Financial Markets This Week

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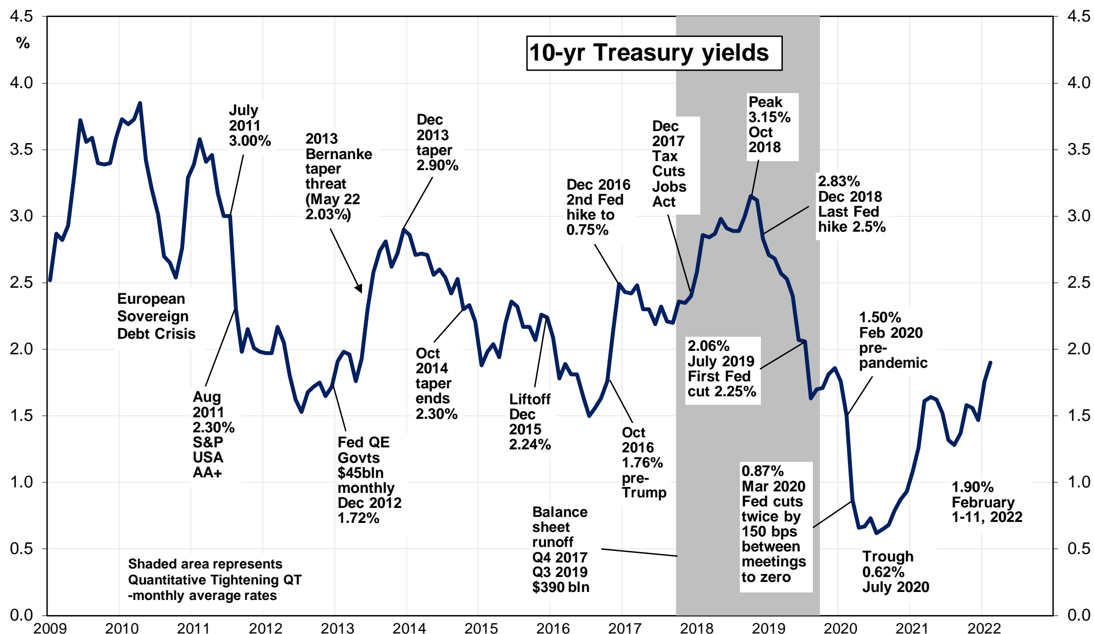
BOND MARKET VALUATION

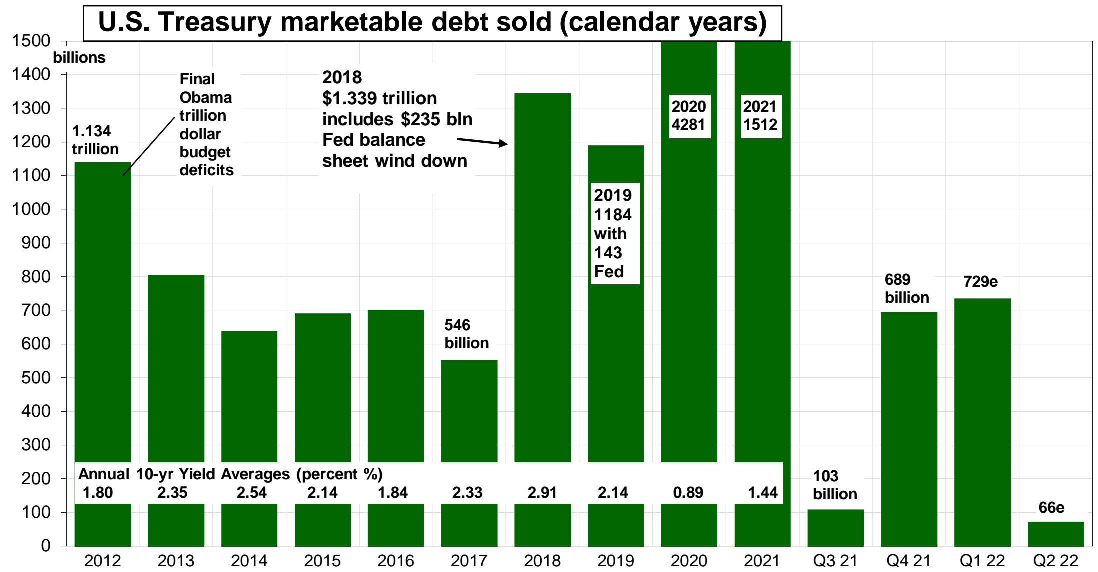


One way to forecast bond yields is to look at what happened the last time around when the Fed started raising interest rates. 10-year yields reached as high as 3.15% in October 2018 on a monthly average basis. The Fed raised rates to 2.25% in September 2018 and was looking to raise rates to 2.5% in December 2018 and up to 3.25% by December 2019. There was a reason 10-yr Treasury yields were up there, it was the Fed, and it wasn't inflation or Treasury auctions and Federal budget deficits. The final peak in the Fed funds rate in recent decades has matched the 10-yr yield. 10-year yields peaked at 3.15% in October 2018 and the Fed was saying they would raise the Fed funds rate to 3.25%. Close enough, this isn't rocket science. It's the economy and markets where anything can happen. In this cycle, which has barely begun, the 10-year yield was as high as 2.06% Thursday after CPI; the Federal Reserve December meeting Fed funds rate forecast is as high as 2.25% by the end of 2024. We will see where they think the Fed funds rate needs to go on March 16 at 2pm ET.

Memo: Projected appropriate policy path								
Fed Meeting	2018	2019	2020	2021	2022	2023	2024	Longer run
Dec 21				0.1	0.9	1.6	2.1	2.5
Sep 21				0.1	0.3	1.0	1.8	2.5
Jun 21				0.1	0.1	0.6		2.5
Mar 21				0.1	0.1	0.1		2.5
Dec 20			0.1	0.1	0.1	0.1		2.5
Sep 20			0.1	0.1	0.1	0.1		2.5
Jun 20			0.1	0.1	0.1			2.5
Mar 20	No meeting: 150 bps rate cuts between Jan and Mar (scheduled)							
Dec 19		1.6	1.6	1.9	2.1			2.5
Sep 19		1.9	1.9	2.1	2.4			2.5
Jun 19		2.4	2.1	2.4				2.5
Mar 19		2.4	2.6	2.6				2.8
Dec 18	2.4	2.9	3.1	3.1				2.8
Sep 18	2.4	3.1	3.4	3.4				3.0
Jun 18	2.4	3.1	3.4					2.9
Mar 18	2.1	2.9	3.4					2.9

The second building block of bond yield forecasting is inflation, and 7.5% CPI inflation is off the charts and the highest since 10.3% in 1981 on a full year basis. The year 1981 when the 10-yr monthly average yield peak was 15.32% in September that year (Recession was July 1981 to November 1982). Current inflation is so high relative to 10-year yields that isn't much help in

valuing where bonds should trade. Eliminate food and energy and 7.5% CPI comes down to 6.0% which is still too high to be useful. We'd say look at CPI services prices ex-energy at 4.1% but still too high to value bonds.

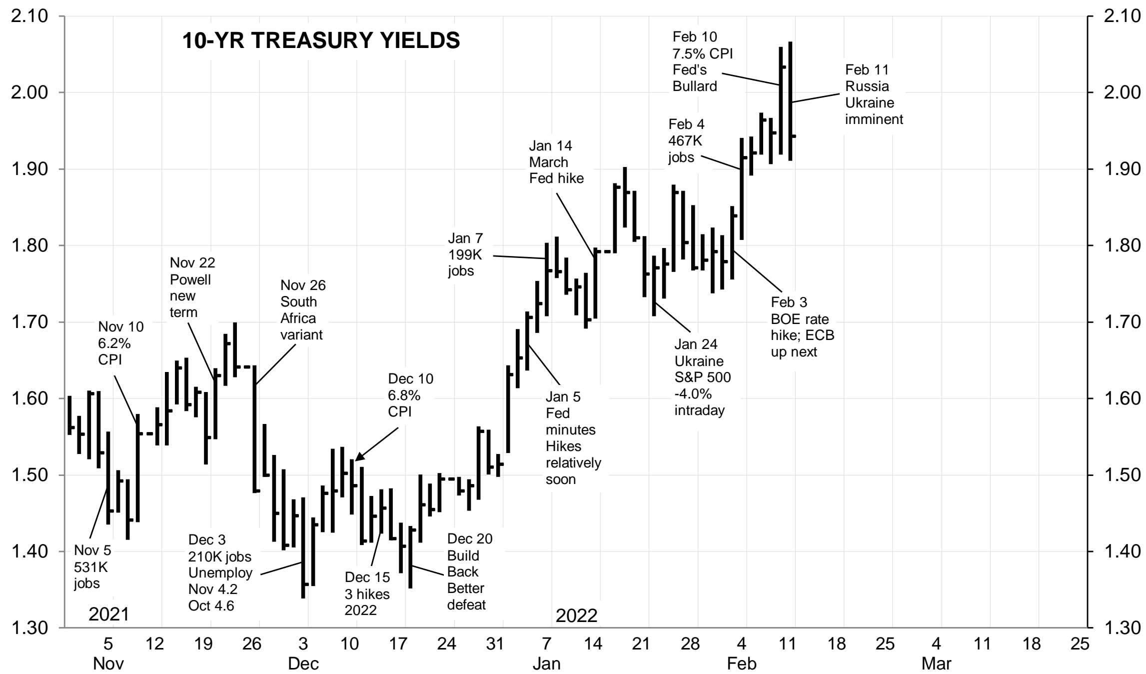


Let's move on to the third pillar of bond market valuation which also is less than clear. The Fed started $45 billion of monthly QE Treasury securities purchases ($540 billion annual) in December 2012 and yields went up not down, in part because Bernanke said the Fed might taper in the next few meetings in May 2013. When the Fed did eventually taper in a December 2013 announcement, finishing in October 2014, bond yields didn't go up, they went down. The Fed did quantitative tightening (QT), where they allowed the Treasury securities on their balance sheet to roll off from Q4 2017 to August 2019, which totaled $390 billion over two years. Bond yields were rising in much of the period, but probably more due to the Fed raising interest rates. This time some Fed officials are saying they want the balance sheet wind down to occur faster and we will see if there's an effect that we can see with the naked eye on charts. Every dollar that rolls off the balance sheet increases the amount the Treasury needs to auction to the market by one dollar.

Speaking of Treasury auctions or "supply," the February quarterly Treasury funding announcement sees new cash raised of $725 billion in the first quarter about the same as $689 billion in the fourth quarter of 2021. Supply doesn't always matter as seen by the massive calendar year 2020 pandemic financing of $4.281 trillion at a very low average 10-year yield of 0.89%. In calendar year 2021, new cash raised was $1.512 trillion at an average 10-year yield of 1.44%.

To conclude, we aren't sure that looking at the foundation of a bond yield forecast, the three pillars of Fed policy, inflation, and supply/demand from Treasury auctions, Fed QE and QT, provides much to what is really a dart-throw rates forecast. We are really just left with a bowl of mush that is filled with uncertainty. Bond yields are still ignoring the inflation surge despite yields moving a little over 2% this week. Maybe they forgot or perhaps today's Wall Street traders were not born in the early 80s. Treasury supply seems manageable if the Fed's balance sheet wind down doesn't add too much to the supply auctioned to fund the Federal budget deficit. Foreigners still seem to be buying the higher U.S. yields. The backbone of Treasury bond yields is the Fed so the March 16 2pm ET updated forecast will be important. Currently, Fed officials forecast a 2.25% rate at the end of 2024 and the 10-yr Treasury closed at 1.94% on Friday. Stay tuned. Watch here where the world goes next.

INTEREST RATES

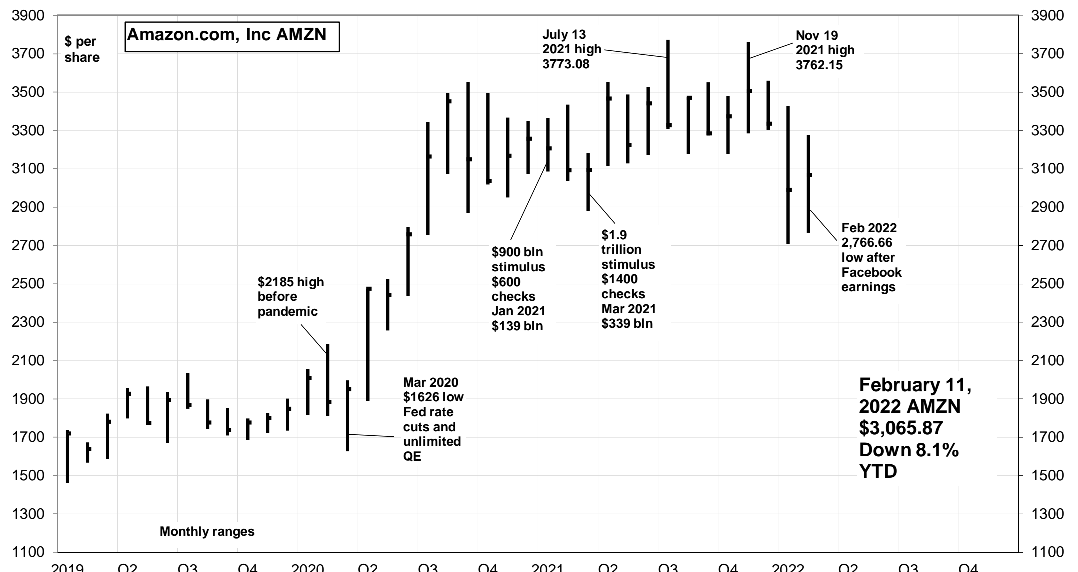


We don't know, we like higher yields. But January CPI on Thursday was 7.5% and in December CPI inflation was 7.0%. 7.5, 7.0, we'd say what's the difference although February and March CPI inflation will likely move higher than 7.5% before peaking if you can call it that. You never know what's going to set the market off, although we left out St. Louis Fed President Bullard who we discuss in the Federal Reserve Policy section. 10-year yields rose as high as 2.06% on Thursday. News Friday that a Russian invasion of Ukraine was imminent brought stocks and bond yields down sharply around 1:25pm ET. S&P 500 was 4,475, down 0.6% on the day at the time, and closed Friday down 1.90%.

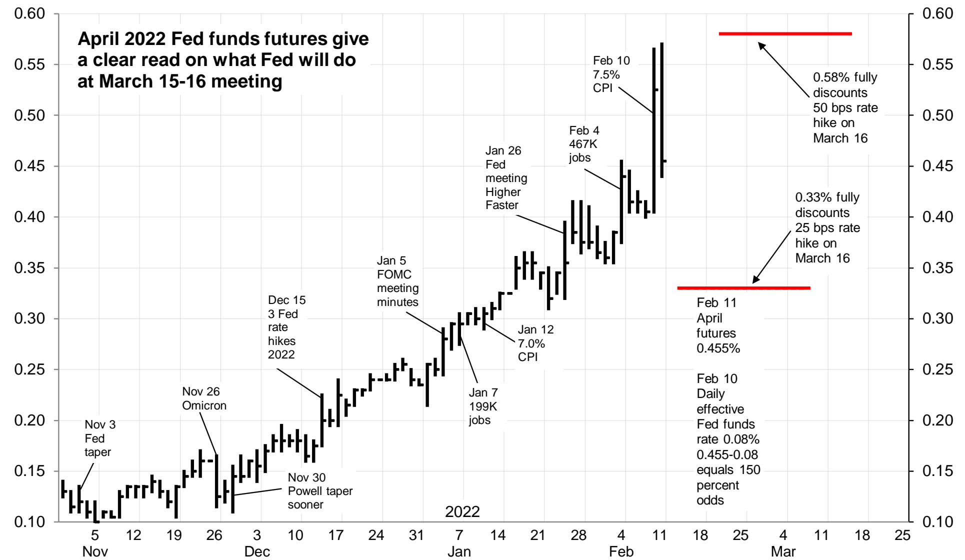
Amazon AMZN was down as much as 28% from November 2021 "record"

A strong rally coming out of the pandemic which has stalled since Q3 2020. The relative underperformance keeps prompting many on Wall Street to call the company its stock of the year. Overall market decline in January 2022 brought Amazon down 28.0% from its "record" in November 2021. The stock jumped 13.5% last Friday after its earnings, but this was partly a rebound from its Facebook earnings loss. AMZN earnings are all from AWS: not from our Amazon Prime purchases.

S&P 500 Weights	
Top 6: 24% of S&P	
7.03	AAPL
5.95	MSFT
3.64	AMZN
1.93	TSLA
1.69	NVDA
2.19	GOOGL
2.03	GOOG
24.46	Top 6



FEDERAL RESERVE POLICY



The Fed meets on March 15-16, 2022 to consider its monetary policy. This week's Fedspeak spoke the unspeakable and it had a major effect on the markets. One guy on the FOMC did it all on his own. St. Louis Fed President Bullard is back and at 1245pm on Thursday, 15 minutes before the 30-year Treasury auction, he shouted fire in a crowded theatre. It was the CPI report on Thursday that led him to say a 50 bps rate hike was needed on March 16 and he wanted to see 100 bps in total by July 1, so that means 50 bps at the March 15-16 meeting, 25 bps at the May 3-4 meeting and 25 bps at the June 14-15 meeting. That would put the Fed funds rate at 1.25% so the 2-year Treasury note didn't waste any time: it was about 1.49% on the day before Bullard, already 13 bps higher than Wednesday's 1.36% close because CPI inflation is 7.5% now up from 7.0% in the last report, and 2-year yields went as high as 1.64%, 28 bps on the day, after Bullard spoke. We aren't sure if this hurry-up rate-hikes approach is the right thing for the Fed to do, but we hope higher market rates will push commercial banks to start paying interest to those who have savings accounts with them. Fine, spend money to hire people in ESG, but make sure you are doing right by your depositors.

Hard to know what is right for the Federal Reserve to do at this point. The inflation mistake was already made and no clear way to correct it in the near term without risking harm to the economy: growth and employment. The Fed funds futures are giving the Fed the greenlight to go 50 bps in March. April 2022 Fed funds futures closed at 0.455%, which after subtracting the current 0.08% daily effective Fed funds rate means we are 37.5 bps of the way there. August 2022 Fed funds futures, which give a pure read on where the Fed's policy rate will be after four meetings, March, May, June, July, closed Friday at 1.23% and are saying 115 bps after subtracting the 0.08% daily effective Fed funds rate. Markets to Fed: it's your move. Feel free to go at least 25 bps per meeting and maybe throw in a 50 bps hike to start. Stay tuned. The public doesn't like inflation, but it also might not like what it means when the Fed acts to rein in demand and take the punch bowl away. The Fed, the American public, the economy, all facing between a rock and a hard place choices. Bet on it.

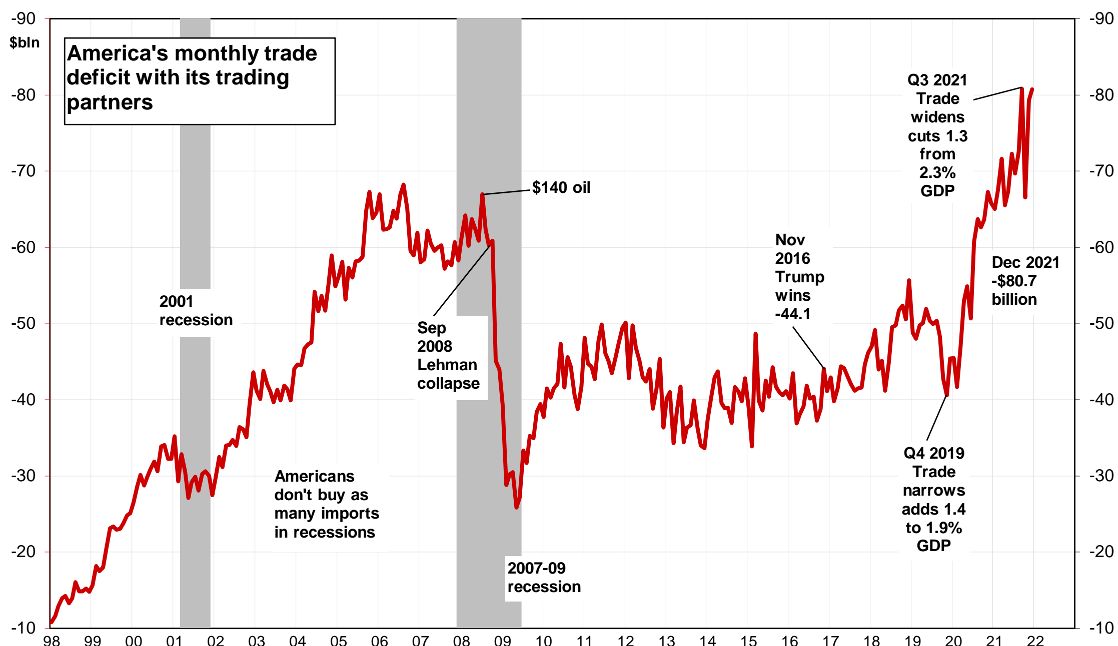
P.S. Regular predictable Fed policy after 7.5% CPI, even as the stock market plunged Friday afternoon on worrisome imminent Russian invasion of Ukraine headlines at 125pm ET. Fed said at 3pm ET it continues its QE purchases and will buy $20 billion of Treasury securities from February 14 through March 11, and then they are done. No more QE to send the stock market higher. If that's what it did.

OTHER ECONOMIC NEWS

US trade picture not likely to add to economic growth until world returns to normal (Tuesday)

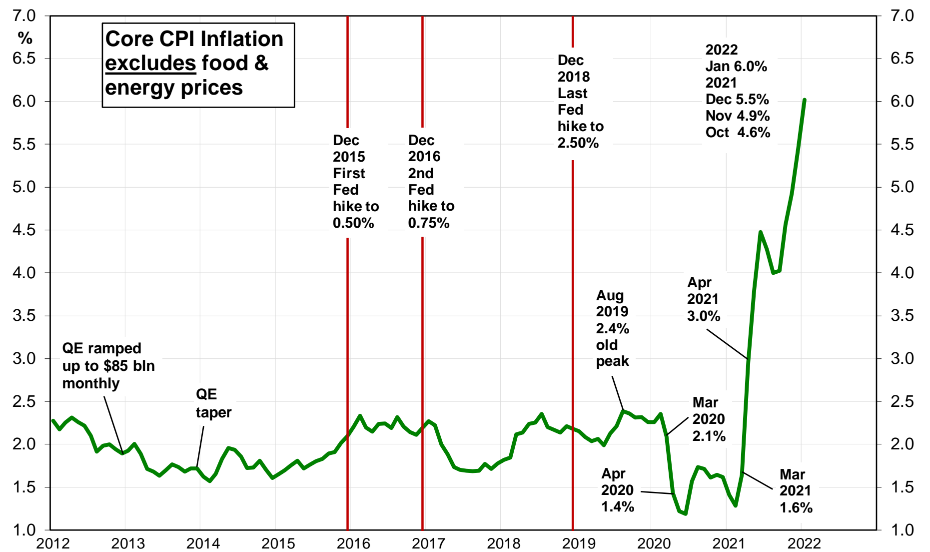
Breaking economy news. The December trade deficit reached $80.7 billion, more than $79.3 billion last month, and just short of the $80.8 billion record in September. A big jump in Services exports kept the overall deficit from setting a new record. The US trade picture is not likely to add significantly to economic growth until the world returns to normal. Travel exports were $8.6 billion in December 2022 versus over $16 billion per month in the fourth quarter of 2019 before the pandemic shut down business travel and tourism. The US trade picture won't return to normal until the pandemic purchases start to slow and life returns to what it was. Imports of cell phones and other household goods rose $22.8 billion to $121.2 billion in 2021. Imports of Toys, games and sporting goods rose $16.6 billion to $57.2 billion in 2021. Imports of Pharmaceutical preparations increased $8.0 billion to $171.2 billion in 2021.

Net, net, the world isn't back to normal yet when it comes to the pattern of trade in goods and services that existed before the pandemic. There's a lot of red ink in the trade deficit that remains uncomfortably close to record levels, some of which could be brought back once travel to the U.S. returns and gives a boost to U.S. exports of services. Meanwhile, the shooting has stopped in the U.S. trade war with China even if Washington called for concrete action this week for China to meet its Phase 1 commitments to buy U.S. goods. Exports of goods to China peaked at $130.0 billion in 2017, and slipped to $106.4 billion in 2019 during the height of the trade war and tariffs. Exports of goods to China made a new peak in 2021 at $151.1 billion but the U.S. wants more purchases. Full year US exports to China rose 21.4% to $151.1 billion, but the deficit widened with full year 2021 imports from China rising 16.5% to $506.4 billion. $506.4 billion of goods imported from China would create a lot of jobs if the country could produce it here, but with American wages soaring out of sight, it is unlikely that US manufacturers will restart their factories here especially for consumer goods where margins are tight. Stay tuned. Story developing.



CPI inflation fire burns hotter and the Fed will need a bigger firehose (Thursday)

Breaking economy news. The labor market is hot and inflation is even hotter which places the Federal Reserve in an awkward position with an interest rate hike over a month away. As the inflation fire burns even hotter, the Federal Reserve will have to bring an even bigger firehose to put it out. Weekly jobless claims falling 16K to 223K in the February 5 week shows the nation's Omicron sickout is over which is a good thing for the economy even if it does little to stop the unprecedented surge in consumer demand. Meanwhile, the prices of everything Americans buy is going straight up.



CPI inflation is up 7.5% the last year with the monthly changes intensifying since the third quarter of 2021. 0.9% October, 0.7% November, 0.6% December, 0.6% January. These are big numbers and a big deal. The inflation fire is showing no let up in recent months. Inflation is not going away. It's not just consumer goods going up, so don't bother waiting for the pandemic to go away and allow more workers to return to their jobs and lessen those supply bottlenecks. Inflation is raging out of control due to too strong consumer demand and the only thing the Federal Reserve can do is rein in consumer spending. Fed officials can talk all day about how rate hikes won't slow the economy, but the markets know that that is just when the doctor ordered to cure this inflation outbreak. Slow the economy and consumer demand.

Only new car prices were unchanged this month and even that doesn't count as a big deal because car prices are up 12.2 percent from last year. Gasoline at the pump fell 0.8% in January, but are already rising higher in February. It's not just goods on store shelves at the mall because inflation in services less energy is also going gangbusters which means the fire will be even harder to put out. Services inflation ex-energy is up 4.1% the last year and this gives you an idea of where inflation will come back down to after we pass the peak hopefully in the second half of 2022.

Net, net, inflation pressures are showing no sign of stabilizing and they won't anytime in the near future if the tightening labor market with declining jobless claims sends wages of workers to the moon. The wage-price spiral from the 1980s is back and the only way the central bank fought the inflation fire back then was to raise rates high enough to turn off demand and send the economy over the cliff into a recession. Inflation has triggered a recession before and will be a miracle if the country can avoid one again.

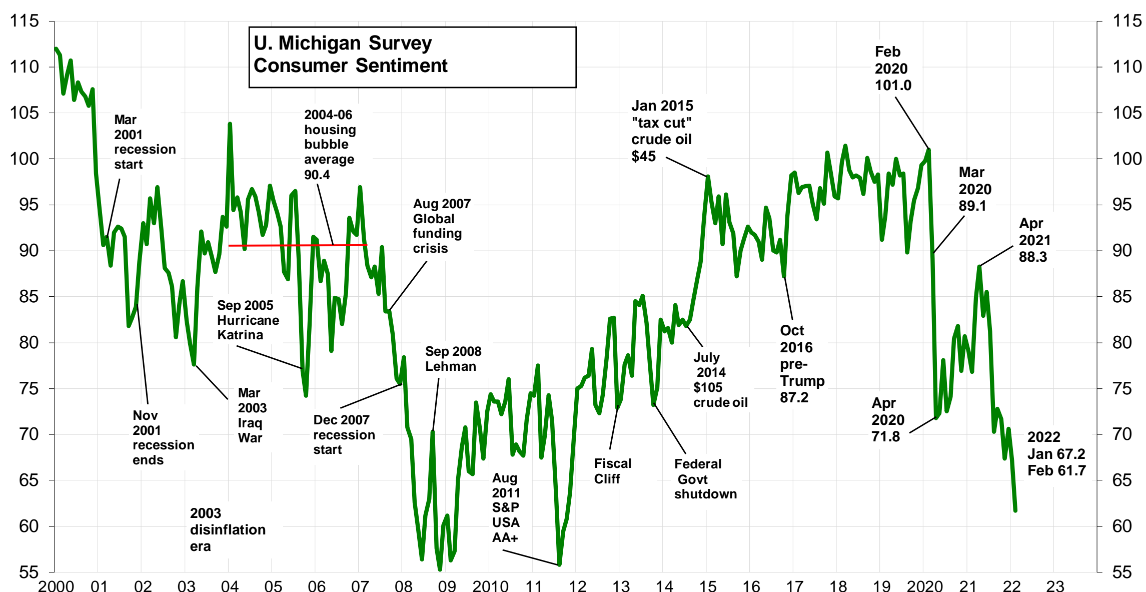
		Monthly Percent Changes			YOY %
Weight	CPI inflation	Nov 2021	Dec 2021	Jan 2022	Jan 2022
100.0	Total	0.7	0.6	0.6	7.5
13.990	Food	0.8	0.5	0.9	7.0
6.269	Food away from home	0.6	0.6	0.7	6.4
7.542	Energy	2.4	0.9	0.9	27.0
78.468	Ex-food & energy	0.5	0.6	0.6	6.0
3.884	New vehicles	1.2	1.2	0.0	12.2
3.419	Used cars/trucks	2.4	3.3	1.5	40.5
2.669	Clothing	0.7	1.1	1.1	5.3
1.487	Medical care goods	0.1	0.0	0.9	1.4
32.393	Shelter	0.5	0.4	0.3	4.4
23.509	Owner equiv. rent	0.4	0.4	0.4	4.1
5.046	Transportation	0.7	0.0	1.0	5.6
6.987	Medical care services	0.3	0.3	0.6	2.7
	Special: Where inflation might come back down to				
57.700	Services ex-energy	0.4	0.3	0.4	4.1

Consumer worries inflation means recession (Friday)

Breaking economy news. The Michigan survey shows the consumer is more negative on the future than they were even in the darkest days of the pandemic. You have to go back to the Great Recession and financial crisis of 2007-09 to see the consumer so worried. There's no other conclusion other than the consumer is worried inflation means a recession just like it has so many other times in U.S. economic history.

Incredibly, the consumer is polling negatively on almost everything when it comes to the economy, and if their confidence doesn’t improve, the economy could be headed towards the cliff of recession. The consumer sentiment reading is something that looks more like the economy is in a recession not in a demand boom that has sent inflation soaring. We almost have to recheck our figures because the consumer is clearly in a deep funk and if they decide to call it quits then the economic growth we have seen is going to fade fast. We aren't sure who is right, the bond market which can only see inflation or the general public who thinks the economy is half rotten if you pull back the tarp. Maybe they are both right, consumers are depressed by the upward spiral in prices and the bond market is readjusting yields to account for the worst inflation outbreak since the 80s. With this much uncertainty, the Federal Reserve needs to take a calm and measured approach to its policy tightening steps this year. The consumer has enough to worry about and doesn't need an unpredictable Fed.

Net, net, a downbeat consumer in retreat risks sending the economy over the cliff if they don’t start spending more at the shops and malls. Washington policies gave consumer jobs, but now the consumer is worried about too much inflation stoked by their own demand coming out of the recession. Stay tuned. The outlook for the economy is in turmoil just like the stock and bond markets.



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