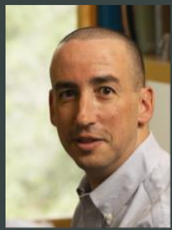

MARKET UPDATE

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August 28, 2023 – Market Update

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I. Stocks (Last Week and Next Week)

1. Last week: DJIA -.5%; **S&P 500 +.8%**; Nasdaq +2.3%
    a. Nasdaq and the S&P 500 had their first week of gains after three weeks of losses
    b. Equities have recovered **65%** of last year's bear-market drop
        i. But only **45%** in real terms (Bloomberg)
2. **Bullish** points:
    a. Peak-Fed optimism
        i. Powell didn't comment on neutral rate being higher
    b. Earnings revisions turning positive again
    c. NVDA reported EPS of $2.70, crushing the $2.08 expectations.
        i. NVDA guided Q3 revenue more than 25% ahead of consensus
3. **Bearish** points:
    a. Powell spoke and was marginally hawkish. He didn't shut the door on the possibility of a rate increase in September.
    b. 10-year yield reached highest level since 2007
    c. 2024 earnings estimates are still too high
        i. Late in business cycle
        ii. Monetary policy headwinds
        iii. Mortgage rates hit a 23-year high
    d. Softer economic data led to growth fears
    e. Macy's and Dick's Sporting Goods warned that the consumer may not be as healthy as we think. Dick's cut its outlook and missed expectations for the first time in three years. Macy's said credit card delinquency rates had increased faster than expected. They also both reported more shrink than expected.
    f. Market didn't rally after NVDA's earnings
        i. Investors seem to be selling the rallies rather than buying the dips
4. **Next week**:
    a. Aug. Consumer Confidence
    b. July JOLTS report
    c. July PCE
    d. August payrolls

(Barron's) (WSJ)

II. Bonds and Rates

A. UST Yields

1. 3-month 5.61% (+6 bps); 2-yr 5.03% (+11bps); 10-yr **4.25%** (-1 bp)
    a. The yield on the 10-year Treasury note rose to 4.34% in mid-August, its highest level since November 2007
    b. Odds of recession have dropped and large deficits increase the supply of bonds
        i. Pushing nominal rates higher
2. Most of the recent increase in nominal rates has been on the **real side** (not inflation) (Bloomberg)
    a. The yield on the 10-year TIPs pushed over 2% for the first time since 2009
        i. It was at 1.06% on April 6
3. Minneapolis Fed Pres. Kashkari has previously written that policy is **restrictive** when the **real 10-year yield is 200 bps higher than the real neutral rate**
    a. This would imply that policy still may not be restrictive (Bloomberg)

B. Credit Quality Could Deteriorate

1. Highly indebted companies are now paying high interest rates at same time as wage inflation is increasing.
    a. This is especially true if the debt is floating-rate
2. Moody's 12-month trailing default rate for lower-rated companies rose to **3.8%** in the second quarter, up from 1.4% a year earlier.
    a. Moody's forecasts that defaults will rise to 5.8% in 2024 Q1, but it could go as high as 15.6% if economic conditions deteriorate.
3. Banks are also starting to pull back on lending
    a. Will make it more difficult for highly indebted companies
4. Expect to see problems with **leveraged loans** first
    a. Then junk bonds – which are still priced for perfection
        i. BB-rated bonds are trading with just a 2.5% spread over USTs. Over the past 20 years, this has averaged 4%. (Barron's)

C. Mortgage Rates

1. The average 30-year fixed rate mortgage has a **7.23%** interest rate
    a. Two years ago, the rate was below 3%
2. Applications for **purchase mortgages** fell to their lowest level since 1995
    a. **Existing home sales** fell in July for the fourth time in five months
3. Over the past 50 years, mortgage rates have averaged **10-yr UST yield + ~1.75%.** Now, the spread is **~3% higher**. **Reasons:**
    a. Investors see more risk in mortgages
    b. Greater volatility in interest rates
    c. Less demand from investors for mortgages
        i. Fed has stopped buying MBS
        ii. Banks are trimming their holdings (lowering portfolio duration) (WSJ)

D. The Neutral Rate

1. The Fed has raised rates 525 bps and the **economy has not slowed**. Maybe the neutral rate is higher and we won't return to low rates.
    a. If borrowing and spending are still strong and inflation pressure rising, neutral must be above the current interest rate.
    b. If the neutral rate has increased, the Fed will have to take the Fed funds rate higher and long-term yields could also increase.
2. The median estimate in the SEP declined from 4.25% in 2012 to 2.5% in 2019. The real neutral rate (if you strip out the 2% inflation estimate) was .5%. (Referred to as r*)
    a. In June, seven of 17 estimates were above .5% and only three were lower.
3. **Possible reasons why the neutral rate may be rising:**
    a. Economic growth is above potential
    b. Swelling deficits and investment in clean energy could increase the demand for savings
    c. Productivity-boosting investment opportunities could push up the neutral rate
    d. Faster depreciation makes investment less sensitive to borrowing costs and that could raise the neutral rate
    e. Retirees may be spending their savings
4. Some economists still think the **neutral rate will stay low:**
    a. Aging population – could boost supply of savings
    b. Slow productivity growth
    c. Inequality
    d. Shortage of investment opportunities
    e. Technological changes that reduce the capital intensity of production
    f. Inflation is being driven by the supply-side
5. We can also differentiate between the short-run and long-run neutral rate (WSJ)

E. Fiscal Issues

1. The **CBO expects the deficit to expand to ~6% of GDP** this year and to stay in that area for the next 10 years. In the 60 years after WWII (until 2008), the deficit had not been that large.
    a. Net interest payments have surged above $600B this year, up from $380B pre-pandemic. Interest payments use 14% of tax revenue.
    b. Almost 1/3 of the national debt has to be rolled over in the next 12 months. (Businessweek)
2. GS says the government is more likely than not to **shut down** at the end of September. This is because of lack of agreement over appropriation bills. This could cause the Fed to wait to raise rates. (Bloomberg)
3. A paper presented at the Jackson Hole conference suggested that the capacity of **primary dealers** in US Treasuries to serve as intermediaries between buyers and sellers hasn't grown in step with the size of the UST market.
    a. Suggestions include a clearinghouse and changing the **supplementary leverage ratio rule** (which requires capital to be held against USTs). (Bloomberg)

III. Inflation: Progress and the Path Ahead, Jerome Powell, Aug. 25, 2023

A. The Decline in Inflation So Far

1. The ongoing episode of high inflation emerged from a collision between:
    a. Very strong **demand**
    b. Pandemic-constrained **supply**
2. By March 2022, it was clear that bringing down inflation would depend on:
    a. Unwinding of the unprecedented pandemic-related demand and supply distortions
    b. Our **tightening of monetary policy**
        i. Need to **slow aggregated demand** so supply can catch up
3. Even with favorable recent readings, process **still has a long way to go**
    a. On 12-month basis, **headline PCE** peaked at 7% in June 2022; 3.3% by July
        i. In line with global trends
        ii. Russia's invasion been a primary driver of worldwide headline inflation
        iii. Food and energy can be volatile and a misleading signal of future inflation
    b. **Core PCE** peaked a 5.4% in Feb. 2022 and declined to 4.3% in July
        i. Lower monthly readings in June and July were welcome
            1. But this was only beginning of what it will take to be confident
        ii. 12-month is still elevated; further ground to cover
4. **Three broad components of core PCE inflation**
    a. Goods
        i. Core goods has fallen sharply in past two months, particularly for durable goods; but 12-month is still well above pre-pandemic level
            1. Tighter monetary policy and the slow unwinding of supply and demand dislocations are bringing it down
            2. Motor vehicle sector provides an illustration
                A. Demand rose, supply dropped
                B. Production and inventories are growing now and higher rates have weighed on demand; inflation has dropped
        ii. Restrictive monetary policy will help attain sustained progress
    b. Housing services
        i. Mortgage rates doubled over 2022, causing housing starts and sales to fall and house price growth to plummet
            1. Market rent growth peaked and then steadily declined
        ii. Measured housing services inflation **lagged changes**, but has begun to fall
            1. Inflation includes rent by all tenants, but leases turn over slowly
                A. Takes time for a decline in rent to work its way through
            2. Watch market rent data for a signal of the upside and downside risks
    c. All other services ("nonhousing services")
        i. Over half of the core PCE index and includes a broad range of services, such as health care, food services, transportation, and accommodations.
        ii. **12-month** inflation has moved **sideways since liftoff**
            1. 3-month and 6-month has declined
            2. Part of reason for modest decline is that many of these services were less affected by global supply chain bottlenecks
                A. Also less interest-sensitive than housing or durable goods
        iii. Production of services is **labor intensive** and labor market remains tight
        iv. Some further progress is essential in order to restore price stability
        v. Restrictive policy will help bring supply and demand back into balance

B. The Outlook

1. Further unwinding of pandemic-related distortions should continue to put downward pressure on inflation, but **restrictive policy** will play an increasingly important role.
    a. To get inflation back down to 2%, we will need a period of **below-trend growth** and some **softening in labor market conditions**.
2. **Economic growth**
    a. Restrictive policy has tightened **financial conditions**: since last year, the **two-year real yield is up ~250 bps** and **longer-term real yields are up by nearly 150 bps**
    b. Bank **lending standards** have tightened and **loan growth** has slowed sharply
        i. Leveraged loans, junk issuance and unrated bonds have declined
    c. We're seeing slowing:
        i. Slower growth in **industrial production**
        ii. **Residential investment** has declined in each of past five quarters
    d. But we are attentive to signs that the economy **may not be cooling as expected**
        i. **GDP growth** has been above expectations and above its longer-run trend
            1. Recent **consumer spending** data has been especially robust
        ii. **Housing sector** is showing signs of picking back up
        iii. Additional evidence of persistently **above-trend growth** could put further progress on inflation at risk and **could warrant further tightening** of policy.
3. The **labor market**
    a. Labor **supply** has improved:
        i. Stronger **prime-age participation**
            1. Prime-age women participation rate hit all-time record in June
        ii. Increase in **immigration** back toward pre-pandemic levels
    b. Labor **demand** has moderated
        i. Job openings remain high but are trending lower
        ii. Payroll job growth has slowed significantly
        iii. Total hours worked has been flat over past six month
        iv. Average workweek has declined to the lower end of its pre-pandemic range
    c. Rebalancing has eased **wage pressures**
        i. While nominal wage growth must ultimately slow to a rate consistent with 2% inflation, real wage growth is what matters to households
            1. Real wage growth has risen as inflation has fallen
    d. Evidence that the **tightness** in the labor market is no longer easing could also **call for a monetary policy response**

C. Uncertainty and Risk Management Along the Path Forward

1. Can't identify **neutral rate** with certainty – so hard to know if policy restrictive
    a. Real rates are now positive and well above mainstream estimates of the neutral policy rate. We see policy as restrictive.
2. Uncertainty about the **duration of lags** with which monetary policy tightening affects economic activity and inflation
    a. Past 12 months: raised Fed funds rate by 300 bps and quantitative tightening
3. **Job openings** have declined substantially **without increasing unemployment**
    a. This appears to reflect excess demand for labor
4. Inflation seems to have become more responsive to labor market tightness than we've seen in recent decades (**Phillips curve**)

IV. Economic Statistics

1. Atlanta Fed's **GDPNow** is currently forecasting **5.8%** Q3 growth. This would be the fastest non-pandemic growth in 20 years (Bloomberg)
2. A survey by the Insurance Information Institute found that **32%** of homeowners said that they have been affected by **weather events** in the past five years and nearly **60%** expect to be affected in the next ten years. (Barron's)
3. A **2021** survey found that nearly **2/3** of home buyers said they didn't consider the impact of climate change when deciding where or what to buy. More than **12%** said that they don't believe in climate change. (Barron's)
4. A **2022** Redfin survey of people who plan to buy or sell a home in the next year showed that **two in five** said risk of natural disasters, extreme temperatures, and rising sea levels played a role in their decision to move, and nearly **two-thirds** said that they are hesitant to move to high-risk areas. (Barron's)
5. Average annual **home-insurance premium** for Floridians: $1,988 in 2019 to $6,000 today.
    a. In a recent survey, almost **a third** of house builders in Florida said buyers' concerns about home insurance were "somewhat slowing sales." In Southern California, it was **29%**. Nationally, it's **9%**. (WSJ)
6. Among postings for more than 20,000 job titles on ZipRecruiter's site this year, the **average pay** for a majority of roles has declined YoY. (WSJ)
7. The **average reservation wage** (the lowest annual pay that workers would accept to take a new job) increased to $78,645 in July (according to the NY Fed). It was $72,900 a year earlier and $69K in July 2021.
    a. For men, it's ~$91K. For women, it's $25K.
    b. For workers with a college degree, it's $98,600; without a degree: $63,300
    c. The **median US household income** was $70,784 in 2021 (Bloomberg)
8. There is only one new car that sells for less than $20K: the Mitsubishi Mirage hatchback. There are more than 32 models that sell for more than $100K. The average used car sells for **$27K**, up more than 30% from pre-pandemic levels.
    a. The average new car loan is more than $750K with a **9.5%** interest rate. The average term is six years.
    b. Severe delinquency rates are the highest since at least 2006. (WSJ)
9. Approximately **$1.2T of debt on US commercial real estate is "potentially troubled"** (i.e., debt represents at least 80% of the real estate's current market value).
    a. **Offices** account for more than half of the $626B of at risk debt maturing by the end of 2025. **Apartment buildings** are next with $192B.
        i. Office values have dropped **31%** since March 2022.
    b. **Banks** carry the biggest share of this debt: $303B of troubled loans maturing through 2025. (Bloomberg)
10. KPMG said **~2/3** of its consultant hires that it recruited over the past year will now start in 2024. Deloitte, KPMG, BCG and McKinsey are all delaying start times. (WSJ)
11. In a recent survey, nine in ten college graduates said that learning a **skilled trade** can create a better pathway to financial security than going to college.
    a. Recent graduates in the bottom quarter of income levels aren't earning much more than workers who only have a high school degree. (Bloomberg)
12. There were **714K new homes** sold in July (at an annual rate) vs. 684K in June and 543K in July. This is still below the 1.03MM in Aug. 2020, but faster than the 683K in 2019.
    a. There are only **980K existing single-family homes for sale**.
    b. Average price of an existing home sold in July was **$406,700** (vs. $399K last yr) (WSJ)