Nolte Notes

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"Alice Doesn't Live Here Anymore". Rather than a movie from the 70's, referencing Alice, it may instead refer to Goldilocks, who also doesn't live on Wall Street anymore. Mangled metaphor for sure, but nothing worse than the market action on Friday. Following a "could not have been better" employment report that showed more people coming into the workforce, lower wage growth and workers getting added to payrolls, the initial market cheer turned to jeers by the end of the day. Inflation data, the key metric for the Fed, showed some signs of easing in various economic reports last week. Manufacturing surveys showed lower prices and better deliveries, indicating the supply chain is getting better. Airlines have announced some easing in traveling, gas prices at the pump continue to fall, but food prices remain elevated. Fed officials continue to be very comfortable raising rates later this month and keeping rates high, no matter what the economy looks like as it is all about inflation. If there is any issue with using employment and inflation to gauge economic health, both are backward looking. Too, the rate increases operate with a lag impact on the economy, so we are today just feeling the impacts of the initial hike in January. The subsequent increases will not be felt until after 2023, when the economic outlook is likely to be much worse than today.

Since the beginning of Covid, there have been so many pronouncements that have, after further review and additional data, been proven very wrong. Inflation metrics went from not being an issue, to merely transitory to job number one. Each of the comments have proven to be, upon hindsight, very wrong. Making inflation the key focus of the Fed means they are very willing to sacrifice the economy to achieve that goal. Even, as mentioned above, inflation (and economic activity) has turned lower. The easy part of reducing inflation is likely here, with the hard part of getting rates to the two percent target likely only being achieved by forces outside of the Fed's control. What does the future hold? Obviously, given the predictions that were wide of the mark over the past two years, any prediction here is also likely to be way off. Looking at a few data points, like monetary growth and the Fed's balance sheet, it can be argued that inflation could turn to deflation sometime next year. Monetary stock, adjusted for inflation, in the year following shot well over 20% the year following Covid. Today, that rate is now declining at the fastest rate since 1980. The Fed balance sheet is finally contracting, now off 2% from the recent peak. Housing has slowed to a crawl, even though prices have not yet come down. Official inflation data will not be released for another week. This week's economic calendar will be relatively light, with a few Fed speakers to keep the pressure on the markets.

The yield curve remains in negative territory and the high yield market is indicating more volatility in the weeks ahead. The yield curve is improving though, getting less "negative", where 2-year yields are still above 10-year yields. The recent rise in yield is "across the curve" at not just short-term rates. Bond investors have been taking their cues from the Fed chatter about hiking rates. High yield bonds have been a good proxy for "risk", rising vs. the 10-year yield as risks rise, falling when investors are willing to take on risk. High yield spreads, while widening, remain below their peaks of June, which also corresponded with the stock market lows. It would be "nice" to see those spreads widen out dramatically, which could signal a market low. The bond market remains the one to watch.

Another rough week for stocks, but a bit better for value vs. growth. Riskier assets like small US had a rough week, while international still struggled as the dollar remains strong. The only "safe" haven were utilities and consumer staples. Both declined last week as well, just less than the broad market. Traders are still likely to be on extended vacations, so the markets will remain volatile with trading volumes very low. Historically, September has been one of the poorer months of the year but have also led to meaningful bottoms in stocks. A decline of roughly 5-7% would target the June lows and could set the trading through the remainder of the year.

Trading will continue to be volatile as investors follow the Fed commentary. Expect that both inflation and economic activity will be weakening in the months ahead. What the Fed's response will be remains a mystery.