MARKET UPDATE

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August 21, 2023 – Market Update

I. Stocks 2

A. Recent Performance 2
B. Looking Ahead 2
C. Issues that Could Be Affecting Stocks 3

II. Bonds and Rates 3

A. Last Week 3
B. Issues to Think About 4
C. Forecasts for the Future 4
D. Mortgage Rates and Home Prices 4

III. The Fed 5

IV. The Economy 6

V. China 7

I. Stocks

A. Recent Performance

1. **Last week**: DJIA -2.2%; **S&P 500 -2.1%**; Nasdaq -2.6%
    a. The S&P 500 and Nasdaq were both down for a third straight week.
    b. All three indexes below 50-day moving average
2. **Bearish stories** this week (many discussed later on):
    a. The 10-yr UST yield hit 4.33%, the highest since 2007
    b. 10-yr TIPS yield hit the highest level since 2009
        i. Stronger economic data and more support for soft landing narrative
        ii. Higher-for-longer narrative: markets are pricing in a median year-end Fed funds rate of 5.40% (little changed), but during the past two weeks, there has been a 40 bp increase in expectations for January to 4.20%
        iii. FOMC minutes warned of significant upside risk to inflation
    c. 30-year mortgage rate hit the highest level in 21 years
    d. Fitch warning about banks continues to worry investors
    e. UAW demands could impact margins (as could UPS contract)
    f. Depleted excess savings could impact consumer spending
    g. China headlines were negative
3. **Bullish view:**
    a. Strong economy: Atlanta Fed's GDPNow forecast 5.8% growth for Q3
    b. Money market fund assets hit a record high this month
    c. Stronger July retail sales than expected
    d. NY Fed Survey of Consumer Expectations showed lower one-year inflation expectations (lowest since April 2021)

B. Looking Ahead

1. This week:
    a. NVDA's earnings on Wednesday
    b. Fed Chair **Powell speaks** at Jackson Hole on Friday
2. Next year:
    a. The bar for corporate earnings was very low this year, so it was easy to beat. Now, **analysts are expecting 2023's earnings of $219 to grow to $246 in 2024** and that's not likely. If earnings actually drop to $210, the market would be selling above 20X earnings. (Barron's)

C. Issues that Could Be Affecting Stocks

1. Maybe stocks were **discounting the best of all worlds**: a soft landing and lower rates. A stronger economy and higher rates have hurt that story.
    a. Approximately 80% of S&P 500 companies have beaten earnings estimates, yet the average gain after a positive surprise has been .5% vs. the 10-yr average of 1.6%. (WSJ)
    b. This is the **first earnings season in the past five in which stocks had a negative return**…despite the fact that 80% of companies beat earnings. Tech has dropped 6.4% in August.
2. **Higher interest rates result in a lower multiple for stocks**. We received hawkish FOMC minutes this week. We also have a stronger economy and wage growth that are high and this could result in tighter Fed policy for longer. With huge budget deficits, the market worries about great supply of Treasuries. Inflation expectations are no longer falling and the real rate is approaching 2%. (Barron's)
3. With higher rates and the shrinking of central banks' balance sheets, **liquidity is being drained out of the market**. In other words, there is less cash available, financing and refinancing is more difficult to obtain and more expensive.
    a. A strong economy can trump liquidity issues. That's what we saw in the first half of the year. We also saw the Fed's Bank Term Funding Program (allowing banks to borrow against their bond holdings).
    b. Liquidity is often used and maybe we should consider it to be sentiment. (Bloomberg)
4. Some **momentum** in the stock market may be coming **from zero DTE options**. If speculators are buying puts, it forces market makers to sell stock short. Similarly, if speculators buy calls, market makers buy stock to hedge. (Bloomberg)

II. Bonds and Rates

A. Last Week

1. UST: 3-month 5.55% (+1 bp); 2-yr 4.92% (+3 bps); **10-yr 4.26%** (+10 bps)
    a. Since May 11, the 10-yr UST yield has increased 93 bps
2. The latest surge in rates has been driven by real yields, not expected inflation. The real yields have been driven up by Fed tightening. (Bloomberg)
    a. The 10-yr TIPS (real) yield is 1.94 bps (+14 bps) – up 71 bps since May 11
        i. Real yields have increased 71 bps in three months
        ii. Expected inflation has increased 22 bps in three months
3. What's driving yields higher?
    a. The resilient US economy (belief that there will be no recession)
    b. Ballooning debt and deficits (greater supply of bonds)
    c. Possibility that inflation will persist above 2%
        i. Greater concerns that the Fed will need to keep rates higher for longer
    d. Demographics could push up wages (as older workers retire)
    e. Deglobalization
    f. Drives to fight global warming
    g. A need for a positive term premium
    h. The BoJ decision to let their 10-yr yield go higher (Bloomberg)
4. In the past week, stronger-than-expected retail sales, housing starts and industrial production data propped up the case for a soft landing. The FOMC minutes noted "significant upside to inflation." (Barron's) (Barron's)

B. Issues to Think About

1. The **2/10 spread** is near 66 bps after entering July below -100 basis points.
2. **Inflation could be persistent**. The Cleveland Fed's trimmed mean, the Atlanta Fed's sticky prices, and the super-core suggest that the 2% inflation target is further away than the headline and core suggest. (Bloomberg)
3. The **higher 10-year yield could impact the housing and stock markets**. In addition, the fact that it is still lower than the short-term yield gives it room to rise further. (WSJ)
    a. There is debate as to whether growth and tech stocks are truly long-duration assets. But, if investors perceive that they are, they will behave that way. (Bloomberg)
4. The 10-year TIPS yield is now near 2%. We've **relied on cheap money for some time**, as VC firms have financed money-losing companies and the gov't borrowed to spend money in an already-improving economy.
    a. Now, investors seem to be pricing in a 1.9% real rate and 2.4% expected inflation
    b. Risks from higher rates:
        i. They are just hitting and we don't know **what surprises await us**
        ii. Some of the issue is an expectation of higher inflation at any given level of growth and that means a higher Fed funds rate (and a higher real Fed funds rate). Maybe this higher real rate simply reflects decent growth plus really high government spending. (WSJ)
5. The **CBO's** debt **forecast** anticipates the government paying **3% interest** in coming years. If it's 1% higher, that will add $3.5T of debt by 2033. At that point, the annual interest bill would be $2T. Total tax revenue is currently around $4T.
    a. The government will lose the ability to fund vaccine, subsidize technologies, fight wars. (WSJ)

C. Forecasts for the Future

1. Former Treasury Sec'y Larry Summers said that the 10-yr UST yield could increase to 4.75%. He thinks of the 10-yr yield as offering compensation for:
    a. Real neutral rate of 1.5% - 2.0% -- due to increased borrowing by the gov't
    b. Inflation of 2.5%
        i. Demand for workers and deglobalization could be factors
    c. Term premium of .75% - 1.0% (Bloomberg) (Barron's)
2. Jim Bianco thinks the 10-yr UST yield will hit 5%:
    a. Real neutral rate of .5%
    b. Inflation of 3%
    c. Term premium of 1.5% (Barron's)
3. Vanguard thinks that the Fed funds rate will remain above 5% until late 2024.

D. Mortgage Rates and Home Prices

1. The average mortgage rate rose to **7.09%,** its highest level in more than 20 years. A year ago, rates were ~5%. Mortgage rates tend to move with the 10-year UST. (WSJ)
2. The **median existing-home price** was over **$410K** in June. This is slightly lower than the all-time high, but still the second-highest price ever recorded. (WSJ)
    a. Sales of existing homes were down 19% YoY in June. (WSJ)
3. **Housing affordability** is the lowest it's been in almost four decades. Tight inventory and high mortgage rates are the explanation. (Bloomberg)
    a. Monthly payments on a $600K mortgage would be ~$4,028. That's up from $2,601 at the start of last year (before the Fed started raising rates). (Bloomberg)

III. The Fed

1. **FOMC minutes** showed **tension between inflation that is slowing but growth that is stronger than expected**:
    a. "Most participants continued to see **significant upside risks to inflation**, which **could require further tightening** of monetary policy."
        i. They worried about stronger economic growth, and the reversal of recent supply-chain improvements or declines in commodity prices, which have been largely responsible for the slowdown in inflation.
    b. Two Fed officials favored leaving rates unchanged or "could have supported such a proposal."
    c. Fed's staff economists "no longer judged that the economy would enter a mild recession toward the end of the year."
        i. Still, they expected economic growth over the next two years "would run below their estimate of potential output growth, leading to a small increase in the unemployment rate relative to its current level."
    d. Some officials thought the risks of raising rates too much versus too little "had become more two-sided, and it was important that the committee's decisions balance the risk of an inadvertent overtightening of policy against the cost of an insufficient tightening." (Bloomberg) (WSJ)
2. **Fed comments**:
    a. Fed Gov. Bowman: more increases will be needed
    b. Minneapolis Fed Pres. Kashkari: he wasn't ready to say that they were done with raising rates.
    c. Phil. Fed Pres. Harker: FOMC could hold rates where they are "for a while"
    d. NY Fed Pres. Williams: Fed may be pretty close to a peak rate
    e. Boston Pres. Collins: "the risks of doing too much have absolutely increased and mare much closer to balance, relative to the cost of not doing enough."
    f. Richmond Fed Pres. Barkin: he would have greater conviction that inflation was set to return to the Fed's 2% target "if the economy is in fact softening as you would expect." (WSJ) (Bloomberg)
3. Last year, **Powell** spoke for just a few minutes at Jackson Hole and said that the Fed would tame inflation, notwithstanding the economic pain. Since then, headline inflation has been slashed by 2/3. But there are **risks with inflation** going forward:
    a. Gas, car insurance and health insurance costs are likely to rise. Health insurance costs were down 30% YoY in July after the Covid anomaly.
    b. We could have long-term issues:
        i. Deglobalization and reshoring supply chains
        ii. Declining immigration + an aging population = labor shortage (Barron's)
4. It's **hard to believe that Fed policy is restrictive** if unemployment is near a record low and the economy is growing above the historical trend. (Bloomberg)
    a. Even with 525 bps of increases in the Fed-funds target, when you see GDP growth estimates for Q3 that are above 5%, do you believe that we've hit the neutral rate yet? (Barron's)

IV. The Economy

1. Niall Ferguson: "if the world's pilots had the same success rate touching down as the world's central bankers at achieving price stability, most of us would opt to drive or sail." **Reasons to worry that the Fed will have to do more:**
    a. Average hourly earnings are rising at an annual rate of 5.1%
    b. The Teamsters recent deal with UPS was notably generous
    c. The UAW is currently seeking a 40% pay increase (Bloomberg)
2. The SF Fed says that **excess savings** built up during the pandemic **will be exhausted in the current quarter**. They believe that households held less than $190B of excess savings by June. (Bloomberg)
3. Wall Street firms are raising **new funds to acquire office buildings, apartments and other troubled commercial real estate**. Commercial property values have already fallen 10 – 15 percent from their peak and may fall a total of 20 – 25 percent according to one analyst.
    a. A lot of CRE has debt that will need to be refinanced at higher rates and those numbers are unlikely to work out. Apartments, malls and office buildings are especially troubled. (WSJ)
4. The median affected household will pay **$180 per month for student debt**. (WSJ)
5. The percentage of **credit-card and auto-loan balances transitioning into delinquency** (30+ days late) is happening at a faster pace than 2019, according to the NY Fed.
    a. This is particularly acute for borrowers with poor credit records. The 60+ day delinquency rate for subprime auto loans rose to 5.37% in June (according to S&P), while it is only .49% for prime loans. This is the highest June level ever for subprime.
    b. We're still seeing lower levels of foreclosures and bankruptcies.
    c. **Texas had the highest rate of loan balances transitioning into 30+ day delinquency among the 11 individual states reported by the Fed**. One possible factor could be the impact of extreme heat straining many businesses. Another potential factor is that Texans have expanded their debt loads quite a bit. (WSJ)
6. Stat of the week:
    a. A recent survey showed that **46% of Americans said that it's rude to fully recline their airline seat and that they don't recline**. Some 28% said it was rude and they would politely ask if it was okay before reclining. Another 23% said it wasn't rude. (Another 3% were asleep in the lap of the person behind them and didn't answer the question.)
        i. Europeans were less tolerant of reclining, with 59% saying that it was unacceptable. (WSJ)

V. China

1. China accounted for **13.3% of US goods imports** during the first six months of this year. This had peaked at 21.6% in 2017. This is the lowest level since 2003, when it was 12.1%.
    a. Some of this has shifted to other Asian nations. A group of 25 other Asian nations including India, Thailand and Vietnam accounted for 24.6% of US imports in the year ended in June, vs. 14.9% for China. (WSJ)
2. Chinese officials said that they would **stop reporting the country's youth unemployment rate** after months of spiraling increases. This extends China's efforts to restrict access to a variety of data. The jobless rate for people ages 16 – 24 had moved higher for six consecutive months and reached 21.3% in June.
    a. Opacity does not bring back growth or trust. This reminds me of when I started to gain weight, so I threw out the scale.
3. The **PBOC lowered the interest rate** on a key facility that funnels one-year loans to banks from 2.65% to 2.5%. Figures last week showed weakening credit growth, crumbling exports and a YoY decline in consumer prices. (WSJ)
    a. China is being hurt by a drawn-out real estate crunch, worsening relations with the US-led West and difficulties in nurturing a consumer-led expansion while the usual growth engines of investment and exports misfire. (WSJ)
    b. Bank loans had fallen to a 14-year low in July. The currency is also near a 14-year low.
    c. China has too much debt to use government spending to fuel growth. (Bloomberg)
4. Figures last week showed **consumer prices in China fell last month YoY.** A spokesman for China's statistics bureau said China hasn't seen deflation and won't see it in the future. (That's one thing I believe from the CCP – if they don't want us to see it, we won't.) (WSJ)
5. **China's 10-year bonds** have consistently yielded more than UST's (as China has been growing faster). But, no more. The gap between the 10-year US and Chinese bonds is now more than 160 bps (US yields are higher), the widest since 2007.
    a. This may mean that more than a decade of US dependence on holding rates low while relying on China to drive growth are over. But in the short-term, it could put more pressure on China's currency. (Bloomberg)