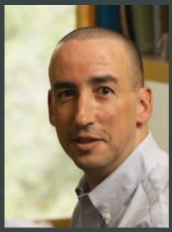

MARKET UPDATE

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April 17, 2023 – Market Update

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I. Stocks

A. Current Situation

1. The week: DJIA +1.2%; **S&P 500 +.8%**; Nasdaq +.3%
    a. **CPI** – core inflation still high
    b. **FOMC minutes** – higher chance of recession
    c. **Earnings** from three of the biggest banks – large banks rallied on Friday
2. There are a lot of things that you would **think would scare investors**: bank stress, stubborn inflation, rising recession odds, a central bank that keeps raising rates, high valuations, etc.
    a. Yet, no real effect
        i. Market has been in a trading range of 3,800 to 4,200 YTD
    b. **VIX** dropped below 18
3. Maybe a lot of dismal news is **priced in**
    a. We expect Q1 earnings to drop 7% YoY
4. **Potential problems**:
    a. Investors are still susceptible to statements of pessimism about future **credit and lending** standards
        i. JPM's Jamie Dimon said that there would be a little tightening, but it's not a credit crunch
    b. The **debt ceiling**
        i. Fear of default
        ii. Once Congress either raises or suspends the limit, the Treasury will issue more T-bills to quickly boost its cash buffer and this drains liquidity
    c. The S&P 500 trading at **~18X earnings**, but its top ten stocks are ~28X earnings
    d. Continued **rate hikes** and added commentary about inflation-fighting may push stocks down (Bloomberg)

B. Pre-earnings Rally

1. This is the **biggest pre-earnings rally since 2009**, as the S&P 500 jumped almost 6% since the start of March. This is despite the fact that Q1 earnings are forecast to drop almost 8%.
2. **Why** has the market done well:
    a. Defensive positioning
    b. Relief that banking stress appears contained
    c. Faith that companies can deliver on earnings
    d. Belief that profits will be better later in the year
3. **What the bears say:**
    a. This will be the largest profit decline since the pandemic
    b. As margins shrink, companies have had more trouble topping estimates
        i. In Q4, earnings only beat estimates by .3% -- the smallest positive surprise since early 2020
    c. During earnings season, the S&P 500 has moved in the opposite direction of the prior month in each of the previous four quarters (Bloomberg)

II. Rates, Credit and the Dollar

A. Rates and Bonds

1. Rates: 3-month 5.14% (+19 bps); 2-yr 4.08% (+11 bps); 10-yr **3.52%** (+13 bps)
2. The market is getting **whipsawed because of two different scenarios**:
    a. A drop-off in banks' lending could exacerbate the Fed's previous rate increases, quickly slowing the economy
    b. Core inflation was still at .4% MoM (WSJ)
3. A **survey** by the International Association of Credit Portfolio Managers found that:
    a. 84% expect a US **recession** sometime this year
    b. 81% of fund managers see **defaults** picking up in the next 12 months
        i. Reduced bank liquidity and credit risk concerns are top issues
    c. 58% see **IG credit spreads** widening over the next three months
    d. 80% forecast **high-yield spreads** rising (Bloomberg)
4. If you look at **inverted yield curves** since 1953, you're better off investing:
    a. In one-month T-bills for the next year
    b. In the five-year Treasury note for the next three or five years (Bloomberg)

B. Markets Don't Heed the Fed's Warning

1. The bond market continues to price in **rate cuts** for the second half of the year, **despite**:
    a. Fed says otherwise
    b. FOMC minutes showed that they raised rates even though fears of recession
    c. Core CPI +5.6% YoY. Last three months annualized +5.1%.
    d. Univ. of Michigan inflation expectations rose from 3.6% to 4.6%. Similarly, NY Fed's consumer survey saw expectations rise from 4.2% to 4.7%.
2. Companies may have less ability to pass through price increases. This could mean slimmer margins. (Barron's)

C. IMF Warning

1. The **IMF warned**:
    a. **Tighter bank lending** prompted by the recent failure of two US banks will slow US economic growth this year. They suggested that US banks' lending capacity will decline by 1% this year due to the fall in the value of many bank stocks.
        i. The reduction in lending should reduce 2023 GDP by .44%.
    b. A growing source of risk is in the **commercial real estate** sector where companies are facing lower property valuations and struggling to find tenants.
        i. Higher rates and lower demand for CRE raises the risk of a broader correction to CRE valuation.
    c. The **Fed's QT** plus the political impasse over raising the **debt limit** could pose challenges to the Treasury market.
2. The economy could see **growth** supported by resilient consumer demand and a strong jobs market. (WSJ)

D. Lower Neutral Rate

1. The IMF projects that once the current bout of inflation subsides, **interest rates globally will return to close to zero**
    a. The **neutral rate will be pushed down** by:
        i. Slowing productivity growth
        ii. Aging demographics
        iii. De-globalization
        iv. The shift to greener economies (and the debt required for this) (Bloom.)
2. On the other hand, **Larry Summers** believes the **neutral rate will be 1.5% - 2.0%** because of stepped-up **government borrowing**:
    a. Increased military outlays
    b. Transition to a greener economy
3. The IMF also said that **spending cuts** are more likely to lower debt ratios than increasing gov't revenue (Bloomberg)

E. The Dollar

1. Investors are convinced that the Fed is close to the **peak of its tightening cycle**. As a result, they believe that the **dollar will weaken**.
    a. The US growth and interest rate premium will dissipate
2. The dollar has **tumbled almost 10%** since it reached a record high in September.
    a. The euro and British pound have surged as traders expect central banks there to lift cash rates (while the Fed is likely to remain on hold after the possibility of one more rate increase). (Bloomberg)
3. There's a lot of talk about **threats to the dollar**
    a. To compete with the dollar, a rival would require free flow of capital, a liquid bond market, implicit acceptance of less control of exchange rates and interest rates, a strong rule of law, and the willingness of the central bank to provide swap lines when needed.
    b. The most proximate threat to the dollar and its global status would be a US default. (Barron's)

III. Economy

A. CPI

1. Headline CPI +.1% MoM, +5% YoY; core CPI **+.4% MoM**, +5.6% YoY
    a. This was the first time in over two years that the core was higher than the headline number
    b. Headline was down from Feb. (6%); smallest gain since May 2021
2. Key measures of housing costs posted the smallest monthly increase in about a year and grocery prices dropped
    a. **Shelter costs** rose at the slowest pace since November, but they remained by far the largest contributor to the monthly number
        i. Shelter costs make up about 1/3 of CPI and climbed .6%
    b. **Grocery prices** fell for the first time since Sep. 2020
        i. Biggest monthly drop in egg prices since 1987
3. Goods vs. services:
    a. Core goods rose .2% -- the most since August
    b. Excluding housing and energy, service prices rose .4% MoM and 5.8% YoY (Bloomberg) (WSJ)

B. PPI

1. The PPI **fell .5% MoM**, the largest monthly decrease since April 2020. Up 2.7% YoY.
    a. If these easing costs are passed on to consumers, inflation will drop.
2. The **core PPI decreased .1%** and was up 3.4% YoY.
3. A decline in goods prices, particularly gasoline, diesel and residential natural gas lowered the headline number. A drop in warehousing costs as well as in machinery and vehicle wholesaling drove a more modest decline of the services supply index. (WSJ) (Bloom.)

C. Fed Speak

1. Chicago Fed Pres. Austan **Goolsbee** said that the central bank should **proceed cautiously** with any additional rate increases as it assesses after-effects of the bank failures.
    a. "At moments like this of financial stress, the right monetary approach calls for **prudence and patience**."
    b. Goolsbee said bank-lending surveys showed **lenders were already tightening** loan standards before the failures of the two banks last month. He said that he would place considerable attention on surveys and other anecdotal data about borrowing conditions.
2. Philadelphia Fed Pres. **Harker** also signaled that the Fed should be **cautious**. He cited the fact that it can take 18 months for rate increases to influence economic activity.
3. NY Fed Pres. **Williams** said that there **weren't signs** yet that business or consumer spending were strongly influenced by **changing lending standards**. (WSJ)

D. The FOMC Minutes

1. FOMC minutes showed that **officials dialed back their expectations of how high** they'll need to raise rates. They were balancing the risk of a **credit crunch vs.** data showing that **inflation** remained too high.
    a. The 25-bp rate increase was a **compromise** between some participants that wanted a **50-bp** move and others that wanted **zero**.
2. There is **risk to inflation in both directions**, with resilient labor demand pushing prices higher but a credit crunch having potential to slow inflation.
3. Fed advisers were forecasting a "**mild recession**" later this year.
    a. Policymakers "commented that recent developments in the banking sector were likely to result in **tighter credit conditions** for households and businesses and to weigh on economic activity, hiring and inflation."
        i. Officials judged the **worst bank turmoil was likely limited** to a "small number of banks with poor risk-management practices and that the banking system remained sound and resilient."
4. Most economists now expect a **25-bp increase** in May, followed by a long pause. (Bloomberg) (Bloomberg)

E. Oil

1. OPEC+ **hit the short-sellers** with the production cut.
    a. Money managers slashed short-positions in Brent crude by 29,118 contracts in the week to April 4, the sharpest drop since 2020.
    b. In percentage terms, the 46% reduction is the biggest in data going back to 2011.
2. **OPEC expects oil demand to climb** this year. This is at odds with the move by some of its biggest members to cut output.
    a. OPEC expects demand to rise to 103.27MM barrels per day in Q4 (from 101.55MM barrels per day in Q1). Supplies from non-OPEC oil producers are expected to remain largely unchanged at ~67.6MM barrels per day. (Bloomberg)
3. The recently announced cut was unusual in that it was **announced by the states involved**, rather than OPEC itself. (WSJ)

IV. Commercial Banking and Real Estate

A. A $1.5 Trillion Wall of Debt is Looming for US Commercial Properties

1. Almost **$1.5T of US commercial real estate debt** comes due before the end of **2025**
2. MS estimates **office and retail property** could fall as much as **40%** from peak to trough
   a. Plus small and regional banks may not have the capacity to make loans
3. If you exclude apartments, as much as **70%** of the other commercial real estate loans that mature over the next five years are **held by banks**
   a. Banks also own more than half of the **agency CMBS** – increasing their exposure
      i. Sales of **non-agency CMBS** fell ~80% in Q1 YoY
4. There is **some good news**:
   a. Conservative lending after Global Financial Crisis (GFC)
   b. Sentiment toward multifamily housing remains more positive as rents continue to rise (Bloomberg)

B. What Investors Want to See from Regional Banks

1. The **acute phase** of the banking crisis may have passed, but the **chronic phase** may just be starting.
2. **Investors want to see** (in the earnings reports):
   a. Which banks had inflows and which had outflows
   b. What banks had to do to buy stability (and what it will cost them going forward)
   c. The quality of commercial real estate loans
3. Maybe some of these regional banks won't have **access to cheap, stable deposits** in the future.
   a. The bank crisis was a reminder to some people that they're earning nothing on deposits.
   b. Borrowing from the FHLB is limited and more expensive than deposits.
4. On the **positive side**, losses on bond portfolios may have decreased due to lower rates
   a. But banks are still locked into lower yields for some time. (WSJ)

C. Shadow Lenders Fill in for Regional Banks

1. Regional banks make up **~70% of the commercial real estate loans** made by US banks.
   a. There is nearly $1.5T of US commercial real estate debt coming due over the next three years.
      i. This includes nearly a quarter of mortgages on office buildings in 2023.
2. **Regional banks are pulling back** from commercial real estate due to duration risk, economic uncertainty, and reduced syndication liquidity. The bond market (the other major source of liquidity), has dried up too. Issuance of CMBS is down 82% YoY.
   a. This leaves room for **shadow lenders**. They're mostly private credit funds using their own capital to make loans, usually charging more than banks.
      i. A broadly syndicated loan currently prices around 4.5% over SOFR, while a unitranche from a direct lender could price at over 6%.
3. Many private credit lenders are also private equity shops with experience working out distressed debts. (Bloomberg)

D. Small Businesses Worry about Credit

1. More US small businesses reported having **greater difficulty getting a loan** in March after multiple bank failures led to a tightening of credit conditions.
    a. A net 9% of owners who borrow frequently said financing was harder to get compared to three months ago.
        i. This is the most since Dec. 2012
2. The same share expects **tougher credit conditions** in the next three months.
    a. 26% of owners who borrow said they paid a higher interest rate in March vs. three months ago. Biggest share since 2006.
    b. Percentage saying next three months would be a good time to expand fell to lowest level since 2009
    c. One in five owners expect to invest in equipment or structures in the next three to six months, the smallest share in two years.
    d. A net 15% said they expect weaker sales in next three months
3. Credit still ranks below **inflation** and **quality of labor** as single biggest problem. (Bloom.)

E. Auditors and SVB

1. **KPMG** gave SVB a clean bill of health just 14 days before it collapsed
    a. They flagged potential losses on **loans** as a critical matter
    b. They didn't say anything about **unrealized bond losses or flighty deposits**
2. **Great line** from Univ. of Mich. Prof. Erik Gordon: "The auditors failed to mention the fire in the basement or the box of dynamite on the first floor, but they did point out the peeling paint on the flower box."
3. Accounting rules say banks can classify bonds as **held-to-maturity** only if they have **both the intent and ability to hold on to them**, rather than have to sell them to meet demands for withdrawals
    a. SVB had $91B of HTM bonds on its balance sheet and a footnote said that they were worth $76B. That would wipe out most of their $16B of equity
        i. In addition, their cash was only ~8% of total deposits
            1. This means they'd have to sell some HTM bonds if depositors left
    b. Auditors for nine other US banks most exposed to bond losses also didn't flag this (WSJ)

V. Other

A. Macron Embarrasses the Free World

1. French Pres. Emmanuel Macron visited China and **said that Europe shouldn't be pulled into tension between Washington and Beijing over Taiwan**. He said that Europe should aim to be a third **superpower.**
    a. Macron dined with authoritarian Xi Jinping as China was preparing to conduct military drills around Taiwan.
2. He also said that Russia's invasion of Ukraine had exposed **Europe's reliance on foreign suppliers** of essentials like medicine and energy. Apparently, he forgot that the US replaced a significant part of that lost energy.
3. Some US lawmakers called Macron's statements **embarrassing and disgraceful**. A group of European parliamentarians said this was "the **worst moment to send a signal of indifference** over Taiwan."
    a. **Poland's leader** chastised Macron and said "instead of building strategic autonomy from the United States, I propose a strategic partnership with the United States."
    b. Many European leaders privately said that Macron's comments had **damaged Europe's standing.**
    c. No one in Europe sees "business as usual" with China after Covid and the war in Ukraine. There is no belief in engagement through trade. There are anxieties over technology transfers, anti-competitive practices and bullying of states like Lithuania over Taiwan.
4. An op-ed piece in the **state-run China Daily** said that if war breaks out over Taiwan, Washington's allies will not only refuse to join the US, they "will instead do everything in their power to persuade or compel the US away from war." (WSJ) (Bloomberg) (WSJ)

B. Americans Paid More in Taxes

1. Americans paid out an estimated **14.7% of personal income** in 2022 in personal income taxes (federal, state and local). This is an all-time high. It also hit a record **10.5% of GDP**.
2. The increase was **due to**:
    a. The pandemic asset-price boom
    b. Inflation – pushing people into a higher bracket (bracket creep)
        i. The indexing of brackets is delayed
        ii. 15 states and DC don't adjust their brackets for inflation
        iii. Several other states don't adjust standard deductions or exemptions
    c. A progressive tax code
    d. In a few states, the aftereffects of tax legislation enacted by Congress in 2017
        i. Cap on the amount of property tax that can be deducted (Bloomberg)

C. Earnings in Marriage are Becoming More Equal

1. Earnings in U.S. **opposite-sex marriages**:
    a. ~54% of the time, the husbands earned more.
        i. 23% of the time, the husband was the sole breadwinner. In 1972, that was 49%.
    b. ~30% are egalitarian in earnings (each spouse earns 40% - 60% of joint earnings)
    c. ~16% of women earn more than husband. Fifty years ago, this was 5%.
2. **Median income** for married couples: **$121K**. Sole-breadwinner marriages, median is $75K.
3. **Even when women earn as much** as their husbands, they still put in around **two more hours** per week on **caregiving** than their husbands plus another **2.5 hours more on housework**. Men spend nearly 3.5 more hours on leisure. (WSJ) (Bloomberg)