Capital Markets Group

Points to Ponder

July 15, 2022

The First Tee...

Equal Time…given all the talk and writing about recession *(including by yours truly)*, **there remains an argument the economy might be able to withstand higher rates and inflation:**

- There is a strong perception that rising prices and tightening monetary policy, combined with the major stock market correction, makes a recession a foregone conclusion:
  - These assumptions are easy to understand given the extended periods, over the past couple decades, of low inflation levels, low borrowing rates, large government stimulus, and record stock levels:
    - Of course, the wild card in the current environment is the pandemic; you have to go back to the Spanish Flu in 1918 to find something similar…this lack of experience has attributed to some of the gap between optimism and pessimism.
- Jobs and consumption are underlying factors bucking the economic contraction theories:
  - Unemployment remains at a 70-year low, while job openings are close to a record, over 11 million:
    - The U.S. has the lowest jobless rate among the G-7 nations, with the exception of Japan…this trend is expected to continue.
    - Jobs create spending power…consumer spending comprises about 70% of total U.S. GDP (accounting for $13 trillion annually):
      - Retail Sales averaged a healthy 1.2% monthly gain for the first 6-months of this year…well above the .5% pace seen the same period in 2019:
    - Household balance-sheets are much healthier than they were prior the Great Recession…providing an economic buffer.
- **Crunching the Numbers**…comparing data between when inflation peaked in the early 80's and now:
  - Examining the average rates for 1980 and the first six-months of 2022 shows some large disparities:
    - Averages in 1980 saw **CPI Inflation** at 13.6% (Core CPI at 12.4%), **Unemployment** at 7.2%, **GDP** down .3%**, Federal Funds** at 16.0%, **Prime Rate** at 15.3%, rate on **10-year T-Note** at 11.4%, rate on **3-month T-Bill** at 11.4%.
    - Current levels in 2022 have **CPI Inflation** at 9.1% (Core CPI at 5.9%), **Unemployment** at 3.6%, **GDP** down 1.6% (primarily due to trade gap)**, Federal Funds** at 1.6%, **Prime** at 4.75%, rate on **10-year T-Note** at 2.9%, rate on **3-month T-Bill at** 2.14%.
  - **The Nitty Gritty**…the numbers clearly show how much more restrictive monetary policy and bond rates were in the 80's
    - The CPI rate versus the Fed Funds rate was 43% lower in 1980, compared to being 468% higher currently…the CPI rate versus the 10-year T-Note rate was 17% higher in 1980, compared to being 213% higher currently:
      - **The Bottom Line**…despite increasing rates, the Central Bank and Treasury market's cost to borrow money remain much cheaper and extremely more stimulative to the economy today than in 1980 (the reason you hear accusations the Fed is behind the curve).
- **Inversion Indicator**…the downward trend in interest rates for shorter to longer maturity dates is warning of an approaching recession…but the Fed Funds target below the neutral rate and ongoing job growth should hopefully delay any economic slump until next year, if not avoiding one all-together (there are still hopes the Fed can engineer a soft landing).

Visualization…in many cases, if you think something will happen, it will ***(soothsayer phenomenon)*****:**

- Expectations of a recession is altering consumer behavior into a defensive stance:
  - As people begin to fear the economy is going to slow, they will reduce spending activity, buy cheaper brands, and delay major purchases on items such as cars, appliances, and homes:
    - The most recent University of Michigan's consumer confidence survey shows buyers say this is currently the worst time to purchase a vehicle or major appliance on record…this data goes back to 1980.
- **Self-fulfilling Prophesy**…if consumers (and businesses) believe tougher times are ahead their reactions can create the situation they feared (just as inflation rises when people start hoarding items when they believe the price is going to increase):
  - The sentiment effect will be more evident if the current economy falls into recession despite the U.S. job market being at one of its strongest levels in history (consumer activity has historically led economic trends):
    - The current environment has had other external factors, besides financial, that have had a negative impact on consumer psyches, Including the ongoing pandemic, political upheavals, war, volatile severe weather, and fires.

At the turn...

The Back Nine…

Quick Time…uncertainty in accelerated unwinding of $8.5 trillion Fed bond holdings:

- Known as quantitative tightening (QT), the balance sheet reduction is targeted to reduce U.S. Treasury and mortgage-backed holdings by over $1.1 trillion per year:
  - The Fed's action is designed to shrink the money supply, while pushing interest rates higher:
    - The Fed targets short-term rates through the setting of the benchmark rate, but longer rates are typically harder to control…the Central Bank has instituted quantitative easing and QT to have a larger impact on the longer portion of the yield-curve:
      - The Fed's shrinking of the bond portfolio will at almost double the pace as the QT performed after the financial crisis:
        - Reduced Treasury buying by foreigners, and banks (due to capital requirements), has raised concerns by bond dealers for how they are going to intermediate the additional Treasury and mortgage-backed securities, due to Fed QT, into the private sector.
  - Mortgage rates could see added upward pressure as the Fed exits buying mortgage-backed bonds:
    - The Fed has indicated plans to eliminate mortgage-backed bonds on its balance-sheet and only hold Treasury's:
      - The plan has been for the Fed to reduce its bond holdings by not reinvesting maturing issues, but it has been noted the amount of mortgage bond monthly reductions are more than what is maturing (forcing the sale of bonds and pressuring rates higher):

Shot through the Heart and the Market's to Blame…the 2nd quarter gave investing a bad name:

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

Equities

Dow: 34502 / 36338 / 34678 / 30775
S&P 500: 4297 / 4766 / 4530 / 3785
NASDAQ: 14503 / 15644 / 14220 / 11028
Russell 2000: 2311 / 2245 / 2070 / 1707

Commodities

CRB: 213 / 232 / 295 / 291
Oil: $73.47 / $75.21 / $100.28 / $105.76
Gold: $1770 / $1829 / $1937 / $1807
Copper: $429 / $446 / $475 / $371
Natural Gas: $3.68 / $5.85 / $5.64 / $5.42
Bitcoin: $34585 / $46,333 / $45767 / $18731

Borrowing Benchmarks

SOFR: (U.S. Secured Overnight Financing Rate)
1 day: .05% / .05% / .29% / 1.50%
1mo: .083% / .080% / .392% / 1.68%
3mo: .022% / .091% / .675% / 2.11%
IORB (Interest on Reserve Balances): .15% / .15% / .40% / 1.65%

Treasuries Issues

3mo: .04% / .03% / .49% / 1.72%
6mo: .04% / .17% / .99% / 2.51%
1yr: ..06% / .37% / 1.55% / 2.80%
2yr: .24% / .73% / 2.31% / 2.92%
3yr: ..45% / .95% / 2.48% / 2.99%
5yr: ..87% / 1.26% / 2.44% / 3.01%
7yr: 1.21% / 1.43% / 2.41% / 3.04%
10yr: 1.44% / 1.51% / 2.32% / 2.98%
20yr: 1.99% / 1.93% / 2.59% / 3.38%
30yr: 2.05% / 1.90% / 2.43% / 3.14%

Currencies

Euro: 1.185 / 1.158 / 1.106 / 1.048
Yen: 111.09 / 111.30 / 121.68 / 135.72
Peso: 19.938 / 20.626 / 19.889 / 20.118
Canadian $: 1.239 / 1.126 / 1.250 / 1.287
Yuan: 6.457 / 6.356 / 6.340 / 6.699

Grain Futures

Corn: $5.85 / $5.93 / $7.47 / $6.19
Soybeans: $13.93 / $13.39 / $16.17 / $14.58
Wheat: $6.80 / $7.70 / $10.08 / $8.84
Random Lumber: $748 / $1147 / $960 / $694

Job / Inflation Indicators

Unemployment: 5.9% / 3.9% / 3.6% / 3.6%
Consumer Price Index: 5.4% / 7.0% / 8.5% / 9.1%
Core PCE Index: 3.4% / 4.7% / 5.4% / 4.7%

Federal Funds Open: .05% / .07% / .32% / 1.56%
Prime Rate: 3.25% / 3.25% / 3.50% / 4.75%

19th Hole...

You don't drown by falling in water; you drown by staying there. Edwin Cole

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