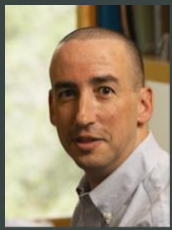

MARKET UPDATE

subscribe at sandyleeds.com

Market Update – May 6, 2024

I. Markets

A. Last Week

1. **Stocks**: Nasdaq +1.43%; DJIA +1.14%; IWM (Russell 2000) +.99%; **S&P 500 +.55%**
    a. S&P and Nasdaq both up for a second-straight week after three weekly declines
    b. S&P is still 2.6% below its intraday high and just below its 50-day moving average
2. **UST rates**: 2-yr fell 15 bps to 4.81% and the 10-year fell back to 4.50% (-17 bps)
3. **Positive stories**:
    a. Dovish Fed – Powell said a rate hike was unlikely
        i. Of course, he also said conditions weren't right to lower rates
    b. Jobs report that was consistent with soft landing
        i. Economy still growing, but not so fast that inflation will increase
        ii. Consistent with lower rates
4. But, the **stagflation** camp had their **arguments**:
    a. April ISM Services report contracted for the first time since Dec. 2022
    b. Employment cost index was high
    c. Q1 unit labor costs were up 4.7% (Barron's)
5. **Odd story**: the S&P dropped .6% during the last 10 minutes of the trading day on both Tuesday and Wednesday.
    a. This has **happened just nine other times since 1985**, including:
        i. Last time this happened was Feb. 2018 ("Volmageddon" – sharp rise in VIX wiped out a "short VIX" ETF)
        ii. Aug. 2015 – when China devalued the yuan
        iii. Oct. 1987 – during Black Monday selloff
    b. **But the other nine times**, the market was down an average of 28% from its 52-week high before this happened (or 19% if you include just one of the four times it happened during the financial crisis)
        i. Now, we're just 2.6% off the record high (Barron's)

B. How Bad is Inflation for Stocks?

1. Two weeks ago, inflation proved to be sticky, so rates went higher. Yet stocks rallied.
    a. **If inflation is a symptom of an economy that's doing well**, this implies getting out of bonds and into stocks (strong earnings)
    b. **If inflation is part of stagflation**, that's bad for all financial assets
2. So investors are resigning themselves to a longer battle against inflation, while betting that the economy remains in good shape (Bloomberg)

C. The Dollar and Stocks

1. **US stocks have risen in tandem with the dollar this year**
    a. A break with historical trends
        i. How much longer can the rally withstand the stronger dollar
    b. Dollar has risen 3.85% this year; S&P has added 7.5%
        i. Better growth has meant higher rates (and stronger dollar) and higher earnings
2. The dollar's increase was one of the factors weighing on stocks in 2022
    a. The dollar gained 8% that year; S&P lost almost 1/5 of its value
3. When the dollar is strong, overseas earnings convert into fewer dollars (FT)

D. Index funds

1. BlackRock, Vanguard, and State Street have $23T in assets between them. More than 75% of the assets are in strategies designed to be passive. These entities have a tremendous amount of **voting power. Is this passive investing?**
    a. With **equity funds**, there's **~$12T in passive funds** and **$8.5T in actively managed funds.**
2. Equities trade for 390 minutes per day. But **~1/3 of all trades happen in the final 10 minutes of the session**. This is up from 27% in 2021.
    a. Critics of passive investing say that this is when index funds buy and sell
    b. Active investors try to take advantage of that liquidity during the last 10 minutes
        i. Passive investors may be buying at fractionally higher prices at the close (Bloomberg) (Bloomberg)

E. Convertible Bonds

1. **Global issuance** of convertible bonds rebounded to ~$90B in 2023 from less than $50B in 2022. Companies want to minimize their debt-servicing cost.
2. The majority of this issuance is from **non-investment-grade borrowers**, with constrained cash flow problems and low profitability.
    a. Nearly **1/3 of all Russell 2000 companies are now unprofitable** (vs. ~5% two decades ago). Many have been hurt by higher interest rates.
3. The average coupon on convertibles issued in 2023 was 3.13%
4. The problem for these issuers is that if the company doesn't do well, the stock drops (making the conversion option worthless) and it will be very expensive to issue more debt (in order to repay this debt). (FT)

II. Thinking About Where Interest Rates Will Settle

A. The Neutral Rate Has a Big Impact on Where the 10-Yr UST Will Eventually Settle

1. **Neutral rate**: when the economy is at the dual mandate (full employment and stable prices), this is where the FOMC could set the Fed funds rate and it wouldn't be restrictive or stimulative. It would be neutral.
2. Arguments that the **neutral rate may be higher now**:
    a. With the Fed funds rate at 5.33%, the economy is still doing well
        i. Others argue that this is just the lag in monetary policy or that the economy has become less sensitive to rates
    b. The FOMC's estimate of the real neutral rate inched up to .6%
    c. Soaring government deficits and strong investment driven by the green-energy transition
    d. An AI-fueled frenzy for electricity-intensive data centers
    e. Higher productivity from AI could lift long-run growth and the neutral rate
3. Arguments that the **neutral rate is not rising**:
    a. Aging global workforce will boost savings and keep the neutral rate low
    b. Economic strength could be explained by idiosyncrasies of the pandemic
        i. Such as a boost in the supply of labor from immigration
    c. No good explanation as to why real rates on safe, liquid gov't debt fell for 40 years and why it would suddenly turn around (Chris Waller argument) (WSJ)

B. Barclay's Thinks the Neutral Rate Could be Higher (pushing 10-yr UST higher)

1. **R*** (the real neutral rate) **could be higher** than .5%:
    a. Debt (deficits permanently larger by 1 – 2% of GDP) +.5%
    b. Demographics (rising dependency ratio shifts from savings to drawdown) +.6%
        i. **SL**: notice that demographics was used as a contrary argument above
    c. Decarbonization +.2%
2. The neutral Fed funds rate (which is a nominal number) might be 3.5% - 4.0%
3. **10-yr term premium** could be higher due to supply gut, higher rate volatility, greater risk of fiscal dominance, becoming a less useful hedge
4. Higher UST yields could mean tighter financing conditions in other countries (FT)

C. High Treasury Borrowing Will Lead to Higher Rates in the Long-Term

1. The US Treasury needs to finance the nearly $2T per year budget deficit.
    a. They expect to borrow $243B during **Q2**, $41B more than the estimate at the start of the year. Their forecast for tax receipts decreased.
    b. The initial forecast for **Q3** is $847B
    c. There will be $1T of Treasuries issued between May to July.
        i. The shift to issuing shorter maturities made sense when we believed that short-term rates would be lowered.
2. Barclay's thinks that with **structurally wide deficits** and a **low personal savings rate** and the need for **major green energy-related investments**, the steady state nominal policy rate could be 3.5% (nominal neutral rate). The Fed thinks it will be 2.6%.
    a. If you believe this, why buy a 4.6% 10-yr UST when you could buy a 5.3% 3-month T-bill. Even if the Fed cuts rates to 3.5%, with a term premium, the 10-year yield does not decrease that much. (Barron's) (MarketWatch) (WSJ)

III. Currencies

A. Yen Intervention

1. After falling below 160 yen to the dollar, the yen rebounded on Monday, jumping to 154.5 yen to the dollar. The suspicion is that **Japan's finance ministry intervened**.
    a. The yen has dropped ~10% YTD.
2. The yen has been weak due to low Japanese rates and high US rates.
    a. The decline of the yen shows the huge impact of US interest rates.
3. **For Japan**, the weaker yen has boosted inbound tourism and fueled a surge in corporate profits earned overseas. On the negative side, it has raised living costs and hit domestic consumption. (FT) (WSJ) (Bloomberg)

B. The Dollar

1. **Risks that the strong dollar creates**:
    a. A strong dollar alters trade flows, with the potential to renew **global inflation**
        i. It raises America's purchasing power
            1. It can result in higher inflation for other countries
        ii. Commodity prices have also been moving in line with the dollar since 2020
    b. A strong dollar can **destabilize the US**
        i. It makes **imports more appealing** and our exports less appealing
        ii. It could undercut efforts to de-risk supply chains from China
            1. Potentially leading to more tariffs and tension
        iii. A strong dollar paired with a deflating Chinese economy could allow Chinese goods to flood the market
    c. A bullish dollar could **add to existing stresses in the financial system**
        i. It raises debt repayments facing emerging economies
2. Potential solutions are few and far between
    a. Many countries sit on large reserves and could sell dollars
        i. But this isn't a long-term solution
    b. Some countries may choose to raise rates (FT)

IV. China

A. Americans Don't Like China

1. According to Pew Research, **42% of Americans labeled China as an enemy** (up from 38% last year)
    a. Another 50% said China is a competitor
    b. Only 6% think of China as a partner
2. Separately (but within the same poll), **81%** have an **unfavorable view of China** (Bloomberg)

B. China has More Warships Than the US

1. China estimates that there are ~300 billion barrels of oil and 50 trillion cubic meters of natural gas in the South China Sea. This would be worth ~$40T in today's prices, more than twice China's annual GDP. This is one reason that China is very sensitive about this area.
2. **China has 350 warships while the US has 290**. The US is also spread thinner and any conflict in the South China Sea would take place in the shadow of the Chinese mainland. (Bloomberg)

V. The Economy

A. Jobs

1. US **employers added 175K jobs in April** (down from 300K in March and below the expectations of 240K). This kept alive hopes for a summer rate cut.
2. The **unemployment rate** ticked up to **3.9%**.
3. **Wages increased 3.9% YoY** (down from 4.1% in March).
4. We've already seen lower demand for workers with declines in job openings and in the share of workers voluntarily leaving their jobs. (WSJ)

B. Inflation

1. It's clear that inflation fell last year due to improved supply, softer demand, and well-anchored expectations.
2. But **why has disinflation stalled even though the labor market is coming back into balance and inflation expectations have edged lower**?
3. A **SF Fed model** divides core PCE inflation into **cyclical components** (those more sensitive to changes in unemployment) and **less sensitive "acyclical" components**.
    a. The model shows that while cyclical inflation stayed around 4% between Q4 and Q1, **acyclical inflation leapt** from zero to 4%. (WSJ) (Bloomberg)

C. Productivity

1. Productivity rose at a **.3% annualized rate** in Q1 (after rising at a 3.5% rate in Q4).
2. **Unit labor costs** (what an employee costs to produce one unit of output) increased at a **4.7% annual rate**. (Bloomberg)

D. Investors are Buying Homes

1. Since 2021 Q4, **investors** have been responsible for more than **22.5% of home transactions every quarter.**
2. Investors say that they are giving people the opportunity to live in nice areas
    a. Others say that they're crowding buyers out of the market (WSJ)

E. Home Insurance

1. The cost of **homeowner's insurance in the US rose 23% from Jan. 2023 to Feb. 2024**
    a. In hurricane-prone Louisiana, premiums were up 63%
    b. In Florida, many providers are pulling out of the market
2. The obvious driver is climate change and the risk of more severe weather events (floods, fires, wind storms, tornadoes) (FT)

F. Healthcare services

1. In 2022, the **US spent ~$4.5T on healthcare services**.
    a. More than **17% of GDP**
2. A lack of transparency on pricing and waste makes the sector ripe for disruption.(FT)

G. Young Americans are Being Left Behind

1. **Home-affordability** fell last year to the lowest level since 1985
    a. The median household now needs more than 40% of its income to cover payments on a median-priced home
    b. **Factors** that are hurting rates and prices:
        i. QT is having an impact on keeping mortgage rates high
        ii. A decline in housing construction has limited the supply of homes (as has mortgage lock) and a surge in immigration is increasing demand
2. Americans 55+ have $114T of **assets**; nearly 70% of the total assets. Three decades earlier, this was 51%.
    a. **Households under 40** have less than $15T (**9% of total assets**), below the 14% 30 years ago

VI. The Fed

A. FOMC Statement

1. **Economic activity** has continued to expand at a **solid pace**
    a. Job gains have remained strong; unemployment low
2. **Inflation has eased** over the past year
    a. But **remains elevated**
    b. Committee remains highly attentive to inflation risks
3. **Will slow QT** beginning in June
    a. Sell $25B of USTs (down from $60B)
    b. Maintain cap on agency debt and MBS at $35B (Federal Reserve)

B. Fed Says Inflation Progress has Stalled

1. Powell indicated that the **bar to cut interest rates had gone up**, but the **bar to hike rates was even higher**
2. Fed approved plans to slow the ongoing reduction of its $7.4T asset portfolio.
3. Powell said that the **Fed could cut rates if**:
    a. The labor market showed material and unexpected weakness
    b. Inflation resumed its decline (WSJ)
4. The **great quote** from Powell:
    a. "I don't see the 'stag', I don't see the 'flation'." (FT)

C. Economic Policy

1. On Wednesday, we heard that a rate increase was very unlikely. On Friday, the market decided that there was **still a chance of two rate cuts this year**.
2. FOMC statement pointed to the "lack of further progress toward the Committee's 2% inflation objective."
    a. At press conference, Powell said that a **rate hike was unlikely**.
3. Powell also said that it **would take "an unexpected weakening" in the labor market** for the Fed to react by lowering rates.
    a. He said that "it would have to be meaningful. And get our attention."
4. **Average hourly earnings** rose 3.9% YoY. But if you **annualize the past three months, it's only 2.8%.**
5. Financial conditions remain accommodative according to Chicago Fed and Bloomberg, despite "restrictive" policy. (Barron's)

D. What High Rates Can Do

1. Between 1998 and the pandemic, the share of Americans with mortgage rates more than 1% below the market rate was never far above 40%. Yet, at the end of 2023, **~70% of mortgage borrowers had rates more than 3% below the rate that they could get today. Higher for longer may be futile.**
2. The manufacturing and construction sectors are more capital-intensive than the service economy. Rates may not impact services as much.
3. High rates can't lower motor vehicle insurance. (FT)

E. Tyler Cowen Argues for Continued Fed Independence

1. Trump advisers have been drafting plans to significantly limit the operating autonomy of the Fed. The Trump campaign has disavowed these plans, but the ideas have been spreading in Republican circles.
2. The WSJ reported that one proposal was to **require the Fed to informally consult with the president on decisions concerning interest rates and other major aspects of monetary policy.**
    a. Presidents worry about reelection and that can be different than the dual mandate.
3. **Another of the new proposals would subject the Fed to the executive-branch review process, ostensibly to ensure that "the president's policies and priorities are reflected in agency rules."**
    a. Who thinks that the executive branch will improve bank supervision?
4. If Congress wants to restore greater monetary and financial stability, they should **try being fiscally responsible**. (Bloomberg)