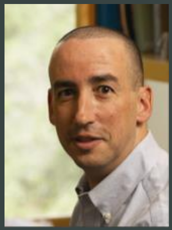

MARKET UPDATE

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November 6, 2023 – Market Update

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I. What a Week!

A. Stocks and Bonds Rallied; Oil and the Dollar Dropped

1. Stocks: DJIA +5.07%; **S&P 500 +5.85%**; Nasdaq +6.61%
    a. S&P had its best week in a year; **bond proxies** did well
    b. Nasdaq was up on Friday for sixth day in a row
    c. It was the best week for the **Russell 2000** in 2.5 years (**IWM +7.57%**)
2. UST: 3-month 5.53% (-6 bps); 2-yr 4.83% (-16 bps); **10-yr 4.57% (-27 bps)**
    a. Favorable Treasury refunding announcement
    b. Softer economic data
    c. Dovish FOMC meeting
3. **TIPs yields**: 5-yr 2.17% **(-20 bps)**; 10-yr 2.18 (**-24 bps**)
    a. **Breakeven inflation**: 5-yr 2.32% (-7 bps); 10-yr 2.39% (-3 bps); $f_{5,10}$ 2.46% (+1 bp)
4. **WTIC** ended the week at $80.51 (**down 5.88%** for the week)
5. The **dollar dropped 1.43%** for the week; **emerging markets** (EEM) rallied

B. The Big Picture from the Week

1. **Three impactful events**
    a. **Treasury's borrowing plan** showed fewer longer-term securities being issued – so rates dropped (less supply; short covering). Removed refunding overhang.
    b. **Fed** met and didn't raise rates. Powell suggested that the "**efficacy**" of dot plot projections "**decays**" after they are made. Consistent with Peak Fed.
    c. **Employment report** added to view that labor market is cooling. The economy added 150K jobs (180K expected) and prior reports were revised down by 101K. The unemployment rate ticked up to 3.9%. Participation rate: 62.7% (-.1%).
2. **Softer economic data** (consistent with **soft landing narrative**)
    a. Weaker job growth
    b. JOLTs report showed job openings relatively flat from prior month
    c. **ISM manufacturing index** had its 12th consecutive month <50
    d. **ISM services index** weakened more than expected (new orders up; employment index fell to lowest level since May)
    e. **Consumer confidence** dropped for third straight month (due to inflation)
3. **Issues to worry about** (keeping the bearish recession narrative alive):
    a. The **Employment Cost Index** was +4.3% YoY for private sector. (WSJ)
    b. The tightening of financial conditions (higher rates, lower stock prices, stronger dollar) allowed the FOMC to not raise rates. After the FOMC paused, the result was that **financial conditions loosened** (lower rates, higher stock prices, weaker dollar). (Barron's) (Bloomberg)
    c. While Q3 earnings are +3.7% YoY (vs. -.3% expected), **management commentary** has been very cautious about the economy
    d. Tightening of **lending standards**; **lag effects** from prior FOMC rate increases
    e. Geopolitical uncertainty

C. The Employment Report

1. Added **150K jobs** (**180K** estimate). Prior two months were **revised down by 101K**.
    a. There was a 30K drag from the UAW strike (which should rebound next month).
    b. The **household survey** showed a decline of **348K jobs**.
2. The **unemployment rate** ticked up to **3.9%** (highest since Jan. 2022).
3. **Average hourly wages** up **.2%** (down from .3% in Sep.). Wages are up 4.1% YoY (lowest since June 2021).
4. Employment trends predict **stocks vs. bonds**. Strong employment is good for stocks; weak employment is good for bonds.

D. Bullish Talking Points for Stocks

1. **Huge bond rally** after refunding announcement, softer growth data (jobs and ISM manufacturing most important), dovish Powell comments (full effects of past hikes not yet felt, tighter financial conditions doing some of Fed's work, wage increases down significantly, efficacy of dot plot decays between meetings), and less hawkish BoJ (didn't push yield up to 1.50%).
2. Some **contrarian indicators** flashed buy signals (BofA Bull & Bear Indicator lowest since last November).
    a. Among BofA clients, cash is high (13% of portfolio; was 10% in early 2022) and equity is low (58%, down from a recent peak of 66%). (Barron's)
    b. Boomers hold more stock in their portfolio than Gen X or Millennials (69% vs. 63% and 55%). Millennials: 1981 to 1996; Gen X: 1965 – 1980.
3. Mutual fund selling is done.
4. **Q3 earnings** beat-rate of 81%
5. After the final rate increase, the S&P averages a .8% gain per month leading up to a rate cut. (Barron's)

E. Bearish Talking Points for Stocks

1. **Growth concerns** with nearly 350K decline in jobs from HH survey, ISM manufacturing survey contracted for 12th straight month and ISM services weakest since May. Bad news is good news can only work if economy avoids recession.
    a. Sales growth is declining.
2. **Powell did express uncertainty** as to whether policy was restrictive enough.
    a. Fed not thinking about rate cuts or ending QT commitment.
3. **Earnings guidance** has been relatively weak.
    a. Q4 growth expectations down nearly 5% since start of Q4.
4. Fear that **inflation could reappear**
    a. Margins are back at pre-pandemic peak. (Bloomberg)
    b. US defense spending could rise due to the Middle East, Ukraine and China. This could resume inflation pressure. (Barron's)
5. **Can the US continue to outperform?** World markets peaked on Halloween 2007 before the financial crisis. The US market has nearly tripled since then, while other markets remain below 2007 levels. US EPS have doubled since then while other earnings are flat. (Bloomberg)

II. Bond and Rate Stories

1. **Bond investors** are focused on three things: the **economy, government spending**, and the **Fed**. So far, the Fed has not had to choose between inflation and employment as rates increased without slowing growth (employment). (WSJ)
    a. Some institutional investors are warning that the Fed could still be forced to increase rates and that the recent bond rally will prove temporary. (Bloomberg)
2. The **Treasury** announced their plans for **refunding auctions** for the quarter and the market took it as good news because they announced that they would **issue less long-term debt** than expected and more short-term debt. There is still over $1T regularly invested in the **Fed's reverse repo facility** and that should be able to soak up a fair amount of the new short-term debt. This announcement sent **longer-term yields lower**.
3. **TLT** (ETF with long-term USTs) has attracted $21B in inflows this year despite losing over half its value from its 2020 peak.
    a. **Short interest** has increased recently to almost 11% of shares. (WSJ)
4. Investment-grade and high-yield spreads (1.59% and 4.15%) are below 20-yr averages.
    a. In the US, the share of junk bonds maturing in one to three years is ~20%. It's ~40% in Europe.
    b. Corporate borrowing remains robust, despite higher rates: $1T of investment-grade debt issued YTD; HY debt has topped 2022 issuance already
    c. Does the FOMC need spreads to increase in order to slow the economy? (Bl.)
5. The **BoJ** kept the 10-year bond yield target around 1%. They are now saying that 1% is a "**reference**" level and that they will react flexibly around that target. It is no longer a hard limit. They will allow long-term yields to rise if driven by fundamentals, but will respond to speculative moves with intervention. This gives the BoJ more flexibility, possibly allowing the 10-yr JGB yield to move above 1% sustainably, but allowing the BoJ to intervene if it moves too fast.
    a. They had **already raised the yield cap** in July from .5% to 1.0%.
        i. The 10-year JGB settled at **.95%** on Tuesday, a decade high.
    b. The wide gap between the UST yield and the JGB over the past year resulted in the **weak yen** and higher inflation for Japan.
    c. It is possible that this could result in the **carry trade unwinding**. This would result in selling pressure on US Treasuries and weakening of the US dollar. There is speculation that they will take their policy rate positive early next year. (Bloomberg) (WSJ) (WSJ) (Barron's) (Bloomberg)
6. **Commercial real estate** faces huge **headwinds**: WFH, higher rates, and less lending from regional banks. **CMBS spreads** have increased vs. UST yields. (Bloomberg)
    a. CRE lending has declined significantly since early 2022 due to rising interest rates and recession concerns.
    b. 2022 saw the lowest issuance of CMBS since 2011.
    c. Loans are available but with fewer lenders, at higher rates, lower leverage and higher costs.
    d. Office properties are facing tight standards. (WSJ)
7. Jamie Dimon said Texas risks undermining its business-friendly reputation with laws designed to punish Wall Street banks for policies that limit work with the gun and fossil fuel industries. JPM has over 30K employees in Texas, its largest workforce in any state. (Bl.)

III. The FOMC

1. The FOMC left rates unchanged at 5.25% - 5.50% and will continue QT. This is the first time that the Fed went two consecutive meetings without raising rates since March 2022.
    a. Fed funds futures show a 6% chance of a December hike. They indicate a Fed funds rate of 4.33% by the end of 2024.
2. After the FOMC meeting, investors seemed to believe:
    a. The Fed is **unlikely to raise rates again** unless inflation reaccelerates. The Fed **does not expect to cut rates anytime soon**.
        i. Powell emphasized how much inflation has fallen rather than the economy's strength.
    b. Powell suggested **higher long-term yields could slow the economy** (similar to rate hikes). The Fed mentioned "tighter financial and credit conditions," where in the past they only referred to tighter credit conditions. It seems like they are considering the increase in the 10-year yield.
        i. They also changed their description of growth from "**solid**" to "**strong**."
    c. Powell distanced himself from the September SEP, saying that the **dot plot** only shows individual views at one point in time.
    d. Powell said **risks** have become more "**two-sided**" as hikes near their end.
    e. If rates stay high, that implies that the **neutral rate may be higher**. This will make the Fed's job easier in the future (more room to lower rates in a recession). (WSJ) (WSJ) (Bloomberg)
3. The FOMC's **September Summary of Economic Projections is likely wrong** now that we've had 4.9% GDP growth in Q3.
    a. GDP would need to contract at a .7% annual rate in Q4 in order to meet the SEP's 2023 GDP forecast of 2.1%.
    b. Core inflation would also have to reaccelerate in order to meet the FOMC's projections. Inflation has come down faster than expected. (WSJ)
4. Former NY Fed Pres. Dudley sees **four problems with the Fed's belief** that they can pause rate hikes and inflation will drop:
    a. The **labor market is still too tight**. We have strong job growth (275K / month) and 1.5 openings per unemployed person. Wage growth is still above 4%.
    b. **GDP growth** of 4.9% is above the 20-year average.
    c. Monetary **policy doesn't operate with the same lags that it used to**. This is because the Fed operates with much more transparency.
    d. The idea that higher long-term rates can substitute for rate hikes depends on **why rates increased**. Higher long-term rates may reflect higher neutral rates or inflation expectations. If this is the case, short-term rates need to increase. (Bl.)
5. Inflation has dropped, despite high economic growth. This may evidence **supply improvements.**
6. We haven't seen the economy slow as a result of the Fed's tighter policy. The **economy is less interest rate sensitive** than in the past.
    a. 4% difference between new mortgage rates and existing mortgages

IV. General Economics

1. **China has launched an investigation into Apple supplier Foxconn**. There is speculation that this investigation is either due to (a) Foxconn's diversification away from China; or (b) the fact that Foxconn's founder, Terry Gou, is running for Taiwan's presidency. Either way, it encourages Apple and other companies to **diversify away from China**. (WSJ)
2. **Social Security will exhaust its imaginary trust fund by 2034 and benefits will be cut by ~25%.** Bloomberg's editorial board suggests raising the retirement age to 69 by 2075 and raising the income cap on payroll taxes above the current level of $160,200. (Bloomberg)
3. **A federal jury found the National Association of Realtors (NAR) and large brokerages liable for ~$1.8B in damages for conspiring to keep real estate commissions artificially high.** Damages could be tripled to over $5B and there is another lawsuit pending with over $40B of potential damages. Under current rules, sellers pay their own agent's commission (5% - 6%) and the selling agent shares that with the buyer's agent. The amount that will be shared is listed on MLS. Plaintiffs argued that this model suppresses competition and makes it hard to negotiate lower rates. (WSJ) (WSJ)
4. **Climate change is making risks more unpredictable**, challenging traditional catastrophe risk models. Rising disaster costs are more due to **population growth** than climate change itself. (WSJ)
5. **The infant mortality rate in the US rose 3% from 2021 to 2022, the first significant increase in 20 years**. There are now 5.6 deaths per 1,000 live births. This rate is double that of many other developed nations. Sepsis, opioids and economic stresses may all be issues. Infant mortality increased significantly in Georgia, Iowa, Missouri and Texas. The Black infant mortality rate was more than double the white rate. (WSJ)
6. **The Fed thinks that our potential growth rate is 1.8% (once we're at full employment).** Potential supply changes with demographics, investment and innovation.
    a. **In Q3, we had 4.9% growth, yet inflation has decreased.** Part of this is because we added 3MM workers in the past year, ~4X the normal rate. Labor force participation is back to pre-pandemic levels and immigration is high.
    b. The FOMC doesn't want to raise rates and choke off future growth if our supply potential is increasing. (WSJ)
7. **Some economists want the Fed to raise rates because they think that the output gap is close to zero or negative.** Others don't want the Fed to raise rates without evidence of inflation. This is why **everyone is watching wage growth.**
    a. Employment is the biggest factor in supply. High wage growth signals that the small (or negative) output gap is inflationary. (WSJ)
    b. JOLTS job openings rose slightly to 9.553MM (from 9.5MM) indicating a tight labor market. The quits rate stayed at 2.3% for a third month (lowest since early 2021). (Bl.)