MARKET UPDATE

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Market Update – June 12, 2023

I. Stocks

A. Ideas from the Markets

1. For the week: DJIA +.1%; **S&P 500 +.4%**; Nasdaq +.1%. The **VIX** dipped below 14, a level last seen before the pandemic. The S&P 600 has gained 7% this month, despite the fact that small-caps are less exposed to AI and may have more difficulty borrowing. (Barron's)
2. Some commentators are saying that we're in a **bull market** because the market is 20% higher than its October low. I'm not a big fan of thinking about it this way. Imagine the market dropped 80% and then rallied 20%. Would you feel like we were in a bull market. I feel like we'll be in a bull market when stocks hit a new high.
3. The **S&P 500 is up 12%** this year. The **median gain** of the **10 largest** members of the index is **39%**. For the **rest,** it's less than **1%**. (Barron's)
    a. **People complain about market breadth when they're positioned defensively or don't own the leading stocks**. (Bloomberg)
4. **Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Tesla and Nvidia**—now account for **30%** of the S&P 500's market capitalization. That is up from about **22%** at the start of the year.
    a. While the market-cap weighted S&P 500 is up 12%, the **equal-weighted** is up 1**.8%.** This is the largest-ever outperformance on a YTD basis. Last week, only 38% of S&P 500 stocks were above their 200-day moving average. (WSJ)
    b. The argument that **narrow breadth isn't a problem**: the top five stocks in the S&P 500 account for **24%** of the market value. While that sounds like a lot, they also account for **21%** of the net income. The reality is that a few companies are making a lot of money. (Bloomberg)
5. The **market has rallied this year despite** an aggressive Fed, slower growth, the debt ceiling standoff, a banking crisis and a potential earnings slump. If investors who were positioned defensively start to **chase returns**, the market could go higher. (Barron's)
    a. The **consensus trades for 2023 haven't worked out**: short the dollar, buy emerging markets, sell big tech, etc. (Bloomberg)
    b. The stock market is rallying despite economic **gloom in the bond market**. Stocks often do well after inversion…until the economy starts to slow. (Bloom.)
6. You're starting to hear more commentators refer to the "**pain trade**." This is where the market is moving in a way that is hurting a large percentage of investors. A common saying among investors is that the market has a way of inflicting the most pain on the most people.
7. S&P 500 **earnings** are expected to be up **8.2% YoY in Q4**. AMZN, META, GOOGL and NVDA are expected to be the largest contributors (with several growing their earnings 100%). Excluding these companies, Q4 earnings would be expected to be **+4.2%.** (FactSet)
8. Overall, this felt like a rather boring week for stocks. Next week, we get the **CPI report** and the **FOMC meeting**. The Fed is expected to pause, but it's not certain.

B. Narratives Rarely Pan Out

1. Investors hear narratives and then find stories and data to confirm them
2. Think of all of the **narratives we've heard in the first five months** of 2023:
    a. US hard landing and recession
    b. US soft landing
    c. US no landing, acceleration
    d. China reopening and consumption boom
    e. China slowdown and disinflationary balance sheet recession
    f. Inflation boom in Germany and Europe
    g. Recession in Germany and peak inflation
    h. Regional bank crisis in the US may signal end of US hegemony
    i. Fed's going to cut in July
    j. Fed's going to hike in July
    k. OPEC production cuts will take oil back up through the highs
    l. OPEC doesn't matter – they've lost control of the market
    m. US debt crisis
    n. AI will save or kill us all
3. Think of **others that are not on the list** (but could be):
    a. The pandemic and the war in Ukraine – neither is over
    b. MAMU – Mother of all Meltups
    c. Possible commercial real estate crash
    d. De-dollarization
4. Now, people are telling a **Goldilocks narrative**
    a. MSCI's index for all the world's exchanges hit a 12-month high
    b. Inflation news has been more positive; expectations in-check
    c. Labor market is strong; prime-age participation rate is high
    d. Earnings forecasts have resumed their rise (Bloomberg)

II. Bonds, Rates and Credit

A. Yields

1. UST: 3-month 5.37 (-13 bps); 2-yr 4.59% (+9 bps); **10-yr 3.75%** (+6 bps)
2. There's a lot of disagreement concerning whether the upcoming **issuance of a large amount of debt by the US Treasury** will hurt risk assets.
    a. **No**: there are trillions of dollars in the Fed's reverse repurchase facility (RRP). This money can be brought back into the system with higher rates. In addition, realize that banks have a tremendous amount of excess reserves.
    b. **Yes**: Money will come out of the system in order to finance the government. This will push rates higher and banks will have to pay more for deposits. Money market funds may prefer to leave money in the RRP if they fear rates will go higher (hurting Treasury bonds). (Bloomberg) (WSJ)

B. The Private Credit Market

1. **Like private equity** funds, private debt companies raise capital from investors but instead of using that money to take ownership of companies, they **lend** to them instead. Many PE firms have large private credit businesses to finance their acquisitions.
    a. The private credit market has increasingly become a **catch-all concept** that incorporates everything from traditional direct lending to smaller companies, buyout financing and even real estate and infrastructure debt. In short, it's a way for fund managers to capitalize on strategies they say shields them from the volatility of mark-to-market losses in public markets.
    b. **Risk strategies vary** from providing credit to back PE buyout deals, to offering so-called **senior secured debt** to mid-size companies with relatively low leverage. Others are offering higher risk **mezzanine financing**, which sits between debt and equity, to firms that are struggling.
2. Everyone wants into private credit. **Higher rates, banks' lending retreat and strong fees** make it desirable.
    a. The private credit market – which began by catering to private equity businesses and grew rapidly as banks pulled back after the global financial crisis – has roughly **tripled in size since 2015 to $1.5T**. Apollo says that it could grow to replace as much as $40T of the debt markets.
    b. Managers can charge **1% - 1.5% of AUM and a 15% of gains** provided they hit an 8% hurdle rate.
3. Most private credit funds arrange loans on a **floating-rate basis**. This boosts returns for the funds as rates rise and protects their holdings from interest-rate risk. At the same time, higher interest payments will stress borrowers' balance sheets and could lead to defaults. (Bloomberg)

C. CRE Refinancing

1. Nearly **$1.5T in commercial mortgages** are coming due over the **next three years**. **Many** commercial mortgages are **interest-only loans**. The entire principal is due at the end.
    a. **Interest-only** loans as a share of new commercial mortgage-backed securities issuance increased to **88% in 2021**, up from 51% in 2013.
    b. The share of interest-only commercial mortgages held on **bank balance sheets** also rose between 2013 and 2021.
    c. It **may be difficult to get a new loan (to refinance) or to sell a building**. Many banks have stopped issuing new loans for office buildings.
2. Fitch Ratings recently estimated that **35% of pooled securitized commercial mortgages coming due between April and Dec. 2023 won't be able to refinance** based on current interest rates and the properties' incomes and values. While many malls and hotels face high default risks, the situation is particularly dire for office owners.
    a. One estimate (from CoStar) is that **83% of** outstanding securitized **office loans** won't be able to refinance if interest rates stay at current levels.
3. A rise in defaults could result in distressed sales and lower property values. It could also hit regional banks.
4. The share of securitized office loans that are **delinquent** jumped to **4.02%** in May, up from 2.77% in April and the highest level since 2018. (WSJ)
5. Torsten Slok (Apollo) says that two years ago, the number of **banks exceeding the FDIC's CRE loan concentration guidelines** was ~300. Today, there are almost 700. In other words, banks are much more susceptible to a decline in commercial real estate prices.

D. The FOMC Meeting

1. The market is expecting the FOMC to **pause rate hikes but say that more rate hikes are possible**. Fed officials don't want to push the economy into recession, but they do want to slow inflation.
    a. Core PCE is up 4.7% YoY. The trimmed mean is running at a 4.4% annualized basis over the past six months.
    b. The reasons for pausing include the long and variable lags (i.e., it takes time for rate hikes to work through the real economy) and signs of economic weakness (such as the leading economic indicators). (Bloomberg)
2. A pause may be described as a "**hawkish pause**" since Powell will likely emphasize the potential for more rate hikes. In addition, investors will be watching the **Summary of Economic Projections**. (Barron's)

III. International

A. General

1. **Saudi Arabia** said that they would unilaterally cut an additional **1MM barrels of oil** production per day. The price of oil jumped last Sunday on the announcement, but ended the week lower than where it started. The price of oil is ~20% lower than it was when OPEC+ announced a cut of 2MM barrels per day in October. Saudi Arabia needs $81 oil to balance its budget (violating human rights can be expensive). (WSJ)
2. The **Turkish lira** plunged to a record low as Turkey's central bank stopped intervening in the currency market. Since the May 28 election, the lira has weakened more than 13% versus the dollar. (Bloomberg)
3. **Unemployment for Chinese citizens age 16 – 24 is above 20%** and likely to move higher as 11MM new college graduates enter the market. (WSJ)
4. **China is paying Cuba to allow China to establish an electronic eavesdropping facility** – to better monitor the US. Others say that this has already been going on for some time. (WSJ)

B. Monahan is a Hated Man

1. The **PGA Tour, LIV Golf and the DP World Tour have agreed to merge**. It's a combination of Saudi money and the PGA Tour name and connections. This effectively makes the Saudis investors in US golf's legacy powerhouse.
2. Many players had rebuffed lucrative offers to stay with the PGA Tour. How do they feel now?
    a. LIV was accused of trying to use the sport's popularity to **whitewash** the country's record on human rights, and Monahan, just a year ago, dubbed LIV "a foreign monarchy that is spending billions of dollars in an attempt to buy the game of golf." Well Jay, you just sold it to them.
    b. Remember when Phil Mickelson referenced Saudi Arabia's "horrible record on human rights,", but realize that they had a lot of money? Well, that was apparently the view of the PGA.
    c. We can also remember that Monahan once asked LIV golfers if they ever had to apologize for being a member of the PGA tour. (Ask them again Jay. They may give a different answer today.)
3. This **ends litigation**. It also makes PGA Tour Commissioner Jay Monahan a hated man. (Monahan is now defending himself by saying that the PGA couldn't afford the litigation.)
    a. There was no evidence that LIV had been financially successful. The only strength that they had was in litigation.
4. The new entity will be chaired by the governor of Saudi's Public Investment Fund. Monahan will serve as chief executive. The Tour will hold a majority voting interest.
5. **Both sides of the political aisle** railed on the deal.
    a. Chip Roy said, "I wonder if the PGA Tour – having wrapped itself in the flag – invited 9/11 families to the big announcement? I guess not, because money was worth more than principle, apparently."
    b. Connecticut Sen. Chris Murphy said, "They came to my office and told me it would be a moral outrage for Saudi Arable to have an ownership stake in a major American sport. The announcement speaks for itself as to what really matters." (WSJ)

IV. The Power and Perils of the "Artificial Hand": Considering AI Through the Ideas of Adam Smith, by Gita Gopinath, First Managing Director, IMF (IMF)

A. Introduction

1. Adam Smith grappled with how to advance well-being and prosperity at a **time of great change** (the Industrial Revolution). At these times, **new technologies revolutionize the nature of work, create winners and losers, and potentially transform society**.
2. Today, we're at the **same point with artificial intelligence**. It could change our lives in spectacular ways.
    a. If he were alive, how would he respond to this new "artificial hand"?

B. Beyond the Invisible Hand

1. A seminal idea from The Wealth of Nations is that the **wealth of a nation is determined by the living standards** of its people and those standards can be **raised by lifting productivity**.
    a. Global productivity has been slowing for more than a decade, undermining the advancement of living standards.
2. **AI could reverse this trend in productivity**. It could boost growth and benefit workers.
    a. It could raise productivity by automating certain cognitive tasks while giving rise to new higher-productivity tasks for humans to perform
    b. While machines take care of routine and repetitive tasks, humans could spend more time on what makes us unique: being creative innovators and problem solvers.
3. **Early evidence** suggests AI could substantially raise productivity.
    a. A study showed that an AI assistant that monitored customer chats and gave suggestions about responses increased productivity by 14%.
        i. The greatest productivity impact was on **newer and lower-skilled workers**.
            1. AI can help spread the knowledge of more experienced, productive workers. Think of making every employee like the best employee.
    b. GS estimates that **AI could increase global output** by 7% (~$7T) over a decade.
        i. This is bigger than the combined size of India and the UK
        ii. If it comes to maximizing efficiency, Adam Smith would be wary of stifling the artificial hand of AI
    c. AI **could reduce job-market polarization** by putting downward pressure on wages of high-paying jobs
        i. Some studies suggest that AI could flatten the hierarchical structures of firms, increasing the number of workers in junior positions and decreasing the number in middle management and senior roles
        ii. Some researchers suggest that 2/3 of US occupations are vulnerable to some form of automation
4. It's also possible that AI **might simply replace human jobs without creating new, more productive work** for human to move into
    a. The well-being of the individual and the plight of the common worker underpinned much of Adam Smith's thinking – he didn't want to much power in the hands of a few.
        i. Today, the market for the components to develop AI tools is highly concentrated.
            1. A single company has a dominant position in the market for silicon chips best suited for AI applications
        ii. Many AI models require massive computing power and huge amounts of data (the "intelligence"). Only a handful of large corporations may have the computing and data firepower to develop high-end models.
5. While Smith would have been impressed by the emergence of such a powerful technology, he might have recognized that **the invisible hand alone may not be enough to ensure broad benefits to society.**

C. New Approach to Regulation

1. We urgently need **sound, smart regulation** that ensure AI is harnessed for the benefit of society. (This assumes that countries like China would abide by this…and they won't.)
    a. A challenge is the extent to which humans may come to depend on the **judgment of AI systems**.
        i. These systems relay on existing data which may have **embedded b**ias
    b. Some models have shown a tendency to confidently defend **false information**
        i. "**AI hallucination**" – very dangerous in medicine and critical infrastructure
2. We need more than new rules. We need to recognize this may be an entirely new game.
    a. The EU's AI Act is a good start. It classifies AI by risk.
        i. The highest-risk systems would be banned. This would include gov't systems that rank people based on social compliance ("social scoring").
        ii. The next highest risk level would be tightly regulated, with requirements for transparency and human oversight.
3. Aside from regulation, we need to **be prepared to address the broader effects of AI on our economies and societies.**
    a. Given the possibility for widespread job loss, we need **nimble social safety nets**.
        i. Need to help the displaced; need to reinvigorate policies so people stay in labor market
    b. **Tax policies** should not favor indiscriminate substitution of labor
    c. We have to make the right **adjustments to the education system**
        i. Prepare the next generation of workers to operate these new technologies
        ii. Provide current employees with ongoing training opportunities
        iii. Demand for STEM specialists will grow
        iv. Value of liberal arts may increase – to think about big questions facing humanity and do so by drawing on many disciplines
    d. We need **international coordination** b/c AI operates across borders

D. Redefining Human

1. Adam Smith (*The Theory of Moral Sentiments*) said that our **ability to experience empathy** is what allows us to be civil toward others and to behave morally. It's what allows for a rules-based society.
2. The latest wave of generative AI combs through vast amounts of knowledge and distill it into a convincing set of messages.
    a. It doesn't just think and learn fast. It now speaks like us too.
3. AI can already replicate human speech. Some researchers think that this could allow AI to form close relationships with people using "**fake intimacy**" to influence our opinions.
    a. This could **destabilize societies**. It could even undermine our basic understanding of human civilization, given that our cultural norms, from religion to nationhood, are based on accepted social narratives.
4. Smith believed that **information must be effectively transmitted through society**. Markets send signals through prices. Human beings pick up social cues. **AI can damage the integrity of information.**