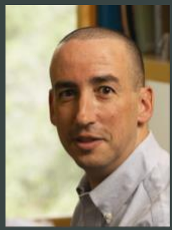

MARKET UPDATE

subscribe at sandyleeds.com

March 6, 2023 – Market Update

Table of Contents

I. Last Week

A. The Big Picture

1. A lot of Fed commentary supported a **25-bp rate increase** in March.
2. The **ISM services index** held steady at 55.1, showing that the economy is still expanding.
3. There seems to be a growing feeling that **soft data** (such as consumer expectations from The Conference Board) is coming in soft, while **hard data** is strong. (ISM is also soft data.)
4. This week: **Powell** testifies before Congress and the **jobs report** comes out on Friday.

B. Stocks

1. For the week: DJIA +1.8%; **S&P 500 +1.9%**; Nasdaq +2.6%
    a. S&P snapped a three-week losing streak
    b. The **VIX** fell to **18.5**
    c. A basket of the most-shorted stocks rose 3.2% on Friday while a gauge of unprofitable tech stocks jumped almost 6%. (Bloomberg)
2. The stock market was driven by **speculation that the Fed won't raise rates beyond peak levels already priced in**. A measure of prices paid by service providers showed costs rising at a slower pace. (Bloomberg)
3. **Disconnect: Rates** on the two- and 10-year USTs were up for the sixth straight week. Short-term yields are close to the S&P 500's earnings yield (5.1% six-month T-bill vs. 5.3% earnings yield).
    a. Maybe stocks are bouncing from their 200-day moving average
    b. Maybe there's a belief that growth will continue
    c. Maybe there's a belief that rates will be lower in short order (Bloomberg)
4. Even with stocks falling 2.6% in February, the **uptrend** that started in the fall is still intact. But some economists are arguing that the Fed funds rate could have to go to 6.5% and that would mean lower stock prices (particularly growth stocks). (Bloomberg)

C. Strategists

1. MS says **headwinds** for stocks will be worse in March due to faltering **earnings** and **high valuations**. They think that the earnings recession is far from over. The market is back above the 200-day moving average but needs **interest rates and the dollar to fall**. Otherwise, being above the 200-day average will be a **bull trap**. (Bloomberg)
2. JPM warns that if stocks drop below their **200-day moving average**, quant funds will sell $50B of stock. On Fri., stocks closed above the average for the 30th straight day. (Bl.)
3. JPM says last year's **outperformance by value will likely reverse soon**. They think that the market will move back to the recession trade. Value had been boosted by rising bond yields and inflation while those higher rates hurt growth. The **economy is likely peaking** and that hurts value.
    a. The contrary argument is that "higher for longer" feeds value stocks. Value tends to outperform when the yield curve steepens. (Bloomberg)
4. JPM says **S&P 500 P/E is 2.5X too expensive given the level of real rates**. (Bl.)
5. Citigroup says **investor pessimism is increasing** with more short bets in the US and Europe. Yet, overall positioning remains "moderately" positive. This could mean that investors are not convinced of the bearish turn or there is more selling ahead. (Bl.)

D. Stocks General

1. **Active managers** are struggling YTD as January included a **surprise rally** and now **correlations** are very high. The correlation between growth and value is now the highest since 2005. Only 29% of core funds outperformed in January. It's a **macro-driven market**. (Bloomberg)
2. **0DTE options** are often being used to "buy the dips." In this way, they **suppress volatility**. (Bloomberg)
3. **Stock buybacks** are projected to top **$1T** in 2023 for the first time in a calendar year. With margins being squeezed, this can help **maintain EPS growth**. Repurchases slowed in Q4 and some investors think that this was good news b/c it indicates that companies weren't pulling the buybacks forward in order to avoid the 1% federal tax that started on Jan. 1. (WSJ)
   a. Buybacks actually **reduce market cap**. Maybe market cap would be a better metric to judge managers by? Also, while buybacks are often thought of as a way to dodge taxes, the reality is that someone is selling their shares and must pay taxes. (WSJ)
4. So far this year, PE firms have entered into **eight leveraged loans** where at least part of the money was **used to pay a dividend**. There have been $5.8B of one-time dividends in the US and Europe YTD. (Bloomberg)

E. IPO Market

1. Almost 100 companies that listed through a combination with a **SPAC** don't have enough money on hand to fund their current level of spending through next year. That's on top of the 73 companies that currently trade below $1 per share.
   a. Over the course of 2020 and 2021, more than **850 SPACs raised roughly $245B**.
   b. The majority of companies that were formed when a SPAC made an acquisition (a de-SPAC) are trading below $10. (Bloomberg).
   c. Sponsors received a chunk of shares in the newly public company. The early investors had warrants and would usually sell the shares.
2. The IPO market was pessimistic in December, optimistic in January and pessimistic in February. The **IPO market needs more certainty around rates and valuations**. Sixteen US IPOs priced in February vs 40 during this period in 2022 and 138 in 2021. (Bloomberg)

F. ESG

1. Congress is fighting over a **Labor Department rule** that would **allow managers of retirement plans to consider ESG issues**. The House and Senate both voted to overturn Biden's regulation that allowed consideration of ESG. Republicans argue that ESG pushes a political agenda. (Bloomberg) (WSJ)
    a. Under Pres. Trump, the Labor Dep't said that managers could only take relevant investment factors into account.
        i. Under Pres. Biden, they said that ESG could be taken into account, but doesn't have to be
2. ESG has succeed SRI.
    a. Arguments in favor of ESG:
        i. It allows more factors to be considered than shareholder value
        ii. It may be profitable in the long-term to consider these factors
        iii. Gave passive managers more power over companies and made the funds more attractive to investors
    b. Problems with ESG:
        i. Different index providers have very different ratings of the same company, particularly with respect to governance
        ii. **Greenwashing** – investors and companies are finding ways to appear ESG-compliant while not making substantial changes
        iii. Politicization of investing
        iv. Decisions should be based on likely returns
        v. Private indexes decide which stocks indexes should include (Bloomberg)

G. Rates and Currencies

1. Past week: 3-month 4.91% (+5 bps); 2-yr 4.86% (+8 bps); 10-yr **3.97%** (+2 bps)
2. On Thursday, all UST yields moved above 4%. It seemed that "higher rates for longer" was sinking in. The Fed funds futures now implies a **5.25% - 5.50% terminal rate**. (Bl.)
    a. Higher inflation fears and the belief in a more-Hawkish Fed pushed the entire yield curve above 4%. GS said that they no longer believe that inflation will fall below 3% this year. Higher yields impact margins and can undermine business conditions for weaker firms. (WSJ)
        i. Low unemployment claims and a strong ISM services report also pushed yields higher
    b. But rates dropped at the end of the week with **dovish Fed comments**.
3. Approximately $283B of investment-grade bonds have been issued YTD, the highest amount on record. This is ~1/4 of the $1.2T that is expected to be issued in 2023. (Bloomberg)
4. The **dollar fell** as higher European inflation will lead to more aggressive ECB policy
    a. Euro-area headline inflation was 8.5% in February and core increased from 5.3% to 5.6%. This followed strong inflation numbers from Germany, France and Spain. (Bloomberg) (WSJ)
    b. ECB President Christine Lagarde said that interest rate increases may need to persist beyond a planned half-point increase in mid-March. (Bloomberg)
    c. The biggest concern is Italy's 10-year yield, which is back up to more than 4.6%. (Bl.)

II. The Fed

A. Fed Speak

1. Atlanta Fed Pres. **Bostic** said that he still prefers to raise rates by another **quarter percentage point** at the next meeting, but that he's mulling whether central bankers need to lift rates above the 5% - 5.25% range. Atlanta Fed Pres. Bostic said that the Fed could be in a position to pause rate hikes sometime this summer. But, he also said that rates may need to remain high well into 2024. (Bl.) (Bl.)
2. Richmond Fed Pres. **Barkin** said that the Fed must continue to raise rates and hold them at a high level. But he also said that there is a case to "**move more deliberately**" and this was seen as a signal that he favors a 25-bp increase. He said that "the beauty of a shallower rate increase path is if you're wrong, you're not that far wrong." (Bloomberg)
3. Minneapolis Fed Pres. **Kashkari** said that he was open to the possibility of raising rates **50 bps**. The Fed seems particularly concerned about inflation in core services excluding housing. (Bloomberg)
4. Fed Gov. Chris **Waller** said that the Fed will need to raise rates to **higher levels than previously anticipated** to prevent inflation from picking up if the recent strength in hiring and consumer spending continues. (WSJ)
5. New Chicago Fed President Austan **Goolsbee** said that central bankers must augment what they learn from incoming data with clues gleaned from the **real economy** and avoid putting too much weight on financial markets. (Bloomberg)
6. The **Monetary Policy Report to Congress** was released and said that "ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive." (Bloomberg)

B. Fed Policy

1. Some commentators feel like the Fed is **behind the curve** and should raise rates **50 bps** while those in the **25-bp** camp think that the FOMC should **wait and evaluate** the impact of past increases and that smaller moves will reduce the **risk of destabilizing financial markets**. But this could create risk that inflation will become more embedded, which could eventually force the Fed to have to raise rates into a weak economy. (Bl.)
    a. Since the FOMC meeting is on March 22, the participants will have the opportunity to see the **jobs report, CPI and retail sales**.
2. A paper by economists from Brandeis, JPM, Columbia and NYU argue that given the significant tightening that has already occurred and the prospect for further tightening, "an **immaculate disinflation would be unprecedented**." They commended the Fed for abandoning gradualism and raising rates aggressively. (Bloomberg).
3. When we talk about **financial conditions**, **investors look at indexes** created by GS and Bloomberg. Spreads are important and so is the VIX. The **Fed** tends to think about **short-term rates** being positive in real terms and **mortgage rates**. In other words, the Fed thinks about what they control. The stock market might not matter to the Fed. (Bl.)
4. When central banks engage in QE, they end up paying **interest on reserves**. This is like paying **floating (variable) rate** interest. The Fed was sending $100B annually to the Treasury. Now, this has flipped as interest-on-reserves has increased. The Fed accumulates a "deferred asset" that will be paid down when it's profitable again. For the federal government, this source of "income" has gone away. (Bloomberg)

C. Fed Selections

1. Austan Goolsbee's wife works at the search firm hired by the Chicago Fed to help find a new president. They selected Goolsbee. Fed Gov. Waller and Gov. Bowman abstained from supporting Goolsbee. Goolsbee was known for defending Democratic policies and criticizing Republican ones when he worked for Pres. Obama. (Bl.)
2. Senator **Elizabeth Warren** wants Biden to select a vice-chair to counter Chair Powell, who she says "has made clear that he will take extreme steps on interest rates and he's willing to put millions of people out of work." (Bloomberg)
    a. Larry Summers said that signs of **politicization of the Fed could push up inflation expectations** over time. (Bloomberg)

III. Economy

A. General Economy

1. The **ISM's manufacturing index** ticked up to **47.7** in February from the weakest print since May 2020. This is contractionary territory amid fragile demand and inflationary pressures. (Bloomberg)
2. **Global PMI is back above 50**, a good sign for growth, but maybe a negative sign for inflation.
3. **Money supply doesn't determine output**. MV=PQ doesn't help because the velocity of money changes and is highly variable. The Fed doesn't target the money supply. In addition, paying interest on reserves and QE had a tremendous impact on the amount of reserves (a key part of the money supply) and the velocity. (Bloomberg)

B. Debt

1. The average **student debt** was $1,070 in 1970 vs. $31,100 in 2021, an increase of more than 2,800%. In **real terms**, it has risen more than **500%**.
    a. In 1970, it **cost** just $1,326 a year to attend a public four-year college and $2,754 for a private school. In 2022 – 2023, it was $20,500 and $52,590. This includes tuition, room and board. In real terms, **public** college has **doubled** and **private** schools have nearly **tripled**. (Bloomberg)
2. Car dealers say that buyers are showing up to lots with $10K of **negative equity** (aka "being underwater" or "being upside-down"). They are sometimes rolling that debt onto the next car. They are buying (expensive) new cars too soon. Today, ~2/13 of people are making car payments of $1,000 or more. For trade-ins that carry negative equity, the average amount is approaching pre-pandemic levels of $5,500. The surge in prices and prevalence of 84-month loans are scaring watchdogs. (Bloomberg)
3. American **millennials** (1981 – 1996) in their 30s have $3.8T of debt, a **27% increase** from late 2019 through late 2022. This is the steepest increase of any age group. Their **average credit card balance was ~$6,750** in January, up 26% from three years earlier. When **federal student-loan payments resume**, millennials could struggle. (WSJ)

C. Inflation

1. The **ECI** has shown **three straight quarters of smaller advances**. The **average hourly earnings** of employees has **slowed to 4.4% YoY** (from 5.9% last March). **Why is wage growth slowing if the jobs market is so tight?** If wage growth continues to slow, maybe the Fed doesn't have to be as aggressive. Maybe we have a **reverse wage-price spiral**. Maybe employees and employers have lower inflation expectations and this leads to tempered wage demands and then prices don't have to be increased. (Bloomberg)
2. While **CPI** is **normally .3% higher** than **PCE**, this **might temporarily flip** this year (as CPI drops much faster):
    a. **Housing** costs should decrease and are 33% of CPI vs. less than half of that in the PCE.
    b. **Medical care costs** should increase and are just 7% of CPI and 16% of PCE.
        i. In addition, CPI includes health insurance, which will be a deflationary drag, and PCE does not include it
    c. **Energy** is 6.9% of CPI and ~4% of PCE (WSJ)
3. **Apartment rents fell** in every major metropolitan area in the US over the past six months through January. In addition, this year is expected to be the **biggest delivery of new apartments in 40 years**. Renters with new leases in January paid a median rent that was **3.5% lower than Aug** (but they are still 20% - 30% higher than pre-pandemic).
    a. Many tenants are maxed out as to how much of their income they can devote to rent. Others are concerned about potential layoffs. The average rental price for single-family homes was unchanged in January. (WSJ)

D. Housing

1. **Pending home sales rose** the most since June 2020, helped by temporarily lower mortgage rates. The index of contract signings to purchase existing homes increased 8.1% in January. They were still down 22.5% from Jan. 2022. This is often a **leading indicator** to existing home sales (which has had 12 straight down months). (Bloomberg)
2. Some **homebuilders are reporting great orders**. Existing homeowners don't want to sell and give up their mortgage. Ironically, homebuilding requires securing land and building materials and this can be inflationary. So, as the Fed tries to use rates to slow inflation, they could be doing the opposite. (Bloomberg)
3. The share of **all-cash deals for houses** rose to the highest level since 2013 last year, while **institutional investors** (who usually account for a large percentage of these transactions) **retreated**. Investor purchases fell by a record 46% in Q4 YoY. Many buyers are people who sold expensive homes in other areas. (Bloomberg)
4. According to Redfin, **YOY home prices dropped for the first time since 2012**. They said that the median price is now $350,246, down .6% YoY. (Bloomberg)
5. **First-time homebuyers made up the smallest share of sales on record last year** (26%). **Inventories** of entry-level homes remain **tight** and the 30-year fixed rate **mortgage** is now **6.65%.**
    a. The typical household income for first-time buyers rose to $90K from $70K in 2019.
    b. The **median age** of first-time buyers jumped from 29 in 1981 to 36 in 2022 (consistent w/ home prices rising faster than wage gains).
    c. The number of first-time buyers who relied on a **gift or loan** from families or friends jumped from 33% pre-pandemic to 40% in 2021. (Bl.) (Bl.)