Great-West Investments Capital Markets Perspective

Week in Review: September 20th – 26th

INDEX/ SECURITY	ASSET CLASS	LEVEL (CLOSE)	% CHANGE (THROUGH FRIDAY'S CLOSE) 1 WK.	YTD		INDEX/ SECURITY	ASSET CLASS	LEVEL (CLOSE)	% CHANGE (THROUGH FRIDAY'S CLOSE) 1 WK.	YTD
Dow Industrials	Lg. Cap Eq.	34,798.00	0.62%	14.54%		FTSE 100	UK Equity	7,051.48	1.26%	9.15%
S&P 500®	Lg. Cap Eq.	4,455.48	0.51%	19.44%		Nikkei 225	Japan Equity	30,248.81	-0.82%	10.22%
NASDAQ Comp.	US Equity	15,047.70	0.02%	17.16%		EEM:US	Emkt. Equity	$50.78	-1.15%	-1.24%
S&P Midcap 400©	Mid-Cap Equity	2,699.38	0.80%	17.03%		EFA:US	Non-US Equity	$80.30	-0.25%	10.00%
Russell 2000®	Sm. Cap Eq.	2,248.08	0.50%	13.61%		UST 10y (yield)	US Treasury	1.45%	+0.09%	+0.54%
Stoxx 50	Europe Eq.	4,158.51	0.67%	16.43%		B/Barc AGG	Fixed Inc.	2,346.23	-1.16%	-1.82%

It could've been this cycle's "Lehman moment."

Until last week you'd probably never heard the name "**Evergrande**." And no, that's not the title of Eminem's comeback album (although that was my first thought, too…) Instead, the name belongs to an **enormous property developer in China**, who's book of assets is dwarfed only by the amount of debt the company took on to purchase all those assets.

If you've been following markets at all, you'll likely know that **Evergrande's near-death experience was topic #1 in markets last week**. In hindsight, it was probably inevitable that the company would run into trouble. After all, leveraging your balance sheet to buy a bunch of properties in a red-hot housing market rife with speculation is a tried-and-true way to run yourself aground. But compounding Evergrande's troubles was a central government that is suddenly very keen to let air out of the various bubbles percolating up from the peat bog that is China's secular economic growth. As soon as said government applied a little pressure to the bubbly Chinese housing market, Evergrande started to buckle. By Monday, **rumors were circulating that the company would miss an interest payment on some of its bonds**.

It sort of did miss those payments, but the issue nonetheless **failed to metastasize into a broader panic** at least in part because **the company appeared to work out a deal with some of its creditors** (at least *domestic* creditors,) and the **Chinese government repeatedly injected liquidity into its banking system**. To make a long, complicated story shorter (and only a *little* less complicated) Chinese authorities seemed to have learned a lesson from the failure of Lehman Brothers more than a decade ago: if you're going to pop a bubble, you need to act fast to limit the collateral damage by throwing lots of money at it and leaning hard on the company at the center of it all.

So at least for now, Evergrande hasn't become the catalyzing crisis for markets that it could have been. But that doesn't mean capital markets fully escaped Evergrande's troubles: Monday's session saw US equity markets drop by almost 3%, making it the **worst session for stocks since Mid-May** when the inflation scare first started to rile investors. The sort-of-resolution with Evergrande's bondholders reached at mid-week helped to temporarily calm those worries, joining reassurances from none other than **Fed Chairman Jerome Powell**, who used the Q&A session following

Wednesday's FOMC meeting to **downplay the risk to US and global markets by saying "the issue seems very particular to China**[1]."

That was enough to at least temporarily soothe fears that Evergrande would become China's "Lehman moment" and also **enough to allow stocks to recover all the ground lost earlier in the week (and then some.)** To be clear, though, the issue is probably not done with markets just yet: things like this have a tendency of becoming messy in ways that nobody really expects, and the Evergrande issue is further complicated by market sentiment stretched thin by a relentless advance in valuations – not to mention an additional layer of increasingly ugly geopolitics between the two players who stand to lose the most in a disorderly unwind and any potential accompanying market panic: the US and China.

But enough about Evergrande (something tells me that we may have another opportunity to discuss it in future editions of this update anyway.) Let's talk about the Fed. As expected, last week's meeting of the Federal Open Market Committee **(FOMC) held little in the way of surprises**. Rates didn't change (although the "dot plot" did, at least marginally[2],) and the message surrounding the coming **taper** of asset purchases was more or less on-point. Specifically, Powell offered up that the Fed might begin to take its foot off the decelerator **by November** (the next FOMC meeting is scheduled for November 2-3,) buying fewer and fewer Treasury- and mortgage bonds each month between then and **mid-2023,** when **the taper might be complete**.

Not coincidentally, market-implied expectations for the fed funds rate started to show signs of life at both the June- and July timeframe, confirming that **markets are viewing the end of the tapering of asset purchases as a necessary (and, at least for the time being, also a *sufficient*) condition for the "lift-off" in rates**. That must've aligned pretty well with market expectations, because **equity markets hardly noticed** as they continued a quiet relief rally associated with the (temporary?) side-stepping of the Evergrande issue. Bonds, though, were a different story: **yields** on 10-year US treasuries **were up a stout 0.13% on Thursday, the biggest move since late February**.

Frankly, not much else of note happened last week. Markit Economics' flash **PMIs came in almost exactly as expected**, with the usual cast of characters acting as a restraint to otherwise pretty robust expansion: namely, a continued inability to hire and retain workers, near-record increases in prices and supply chain pressure that shows no signs of relenting[3].

Speaking of which…logistics superpower **Federal Express** reported earnings for its fiscal first quarter on Tuesday and quickly became a perfect meme for what it means to have a snarled network and less-than-optimal staffing[4]. Revenues were just fine – apparently, people are still availing themselves of FedEx's enormous distribution network even as they return to strip malls and department stores in a post-COVID-kind-of-way. But where they company struggled is with its margins: **labor costs were up 9%** and inefficiencies related to **staffing difficulties** cost the company literally hundreds of millions of dollars in lost profits. **That must've spooked executives, because they also trimmed guidance** for the rest of the year, causing the stock to drop significantly. Incidentally, that's **not a great read-through for anyone who has (or uses) a global logistics and transportation network**, (or anyone worried about the durability of inflation-creating supply chain problems, for that matter.)

Two last bits of data from last week are probably worth a quick mention. The latest signs that **the housing market is indeed cooling** came by way of the National Association of Realtors' existing home sales release[5] as well as the Census Department's latest read on new home sales[6]. While both numbers themselves were fine, (new home sales were even a little bit higher than economists' expectations,) the accompanying commentary included references to all the things that are currently causing the US housing market to slowly become less bubblicious: namely, **higher prices acting as a restraint on buyers** (as was the case for existing home sales,) and a surp**risingly big increase in the inventory of unsold**

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[1] Federal Reserve, Bloomberg (9/22)
[2] https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20210922.pdf
[3] https://www.markiteconomics.com/Public/Home/PressRelease/3ea9d747369341f98b0e55f542fd0d27
[4] Company reports (Investors.Fedex.com), seekingalpha.com
[5] https://www.nar.realtor/newsroom/existing-home-sales-recede-2-0-in-august
[6] https://www.census.gov/construction/nrs/index.html

homes (new home sales.) In fact, the number of new houses currently for sale now stands at the highest level it's been since late 2008, when the US housing market was in the middle of melting down[7].

To be clear, that's probably a good thing. Builder sentiment remains okay, as demonstrated earlier this month by a still-elevated reading in the NAHB's housing market survey[8] (which makes a sudden downturn in building activity less likely,) and constrained inventories are one of most obvious factors behind the massive increase in home prices in recent months. **Again, the real trick will be finding the sweet spot** in inventories (and other housing market fundamentals,) that generates enough of a response in prices to encourage new would-be buyers to enter the market while at the same time avoiding a big dump in home equity gains that could spur further declines in consumer confidence.

But like the Evergrande drama, something tells me we'll be writing about things like home prices and snarled logistics networks again in the near future. Stay tuned.

What to Watch This Week: September 27th – October 3rd

Notable economic events (Sept. 27th – Oct. 1st)

Monday: Durable goods orders, Dallas Fed

Tuesday: Home prices (x2), Consumer confidence, Richmond Fed Yellen/Powell testify (Senate)

Wednesday: Pending home sales, Yellen/Powell testify (House)

Thursday: Weekly jobless claims, 2Q GDP (final)

Friday: Income/Outlays, ISM/PMI manufacturing, UofM Consumer sentiment

It should be a fairly **busy week**, with a pair of consumer confidence reports, a full slate of ISM and PMI data and loads of detail about where (and how much) Americans are earning and spending their dough. Meanwhile, both houses of Congress will get an earful from not one but *two* Fed Chairs when Jerome Powell and former Fed Chair (and current Treasury Secretary) Janet Yellen appear before the Senate and House Banking Committees to discuss the efficacy of the CARES act. And **in the background** to all that, we should probably **expect to hear more about Evergrande** and its potential rescue/decent into chaos, as well as a growing chorus of commentary surrounding the pending inability of the US to pay its bills if and when the **debt ceiling** fails to get a reprieve.

Taking these one at a time, let's start with consumer confidence. On Tuesday, the Conference Board will release its September read on **consumer confidence**, followed by the University of Michigan's final release on Friday. Consumer confidence **has waned noticeably in recent weeks**, pressured by inflation, the persistence of COVID and, increasingly, by signs that the fastest part of the economic expansion may be behind us. Both reports will be **closely read by analysts to see whether the recent declines were simple blips in the data, or something more durable**.

On Friday, the **Institute of Supply Management and Markit Economics** will each release their respective looks at September trends in manufacturing. Last week's flash PMIs by Markit said essentially the same thing they've been saying for months: growth is robust (more so in manufacturing than in services, by the way,) but **price pressures, supply chain stress and labor market issues** are all still very much with us. **Expect Friday's releases – as well as the regional Fed reports from Dallas and Richmond expected this week – to be more of the same**.

Also on Friday will be the **income and outlays report**, a detailed look at where Americans are earning and spending. This report is always second to perhaps only the monthly payroll report in terms of interest to traders and investors, and this time it will show the continued decline in government-related support as a source of income for the American economy.

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[7] US Department of Census, FRED St. Louis Federal Reserve

[8] https://www.nahb.org/news-and-economics/housing-economics/indices/housing-market-index

In terms of **housing market data**, we'll get pending home sales data on Wednesday, together with two looks at home prices on Tuesday. While the pending home sales data could be an interesting confirmation of slowing transaction volumes, the **home price data** on Tuesday is somewhat stale (July) and **probably won't show the kind of deceleration suggested by recent housing market data** just yet. Nonetheless, these releases are still worth watching for further evidence that the US housing market is **continuing to successfully walk the tightrope** between cooling and collapse.

Finally, as is always the case in the week following the FOMC's announcement, **the speaking circuit will be full of Fed luminaries** each making their case to the public and the press about which way rates and the economy should head from here. While the list of engagements is too full to discuss here, the banking committees of both the Senate and the House will get the rare opportunity to hear from both a past and a present Fed chair when **Treasury Secretary Janet Yellen** – who led the Federal Reserve between 2014 and 2018 – and current Fed chairman **Jerome Powell** when they **travel to "the Hill" to discuss the CARES Act**. While that might be at least marginally interesting to policy wonks, at least two other issues could capture the market's attention if either are raised during the testimony: **Powell's potential re-appointment** to another term as Fed Chair (Yellen is on record as supporting it,) as well as **the now-looming inability of the US government to pay its bills.** Yellen's stance on the issue is well-known: she has penned at least one Op-Ed encouraging Congress to lift the debt ceiling that could force the US to become technically insolvent. Less known is Powell's view: if given the opportunity to opine, his views could help set the tone for markets this week.

Source for index data: Bloomberg.com; GWI calculations.