MARKET UPDATE

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July 3, 2023 – Market Update

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I. Markets

A. Recent Performance

1. This **week**: DJIA +2.02%; S&P 500 **+2.35%**; Nasdaq +2.19%
    a. The DJIA is 6.5% below its record.
    b. The S&P 500 is only 7% below its record.
    c. The Nasdaq is still 14% below its record.
2. This **month**: DJIA +4.56%; S&P 500 **+6.47%**; Nasdaq +6.59%
    a. The S&P 500 and Nasdaq extended their streak of monthly gains to four months.
    b. The Russell 2000 had its first positive month since January.
3. This **quarter**: DJIA +3.41%; S&P 500 **+8.30%**; Nasdaq +12.81%
4. **YTD**: DJIA +3.80%; S&P 500 **+15.91%**; Nasdaq **+31.73%**
    a. In the first half of the year, the market wasn't fazed by the Fed, bank failures, the possibility of a recession, geopolitics or even the debt-ceiling drama. (Barron's)
    b. **Apple** hit a market cap of **$3T** and is up 48% YTD; **NVDA** is up **189%** YTD.
    c. Nearly **$5T** has been added to the value of companies in the Nasdaq 100 since the start of the year.
    d. For the Nasdaq, years that start with returns greater than 10% average a 14% gain in the second half of the year, but if the first-half gain is above 20%, the second-half gain has averaged a little lower (+8.3%). (Bloomberg)
    e. While the S&P is up ~16% YTD, the **average stock is up only 6%** and the Russell 2000 is up only 7%. (Barron's)
5. The S&P 500 has gained just over 20% from the October low. Economically-sensitive stocks and small-cap companies should see the fastest rebounds in earnings after the economy stabilizes. (Barron's)

B. Bonds and Interest Rates

1. This **week**: 3-month – 5.43% (+2 bps); 2-yr – 4.87% (+16 bps); 10-yr – **3.81%** (+7 bps)
    a. In **Q2**: 3-month +58 bps; 2-yr +81 bps; 10-yr (+33 bps)
2. Former NY Fed Pres. **Dudley** says that the **10-year UST yield is headed higher**. He said that with such a strong economy, the FOMC will continue to take rates higher and that their view of the neutral rate is increasing. (With boomers spending down savings and the gov't borrowing more, higher rates will be necessary to balance demand for borrowing with a smaller supply of savings.) **Higher average inflation** will drive yields up and **volatility** in inflation will impact the **term premium**. (Bloomberg)
3. **Junk bond issuance YTD is up 35% YoY**, but a very high percentage (62%) are secured (by **collateral**). This is the highest percentage on record (with records back to 2005). In addition, the **average maturity of the issuance has shrunk** to 6.1 years (down from an average of 7.4 years over the past decade). Both measures help to reduce the cost of debt. (WSJ)

C. General Stories about Stocks

1. The market may be **doing well despite higher rates** because: (1) the consumer is resilient; or (2) the markets don't believe that Fed policy is restrictive. There are many ways to think about the real rate. Powell likes to subtract the one-year breakeven inflation rate from the Fed funds rate (which does imply that policy is restrictive). (Bloomberg)
2. **Top-down strategists** tend to believe that the market has gone up too far, too fast. **Bottom-up analysts** tend to believe that there is still room to run. Top-down strategists see $210 of EPS, while bottom-up see $218 for the next 12 months. The difference isn't significant, so the **real difference is in what multiple should be applied** to the earnings. (Bloomberg)
    a. The S&P 500 trades at **19X** expected earnings. It was trading at **15X** earnings in October. (Barron's)
3. **Bulls** are focused on possibility of a soft-landing, driven by a strong labor market (positive real wage growth) and a resilient consumer. Home prices are stabilizing and we see disinflation. In addition, AI and FOMO are driving stock gains. While Q2 earnings are expected to be 6.5% lower, Q4 earnings are expected to be 8% higher YoY.
4. **Bears** are focused on the Fed having to raise rates higher and keep them high for longer. They worry about the inverted yield curve, risk to margins, student loan repayment hurting consumers, narrow market leadership, stretched valuations, and geopolitical tensions. There is also concern about the lagged effect of rate increases and tighter lending standards. There could be a fiscal drag.
5. In the past nine decades, US stocks added **$55T** in aggregate worth for investors. Over that stretch, Apple, Microsoft and Exxon Mobil are responsible for 11% of that. This also lends support to the idea that it's not unusual for a small number of stocks to be responsible for the majority of gains. (Bloomberg)
6. It's been **more than three months since the S&P 500 has pulled back at least 3%**, one of the longest stretches since WWII. The S&P has gone **26 days without a 1% drop**. The **VIX** closed the week at 13.59. (WSJ) (Bloomberg)
7. **Option skew** is at some of the lowest levels since 2019. Skew measures pessimism vs. optimism. Extreme call-buying results in lower skew. (WSJ)

II. The Economy

A. Inflation

1. The **headline PCE** was up **3.8% YoY (+.1% MoM**), its lowest level since April 2021. **Core PCE** was up **.3% MoM and 4.6% YoY**. (WSJ)
2. Prices of **services excluding energy and housing** rose .23% in May, 4.53% YoY, and at a 3.9% annualized rate over the past quarter. (Bloomberg)
    a. Prices of goods excluding food and energy increased 2.6% YoY (surprisingly high). (WSJ)

B. The Fed

1. Powell said that the question now is **whether policy is tight enough**. He said that he and his colleagues "almost overwhelmingly…think that we **need to do more** to get to a level of tight policy." (WSJ)
2. Powell said **at least two rate increases are likely necessary** to bring inflation down and that acting at consecutive meetings isn't off the table. He also said that the risk of doing too much is smaller than the risk of doing too little. (Bloomberg)
3. Powell said that he doesn't anticipate core inflation will **return to the 2% target until 2025**. They also see a chance of a slowdown due to past rate increases and banking stress. The banking stress was significant enough that Powell said it played a part in his desire to spread out rate increases. (WSJ)
4. Powell said that **AI could be disinflationary** by reducing the need for labor but **could be inflationary** in terms of faster growth.

C. Fiscal Policy

1. The federal budget **deficit** is expected to be **5.8% of GDP** this year, declining to 5% of GDP by 2027, then climbing every year to **10% by 2053**.
    a. The total federal **debt held-by-the-public** is projected to climb from 98% of GDP to **181% by 2053**.
2. High and rising debt could slow growth, push up interest payments to foreign holders.
    a. The federal government will spend **$71T on interest through 2053**, sucking up 35% of revenue by then (crowding out other spending).
3. The BIS warned that **excess deficits could impact the financial system**. Banks could get into trouble due to their exposure to government bonds. This could force the government to bail out the banks and this could create a **doom loop** (where credit problems of governments and banks would reinforce each other).
4. The BIS also said that **governments should take into account the impact of financial booms**, which can fill their coffers when capital gains are being reaped and taxed.
5. The CBO projects **interest will consume over 1/3 of federal revenue after 2050**, up sharply from a bit less than 14% in the current fiscal year. The CBO also assumed that the average interest rate rises relatively slowly, only reaching 3% by 2028 (from 2.7% this year). (Barron's)

D. General Stories about the Economy and Politics

1. ECB Pres. Christine Lagarde said that the **ECB** won't be able to declare the end of its historic cycle interest-rate increase anytime soon. July will bring a ninth straight boost to borrowing costs. (Bloomberg)
2. **Consumer confidence rose** to 109.7, its highest level since last year. There is optimism about the labor market and the economic outlook. (Bloomberg)
3. **Socioeconomic status turns out to be a weak proxy for race**. In the US, the median income for non-Hispanic white households is $78K, about 1/3 higher than it was for Hispanic households and the gap is even larger with Black families. But there are more than three times as many white households earning under $50K than Black or Hispanic households. (WSJ)
4. This week, we get the **JOLTs report**, the **jobs report** and the **FOMC minutes**.
5. Given Putin's problems, Xi Jinping's gamble on a "no limits" friendship with Putin looks like a losing bet. The only thing that these authoritarian dictators really share is a desire to reduce western power. It can't help when your closest pal is losing power and you are becoming dependent on him for oil. (Bloomberg)

III. Three Uncomfortable Truths for Monetary Policy, by Gita Gopinath (IMF), June 26, 2023

A. Intro

1. The **battle against inflation is ongoing**. Headline inflation has declined, but the **stickier components** remain persistently high. Central banks must continue to fight inflation now, while also determining if and how monetary policy strategy may need to change in the future.
2. **Three uncomfortable truths** for monetary policy:
    a. Inflation is **taking too long to get back to target**.
        i. Central banks need to remain committed to fighting inflation, despite risks of weaker economic growth
    b. **Financial stresses could generate tensions** between central banks' **price and financial stability** objectives.
        i. Achieving "separation" through additional tools is possible, but not certain
    c. Going forward, central banks are likely to experience **more upside inflation risks** than before the pandemic.
        i. Tools like forward guidance and QE will need to be refined in the future

B. Uncomfortable Truth #1: Inflation is taking too long to get back to target

1. Inflation **forecasters have been optimistic** that inflation will revert quickly to target ever since it spiked two years ago. Inflation sits well above previous forecasts.
2. Despite repeated forecast errors, **markets remain particularly optimistic** that inflation will recede to near-target levels relatively quickly.
    a. These disinflation hopes—likely fueled by the sharp drop in energy prices—**underpin expectations that policy rates will decline soon**, despite central bank guidance to the contrary. Surveys of market analysts paint a similar picture and suggest that inflation is likely to come down without much of a hit to growth. It is useful to bear in mind that there is not much historical precedent for such an outcome.
3. Setting aside forecasts, the fact is that **inflation is too high and remains broad-based in many countries**. While headline inflation has eased significantly, **inflation in services** has stayed high, and the date by when it is expected to return to target could slip further.
4. While ongoing research will shed light on **why inflation has proved so sticky**, several **factors** are probably at play, and continue to pose upside inflation risks.
    a. First, **while central banks have raised rates significantly, activity has only slowed modestly**. Unemployment rates are at historic lows. Wage growth has been solid and is picking up, though not by enough to begin reversing sharp declines in real wages over the past two years.
        i. The combination of **tight labor markets with** a still solid stock of **household savings** and **residual pent-up demand** may be behind the resilience in activity we have seen so far.

   b. Second, despite the large increase in the nominal policy rate, **financial conditions may not be tight enough** which impedes monetary policy transmission. Real rates using market-based measures of inflation expectations are still quite low, and near-term real rates using household measures are likely negative.
   c. Lastly, the **pandemic has likely lowered potential output and productivity**, which would also help explain some of the upward pressure on inflation.
5. What is worrisome is that **sustained high inflation could change inflation dynamics** and make the task of bringing inflation down more difficult. Given the massive decline in real wages since the pandemic, some wage catchup is to be expected.
   a. All else equal, **if inflation is to fall quickly, firms must allow their profit margins**—which have shot up during the past two years—**to decline** and absorb some of the expected rise in labor costs. But firms may resist this, especially if the economy remains resilient, while workers may demand payback for their real wage losses. Such dynamics would slow inflation reduction and likely feed into expectations and increase susceptibility to further upside cost or resource pressures.
6. Some side effects of fighting inflation with monetary policy could be reduced by **giving fiscal policy a bigger role**. Indeed, economic conditions call for **fiscal tightening**. It could help cool demand and reduce the need for rising interest rates, especially if done in concert by a broad group of countries.
   a. Where support is needed, they must shift from providing broad-based to well-targeted support, and revenue windfalls from high inflation should be saved.
7. Ultimately, it is **up to central banks to deliver price stability** irrespective of fiscal stance. With underlying inflation high and upside inflation risks substantial, risk management considerations suggest that **monetary policy should continue to tighten** and then remain in restrictive territory until core inflation is on a clear downward path. Central banks should be prepared to react forcefully to further upside inflation pressures, or to evidence that inflation is more persistent, even if it means much more labor market cooling.
   a. The costs of fighting inflation will be significantly larger if a protracted period of high inflation boosts inflation expectations and changes inflation dynamics.
8. There are also **some downside risks to inflation that could arise**, for instance, from the recent unwinding of supply chain disruptions and fall in energy prices. The effect of the recent tightening in monetary policy is still working through the system.
   a. While central banks must be vigilant about not easing prematurely, they should be prepared to adjust course if a chorus of indicators suggest that these downside inflation risks are materializing.

C. Uncomfortable truth #2: Financial stresses could generate tensions between central banks' price and financial stability objectives.

1. **If inflation persists and central banks need to tighten much more** than markets expect, today's modestly tight financial conditions could give way to a **rapid repricing of assets and a sharp rise in credit spreads**.
    a. For the euro area, tighter monetary policy may also have **diverse regional effects**, with spreads rising more in some high-debt economies. Higher rates can also amplify other vulnerabilities arising from household indebtedness and a large share of variable rate mortgages in some countries.
2. This brings me to the second uncomfortable truth: Financial stresses could generate tensions between central banks' price and financial stability objectives. This is because, **while central banks can extend broad-based liquidity support to solvent banks, they are not equipped to deal with the problems of insolvent borrowers**.
    a. If financial stresses remain modest, central banks shouldn't face too much of a challenge in achieving both price and financial stability objectives. If households and firms face a rise in borrowing costs, central banks can lower policy rates to keep output and inflation on roughly the same path. Other relatively standard central bank tools—such as discount window lending and other forms of liquidity support—can also help.
        i. Of course, lowering policy rates—even if to keep broad financial conditions unchanged—may be misinterpreted as waning resolve to fight inflation, so effective communication is important.
    b. The **situation becomes much more difficult if financial stresses threaten to morph into a systemic crisis**. Critically, forestalling a crisis may go beyond what central banks can do alone. While they can extend broad-based liquidity support to solvent banks, they cannot support insolvent banks, firms, or households. These must be addressed by governments and may require sizeable fiscal resources. And central banks may be considerably limited in alleviating nonbank stresses given difficulties in assessing solvency and the political economy risks of picking winners and losers.
        i. Forceful and timely interventions that are backed with the requisite fiscal support could allow monetary policy to focus on price stability, as was the case during the recent stress episodes.
        ii. But **when governments lack fiscal space or political support to respond** to the problem, central banks may need to adjust their monetary policy reaction function to account for financial stress. While central banks must never lose sight of their commitment to price stability, they could tolerate a somewhat slower return to the inflation target to avert systemic stress.
            1. Such a shift in the reaction function could leave the central bank behind the curve in fighting inflation – as, for instance, happened when the Federal Reserve decided to ease policy in the mid-1960s on fears of a credit crunch, even as inflation pressures were sizable.
        iii. Put simply, while **separation is achievable in principle**, it is **challenging in practice**, and must not be taken for granted.

D. Uncomfortable truth #3: Central banks are likely to experience more upside inflation risks than before the pandemic.

1. The monetary policy strategies implemented in the post-GFC period by the major central banks focused heavily on supporting activity and boosting too-low inflation when the effective lower bound (ELB) seemed a pervasive constraint. There was little sense that inflation could rise persistently above target given the perceived flatness of the Phillips Curve, or that central banks would face significant tradeoffs in addressing supply shocks. Risk management considerations tilted heavily toward downside risks to activity and inflation.
    a. Monetary policy strategies and the use of tools like forward guidance and quantitative easing must accordingly be refined.
2. Looking forward, **central banks are likely to experience more upside inflation risks than before the pandemic for three reasons**. Some of the upside risk reflects **structural changes affecting aggregate supply**—heightened by the pandemic and the war in Ukraine—and that may result in larger and more persistent shocks. In addition, we have also learned the lesson that **the Phillips Curve is not reliably flat**. A third reason could be the cost of **climate change**.
    a. There is a substantial risk that the **more volatile supply shocks** of the pandemic era will persist.
        i. Despite a considerable easing of pandemic-related supply pressures, the **restructuring of global supply chains** that was intensified by the pandemic and war, coupled with geo-economic fragmentation, may cause ongoing disruptions to global supply. Many countries are turning to **inward-looking policies**, which raise production costs, and, ironically, make countries less resilient and more susceptible to supply-side shocks.
    b. The pandemic has also taught us more about the **Phillips Curve**. Evidence increasingly shows that **nonlinearities may become pronounced at high levels of resource utilization**, so that inflation is more sensitive to resource pressures. Difficulties in measuring economic slack may also make it harder for policymakers to gauge the point at which inflationary pressures will escalate.
    c. The increasing **physical and transition risks from climate change** are also likely to amplify short-term fluctuations in inflation and output. Delays in achieving Paris Agreement goals increase the risk of a disorderly transition and serious disruptions to energy supply, which could boost inflation sharply and create more difficult tradeoffs for central banks.
3. These takeaways suggest that when it comes to policy strategy, it will be **important to be more cautious about "looking through" supply shocks** (and they need to be certain that shocks are supply-driven). **Central banks may need to react more aggressively**:
    a. If the supply shocks are broad-based and affect key sectors of the economy, or
    b. If inflation has already been running above target, so that expectations are more likely to be dislodged.
    c. If we're in a strong economy in which producers can pass on cost hikes more easily and workers are less willing to accept real wage declines.

4. While the focus now is on high inflation, what we've learned about the Phillips Curve **also has important implications for** the monetary policy response to **future periods of below-target inflation**. **Some refinement may be needed to the "lower-for-longer" strategies**—used widely after the Global Financial crisis—that typically involved maintaining policy rates at the effective lower bound until inflation reaches or overshoots its target. Lower-for-longer strategies may still be desirable under some conditions, particularly for an economy in deep recession and facing chronically low inflation.
    a. But the pandemic experience suggests that policymakers should **be more cautious about calibrating policy** to generate a persistent fall of unemployment below the natural rate U* when inflation is running only modestly below target—say between 1.5 percent and 2 percent.
    b. And there could well be a **case for preemptive tightening** under these conditions if resource pressures appear tight and there is a material risk that new shocks—such as fiscal expansion—could push the economy to overheat.
        i. By allowing for a more gradual pace of tightening, a preemptive approach would also **reduce the financial stability risks** likely to accompany a rapid exit from low rates (the second uncomfortable truth).
5. Refining monetary policy strategies also calls for **adjusting the use of tools**.
    a. **Forward guidance** is a helpful tool, and conditional promises can enhance its impact. But such promises should be tempered by **escape clauses** if developments unfold much differently than expected. The forward guidance provided by central banks during the pandemic may have been too much of a straitjacket and prevented a faster reaction to inflation surprises.
    b. The **costs and benefits** of **quantitative easing** (QE) should also be reconsidered. QE will likely remain a critical tool should central banks face circumstances like the post-GFC period in which unemployment runs high and inflation low even though policy rates have hit their floor.
        i. But there should be **more wariness of using QE**—and accompanying it with forward guidance promising low policy rates—when employment has largely recovered, and inflation remains only modestly below target.
6. So, when we consider the monetary policy of tomorrow, it is important to recall **today's lessons**:
    a. First, **take a closer look at supply shocks** before deciding to simply "look through" them.
    b. Second, **be careful about running the economy hot**, and be ready to act preemptively if it does—even if inflation isn't yet burning brightly.
    c. Third, make sure that **forward guidance is coupled with escape clauses**; and
    d. Fourth, be **more cautious about deploying QE** outside of a recession.