Financial Markets This Week

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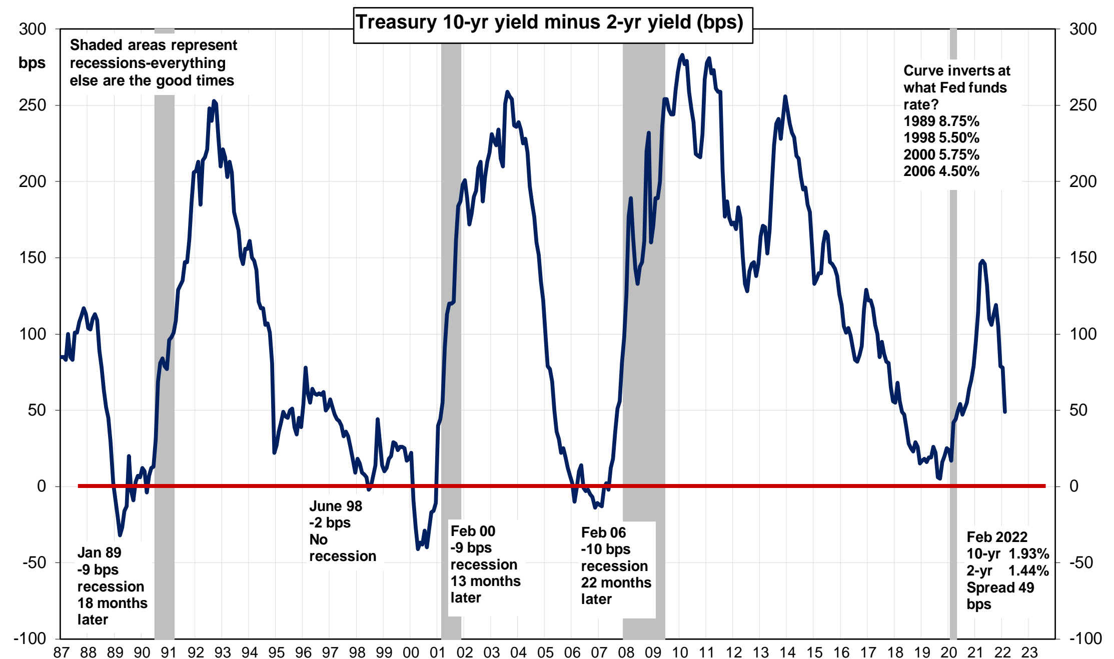
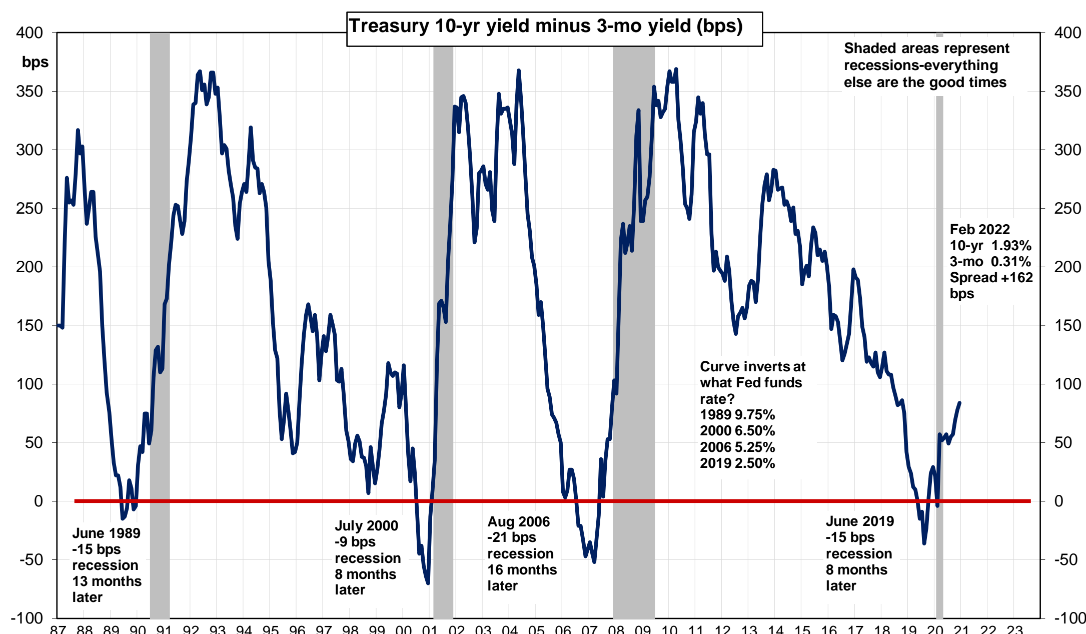
TALE OF TWO CURVES



Sometimes we wonder if it is a fairy tale. Is it really real, and can we make money on it. The market seems to believe it. There's no there there when it comes to market lore that an inverted yield curve signals recession. But the track record from curve inversion date to recession start-dates isn't going away either. Powell gave his climb-every-mountain, sail-every-sea speech Monday promising to tackle inflation even if it took 50 bps rate hikes and moving interest rates above 2.4% neutral levels for the economy. He did not believe in ghosts when it came to the yield curve's ability to forecast a recession. In fact, he threw out his own secret recession signal which is the curve bent of yields inside of the first 18 months of the yield curve that goes all the way out to 30-year bonds. The Fed economic staff told him. Researchers who don't bet their own money. You can see the 18-month inversion well enough in the chart normally in the Federal Reserve Polcy section (see March 11 newsletter) which plots the top of the Fed funds rate target to the 2-year Treasury yield. Two-years, 18-months, what is the difference and we don't mean the answer of 6-months. This Fed funds rate 2-year curve inverted in December 2018 and the recession began 14 months later in February 2020, that is to say, February 2020 was the last month of the economic expansion. It doesn't count really because the recession came from out of nowhere with the appearance of the coronavirus.

For the old faithful curve inversion, when 2-year yields rise above 10-year yields, there are probably many don't really count cases. But still the graph here is compelling. Traders can't not look. This curve missed the pandemic recession, but who cares, it was only two months long. Since the mid-1980s, the 2-year/10-year curve has inverted 4 times and a recession took place 3 times after the signal. The signal was early so you had enough time to get your affairs in order, pack your bags or whatever.

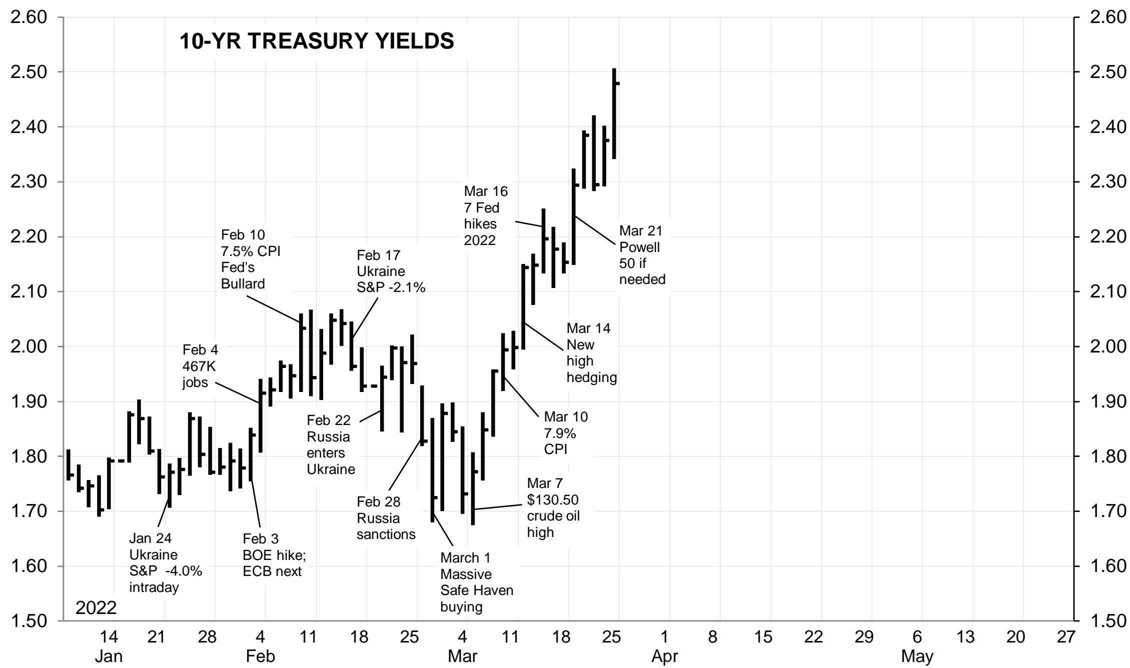
The curve inverted in January 1989 and the 1990-91 recession began 18 months later in July 1990. The curve inverted in June 1998 before the Global financial markets crisis, but that was a false signal. The curve inverted again in February 2000 and 13 months later the recession started. The curve inverted in February 2006 with the Fed funds rate at 4.5%, incoming Fed Chairman Bernanke didn't heed the recession signal and raised rates three more times to 5.25% and sure enough a recession started in December 2007 which was a long 22 months later. Bernanke always maintained the proximate cause of the worst financial crisis and recession since the Great Depression was the turn of the housing cycle. No argument there. Unless you are a yield curve trader.



The way to look at the curve inversion signal is the market, dealers, investors, speculators, think the central bank has raised rates high enough and that a recession is coming with a declining trend for bond yields is not too far off in the future. The 2-year/10-year close at 20 bps on Friday is just a number on a piece of paper. But for curve inversion to make sense it is best to know where the Fed funds rate was when the curve inverted. How high did the Fed need to push rates up to get people thinking policy was tight enough to bring the economic expansion to a halt. It used to make sense, the Fed funds rate was 5.75% in 2000 and 4.5% in 2006, reasonably high rates to slow borrowing in the economy and retard interest-sensitive sectors like housing and autos. But now the curve is close to inverting with the Fed just having raised rates once to 0.50% on March 16. Maybe the market is thinking the six more rate hikes the Fed forecast this year to 2.0% is tight monetary policy. Or maybe the curve is close to inverting looking at the crazy August 2022 Fed funds futures that discount at least two 50 bps rate hikes at the next three Fed meetings in May, June and July. Too fast a pace of Fed tightening could harm the economy as much as the level maybe.

One last thought is our own secret recession leading indicator, "we're telling you," the 3-month to 10-year Treasury yield curve that does have a perfect track record. There is a longer history starting in 1962, although we won't be going back there; the 2-year Treasury note was not auctioned on a regular basis until the early 1970s. The 3-month/10-year spread is a true champion. Signaling the last four recessions perfectly and the warning didn't come as early, too early to be useful, like the 2-year to 10-year curve. No false positives and it even forecast the 2020 recession Powell says was not his fault. Recession is a long way away for now, but who knows, if the Fed is really going to push the Fed funds rate to 2.5% at the end of the year, the recession signal may be coming faster than you think. Here's hoping. Bet on it.

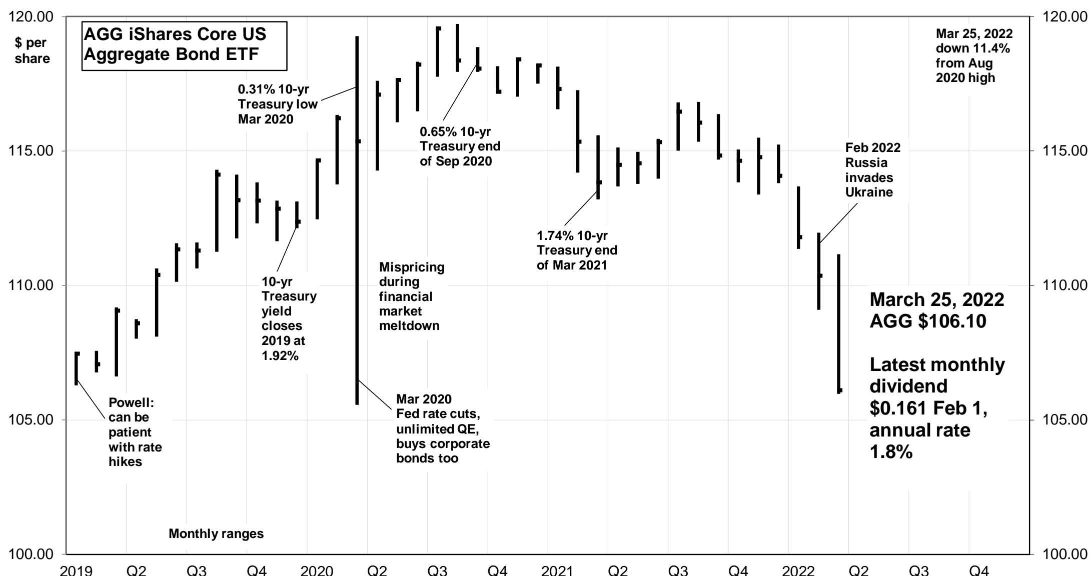
INTEREST RATES



Stocks were up 1.3% this week, and bond yields were up as well, increasing 33 bps for 10-yr Treasuries closing Friday at 2.48%. Who says stocks don't like higher yields. For the bond market, Powell's jawboning on rates Monday led 10-year Treasury yields to close above 2.25%, a nice round number that likely caused some mortgage-hedging and selling of even more Treasuries. By Friday, 10-year yields reached as high as 2.50% and August Fed funds futures are pricing in the new forecasts of U.S. primary Government securities dealers with Fed hikes of 50 bps in May, 50 bps in June, 25 bps in July. 1.75% interest rates, time to move money to an online bank, Ally, Marcus, Amex.

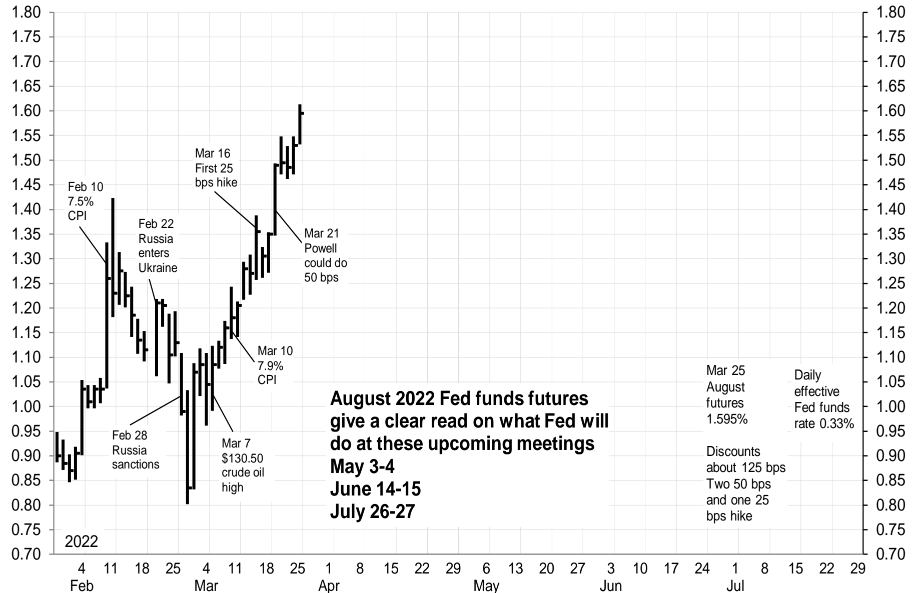
AGG iShares Core US Aggregate Bond ETF down 7.0% YTD

Bond yields are soaring so we thought we would check in on our AGG ETF. With 7.9% CPI inflation and Fed guns blazing we can't sleep at night thinking bond yields might suddenly adjust sharply higher just like the early 1980s finally reacting with a lag to the inflation shock. Terrifying. Like an old man with a grandchild on a roller coaster at Disney World (Florida). Using our HP 12C calculator, the 30-year Treasury closed at 2.59% tonight, good luck if the yield goes to 4.5%, you just lost 32%.



FEDERAL RESERVE POLICY

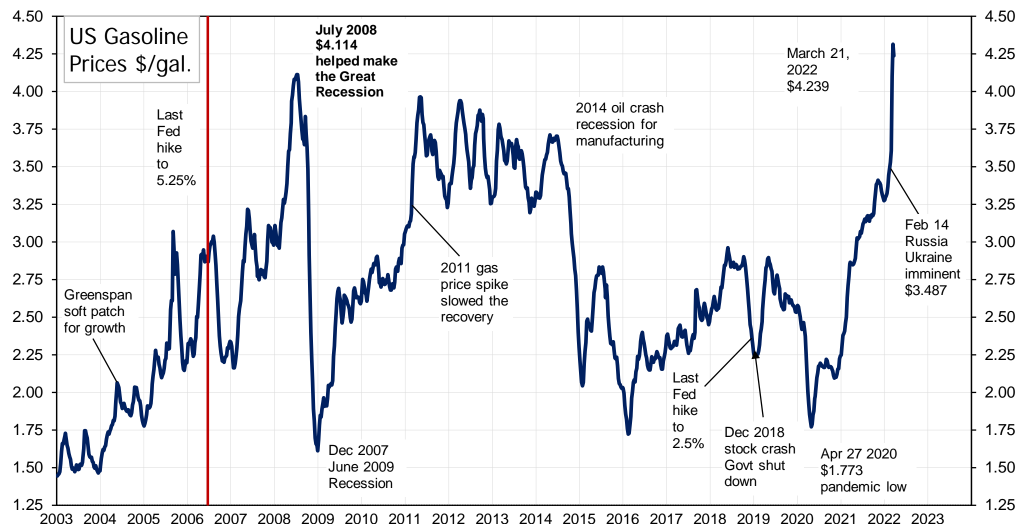
The Fed meets on May 3-4, 2022 to consider its monetary policy. Not even a week after the March 15-16 meeting and Powell doubles down on Monday, March 21 in a speech saying 50 bps hikes at Fed meetings later this year are not out of the question to address the inflation outbreak, or more properly and not stated, to make up for the Fed's slow response to the inflation outbreak that was not transitory as they thought "with the benefit of hindsight."



We read the speech and listened to the Q&A afterwards. The policy approach that will bring inflation down is the rate hikes the committee forecasts, and winding down the Fed's balance sheet at what looks like a terrific meaning dangerous rate of speed: apparently $1.5 trillion of Government securities per year for three years. Wow. If the Federal budget deficit is $1.5 trillion the next year you can double the U.S. government securities that need to be auctioned to $3 trillion. Will you buy it? Stay tuned. The world will be watching to see if Powell can restore price stability. Maybe make the banks pay interest on our savings accounts this time just in case you can't achieve the stated outcome.

> Finally, what will it take to restore price stability? The ultimate responsibility for price stability rests with the Federal Reserve. Price stability is essential if we are going to have another sustained period of strong labor market conditions. I believe that the policy approach that I have laid out is well suited to achieving this outcome. We will take the necessary steps to ensure a return to price stability. In particular, if we conclude that it is appropriate to move more aggressively by raising the federal funds rate by more than 25 basis points at a meeting or meetings, we will do so. And if we determine that we need to tighten beyond common measures of neutral and into a more restrictive stance, we will do that as well.

If consumers can't pay the prices at the pump, maybe a recession is coming.

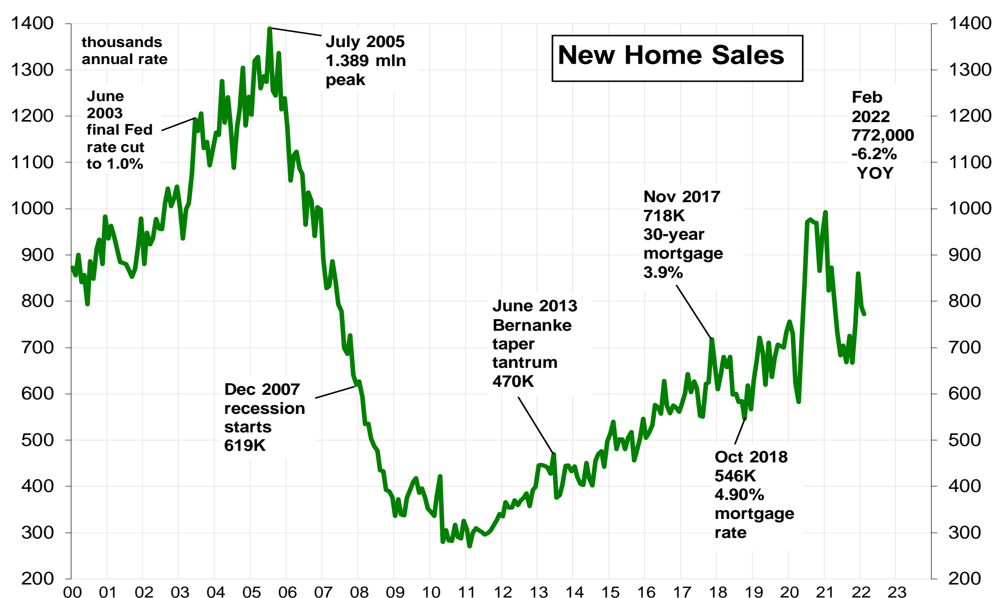


OTHER ECONOMIC NEWS

If you didn't buy a new home yet, it is too late (Wednesday)

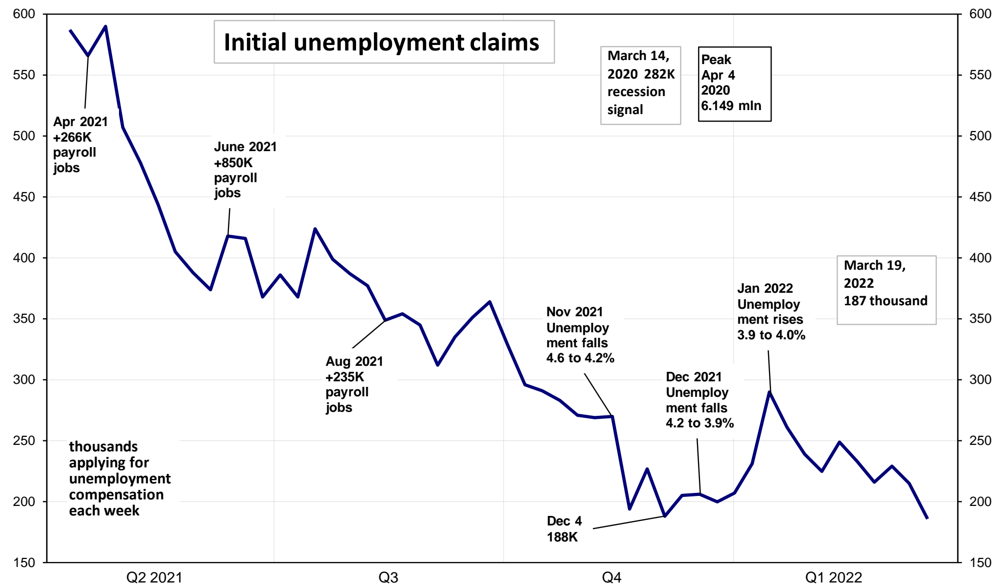
Breaking economy news. New home sales have been volatile this winter and sales nationwide were 772 thousand in February down 2.0% from 788 thousand in January. The 14.2% jump to 860 thousand in December did not hold. Sales in February would have been weaker without the strange 59.3% jump in Northeast sales. Even with the jump this month, Northeast sales were 43 thousand at an annual rate which are not even 10% of the biggest sales region in the U.S. down South with 451 thousand in sales. The outlook for new home sales is filled with storm clouds with Washington stimulus fading further in the rear view mirror and the Federal Reserve moving aggressively to take the punch bowl away and push mortgage and interest rates back to where they were before the pandemic. It is right there in the Fed's monetary policy playbook, slow economic demand by pushing rates high enough to hit interest-sensitive sectors of the economy like housing and autos hard. Powell said monetary policy was a blunt tool, but for new home sales the faster higher interest rates are going to fall like an axe. Powell was quite clear and the Fed is unlikely to stop raising rates until new home sales come down dramatically. The Fed doesn't want to trigger a recession, but recession is what it is going to feel like for those employed in the housing sector. New home median sales prices are holding at $400,600 in February, but for how long. Median prices moved up 18.4% from $336,900 in 2020 to $398,800 in 2021, but the Fed rate hikes may stop the latest pandemic housing price bubble in its tracks.

Net, net, home sales and prices have cooled off from the pandemic buying frenzy triggered by work from home options for many company employees. With fear of war building up over in Europe and gasoline prices and other commodity prices reaching new heights, home buyers are likely to be cautious on whether to make the biggest financial purchase of their lives. Rising mortgage rates sometimes sets off a rush to purchase a new home before borrowing costs grow even higher, but it is too early to see this in the home sales data at least this month. We will see.



Summer of ’69 joblessness (Thursday)

Breaking economy news. Weekly jobless claims show there are no jobless. March 19 week unemployment claims fell 28 thousand to 187 thousand which is the lowest since September 6, 1969. Better hang onto your hats because next week’s payroll jobs report could be the biggest one yet in this recovery from the pandemic. Federal Reserve officials are already chomping at the bit for bigger 50 bps rate hikes at upcoming meetings, and today’s tightest labor market since the 1960s is like pouring gasoline on the fire where any policy official worth his or her salt is burning with desire to get interest rates up to 2 percent neutral levels now.



Meanwhile, business orders for nondefense capital goods ex-aircraft had a rare off-month posting a modest decline of 0.3% in February. These orders have been streaking skyward almost immediately after the shortest recession in U.S. history ended in April 2020. Looking at orders more broadly, machinery orders fell 2.6% in February after climbing 3.0% in January. Computers and electronic products fell 1.1%, but it wasn’t computers as computers and related products were up 4.4% in February. Companies are not pulling orders despite the stock market weakness at the start of the year and the latest headlines out of Europe. It is still early to assess the business climate however as this is February data on orders and Russia didn’t enter Ukraine until February 22. Energy costs at factories are going straight up and will weigh on corporate profits sooner rather than later. Crude oil goes up before almost every U.S. recession since the 70s, and the chart pattern on oil prices right now looks just like it did before prior recessions. It will be a miracle if the economy can dodge a recession if history is any guide.

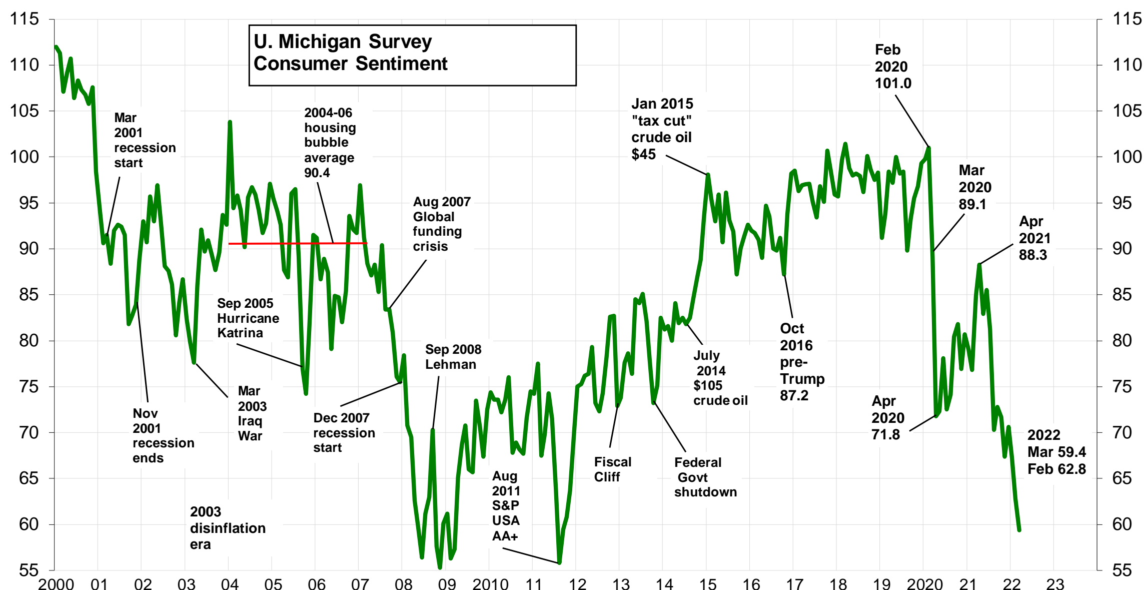
Net, net, no one is losing their job with companies holding on tight to their workers despite the worrying signs of recession on the horizon from rising gasoline prices, stock market corrections and the horrific World War II photos coming out of Europe. No wonder worker wages are soaring as company managers offer carrots where they used to give out sticks. The omicron variant is having no impact on the labor market and the anecdotal reports of massive labor market shortages are very, very real. There is a lot of talk about countries going back to local production and the era of globalization and long overseas supply chains is over. But that economic model has one gigantic stumbling block in the USA because there is no one to work the factories to produce the goods here on American soil.

Consumer says we are in recession (Friday)

Breaking economy news. Consumer sentiment from the University of Michigan was revised lower in March to 59.4 from 62.8 in February. The confidence of the American public has taken an unexpected hit from the soaring prices of everything they buy. The Fed is speeding up their rate hikes to bring inflation under control, but this is doing nothing to bolster consumer confidence where the outlook for the economy has turned from cloudy and gray to one of impending darkness. It is almost as if the consumer is saying we see no way out of this inflation mess without a dramatic slowdown of the economy that brings the country back to the brink of recession.

Net, net, consumers have lost confidence that the economy can move forward with inflation fires running out of control across the country. Usually consumers fret about job opportunities and the lack thereof, but this time, the consumer is in sync with Fed officials that the greatest danger the economy faces is inflation. Consumers continue to spend, but future consumption is very much in doubt as the cost of store bought goods soars ever higher. Prices will rise so high that consumers can’t afford to buy, stopping the economy in its tracks.

We have rarely seen consumers this pessimistic outside of the darkest days of recessions, but the polling indicates the public is more scared about their economic future than they have been in years. Everyone get out of the way because if the consumer stops, then the economy drops and it will be a miracle if the economy can avoid a shipwreck on the shores of recession.



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