



MARKET UPDATE

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I. Last Week

A. The Big News – High Inflation and a Strong Consumer

1. **Headline and core PCE inflation** both increased **.6% MoM**, the largest increase since last summer. The forecast for core was .5%. Headline was up 5.4% YoY and the core was up 4.7% YoY. The Fed has clearly not broken the economy. Inflation seems sticky and persistent. It's not coming down as quickly as expected. ([Barron's](#)) ([MW](#))
 - a. Services inflation excluding housing and energy services increased .6%. ([Bloom.](#))
2. **Real consumer spending jumped 1.1% MoM**, the most in nearly two years. Consumer spending was driven by an increase in motor vehicle sales, as well as food services and accommodations.
 - a. Incomes rose .6%, bolstered by an increase in wage growth. Social Security had its COLA increase and that helped to offset the expiration of the extended child care tax credit.
 - b. Real disposable income increased 1.4% MoM in January, the largest increase since March 2021 when the government distributed stimulus payments. ([Bloom.](#))

B. Stocks

1. **Last week:** DJIA -2.99%; **S&P 500 – 2.67%**; Nasdaq -3.33%
 - a. **YTD: Nasdaq +8.87%**; S&P 500 +3.40%; DJIA -1.00%
 - b. The S&P is down 7.78% since Russia's invasion. Gold is down 4.43%. ([Bloomberg](#))
2. For the YTD through Feb. 22, the S&P 500 was up 3.81%. **Eight stocks** were responsible for 3.05% of that gain: META, AAPL, AMZN, NFLX, GOOGL, MSFT, NVDA, TSLA. ([Barron's](#))
3. The S&P 500 is still trading at **17.5X forward earnings**. The YTD rally has been driven entirely by multiple expansion as forward earnings have decreased. ([Barron's](#))
4. **Why have stocks defied higher rates?**
 - a. This was just a bear market rally.
 - i. Maybe stocks are in a new regime and less sensitive to rates. There is more concern about growth and earnings. ([WSJ](#))

C. Are We in a New Bull Market?

1. During the first 30 days of the year, cyclicals beat defensive stocks, small-cap beat large-cap, and growth beat value. It was **risk-on**. This type of behavior is consistent with the start of a new bull market.
 - a. At the same time, the **Rule of 20** says that 20 minus the inflation rate should give you the market multiple. If CPI was 6.4%, that would mean a P/E of 13.6. ([Bl.](#))
2. Only 40% of **BofA's checklist of indicators** for a new bull market signal that one has started. Normally, at market bottoms it's 80%. ([Bloomberg](#))

D. Continued Fears About Stocks

1. **Higher interest rates** could wear down the market. **Inflation** seems persistent and Fed officials are hawkish.
 - a. The Fed will only pivot if there is very negative macroeconomic news.
 - i. If you want the Fed to pivot, we're going to need a weaker economy – which will result in lower corporate profits. If the economy continues to be strong, the Fed will continue to tighten. Neither scenario is promising for asset prices. ([Barron's](#))
2. **The Fed is still tightening.** We've never seen a low before the Fed has stopped hiking.
 - a. In the past, the S&P 500 hit a low only after the Fed stopped raising rates (and closer to when the Fed is almost done lowering). ([Bloomberg](#))
3. **The early-year rally may have been misleading.** The S&P's 6.2% January rally may have been fueled by short sellers covering their bets.
 - a. Investors are chasing rallies. Last week, ODTE options hit 50% of all S&P 500 option volume.
4. **Earnings appear weak.**
 - a. Profit growth is negative on a YoY basis (for just the fifth time in 20 years).
 - i. If the dollar rally continues, this could hurt earnings. Geopolitical fears could push the dollar higher. ([Bloomberg](#))
 - b. Net profit margins have fallen to 11.3% in Q4. This is the sixth consecutive quarterly decline from the 13% peak in 2021. Rising input costs, such as labor, materials and energy are hurting margins. This can portend an economic slowdown and leave companies struggling for cash (and lead to layoffs).
 - i. Stocks have gained an average of 5.3% after a year of falling margins (since 2002). The average annual return during that period is 6.6%.
 - ii. Analysts are expecting \$222.29 / share in 2023. Expectations for 2023 were \$250.32 in May of last year. ([WSJ](#))
5. **Stocks are expensive.**
 - a. According to Morgan Stanley the equity risk premium is only 1.6% and rates are headed higher while earnings estimates could drop 20%. (MS's Michael Wilson says stocks are in the "death zone.")([Bloomberg](#)) ([Barron's](#))
6. **Retail investor optimism.**
 - a. Retail investors purchased a net \$32B in US shares and ETFs over the 21 trading sessions through Thursday. ([Bloomberg](#))
 - b. JPM says that investors have become far too optimistic. It's too early to take a recession off the table as Fed policy works with a lag.
7. **The yield curve is inverted.** ([Bloomberg](#))

E. Venture Capital

1. **Fundraising by VC firms hit a nine-year low in Q4.** They raised \$20.6B, a 65% drop from Q4 2021 and the lowest Q4 since 2013. This was less than half of the amount raised in Q3.
 - a. Without the payouts from portfolio companies going public (IPO shares are typically distributed to LPs who sell them), LPs had less to invest in new funds.
 - b. As stocks have dropped, **endowments and pensions are overweight** in PE.
2. **Limited partners invested in 226 VC funds in Q4, the fewest since 2012.** The invested in 620 in 2021 Q4. In 2022, LPs backed 141 funds run by first-time managers, a 59% decline from 2021 and the lowest number since 2013.
3. **The VC funds invested less in tech stocks as fewer went public and valuations dropped.**
4. **Some funds have reduced the fees they charge due to slow investing.** Rather than charging a % of the committed capital, they are charging on the amount invested. ([WSJ](#))

F. Random Investment Data

1. Despite fears about stocks and a crypto crackdown, **Bitcoin has gained 40% YTD.** ([Bl.](#))
2. **Fidelity has ~30MM 401(k) accounts and only 299K have \$1MM or more,** down from 442K last year. The **average is \$103,900,** basically the same as the average IRA balance (\$104,000). The average contribution rate (including employer and employee contributions) is **13.7%**, just below Fidelity's recommendation of 15%. Vanguard found that the average 401(k) balance was \$112,572. Nearly half, or 48%, of retired Americans believe they'll outlive their savings. ([Bloomberg](#)) ([CNBC](#)) ([Fidelity](#))
3. **More than 40% of the S&P 500 option trading volume is made up of 0DTE** (zero days-to-expiration) **options.** This is almost double what it was six months ago. JPM estimates that by November, **only 5.6% of this was retail investors.** The fear is that this could lead to **increased volatility.** Call-buying results in market-makers hedging (by buying stock) and put-buying results in market-makers hedging (by shorting stock). ([Bloomberg](#))

G. Rates, Currencies, Oil

1. UST: 3-month 4.86% (+2 bps); 2-yr 4.78% (+18 bps); **10-yr 3.95%** (+13 bps)
 - a. **Since Feb. 2: 2-yr +69 bps; 10-yr +55 bps**
 - i. The optimism of a Fed reversal has gone away. Powell's talk of disinflation is a distant memory.
 - b. The Fed funds futures market sees a peak rate of **5.40%.** In early Feb., the peak was thought to be 4.88%. The FOMC's Dec. SEP saw a 5.1% peak. ([Barron's](#))
2. The **bullish and bearish case for the dollar:**
 - a. Bearish: Many investors think that the dollar has peaked as the bulk of the Fed's rate increases are done and that other central banks will keep tightening. A weaker dollar will bring lower import prices for developing nations and is likely to boost their stock prices.
 - b. Bullish if you think the US will do great or poorly: The **dollar smile** say that the dollar tends to outperform if the US economy is in a deep slump or growing strongly. The dollar underperforms during times of moderate growth. ([Bloom.](#))
3. **WTIC dropped .3% for the week.** The Fed's hawkish outlook was consistent with the argument that further monetary tightening will hurt energy demand. ([Bloomberg](#))

II. The Economy

A. Uncertainty in the Economy

1. **WMT's CFO** said that the company is being cautious because **“there's just a lot we don't know.”** He expressed uncertainty about consumer spending due to layoffs and income. ([Bloomberg](#))
2. **JPM CEO Jamie Dimon** said that **“there's some scary stuff”** in front of us. He said that the level of uncertainty for our economic future is worse than usual, including QT, Russia, oil, gas, war, migration, trade and China. He suggested that the Fed may pause and have to resume raising rates. He said that there was a 50% chance that the Fed would have to take rates to 6%. ([Bloomberg](#))
3. **When everyone was forecasting a recession for early this year, they missed:**
 - a. The long-tail of the fiscal stimulus
 - b. The excess consumer savings
 - c. Low interest rates that are fixed for homeowners. In 2008 – 2009, ~40% of homeowners had variable-rate loans; today, it's 10%.
 - d. A shrinking supply of labor led to **labor hoarding**
 - e. An undersupply of housing has kept the construction industry going
 - f. Looser financial conditions since the fall have led to optimism and made the Fed's job more difficult ([Barron's](#))

B. The FOMC Minutes

1. The FOMC minutes were **consistent with the belief that rates could go higher for longer.** Several officials said that an **“insufficiently restrictive” policy stance could stall progress** on moderating inflation. A few officials favored a 50-bp increase instead of 25 bps. ([Bloomberg](#)) ([Bloomberg](#))
2. The **FOMC minutes might matter less b/c there was crucial data released after the meeting,** including a huge jobs report and strong retail sales. In addition, CPI and PCE inflation were high. We know that if inflation keeps going, so will the Fed.
 - a. The minutes made it appear as if Powell misspoke about financial conditions having tightened. Everything shows that conditions had eased at the time of the FOMC meeting and have tightened since then.
 - i. A stronger dollar, weaker stocks and higher yields = tighter conditions
 - ii. Cheaper oil and small spreads are inconsistent w/ tighter conditions([Bloomberg](#))
3. Some FOMC participants stressed that a **drawn-out period of negotiations to raise the federal debt limit could post significant risks to the financial system and the broader economy.** There are already concerns about diminished liquidity in the Treasury market. ([Bloomberg](#))

C. Soft-, Hard-, and No-Landing

1. The **soft landing** and **hard landing** (and **no landing**) terms are an **analogy to a plane landing**. Of course, if there is no landing, the plane will eventually run out of fuel and crash. In reality, no landing with lower inflation may be great. But no landing combined with persistent inflation could be a disaster.
 - a. Alan Binder argues that seven of the 11 hiking campaigns since 1965 have ended softly. But, it's hard after inflation has already become a problem. ([Bloomberg](#))
2. The **argument for "no landing"** is the high CPI and PPI, as well as the strong labor market and the strong consumer. ([WSJ](#))

D. The Labor Market – Lower Supply and Higher Wages

1. **We've lost millions of workers from the work force, but we're not quite sure about the exact number or why.** The best estimate may be that if the LFPR was the same as pre-pandemic times, we would have had 168MM workers at the end of 2022, rather than 165MM. But in January, the Labor Department then revised their numbers and added 800K workers. In addition, that ignores the assumption that an aging population would naturally result in a lower LFPR. The current **LFPR is 62.4% and it was 63.3% pre-Covid.**
 - a. **Theories** include excess retirements, fewer retirees returning, low-wage workers leaving because people in big cities didn't return to work (and use their services), lower immigration during lockdowns (although immigration has picked up), and long-Covid. ([Bloomberg](#))
 - b. On the **positive side**, some retirees may have an incentive to return to work due to high inflation. In the US, we added more than 1MM immigrants in the year through mid-2022. ([WSJ](#))
2. **The prime-age LFPR of women has recovered (76.9%), but the prime-age LFPR for men (88.5%) is still .7% below the pre-pandemic level.** In every economic turndown, we see men exit the labor force. In a Census Bureau survey, more than one-third of men who weren't in the labor force chose "other reasons" to explain their absence. It's possible that more men now have partners that support them. With that said, non-working men have lower rates of marriage.
 - a. **Other possible reasons** include: the shift from manufacturing jobs, higher rates of women continuing their education, the opioid economic, disability compensation, and better leisure options. ([Bloomberg](#))
3. **Real wage growth since 2019 has been negative.** One reason for that is that **wages tend to be sticky**, changing relatively slowly and sluggishly, while prices change quicker. Now, slowing growth and the threat of layoffs may be tempering workers' demands.
 - a. Remember that the Fed is concerned with negative real wage growth (resulting in a lower standard of living). As Jim Bianco says, the main group that wants the Fed to relent in its fight against inflation is "a bunch of whiny people worried about their stock portfolios." ([Barron's](#))

E. Inflation Could Decrease

1. **YoY inflation numbers should start to decrease due to the base effect.** This is just saying that Feb – June 2022 MoM numbers were high. Jim Bianco thinks CPI will be down to **3.29% YoY by June**.
 - a. The problem is that **services account for 61.8% of CPI** and were climbing at a 7.6% annual clip through January and haven't peaked yet. ([Barron's](#))
2. **Twenty percent fewer companies have mentioned inflation in Q4 earnings calls**, but there are still 30 companies that need to report. ([MarketWatch](#))

III. Fiscal Policy

1. The CBO is estimating an **\$18.8T deficit over the next 10 years and mandatory spending will comprise 15.3% of GDP by 2023**. This is \$3T more than the last estimate b/c of higher interest rates and entitlement costs. None of this includes the Democrats' priorities: restoring the child tax credit, health care for all or student debt relief. ([Bl.](#))
2. New legislation that expands veterans' benefits will cost nearly \$800B over 10 years. Higher inflation is increasing entitlement program spending and interest costs.
 - a. Democrats seem to want boundless spending and Republicans want spending cuts but seem fine with deficits as long as taxes are lower. Neither is good. ([Bl.](#))
3. **The Biden administration continues to promise that no one who earns less than \$400K will pay more in taxes.** We know that we need to fix Social Security. But, even if we eliminate the cap on the Social Security payrolls tax, this would only cover 75% of the shortfall and if we eliminate the cap on income over \$250K, it's only 73%. If we limit this to income over \$400K, it will be even less.
 - a. Brian Riedl at the Manhattan Institute estimates that if we eliminate the cap and add in every other proposed tax on high earners, we'd end up with tax brackets above 70%. Plus, it would only bring in \$10T in new revenue, well short of the \$18.8T that we'd need. ([Bloomberg](#))
4. **A "debt bomb" occurs when a country's borrowings get so large that it has to borrow just to service the debt and meet interest payments.** This results in higher interest rates and more debt. Taxes have to increase and spending has to be cut. Interest payments are forecast to be as much as 6.2% of GDP by 2044 (in a high-cost scenario). Remember that our tax revenue is typically 17% - 18% of GDP. ([Bloomberg](#))
5. **More than 41MM Americans participate in SNAP (Supplemental Nutrition Assistance Program).** SNAP is funded through the farm bill every five years. Some extra assistance during Covid is coming to an end. The average person will get ~\$90 per month less. SNAP benefits will average ~\$6.10 per day. A family of three that earns less than \$30K / year qualifies. You can't receive benefits for more than three months within three years if you are between 18 and 49 and able-bodied. ([WSJ](#))