MARKET UPDATE

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Market Update – January 8, 2024

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I. Markets

A. Last Week – Stocks

1. **The DJIA was down .9%, the S&P 500 dropped 1.5%, and Nasdaq fell 3.25%.** Stocks ended a nine-week winning streak. The market's performance was driven by higher yields (10-yr UST yield went above 4%), the mixed jobs report creating uncertainty about the Fed's rate path (discussed later), poor performance by the Magnificent Seven, overbought conditions (late-2023 rally), the FOMC minutes, concerns about earnings, and concerns about shipping. (Barron's) (Bloomberg) (WSJ)
2. **The "Santa Claus" period** (final five trading days in December plus the first two in January) ended with a .9% drop for the S&P 500.
3. **January barometer theory**: January performance indicates market's direction for year ("as goes January, so goes the year"). When S&P is positive in January, average return for year is 9.2%. When it is negative in January, average return for year falls to 2.1%. Currently, investors are questioning the timing of the Fed's cuts, valuation, and the 2023 end-of-year runup. (WSJ)
4. **The bullish view** is that the soft / no-landing narrative continues. The jobs and JOLTS report were consistent with continued growth. Disinflation was seen in the ISM prices paid data.
5. **The bearish view** is that the markets are still overbought, the strong labor market will stop the Fed from cutting aggressively, FOMC minutes were less dovish than the press conference, the Magnificent Seven are under pressure and geopolitical tensions continue to escalate.

B. Other Concerns – Valuation, Earnings and Expectations

1. **Stock returns are likely to be much lower over the next decade.** The S&P 500 has beaten cash by 11.9% over the past decade. Now, it is trading at a trailing P/E that is above 25. In order to continue to have high returns, we need:
    a. High earnings growth
    b. Multiple expansion – if earnings grow 6%, you'll need significant multiple expansion and that will require lower interest rates
    c. Higher dividend yields (Bloomberg)
2. Despite fears of recession in 2023, we had an "**everything rally**" late in the year and the S&P finished within .6% of its high. The 10-year UST yield peaked at 5.02% but ended much lower. **Risks**: rates could fall sharply on bad news; market concentration; global conflicts; election uncertainty. **Expectations are very bullish at this point, earnings are expected to grow 11.6% and the Fed is expected to cut rates six or seven times**. (WSJ)
3. **During Q4, analysts lowered their estimates by 6.8%.** In the past five years, estimates have dropped 3.5% on average. Estimates for health care dropped the most. (FactSet)

C. Forecasts

1. **Key themes for 2024:**
   a. Fed policy and rate cuts – investors betting on six cuts, SEP projects three; uncertainty about lag effects of prior rate increases
   b. Market concentration – Magnificent Seven responsible for 64% of S&P growth since 2020; analysts expect these companies to grow earnings 22% in 2024, double the rate of the S&P 500; valuations already high, so good earnings may be priced in
   c. Presidential election – enough said
   d. Asia risks – will BoJ take their policy rate positive? How fast will China grow? Will India's strong performance continue?
   e. ECB and BOE – expected to lag the Fed in rate cuts (Bloomberg)
2. **Reasons investors are bullish for 2024:**
   a. Interest rates back to normal – but real rates still positive and higher than pre-pandemic
   b. Consumers have purchasing power (and easier financial conditions) – could still have recession
      i. Households are wealthy and liquid
      ii. Demand for labor is strong
   c. Onshoring boom boosting capital spending
   d. Housing set for recovery
   e. Inflation is turning out to be transitory
   f. High-tech revolution boosting productivity (Bloomberg)
3. **Investors are hoping for normalcy**: moderate inflation and middle-of-the-road interest rates. They worry that high inflation remains, stocks are expensive and the Fed is unlikely to cut rates as much as they did in the past. (WSJ)
4. **Be wary of forecasts.** When we entered 2023, strategists suggested that stocks would drop and bonds would rally due to a recession. GS recommended investing in Chinese stocks due to reopening after Covid. None of that worked out. The reasons why forecasts were wrong:
   a. Persistent consumer strength despite rate hikes
   b. Inflation dropped faster than expected
   c. Breakthroughs in AI fueled tech rally
   d. Fed managed to contain fallout from bank collapses in March
   e. Economy proved more resilient than expected to handle higher rates (Bloomberg)

D. Private Equity

1. **VC funds are struggling to fundraise** as LPs are questioning the VC funds' valuations of startups. (WSJ)
2. **PE deal activity is expected to increase** in 2024 due to increased pressure from LPs to have funds return capital, lower bond yields (making borrowing easier), and sellers willing to accept lower prices. (Bloomberg)
3. **A JAMA study examined 51 hospitals acquired by PE firms** between 2009 – 2019 and found a 25% increase in adverse events like infections and falls, but a 5% decrease in in-hospital mortality rates. The question is whether over-eagerness to cut costs leads to a decline in care or does PE bring capital and innovation in some cases. Most likely cause of problems is due to a decrease in hospital staffing after acquisitions. Study was funded by Arnold Ventures which is critical of PE. (NY Times)

E. Rates and Debt

1. **UST yields**: 3-month 5.47% (+7 bps); 2-yr 4.40% (+17 bps); **10-yr 4.05% (+17 bps)**
2. **The spread between the 10-year UST yield and the 30-year mortgage rate is still high**, but it has declined for the past eight weeks. A possible reason for the decrease is that with rates dropping, refinancing (prepayments) increase, meaning that the duration of mortgages will decrease. (WSJ)
3. The **Treasury Department's August** 2023 decision to **issue more long-term debt** resulted in higher yields and lower stock prices. The **November** refunding announcement that indicated **greater usage of short-term debt** led to higher bond prices (lower yields) and higher stock prices.
    a. Unfortunately, as we continue to increase our debt (we've added $1T just since mid-September, despite full employment and no declared wars), we're going to have to issue more long-term debt in the future. (Barron's)
4. **Private credit industry is booming** – from $200B in 2000 to $1.5T today. It is expected to reach $2.8T in five years. Banks are actually enabling private credit growth rather than fighting it. Banks are acting as intermediaries between borrowers and private lenders. They provide deal flow and advice while the private lenders provide the capital. This allows banks to serve midsize corporate clients without balance sheet risk. It generates fees and profits for banks. But there is less transparency in the system. Be wary if individual investors start providing funding for private credit and they are allowed to redeem quickly.
    a. Private credit is filling the gap as regulations tighten on banks. Regulations favor making less risky loans.
    b. Private lenders offer financing to riskier credits at higher rates
    c. We see a shift from banks to the "shadow banking system," which now has 47% of assets (up from 43% in 2007). (Barron's)

F. Oil

1. **Despite attacks on shipping the Red Sea, surging US shale oil and gas production is keeping global energy markets well supplied**. Oil prices are down 5% in the past month and natural gas prices are down 23%. Oil exports reached a record 4.5MM barrels/day in November. US oil is replacing Russian oil in Europe. LNG exports likely hit a new record in December. It's unclear how long growth can continue as the rig count is dropping.
    a. If Iran gets fully involved in conflict, this threatens the Strait of Hormuz where 18MM bpd flow. (WSJ)
2. **Non-OPEC nations like the US have been increasing oil production faster than demand is growing.** At the same time, OPEC+ is pledging production cuts to increase prices. US oil production hit a record 13.3MM bpd in December. (Bloomberg)

II. The Fed

A. Fed Commentary and Other Fed News

1. **Key points from the FOMC minutes**:
    a. Fear of downside risk if policy stays restrictive for too long; labor market could shift abruptly from a gradual to sharp downturn
        i. Opposing fear that rates need to be higher because inflation is >2%
    b. Markets starting to believe Fed policy is working
        i. Easing financial conditions make the inflation fight difficult
    c. Inflation and wages give Fed room to cut rates
        i. Supply chains healed + more workers = lower inflation (WSJ)
2. **Richmond Fed President Tom Barkin said that "a soft landing is increasingly conceivable but in no way inevitable."** Using the airplane landing analogy, he identified risks:
    a. Economy could run out of fuel – lag effects of tightening; rising interest costs
    b. Unexpected turbulence – unforeseen geopolitical, cyber, sector-specific shocks
    c. Approaching the wrong airport – inflation is still too high (3% is not our destination), companies are still planning larger-than-normal price increases
    d. The landing could be delayed – due to consumer strength, high asset values and low unemployment; long-term rates just recently dropped (to help housing) (Richmond Fed) (Barron's)
3. **The Fed's actions to curb inflation regained credibility, but now there is fear that unemployment could rise if they hiked too much.** With that said, spreads declined recently to their narrowest level since April. (Bloomberg)
    a. You can dislike the Fed's regulatory record, but their role in stabilizing the economy during the financial crisis, Covid, and the recent mini-banking crisis is pretty good. (Bloomberg)
4. **Alberto Musalem was named the next St. Louis Fed president**, effective April 2, 2024. His experience includes being a senior advisor at the NY Fed, head of research at Tudor Investment Corp., an economist at the IMF, and the CEO of Evince Asset Management (quant firm). He will bring financial market knowledge to the FOMC meetings. (WSJ)

B. The Employment Report and the Fed

1. **Employment report and arguments against aggressive cuts**:
    a. Payrolls rose 216K, above expectations
    b. Unemployment rate is only 3.7%
    c. Average hourly earnings rose .4% MoM and 4.1% YoY
    d. Manufacturing wages were up .8% MoM in Nov. and .9% in Dec. (40-yr record)
2. **Employment report and argument for aggressive cuts**:
    a. While we added 216K jobs, last two months were revised down by 71K
    b. Drop in average workweek offset job gains
    c. Unemployment rate stayed at 3.7% because of 676K drop in labor force
    d. Manufacturing wage gains likely due to auto industry union agreement
    e. 92% of job growth was healthcare, gov't, and leisure/hospitality (Barron's)

III. The Economy

A. Labor

1. **22 states raised their state minimum wage on January 1, 2024.** This will affect 9.9MM workers. In addition, 38 cities and counties also increased their minimum wage above state minimums.
    a. States can set their minimum wage higher (but not lower) than the federal minimum wage. The federal minimum wage of $7.25 hasn't changed since 2009. The dollar has lost 30% of its purchasing power since 2009.
    b. There are 17.6MM workers that earn less than $15 per hour. Nearly half of these low-wage workers are in 20 states that abide by the federal minimum wage. (NPR) (WSJ)
2. **Despite strong labor market, there are unemployed people and many are struggling**. Most states do not index unemployment benefits with price inflation. Several states pay a maximum $275 weekly benefit. (Bloomberg)
3. **With all of the recession fears in the past year, why haven't companies fired employees?** Possible reasons: (1) companies' own outlooks remained more positive than the economic outlook (Duke CFO survey showed lower optimism for economy, but higher optimism for own companies); and (2) letting workers go is risky if recession doesn't come ("labor hoarding).
    a. Fading recession fears could lead to more hiring. (WSJ)
4. **November job openings (JOLTS report) was the lowest in nearly three years.**
5. Nobel Prize winner Christopher Pissarides warned that **STEM fields may become less necessary due to AI** and that irreplaceable skills are managerial, creative, and empathetic skills (e.g., communications and customer service). (Bloomberg)
6. **The US has ~11MM undocumented immigrants and ~10K illegal border crossings per day.** Migration can be driven by vast wage gaps and fears of violence in home country. Migrants often fill undesirable, low-wage jobs, provide workers to support aging populations and provide tax revenue. Opponents argue that it's hard to control migration and it changes the cultural identity of a country. Solutions include:
    a. Aiding the developing world to reduce incentives to migrate
    b. Accepting the reality that immigration is unavoidable and managing the flows
    c. Convincing voters that some migration benefits economies (Bloomberg)

B. Forecasts and Inflation

1. **Rents** rose over 20% during 2021 – 2022, but are **estimated to grow at ~1.5% in 2024** due to:
    a. Nearly 1MM new units under construction
    b. Renters hitting affordability limits
    c. Prices paid for apartment buildings have dropped 12% in past year. (WSJ)
2. **How many forecasters predicted** that 2023 would avoid recession, get the annualized six-month inflation rate down to 1.9% and finish the year with 3.7% unemployment? Forecasting the economy is difficult and being right for the right reasons is even harder. (Bloomberg)
3. The **CPI report** will be released on Thursday.

C. Recession vs. Soft-Landing

1. **IMF Managing Director Kristalina Georgieva says that the US is "definitely" headed for a soft landing and she credits the Fed**. Avoiding recession means Trump's protectionist policies are less likely to find support (but inflation will hurt Biden). She warned that US-China rivalry could hurt global GDP and threaten supply chains for critical minerals (necessary for green technologies). (Bloomberg)
2. **While personal consumption is ~2/3 of the economy, it is not the key driver of recessions**. Consumption tends to continue to grow during recession. **Private fixed investment is the key driver of GDP declines.** It has declined in every prior recession, accounting for 93% of the GPD decline (1.6% of the 1.7% drop). Investment typically declines before recessions. Residential investment has been the main contributor.
   a. While builder sentiment has declined sharply, mortgage rates have dropped 1% and housing permits/starts are well above the 2022 lows. (Dallas Fed)
3. **We waver between the Goldilocks narrative and the "reverse Goldilocks" narrative. Goldilocks:** (1) housing is rebounding with lower mortgage rate; (2) labor market is still strong; and (3) manufacturing PMI has shown slight recovery. The "**reverse Goldilocks**": (1) the Fed may not lower rates as much or as quickly as market expects; and (2) inflation could stay high. (Bloomberg)

D. Risks

1. **Geopolitical risks to the soft-landing narrative**:
   a. Russia – Ukraine – currently a stalemate; could intensify if US support wavers or EU unity cracks due to Hungary's relations with Russia
   b. Hamas / Israel – huge number of deaths; could intensify if Israel strikes Iran/Hezbollah in Lebanon
   c. Taiwan presidential election – China is opposed to Taiwan's VP who is running for president
   d. Trade disruption – 10% of world trade through Red Sea/Suez (Bloomberg)
2. **The global economy faced major challenges in 2023**: (1) inflation; (2) aggressive interest rate hikes; (3) war in the Middle East; (4) real estate crisis in China; and (5) US-China rivalry. **Potential trouble spots for 2024 include**: (1) US consumer spending and job market; (2) China's real estate crisis continues; (3) Germany's economic struggles; (4) Japan's exiting negative interest rate policy; and (5) India's economic promise. (Bloomberg)
3. **The Panama Canal is capping the number of ships per day to 24** (vs. 38 normally) due to drought conditions. The Canal moves 3% of global trade, including 46% of Asia to US containers. (Bloomberg)
4. **Banks are behaving cautiously**. Possible reasons include:
   a. Preparing for new capital and liquidity rules from the Fed
   b. Potential changes to the FHLB system (which was heavily relied up in 2023 crisis)
   c. Banks as Treasury dealers have had to absorb heavy debt issuance
   d. Desire to secure high cash levels as long as possible (WSJ)