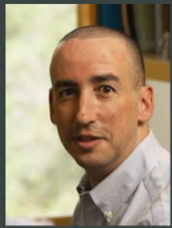

MARKET UPDATE

subscribe at sandyleeds.com

Market Update - December 11, 2023

I. Stocks

For the **week**: DJIA +.01%; **S&P 500 +.21%**; Nasdaq +.69%; Russell 2000 +.98%

The S&P and Nasdaq were each up for the sixth straight week – the longest win-streak in four years. The S&P is up nearly 12% since its Oct. 27 low. There is increasing confidence in a soft landing and Peak Fed. Investors are focused on disinflation and a Goldilocks labor market.

The S&P 500 is only 5% below its all-time closing high (from Jan. 2022). Maybe Q4 earnings will be the catalyst to push stocks to a new high. Earnings are expected to grow 3.6% in Q4 with sales up 3.5%. If the economy grows in low single digits, 2024 sales growth forecast of 5% seems reasonable and margins are likely to improve with moderating costs. Add in buybacks and you could get the 12% EPS growth in 2024. (Barron's)

The Magnificent Seven (AAPL, MSFT, GOOGL, AMZN, NVDA, TSLA, META) account for 30% of the S&P 500. The S&P 500 is up 19% YTD, but only 8% without these stocks. This makes the S&P 500 less diversified. The average forward P/E of the Magnificent Seven is 32 vs 19 for the S&P 500. These stocks are trading at more than twice the P/E of mid-cap (P/E of 14) and small-cap stocks (P/E of 13), yet a soft landing should benefit the smaller companies. (WSJ)

Bullish arguments: Goldilocks data with solid non-farm payroll job growth of 199K in November; a favorable rebalancing in the labor market via the lowest JOLTS jobs opening in two years; disinflation is being supported by lower gasoline prices (below $3 a gallon); stocks continue to be helped by an AI tailwind.

The biggest concern right now is that the market has aggressive expectations regarding how many times the FOMC will cut rates in 2024. The market is pricing in four rate cuts next year, with the first cut happening by the end of May. **Other concerns** include:

1. An overbought market – nearly 1/3 of S&P 500 stocks have an RSI >70. Maybe the Nov. rally went too far too fast (due to the aggressive expectations about the Fed). (Bl.)
2. Deflation – Walmart CEO said lower prices will put more of the onus on volume growth to drive top-line growth.
3. The resilience of Treasury demand
4. China's anemic recovery -- China has been underperforming other emerging markets due to economic slowdown and debt issues, property and real estate crisis, and less foreign investment (due to geopolitical tensions and risk of Chinese government intervention). Emerging markets (other than China) have been helped by the belief that the Fed will cut rates. (Bloomberg)
5. Geopolitical concerns (even though they haven't seemed to impact the market)

The S&P 500 has moved less than 1% for 16 straight days. It gained 2.25% during this period and the VIX moved below 13. **Reasons for this calm**: valuations are reasonable (P/E ratio near seven-year average), earnings outlook decent next year (expect 10% - 12%), and sentiment is not too excessive. (Barron's)

The VIX has dropped from 22 in October to 13, showing increasing confidence in more expensive stocks. Any economic risk or profit risk could spark a sell-off. A premature Fed cut could raise inflation/credibility concerns. (Barron's)

557 stocks listed on US exchanges are below $1 (as of Dec. 2); 464 of these are listed on Nasdaq. Nasdaq rules allow 180 days for companies to regain compliance with the >$1 requirement, but companies are often given an additional 180-day grace period. (WSJ)

II. The Big News was the Employment Report

Payrolls increased by 199K (175K expected). The prior two months were revised down by a net of 35K jobs. The average monthly job gain for the past year was 240K. Payroll gains are becoming more concentrated, mainly in government and healthcare – two sectors that don't feel the effects of higher interest rates. The Household survey showed the addition of 757K jobs and unemployment down 215K.

The unemployment rate moved down from 3.9% to 3.7%. Average hourly earnings were up .2% to .4% MoM and 4.0% YoY. The participation rate increased .1% to 62.8%, the highest since Feb. 2020. The October JOLTS report showed a larger-than-expected decline in job openings. Continuing jobless claims were lower after hitting a two-year high the prior week.

Next week: On Dec. 12, we'll get the November CPI report. The FOMC meets on Dec. 12 and 13 and this meeting will include a new Summary of Economic Projections. There will be $108B of Treasury auctions on Tuesday and Wednesday.

III. Rates, Debt, Oil and Gold

The 10-yr UST yield dropped to 4.12% during the week but increased back to 4.23% after the employment report. The 2-yr yield increased 25 bps for the week to 4.71%. (Bloomberg)

Interest rates are likely to remain higher than pre-pandemic levels for the long-term due to:

1. Government deficit spending: climate change, healthcare, military
2. Slowdown in global trade and more domestic production (Barron's)

Over 20% of US companies are "zombie" companies – they could not cover interest expense for over three years. This is concentrated among smaller companies and banks are reluctant to lend to them. At the same time, 150 of the largest companies have never been stronger on interest coverage ratio. (Bloomberg)

Who would have ever guessed that the government can't issue an infinite amount of debt? Ultra-low interest rates have led to complacent views about government debt. The left advocated expanding social programs and the right advocated tax cuts. These desires were based on the idea that rates would stay low forever. Now, rates are higher and they could stay higher due to: high debt levels, deglobalization, defense spending, green transition, populist demands, and persistent inflation. In addition, demographic shifts may not lower rates. (PS)

Private credit has been outperforming private equity since the start of 2022. Floating rates help private credit while PE has struggled with higher rates and difficulty in selling businesses (buyers and sellers are far apart on valuation). PE "dry powder" is decreasing, while it's increasing for private debt. The private credit market is $1.6T. (Bloomberg)

Private credit typically charges 1 – 2% asset management fee plus 20% of returns above 6%. It's not hard to exceed 6% when the Fed funds rate is 5.25% - 5.50%. Loans have floating rates, so borrowers are often paying 10%+. (Bloomberg)

Private credit gets funding from stable sources like pensions with long-term commitments (not flighty deposits). It would be more troubling if the product was funded by retail investors who could pull their money quickly. (Bloomberg)

Moody's retained their A1 rating for China, but they cut their outlook from stable to negative. Moody's cited China's increased fiscal stimulus, rising local government debt, the property slump and slowing growth. The budget deficit was 3.8% in 2023. (Bloomberg)

1. China has an estimated $7 – $11 trillion in off-balance sheet local government debt. This includes corporate bonds from local government financing vehicles (LGFVs) used to fund infrastructure and other spending. With slower growth, it's harder to service the debt. LGFV bonds are 48% of the corporate bond market. Banks have $6.9T exposure to LGFVs. (WSJ)
2. China has argued that their economy is recovering, the methodology is flawed and that this is an attempt to suppress China's development. (WSJ)

Gold is up 10.31% YTD as investors speculate that the Fed will cut rates. Gold offers no interest (or coupon income) or dividends. As a result, when rates are lower, the opportunity cost of holding gold is reduced. Investors often buy gold as a hedge against inflation, economic downturns, market uncertainty or geopolitical risk. Currently, inflation is falling and the economy is still strong. (WSJ)

Oil prices have dropped since OPEC+ announced a 2.2MM barrel per day cut in production. Investors say that the cuts are not what they may seem: 1.1MM barrels come from an extension of Saudi Arabia's previous cuts. Russia is enacting an "export cut," but this is effectively the same as the prior production cut. In addition, Angola and Iraq may not comply. (Bloomberg)

IV. Fed Policy

Investors are betting against the Fed's interest rate forecasts in two contradictory ways. Some investors are betting that there will be rapid rate cuts in 2024. Others are betting that the Fed will have to leave rates higher for longer and that the long-run real rate will be close to 2.5%. The second group believes that there will be high long-run inflation pressures due to deficit spending, higher investment needed, higher military spending, demographic changes, and more powerful unions. (WSJ)

Markets no longer believe in "higher for longer." We're seeing lower real yields (not lower breakeven inflation rates). Gov. Waller's comments that rates will follow inflation had a big impact, as did lower oil prices and PCE lower than Fed's expectations.

- Lower rates, higher stock prices and a weaker dollar (easier financial conditions) make the Fed's job more difficult. In fact, GS Financial Conditions Index say that the past month's market action has been the equivalent of four rate cuts. (Bloomberg)

The argument for the end of Fed rate hikes: PCE inflation was +3% in October (down from 7.1% peak); consumer spending is showing fatigue; job and wage growth is slowing. The risks that this won't happen: Powell said talk of rate cuts "premature" on Dec. 1; ultimate path depends on trajectory of economy. (Bloomberg)

- **The argument that the Fed has to plan for rate cuts** is that despite the fact that job growth was strong, job growth is significantly slower than a year ago, job vacancies are declining, productivity is up 2.4% in Q3 YoY (indicating that wage inflation is consistent with 2% inflation), core PCE is 3.5% YoY, and new lease inflation is falling sharply. (WSJ)

On the other hand, the strong November jobs report makes large rate cuts unlikely. The labor market continues to attract workers and create jobs. The market expects significant rate cuts that we'll only get if the economy slows. Higher rates for longer could challenge stocks and bonds. (Barron's)

- **A higher neutral rate makes it harder for the Fed to cut rates without spurring inflation.** The housing market could have issues (which affects the mobility of labor), more businesses could fail, and there could be less money for productive investment. On the positive side, higher rates promote saving and efficient capital allocation. (Barron's)

The return of "the Fed put?" If you believe that Fed Chair Powell does not want a second Trump-term, the Fed has added incentive to avoid a recession and protect stock prices. (Bl.)

The Fed will start to slow its QT when reserves equal 10% of nominal GDP and stop when they get to 9%. Currently, reserves are down to $3.4T, having peaked at $4.28T in Dec. 2021. The Fed's rule would require $2.6T of reserves. (Bloomberg)

V. Economy

Jobs report: added 199K jobs in November; excluding effects of auto strikes, added ~169 jobs (slightly cooler than October's 180K). Unemployment rate fell to 3.7%. Half-a-million more Americans entered the labor force. Wage growth picked up on a monthly basis, but only 4% YoY. This could temper the belief the market's hopes for a March rate cut. (WSJ)

Most investors believe that inflation has been beaten. The stakes are high because the recent stock and bond rally was fueled by this belief.

- Arguments to be **optimistic**: core PCE of 3.5% YoY in Oct.; effects of pandemic fading; productivity normalized; lagged impacts of rate hikes still unfolding; and housing inflation should ease.
- Arguments to be **pessimistic**: economy has not cooled sufficiently (wage growth still high); investor optimism could be self-defeating; price pressures could resurge. (WSJ)

Durable goods prices (e.g., appliances, furniture, used cars) are down 2.6% over the past five months, helping to bring inflation down. Factors: supply chains are running smoothly; demand constrained by higher rates. Services inflation was +4.4% in October. (WSJ)

Corporate profits were a key driver of inflation in 2022, but pricing power seems to be fading. Consumers seem less willing to accept higher prices. Profit margins are clearly falling on the manufacturing side. (WSJ)

Commerce Department data shows Q3 before-tax corporate profits up 1.1% YoY. In Q2, they were down 6% YoY. If you exclude the Fed's losses, profits are up 6.7% and were up 1.6% in Q2. S&P 500 earnings were up 7.1% YoY in Q3 (after dropping 2.8% in Q2). The forecast is for 5.2% in Q3.

- Companies are less likely to fire people when earnings start rising again. Cyclical companies tend to drive profit and economic cycles. Profits tend to grow for a while and this makes a recession less likely. (WSJ)

In 2022, repairing an EV after a crash cost an average of $6,587 compared with $4,215 for all vehicles. Fixes tend to require more replacement parts, the vehicles are more complicated and fewer people do these repairs. Many parts are bolted or welded in the vehicles and the result is that they have to be replaced (not repaired). Repairs take ~57 days for EV vs. 45 days for non-EVs. EVs have ~50% lower maintenance costs (no oil changes, tune-ups or timing belts). EV insurance is ~$357 / month on average vs. $248 for gas vehicles. (WSJ)

Median net worth was $166,900 in 2021. Asians: $320,900; white $250,400; Hispanic $48,700; Black $27,100. Low-income white households had 21X the wealth of low-income Black households. Homeownership accounted for 2/3 of median household net worth. (WSJ)