SEVENS REPORT

Sevens Report Alpha Webinar – Post Fed Market Analysis and Outlook

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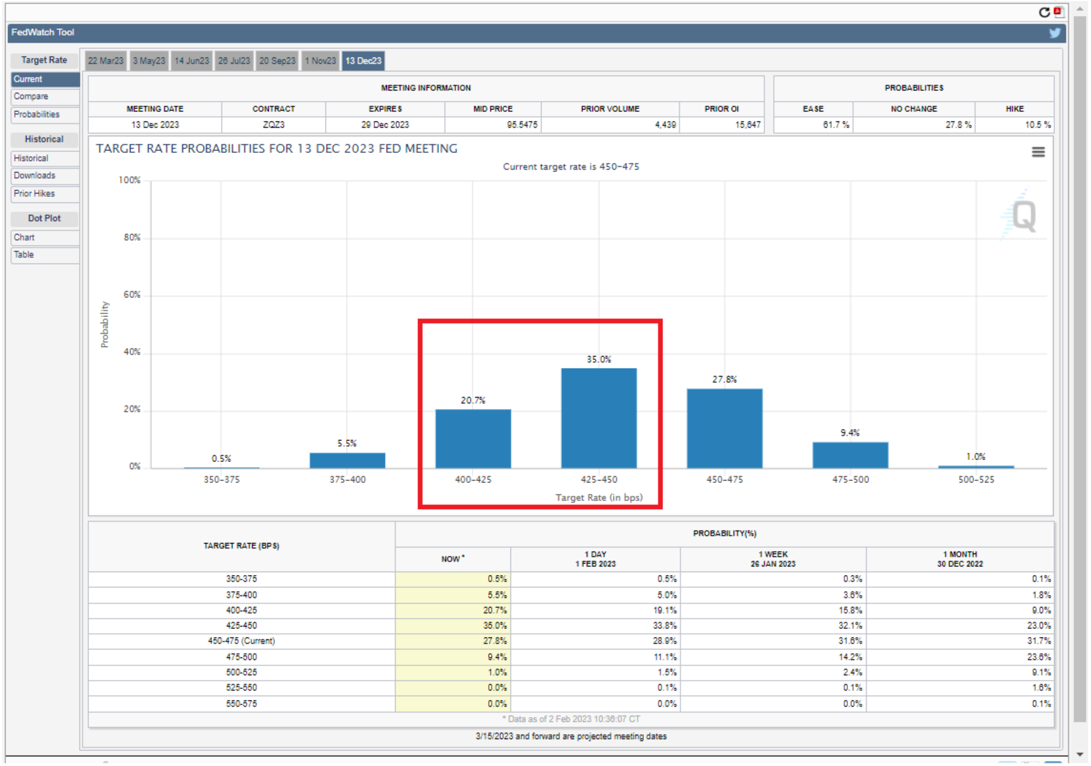
Fed Decision

- What happened?
  - 25 bps hike, no hint of a pause in the statement.
  - But, Powell was wishy-washy in the press conference and did not push back on the market's assumptions.
  - Stocks and bonds rallied as a result.
- Bullish assumption: Less Hawkish.
  - Accomplished? Yes!
  - Two-year yield fell.
  - Year-end Fed Funds estimates declined further (now under 4.375%).



Central Bank Decisions (ECB/BOE)

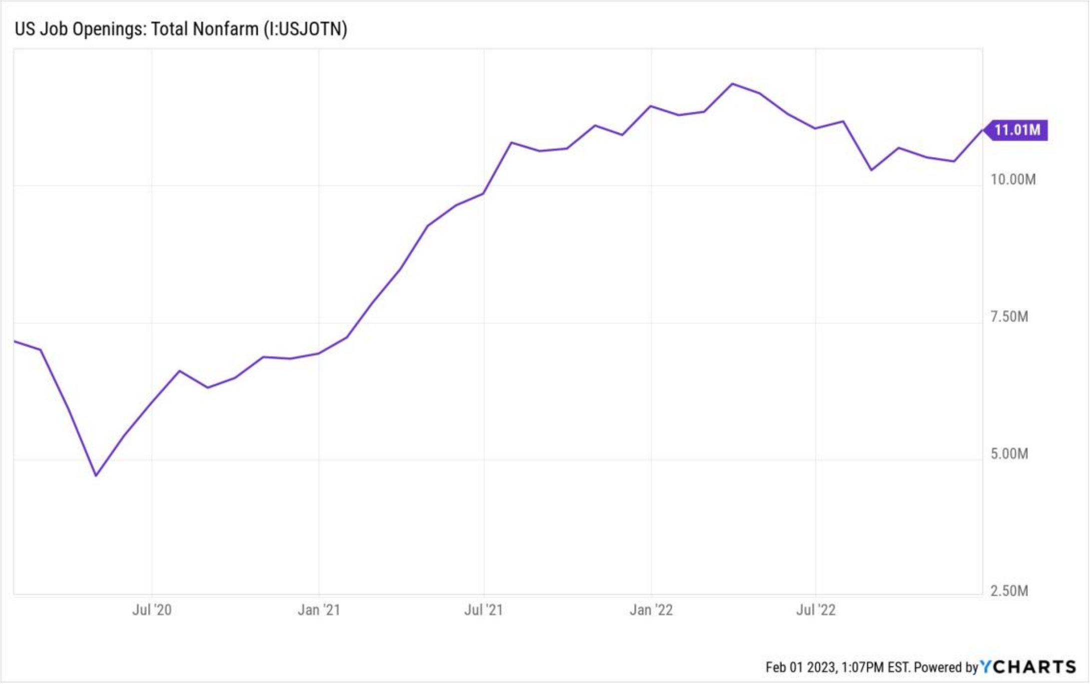
- What happened?
  - ECB raised rates 50 bps but wouldn't commit to 50 bps hikes beyond March. Less Hawkish.
  - BOE raised rates 50 bps, but it was a split decision (7-2) and likely no more rate hikes coming. Less hawkish.
- Bullish assumption: Beginning of the end of hikes?
  - Accomplished? Yes.
  - The ECB and BOE followed the same script the Fed was on – namely not being convicted about future rate hikes.
  - The market seized on that lack of conviction.
  - 10-year bund yield collapsing today from 2.29% to 2.07%.

Inflation Data

- What happened?
  - Inflation data this week has been mixed.
  - Positives
    - More disinflation in wages.
    - Employment Cost Index 1.0% vs. (E) 1.1%.
    - Unit Labor Costs: 1.1% vs. (E) 1.5%
  - Negatives
    - Other inflation metrics implying a bounce back in prices.
    - Spanish CPI: 5.8% vs. (E) 4.9%.
    - French CPI: 6.0% vs. (E) 6.1% but up from 5.9%.
    - ISM Manufacturing Prices: 44.5 vs. (E) 39.4.
- Bullish assumption: More clear evidence of disinflation and an acceleration in the decline.
- Accomplished? No.
- It's still not clear that core inflation is consistently declining and the data hints a bounce back in core inflation could be coming. If that happens, central banks will have to get more hawkish, again.

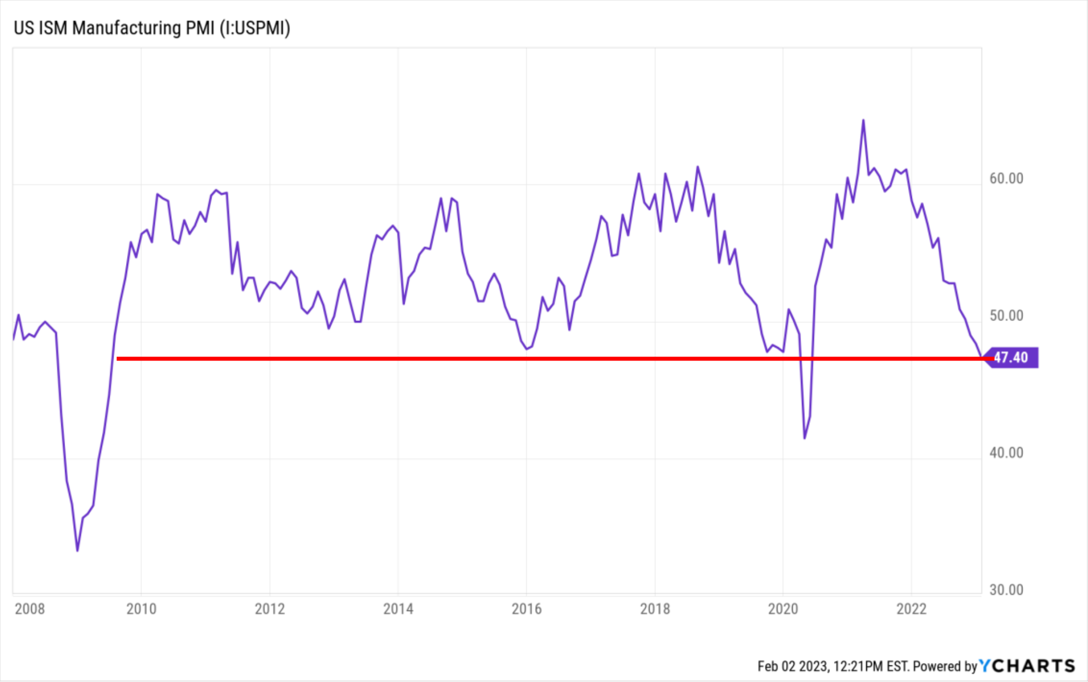
Labor Market Data

- What happened?
  - Employment data remained very robust on balance.
  - Jobless Claims: 183k vs. (E) 193k
  - JOLTS: 11.01M vs. (E) 10.2M
  - ADP: 106k vs. (E) 180k (but significant weather distortion)
  - The only negative was Challenger job cuts, which surged to 102,943 vs. previous 43,651.
- Bullish assumption: Moderation in the data that helps Fed get less hawkish.
- Accomplished? No.
  - Employment remains very robust, and while there is some evidence of an easing of wage pressures, it's faint and the labor market remains very tight.



Growth Data

- What happened?
  - Manufacturing data universally disappointed this week.
    - ISM Manufacturing PMI. 47.4 vs. (E) 48.0. Lowest since ’09 (excluding pandemic).
    - Factory Orders. 1.8% vs. (E) 2.2%.
    - Chicago PMI. 44.3 vs. (E) 45.1.
- Bullish assumption: Soft landing
- Accomplished? No.
- Manufacturing activity continued to slow in January, and while that’s the minority of the economy, service activity has also been slowing. These are not the type of readings we’d expect to see from a soft landing.



So What's It All Mean?

- The data this week was hawkish in aggregate:
  - Inflation pressures rebounded outside of wages, which saw some moderation.
  - Economic growth continued to cool in the manufacturing sector but hasn't imploded.
  - Labor market indicators remain very, very strong.
- Based on the past year of Fed decisions, these inputs should have resulted in Powell admonishing the market for pricing in less than 5% terminal fed funds and rate cuts in 2023. He did the opposite.
- Market implications:
  - If the Fed isn't going to provide any more hawkish shocks to the market, then clearly the downside is reduced as Fed hawkishness was accountable for the most intense pullbacks of 2023.
  - But, the Fed is still hiking and short term rates will stay high. That means growth will continue to slow, and despite the bullish euphoria, there was <u>no</u> more evidence this week that a soft landing is more likely than a hard landing.
  - Meanwhile, inflation is declining, but not materially faster than before and there are hints of a rebound.
  - Finally, the labor market remains incredibly tight.
  - Here's the takeaway
    - The biggest risk for markets over the medium term is if the Fed blinks too early like they did in the 1970's. Powell's commentary is good in the short term but raises concerns about the Fed having to get hawkish again – like what happened in the 1970's. So, risks are not eliminated just because Powell was dovish yesterday.
    - The key now is data: Inflation, especially core services inflation **<u>must</u>** come down and quickly to support the gains in stocks. Economic growth **<u>must</u>** stabilize, and a soft landing needs to become apparent to prevent a '01'-03 style recession-based stock market decline.
    - If that happens, then stocks can move higher throughout 2023. If it does not, then this rally won't be sustainable.

Two Remaining Events: Jobs Report & ISM Services

- Advanced JRP:
  - Just Right: 0 – 300k Job Adds, > 3.5% UE Rate, **< 4.5% Wages y/y.**
  - Too Hot: > 300k Job Adds, < 3.5% UE Rate, **> 4.4% Wages y/y.**
  - Too Cold: < 0 Job Adds, > 4.0% UE Rate.
- ISM Services PMI
  - What makes it positive for markets:
    - Headline: > 49.5 (Shows stability)
    - Prices: < 67.6 (further declines)
  - What makes it negative for markets:
    - Headline: < 49.5 (Implies further deterioration in services).
    - Prices: > 67.6 (rebound).