07/26/22

Quarter in Review

The three main topics shifted a bit this quarter, dropping covid and adding recession. Covid has literally disappeared from the headlines, as if we aren't reporting over a 125k cases a day (and taking far less tests), and hospitalization for people over 70 aren't climbing again. But nothing to see over here. Inflation and Russia remain the two other top focus points. The likelihood of either being in a technical recession now or in the near future, are both either highly likely or assured.

The most important topic to discuss is inflation, which although CPI declined from March to April, it has risen again in both May and June, and thus ending at over 9% annualized. A bigger issue is the fact that the Fed continues to be reactionary and desperately trying to avoid a hard economic landing. Their attempt, by slowly increasing the Fed Funds rate and reducing the balance sheet by negligible amounts, while continuingly propping up the mortgage market, may once again be ill timed. The balance sheet started to be reduced in May but since April's high of $8.965 trillion it currently stands at $8.948… $17 billion less, a paltry amount if anything. I remind the reader that the Fed was adding $120 billion to the balance sheet on a monthly basis since July of 2020, and that was after a **$3 trillion** increase in 2020 to cover the cost of congress' covid emergency policies, without effecting interest rates. Meaning they have yet to really, in earnest, reduce the balance sheet or take away liquidity. All while global food prices climbed 13%. Over the quarter WTI went from $95 a barrel to $120 at the peak in early April and back to $95 as of the time of this write up. Even though OPEC agreed to increase production in early June, it only accounted for 0.4% of total global demand. The reason oil prices have fallen, is our third topic and that is the current/impending recession depending on how you look at it.

To combat inflation in Europe, which hasn't been seen this high in 40 years (UK inflation went from 7% in March to 9.4% in June), traders believed the ECB would raise rates by 75 bps by year end. (They just raised by 50 this past week so we are already two thirds the way there, phew.) Japan is simply ignoring inflation, which, at 2.4%, is also the highest in 40 years. But with their national debt being 266% of their GDP they can ill afford to raise rates. They are already bankrupt. But the issue with holding their interest rates at zero is that the Yen has cratered to 136 to the dollar. This is a level not seen since the late 1980s, during their stock market crash. Back here in the States the Federal Reserve raised interest rates by 50 bps in early May, an amount not used since 2000. Less than two weeks later Chairman Powell said he wouldn't raise rates by more than 50 bps at the next meetings. Well, that was until CPI and PCE turned the other direction and the fear they are losing control (spoiler alert, they already have) forced them to leak to the WSJ two days prior to the June FOMC meeting that they were going to raise 75bps at the next meeting. Markets don't like surprises. In the beginning of June, Treasury secretary and prior Chairman of the printing machine, sorry the Fed, said that she was wrong about inflation… it only took a year for her mea culpa. By mid-June the European bond market started to fragment, Greek and Italian bond spreads blew out and the ECB had to have an emergency meeting on the same day the Fed was coming out with its rate increase. The Fed increased by 75 bps, an amount not used since 1994, and the Swiss National bank also “surprised” with a 50 bps increase in rates. These rate increases, which is the only tool the reserve banks feel they have to reduce inflation, will do little to destroy demand (it will do it itself). Supply chains have been permanently disrupted with reduction in both truck and train crews domestically close to 25%. The Fed hopes that consumers slow down their purchasing, which as credit cards become maxed out, this will happen without the Fed’s help. Couple that with expected increased unemployment and defaults, both commercially and in retail, will increase by year end.

Russia also remained in the news feeds constantly, with sanctions coming from the EU and the US for their invasion and continual bombardment of Ukraine. The US continued to fight a proxy war with Russia, sending billions in weapons aid to include switchblade drones, while halting any payments in dollars from Russian accounts on their debt, forcing Russia into technical default. In a knee jerk reaction, Russia showed partially its hand by insisting payment for Russian oil be made in Rubles, despite the Ruble already rebounding to pre-war levels of 75 to the dollar as of the end of March. More interestingly, the Ruble continued to rally all the way to 51 as of the end of June, while Putin was making Russian companies delist from foreign stock exchanges. In an effort to ban Russian oil from EU countries by year end, Hungary and Slovakia were given an exclusion until December 2024. Meanwhile, record amounts of Russian oil have been flowing to China and India at a discount to Brent market prices. **Russia’s current account surplus stood at $70.1 billion for Q2 of 2022, the highest level EVER recorded since the records began in 1994.** In July, Russia shut down Nord Stream 1 for 10 days for maintenance. Prior to the maintenance period, Russia was providing only 40% of the capacity in the pipeline, and fear was that they would simply not turn it back on. Then on July 14 Gazprom sent letters to customers claiming a Force Majeure and because it could not fulfill its contractual obligations, spooked the markets even more. But on Thursday July 21st Russia resumed supply gas at the previous 40% capacity level, but laid bare Europe’s dependency on Russian gas, as wells as Putin’s ability to freeze a continent at will. But by the next week they reduced supply further, now at 20% capacity while prices surge across Europe.

Recession is now either current or inevitable. As of the time of this write up preliminary Q2 GDP will be reported in less than week, just following the Fed’s next FOMC meeting of which another increase of 75 bps to the funds rate is likely. Employment has leveled off to around 375k jobs a month, but firms are starting to lay off more, with the Challenger index rising to 70k a quarter, up from 50k for the past three. The struggle to find labor has been prevalent in every ISM report for the past 12 months. In the beginning of April, Walmart lifted pay for all new truckers to 110k a year. As Elon Musk launched a $34 billion bid for Twitter, Netflix lost close to 36% in its stock market value, stating it lost 200k customers for the first time in a decade and estimated another 2 million subscriber losses in Q2 of 2022. China’s Zero covid policy and lockdowns resulted in a negative 2.6% quarterly annualized GDP in Q2. In Europe Fabio Panetta, and ECB board member said the EU's economy is stagnating, or better stated, getting back to the sub 2% level it has been growing at for the past 25 years.

As inflation has forced the Fed to start increasing interest rates, many crypto currencies and their highly levered investment funds have faltered this quarter. Bitcoin lost 60% of its value from 46k to under 19k a coin, and as it broke below 20k, other coins using it as loan collateral started to come unhinged. TerraUSD in early May, the algorithmic stable coin, lost its dollar peg and dropped 99.95% in value. Followed by 3AC, the crypto hedge fund, going under and affecting 12 different crypto currencies. Defi (decentralized finance) market cap in general looks like it has lost close to 75% of its market value largely due to TerrasUSD, but other investors have pulled large amounts of money out of the space overall.

Other growth-related companies weren't spared during the quarter with Snap losing 64% for the quarter, while names like Meta, Google, Apple were done over 20%. Twitter was the only firm down in the single digits thanks to Musk's bid for the company which has now almost come unglued due to the fact of the amount of unrecognized bot accounts. In the beginning of June, Tesla announced a cut of 10% of its workforce or close to 10k people. Other companies and their earnings are all under pressure, and the World Bank cuts its growth forecast for the world from 4.1% in January, to 3.2% in April to now a 2.9% in June. Citigroup is following suit saying a global recession now has a likelihood of 50% as supply shocks and inflation continue to drive slower growth. Finally, the Atlanta's Fed GDP Now indicator is calling for Q2 GDP of negative 1.6%, far below the main US bank consensus of positive 2%.

Therefore, we probably started the third quarter already in a technical recession, and the second half of the year will see unemployment start to pick up. Unemployment claims have already turned around and are heading up again. The Fed is caught, since it has to fight inflation that is more than 4x their target and can't change its focus, even if unemployment would increase beyond 3.6%. Their resolve will be tested. They have managed for stock markets returns for the past decade, but can they shift their focus in the face of rising unemployment, crashing stock and housing markets, and actually try and combat inflation they are almost solely responsible for. I am not holding my breath.

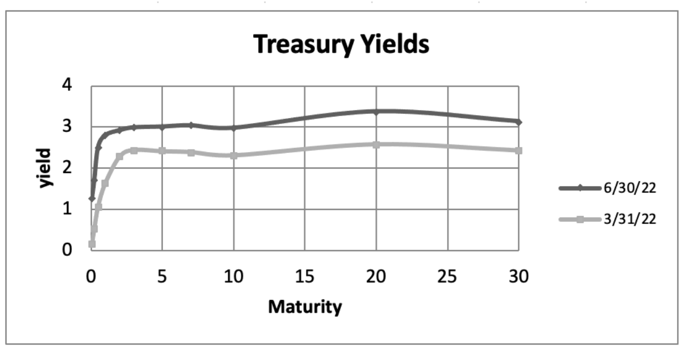
Markets

"Wild rumpus" started? The second quarter saw large losses across the equity space with the Russell 3000 down over 16%. Value did better than growth with large cap down over 12% vs. growth down over 20%. Developed markets abroad fared about the same with the EAFE down about 14%, but emerging markets down only about 11%. As interest rates climbed, fixed income didn't do much better, down over 12% in long bonds, about 5% in mid-term, while high yield followed equity down over 10%, and global bonds down about 11%. REITs are not off to a good start this year, down close to 17% for quarter and over 20% ytd. Commodities started their downward trend in the June, down 7% but held up ok in Q2 up 2%. With recession either here or on the horizon, the will of the Fed will be tested and that of the markets as well. If the Fed doesn't take its foot off of inflation's neck, don't look for an equity rebound in the second half of 2022.

Interest Rates

The **Fed's balance sheet fell a monstrous $23 Billion during Q2 2022 (enter sarcasm here)**. Doing almost nothing to tighten monetary policy. However, they did **increase the Fed's fund rate by 125 basis points**. If the Fed goes through with another 75 bps this Wednesday, they will match the high point of December 2018. This rate only lasted for 6 months prior to them loosening again. Not because of an emergency pandemic, not due to a recession, but because the stock market started to fall. The entire curve widened this quarter, but an inversion started in the belly and has continued spreading to the 2s-10s. The spread currently stands at -21 bps. An inverted yield curve has often preceded recession from 6 to 18 months.

Years	6/30/22	3/31/22	Difference
0.08	1.28	0.17	1.11
0.24	1.72	0.52	1.2
0.5	2.51	1.06	1.45
1	2.8	1.63	1.17
2	2.92	2.28	0.64
3	2.99	2.45	0.54
5	3.01	2.42	0.59
7	3.04	2.4	0.64
10	2.98	2.32	0.66
20	3.38	2.59	0.79
30	3.14	2.44	0.7



The Primary Mortgage Market Survey from Freddie Mac showed the 30-year conforming balance fixed rate mortgage at 5.70%, up 103bps, with 0.8% in fees and points from March. The 15-year conforming balance rate was 4.83% up 100 bps with 0.8% in fees. The 5/1 ARM rates also increased to 4.5% up 100 bps and the fees and points remained at 0.3%. The spread between the 30-year FRM and the 5/1 moved out only 3 bps to 120 bps. **At the time of this write up though, 30-year FRM now stands at 5.54% as housing has come off the boil.**

Leading Economic Indicators

The Conference Board's leading economic indicator (LEI) stood at 117.1 in June, down for the past four months and highlighting the slowing in the economy. The Conference board expects the US economy to continue to slow and enter a recession by the end of the year. The Coincident indicator continues to increase, and stands at 108.6. The lagging index stands at 113.9 and has increased 4% over the past six months. With preliminary GDP coming out on 07/29/22, two days after the Fed should increase interest rates further, a technical recession will probably be confirmed. I expect the LEI to continue to deteriorate in Q3 of 2022.

Jobs

Nonfarm payrolls for Q2 were up 1.124mm with an average of 374k per month. The average has dropped by close to 200k jobs per month as the economy has started to cool. As a reminder we still haven't reached the level of nonfarm employment since January 2020. Looking at the household survey, which is more volatile, it has lost 347k over Q2, with two of the three months negative for the quarter. Median duration of unemployment continued to fall to 8.5 months, not counting the two anomaly months during the most recent recession. This is lowest level since 2007. Temporary help services, typically the canary in the coal mine, hasn't turned decidedly negative, as a dip in April was quickly reversed, while the participation rate has stagnated not moving at all for the past six months. Two items of concern are the recent uptick in both the Challenger Index of intended dismissals, currently at 78k up from a recent index low of 53k, and the uptick in in claims data to 251k as of July 16th. After the unemployment programs of the pandemic ended, claims have dropped to multi decade lows. Still, anything south of 400k isn't a concern yet, but the trend is problematic.

The JOLTS report for May showed 11.254 jobs available, almost the exact amount in March. Hires still outpaced separations by over 500k. Professional and business services saw the largest decrease in job openings by 325k, then durable goods manufacturing down 138k, and nondurables down by 70k. In Separations, the quit vs layoffs were little changed at 4.3 million in quits, and 1.4million in layoffs and discharges. Less people quit real estate jobs and state and local government in Q2, while arts, entertainment and recreation saw a 19k uptick. As this is the May report we haven't seen much in a downtrend signal from this data.

Manufacturing gained 108k in Q2, and a revised 134k in Q1 of 2022. Total manufacturing has just surpassed the level of January 2020. However, the ISM survey has shown two months of contraction dipping below the 50 threshold and coupled with new orders falling below 50 as well, this is just another negative signal for the economy.

The recovery looks to be over in employment and the second half of this year should start to show weakness. I don't believe the Fed will stop increasing rates until the unemployment and inflation rates cross. Firms are still trying to find workers to fit skilled labor position and now they will probably be forced to reduce staffing heading into a recession.

Industrial production

Q2 IP was up 0.61% compared to a dramatically revised lower 1.94% Q1 number (previously 2.9%). This is a huge revision and not something to be happy about. This confirms my initial assumption that demand for durables would wane after the stimulus checks ended. **Capacity Utilization was 80 for June, primarily flat from a revised 79.9 in March.** It looks like the industrial/manufacturing recovery is over too. The June **Monthly Advance Report on Durable Goods Manufacturers' Shipments, Inventories and Orders** is due out on the same day the as the Fed interest rate decision and the consensus is that it will be **down 0.4% (and this is not inflation adjusted, meaning real is much lower).** This would be the second negative print since February, and the third in the last twelve months. Durable goods reports have been very positive over the last year and prior, as the consumer switched from purchasing services like dining out, to durables like cars and home appliances during the pandemic. But as the economy has opened back up, those purchasing trends are reverting, and durables are starting to decline. Another area of concern is the auto industry which, over the past two years, have benefited dramatically from low interest rates, stunted supply chains, and skyrocketing prices from both new and used vehicles. As interest rates rise and recession problems start, car prices should plumet as people default on their auto loans and large amounts of cars are repossessed and hit the market. This should then lead to greater cuts in employment in the industry and reduced supply of new cars.

Housing

New homes sales were down to 590k in June, down from a revised March number of 707 (from 763k). Existing home sales were also down to 5.12mm per annum vs 5.75mm in March. Both interest rates and house prices have slowed the market down substantially. The Case-Shiller home price index was up 20.5% yoy and 1.5% in the month of May. The National Association of Home Builders index continued to fall reporting 77, 69, and 67 for the three months of Q2. It currently stands at 55 as of July down 31% year over year. A number not seen since the pandemic and 2015 before that. The previous decade low was 8 during the great financial recession. Along with the above, building permits have finally come off the boil as well and June's number was 1.696 mm or 10% lower than March's. Interestingly housing starts showed that single family starts have collapsed to 982k annualized down 18% from March's number.

These numbers show the turning point in housing, and it has been abrupt. With mortgage rates in the mid 5% area and low 6% when you add in points, and house prices adding 20% on an annualized basis, affordability is gone for many, regardless of the desire to own. The single-family housing starts show that builders are seeing a renter's market in near to mid- term.

The Consumer

The Conference Board's consumer confidence index stood at 98.7 in June, down from 107.6 in March. Consumers are almost completely focused on inflation in both food and gas prices. With interest rates rising, those people looking to finance new durables have remained the same since the beginning of the year, but vacation planning and thus the travel and hotel industry will feel the reduction over the next six months. **The Expectations Index has now fallen below 66.4, a level not seen since 2013.** University of Michigan's consumer sentiment stood at 50, a level also not seen since 2012. Their preliminary July results moved up to 51.1 but still consumer's current and future expectations are down over 30% year over year. Consumer expectations of inflation did moderate a bit this month to 5.2% over the coming year, and 26% of consumers polled expect prices to stay the same or fall over the next 5 to 10 years, whereas only 11% thought that a year ago. **Retail Sales in June were up 1% and excluding motor vehicles it was up 1.04%.** These are good numbers but not because wages have dramatically outpaced inflation and people have more disposable personal income. On the contrary they are putting it on their credit cards. Please DO NOT believe any article written about how the US consumer has squirreled away some monster amount of savings that will be relied upon during the recession. All of the money that was handed out during the pandemic is gone, and people are living paycheck to paycheck again. Simply look at the year-to-date increase in **revolving consumer credit**; it is **up $69 billion dollars ending May 2022**… It was up $67 billion over the **entire year of 2021!** Since 2010 the most we added in revolving debt was $62 billion, and the average (not including the reduction of $117 billion in 2020) was $17 billion per year.

Personal income grew by 5.31% ending May over the past twelve months. This is after the base affects really kicked March in the teeth, down over 11%. Disposable income was up close to 3% and personal expenditures up 8.5% year over year ending May (between Feb and March they dropped from 13% to 8%). This is when the last stimulus checks went out. **Personal savings rates have cratered to the low 5%s** over the quarter, a level not seen since the end of the great financial crisis. Personal savings is a combination of people saving and not spending and people taking loans or using their credit cards. **Real personal consumption expenditures turned negative in Q2** for each month year over year, and as I guessed, **real personal income less transfers** went sub 2% in May at 1.82% over the last twelve months. The consumer is tapped out, and pretty soon so will their credit cards, and then credit card and auto loan defaults will tick up as people start to lose their jobs during the recession and push expenditures lower. The rent moratoriums are over with the last one having ended on 06/30/22 in Oregon. Nothing kills inflation like demand destruction, but will this recession be shallow as many are calling for, and if so, will it be long lasting? My guess is it will take years of structural employment change to occur and many over-levered companies to default to truly purge our dependence on the easy money train and get back to some basis of economic normalcy. But I fear the needed weening off may prove too politically and monetarily painful for a real cure to be enacted.

Inflation

April – 8.26%, May – 8.58%, June 9.06% on an annualized basis

I guess peak inflation didn't peak in Q1, and thus the reason for the 50 and 75bps increases in the Fed funds rate. Oops. The decline in energy in April was quickly reversed in both May and June, up 3.9% and 7.5% month over month. **The past twelve months have seen energy prices rise 41.6%, with fuel oil up 98.5%.** Food has not stopped it's march north, up in each month in Q2, up close to 1% in *each* month. **Food is up 10.4% over the past 12 months**. New and used cars (which saw a 3.8% decline in March), again started to rise. New vehicles are up 11.4% and used cars are up 7.1% over the past twelve months. The Manheim index (which is a more current index of used car prices) was up 13.4% from July 2021 until July 2022, but it looks like the peak was in January, and we are now treading water.

The bond markets however have shifted their fear from inflation to recession. You can observe this from looking at the breakevens, the difference between inflation adjusted treasuries (TIPS bonds) and regular Treasury notes and bonds yields. Breakevens are a market-based measure of expected inflation. These peaked at the end of March with the 5yr at 3.59%, and since then they have fallen over 100 bps and currently stand at 2.55% for the 5yr as of 07/21/22. This can also be confirmed later in the month of June as the bid for longer dated treasuries resulted in the 10-year bond falling from a 3.48% yield on 06/14/22 to 2.80% as of today, which inverted over half of the interest rate curve. This may not mean that inflation is done, just that the fear of recession has replaced it.

As WTI has gotten pummeled in June from close to 120 all the way to 95 as of the time of this write up, the energy portion of the CPI should show some signs of cooling off. But as Putin turns off/on the Nord Stream 1, Natural gas prices both here and in Europe are climbing again. Commodities have dropped because of the view that we are in or are heading into a recession. But slower CPI doesn't mean declining CPI. We might actually see disinflation if the demand destruction is heavier than the Fed anticipates. But this may take much longer to play out as wage inflation is much stickier than commodity inflation, and that bleeds into PPI, and eventually into CPI as firms have to raise prices to defend profit margins.

In Closing

Stocks had a much worse second quarter of 2022 than the first. Down close to 16% for blended indexes, with value outperforming growth two to one (both being negative though). DM and EM equity were down 14 and 11% respectively for the quarter, and 19 and 17% for the year. Long bonds were crushed as interest rates rose, down over 12% for the quarter and 22% for the year. Mid-term bonds in the Barclays Agg did much better, down only 4.7% for the quarter and 10% YTD (Duration matters). International bonds were down 11% for the quarter and 16%

for the year, while High Yield was down 10% for the quarter and 15% for the year. In alternatives, REITs were down 17% for Q2 and over 20% YTD, and commodities were up 2% for Q2 and up 29% for the year.

Last quarter I said the Fed is in full panic mode. They proceeded to raise rates by 50 and 75bps and tomorrow will probably raise by another 75 bps tomorrow. The futures are already showing that the Fed will overshoot and expect the first rate *cut* to be in 2023, nothing that the Fed is showing in their dot plots. The Fed balance sheet has barely moved, let's see if they actually reduce in August or if they will continue to support an imploding mortgage and housing market. The Fed could regain a level of respect not seen since the days of Volcker and at the chagrin of every politician up for election in November. But I simply don't see them deviating from their playbook of the past 12 years.

The job market has started to slow, and it should have, after a very strong run. The participation rate is still too low though and this means we have created structural damage not easily fixed in the short run. Manufacturing has recovered as well, but with durable orders slowing, I don't see a good second half for them, outside of utilities. Industrial production is slowing, quickly, and could turn negative as soon as July or, more realistically, August. Inflation is bad, but as commodity prices somewhat cool, we could see a peak in the coming months because of the anticipated (or already existing) recession.

Housing looks like it is done, with new home and existing home sales falling, and people dropping housing prices to get out before a crash. Mortgage levels are in the mid 5%s and with points puts them over 6%. Recession and job loss could spur foreclosures and large reduction in valuations. Lastly, the consumer is in a bad place, out of stimulus money and heavily indebted, delinquencies and defaults are going to pick up, along with auto repossessions over the next six months.

Fed is tomorrow. 75 bps, it will do nothing. Demand destruction has already started. I am still staying in floating rate bonds and little volatility to hedge, and with swap hedges going the wrong way for many corporates, commercial paper is being issued in quantity, go ahead boys, I will vacuum that right up.