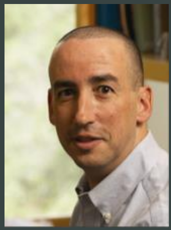

MARKET UPDATE

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Market Update – January 1, 2024

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I. Stocks

A. Recent Performance

1. **Week** ending Dec. 29: DJIA +.76%; **S&P 500 +.49%**; Nasdaq +.32%
    a. S&P 500 is up nine weeks in a row (longest streak since 2004)
        i. S&P 500 is within .6% of record.
    b. 84% of stocks above 20-day moving average
    c. 90% of stocks above 50-day moving average
    d. 78% of stocks above 200-day moving average
2. **Q4:** major stock indexes up 11% – 14%; 2-yr yield down 75 bps to 4.25%; 10-yr yield down 70 bps to 3.88%; dollar down 4.5%; gold up 11%; WTIC down 21%. We also saw a broadening of leadership to small-caps, most-shorted stocks, lower quality stocks, unprofitable tech.
    a. Key narratives of Q4: financial conditions eased (Fed said conditions were already tight), disinflation theme became more pronounced, Treasury refunding announcement indicated more short-term borrowing
3. **Why investors are bullish:**
    a. Economic growth moderating and inflation slowing (low PCE reading)
    b. Interest rates falling / continued optimism about Fed's pivot
    c. Earnings growth forecast over 10% in 2024
        i. Sales growing modestly
        ii. Cost inflation subsiding
        iii. Profit margins increasing
        iv. Share buybacks and dividends continuing (Barron's)
    d. Belief that there is cash to enter the market. Still $6.1T in money market funds – 29% higher than pre-Covid; portfolio managers hold 4.5% cash; long-term average is 3%
        i. Managers tend to add equity exposure when Fed cuts rates with economy still growing
            1. As rates fall, cash balances become less attractive
4. **Bearish narrative:** sentiment may be too bullish, investors too optimistic about Fed policy, stocks have already priced in all of the good news, cooling economic growth, downside risk to 2024 earnings with disinflation, CAPE of 32, cautious consumer trends (Nike), UST liquidity concerns, shipping risks
    a. Signs of irrational exuberance:
        i. Huge SPY ETF inflows
        ii. Net call volume near record highs
        iii. High equity positioning given still-high yields

B. Market Observations

1. **Index funds continue to gain market share.** S&P 500 and total stock market index funds had 17.5% market share in Nov. 2023
    a. Up from 8.76% at end of 2013
    b. S&P 500 funds over $2.7T of assets; total market funds $1.39T (Barron's)
2. **Emerging markets underperformed in 2023** (EEM +8.95% vs. S&P 500 +24.23%)
    a. China's weak economy dragged down EMs; India, Brazil and Mexico rallied
    b. Lower rates in advanced markets help capital flows to EMs
    c. Weaker dollar is good for EMs
3. **Broader participation indicates positive sentiment.** Can also look at advance/decline line, percentage of stocks above moving averages, new highs vs. new lows.
4. **The Magnificent Seven account for 28.5% of the S&P 500's market value**
    a. Approaching the highest-ever share for seven stocks
    b. Worth more than Japan + France + China + UK stocks
    c. S&P earnings expected to be up ~3% for 2023; down 4% without Magnificent Seven (WSJ)
    d. The top 10 companies drove 75% of the S&P 500 returns; 10-yr avg is 39%. (FactSet)
    e. Of course, in 2022, the Magnificent Seven fell 40% (S&P down 12%)
5. **Thematic investing can work:** pandemic is over from a stock market perspective (Bl.)
    a. Hotels/resorts/cruises index up 66% in 2023; Pfizer and Moderna down 46%
6. **The Santa Claus rally period is the last five trading days of the year and the first two of the following year.** When there is a Santa rally, the S&P gains 72.4% of the time in the next year (with an average gain of 10.2%). Without a Santa rally, the S&P gains 66.7% of the following years (with an average gain of 5%). (WSJ)
7. **Geopolitics don't seem to drive the market:** Russia's invasion of Ukraine, conflict in the Middle East, US-China tensions

C. Stock Ownership

1. **58% of US HHs own stock in 2022** (up from 53% in 2019)
    a. Includes individual stock ownership, funds, 401k
    b. Direct ownership increased from 15% to 21%
    c. Pandemic and cheap commissions helped; fractional shares also help
2. **Median value of HHs direct stockholdings nearly halved** from 2019 to ~$15K
3. **Median value of a US HH's primary residence surged** to $323,200 in 2022
4. **US households held about 39% of their financial assets in equities** in 2022 (WSJ)

D. Year in Review

1. **2023 performance**: DJIA +13.70%; S&P 500 +24.23%; Nasdaq +43.42%; Russell 2000 +15.09%. The S&P 500 got close to a record high but didn't reach it. This is the first time since 2012 that it didn't have a record high during the year. The Nasdaq gained 43.4% but also failed to hit a record high. The DJIA increased 13.7% and did hit a record.
    a. The equal-weighted S&P 500 (RSP) only gained 11.7%.
    b. The best performing sectors were semiconductors (AI) +64.9%, homebuilders (rate cut hopes), and retailers (consumer strength). The worst performing sectors included utilities, energy, food, and drug stores. (Barron's)
2. **Key narratives in the stock market in 2023**:
    a. Dovish Fed pivot / belief in soft landing
    b. Resilient consumer spending
    c. High expected earnings growth for 2024
    d. AI and obesity drugs excited market
    e. Banking crisis was quickly contained
    f. Dysfunction in Washington – debt ceiling debate, government shutdown threats, Speaker ousted
3. **Macro factors that drove 2023:**
    a. **Interest rates and Treasuries** – yields slid during the banking crisis (March); rates rose in October during the "higher for longer" period; rates dropped at the end of the year with hopes for rate cuts.
    b. **US dollar** – declined for first time since 2020
    c. **Commodities** – gold was up 13.4% to a new record high; WTIC was down 10.7% for year. Geopolitics did not help oil. Oil was driven by concerns over China, OPEC+, rising non-OPEC output.
    d. **Inflation** – headline CPI peaked at 8.9% in June 2022 and fell to 3.1% by Nov. 2023; core PCE was 3.2% in November (lowest since April 2021). There is increasing confidence that the Fed is winning its battle with inflation.
4. **Despite expectations of a recession, GDP grew over 2% in H1 and 4.9% in Q3**. Current estimates for Q4 are 2.3%. Corporate profits are estimated to have grown 3% in 2023 with eight of the 11 S&P 500 sectors having shown earnings growth. (Barron's)
5. Some of the **surprises of 2023**:
    a. The Fed was forced to raise rates much higher than expected. Bond yields spiked, causing some regional banks to fail.
    b. Investor enthusiasm for AI drove gains in stocks like NVDA and MSFT and helped lead a top-heavy rally through October.
    c. The rally broadened out in November, but 2/3 of the S&P 500 stocks underperformed the index for the year.
    d. The stock market rallied violently in the final months of the year. (Barron's)

E. Looking Ahead

1. **Potential catalysts for exceeding modest 2024 expectations**:
    a. Market leaders continuing to rise on better-than-expected earnings / AI potential
    b. Laggards playing catch up as recession fears fade, earnings recover
    c. Further declines in bond yields supporting high P/E multiples (Bloomberg)
2. **Are small-caps cheap?**
    a. For S&P 600 components, 2024 EPS estimates are down 33% in the past 18 months. Profit margins are expected to drop due to higher product costs, higher employee pay, and higher interest rates.
        i. The S&P 500's 2024 EPS projection has dropped just 9% during this time period. Smaller firms have more short-term debt (refinanced at higher rates).
    b. The S&P 600 trades at 14X next year's earnings vs. 19.4X for large-caps.
3. **With recession fears**, tech giants (Magnificent Seven) were viewed as a safe-haven due to earnings stability, robust cash flows, and strong balance sheets. **Now, with growing confidence in soft landing**, tech giants are less likely to outperform. (Bloomberg)
4. **With the Fed signaling an end to interest rate hikes, the focus shifts to the economy, earnings, and the elections**. The market rose in 2023 despite predictions of recession, bank collapses and high rates. Some of the key themes for 2024:
    a. Timing of Fed rate cuts
    b. Big tech growth stocks (seven largest tech stocks accounted for 64% of S&P growth since 2020) expect 22% earnings growth next year, double the overall index
    c. Presidential election (Bloomberg)

II. Rates and Currencies

1. **A volatile year**: the 10-yr ended 2022 at 3.88%, increased to ~5% and ended the year back 3.88%
    a. Markets expected 75 bps of hikes and received 125 bps
    b. By end of year, Fed had taken a more dovish tone
    c. Concerns about fiscal policy: Fitch downgraded US in August and Moody's threatened downgrade
2. **Recently, a 5-year ARM cost 7.04% while a fixed-rate mortgage cost 6.86%.** Normally, ARMs have lower rates than fixed mortgages. ARMs accounted for 7% of mortgage applications in 2022 – 2023, double their share from prior years. They accounted for 33% of applications before the 2008 crisis. (WSJ)
3. **Approximately 2/3 of China-Russia bilateral trade is now in yuan**. Currently, 3.6% of global payments are in yuan while 47% are in dollars and 23% are in euros. (WSJ)
    a. **It's estimated that 20% of global oil traded in non-dollar currencies in 2023**. This was driven by Russia and Iran selling oil to China and India (buyers willing to purchase discounted oil, even if not in dollars). Result is that countries don't hold dollars that need to be invested in the U.S. (WSJ)
4. **If the BOJ raises rates, this could cause a reversal of the carry trade**. Capital could flow out of the U.S. and back to Japan.

III. The Economy

A. Long-Term Growth

1. **US population grew .5% in 2022 to 334.9MM**
    a. Slow growth due to:
        i. Elevated deaths
        ii. Record low births (504K more births than deaths)
    b. Immigration (1.1MM)
        i. Accounted for 70% of population growth
2. **By 2030, there will be more residents over 65 than under 18 for the first time**
    a. According to Pew Research, 30% of Americans over 50 are single
        i. For people over 65, it is 36% (WSJ)
3. **Immigration divide**
    a. **Democrats**/immigration activists
        i. US has a responsibility to take in migrants fleeing poor/tumultuous countries
        ii. Border security is cruel/xenophobic
    b. **Republicans**/most voters
        i. Concerned over four-fold increase in border apprehensions under Biden
        ii. Data suggests thousands entering illegally daily
            1. Causes chaos in border regions and strains resources nationwide
    c. Migration surge is caused by:
        i. **Push factors** (conditions driving people out of home countries)
            1. Economic/political turmoil
        ii. **Pull factors** – attracting migrants to US
            1. Biden's more welcoming rhetoric during campaign
            2. Migrants believe chance of entering and staying is higher
    d. Republican proposals
        i. Temporary seal border when apprehensions exceed threshold
        ii. Expand powers to detain and deport those without valid asylum claim
        iii. Require asylum applicants to first apply in countries traveled through

B. Credit

1. **25% of American adults have used "buy now, pay later" (BNPL)**
    a. Accounts for 7.2% of online sales during Black Friday/Cyber Week
    b. Use for "necessary" and "everyday" purchases grew 434% YoY
    c. These are installment loans for purchases instead of credit cards
        i. Fixed loan payments instead of revolving balances
        ii. Interest rates from 0% to 36%
        iii. Not reported to credit bureaus
            1. Can have multiple loans unknown to lenders (WSJ)
2. **Credit card debt distress (30+ days delinquent) is 3.87%, the same as the Great Recession peak.** It was 2.62% pre-pandemic and it has increased 1.77% since 2021. (St. Louis Fed)

C. Inflation

1. **Overall prices fell last month, the first decline since April 2020**
    a. **Headline PCE** price index dropped .1% from Oct. to Nov. (first decline since April 2020); +2.6% YoY
    b. **Core PCE** +.1% MoM; +3.2% YoY
        i. Six-month annualized core PCE is 1.87%; 2.16% annualized 3-month
    c. **Services** +4.1% YoY; +.3% MoM
    d. **Goods** -.3% YoY; -.7% MoM (Barron's) (WSJ)
2. **Shelter is ~35% of CPI. Without shelter, inflation would only be 1.4%**
    a. Tenant rent is 7.7% of CPI. Based on rents by existing tenants.
        i. Lages new lease data due to annual lease terms
    b. Owner-equivalent rent – 25.8% of CPI
        i. Hypothetical rent for owner-occupied homes; based on rents for similar single-family properties
    c. Zillow shows rent growth has fallen to 3.3% this past year
3. **Inflation seems to have fallen without economic weakness**
    a. We don't need labor or housing market declines
    b. Supply factors have driven disinflation
        i. Reversals in commodity prices, supply chains, labor force participation (Bernanke interview, PIMCO)
4. **What could increase inflation pressures?**
    a. Tight labor markets
    b. Volatile energy prices
    c. Supply chain issues: Panama Canal restricting ships due to drought, attacks on ships by Houthi rebels (Bloomberg)

D. Commercial Real Estate

1. **~14% of all CRE loans and 44% of loans on office buildings appear to have negative equity**
    a. Could cause runs at regional banks
2. **US banks held ~$2.7T in CRE debt** at the end of Q3
3. **Commercial property values have fallen 22% since 2022 Q1**
    a. Office prices have fallen 35%
4. **A 10% default rate on CRE would = ~$80B of additional bank losses**.
    a. In the global financial crisis 15 years ago, delinquency rates on CRE peaked at ~9%, while charge-offs of such loans hit 3.3%. (Bloomberg via Yahoo)

E. Cars

1. **Households still own 2.2 cars, but they are driving less**. This could be work from home and delivery services. Overall, Americans are becoming homebodies. (WSJ)
2. **The average EV price is $51,668 vs. $44,112 for gas vehicles**. Approximately 25% of EV sales are in California. EVs account for 27% of sales in China, 15% in Europe and 8% in the US. (WSJ)

F. Looking Ahead

1. **Global GDP could be helped if China rebounds**. Sentiment has been negative. China would be helped by:
    a. A reduction in property concerns
    b. Improving exports
    c. Ongoing support of industry
2. **Will AI improve productivity and reduce labor tightness?**
3. **Different arguments about sentiment:**
    a. The "**vibecession**" that has puzzled economists for two years is finally **ending**. Some of the reasons for improving vibes: declining inflation, gas prices 40% lower than June 2022, higher real wages, productivity gains, lower borrowing costs, stock market gains. Vibecession was the last Covid-era disruption. Confidence is tracking the economy again. (Bloomberg)
    b. The Misery Index (inflation rate + unemployment rate) has dropped from 12.5% in June 2022 to 6.8%. Yet, **consumer sentiment remains depressed**. Possible reasons for disconnect between sentiment and spending:
        i. Job market and cooling inflation is allowing real wage gains (helping spending)
        ii. Sentiment is being impacted by **politics** (Republicans don't like Biden), the lasting impact of **high inflation**, and the experience of the **pandemic** (WSJ)
4. **Some things to consider as we enter 2024:**
    a. What are some things that we're certain about that will be proven wrong?
    b. What comes after a soft landing? Will inflation return? How fast will the economy grow?
    c. What is already priced into stocks and bonds?
    d. Is inflation done for good?
    e. Can consumers continue spending? (A Wealth of Common Sense)

G. Be Careful of Predictions

1. Be careful when listening to all of the predictions for 2024. **Remember some of the things we hear prior to and during 2023:**
    a. There would be a recession in 2023
    b. We needed to raise unemployment in order to get rid of inflation
    c. Home values would fall with higher rates (Bloomberg)
2. **85% of economists predicted a 2023 recession in a poll last year.** Fed Chair Powell predicted job losses from reducing inflation. **Why did economists go wrong?**
    a. Overreliance on models that predict recession from disinflation
    b. Failure to account for a credible Fed disinflation policy avoiding recession
    c. Politicization of macroeconomics (Bloomberg)

H. Learning from our Mistakes

1. **Explanations for recession not happening in 2023**
    a. Transitory factors – supply disruptions from pandemic went away; demand shifts between goods and services leveled out; prices slowed as supply issues were fixed
    b. Government spending filled gap – tremendous deficit spending
    c. Rates did not bite – homeowners had fixed-rate loans; companies had locked in low-rate loans
    d. Fed offset their own tightening – rescued banks after SVB (WSJ)
2. **The consensus opinion going into 2023 was to sell stocks (recession) and buy bonds**. But the economy was stronger than expected (stronger consumer spending), inflation dropped faster than forecast, breakthroughs in AI fueled tech stock mania, and the Fed pivoted. (Bloomberg)
3. **Tyler Cowen with some things we learned in 2023**:
    a. Huge gains in technology can be made very quickly (e.g., AI)
    b. Deterrence is less powerful than predicted (e.g., Israel is much stronger than Hamas, yet Hamas still attacked; NATO did not deter Russia's invasion of Ukraine)
    c. International conflict is on the rise again
    d. Governance doesn't matter…until it does (e.g., universities) (Bloomberg)

IV. The Fed

A. Fed Policy

1. **Fed funds futures show that investors expect the Fed to lower rates six times in 2024.**
    a. If the Fed has to lower rates six times, we've got a problem
2. **Array of Fed governors warning against overreacting to dovish signals**
    a. But bond market is increasingly convinced cuts are coming
    b. Inflation data supports bond market
3. **SF Fed Pres. Mary Daly said that rate cuts could be needed in 2024 to prevent over-tightening**. If inflation keeps steadily declining, rates will still be "quite restrictive" even with three cuts.
    a. She said that we must watch the employment market because when unemployment rises, it tends to rise a lot. We don't want to give people price stability and take away their jobs. (WSJ)
4. **Reasons for confusion over timing and pace of Fed rate cuts**:
    a. Recent inflation data taking Fed by surprise (shift in Fed's outlook)
    b. While there have been prior disagreements between the FOMC and the markets, this one is caused by an improvement in inflation data
    c. Fed officials are uncomfortable with market expectations
    d. Wide range of 2023 rate cut projections (WSJ)
5. **Interpretations of Fed's projections**:
    a. Further rate increases are off the table
    b. Three cuts anticipated in 2024
    c. "Soft landing" is forecast
6. **Fed wants to cut rates so that real rates don't increase; arguments to delay cuts:**
    a. Avoid overstimulating economy
    b. Data is noisy month-to-month
    c. Have been prior head-fakes on inflation slowing

B. Problems that the Fed Faces

1. **The Fed faces some difficult challenges this year:**
    a. The market expects more rate cuts than the FOMC expects
    b. There is uncertainty as to how low rates will eventually go
    c. 2024 is an election year (Barron's)
2. **Financial conditions have been volatile lately**
    a. Steep increase in rates in September and October (5% 10-year yield) and then rapid declines.
    b. Real rates may be high right now
    c. Stock and bond prices have increased
3. **Politics and Fed policy**
    a. Concern that Fed wants to goose economy before 2024 election
    b. Embracing average inflation target may show dovish leaning
        i. Willing to tolerate higher inflation
    c. May just want to avoid a "vibecession" (Bloomberg)