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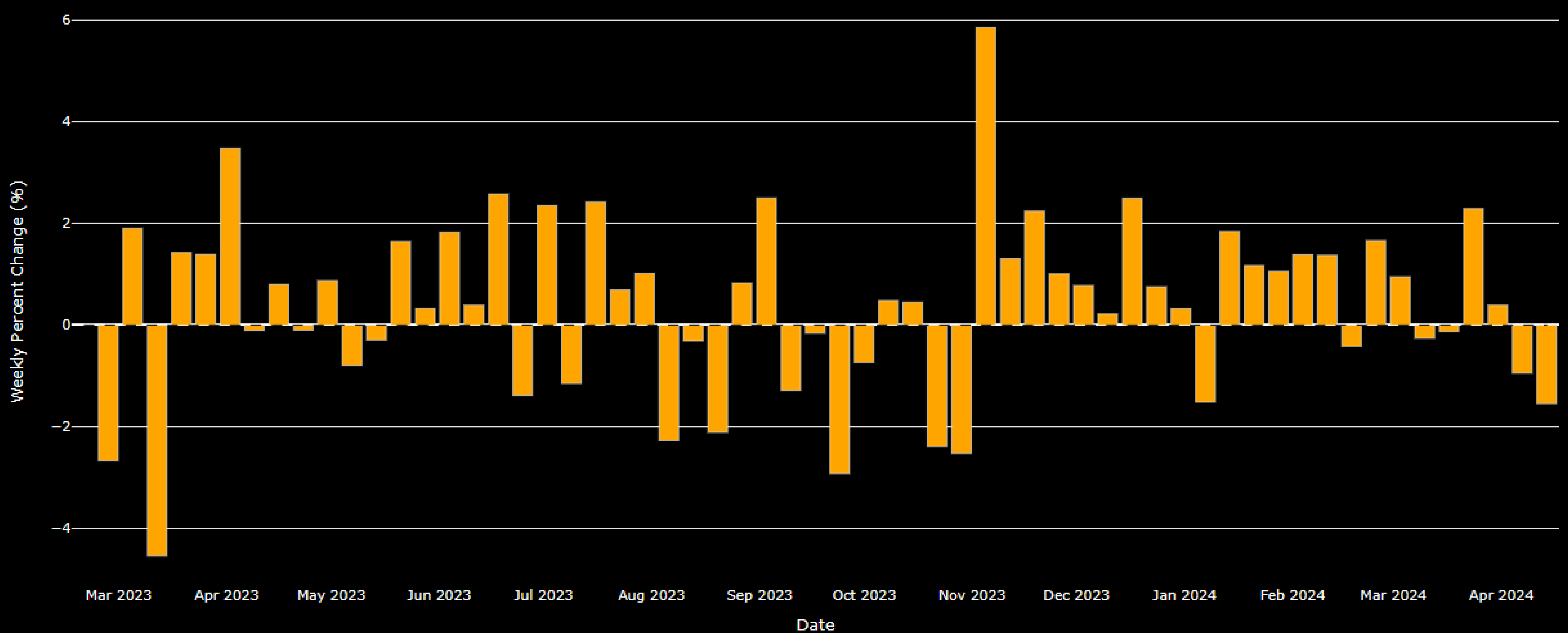
The Uptrend is Broken

The S&P 500 has established a new support level to monitor, shifting focus from the 20-day moving average (DMA) and the narrow trading channel seen since last November, to now the 50 DMA. Market dynamics shifted last week as the expectation for June rate cuts—previously a hopeful speculation—diminished significantly. This change in sentiment was triggered by hotter-than-expected CPI data released on Wednesday. Adding to the market's unease, there was a spike in volatility towards the week's end, which occurred without clear triggers, leading to a broad downturn across all asset classes on Friday. Amidst this uncertainty, investors gravitated towards bonds as a safe haven, a move that has been uncommon in recent years. Notably, the correlation observed has been between bonds and asset prices, rather than interest rates and prices. The increased market anxiety presumably fueled by escalating tensions in the Middle East, particularly concerning reports about Iran's potential involvement in the conflict between Israel and Gaza. As a result, the S&P 500 closed the week down by just over 1.5%, marking the largest one-week drop since the beginning of the year.

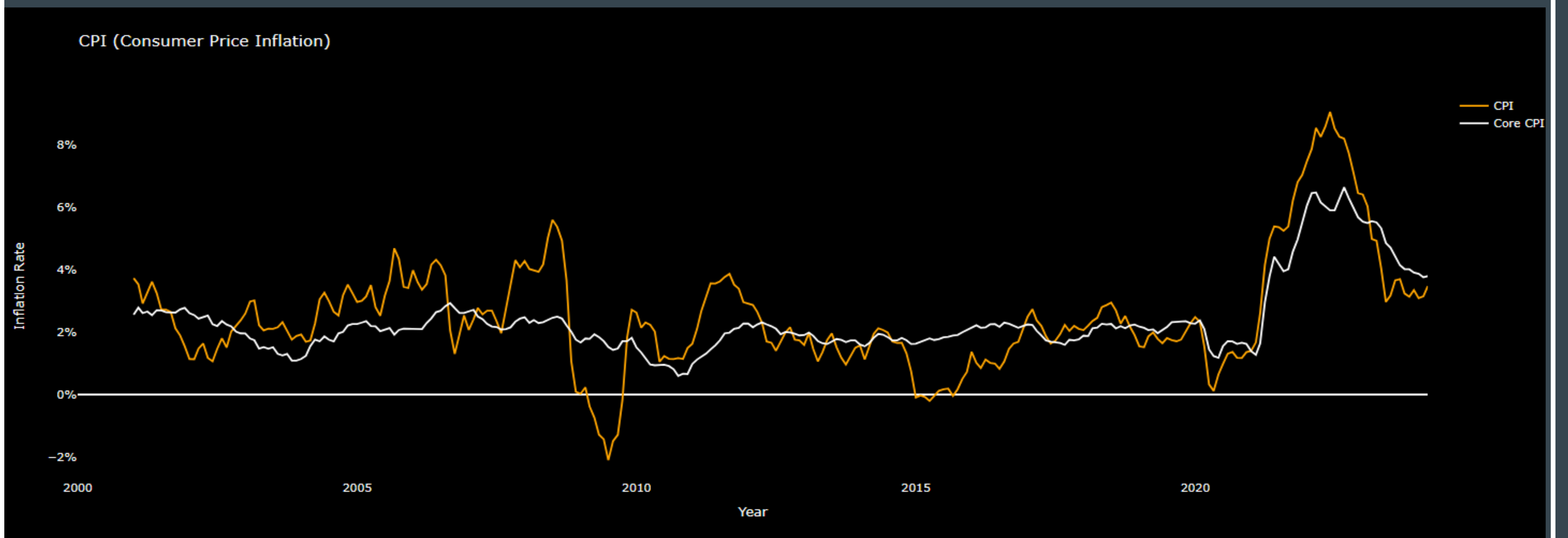


From a technical perspective, a pullback like the one experienced this week, or even a more extensive 5-10% retreat, seems overdue. Continued selling leading to a drop toward the S&P 500's 200-day moving average (DMA) would not be surprising. While I'm not predicting this definitively, the sharp rally we've seen, lacking fundamental support—as evidenced by the modest 1.4% projected earnings growth for Q1—suggests that the recent gains have been largely due to multiple expansion. Currently, the market remains over one standard deviation above its 200 DMA, a level it has reached only once since the beginning of 2022.

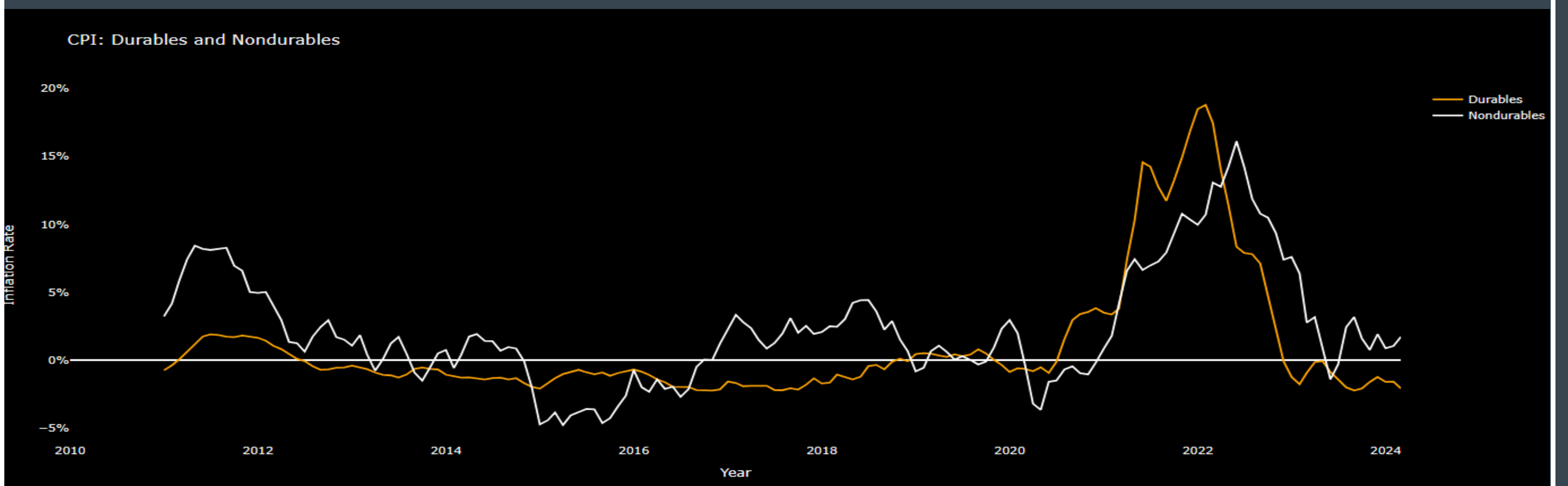
The Relative Strength Index (RSI) has shown a negative divergence from the S&P 500 since December 2023. This occurs when the market is rising but the RSI is trending lower, which can signal underlying weakness in the market rally. This past week, the RSI notably dropped to 37 from its starting point in the mid-50s at the beginning of the week.

The VIX showed signs of activity this week. Since October 2022, it has primarily trended lower, consistently bouncing off its downtrend resistance line. A confirmed break above this line would indicate heightened market volatility, potentially reinforcing the likelihood of a pullback. This development coincides with the start of earnings season, which began with the banking sector on Friday. The unfolding earnings season could either exacerbate the current technical weaknesses or help the market recover from potentially rolling over.

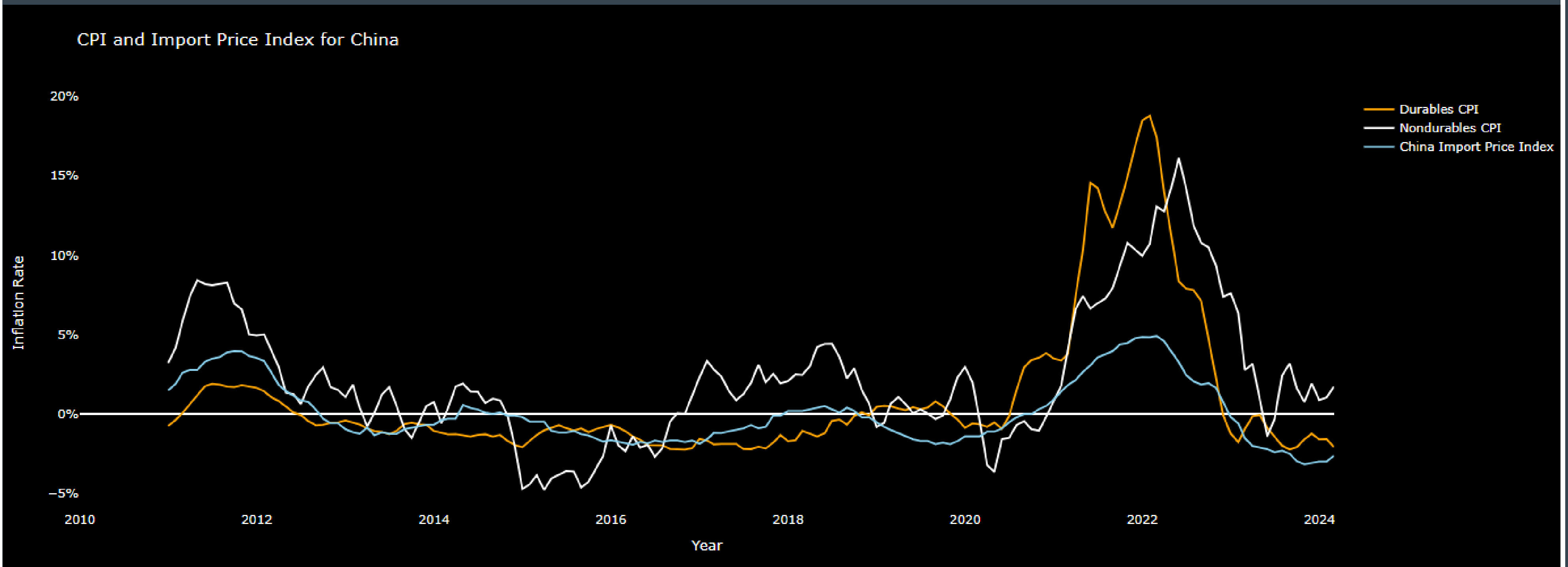
CPI data has complicated the Federal Reserve's plans to cut rates, with the likelihood of June rate cuts now estimated at around 20% according to the CME Fed Watch Tool. This week, CPI was reported at 3.5% year-over-year, an increase from last month's 3.4%. Core CPI also came in above expectations at 3.8% compared to 3.7%. This reacceleration aligns with recent trends, as many commodities have shown price increases over the past month. Additionally, both manufacturing and services surveys from the various Federal Reserve Banks have reported higher prices paid. With oil prices climbing to the high $80s, the pressure on inflation metrics continues. Although the Fed typically places more emphasis on PCE, the combination of strong employment data and rising CPI leaves little room for justifying rate cuts.



However, there are two sides to the inflation story. On one hand, the goods side of inflation has returned to target levels, or in some cases, even dipped below target. This month, nondurable goods prices rose but remain around 2%. In contrast, durable goods are experiencing deflation.



Some of the observed deflation in goods prices can be linked to economic challenges in China, which is experiencing a crisis reminiscent of the 2008 financial downturn in the U.S., characterized by widespread defaults in its property sector. In China, real estate is commonly used as a savings mechanism, and several of the country's largest property developers have declared bankruptcy in recent years. Unlike in past crises, the Chinese government has refrained from implementing large-scale bailouts, leading to a reduction in domestic consumption. As a result, China, known as the manufacturer for the world, is experiencing goods deflation, which it is managing in part by exporting this deflation to international consumers of its products. This has helped drive down inflation for goods in the U.S. However, this could pose longer-term challenges if service sector inflation in the U.S. is not addressed before goods prices bottom out.



The real struggle the Fed is dealing with pertains to services, wage growth and rents. Services inflation is back above 5% as of March and rising again.

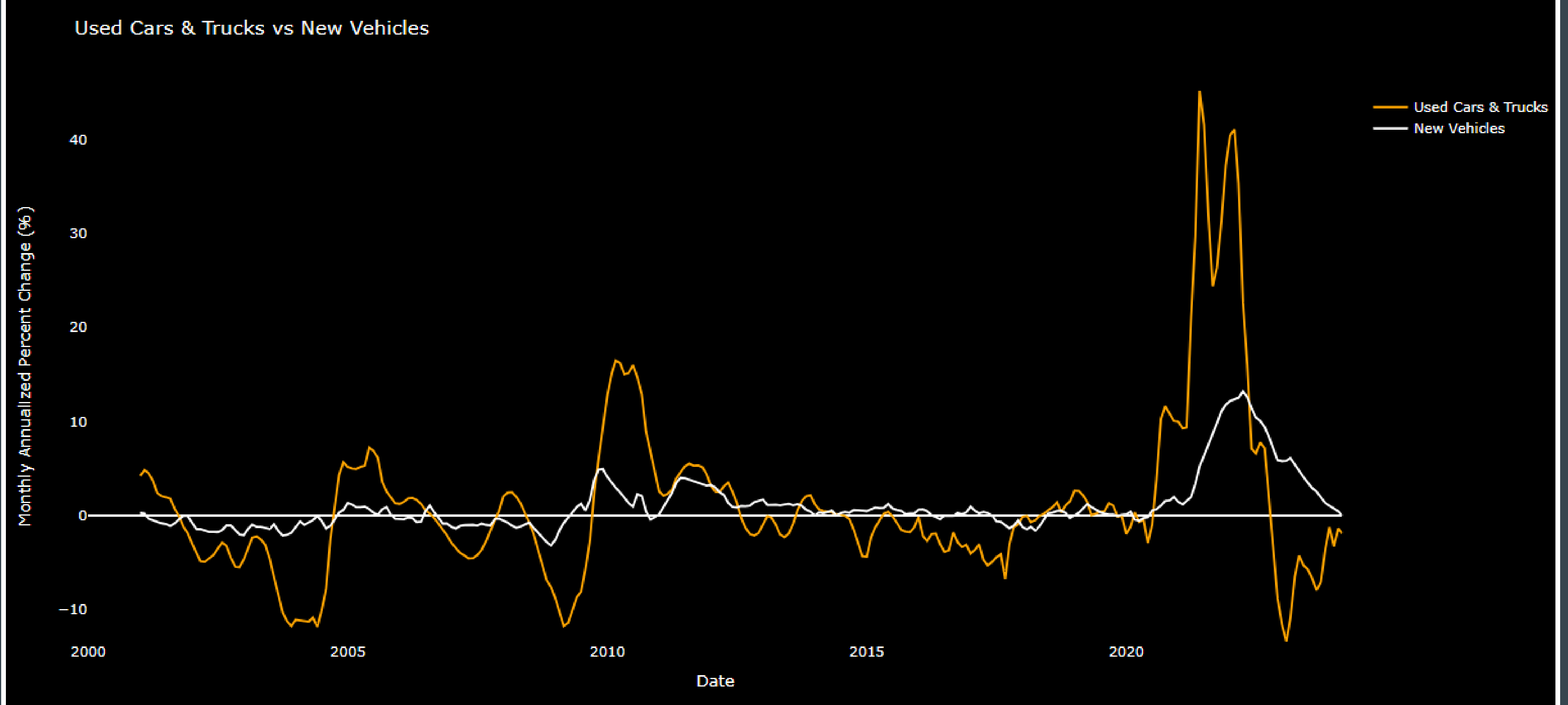
Wage growth continues to remain elevated, currently at 4.2% as measured by the annualized growth in average hourly earnings. Although there was a slight decrease in March, the persistent strength in wage growth reflects the ongoing tightness in the labor market. Employees retain substantial negotiating power, and this robust wage growth is supporting sustained consumer spending.

Shelter is 40% of CPI and is measured in 2 ways, Owners Equivalent Rent and Rent of Primary Residence. Shelter inflation is coming down but very slowly. For March it was reported at ~6%.

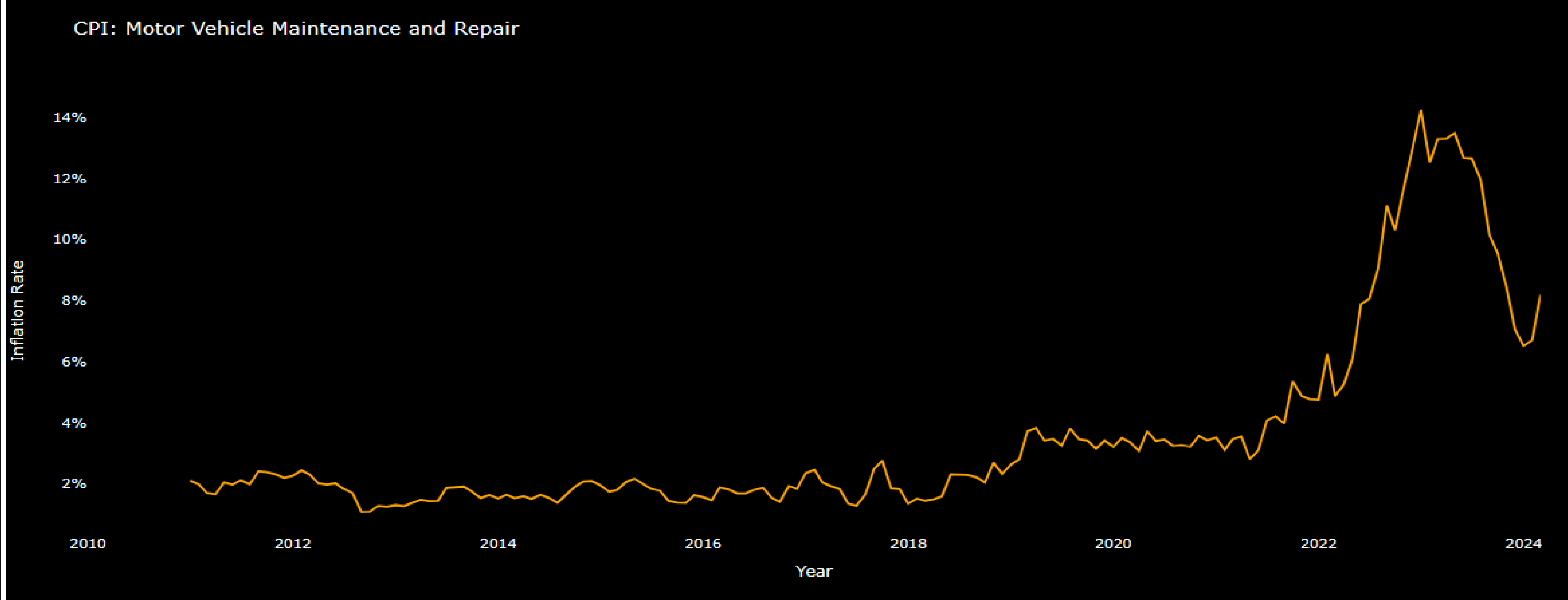
Economists often look at CPI excluding the shelter component due to the lagging nature of rents. As of June 2023, this measure was at 0.65% year-over-year but has since increased to 2.3%, still about the Fed's target. The Owners Equivalent Rent (OER) measure is determined through a survey asking homeowners what they believe their home could rent for. This method, along with still-elevated home prices, means that the impact of changes in the rental market may be slow to reflect in the CPI. Consequently, the Fed might be working with a CPI figure that overstates actual inflationary pressures.

Another notable component reported in CPI, is energy. It turned positive after being negative for approximately a year, thus previously acting as a drag on CPI. When examining the year-over-year changes, energy prices peaked in June 2022. Therefore, lower energy prices throughout 2023 contributed to negative year-over-year figures. However, with those previous high comparables now lower, the downward pressure on CPI from energy prices has shifted to being a tailwind.

New and Used Car prices are 0% and -1.3% Year-over-Year. This follows the goods and non-durable goods back to target narrative



Vehicle Repairs and Maintenance rose to 8% and shows the nuanced nature of the inflation picture. The actual good is falling in price but the cost to fix the good is rising.



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