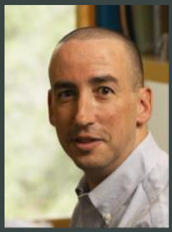

MARKET UPDATE

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Market Update – January 15, 2024

Stocks

Stocks rose last week: S&P 500 +1.84%, just .3% below record close. DJIA +.34%; Nasdaq +3.09%. The Fed funds futures market implies ~80% chance of a rate cut in March and a Fed funds rate of 3.65% by the end of 2024.

Stocks were driven higher by continued belief in the soft-landing narrative, disinflation belief (although the CPI report was not great), and optimism about earnings season. Low jobless claims furthered the belief that we will avoid recession.

The big news: December inflation data exceeded expectations. CPI was +.3% MoM (.2% expected) and +3.4% YoY (up from November's 3.1%). Disinflation is slowing and rate cuts may be delayed.

Earnings season started on Friday with the banks. JPM, BAC, and WFC all dropped. Citi rose 1% after announcing that they would fire 20K people. (Barron's)

The bearish case: The market is expecting large rate cuts despite the fact that inflation is still above 2% and we're near full employment. The Middle East conflicts seems to be broadening as the US and UK launched strikes on Houthi targets.

The Dogs of the Dow strategy involves buying the 10 highest dividend-yielding Dow stocks and holding for 12 months. The idea is that high yields reflect beaten-down companies. This strategy has trailed the DJIA in four of the past six years. The average yield for this year's Dogs is 4.6% (vs. 2% for the DJIA). Names include JNJ, AMGN, WAG, KO, CHV, IBM, and VZ. Over the past 20 years, this strategy has returned 8.5% vs. 10.2% for the DJIA. (WSJ)

Many companies have stopped using "ESG" terminology as some state officials refer to it as "woke capitalism." Investors pulled $14B from ESG funds in 2023. In 2021 Q4, there were 155 companies that mentioned ESG in their earnings call. In 2023 Q2, there were only 61. (WSJ)

2023 was a bad year for private equity. There was $871B in PE deals, the lowest since 2016. The projected distribution rate to investors is the second-smallest in 25 years. IPO activity fell almost 60% from 2021 peak. Fundraising is difficult as investors are "maxed out" on capital allocation to PE. (Bloomberg)

The SEC voted to allow retail investors to buy and sell Bitcoin through ETFs. They approved 11 Bitcoin ETF applications. While the SEC is afraid of fraud, they said that the high correlation between the futures prices and spot prices should make fraud more detectable. (WSJ)

Earnings

Q4 earnings are expected to be +1.3% YoY (second straight quarter of earnings growth), but down from the +8% projected at the end of September. For all of 2023, earnings are expected to be up .8%. Investors are watching for big bank commentary and retailer warnings about the consumer. Earnings are expected to increase 12% in 2024, but stocks moved ahead of earnings in 2023. (WSJ)

More S&P 500 companies than normal have issued earnings pre-announcements and a greater percentage of those pre-announcements were negative. Overall, 111 companies issued guidance (5-yr and 10-yr average of 97 and 98). Of those 111 companies, 72 issued negative guidance and 39 issued positive. The 65% issuing negative guidance is above the 5-yr and 10-yr averages of 59% and 63%.

Rates / Debt

UST yields: 3-month: 5.45% (-2 bps); 2-yr 4.14% (**-26 bps**); 10-yr 3.96% (-9 bps).

It was interesting to see the 2-year yield drop after the CPI report. Will the Fed continue QT? Dallas Fed Pres. Logan suggested that liquidity is becoming scarcer in the financial markets while NY Pres. Williams said that bank reserves are little changed from levels prior to the start of QT.

Since the 1970s, the 10-yr UST yield has averaged a .9% drop prior to the first rate cut. We have already seen that in the last few months. The question is whether yields can fall further if the economy is still expanding solidly. The other concern is that the market is pricing in more rate cuts than the FOMC is projecting. (WSJ)

Banks are taking advantage of the Bank Term Funding Program (BTFP) where they can borrow at a rate that reflects the market expectations for one-year (+.1%) and then earn 5.4% on reserves. The idea is that the one-year rate reflects expected rate cuts. This program is set to expire March 11th. (WSJ)

Banks had $80B in losses on hung debt last year. This was usually debt that was issued to finance an LBO and then it couldn't be sold as rates rose. (Bloomberg)

Companies are issuing long-term debt to secure funding for several years. In addition, long-term rates are lower than short-term rates. Borrowers are interested in locking in rates before the Fed starts cutting rates. (Bloomberg)

Private credit has grown into a $1.6T market. It's marketed as attractive due to diversification (seems to have low correlation with equities and fixed income), low historical default rates, lenders control terms and covenants, funds are selective about companies they lend to. (Bl.)

The Evergreen fund structure is increasing in private credit. This allows institutional investors to add money to the fund or withdraw money much more easily. The money is not locked up for 10 years with the uncertainty of when capital will be called or distributed. (Bloomberg)

Real Estate

The US office vacancy rate was 19.6% in Q4, up from 18.8% one year earlier. This is the highest vacancy rate since at least 1979. This is driven by overbuilding and WFH. Easy lending and speculative building led to excess supply. There also has been a shift from private offices to open floor plans and that resulted in less need for space. The highest vacancy rates were in Texas: Houston (26.4%), Dallas (25.5%) and Austin (24.7%). The lowest were NY (13.1%) and Chicago (14.3%). (WSJ)

Over $1T of multifamily debt is maturing through 2028. Multifamily assets valued at $67B are potentially distressed (most of any property type). Distress is being caused by higher borrowing costs, rents stabilizing, landlords' expenses rising, and more supply coming to market. During the pandemic, rents rose due to demand for more space. At same time, supply increased with low interest rates. (Bloomberg)

General Economic News

Economists are pleasantly surprised by the prospects of a soft landing with unemployment still low (3.7%), inflation forecast at 3.3%, and supply chains normalizing. Job growth could continue to be strong with the participation rate rebounding and immigration recovering. Risks involve inflation still being too high, easier financial conditions and deglobalization. Long-term growth is still expected to be low unless we have large productivity gains. (WSJ)

St. Louis Fed research suggests that the disconnect between the health of the economy and sentiment is related to lagging real wage growth. Brookings suggests that it is largely the result of media coverage. (St. Louis Fed) (Brookings)

Private company bankruptcies are increasing due to weakening demand, higher wage inflation, rising funding costs, less control over expenses than large companies, and intense competition that makes it difficult to raise prices. (Bloomberg)

47% of adult children (age 18 – 29) live with their parents, the highest percentage since the 1940s. 70% of parents with adult kids say that they have made financial compromises to support their kids. Nearly 20% say they sacrificed retirement savings to help kids financially. Young adults are struggling with student debt, high interest rates, and high inflation. (Barron's)

Fear of overpopulation has turned into fear of depopulation and lower growth. From 2000 – 2017, US population growth was .75% - 1%. Population growth in 2021 was .16% and 2022 was .49% (2/3 of which was from immigration). China's population could fall from 1.4B now to .5B in 2100. (Barron's)

Economic Risks

De-risking supply chains from reliance on China is creating an illusion of resilience. The average supplier per customer is not increasing, costs are rising, and we are mostly still relying on Chinese companies that are producing in Vietnam, Thailand, and Mexico. Most of the parts are still coming from China. (WSJ)

Extreme weather can impact businesses by damaging physical assets, disrupting normal operations, affecting supply chains or slowing demand. It can also create higher demand for some products and provide an opportunity for a firm to display its risk management. Uncertainty is increased if a firm is not fully insured and by the amount of time that it takes to assess and communicate the impact. (SF Fed)

2023 was the hottest year on record since record-keeping began in the mid-1800s. Global average temperature was 14.98C (58.96F), 1.48C (2.66F) hotter than pre-industrial baseline. (WSJ)

Retailers estimate that 13.7% of overall returned good was returned fraudulently in the US in 2023. This is $100B+ of fraudulent returns. Tactics include returning a box with bricks instead of purchased product, affixing a higher price tag on lower-priced item, returning counterfeit luxury goods, and returning merchandise stolen by organized retail crime rings. Retailers also deal with items that have been extensively used, items purchased elsewhere, and falsely claiming an order arrived damaged for a refund without returning item. (WSJ)

International

China surpassed Japan as the world's largest car exporter with a record 5.26MM cars sold overseas. The increase was driven by gas-powered cars being sold to Russia after Western automakers left. Chinese demand for gas-powered cars is decreasing as they shift to EVs. The US largely shuts out Chinese auto imports with tariffs. (WSJ)

Bloomberg estimates that a war over Taiwan would cost ~$10T globally, or 10% of global GDP. Conditions are ripe for a crisis because: (1) China's rising power and assertiveness; (2) Taiwan's growing sense of national identity; (3) Fractious US-China relations; and (4) Taiwan's Jan. 13th election of a pro-independence president. Taiwan makes 92% of advanced logic chips used globally. (Bloomberg)

Inflation

CPI +.3% MoM in December and +3.4% YoY (the highest in three months). Core was +.4% MoM and +3.9% YoY. Services excluding housing and energy ("supercore") rose .4% MoM. Inflation may not be easing as quickly as the Fed had hoped. Services inflation could continue. You have to question when and how many times the FOMC will cut rates this year. (WSJ) (Bloomberg) (Bloomberg)

Supercore inflation (core services ex-shelter) suggests stalled disinflation. This is sensitive to wages. Fed funds futures still expects rate cuts. Investors must believe that the Fed is afraid of inflation returning to levels that are too low or they are worried about causing a recession during an election year. (Bloomberg)

Median CPI has been high lately (5.1% in Dec. vs. 3.9% core), but it's been inflated by housing costs. Shelter accounts for 35% of CPI. If you take out housing, median CPI was up just 2.1% in November. Since housing inflation operates with a lag, the median inflation rate may be misleading. (WSJ)

Car insurance rates are 19.2% higher in the past year. Inflation is driving up the cost to repair and replace homes and vehicles. In addition, climate change is making risks harder for insurers to predict. Other problems include huge losses from disasters, more homes in high-risk areas (such as wildfire zones), and higher reinsurance costs. Many insurance companies are moving out of some markets. (WSJ)

Fiscal Policy

A bipartisan deal set the 2024 spending limit at $1.6T, but it's still not clear that this can be passed. Congress must still pass 12 appropriations bills (they've passed seven). There's not much time to align the House and Senate bills. Funding expires for some agencies on Jan. 19 and the remaining agencies on Feb. 2. (WSJ) (Bloomberg)

Geopolitics

The Middle East conflict seems to be broadening as the US and UK launched strikes on Houthi targets.

US politics/elections are the top geopolitical risk for 2024 due to: (1) polarization, dysfunction, unlikeable choices that create uncertainty; (2) close margins likely in swing states; (3) global impact with the election being decided by tens of thousands of people in swing states. We're already seeing some countries correlating positively with US political parties: Mexico with Democrats and India with Republicans. (Bloomberg)

The Fed

NY Fed President Williams spoke on January 10th. Here were his key points:

1. The economy added 2.9MM payroll jobs in 2023. The prime-age employment-to-population ratio regained pre-pandemic levels. Unemployment has been below 4% for two years, the longest stretch in over 50 years.
2. Inflation has fallen from a 40-year high of ~7% in June 2022 to just over 2.5%.
3. With respect to the three layers of inflation:
    a. Layer 1 – globally traded commodities
        i. Prices are now falling significantly; food <2%, energy declining
    b. Layer 2 – core goods
        i. Benefiting from rebalancing of supply and demand; near 0%
    c. Layer 3 – core services
        i. Inflation peaked in early 2022, but still coming down
        ii. Slowing shelter inflation as rent growth moderates
4. Wage growth is now ~4.5%
5. FOMC will consider cumulative tightening, lags, new developments
6. In 2024, expect GDP growth of ~1.24%, unemployment ~4%; PCE inflation 2.25% (NY Fed)

NY Fed Pres. Williams said policy may need to remain restrictive for the Fed to meet its goals. Cleveland Fed Pres. Mester said that March is too soon to cut rates. Dallas Fed Pres. Logan also said that inflation could pick back up if the Fed doesn't maintain sufficiently tight conditions.

Dallas Fed Pres. Lorie Logan said that while inflation, the labor market and GDP are moving into better balance, the key risk to the economy is premature easing of financial conditions that would allow demand and inflation to pick up. She said that the FOMC should not take the possibility of another rate increase off the table yet. (Dallas Fed)

The Fed has shown a willingness to aggressively cut rates despite low unemployment rate (e.g., Dec. 2018). A weak labor market could lead to this happening again. The six-month annualized inflation rate is 1.9%. Real rates are currently high, given the employment market. But, the Fed is also afraid of pushing home prices higher. (Bloomberg)