Monday July 10, 2023

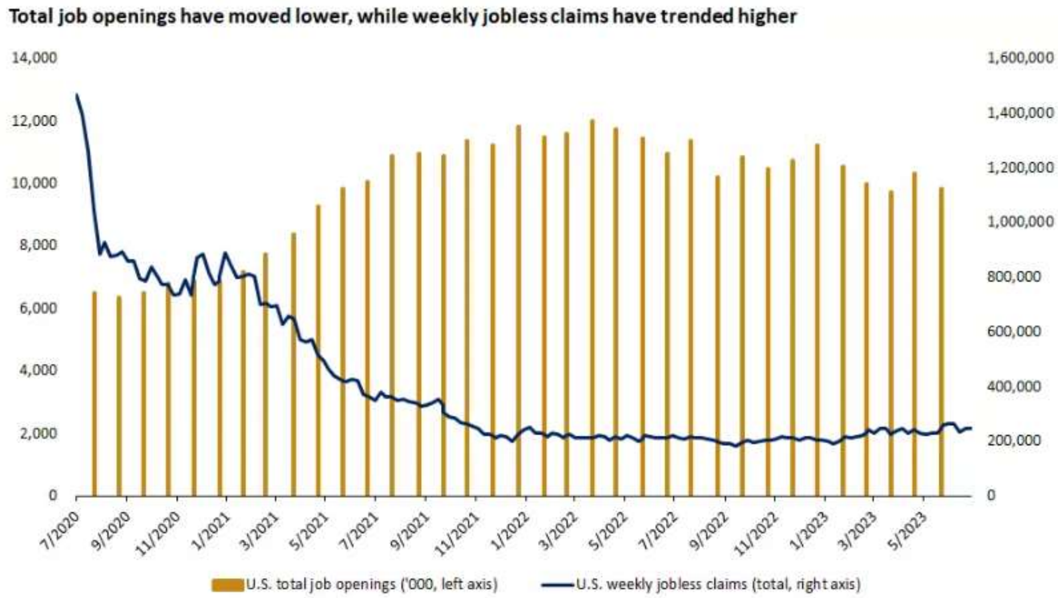
SUMMARY-

I. *Strong labor data supports the Fed's case for more hikes.*
II. *Inflation remains in decline thanks to several key factors.*
III. *Markets believe Fed nearly finished but expect higher rates for longer.*
IV. *Earnings, Inflation, and Sentiment reports to drive markets this week.*

Good afternoon:

After two strong quarters for equities, stocks began Q3 last week on a weaker note with all major stock indices down between 1-2%. Two key jobs reports for June confirmed the economy's resiliency, driving bond yields higher and increasing expectations for the Fed to keep rates higher for longer. However, the strong labor market decreases the likelihood for a near-term recession or sharp economic downturn.

The ADP private payrolls report for the month of June came in well above expectations, adding 497,000 jobs versus forecasts for 225,000. Of the jobs added, nearly 75% were in services sectors while 25% were in goods-producing sectors, with the biggest gains coming from leisure and hospitality. Markets then digested the somewhat softer June nonfarm payrolls report showing 209,000 new jobs added last month versus expectations of 230,000 and well below last month's 306,000 (which were also revised lower). Although showing signs of cooling, these results continue to support a growing level of consumer spending typical for an economy enjoying full employment conditions.



Source: FactSet

Despite continued strength in the labor market and the resulting growth in consumer spending, inflation remains in decline. This is due to several key recent trends. Last year's price spikes in various commodities, particularly energy and raw materials, have mostly settled back down to far lower levels. The ADP private payrolls report also showed wage growth declining for the ninth consecutive month. And finally, both prices-paid components within the Institute of Supply Management's (ISM) manufacturing and services indices continued to decline in June. Considered a leading indicator of inflation, both measurements came in at their lowest levels in more than two years. At this current trajectory, inflation may be down to the 3% level by year end.

ISM prices paid in manufacturing and services point to a cooling in inflation

Source: Bloomberg

These recent economic reports have reinforced the market's expectation that the Fed will likely resume their tightening with another ¼% hike this month with the chance for another small increase in the fall, and that rates may remain higher for longer before any Fed rate cuts would be considered. With the yield curve still clearly inverted (shorter-term bonds yielding more than longer-term), 2-year Treasury bond yields climbed back to 5%, while 10-year Treasury bonds again eclipsed 4%. However, whether the Fed feels the need to impose another small raise or two for good measure, they are clearly at or near the end of the long and historically aggressive tightening cycle. Recent market strength reflects this reality along with the economy's surprising resiliency during this process.

Source: Bloomberg

Second-quarter earnings season kicks off this week with several of the nation's largest banks set to report their revenue and earnings. These results, along with their forward-looking guidance, will be closely watched as they may provide a glimpse into the state of corporate America and how their profits are holding up in this higher interest rate environment. Additionally, this week's CPI and Consumer Sentiment reports will all likely set the tone for market action this week with all major averages starting off this morning in positive territory. The result may be enhanced volatility in either direction as this new data is digested.

Have a great week!

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