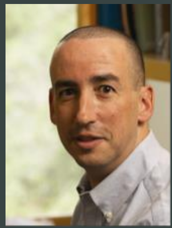

MARKET UPDATE

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May 1, 2023 – Market Update

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I. Stocks

#1. It was another positive week but the YTD gains are concentrated in tech.

1. DJIA +.86%; **S&P 500 +.87%;** Nasdaq +1.28%
2. **Less than a third of stocks in the S&P 500 have outperformed the index**, the fewest in any year since 1999.
3. The financial crisis seems to have pushed investors into the stocks that they are familiar with and that have delivered in the past. Then, **positive earnings reports** from those companies helped some more.

#2. Tech is dominant!

1. The S&P IT sector is up **21.47%** YTD vs. **8.59%** for the S&P 500
    a. Some of this may have been the result of a belief that the Fed will pivot
2. **Five tech stocks** (AAPL, MSFT, NVDA, META and AMZN) are responsible for **2/3** of the S&P's advance this year
    a. Uniformly strong earnings from META, MSFT, GOOGL and AMZN are defying concerns that weakening growth prospects would dent the world's largest companies and leave the whole market vulnerable to reversal.
    b. If you exclude **eight companies**, the **S&P 500 is flat** for the year
        i. AAPL, AMZN, GOOGL, META, MSFT, NFLX, NVDA, TSLA
3. Tech stocks in the S&P 500 are now trading at almost **25X** prospective **earnings**
    a. Analysts expect a 15% drop in tech's Q1 earnings (largest of any sector)
4. **Apple and MSFT** now add up **14% of the S&P 500**. Add in GOOGL, AMZN, META and NVDA and you're near **25%**.
5. If you look at the **KBW index** (which includes the 22 largest commercial banks in the US) **plus the FANG+ index**, the combination has gained value (market cap) this year.
    a. In other words, tech gains > banking losses
6. *Many tech stocks have risen dramatically in recent months, which is reminiscent of the **last four bear market rallies** in the past 16 months, and none of these periods ended well for tech stocks.* (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg)

#3. There's plenty to worry about.

1. Slowing growth
    a. Tighter lending
2. Inflation that is still high
3. The debt ceiling
4. March rally was fueled by increased liquidity in response to the regional banking crisis
5. Lower earnings – typically, when forward EPS growth goes negative, the Fed is cutting rates, not raising rates
6. Valuation
7. Tech run-up (Bloomberg)

#4. Despite being 14% below its 2022 high, the S&P 500 still isn't cheap.

1. The S&P 500 trades at **18.3X next year's earnings**.
    a. In the five years ended in 2019, it averaged 16.9X.
    b. And analysts expect Q4 earnings to be 8.5% higher YoY.
2. The **CAPE** (which uses GAAP) is at **28.9.**
3. It trades at **2.25X forward sales**.
    a. It averaged 1.91 in the five years ending in 2019.
4. Stocks are **179% of GDP**. (WSJ)

#5. Earnings have been beating low expectations. Future expectations may be far too high.

1. So far, **82%** of companies have beaten earnings estimates. In the past five years, the average has been 76% and has not dipped below 65%.
2. EPS **projections are still coming down** for the next four quarters.
3. The average recession takes **~31% from EPS** and the market is nowhere near pricing that in. Sell-side forecasts now imply a peak-to-trough decline of about 3.4% in trailing 12-month EPS, with the bottom in Q2.
4. If the economy and profit margins remain resilient, the Fed will likely keep rates high and p/e multiples will struggle to rebound.
    a. Conversely, any hint of easier monetary policy will probably coincide with a more dire outlook for profits. (Bloomberg)

#6. Who would have ever guessed that SPACs wouldn't do well?

1. A study of **342 SPACs** that went public between 2016 and 2022 found that **101 could run out of cash within a year**. On average, they have enough cash and short-term investments to cover spending for approximately five months.
2. Only about **15%** of companies that did SPAC deals during **2021** were **profitable**, compared with **30%** of SPACs that went public from **2013 to 2020**. (WSJ)

II. Bonds and Interest Rates

#1. Rates moved lower last week.

1. 3-month: 5.10% (-4 bps); 2-year: 4.04% (-13 bps); 10-year: **3.44%** (-13 bps)
2. **Inversion**: 3-month/10-year = 166 bps; 2-yr/10-yr = 60 bps
3. **Fed funds futures**: ~4.50% by the end of 2023

#2. Yield curve and spreads are not consistent.

1. US **credit spreads have been shrinking** lately – despite tighter lending standards, a financial crisis, recession fears
2. **High short-term rates** mean that there is continued incentive to move money to money market funds. The **inverted yield curve** means that there is less incentive to lend. (Bl.)

#3. There are some signs that credit is drying up.

1. **Small businesses** say it hasn't been this difficult to borrow in a decade
2. The amount of corporate debt trading at **distressed levels** has surged ~300% over the past year (effectively locking some companies out of the financial markets) – from $74B to $300B
    a. 10% above the UST yield for bonds
    b. Less than 80 cents on the dollar for loans
3. Bond and loan **defaults** have ticked up
4. The Fed says that banks have **tightened lending standards**
5. Corporate **bankruptcies** are on the rise (particularly in construction and retail)
6. About **25% of the $1.4T leveraged loan market carries a B- rating**, just on the cusp of CCC rating that sharply curtails access to Wall Street borrowing
7. Citigroup more than doubled what it has set aside to cover bad loans to $2B (Bl.)

#4. Private credit could make things worse.

1. The fastest growing segment of the lending world has been **private credit** – loans to companies generally too small to issue bonds but who want to avoid more restrictive bank loans.
    a. **Since** the start of **2008**, private credit has **grown almost sixfold**, to $1.5T
        i. Bigger than the high-yield or leveraged loan market
        ii. At $4.4T, those three markets are worth more than all banks' C&I loans ($2.7T)
        iii. Private credit is mostly financed with investor capital that is locked up for a few years (no run risk). And loans are often **floating rate**.
    b. Private credit does have some **risks**:
        i. It often funds leveraged buyouts of companies more vulnerable to economic slowdowns
        ii. Competition has led to laxer loan terms
        iii. Managers of private credit deals often finance deals of other managers, which concentrates risk
        iv. The investors who commit capital to private-credit funds also do so for private equity and other alternative assets (interconnectedness that can amplify stress)
2. Even without runs, private-credit **could feel the need to retrench**, aggravating the credit crunch and worsening the economic downturn
    a. **Fundraising** by private-credit funds **fell 42%** last year from 2021 (WSJ)

III. The Debt Ceiling

#1. Investors are starting to grow concerned about the debt ceiling.

1. This past week, the **spread between the three-month and one-month T-bill increased**. That two-month period is when the debt ceiling situation is likely to come to a head.
2. The price of **credit default swaps** on US debt has increased to a cost higher than post-Lehman and higher than the 2011 debt ceiling crisis.
3. Concern has increased because **April tax receipts are running 29% below** their level for April 2022. This means that we'll reach X-Day faster.
4. It took four days to elect Kevin McCarthy as Speaker and he had to make promises to the **Freedom Caucus** that he wouldn't raise the ceiling without negotiating spending cuts. Meanwhile, the Biden administration refuses to negotiate. (Bloomberg)

#2. Remember that stocks dropped in 2011 after the debt ceiling was raised.

1. One reason for this is that the $**2T of spending cuts were far greater** than the consensus expected and growth was downgraded.
2. When the Treasury replenishes its bank account, it **drains liquidity** from the private sector. (Bloomberg)

#3. Some comments about the Republicans' debt-ceiling bill.

1. The Republican bill would **reverse much of Pres. Biden's plans**. So, it's not something that will lead the Democrats to negotiate.
2. Moody's says that the Republican plan would **slow economic growth and increase unemployment**. There's a hot take…if the government spends less, the economy will grow slower. Who knew?
3. The CBO says that the bill would **cut government deficits by $4.8T over ten years**. This is a significant reduction in the $21T of deficits projected over this time period. (WSJ) (Bl.)

IV. The Dollar

#1. Some argue that the yuan can challenge the dollar without loosening capital controls.

1. Offering **swap lines** gives other countries confidence that they can access yuan
2. **Offshore markets** make the yuan **convertible**
3. China is establishing itself as a **lender of last resort**
4. China has pioneered **online payment platforms** on a larger scale than the West
5. The **Fed has monetized 35% of the debt** (Bloomberg)

#2. The dollar will not lose its dominance anytime soon.

1. As mentioned before, everyone wants **access to our markets** and that requires dollars. In addition, if foreign central banks held other currencies as reserves, what would they buy? In other words, the fact that central banks want to hold our **Treasury bonds** is an argument for the dollar retaining its status.
2. I love what **Larry Summers** said: "you cannot replace something with nothing." What other currency is preferable to the dollar as a reserve and trade currency "when Europe's a museum, Japan's a nursing home, China's a jail, and Bitcoin's an experiment"?
3. Without **capital controls**, a very large amount of Chinese capital would leave the country in search of diversification and more secure property rights. (Bloomberg)

V. Banks and Real Estate

#1. I assume FRC is no longer FRC by time that you're reading this.

1. FRC reported that customer **deposits plunged 41% to $104.5B** in Q1. Analysts expected deposits of $137B. Remember that the largest lenders parked $30B of their own cash there.
    a. **Customers pulled ~$100B** in deposits out of First Republic Bank last month. Deposits fell from $176.4B on Dec. 31 to $104.5B at the end of Q1, but that $104.5B includes the **$30B that large banks deposited**.
    b. It is left with **$55B of insured** deposits, **$20B of uninsured** deposits and **$30B of term deposits** from other big banks
    c. **Higher funding costs** are squeezing their ability to generate profits on loans.
        i. The banks said it paid between **3% and 4.9%** for loans from the Fed and FHLB.
            1. In Q1, their **loan book yielded 3.73%**.
2. The bank's balance sheet showed **loans of $166.1B** as of Dec. 31. A footnote said that their **fair-market value was $143.9B**. the $22.2B difference was greater than the $17.4B of total equity.
    a. At the end of 2022, **commercial and residential mortgages had a carrying value of $136.8**
        i. But the estimated resale value would be just **$117.5B, or a loss of $19B**
            1. This was more than its core regulatory capital of $13.9B
        ii. **Residential loans** make up most of its mortgage book, about $100B, and accounted for nearly half of its total assets
    b. **SVB** had 57% of its assets in bonds – 14% held at market value as AFS and 43% booked as HTM. At **FRC**, only **15.5% of its assets were in bonds** and they were mostly held to maturity.
        i. But FRC had **interest-only loans** that were not due to get any principal repayments for 10 years. This was like owning 10-year bonds.
3. The bank said that they would cut as much as 25% of its workforce, lower outstanding loan balances and curb other non-essential activities. FRC's executives **refused to answer questions** on their earnings call. Markets lost confidence. (Bloom.) (WSJ) (Bl.)

#2. Moody's downgraded banks. They also said that the Jets would win Super Bowl III.

1. Moody's **downgraded 11 regional lenders** last Friday, suggesting that **higher interest rates and recent bank failures** have ushered in greater instability.
2. Some **problems**:
    a. Low-rate loans
    b. Low-rate securities
        i. Large unrealized losses
    c. High share of customers with uninsured deposits
    d. Exposure to CRE
    e. Low capital levels (WSJ)

#3. Small business will be hurt by tighter lending standards.

1. More banks face losses down the road on riskier CRE loans and C&I loans for which they **haven't set aside enough** of a cushion. As a result, lending standards will tighten.
    a. Any lending squeeze could disproportionately affect **small businesses**
        i. Business with fewer than 100 employees receive nearly 70% of their C&I loans from banks with less than $250B in assets and 30% of such lending from banks with less than $10B
2. In **most** US **counties**, **small and midsize banks account for 90%** of loans to small businesses (WSJ)

#4. Commercial real estate has cyclical and structural issues.

1. Landlords are contending simultaneously with a **cyclical market downturn** and with **secular changes** in the way that people work, live and shop. The sudden surge in interest rates caused property values to fall while the rise of remote work and e-commerce are reducing demand for office and retail space.
2. The **US office vacancy rate hit 12.9%** in Q1, exceeding the level during the 2008 crisis. Despite low unemployment, we have high vacancy rates.
    a. Nearly 30% of San Francisco's office space is vacant, more than 7X the rate pre-pandemic.
3. Depressed building values could hurt cities, which depend on **property tax revenue**. Obviously, it will also hurt bank balance sheets, leading to less lending.
    a. Commercial mortgages account for **~38%** of the median US bank's loan holdings.
    b. Public pension funds hold ~9% of their assets in real estate.
4. **Office building prices are down 25%** since early 2022. Prices of **malls** are down 19% since early 2022 and down 44% since 2016.
5. About $80B worth of loans backed by US office buildings come due this year. Most will need to be refinanced at a time of higher interest rates and lower occupancy. (WSJ)(WSJ)

VI. The Economy

#1. Q1 GDP was a mixed picture.

1. Q1 GDP increased at only a **1.1% annualized pace** (down from 2.6% in Q4). The slowdown was largely driven by an **inventory drawdown**. Inventory drawdown subtracted **2.26% from GDP**.
    a. **Consumer spending** was still strong – 3.7% annualized pace (fastest since 2021 Q2)
    b. **Final sales to private domestic purchasers** grew 2.9%
2. **Businesses** pulled back sharply, drawing down **inventories, cutting equipment purchases** and **reducing housing investment**.
    a. Residential investment declined 4.2% in Q1
    b. Nonresidential equipment investment declined 7.3% (WSJ) (WSJ)

#2. The economy was slowing later in the quarter.

1. **Real PCE** stagnated last month after a .2% drop in February.
    a. Real spending on **goods** was down .4%. **Services** were up .1%.
    b. Real disposable income increased .3%.
2. The **savings rate** climbed to 5.1%, the highest since the end of 2021. (Bloomberg)

#3. Inflation is still high.

1. **Core PCE** rose **.3%** in March MoM and **4.6%** YoY.
    a. Silver lining: price of services excluding housing and energy services increased .2% in March. It's still up 4.5% YoY.
    b. Core PCE picked up to 4.9% in Q1.
2. The **Employment Cost Index** increased **1.2%** in Q1 QoQ.
    a. Labor costs in the US have risen at least 1% for seven straight quarters. (Bl.) (Bl.)

#4. We need collective action on inflation.

1. Inflation is fundamentally the outcome of the **distributional conflict between firms, workers and taxpayers**. It stops only when the various players are forced to accept the outcome.
2. When everyone stands up in a stadium, we're all worse off. We need to **collectively agree** to stay seated. Similarly, when companies raise prices to maintain profits, workers demand raises. Yet somehow, we all have to agree to accept some pain to eliminate inflation.
3. On an unrelated note…**ESG** was an attempt to deny that there was a problem of collective action. It was premised on the idea that issues could be treated as usual by profit-seeking capitalism. (Bloomberg)

#5. The housing market is still tight.

1. Sharply higher mortgage rates have not done much to cool the housing market. This is because **supply is tight** (no one wants to get rid of their low-rate mortgage). In addition, homebuilders are slowing production and this will further the supply issue.
2. If rates decrease, it will bring more buyers back into the market. We'll need more supply. Also, remember that **institutional investors bought 90% fewer homes** in the first two months of 2023 than they did in 2022 – so if they return, we'll be in an even tighter market.
3. Redfin says that while median sale prices in its database are down 2.6% YoY, the **monthly payments** of buyers are up **11.6%.** (Bloomberg)

#6. The Fed is in conflict about whether wage gains are a cause of inflation.

1. Chicago Fed Pres. Austan Goolsbee and St. Louis Fed Pres. James Bullard are **skeptical that wage gains will fuel further inflation.**
    a. **Goolsbee** argues that **wages lag prices** (rather than lead them)
    b. **Bullard** stresses the importance of inflation **expectations** and suggests that companies will scale back prices when they fear losing customers
2. **Wage growth** seems to be **slowing** (according to the Beige Book) (Bloomberg)

#7. The FOMC is expected to raise rates on May 3rd.

1. This will be the **Fed's 10th consecutive rate increase in 15 months**. So far, headline CPI has been cut in half and the economy has been relatively strong.
2. The issue now is that the **economy may be slowing** and the **drop in inflation** also seems to be **stalling**.
    a. Core PCE is down less than a full percentage point from its peak. The slowdown in shelter costs has been elusive. Service prices have barely budged and goods prices (which had been falling) are turning up again. Wage inflation accelerated from 1.1% to 1.2% in Q1.
    b. Some evidence that the economy is slowing: first time claims for unemployment are 45K higher than the September low; factory activity has contracted for five straight months; credit conditions are tightening.
3. There is fear that since the Fed acted too slowly to curb inflation, they will also **pause and pivot too slowly.**
4. Realize that if we want to bring overall inflation down, we will have to **overshoot in the sectors that are more interest-rate sensitive.** (Barron's)

#8. R&D is no longer immediately deductible.

1. Last year, five years after former Pres. Trump signed the Tax Cuts and Jobs Act into law, one of its many delayed provisions kicked in. Companies no longer have the option of deducting their R&D expenses in the year they're incurred. Instead, the **costs have to be amortized over five or 15 years**, depending on whether they're domestic or foreign.
2. This was never intended to happen. It was done to make budget numbers add up. In other words, laws are written so that tax cuts go away and then the CBO says that the proposed tax cut is less costly.
3. **Other countries can provide generous incentives** for R&D expenses. The increase in the effective tax burden falls most heavily on companies that spend disproportionately on developing new technologies.
    a. According to one estimate, the new treatment raises the effective marginal tax rate on domestic research by 16 – 28 percentage point. (Bloomberg)

#9. People are hungry.

1. According to the Census Bureau, more than **11.4MM households collected free groceries in early April, up 15% YoY**. An officer of Feeding America said that this is the first time that we are seeing unprecedented **high food demand combined with historically low unemployment.**
2. The fact that we have a lot of first-time users who are no longer concerned with the stigma of a food panty b/c they can no longer afford retail food, tells you about the economy. (Reuters)
3. The sustained demand comes as most **gov't pandemic emergency aid ends**, most notably: temporary Covid-related increases to SNAP.
    a. **Inflation** is also playing a part: grocery prices are up 23% since March 2020
4. **SNAP** is by far the largest method of feeding the hungry in the US. Food banks and pantries account for about 1/10 as many meals distributed, but they are still second.

VII. International – France and China

#1. Macron loves that peaceful Chinese Communist Party.

1. French Pres. Emmanuel **Macron** has made a fool of himself in the last 15 months. After Macron tried to enlist China's help to intervene in Russia's invasion of Ukraine, the Chinese ambassador to France said that the ex-Soviet states don't have sovereign status as independent nations. China later backtracked on those comments.
    a. Don't forget that in Feb. of 2022, Macron traveled to Moscow and said that he had received **assurances that Ukraine wouldn't be attacked**. Two weeks later, the invasion started.
    b. Now Macron thinks that China can bring peace.
2. And one other thing…remember that a few weeks ago, **China was promoting themselves as the global peacemakers**.
    a. Earlier this month, China's defense minister had met with Putin and said that he was "an extraordinary state leader" for "**promoting world peace and development.**"
        i. Which is worse: the Chinese Communist Party for their comments or Macron for being so dumb as to think he could turn to them for peace? (Bloomberg) (Bloomberg)
3. Speaking of that peace-loving, law-abiding Chinese Communist Party, in recent weeks, **Chinese authorities have questioned staff** at consulting firm Bain & Co.'s Shanghai office, launched a cybersecurity review of imports from chip maker Micron Technology, detained an employee of Japanese drugmaker Astellas Pharma and raided the Beijing office of US due-diligence company Mintz Group.
    a. Commentators are saying that China wants to control the narrative about China – so they are investigating companies that gather information.
    b. China is also slowing down the reviews of proposed acquisitions by US companies that need China's blessing. (WSJ)