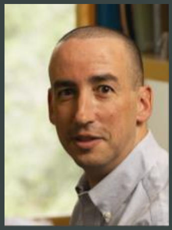

MARKET UPDATE

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September 25, 2023 – Market Update

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I. The FOMC Meeting Drove the Markets

1. The FOMC held the Fed funds rate steady at **5.25% - 5.50%**. It was a **hawkish pause**.
2. Key points from the **Summary of Economic Projections** (**SEP**) (Federal Reserve):
    a. Increased **GDP** forecast for 2023 to 2.1% (was 1.0%) and 2024 to 1.5% (was 1.1%)
    b. **One more rate hike this year** (12/19 said they thought one more rate increase) – could this be intended to just stop us from asking when they'll cut rates?
    c. Only **two rate cuts next year** (had been four) – 5.125% by end of 2024
    d. **Unemployment** of 4.1% by the end of 2024
    e. **Core inflation** of 3.7% by Q4 and 2.6% by end of 2024. In 2026, 2.0%.
        i. If inflation recedes, the real Fed funds rate is effectively higher.
    f. **Neutral rate** still 2.5% (but slightly higher range) (WSJ) (Bloom.) (Bloom.)
3. For a short time, it felt like Fed officials had shifted from **fear of under-tightening to fear of over-tightening**. Now, it feels like they've shifted back. Maybe b/c of oil?
    a. On Friday, Boston Fed Pres. Susan Collins said further tightening "is certainly not off the table," and Fed Gov. Michelle Bowman said that "further rate hikes will likely be needed to return inflation to 2% in a timely way." Bowman might be the dot on the dot plot that is above 6% next year. SF Fed Pres. Mary Daly said that she's not ready to declare victory over inflation. (Bloomberg)
    b. At the same time, Powell said that "the fact that we've come this far lets us proceed carefully" and he used the term "proceed carefully" six times during the press conference. (WSJ) (Bloomberg)
4. **The market doesn't believe the FOMC**. The Fed funds futures is pricing in a 50% chance of one more rate increase this year and a 4.665% rate by the end of next year. (CME)

II. Stocks

A. Market Performance

1. Last week: DJIA -1.9%; **S&P 500 -2.9%**; Nasdaq -3.6%. Worst week since March for S&P and Nasdaq.
    a. The S&P 500 moved **below its 100-day MA** for the first time since March and retested June lows (just above 4,300). Big Tech lost, with TSLA -10.8%, AMZN -8.0%, and GOOGL -5.2%.
2. The **S&P equal-weighted index** has a P/E close to its historical average. Seven companies make the S&P appear expensive. (Bloomberg)
    a. The S&P is well-above its **200-day MA**, but the equal-weighted S&P is below.
3. The **DJIA** is greatly underperforming the S&P. It lacks FANGs. (Bloomberg)
4. **Discretionary** stocks have turned down against **staples**.
5. The driving force for stocks this week was the idea of **higher rates for longer**. (Barron's)
    a. The **yield curve** moved higher – creating particular risk for tech stocks. Realize that tech stocks contributed 59% of the S&P 500's returns through August. **Higher rates** could **hurt** these **high multiple stocks**.
    b. **S&P 500 tech stocks** have a 25.5X P/E. AMZN has a 50 P/E; TSLA is 63.8. (Bl.) (WSJ)
    c. The **Nasdaq 100** is trading at more than 31X earnings. **Real rates** are increasing, yet spreads are remaining low. More consumers will fall behind on payments and more companies will default. (Bloomberg)
6. The **VIX** increased to 17.20.

B. Bullish Arguments

1. Oversold market (almost)
2. Peak Fed
3. Decent IPO headlines
4. M&A activity (CSCO acquired Splunk for $28B cash)
5. Ongoing consumer resilience
6. Additional China policy support
7. Powell said that the Fed would proceed carefully

C. Bearish Arguments

1. Higher rates for longer / hawkish Fed
    a. Powell acknowledged neutral rate may be higher
    b. Friday's hawkish comments from Bowman and Collins (discussed above)
    c. Initial jobless claims fell to eight-month low (strong labor market) (WSJ)
2. Weaker tech momentum (leadership)
3. Margin pressure from energy costs and Fed's goal to have below-trend growth (WSJ)
4. Weaker economic growth – housing market; UAW strike; gov't shutdown likely; Markit PMI

D. IPOs and Acquisitions

1. **CART** priced at $30, opened at $42 and closed the week at $30. **KVYO** priced at $30, started trading at $36.75 and closed the week at $33.39. **ARM** IPO'd at $51 and closed this week at $51.32.
2. Instacart went public with a valuation of ~$10B. At its peak funding valuation, it was valued at $39B. (WSJ)
3. The **2020 – 2021 IPO class** underperformed the Russell 3000 by 48% in their first 12 months after IPO. The worst performers were those priced at more than 15X sales. Not a single one of those outperformed the market in their first two years. On average, they trailed the market by 84%. (Barron's)
4. Many studies indicate that 70% to 90% of **acquisitions** fail to create value for the buyer. But, acquirers that do frequent, smaller deals may outperform as they develop skill identifying targets and integrating the businesses. (WSJ)

III. Rates, Loans and Currencies

A. Rates

1. UST rates: 3-month 5.56% (+0); 2-yr 5.10% (+8 bps); 10-yr **4.44%** (+11 bps)
    a. The 2-yr yield hit 5.20% intraday for the first time since 2008. (Bloomberg)
    b. The 10-year yield went above 4.5% intraday; this is the highest level since 2007. But, 4.5% is the long-term average, going back to 1790. (Barron's)
    c. The 1.25% Treasury bond due May 15, 2050 is now trading at **48.186**. (Barron's)
2. The **10-yr UST yield**: +56 bps YTD. The **real rate** increased 49 bps to 2.07% and **expected inflation** increased 7 bps to 2.37%. Higher real rates reflect tighter Fed policy. (Bl.)
3. **Junk spreads** (over UST yields) are only 389 bps.
    a. At the start of 2023, high-yield issuers had $878.4B of dollar-denominated bond and loan issues coming due through 2025. Now, it's 542.3B.
    b. There still is not fear of an imminent recession. (Bloomberg)
4. **Leveraged loans** have done well as interest rates have increased but **defaults** (1.55%) are still slightly below the 10-year average. (WSJ)

B. Arguments for Higher Rates

1. Bill Ackman argued that **rates are headed higher**:
    a. Losing the long-term deflationary forces of outsourcing to China
    b. Workers and unions are gaining power
    c. Energy prices are rising (and the SPR needs to be refilled) (Bloom.)
    d. Higher energy costs impact expectations
    e. The transition to green energy will be expensive
    f. High government deficits and debt
    g. The constant threat of default
    h. QT
        i. The term premium was likely reduced by QE. With QT and large debt issuance, it could increase significantly. (Barron's)
    i. The economy is growing above expectations
2. **Other arguments**:
    a. History shows that the **Fed funds rate and the 10-year UST** have tended to peak around the same level. (Barron's)
    b. The **higher neutral rate estimate** in the SEP indicates that rates could be higher forever (not just for a little longer). While the median was still 2.5%, five of 18 Fed officials had it at 3% or higher (in nominal terms).
        i. The neutral rate is impacted by demographics, global demand for capital, government debt, and investors' assessments of inflation and growth risks.
        ii. Factors that could hold it down are that older people buy fewer homes (but will they do reverse mortgages or have to sell to pay for retirement) and the idea that companies could be less capital-intensive.
        iii. Before 2007 – 2009, the estimated real neutral rate was 2% - 2.5%. (WSJ)
    c. Rates will keep rising until something breaks or we have a recession. (Bloomberg)
    d. BoJ YCC exit

C. Arguments for Lower Rates

1. Slower growth, peaking inflation and Peak Fed
    a. Recession fears come from high oil prices (which could lead to more Fed tightening), the UAW strike and the gov't shutdown.
2. **Spreads on BBB-rated bonds** are ~1.48%. The last time that spreads were at their cycle-low, it was right before a crisis and UST yields were at their cycle-high. (Bloomberg)

D. Currencies

1. The **dollar appreciated** .26% for the week.
    a. The **drivers** of the dollar include US economic strength, Europe's underperformance, and China's economic uncertainty. (Bloomberg)
2. The stronger dollar continues to put **pressure** on Japan, China and other countries to defend their currencies. Developing countries are seeing tremendous commodity inflation. (Bloomberg)
    a. The yuan and the yen are both near their lowest levels versus the dollar in more than a decade. The yuan has lost more than 13% since the start of 2022 and the yen has dropped 22%. But China is fighting deflation and the property implosion while Japan is fighting the highest inflation they've experienced in decades.
    b. China has been easing policy and Japan has been largely maintaining easy policy.
    c. US yields are 3.6% higher than the JGB and 1.7% higher than the Chinese bond. (WSJ)

IV. The Economy

A. Soft Landing

1. **Arguments in favor of a soft landing:**
    a. Underlying inflation is looking cooler and the economy is looking stronger. (WSJ)
    b. The SEP sees a soft landing: unemployment rising from 3.8% to 4.1% (2024), growth slowing from 2.1% to 1.5% in 2024, and inflation easing from 3.3% to 2.5% next year. (Bloomberg)
    c. Consumer spending remains strong and the labor market has been steady (maybe moderating?). Maybe this indicates a soft landing, but maybe it indicates that the Fed will have to continue to be aggressive.
2. **Arguments against a soft landing:**
    a. Maybe a soft landing is less likely due to the stronger dollar, higher energy prices and higher interest rates.
    b. On the eve of recessions in 1990, 2001 and 2007, many Wall Street economists proclaimed that we were on the cusp of a soft landing. There are four threats:
        i. The Fed holds rates too high for too long
        ii. Economic growth accelerates
        iii. Energy prices
        iv. A financial crisis (WSJ)
    c. Powell indicated that a soft landing was the goal and a "plausible outcome," it was not his base case. (Barron's)
3. When your **party is out of office**, you think the economy stinks. (Bloomberg)

B. UAW

1. When the strike originated, **13K** workers left the factory floors. This could cost 3,200 vehicles daily. (Bloomberg)
    a. The UAW expanded its strike to **38 GM and Stellantis parts-distribution facilities**. This brought the number of strikers up from 13K to 18K. Workers on the picket lines get ~$500 per week from the UAW's strike fund. (Barron's)
2. **Auto-parts manufacturers** that supply the big carmakers have $38B of revenue at risk. At least 76 publicly-traded companies supply Ford, GM and Stellantis.
3. Workers are afraid of EVs – fewer parts and less labor

C. Oil

1. **WTIC** finished the week at $90.03.
2. Economic strength has led to demand for oil at the same time that Saudi Arabia and Russia are cutting supply. (WSJ)
    a. Higher rates could cool demand. (Bloomberg)
    b. Demand might be overstated as China imports cheap Russian oil and is importing more than they need. (WSJ)
        i. Russian oil is selling at $82 / barrel, far above the U.S. cap of $60. (WSJ)
    c. The U.S. has backed away from some actions meant to stop Iran's oil shipments. Iranian crude production has topped 3MM barrels per day and oil exports are approaching 2MM barrels per day (China is their biggest buyer, by far -- ~80%).
3. The spot market for oil is higher than forward prices (**backwardation**; normally the market is in **contango**). Refiners are fighting for tight supplies. (WSJ)
4. Oil consumers outside of the US are suffering from high oil plus a strong dollar. (WSJ)

D. A Few Economic Stats

1. The **OECD** said world economic growth would slow from 3% this year to 2.7% next year due to higher rates and slower-than-expected Chinese growth. (Bloomberg)
    a. World growth is slowing while the price of oil is increasing. Stagflation? (Bloomberg)
2. The Conference Board's **Leading Economic Index** fell for the 17th consecutive month. (Barron's)
3. **Markit PMI** showed service at 50.2 and manufacturing at 48.9. Composite was 50.1. Broad stagnation was seen across private sector. New orders dropped at fastest pace this year.
4. Sales of **existing homes** were down 15.3% YoY and near a 13-year low. The **median** existing home sold for **$407,100** in August. There were 1.1MM homes for sale at the end of August (down 14.1% YoY). (Barron's)
    a. Nearly **one in six home purchases fell apart** before closing last month. Traditionally, this is one in eight. (WSJ)
5. Approximately **45%** of all Americans ages 18 – 29 are living with family, similar to the 1940s. Almost **90%** of Americans say that people shouldn't be judged for moving back home. (The other 10% are the parents…) (Bloomberg)
6. While **real wage growth** has turned positive, **inflation and high rates are impacting consumers:**
    a. The median household needed a record **44% of income to cover** payments on a **median-priced home** in August
    b. The **average monthly payment** on a new **car** is ~$725; >$500 for a used car
    c. In Q2, there were **record credit card balances** and **car loan debt**
    d. The percentage of **credit card debt and car debt that was past due** moved above pre-pandemic levels for the first time in Q2 (WSJ)

E. China

1. A lot of people are **comparing China to Japan**. But China's public debt may be worse than Japan's debt was in 1990, its demographics are worse, and the geopolitical tensions are worse. The Chinese gov't is also less inclined to support growth. They are also suffering from a property bubble (Japan had a worse bubble in the late 1980s). China does have less urbanization (more potential growth) and they don't have an appreciated currency (like Japan did). China is starting from a lower per capita income ($12,850). (WSJ)
2. During one day this week, Taiwan detected **103 Chinese military aircraft** in the areas surrounding the island. Interestingly, this has not been accompanied by their usual propaganda. This may indicate that the true purpose is training and trying to figure out how to encircle Taiwan and block the U.S. from helping. (WSJ)
3. Two prototype **US drone ships** have arrived in Japan for their first deployment in the western Pacific, testing surveillance and attack capabilities that could be useful against China's larger fleet. (WSJ)