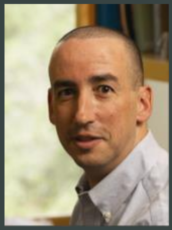

MARKET UPDATE

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June 26, 2023 – Market Update

I. Stocks and Bonds

A. Stocks

#1: Last week: DJIA -1.7%; **S&P 500 -1.4%**; Nasdaq -1.4% (ending eight-week win-streak). The big seven (AAPL, MSFT, GOOGL, AMZN, NVDA, TSLA, META) are up a market-cap weighted average of 25% in eight weeks and 14% since NVDA reported great earnings. (Barron's)

1. The market dropped as there was **increased fear of higher rates to bring inflation down**. Powell's testimony, a 50-bp increase by the BOE, and the ECB's recent rate increase all had an impact. In addition, the US manufacturing PMI fell to 46.3 in June (from 48.4). (Bloomberg)
2. **Retail investors are chasing the rally**. They bought $4.4B of equities during the week ending on Tuesday, a pace that's two standard deviations above the 12-month average. (Bloomberg)

#2: What really matters for long-run returns is the direction of the economy, not rate hikes. There is **evidence that the economy is getting better, not worse**: the Atlanta Fed's GDPNow is estimating Q2 growth of ~2%, consumer sentiment is up, inflation expectations are down, home construction is showing signs of life. Financial assets are doing well, spreads are down. We're seeing a broadening of the market as the Russell 2000 and equal-weighted S&P 500 have started outperforming. (WSJ)

#3: Even though the economy is doing well right now, there are concerns for investors:

1. The earnings yield is shrinking vs. the 10-year yield
2. Signs of FOMO with TSLA +61%, GME +32% and Plug Power +20% since May
3. The lagged effect of rate increases (credit card debt, auto loans, CRE, weak companies with variable rate loans)
4. Excess savings has mostly run off
5. Banks may reduce lending
6. Some data isn't positive: manufacturing appears to be in recession with inventories rising and new orders falling; new claims for unemployment insurance are higher (WSJ)

#4: Back in December, US strategists were bracing for an annual decline in the S&P 500 for 2023. This was the first time that the prediction was for negative returns since polling started in 1999. The average prediction was for the S&P to end the year at 4,009. We're currently at 4,348. Strategists are raising their projections, citing better earnings expectations, low layoffs and recovering corporate confidence. They are also saying that AI has single-handedly added 500 points to the stock market. (Bloomberg)

#5: Nearly 2/3 of US adults age 65+ own equity. Prior to 2008, roughly half of seniors owned stock. Baby boomers hold 56% of the country's household corporate equities and mutual fund wealth. Since the 2009 market bottom, the S&P 500 has returned more than 700% vs. the Bloomberg U.S. Aggregate Bond index's total return of 46%. Boomers seem to have become used to the idea that stocks bounce back from drops. They also tend to not have pensions and need to fund many years after retirement. (WSJ)

B. Bearish Views

#1: MS's Michael Wilson remains bearish and says that investors may be in for a "rude awakening." He cites fading fiscal support, lower liquidity and falling inflation (which will lead to disappointing revenue growth). He also thinks valuations are stretched due to excess liquidity from the banking bailout. (Bloomberg)

#2: GS strategists say that investors should consider hedging their recent gains in the S&P 500. They cite crowded bullish options positions, a narrow rally, high valuations, overly optimistic growth expectations, and investors that have become more aggressive. They think that there is a 25% chance of a recession and the market has 23% downside risk (in a recession). (Bloomberg)

#3: WFC says that the tech rally won't stop until the Fed gets more aggressive and breaks the economy. They say that the market now resembles the tech boom of 1999 and 2000 which didn't end until tighter monetary policy had roiled stocks. They also said that the US economy has turned out to be a lot less rate-sensitive than expected. (Bloomberg)

#4: Total short interest in the US market topped $1T this month for the first time since April 2022. This is up from $863B at the start of the year and represents ~5% of all shares that are available to trade.

1. Of course, these short positions become more valuable as the market has rallied. In addition, as hedge funds have increased their market exposure, they have done this on both the long and short side. Also, some of these short positions are effectively long positions, as investors are shorting inverse ETFs.
2. A GS index that tracks the 50 most-shorted stocks in the Russell 3000 has advanced 20% this year. Approximately 25% of short positions are in ETFs. (WSJ)

C. Small-Cap Stocks

#1: Concerns about small-cap stocks:

1. Higher interest rates
2. Possible recession
3. Instability in banking system
4. One-fifth of Russell 2000 companies have not been profitable in last year (WSJ)

#2: Support for small-cap stocks:

1. Index is down 24% from 2021 record
2. Russell 2000 has lagged larger stocks by 7% per year over past five years
3. Thaw in capital markets
4. Valuation discount to large stocks (WSJ)

D. Debt

#1: Rates didn't move much for the week. The 3-month ended at 5.41% (+6 bps), the 2-yr at 4.71% (+1 bp) and the 10-year at 3.74% (-3 bps).

#2: Money market funds seem to be taking money out of the Fed's reverse repurchase facility and buying Treasury bills that are offering slightly higher yields. The reverse repo facility fell below $2T last week. This is making investors hopeful that we're not going to have liquidity issues that could drive stocks lower. But it's also possible that money market mutual funds were facing redemptions for corporate tax payments that were due on June 15th and that's why money came out of the reverse repo facility. (WSJ)

#3: In New York, some bonds partly backed by bus, subway and commuter-train fares yielded 1.25% above top-rated muni bonds on June 14, a spread 56% wider than pre-Covid.

1. **Some CMBS that have a significant amount of office-space-mortgages have a 9.25% spread above USTs, three times as big as pre-pandemic.** One academic study argues that the value of office space across US cities is 38% lower than pre-pandemic (equaling a loss of ~$500B). Office building property taxes make up ~10% of revenue in major cities. (WSJ)

#4: In the US, nearly ¾ of the floating-rate debt taken out during the LBO boom wasn't hedged (as of last August) and 70% in Europe wasn't hedged (as of January). Apparently, PE shops were also surprised by the pickup in inflation and how central banks would respond. (Remember that when everyone says that the Fed made obvious mistakes, nothing was all that obvious to the PE firms either.)

1. Across North America, interest costs at the median PE-backed company ballooned to 43% of EBITDA last year. This is 6X as much as the median S&P 500 company.
2. Interest rates on the largest US leveraged loans hit an average of 10% this month, up from 3.9% at the end of 2021.
3. One study of ~2,000 private, medium-sized companies in the US asserts that over 300 of these companies will be unable to meet their interest payments and will have to renegotiate their debt or seek help from their PE owners. (Bloomberg)

#5: Direct lending refers to private loans made by investors to small and midsize companies. Surging demand for PE and tighter bank lending standards have created these opportunities. **Nearly $1.5T is invested in private debt globally, up fivefold from 2010. Many claim that private debt has a low standard deviation, but it's misleading because the prices would be much more volatile if they traded in the public market.** (Bloomberg)

E. SVB

#1: When SVB failed, the FDIC protected all of the California bank's US deposits and sold SVB's loans to First Citizens Bancshares. The deposits at SVB's branch in the Cayman Islands were not protected. There were many Asian PE and VC funds that kept money there. Many of these funds had capital-call credit facilities with SVB, where SVB would loan them money to invest and would later be repaid when the fund did a capital call. These funds lost their deposits but still have to pay their loans. (We don't know what percentage of their deposits will be lost.). (WSJ)

#2: At SVB, company stock made up 18% of retirement plan assets. First Republic staffers had $142MM of company stock in their deferred-compensation plan. (WSJ)

II. ECONOMY

A. The Fed

#1: Fed Chair Powell testified before the House and said that policymakers expect rates to move higher to reduce growth and slow inflation. He said "reducing inflation is likely to require a period of below-trend growth and some softening of labor market conditions." He also said that there is uncertainty as to how tighter that credit conditions will become. (Bloomberg)

#2: Powell said that the Fed was likely to continue to raise rates, but at a slower pace. He said, "given how far we've come, it may make sense to move rates higher but to do so at a more moderate pace." (WSJ)

#3: Powell compared the Fed's latest action to a driver that, after pulling off the highway, proceeds at a slower speed to avoid missing the ultimate destination. Chicago Fed Pres. Austan Goolsbee said that it was too soon to say whether rates would rise further. He said, "we are in this weird, foggy environment where it is hard to figure out where the road is." So, if you're keeping score at home, Powell is getting off the highway and trying to slow down, but Goolsbee is screaming that he can't see the road. (WSJ)

#4: Powell said that the Fed has to continue to work to lower inflation. He said that the Fed was "over-achieving" on its goal of maximum employment, with demand for workers far outstripping supply. Of course, the question is whether this "over-achievement" is inflationary. Powell reminds me of when I was in law school and interviewers would ask us for our biggest fault and we would all say that we pay too much attention to small details. (Bloomberg)

#5: Atlanta Fed Pres. Bostic said that we should hold rates steady for the rest of the year. He said that rates have been truly restrictive for less than a year. My view is that it's not even certain that policy is restrictive now, so I don't agree with him. (WSJ)

B. Commercial Real Estate (CRE)

#1: In the US, ~$1.4T of CRE loans are due this year and next. Most of this has large balloon payments. It will be hard to refinance if rents are not increasing and the cost of debt is much higher. In the US, values for institutional-quality offices are down 27% since March 2022. Apartment building prices have declined 21% and malls are off 18%. (Bloomberg)

#2: CRE borrowers are going to have to come up with cash to offset the lower values of their buildings. In addition, banks and insurers are facing scrutiny over the CRE lending. There's about $20T worth of commercial property in the US, including offices, rental housing, warehouses and retail space. CRE loans tend to be shorter and require a large balloon payment at the end. **Regional and community banks hold ~$2.3T in CRE debt.** (Bloomberg)

#3: Signs of trouble in CRE include sharp declines in the share price for publicly-traded property firms, high vacancy rates, and recent defaults by large landlords. The biggest problems are high interest rates and the inability to raise rents due to lower demand. With lower valuations, the loan-to-value ratios are too high. Converting office buildings to residential use is expensive and doesn't necessarily make sense at current prices. (Bloomberg)

C. Personal Real Estate (Homes)

#1: The median existing home price fell 3.1% YoY in May to $396,100, the largest drop since Dec. 2011. Existing home sales are down 20.4% YoY. Prices fell the most in Austin (15.1% YoY). The number of new listings in May fell 23% YoY. (WSJ)

#2: According to Redfin, the number of homes for sale in the US fell to record low levels in May. Active listings fell 7.1% in May and were down 38.6% from pre-pandemic levels. The brokerage said that just 1.4MM homes were up for sale in May, lower than any month on its records (which date back to 2012). (Bloomberg)

D. Inflation

#1: Some of the reasons why inflation hasn't gone away:

1. The uneven and stop-and-go recovery
2. Consumer spending
3. Interest rate impacts may be hitting the economy more quickly than in the past because bankers are telling the world what they will do before they do it
4. Businesses and households may have adjusted their behavior to a higher-inflation world (WSJ)

#2: There is evidence that the labor market is loosening.

1. The quits rate fell to 2.4% in April.
    a. The quits-to-layoffs ratio has retraced about 2/3 of the rise seen in 2021 and into 2022.
2. The number of job openings is shrinking, even as the labor supply is growing (workers rejoining the labor force + increase in immigration).
3. The increase in worker compensation grew 4.8% in Q1, down from 5.1% in Q1 of 2022. While wage gains have begun to outstrip inflation, workers have not made up for their overall loss in purchasing power. (Bloomberg)

#3: The WSJ analyzed 450 of the companies in the S&P 500 and found that the median worker was paid at least $100K in more than 1/3 of them. (WSJ)

#4: Rents should be coming down as more apartments are under construction than ever and the population of adults between the ages of 20 to 34 (a group that tends to rent) is expected to decline. One problem with this theory would be if the supply of starter homes is too low, particularly with increased corporate ownership of homes. (Bloomberg)

#5: Auto repair bills are increasing (resulting in higher insurance premiums) due to higher used car values, an uptick in dangerous driving, rising theft, spare part and technician shortages, and increasing complexity in fixing vehicles. In effect, cars are like computers on wheels. EVs can be up to 50% more expensive to repair. If a battery is involved in the accident, the replacement cost could be $15K. Plus, to offset the weight of the battery, EVs use more expensive, lightweight material. (Bloomberg)

E. General Interest

#1: The argument that there won't be a recession:

1. The Blue Chip consensus forecast for Q2 is now positive and the Atlanta Fed's GDPNow is ~2%.
2. The Univ. of Michigan consumer sentiment survey is up 8% in June.
3. Older people are spending briskly after getting the largest boost in Social Security since 1981.
4. The three spending bills (worth $2T): the Infrastructure Investment and Jobs Act, the Creating Helpful Incentives to Produce Semiconductors and Science Act, and the Inflation Reduction Act. (Barron's)

#2: Treasury Secretary Yellen sees diminishing risk for a recession, but she said that we may need to have a slowdown in consumer spending to reduce inflation. (Bloomberg)

#3: Some daunting numbers on fiscal policy:

1. Debt held by the public to GDP will break our post WWII record in 2033
2. Entitlement spending is 49% of all spending and it's increasing
    a. It's 63% if you include farm support
    b. The CBO projects that Social Security spending will rise from 4.8% of GDP in 2022 to 6% in 2033.
3. Interest and defense spending are ~20% of spending
4. Non-defense discretionary spending is only 16% of total spending: ~$.9T in 2023
    a. With a $1.4T deficit, cutting non-defense discretionary spending doesn't fix our problems. It will take a lot more of that. And remember, a lot of this spending includes air traffic control, law enforcement, immigration control, national parks and the weather service. (Project Syndicate)

#4: Last year, 62% of recent high school graduates were enrolled in college. It was 70% in 2009. This is being attributed to school closures during the pandemic and rising wages in a tight labor market. But, it may also be that students are looking for a higher return on investment. Enrollment has dropped 20% at community colleges (since the pandemic) and it has risen for two-year programs in technical trades. (Bloomberg)

#5: McKinsey says that AI will allow workers to delegate mundane tasks to that they can concentrate on higher-value-added work. (Interestingly, AI could hurt white-collar workers and have less impact on blue-collar workers.). But, just like when Robert Solow said in the 1980s that the computer age was everywhere except for the productivity statistics, there are **skeptics:**

1. Robert Gordon (Northwestern) argues that the internet and robots haven't been as revolutionary as "general-purpose technologies" such as electricity.
2. Productivity may increase, yet wages and living standards for the median worker could decrease. The question is whether AI will help workers with their jobs or will replace workers. (Bloomberg)

#6: Used car loan-to-value ratios increased to 125 in Q1, up from 104 in 2021 Q1. Used-car buyers are showing up to dealerships underwater with their current loan. (Bloomberg)

#7: A WSJ study found that ~2/3 of cities reported higher homelessness last year, with the combined count up ~9%. Nationally, HUD estimates that ~582,500 people were homeless on a single night early last year. Rising housing costs (and a limited supply of affordable apartments), mental illness, substance abuse and migrant arrivals are all possible factors. (WSJ)

III. Russia and China

A. Russia

#1: There was a short-lived uprising in Russia. The Wagner paramilitary group seized the southern Russian city of Rostov. Wagner is led by Yevgeny Prigozhin, who said that Russia's invasion of Ukraine was launched on false pretenses and that Russia was hiding the true extent of their casualties. (WSJ)

#2: On Friday, Prigozhin said that Defense Minister Sergei Shoigu had orchestrated a missile attack that had killed a huge number of Wagner's fighters. At its peak, Wagner may have had 50K solders (many of them were convicts). Some estimates put current numbers near 10K. (Bloomberg)

#3: Wagner was responsible for winning the towns of Soledar and Bakhmut in eastern Ukraine, the only successes in Russia's winter offensive. After those victories, Shoigu wanted Wagner's troops to sign contracts with the defense ministry and Prigozhin refused. (Bloomberg)

#4: Prigozhin is not necessarily popular with the Russian people. Some don't like that he's Jewish. Others see him as a criminal adventurist. He's seen as abrasive and bloodthirsty. (Bloomberg)

#5: On Saturday, Belarus Pres. Lukashenko brokered a deal where Prigozhin would go to Belarus and Russia would drop criminal charges. (Prigozhin is lucky that Putin doesn't hold a grudge and won't have him killed…) (WSJ)

#6: The remaining questions: how this insurrection weakens Putin and how this will impact Russia's invasion of Ukraine. Will Russian morale be lowered? Can Russia be successful without Wagner?

B. China

#1: China lashed out at the US after Pres. Biden referred to Xi Jinping as a dictator. This reference likely solidifies China's view that the US is trying to contain Beijing. **A few thoughts:**

1. While running for office, Biden referred to Xi as a "thug." I thought dictator was nicer.
2. I thought Biden was wrong to call him a dictator. He should have said "authoritarian dictator."
3. China's constitution refers to China as "a socialist state under the people's democratic dictatorship." A democratic dictatorship? The last time that I heard such an extreme oxymoron was "University Oklahoma." (I'm kidding. I used to live in Tulsa.)
4. Xi responded to Biden by saying that "the only Chinese citizens who think I'm a dictator are in prison." Okay, he didn't really say that. (WSJ)

#2: China is trying to improve relations with Europe and drive a wedge in Europe's relationship with the US. Europe is less concerned (than the US) about China as a security threat. But Europe has tightened control over technology exports to China. **Europe has many issues with China, including:**

1. Restricted access to the Chinese markets, China's subsidies to its firms, and China's poor record on protecting intellectual property.
2. China's low concern for fighting climate change. Xi did not attend the UN climate summit. They are building six times as many coal-fired power plants as the rest of the world combined.
3. China's poor human rights record. Europe, more than the US, has a purist view about this (while the US often tempers its support for human rights abroad depending on geopolitical considerations).
4. European nations resent China hiding behind a façade of neutrality while continuing to support Putin. (Bloomberg)