MARKET UPDATE

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July 31, 2023 – Market Update

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I. Stocks

A. Last Week

1. Week: DJIA +.7%; **S&P 500 +1.0%**; Nasdaq +2.0%
    a. S&P 500 up for the third-straight week.
    b. S&P 500 is now up 28% from its October 12 low. It hit a 52-week high this week.
    c. The DJIA tied a record on Wednesday with its 13th-straight daily gain. It dropped on Thursday.
    d. Big-tech had a great week, with META and GOOGL each up over 10% after earnings.
2. Several **factors likely behind renewed push higher**:
    a. Belief in soft landing
        i. Disinflation traction with PCE and ECI
    b. **Earnings** takeaways more upbeat; especially mega-cap tech companies
        i. 81% of S&P 500 companies that have reported have beaten estimates
    c. Belief in peak-Fed
        i. The Fed voted to hike rates 25 bps to 5.25% - 5.50%. Powell said that future increases would be data dependent.

B. Bullish Talking Points

1. **Peak Fed** – maybe this was the last rate hike
2. **Soft landing** narrative
    a. Fed staff no longer forecasting a recession
    b. Strong GDP fits into soft landing narrative
        i. GDP was up 2.4% (SAAR).
        ii. Initial jobless claims fell to 221K
    c. Core PCE lowest since Sep. 2021
        i. June core PCE was .2% MoM and 4.1% YoY.
    d. ECI expanding at slowest pace since 2021
3. **ECB** becoming data-dependent (dovish)
4. Record **money market assets** could flow into equities
5. **Q2 earnings** beat rate running 4+ points above five-year average. (Source: FactSet)

C. Bearish Talking Points

1. Potentially **higher rates**:
    a. No explicit removal of Fed tightening bias
    b. BOJ YCC policy tweak could send rates higher
2. **Extreme optimism** in market
    a. Stretched positioning noted by multiple firms
    b. Overbought conditions with nearly 70% (highest for year) of S&P 500 companies trading one standard deviation above 50-DMA to start week
3. **Earnings** at risk
    a. Negative operating leverage and drag on earnings as price increases roll off and wage/input pressures remain sticky
    b. AI investment is cannibalizing other tech investment
    c. Disinflation will make 12.5% earnings growth difficult for 2024. (Source: FactSet)

D. Earnings

1. Companies are reporting earnings **6.1% above expectations**
   a. Themes include:
      i. Consumer company pricing power; continued consumer resilience
      ii. Disinflation
      iii. Some loosening of labor market
      iv. Select volume/elasticity scrutiny
      v. EV price pressure
      vi. PC inventory normalization
      vii. Tight housing market tailwind for builders
      viii. AI cannibalization
2. S&P **earnings are down 7.3% YoY**, slightly worse than the 7% drop that was expected. (Source: FactSet)

E. It's Hard to be a Market Strategist

MS's Michael Wilson was lauded last year for his market call. This year, he's been bearish and wrong. He said that **he got things wrong because**:

1. Growth was higher than he expected
2. The Fed's balance sheet expansion in March
3. Excitement about AI
4. P/E expansion as the result of cooling inflation (Bloomberg)

F. Nasdaq

1. The Big Seven (AAPL, MSFT, NVDA, AMZN, GOOGL, META, TSLA) became so big that **Nasdaq had to rebalance the index**. They have a rule that requires such a reweighting when all of the stocks that make up 4.5% of the portfolio or more combine to make up 48% or more of the index.
2. The Nasdaq gained **42% so far this year**, more than the index's 29% start of 1999 (the dot-com bubble). But, Nasdaq is up only 4.2% over the past two years while it had surged 134% over the two years ended July 13, 1999. Nasdaq's CAPE is 46, while it had reached 113X in 2000. With that said, valuations are still high. (Barron's)

II. Interest Rates and the Dollar

1. UST rates: 3-month 5.52% (+2 bps); 2-yr 4.87% (+5 bps); 10-yr **3.96%** (+12 bps)
    a. Treasury prices were weaker
    b. The yield curve steepened
2. The argument about the **inverted yield curve**:
    a. Is it signaling recession?
    b. Is it signaling that long-term rates will be lower because inflation will subside? (Bloomberg)
3. The **dollar strengthened** for the week (with higher rates)
    a. **Dollar bears** are counting on:
        i. The Fed being done raising rates
        ii. The BoJ expanded flexibility of its yield curve control policy
            1. This could result in money leaving the Treasury market
            2. While rates would go higher, we would expect the dollar to drop
    b. **Dollar bulls** are counting on:
        i. The ECB also stopping their rate increases
        ii. Extreme bearish sentiment about the dollar (Bloomberg)

III. The Fed

A. The Fed Raised the Fed Funds Rate

1. The FOMC raised the Fed funds rate to a range between **5.25% and 5.5%.** It's the 11th increase since March 2022.
2. The FOMC meets three more times this year.
    a. Fed Chair Powell said that it's **too early to know** if they were done.
    b. Powell had no incentive to say that the FOMC was done as that would have eased financial conditions significantly. Or, such a statement could be wrong. (WSJ) (WSJ)

B. The Arguments that the Fed Could Keep Raising Rates

1. **Consumer sentiment is at a two-year high**. Combine this with **positive real wage gains** and consumers could keep spending and this will keep demand high.
    a. While this is a sign of a healthy economy, the Fed could be forced to raise rates to slow price growth.
2. The **housing market** appears to have bottomed (and Powell acknowledged this in his press conference). Housing is interest rate sensitive, so this could lead the FOMC to tighten.
3. Powell is watching the **non-housing core services sector**. To get a slowdown in supercore services, we will likely **need to see weakness in the labor market and wage growth**.
    a. On Wednesday, Powell said that "labor market conditions broadly are going to be an important part of getting inflation back down." He also said that this was "why we think we need some further softening in labor market conditions." (Barron's)
4. As of the first quarter, **only 11% of outstanding household debt carried rates that fluctuated** with benchmark interest rates. This is why Fed policy is having a limited effect (and they may need to do more). (WSJ)

IV. Inflation

A. Disinflation

1. **Two separate releases** provided good news on the disinflation front.
   a. The **core PCE** increased **.2%** in June **(+4.1% YoY**, an improvement from the +4.6% reading in May). At 4.1%, this is still double the Fed's 2% goal.
      i. Core PCE had been as high as 5.4% in Feb. 2022 and is back to its slowest pace since Sep. 2021.
      ii. Prices rose more slowly because the **price of goods dropped** .1% MoM, leaving them down .6% YoY. The cost of **services, however, rose .3% MoM** and 4.9% YoY. Service inflation could be helped by lower wages.
   b. The **employment cost index** grew **1% in Q2, up 4.5% YoY** (an improvement from the 4.8% annual rate in Q1). This is the slowest pace in two years. Economists tend to think that wages need to retreat to a 3.5% annual rate to be consistent with 2% inflation.
      i. The ECI includes wages and benefits. It's also not distorted by shifts in the composition of employment among occupations or industries.
2. **Fears about inflation** include: gas prices are rising again (pushing up headline inflation); supply chains remain fragile; YoY comparison will become less favorable since inflation began slowing last July.
   a. Consumer spending remains strong, rising .5% in June or .4% in real terms. This is the largest monthly increase since the start of the year. If consumers keep spending, companies have little incentive to lower prices.
3. We also have to recognize the **differences between PCE and CPI**.
   a. CPI gives more weight to the cost of housing, which should continue to cool. PCE puts more emphasis on core non-housing services, which are less affected by higher interest rates. The PCE gives especially significant weight to medical services costs. (Barron's)

B. Different Views on Inflation

1. **Argument 1: easing in inflation will be temporary**
   a. The slowdown is just the result of fading pandemic-related shocks that pushed up rents and cars.
   b. There is too little slack and too much demand in the economy. Underlying price pressures could persist, requiring higher rates for longer.
   c. The labor market is too tight and will likely remain tight until we have a recession.
2. **Argument 2: we are well on our way to 2% inflation**
   a. Current economic slowing will gradually subdue price pressures.
   b. We have ample evidence that the labor market is cooling:
      i. It is taking longer for unemployed workers to find new jobs.
      ii. Increases in hours worked by private-sector employees has slowed.
   c. Inflation will be slow enough to push real rates higher – which will provide further restraint (WSJ)

C. Argument that Higher Growth will Drive Inflation Higher

1. Inflation is a lagging indicator and we're seeing signs of higher growth.
2. Stocks and corporate spreads are showing expectations of higher growth.
3. Single family building permits hit a one-year high, rising 23% in six months.
4. Initial jobless claims are at the lowest level in two months.
5. The Conference Board's gauge of consumer sentiment hit its highest level in two years. (Bloomberg)

D. Other Inflation News

1. **UPS reached an agreement** with the Teamsters union, raising wages by a 6.5% CAGR for the next five years. Much of this was catch-up for past inflation, but the question is whether this will **result in higher shipping costs** (and inflation). (Barron's)
2. **Gas prices hit an eight-month high** of $3.71 per gallon. This is still 59 cents a gallon cheaper than last year's average of $4.30 per gallon and June 2022's peak of $5.02. The price of crude has risen 13.3% in the past month. The rise could be linked to refinery outages. (Barron's)

V. GDP, Growth and Recession

A. Data and Ideas about the Economy

1. **GDP grew at a 2.4% annual rate** in Q2 (up from 2% in Q1). **Consumer spending** grew at **1.6%** (down from 4.2%). Business investment grew at a 7.7% annual rate. (WSJ)
2. In the first months of the pandemic, nearly 4MM **prime-age workers** left the labor market, pushing participation to the lowest level since 1983. All those workers have come back, plus an **additional 2.2MM**. A tight labor market, flexible work, and having fewer kids are all having an impact. This can help to take the pressure off the labor market. (WSJ)
3. Approximately 71% of economists now say that the **odds of the US entering a recession** in the next 12 months are 50% or less according to the NABE. (Bloomberg)
    a. The Fed's staff economists are no longer calling for a recession this year. (Bloomberg)
4. In order to believe that we will experience a soft landing, you must believe that the FOMC will stop raising rates. Since the labor market is still tight (with wages elevated), you must further believe that the Fed is going to accept inflation above 2%. (Bloomberg)
5. Recession statistics:
    a. The past four expansions, dating back to 1982, have lasted an average of 8.6 years. The current expansion only started in April 2020.
    b. Until 1981, expansions lasted an average of 3.7 years. Globalization, brisk labor force growth and technology have all pushed inflation lower and resulted in longer expansions (less reason for Fed to end the party). (WSJ)

B. A U.S. Recession is Still Possibly, by Michael R. Strain

(American Enterprise Institute) (Project Syndicate)

1. **Optimism in a soft landing is growing** (especially after July 12 CPI data):
    a. Opinions:
        i. WSJ survey of economists: 54% expect recession in next year (down from 61%)
        ii. GS lowered estimate of recession to 20%
    b. Arguments:
        i. Shelter inflation will likely put downward pressure on core inflation
        ii. Demand could fall with reduced bank lending and depletion of household savings
        iii. Labor market is cooling
            1. To extent that we just need fewer job openings, we don't need to have high unemployment
2. But a **recession is still likely**:
    a. Inflation is still double the Fed's target
        i. Yes, June CPI was only .2%, but:
            1. Just one month (and we've seen one-month drops before)
            2. Still up 4.8% YoY
            3. Core PCE is what the Fed cares about – no improvement in 2023
    b. The **Fed's tightening has mostly hit the economy already**
        i. We saw lower stock prices, higher rates and stronger dollar
            1. We haven't seen any more tightening in fin'l conditions in 2023
    c. **Monetary policy may not be that restrictive** w/ a 5.1% Fed funds rate
        i. Author estimates the real rate is 1.5% (it could be even lower)
    d. Given these three factors (above), the **Fed is likely to keep tightening**. And the longer it takes to gather evidence that we're on a path to 2%, the higher rates will go.
        i. This will increase the risk of recession
3. **Even if inflation falls, unemployment will climb into recessionary territory**
    a. The costs of disinflation rise as the rate of inflation falls
    b. From April 2021 until May 2023, consumer prices rose faster than wages
        i. This is no longer the case. Facing lower margins, companies will shed workers.
4. **History argues against a soft landing**
    a. Since WWII, a .5% increase in the unemployment rate in a given year has been followed by a 2% increase
        i. Recessions are driven in large part by a loss of confidence by businesses and households about the near-term future

VI. Insurance and Climate

1. It's expected that by 2050, **Phoenix** will spend half the year with temperatures above 95 degrees Fahrenheit. In addition, more than one-third of its water comes from the Colorado River, which is drying up. (Bloomberg)
2. When **Farmers** exited the Florida insurance market, it became the **15th insurer** to do that since early last year.
    a. Homebuyers may get a fixed rate mortgage, but their insurance premiums could increase drastically. (Bloomberg)
3. In **1980**, losses from **three** US natural disasters (a drought, a flood and a hurricane) topped $1B in 2023 dollars.
    a. **Last year**, there were **18** $1B events across the country, including Hurricane Ian (with $114B in damages). (Bloomberg)
4. **Global oil consumption** likely hit a **record** of 102.5MM barrels per day in the last few weeks of July. The prior record was 102.3MM barrels in August of 2019. (Bloomberg)