SUNDAY, APRIL 30, 2023

ECONOMIC COMMENTARY
JIMMY SAID & IAN WHITE

MONTHLY REPORT

THOUGHTS OF THE MONTH

MARKETS:

S&P 500 valuation and sectors provided by Goldman Sachs Investment Research Team.

Current aggregate valuation metrics - absolute

	EV/ Sales	EV/ EBITDA	Price/ Book	FCF Yield	PEG Ratio	NTM P/E
S&P 500	2.5x	12.7x	4.1x	3.8 %	1.9x	18.3x
Energy	1.2	4.8	2.4	12.6	58.3	10.5
Financials	NM	NM	1.8	NM	1.6	13.1
Comm Services	3.1	9.5	3.1	4.9	1.0	16.1
Materials	2.2	9.5	2.9	4.6	1.9	16.7
Real Estate	NM	NM	3.0	NM	2.4	17.1
Health Care	1.9	13.6	4.8	6.0	2.3	17.3
Industrials	2.3	12.7	5.2	3.8	1.7	18.0
Utilities	NM	12.6	2.2	(5.0)	2.6	18.2
Cons Staples	1.7	15.5	6.5	2.9	2.9	20.6
Cons Discr	2.3	15.9	8.5	1.7	2.1	24.3
Info Tech	6.1	18.8	9.5	3.1	2.3	24.3

Current relative valuation vs. historical average (Z-score)

	10-year							30-year
	EV/ Sales	EV/ EBITDA	Price/ Book	FCF Yield	PEG Ratio	P/E	Median Z-Score	Median Z-Score
S&P 500	0.5	0.0	1.0	1.1	1.8	0.1	0.8	0.9
Comm Services	(2.3)	(2.0)	(1.8)	(1.0)	(3.1)	(2.4)	(2.1)	(1.6)
Real Estate	NM	NM	(2.5)	NM	(0.8)	(1.5)	(1.5)	(0.7)
Financials	NM	NM	(1.1)	NM	(0.5)	(2.4)	(1.1)	(0.9)
Energy	(1.2)	(1.1)	0.3	(2.6)	3.0	(0.8)	(1.0)	(1.2)
Materials	(1.5)	(1.3)	(1.0)	(0.8)	(0.7)	(0.4)	(0.9)	(0.7)
Industrials	(0.8)	(0.2)	(0.9)	(0.2)	(0.5)	(0.9)	(0.6)	(0.3)
Health Care	(0.9)	0.3	(0.9)	(2.1)	0.1	0.3	(0.4)	(0.7)
Cons Discr	(0.4)	0.3	(0.1)	1.2	1.2	(0.0)	0.1	1.0
Cons Staples	(0.3)	1.4	0.1	2.4	(0.8)	0.5	0.3	0.2
Utilities	NM	0.6	(1.1)	2.6	(1.7)	1.2	0.6	0.9
Info Tech	2.1	2.5	1.0	1.7	0.8	2.5	1.9	1.1

Source: FactSet, I/B/E/S, FirstCall, and Goldman Sachs Global Investment Research.

So far, 88 S&P 500 companies, which make up 25% of the total earnings, have reported their earnings. Of these, 68% beat EPS estimates, down from last week's record high of 90%. However, this figure is still above the historical post-Week 2 average of 63%.

Exhibit 4: % of S&P 500 companies beating consensus expectations on 1Q23 EPS and sales

Results from companies that have reported 1Q earnings

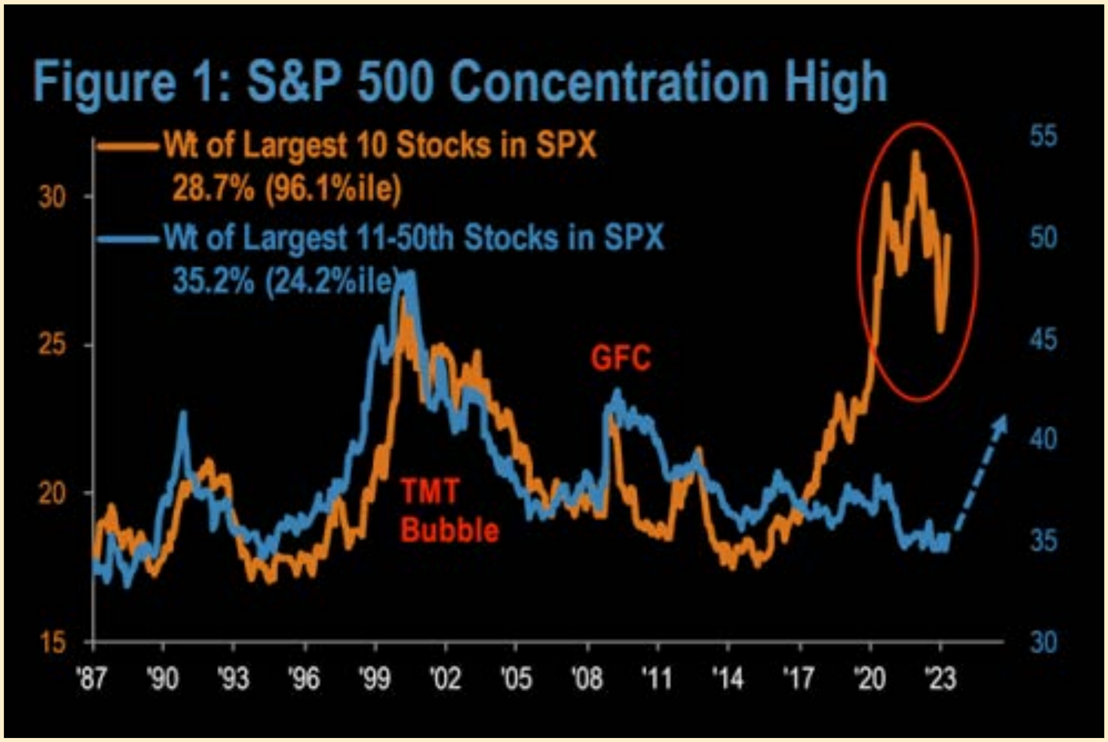
Sector	Total companies	Number Reported	% with EPS beat	% with Sales beat	% EPS & Sales beat
Cons. Disc.	53	11	82%	82%	82%
Cons. Staples	37	9	100%	67%	67%
Energy	23	3	67%	67%	67%
Financials	73	30	43%	93%	40%
Health Care	65	6	100%	100%	100%
Industrials	73	13	69%	54%	46%
Tech	66	8	75%	50%	50%
Materials	29	3	100%	33%	33%
Real Estate	30	2	50%	100%	50%
Comm. Svcs.	21	3	67%	33%	33%
Utilities	30	0	N.A.	N.A.	N.A.
S&P 500	**500**	**88**	**68%**	**75%**	**55%**
ex. Financials	**427**	**58**	**81%**	**66%**	**62%**

Source: FactSet, BofA US Equity & Quant Strategy

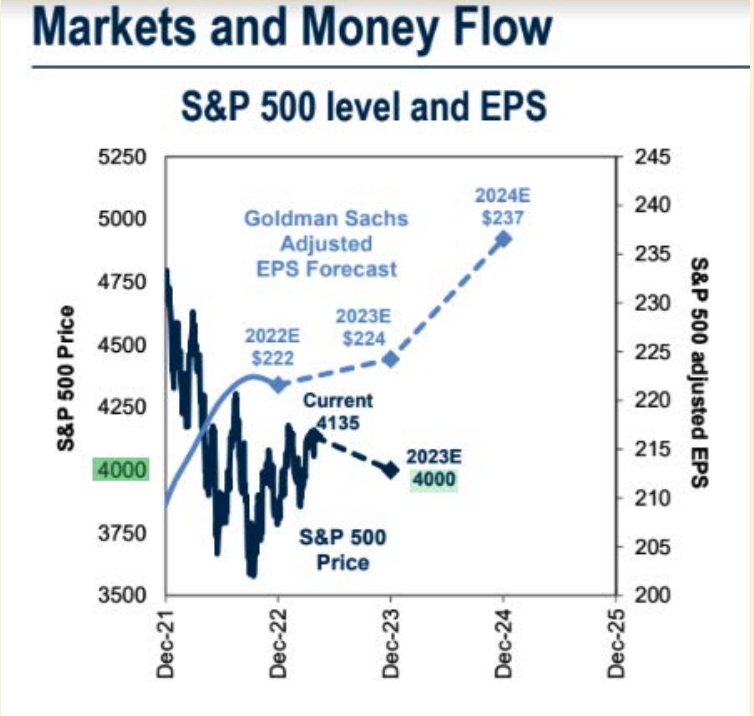
BofA GLOBAL RESEARCH

Investors are beginning to shift towards defensive, end-of-cycle themes, such as moving from high beta to low volatility investments.

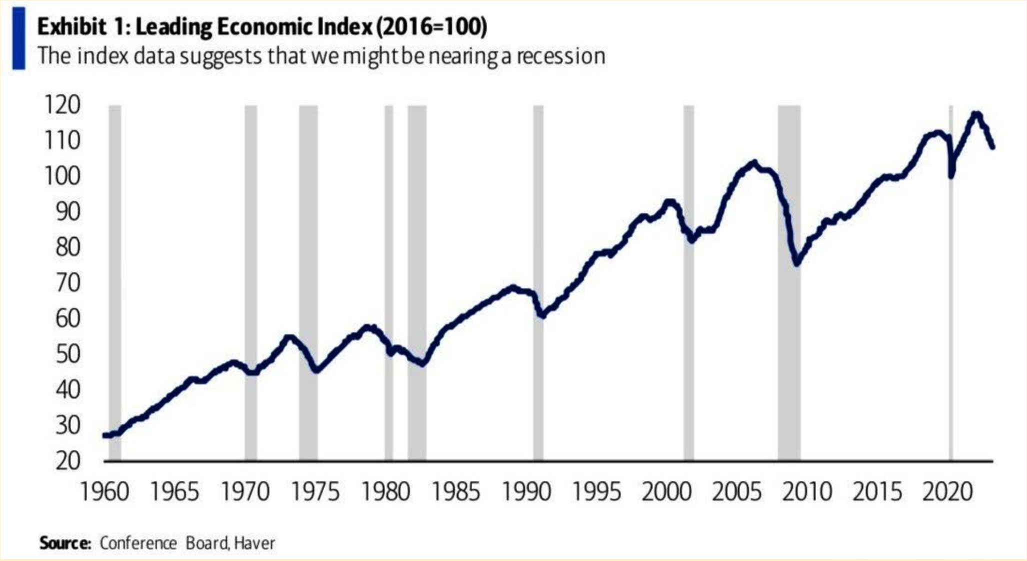
The top 10 stocks in the S&P 500 make up 28.7% of its weighting vs the next 40 largest weightings making up 35.2% in comparison. Is this a concentration extreme?
To help answer this question, please see: https://awealthofcommonsense.com/2023/05/concentration-in-the-stock-market-2/.
Apple's current representation in the market index stands at over 7%; however, in the 1930s, AT&T accounted for 13% of the index, indicating that some companies have outperformed and become more prominent over time. Although this phenomenon is noteworthy, it is not unusual.



Goldman Sachs Economists: “Despite Economic uncertainty, we continue to expect the S&P 500 will trade sideways in coming months and finish the year at 4000” representing a 3% decline from current levels.



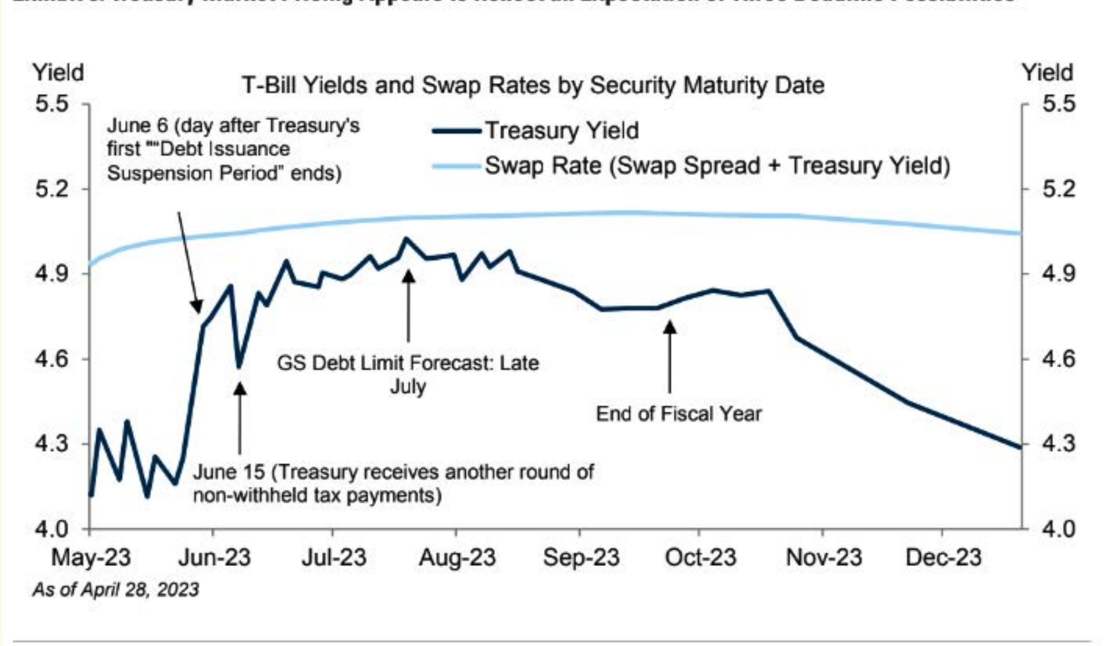
The leading economic indicator (LEI) is a composite index that uses a combination of economic variables, such as stock prices, interest rates, and consumer expectations, to forecast future economic activity. It is intended to provide insight into the direction of the economy in the near term, typically within the next six to nine months. Currently, the LEI is indicating that we may be headed towards a recession. However, it is important to note that a decline does not necessarily guarantee a recession.



CREDIT DEFAULT SWAPS & DEBT CEILING:

Treasury Market Pricing Appears to Reflect an Expectation of Three Deadline Possibilities for the Debt Ceiling.

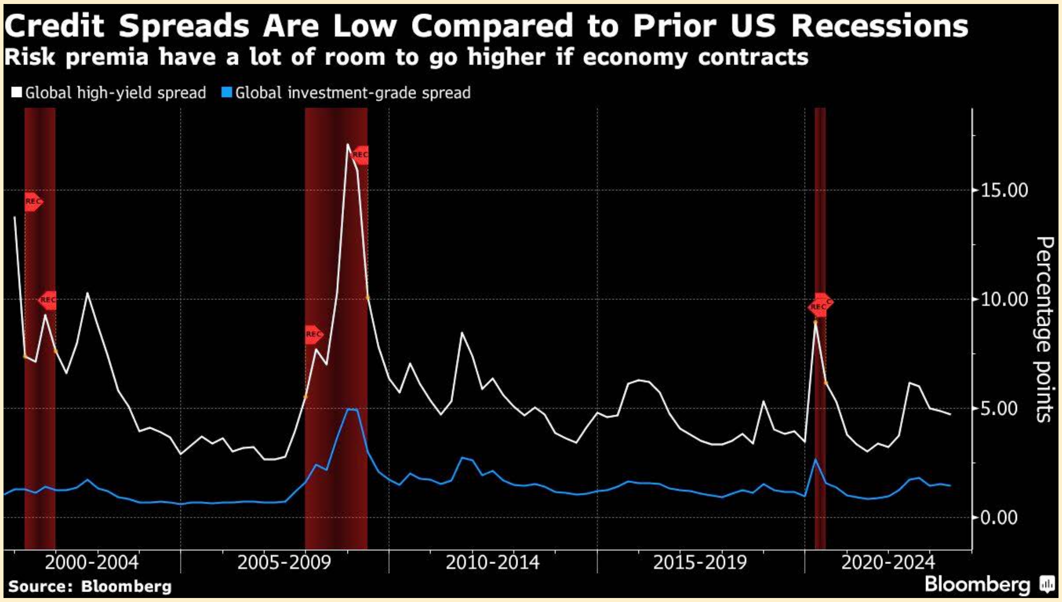
Exhibit 5: Treasury Market Pricing Appears to Reflect an Expectation of Three Deadline Possibilities



Source: Goldman Sachs Global Investment Research

Although the US Sovereign CDS has been receiving attention due to the debt ceiling, it's worth noting that the 1-year rate is higher than in the 2011 episode. While the CDS market is generally viewed unfavorably, it's important to keep in mind that the US has technically defaulted on its debt four times in the past, and none of these incidents have had a significant impact on the world as we know it today.

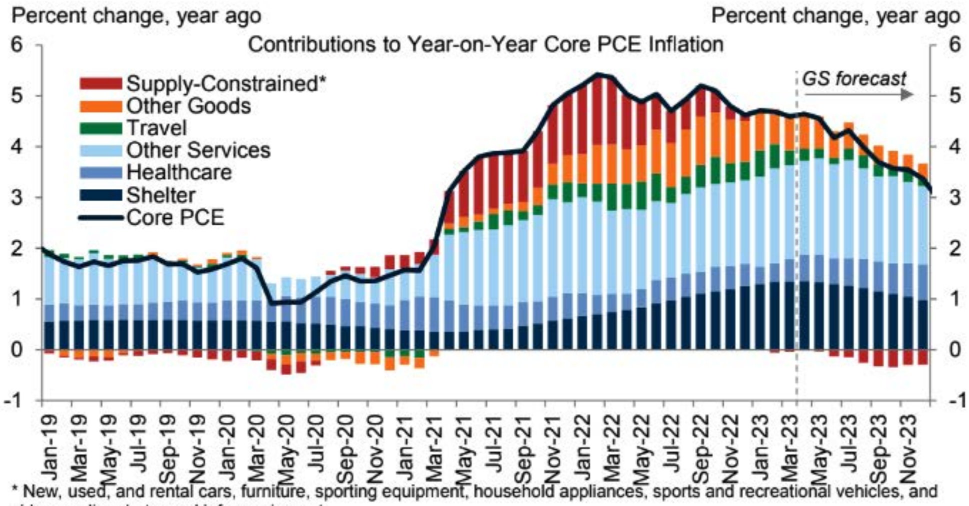
Stern warning from Citi as markets buckle up for $600-800B CB liquidity drain in coming weeks. "With peak liquidity past, we would not be at all surprised if markets were now to experience a sudden pressure loss. Keep watching the liquidity data — and buckle up."



INFLATION:

Goldman Sachs Economists: "We Expect That a Shrinking Contribution From Goods and Shelter Inflation Will Slow Core PCE Inflation to 3.4% By End-2023"

Exhibit 24: We Expect That a Shrinking Contribution From Goods and Shelter Inflation Will Slow Core PCE Inflation to 3.4% By End-2023



* New, used, and rental cars, furniture, sporting equipment, household appliances, sports and recreational vehicles, and video, audio, photo, and info. equipment.

Source: Goldman Sachs Global Investment Research

BANKS:

A Growing Number of Banks Report Unrealized Losses that Threaten Capital - Federal Reserve

A Growing Number Report Unrealized Losses that Threaten Capital

At third quarter end, 722 banks reported unrealized losses exceeding 50% of capital

- 31 of these banks report negative tangible equity levels
  - Banks reporting negative tangible equity are currently not able to borrow new money from Federal Home Loan Banks and may lose the ability to sell loans to Government Sponsored Enterprises
  - Some banks are taking actions to shelter further market losses, including
    - Changing the accounting treatment of their securities, thus their intent to use securities for liquidity purposes,
    - Hedging their interest rate risk, and/ or
    - Retaining more tangible capital
  - The decisioning around such actions is complex, particularly at smaller banks where securities have always been used for liquidity purposes and expertise with hedging is limited

“Banking is probably the only industry in the world where you can hide your cost of goods sold until there's some sort of downturn,” PNC Chairman & CEO Bill Demchak once remarked (the lag from when a loan is made, to when it gets paid back or not).

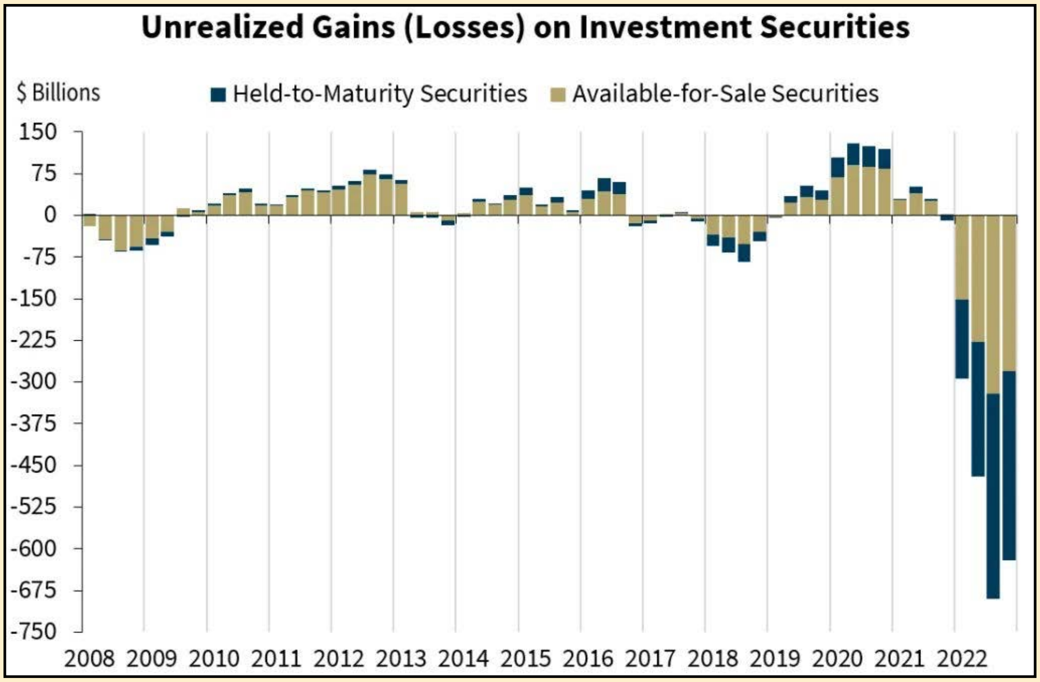
PNC

The Transcript
Weekly Quotes From Earnings Calls

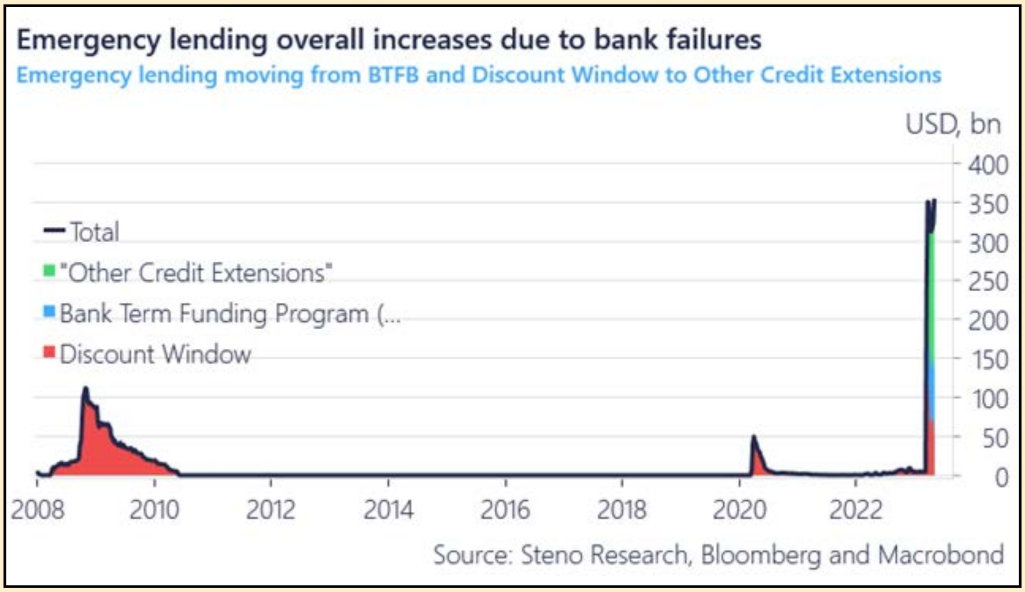
Banking is probably the only industry in the world where you can hide your cost of goods sold until there is some sort of downturn. So today, everybody sees loan growth and they say, okay, it's all equal. It's great. Somebody's growth beat somebody else. **We can make loan growth be anything you guys want for a period of time until it comes back to haunt us.** And the one thing I would say is, we've been able to hold our own, if not outpace the peers, without changing the credit box at all. We're not doing it in consumer, and importantly, we're not doing it in C&I. We're doing it through growing clients across the board. So we may or may not accelerate loan growth, but what I can say is that the loan growth we are seeing is not changing the risk profile of this company and exposing us to excess losses should we get into a downturn. And it's really frustrating to me because I watch some of our peers who will post loan growth, and then I look up at the league tables, and they will be top on the league tables on leverage loans covering private equity, right. Those loans are really different than what we're putting on our books.

PNC Financial Services CEO William Demchak

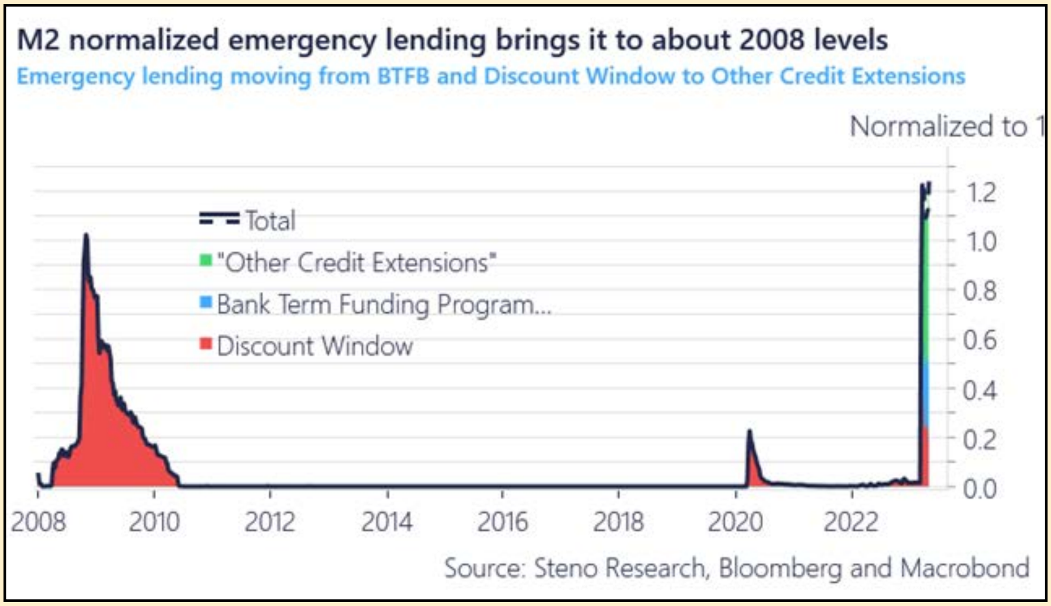
Many banks are still holding significant unrealized losses and have asset-liability duration mismatches. If fear leads to bank runs, it could cause more failures. Many banks are ill-equipped to handle a high volume of withdrawals without facing extreme stress or failure. It is essential to take proactive measures to address these risks before they worsen.



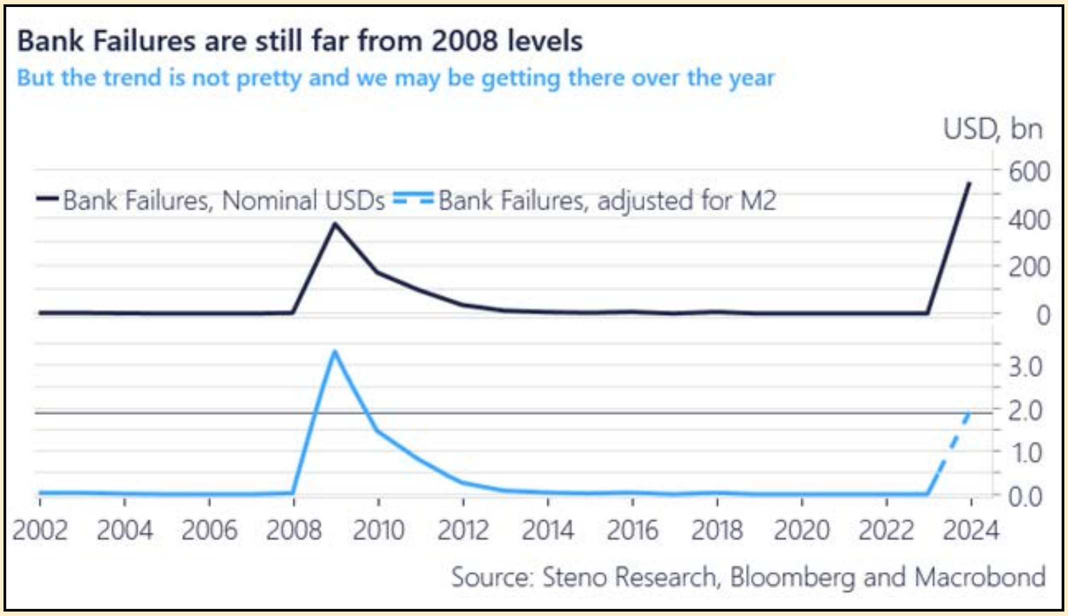
Emergency lending looks violent on the surface as FDIC has taken up loans in the "Other Credit Extensions" as part of bridging the banks on receivership.



Upon normalizing lending with M2 money supply, the situation does not appear to be worse than the circumstances observed in 2008. It is important to note that the easing of credit and collateral standards in the Business Term Funding Program (BTFP) was necessary to prevent emergency lending from dropping below the levels witnessed in 2008.



Several sources, including the NY Times, various Twitter commentators, and Investment Banking economists, have concluded that recent bank failures have exceeded 2008 levels when adjusted for inflation. However, it's important to note that using the CPI to discount notional amounts is inaccurate. By adjusting for M2 money supply instead, we can see that the situation is not as dire as it may seem, although the trend is certainly concerning and still significantly far from the levels observed in 2008.



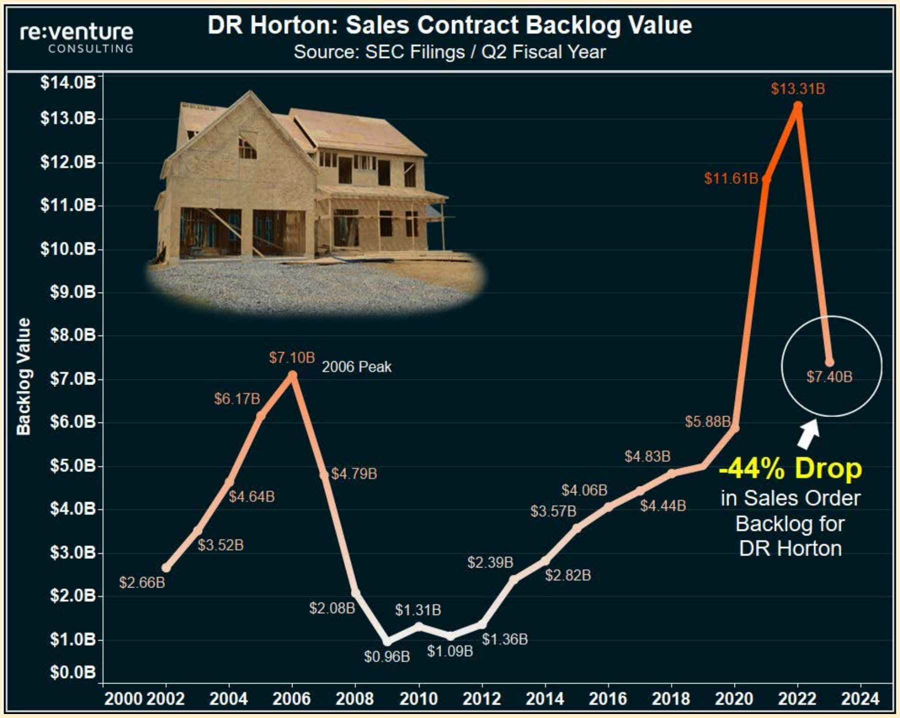
Real Estate:

DR Horton sales order backlog fell 44% YoY.

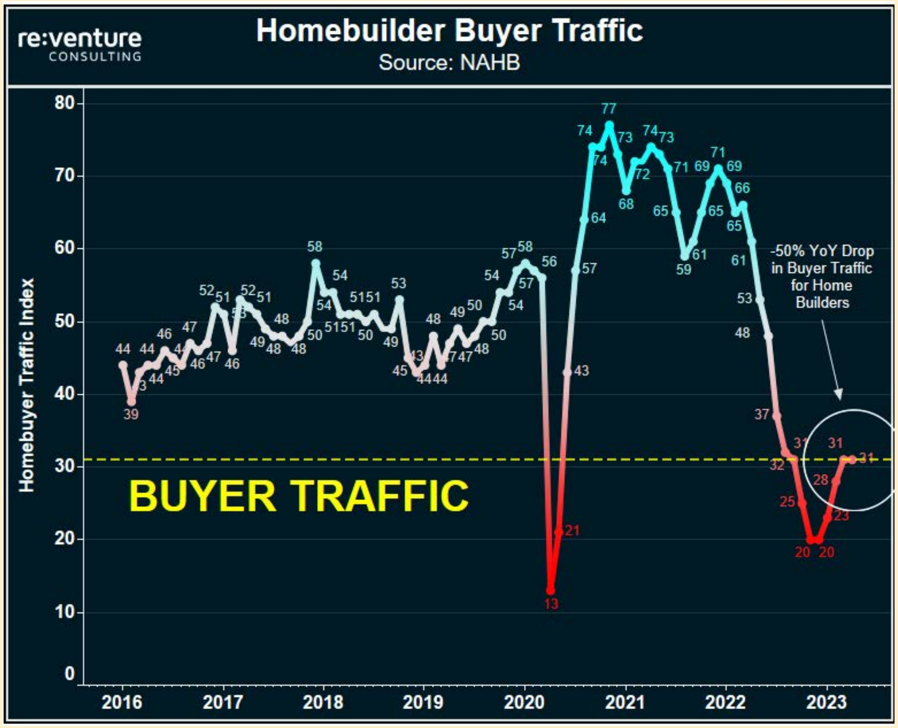
2022 Q2: $13.3 Billion

2023 Q2: $7.4 Billion

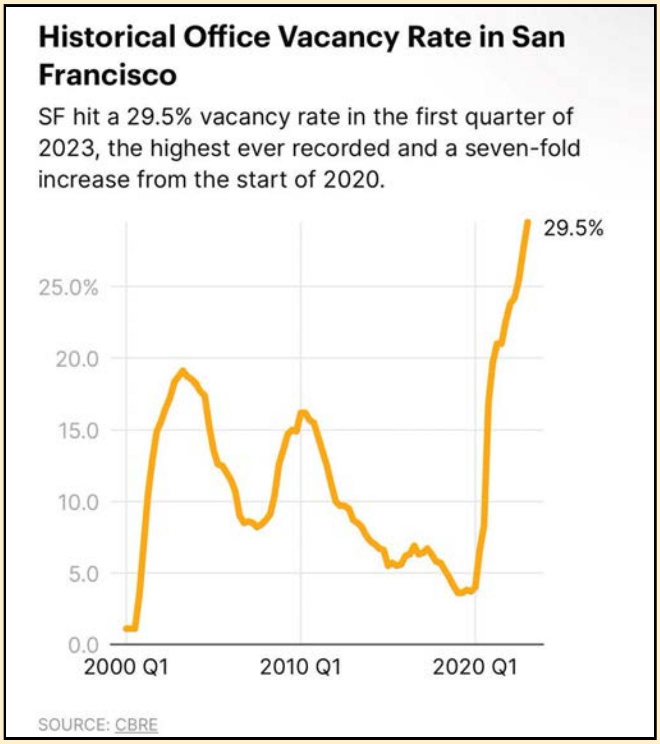
The magnitude of this decline is similar to what was observed during the initial stages of the previous housing downturn from 2006 to 2007. However, upon analyzing the trend, it appears that the current volume is consistent with expectations.



Home Builders have reported an increase in buyer traffic to their sites. If there is a recovery in sight, we should see an continuous increasing trend.



The current office vacancy rate in San Francisco stands at a record high of 29.5%, which represents a significant increase of 7 times the pre-pandemic levels. It's likely that this trend is primarily due to the widespread adoption of remote work policies following the pandemic. However, as more companies begin to require in-office work, we anticipate that this vacancy rate will decline.



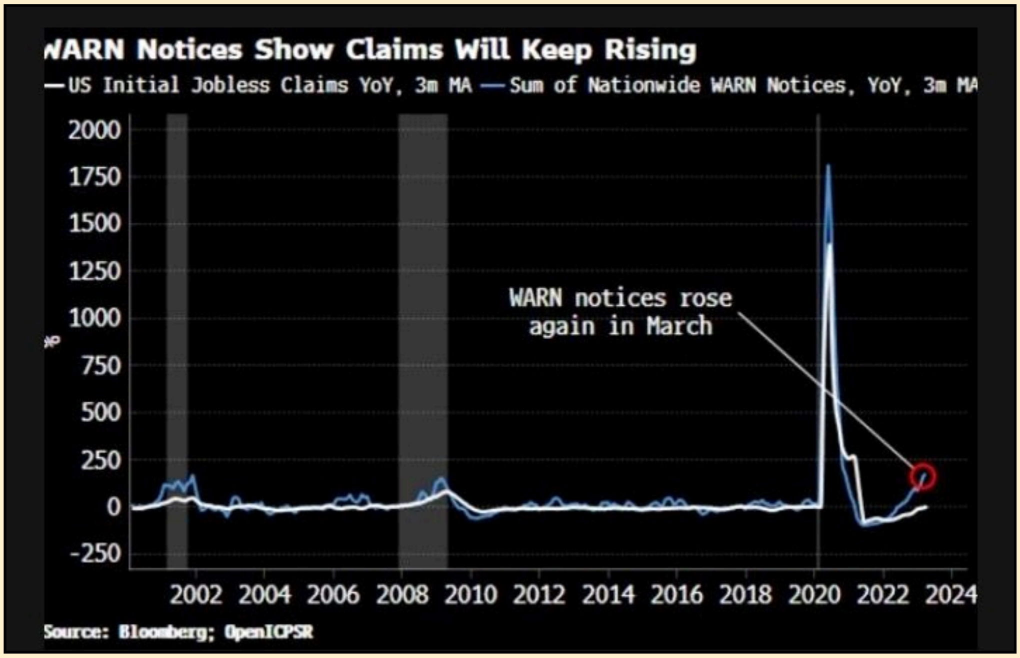
INTERNATIONAL MARKETS:

Bank of Japan Governor Ueda is scheduled to hold his first BoJ meeting this week. While the economic conditions in Japan may not be flourishing, the YCC policy approach implemented in 2016 to counter the risks of deflation and the yen's decline towards 100 is no longer suitable. In 2016, core inflation was negative, whereas at present, it stands at a range of 3-4%.

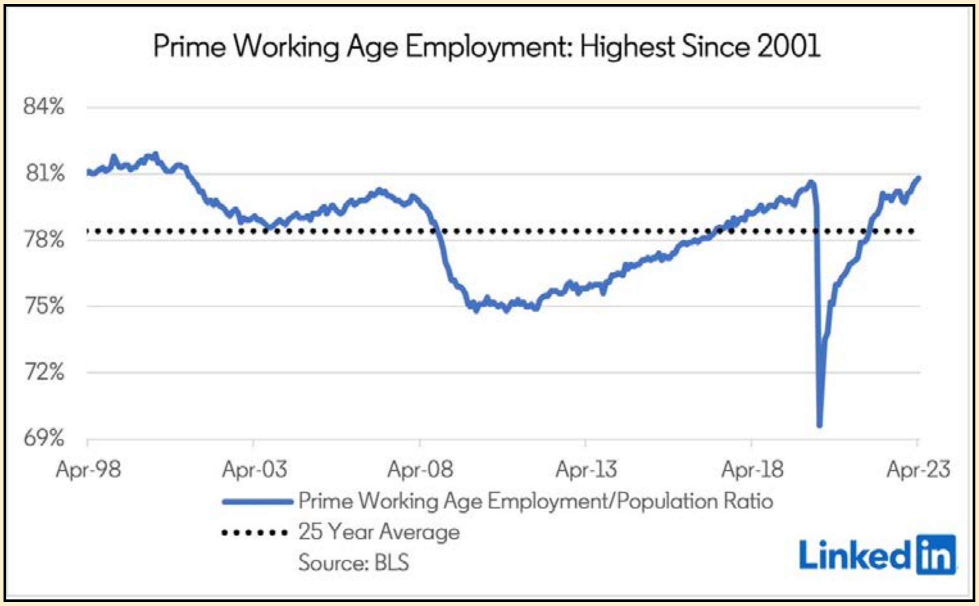
It has been over three decades since Japan's inflation has remained within this particular range, except for a few brief periods associated with tax hikes, such as in 2014. The headline figures have remained consistent, with inflation running negative in 2016 and presently ranging between 3-4%.

EMPLOYMENT:

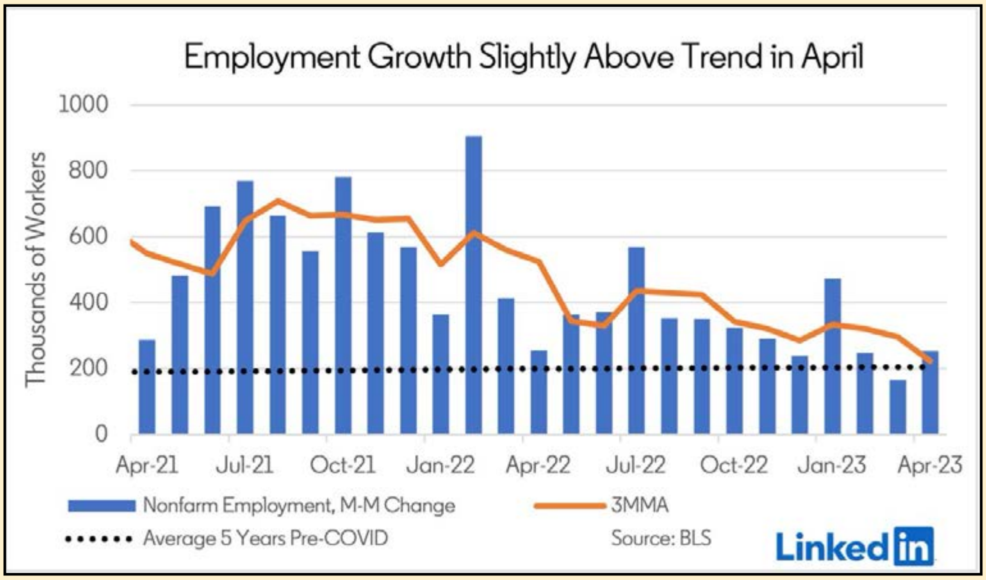
WARN notices must be filed at least 60-90 days before large firms are planning plant closures or mass layoffs. They have been rising since last year, and the latest update shows a further rise in March.



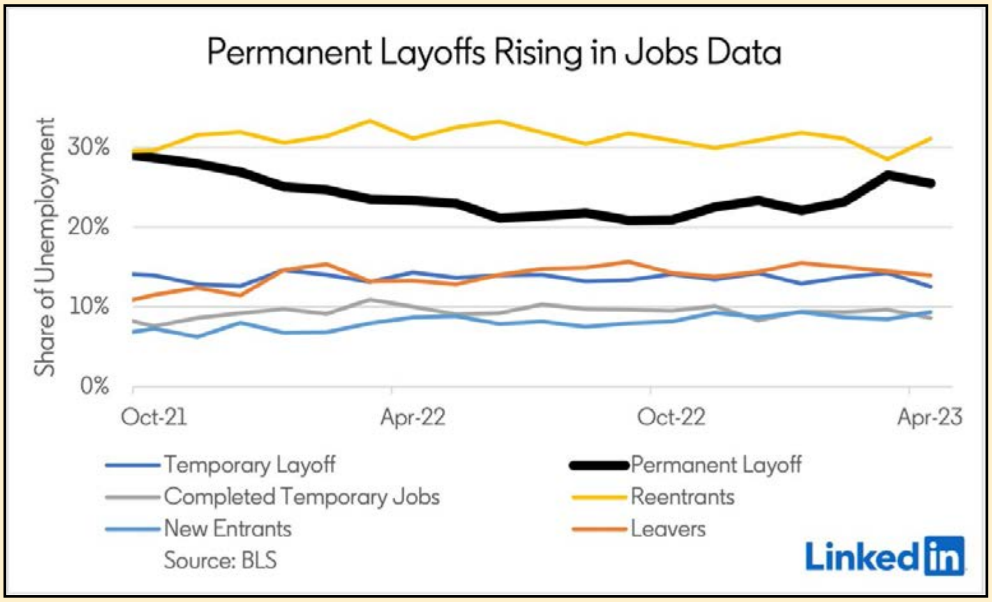
The share of prime working age Americans with a job hit a new post-2001 high, at 80.8%. Getting closer to the all time high of 81.9%, reached in April 2000.



Non-farm payroll growth in April was strong, at 253K. However, there were big downward net revisions to the prior two numbers (-149K).



There has been a slight improvement in a key metric that has been a cause for concern, namely the increase in the number of individuals who are unemployed due to permanent layoffs. In April, this figure declined from 26.6% to 25.5%, although it remains the second-highest figure since 2021. This small, persistent group of individuals represents a source of ongoing labor market distress.



In April, wage growth demonstrated a considerable degree of resilience, showing an upward trend, despite the overall two-year trend showing a slight decline.

BRIEF SUMMARIES

INTERNATIONAL ECONOMICS

The European economy is currently facing a number of challenges, including high inflation, slowing economic growth, and rising interest rates. In March 2023, the eurozone saw a record high inflation rate of 7.5%, which was largely driven by rising energy and food prices. This has put pressure on household budgets and impacted consumer spending. Additionally, slowing economic growth has further compounded these challenges. The European Commission has downgraded its growth forecast for the eurozone in 2023 to 2.8% from 4.0%, while the IMF has downgraded European growth to 0.8% for the same period. The European Central Bank (ECB) also increased interest rates by 50 basis points in April.

Despite these difficulties, there are some positive indicators for the European economy in April 2023. For instance, the unemployment rate in the eurozone fell to a new record low of 6.8% in February, and business confidence remains relatively stable. It is clear that the European economy is facing headwinds, but there are also some positive signs that can be capitalized on. To ensure a strong economic recovery, it is essential that these challenges be managed effectively.

In contrast, the emerging markets are showing relative strength, with interest rates remaining above inflationary levels, the dollar weakening, and economic activity rebounding. This trend is more concentrated in specific regions such as the Middle East, Southeast Asia, and parts of South America. This is evidenced by the strong quarterly earnings of companies such as LVMH, Apple, Proctor & Gamble, and Johnson & Johnson, who all cited stronger demand. However, there are still issues in China and Taiwan that continue to create uncertainty in the markets. Although China's economic activity, including household consumption and spending, has rebounded, this is not universal across all emerging markets. Thus, it is important to continue monitoring foreign markets as compared to historical norms and US markets to see the trend.

US MARKETS

EMPLOYMENT

In April 2023, the unemployment rate remained steady at 3.4%, continuing the trend of 12 consecutive months with unemployment below 4%. The job gains were once again concentrated in sectors such as hospitality, healthcare, and professional and business services, which align with spending and inflation trends in the services industry. Furthermore, the labor force participation rate held steady at 62.6%. The number of long-term unemployed individuals, defined as those without work for 27 weeks or more, remained largely unchanged at 1.1 million.

Nevertheless, the labor market remains tight, presenting a challenge for the Federal Reserve as they consider raising or keeping the Federal Funds Rate at 5% - 5.25%.

BANKING

In April, the banking industry experienced both positive and negative developments. The robust first-quarter earnings reported by large banks like JPMorgan Chase, Citigroup, and Wells Fargo indicated that many customers preferred larger and safer institutions. This preference could be attributed to the perception that bigger banks were better able to withstand market volatility and economic uncertainty. However, First Republic Bank's loss of over half of its customer deposits during the first quarter signaled a troubling trend for the banking industry. The bank's drastic decline in customer deposits was likely due to concerns about the bank's financial stability, particularly in light of the COVID-19 pandemic and its impact on the economy. The decline in deposits led to significant drops in First Republic's stock value, resulting in the bank's takeover by the FDIC and its subsequent sale to JPMorgan Chase. This collapse was the second-largest in U.S. banking history after Washington Mutual's in 2008.

The FDIC's report on Signature Bank's insufficient risk policing practices and the Fed's report on its failure to act ahead of Silicon Valley Bank's collapse highlighted the importance of effective risk management in the banking industry. Poor risk management practices can have serious consequences for banks, including reputational damage, financial losses, and regulatory intervention. The reports also underscored the need for regulators to take a more proactive approach in identifying and addressing risks in the banking sector. Overall, the events in April highlighted both the strengths and weaknesses of the banking industry. While the strong earnings reported by large banks indicated their ability to weather economic uncertainty, the collapse of First Republic Bank served as a cautionary tale for the importance of financial stability and effective risk management practices in the banking industry.