04/26/22

Quarter in Review

The three main topics of this quarter were the end to Covid restrictions, the beginning of the war in Ukraine, and the continuing problem with inflation in the US and the world. Each of these topics had separate effects on the securities markets and two of them continue to persist into Q2.

In the beginning of the year over ten million people tested positive for Covid, in the US alone there was one million. However, the hospitalization rate correlation was declining, or said another way the most recent strain wasn't causing people to get as sick. This didn't persuade China to change its Zero Covid policy and they locked down millions of their own citizens, some of which are still locked down or are just being able to leave their houses. This will stress the world's supply chains again as can be seen by looking at port backlogs from some of China's busiest ports. This doesn't bode well from a supply side inflation standpoint, with producer and consumer prices continuing to rise throughout the quarter.

Before we get to inflation though, I should address the 400 lb. Gorilla (maybe Bear) in the room. Russia built up well over a hundred thousand troops on the boarder of Ukraine over January and the beginning of February. They officially invaded Ukraine on the twenty second of February and oil surged into the high 90s. The West reacted with economic sanctions the next day, while Germany halted the certification of Nord Stream 2 gas pipeline. NS2 was half paid for by Gazprom (Russia) with the other half by Shell (UK), OMV (Austria), Engie (France) and Uniper (Germany). The entity has since filed for bankruptcy. It cost 11 billion dollars to build. Major fighting started on the twenty fourth and shortly after that the ruble cratered going from 83 to north of 109 (with certain banks quoting a 119). By the twenty fifth of the month Russia had closed its stock market and was close to defaulting on several bonds as they were removed from the SWIFT messaging system of payments. On the twenty eighth of the month the economic sanctions began taking a toll on the corporate world as BP Plc. took as much as a $25 billion loss exiting its 20% stake in a Rosneft joint venture. This was followed in the beginning of March with Honda and BMW stopping exports to Russia, while Exxon Mobil said it would also exit joint ventures in Russia. This was then followed by the credit agencies cutting Russian debt to junk rating, while the House of Representatives passed legislation banning the imports of Russian oil. At the end of the month the Russian stock Market reopened after a month, gaining almost 10% in the first day and 30% by the beginning of April but February 16th it is still down 35% as of the time of this write up.

Inflation was the second most discussed topic of the quarter and obviously influence by the above. January CPI came in at 7.48% year over year, February at 7.87% and March at 8.54% (more importantly beating consensus estimates each time!). The language from the Fed has grown increasingly hawkish, with now a 50-bps rise expected

in May coupled with the starting of a balance sheet write sell down of almost 100 billion a month. In December the expectation across Wall Street was for three rate hikes, by the end of January it was five, and by early February it was seven. Now the expectation will be a hike in every remaining meeting for the year, and some of them will be 50 bps hikes. In Europe, although not as bad as in the US, their current inflation rate is around 7.5%, with Germany at 7.3% and France at 4.5%. France's energy independence is showing in these numbers. Oil started around $74 a barrel and finished at $100 in the quarter while the treasury market sold off dramatically in the face of inflation. The Ten-year bond started the year at 1.61% and ending the quarter at 2.34% (at the time of this report it has climbed to 2.75%). Crypto is a not correlating well with inflation and proving to be more like a risk asset as it traded between 47k at the beginning of the year, down to a low of 33k in late January, only to finish the quarter back to 45k. In the beginning of February, the bank of England raised interest rates with their upper bound 0.75% (a 25bps increase), however showed a more hawkish tilt with more than half of the policymakers voting for larger than a 25-bp increase.

There has been a lot of discussion of the demise of the US dollar from the beginning of the year. Between crypto currency alternatives to talk of oil contracts getting done in currencies other than the dollar, one would believe that the US dollar was sinking fast. However, since January the dollar has been climbing against other currencies. In fact, the dollar has been trading in a range from 90-100 since the beginning of 2015. (100 being the start of the dollar index back in 1973 by the Federal reserve after the dissolution of the Bretton Woods agreement). The low of the index was near 70 (dollar cheap to other currencies) in 2007 while the high was at 165 in 1984 (think large inflation and Volcker trying to crush it with high interest rates). If anything, the dollar has been strengthening since midway through 2021. And with the Fed increasing interest rates, compared to the ECB and BOE, the dollar should be stronger. It doesn't look like the Yuan is displacing the greenback just yet, especially since China is engaged in quantitative easing to help its struggling real estate giants and slowing economy due to lockdowns (17.5 million residents in Shenzhen in mid-March).

On the eighth of March Nickel more than doubled to $100,000 a ton before paring gains and eventually seeing trading suspended on the LME. The LME calculated margin calls on the previous day's closing price and considered canceling trades made during the previous close and suspension. Some animals are just more equal than others. Eight days later the LME resumed trading Nickel contracts only to shut down immediately after a limit down threshold was hit and then hit down limits over the next five days.

As expected on March sixteenth the Fed raised rates by 25-bp and planned 6 more for the year as per their dot plot. Not expected was that five days later Chairman Powel would say that the Fed was prepared to raise rates by 50-bp in the next meeting, and over the remainder of the month a chorus of Fed Governors to include the new vice chair Lael Brainard, a strong dove until now, issued statements reiterating a 50-bp hike, and the beginning of the balance

sheet run off. By the end of month, the treasury curve inverts between the 2- and 10-year notes, marking a countdown of anywhere from 6 to 18 months until the next recession.

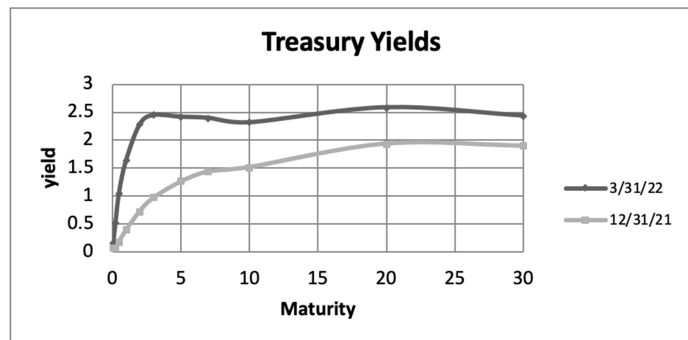
Markets

Well, the “wild rumpus,” may not have begun in earnest Mr. Grantham, but I think you are on to something. The first quarter saw a selloff across equity markets, more so in growth than value, but the Russell 3000 was down close to 5.3%, with growth stocks down close to 9.3% and large cap value down only 0.74%. Mid and small cap value performed worse (-1.82% and -2.40%) but not as bad as diversified emerging markets down over 7%. The big losers this quarter were long duration assets, with US long bonds down close to 11% and the Aggregate Bond Index down around 6%. Real estate rebounded somewhat in March, but still down close to 4% for the quarter. The big winners for the quarter were volatility up around 20% and commodities up 26% on the quarter.

Interest Rates

Wasn’t the Federal Reserve supposed to stop by assets at the beginning of March?!? Their balance sheet **expanded by $171 Billion to 8.9 trillion** in the first quarter of 2022. And their last purchase was supposed to be on 03/09/2022. Funny how **$26 more Billion was added to it after that in March**. And even funnier that since 03/31/2022 until the time of this write up it has **expanded AGAIN by another $28 Billion.** So, I guess QE hasn’t stopped after all. But don’t tell the markets that because belly of the curve blew out on average of 135 bps, while the back end was up about 73 bps from the 7- to 30-year. (At the time of the write up the curve has steepened, up 30bps in the belly and around 60 bps in the back end). As stated in the intro the Fed has become increasingly bearish in their message and stance on quantitative tightening.

Years	3/31/22	12/31/21	Difference
0.08	0.17	0.06	0.11
0.24	0.52	0.06	0.46
0.5	1.06	0.19	0.87
1	1.63	0.39	1.24
2	2.28	0.73	1.55
3	2.45	0.97	1.48
5	2.42	1.26	1.16
7	2.4	1.44	0.96
10	2.32	1.52	0.8
20	2.59	1.94	0.65
30	2.44	1.9	0.54



The Primary Mortgage Market Survey from Freddie Mac showed the 30-year conforming balance fixed rate mortgage at 4.67%, up 156 bps, with 0.8% in fees and points up 10bps from December. The 15-year conforming balance rate was 3.83% up 150 bps with 0.8% in fees. The 5/1 ARM rates also increased to 3.5% up 109 bps but the fees and points dropped from 0.5 to 0.3%. The spread between the 30-year FRM and the 5/1 moved out 47 bps to 117 bps. **At the time of this write up though 30-year FRM now stands at 5.00% the highest since 2010.**

Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) stood at 119.8 in March down from 120.8 in December and essentially flat for the entire quarter, despite the Conference Board's revisions to prior month data. The Coincident indicator was at 108.7, up 107.4 in December and up throughout the quarter, while the Lagging Economic Index stood at 110.9 up from 109.4 in December. Each index was up only two percent over the past 6 months. The three indexes are much more volatile than GDP but have correlated with increases and declines pretty well. As GDP slows down, Wall Street expectations are anywhere from 0 to 2% for Q1 2022, the LEI should decline much faster over the next several months.

Jobs

Nonfarm payrolls for Q1 were up 1.685mm with an average of 561k per month. Shockingly this was exactly the same average as all of 2021. Looks like the DOLs excel solver functions are working perfectly. The main growth came in February with an addition of 750k jobs. The non-seasonally adjusted amount of nonfarm payroll jobs for the quarter was -414k, with the bulk of the loss coming January after the holiday season. The April expectation for Jobs is sub 400k, and as the economy cools, look for this number to continue to drop over Q2 and possibly start to turn negative in Q3 or Q4 as the quantitative tightening really kicks in and losses in financial assets and housing start to happen.

The JOLTS report for February showed 11.266mm jobs available, and decline from December's 11.448mm, and January's 11.283mm. The February report short showed a decline in Finance and insurance openings of 63k and declines in nondurable goods manufacturing of 39k. Whereas arts, entertainment, and recreation increased 32k, educational services up 26k, and the federal government was looking to hire 23k. Job openings have steadily increased since 2012, then started to fall in 2019. When the pandemic restrictions hit, they plummeted to 2014 levels of 4.7mm, but since then have skyrocketed to north of 10mm and have stayed there since mid 2021. We can see this pressure come through in wage increases, but it is still not keeping up with inflation, as real wages have declined now for 6 months in a row and have remained less than zero for the ten of the past twelve months. (https://www.bls.gov/news.release/pdf/realer.pdf)

Temporary services gained 75k jobs over the quarter, less than 2021's 118k, but still the highest level since the statistic started in 1990. The labor participation rate moved from 61.9 to 62.4, slowly creeping back up. **For some perspective, prior to pandemic, 62.4 in 2015, was the lowest level since the mid 1970s.** Still think the labor market is healthy? **Manufactures gained 102k jobs** in the first quarter of 2022. Total manufacturing employment is only 127k less than where we were in January 2020 prior to the latest recession. The view in the ISM survey though has shifted from hiring qualified people to supply chain issues and costs. This was apparent in the Producer Price index where prices increased 1.4% in March and 11.2% year over year. This will flow though to CPI regardless of base effects.

Continued job increases and lower unemployment are a sign the economy is still relatively strong, but the Fed is going to be willing to see that fall as it attempts to crush inflation. They know they are late to the show, again, and are going to have to overcompensate for this. New orders for manufactured goods slowed again in March, along with production, and supply deliveries, all while prices are skyrocketing across the industries.

Industrial production

Q1 IP was up 2.9% compared to Q4, 1.78%. This was the largest quarterly increase since Q3 2020's rebound. This was surprising to me as I thought the demand for products would wane after all the stimulus checks ended. But the opposite has happened, and backlogs are growing, albeit slower, and lead times are extending, sometimes over 12 months. Total vehicles sales rebounded in January back up to 15mm year over year, but then slipped back down to 13mm in March. My belief is that this downward trend will continue into the next recession, and we could see sub 10mm numbers like 2009. **Capacity Utilization was at 78.3 ending Mach**, the highest level since January 2019. These are great numbers for the economy as IP is a real not nominal number. I truly hope we can sustain that, and we begin to onshore much more of items deemed essential to the economy. The invasion of Ukraine and the supply chain issues may force the hand of companies to think about multiple supply chains going forward that are closer to their facilities. I am worried about, as GDP is slowing substantially and the monetary accommodation for over the past decade is now being taken away, the effect this has on production. Will new factories and jobs be created again in the US to replace those imports from countries hostile to us? Or will demand destruction caused by rising inflation and the Fed's response, shutter more or our production facilities?

Housing

New home sales were down to 763k annually in March, off from the 873k in December, 845k in January, and 835k in February. Existing home sales were also down to 5.770mm per annum, with the national association of realtors blaming the increase in mortgage rates, predicting transactions will contract 10% this year. The Case-Shiller home price index was up 20.20% ending February 2022, but I don't think it holds there as transactions start to wane. The National Association of Home Builders index peaked in December of last year at 84 and now stands at

77, still higher before than before the Great Financial Crisis of 2008, but with the economy starting to slow, commodities through the roof, and financing start to get costlier, I don't know how many spec houses builders are willing to make this year.

The interesting part though is even though the NAHB index is falling, building permits are up in the 1800 range and have been for the past four months. Some perspective here is needed, we haven't seen permits up in the 1800 range or higher since 2006, pre housing crisis. And there is follow through as well, as housing starts along with single family starts are both at pre GFC levels! Therefore, we have rising interest rates, rising house prices, lower builder, and consumer house purchase sentiment, a slowing economy, but we are still building houses. I don't know where, but I think I have seen this movie before.

The Consumer

The conference Board's consumer confidence index stood at 107.2 in March, down from a revised December level of 115.2, but up from February's 105.7. The rising prices and war in the Ukraine were cited as the main cause the indexes are not increasing. Also, they cited that the demand for more expensive items have declined as interest rates are rising. For April however, the Michigan Consumer sentiment rebounded from 59.4 in March to 65.7. The summary on their website was not only short, but pessimistic, as they believe this could be a short-lived blip in the data, and future months will revert southwards. **Retail Sales in March was only up 0.50%, and as the base effects kick in, only up 6.88% for the year.** This in comparison to February up 0.79% and 18.18% year over year. In comparison February was very flat with autos up and general merchandise down, while March flipped and saw **autos down close to 2%** while general merchandise was up near 5% with **gasoline stations up 37%** and restaurants and bars were up 19.4% contributing the most. This aligns with the Conference Board's statement of people shying away from large purchases. With stimulus checks gone people are loading up their credit cards again. **Through January and February consumers have increased their debt by 50 trillion**, 21 in revolving debt and 29 in nonrevolving. This is more than double the start of 2021.

Personal Income grew by 6% over the past twelve months ending February 2022. With February looking like the last month before the basis effects kick in March which should show more real numbers. Personal consumption expenditures grew by 13.70% for the past twelve months. We are now close to 2 trillion more in expenditures than before the pandemic, and at growth rates north of ten not seen since… wait for it… the early and mid 1980s when inflation was as high or higher than now. Real Personal Income Less Transfers was up over 2% in both January and February, a bounce back from December. My guess is this will decline along with GDP sub 2% for Q1 2022 and so will Personal income less Transfers.

If the Fed is trying to crush the consumer with higher mortgage and credit cards rates and less available credit in a vain attempt to slow the demand side, they have a new problem with the lockdowns in China. Meaning if both demand and supply are restricted it will do nothing to decrease prices.

Inflation

January 7.48%, February 7.87%, March 8.54% on an annualized basis.

The word “transitory” has now been replaced with the phrase “peak inflation”, just in time for basis affects to allow Fed bankers and politicians to say their policies are working. **Food was up 8.8% and energy was up 32% year over year ending march.** All items less food and energy (for those of us who don’t eat or drive) were up 6.5% for the twelve months ending March. The only bright side in the whole report was that used cars and trucks were down -3.8% in March… but still up over 35% for the last twelve months. Looks like my guess last quarter on when the CPI would catch up with Manheim was pretty close.

But in all honesty every person that reads this should be furious with the financial leadership in this country. We have destroyed our supply chains and injected more money than God into the system while letting inflation rip. These people thought that the last time they blew this bubble, and it didn’t have an inflationary effect, was a precedent for the current situation the pandemic response caused our economy. Wrong! Last time the injection only made its way into the housing and stock/bond markets. This time around congress cut checks, paid for by the Fed, to the consumer. And now everyone is going to pay for it. Whether it is at the gas pump, the grocery line, or eventually the stock and bond markets. And for what, a GDP that was up 1.56% annualized over two years. All the time Wall Street sits back and tries to force feed the climate crazies ESG funds. We never learn, over hundreds of years we never learn. We make the same mistakes, we sell the public the same snake oil, we just slap a new label on it with a shinier bottle.

In Closing

Stocks had a bad first quarter of 2022, down about 5% for blended indexes, with Value well outperforming Growth (also known as long duration equity). Bonds too had a tough start to the year with long bonds down close to 11% and the Agg down almost 6%. Commodities and Volatility did the best this quarter up 26% and 19% respectively.

The Fed is now in full panic mode, with plans to raise interest rates in every meeting for the rest of the year, and now 50 bps and even 75bps per meeting is being considered to fight inflation. The balance sheet as well, which continues to expand, is looking to be reduced by almost 100 billion per month starting May of this year. Interest

rates in the belly of the curve were up close to 135 bps this quarter. The 10-year finished March at 2.32% and currently stands at 2.76% at the time of this right up. People running from stocks and thinking treasuries are a safe place to hide will understand duration by the end of this year.

The job market continues to remain relatively strong as an unprecedented level of job openings exist in the US and our unemployment rate stands at 3.6%. I would like to see the participation rate closer to 63 or 64 (currently at 62.4 just slightly lower than the long-term average), but manufacturing jobs are close to pre-pandemic levels. Industrial production was up 2.9% for the quarter, the highest level since the end of the recession and prior to that the highest level since Q3 2009. But inflation pressures have started to dampen the demand for durables and higher priced purchases. I don't see Q2 IP continuing to hold in manufacturing, possible in Utilities and Mining, but that may not be enough.

Housing was strong for the first quarter of the year, but with rising interest rates and prices at elevated levels, I don't know how this can be sustained for much longer. We seem to be building more again in a downturn, hopefully low inventories will justify this, but the costs to build are much more than they were in 2005/06.

Lastly the consumer is not necessarily in a good place. Although personal income is growing, inflation is eating away at it faster and faster. With a war in Europe and threats to fuel and food sustainability, the consumer may be watching their retirement funds take a large hit over the next six months. Housing is less affordable; car prices are up and even the upper middle class is starting to talk about grocery bills. With consumer credit rising at a fast pace, the consumer seems to be replacing their stimulus checks with credit card debt.

In about a week the Fed will sit down again and decide how much they will raise rates by and how much they need to bleed off the balance sheet. Liquidity is being withdrawn from the marketplace, from taxes to the treasury, to the Fed's balance sheet run off. The stock and bond markets have not started off the year well, but by no means is this the crash yet. I am hoping this continues, with one, two or at most three-percentage point down days. The Fed put may be a lot lower this time, but they will not sit idly by after a couple limit down days. They have telegraphed their intentions well, which the meme-stock buyers, and NFT consumers still don't believe. And why should they, the Fed hasn't successfully raised rates in over a decade and a half, and look what that caused.

For now, I am staying in floating rate bonds and little volatility to hedge any sudden drops or liquidity problems in the front end or commercial paper issues. The end is nigh.