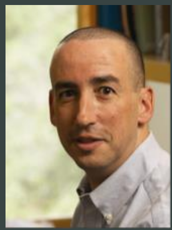

MARKET UPDATE

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October 16, 2023 – Market Update

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I. Stocks

A. Weekly Recap

1. Last week: DJIA +.8%; **S&P 500 +.5%**; Nasdaq -.18%; Russell 2000 -.2%
2. S&P 500 was higher for the second straight week

B. What Caused Rally?

1. **Treasury rally** was the main catalyst
    a. Flight to safety from geopolitical uncertainty
    b. Oversold conditions
2. **Peak Fed narrative** as multiple Fed officials said the recent increase in yields has done some of their work for them
    a. Harker said that he believes rate hikes are done
3. Optimism over **earnings**
    a. FactSet projects Q3 earnings growth of .4% YoY for S&P 500 (FactSet)
4. Continued **consumer resilience**
5. Consumer **credit conditions** continue to hold up
    a. JPM said they are not seeing softening credit either on the consumer or commercial side
    b. JPM, WFC and C all rallied on good earnings on Friday
6. Optimism over **dealmaking**

C. Problems this Past Week

1. **Treasury auctions** – three straight disappointing auctions
    a. 30-yr bid-to-cover 2.35; prior auction was 2.46
    b. Fears about supply, deficits, weakening foreign demand, rising term premiums
    c. Treasury increasing size of auctions in anticipation of larger federal deficits
2. **Cautious headlines around disinflation** momentum (higher rates for longer?)
    a. Headline CPI stronger than expected
        i. Some analysts blamed it on housing
    b. Higher supercore number (core services ex housing)
        i. Some analysts blamed it on hotels and sports tickets
    c. Univ. of Michigan survey: one-year inflation expectations rose .6% to 3.8%
        i. Analysts blamed it on gas
    d. You'll be fine if you don't live anywhere, drive anywhere, visit hotels or go to sports events
3. **Valuation worries** continue
    a. Risk premium is lowest since June 2002.
    b. Magnificent Seven are over 30% of S&P
    c. S&P market cap outperformance over equal-weight – most since 1998 (WSJ)
    d. Birkenstock (BIRK) went public at $46; dropped 13% (to $40.20); ended week at $36.38
4. Fear that the conflict between **Israel and Hamas** will include Iran
    a. Israel told 1MM Palestinians from northern Gaze to head south
    b. Saudi Arabia's US-backed normalization plan with Israel is now on the backburner (which is exactly what Iran wanted)
5. GOP race for **House speaker** is still in disarray – how can this group fix the budget?
6. No signs of progress in UAW strike

II. Interest Rates

A. Treasury Yields

1. Last week: 3-month 5.62% (-1 bps); 2-yr 5.04% (-4 bps); **10-yr 4.63% (-15 bps)**
    a. Bond investors are unwinding their steepener bets that short-term notes would outperform longer-term notes. (Bloomberg)
    b. Treasuries jumped (lower yields) due to **dovish Fed comments** and the conflict in the Middle East (**flight to safety**). (Bloomberg)
        i. The jobs shock and the shock from Gaza canceled each other out in the bond futures market.
    c. **Real yields** have increased in US and Germany.
    d. When will the **SPY/TLT** reverse?
2. Some of the **issues that bond investors are worried about**:
    a. The 10-year yield tends to **max out** at or near the **peak Fed funds rate**.
        i. Prognosticators' estimates of the 10-yr yield have been way too low (Bloomberg)
    b. US **marketable debt outstanding** has **increased substantially**
        i. Treasury issuance is high.
    c. **QT**, no more buying by other central banks, bond vigilantes sending a message
    d. **10-yr JGB** yield is rising (WSJ)
    e. Could be our third year in a row of negative bond returns (Bloomberg)

B. Other Rate Stories

1. **Bad auctions**:
    a. The $20B 30-year Treasury auction went off at the **highest rate since 2007**. The weak demand weighed on sentiment.
    b. The Treasury auction was awarded at 4.837%, nearly **four basis points higher than its yield in pre-auction trading**. Demand fell short of dealers' expectations, despite being the highest-yielding bond auction of its kind since 2007.
        i. It also came after a weak 3-year auction on Tuesday and a 10-year auction Wednesday. (Yahoo)
2. On average over the past 15 years, **private loans** charged rates **5%** higher than comparable bank debt. They don't require credit ratings. They have tougher covenants. The spread is only **2.39%** now. (WSJ)
3. **Small-cap company debt**:
    a. The Russell 2000 makes up less than 10% of the overall market cap. Their size makes them much more sensitive to emerging economic strains.
    b. RBC says that small-caps have a **weighted average maturity of 4.8 years** on their borrowings vs. **8.8 years for large companies**. In addition, more small-company debt is **floating**. (WSJ)

III. Economic News

A. Inflation

1. **Headline** CPI: **+.4%** MoM and **3.7%** YoY; **core +.3%** MoM and **4.1%** YoY
2. The **trimmed mean** dropped to **4.29%**, **sticky price CPI** is at **5.07%**.
    a. Core sticky price inflation ex shelter dipped below 3%.
3. **Shelter** is still **above 7%** YoY. **CPI ex shelter** was exactly **2%**. Shelter is lagged b/c it includes all leases currently in force, rather than only those that were signed in September.
    a. Private sources of rent data show that rent is coming down.
4. The **supercore** (services excluding shelter) was up **.61%**, the highest MoM increase since September of last year.
5. All of the inflation comes from sectors that weren't impacted by Covid. So this is no longer a Covid story. (Bloomberg)

B. Fed Speakers

1. Dallas Fed Pres. Logan said that "higher term premiums result in higher term interest rates for the same setting of the Fed funds rate, all else equal." As a result, there may be less need for more tightening.
    a. On the other hand, "to the extent that strength in the economy is behind the increase in long-term interest rates," the Fed may need to raise rates more. (Bloomberg)
2. Fed Vice-Chair Philip Jefferson said that he would "remain cognizant of the tightening in financial conditions through higher bond yields."
    a. *"We are watching the tightening of financial conditions and the sharp increase in long-term real yields, and these developments are doing some of the hard work for us, and as such, we believe we have reached that fabled sufficiently restrictive level."*
3. Minneapolis Fed Pres. Neel Kashkari said that he wasn't yet convinced that higher long-term yields would lessen the need for further rate hikes.
    a. He said that it's possible that higher yields may do some of the work in bringing inflation down, but it's also possible that those higher yields are due to expectations of tighter Fed policy and the FOMC may need to deliver on those expectations. (Bloomberg)
4. Fed Gov. Michelle Bowman said that interest rates may need to rise further and stay higher for longer than previously expected to get inflation back down to 2%. She said that inflation is well above target, domestic spending continues to be strong and the labor market is tight.
    a. She did say that higher yields in the market allow the FOMC to be more patient.
        i. But these higher rates could erode the credit quality of banks' balance sheets if the economy weakens. (Bloomberg)
5. SF Fed Pres. Mary Daly said that the neutral rate could be higher than it was pre-pandemic. She said that it's possible that it went from 2.5% to 3.0%.
    a. "Recently, bond yields have tightened, meaning financial conditions have tightened."
    b. "If that's tight, maybe the Fed doesn't need to do as much." (Bloomberg)

C. Other Fed News

1. The FOMC minutes from Sep. 20th said that a majority of participants felt like one more rate increase would be appropriate, while others thought that they should be done.
    a. All of this happened before the increase in longer-term yields.
    b. Participants thought that the risks of raising rates too much or too little were more balanced than they had been since the Fed started raising rates.
    c. Some participants commented that the real Fed funds rate could rise as inflation falls (if the nominal Fed funds rate is held steady). (WSJ)
2. From 2008 – 2022, the Fed returned $1T of profits to the Treasury. Now, they have $100B of losses per year. This is because they're paying more in interest than they're earning.
    a. Profit is not the Fed's goal. The goal is the dual mandate.
    b. They will book the losses as a deferred asset (future remittances that won't have to be paid). This won't affect the Fed at all. There will be no runs on the bank. (WSJ)

D. Real Estate

1. The 30-year fixed rate mortgage hit 7.67% in the week ending Oct. 6, according to the Mortgage Bankers Association. This is the highest rate since 2000. (Bl.)
2. US housing affordability worsened to a new record low in August. The National Association of Realtors index decreased to 91.7. A level below 100 means a household with a median income doesn't earn enough to qualify for a mortgage on a median-priced home.
    a. The typical family spent 27.3% of their income on their annual mortgage payment. Qualifying income for a mortgage, based on a 20% down payment, was $107,232 in August. (Bloomberg)
3. **California to Texas** was the most popular interstate relocation route in the country in 2021. About 111K people (~300 per day) did the move.
    a. Texas gained 9MM residents between 2000 and 2022, more than any other state.
    b. Texas is still affordable relative to California. The **median listing price in Texas** was **$379.9K** vs. **$760K in California**. (WSJ)
4. **Houston, Dallas and Austin top the list** of major U.S. cities with the highest **office-vacancy rates**. About 25% of their office space wasn't leased as of the third quarter. NY is at 12% and SF is at 17%. This is despite the fact that Texas has a high percentage of workers who have returned to work.
    a. This tells us that it's not just WFH that's causing problems. It's a **glut of office space**.
    b. **Austin's vacancy rate** was **24.2%** in Q3, up from 12.9% in 2019 Q3. (WSJ)

E. General Economy

1. We're starting to see **more large bankruptcies**, such as SVB, Bed Bath & Beyond and Yellow. They blame high inflation, high interest rates, waning government aid and lingering supply-chain disruptions. Large bankruptcies can cost thousands of jobs and they may convince people that a downturn is under way.
    a. "**Mega bankruptcies**," or those filed by companies with more than $1B in assets, hit 16 in the first half of this year. From 2005 – 2022, the average had been 11 for this time period. (WSJ)
2. In August, **17.7%** of the population was **65 or older**, the highest percentage on record and up sharply from 13% in 2010. This group has relatively healthy finances and less need to borrow and they are at less risk of layoffs.
    a. Americans age 70+ now hold nearly **26% of household wealth**.
    b. This group accounts for **22% of spending** last year (up from 15% in 2010).
        i. Spending reflects health, wealth and maybe lingering effects of the pandemic.
    c. In real terms, households headed by someone age 65 and older spent 2.7% more in 2022 than 2021 vs. .7% more for under-65 households. It's up 34.5% from 1982, compared with 16.5% for younger households. (WSJ)
3. **70% of the September job gains** were in three sectors: **government, healthcare, and hospitality and leisure**. Job gains in professional services, such as architects, marketers, engineers and managers, rose by only 21K.
    a. IT unemployment is **4.3%**.
    b. **College grad unemployment** was 1.8% a year ago. Now it's 2.1%. (WSJ)
4. **Arguments that recession is unlikely**:
    a. **Revisions** to **employment growth** have turned positive. Think of this as the BLS predicting worse outcomes than actually happened.
    b. The **rise in unemployment claims has reversed**.
    c. **Wage growth** is **slowing**. (Bloomberg)
5. The **IMF** boosted its projection for **world consumer price inflation to 5.8% for 2024**, up from 5.2% three months ago.
    a. Global inflation reached 8.7% in 2022, the highest level since the mid-1990s.
    b. The IMF sees **global growth of 2.9%** next year, down .1% from its July outlook and below the 3.8% average of the 20 years before the pandemic. (Bl.)
6. **Claudia Goldin** (Harvard) won the **Nobel Prize in Economics**. She's the third woman to receive it since the award started in 1969.
    a. Goldin's research questioned the assumption that women had steadily, or would inevitably, narrow the wage gap (and work responsibility gap). Her work establishes that the gap in pay occurs with the birth of a first child, with women typically devoting more time to childcare. She also established darker issues at work…where blind auditions helped women get more orchestra seats. (WSJ)

IV. Politics and Fiscal Policy

A. Political Gridlock

1. For the first time ever, the **House speaker was ousted**. The Republicans can't agree on a replacement.
2. A single senator, **Tommy Tuberville is holding up promotions** for hundreds of senior military officers to protest the Pentagon's abortion policies.
3. The government is **only funded through mid-November**.
4. For the past year and a half, the **US hasn't had an ambassador to Egypt**, which has played a central role in brokering cease fires in the past between Israel and Hamas.
5. Pew Research found that:
    a. Only 4% of Americans believe that the government is working extremely or very well
    b. **85%** of people in each party agreed that Republicans and Democrats are more **focused on fighting each other** than on solving problems. (WSJ)

B. The Budget is a Mess

1. Previously, the federal **deficit exceeded 5% of GDP only** in years **when unemployment exceeded 7%**.
    a. Given the global stress, **concern about the deficit may have to be subordinated** to other concerns.
    b. **Treasury auctions** are expected to ramp up by 24% in 2024.
2. **Fiscal dominance** is being used to describe how budget deficits are overwhelming monetary tightening by the Fed.
3. Our two likely **presidential candidates**:
    a. Trump added $7.5T to deficit; $3.5T not related to pandemic
    b. Biden has added $4.8T so far; $2.3T is not related to pandemic (Barron's)

C. Deficit Bigger Than it Looks

1. The CBO estimates that the FY 2023 **deficit was $1.7T**. That's $300B worse than FY 2022. But this year is actually worse than this sounds.
2. When Pres. Biden tried to release 40MM Americans from some of their student debt, the administration logged the $379B on the budget in Sep. 2022. That brought the deficit to $1.4T.
    a. In June 2023, the Supreme Court disallowed this program. Rather than update last year's numbers, the Treasury recorded this as a $333B spending cut in Aug. 2023. Without this student debt accounting, **last year's deficit would have been close to $1T and this year would have been close to $2T**.
3. Our debt is headed higher – it has increased 400% in past 15 years
    a. And the interest rate on our debt is headed higher. (WSJ).

D. Not Paying Taxes

1. Americans didn't pay an estimated **$688B in taxes due on their 2021 returns** – the largest shortfall ever. This includes $542B due to **underreported income**, with the remainder owed by those who didn't file returns when they should have or never paid their bills.
2. There is less compliance with **gig income**.
3. Taxpayer compliance is **86.3%**. (WSJ)