MARKET UPDATE

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Market Update – January 22, 2024

I. Stocks

A good week for large companies and tech. DJIA (+.7%), S&P 500 (+1.2%), and Nasdaq (+2.3%) were all higher. Russell 2000 was down for fourth consecutive week. S&P 500 equal-weighted was down for week. S&P 500 set a new all-time closing high at 4840 – first record high in two years. Tech earnings were strong and there is continued optimism about AI. NVDA and MSFT hit all-time highs.

The stock rally defied the big story of the week: lower expectations for the Fed to begin rate cuts in March. The lower expectations are due to:

1. Stronger economic data
    a. Retail sales showed consumer strength, despite higher interest rates and resumption of student loan repayments
    b. NAHB homebuilder sentiment and December housing starts (beat expectations)
    c. Large improvement in Univ. of Michigan consumer sentiment
2. Negative Fedspeak
    a. Waller – no reason to cut rates as quickly as in the past
    b. Bostic – start cutting rates in Q3

Other than tech, earnings haven't really helped stocks. 62% of S&P 500 companies that have reported have beaten estimates, but the average reporting company has seen their stock price drop. Earnings are expected to increase 4.4% YoY in Q4. This is an easy comparison as 2022 Q4 earnings fell 3.2%. (WSJ). Q4 earnings estimates have dropped 7% over past three months, lowering the bar for companies. (Bloomberg)

- Managements continue to talk cautiously. The consensus is for 11% earnings growth in 2024 which is being used to justify the 20X multiple. (Barron's) (FactSet)

Bond proxies did poorly. Utilities and real estate stocks fell for the week.

Bullish themes: eventual Fed easing, QT will slow, ongoing disinflation, labor market strength, strong consumer spending, AI optimism, low Q4 expectations, and strong 2024 earnings expectations. There is over $8.8T in money-market funds, driven by rising interest rates over past two years. If rates fall, maybe some of this money will move to stocks. (WSJ)

Bearish themes: the repricing of Fed rate-cut odds (higher yields – tighter financial conditions), narrow market leadership (Magnificent Seven), stretched positive sentiment, weaker China growth (deflation, property weakness), geopolitical considerations. (WSJ)

- S&P 500 trading at 19X forward earnings. This is near the highest valuation since the Fed started raising rates in early 2022. This is a 5.3% earnings yield, only 1.3% higher than 4% yield on 10-yr UST. (Barron's)

II. Rates and Currencies

Higher UST rates: 3-month 5.45% (Unch); 2-yr 4.39% (+25 bps); 10-yr 4.15% (+19 bps). If rates increase, it could pressure valuations (multiples) and earnings.

- Strong economic news and negative Fedspeak were to blame.
- The bearish view is that Treasury issuance is going to double to $2T in 2024. Maybe some of this will be offset by the eventual slowdown and ending of QT. (Reuters)
- Other bearish possibilities: higher inflation due to Middle East conflict, Fed pivot could be premature (inflation could resume); Japan could end yield curve control. (Bloomberg)

Low spreads: BBB 1.24%; high-yield 3.58%. Low spreads indicate healthy economic growth. Strong growth could help value stocks and small-caps. (Barron's)

Over $2.2T of commercial real estate debt is coming due between now and the end of 2027. Office buildings were hit hard due to WFH, increasing vacancies. Fitch expects loan delinquencies to double from 2.25% in 2023 to 4.5% in 2024. The sale of distressed properties could lead to valuation spiral. (WSJ)

Stronger dollar. The dollar appreciated almost 1% this week. Reasons include (1) high rates for longer; and (2) Trump's success in Iowa (Trump policies seen as negative for euro, yuan and peso). (Bloomberg) (Bloomberg)

III. The Fed

Fed funds futures are now pricing in only a 20% chance of a rate cut in March. Investors are still pricing in five-and-a-half cuts by the end of the year (3.97% Fed funds rate).

- Investors are confident in disinflation and a soft-landing (or even recession). There is also a view that the Fed wants to help Biden's reelection. (Bloomberg)
- The Fed wants to lean against market narratives and rampant speculation. They are concerned about inflating new bubbles. (WSJ)

SF Fed Pres. Mary Daly said that it's premature to think that interest rate cuts are around the corner. We need more evidence that inflation is consistently heading to the 2% target. Core PCE has risen 1.9% in November on a six-month annualized basis. (Bloomberg)

- Later, we'll see Waller's comments and Bostic's comments

Good news is bad news? Good news decreases the expectations for Fed rate cuts. The late 2023 rally was based on unrealistic expectations of quick and significant Fed cuts. Lower interest rates are filtering through the economy and may prevent any slowdown that is necessary to eliminate inflation. If the market becomes more pessimistic about rate cuts, yields could increase. Stocks need growth without inflation. (Bloomberg)

IV. The Economy

Existing home sales slumped to the lowest level in nearly 30 years, dropping 19% to 4.09MM (lowest since 1995). December sales were the lowest monthly rate since Aug. 2010 and were down 6.2% YoY. The decline in home sales is due to:

1. High mortgage rates – the 30-yr fixed rate mortgage is now 6.6%
2. High home prices (median sales price $382,600 in Dec.; +4.4% YoY)
3. Low inventory – 3.2 month supply at current sales pace (WSJ) (WSJ)

Univ. of Michigan consumer sentiment index rose 13% in the first half of January, a 29% combined rise over the last two months. This is the largest two-month increase since 1991. It is still 20% below pre-pandemic levels. A NY Fed survey shows that a record share of people expect better finances in a year. The Conference Board showed the biggest one-month increase since March 2021. Reasons for improving sentiment:

1. Strong job market
2. Cooling inflation
3. High stock prices
4. Lower mortgage rates (Bloomberg)

Risks remain: slower growth in 2024, possibility of recession, inflation could be sticky, market volatility. (WSJ)

Economists are expecting 1% GDP growth in 2024. This might not be a recession, but it will feel like one. (WSJ)

Reasons to be optimistic about the economy:

1. Positive real wage growth will support consumer spending
2. Delinquencies reflect normalization from very low levels
3. Job openings and layoffs signal a strong labor market
4. Corporate bankruptcies are low
5. Peak pain from higher rates has passed (MarketWatch)

Of the Americans who missed their most recent student loan payment, 56% attributed it to affordability; the next highest reason was that they couldn't contact servicer (18%). (Bloomberg)

China reported 5.2% GDP growth in 2023, meeting its annual target. Some economists doubt the accuracy of the statistics. There is pressure on local officials to manipulate data to meet growth targets. (There are actually some economists who think China's growth was higher, although it's hard to understand why they would underreport it.) (Bloomberg)

- Chinese stocks are performing horribly. Property values continue to fall, deflation risk continues, nominal GDP growth has slowed dramatically, unemployment ticked up, the election in Taiwan was negative, Trump has reemerged as a candidate, concerns about the investability for foreign investors. (Bloomberg)
- China's 9MM births is less than half of their 2016 total when the one-child policy was abolished. The fertility rate is close to 1.0. They currently have 1.4B people. (WSJ)

Next week: 75 S&P companies report; $162B of Treasury auctions; Q4 GDP; December PCE.

V. Almost as Good as It Gets…But Will it Last, Fed Gov. Christopher Waller (Fed'l Reserve)

A. GDP

1. Averaged 3% real growth over first three quarters – above long-term trend of 1.8%. In Q3, we grew at a 5% annualized pace.
2. We'll get Q4 numbers at the end of the month, but everyone expects that growth is slowing. The Blue Chip forecast - ~1.5% growth and Atlanta Fed (GDPNow) is ~2.4%.
    a. Business spending and government spending moderated.
    b. Consumer spending moderated, but maybe not as much as expected.
        i. Consumer spending is being impacted by high interest rates, lower excess savings, and higher credit usage.
3. The bottom line is that economic growth appears healthy right now.

B. Labor Market

1. The labor market continues to improve. And by improve, what the Fed is really looking for is demand for employees to weaken and supply to increase.
2. While the participation rate dropped in December, the Q4 average was higher than 2022. We're bringing workers back.
    a. Still below pre-pandemic level
        i. Retirees haven't returned (maybe inflation will change that)
3. Hiring: 165K average monthly gain in Q4 vs. 221K in Q3 and 257K in H1
    a. You might say that we headed in the wrong direction in December b/c we added 216K jobs after adding 173K in Nov. and 105K in October. But if you look at the 2023 employment reports, they get revised two times after their initial announcement, and in 9 out of 10, they were revised down.
4. Wage growth ticked back up to .4% in November and December and up to 4.1% YoY. When you want 2% inflation, 4.1% wage growth sounds really high, but that's misleading. Wage inflation of 3.25% is probably consistent with 2% overall inflation.
5. Key idea to Fed: Job openings are declining, but we haven't lost jobs. If you think of demand for employees as the # employed + vacancies, you want to just lose the vacancies. We're looking at the percentage of jobs that are open.
    a. In the spring of 2022, vacancy peaked at 7.5% (nearly 12MM vacancies), with ~6MM unemployed
    b. The FOMC raised the Fed funds rate over 5% and:
        i. Core PCE fell substantially – especially over the past six months
        ii. The vacancy rate fell to 5.3%
            1. Vacancies/unempl. fell from 2 to <1.4 (pre-pandemic 1.2)
        iii. Involuntary job separation has remained near 1% since April 2022
            1. Don't fire people (labor hoarding)
        iv. 3.7% unemployment same as March 2022
6. Research: if vacancy rate < 4.5%, tighter policy leads to significantly higher unemployment

C. Financial Conditions

1. Waller says financial conditions remain restrictive (even though some argue they've eased)
2. 10-year yield peaked at 5% in October – after strong Q3 GDP and strong jobs report for Sep.
    a. At that time, investors still expected one more rate hike
    b. Then, data started to cool and SEP showed no more rate hikes
        i. 10-yr yield ~4.15% now
        ii. He argues that 4% is roughly where 10-yr was after last rate hike in July
            1. In July, we considered conditions tight
                a. Supported by financial conditions indexes – I'm not sure!
3. Waller suggests that tight conditions putting downward pressure on inflation

D. Translating GDP, Labor and Financial Conditions to 2% Inflation Goal

1. Total PCE down from 5.3% in Jan. to 2.6% in Nov.
    a. Core PCE down from 5% to 3.2%
2. Focus on 3- and 6-month measures to understand current level
    a. Core at ~2% annual rate
3. But 2% goal needs to be sustained over time

E. Policy Implications

1. Growing confidence of sustainable 2% inflation path
    a. Policy now more balanced (rather than focused on bringing inflation down)
        i. Because the labor market is now more in balance
    b. Balanced means that we're just as worried about full employment as inflation
2. Rates are set properly to maintain downward pressure – it is restrictive – the key issue
    a. As long as inflation doesn't rebound, we should be able to lower rates this year
    b. This view consistent with SEP of three rate cuts
3. What would change my view of rate cuts?
    a. Economic activity that seems to have moderated in Q4 does not play out
    b. Balance of supply and demand in labor market stops improving or reverses
    c. Gains on moderating inflation evaporate
4. Cuts should be careful and data-dependent
    a. No need to cut rapidly as in some past cycles
    b. Healthy economy gives us flexibility to move slower
        i. And keep real rate at an appropriately tight level

VI. The Arc of Monetary Policy May Start Bending Soon, Atlanta Fed Pres. Bostic, Jan. 18, 2024

A. May be Approaching a New Phase in Monetary Policy Cycle

1. Real Fed funds rate is sufficiently restrictive to return inflation to 2%
2. Primary question: how long do we leave rates here before unwinding policy
    a. Must consider the long and variable lags of monetary policy
3. The goal is soft landing (or "the golden path" or "immaculate disinflation")
    a. Very rare and hard to achieve
4. Best sign of progress: March 2022, unemployment was 3.6%; now it's 3.7%
5. Don't forget:
    a. Still a ways away from 2% goal
    b. Considerable uncertainty about how supply and demand will evolve in 2024

B. Inflation Rate Declining Faster than Expected

1. Many indicators declined faster than expected (this is why we may remove restriction)
    a. GDP growing ~2.6% for year (many expected a recession)
    b. PCE has similarly surprised for the better
        i. June 2023: forecast 3.5% PCE at end of 2023
        ii. Late 2023: lowered forecast to 2.9%
        iii. Latest print through Nov. was 2.6%
2. The golden path of declining inflation and still-solid labor markets and economic growth may stretch farther than most of us figured
3. With this data, I think we start normalizing policy in Q3
    a. Don't want to risk unnecessary damage to labor market and macroeconomy
        i. Worry about "passive tightening" – lower inflation = tighter policy
        ii. Have to take turkey out of the oven before it's done – b/c it keeps cooking

C. What am I Watching?

1. Shorter-term inflation measures to see where inflation is headed
2. Labor market indicators
    a. Nominal wage growth seems to be headed back to just over 3%
        i. Inflation has receded faster, positive real wages since mid-2023
            1. But real wages are below pre-Covid levels
    b. Job growth – has slowed, but unemployment still near historically low levels
        i. Would be slowing more but for health care and social assistance – only 14% of labor force, but 60% of job growth over past seven months
    c. Job losses – few business leaders expect layoffs

D. Uncertainty Abounds (Must be data-dependent)

1. Continued disinflation, normalizing wage growth, and a healthy labor market – none of this is assured; recall the continued shifts in the outlook for GDP and inflation
2. Uncertainty lurks in numerous corners:
    a. Conflicts around the world could complicate supply chains and energy markets
    b. Budget fights and elections at home/abroad could affect GDP growth & markets
    c. A weakening labor market could sap consumer spending

Survey of Business Uncertainty finds executives are more unsure of future sales and employment growth than they were before the pandemic