MARKET UPDATE

subscribe at sandyleeds.com

May 15, 2023 – Market Update

Table of Contents

I. Markets **2**

A. Equities **2**

#1. The broader market dropped last week. 2

#2. Even if tightening is done, equities have plenty to fear. 2

#3. Should shareholders be scared about recession? 2

#4. Bank of America thinks that tech stocks are at risk. 3

#5. Fear vs. greed is one thing. Desperation vs. greed is another. 3

B. Bonds and Rates **3**

#1. Rates didn't change much during the past week. 3

#2. Bond bulls are overly optimistic. 3

II. Fed Policy **4**

#1. Three interesting Powell comments about policy. 4

#2. Why do you believe that the Fed is going to pivot? 4

#3. An inverted yield curve makes investors think that the Fed will pivot. But there's more to the story. 4

III. Debt Ceiling **5**

#1. The argument that markets don't seem particularly scared about default. 5

#2. The argument that we are seeing some signs of fear in the markets. 5

#3. The price of credit default swaps on USTs is increasing. 5

#4. Prioritizing Social Security payments is difficult with our computer systems. 6

#5. The debt ceiling could result in some improvements if there were adults in the room. 6

IV. Financial Crisis **7**

#1. S&P bank stocks are back down to levels seen during the Great Financial Crisis. 7

#2. Investors are nervous about PacWest. 7

#3. Former NY Fed Pres. Dudley says that the Fed must take more responsibility. 7

#4. Lending standards are tightening. Demand for credit is weakening. 8

#5. The problem with apartment mortgages will be felt by CLOs. 8

V. Economy **9**

#1. The debate over a soft-landing is ongoing. 9

#2. CPI is still high, but seems to be decelerating. A pause is likely; a pivot is not. 9

#3. A recent Gallup poll shows that consumers are getting used to inflation. 9

#4. Small-business confidence is weak. 10

#5. Expensive areas are becoming less expensive. 10

I. Markets

A. Equities

#1. The broader market dropped last week.

1. Last week: DJIA -1.11%; **S&P 500 -.29%**; Nasdaq +.40%
    a. **Slowing inflation** means a Fed pause is possible
        i. CPI showed its 10th straight month of decelerating inflation
        ii. PPI is increasing at its slowest pace since early 2021
2. The market had done well when CPI has subsided and the Fed has paused.
    a. Investors are not positioned for a rally
        i. Discretionary investors are heavily underweight (9th percentile)
        ii. If the market breaks higher, a lot of investors will be chasing it
3. Of course, a lot could go wrong:
    a. Debt ceiling fight could lead to default
    b. Credit crunch
    c. Earnings could drop in second half
    d. Recession signals continues to flash red (Barron's)

#2. Even if tightening is done, equities have plenty to fear.

1. Stocks are expensive (Nasdaq trading at 25X earnings)
2. Inflation is still high
3. Concerns about banking system
4. Earnings growth is negative (Bloomberg)

#3. Should shareholders be scared about recession?

1. To avoid a recession, we need:
    a. Regional bank problems to be contained
    b. The debt ceiling fight to be resolved
    c. Job growth to moderate without unemployment spiking
    d. Inflation to subside while the economy is still growing
    e. The shift in demand from goods to services to not be inflationary or hurt stocks
        i. Manufacturers and retailers accounted for approximately half of S&P 500 sales last year
            1. But only ¼ of US private sector sales
        ii. Demand for service workers could also push labor costs higher
2. Positives:
    a. Added 253K jobs last month
    b. Inflation has begun to cool
    c. Household balance sheets look strong (WSJ)

#4. Bank of America thinks that tech stocks are at risk.

1. Bank of America says that a prolonged period of economic decline in the US will hurt tech stocks.
2. Investors added $3.8B to tech stocks in the week ending May 10th, the largest inflow since Dec. 2021. On the flip side, $2.1B was pulled from financial stocks.
    a. Tech is up 22% YTD, possibly due to the hope of lower interest rates.
        i. BAC thinks that the Fed may raise rates more. In addition, a recession will result in lower earnings estimates. (Bloomberg)

#5. Fear vs. greed is one thing. Desperation vs. greed is another.

1. Markets operate at the intersection of fear and greed. But, if your fear is not of loss as much as it is fear of being so far behind, your fear may change into desperation.
    a. People with nothing to lose are dangerous.
2. Examples of **desperate investing**:
    a. The meme stock phenomenon two years ago
        i. Young people don't have pensions; they have student loans and little prospect at being able to buy a house
    b. Pension funds that have to invest in private equity
        i. Low interest rates have resulted in large underfunded pension deficits
        ii. Pensions now account for 2/3 of the capital in PE
            1. Many of these pension funds don't have PE expertise
        iii. Study found that the firms financed by PE funds owned by desperate capital (very underfunded pensions) became less productive (Bloomberg)

B. Bonds and Rates

#1. Rates didn't change much during the past week.

1. UST: 3-month 5.25% (-1 bp); 2-yr 3.98% (+6 bps); 10-yr 3.46% (+2 bps)
2. Inversion: 3-month/10-year 179 bps; 2-yr/10-yr 52 bps

#2. Bond bulls are overly optimistic.

1. Recession fears are encouraging bond bulls to bet that the Fed will abruptly shift direction
2. There are problems with this view:
    a. Job data on Friday may have tempered that view
    b. A rate cut just two months after a hike would be the first time since Oct. 1987
    c. Fed faces a still-resilient labor market, elevated inflation and increasing financial risks
    d. The 10-year yield is already 160 bps below the Fed funds rate (Bloomberg)

II. Fed Policy

#1. Three interesting Powell comments about policy.

1. The fact that the FOMC has stopped telegraphing future rate increases in the post-meeting statement was “a meaningful change”
    a. This is consistent with the idea that the FOMC is considering a pause.
2. The “separation principle” where they would use tighter monetary policy to fight inflation and lending programs to fight bank stress “ultimately…has its limits”
    a. This could indicate that Powell believes that Fed tightening could cause more problems.
3. “Policy is tight” and you want to wait a few months to “persuade you that you’ve got this right.”
    a. This reflects the belief that it changes in monetary policy take 6 – 18 months to work through the economy. It is interesting to think that Powell believes policy is tight when inflation is still near 5%. (WSJ)

#2. Why do you believe that the Fed is going to pivot?

1. The market is pricing in that the FOMC will cut the Fed funds rate four times by January.
2. There are many reasons why this is unlikely:
    a. The labor market is very healthy
        i. The prime-age LFPR is very high
        ii. Average hourly earnings rose by almost .5% MoM in April
    b. Core PCE is still very high
    c. A recession would have to arise immediately to get four rate cuts in by January
    d. The Fed has hiked rates twice since the closure of SVB – they’re not afraid
3. The arguments in favor of the Fed cutting rates:
    a. Strong employment is a lagging indicator – job cuts are the last resort for employers
    b. Recession indicators
        i. Yield curve is still inverted.
        ii. LEI are pointing down
        iii. The ISM surveys have been signaling recession for six months
        iv. Commodity prices are falling, particularly oil (Bloomberg)

#3. An inverted yield curve makes investors think that the Fed will pivot. But there’s more to the story.

1. The case for concerted easing rests fundamentally on the yield curve
    a. The yield curve usually starts to return to normal when the Fed starts cutting rates.
2. But can the Fed cut rates when there is high inflation? And low unemployment?
    a. When pauses have occurred against the backdrop of tight labor markets, the Fed has rarely eased in the subsequent six months
        i. They ease when the labor market is deteriorating.
3. Realize that high inflation is not due to energy prices.
    a. The energy price shock from Russia’s invasion has now dropped out of YoY comparisons
        i. As has the spike in goods inflation from the pandemic
    b. This means the key is core services and food (Bloomberg)

III. Debt Ceiling

#1. The argument that markets don't seem particularly scared about default.

1. Treasury Sec'y Yellen said that a default would trigger a "financial catastrophe." Moody's said that financial markets would be "upended." The White House estimates that the stock market would be cut in half. (I'm going to take the other side of that bet.) Jamie Dimon said that a default is "potentially catastrophic."
2. Yet, the markets don't appear to be scared.
    a. Corporate spreads are stable.
    b. The VIX is subdued.
    c. The S&P multiple is above average.
    d. There is no spike in Treasury yields (other than short-term yields)
3. Possible explanations:
    a. The market doesn't believe that we'll default
    b. The market believes that delayed payments wouldn't hurt profits or the ability to repay debts
    c. Treasuries remain the world's safe haven (Bloomberg)

#2. The argument that we are seeing some signs of fear in the markets.

1. Bid-ask spreads have widened and yields have increased sharply at the short end of the curve.
2. Junk bond funds saw $1.58B in outflows during the week ended May 3
    a. Investment-grade funds added $321.6MM
3. The cost of CDS on USTs is increasing
4. Moody's says that a missed interest payment would cause a downgrade in the AAA rating and would impact GSEs. (Bloomberg) (Bloomberg) (Bloomberg)

#3. The price of credit default swaps on USTs is increasing.

1. The cost of insuring US Treasuries against default now eclipses some emerging markets and even junk-rated nations. It is now more expensive than insuring the bonds of Greece, Mexico and Brazil, which have defaulted multiple times and have credit ratings below the US's rating.
2. While any default would be considered to be a technical default (the US will eventually pay), the fear is that if we roil the Treasury market, we're messing with the risk-free rate, the building block for pricing all other assets.
3. Net notional amounts outstanding on US CDS are now comparable with many larger emerging markets, at $5.5B. But overall, this is a small market.
4. The five-year contract is ~100 bps cheaper than the one-year contract. (Bloomberg)

#4. Prioritizing Social Security payments is difficult with our computer systems.

1. There are currently 52MM Social Security beneficiaries. Social Security payments go out on four days per month. It's ~$25B each of the four times.
    a. It would be hard to logistically have the system make these payments and not make the other payments.
2. It's easy to separate Treasury bond payments that are made using Fedwire. (Bloomberg)

#5. The debt ceiling could result in some improvements if there were adults in the room.

1. We need to recognize two things:
    a. We need to raise the debt ceiling.
    b. We need to fix our fiscal outlook
2. Remember that any debt ceiling based on a nominal figure for debt (such as $31.4T) will be exceeded in due course under even the most prudent fiscal oversight – simply due to growth and inflation.
    a. We'd be better off to base the debt ceiling on debt-to-GDP.
3. Some ideas to consider:
    a. Freeze discretionary spending in real terms
    b. Curb tax expenditures in the form of itemized deductions
    c. Higher corporate tax rate, but immediate expensing for investment
    d. Some stronger work requirements for some spending
4. At some point, we have to address Social Security and Medicare (Bloomberg)

IV. Financial Crisis

#1. S&P bank stocks are back down to levels seen during the Great Financial Crisis.

1. The S&P financials index is on the verge of falling back below its 2007 peak
   a. After the 2008 crisis, it took over a decade to recover losses
2. The index has been above the 2007 high since January 2021
3. Falling below this level would be an ominous sign
   a. It could put further pressure on banks to conserve capital and cut back on lending
   b. Hard to have a bull market if bank stocks are falling (Bloomberg)

#2. Investors are nervous about PacWest.

1. PacWest Bancorp (PACW) fell 23% on Thursday after saying that it had lost 9.5% of its total deposits last week.
   a. Shares are down ~80% since March 8.
2. Jamie Dimon said that the SEC should investigate short-sellers that tweet about banks. He didn't mention what the SEC should do about bank managers who sold their stock before their banks were shut down by the FDIC. (WSJ)

#3. Former NY Fed Pres. Dudley says that the Fed must take more responsibility.

1. The Fed needs to recognize two ways that monetary policy contributed to the crisis:
   a. By committing to keep short-term rates near zero until the economy reached full employment and inflation exceeded 2%, the Fed ensured it would be late to tighten policy. As a result, they had to raise rates faster.
      i. This delivered a larger shock to banks' funding costs and to the value of banks' investments
   b. QE flooded the banks with deposits and reserves. This tempted banks to boost earnings by buying higher-yielding, long-term, fixed-income assets.
2. Three lessons for the Fed:
   a. The FOMC must consider financial stability risks in its monetary policy decisions.
   b. The Chair and the FOMC must bear ultimate responsibility for financial stability, rather than delegating it to the vice-chair for supervision.
   c. Fed officials must avoid the silos of economy, financial stability, regulation and supervision. (Bloomberg)

#4. Lending standards are tightening. Demand for credit is weakening.

1. The Fed said that banks reported tighter standards for loans in Q1
    a. Credit standards are elevated, approaching their Covid highs
    b. The proportion of US banks tightening terms on commercial and industrial loans for medium and large banks rose to 46%, up from 44.8% in Q4
        i. The picture for CRE loans is worse
    c. The survey also showed a lower risk tolerance, a dimmer economic outlook and worsening industry problems as reasons for tightening credit
2. The report also showed much weaker demand for credit in Q1
    a. 55.6% of banks reported weaker demand for C&I loans among large and mid-size firms in Q1. It was 31.3% in Q4
        i. These are all net percentages (tighter minus easier)
    b. Lower loan demand is counterintuitive to the potential need for liquidity in the near-term. This may be a reflection of less favorable loan terms.
3. While all this is happening, corporate bond spreads are low. (Bloomberg) (Bloomberg)

#5. The problem with apartment mortgages will be felt by CLOs.

1. After the Global Financial Crisis, banks became more conservative, lending less money as a share of a buildings' value
    a. CLOs popped up to help fill that void
2. Rental apartments accounted for 2/3 of the CLOs issued in 2021 and 81% of those issued in 2022. These apartments tend to be more highly leveraged.
    a. The loans also have shorter terms and floating rates
3. After the Global Financial Crisis, banks became more conservative, lending less money as a share of a buildings' value
    a. CLOs popped up to help fill that void
4. Nearly $88B in securitized mortgages are at risk of default and 42% of them are backed by apartment buildings.
    a. Approx. 1.4% of commercial real estate CLOs were delinquent as of April 30
        i. Up from .4% last July
            1. ≈
5. CLO lenders typically hold the most junior 15% or 20% of bonds they create (WSJ)

V. Economy

#1. The debate over a soft-landing is ongoing.

1. Optimism for a soft landing:
    a. The strong labor market could give us a soft landing despite the 5% increase in the Fed funds rate.
    b. CPI has come halfway back down
2. But, we will have to overcome:
    a. A looming credit-crunch
    b. Debt-ceiling deadlock
    c. A climate wildcard
        i. A strong El Nino could add to inflation
            1. Storms and floods could hit California and the South, hurting food and energy output
    d. Sticky inflation will make it difficult for the Fed to respond to recession
3. How higher rates slow the economy:
    a. As borrowing costs climb and asset prices fall, spending slows and businesses cut jobs
    b. Recessions are not an accidental side-effect of attempts to rein in inflation. They are the main show.
    c. Bank failures amplify the effect of higher interest rates in curbing credit.
        i. Even last year, the Senior Loan Officer Survey showed lending standards getting tighter
        ii. Typically, lending slowdowns follow with a lag after banks turn cautious (Bloomberg)

#2. CPI is still high, but seems to be decelerating. A pause is likely; a pivot is not.

1. CPI rose .4% MoM and 4.9% YoY
    a. Core CPI rose .4% MoM and 5.5% YoY
    b. Supercore inflation: excluding shelter, food and energy (which is awesome if you don't sleep, eat or drive), inflation was up 3.7% YoY and .1% MoM
    c. The median and trimmed mean both remain above 6%
2. Powell has shifted the assumption from the idea that rates would be raised unless we see weakness to the idea that the FOMC will pause unless they see more strength than expected
    a. This inflation report has led investors to believe that the FOMC will pause raising interest rates. But there's no reason that it would lead them to lower rates. (WSJ) (Bloomberg)

#3. A recent Gallup poll shows that consumers are getting used to inflation.

1. A recent Gallup poll showed that only 9% of respondents thought that inflation was the most important problem. This could make inflation more persistent.
2. Central bankers may be wedded to ending inflation gradually (WSJ)

#4. Small-business confidence is weak.

1. US small-business sentiment fell in April to the lowest level in a decade, reflecting dimmer prospects for the economy and sales that are causing firms to back away from investment plans
    a. Businesses are impacted by high inflation, high interest rates, tighter credit conditions and recession concerns
2. The NFIB optimism index decreased by 1.1 points to 89
    a. The future business conditions index slipped to a four-month low
    b. Sales expectations were the weakest since August
3. Less than 20% of firms said that they're planning capital outlays in the next few months
4. The share of owners who reported raising average selling prices declined for a fifth-straight month to a more-than two-year low of 33% (Bloomberg)

#5. Expensive areas are becoming less expensive.

1. Nationwide, the median single-family existing home sale price fell .2% in Q1 YoY to $371,200. This is the first YoY price decline in Q1 since 2012
    a. Home prices fell in more parts of the U.S. than they have in over a decade during Q1
        i. Nearly 1/3 of metro areas posted annual price declines
2. Home sales have dropped nationwide b/c of higher mortgage rates and lower supply
3. The hardest-hit markets were in California and the Mountain West
    a. SF's median single-family existing-home price is down 14.5% YoY
    b. Austin prices are also down more than 10%
4. In Q1, they typical monthly mortgage payment for a single-family home rose to $1,859, a 33% increase YoY (WSJ)