Capital markets perspective

Index/ Security	Asset class	Level (close)	% Change (Friday close)		Index/ Security	Asset class	Level (close)	% Change (Friday close)	
			1 WK.	YTD				1 WK.	YTD
Dow Industrials	Lg. Cap Eq.	32,920.46	-1.66%	-9.41%	FTSE 100	UK Equity	7,332.12	-1.93%	-0.71%
S&P 500®	Lg. Cap Eq.	3,852.36	-2.08%	-19.17%	Nikkei 225	Japan Equity	27,527.12	-1.34%	-4.39%
NASDAQ Comp.	US Equity	10,705.41	-2.72%	-31.57%	EEM:US	Emkt. Equity	$37.83	-3.05%	-22.56%
S&P Midcap 400©	Mid-Cap Equity	2,416.51	-2.15%	-14.97%	EFA:US	Non-US Equity	$65.42	-2.23%	-16.58%
Russell 2000®	Sm. Cap Eq.	1,763.42	-1.85%	-21.46%	UST 10y (yield)	US Treasury	3.49%	-0.09%	1.98%
Stoxx 50	Europe Eq.	3,804.02	-3.52%	-11.50%	Bloomberg U.S. AGG	Fixed Inc.	2,093.05	0.80%	-11.13%

Somehow, I don't think this is what the market had in mind when it started asking for 'The Big Pivot.'

Last week was always going to be **all about the Fed**, and it was. Sure, the **half-point increase** wasn't really a surprise at all (futures traders had correctly placed the odds of a 0.50% increase at more than 80% coming into the meeting,) and there was **very little change in the Fed's overall message**. In fact, if you line up the FOMC's post-meeting statement from six weeks ago against the one it issued last Wednesday[1], what you'll find is that the two statements read verbatim. Except for the numbers part where they list the range for the federal funds rate itself, not a single word changed between the two. (I guess the team that writes the Fed's correspondence knocked off early for the holiday: *cut/paste/post/goodbye!)*

Not a bad gig, if you ask me.

So all-in-all, pretty standard stuff. Definitely **nothing that you'd consider massively market-moving**. Why, then, did stocks spend 30 minutes after the Fed decision dropping faster than Will Smith's chances of ever hosting the Oscars? And why did markets follow up those losses on Thursday and Friday by dropping even deeper into the red? Did Powell imply that the Fed's thinking had changed regarding the need for future rate increases? No, he continued to recycle phrases like "**ongoing increases will be appropriate**" and "it will take **substantially more evidence**" than just a pair of soft CPI readings to put the Fed off its job. **None of that is exactly market-*friendly*, but it's also nothing Fed celebrities haven't said out loud a hundred times before**.

In fact, **if anything, Powell's message was somewhat *friendlier*** than it has been in the past: during the Q&A portion of Wednesday afternoon's Fed-stravaganza, he acknowledged that the FOMC's decision-makers now believe **a slower pace of rate increases is appropriate** and will likely remain so for a while. **Again, nothing new** – the Fed had been telegraphing that very message for weeks. But it was still nice to hear Powell say it unambiguously (and back it up with action to boot.)

[1] https://www.federalreserve.gov/monetarypolicy/files/monetary20221214a1.pdf

But there was still *something* that kept markets under pressure during the back half of last week. Maybe it was the "**dot-plot**", a collection of guesses about where the Fed Funds rate will be in the future based on the Fed's own poll of FOMC participants that gets released alongside the Fed's rate decision after every other meeting.

Last week's dot-plot – the first published since September – showed that Fed decision-makers are **coalescing around a slightly higher overall terminal rate**. Specifically, FOMC participants now think that the Fed Funds rate will stop rising somewhere just above 5.0%, whereas in September they thought rates would peak slightly *below* that threshold. Moreover, they are **increasingly confident and better aligned in their thinking**: this time, only two "dots" fell below the median estimate. Last time, the FOMC's own guesses were almost evenly distributed above and below, suggesting that the rate-setters themselves weren't sure what to do with rates in the future, but are increasingly finding themselves on the same page.

But even that "higher for longer" message isn't exactly new. Markets have been hearing that from the Fed for weeks, so it's hard for me to believe that it was the dancin' dots of the December dot-plot that kept markets in the red last week (a week, by the way, that also featured another softer-than-expected reading on inflation in the form of a CPI that advanced 0.1% - far slower than then 0.3% expected by economists[2].)

So what gives? **Here's where "The Big Pivot" comes in**. But let me be clear: it wasn't a pivot in Fed thinking or Fed messaging that mattered last week – we've just spent the last six or eight paragraphs arguing last week's Fed meeting wasn't much of a pivot at all as far as the Fed is concerned. Instead, the "pivot" that seemed to matter most was **the market's own *internal* pivot**: away from its months-long tendency to obsess about every word spoken or hand gesture made by Fed officials, and **toward a tendency to worry more about where economic fundamentals are headed**.

Case-in-point: retail sales. It might have been easy to miss Thursday's latest read on retail sales given all the hubbub surrounding the Fed (in fact, it was so far below-the-radar that I forgot to even put it on last week's list of "what to watch." Sorry about that, my bad…) But it was nonetheless a notable report. Retail sales **declined 0.6%** in November, dropping about three times as fast as analysts had expected[3]. **If the previous "bad news is good news" regime were still intact**, weaker-than-expected retail sales figures, especially coming as the all-important holiday sales season was just beginning to ramp up, that miss would've **almost certainly been cheered by markets because it would have implied that the Fed could back off a little**.

Not so this time. In fact, Thursday's trading session was quite a bit worse that Wednesday/FedDay, and the retail sales report is probably the best candidate as to why trading was so weak that day: investors truly seemed concerned that US consumers might be pulling in their horns after months and months of splurging on stuff they probably didn't need in the first place. But perhaps even more interesting than the headline miss was the below-the-headline data showing which spending categories increased versus which decreased. Not to spoil the suspense, **but Americans are spending more for staples** like groceries, in restaurants and at their corner drugstore, **while spending less on just about everything else** (including BIG declines on things such as cars, furniture and home improvement goods). Basically, **exactly what you might expect so see if the economy was truly beginning to buckle** under the weight of months and months of inflation.

To be sure, that wasn't the only signal suggesting that **the economy is slowing quickly** – see also last week's Empire State and Philly Fed manufacturing reports [4,5], as well as further deterioration in S&P Global/Markit Economics' Purchasing Managers Indices[6] for corroborating evidence. But regardless, if the market's reaction (or, perhaps more appropriately, its *non*-reaction) to Thursday's stinky retail sales report is any indication, **bad news is bad news again.**

And that's probably good news.

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[2] https://www.bls.gov/news.release/cpi.nr0.htm
[3] https://www.census.gov/retail/marts/www/marts_current.pdf
[4] https://www.newyorkfed.org/medialibrary/media/survey/empire/empire2022/esms_2022_12.pdf?la=en
[5] https://www.philadelphiafed.org/surveys-and-data/regional-economic-analysis/mbos-2022-12
[6] https://www.pmi.spglobal.com/Public/Home/PressRelease/2449edd6ab0a49b9bd0103ecc24a28b3

What to watch this week

Economic Events, December 19-25

Monday: NAHB homebuilder sentiment
Tuesday: Housing starts/permits
Wednesday: Consumer confidence (Conference Board), existing home sales
Thursday: Leading economic indicators, weekly jobless claims
Friday: Income/outlays, UofM consumer sentiment, new home sales

If markets really are in the process of re-focusing themselves away from things like "what color is Jerome Powell's tie today and what does that mean for Fed policy?" and toward more important things like "is the economy in recession or not?" that's healthy because it suggests that **the Alice-in-Wonderland phase of this market cycle is probably ending**.

But before you start planning a party, **keep in mind that none of this necessarily means that we're out of the woods just yet**. While it would represent clear progress toward normalcy and is an obvious maturing of the market's outlook, it also means that questions like "**how much will corporate earnings suffer as the economy slows**?" or, "**will market valuations overshoot to the downside?**" and "**has US consumption been permanently impaired by its bout with COVID**?" will start to matter more. And there are no guarantees that investors will like any of those answers.

With that out of the way, here's a quick glance at what's on this week's calendar. The biggest event will be the Christmas Holiday, celebrated by much of the world on Sunday and observed here in the US with a market closure next Monday. As always, though, **the last two weeks of the year will very likely see a steady decline in activity** as traders step away from their desks one by one to enjoy the holidays with family and friends.

In the meantime, though, the calendar marches on with **a mostly full slate of housing data**, beginning with the NAHB's monthly read of homebuilder sentiment on Monday, followed by housing starts and permits data on Tuesday and home sales volumes on Wednesday and Friday. As we've discussed before, housing is typically among the first major sectors of the economy to react to higher interest rates given the connection between mortgage rates and overall housing activity. That's certainly been true this time around, and **in my view the next surprise in housing is likely to be to the upside. We're probably still a long way from that, though**, which means this week's housing data is likely to show continued weakness. **Of greater interest will be next week's home price data** and the extent to which that has begun to rationalize. Stay tuned for that.

We will also get a pair of **consumer confidence** releases, including the Conference Board's survey results on Tuesday, followed by the University of Michigan's release on Friday. The UofM's mid-month read a few weeks ago showed a **hopeful uptick** supported by an easing of consumer inflation and positive stock market performance, but the extent to which those trends might carry into the Conference Board's data (or next month's UofM data) is an open question. In any case, **the next shoe to drop for consumers (if there *is* a next shoe to drop,) will probably be softer employment data**. Again, we're probably not quite there yet, but I'm pretty sure it's coming.

Like consumer confidence, Friday's **income and outlays report** might find itself cast in a slightly different light following last week's disappointing retail sales report. It's commonly believed that the US consumers' spending splurge has been supported by surplus savings provided by COVID-era stimulus. The **extent to which that dry powder is being burned away is sometimes evident** in the income/outlays report, making it potentially one of the more interesting releases scheduled this week.

Finally, one of my favorite "tells" about whether the US economy is in recession is the gap between the **index of leading economic indicators and the index of coincident indicators** as published by the Conference Board. When that gap narrows and ultimately inverts, it's a pretty reliable sign that the economy has indeed slipped into recession. Recently **that gap has narrowed but has yet to fully close**. We get the latest read of both indices on Friday, which could provide some much-needed context to a market that seems newly-focused on questions like "are we in recession or not?"

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