MARKET UPDATE

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Market Update – May 22, 2023

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I. Stocks

#1. It was another strong week for stocks.

1. The week: DJIA +.4%; **S&P 500 +1.7%**; Nasdaq +3.0%
    a. The S&P 500 hit a nine-month high on Thursday.
2. The market continues to rally despite recession fears, banking turmoil, falling earnings, an aggressive Fed, and the risk of government default.
3. The VIX closed the week at 16.81. The S&P 500 has posted daily moves of less than 1% in all but six of the past 33 sessions. It has been stuck in a 3.8% range since March. (Bloomberg)

#2. Justifications for the 17% rally since October.

1. As the market rallied, short sellers were forced to close their positions.
    a. But sentiment is still negative. Sentiment in May dipped to its lowest level YTD according to a BAC survey.
2. On a recent-history basis, maybe stocks aren't that expensive. Over the past 30 years, the S&P average P/E has been 20 and there is enough skepticism baked into stocks for whatever goes wrong. At 4,200, that implies EPS of $210 and estimates are currently higher than that.
    a. But if risk appetite declines, multiples decline
3. Low earnings are still better than expected.
    a. Margins stabilized this quarter and are higher than pre-pandemic. As the market steadies itself, more investors could enter. Bond yields have stayed relatively constant.
4. Lower cost of capital that came w/ higher multiples and lower yields
    a. There was a decrease in expected Fed funds rate over the past few months
5. The Bank Term Funding Program – loaning to banks based on face value of bonds – added liquidity to the financial system.
    a. Virtually all of S&P's gains can be traced to 7.5% rally from March 13 – April 13
        i. Coincided with creation and growth of BTFP + balance sheet expansion.

(Bloomberg) (Bloomberg)

#3. There is still plenty to worry about.

1. FOMC has raised rates 500 bps and could raise rates more
2. While banking system is stabilizing, credit conditions are tightening
    a. It's strange to see the market doing well with banks struggling.
3. LEI has fallen for 13 consecutive months (longest since 2009)
4. Debt ceiling is still unresolved
5. Market breadth is terrible (Barron's) (Bloomberg)

#4. Tech is killing it.

1. Apple's $2.76T market cap is greater than the entire Russell 2000.
    a. It's also bigger than the entire market cap of the Toronto Stock Exchange
    b. Only the recent rebound of the pound has stopped Apple from overtaking the FTSE-All Share index of stocks listed in London.
2. AAPL, MSFT, GOOGL, AMZN and NVDA have a combined $8.7T market cap
    a. Almost 25% of the S&P 500
    b. ~3.2X the $2.7T Russell 2000
        i. Larger ratio than during the tech bubble
    c. These top-five stocks have returned an average of 50% in 2023
        i. Accounts for ~80% of the S&P 500's 8% gain
        ii. Median S&P 500 stock has gained <2% and less than half are trading above their 200-day moving average
        iii. These top-five stocks trade at 31X 2024 earnings (vs. 17.4X for index) (Barron's) (Bloomberg)

#5. The Bank of America global fund manager survey shows high pessimism.

1. BofA's monthly global fund manager survey deteriorated to the most bearish this year, with 65% of survey participants now expecting a weaker economy.
    a. At the same time, almost 2/3 see a soft landing as the most likely scenario and expect only a small contraction in earnings.
2. Cash levels rose to 5.6% in May, but exposure to equities also climbed to the highest this year, while bond allocations are now the biggest since 2009.
3. Investors are rotating out of commodities, utilities and into tech and euro-zone equities.
4. Investors are the most long growth vs. value since July 2020.
5. The most crowded trades include long tech, short US banks, short US dollar, long European equities, long T-bills and long China equities.
6. Bank credit crunch and global recession are seen as top tail risks, followed by high inflation keeping central banks hawkish, worsening geopolitics and a systemic credit event.
7. The share of investors expecting a debt ceiling resolution ahead of the X-date dropped from 80% in April to 71% in May. (Bloomberg)

#6. Doomsday forecasts get a lot of attention…and are usually wrong.

1. Nasdaq 100 has notched a 23% return YTD and is near a 52-week high.
2. Remember in September when Nouriel Roubini called for a global downturn starting in late 2022 or when Elon Musk urged the Fed to cut rates immediately in November? Or when Michael Blurry tweeted "sell" in late January?
    a. At the very best, their calls were too early.
3. It was never going to be easy for consumption and earnings to fall off a steep cliff so soon. Corporate and consumer balance sheets were very strong after the pandemic. (Bloomberg)

#7. With the last point in mind (that doomsday forecasts are usually wrong), Bank of America says that we should sell.

1. BAC strategist Michael Hartnett says that we should sell stocks for two reasons:
    a. Tech and AI are forming a bubble
        i. Nasdaq is up 26% this year (14-day RSI shows that it is overbought)
    b. The Fed's rate hikes may not be over
2. He said that if the Fed mistakenly pauses rate hikes, US bond yields will rise above 4% (Bloomberg)

#8. VC investments are being marked down.

1. For the first time in more than a decade, returns for venture funds were negative for three consecutive quarters last year as investors finally began to mark down startups that had ballooned in value. Initial data for Q4 also show a negative quarterly return.
2. In 2021 Q2, the yearly internal rate of return for venture funds was 74%!
    a. In 2022 Q3, it was -7%.
3. With Nasdaq up ~20% YTD, this raises the prospects of a broader recovery in technology valuations. But venture investors say that the bulk of startup write-downs have yet to occur, given that the market is still far below its 2021 peak, and they expect more companies to raise cash at lowered valuations in the coming months.
4. Fundraising for new venture funds hit a nine-year-low earlier this year. (WSJ)

II. Bonds and Rates

#1. Yields moved higher last week.

1. Last week: 3-month 5.29% (+4 bps); 2-yr 4.28% (+30 bps); 10-yr 3.70% (+24 bps)
2. A weeklong selloff in US Treasury bonds (lower prices = higher yields) was caused by rebounding expectations for economic growth and inflation. Yields hit two-month highs.
3. The 10-year UST yield settled at 3.70%. Yields have been helped in recent weeks:
    a. Signs of progress over the debt ceiling
    b. Low unemployment
    c. Solid consumer spending
    d. Stickiness in key inflation components
4. In short, investors have to give some credence to tighter Fed policy for longer. (WSJ)

#2. Corporate debt has grown faster than the economy in Europe and the US.

1. Since 2000, non-financial corporate debt across America and Europe has grown from $12.7T to $38.1T. It increased from 68% to 90% of their combined GDP.
    a. Strong profits and fixed-rate debts have helped to avoid problems
        i. EBITDA was 32% higher in 2022 Q4 than 2019 Q4
        ii. ¾ of debt is fixed-rate
            1. Less than half of junk debt is fixed-rate
2. On both sides of the Atlantic, roughly 1/3 of rated debt is speculative
    a. Default rate is only 3%
3. Only a quarter of the combined debt will mature in the next three years
4. The average coupon rate that issuers pay is currently 3.9% vs. 5.3 % current issue rate
    a. For HY, the average coupon is 5.9% vs a market yield of 8.4%
5. Problems:
    a. Growth is slowing
    b. Earnings are dropping
    c. The Fed is still raising rates (Economist)

III. The Debt Ceiling

#1. We're hearing conflicting stories about the debt-ceiling negotiations.

1. While Pres. Biden continues to express confidence that a deal will get done to raise the debt ceiling, other sound less confident.
    a. Biden's press secretary said that there were "real differences between the two sides."
    b. Biden's communications director issued a statement that called for Republicans to "negotiate in good faith."
2. Republicans walked out of talks on Friday and that diminished hopes that a deal was close. Talks resumed late Friday.
3. Republican Rep. Patrick McHenry, a key ally of Speaker McCarthy said that he was not confident the parties would reach a deal in time to prevent default. (Bloomberg)

#2. This is a crazy way to run the government.

1. The debt ceiling issue is playing into the narrative that it's becoming harder to view the US as a well-functioning, dynamic economy with a deep and sound financial system, backed up by a robust policymaking process with checks and balances
2. We benefit from low UST rates
    a. Higher rates would mean less money to invest in infrastructure, cleaner energy and the massive subsidies that the gov't has rolled out to boost high-tech manufacturing to compete with China
    b. Even Clarence Thomas accepting gifts and travel without disclosing them is a black eye for the US
3. China and Russia would certainly attempt to benefit from a default through misinformation. China would try to promote itself as a reliable leader. (Bloomberg)

#3. A few other random facts about the debt ceiling…

1. Federal tax revenues have been lower due to lower asset prices. (Bloomberg)
2. In the event of a default, the Fed could be forced to buy Treasury bonds that investors don't want and they could allow banks to pledge defaulted securities as collateral for loans. (WSJ)
3. The Treasury's cash balance dropped from $94.6B on Tuesday to $68.3B on Wednesday and $57.3B on Thursday. (This reminds me of watching my checking account in college to see when I'd run out of money.) (Bloomberg) (Bloomberg)
4. Once the debt ceiling is raised, the Treasury will need to replenish its dwindling cash buffer through a deluge of Treasury-bill sales. This would quickly drain liquidity from the banking sector, raise short-term funding rates and tighten conditions in the economy.
    a. The Treasury is basically pulling money out of private accounts and into its checking account.
    b. If money-market funds don't pull cash from the reverse-repo facility to buy some of the newly issues bills, it would drain more bank reserves and force the Fed to reconsider QT. (Bloomberg)

IV. The Fed

#1. On Friday, Fed Chair Powell gave the market hope that the FOMC will pause rate increases.

1. "We've come a long way in policy tightening and the stance of policy is restrictive and we face uncertainty about the lagged effects of our tightening so far and about the extent of credit tightening from recent bank stresses."
2. "Having come this far, we can afford to look at the data and the evolving outlook to make careful assessments."
3. "While the financial stability tools helped to calm conditions in the banking sector, developments there on the other hand are contributing to tighter credit conditions are likely to weigh on economic growth, hiring and inflation. As a result, our policy rate may not need to rise as much as it would have otherwise to achieve our goals. Of course, the extent of that is highly uncertain." (Bloomberg)
4. "Until very recently, it has been clear that further policy firming would be required. As policy has become more restrictive, the risks of doing too much versus doing too little are becoming more balanced." (WSJ)

#2. Most Fed officials seems to support a pause.

1. NY Fed Pres. John Williams, Richmond Fed Pres. Thomas Barkin, Dallas Fed Pres. Lorie Logan and Chicago Fed Pres. Austan Goolsbee seem to be more in favor of a "wait-and-see approach" where the Fed pauses and watches the effect of past rate increases. (Bloomberg)
2. NY Fed Pres. Williams spoke at the same conference as Powell and argued that the neutral rate remains low. This implies that the FOMC does not have to take the Fed funds rate that much higher. (WSJ)

#3. Not everyone is on board with pausing.

1. Cleveland Fed Pres. Loretta Mester said that the chances of a rate hike at the June meeting are equal to the chances of pausing. (Bloomberg)
2. Dallas Fed Pres. Lorie Logan said that while the data "could yet show" it is appropriate to skip a rate hike, the current environment suggests that "we aren't there yet." (Barron's)
3. A new working paper from the SF Fed says that despite years of strong demand and high inflation, US households across the income spectrum still hold an estimated half-trillion dollars in excess savings – enough to fuel consumer spending at least into Q4. (Barron's)

V. The Economy

A. General Economy Stories

#1. Higher credit card balances may show that inflation is impacting consumers.

1. Consumers typically build up more credit-card debt at the end of the year and then reduce those balances at the start of the following year. But for the first time in 20 years, that wasn't the case. This may be the strain of inflation and relying on credit cards to maintain spending.
2. The overall delinquency rate remained low at 2.6%.
3. Separately, the NY Fed said that 14MM mortgages were refinanced between 2020 Q2 and 2021 Q4, during which $430B of home equity was extracted through cash-out refinancing. (Bloomberg)

#2. Home sales and home prices are both falling.

1. U.S. existing home sales fell 3.4% in April MoM and 23.2% YoY.
   a. Existing home sales have declined for 14 of the past 15 months are down roughly one-third since the start of 2022.
2. The national median existing-home price fell 1.7% in April YoY to $388,800, the biggest YoY decline since January 2012.
   a. Median prices were down 6% from the June record of $413,800.
3. Nationally, there were 1.04MM homes for sale or under contract at the end of April, up 7.2% from March and up 1% from April 2022. This is a 2.9-month supply.
   a. The number of new listings in April fell 21% YoY. (WSJ)

#3. JPM says that recession is a certainty.

1. JPM Asset Management says that a US recession is a virtual certainty and the Fed may lower rates by Q3 as growth loses momentum. They believe that the market is right to be pricing in rate cuts, especially when you consider the banking problems.
2. GS and Barclays caution that the Fed will be less aggressive in cutting rates this year than the markets are predicting. (Bloomberg)

#4. Americans are unwilling (or unable) to move for work.

1. The share of job seekers who relocated to take up a new position fell to 1.6% in Q1, the lowest level on record.
   a. In the 1980s and 90s, nearly a third of job seekers would move for new positions.
2. There has been a surge in remote and hybrid positions as well, as workers don't want to give up their current low-rate mortgage.
   a. Moving also seems riskier due to diminishing job security.
   b. Approximately 1/3 of US companies say most of their workers are in the office, up from 13% last fall. (Bloomberg)

#5. Office usage is relatively stagnant.

1. Approximately 58% of companies allow employees to work a portion of their week from home. The number of companies that require employees to be in the office full time has actually declined to 42%, from 49% three months ago.
    a. Employees at companies with hybrid strategies work an average of 2.5 days a week in the office.
2. Cities are suffering from declining real estate values, lower property-tax revenues, and injuries to restaurants, bars and small businesses.
3. The average office usage rate, which crossed 50% of pre-pandemic levels in late January, has remained around there ever since. (WSJ)

#6. China is not going to power a global recovery.

1. China's post-Covid growth spurt is sputtering and its youth unemployment rate hit a record high. The unemployment rate for Chinese aged from 16 to 24 rose to 20.4%. At the end of last year, it was 16.7%.
2. There is no longer a belief that China will power a global recovery. (WSJ)

#7. The idea of "narrow banking" is not a good one.

1. The idea of "narrow banking" is that banks hold all deposits in cash or something just like it.
    a. Some people want risky non-bank financial institutions to raise money and loan it out.
2. The Fed has many concerns with narrow banking, including:
    a. In times of stress, they'd be too attractive as a haven. Money could flee traditional banks (lenders) and amplify the risks to the financial system.
    b. Narrow banks make it more difficult for the Fed to manage short-term rates.
    c. Because conventional banks could end up holding few deposits, they'd make fewer loans, with loans being more expensive and credit harder to get. (Bloomberg)

#8. Young Americans are dying.

1. Death rates for American children have risen to the highest level in nearly 15 years, driven by homicides, drug overdoses, car accidents and suicides.
    a. Social disruption in 2020 added to the problem.
    b. Greater access to firearms, dangerous driving and more lethal narcotics also pushed up the death rates.
2. Between 2019 and 2020, the overall mortality rate for ages 1 to 19 rose by 10.7% and increased an additional 8.3% the following year.
3. The US is the only place among peer nations where firearms are the leading cause of deaths in young people.
4. Black teenagers accounted for nearly 2/3 of homicide victims ages 10 to 19 early in the pandemic. White teenagers have historically died at higher rates of drug overdoses. (WSJ)

B. Inequality

#1. Some executives effectively have 401(k) plans with no limit as to contributions.

1. The top five executives at the S&P 500 companies held a combined $8.9B in savings plans known as **top hat plans** (also known as **nonqualified plans**). The average balance of $14.6MM for CEOs with those plans rose to $19.4MM once the value of pensions was included.
    a. More than 400 of the S&P 500 companies offer these plans.
2. These plans allow executives to defer up to 100% of their compensation without paying income tax on the money until they withdraw it.
    a. There is a **major downside**: if the company declares bankruptcy, executives can lose some or all of their savings. This is different than 401(k) plans that are protected in bankruptcy.
3. Typical workers can only get $22,500 of tax savings per year in their 401(k). Workers age 50 and older can save $30K.
    a. The average workers with a retirement savings plan at Vanguard had an account balance of $112,572 at the end of 2022. The median was $27,376.
4. The median pay package for S&P 500 CEOs was $14.5MM in 2022.
    a. The median household income in the US was $70,784 in 2021. (WSJ)

#2. Unemployment, homeownership, compensation and emergency cash.

1. The unemployment rate for Black workers fell to a record low 4.7% in April – below 5% for the first time since this statistic started being reported (1972)
    a. Approximately 1.1MM more Black Americans held jobs last month than in Feb. 2020. That accounts for nearly half the total gain in employment during that time. Black Americans now comprise ~13.1% of the labor force (up from 12.7% in Dec. 2019).
    b. In 2021, the typical white American was 43 years old, vs. 35 among the Black population.
2. In the seven recessions since 1972, the Black unemployment rate jumped about 60% more on average than the rate for non-Black workers.
3. Black workers earned about 80% of white workers' pay in 2010. The wage gap widened, after the Great Financial Crisis. Black workers earned 75% of the typical white employee in 2018.
4. The Black homeownership rate was 45.8% in 2023 Q1, far beneath the 74.4% rate among white households.
5. In 2019, the typical Black household had ~1/5 the amount of emergency cash on hand as the typical white household, according to the Fed's SCF. (WSJ)

VI. China and Hostage Diplomacy

#1. China sentenced a 78-year-old American to life-in-prison.

1. Chinese authorities sentenced an American citizen to life-in-prison on espionage charges. John Shing-wan Leung is a 78-year-old American passport holder. He had been detained since April 2021.
2. Interestingly, Mr. Leung's political ideology is aligned with Beijing on issues such as Taiwan's status as being part of China. (It's unclear whether he supported China's propensity to imprison innocent people.) It really makes it hard to understand why Taiwan wants to remain independent, doesn't it?
3. Japan has said that China recently detained a Japanese citizen and this was the 17th time that this has been done since 2015. (WSJ)

#2. China detained a South Korean soccer star.

1. China has detained a South Korean soccer star who plays in China's top-tier soccer league. He has been accused of accepting bribes.
2. Interestingly, in the past few weeks, China and South Korea have been exchanging barbs about Taiwan's independence. What a coincidence. (WSJ)