Monday November 13, 2023

SUMMARY-

I. Large cap stocks continue rebounding while small caps retreat.

II. Q3 earnings have again been strong but guidance is softening.

III. Consumer spending has led to less savings and higher credit balances.

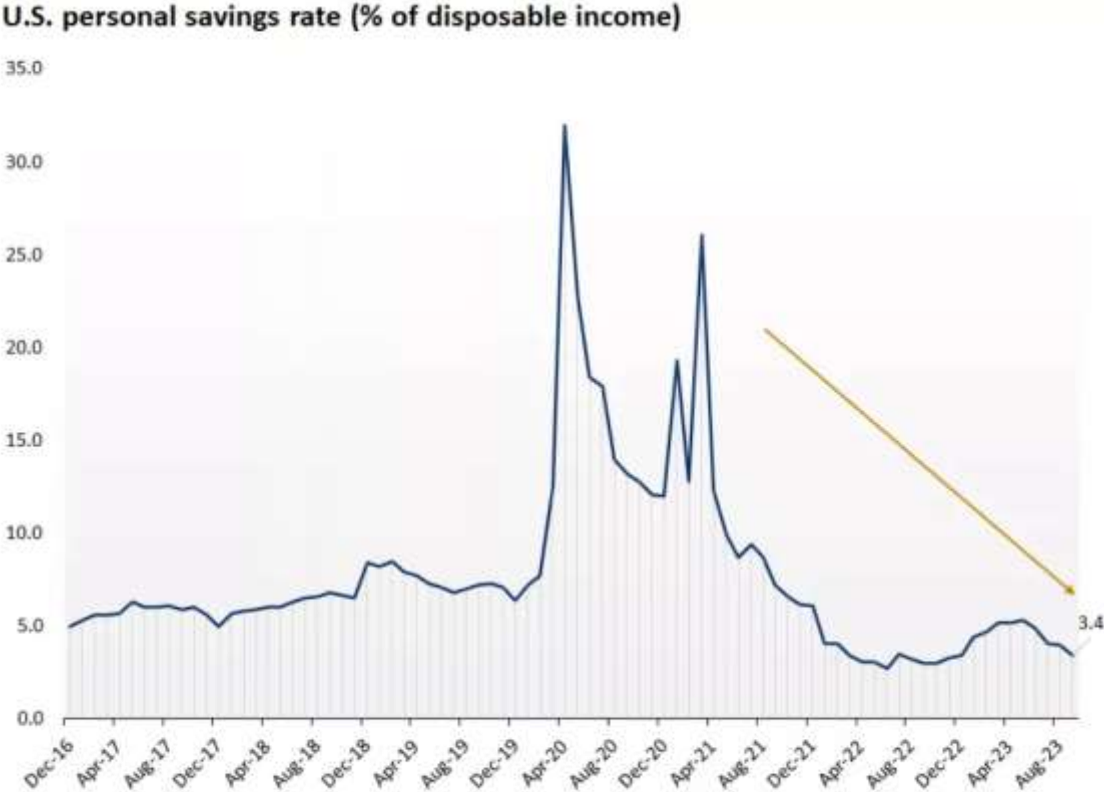
IV. This week's inflation data could predict Fed's next moves.

Good morning:

Most of the equity market continued to rebound last week, led once again by large cap technology companies. Leading all major averages was the NASDAQ that added 2.40%, while the small caps in the Russell 2000 Index was the outlier declining -3.11% by Friday's close. With almost 90% of the index's market cap having reported, S&P 500 operating earnings are on track to finish 3Q23 +4.5% y/y. While results have fared well this quarter, we are beginning to see a slowdown on a sequential basis. Analysts are currently tracking a q/q operating EPS decline of 3.8%, with many companies also downgrading guidance for 4Q23 and 2024. Nevertheless, the U.S. economy has remained remarkably resilient through the first three quarters of 2023. In fact, the third-quarter GDP annualized growth rate of 4.9% was the strongest since 2021 and well above what is considered trend growth in the U.S. of 1.5% - 2.0%. As we have discussed, this economic growth has been due to remarkably strong and increasing personal consumption this year. Remember, the U.S. economy is driven by the consumer and their propensity to consume (consumer spending comprises about 70% of

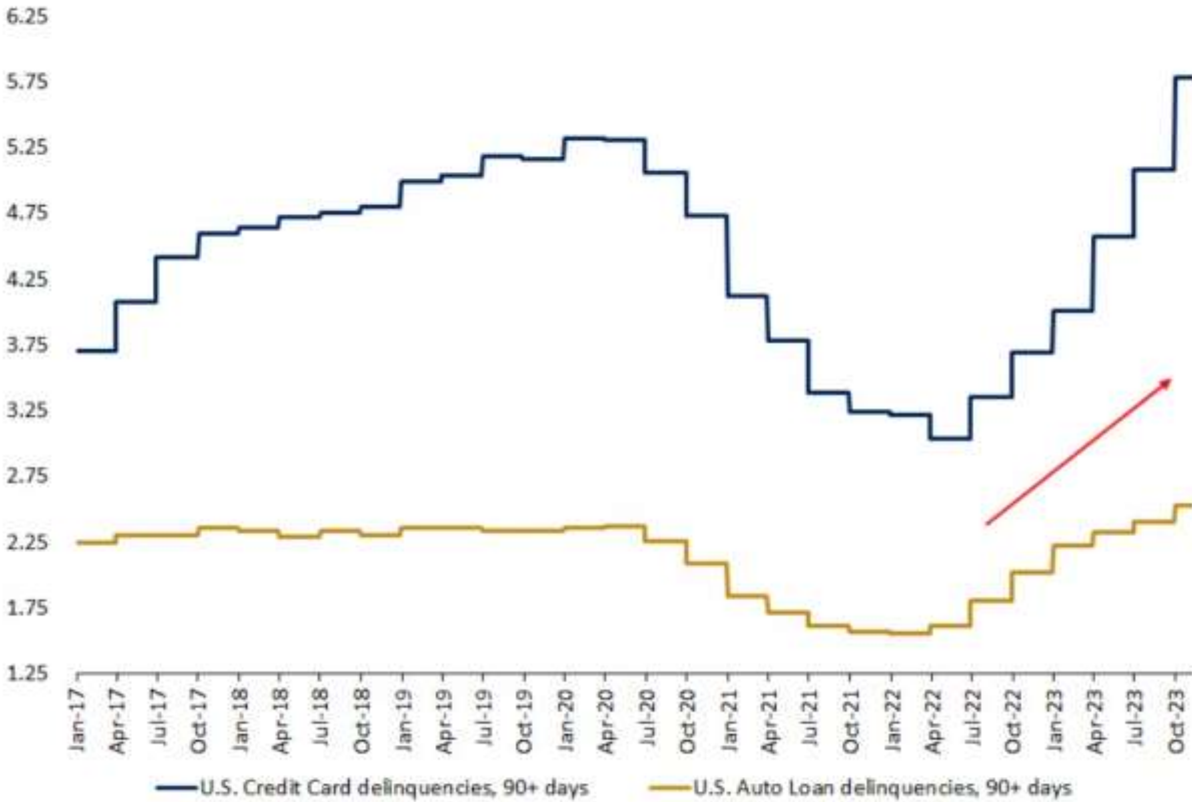
U.S. GDP). As the holiday shopping season rapidly approaches, several factors are emerging, however, that could spell a modest slowdown in consumer spending.

During and immediately after the pandemic, many households were flush with cash from a combination of stimulus payments and a lack of normal activities outside the home. According to the San Francisco Federal Reserve, households had accumulated about $2.1 trillion in excess savings in 2021. However, much of this may now be depleted, as consumers have spent on both goods and services over the past two years. Additionally, higher inflation rates may have hit those at lower income brackets the hardest as the U.S. personal savings rate is now down to 3.4%.



Source: Bloomberg.

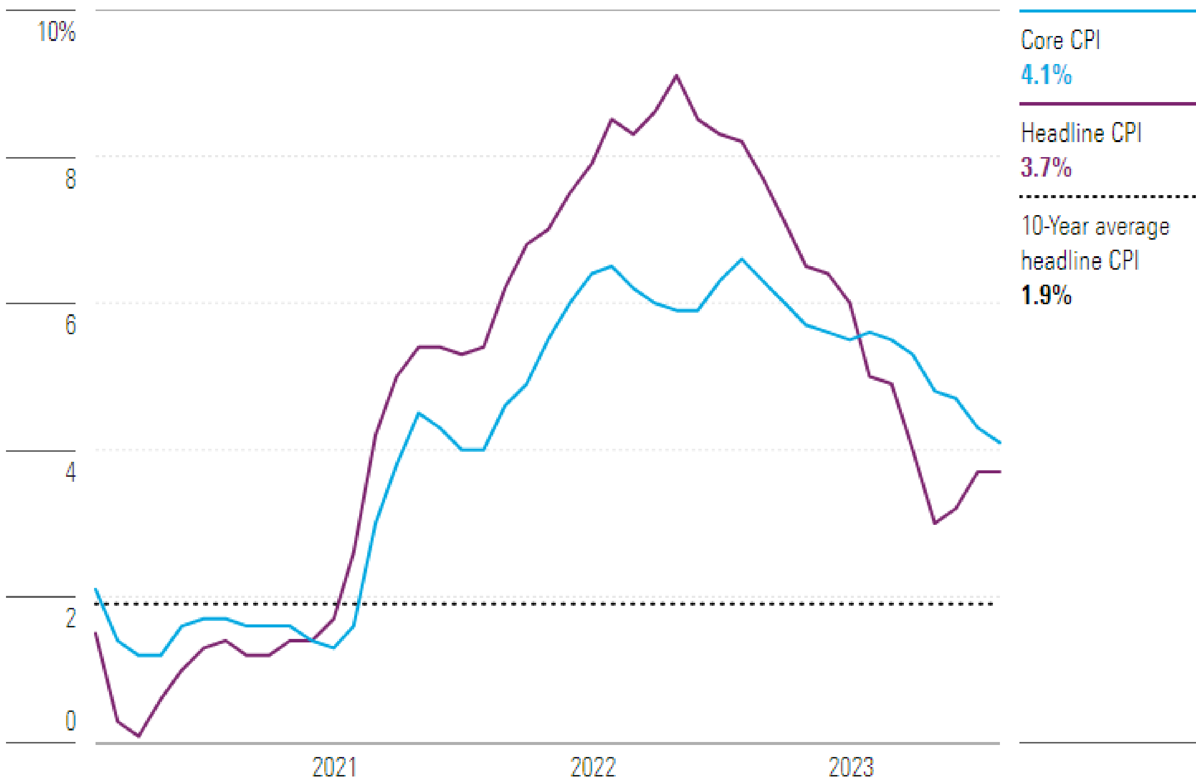
At the same time, consumers have also increased their overall credit card debt. The total credit card debt in the U.S. has risen to over $1 trillion as of the end of third quarter 2023, its highest on record. As one would expect, delinquencies on credit cards, as well as auto loans have also started to increase. While these are both far from prior recessionary levels, it is reasonable to expect some level of decline in further consumer spending or borrowing in the coming months.



Source: Bloomberg.

Although the market's direction in the long run comes from corporate earnings, its short-term direction often takes its queues from the Fed and the direction of interest rates. Remember, the Fed has been aggressively hiking rates for more than a year in an attempt to slow the economy down to quell inflation. Any evidence of such a slowing should not only be seen as expected, but as evidence of a *successful* tightening campaign…so long as the economy doesn't roll over too hard! Once again, this is the elusive Goldilocks economy that they are trying to orchestrate.

The next important pieces of critical economic data the Fed will be closely analyzing to help guide their next moves will both be released this week. Before markets open tomorrow, October CPI data will be announced. The Consumer Price Index is forecast to come in at a 3.3% annual rate, down from 3.7% in September. Meanwhile, Core CPI (which excludes volatile food and energy prices) is anticipated to remain at September's level of 4.1%. Then on Wednesday, perhaps an even better *leading* indicator of near-term consumer price trends will be released in the Produce Price Index (PPI) data for October. This measures the average change over time in wholesale prices paid for goods and services by enterprises. Such higher costs are generally passed on to customers as higher prices down the road.



While the Fed wants to remain cautious with their recent rhetoric, and ready to hike again if necessary, their actions tell a different story. The lagging impact from recent rate increases, softening labor statistics and consumer spending data, as well as declining oil prices may very well be enough to keep inflation on a glide path to their 2% target rate and therefore mean we have already seen their last hike in this cycle. It seems clear that many equity traders have come to this conclusion as well, prompting further justification for this month’s rally. This week’s inflation data could help or hurt this thesis and will likely set the tone for equities in the near term.

Have a great week!

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