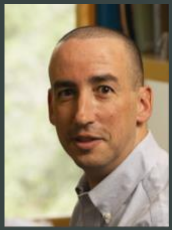

MARKET UPDATE

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September 4, 2023 – Market Update

I. Stocks

A. A Strong Week for Stocks and Bonds

1. Week: DJIA +1.4%; **S&P 500 +2.5%**; Nasdaq +3.2%
2. What drove the stock market's increase?
    a. **Lower yields** helped
        i. 10-yr yield dropped: 4.25% to **4.18%**; 2-yr dropped: 4.98% to 4.87%
            1. 3-month dropped from 5.61% to 5.53%
            2. **Least inversion** on 2/10 since late May
        ii. Median year-end **Fed funds** rate 5.40%; was 5.54% on Monday
            1. 2024 year-end dropped from 4.46% to 4.30%
    b. **JOLTS report** showed fewer vacancies – "less tight" job market (discussed later)
    c. **Jobs report** was seen as close to perfect (discussed later)
        i. Added jobs at moderate pace, wage growth slowing
    d. **Consumer sentiment** showed narrowest labor market differential:
        i. Jobs "plentiful" vs. "hard to get" (Reuters)
    e. Belief that negative September stock sentiment was pulled forward (discussed later)

B. The Bullish Narrative

1. Belief in **soft-landing narrative** – inflation slowing, growth continuing
2. The **impact of high rates is overstated**
    a. While interest rates are high, they remain below pre-2009 levels
    b. About a third investment grade debt have maturities of 10 years or longer
        i. Companies refinanced when rates were low (Bloomberg)
            1. Interest expense / EBIT is near lows from 2009
    c. NY Fed data shows that 89% of consumer debt is shielded from fluctuating interest rates
        i. More than 40% of all US mortgages were originated in 2020 or 2021, when borrowing costs were at a low (Bloomberg) (Bloomberg)
3. **BofA's Sell Side Indicator** was unchanged for August – still a buy signal
    a. Measures strategists' stock allocation – 53.5%
        i. Hit low of 52.5% in May (most bearish in six years)
        ii. 15-year average is 54.7%
        iii. Predicts a 15% return over next 12 months
            1. Positive returns 95% of time
            2. Median return 21% (Barron's)
4. **Favorable positioning** – systematic funds flipping to buy
5. BEA showed Q2 profits dropped .65% YoY (S&P 500 earnings dropped 2.9%)
    a. But earnings fell just .4% QoQ, so **earnings may have bottomed**. (Barron's)
    b. Earnings revisions have turned positive. Q2 earnings may be the trough. (Bloomberg)
6. China stimulus
7. AI hype

C. The Bearish Narrative

1. How sustainable is "**bad news is good news**"
2. We've had **peak-Fed view before**
3. Weaker labor market may create fear about **growth**
4. **Fear of September** -- Since 1928, the average return in September has been -1.1%.
    a. September has been negative for stocks for three years in a row. But…
        i. The last time we had a three-year losing streak, we followed with a three-year winning streak
        ii. When the S&P 500 has gained 10% - 20% through August, it has averaged a 7.6% gain for the rest of the year (Barron's)
5. **High multiples** (valuation)

D. Impact of Higher Interest Rates in the U.S. Economy

1. The **government** will have to pay more
    a. 67% of US debt matures within five years. The US pays an average rate of 3.4% on that debt. Current rates are higher.
2. Higher rates have **locked homeowners into their mortgages** and resulted in low inventory of homes available for sale.
3. **CRE defaults**. More than $1.5T of CRE loans come due by the end of 2025. The MBA predicts commercial property lending will have fallen **38%** by the end of this year.
4. **Future impact on profits**, amount spent on R&D, labor, etc.
    a. US companies have $600B in corporate debt that will mature this year. More than $1T matures each year from 2025 – 2028.
5. **Banks** are now under pressure to **pay more for deposits**. (WSJ)

E. Higher US Rates Hurt Emerging Markets

1. **Rising US interest rates** and **China's slowdown** are hurting emerging markets.
2. **Higher US rates** mean that the difference between EM rates and US rates is smaller.
    a. It's currently the **lowest spread since 2007**.
3. The stronger dollar also means that **EMs struggle to pay for goods denominated in dollars.**
4. As EMs slow, it's **hard** for them **to cut rates** (b/c their currency will drop further). (WSJ)

F. Do Higher Rates Matter to Stocks?

1. **Traditionally**, we think of **lower rates and higher stock prices**.
2. Typically, **stronger economy = higher profits**, but it can also mean higher rates
    a. When inflation isn't a worry, higher profits matter more
    b. If inflation isn't a worry or you believe inflation will recede, good news on economy can be good for stocks, despite higher rates
3. **Higher rates may be here to stay** w/ deglobalization, industrial policy, a corporate switch from efficiency to resilience and spending on defense and clean energy (WSJ)

II. The Labor Market

A. The JOLTS Report

1. **Job openings** declined by 338K to 8.8MM in July. This was the lowest since March 2021. This was the **sixth decline in seven months**.
    a. There are still **1.5** jobs for every unemployed person.
2. The **quits rate** dropped to 2.3%. This might be better evidence that the labor market is becoming softer.
3. Very few people are getting fired. They are too difficult to replace. This might be evidence that the job market could loosen without seeing unemployment rise too far. (WSJ) (WSJ) (Bloomberg) (WSJ)

B. Employment Report (August)

1. **Payrolls reports**
    a. Added **187K jobs** (170K expectation)
        i. Transportation sector lost jobs (Yellow shut down)
        ii. Entertainment fell (strike)
    b. June + July **revised down by 110K**
        i. June 185 taken down to 105; July 187 down to 157
        ii. Three-month average of **+150K** (< Feb. 2020)
            1. Had been ~400K per month in 2022
    c. **Average hourly earnings** lower than expected (4.3% vs. 4.4% expected)
        i. Up .2% for month
2. **Household survey**
    a. Unemployment rate rose to **3.8%** (from 3.5%)
    b. **Participation rate** up .2% to 62.8% (had been 62.6% since March) – added 500K people to labor force
        i. **Prime-age participation rate** highest since pandemic began
3. Consistent with **soft-landing** (and **peak-Fed**) / the "**Goldilocks report**"
    a. Solid hiring, slower wage growth, higher participation
        i. Still adding jobs -- unemployment increased b/c of higher participation
    b. More workers available for each job (Barron's) (Bloomberg) (WSJ) (Bloomberg)

C. Other Stories about the Labor Market

1. Companies are engaged in "**quiet cutting**" – reassigning workers and putting them in jobs that they don't want or in locations they don't want so that they will quit without severance. (WSJ)
2. The number of **temp workers** has been trending down since peaking in March 2022. Normally, this is seen as a sign of weakness. This has fallen for six consecutive months, the longest stretch since 2007 – 2009.
    a. But now, it's seen as a labor market that is so tight that people can get full-time work.
    b. Also, fewer traveling nurses (since pandemic has receded). (WSJ) (Bloomberg)

III. The Rest of the Economic News

A. GDP

1. **Economic growth**
   a. Q2 GDP was revised down from 2.4% to **2.1%**. Business investment in equipment and inventories were revised lower. (Bloomberg)
   b. **August ISM manufacturing** was better than expected but still in **contraction**
      i. Up 1.2 to 47.6
   c. Americans say that two to three children is the ideal number. But, the current **fertility rate is 1.67**. The **replacement rate** is 2.1. (WSJ)
2. **Consumer spending**
   a. **Household spending** rose **.8%** in July, up from .6% in June. In real terms, it rose **.6%** in July. (WSJ)
   b. Consumer spending **may have to slow** as excess savings are dropping. (WSJ)
      i. US households have $1T in **credit card debt** with an average interest rate of 20.6%.
      ii. Dollar General and Dollar Tree have said that their customers are pulling back on discretionary purchases while spending more on food and essentials (which are less profitable). (WSJ)
   c. On the **other hand**:
      i. US households spent just 9.6% of their disposable income on debt payments, well below the peak of 13.2% in 2007.
      ii. Prior to the pandemic, money in checking accounts for households and non-profits totaled less than $1T. That figure shot up to a record $4.77T in Q3 2022. It was just over $4.5T at the end of March. (Bloomberg)

B. Inflation News

1. **PCE** price index **+.2%** in July (3.3% YoY), the same as June. **Core** also **+.2%** (**4.2% YoY**).
   a. **Headline** inflation rose at a **2.1%** annualized rate over the past **three months**.
   b. **Core** PCE rose at an annualized **2.9%** over the **past three months**, the lowest reading since Jan. 2021. (WSJ)
   c. **Super-core** inflation (core services excluding housing) was **+4.7%** YoY
2. **WTIC** rose **7.2%** for the week
   a. Over the longer term, **higher oil prices** have resulted from :
      i. Russia's invasion of Ukraine
      ii. Production cuts by Saudi Arabia and Russia
      iii. Refineries shutting down for maintenance
      iv. Belief that the US won't enter recession
   b. Over the longer term, **oil prices have been kept down** by:
      i. The use of the Strategic Petroleum Reserve
      ii. Recession fears for China (WSJ)

C. The Fed

1. Powell left the option of raising rates on the table because he **doesn't want the market focused on when the FOMC will cut rates** (WSJ)
2. The Fed's **reverse repo facility** is approaching $1.5T after topping $2.5T at start of year
    a. Institutional investors are becoming convinced that the **Fed is done raising rates**, so they are locking in Treasury bills
    b. There is also a **greater supply** of Treasury bills (as more debt is issued) (Bloomberg)
3. Atlanta Fed Pres. Bostic said that inflation was already making progress toward 2%
    a. Atlanta Fed's **sticky prices** (prices that don't change often)
    b. Rental housing prices
    c. Businesses planning to taper wage increases
    d. Growth in total hours worked has slowed more than growth in employment
        i. Due to recent increase in part-time work (Bloomberg)
4. One concern for the Fed is that several **factors could lead to a drop in consumer spending** faster than the Fed could cut rates
    a. Resumption of student-debt payments
    b. Reduction in excess savings
    c. Tighter lending standards (WSJ)

D. Fiscal issues

1. The **SALT cap limits** ($10K cap on state and local tax deductions) is **only generating 80% - 85% of its intended revenue**. This is because 36 of the 41 states with income taxes have enacted workarounds.
    a. The workaround is an elective tax that the pass-through entity pays. This payment by the entity serves as the owners' state taxes and lowers the income that is passed through to the owner.
        i. Effectively, the owner has now received the deduction for state taxes (without a $10K limit) (WSJ)
2. The US government named 10 drugs that will be subject to the first **price negotiations by Medicare**. Drugmakers are trying to persuade courts to stop the negotiating powers that Medicare was granted last year.
    a. Medicare spent $378B on these 10 drugs last year. The estimated savings could be $25B. (WSJ)

E. China

1. Xi Jinping has philosophical objections to **consumption-driven growth**. He sees it as wasteful and at odds with his goal of making China a world-leading industrial and technological powerhouse.
    a. He sees investment in roads, factories and other hard assets as better.
        i. But this is limited now due to debt levels
2. China needs to expand health, unemployment and other social programs if they want to increase personal consumption.
    a. Consumption has plateaued at **~38% of GDP**.
    b. Chinese families saved **33.5%** of their disposable income last year. (WSJ)

IV. Inflation: Four Questions Requiring Further Research to Inform Monetary Policy, Cleveland Fed Pres. Loretta J. Mester, Sep. 1, 2023 (Cleveland Fed)

A. How Can We Best Estimate the Underlying Trend in Inflation?

1. Need to be able to separate **temporary** changes **from persistent** changes
    a. We got this wrong when we attributed too much to supply shocks
2. We can look at **core** inflation, **trimmed means**, **median** inflation

B. Can We Understand (and model) Actual Pricing Behavior of Firms?

1. Research has shown that **firms' prices are strongly influenced by** their perceptions about demand for their products, a desire to maintain steady profit margins, and labor costs.
    a. Cost-price passthroughs were estimated at ~60% (significant heterogeneity)
2. While firms raise prices with wages, Cleveland Fed research shows **workers don't expect their wages to keep up with inflation** (explains why people hate inflation)
3. If we set a **higher inflation target**, firms would change their price-setting behavior and adjust prices more frequently
    a. Monetary policy (which relies on price stickiness) would be more difficult
4. It is much more difficult to bring inflation down once it is embedded in economy
    a. **Expectations** matter

C. How Should Inflation Expectations Be Measured (and what time horizon)?

1. We measure expectations through **surveys and markets** (breakeven inflation)
2. Consumers tend to expect **lower inflation in components than in aggregate**
    a. Cleveland Fed now has "**indirect consumer inflation expectations**" where they ask how much their income will have to change to afford same consumption
3. Central banks focus on **medium- to longer-term expectations** because this is how long it takes monetary policy to impact the economy
    a. Changes in **gas prices** have outsized effect on short-term expectations
        i. Short-term expectations can matter…especially if persistent
    b. If Fed responds to short-term expectations, this can limit the experience households have with high inflation and keep expectations anchored

D. How Should Monetary Policymakers Respond to Supply Shocks?

1. Recently, we've had **supply shocks** from pandemic and Russia's invasion
    a. Concentrated in goods sector (where demand has shifted)
2. Recent experience has challenged **traditional view** that Fed should look through supply shocks (idea that they tend to be transitory and do not change expectations; also, don't want to hurt the economy after the supply shock resolves itself)
    a. But to extent that supply shocks are more persistent (or there is a series of them), such shocks can impact expectations – and we need to act
3. The **reaction may need to depend on the size and persistence of the shock**
    a. May have to respond more aggressively if inflation is already high and prices are more flexible than wages (and agents have bounded rationality)
    b. Maybe look through supply shocks at first; respond as they continue
    c. Or, maybe if expectations are not rational or well-anchored, central bank needs to respond quickly (central bank should overestimate persistence rather than underestimate it)