Points to Ponder

April 14, 2022

The First Tee...

Doomsville…it is probably going to take some (or a lot of) pain to make gains against inflation:

- 8.5% year-over-year inflation growth is forcing the Fed to break-out the big monetary guns:
  - Inflation growth has been on a steep trajectory as the combination of tight labor markets (surging wage costs), supply-chain goods shortages (enhanced by the pandemic and Russian invasion), and fiscal/monetary stimulus has pressured the pace of price growth to levels not seen since the late 1970's and early 1980's:
    - Four decades ago, it took a brash monetary tightening move by then Federal Reserve Chairman Paul Volker to the wage-price spiral that saw the Consumer Price Index increase by 770 basis points to double-digit levels during the 70's.
    - Volker shocked the markets by drastically reducing the supply of money and credit…**while raising the Fed benchmark rate to 20%**:
      - Volker, who had only been in office two months, made the announcement at an unscheduled press conference on a weekend in October 1979…his move came at the objection of many Fed Governors, and became known as the **"Saturday Night Special"**:
        - Volker's move resulted in a recession and high unemployment, but CPI went from a record high of 14.6% in 1980 to average 3.2% by 1983:
          - From 1979 to 1982, GDP growth went from a gain of 3.2% to a contraction of 1.8%…the Unemployment rate rose from 6% in 1979 to 10.8% by 1982.
          - The 30-year T-Bond yield increased 300 basis points in 3 months after Volker's announcement…from 9.85% in October 1979 to 12.85% in February 1980.
- **Sacrificial Lamb**…the economy will be negatively impacted by actions taken to subdue inflation:
  - Fed officials hope for an economic "soft landing", this assumption is in jeopardy due to the ongoing pressure on prices for goods and services from the Ukrainian war and COVID persistence *(inflation immunity)*:
    - Given the current level of inflation, the benchmark rate target would historically be set at a level between 4% and 6%:
      - This places the Fed behind the curve for increasing rates if they follow a traditional approach to monetary policy:
        - **Dr. Doom** returns…Henry Kaufman, who was the chief economist for Salomon Brothers during the 70's and 80's, received the nickname Dr. Doom after correctly predicting the crippling inflation increase of that era *(Solomon made huge profits shorting bonds)*:
          - Kaufman asserts, "to shift to a non-inflation attitude, you have to shock the market…**you can't raise rates bit-by-bit to achieve this goal**."
          - Until recently, the Fed has been talking up measured steady rate increases…the Fed speak has gotten much more hawkish over the past month.
    - The Fed raising rates and reducing balance-sheet holdings will contract the size of money supply in circulation…these are the first steps in slowing demand, which in-turn will start relieving price pressures…the delicate trick is to avoid over-kill:
      - Current Fed projections are calling for GDP to increase 2.8% this year (the FOMC was expecting 4.0% GDP growth at the start of 2022):
        - The GDP number would be down from 2021's gain of 6.9%, but still not a recessionary number…the strong labor market could help sustain economic growth despite monetary tightening…the current tight job market is expected to keep Unemployment levels close to a record low of 3.5%.
      - CPI inflation is forecast to pull-back to 5.4% by year-end, while Core PCE inflation is expected to drop to 4.1% from its current 5.4% level.

Backwardization…commodities are currently a hot commodity (attracting the most investor buying in a decade):

- Strong demand and tight supplies have pushed raw material prices to record levels:
  - Near term supplies of commodities are selling at premium prices…this phenomenon has allowed investors to book profits by selling spot contracts and buying later-dated ones at a lower price (a market quirk called ***backwardation***):
    - Positive forward yields are currently attractive in the commodities market…these allow investors to make returns rolling expiring positions ahead by a month, even if the outright price of the item has not changed (this strategy becomes useless if prices collapse):
      - Aluminum spent the most of the last decade in the opposite position to backwardation…this situation is called **contago**.
- Commodity price gains have been across almost all categories…powered by the global economy emerging from the pandemic shutdown…with outsized demand pressuring production capacity and delivery of goods:
  - The energy sector had drawn the most investor attention, led by oil's rise from the bottom of the well:
    - During the past two years, the price of WTI crude had appreciated 200% (the first time over $100 per barrel since 1982):
      - Coal and natural gas prices have also outperformed, with price gains of 333% and 352% respectively the past two years.
  - Grain and metal prices have seen large value appreciations…with record highs seen in many product categories.
  - There are some analysts who believe commodities are currently in an elevated price super-cycle:
    - There are some projections the cycle could last ten years…we saw a strong commodity price run-up in 2010, that turned into a bust.

At the turn...

Capital Markets Group

The Back Nine...

A Hill of Beans...the spike in fertilizer costs has U.S. farmers changing planting plans:

- The cost of fertilizer is up about 27% so far this year, and 130% over the past year:
  - There are three main types of fertilizer: nitrogen, phosphate, and potassium...Russia is the largest producer of fertilizer, exporting about 50% of its output (mostly to Europe)...Belarus it the third largest global producer of potash:
    - Supply-chain issues (and Russian sanctions) are going to make getting fertilizer as big of a problem as the higher cost.
- Farmers are shifting planted acres from corn to soybeans due to fertilizer costs:
  - On average, farmers applied 255 pounds of total fertilizer on corn, versus 65 pounds on beans:
    - With nitrogen costing about $930 per short ton, that equates to 45 cents per bushel of corn (about 6% of total sales price):
      - Projections are showing 2 million acres of U.S. farmland will be converted from corn to soybeans this year.
- Fire and Rain...surging fuel costs and lack of rain are additional obstacles faced by farmers:
  - The higher cost of production and tighter grain inventories have increased corn and bean prices:
    - The price of corn rose 26% last quarter, while beans were up 21%...food costs have jumped 8%, the largest increase since 1981.

Bombardment...equity and bond prices are bashed by invasion and inflation (commodities rocket higher):

- Data format: April 1, 2021 / January 1, 2022 / April 1, 2022:

Equities

Dow: 32981 / 36338 / 34678
S&P 500: 3972 / 4766 / 4530
NASDAQ: 13246 / 15644 / 14220
Russell 2000: 2223 / 2245 / 2070

Commodities

CRB: 184 / 232 / 295
Oil: $59.16 / $75.21 / $100.28
Gold: $1707 / $1829 / $1937
Copper: $399 / $446 / $475
Natural Gas: $2.60 / $5.85 / $5.64
Bitcoin: $58960 / $46,333 / $45767

Borrowing Benchmarks

SOFR: (U.S. Secured Overnight Financing Rate)
1 day: .01% / .05% / .29%
1mo: .083% / .080% / .392%
3mo: .022% / .091% / .675%
IORB (Interest on Reserve Balances): .10% / .15% / .40%

Treasuries Issues

3mo: -.005% / .03% / .49%
6mo: .01% / .17% / .99%
1yr: ..05% / .37% / 1.55%
2yr: .15% / .73% / 2.31%
3yr: ..33% / .95% / 2.48%
5yr: ..93% / 1.26% / 2.44%
7yr: 1.40% / 1.43% / 2.41%
10yr: 1.73% / 1.51% / 2.32%
20yr: 2.31% / 1.93% / 2.59%
30yr: 2.40% / 1.90% / 2.43%

Currencies

Euro: 1.173 / 1.158 / 1.106
Yen: 110.72 / 111.30 / 121.68
Peso: 20.432 / 20.626 / 19.889
Canadian $: 1.256 / 1.126 / 1.250
Yuan: 6.552 / 6.356 / 6.340

Grain Futures

Corn: $5.64 / $5.93 / $7.47
Soybeans: $14.36 / $13.39 / $16.17
Wheat: $6.18 / $7.70 / $10.08
Random Lumber: $1009 / $1147 / $960

Job / Inflation Indicators

Unemployment: 6.0% / 3.9% / 3.6%
Consumer Price Index: 2.6% / 7.0% / 8.5%
Core PCE Index: 1.4% / 4.7% / 5.4%

Federal Funds Open: .07% / .07% / .32%
Prime Rate: 3.25% / 3.25% / 3.50%

19th Hole...

The meek shall inherit the earth, but not the mineral rights. J. Paul Getty

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