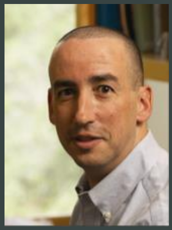

MARKET UPDATE

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August 14, 2023 – Market Update

I. Stocks

A. Last Week

1. For the week: DJIA +.6%; **S&P 500 -.3%**; Nasdaq -1.9%
    a. First time this year that Nasdaq fell two straight weeks
        i. Nasdaq has fallen seven of past nine trading days
        ii. For the week: NVDA -8.6%; TSLA -4.4%; AAPL -2.3%
    b. Nasdaq is down 4.9% in August (but still up 30.4% YTD)
        i. Rising yields and profit taking / high valuations may be hurting tech
2. **Inflation** continues to be a key focus
    a. Soft CPI report reinforced belief that Fed wouldn't raise rates in September
3. **Bulls** pointed to disinflation theme, dovish Fed comments, and higher cap ex (from fiscal stimulus, prior underinvestment, re-shoring, and AI)
4. **Bears** pointed to higher yields and worries about more supply, still-too-high inflation, an aggressive Fed, geopolitical tensions with China, war in Europe, concerns about China's economy, Moody's bank downgrade, catastrophic weather, and challenging seasonality

B. Some Pessimistic Views

1. Ed Yardeni worries that **strategists have capitulated** and decided that there will be no recession and that price targets should be raised. He worries that real personal income may have fallen last month, real business sales slipped last month, and the Conference Board's Leading Economic Index fell for the 15th straight month. (Barron's)
2. The **S&P 500** has gained 17% this year and this has been the result of **multiple expansion**. The S&P 500's P/E increased from 16.8 to 19.2 this year.
    a. One proxy for the **equity risk premium** is the earnings yield minus the 10-yr UST yield. Currently, it is 1.12, down from a 10-year average of 3.52. (Barron's)
3. GS says that **short covering by hedge funds** in June and July combined was the largest over a two-month period. A GS index of the 50 most shorted US stocks surged 32% in June and July (pushing stocks higher). The S&P 500 was up 9.8% over the same period. (WSJ)
4. **Chinese exports** dropped more than expected YoY, **evidencing weak global demand**. Central banks worldwide have raised rates and this has slowed demand. Corporate profits could be at risk. At the same time, we've been seeing inflows into stocks (possibly due to the disinflation story). (Barron's)
5. **Moody's downgraded** the credit ratings of **10 regional banks** and put others under review or gave their ratings a negative outlook. Ratings are very important to the banks as they issue a lot of debt. Moody's cited rising deposit costs and risks to commercial property and construction loans posed by the shift to remote work. (WSJ)
    a. Of course, funding cost and other profitability pressures, as well as concerns about CRE exposure have been known for some time.

C. Earnings

1. Earnings are on pace for a **5.2% YoY decline** in Q2; **revenue is up .6% YoY** (WSJ)
2. 91% of S&P 500 have reported Q2 earnings
    a. ~80% have beaten estimates and 44% of those traded higher

II. Bonds and Interest Rates

1. **UST**: 3-month 5.54% (NC); 2-yr 4.89% (+11 bps); **10-yr 4.16%** (+11 bps)
2. The **10-year UST yield** is close its highest level in more than a decade. This is being **caused by**:
    a. New issuance will be large (supply issues)
    b. Bets that a strong economy could support years of higher rates
        i. Possibility of higher Fed funds rate for longer
    c. Focus on fiscal budget issues
    d. BoJ lifted its hard cap on 10-year yields from .5% to 1% (Japanese investors could shift from USTs back to domestic bonds) (WSJ)
3. The change in the yield curve is referred to as a **bear steepening**
    a. Bond prices are falling ("bear")
    b. Longer-term yields are climbing relative to short ones ("steepening") (WSJ) (Barron's)
4. **Moody's said that they may downgrade major firms** including U.S. Bancorp, Bank of New York Mellon Corp., State Street and Truist. (Bloomberg)

III. General Stories About the Economy

1. According to **Tyler Cowen**: The good news about the economy: 2.4% GDP growth in Q2, headline CPI is near 3%, wage gains are finally exceeding price hikes, stocks have been higher and VIX lower, consumer sentiment is improving
    a. But job openings are falling, banks still have some problems and inflation is too high (Bloomberg)
2. **WTIC is up more than 20% over the past six weeks**, raising the cost of commuting, moving freight, and so much more. This threatens to prop up inflation (forcing the Fed to keep rates higher for longer). Much of the price increase comes from the production cuts enacted by Saudi Arabia and Russia. On the positive side, higher oil prices may also signal economic resilience. (WSJ)
3. The **average homeowner with a mortgage** had **just under $200K in equity**. Homeowners were spending an average 21% of their income on mortgage payments. **Prospective buyers** would need to spend 36.4% of their income in today's market. (Barron's)
4. **Apartment building values fell 14% for the year ended in June after rising 25% the previous year**. The drop is roughly the same as the fall in office values. Borrowing costs have doubled, rent growth is slowing and building expenses are rising. Outstanding multifamily mortgages more than doubled over the past decade to ~$2T. Approximately half of that will come due prior to 2028. For perspective, there is approximately $1T of office debt. Apartment building owners often borrow more than 80% of the building value in the bond markets. But during the pandemic, investors took out more shorter-term floating rate loans. There is a lot of supply of new apartments coming into the market. (WSJ)
5. According to the nonpartisan think-tank Committee for a Responsible Federal Budget, if no reforms are enacted and the **Social Security** trust fund becomes insolvent in 2033 as projected, the program will see a **23% cut in benefits**. This would translate to a reduction in annual benefits of $17,400, or $1,450 a month for a recently retired couple in which both members had worked and earned typical salaries. (Barron's)
6. The **US will prohibit Americans from investing in some Chinese companies developing advanced semiconductors and quantum computers** starting next year. This is part of the effort to prevent Beijing from producing cutting-edge technology for its military. Americans doing business in China will need to inform the U.S. government about direct investments in artificial intelligence and other types of semiconductors. (WSJ)

IV. The CPI Report

1. **Headline CPI** rose **.2%** MoM and **3.2%** YoY
    a. **Shelter inflation** was responsible for **90%** of this; up **.4%** MoM and **7.7%** YoY
        i. Rent is the largest component and was up .4% MoM
        ii. Shelter costs tend to lag
            1. **Asking rents** measured by Zillow were up 3.6% YoY (these had been as high as 16.2% in Feb. and March 2022)
            2. Rents measured by Zillow were up .5% MoM (Barron's)
    b. **Grocery prices** also rose .3% MoM
    c. The portion of categories that have experienced three-month annualized inflation at or above 5% is now at 23.2%, the lowest reading since Nov. 2020 (Barron's)
2. **Core inflation** rose **.2%** MoM and **4.7%** YoY
    a. We have had a .2% increase two months in a row
        i. Smallest back-to-back gains in two years
    b. Costs for core goods declined MoM
        i. Mostly b/c of new and used cars
    c. Absent shelter costs, core prices fell .1% MoM and rose 2.5% YoY
    d. Core services excluding shelter rose .2% MoM
    e. The three month annualized core inflation rate is 3.1% -- the lowest reading in two years (down from 5% in May) (WSJ)
3. The market's conclusion from this data is that the **Fed can be on hold** in September
4. **Concerns about the inflation numbers going forward**:
    a. **Higher gas prices** could impact the headline number (and even work its way into the core number) in coming months
    b. **Base effects** had been helping inflation numbers recently (high inflation months dropping out), but those benefits are largely behind us
    c. The **housing market** may be tightening again (Barron's) (Bloomberg)
    d. **Supercore prices** (services minus energy and housing) accelerated for the first time this year (Bloomberg)
        i. It was 4.1% YoY vs. 4.0% YoY in June
        ii. On a monthly basis, it was up .2%
        iii. If you also exclude medical care services (which includes health insurer profits) rose .4% MoM
            1. This is more similar to PCE which isn't affected by health insurer margins (Bloomberg)
5. **Deflation in China** could lower the inflation battle worldwide
6. **Fed speak**:
    a. Gov. Michelle Bowman indicated rates still need to go higher
    b. SF Pres. Mary Daly said that it's too early to declare victory
    c. Philadelphia Pres. Harker said that Fed can be patient
    d. NY Fed Pres. John Williams said that if inflation drops, the real Fed funds rate will become more restrictive (unless it is lowered)

V. Where is Shelter Inflation Headed? (SF Fed) by Augustus Kmetz, Schuyler Louie and John Mondragon

A. Introduction

1. **Shelter inflation has remained high**, even as other components of inflation have fallen. But home prices and rent suggest that the **housing market has slowed significantly** with higher interest rates.
    a. House prices and asking rents slowed sharply in 2023 after a period of extraordinary growth starting in early 2020.
        i. But measures of shelter inflation tracked by CPI continue to grow.
    b. If shelter inflation persists at current levels, the FOMC will struggle to get inflation back to 2%.
2. Forecasting models that combine several **measures of local shelter and rent inflation** can help explain how recent trends might affect the **path of future shelter inflation**.
    a. These models indicate that **shelter inflation is likely to slow significantly over the next 18 months**, consistent with the evolving effects of rate hikes on housing markets.

B. The Unclear Relationship Between Asking Rents and Shelter Inflation

1. How much **inflation pressures** have moderated **depends** significantly on the impact of **shelter inflation**, which has been above 8% since early 2023.
    a. Whether shelter inflation remains high will strongly influence the **path of future overall inflation** b/c shelter makes up ~30% of the CPI consumption basket.
2. **CPI** includes households who have **just moved** and are paying prevailing asking rent, as well as **households who have not moved recently** and are paying different rent amounts.
    a. Persistent **shifts in asking rents are gradually incorporated** into the stock of total rents as households move or landlords update leases.
        i. As a result, **indexes of asking rents can provide insights about the future path of shelter inflation.**
3. However, how specific asking-rent indexes are accounted for in the CPI shelter inflation is complicated by differences in building types and geographic areas, as well as differences in methodologies used to estimate rents.
    a. Asking-rent indexes do not necessarily represent the overall market, which means changes in these indexes might not translate one-for-one into changes in the CPI shelter index, even with a lag.
4. We can see that **as asking rents and house prices increased, the shelter index also eventually increased.**
    a. But, a **significant gap** remains between the spot-market indexes and CPI shelter. If we assume that these indexes should eventually converge, this implies that the shelter price index would need to rise much further or that asking rents would need to decline further.
        i. Or this could mean that that the underlying construction of the indexes vary significantly and these indexes need not all agree

C. Shelter Inflation is Likely to Slow

1. Some recent research indicates that **asking rents can be quite informative** for forecasting the path of shelter inflation
2. The researchers predicted the evolving cost of shelter based on monthly data for **lagged YoY growth** from Zillow Home Value Index, Zillow Observed Rent Index, Apartment List National Rent Index, Apartment List Vacancy Index, CoreLogic Single-Family Rent Index, S&P/Case-Shiller U.S. National Home Price Index, and past CPI shelter inflation.
    a. They forecast cumulative shelter inflation and then convert it into YoY shelter inflation rates
    b. They do this on a disaggregated basis (studying cities or statistical areas) and then aggregate them
3. They used pre-pandemic data to produce a forecast for the 18 months starting Feb. 2020
4. They **forecast that shelter inflation will continue to slow through late 2024** and may even turn negative by mid-2024
5. The deflationary component of this forecast would be the most severe contraction in shelter inflation since the GFC of 2007 – 2009
    a. As a result, the researchers had to **assess whether their results were overly sensitive to the rapid increase in housing costs**
        i. This is important b/c shelter prices tend to be less flexible in economic downturns (they may not decline as rapidly as they rose)
        ii. So they dropped the index that had the most negative effect on the cumulative forecast (which turned out to be the lagged CPI shelter inflation) and then re-estimate the model
    b. This **second model** is only slightly less accurate than the baseline model in the testing period starting Feb. 2020
        i. This limited model does not forecast a deflationary episode in 2024, although it does suggest that YoY shelter inflation will hit zero around summer 2024
6. **Both models agree** that shelter **inflation is likely to slow significantly** over the next 18 months
7. There are **several important caveats** to these forecasts:
    a. The range of possible forecast errors is quite wide
        i. YoY shelter inflation in late 2024 estimated to be anywhere between -9% and 2% in baseline and -2% and 5% in limited model
    b. These models are estimated primarily on data from the pandemic period, which saw exceptional growth in housing markets and inflation
        i. The relationship between these housing market indicators and shelter inflation could be different going forward
    c. These forecasts do not account for any potential future shocks
        i. The distribution of forecast errors should account for this uncertainty, but that will depend on future shocks being similar to past shocks
8. The forecasts suggest that the **rapid rise in interest rates since early 2022 is likely to have had a significant effect on slowing housing markets**
    a. And this slowing is likely to continue going forward

D. Conclusion

1. The forecasts presented indicate that shelter inflation may decline considerably
    a. Reflecting the signals of slowing in recent rental markets
2. At a minimum, the results imply that the **risk of surprise increases** in shelter inflation has become **significantly smaller** with the rapid rise in interest rates