THE DANA VIEWPOINT

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Dow: 31,827

Listening to the Markets

Often the markets will send signals about the current, and potential future, state of both the economy and the markets, but investors have to be willing and open to listening. Most often, preconceived notions about what should be happening get in the way. It's easy to only see factors that support one's worldview, and this "recency bias" leads investors to expect that whatever is happening currently will continue. We have suspected since the early spring that the July and September FOMC meetings would be key for the economy and the markets. Rate increases of 25 basis points in March, 50 basis points in May, and 75 basis points in June were expected by the markets. The stakes get much higher from here.

Over the last month or two, fears of a recession have begun to approach or surpass fears of inflation. The markets are sending this message. Most stock indexes fell between 15-20% in the second quarter, and the NASDAQ, the home market for many growth and tech companies, dropped by more than 20%. The Fed paid little respect to the stock market as a leading indicator at their June meeting. Stock prices and valuations dropped during the period, as investors feared future actual and estimated reductions in earnings.

But changes are afoot, especially over the last four to six weeks. National Association of Purchasing Managers manufacturing and services indexes fell to yearly lows, and their pricing index declined for the third straight month. New and existing home sales have declined. Small business optimism is at a nine-year low. Indicators of consumer confidence have plunged. One bright spot is employment; the unemployment rate has remained below 4% since the beginning of the year, employers struggle to find employees, and many who are willing to change jobs can gain significant salary increases. At the same time, changes with the employment picture are also creeping in. Weekly unemployment claims have slowly climbed to an eight-month high. These are economic activity indicators that have rolled over, but price indexes are also moving lower.

The commodities index is now down over 10% since early June. Crude oil is also down over 10% over the same five-week period. Market indicators of inflation over the next five and ten years have moved to twelve-month lows. All of these market price indicators have moved lower. The Consumer Price Index (CPI) is a trailing indicator. Waiting to stop rate increases until you see a decline in CPI is truly like

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driving a car while looking in the rear view mirror. Chairman Powell, are you playing checkers while market participants play chess?

It is entirely possible that we have already seen the high in longer Treasury rates and the low in the stock market. The FOMC raised rates 75 basis points on June 15th. The ten year Treasury yield hit a high of 3.48% on June 14th and is now 50 basis points lower. The S&P 500 Index closed at a low of 3667 on June 16th and is now 7% above that level. Based on what has happened in the economy and the markets over the last month, we would not expect the Fed to follow through on the 2% of rate increases that are anticipated over the next four Fed meetings this year. Those potential increases would bring short-term rates to over 3.5%. That is higher than all longer Treasury yields, which have moved lower over the last month. Keep in mind that all of these lower commodity prices and slowing of economic indicators have happened with the Fed Funds rate at 1.625%.

If the Fed is successful in recognizing a decline in price pressures, and responding with a slower path of rate increases, that could be very good for both the stock and bond markets. Declines in stock and bond markets are painful, especially when they happen concurrently. In most bear markets, defined as 20% declines from peak, market returns are higher one, three, and twelve months out. So far, that is what has happened since early June.

We have remained focused on summer as a key point of reckoning for both the Fed and the economy. Our best case scenario is that price indicators would slow or reverse their rise and the Fed would recognize the change and slow the path of rate increases. The apparent softness in the economy should help get their attention as well. Our concern is that the Fed now wants to see a material slowing in the economy, in addition to lower price indicators and inflation, in order to feel justified that they have vanquished the inflation genie. We believe that the market is sending signs that their work is on-track and closer to complete than recent backward looking inflation indicators may indicate. Jerome Powell, listen to the markets.

Random thought: "In my career, the Fed has a 100 percent error rate in predicting and reacting to important economic turns." - John Allison IV, retired CEO of BB&T bank

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