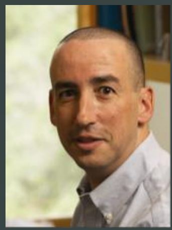

MARKET UPDATE

subscribe at sandyleeds.com

Market Update – February 5, 2024

I. Markets

A. Stocks

1. Last week – DJIA +1.4%; **S&P 500 +1.4%;** Nasdaq +1.1% **despite**:
    a. Powell said not to expect March rate cut
        i. Then, rate cuts became even more unlikely with strong jobs report
    b. GOOGL disappointed (dropping 6% on Tuesday) and AAPL disappointed
        i. In contrast, AMZN and META beat expectations. META was responsible for 40% of the S&P's weekly gain. META added more than the market cap of MS or GE or Philip Morris (Bloomberg)
    c. 271 stocks finished higher and 231 lower
        i. S&P 500 equal-weighted was +.43% for the week. Small-caps declined (-1.27%) for the fifth week out of the last six.
            1. Not seeing participation in breakouts (Barron's)
2. Stories about **WWIII** are their highest in 16 months, yet markets rallied to all-time high:
    a. Gradual desensitization to bad news
        i. Each fresh shock has to be greater to get our attention
    b. The US wouldn't go to war in an election year
        i. We want to retaliate but not escalate
    c. Traders sub-contract the job of risk assessment to the oil market
        i. If oil isn't spiking, people figure we're fine – b/c this is the big fear
            1. But remember: more signs of China slowdown = lower oil price
            2. Also, biggest supertankers don't go through Red Sea and Suez Canal (Bl.)

B. US vs. Europe

1. We currently have the **widest gap** between the S&P 500 current earnings yield and the MSCI Europe index ever. Europe has never been this cheap relative to the US.
    a. Same result if you use forward P/E
2. **Some discount is warranted**:
    a. The Magnificent Seven are all American
        i. The S&P equal-weighted and the European Stoxx 600 are on relatively equal terms since the beginning of 2021
            1. This means that the difference is the US mega-caps
    b. US companies are managed very well and the size of the US economy provides for economies of scale
        i. The VC and PE and animal spirits provide an unparalleled level of innovation
    c. European equities have a poor track record of delivering persistent positive earnings growth
3. **Potential catalysts** to narrow the gap:
    a. Earlier-than-forecast central bank cuts in Europe driven by a weaker economy
    b. Tightening of financial conditions in the US
    c. Any disruption in the rally spurred by AI on mega-cap tech shares
4. **US stocks face risks**:
    a. High earnings expectations
    b. Repricing of Fed rate cut expectations
    c. Upside risks to inflation due to shipping disruptions in the Red Sea (Bloomberg)

C. Bulls vs. Bears

1. **Bullish arguments**
    a. Broader Fed pivot underpinned by disinflation traction
        i. JOLTS: 6.1MM fewer **quits** in 2023 (-12% YoY) (50.6MM to 44.5MM)
            1. Dec. quits – lowest monthly level in nearly three years
            2. Should lead to lower wage growth
        ii. JOLTS: 9MM **job openings** in Dec. (was 11.2MM a year earlier)
            1. Still higher than the 6.7MM in Dec. 2019 (WSJ)
    b. More data support recession avoidance (jobs report – discussed later)
    c. Q4 earnings have picked up
        i. Earnings are now up 1.6% YoY. At the end of Q4, estimates were for 1.5%.
        ii. 46% of S&P 500 companies have reported; 72% have beaten estimates (slightly below longer-term averages). Numbers improving since financials are done reporting. (FactSet)
    d. Pushback against regional bank contagion concerns
2. **Bearish arguments**
    a. March rate cut not likely
    b. Surge in UST yields on Friday
        i. 2-yr UST yield increased 16 bps on Friday but ended the week only 2 bps higher (at 4.36%)
        ii. 10-yr UST rose from 3.87% to 4.03% on Friday (but it had ended the prior week at 4.15%)
    c. Only the tech sector has hit a new high. The other 10 sectors are 15% below their all-time highs on average. A few stocks could bring down the whole market.
        i. The Russell 2000 index is off ~20% from its Nov. 2021 record.
        ii. The A/D line is not confirming the rally. (WSJ)
        iii. The share of the top ten stocks on the MSCI USA Index has risen to 29.3%. The historical peak was 33.2% in June 2000. Only four sectors are represented in the top 10 stocks, compared to a historical median of six. JPM says that this is a threat to the stock market in 2024. High valuations mean that concentration could be reaching its limit. (Bl.)
    d. Earnings are weak outside of the Magnificent Seven (or six?)
        i. FactSet projects that the Magnificent Seven excluding TSLA will be the top six contributors to YoY earnings for Q4. They are expected to report YoY earnings growth of 53.7% for Q4.
            1. Excluding these six companies, the blended earnings decline for the remaining 494 companies would be -10.5% for Q4.
        ii. The S&P 500 is expected to have 4.6% earnings growth in Q1. Four companies (NVDA, AMZN, META, GOOGL) are projected to be top contributors for 2024 Q1 with earnings growth of 79.7%.
            1. Excluding these four companies, the remaining 496 companies are projected to have .3% earnings growth in Q1. (FactSet)

D. Commercial Real Estate

1. New York Community Bank
   a. Shares of NYCB fell 38% after the company swung to a Q4 loss and slashed its dividend to shore up capital following its purchase of the assets of the collapsed Signature Bank.
      i. They also acquired Flagstar Bancorp in late 2022.
   b. Loan losses surged. They said that more of their property loans started to sour.
   c. Total assets are now over $100B, a key regulatory threshold that comes with stricter capital and liquidity standards. (WSJ)
2. NY Community Bank took a $550MM charge for CRE
   a. Banks in Germany and Japan are also taking hits from their exposure to US CRE
   b. Boston Properties purchased a 29% interest in 360 Park Avenue South (a prestigious Manhattan location) for $1 from JV partner Canadian Public Pension Investment Board
      i. The pension board had invested $71MM in the property (Bloomberg)
   c. Problems from banks increase chances of Fed adding liquidity
      i. Good for bonds relative to stocks
3. CRE loan maturities
   a. Banks are facing roughly $560B in CRE maturities by the end of 2025 (more than half of all property debt). Regional lenders stand to be hurt the most.
   b. CRE loans account for 28.7% of assets at small banks, compared with just 6.5% at bigger lenders.
   c. NYCB has a fair amount of loans to rent-stabilized properties. (Bloomberg)

E. Why Oil has Been Rising (although not last week), But Not Shooting Higher

1. Higher prices due to:
   a. Deep freezes in ND and TX oil fields slowed US production. At same time, a strong GDP report drove up forecasts for demand.
   b. Trend-followers jumped on the trade
2. Yet prices haven't surged:
   a. Despite Israel – Hamas war and Houthi rebel attacks, there have not been major supply disruptions.
   b. Global surplus of crude
      i. US, Brazil, Guyana are producing more
      ii. Expanding offshore projects
      iii. Less demand with EVs
   c. OPEC has almost 5MM barrels of spare capacity (WSJ)

II. The Fed

A. The FOMC

1. Left the Fed funds rate unchanged (5.25% - 5.50%)
2. The statement got rid of guidance that suggested they were more likely to raise rates than lower them. They adopted a neutral view by noting that the risks to achieving its inflation and employment goals are in balance.
    a. Dropped the reference to a possible additional "firming" of policy and indicated that it wouldn't be appropriate for the Fed to cut rates "until it has gained greater confidence that inflation is moving sustainably toward 2%." (WSJ) (Bl.)

B. Powell's Press Conference

1. "It's a highly consequential decision to start the process [of lowering interest rates] and we want to get it right."
2. "We believe that our policy rate is likely at its peak for this tightening cycle and that if the economy defaults broadly as expected, it will likely be appropriate to begin dialing back policy restraint at some point this year."
3. He said that the economy has surprised us in many ways since the pandemic and our progress toward 2% is not assured. He said that they would maintain the current rate for longer if appropriate.
4. "I don't think it's likely that the committee will reach a level of confidence by the time of the March meeting to identify March is the time to [lower interest rates]" (Barron's)

C. Arguments to Cut Rates Later

1. Economy still growing solidly
    a. Growth may strengthen with lower inflation
2. Ensure inflation is under control before cutting
    a. Avoid cutting and then raising rates again
    b. NFIB survey shows biggest problem is inflation, not rates
3. Bond yields have fallen, stocks have risen recently
    a. Bloomberg and GS financial conditions indexes make conditions appear easy
        i. VIX is low and MOVE has gone lower
        ii. Asset price inflation could cause overall inflation
4. Neutral rate may be higher (WSJ)

D. Arguments to Cut Rates Sooner

1. Core inflation at or below 2% in six of last seven months (makes real Fed funds rate higher)
    a. Remember that the Fed raised rates to this level when core PCE was at 4.3% and they thought it would be 3.9% at the end of the year. (WSJ)
        i. It's actually 2.9% now and the last six months annualized is 1.9%. (WSJ)
        ii. ECI had its smallest increase in two years (Bloomberg)
    b. Powell looks at Fed funds rate minus one-year breakeven inflation rate (Bloomberg)
2. Rates were raised rapidly to 22-year high in 2022
    a. QT proceeding quickly
    b. Still above neutral rate
3. Waiting for more data risks aggressive cuts
4. Labor market risks deterioration before clear downturn signal
    a. Labor market can be hard to repair

E. Market Reaction

1. Powell said that a March cut was "not the most likely case or the base case."
    a. His words pushed the market down
2. Bonds rallied, swallowing the bond supply news without difficulty
    a. Fears around New York Community Bank led to UST buying
        i. Loan loss provision of $550MM (mostly for real estate) was a shock
    b. Sharpest risk-off day since last March
3. Fed funds futures curve ended Wednesday predicting more cuts by the end of the year than it had on Tuesday (Bloomberg)

F. Questions for the FOMC

1. Once the FOMC starts lowering rates…how low should they go?
    a. Many ideas are based on the Taylor rule
        i. Atlanta Fed has a "Taylor Rule Utility" webpage; Cleveland Fed also does this
        ii. Shows that Fed funds rate should be 4.8% right now, falling to 3.9% by year end
2. Is policy restraining economic growth if GDP is growing at 3.3%?
3. How low should the Fed funds rate go if the 10-year yield is already below 4%?
4. Is CRE messy enough to impact Fed policy?
5. George Box: "all models are wrong, but some are useful."
    a. Models seem to be saying that it's okay to cut rates even if everything is okay with the economy (WSJ)

III. Employment Report

1. Added 353K jobs in January
    a. Strongest in a year; nearly double expectations
    b. Added 289K jobs per month over past three months (fastest since 2023 Q1)
    c. Added 2.9MM jobs in past 12 months
    d. Nearly 2/3 of private-sector industries added to payrolls or kept them steady
    e. December revised upward from 216K to 333K
2. Wages increased 4.5% YoY (and .6% MoM)
    a. Mostly due to a reduction in hours worked (probably weather-related)
    b. Means that salaried workers count more
3. Unemployment rate held steady at 3.7%
    a. Labor force grew 124K
    b. Participation rate unchanged at 62.5% (was 62.4% a year earlier)
4. The household survey has been showing much slower employment gains than the employer survey over the past year
    a. Maybe the Census Bureau data that the Labor Dep't relies on are underestimating how quickly the population is growing and this has led it to undercount employment in the household survey.
        i. CBO estimated that US population rose .9% in 2023 (vs. .5% from Census)
5. Market reaction:
    a. Yields increased – indicating Fed may take longer to cut rates
        i. What would the reason be to cut rates at this point?
    b. Stocks increased – more belief in soft landing
    c. Atlanta Fed's GDPNow is currently estimating Q1 growth at 4.2% annual rate
    d. Fed funds futures is now only pricing in five moves and the first rate cut in May (WSJ) (Bloomberg) (WSJ)