MARKET UPDATE

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January 23, 2023 – Market Update

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I. Markets

A. Stocks

1. **Last week**: DJIA -2.7%; **S&P 500 -.7%**; Nasdaq +.55%
    a. S&P 500 is still up 3.5% this year; Nasdaq is +6.4%
    b. Long-term trend is still negative
2. **Good news for stocks**
    a. ~3/4 of S&P stocks are up 20%+ from 52-week low
        i. AAPL, AMZN, TSLA, MSFT, META – ½ of S&P losses over past yr
        ii. Equal weighted S&P +17% since Sep. 30
    b. Communication services and consumer discretionary both up >5%
        i. Staples, utilities and healthcare have all declined more than 2%
    c. Maybe no recession: Value stocks holding up (outperformed growth) since Aug.
    d. Increased belief in **soft landing**
        i. Lower yields and inflation, China reopening, lower Europ. energy prices
    e. Maybe since Oct. 12, investors believed things couldn't get worse (UK gilt panic, Chinese protests, strong dollar) – and inflation had peaked
        i. Back-to-back calendar year declines have only happened twice since 1950
    f. Lower **VIX**
3. **Stock market concerns**
    a. Market-driven fears:
        i. At 17.3X earnings, market still not cheap
        ii. Bear market usually results in recession (11 of past 14 times)
            1. Earnings normally drop 20% - 30% in recession
        iii. Concern about Q4 earnings (-4.6% so far) and forward guidance
            1. 55 S&P companies reported: ~2/3 beat estimates (vs. 80% last qtr)
        iv. Market driven by institutional short covering and retail inflows
    b. Fed doing what they say they will do (due to tight labor market) – recession?
        i. Weaker cap ex expected (6% growth for next year)
        ii. Existing home sales fell 1.5% (11th straight monthly decline)
        iii. Weaker consumer (retail sales -1.1% in Dec; fell ¾ last months; +9.2% YoY)
        iv. Disinflation may not progress smoothly
        v. China reopening could be inflationary (and spread Covid)
        vi. All Fed speakers discussed continued rate hikes (fear 1970s mistake)
    c. Bonds show recession fears – TLT (UST 20+ years) +6.7% YTD
        i. 50-day advance >12.5%; 3rd consecutive month outperforming S&P
        ii. Inverted yield curve
    d. Debt ceiling
4. Europe continues to outperform the US – 100 week moving average
    a. Continue to have cheaper valuations (13X vs. 17X) and euro strengthening
    b. BAC survey of fund managers: almost lowest amount ever overweight US

(MarketWatch) (Barron's) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (WSJ) Bloomberg) (Bloomberg) (Bloomberg) (WSJ) (Barron's) (MarketWatch)

B. Bonds

1. UST last week: 3-month 4.72% (+5 bps); 2-yr 4.14% (-8 bps); 10-yr **3.48%** (-1 bp)
    a. Yield curve **inversion**: 3-month/10-yr – 124 bps; 2-yr/10-yr – 66 bps
    b. 30-year fixed-rate mortgage down to **6.15%**
2. There is a lot of **uncertainty** in the bond market – are yields sliding b/c lower inflation will make Fed less aggressive? Or recession fears?
    a. JPM survey of bond market participants – 80% are neutral (no conviction)
    b. **MOVE index** is double pre-pandemic levels
3. **Past week**:
    a. Emerging consensus that Fed will raise rates only one or two more times
    b. BOJ said it would continue with large-scale bond purchases to keep its cap on the 10-year Japanese government bond yield at .5%.
    c. Conflicting economic data
        i. Continued weakness in manufacturing sector, larger-than-expected fall in US retail sales, further decline in producer price index
        ii. Strength in jobs market (weekly jobless claims +190K)
4. Global issuance of investment- and speculative-grade government and corporate bonds across currencies reached **$586B through Jan. 18**, the biggest amount on record for that period. Very little of this is actually junk debt.
    a. **Spreads** have moved lower

C. Gold

1. Gold is up **14.4%** since the mid-October low for stocks.
2. Different **explanations**:
    a. Drop in the dollar
        i. Saudi Arabia may be willing to settle oil trades in other currencies
    b. Lower interest rates
    c. Drop in cryptocurrencies ("digital gold")
    d. Geopolitical fears
    e. Possibly more inflation if Fed pivots too soon

(Bloomberg) (WSJ) (MarketWatch) (Bloomberg) (WSJ) (Bloomberg) (Bloomberg) (Barron's)

II. Debt Ceiling

A. Background

1. Debt ceiling is a **statutory maximum** as to how much debt the gov't can accumulate.
2. **Does not result in spending**. Simply says you can borrow enough to pay for obligations.
3. Debt ceiling has been raised **78 times** since 1960; **20 times** since 2001.
4. Only one other developed nation (Denmark) has a debt ceiling and they don't use it as a political weapon.
5. The limit applies to **total debt** – including intragovernmental debt.
6. When we hit the debt ceiling, the Treasury Department uses **accounting gimmicks** to postpone day of reckoning. They withhold contributions to gov't retirement funds.

B. Financial Implications

1. Would eventually mean **defaulting on US Treasuries, Social Security, Medicare**.
2. If debt ceiling is not raised, we would have to **balance the budget** ($1.5T deficit).
3. US debt could be **downgraded**.
    a. We had a crisis over this in 2011 and our bond rating was downgraded.
4. Could drive up **interest rates** (government borrowing costs). An increase in risk-free rate decreases value of all assets.
    a. Money would flow out of Treasury money-market funds and into commercial banks.
    b. Treasury auctions may be weak.
5. Could undermine confidence in **dollar**.
6. Markets expect a resolution, so **stocks** could be hurt.

C. Political Issues

1. The 2011 debt scare had a similar situation: Democratic President and Senate; Republican House
2. **Kevin McCarthy** agreed to use debt ceiling as leverage to get spending cuts. Also agreed that it would just take one representative to call for a no-confidence vote.
    a. Republicans haven't even agreed on what spending they want cut. Commentators have referred to it as taking hostage without demands.
    b. One idea is **prioritization**: pay Treasuries and delay other payments.
3. **Democrats** refuse to negotiate spending cuts. Arguing that they want to protect Social Security, Medicare and climate investments.
4. Most non-partisan observers believe that we need to change the course of future spending and taxation. But refusing to pay our bills is not a solution.
    a. **Wall Street** is widely opposed to using the debt ceiling for political leverage.

D. Fed Involvement

1. Fed never wants to imply that they would get involved in politics.
2. But, to save financial system, they may **buy USTs and accept USTs as collateral**.

(Brookings) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (WSJ) (Bloomberg) (Bloomberg)

III. “The U.S. Economic Outlook and Monetary Policy,” Dallas Fed Pres. Lorie Logan (01-18-2023)

A. Inflation

1. **PCE inflation** have averaged **5.8%** since Jan. 2021
2. Incomes fall short (particularly low-income), businesses can’t plan, expectations change
3. Run-up in inflation has **two sources**:
    a. **Special circumstances**
        i. Energy – volatile due to pandemic and invasion while production low
        ii. Manufacturing – high goods consumption, prices now falling; China risk
        iii. Housing – bigger homes; low mortgage rates; supply changes slowly
    b. **Core services excluding housing** (health care, transportation, dining, etc.)
        i. Running at 4% - 5% for two years
        ii. A symptom of an overheated economy, particularly a tight labor market

B. Employment

1. Important b/c part of **dual mandate** and driving **service inflation**
2. Wages growing **5%** by variety of measures (but moderating)
    a. Productivity has only grown 1.25%/yr from 2012 – 2019
3. **1.7 job openings** for every unemployed person
4. Payrolls growing by more than 200K workers per month
    a. Household survey numbers lower 2022: ~3.1MM jobs added vs. 4.5MM
5. **Supply** needs to increase or **labor demand** has to decrease
    a. Several million workers below pre-pandemic trend (drop in real wages, early retirements, deaths, long-Covid, child care issues, lower immigration)
    b. When workers available, they often lack necessary training or skills

C. Interest Rates

1. **4.25% increase** in Fed funds rate this year is largest in four decades; also **QT**
    a. Pushes up rates for consumers and companies
    b. **Financial conditions tightened** – 10-yr UST +~2%; mortgage rates +3%
    c. Since Sep. FOMC meeting, **real medium-term rates** have averaged >1.5%
        i. This is restrictive since most believe **real neutral rate** is <1%
2. Need to manage **two risks:**
    a. Tighten too little – economy will remain overheated; expectations rise
    b. Tighten too much – too many job losses
3. How will economy respond – there are “**long and variable lags**”
    a. Could labor supply increase? Productivity increase? Wage pressures decrease?
    b. Or new geopolitical headwinds or rising inflation expectations?
    c. Financial conditions could ease or tighten for unrelated reasons
4. Fed policy needs to be **flexible and robust**
    a. Don’t lock in on peak interest rate – data can be mixed (e.g., labor data)
    b. Slow pace of rate increases to make better decisions; this **could reduce interest rate volatility** (easing financial conditions) – so have to raise rates more
5. Need to see: better inflation statistics; balanced labor mkt; economy meeting forecasts

IV. Staying the Course to Bring Down Inflation, Fed Gov. Lael Brainard (01-19-2023)

A. Background

1. **Financial conditions** have **tightened**; 2-yr TIPs yield +4.5% to 2.1%; 10-yr TIPs yield +2.25% to 1.2%; mortgage rates have doubled; spreads have widened; stocks have dropped 17%; dollar has appreciated
2. **Inflation** has been **declining** while **growth** has been **moderate**
    a. Yesterday, industrial production showed weaker manufacturing sector
    b. Retail sales showed moderation in consumer spending
3. **Subdued 2023**: Drops in real income, wealth, sentiment, and ISM services at 49.6
    a. Real disposable personal income: dropped annualized 4.1% through Q3
        i. So recent consumption is based on savings
    b. **Growth below potential** in 2022 and 2023 due to monetary and fiscal policy
        i. Financial markets adjust immediately, actual changes lag (GDP, labor, inflation)

B. Employment

1. **Labor markets** remained **tight** – U-3 rate 3.5%; layoffs below pre-pandemic levels; quit rates low; jobs / unemployed person is high (but lower than peak)
2. Recent declines in **average weekly hours** (bottom of 5-yr range), **temporary-help** services (peaked in July), **payroll growth** – all show **demand is cooling**.
    a. Payrolls +540K/month in Q1; +250K/month in Q4
3. But **labor supply** remains **constrained** – participation rate 1% lower than pre-pandemic
4. **Wages growing faster than consistent w/ 2% inflation**, but no wage-price spiral
    a. Real wages have fallen (labor share of GDP dropping)
    b. Compression in real-wage distribution as low-income has done better
    c. **Price-price spiral**: retail prices rising faster than input costs; should reverse
5. **Avg. hourly earnings** 4.1% (Q4 annualized) vs. 4.5% on 6-month; 4.6% YoY

C. Inflation

1. **Headline PCE** is likely to be **~2.3%** annualized on 3-month and 6-month; vs. 5.1% YoY
    a. Easing in energy and core goods inflation (each subtracted ~.75% recently)
2. **Core PCE 3.1%** on 3-month annualized; 3.8% on 6-month annualized; 4.5% YoY
    a. Drop in core import prices, easing of supply chains, inventories restocked, less demand; core goods will likely flatten out (after these large decreases)
3. **Housing** is **+8.8%** on 3-month basis vs. 7.7% YoY; will decline by Q3
4. **Non-housing services +4.4%** on 3-month basis – **wages** are key
    a. Persistent components (transportation, recreation, food, accommodation) peaked in early 2022
5. We must continue to defend the **expectations anchor** – looks good so far
6. **No wage-price spiral**: trends in core goods and non-housing services are good: deceleration in wages, anchored expectations, scope for margin compression
    a. Demand could weaken further without significant loss of employment
7. **Risks**: China's exit

V. Other Issues

A. General Economic Issues

1. **China's population** started shrinking in 2022 for the first time in six decades. The drop was small (850K) from 1.413B to 1.412B.
    a. Fewer women of child-bearing age, less willingness to have babies, Covid
    b. **India** may pass China as most populated country
    c. 62% of population are working age (16 – 59); was 70% a decade ago
2. It's possible that **inflation could drop and bounce back**.
    a. Prices rise. Then, they drop, but are still far higher than the original price. The drop is measured as a YoY deflationary event. Then, prices increase again.
3. **Strong labor market**
    a. Almost **80%** of laid-off workers found a new gig in less than three months.
    b. Only **190K** first-time jobless claims were reported (down 15K).
4. **Weak housing market**
    a. Existing home sales -1.5% MoM; -17.8% YoY
        i. First-time buyers = 31%; cash buyers = 28%
    b. Housing starts fell for year for first time since 2009

(Bloomberg) (WSJ) (WSJ) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloom.) (Bloom.)

B. Economic Studies

1. A Chicago Fed study argues that industrialized countries may be able to bring inflation down without triggering huge jumps in unemployment.
    a. Just studying the most recent ~9 years (with only 1.5 years of recovery), found that **Phillips curve had steepened**. This means decline in inflation leads to smaller increase in unemployment.
        i. Also referred to as a smaller **sacrifice ratio** (how much employment you have to give up to curb inflation)
    b. The results are simply driven by idea that drops in unemployment are associated with larger increases in inflation during the recovery.
    c. Prior to pandemic, the **Phillips curve had been flattening**. This means that to change the inflation rate, it requires a large move in employment.
2. KC Fed found that **some companies raised prices** not only b/c their costs were higher, but **b/c they anticipated rising costs**. Those price increases drove inflation higher.
    a. Found that these higher markups were a significant cause of inflation.
3. Raj Chetty (Harvard) found that the **US is missing about a fifth of pre-pandemic low-income workers**. Some have moved to higher-paying jobs. But, even after adjusting for that, the poorest quarter of the workforce was still 13.5% below pre-pandemic levels.
    a. Wealthy neighborhoods were hardest hit. Workers (who lived nearby in less wealth neighborhoods) may have moved to places more affordable. Plus, increase in child care cost makes work unprofitable. (Bloomberg) (WSJ) (Bloomberg)