MARKET UPDATE

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November 27, 2023 – Market Update

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I. Stocks

A. A Slow Week

1. DJIA +1.3%; **S&P 500 +1%**; Nasdaq +.9%
2. Stocks have benefited from an outsized **easing of financial conditions**. Risk-on due to:
    a. Disinflation
    b. Peak Fed narrative
    c. Soft landing narrative
3. Next week:
    a. **PCE price index** on Thursday
    b. ISM's Manufacturing PMI on Friday

B. A Market Melt-Up

1. **Belief that the Fed is done** has led to a market melt-up. The S&P 500 increased more than 1% for the fourth consecutive week. There have only been three down days in the past 19 trading sessions.
    a. The cost to protect against a market drop has decreased by ~10%. (Bloomberg)
2. The **VIX** dropped to 12.46, the lowest since Jan. 2020.
3. Global stock funds have seen **$40B of inflows** in the two weeks through Nov. 21.
4. While the rally has been predicated on the Fed being done raising rates, it may also be based on the **Fed lowering rates sooner than will actually happen**. (Bloomberg)

C. Santa Claus Rally?

1. Since 1950, the S&P 500 has risen **70% of the time** from Thanksgiving through New Year's Eve, with an **average gain of 1.7%.**
2. **Arguments for a Santa Claus Rally:**
    a. **Momentum**
        i. S&P 500 gained 8.1% in the month before Thanksgiving this year
        ii. Best run since 1999 – when the market gained another 3.7% in December
    b. **End of the Fed's tightening cycle**
        i. Market believes that the July rate hike was the last
    c. **Possibility of rate cuts starting soon**
        i. Market is pricing in 100% certainty that the FOMC will cut rates prior to July
        ii. On average, Fed starts cutting nine months after final hike
    d. **Economy seems healthy**
        i. November S&P Global Flash US Composite PMI at 50.7 (Barron's)

D. A More Pessimistic View (Blackstone)

1. S&P 500 returned **19% YTD**, but just **7% without Magnificent Seven**
2. At current valuations, expect a **7% annualized 10-year return** (going forward)
    a. **Maybe lower** since interest rates are higher (Blackstone)

II. Interest Rates and Oil

A. Rates

1. UST: 3-month 5.54% (+4 bps); 2-yr 4.92% (+4 bps); **10-yr 4.47%** (+3 bps)
2. Bloomberg US Treasury Index is roughly **flat for the year** (after being down 3.3%)
    a. Investors had expected a great year, but a resilient economy led to more Fed tightening.
        i. Bond investors had lost 2.3% in 2021 and 12.5% in 2022
    b. Recently, inflation eased and the market started betting on rate cuts in 2024.(Bl.)
3. **Factors to consider when thinking about the 10-year yield**
    a. Inflation
    b. Real rate of interest
    c. Neutral rate of interest
    d. Geopolitical uncertainty
    e. Supply (PS)
4. **Central banks may need to curb QT** due to large budget deficits (creating more supply) and fickle demand.
    a. Average G-7 10-year yield was above 3.5% this year, more than double the five-year average
    b. There is expected to be **$1.34T of UST issuance** in 2024 (less than $1.8T deficit)
        i. **If dollar weakens**, foreign demand could weaken (Bloomberg)
5. The US spent a record **$659B on net interest payments** in FY 2023 – 2.45% of GDP
    a. Net interest is currently the largest expense after the entitlement programs and defense
    b. Fear is that higher rates could crowd out private borrowing
        i. And that we're using so much tax revenue to pay interest (rather than benefit citizens) (WSJ)

B. Oil

1. **OPEC+ delayed a meeting** that was supposed to start on Sunday. The members have disagreements about future production cuts.
2. **WTIC is down 20%** from its September highs.
3. The **effect of geopolitical events** (on the price of oil) seems short-lived. Supply and demand matter more than sentiment.
4. **Oil price/gold show exporters' buying power**
    a. Currently shows oil relatively cheap (but not dramatically)
    b. If ratio falls further, it signals weak economic growth (hard landing?) (Bloomberg)

III. Economic News

A. General Economic News

1. A NY Fed survey showed that only **65.8% of US households could cover an unexpected $2,000 expense**. This is the lowest level in a decade.
    a. Only **58% of those 40 and younger** could cover this expense (Bloomberg)
2. **17.8% of credit cardholders sought credit limit increases** this year, up from 11.2% (Bl.)
3. **Reasons to be thankful**:
    a. No recession (despite expectations)
    b. Interest rates have been coming down
    c. Dollar is no longer surging
    d. Falling oil and gas prices
    e. US government remains open
    f. China not in financial crisis; inflation has returned to Japan
    g. No dangerous new Covid variants (Bloomberg)
4. Fed has raised rates 5.25% but economic growth has exceeded forecasts. Households are **less sensitive to rate hikes** than in the past.
    a. A lower share of debt has an adjustable rate
    b. Homeowners have locked in lower rates
        i. 60% of homes have a mortgage; 90% of those are below 4%
    c. Rate hikes hurt stocks last year, but not this year (Barron's)
5. A resilient economy means **Fed rate hikes are not as aggressive as they seem**. (Barron's)
6. Initial jobless claims fell by **24K** to 209K (week ending Nov. 18). Sharpest decline since June.
    a. Continuing claims fell for the first time in two months. (Bloomberg)
7. **Maybe inflation was transitory!** Inflation was caused by supply chain disruptions and demand shifts, not excessive aggregate demand. Fed tightening did little to solve the underlying issues.
    a. Tighter Fed policy led to higher mortgage rates which could have been inflationary (by decreasing the supply of existing homes for sale)
    b. Inflation expectations stayed low due to belief that inflation was a supply issue (PS)

B. Housing

1. **Higher interest rates make housing less affordable** – currently 40% less affordable than norm
    a. Mortgage rates at highest level in a generation; home sales at lowest level since 2010
        i. GS predicts home transactions falling to early 1990s levels by 2024
2. **Problems caused by high rates and low affordability**
    a. **Prices keep rising** while supply keeps shrinking
        i. Monthly payments on a $400K loan are up $1,100
        ii. High rates haven't brought down prices due to the "lock-in" effect
            1. Boon for homebuilders (new homes are available for sale)
    b. This **diminishes housing as a path to wealth and exacerbates inequality**
        i. Less viable path to middle-class wealth
        ii. Long-time owners benefit from equity gains, affordable payments
        iii. Hurts young people; hurts family budget
    c. **Other issues**
        i. Makes job market less efficient
        ii. Can hurt consumers' outlook when they are "forced into holding patterns"
        iii. Hurts 1.6MM real estate agents (also hurt by recent collusion ruling)
3. Strong economy means **rates could stay high for years** (Bloomberg) (Bloomberg) (WSJ)

IV. The Fed

A. FOMC Minutes (Based on Nov. 1 meeting – many things have changed)

1. **Financial conditions** were tightening – higher yields, lower stock prices, stronger dollar
    a. **Now**, they are **loosening**
2. Investors **expected the Fed funds rate to remain at current levels** until June 2024
    a. Nov. 1: 30% chance of 25 bp rate increase in December or January
    b. Today: little chance of rate cut until middle of next year
3. **Real GDP growth strong in Q3** (4.9%)
    a. Real exports and imports grew robustly in Q3
    b. But **foreign economic growth remains subdued**
        i. Monetary policy restraint weighing on activity, especially in Europe
        ii. Inflation abroad remains elevated
    c. Expecting Q4 growth to slow
4. **Labor market tight**
    a. Strong job gains in September (this was later revised down)
        i. 250K in September, down to 150K in October
    b. Unemployment rate was 3.8% in September (3.9% in Oct.)
5. **Inflation still high, but disinflation continues**
    a. Headline PCE 3.4% YoY in September
    b. Core PCE 3.7% YoY
    c. Projected to reach 2% in 2026
6. **Risks remain elevated**
    a. Upside risks around inflation forecast
    b. Downside risks around GDP forecast
7. **FOMC maintained Fed funds rate at 5.25% - 5.50% and will continue QT**
    a. Consensus that restrictive policy is needed for some time until clear inflation progress
        i. Important to balance risk of too **much tightening vs. too little**
            1. Inflation is bigger risk right now – consumer could be resilient
            2. GDP could slow from student loan repayment or tighter financial conditions (which have loosened since meeting). Also, there was concern about auto strike (which has been resolved).
        ii. Concern about declaring victory of inflation too soon
        iii. Greater chance of more tightening than a quick cut
            1. But we have to see if there are lag effects of past cuts
    b. Still need **below-potential GDP growth and some labor market softening** to reach 2% inflation target (Barron's)

B. Thoughts from the Fed

1. Fed Chair Powell has recently said that **strong growth may not lead to higher inflation if our potential growth has temporarily increased** due to easing bottlenecks and boosts in labor supply and productivity
    a. He said that **short-term growth potential can vary from long-run** trend growth (~2%)
    b. Growth exceeded 2% in 2023 but inflation fell and unemployment rose
        i. Labor force participation increased from 81.7% in Oct. 2021 to 82.8% in 2022
        ii. Prime-age participation increased from 80.9% to 82.3%
        iii. Job openings and quits rates have fallen (easing wage growth)
        iv. Housing starts increased, adding to supply
    c. Powell's explanation:
        i. Pandemic may have temporarily reduced economy's capacity, which is now catching up
        ii. Uptick in immigration and participation
        iii. Easing supply bottlenecks
    d. Benefits:
        i. Allows inflation to fall without large rise in unemployment
        ii. Wage growth slowing without big drop in demand
    e. Risks:
        i. Immigration may slow in future
        ii. Childcare costs could lead some to leave workforce
        iii. Unclear if productivity gains will persist
    f. Implications for Fed policy
        i. If higher growth potential persists, this supports Fed's 2% inflation goal and earlier rate cuts. But if supply gains reverse, slower growth likely needed for more inflation progress. (WSJ)
2. The **Fed seems to be relying more on anecdotal evidence** as the economic picture gets more complex
    a. They are **seeking real-time information** from business managers and consumers
        i. A complement to backward-looking revisable hard data
    b. Anecdotes show:
        i. Economy slowing late 2023, contrary to strong Q3 GDP data
        ii. Continued high inflationary pressures
    c. Recent references to anecdotal evidence:
        i. Small firms struggling with access to capital (Harker)
        ii. Bankers concerned rates too high for business plans (Harker)
        iii. Employers not planning labor expansions (Bostic)
        iv. Farmers and small business owners suffering (Powell)
    d. **Conflicting signals lead to Fed being patient** (Bloomberg)