The Longo Group

Source: Bloomberg 12/2022

Week of **January 17, 2023**

Markets Cheer CPI Data

Last week's CPI report came in as expected and the markets cheered. Although the level is still elevated at 6.5%, on a year-to-year basis, it does appear that CPI has peaked. As a result, markets will focus on the future direction of inflation, and we see that the bond market is already voting that inflation will be coming down.

We believe the inflation picture is more reminiscent of the 1950s than the 1970s. However, the Fed is hyper-focused on not repeating the 1970s era mistake of easing too soon – so we know that Fed Chair Powell will "keep at it." But when we look at the money supply measured by M2, the year-over-year growth rate is now zero. Yes, the money supply had an unprecedented increase in growth during the Covid pandemic, but this has been reined in. The current situation is also different from the 1970s when money supply growth stayed strong, up 10%-13%, despite the uptick in inflation. Furthermore, the Fed has been doing quantitative tightening by letting its balance sheet decline by $457 billion dollars, another way to have restrictive monetary policy. Please see charts in the Postscript at the end of this report for illustrations of the effects of these actions.

To sum up: the Fed has been busy and aggressive in fighting inflation. It's been working. The market is expecting another interest rate hike on Feb 1; the forecast is 25 basis points. We expect inflation to continue to come down over the coming months and quarters.

This is not the start of the Bull market (yet)

I was quoted in The New York Times on Jan. 12, which I'm happy to reshare here:

"We think any rally here based on the C.P.I. report will be temporary," said Mary Ann Bartels, chief investment strategist at Sanctuary Wealth. "We have months if not quarters ahead of us where we need to see much lower levels of inflation, and we think we will get there but it's going to take time."

Let's Take a Look at the Technicals

After the pullback in the S&P 500 in December, the markets came into the new year, rallying into resistance and pushing the 200-day moving average near 4000. But the market still has an oversold reading. This does leave room for the S&P to push a bit higher near 4100. The CBOE Volatility Index (VIX) has also fallen again to 18; last year, a market sell-off was triggered when VIX hit a level at 20 to 18.

Week Ahead

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Week of **January 17, 2023**

S&P 500 Index with 200-day Moving Average and Daily Price Momentum Stochastic

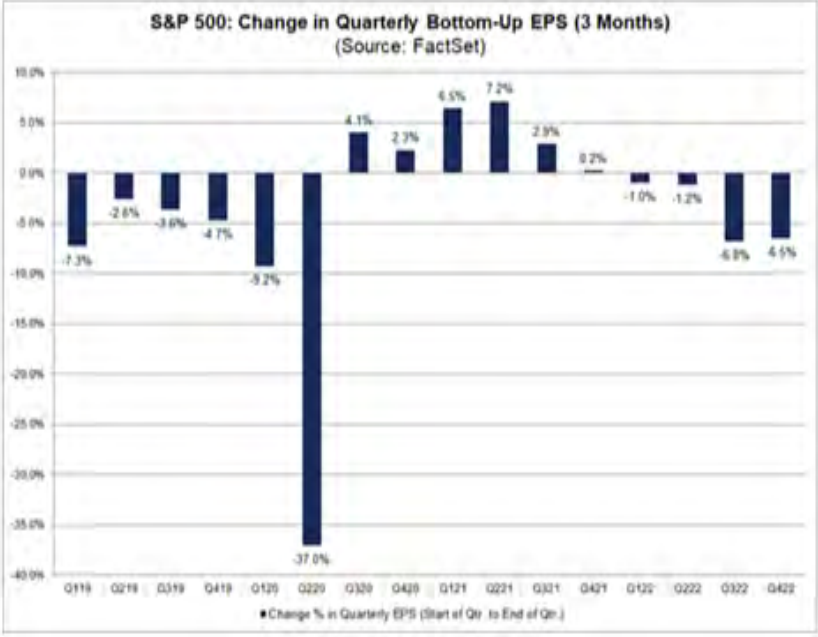
Source: Bloomberg 1/13/2022

Earnings Downgrades

Earnings season took off last week with the major banks reporting. Their earnings overall seemed to come in line, and markets initially struggled but closed with a gain right at resistance for the S&P 500 near 4000. Earnings season will likely cause occasional volatility.

We took a look at what industry analysts have been doing to their earnings numbers. Analysts have been revising their numbers down and we believe this can add to the uncertainty of what the S&P 500 earnings are likely to be. We believe corporate comments about their business outlook for 2023 will be pivotal in determining the direction of the market. We believe earnings will be mixed with the most risk to the Growth stocks, particularly Technology as this is where we are seeing the most announcements about layoffs.

Historically, there is a high correlation between analysts' revisions to their estimates and market direction. Since we believe that their numbers still need to come down more, the risk is to the downside as analysts revise downward. On the flip side, when earnings estimates start to rise, it's typically the signal of a market bottom.



Source: FactSet 1/6/2023

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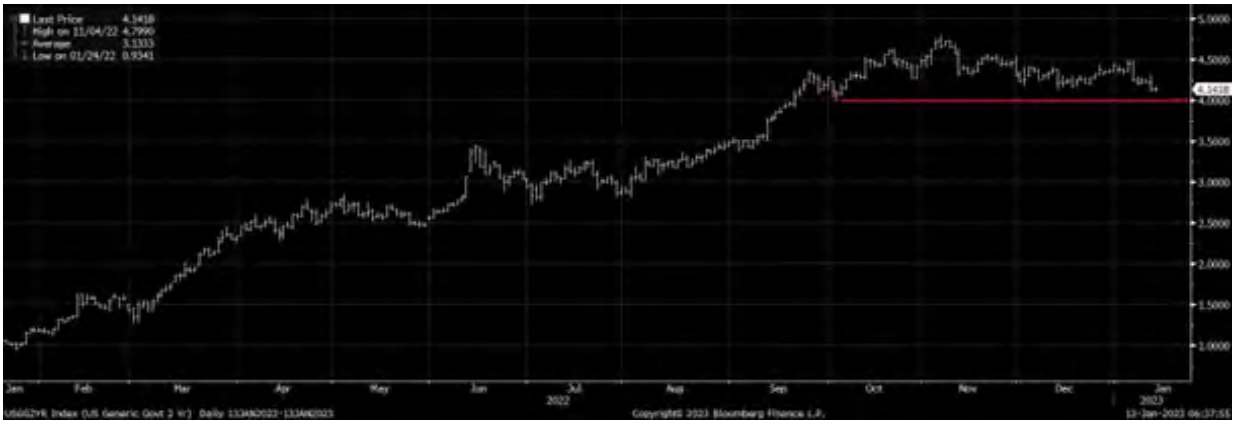
2-Year Treasury Yields May Hold the Key

We have been saying it appears that interest rates may be peaking. We will be watching the 4% level on the 2-Year Treasury yield. A clear break of this level would be bullish for bonds and a sign that the market believes inflation has peaked. But it's important to note that this could also suggest a recession. In that case, the markets would look to the Fed to cut rates sooner than it expects to.

2-Year Treasury Yield Appears to Be Peaking: A clear break of 4.0% Signals a Peak



Source: Bloomberg, 01/13/2023

What's In Store This Week?

This is the week that we pay attention to how the 2-year Treasury yield trades against the data of the next four days.

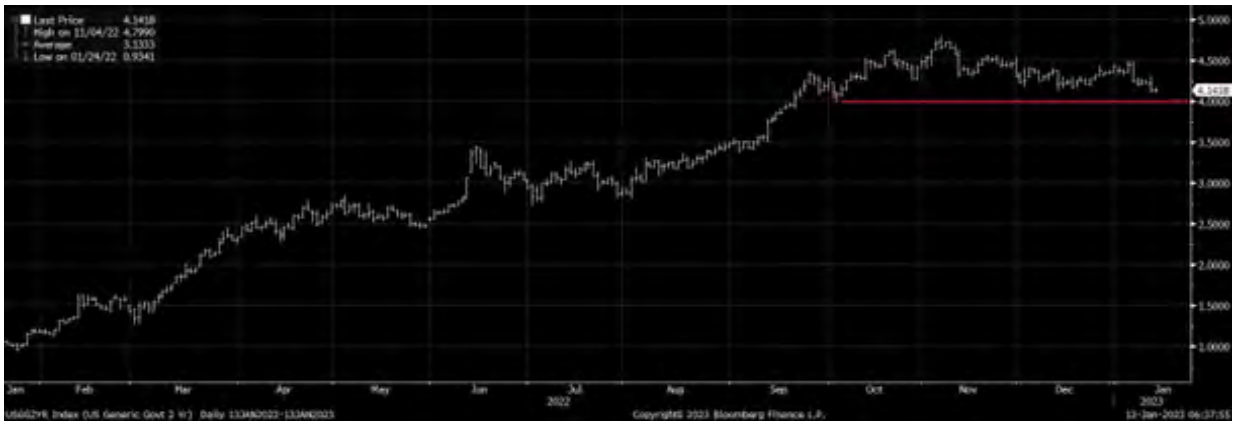
We'll be jam-packed this week with very important economic data releases on inflation – from the Producer Price Index and retail sales data, giving us a sense on how the consumer is spending to jobless claims, giving us a key barometer on the employment story (the Fed's obsession). All these datapoints, along with the drumbeat of earnings reports, will be a lot for the markets to digest – and will give us a little more clarity on what equities might look to do. Maybe.

Week of **January 17, 2023**

Postscript

Look at the five charts below and you'll see evidence that the Fed has done a yeoman's job in 2022 at fighting inflation by aggressively raising in rates, bringing down its balance sheet, and reining in money supply growth to zero growth (an historical rarity!). In response, CPI appears to have peaked and corporate profits appear to be at risk. Hence, what companies say about the outlook for 2023 will be important!

CPI Year-over-Year Growth Rate Appears to have Peaked – Note similar pattern to 1950s



Source: Bloomberg, 01/13/2023

M2 Money Supply Year-over-Year: Growth rate is now zero -- very different from 1970s' sustained 10%-13%

Source: Bloomberg, 01/13/2023

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M2 Money Growth Historically Appears to Forecast CPI with a 13-Month Lag

Source: Strategas, 1/13/2023

M2 Money Growth Also Appears to Predict Future Corporate Profits with a 2 Quarter Lag

Source: Strategas, 1/13/2023

Federal Reserve Balance Sheet has declined by $457 Billion which is Quantitative Tightening

Source: St Louis Federal Reserve 01/2023

Calendar

Mon.

None scheduled.

Tue.

8:30 a.m. Empire state manufacturing index
Earnings: Citizens Financial Group, Fulton Financial, Goldman Sachs, Interactive Brokers, Morgan Stanley, Progress Software, Signature Bank, United Airline

Wed.

8:30 a.m. Retail sales, Producer price index, final demand
9:15 a.m. Industrial production
10:00 a.m. NAHB home builders' index
Earnings: Kinder Morgan, Alcoa, Charles Schwab, Discover Financial Services, First Horizon, H.B. Fuller, PNC, Prologis, Wintrust Financial

Thu.

8:30 a.m. CPI, Initial & Continuing jobless claims, Building permits (SAAR), Housing claims
1:15 p.m. Fed Vice Chair Lael Brainard speaks
Earnings: Netflix, American Airlines, Comerica, Commerce Bancshares, Fastenal, Fifth Third Bancorp, Heartland Express, KeyCorp, M&T Bank, Northern Trust, PPG Industries, Procter & Gamble, Shaw Communications, SVB Financial Group, Truist Financial

Fri.

810:00 a.m. Existing home sales (SAAR)
1:00 p.m. Fed Gov. Christopher Waller speaks at Council on Foreign Relations
Earnings: Ally Financial, Ericsson, Huntington Banc, Regions Financial, SLB, State Street

Source: MarketWatch/Kiplinger's