Capital Markets Group

Points to Ponder

November 18, 2022

The First Tee...

The Price for High Prices…not surprising, elevated inflation taking toll on consumers:

- Inflation adjusted personal consumption expanded at an annual pace of 1% in 3rd quarter
  - This is the weakest rate since the start of the pandemic, and half the level seen in the 2nd quarter:
    - Inflation has outpaced wage gains annually every month since April 2021(hard to maintain spending when real income is heading lower):
      - Changing buying patterns, as consumers shift more spending from goods to services, is negatively impacting manufacturers:
        - Spending on core necessities of food and gasoline has greatly reduced leeway in discretionary purchases *(rethinking that pick-up/SUV purchase?)*
- **TV Dinner**…many households are reducing restaurant spending as budgets feel inflation squeeze:
  - A recent survey showed half of respondents have cut-back on dining-out *(passing on the full-meal deal!)*:
    - Restaurant spending was the leading expenditure consumers opted to trim to save money…followed by apparel and travel.
  - Restaurants benefited greatly when COVID restrictions were relaxed…as people wanted to get out of the house:
    - Eating establishments have been forced to raise menu prices due to higher food, labor, and transportation costs:
      - During September, the cost of eating-out surged 8.5% versus a year ago…grocery store inflation rose by 13% for the same period.
      - Restaurant earnings have been negatively impacted…of the 32 companies on the Russell's 3000 index for restaurants and bars, only two have gains this year in stock value…the index is off over 16% so far this year *(but to be fair, the general market is down as well)*
- **Beg, Steel, or Borrow**…consumers are hitting credit cards and savings accounts to maintain lifestyle:
  - As inflation exceeds wage gains, more households are relying on revolving debt to make ends-meet:
    - Consumers in there 20's and 30's, as well as the lower income brackets, are relying on credit cards to buy necessities.
  - Consumer credit-card debt is being extended into longer-term borrowing scenarios (a costly prospect):
    - Beyond an insta-credit shop or loan shark, long-term credit card debt is one of the most expensive forms of borrowing
      - Current average credit card rates…All Cards: 22.2%; Retail Store Cards have the highest rate at 25.9%; Business Cards have the lowest rate at 19.8%, the Penalty Rate for Cards is 29.3% *(it's hard to catch-up when falling behind on payments and a third is going to interest!)*
    - Sixty percent of credit card debtors say they have been in credit card debt for at least a year…up 50% from a year ago:
      - The number of credit card borrowers who have been in debt for two years has increased to 40% from 32% the previous year.
  - Wishing for no rainy days…the savings rate is approaching the lowest level since the Great Recession (at 3.1%).
- **Not taking a Dip**…Americans are investing less in stocks as they shift money to fund daily living:
  - One in four investors reduced stock investing to pay for groceries, gas, and housing (from a Wells Fargo survey):
    - 42% of respondents want to totally cash-out of the market, while a third would like to deplete IRA/401k accounts:
      - So much for buying the market dips and lowering the dollar cost average of the portfolio…the S&P 500 is down 18% from its record high set at the beginning of the year, but the benchmark index is still up 76% since the beginning of the pandemic:
        - A large number of investors have never experienced elevated inflation levels and an extended bear equity market *(rookies!)*

King of the World…rising rates and falling stocks are making cash-equivalents royalty:

- The inverted yield-curve has placed maturities less than a year at the rate mountain top:
  - Years of subdued interest rates made short-term cash equivalent investments a stop-off for moving money to a more attractive alternative, or a place to park funds for those who were indecisive:
    - Cash and cash-equivalents have become a legitimate asset-class for the first time in decades *(seems more like a lifetime to me!)*
      - Unfortunately, the high inflation levels still make returns on cash equivalent investments negative in real terms (with rest of curve).
  - Fed's monetary policy tightening has pushed short-term yields to the high 3% to mid-4% range, while shredding the value of stocks and longer dated bonds (the 30-year Treasury Bond has lost 40 cents on the dollar over the past year):
    - Treasury bills have no duration and credit risk, and with marginalized market risk it is an attractive alternative:
      - Money market funds have been attracting money searching for daily liquidity…with balances approaching a record $4.8 trillion.
- **Timing is Everything**…given the Fed's intention to keep hiking rates, the yield-curve could invert further:
  - Short-term investment rates should continue to increase…but it will be prudent to start migrating into longer dated issues if the economy moves towards recession and monetary policy tightening activity begins to stall.

At the turn...

The Back Nine…

Own Worst Enemy…Fed's flurry of rate hikes has devalued its balance-sheet holdings:

- With a $9 trillion in Treasury and mortgage-backed security portfolio, the Fed has seen massive paper losses due to the rise in interest rates (the yield on a 2-year T-Note is up over 500% this year):
  - Monetary policy tightening has also increased the rate the Fed pays banks on reserve balances to a current level of 3.9%, up from the .15% rate seen at the start of 2022 (an increase of 2500%):
    - These changes have pivoted the Fed into an operating loss…last year, the Treasury received about $100 billion from the Fed, the increase in interest rates could put the central bank at an annualized loss of $80 billion by year end:
      - Fed remittance owed to the U.S. Treasury hit negative $5.3 billion in mid-October…a negative number is basically an IOU that would have to be repaid by the Fed from any future income (Fed losses should not have a near-term impact for conducting policy):
        - The Fed is not tasked with generating profits, but large losses will not sit favorably with Congress (placing added pressure on the Treasury).
  - There are no clear economic constraints to the Fed running losses…but they could become more politically constricting
    - Central banks are under political pressure after they failed to anticipate and react to the extended rise in inflation:
      - Congress has been pressing for more control over Federal Reserve Bank activity…Central Bank losses will boost their case.
- **Blow the Roof Off**…rising funding pressures on the Treasury and Fed brings debt-ceiling into focus:
  - Another political storm could be brewing as we are swiftly approaching the mandated debt cap:
    - The current debt-ceiling stands at $31.4 trillion, leaving about $300 billion cushion for government borrowing:
      - The debt-ceiling has been suspended or adjusted 28 times over the past twenty-nine years…most of the time without fanfare:
        - There have been some occasions though where a major political battle ensued, creating extended government shutdowns.
    - There are opposing forces at work here as Congress loves to pass spending increases, but wants tax-cuts as well:
      - The debt-ceiling has become a leveraged political tool that places additional pressure on the Treasury Department and Fed:
        - Congress passes spending packages, but then they balk at approving borrowing capacity to pay for what they have legislated.
    - In the past, most debt-ceiling battles have occurred in periods when the economy is performing well:
      - With inflation trending close to a forty-year high, combined with growing concerns of an impending recession, the impact of a delayed debt ceiling passage could be even more detrimental to the economy…creating pressure on the bond market and dollar:
        - An unresolved debt ceiling will push short-term interest rates higher (on concerns about delayed payments on maturing Treasury issues), higher rates on short-term dollar denominated securities would pressure the value of the dollar lower (delaying of some government payments).
      - The stakes are higher for the upcoming debt ceiling debate due to the much larger government debt and budget deficits:
        - The unfunded gap in fiscal programs such as Medicare is becoming a larger problem, requiring prudence to protect future generations.
- **Not so Lame Duck**…there is a possibility the House will try to pass a debt ceiling extension before year-end:
  - The Democrats may try to leverage their current majority to get funding enacted (avoiding a 2023 political fight):
    - The Treasury could also use extraordinary accounting measures…to keep government operating into the second half of next year.
- **Lunch Money**…there is no such a thing as a free lunch…a moderate/centrist strategy is needed between the parties to balance reckless spending and runaway government debt, while adjusting the tax-code to be fair and not over-burdensome or beneficial to any income class.

19th Hole...

Procrastination makes easy things hard, and hard things harder. Mason Cooley

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