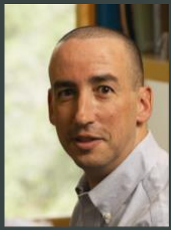

MARKET UPDATE

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February 13, 2023 – Market Update

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I. Stocks

A. Last Week

1. Last week: DJIA -.2%; **S&P 500 -1.1%**; Nasdaq -2.4%; S&P 600 -3.5%
2. Until this week, **fighting the Fed** has been a winning strategy. The S&P 500 is up 15% since the start of Q4 and 16% from its October low. Investors had been betting that the rate hikes have been priced in and the Fed will achieve a soft landing. What this really shows you is that you don't want to fight the tape. (Bloomberg)
    a. One study shows that the S&P rises 9% on an annualized basis between the bank's first and last rate increase. (Economist)
3. **Trades favoring disinflation may reverse** as price increase prove more entrenched than anticipated. Higher-duration sectors such as tech and consumer discretionary have led stocks' advance, while low duration ones such as energy and utilities underperformed. (Bloomberg)
    a. Tuesday's **CPI report** will be crucial.
4. The **VIX, VVIX and the put-to-call skew ratio** are rising. (Bloomberg)

B. Earnings

1. With more than 2/3 of S&P 500 companies having reported Q4 earnings, just **69% are topping estimates** – below their average of 76% for the past four quarters. In addition, they're **only beating estimates by 1.6%**, vs. the 5.3% average over the past year. Future earnings **estimates are also dropping**: Q1 estimates have fallen 4.5% versus an average 2.6% historically. (Barron's)
2. During the month of **January**, bottom-up S&P 500 earnings **estimates decreased by 3.3%.** Estimates typically drop in the first month of a quarter, but this is larger than the 5-year (1.5%), 10-year (1.8%), 15-year (2.2%) and 20-year (1.7%) average.
    a. **Full-year (2023) estimates decreased by 2.5%.** This was also larger than the 5-year (1.2%), 10-year (.3%), 15-year (1.2%) and 20-year (1.0%) average. (FactSet)
3. The biggest tech firms (e.g., META, AAPL, AMZN, GOOGL) in aggregate have missed consensus Q4 earnings estimates by 8%. What's bizarre is that **Big Tech outperformed during this period**. Excluding tech, S&P 500 top-line growth has been 5.6% and bottom-line growth has been 5.9%.

C. Technology – Junk Rally?

1. While **lower rates** (until this week) helped tech, there was more going on.
2. The Nasdaq climbed more than 10% despite (or because of?) **layoffs.** (Bloomberg)
    a. Maybe with concern about margins, tech layoffs have made them look like leaders. (Bloomberg)
3. A GS basket of **unprofitable tech stocks** is up 28%. BAC says that the **most shorted** 10% of S&P 500 stocks has outperformed the least shorted by ~14% in 2023. Companies whose earnings missed estimates outperformed the S&P 500 in the five days following the results. This is a junk rally – where the lowest-quality stocks do the best. (Bloomberg)
4. Tech stocks are starting to look **expensive relative to real yields**. The tech P/E has jumped to 24. (Bloomberg)

D. Concerns About the Market

1. Stocks have **rallied in the face of worsening earnings and economic expectations**, producing a **massive disconnect** (according to MS). Economically sensitive shares have surged relative to defensive stocks, a sign of confidence in future growth. Yet indicators of retail sales, manufacturing and business leaders' confidence have been weakening, as have earnings.
    a. There's a belief that we're going to start to see the **impact of rate hikes**.
        i. Outside of the labor market, we've seen a weakening economy.
    b. Gains may be attributable to **short covering** and **the seasonal tendency** of investors to flock to the biggest losers from the previous year.
    c. The rush into **short-dated options** is another sign of speculating/chasing returns.
2. **Short-term yields are headed higher and the inversion is worse**.
    a. Fear that the Fed may raise rates to 6%.
        i. A Citi strategist predicted a 6% Fed funds rate and a 15% drop in stocks.
        ii. **Financial conditions** have eased, contrary to what the Fed wants.
3. The market is **relatively expensive** (18.3X earnings) – a relatively low earnings yield relative to cash.
4. **Retail investors are becoming bullish**. The latest survey from the AAII showed US retail investors turned bullish for the first time since April with the bull-bear spread rising to 12.5 from -4.7 a week earlier. The percentage of investors with a bearish view over the next six months fell to 25%, the lowest since Nov. 2021.
    a. Sentiment always follows price.
    b. **Trading orders from retail investors accounted for 23% of total volume** in late January. This beat the previous high of 22% reached during the 2021 meme mania.
    c. At the same time, GS says hedge funds are trimming their positions.
5. Technically, the recovery is reaching the same half-way point that stopped the rally in Aug. The **50% retracement indicator** failed in August and may fail now.

(Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg)

E. General Knowledge

1. Since WWII, there have been **nine bear markets that have been accompanied by recessions**. They've averaged a 35% decline vs. 28% for the **three without recession**. After those three, the new bull market started within five months of stocks hitting a new low.
    a. The **peak-to-trough** real GDP declines aren't correlated with the severity of the stock move. **But shorter recessions** have led to more rapid rebounds. (Bloom.)
2. Estimates put **passive investing** in the US as ~40% of assets. It's cheap and it's outperformed for most of the past 20 years. But remember, with a cap-weighted index, you're putting more of your money into the stocks that have gone up the most. Maybe passive investing can be thought of as **momentum investing**. Will today's great companies be tomorrow's? (Bloomberg)

II. Rates and Currencies

A. Rates

1. UST:3-month 4.79% (+9 bps); 2-yr 4.50% (+20 bps); 10-yr **3.74%** (+21 bps)
    a. The 2/10 yield curve inverted by the **widest margin** since the early 1980s, a sign of flagging confidence in the economy's ability to withstand additional Fed rate hikes. The 2-year has increased **41 bps** since Feb. 2. (Bloomberg)
    b. Treasury yields rose the most in a month as the market decided that the Fed may have to continue to raise rates.
2. The market has taken the **implied Fed funds rate higher and the yield curve inversion steepened** as shorter-term rates increased more than longer-term rates.
    a. If you examine the **six inversions since 1976**, the **average duration is 13 months**. At present, the **2/10 inversion has lasted seven months**.
    b. Every time the **inversion reversed**, it was due to both the **two-year and 10-year moving lower**, with the two-year moving further. It never became normal from the 10-year moving higher.
    c. The current inversion is the **most significant since the 1980s** and that makes sense b/c that's the last time that the Fed was so aggressive. If this research is correct, we should expect the 2-year yield to come down in the next year. (Bloomberg)
3. The 30-year fixed-rate mortgage was **6.12%**, up from 6.09% (last week). It was the first time the rate increased in more than a month. (Bloomberg)
4. Many investors assume that once we beat inflation, rates will be low again. The idea is that an **older population = lower rates** because of the need to save plus slower growth with fewer people working.
    a. Harvard professor Ken Rogoff argues that people in developed countries aren't saving enough and will **depend on the government to pay for their consumption and medical care.** This will lead to more government borrowing.
    b. With less production, inflation could go higher. (Bloomberg)

B. Currencies

1. U.S. **growth prospects** remain the top factor driving currencies. The strong jobs report made investors believe that we could have either a soft or hard landing. (MarketWatch)
2. U.S. investors have been betting on Europe and emerging markets with the belief that the Fed would finish raising rates sooner and the **dollar would retreat**. Last week, as fears of a more aggressive Fed reignited, the dollar strengthened. (Barron's)
3. EM currencies moved back down to their 200-day moving average and this has hurt EM stocks. Outside of China, **EM is basically a "short-dollar" trade**. The shift in the market's view about Fed policy is resulting in a firmer dollar and hurting EMs. At the same time, US growth should be good for EMs.
    a. The spread of EM real yields over US real yields has narrowed recently.
    b. The spread of US P/B vs. EM P/B makes EM look attractive. (Bloomberg)

III. The Fed

A. Statements from Fed Officials

1. Atlanta Fed Pres. **Bostic** said that last week's strong jobs report raises the **possibility** that the Fed will **need to increase rates to a higher peak than previously expected**. He reiterated his base case for 5.1% (and keeping it there through 2024). He said that we need to understand whether the jobs report was anomalous. He expects inflation to be in the "low 3s" this year, requiring rates to be higher for longer. (Bloomberg)
2. On Tuesday, **Powell** stuck to his message that **rates had to continue to move higher**. He even suggested the idea that **rates may have to go higher than traders anticipate**. He believes that labor inflation is crucial to inflation in core services excluding housing. (Bloomberg)
3. Minneapolis Fed Pres. Neel **Kashkari** said that the Fed funds rate **needs to reach 5.4%.** (Bloomberg)
4. NY Fed Pres. **Williams** said that the **December SEP forecasts are still a good guide** for where rates are heading. He also said that policy **may need to stay at restrictive levels for a few years. If inflation worsens or financial conditions loosen, rates may need to go higher**. He noted that rates were **barely restrictive now**. (Bloomberg)
5. Richmond Fed Pres. **Barkin** said that it's important for the Fed to **continue to raise rates** to ensure that inflation is brought back down to the 2% target. Demand is slowing, but still resilient, labor markets are healthy, and we have the enduring shock of Russia's invasion. So it should be no surprise that **we still have inflation**. While the past three months inflation reports have been positive, we have to be confident that the things people care about are under control. He said that we still have a ways to go. (Bloomberg)
6. Philadelphia Fed Pres. **Harker** said that the odds of a soft landing have increased but that the Fed funds rate **must get above 5% and stay there** to ensure that price pressures ease. (Bloomberg)

B. Other Comments about Monetary Policy

1. Former Treasury Sec'y Lawrence **Summers warned about complacency in the financial markets**. He suggested that the **Fed may need to tighten more than the market expects** in order to get inflation down to 2%. He said that some factors that have been helping inflation drop (like used-car prices) are reversing. In addition, financial conditions are very loose. (Bloomberg)
2. The market is questioning if it's even possible for the Fed to walk the line to do what they're aiming to do b/c it's a very difficult job – slowing the economy down through interest-rate increases while keeping us from having a severe recession. (Bloomberg)
3. One senior strategist from Macro Hive is forecasting that the **Fed funds rate will have to go to 8%**. This estimate is based on her analysis of a **Taylor Rule model**. She warns that the **2-year UST yield will go above 6%**. This analyst previously worked in the NY Fed's markets group.
    a. Former Fed Presidents **Jeffrey Lacker and Charles Plosser** wrote a recent WSJ opinion piece that, if inflation stays where it is now, typical policy rules would recommend a rate between **6.5% and 8%** by the end of the year. (Bloomberg)

IV. The Economy

A. Inflation and Recession Terminology

1. **Hard landing** – inflation recedes to 2%; economy enters recession
2. **Soft landing** – inflation recedes to 2%; growth slows, but no recession
3. **No landing** – Torsten Slok (Apollo) describes the "no landing" scenario as one in which the economy doesn't slow down (and even revs up) and upside risks to inflation return after the initial decline in inflation (that was driven by supply chain improvements). This scenario would lead to higher rates for longer and would create downside risk for stocks and bonds. (Bloomberg)
4. **Rolling recession** – one in which one industry suffers a contraction, then another, but the economy as a whole never swoons and the job market largely holds up. So far, housing has been hit and then came manufacturing. (Bloomberg)

B. Inflation News

1. "**Immaculate disinflation**" is the term being used to describe the possibility that the Fed could **eliminate high inflation without causing a massive rise in unemployment**. This is slightly different than a **soft landing** which envisions eliminating inflation without causing a recession (but still causing the economy to slow).
    a. If the Fed did pull off an "immaculate disinflation," we would have to go back and remember all of the ridicule they endured when their summary of economic projections forecast lower inflation without rising unemployment. (Bloomberg)
2. **Used care prices rose 2.5% in January MoM**, retracing some of last year's 15% decline. Prices are down 12.8% YoY. Used-car prices are ~4.5% of its core inflation rate. These are also a bellwether for new-car prices. Used-car retail sales were up 16% in January MoM and 5% YoY. (Bloomberg)
3. The **S&P CoreLogic Case-Shiller index has slipped ~20%** since June 2022. The question is whether this has bottomed given that mortgage rates are off their high. (Bloomberg)

C. Oil Prices

1. WTIC rose **8.6%** this week.
2. **Russia plans to cut its oil output by 500K barrels per day next month**. They say that this is to retaliate against western sanctions. The question is whether this is actually retaliation or their output is being limited. (Bloomberg)
3. The **five integrated majors** – BP, Chevron, Exxon Mobil, Shell and TotalEnergies had more than a trillion dollars of **cash flow** last year – **40% higher than the prior peak** (2008). They have shed more than a fifth of their workforce since 2008.
    a. **FCF after cap-ex was more than double**. Cap-ex is only expected to return to 2018 levels (in nominal, not real terms). The majors used to reinvest $3 or $4 for every dollar of dividends and buybacks, but the balance is now more even. They will produce less oil and gas in 2023 than 15 years ago. (Bloomberg)

D. Labor

1. Last Friday's jobs report was only the **second time in 25 years that the rise in payrolls had topped the highest estimates by more than 200K**. But average hourly earnings didn't rise.
    a. The implied Fed funds futures rose for Jan. 2024. (Bloomberg)
2. A study by a Stanford economist indicates that **nearly 10% of workers have a side gig**. By contrast, the **jobs report showed that 5% do**. In addition, **13%** of full-time employees are fully remote, **59%** are full-time on site and **28%** are hybrid. (Bloomberg)
3. **Retailers are moving toward automation** with self-checkout, robotic sorting machines and automated customer service. Fewer low-paid workers will be needed. **Walmart** employs **~1.7MM** workers and **Amazon** employs **1.5MM** around the world. (Bloomberg)
4. The **median annual pay** for **recent college graduates (age 22 – 27) was $52K last year**. This is a **7.4% decline** in real terms. For **high school graduates**, **wages increased 6% to $34,320**. Americans with only a high school diploma made **93%** of what the bottom 25% of recent college graduates made. That is up from 79% in 2021. (Bloomberg)
5. **Last year, wages increased more than stocks**. In 1980, a week's wages at then-minimum $3.10/hour bought shares of the S&P 500 that now would take 3.5 months.
    a. In the four decades through 2021, the S&P returned **11.9%/year**, while wages increased **3.28%/yr.** After last year, it was 11.2% and 3.32%.
    b. The federal minimum wage is still $7.25 and hasn't changed since 2009. (Bloom.)
6. **Less than 1/3 of lower-income families participate in the stock market**, while 70% of middle-income ones and 90% of the top-decile ones do.
    a. A 2019 Fed paper said that the median value of stock holdings for the bottom half of the income distribution was ~$10K vs. $40K for the upper-middle-income group and roughly $439K for the top decile.
    b. A Gallup poll last spring said that ~58% of Americans own equities, down from ~62% in 2008. The survey confirmed that 90% of the top decile own stocks and 25% of those making under $40K do. (Bloomberg)

E. Fiscal Policy

1. The **$31T of debt is bad, but the 4.3% average deficit** (as a % of GDP) from now until 2027 **is worse**. **Publicly-held debt** is currently 102% of GDP (was under 80% pre-pandemic). It's approaching the record 106% after WWII. Back then, the deficit was 1.6% in 1947 and 4.3% in 1948. If the deficit is greater than the nominal growth rate of the economy, it's a problem. Boomers are retiring and productivity is sluggish. (Bloomberg)
2. **Powell said that we're on an unsustainable fiscal path**. Powell looks at whether debt is growing faster than GDP. Janet Yellen looks at real net interest as a share of GDP. She said that was historically closer to 2%, but now we're under 1%. (Bloomberg)
3. Approximately **84% of Republicans and 86% of Democrats want Social Security benefits to grow**. Fewer than 5% of claimants wait to age 70 to start benefits. More than 50% get most of their income from Social Security. The average check is $1,676. (Bloomberg)
4. Social Security's retirement **trust fund is projected to be depleted after 2034**. The **Medicare trust fund** should be exhausted by **2028**. (Bloomberg)