

Financial Markets This Week

25 AUGUST 2023

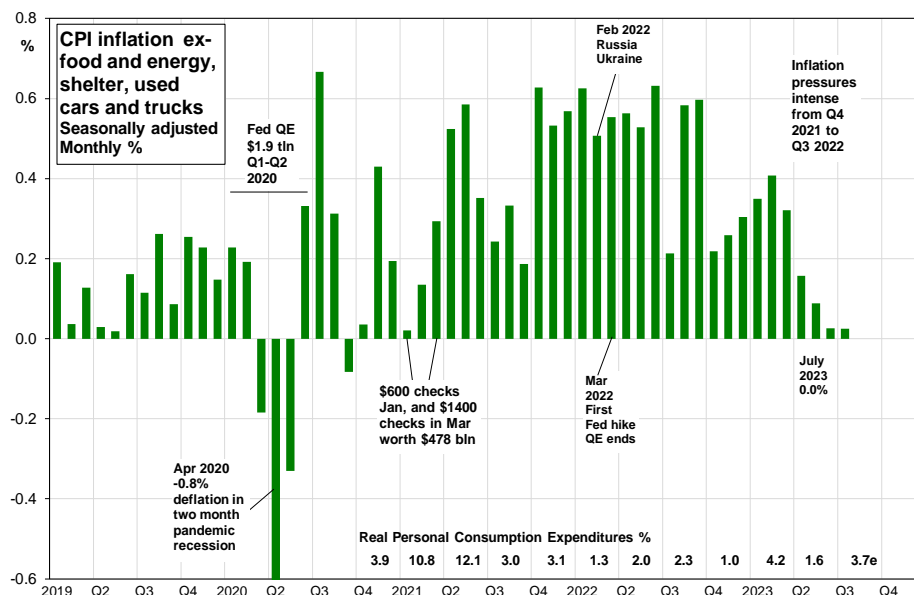
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JACKSON HOLE MESSAGE THE SAME

The market took Powell's speech in Jackson Hole at 10:05am ET more hawkishly than we initially thought it would. The yield curve flattened in preparation for a rate hike and stocks fell as much as 0.5% at the low point, after dropping 1.3% on Thursday in preparation for Powell. Powell said the job wasn't done until inflation returned to the 2% target, which is similar though

180 degrees in the opposite of Powell promising to keep at it, keep rates at zero and flood the country with QE stimulus dollars, until double-digit unemployment returned to the 3.5% best economy in fifty years before the pandemic struck. That policy move didn't work out well as it arguably helped to unleash the worst inflation outbreak since the 1980s. Not sure of the reason for the Fed speaker to jab his finger in the air for emphasis. Even before the inflation data improved recently, Fed forecasts were not looking for core PCE inflation to return to 2.2% until Q4 2025 nearly two-and-half years from now. In fact, the Fed forecasts look for 75 bps of rate cuts to 4.75% at the end of 2024 if Q4 2024 core PCE inflation falls from 4.1% today to 2.6% in Q4 2024. It was always going to take some time. A long time. Like years.

The executive summary of today's speech is all in the opening and final paragraphs. First inflation remains too



First paragraph

Good morning. At last year's Jackson Hole symposium, I delivered a brief, direct message. My remarks this year will be a bit longer, but the message is the same: It is the Fed's job to bring inflation down to our 2 percent goal, and we will do so. We have tightened policy significantly over the past year. Although inflation has moved down from its peak—a welcome development—it remains too high. We are prepared to raise rates further if appropriate, and intend to hold policy at a restrictive level until we are confident that inflation is moving sustainably down toward our objective.

In last paragraph

As is often the case, we are navigating by the stars under cloudy skies. In such circumstances, risk-management considerations are critical. At upcoming meetings, we will assess our progress based on the totality of the data and the evolving outlook and risks. Based on this assessment, we will proceed carefully as we decide whether to tighten further or, instead, to hold the policy rate constant and await further data...

high, and they can hike again and they will hold rates at a restrictive level until they get results. The final paragraph says they will assess their progress in future meetings when deciding whether to tighten or whether to hold rates where they are, currently 5.5%.

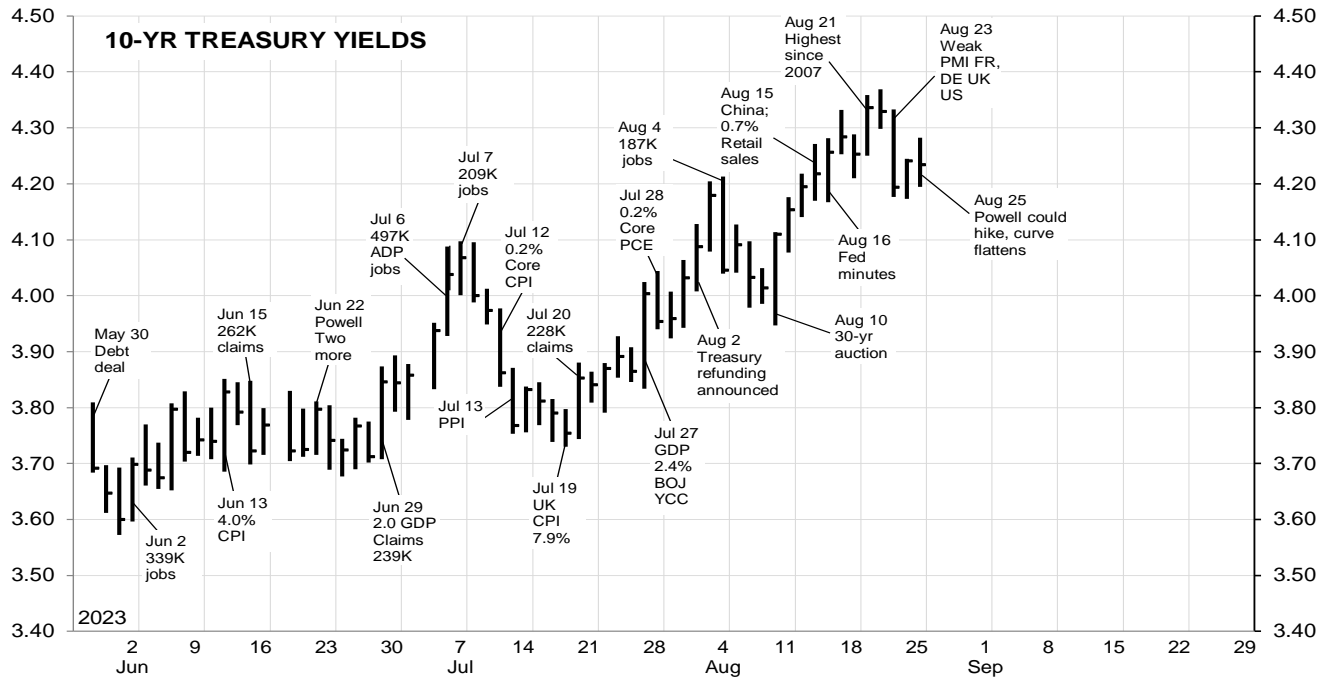
Saying inflation is too high doesn't seem to be completely accurate. Monthly changes in inflation have slowed dramatically, and here we refer to the graph at the top of page one of this report. Extra core CPI which leaves shelter and used vehicles on the side, in addition to traditional core CPI that subtracts away food and energy prices that the Federal Reserve historically says it cannot have any influence over, extra core price increases have stopped the last two months. Extra core price changes have been 0.2% or less for four straight months which is the best and lowest seen since early in 2019 before the pandemic. On a year-year basis, extra core CPI was 6.3% at Jackson Hole in 2022 and it is 3.4% today. The inflation fire isn't out, but it sure isn't burning as brightly either.

Looking ahead, Powell said at the July 26 press conference they were waiting on more data which at this point includes payroll employment on Friday, September 1, and August CPI inflation on September 13. There have been two consecutive months of 0.2% core CPI changes, June and July, and one month for core PCE inflation that Powell cannot stop talking about which is 0.2% in June (4.1% year-year). In Powell's speech today, the economics staff forecast the July core PCE inflation to be released Thursday, August 31 will be 4.3% which means after our pencil sharpening that it is not impossible for core PCE inflation to rise 0.3%. Probably not a good outcome if it happens, but keep in mind core PCE inflation year-to-year should fall sharply in August and September (maybe back to 3.8% YOY) because of the big increases last year 0.6% in August, 0.5% in September which will fall out of the year-year calculation. We don't know about higher for longer. Home prices are at record highs and maybe rates need to stay high. But if you think inflation is still too high, the last few months are actually weak. Consumer spending is back on this quarter with perhaps an increase of 3.7% at the bottom of the graph on page one, but spending may not last at that level and the estimate made for Q3 only has partial retail sales data for July. Stay tuned.

Dec 2021 Weight	Year-Year % Change			Monthly % changes			
	Dec 2020	Dec 2021	Dec 2022	Mar 2022	Apr 2023	May 2023	Jun 2023
1.000 PCE inflation	1.3	6.0	5.3	0.1	0.3	0.1	0.2
0.075 Food at home	3.9	5.7	11.6	-0.2	0.0	0.1	-0.1
0.027 Energy goods	-15.1	47.1	3.1	-4.6	2.4	-5.5	0.8
0.016 Electricity/Gas	2.3	9.9	17.1	-2.4	-1.7	-1.4	0.3
0.883 Core PCE	1.5	5.0	4.6	0.3	0.4	0.3	0.2
Durable goods							
0.020 New vehicles	1.8	11.2	7.4	0.4	-0.2	-0.1	0.0
0.017 Used vehicles	10.1	36.2	-6.7	-0.9	4.5	4.5	-0.4
0.030 Furnishings	3.1	8.8	5.0	0.0	-0.9	-0.6	-0.3
0.037 Recreational	-0.9	1.3	-1.5	-0.3	-0.5	-0.3	-0.7
Nondurable goods							
0.028 Clothing	-4.6	5.5	3.0	0.3	0.4	0.4	0.3
0.030 Prescription drugs	-2.4	0.0	1.8	0.1	0.3	0.1	0.0
0.010 Personal care	-0.3	0.3	7.9	0.9	0.6	1.1	0.2
0.239 Goods x-foodenergy	0.0	6.1	3.4	0.2	0.2	0.4	-0.1
0.644 Services ex-energy	2.0	4.6	5.1	0.4	0.4	0.3	0.3
0.036 Rents	2.3	3.3	8.4	0.5	0.6	0.5	0.5
0.112 Home prices	2.2	3.8	7.5	0.5	0.5	0.5	0.4
0.161 Health care	2.6	2.7	2.5	0.3	0.4	0.3	0.1
0.031 Transportation	-2.9	8.3	13.5	0.5	-1.1	0.1	-0.4
0.035 Recreation	1.7	4.3	5.7	-0.1	0.2	-0.3	0.5
0.059 Food services	4.3	6.8	7.5	0.5	0.5	0.5	0.4
0.011 Hotels/Motels	-8.0	20.8	1.7	2.4	-2.6	1.6	-1.8
0.080 Financial/Insurance	1.4	5.0	0.6	-0.3	1.1	0.0	0.4
0.080 Other services	1.3	3.0	4.1	0.4	0.8	0.0	0.5
0.030 Nonprofits	3.7	13.0	7.6	0.7	0.0	0.9	0.3
Year-year is Dec/Dec Percent Change							

Next up: July PCE inflation report Thursday, August 31															
Monthly % Changes	2023					2022							2022		
	Jul	Jun	May	Apr	Mar	Feb	Jan	Dec	Nov	Oct	Sep	Aug	Jul	Jun	May
Core CPI inflation	0.2	0.2	0.4	0.4	0.4	0.5	0.4	0.4	0.3	0.3	0.6	0.6	0.3	0.6	0.6
Core PCE inflation		0.2	0.3	0.4	0.3	0.3	0.5	0.4	0.2	0.3	0.5	0.6	0.1	0.6	0.4
Core PCE YOY		4.1	4.6	4.6	4.6	4.7	4.7	4.6	4.8	5.1	5.2	4.9	4.7	5.0	4.9
Core CPI YOY	4.7	4.8	5.3	5.5	5.6	5.5	5.6	5.7	6.0	6.3	6.6	6.3	5.9	5.9	6.0

INTEREST RATES



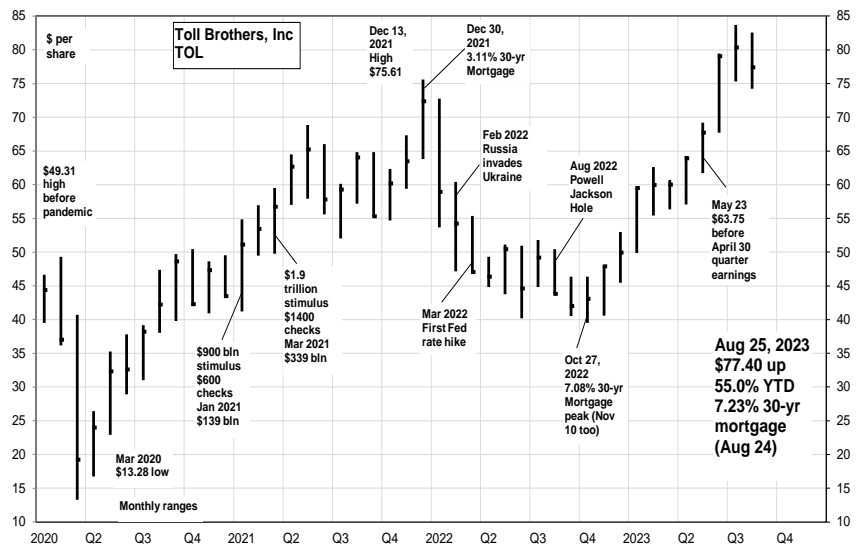
Starting in European trading on Monday, bond yields went to the highest levels since 2007. Sounds dramatic, but the old high was 4.325% on October 21, 2022 when the Fed funds rate was 3.25%. Bonds ahead of the Fed last year, now behind the Fed and waiting for a policy reversal with the Fed funds rate way up at 5.5%. The 10-year yield high Monday was 4.355% and 4.37% on Tuesday, the new peak. What happened starting in Europe came back down during the European trading session on Wednesday starting with French purchasing managers saying there is weakness at 315am ET, then weak PMIs from Germany, UK, and finally USA. Powell the hawk sent yields up the first half-hour after the headlines appeared, and settled back some. Short-term yields went up, and bonds sat still, a yield curve flattening that happens when the market sees rate hikes ahead. All that was missing from Powell was him trying to talk Fed officials' terminal rate forecasts higher than 5.75%.

Toll Brothers, Inc. (TOL) up 55.0% YTD, Powell watching housing's recovery

The stock was \$75.94 at Tuesday's close and after earnings went as high as \$80.13 on Wednesday. Along with other homebuilders, the stock fell 4.6% on August 17 to \$76.45, when 10-year yields matched 2022's high of 4.33% the first time. Record Q3 earnings; higher interest rates a risk.

Quarter end	Home Sales Revenue	Home Sales Units	Home Starts	30-yr mortgage	Home Sales
10.31.21	2.950	3,341	1,087,000	3.14	680,000
1.31.22	1.690	1,929	1,157,000	3.55	810,000
4.30.22	2.190	2,407	1,176,000	5.10	611,000
7.31.22	2.260	2,414	898,000	5.30	543,000
10.31.22	3.580	3,765	858,000	7.08	577,000
1.31.23	1.750	1,826	823,000	6.13	649,000
4.30.23	2.490	2,492	847,000	6.43	679,000
7.31.23	2.670	2,524	983,000	6.81	714,000

Last month of quarter, 1 unit housing starts, new home sales



FEDERAL RESERVE POLICY

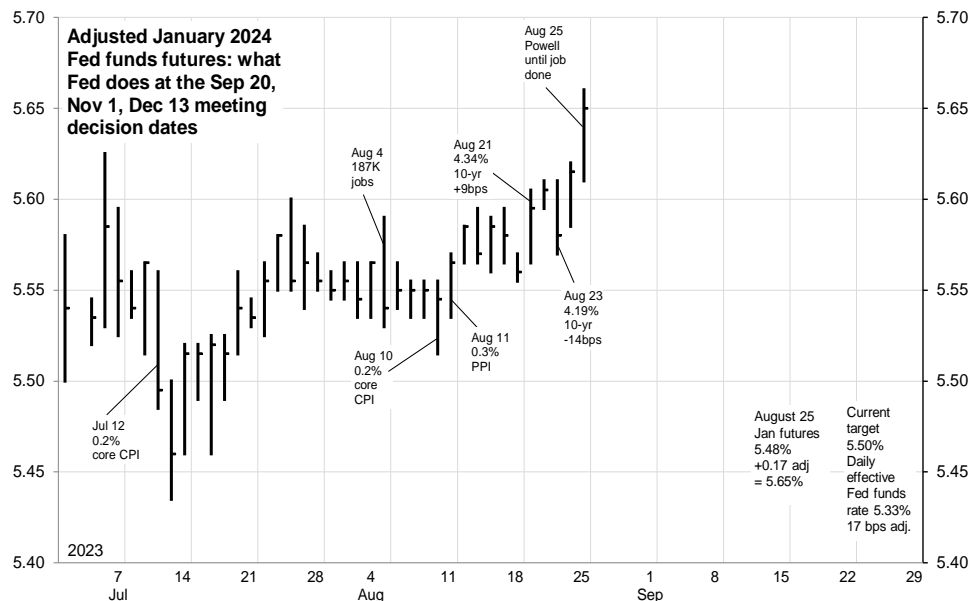
The Fed meets September 19-20, 2023 to consider its monetary policy. It will be important to get those quarterly forecasts. We don't know how interest rates this week could possibly be "higher for longer," more than we already knew unless they take the scissors out to the Fed funds rate forecasts. The June forecasts see rates falling from 5.75% at the end of 2023 to 4.75% at the end of 2024 (can't be higher for too long) which would be consistent with their idea of core PCE inflation coming down further from the forecast of 3.9% in Q4 2023 to 2.6% in Q4 2024. This means core PCE monthly changes in 2024 should have quite a lot of 0.2% increases.

We want to talk about the S&P 500 1.3% drop on Thursday ahead of Powell. Stocks stalled at the highs of the day shortly after 10am ET on an interview with Philadelphia Fed President Harker. While he said (again) they have probably done enough, he also said the current level of restrictive rates should be maintained for a while. The market is looking for lower Fed rates or hoping for it, and it was once banking on a recession to stop the Fed rate hikes. Now the worry is less on how high interest rates are going, but how long will interest rates stay at these levels. Harker seemed to be dovish, no more rate hikes, but the markets did not like hearing higher for longer or no rate cuts, the same thing more or less.

Fed funds futures yields have moved higher the last two week and after Powell's remarks on Friday as well. Inflation appears to be coming down, virtually on its own accord after the pandemic shortages and stimulus are gone, although the 5.5% Fed funds rate helped certainly. Powell seems to rely on the old economic models in his speech: his remarks on economic growth and the labor markets. He said monetary policy could respond (rate hike) if growth picks up or if the labor market rebalancing does not occur. Stay tuned. Story developing. Slightly over halfway there to discounting a 25 bps rate hike at the October 31-November 1 meeting.

Selected Fed assets and liabilities						Change from
Fed H.4.1 statistical release						3/11/20
billions, Wednesday data						to Aug 23
Factors adding reserves						
U.S. Treasury securities	5006.494	5006.075	5048.370	5048.025	2523.031	2483.463
Federal agency debt securities	2.347	2.347	2.347	2.347	2.347	0.000
Mortgage-backed securities (MBS)	2513.140	2517.483	2517.559	2517.559	1371.846	1141.294
Repurchase agreements	0.000	0.006	0.000	0.001	242.375	-242.375
Primary credit (Discount Window)	2.190	1.966	1.911	1.898	0.011	2.179
Bank Term Funding Program	107.386	107.242	106.864	105.684		
FDIC Loans to banks via Fed	137.171	141.636	145.407	148.072		
Paycheck Protection Facility	5.817	6.055	6.142	6.401		
Main Street Lending Program	19.512	19.497	19.771	19.752		
Municipal Liquidity Facility	5.615	5.612	5.609	5.607		
Term Asset-Backed Facility (TALF II)	1.581	1.580	1.579	1.577		
Central bank liquidity swaps	0.230	0.229	0.229	0.235	0.058	0.172
Federal Reserve Total Assets	8189.8	8196.6	8258.2	8256.6	4360.0	3829.751
3-month Libor-% SOFR %	5.30	5.30	5.30	5.30	1.15	4.150
Factors draining reserves						
Currency in circulation	2328.199	2330.572	2332.594	2333.186	1818.957	509.242
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000	0.000
U.S. Treasury Account at Fed	416.031	384.814	432.262	460.926	372.337	43.694
Treasury credit facilities contribution	13.358	13.358	13.358	13.358		
Reverse repurchases w/others	1816.533	1796.725	1796.519	1770.186	1.325	1815.208
Federal Reserve Liabilities	5012.398	4967.670	5029.632	5039.157	2580.036	2432.362
Reserve Balances (Net Liquidity)	3177.380	3228.952	3228.582	3217.397	1779.990	1397.390
Treasuries within 15 days	68.144	71.990	125.994	130.448	21.427	46.717
Treasuries 16 to 90 days	251.632	214.937	246.183	236.616	221.961	29.671
Treasuries 91 days to 1 year	634.931	667.757	624.898	629.989	378.403	256.528
Treasuries over 1-yr to 5 years	1719.070	1718.845	1723.880	1723.730	915.101	806.969
Treasuries over 5-yrs to 10 years	831.951	817.656	835.441	835.362	327.906	504.045
Treasuries over 10-years	1500.768	1514.890	1491.975	1491.880	658.232	842.536
Note: QT starts June 1, 2022						
Change 8/23/2023 6/1/2022						
U.S. Treasury securities	-764.285	5006.494	5770.779			
Mortgage-backed securities (MBS)	-194.306	2513.140	2707.446			
**March 11, 2020 start of coronavirus lockdown of country						

Fed Policy-key variables				Long
	2023	2024	2025	Term
Fed funds	5.6	4.6	3.4	2.5
PCE inflation	3.2	2.5	2.1	2.0
Core inflation	3.9	2.6	2.2	
Unemployed	4.1	4.5	4.5	4.0
GDP	1.0	1.1	1.8	1.8
June 2023 median Fed forecasts				

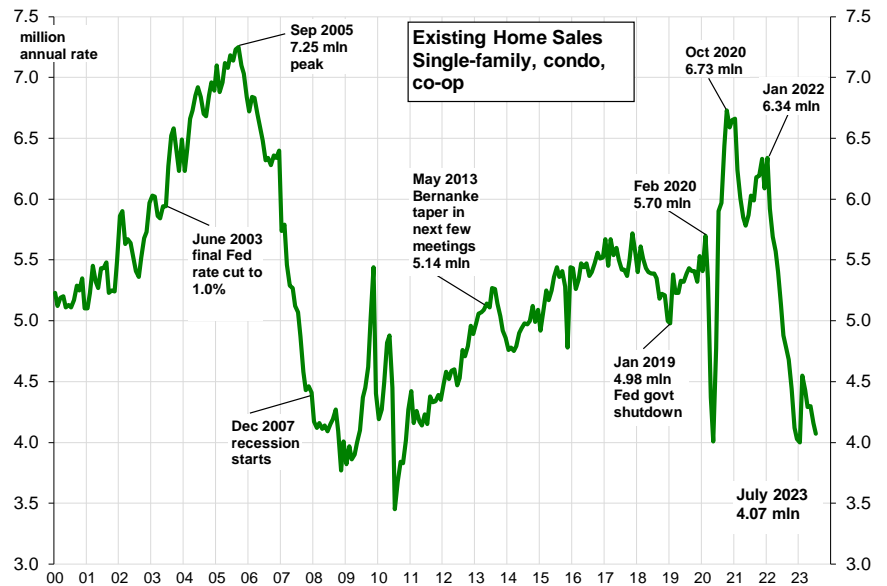


Fed funds futures call Fed hikes	
Current target: August 25 -- 5.50%	
Rate+0.17	Contract
Fed decision dates	
5.550	Oct 2023
	Sep 20
5.655	Nov 2023
	Sep 20, Nov 1
5.650	Jan 2024
	Sep 20, Nov 1, Dec 13
Last trade, not settlement price	

OTHER ECONOMIC NEWS

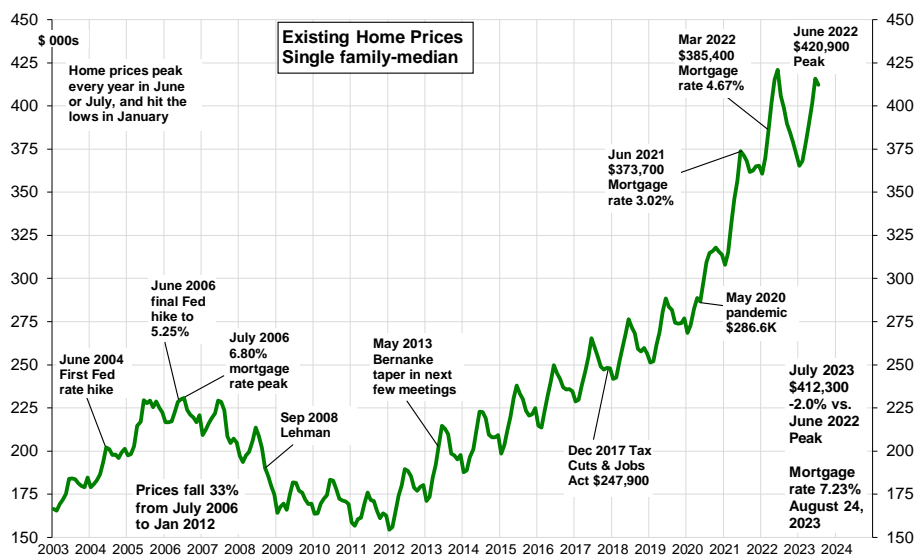
Home sales down in the dumps, prices off record highs (Tuesday)

Breaking economy news. Existing home sales retreat further from the optimism and flood of buyers seen earlier this spring. From a January low of 4.0 million for home sales, turnover jumped in February and while sales remained moderate this spring, sales have come back down, falling 2.2% in July to 4.07 million at an annual rate. Homeowners are staying put in part as they are locked in with very low mortgage yields from prior years, and this is limiting the supply of homes available for sale and keeping upward pressure on home prices. With mortgage yields approaching 7%, no one will be crazy enough to want to trade up in homes if they have to give up their 3 percent mortgages.



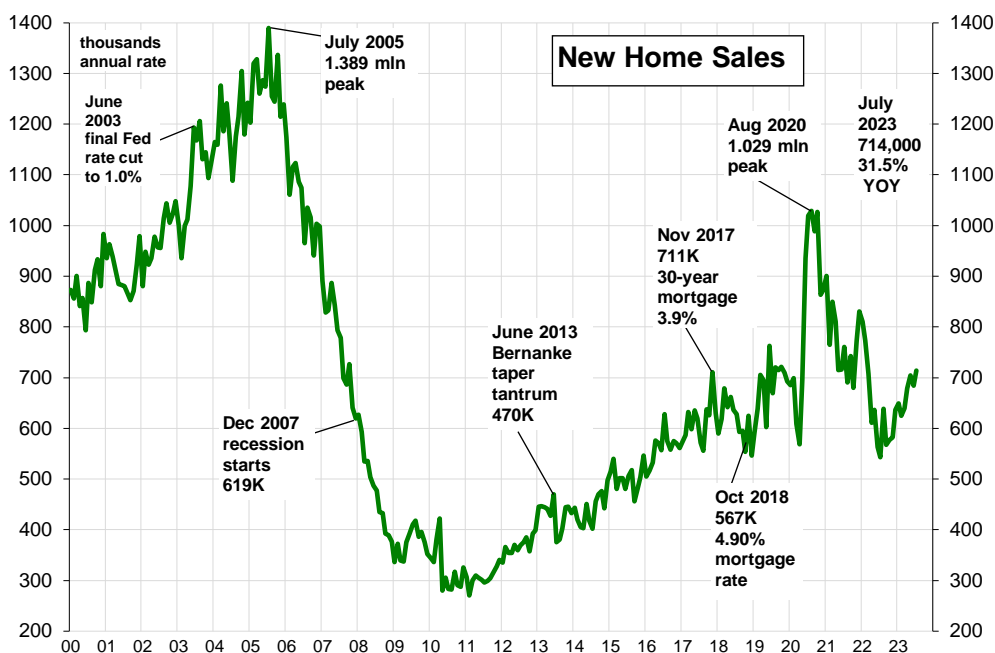
Single-family home prices did fall slightly in July as they normally peak during the summer selling season. Existing home prices fell 0.8% from \$415,700 in June, from very close to the record highs set last summer, to \$412,300 in July. The Fed's rate hikes haven't burst the housing bubble in prices yet.

Net, net, the pickup in existing home sales this spring has faltered as buyer confidence turns to pessimism and it is only going to grow worse as the housing affordability crisis intensifies from Fed rates staying higher for longer and home prices remaining elevated as well. The nationwide housing shortage keeps home prices out of reach for many home buyers and this along with higher borrowing costs is keeping the outlook for the residential housing market cloudy and gray. Unless there is a sudden drop in borrowing costs or home prices, the shortage of homes for sale on the market will not abate



New home sales, 306K fewer jobs! (Wednesday)

Breaking economy news. New home sales for July, and the benchmark revision estimate to nonfarm payroll jobs. There were 155.472 million nonfarm payroll jobs in March 2023 and that will be revised down by 306 thousand next January if the preliminary revision estimate holds up when it is finalized. The employment level is benchmarked annually to the more accurate count of jobs from state unemployment insurance records. The change is -0.2% and the average adjustment over the last ten years has been 0.1%. We don't see any sign here that the labor market is secretly weak. And keep in mind the economy is still growing, having created 870 thousand more jobs since March: July payroll employment is 156.342 million. When the economy stops growing, we will see nonfarm payroll employment fall. No recession looming here in the benchmark revision.



Another day, another sign that Fed rate hikes are not putting the kibosh on the housing market. Except maybe higher mortgage rates are keeping existing homeowners from wanting to trade their homes in and have to also have to trade in their 3% mortgage for a 7% one. New home sales in July are 714 thousand up at a new 2023 high that is 4.4% greater than June and 31.5% higher than it was in July 2022. Most of the gain was out West, up 21.5%, while the biggest market in the South fell 6.3%. We are not sure why homebuilders are so glum in those sentiment surveys that are taken because they completed the construction of 1.018 million single-family homes in July and the public bought 714 thousand of them. Both figures are at annual rates of course.

The housing bubble in prices has not burst even though we think these data are almost too volatile to tell a story. The median sales price in July was \$436,700 versus the full year 2022 average price of \$457,800. No real sign of deflation in home values that could scare consumers.

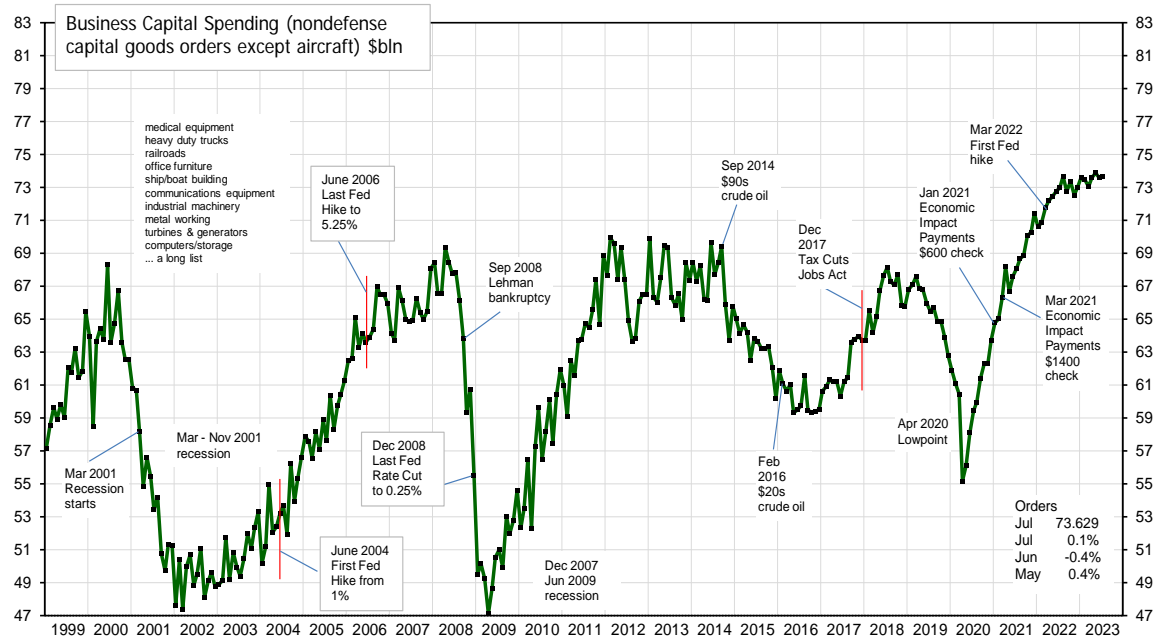
Net, net, the market for new homes is seeing a boom as the Federal Reserve's interest rate hikes are not deterring buyers. Inflation has been so high until recently that the rapidly advancing levels of prices and wages has made even a 7% mortgage look cheap for new homebuyers. It is a good thing the Fed is likely to pause its rate hikes later this year because of its success in slowing inflation down. If new home sales data were guiding policymakers, today's report would tell them interest rates are not nearly high enough to slow the housing market down, the most interest-rate sensitive sector of the economy next to autos and light trucks.

Orders up and layoffs down (Thursday)

Breaking economy news. Jobless claims and durable goods orders. Durable goods orders were walloped in July with a 5.2% drop, but the orders were actually up 0.5% when subtracting out volatile transportation orders. The proxy for business investment is nondefense capital goods orders ex-aircraft and these eked out a small 0.1% increase in July with June's prior 0.1% gain revised to a 0.4% decline. Companies are not in a rush to order more long-lived capital goods to meet the demand for their goods and services that they provide and time will tell if this reflects caution about the outlook. The Federal Reserve has pumped up interest rates to levels not seen in two decades in the attempt to slow aggregate demand and there is a question mark on whether Fed officials need to keep pushing interest rates even higher. We don't recall a Jackson Hole speech so hotly awaited, although part of this nervous anticipation may reflect Powell's short and sweet warning a year ago which dropped the stock market 3.4% the day he spoke. Times are different today as the Fed funds rate was only 2.5% when he spoke at Jackson Hole in August 2022 with many more hikes to come.

The labor market remains on solid ground with first-time applications for unemployment benefits falling back to 230K in the August 19 week from 240K in the August 12 week. Companies may be growing more cautious when it comes to ordering up more equipment, but they are not tightening their belts when it comes to labor costs and they continue to keep headcount revisions to a minimum. The labor market is tight and it is not easy to replace workers that companies let go with the unemployment rate just a tenth above the lowest, and best level since the late 60s.

Net, net, the growth in capital spending orders is starting to slow down, but labor markets remain firm and are supportive of an overall strengthening of GDP in the third quarter from 2.4% in the second quarter. It is a miracle



that the economy is still standing after \$5 dollar gasoline prices and the Fed's rapid rate hikes last year. Fed officials may need to tinker with their economic models because monetary policy is having less effect on the economy than it did in prior years and decades. It is a good thing inflation is coming down because the economy is not slowing down. The current group of Fed officials are one of the luckiest in history and the days for more and more interest rate hikes are likely nearing the end. The inflation battle is not over, but the central bankers have the upper hand.

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