Nolte Notes

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August 8, 2022

“What a long, strange trip it’s been”. While the economy keeps truckin’, the economists are left scratching their heads about the dynamics of it all. The employment report (admittedly a backward-looking report) showed job growth twice the estimates with the service portion of the economy creating most of the jobs. All the “job losses” since the beginning of the pandemic have now been recovered and going forward the added jobs will be “new jobs” rather than returning jobs. Interesting too, the back months were revised higher, a reversal of the past reports that were revised lower. The services survey, released earlier in the week showed strong/continued growth, which the jobs report later confirmed. Up this week will be the inflation reports, the next big market hurdle. Based solely on commodity prices, inflation should be running well below the 9% level of last month. The easy part will be getting inflation down to the 5-6% range, the hard part will be to return to the desired 2% target of the Fed. Rate hikes remain on the table and the bond market is signaling economic weakness, but stocks keep on truckin’.

The economic environment is still a long way from “normal” and even the definition of normal has likely changed. Workers now working a few days per week from home, some permanently. Many have moved from the cities to other parts of the country since their physical presence is no longer needed. “Experiences” are the new thing, rather than buying goods as many did during the height of Covid. Supply chain issues still have some impact, but in other areas (like airlines/hotel), the mass layoffs during Covid and attempts to rehire have not gone very well, creating significantly higher prices across the board that may take quite a while to dissipate. During the Fed’s press conference, Chair Powell maintained his rather benign outlook on inflation, spurring stocks higher. However, even after various Fed governors maintained the need to keep raising rates, the markets have gone higher still. Various economic models, using employment, retail sales, income and industrial production are still well into “expansion” territory. So, while the bond market is calling for a recession, the economic data does not (yet) back it up. The economic life after Covid has been a tough one to prognosticate, and economists are likely to get it wrong at the wrong time. For now, the equity markets want to party on!

For the second consecutive week, the interest rate market is calling for lower yields. High yield bond spreads have fallen over 20% from mid-June, a sign that bond investors are willing to take on risk. Treasury yields have generally declined from their peak of six weeks ago. The only exception are short-term maturities, which have moved higher in yield as the Fed increases rates. The one missing piece is the very short-term bonds (3 months) and the 10-year yield, which has yet to invert. When it does, the “calling” of a recession has been 100% over the coming year. Although and as mentioned above, history is a very poor guide in today’s economy. The new rules are being created and everyone is trying to catch up.

When looking at the markets across various time periods, whether presidential cycles, years ending in “2” or just the run of the mill year, it is rather surprising how well this year has fit the script set January first. The first half of the year, the markets were supposed to fall, bottoming in June/July and rally into the end of the year. So far so good. What about a recession? Generally, stocks fall in the early phases of a recession and bottom well before the recession has ended. The jury is still out on this one but looking plausible. If the bottom is already “in” then the recession is/would be a very mild one. Judging by some of the economic indicators, some scream recession, others are still expansionary. The bond market is indicating a favorable backdrop for stocks. Within the SP500, the usual suspects of industrials and technology are leading, while the more defensive consumer staples and healthcare have lagged.

The next market hurdle is the inflation reports coming this week. Based upon commodity prices alone, inflation rates should be much lower than last month, although still high vs. the pre-Covid period. The reaction of the bond market and chatter from the Fed will be instrumental in setting the course into the mid-term elections. Way too much to be thinking and worrying about on a hot summer’s day!

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