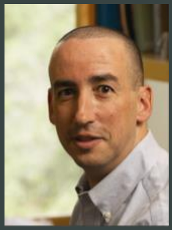

MARKET UPDATE

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October 9, 2023 – Market Update

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I. Stocks

A. Last Week

1. Indexes: DJIA -.3%; **S&P 500 +.5%**; Nasdaq +1.6%
    a. S&P **broke four-week down streak**; markets were oversold
    b. **Treasuries were weaker** with a big curve-steepening move
        i. Rising term premia
        ii. Gnawing concerns about federal deficits
    c. **Stocks have absorbed every blow** this week: higher yields, Fed hawkishness, drama in commodities
        i. The **resilience** comes from a view that the economy remains strong enough for the financial markets to withstand higher borrowing costs
            1. **High rates could be good news?**
                a. Stocks did great (15%/yr) in the 1990s with an average 10-year yield of 6.65% and average real yield of 3.35%.
    d. Huge **intraday reversal** on Friday
        i. Added twice as many jobs as expected – tight labor market?
        ii. Then realized underlying sign of **soft landing** – wages up .2% MoM (best in a year and a half). Wage growth is down to lowest annual growth rate (4.2%) in more than two years (June 2021)
        iii. At first, probability of Nov. rate hike increased, then **<30%** chance
2. **Little fear** in market
    a. **VIX** 17.45 after trading above 20 on Wednesday (highest since May)
    b. 30-day **realized volatility** is more than 30% below its five year average
        i. Has been subdued during the market drop
    c. **Investment-grade spreads** are just 159 bps vs. 370 during the early days of the pandemic.
3. Arguments for **big tech**
    a. Rate increases are likely to slow down
    b. Net income for the Magnificent Seven is expected to rise 20% in 2024 and these forecasts have risen since March
    c. These stocks now trade at 27X earnings for 2024, down from 34 at this year's peak
        i. Their PEG ratio is 1.3 vs 1.9 for the other 493 stocks
4. **What's not working?**
    a. **Small-caps** are weak
        i. Small-caps susceptible to recession; more domestic revenue; and weaker balance sheets
        ii. Equal weighted S&P 500 at support levels
    b. **Utilities** are down ~18% since mid-January
    c. **Emerging markets** hurt by rising dollar (debt; high oil prices hinder growth)

B. Bulls vs. Bears

1. **Bullish arguments:**
   a. Positive economic data supports **soft landing** story
      i. Drop in the price of **oil** helps alleviate inflation worries
      ii. Slight deceleration in **average hourly earnings** in jobs report
      iii. Strong **jobs report**; strong **JOLTS**; low unemployment claims
      iv. **Manufacturing ISM** up for third straight month, highest in nearly a year
         1. Prices paid lower
      v. **UAW** didn't widen strike
      vi. **Discretionary** outperforming staples
         1. Maybe because staples sold off with weight-loss drugs
   b. **Earnings estimates** for Q3 have risen. Q4 earnings expected to be +6.5% YoY.
      i. **Stronger job market** may indicate good earnings
         1. Companies that are confident enough to add to payrolls are more likely to deliver on profit targets (stronger consumer spending)
   c. Treasury selloff is overdone
      i. Treasuries:$158B of inflows YTD
   d. **Fed commentary**:
      i. Chicago Fed Pres. **Goolsbee** said he sees few signs that we're not going to have soft landing
      ii. SF Fed Pres. Mary **Daly** argued that higher rates were equivalent to another Fed tightening
   e. Oversold stock market
2. **Bearish arguments:**
   a. **Disconnect** between high rates and high stock prices
      i. Magnificent Seven too expensive (distant cash flows); AAPL P/E 26 (10-yr average of 18) and MSFT P/E of 27 (10-yr average of 23)
      ii. **Dividend yields** not attractive with high rates
   b. **Lag effects** of rate hikes
      i. Potential financial **accidents:** magnitude and velocity of bond yield surge
   c. Higher rates for longer
      i. High rates could impact **earnings**
         1. For decades, falling interest costs and greater leverage have accounted for nearly one-fifth of an overall 8.8% increase in ROE. Now, rates are higher and leverage may not increase.
      ii. **Rising term premia** due to deteriorating US fiscal position
      iii. Commentary about "**bond vigilantes**" – deficit spending; debt issuance
   d. **Political dysfunction** = increased chance of gov't shutdown (Nov. 17)
      i. Conservative Republicans ousted Kevin McCarthy as Speaker
   e. Services ISM in line, but **lower new orders**
3. What we'll be watching **next week**
   a. **CPI** on Thursday
   b. FOMC minutes on Wednesday
   c. Q3 earnings start – banks on Friday
   d. Univ. of Michigan Consumer Sentiment on Friday

(WSJ) (Bloomberg) (WSJ) (Bloomberg) (Barron's) (Barron's) (Bloomberg) (Stockcharts.com)

II. Bonds and Rates

A. Past Week

1. UST: 3-month 5.63% (+8 bps); 2-yr 5.08% (+5 bps); 10-yr **4.78% (+19 bps)**
    a. **10-yr real yield: 2.47% (+23 bps)** (Bloomberg)
        i. Is this a buying opportunity? (WSJ)
    b. Greece's 10-year debt is yielding 4.36%
2. **Yield curve is dis-inverting**
    a. This happens when a recession is about to start
    b. The yield curve often dis-inverts because shorter yields come down
        i. This would be a **bull steepening** b/c a rise in two year prices (bullish) leads to a flattening (this isn't what's happening)
    c. What we're seeing is a **bear steepening**
        i. The move has been driven by a **fall in the price of long-dated bonds**
        ii. When there's a bear steepener from an inverted curve, a recession often starts
            1. Often followed by significant drop in long-term government bond yields, as well as equity indices (Bloomberg)
3. **Why are rates increasing?**
    a. Expectations of **higher growth**
    b. Huge **federal deficits**
    c. The **term premium** seems to be rising
        i. Greater inflation, inflation volatility with higher growth, tighter labor market, deglobalization, unfavorable demographics, energy price volatility (WSJ)
        ii. Higher rates, more rate volatility, concerns about fiscal trajectory, slower foreign demand for our USTs at same time as we're issuing more
    d. QT
    e. A **muddled message from the Fed** regarding its stance on real interest rates
        i. Do you look at current or expected inflation (Bloomberg)
4. Higher rates don't seem to have impacted the **Magnificent Seven**.(Bloomberg)
5. **Japanese intervention** could send our rates higher
    a. Could be **massive repatriation** of funds (Bloomberg)
6. If **something breaks**, our rates should go lower
    a. A stock market crash could help bonds (Bloomberg)
7. The average 30-year **fixed-rate mortgage** hit 7.49% this week, a new 23-year high. It was 7.31% last week. Also there was a **bigger range** than normal.
    a. Lenders aren't doing well after sales and refinancings plummeted. Some are keeping rates high to try to maximize profit per loan. Other stronger lenders are keeping rates low to bring in more business.
    b. **Adjustable-rate mortgages** made up **8%** of applications last week, compared with 5.6% over the past five years. They are no longer a huge savings. The average rate (fixed for five years) is not much lower than fixed rate. (WSJ)
8. **Who is buying** the government-backed bonds that pool many home loans into investments drives the market price of a standard mortgage.
    a. For years, it was the Fed or big banks or both
        i. Now the **Fed** is trying to shrink its balance sheet
        ii. **Banks** are trying to overcome the effect of rising rates
        iii. They have collectively reduced their portfolios of agency MBS by $207B (WSJ)

B. Bond Vigilantes

1. In 1993, "**bond vigilantes**" sold bonds and pushed the 10-yr UST yield from 5% to 8% ("the Great Bond Massacre"). Then, the government ran a surplus.
2. Now, rates have increased 3% again. Without a crisis, we've still run a **$**1.5T deficit in 11 months. Net interest payments in the coming fiscal year will be $745B
    a. Concerns about domestic politics and the global economic backdrop are pushing yields higher. Remember, **inflation is improving and yields are rising**.
        i. Of the $6.4T of fiscal outlays in 2024, only **$1.85T** is neither mandatory nor net interest. Of that, half is defense spending.
        ii. The increase in yields happened as Fitch downgraded the US, the Treasury increased the size of the auctions, analysts began projecting larger fiscal deficits, and Congress nearly shut down the gov't b/c they couldn't pass spending bills.
    b. 10-year yield diverged from **copper-gold ratio** and **ISM manufacturing** data
    c. If our **tax rate** was the average of developed economies, we'd take in $26T more revenue in the next 10 years. (WSJ) (Bloomberg) (Bloomberg) (WSJ)

C. What We're Afraid Of

1. Higher rates mean **greater unrealized losses** on bonds and loans held by **US banks**, as well as more pressure to pay more to keep depositors.
    a. Banks had $558B of unrealized losses on bonds classified as either "available for sale" or "held-to-maturity." (WSJ)
2. **European yields** have gone higher
    a. **German yields** have increased even though they have slow growth.
3. The **dollar has risen steadily** and this was painful for EMs with almost-$100 oil.
    a. The world is reallocating capital to the US. (Bloomberg)
4. **Pain is ahead** for everyone – remember that the **risk-free rate is the primary building block** for valuing all assets:
    a. **Mortgage rates** above 7.5% on many new mortgages
    b. Higher **government interest**; US interest bill totaled $808B for 11 months through Aug. (was $130B last year).
        i. Europe is also running deficits
    c. Stock market risk. **Equity risk premium** (earnings yield – 10-yr yield) is the lowest in more than two decades
    d. **Weaker companies** will suffer when they have to refinance
    e. Limits on **M&A**
        i. PE acquisitions have fallen 45% this year
    f. **Commercial real estate** valuation has dropped with high yields
        i. Now, loan-to-value ratios have increased and there is more risk of breaching debt terms
        ii. Either have to inject more equity or sell into a falling market (Bloomberg)

III. Other Assorted Ideas (Summary)

1. **Employment report**
    a. Employers added **336K jobs**; most since January; ~2X estimate.
        i. Revisions added **119K** more jobs for July and August
    b. Unemployment rate held at **3.8%;** participation rate stayed at 62.8%
    c. **Wage growth** was .2% MoM, 4.2% YoY; 3-month annualized: 3.2%
        i. Can wage growth be slowing when we see labor pressure (UAW, Kaiser Permanente, etc.) (Bloomberg) (WSJ) (WSJ) (Barron's)
2. **JOLTS**
    a. The number of **job openings** increased from 8.9MM to 9.6MM in August.
        i. **Job openings per unemployed person**: **1.5**. Pre-pandemic average: 1.2
    b. The **quits rate** dropped to 2.3%. This could be a sign of a weaker job market. It could also be affected by high quit rates in the past and the possibility of workers being happier in their jobs.
        i. According to The Conference Board, **job satisfaction** is the highest that it's ever been.
3. The **premium for job switchers** has decreased. That could evidence a weaker job market. (WSJ) (WSJ)
4. **Recession still likely**:
    a. **Soft landing calls** always precede recessions. **Unemployment** could turn up in a **nonlinear** fashion.
    b. Monetary policy operates with **long and variable lags**.
    c. **NBER gauges** are already headed down. (There are six of them.)
    d. **Shocks:** UAW, student bills, oil spike, yield curve, global slump, gov't shutdown
    e. **Excess savings** is done (and consumer spending is coincident or lagging)
    f. **Delinquencies** are climbing
    g. **Credit squeeze** just getting started – Fed's survey of senior loan officers at banks (SLOOS) has good record. (Bloomberg)
5. Larry Summers: **risks to our economy** from bond selloff, China's slowdown, elevated valuations, foreign investors buying fewer of our bonds, bank balance sheets not growing as fast as debt (Bloomberg)
6. Even though Fed has paused, **financial conditions are tightening**: higher real rates, 30-yr mortgage rate higher, investment grade yields are higher
    a. Drop in inflation also makes **effective rates** higher (Bloomberg)
    b. **Higher yields** may be doing some of the Fed's work for them. But, the Fed still needs to see a period of below-trend growth. (Bloomberg)
7. Fed stopped using **money supply** to predict inflation in 1993. But, BIS research says that the relationship may be valid in periods of high inflation.
    a. The key may be when the **money reaches the consumer** (fiscal policy) (WSJ)
8. Some investors want **China** to take action and allocate developer losses to banks, developers and other stakeholders. Recapitalize strong competitors.
    a. **Home sales** dropped 29% YoY
    b. Individual mortgages are a big part of Chinese bank loans
        i. NPLs are increasing
        ii. Banks have done a good job of reserving for losses
    c. Land sales were 38% of local government revenue in 2021 (WSJ) (WSJ)
9. **Ukrainian support** in the Senate is bipartisan. Many House Republicans don't support it.