CETERA® INVESTMENT MANAGEMENT

COMMENTARY

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The Upside Down World - When Good News is Bad News

- Better than expected labor data caused fear of higher interest rates.
- Recession risk is increasing, but any recession should be mild for a host of reasons.
- Volatility will remain as we continue forward in this rate hike cycle.

Like an episode of Stranger Things, stock markets appear to be in the upside down world. A world where bad news can be good news and good news can be bad news. On Friday, the Labor Department reported that the unemployment rate fell to 3.5% and the U.S. economy added 263,000 jobs (more than expected) in September. One would think this is good news, but it can become bad news if it gives the Federal Reserve more confidence that it can raise interest rates even more and keep a relatively strong labor market.

Investors fear higher interest rates because higher rates increase borrowing costs for businesses and consumers. Both businesses and consumers will have less money to spend because a higher percentage of their spending will be on interest payments. Leases, loans, financing, and mortgages all become more expensive. All this hurts corporate profit margins. The futures market now points to an 80% probability of another 0.75% hike in the Fed Funds rate on November 2. Markets also are anticipating another 0.50% hike on December 14.

The probability of a recession is rising with interest rates. If we are not already in a recession, a recession is becoming more likely in 2023. Economic growth is slowing and is likely to contract. This should cool price pressures though and that's what the Fed wants. The good news is that we think any recession will be mild.

While the labor market will eventually weaken, it is hard for companies to get rid of workers when they can't even find workers. There are about 5 million more job openings than unemployed individuals, which equates to two job openings for every unemployed person. While this should come down with a recession, it is an amazing starting point considering there are usually more unemployed workers for every job available. Also promising is that average hourly earnings are easing. This may be a case of bad news being good news though. Fed Chair Jerome Powell talked about this metric in his most recent press conference. Wage inflation is more persistent, and the Fed would like to bring this down, which they appear to be doing already. While annualized wage growth over the past three months is still high at 4.4%, it is heading in the right direction from the Fed's perspective. This could give them a reason to pause their hikes in the future.

Unlike 2008, the housing market is also very strong. While home prices are weakening, the good news from the Fed's perspective is that homeowners have a lot of equity to pull from. Savings rates have fallen but many still have savings created from two bouts of fiscal stimulus and those that were able to refinance mortgages early in the pandemic at low fixed rates. Low housing inventories will also keep a lid on home price declines caused by rising mortgage rates. We mentioned the unemployment rate above too. As long as people have jobs there should be relatively low default rates on mortgages.

Additionally, and maybe most importantly, much of the bad news is already accounted for in stock prices, bond prices, and future earnings projections. Bearish sentiment is high right now. This creates more opportunities for upside surprises. The inflation data being released is backward looking. We are seeing signs of inflation already easing and not accounted for in current reports. Falling oil prices and wheat prices will eventually cause other goods and services to fall in price. This can take time to make its way to the supermarkets and retailers.

Ultimately, the data will drive the Fed's decisions going forward. As we go through this rate hike cycle, please continue to work with your financial professional to make sure you are properly diversified to help mitigate market volatility and your portfolio is aligned with your long-term investment objectives.

This report is created by Cetera Investment Management LLC. For more insights and information from the team, follow @CeteraIM on Twitter.

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