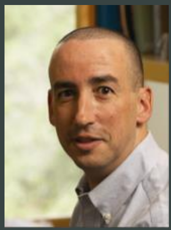

MARKET UPDATE

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Market Update – April 15, 2024

I. Last Week

A. Stocks

1. **Last week**: DJIA -2.37%; **S&P 500 -1.56%**; Nasdaq -.45%; IWM (Russell 2000) -2.82%
    - a. A disappointing **CPI report** (high inflation) led to higher yields
        - i. Although yields moved lower on Friday due to the expected attack by Iran against Israel
    - b. It became clear that the prior two inflation reports were not anomalies
2. Until this week, stock market had been driven by:
    - a. **Stronger economy** – leading to belief in higher earnings
    - b. **Inflation data easing** – leading to belief in lower rates (may not happen) (WSJ)
3. **Maybe the risks are rising** and it's okay to miss out (no more FOMO)
    - a. Need strong economy for earnings, but strong economy could limit rate cuts
        - i. Fed funds futures: still ~30% chance of cut in June; almost 2 cuts in 2024
    - b. Stocks are trading at **high multiples** if rates aren't coming down
        - i. S&P 500 trading at 21X 2024 earnings (only exceeded during dot-com bubble and pandemic rebound)
            1. Above 5-year (19.1)
            2. S&P up 8% YTD
    - c. If rates aren't coming down, **need high earnings growth**
        - i. 2024 earnings expected to be 11% higher YoY (2025: +14%)
        - ii. Can consumer / business spending support earnings growth
        - iii. Can companies continue to raise prices? (Barron's) (WSJ)
4. **Concentration is still a concern**
    - a. As of March 28, META and NVDA accounted for 1/3 of S&P's 10% YTD gains
        - i. S&P's **advance/decline line** is weakening (WSJ)
    - b. The top 10 stocks of the MSCI All Country World Index (ACWI) account for 19.5% of index (up from under 9% in 2016; above 16.2% in March 2000)
        - i. High concentration reduces diversification benefits for fund investors, making them more exposed to US macroeconomic environment and investor sentiment
        - ii. Makes the market more susceptible to substantial decline in value
    - c. Concentration may be related to increasingly **oligopolistic industries**
        - i. Tech giants have "monopoly power" (FT)
5. In markets, there are **constant narratives** about why stocks are moving up or down. The **number of narratives has increased** in recent months. People choose a narrative based on their own bias.
    - a. **Bullish narratives**: AI, momentum (one of best performing factors; often associated with tech, but may now be strong fundamentals), Magnificent Seven, market breadth broadening out
    - b. **Bearish narratives**: Fed cuts being priced out, good news is bad news (high rates are bad), sticky inflation, Mideast conflict
    - c. Which narrative is winning? Look at sentiment: AAII, put/call, etc. (FT)

B. Inflation (CPI)

1. **Headline** CPI +3.5% YoY; +.4% MoM
    a. **Core** +3.8% YoY; +.4% MoM
        i. **Shelter** +.4% -- still not coming down significantly (WSJ)
2. Looking at inflation in different ways:
    a. **Core services** (+5.4% YoY; +.5% MoM)are driving inflation higher
    b. **Supercore inflation** is up 4.6% YoY; .6% MoM
    c. **Trimmed mean** is high: +3.86% YoY
    d. **Sticky inflation** is 4.5% YoY (Bloomberg)
3. We don't know if inflation is moving toward 2% in a **bumpy** way **or** if inflation is **sticky** near 3%.
    a. Core inflation rising .4% in two consecutive months makes us wonder if we were overconfident about soft landing
    b. Maybe auto insurers and hospitals are still catching up to past cost spikes (WSJ)
4. CPI includes "tenants and household insurance," – but this is just **renters insurance**
    a. Renters insurance only increased 3% YoY
    b. **Homeowners insurance** increased 21%; this would have increased CPI by .8% last year (Bl.)
        i. Homeowners insurance is up 50% since 2019 (to ~$1,900 in 2023)
        ii. Inflation is effectively ignoring the financial cost of climate change

C. Reactions to CPI Report

1. **Market reaction**: June Fed cut less likely, higher yields, stronger dollar, weaker stocks
2. **Fed officials**:
    a. Chicago Fed Pres. Goolsbee – worried about housing inflation
    b. Dallas Fed Pres. Logan – sees greater upside risks to inflation outlook
    c. Atlanta Fed Pres. Bostic – thinks Fed may only cut rates once in 2024 (WSJ)
3. Former Treasury Sec'y **Larry Summers** says that a June rate cut would be a "dangerous and egregious error" – comparable to the error of leaving rates low for too long in 2021
    a. He says that the next rate change could be higher rather than lower (MW)
4. **Torsten Slok** (Apollo) thinks that the Fed is to blame for inflation staying high
    a. When Powell said that they were likely done raising rates, it unleashed a "dramatic easing in financial conditions"
        i. Stock market gains
        ii. Tightening credit spreads (MarketWatch)

D. Gold and the Dollar

1. **Gold** continues to move **higher**. **Possible reasons**:
    a. Hedge against dollar (even though dollar has been rising)
        i. A second Trump presidency – may push for a weaker dollar
    b. China buying gold
        i. Dollar weaponization with Russia
    c. Mideast uncertainty (FT)
2. **S&P GSCI global commodities index** is up 11% YTD
    a. Copper is up >10%, oil >16%; gold >14%
    b. **Drivers**: expectations for increased economic growth and demand; tight supplies in certain markets; speculation
    c. Higher commodity prices could be **inflationary** (WSJ)
        i. **Higher oil** prices result **higher breakeven inflation rates** (MW)
3. The **dollar strengthened** this past week as high inflation led traders to reverse their expectations of rate cuts
    a. The US has had loose fiscal policy and tight monetary policy
    b. ECB is still on course to cut rates in June
    c. Mideast tensions leading to dollar-buying as safe-haven
    d. Other countries have to struggle with the inflation that comes with a weak currency (FT)

E. Looking Ahead

1. FOMC minutes indicate that they are moving closer to **slowing QT**. There is fear of having too few reserves in the system and disrupting the money market.
    a. If QT slows, will the FOMC have to leave rates high for longer to slow inflation? (WSJ)
2. The Philadelphia Fed says that **3.5% of credit card balances were 30+ days past due** as of the end of December, up 30 bps from Q3. This is the highest delinquency rate since the data series began in 2012.
    a. 25% of cardholders have debt over $1,000; 10% have debt over $5,200
    b. 1/3 of cardholders pay full balance each month (Bloomberg)
3. **Economic data** argues that **growth is strong**, meaning there is no reason to cut rates: strong job gains, firm housing market, rising prices for oil and other commodities.
    a. Other data argues that growth is strong, but it **pushes back on the inflation argument**: increased productivity (would indicate that wage inflation is not that high) and immigration (WSJ)

F. Iran and Israel

1. Iran launched its first **direct attack** on Israel (normally use proxies, such as Hamas and Hezbollah). They did this in retaliation for a suspected Israeli strike in Damascus that killed several Iranian commanders.
2. The Iranian **strike was large** (300 projectiles, including 170 drones, 30 cruise missiles and 120 ballistic missiles), but mostly **ineffective** (although a girl was critically injured).
    a. The attack was **widely expected** (and mentioned in last week's video)
3. After the attack, Iran said it was over. It seemed to be an obvious attempt to de-escalate the situation. (SL: I wouldn't be surprised to learn that Iran had alerted us to exactly what they were doing. They needed to strike back in order to retain power domestically. But, they also know what could happen to them if Israel attacks.)
4. The question is **how Israel reacts**. (FT)(FT)

II. Housing's Fundamental Role in Economic Inclusion, Atlanta Fed Pres. Raphael Bostic, April 12, 2024 (Atlanta Fed)

1. **Housing is a platform** – people have better outcomes in other areas, like education and employment, when they are housed well
2. An inclusive economy is one in which more people maximize their human capital and secure a job earning a family-supporting income
    a. **Economic mobility and resilience** (ability to rebound from a shock) are essential to an **inclusive economy**
    b. **Economic inclusion** requires **two core elements** (housing is important to both, and therefore, it is important to economic mobility and resilience):
        i. Income security
        ii. The ability to build wealth
3. Research shows that Black and Latino homeowners **tap their accumulated home equity** much less than White owners
    a. Driven by differences in credit scores and debt-to-income ratios
    b. Home equity allows you to smooth consumption amid income or employment shocks
4. Housing is **too expensive**. Nationally, a household that earns the **median income** (~$75K per year) must spend **41%** to own the median-priced home (~$359K).
    a. The threshold for affordability is **~30%**
        i. If you are paying more than 50%, we say you are **severely cost-burdened**
    b. More than 90% of new housing starts are homes priced at $300K and higher, compared to 48% of new housing before the pandemic
5. **Renters** face the same issues.
    a. And if you are evicted, it can harm your ability to work, attend school, or find another place to live
6. To increase the supply of housing, this could require changes in zoning restrictions

III. Sustainability of Government Debt (FT) (Bloomberg)

A. Debt Sustainablity

1. **Three factors affect debt sustainability**:
    a. Primary balance (revenues minus non-interest expenditures)
    b. Interest expense
        i. Existing debt x interest rate
    c. Economic growth
2. **Debt-to-GDP increases to the extent that**:
    a. We run a primary deficit (spending more than we take in; excludes interest)
    b. Interest expense is greater than economic growth

B. Challenges to Debt Sustainability in the Future

1. **Primary deficits**
    a. Aging population raises public spending pressures
2. **Potential for persistently high long-term interest rates**
    a. Higher perception of inflation risk ("term-risk premium")
    b. Quantitative tightening
    c. Expectation of continued large fiscal deficits
3. **Projected decline in medium-term growth**
    a. Mediocre productivity growth
        i. Feeble investments
    b. Weaker demographics
        i. Pandemic **scarring**

C. Potential for a Vicious Circle

1. High risk perceptions could keep interest rates above growth rates
2. High rates make fiscal positions (debt) less sustainable
3. This keeps risk premia elevated
    a. Also remember that lower bond prices could hurt the banking system
    b. Then, we could fear that the government couldn't rescue banks

D. CBO Projections

1. **Debt held-by-public** reaches **116%** of GDP by 2034
2. Mandatory spending increases more than discretionary spending declines
3. Interest expense increases faster than GDP growth

E. CBO Projections are Optimistic

1. Assumes **Trump tax cuts** will expire as scheduled in 2025
2. Assumes a decline in **defense spending** as a share of GDP
3. Assumes **interest rates** to be slightly lower than financial markets suggest

F. Important Quotes

1. **Rudi Dornbusch**: "In economics, things take longer to happen than you think they will, and then they happen faster than you thought they should."
2. **Herb Stein**: "If something cannot go on forever, it will stop."