OBSERVATIONS: *Markets modestly negative last week, CPI in line but PPI higher, unemployment claims nudge higher.*

- Interest rates drifted higher as the 10-Year US Treasury yield reached 4.16% by week's end and equity markets were generally negative last week with earnings season near ending. The S&P 500 lost -0.3% on the week and small cap stocks (Russell 2000 Index) dropped -1.6%, bringing month-to-date declines to -2.7% and -3.9%, respectively.[1]
- Core inflation (CPI ex. food and energy) rose +0.2% month-over-month (MoM), in line with expectations, bringing the year-over-year (YoY) core CPI to +4.7%, also in line with expectations.[1]
- Wholesale prices, meanwhile, rose more than expected with core PPI (ex. food and energy) up +0.3% MoM and +2.4% YoY—both higher than expectations of +0.2% and +2.3%, respectively.[1]
- The NFIB Small business Optimism Index increased in July to 91.9, though for nineteen consecutive months has remained below the 49-year average of 98. The biggest jump in the index from June was in expectations of improved business conditions for the next six months—the expectations sub index rose to the highest level since August 2021.[2]
- Initial unemployment claims increased last week to 248,000 (seasonally adjusted), which was +21,000 more than the previous week's figure. More crucially, on an unadjusted basis claims also moved higher by +20,000 at the time of the year when initial unemployment claims typically fall. One week does not make a trend, but should it continue, it would be the first significant sign of labor market weakening.[1]

EXPECTATIONS: *New Fed study on inflation and, not surprisingly, Moody's downgrades banks.*

- A new study from the Federal Reserve Bank of San Franscico (FRBSF) suggests that US shelter inflation—owners' equivalent rent of residences (OER) represents about 40% of core CPI—is likely to continue to decline in 2024. Two models are employed by the FRBSF study, with one showing shelter inflation reaching zero by mid-2024 while the other shows shelter inflation turning negative by mid-2024 (both on YoY basis).[3]
- Moody's cut the credit ratings for 10 small and mid-sized banks last week. Unlike Fitch's downgrade of the US, Moody's downgrade has merit as it reflects increasing risks that many banks are facing. Moody's cited regulatory capital weaknesses, risks associated with commercial real estate, and higher funding costs as the primary reasons for the downgrades (nothing new but still).[1]
- In a new executive order, the White House moved to block further public or private investment in advanced semiconductors and quantum computing in China, which is intended to deny Chinese firms the market access and other benefits that flow from the involvement of US venture capital and private equity firms.[4]

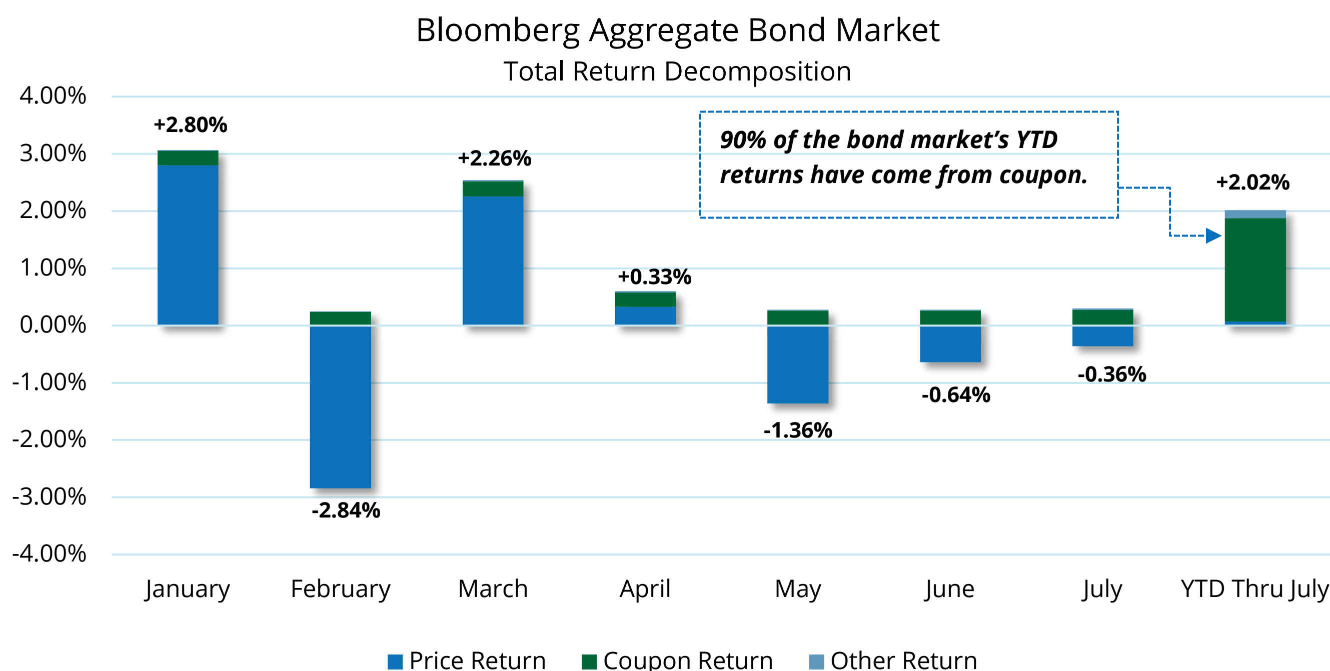
ONE MORE THOUGHT: *Coupon driving bond market returns, and is a 3rd negative bond market in the cards?*[1]

A few weeks ago we wrote about 2023 stock market returns being driven by P/E multiple expansion and the near mirror image of 2023 to that of 2022. The punchline of that writing was that trying to predict the direction of the P/E multiple over short periods of time is a near impossible task. In bond markets, investors face a similar conundrum of sorts. To be fair, our view is that today's bond market offers long-term investors a better relative starting point than we have seen in over ten years. Though like the P/E multiple for stocks markets, the direction of interest rates—which drives price—is similarly difficult to predict over short periods. This year has been a good example of this as the bond market (Bloomberg Aggregate Bond Market Index) has generated a 2.0% return year-to-date (YTD) through July, of which 90% has come from coupon income (Chart of the Week). The volatility that has accompanied

[1] *Bloomberg LP*
[2] *https://www.nfib.com/surveys/small-business-economic-trends/*
[3] *https://www.frbsf.org/economic-research/publications/economic-letter/2023/august/where-is-shelter-inflation-headed/*
[4] *https://www.wsj.com/articles/u-s-and-china-poised-to-drift-further-apart-after-investment-ban-1e37427d?mod=hp_lead_pos1*

bond markets has been a function of gyrating interest rates coupled with a duration (interest rate sensitivity) for the bond market that is higher than historical observations—the combination of which has led to unusually high volatility for bond markets. Our solution here has been, and continues to be, a focus on income (yield). Taken a step further, a focus on yield that exceeds duration has been important this year for investors. To put the bond market's interest rate sensitivity into perspective, the 10-Year US Treasury yield need only rise by +50bps to +75bps by the end of the year in order to see the Bloomberg Aggregate Bond market Index (Agg Index) suffer a 3rd consecutive negative returning year (-1.5% in 2021, -13.0% in 2022). Until 2021-2022, the index had not suffered back-to-back negative returning years, dating back to the index's mid-1970's inception. Conversely, if the 10-Year Treasury yield were to finish the year unchanged from today (about 4.0%) the Agg would end the year up ≈+3.5%. Given the unknown direction of interest rates at this time, we would prefer to invest in higher income/low duration products than low coupon/long duration assets that have been extremely volatile in a rising rate environment.

CHART OF THE WEEK



Source: Clearstead, Bloomberg LP, Monthly index decomposition by factor, as of 7/31/2023, Past performance is not an indicator of future results

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