Nolte Notes

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If there is a bit of good news out of last week's trading, its source is likely a very twisted view of the economy and the next steps for the Fed. Consumer and producer prices both hit 40-year highs, spurring discussion about a full percentage point increase by the Fed in two weeks. Retail sales were decent, but likely spurred by those higher prices. Almost all the increase was attributed to higher prices. Some are recognizing the decline in commodity prices over the past month, that started after the inflation surveys were done, meaning "peak inflation" may be at hand. Here is the twisted Wall Street logic: The Fed will increase rates too much and be forced to CUT rates later in 2023. It is now that expectation of a rate decrease that has investors excited about the markets. The only issue may be that the valley investors are looking through may be deeper and longer than expected. The housing reports this week may provide a window into some economic weakness. Higher mortgage rates have curbed enthusiastic buyers and homes are sitting a bit longer. Due to the nature of the pandemic shutdown and restart, the trillions of dollars tossed at the economy and a slow to react Fed, the "normal" economic models are not working very well.

There have been a few signs that just maybe the markets are trying to form a bottom around current levels. Friday saw the first 9/1 advance to decline ratio since spring, an indication that investors are buying the market on a very broad basis. We'd like to see that enthusiasm continue for more than a day or two. The SP500 has been trading between 10-15% below its long-term average price for the past month, something not seen since 2008-09. It seems the markets have been putting a "bad" spin on every news item and selling first without asking questions. The key for the markets continues to be the overall direction of the economy. If the recession that is heading our way is mild, then much of the decline has already occurred, and this is a good time to accumulate shares. If the recession is deeper/longer, then there is a risk of another 15% decline in stocks from here. This is the valley investors are trying to look through. The aggressiveness of the Fed will be an important component. If the economy shows increased signs of weakening, the Fed is likely to back off rate increases that could pave the way for stocks to recover some of their early year losses.

The very hot inflation reports this week pushed short-term rates well above those on the 10-year treasury. This "inversion" is now deeper than any time since 2000 and is signaling an over 80% chance of a recession within the next 12 months. At the time, the markets had not reacted to the signs of economic slowing and fell 40%, with technology stocks falling over 60%. Today, the markets have already begun to react and have shaved 20% from the SP500 and over 30% from the tech sector. High yield spreads were much higher in those prior periods than today, suggesting that there may be a bit more pain before the gains.

The sectors within the SP500 are almost uniform in their declines over the past few months. Models that measure momentum of each sector are in or near "buy" ranges. The same is true of many of the asset classes, with emerging markets among the hardest hit (due to the rising dollar) and treasury bonds due to higher inflation. In both cases, they have been flashing very low readings for months, like late 2008, but still 3-6 months ahead of "the" bottom. If investors bought stocks after the markets fell 20% from the peak, they would lose another 20% decline into the March '09 but be "breakeven" within a year of their initial purchase. Trying to call "the" bottom is difficult, however methodical, and gradual increase in equity exposure over the coming 12 months may be rewarding over the next 3-5 years. A short-term bounce may finally be at hand that may lead to a meandering market for the next 6-12 months that may provide patient investors very good long-term buying opportunities.

The housing data due out this week may move the markets a bit, but the Fed meeting next week will be the market highlight as we head into the dog days of summer. Trading volume remains light daily and could exacerbate market moves, but signs are emerging that a short-term bottom may be happening. The long-term picture is still cloudy. Opportunities are beginning to emerge, but patience is still the watch word of the day.