Financial Markets This Week

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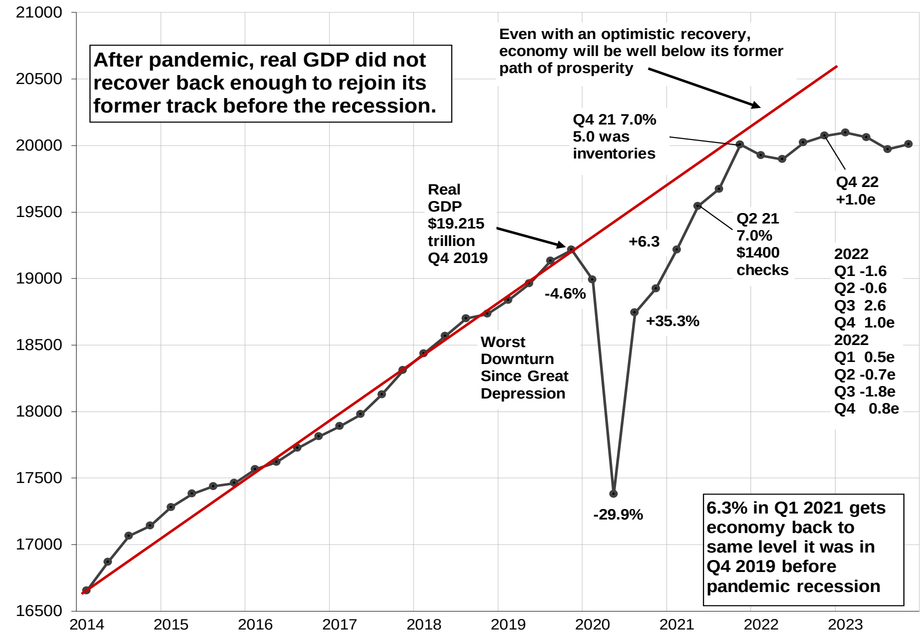
GROWTH IS BACK. NO RECESSION YET.



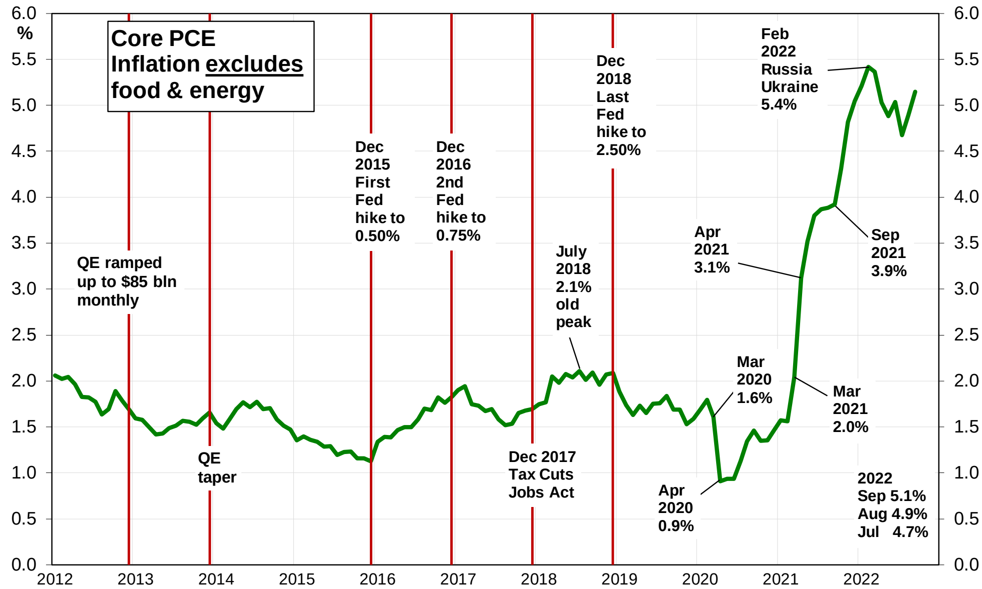
If you can stop watching the big tech wreck in earnings this week, and the equally fascinating S&P 500 "we don't care" stock market rally to new highs on Friday, we will take a look this week at what is happening in the real economy.

Real GDP was up 2.6% in Q3 2022 after falling in the first half of the year. Imports fell boosting growth which is not what you would expect for "growth," Americans buying fewer imported goods, but it is gross domestic product GDP. Business investment in equipment added 0.5 percentage points as it looks like civilian aircraft orders came back. Maybe not in the fourth quarter as the consumer was still buying in September which boosts Q4 GDP, but we will forecast another downturn in economic growth next year, basically because the Fed will keep lifting rates until something breaks, either the upward trend in inflation, or economic growth and the labor market, or both. Continuing unemployment claims rose the last two weeks, maybe there aren't as many jobs out there and jobless workers can't come off the unemployment rolls as quickly as they normally do.

	Q2 21	Q3 21	Q4 21	Q1 22	Q2 22	Q3 22p
REAL GDP	7.0	2.7	7.0	-1.6	-0.6	2.6
REAL CONSUMPTION	12.1	3.0	3.1	1.3	2.0	1.4
CONSUMPTION	7.8	2.0	2.1	0.9	1.4	1.0
Durables	0.9	-2.2	0.4	0.6	-0.2	-0.1
Nondurables	1.7	0.3	0.1	-0.7	-0.4	-0.2
Services	5.2	3.9	1.6	0.9	2.0	1.2
INVESTMENT	0.3	1.8	5.1	1.0	-2.8	-1.6
Business Plant	-0.1	-0.2	-0.4	-0.1	-0.3	-0.4
& Equipment and	0.7	-0.1	0.1	0.6	-0.1	0.5
Intellectual Property	0.6	0.4	0.4	0.5	0.5	0.4
Homes	-0.2	-0.3	-0.1	-0.2	-0.9	-1.4
Inventories	-0.8	2.0	5.0	0.2	-1.9	-0.7
EXPORTS	0.5	-0.1	2.4	-0.5	1.5	1.6
IMPORTS	-1.1	-1.0	-2.5	-2.6	-0.4	1.1
GOVERNMENT	-0.5	0.0	-0.2	-0.4	-0.3	0.4
Federal defense	-0.1	-0.1	-0.2	-0.3	0.1	0.2
Fed nondefense	-0.4	-0.4	0.2	0.0	-0.3	0.1
State and local	0.0	0.5	-0.2	0.0	-0.1	0.2

Below line: Percentage point contributions to Q3 2022 2.6% real GDP
Second estimate for Q3 is Wednesday, November 30

To conclude, the economy took a step back from the cliff with a return to positive growth in the third quarter that slams the door shut on the downturn in real GDP growth in the first half of the year. There hasn't been a recession yet with positive growth and this report on Thursday pushes back at Wall Street's fears of a hard landing for the economy. We aren't out of the woods. The Fed is still on its aggressive path of tightening credit and financial conditions in the economy and the Fed funds rate was still relatively low at just 2.5% until very late in the third quarter, so a dramatic slowdown from monetary policy tightening could still be coming in the months to come. The third quarter escaped from the economic downturn, but the fourth quarter and 2023 may not be so lucky if the Fed keeps pushing rates up looking for the breaking point where the economy cries uncle.

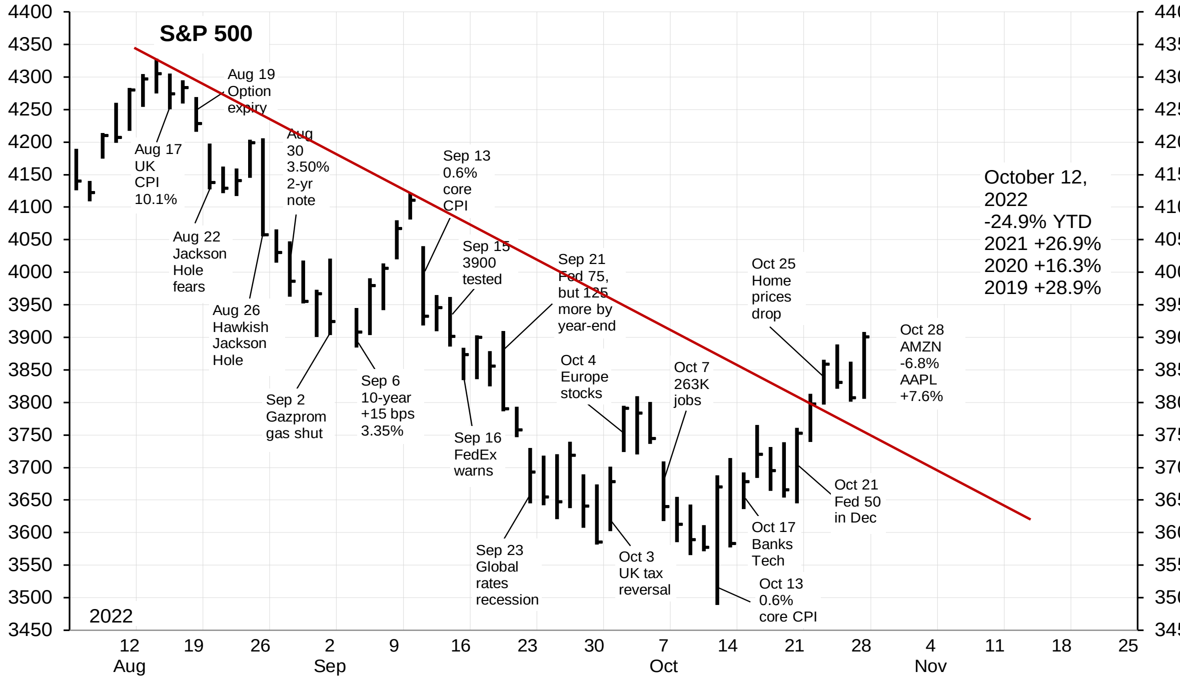


Now for the Fed's preferred measure of inflation released Friday in the personal income report. Two weeks ago, the Fed's not-preferred measure of inflation, core CPI, rose 0.6%, up 6.6% year-on-year. The S&P 500 dug a hole in the ground falling all the way to 3,491.58, down 27.5% from the highs in January this year on the CPI news. Heck the stock market only fell 28.0% in the long 1981-82 recession with the huge Volcker rate hikes to over 20%. On Friday, a second look at consumer inflation for the month of September, core PCE inflation, rose 0.5%, up 5.1% year-on-year. The market has had enough of September consumer inflation apparently in Friday's rally. The stock market obviously knows what it is doing and looks like it no longer cares the Fed is still pushing up rates another 150 bps to the 4.75% terminal rate, so-called because it will terminate economic growth and send the economy over the cliff.

		Year-Year %		Monthly % changes		
Dec 2021 Weight		Dec 2020	Dec 2021	Jul 2022	Aug 2022	Sep 2022
1.000	PCE inflation	1.3	6.0	-0.1	0.3	0.3
0.075	Food at home	3.9	5.7	1.3	0.8	0.6
0.027	Energy goods	-15.1	47.1	-7.7	-10.0	-4.6
0.016	Electricity/Gas	2.3	9.9	3.3	0.2	2.0
0.883	Core PCE	1.5	5.0	0.0	0.5	0.5
	Durable goods					
0.020	New vehicles	1.8	11.2	0.7	0.9	0.6
0.016	Used vehicles	10.1	36.2	-0.3	-0.1	-1.1
0.030	Furnishings	3.1	8.8	0.3	0.6	0.1
0.037	Recreational	-0.9	1.3	-1.0	0.5	0.5
	Nondurable goods					
0.028	Clothing	-4.6	5.5	0.0	0.3	-0.5
0.030	Prescription drugs	-2.4	0.0	0.3	0.4	-0.1
0.010	Personal care	-0.3	0.3	1.1	1.4	0.4
0.239	Goods x-foodenergy	0.0	6.1	0.1	0.6	0.2
0.644	Services ex-energy	2.0	4.6	0.0	0.5	0.5
0.036	Rents	2.3	3.3	0.7	0.7	0.8
0.112	Home prices	2.2	3.8	0.6	0.7	0.8
0.161	Health care	2.6	2.7	0.1	0.1	0.2
0.031	Transportation	-2.9	8.3	-1.7	1.1	2.1
0.035	Recreation	1.7	4.3	0.5	-0.2	0.0
0.059	Food services	4.3	6.8	0.7	0.7	0.6
0.011	Hotels/Motels	-8.0	20.8	-2.3	0.2	-0.9
0.080	Financial/Insurance	1.4	5.0	-1.2	1.0	0.5
0.080	Other services	1.3	3.0	0.3	0.0	0.4
0.030	Nonprofits	3.7	13.0	-0.2	2.0	0.7

We can't see much slowing in core inflation pressures although there is some weakness in used vehicles, clothing, hotels/motels and your meds. Home prices are accelerating with a 0.8% increase in September even while the home price indices elsewhere show prices down in July and August. Home prices weight is much less in PCE than CPI: 11.2% (12.7 core) for PCE, 30.5% for core CPI.

INTEREST RATES

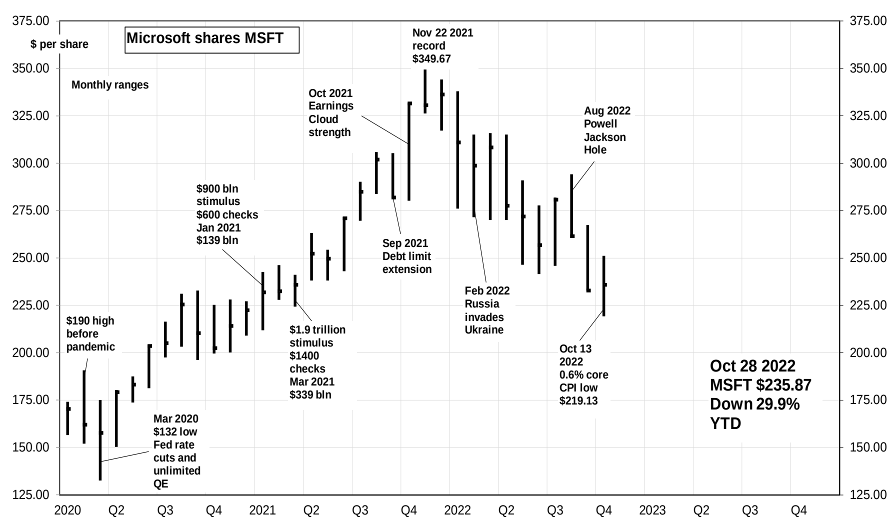


The stock market broke out above the downtrend line since August this week and Friday's close was off just 19.0% from the year's high versus the worst point, down 27.5%, after CPI inflation on October 13. A stock rally despite the expected 75 bps Fed hike to 4.0% next Wednesday. What size rate hike in December, 50 bps slowdown to 4.5% or another 75 bps hike to 4.75%? January Fed funds futures (adjusted) can help we guess: closed 4.59% on Friday versus 4.61% last Friday. 10-year Treasury yields closed the week at 4.02% down from the 2022 high last Friday of 4.32%. There might be some Fed slowdown behind the drop in bond yields this week although a lot of trading took place overnight in Europe. For example, yields were up Friday at the NY open on stronger inflation reports in Germany, France and Italy. The yield drop Tuesday was on the second month of negative home prices.

Microsoft MSFT down 32.5% from November 2021 record high

Microsoft fell 7.7% on Wednesday after the earnings call Tuesday evening. PC demand slumped in September and is expected to be a headwind for all fiscal year 2023 ending in June. The Azure cloud business sales remain strong but investors are worried about a slowdown there as well. Revenue was $50.1 billion this quarter and $52-53 billion expected in the December holiday quarter.

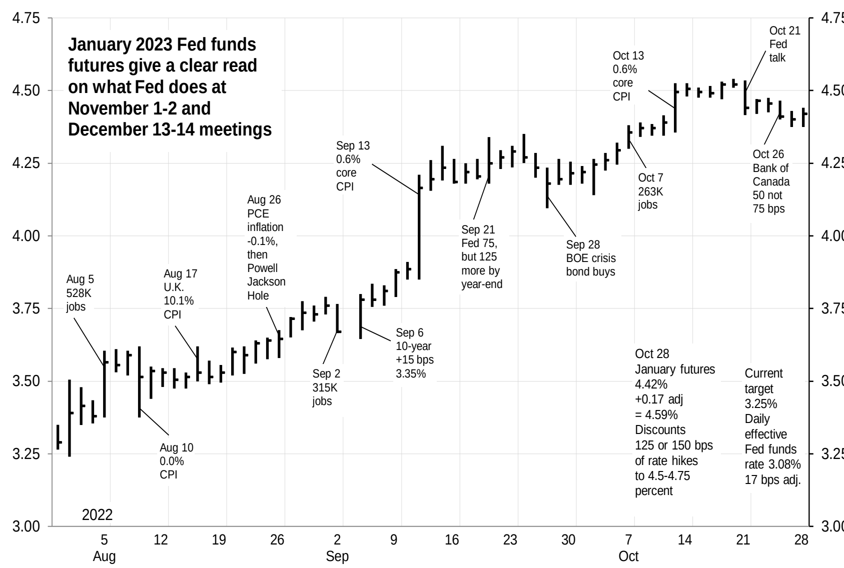
Calendar Year Mln $	Revenue	Productivity Business Processes	Intelligent Cloud	More Personal Computing
Q3 2022	50,122	16,465	20,325	13,332
Q2 2022	51,865	16,600	20,804	14,461
Q1 2022	49,360	15,789	18,987	14,584
Q4 2021	51,728	15,936	18,262	17,530
Q3 2021	45,317	15,039	16,912	13,366
	Income	Processes	Cloud	Computing
Q3 2022	21,518	8,323	8,978	4,217
Q2 2022	20,534	7,236	8,808	4,490
Q1 2022	20,364	7,185	8,391	4,788
Q4 2021	22,247	7,688	8,323	6,236
Q3 2021	20,238	7,581	7,681	4,976



FEDERAL RESERVE POLICY

Selected Fed assets and liabilities						Change
Fed H.4.1 statistical release						from
billions, Wednesday data	26-Oct	19-Oct	12-Oct	5-Oct	3/11/20*	3/11/20
Factors adding reserves						to Oct 26
U.S. Treasury securities	5608.738	5611.953	5629.841	5633.926	2523.031	3085.707
Federal agency debt securities	2.347	2.347	2.347	2.347	2.347	0.000
Mortgage-backed securities (MBS)	2678.519	2698.651	2698.158	2698.158	1371.846	1306.673
Repurchase agreements	0.001	0.010	0.000	0.000	242.375	-242.374
Primary credit (Discount Window)	5.585	5.139	7.669	7.511	0.011	5.574
Paycheck Protection Facility	13.408	13.546	12.356	13.847		
Main Street Lending Program	25.225	25.203	25.742	25.722		
Municipal Liquidity Facility	5.572	5.570	5.567	5.565		
Term Asset-Backed Facility (TALF II)	2.140	2.138	2.137	2.136		
Central bank liquidity swaps	11.302	6.482	3.307	0.300	0.058	11.244
Federal Reserve Total Assets	8772.6	8793.8	8808.8	8808.9	4360.0	4412.603
~~3-month Libor %~~ SOFR %	3.03	3.04	3.04	3.04	1.15	1.880
Factors draining reserves						
Currency in circulation	2284.547	2284.270	2287.827	2283.376	1818.957	465.590
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000	0.000
U.S. Treasury Account at Fed	636.327	640.613	583.513	622.131	372.337	263.990
Treasury credit facilities contribution	17.940	17.940	17.940	17.940		
Reverse repurchases w/others	2186.856	2241.835	2247.206	2230.799	1.325	2185.531
Federal Reserve Liabilities	5664.483	5753.066	5718.491	5732.414	2580.036	3084.447
Reserve Balances (Net Liquidity)	3108.146	3040.777	3090.307	3076.450	1779.990	1328.156
Treasuries within 15 days	87.888	91.037	66.698	71.778	21.427	66.461
Treasuries 16 to 90 days	323.110	323.378	346.045	347.710	221.961	101.149
Treasuries 91 days to 1 year	784.922	784.695	790.328	787.632	378.403	406.519
Treasuries over 1-yr to 5 years	1966.052	1966.054	1979.960	1979.974	915.101	1050.951
Treasuries over 5-yrs to 10 years	991.947	991.959	991.971	991.982	327.906	664.041
Treasuries over 10-years	1454.819	1454.830	1454.839	1454.849	658.232	796.587
Note: QT starts June 1	Change	26-Oct	1-Jun			
U.S. Treasury securities	-162.041	5608.738	5770.779			
Mortgage-backed securities (MBS)	-28.927	2678.519	2707.446			
**March 11, 2020 start of coronavirus lockdown of country						

The Fed meets November 1-2, 2022 to consider its monetary policy. A 75 bps rate hike to 4.0% is discounted. Powell will be pressed on the timing of the final 75 bps left in the September forecast to 4.75% by next year. But it is uncertain how much guidance he would give with no new committee forecasts until the final meeting of the year on December 13-14. Core PCE on Friday was 5.1% year-year, and the Fed is saying they can stop at a 4.75% terminal rate because, because, they are forecasting a 3.1% core PCE rate by the end of 2023. Looks like a lot can go wrong here in terms of market expectations that the Fed will slow their rate hikes. The Fed must hope the pandemic inflation pressures will subside as we get further beyond that period because the economy isn't slowing or at least there are no job losses yet, not counting this week's news on continuing unemployment claims.



At least one central bank in the world, the Bank of Canada (BOC), slowed down its rate hikes this week. Fed funds futures liked it anyway. On Wednesday, the BOC lifted rates 50 bps to 3.75% where a 75 bps hike was expected. Similar situation for America's neighbor to the north, where there's high inflation even without the U.S. $600 and $1400 stimulus checks. The latest inflation in Canada is 6.9% year-year in September and 5.4% for core CPI, very close to US core PCE inflation. After Wednesday next week US rates will be 4.0% and Canada 3.75%.

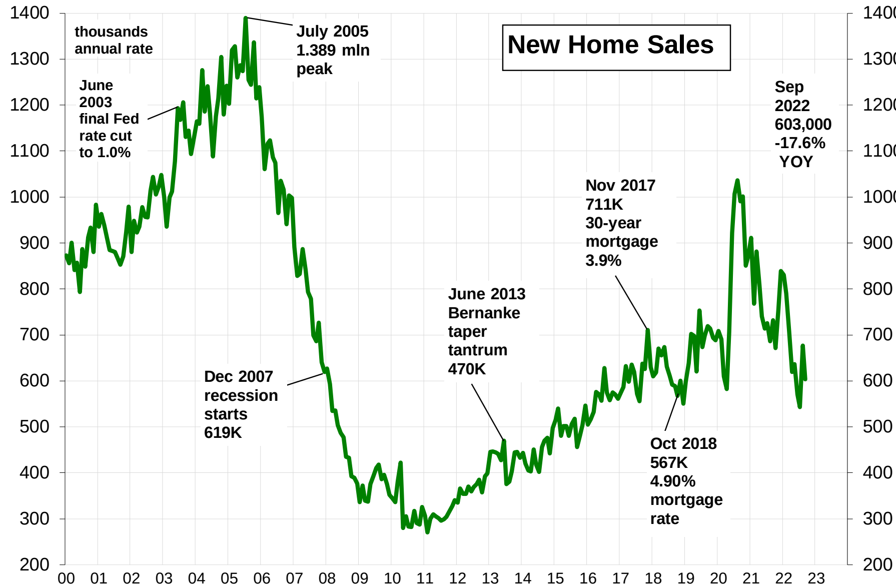
The dollar funding crisis the Swiss National Bank (SNB) was helping with went away. Zero was drawn this week after last week's SNB U.S. dollar liquidity swap of $11.09 billion for a 7-day term maturing October 27.

Fed Policy-key variables					Long
	2022	2023	2024	2025	Term
Fed funds	4.4	4.6	3.9	2.9	2.5
PCE inflation	5.4	2.8	2.3	2.0	2.0
Core inflation	4.5	3.1	2.3	2.1	
Unemployed	3.8	4.4	4.4	4.3	4.0
GDP	0.2	1.2	1.7	1.8	1.8
September 2022 median Fed forecasts					

OTHER ECONOMIC NEWS

New home sales tumble down South (Wednesday)

Breaking economy news. New home sales fell 10.9% in September to 603 thousand at an annual rate, dragged down by the storm-ravaged South where sales collapsed by 20.2%. Sales in the Northeast jumped 56.0%, but it is a tiny region of the country with just 39 thousand new homes sold. New home sales are tumbling just as they did after the housing bubble burst in 2006 and time will tell if a new housing recession brings down the rest of the country. New home sales prices are often quirky and do not match the declines seen nationwide by other home price indices in August and September. The median sales price jumped 8.0% this month to $470,600. Home sales are sliding but new home prices just made a record high in July and are sticking up near those highs.



Net, net, new home sales tumbled as soaring mortgage rates have led buyers to pull back from the market. The results this month were almost all due to the fall off in activity in the biggest regional market down in the South possibly reflecting the devastation from Hurricane Ian. The 10.9% decline in new home sales caught the market's eye and the report seemed to stop the decline in stocks this morning after disappointing earnings from tech giants Alphabet and Microsoft yesterday afternoon. Market-based odds of a 75 bps rate hike at next week's Fed meeting were little changed after the data where the story remains the same. Aggregate demand is not slowing enough yet to make Fed officials confident they are winning the battle with inflation and Thursday's report for third quarter real GDP is likely to show moderate growth of over 2%. Stay tuned. Story developing.

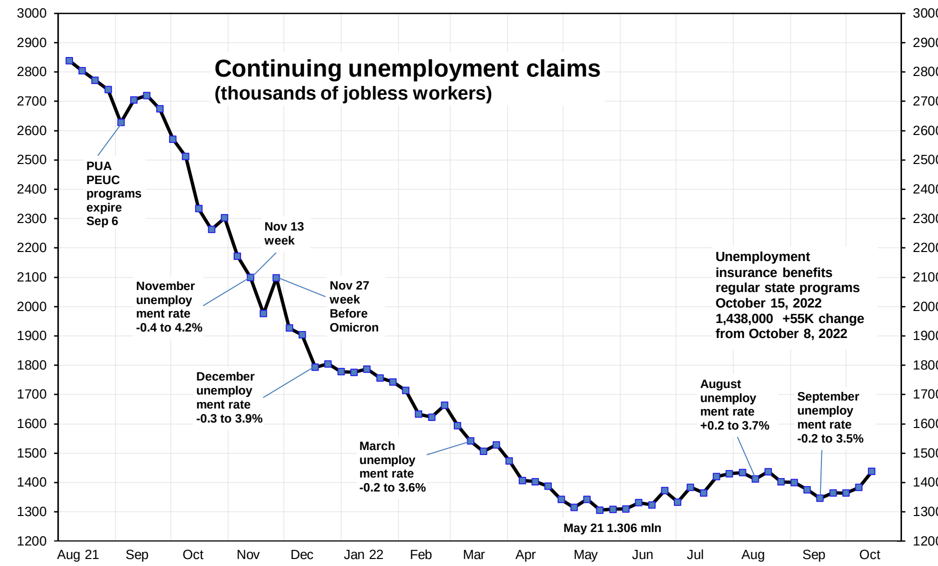
New Home Sales

	Total	Northeast	Midwest	South	West	Median Price $
2019 Year	683	30	72	399	182	321,500
2020 Year	822	37	93	474	218	336,900
2021 Year	771	36	86	453	196	397,100
Apr 2022	619	44	64	371	140	458,200
May	636	19	52	393	172	450,700
Jun	571	17	66	383	105	432,700
Jul	543	26	54	354	109	479,800
Aug	677	25	70	446	136	435,800
Sep	603	39	73	356	135	470,600

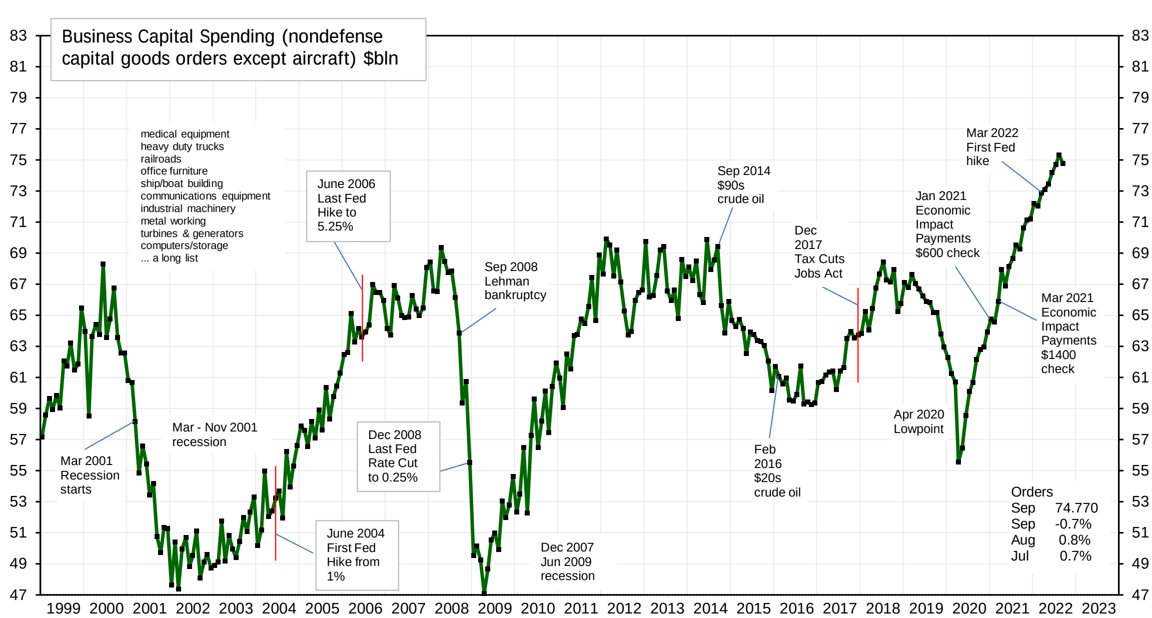
Thousands at Seasonally Adjusted Annual Rate

Not just 2.6% GDP, durable goods, jobless claims too (Thursday)

Breaking economy news. Initial weekly jobless claims didn't do much at 217K in the October 22 week little changed from 214K the week before. But the total number of people receiving benefits, so-called continuing claims are moving up the last two weeks which could mean people are not finding jobs as quickly as they had been so they remain stuck on the nation's unemployment rolls. The Fed is still pushing interest rates up until something breaks, so we are watching the labor market for whatever number is moving higher, either initial or continuing unemployment claims. The unemployment rate could start moving back up (after declining two-tenths to 3.5% record lows in last month's payroll jobs report) starting with the report out on Friday, November 4.

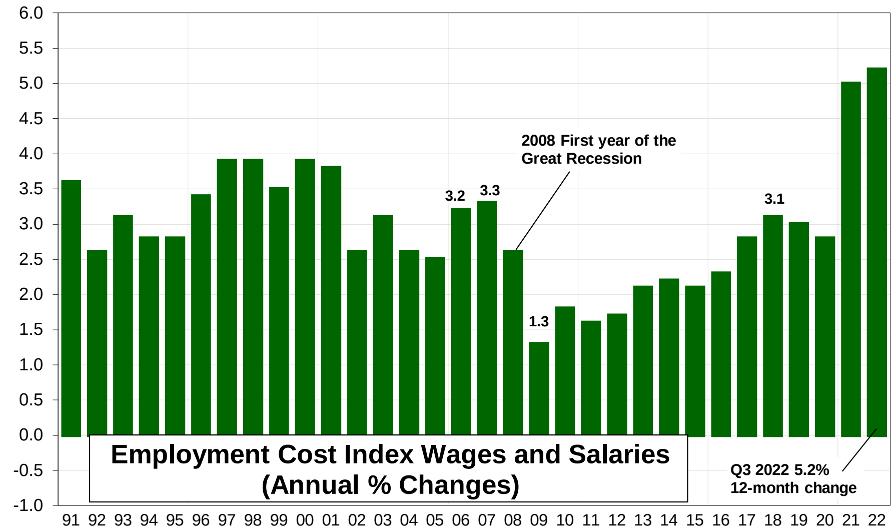


The news on GDP the same time as durable goods orders means the news on orders was not widely reported. Our proxy for business capex is nondefense capital goods orders ex-aircraft and these orders finally fell 0.7% in September, the first decline since February and February's 0.2% decline didn't really count as it came after January jumped 1.4%. Speaking of 1.4%, August's 1.4% increase was revised to up just 0.8%, so these orders are actually 1.3% less than we thought a month ago. Machinery orders dropped 0.4% this month, and computers and electronic products fell 0.4% after declining 0.1% in August. These data often lag during recessions and in addition to overordering, much of the increase this year is the result of inflation. Still, if it continues to decline in the fourth quarter then we have a possible recession story.

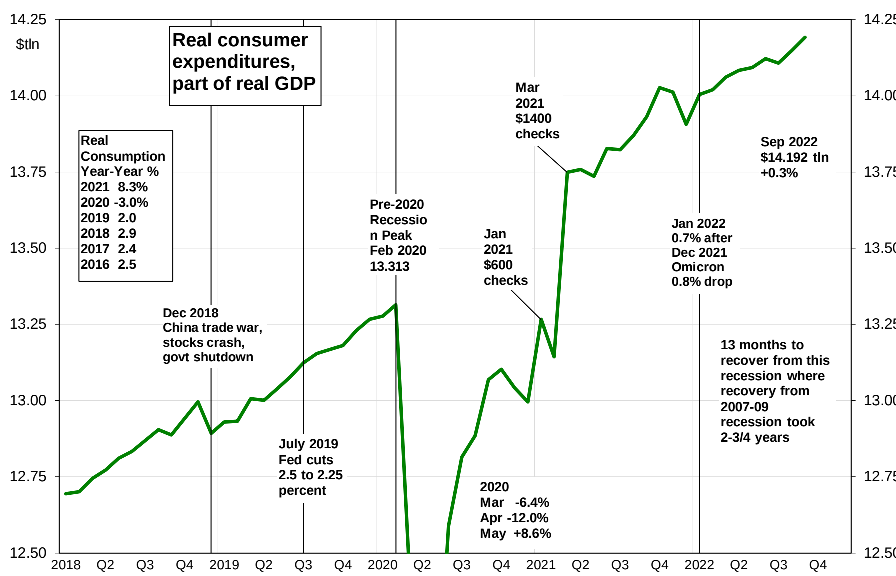


Consumption solid, wage-price spiral rages on (Friday)

Breaking economy news. The wage-price spiral continues to move upward at a fast and furious pace with wages and salaries in the employment cost index up 5.1% year-over-year in Q3 2022, and core PCE inflation taking another big 0.5% jump in September, pushing it 5.1% higher over the last year. Worker paychecks are matching core inflation the last year but that leaves company employees somewhat short of headline PCE inflation including food and energy that rose 6.2% the last year. Services prices inflation is still out of control, especially for housing and transportation, but at least the supply chain disruptions appear to be lessening where PCE goods less food and energy rose just 0.2% this month. Services prices excluding energy jumped 0.5%. Historically, once the inflation shifts from goods to services, it becomes harder for central banks to bring inflation back under control.



Real consumption spending was more solid in the third quarter than we thought after yesterday's Q3 real GDP report said expenditures slowed to 1.4% from 2.0% in Q2. After declining 0.1% in July however, there have been solid real monthly increases of 0.3% in August and in September. Based on momentum alone, real consumer spending will increase 1.2% in the fourth quarter even without additional expenditures in October, November, and December which doesn't sound very recession-like and doesn't match with the depressed consumer confidence surveys. Americans may say they are worried about inflation, but they are still out shopping which keeps the economy growing for another quarter. The negative GDP growth scare in the first half of the year is over for the foreseeable future.



Net, net, the economy isn't dead yet with consumer spending on the strong side in August and September so there can be no chance that inflation pressures will subside in the near term from slowing demand. Core PCE inflation is up 5.1% the last year which means the Fed is still likely to push its target rate up to 4.75% in early 2023 as they have planned. At next week's meeting another 75 bps rate hike is a done deal, so while the rate hikes may be slowing in the near future, they are still going, with the level of interest rates going higher and higher with the wage-price spiral. The economy is not cooling down yet so inflation will stay high until the Fed's restrictive monetary policy kicks in at some unknown higher level of interest rates.

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