Capital Markets Group

Points to Ponder

April 14, 2023

The First Tee...

Crunch Time…after spiking during the pandemic, money supply is starting to contract:

- The monetary base (money supply the Fed has direct control over) has risen about $3 trillion since 2019:
  - Broader monetary aggregates increased more than twice as much with households and businesses depositing government fiscal stimulus payments…**with M2 money supply hitting a record high of $21.8 trillion in Jan. 2022**:
    - **A little Money Supply 101**…the money supply is broken-down into categories (with each larger in size ranging from 0 to 3):
      - **M0**…includes currency in circulation, such as coins and cash.
      - **M1**…this measurement includes money in circulation, along with demand deposits, checking accounts and traveler's checks.
      - **M2**…includes M1, plus savings deposits and certificates of deposit.
      - **M3**…includes M2, as well as large time deposits (>$100k), institutional money market funds, short-term repurchase agreements:
        - M3 is no longer tracked by the Fed due to some its holdings being less liquid…**MZM** (money zero maturity) has eclipsed M3 as it is seen as a better measure of readily available money in the economy and a clearer illustration of the expansion and contraction of that supply.
    - The largest increase in balances during the pandemic were seen in the M1 category of money.
  - The pandemic policy money creation response was one of the catalysts causing the inflation spike:
    - The surge in cash balances was not only seen in the U.S., but also in the United Kingdom and the Eurozone:
      - Monetarist are drawing the most attention they have seen since the 1980's…they assert economic growth and inflation are a function of the quantity of money in circulation and its velocity (the number of times money changes hands):
        - If nominal economic growth does not decline, then a drop in M2 would represent an acceleration in monetary velocity.
        - A large expansion in the size of the money supply in the late 1970's and early 1980's played a role in the double-digit rate of inflation.
- **Drought Conditions**…the money well is starting to run dry, leading to liquidity and credit concerns:
  - M2 is declining on a year-over-year basis…the first time this has occurred since record keeping began in the early 1960's:
    - In the Europe, M3 has declined the past six months to its weakest level since the aftermath of the financial crisis:
      - Annual broad money growth rates in Europe and the United Kingdom are below averages of the last decade…this period was associated with low inflation, the trend is suggesting recession, disinflation, and deflation from a Monetarist's point of view.

Quantity over Quality…composition of corporate profits is shifting…*accounting manipulation to the rescue*:

- Earnings across the business spectrum are expanding noticeably faster than cash balances:
  - S&P 500 company income (adjusted for amortization and depreciation) exceeded cash-flow from operations by 14% (in 2022)
    - This trend equates to, for every dollar of profit, only 88 cents was matched by cash inflows…the largest differential since 1990:
      - Managers are under a lot of pressure to deliver earnings, so aggressive accounting is being used to help numbers look better:
        - There are a couple of accounting methods companies can utilize to boost income figures in a deteriorating business environment:
        - One way is when money owed to companies is booked as sales before the payment arrives (an acceptable accounting treatment, but undesirable).
        - A second, is when the cost of producing goods understates the cash being consumed as inventory levels increase.
- An increase in income without a commensurate rise in cash flow…is considered low quality earnings:
  - Currently this issue is widespread…as measured against assets, the median company in the S&P 500 had this type of cashless earnings last year (falling into the **accruals** accounting category)…the most ever on record:
    - One of the key drivers to the low cash phenomenon is the surge in inventories…tying-up cash on floor-planning costs.
  - **Accruals Anomaly**…a pattern where firms with high accruals tend to perform worse than those with low accruals:
    - Expansion of accruals is typically a sign a cycle of earnings downgrades is far from over *(an extended ride on earnings pain train!)*
      - The latest rise in accruals reflects an urgency by companies to sustain profits following the end of the post-pandemic boom.
- **Good Will Hunting**…earnings season is upon us; analysts continue to lower the expectations bar:
  - Earnings for S&P 500 companies were down 2.3% in the 4th quarter…the first contraction since 2020:
    - For the past 12 months through January, 32% of the firms in the Russell 3000 were losing money:
      - Prior to the pandemic, there has only been two times since 1978 that so many firms have been profitless…in the dot-com era and the aftermath of the 2008 global financial crisis (not a big confidence builder given the high interest rates and talk of recession).

At the turn...

The Back Nine...

Doing Less with Less...besides rising Baby Boomer retirements, the supply of labor is being significantly impacted by a reduction in weekly hours worked *(not working for the weekend!)*:

- The average U.S. workweek has declined by over 30 minutes during the past three years:
  - The drop-in time worked is equivalent to a loss of 2.4 million employees (according to Bureau of Labor Statistics).
- American workers appear to be re-thinking their work/life balance...spending more time on leisure:
  - Americans have historically worked longer hours than counterparts in other industrialized countries:
    - Washington University professor Yong Seok Shin points to three groups who have reduced their work hours:
      - Educated young men and high earners, who have cut their workweek by 1.5 hours, as well as workaholics who have reduced time working by 3 hours to 52 hours...people doing remote and hybrid work are also more prone to shortening time on the job.
  - Long COVID has played a lessor role in reduced working hours, accounting for about 10% to the total.
- Fed Frustration...the central bank had hoped the end of the pandemic would result in a surge of people returning to the workforce, which in-turn, would keep the job market and wage pressures in check...unfortunately, this did not playout as planned

Calm before the Storm?...stocks make gains, while bonds signal trouble on economic horizon:

- Data format: <u>January 1, 2022 / January 1, 2023 / April 1, 2023</u>:

Equities

Dow: 36338 / 33147 33274
S&P 500: 4766 / 3839 / 4109
NASDAQ: 15644 / 10466 / 12221
Russell 2000: 2245 / 1762 / 1802

Commodities

CRB: 232 / 277 / 267
Oil: $75.21 / $80.26 / $75.67
Gold: $1829 / $1824 / $1969
Copper: $446 / $381 / $409
Natural Gas: $5.85 / $4.47 / $2.21
Bitcoin: $46,333 / $19425 / $16539 / $28,395

Borrowing Benchmarks

SOFR: **(U.S. Secured Overnight Financing Rate)**
1 day: .05% / 4.30% / 4.82%
1mo: .080% / 4.36% / 4.80%
3mo: .091% / 4.78% / 4.91%
IORB **(Interest on Reserve Balances):** .15% / 4.40% / 4.90%

Treasuries Issues

3mo: .03% / 4.24% / 4.57%
6mo: .17% / 4.58% / 4.66%
1yr: .37% / 4.47% / 4.35%
2yr: .73% / 4.42% / 4.02%
3yr: .95% / 4.22% / 3.79%
5yr: 1.26% / 4.00% / 3.58%
7yr: 1.43% / 3.96% / 3.54%
10yr: 1.51% / 3.87% / 3.47%
20yr: 1.93% / 4.14% / 3.80%
30yr: 1.90% / 3.96% / 3.65%

Currencies

Euro: 1.137 / 1.070 / 1.083
Yen: 115.08 / 131.12 / 132.86
Peso: 20.529 / 19.499 / 18.046
Canadian $: 1.263 / 1.355 / 1.351
Yuan: 6.356 / 6.898 / 6.873

Grain Futures

Corn: $5.93 / $6.785 / $6.585
Soybeans: $12.53 / $15.24 / $15.05
Wheat: $7.70 / $7.92 / 6.92
Random Lumber: $1147 / $373 / $371

Job / Inflation Indicators

Unemployment: 3.9% / 3.5% / 3.5%
Consumer Price Index: 7.0% / 6.5% / 5.0%
Core PCE Index: 4.7% / 4.7% / 4.6%

Federal Funds Open: .07% / 4.32% / 4.82%
Prime Rate: 3.25% / 7.50% / 8.00%

19th Hole...

Perhaps too much of everything is as bad as too little. Edna Farber

Ross Elford, Senior Vice President

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