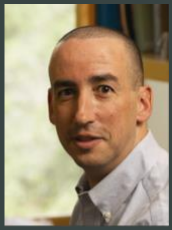

MARKET UPDATE

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August 7, 2023 – Market Update

I. Stocks

A. Last Week

1. DJIA -1.1%; **S&P 500 -2.3%**; Nasdaq -2.9%
    a. This was the first down week for the S&P in four weeks.
    b. Even with strong earnings and performance by AMZN, Nasdaq dropped 2.9%.
    c. In July, the S&P 500 notched its fifth consecutive month of gains, up 3.1%. Nasdaq added 4% and the DJIA increased 3.3%. (WSJ)
2. **Fitch's downgrade of US debt** resulted in higher yields and lower stock prices. Yields are now near their highest level since last November. The downgrade is being accompanied by a large supply of bonds being issued by the Treasury.
3. **Hiring is slowing** this year, yet inflation is still high. If the Fed has to maintain high rates, we have an increased chance of recession. (WSJ)
4. The **VIX increased** from 12.7 (last week) to 17.10.

B. Bullish and Bearish Thoughts

1. **Bullish thoughts** for the week
    a. Jobs report consistent with **soft landing**
    b. BAC and JPM revised outlook – see **no recession**
    c. Peak Fed
        i. Belief that the Fed will cut rates in first half of 2024
    d. Yield curve steepening
    e. Actual **decline in earnings is only 5.2%** (-7% expected)
        i. 84% of companies have beaten earnings estimates
2. **Bearish thoughts** the week:
    a. **Fitch's downgrade** of US debt
    b. Fear of higher rates for longer
        i. Higher long-term rates
    c. Fear of **extreme optimism**
    d. **Disinflation** could weigh on **earnings**
    e. Rising **oil prices** (inflationary and could hurt consumer spending)

Source: FactSet

C. Valuation and Sentiment Concerns

1. The **S&P 500 has risen 16.63% this year** while **Q2 earnings are down ~7% YoY**. In addition, at the beginning of the year, analysts were predicting that Q3 earnings would grow 5% YoY and Q4 would grow 10% YoY. Now, those forecasts are down to .2% and 7.4%.
    a. **Margins** for Q2 are ~11.4%, down from 2022 Q2 of 12.2%. (WSJ)
2. The S&P's **earnings yield minus the 10-yr UST yield dropped to 1.1%**, the lowest level since 2002. This is how some investors think about the **risk premium**.
    a. For this to normalize, stock prices or yields have to fall. (WSJ)
3. Until the middle of this week, **sentiment seemed to be ecstatic**.
    a. BAC says that buying option protection against drops in the market is the "cheapest you likely have ever seen."
    b. The CBOE put-to-call ratio is at the lowest level in more than a year. (Bloomberg)
    c. Strategists from Citi and Piper Sandler raised their year-end forecasts.
4. While the average forecast of **market strategists** is lower than the current value of the S&P 500, **momentum is shifting to a more positive view**. Of course, this is a reminder that strategists were mostly negative coming into 2023 and that view was wrong.
    a. If you had bought the S&P 500 every time that the 20-day moving average dipped below strategists' year-end target and sold every time the moving average was above, you would have earned 8.3% since 2019, instead of the 48% from buying and holding.
    b. Strategists have done **fine with predicting earnings**. They've **struggled with figuring out the multiple** to apply to the earnings. Very few strategists or investors expected a higher P/E multiple while interest rates were so high. (Bloomberg)
5. The median company pushed up **capital expenditures** by 15% in Q2 and announced buybacks decreased. (Bloomberg) (Bloomberg)

II. Rates, the Fed and Oil

1. UST: 3-month 5.54% (+2 bps); 2-yr 4.78% (-10 bps); 10-yr **4.05%** (+9 bps)
    a. The yield curve has been steepening since the BoJ tweaked policy.
    b. The 10-yr UST rose above 4.10% for the first time in 10 months
2. The path of inflation and interest rates could be determined by the **drivers of inflation**:
    a. If inflation is **subsiding on its own**, monetary policy is less important.
    b. If inflation is subsiding because of weaker demand due to the higher Fed funds rate, the Fed will have to consider holding rates high until inflation subsides.
3. A **stronger economy and inflation well above 2%** could keep the **Fed funds rate higher for longer** than the market expects. This could bring **long-term rates closer to the short-term rate** and that wouldn't be great for stocks.
4. German insurer Allianz has seen these **impacts on US inflation in the past year**:
    a. Consumption growth, strong labor markets and gov't spending have pushed inflation higher
    b. Fading supply-chain disruptions lowered inflation
    c. Fed policy lowered inflation
5. **WTIC reached a three-month high** and closed the week at **$82.82**. It increased 16% last month.
    a. The price is being helped by a belief that the US won't go into recession, short covering, and production cuts in the Middle East. Of course, slow Chinese growth could put a lid on price increases.

(Bloomberg) (WSJ) (WSJ) (Barron's)

III. The Economy

A. Fitch Downgraded US Debt to AA+

1. Fitch Ratings downgraded the US government's credit ratings after Pres. Biden and congressional Republicans came to the brink of a historic default. Fitch cited the **growing debt burden** and the **political dysfunction** in Washington. S&P had downgraded the US in 2011 after a similar standoff.
    a. Fitch said that "the **repeated debt-limit political standoffs** and last-minute resolutions have eroded confidence in fiscal management."
    b. Fitch expects the government **deficit to rise to 6.3% of GDP** in 2023 from 3.7% last year. This is the result of **weaker federal revenues, new spending initiatives and higher interest burden**. Remember that we are running this deficit when we are at full employment.
        i. The CBO expects **interest expense of $745B in FY 2024**.
2. The **federal deficit hit $1.39T for the first nine months** of the current fiscal year, **up 170% YoY**.
3. **Social Security, healthcare** (particularly Medicare and Medicaid) **and military spending are ~70% of spending in most years**. No one believes that Congress will do anything to significantly fix Social Security or Medicare. It is unlikely that military spending will be reduced in a time of a more aggressive Russia and China.
4. After the downgrade in **2011**, Fed Chairman **Bernanke said**, "**everybody** who reads the newspaper **knows** that the United States has a **very serious long-term fiscal problem**."
    a. Unlike 2011, yields rose with this downgrade.
5. At the same time as this downgrade, the **US Treasury is issuing more debt**. The Treasury is replenishing their checking account. In addition, some of the demand is going away as the **Fed reduces the size of its balance sheet**.
6. We will continue to hear more about the possibility of **financial repression**. This is where we have high inflation but arrangements that suppress borrowing costs for the government.
    a. An example of such a technique would be yield curve control (like Japan).
7. **Australia, Germany, Singapore, and Switzerland** all still have AAA-ratings from Moody's, S&P and Fitch. China has an A+ rating.
    a. At the corporate level, **MSFT and JNJ** are rated AAA.

Sources: (WSJ) (Bloomberg) (Bloomberg) (WSJ) (Bloomberg) (Barron's)

B. Labor Market

1. Tuesday's **JOLTs report**
    a. **Job openings fell** in June to 9.6MM (lowest level since April 2021)
        i. Job openings to unemployed people: 1.6 (still high)
    b. **Hiring fell** to lowest level since Feb. 2021
    c. **Layoffs also declined** to lowest level since end of last year – don't get rid of workers!
    d. The **quits rate is 2.4%** -- lowest since Feb. 2021 – a little less job security
        i. Still a high number
2. Key numbers from Friday's **employment report**:
    a. **+187K jobs** in July (~200K expected)
    b. **Unemployment rate** dropped from **3.6%** to 3.5%
    c. **Participation rate** remained at **62.6%** for fifth consecutive month (highest since March 2020)
        i. Prime age participation dropped for first time since 2022
    d. **Wages grew 4.4% YoY** and **.4% MoM**
    e. **Weekly hours worked** ticked **down** (lowest since April 2020)
    f. Temporary help services continued their slide (cooler market)
3. **Conclusions:**
    a. **Job market is cooling**, but it's **still too tight** for the Fed's comfort
        i. But it may reduce the pressure to raise rates at next meeting
    b. Consumers will remain **confident in job prospects** and keep spe**nding**
    c. Jobs report is consistent with **soft landing narrative**
4. **Wages** may not be increasing as fast as they could because workers are negotiating for **remote work** (and will take lower pay for flexibility).
    a. The Society for Human Resource Management says **62%** of employers offer some remote work
    b. The Census Bureau finds that **39%** of workers are teleworking from home at least some of the time
        i. Half are doing it all of the time
5. The "**Sahm rule**" says that the economy is contracting when the three-month moving average of the unemployment rate rises .5% above the previous 12-month low
    a. We have no evidence of this right now

Sources: (WSJ) (WSJ) (Bloomberg) (Bloomberg) (Bloomberg) (WSJ) (Bloomberg)

C. Former NY Fed President Dudley Argues that We Could Still have a Recession

1. **Markets and economists** are starting to repeat the **soft landing narrative**, where inflation falls back to 2% without causing a recession
2. To assess the chances of a soft landing, you **must consider three questions**:
    a. Will the **effects** of the Fed's tightening keep mounting (**lags in policy**)?
    b. Once lags have played out, **will Fed's stance by tight enough to keep growth in check?**
    c. **Does the unemployment rate need to go higher** to get inflation to 2%?
3. **Dudley's thoughts** on the three issues:
    a. **Lags have shortened** due to forward guidance
        i. The expectation that the Fed will soon be done tightening has already eased financial conditions more broadly
            1. Stock prices are higher, credit spreads have narrowed, dollar has weakened
            2. Even interest-rate sensitive housing sector has begun to recover with new construction and sales moving higher
    b. There's a compelling case that the **neutral rate is higher** (so policy is not restrictive) due to:
        i. he Biden administration's infrastructure, semiconductor, and climate change initiatives. We have stronger demand and less available savings (because of government debt).
    c. We **don't know what** the non-accelerating inflation rate of unemployment (**NAIRU**) **is**, but Fed officials think it's 3.8% to 4.3% (down from 5.2% to 6.0% ten years ago).
        i. While it could be lower than 3.8%, it's unlikely. (Bloomberg)

D. Other Assorted Stories about the Economy

1. **Euro-area GDP returned to growth** (+.3% QoQ) and **consumer prices rose 5.3%** (core 5.5%). The ECB may have to keep tightening. (Bloomberg)
2. **Signs of deflation are becoming more prevalent across China**. This could hurt profits, consumer spending and employment. It could ripple across the globe, lowering prices, but also lowering Chinese demand for raw materials and consumer goods.
    a. **Reasons** for low inflation include subdued consumer spending, a reversal of high pandemic production demand (from overseas), and the property slump.
    b. As borrowers worry that the cost of servicing their debts will rise, they save more and spend less. Deflation can be self-fulfilling. (WSJ)
3. The **average savings target in the US is now $1.8MM** according to a Schwab survey. The percentage of workers who believe that they'll meet this goal fell to 37% from 47% last year and 53% two years ago.
    a. Remember that the **average 401(k) balance** last year was $112K at Vanguard and $108K at Fidelity in Q1 of this year. The **median** at Vanguard was $27K. (Bloomberg)