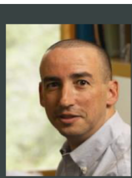

MARKET UPDATE

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Market Update – February 26, 2024

I. Markets

A. Stocks

1. **Last week**: DJIA+1.31%; **S&P 500 +1.66%**; Nasdaq +1.4%; Russ. 2000 (IWM) -.88%
    a. S&P and Nasdaq up for 15th time in past 17 weeks and ended at **record highs**
    b. **NVDA** was the big story
        i. But **more broad-based**: tech, healthcare, and industrials hit new highs
            1. Financials and materials are less than 5% from their peak
            2. The DJIA hit 39K for the first time and the Stoxx Europe 600 had its first record since 2022. Germany, France, Turkey, Taiwan, and Argentina are at record highs. (WSJ)
    c. Rally has persisted **despite rate cut hopes fading**
        i. Expected rate cuts were the reason the rally started! (Barron's)
2. **Bullish arguments**: AI optimism (NVDA earnings), Fed still expected to cut rates this year, 78% of companies beating estimates (7% YoY earnings growth), M&A activity (COF acquiring DFS), narrowing bond spreads, TOL says strong start to spring selling season, RCL said bookings significantly higher, China cut rates (FactSet) (Bl.)
    a. Soft-landing narrative: jobless claims back near post-Covid lows; manufacturing PMI had sharpest monthly increase since Sep. 2022 – factory output at fastest pace in ten months, cost growth lowest since Oct. 2020.
3. **Bearish arguments**: talk of AI bubble, equities have ignored the back-up in yields, FOMC minutes focused on risk of premature easing, concentration concerns (three stocks account for nearly half of S&P gains YTD), mortgage rates back near 7%, CRE, negative earnings growth for S&P 500 ex-Mag Seven, aggressive positioning, Services PMI showed slowest increase in new business in three months, weak 20-year auction (record 3-bp tail)
    a. Of companies that provided guidance for future earnings while reporting Q4 earnings, only 40% had outlooks greater than analysts' expectations. (Bl.)

B. NVDA

1. $22B in revenue for Q4 (this is their FY 2024) – **3X** Q4 2023 revenue
    a. Net profit was **8X** greater ($12B+) (WSJ)
2. Quarterly revenue growth was **+265%**; data center business **+409%** to $18.4B
    a. Six other members of Mag 7: revenue growth of 2% (AAPL) to 25% (META)
    b. NVDA's major chip rivals, AMD and INTC, both grew revenues by 10%
3. NVDA forecasts **234%** YoY growth next quarter. Their guidance midpoint is $24B vs. Wall Street's expectation of $22.2B.
4. NVDA is now the third most valuable US company with a market cap near **$2T**
5. With the internet, there was a network effect. With AI, every product has a separate use. (Barron's) (Barron's)

C. Stock Indexes

1. **AMZN** will replace WBA in the DJIA on Feb. 27. WMT is about to do a 3:1 stock split (reducing its importance in the price-weighted index), so this addition will increase the consumer sector.
    a. The 15 stocks added this century have lagged the S&P 500 by an average of 13.83% over the next 12 months. WBA has lost 2/3 of its value since joining the DJIA in 2018. (WSJ) (Barr.)
2. The **Wilshire 5000** started with 4700 stocks. The goal was to track the entire market. It peaked at 7,378 stocks in 1998. It now covers **3,392** stocks. (Barron's)
3. Japan's **Nikkei 225** closed at a record high for the first time in 34 years (since Dec. 29, 1989). Foreign investors are piling into Japan as China's appeal fades and Japan's corporate governance changes. Japan also seems to be breaking out of deflation, wages and profits are improving, and they will benefit from AI demand. Warren Buffett invested in Japan. (WSJ)
    a. Japanese markets have been beating the rest of the world.
    b. Overseas investors are driving this rally, accounting for almost 70% of the trading.
    c. In 1989, Japanese companies accounted for 32 of the top 50 companies by global market cap. Today, only Toyota makes the list.
    d. 37% of Nikkei members are trading below their book value. In the US, it's only 3%. For the Euro Stoxx 600, it's ~20%. (Bloomberg)

D. Bubble Questions

1. **Is there something to be excited about?**
    a. Yes – AI. NVDA represents this and has had great earnings.
        i. This is completely different than many of the tech bubble companies
2. **Is there cheap money available?**
    a. Rates are actually higher than they have been in the past few years
    b. Money is expected to get cheaper soon
3. **Does behavior suggest excessive speculation?**
    a. A bubble's final stage is almost entirely about judging human behavior
        i. Greater fool theory; try to get out in time
    b. For the Nasdaq 100, this is hardly comparable to 1999
    c. Little evidence of excessive margin debt
4. **Valuation – is the market too expensive?**
    a. Tech stocks are almost as expensive to the rest-of-the-world as 2000
    b. Stocks expensive relative to bonds (equity risk premium is small)
        i. Rally needs earnings to exceed expectations and/or lower rates
5. **Is concentration in the market excessive?**
    a. The top 10 stocks are a larger percentage of the US stock market than any time other than 1929
    b. As a percentage of the S&P 500, the top 10 are (by far) the largest percentage in records going back to 1980
        i. More than 1/3 of the S&P 500 market cap is just 10 stocks
    c. S&P tech is dominating S&P ex-tech by more than it did during tech bubble
6. **Does it matter that companies are so big?**
    a. Magnificent Seven profits are larger than the profits of most country indices
7. **Does it make sense? Are the assumptions valid? Can these companies stay dominant?**
    a. It's hard to stay dominant – competitors arise; governments intervene
    b. Investors tend to buy the "picks and shovels" that enable people to mine for gold (this is the CSCO story during the tech bubble)
8. **So is this a bubble?**
    a. It's not if we're comparing it to 1999 (Bloomberg)

II. Economic News

A. General Economic News

1. **Food spending** is currently 11.3% of disposable income, the highest since 1991 (when it was 11.4%). Restaurant prices: +5.1% in January YoY. Companies face **high labor costs** (22 states raised minimum wage in January) and some **commodities** (cocoa, sugar, beef) are high. (WSJ)
2. **Productivity** has averaged **3.9% growth** over the past **three quarters**, over 3X the pre-pandemic rate. Allows faster wage growth without higher prices. Productivity can be volatile.
    a. **Explanations** for recent productivity boom:
        i. Tight labor market encouraging efficiency
        ii. Investments due to Biden policies – plants and semiconductors; infrastructure
        iii. Firms catching up after pandemic disruptions
        iv. Workers gaining more experience and skills (Bloomberg)
3. **Risks of US-dependent growth for the rest of the world**:
    a. US inflation is still high and reducing rates too quickly risks inflation
    b. The strong dollar could continue to appreciate, hurting other economies
    c. There are signs of US weakness (e.g., declining small business optimism and higher credit card debt)
    d. Further weakness in China and Europe could impact US confidence (BW)
4. A recent study found that **52% of college graduates are in jobs that don't require their degree in their first year after graduation**. It's 45% ten years after graduation. College-level job holders earn 90% more than high school grads in their 20s. Underemployed grads earn only 25% more. Non-quant business majors are twice as likely to be underemployed. (WSJ)
5. **Existing home sales rose 3.1% MoM in January**. Mortgage rates had decreased although home prices stayed near record highs due to low inventory levels. The **median existing home price** was $379,100, up 5.1% YoY. (WSJ)

B. The Fed

1. **FOMC minutes**: "Most participants noted the risks of moving too quickly to ease policy stance." Only two officials highlighted risks of "maintaining an overly restrictive stance for too long."
    a. **Since meeting**: jobs report much stronger than expected, high CPI (WSJ) (Bl.)
2. **Fed Gov. Lisa Cook** said that she is optimistic that inflation is cooling but wants more evidence before cutting rates
3. **Fed Gov. Christopher Waller** said that January's inflation data warrants caution on the timing of rate cuts. He still expects rate cuts this year, but there's no rush. (Bl.)
4. **Phil. Pres. Harker**: In the past year, the Fed funds rate has increased 1% while PCE is down 2%. We need to see broad-based disinflation across goods and services. Harker looks at three key things: transportation (down from peak), food (generally back down to normal YoY levels), and shelter (remains high, but there are lags). The greatest risk is to lowering rates too early. The labor market is coming into better balance. Harker is concerned about credit card delinquencies, especially among younger borrowers and lower-income families. Anecdotal evidence is that consumers are switching brands and using credit cards more.
5. **Former Treasury Sec'y Larry Summers** sees a "meaningful chance" that the next FOMC move could be higher: no Fed policymaker has recently suggested cuts, FOMC has not given decisive forward guidance, hotter CPI, higher yields (Bl.)
6. **Questions that the FOMC faces**:
    a. Why is the economy so strong after the pandemic and rate hikes?
    b. Is monetary policy as tight as the Fed thinks?
    c. How tight is labor market (low unemployment, but wage growth and job switching rates are declining)? (Bloomberg)

III. Is This Time Different? Recent Monetary Policy Cycles in Retrospect, Gov. Philip N. Jefferson, Feb. 22, 2024 (Federal Reserve)

A. Aggregate Economic Activity

1. **2023 GDP** was much **higher than expected** by most professional forecasters
    a. Buoyed by strength in **consumer spending**
        i. But HH balance sheets began to weaken toward end of 2023
            1. High delinquency rates
            2. Further decline in savings
2. **Expect slower growth** in spending and output in 2024
    a. But spending is an upside risk b/c we don't know why it's so resilient
        i. Maybe consumers don't want to give up previous levels of consumption
            1. Because of habit formation + optimism over future income
        ii. Maybe socially motivated consumption ("keeping up w/ the Joneses")
            1. Models only consider wealth and income

B. The Labor Market

1. **Imbalance** between labor demand and supply **has narrowed**
    a. Demand has cooled
        i. Decline in job openings by 3MM from March 2022 peak
    b. Labor supply has improved
2. But labor market **remains tight**
    a. Job openings ~20% above pre-pandemic level
    b. Layoffs have remained very low
    c. Pace of payroll employment gains remains strong
        i. Monthly gains averaged 289K over past three months
    d. Unemployment rate was 3.7% (near historical lows)
3. Fact that unemployment rate and layoffs have remained low over past year amid disinflation suggests that there is a path to restoring price stability
    a. Without a substantial increase in unemployment

C. The Inflation Outlook

1. We've **made clear progress** toward the FOMC's 2% target **due to**:
    a. Unwinding of pandemic-related supply and demand distortions
    b. Restrictive monetary policy
        i. Cooled demand
        ii. Gave the supply side time to catch up
2. In January, **total PCE** prices rose 2.4% YoY (down from 5.5% in prior year)
    a. **Core PCE** prices rose **2.8%** (down from 4.9%)
    b. These numbers are **Fed estimates** (incorporating Jan. CPI)
3. **Slowing in core inflation has been especially pronounced** recently
    a. 3-month change in core 2.5%; 6-month 2.4%
    b. Most striking: core goods prices have declined
    c. Core services (both housing and nonhousing) have also slowed, but not as much.
        i. As labor market continues to cool, core service prices will moderate

D. A Longer-Term Perspective on Monetary Policy Cycles

1. **Fed funds rate** is likely at its **peak** for this tightening cycle
2. In **five of past six episodes**, peak rate is reached **once inflation is contained**
    a. Only exception: 1989 – inflation was elevated, but coming down
    b. Every other easing cycle began w/ inflation near 2% (1989 was near 4%)
        i. Situation today: closer to 2% than 4%
3. **Reasons the Fed gave for each easing cycle**:
    a. Most started due to concern about **slowing economic growth** (and sometimes reduced inflation concerns)
        i. One exception: 1995 started b/c of reduced inflation concerns (belief in soft landing)
    b. History is replete with **events that complicate monetary policy decisions**
        i. Four of the six easing cycles had multiple "easing phases" w/ later phases triggered by events such as 1991 Gulf War, 9/11, GFC, Covid
            1. Resulted in accelerated policy easing
4. In **some easing cycles** (Jan. 2001 and Sep. 2007), **unemployment increased quickly and economy weakened quickly**
    a. In Jan. 2001, we had seen moderating growth in H2 of 2000
        i. By Jan. 2002, unemployment had risen almost 2%
    b. Sep. 2007: not seeing much weakening in economy, but financial markets were exhibiting heightened and broad-based volatility and short-term funding markets were significantly impaired
        i. Only in Dec. 2007 did we see more significant spillover of housing downturn
            1. Several financial firms began to report larger-than-expected losses
        ii. Unemployment rose rapidly within a year of easing
5. **Inflation can also change rapidly**
    a. Russia's invasion highlighted this fact
    b. Excessive easing can lead to a stalling or reversal of progress
6. **Careful easing in the July 1995 easing cycle** allowed the FOMC to assess incoming data and other information to ensure that inflation was under control
    a. FOMC eased with lessening in inflation concerns, left rates unchanged for three meetings (waiting for more information), and then continued to ease

E. Lessons for Monetary Policy

1. We cannot know **if there will be unanticipated exogenous shocks** that require a policy response different from what is expected when easing begins
2. In the absence of unanticipated exogenous shocks, we **weigh keeping policy restrictive enough** to stop a resurgence of inflation **versus easing sooner** to avoid an undue increase in unemployment
3. **Three risks**:
    a. **Consumer spending could be more resilient** than expected – causing progress on inflation to stall
    b. **Employment could weaken** as factors supporting economic growth fade
    c. **Geopolitical risks** could remain elevated, and a widening of the Middle East conflict could affect commodity prices (e.g., oil) and financial markets