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Monthly Market Commentary
Edition 2023-08

This month I am continuing the discussion about the path of Fed rate hikes, but also why the bond market might disagree with the rate path, and finish with what I believe are three pillars necessary to sustain this market.

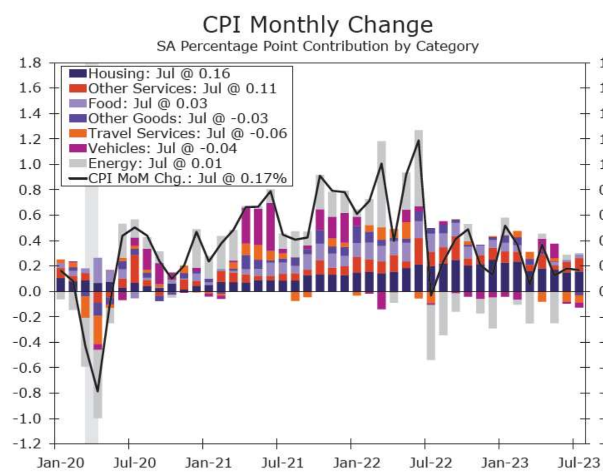
Commentary Summary

- The Fed may have reached a point where inflation is within target, and the rise in wages seems to be abating. However, what seems like an end to rate hikes could be better described as an uneasy truce. The Fed has left their options wide open and now the bond market seems to think that rates may remain elevated for longer than expected.
- I have narrowed down what I believe are three pillars necessary to sustain this year's market growth. Inflation needs to continue to decline, the job market needs to soften, and we need to have some corporate profits growth. The markets want a "Goldilocks" scenario: its good if things generally soften because this will tell the Fed to ease off additional rate hikes (or even cut) but not soften so much that a recession occurs.

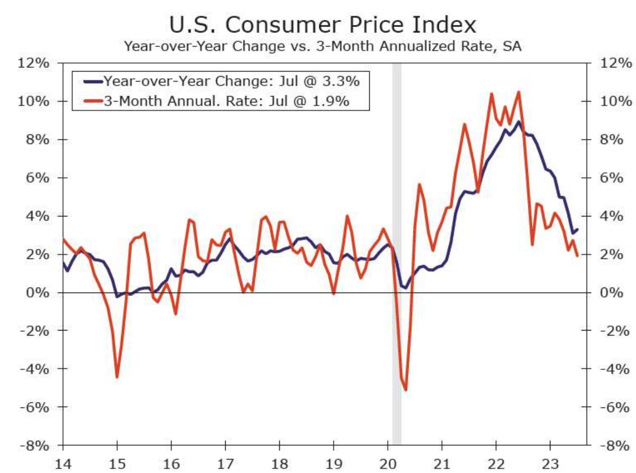
Prices and wage growth are finally slowing down, but The Federal Reserve has chosen to keep interest rate options wide open.

Fed Chair Powell commented last week that the Federal Reserve may not need to wait for inflation to hit their 2% target before they can start cutting rates, but he also mentioned that a less robust environment for wages can nudge things towards their objective.

Inflation continues to trend in the right direction. The left chart shows that the Consumer Price Index (CPI) has increased over the last month, but only by 0.2%, extending a general monthly trend of moderation in price increases. When comparing inflation to the prior year, the right chart (blue line) shows that inflation has declined to 3.2% over the prior year, also a general continuation in the downward trend. I should also note that there are many inflation pressures in the economy that do not show up in the CPI.



Source: U.S. Department of Labor and Wells Fargo Economics



Source: U.S. Department of Labor and Wells Fargo Economics

In the last newsletter, I shared that former Fed Chair Ben Bernanke published a whitepaper which emphasized the importance of normalizing the employment market with higher unemployment and lower wages. The thought is that wage expectations can be very difficult to undo once in place. Workers don't like pay cuts, and if there are still more job openings than there are available workers, those who receive pay cuts can quit to find more attractive wages elsewhere. Workers who make more money can afford higher prices for services whether it's dining out, massages, or airline tickets. A great way to monitor this is the Job Openings and Labor Turnover (JOLTS) survey, and the Department of Labor's hourly earnings report.

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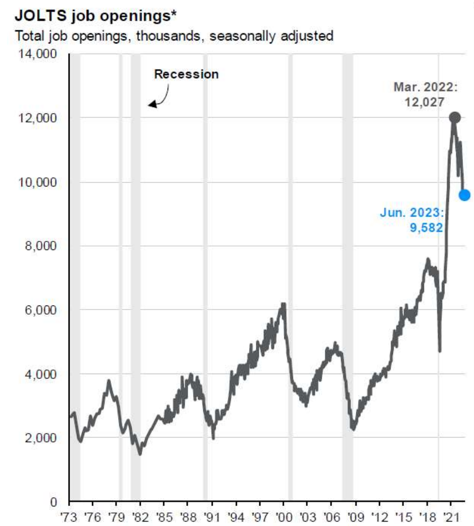
The JOLTS job openings report (right) shows the trend of job openings continuing to decline. Fewer openings should lower wages over time. Workers who have fewer employment options, or who face higher risks of not finding a job are disincentivized to leave their current employer. Employers then have more flexibility and don't have to offer higher pay to attract workers.
The JOLTS quits report (below) seems to verify this because there is a general decline in workers quitting their jobs for greener pastures.

Source: US Dept of Labor, JP Morgan.



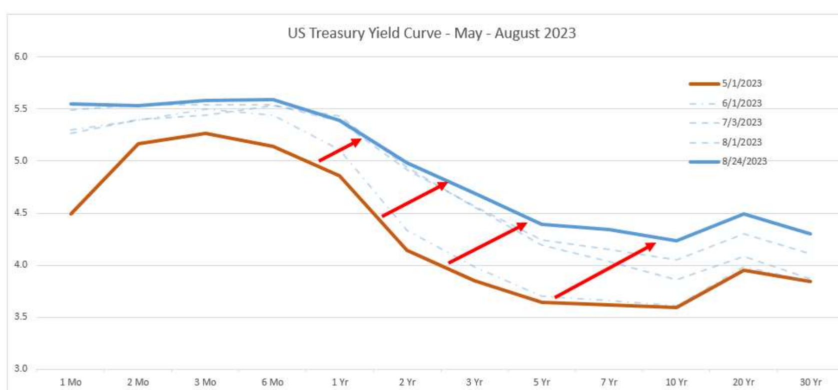
Source: US Dept of Labor, JP Morgan.

Other measures of labor market health could be confirming a softening trend. Last week's jobless claims report showed that claims rose to 248K, whereas forecasted claims were only 229K. Jobless claims reports are notoriously volatile and subject to revisions, but the *general trend* points towards labor market moderation.

Both job openings and the number of workers quitting are declining while unemployment claims are rising. However, average hourly wages increased by 0.3% in July on a monthly basis and rose 1.1% over a year earlier. A 0.3% increase may not seem like much, but little increments each month eventually add up to large percentages. Plus, this increase is applied to worker pool in the largest economy in the world. It is okay for wages to increase to help support a quality of life and to keep pace with inflation, but the trouble starts when the growth of wages outpaces even inflation. Wages that increase faster than inflation support more spending on good and services, which supports higher prices, and the feedback cycle continues. If the Fed is trying to slow things down, this is the opposite outcome of what they want to achieve. Former Chair Bernanke's report must have resonated with policy makers. Several Federal Reserve governors (and the Bank of England) have noted that the hardest part now is bringing down services inflation and wage inflation, both of which seem less sensitive to interest rate policy, which could make the Federal Reserve's job more difficult.

The bond market has changed its tune: it's no longer how high interest rates could get, but how long rates can stay high.

US Treasury yields can offer insight into the direction of interest rates over time. Prior newsletters have focused on the inversion of the yield curve (short term rates are higher than long term rates) because it's historically been an accurate predictor of recessions. This time I'm highlighting an unexpected change in the *slope* of the yield curve.
The orange line is the US Treasury yield curve in May. It can predict higher rates over the next year before sharply



Source: Federal Reserve Bank of St. Louis dropping from years 2 – 10 then rising a bit thereafter. The bond market was reflecting Fed rate cuts in mid to late 2024. The blue line is the same US Treasury yield curve as of August 24. The bond market still thinks that rate hikes are over, but no dramatic rate cuts next year. Rates still decline, but they do so in a more graduated pace over a longer period of time. Through the US Treasury yield curve, the bond market is telling investors that it thinks the Fed is *probably* done with rate hikes, but we're going to be in this interest rate environment for longer than expected. Higher rates mean more expensive loans, but they're also a headwind for the stock market. The modest August pullback in performance is likely attributable to investors digesting this new bond market signal. One takeaway for clients is that returns may be more muted in the coming months, and this may be a potential source of volatility, in my view.

Three pillars to sustaining this year's markets: lower inflation, softening job market, and *some* corporate growth.

The Federal Reserve has rarely hiked interest rates and avoided a recession. I discussed last month that predicting or timing a US economic recession is virtually impossible, in my view. Clients understandably expect some conviction, and I will reiterate what I have said in meetings and prior newsletters: I think we need a "Goldilocks" scenario where everything is "just right". Inflation slows down and stays around 2 – 3%, the job market softens (higher unemployment, slower wage growth) but doesn't go into reverse, and some corporate growth but nothing too crazy. I've touched on inflation and the job market. Corporate growth needs to be just enough to support stock prices and dividends, maintain margins, and modestly raise sales.

Closing comments

Closing this newsletter with yet another analogy, the markets are hoping for a US Economic glide path like an airplane landing: perhaps there's some turbulence, but the plane touches down without incident. Unfortunately, when the Fed hikes rates, historically the airplane landing was jarring (a recession) or even a crash. Many of the challenges we have faced over the past year seem to be resolving themselves, but they haven't disappeared. I continue to be on guard and focused on risk/volatility management as much as I am on upside market potential. Regardless of what happens, I know that the best client outcomes are the product of meeting regularly, contacting us if you're losing sleep, having a plan (and sticking to the plan), and never making investment decisions based on emotion.

Questions and comments are welcome.

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