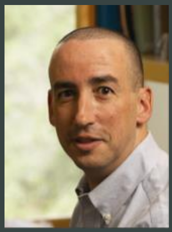

MARKET UPDATE

subscribe at sandyleeds.com

March 13, 2023 – Market Update

Table of Contents

I. Last Week

A. The Big Picture – What a Week

1. **Fed Chair Powell testified** before the Senate on Tuesday. His comments were seen as **hawkish** and the market started pricing in a higher possibility of a 50-bp increase on March 22nd. On Wednesday, he tried to emphasize that this was not a guarantee.
2. On Friday, **Silicon Valley Bank failed**. It's the second largest bank failure in U.S. history. Everyone had been saying that Fed policy hasn't broken anything yet. **Something broke**! Now, the question is whether the Fed will raise rates at all. The market now expects that **25 bps** will be the increase.
3. The **jobs report** was positive news for the market (311K jobs, higher participation, lower wage growth), but it had no chance of overcoming the effect of the second-largest bank failure.

B. Stocks

1. For the week: DJIA -4.44%; **S&P 500 -4.55%**; Nasdaq -4.71%
2. Be careful with **leveraged ETFs**. SQQQ is a -3X Nasdaq 100 ETF. In the past 12 months, the Nasdaq is down 15%. You might think that this means you should be up 45%. Instead, you'd be down 9.98%. This is the result of **variance drain**.
    a. Imagine losing 20%. You need to earn 25% to get back to even. When this happens repeatedly, you lose. These leveraged ETFs promise to give you that particular return for a day (not for the long-term). (Barron's)
3. MS's Michael Wilson says that the **gap between earnings and cash flows** is the widest it's been in 25 years. He says that high accruals will hurt future margins. (Bl.) (Bl.)
4. The bullish argument prior to this week was that **soft data is coming in weak but hard data is strong**. (WSJ)

C. The Disconnect Between Stocks and Yields

1. **Earnings dropped 4.6%** in Q4, the first drop since 2020 Q3. Earnings are expected to decline in Q1 and Q2. Stocks are trading at **17.5X earnings** vs. 10-year average of 17.2. The dividend yield is 1.71% and the **T-bill offers more than 5%.** (WSJ)
    a. The forward earnings yield to the 10-year TIPs yield have diverged. (Bloomberg)
2. The bottom-up consensus for S&P 500 earnings per share **is $220 vs. $222** last year. From June 2022 to now, estimates have been cut by 12%, on pace for the sharpest decline in full-year outlook since 2010. (Bloomberg)
3. The **spread between BBB corporate debt and the S&P 500's earnings yield is above zero for the first time since the financial crisis**. This differential is usually negative as equities are riskier. (Bloomberg)
4. The **MOVE index** is near the top of its historic range while the **VIX** is unexceptional (although it increased at the end of the week). In other words, the equity-risk premium suggests the stock market is the least attractive in a while. (Bloomberg)

D. Rates

1. 3-month: 5.01% (+10 bps); 2-yr: 4.60 (-26 bps); **10-yr: 3.70%** (-27 bps)
    a. The **2-yr yield dropped 45 bps in two days**. That's a huge move. Jim Bianco said that it rivaled its drop after Lehman's failure in Sep. 2008, 9/11 and Oct. 1987. (Barron's)
    b. The **30-year fixed-rate mortgage** rose 8 bps to **6.79%**. (Bloomberg)
2. Maybe inversion doesn't matter…maybe it's the true borrowing cost that matters. **Long-term, real-rates** may be negative. (Carson Report)
3. **Credit** is available at rates that imply **little risk of default** and very little risk of recession. **Junk spreads are low**. The reward for investing in IG bonds is historically low (vs. the 6-month T-bill). Shares of companies with the weakest balance sheets have outperformed. Yet, the Fed's survey of senior lending officers shows **lending standards are being tightened**.
    a. With rates higher and profits falling, you'd think investors would be nervous about credit risk.
    b. Volker once said that **higher rates bring inflation down through bankruptcies**. If this is true, rates will have to rise further until they force defaults and lower corporate profits. (Bloomberg)

E. President Biden's Budget (Tax) Proposals

1. Increase **capital gains rate** from 20% to 39.6% for people earning >$1MM
2. Increase the **3.8% Obamacare tax** to 5% for those earning at least $400K
3. Tax the price appreciation of assets when owner dies
4. **25% minimum tax** rate on households worth at least $100MM
5. Increase top **personal-income tax ra**te from 37% to 39.6% if earning > $400K
6. Increase **corporate tax rate** from 21% to 28%
7. Increase **tax on foreign earnings** of US companies from 10.5% to 21%
8. Eliminate the **carried-interest tax break**
9. Increase the **tax on stock buybacks** from 1% to 4%
10. Create **wash-sale rules for crypto** investors
11. Expand the **child tax credit** to $3,600 for children under six and $3,000 for older children (up from $2,000)
12. Expand the **earned income tax credit** for low-income workers (Bloomberg)

II. Powell's Testimony

A. The Actual Testimony

1. **Faster and higher**. "The latest economic data have come in stronger than expected, which suggests that the ultimate level of interest rates is likely to be **higher than previously anticipated**. **If the totality of the data were to indicate that faster tightening is warranted**, we would be prepared to increase the pace of rate hikes." (Bloomberg)
    a. In Powell's second day of testimony, he stressed the "if." (Bloomberg)
2. The Fed funds market moved to a terminal rate of **~5.25%**. The 2-year yield exceeded the 10-year yield by more than one full percent for the first time since 1981. The dollar climbed 1%, hurting commodity prices. (Bloomberg)
    a. Powell's testimony increased the chance of a 50 bp rate increase in March.
    b. He said that the process of getting back to 2% will likely be bumpy.
    c. Payrolls increased by more than 1MM in the three months through January.
    d. The presumption should now be 50 bps unless the data argues otherwise. (Bl.)
3. **Elizabeth Warren** asked, "how would you explain your view that they need to lose their jobs?" Powell responded, "Will working people be better off if we just walk away from our jobs and inflation remains 5% to 6%?" (Bloomberg)

B. Commentary About the Testimony (Remember: this was before SVB failed)

1. GS raised their forecast for the peak Fed funds rate to 5.5% - 5.75%. They still expect just a 25 bp rate increase in March, but they say that it will be a close call. It will be interesting to see what happens with the dot plot (part of the SEP). (Bloomberg)
2. Just five weeks after slowing the pace of rate hikes, Powell indicated that they may need to reaccelerate. Some speculate that **Lael Brainard (the dove) is gone** and this had an effect. More likely, it was a **really strong jobs report and strong inflation reports**. (Bl.)
3. While the Fed has moved to greater transparency, it seems like press conferences and testimony are leading to **greater volatility**. Greater volatility could increase the risk of economic and market accidents – a recession caused by the Fed. (Bloomberg)
4. Investors are starting to consider the possibility that the Fed will need to take rates to 6%. Higher rates for longer could hurt emerging markets. (Bloomberg)
5. JPM said that a 50-bp rate increase could confuse the market and rattle the economy.(Bl)
6. Some **key ideas** from Powell's testimony:
    a. Maybe we have abandoned the belief in the possibility of a soft landing. The 2-year UST yield was 4.03% in early February and now it's over 5%.
    b. Fed officials always say not to be swayed by one-month of data, yet they seem to have done that.
    c. Maybe Powell has basically admitted that just raising 25 bps was a mistake.
    d. In Powell's Feb. 1 press conference, he said the word "disinflation" 11 times. In his testimony, he only said it once.
    e. It will be interesting to see the new dot plot. It will also be interesting to see when Fed officials think inflation will return to 2%.
    f. This is only the fourth 100-bp inversion since 1920: 1929, 1973 and 1980.
    g. Almost the entire yield curve is inverted. This could be a more serious signal. (Bl)

III. Silicon Valley Bank

A. The Story

1. SVB was very closely tied to the **startup community**. They did business with almost half of all US venture capital-backed startups.
2. SVB **grew with more startups getting funded**. In March 2021, SVB's deposits had grown to $124B (from $62B 12 months earlier).
3. By the end of 2022, the bank had **$212B of assets** and was 10% of the size of JPM. They were the **16th largest bank** in the U.S.
4. SVB used deposits (and other funding) to **buy securities and make loans**. SVB's **investment portfolio was 57% of its assets**; no other competitor among 74 major US banks had more than 42%. They owned a lot of bonds that were purchased at high prices (low yields).
5. As rates increased, **customers (including start-ups) took their deposits elsewhere** (to earn more interest). In addition, deposits were being withdrawn b/c start-ups haven't been raising much money in the past year. As the bank's funding was reduced, the bank had to reduce their assets. This meant selling bonds (at a $1.8B loss). The bank also announced a $2.25B share sale.
    a. In a meeting late last week (the week of March 3), **Moody's told the bank that their unrealized losses meant that it was at serious risk of a credit downgrade**, potentially of more than one level. The bank needed to offload a large portion of its bond investments to increased its liquidity. They ultimately sold the portfolio and announced a $2.25B equity deal. Moody's downgraded the bank on Wednesday anyway.
6. This started a **run on the bank**. Several venture firms told their portfolio companies to withdraw their funds.
7. The **bank failed** on Friday. This was the second-largest bank failure ever ($200+B of assets). Washington Mutual was the largest ($300+B of assets).
8. As of Dec. 2022, **more than 93% of their domestic deposits were insured**. It is unknown how much uninsured depositors will recover.
9. SVB helps handle payments for payroll service provider Rippling. Some paychecks were already "in flight" with SVB and have yet to be paid out. Companies may have to fire employees rather than not be able to pay them. Venture firms are likely to come up with some access to funding.
10. The bank also invested in these startup firms, so people are wondering if they will be liquidating their stakes.
11. This situation is very similar to what recently happened with Silvergate Capital. **Silvergate** served a lot of crypto-clients. Silvergate had $12B of zero-interest demand deposits. They invested it into securities that dropped in value when rates increased. At the same time, crypto firms were withdrawing money. (Interestingly, crypto may also be very interest rate sensitive.) Then, Silvergate had to sell their bonds at a loss.

(Bl.) (Bl.) (Bl.) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Barron's)

B. Other General Thoughts from the SVB Story

1. Regulators have openly talked about spending less time policing the balance sheets of small institutions, giving them an opportunity to innovate. On the other hand, they have tightened oversight of "**systemically important**" banks. (Bloomberg)
2. Banks are always told to **diversify their assets** (loans and securities) and match the duration of their assets and liabilities. Silicon Valley Bank and Silvergate offer another lesson – **diversify your deposits**. (Bloomberg)
3. High short-term rates, exceeding the rates at which banks can lend for longer-term, make it harder to compete for deposits. An inverted yield curve is a huge headwind if you're in the business of borrowing short-term and lending long-term. (Bloomberg)
4. Banks are going to need to **fight to keep deposits**. That means higher interest rates and less profit. (Bloomberg)
5. In all, US banks had booked **$620B in unrealized losses** on their available-for-sale and held-to-maturity debts at the end of 2022. (Bloomberg)

IV. Labor Market

A. The Employment Report

1. Nonfarm payrolls increased **311K** (Jan. revised down to 504K)
    a. Beat estimates for 11th straight month
2. Unemployment ticked up to **3.6%**
3. Average hourly earnings increased **.2% MoM and 4.6% YoY**
    a. Wages for production and nonsupervisory workers (the majority of US workers) increased .5%
4. **Participation rate increased to 62.5%**, the highest since March 2020
5. **Average workweek moved down** (often happens before lowering headcount) (Bl.)

B. Other Important Labor Data

1. **Initial jobless claims** increased by 21K to **211K**. (Bloomberg)
2. The **quits rate** has fallen to **2.5%** (it was as high as 3.0% last year)
3. The number of **job openings to unemployed people is 1.9.**

C. Other Interesting Labor Stories

1. Traditionally, proxy statements would show **executive compensation** based on the value of options and restricted stock when received. Now, companies will also **show how the value of the compensation has changed over the past three years**. This is referred to as "compensation actually paid." (WSJ)
2. The share of **independent contractors** in the labor force may be ~15% of all workers according to a recent research paper. The BLS typically estimates that it's ~7%. The study found that less-educated workers and people who have several jobs were the most likely to be under-reported. This implies that a greater percentage of the labor force may not have benefits or insurance. But it could also explain why spending continues to be strong. (Bloomberg)
3. New research argues that even as the pandemic fades, competition for low-wage workers will be more intense than pre-pandemic. This could lead to further reductions in income inequality. It could also raise labor costs. (WSJ)

V. Miscellaneous

1. The **NY Fed says that global supply chains have returned to normal**. In fact, supply pressures around the world fell below normal for the first time since Aug. 2019. (Bl.)
2. Researchers are arguing that **companies are using unusual disruptions as an excuse to raise prices** and expand margins. Margins hit a record 13.5% in Q2. New research called this "**seller's inflation**." Bottlenecks can create temporary monopoly power and render it safe to raise prices. It adds legitimacy. This may explain declining wholesale inflation and stubborn retail ones. It also is an example of Fed Gov. Lael Brainard's discussions of a "**price-price spiral**," whereby final prices have risen more than input costs. (Bl.)
3. A NY Fed study showed that **price gains** in the last three months of 2022 as measured by the PCE price index were **stronger** and more broad-based than previously thought. This points to **more persistent inflation**. The expectation for more persistent inflation can be explained in "roughly equal parts" by the trends in prices for core goods and core services excluding housing components. Housing's contribution, on the other hand, appears to have stabilized. (Bloomberg)
4. When looking at **recession indicators**, you also have to **look at timing**.
   a. The **3-month/10-yr**: recession never started until the curve began to steepen. Usually, it was **no longer inverted** by the time the recession began. This could put us at the end of 2025. In periods of high inflation, recessions began five months before curve un-inversion, whereas when inflation is low, recessions started five months after.
   b. The **Leading Economic Indicator lag** has been growing. The average from the last eight cycles for LEI to peak and recession to start has been 11 months, but it topped at 21 months before the Great Recession (2007).
   c. Recessions tend to start when **operating margins peak and start to fall**. Margins look to have stalled if using the NIPA accounts (profits reported for tax purposes). A strong labor market hurts margins. Weak margins result in layoffs.
5. The ISM says that **new orders for manufactured goods contracted for the sixth straight month** through February. Manufacturing is only ~11% of GDP, but it has been an early indicator of recession. Higher interest rates make it more expensive to borrow for appliances or machinery. The strong dollar has also made our exports expensive. (WSJ)
6. Citadel's **Ken Griffin** said the **setup for a US recession is unfolding** with the Fed raising rates and Americans being stung with traumatic levels of inflation. He said that the Fed is limited how much it can fight inflation with interest rate increases. (Bloomberg)
7. The **Beige Book** showed **steady consumer spending and stabilizing manufacturing activity**. Overall, economic activity increased slightly in early 2023, but uncertainty also increased. Firms said labor availability was improving slightly. (Bloomberg)
8. China is the second-largest consumer of oil and commentators believe that their reopening will result in **oil hitting $100** in the second half of the year. China's demand should reach **16MM barrels per day**. Total demand could hit 101.9MM barrels per day. Air traffic is also recovering. The US is growing production at a slower pace as producers run out of prime areas to drill. We are still about 800K barrels per day below our record 13.1MM barrels in early 2020. (Bloomberg)