10/03/22

Quarter in Review

The three main topics discussed in this quarter remain, inflation and interest rates, Russian and Ukraine, and the upcoming recession. Inflation started to come off the boil this quarter, but remains really elevated, only dropping 86 bps to 8.2% on an annual basis for the CPI ending September. The Federal Reserve raised the Funds rate two times by 75bps during the quarter and stood at 3.00 – to 3.25% at the end of September. We have two more Fed meetings until the end of the year. The Street's best guess is that they will raise by 75bps in November and 50bps in December and ending with a terminal rate somewhere near 5.00%- 5.25% in early 2023. While fuel costs have eased, core inflation has continued to climb along with food, and the median rent went above $2000 per month for the first time ever. All this while 20 million US citizens, about 1 in 6 American homes, have fallen behind on their utility bills.

Which means the Fed is not going to take its foot off the neck of inflation for a while. The entire Street is climbing all over itself trying to figure out when the Fed is going to pivot, which is another word for when they are going to decrease rates. What they are missing is that even if the Fed stops raising rates, they may just leave them elevated for longer until they can see some real tractions and get back to their target of an average of 2%. What many in the alt-street are saying is that they won't be able to get there, and instead will move their goal posts and increase the inflation target to 3%. The Fed is also reducing the size of its balance sheet now by $95 billion. They were supposed to reduce the balance sheet in Q3 by $190 billion but only managed about $117 or $72 billion short! As of this write up the Fed has only reduced its balance sheet by $72 billion for the month of October and are on track to fall short again by about $23 billion. If you don't believe this is on purpose as they are staring a hard landing in the face, then I have some land in the Florida Everglades and a couple of bridges to sell you.

As the Fed is increasing interest rates the dollar has become stronger and stronger, forcing everyone (except Japan) to increase their interest rates right alone with them. In July the ECB raised 50 bps, the first in over 10 years, before the Fed raised by 75bps. China cut the 1- and 7-year interest rates in August by 10 bps following a bunch of negative economic from covid lockdowns. The ECB raised interest rates by 75 bps in the beginning of September, to be followed by Norway's 50bps hike, the Swiss National Bank's 75bps raise, and Sweden's Riksbank raising it by 100 bps, all before the Fed raised rates again by 75bps. With a debt exceed 260% of their GDP Japan can little afford to raise interest rates and have been fighting (four currency interventions as of this write up) to keep its 10-year glued to 0.25%. What this has done since June is weaken its currency by 5.4% for Q3, and another 2.8% at the time of this write up. But not before the exchange rate peaked at over $150/Yen, and Japan had to intervened (sell US Treasuries) a fourth time. In the end they won't have the ammo to hold back the tide much longer. They will be

forced to raise rates are watch their currency be decimated. For some context here, the dollar/yen exchange rate hasn't been here since 1990.

In international and political news Russia resumed flowing natural gas to Europe at the end of July while the conflict in Ukraine was ongoing. But things took a turn for the worst in September starting on 09/21/22 with the Russian President declaring a partial mobilization of 300k reservists. On the same day Germany nationalized the country's largest gas importer to avert a collapse in the energy sector in Europe. Five days later large explosions occurred in the Baltic Sea damaging both Nord Stream 1 and 2, with 50-meter-long pieces now missing from the pipelines. Although not the only way Europe gets gas from Russia these two pipelines can deliver 55 billion cubic meters a year of natural gas each. Two days after that Russia annexed a large portion of occupied Ukraine after those areas held referendums to join Russia. Making energy and transportation issues worse, the Rhine river's water levels have declined so much in certain areas that they are impassable for barges carrying coal and diesel fuel. Not to be outdone UK households are estimated to pay triple the amount this winter to heat their homes.

July was not a good month for world leaders, with the UK's Boris Johnson and Italy's Mario Draghi (prior ECB Chair) both resigning and selections of their replacements taking over by October. Japan's Shinzo Abe, the longest serving premier, was assassinated on 07/08/22 at a Liberal Democratic Party campaign event. In August, Nancy Pelosi, the speaker of the US House of Representatives, flew to Taiwan despite Chinese threats. In response China scrambled its military and launched no less that 11 missiles into the waters around the island. In the beginning of September China locked down yet another city because of a covid outbreak, this time it was Chengdu, a city in west China with a population of 21 million people. Last but certainly not least Queen Elizabeth the II, Britain's longest reigning monarch died in the beginning of September in Balmoral, Scotland. Charles her eldest of four children will be crowned king. At 73 he is oldest person to accede the throne.

In US politics at the end of July Senator Manchin, a hold out to previous Build Back Better bills, agreed to the Inflation Reduction act of 2022. This bill was supposed to raise $737 billion, spend $437 bill on "green initiatives," and reduce the deficit by $300 Billion. After analyzing the bill, the Congressional Budget Office stated that it would only reduce the deficit by $102 billon or a third of what was originally stated. The budget reconciliation bill was passed by both houses and signed into law on 08/16/2022. Nine days later the president announces a student debt relief package of up to $20k per person, extended the moratorium of student loan repayments, and capped undergraduate repayments at 5% of their current income, all with executive order. The CBO estimates that the student debt relief package would cost over $400 billion over 30 years.

In corporate news Twitter shares slumped in early July as Elon Musk walked away from deal as he alleges Twitter lied about the number of bot accounts. Another cryptocurrency lender, Celsius Network, filed for chapter 11 bankruptcy protection, this after it had amassed over $20 billion in assets, but was offering 18% interest! Like other

tech giants Apple decided to reduce hiring in early July and has since come out with a series of statement regarding reduction in iPhone manufacturing. At the end of July Credit Suisse replaced its CEO and started a new turnaround, only after the previous one started 9 months ago! In August news, Robinhood stated that it planned to reduce its workforce by 25% following a 9% reduction in April. Finally in September the notables were that UK Gilts sold off for a second day sending the 10-year up about from 3% to 4.5% as the new PM brought out a ridiculous tax cutting budget into the greatest inflation pressure the UK has seen in decades. (The punchline to this story is she fell on her sword six weeks after she took office and will go down as the shortest PM in UK history).

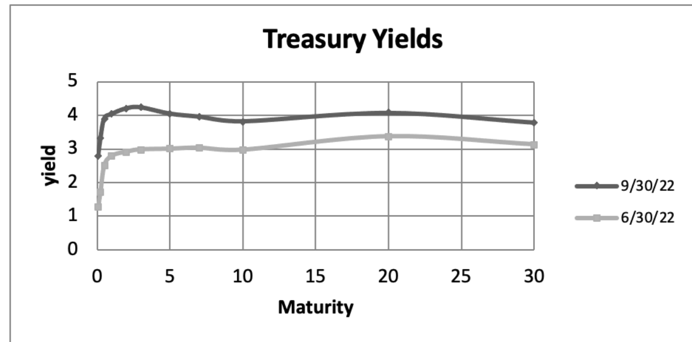
Markets

July's equity market rally was short lived, and August and September reversed all July gains. US value stocks were down from 4.5-5.5% on the quarter, while International developed markets where down close to 9% and large cap emerging markets were down almost 12%. Bond markets didn't fare any better, with long bonds down 9%, intermediate term bonds down 4.75% and short-term bonds down over 2%. High Yield was only down 1%, while international bonds were down close to 9%, but T-Bills were up about 0.5% over the quarter. REITs were down close to 10% along with Commodities down over 10%. The best performer for the quarter was Volatility up over 10%. With Q3 GDP at 2.6% and inflation still strong, I am not yet buying the Fed pivot argument. Things are slowing but markets aren't crashing into areas where the Fed starts to panic. Not yet.

Interest Rates

The **Fed's balance sheet fell $118 billion during Q2, short of their $190 billion target.** As of the time of this write up, it is lower by another $72 billion as October, but not on track for their target of $95billion. The Fed's terminal rate is estimated around 5% to 5.25% or another 2% from our current place. This could mean about 14% to 20% decline in stock based on empirical durations, putting the S&P closer to 3000 than 4000. As expected, the street and retail simply don't expect us to go anywhere near this number because the Fed will cave as we enter into a really bad recession. But at least for this past quarter the Fed was having none of it and yields widened out, from 150bps in the front end to 65 bps in the back end (almost exactly like Q2 did). As of 09/30/22 the 2-10s spread was negative 39bps not seen since the dot com bust in 2000. Not close to -201 bps of 1980, but we still have time.

Years	9/30/22	6/30/22	Difference
0.08	2.79	1.28	1.51
0.24	3.33	1.72	1.61
0.5	3.92	2.51	1.41
1	4.05	2.8	1.25
2	4.22	2.92	1.3
3	4.25	2.99	1.26
5	4.06	3.01	1.05
7	3.97	3.04	0.93
10	3.83	2.98	0.85
20	4.08	3.38	0.7
30	3.79	3.14	0.65



The Primary Mortgage Market Survey from Freddie Mac showed the 30-year conforming balance fixed rate mortgage at 6.70% at the end of September, up 100bps, with 0.9% in fees and points from June. The 15-year conforming balance rate was 5.96% up 113 bps with 1.3% in fees. The 5/1 ARM rates also increased to 5.3% up 90 bps and the fees and points increased to at 0.4%. The spread between the 30-year FRM and the 5/1 moved out 20 bps to 140 bps. **At the time of this write up though, 30-year FRM now stands at 7.08% as housing begins to crack.**

Leading Economic Indicators

The Conference Board's leading economic indicator (LEI) stood at 115.9 in September, down for the past 6 months and tripping their recession signals as year over year change pushes further negative. They are sticking to their call for a recession to start before year end. They are expecting 2022 GDP growth to be 1.5%, at current real GDP levels our economy would have to add another $410 billion in production from Q2s levels. And since the Atlanta Fed's Q3 GDP projections are 3%, we would need to grow by almost 5.25% annualized in Q4 to make that. All this as consumers have maxed out their credit cards already, and major retailers are dropping bulk orders to reduce inventory accumulation. The LEI will continue to fall off the cliff.

Jobs

Nonfarm payrolls for Q3 were up 1.115mm with an average of 419k per month YTD. The average was boosted by a large July number of 537k. Nonfarm payrolls have just now reached the level of employment prior to the pandemic. The issue is the participation rate is stuck at 62.3, down from 63.4, or 1.1% below the January 2020. This means that close to 3 million people have simply given up and left the workforce, all the while there are 10.1 million jobs available. The median duration of unemployment is at 8.3 months the lowest level since before the great financial crisis of '08/'09. Temporary help services have steadily risen since April and now exceed pre-pandemic levels by 262 million workers. After bottoming out in March of this year, unemployment claims have started to rise, albeit not by much. The four-week average ending September was only 206k, while the Challenger Index of intended dismissals declined slightly from Q2 but holding around 76k per quarter but the trend in

September was up 46% from August and 68% from September 2020. So, we are still in a tight labor market, job losses haven't really started in earnest, nonfarm payroll is slowing, and companies are reducing capex.

As mentioned above the JOLTS report for August was 10.629 million jobs available, declining 1.1 million from July. Those sectors that lost the most were health care and social assistance (236k), other services (183k) and retail trade (143k). Job loss (total separations which equals quits, layoffs and discharges and other separations) was all little changed over the month at 6 million. But the reduction in jobs available showed companies pulling back in the service sectors and looks to be anticipatory.

Manufacturing gained 86k in Q3, and a revised up 15k in Q2 of 2022. 2022 hiring might pass 2021s but again the ISM survey is showing a contraction under 50 in employment and teetering ever closer to less than 50 on the entire index. As firms are now facing a glut in inventory my belief is that we have peaked in manufacturing, and we will start see a contraction.

My belief is that we have now peaked in employment and although the Street's assumption that we will have a 200k October nonfarm report, I think we will be closer to the 110k range and thus not statistically different than a zero percent change for the month. If not this month then November. Companies are batting down the hatches and preparing for a recession.

Industrial production

Q3 IP was up 1.04% compared to a revised lower Q2 of 0.51% and a revised lower Q1 1.78% number. The large revision last quarter wasn't matched, but the positive values pushed the quarter into a growth category as inflation was up only 0.39% for the quarter. **Capacity Utilization was at 80.34% as of September, edging up slightly from the previous quarter.** The last time it was this high was pre-2009. The September **Monthly Advance Report on Durable Goods Manufacturers' Shipments, Inventories and Orders was up** every month this year except for February and July. Excluding defense, new orders were up 1.4 percent in September, with transportation driving the majority of the increase up 2.1%.

Industrial production, and manufacturing in general, has been much more resilient than I had imagined for Q3. The overall PMI measure is still at 50.9, but new orders and employment are in contraction area, which runs counter to what the BLS is showing (positive in every month this year). Manheim's used car index has steadily declined for this year, only pausing for a bit in May. I don't believe we are truly prepared for the type of recession that is coming. Although GDP was up 2.6% annualized for Q3, this came almost entirely from export. The domestic consumer looks tapped out, and I don't believe we will see the same for Q4.

Housing

New home sales were at 603k per year to end September, although higher than the July bottom of 543k, off the August rebound of 677k. The close to sixty-year average is about 656k, so we are still below the average, and I believe will continue to fall. The Case-Shiller home price index was up 13.11% year over year, or 7.43% less than May 2022. Month over month the declines in July and August were -0.69% and -1.32%. The NAHB Housing market index has cratered. With the near 40-year index having a 52 average, and the value at 83 starting the year, the September value of 46 (and October value of 38), is showing a drastic reduction in home building sentiment. Housing starts have also cooled to their long run averages at 1.4 million over the last 12 months. The real news on the building front though is the drastic fall in single family starts, while multi family is holding or climbing. With mortgage interest rates through 7% now and housing affordability as low as 2006 pre-housing bubble and great financial crisis, people look like they are renting more.

Housing looks like it is in trouble, maybe as bad as ’08-’09. People have paid huge amounts to escape the cities, and now as mortgage rates are above seven, **a level not seen in over 20 years**, the only way this market can tread water is if the Fed stops raising rates and begins to cut.

The Consumer

The **Conference Board’s consumer confidence index stood at 107.8 in September,** up over 9.5% for the quarter, while the **University of Michigan** (Happy Trails Mr. Curtin) also rebounded up **to 59.8** from 50 or 17%. Inflation expectation also moderated a bit during the quarter, but expectations have since risen again to 5% in October. **Retail Sales were flat on the quarter**, further evidence of a reluctant consumer to spend heading into a recession. Consumer debt is well above pre pandemic levels. All the paying down of debt with stimulus checks stories have seemingly evaporated, as we have run out of stimulus money, and the only way to keep up with the cost of living is to put it on the cards. **We have added 112 billion YTD in revolving credit ending August, and unless things cool off considerably, we will have added close to THREE TIMES the amount of debt in a year than in any of the past 12 years.** And you can see this as the personal savings rate has cratered to 3.1% of personal income (average since 1959 is 8.9%). Personal income has expanded in every month this year except for January. The problem is that inflation has expanded at a higher rate, thus reducing everyone standard of living. With 20 million Americans now behind on their electrical bills, the proof is there.

Inflation

July – 8.48%, August – 8.25%, and September 8.22%

Looks like the peak happened sometime in June, but even with two more 75bps increases in the Funds rates getting inflation under control is proving a little harder than the Fed had imagined. Obviously, the CPI "peak" is mostly base effects, and the Fed is more concerned with core PCE, which has been stubbornly sticking around 5% for the entirety of the year.

Looking at CPI for a moment, **energy costs on an annualized basis (base effects again) are still up 19.8% year over year.** Gas prices have fallen, of which I don't really believe it was due to the draining of our strategic oil reserve, and no, a political emergency doesn't count for a reason to drain it. Food prices however continue to climb, now up 11.2% over the past twelve months. New car prices were up 9.4% for the twelve months ending September, but used car prices, which rocketed higher during the past several years, are starting to come down, in each month in Q3. Just like all the rest of core CPI shelter was up 6.6% this past year.

I don't see inflation truly making its way back down to 2% for a while if at all. Since the Fed has unleashed a tidal wave of cash on the market, the only way they can seemingly look like they are succeeding in their mandate is to move the goal posts, and they probably will move the target to 3% in 2023, as removing trillions of dollars from the economy will put us into a deep recession that will be unpalatable for any central banker or politician in DC. I am not saying that we will have a successful soft landing, the Fed will overshoot this tightening cycle as well, and 2023 will be a recession.

In Closing

July had a bit of a stock market rally but was quickly reversed in August and September. Most US stocks were down 4.5 to 5.5% for the quarter while international markets were worse, down 9% in developed to 12% in EM. Bond markets continued the fall, with long bonds down 9% for the quarter and 29% for the year. Intermediate bonds were down 4.75% for the quarter and down over 14% for the year, while international bonds were down close to 9% for the quarter and down 15% for the year. Alternatives like real estate and commodities were down in Q3 about 10% each.

At the time of this write up the fed has raised rates again another 75 bps, or 375bps this year, one of the fastest tighten periods in years. The street has the Fed stopping somewhere between 5-5.25%. The Fed's commentary today let the world know they are not stopping and are committed to reducing inflation at the cost of GDP and the labor market. The housing market is rolling over but doesn't seem to be affecting the Chair's position or the

FOMC's. Mid Term elections are next week, and it almost looks like the Fed is acting independently, unlike several of the economic data agencies in Washington. Looking forward to the revisions after the elections. I am pleasantly surprised that the Fed is deviating from their playbook of the past decade, and with statements from the Chair that they could be higher for longer, an ounce of legitimacy is creeping back into this committee. 2023 will be the true test though, whether they can hold the line under the political, media, and social unrest of increases in unemployment.

Employment popped in July but continued its downward trend for the remained of the quarter to more late cycle realistic increases. (Albeit there could be some post-election revisions). The participation rate is stuck at 62.3 a full point below the pre-pandemic number. Job openings lost a huge amount over the quarter but have since increased again in October. The job market is still very tight, and workers are leveraging their pricing power. Manufacturing continued to add jobs over the quarter and is now larger than it was pre-pandemic, but ISM PMI is teetering near 50, and employment and new orders fell below 50 in September. My concerns for industrial production were proven wrong and IP was up over a 1% for the quarter with strong July and September numbers. We have seen somewhat of a peak in inflation, but core PCE hasn't really moved for the entire year (another talking point Chair Powell made.)

Housing has started to decline, mortgage rates are above 7%, prices are falling in the 20 series Case Shiller index, and home builder association index is at a decade low (not including the pandemic). Job loss hasn't started in earnest this quarter and probably not until the lag effects of rate increases catch up. But the consumer is in a worse place than they were three months ago. Credit cards and overall debt continues to increase. Corporates have already started to report declining revenues and big misses. This is the start, and if the Fed keeps its nerve, this is going to be a painful one.

I am still holding floating rate bonds which should once again see another 50-75bps added in yield over the next several months. I am also still holding some volatility hedges in case there is a panic sell of everything including floating rate debt. The stock and credit markets still haven't really crashed, it has been an extremely well managed sell off, very calm, with little panic. These past couple of years have been very trying for me as an investor, let's see what the next three months have in store for us.