MARKET UPDATE

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I. Stocks and Bonds

A. Last Year

1. 2022: DJIA -8.8%; **S&P 500 -19.4%**; Nasdaq -33.1%. Worst year since 2008.
    a. The 20% drop hasn't been huge, but there have been three 10%-drops and this has lasted a long time. It's hard to think that you should buy the dip. FOMO is gone. (Bloomberg) (Bloomberg)
    b. The S&P saw 46 daily moves of 2% or more in either direction; most since 2008 – 2009. (Barron's)
    c. Value has crushed growth. The Russell 1000 growth dropped ~30% and Russell 1000 Value is down ~10%. The S&P 500 dropped twice as much as the DJIA. Value tends to outperform in inflationary times. (MarketWatch) (Bloomberg)
2. 2022 was dominated by **high inflation, higher interest rates and recession fears.**
    a. Nasdaq is more interest rate sensitive (explaining 33% drop). (Bloomberg)
    b. Borrowing costs are at their highest level since 2007. We could see more trouble in capital intensive businesses. (MarketWatch) (Bloomberg)
3. The market was driven by **macro factors**. The **Fed** mattered.
    a. All of the S&P's five biggest weekly declines took place immediately before or around a Fed meeting. (Bloomberg)
    b. For 83 sessions in 2022, at least 400 stocks in the S&P 500 moved in the same direction. (Bloomberg)
    c. Stocks moved in tandem with Treasuries (both dropped) and the dollar rose (with higher rates). Diversification didn't help you. (Bloomberg)
4. Bubbles were deflated (Nasdaq and crypto).
5. Valuations are more normal (as are interest rates)

B. Last Week

1. Last week: DJIA +2.0%; **S&P 500 +2.7%**; Nasdaq +4.8% (Barron's)
    a. The S&P 500 is above its **200-day moving average** and near 4,000. (Bloomberg)
    b. The Nasdaq 100 climbed for a sixth straight day, the longest winning streak since Nov. 2021. (Bloomberg)
2. So far in 2023, the **big trends from 2022 are reversing**:
    a. Interest rates are lower
    b. Dollar is lower
    c. The 60/40 portfolio is doing well
    d. Tech stocks are outperforming the S&P 500
    e. Crypto is bouncing
    f. Gold is doing well (weak dollar and low rates)
    g. Inflation expectations are lower (trend started last year) (Bloomberg)
3. The market is wrestling with whether we will have a recession or a **soft landing**.
    a. We're watching inflation, the labor market and the Fed closely.
    b. This past week, **CPI** was the most important release (discussed later).

C. Earnings

1. S&P 500 companies are expected to post a **3.9% YoY decline in earnings in Q4**. Excluding the five biggest companies, the estimate is -.9%. (Bloomberg) (Factset)
2. Analysts expect S&P 500 earnings to **rise 4.7% in 2023**, about in line with 2022. (WSJ)
3. MS's Michael Wilson said that **earnings estimates are still too high** and the **equity risk premium** is the lowest it's been since 2008. He believes that a peak in inflation would support bond prices and be negative for profitability. (Bloomberg)
   a. **Margins** tend to be mean reverting and workers are in a stronger position.
4. Everyone focuses on **operating earnings**, which could also be called, "earnings before whatever went wrong." Over the last 40 years, **reported earnings** have been, on average, 14% below operating earnings. The current forecast for 2023 is $223. GAAP 2022 earnings will likely come in around $181. The forward P/E of 17 is based on earnings that won't happen. This is the "price-to-fantasy." (Bloomberg)

D. Technology

1. Apple, Microsoft, Alphabet and Amazon comprise **16% of the S&P 500**, greater than the entire health-care sector, the indexes' second biggest industry. (Bloomberg)
2. The S&P tech sector still trades at 20X earnings, above its 10-year average of 18.9. (Bloomberg)

E. What's Doing Well Right Now?

1. **European stocks** have been outperforming over the past three months as there have been signs of slowing inflation, falling energy prices and optimism surrounding China's reopening. In addition, euro appreciation has helped US investors. (WSJ)
2. MSCI's **emerging market** index has rallied 20% over the past three months. The EM index tends to be inversely related to the dollar. A cheaper dollar lowers the debt servicing costs and results in looser financial conditions. In addition, the weaker dollar creates value for foreign assets on its own (when converted back to dollars).
   a. **Multinationals** tend to do well when their home currency is declining because this will increase the value of revenues overseas. (Bloomberg)

F. Bonds and Rates

1. UST – 3-month: 4.67% (NC); 2-yr: 4.22% (-2 bps); 10-yr: **3.49%** (-4 bps)
2. The **30-year mortgage** rate is at **6.42%**. Refinancing remains near the lowest level in 20 years. (Bloomberg)
3. Treasury Sec'y Yellen warned that the U.S. would hit its **debt ceiling** on Thursday. The Treasury has enough cash and other ways to raise money to pay its bills until at least early June. With a Democratic-controlled Senate and Kevin McCarthy running the House with a small majority and having ceded enough power to a small group of legislators, this could be a disaster.
   a. Pres. Biden's 2023 budget calls for a $1.2T deficit, larger than Pres. Trump's $984B deficit (pre-Covid). Remember that both Trump's and Biden's trillion-dollar deficits happened or are happening when unemployment is at historic lows (meaning that everyone is paying taxes). (Barron's)

II: The Biggest Issue…Inflation

A. Background

1. Supply-chain issues, input shortages, rising rents, concentrated demand for goods, Russia's invasion of Ukraine, stimulus payments, pent-up demand, labor shortages, – all added to inflation over the past 18 months. (WSJ)
    a. Pre-pandemic, higher inflation would have been seen as a great thing
2. Inflation is a **worldwide problem**. Consumer prices across the G-20 (80% of world GDP) rose 9% YoY in Nov., down from 9.5% in October. That was actually the first drop since Aug. 2021. (WSJ)

B. The CPI Report

1. Thursday, we got the CPI report (Fed's 2% goal is actually based on PCE price index)…
    a. **Headline** -.1% MoM; +6.5% YoY
    b. **Core** +5.7% YoY; +.3% MoM – **decelerating**
        i. In fact, it was +3.4% in the first six month and +2.2% in the last six (Bloomberg)
        ii. In the past three months, core inflation is only up **3.1%** on an annualized basis
2. The report was a **positive report** – 6th consecutive monthly deceleration
    a. Slowest monthly pace since Oct. 2021 (WSJ)
    b. Headline inflation is down from **9.1%** in June and 7.1% in November
    c. Investors took the CPI report to mean that price pressures have peaked and the **Fed can slow the pace of rate hikes**. Others worry about resilient consumer demand and a tight labor market. (Bloomberg)
3. Realize that **shelter costs were up .8% MoM**. But this is a lagging indicator. Rents are stabilizing and even decreasing right now, but it takes a while for this to work its way into the inflation numbers. Think of it as new leases need to be signed. So this means that inflation is artificially high right now. (Bloomberg)
    a. Services inflation (+.6%) is what scares us the most and that includes rent.
        i. If you strip out energy and rent (and OER), services were up .3%.
        ii. If you annualize the past three months, they are only up 2.6%. Not long ago, this was 7.1%.
    b. If you also exclude goods, inflation was up 2.9% on an annualized basis off the past three months. (WSJ)

C. Other Key Inflation Numbers to Know

1. Increases in **average hourly earnings** are +4.6%. That's probably only 1% too high.
    a. Think about 2% inflation and 1.5% productivity.
    b. In the last three months of the year, wages grew at a 4.1% annualized rate.
    c. Remember that real wage growth is negative (WSJ)
2. **PCE core goods inflation** over the past three months are annualized at **-1.9%**. Affects averages.
    a. The **Cleveland Fed's trimmed mean** (6.5%) and **median CPI** (6.9%) have not turned down enough.
    b. The **Atlanta Fed's sticky price inflation** is 6.7%.
        i. Even the last three months annualized rate is still close to 6%.
3. The Employment Cost Index (ECI) will be released Jan. 31. (Barron's)
4. There are still **1.7 job openings for every unemployed person**.
    a. Unemployment is at a 50-year low.
    b. We've lost workers – our participation rate is lower than pre-pandemic.

III. The Fed

A. Background

1. We've had the **fastest tightening** in 40 years.
2. The FOMC's **dot plot** does not match the **Fed funds futures**
    a. The Fed is not going to lower rates while the labor market is so strong. The resiliency of the **job market** will keep Fed policy restrictive. (Bloomberg) (Bloomberg)
3. Powell is concerned with inflation for **core services excluding housing** and he believes that **wages** are crucial to this rate.
    a. Has the increase in wages been a one-time bump as companies adjust to scarce labor and a realization that labor was undercompensated or is this a feedback loop in which prices and wages drive each other up?
4. **Average hourly earnings** are key for two reasons:
    a. The longer incomes remain healthy, the longer households keep spending
    b. But continued growth in wages will keep inflation high
5. We learned that we could increase rates **more than 25 bps at a time**. (Project Syndicate)
6. The Fed knows the **risk of being wrong**.
    a. Powell does not want to be the next Arthur Burns
        i. They don't want expectations to become unanchored

B. Key Ideas from the FOMC Minutes

1. The Fed believes that **tighter financial conditions** (higher borrowing costs and lower stock prices) are necessary in order to lower inflation. (WSJ)
    a. "An unwarranted easing in financial conditions, especially if driven by a misperception by the public of how" the Fed will react to economic developments "would complicate the committee's effort to restore price stability."
    b. Remember – the Fed's strategy is to use a tightening of financial conditions to spur the corporate sector into driving a slowdown that will curb inflation. Higher stock prices, lower yields, lower spreads and a weaker dollar all do the opposite. (Bloomberg)
        i. $1T of wealth has been created in the stock market since the FOMC minutes were released. (Bloomberg)
2. The FOMC still **hasn't seen enough progress in ending inflation**. (WSJ)
    a. Minutes said that officials in the last month "stressed that it would take substantially more evidence of progress to be confident that inflation was on a sustained downward path."
3. There are many **downside risks** to the economy. (Bloomberg)
    a. "The sluggish growth in real private domestic spending expected over the next year, a subdued global economic outlook, and persistently tight financial conditions were seen as tilting the risks to the downside around the baseline projection for real economic activity."

C. Issues to Consider

1. SEP vs. Fed funds futures
    a. Are market participants being swayed by declining goods inflation?
2. How high will the FOMC have to raise rates?
3. How long will rates have to stay there?
4. Can the economy just slow down or do we need a recession? (Bloomberg)
5. Do we have another conundrum (like 2006)
6. Growth that continues to be too high is a risk; growth that is too low is a risk.

D. What Will the Fed Do?

1. Everyone is saying **higher rates**: Powell, Bostic, Esther George, Mary Daly, Bullard
    a. Atlanta Fed Pres. Bostic said that the Fed should raise rates above 5% by early Q2 and then go on hold for "**a long time**."
    b. KC Fed Pres. Esther George said that Ed should hold above 5% into 2024. (Bloomberg)
2. With that said, they're only going **to raise 25 bps** (this used to be normal) in Feb.
    a. **Lags** between Fed rate increases and their effect on the economy mean that it will help to have some time
        i. One of the reasons that our lags are so large is the fact that we have predominantly fixed rate mortgages.
        ii. Once demand weakens, studies estimate that it can take another 6 – 12 months before pullbacks quiet the rate of inflation.
    b. Raising rates in gradual steps allows you to be more data dependent
3. Chicago Fed Pres. Evans, who retired this week, reminded us that **25-bps doesn't mean that the Fed is stopping**. (WSJ)
4. Don't forget that we still have **high inflation** and a lot **left over** from the pandemic:
    a. Excess savings
    b. Billions in fiscal appropriations are still being distributed
    c. Strong order pipelines and the need for inventory replenishment are sustaining businesses
    d. Employers who fought hard to hire scarce workers are reluctant to fire them (Richmond Fed)
5. Powell has said that history warns against "**prematurely loosening policy**." Of course, when the market ignores Powell and makes markets more accommodative, it increases the chance of aggressive Fed policy.
    a. If you back off on inflation and it comes back stronger, the Fed will have to do even more. This puts their **credibility** at risk. (Richmond Fed)

IV. The Economy

A. The Good and Bad News

1. The **good news**:
    a. The jobs report was the goldilocks report – really increased enthusiasm. We added 223K jobs and wage growth slowed to 4.6% (.3% MoM). Participation ticked up.
        i. This is the argument for the soft landing. (Bloomberg)
2. The **bad news**:
    a. The inverted yield curve
    b. The ISM Services index contracted – below 50 – first time since May 2020.
    c. The decline in manufacturing overtime hours is consistent with a recession. (Bloomberg)
    d. Approximately 46% of credit cardholders don't pay off credit cards in full each month, up from 39% a year earlier. About 43% of those with debt aren't aware of the rates associated with their cards.
        i. If you roll over $5K of credit card debt over five years at 20%, it balloons into $12,441.
        ii. Around 45% of those making less than $50K cleared their balance each month vs. 63% of those making $100K. (Bloomberg)

B. Some Grim Forecasts

1. IMF Managing Director Kristalina Georgieva warned that the **global economy faces "a tough year, tougher than the year we leave behind."**
    a. She said that "we expect one-third of the world economy to be in recession." She said that the three big economies (US, EU, China) are all slowing simultaneously.(Bloomberg)
2. The World Bank forecasts that global GDP will probably increase 1.7% this year, about half of their forecast in June. This would be the third-worst performance in the last 30 years, after the contractions of 2009 and 2020. (Bloomberg) (WSJ)
    a. A global recession is defined as a contraction in annual global per capita income and it has been rare due to growing emerging markets.
3. Economists now say there is a **7-in-10 chance** that the US economy will sink into **recession** next year (up from 65% chance in November and more than double what it was six months ago).
    a. High inflation, the end of fiscal stimulus, weak export markets are problems.
    b. Businesses have turned cautious about adding to inventories and hiring.
    c. Excess savings are dwindling.
4. **Larry Summers** reminds us that all major reductions in the past 70 years have been associated with recessions.
    a. The Salm **Rule** demonstrates that whenever unemployment rises by more than half-a-percent within a year, it goes on to rise by 2%.
5. Alan Greenspan
    a. A **recession is the most likely outcome** at this time. While the last two monthly inflation reports did show a deceleration in the rate of prices increases, prices are still increasing.
        i. Wage increases, and by extension employment, still need to soften for a pullback in inflation to be anything more than transitory.
    b. The Fed must be a moderating force on animal spirits. **If the economy is based on creative destruction, you have to have some recessions**.

C. Barkin – What we have to figure out in 2023

1. ***Is inflation calming?*** Are consumers slowing spending? Are supply issues resolving? What are business leaders' attitudes toward pricing? How are consumers reacting to higher prices?
2. ***Is the labor market cooling?*** Will we see layoffs spread beyond housing and tech? Will those on the sidelines finally come back into the workforce? Will compensation increases continue, or slow?
3. ***Are we headed for a recession?*** Businesses seem to have pulled out and updated their recession playbooks. What happens next? Do they turn the pages in the book, or return it to the shelf?
4. ***How much of the pandemic economy sticks around?*** Do the sectors that benefitted from COVID-19 (e.g., recreational goods) get a permanent boost? How will commercial centers evolve in the context of hybrid work? (Richmond Fed)