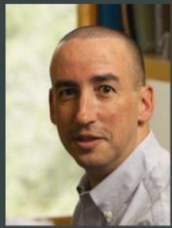

MARKET UPDATE

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June 19, 2023 – Market Update

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I. Stocks

A. Last Week – The Rally Continued

#1: The week: DJIA +1.25%; **S&P 500 +2.58%**; Nasdaq +3.25%

#2: Investors had plenty of reason to sell this week, but they didn't. Core CPI is still twice as high as the Fed's 2% target. While the Fed paused, they said that there were two rate increases left. The S&P 500 is already up 20% from its bear market low and this increase was largely based on the Fed being done with rate increases. The S&P 500 trades at 19X forward earnings and short-term USTs are yielding above 5%. (Barron's)

#3: To see the market drop, sentiment has to change. Given the lagged effects of the monetary policy tightening, investors would need to start to focus on a recession and lower earnings. (Barron's)

#4: Estimates are that Q1 earnings were flat from a year ago. As of April 1, the prediction had been for a 5.1% YoY decline. S&P 500 sales grew 3.6%, but **margins dropped** to 11.8% (down from 13.2% a year earlier). But, margins are still relatively high on a historical basis – they were 11.6% in 2019 Q1. If you use GAAP earnings, the margin drops to 10.8%. (WSJ)

#5: NVDA is now trading at more than **200X earnings**. (Bloomberg)

B. Market Breadth

#1: Seven stocks account for almost all of the market's gains YTD: AAPL, MSFT, GOOGL, AMZN, META, NVDA and TSLA. This group is expected to have $315B in profits for 2023. This is nearly double their 2019 earnings. This group's earnings have increased 14%/year for the decade through 2022. While the group's earnings dropped 20% last year, earnings are expected to increase 15% this year and next year. The group's total market cap is ~$11T so they sell for ~35X earnings. The Nasdaq 100 is up ~37.9% YTD. (Bloomberg)

#2: Market breadth is improving. Approximately 70% of S&P 500 stocks are trading above their 50-day moving average (up from ~30% in the past month) and 65% are above their 200-day average (up from less than 42% in the past month). The market rally is being driven by a belief that the FOMC is getting closer to being done with rate hikes, reduced fears of recession, a strong labor market, a stabilizing bank sector, love of AI, and fear of missing out. (WSJ)

C. It's Easier to Sell Stock

#1: Companies and PE firms sold $17B of stock in May, well above the $6.9B monthly average last year. In addition, the sales were done at smaller discounts than usual (~8%). (WSJ)

#2: The IPO market seemed to reopen. Cava Group (CAVA), a Mediterranean-style restaurant chain, went public on Thursday and the shares jumped 99% on the opening day. The company raised $318MM and now has a market cap of more than $4B. One-third of the offering went to two investors (to help ensure that the IPO would go through). (WSJ)

D. Strategists' Conflicting Views and Individual Investors are Bullish

#1: GS strategist David Kostin thinks stock gains will continue as other sectors catch up with tech. MS strategist Michael Wilson, on the other hand, thinks earnings will drop 16% and stocks will fall. (Bloomberg)

#2: Citigroup says that the S&P 500 will drop to 4,000 by year end (currently near 4,410). They cite a lack of concrete earnings revisions and a looming US recession. BAC says that it's unlikely that a "brand new shiny bull market" is underway, comparing the current setup to 2000 or 2008. MS and JPM are bearish, but they have been that way for some time. (Bloomberg)

#3: The AAII survey of individual investors (considered to be a contrarian indicator) shows net bullishness among retail investors at its highest since Nov. 2021 (two months before the market peak). The value-to-fear ratio (S&P forward P/E divided by the VIX) shows higher valuations and lower fear. The last time it was so high was also Nov. 2021. Interestingly, this deviates from the Philadelphia Fed Survey of Professional Forecasters Anxious Index (perceived recession risk). They typically move in unison. But, realize that they deviated in 1995 and then the market had a great rally. (Bloomberg)

II. Rates and Lending

A. Rates

#1: UST – 3-month 5.34% (-3 bps); 2-yr 4.70% (+11 bps); **10-yr 3.77%** (+2 bps)

#2: Recently, the 10-year yield has been rising faster than the 3-month yield. While the curve is still significantly inverted, it usually normalizes when short-term rates decrease (rather than long-term rates increasing). (WSJ)

#3: The 2/10 yield curve inversion deepened back to a level last sustained in March. This is consistent with a recession and the Fed having to lower rates. Traders who bet on the yield curve steepening have lost. (Bloomberg)

B. Regional Banks

#1: Regional banks ended up in their situation because of a triple-whammy from the Fed: (1) higher rates meant paying more to depositors and losing access to zero-rate funding; (2) higher rates lowered the value of fixed-rate loans and bonds; and (3) banks could no longer borrow overnight at zero and simply invest in Treasuries. Banks need to hold depositor money long enough to work off the unrealized losses of assets. (WSJ)

#2: The Fed and SEC are investigating Goldman Sachs as they (GS) were advising SVB with SVB's doomed capital raise and then bought $21B of SVB's bond portfolio at a discount to market value. (Supposedly, SVB didn't want to shop the portfolio around because they didn't want people to know they were in trouble. This would be like Michelle Duggar not wanting people to know she was pregnant. At some point, people just assume.) GS bankers told SVB that before SVB raised capital, SVB must sell part or all of its securities portfolio to illustrate a need for capital. I'm really hoping that the WSJ got this wrong. I'm no banker, but I'm pretty sure that a bank doesn't want to signal that they NEED capital in that way. (WSJ)

C. Private Credit (second week in a row)

#1: When companies need to borrow billions of dollars or dealmakers need to finance a buyout, they often bypass public debt markets and investment banks. They head to private credit. Private credit got a boost after the GFC, when Congress tried to push risky lending away from traditional banks. They compete with banks but are less regulated.

#2: Private credit has grown from $300B in 2010 to $1.5T globally as of Sep. 2022. This is about the same size as the US junk bond market and the US leveraged loan market.

#3: Private debt is similar to private equity. They raise capital from investors and then lend money directly to companies.

#4: Private credit loans almost always have floating interest rates. Since these loans don't trade in the public markets, it's hard to know how many borrowers are in trouble with higher rates.

#5: US public and private pension funds hold about 31% of private credit fund assets. Insurance companies hold about 10%. (Bloomberg)

III. Economy

A. Inflation

#1: CPI rose 4% YoY and .1% MoM. Core CPI rose 5.3% YoY (down from 5.5%) and .4% MoM. Core inflation excluding goods and housing rose .24% MoM, close to its 20-year average. (WSJ)

#2: Cleveland Fed: median CPI = 6.74%; trimmed-mean CPI = 5.54%. The trimmed mean inflation rate has come down. (Cleveland Fed)

#**3: Atlanta Fed: sticky inflation = 6.1% YoY, but only 4.1% if you annualize this past month.** If you exclude housing from sticky inflation, this is abating. **Flexible inflation is down .2% YoY and down 4.5% if you annualize this past month**. (Atlanta Fed)

#4: Shelter costs account for 1/3 of the CPI basket. It was up 8% YoY. Exclude shelter and CPI was up just 2.1% and core was up 3.4%. The Labor Department measures what renters are paying – both newly signed leases and those that were signed a while ago. (WSJ)

#5: The average of six national rental-price measures from rental-listing and property data companies shows new-lease asking rents rose just under 2% over the 12 months ending in May. This should lower future inflation numbers. But it will be tough for investors who took out large loans to buy buildings with the hope that they could continue to increase rents. This is only the second YoY decrease since 2008. (WSJ)

#6: GS says that inflation won't come down as quickly as markets are currently pricing in. Investors could be assuming that a sharp deceleration in growth will lead to a more rapid easing of price pressures, and tending to be more bearish on energy prices that what is implied by commodity futures. GS sees limited ability for those things to lower prices, and says markets are also ignoring the potential for "delayed-onset inflation" in sectors like health care. (Bloomberg)

B. FOMC

#1: After 10 consecutive rate increases, the Fed paused at their meeting this week. But, their economic projections showed that 12 of their 18 members expect at least two more rate hikes this year (and four thought one more increase will be in order). None of the FOMC members expect a rate cut this year. In March, most officials thought that they'd be done after lifting the rate to its current level. On the positive side, they took their Q4 GDP estimate to 1% (from .4% in their March estimate) and the year-end unemployment rate was taken down to 4.1% (from 4.5% in the March estimate). (WSJ)

#2: JPM pointed out that it is interesting that 2/3 of the FOMC members see at least two more rate hikes this year, yet there were no dissents with respect to pausing. Independent Advisor Alliance argued that the labor market is too tight, inflation risks becoming entrenched and the wealth effect from stock prices could make matters worse. We will need a recession and/or a bear market to curb price increases.

#3: Powell had to explain two possibly contradictory policies: deciding to leave rates unchanged following 10 straight hikes while also indicating that at least two more rate increases might happen this year. In addition, it was interesting to see a unanimous vote under these conditions. Possible reasons for the pause (despite plans for future increases):

1. They had communicated that a pause was likely.
2. The last Fed speaker was the incoming vice-Chair Philip Jefferson and they couldn't make him look bad.
3. They couldn't be more aggressive in their speeches leading up to the meeting because of the debt ceiling.
4. They want to see the impact of the prior 10 rate increases. (Bloomberg) (Bloomberg)

#4: The markets clearly don't think that Fed policy is tight. If investors thought policy was tight, you wouldn't see a new bull market or a rebounding housing market. If the Fed thinks that the real neutral rate is .5%, and the Fed funds rate is 5.1%, it's hard to see how restrictive policy is if the core PCE rate is 4.7%. It would appear that Fed policy is relatively neutral. (WSJ)

#5: The median projection on the dot plot increased even more than the projection for inflation. This implies a need to raise the real rate even further. The FOMC is trying to figure out what is "**sufficiently restrictive**." Powell says that they'll know that policy is sufficiently restrictive when inflation is topping out and coming down. (The core PCE has been relatively steady this year.). (Bloomberg)

#6: The **Fed funds futures market** is only pricing in **one more rate increase** this year. (CME)

C. General Economy Stories

#1: Torsten Slok (Apollo) says that there are three reasons why Fed policy is having a slow impact on the economy:

1. High savings in the household sector
2. Corporate borrowers extended the maturity of their debt during the pandemic
3. The service sector is less sensitive to interest rates and has a post-Covid tailwind

#2: According to the Fed recently released Q1 U.S. financial accounts, Americans held $16.9T in savings accounts and cash equivalents, down from 2022 Q1's $17.5T, but well above the $12.7T that was held in 2019 Q4 (right before the pandemic). (WSJ)

#3: Larry Summers says that the US economy remains "very, very hot," though not as hot as it was six to 12 months ago. He said that the US is an underlying 4.5% - 5% inflation country. He also said that soft landing "represent the triumph of hope over experience," and commercial real estate is one area where there are likely to be "pockets of distress." (Bloomberg)

#4: In the last six weeks, Dollar General (DG) has lost more than 25% of its value. Maybe investors think that there **won't be a recession? Or** maybe investors realize that **low-income people are struggling** so much that they can't even afford Dollar General. (Bloomberg)

#5: Do high wages from a tight labor market lead to inflation or does inflation lead to higher wages? If wages lead the way, the labor market needs to cool and workers need to feel some pain of lower real wages in order to cool inflation. If wages don't lead inflation, the Fed doesn't want to weaken the labor market and be left with high inflation. A SF Fed paper argued that businesses can absorb higher wages by accepting lower profit margins or by becoming more productive. (Bloomberg)

IV. International

#1: On Thursday, the ECB lifted interest rates to 3.5%, the eighth consecutive increase and the highest level in more than 20 years. (Bloomberg)

#2: The Turkish lira continued to fall this week, dropping ~1%. Last week, it fell 11%. It has fallen every week since early March. They sure are lucky to have reelected Erdogan. (Bloomberg)

#3: Twice in the last month, Chinese dictator Xi Jinping has used phraseology to imply that there could be war with the US. Recently, he said, "We must be prepared for worst-case and extreme scenarios and be ready to withstand the major test of high winds, choppy waters and even dangerous storms." Recently, Chinese officials appeared to be telling Western diplomats and business executives that the US will seek to goal China into war over Taiwan. This is the same rhetoric they've used to describe Russia's war in Ukraine. (WSJ)