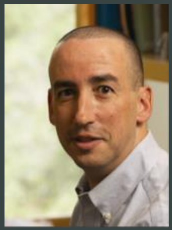

MARKET UPDATE

subscribe at sandyleeds.com

October 23, 2023 – Market Update

Table of Contents

I. Stocks

A. Last Week

1. Performance: DJIA -1.6%; **S&P -2.4%**; Nasdaq -3.2%
    a. Tech: TSLA (-15.6%), NVDA (-9.0%); NFLX (+12.7%)
    b. S&P 500 closed **below 200-day moving average** (has been above it since March)
2. **Negatives**
    a. **Higher UST yields** – higher for longer
        i. Maybe it's not 5% yields, but the **speed** in which rates have increased
            1. 10-yr yield **+1.64%** from its lowest point of the past six months
        ii. Powell
            1. Rates are not too tight
            2. If we are persistently growing above trend, that will be a problem
            3. High for longer is the theme
        iii. September **retail sales** beat expectations, **jobless claims** below 200K
        iv. The **Beige Book** was more downbeat, just barely above recession levels. Based on text analysis…
            1. The greatest fear is high rates
            2. Feels like tighter credit standards and higher rates are just starting to have an effect.
    b. Unsettled **geopolitical situation**
        i. Risks add to the de-globalization trend and higher oil
        ii. Is Israel reconsidering its approach?
    c. **Mixed earnings** reports – TSLA and MS negative
        i. Citi's Earnings Revisions index has turned negative recently
    d. Congressional dysfunction
3. Positives
    a. **Economy is still strong**, unemployment claims are low (soft landing)
        i. Stocks won't have a deep drop with a strong economy
            1. Atlanta Fed GDPNow is forecasting 5.4% Q3 growth.
        ii. Market just needs time to adjust to high rates (Barron's)
        iii. More indications of China policy support
    b. **Powell** was seen as somewhat dovish – tightening of Financial Conditions Index suggests Fed may have to do less on the margin
        i. Harker reiterates call for no more rate hikes; Mester says we may be done
    c. **Earnings** are recovering
        i. 88% of companies that have reported have beaten estimates (Bl.)
        ii. Higher S&P 500 earnings estimates could mean higher stock prices.
        iii. Earnings have beaten estimates by 9%. The S&P now trades at 18.7X next year's earnings. Equal weighted is trading at 15X earnings vs. a 10-yr average of 17 (Bloomberg)
    d. More **M&A headlines**
    e. Extremely **negative sentiment**
        i. Cash levels indicate extreme pessimism – giving a buy signal.

B. Are We in a Bull Market?

1. S&P 500 has increased **20%** from the October 2022 low
2. Stock market rally **does not resemble the typical early-stage bull markets**.
    a. This has been a **weak market** since the Oct. 12, 2022 low (compared to other early-stage bull markets).
    b. There's still **only 44%** of the S&P **above the 200-day moving average**
    c. **Only 2/3** of the S&P **rose** over 12 months. Normally **88% - 97%.**
    d. **Small-caps are up just 5%** since last year's lows, their worst showing in history
    e. Even **within large-cap** stocks, half of the S&P 500 **gains came from eight stocks**. In the first year of the previous four bull markets, it took **at least 38 stocks** to get half the gains
    f. **Banks are down** (-18%) in the first year off an S&P low in 100 years of market history.
        i. Banks elsewhere are doing better, even though our economy is doing better.
    g. **Earnings estimates** normally rise. This time, they have fallen. (WSJ) (Bloomberg)

C. Argument for Small-Caps

1. You **expect small-caps to do well** when:
    a. Recession appears less likely
    b. Spreads are lower
    c. VIX is lower
2. **Explanations for the poor performance**:
    a. Smaller companies have **weaker balance sheets** and **higher interest expense**
    b. Weighed down by **regional b**anks
3. **Arguments for small-caps**:
    a. **Forward P/E** of Russell 2000 is ~12, while it's 18.2 for Russell 1000
        i. P/B for 4 to <2 for Russell 1000 to Russell 2000
    b. Outside of the tech bubble, small stocks have never traded at such a deep **discount to tech**. (Bloomberg)

D. TINA is Dead

1. **There is an alternative** with a 10-year UST yielding near 5% and cash yielding more.
2. First time this century, the S&P 500 **earnings yield is lower than** the **cash yield**
    a. The earnings yield also lags the 1-yr and 10-yr UST yields.
    b. On a **cash-adjusted basis**, the S&P 500 P/E is elevated at 21.4X vs the historical average of 16.2X. The dividend yield of 1.62% also looks low vs bond yields.
3. For the first time since Dec. 2009, **corporate bond yields** like BBB credits now exceed the forward earnings yield for the S&P 500, making stocks less appealing. (Bloomberg) (Barron's) (Barron's)

II. Rates

A. Last Week

1. UST: 3-month 5.58% (-4bps); 2-yr 5.07 (+3 bps); **10-yr 4.93% (+30 bps)**
    a. 10-yr yield has hit a **16-year high**
    b. Bond investors have lost a lot and volatility has increased.
2. 2-yr yield isn't changing much (so not a reaction to Fed). **Long-term yields rising due to**:
    a. Idea that rates will stay high for longer
        i. Shift of belief from recession to growth
    b. QT
    c. Massive fiscal deficits (Bloomberg)
    d. Less Chinese demand for bonds (trade issues; conflict with US) (Bloomberg)
3. **Breakeven inflation rates have increased** significantly in the past few days
    a. Does the market not believe that we've broken inflation?
4. **High-yield spreads are actually down** for the year, at 4.3%. The median spread since 1996 is 4.7%. (WSJ)
    a. Smaller spreads point to looser financial conditions and a growing economy.
5. The **SPY/TLT trade continues to succeed**.
    a. Core retail sales rose .6% (vs. .1% expected); maybe excess savings aren't exhausted
    b. The Fed may have to hike again
    c. Bond vigilantes (buyers strike) (Bloomberg)

B. Other Ideas about Rates and Bonds

1. **Price agnostic UST buyers are being replaced by price-sensitive buyers**. Foreign governments, US commercial banks and the Fed are being replaced by hedge funds, mutual funds, insurers and pensions.
    a. Japanese investors face a steep hedging cost to buy USTs.
    b. US commercial banks have been selling Treasuries amid steep declines in deposit balances. (Bloomberg)
2. The **term premium** could be impacted by inflation volatility, real rate volatility, and the supply of bonds.
    a. Some investors are concerned about rising real rates because it could indicate that rates are not increasing due to a stronger economy and fear of higher rates. Rates could be rising due to something harder for the Fed to control. (WSJ)
3. With the **ballooning of the Treasury market**, the Fed needs to stand ready to loan money against Treasury bonds. This way, you won't have panic selling. (Bloomberg)
4. Continued **tightness in the labor market** with unemployment claims < 200K
    a. Could **push rates higher**
5. On the positive side, **high rates mean lower pension liabilities**. S&P 1500 companies now have their biggest surplus since 2007
    a. State and local pensions are improving, but still in bad condition.
        i. State and local pensions make aggressive pension returns (Bl.)
6. Market is pricing in **0%** chance for a November rate hike and **20%** for December

III. The Fed

A. Powell Spoke on Thursday

1. **FOMC likely to pause**, but **future rate hikes are possible**. Fed is "**proceeding carefully**."
    a. The **2-yr yield decreased** after Powell spoke
    b. "Additional evidence of **persistently above-trend growth**, or that **tightness in the labor market is no long easing**, could put further progress on inflation at risk and could warrant further tightening of monetary policy."
2. Powell suggested that the **increase in long-term UST yields** could allow (at the margin) the FOMC to pause rate hikes so long as recent progress on inflation continues. He said that it was a clear **tightening of financial conditions**.
    a. Powell said the recent surge is mostly due to **rising term premiums** possibly from **fiscal deficits or QT or beliefs in changes in Fed policy**.
    b. Another possibility (not suggested by Powell): bond yields may have increased because they **haven't served as an attractive hedge to stocks**.

(Bloomberg) (WSJ) (Bloomberg) (Bloomberg)

B. Other Fed News

1. Cleveland Fed Pres. **Mester** says that the FOMC is **almost done** raising rates, but she still favors one more rate hike this year. She said that inflation-forecast risks remain tilted to the upside.
    a. Mester said that **higher rates** may be driven by **higher growth expectations**, an acceptance that rates are likely to remain **elevated for longer** and investors demanding **greater compensation**.
    b. She also said that **QT** could continue for **two to 2.5 years**. (Bloomberg)
        i. **Excess reserves** are currently **12% of GDP**. To get it back to 7% (like Sep. 2019), we will have to do two more years of QT. This creates risks in Treasury market. (Bloomberg)
2. Philadelphia Fed Pres. **Harker** thinks that the **FOMC should wait** to consider raising rates again. A lot of refinancing at higher rates has to occur and this will slow economy. (WSJ)
3. Dallas Fed Pres. Lorie **Logan** said that she's **"not yet convinced" that inflation is trending down** to the 2% target, but that higher long-term yields are giving officials time to evaluate data.
4. The **Chicago Fed's Financial Conditions Index** does not show policy as restrictive.
    a. Mortgage rates are near 8%. (Bloomberg)
    b. Monetary policy may not be as tight as we think because firms can still get relatively cheap financing in the bond market (Barron's)

IV. Economic and Other News

A. Labor

1. The **Worker Adjustment and Retraining Notification (WARN) Act** gives 60 to 90 days advance notice in cases of plant closings and mass layoffs. The latest data shows a **significant increase** in recent WARN notices. This indicates that there will be an **increase in unemployment claims**.
2. **Big banks are increasing their hiring** with the thought that banking business will increase once we know that rates have peaked. This is **raising the compensation ratio** for banks (the percentage of revenue that is used for compensation). (Bloomberg)

B. Energy

1. **Brent crude rose 6%** since Hamas attacked Israel. **Europe's** TTF **natural gas** benchmark has surged more than **40%**.
    a. The Israeli energy ministry asked Chevron to stop production at one gas field and an export pipeline that runs to Egypt close to Gaza has been closed.
2. The **risk to the price of oil** comes from **Iran** being involved.
3. There is **no backup supply for natural** gas. We are missing 2MM barrels of oil equivalent from the gas market because Russian pipeline flows are locked out. (WSJ)
4. The **SPR has ~350MM barrels**, its lowest since 1983. We released 270MM barrels over the last two years to cap oil prices. (Bloomberg)

C. Health Care and Child Care

1. The **average employer-sponsored health insurance premium** for US families rose **7%** to almost $24K this year, compared with a 1% increase last year.
    a. The 7% increase is the **largest since 2011**.
    b. **Costs**:
        i. **Individual** health insurance $8,435 total; worker share is $1,401
        ii. **Family** health insurance $23,968; worker share is $6,575
        iii. Insurance premiums are rising faster than salaries
        iv. On average, companies pay **71%** of the family coverage premium.
    c. Approximately **153MM** people get health insurance through their employer.(WSJ) (Bl.)
2. Average monthly payments for **child care** in September were **32% higher than the 2019** annual average.
    a. In **NYC**, the average price of infant care is **$45,490** per year. This is ~16% higher than the **national average of $39,270**.
    b. Costs could rise as an estimated **70,000 centers are likely to close** now that $24B in government aid has dried up. (Bloomberg)

D. International

1. **Qatar** has good relations with Iran and Hamas and does sensitive hostage diplomacy for the US. They've been working to get the release of ~200 hostages taken to Gaza and they're also working to prevent a second, northern front from opening up with Hezbollah. Qatar hosts the largest US military base in the Middle East. (Bloomberg)
2. **Chinese jets** are harassing US jets flying over the East China Sea and South China Sea.
    a. There have been over 180 close encounters in the past two years. (WSJ)
3. Beijing has clashed with India over land border claims, swarmed jet fighters and warships near Taiwan and triggered confrontations with Philippine coast-guard ships.