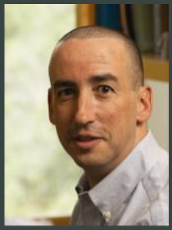

MARKET UPDATE

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December 4, 2023 – Market Update

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I. Markets

A. Stocks

November was an incredible month: DJIA +8.8%, S&P 500 +8.9%, Nasdaq +10.7% and volatility fell to pre-pandemic levels. The rally was triggered by a belief that the FOMC was done raising rates due to disinflation, cooler consumer spending and a loosening labor market. The 10-yr UST yield fell from above 5% in late October to 4.349%. The S&P 500 gained $3T in value and is just 5% below its all-time high. **Risks:** the market has believed this before, real rates are still high, market leadership is narrow (seven tech stocks account for 68% of the S&P 500 return; the top 10 account for 90%), stocks are expensive, and geopolitical risks remain. (WSJ) (Bloomberg) (Bloomberg)

On the positive side, the market rally did broaden out. In November, 10 of the 11 S&P sectors increased. Only energy dropped. With lower rates, real estate did very well.

The DJIA (+2.42%), S&P 500 (+.77%) and Nasdaq (+.38%) had their fifth consecutive positive week. Small caps did the best (IWM +3.11%). The Peak Fed narrative is driving the market right now, but the easing of financial conditions may make it more difficult for the Fed to lower rates. The VIX is at 12.63. In addition, realize that investors bought into this narrative before, only to be disappointed. Technical analysts believe that the market is overbought (RSI > 70 and prices far above the 20-day moving average). (Bloomberg) (Stockcharts.com)

S&P Value is up 14.68% YTD vs. S&P Growth +24.27% YTD. Growth has been helped by AI and the belief that the Fed would stop raising rates. Growth is trading at 21.2X forward earnings while Value is trading at 16.8X earnings. Growth has a PEG ratio of 1.20, while Value is at 1.37. (WSJ) (Yardeni)

The Magnificent Seven (AAPL, AMZN, META, GOOGL, MSFT, NVDA, TSLA) account for 28.9% of the S&P 500 market cap. These companies reflect genuine innovation and strong business fundamentals. At the same time, they could be overvalued and the trade could be crowded. These stocks account for 68% of the S&P 500's YTD gain. The top 10 account for 90%. (Bloomberg) (Bloomberg)

There has been a lot written about the amount of cash on the sidelines (almost $6T in the money market funds). Some of this is simply bank deposits searching for higher rates. Be careful in believing that all of this money somehow belongs in stocks. Aside from the fact that many investors are naturally risk-averse or need to hold cash, yields are still attractive at the 5% level. (WSJ)

Market strategists have turned bullish on the stock market for 2024. That's good news until you remember that many told us that we'd be in recession this year and stocks would do poorly. Coming into 2023, it was the first time this century that strategists predicted lower stock prices. They failed to anticipate the resilience of the US consumer (and the level of pandemic savings), the post-pandemic labor market, and the fact that rate increases were raising rates from a really low level. Some of the risks that remain include: savings running out, possibility of a recession, the labor force normalizing, narrow leadership (Magnificent Seven), slowing earnings, and inflation leading to more rate hikes. (Bloomberg) (Bloomberg)

Q3 net income for the S&P 500 increased 4.1% YoY. EPS were up **7.1% YoY** due to buybacks. (Barron's)

Bottom-up analysts are expecting that S&P 500 earnings will be $246.30 in 2024. Over the past 25 years, the estimate as of Dec. 31 (one year in advance) has been too high by 6.9%. The estimate was too high in 17 of the 25 years and too low in the remaining eight. In four of the 25 years, the estimates were 25% higher than actual earnings (2001, 2008, 2009 and 2020). If we take the estimate 6.9% lower, earnings would be $229.25. If you exclude the four extreme misses, estimates are typically 2% too high and earnings would come in at $241.38. (FactSet)

The market continues to want "Goldilocks" news – not too hot, not too cold. While higher growth means higher earnings, there is also fear that it could result in more rate hikes that make borrowing/spending harder. Remember that November's rally coincided with declining inflation. (Barron's)

B. Bonds and Debt

Bonds had a great rally in November. The 10-year yield fell 52.5 basis points (to 4.349%), the biggest monthly drop since August. TLT (20+ Year ETF) gained 9.92% (but is still down 3.66% YTD). The bond rally was caused by smaller-than-expected Treasury issuance and disinflation (leading to belief that the FOMC would stop raising rates). The term premium is gone from Treasuries and spreads are tight. (Barron's)

This past week, the 2-yr UST yield dropped ~35 bps (4.56%) and the 10-yr UST yield dropped ~25 bps (4.22%). The biggest moves seemed to come from Fed Gov. Waller's comments that rates would follow inflation down. Fed Chair Powell also said that policy rates are well into restrictive territory but also said that it is unclear whether policy is **sufficiently** restrictive. The markets barely paused when Powell seemed to warn the market. October PCE was released and was consistent with this story…headline PCE inflation was +3.0% YoY. Everyone will be watching this Friday's employment report and the Summary of Economic Projections on Dec. 13.

Dovish Fed comments have pushed the 10-year real yield down ~21 bps to 2.00%. Fed funds futures are projecting two rate cuts by the end of June 2024 and a Fed funds rate near 4% by January 2025. (CME)

II. Economy

While personal income and consumer spending both rose .2% in October, there are factors that could erode consumers' ability to spend: slowing income growth, high interest rates and prices, declining pandemic savings, the resumption of student loan payments. (WSJ)

The November ISM manufacturing index was at 46.7 in October. In addition, respondent commentary was cautious – consistent with a slower economy.

S&P CoreLogic Case-Shiller National Home Price Index rose 3.9% YoY in September and .7% MoM. Separately, the National Association of Realtors said that the median existing home sale price rose 3.4% in October to $391,800. Home sales are down because of high mortgage rates and low affordability. But low inventory is stopping prices from falling. The Atlanta Fed's Home Ownership Affordability Monitor shows that the median household income is only ~67% of what is needed to pay for the median house (based on the idea that the cost of housing should not exceed 30% of household net income). (WSJ) (WSJ) (Atlanta Fed)

OPEC+ announced a production cut of an additional 900K barrels per day. Their stated goal is to stabilize prices and to pre-empt potential demand weakness. The global economy is slowing. Nigeria and Angola opposed the changes, but Nigeria eventually agreed. The cuts are voluntary and investors are skeptical that they will occur. All of this is happening while tensions are high in the Middle East: conflict in Gaza, ship with Israeli ties was seized by Yemen rebels, and clashes between militias and the US in Iraq. Investors think that Saudi Arabia needs oil at $88 in order to balance their fiscal budget. (WSJ) (WSJ)

A Gallup poll shows that American workers are more unhappy and dissatisfied at work compared to prior years. Workers feel angry, stressed, and disengaged at work. The sources: inflation has erased any pay gains, the changing rules concerning remote work, and the cooling job market has left workers feeling stuck. (WSJ)

ACT scores are the lowest in 30 years. Only 20% of test-takers met college-readiness benchmarks in core subjects (English, math, reading and science) in 2022 (down from 24% in 2021). Another 43% met no benchmarks in 2022, up from 35% in 2018. Students are leaving school unprepared for college or work. Despite this, high schools are graduating students. (Bloomberg)

We continue to struggle with hard data that shows a strong economy and anecdotal evidence that shows fear and misery. Remember that data is backward-looking while anecdotal evidence provides real-time analysis. While retail sales show that spending remains resilient, the Beige Book shows the economy losing momentum, consumers pulling back ahead of the holidays, and labor demand and wages cooling. (Bloomberg) (KC Fed)

III. Key Fed Ideas

Fed Gov. Michelle Bowman seems to be the most hawkish member of the FOMC. She says that her base case is to continue to raise rates. She is concerned that recent inflation progress has been uneven, driven by supply-side improvements, increased labor participation (which could reverse or stop due to retired workers not returning to the labor force), and lower energy prices. She also seems to believe that higher investment demand could mean that the neutral rate is higher. (Bloomberg)

Fed Gov. Waller said that policy rates should follow inflation rates coming down. He said that this is consistent with the Taylor rule. Policy rates become more restrictive as inflation falls. While easier financial conditions may argue against lowering rates, Waller said that real economy data is more important. (Bloomberg)

Atlanta Fed Pres. Bostic expects continued disinflation because tighter policy is hurting economic activity, companies' pricing power is diminishing (customers resisting price increases, companies sacrificing margins to maintain market share) and wage growth is slowing. In addition, surveys are showing uncertainty and lower inflation expectations. (Atlanta Fed)

Fed Chair Powell said that the labor market is coming into better balance (job openings vs. unemployed people, increase of supply due to higher participation rate and immigration, pace of job creation slowing, wage growth moving toward the level consistent with 2%) **and that inflation is moving in the right direction**. He said that disinflation is due to normalization of supply/demand conditions and substantial tightening of monetary policy and financial conditions over the past two years. (Federal Reserve)

NY Fed Pres. Williams noted that unemployment has been below 4% for 21 months, the longest since the 1960s. At the same time, PCE has fallen to 3% (from 7% in June 2022). He said that demand is now better aligned with supply (food and energy disinflation) and supply chain bottlenecks are clearing up. But services excluding housing and energy is still suffering from 4% inflation. (NY Fed)

Investors believe that the FOMC will cut rates. The optimistic view is that the FOMC will cut rates regardless of whether there is a recession or a soft-landing. In the soft-landing scenario, rate cuts can be seen as insurance (to protect against a recession). On the other hand, the economy has been extremely resilient. Q3 GDP was revised higher to 5.2% and that does not scream "lower rates." (WSJ)

Inflation has cooled faster than the Fed predicted. Headline PCE was flat in October and up 3% YoY (lowest 12-month increase since March 2021). Core inflation rose .2% MoM and 3.5% annually. (It only rose 2.5% at a six-month annualized rate.) The Fed predicted headline inflation of 3.3% at the end of the year and 3.7% for core inflation. This makes it easier for the Fed to cut rates if the economy seems to be softening. (WSJ) (Bloomberg)

IV. The Dismal Side of the News

If ever you're feeling too happy, you can always turn to Nouriel Roubini's most recent writing. Here are some of his observations:

1. Despite the fading of short-term negative supply shocks (pandemic, Russia's invasion of Ukraine, China's zero-Covid policy), inflation is still well above 2% target
2. Deglobalization continues – countries shift from free trade to secure trade. Countries favor resilience ("just-in-case" supply chains) instead of efficiency ("just-in-time").
3. Aging societies are reducing the supply of workers at the same time as immigration restrictions.
4. Climate change is fueling energy and food insecurity and increasing costs.
5. AI can enhance cyber-warfare and disinformation (e.g., "deep fake" videos). It can also increase wealth inequality (which could lead to more wage-increasing fiscal policies).
6. The US is using the dollar as a foreign-policy tool and risks de-dollarization.
7. Rising debt levels are starting to matter more as interest rates have increased. Central banks are caught in a "debt trap" trilemma: how to achieve price stability while also avoiding a recession and a financial crisis.
8. Monetization of debt is a greater likelihood as deficits grow due to:
    a. Intensifying rivalry between the West and China, Russia, Iran, North Korea and Pakistan. You also have the conflict in the Middle East and Russia's invasion of Ukraine.
    b. The battle against climate change. To keep the average global temperature from going more than 1.5 degrees Celsius above pre-industrial levels (which we are expected to reach in the next five years), we would have to cut greenhouse-gas emissions in half by 2030.
    c. The battle against future pandemics. These could become more frequent with climate change.
    d. The disruptive effects of "globotics" – the combination of globalization and automation is threatening more occupations.
    e. Fight against income and wealth inequality. These issues are fueling a backlash against liberal democracy and free-market capitalism.
    f. Aging will require tremendous spending on health-care and pension systems
9. Higher spending without more tax revenue will lead to greater structural deficits. This will lead to debt levels that could result in a debt crisis. Growing deficits and lower private savings (due to aging) will result in higher real rates.
10. Many of these problems could result in stagflation and a secular bear market. (Project Syndicate)

Emerging markets are facing a daunting external landscape: tough financial conditions (higher global interest rates, a strong dollar) and central banks that may leave rates high for longer. Continued concerns over supply chain security and national security are resulting in fragmented trade. We're seeing more trade restrictions (3,000 were imposed in 2022, 3X the amount in 2019). Emerging markets also face tremendous costs for climate adaptation (estimated $2T annually by 2030 globally). (IMF)

Republicans are holding hearings on fiscal commissions, but there is a lot of skepticism. The 2011 "supercommittee" didn't work and Congress won't follow the rules if they don't want to. There doesn't seem to be any real desire to cut deficits. These commissions may also remove incentives from the normal budget process. (Bloomberg)