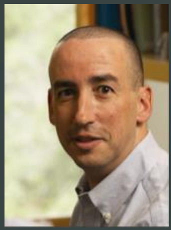

MARKET UPDATE

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September 11, 2023 – Market Update

Table of Contents

I. Stocks, Bonds, Oil, and Commercial Real Estate

A. Stocks

1. Last week: DJIA - .75%; **S&P -1.29%**; Nasdaq -1.93%
    a. S&P 500 is up **16% YTD** despite recession fears, higher rates, a mini-bank crisis
    b. S&P 500 is just **8%** away **from an all-time high** (Barron's)
    c. S&P 500 and Nasdaq dropped **below 50-day moving averages**
    d. **Small-caps** are **underperforming**
2. **Nasdaq** 100 trades at **27X** earnings and nearly **5X** sales
    a. Nasdaq 100 has added **$5T** of value YTD
    b. AAPL, AMZN, META, GOOGL and MSFT are mature companies (slower growth)
        i. Their collective **net income fell 9%** in past four quarters
    c. 20% of large-cap active funds now has more than 40% in the magnificent seven
        i. This was 12% last year (Bloomberg)
3. **Positive** news this week:
    a. Better economic news = **soft landing**
        i. Better-than expected **August ISM Services** report
        ii. Initial **jobless claims** lowest since February
    b. **WMT** lowered starting **wages** – disinflationary (weaker labor market)
    c. **Belief** that **Fed is done** raising rates
        i. Several Fed officials signaled no raise in September (but Dallas Fed Pres. Lorie Logan said that this wouldn't mean they were done)
    d. **Capital markets** are open
        i. High corporate debt issuance (but this pushes rates higher)
        ii. Upcoming wave of tech IPOs
4. **Problems** this week:
    a. "**Good news is bad news**" – strong economic data scares investors about Fed
        i. A sign of belief in disinflation and soft landing narratives
    b. **Higher rates** and **stronger dollar** are a financial tightening
        i. **10-yr UST yield is .79X the S&P earnings yield**, more than double the .37X average from 2009-2021.
        ii. Estimates of **r*** are rising (Bloomberg)
    c. **Higher oil prices** could be inflationary (airlines warned about fueld costs)
        i. Also stories about higher insurance costs (auto, property, health)
    d. **Beige book** warnings: slowing retail spending ex autos, higher delinquencies on consumer credit and lines, and maybe spenders have exhausted excess savings
    e. Continued fears about **CRE**
    f. Concern about extreme **complacency** (per JPM)
        i. **Low VIX**, positioning is increasing, FOMO
        ii. High multiple (low earnings yield) vs. high real rates (Bloomberg)
    g. **Chinese ban** on iPhone use at gov't agencies
5. **Issues to worry about**: if US-China tensions deteriorate, a UAW strike, a rise in defaults

B. Bonds and Rates

1. 3-month 5.55% (+2 bps); 2-yr 4.98% (+11 bps); 10-yr **4.26%** (+8 bps)
2. **Fed** has now lowered their bond holdings by **~$1T**
    a. Will this continue to be painless as the Treasury has to issue more debt
3. At least 40 companies issued **investment-grade debt** on Tuesday. About half of those deals, worth **~$38B**, were in the US (Bloomberg)
    a. Paid an average of **5.7%** (highest since GFC)
        i. Coupon is ~2% higher than the average debt that they're refinancing
    b. **Spreads** are still low (strong economy)
    c. Shows resignation that **rates aren't going lower**
    d. High yields + high valuations = limited M&A
        i. Global M&A down 40% YTD
4. Six **leveraged loans** issued this week ($9.3B)
    a. Higher rates will hurt profits and result in more cash burn (WSJ)
5. Higher rates are keeping the **dollar stronger**
    a. Dollar has rallied eight straight weeks (longest streak since 2005) – based on:
        i. Strong US growth
        ii. Idea that Fed will keep rates higher as we have soft landing
        iii. Weakening momentum in China – US is safe haven
        iv. Euro under pressure from slower growth (Bloomberg)
    b. A little **strange** since other central banks are more likely to raise rates (Bloom.)
        i. Japan warned against weak yen and threatened to intervene

C. Oil

1. WTIC was up ~$2 to **$87.51**
    a. National average for a gallon of regular gas $3.81 (Bloomberg)
    b. Higher oil prices can often lead to **higher 10-yr yields** and **lower stock prices** (Stockcharts.com)
2. **Saudi Arabia and Russia** extended their production cuts for three months
    a. Maybe this indicates that **China is growing slower** (WSJ)
3. At same time as cuts, **demand is climbing** toward record levels
    a. Many OPEC members are suffering output losses due to underinvestment
    b. Clearly, Saudi is trading volume for price (Bloomberg)

D. Real Estate

1. If banks **cut lending**, prices will drop and losses will increase
2. Banks doubled their lending to landlords from **2015 – 2022 to $2.2T**, but there could be much more. They also lent to financial companies that made loans to landlords
    a. This **indirect lending** could bring exposure to **$3.6T**.
    b. Holdings of CMBS, loans to mortgage REITs and other nonbank lenders account for ~18% of the $3.6T
3. Banks with less than $250B in assets hold ~3/4 of all CRE loans
4. **~$900B** of real estate loans and securities must be paid off or refinanced by end of 2024
5. Commercial property **sales were down 74%** in July (WSJ)

II. Economy

A. News About the Fed

1. Fed officials are becoming **increasingly confident** that they can engineer a **soft landing** and this is why they are nervous about tightening rates too much. The PCE price index rose only .2% for each of the last two months. (Bloomberg)
2. **SF Fed research** found that **rate increases reduce potential economic output for at least 12 years**. This conflicts with traditional theories of national economies that assume policy is neutral in the long run.
    a. They believe that these long-run effects develop primarily through **investment decisions** that ultimately result in **lower productivity** and lower capital stock. (Bloomberg) (SF Fed)
3. The Fed has **reduced their System Open Market Account by $1T to 7.4T**. The Fed is letting up to $60B of Treasuries and $35B of MBS roll off their portfolio each month. The private sector has been happy to buy the Treasury bills. (Bloomberg)
4. Fed officials may need to **double their 2023 growth projections** in the September SEP. In June, they had a 1% expectation for 2023 GDP growth.
    a. This could also scale down the 2024 easing from 100 bps to 75 bps. (Bloomberg)

B. Inflation

1. **Rising inflation helps profits** in two ways (and now we may be seeing the opposite):
    a. Revenue grows faster than labor cost
    b. Existing inventory can be sold for more (WSJ)
2. As of July, just **53%** of CPI categories by weight were inflating at a greater-than-4% annualized rate, **down from 73%** in June 2022. (Bloomberg)
3. Costs for **employer-covered health insurance** are expected to increase **6.5%** in 2024. Plans already cost $14,600 per employee.
    a. Companies cite hospitals' **higher labor costs** (e.g., nurses) and heavy demand for **new** and expensive diabetes and obesity **drugs**
    b. Because the labor market is tight, employers are expected to take on the majority of this increase
    c. Health-coverage costs had been increasing slowly due to the pandemic (fewer doctor and hospital visits) (WSJ)
4. After declining on a YoY basis for five consecutive months (the longest run of declines in 11 years), **US home prices rose in July**.
    a. The national median **existing-home sale price** rose 1.9% YoY to **$406,700**
    b. **Sales** of existing homes are **down 36%** since Jan. 2022
    c. **Active listings** were **down 7.9% YoY** and **46%** from Aug. 2019. (WSJ)
5. A new Zillow survey found that **83% of US homebuyers are factoring in climate risks** when they shop for a new house. This means that they weighed at least one risk, such as floods, extreme temperatures, wildfires, hurricanes or droughts. (Bloomberg)
6. Economists from the Federal Reserve said that the **US automobile industry** faces some of the highest **supply-chain risks** due to geopolitical factors and sourcing of electronic components. (Bloomberg)

C. Other Stories About the Economy

1. The **ISM US Services index** rose to a six-month high in August – hitting **54.5**. Unfortunately, similar to the manufacturing index, the **prices-paid component** moved in the wrong direction (higher prices). (Bloomberg) (Bloomberg)
2. **Real wage growth** is positive right now.
3. The **job switcher's premium** is currently small (meaning a weaker labor market) (Bloomberg)
4. **46%** of consumers used "**buy now, pay later**" in 2023.
5. Nearly **8MM Americans work in retail**. The annual turnover for part-time employees (who make up the majority of the in-store work force) is **~95%.**
    a. Nearly 80% of retailers have seen an increase in "guest-on-associate" violence.
    b. Annual apprehension of shoplifters climbed more than 50% in 2022.
    c. From 2006 to 2022, the median wage for retail salespeople rose 55%, while US workers overall saw a 52% gain. They still make much less than average. (Bloomberg)
6. McKinsey Global Institute estimates that pandemic shifts (WFH) could erase as much as **$1.3T of real estate value** in big cities around the world by 2030. (Bloomberg)
7. **Household wealth** increased by $5.5T to $154.3T during Q2. Real estate was up $2.4T and stocks added $1.7T.
    a. Net household wealth to income is just below a record 400%.
8. In the past five years, **EVs** have gone from 2% of new car sales in **California** to 22%. (Bloomberg)

D. China's Problems

1. Bloomberg is now forecasting that it will take until the **mid-2040s for China's economy to overtake the US's GDP**. Even then, it will happen by a slow amount before falling back behind.
    a. Their economy is expected to slow **3.5%** in 2030 and **1%** in 2050.
        i. US growth should slow to 1.5% in 2050.
    b. China's growth has slowed with **fewer exports** and a significant **real estate slump**.
    c. China has had their first **population drop** since the 1960s.
    d. **Regulatory crackdowns** have hit confidence, as have **geopolitical tensions** with the West. (Bloomberg)
    e. More than 20% of **young people** are unemployed
    f. China's **debt-to-GDP** ratio has overtaken the US (Bloomberg)
2. China's **offshore junk bonds**, most of which were issued by builders, have lost more than **$127B** in value since peaking 2.5 years ago.
    a. Global investors are becoming more alarmed by **governance and disclosure** practices (and this could impact future financing). (Bloomberg)

III. "The Major Challenges in US Monetary Policy," **Atlanta Fed Pres. Raphael Bostic, Aug. 31, 2023**

A. Background

1. Bostic believes that **policy is appropriately restrictive**. He suggests **caution is in order**, lest we risk tightening too much and inflict unnecessary economic pain.
2. In 2020, the **US lost 22MM jobs** in two months. In Q2 of 2020, **GDP contracted 30%.** Americans **binged on goods** and production was operating on hyper-efficient designs with **just-in-time** supply chains. **Factories** started operating on limited hours and **ports** and transportation systems were limited and overwhelmed. At the same time, **fiscal expansionary policy** was sending money to people and the FOMC was cutting rates.
    a. Employment rebounded quicker than expected. It took longer than expected for supply and demand to return to longer-term trends. Inflation ensued. The FOMC raised rates.

B. The Outlook for Inflation is Positive

1. **July headline CPI** was **3.2%** and **core** was **4.7% YoY**. These are down from nearly 9% and 7% respectively.
    a. In **July**, core rose at an annualized rate of only **1.9%** (same as June). Had been growing at 5% annualized rate in first five months.
    b. **Without housing** services, **core CPI** would have been **2.6% YoY** and just **1.1%** over **past three months**. Housing data lags, so inflation may be close to target.
    c. After **excluding food, energy and shelter**, **Sticky Price CPI** has risen at an annualized rate of **.8%** over the past three months.
        i. This includes things like personal care services, trash collection, medical care services, shelter and education.
        ii. Sticky prices are slow to change (slow to respond to economy), so they may show embedded expectations (good forecast of 2 – 3 years).
    d. Over past three months, just **35% of CPI rose 5% or more**. Higher than pre-pandemic 15% - 20%, but in July 2022, it was 80%.
2. **Atlanta Fed's Business Inflation Expectations (BIE)** survey of 200 US companies shows **fewer firms say they plan to continue raising prices** and those that will raise prices will raise them by smaller amounts.
    a. **72%** said they increased prices; avg **7%** increase in 12 months through May 2023
    b. For the year ahead, **57%** expect to raise prices; average is **4%**
3. **Survey of Business Uncertainty**: **sales growth expectations dropped** from 5% to 3%
4. **Job growth is slowing** in the employment report and numbers continue to be revised down. It may be **slowing even faster** than the headline numbers suggest b/c growth in total hours worked has slowed more than growth in employment (b/c more p/t work).
5. SBU says **employers plan to raise wages an avg of 3.6%,** down from 5.2% last yr.
    a. We're likely to see some real wage growth with firms absorbing margin contraction
6. Still **tremendous uncertainty**: don't have historical models to guide us through pandemic shock; lingering effects of Covid, heavy corporate and gov't debt, war in Ukraine, other possible geopolitical shocks abroad and at home, extreme weather events.
    a. Also **watching CRE** (particularly offices due to WFH, higher rates, lower occupancy).
    b. Housing affordability is problem. Banks navigating high rates.
        i. Have to watch high rates and effect on CRE, housing and banks.