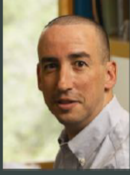

MARKET UPDATE

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Market Update – July 17, 2023

I. Stocks

A. This Past Week

1. For the week: DJIA +2.3%; **S&P 500 +2.4%**; Nasdaq +3.3%
    a. **Everything is rallying** – equities, bonds, commodities.
        i. The prospect of a soft landing has improved with inflation cooling and economic growth holding up. (Bloomberg)
        ii. Last year, the market dropped with higher inflation. This year, the market rose after deciding that inflation had peaked. (Bloomberg)
2. The **equal-weighted S&P 500 is up 6% in the past three weeks**, outperforming the S&P 500 by 3%. Strong economic news is good news for smaller companies. The S&P 500 is up 17.34% YTD while the equal-weighted S&P is up 7.57% YTD.
    a. The S&P 600 (small-caps) is trading at 13.3X forward earnings while the S&P 500 is trading at 18.9X earnings. (Barron's)
        i. The Magnificent Seven are trading at 40X earnings. If you exclude those stocks, the S&P 500 is trading at 15X earnings. (Barron's)
3. If you **exclude China, emerging markets are doing quite well** and their stocks are cheaper than the US. ETF EMXC (Emerging Markets excluding China) is up 13.93% YTD and 15.21% since March 16. The EEM (Emerging Markets, including China) is up 9.05% YTD and 10.9% since March 16. (Bloomberg)
4. **Nasdaq announced a "special rebalance"** to reduce the influence of MSFT, AAPL, GOOGL, NVDA, AMZN and TSLA. The weight of the six companies reached 50.9% on July 3. According to a Nasdaq white paper, this weight needs to be reduced to 40%.
    a. This is reminiscent of 1998, when the index changed from being weighted on market cap to a modified market cap or adjusted index.
    b. QQQ and other ETFs will be forced to sell the names that are having their weights reduced and buy others that will be increasing. (Bloomberg)

B. Looking Ahead

1. Analysts expect companies in the S&P 500 to report a **third consecutive decline in quarterly earnings**. Q2 earnings are projected to have dropped 7.2% YoY. This would be the steepest pullback since 2020 Q2 (a 32% decline).
    a. Analysts expect Q3 earnings to be .3% higher YoY and Q4 to be 8% higher. (WSJ)
    b. The consensus is for **revenue to be flat and margins to shrink**. (Barron's)
2. **Concerns about the market include**:
    a. Pricing power may be ebbing. The S&P 500 profit margin may fall to 11.4%, down from the 13% peak in 2021.
        i. Falling margins typically result in lower multiples.
    b. The yield curve is still inverted.
        i. It has flattened in the past few weeks. Of course, the yield curve usually normalizes by time a recession starts.
    c. Global markets look weak – the eurozone is in recession and China is struggling
    d. Investors have been chasing returns with large tech stocks (WSJ)
3. A 50% difference between the most bullish **strategist forecast** for the S&P 500 and the most bearish is the **widest gap** in 20 years. (Bloomberg)
4. An index of **MEME stocks** (MEME) was up 10% in a few days, compared with a 2% decline for consumer staples. Some analysts worry that a surge in low-quality stocks could be the **tail-end of the rally**. (Barron's)

C. The Market Rally has Broadened

1. Just **six weeks ago, the S&P 500 would have been negative YTD without the contributions of the Magnificent Seven** (AAPL, MSFT, GOOGL, AMZN, META, NVDA, and TSLA). It would **now take wiping out the gains of the top 50 stocks** in the S&P 500 to negate the index's rally this year.
2. More than **140 stocks in the S&P 500 have hit 52-week highs since the end of May**. All 11 sectors in the S&P 500 have climbed during that period.
3. The **equal-weighted S&P 500 has outperformed the cap-weighted S&P 500 over the past six weeks**. The equal-weighted S&P 500 was down 1% for the year at the end of May.
4. The share of S&P 500 stocks **closing above their 50-day moving averages surpassed 80%** for the first time since December 2022.
5. The broadening rally gives investors confidence to move to stocks, despite lingering concerns about slowing corporate profits, the potential of a recession, and Fed tightening.
    a. The US economy has proved to be more resilient than expected. The labor market has remained robust, consumers are spending, and fear about the banking sector has subsided.
6. A **broader rally could create a wealth effect**, increasing consumer spending and inflation. This could make the Fed's job more difficult. (WSJ)

II. Interest Rates, Debt and Banking

A. Rates and Debt

1. UST yields: 3-month 5.49% (+3 bps); 2-yr 4.74% (-20 bps); **10-yr 3.83%** (-23 bps)
    a. Prior to Wednesday's CPI report, strong economic data had been pushing yields higher. Markets seemed to believe that the Fed funds rate would have to go higher for longer. (WSJ)
2. In late June, the **2/10 yield curve inversion** was 1.1%, the widest gap since 1981. Now, it's 91 bps. The **three-month / 10-yr** had inverted as much as 1.9% and now is 1.66%.
    a. Powell likes to look at the **near-term forward spread** – the difference between the current three-month yield and the expected three-month yield 18 months from now. This inverted in November and reached its widest point early in April at 2.1%. Now, this is down to ~.9%.
    b. The narrowing inversion seems to reflect an expectation that the Fed will soon stop raising rates. If the job market is able to stay steady, rate cut expectations may diminish, pushing longer-term rates higher. (WSJ)
3. The BIS says that **total G20 non-financial debt is $250T**, double its level since the GFC. (Of course, the global economy has also grown.). Bloomberg's Global Agg yield, the broadest measure of fixed income, is at 4%, up from under 1% in 2021. The average coupon in the index has only increased 50 bps – meaning that most issuers haven't had to refinance yet. If coupons increase 320 bps, the incremental interest expense will increase by $8T. This is equivalent to Japan + Germany GDP. (Bloomberg)
4. A **Minsky Moment** can occur after a long period of calm. The calm can encourage households, corporations and governments to take on too much risk. Private sector debt (companies and households) is above 150% of US GDP. (Bloomberg)

B. Banking

1. The **Fed expects to launch FedNow this month**. This system will make payments available immediately, but it could destabilize banks. Deposits could quickly flee outside of business hours (lowering the stickiness of deposits). Transactions are limited to $500K at a time (so big depositors can't totally flee). (WSJ)
2. The **Fed appears to want large banks to hold an additional two percentage points of capital**, or an additional $2 of capital for every $100 of risk-weighted assets. This could result in less lending. Of course, the recent problems were not with the large banks. (WSJ)

III. The Economy

A. CPI

1. **Headline CPI increased .2%** in June and was up **3.0% YoY**. This was the smallest annual increase since March 2021. Average hourly earnings were up 4.2%, so this is **1.2% real wage growth.**
    a. **Energy prices were down 17% YoY**. Prices of used cars and trucks fell 5.2%. Airline fares, appliances, health insurance and footwear were all lower YoY.
    b. **Shelter prices were up 5.7% YoY**, food was up 7.8% and non-housing services were up 6.2%.
    c. **The big drop in June has a lot to do with June 2022 rolling off**. CPI was up 1.2% in June 2022 and only .2% in June 2023. That took inflation down 1%.
        i. In July 2022, CPI was unchanged, so we won't have that advantage next month.
        ii. If inflation in the second-half of 2023 is similar to its pre-pandemic average, CPI will be 3.9% in December and it will appear as if inflation is reaccelerating.
            1. In order to continue the disinflationary momentum, there will have to be slower month-over-month gains in core services prices. This may require a weaker labor market. (Barron's)
2. The **core CPI was up .2% MoM and 4.8% YoY**. This is the slowest since Aug. 2021, but it's still too high. Unemployment may still need to rise to get back to 2%. The "free disinflationary lunch" from rapidly falling energy prices, cooling food price inflation and easing core goods inflation is now over. Now we need core service prices to fall.
    a. Services were up .3% MoM, including shelter which was up .4% (which includes OER +.4% MoM).
        i. Without OER, core inflation is 2.3%.(WSJ)
        ii. Core services was the lowest in two years.
    b. Core goods inflation is almost nothing.
3. **Economists are optimistic that rent inflation will slow** and this can bring inflation down further. In June, rents were up 8.3% YoY and OER was up 7.8%. But rents lag behind newly signed leases and that's where we see much slower growth. Rents are also used to impute OER.
    a. **Used car prices could also drop**. The Manheim Used Vehicle Value index of wholesale used car prices tends to lead retail prices and it started falling three months ago. In June, it logged its biggest one-month drop since April 2020. (WSJ)
4. The **trimmed mean CPI is down to 5.02% YoY** and if you annualize the month-over-month increase in CPI, it's +2.70%.
5. **Lower inflation pushed the dollar lower**.
    a. The weaker dollar means stronger dollar-denominated foreign profits for US multinationals. It also reduces pressure on emerging markets due to debt denominated in dollars and a cheaper dollar improves the availability of liquidity worldwide. It also boosts commodity prices. The cheaper dollar can be inflationary.
    b. The dollar could also be hurt if the BOJ moved away from yield curve control. This could push Japanese rates higher and the yen could rally. (Bloomberg)

B. PPI

1. The **PPI for final demand rose .1% YoY**, the smallest advance since 2020. It was **also up .1% MoM.**
    a. Normalizing global supply chains, stabilizing commodity prices, and a broader shift in consumer demand away from goods have generally helped alleviate inflationary pressures at the producer level. (Bloomberg)
2. The **gap between the CPI and PPI is at a record high**. Historically, high spreads were typically followed by above-average equity returns and occurred very late in a recession or the early stages of an expansion. (Bloomberg)

C. The Fed

1. **Mary Daly** said (prior to the CPI report) that we likely need a **couple more rate hikes** to bring inflation back to the 2% path.
    a. Consumers seem convinced that medical bills, rents and college tuition are going to rise sharply in the next year. Expectations for house prices are also starting to rise.
    b. Some economists believe that the labor market is the biggest problem. So, if the Fed wants to raise rates, they are likely to blame the labor market. (Bloomberg)
2. After the CPI report, **Richmond Fed Pres. Tom Barkin** said that the **growth in US consumer prices is still too high**. He warned that if the Fed stops their inflation fight too soon and inflation returns, the Fed will have to do even more. (Bloomberg)
3. It's **hard to imagine that the Fed funds rate is much above the (theoretical) neutral rate** and this means policy isn't tight. We're not seeing tightness in the economy.
    a. On the other hand, if inflation continues to drop, this makes the Fed funds rate tighter. (WSJ)
4. **Minneapolis Fed President Neel Kashkari said that banks must be prepared for higher interest rates** in case policymakers need to lift rates further to combat entrenched inflation.
    a. Managing inflation and supporting financial stability are usually not in conflict, but they can be. As markets expect lower rates in the future, it's always possible that inflation can become entrenched. (Bloomberg)

D. Other Articles about the Economy

1. Some strategists believe that we're in a **period that will be marked by growth and significant equity returns**. Others say that there will still be **lag effects** from the Fed's rate increases. Also, when inflation comes down, corporate revenue growth slows too (and this may squeeze margins). (Bloomberg)
2. It's **not a huge surprise that a recession didn't occur in the first half of the year**:
    a. US consumers, especially wealthier ones who actually benefit from higher rates, have kept up their spending.
    b. House prices did not fall much, so there wasn't much of a negative wealth effect.
    c. The decline in gas prices helped confidence and there is much pent-up demand for cars after production shortfalls.
    d. There was also strong demand for travel and entertainment. (Bloomberg)
3. **Consumer sentiment soared to an almost-two-year high**.
    a. Short-term yields increased.
    b. Earnings forecasts are increasing. (Bloomberg)
4. There is currently **$1.1T of student debt in forbearance** and it's owed by almost 27MM borrowers. They will need to start paying again on Oct. 1. The average repayment will be ~$400 per month.
    a. The delinquency rate is expected to return to ~11.1% and that would mean $167B of delinquent debt. Economists think that the repayments will lower PCE and GDP by ~.1% per year. (Bloomberg)
5. **Some public companies are starting to report a shortage of accountants as a material weakness**. This year, nearly 600 U.S.-listed companies of a total 7,359 reported material weaknesses related to personnel, typically in accounting or technology. This is 40.6% higher than 2019 (but down 5.2% YoY). Accountants want higher pay (and they probably want to stop being called bean counters). (WSJ)
6. **It now takes more than $650K of income to be in the top 1% of income levels across the US.** In Connecticut, you must make $953K.
    a. The CBO says that the top 1% of households hold more than a third of the country's wealth. (Bloomberg)