Capital Markets Group

Points to Ponder

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The First Tee...

Future Shock…the run-up in inflation to levels matching three-decade highs is swaying analysts to resurrect 1970's economic history and talk of stagflation possibilities:

- Stagflation is an economic dirty word of an excessive wrong direction in prices and growth
  - More precisely, stagflation is depicted by persistent high inflation combined with high unemployment and stagnant GDP growth…the word was coined in the 1960's by Lain Macleod, during a period of economic stress in the United Kingdom:
    - The U.S. economy from 1973 to 1975 was the best depiction of stagflation in modern times, when GDP growth contracted for five consecutive quarters and the consumer price index averaged a 9.3% rate (CPI was 3.4% in 1972):
      - During the later 70's the energy crisis emerged, and the price of oil exceeded $100 per barrel (based on 2019 dollars).
- **No Stairway to Heaven**…there are some signs the stars are aligning for the possibility of another economic period like the recession seen in the 1970's that could occur in a couple quarters in the future:
  - The strong run-up in prices could choke-off growth…consensus is growing that some level of stagflation is more likely than not:
    - Persistent shortages continue to create supply chain problems, combined with rising raw material costs (especially in the energy sector) is increasing the cost of goods and sapping discretionary spending capabilities from consumers:
      - It is difficult for most households to find substitutes to offset the high cost of energy…without major lifestyle and comfort changes.
      - The consumer has been the driving force for GDP growth since the emergence from the Great Recession that started in 2009.
    - The higher cost for goods and services is occurring at the same time the pandemic induced fiscal and monetary stimulus programs are either ending or are being scaled-back *(less government checks in the mail)*.
      - The Brookings Institute calculates the economic impact from federal, state & local government taxes and spending programs turned negative during the second quarter and will remain that way into 2023 (unless new legislation is passed).
- **What's Going On?**…an economy trending towards stagflation could flip the equity and bond markets:
  - Over the last century, the 1970's represented an all-time low for equity valuations and an all-time high for nominal interest rates (not considering the impact of inflation)…today the opposite exists:
    - During the past decade stock and bond values have benefited from low inflation levels and lax monetary policy.
  - Bond Bombshell…bonds are poised to have their worst performing year in over twenty years as inflation erodes values and central banks around the world pull-back on their expansive asset buying programs *(reviving the taper tantrum)*:
    - The Bloomberg global benchmark of government and corporate debt has lost 4.1% this year (its largest decline since 1999):
      - Dollar denominated emerging market bonds wiped-out all their gains for the year during September.
  - Back to the 70's…during the 70's the 10-year Treasury Note averaged a 7.5% rate; during the past ten-years the benchmark issue has averaged a 2.05% rate…from 1972 to 1975 the 10-year T-Note yield rose from 5.9% to 8.58%...finishing the decade at 10.4%:
    - During the past year the rate on the 10-year T-Note has increased 82 basis points (an increase of 112%):
      - Since August 2020 the 30-year Treasury Bond has lost over 15 points in value (a $150,000 loss per $1 million invested).
- **Born to Run**…not all is gloom and doom as the economy is riding strong wave of momentum:
  - After GDP posted an annual contraction of -3.5% in 2020, the economy is poised to gain 5.9% this year as the country has emerged from the pandemic shutdown (it has been a slow boat to partial normalcy):
    - The current consensus forecast for U.S. economic growth is for gains of 4.1% in 2022 and 2.4% in 2023…annual GDP growth averaged 1.95% the past ten years, placing the current economic outlook well above recessionary numbers:
      - The economy should also benefit as we move past the pandemic and COVID infection flare-ups.
      - The uptick in inflation did boost company operating margins so far this year, which rose by a record high 14.4% in the 2nd quarter:
        - Corporate margins will get start getting squeezed if companies do not have the ability to pass-on rising production costs to end users.
    - The Federal Reserve Bank continues to assert the rise in inflation is temporary…year-over-year CPI currently stands at a thirteen year high of 5.4%...a year ago y-o-y CPI was +1.4% and two-years ago it was 1.7%:
      - The key inflation question is, if the upward price trends can be sustained as the supply-chain and labor issues ease?
      - Energy costs remain an inflation hot button, as the price of crude keeps rising the frackers should become increasingly active.
    - The Consumer Cushion…U.S. households increased their savings during the pandemic by almost $2 trillion:
      - The savings backstop could come in handy for the economy if activity starts to slow…*consumers like to spend*.

At the turn...

The Back Nine…

Getting Schooled…many college graduates are probably wishing they had taken a class in budgeting as student loan payments have recommenced from their pandemic freeze:

- On October 1st, about $7 billion in monthly student loan payments were reactivated:
  - Americans now owe about $1.7 trillion in student debt…more than double the size of their credit-card liabilities:
    - The range of student loan debt holders range from recent graduates (and some who did not graduate) to retirees:
      - Student loans in serious delinquency (over 90 days late) exceeded $135 billion before the payment freeze…a level higher than most other kinds of debt, a number that is expected to escalate now that payments are coming due again:
        - The New York Fed predicts the real number of student loans gone bad is likely twice as high, since many borrowers have not reached the stage where they have had to start making payments *(although very worthwhile, education is an expensive undertaking!)*
    - The government is debating student loan forgiveness, but these measures have not gained much traction:
      - The pandemic relief bill from last year does allow for firms to reimburse employees $5,250 annually for student loans.
  - Short Changed…with the abundance of degrees in the market, it is becoming evident they are an asset of diminishing return in terms of enhanced earnings.

Reality Nibbles…inflation rises from the ashes to impact stock, bond, and commodity prices:

- Data format: Oct 1, 2020 / January 1, 2021 / July 1,2021 / Oct 1, 2021:

Equities

Dow: 27781 / 30606 / 34502 / 33843
S&P 500: 3362 / 3756 / 4297 /4307
NASDAQ: 11167 / 12888 / 14503 / 14448
Russell 2000: 1507 / 1974 / 2311 / 2204

Commodities

CRB: 148 / 167 / 213 / 228
Oil: $40.22 / $48.52 / $73.47 / $75.03
Gold: $1885 / $1898 / $1770 / $1756
Copper: $303 / $351 / $429 / $408
Natural Gas: $2.52 / $2.53 / $3.68 / 5.85
Bitcoin: $10706 / $28996 / $34585 / $43,436

Borrowing Benchmarks

Libor:
1mo: .146% / .143% / .100% / .082%
3mo: .220% / .238% / .144% / .130%
SOFR: (U.S Secured Overnight Financing Rate)
1day: .08% / .07% / .05% / .05%

Treasuries Issues

3mo: .09% / .09% / .04% / .03%
6mo: .10% / .09% / .04% / .03%
1yr: .11% / .10% / .06% / .07%
2yr: .12% / .12% / .24% / .28%
3yr: .15% / .17% / .45% / .51%
5yr: .27% / .36% / .87% / .98%
7yr: .47% / .65% / 1.21% / 1.31%
10yr: .68% / .93% / 1.44% / 1.51%
20yr: 1.23% / 1.45% / 1.99% / 2.02%
30yr: 1.46% / 1.65% / 2.05% / 2.08%

Currencies

Euro: 1.123 / 1.172 / 1.185 / 1.158
Yen: 105.48 / 103.25 / 111.09 / 111.30
Peso: 22.114 / 19.914 / 19.938 / 20.626
Canadian $: 1.357 / 1.272 / 1.239 / 1.126
Yuan: 6.791 / 6.527 / 6.457 / 6.444

Grain Futures

Corn: $3.79 / $4.84 / $5.85 / 5.37
Soybeans: $10.22 / $13.11 / $13.93 / $12.57
Wheat: $5.78 / $6.40 / $6.80 / $5.37
Random Lumber: $612 / $642 / $748 / $630

Job / Inflation Indicators

Unemployment: 7.9% / 6.7% / 5.9% / 4.8%
Consumer Price Index: 1.4% / 1.4% / 5.4% / 5.4%
Core PCE Index: 1.6% / 1.4% / 3.4% / 3.6%

Federal Funds Open: .08% / .08% / .05% / .07%
Prime Rate: 3.25% / 3.25% / 3.25% / 3.25%

19th Hole...

It's better to know some of the questions than all of the answers. James Grover Thurber

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