OBSERVATIONS: *Volatility introduces itself to markets, manufacturing vs services, jobs gains still strong.*

- August gets a choppy start with the S&P 500 dropping -2.3% last week as volatility picked up. Small cap stocks (Russell 2000 Index) declined -1.2% and the Nasdaq took the brunt of selling, declining -2.8%.[1]
- The ISM manufacturing index continues to be in contraction after registering 46.4 for July (figures below 50.0 indicate economic contraction). While better than June's reading of 46.0, this marked the ninth consecutive month below 50.0. Notably, the prices paid component of the index came in below expectations with a 42.6 reading, continuing to point to disinflationary pressures on the goods side of the economy.[1]
- The ISM Services Index continues to be in expansion territory after July's reading of 52.7, the seventh consecutive monthly gain. While continuing to grow, last month's reading was below expectations of 53.1 and lower than June's 53.9—the services sector indicator has shown expansion in 37 of the last 38 months.[1]
- Job openings were little changed month-over-month (MoM) at 9.58 million from the prior month's 9.62 million. This marks the lowest figure for 2023 but remains above the post-Covid average of 9.40 million.[1]
- Labor productivity posted its biggest quarterly increase in Q2 in nearly three years rising +3.7% (annual rate) and beating expectations of +2.2%.[1]
- US employment rose by 187k jobs in July, less than expectations for 200k and slightly above the downwardly revised June figure of 185k jobs. July's job gains were driven by healthcare, which contributed +63k jobs in the month, higher than the 12-month average gain of +51k. The unemployment rate declined from 3.6% to 3.5%, continuing a trend of unemployment ranging between 3.4% to 3.7% since March 2022.[2]

EXPECTATIONS: *Bank of England hikes rates, US treasury yields move higher, earnings season nears completion.*

- The Bank of England (BOE) raised its main policy rate by +25bps to 5.25%, marking the fourteenth consecutive rate hike. The UK's most recent inflation reading (headline CPI) stood at +7.9% year-over-year (YoY) and the BOE now expects the measure to fall below 5.0% by the end of 2023.[3]
- The 10-year US Treasury yield reached a 2023 high of 4.20% last week and looks primed to retest multi-year highs of 4.30% set in October 2022. We view this more as a result of better economic data, higher for longer interest rate policy, and technical factors relating to the expected increase in issuance from the Treasury rather than Fitch's decision (more in One More Thought) on the US Government's credit rating.[1]
- Earnings season enters its final stretch, nearly 85% of S&P companies have reported earnings with 79% beating earnings estimates and 65% beating revenues estimates. The blended (actual plus reported) earnings growth is set to decline -5.2% on a YoY basis for Q2—if this figure holds, it will mark the largest YoY decline since Q3 2020. This week, 34 S&P 500 companies will report earnings.[4]

ONE MORE THOUGHT: *Fitch downgrade, government shutdown looms, and should we care.*

Last week Fitch downgraded the US long-term credit rating one notch from AAA to AA+—Fitch did not change its short-term rating for the US, which are more relevant for government money market funds. The downgrade was not a big surprise to many as Fitch had placed the US on negative watch back in May following the latest debt ceiling debacle. In this recent downgrade Fitch cited a worsening expected fiscal outlook and an erosion of governance—which by our estimates should be on full display in September as Congress is unlikely to pass the 12 appropriations bills that fund the government leading to a government shutdown. Rest assured the Fitch decision will be

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[1] *Bloomberg LP*
[2] *https://www.bls.gov/news.release/empsit.nr0.htm*
[3] *https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2023/august-2023*
[4] *Factset Earnings Insight, 8/4/2023*

weaponized as part of that process. Two of the three major ratings agencies have now downgraded the US, the first being from S&P in August 2011 when it stripped the US of the prized AAA rating and downgrading it to AA+. There are now only 9 countries that carry a AAA rating across all three major rating agencies—S&P, Moody's, and Fitch (Chart of the Week). A couple of thoughts, the first is the oddity of sovereign credit ratings for the world's reserve currency whose government securities serve as the widely accepted risk-free rate in finance—and as the foundation from which most debt securities are priced and traded. Second, the downgrade is likely to not have an impact on corporate or municipal AAA issuers, which similarly seems odd. As JP Morgan's CEO noted for the US "it's the market, not the rating agencies that determine borrowing costs." That point rings especially true and when it comes to the risk-free rate and world reserve currency status, we do not think ratings necessarily inform the markets—making this entire exercise mostly irrelevant. This is not to condone the level of debt or fiscal trajectory of the country, as both are on unsustainable paths. Markets will decide when and how to punish the government for putting the country on this path, not Fitch. As for last Wednesday's selloff (S&P 500 -1.4%) following the downgrade, the market had posted five consecutive monthly gains as part of the rally that has taken the S&P to the top end of our year-end target range of 4,500. Additionally, the S&P 500 did not experience a greater than -1% decline in over 40 days and with volatility unusually low, it was just a matter of time before the S&P 500 experienced a setback. The downgrade was a reasonable catalyst for the selloff and could be the beginning of a narrow drawdown—on the order of -3% to -5% to 4,200 on the S&P 500—in coming weeks.

CHART OF THE WEEK

US 10-Year Treasury Yield

Long-term Credit Rating

	Standard & Poors	Moody's	Fitch
Australia	AAA	Aaa	AAA
Denmark	AAA	Aaa	AAA
Germany	AAA	Aaa	AAA
Luxembourg	AAA	Aaa	AAA
Netherlands	AAA	Aaa	AAA
Norway	AAA	Aaa	AAA
Singapore	AAA	Aaa	AAA
Sweden	AAA	Aaa	AAA
Switzerland	AAA	Aaa	AAA
US	AA+	Aaa	AA+

Source: Clearstead, Bloomberg LP, Standard and Poors Global Ratings, Fitch Ratings, as of 8/3/2023

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