Financial Stability or Is Something Breaking?

Recently we have noted that the odds are increasing that financial instability, or as we say, ?something breaks,? is the likely culprit to force the Fed to reverse course. Given the strong link between Fed policy and asset prices, it?s valuable to appreciate how the Fed monitors financial stability. The illustration below categorizes the four factors the Fed assesses in its *Financial Stability Report*. The red-shaded areas provide a current update on the four financial stability categories. While conditions can change rapidly, there are few signs of financial instability rearing its ugly head.

Some may argue that stock and bond prices are down 15-20%, which does not portend financial stability. However, as noted, they have been offset to some degree by rising home prices. If stock and bond prices stay down and house prices start falling as many expect, we might see one of the four financial instability measures trigger a warning. However, such would likely not be enough for a pivot unless stock and or bond prices decline further from current levels. As for the three other categories, there is nothing concerning at the moment, but conditions can change quickly.

The Federal Reserve monitors four broad categories to gauge financial stability risks in the United States

Asset valuations	Borrowing by businesses and households	Financial sector leverage	Funding risks
Indicators: Asset prices House prices Treasury yields	Indicators: Debt-to-GDP ratios Gross leverage Interest cov ratios	Indicators: Capital ratios Leverage	Indicators: Holdings of liquid assets
Vulnerability assessment: Asset prices generally have fallen amid a less favorable backdrop, but real estate valuations remain very elevated	Vulnerability assessment: Debt rose but debt-to-GDP ratios remain at a moderate level, and interest coverage ratios for large businesses have reached historical highs	Vulnerability assessment: Banks are well-capitalized and stress tests show the system is resilient; leverage is somewhat elevated at hedge funds	Vulnerability assessment: Banks have high levels of liquid assets and stable funding; structural vulnerabilities in some areas persist

Note: Vulnerability assessment as of Nov 2022 (latest assessment done).
Source: Federal Reserve Board (FRB) of Governors Financial Stability Report.

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What To Watch Today

Economy

- 7:00 a.m. ET: **MBA Mortgage Applications**, week ended Nov. 18 (2.7% prior)
- 8:30 a.m. ET: **Durable Goods Orders**, October preliminary (0.4% expected, 0.4% prior)
- 8:30 a.m. ET: **Durables Excluding Transportation**, October preliminary (0.0% expected, -0.5% prior)
- 8:30 a.m. ET: **Initial Jobless Claims**, week ended Nov. 19 (225,000 expected, 222,000 prior)
- 8:30 a.m. ET: **Continuing Claims**, week ended Nov. 12 (1.520 million prior)
- 9:45 a.m. ET: **S&P Global U.S. Manufacturing PMI**, November preliminary (50.0 expected, 50.4 prior)
- 9:45 a.m. ET: **S&P Global U.S. Services PMI**, November preliminary (48.0 expected, 47.8 prior)
- 10:00 a.m. ET: **University of Michigan Consumer Sentiment**, November (55.0 expected, 54.7 prior)
- 10:00 a.m. ET: **New Home Sales**, October (570,000 expected, 603,000 prior)
- 10:00 a.m. ET: **New Home Sales**, month-over-month, October (-5.5% expected, -10.9% prior)
- 2:00 p.m. ET: **FOMC Meeting Minutes**, November 1-2

Earnings

	Company	Time	Estimate		Growth	Surprise
DE	Deere & Company	6:45 AM ET	$7.08	$13.39 B	18.2%	+ = -
LU	Lufax Holding Ltd	4:30 PM ET	$0.15	$2.05 B	-17.1%	+ = -

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Market Trading Update

Yesterday, the market traded all day positively, building on the gains from the morning open. As noted previously, there is little volume this week due to the holiday-shortened trading week, so don?t read too much into yesterday?s action. The market has been trading in a consolidation pattern for the last two weeks, and a rally tomorrow will set up a test of the 200-dma, which has acted as important resistance to the market all year. A confirmed break above the 200-dma would suggest a continued rally higher, but there are still many headwinds currently facing asset prices.

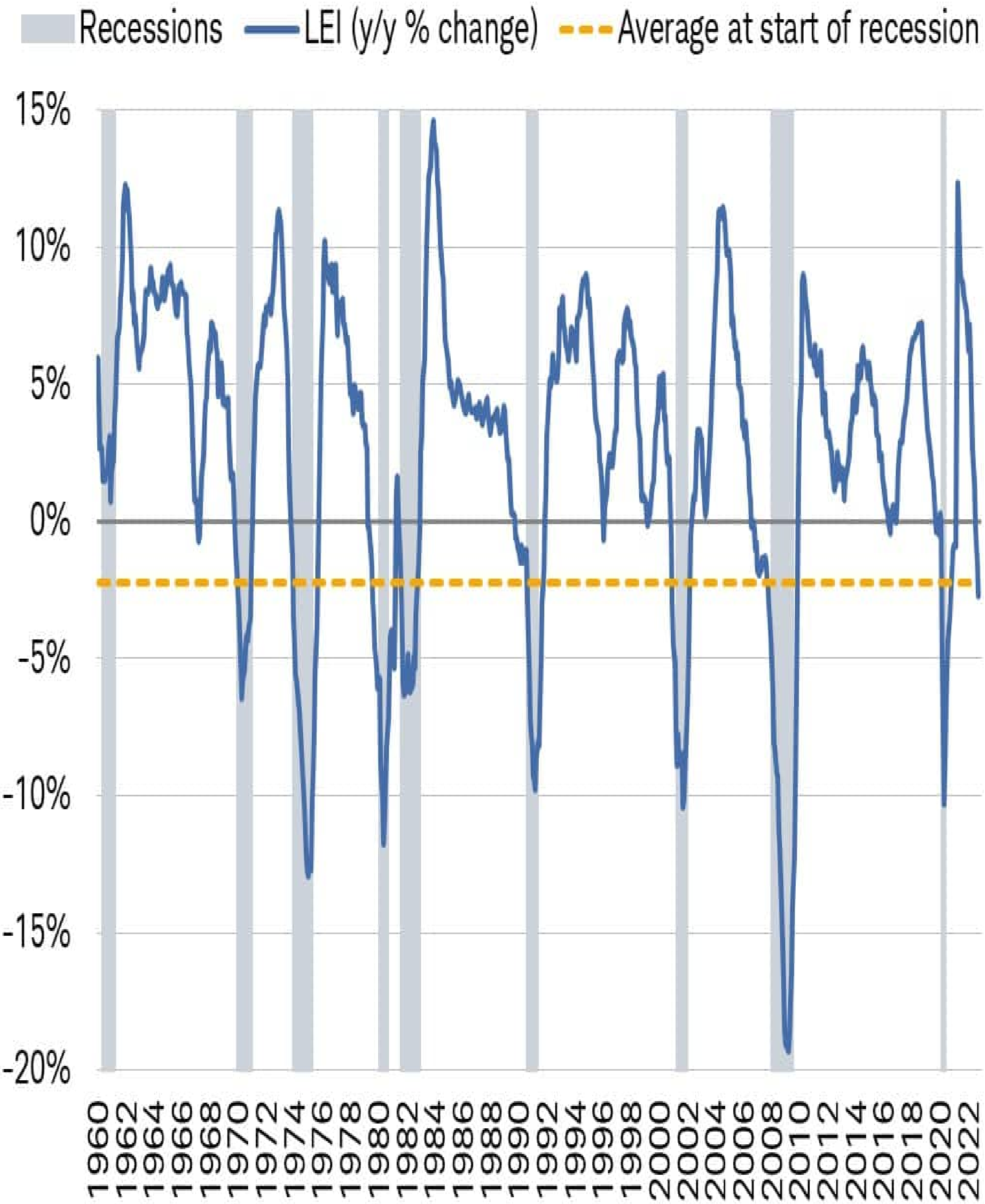
TradingView

While the bulls are getting excited short-term by the action, the longer-term picture remains challenging, with numerous weekly moving averages sitting just above the market. We still suspect a rally into year-end, but the beginning of next year will likely be more challenging. Continue to use rallies to raise cash and rebalance positions heading into year-end.

TradingView

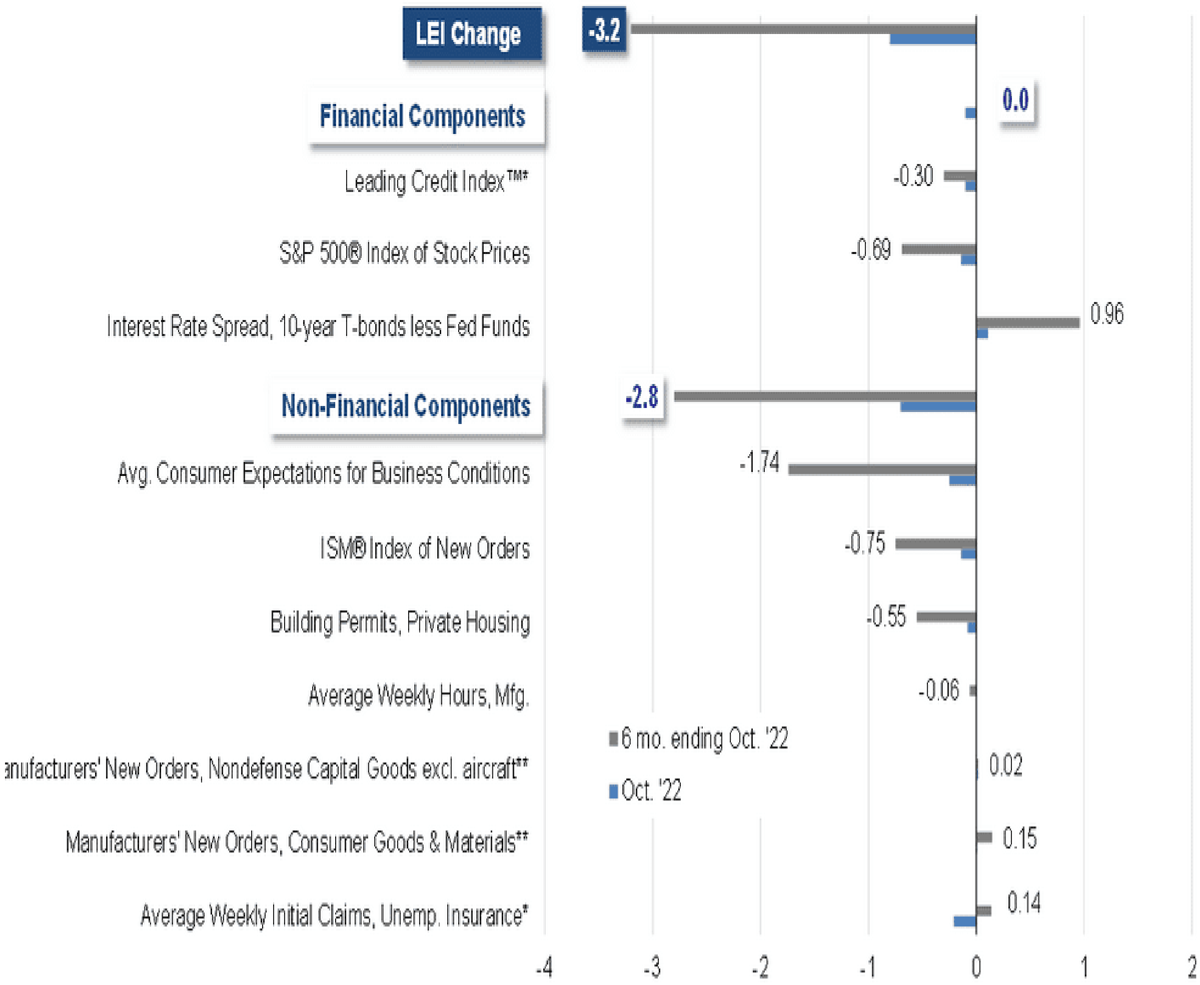
Another Day, Another Recession Warning

The graph from Charles Schwab shows that the Conference Board?s Leading Economic Indicators (LEI) is -2.7%, below -2.2%, the average start of recessions since 1960. The second chart shows the factors that make up the LEI. It shows that market indicators for a recession portend flat growth. Non-financial indicators are flashing red. Of note, the biggest drag to the LEI index is Consumer Expectations. Consumer consumption accounts for almost two-thirds of GDP, so it is not surprising consumers? dour outlook raises the odds of a recession.



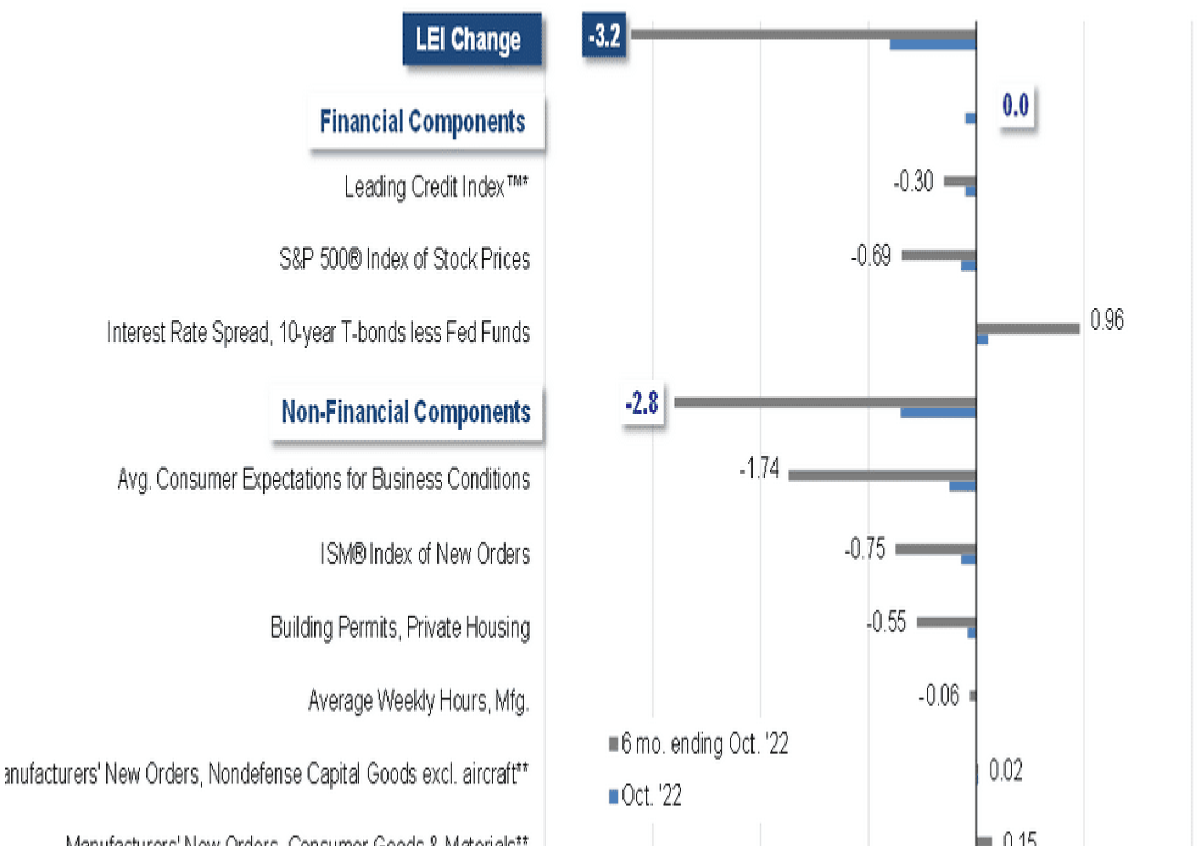
Source: Charles Schwab, Bloomberg, The Conference Board, as of 10/31/2022.

The Conference Board Leading Economic Index® and Component Contributions (Percent)



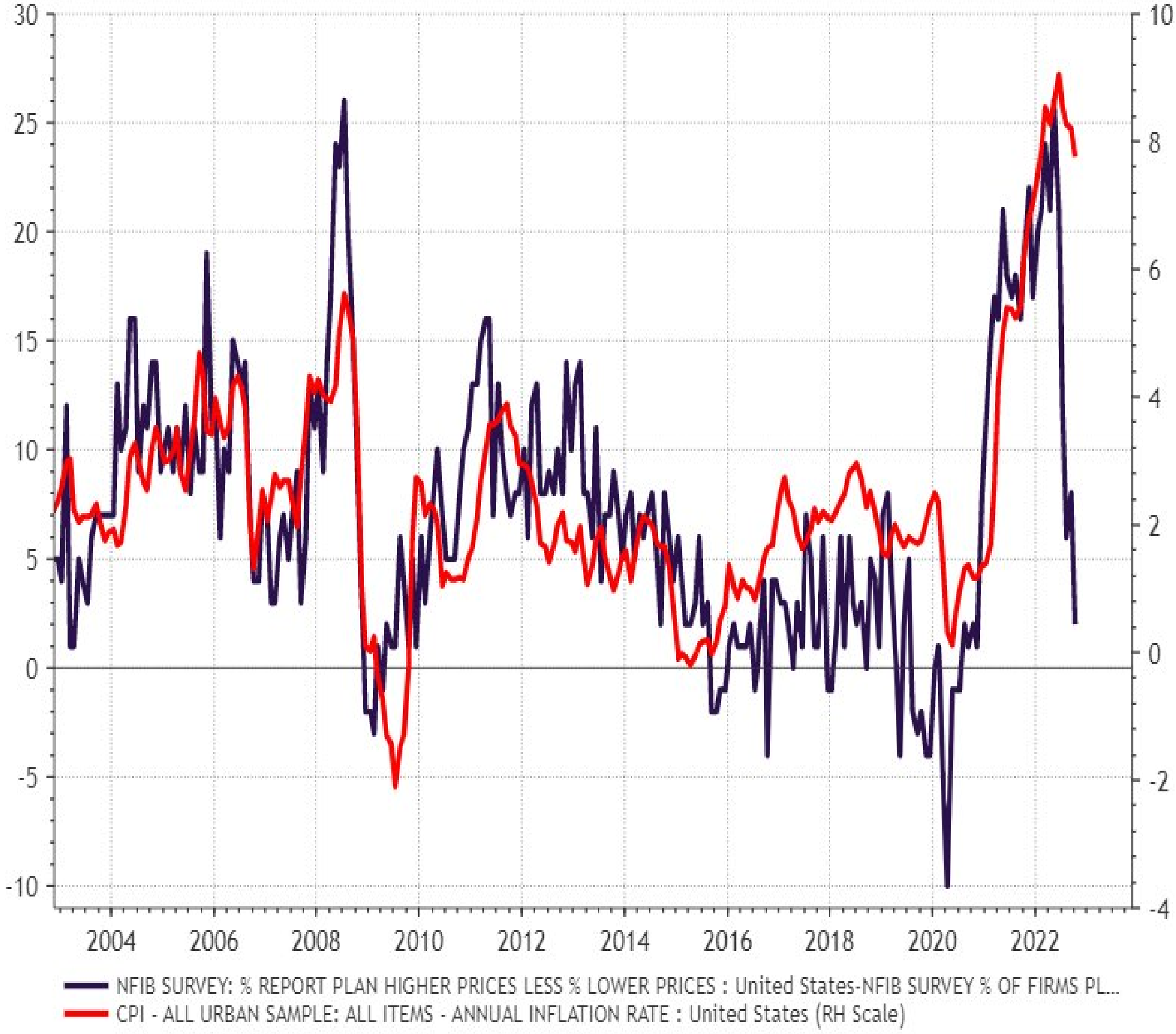
Source: The Conference Board
* Inverted series; a negative change in this component makes a positive contribution.
** Statistical Imputation
LEI change might not equal sum of its contributions due to application of trend adjustment factor

The Conference Board Leading Economic Index® and Component Contributions (Percent)

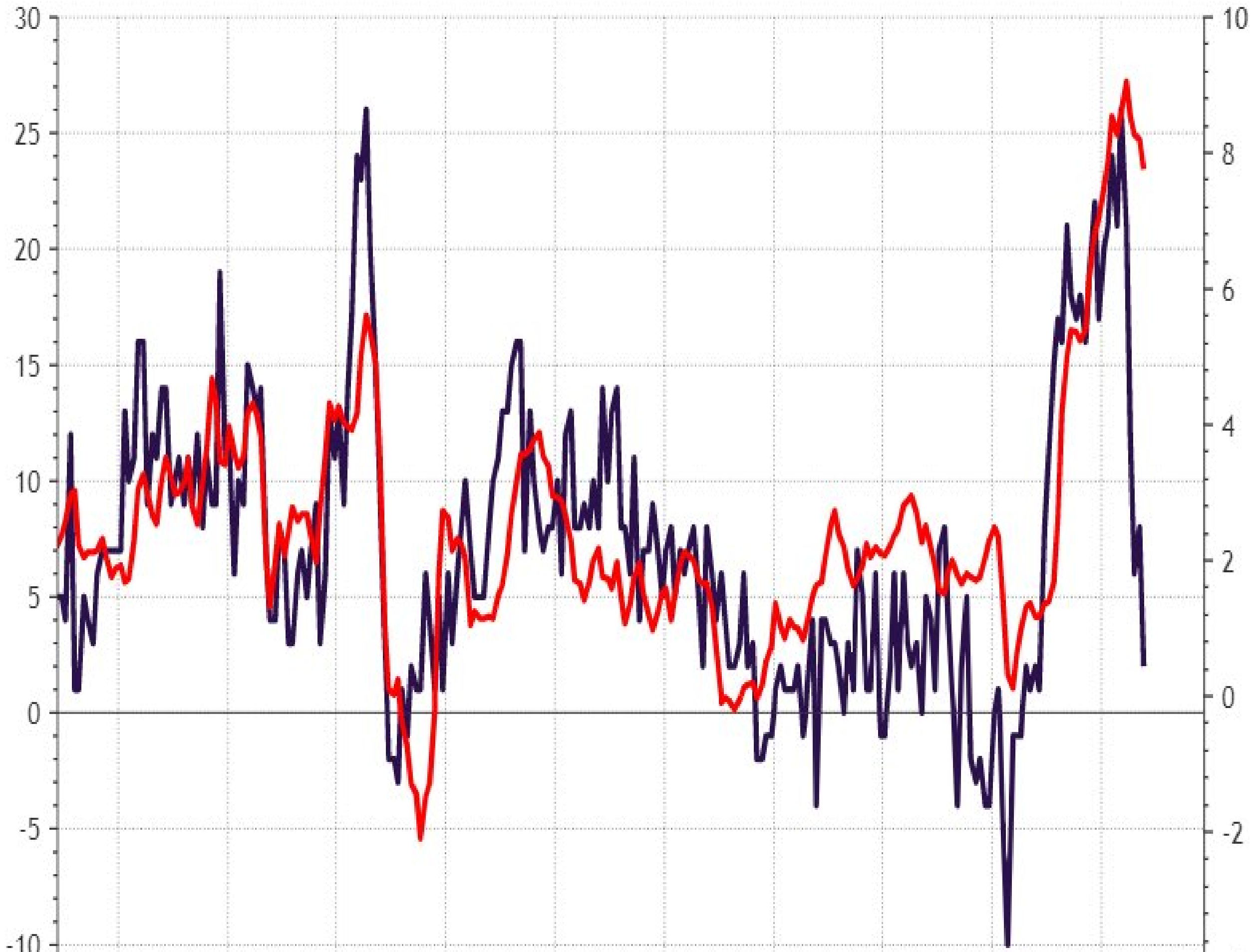


Inflation Set To Plummet

The graph below shows the robust correlation between the NFIB (small business owners survey) and CPI. Assuming the correlation holds up as it has for the last 20 years, we should expect inflation to normalize quickly. It is worth caveating that the reasons for inflation today are unlike any prior experiences of the last 20 years. While we think inflation will decline, we are not sold it will be as much or as fast as the graph portends.



Source: Refinitiv Datastream @ACTIAM 22/11/2022



Crypto vs. Sub-Prime, Perspective Matters

Joe Weisenthal of Bloomberg, in his daily commentary, reminds us there is a vast difference between the popping of the cryptocurrency bubble and the subprime/mortgage meltdown of 2007-8. People need housing. Nobody needs cryptocurrency. Accordingly, there is a natural bottom to home prices and, therefore, a limit to losses for mortgage debt investors. In contrast with crypto, ? *There?s no obvious circuit breaker or curb to stem the decline.?*

> But the big elephant in the room is that crypto is a closed loop. Its only source of "revenue" is speculation on coins. To the extent the value of coins can be modeled in ways that are similar to equity (and some can be), that future revenue is only a function of desire to speculate on coins. And then when coin values fall, and desire to speculate goes down (because that's what happens in a bear market), then the "fundamentals" fall as well, and down the spiral goes. There's no obvious circuit breaker or curb to stem the decline.

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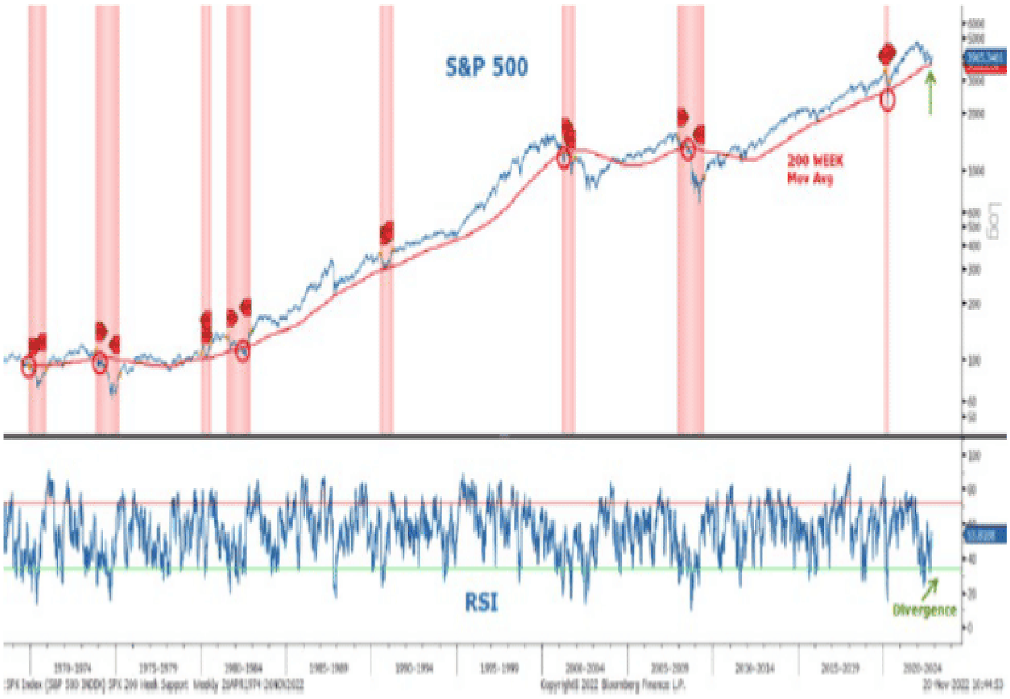
Tweet of the Day

Lance Roberts @LanceRoberts · 28m

The 200-week moving average is key support, falling #interest #rate volatility provided support for higher valuations driving this rally absent positive #EPS revisions. However, it is no longer arguing for further upside. - Morgan Stanley

Exhibit 1: 200-Week Moving Average for S&P 500 Will Not Break Until Labor Market Does



Source: Bloomberg, Morgan Stanley Research

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