04/30/21

Quarter in Review

The Markets

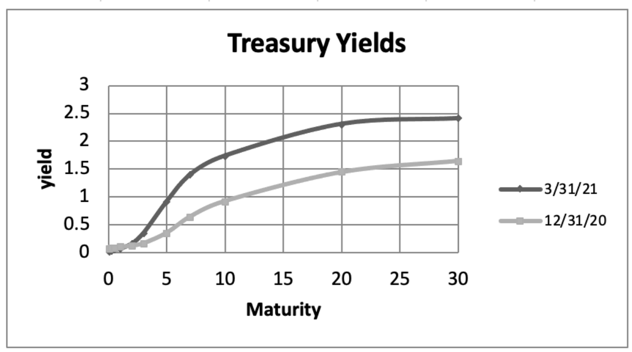
This quarter was not lacking in headlines, from the US Capital being stormed by protestors, to GameStop rallying north of $300, and new daily Covid cases falling from 200k to around 50k. Vaccinations in the US increased in earnest and at the time of this write up 27% of the country have received 2 doses. Vaccinations worldwide have not come without issues, from allergic reactions and blood clots causing death. Johnson and Johnson's vaccine was paused in the US while AstraZeneca has been paused in many European countries and the EU is looking into a lawsuit on top of class actions that have already been started from those families that lost people. Robinhood the online trading platform was pulled in front of congress for its role in the GameStop short squeeze and subsequent restriction of trading in the name and many others. Maybe commission trading wasn't a bad thing after all… Another $1.9 trillion in stimulus was passed by congress using the budget reconciliation processs. That is now a total of $5.1 trillion dollars in the past twelve months, and President Biden unveiled a $2 trillion infrastructure bill paid for partially by an increase the corporate tax rate to 28% and another $1.8 trillion family aid play was announced during this write up. Interest rates on US Treasury bonds increased relatively dramatically in the first quarter, with the ten-year bond increasing by over 80 bps to end March at 1.74%. Since then and at the time of this write up the ten-year has grinded back down to 1.63%. After a significant cold snap in February millions of Texans were in the dark and without heat for several weeks, with over 100 people dying, and several hundred million in estimated damage. Lastly a large cargo vessel blocked the Suez Canal for several days, halting over $9 Billion in daily traffic. As supply disruptions begin to be felt and agricultural products prices dramatically increasing, the Fed will have an interesting balancing act if there "transitory inflation" isn't so transitory.

The markets in the first quarter of 2021 saw value outperform growth for what seems like an eternity, as the "reflation trade" was in full effect for February and March. Small cap value was ranked #1 out of the 43 indexes I monitor, up over 21% for the quarter. Mid and Large cap value didn't perform poorly either up 13 and 11% respectively. Foreign developed market value was up around 7% with large cap emerging markets up just 2%. In dead last was long term taxable bonds (corps and treasuries), down over 10%. (I exited this position in early January after having lost faith in the Feds willingness to step into the back end.) The medium term and short-term fixed income indexes were down -3 and -.57% respectively, while TIPS were down around -1.5% despite increase inflation expectations. High Yield or Junk Bonds were up 0.57% for the quarter as CCC yields have come in close to 80 bps over the quarter, while BB and single B names have remained mostly flat. Global bonds lost over 5% while US T-bills returned a spectacular 2 bps. The two alternative classes I watch, REITs and a broad basket of Commodities returned over 8 and 13% respectively (both of which lost about 8% in 2020 after a strong Q4 recovery).

Interest Rates

The Federal Reserve's balance sheet expanded by $354 Billion to $7.7 trillion in the first quarter of 2020. There were no rate adjustments in the quarter. The yield curve steepened around 80 bps in the back end of the curve. Many members of the FOMC and the chair didn't express any concern in this rise, almost as if it was planned. My belief is that the Federal reserve thinks it can and will control the yield curve with continual buying of treasuries and mortgage back securities and will not flinch on inflation into the latter part of this year if and when "transitory inflation" becomes more permanent. By then it will have gotten away from them… again. Since the end of the quarter the ten-year has grinded back in fallen about 11 basis points on what looks like a manufactured or controlled burn, while the front end has almost not moved.

Years	3/31/21	12/31/20	Difference
0.08	0.01	0.08	-0.07
0.24	0.03	0.09	-0.06
0.5	0.05	0.09	-0.04
1	0.07	0.1	-0.03
2	0.16	0.13	0.03
3	0.35	0.17	0.18
5	0.92	0.36	0.56
7	1.4	0.65	0.75
10	1.74	0.93	0.81
20	2.31	1.45	0.86
30	2.41	1.65	0.76



The Primary Mortgage Market Survey from FHLMC showed the 30-year conforming balance fixed rate mortgage rose to 3.17% at the end of March from 2.67% at the end of December. 15-Conforming balance loans also rose from 2.17% in December to 2.45% in March. The increases were substantially less than the moves in treasury rates in the back end, but last year's ability to lock in low funding costs for lenders while still paying extremely low interest rates in the front end on their savings deposits, and profitable M&A and trading businesses, may have contributed to the ability to absorb the yield differential.

The Mortgage Bankers Association information as of 04/21/2021 showed 30-Year conforming balance FRM rose from 2.88% with .33 points in January to 3.24% with 0.31 points in April for conforming balance loans. 15-year conforming balance FRMs were up to 2.39% with 0.31 points in January to 2.65% with .41 points. The difference in delta between the two sets of data is caused by the different time periods of observation.

Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) stood at 111.6 in March (111.8 in Feb 2020), climbing from 109.7 in December. Taking into account the two statistical imputations (smarter people than me guessing) for new orders, *every* input contributed positively to the overall index. The main three contributors were the improvement in unemployment claims, the ISM new orders index, and the interest rate spread between 10 year and federal funds. The lowest contributors were new orders and stock prices. My thought last quarter that new orders would level off as a contributor to the LEI held, while average workweek production has turned out to be much more volatile than expected. With domestic growth set to peak in Q2 of 2021 and an estimate by GS of only 1.5% GDP growth in 2022(while consensus is 1.3%) the LEI should look much different a year from now.

Jobs

At the time of this write up, **nonfarm payrolls** posted an **increase of 916 thousand jobs for March.** Using the BLS numbers the US is still out almost **8.5 million** jobs from March of last year. The unemployment rate dropped from 6.7% in December to 6.0% in March 2021. But I simply think these number aren't accounting for the actual picture of unemployment as the total claims for unemployment across all programs is 16.6 million, and widely fluctuating from week to week. Now there are estimates that April employment gains are going to 1.5 million, based on the weekly reduction in claims. I am glad that the economy is doing better and that some people have gotten back to work. But I think the stock market has priced a perfect recovery in, and much, much more. The Dallas Fed's Mobility index (while extremely creepy in concept) shows a substantial increase from February in people's mobility. The Dallas Fed is using this as a better proxy for people going back to work vs the BLS data as most of the Fed believes the BLS numbers are very low.

Temporary services recovered much of the losses and are about 94% of pre-Covid numbers at 2.8mm. **Median duration of unemployment** has reversed its downward trend and is now back at 19.7 months in March, up from 15 months in January and 18 months in February. I hope that this is just bad data, and the April numbers show something better. If not, just like the great financial crisis of 2008-09, this means that a large portion of the labor pool have skills that are outdated and need to be retrained. The **civilian labor force participation rate** is still stuck at 61.5 since June 2020. This rate was near 67-66 since the late 1980s, and after the 2008-9 recession has been in decline. It started to increase in 2019 off 62, but Covid lockdowns reversed that trends and seem to be stuck below 62 now. **Manufactures lost a total of 557k jobs in 2020,** and year to date they have only added about 53k. This is even as new orders have increased substantially in the ISM survey.

Unemployment claims at the time of this write up are 553,000 for the week ending April 24th. This is substantially lower than the first quarter which saw average four week claims near 800k. However Pandemic Unemployment assistance and Pandemic Emergency UC both saw increases from the end of March until early April. Are people simply shifting from the state to the federal UC rolls? Anecdotal evidence is showing lower wage employers having issues hiring people when claims payments are more than what they would make working.

Industrial production

Q1 IP was down -0.30% for the quarter, down -3.43% since the beginning of the recession. At 14 months we are approaching the length of the last recession (18) if NBER doesn't call it sooner. For the past twelve months the **mining group has shown the biggest loss down -8.8** percent for the past twelve months. Utilities didn't have a stellar **Q1 2021 either down about -6.2%.** February's severe weather took its toll across almost every group (except for utilities which should have been able to capitalize on this). **Capacity Utilization fell to 74.39 from a January twelve month high of 75.35.** Capacity utilization started to decline from its post financial crisis high of 79.57 in November 2018 and hit bottom of 64.24 in April of last year. There are obvious supply constraints, from lack of semiconductors to dozens of container ships sitting off port, while container shortages are starting to appear in China ports, capacity looks like it is constricted by this and a skilled labor shortage.

Housing

New home sales for March were up to 1.021 million, a level not seen since October 2006. Existing home sales peaked in January at 6.66 million and slid back to 6.01 million in March. Although this was a 3.7% decline since February the annual median single family home price increase was 18.4%. (no inflation here though, so just exclude that from CPI and we are fine). Why on earth the NAR felt the need to say that half the US population now has received the COVID-19 vaccination is beyond me. Do they feel that vaccinated people buy more? Sell more? Bid up house prices, or do homebuilders make more now that they are vaccinated. Lumber prices are at levels never seen before, over 5x the amount just in 2019, as homebuilders are scrambling to take advantage of an urban exodus. We will probably build too much again. I wonder, will down payment percentages decline, loan requirements soften, all in order to take advantage of the increase in demand?

The Consumer

The Conference Board's consumer confidence index stood at 109, up from 87.1 in December. As of the time of this write up the index stands at 121.7. The Conference Board posited that this may be due to economic recovery, income and thus job prospects, as well as stimulus checks from the government. Vacation planning is increasing, and their assumption is vaccine increases and loosening restrictions are the cause. University of Michigan's index was at **84.9 for March up from 80.7 in December (**88.3 for April which isn't the same delta as the Conference boards.). Michigan attributed the gain to strong job gains and stimulus spending like the Conference board. They did add that other factors like persistent concerns with vaccine safety as well as a surge in inflation expectations suppressed their number. At 3.4% inflation expectation over the next year, this is **the highest level in nearly a decade.** The **savings rate** spiked in January to 19.8% in January and is now **27.6%** after the third round of stimulus checks. **Personal Income was up 29% year over year and 34% of all income is now received from the government of the United States.**

BUT… REAL PERSONAL INCOME LESS GOVERNMENT TRANSFERS WAS DOWN -18.64% OVER THE LAST TWELVE MONTHS!

The most recent consumer credit data is as of February this year. Revolving consumer credit was lower by 123 billion last year, and as of February is essentially flat. Nonrevolving was up 119 billion in 2020 and up 30 billion so far in 2021. Since December the number of mortgages in forbearance fell to 2.5 M as of the end of March. The trend is definitely smaller but the amount of principal and interest advances on those plans remained the same at $2.8 billion. The forbearance enrollment window was extended to the June of this year providing six more months for those who entered before June 2020. So, if the economy is back on track, jobs are printing high six figures a month, and savings are at all-time highs, I am interested to see what happens in June and where the money flows.

The consumer has been able to save trillions of dollars over the past year, pay down credit cards, not have to pay rent or mortgages and is in a good, maybe great position, unless inflation takes hold, and all those savings start having to pay for goods and services that cost a lot more, and the rest of the 16 million people collecting unemployment can't find work. Once the stimulus checks have stopped, and people have to go back to their old jobs earning less, will their consumption drop too?

Inflation

As of March, **CPI was 2.00%, PCE was 2.32% and the GDP deflator was 1.85%.** The Federal reserve has stated that inflation numbers will increase substantially as base effects kick in. (Last year's dramatic price declines will make annualized numbers much higher.) And there is absolute validity to that argument. But there is also substantial evidence that their easy money policies (just like Greenspan, Bernanke, and Yellen prior) have led to several areas of gross price inflation. Lumber, used cars, agriculture products, house prices and above all else the stock market. The Feds actions effect the economy on a lag, they always have, and they always will. The time to turn the spigot off was years ago, and Bernanke and now Powel flinched when the markets reacted to any contraction of the balance sheet. As it very well should have. Prices of debt vs their real credit risk should be substantially higher. The risk the Fed faces is if energy and food price increases are NOT transitory. The Fed is caught with substantial pressure from Yellen and the treasury to fund, yes I said that correctly, fund the many stimulation bills passed over the past year, and the new bills proposed. Maybe BOJ can show Powell how to buy equity too.

In Closing

Last quarter I said I was disenfranchised with what our economy has become, and I am now more so as the federal government continues to hand out stimulus after stimulus and bailout out after bailout for states, some of which (UTAH) that didn't even need it. The Federal reserve then turns around and monetizes this debt created by the government and new mortgages, which continue to drive house prices up, and affordability down. People all over the internet continue to virtue signal, saying that the Fed has been largely to blame for chasm between the top 2%'s net worth and the rest of America… these commentators don't give a rat's ass about the middle class, because it is easy to blame someone else while your own 401-ks are bigger and personal brokerage accounts are bigger, they just don't want to get called out as being part of the 2%.

Jobs have rebounded somewhat, but definitely not because the BLS is showing a million jobs a month now. Mobility is up, people are going places, back to work and on vacations. My wife and I took our first vacation in three years with the kids in April. A road trip. I-95 was busy, beltways too, amusement parks were 80% full, restaurant reservations booked, hotels, booked solid, park tickets sold out. My guess is that we are open for business again, but there are definitely some areas of the economy which have shifted, certain skills sets not as valuable any more, countless small businesses are closed, and there are lots of new Amazon drivers.

I have heard an almost equal amount of people ready to get back into the office as well as those that would be fine never seeing those four walls again. How will big cities, their tourism industries, and commercial real estate be able to recover if a large portion of commuters… don't commute? Or if they do, it is only once or twice a month in a car instead of mass transit. SoHo has 1 in 3 retail spaces dormant and available for rent. Would you plan a vacation or a trip to major metropolitan area right now?

This past year has left a mark, maybe even a scar, that won't be too quick to heal or forget. We value different things now, and I am not sure just how many, although some are willing to do just about anything to "get back to normal," will truly ever feel like we are really back to normal. We trust less; journalists, governments, doctors, even our schools (for those of us that have now homeschooled). The veils are completely off now, if we were once gullible enough to believe people/corporations were or could be neutral in thought and action, we don't now. Those of us with long enough memories in finance are floored in disbelief that everything we were taught and trained for, has been tossed aside by a very small group of people, with almost no recourse for their actions, and very little in the form of results to show for it for the past 20 years.

I am still faced with the same impossible decision today as I was three months ago. I am mostly in short term bonds and stable value funds, earning negative real yields but keeping duration low if the ten year is *allowed* to start rising again, or if inflation, come summer, hasn't start to cool off. Stocks seem ridiculous to me as they are still 2x GDP while the Shiller PE Ratio is north of 37. Even the value funds I often invest in have PEs of 22 and higher. Gamestop is even the third highest holding in Vanguards small cap value fund. I get it is an index replication fund but…

So, I hold, reading Jeremy Grantham's January 5th piece weekly to remind myself of the fact that markets become irrational and exuberance and euphoria, like fear and panic, are to be taking advantage of. "Perhaps a lunatic was simply a minority of one." – George Orwell.