07/31/21

Quarter in Review

The Markets

The second quarter seems to have been the peak of many different things from asset prices to the rebound in the economy, to daily vaccination rates. Bitcoin hit its peak of $64k, only to end the quarter almost down 50% to $34k. Most estimates were that the economy grew at a range from 7 to 9% annual rate in Q2 but just like inflation estimates, economists missed badly, and it only grew by 6.5%. Daily vaccine rates peaked in the beginning of April around 4.4 million a day and then have been in decline to around 600k at the end of June while the US began exporting millions of vaccines to the rest of the world. One data point that doesn't seem to have peaked is inflation, which was 4.15%, 4.93% and 5.32% year over year for the past three months in each of the respective months. With used cars accounting for more than 1/3rd of last month's increase, and energy and food contributing heavily as well, Federal Reserve officials betting on inflation being transitory because of base effects from last year, are starting to squirm a bit in their seats. Even without energy or food, core inflation was up 4.5% year over year ending June. In June the Fed came out a little more "hawkish," by showing via their dot plot (a graph assumption each member has on where rates will be in the future) their beliefs. The market tries its hand at divination by using the graph to estimate when the first interest rate increase (hike) will be. And from the June dot plot it seems like "lift off" will be in 2023, earlier than expected. Another high was JPM's largest ever bank issuance of $13 billion in bonds in April. The President also proposed doubling the capital gains tax to 39.6% or 43.4% when Obamacare surtaxes are included, in addition to raising corporate taxes to help pay for his planned expenditure bills. This was preceded by the Secretary of the Treasury arguing for a global minimum tax rate of 21%, which was subsequently then brought down to 15% in mid-May. Lastly India saw a surge in Covid cases and deaths as the countries medical system became overwhelmed, which peaked daily cases near 400k.

There were also a couple of troughs as well during the quarter as Archegos Capital Management collapsed costing Credit Suisse Group $5.5 billion. Shockingly bonuses have been cut back and the heads of their prime brokerage have departed, along with 30 other senior bankers that saw next year's bonus evaporate. Apple and Alphabet were dragged in front of the Senate Judiciary Committee to speak about how they run their app stores in late April. In the beginning of May Infineon Technologies AG warned that 2.5 million cars won't be produced this year because of supply chain bottlenecks. By mid-May the Justice Department and IRS were investigating Binance Holdings, LTD (a bitcoin marketplace), followed by the UK's Financial Conduct Authority banning its affiliate Binance Markets Limited. UK citizens could continue to use Binance's non-UK operations. I wonder whether that will hurt its IPO… who am I kidding. Even though inflation has been climbing, the Treasury curve has flattened with the 10 to 30-year dropping around 30 bps each as the time of this write up. Inflation reduces the value of fixed income instruments, which should be causing bond prices to fall, but is seems fear of another recession (this time one longer than two to three months) might be spooking markets, or the fact that there are trillions of dollars sloshing around in the system looking for a home.

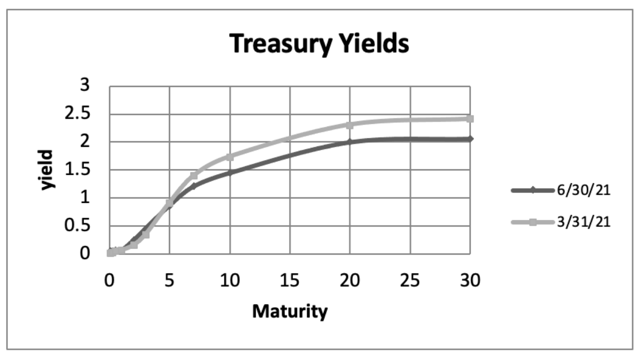
In other news, the Federal Reserve Chairman stated that the Fed was in a large-scale research project on a digital dollar while El Salvador intends to make Bitcoin legal tender. A US proposal was being considered and then dropped (as Germany opposed it) to waive patent protection for Covid-19 shots. Amazon bought MGM for $4.45 billion in late May, while Discovery will merge with WarnerMedia (as AT&T divests). And lastly the US and the EU are announcing a five-year truce over aircraft subsidies to Airbus SE and Boeing, Co., mainly driven by the China aircraft maker Comac.

The markets in the second quarter of 2021 were up across the board as disparate asset classes had stronger correlations. The big winners for the quarter were Commodities (+16.4%) and Real Estate (+12%). Bonds were up as well but Long-Term Taxable bonds were up the most (6.4%). Stocks and Global bonds were up for the quarter but have reversed their course heading into June. Stock returns for the quarter were up around 5% and about 1% for global bonds, but June had negative returns. YTD Commodities and Small Cap Value stocks (31.7% and 26.7% respectively) held the top spots, but Real Estate and Mid Cap Value wasn't far behind (21.8% and 19.45%). I believe the stock and bond markets are grossly overvalued, and at a very dangerous place right now. **The Shiller PE ratio currently stands at 38.68**, and it has only been higher once over the past 150 years and that was before the dot com bubble. **The Buffet Indicator (Wilshire 5000 full cap index over US GDP nominal) stands at 205%**, while the closest prior peak was 140%, again before the 2000 dot com bubble period. Even other measures, corporate equities to GDP or Dow to GDP, show the markets are simply off the scale. To put bonds in perspective, ONLY CCC rated bonds have a positive real rate of return (return minus inflation). Although spreads (the amount of yield above a similar maturity risk free bond) have been tighter historically, durations have extended because coupons have collapsed, and maturities have lengthened. The Barclays Aggregate Index had a modified duration of sub 5 for the first ten years of this millennium. Since then, it has steadily increased to 6 through September of 2018, only to fall back to mid fives until March of 2020. It currently stands at 6.6 while spreads are roughly 55 bps, and yield to worst is 1.39% in a 5% inflation environment. Duration is the sensitivity of a bond to changes in interest rates, the higher the number the more sensitive. An increase of 1% will cause a decline of around 6% in value for a bond with a 6 duration.

Interest Rates

The Federal Reserve's balance sheet **expanded by $390 Billion to $8.1 trillion** in the second quarter of 2020. On June 18th the Fed increased the rate it pays on excess reserves *and* overnight reverse repos by 5 bps. Both banks and money market funds, are awash in cash to the extent some are having to turn away deposits. Increasing these rates only makes these institutions utilize the Fed more instead of investing in other assets. As the US Treasury spends down its general account at the Fed, spending more without issuing new treasuries, less treasuries are thus available for institutions and investors to buy, therefore treasury bonds are increasing in price from a scarcity standpoint. Instead of letting these bonds go into negative yielding territory by institutions bidding up the price, the Fed has sucked out trillions from the banks and money market funds, relieving the pressure somewhat. But that is NOT the naturally way of markets and needs to be unwound. This only happens if and when the Fed stops buying $120 billion per month of Treasury and Mortgage back securities. To me they are trapped. They know there is a bubble in most assets and the second they tighten, (e.g. 2017-2018) they have a huge problem on their hands. Now the economy is starting to slow, inflation pressures are up, and fiscal stimulus checks are almost done. They need to let interest rates rise in a managed approach but they needed to start yesterday. The treasury curve flattened with the back end of the curve coming in about 30 bps as long dated treasuries were well bid during the month of June, coinciding with the equity sell off.

Years	6/30/21	3/31/21	Difference
0.08	0.05	0.01	0.04
0.24	0.05	0.03	0.02
0.5	0.06	0.05	0.01
1	0.07	0.07	0
2	0.25	0.16	0.09
3	0.46	0.35	0.11
5	0.87	0.92	-0.05
7	1.21	1.4	-0.19
10	1.45	1.74	-0.29
20	2	2.31	-0.31
30	2.06	2.41	-0.35



The Primary Mortgage Market Survey from FHLMC showed the 30-year conforming balance fixed rate mortgage dropped back to 3.02% at the end of June from 3.17% at the end of March. 15-Conforming balance loans also fell back to 2.34% in June from 2.45% in March. The declines were a half to a third of the decline in long-dated Treasury bonds. This coincides with a drop in mortgage applications at the same time coupled with declines in affordability from large increases in housing prices.

The Mortgage Bankers Association showed mortgage applications continued to decline for the week ending 07/21/21, dropping 4% from the prior week. The average FHA rate for fixed rate 30-year conforming balance loans was 3.11% up from June month end with 0.43 points for 80% LTV loans. Jumbo loans (larger than $548k) rates were only slightly higher at 3.13% with .32 in points. 15-year fixed rate mortgages have increased since last quarter to 2.46% with 0.30 points. Lastly the average 5/1 Adjustable-Rate Mortgage decreased to 2.74% from the previous week's 3.02% with 0.19 in points. The declines were caused in part by the bid in Treasuries and their lower yields, but the decline in applications should be attributed to the affordability problem and smaller house inventory.

Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) stood at 115.1 in June (111.6 in March), climbing from 109.6 in December. Eight of the ten contributors to the index were positive for the month. The largest two were the decline in unemployment insurance claims which declined throughout the quarter, and ISM New orders which has been in positive territory throughout the year. The two areas for concern were the steady decline in the average workweek for production workers and the decline in building permits. Although housing starts were up over the quarter new permits have slowed, showing a future slowdown in building. Manufacturing new orders for consumer goods have only been positive twice this year, and the June number is still a statistical input. Manufacturers new orders for nondefense capital goods excluding aircraft has been hovering around zero for the year, vacillating between positive and negative each month. I don't expect the LEI to reverse trend in July but it is going to slow down if not go flat, with several indicators hovering around zero and claims having reversed in July.

Jobs

At the time of this write up, **nonfarm payrolls** posted an **increase of 850 thousand jobs for June.** However, the quarter and really the year so far, has been disappointing for job gains. The average for the payroll survey has been 543k per month, and the household survey is 295k, with June turning negative. As the National Bureau of Economic Research (NBER) has just stated, the recession only lasted 2 to 3 months (admittedly the data they follow support this), and the job gains from May through August 2020 were substantial. But from September 2020 going forward, especially after more lockdowns in the latter half of the year were enacted, the gains have been sporadic, and industry specific. Economists have missed, terribly, estimating job gains although the BLS survey has been imperfect to say the least through this time period. What is frustrating is the lack of willingness to adjust the survey or even attempt at a reconciliation between claims.

Temporary services, which lost almost a million jobs during in April 2020 alone, is still about 280k short thanks to losing another 122k this April. The unemployment rate was stuck near 5.9% for the quarter and the civilian labor force participation rate was also stuck at 61.6% and has been around this number since August of last year, declining and then rising again. The long-term average has been about 62.9%, but pre covid shut down was 63.4%. That is about **six million people** that have been removed from the workforce. **Manufactures lost a total of 578k jobs in 2020,** and year to date they have added about 87k. As new orders are still climbing, manufacturing is struggling not only with material supplies shortages, higher transportation costs, but also labor shortages.

Unemployment claims at the time of this write up stood at 400k, lower than last weeks revised print of 424k but still higher than June's mid to high 300k range. Claims have been in a downward trend from their April 2020 peak of over 5mm, but still double its pre-covid levels. The real data point that is being watched though is the Total Claims number, which includes both the Pandemic Unemployment Assistance and the Pandemic Emergency UC. These two programs together account for 74% of the total claims, whereas regular state accounts for only 25% (the missing 1% is from other claims programs). They will expire on September 4th of this year, and 25 states have ended the extra benefits early. Job openings are now at 9.2 million and many pundits are arguing different sides to this issue. Is paying people more to stay home a disincentive to find work? Do people feel comfortable going back to work once vaccinated? Is there a structural problem where people do not have the skills required for a specific role? Or have people in the restaurant/bar and retail industry found more gig related jobs and thus not returning to previous roles? As with every difficult problem there isn't a single answer, there are millions of people each with very specific situations. I don't believe there will be a large September employment pop once the assistance stops. People put a lot more away in savings as the personal savings rates have been in the double digits since March of 2020, and revolving credit was down over $117 billion last year (people paid off credit card debt). Real personal income less transfers (non-government assistance program money) was up 4.66% year over year ending June, this is above pre-covid shut down level. People may be in a better position to wait for higher pay even though the unemployment market shows otherwise.

Industrial production

Q2 IP was up 1.17% for the quarter, and Q1 was revised up over a percent to 0.67%. Therefore, IP YTD is positive following being down for 2019 and 2020, -2.2% and -3.28% respectively. IP isn't close to the levels in 2018 when it started to fall in Q4, but has come back, and so has **Capacity Utilization at 75.4,** down from 76.1 at the beginning of the contraction in February 2020. Manufacturing employment is still lower by 474k jobs since January of last year, and almost all the comments from the ISM survey talk about strong sales and production, limited by supply chain restrictions, and rising prices which are now being passed on to the consumer, and lack of available labor. Let's see if some of these labor issues start to resolve themselves after September 4th.

Housing

New home sales fell to 676 thousand per year in June 2021, lower than before the pandemic shut down. In fact, the March numbers were revised from 1.021 million down to 873 thousand (a 14.5% lower revision!). The peak of **existing homes** in January has remained, as the average for the quarter was 5.83 million homes per year. In June the number rebounded from a steady decline since January, with economists citing strong demand and limited inventories. Low interest rates and mortgage-backed securities purchases from the Fed, have driven up the cost of houses faster than ever. At the time of this write up the **Case-Shiller index for home prices were up 16.61% (**in

May mind you), the largest year over year increase in the index's 33-year history. As the National Association of Realtors reported in July, the median *existing* home sales price was up 23.4%, a record not seen since 1999. Also, existing homes were on the market for just 17 days, **and 89% of homes sold in June were sold within a month.** New building permits were down in each of the months in Q2 and down 5.05% in June alone. Housing starts have increased in June to 6.27%, but this is more a coincident or lagging indicator than permits. Even though the Homebuilder sentiment index has been above the pre-pandemic average levels since August of last year, completely detaching from the Homebuyer confidence index which, is at multi-year lows. New home supply has rebounded and is above the six-month level, seen prior to the shutdown, (it was north of 8 months in 2010 after the last recession). Inventory is a way off from the oversupply seen during the financial recession of 08-09, but people and companies have short memories.

The Consumer

The Conference Board's consumer confidence index stood at 128.9, up from 109 in March and 87.1 in December. The June (and July) numbers are very close to pre closure levels. In July the number stands at 129.1 and the consumer opinions were stable on the economy, jobs, and inflation. The interesting statement was that more consumers were looking to buy housing, cars, and other durables. This unfortunately didn't jive with the July report on new durable goods orders, which was up only 0.8% from June compared to May's revised positive increase of 2.3% on a monthly basis. It would seem to me as the stimulus checks are running out, so are purchases of large ticket items. I would go back to the new home sales numbers are well. This topping out in June was also supported in the University of Michigan's survey which dropped from 85.5 in June to 81.2 in July. And now consumers are commenting on the affects of price increases across a slew of durables and non-durables. As of June the personal **savings rate stood at 9.4% and May's was revised from 12.4% to 10.35%**, which declined over the quarter from a 26.9% level. Real personal income less transfers is up about 4.66% for the past twelve months but mostly flat for the quarter, this number excludes unemployment and the stimulus money. Real personal consumption on durable goods is still above pre shutdown levels but is dropping steadily since the last March round of stimulus.

The most recent consumer credit data is as of May of this year. **Revised Revolving credit was down $117 billion in 2020.** YTD revolving credit is up by $5 billion. I expect this number to be much higher by the end of the year as stimulus disappears and the desire to consume remains. **Nonrevolving consumer credit (autos and student debt)** was up $110 billion last year and is already up $93 billion through May, and while credit card debt fluctuates much more, non-revolving credit is smoother, and thus could be up over $220 billion this year, or the highest single year increase in a decade. Last quarter I wondered how the consumer would react to no stimulus checks coupled with eviction moratoriums ending. My view is still that the consumer is in a good place and has squirreled away a large sum of money, but inflation has taken hold and the argument over "how long" the definition of transient is, is laughable at best and criminally incompetent at worst. As I will discuss below, this quarter saw inflation not seen since the financial recession of 08-09, and before that not since 1990.

Inflation

As of June, **CPI was 5.32%, PCE 3.99% and the GDP deflator was 4.01%.** The dismissive nature of the Federal Reserve's statements on inflation shows a level of hubris typical of their predecessors for the past 20 years. It is dangerous and unnecessary. Now that NBER has shown the 2020 recession started in February and ended in April, now that GDP increased at an annual rate of 6.3% in Q1 and 6.5% in Q2**,** now that inflation is above 5%, and housing is up over 16% nationally and 23% in existing home sales, how on earth can they continue to buy billions of debt monthly in the treasury and mortgage markets? I do believe that our nation needs infrastructure investment, but if we pass a bill(s) that unleashes 3 to 6 trillion dollars, the Fed will have no option to EVER stop quantitative easing and buying this debt, as there is simply no longer a market for it, and inflation will continue to accelerate.

In John Greenwood and Steve H. Hanke's July 20th 2021 opinion piece in the WSJ entitled "Too Much Money Portends High Inflation," the chief economist at Invesco in London requoted Milton Friedman's famous statement that "Inflation is always and everywhere a monetary phenomenon." The article argues that during Mr. **Powell's Feb 23rd testimony** to congress, his statement that the money supply, specifically M2 "doesn't really have important implications," and that "we repeatedly hear inflation is anomalous and transitory," was **"wrong."** I agree, it keeps me up at night, and in an already extremely tired, nerve frayed, rage filled country the LAST thing we need is oppressive inflation.

In Closing

I am not chartist by any means, I was raised in a value shop and studied at the birthplace/Mecca of value investing. But I have come to appreciate one chartist's twitter rantings (although I am still not on twitter and about to pull the plug on LinkedIn). His name is Sven Henrich and he once tweeted "Sometimes I feel like I'm standing on the Titanic screaming "iceberg" while everyone keeps on dancing on the deck below." That is exactly how I feel.

Scott Rubner a trader at Goldman Sachs observed early on in July that in Q1 2021 global equities recorded the largest inflow *ever* on record for the first half of the year, $517 billion, which is **2.6x higher than the prior record in 2017.** Q2 2021 recorded the second highest inflow at $169B which was only beaten by Q1 2021 at $348 billion. If annualized or extrapolated for the entire year, this would mean that **2021's inflows would be greater than the prior 20 years… combined!** If you haven't picked up your copy of Manias, Panics and Crashes, now is a good time to add it to your summer reading list.

Our economy and our people have just begun to heal from last year's experiences. Job growth looks ok, pandemic emergency (not just state), unemployment claim numbers are falling. The economy has reopened, people are (or were) traveling. Even summer camps are back open, although I sometimes expect my younger son's bus driver to scream "show me your paperz!" in a Sergeant Schultz voice (look it up millennials). But GDP will start to slow, the remaining 10 to 15 million people that are still out of work may have pricing power, or they may not because their skills need to change. Interest rates are at rock bottom, exacerbating the housing shortage/affordability issue. Industrial production has reversed the two-year downward trend, but price pressure and labor shortages permeate almost every industry. Housing sales have started to come off the boil, and hopefully buyer reluctance to enter here slows the price appreciation as we have witnessed (and seemingly forgotten) the last time we ran up home prices over 14 years ago, and how that ended. But that won't help renters, especially those 14 months behind and now outside of the eviction window. Prices are going up, period, and option markets are pricing in some action by the Fed in their Jackson Hole meeting in August and a more hawkish tone in September.

As inflation has started to show its head, I switched out of short-dated treasuries and corporates and into floating rate debt with a commodity hedge in case inflation starts to get out of hand and the Fed doesn't start to taper their bond buying programs. This is one of the most dangerous investing times I can remember since 08/09, and the irrational exuberance is palatable and mind numbing. I also feel like I am "Waiting for Godot," and try to remember it took three years for Grantham to be right on Japan, as I have now been out of equities for over 15 months. The Wilshire 5000 full cap price index is still 2x that of US GDP, while the Shiller PE is now north of 38 (with a 140 year mean of 16.8). Weekly Economic indicators, from both the Fed and Barclays continue to slow from their January peaks, dusting off authors use of the word "Stagflation." I will wait to see how July inflation shakes out as that will probably shape the Fed's Jackson hole comments and its September meeting decision to curb QE. If so and interest rates start to pop then I will exit commodities, which are not huge fans of rising interest rates. But I am starting to feel, and reading more articles that support that feeling, that we are the next Japan, and the Fed will never stop QE, they can't, and the next thing they will do when the market crashes is buy equities. Heaven help us if they do.