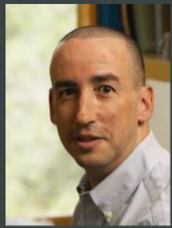

# MARKET UPDATE

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## April 24, 2023 – Market Update

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# I. Markets

## Issue #1: The stock market is getting boring!

1. Last week: DJIA -.2%; **S&P 500 -.1% (+7.7% YTD)**; Nasdaq -.4%
2. It seems like **Fed tightening is working** to slow inflation by reducing economic demand
    a. Inflation and growth are both slowing
    b. Since rate hikes operate with a lag, there's probably more slowing to occur
        i. Including the possibility of a recession
3. **Earnings estimates** for 2023 are ~$218, up from last year's $216
    a. Obviously, a recession would push earnings down
    b. The S&P is trading at 18.3X earnings
4. As of Friday, **earnings have come in almost 5% above analysts' es**timates
    a. The companies that beat sales and earnings expectations have gained 2.3% on average (vs. 1% 5-yr average).
    b. A double-miss resulted in a 1.8% drop (vs. 2.9% 5-yr average)
5. Ned Davis Research says that **76%** of companies in the MSCI USA index have seen **upwardly revised earnings estimates for the next year**
    a. Highest level in 10 months
    b. Up from a recent low of just under 60% (Barron's)

## Issue #2: Maybe stocks are too sleepy.

1. Three weeks into **April**, the S&P 500 has **risen just .6%.** If this trend holds, it would be the smallest monthly change since May 2022 and only the fourth time in the past five years that the index moved less than 1% in either direction in a month.
2. The **Nasdaq 100** has had a **range of just 2.9% this month**. This would be just the sixth time since 1986 that the index has been in a range of less than 3%.
3. This may all **reflect uncertainty** (which way to go):
    a. When the Fed will stop raising rates and start cutting
    b. The debt ceiling and when it will be raised
    c. Whether we will have a recession
    d. Uncertainty about earnings season
4. **Realized volatility** over the past 30 days has been just **9.4%**
    a. **VIX** hit its lowest reading since 2021: **16.46**
    b. Few market participants are well-positioned if volatility resumes
5. The **VVIX index** (the volatility of the VIX) has **stopped falling** – so maybe the VIX will turn up. VIX has fallen five straight weeks, dropping 34% during that time.
6. The **S&P 500 is up ~2% for the past two years**. (Barron's)

## Issue #3: Transport stocks are sending a negative signal.

1. **Economically sensitive stocks**, like transportation and small-caps, are trailing the broader market, reflecting **growing concerns** about a **possible recession**.
2. The **DJ Transportation Average**, which tracks 20 large US companies has **underperformed the DJIA by ~6.9% since early February**. The S&P 600 is also ~7% behind the large-cap S&P 500.
3. These stocks have often **led the market down** and also **led the recovery**. (WSJ)

## Issue #4: Looking at the BAC survey, professional investors are nervous.

1. Investor **allocation to equities** vs. bonds has dropped to its **lowest level** since the GFC
    a. Investors say that **fear of a credit crunch** have driven up **bond allocation** to a 10% **overweight** – the highest since March 2009
        i. **63%** expect a **weaker economy** (most pessimistic since Dec. 2022)
    b. The bearish sentiment **may be a contrarian indicator** for risk assets
2. A **credit crunch and** a **global recession** are seen as the **biggest tail risks**, followed by high inflation that keeps central banks hawkish
3. **28%** expect the **Fed to begin easing** in Q4
    a. 35% expect it in Q1
4. Other data:
    a. 84% see a pullback in **global CPI**
        i. 58% see lower short-term rates
    b. Allocation to **cash** remained above 5% for 17 consecutive months
    c. 80% expect the **debt ceiling** to be raised by September
    d. 49% expect **IG to outperform HY** over next 12 months
    e. **CRE** is seen as most likely source of a credit event
        i. Followed by US shadow banking, US corporate debt and a Treasury debt downgrade (Bloomberg)
5. So **why are stocks rallying**? (Bloomberg)
    a. Maybe the belief that **banks' problems will stop the Fed from raising rates aggressively**
        i. But that would also **imply lower earnings**
            1. You can't have both lower rates from a recession and improved earnings
    b. Stocks were **positioned for something even worse** at the beginning of the year
        i. That turns every little piece of good news into a reason to cheer
    c. From a **technical perspective**, maybe the move is based on mispositioning, money flows and sentiment
        i. But the mispositioning may be becoming worse
        ii. Investors' allocations to banks and insurance fell 12% and 13% to their lowest levels since May 2020
    d. The **mini-crisis** could be perceived as confirmation that interest rate hikes are beginning to bite
        i. Tighter credit conditions are one of the key channels through which monetary policy works. Rising rates and slowing growth dampen confidence in banking and credit, leading to tighter financial conditions, which ultimately slow growth further.

## Issue #5: Investors are chasing stock while strategists warn of doom.

1. **ETFs took in $12.6B in April**, the largest influx since January and more than twice the rate of February and March. Money is coming out of ultra-short duration ETFs (cash). Investors seem to be relieved that there hasn't been a crisis.
2. **Strategists are complaining** about:
    a. **Inflation** that is coming down, but still high
    b. Market optimism about **Fed policy** that conflicts with Fed commentary
    c. A **labor market** that is loosening, but still too tight
    d. **Beige Book report** was negative – continued fear of a credit crunch
    e. The **S&P 500** hitting a **level** that resulted in **selling** in February, Nov. and Sep.
    f. **Earnings estimates** for the rest of the year that are too high
    g. The **market isn't cheap** at 18X earnings (Bloomberg)

## Issue #6: Small investors lose $358K per day in 0DTE-options.

1. An academic study found that **small traders lost $358K per day** since May 2022, when zero-days-to-expiration contracts started trading.
2. The researchers estimate that retail traders accounted for **6% of ODTE trading volume** in 2022. The 0DTE contracts accounted for more than 75% of S&P 500 option trading.
3. Approximately 2/7 of the loss was from being on the **wrong side** of the trade (positioning). The other 5/7 was the cost of doing business with **market makers**.

## Issue #7: Rates are steady, but we're seeing churn between IG and HY issuers.

1. 3-month: 5.14% (unchanged); 2-yr: 4.17% (+9 bps); 10-yr: 3.57% (+5 bps)
2. Ratings firms are on track to cut the most US corporate bonds to junk since the early part of the pandemic (boosting funding costs for some companies as there are a smaller number of potential investors for HY bonds)
    a. In Q1: $11.4B were downgraded from IG to HY (60% of 2022's total)
        i. Reflects pressure that Fed tightening is creating
        ii. Nissan, First Republic Bank and Axos Financial were in this group
        iii. SVB skipped the move and jumped straight to default
3. At the same time, a growing number of bonds are likely to be upgraded from HY to IG.
    a. The amount of "rising stars" should offset the amount of "fallen angels" (Bl.)

## Issue #8: Stocks and bonds are sending conflicting signals.

1. Everything seems **calm in the stock market**. The VIX closed below 17. Stocks seem to be pricing in a **soft landing**.
    a. The **MOVE index**, on the other hand is **quite high**, consistent with economic volatility (but it has been decreasing).
2. The **rates market** has bet that inflation will soon collapse, the Fed will raise rates one more time and then cut rates twice by December and five times by May.
    a. If this happens, doesn't that mean we're in **recession** and stocks have to drop?
    b. And the Fed doesn't typically lower rates when the VIX has been this low. (Barron's)

## Issue #9: Corporate bond yields need to increase if the Fed funds rate stays high.

1. TD Securities suggests that **banks' collective higher cost of funding will curb appetite for higher-quality credit and eventually** force a spike in risk premiums.
    a. Even though banks own just 7% of outstanding corporate bonds, they could still drive a correction in credit risk premiums.
2. At issue are **shrinking yields** on investment-grade bonds **relative to the effective Fed funds rate** (a proxy for funding costs). This "**carry spread**" has now reached levels seen only twice before in the past 27 years – the last time being in 2007.
    a. These carry spreads are just 23 bps – the third tightest level in data going back to 1996.
        i. In other words, the higher cost of funding these positions could curtail bank purchases and eventually force a move higher in spreads.
3. A **recession** along with SVB and CS could also cause the IG bond market to correct. (Bl.)

## Issue #10: The de-dollarization argument is wrong.

1. Everyone is talking about **de-dollarization**
    a. Russian and Chinese government-sponsored newspapers (propaganda) promote the idea
2. It is **easy to argue** that:
    a. Global confidence in the US is eroding
    b. We have had cheap money for longer and that leads to bad behavior. Most of the stupidity in recent years was a US phenomenon – Theranos, FTX, GameStop, Bed Bath & Beyond
3. The **counter argument**:
    a. I could make an argument that AMZN will collapse and WMT will thrive. But, we have orders pre-set to Amazon Prime, we watch AMZN video, etc. Are we all going to switch? The US dollar is Amazon and the Chinese yuan is Walmart.
    b. As long as the US is the **largest open trading economy and everyone wants access** to it, the position of the dollar as the global reserve currency is secure
    c. The BIS triennial survey of **foreign exchange markets** show that the dollar has barely lost any share since 1989
        i. The British pound is still involved in more transactions than the Chinese yuan
    d. **Three things make the dollar special**:
        i. The **size of the US economy** (only the euro and yuan are close)
        ii. The **freely convertible nature** of the dollar. While China's gov't continues to exercise strong control over the yuan's exchange rate, it creates more political risk.
        iii. The **political and economic stability** of the US compared with Europe and China. (Of course, our polarization is a concern.) (Bloomberg)

## II. The Economy

### Issue #1: There are signs that the economy is slowing.

1. **Crude oil** has wiped out all of its gains after the surprise output cut. In addition to the cut, an EIA report showed that stockpiles fell 4.58MM barrels last week.
    a. This was overshadowed by the increasing risk of a US recession.
    b. From a technical perspective, the drop is being accelerated by a **gap fill** (where prices are falling back into the gap and there is little to stop the decline)
    c. The drop in oil prices is good news for central banks (inflation)
2. We have some **evidence** building that the economy is slowing:
    a. **Lower oil prices** despite production cuts
    b. **Jobless claims** increased to 245K
    c. The **Leading Economic Indicators** (Conference Board) was very weak, declining at a rate that implies a recession is virtual certainty
    d. The **two-year yield** declined to 4.14% (Bloomberg)
3. The **Beige Book** also provided some negative news:
    a. Consumers and businesses **borrowed less** and overall **economic growth flattened** in the weeks since the bank crisis.
    b. Banks in several parts of the country **tightened lending standards** and raised concerns about liquidity and uncertain expectations for future growth
    c. **Core deposits** continue to **decline** due to competition with higher-yielding alternatives. (WSJ)

### Issue #2: Home prices are falling.

1. US **existing-home sales decreased 2.4%** in March MoM and **22% YoY**
    a. This was the 13th time in the 14 previous months that sales have slowed
2. The national **median** existing home price declined .9% YoY in March to **$375,700**
    a. This is the first time in 11 years that this has fallen on an annual basis for two consecutive months
    b. It's the biggest YoY price drop since Jan. 2012
    c. Median price is **down 9.2%** from a record $413,800 in June
3. The average rate for a 30-year fixed **mortgage** was **6.39%** this week
    a. First increase after five straight weeks of declines
    b. Up from 5.11% a year ago
4. There were **980K homes for sale** or under contract at the end of March
    a. This is a **2.6-month supply**
    b. It is up 1% MoM and 5.4% YoY
        i. Houses are sitting on the market longer
        ii. The number of **new listings** actually **dropped 20% YoY** (WSJ)

## Issue #3: Millennials have low homeownership.

1. The **millennial** (1981 – 1996) homeownership rate hit **51.5%** in 2022 – the first time it went above 50%.
    a. By age 30, 42% of millennials owned their homes compared to 48% of Gen X and more than half of baby boomers
2. Nearly **one in four millennials plan to rent forever**, up from one in seven (three years ago)
    a. Can't afford b/c of down payment or monthly mortgage cost
3. About **67% of those who want a home** have **no money saved** for a down payment and 18% have less than $10K.
    a. About 42% say one of their biggest obstacles to homeownership is **bad credit**, up from 39% in 2018.
4. Nearly **half** of millennials are living **paycheck-to-paycheck**.
5. Most millennials who own homes live in **affordable cities**: 63% of millennials in Grand Rapids own homes, vs. just 27% in LA. (Bloomberg)

## Issue #4: More refineries coming online could reduce the price of oil.

1. Oil has to be refined into gasoline, diesel, jet fuel and petrochemicals. For several years, refineries were the bottleneck.
    a. In 2021, net refining capacity fell for the first time in 30 years.
2. The world is building **new refineries and expanding older ones** at a speed unseen in nearly two generations.
    a. New plants are coming online in Kuwait, Nigeria, Mexico and China.
3. RBC believes that net global refinery capacity will **increase by 1.5MM barrels a day this year and by another 2.4MM next year**. The combined two-year increase in net capacity is the largest in 45 years.
    a. This could keep energy prices lower.
4. As this capacity comes online, **refining margins drop**. The American oil industry measures refining margins using the "**3-2-1 crack spread**": for every three barrels of WTIC, we make two barrels of gasoline and one barrel of distillate fuel like diesel and jet fuel.
    a. US oil refining margins have fallen ~50% from their all-time high set in mid-2022, but still remain well above historical levels.
        i. At one point last year, as the global economy struggled to process enough crude into fuels, the spread surged to **$65** per barrel. The average from 2000 – 2020 had been less than $15. Now, they're **~$32**.
5. Another factor pushing margins down is that Russian refineries are still operating at high rates despite Western sanctions. (Bloomberg)

# III. The Banking Crisis and Commercial Real Estate

## Issue #1: Former NY Fed Pres. Dudley says the Fed needs to accept some blame.

1. As the Fed reviews recent bank failures, they will likely address the need for **tougher oversight of mid-sized institutions**, more **proactive supervision**, more diverse **stress tests** and greater scrutiny of **how long-term investments are funded**.
2. They should also consider **how accommodative policy and subsequent tightening contributed** to the crisis.
    a. Deciding to keep **rates near zero despite full employment** led to the Fed **tightening quicker** than under a more preemptive regime.
    b. **QE** flooded the system with **deposits**, which banks often invested in the same longer-term securities at extremely low yields.
        i. The Fed's actions led to excess deposits and banks were able to keep rates low. Banks ended up with high net interest income.
3. The Fed has to consider the risks that it creates. They probably **should have started tightening sooner**. This would have resulted in a smaller central bank balance sheet, fewer unwanted deposits, higher interest rates for households and less distress at banks. (Bloomberg)

## Issue #2: Another commercial real estate default shows us some important numbers.

1. **Brookfield Corp.** has defaulted on a **$161.4MM mortgage** for a dozen office buildings, mostly around Washington, DC. Among the dozen buildings in the portfolio with $161MM of debt, **occupancy rates averaged 52% in 2022, down from 79% in 2018**, when the debt was underwritten.
    a. **Monthly payments** on the mortgage's floating-rate debt jumped to about **$880,000** in April, from just over **$300K** a year earlier.
2. Landlords are defaulting as borrowing costs surge and the prospect of filling up office towers wanes given the rise in remote and hybrid work. According to Green Street, **prices on high-quality office properties have fallen 25% in the past year**. They estimate a 36% drop in DC.
3. Brookfield, a major office owner previously defaulted on debt tied to two Los Angeles buildings. Columbia Property Trust (owned by funds managed by PIMCO) and a venture started by WeWork Inc. and Rhone Group have also defaulted. (Bloomberg)

## Issue #3: Insurers may be pulling back from financing commercial real estate.

1. A Feb. survey by Goldman Sachs Asset Management found that **15% of insurers with CRE lending businesses said that they plan to shrink their activity this year**, more than 3X as many as last year.
2. Life insurers **hold ~15% of the outstanding $4.5T in US debt backed by CRE**. They are less subject to runs b/c they are funded by premiums, not deposits.
    a. Low yields on corporate bonds after the GFC pushed insurers into CRE.
3. A record $270B in commercial mortgages held by banks is set to expire this year. Approximately $80B of that is backed by office buildings. (WSJ)

## Issue #4: What is the FHLB (the Federal Home Loan Bank Board)?

1. The **FHLB system** was established during the Great Depression to help **promote mortgage lending**. It's **now a source of liquidity** for banks of all stripes.
    a. The home-loan banks are owned by their member institutions, which receive dividends. Banks leave collateral, such as mortgages in exchange for credit lines.
        i. The banks are jointly liable for each other's debt offerings. If one were to fail, the others would be responsible for paying bondholders.
        ii. The banks have never booked a credit loss in their 90-year history.
2. They issued a record **$495B of debt in March** to fund loans (called "**advances**"). Banks needed to borrow money as customers pulled their deposits as the Fed raised rates.
    a. FHLB advances to banks reached a post-financial crisis record of ~$820B at the end of 2022. SVB, Signature and Silvergate were all big borrowers.
3. **Money is more expensive** for banks than consumer deposits. Currently, banks are paying between 4% and 5%. The typical savings account pays .37%.
    a. SCHW (as an example) said the cost of funding would hurt profits (WSJ)

# IV. The United States

## Issue #1: Get some perspective on how well the US has done.

1. Everyone has a **doom story**:
    a. The **right** says that big government has stifled the frontier spirit and debt will condemn future generations to poverty
    b. The **left** worries that inequality and corporate power have hollowed out the economy
    c. **Everyone** bemoans the death of manufacturing and the crushing of the middle class
2. **Yet American dominance is striking and it's increasing**
    a. US **GDP** of $25.5T last year was **~25% of world GDP**; almost the same share as 1990
        i. China is now 18%
    b. In 1990, US was 40% of **G7 nominal GDP.** Today, the US is **58%**.
        i. In purchasing-power-parity terms, it went from **43% to 51%**
    c. In 1990, **income per person** in US was 24% higher than western Europe **in PPP terms**; today, it's 30%
        i. It was 17% higher than Japan in 1990. Now, it's 54% higher.
    d. America's **social spending** was 14% of GDP in 1990, but rose to 18% by 2019
    e. $100 invested in **S&P 500** in 1990 grew to $2,300 today.
        i. $100 in rich-world stocks excluding US would have grown to $510
3. America is getting richer b/c we are **getting more productive** more quickly
    a. America **spends 37% more per pupil on education** than the average OECD member
        i. When it comes to post-secondary, we spend twice the average
        ii. 34% of Americans have completed tertiary education
            1. Only Singapore has a higher rate
        iii. US is home to 11 of the world's 15 top-ranked universities
    b. **R&D spending** has risen to 3.5% of GDP
        i. US share of patents has increased from 19% in 2004 (first year of data) to 22% in 2021, more than any other country
    c. A **large single market** helps
        i. Rewards to scale seen in technology
    d. American **mobility** is high – they move to the most productive jobs
    e. 5.4MM **new businesses** started in 2021; a 53% increase from 2019
    **f. Management**
        i. We're more comfortable with firing
        ii. Markets are ready to reward companies for evidence that they are well-run
4. The US currently has some advantages and does some things really well
    a. Wide variety of **geological riches**
    b. US has the **deepest and most liquid financial markets** – providing financing and sorting winners and losers
        i. Stock market capitalization is 170% of GDP
            1. Most other countries are below 100%
        ii. Funding for startups is bountiful
            1. About half of world's venture capital goes to American firms

5. The US isn't without problems:
    a. **Unemployment** soars in bad times
    b. Haves vs. have-nots (**high inequality**)
    c. Americans born today can expect to **live to 77**; about five years shorter than other developed countries
        i. Poor have less access to medical care and more violence
    d. **Fertility rates** have dropped to close to European levels
    e. We have **suspicion of immigrants**
    f. **Globalization** has become a **dirty word**
    g. Highly **polarized politics**, including state governments, endanger the unified market
        i. Texas banned financial firms if they deem them unfriendly to oil
        ii. Florida has gone after Disney
        iii. California would force oil firms to cap their profits (Economist)

## Issue #2: A lot of Americans have nothing.

1. According to a new survey, nearly **one in five people aged 59 and older said that they didn't have a retirement account** and 27% of respondents (age 59+) said that they hadn't set anything aside for their later years
2. Among **baby boomers** who are employed and saving for retirement, **17% said they've decreased their contributions** to their retirement accounts as a result of inflation.
3. More than **30%** of respondents (all ages) said their **net worth is $0 or less**.
    a. 41% of Gen Z
    b. 38% of Millennials
    c. **21%** of people age 59+ (Bloomberg)