Finding the Bogeyman

Weekender

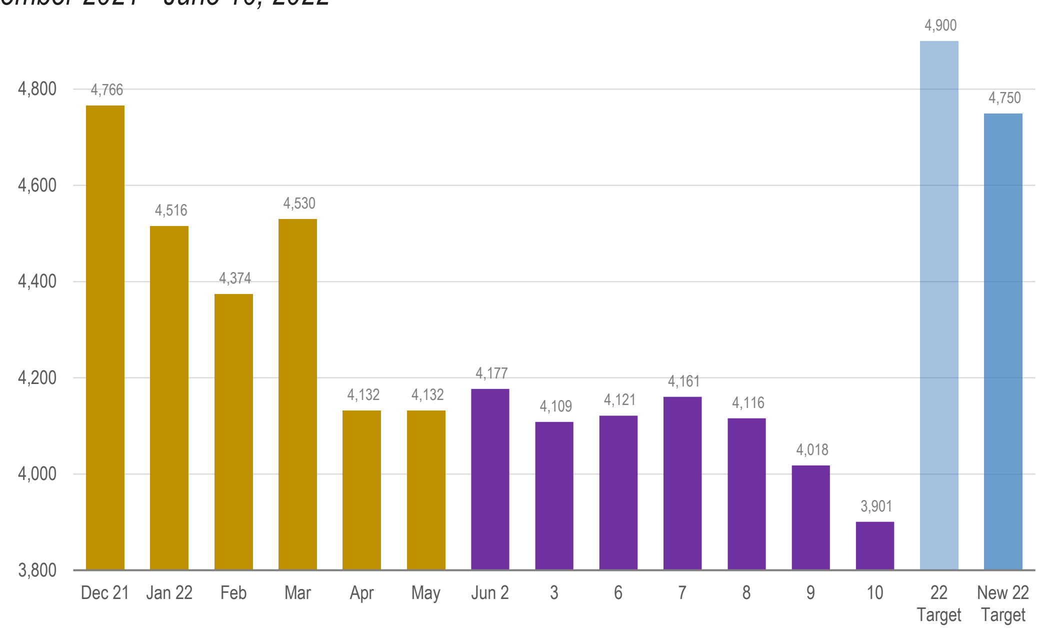
June 11, 2022

Good morning and welcome to the weekender for Saturday, June 11, 2022. This weekender is presented in print form. After a few hours with grandkids in what is often our residential petri dish, I contracted a cold with a nasty sore throat. Having lost my voice almost entirely, I opted to do this weekender in print form.

As measured by the S&P 500, US equity markets fell by 5.1%, closing at 3900.86, coming within a whisker of the May 19, 2022 low of 3900.79, Markets fell hard on Thursday in anticipation of Friday's inflation report. On Fraiday, markets fell on the fact that inflation continues to be persistent.

S&P 500 Daily Levels

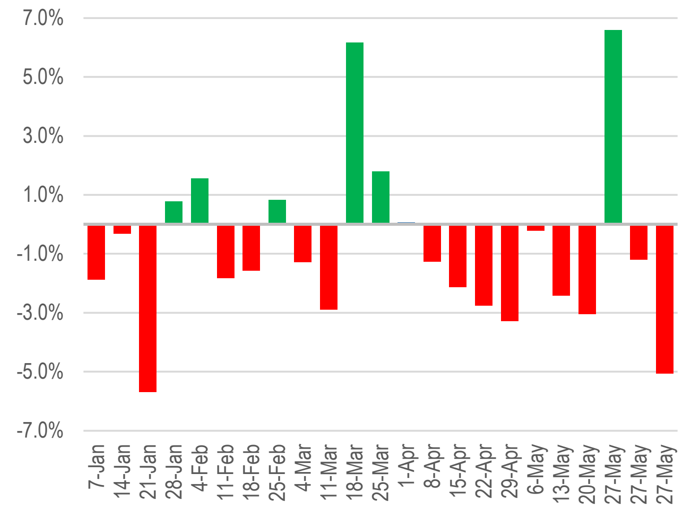
December 2021 - June 10, 2022



Looking at weekly returns for the year, green weeks are getting harder to find. The makings of a bear market certainly seem to be upon us. Up to now, negative financial market performance has been driven by high inflation pushing interest rates higher which will certainly slow the US economy. In the coming months we expect upward pressure on inflation to moderate. Markets will then need to digest the very real prospect that inflation will remain persistent for some time, although lower than it is presently. The economy will certainly slow its growth and likely fall into a shallow recession in 2023.

S&P 500 Weekly Returns

January 7 - June 10, 2022

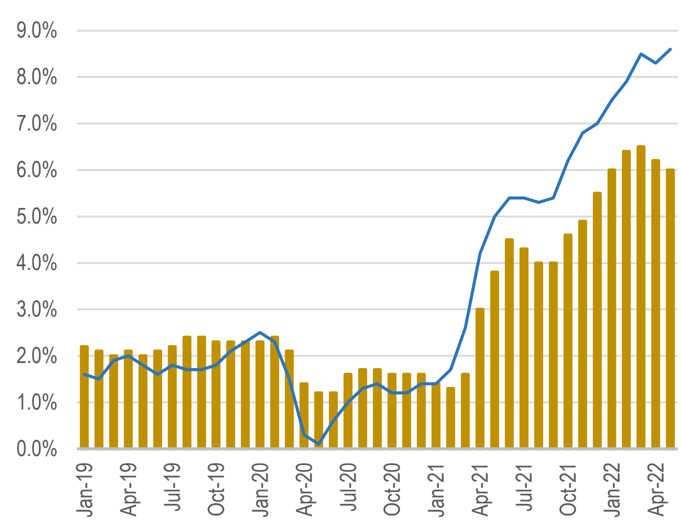


On the horizon, and yet poorly telegraphed, is the likelihood that corporate earnings will begin to fall in the second half of 2022. As we have discussed in previous weekenders. This is the shoe yet to drop for markets.

From a headline perspective, markets around the world were wrapped by inflation coming in hotter than expected. Headline inflation at the consumer level, came in at 8.6%, the blue line. Higher than expected and the highest since March of 1980. Core consumer inflation, which removes the volatile elements of energy and food, has begun to bend, which suggests we are at or close to a peak in consumer inflation. Next week we will see the readings for producer inflation.

US CPI (Blue) and Core CPI (Gold)

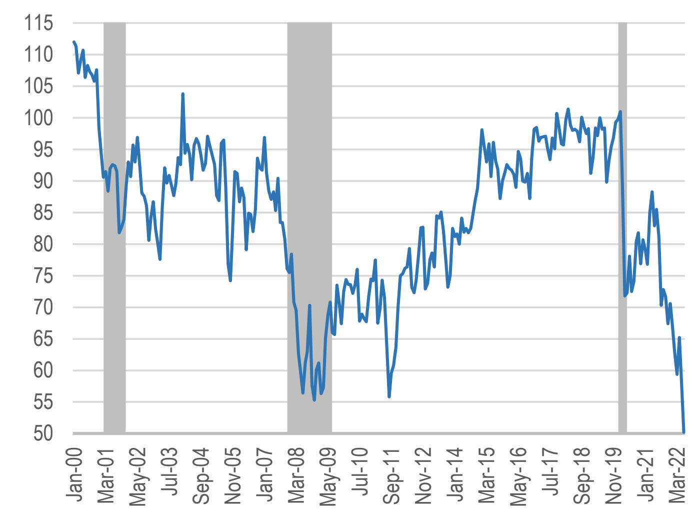
January 2019 - May 2022



Hidden under the inflation headlines was a data release on consumer sentiment. The data has been published by the University of Michigan since 1978. Its posting on Friday was 50.2, the lowest reading since the dataset began. This should give markets pause. Those who suggest the economy can weather its current storms, universally point to the strength of the consumer as justification. Consumer strength is a function of a tight labor market and healthy balance sheets. But inflation can change all of that over the course of a year.

US Consumer Sentiment

January 2000 - June 2022



Technology has been a primary target of the 2022 bear market adjustments. But another sector is doing worse—retail. The MSCI Retailing Index is on track for its first negative year since 2008. Its down 32.1% year-to-date, while the MSCI World Information Technology Index is lower by 28.0%. Technology stocks are responding poorly to higher interest rates and inflation because they were richly valued going into 2022. Retail stocks are being pushed lower on deteriorating fundamentals. Elevated interest rates and inflation are leading to a squeeze on consumer disposable incomes which portend an end to free money and a much more discriminating consumer in the months ahead. Retail stocks are falling as a softer consumer gets discounted into stock prices.

Data released this week support our view published in previous weekenders. The Fed finds itself well behind the curve on inflation. Extreme measures, like an inter-meeting rate hike, are warranted, but very unlikely. The purpose of rate hikes is to destroy demand and relieve pressure on prices. In the Fed's absence of doing what it should, higher inflation is doing the Fed's job for them.

We continue to believe that in the wake of Fed inaction, financial markets will carry their water for them, as they did this week. Europe is almost certain to fall into a recession over the Summer. The US economy will slow dramatically as soon as inventories are replenished by the end of summer, which has been a driver of economic growth all year.

In this weekender, we will look at how effective the Fed may be at controlling inflation by demand destruction using its blunt monetary instruments. We will also summarize market moves in countries, instruments, sectors and themes.

Market Narrative

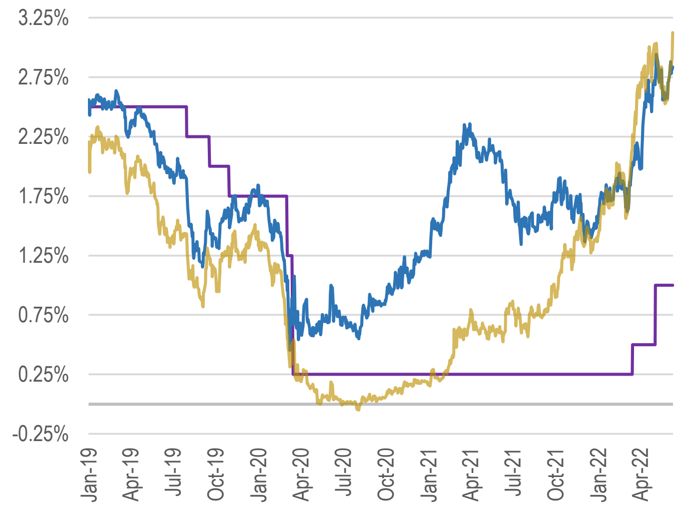
Last week, Jamie Dimon, the vaunted CEO of JP Morgan Chase suggested that, more than just clouds, a hurricane is approaching. The meteorological term has no readily translatable equivalent in finance, but it implies big "do do", another technical term. Dimon's pronouncement was particularly interesting because only a week earlier he suggested the future was bright. Elon Musk, one of the wealthiest people in the world, and known for his ephemeral statements, suggested he was also worried about the future. These two titans of business are not alone in their predictions. Many others have joined the chorus.

A bogeyman is an imaginary person or thing that is seen as an object of fear. Usually they are a manifestation of fears of events the probability of which we cannot quantify or understand. The thing under the bed or in the closet that prompts us to keep the light on. I was always scared of the dark as a child so I speak from some experience.

An interest rate exists, the neutral rate, where the economy with neither grow nor contract, the blue line. The best predictor for how high the fed will need to raise rates, the gold line, is already well above the neutral rate. More importantly, look at the distance the Fed still needs to go from its current rate stance, the purple line.

The last two rate hikes have all but shut down the residential mortgage market. If the Fed needs to move

Neutral Rate (Blue), Predicted (Gold) and Fed (Purple)
January 3, 2019 - June 10, 2022



rates another 180 basis points from here to reach neutral, maybe the bogie man is real. I knew it. Better keep the light on.

To illustrate this point lets look at a few graphs from real estate.

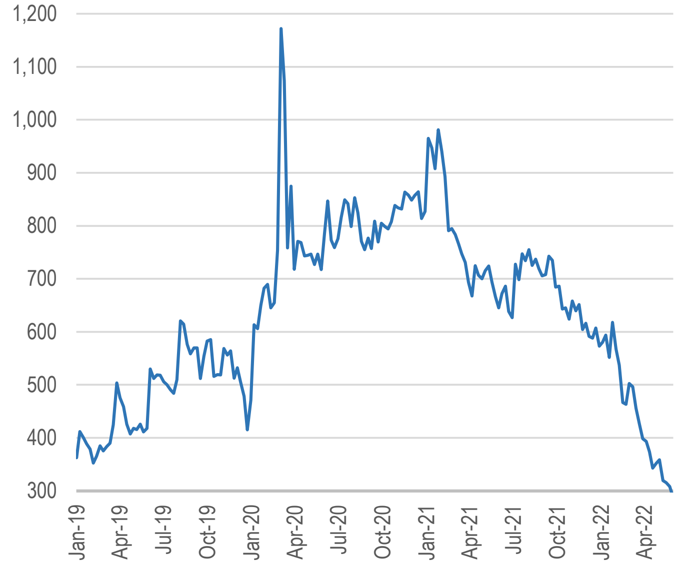
This is a graph of the thirty year fixed mortgage rate. It has been undergoing a stunning rise from the begging of the year on the back of only a token raise in interest rates from the Fed.

Average 30-Year Mortgage Rate
January 3, 2019 - June 10, 2022

Higher mortgage rates have pushed mortgage demand to levels well below the pre-pandemic era. Obvious intuition suggests that lower mortgage demand will lead to fewer home sales and a general softening of home prices. Certainly that is in the cards. But there is more.

US Weeky Mortgage Applications

January 7, 2019 - June 9, 2022

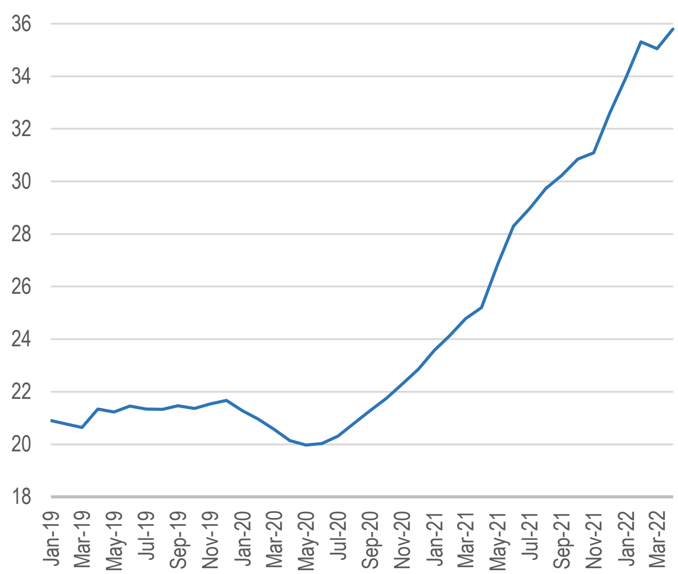


As the new home market increased to boil during the pandemic, driven by monetary and fiscal give aways, construction supplies also rose in price. Shortages were to blame. And certainly for a short period of time, on the margin, shortages played a role.

Consider lumber. Supplies dipped during the pandemic shut downs, but then rose dramatically.

US Lumber Inventories

January 7, 2019 - June 10, 2022



When inspected over a longer-term, lumber inventories are now at extreme levels.

US Lumber Inventories

January 3, 2000 - June 10, 2022

The impact. Lower prices. Lumber prices have fallen significantly, but no where close to where they are going to fall given the demand destruction of higher rates and the oversupply currently in the system.

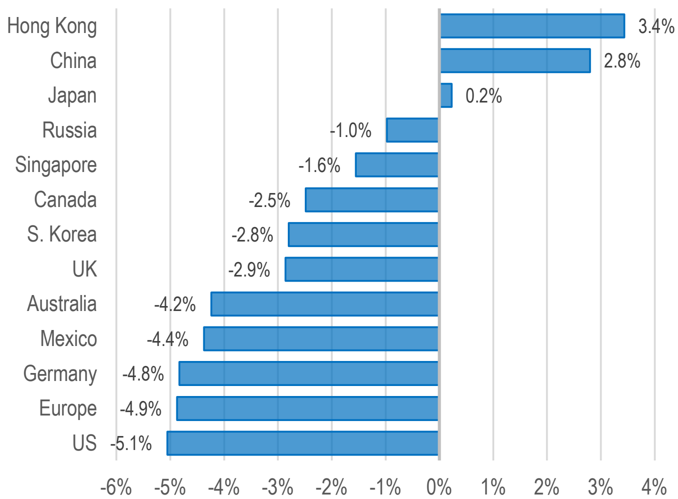
We believe a rise in inventories broadly, beyond lumber, will result in a dramatic shift from shortage to surplus in the global economy. The result is falling profits. More on that next week.

Countries

Last week, Hong Kong and China were the best performing countries by a large margin. Approximately half of the thirty major global central banks raised rates in May, a record since at 1998, and maybe longer. As Bloomberg reports, during the last two times when more than 40% of central banks raised rates, June 2008 and February 2000, the US economy was in or about to dip into a recession.

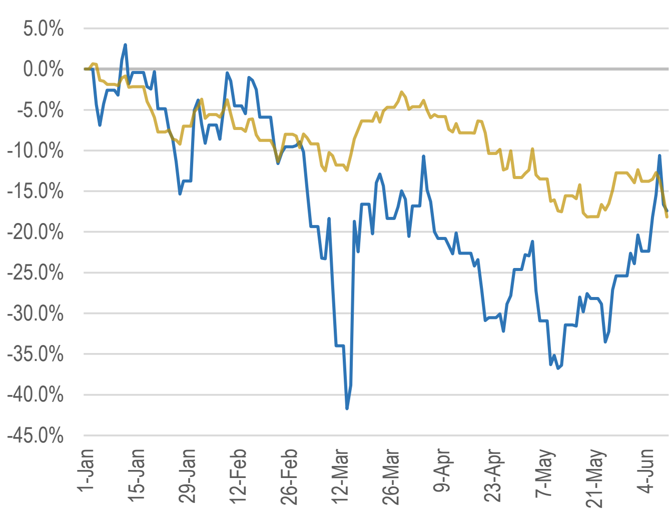
In addition to the positive run of stocks listed in China and Hong Kong, Chinese stocks listed in the United States have staged their best run since 2020, rising for the fourth consecutive week. Most of the moves are being driven by completion of pre-announced company investigations and loosening up of COVID-related lockdowns.

Country Returns
June 6 - 10, 2022



Since the beginning of May, the Golden Dragon index of Chinese companies listed in the US is higher by 9.5% compared to the S&P 500 which is lower by -5.6%, on a year-to-date basis, the Golden dragon and S&P 500 are close to even.

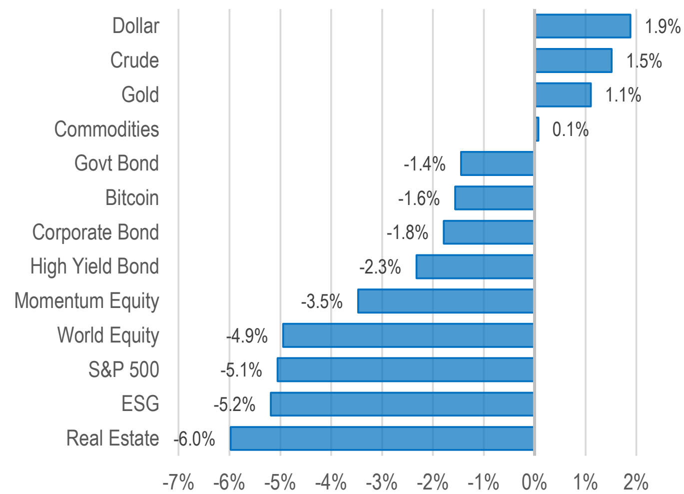
Golden Dragon Index (Blue) and S&P 500 (Gold)
Cumulative Return from January 3 - June 10, 2022



Instruments

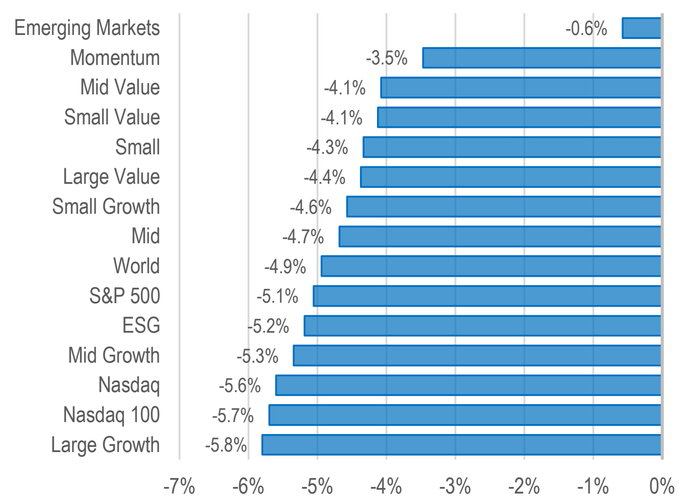
Among investment instruments, the dollar was higher with crude and gold. All suspected hedges against inflation. Commodities were flat, while instruments with even a slight degree of interest rate sensitivity were lower.

Instrument Returns
June 6 - 10, 2022



All equity buckets were lower. In a bit of a surprise, given the dollar strength over the week, emerging markets were the best performer. This was partly driven by the strength of commodities relative to equities.

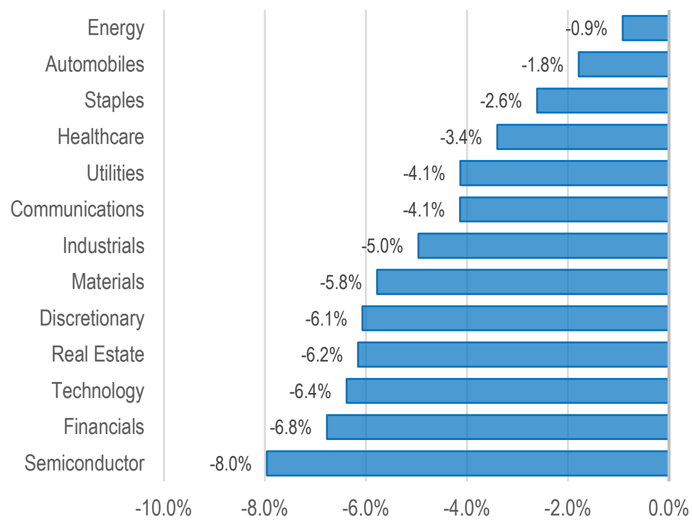
Instrument Returns
June 6 - 10, 2022



Sectors

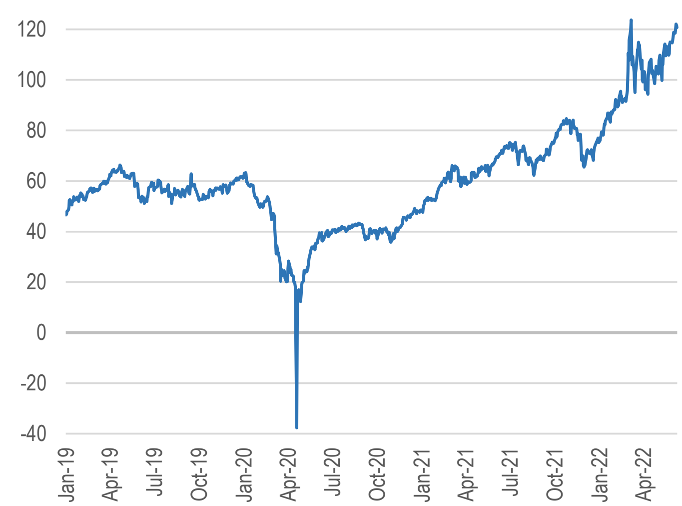
All equity sectors were lower. Semiconductors were the worst. The best performer was energy.

Sector Returns
June 6 - 10, 2022



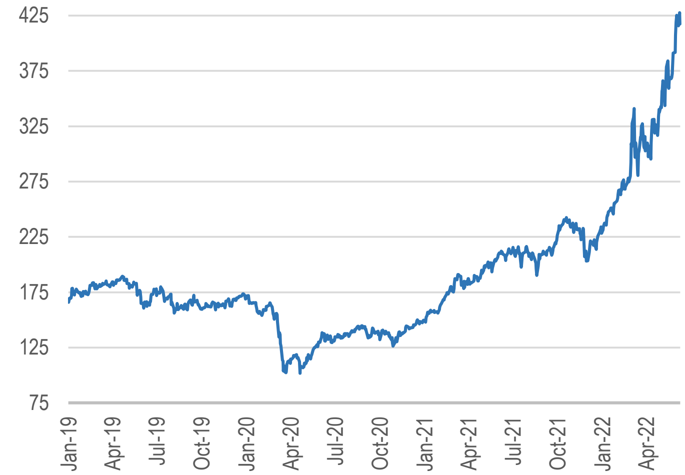
A few energy graphs, in staccato fashion, will simplify our position on energy. Below is a graph of crude oil price per barrel. Close to highs, but well higher then its pre-pandemic level.

Crude Oil, US$ Per Barrel
January 2, 2019 - June 10, 2022

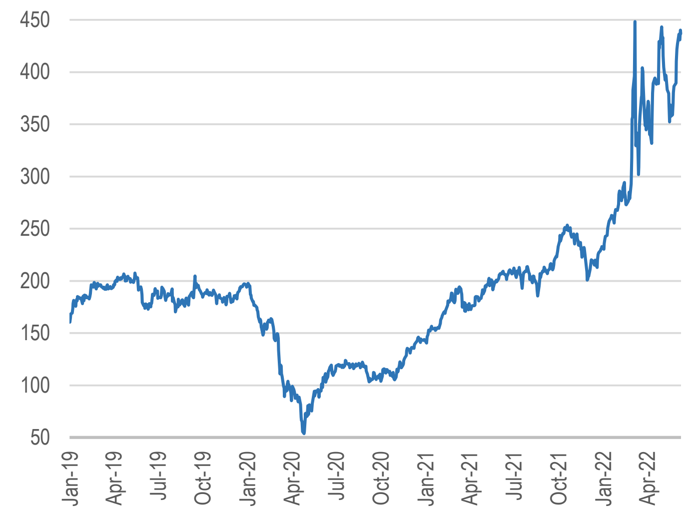


Higher crude prices have led to higher gasoline and diesel.

Gasoline, Index Price
January 2, 2019 - June 10, 2022

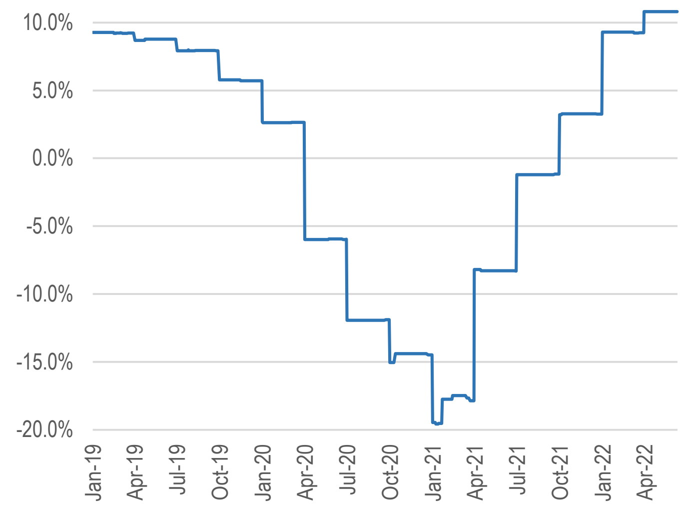


Gasoline, Index Price
January 2, 2019 - June 10, 2022



Higher crude, gasoline, and diesel prices have helped push the operating margins of US energy companies higher, but far from the cries of Nancy Pelosi and Elizabeth Warren, operating margins have just recovered to a point that they are slightly higher than where they were before the pandemic.

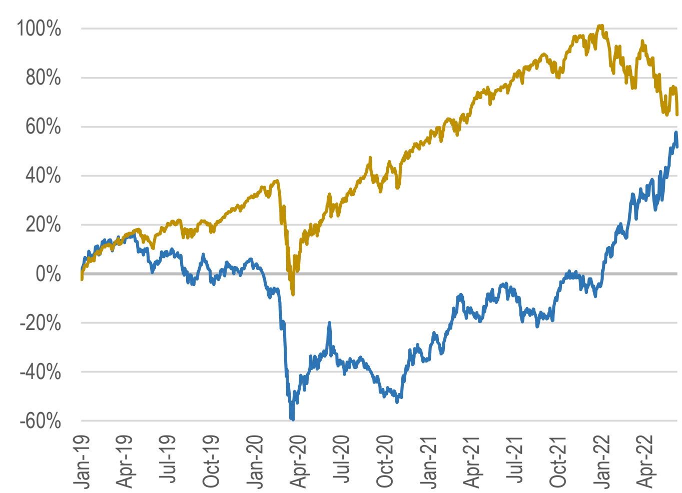
Energy Company Operating Margins
January 2, 2019 - June 10, 2022



However, despite higher prices and margins, oil drilling rig counts, although rising, are still far from where they were prior to the pandemic. This is due to a degree of capital discipline among the exploration and production group combined with a lack of pipelines and other transport options required to get the oil to market.

Consequently, most US production increases are coming from depleted and peaked wells. Without more aggressive drilling and completion, its likely high oil prices, higher than $80 per barrel, may be with us for a while.

Energy Company Operating Margins
January 2, 2019 - June 10, 2022

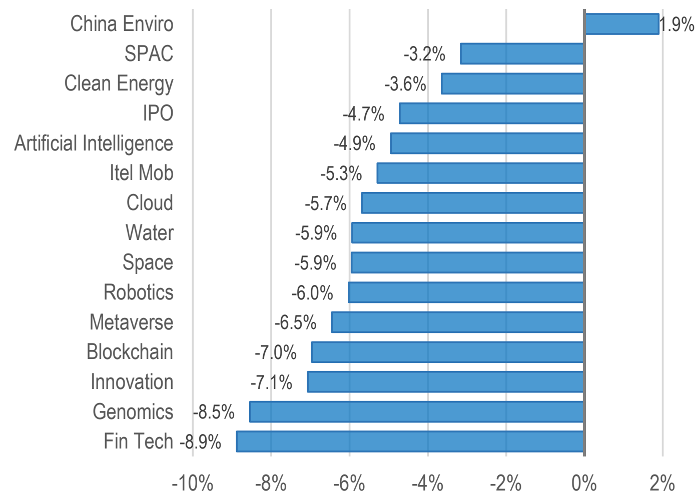


These energy dynamics have combined to drive energy stocks, the blue line, to remarkable gains, making their cumulative returns, since January 2019, competitive with the S&P 500, the gold line.

Themes

The China Environment theme was the only one positive on the week, driven mainly by increases in China and Hong Kong more broadly.

Theme Returns
June 6 - 10, 2022



Conclusion

That's it for this weekender. Have a wonderful week.