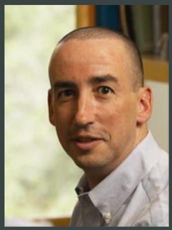

MARKET UPDATE

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September 18, 2023 – Market Update

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I. Stocks

A. Last Week

1. For the week: DJIA +.1%; **S&P 500 -.2%**; Nasdaq -.4%; indexes below 50-day MA
    a. It's been a **large-cap rally YTD**; equal-weighted S&P 500 is only up 5.5% YTD
        i. Russell 2000 underperforming Russell 1000 by most since 1998
        ii. 11 months after S&P 500 bottom, only 40% of Russell 2000 are above 200-day MA; after 2020 bottom, 90% were above 200-day MA after 11 months (Bloom.)
    b. **FOMC** meets this week – watch dot plot, 2024 Fed funds rate; r* (higher deficits, QT)
2. After three quarters of YoY **earnings** declines, analysts expect a .5% increase for Q3, and a 1.2% increase for 2023. **Growth may already be priced in** – S&P 500 trading at 18.7X forward P/E (10-yr average of 17.7). P/E was 16.8 at the end of last year. (WSJ)
3. BofA's money manager survey: "**avoid China**" has become a huge theme. Chinese real estate is now seen as the number one source for the next global credit event.
    a. In Feb., 78% thought China's growth would increase in near future. Now, it's 0%.
    b. In **US**, 74% see a soft or no landing; 21% expect a hard landing. 53% expect a weaker US economy in the next 12 months, vs. 45% in August. (Bloomberg)
4. The **equity risk premium** (ERP) moves around a lot. In 2001, for 10 years, stocks underperformed by 1.1%. In the following decade, stocks outperformed by 11.1%.
    a. A **high Shiller PE** is like a **low implicit ERP**. This will only make sense if inflation will be tame and bond yields will come down. (Bloomberg)
5. Over the **past 22 years, large caps have outperformed small caps** in the US, but not elsewhere. The 10 largest companies now account for more than 1/3 of the S&P 500. Russell 2000 has consistently traded at ~2X BV; Top 50 index has traded around 6X BV.
    a. Smaller companies use **more debt** and more floating rate debt. So higher rates are already affecting them (while larger firms locked in rates).
    b. In 2025, more large firms will have to refinance. Small firms could be in bad trouble if rates stay high. (Bloomberg)
6. **Energy sector** has been the top performer of the 11 S&P 500 sectors Q3 (so far): up 13.35% vs. S&P 500 +.37%. Reason: Saudi + Russia production cuts; belief in US soft landing. (WSJ)

B. Reasons for Optimism

1. Peak Fed funds rate?
2. Core CPI continued to drop – disinflation, but energy costs are increasing
3. ECB had a dovish rate hike
4. Possible improvement in China recovery expectations (stimulus)
5. High short sales means that a move up could lead to a lot of short-covering

C. Bearish Points

1. 2-yr yield back above 5% (higher Fed funds rate for longer)
2. Fear that FOMC meeting will reveal higher r* estimates and higher 2024 Fed funds rate
3. Waning disinflation (CPI and PPI higher than expected b/c of energy)
4. Higher energy cost resulted in profit warnings from airlines
5. UAW adds to economic uncertainty – targeted strikes at all three big US automakers
6. High valuations
7. California unemployment rising faster above the rest of the country (VC is rate sensitive)

D. Arm IPO

1. Arm doesn't make chips, but supplies chip makers with essential **circuit designs**. Founded in 1990, it focused on the nascent mobile-phone market in its early years and became a dominant supplier to that industry.
    a. The company's circuitry is in more than 99% of smartphones, but it is seeking to make inroads in areas where it is less dominant, including computer networks, cloud-computing and the automotive industry. (WSJ)
    b. Year that just ended: $2.68B of revenue; $524MM of net income
2. Arm surged **25%** to $63.59 giving the company a valuation of nearly **$69B**.
    a. SoftBank acquired it for **$32B** in 2016
        i. It acquired 25% from its Vision Fund at a **$64B** valuation
    b. Softbank almost sold Arm to NVDA for **$40B** in Nov. 2021 (WSJ)
    c. SoftBank raised **$5B** through this IPO
3. Arms oversubscription was a reflection of the **small number of shares sold**. From 1980 – 2022, the average IPO floated **29%** of the shares. If a company only floated 20%, that put it in the bottom 25%. Arm only floated **10%**. SoftBank will still own **90%**.
4. The 28 investment banks will share **$100MM** in fees. Barclays, GS, JPM and Mizuho each get $17.5MM. To give you perspective, banks have collected **$323MM** in IPO fees YTD.
    a. The banks will have to make a new $8.5B loan to SoftBank. It will be backed by 75% of SoftBank's stake in Arm. (Bloomberg)
5. **Listing in New York** was a harsh blow to the London Stock Exchange. SoftBank liked the deeper investor base and the more attractive valuations (Bloomberg)
6. Instacart and marketing and data automation provider Klaviyo are also ready to IPO (Bloomberg)

E. 0DTE options

1. **Option volume** has already surpassed last year's record average daily volume
    a. **~44MM** contracts change hands each day (+8% YoY)
2. Shorter-dated options, expiring in **five or fewer days**, accounted for about **half** of all options-market activity in August
    a. It was **1/3** three years ago
    b. This year, **~40%** of all option trading was in **0DTE**
3. **Individual investors** made up **27%** of all activity in options as of June
    a. It was 23% in the start of 2020
    b. For **0DTE S&P 500 options**, **individual investors** made up **~1/3** of all trades
        i. Mentions of 0DTE options have exploded on social media
4. A London Business School study estimated that most individual traders lost money
    a. Between Nov. 2019 and June 2021, **individual investors lost ~$2.1B**
5. **Brokerage firms** made 2X as much from option trading last yr as from stocks (WSJ)

II. Rates and Currencies

A. Rates

1. UST: 3-month 5.56% (+1 bp); **2-yr 5.02%** (+4 bps); **10-yr 4.33%** (+7 bps)
    a. The three-month / 10-yr **inversion** is the longest since 1962 (212 days) – when Bloomberg started tracking this
2. Even with a slightly higher-than-expected CPI report, investors **don't expect a rate change** in September
    a. A rate hike by the end of the year is a 50-50 issue
    b. Investors are pricing in three or four cuts next year
        i. Surprising – unless we see inflation lower or growth slow
3. Higher rates have actually helped some of the largest, most secure companies
    a. They had locked in low rates
        i. They have cash that is being invested at higher rates
    b. This blunts the impact of tighter Fed policy
        i. The pain falls on the weaker companies w/ variable rate debt
        ii. Junk bonds also tend to have shorter maturities (WSJ)
4. Overall **loan growth** at US banks has been 3.6% on an annualized basis in Q3, well below the long-term average of 7%
    a. Combination of weaker demand and bank fear about lending to certain sectors
    b. Banks may also worry about the stability of their deposits (WSJ)
5. The **ECB may be done with tightening**
    a. Christine Lagarde: "With today's decision, we have made sufficient contributions, under the current assessment, to returning inflation to target in a timely manner."
    b. They cut growth forecasts
        i. The problem is that inflation expectations are still high

B. Currencies

1. The **strong dollar** is **hurting** US companies with **foreign earnings**
    a. S&P 500 companies that derive more than half of their revenue outside the US are on pace to post an 18% drop in Q2 earnings
        i. Companies with more than half of their sales in the US will have 4% earnings growth
    b. Rising confidence in a **soft landing** has led to the idea of higher rates for longer and this has pushed the dollar higher (WSJ)
2. The **yen** has been weakening to close to 150 yen per dollar
    a. This is where the BOJ intervened last year (first time since 1998)
        i. Japan has $1.25T in foreign reserves
    b. Weak yen raises cost of food and energy
3. Weak yen may be justified by **5.38% difference** between the Fed funds rate and the BOJ policy
    a. BOJ said that ending negative rates may be option if inflation and wages keep rising (Bl.)
    b. There is some question as to whether the BOJ would raise rates prior to ending **yield curve control** (where they cap the 10-year yield on the JGB). (Bloomberg)
4. China's policy easing has weakened the **yuan** (16-year low), but the PBOC is trying to push their currency higher. They have drained yuan liquidity in the offshore market
    a. They have also **limited gold imports** to reduce money outflows
5. Strong dollar causing **inflation in EMs**; also harder to pay back **dollar-denominated debt**
    a. IMF says EMs no longer growing faster than advanced economies (Bloomberg)

III. Inflation

1. **Headline CPI** rose **.6% MoM** (**3.7% YoY**)– the fastest rate in more than a year (since inflation peaked in June 2022). More than half of the increase was due to higher gas prices. **Core** prices rose by **.3%** (accelerating for the first time since Feb.) and **4.3% YoY** (vs. 4.7% last month). Increase was due to airfares and vehicle insurance, among other things (services).
    a. **Gas: +10.6% MoM**; the largest one-month increase since June 2022
    b. Higher energy costs can feed into transportation services and other items. (WSJ)
    c. **Core: 2.4% annualized** rate over past **3 months** (was 5% during prior 3 months).
    d. The **supercore** – services excluding housing – improvement has stalled (Bloom.)
        i. **+.4% MoM; +4% YoY** (Bloomberg) (Bloomberg)
    e. The slightly higher-than-desired inflation numbers may result in a different tone at the **Fed's press conference** or in the **SEP.** (Bloomberg)
    f. Oil production cuts, the UAW strike, and recent labor contracts in the airline and healthcare industries and with UPS, could all add to inflation.
2. A NY Fed study: median one-year-ahead inflation **expectations** rose slightly last month from 3.5% to **3.6%**. Expected inflation in three years: **2.9%** (-.1%); five years **3.0%** (+.1%). (Bl.)
    a. **Energy** tends to have a big impact on **short-term inflation expectations**. (Bloom.)
3. The US stopped Russia from driving oil prices higher last year by releasing oil from the **SPR**. Reserves are too low to do that again. Saudi Arabia is trying to show the US that they don't need us – buying golf and soccer and they are cutting the supply of oil.
4. **Diesel, jet and marine fuel** prices are soaring – these heavy fuels have risen > WTIC
    a. Jet fuel has risen the most – China eased travel restrictions
    b. More easily made from the more dense Russian and Middle Eastern crude (WSJ)
5. Higher oil prices should be thought of as an **exogenous shock** rather than trying to explain it with supply and demand. Higher oil prices are like a **tax hike**, taking money from consumers and businesses and lowering demand. This could **raise inflation**.
6. Premiums for **insurance required by mortgage lenders** in order to make a loan for apartment building owners have increased three-to-four-fold over the last five years. This is due to **climate change and different rankings for the risk of crime**. These increases have been particularly serious for builders of affordable housing (which have capped rents). Evictions have become more difficult and that creates greater risk. (Bl.)
7. A Fed paper argued that **greedflation** is not real. The author said that once the huge fiscal and monetary support provided to the economy is accounted for, "corporate profit margins were not abnormally high in the aftermath of the Covid-19 pandemic." (Bl.) (Fed)
8. The WSJ reported that **pharmacies** are selling some generic drugs for ~25X higher than what the manufacturers charge. Companies like CVS Health and Cigna run **pharmacy benefit managers**. Some of these PBMs run pharmacies and steer customers to using their pharmacy to fill prescriptions. (WSJ)
    a. Result: high deductibles and other out-of-pocket costs for people on fixed incomes.
9. The **UAW** negotiates a new contract every four years on behalf of 150K workers
    a. UAW wants **~36%** over four years; automakers offering **17.5% - 20%** over 4.5 yrs
        i. Analysts expect 25% - 30%
    b. The Detroit Three have total labor costs of **~$64** per hour
        i. $55/hour at non-union assembly plants of internat'l mfrs (e.g. Toyota)
        ii. Labor costs at Tesla are $45 to $50 per hour (Bloomberg)
    c. Strike will put pressure on inventories and could drive car prices higher

IV. Other Economic News

A. Fiscal Policy

1. The **federal deficit** is expected to be more than **$1.5T** (~6% of GDP).
2. Federal debt has climbed from **33%** of GDP in 2001 to **97%** in 2022. It is expected to be **115%** in 2033. (WSJ)
3. Pres. Biden has promised to avoid raising taxes on anyone making under $400K. This rules out rethinking provisions that account for **~2/3 of the cost of the 2017 tax cut**.
4. Both parties seem to agree that Social Security and Medicare can't be touched. They are the two largest spending programs. We seem willing to cut taxes, but not spending.
5. The **effective tax rate** (federal taxes as a percentage of income) on the middle 60% of the population fell from **19%** in 1979 to **14%** in 2019.

B. Assorted Stories

1. U.S. banks held more than **$1.2T in brokered deposits** in Q2. This was an **86% increase** YoY. These are more expensive funds and can trigger liquidity risk. (WSJ)
2. **Mexico** is the U.S.' largest trading partner. But, many new businesses in Mexico are run by **Chinese firms** that are looking to avoid US tariffs. (Bloomberg)
3. While the American consumer will have **student debt** payments restarting and they are running out of **excess savings** and their **savings rate** has dropped to 3.5%, it's not all bad. **Household net worth** is near record high levels due to high home values. In Q2, household net worth stood at **7.75X disposable income**. Two-thirds of households own homes. (Bloomberg)
4. In 2022 dollars, **Americans' household income fell 2.3% in 2022**, from $76,330 to $74,580. The total **drop since 2019 is 4.7%.**
    a. By **race**: Asian $108,700; White $81,100; Hispanic $62,800; Black $52,900
    b. **Median earnings per worker** fell 2.2% to **$48K**. For **full-time workers**, it fell 1.3% to **$60,100**.
    c. The female to male ratio for full-time workers was 84%
    d. A household in the 90th% received **12.6X** as much as the 10th%. It was **13.5X** in 2021.
    e. The **top 20%** (>$153K) collected 52.1% of household income. The **top 5%** (>$295K) collected 23.5%.
        i. Households earning less than $58K took in 11.2% of all income.
    f. The national **poverty rate is 11.5%.** For a family of four, this is income <$30K.
    g. **7.9%** of Americans don't have **health insurance** (WSJ)