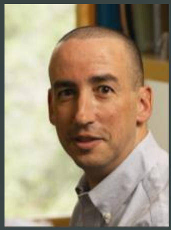

MARKET UPDATE

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May 8, 2023 – Market Update

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I. Stocks

A. Last Week

#1. The broader market dropped for the week.

1. DJIA -1.2%; **S&P 500 -.8%,** Nasdaq +.1%
    a. We've been in a bear market for 226 days (WSJ)
2. KBE (an ETF which owns banks and other finance companies) was down 8.1%.

#2. There was a lot of news this week.

1. JPM acquired First Republic (FRC).
2. The FOMC raised the Fed funds rate 25 bps to 5.0% - 5.25%.
3. Treasury Sec'y Yellen said that the Treasury could be unable to meet all of its obligations as early as June 1 (referred to as the **X-date**).
    a. The auction of one-month T-bills saw yields hit 5.84%
4. A stronger-than-expected jobs report did a lot to calm nerves about an imminent recession. (Barron's)

B. Volatility

#1. After a long period of calm in the markets, volatility returned. Recession fears are high.

1. The **VIX** had its first weekly rise in seven weeks (and temporarily went above 20).
    a. A basket of highly-shorted stocks tracked by GS jumped more than 3% on Friday
2. S&P's regional banking index (KRE) twice moved as much as 8%.
    a. PacWest fell 11%, 28%, 51% and rose 82%
        i. Friday looked like a lot of short covering.
    b. Western Alliance lost nearly 1/3 of its value
3. The 2-yr yield swung 50 bps from its peak Tuesday to a low Thursday
    a. Sent the MOVE index of bond volatility to its highest level in almost a month
        i. How will bank stress impact Fed policy?
4. Foreign currency volatility rose for five consecutive days
5. WTIC dropped 7% for the week and finished at $71.34.
    a. Ten-day volatility in oil jumped to the highest level since October
6. Gold moved to its highest level in a year, finishing the week at 2,024.80
7. Money market funds hit a record amount of assets. (Bloomberg)

#2. Several factors had been keeping volatility low (prior to this week).

1. Strong earnings
2. Strength in jobs and consumer spending
3. Belief that inflation is cooling
4. The Fed's balance sheet of $8.6T (with an avg. maturity >8 years) (WSJ)

C. Earnings

#1. Q1 earnings have beaten expectations, but the outlook is weak.

1. Nearly 85% of S&P 500 companies have reported earnings so far and 79% of those firms beat estimates.
    a. Earnings were expected to be ~-7% YoY and are now expected to be ~-2% YoY
2. GS says that sticky inflation and the recent turmoil in the financial sector will lead to slower economic growth. They expect 5% earnings growth in the US in 2024.
    a. The lackluster outlook + high valuations + 5% risk-free rate = not much return for the risk assumed (Bloomberg)

#2. Margins seem to be stabilizing.

1. Halfway through Q1's earnings season, the net profit margin of S&P 500 companies has ticked up to 11.5% from 11.3% in Q4. This would mark the first increase after six quarters of sequential declines.
    a. Maybe margins have bottomed.
    b. Net margins peaked at 13% in 2021 Q2.
2. Companies are still rushing to cut costs. (WSJ)

D. Other News About the Equity Market

#1. Global dealmaking has had its weakest start to a year since 2013.

1. Global volume fell to $579B during Q1, the worst start to a year since 2013.
    a. To do a deal, you have to believe that current conditions are comprehensible and future ones will improve. Uncertainty is the enemy of decision.
    b. Fear of a recession doesn't lead to mergers or acquisitions.
2. On the positive side:
    a. Private equity buyers have $3.7T of cash (beg. of year)
    b. Shareholders of public companies are supportive of dealmaking.
    c. Companies are racing to adapt to technological disruption. (Bloomberg)

#2. Active ETFs are gaining market share.

1. Actively managed ETFs make up less than 6% of the $7T ETF market, but they have attracted ~30% of the total flows to ETFs so far this year. In 2022, they gathered 14% of the flows.
2. Dimensional was the largest active ETF manager at the end of 2022, with 30 actively managed ETFs and $70B under management in those funds. They have attracted $9.4B YTD through April 26th.
3. Actively managed ETFs have an average expense ratio of .7% vs. .16% for passive ETFs. (WSJ)

#3. Share repurchases will be more regulated in the future.

1. The SEC voted 3-2 to adopt a rule requiring more disclosure from public companies about share repurchases starting in Q4.
2. Under the new rule, most companies will have to provide daily tallies on their buybacks during the previous quarter rather than the monthly aggregates currently required.
    a. They will also have to explain rationales for buybacks and any policies to limit insider transactions during a repurchase program.
3. The SEC officials say that this will make it easier for analysts to compare the timing of buybacks and insider trades, or to identify buybacks designed to boost executive compensation or EPS. (WSJ)

II. Banks

A. General Background Stories

#1. Investors didn't want to be short banks going into the weekend.

1. Friday's bank rally may have been **short-covering**. The $2.7B ETF KRE (regional banks) increased as much as 6.6% on Friday, fueled by a record surge of ~80% in PacWest.
    a. Even with this, PacWest was down ~40% for the week.
2. If you've been short, you've made money. You have no idea what announcements will come out of the weekend.
    a. The S&P has risen on six of the last seven Monday trading sessions. (Bl) (Bl)

#2. The FDIC is planning to exempt small banks from its special assessment.

1. The FDIC is poised to exempt smaller lenders from kicking in extra money to replenish the deposit insurance fund.
    a. Smaller lenders with less than $10B in assets wouldn't have to pay. There were more than 4,000 institutions under that threshold.
2. The FDIC has said that covering uninsured depositors will cost the DIF $19.2B and will be paid by a special assessment.
    a. This special assessment will not cover the $13B in losses from First Republic. (Bloomberg)

#3. The deposit beta isn't as high as it has been in the past.

1. The current deposit beta is ~.2. It often reaches .4 with rising rates.
    a. The deposit beta describes how sensitive deposit rates are to changes in the market rate.
    b. Even though the beta is low, the increase in rates has been significant (so the amount of deposits that have fled from banks is large).
2. Depositors have headed to money market funds
    a. The average bank savings rate is .39% vs. a Fed funds rate of nearly 5%
    b. Academic research shows that interest rate hikes have led to $1.84T of unrealized losses for banks (scaring depositors). (Bloomberg)

#4. Depositors are worried about their insured deposits. We're a nation of morons.

1. A Gallup poll showed that 48% of Americans are very or moderately worried about the safety of their deposits in banks. Only 20% said that they're not worried at all. **Remember that depositors are insured for deposits up to $250K**.
2. 55% of Republicans said that they're worried vs. 36% of Democrats
    a. During the Financial Crisis, the numbers were reversed (when Pres. Bush was in office)
3. Worries are higher for people with less than $100K in the bank (even though they are insured up to $250K). (Bloomberg)

B. First Republic Bank (FRC)

#1. FRC had problems.

1. FRC had ~$19B of unrealized losses in interest-only loans and another $8B of unrealized losses in other loans and bonds.
    a. This $27B would have more than wiped out the $13B of tangible common equity.
    b. FRC held $58B in interest-only mortgages on single-family homes.
        i. These are similar to high-duration bonds.
    c. In 2022, more than half of FRC's loans were residential mortgages with an average interest rate of 2.89%.
2. At the end of 2022, FRC had $176.4B of deposits, 68% of which were uninsured. Deposits had plummeted to $92.6B by the end of April.
    a. Advances from the FHLB and Fed had reached $121.3B
3. This was the **second largest bank failure** in US history. (Bloomberg) (Bloomberg) (WSJ)

#2. JPM acquired FRC. So much for worrying about too-big-to fail.

1. JPM now owns ~$173B of FRC's loans, $30B of securities and $92B in deposits.
    a. JPM will share any losses on the firm's single-family and commercial loans with the FDIC.
    b. JPM will receive $50B in financing from the FDIC.
2. JPM's purchase of FRC spares the FDIC of more losses, but it **makes JPM even larger**.
    a. Similar to UBS's purchase of CS, **the big banks are getting bigger**.
3. Both FRC and WM are now substantially owned by JPM. Also add in Bear Stearns.
    a. Three of the four largest-ever US bank failures have occurred in the past two months. FRC ($233B at end of Q1), SVB and Signature Bank all rank behind WM.
4. The FDIC expects to lose $13B in the FRC deal. (WSJ) (Bloomberg) (Bloomberg)

#3. JPM is trying to gain wealth management clients and circumvent size rules.

1. JPM really liked FRC's wealth management business. Some First Republic branches will be converted to JPM "wealth centers."
    a. Wealth management is a steady business. It also allows for cross-selling. But, unlike FRC, JPM will not be in the low-cost lending business.
    b. JPM has $2.59T in client wealth-management assets. They trail MS ($4.56T) and BAC ($3.52T). FRC had $290B in assets.
    c. JPM had $3.7T of total assets before the acquisition.
2. JPM already had more than 10% of US deposits, meaning that it was barred from acquisitions
    a. If we don't raise or take away the FDIC's $250K limit on deposit insurance, we will continue to increase the size of banks that are too-big-to-fail
        i. The too-big-to-fail banks are more tightly regulated and are less vulnerable to deposit flight. (WSJ) (Bloomberg) (Bloomberg) (Bloomberg)

C. PacWest and Lots of Warnings about Banks

#1. The concerns about PacWest involve profitability (not unrealized losses or uninsured deposits).

1. At PacWest, **75% of its deposits were fully insured** and it has even attracted a little new money since the first wave of panic. It also has cash and other liquidity sources amounting to nearly 2X the value of its remaining uninsured depositors.
2. They also **don't have an excessive burden of long-term fixed-rate assets**.
    a. It's $2.7B of tangible equity at the end of March already has unrealized losses on long-term bonds of $736MM deducted. (But deducting unrealized losses from loans would bring the tangible equity down much further.)
    b. Its mortgages and other real estate loans, which account for 78% of assets, are mostly variable-rate loans.
        i. At the end of last year, only 40% of its mortgages and less than 25% of all loans were fixed-rate. (Vs. >90% of FRC's mortgages were fixed rate.)
3. PacWest is **more a story of reduced profitability**.
    a. They have become more reliant on higher cost consumer and brokered time-deposits, which lifted its total deposit cost to 1.98% for Q1 (from 1.37% in Q4).
    b. They have borrowed more from the FHLB and the Fed's Term Funding Program.
    c. Their net interest margin is now 2.89% after being 3.4% last year.
4. Of course, falling share prices make depositors more skittish, funding costs rise further, profitability worsens and the cycle continues. (Bloomberg)

#2. Merger rumors can crush bank stocks in today's world.

1. A Wednesday Bloomberg story said that PacWest was considering strategic options. **Normally, a merger wouldn't be bad news for depositors, but it is bad news for shareholders**.
2. Any bank that acquired PacWest would have to mark its loans down. This markdown would be $1.78B. Plus, investors want to focus on tangible common equity, which removes intangible assets and preferred shares.
    a. TCE was $2.24B as of March 31. Marking down the loans would bring it to $464MM or $3.86 per share. (WSJ)

#3. Lots of commentators warned about banks.

1. **Charlie Munger** told the FT that banks are saddled with bad loans, noting trouble ahead in the US commercial property market.
2. **Bill Ackman** said that the regional banking system is at risk.
3. **Former Dallas Fed Pres. Rob Kaplan** said that the regional banking crisis is far from over and that the Fed should pause.
    a. He said that banks have been hurt by overinvesting in Treasuries. But, the **credit phase** is normally more serious and has not started yet.
4. The **IMF's chief** said the rapid acceleration in interest rates "exposed vulnerabilities in the financial sector." (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg)

III. Bonds, Rates and the Dollar

#1. The 3-month / 10-year inversion became steeper.

1. 3-month 5.26% (+16 bps); 2-yr 3.92% (-12 bps); 10-yr 3.44% (unchanged)
    a. 3-month/10-yr inversion is **182 bps**
2. Some strategists believe that US Treasuries will rally as the economy slides toward a recession. If the 10-yr UST at 3.35% dropped to 2% in December, an investor would have a pre-tax return of 13%.
    a. Of course, a 2% yield is far below the current inflation rate. (Bloomberg)

#2. Corporate bond issuance has dropped significantly this year.

1. Investment-grade issuance is down **15%** this year from the previous five-year average.
    a. High-yield issuance is down **45%**.
2. The corporate bond market slowed as the Fed raised rates. Then, the collapse of SVB really hurt the market.
3. Companies are hoping that a Fed pause will push rates down.
    a. But remember: yields on 10-year USTs are already 143 bps below the policy rate.
    b. In addition, the risk to spreads is growing.
        i. At 136 bps, investment-grade spreads are still well below the 225 to 250 bps they would be expected to reach in a recession.
        ii. High-yield spreads are at 452 bps and would be expected to reach 800 bps. (Bloomberg)

#3. The dollar could continue to weaken and this could help the global economy.

1. **Reasons** why the dollar could weaken:
    a. The US economy no longer looks so exceptional. Other countries are growing faster.
    b. The Fed is near the end of its tightening program.
        i. Fed could be lowering while other central banks are tightening.
    c. There are concerns about the US banking system.
    d. There is a potential US debt default.
    e. There are fears of a recession.
2. A **weaker dollar could help the global economy**.
    a. It lowers the cost of servicing or repaying dollar-denominated debt for foreign companies and governments
    b. It boosts the value of overseas earnings by US multinationals
    c. It can help global trade (b/c goods priced in dollars become more affordable to international buyers)
3. Sixty percent of global liabilities are denominated in dollars.
    a. A lot of this is in the emerging markets and EMs are responsible for 2/3 of global growth in the last decade. (WSJ)

IV. The Debt Ceiling

#1. If the debt ceiling isn't raised, the Treasury may prioritize certain payments.

1. If Congress doesn't raise the debt ceiling, the Treasury Department would start missing federal payments, such as interest on debt, Social Security benefits or military salaries. This could make people question our debt (and the risk-free rate).
    a. The Treasury Department makes 80 million payments a month!
2. Documents released after 2011 showed that the Treasury planned to give **priority to paying principal and interest on Treasury securities out of available tax revenue**.
    a. We don't know what kind of penalty or added interest the government would pay if it missed a payment.
3. Brookings estimates that outlays would fall by 25% overnight, and up to 35% and beyond when tax inflows are particularly light or **if Social Security payments are prioritized**.
4. The economy is already on the verge of recession. Last July and August, the federal gov'ts **monthly budget deficit was more than $200B**. Cutting that amount would represent a fiscal tightening of ~10% of GDP. (WSJ) (Bloomberg)

#2. The Treasury Department says that we could hit the X-date on June 1.

1. Treasury Sec'y Janet Yellen said that the US government could become unable to pay all of its bills on time as soon as June 1. The CBO updated its forecast to early June.
    a. The government gets **considerable revenue in mid-June from corporate and personal income tax payments**, so if the Treasury can make it that far, they'll get another six weeks.
2. The special measures that the Treasury has engaged in include suspending investments for certain government accounts. (WSJ) (Bloomberg) (Bloomberg)

#3. The controversy: the Republicans vs. the Democrats.

1. Republicans want to cap discretionary spending growth at 2022 levels and increase them 1% per year after that.
    a. The Republican legislation would undo several of Biden's major policy initiatives, including student loan forgiveness and funding for IRS to improve tax compliance. It would add new work requirements for programs such as Medicaid and slash domestic discretionary government spending.
    b. In return, it would raise the debt limit by $1.5T or until March 31, whichever comes first. That way, Republicans could demand more in the spring.
2. Biden argues that these decisions should be made through the budget process, not by holding the country hostage. The debt ceiling was raised several times under Pres. Trump. (Bloomberg)

V. The Economy

A. General Economic News

#1. There may be increasing fear of stagflation in the markets.

1. Financial markets are caught up in a war: **inflation concerns vs. recession fears.**
    a. Slowing growth and persistent inflation could mean no Fed reversal. Then, we could see that a series of mis-pricings have to be corrected.
        i. Investors may want to own high-quality bonds, gold and equities of companies that can maintain pricing power.
2. The yield curve remains deeply inverted.
3. Hedge funds are betting against stocks and Treasuries. (Bloomberg)

#2. JPM recommends gold and tech stocks as a hedge against recession risk.

1. The "**long duration**" trade is expressed by being overweight on gold, growth stock and currencies (short USD).
2. The banking crisis has increased the demand for gold as a proxy for lower real rates.
3. Tech has appreciated and short-interest in tech has dropped – showing higher net exposure. (Bloomberg)

#3. New construction is crucial to the home market.

1. Active listings in the existing-home market are roughly half of where they were four years ago. Higher rates make owners reluctant to sell.
2. Newly built homes made up ~1/3 of single-family homes for sale in March. The historical norm is 10% - 20%. (WSJ)

B. Inflation

#1. Inflation is still too high.

1. The **Dallas Fed trimmed mean PCE** has stopped increasing, but hasn't really declined.
    a. The number of items inflating at 10% or more has dipped sharply
    b. The number rising between 5% to 10% is still close to its high
    c. More than 40% of items are rising more than 5%
2. The **Employment Cost Index** is still too high (Bloomberg)

#2. Sticky inflation may be caused by businesses boosting margins.

1. Businesses may be using inflation as a rare opportunity to boost margins.
    a. Some businesses have raised prices more than the growth in costs from supply chain disruptions.
2. Normally, economists would expect higher prices to result in fewer customers. But we haven't seen this.
    a. Maybe this is because consumers are aware of the higher costs for businesses.
3. Maybe businesses are raising prices with knowledge that competitors will act in the same way (due to higher costs).
    a. A cost shock can create an implicit agreement among firms to raise prices. (WSJ)

C. The Labor Market

#1. The JOLTs report showed fewer job openings (a positive).

1. U.S. job openings dropped to their lowest level in nearly two years in March (down from 10MM in Feb. to 9.6MM in March) and layoffs rose sharply (from 1.6MM in Feb. to 1.8MM in March).
    a. Lowest level of job openings since April 2021
    b. Job openings had hit a record 12MM last March
2. There are 1.6 openings for every unemployed person (5.8MM).
3. Layoffs are approaching pre-pandemic levels. (WSJ) (WSJ)

#2. The Employment Report was relatively strong.

1. Nonfarm payrolls rose **253K** last month. Economists had expected 185K.
    a. Feb. and March were revised down by 149K jobs.
    b. Part of latest rise in payrolls was due to Labor Department's birth/death adjustment to reflect assumed net business formations
2. The unemployment fell back to a multi-decade low of **3.4%**.
    a. Lowest since May 1969
    b. Part of this was due to a slight dip in the labor force
3. The labor market remains tight and this could keep the Fed funds rate higher for longer.
4. Average hourly earnings rose **.5%** in April, the most in about a year and 4.4% YoY.

(Bloomberg) (Barron's)

D. The Fed

#1. The FOMC raised the Fed funds rate to 5% - 5.25%.

1. The Fed funds rate is now at its highest level since 2007.
    a. They raised rates for the 10^{th} time in 15 months.
2. Policymakers are resolved to ensure that inflation will continue decelerating – potentially with costs to employment – even as the banking system endures ongoing stress, lawmakers step up criticism and the latest data suggests emerging weakness in the labor market. (Bloomberg)

#2. The Fed's history of mistakes may mean higher rates.

1. The harsh lessons of past policy errors will influence the Fed. Their credibility was compromised by their slow detection of inflation.
    a. Core PCE was up 4.9% in the Q1 period.
2. Powell doesn't want to have a stop-and-go policy. How much can you overtighten? (Bloomberg)

#3. Powell signaled that the FOMC may pause (but lowering rates soon is unlikely).

1. Powell hinted that this could be the last rate increase, but left the door open to more.
    a. He suggested that they may pause in June to assess how the US economy is responding to tighter credit conditions resulting from higher rates and recent banking stress.
    b. The FOMC statement omitted line that the committee "anticipates that some additional policy firming may be appropriate."
2. Talking about the upcoming Fed's Senior Loan Officer Survey, Powell said that banks started tightening lending conditions last year, but SVB exacerbated that. He said that lending has continued to grow but the pace is slowing.
    a. Tighter credit conditions could take pressure off the Fed to continue to raise rates.
3. Powell said that they expect inflation to decline slowly. And, he said that if that forecast is broadly right, **it would not be appropriate to cut rates**. (Bloomberg)

#4. Bullish stock investors are hearing something different than Powell is saying.

1. FOMC statement removed, "The Committee anticipates that some additional policy firming may be appropriate…
2. While it appears that the Fed is going to pause, any deviation from that plan is likely to be more tightening.
3. Remember that core PCE on a three-month annualized basis is moving sideways.
    a. SL: Not sure why Powell would think policy is restrictive
4. Post-pause stock rallies tend to rely on two drivers:
    a. A rally in Treasuries
        i. The 10-year UST is already 186 points below the Fed funds rate
    b. The assumption that earnings are still expanding
        i. The US is already in an earnings recession (Bloomberg)

#5. There are some factors that speak to the Fed pausing.

1. When you factor in revisions, the US added an average 182K private sector jobs in the past three months, the least since Jan. 2021.
    a. Job growth is certainly cooling.
2. Economists believe that we have to factor in:
    a. The long and variable lag to see the impact of Fed policy
    b. Uncertainty from SVB, Signature Bank and FRC
3. Powell said that he wants to see wage inflation closer to 3%.
    a. He also said that wages and prices tend to move together, but that he never said that wages are the principal driver. (Bloomberg)

#6. The Fed believes in "disinflation gradualism" while investors expect rates to be cut.

1. Central banks are embracing "**disinflation gradualism**" to bring inflation back to target over a two-to three-year period
    a. Core PCE increased at a 4.9% annual rate in Q1
2. Market still seems to believe that the Fed will have to begin to take back its rate hikes starting with its Sep. 19 – 20 market
    a. Three rate cuts by year-end (Barron's)