1/20/21

Quarter in Review

The Markets

For the past ten years I have tried my best to write a quarterly commentary (http://tildencm.com/quarterly-review). I missed a couple along the way because life has tendency to dictate your schedule, and as Dr. Claire Lewicki so eloquently put it "Control is an illusion, you infantile egomaniac." Yes, it has gotten so bad I am quoting 30-year-old race care movies. To be honest I am tired, mentally, physically, emotionally and spiritually. I want to be able to dive into the data and come up with a well-reasoned argument for you based on facts, using my years of education and experience. But even if I could it wouldn't matter. Facts are so last century, we don't care about facts today, we care about opinions, ours or our sides, or our view of the markets, and finding any data point that will fit our myopic view of our portfolio's positioning in a world that has gone off the tracks. I could show you a graph how the Federal Reserve of the United states has monetized (printed money out of thin air) over 6 trillion dollars in the past decade.

Or that in 2020 alone the money supply in our country has increased by 26%.

"But Mason" you would say, "inflation is nowhere in sight, jobs have come back, we have vaccines now, what are you worried about, these are professionals at the helm, trained, with years of academic integrity, experience that far exceeds your own."   Which segues nicely back to the rest of Dr. Lewicki's quote. "Nobody knows what's gonna happen next: not on a freeway, not in an airplane, not inside our own bodies and certainly not on a racetrack with 40 other infantile egomaniacs."

Substitute "stock market" for "racetrack.", and "40 other infantile egomaniacs" with "10 million new account retail day traders." Inflation is here, and it is in the stock market (S&P 500 up over 18% this year), real estate (7.95% yoy ending 10/31/20), and education (private nonprofit four year up 2.1% BEFORE inflation for 2020-21). It has been this way for the past decade until the Fed started to take away the punch bowl the first time and the markets threw up all over themselves (see Q4 2018). Even this month when the Fed's minutes came out with governors talking about tapering their bond purchases, the ten-year treasury backed up 25 bps in a week. On 01/14/31 the president elect came out with his plan to print another 1.9 Trillion, which wasn't enough for the markets and we sold off again. Not to mention that retails sales were off for the second month in a row, or that consumer sentiment started to slip with inflation expectations now at 3%. But make no mistake the stock market is directly correlated to fiscal and monetary policy injections, not economic recovery. Bad soft or hard economic data drives the market up as people believe more fiscal and monetary stimulus are on the way.

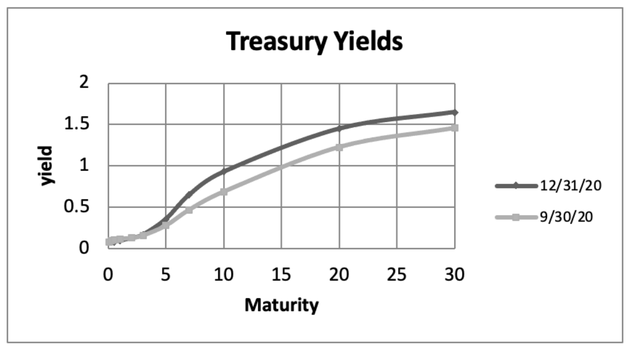
Lastly if the Fed truly wanted banks to start lending then why are they paying interest on excess reserves… because they don't, just look at the velocity of money since the great recession for a clue. It has been declining and recently fell off a cliff because the equation is GDP/M2, and obviously GDP got crushed in Q2, and money supply went up by over a quarter.

So. for a quick market recap: Value stocks underperformed growth (again) this year, although they were up around 5%. Developed market value stocks down about 2% for 2020, while emerging market large caps were up close to 20%. US long bonds put up another great year up over 16% while the Aggregate Bond Index was up over 7.5%. High Yield bonds didn't do that poorly either up over 11% (and the Fed didn't even have to buy that many). REITS and Commodities took it on the chin though both down over 8% for the year.

Interest Rates

The Federal Reserve's balance sheet expanded by $307 Billion in the fourth quarter of 2020. There were no rates hikes in the quarter. Prior to the new $1.9 Trillion-dollar fiscal plan announcement the long end of the Treasury curve backup about 22 bps. Since that time, we have widened out another 20 bps with Fed governors showing little sign of concern. The Federal reserve is currently buying $120 billion per month in US Treasury and Mortgage-backed securities, with no termination date or taper planned. So, they are printing $1.4 Trillion per year (an increase of 7.5% per annum of the money supply) and using that money to buy US Treasuries created by the US government to pay for fiscal plans. Thus holding Treasuries down while inflating other assets.

Years	12/31/20	9/30/20	Difference
0.08	0.08	0.08	0
0.24	0.09	0.1	-0.01
0.5	0.09	0.11	-0.02
1	0.1	0.12	-0.02
2	0.13	0.13	0
3	0.17	0.16	0.01
5	0.36	0.28	0.08
7	0.65	0.47	0.18
10	0.93	0.69	0.24
20	1.45	1.23	0.22
30	1.65	1.46	0.19



The Primary Mortgage Market Survey from FHLMC showed the 30-year conforming balance fixed rate mortgage fell to 2.67% at the end of December from 2.88 in September. 15-Conforming balance loans also fell from 2.92% in March to 2.59% in June, and 2.51% as of the time of this write up.

The Mortgage Bankers Association information as of 01/13/2021 showed 30-Year conforming balance FRM down to 2.88% with .33 points in January. 15-year conforming balance FRMs were down to 2.39% with 0.31 points.

Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) stood at 109.1 for November, climbing consistently from the trough of 96.9 in April. The three main contributors to the index were the reduction in Average weekly claims, then building permit increases, and finally stock prices. The credit index and the interest rate spread also contributed to the increase. With increases in weekly claims in the latter half of December this will not be a contributor in the December report. But as the spread between the 10-year treasury bond and the federal funds rate widens this should help to offset the rising weekly claims. It looks like new orders for both consumer goods and nondefense capital goods are leveling off, so this won't be much of a contributor going forward. Neither will average workweek for production workers, as it has already reached pre covid levels which had been declining since 2016. The latter half of this year has seen 7 or 8 out of 10 of the data points contributing, which makes sense as the economy was recovering. I don't know how much more recovery there is left though, especially given the length of the country's lockdown. Certain industries and companies can simply not hold out any longer and the damage will probably be permanent, along with the job loss.

Jobs

At the time of this write up, **nonfarm payrolls** posted a **decrease of 140 thousand jobs for December.** This is following a steady decline in the rate of job gains from June of this year. For the year the Bureau of Labor Statistics **estimated that the US lost over 9.3 million jobs.** The unemployment rate stands at 6.7% (or 7.3% had misclassified unemployed been classified correctly).

A side note here: the employment numbers are probably THE most widely followed statistical data point(s) by professionals and lay people alike. But rarely do people speak about the statistical adjustments made to this data point, or the representativeness of the sample, and those of us who often criticize the number are shunned for blasphemy. And again, although I am offering facts here it probably won't matter, because opinions only matter remember.

1) The nonfarm payroll number **SAMPLES 145,000 business** of which the collection rate as of December was 76% (back up from 63% in June). (bls.com)

2) **Total US businesses are about 18mm** (naics.com).

3) Therefore, the sample size is **less than 1%** of all US business.

4) Birth/Death – BLS can't capture firms that are new or have gone out of business in a timely manner. Therefore, to estimate this the BLS uses an ARIMA model or autoregressive integrated moving average. In statistics it is easier to glean correlation about the total population (all observations) from a sample when the average (mean) isn't moving all around, or "stationary". To understand the labor statistics better the BLS uses and ARIMA model to better "fit" the data.

All of this is on the BLS' website, it isn't as if they are trying to pull one over on us, but no one reads these clarifications, but they do make statements like all 140k jobs that were lost in December were women with no explanation of the assumptions about the statistical implications from the adjustments. These statements are good twitter food, but that is about all.

Temporary services recovered much of the losses and are about 92% of pre-Covid numbers at 2.7mm. **Median duration of unemployment** has started to descend from the October high of 19 months, but is still at 16.8 months, a number not seen since October of 2013. I was wrong though in my prediction that this number would exceed the 25 months high from the previous recession (games not over yet though). The **civilian labor force participation rate** hasn't really moved since June of this year, hovering around 61.5. Some perspective here, this rate was near 67-66 since the late 1980s, and after the 2008-9 recession has been in decline. It actually started to increase in 2019 off the 62 floor, but Covid lockdowns reversed that trends and seem to be stuck below 62 now. **Manufactures lost a total of 557k jobs in 2020,** and at the past six months average of 40k a month it will take a year or more to get those jobs back.

Unemployment claims hit unprecedented numbers this year (along with many other statistics), and like the collection problems at the BLS, the department of Labor had its own issues. Many states were (understandably) simply not prepared for the quantity of claims, nor had the ability to accurately report on a timely basis to the DOL. Although we have seen a large reduction in the number of state claims from April and May, some of these claims have transitioned over to the federal pandemic unemployment assistance or pandemic emergency UC. Context here is key, whereas the BLS numbers estimate job loss in both the payroll and household surveys near 9mm, the claims data show **twice the number of people collecting unemployment. Total claims in December 2019 where 2.1 million, and now they are 18.4mm.** This number has come down, but initial claims have started to turn up again in January 2021. So how do we reconcile this, have there been 9 million people out of work since the last recession that were ineligible to collect state money but could qualify under federal?

Industrial production

Q4 IP was up 3.05% for the quarter, but down -3.6% for the year. Those market groups that felt the brunt of the covid lockdowns were in business equipment, specifically **transit and industrial down 14 and 7% respectively**. In the Industry group Manufacturing **petroleum and coal products, printing and support, and primary metals were down 13, 10 and 8%** respectively, while **mining was down 12% for the year**. Motor vehicles recovered and were up 3.6% for the year, the second-best industry group after Natural Gas, which was up 5.1%. **Capacity utilization has climbed back 10% points from the low in April to a 74.5% level.** My call of a negative IP for the year was a conservative one, but still one of the few I got right.

Housing

New home sales for December were up 841k per year, off from the previous four months of 900k numbers, but still well above anything for the past 12 years! **Existing Home Sales picked up steam as well, rising to 6.690mm** for November (down from October), a number not seen during the past decade. The median sales price of existing homes was 310k up 14.6% from the same time last year, whereas average sales price was 343k up 11.3%... inflation.

The Consumer

The Conference Board's consumer confidence index stood at 88.6, down from the 101.4 peak in October, as the reaction to increases in Covid cases made consumers decide to cancel many vacation plans in leu of buying durable goods. Consumers are also not viewing the economy in 2021 as doing much better or having a breakout year. University of Michigan's consumer sentiment index was back up to 80.7 in December after falling to 76.9 in November, but at the time of this write up is back down to 79.2. **The savings rate has come down to 12.9%** as of December, close to a third of spike of 33.7% in April of this year. Total consumer credit was down from Nov 2019 to November 2020 about 4 billion dollars. Interestingly revolving consumer credit (think credit cards) was down 115 billion (bulk of which was paid back in March, April and May) while non-revolving (think student loans and cars) was up 111 billion. The consumer paid back a little credit card debt (average increase about 24 billion a year for the past ten years) and didn't take out as much debt for car and student loans (average increase is about 140 billion a year for the past ten years). Maybe parents got tired of paying 60k a year for their college student to be on zoom sessions all day long…

There are currently 2.7 million mortgages in forbearance or just over 5% of the total mortgages outstanding. This is down from the peak of 8.6% in June which should be good thing. But what this number is hiding is just what percentage of those in forbearance are going to be able to repay or fall off the cliff. It seems to me that those that have been able to pay are currently paying meaning the 3% that rolled off last year were those people that got back on track, while the remaining five are treading water with government assistance. ATTOM's yearend 2020 report said foreclosures were also extremely small this year because of the moratorium, only 214k or 57% off of 2019. But the thought here is that there will be a huge backlog of foreclosures once the moratoriums end. Let's see if it will get to the 2.9million reported in 2010. I don't think the consumer is on firm footing or they feel their situations are going to get much better in 2021.

Inflation

As of December, **CPI was 1.29%**, and PCE was 1.13% for November. If it held the annualized rate of inflation would be north of 4%. **Used Cars and Trucks were up 10%** over the past year, followed by piped utility gas up 4.1%, while food (both at home and away) was up 3.9% over the past twelve months. Energy were the big losers for the year with gas down 15.2% and Fuel oil down 20%. Shelter was up 1.8% for the year with rent up 2.3% and OER (owners' equivalent rent) up 2.2%. The reason shelter as a total was lower than those two components was because hotels and motel cost was down -11.2%. (Oh but school housing was up 2.1%). The Fed has blatantly failed at achieving its 2% target for inflation and will continue to fail as its and other central banks policies become more and more irrelevant. But like FDR outlawed owning gold in 1933, what is to say (the ECB has already indirectly said it) that private crypto currencies won't be illegal to own or transact in soon, and therefore reserve banks continue to hold onto their ability to manipulate prices of securities and other assets for a little while longer.

In Closing

I am pretty disenfranchised with what our economy has become and how it marches its way to some semblance of a planned economy. Market prices of securities are so far out of touch with reality it would be comical if the future of our wealth and those of our children won't be greatly affected by it. None of the above macro statements matter anymore, tracking jobs or housing or any other statistic is useless, as those pieces of information have been irrevocably altered through lock downs and fiscal transfers.

I am faced with an almost impossible investment decision. If I remain uninvested because of the disconnect between asset prices and reality I will surely lose a substantial portion of my clients if not all. On the other side if I invest client assets in this time and we have a 50 to 80% equity correction coupled with a blow out in spreads for non-treasury securities, I will lose a great portion of the wealth my clients have worked their entire lifetimes to accumulate. There simply is no right choice here. The price disconnect can last for years and we will no doubt see both fiscal and monetary actions continue to obfuscate reality. So then do we just hold our noses and play the game or wait it out until the real economic forces come to bear?