



MARKET UPDATE

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November 20, 2023 – Market Update

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I. Stocks

A. Last Week

1. Performance: DJIA +1.94%; **S&P 500 +2.24%**; Nasdaq +2.37%
 - a. S&P 500 and Nasdaq had **third straight week of gains**. This was the **biggest three-week streak** for the S&P (+9.63%) since **June 2020**
 - i. RSI near 70 (overbought)
 - ii. 71% of S&P 500 above 50-day moving average, up from <10% in October
 - b. **VIX** closed the week at 13.80
2. **Russell 2000** had its second-best weekly performance of the year (**+5.4%**). But it has been 500 days since its Nov. 8, 2021 high (~26% above Friday's close)
 - a. Russell 2000 YTD +3.4% vs. S&P 500 YTD 19.2%
 - b. Forward P/E on Russell 2000 is 12.3 – a 14-month low
 - c. **40% of Russell 2000** companies are **unprofitable** (Torsten Slok, Apollo)
 - d. These companies benefit from lower rates, but lower rates are associated with a slower economy ([Barron's](#))
 - i. Can lower interest rates persist?
3. Key issues during past week
 - a. Headline **CPI** was unchanged; core was up +.2% (lower than .3% expectation)
 - b. **Fed funds futures** show no chance of rate hike this year and 28% chance of a cut by April.
4. The market seems to be **overreacting to economic data** (such as CPI). Reasons:
 - a. Economic volatility from shocks like war and financial turmoil has led to **volatility in yields**
 - b. Difficulty extrapolating economic data to markets when **outcomes are uncertain**
 - i. Soft-landing means lower rates but hard landing means even lower rates
 - ii. Fed has shifted messaging from hard to soft landing
 - c. Uncertainty about **long-term economic shifts** like higher rates, inflation, deglobalization ([WSJ](#))

B. The Bull Case

1. **Rally** was driven by disinflation optimism and weaker labor market data supporting the Peak Fed and soft-landing narratives.
 - a. **CPI** declined on an annualized basis for the first time in four months. The argument was made that inflation is decelerating faster than the Fed or markets expected. Market is now pricing in ~100 bps of rate cuts in 2024.
 - b. The **GS Financial Conditions index** reversed all of the Sep. and Oct. tightening
2. **Other bullish stories**: no government shutdown, 2024 consensus earnings holding steady, resilient consumer.
3. Reasons for optimism for a **year-end rally**:
 - a. Fed likely done raising rates, which historically leads to lower bond yields
 - b. Stocks tend to rally in Q4, with average returns of ~4.4% from Oct. – Dec.
 - c. Earnings season ended better than expected
 - d. Economy seems headed for soft landing rather than recession ([WSJ](#))

C. The Bear Case

1. **Bearish narrative:** Fed officials continued to offer hawkish messaging, warnings around a potential premature dovish pivot, QT has a long way to go, can bad-news-is-good-news continue, cautionary comments about consumers from retailers, fears that fiscal policy could turn into a headwind, OPEC could cut the supply of oil by even more due to falling prices and anger over war
2. **Cooling labor market** as initial jobless claims were higher and continuing claims were the highest since Nov. 21.
3. There have been **six previous “dovish pivots” anticipated** since 2021 that were eventually reversed. ([WSJ](#))
4. Other reasons for **caution based on financial markets:**
 - a. Stocks already pricing in a lot of optimism; S&P 500 P/E back to pre-pandemic levels of ~18.7
 - b. Gains have been concentrated in tech/growth stocks; five of 11 sectors down YTD
 - c. Bond yields have only fallen to Sep. levels (4.4%)
 - d. The inverted yield curve implies longer-term rates don't have much more room to fall
 - e. Investment grade yields of 6% and high-yields offer 9% -- competition for stocks
 - f. S&P 500 earnings yield of 5.4% is not very attractive vs. IG bonds ([WSJ](#))

D. Other Interesting Stock Stories

1. **Tesla** traded at \$231.67 on Dec. 18, 2020, the day before it joined the S&P 500. On Friday, it closed at \$234.40. During its three years in the S&P 500, it's been a wild ride but the **stock hasn't really gone anywhere.** ([Barron's](#))
2. A recent study by Leuthold argued that **active managers tend to outperform when the market declines.** Active managers:
 - a. Avoid high-risk, money-losing companies that drive declines
 - b. Embrace diversification and lower valuations
 - c. Add some foreign stocks which helps when US underperforms global markets ([Bloom.](#))
3. **S&P 600** YTD is +1.18% vs. the **S&P 500** +17.57%. This is the widest underperformance in 25 yrs.
 - a. Small-caps tend to issue more floating-rate debt: ~40% of S&P 600 companies have floating-rate debt vs. 10% of S&P 500 companies rely as heavily on floating-rate debt
 - b. 21% of S&P 600 companies are unprofitable vs. 8% of S&P 500 ([WSJ](#))
4. S&P 500 **Growth** is +22.91% YTD while S&P 500 **Value** is +11.76%

E. Small Businesses

1. **Average interest rate** small businesses pay on short-term loans has been 9% or higher over the past three months, up from 6.7% a year earlier and 4.6% in Aug. 2021
 - a. In October survey, **over 50%** of small business owners said higher interest rates were **affecting their business**
 - b. **Over 20%** said higher rates and tighter lending standards influencing **hiring decisions**
2. Entrepreneurs are **postponing** equipment purchases, expansion plans, and hiring
 - a. They are rethinking loan terms and stepping up efforts to collect payments on time
 - b. Managing cash flow is challenging w/ labor shortages, inflation and economic uncertainty
3. Small businesses tend to operate with **thinner margins** and have **fewer financing options**
 - a. Spent 6% of revenue on interest payments in 2021 vs. 2% for larger companies
 - b. Value of new small business loans declined 16.8% in Q2 YoY
 - c. 53% of small businesses say they can't afford to take out a loan at current rates ([WSJ](#))

II. Rates and Bonds

A. UST

1. UST rates: 3-month 5.50% (-3 bps); 2-yr 4.88% (-16 bps); **10-yr 4.44% (-17 bps)**
2. Markets have consistently pushed out the time of the **first rate cut** throughout tightening cycle. At no point have markets expected the first cut within four months.
 - a. Betting on cuts means betting on a slower economy
 - i. If yields fall, there is an incentive for more hawkish Fed comments
 - ii. Lower rates mean that there is less need for Fed cuts (already have easier financial conditions) ([Bloomberg](#))
3. **Challenges facing U.S. Treasury**
 - a. Growing federal deficits require more borrowing
 - b. Forced to increase auction size
 - c. Flood of long-term supply came when investors expected higher rates for longer
 - i. Weak investor appetite for long-term debt as rates rise ([WSJ](#))

B. Mortgages

1. From 2012 – 2022, share of **mortgage-free homes** jumped 5% to a record just shy of 40%
 - a. Almost half of mortgage-free homeowners have reached retirement age
 - b. Of 84.6MM owner-occupied homes in 2022, almost 33% owned by people age 65+ ([Bl.](#))
2. There have been a record number of foreclosure notices for **mezzanine loans on CRE**. These are higher-rate loans and are easier to foreclose on (b/c they are technically not mortgages; they are secured by the LLC owning the real estate itself).
 - a. Before rates started rising last year, these loans often had rates of 10% - 12% or more. Now, they charge more than 15%. ([WSJ](#))

C. Fed

1. **Not a single FOMC member has dissented in the past 11 meetings.** Under Powell, there have been .3 dissents per meeting. Volker had .7 and Greenspan had .5. Minneapolis Fed Pres. Kashkari has dissented four time but says that uncertainty has tempered convictions recently. It's good to be unanimous in fighting inflation, but it's concerning to have groupthink. ([Bl.](#))
2. **Argument for multiple rate cuts:** the labor market and inflation are weakening faster than the Fed had forecast. The real Fed funds rate is the highest that it's been in 16 years. If the Fed waits until inflation is 2%, the economy will already be close to recession. ([Bloomberg](#))
3. Typically, the **period between the Fed stopping a hiking cycle and starting to cut rates** is three to six months. If **inflation is higher for longer**, rates will also be higher for longer. Reasons that inflation could be higher for longer:
 - a. Labor shortages as boomers retire (loss of skilled workers)
 - b. Millennials and Generation Zers will reach peak homebuying years with limited supply of new homes and existing homes
 - c. Deglobalization as companies seek supply chain resiliency
 - d. Renewable energy will require massive investments in infrastructure, equipment and retrofitting. This will add to deficit. ([Barron's](#))
4. **QT:** as bonds mature, the Treasury pays the Fed by reducing its account balance at the Fed. (Fed's asset drops as does its liability – the Treasury's account). The Treasury then sells new bonds to replenish its cash, draining reserves from the financial system. This reverses the money creation from QE. ([Bloomberg](#))

III. The Economy

A. Inflation

1. **Headline CPI** was flat in Oct. and +3.2% YoY. **Core CPI** was up .2% MoM (.3% expected) and 2.8% annualized in the past five months. Stocks rallied on the news (S&P +1.9%) and the 10-year yield dropped 19 bps. ([WSJ](#))
2. **Home prices** are up 29% since Jan. 21 and **mortgage rates** have nearly tripled. ([WSJ](#))
3. **Shelter** accounts for 40% of core CPI. It peaked at 8.2% YoY in March and was 6.7% in October. Rent (which also drives OER) was up 7.2% YoY in October, down from 8.8% in March. Zillow national rent index was up 3.2% YoY in September, after peaking at 16.1% in Feb. 2022. ([WSJ](#))
 - a. Shelter inflation slowed to .3% on a MoM basis
4. Larry Summers says **transitory factors** helped drive inflation higher but are now easing. He was referring to supply chain bottlenecks and other temporary issues. ([Bloomberg](#))

B. Soft Landing

1. US economy may be headed toward a **soft landing**
 - a. **Argument:**
 - i. Inflation dropped to 3.2% in October
 1. Core inflation averaged 2.8% over past five months
 2. Wage growth slowed to 4.1%
 - ii. Q3 GDP rose 4.9%
 1. Unemployment still low at 3.9%
 - b. **Risks:**
 - i. Consumers savings buffer has declined
 1. In Q3, credit card debt was up \$154B YoY (nominal), the largest increase in records that go back to 1999. The share of delinquent cardholders (30+ days) is above pre-pandemic average. ([WSJ](#))
 - ii. Businesses face higher debt burdens and are scaling back extension plans
 - iii. Fed doesn't want to declare victory too early
 - c. It would be **highly unusual** based on history ([WSJ](#))
2. **Signs of soft landing in the financial markets**
 - a. Stocks rising globally
 - b. Treasury yields declining – expectations of rate cuts
 - c. High-yield bonds rallying (no recession)
3. **Implications** of soft landing
 - a. Higher asset prices
 - b. Lower terminal Fed funds rate could limit yield curve inversion
 - c. Weaker dollar could help commodities and foreign assets ([Bloomberg](#))
4. We **always think that a soft landing is coming**...even if we end up in recession. ([Bl.](#))
 - a. Recessions often follow spikes in interest in the topic of soft landing
 - b. Only soft landing since 1980 has been 1995 ([Bloomberg](#))
 - i. And that was during a period of globalization, peace dividend, better budget conditions ([Bloomberg](#))

C. Labor Market

1. **Continuing jobless claims** rose to 1.87MM for the week ended Nov. 4, the highest level in nearly two years. This is the eighth straight week of increases.
 - a. Initial jobless claims rose to 231K for the week ended Nov. 11, the highest level since August.
 - b. This data shows some cooling in the labor market ([Bloomberg](#))
2. Signs of **strength in the labor market**:
 - a. 3.9% unemployment
 - b. Rate at which people are being laid off
 - c. Percentage of prime-age Americans who have jobs is 80.6%, higher than any point between 2002 and 2019.
3. Signs that the **labor market is not so strong**:
 - a. Hires rate was flat in September for third consecutive month
 - b. Conference Board shows slippage. In October, 39.4% said jobs were plentiful.
 - c. Continuing claims have risen 25% YoY b/c hiring has slumped.
 - d. Large increase in people unemployed for at least five weeks. ([Bloomberg](#))
4. The **wage surge for low-wage workers seems to be ending**. From January to October, wages for all workers saw the increase drop from 6.3% to 5.8%. For the bottom quarter, it dropped from 7.2% to 5.9%.
 - a. Leisure and hospitality is often seen as a proxy for low-wage workers. It went from a 7% YoY increase to 4.5%. ([WSJ](#))

D. Other News

1. The **House passed their funding bill** with bipartisan support: 209 Democrats and 127 Republicans supported it. Two Democrats and 93 Republicans voted against it. The Senate also passed the bill and the President signed it. The funding is temporary, and the issue will return during the second-half of January.
 - a. There were no spending cuts, no changes to border policies and no additional aid to Ukraine or Israel.
2. Some 43% of white students admitted to Harvard are recruited athletes, legacies, from the “dean’s interest” list (often related to donations), or children of faculty and staff.
 - a. One justification that colleges and universities need to grow wealthier is that in the long-run, they will produce more innovation that will eventually benefit everyone. Of course, this is the “trickle-down economics” argument.
 - b. It’s ironic to see the liberal Ivy league schools support their admissions policy. They try to support inclusion, yet their value comes from being exclusive. ([Bloomberg](#))

IV. Climate Change

A. Key Findings from the Fifth National Climate Assessment (mandated by Congress)

1. **Climate impacts are here, getting worse and costing a lot of money.** We're seeing warming on land and ocean. Between 2018 and 2022, the US experienced 89 disasters that cost at least \$1B (droughts, floods, severe storms, fires, winter storms). Texas alone experienced \$375B in disaster damages.
2. **Certain communities are at higher risk**, particularly low-income communities and people of color. They are most likely to live in an area that could be flooded.
3. **Climate solutions are already being deployed nationwide.** The burning of fossil fuels is the primary driver of greenhouse gas releases into the atmosphere which are causing the planet to warm. Greenhouse gas emissions fell 12% between 2005 and 2019, largely by using natural gas to replace coal for some electricity generation.
4. **Today's efforts aren't nearly enough to halt global warming.** The world is not on pace to limit future global warming to below 2C. The US is not meeting its goal. We would need net emissions to fall 6% per year to meet targets and they fell less than 1% per year between 2005 and 2019. ([Bloomberg](#))

B. Nowhere is Safe

1. This **June, July, August, September and October were all the hottest respective months on record globally.**
2. Climate **impact on GDP varies by year**, but has increased.
3. **US emissions have declined since peaking in 2007**, even as the country's population and per capita GDP have risen. But we remain the second-largest emitter of greenhouse gases. ([Bloomberg](#))

C. Extreme Weather Events

1. The US now experiences **an extreme weather event** in which damages and costs top \$1B **every three weeks**. It was one such event every four months in the 1980s (adjusted for inflation).
2. About **40% of the US population lives in coastal communities** exposed to sea level rise and millions of homeowners could be displaced by the end of the century.
3. We would **need net emissions to fall 6% per year to meet targets** (to stop from warming more than 1.5 degrees Celsius above preindustrial levels by midcentury) and they fell less than 1% per year between 2005 and 2019. ([WSJ](#))