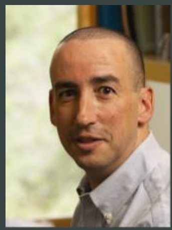

MARKET UPDATE

subscribe at sandyleeds.com

Market Update – January 29, 2024

I. Stocks

A. Last Week

1. DJIA +.65%; **S&P 500 +1.1%**; Nasdaq +.9%; Russell 2000 +1.75%
2. Stocks were **helped by** a strong GDP report, low inflation, and China stimulus (cut reserve requirement). Stocks were **hurt by** lackluster Q4 earnings, skepticism over China's stimulus, lower optimism about a March rate cut and TSLA's earnings.
    a. Q4 earnings are down 1.4% YoY (expected +1.5%); only 25% have reported and of those, 69% have beaten expectations (5-yr avg. is 77%; 10-yr avg is 74%). In aggregate, they are missing estimates by 5.3%; the 5-yr average is beating by 8.5%
        i. Still expecting 11.6% earnings growth for 2024. (FactSet)
3. **Problems that stocks face**:
    a. Rally seems to be slowing.
        i. See caution in bank stocks, small-caps, and real estate.
    b. Rate cut hopes may not materialize (and may already be priced in). Inflation may still be too high and economy too strong.
    c. Yields are rising again. (WSJ)
4. Evercore says some clients are asking **whether market is rallying because of Trump**. Evercore says it's unlikely:
    a. Small caps would likely benefit (under Trump) because they get 79% of their revenue from the US (vs. 59% for the S&P 500) and they could benefit from Trump's proposed 10% tariffs on imports, but small-caps are underperforming large-caps YTD.
    b. In addition, Trump Fed appointee Michelle Bowman opposes hiking bank capital requirement, yet S&P 500 bank ETF is trailing the S&P 500 YTD. (Barron's)

B. Magnificent Seven

1. The Magnificent Seven added **$5.1T** in market value in 2023. They now comprise **~28%** of the S&P 500. **T**ech is doing well with inflation under control. These companies are very profitable. There is enthusiasm about AI. (WSJ)
2. The Magnificent Seven's market cap has increased over 60% **since the Oct. 12, 2022 low**. NVDA increased 427%. The Magnificent Seven account for over 60% of the S&P 500 return over past 12 months. (NYT)
3. **MSFT** is the second company to ever reach a $3T market cap (after AAPL).
    a. This is largely driven by AI and its partnership with OpenAI. MSFT invested $13B in OpenAI for 49% stake in profits. (WSJ)
4. **TSLA** fell 12% on Thursday, losing $80B of market cap and is down ~26% YTD. TSLA is now the 10th largest company in the S&P 500. EV is losing out to weight loss drug companies. Thursday's drop was blamed on:
    a. Failing to give specific targets for 2024
    b. Admitting growth will be "notably lower"
    c. Falling short of their 50% annual growth target, despite lowering prices
    d. Elon's demand for a 25% ownership stake (Bloomberg)
5. Some are comparing NVDA's run-up to the tech bubble. (Bloomberg)

C. Looking Ahead

1. **Bullish arguments** for stocks:
    a. Lack of Fed pushback against broader pivot narrative
    b. Retail FOMO
    c. Dry-powder hopes from MMFs
    d. More resilient US growth
2. **Bearish arguments**:
    a. Repricing of aggressive Fed rate cut expectations
    b. Overhang from stretched positioning
    c. Lackluster reaction to Q4 earnings
        i. The net profit margin for Q4 is expected to be 10.7%, down from Q3's 12.2% and 11.2% in Q4 of 2022. The five-year average is 11.5%. (FactSet)
            1. QoQ decline in margins across all sectors
    d. Concentration and valuation concerns
        i. The Magnificent Seven = 28% of the S&P 500 and a 28 P/E. (Bl.)
        ii. Low equity risk premium for the S&P 500
    e. Geopolitical tensions (MarketWatch)
3. **Small-caps** could outperform if economic growth continues and the Fed cuts rates. The S&P 600 trades at 13.7X forward earnings while the S&P 500 is at 19.8X. Consumer and financial sectors are ~38% of S&P 600, so a strong economy would help significantly.
    a. In addition, there could be a rotation from large-caps. (Barron's) (WSJ)
4. **Next week**: FOMC meeting; jobs report (expecting 175K jobs and 3.8% unemployment)
    a. Also getting earnings from AAPL, AMZN, MSFT, and GOOGL

D. China

1. China's CSI 300 index is down over 1/3 since 2020, and is now in its fourth year of declines. Foreign capital is fleeing and domestic investors are shifting assets.
    a. The government is trying to intervene even though they also try to discourage speculation. They have cut the stock trading tax and eased restrictions on index funds and foreign investment. (WSJ)
    b. China is putting together a **$278B package** to stabilize stock prices. Their property crisis, weak consumption, and policy uncertainty are hurting stocks. (Bloomberg)
2. China's stock market drop adds to the gloom from the property downturn and the weak economy. China's stock market has wiped out $6T in market value. (Bloomberg)
    a. This is approximately the size of Japan's stock market.
3. Chinese stocks are no longer leading the emerging markets
4. China appears cheap relative to the US

II. Bonds, Rates and Currencies

1. **UST rates**: 3-mo 5.44% (-1 bp); 2-yr 4.34% (-5 bps); **10-yr 4.15%** (unch) (Treasury)
    a. **2/10 spread** is just 19 bps – lowest since 2022
2. **Robert Rubin**, former Treasury Sec'y, warned of "enormous risks" due to federal deficits. Risks include higher longer-term yields and the fact that markets can "correct savagely." Republicans refuse to increase taxes and Democrats refuse to cut entitlements. (Bloomberg)
3. **Asian investors** own nearly $3T of US debt. They've been scared by high inflation, Fed policy, Fitch's downgrade, and Moody's threat of downgrade. Chinese media is questioning why China lends money to the US. Chinese holdings have dropped from $1.3T (2013) to $782B today.
    a. Japan is the biggest holder ($1.1T). Selling could lead to a contagion effect. (Barron's)
4. JPM and MS are arguing that investors should **buy the dip on the 5-yr UST bond**:
    a. Large sell-off has led to attractive yields
    b. Possible weaker economic data (less fiscal support, cold weather)
    c. Rate cuts (Bloomberg)
5. During the past two years, stocks have fallen when the 2-yr yield has risen. (Barron's)
6. The **$4T municipal bond market may experience less liquidity** as Citigroup has decided to exit the market. (WSJ)
7. **Dollar has risen 2.1% YTD** due to scaled back expectations of rate cuts. (MarketWatch)

III. The Economy

A. GDP

1. GDP grew **2.5%** over the past year to $27.36T. Q4 showed **3.3% annualized growth ($27.94T annualized)**. It grew 3.1% from Q4 2022 to Q4 2023. (WSJ)(WSJ)
    a. The economy was helped by a resilient consumer, higher government spending (especially state and local), and a boost from trade. Business investment rose slower than the prior year. Residential investment dropped >10% YoY. (WSJ)
    b. In Q4, cooling inflation may have fueled consumer spending. Personal spending rose at a 2.8% rate. Consumer spending accounted for 1.91 percentage points of GDP growth. Final private domestic demand rose at a 2.6% rate (stripping out trade, inventories, and gov't spending). (Bloomberg)
2. While Fed rate cuts could stimulate further growth, economists are predicting just **1% growth for 2024**.
    a. We're seeing rising delinquencies, personal savings rate dropped to 4%, layoff announcements, and uncertainty about pricing power and demand. (WSJ)
3. Future **productivity could increase**:
    a. Learning curve for pandemic/post-pandemic hires
    b. Improved employer-employee matching
    c. Manufacturing investment from policy initiatives (The Hill)
    d. Lessons from remote work leading to efficiency gains (Bloomberg)
4. A Pew Survey found that **59% of parents provided financial help to children under 35** in the past year. In addition, 57% of adults under 25 live with their parents. Young people are waiting until a later age to buy a home and get married. (WSJ)

B. Labor

1. There has been a lot of argument over the **Beveridge curve** and whether unemployment needs to increase in order to lower inflation. Gov. Waller has been right in that job openings have decreased, but we haven't had job cuts (higher unemployment). (Bl.)
    a. The Beveridge curve typically shows higher job openings (Y-axis) when unemployment is lower (X-axis).
2. **Labor force** added 2.6MM people in 2022 and 2.4MM in 2023. This was mostly prime-age workers, immigrants, and people sidelined by the pandemic.
    a. This improved the supply of labor and reduced wage growth. To see further decline in wage growth, we may need to see a slowdown.
    b. We're seeing signs of cooling in the labor market and inflation: fewer job openings, fewer people quitting, higher productivity (WSJ)
3. **Workers are unhappy** due to lingering work-life balance issues, decline in real wages, pressure to do more with less staff/resources. There are fewer job openings. (WSJ)
4. In 2023, **remote workers were 35% more likely to be laid off** than peers working in-office full-time or hybrid. It's harder to build attachments to people not seen face-to-face. Executives believe office workers are higher performers. There is reluctance to fire people that you see. (WSJ)

C. Inflation

1. **Headline PCE** 2.6% YoY; +.2% MoM. **Core PCE**: 2.9% YoY; +.2% MoM. Inflation is retreating faster than expected. (Bloomberg)
    a. Headline PCE was 7.1% in June 2022 and 5.4% at end of 2022.
2. **Core annualized rates**: 1.5% over past three months; 1.9% over past six months. (WSJ)
3. With respect to inflation, consumers (voters) focus on:
    a. **Prices of items that they purchase frequently**, regardless of the fact that it may constitute a small part of our spending (e.g., Snickers vs. television).
    b. **Negative news** and big price increases
    c. **Price levels** rather than inflation – so we expect prices to return to earlier levels. Food inflation can be very troubling for an incumbent. (NYT)
4. A new Fed paper disputes the idea that the **"last mile" of inflation is the hardest** to travel. It finds no structural reason for this. But it may take more patience. (Bl.) (Atlanta Fed)
5. The next **annual update to CPI** is Feb. 9. Last year, this update led economists to conclude that inflation hadn't cooled as much as hoped. They update the previous five years based on new and improved information. (MarketWatch)

D. Real Estate

1. **Businesses purchased 570K homes in 2023, down 29%** from 802K in 2022. 2023 Q4 was the lowest quarterly total in eight quarters (123K). **Contributing factors** include high interest rates, record home prices, tight inventory, and slowing rent growth. Investors accounted for **11%** of home purchases in 2023. Small investors accounted for the majority of those purchases. Institutional buyers purchased 69% fewer homes in 2023 than in 2022. (WSJ)
2. There are a record number of **office-to-apartment conversions** planned in 2024. Over 55,300 housing units being converted from offices. This is more than a 40% increase from 2023. Growth is being slowed by higher financing costs and permitting. (Bloomberg)

E. Fed

1. Markets still expect **5.5 cuts** in 2024 and there is a **50% chance of a March rate cut** being priced in.
2. **Arguments that the Fed won't cut rates in March**:
    a. Economic data remains strong with 3.3% GDP growth in Q4. Unemployment is low.
        i. Fed funds rate is < nominal 5.8% growth rate from 2023. (Barron's).
    b. Policy isn't that restrictive. The short-term neutral rate is currently around 4%.
    c. Stock market is at record highs (and wealth effect) – lowering the Fed funds rate would result in looser financial conditions (Bloomberg)
        i. AI stocks are front-running Fed rate cuts. Need high rates to pop the bubble. (MarketWatch)
    d. The Fed's greatest fear is lowering rates too soon and having inflation reignite. Some critics say that the Fed is overly sensitive to this and that they should be just as worried about a hard landing. Fed officials look at fighting inflation as job #1, so allowing inflation to reappear may feel like a bigger mistake. (Bloomberg)
        i. In the early 1980s, the US had a double-dip recession. Paul Volker had lowered rates before inflation was done and then the FOMC had to increase rates again. Powell doesn't want to repeat these mistakes. (Bloomberg)
3. **Arguments that the Fed will cut rates in March**:
    a. There is a widespread belief that the Fed doesn't want Trump re-elected. If that's the case, that would result in them cutting rates sooner.
        i. This would help the economy and be further from election. (Bl.) (WSJ)
    b. Real Fed funds rate is increasing with the drop in inflation

IV. Politics

1. **Are we still a great power?** Niall Ferguson posits that a great power can make other states or entities do what is in the great power's national interest and can shrug off pressures from other countries.
    a. Some of our sources of power have decayed, including immigration policy (a shift from legal to illegal), the rule of law (perceived inequities have resulted in the World Justice Project dropping us to a #26 ranking), education, public health, fiscal issues, and even in some areas of innovation. If we want to get bipartisan support to fix all of this, argue that remedies are aimed at fighting China. (Bloomberg)
2. Before Trump was president, Democrats favored **immigration and border security**. Trump's anti-immigration policies pushed Democrats to the opposite end of the spectrum. But most Americans are closer to the Democrats' old view. (NYT)
3. Lai Ching-te's election in Taiwan was a display of support for democracy. China called Lai a "**secessionist**." His election creates a new wedge between the US and China. (Bl.)(WSJ)
4. Over 600K people in the world face **starvation**. 95% of them are in **Gaza**. The rest live in South Sudan. (WSJ)
5. The **Houthi attacks in the Red Sea** have resulted in over 500 container ships being rerouted around Africa, adding two weeks to trips. Approximately 12% of world's seaborne trade passes through the Red Sea. Shipping costs are increasing and there are supply chain disruptions. (Bloomberg)
6. The **gender pay gap** was the smallest on record in the US at 17%. It is 25% for women with advanced degrees. High paying jobs that require 24/7 are a big issue as women with children often can't take these roles. (Bloomberg)