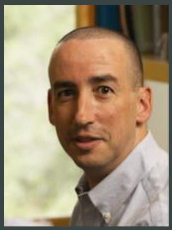

MARKET UPDATE

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Market Update – February 19, 2024

I. Markets

1. **Last week**: DJIA -.1%; **S&P 500 -.4%**; Nasdaq -1.3%; **Russell 2000 (IWM) +1.16%**
2. S&P 500 reached a **record high** on Thursday **despite**:
    a. Stronger-than-expected January inflation report (CPI and PPI)
    b. Weaker-than-expected retail sales
    c. Higher rates: 2-yr UST 4.64% (+16 bps); 10-yr UST 4.30% (+13 bps)
        i. Realization that the Fed won't cut rates as soon as expected
            1. CPI was higher than expected
            2. 2.9% GDP growth expected for Q1 (Atlanta Fed GDPNow)
            3. Continuing to add jobs (Barron's)
3. **Bulls**: "January effect" on CPI data, disinflation intact, soft landing in 1995 led to 25% annual returns for rest of 1990s (tech bubble), markets not expensive outside of top 10 stocks, operational efficiency will boost margins, small-cap outperformance, AI proliferation (Bloomberg) (Bloomberg)
4. **Bears**: hot CPI/PPI makes disinflation story questionable, more hawkish Fed, weaker retail sales show stretched consumer, investors are too bullish, valuation concerns, crowded trades, growth is primarily a handful of companies, geopolitics, systemic credit risk (CRE), US election, recession concerns about Japan and UK, China slowdown (Bloomberg) (Bloomberg)
    a. **Sentiment** is really optimistic:
        i. CBOE put/call ratio is moderately low
        ii. BofA Global Fund Manager survey – greatest global growth expectations in two years, falling cash levels, highest allocation to US stocks since 2021 and highest allocation to tech since Aug. 2020.
            1. Soft landing is consensus
        iii. 2025 earnings expected to grow 13%
    b. Valuation
        i. S&P 500 +4.94% YTD
        ii. Trailing P/E: 24.18 (10-yr average: 20.36)
            1. Forward P/E: 20.38 (above 20 for first time in several years)
        iii. P/B: 4.15 (10-yr average: 3.26; 20-yr average: 2.76)
        iv. Equity risk premium (EY – 10-yr UST yield = .7, lowest in ~20 years)
            1. Forward EY – 10-yr TIPS yield is lowest on record (idea: earnings adjust w/ inflation)
        v. PEG:1.48 (10-yr average: 1.49; 20-yr average 1.35)
        vi. CAPE: 33.4 (higher than 96% of the time since 1881) (WSJ) (Bl.)
5. **Maybe energy is a good hedge to a tech portfolio?** Tech stocks overtook energy stocks in the S&P 500 weighting on May 17, 1995. Today, tech is ~8X bigger than energy, an even wider gap than during the dot-com bubble. **Reasons for energy underperformance**:
    a. Investors wary of overinvestment
        i. Shale boom excesses – industry spent years proving it can prioritize dividends and buybacks
    b. Lack of clear catalysts – OPEC may be cutting supply, but they have spare capacity; geopolitical events haven't impacted price
    c. Overshadowed by tech (Bloomberg)

II. The Economy

A. CPI

1. **Headline**: 3.1% YoY (.3% MoM) – down from 3.4% (Dec), but market expected 2.9%;
    a. **Core**: 3.9% (.4% MoM) (WSJ)
2. Breakdown:
    a. Goods inflation fell last month, while services rose
        i. On a YoY basis, service inflation is coming down
        ii. On a MoM basis, service inflation is back close to its peak
    b. Break services down further:
        i. **"Supercore"** (services excluding shelter) – rising
            1. Particularly sensitive to wages
        ii. **Shelter** – disinflation is proceeding slowly
    c. **Trimmed mean** saw largest rise since early 2023
        i. YoY is barely below 4%
    d. **Sticky inflation** has picked up over the last three months (Bloomberg)
3. Overall prices are up **19.6% over four years** vs. 8.9% pre-pandemic. Groceries, gas, restaurants are all up more than overall inflation. (WSJ)
4. Companies raise prices at the start of the year (the "**January effect**"). After two years of high inflation, these increases may have been greater than seasonal adjustments account for. We saw inflation spike in medical care services and personal services.
    a. But it was also odd to see shelter inflation that was really high. Rent inflation is cooling but CPI lags current trends. OER rose faster than rent. (Bloomberg)
5. The January CPI report may delay rate cuts, but it's not a reason to panic. Remember that **core CPI was 4.7% in July**.
    a. The **bear case** is that a tight labor market may be driving services inflation. (Remember that the January jobs report was very strong.) Core services inflation accelerated to .7% in January. (WSJ)

B. Other Economic News

1. **Retail sales fell .8%** MoM in January. Excluding autos, sales fell .6%. There is fear that consumer spending growth may be weaker than expected. It's also possible that this was **caused by**:
    a. Seasonal adjustments that were less supportive than prior years
    b. Cold weather (WSJ)
2. The **UK and Japan** both had their second consecutive quarters of negative GDP growth in Q4. There is also weak growth in the rest of Europe and China.
    a. In contrast, US GDP grew at a 3.3% rate in Q4. The US has benefited from more resilient consumer spending (despite rate hikes) and high government spending. (WSJ) (WSJ) (Bloomberg)
3. The **yen has fallen back to 150 yen per dollar** for the third time in 15 months. Before that, it hadn't reached this level in three decades. Higher services inflation in the US pushed the dollar higher. Maybe the BOJ has to raise rates, but they don't want to return to deflation and they could be in recession. (Bloomberg)
4. The CBO projects that **immigration will boost US GDP by $7T** over the next decade. The labor force will be 5.2MM larger in 2033 due to immigration. This will also add $1T to tax revenue. The increased supply of lower-skilled immigrants depresses average wages. (Bloomberg)

III. Commercial Real Estate

1. **Stress in CRE market** due to:
    a. Investors bought at high prices and values are now dropping
    b. Interest rates are now higher (~4%)
    c. Regional banks are trying to reduce exposure (not providing extensions)
        i. Over $2.2T of loans maturing by end of 2027
        ii. $85.8B of distressed CRE (2008 peak was $194.8B)
2. **Over $1T of CRE loans will mature by the end of 2025**. This will force sales. For years, lenders have employed the "**extend and pretend**" strategy – lengthening loan terms while ignoring short-term valuations.
    a. As of December, **offices accounted for 41% of the value of distressed US properties** ($86B). Potential distress is at nearly $235B across all property types. Regional banks account for 70% of the CRE debt maturing through 2025. (Bl.)
3. On **positive side**: global real estate funds operated by PE firms sitting on $544B of cash in 2023 Q2. (WSJ)
4. We often don't know about losses (provisions) on banks' books until announced. So we look at **CMBS as proxy**. They account for 14% of CRE lending and provide monthly data on default rates and building valuations.
    a. In 2023, $35.8B of office CMBS matured and only 26% of loans paid off in full
        i. They struggled to get refinancing or sell properties
        ii. ~$14.8B of loans are now with **special servicers** (try to get best outcome for debt). Buildings get reappraised when transferred to special servicers – average valuation decline is 40%.
    b. Pool of distressed CMBS office loans is growing
        i. **10.5% of loans in distress** by Jan. 2024 (more than 3X YoY)
        ii. An additional $46.6B of office loans mature through 2025 (WSJ)
5. **Community banks** have **~25.7%** of assets in CRE vs. **18% for regional and small banks** and **4.4% for large banks**.
    a. An estimated **20% of the outstanding $4.7T of CRE loans come due this year**. Banks have extended / modified loans, but rates are still high and property values are down 21% (offices 35%; apartments 28%). (MarketWatch)
6. NYCB has lost over 50% of its value since its Jan. 31st earnings report when it disclosed a surprise loss and cut its dividend. Losses and provisions were 10X bigger than expected.
    a. The issues stem more from **regulatory costs of increasing NYCB's size** than commercial property loan issues. When they crossed $100B in assets threshold, they started facing tougher regulations. They must take a harsher view of risks in loan books, hold more liquid assets (lowering yields and earnings power) and build equity to higher capital ratio (cut dividends).
    b. Managing balance sheet more prudently hurts earnings and capital bases. Weaker stock price makes other funding sources more costly, hurting earnings.
    c. NYCB's big jump in provisions were mainly for office and apartment loans. Office loans are only 4% of total loan portfolio. **Apartment buildings** are 44% of portfolio – mostly NYC properties with rent regulations. Inflexible rents and higher funding costs hurts landlords and increases risk.
    d. There is risk that NYCB needs to raise equity to meet capital targets (they prefer to cut risk on balance sheet for now). (Bloomberg)

IV. Grateful but Vigilant: New Perspectives for a New Policy Environment, **Atlanta Fed Pres. Bostic, Feb. 15, 2024 (Atlanta Fed)**

A. Introduction

1. **Restrictive monetary policy** has helped to decelerate inflation faster than expected
    a. Policy combined w/ a **healing supply side**
        i. Goods supply chains and labor supply
    b. But inflation is still higher than 2%
2. We've **experienced disinflation without higher unemployment** or slower GDP (unusual)
3. For past two years, my **watchwords** have been purposeful, cautious, resolute and patient
    a. Purposeful in formulating policy (based on signals, not noise)
    b. Cautious in my stance given the economic uncertainty
    c. Resolute in commitment to keep rates high as needed
    d. Patient in reaction to incoming data (ensure sustainable path to 2%)
4. **Today,** my watchwords are **grateful yet vigilant**
    a. Grateful for substantial progress toward price stability
        i. PCE was over 7% in mid-2022; now, just over 2.5%
    b. Vigilant because fight is not finished – need continuing evidence that inflation is headed toward 2%
        i. Just look at CPI from earlier in week

B. Underpinnings of Vigilant Position: Risks have become more balanced

1. The committee has been trying to **manage two primary risks**:
    a. Staying **restrictive too long** could damage labor markets and the economy
    b. **Removing restriction too soon** could leave inflation high or spark reacceleration
2. I had been much more focused on the second risk, but now it's more balanced
    a. Absent a new shock to the economy, a reacceleration is much less likely
        i. But economic forecasting is difficult!
3. **Textbook theory has not played out**…rapid rate hikes have not resulted in rising unemployment and slowing growth
    a. Instead, as inflation decelerated, employment growth has outpaced its performance amid previous tightening cycles
        i. Previous tightening cycles on average led to a 1.5% increase in unemployment – mostly concentrated in construction and durable goods manufacturing
            1. These sectors have added jobs this time
    b. Unemployment was 3.6% in March 2022; now it's **3.7%**
    c. After monthly employment growth slowed last fall, it surged the past two months
        i. Have to **watch wage growth**: annual salary adjustments vs. tight market
    d. Seeing **some cooling** in **job openings** – peaked in March 2022
        i. But vacancy rate still higher than any time pre-pandemic
4. Past tightening cycles led to **~.5% dip in real GDP over 2.5 years**
    a. By contrast, GDP grew 3.1% for 2023
    b. **Anecdotal evidence**: businesses are sitting on pause, waiting for the optimal time to deploy assets and resume hiring to expand operations
        i. Sounds like **expectant optimism or pent-up exuberance**
        ii. Has the potential to unleash a burst of new demand to reverse progress
            1. This is a new **upside risk**

C. We are NOT Done with Inflation

1. A **durable labor market** rally **+** muscular **economic growth +** resurgent business **optimism**
    a. Argues for continued **patience**
2. Rapid deceleration of inflation would appear to offer a counterargument to leaving restriction in place
    a. The headline's 12-month, six-month, and three-month are near target
    b. While higher CPI will probably translate into a higher PCE, these **trends will not likely be substantially reversed** as a result of one month's data
3. **Reasons I need more confidence before declaring victory**
    a. **Goods inflation may rebound** a bit in coming months
        i. Many businesses still have inventories to work through and may ramp up orders once inventories are exhausted
        ii. Falling goods prices have been a significant share of decline in inflation
    b. A shade **over a third of the PCE basket rose at rates at or above 5%** in Dec.
        i. In line with reports over past six months
        ii. Well above the 20% that we expect with 2% inflation.
            1. So inflation pressures are still more **broad-based**
    c. The **Dallas Fed's trimmed-mean PCE**: +2.6% annualized increase in Dec.
        i. Identical to its reading over the past six months
        ii. One of the better predictors of near-term inflation
    d. The **Atlanta Fed's Underlying Inflation Dashboard** – 2/3 are above target
    e. The world-at-large remains rife with **uncertainty** that could derail progress
        i. **Consumer debt loads** are growing (particularly lower income/wealth)
        ii. **Geopolitical risks** could rattle energy markets or financial markets or reintroduce snarls in supply chains

D. History May Not Be a Good Guide

1. **Possible reasons**:
    a. We're navigating a once-in-a-century **pandemic**
        i. Models don't contemplate supply chain kinks, consumers being homebound, huge gov't fiscal support, losing 20MM jobs
    b. The US economy has grown **less sensitive to interest rates**
        i. The most interest-sensitive sectors, concentrated in goods production, account for a smaller share of GDP
            1. Over past 50 years, services have risen from 60% to 80% of GDP
            2. Goods have shrunk by half
        ii. Interest rate sensitivity of employment has shrunk in nearly all industries
            1. Might mean that rates have to **stay low or high for longer**
        iii. Many HHs and businesses have refinanced into low-cost loans
2. **Conclusion**: inflation will continue to decline, but **more slowly than pace implied by where the markets signal monetary policy should be**
    a. Labor market and macroeconomy mean we **can make policy decisions without oppressive urgency**