MARKET UPDATE

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Market Update – April 29, 2024

I. Markets

A. Stocks

1. **Week**: DJIA +.67%; **S&P 500 +2.67%**; Nasdaq +4.23%; Russell 2000 (IWM) +2.70%
    - a. Strong **tech earnings** saved stocks (GOOGL +11.59%) (MSFT + 1.80%)
    - b. But META was crushed (-7.85%) by plans to spend billions more than expected on AI
2. The **big news** (aside from tech earnings) was **high inflation** and **slower growth**:
    - a. **Core PCE** +.3% MoM, +2.8% YoY
        - i. Q1 annualized PCE +3.4% (Q4 was 1.8% annualized)
        - ii. Shows stalled progress toward Fed's 2% inflation goal
        - iii. Investors see one rate cut this year with less than a 50% chance of a second cut
            1. No one believes that we'll have the three rate cuts suggested in the most recent dot plot
            2. The risk has shifted to inflation remaining too high for longer (Bloomberg)
        - iv. Rates moved higher: **10-yr UST yield 4.67%** (+5 bps); 2-yr 5.00%
    - b. Growth concerns: **Q1 GDP +1.6%** annualized (~2.4% expected) (GDP report)
        - i. Down from 3.4% in Q4
        - ii. **Reasons** for slower growth
            1. Slowdown in spending on goods like cars and gasoline
            2. Shifts in business inventories and increased imports
                - a. Decrease in inventory could be good news (restock in future)
3. **Stocks have been resilient** due to the idea that earnings will continue to grow
    - a. But if the 10-year UST yield hits 5%, will this cause concerns
        - i. It becomes a tougher tradeoff: 5% UST vs. higher P/E stocks (FT)
4. **Arguments to not worry about economic growth**:
    - a. Employers adding staff at rates outpacing projections
    - b. Influx of immigrants boosting growth and tax revenue
    - c. Credit card companies reporting higher customer spending YoY
    - d. Strong corporate earnings and optimistic guidance
    - e. Industries investing in capital projects despite higher borrowing costs (WSJ)
5. As the Fed has to delay rate cuts, this makes it **difficult for the ECB and BoE to cut rates**
    - a. If these other central banks cut rates, **their currencies could decrease** in value (causing import inflation)
        - i. The euro has fallen 3% against the dollar YTD
    - b. The BoJ may need to keep raising rates as the yen has hit a 34 year low vs. the dollar (FT)

B. Move Aside, Big Banks: Giant Funds Now Rule Wall Street (WSJ)

1. **Today, traditional and alternative asset managers control twice as many assets as US banks**.
    a. **In 2008, US banks and fund managers both had ~$12T of assets.**
    b. Today, traditional asset managers, private fund managers and hedge funds control about **$43.5T**, nearly twice the banks' **$23T**.
        i. Private equity and debt fund assets doubled to almost $6T in the past four years, far outpacing the 31% growth rate for public funds.
            1. Firms like Blackstone, Franklin Templeton, BlackRock and KKR
        ii. Public fund managers are much bigger than their private counterparts, but less profitable.
2. **The move by traditional and alternative asset managers**:
    a. PE and private-debt funds, such as Apollo and Blackstone, mostly manage money for institutions, but are **increasingly selling products to individual investors**
        i. KKR says that only 2% of wealthy individuals currently invest in alternative funds and that will jump to 6% by 2027.
    b. Asset managers are also **supplanting banks as lenders to US companies and consumers** and intertwining with the insurance industry
3. Large banks have responded by becoming more like fund managers (beefing up investment teams)
4. PE fund managers took 41 spots on Forbes list of US billionaires. They make up 5.5% of all the country's billionaires.

C. Path for 10-Year U.S. Treasury Yield to 5% is Possible but Tricky (WSJ)

1. The **10-yr UST yield hit a 5-month high** of 4.696% last week **due to strong inflation** data that led to the belief that the Fed wouldn't cut rates quickly
2. Reaching 5% will require expectations to be pushed back further (or a rate hike)
3. The **reasons that the yield could increase**:
    a. Inflation
    b. Substantial budget funding pressures
    c. Lack of term premium (could increase)
    d. Fed raises its estimate of the neutral rate
4. **Yields could decrease if**:
    a. Inflation drops
    b. Geopolitical tensions increase (UST is a safe-haven)

D. Do Interest Rates Matter Anymore? (WSJ)

1. **The Fed raised rates 11 times (5.25%) between March 2022 and July 2023. Yet…**
    a. The economy is growing close to 3%
        i. Retail sales were up significantly in March
            1. Credit card debt is a record $1.3T
                a. But, note that that Philadelphia Fed has said that delinquency rates were over 3% -- the highest since 2012
    b. Commodities are booming
        i. Global energy demand remains strong
    c. Unemployment hasn't surged
    d. Stocks hit an all-time high at the end of March
    e. Despite mortgage rates increasing from 3% to 7%…
        i. The median home price increased from $350K (2022) to $384,500
2. **High interest rates used to cause recessions**
    a. Carrying inventory used to get more expensive and orders halted
        i. Now, most retailers use just-in-time deliveries to minimize inventory costs
        ii. Autos are exposed – but manufacturers subsidize inventories and offer cheap loans
    b. Some banks (SVB and Republic) did end up in trouble with high rates
        i. But big banks hedge; they simply profit from the net interest margin
    c. CRE prices are way down – higher rates and WFH
3. **Reasons that higher rates don't matter:**
    a. Tech companies are flush with cash and advertising is growing
        i. Service economy is winning
    b. We are now an economy of logistics, online sales and electronic delivery
        i. Manufacturing economies such as China and much of Europe are more interest-rate sensitive
    c. Homeowners locked in low mortgage rates; companies locked in rates
4. **But, interest rates do matter in federal deficits**
    a. Interest payments this year will likely be larger than defense spending
    b. Treasury auctions have been weaker, sending rates higher
    c. Maybe the new economy will be fine, but higher rates will result in fiscal pressure

E. Is the Boom in Private Credit Losing Steam? (FT)

1. In 2023, **non-bank lenders funded 86% of leveraged loans, up from 61% in 2019**
    a. Banks' share of private lending in the US economy has fallen from 60% in 1970 to 35% last year
2. **Long history of bank disintermediation**
    a. 1973 – 1974 – investment grade companies moved to commercial paper and bonds
    b. 1980s – high yields bonds; securitization
    c. 2008 – mid-market corporates and mortgage borrowing have moved away from banks
3. But one year after the failure of SVB and Credit Suisse, the **strongest banks are ramping up their lending into the broadly syndicated bank loan markets**
    a. A key way to finance LBOs
    b. In Q1, 28 companies arranged loans to refinance $11.8B of debt that was previously provided by private credit firms
        i. In other words, banks have been able to claw back just over half of the $20B that shifted in favor of private credit firms in 2023
4. **Lessons:**
    a. It typically takes at least two to three years for weakened banks to get over large rate shocks
        i. Regional banks take longer than the large banks to get the rates of their assets and liabilities back in balance
        ii. Lending by regional banks remains anemic
    b. Outdated financial regulations often exacerbate shocks
        i. In 1970s and 1980s, Regulation Q (ceilings on interest rates to depositors) exacerbated deposit flight to money market funds
        ii. Fed's overnight reverse repo facility triggered deposit flights
    c. Financial product innovation is a vital enabler
        i. Money market mutual funds facilitated disintermediation
        ii. New private credit structures are giving investors access to assets previously confined to banks' balance sheets
    d. New regulation aimed at addressing banks' vulnerabilities can inadvertently push even more lending elsewhere
5. **Watch for private credit to get into specialty finance lending ($5.5T market)**
    a. Includes equipment leases, trade finance, and royalty agreements
        i. Private credit currently has less than 5% of these loans
    b. Infrastructure loans, CRE and mortgages are also lucrative markets ($26T)
    c. Private credit players are looking to partner with banks to secure access to these new asset classes
        i. Seeing banks parcel the riskiest slice of debt to private credit

II. Currencies

A. U.S. Dollar's Extended Reign ([Bloomberg])

1. **Investors didn't expect a strong dollar this year**
    a. But the **hot economy + sticky inflation = no rate cuts**
        i. Labor market has stayed tight
        ii. Manufacturing activity continues to expand
        iii. Growth has moved to a higher plane in light of strong immigration, productivity, and investment
        iv. Higher Treasury yields are pushing the dollar higher
    b. Talk of US exceptionalism as the IMF predicts that the US will grow at twice the rate of its Group-of-Seven peers
        i. Supporting stocks and bond yields (adding to dollar's appeal)
    c. Dollar is safe-haven in times of strife
    d. CFTC data says **dollar sentiment is now the most bullish since 2019**
2. **Dollar smile**
    a. Dollar rises when the US economy is either booming or in a deep slump
        i. Dollar weakens during periods of moderate growth
    b. Heightened geopolitical risks are working with a booming economy to create a "curlier smile with steeper tails" (more of a U-shape)
3. **Other countries are seeing their currency weaken**
    a. Some are threatening to intervene
    b. Others are realizing that they can't lower rates (b/c their currency will drop and inflation will result)
    c. Countries with dollar-denominated debt find it expensive to repay
4. **Maybe the stronger dollar will help Europe, China, and Japan** to export their problems away

B. Investors Raise Bets on Euro Falling to Parity with Dollar ([FT])

1. **Traders have increased their bets that the euro could fall back down to parity with the dollar.** Investors have been buying options that will pay out if the euro falls to $1 or lower
    a. **High inflation and resilient growth** in the US raise expectations that the Fed will only begin cutting rates months after the ECB starts
        i. Eurozone inflation has dropped to 2.4% in March
    b. Fears of a widening conflict in the Middle East could also have an impact
        i. Buying pressure on dollar (**safe-haven**)
        ii. Hit to euro because they are dependent on energy imports
2. The **euro has slipped 3.5% vs. the dollar YTD**
    a. Parity would require a further drop of 6.5%
3. The euro last dropped to parity in **2022** – the first time in 20 years
    a. Caused by energy shock after Russia's invasion
4. The ECB may even welcome a falling euro in order to help revive growth

C. Japan Feels Inflation Heat from Fed (FT)

1. Investors are **expecting the BOJ to need to keep raising rates** as a weaker yen fuels inflation.
    a. The yen has weakened as investors stopped believing that the Fed was going to cut rates six times.
    b. The BOJ took rates from negative to slightly positive last month.
2. The **yen is at a 34-year low against the dollar**.
    a. The weaker yen has helped tourism as well as corporate profits earned overseas. But it has raised living costs.
        i. Japan’s core inflation (which excludes food prices in Japan) rose 2.6% YoY in March
3. **Investors are afraid of the BoJ having to raise rates quickly** (like the Fed did)

III. Other Economic News

A. Fiscal Stimulus ("The Overstimulated Superpower") (FT)

1. The FT suggests that **US growth is strong due to fiscal stimulus and this is also inflating both consumer and asset prices**
    a. US government spending has been running at a yearly level about $2T higher than its pre-pandemic norm.
        i. Since the start of the pandemic, **rising deficits amounted to a cumulative 40% of GDP in the US** (2X the average in Europe)
    b. We've seen **higher earnings with this strong growth**
        i. We've also seen **higher multiples**, which is **unusual** with higher rates
2. There are **other reasonable explanations for US resilience**, including the surge in immigration and the AI boom. In addition, fixed rate mortgages have helped.
    a. New government incentives are drawing billions in investment to subsidized industries (from green tech to computer chips)
3. **But this much is clear**: with consumer prices and asset prices more elevated in the US than its peers, **the economy is overheated and the Fed has less room to cut rates**
    a. As long as interest rates remain higher for longer, the US will be asking for worse trouble if it keeps running deficits close to 6% of GDP
    b. Once the stimulus sugar-rush wears off, the landing may come faster than anyone expects

B. Productivity (Barron's)

1. Growth in **labor productivity** has helped the economy (real output / total hours worked)
    a. 1.6% average annual rate from 2020 to 2023; 3.3% in 2023 Q4
        i. Was 1.2% in 2010s
        ii. Productivity boom from 1995 to 2005 – 2.8%
    b. **Total factor productivity** (includes labor and capital outlays): .7% in 2023
2. **Factors contributing to productivity growth**
    a. Public and private investment
        i. Five largest tech companies invested $400B in 2023 (up from $71B in 2017 and $127B in 2020)
    b. Changes in labor dynamics
        i. Low unemployment and Great Resignation – workers moved to more productive jobs; companies had to do more with less; companies invested in technology
    c. Remote and hybrid work increased participation
        i. Research shows 3 – 5% productivity gains for well-organized hybrid workers
    d. New business formation

C. Power, Productivity and How Our System Works (FT)

1. **Traditional explanations for low productivity growth over the past 20 years**:
    a. Poor education, declining tech skills, aging workforce, lack of investment by companies, move to a service-based economy
2. **Maybe the productivity gap is really about how large corporations use their economic and political power to squeeze out innovation in favor or large profit margins**
    a. Research shows that when innovators and entrepreneurs take their work into larger companies, new patent and product development drop by 50%
        i. Large companies also get more state subsidies (despite being less innovative)
    b. Research also showed the inverse correlation between falling innovation and the rising number of local politicians hired by large firms to support their lobbying efforts
3. Researchers should study how long it takes phone calls from different stakeholders to get returned by various politicians or regulators
    a. Also look at other **real-world expressions of power** – such as visitor records to the White House or the agencies on a regular basis
        i. 96% of the visits to the financial regulators during the creation of Dodd-Frank were from the largest "too big to fail" banks

D. America's Economy is #1 (WSJ)

1. This year, the **US will account for 26.3% of global GDP** – the highest in almost 20 years
    a. China's GDP is 36% smaller than the US
2. These figures are **based on current prices and exchange rates** (strong dollar)
    a. Using **purchasing power parity** (which accounts for different price levels across countries), the US share of world GDP would be lower
    b. Of course, current prices are what we pay for oil, phones, etc. – that's the argument that current prices are a better metric than PPP
3. So **why has the US been outperforming:**
    a. Structurally, the **US continues to innovate** and reap the rewards
        i. Look at big-tech stocks and AI
    b. **Terms of trade** – the price of what the US exports (e.g., natural gas) has risen more than the price of what it imports
    c. **Government borrowing** – Trump's tax cut, bi-partisan Covid relief, Biden's 2021 stimulus
        i. Continue to inject stimulus with veterans' benefits, infrastructure, semiconductor manufacturing and renewable energy
        ii. Deficits made sense when unemployment was high, private demand moribund and inflation and interest rates low
4. The IMF thinks that **core inflation is .5% higher due to fiscal policy**
    a. At the same time, tight monetary policy and loose fiscal policy can suck in capital from overseas and drive up the dollar (which decreases inflation)

E. US Fertility Rate Falls to Record Low (WSJ)

1. The **US fertility rate fell to 1.62 births per woman** in 2023, a 2% decline YoY
    a. Lowest rate that we've ever recorded (data started in 1930s)
    b. The replacement rate is considered to be 2.1
2. Some of the **reasons:**
    a. Having children later in life
    b. Careers
    c. More access to contraception
    d. Uncertainty about futures
    e. Spending more income on homeownership, student debt, and child care
3. The only way to offset lower birthrates is immigration

F. AI Isn't a Simple Path (WSJ)

1. The **frenzy to build data centers** to serve the exploding demand for artificial intelligences is **causing a shortage of the parts, property and power that the supercomputers' warehouses require**.
    a. The lead time to get custom cooling systems is five times longer than a few years ago.
    b. The delivery time for backup generators has gone from a month to as long as two years.
    c. There is little inexpensive real estate that also has access to power.
2. The **amount of data-center space in the US grew 26% last year** and a record amount was under construction.
    a. It usually takes 1.5 to 2 years to put up a data center.

IV. Other Interesting Stories

A. McKinsey Under Criminal Investigation (WSJ)

1. The **Justice Department is conducting a criminal investigation into McKinsey's role in advising some of the nation's largest opioid manufacturers on how to boost sales**
    a. They are **also investigating whether they may have obstructed justice** in relation to records of these consulting services
2. **In 2021**, McKinsey reached a **settlement with all 50 states**, five US territories, and Washington, D.C. to pay **$642MM** to resolve civil opioid-related litigation without admitting wrongdoing (SL: call me funny, but I think you know you did something wrong when you write a check for $642MM)
    a. They reached separate deals totaling $347MM with Native American tribes, public school districts, insurance companies and municipal governments. (SL: again, they didn't admit wrongdoing. Apparently, just being generous. Love those guys.)
3. **McKinsey's recommendation was for the drug manufacturers to increase their sales pitch to the doctors that prescribed the most and spend less time with those that prescribe the least**. (SL: do people really pay McKinsey for insights like this? That's like telling a guy in a bar to spend the most time with the woman who will talk to him and ignore the women who won't talk to him. I didn't need McKinsey to figure this out.)
4. **Nearly 645,000 Americans have died from overdoses involving opioids from 1999 to 2021**, according to the CDC.

B. Links to Other Interesting Stories

1. $100K no longer buys you a middle-class lifestyle (MarketWatch)
2. Potential change for Social Security COLA (MarketWatch)
3. DraftKings spotted odd gambling on an NBA player (MarketWatch)
4. DJT's short-selling claims don't add up (MarketWatch)