MARKET UPDATE

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June 5, 2023 – Market Update

I. The Past Week 2
- A. Stocks Continued the Rally; 3-Month Yield Increased 2
- B. The Good News for the Markets 2
- C. Problems for the Markets 2
- D. Former NY Fed Pres. Dudley: Pausing vs. Increasing Rates 3

II. Friday's Employment Report Gave Mixed Signals 3
- A. Signs of a Strong Economy 3
- B. Signs of a Weaker Economy 3
- C. Implications 3

III. The Debt Ceiling Agreement 4
- A. The Debt-Ceiling Deal Does Not Solve the Debt Problem 4
- B. Will the Issuance of a Significant Amount of Debt Hurt the Economy and Stocks? 4
- C. Other Ideas About the Debt Ceiling 5

IV. Other Interesting Stories that I Read this Week 5

V. Financial Stability and the U.S. Economy, Gov. Philip Jefferson, May 31, 2023 6
- A. The Fed's Approach Toward Financial Stability 6
- B. The U.S. Financial System and Economic Outlook 6
- C. Current Financial Stability Risks and Vulnerabilities 7

VI. Out of the Office, Into a Financial Crisis?, by Tim Sablik (Richmond Fed) 8
- A. Introduction 8
- B. Gauging Office Demand 8
- C. The Next Shoe to Drop 9
- D. Silver Linings 9

I. The Past Week

A. Stocks Continued the Rally; 3-Month Yield Increased

1. For the week: DJIA +2.0%; **S&P 500 +1.8%**; Nasdaq +2.0%
    a. Nasdaq has risen six straight weeks (longest streak since Jan. 2020)
        i. There were record inflows to tech stocks (**FOMO** – fear of missing out)
    b. YTD Nasdaq 100: **+32.97%** (large-cap tech)
    c. YTD: S&P 500 **growth** +15.96%; S&P 500 value +6.73%
2. What is driving the **large-cap rally**? (Small caps had a huge rally on Friday.) (WSJ)
    a. Uncertainty surrounding global economy
        i. Investors want quality firms – those with big cash buffers and strong margins. Smaller companies are more likely to be value companies.
    b. Pricing power at a time of inflation
    c. Diversified supply chains amid geopolitical fragmentation
    d. Craze for language-generating artificial intelligence that started six months ago
3. UST: 3-month 5.50% (+16 bps); 2-yr 4.50% (-4 bps); 10-yr 3.69% (-11 bps)

B. The Good News for the Markets

1. **Debt ceiling** agreement
2. The **jobs report** led to increased belief in the **soft-landing** narrative.
    a. Added 339K jobs (186.5K forecast) (discussed later)
3. For the week, the **odds of a June rate hike decreased**. The lower expectations largely resulted from Fed Gov. Philip Jefferson's speech (discussed later).
    a. Slower wage growth and higher unemployment rate (3.7%) meant investors worried less about Fed raising rates
    b. Manufacturing ISM showed that prices manufacturers had to pay for inputs had fallen – adding to the disinflation story
4. Earnings cushion from **supply chain** and input cost **normalization**
5. Commentators **pushing back against the narrow-market-breadth story** (arguing that it is often this way)

C. Problems for the Markets

1. Households and businesses continue to feel the sting of **inflation**
2. Conflicting concerns about the **job market**
    a. JOLTS report showed 10.1MM job openings in April – a **tight labor market**
    b. Headlines about layoffs at large companies make workers worry about **job security**
3. **Fears of recession** loom large
    a. Manufacturing ISM showed seventh consecutive month of contraction
    b. The resumption of student loan repayment (impacting consumer spending)
    c. Lower commodity prices are consistent with disinflation, but they are also consistent with fear of recession.
4. The **upcoming liquidity drain** as the Treasury issues a lot of debt (discussed later)
5. The market is pricing in a **July rate hike** (after a June pause) (Barron's)

D. Former NY Fed Pres. Dudley: Pausing vs. Increasing Rates

1. The **case for pausing rate increases** has become more compelling:
    a. The Fed is **no longer** woefully **behind the curve**
        i. The Fed funds rate can be thought of as restrictive
        ii. Goods prices are abating
        iii. Shelter prices should soon follow home prices
    b. Distress at some **regional banks** will likely act as an independent **restraint on credit** and economic growth
    c. There's a **risk of tightening too much**
        i. Remember the long and variable lags
2. But there are also **arguments for future tightening**
    a. The Fed hasn't accomplished much yet (**inflation** is still too high)
        i. The economy still has considerable momentum
    b. **Labor market** is too tight
        i. Unemployment rate is too low
        ii. Ratio of unfilled jobs to unemployed workers is too high
        iii. Wage inflation remains too high
    c. **Growth is too high** to create slack in the labor market (**tight labor market**)
    d. Single-family **housing starts** and new home sales are rising again
3. Dudley doesn't believe the argument about restrained credit (even though he used it)
    a. Distressed regional banks account for less than 5% of total US banking assets and their main challenges are higher funding costs and lower net interest margins
        i. Not bad loans
    b. Fed still has a large balance sheet (Bloomberg)

II. Friday's Employment Report Gave Mixed Signals

A. Signs of a Strong Economy

1. Nonfarm **payrolls increased 339K** in May after an upwardly revised 294K in April
    a. Most jobs gained in a month since January
    b. Payrolls beat estimates for a 14th straight month
    c. The **Establishment Survey** is larger than its household counterpart and thus has typically a smaller margin or error on month-to-month changes in employment
2. **Average hourly earnings** increased .3% (down from .5% in May)
    a. Workers who aren't in management roles (the vast majority of the labor force) rose **.5%,** the most in six months

B. Signs of a Weaker Economy

1. The **unemployment rate rose to 3.7%** (biggest one-month increase since April 2020)
    a. The **Household Survey** show people entering the labor force had a tough time finding a job. There was also an increase in previously employed persons who found themselves unemployed.
2. The **average workweek** edged down to 34.3 hours (lowest since April 2020)

C. Implications

1. The bond market may have **underestimated the likelihood of more Fed tightening**
    a. The 2-year UST yield increased 17 bps on Friday
2. **Concerns about consumer spending**, earnings and the broader economy **may be overstated** in the near-term (Bloomberg)

III. The Debt Ceiling Agreement

A. The Debt-Ceiling Deal Does Not Solve the Debt Problem

1. The CBO estimates that the deal will **reduce deficits by $1.5T** over a decade (a tiny amount). Federal debt held-by-the public will rise from 97% currently to **115%** over a decade. Prior to this agreement, it would have been 119%.
    a. And that's assuming Pres. Trump's tax cuts expire after 2025.
2. The Democrats didn't want any cuts. For the Republicans, the following was off the table with respect to negotiating: Social Security, Medicare, veterans' benefits, defense, interest on debt and taxes. This left **nondefense spending**, less than 15% of the total, to bear the brunt of any cuts.
    a. If you're serious about debt and deficits, you can't just focus on 15% of the budget.
    b. Republicans' beef is not with debt. It's with size and nature of gov't spending. If it was with debt, they wouldn't routinely vote for tax cuts.
3. Discretionary spending will actually increase next year. (WSJ)

B. Will the Issuance of a Significant Amount of Debt Hurt the Economy and Stocks?

1. The Treasury's checking account (the Treasury General Account or **TGA**) increased during the pandemic, but now is very low. It **needs to be replenished**.
    a. The Treasury **will issue** a lot of **debt**. This will **take money out of the economy**.
2. We need to see **how unwinding** the Treasury's measures **will affect** the **liquidity** flowing through the economy
    a. Some commentators believe that the end of the impasse could be **equivalent to another 25-bp rate increase** (due to the issuance of debt).
    b. Excess liquidity injected into the financial system (the result of the Treasury running down its cash balance since early this year) has helped fuel the rally in tech stocks.
        i. Now, this liquidity will be reversed.
3. Steven Blitz of TS Lombard explains it this way:
    a. TGA dropped $360B in actual (not annualized) dollars. That means that $360B was spent during this period and it was neither taxed nor borrowed. This amounts to 3.3% of five months of nominal GDP. This is one reason that growth seemed resilient. Looking forward, assuming Treasury raises $650B to put on deposit at the Fed in the next three months, that would amount to a drain equal to 9.8% of three months of nominal GDP.
    b. The Fed will likely need to stop Quantitative Tightening (QT).
4. Deutsche Bank, on the other hand, says that recent drops in the TGA, followed by a rebuild have become more common.
    a. They say that the only thing that will happen is investor allocation will shift from one cash-like instrument to another. There will be no large-scale duration withdrawal from the market.
    b. The Fed has already increased liquidity by making it easier for financial institutions to borrow from the Fed. (Bloomberg) (Barron's)

C. Other Ideas About the Debt Ceiling

1. GS called the debt-ceiling deal a "major reduction in uncertainty, minor reduction in spending."
    a. The fiscal tweaks don't kick in until the 2024 fiscal year, which starts in October. So the impact is four to 16 months out. (Bloomberg)
2. The IMF says that the government will need to rein in the deficit through options that include higher taxation, cutting health-care costs and closing tax loopholes. Good luck.
3. Outstanding debt held by the public stood at **$23.9T** as of the end of 2022. That's ~97% of GDP.
    a. Treasury Sec'y Janet Yellen says that you shouldn't look at debt-to-GDP. You should look at **interest payments (adjusted for inflation)-to-GDP**
    b. Nominal interest-to-GDP has been about 1.5% in recent decades, though it went to 1.9% in 2022.
        i. But if you factor in inflation, it's **negative**. In other words, our interest rate is lower than the inflation rate. (Bloomberg)

IV. Other Interesting Stories that I Read this Week

1. **Falling populations** have many issues: (Economist)
    a. Lower government revenue
    b. Higher spending on public pensions and health care
    c. Fewer educated workers – **reduced innovation** (lower growth)
    d. Fewer workers with "**fluid intelligence**" – the ability to solve new problems and work with new ideas (as opposed to "**crystallized intelligence**") – thought to peak in our 30s
    e. Potentially lower real rates of interest b/c of excess savings and fewer investment opportunities
        i. Others argue that the opposite is true – that we will have less savings
2. **College enrollment** for recent US high-school graduates, ages 16 to 24, declined to 62% last year from 66.2% in 2019. The rate topped out at 70.1% in 2009.
    a. Job growth at restaurants, theme parks and other parts of the leisure and hospitality sector – which tend to employ young people and typically don't require a college degree – has increased more than twice as fast as job gains overall in the past year.
    b. The unemployment rate for teenage workers ages 16 to 19 fell to a 70-year low of 9.2% last year.
    c. Last year, 66.1% of women who graduated from high school, ages 16 to 24, enrolled in college, nearly 10% higher than the rate for young men. (WSJ)
3. **Workers** say high costs, caregiving duties, long commutes and days still scheduled full of Zoom meetings are keeping them at **home** at least part of the time, along with a lingering sense that they're able to do their jobs competently from anywhere. (WSJ)
4. **Retailers** reported that incidents of organized retail crime increased in 2021 by an average of 26.5%, according to the retail federation. The report says that store owners blamed organized retail crime for about half of the $94.5B lost that year to retail shrink.
    a. At the same time as high shrink, retailers are paying more for labor and rents (although they may start to decline). (Washington Post)
5. **India and China** have ejected each other's journalists in recent weeks, virtually wiping out mutual media access. (WSJ)
    a. The India-China relationship has deteriorated since a deadly skirmish on the contested Sino-Indian border in June 2020.
        i. Also, India has banned dozens of Chinese mobile apps.
    b. India is more focused on the Quad group – U.S., India, Australia and Japan.
    c. In 2020, China expelled more than a dozen American reporters (including for the WSJ), while the US capped the number of accreditations for Chinese journalists.
6. Since **Erdogan** became Turkey's prime minister (20 years ago), the **lira has dropped 90%** against the dollar and against a basket of currencies. (Bloomberg)

V. Financial Stability and the U.S. Economy, **Gov. Philip Jefferson, May 31, 2023**

A. The Fed's Approach Toward Financial Stability

1. A **stable financial system** is resilient even in the face of sharp downturns or stress events.
    a. It provides households (HHs) and businesses with the financing they need
2. We **don't want** initial **shocks** in one area of the financial system **to spill over** to others.
    a. If they do, it can cause widespread strains and **disrupt the flow of credit**.
        i. Employment and output can be hurt
3. **Financial and nonfinancial institutions** are **linked**
    a. HHs and businesses need banks to have strong balance sheets to make loans
    b. The financial sector needs HHs and businesses to have strong balance sheets to repay loans
4. The **Fed monitors and assesses potential vulnerabilities** that may develop because of **interactions** among key participants
    a. Examine safety and soundness of individual supervised institutions (**micro-prudential**) and looking across the entire financial and nonfinancial system (**macroprudential**) for risks and vulnerabilities:
        i. Elevated valuation pressures
        ii. Excessive borrowing by HHs and businesses
        iii. Excessive leverage in the financial system
        iv. Elevated funding risks
5. Risks and vulnerabilities are constantly changing (as we saw in March)

B. The U.S. Financial System and Economic Outlook

1. US financial markets and institutions remain resilient even though financial **stability risks** and vulnerabilities in the US financial system **have increased**
    a. Conditions stabilized due to the Fed, the FDIC and the Treasury
2. **Spending and growth should remain quite slow** over the rest of 2023, due to:
    a. Tight financial conditions
    b. Low consumer sentiment
    c. Heightened uncertainty
    d. A decline in HH savings that built up after the onset of the pandemic
3. **Inflation is still too high**, but it has come down substantially since last summer
    a. Core services sector inflation has made some progress recently
4. It's reasonable to expect that the **recent banking stress** events will lead banks to **tighten credit standards** further…
    a. But the amount of tightening and the magnitude of the effect of such tightening on the economy is not yet clear
5. **Short-term rates** are **5% higher** than a little over a year ago
    a. Monetary policy works with **long and variable lags**
        i. A year is not long enough for demand to feel the full effect of higher rates
    b. Higher rates and lower earnings could test the **ability** of businesses to **service d**e**bt**
    c. Higher rates could cause stress to financial institutions with **high-duration assets** and a high rate of **uninsured deposits**
6. A decision to **hold rates constant** at next meeting **shouldn't be interpreted as our peak rate**
    a. Just allows us to collect more data before deciding about additional policy firming

C. Current Financial Stability Risks and Vulnerabilities

1. The **failure of a large banking organization matters**, even if not deemed to be individually systemically important under Fed's regulations
    a. It can **cause markets to reassess the condition of other firms** with roughly similar size and risk profiles
        i. Resulting **spillover** can generate significant negative consequences for the broader economy
2. Can see the **resilience** of the financial system by comparing to 2008 Global Financial Crisis
    a. Global Financial Crisis (GFC)
        i. Leading up to GFC, housing markets were overvalued, mortgage underwriting standards were weak, and borrowers were at risk of being underwater if prices fell
        ii. Banks had limited loss-absorbing capacity and were heavily reliant on wholesale short-term funding
        iii. Interconnections across the financial system were opaque. When housing markets weakened, opacity contributed to investors' fears, short-term funding pulled away, and excess leverage led to fire sales as financial institutions experienced losses and major firms failed or were rescued by gov't
    b. Recent Banking Crisis
        i. Failures of SVB, Signature Bank and FRB showed:
            1. Excessive reliance on uninsured deposits
            2. Excessive exposure to interest rate risk
        ii. Yet the overwhelming major of banks have strong balance sheets with limited leverage, high levels of loss-absorbing capacity and healthy liquidity
        iii. Plus, HHs and business balance sheets are generally strong and the credit quality of loans is generally much better than before the GFC
        iv. The current resilience of the financial sector point to **more limited spillover**
3. But there are **three areas of potential concern** that have been the focus of our supervisory and regulatory work:
    a. The importance of effective **liquidity and interest rate risk management**, including both reliance on **uninsured deposits** and **exposure to duration risk**
        i. While spillovers will be limited from recent events, the strains will lead to a further tightening of credit supply
    b. How changes in the financial sector, including expanded use of online banking and shifts in behavior that may be driven by social media, may alter the potential **speed of deposit flows**
    c. How the weakness in some sectors of **commercial real estate loans** will place strains on lenders with high concentrations of those loans
        i. Changes in work preferences and the increase in remote work is leading to a reassessment of the outlook for office and associated retail properties
            1. It will take time for the extent of that weakness to become clearer

VI. Out of the Office, Into a Financial Crisis?, by Tim Sablik (Richmond Fed)

A. Introduction

1. In the initial months of the pandemic, more than 60% of all paid full days were worked from home. Now, **workers don't want to go back**.
2. The share of **remote work** is **~28%,** nearly 6X the pre-pandemic level
3. In surveys, workers place a high value on working from home
    a. A 2023 NBER paper showed that workers saved an average 72 minutes/day by not commuting
    b. Employers offered remote work to compete for scarce workers
4. With less workers coming going to the office, this could mean **less demand for commercial real estate (CRE)**

B. Gauging Office Demand

1. Most buildings are privately held, so it's **hard to gauge demand**
    a. Kastle (office security) estimates that it's currently ~50% in the top 10 metro areas
        i. Higher in the middle of the week; lower on Monday and Friday
    b. CoStar Group estimates **12.9% of office space is vacant** – a record high
    c. The **FTSE NAREIT office index fell by 37.6%** in 2022 and was down another **15.9%** at the end of March
        i. Offices owned by publicly-traded REITs tend to be in higher demand, so they are often viewed as a leading indicator
    d. A Sep. 22 academic working paper suggests that a 10% increase in a firm's share of remote job postings reduces its demand for office space by 4% - 5%
2. Other research isn't as pessimistic
    a. There seems to be **demand for A+ buildings**
    b. Office buildings that are more than half vacant account for just 7.5% of the market
3. The estimate is that there will be **1.1B sq. feet of excess space** in the next decade
    a. Only 30% of this is due to the increase in remote work
    b. The rest is due to aging buildings and changing business conditions
        i. Weakening economy – particularly technology
            1. Tech was very aggressive in leasing space
        ii. Businesses attempting to cut costs out of recession fears
4. The **relationship** between office job growth and demand for office space has **broken down**
    a. This will likely stabilize once employers settle on a mix of remote and in-person work
        i. But the amount of space per employee will be lower than it was

C. The Next Shoe to Drop

1. **Less demand** for office space should lead to **lower values**; so will **higher rates**
   a. The typical office mortgage has a duration of 10 years – so you have less demand and higher interest expense
      i. This could lead to more **defaults**
   b. An academic paper argues that the office building space will lose 39% of its value relative to 2019 by the end of the decade
2. **CRE mortgages** (including loans for retail, multifamily apartments, offices, and other commercial property types) come from a variety of **sources**:
   a. **Banks and thrifts hold ~45%** (but less than 40% when you exclude construction loans)
      i. The 25 largest banks hold ~13% of all CRE loans (including construction loans)
         1. Exposure is <4% of assets
      ii. **Regional and community banks** outside the top 25 hold 32%
         1. Exposure is a much larger percentage of assets
   b. Obviously, banks with higher concentrations of office mortgages are more at risk
3. The **argument that things might not be too bad**:
   a. The delinquency rate on CRE loans at banks is still <1%
   b. Commercial lending standards were more conservative after the GFC
      i. The loan-to-value for office mortgages is typically 50% - 60%
   c. Offices make up <17% of the total CRE mortgage market
      i. And only 3% of regional and community banks' assets
   d. While office property values are falling now, the value of all CRE rose by 40% over the last decade
      i. Current losses would have to be quite large to wipe out equity, especially if property was financed in 2013

D. Silver Linings

1. The worst-case scenario for office space hinges on remote work staying elevated. But as the labor market softens, **employer bargaining power is increasing**
   a. Some employers are realizing that if work can be done remotely, it can also be done remotely overseas (for less).
      i. This could scare workers into returning; but it could also lead to offshoring and less demand for space
   b. Some firms are recognizing the importance of having workers grouped together
2. There can be some **renovations to accommodate new or expanded uses**
   a. Depending on zoning laws
   b. But realize that it's hard to turn office building into residential space
      i. Zoning laws
      ii. Office building layout is very different from typical apartment
         1. Plumbing; windows
      iii. Commercial properties are significantly more valuable than apartments
         1. So price would have to fall significantly to make this attractive
   c. Tax incentives helped turn 13% of NYC office space into apartments in the 1990s