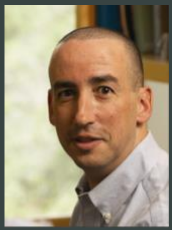

MARKET UPDATE

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November 13, 2023 – Market Update

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I. Stocks

A. Last Week

1. Week: DJIA +.65%; **S&P 500 +1.31%**; Nasdaq +2.37%
    a. Stocks have been moving due to **interest rates more than earnings**. The 10-year yield was 3.95% at the end of June and nearly 5% by mid-October. Friday: 4.61% You have to be asking where you believe rates and earnings are headed.
        i. 2-yr yields moved back above 2% (Bloomberg)
        ii. 30-yr fixed rate mortgage fell from 7.76% to 7.50%
    b. **Small-caps** had 12th decline of past 15 weeks.
2. Stocks increased every day other than Thursday. On **Thursday**:
    a. **$24B auction of 30-year UST bonds was weak**. Primary dealers were forced to accept 25% of the offering, more than double the average over the past year. The auction had a **large tail** (largest since 2016), meaning that the auction yield was significantly higher (5 bps) than the yield in the "when-issued" market.
        i. Even with a weak auction, 30-yr yields (4.73%) remained well below 5% that was seen in late October
        ii. As the US runs large deficits and has to issue more debt, bad auctions could be a problem.
        iii. The next long-bond auction is Nov. 20th
    b. **Fed Chair Powell** said that additional **rate hikes were not off the table**. (Barron's)
        i. Fed funds futures: ~10% chance of December rate hike
        ii. 4.60% rate by end of 2024
3. **Bulls vs. bears (arguments):**
    a. **Bulls:** Peak Fed, "goldilocks" economic data, disinflation momentum, solid earnings, positive seasonality
    b. **Bears:** Fed giving up inflation fight too soon, lag impact of rate hikes, weak management commentary, cuts to Q4 estimates
4. The **upcoming week**: CPI; will the government shut down

B. Earnings

1. After **three consecutive quarters of earnings declines**, it seems like the **earnings recession is done** – Q3 earnings look like they will be positive YoY.
    a. Unfortunately, **guidance** has not led to an increase in 2024 earnings estimates, which sit at $242 per share.
2. We **could still have an economic recession**: Leading Economic Indicators are negative, the Fed Senior Loan Officer Survey still shows tight lending conditions, unemployment has increased from the cycle low of 3.4% (in Jan. and April) to 3.9%.
    a. The **typical recession** results in a **30% decline in EPS**. (Barron's) (WSJ)
3. **Corporate profits have lagged GDP growth** for the fifth straight quarter. Earnings have typically outpaced GDP growth by 1.5% historically. (Bloomberg)

II. Rates, Downgrade and Oil

A. Rates

1. UST: 3-month 5.53% (NC); **2-yr 5.04% (+21 bps)**; 10-yr 4.61% (+4 bps)
    a. The 10-year yield is below its 50-day moving average for the first time in six months
2. Hedge funds had increased their short positions on Treasury futures to a record high of $101B net short as of Oct. 31. Yields have fallen since then. Some of this was **short covering**. (Bloomberg)
3. Assuming a **balanced primary budget** (i.e., not including interest), debt-to-GDP will still grow if the interest rate is greater than the nominal GDP growth rate.

B. Moody's Changes US Credit Outlook to Negative

1. **Moody's** affirmed the US credit rating at Aaa, but **changed the outlook to negative**
    a. Fitch and S&P have previously downgraded the US
2. **Reasons** for the negative outlook:
    a. Wider **budget deficits** and high government **debt levels**
        i. The deficit nearly doubled in fiscal year 2023 to around $2 trillion
    b. **Rising interest rates** have increased the government's interest payments on the debt.
        i. **Interest payments as a share of revenue** could rise from 9.7% in 2022 to 26% by 2033.
        ii. **Interest payments as a share of GDP** could rise from 1.9% in 2022 to 4.5% by 2033.
    c. **Political polarization** makes consensus on fiscal reforms unlikely in the near term.
3. **Impact** of negative outlook:
    a. The negative outlook **signals increased risk** for the US government.
        i. It does not represent an actual downgrade of the credit rating yet.
        ii. But it indicates Moody's **could downgrade the US** if deficits and debt burdens continue to rise.
    b. The move **puts further focus on US fiscal issues** ahead of the APEC summit.
    c. **Long-term Treasury yields rose** following the announcement. (Bloom.)

C. Oil

1. Oil hit **$89.37 on Oct. 19th** and closed this week at **$77.17**.
    a. When the Middle East conflict started, **speculators did buy oil**. But then they had to **unwind** these positions.
2. Fear of a disruption of oil supply in the Middle East has shifted to a **fear of a global slowdown.**
    a. But recession concerns aren't consistent with the stock market's rally.
3. **Backwardation is easing** – more evidence that there's less fear of shortages.
    a. Supplies in Cushing (Oklahoma) have increased
    b. Russian oil shipments are at a four-month high. (Barron's)

III. Economy

A. GDP

1. The Census Bureau expects the **US population to peak at 370MM in 2080** and then decline due to declining birthrates, higher death rates, and increased reliance on immigration. **US population growth is currently .5%.**
    a. The 2022 US birthrate was ~19% lower than in 2007
    b. Life expectancy at birth is projected to rise from 79.8 now to 87.8 in 2100.
    c. The prime-age population will begin shrinking in the mid-2040s
    d. The US could be surpassed as the third largest country by Nigeria and Pakistan by mid-century. (WSJ)
2. The **Sahm rule** predicts recession when the three-month average unemployment rate rises .5% above its low from the past 12 months.
    a. Currently, the three-month average is only .33% above the low. (Bl.)
3. **Arguments that economic growth is slowing**:
    a. Job growth of 150K in October (half of the Sep. pace)
    b. Unemployment rate of 3.9%, a nearly 2-year high
    c. Consumer confidence dropped to a 5-month low
    d. Bank lending is more cautious
    e. Credit card balances rose by $154B in the past year (most since 1999)
    f. Manufacturing index shows contraction (Bloomberg)

B. Inflation

1. **Global conflict** could cause higher inflation
    a. The World Bank says that in a worst-case scenario, **oil** could reach $150 / barrel
    b. Russia's invasion continues to influence **food** prices
    c. Rivalry between US and China has led to **tariffs and export controls**
2. Ken Griffin said that the world is facing unrest and structural changes that are pushing it toward **de-globalization** and causing higher baseline inflation that may last for decades. He said that the "**peace dividend** is clearly at the end of the road." (Bloomberg)
3. **58%** of working parents with children 5-year-old and younger spend **10%** or more of their annual income on childcare
    a. The median hourly wage for childcare workers was **$12.24** in 2021
    b. These business have a lot of regulatory requirements, curriculum development, hiring specialized staff, maintaining proper staff-to-child ratios, always advertising for new clients (Bloomberg)
4. Just over half of respondents in a **Census Bureau survey** described **recent increases in the cost of living as "very stressful."** Inflation stress correlates with poverty rates and income levels. (Bloomberg)
5. The **IRS adjusted tax brackets by 5.4%.** The **standard deduction** will increase to $14,600 for individuals and $29,200 for married couples. The 3.8% **investment tax** and $10K **SALT deduction cap** are not adjusted for inflation. The **estate tax exclusion** will increase to $13.61MM. The **401(k) contribution limit** will be $23K and the **IRA limit** will be $7K. (WSJ)

C. International

1. **Foreign firms have pulled over $160B in earnings out of China in the last six quarters**. The outflows turned **foreign direct investment** in China negative in Q3 2022 for the first time in 25 years.
    a. **Factors** include: interest rate gaps between China and the West, the slowing Chinese economy, geopolitical tensions between China and the West, US restrictions on American investments in China (WSJ)
2. The **war in Gaza is providing China and Russia an opportunity to gain support globally** by positioning themselves as champions of the Palestinian cause. They have declined to criticize Hamas for the October 7th attack (where 1,200 people were killed and 240 people were kidnapped) and they are framing the war as part of a **global power struggle against the US**. They are trying to unite developing nations against the US. (WSJ)
    a. Over **4,000** Palestinian children have been killed in the past month.
    b. **67%** of all casualties are women, children and infant babies. (WSJ)

IV. Retirement

A. The Great Retirement

1. The "**Great Retirement**" of older Americans continues:
    a. 2019 labor force participation rate for aged 65+: **20.8%**
    b. July 2021: **18.3%**; Oct. 2023: **19.3%**
2. Fed thinks we have **1.98MM excess retirees**
3. Hard for retirees to return to work
    a. Skills atrophy, loss of professional connections, ageism in hiring (Bloomberg)

B. Social Security

1. Chris Christie and Nikki Haley support **raising the retirement age** for younger workers. Ron DeSantis and Tim Scott do not.
    a. Biden and Trump are both against it, but have favored it in the past.
2. There is more money being paid out of the Social Security program than being brought in. This is why the **trust fund is shrinking**.
    a. The trust fund is scheduled to run out in 2034.
3. There are currently **66MM recipients**, including retired workers, survivors of deceased workers, and workers with permanent disabilities.
    a. This is **16%** higher than 10 years ago. Population has grown 7% during this period.
    b. **Almost 20% of the US population** receives some sort of Social Security benefit! (Barron's)

V. "What's Next for the Economy?" Richmond Fed Pres. Tom Barkin, Nov. 9, 2023 ([Rich. Fed])

A. Recent Data

1. Headline PCE **inflation has come down** from 7.1% (June 2022) to 3.4%
    a. **Core** is **3.7%** and **2.5%** annualized over the past three months
2. **GDP grew 4.9%** in Q3, fueled by consumer spending up 4%
3. **Unemployment** remains low at **3.9%**

B. Potential Paths Forward

1. **Resurgence** – demand and inflation pick up
    a. Arguments supporting this:
        i. High-end experience market is hot
        ii. Home prices are moving up again
        iii. Job market is resilient
    b. Arguments against this happening
        i. Anecdotally, real estate, manufacturing and deal-making hurt by rates
        ii. Low-income consumers are reprioritizing
        iii. Middle-income consumer is trading down (buying notebooks at the dollar store)
        iv. Banks avoiding riskier loans
    c. Would likely require more rate hikes
2. **Soft landing**
    a. Arguments in favor:
        i. Lag effects of rate increases and tight credit may bring inflation down
        ii. Labor markets in better balance
        iii. Supply-side improving: supply chains, productivity, prime-age participation, gas prices
    b. Arguments against:
        i. Inflation still high – especially shelter and services; health care; insurance
        ii. Businesses won't stop raising prices until customers force them to
3. **Recession**
    a. Could be caused by:
        i. Fed's aggressive rate hikes
        ii. Geopolitical events
        iii. New financial crisis by some troubled sector (such as CRE)

C. Barkin's View

1. GDP will slow as tightening takes effect
2. Need to convince businesses that inflation era is over
    a. Data will determine whether we need more rate hikes
3. If slowdown comes, it could be **less severe** than prior recessions
    a. Less labor market dislocation
    b. Latent demand could support spending (houses, cars)
    c. Businesses prepared for downturn already – already slowed hiring, inventory