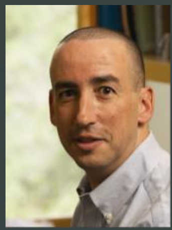

MARKET UPDATE

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Market Update – May 13, 2024

I. Equities

A. Current Conditions

1. **Last week:** DJIA +2.16%; **S&P 500 +1.85%**; Nasdaq +1.14%

2. **Stocks have done well, despite weak consumer sentiment.**
    a. The S&P 500 is within 1% of its record high, while the Univ. of Michigan's consumer sentiment survey hit a six-month low. Consumers' inflation expectations have also increased.
    b. Stocks have been helped by:
        i. Earnings – beat forecasts by 7.5%
            1. Optimistic forecasts: Q4 +17% YoY (too optimistic?)
        ii. Less worry about interest rates (Powell taking rate hikes off the table?)
    c. XLU (S&P 500 utilities) are up 19.34% in the last three months
        i. Dividend yield is now below 10-yr UST yield (Barron's) (FactSet)

3. **Earnings have been relatively strong, forecasts are high, and there's less fear of recession.**
    a. Q1 EPS growth is up 5.4% YoY, the strongest growth in two years
        i. Without the Magnificent Seven, earnings would be -2.4% YoY
        ii. If you exclude Bristol Myers, earnings growth would be +8.3%
    b. Q2 earnings growth is now expected to be 9.3% YoY
    c. Only 100 S&P 500 companies mentioned "recession" in their earnings call, down from 302 in 2023 Q1 (WSJ) (FactSet)

4. **While the Atlanta Fed's GDPNow indicator is currently forecasting 4.2% growth for Q2, there are also arguments that we should worry about the economy (and therefore earnings and stocks):**
    a. Temporary employment is falling sharply
    b. Excess savings is depleted according to SF Fed
    c. Small business optimism index is low
    d. Lots of negative anecdotal evidence about low-end consumers
    e. ISM services index is negative
    f. Utilities has been strongest sector in S&P 500 (FT) (Atlanta Fed)

B. Less Fear

1. **Maybe the Fed put has returned.**
    a. Powell said that the Fed was looking to "balance" inflation and employment
        i. No longer focused solely on inflation
        ii. May mean that the "Fed put" is back – they will cut rates if economic data is weak
            1. This results in good news being good news and bad news being good news
            2. Will this change with Wednesday's CPI report? (Barron's)

2. **There is optimism in the equity market and we see this through the decrease in put skew over the past several months.**
    a. Put skew refers to demand for out-of-the-money puts on the S&P 500 relative to out-of-the-money calls
    b. The VIX and VVIX (the volatility of the VIX) have also dropped (MarketWatch)

3. **VIX is currently low, but actual volatility has also been low.**
    a. The standard deviation of the S&P 500 returns over the past 100 days is .7% compared with its average of 1% since 2010
    b. Over the same period the VIX has averaged 18.5. On Friday, it was at 12.55. (MarketWatch)

C. Longer-Term Performance

1. **The DJIA has grossly underperformed the S&P 500 for the past 4.5 years.**
    a. The DJIA has underperformed the S&P 500 by more than 25 percentage points over the past 4.5 years. The only other times that it has trailed so much has been 1976 – 80 and during the dot-com bubble (1999 – 2000).
    b. Part of the issue is the fact that the DJIA is price-weighted (highest per-share price has the highest weighting) and that can lead to bizarre outcomes. The other issue is that by time stocks are added to the DJIA, it is usually too late (after they've had a great run). (WSJ)

2. **Fifty corporate winners from the Covid pandemic have lost ~$1.5T in market value since the end of 2020, but others have replaced them.**
    a. A few interesting stocks:
        i. Zoom increased 765% in 2020 and has since lost ~80% (~$77B).
        ii. Peleton has lost 97% of its value.
        iii. Pfizer has now completely reversed its gains from 2020 and 2021.
    b. Two companies that did well but were not in the top 50 performers in 2020 were NVDA and AMZN. Since the end of 2020, NVDA has added ~$1.9T of value. (FT)

D. Investing

1. **US mutual funds and ETFs brought in more than $188B in 2024Q1, but (within that) active mutual funds are losing.**
    a. Active mutual funds have posted negative overall monthly flows for 30 consecutive months, losing nearly $1.7T to investor withdrawals in that time.
    b. Active ETFs pulled in ~22% of net ETF flows in March, despite accounting for less than 7% of the $8.9T industry (FT)
    c. Investors have put ~$5.2B into the top 22 leveraged ETFs in the year ending April 30th. (FT)

2. **Money is flowing into ETFs, but the mutual fund industry has a significant lead because of 401(k)s.**
    a. 95 new mutual funds have debuted this year, but 123 have been closed
        i. This could be the 9th straight year of net closures
            1. 1,100 funds liquidated over that span
    b. Nearly $114B has exited mutual funds so far this year
        i. ETFs have absorbed ~$258B
    c. The mutual fund industry has $20T of assets while ETF has $9T (Bloomberg)

3. **Arguments that active value investing is going away:**
    a. Value indices have trailed the Russell 1000 benchmark in all but two years since 2012.
    b. Actively managed mutual funds and ETFs peaked at 1,082 in 2015 and have fallen 15% since then.
    c. The average active fund manager with a broader mandate has value exposure 15% below that of momentum stocks, a level not seen in 15 years.
    d. The cheapest quintile in the Russell 1000 has seen its multiple stay depressed vs. the most expensive for five straight years. (Bloomberg)

4. **College and university endowments total $839B. Over the past 35 years, they have made a huge move toward alternative assets ("the Swensen effect").**
    a. In 1987, the overall asset allocation was 54.2% equities, 29.4% fixed income, 12.7% cash, 1.9% real estate, and 1.8% miscellaneous.
    b. Today, over 55% of the allocation is to alternative investments:
        i. 17.1% private equity
        ii. 15.9% hedge funds
        iii. 11.9% VC
        iv. 11.2% real assets
    c. The average 10-year return of the 688 endowments in a recent study was 7.2%. (FT)

II. Bonds, Debt, and the Fed

A. Current Conditions

1. **Last week UST:** 2-yr 4.87% (+6 bps); 10-yr **4.50%** (unchanged)

2. **"Higher for longer" seems to imply that interest rates are abnormally high. But maybe this is just a return to normal**
    a. Over the past 10 years, the 10-year UST yield has averaged 2.36%. Today, it's near 4.50%.
        i. But it's significantly below the 5.93% over the past 60 years
    b. Investment-grade bonds and high-yield bonds have very low spreads
        i. Investors love the overall (perceived) large yield

3. **Consumers are expecting even higher mortgage rates in the future.**
    a. A NY Fed survey showed that consumers (on average) expect the 30-year mortgage rate to be 8.7% in the next year and 9.7% in three years.
    b. The current rate is 7.28%. (MarketWatch)

4. **Be careful when you hear default rates. This may be misleading.**
    a. Moody's says that the US bond default rate hit 5.8% at the end of March.
        i. This is an issuer-weighted calculation – implying that all of the issuer's debt will default.
    b. When a company tries to avoid bankruptcy by entering a distressed debt exchange, this swap can result in all of a company's debt counting as having defaulted.
        i. But a distressed debt exchange may not translate to a company failing to make all of its interest payments. In a par-weighted measure, debt used in a distressed exchange is included but only the amount that was actually swapped.
    c. More than 50% of the default volume in Q1 included a distressed debt exchange (compared to ~30% in 2023). (Bloomberg)

5. **Having bad credit is costly!**
    a. The average interest rate for a subprime auto loan is 18.38%. For prime, it's 6.24% (MarketWatch)

B. Government Debt and Involvement in the Bond Market

1. **The CBO projects that the US debt-to-GDP ratio will surpass its WWII high of 106% by the end of the decade and keep rising. The total deficit is expected to average 5.5% of GDP until 2030 (~2% higher than the post-1940 mean).**
    a. Pres. Biden is proposing a $7.3T budget for 2025. Trump has vowed to renew tax cuts that could add another $5T to the nation's debt.
    b. Rising debt could pressure borrowing costs. Without QE, debt needs to be absorbed by more price-sensitive investors.
    c. The dollar's role as the world's reserve currency means that there is continued interest in Treasury securities. (FT)

2. **In March, the Treasury Department paid out ~$89B on interest to debt holders -- ~$2MM per minute.**
    a. This interest may be creating a wealth effect that could result in higher rates for longer
    b. Last year, investors pocketed nearly $900B in annual interest from US gov't debt. This is set to rise as just about all Treasuries now carry a yield of 4% or more. (Bl.)

3. **The Social Security Trustees report said that the "trust fund" (and I use that term loosely) for Social Security will run out in 2033 and then benefits will drop by 21% if nothing is fixed.** (SSA)
    a. Pres. Biden has previously said that he wants to have a payroll tax on income above $400K (this year, it is not collected on anything above $168,600) and former Pres. Trump says that he would look for spending cuts in government programs but won't touch Social Security.
        i. Note that both have had four years and neither did anything to fix this.
    b. Spending on Social Security represented 5% of GDP this past year. (WSJ)

4. **Stricter post-crisis regulations make it much harder for banks to intermediate trading in bonds. Increasingly, they act as pure brokers rather than dealers, due to balance sheet constraints.**
    a. At the same time, the size of the bond market has ballooned due to:
        i. Government deficits
        ii. More companies turning to fixed income markets (also partly due to tougher regulations on banks)
    b. The problem is when everyone suddenly wants to sell – especially if bond funds suffer a rash of outflows.
    c. Barclays says that investors and regulators are faced with a trilemma. It's impossible to simultaneously have:
        i. Stable markets
        ii. Stable intermediaries
            1. We used to have extreme liquidity b/c banks were highly levered
        iii. No moral hazard
            1. Pre-crisis intervention has been transformed into post-crisis official interventions to support market functioning (moral hazard)
    d. Central banks have become dealers-of-last-resort in addition to lenders-of-last resort (FT)

III. Economy and Politics

A. General Economic News

1. **There continues to be debate over whether monetary policy is restrictive.**
    a. Evidence that the Fed funds rate is restrictive:
        i. Jobs are less plentiful. Workers are more reluctant to quit.
        ii. More than 3% of borrowers failed to pay their credit card bill on time during Q4 (highest delinquency rate since 2011 and double the low from three quarters ago).
        iii. A higher proportion of the worst-rated junk bonds are trading at prices more deeply distressed than at any time outside of a recession.
        iv. M2 has fallen YoY for 16 months.
    b. Evidence that the Fed funds rate is NOT restrictive:
        i. S&P 500 is just 1% below its all-time high
        ii. VIX is just at 12.55
        iii. Junk spreads lowest in 30 years (WSJ)

2. **There has been some recent evidence of the economy slowing down.**
    a. Added just 175K jobs in April (vs. 315K in March)
        i. Added just 5K jobs in leisure and hospitality (vs. 53K in March)
    b. Wage growth slowed to 3.9% (from 4.1%)
    c. Starbucks and McDonald's both citing caution among consumers
    d. ISM Services dipped into contractionary territory for the first time in 15 months (WSJ)

3. **A 10% increase in the 3-month moving average of number of unemployed people has been a pretty good indicator of a recession. We're currently at 10.14%.**
    a. This is similar to the Sahm rule, which predicts recession when the three-month moving average of the unemployment rate is .5% higher than the lowest 3-month average over the past year
    b. Economists are arguing that the increase in the number of unemployed people is actually just the labor market returning to pre-pandemic conditions. (MarketWatch)

4. **According to the OECD, global trade in goods and services is expected to rise 2.3% this year and 3.3% in 2025. This compares with just 1% growth last year.**
    a. Between 2006 and 2015, goods and services trade volumes grew at an average annual rate of 4.2% (according to the IMF).
    b. Risks include: geopolitical tensions, regional conflicts and economic uncertainty, as governments focus on national security, self-reliance and support for domestic companies. (FT)

5. **New research argues that new low-skilled immigrants to the US are a net fiscal plus – each adding an estimated $750 a year to government coffers at the federal, state and local levels.**
    a. This research is different because it considers the fact that low-skilled immigrants enable native workers to move into higher-wage jobs, and in some cases to work more hours.
        i. E.g., working parents may choose more demanding and higher-paying jobs if cheaper and more convenient child-care exists.
    b. When cheaper labor is available, businesses may make bigger and more ambitious plans, and this also impacts government revenue. (Bloomberg)

B. Housing

1. **A research paper by the Federal Housing Finance Agency found that for every percentage point that market mortgage rates exceed the origination interest rate, the probability of home sale is decreased by 18.1% (the "lock-in effect").**
    a. This mortgage rate lock-in led to a 57% reduction in home sales with fixed-rate mortgages in 2023 Q4 and prevented 1.33MM sales between 2022 Q2 and 2023 Q4.
    b. The supply reduction increased home prices by 5.7% (during the same period), outweighing the direct impact of elevated rates, which decreased prices by 3.3%.
    c. The findings underscore how mortgage rate lock-in restricts mobility, results in people not living in homes they would prefer, inflates prices, and worsens affordability.
    d. Mitigating market features that exist internationally or have been used in the past in the US include:
        i. Portability – where you could take your financing terms with you
        ii. Assumability – where a seller could transfer mortgage terms to the buyer (FT)

2. **A Fed survey showed that only 40% of renters think that they will ever be able to buy a home.**
    a. This is the lowest rate in the 10 years of data. (Bloomberg)

C. Politics

1. **The geopolitical uncertainty that has resulted from the Middle East has been a gift to Moscow and Putin. Putin now finds it easier to depict Biden's "liberal international order" as a hollow shell.**
    a. The more chaos that exists in Gaza between now and November, the less likely Biden will beat Trump. A Trump victory is more likely to lead to Ukraine having to enter into concessions with Russia.
    b. Netanyahu has every reason to keep the Middle East conflict going. Once it ends, there will be general elections and polls suggest his party will lose. He could end up serving time on his delayed corruption trials. (FT)

2. **The media gets attention by making us feel like crime is all around us. Now, the media is getting attention by making us feel like the economy is awful. The more that media is rewarded for clicks, the worse the result for our understanding of the world.**
    a. William Randolph Hearst said "if it bleeds, it leads" – our perception of crime is driven more by news reports than by their own experiences
    b. Today, people's perceptions of their own financial situation and the wider economy are diverging.
        i. People assess their own financial situation to be relatively healthy, but their view of the national economy has cratered
        ii. One study found that even as recessions have become far fewer and further between over the last century, news articles written about the economy have been more and more downbeat
        iii. Reporters report on high gas prices, but not lower ones
            1. In real terms, higher gas prices may not be as high as you think
            2. The switch into bad-news-about-prices mode happens much more abruptly on cable news channels – where the incentive to keep the viewer glued to the screen is the strongest
    c. A recent paper in Nature found that the more negative a headline, the more people will click on it (FT)