

Market Ethos

The latest market insights from
Richardson Wealth

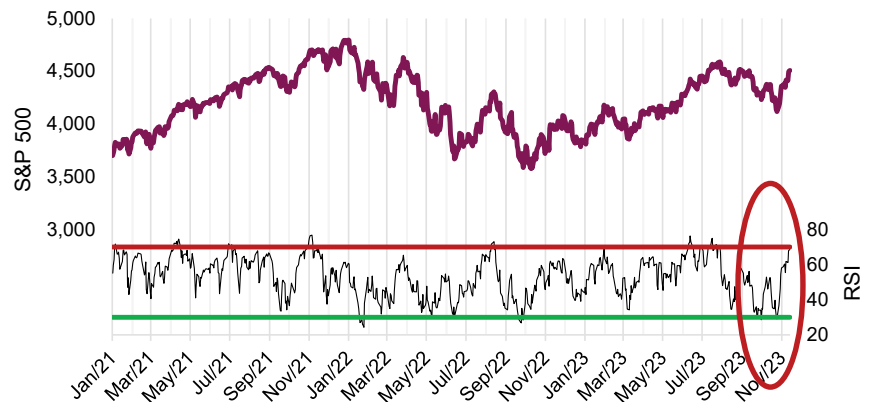


Craig Basinger

False start for inflation victory lap?

Grab that bottle of Veuve and give your sabrage skills a test; inflation is over, and it's time to party. At least that is the way the equity markets have rejoiced on a handful of data points supporting the view that inflation risk is quickly fading. Rejoice may be a bit of an understatement; the S&P 500 went from woefully oversold at the end of October to being overbought a mere 2½ weeks later (as measured by S&P 500 relative strength, aka RSI). The old adage is markets take the stairs when going higher and the elevator when lower, denoting the amount of time passing (stairs being slower than an elevator). Well, over the past few months, it has been the opposite after a three-month steady grind lower and a sudden jump higher.

S&P RSI from 30 to 70 in 11 trading days!!



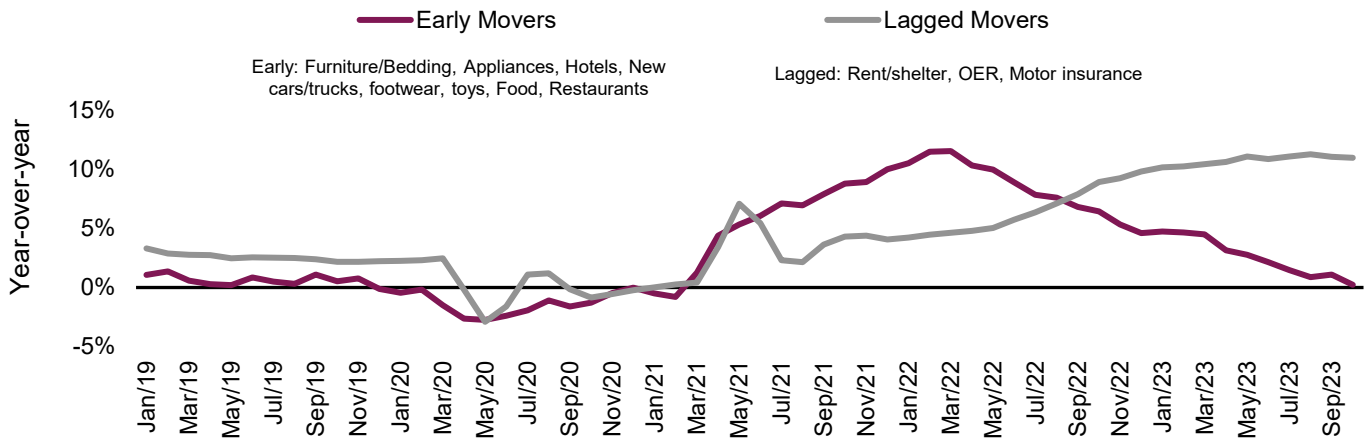
Source: Bloomberg, Purpose Investments

This swing in the RSI measure isn't unprecedented, but looking back at the past 25 years, it certainly doesn't happen often. Most past occurrences followed more tumultuous declines, such as the Asian crisis, or a few during the multi-year tech bust. But let's not diminish the good news – inflation and the response to inflation by central banks (rates/yields) have been the greatest angst for markets during the past couple of years. Cooling inflation fears is a HUGE positive for markets.

Among all the components of the CPI index, some react to changes more quickly than others. The faster moving parts are coming down quickly and are now flat on the year (see chart). The slower components are still high but also appear to be starting to roll over.

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Early / fast inflation components vs slow moving components

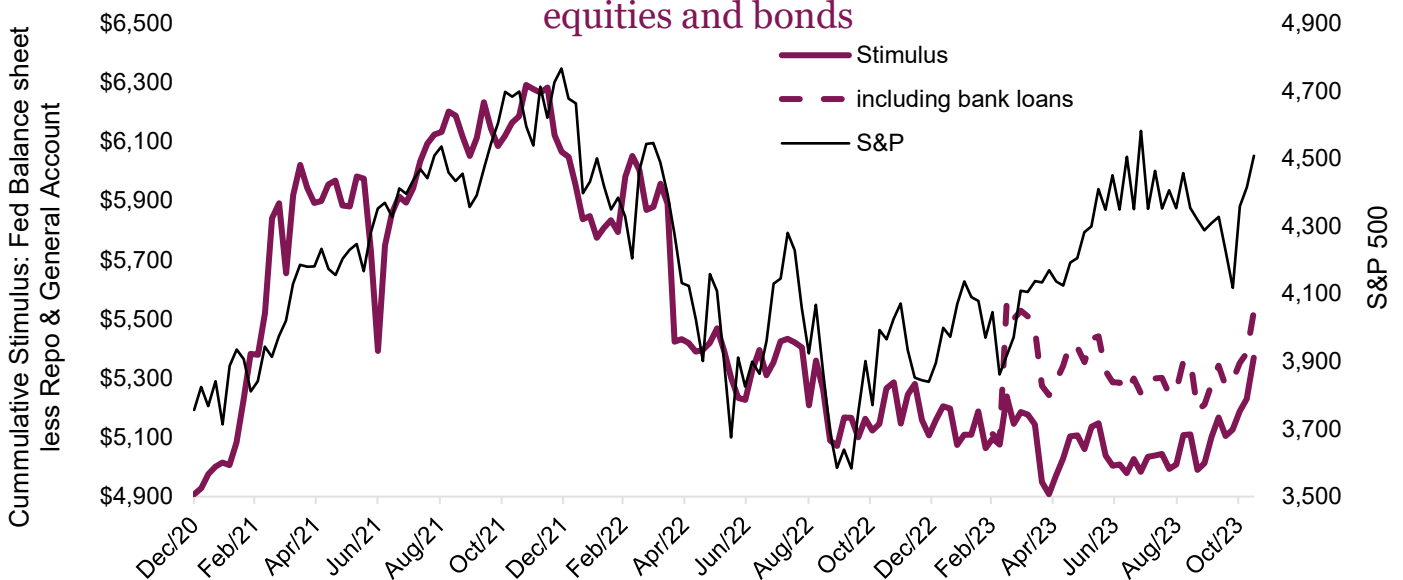


Source: Bloomberg, Purpose Investments

We are not saying inflation is over, nor that it will follow a nice orderly decline back to that sweet spot of 2%. In fact, we believe it will become more volatile in the years ahead. And while it may get down that low (or even lower), the swings will be higher than in recent history. A lot of long-term factors will keep it higher than in the past decade. Yet, with the news at the moment, we appear to be clearly on one of those downward trends, so let's party.

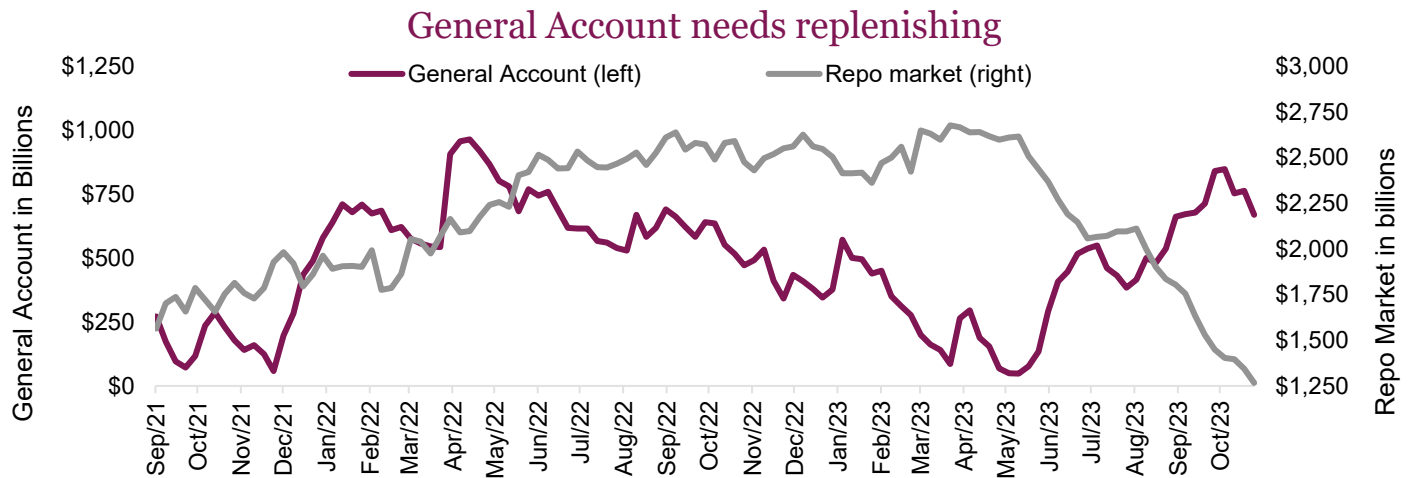
Cooler inflation data and cooler economic data have helped bond yields come down. Measuring the 10-year Treasury, yields dropped from 5.0% at the S&P 500 low near the end of October to 4.46% at the time of writing. So does a 50 bps yield drop equate to a 9% or near 400-point rise in the S&P 500? The lower yield does open the door to some multiple expansion. The market weakness in October was primarily caused by high yields. If 50 bps = 9%, well load up. We think yields will continue to grind lower on softer economic data. Unfortunately, that "math" won't hold. There has been something else afoot in the month of November... stimulus.

Stimulus has dropped since early September, a negative for equities and bonds



Source: Bloomberg, Purpose Investments

In a simpler world, higher overnight Fed funds rates plus gradual selling of bonds at about \$50 billion per month from the central bank's \$7 trillion hoard would equate to tightening financial conditions. Or quantitative tightening (QT), the opposite of quantitative easing (QE). But just like inflation, Q (E or T) doesn't move in a straight line. The Fed's balance sheet has continued to grind lower, but the general account and repo market (reserve repurchase agreements) have not. In June, with the debt ceiling kicked down the road a bit, government bond issuance jumped higher to replenish the general account (the government's chequing account). This would add to tightening, sucking money out of the financial system. But the repo market simultaneously started to move lower. Think of the repo market as a place where money ended up when there was too much money sloshing about, and it has ballooned since 2021.



Source: Bloomberg, Federal Reserve, Purpose Investments

Declining repo balances is money making its way into the financial system (QE). From mid-June till the end of October, this was largely offset by a rising general account (roughly net neutral). But since the general account was topped up to the more historical balance of \$700-800 billion and given the repo market keeps declining, this equated to QE since mid-October and into November.

Final thoughts

We are not saying the cooling inflation plus softer economic data bringing down bond yields isn't the main good news story of this recent rally. It likely is, and it is really good news. But stimulus has increased the magnitude of the gains. So what happens next? The repo market, which before 2021 was near a zero balance, could continue to drain. At \$1.26 trillion, it still has a ways to go. If the general account remains stable, any faster draining of the repo above \$50B per month to offset the Fed's balance sheet reduction would be stimulative. So this could have further legs, perhaps even leading to that Santa Claus rally many like to talk about.

Alternatively, if the draining of the repo slows or if bond yields stop heading lower, this market rally may run out of steam, becoming more of a turkey rally (American Thanksgiving turkey, that is). Wouldn't stand in the way of it, but this is a renter's rally. Especially given earnings revisions have turned flat to slightly negative and economic data is softening, making the underlying foundation not so solid.

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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