MARKET UPDATE

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July 24, 2023 – Market Update

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I. Stocks

A. A Mixed Week

1. Week: DJIA +2.1%; **S&P +.7%**; Nasdaq -.6%
    a. S&P has risen 18.2% YTD **despite** recession worries, tighter Fed policy, mixed economic data, a banking crisis, and political instability
2. The S&P 500 posted its **fourth weekly gain in the past five weeks** (and eight out of 10).
    a. The Nasdaq dropped for the second time in three weeks.
3. The **DJIA** has had **10 straight days of gains**.
4. The **Russell 2000 outperformed** the S&P 500 for the second-straight week. This is consistent with **soft-landing expectations**. (Barron's)

B. Reasons that Investors are Optimistic

1. There is optimism over the **broadening of the rally**.
2. There is an increasing belief in the **possibility of a soft landing**.
3. Banks are reporting **stable deposits**.
4. **Liquidity fears continue to fade** as the TGA is largely replenished.
5. Many economists think that the Fed will raise rates next week and that will be the **last hike**.
6. Investors believe that the FOMC will be **cutting rates** next year.
7. **Builder confidence** rose for a seventh straight month.
8. Initial **jobless claims** came in at 228K.
9. **Retail sales** were a bit softer, but the control group sales were above expectations (evidence of consumer resilience).

C. Reasons that Investors are Pessimistic

1. **Tech** may be **losing momentum**
    a. Interesting to see some of the more defensive sectors leading this week: energy +3.53%, healthcare +3.46%, utilities +2.40% and staples +1.64%. Losers included communication services -3.01%, consumer discretionary -2.28% and technology -.08%.
    b. Without tech, everything else needs to do well to keep the market moving higher
2. TSLA and NFLX dropped this week even though their EPS number beat expectations. The market may be nervous about **valuations**.
3. **Overbought conditions** and **extended sentiment** (AAII survey.)
4. The two-month returns for GS' "most-shorted" basket was in the top 1% of all two-month returns since 2010. Maybe the **short-covering is done**.
5. If we have a **soft landing**, it **will defy two of our best indicators**:
    a. **Leading economic indicators** index has fallen for 15 consecutive months – this has always resulted in a recession
    b. The **yield curve** has been inverted for a year
6. **Market is pricing in just one more rate hike** (this week) despite:
    a. Core inflation is still at 4.8%
    b. Labor market is still tight
        i. Jobless claims were just 228K this week
    c. FOMC projections (SEP) of at least two rate increases

Source: FactSet

D. Signs of Optimism

1. The **MEME ETF** is up 58.6% YTD.
2. **Bitcoin** is up 80.75% YTD.
3. The **AAII survey** of retail investors shows the most bullish sentiment since 2021. This survey asks about whether you think returns will be positive in the next six months.
4. **Consumer sentiment** jumped from 64.4 in June to 72.6 in July. This is the largest increase since 2005.
5. The **put-call ratio** is the lowest since Jan. 2022.
6. The **VIX** is below 14 (closing the week at 13.60). (WSJ)
7. If 2023 had ended this week, the **Nasdaq 100's 45% gain** would have been the second-largest annual advance since 2009. (By the end of the week, Nasdaq was up 41.5%). (Bloomberg)

E. Some of the Biggest Problems Facing Us in the Next Five to Ten Years

1. **Fed** may not be able to bail us out in the future.
2. **Private credit loans** are being made at rates that may be too high for companies to service.
3. The clash between the **haves and the have-nots**, particularly as people don't have enough money to retire.
   a. Social Security is underfunded as are many state and local pension plans.
4. **Government debt**
5. Extreme weather / **global warming**
6. **Emerging markets** will want more control over world politics and may have increasing power due to global warming.
7. **Polarization**
8. **US vs. China** – and especially the issue of Taiwan (Bloomberg)

F. Earnings

1. According to FactSet, **earnings are on track to drop 9.0% YoY**. At the end of the quarter, a 7.0% drop was expected. Revenue is expected to drop .3%.
2. So far, 18% of S&P 500 companies have reported earnings and **75% have beaten expectations** (close to the five-year and ten-year average). In addition, 61% have beaten sales expectation (and this is lower than normal).
3. **Positive themes** have included consumer resilience, benign credit, deposit stabilization, investment banking green shoots, robust travel demand, structural tailwind for housing demand, and signs of disinflation.
4. Some of the **scarier themes** include macro uncertainty, a high bar for mega-cap tech after a strong 1H rally, dampened pricing power, consumer selectivity, ongoing freight recession, lingering de-stocking pressure in select industries, challenging environment for hiring/staffing, and fundamental headwinds on office CRE. **Source: FactSet**

G. Strategists Got it Wrong

1. We're in the middle of the year and the **market has already passed most strategists' estimates for the end of the year.** The markets have rallied, despite recession risks, high inflation, and tighter monetary policy.
2. The S&P is ahead of the January year-end estimates for 22 of the 23 firms polled
    a. Even after upward revisions, all but five of the strategists expect the market to fall between now and the end of the year.
        i. Many will feel pressure to rise estimates more
    b. It's like a **strategist short squeeze** (or an **ecomomist capituation**)! The S&P is just 6% shy of the highest strategist forecast (Fundstrat at 4,825).
        i. As the market rises and strategists have to raise their estimates, this can push the market higher.
3. Eighteen of the 24 strategists **expect the market to drop** between now and the end of the year.
4. **What did strategists miss?**
    a. The effect of the extraordinary stimulus
    b. The feared consumer slowdown that would hurt earnings didn't happen
    c. The Treasury's General Account (TGA) was replenished smoothly
5. Strategists seem to be **raising estimates without enthusiasm**. Some have referred to the rally as the result of storytelling (about AI) and momentum mania.
    a. They are having to assume that recession will be averted, and inflation will not move higher again.
    b. It's hard to get enthusiastic when P/Es are already high and volatility is already low. Plus, we could have credit contraction and economic weakness in China. (Bloomberg)

H. Venture Capital's Problems

1. In **2013**, there were **40** private companies with valuations of $1B or higher (**unicorns**). Recently, there were **1,350**.
2. Coatue Management (an investment firm) estimates:
    a. Unicorns have a **combined value of ~$5T** based on their most recent funding rounds
        i. Coatue thinks that their value is **half of that**
        ii. A trading platform for pre-IPO shares of venture-backed companies said secondary market transactions have been taking place in line with valuations two funding rounds back (more than 50% less than current round)
    b. The current unicorn herd represents a **25-year backlog of IPOs** at a pace of about one per week. Even at 2021's elevated rate (124 venture-backed IPOs), it would take a decade.
        i. Global tech M&A activity is likely to be half or less than last year's $620B, which was down from $850B in 2021
3. **Problems within the venture sector:**
    a. Can't sell
        i. Can't go public (IPO market is barely open)
        ii. Hard to get acquired
    b. Can't raise cash without a massive valuation haircut
    c. Demise of SVB and generally tighter credit conditions have reduced the financing options available to tide companies over (until IPO or acquisition)
4. **Reasons can't sell:**
    a. Disconnect between what entrepreneurs (and sometimes VC firms) think the company is worth and what public investors or companies will pay
    b. Regulators worldwide are trying to limit the power of tech companies and this could make them reluctant buyers
5. **Some companies have reset their valuations**
    a. Stripe is down 47%, Klarna is down 85%, Instacart is down 75%, Shein is down one-third
6. If start-ups don't reprice, it will be very **difficult to raise more capital**
    a. 88% of the start-ups that Forge Global tracks haven't raised capital for at least a year (and most are losing money) (Barron's)

II. The Economy

A. Is the US Economy Headed for a Soft Landing?

By Jeffrey Frankel (Harvard) ([Project Syndicate](#))

1. Ever **since March 2022**, when the Fed began raising rates and shrinking the balance sheet, there have been **predictions of recession**
    a. Everyone cites the inverted yield curve
    b. A May 2022 poll found that 55% of Americans believed that the US was already in recession and only 21% disagreed
2. While a recession normally follows aggressive monetary tightening, a **hard landing is not inevitable**
    a. **Wouldn't a soft landing resemble where we are now?**
3. **Soft landing**:
    a. Defined
        i. A gradual slowdown of output growth to below potential
        ii. A gradual slowdown of employment to below its natural rate
        iii. A decline in inflation
            1. Inflation does not need to reach 2% immediately
    b. To qualify as a soft landing:
        i. The slowdown must not develop into anything more severe than a very mild recession
4. **What we've seen so far**:
    a. **Growth slowed** in 2022 relative to 2021, but has still averaged 1.8% over past four quarters
    b. **Labor market** has remained exceptionally **strong**
        i. Averaged 278K jobs per month over first half of year
            1. Very rapid; average since 2000 has been 87K
        ii. Unemployment rate is 3.6% (nearly matching lows of late 1960s)
    c. **June CPI was 3% YoY** (significant decline from June 2022 peak of 9.1%
        i. Core of 4.8% is down from Oct. 2022 6.3%
        ii. PCE was 3.8% in May, down from June 2022 peak of 7%
        iii. Core PCE fell to 4.6% in May (from 5.4% in March 2022)
        iv. Rental costs could bring CPI down in coming months
5. While a severe recession could have brought inflation down to 2%, maybe it's **a good tradeoff** to have 2% growth, inflation of 3-4% and a longer-term goal of 2% inflation
    a. Maybe this should be considered a soft landing
6. **Every expansion has to end at some point**
    a. But there's no reason that this has to happen this year or next
    b. Maybe the chance of recession is higher than the 15% average year, but it could still be less likely than not (i.e., less than 50%)
7. It's also interesting to see that the **market seems to be pricing in a soft landing**:
    a. Stocks continue to rally
    b. The 10-year yield dropped 20+ bps a week ago

B. “Taking Aim at Sellers’ Inflation,”

By Isabella Weber (UMass, Amherst) (Project Syndicate)

1. **Firms** have been **able to hike prices** for two reasons (Christine Lagarde)
    a. Mismatches of supply and demand where bottlenecks have prevailed
    b. The **coordinating effect** produced by recent mega-shocks (everyone is in the same position and we’re all going to raise prices)
2. This “**sellers’ inflation**” happens when the corporate sector manages to pass on a major cost shock to consumers by increasing prices to protect or enhance its profit margins
    a. Sellers’ inflation results in an **increase in total profits**
3. Back in the **1970s**, labor managed to protect itself and fend off the shock. Beyond oil, the increase in prices was almost exclusively driven by **rising labor costs and profits fell**.
    a. Today, profits account for 40% of inflation and, along with import prices, have replaced labor costs as the main driver
        i. Real wages have fallen more than they did in past inflation episodes
4. The standard prescription for addressing inflation is still to **hike interest rates**, even though doing so implies higher unemployment and heightens the risk of recession and financial instability.
5. You **can’t have higher real wages and higher margins**…without starting a spiral.
6. When we **have inflation**, the **cost is passed** to:
    a. Labor (by suppressing wages)
    b. Social programs (through austerity)
    c. To future generations (by discouraging investment)
7. **If inflation is going to fall quickly**, you’re going to see either:
    a. Lower margins; or
    b. Lower real wages

III. Big Shocks Travel Fast: Why Policy Lags May Be Shorter Than You Think, Fed Gov. Christopher Waller, July 13, 2023 (Federal Reserve)

A. Covers Three Issues in Speech

1. How my outlook has been shaped by both economic data and uncertainty
    a. **What we have learned** at each point and what we don't know yet
2. How I think about **lags** with which policy affects economic activity and inflation
    a. And the impact on the appropriate path of policy
3. The **recent data** and how I see **policy evolving**

B. Recent Policy Actions

1. I believed that a **25-bp rate increase was justified** at the June meeting
    a. Due to tight labor market and stubbornly high inflation
2. Reasons **why I voted to pause**:
    a. Lingering doubts about possibility of an abrupt tightening of credit conditions
        i. I viewed the lingering effects of the banking stress as a downside risk
            1. Not much evidence of it, but waiting would be prudent risk management
            2. Risk management was more important than speed of hiking rates
    b. Median of the SEP signaled two more rate hikes by end of year
        i. With March SEP, I believed that we'd see credit tightening
        ii. By June, little evidence of credit tightening more than would already be expected due to tighter monetary policy
            1. Led me to believe that we need to tighten policy more
3. Why this **evolution matters**:
    a. Highlights how the appropriate setting for monetary policy shifts over time
    b. Shows that managing uncertainty and risks is a big part of job
    c. Allows you to see how policymakers will adjust monetary policy in response to incoming data going forward

C. Monetary Policy Lags

1. An issue for the FOMC is **how long it takes for changes in monetary policy to affect economic activity and inflation.**
    a. How long will it take last year's increases to show up in data?
    b. **Traditional rule of thumb**: the maximum effect of an unexpected policy change (a shock) on the real economy is between 12 and 24 months
    c. Some commentary treats lagged effects as a "Wile E. Coyote" moment where nothing happens for a time and then we **fall off a cliff**
2. When applying the **12- to 24-month rule** to last year's actions, there are **two questions**:
    a. When did the policy shock occur?
    b. Does the size of the shock matter?
3. I want to **push back on the idea that the bulk of the effects from last year's policy hikes have yet to hit the economy**
4. Typical model to capture how past changes in a variable affect the current realization of that variable is usually either linear or log-linear
    a. Then, we see how that variable affects another variable (impulse response function)
        i. Normally, these functions are hump-shaped: a small effect initially and the effect grows over time with the maximal impact occurring several quarters after the policy surprise
        ii. After the peak impact, the effect of the policy change on the real economy fades away
            1. With the variables returning to their long-run steady states
        iii. These impulse response functions illustrate the lagged effects of policy surprises (and give us the 12 – 24 month rule of thumb)
5. Two key takeaways from this discussion of models:
    a. There are **no "cliff effects"**
    b. **Economic variables respond sluggishly** to unexpected policy changes and the sluggishness is what generates a **lagged response** to a policy action
        i. **Reasons for sluggish response** from households and businesses:
            1. Adjustment costs
            2. Sticky prices and wages
            3. Nominal contracts
            4. Habit persistence in consumption
            5. Option value of waiting when deciding to invest
6. So **when did this policy shock occur** (the first of the two questions from above)?
    a. It occurs when there is an unexpected change in the Fed funds rate
        i. Actual shocks are rare. More often, **forward guidance** pushes the **market view** over time (but we price everything in immediately to interest rates).
            1. So policy tightening occurs with the announcement, not the actual rate change
                a. The 2-yr UST yield increased from 25 bps in Sep. 2021 to ~200 bps by the March 2022 FOMC meeting. Didn't actually get to 2% until Aug. 2022
                b. So forward guidance took six months off the lag. **Forward guidance shortens the lag time** between when the policy rate changes and when the effects of actual policy tightening occur.

7. **Does the size of the shock matter for estimating lags** in policy (2nd question from above)?
    a. In standard models, the size of the shock doesn't matter (scales proportionately)
    b. Waller argues that the **size of the shock may lead to changes in economic behavior that change the coefficients in the statistical models**
        i. In other words, the sluggish behavior of economic variables to a policy surprise is not constant but can change with the size and nature of the shock
    c. **Reasons** to think that "**big shocks travel fast**" – meaning that they elicit a change in economic behavior that would not be associated with small shocks:
        i. "**Rational inattention**" is the idea that households and firms have a limited amount of attention that they can dedicate to processing information.
            1. It is costly and time consuming to constantly adjust behavior and portfolios in response to small changes in prices or interest rates.
                a. People rationally ignore certain data and look at it infrequently. Thus, behavior looks sluggish.
            2. But a **big policy change** will get attention and have a much faster impact on consumption, saving and portfolio allocation.
                a. The sluggish behavior disappears; behavior changes quicker. In other words, lags will be shorter when policy rate changes are larger and rapid
        ii. Firms typically change prices once per year (**prices are "sticky"**). Yet recent evidence shows that the big inflation shock over the past two years has led to more frequent price changes.
            1. This shift in frequency affects the slope (the coefficient) of the Phillips curve (linking unemployment and inflation).
                a. The slope indicates how sensitive inflation is to a change in unemployment.
            2. Where price adjustment is once per year, the Phillips curve is flatter.
                a. Unemployment has to increase a lot to bring inflation down a small amount.
            3. With more frequent price changes recently, the Phillips curve has steepened.
                a. This implies that monetary policy will affect inflation faster and with less effect on the unemployment rate than would occur if price changes were slower.
                b. So the lags between policy changes and inflation should be shorter than historical experience.
8. The **implications of this economic research**:
    a. The **effects** of policy tightening last year are feeding through to market interest rates **faster than typically thought** due to forward guidance.
    b. **More dramatic (and faster) policy rate changes has led to a more rapid adjustment** in the behavior of households and firms
    c. Conclusion: the effects of the recent large policy changes should hit economic activity and inflation much faster than typically predicted.
9. If you believe that the bulk of the effects from last year's tightening have passed through the economy already, we **can't expect much more slowing of demand and inflation from that tightening.**
    a. Past tightening was appropriate, but **more will be needed**.
    b. Pausing to wait for lag effects may leave you waiting for something that never arrives

D. Economic Outlook

1. **Economic activity** grew 2% in Q1 and GDPNow predicts a touch higher in Q2
    a. Recent ISM data suggests continued slowing in manufacturing but solid growth in services
2. **Labor market** has been tight for a long time and we added 209K jobs in June
    a. Lower than expected and much lower than last year
    b. Data on job openings is also showing some signs of cooling.
        i. Vacancies to unemployed people has declined
    c. Number of people quitting (often for higher wages) has declined.
    d. But…labor market is still very robust
        i. Job growth is still well-above the pre-pandemic level
        ii. Unemployment rate is quite low
        iii. Wage growth is inconsistent with 2% inflation
3. After five consecutive monthly readings of .4% or higher for **core inflation**, this rate cut in half in June to .2%
    a. Great news, but one data point isn't a trend
        i. Inflation briefly slowed in the summer of 2021
4. The Fed's weekly release of assets and liabilities of commercial banks (the H.8 data release) suggests that **banks are responding in a way that is consistent with monetary policy tightening but not banking stress**.
    a. **Growth in core loans** on banks' books has **decelerated** since late 2022
        i. As banks tightened lending standards and demand slowed amid lagged effects from monetary policy tightening
        ii. The deceleration was especially pronounced in early 2023, even before the regional banking crisis
    b. **Deposit outflows have stabilized** (and yet deceleration in loans continues)
        i. Banks have been aable to replace core deposit outflows with large time deposits, FHLB advances and other sources of funding
    c. All of these actions are leading to a slowdown in credit growth, but one that is line with monetary policy tightening.
5. So what does all of this mean for **monetary policy**?
    a. With the banking sector sound and resilient, **fighting inflation** should be top priority
        i. We need a **policy stance that will continue to bring supply and demand into balance**
        ii. Need disinflation to feed broadly across goods and services
    b. The robust strength of **labor market** and solid **GDP growth** gives **room to tighten**
        i. I see **two more rate hikes** over course of four meetings
        ii. Need to keep policy restrictive for **some time**
    c. Since the June meeting, I'm more confident that the **banking turmoil will not create a significant problem** for economy
    d. After first hike, watch data
        i. If inflation doesn't continue to show progress and there is no suggestion that growth is slowing, second 25-bp increase should come sooner.

IV. Other Interesting Ideas

A. Even the Vatican Doesn't Trust the Chinese Communist Party

1. In 2018, the **Vatican and Beijing signed an agreement**, renewed in 2020 and 2022 for two-year terms that gives both sides a say in the appointment of bishops. (This was an absurd thing for the Catholic Church to do.)
2. Three months ago, **ignoring that agreement**, Chinese authorities installed an individual as bishop of Shanghai without consulting the Vatican. Recently (three months after China installed this bishop), Pope Francis announced that he has now named that individual to run the diocese of Shanghai.
3. The **Vatican secretary of State** said that the Pope acted for "the greater good of the diocese," but **said that Beijing's unilateral decision to install this bishop was contrary to "the spirit of dialogue and collaboration."** (News flash: there are just some people that you don't collaborate with.)
4. Religious groups have been required to revise their practices and teaching in accordance with Communist Party doctrine and to develop what Xi has called "socialist religious theories with Chinese characteristics" through a process of "sinicization." (WSJ)

B. Interesting Random Issues and Questions

1. Did we see the return of the "**Fed put**" as the Fed provided liquidity to regional banks or was this just "**the lender of last resort**" function of the Fed?
2. There's no question that technology has improved our standard of living. But do you subscribe to the view that **all technology is good** (and therefore, it would be **wrong to regulate it**)?
3. Paul Krugman asked whether we have a **theory of immaculate transmission of monetary policy to prices**, without any real-economy weakness along the way.
4. Insurers are responding to more severe and frequent climate-driven losses. They are raising prices or exiting markets. Farmers Insurance announced that they won't write new home, auto, or umbrella policies in Florida under the Farmers' brand. Are there **places that you would be afraid to buy real estate**? (Barron's)