Summary

For the short holiday week, economic data included U.S. GDP growth being downgraded a few tenths, continued improvement in lower PCE inflation, higher home prices, and improved consumer sentiment.

Equities were mixed globally, with developed markets down a bit on net, while emerging markets fell further. Bonds were little changed domestically, while foreign markets saw mixed results. Commodities fell back across a variety of sectors.

Economic Notes

(-) The second release of the **U.S. GDP** report for Q1 was revised down by -0.3% to a new rate of 1.3%. Largely, this was due to personal consumption growth being edited down from 2.5% to 2.0%, along with a small downgrade to inventories, while upgrades were made to nonresidential fixed investment (by 0.7%), residential investment (by 1.5%), and government spending (by a tenth). PCE inflation indicators were revised down by about -0.1% at an annualized quarterly pace for both the headline and core side, to 3.3% and 3.7%, respectively, while the year-over-year rates saw minimal change.

The **Atlanta Fed GDPNow** measure is currently pointing to 2.7% growth for Q2, having been revised down from earlier estimates as high as 4% a few weeks ago. The Blue Chip consensus group estimate remains at just over 2%, although that's come up from around 1.5% earlier in the quarter. Expectations are that consumer spending will continue to dominate (at 1.8% of the 2.7%), along with strength in non-residential fixed investment, fueled by government stimulus, as well as a rebound in inventories from a drop in the prior quarter, offset by an expected drop in net exports.

(0) **Personal income** rose 0.3% in April, on par with expectations, led by higher gains in asset income and transfer receipts. **Personal spending** rose 0.2%, a tenth short of the median forecast. In terms of real spending, services rose by 0.1%, while that of goods fell by -0.4%. Both income and spending were sharply lower than the prior month's results, although the personal saving rate was unchanged at 3.6%. Over the past year, income has been up over 4%, while spending is up over 5%, both on a nominal pre-inflation basis.

The **PCE price index** rose around 0.25% on both a headline and core (ex-food and energy) measure, largely in line with expectations, but each about a tenth of a percent lower than the prior month. Year-over-year, headline PCE ticked down a few basis points to 2.65%, as did core PCE to 2.75%. These continue to improve but remain well above the Fed's preferred target. The 'supercore' inflation measure, which removes food, energy, housing, and goods, to leave only primary services, was up 3.4% over the past year, which shows the crux of the problem.

(0) The **S&P Case-Shiller 20-city home price index** rose 0.3% in March, on par with expectations but about half the pace of the prior month. Year-over-year, the non-seasonally-adjusted index rose 7.4% nationally, a tenth of a percent faster than the previous month, and the fastest pace in nearly two years. By city, San Diego led the way over the past year at 11%, followed by New York and Cleveland, while Denver lagged with only a 2% rise.

(0) The **FHFA house price index** for March showed a 0.1% increase, well below the 0.5% expected and the 1+% the prior month. Year-over-year, home prices rose 6.6% nationally, decelerating by about a half-percent from the prior month's pace. Over the last 12 months, the fastest pace of growth was in the Middle Atlantic region (NJ, PA, NY) up 10%, while the West South Central segment (OK, TX, AR, LA) lagged with gains just under 4%. By state, VT, NJ, NY, and DE were each up over 10%, while Washington, DC saw a drop of over -1% for the year. The national trailing 12-mo. growth rate is down from the Q1-2022 19% pace, and more in line with the 5-7% pace of the past ten years, with every quarter since 2012 having shown positive house price returns. Prices remain far stickier than many economists would have expected with mortgage rates more than

doubling from year-end 2021, from 3% to 7%, with low inventories remaining the overwhelming culprit—with no easy or quick fix other than more units.

(+) The Conference Board **index of consumer confidence** for May rose 4.5 points to 102.0, well above the expected decline to 96.0, and represented the first increase since early in the year. All key components increased, led by expectations for the future, which rose nearly 6 points. The labor differential, measuring the ease in finding employment, also improved but remains below the highs earlier in the year. However, consumer estimates of a recession over the next year rose to just under 70%, which is the highest rate in about 18 months, so plenty of pessimism abounds. Much of this is seemingly tied to political rhetoric.

(0) **Initial jobless claims** for the May 25 ending week rose by 3k to 219k, just above the 217k median forecast. Continuing claims for the May 18 week rose 4k to 1.791 mil., just under the 1.796 mil. expected. Claims were mixed amongst the states, with no substantial outliers, pointing to a balanced environment, with no signs of deterioration.

Question of the Week

What happened with the AAA-rated real estate office debt loss this month?

There has been a reaction in some corners of the real estate lending market to headline losses in the CMBS debt space. This was specifically related to a single $308 mil. note for an office property on Broadway in New York City (a location where property values tend to be higher-profile than other places), but the first time since 2008 that AAA-rated debt has been affected. It's important to note that the total non-agency CMBS market is valued at upwards of $700 bil., in addition to another $3 tril. of commercial mortgages on bank balance sheets, so this represents a tiny piece. But it's an unsurprising indicator that the office sector is experiencing stress. Another caveat is that office represents only 5% of the FTSE NAREIT Equity REIT Index, so it's been a small (and shrinking) piece of commercial REIT portfolios generally. This follows more traditional real estate assets like office being unseated due to strong growth in 'modern' sectors, including data centers, internet distribution hubs, cell towers, tech-related industrial, and health care, among others.

First, it's worth pointing out what can designate parts of a CMBS structure as 'AAA' quality. This is not an indication that the property itself would warrant a general AAA rating, based on loan-to-value, vacancy rate, demographics, etc. Rather, total debt is carved into 'tranches' (French for slices), which are turned into their own securities for sale to investors. The tranches are ranked by risk, with offered yields in line with risk being taken. An equity tranche at the bottom is the most speculative and subject to being forced to absorb any first losses caused by loan default, followed by successive tranches upward that absorb losses as necessary, if they're substantial enough to move up the stack. The tranche at the top earns the lowest yield (due to its higher safety) and is often assigned an AAA rating due to it being the last in line subject to losses. Of course, avoidance of losses isn't a given; it just has the largest buffer, at least relative to the riskier tranches. (If these sound like residential MBS securities, such as those assembled by Ginnie Mae, Fannie Mae or Freddie Mac, the construction is similar.)

However, there were some underlying differences between the Broadway structure and what's seen in a typical deal. For one, the bond was tied to a single office property, which is unusual, as securitized debt structures are often built with a mix of property loans. Naturally, this combination of loans underlying the securities some built-in diversification against bad outcomes in a single property, which is the point. As have many office buildings lately, that one saw a streak of bad luck—one of which was the departure of its core tenant (representing the majority of square footage). Such a concentrated tenant mix is also unique, and while it can offer income stability in some instances under a long-term lease, it can also be potentially problematic in the event of a major exit like this. This property experienced the worst possible outcome.

Interestingly enough, after it was reappraised at a far lower valuation, the building was able to be refinanced. This shows the resilience and underlying attractiveness of many office properties generally (they can't readily be torn down, or even converted to something else, at least quickly or cheaply). Everything has a floor valuation at the right discount rate. Who took the losses? It appeared that it was several foreign pension funds, who tend to be major participants in the global commercial real estate market. This is also a positive from a risk-sharing standpoint, with smaller losses diffused globally being a preferred outcome to larger and more concentrated losses (the kind that could bring down smaller regional U.S. banks, for example). This case was extreme but might be an instructive story for how some similar situations might be handled in years to come. Securities have more rigid structures, but for private and direct debt, terms can get more creative, such as lowering interest rates or extending out loan terms to provide some buffer against a default occurring.

Market Notes

Period ending 5/31/2024	**1 Week %**	**YTD %**
DJIA	-0.88	3.52
S&P 500	-0.49	11.30
NASDAQ	-1.09	11.82
Russell 2000	0.04	2.68
MSCI-EAFE	-0.05	7.07
MSCI-EM	-3.10	3.41
Bloomberg U.S. Aggregate	0.04	-1.64

U.S. Treasury Yields	**3 Mo.**	**2 Yr.**	**5 Yr.**	**10 Yr.**	**30 Yr.**
12/31/2023	5.40	4.23	3.84	3.88	4.03
5/24/2024	5.46	4.93	4.53	4.46	4.57
5/31/2024	5.46	4.89	4.52	4.51	4.65

U.S. stocks fell on the shortened week, but ended May with solid gains to offset weakness from the prior month. By sector, energy and utilities led the way with gains upward of 2%, while technology fell back by over -2% (as a positive week for some stocks was offset by weakness in Salesforce, Adobe, and Microsoft). Real estate also gained, with Friday's 'less bad' inflation news providing a boost.

Foreign stocks were mixed, with gains in Japan offsetting declines in Europe similar to those in the U.S., with inflation coming in stronger than expected, which threatened the consensus view that the ECB will cut rates by a quarter-percent next week. The base case is that a rate cut will still occur, but doubt remains about the path forward through the summer and fall, with this stickier inflation. In Japan, inflation ticked up but remained below the central bank target. Emerging markets declined to a further degree for the week. Chinese PMI manufacturing data fell back again below 50 into contraction, which raised some concerns (again) about the durability of the recovery.

Bonds were little changed on the investment-grade side, with yields ticking up slightly higher across the U.S. Treasury curve. Subdued demand for 5- and 7-year Treasury notes mid-week could have been hampered by recent further Fed comments that rate hikes aren't completely 'off the table,' although that was offset by better inflation readings later in the week. Foreign bonds were mixed, with little net change in the U.S. dollar index.

Commodities lost ground across the board last week, with agriculture and industrial metals down around -2%. Crude oil fell just under -1% on the week to $77/barrel, despite an expectation that OPEC+ members will choose to keep current production cuts in place. Natural gas also fell back -7%, with a lack of weather extremes to affect usage or shortages.

Have a good week.

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Sources: FocusPoint Solutions, American Association for Individual Investors (AAII), Associated Press, Barclays Capital, Bloomberg, Citigroup, Deutsche Bank, FactSet, Financial Times, First Trust, Goldman Sachs, Invesco, JPMorgan Asset Management, Marketfield Asset Management, Morgan Stanley, MSCI, Morningstar, Northern Trust, PIMCO, Seeking Alpha, Standard & Poor's, StockCharts.com, The Conference Board, Thomson Reuters, T. Rowe Price, Univ. of Michigan, U.S. Bureau of Economic Analysis, U.S. Federal Reserve, Wall Street Journal, The Washington Post, ZeroHedge. Index performance is shown as total return, which includes dividends. Performance for the MSCI-EAFE and MSCI-EM indexes is quoted in U.S. Dollar investor terms.

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Notes key: (+) positive/encouraging development, (0) neutral/inconclusive/no net effect, (-) negative/discouraging development.