

FEBRUARY MARKET COMMENTARY

By Tom Crow

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Index	Month End	Gain (Loss) by Period (ending February 29, 2024)			
		Month	Most Recent Quarter	Year-to-Date	Trailing Twelve Months
Dow Industrials	38,996	2.2%	8.5%	3.5%	19.4%
S&P 500	5,096	5.2%	11.6%	6.8%	28.4%
Nasdaq	16,092	6.1%	13.1%	7.2%	40.7%
Gold	2,048.05	(0.3%)	0.6%	(0.7%)	12.3%
Silver	22.34	(3.3%)	(10.7%)	(6.1%)	8.8%

The indices all fared better in February than they did in January and ended the month no more than 1.5% below recent all-time highs. Weakness in a few mega-cap stocks lately has stalled this seemingly unshakable market. We don't see the end of this bull market just yet, but we're expecting some volatility, and thinking the current rally may have stalled.

Last week's economic data pointed towards stagflation and decreased expectations for a rate cut in June and stocks dropped accordingly. The news wasn't enough to cause significant damage to the bullish mantra of stable growth, falling inflation, imminent Fed rate cuts and AI enthusiasm.

Don't let the modest decline in stocks fool you, economic data this week has not been positive for stocks and while it hasn't invalidated any of that bullish mantra, it has weakened it. Thursday's PPI reinforced the idea that the decline in inflation has slowed to an apparent crawl. Bulls will hold on to the belief that a drop in housing prices over the past year will soon hit the CPI data and push that number lower. Retail sales, meanwhile, posted a second straight underwhelming number.

Put simply, the data over the past week, starting with February's jobs report has pointed towards a potential slowing of economic momentum and buoyant price pressures, not falling inflation. That is the present market reality.

On the jobs front, as reported, February was another month with a solid headline gain in payrolls, but the details of the report show a murkier situation in the labor market, where not all is well. Nonfarm payrolls rose 275,000 in February, easily beating the consensus expectation of 200,000 and higher than the average monthly gain of 229,000 for the past year. But downward revisions to prior months reduced payrolls by 167,000, bringing the net gain to a moderate 108,000. More importantly, net of downward revisions, private sector payrolls rose only 19,000 in February.

Looking at payrolls excluding government (because it's not the private sector), education & health services (because it rises for structural and demographic reasons, and usually doesn't decline even in recession years), and leisure & hospitality (which is still recovering from COVID Lockdowns) shows that "core" measure of payrolls rose a modest 80,000 in February.

Meanwhile, civilian employment, an alternative measure of jobs that includes small-business start-ups, declined by 184,000. In the past, at economic turning points, the civilian employment figure has done a good job of picking up future weakness in payrolls. Over the past year, full-time civilian employment is down, while part-time employment is up, which can be a sign of impending economic weakness. Due to the drop in civilian employment, the unemployment rate rose to 3.9% in February from 3.7% in January, which is the highest level in more than two years.

It's not all bad news in the labor market, though. Total hours worked in the private sector increased 0.4% in February, reversing the decline in January. Hours are up a moderate 1.0% from a year ago. Meanwhile, average hourly earnings rose only 0.1% after a 0.5% surge in January and are now up 4.3% versus a year ago. The Fed will like that a 4.3% gain is slower than the 4.7% gain we saw in early February, and workers will like that a 4.3% gain is beating consumer prices, which are up 3.1% from a year ago.

It seems like companies may have gotten out over their skis in terms of hiring. If that's the case, it could be a recipe for layoffs later this year. Total payrolls are up 1.8% in the past year. That pace would be normal in the middle of an economic expansion when the unemployment rate (and number of available workers) would be much higher than they are today. If our interpretation is correct, a weaker job market could be heading our way.

Now, from employment and earnings to spending... Washington D.C. continues to spend much more than it receives in revenue. The president's just-released budget adds over \$16 trillion to the \$34.5 Trillion national debt over the next 10 years and relies on massive tax increases that will never make it through congress.

One problem with the budget numbers is that government accountants lowered spending in 2023 by about \$300 billion after the Supreme Court struck down a large part of the president's proposal to forgive student loans. That legal decision didn't change the government's cash flow last year in any significant way, but it did allow the Department of Education to "write up" the value of its loan portfolio by about \$300 billion, which they counted as "negative spending," which then reduced the official budget deficit. The reported deficit in 2023 was \$1.8 trillion but the Treasury needed to borrow more than \$2 trillion to make ends meet. I can't claim to be a fan of this kind of government accounting, but politicians live by it.

These high levels of borrowing are causing some investors to fear some sort of imminent and unprecedented snowballing of federal debt. If continual borrowing leads to skyrocketing interest rates (and higher interest payments), it could lead to severe problems in the financial system.

Since the debt ceiling was suspended in June of 2023, total Treasury debt outstanding has gone up by nearly \$3 trillion, including \$874 billion in the second quarter of 2023, \$835 billion in the third quarter, and \$834 billion in the fourth quarter. Other than during the 2020-21 COVID lockdowns, the debt has never gone up this rapidly, not even during the massive bank bailouts in 2008-2009.

It is important to remember that the debt does not go up at a steady rate during the course of the year. In 2023, during March and April, the federal government received a surge in tax receipts, which temporarily reduced the debt. This will probably happen again this year, especially since the S&P 500 went up 24% last year making it more likely than not that the federal government is likely to reap lots of non-withheld revenue.

The Congressional Budget Office estimates that individual income tax payments will be 13.4% higher this year and the budget deficit will come in at roughly \$1.5 trillion versus \$1.7 trillion in Fiscal Year 2023. Given that congress is debating foreign aid measures that, by themselves, will boost the deficit, I'm not as optimistic.

While the cost of servicing the debt is going up, the important measure is the net interest on the debt relative to GDP, or how much of our national income is needed to service the debt. That measure, while climbing, and a problem, is still below the average of roughly 3% of GDP it was back in the 1980s-90s. But, if interest rates remain higher than government accountants think, the carrying cost of our debt will move higher.

My considered opinion... federal government spending is way too high, and most politicians do not seem to care. Some folks look at these numbers and assume some kind of imminent crisis. I see a slow, but unavoidable decay in our economy's underlying ability to expand. New technologies will continue to increase productivity, but a huge and expensive government will drag on expansion like a ball and chain.

For now, investors are ignoring this, assuming a soft landing with lower interest rates, but the more economic growth is undermined, the less likely that outcome.

Our technical indicators point to limited upside potential from current levels, and a substantial, but short-lived correction before year-end. Historically, markets do well in the years immediately following elections, no matter who wins, but we could be in for a bit of a bumpy ride between now and November. We also have a Fed meeting this week, and while we're not expecting a rate cut, any comments or minutes they release could add to the volatility.

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