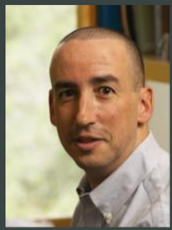

MARKET UPDATE

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Market Update – April 22, 2024

I. Stocks

It was a bad week for stocks. While the DJIA rose .01%, the S&P 500 dropped 3.05%, and Nasdaq fell 5.52%. Economic data was too strong (March retail sales were +4% YoY), Powell said that the FOMC may need to leave the Fed funds rate high for longer, interest rates increased, and geopolitical tension was high. Stocks are relatively expensive, as the S&P is trading at 20X forward earnings, well above the 16.5X average since 2000. (Barron's)

The Magnificent Seven lost $950B this week. It was the worst-ever weekly loss of market value for the group (the previous record was $872B in January 2022). NVDA lost almost $300B (including $212B on Friday), AAPL lost $178B, and MSFT lost $169B. TSLA has fallen to the 14th largest company (lowest since Jan. 2023). (MarketWatch)

Small-cap stocks are more sensitive to interest rates. The S&P 600 interest expense to operating income is 2.3 while it is 7.6X for the S&P 500. In addition, 44% of Russell 2000 debt is variable rate, while only 10% of S&P 500 debt is variable. Finally, 40% of Russell 2000 stocks are unprofitable, while only 10% of S&P 500 stocks are unprofitable. (WSJ)

The Russell 2000 small-cap index has lagged the S&P 500 since its 1978 inception. So much for the relationship between risk and return! While small-caps have outperformed large-caps in Europe and Japan, the US accounts for the majority ($1.3T of $1.7T) of global small/mid-cap dedicated funds. The largest companies have dominated the S&P 500 and higher rates have hurt smaller companies. PE has allowed small companies to stay private for longer. Automatic inclusion in the Russell 2000 has allowed front-running by speculators. In addition, the increase in the healthcare sector in the Russell 2000 index has been driven by a lot of unprofitable biotech. The Russell 2000 currently has a P/B of 2 while the S&P 500 is near 5. (FT)

Thinking about interest rates and stocks. The 2-year UST yield is now significantly above the S&P dividend yield. Since the financial crisis, low yields had led to a belief that there was no alternative and forced people into stocks. Has that changed?

In addition, the 10-year UST yield has moved above the S&P 500's earnings yield for the first time in approximately 20 years (prior to 2000, this was the norm). It used to be the belief that high UST yields were necessary in order to compensate investors for the lack of growth in bonds. While high 10-year yields might seem to be inconsistent with high multiples, what really matters is the direction of rates: there is a correlation between the change in the 10-year yield over the past six months and the six-month change in the forward P/E. (Bloomberg)

II. Bonds, Rates, Currencies, Oil, and Gold

Yields increased last week. The 2-year UST yield increased nine basis points to 4.97% and the 10-year yield increased 12 basis points to 4.62%.

The Treasury is issuing a tremendous amount of debt. There was $7.2T of securities sold in Q1, the largest on record (surpassing 2020 Q2 – the Covid stimulus). (WSJ)

The IMF warned that US fiscal deficits have stoked inflation and pose risks to the global economy. The US is expected to record a 7.1% fiscal deficit in 2025. This is more than three times the 2% average for other advanced economies. This could complicate the Fed's attempts to return inflation to 2%. If there is a surge in US borrowing costs, this could spill over to the rest of the world. (FT)

High rates are continuing to crush the housing market. Mortgage rates are above 7%. Existing home sales fell 4.3% MoM in March, the largest monthly drop since Nov. 2022. The supply of homes available for sale was 37.9% below pre-pandemic levels and the result is that the national median existing-home prices rose 4.8% YoY to $393,500. (WSJ)

The average existing mortgage is ~3% lower than the current 7% mortgage rate. This creates "house-lock," where homeowners don't want to sell their house. Low-rate mortgages are seen as an asset worth ~$50K. The result has been ~1.3MM fewer home sales in America from spring 2022 to the end of 2023. This prevents people from moving for new jobs. It also stops older homeowners from downsizing and younger people from having an opportunity to buy. (NYT)

The growth of private credit creates risks for the economy. This is mostly floating-rate loans to highly leveraged small borrowers. Poor performance could hurt investors like insurers and pension. Growth of semi-liquid retail funds could cause a run. There is a lack of price discovery and oversight. (FT)

Higher rates for longer could hurt emerging market currencies. In addition, Japan will have to decide whether to intervene in the currency market. (Bloomberg)

Gold continues to increase. Reasons include higher inflation, geopolitical instability, and anxiety over the markets. China seems to be selling Treasuries and buying gold. (FT)

WTIC has dropped from $87 to $82 in the past two weeks. Oil had increased from $73 in early February to $87 in early April. Higher oil prices raise inflation concerns and this means that the Fed won't cut rates. This lower chance of cuts is hurting stocks. It is uncommon for oil to do well while stocks have a sustained decline. (FT)

III. Economy

The IMF projects that the US economy will grow 2.7% in 2024, double the rate of any other G-7 nation. Strong household spending and investment are helping growth. The surging US economy could push back rate cuts. (FT)

Retail sales increased .7% in March MoM and 1% MoM if you exclude autos and gas. Retail sales represent ~1/3 of all consumer spending. February's retail sales were revised up from .6% to .9%. We're not seeing any slowdown in consumer spending. Strong retail sales could boost Q1 GDP. Q1 GDP is now expected to be ~2.9% (Atlanta Fed), which is higher than our long-run sustainable growth rate of 1.8%. Higher rates don't seem to be slowing the economy. (MarketWatch)

More evidence of a tight labor market? The reservation wage has increased to more than $81,800. The reservation wage is the lowest compensation that US workers are willing to accept for a new job. For men, it is $95,800 and this is $29,300 higher than for women. Four years ago, the gap was under $5K. (Bloomberg)

Boston Fed President Susan Collins says that consumer sentiment could cause economic problems. Despite low unemployment, growing wages, and disinflation, consumers are pessimistic. Pessimism may come from the high price of many consumer goods, lingering uncertainty and anxiety from the pandemic shock, or higher interest rates. Pres. Collins says that people in her district are concerned about housing, and she also sees a low personal savings rate. This pessimism could be self-fulfilling. (MarketWatch)

There are some economists that believe that high interest rates are actually boosting the economy rather than slowing it down. (This sounds like Turkey's Pres. Erdogan.) They argue that in a typical rate hike cycle, the added spending from people/companies that receive higher returns is not enough to match reduced spending from borrowers. This time, it may be that the added spending is enough. The exploding US debt means that interest payments to bondholders is much higher. (Bloomberg)

IV. Fed

Fed Chair Powell spoke and made it sound as if rate cuts were less likely. He said, "the recent data have clearly not given us greater confidence and instead indicate that it is likely to take longer than expected to achieve that confidence." He also didn't sound like he was thinking that rates should rise, as he said, "we think policy is well positioned to handle the risks that we face." He continued, "right now, given the strength of the labor market and progress on inflation so far, it's appropriate to allow restrictive policy further time to work." (WSJ)

The Fed funds futures market is now pricing in a 16% chance of a rate cut in June. For the rest of 2024, the market is pricing in one rate cut and an ~60% chance of a second rate cut. Expectations for rate cuts have decreased as a result of persistently high inflation data (March was the third consecutive CPI reading that was higher than expectations) and Fed Chair Powell's comments that rates may need to stay high for longer. Higher rates could hurt stocks, commercial real estate, people with credit card debt, and foreign currencies. (FT)

Could the Fed raise rates? While Powell has simply said that rates are going to have to stay high for longer, there are reasons to consider a rate hike. Inflation readings have consistently been higher than expected during Q1. In addition, GDP growth is now forecast to be higher. The market has reacted by pushing rates higher. The 2-year and 10-yr UST yields are up over 70 bps since the start of the year. The five-year breakeven inflation rate has increased 32 basis points this year to 2.44%. (MarketWatch)

Despite the Fed's argument that policy is restrictive, real-world financial conditions are in "easy" territory. The Chicago Fed's National Financial Conditions Index (NFCI) is as loose as January 2022 (two months before the Fed started raising rates). This index has 105 variables that include bank lending standards, yield spreads, debt levels and new issuance, and the dollar. The Fed only controls interest rates. Corporations refinanced before the hikes, homeowners locked in low mortgage rates, and AI enthusiasm pushed stocks higher (until a few weeks ago). (Barron's)

There are many reasons why monetary policy tightening has had limited impact on the economy. Fiscal policy has been very supportive. Real interest rates fell as inflation rose. The vast majority of homeowners have fixed-rate mortgages. Pandemic savings helped finance spending. (FT)

The Fed released the Financial Stability Report and the biggest risk was higher-than-expected interest rates. Higher rates could strain household and business balance sheets and debt-servicing capacity, weaken the economic outlook, lead to greater losses for banks exposed to CRE and consumer loans, tighten financial conditions, and cause spillover to global economies from high dollar value and rapid portfolio rebalancing. The next two largest risks were geopolitical tensions and the possibility of unexpected weakness in the US economy. (MarketWatch)

V. Political / General Interest

Throughout last week, House Speaker Mike Johnson was pushing a bill to support Ukraine, Israel, and Taiwan. The WSJ editorial board (conservative) said Johnson deserved bipartisan support given the national security implications of a potential Ukrainian defeat. Amen brother. Ukraine has air defense shortages, not enough ammunition, and a shortage of fighters. A victory could embolden Putin to threaten Baltic states next. Europe is less likely to curb ties with China if the US abandons them in Ukraine. (WSJ)

On Saturday, the House passed a bill with $60B of aid for Ukraine. The bill was passed by a vote of 311 – 112. Every Democrat supported the bill and just under half of Republicans supported it. Marjorie Taylor Greene (recently called "Moscow Marjorie" by former Republican Rep. Ken Buck) wants Johnson ousted from the speaker position.

The Baltic states are scared. Estonia is building reinforced bunkers. Lithuania is opening counter-mobility parks for anti-tank obstacles, and they are putting up barbed wire and concrete blocks. Latvia and Finland are erecting fences on borders with Russia and Belarus. Estonia, Latvia, and Lithuania joined NATO and the EU in 2004 (they had been annexed by the Soviet Union in 1944 and regained their independence in the 1990s). The Baltic states are seen as a potential testing ground for Putin. There is fear that NATO will appear more divided if Trump returns to the White House (especially after his comments about Russia being able to do "whatever the hell they want" with countries not spending enough on defense). Normally, Republican presidents were seen as better for Baltic security. (FT)

What should happen to seized Russian sovereign assets? The US has proposed confiscating Russian assets and giving them to Ukraine. European officials are concerned about violating international law and destabilizing financial markets. As a result, the EU prefers giving Ukraine profits generated by the assets, not the assets themselves. Approximately 97% of the assets are in Europe and 3% in the US. (FT)

CEO pay at companies with $1B+ revenue rose 11.4% in 2023 to a median of $23.7MM. This outpaces 3.4% inflation and the average worker gain of 4.3%. Median CEO pay is 300X median employee pay, up from 255 in 2018. This leads to a discussion about inequality and corporate governance issues. (Barron's)

Very few people pay full sticker price for colleges. At private nonprofit four-year colleges, 16% paid full price in 2019 – 2020 (down from 29% in 1995 – 1996). At in-state public colleges, 25% paid full price (down from 50% in 1995 – 1996). Colleges are trying to signal quality and then encourage attendance with merit aid. During this time period, sticker prices rose ~70%. High sticker prices can deter low-income applicants. Quick hint: if you want to find out a tremendous amount of info about a school, search "School name Common Data Set." For example, google "University of Texas Common Data Set." (NYT)