OBSERVATIONS: *Lots of employment data, shift from goods to services continues, Fed and regional banks in focus*

- Regional bank selling last week—S&P Regional Bank index declined -10.0%—weighed on overall market sentiment and overshadowed earnings. Friday's rally reduced the week's losses, still the S&P 500 dropped -0.8%, while the Russell 2000 fared better after declining -0.5% for the week.[1]
- Manufacturing economy: The ISM Manufacturing index rose in April to 47.1 from March's 46.8 reading though remains in contractionary territory for the 6th consecutive month. The inflation component was notable with prices paid jumping to a 9-month high of 53.2—still well off the highs of 92.1 from mid-2021.[1]
- Services economy: The ISM Services index rose in April in a sign of continued expansion in the services economy with the index rising to 51.9 in April, the fourth consecutive monthly increase. This sector of the economy has now grown for 34 of the last 35 months, with December 2022 being the exception.[1]
- The European Central Bank (ECB) lifted rates as expected by +25bps to a new policy rate of 3.25%, a 15-year high. The ECB will also be reducing its bond holdings, so called Quantitative Tightening, at a faster pace starting in July, while also noting that the inflation outlook remained "too high for too long."[1]
- The job market remains strong, with 253k new jobs in April and the unemployment rate falling to 3.4%. Job gains, however, have slowed from last year's pace and job openings have fallen to a two-year low—job openings from the Job Opening and Labor Turnover Survey reached a two-year low of 9.6 million in March.[1]

EXPECTATIONS

- As expected, in a unanimous decision the Federal Reserve lifted its benchmark policy rate by 25bps to 5.0% to 5.25% with a notable change in their statement that seems to align with the notion that further rate hikes would depend on data—a so called 'conditional pause' as we noted last week. Markets are currently not pricing in any more rate hikes and are now looking for a 25bps cut in late summer/early fall.[2]
- With nearly 85% of the S&P 500 having reported, the Q1 earning season has turned out better than initial expectations. 79% of companies reporting thus far have had positive earnings surprises, which is better than historic averages. Overall, Q1 earnings are tracking towards -2.2% year-over-year (YoY), which is a smaller loss than was projected at the beginning of earnings season.[3]

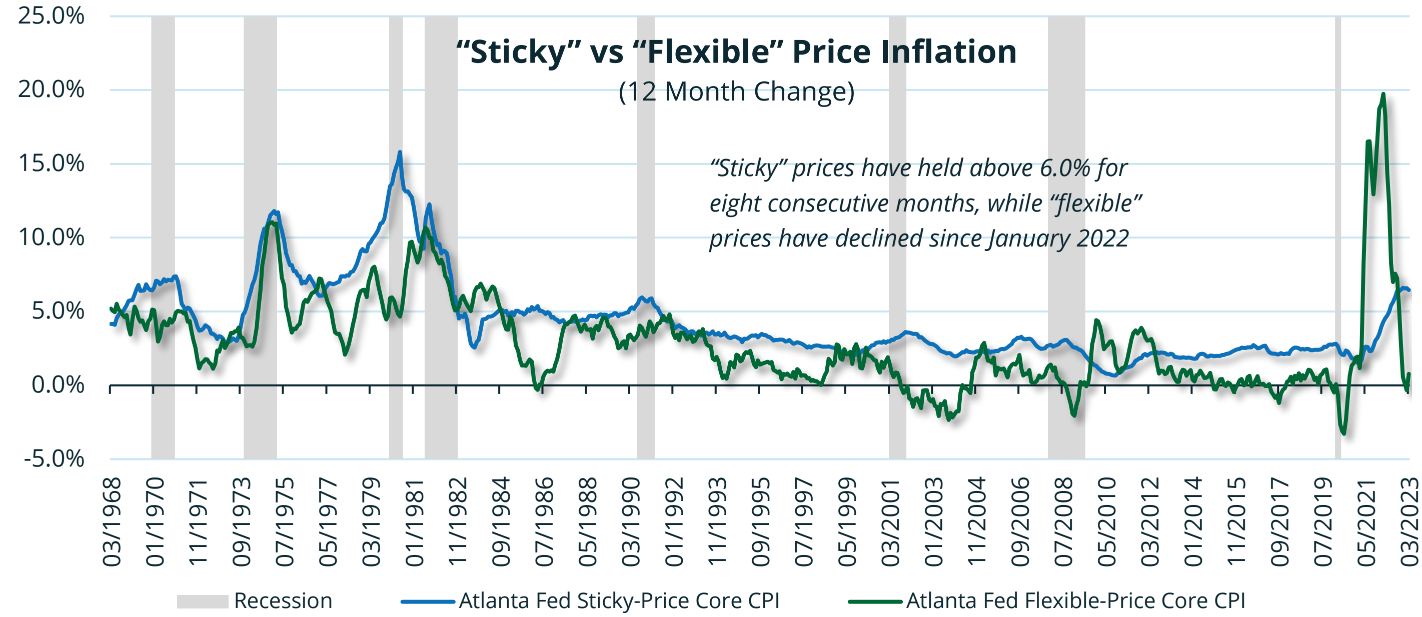
ONE MORE THOUGHT: *The Fed's "sticky" problem and financial (in)stability[4]*

Today's One More Thought should really be titled One More Question. Last week saw more regional banks targeted by short sellers and general selling. The pressure is increasing the potential for a self-fulfilling prophecy where selling begets selling cascading into certain banks needing to take strategic action—PacWest Bancorp as the most recent, though unsurprising, example. This is before considering the potential for bad credit related outcomes, notwithstanding the stresses that are building in certain commercial real estate markets where many regional banks play a significant role. Many of these banks, if they do not go away today, are likely to go away later so perhaps the market is accelerating that process. This brings us to the question—how can the Fed simultaneously focus on financial stability and inflation when policy meant to lower the latter is now seemingly destabilizing the former? The answer is that fed actions and monetary policy might look contradictory for a period of time as the Fed uses its balance sheet and new lending facilities to support banks, while holding a restrictive interest rate policy to bring down inflation. This is where it seems to get tough, inflation is highly nuanced but when one looks at the

[1] Bloomberg LP
[2] https://www.federalreserve.gov/newsevents/pressreleases/monetary20230503a.htm
[3] FactSet Earnings Insight 5/5/2023
[4] Clearstead, Bloomberg LP, Federal Reserve Bank of Atlanta, https://www.atlantafed.org/-/media/documents/research/inflationproject/stickyprice/sticky-price-cpi-supplemental-reading.pdf, https://www.macrobond.com/charts-of-the-week/credit-crunch-fears-a-rebound-in-china-and-falling-housing-costs

composition of inflation data certain things stick out (pun eventually intended). Inflation items considered to be “flexible” include categories of goods and services that tend to be repriced, on average, in less than four months and represents about 1/3rd of the consumer price index (CPI). “Sticky” inflation categories are goods and services, including housing, that tend to reprice beyond four months and represents about 2/3rd of CPI. On YoY basis, “flexible” price inflation has dropped significantly, with prices for this basket essentially unchanged from last year (Chart of the Week). “Sticky” price inflation has now printed eight consecutive months of greater than +6.0% YoY and shows no sign of abating as of right now. There are many factors at play, but a 3.4% unemployment rate has amplified the persistence of higher prices in “sticky” inflation categories, particularly housing. House prices—which shows up as Owners’ Equivalents Rent (OER) in CPI—typically have a twelve plus month lead time before price declines would translate into a lower trending OER, ergo lower “sticky” inflation rates. As it relates to OER, 60% of metropolitan statistical areas are reporting month-over-month increases in rents, which compares to 90% this time last year—this could bode well as slower growing OERs work into broader inflation data over time. For now, we are likely to continue to see a higher for longer policy stance from the Fed and financial instability may continue to be a key risk factor as high rates continue to work through the economy.

CHART OF THE WEEK



Source: Clearstead, Bloomberg LP, Federal Reserve Bank of Atlanta, as of 4/30/2023, Monthly data, Core excludes food and energy prices

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