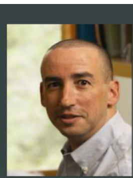

MARKET UPDATE

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Market Update – March 4, 2024

I. Stocks

A. Recent Performance and Trends

1. **Last week**: DJIA -.11%; **S&P 500 +.95%**; Nasdaq +1.74%; **IWM +3.00%**
   a. S&P and Nasdaq up for 16th week out of past 18
   b. **Relief rally** after fear of a bad PCE report
   c. **Fears:** investors are relatively optimistic; financial conditions easiest since late 2021; Apple has dropped 7.5% (Barron's)
2. The **Nasdaq Composite** hit a new record for the first time in two years. This ended a streak of 569 days without a record, the longest since the 3,801 trading days that ran from the bursting of the tech bubble (March 2000) through April 2015. The Nasdaq saw three rallies of 40% or more over the bear market that followed the tech bubble. (MarketWatch)
   a. Five years ago, AMD was the 222nd largest company in the S&P 500. Now, it's 22nd, with a market cap greater than $300B. (MarketWatch)
3. **February** was our fourth straight month of gains. Markets rallied despite decreased optimism about rate cuts. ISM manufacturing is in recession territory.
4. We're seeing **very little short-selling** (~1% of shares) among the Magnificent Seven. The Nasdaq 100 has a p/e >25 and a p/s near 5. (Bloomberg)
5. During January and February, **analysts lowered EPS estimates for Q1 by a smaller margin than average**. The average decline during the first two months has been 3.0% over the past five years. This time, it was 2.2%. (FactSet)
6. "**Private IPOs**" – this is a private placement with a new name. It's a private stock sale to longer-term investors (e.g., mutual funds, SWFs). The buyers can get a bigger piece of the company. The issuer avoids the potential embarrassment of a failed IPO. The PE firm gets money to distribute to investors. The problem is that the shares are not liquid. (WSJ)

B. Market Concentration

1. The **US is not that concentrated** by global standards. Only Japan is less concentrated.
   a. Second least concentrated stock market of the largest 12.
2. If you don't base it on nations, but you look at indexes, the top 10 stocks are only 23.1% of the MSCI Emerging Markets and 15.3% of the MSCI EAFE (Europe, Africa and Far East).
3. **Concentration isn't necessarily bad**, but it does tend to imply an **unbalanced economy**. In 1900, we were dominated by railways. Today, it is technology.
   a. But it's hard to outperform if this industry does well b/c investors find it difficult to overweight the biggest stocks.
4. Maybe the global market is concentrated:
   a. US is now **61% of global market cap**, its highest since the 1960s. (Bl.) (MW)

C. The Bubble Argument Continues

1. **Reasons for bubble speculation**: **big gains** recently (S&P up 7% to start year, Nasdaq at new record high), high **valuations** (S&P 500 forward P/E = 20.6), signs of **froth** in some areas (Bitcoin up 23% in past week, stocks like SMCI surging on hype), **gains concentrated** in handful of mega-cap stocks, disinflation is slowing (Fed isn't cutting seven times!).
    a. Apollo's Torsten Slok says that the **median valuation (p/e ratio) of the 10 largest companies** in the S&P 500 is higher now than it was at the peak of the dot-com bubble. This has resulted in the top five stocks reaching 25% of the S&P 500, the highest level since the 1970s.
    b. The only times that the **CAPE** has been higher in recent years was late 2021 and at the top of the internet bubble. The CAPE is currently at a higher level than it's been at 95% of the time since 1881. (MarketWatch)
2. If the stock market is **melting-up**, the FOMC can't lower rates. A melt-up is a swift rise in stocks, fueled by FOMO. **Factors** to spot a melt-up:
    a. Extreme bullishness – look at AAII survey, put/call ratio. If these stay high as markets hit a new high, investors aren't considering the downside.
    b. High valuations
    c. Analysts' expectations for long term growth. Five-year growth estimates have averaged 12.5%/year since 1985. Currently at 14.7%.
    d. Every dip leads to a view that it should be bought. (Barron's)

D. More Arguments Against a Bubble

1. **Reasons this isn't a bubble**: **economy** doing well (strong GDP, jobs), **inflation** is easing**, investors expect a downturn** (fund managers underweight economically sensitive stocks, hedge funds keeping exposure low), **market concentration** may **not** be a **risk**, current **bull market** is **only 344 days** old (average lasts 694 days). (Barron's)
2. Since 1974, the S&P 500 has risen **100% or more** during the three years that **preceded every bubble peak**. The index is only up 31% during past three years. They are considering 1987, 1999, 2012, and 2021 as bubbles. (MarketWatch)

II. Rates, the Dollar, Inflation

A. Rates

1. UST yields: 3-month 5.42% (-4 bps); 2-yr 4.54% (-13 bps); 10-yr 4.19% (-7 bps)
2. The most common bond bet going into 2024 was the **steepener –** betting that the yield curve would steepen. Last March, the **2/10 inversion** went above 100 bps. It got down to 16 bps, but is now closer to 40 bps. The problem is that the carry costs (holding and rolling) are ~40 bps. (Bloomberg)
3. According to Freddie Mac, the **30-year fixed-rate mortgage rose and averaged 6.94%**, up 4 bps from the prior week. According to Mortgage News Daily, the rate was 7.15%. The average rate on the **15-year mortgage** was 6.26%. (MarketWatch)
4. According to BofA, compensation from high-yield bonds has fallen to levels "only sustainable in an economic upturn." **Single-B** rated bonds saw their spread fall to 317 bps – a post-GFC record. (MarketWatch)
    a. Very small difference between BB and B yields

B. Other Ideas about Debt and Rates

1. The **CBO** has forecast that **debt will rise faster than it has** because of high interest rates. CBO predicted interest payments 50% higher than actual over the past 30 years. CBO projects that interest payments will be 3.9% of GDP by 2034 (was 3.2% in 1991).
    a. Discretionary spending is expected to fall from 6.2% of GDP to 5% by 2034. (Bl.)
2. The **10-year term premium** has only averaged 50 bps since the GFC. It had been above 400 bps in the 1980s. The high CPI report and the CBO's debt trajectory predictions could result in a higher term premium. Politicians do not have the will to fix our deficits and it could fall to the markets to impose discipline. (PIMCO)
3. If the **aging population** spends down their savings, we could see **higher real yields and term premiums**.
    a. The counterargument is that this spending will result in income and savings for someone else. In addition, no one is arguing that wealth inequality will be reduced. (Bloomberg)

C. The Dollar

1. Dollar is having a **strong year** and is near pandemic highs. **Reasons** include:
    a. Continued US economic strength (and productivity)
    b. Capital flows to the US
2. **Longer-term**, the dollar has been consolidating at levels higher than pre-pandemic. Emerging market currencies are close to an all-time low. **Explanations**:
    a. Over the past 20 years, the US has had higher productivity growth, improvements in its terms of trade, and higher returns on capital
    b. The US has opted for policies that have supported its domestic economy. Countries that rely on globalization are being hurt.
        i. Energy independence
    c. Policies that have worked in big tech's favor have attracted overseas funds
    d. Prevailing high interest rates
    e. Equity outperformance (vs. other countries) provides some marginal tailwind
    f. Potential trade wars could help the dollar (as we import less)
3. **Downsides to a strong dollar**:
    a. Drags down earnings for US multinationals
    b. More difficult to export (and forces other countries to raise rates) (Bl.) (Bl.)

D. Inflation

1. **PCE headline inflation** +.3% MoM, +2.4% YoY; **core** +.4% MoM, +2.8% YoY
    a. If you annualize the monthly core number, it is almost equivalent to the current Fed funds rate. It would be hard for the FOMC to drop the Fed funds rate below this.
2. **Supercore** inflation rose .6% in January. Excludes energy and housing.
    a. Biggest increase in a year
3. **Trimmed mean** increased MoM (Bloomberg)
4. **CPI and PCE have different weights** (CPI – surveys on what consumers say they spend money on; PCE based on actual spending data):
    a. Housing/shelter – CPI 34% vs. PCE 15%. Has driven CPI higher.
    b. Healthcare services – CPI 6.5% vs. PCE 16.1%. (WSJ)

III. Fed Policy

A. Torsten Slok (Apollo) – Arguing that the Fed will NOT cut rates this year:

1. The economy is reaccelerating, not slowing.
2. Underlying measures of trend inflation are moving higher.
3. Supercore inflation is trending higher.
4. Following the Fed pivot in December, the labor market remains tight, jobless claims are very low, and wage inflation is sticky between 4% and 5%.
5. Surveys of small businesses show that more small businesses are planning to raise selling prices.
6. Manufacturing surveys show a higher trend in prices paid.
7. ISM services prices paid is also trending higher.
8. Surveys of small businesses show that more small businesses are planning to raise worker compensation.
9. Asking rents are rising, and more cities are seeing rising rents, and home prices are rising.
10. Financial conditions continue to ease following the Fed pivot in December.
    a. Record-high IG issuance, high HY issuance, IPO activity rising, M&A activity rising, tight spreads, and the stock market reaching new all-time highs. (MW)

B. Higher Rates Haven't Really Slowed the Economy

1. Maybe there is a particularly **long gap** in monetary policy affecting the economy because the **hiking didn't start until inflation was virtually at its peak**. Rates have risen at the same time as inflation has come down and these effects have canceled each other out (one is contractionary, and the other is stimulative).
2. Another possibility is that the Fed's long wait created a generous **opportunity for companies and consumers to lock in rates.**
3. Heavier interest costs are being offset by **higher interest income** and declining income taxes.
4. **Disinflation** tends to provide stimulus to the economy even though it often results from an economic slowdown. Growth averages 3.8% after disinflation and 2.6% after inflation. Productivity growth is 2.4% following disinflation and 1.8% following inflation.
    a. Disinflation is like a tax cut. Employment grows. Earnings grow.
5. YoY **productivity** dropped for five consecutive quarters through 2023 Q1. Now, it has **risen for three consecutive quarters**. Rising productivity reduces inflationary pressure and makes the soft-landing more likely. It allows living standards to rise. Labor productivity divides GDP by hours worked. Total factor productivity includes other inputs. (Bloomberg)
    a. UBS says that **Generative AI** could increase productivity growth to 2.5%, fueling a 20% return for equities in 2024. If this is true, rate cuts could happen faster. (MarketWatch)
6. One reason that rate hikes have not had a large impact on the economy is the **increase in "asset-light sectors."** The real impact of higher interest rates on tech companies is that it made them more efficient. (Bloomberg) (MarketWatch)

IV. General Interest

1. Approximately **1.8% of 401(k) participants** in plans administered by Fidelity have **$1MM**. For IRAs, it's 2.61%. The **median balance** among the millionaires is **$1.34MM**. The average 401(k) balance is $118,600. The BLS said that while **73%** of civilian workers had access to an employer-sponsored retirement plan, only 56% participated in them. (Washington Post) (CNN)
2. There is a **myth** that **everyone used to have a pension**. In reality, in 1980, only 27% of those over 65 had a pension. At its peak in 1990, **37%** had a pension. Pensions only provided about 1/5 of retirement income. The median income for 65+ households today is $50,290. In 1980, it was $30,217 in today's dollars. (MW)
3. Bernie Sanders argued that **23%** of senior citizens live in poverty, one-quarter of seniors are living on less than **$15K / year**, and **nearly half** of Americans 55+ have **no retirement savings**. (Barron's)
4. **How we measure up against our friends and peers** has an outsized effect on our financial perception, especially as people spend more time scrolling social media. These comparisons can make our finances seem inadequate even when things are going fairly well. A recent survey found that **~25% of people feel less satisfied with the amount of money they have because of social media and ~1/3 said that they have spent more than they could afford to "keep up with the Joneses"** on Instagram and other apps. Peer groups also matter – people were happier when they thought they were doing better than their peer group. (WSJ)
5. **Trump leads Biden in seven key swing states**. Trump leads Biden in AZ, GA, MI, NV, NC, PA, and WI. Approximately eight in ten voters (82%) in these swing states say **Biden is too old** (including 70% of his own supporters) while less than half (47%) say that about Trump. On the other hand, 58% of voters see **Trump as dangerous** (including 28% of his own supporters) and Biden as more compassionate and caring. Approximately **half of voters are unwilling to vote for Trump if convicted in pending cases** (hush money, mishandling classified info, election conspiracy). Approximately **55% blame Biden and the Democrats** in Congress for the **border crisis**. (Bloomberg)
6. Congress passed a bill to **temporarily fund** one set of Federal agencies through March 8 and another through March 22. This is exactly what the rating agencies were talking about when they downgraded the US, partly due to our **dysfunctional government.** (MarketWatch)
7. GS forecasts that **GLP-1 medications could boost US GDP by .4%** (and as much as 1% if there is widespread uptake). Health problems reduced US labor-force participation by 2% - 3% over the past 30 years. Early deaths subtract another .2% from annual labor supply growth. There are also those that need to care for sick individuals (and leave the labor force). Obese individuals are also less likely to work. (Barron's)
8. With an earnings yield just over 4% and investment grade debt costing 5.5%, it may be **cheaper to issue equity than debt**. Of course, interest is deductible.