



MARKET UPDATE

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July 10, 2023 – Market Update

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I. Stocks and Bonds

A. Stock Performance

1. Last week: DJIA -1.96%; **S&P 500 -1.16%**; Nasdaq -.92%
2. The S&P's **forward P/E is 19.2**, a relatively high multiple given a 4.06% 10-yr UST yield.
3. The **homebuilder ETF (XHB) is up ~30.5% YTD**. High rates are keeping homeowners in place, so the demand for new homes is strong. New listings for existing homes are down 25% YoY. New homes as a percentage of home sales increased from 15% in early 2018 to 19% this year. New homes sales are up 20% YoY while existing home sales are down 20% YoY. ([WSJ](#))
4. **The IPO market has barely reopened this year**. CAVA did really well, as did SVV. But FIHL and KGS both priced their targets below their targeted range and then dropped on their first day. Class of 2020 IPOs are down an average of 34% from their listing prices, while 2021 IPOs are down 46% and 2022 IPOs are down 49%. ([WSJ](#))

B. Thinking about the Future

1. From 1989 – 2019, EPS for nonfinancial companies grew 4% / year in real terms. While analysts are expecting higher earnings in coming years due to inflation, real earnings are expected to continue to grow at ~4%. **A recent Fed paper argues that earnings growth during the 1989 – 2019 period has resulted largely from lower effective tax rates and lower borrowing costs. The author thinks that real returns for the S&P 500 will be near real GDP growth of 1.8%**. He argues that while EPS grew 3.8% in real terms from 1989 – 2019, EBIT only grew 2.2%. ([Bloomberg](#)) ([Federal Reserve](#))
2. **QQQ rose 38.8% in the first half of the year**.
 - a. In the first half of 1995, QQQ rose 33.1% and in the first half of 1998, it rose 35%. Both these years had positive returns in the second half as well (an additional 7.1% in 1995 and an additional 37.3% in 1998). But, during the second half of each of those years, interest rates were declining.
 - b. Nasdaq increased 33.8% in 1987 but was followed by a 17.8% drop in the second half of the year. During the second half of that year, rates increased. ([Barron's](#))
3. For the sixth quarter in a row, **most money managers expect a global recession within the next 12 months**. But, pessimism is declining (after being wrong for the past year) and this is shifting more bears into bulls. ([Bloomberg](#))

C. Random Stories about Stocks

1. **Nearly half** of Vanguard 401(k) investors actively managing their money and **over age 55 held more than 70% of their portfolios in stocks**. In 2011, 38% did so. ([WSJ](#))
2. In 2021 and 2022, margins rose with inflation. In **2023 Q1, margins have dropped back to pre-pandemic levels** (according to the Commerce Department). Instead of greedflation, we're seeing **wages increase faster than prices plus productivity**. ([WSJ](#))
3. After GS issued a report recommending selling shares of Chinese banks, a state-owned Chinese newspaper issued a rebuttal. This should make you **think about the pressure on banks to put out favorable reports about Chinese companies** (if the banks want to do business there). ([Bloomberg](#))

D. Bonds and Interest Rates

1. UST yields: 3-month 5.46% (+3 bps); 2-yr 4.94% (+7 bps); **10-yr 4.06% (+25 bps)**
2. Bond investors had been betting that central banks would halt rate hikes and they exited this bet after the **strong ADP report**, the **FOMC minutes** that indicated more tightening in July, and **Dallas Fed Pres. Logan's comments** that more rate increases will likely be needed. In addition, the **JOLTS report** led investors to believe that the labor market was still tight and that employers would have to raise wages to attract workers. ([Bloomberg](#))
3. On Thursday, the **2-year UST yield went above 5% intra-day**. The 2-year yield hadn't been this high **since June 2007**. In fact, since the start of **2001**, this was only the **65th day** when the 2-year yield traded above 5%. The 10-year yield went above 4% and the real 10-year yield is at its highest level since the end of the GFC in 2009.
4. After former NY Fed President Dudley said that they 10-year UST yield would go to 4.50%, Morgan Stanley argued that the yield would head to 2% - 3%. They said that the real Fed funds rate will be 0% - .5% (not 1%), inflation will average 2% (not 2.5%), and the term premium will be 0% - .5% (not 1%). ([Bloomberg](#))
5. **CCC-rated bonds have returned 10% this year** while AA-rate have returned 2.7%. This has been the result of the declining belief as to whether we will have a recession. ([WSJ](#))

II. The Economy

A. Labor Market

1. The **payrolls report** showed that the economy **added 209K jobs** in June. This was below the 230K estimate and was the first miss after beating estimates for 14 consecutive months. This was the fewest number of jobs added in 2.5 years. The **prior two months were revised down by 110K jobs**.
 - a. **Average hourly earnings** were up .4% MoM and **4.4% YoY**.
 - b. The **unemployment rate** dropped to **3.6%**. ([Barron's](#))
2. The payrolls report shows that we've added 1.6MM jobs through May (~2.5% annualized), nearly twice the average increase in 2019. But the payrolls report may not sync with other data:
 - a. The unemployment rate increased .3% to 3.7% in May
 - b. We're seeing a decline in hours worked
 - c. The **household survey showed 310K fewer jobs in May while the payrolls survey showed that we added 339K**. Payrolls tend to be more reliable, except at turning points. It is difficult for the "birth-death model" (how many new businesses were started and how many closed) to keep up with the changes. In the 12 months through May, net births contributed 43% of the net increase in private-sector payrolls. ([WSJ](#))
3. The **ADP report** showed that US companies added **497K jobs last month** – an astounding number. ([Bloomberg](#))
4. From the JOLTS report: the number of workers who quit their job in May was the highest since Nov. 2021. It rose 250K in May to 4MM. This was a **2.6% quit rate**. While this is below the 3% peak, the quits rate is highly correlated with inflation (as it shows worker power). Workers are effectively creating bidding wars between employers.
 - a. Job vacancies dropped to 9.8MM and there are now **1.6 openings for every unemployed worker**. Prior to the pandemic, this was near 1.2. ([Bloom.](#)) ([Bloom.](#))
 - b. To get the job market back in balance, there would need to be 2.8MM fewer job openings than today. This would bring the openings-to-unemployed people ratio back to 1.2. So far, job openings have fallen by 2.2MM, so there is a long way to go. Services are still understaffed. ([WSJ](#))

B. Banking

1. **Banks have been getting rid of their "hung" debt** (debt that they issued and couldn't sell) and this should free them up to make more loans. There is now only \$35B on banks' balance sheets and 1/3 of that is debt backing Elon Musk's purchase of Twitter. Some of the hung debt has been purchased by private-credit funds. ([WSJ](#))
2. **Private equity is a huge drive of investment banking revenue**. GS estimates that 30% of their global investment banking fees came from PE-related work. **Now, PE is being hurt by:**
 - a. Higher rates
 - b. The fact that PE investors are receiving capital calls, but they're not getting money out (because there are fewer transactions)
 - c. As investors saw their public stocks and bonds lose value last year, this meant that they were overweight PE
 - d. PE deals are difficult now because it's particularly hard to value companies in time of turmoil and your interest rate estimate affects how much debt the company can handle (and rates are particularly uncertain). ([Bloomberg](#))

C. The Fed

1. The **FOMC minutes** were released and confirmed the fact that while the vote to pause was unanimous, **several committee members wanted to raise rates** due to momentum in economic activity that was stronger than anticipated and few clear signs that inflation was on path to return to the 2% target.
 - a. In addition, the Fed staff maintained their forecast of a recession starting later this year but also saw the possibility of avoiding such a downturn as “almost as likely” due to continued strength in labor markets and consumer spending. ([WSJ](#)) ([Bloomberg](#))
2. **Dallas Fed Pres. Lorie Logan** said that more interest rate increases will likely be needed to spur meaningful disinflation. The core PCE rose 4.6% YoY in May, virtually unchanged since the beginning of the year. ([Bloomberg](#))
3. It’s always possible that the **long-term neutral rate could be higher than the (nominal) 2.5% that the FOMC projects**. Greater income equality (from higher wages for lower-income workers), excess savings (in the short-term) and higher productivity would all mean that the Fed could raise rates higher without slowing the economy. (Productivity has actually been lower recently.) ([WSJ](#))
4. **Higher interest rates can’t directly impact commodity prices nor do they impact services**. Services are responsible for a significant amount of inflation. This could mean that rates will stay higher for longer and the central banks could lose confidence in their ability to curb inflation. ([WSJ](#))

D. General Stories about the Economy

1. The **ISM non-manufacturing survey** of supply managers suggested that the service industry was **stronger than expected**. Fortunately, both the manufacturing and services surveys showed that fewer purchasing managers are complaining about the prices that they have to pay. ([Bloomberg](#))
2. The **housing market has been rebounding** with more foot traffic, more offers per seller and new home sales jumping 12.2% in May. This could impact inflation and could make the Fed’s job more difficult. Economists believe that housing inflation will need to fall close to a 3.3% YoY rate for the Fed to reach its target. As of May, rent was at 8.7% and OER was at 8%.
 - a. **Higher rates tend to hurt supply** in that owners don’t want to sell (because they’ll need to get a new, higher-rate mortgage) and it discourages new construction (raising costs, including the cost of acquiring land). ([Barron’s](#))
3. U.S. **new-vehicle sales** were estimated to have **risen ~13%** during the first half of the year. The average price paid rose 3% over that time period to **~\$46K**. ([WSJ](#))
4. Some commentators are saying that we’re in a **richcession**, where wealthier Americans are being hurt more than usual. Layoffs are disproportionately impacting higher-earning workers. While they can get other jobs, those jobs will usually pay less than the large tech companies. Studies have shown an unusually large number of previously higher-income earners receiving unemployment insurance (in 30 states, these benefits are direct-deposited). If higher income people slow spending, that will affect the entire economy. Households in the top 40% of income account for more than 60% of spending. ([WSJ](#))
5. **China announced export controls on gallium and germanium** – two materials key to the production of semiconductors. ([Barron’s](#))
6. According to the NOAA, **last month was the hottest June on record** (worldwide). July 3 – 5 were also the three hottest days ever. Scientists attribute this to global warming plus an El Nino. ([WSJ](#))

III. “Opening Remarks at the Panel on Policy Challenges for Central Banks,” 2023 Annual Meeting of the Central Bank Research Association, Dallas Fed Pres. Lorie Logan, July 6, 2023 ([Dallas Fed](#))

A. Introduction

1. Pres. Logan remains very concerned about whether inflation will return to target in a sustainable and timely way
2. She thinks more-restrictive monetary policy will be needed to achieve the dual mandate

B. The Economic Outlook

1. Both inflation and the labor market came in hotter than expected in H1 2023
 - a. Dec. 2022: professional forecasters expected core PCE of 4.3% in Q1 and unemployment to rise to 3.9%
 - i. Core PCE was 4.7% in Q1 and unemployment averaged 3.5%
2. Final Q2 data isn't in yet, but it was clearly pretty hot
 - a. Core and trimmed mean inflation continue to run ~4% (2X our target)
 - i. Both filter out especially volatile prices; important signal of future
 - b. While labor market indicators have eased, overall pace of rebalancing remains slower than previously expected. There is no indication of an abrupt deterioration in labor market conditions:
 - i. We have added an average of 314K jobs/month this year
 - ii. Job openings remain far above the 2019 level
 - iii. Layoffs remain low
 - iv. Wage growth remains ~4.5% to 5%
 1. Dallas Fed's business survey respondents expect ~5% wage growth next year. They cite labor costs as a key driver of higher prices.
3. Pres. Logan is skeptical of the argument that further cooling will result from lagged consequences of the prior rate increases
 - a. The lags have to be measured from the right starting point
 - b. Broad financial conditions matter more for economic activity than the rate itself
 - i. Of course, financial conditions respond to the rate and expected path
 - ii. Financial conditions began to tighten in early 2022 (w/ expectations)
 1. We've already had a fair amount of time to see effects
 - c. The housing market even looks like it may have bottomed out. While housing inflation will likely continue to soften in the near term (as a result of progress on rents last year), a rebound in housing poses upside inflation risk.
 - i. Housing starts and home prices have trended up since January
 - ii. Market rents have risen at a ~4% annual rate in the first four months of this year after being roughly flat at the end of last year

C. Monetary Policy

1. The outlook for above-average inflation and a stronger-than-expected labor market calls for more-restrictive monetary policy
2. Tighter credit conditions don't seem likely to fully offset the need for a higher policy rate
 - a. Bankers have been cutting back on credit availability since the fall (pre-crisis)
 - i. Bankers say main reason is tighter monetary policy (not banking stress)
 - ii. So credit conditions are due to policy, not an additional factor to weigh
 1. Plus, banking stresses have calmed since March
 - b. Commercial real estate remains a risk, but not uniformly
 - i. Challenges concentrated at some banks and some property types (e.g., office)
 - c. We can rely on our liquidity tools (not monetary policy) for banking stresses
3. The near-term dynamics of the Fed's balance sheet should not create liquidity pressures that would call for a change in monetary policy strategy
 - a. Some feared that the rebuild of the Treasury General Account (TGA) balance plus the runoff of the Fed's balance sheet would drain regional banks' reserves
 - i. Treasury has issued more than \$450B in new marketable debt
 - ii. Investors (MMFs) have pulled \$340B from Fed's overnight reverse repo facility
 1. This offsets the \$360B growth in the TGA
 - b. Pres. Logan believes most of the TGA rebuild will come from the reverse repo facility or from reserves at very large banks
 - i. Small differences in yield will drive MMFs to move money
 - ii. She doesn't see the money coming from regional banks' reserves
 - c. We could still see some upward pressure on money market rates as the TGA grows and the Fed's balance sheet normalization continues
 - i. Banks may have to pay more for short-term funding
 - ii. But rate pressures are not a sign of scarce liquidity as long as there are significant balances in the reverse repo facility
 1. The rate pressure creates incentive to exit the facility
4. History has shown the dangers of central banks easing off too soon on inflation
 - a. Look back at the Fed in the 1970s
 - b. Several central banks have recently had to resume or accelerate rate increases after pausing or slowing
 - i. Bank of Canada has said that inflation is "stubbornly high" and they have more flexible mortgage rates (which are more responsive to changes)
5. Need to make policy more restrictive to return inflation to target in a sustainable and timely way
 - a. It would have been entirely appropriate to raise the rate in the June meeting, but I was mindful of several factors:
 - i. In a challenging and uncertain environment, moving gradually can make sense
 - ii. Financial conditions matter more for the economy than the precise path of rates
 1. Financial conditions depend not just on how fast rates rise, but also on the level they reach, the time spent at that level, and the factors that determine further increases or decrease
 - a. So hopefully the communication from the June meeting sent a strong signal to the markets
 - b. The FOMC must follow through on the signal we sent in June
 - i. Two-thirds of participants projected at least two more rate increases
 - ii. Inflation and the labor market evolving as expected won't change the outlook
 - iii. If we lose ground, we'll have to do more to catch up later