of the currency.

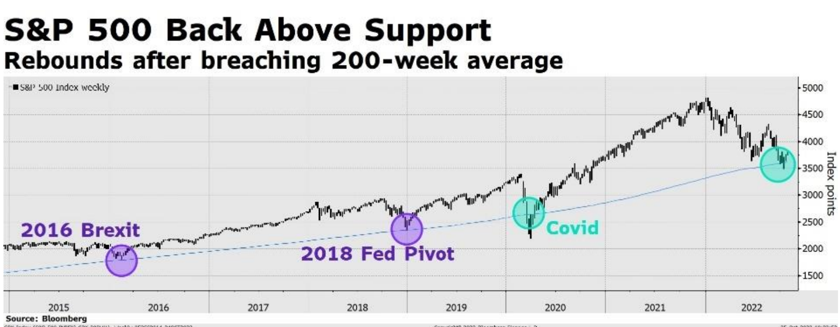


Despite the slowest economy in decades, China's communist leader Xi Jinping solidified his power at the 20th Communist Party Congress by installing himself as leader to a third five-year term – beyond the standard precedent of 10 years – and left himself with no apparent successor. Turning away from collective leadership of party elites Xi consolidated his power even further as he named loyalists to the central party and had the ex-leader Hu Jintao unceremoniously escorted from the stage. The conference results signaled a significant shift in recent Chinese policies and goals, and markets took note with Chinese stocks declining the most since 2008. It seems going forward that there will be less emphasis on Chinese economic development and openness to the world. The turn seems more inward with priorities on security, common prosperity and global dominance. He has stated his goal to make China a modern Socialist power by 2035 and lead the world in terms of "composite national strength and international influence" by 2049 (the 100th anniversary of the People's Republic of China) as an alternative to the U.S.-led West. How he gets there will be problematic – growth is slowing, and economic globalization is being called into question. China's GDP fell to 3.3% last quarter and the continued political and possible military opposition to the West will also make the path forward bumpy. With falling GDP growth, the Chinese economy taking over the U.S. is estimated to be delayed to the second half of this century.



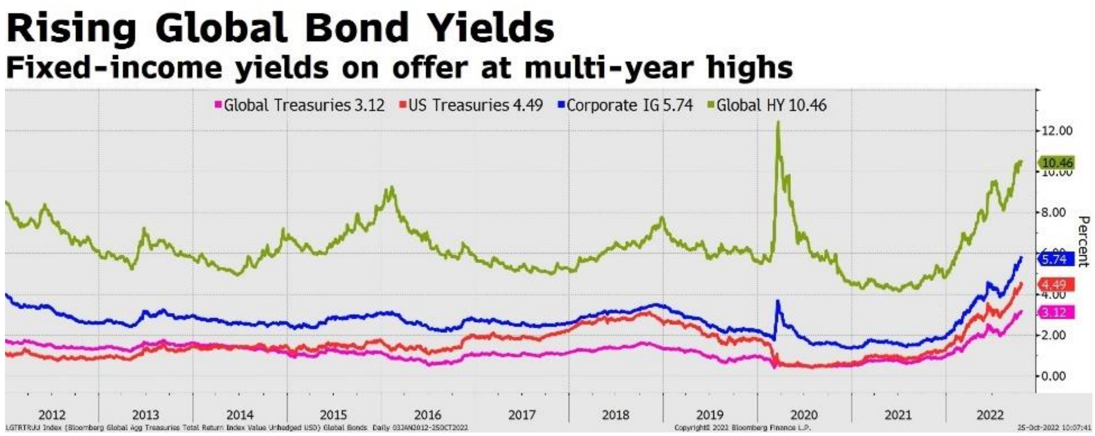
Finally, nothing too different on the Russia-Ukraine front. Putin has called up 300,000 draft inductees and is sending 82,000 to the front to turn the tide from recent Ukrainian victories. Already causing problems in the energy markets Russia has now ended cooperation in grain shipments which will affect food stocks.

Financial Markets

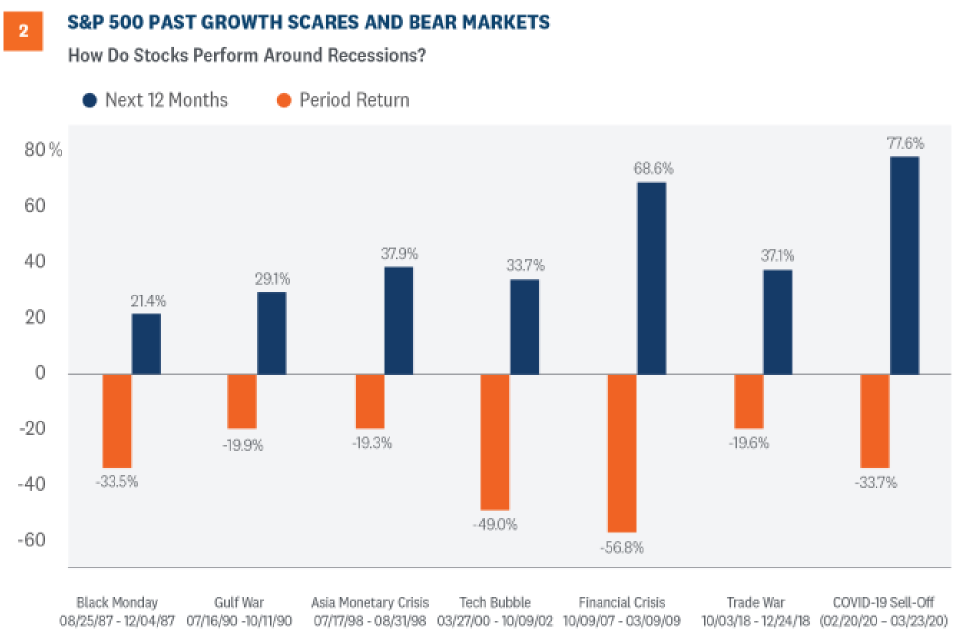


It may have not felt like it due to the volatility, but the markets performed well in October. The S&P 500 returned over 8.0% during the month, reducing the year-to-date decline to 17.7%. The narrower Dow Jones Industrial Average had its best month since 1976, returning just above 14.0%. Shrugging off generally rough earnings reports from some of the big technology companies even the tech-heavy NASDAQ 100 managed to eek out a gain for the month despite disappointing earnings reports from Meta (Facebook), Google and Microsoft. From a U.S. sector perspective Energy continues to be the runaway winner this year and the only positive sector. Consumer Staples follows with the smallest loss this year of 3.9%. International equites of developed economies also were positive for the month, but Emerging Markets posted further losses given the weakness in China discussed above.

The key question is if the returns we saw in October were based on fundamentals or more hope that the Federal Reserve is going to slow the pace of interest rates hikes sooner than expected.



We are now in a period where most developed central banks are raising rates (except Japan as noted above) so global yields are on the rise. The European Central Bank raised rates 0.75% again, matching the Federal Reserve in magnitude. This has resulted in U.S. treasury yields with maturities greater than 1 month to all be over a 4.0%. This pace of rate increases has caused most fixed income returns to be negative for October adding to 2022 losses. Leveraged Loans and High Yield bucked the trend for the month. Fixed income will continue to be challenged until the pace of rate increases slow (or reverse). We should get more information about that direction in November.



Source: LPL Research, FactSet 10/20/22 (1987 - Current)
All indexes are unmanaged and cannot be invested into directly. Past performance is no guarentee of future results.

Looking forward there are some significant events that will be behind us in coming months. Historically, the markets have performed well in the months after the mid-term elections the past 18 times, regardless of the political result. Moreover, as mentioned above, most of the interest rate increases should be behind us. Finally, the markets are always forward-looking and, rebound well before the economy officially turns. The chart on the left shows S&P 500 returns during the periods of economic stress and the subsequent 12 months going back to 1987.

Should you have any questions please contact us.

Image sources: Bloomberg and CNBC unless otherwise noted

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