Weekly Investment Insights

March 13, 2022

VERDENCE CAPITAL ADVISORS

Key Takeaways:

- Consumers still turning to credit.
- Fed Chairman fuels angst about higher rates.
- Labor market strong but signs of weakness emerging.
- Financials under pressure amid SVB shut down.
- Bond yields fall despite aggressive Fed fears.
- Commodities lower on energy product weakness.

Weekly Economic Recap –

Labor Market Remains Strong; Fed Likely to Tighten More Than Expected

Wholesale inventories fell 0.4% in January, in line with consensus estimates led by a sharp decrease in nondurable goods, with apparel leading the decrease.

Consumer credit increased modestly in January. Revolving credit (e.g., credit cards) increased led the gains and made a fresh record high.

The U.S. trade deficit grew to the widest in three months in January as imports outpaced exports. However, exports of consumer goods and auto parts rose to a record high.

Fed Chair Powell addressed questions on the economy and the Fed's rate hike path before the House Financial Services Committee last week. As inflation data has remained resilient, Powell stated, "the level of interest rates is likely to be higher than previously anticipated."

Job openings decreased in January led by construction jobs falling to their lowest level since October 2020. The quits rate fell to 2.5%, the lowest level since March 2021 as employees are choosing to stay at their current jobs amid macroeconomic uncertainty.

The U.S. economy added more jobs than expected in February (311K vs. 215K estimate) but the pace of gains slowed on a monthly basis. The labor force participation rate climbed to its highest level since March 2020 (62.5%) as more people enter the workforce. In addition, average hourly earnings rose less than anticipated and the work week fell.

Weekly Market Recap –

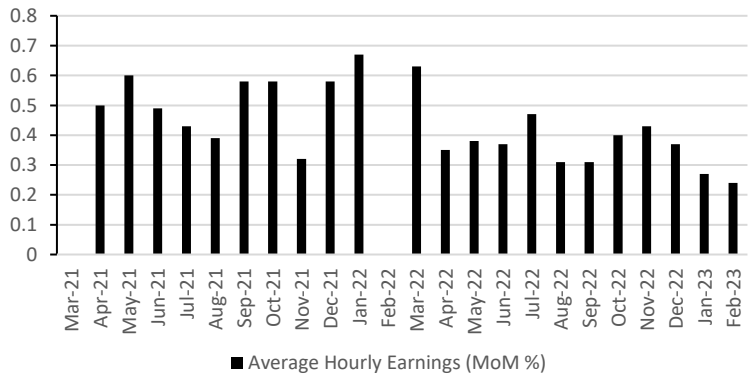
Aggressive Fed Fears and SVB Fallout Cause Equities to Falter

Equities: The MSCI AC World Index fell for the second time in three weeks as strong U.S. employment data sparked fears the Fed will likely tighten more than expected. U.S. equities plummeted amid banking/financials fears as Silicon Valley Bank (SVB) shut down after a run on deposits. The S&P Regional Banking ETF (KRE) posted its worst weekly performance since March 2009 (excluding COVID selloff) as investor fears spiked.

Fixed Income: The Bloomberg Barclays Aggregate Index posted its first gain in seven weeks as bond yields retreated, despite growing fears of a more aggressive Federal Reserve than originally anticipated. U.S. TIPS posted their second straight week of gains as 10YR breakeven inflation rates remained elevated. Municipals posted their best weekly performance since the first week of the year.

Commodities/FX: The Bloomberg Commodity Index fell for the third time in four weeks as energy product weakness (i.e., natural gas and crude oil) weighed on performance. Gold prices were higher for the second straight week on growing inflation fears. Copper prices, a key leading economic indicator, fell for the fifth time in six weeks as consumer spending in China hasn't rebounded as strong as hoped.

Average Hourly Earnings Increases Less Than Expected



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Key Takeaways:

- One year anniversary of most aggressive Fed tightening cycle since 1980.
- Futures see higher peak rate.
- Wages and labor market a key indicator to decipher Fed peak.
- Service sector and inflation expectations worth monitoring.
- One month data not a trend, watch next couple months closely.

What Would it Take to See a 6.0% Peak Fed Funds Rate?

This week is the one year anniversary of the start of the most aggressive Fed tightening cycle the U.S. economy has experienced since 1980. On March 16, 2022 the Fed raised interest rates for the first time since December 2018. Unfortunately, the modest first attempt to stave off inflation (from 0.25% to 0.50%) did little to help and the Fed had to take a much more aggressive stance, raising its benchmark rate by 450 bps in one years time. While inflation peaked in June 2022 and is steadily decelerating, January's hotter than expected inflation data and ensuing hawkish Fed rhetoric had the Fed funds futures market pricing in a peak Fed funds rate as high as 5.75% - 6.00%. At the start of 2023, the futures market was expecting a peak in the rate of 4.75-5.00% and cuts by mid year.

In our December 19, 2022, weekly insights titled, "How High Can We Go" we cautioned investors about believing that the Fed's decision to slow rate hikes to 50 bps (versus 75 bps) was a sign the tightening cycle was close to done. We expected a peak at the upper bound of 5.50%. However, with some economists now suggesting a 6.0% peak in the Fed funds rate, we wanted to offer our opinion about how and if a 6.0% peak rate could come to reality.

- **Wages and the labor market:** Despite volatile monthly data, the labor market remains tight. In fact, in 83% of the months since December 2000, there have been more unemployed Americans than jobs posted. However, now there are ~double the number of postings vs. unemployed. If this does not narrow, the Fed may be forced to raise to 6.00%. While wage growth is slowing it is still problematic for the Fed.

- **Service prices:** The ISM Services Index fell into contraction territory (below 50) in December but has since recovered. The prices paid portion of this Index has been steadily decelerating (to a 2-year low). Since Americans spend most of their money on services, if this downward trajectory reverses the Fed may need to tighten more aggressively.

- **Inflation expectations:** Market inflation expectations as measured by breakeven rates (5YR) and consumer inflation expectations as measured by the U. of Michigan Consumer Sentiment Index are rising. If investors or consumers think inflation will be higher in the future it can pull spending forward and cause inflation. Both these indicators are lower than their peak but worth monitoring.

- **Small business sentiment:** Small businesses employ nearly half of all U.S. employees. If small businesses cannot raise prices, they are unlikely to raise wages (contributing to wage spiral). This week, we will receive the NFIB Small Business Optimism Index. In recent months, the percentage of small business owners expecting to raise prices or compensation continues to fall. If this changes it could put pressure on the Fed.

The Bottom Line:

We do not take one month worth of data as a trend. There are many underlying factors that suggest inflation is coming down. It will be a bumpy ride but we believe the peak was in mid 2022 and the Fed is in the final stages of the tightening cycle. We think a peak of 5.50% is still likely but will monitor incoming data closely. Higher rates are starting to filter into the economy (e.g., current banking turmoil) and the Fed is aware their actions have a delayed effect. A 6.00% peak would look likely if the labor market does not continue to cool, consumers do not slow spending and if the recent weakness in home prices does not filter into rent in the Consumer Price Index.

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Banking Fears Hamper Risk Appetite

U.S. Equities	Current	1WK	1MO	3MO	1YR	YTD
Dow Jones Industrial Average	31,910	-4.3%	-5.4%	-4.2%	-1.7%	-3.2%
S&P 500	3,862	-4.5%	-5.4%	-1.4%	-7.8%	0.9%
Russell 1000 Growth	2,253	-4.2%	-4.6%	0.4%	-11.5%	4.6%
Russell 1000 Value	1,456	-5.5%	-6.6%	-2.9%	-5.2%	-2.3%
Russell Midcap	2,707	-6.9%	-7.0%	-1.3%	-7.0%	0.5%
Russell 2000	1,773	-8.0%	-7.5%	-1.0%	-10.6%	0.9%
Nasdaq	11,139	-4.7%	-4.8%	1.5%	-14.4%	6.6%

International Equities	Current	1WK	1MO	3MO	1YR	YTD
MSCI AC World (USD)	617	-3.6%	-4.5%	-0.1%	-6.5%	2.1%
MSCI EAFE (USD)	2,052	-0.8%	-1.3%	4.1%	2.7%	6.0%
MSCI Europe ex UK (USD)	2,281	-1.3%	-0.4%	5.9%	6.5%	8.0%
MSCI Japan (USD)	3,309	2.0%	-0.6%	4.8%	-2.8%	5.5%
MSCI UK (USD)	1,121	-1.4%	-1.0%	2.8%	4.9%	5.2%
MSCI EM (USD)	955	-3.3%	-5.7%	-2.0%	-10.9%	0.0%
MSCI Asia ex Japan (USD)	616	-3.9%	-6.8%	-2.8%	-10.4%	-0.4%

Fixed Income	Current Yield	1WK	1MO	3MO	1YR	YTD
U.S. Aggregate	4.7%	1.2%	-0.1%	0.1%	-7.4%	1.5%
U.S. Govt/Credit	4.6%	1.3%	0.2%	0.1%	-7.3%	1.6%
U.S. 10 Year Treasury	3.7%	2.3%	0.8%	0.1%	-11.1%	1.8%
U.S. TIPS (1-10YR)	4.5%	0.0%	0.0%	0.2%	-7.1%	0.7%
U.S. High Yield	8.8%	-0.9%	-1.2%	0.5%	-4.5%	1.9%
EM Bonds (USD)	7.5%	0.5%	-0.8%	0.6%	-4.7%	1.1%
Municipal Bonds	3.5%	0.9%	-1.1%	0.8%	-3.2%	1.3%

Commodites	Current	1WK	1MO	3MO	1YR	YTD
Bloomberg Commodity Index	230	-3.4%	-3.4%	-5.3%	-14.0%	-6.5%
Crude Oil (USD/bbl)	$76.7	-3.8%	-3.8%	8.0%	-27.7%	-4.5%
Gold ($/oz)	$1,868.3	0.6%	0.1%	3.9%	-6.4%	2.4%
Copper	$404.6	-0.8%	0.7%	4.4%	-12.9%	6.2%
Wheat	$679.3	-4.2%	-14.6%	-8.8%	-24.5%	-15.0%
U.S. Dollar	105	0.1%	0.9%	-0.2%	6.2%	1.0%
VIX Index	24.8	34.1%	20.8%	8.6%	-18.0%	14.4%

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