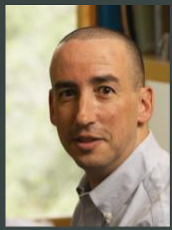

MARKET UPDATE

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February 6, 2023 – Market Update

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I. Markets

A. Stocks – Last Week

1. Week: DJIA -.2%; **S&P +1.6%**; Nasdaq +3.3%
    a. Nasdaq rose for fifth straight week; longest streak since Nov. 5, 2021
    b. Nasdaq +14.7% YTD (on Thurs., ~20% from Dec. 28 low); S&P +7.7% YTD (MarketWatch)
        i. But QQQ had also reached the **overbought** level on Thursday using RSI (and then dropped on Friday) (Bloomberg)
    c. Small cap stocks are up 13.2% YTD and are at an overbought level on the RSI (72)
    d. Emerging markets (EEM) dropped 3.36% this week (still +7.86% YTD) (Bloomberg)
2. Investors are attributing the **current market rally** (since Oct.) to **several factors**:
    a. Inflation has peaked
    b. The pace of rate increases has slowed and will soon halt
    c. China has reopened
    d. Europe was saved by a warm winter (Bloomberg)
3. With respect to **this week's rally**, there were **two positive events and one negative**:
    a. Lower employment cost index was positive surprise
    b. Powell's press conference (investors had expected more of a scolding)
    c. A jobs report that may have been too strong
4. The argument to jump into this rally is if you believe that we're going to keep employment strong and reach our inflation goal (Bloomberg)

B. Some Positive Possibilities

1. A stronger dollar hurt US earnings for the past two years; **weaker dollar** could provide a tailwind this year. (Bloomberg)
2. With the **VIX moving lower** and tech and **small-cap** stocks and **growth stocks** rallying, the **IPO market** could re-open. (Bloomberg)

C. Some Negative News/Ideas This Week

1. AAPL, AMZN and GOOGL posted results Thursday that indicated an economic slowdown is hurting demand. (Bloomberg)
2. The **S&P 500's P/E ratio** is up **8%** this year even though **earnings expectations** have declined by **1%**. Small-caps and growth (since mid-January) are outperforming. (Barron's)
    a. The market is trading at **18X earnings**. In order to get more multiple expansion, you would need inflation to abate and lower rates. (Bloomberg)
        i. This assumes that earnings stay constant.
3. If Oct. 12 was the bottom, it would be almost the **highest bear market bottom** ever. (Bloomberg)
4. Bespoke Investment Group describes this year's equity market performance as "a **dash for trash**." They said that the top 10% of the most heavily shorted stocks were up an average of 36.3% this year. The lowest 10% of stocks based on 2022 returns have risen 39.6%. (Barron's)
5. **0DTE** stands for Zero Days to Expiration. Speculators are rushing into these short-term options, yet this doesn't get measured by the VIX. (Barron's)

D. Pessimistic Comments

1. **Michael Wilson** (MS) thinks that the recent increase in stock prices is bringing in investors, but they're being led astray by **seasonal patterns** and **short covering**. Right now, we're rewarding companies that beat expectations and dialing back the punishment on those that don't.
    a. Earnings will be worse than expected. Q4 earnings are currently -5.3%.
    b. **Never fight the Fed**. (Bloomberg)
2. Nobel Laureate **Paul Krugman** thinks that investors have put **inflation** in the rear-view mirror too soon and that easing financial conditions could spark it again. He cites **rising food prices** and a **tight labor market**. (Bloomberg)
    a. Not only do rising asset prices create a wealth effect, they also make it cheaper for companies to raise more capital. (Bloomberg)
3. Black Swan author **Nassim Taleb** says that "Disneyland is over." A generation of **near-zero interest rates** triggered a monumental series of **asset bubbles** and turbocharged **inequality**. He said that crypto was indicative of the naivete in markets. (Bloomberg)
4. BAC's **Michael Hartnett** said that US stocks have already gone **too far** and investors face brutal declines if **economic growth** crumbles in the second half of the year. JPM's Marko Kolanovic said the **economy is headed for a downturn** at a time when **stocks are rallying**, setting up for a "clash." (Bloomberg)
5. Famed investor **Michael Burry** (The Big Short) sent out a one-word tweet on Tuesday. It said, "Sell." That turned out to be incorrect for the week. His relatively recent tweet that we were in recession was also incorrect. (Bloomberg)

E. General Knowledge -- Stocks

1. **Short-selling** is difficult as markets tend to **rise** over the **long-term**. In addition, your **winners are capped at 100%.**
    a. A recent academic paper argued that "on average 11% of large publicly traded firms are committing securities fraud every year." (Bloomberg)
2. **SPY** is the largest ETF ($375B). It has tremendous liquidity and there are options on it. (Bloomberg)
3. Strategas Securities says that **62%** of active, large-cap "core" funds **beat the market** in 2022 – the highest percentage since 2005. Fund fees (.63% vs. index .08%) weigh on active managers. **Possible reasons for outperformance**:
    a. The five largest companies were close to 25% of the index and many funds had underweighted them. AMZN, MSFT and TSLA fell hard.
    b. There may have been a stylistic tilt towards value (similar to first explanation).
    c. Funds hold cash reserves (which outperform in a down-market). (Bloomberg)

II. Bonds, Interest Rates and Financial Conditions

A. Last Week

1. USTs: 3-month 4.70% (-3 bps); 2-yr 4.30 (+11 bps); **10-yr 3.53%** (+1 bp)
    a. The 2-yr went to **4.09%** on Weds. And the 10-yr went down to **3.39%**
    b. UST yields surged on Friday as the **jobs report** came in stronger than expected and the **ISM Services report** was also strong – surging from below 50 to 55.2. The market moved from thinking one more rate increase to two. (Bloomberg) (MarketWatch)
2. Treasuries rallied since Oct. due to the belief that the Fed was nearing the end of its **tightening cycle**. The jobs report may have ended that belief. (Bloomberg)
3. Prior to Friday's drop in UST prices, speculators were taking **large short positions** on bond futures. They were effectively betting on either a hawkish Fed or continued strong growth. (Bloomberg)
4. **Creative destruction** (Joseph Schumpeter) is the idea that in order for the best companies to survive and flourish, the worst need to be destroyed. Rather than suck up more capital, they can go away and new entrepreneurs can do a better job.
    a. Yet, it seems like credit investors have lost all enthusiasm for creative destruction. **Defaults** are **low** and **credit spreads** are **narrow**. Either the world is in a genuinely good place or the money injected into the system in 2020 and 2021 is still distorting outcomes and leading to malinvestment. (Bloomberg)

B. Understanding Financial Conditions

1. The Fed wants **tight financial conditions that could reduce growth**:
    a. Rising mortgage rates cool off the housing market
    b. Higher lending rates make corporate investment more expensive
    c. A stronger dollar hurts manufacturing (exports more expensive; imports cheaper)
    d. Lower stock and bond prices create a reverse wealth effect (Bloomberg)
2. **Financial conditions** are the **loosest since last February** as investors bet that fading inflation will allow the Fed to stop raising rates and eventually cut them. (Chicago Fed) (Bloomberg)
    a. This means conditions are now looser than in March when policymakers began to raise rates. Remember that the minutes discussed an "unwarranted" easing in conditions that would complicate the Fed's efforts.
        i. While Powell doesn't want to declare victory over inflation, the market already has
    b. Dallas Fed Pres. Logan also had said that if financial conditions ease further, the Fed could offset the effect by gradually raising rates to a higher level. (Bloomberg)
3. **Pension situation could lead to even looser financial conditions**.
    a. With higher interest rates, more pension funds are fully funded. As a result, more will buy bonds to guarantee their income levels. This could push yields down and lower yields could lead to higher stock prices. (Bloomberg)

III. The Fed and the Markets

A. Powell's Press Conference

1. We entered the week **expecting the Fed to raise rates and Powell to scold the markets**. The FOMC did raise rates for the eighth straight time and signaled more to come, but the scolding never happened.
2. Powell's **press conference had the reverse effect** that we think he wanted.
    a. The Fed funds futures curve moved lower
    b. Interest rates moved lower
    c. The dollar moved lower
    d. Stock prices move higher
3. Some of **Powell's comments** that moved the markets:
    a. The very first question was whether he was concerned that financial conditions had eased. He should have said yes. Instead, **he said that financial conditions had tightened**. He said that "our focus is not on short-term moves, but on sustained changes" to financial conditions. (Bloomberg)
        i. Some investors think that this was a "slip" and that Powell let on that the Fed thinks that they've won. Bears think that the bulls just heard what they wanted to hear.
    b. He said that "the **disinflationary process has started**"
    c. He said that he believes in a **path** to getting inflation down **to 2% without** a significant economic decline or **significant increase in unemployment**
    d. He gave the market hope that if the Fed sees inflation coming down quicker than they expect, that would play into their rate-setting
    e. Describing the Fed as "**data-dependent**" implies that forward guidance doesn't matter. (Bloomberg)
4. Powell did say that he thought that there would be a couple more rate increases and that "I just **don't see us cutting rates** this year." (Bloomberg)
5. **Possible reasons that the market rallied** on Powell's press conference:
    a. Just a straightforward disagreement – the Fed thinks it will take some time to solve the problem and the market doesn't
    b. The Fed and investors disagree (described above) and the Fed is trying to use forward guidance to suppress demand but investors don't believe the guidance.
    c. Investors may believe that the Fed is using guidance dishonestly. In other words, investors may believe that the Fed is bluffing. This would mean that the Fed's **credibility** is being called into question. (Bloomberg)

B. The Strong Jobs Report and the Fed

1. We expected the week to end with the jobs report showing that supply and demand for labor had moved more into balance. That also didn't happen.
2. While the chance of a recession may be lower than we thought, that will make it **difficult for the FOMC to lower rates**. (Bloomberg) (Barron's)

IV. The Economy

A. JOLTs, Employment Cost Index (ECI) and Tech

1. The JOLTs report was released and the number of **job openings** increased from 10.4MM to **11MM** – a five-month high. The increase was mostly in accommodation and food services. Retail trade and construction openings also increased. The information sector (which includes many tech jobs) decreased. The ratio of **openings to unemployed people** returned to **1.9**. The **quits rate** held at 2.7% (4.1MM workers). (Bloomberg)
2. The **ECI** is the Fed's preferred measure of workers' pay. The 1% QoQ increase was a pleasant surprise. The **5.1% YoY** number is still too high.
    a. Labor costs have risen at least **1% for six straight quarters**, the longest streak in data going back to 1996. The ECI is not distorted by employment shifts among occupations or industries.
    b. Once industries that pay significant amounts of their wages via bonuses are excluded, **core wages are still rising**. In other words, companies with the flexibility to reduce pay by cutting bonuses have done so, but underlying wages are still increasing. (Bloomberg) (Bloomberg)
3. Everyone is talking about **tech layoffs**. But tech over-hired. In the past three years, **employee growth was 80%, but real sales only grew 60%.** In addition, cost cutting will minimize margin compression. Realize that markets can bottom before layoffs are done. Maybe layoffs are a necessary condition for a bottom. (Bloomberg)

B. The Jobs Report

1. Nonfarm payrolls increased **517K** in January and Dec. was revised up to 260K. The unemployment rate dropped to **3.4%**, the lowest since May 1969. The **Black unemployment rate** matched a historic low of **5.4%**. The **average workweek increased to 34.7 hours**, the highest since March. This makes it harder to believe that the Fed will end its tightening cycle. In addition, the **strong ISM services report** implies strong demand for employees.
    a. If you think about the increase in **total income** (people working x average # of hours x average income), it increased **1.5% MoM**. This indicates strong purchasing power. (Bloomberg)
2. Possible reasons **why the market didn't tank** on the strong jobs report:
    a. **Average hourly earnings were only up .3% MoM** and 4.4% YoY. (Bloomberg)
        i. But the Fed has to be concerned that the labor market is tight, service inflation (ex housing) is high and financial conditions have eased. (Bloomberg)
3. Some economists are questioning **whether the jobs report was misleading**. The report was complicated by the annual benchmarking process, as well as an update of seasonal adjustment factors and population controls.
    a. The population controls are part of the Household survey and track the unemployment and participation rates. The adjustment boosted the estimated population size by nearly 1MM and the labor force by 871K.
    b. In the establishment survey, without updated seasonal factors, payrolls fell by 2.5MM last month. But that's the smallest unadjusted decrease in January since 1995. This may reflect **labor hoarding**. (Bloomberg)
4. Just before the jobs report was released a **trader sold short 13,996 Fed funds futures contracts** (expiring in Jan. 2024). By 10 AM, he had a profit of $10MM as each basis point was worth $580K and the contract dropped from 95.59 to 95.405. (Bloomberg)

C. Inflation

1. Janet Yellen thinks that **low-inflation** will eventually return as a **long-term problem**. Larry Summers and Kenneth Rogoff think that **geopolitical tensions** and **debt crises** risk making **high inflation** and high interest rates more common. (Bloomberg)
2. **Spain's CPI** came in at 5.8% vs. expectations of 5.0%. Earlier in the month, **Australia** also saw higher inflation. Inflation has become more **synchronized globally**, so some economists wonder if we're going to see a second wave of inflation. (Bloomberg)
3. **Turkey** was the biggest buyer of gold among central banks last year, with households also rushing to buy it to store value. Turkey's inflation rate was as high as 85% last year before falling to 64% in December. The **Turkish lira depreciated** by almost 30% last year. The price of gold in lira increased by 40%. (Bloomberg)
4. **China's reopening** could lead to price pressures in two ways:
    a. A **negative supply shock** as workers are sick and absent.
    b. A **positive demand shock** as China reopens and purchases increase. (Bloomberg)

D. General Economic News

1. The **IMF raised its global GDP forecast** by .2% to 2.9% for 2023. This is the first increase in a year. This is still slower than the 3.4% expansion in 2022. Risks include China's recovery stalling, the war in Ukraine escalating, more emerging and developing economies experiencing debt problems, and inflation being more persistent. (Bloomberg)
2. **ISM manufacturing** dropped. There was a continuing drop in new orders. **New orders** have never fallen this low without the economy entering recession. (Bloomberg)
3. **Pending home sales climbed 2.9%** in December, the first MoM increase since Oct. 2021. Requests for home tours and people contacting agents are both up. (Bloomberg)
4. The percentage of US consumers living **paycheck-to-paycheck** increased from 61% to 64% (166MM people) in the year ending Dec. 2022. More than half of people making $100K+ are living paycheck-to-paycheck. The survey found that 24% of respondents had issues paying their bills in December. (Bloomberg)
5. **More than half of workers in major US cities went to the office last week**. This is the first time that the percentage crossed 50% since the pandemic. Austin had the highest level (68%). San Jose (CA) had the lowest (41%). (Bloomberg)