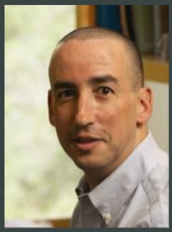

MARKET UPDATE

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April 10, 2023 – Market Update

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I. Last Week

A. Stocks

1. For the week: DJIA +.6%; **S&P 500 -.1%**; Nasdaq -1.1%
2. **YTD**: S&P 500: +6.9%; **Nasdaq +15.5%**
    a. **Breadth** has been weak
    b. **Regional banks** are down 26% and not much of a bounce (Barron's)
3. The **largest 20 stocks** in the S&P 500 have added roughly $2T in market cap this year. The **other 480** have added $170B.
    a. Just **seven companies** make up **half** of the **Nasdaq 100's weight**. MSFT and AAPL comprise 25%.
    b. The **spread between the Nasdaq 100 and the Nasdaq Composite** is the largest it's been in 30 years.
4. **Q1** was a **rebound** of what had done the worst in 2022 (Bloomberg)
5. The **equity risk premium** (earnings yield minus the 10-year UST yield) is at 1.59%, a low not seen since Oct. 2007. This is well below the average gap of around **3.5%** since 2008.
    a. But the average premium since 1957 is ~1.62% (WSJ)
6. In addition, the **CAPE** is at 29 – higher than it's been **90%** of the time since 1881.
7. **Earnings season** is about to start. There have already been **81 negative** preannouncements and only **26 positive** ones. The average ratio is **2.5** (going back to 1997). (Barron's)

B. Bulls and Bears

1. Despite all of the extreme calls, the S&P 500 has ping-ponged around **4,000** for the past 11 months. About **81% of trading days** have closed within 5% of that level.
    a. These narrow trading ranges rarely last longer than **250 days**; we're at 233
2. **Negatives**:
    a. Banks' willingness to lend
    b. Commercial real estate owners face a looming wall of mortgage maturities
    c. Credit card balances are rising
3. **Positives**:
    a. This is what Fed wanted
    b. If profits can be maintained and disinflation…everything is good (Bloomberg)

C. Profits Will Drop

1. S&P 500 earnings are expected to **fall 7% in Q1** YoY. This would be the sharpest decline since 2020 Q3.
2. Just three sectors are expected to report **improved margins**: energy, industrials and consumer discretionary
3. Investors will be **watching**: the outlook for margins, references to artificial intelligence, evidence of slowing cash use and signals of a China reopening boost.
4. **Smaller firms** are more economically sensitive and have greater exposure to regional lenders (Bloomberg)

D. Saving for Retirement

1. Investors have **~30%** of their retirement savings in **cash**. Another 30% is in equities, 16% is in fixed income and 13% is in target date funds.
2. Approximately **29%** of millennial workers (born 1981 – 1996) expect to reach **$1MM** in savings by time they retire; 49% expect to have less than $500K and 27% expect to have less than $20K
    a. For workers aged **45+**, the numbers are **21%**, 59% and 34% (Bloomberg)

E. Bonds and Interest Rates

1. This week: 3-month 4.95% (+10 bps); 2-yr 3.97% (-9 bps); 10-yr **3.39%** (-9 bps)
2. Investors have no idea about the path for the **economy, inflation and Fed policy**.
3. Earlier in the week, Cleveland Fed Pres. Mester warned that rates have to go a "little bit higher"
4. **Inconsistencies**:
    a. Credit **spreads tightened** (not consistent with recession)
        i. Credit traders showed confidence in company balance sheets.
    b. Treasury turbulence is much higher than the VIX. March saw the widest gap since 2008 (b/t the **MOVE and VIX**).
        i. Maybe index volatility is suppressed by low sector and stock correlations
    c. While **stocks hit highs**, investors kept pouring **cash into money markets**
        i. In addition, many big investors don't want to chase the rally and have stayed defensive (Bloomberg)
5. It's funny to think of the two **safe-havens** that emerged during Q1: **money-market funds and tech stocks.**
    a. Investors have added $336B to US MMFs this year, including $283B in March alone.
    b. Of course, if the Fed starts cutting rates, MMFs could lose their allure.
    c. The S&P 500 **dividend yield is 1.6%.** Only 47 of those stocks have a yield above the **4.6% average yield of MMFs**. (WSJ)

II. OPEC Announces Production Cut

A. Background

1. OPEC+ announced a **surprise oil production cut** of **more than 1MM barrels** per day. Saudi Arabia pledged a cut of 500K. Kuwait, the UAE and Algeria also followed suit. Russia had previously announced a 500K barrel cut.
    a. Remember that OPEC+ made a surprise cut of 2MM barrels just before the midterm elections. In seven months, they've reduced supply by 3%.
2. **Energy rose** with OPEC+ announcement to cut production.
    a. St. Louis Fed Pres. Bullard said the OPEC+ decision was unexpected and higher oil prices could make the **Fed's job more challenging** (Bloomberg)

B. Why OPEC+ is Cutting Oil Output

1. The simple desire to **push oil prices higher**. Prices fell with turmoil in the banking sector and fears of recession. Maybe OPEC+ believes second-half of the year growth will be weak.
2. Saudi Arabia is frustrated with **US comments** last week that it will take years to refill its **SPR**. The US had indicated that the SPR purchases would provide a floor for the market.
3. They have **less fear of the US filling the gap** that they are leaving.
4. **Punish short-sellers**.
5. A desire to show the US that the Saudis have a "**Saudi First**" policy. The friction between Biden and MBS has never diminished. Saudi Arabia's relationship with China is strengthening. (But China doesn't want very high oil prices.)
6. Maybe the Saudis are trying to recover their **CS losses** (FT) (WSJ) (Bloomberg)

C. What the Market Reaction Tells Us

1. The fact that **oil didn't hurt stocks** may evidence that investors are **more nervous about growth than inflation.**
    a. The link between **10-year breakeven inflation and oil** is very high
        i. Part of this is TIPs traders use oil futures as a hedge
        ii. Yet **breakevens dropped** after this announcement – no inflation fear?
2. You really **need strong demand** for sustainable oil moves
    a. There is widespread belief that this move was defensive (Bloomberg)

III. The Labor Market

A. The Employment Report and the Atlanta Fed

1. Nonfarm payrolls increased by **236K** in March – robust, but the smallest since pandemic.
    a. This is pretty strong, considering that the Fed has been raising rates for a yr.
2. The unemployment rate ticked down to **3.5%**
    a. The **gap between the Black and White unemployment** rate shrank to its narrowest level on record.
        i. The Black unemployment rate fell to **5%** last month. It's still 1.8% higher than the White unemployment rate of **3.2%.**
3. The average workweek dropped to **34.4 hours**, the lowest of the expansion, but consistent with the pre-pandemic workweek.
4. **Average hourly earnings increased .3%,** in line with the **3.8% annualized gain** for the past three months. (Barron's) (Bloomberg)
5. The latest Atlanta Fed study shows that the **premium for job-switching was falling** very significantly after hitting an all-time high last year. The bargaining power of workers is weakening. (Bloomberg)

B. JOLTs

1. **Job vacancies** dropped to **9.9MM**, the lowest since May 2021. We were at 12MM last March.
    a. The two-year yield and the dollar fell
2. **Openings / unemployed people** dropped from 1.9 to **1.67**
3. The **quits rate** edged up to **2.6%**
4. The drop in job openings was **before the banking crisis and tighter credit conditions**
    a. Would have been even worse (we think) (Bloomberg) (WSJ) (WSJ)

IV. Bank lending

A. Lending

1. US **bank lending contracted** by the **most** on record in the last **two weeks** of March
    a. This is our best indication that **credit conditions are tightening**
2. **Commercial bank lending dropped** nearly **$105B** in the two weeks ended March 29
    a. This is the most ever in data going back to 1973
    b. The $45B+ drop in the latest week was **primarily due to a drop in loans by small banks**
    c. The pullback in total lending was broad and included **fewer real estate loans and fewer commercial and industrial loans**
3. The Fed's report showed that by **bank size**, lending decreased (over the past two weeks):
    a. $23.5B at the 25 largest banks
    b. $73.6B at smaller commercial banks
    c. $7.5B by foreign institutions in the US
4. The **25 largest** domestic banks account for almost **3/5 of lending**
    a. But small banks are most important in commercial real estate
5. By **type of loan**, the drops were:
    a. Commercial and industrial lending: $68B
    b. Commercial real estate loans: $35.3B
6. Total assets dropped nearly $220B, while total liabilities dropped more than $188B (Federal Reserve)
7. On Thursday, the American Bankers Association **index of credit conditions fell** to the lowest level since the start of the pandemic (ABA)
    a. This indicates that bank economists see credit conditions weakening over the next six months
8. JPM's Jamie Dimon said that the recent failures have "provoked lots of jitters in the market and will clearly cause **some tightening of financial conditions** as banks and other lenders become more conservative."

B. Deposits

1. The Fed's **H.8 report** also showed that commercial bank **deposits dropped $64.7B**
    a. This was the **10th straight weekly decrease**
    b. This was mainly a decline at large firms
2. So-called "**other deposits**," which exclude large time deposits, have fallen **$260.8B** in two weeks:
    a. At domestically chartered banks, they declined $236B
        i. Mostly reflecting a drop at the 25 largest institutions
    b. Deposits at small banks fell $58.1B (Bloomberg)

V. Commercial Real Estate

A. Commercial Mortgage-Backed Securities (CMBS)

1. Prices of bonds backed by commercial mortgages have dropped to levels not seen since the early days of the pandemic.
    a. Higher vacancies, risk of default, less financing and rising interest rates are causing problems.
2. The **spread** on BBB-rated commercial mortgage-backed securities (**CMBS**) has risen to 9.52% (up from 7.6% at the end of Feb.).
    a. It had reached 10.8% in March 2020.
3. **Risk premiums** on securities that tend to be **dominated by bank buyers** (e.g., securitized products like RMBS or CMBS) remain closer to their recent highs than those that tend to have a more diversified pool of potential purchasers.
    a. As banks pay depositors more, they'll have less cash to invest
4. CMBS prices **provide us with information** about a much larger universe of commercial real estate loans that aren't sliced into securities.
    a. At the end of last year, only ~9% of the $5.4T in outstanding commercial real estate loans were bundled into private-label CMBS.
5. **Banks hold 46% of all commercial real estate debt**. But, they don't necessarily have to cut the value of these loans until borrowers have trouble making payments.
6. Most commercial property owners remain current on their loans. The **delinquency rate** on commercial mortgage securities (which includes offices, hotels, retail properties and industrial complexes) was **3.09%** last month – less than half the rate from two years earlier.
    a. But delinquency rates are rising and investors are scared about offices.
7. **Floating-rate** borrowers are paying more. **Fixed-rate** borrowers may have a hard time refinancing and will pay higher rates. (WSJ) (Bloomberg)

B. Apartment Buildings

1. Investors purchased $14B of apartment buildings in Q1, **74% lower YoY**
    a. Largest annual sales decline since the 77% drop in 2009 Q1
2. **Issues**:
    a. The cost to finance building purchases has jumped with interest rates
    b. Rents are running flat
        i. Nationally, rents were up 2.6% YoY
    c. Lending is pulling back
3. **Prices** of multifamily buildings **dropped 8.7%** in February YoY (MSCI)
    a. A separate measure by Green Street, which tracks publicly traded landlords found prices down **20%** from their late 2021 highs
4. Recent buyers that used variable rate loans may become forced sellers (WSJ)

VI. Four Financial Questions (John Authers)

A. Why Have Stock Markets Recovered So Quickly (after bank failures)?

1. We've seen that a banking crisis has been thwarted, yet banks are riskier and less profitable.
   a. We've seen depositors made whole – making our **economy safer**
   b. But we've seen shareholders wiped out
      i. And we're likely to see more regulation and higher deposit insurance premiums
      ii. This explains why the banks have not had any days of big bounces (which is unusual)
2. Since **QT** takes deposits out of the system, maybe the Fed **will stop** (and the market likes this)
   a. QE increased bank deposits
3. The Fed keeps raising **rates** until something has broken – and now it has

B. Why are Markets Predicting Several Rate Cuts this Year?

1. The Fed believes that they can use their **balance sheet for macroprudential** issues and use **rates to curb inflation**.
   a. Several central banks raised rates during the recent banking crisis.
2. The market believes in rate cuts and points to data from this week:
   a. The **ISM services survey** shows that the number complaining of rising prices continues to drop precipitously
      i. In 2021, this was an accurate prediction that inflation was coming
   b. **Jobless claims** rose to its highest level since 2021
3. But remember: rate cuts are generally followed by rising spreads

C. Why are Corporate Earnings Still So High?

1. Background:
   a. Corporate profits are **greater share of GDP** than any time since 1929.
   b. Profit margins **tend to be highly cyclical and mean-reverting**, but have continued to rise in this cycle.
      i. The logical explanation is **greedflation** – price rises being driven by companies' determination to maintain their margins (and fully pass on higher costs)
      ii. The ability to **outsource** has stopped wages from being cyclical
2. Explanation – margins will stay high because of:
   a. **Lower rates** – will reduce borrowing costs
   b. **Falling inflation** reduces pressure on input costs
   c. **Rising unemployment** will keep labor costs lower
   d. **Concentration** in industries keeps prices high

D. Why is Gold Close to an All-Time High (when Inflation is falling)?

1. **Lower yields**
   a. Inverted yield curve – which forecasts lower yields and weaker dollar
2. **Weaker dollar**
   a. Including recent bank bailout ([Bloomberg])