Capital markets perspective

Index/ Security	Asset class	Level (close)	% Change (Friday close) 1 WK.	YTD	Index/ Security	Asset class	Level (close)	% Change (Friday close) 1 WK.	YTD
Dow Industrials	Lg. Cap Eq.	33,630.61	1.55%	1.55%	FTSE 100	UK Equity	7,699.49	3.32%	3.32%
S&P 500®	Lg. Cap Eq.	3,895.08	1.45%	1.45%	Nikkei 225	Japan Equity	25,973.85	-0.46%	-0.46%
NASDAQ Comp.	US Equity	10,569.29	0.98%	0.98%	EEM:US	Emkt. Equity	$40.07	5.73%	5.73%
S&P Midcap 400©	Mid-Cap Equity	2,489.95	2.45%	2.45%	EFA:US	Non-US Equity	$68.13	3.79%	3.79%
Russell 2000®	Sm. Cap Eq.	1,792.80	1.79%	1.79%	UST 10y (yield)	US Treasury	3.56%	-0.32%	-0.32%
Stoxx 50	Europe Eq.	4,017.83	5.91%	5.91%	Bloomberg U.S. AGG	Fixed Inc.	2,086.58	1.85%	1.85%

"Unwarranted."

It's never easy to deliver bad news to someone you care about, but it can be especially challenging if there's also a hint of blame imbedded in there somewhere. Think of it like this: it's pretty easy to tell your pal "Hey, your car was just stolen and that really sucks…" without sounding harsh or further damaging his state of mind. But when its "hey, you left your car doors unlocked with the windows rolled down and the keys in the ignition, and somebody stole your car…" well, in cases like that it can be quite a bit harder to sound sympathetic.

So how does the Federal Reserve tell the market that what it's doing might be damaging to itself in the long run? Remember, if you're the Federal Reserve, obfuscation is in your blood – **it's almost never possible for the Fed to say exactly what's on its mind** for fear of upsetting the market in unintended ways. Well, one way for the Fed to walk that communications tightrope is to bury its message on the bottom of page 9 of the Fed minutes, (which, incidentally, is exactly where you'll find this phrase: "…**an unwarranted easing in financial conditions**, especially if driven by a misperception by the public of the Committee's reaction function, **would complicate the Committee's efforts to restore price stability**[1]."

That sounds a little bit like Powell & Co. chastising the stock market for rallying so hard during the fourth quarter of 2022. Keep in mind that stock prices are a major component of "easing financial conditions" that the Fed may eventually have to counterbalance with more aggressive action if said conditions ease too much. It all feels sort of analogous to the Fed warning the market, **"hey, cut it out or we might have to get out the big sticks again…"**

I **don't want to make too much out of this**, because if this potential for a big negative feedback loop was really the biggest risk on the Fed's mind, **they would certainly be more vocal about it and be actively trying to jawbone markets lower**. They aren't – at least not yet – but the fact this phrase appeared in the December minutes at all is proof-positive that the rate-setters of the FOMC are **paying close attention to what the market is doing, and that they don't really like it** all that much.

[1] https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20221214.pdf

So let's put "the Fed jawboning the stock market lower" on the list of risks that could define the first few weeks of 2023 – especially if stocks continue to roar. But for the time being, it still looks like the Fed has been demoted to second- (or even third-) chair as far as the market narrative is concerned. Case in point: **if markets were still singularly focused on the Fed's messaging, then Wednesday's JOLTS report might have caused a sell-off**: the number of available jobs in the US economy during November rose to 10.46 million, half a million above economist expectations and around 130,000 higher than the number originally reported for October[2]. (For what it's worth, that October number was also revised higher, leaving the October-November gap essentially unchanged.)

That's clearly too many. Remember, Powell has been perfectly clear in repeatedly calling for a return to "balance" in the job market, something that seems wholly inconsistent with the idea that there are **still more than 1.7 jobs available for every would-be job seeker**.[3] A few weeks ago, that would've convinced traders that more Fed-induced pain was on the way and caused a big reaction. And that's not even all: there were other signs that the labor market is still a long way from balanced in last week's releases, too – the overall **unemployment rate actually *fell* in December** (to 3.5%)[4], and the number of new **jobs created in December were above economist estimates** by both ADP's and the Bureau of Labor Statistics' reckoning[5].

So if a rebounding stock market and the easing of financial conditions it implies aren't enough to keep Powell awake at night, the Fed still has to worry about a potential over-heating of the job market as it enters what is (hopefully) the final lap in its race against inflation. The fact that **markets looked through all of that jobs data and still managed moderate- to robust gains** last week seems like confirmation that – for better or worse – **investors aren't as worried about the Fed's rate tightening campaign as they were even just a few weeks ago**.

But it wasn't all bad news (er, good news), for the labor market last week, either. The number of December **layoffs** cataloged by Challenger, Gray and Christmas last week **continued to rise** and has now surpassed 2021 totals for each of the last six months. Meanwhile, **wage growth** – which, after all, is what Powell is really concerned most about when he talks about restoring balance to the labor market – **might be decelerating too**. Hourly earnings advanced 0.3% in December, bringing the year-over-year increase to "only" 5.0% and continuing a downtrend in that figure that has been in place since at least April.

Still, if I were asked to design the ideal set of labor market data that might put the Fed more at ease, it would probably involve three things: one, a significant drop in the number of jobs per available worker back below (or at least *toward*,) the 1.0 level; two, a widening of layoffs beyond just the big-cap tech, finance and autos sectors; and three, a further decline in wage growth to a level more consistent with historic norms. Until we get there, **the risk of renewed missionary zeal by Powell's Fed** laser-focused on controlling inflation and not repeating the mistakes of past Fed regimes **will always remain in the background**.

This all sets up a big question: did the **market fail to freak out** about last week's relatively strong **jobs data** because it **wasn't really that strong to begin with** (witnessed by rising layoffs and tamer wage growth,) **or because it simply doesn't care** about the Fed anymore? **That's an important riddle to solve**, because the Fed is still more than capable of inflicting pain if it feels the need, regardless of whether or not markets have given up caring about it.

Feel free to form your own opinions, but what last week's lack of negative response to the mostly-stronger-than-expected labor market releases seems to have re-confirmed at least to me is that **markets have indeed moved on from their singular obsession with all things Fed-related** and on to something else (more about that below.)

I'm just a little worried that the Fed *itself* may not be ready to move on just yet, and that markets are ill-prepared to absorb the blow if and when it comes.

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[2] https://www.bls.gov/jlt/
[3] Bureau of Labor Statistics, FRED St. Louis Federal Reserve, and Empower Investments calculations
[4] https://www.bls.gov/news.release/empsit.nr0.htm
[5] Ibid, and https://adpemploymentreport.com/

What to watch this week

Economic Events, January 9 - 13

Monday: *No major economic events planned*
Tuesday: NFIB small business confidence
Wednesday: Atlanta Fed inflation expectations; KBH earnings
Thursday: Consumer price index, weekly jobless claims
Friday: Financial company earnings, Exim prices, UofM consumer sentiment

If the market really has dropped its obsession with the Fed, then it's almost certainly **replaced it with something else: namely, a concern about how deep and long-lasting the ongoing economic downturn will be**. As we've pointed out before, that's probably a *good* thing in the grand scheme because it represents a return to a more normal environment where investors care about things that matter in the long run, like earnings.

But it also doesn't guarantee ambivalence if the Fed should suddenly start talking tough again, either to bring the labor market to heel or to convince the market to slow its roll a little bit with all this green. Either way, last week's data – either in the form of weakening PMIs[6] or collapsing factory orders[7] – also reconfirmed that the economy is indeed weakening. On **Friday**, we'll get a chance to see whether or not that weakness is finally being felt by companies themselves when financial firms like **Citigroup, Bank of America, JPMorgan Chase and a handful of others report fourth quarter earnings**. Prior to that, we'll get the National Federation of Independent Business' read on small business sentiment – a more direct way to take the pulse of the nation's businesses.

Mega-cap financials always kick off the quarterly earnings derby, which stretches for weeks and should peak somewhere around the last week of January or the first week of February. Financials are usually followed by large-cap tech – previously relevant because they were home to so many hopes and dreams (as well as trillions of market capitalization), but now because they've been out in front in the fight to control costs through job cuts as the economy slows. After that, earnings season becomes a mash-up of companies of all shapes and sizes, each one capable of hijacking the market narrative with their past results or future guidance. Suffice to say that **economic data will begin to take a backseat for the next several weeks as the earnings parade starts** to roll.

That doesn't mean economic data will pause, though. This week's marquee event will likely **be Thursday's consumer price index release**, which should (hopefully!) show that inflation continued its slow decline as a result of the Fed's efforts to cool the economy by way of aggressive rate-rising. If you'd like to imagine yourself as Powell-for-a-day, **pay particular attention to inflation beyond food, energy and housing** – the Fed chair mentioned that particular flavor of inflation over and over again during the press conference following last month's 0.5% increase in rates[8]. Again, it seems unlikely that anything other than a big(ish) surprise in this week's CPI would do much to sway sentiment. **With luck, we'll see another step toward moderation in prices that will keep the Fed's new kindler, gentler approach intact.**

[6] https://www.pmi.spglobal.com/Public/Home/PressRelease/fd49c3c51d79418b9622ad78993a762b
[7] https://www.census.gov/manufacturing/m3/prel/pdf/s-i-o.pdf
[8] https://www.federalreserve.gov/monetarypolicy/fomcpresconf20221214.htm