MARKET UPDATE

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October 30, 2023 – Market Update

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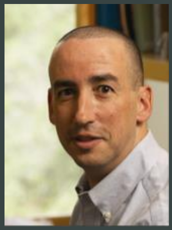

I. Stocks

A. The Past Week

1. DJIA -2.1%; **S&P 500 -2.5%**; Nasdaq -2.6%; markets at lowest levels since April
    a. The DJIA is down 2.20% YTD
    b. S&P and Nasdaq are now in **correction** territory (down 10% from high)
    c. S&P 500 below 200-day moving average (stockcharts.com)
        i. Less than 25% of stocks are above their 200-day moving average
    d. S&P **market-cap** index outperforming **equal-weighted** by widest gap in over 30 years; Russell 2000 back to Oct. 2022 lows.
    e. The **VIX** is back above 20. (Bloomberg)
    f. May have seen some **mutual fund tax-loss selling** this week
2. **Q3 earnings** are up **2.7%** YoY so far (vs. -.3% expected). Revenue growth is 2.1%. 78% have beaten expectations. 62% have beaten sales expectations.
    a. Companies are beating expectations by 7.7% (FactSet)
    b. Companies that have **missed have been treated harshly** – avg. decline of 5.5% (five-year average of 2.3%)
    c. Companies with more foreign revenue are doing worse (strong dollar).
3. **Bearish arguments:**
    a. **Earnings** have been **underwhelming** – tech had high expectations
        i. Guidance has been lackluster due to macro uncertainty
        ii. **Q4** S&P 500 earnings growth **expectations down nearly 350 bps** since end of September
    b. **High interest rates**; elevated bond **volatility**
        i. **MOVE** index seems to behave inversely with S&P 500
        ii. **Strong GDP report** could result in rates staying high for longer
        iii. Growth headwinds from **tightening of financial conditions**
        iv. Lower rates on Thursday did not help stocks
    c. **Tech valuations** still high; Nasdaq 100 P/E of 22
        i. Waning interest in AI (Bloomberg)
    d. **Middle East tensions** rising with Iranian-backed militias attacking US personnel
4. **Bullish arguments:**
    a. **Bond market stabilization** with 10-year yields back below 5%
    b. **S&P 500 EPS +2.7% YoY** with -.3% expected
    c. **4.9% GDP growth** shows consumer resilience
    d. **UAW** reached tentative agreement with **Ford and Stellantis**
    e. House elected a **Speaker**
    f. **China** added economic support
    g. Oversold conditions – 2σ below 50-day moving average
5. **Week ahead:**
    a. **FOMC meeting** (Wednesday announcement)
    b. Q3 earnings announcements continue
    c. Other: **Employment Report**, ECI, JOLTs, ISM (Manufacturing and Services)

B. Observations About the Market

1. **Small-caps** back to **pre-pandemic** level, while the **top 50 stocks** are up 50%.
    a. US **large-caps locked in rates** for much longer than small-cap companies.
    b. Over **30% of Russell 2000 companies aren't profitable** – so how do they pay higher interest?
2. **Junk spreads** are rising (now 400+ bps above USTs)
3. **Banks are tightening lending standards** for small and medium-size companies.
4. A lot of **corporate debt comes due** in coming years (peaking in 2026)
5. Interest payments are increasing for **consumers** (Bloomberg)

C. A Macro-Driven Market

1. In four of the first six trading days of the earnings season, **at least 400 members of the S&P 500 moved in the same direction**. Macro factors are driving the market.
2. **Companies beating** EPS and sales estimates have **underperformed by .1%** on average the next day, below the +2-3% (outperformance) historical average. Companies missing estimates saw shares drop 6.2%, much more than usual.
3. As of the end of September, only **37% of large-cap active managers were outperforming** benchmarks. (Bloomberg)

D. Dumb Money?

1. Approximately **58%** of American families have stockholdings, including **21%** that own stocks directly (not in funds).
    a. Since 2014, the **average individual/amateur investor has outperformed** the market because they are overweight technology. They are up 150% vs. 140% for the S&P.

    b. Tech makes up ~40% of the average individual portfolio.
2. Over the past decade, **~86% of large-cap equity funds have underperformed** the S&P 500. (WSJ)

E. The Dying Mutual Fund Industry

1. T. Rowe Price, Franklin Resources, Abrdn, Janus Henderson and Invesco oversee **$5T** combined. Since 2018, they have seen over **$600B in net client outflows**.
2. These stocks are mostly **down 30 – 40%** during the past five years while the S&P is up 60%.
3. About 90% of asset manager **revenue growth** since 2006 has simply been from **rising markets**, not net inflows. They have also had to cut fees in order to compete.
4. The firms face a **demographic time bomb** as young investors prefer ETFs. (Bloomberg)

F. Repurchases

1. **Stock repurchases** by US companies were **down 22% YoY** in the first half of the year.
2. The S&P 500 Buyback Index has underperformed the S&P 500 by 10% this yr.
3. High rates stop companies from borrowing to repurchase shares. This is another reflection of **low earnings yield versus a high cost of debt**. (Bloomberg)

II. Bonds and Rates

A. Rates

1. UST: 3-month 5.59% (+1 bp); 2-yr 4.99% (-8 bps); **10-yr 4.84%** (-9 bps)
    a. The 10-year UST yield was near **1.5%** in early **2022**.
    b. We may have seen some **short covering** on Monday (after Ackman's tweet that there is "too much risk in the world" to remain short bonds and the economy was slowing faster than recent data suggests. (Bloomberg)).
2. **Higher yields may reflect** economic resilience, high rates for longer, increased deficit financing needs, a downgrade of the US credit rating, dysfunction in Washington, or supply/demand factors. (WSJ)
    a. The bond market is experiencing a "**vicious cycle**" where rising Treasury supply and QT are pushing long-dated yields higher.
        i. The Fed is shrinking its balance sheet by $720B per year through QT. At the same time, we're running a $2T deficit.
    b. Right now, money is coming from the **Fed's reverse repurchase program**. (Bloomberg)
3. Over the last two years, the **MOVE index** has increased while the **VIX** hasn't.
    a. Long-term bonds have never been so volatile relative to stocks. (Bloomberg)
4. **Mortgage rates** rose for the seventh straight week, climbing to **7.79%** for a 30-year fixed-rate loan. (Bloomberg)
5. **Corporate bonds** pay **6.3%** on average, not seen since mid-2009.
    a. Junk bonds average 9% but spreads are narrow so they aren't cheap.

B. Bulls vs. Bears (on Bonds)

1. **Bearish narrative**:
    a. Positive macro surprises
    b. Sticky inflation (particularly shelter, energy, and goods)
    c. Elevated Treasury volatility
        i. Rising term premia
    d. Risks around BoJ intervention
        i. Spike in yields pushed the yen lower
    e. More debt/deficit and supply concerns
2. **Bullish narrative:**
    a. Bill Ackman closed his Treasury short position
    b. Flows into Treasury bonds (attractive yields; attractive real yields)
        i. Bonds offer a large coupon and the potential for price appreciation.
            1. Recession risk
            2. After final Fed hike, yields typically fall 1% (Barron's)
    c. Potential flight to safety (uncertainty around the world)
    d. Valuations relative to equities (high yields vs. low earnings yield)

C. Regional Bank Lending is Slowing

1. Regional banks are facing a potential **slowdown in business lending** (commercial and industrial loans as well as lending secured by mortgages).
2. In Q3 earnings reports, large regional banks saw a **4% decline in total lending**, as opposed to gains for the mega banks and smaller banks.
   a. Banks cited caution among corporate clients for growth plans given **economic uncertainty**.
   b. From 2010 – 2022, commercial lending grew 4% annually in real terms. (WSJ)
3. **Financial bonds** are underperforming. (Bloomberg)

D. Correlations

1. **Early 2022**: correlations **positive** as Fed began raising rates (stocks and bonds down)
   a. **Early March 2023**: **negative** correlation due to recession fears (banking crisis)
   b. **April – July**: **negative** w/ AI stock boom; emergency rate cut speculation faded
   c. **August: positive**; AI hype ended; Fitch downgraded US, higher for longer
2. At this point, **high inflation** can keep correlations positive
   a. If inflation fades, bonds could rally
3. From 2000 – 2020, correlations often negative with low rates
   a. In the late 1970s, correlations often positive with high inflation
4. **Correlation concerns** can push bonds down further (Bloomberg)

E. Fiscal

1. The 2023 fiscal deficit of **$1.7T** is **6%** of GDP. This was with a strong economy.
   a. Would have been **$2T** and **7.5%** if Supreme Court hadn't invalidated student debt forgiveness (Bloomberg)
2. US total debt is approaching **$34T**, up from $22T in 2019.
3. **Annualized interest expense** on the debt rose to **$981B in Q3.**
   a. CBO expects interest payments to triple as a share of GDP by 2053.
   b. Currently, the Treasury's average cost is **2.92%**.
4. At the **same time** as rising rates, we have a conflict in the Middle East, higher energy costs, long labor strikes, and a potential government shutdown. (WSJ)

F. Texas

1. Texas Attorney General Ken Paxton is reviewing the **energy policies of eight major Wall Street banks**, including JPM, MS, RBC, and WFC. These banks have handled over 25% of Texas' $51B municipal bond issuance in 2023 YTD.
   a. The AG has to approve muni deals in the state.
2. The basis of the investigation is that these companies have given **commitments to cut greenhouse gas emissions.**
   a. Tx enacted laws (2021) restricting Tx governments from working with companies that "boycott" fossil fuels or "discriminate against firearms companies."
3. This could **drive up borrowing costs for Texas municipalities** if it limits the number of banks able to participate in deals. Texas has been the #1 muni bond issuer this year. (Bloomberg)

III. Economy

A. Q3 GDP

1. The economy grew at an annualized rate of **4.9%** in Q3. This is the fastest growth since 2021. Q2 growth was 2.1%.
    a. **Consumer spending** grew **4%** (up from .8% in Q2); accounted for 2.7% of the 4.9%
    b. **Inventories** added **1.3%**
    c. **Business investment declined** for the first time in two years (Bloomberg)
2. **Consumer spending may not be sustainable**.
    a. Real disposable **income** fell 1% in Q3.
    b. Personal **savings** rate fell to 3.8% of disposable income
3. **Residential investment**: +3.9% but could slow with higher mortgage rates. (WSJ)
4. **Positives**: we continue to see strong job growth, real wage growth, and falling gas prices.
5. Economists forecast .9% growth for Q4.
    a. In July, they had predicted .6% growth for Q3. (WSJ)

B. General Economy

1. **PCE** +3.4% YoY, +.4% MoM; core +3.7%, +.3% MoM (Barron's)
2. **6.11% of subprime auto borrowers** are at least 60 days past due on their loans – the highest level since the data started in 1994. Higher prices and higher rates are to blame.
    a. The best borrowers pay **5.07%** interest on new cars and **7.09%** on used. With the worst credit, it's **14.18%** and **21.38%**. (Bloomberg)
3. **37%** households had trouble paying bills in past week.
4. Over half (**57%**) of working-age Americans reported having **difficulty affording medical care** in 2023.
    a. 43% with employer-sponsored plans had trouble and even more with public health plans had problems.
    b. Nearly 40% of Americans reported delaying care or not filling prescriptions due to inability to afford it. (Bloomberg)
5. **12% of 23-year-old women** report every day of their lives is a bad mental health day.
    a. In 2011, about 5% of women under 25 reported mental distress.
    b. 2011 is when the increase started
    c. There is also an uptick happening for young men, but it's not as severe.
    d. This could be affecting the **labor force participation rate**.
6. **China** is increasing their budget and running a 3.8% deficit, the highest since 1994. They typically have a 3% deficit limit. They are fighting problems in the property sector, weak exports and deflationary pressures. (Bloomberg)
7. **Mike Johnson** was elected Speaker of the House after a 22-day vacancy in the position and three failed nominations.

IV. Comments About Trade, Gita Gopinath, IMF, Oct. 25, 2023 (IMF)

A. Introduction

1. **World trade growth is historically low** and growth is projected to decline from +5.1% in 2022 to +.9% in 2023.
2. Global trading systems face **challenges**:
    a. Geopolitical tensions and fragmentation
    b. Industrial policies
    c. Climate change

B. The Problems

1. **Trade policies and the rise in trade barriers**
    a. Trade policy uncertainty and barriers are rising
        i. Nearly 3,000 new trade restrictions were imposed in 2022
            1. **3X** more than in 2019
    b. Foreign direct investment is now increasingly driven by geopolitical preference rather than business fundamentals
        i. Inward- and alliance-oriented policies are often ineffective
2. Rise in **industrial policy** (government intervention)
    a. Use of industrial policies by countries has **surged six-fold** in 2023
        i. Driven by advanced economies for strategic, climate and security reasons
    b. Even if policies are not discriminatory, they distort trade patterns, create negative spillovers, and risk retaliation
        i. Study: when the US, China, or the EU put in place a subsidy measure, there's a **73% chance** that one of the other countries will **retaliate** within 12 months
3. **Fragmentation**
    a. Fragmentation of global trade could cost up to 7% of global GDP
    b. It could exacerbate food security concerns
    c. It could hinder the global green transition (as some critical rare minerals are highly concentrated)
        i. The three biggest suppliers of minerals account for 70% of global production
        ii. We need to cooperate to fight climate change, but fragmentation threatens this

C. Recommendations from IMF

1. Promote **trade openness** and predictability
    a. Address issues like subsidies and tariffs through strengthened trade rules
    b. Secure open markets for services and E-commerce
    c. Restore the dispute settlement system
2. Build **resilient supply chains** (resilient to trade shocks)
    a. Greater diversification of input sourcing across countries
    b. Improve infrastructure, logistics and information systems
    c. Reduce trade costs
3. Increase **transparency and cooperation on industrial policies**