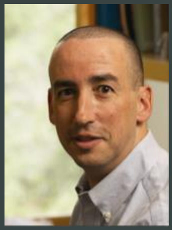

MARKET UPDATE

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January 30, 2023 – Market Update

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I. Markets

A. Stocks – Last Week

1. DJIA +1.8%; **S&P 500 +2.5%**; Nasdaq +4.3%
    a. S&P 500 is approaching 53^{rd} "**golden cross**" since 1930 (50-day/200-day MA)
        i. Markets trade higher 71% of time in next yr – so not meaningful
    b. **Advance-decline line** advancing returning to close to 2022 high
    c. Communication services, consumer discretionary and IT are outperforming
        i. Staples, healthcare and utilities are laggards
        ii. Tech rallying despite disappointing earnings and layoffs
        iii. Energy is now 8.5% of growth; tech is now 16.6% of value
2. **Key news** from week:
    a. Fed seems successful (so far) in move toward **soft landing**
        i. **PCE price index**: +.1% MoM; 5.0% YoY (down from 5.5% in Nov.)
            1. Core PCE: .3 MoM, 4.4% YoY
        ii. Consumer spending fell .2%
        iii. Univ. of Michigan consumer sentiment improved to 64.9
    b. But **labor market needs to weaken significantly before Fed pivots**
        i. Jobless claims: 186K
    c. **Global markets** doing well: China reopening and lower European energy prices
        i. Investors put $3.4B into European stock funds (week ending Weds.)
            1. $300MM went into US equity funds
        ii. MSCI EAFE +16% in three months; MSCI Emerging Markets +19%
3. **Reasons to like stocks:**
    a. Momentum
    b. US money market funds have $4.8T (high liquidity)
    c. Back-to-back declines only twice since end of WW II
4. **Reasons to be nervous:**
    a. Still concern over earnings (expect 4% growth for 2023)
        i. Will be helped by weaker dollar, China, lean inventories, cost-cutting
        ii. MS Michael Wilson is bearish on earnings. All good news is priced in.
        iii. JPM: pricing power starting to reverse, just as margins near record-high.
    b. Expect Powell to push back against stock rally
        i. Fed won't like easing financial conditions w/ inflation still too high
        ii. Powell wants to see a sustained period of below-trend growth
    c. S&P 500 has never bottomed before a recession
        i. Leading economic indicators negative; inverted yield curve
        ii. GDP tends to collapse all at once in a recession
5. Bears may be right, but they're too early (and missing a great rally)

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

B. Bonds and Interest Rates

1. UST yields: 3-month: 4.73% (+1 bp); 2-yr: 4.19% (+5 bps); 10-yr: **3.52%** (+4 bps)
2. **Risk premiums** for investment-grade and junk are both near 10-yr averages
3. 30-year mortgage fell from 6.15% to **6.13%**
4. **Fed funds futures** market pricing in 25 bp rate increase this week
    a. With rate eventually reaching 4.90% (i.e., 4.75% - 5%)
5. Global investment-grade bond **issuance** has been **> $400B** in January
    a. Interesting to see the rush to issue and the rush to buy
6. Debt ceiling issues don't seem to be impacting the bond market
    a. In fact, market overconfidence in a debt ceiling resolution may send the wrong signal to lawmakers and create more risk (Bloomberg) (Bloomberg)
    b. In 2011, USTs rallied around debt crisis and S&P's downgrade of US debt
        i. State Street's CEO says markets aren't as liquid – capital may be withdrawn
7. Some fear that buying **emerging market debt** is a consensus trade (weak dollar)

(Bloomberg) (Bloomberg) (Bloomberg)

C. Currencies

1. Evidence that the **dollar is not losing its prominence**:
    a. Nearly 60% of global currency reserves are in dollars (euro is second: 20%)
    b. ~40% of the world's debt is issued in dollars
    c. ~40% of global trade is invoiced in dollars (4X larger than US share of trade)
    d. ~42% of volume across SWIFT network for interbank transactions is in dollars
    e. Almost 90% of all foreign exchange trades involve the dollar
    f. Half of the $2T of notes in circulation are outside the US
    g. Dollar is a haven in good times and bad times – known as the dollar smile
2. Tokyo inflation jumped above 4% -- seen as a leading indicator of the national trend
    a. Yen rose with belief that BOJ would become more aggressive

(Bloomberg) (Bloomberg)

D. Crazy Solutions Being Discussed for the Debt Ceiling

1. By law, the Treasury is allowed to mint platinum coins for commemorative purposes at any denomination. One crazy suggestion is to **mint a $1T platinum coin** and deposit it at the Fed. This would be clear **monetization of the debt**. Any administration could spend whatever they pleased.
2. Another suggestion would be to **issue high-coupon rate bonds** (low face value).
3. Some argue that the **14th Amendment** says that the validity of American public debt "shall not be questioned" and that this implies that debt could be issued in defiance of the debt ceiling.
4. Some argue for **prioritization**, but that still means defaulting on some payments.
    a. Fitch says that this would put the AAA-rating at risk. Moody's says that they would focus on the debt and interest payments.

(Economist) (Bloomberg) (Brookings) (Bloomberg)

II. The Economy

A. Inflation

1. **Headline PCE** +5.0% YoY; +.1% MoM
    a. **Core PCE** +4.4% YoY; +.3% MoM
    b. The worst inflation seems to be over. At the same time, **service inflation** was up **.32%** last month and the labor market is tight.
2. **China's reopening** could result in greater demand for commodities (higher inflation). At the same time, it could ease supply-chain bottlenecks.
3. The cost of **shipping a container** from Asia to the US peaked at $8,585 in March 2022 and has since plummeted to $1,200, the lowest since 2018. (WSJ) (Bloomberg)

B. Labor – Mixed Signals

1. **Strong** labor market
    a. 3.5% unemployment rate
    b. 186K jobless claims
    c. The JOLTs report indicates job openings are still very high (10MM)
    d. Walmart, the largest private employer, is raising its starting wage 17%.
2. **Loosening** labor market
    a. In Dec., 826K unemployed workers had been out of work for 3.5 – 6 months, up from 526K in April 2022
    b. Postings on Indeed – software developers -38.5% on Jan. 6 YoY; media -30.8%; banking and finance -25.6%. Overall, postings were down 9.9%.
    c. Payrolls grew an average 375K per month in 2022, down from 562K in 2021
    d. An NABE survey showed about a third of respondents say their firms are not facing any labor shortages. Only 12% think headcount will rise in the next three months. Approximately 40% said margins have declined over the past three months.
3. Everyone is watching the recent decline in **temporary jobs**. This is often a harbinger of recessions. They're they first to be added when demand is picking up and the easiest to cut when growth is slowing. The number of temp workers **fell for the fifth straight month** in December (from a record high in July). The drop is 3.5% (or 111K workers).
    a. The Fed wants to see this in their bid for a soft landing.
    b. On the other hand, maybe the temp worker market just reflects the wonkiness of the pandemic. We hired people to track infected people and to take calls at call centers. We also hired people for warehouses. Maybe we're just normalizing.

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

C. The Fed

1. The Fed doesn't like the **loose financial conditions** and may overtighten out of desire to prove their tough on inflation.
2. The annualized QoQ PCE inflation rate slowed from 4.7% to 3.9%. This means that the **real Fed funds rate is positive.**
3. Much research has argued that low rates result in greater wealth inequality as low rates can result in higher asset prices. But a new NY Fed paper suggests that **higher mortgage rates may be exacerbating wealth inequality**. Higher rates stop low- and moderate-income families from purchasing homes and starting to accumulate wealth. Monetary policy affects not only the value of assets, but who is able to purchase those assets. First-time home buyers are even more impacted. (Bloomberg) (Bloomberg)

D. GDP and Other Indicators

1. GDP grew at a **2.9% annualized rate in Q4**, slowing from 3.2% in Q3. About half (1.46%) of the 2.9% was from **inventory growth**. **Trade** added .56%. Gov't spending also had a large impact. Personal consumption grew 2.1%. **Spending on equipment** declined 3.7% and **residential investment** dropped at a 26.7% annual rate.
   a. Real final sales to domestic purchasers rose an annualized .8%.
   b. Final sales to private domestic purchasers climbed .2%.
2. The **inverted yield curve** predicts recession. **Low corporate spreads** indicate everything is fine. These spreads tend to be correlated with jobless claims and the unemployment rate.
3. Since 1960, there have only been six times in which the reading on the **Leading Economic Indicators** was as low or lower as Dec. 2022.
   a. The LEI has dropped by 1% (or more) for three consecutive months. In every prior period when this has happened at least two months in a row, we were already in recession.
   b. We have actually never dipped below -1% YoY without seeing a recession in subsequent months.
   c. Soft data tends to be worse than the hard data.
4. The percentage of **subprime car buyers** who were at least 60 days delinquent on their payments was **5.67%** in December. This is up from 2.58% in April 2021. In the financial crisis, it peaked at 5.04%. The rate on the average new car loan was 8.02% in December and it can be much higher for a subprime borrower. In addition, cars are much more expensive.

E. Recession

1. There have been a tremendous number of headlines about recession this past year – particularly last summer.
   a. Recently, however, **many prominent economists and banks have become more optimistic** in the chance of a soft landing. Larry Summers, Fed Gov. Chris Waller, IMF's managing director and JPM have all said that things aren't looking as bad as expected.
   b. Of course, economists' odds of recession often drop right before recession.
   c. Our ability to predict the economy (and stocks) is limited. Maybe we just need to find ways to understand the current situation.
2. A recent NY Fed paper found that the **term spread (yield curve) and leading indicators** are strong predictors of recession in the short-run. The **unemployment rate and inflation** are strong predictors in the medium term.
   a. There is a lower chance of recession if the yield curve is steeper, corporate bond spreads are more narrow, leading indicators are improving, inflation is decreasing, and unemployment is increasing.
3. The **three industries that normally fall in recession**:
   a. Housing – has fallen back to pre-pandemic levels
   b. Durable goods spending saw a massive rise and has moved sideways for two years
   c. Capex has continued to grow but is well below the pr-pandemic trend
4. High household income, a lower share of income going to housing, and low need for corporate debt issuance are all keeping the economy going.
   (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg)

III. After a Timeout, Back to the Meat Grinder, Jeremy Grantham (Jan. 24, 2023)

A. The State of the Bubble: Things Get More Complicated

1. The S&P 500 needs a rally of **33%** to recover last year's losses in real terms; Nasdaq needs **61%**, and **ARKK** (Cathie Wood) would need to triple.
    a. AMZN, GOOG, META need to rise 70% - 150% to regain their 2021 peaks
2. People attribute last year's performance to **unexpected events** (Russia, inflation, etc.)
    a. We expected decline even without unexpected events – due to excess investor confidence (similar to stocks in 1929, 1972 and 2000 and housing in 2006)
    b. All three **equity bubbles** needed long economic upswings (or handsome margins), strong labor market, and a supportive Fed
3. It was **easy to predict the extreme bubble popping** – you just need investors to question the perfect economic and financial conditions that have been extrapolated forever
    a. **This is a tougher phase to predict** – housing hasn't rolled over, economy isn't in recession, corporate profits haven't been hit
        i. The situation in Ukraine could turn worse or could turn positive
4. The **housing bubble** is global and housing bubbles **take 2X – 3X longer** to pop
    a. Housing is more important to economy through construction, expenditures and middle-class wealth; also greater leverage
5. A **stock market drop of substantial proportions is still much more likely than not**
    a. My **S&P 500 trendline** (adjusted for growth and inflation) is **3200** at end of year
        i. Grantham believes that we'll go below that in 2023 or 2024
        ii. **16.7% decline**; add 4% inflation and you have 20% real decline
    b. There are other risks that could make the drop worse:
        i. **Severe recession** could lead to **50%** drop from here
6. **Factors that will drag the bear market out:**
    a. The **Presidential Cycle**
        i. From Oct. 1 of second year through April 30th of third year, returns since 1932 equal those of remaining 41 months of cycle (**Exhibit 1**)
    b. Strong labor market
    c. Inflation beginning to subside
    d. China regrouping from a strict lockdown
    e. There is a lot of pessimism in the market
7. **Reasons you should worry:**
    a. The 3-month/10-year has gone negative only eight times in the past 50 years and all eight have been followed by recessions (**Exhibit 2**)
        i. And there have been no other recessions
    b. Excess savings should run out by middle of year
    c. You can look at all bear markets and see that the market low has lagged the start of recession by an average of seven or eight months.
        i. During popping of bubbles it took longer (11 – 19 months, not counting 1929)
            1. This could bring us to well into 2024 (if recession starts mid-2023)
    d. With bubbles, the market drop often continues after the first rate cut (**Exhibit 3**)
    e. Even with market pessimism, earnings estimates are still too high

B. The January Rally

1. Large-cap and quality are loved by institutional investors, but small caps often do well in January
    a. In particular, small caps that are cheap and did poorly the prior year
    b. Plus you have bonuses that are getting invested
2. Bitcoin's rally is attributed to exotic reasons. More likely, it just performs like the most speculative stocks.

C. The Real Nightmare: Longer-Term Negatives Start to Impact

1. Examples of long-term problems (identified in prior papers) that are now real problems:
    a. Climate change
    b. Slowing growth of workforces / lower fertility rates
    c. Lack of resources to green the global economy (lithium, copper, cobalt, nickel)
2. These problems interrelate with more obvious problems (like Russia and Covid)
    a. Bottlenecks have become recurring and more severe
3. The result is that **inflation will not revert** to being a non-issue (like it was for 20 years)
4. We need enlightened planning – but we're in an era of deteriorating democracy and geopolitics

D. P.S. – Investing in a Particularly Tricky World

1. Emerging markets are cheap (especially EM value) (**Exhibit 4**)
2. The US spread between value and growth equities is still attractive (**Exhibit 5**)

Appendix 1: Explaining the Presidential Cycle

1. The key to elections is the state of the labor market for the six-months prior to election
2. Have to stimulate economy 12 – 18 months before that
    a. So around year 2, Q4 is when we get extra stimulus
        i. Stock market is much more sensitive (than employment) to the stimulus
3. The seven-month stimulus window delivers 6X the monthly returns of the rest of the cycle
4. We've seen an even bigger cycle in UK

(GMO)