02/11/22

Quarter in Review

In the immortal words of Mel Gibson in Braveheart. "Hold…. Hold…. Hold!!!!" It has been two years of watching this clown show, humbling me in every aspect, and they almost got me. FOMO, TINA, BTFD… they almost got me. But the wheels are coming off, anxiety is setting in, and then will come denial and finally panic and anger. I will buy when depression sets in. Not yet.

In the meantime, we can turn to the ridiculous fabrication of a job report and corrections to open this quarters report. There are literally thousands of economic data points people pour over on a daily basis, making large economic and sometimes life altering changes, by moving their capital around. Unfortunately what is now most tracked are the comments of the Federal Open Market Committee chairman after the Fed's rate decision (not even a data point) after their decision on the level of the federal funds rate (almost a monthly occurrence). But the second most widely watched statistic is non-farm payrolls. If people are getting hired then firms' outlooks should be positive, and thus so should the economy, and therefore the NFP is watched very closely. As of the time of this write up, the Bureau of Labor Statistics (BLS) just did a revision of their data all the way back to 2017 (5 years is the time period the BLS uses in their ARIMA model for birth and death adjustments). The BLS tries to smooth their reported data to deliver a product more "consumable" to the financial community and general public. For years they have been criticized for their birth/death assumptions. This adjustment to the actual data tries to account for those new firms that were created but not accounted for during the observation period, and those firms that failed during the same period. The firms that "died" during the period are *removed* from the actual observations. The belief is that by doing this, it negates both the deaths and the births, and the real net can be accounted for by the ARIMA adjustment. The second adjustment made is using an auto-regressive integrated moving average (ARIMA) times series model. It takes a database of actual firm births and deaths over a 5 year period and applies the adjustments on a monthly basis to 15 different sectors. (https://www.bls.gov/web/empsit/cesbd.htm). People that look at data over a long period of time can start to "see" patterns, smoothing, or anomalies when presented with revised data. A portfolio manager I used to work with in a prior life always asked, "does it meet the smell test?" Now let's think about how many firms died over the past 2 years, whether due to the lockdowns, or simply reduced business, or higher input and labor costs. Simultaneously let's ask how many people *started* new business over the same time period. My suspicion is the scale is tilting way to the side of business deaths… therefore removing the actual business deaths from the model (and thus all the employees that lost their jobs) would probably **inflate** the reported number a substantial amount. So, if you are still with me and not fast asleep drooling into your keyboard or snoozing with your phone on your forehead try this on for size. The reported seasonally adjusted number for January 2022 was **up 467,000. The unadjusted number was DOWN 2,824,000.** Now January sees a lot of seasonal workers laid off but if you clicked the link above you will see that all of the jobs gained in

December, November and a good chunk of October have been erased. But the BLS' adjustments made for a positive number?!?!

The fear many of us have is that the Fed is simply too slow to smooth out the economic excesses and voids, and in fact only exacerbates them. Case in point, the US economy is undoubtedly slowing, you can see it in new orders and falling PMIs. But the Fed is about to start on a course of financial tightening at the same time (long overdue), and positive numbers in the NFP survey help support their actions. For how long will unfortunately be dependent on how far the stock market falls and thus the net worth of the Fed chair and the rest of the committee members declines. The investment community's belief, underneath the ridiculous S&P 500 level calls and even more ridiculous Fed hike estimates, seems to be that the economic downturn we are about to experience could be bad, with the destruction of more business and jobs if indeed the Fed raises rates 5+ times and starts to roll off the balance sheet.

News

Switching to lighter less ominous economic collapse topics now, we should go back to Q3 to recap a bit. In early September El Salvador officially adopted bitcoin as legal tender, purchasing 400 bitcoins at 52k… the price is now at 42k. The dollar index has since moved from 91 to 96… over the same time period. Nice trade guys. On the Fed side Boston Fed Chief Eric Rosengren and Dallas Fed's Robert Kaplan said they were selling their individual stock holdings by the end of September. Both were actively trading while the Fed was buying, essentially insider trading (like members of congress) without any ramifications. The UK energy market saw several small firms go out of business as surges in prices for inputs, specifically natural gas. In June of 2020 it was as low as 12 pounds per thermal unit (https://www.erce.energy/graph/uk-natural-gas-nbp-spot-price/). The price typical hovers around 50 (Since 2007), but as of the beginning of September it shot to 139 and topped out at above 400 in December, and now stands north of 200. Asia - In response to Evergrande (the most indebted property developer in China) potential default, China pumped $71 billion of short-term cash into the banking system to avoid contagion. China's central bank also posted an announcement on its website that all crypto related transactions were illegal. In Europe Olaf Scholz of the Social Democrats (red) defeated the Christian Democratic Union for a change to lead a coalition government. Eventually a "Traffic Light" coalition was formed with the Green party and Free Democrats (yellow) after two months unveiling a 177-page agreement. It covered a wide array of topics, one of which was to make it easier for immigration as Germany's population is expected to shrink from 83 million to 74 million people by 2060. The other more pressing issue is that Germany gets 40% of its gas from Russia, which the 177-page document didn't cover at all.

In October China Evergrande Group's shares were suspended in trading as Hopson Development announced it would buy a controlling stake, while Evergrande had a $260 million note due with no grace period. Fantasia

Holdings (another Chinese property company) failed to repay a $205 million note, adding onto the fears of a contagion in the industry. In Europe Renault SA cut production of cars as the chip production problems globally continue. Back in the US Treasury Secretary Yellen stated on October 29, 2021, that she would still say inflation is transitory even after five months of inflation at or above 5%.

In November the Federal Reserve finally announced that it will taper asset purchases by 15 billion per month, thus taking 8 months to fully stop buying treasuries and mortgage-backed securities. Oil peaked at $85 a barrel in late October then dropped all the way to $65 on December 1st only to end the quarter at $75 on its way to $91 at the time of this write up. The US government warned that Russia could invade the Ukraine as Russian military forces were amassing near the border. Inflation is not just a domestic issue as inflation numbers in the UK are the highest they have been in the past decade at 4.2% for October and did not ease for the remainder of the quarter printing 5.1% in November and 5.4% in December. Bitcoin meteoric rise and fall in Q4 2022 started around 43k, topped at 67k in the beginning of November and almost round tripped finishing at 47k. Jerome Powell was selected to lead the federal reserve again with Lael Brainard selected as the vice chair. The Senate must confirm these picks, but they should get confirmed with ease barring a massive inflation print or equity market crash. In late November a coordinated release of strategic oil reserves from the U.S, Japan, India, South Korea and the UK had little effect on the price of crude but it did move it lower. The US released 50 million barrels of oil to the market (https://www.energy.gov/articles/doe-make-available-release-50-million-barrels-crude-oil-strategic-petroleum-reserve). The daily consumption of oil in the US since 1965 to 2020 has been about 17.6 million barrels a day. (https://www.ceicdata.com/en/indicator/united-states/oil-consumption). So, we released less than three day's worth… wow. The real reason that commodity prices dropped was that a new Covid variant, Omicron, was found in Africa and rapidly spread. The consumer spent slightly less during Black Friday than 2020, and although foot traffic was up 48% from 2020, it was still down 28% from 2019. Cyber Monday sales dropped 1.4% from 2020, which was the first time since the statistic was first monitored. On the last day of November, The Federal Reserve Chair, testifying before congress, spoke in a more hawkish tone (increasing the rate of tapering), causing money market estimates to rise to a 50/50 chance there will be a rate hike in May.

In December the PBOC cut the reserve requirement ratio for banks by 0.5 percentage points releasing $188 billion that may be lent. Maybe they knew that Fitch would cut Evergrande Group and Kaisa Group to restricted default, as they have been rearranging the deck chairs on this Titanic for over a month. Back in the US Inflation was 6.2, 6.8 and 7% for the three months in Q4, its highest level in 40 years, and only being outpaced by Russia and Brazil of the top 13 economies in the world. Inflation in Turkey is being met with their central bank (read Erdogan) ***reducing*** interest rates. Erdogan has replaced the central bank president three times in the past three years. As of this write up Turkey's annual inflation rate stands at over 48%. During the last meeting of the FOMC of the year, they decided to accelerate the taper of its bond buying program, finishing in March rather than in June/July as previously

planned. The end of December saw Senator Joe Manchin reject the Biden administration's build back better plan of spending an additional $2 trillion on top of the $1.2 trillion infrastructure bill and the $3.6 trillion covid relief bills.

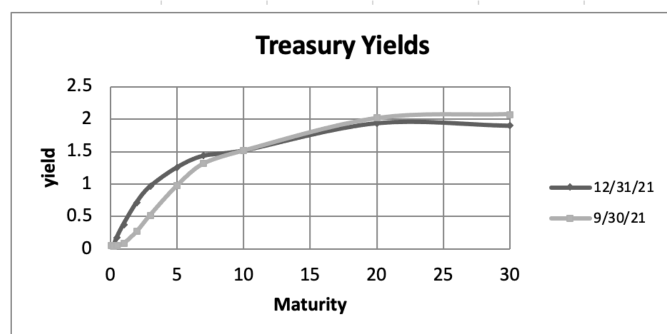
Markets

Stocks made an impressive comeback in the 4th quarter of 2021, with large and mid-cap stocks (7% and 8%) outperforming small-caps (4%). But for the most part all stock were up in the high 20% range for the year, over twice the amount of 2020. Bonds didn't lose money in the fourth quarter other than global and short term. But for the year, long term bonds were down about 4%, global bonds down over 7%, while TIPS were up close to 6%, and high yield came in a close second up 4.5%. The main winners this year though were both real estate and commodities, up over 40% for the year in comparison to both being down over 8% in 2020.

Interest Rates

The Federal Reserve's balance sheet **expanded by $309 Billion to 8.8 trillion** in the fourth quarter of 2021. Chairman Powell testified before congress in late November "retiring" the word transitory for the use with inflation and the FOMC agreed to reduce its bond buying activities on a faster track ending in March of 2022. The belly of the curve widened out substantially up 45bps in the 2 and 3-year, with the 5 year up 28bps. The ten year was flat at 1.5% while the 30 year was bid, losing 18 bps down to 1.9%. Most participants agree that there will be a policy error and anything the Fed does will have to be reversed in the latter half of the year.

Years	12/31/21	9/30/21	Difference
0.08	0.06	0.07	-0.01
0.24	0.06	0.04	0.02
0.5	0.19	0.05	0.14
1	0.39	0.09	0.3
2	0.73	0.28	0.45
3	0.97	0.53	0.44
5	1.26	0.98	0.28
7	1.44	1.32	0.12
10	1.52	1.52	0
20	1.94	2.02	-0.08
30	1.9	2.08	-0.18



The Primary Mortgage Market Survey from Freddie Mac showed the 30-year conforming balance fixed rate mortgage at 3.11%, up 10 bps, with the same fees and points. The 15-year conforming balance rate was only up 5 bps to 2.33% with slightly higher fees. The 5/1 ARM rates actually dropped 7 bps to 2.41% but the fees edged up a bit more. The spread between the 30-year FRM and the 5/1 moved out 17 bps to 70 bps, the widest since late

2018. At the time of this write up though 30-year FRM now stands at 3.55% the highest since the pandemic started.

Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) stood at 120.8 in December up from 117.2 in September with 8 out of ten components contributing positively. The coincident indicator was 107.4 in December up from 105.9 in September, 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

Nonfarm payrolls for Q4 were revised from up 1.096mm to up 1.834mm as of February 2022. The largest gains came in November and December revisions, from 249k to 647k in November and from 199k to 510k in December. The total increase for 2021 was over 6.4mm jobs (the adjustments only increased it by 217k jobs for the entire year), but the BLS mainly shifted the increase in jobs from summer to the end of the year. As stated in the introduction, this is really unsettling in that their estimates for job growth during the year were off substantially. These amounts and the reports were used to make monetary policy, for people and firms to make capital decisions. For years during the pandemic the BLS was undercounting job loss, and they even stated it in their reports, but the main financial publications reported (and are still reporting) the numbers on face value. How on earth can you say here is a number, it is wrong, but still here it is, now go make decisions on it???

The JOLTS report for December showed 10.925mm jobs available, and it has been about 10mm since June of this year, even as unemployment has fallen from 5.9 to 3.9% over the same time period. By the BLS estimates we are only 3mm jobs away from where we were in January 2020. My belief is the Fed may finally be waking up to realization that wage inflation is sticky, the kind that doesn't move down once entrenched, and as they have very limited power to affect supply side inflation, they are limited in effectiveness to stop inflation other than to put us into a recession to reduce demand.

Initial Unemployment claims fell from 329k to 200k over the course of the quarter, while continuing claims fell from 2.6mm to 1.55mm. With the national unemployment programs all ended the total of people receiving benefits as of the end of the year were on 1.9mm. This pales in comparison to the 20mm odd people on benefits the year before.

Temporary services gained 192k jobs over the quarter, with seasonal hires being made. Temporary employment has now exceeded the number of jobs lost over the pandemic. The labor participation rate moved from 61.7 to 61.9 over the quarter but still not near 63.4 level prior to the pandemic. Over to 5mm people have essentially left

the job market. **Manufactures lost a total of 578k jobs in 2020,** and year to date they have added about 369k back. With each PMI report you can see that the number one or two reason for problems is the ability to hire qualified labor.

The BLS, like the Fed, now has a serious credibility issue, one more serious than the historic birth/death issue. On the surface it looks like the job markets has healed and is closing in on employment close to pre-pandemic levels. But the reduced participation rates and losses in manufacturing, couple with factory closures doesn't bode well for an economy or consumer now out of fee money. Orders are slowing, industrial production might have peaked in November, and the revisions make things look a lot rosier than I believe they truly are.

Industrial production

Q4 IP was up 1.88% vs a revised -0.45% for Q3. For the year IP was up 3.6% vs **negative 3.27%** for 2020. Auto manufactures have had to idle factories because of the chip shortage, as total vehicle sales are stuck at 12 million and have been since September of 2021. For context the average vehicle sales in the US since 2000 has been around 17 million, so the even after the surge in the beginning of the year we are off by 30% and trending lower. **Capacity Utilization** finished the year at 76.49% above the pre-pandemic level and the past 22-year average. Looking at both December IP and Capacity Utilization, it looks like December was also the peak. Again, like jobs, it looks like the economy has healed but hasn't grown. In **2020 GDP was down 2.26%**, but up 5.53% in 2021, so over the two-year time period we grew 1.6% a year, or less than the average for the past 20 years. And what part of that growth was generated from the stimulus checks vs. real earnings? What part can be sustained in 2022?

Housing

New home sales were up to 811k annually in December, from an adjusted 725k in September. The average in 2020 was 827k, and in 2021 was down to 765k per year. The Case Shiller Home Price index was up over 10% in 2020, but not to be outdone 2021 recorded close to 18%! I mean who wouldn't want to buy a house up close to 30% in a couple of years. Now will the first half of 2022 year be a screaming buy too, as new homeowners try to beat the rate increases in mortgages?!?! Maybe the view is to buy a house and then get a home equity line of credit as the value goes up, and then plow that into the stock market and lever up the portfolio! **Existing home sales finished the year at 6.1mm per annum.** The average in 2021 was 5.6mm, compared to a 1.3mm amount in 2019. The medium existing home price didn't move much during the quarter and currently stands at 358k as of December. The **NAHB home building sentiment index** stands at 83 for December up again from October's 80. While again the Fannie Mae home buyers index continued to fall to 74.2, while a survey record low of 26% of consumers thought now was a good time to buy a home, compared to 50% in December of 2020.

Switching to building, permits were back up to 1.7mm in December (1.4mm average for 2020, 1.7mm average for 2021), while starts finished the year up to 1.7mm above the 12-month average with single family units starting to make a smaller and smaller percentage of starts, but still 1.1mm on average for the year. As mortgage rates rise and the Fed stops buying mortgage-backed bonds, what happens to house prices. Does the shortage of available housing keep the market afloat into a recession, or do rising mortgage rates only exacerbate the issue and we watch housing start to crack as well?

The Consumer

The conference Board's consumer confidence index stood at 113.8 in December, higher than September's 109.3. The surprising main topics were the pandemic and inflation, and the effects on consumer spending because of them. The Michigan Consumer Sentiment index stood at 70.4 (down from 72.8 in Sept.), with expectations at 67.8 (also down from 68.1 in Sept.). Inflation expectations from Michigan are 4.8%, while current inflation is at 7%. **Retail Sales in December dropped 1.9% month over month**, much worse than a consensus 0.1% drop. We will have to wait till mid-February to see if drop in December is a trend. On a quarterly basis though it was flat, and for the year it was up close to 17%, and up $98 billion since prior to the pandemic. Sales for Retail and Food services increased to $623 billion a year in March of 2021 and have stayed there for the remainder of the year, despite reduction in stimulus checks. It looks like most people pre-shopped the holiday season. This seems to be supported somewhat with the expanse of consumer revolving credit, $19 billion in November vs. just over $2 billion in December. Regardless **consumer credit expanded by $246 billion in 2021**, the most ever since 1943. This comes on the heels of a **credit contraction in 2021 of only $7 billion**.

Personal Income grew by 7.28% in 2021, with personal consumption expenditures growing at 13.32%, above 10% since March of 2021. Durable goods, rising dramatically since June of 2020, have fallen off substantially in December and only up 4.63% for 2021. The most important data point of the Personal Income and Outlays section for me is always the Real Personal income Less Transfers. The average since the 1960s has been about 3%, since 2000 prior to the pandemic, the average has been about 2.1%, as of December the year over year growth has been 1.58%, as GDP was 5.5% and inflation was over 7%.

It seems to me the consumer is paying a lot more for goods and services, borrowing more, and spending less on durables. Maybe the Fed is banking on the consumer slowing, and thus supply side clearing out, because the demand side is demanding less. An awful gamble, but nothing would surprise me now.

Inflation

October 6.22%, November 6.81%, December, 7.04% on an annualized basis.

Energy was off in December across the board, but not because of the release from the strategic oil reserve, this was mostly Omicron fear. Even though it was down in December, Energy was up 29.3% for the year, and although gas has been this high as recently as 2014, other goods and services weren't in the past. Thus, the pain is across the board now. Food was up again in every month this quarter and 6.3% for the year. **Core inflation was up 5.5%** for the past year. The biggest increases were for **commodities less food and energy, up 10.7%, new vehicles up 11.8 and used cars and trucks up 37.3%** (while the Manheim index for used vehicles was up 46.6%). Shelter was up 4.1% in 2021 (thank you OER for keeping a lid on it cough cough), while the Apartment List National rent index was up 17.8% on the year. The inputs for both Auto and Rents come into the CPI on a lag, so the assumption is if those are still rising then CPI will continue to rise into next year. Two things, first the Manheim index looks like it peaked in December, as January's print was a bit lower, so as long as it doesn't continue its upward trend then CPI vehicles on the used side should start to cool in March. On the housing side though, rent peaked back in November, so all else equal we should start to see it cool in January. The issue is while rents were screaming in the first part of 2021, the shelter number in the CPI was holding steady around 0.4% on a monthly basis. If the Fed was still counting house price increases instead of OER, then Shelter would have been around 17.5% instead of 4%, and CPI would have been 11.5% instead of 7%, as shelter comprises 32.39% of CPI (https://www.pewresearch.org/fact-tank/2022/01/24/as-inflation-soars-a-look-at-whats-inside-the-consumer-price-index/).

As in nonfarm payroll, the BLS has made adjustments to the numbers (https://www.bls.gov/cpi/seasonal-adjustment/home.htm) to their seasonality. I look at the unadjusted data, but Fed looks at the adjusted number (actually adjusted PCE). The adjustments look to be immaterial though, with the adjusted 2021 number up 7.1% instead of 7.04%. I think the fear in the market is that like the nonfarm number, the BLS can change CPI to help the Fed goal seek a number that will reinforce their committee action (or nonaction for that matter).

In Closing

Stock had a good 4th quarter with large and mid-caps outperforming small caps. For the year stocks were up in the mid to high 20s. Developed foreign stocks weren't up as much, only 11%, while emerging market large caps were down close to 4%. Bonds were down from 1 to 7% except for high yield and TIPS that were up 4.5% and close to 6%. Real estate and Commodities were both up over 40% this year while inflation started to scream.

For the most part I think the Federal reserve didn't save the economy, in fact it has only delayed the inevitable decline. The consumer is now tapped out and starting to borrow again, the unemployment rate is at 4%, while

inflation is great than 7%. We have never had a spread between the fed funds rate and inflation as wide as it is today, and we are STILL buying bonds and will do so until March.

As of the time I am writing this it looks like the market has completed its bull trap, a fall in January followed by a bounce and then a continual fall. Treasury rates have climbed, and the ten-year spent yesterday above 2.0%, that was until the US is now signaling an imminent invasion of the Ukraine by Russia next year. All while the Olympics is still going on. The Fed looks like they are trapped in a 50-bps increase in March and have called an “expedited, closed board meeting,” on Monday. The last time they did this was in 2015 right before they raised rates. So, there is about to be a war, the economy is slowing down, inflation came in hot again (7.5%), and we are going to raise rates.

Valuations have started to decline, and bond yields are increasing, but getting inflation under control now will be difficult unless the US consumer stops buying, and the supply side can catch up. Jeremy Grantham came out in January with another piece entitled “Let the wild rumpus begin,” a reference to the dance in the book “Where the Wild Things Are,” by Maurice Sendak. In an interview he thinks that the trend line for the S&P is somewhere near the 2500 level, or 2000 points from where it is now. If we do indeed get there the monetary destruction that will have taken place will be unprecedented. I have been wrong for two years now, but have stuck with my guns, and will continue to do so until the Fed bends the knee again. And I have little doubt that will do exactly that.