The Longo Group
Independent Financial Firm

Week of **August 7, 2023**

Jobs And Wages Point To A Strong Economy

Last Friday, we received July employment data which does not show a slowdown in the economy. Although non-farm payrolls and private payrolls came in slightly below expectations, wages came in at 4.4% year-over-year, stronger than the expected 4.2%.

A surprise was a drop in the unemployment rate to 3.5% (3.6% was expected). Continued good employment data and especially strong wages mean the consumer still has buying power to keep the economy growing. The Federal Reserve and several Wall Street economists are now calling for a soft landing in the economy, removing their forecasts for a recession this year. (See note about Bank of America's reversal later is this commentary.) Corporate earnings for 2Q23 are also not as weak as originally feared. So, overall, the backdrop for equities is positive, but a break from the strong gains looks to be going on vacation.

Equities In A Correction Within A Bull Market

Equities have been overbought for weeks, and we have highlighted the risk for a 5-10% pullback. Seasonals also favor a pullback with markets often peaking in the summer, leading to corrections in the fall months of September and October. The likely trigger for this correction is the U.S. debt downgrade by Fitch to AA+ from AAA. Bear in mind (no pun intended!) that the outlook is rated Stable and that an AA+ rating is a very high-quality rating.

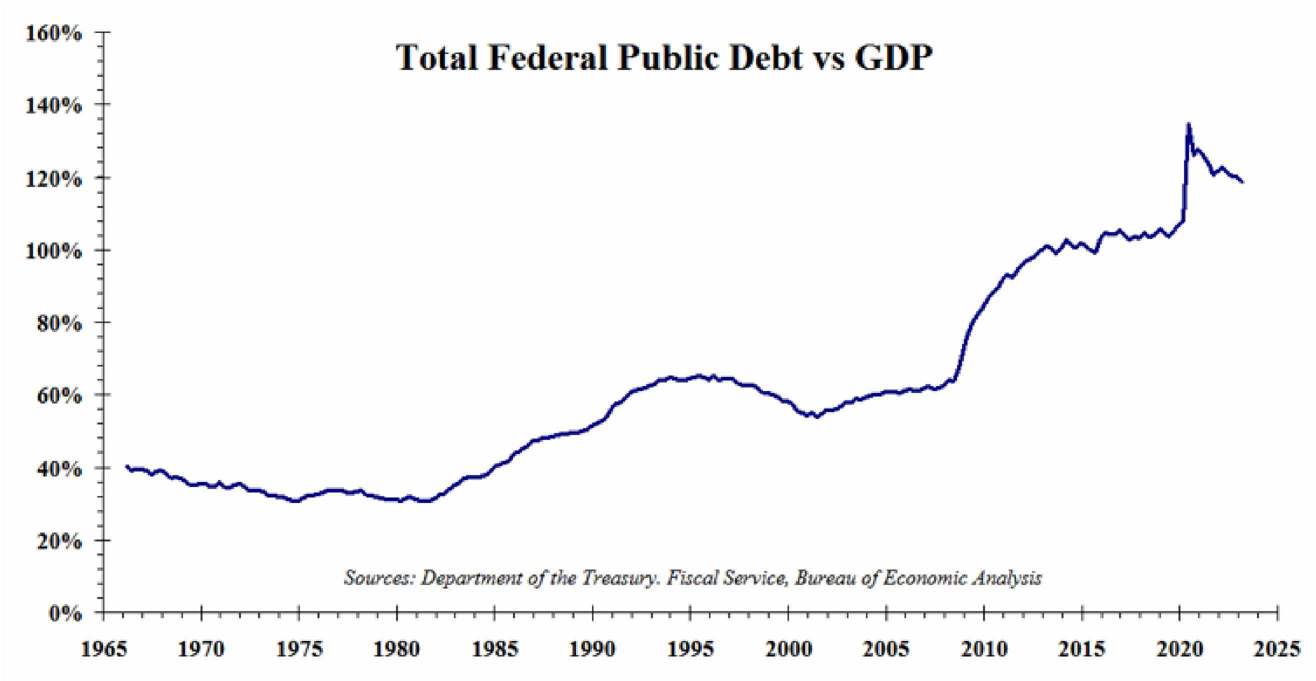
So why the downgrade? According to Bloomberg, the Fitch Ratings downgrade of the U.S. reflects (1) the expected fiscal deterioration over the next three years, (2) a high and growing general government debt burden, and (3) the erosion of governance relative to 'AA' and 'AAA' rated peers over the last two decades which has manifested into repeated debt limit standoffs and last-minute resolutions. Part of the Fitch concern can be seen by looking at U.S. debt as a percentage of GDP, which has grown significantly over recent years, especially since the Great Financial Crisis in 2008-2009. Levels are currently at 118% (see chart below).

We see no risk to the U.S. Treasury market – except: rates have broken out to the upside for both the 10-year and 30-year. Rates look to approach the 5% area, and this will likely continue to put pressure on equities, especially when the S&P 500 is trading quite richly at 20x forward earnings.

Technically speaking there is good support in the 4200-4100 level for the S&P 500. A 10% correction off the intra-day high of 4607 on July 27 would put the S&P 500 at 4146, right in the range of support. A 15% pullback like the last credit downgrade in 2011 would put the S&P 500 just under 4000. We maintain this is a correction within a bull market, so we are buyers of the correction. But we would wait to be aggressive buyers until we have technical signs of a bottom.

Week of **August 7, 2023**

Total Federal Public Debt vs GDP



Source: Department of the Treasury, Fiscal Service, Bureau of Economic Analysis

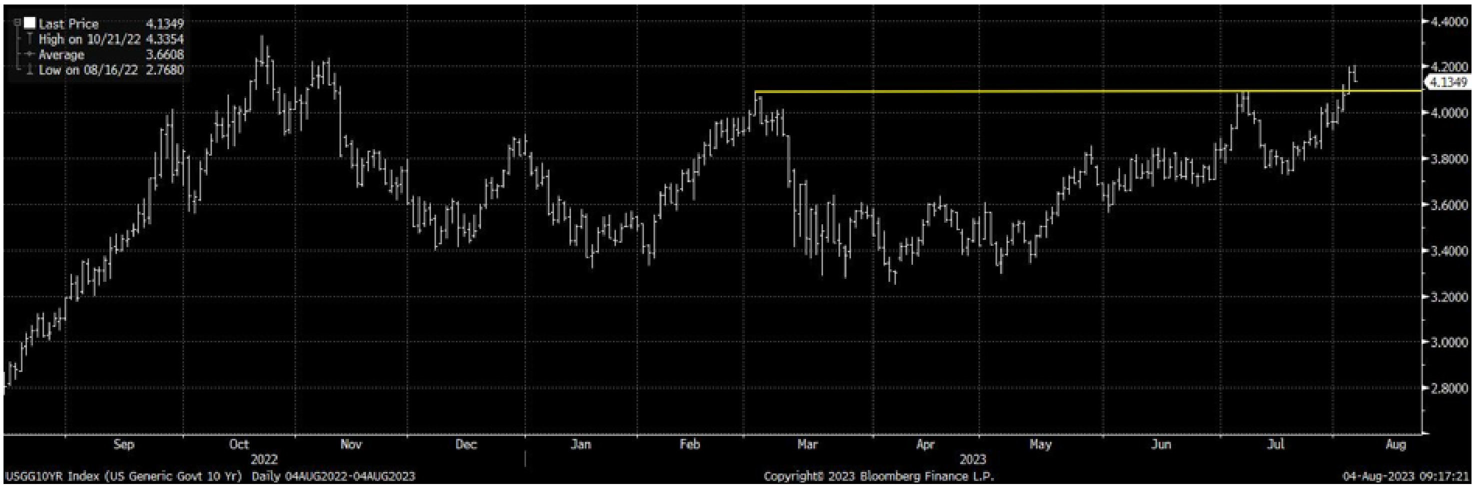
Fitch also highlighted, in their view, that there has been a steady deterioration in standards of governance over the last 20 years, including on fiscal and debt matters, notwithstanding the June bipartisan agreement to suspend the debt limit until January 2025. The repeated debt-limit political standoffs and last-minute resolutions have eroded confidence in fiscal management. In addition, the government lacks a medium-term fiscal framework, unlike most peers, and has a complex budgeting process. These factors, along with several economic shocks as well as tax cuts and new spending initiatives, have contributed to successive debt increases over the last decade. Additionally, there has been only limited progress in tackling medium-term challenges related to rising social security and Medicare costs due to an aging population.

Both 10- and 30- Treasury Yields Break Out – 5% Here We Come?

The good news is higher income levels are coming on Treasury bonds. The bad news is rates are rising and equities, when priced as high as 20x forward price earnings ratio, don't like higher rates. Why? Because higher rates, especially if 5% is reached, become competition to equities. Many investors want to lock in a return that is somewhat guaranteed. The technical measures for both 10- and 30- Year Treasurys risk a move to the 5% area. The 10-year needs to sustainably break the previous high of 4.33% and the 30-year needs to sustainably break the previous high of 4.42% to confirm moves near 5%. But the technicals look to point to this area. This was not expected as we believed rates were in a peaking process. Bonds look to stay under pressure as stronger economic and employment data also support a breakout in yields. This does not look to be a move based only on the debt downgrade by Fitch.

Week of **August 7, 2023**

10-Year Treasury Yields Break Out



Source: Bloomberg, August 4, 2023

30-Year Treasury Yields Break Out

Source: Bloomberg, August 4, 2023

Contrast 10-Year Treasury Yields To 2011 Debt Downgrade

The last time U.S. debt was downgraded was on August 5, 2011. On that day, 10-Year Treasury yields did spike up, but as time went on, rates fell. The trend was already down for yields and the downward trend continued. Compare that to today. Rates have been trending up and rates technically have broken out to the upside, continuing the trend that has been in place. So, the comparison is very different from the last time U.S. debt was downgraded.

Week of **August 7, 2023**

10-Year Treasury Yields In August 2011

Source: Bloomberg, August 4, 2023

Rates Are Up But Inflation Is Falling

Long rates are rising, but let's remember that inflation is falling. The Consumer Price Index year-over-year has fallen sharply from 9% in June of last year to 3% this past June. This is a dramatic decline. Not to the level targeted by the Federal Reserve — which is 2% -- but it still is a significant move. So, the spike up in yields is caused by stronger economic data and especially the credit downgrade, not inflation.

Consumer Price Index Year Over Year Has Fallen Sharply To 3%

Source: Bloomberg, August 3, 2023

Week of **August 7, 2023**

Volatility Is Back – Look For VIX Index To Rise To 20-21

With equity markets in a correction, volatility is back. We expect the VIX index to head toward 20-21.

Source: Bloomberg, August 3, 2023

Why Not A Major Top? – Sell-Side Strategists Still Too Bearish

An indicator we have been watching for over 20 years is called the Sell-Side Indicator, published by Bank of America at the beginning of every month. It looks at what strategists are recommending in their asset allocation. The indicator this month is still closer to a buy than a sell. The indicator had fallen sharply but never gave a buy signal. But it is also very far from a sell signal. Markets peak on optimism, and we are not there yet.

BofA Sell-Side Indicator

Source: BofA Global Research, July 2023

Week of **August 7, 2023**

Also A Dow Theory Buy Signal Right Before The Correction

Two weeks ago, the equity markets flashed a Dow Theory Buy Signal. This indicator was developed by Charles Dow, co-founder of The Wall Street Journal along with Edward Jones and Charles Bergstresser, who founded Dow Jones & Company, Inc. They developed the Dow Jones Industrial Average (DJIA) in 1896. Dow fleshed out his eponymous theory in a series of editorials in The Journal. Today the indicator is based on hundreds of his editorials that were published in The Wall Street Journal more than 120 years ago. Both Dow Industrials and Dow Transports need to achieve new highs or new lows together to confirm a major trend. These two indices confirmed the U.S. equity market rally from March of this year and affirmed the primary bull market from the October 2022 low when both reached 52-week highs.

A Dow Theory Buy Signal confirms the primary bull market trend from the October 2022 low.

ICI Money Market Funds – A Mountain Of Money On The Sidelines Of $5.5 Trillion

Source: Bloomberg, August 3, 2023

Week of **August 7, 2023**

Something Interesting That We Read

Bloomberg reported last week that Bank of America Corp. Chief Executive Officer Brian Moynihan said his firm reversed its prediction for a recession in coming months because of strength in the jobs market and robust consumer spending. “People are employed, they have money, they are spending money,” Moynihan said in a Bloomberg Television interview last Thursday. “It looks like we are reaching a pretty good equilibrium.” Economists at Bank of America earlier last week scrapped their forecast for a recession in the U.S., becoming the first large Wall Street bank to officially reverse its call amid growing optimism about the economic outlook.

CPI And PPI Data Is Coming And We’ll Be Watching

This is the week that recession chatter takes a back seat, but inflation still drives the conversation.

Inflation data will be top of mind for investors this week with the release of CPI (Consumer Price Index) data and PPI (Producer Price Index). The Fed is meeting at Jackson Hole this month for their annual retreat, so there won’t be a rate decision in August. The Fed’s next rate move – or no move – will be in September. Let’s see how bonds react to the new inflation update.

Calendar

Mon.

3:00 pm	Consumer credit
Earnings	Beyond Meat, BioNTech, Cabot, Chegg, CoreCivic, Coterra Energy, Elanco Animal Health, Freshpet, Gogo, Henry Schein, International Flavors & Fragrances, James River Group, KKR, Kyndryl, Lucid Group, Manitowoc, Medifast, ONEOK, Palantir Technologies, Paramount Global, RingCentral, Skyworks Solutions, Spirit Realty Capital, Tyson Foods, Teradata

Tue.

6:00 am	NFIB optimism index
8:15 am	Philadelphia Fed President Harker speaks
8:30 am	U.S. trade balance, Richmond Fed President Barkin speaks
10:00 am	U.S. wholesale inventories
Earnings	ADT, Akamai Technologies, Allbirds, AMC Entertainment, Angi, Aramark, Array Technologies, Bio-Techne, Blink Charging, Bumble, Capri Holdings, Celsius, Choice Hotels, Compass Minerals, Coupang, Darling Ingredients, Datadog, Digital Turbine, Duke Energy, Duolingo, Dutch Bros, Eli Lilly, Energizer, Expeditors International of Washington, FleetCor, Fox Corp, GlobalFoundries, Hecla Mining, Honest Company, Hostess Brands, IAC Inc., Invitae, iRobot, Jacobs Engineering, Kulicke & Soffa, Li Auto, Lyft, Matterport, Medical Properties Trust, New York Times, Novavax, Organon, Payoneer, Perrigo, Proterra, PubMatic, Restaurant Brands International, Rivian Automotive, Sealed Air, SeaWorld Entertainment, Super Micro Computer, Take-Two Interactive Software, Twilio, Under Armour, United Parcel Service, Warner Music Group, WeWork, Zoetis

Wed.

Earnings	3D Systems, Alarm.com, AppLovin, Ballard Power, Clean Energy Fuels, Coeur Mining, Enersys, Genpact, GoodRx, Illumina, Infinera, Jack In The Box, Jazz Pharma, Lions Gate Entertainment, LL Flooring Holdings, Manulife Financial, Nomad Foods, ODP Corp, OGE Energy, Pan Am Silver, PENN Entertainment, Plug Power, Reynolds Consumer Products, Roblox, Stratasys, Taboola, The Beauty Health Company, The Trade Desk, Valvoline, Walt Disney, Warby Parker, Wendy's, Wynn Resorts

Thu.

8:30 am	Initial jobless claims, Consumer price index
2:00 pm	Treasury budget
Earnings	Algonquin Power & Utilities, Alibaba Group Holding, Beacon Roofing Supply, Canadian Natural Resources, CyberArk Software, Dillard's, Flowers Foods, Hanesbrands, Himax Technologies, Krispy Kreme, News Corp., Ralph Lauren, Six Flags, U.S. Foods, Utz Brands, Wheaton Precious Metals, Wolverine World Wide, YETI Holdings

Fri.

8:30 am	Producer price index
10:00 am	Consumer sentiment (prelim)
Earnings	Spectrum Brands

Source: MarketWatch/Kiplinger

250 W 96th Street, Suite 300
Indianapolis, IN 46260
(317) 975-7729