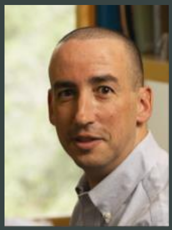

MARKET UPDATE

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Market Update – March 25, 2024

I. Last Week

A. Stocks

1. Week: DJIA +1.97%; **S&P 500 +2.29%**; Nasdaq +2.85%; IWM 1.57%
    a. **FOMC meeting** seen as dovish (discussed below)
        i. Bloomberg's Financial Conditions Index is almost as loose as in 2021 when the Fed funds rate was zero. (Bloomberg)
    b. Improving **breadth** (w/ stronger economic outlook)
2. The S&P 500 is up **33% YoY** and home prices are up 6%. Wealth effect? (Barron's)

B. FOMC Meeting

1. FOMC voted unanimously to leave the **Fed funds rate unchanged** at 5.25% to 5.5%.
2. The **dot plot**:
    a. Still forecasts **three rate cuts** this year
        i. Only one Fed official thinks that there will be more than three cuts this year. In December, it was five.
            1. The market has moved toward these expectations
        ii. The mean expected Fed funds rate (for end of 2024) rose 11 bps to 4.81%.
    b. The median for the Fed funds rate in **2025** shifted from **3.6% to 3.9%**.
    c. The long-run **neutral rate** shifted slightly higher to **2.60%**. (Bloomberg)
3. **Higher growth and inflation** expectations:
    a. They raised their 2024 GDP forecast from 1.4% to 2.1%. (FT)
        i. Expected 2024 unemployment dropped from 4.1% to 4.0%.
    b. Expectations for 2024 PCE shifted higher (2.4% to 2.6%).
        i. Inflation continues to be **sticky**, above the 2% target.
            1. Powell seemed to downplay this…a bumpy path to 2%
4. The Fed's reverse repo facility has decreased from \$2.1T to \$440B. As this continues to drop, **expect the FOMC to slow QT**. (Bloomberg)

C. Should the Fed Lower Rates Due to Anticipated Problems?

1. Seeing stress among lower-income consumers: rising car loan and credit card **delinquencies** (discussed later)
2. **Commercial real estate** (discussed later)
3. Maybe high rates are impacting consumer **pessimism**
4. 56% of **small businesses** use credit cards for financing
5. Commentators discussing "**conundrum**" – higher short-term rates and lower-long-term rates. (WSJ) (FT) (Bloomberg)

D. Arguments that Private Equity Returns will be Lower in the Future

1. Inflow of funds means **more money chasing after deals** (higher prices)
2. **Higher interest rates** (no more cheap financing?)
3. Private equity is similar to **leveraged public equity** and stock returns will be lower going forward (FT)

E. Rates

1. UST: 3-month 5.46% (-2 bps); 2-yr 4.59% (-13 bps); **10-yr 4.22%** (-9 bps)
2. 2/10 yield curve has been **inverted for 430 days** – the longest ever (FT)
3. Spreads are tight due to attractive (high) yields (investors look at the total yield and this seems attractive, even if the spread isn't), solid credit quality, and strong demand
    a. Fridson argues that **credit availability** (which varies with economic growth) determines spreads
    b. Even with low spreads, if the real yield is high and corporate balance sheets are strong, you can do well with corporate bonds. (FT)
4. **Wider spreads on MBS** mean mortgage rates will stay higher than many homebuyers hope. The spread is currently ~1.5%. In the past, it averaged closer to 1%. This is being impacted by QT. (WSJ)

F. Currencies

1. The **strong dollar** has been highly correlated with the **S&P 500's P/E multiple**.
    a. Recently, the strong dollar has helped stocks by helping to fight inflation. In addition, its role as the global reserve currency has supported our bond market and blunted the impact of rising deficits.
    b. A weaker dollar (at this point) may be indicative of stagflation. The dollar could also weaken if the yen strengthens. (MarketWatch)
2. The **Bank of Japan ended negative rates** after eight years. The ECB and SNB had already done this. This was the BoJ's first rate hike in 17 years. The rate is now 0% to 0.1%. They did this as a result of steadily rising wages (unions just negotiated a 5.28% salary increase) and prices (inflation is currently 2.8%). They also removed the target for the 10-year JGB (yield curve control).
    a. They had been fighting deflation and trying to spur growth.
    b. The **yield differential** on 10-yr bonds issued by the US and Japan is 3.5% (down from 4.2% a few months ago but up from 1.5% three years ago).
        i. The shrinking yield differential should help the yen strengthen.
        ii. A stronger yen could hinder Japanese stocks. Japan's stock market (Nikkei 225) is at a 34-year high.
        iii. The shrinking yield differential could also result in the carry trade unwinding (eventually, not now). Japan is largest holder of USTs. (WSJ) (WSJ)
    c. The BoJ owns 54% of JGBs (was 12% pre-2013) (Bloomberg) (Bloomberg) (FT)
    d. A stronger yen could help China to compete (in exporting to other Asian countries).
        i. But China may want a stronger yuan in order to promote de-dollarization. (Bloomberg)

II. Economy

A. Stagflation

1. The stagflation concern is that **growth could be slowing while inflation is plateauing**. Retail sales were only up .6% and CPI was higher than hoped.
2. Part of the problem is that some economists are defining growth below 2% as the "stagnation" part of stagflation. That doesn't make much sense when the FOMC believes that our long-term potential growth is ~1.7% - 1.8%. (WSJ)

B. Possible Long-term Changes to the Economy Post-pandemic:

1. Greater difficulty in finding workers
2. More volatile input prices
3. Longer lead-times needed
4. Increased government support for chip industry
5. Higher inventory levels
6. Higher interest rates (Bloomberg)

C. Why is the economy growing so quickly despite the FOMC tightening policy?

1. Maybe the **neutral rate** is higher
2. Businesses and consumers **locked in low rates** and haven't been affected
3. Government spending (expansionary **fiscal policy**)
4. Rising asset prices created **wealth effect** (homes, stocks, crypto)
5. **Supply factors** – higher immigration and labor force participation (WSJ)

D. More on Immigration

1. GS: there **has not been a rise in native-born unemployment** despite the immigration surge. GS also argues that **all of the rise in unemployment is among foreign-born workers** and this means that we aren't seeing the kind of weakening demand that presages recessions. Instead, we're seeing an increase in labor supply where it takes many of the new workers time to find their feet. The Sahm rule could be misleading in this situation. (NYT)
2. The surge in immigration may be misleading. We are experiencing high apprehensions, but the apprehension rate is much higher than it was in past years. (Bloomberg)

E. Credit Card Delinquencies

1. Americans had more than **$1.1T** on their credit cards at the end of 2023.
    a. While the $1.13T of credit card balances is a nominal record, it is not a record in real terms.
2. Nearly **10% was 90+ days delinquent**
    a. Delinquencies are at their highest level in almost 13 years
3. Credit card interest and fees increased by $51B to $157B from 2020 to 2023 (FT) (FT)

F. CRE

1. US office market **vacancy rate is 17%.** It was 11% in late 2019.
2. GS says that **CRE values have fallen by 33% on average**, and as much as 60% in some places, primarily for office buildings. While demand for high-quality properties remains high, the outlook for low quality buildings is grim. We're not seeing pain because borrowers have exercised extension options. In addition, banks "extend and pretend."
3. **Only 3.5%** of all office deals involved a **distressed seller**. This is **because**:
   a. Most tenants are still paying rent (strong economy)
   b. Pressure is building slowly as leases expire (often reducing required space by 30% to 40%)
   c. Lenders are engaging in "extend and pretend" (so that owners don't have to sell into weak market and banks don't have to recognize loss). (WSJ) (FT)
4. GS: in the past year, **CRE debt that is due in 2024 has increased by $270B**. Borrowers wanted to delay because of higher rates. Lenders wanted to "**extend and pretend**" (modify loans) because the alternative is foreclosing on office properties and experiencing losses.
   a. For balance sheet-constrained lenders, the ability to extend and pretend could diminish over time.
   b. ~62% of office CRE loans held by banks are held by **regional/local banks**
   c. Among non-bank lenders, ~47% of 2023 maturities were pushed into 2024.(FT)

G. Inflation

1. Services inflation has run ~1% higher than goods inflation for the past 20 years.
2. As our income rises, so does our demand for services.
   a. Rising wages in high productivity sectors pushes service costs higher while low productivity growth in the services sector leads to higher services prices.
3. The BIS argues that services inflation could reassert its higher growth trends (forcing central banks to be more aggressive).
4. In addition, remember that globalization and the integration of emerging Asian markets into trade lowered prices for goods, yet now we're seeing de-globalization. So goods deflation may not be able to partially offset services inflation.
   a. Climate change could push up the price of goods (e.g., disruptive weather events or drought-induced restrictions on freight shipping in waterways) and geopolitical tensions which would cause changes to global value chains could also push goods inflation higher.
   b. This could mean that service inflation would need to be much lower. (FT)

H. General Economy Stories

1. Lower-income consumers and weaker companies have been hurt by higher interest rates, inflation, and the depletion of pandemic-era support. Higher rates hurt those that didn't lock in lower rates (not aware or didn't have strong enough credit) and have to rely on credit that comes with a variable rate (e.g., credit cards). (WSJ)
2. Margin compression leads recession. As margins drop, companies stop hiring and doing cap ex. Or, another (bad) alternative is that as margins drop, companies raise prices to maintain their margins, and this causes inflation. (FT)
3. We used to believe that presidents' approval ratings moved with the economy. But that is no longer true in the US. Our hyper-partisanship has resulted in our political affiliation determining our economic perception. If this is the case, what incentive is there to develop good economic policy? (FT)

III. Four Possible Causes of Differential Inflation Effects (Inflation Inequality) (Federal Reserve)

1. **Consumption baskets could differ** (based on income levels)
    a. Lower-income HHs spend 77% of their income on **necessities**
        i. Higher-income HHs spend 31%
    b. Several studies have found that the consumption baskets of lower-income HHs have experienced higher-than-average inflation rates over time
        i. BLS has found that a price index reflecting the consumption of the lowest 25%-income HHs is greater than overall CPI and an index reflecting the consumption of the highest 25% income earners was < overall CPI
        ii. These studies rely on the same elementary price indexes for subcategories of goods and services – so they miss **additional sources of variation** (the other factors)
2. HHs with different levels of income **may purchase significantly different items even within the same index categories of goods and services**.
    a. E.g., caviar and canned tuna are both in the same elementary index
3. HHs at different income levels may have **differing abilities to substitute** for lower-priced alternatives with an elementary category
    a. E.g., if price of breakfast cereal (both brand-name and store-brand) increases, a HH that has been purchasing brand-name could trade down
        i. No effect on actual spending and getting the same quantity
        ii. Lower-income HH would either absorb increase or consume less
4. HHs **pay different prices for identical goods**
    a. Researchers found that almost 2/3 of the variation in inflation across HHs comes from differences in prices paid for identical goods
        i. Only about 1/3 comes from difference in the mix of goods within broad categories
    b. As a result of differences, HHs with lower incomes, more HH members, or older HH heads experienced higher inflation on average
    c. May reflect differences in the ability of some HHs to stock up when prices are discounted or to buy in bulk and save
        i. Need to be able to afford to buy in larger quantities, have storage space, flexibility as to when to buy
    d. Need to be able to buy online
        i. Online inflation averaged more than 1% lower (from 2014 – 2017)