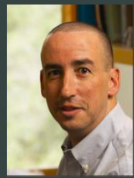

MARKET UPDATE

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Market Update – February 12, 2024

I. Markets

A. Last Week

1. **Last week**: DJIA +.04%; **S&P +1.37%;** Nasdaq +2.31%; Russell 2000 (IWM) +2.54%
    a. The S&P 500 finished above 5,000 for the first time on Friday.
    b. The **2-yr UST yield** ended the week at **4.48%**, the highest level since December, while the **10-yr** ended the week at **4.17%**.
2. S&P 500 and Nasdaq have each been higher for **14 out of 15 weeks**. The Russell 2000 outperformed the S&P for the fifth time in the past seven weeks (still lagging YTD).
3. **Narrative**:
    a. Inflation continues to moderate
    b. Fed expected to cut rates, maybe as early as March (doubtful – 15%)
    c. Economy continues steady growth
    d. Backdrop supportive of strong corporate profits
    e. Q4 earnings coming in above expectations (Barron's)
        i. Q4 earnings are currently +2.9% YoY (vs. 1.5% expected). Of the 67% of companies that have reported, 75% have beaten expectations. In aggregate, companies are reporting earnings that are 3.8% above expectations, below the five-year average of 8.5%.
4. **Fed put is back**. Struggling economy = Fed lowers rate. No recession = strong earnings.
    a. Risk markets still anticipate that the Fed will lower rates, even with the S&P 500 topping 5000 and junk-bond spreads at historic lows. (Barron's)

B. Bullish Arguments

1. Strong earnings and expectations; resilient growth
2. AI tailwinds
3. Strong Treasury auctions – all three (3-yr, 10-yr, and 30-yr) priced through W/I levels
4. CPI revisions were little changed
5. FOMO
6. No broader spillover from NYCB

C. Bearish Arguments

1. Rates and the Fed – negative Fedspeak; Fed is cautious (disinflation could stall)
2. Market is overbought (RSI)
3. Bubble fears
4. Regional bank fear (NYCB debt cut to junk) (Bloomberg)
5. High valuations (Barron's)

D. Other Ideas about Investing

1. Passive funds accept the prices available in the market. The higher a company's value, the more the fund will buy of that company, pushing the price up further.
2. Passive funds have a fee advantage and this has a compounding effect. But, if everyone was a passive investor, there would be no more price discovery.
3. History shows that buying the top 10 stocks underperforms the market in the next year.
4. If the US market becomes less concentrated, stock pickers could have an advantage. (Bl.)

II. Bubble-Watch

A. Bull Market vs. Bubble

1. A **bull market** is a rising tide of investor optimism that encourages gradually increasing stock prices.
    a. A **bubble** is when investors are gripped by mania that results in rapidly rising stock prices that are wildly divergent from fundamental realities.
2. Bubbles and technological progress are necessary partners. A new technology needs excessive capital investment to gather mass adoption and new products that enable fundamentally new experiences.
3. The transition between hesitant concern about valuation and ignoring it altogether is the surest sign we've moved from bull market to bubble.
4. Bull markets can last a long time. Bubbles rarely last longer than two years. (Deload)
5. John Templeton: "bull markets are born on pessimism, grow on skepticism, mature on optimism, and die of euphoria." (Barron's)

B. Bubble Argument

1. It's unusual to see the **10-year yield rise** and a **strong upward move for Nasdaq**
    a. This usually happens after a bad recession (2009) or in a bubble
    b. Junk spreads at historic lows.
2. The US stock market is now ~70% of world market capitalization, yet our economy is only 17.8% of global GDP.
3. US outperformance vs. international developed markets is unprecedented
4. US tech sector now 1/3 of total US market cap, exceeding 2000 bubble peak.
5. The Magnificent Seven have a greater value than the combined GDP of NY, Tokyo, LA, London, Paris, Seoul, Chicago, SF, Osaka, and Shanghai.
6. Meta's gain on Friday (a week ago) was the largest one-day gain in value for a company ever. It was approximately equal to the value of Cisco.
7. Microsoft's $3.1T market cap is nearly 2X the entire energy sector market cap of $1.6T. MSFT has $67B of FCF and the energy sector has $135B. (Bloomberg) (Barron's)

C. Arguments that this is Not a Bubble

1. There's real growth behind the companies' booming market capitalizations
    a. They increased sales by 14% in Q4 with expanding margins
        i. Rest of index: 2% growth and contracting margins
    b. The seven companies are expected to expand sales at 12%/yr over next three yrs
        i. Vs. 3% for rest of index
2. Since Dec. 2019, they have delivered a 28% annualized return
    a. 27% from earnings growth (21% sales growth and 6% margin expansion)
    b. 1% due to multiple expansion
    c. In contrast, earnings drove only 13% of the S&P's 17% annualized return
3. Profit margins expected to expand by 256 bps
    a. Vs. 44 bps for rest
4. There has been some diversification value within the Magnificent Seven (Bl.)

III. Real Estate

A. Maybe Homebuyers are Returning?

1. Falling mortgage rates are starting to bring buyers back to the home market. **Showings** in the week ended Jan. 31 were up 9.9% from the first week of the year.
    a. Mortgage rates were **6.63%** last week. Had hit 23-year high of **7.79%** in October.
        i. A homebuyer with a $3,000 monthly budget has gained ~$50K in purchasing power.
2. **Inventories** are still not normal. Although active listings in January rose 7.9% YoY, they are still nearly **40%** below the typical pre-pandemic level.
    a. Newly built homes made up ~1/3 of single-family homes for sale in December, up from a historical norm of 10% to 20%.
    b. Existing-home sales slumped last year; sales of newly built homes rose 4.2%. (WSJ)

B. The Real Supply Issue

1. The real housing supply issue isn't due to mortgage lock; it's due to **too few homes being built** since the financial crisis
2. Pre-crisis, more than 2MM homes were built when we needed 1.5MM to 1.7MM
    a. After excess supply crushed flippers, home prices dropped
3. Then, housing construction contracted by more than 75% from a peak of 2.25MM (annualized rate) in early 2006 to 500K by the beginning of 2009.
    a. New construction activity reached 1.5MM units only in 2020
        i. Many builders had gone bankrupt
    b. Mortgage lenders were also more demanding
4. Net demand comes from a growing population, household formation, and demand for second or vacation homes
5. Estimates of the shortage range from 1.5MM to several million
    a. New housing is currently running at 1.4MM – close to growth in demand
6. If people can't afford to buy, they must rent
    a. Incentive to build more apartments (Barron's)

C. Commercial Real Estate

1. **Lowest and highest occupancy days** – Texas cities have the highest return-to-work percentages, but they are still relatively low.
2. When leases expire, tenants won't want as much space. Vacancy rates will increase.
    a. The Q4 national vacancy rate is 19.6% (prior record was 19.3% in 1986 and 1991)
3. An office building owner that doesn't earn enough in rent to cover the mortgage will ask for or demand concessions from the lender. The alternative is default and no one wants this.
4. Tenants are upgrading to Class A space. Classes B and C will be hurt.
5. Delinquency rate on private-label CMBS secured by office buildings is back to 6%.
6. Many building owners refinanced at low rates. As this has to be refinanced between now and 2028, it's likely to be much more expensive.
7. Some **offsetting factors**:
    a. The recent decline in rates helps
    b. There's been a sharp decline in the share of domestic banks that are tightening standards for CRE loans
    c. Even smaller banks don't have huge exposure to mortgages on office and downtown retail CRE. It's $510B of their $7.4T in assets (~7%). (NYT)

IV. General Economy

A. Possible Reasons Why Economy is Strong Despite Rate Hikes

1. **Productivity growth**
    a. Workers moved to more productive jobs and corporate investment rebounded
    b. Bearish view: one-time gains; maybe caused by supply chain being fixed
2. **Government deficit spending**
    a. Supported economy as rates rose
    b. Not sustainable for long-term
3. **Monetary policy taking longer to impact economy**
    a. Companies locked in low rates; households had low-rate mortgages
    b. Bearish view – more debt needs to be refinanced; issues in PE will spill over (WSJ)

B. Paul Krugman "Of Luddism and Lumpy Thinking on Labor"

1. The "**lump of labor fallacy**" – the view that there is a fixed amount of work to be done and that if someone or something (some group of workers or some kind of machine) is doing some of that work, that means fewer jobs for everyone else.
    a. This belief leads to fear of immigrants, trade and technology
2. There's no question that an individual worker, company, or industry can be hurt by immigrants, trade, or technology. If there's a limited amount of demand for a particular product and technology can be used to produce it, there are fewer jobs.
    a. BUT, there's no evidence that there's limited demand for goods and services in general. When incomes rise, people find things to spend their money on.
        i. This creates new jobs to replace those lost to technology.
        ii. Output per worker is now 4X the 1952 level, yet employment has tripled
3. If you're worried about immigrants taking jobs, realize that women moved into the work force from the mid-1960s to 2000. There has only been a small decline in the percentage of prime-age men working.
    a. Employment rate of prime-age native-born Americans has increased since 2019. This is despite the fact that immigrants are responsible for all recent employment growth. (NYT)

C. Other Economic News

1. Above-trend economic growth without inflation indicates greater supply. Fixing the supply chain and immigration (and immigrants distributed across the country) help.
2. Income gap (median HH income): $81,060 (W); $74,580 (all); $62,800 (H); $53,500 (B)
    a. Median family wealth: $285K (White); $44,900 (Black) (Bloomberg)
3. Why Americans are so down:
    a. Americans are worried about social and political threats. A college degree no longer looks like a good investment. Wars and attacks are happening. Our leaders are uninspiring. Government is seen as dysfunctional.
    b. Low-income households bear the brunt of inflation b/c of the high share of their income that goes to food, gas and rent
    c. Decline of pensions; high inflation, etc.
    d. 78% of Americans aren't confident that their children's lives will be better than their own
        i. Only 36% believe that the American Dream still holds true (that you can get ahead with hard work) (WSJ)

D. Dollar (Bloomberg)

1. The dollar continued its rally as the US economy has continued to be resilient.
2. Most importantly, the dollar has rallied as traders curtail their expectation of rate cuts. The yen has fallen 5% versus the dollar this year.
3. **Factors**: strong jobs report, China's economic struggles, geopolitical uncertainties. In addition, the BOJ has given little clarity on when it will reverse its negative interest rate policy. Prospects of a wider interest-rate differential in favor of the US have been dragging the euro lower (~2.7% versus the USD since the start of the year).

V. The Fed

1. Powell said that America's role defending democracy and related economic and security arrangements "has benefited our country enormously." He said, "I hope that continues." (WSJ)
2. If the economy is already in balance, shouldn't the Fed funds rate be near the neutral rate?
   a. But, current financial conditions are clearly not getting in the way of people getting jobs.
3. There continues to be speculation that the Fed will cut rates to help Biden. The Fed may permit the market to melt-up because a large stock market drop would certainly hurt Biden.
   a. There are concerns that Trump would politicize the Fed and fiscal policy would include tax cuts and high spending. Bond markets would not like this. (Bl.)
4. Fed's Senior Lending Officers Survey (SLOOS)
   a. This is an important survey – tied to recessions
      i. Spikes in tightening tend to be followed by rising unemployment
         1. But right now, unemployment is low
      ii. But American companies are borrowing from non-banks and their interest expense is lower
   b. Key results:
      i. Majority of bankers reported that they were tightening lending standards
         1. But this was declining
      ii. Demand for commercial and industrial loans is falling, but at a slower rate (Bloomberg)
5. Investors are frequently wrong in the Fed funds futures market. After 2008, they expected rates to return to pre-crisis levels soon, but it took a decade. In the recent tightening cycle, they didn't expect rates near 5.5% or for rates to stay high for so long.
   a. Investors now expect five rate cuts this year, but strong jobs data, inflation, and high growth don't indicate that this will happen. Wage growth has been over 5% since 2021. (WSJ)