Capital Markets Group

Points to Ponder

May 13, 2022

The First Tee...

The Party's Over…**the end of easy money is stressing global economies and markets:**

- Central banks from the Group of Seven countries are expected to reduce their balance-sheet holdings by $410 billion this year…after adding $2.8 trillion last year, and $8 trillion during the pandemic:
  - The record monetary stimulus helped support economies, as well as pump-up asset prices:
    - The resulting huge increase in the money supply built the base for inflation levels to spike to a four-decade high, with additional price pressures from supply-chain problems, raw materials shortages, and outsized buyer demand:
      - **M2, the broadest measure of the U.S. money supply, is up 40% since February 2020, to $21.6 trillion...it does not take monetarist to compute the increase of currency in circulation would result in pressure on the price of goods and services.**
  - The new Fed policy is known a "quantitative tightening (the antithesis of quantitative easing)…which is designed to increase borrowing costs, reduce liquidity, and slow economic growth, with hopes of decelerating inflation growth:
    - The U.S. Central Bank is targeting reducing its bond holdings by about $350 billion this year (plus $1.1 trillion in 2023):
      - The Fed's holding of bonds on its balance-sheet increased by $5.2 trillion during the pandemic, to a total of $8.9 trillion:
        - In an effort to be less market intrusive, the Fed will let Treasury and mortgage-backed securities mature out of its portfolio, instead of actively selling issues…there is a possibility at some point the remaining mortgage-backed holdings will be sold, keeping only U.S. Treasury bonds.
    - The current trend of rising bond yields, falling equity share prices, and the stronger U.S. dollar is doing some of the Fed's work, by tightening financial conditions…this could help expedite the Fed getting back in front of the inflation curve:
      - The European Union is expected to end QE purchases in the 3rd quarter, the Bank of England is already reducing bond holdings, the Bank of Canada is doing a passive roll-off of its balance-sheet (with a 40% reduction in holdings over the next 2 years)
        - The Bank of Japan has been the outlier, continuing to purchase bonds to control yield levels…the value of the yen has hit a 20-year low.
- **Not so Merry Christmas**…current financial conditions have constricted to levels not seen since the last Federal Open Market Committee monetary policy tightening campaign seen in December 2018:
  - CPI inflation hit 2.9% in July 2018 (up from 2.1% at the start of the year) …Fed action pushed the rate to 1.9% by December:
    - The Fed increased the benchmark Federal Funds rate target range 100 basis points in 2018, to 2.25% - 2.50%:
      - U.S. GDP growth slowed from 3.4% in the 2nd quarter of 2018, to a paltry +.9% gain during the 4th quarter of that year:
        - The rate on the 10-year Treasury note had increased 80 basis points from January to November to 3.24%, but fell 55 basis points from November to the end of December in 2018, a decline of 170% in two months…traders were reacting to a slowing economy and falling stock values
        - The S&P 500 declined by 19.9% from September 2018 to Christmas eve 2018 (3935 to 2351) .1% from bear market categorization.
          - Margin accounts are no longer a cheap way to leverage the market…stock margin buying surge helped to drive the rally, but also expedited the sell-off.
  - The S&P 500 is currently off 18.2% from its high set at the beginning of the year (the NASDAQ is down 28%):
    - The Fed "put" to assist equity values is dead, as the FOMC welcomes the market's help to dampen inflation:
      - The Fed's tightening is being felt beyond corporate stock prices, initial public offerings and credit issuance have also slowed.
  - The amount of U.S. distressed debt rose last month to its highest level in a year (impacted by higher interest rates)
    - Distressed debt is defined as corporate bonds trading at least 10 percentage points above Treasury levels, or loans being sold at lower than 80 cents on the dollar…the spread on junk bonds narrowed to their smallest margin in history the past 2 years:
      - There are expectations of a large surge in the amount of distressed debt in the coming months…as conditions deteriorate and investors are less incented to move out the credit curve for yield enhancement…forcing spreads to widen and raising the possibility of defaults.
        - The U.S. junk bond market has doubled in size over the past twelve years to $1.6 trillion…$7.7 billion of junk bonds fell into distress in April.
    - Many companies have built a cushion for slowing economic conditions, by refinancing their debt during the low rates the past two years, while their earnings are relatively high compared to the amount of their debt interest payments.
- **Consumer Conditionality**…the consumer may be needed again to keep the economy going:
  - U.S. consumer spending accounts for about two-thirds of the economy…consumers currently have solid financial position:
    - Household finances (debt, earnings, savings), employment, and demand remain robust, which could help avoid recession:
      - Recessions are typically characterized by rising unemployment, falling wages and stagnant job growth…none of these currently exist
        - Unemployment could possibly hit 3% later this year (lowest in 70 years), year-over-year wage growth at 5.5% (double the 20-year average rate):
          - Despite higher prices, consumers are still buying…household debt was 77.8% to GDP in the 1st quarter, down from 96% in late 2019.

At the turn...

The Back Nine…

Workers Wanted…with job openings at a record level of over 11 million, where are the workers?

- Prime-age males (defined as 25 through 54 years old) who have jobs, stands at 86.1% of total sector:
  - The percentage of prime working age men has been declining in recent decades…in the 1950's and 60's, the employment rate for this category averaged 93.8%...which equates to 4.9 million more men having jobs today:
    - Three-quarters of non-employed prime-age men are not actively looking for work…the reason falls into three main categories:
      - 1. Fewer job opportunities for less educated and formerly incarcerated men (men still imprisoned are counted in the labor statistics).
      - 2. Health problems are more prevalent, especially the drug abuse epidemic, with opioid addiction leading the way.
      - 3. Lack of interest in working, this can vary from increased reliance on disability insurance and other government programs, changes in martial prospects, relying on parents for support, addiction to video games, or just plain laziness.
    - Some prime-age non-working men are still in school or are staying home to care for children…here are a few more stats:
      - **Not Looking for Work**…the share of unemployment for prime age men who didn't have a job, but were actively looking for one, was only 2.9% In March…well below the long-term average of 4.4% seen since 1948 *(It's not too hard to find job opportunities, help wanted signs everywhere.*
      - **Sick Days**…5.2% of prime-age men reported being out of the labor force due to illness or disability, up from 3.5% in 1991.
      - **Employment Rate**…prime-age men employment rates are higher in countries such as Japan at 92.8%, Germany at 86.4%, France at 86.4%.
      - **Working Women**…employment for prime-age women stands at 74.1%, not much lower than its record high of 74.9% set in 2000.
- **Lowering the Bar** (or eliminating it all-together)…different fields are considering reducing or ending need for college degrees, licensing, and compulsory entrance exams to help ease worker shortage issues:
  - The pandemic has reignited the debate over what types of accreditations are essential for workers:
    - Government projections are also anticipating the slowest labor-force growth in recent history for the next decade:
      - Job sectors such as government, education, medicine, and law are all reassessing eligibility/certification requirements.
  - **Breaking Bad?…in the 1950's, about 1 in 20 Americans needed a license to work in their field, today, it's about 1 in 4:**
    - The Treasury Department and Federal Trade Commission are currently looking into changes in licensing criteria to increase the availability of workers, while placing a ban on unnecessary requirements:
      - During the pandemic, four states (including Washington) are now allowing graduates from accredited law schools to skip the bar exam…it has since been reinstated…the Oregon Supreme Court has backed a proposal for graduates to opt out of the test and become licensed via work experience or supervision…there is a push to prioritize talent over credentials *(looks like some loss of fee income!)*
      - The U.S. Dept. of Education is working on setting-up a national licensing system that would make it easier for teachers to move from state to state…payrolls in local education were down by 330k in March, compared to pre-pandemic levels.
      - The American Medical Association is fighting proposals for nurses to carry out some treatments currently limited to doctors… while nurses have opposed allowing less-qualified home-health workers to expand their scope of treatments *(protecting turf!)*
  - **Cost of Certification**…in a 2018 study, Morris Kleiner, professor of Labor Policy at the University of Minnesota, found that licensing costs the economy almost $200 billion a year in misallocated resources:
    - *Does it become a quality versus quantity debate?...or do certification requirements need to be changed to meet staffing needs?*

19th Hole...

Men tire themselves in the pursuit of rest.

Laurence Sterne

Ross Elford, Senior Vice President

Direct: 314.746.3679 | Mobile: 314.223.9739 | Fax: 314.746.8737

Commerce Bank Member FDIC | commercebank.com

The opinions expressed herein reflect that of the author and are not a complete analysis of every material fact respecting any company, industry, or security. The author's opinions do not necessarily reflect that of Commerce Bank or its affiliates. The information contained herein is based upon sources considered reliable but cannot be guaranteed, and is not intended to be investment advice.

Investments in Securities are NOT FDIC Insured; NOT Bank-Guaranteed and May Lose Value. CDs are direct financial obligations of the issuing financial institution and are not, either directly or indirectly, an obligation of Commerce Bank. The information provided in this e-mail or any attachments is not an official trade confirmation or account statement. Information contained herein is from sources deemed reliable but cannot be guaranteed. Prices and/or yields are subject to change and investments are subject to availability. The Capital Markets Group (CMG) of Commerce Bank is not acting as your 'municipal advisor' within the meaning of Section 15B of the Securities Exchange Act, and does not act in a fiduciary capacity. CMG does not provide tax advice; please refer to your tax professional.

Commerce Brokerage Services, Inc. is a registered broker-dealer, member FINRA and SIPC