OBSERVATIONS: *Debt ceiling progress helps markets, Apple bigger than the Russell 2000, Mixed macro data*

- The S&P 500 traded higher last week by +1.7% and tested the year's highs amidst debt ceiling progress—despite a mid-Friday afternoon halt to negotiations. Small cap stocks (Russell 2000 Index) fared better after posting gains of +1.9% and regional banks (S&P Regional Bank Index) gained +8.7% on the week. The 10-Year US Treasury yield rose by 21bps, reaching a two-month closing high of 3.68%.[1]
- US retail sales rose +0.4% in April—less than expectations of +0.8%— after back-to-back monthly declines in February and March. On a year-over-year (YoY) basis, retail sales were up +1.6% in April with inflation (core CPI) up +5.5% over that same period, leaving inflation adjusted spending in the negative.[1]
- Home builder confidence (NAHB/Wells Fargo Housing Market Index) rose to 50 from 45. This marks the fifth consecutive month of improving sentiment and is the first time the index has been at or above 50 since July 2022 (readings above 50 indicate positive sentiment).[2]
- Meanwhile, existing home prices (national median) dropped -1.7% in April on a YoY basis, the largest decline since January 2012. New housing starts (a measure of new residential construction) showed modest improvement registering a +2.2% gain in April from March but are down -22.3% from this time a year ago.[1]
- Twenty years ago, Apple had a market capitalization (cap) of $6.8 billion while the Russell 2000 index (an index of 2000 small cap companies) had a market cap of $830.0 billion.[1] Fast forward to today and Apple's market cap ($2.71 trillion) has now exceeded that of the entire Russell 2000 index ($2.65 trillion) for 17 consecutive days (as of 5/19/23). This phenomenon happened for 1 day on 9/1/2020, from then Apple would go on to lose -10%, while the Russell 2000 gained +50% through 3/12/2021—*this is not a forecast!*[1]
- US industrial production inched up in April and registered +0.2% YoY increase from April 2022, but the May Empire State Manufacturing Index moved sharply lower in May suggesting continued sluggish manufacturing activity in the Northeast.[1]
- China retail sales and industrial production both came in below expectations in April. Industrial production registered 5.6% YoY growth, but that was roughly half of expectations. April retail sales increased 18.6% YoY, but analysts were expecting an even higher number as part of China's post-Covid bounce, which seems to be fading. Meanwhile, youth unemployment (ages 16 to 24) surged to a record high 20.4% in April.[1]

EXPECTATIONS: *Fed speakers galore, handicapping AI's impact on the global economy*

- Goldman Sachs estimates that generative artificial intelligence (AI) could increase productivity growth by +1.5% per year in the US, while lifting global GDP by a cumulative 7% ($7 trillion) over a ten-year period.[3]
- Fed officials pushed back last week on the notion that the Fed would be inclined to cut rates in the back half of 2023. Fed Governors Philip Jefferson, Raphael Bostic, Neel Kashkari, Lori Logan, and Thomas Barkin all gave speeches last week that emphasized that inflation remained stubbornly high, and that a tight monetary policy would need to be maintained even if economic growth slowed.[1]

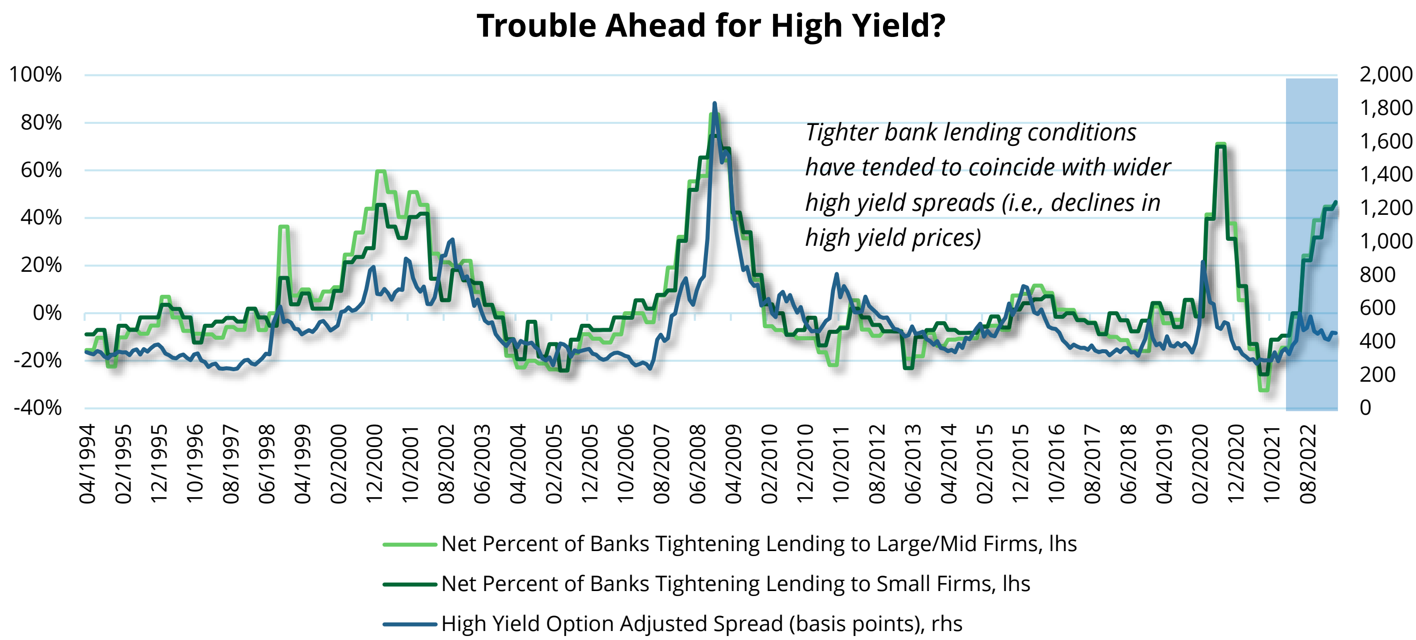
ONE MORE THOUGHT: *Trouble ahead for high yield?*[4]

Banks reported tighter lending conditions for large, mid, and small sized firms in the most recent Senior Loan Officer Opinion Survey (SLOOS). Historically, tighter bank lending conditions have generally coincided with widening credit spreads, particularly for high yield issuers. Widening high yield credit spreads would be a result of high yield bond prices declining during periods of increasing investor risk aversion. As we sit here today high yield spreads

[1] *Bloomberg LP*
[2] *https://www.nahb.org/news-and-economics/housing-economics/indices/housing-market-index*
[3] *GS Economic Research, Briggs/Kodnani, CNBC*
[4] *Clearstead, Bloomberg LP, Fitch Ratings*

(Defined as OAS, or Option Adjusted Spreads. Consider OAS as a proxy for the additional spread over a comparable US Treasury bond that investors require for accepting higher credit risk) are hovering around 450 basis points (bps), which is below the 25-year average of about 530bps. One reason for today's below average reading is due to the increase in quality of the high yield index, where 47% of its bonds are now rated as BB—just one step below investment grade—which is near the long-term average of 45%. Balance sheets for corporations, including high yield issuers, are in good shape and defaults in high yield are projected to be around 3.0-3.5% for 2023 which is mostly in line with long term default rates of 3.6%, but above default rates of 0.5% and 1.3% for 2021 and 2022, respectively. Still, the increase in quality and 'average' default rate expectations may not be fully reflective of the knock-on effect that tighter lending conditions are likely to have on the economy (Chart of the Week). In fairness, the tighter lending conditions witnessed today are being significantly driven by regional banking woes and there is a non-zero chance that, like in 2020, high yield spreads do not move in lock step with the prevailing bank lending conditions. The past may not be repeated but it sure seems likely that it will rhyme, and it is increasingly plausible that high yield may encounter some turbulence in the near future.

CHART OF THE WEEK



Source: Clearstead, Bloomberg LP, as of 5/15/2023

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