10/28/21

Quarter in Review

News

I don't really see the need to write these anymore as none of the underlying data, suspect at best, and manipulated at worst, matter. The only thing that matters anymore is whether the Fed is printing 120 billion in cash every month, while not meeting either of its mandates. And with Q3 GDP about to produce a proverbial goose egg, let's see if Powell has the stones to start tapering in November, or if he holds out for a double-digit CPI print, oh sorry they only look PCE now.

The delta strain of covid went from 14k cases in the US a day in the beginning of the quarter to over 192k a day at the end in September, while deaths went from 200 a day to 2,269 over the same time period. To make matters worse in late July a study from the Israel health ministry stated that Pfizer's vaccine was only 39% effective in preventing people from being infected by the delta variant. Most corporations postponed their return to the office until the fourth quarter of 2021 because of the increase is cases. In mid-August China closed the world's third busiest port on corona concerns, while the FDA authorized giving a third dose of vaccine for the medically vulnerable. And the hits kept coming as a large study done in the U.K. showed that those that had been inoculated but infected carried the same viral load as those that did not take the vaccine. So covid is still with us, still causing havoc and we are just now experiencing the price increases due to the shuttering of our supply chains, while OSHA finalizes that all employees of firms greater than 100 people must be vaccinated.

China cracked down on tech firms, for profit educational institutions and finally property companies, this quarter. They suspended the Ant Groups stock market debut, a rebuke to Jack Ma's October 2020 speech about the regulatory system. Tencent was fined for anti-trust action and hurt by the country's-imposed limit on game time, to help combat addiction. Didi Global saw its stock plunge as China ordered all app stores to remove the company from their listings. Meituan, a food delivery unit, had anti-trust issues as well, accused of violating human rights, stock fell 17%. In July China also barred for-profit tutoring, and thus for-profit education companies saw their stocks drop like stones. In August retail sales in china were up only 2.5% yoy vs an expected 7%, while construction investment contracted 3.2%. But the big news was that Evergrand Group the largest property developer and hugely indebted company in China started to default on its bonds not paying foreign investors in late September. To round out the corporate news both Sands China Ltd and Wynn Macau Ltd. Declined 30% after China said would appoint representatives to "supervise" the businesses. And last but certainly not least Crypto related transactions have been made illegal in China as announced by the PBOC on 09/24/21. Although El Salvador officially adopted bitcoin as legal tender on 09/07/21, the next day Bitcoin plunged 17%.

The Taliban retook Afghanistan in about three months ending in August after the US military pull out. Many people desperately tried to leave the country. The US evacuated over 122k people prior to the 08/31/21 self-imposed deadline, ending a 20-year conflict which killed 2400 Americans and cost over $1 trillion. On 08/27/21 13 US soldiers and 170 afghan civilians were killed in a suicide bombing at the airport during the evacuation. The US response was to target an ISIS-K leader, instead it killed 10 civilians, seven of whom were children.

The next biggest story of the quarter was inflation, and although oil has popped substantially here in October, almost all commodities with the except of natural gas held steady. In mid-July a deal was reached by OPEC to increase the supply of oil to 400k barrels a day. Natural gas however in the US it was up almost 60% in Q3 and 126% ytd ending early October, while in Germany it was up 459% (insert smiling picture of Putin with a Nord Stream 2 sign). Outside of the commodity space inflation has now become much less “transitory,” than the boys in the Eccles building first imagined. CPI printed above five percent in each of the months in Q3 while PCE printed above four in the July and August. (September comes out at the end of October with GDP)

Speaking of the Eccles building, disclosures showed both Boston and Dallas Fed presidents Rosengren and Kaplan actively traded during Federal reserve decision to support markets, they then sold their stocks, and both resigned. The Vice Chair, Clarida was also shown to have traded, and the Fed Chair Powell did as well. Rosengren and Kaplan were regarded as more hawkish than Clarida who has not resigned, and Powell, up for nomination to a second term next year has seen his chances fall as the ultra-dove Lael Brainard sees her chances rising.

The President and congress have been trying to get through an infrastructure and social spending bill totaling close to $4.7 trillion, both of which have been held up by disagreement between democratic moderates and progressives. As the senate is evenly split between Republicans and Democrats, only through the reconciliation can they get it passed, and at this juncture neither look like they are getting down unless they are drastically cut in both dollar amount and duration of underlying programs.

On 07/31 Robinhood, the online/app brokerage house had its IPO, the share price fell from 38 to 34.82 on the first day of trading. I surged north of $70 in the beginning of August but ended the quarter at 42.08. Insider ownership percentage is currently at 0.27%... essentially nothing.

On 09/26/ 21 the SPD and Olaf Scholz garnered the most votes in German national election with 25.7%, replacing the CDU as the top spot but not close enough to form a government without a multi-party coalition. As of October three parties, the SPD, Greens, and Free Democrats were holding talks, which would put the CDU in opposition.

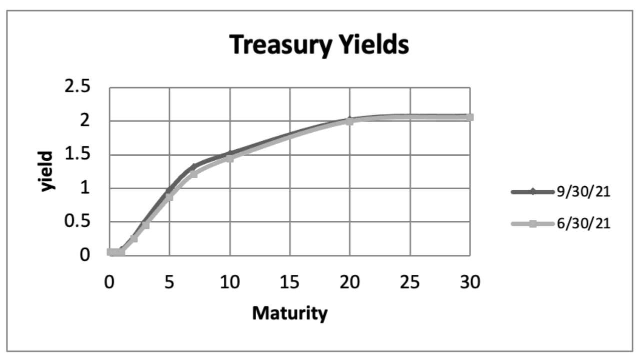
Markets

Stock didn't do well this quarter with value names down anywhere from -.78% for large cap, to almost down -3% for small cap. Emerging markets were the big loser though down 8.6% for large cap names. Bonds didn't fair any better with all taxable indexes flat, world bonds down -1.59%. Tips and High yield were the winners this quarter up 1.75% and 0.74% respectively.

Interest Rates

The Federal Reserve's balance sheet **expanding by $390 Billion to 8.4 trillion** in the third quarter of 2021. Chairman Powell during Jackson Hole confirmed that bond purchased would be reduced this year, but that rate hikes would happen for a while. The September meeting showed multiple members are more concerned with inflation than in Q2, and the expectation is now November will announce a reduction in purchases. The estimate is for the reduction to end by mid 2022, with Bullard saying to end the reduction by March 2022.

Years	9/30/21	6/30/21	Difference
0.08	0.07	0.05	0.02
0.24	0.04	0.05	-0.01
0.5	0.05	0.06	-0.01
1	0.09	0.07	0.02
2	0.28	0.25	0.03
3	0.53	0.46	0.07
5	0.98	0.87	0.11
7	1.32	1.21	0.11
10	1.52	1.45	0.07
20	2.02	2	0.02
30	2.08	2.06	0.02



The Primary Mortgage Market Survey from FHLMC showed the 30-year conforming balance fixed rate mortgage was almost exactly the same at 3.01% at the end September compared to 3.02% at the end of June. 15-Conforming balance loans 2.28% in September compared to 2.34% in June. Lastly the 5/1 ARM mortgage, higher than the thirty-year in beginning of the year, is now at 2.48% down from 2.54% in June.

Leading Economic Indicators

The conference board is no longer providing a breakdown of their index in their technical notes. I will start to make a spreadsheet tracking the components and hopefully from their white papers can build something to talk about next time. The Conference Board's leading economic indicators (LEI) stood at 117.1 in August up from 115 in June with 9 out of ten components contributing positively. The coincident indicator was 105.9 for August up 105 in June, while the lagging indicator was 106.3 up from 105.9. Essentially all indicators were pointing to a continued recovery despite inflation, labor shortages, supply chain issues, declining consumer confidence…

Jobs

At the time of this write up, **nonfarm payrolls** posted an **increase of 194 thousand jobs for September.** Other than July, which printed over a million jobs gained, August at 366k and September at 194 showed a steep drop off in job gains. Even with stimulus checks ending, it doesn't seem as if people are entering the work force again, and if so, they are waiting out for higher paying jobs. The JOLTS report in August showed that we have over 10.4 million job openings, while Americans are quitting their jobs at record rates with 4.3 million in August up 242k from July, and employers only laid off 1.3 million. With many more workers looking for a new job over the next twelve months, it looks like the pandemic has cause a lot of people to take a pause and look at what they are doing with their lives. As of the time of this right up **new unemployment claims** fell to 290k from, while continuing claim dropped to 2.5 million. All claims have fallen to 3.6 million as the Pandemic Unemployment Assistance and the Pandemic Emergency UC have dropped off since September. They stand at 517k and 331 respectively compared to 5 and 3.7 million at the end of August.

Temporary services, gained 9.7k jobs over the quarter, but August and July saw declines in each month. In 2020 we lost about 330k jobs and YTD in 2021 we have made back only 67k of those. The unemployment rate has fallen from 5.9 in June to 4.8%, but the labor participation rate hasn't moved since April of this year at 61.6% vs 63.4% pre pandemic. That equates to over 5.5 million people that have essentially left the work force, in addition to the 5 million that haven't been recovered in the nonfarm survey. **Manufactures lost a total of 578k jobs in 2020,** and year to date they have added about 215k.

On the surface this job data doesn't look great, but we have gained back about 77% of the jobs lost during the pandemic. The issue I think is that there is permanent scarring and structural issues with the remaining unemployed. Coupled with stimulus checks and the Fed injected mountains of cash into the system, we aren't necessarily where we were in February 2020, and the consumer/employee doesn't feel we have either.

Industrial production

Q3 IP was down -0.41% for the quarter, as Q1 and Q2 were revised upward to 0.89% and 1.27%. Year to date Industrial production is up 1.76% following being down for 2019 and 2020, -2.2% and -3.28% respectively.

Although the numbers have a decent way to go, I am a bit surprised at the recovery given the fact that less than half of the lost manufacturing jobs have been made back up. Surprised even still given the supply chain difficulties, and I am wondering if this is sustainable in its current form. **Capacity Utilization is back at 75.2**, albeit down from the 76.2 level in August. Manufacturing did add 114k jobs in Q3, but with Q3 GDP now estimates continually falling and now standing at 0.5 % (seasonally adjusted annual rate), and supply constraints in full effect, I don't know how this picks up more.

Housing

New home sales were up to 800k annually, a 14% increase from an adjusted August. August declined to 702k, and July was also down to 712k. Although this is down 17.6% from September 2020, it is still well above the 2019 and 2018 average of 685k and 618k respectively. Now as interest rates start to creep up let's see if that continues. At the time of this write up the At the time of this write up the **Case-Shiller index for home prices were up 19.7% e**nding in July of 2021. **Existing home sales** jumped in September up **6.97% to 6.29mm** houses annually, while Zillow (yes the online real estate information system) said it can't buy any more houses this year as they are experiencing backlogs renovating houses. **Median existing home price** currently stands at $352,800 which is 13.3% higher than a year ago. The average time a property remains on the market is still only 17 days, while inventory is estimated at on 2.4 months. The **NAHB home building sentiment index** stands at 80 for October up from both August and September mid 70s levels, but down from last years 85 number. But this isn't correlating to the national home buyers index from Fannie Mae, showing that only 28% of consumers thought it was a good time to buy and 66% of respondents said that it was a bad time to buy. There are less fears this time around that we are going to overbuild, building Permits were down over 7% in September to 1.589 million exceeding the 1.3mm 62 year average, and not near the 2.1 million average from 2004-2006. New housing completions have been down -5.8% and -4.6% over the last two months as well. But I have major concerns for people injecting large amounts of capital into high priced houses. If interest rates do rise to combat inflation (and they are rising now albeit slowly), then these house values will be in decline for some time. If we enter a recession and people start to lose their jobs as well, then forced sales will occur again.

The Consumer

The conference Board's consumer confidence index stood at 109.3 in September down substantially from the June peak of 128.9. The blame was the Delta Variant but on the economic side concerns for short-term growth prospects and reduction in spending on durable goods and housing coupled with rising inflation was probably the meat of story. For perspective, consumer confidence was above the 100 area prior to the great financial recession in 2008, then dropped below 30 and climbed back into the 120 range since 2017, it then fell to 80 during the pandemic. **The Michigan Consumer sentiment index** stands at 71.4 (October Prelim), down from its April peak of 88.3 while inflation expectations for the next year are 4.8%, a level not seen since the middle of the great financial recession. Consumer responses to Michigan survey mostly ignored the machinations about the debt ceiling this time around, concentrating on the delta variant, supply chain shortages and labor force participation. The surprising thing to note is that the survey writers said that it would dampen consumer spending into 2022, which correlated with a Deloitte survey showing that 11.5% of holiday shoppers said that they would spending nothing this year on gifts and services, in comparison to 4.9% last year. Speaking of spending, monthly positive changes in real personal consumption expenditures on durable goods correlate almost perfectly which each fiscal monetary injection over the past two years. And when they went negative… another injection of fiscal money. Since April of this year those expenditures have fallen in every month, especially as prices have risen.

The most recent consumer credit data is as of August for this year. **Revolving credit is back above a trillion outstanding**, gaining another 8 billion for the first two months of the quarter. I anticipate September will be even more as stimulus checks stopped. Looking at non-revolving consumer credit, it is as if the pandemic was a blip on the radar, now up $134 billion for the year through, we are on track for the highest year over year gain since 2016 and are already up $235 billion since January of 2020.

The consumer has pushed the pause button on expenditures in durables, which correlates with The Advance Monthly Sales for Retail and Food service. This quarter was flat but excluding Motor Vehicles and Parts they were up 1.87%. Annualized numbers for Retail sales ex autos between the two past recessions are about 4% normally. But the consumer looks like it is starting to put more on the credit card as annualized numbers turned positive in July and August of this year.

Inflation

April CPI – 4.15%, May CPI – 4.93%, June CPI – 5.32%, July CPI – 5.28%, August CPI – 5.2%, September CPI – 5.38%.

Inflation is not transitory. As per the October Apartment List National Rent Report the national median rent increased 16.4% since last year (this has not made its way into the CPI numbers yet). The Manheim used vehicle value index was up 37% from October 2020 (used cars is on a lag into CPI). Gasoline is up 42% as per the CPI (granted we have seen higher gas prices from 2011-2014 north of $3.5 a gallon), but with oils dramatic climb recently, we could get back there soon. Year over year the variable portion of my electric bill was up 42% and my variable Nat Gas was up 72%. Food across the board 4.6% with little difference between at home or away.

The Fed has been late for years in reacting to an event, albeit they dumped a boat load of money a month into the pandemic, but for the most part they don't have a good track record. I don't think we get ahead of this, and we will see persistent inflation for some time, especially since the supply chain issues are not scheduled to go away for some time. At 5% inflation only CCC bonds are now returning a positive real return…

In Closing

The S&P sold off about 5% in September but has since made it all back and then some in October. We have a little under two weeks until the Fed meets and officially says they are going to taper. The stock market doesn't seem to care much, while bonds have sold off a bit. The ten-year treasury is up about 36 bps to a 1.64 yield since the end of August, nothing to sneeze at but nothing to write home about either. Job growth looks like it has plateaued, if this was covid related we could see a pick-up in October, if it was wage related, then we might not without some stickier inflation. Industrial production faltered in September down 1.29%, how much of that was Hurricane Ida I can't tell you, but manufacturing doesn't look on the uptrend. Housing is less affordable even with mortgage rates near all- time lows, inventory is scarce, but builders are confident. I think the consumer has spent their stimulus checks, as there isn't a huge increase in savings amount, or dry powder left to spend as people have to start paying rent again which has gone up now 16% since last year. Inflation is 2.5x from target and holding steady. I believe it will pick up in Q4. as our inventory levels for natural gas are low, chips shortages are causing plant shutdowns for cars, and port back-ups for goods aren't clearing faster, but slower.

Market Cap Valuations remains at 2X GDP, while the Shiller PE is still at 38. Nothing has changed from last quarter. The Fed continued to buy bonds at 120 billion a month (actually 30 billion more, but what's a few billion among friends) while the S&P's correlation to the Fed's balance sheet is as close to one as you could get. In David Einhorn's Q3 2021 letter to Greenlight investors he stated **"…if the Fed were to actually fight inflation, it would harm the financial markets and trigger a fresh recession that our fiscal and monetary policies aren't capable of addressing. We don't think our leaders are prepared to take responsibility for doing so."** There is a ton more in his letter that I agree with, but the above sentence is very concerning. It means the Fed knows it is trapped, knows it blew the infinity bubble, has more inflation than it wanted and is praying it corrects itself, because if they do, it will destroy markets and the economy. They want a soft landing but have waited until the plane ran out of gas and are now trying to glide a 747 into a LaGuardia… good luck.