MARKET UPDATE

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I. Markets

A. Stocks

1. **Week**: DJIA -1.34%; **S&P 500 -.74%**; Nasdaq +.06%; Russell 2000 +.48%
2. **September**: DJIA -3.5%; **S&P 500 -4.9%**; Nasdaq -5.8%
3. **Q3**: DJIA -2.62%; **S&P 500 -3.65%** (S&P hit YTD closing high on 7/31); Nasdaq -4.12%
4. **Quarter**: **started off** with soft landing narrative, disinflation, tight labor market, resilient consumer, improving earnings
    a. **Evolved into** higher rates for longer, higher yield curve, higher energy prices, resumption of student loan repayments, UAW strike, gov't shutdown, high mega-cap valuation, disinflation pressure on earnings, negative September seasonality, slowing China growth
        i. Real 10-yr yield went above 2% for first time since early 2009
        ii. High stock valuation vs. high rates
5. On **positive side**: Fed may be near peak rate, disinflation happening, labor market softening but still healthy, consumer spending decelerating but still strong, AI optimism continues, market may be oversold (2+ standard deviations below 50-day MA), extreme pessimism (AAII bull-bear spread down 40% in past two months); Oct – Dec. have historically been three of the best months for stocks
6. **Questions that we're left with**:
    a. Fed's direction
    b. Will disinflation continue to the 2% level?
    c. Can we continue to have a strong labor market?
    d. Can consumer spending continue to be strong?
    e. Can earnings grow 12% in 2024 with disinflation?
    f. Will energy prices continue to increase?
    g. Does large-cap valuation have to continue to adjust?

B. Private Equity and IPOs

1. In the last decade, PE has increased more than four-fold to ~$7.6T. The correlation between PE and public equities is high. Is this really an **alternative asset**? (Bloomberg)
2. The **IPO market matters**: capital formation and job creation, money into the pockets of employees and early investors, potential growth stocks for public investors (WSJ)

C. Rates

1. **UST**: 3-month 5.55% (-1 bp); 2-yr 4.80 (NC); **10-yr 4.59% (+15 bps)**
2. For first time since tech bubble, the **three-month T-bill yield is > the S&P 500 earnings yield**.
    a. Maybe yields are high b/c of a strong economy that helps stocks.
    b. An economic slowdown could hurt rates and stocks. (Bloomberg)
3. In past, **high yields** have slowed the economy and led to **surges in spreads**. (Bloomberg)
4. BlackRock's **Larry Fink** expects the 10-year UST yield to go **above 5%** due to embedded inflation. He sees labor shortages as among the major risks to the economy that could lead to higher rates for longer. (Bloomberg)
5. The **US government** is spending more to pay **interest** ($807.8B) on its $33T national debt than it does for national defense ($695.44B). (Bloomberg)
    a. If high yields slow the economy, what happens to our government deficit? (Bl.)

D. Fears about High Rates

1. 10-yr yields have hit a **16-yr high**. Valuations may be high relative to rates. (WSJ)
    a. Ten-year yields have a **gravitational pull** on other markets – gold, equities, Chinese stocks, the euro, global growth stocks, etc. (Bloomberg)
    b. **Home affordability** is now worse than 2006 (when prices peaked). If home prices stay high, it could result in Fed policy staying tighter. (Bloomberg)
2. During quarter, **2-yr/10-yr inversion narrowed** from 100+ bps to 50 bps
3. **10-yr TIPs** is only 10 bps behind expected inflation; narrowest gap since 2009 (with exception of one day during pandemic). Since GFC, yields have mostly been compensating us for inflation. Now, the higher yield reflects **tighter policy**. (Bloomberg)
4. **What could break?** The yen (Japan is still the world's largest source of cheap money); emerging markets (dollar-denominated debt is expensive); high-duration bonds (TLT); banks (Bloomberg)

E. Leveraged Loans

1. Interest costs are starting to impact firms which have borrowed in the **$1.7T leveraged loan market**. Fitch says that nearly $270B of leveraged loans carry weak credit profiles and are potentially at risk of default. Leveraged loans have performed well this year due to a strong economy. (WSJ)
2. PE-owned firms have $1.4T of leveraged loans. Approximately 2/3 are **unhedged**. Defaults trebled to 3% in July (vs. mid-2022). Fitch expects that this could reach 4.5% this year. Leveraged loans are yielding 9% and private credit yields are nearer 12%. Many of these leverage loans are **covenant lite**.
    a. PE funds are also able to get **NAV loans**, where they can borrow against the value of the entire fund, rather than an individual investment. This money is often used to return money to investors. (Bloomberg)
        i. These loans are also being made to the LPs so that they don't have to sell at a discount. LTV ratios can be 30% - 50%.(Bloomberg)
    b. **Manco loans** are made against fee streams and equity returns and are often used to seed new strategies, succession planning and even funding an individual partner's equity stake in the PE fund. (Bloomberg)

F. Oil

1. **WTIC +28.5% for quarter**; **dollar strengthened** 3.2% for quarter
    a. Gas averaged $3.88 last week, up **25% YTD**. This can make it too expensive to travel to low-paying jobs. In today's dollars, gas peaked at **$5.71 / gallon** in June 2008. (WSJ)
    b. Seventh successive weekly fall in oil stockpile in Cushing, OK. Leaves us **vulnerable** to weather shock. (Bloomberg)
    c. In the Permian Basin, the number of **rigs** drilling for crude oil had **declined 12%** since April, even as oil prices increased by ~$13. Companies have promised to deliver cash to investors rather than to over-produce. (WSJ)
2. **Russian oil** is selling for ~$85 after previously trading at a $30 discount. (Bloomberg)
    a. Putin and MBS are bringing in billions of dollars of extra oil money by cutting production. Prices have increased more than volume has decreased. Reducing output is risky because you can lose share to rival nations. Production costs average $9.30 in Saudi Arabia and $12.80 in Russia. Saudi Arabia needs $81 oil to balance its budget. (WSJ)
    b. Oil bears think that Saudi cuts are due to signs of weak demand. (Barron's)
3. Developed economies are **less oil-intensive** than the past. Even if oil reached $150, it would take less of disposable personal income than in the past. (Bloomberg)

II. Economy

A. Inflation

1. **Core PCE** rose **3.9%** YoY – the lowest since Sep. 2021. It was up **.1% MoM**. 3-month annualized **2.2%**. Headline PCE was up 3.5% YoY. (Barron's)
    a. Core is a better indicator of the future than headline inflation number. (Bl.)
2. **Core, super-core and the trimmed mean** are all higher than headline inflation. (Bl.)
3. Remember that **disinflation** does not mean that prices have come down. (Bloomberg)
4. High inflation **expectations** are self-fulfilling due to how we set wages and prices. Also, if you expect prices to increase, you consume now. (Bloomberg)
    a. **Republicans** expect 5% inflation over the next year; **Democrats** expect 2%. (Bl.)
5. If you used **real-time rents** and prices, inflation would be less than 2%. (Bloomberg)
    a. The intent of CPI is indexing payments, not guiding the Fed.
6. **Motor vehicle insurance** was **+19.1% YoY** in August. High car prices are due to supply chain issues and chip shortages. The UAW strike could continue the car price inflation. Fatalities are above trend (resulting in higher medical and liability costs). Lengthier repairs mean more rental costs. Extreme weather is also a problem. (Barron's)

B. Labor

1. Despite higher rates, the **unemployment rate hasn't risen significantly**. Possible **reasons**: generous fiscal stimulus, stronger labor-force participation, a rebound in immigration, a boom in small-business creation, and continued growth in in-person service sectors. (Barron's)
2. Labor market **churn helped productivity**. Workers shifted into better-fitting jobs. (Barron's)
3. **Some job openings aren't real**. A company may post a role in advance of an opening becoming available to build a pool of applicants. (Bloomberg)

C. Fed and Rates

1. JPM's **Jamie Dimon** said the Fed funds rate could go to **7%**. (Bloomberg)
2. The typical **credit card** carried a **20.7%** interest rate in May, up from 14.6% in Feb. 2022. Credit card debt exceeds **$1T**. (WSJ)

D. General Economy

1. In the bottom 80% of households by income, bank deposits and other **liquid assets** were **lower** in June than they were in March 2020, after adjustments for inflation. (Bloomberg)
2. There is some talk of a "**vibecession**" – where consumer confidence and other economic "vibes" decline so much that they threaten to be self-fulfilling. The negative views could **reflect** energy prices, stock prices, personal finances (student debt, and unaffordable housing. (Bloomberg)
3. Leaders of F, GM and STLA received between $21MM and $29MM in compensation last year. The S&P 500 median CEO compensation was $14.5MM last year. These three CEOs made **~300X** the average employee earnings. This is in the highest 1/3 of S&P 500 companies. (WSJ)
4. The US State Department says that the **Chinese government** is spending billions of dollars annually into a global campaign of **disinformation**. The have online bot and troll armies, legal actions against those critical of Chinese companies, they launder English-language articles and they place diplomatic pressure on foreign universities and newspapers that publish content deemed offensive. They also engage in "**flooding**," a tactic that manipulates search engine or hashtag results by coordinating large volumes of inauthentic posts. The goal is to make content critical of China harder to find. (WSJ)

III. Policy Has Tightened a Lot. Is it Enough?, Minneapolis Fed Pres. Kashkari (Minneapolis Fed)

1. **Inflation** rose, but then fell dramatically. It's still well **above target**.
    a. Near term **expectations** are consistent with pre-pandemic levels. Suggests that market participants believe the inflation fight will soon have been won.
2. Kashkari's Fed funds **rate path** has **increased** over time.
3. The markets have taken the **10-yr TIPs rate higher** – indicating tighter monetary policy
    a. But I believe that the overall **stance** of monetary policy is determined by the position of **long real rates relative to the neutral real rate**
4. Prior to the pandemic the 10-yr real rate was ~0. That was roughly a neutral stance at the time.
    a. With the pandemic, the FOMC took the Fed funds rate to the ZLB and did QE.
        i. Combined effects drove 10-yr real yield to ~-1%
    b. Since we first tightened over 18 months ago, the 10-year real yields have fully retraced their pandemic decline and are now approximately 2%
        i. So we are in a **contractionary stance** relative to pre-pandemic levels. Is that enough?
    c. I know of no theoretical framework that can tell us how much we will need to tighten long real rates to get inflation back to target in a reasonable time
5. Earlier, I noted that when the FOMC raised the policy rate by 300 bps in the 1994 tightening cycle, it translated into ~200 bp increase in the 10-yr real rate
    a. Coincidentally, the resulting level of the 10-yr real rate was also estimated to be ~200 bps above the then-neutral 10-year real rate. So in that tightening cycle, the Fed drove the **10-year real rate ~200 bps above neutral**
6. I estimate neutral at zero. So, the 10-yr real yield is ~200 bps above that.
    a. But **inflation dynamics are different** than 1994, so we could have to go higher
    b. And the **neutral rate could be higher** than it was pre-pandemic
7. **Two primary scenarios**:
    a. **Soft landing** (60% probability)
        i. One more 25 bp rate increase and then hold there to bring inflation down
        ii. Already made substantial progress while labor market remains strong
    b. **High-pressure equilibrium** (40% probability)
        i. Inflation proves more entrenched and we only get to 3% inflation
            1. Services inflation has been quite sticky
        ii. Robust consumer spending funded by current income may indicate that we are in a high-pressure equilibrium (w/ households more confident)
            1. Housing and autos are strong – maybe even recovering
        iii. FOMC would have to **raise rates further** – potentially significantly higher. Idea is that most of inflation gains may have come from supply-chain issues (workers reentering labor force, supply chains resolving)
8. I'd be more confident in soft landing if I were more certain that policy is truly tight
    a. Also have to watch for shocks: gov't shutdown, escalation of war in Ukraine, extended UAW strike, spillovers from slowing Chinese economy

IV. The New Job Hierarchy, Richmond Fed Pres. Tom Barkin, Sep. 28, 2023 (Richmond Fed)

A. Introduction – Labor is the Key

1. **Economy** has been remarkably **resilient**. Even with 525 bps of rate increases:
    a. Solid **GDP: 2.1%** in Q2; estimates of 4% in Q3. Consumer has driven this by spending pandemic-era savings and benefiting from higher wages and rising equity valuations.
2. **Inflation has started to settle**. Aug. headline CPI was 3.7% (down from 9.1% in June 2022) and core was 4.3%.
    a. Gas prices have fallen from last year's highs, supply chains have largely opened up, and Fed policy is working (especially in housing, CRE and deal-making).
3. **Hard to know where demand and inflation will go from here**.
    a. Some believe inflation will settle further without additional demand erosion
    b. Others believe we need a more significant slowdown
    c. I believe that the labor market will be key to answering this question
4. Everywhere I go, I still hear that **labor is short** (even if hiring is easier than 2022).
    a. Great Resignation has passed and people are returning to office.
        i. But it's not "back to normal"
    b. If good workers remain hard to find, **wages could rise further**, pressuring margins and prices in turn

B. From Labor Abundance to Shortage

1. Feb. 2020: **61.1% of population** was employed. Today: **60.4%** (= -1.8MM workers). Yet GDP is 6% higher than pre-pandemic. This is why labor feels short.
2. **Reasons for drop**:
    a. **Demographics** – natural aging of baby boomers
    b. Lower **participation rates** at or near retirement age
        i. Stronger 401(k) plans
        ii. Desire to help with child-care for grandkids
3. For decades, we had a **growing labor force**: baby boom, women entering the labor force, increased educational attainment, improved health (longer careers), high immigration
    a. We also had access to ever-growing pools of offshore, low-cost labor
4. Now, these are **headwinds**. Fertility rates are down. K-12 enrollment is projected to decline by nearly 8% between 2019 and 2031. Boomers are aging out of labor force. Immigration policy is unlikely to change. Risk of offshoring has become apparent.

C. The Great Reshuffling

1. It's not just the supply of labor…it's also the **distribution**. Employers had been comfortable with where their jobs rated vs. others (the **job hierarchy**).
    a. Wages, benefits, work conditions needed to hire and retain talent
2. The **pandemic reshuffled that hierarchy** considerably – making the market less predictable:
    a. There was a **shift in relative compensation**. Growth sectors (like warehousing) offered higher entry wages. Leisure and hospitality wages have increased 26% (vs. 18% for the overall private sector).
    b. Covid made a **number of jobs objectively less attractive**. Restaurants and theme parks shut down, sending the message that they weren't secure. Supply chain challenges increased stress in manufacturing. Teachers, nurses and child-care providers faced higher health risks.
    c. There was a **shift in employee attitudes**. Jobs that allow **remote work** moved up the hierarchy. Pay gaps shrunk. The ability to control work schedules and work indoor became more valuable. Last-minute OT or physical work needed a larger premium.

D. How Employers are Reacting

1. Many are **investing to increase the supply of labor**.
    a. Trying to bring in **new workers off sidelines** – partnerships with community colleges, apprenticeships and internships, investments to reduce barriers to work like transportation, child-care and access to housing.
        i. Investment could be particularly important after pandemic impacted social and educational preparedness of those entering the workforce
        ii. Good for workers, growth and **reducing inflationary pressure**
2. Others are **investing to reduce demand for labor**.
    a. **Automation** is more economically compelling. McKinsey estimates that automation could replace tasks that account for ~30% of the hours worked in the US by 2030.
        i. These investments are likely **disinflationary** and increase capacity for growth
    b. Hotel housekeeping is no longer daily.
3. Employers are **fighting their way up the job hierarchy** by adjusting wages, benefits and the work environment.
    a. Improving working conditions, limiting OT or last-minute scheduling, offering more flexible work arrangements or installing air conditioning.
    b. Places are paying more if they can. **Reservation wage** has increased 20% from pre-pandemic level.
    c. These changes will be i**nflationary**.

E. How Will This Balance Out?

1. Hard to know:
    a. Will supply come back with investment in training?
    b. Will retired workers get bored or squeezed?
    c. Will demand for workers settle as automation rolls out and economy weakens?
    d. Will employers just pay more?
2. The path of monetary policy depends on whether inflationary pressures are behind us.
    a. I'll be watching labor market closely for signals.