Financial Markets This Week

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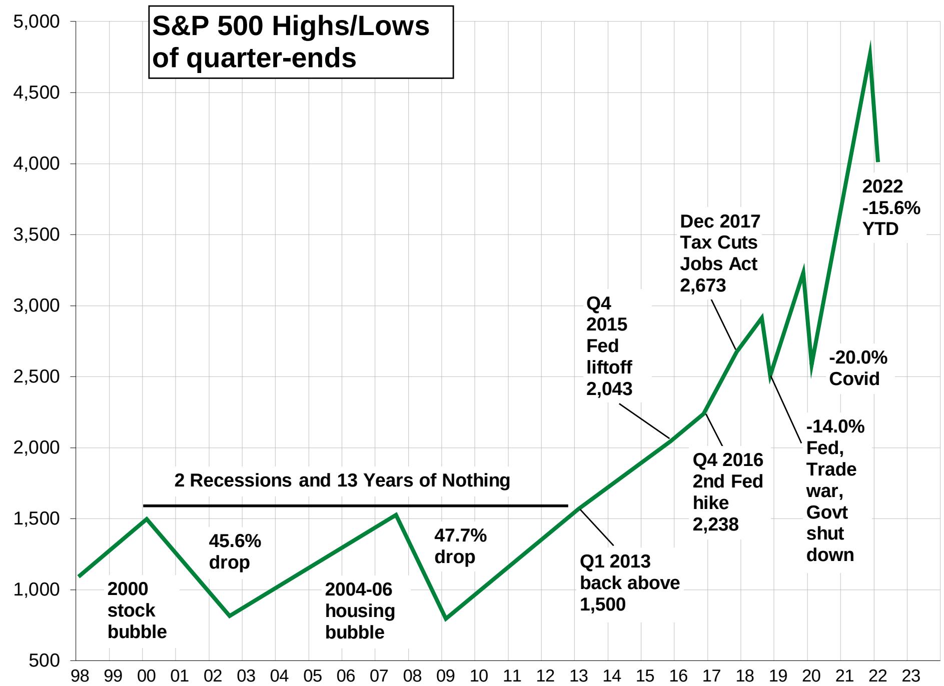
Christopher S. Rupkey, CFA
Chief Economist
crupkey@fwdbonds.com

STOCK MARKET VALUATION

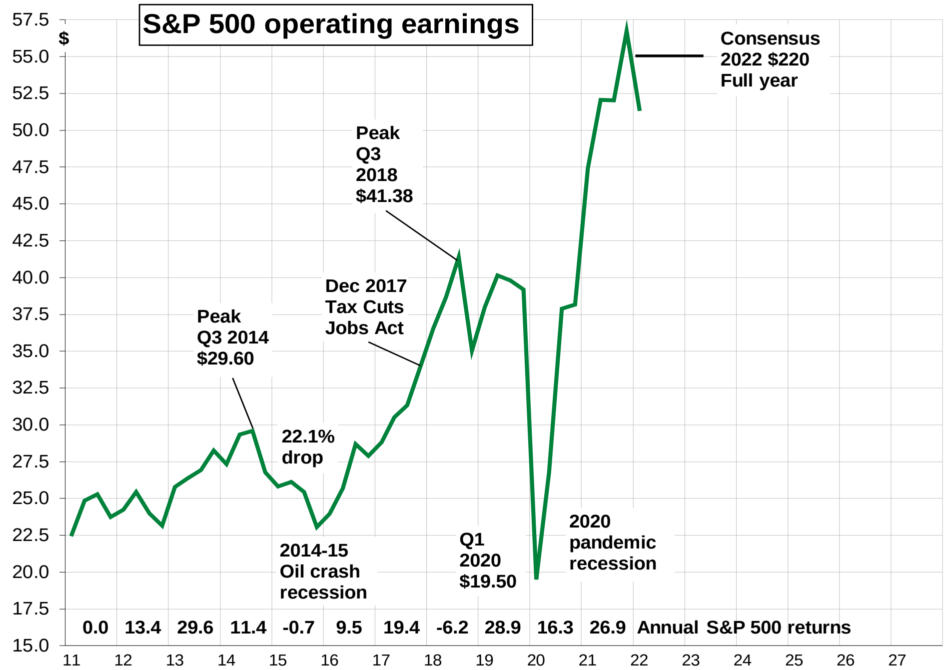


The S&P 500 discounted a recession on Thursday falling 19.9%. Stocks have fallen at least 20% in every recession since the 70s, so we have arrived. (Why did the decline stop at exactly 19.92%? Who watches and controls the market?) Stocks are down, besides the war in Europe, who did this? Who or what caused the sell-off? The Fed did it. The stock market has had a hard time rallying ever since the 1990s while the Fed is in a rate-hike cycle. Investors have forgotten as stocks did manage to ignore the Fed's rate hikes in the 2015-18 period, partly because Fed officials paused after the first hike in December 2015 and didn't hike a second time until December 2016. Another couple of reasons why the stock market ignored the last Fed tightening cycle: one, stocks had been beaten down for over a decade following the 2000 stock market bubble. The S&P 500 peaked back in March 2000 and hadn't broken back above again for 13 long years until March 2013. Secondly, the Tax Cuts and Jobs Act signed in December 2017 with a big corporate tax cut was maybe worth a 20% S&P 500 rally all on its own.

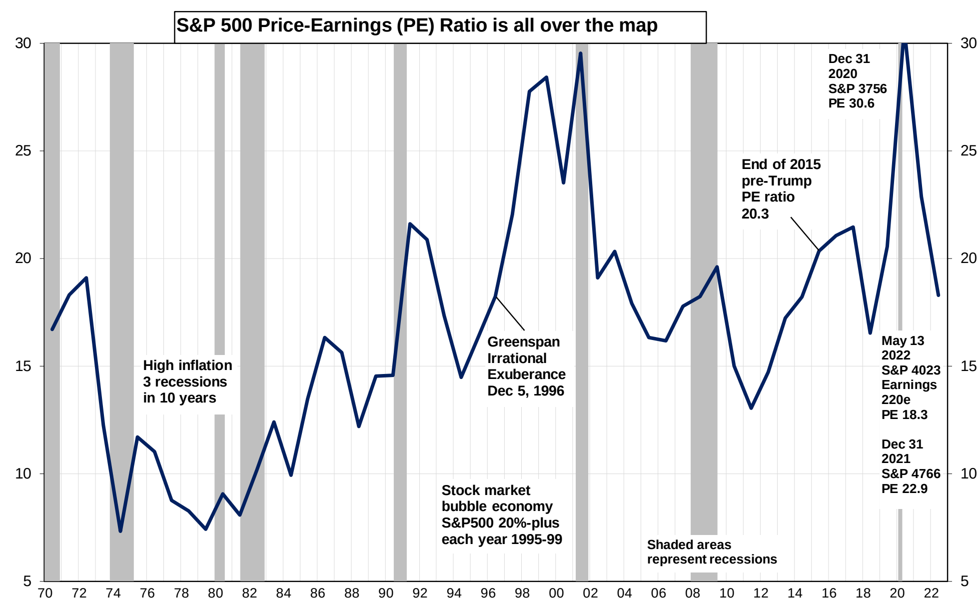
Fed Rate Hike Periods and Stock Market Performance

Tightening Episodes	First Hike	Fed funds low-high	Last Hike	Days
2015-2018	12/16/2015	0.25-2.50	12/19/2018	1099
Dow Industrials	17749.09	31.4%	23323.66	
2004-2006	6/30/2004	1.00-5.25	6/29/2006	729
Dow Industrials	10435.48	7.2%	11190.80	
1999-2000	6/30/1999	4.75-6.50	5/16/2000	321
Dow Industrials	10970.8	-0.3%	10934.6	
1994-1995	2/4/1994	3.00-6.00	2/1/1995	362
Dow Industrials	3871.4	-0.6%	3847.6	

For the record, stocks rallied 31.4% over the three year period of restrictive Fed policy from 2015-18, about 10% per year. During the housing bubble tightening from 2004-06, stocks rallied 7.2% over two years, 3.6% per year. During the two rate hike periods in the 1990s, stocks went nowhere. We keep looking at the Fed funds rate peaks in the 1990s of 6.0% and then 6.5%, and wonder with the worst inflation outbreak since the 80s, how can we still be talking about a 2.5 or 3.5 percent Fed funds rate forecast in the next couple of years.



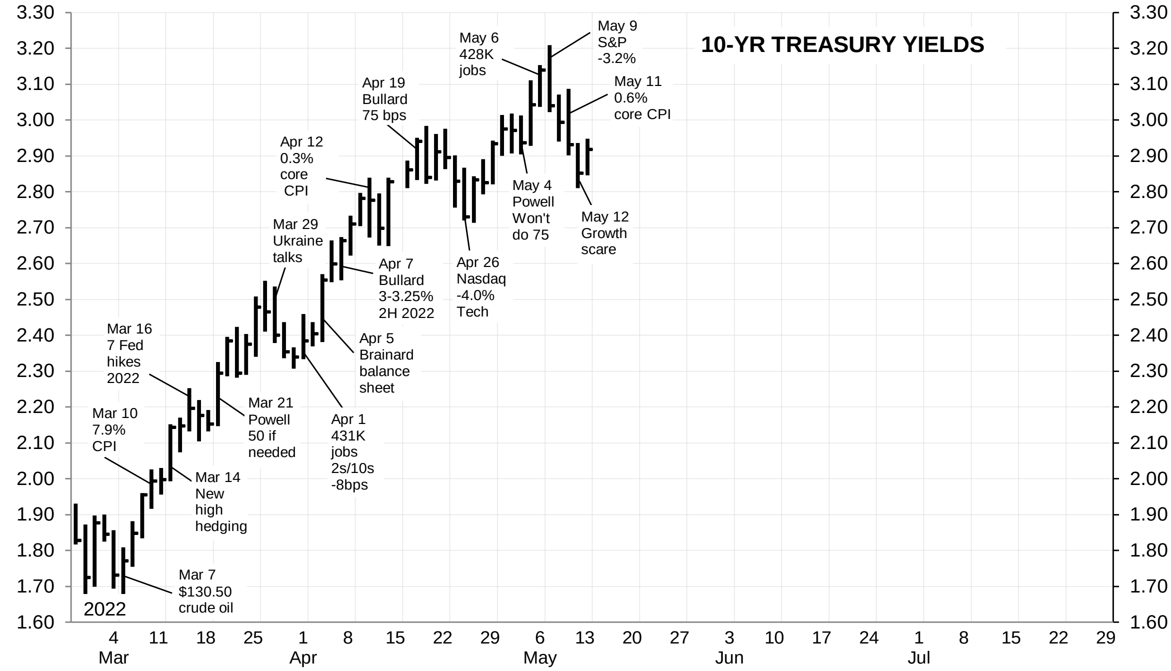
Stock market valuation. How are corporate earnings doing? Can't have stocks moving up in the long run if companies don't make more money. Earnings surged starting the first quarter of 2021 and ran high all year, more than offsetting the losses for a couple of quarters during the pandemic. Looks like the definition of supernormal profits, thinking like an economist which means temporary, but Street earnings estimates for 2022 are high at roughly $55 billion per quarter or $220 for the full year.



The PE ratio has normalized. Assuming the $220 earnings estimates hold up with all the recession talk and consumer confidence fading, Friday's close of 4,023.89 for the S&P 500 gives a PE ratio of 18.3. PE ratios were around 10 back in the high inflation of the 70s. In more modern times, the recent PE ratio low was 13.0 in 2011; earnings picked up dramatically after the Great Recession and stocks just sat there. There was the European sovereign debt crisis part II and S&P downgraded the U.S. to AA+ in August 2011.

To conclude, stocks are down about 20%, the same as at the end of 2018 before turning around when Powell stopped tightening. We will stay away from investment advice. The last time we recommended buying stocks down 20% from the highs, the market fell over 50% in the Great Recession. (Hey, you got your money back, didn't you?). Stay tuned. Story developing.

INTEREST RATES

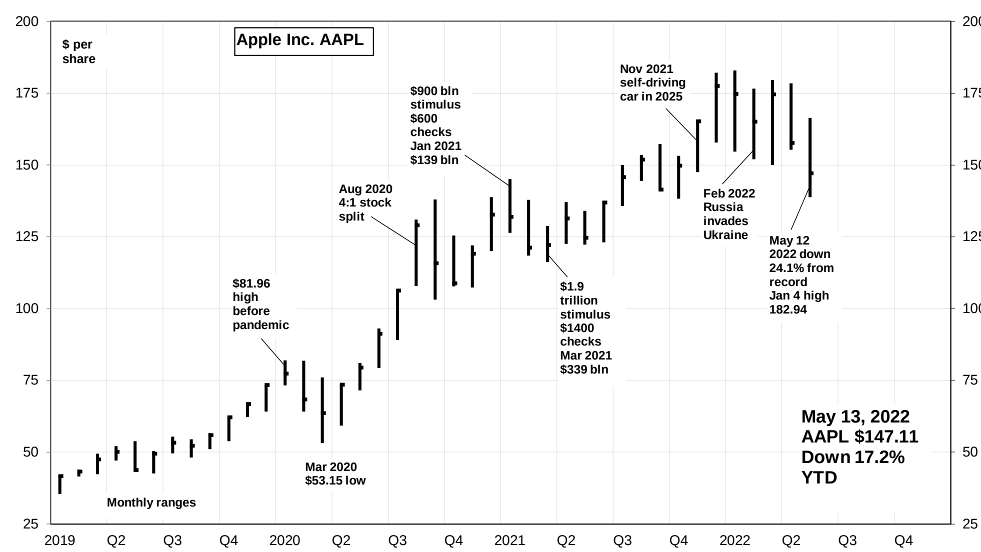


After opening higher Monday, bond yields fell until Friday. The sharp declines in stocks seemed to cause a growth scare for bonds. Stocks and bonds are both looking for signs of an economic slowdown that will stop the Fed from proceeding with its aggressive plan to hike rates. Powell gave an interview to National Public Radio late Thursday which may have turned stocks and bond yields up on Friday. He said they didn't do 75 bps, but they did agree to do back-to-back 50 bps hikes at the June and July meetings. This seemed to be interpreted as no 75 bps hike in the future. He also said he couldn't rule out a hard landing for the economy, but this was ignored by the market. Powell stopped raising rates when stocks dropped 20% in 2018… this time nothing.

Apple Inc. AAPL 17.2% down on year with supply constraints to hurt sales

Apple was $163.64 the night of its earnings release on April 28. All stocks are down with 2022 high-to-low -19.9% for the S&P 500 on Thursday, and Apple falling 24.1% on the same basis. The CFO said supply constraints in the June quarter would be $4 billion to $8 billion for year-year revenues which is substantially larger than the March quarter. Covid could affect consumer demand in China as well. Greater China sales were $18.3 billion in Q1 2022 ending March: total revenues $97.3 billion.

S&P 500 Weights	
Top 6: 22% of S&P	
6.65	AAPL
5.76	MSFT
2.82	AMZN
1.83	TSLA
1.70	Berkshire
2.04	GOOGL
1.89	GOOG
22.69	Top 6



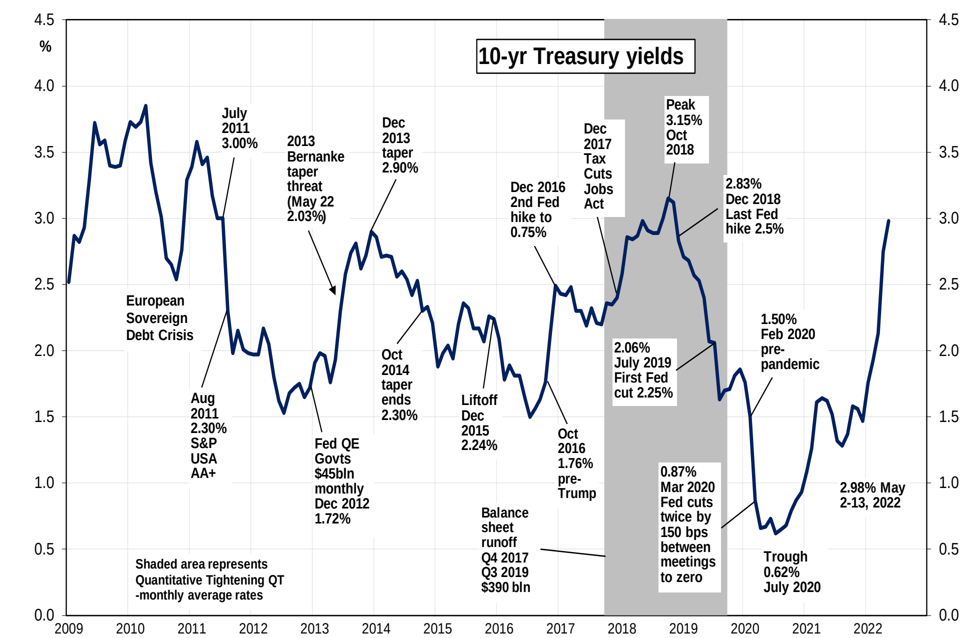
FEDERAL RESERVE POLICY

Selected Fed assets and liabilities Fed H.4.1 statistical release billions, Wednesday data	11-May	4-May	27-Apr	20-Apr	March 11 2020** pre-Covid
Factors adding reserves					
U.S. Treasury securities	5766.625	5765.229	5764.013	5763.035	2523.031
Federal agency debt securities	2.347	2.347	2.347	2.347	2.347
Mortgage-backed securities (MBS)	2715.021	2715.020	2715.012	2730.687	1371.846
Repurchase agreements	0.000	0.001	0.000	0.000	242.375
Primary credit (Discount Window)	0.834	2.606	2.917	2.181	0.011
Paycheck Protection Facility	20.929	21.229	21.791	22.173	
Corporate Credit Facility (CCF)	0.000	0.000	0.000	0.000	
Municipal Liquidity Facility	6.660	6.659	6.657	6.656	
Main Street Lending Program	28.651	28.640	28.486	28.476	
Term Asset-Backed Facility (TALF II)	2.466	2.465	2.513	2.512	
Central bank liquidity swaps	0.222	0.225	0.214	0.237	0.058
Federal Reserve Assets	8991.6	8989.5	8988.2	9005.4	4360.0
~~3-month Libor %~~ SOFR %	0.78	0.30	0.28	0.27	1.15
Factors draining reserves					
Currency in circulation	2273.743	2272.695	2270.662	2270.489	1818.957
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
U.S. Treasury Account at Fed	919.331	964.412	957.419	907.526	372.337
Treasury credit facilities contribution	21.258	21.258	21.258	21.258	
Reverse repurchases w/others	1876.119	1815.656	1803.333	1866.560	1.325
Reserve Balances (Net Liquidity)	33295.680	3313.993	3327.548	3326.857	1779.990
Treasuries within 15 days	125.895	131.150	78.805	87.731	21.427
Treasuries 16 to 90 days	286.505	281.662	328.227	327.570	221.961
Treasuries 91 days to 1 year	802.274	801.777	773.813	769.484	378.403
Treasuries over 1-yr to 5 years	2123.737	2123.221	2158.802	2158.441	915.101
Treasuries over 5-yrs to 10 years	1018.099	1017.659	1017.134	1016.826	327.906
Treasuries over 10-years	1410.114	1409.760	1407.233	1406.984	658.232
**March 11, 2020 start of coronavirus lockdown of country					

The Fed meets on June 14-15, 2022 to consider its monetary policy. 50 bps is on the table at this meeting and the following July 26-27 meeting. On the table means it is already done unless the stock market crashes** and Powell can ride to the rescue like he did in January 2019 and March 2020. The Fed funds rate will be 2.0% by August. October Fed funds futures are 38 bps higher than August Fed funds futures so the market is looking at more than a regular-sized 25 bps rate hike at the September 20-21 meeting. The June 14-15 meeting has an interest rate forecast update which could be hawkish. There's more inflation than in 2018 so the Fed forecasts could be higher than the 3.5% Fed funds rate policymakers were thinking about down the line when they made their forecast at the meetings in 2018.

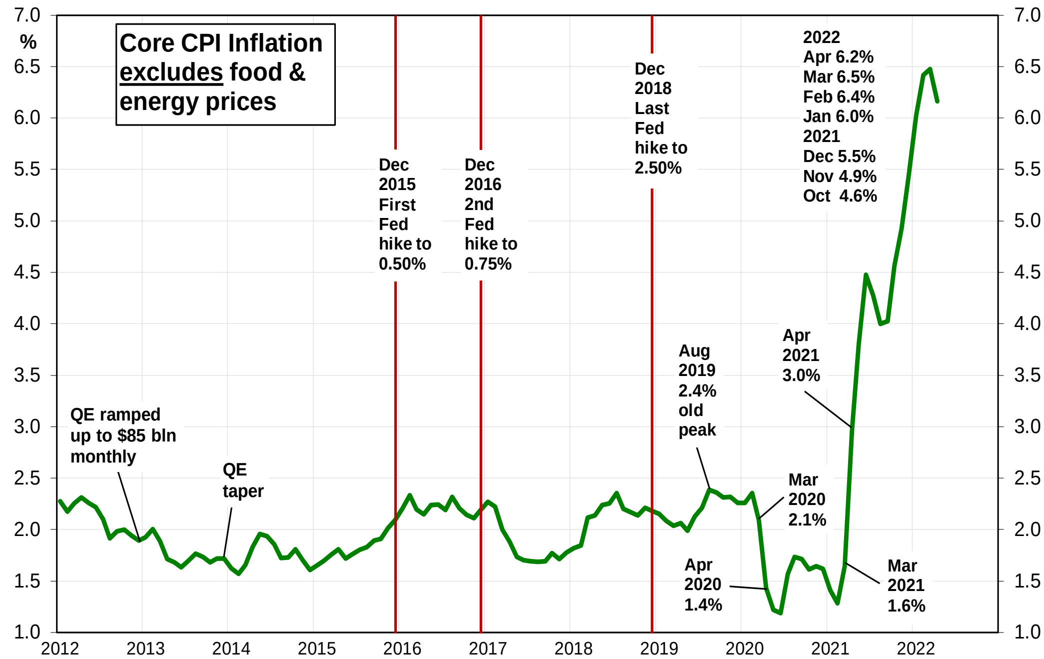
What else? We almost forgot. Quantitative tightening QT. Market still thinks it is important even if Powell said the QT they have planned over a year's time is equivalent to one lousy 25 bps rate hike. Guess this means QE did not fuel the pandemic stock market rally like we read on twitter. The shaded area in the graph below from Q4 2017 to Q3 2019 is $390 billion of QT over a two-year period by our count and indeed, Treasury yields rose for a time. Other things going on of course. Anyway, starting June 1, QT Treasuries is $30 billion monthly (360 annual) for three months and then going to $60 billion monthly (720 annual) which will eventually be significantly more than the (390/2) $195 billion annually the last time. Still unclear why this is necessary, and we are leaving out for now the mess this might make in the mortgage markets. Rates on 30-year mortgages were 5.30% in the May 12, 2022 week, which is 225 bps higher than 3.05% risk-free 10-yr Treasury yields. Wider credit crunch spreads maybe.

** On Thursday, the stock market fell as much as 19.9% from the record high in the first days of the year. Powell said nothing in an interview on National Public Radio. Stocks fell as much as 20.2% in December 2018 after the Fed raised rates to 2.5%, the Trump trade war with China, and the Federal government shutdown. Powell said the Fed could be patient on January 4, 2019 and the Committee shelved the two additional rate hikes to 3.0% they had planned for 2019. Stock market is good for the inflation fight, we guess. Thanks.



OTHER ECONOMIC NEWS

Inflation isn't any hotter, but the fire isn't out yet (Wednesday)



Breaking economy news. CPI inflation was worse than market expectations. Energy prices didn't fall as much and core inflation rose 0.6% for the month with new car prices up 1.1% and services prices ex-energy up 0.7% (0.7 the highest since at least October 2021). Nevertheless, there are tentative signs inflation is close to the peak once we get the higher gasoline prices at the start of the summer driving season in May out of the way.

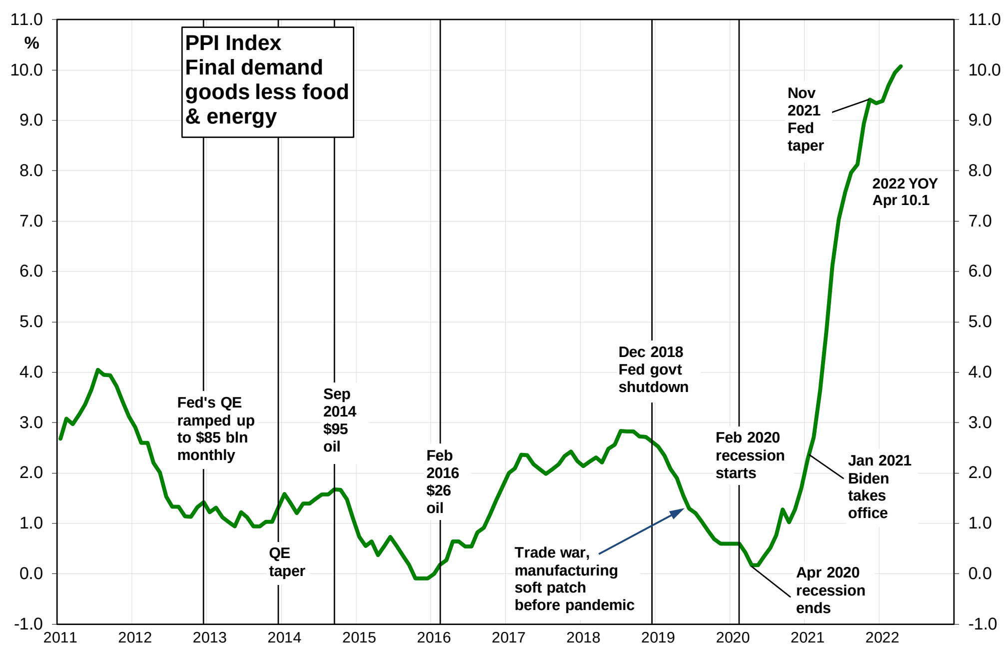
April CPI inflation up 8.3% the last year; it was 8.5% last month. Core CPI inflation up 6.2% the last year; it was 6.5% last month. Inflation may have peaked, but that doesn't mean prices will stop rising. The million dollar question is where inflation slows to whether it is 3 or 4 or 5 percent because if inflation sticks there, then the central bank may need to raise interest rates to 3 or 4 or 5 percent. Every inflation outbreak since the 70s has ended in recession and it will be a miracle if ever tighter monetary policy doesn't bring down the house again within the next couple of years. The Fed has its work cut out for it as the long list of major consumer expenditure categories shows only two, Physicians' services and Medical care commodities, that are at or below the Fed's 2 percent inflation target.

		Monthly Percent Changes			YOY %
Weight	CPI inflation	Feb 2022	Mar 2022	Apr 2022	Apr 2022
100.0	Total	0.8	1.2	0.3	8.3
13.990	Food	1.0	1.0	0.9	9.4
6.269	Food away from home	0.4	0.3	0.6	7.2
7.542	Energy	3.5	11.0	-2.7	30.3
78.468	Ex-food & energy	0.5	0.3	0.6	6.2
3.884	New vehicles	0.3	0.2	1.1	13.2
3.419	Used cars/trucks	-0.2	-3.8	-0.4	22.7
2.669	Clothing	0.7	0.6	-0.8	5.4
1.487	Medical care goods	0.3	0.2	0.1	2.1
32.393	Shelter	0.5	0.5	0.5	5.1
23.509	Owner equiv. rent	0.4	0.4	0.5	4.8
5.046	Transportation	1.4	2.0	3.1	8.5
6.987	Medical care services	0.1	0.6	0.5	3.5
	Special: Where inflation might come back down to				
57.700	Services ex-energy	0.5	0.6	0.7	4.9

In every cycle, commodity prices are the biggest swing factor behind inflation moving up and down sharply in response to supply and demand forces in the economy. Commodities less food and energy rose 9.7% the last year and could go negative next year as the Fed pumps the brakes on demand and supply chains come back on line. Services prices are stickier as once companies gain pricing power they don't easily give it up. Services less energy prices are up 4.9% the last year which shows where inflation might come back down to, if food and energy prices ever stop going up.

Net, net, the country's struggle with high inflation isn't over yet, but the markets can still breathe a sigh of relief that the most virulent outbreak since the 80s is not getting any worse. Bond yields have soared trying to guess how high Fed officials need to go with interest rates to fight inflation. The Fed can stay on plan with 50 bps rate hikes at the next two meetings in June and July and there is no reason to move more expeditiously to fight inflation. There were signs of cautious optimism in the CPI report today from another decline in used car and truck prices: with a 5.2% weight in the core CPI index, the 22.7% rise in used car and truck prices was responsible for 1.2 percentage points of the 6.2% rise in core CPI the last year. It isn't impossible to imagine core CPI falling back near to 2 or 3 percent for a time if used car and truck prices fall as hard as they climbed the last year. Stay tuned. Story developing. Inflation isn't growing any hotter, but the fire isn't out yet either. The Fed's work is not done. Not by a long shot. The biggest central bank policy error committed since the 70s hasn't been corrected yet and no one yet knows whether it can be.

Producer prices still moving up (Thursday)

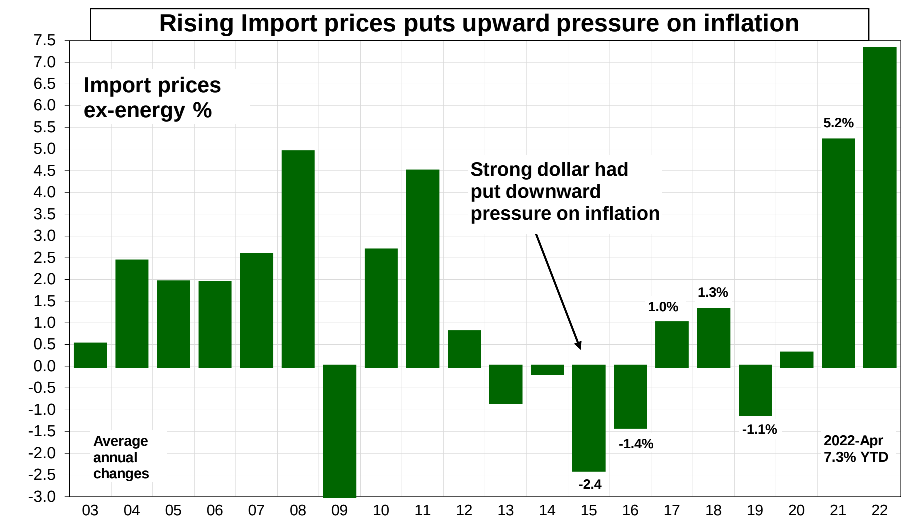


We focus on Final demand goods less food and energy which is 21.543% of the PPI index. It is at a new high of 10.1% year-year in April and was 9.4% in November 2021 when Powell took the first steps to take the punch bowl away. In [Thursday's NPR interview] Powell said with perfect hindsight it would have been better to raise interest rates earlier, but "I'm not sure how much difference it would have made." This is what you get when you put a non-economist in as Chairman to explain how the economy and inflation works. The hotspots for PPI Final demand goods less food and energy inflation year-on-year: Private capital equipment for manufacturing industries 12.5%, Government purchased goods excluding capital equipment 14.2%, Goods for export 12.5%. More inflation is coming the consumer's way. Finished consumer goods less food and energy up 0.8% in April, an increase of 8.0% from last year.

America imports inflation too (Friday)

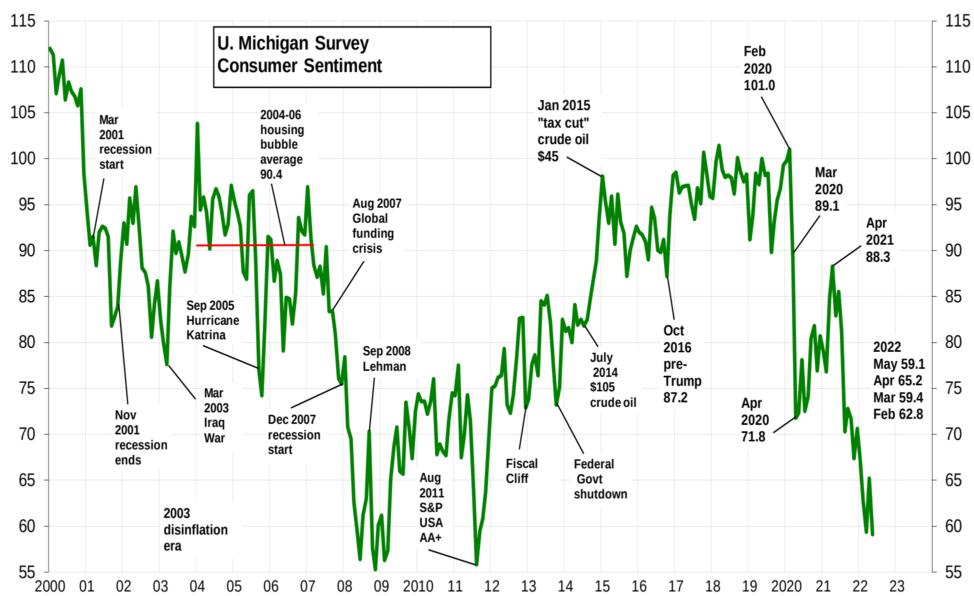
Breaking economy news. Nonfuel import prices slowed to a gain of 0.4% in April, but are 7.2% higher than a year ago. Inflation will be much more entrenched in society if prices of goods coming into the country are just as high as the prices of goods for sale domestically. Of course, many of the imported goods are used in the manufacture of goods in U.S. factories. Industrial supplies and materials, capital goods, foods and beverages, and automotive vehicles are all going higher. For finished goods, capital goods prices are the highest since the early 90s, rising 3.8% the last year. The only good news was prices for consumer goods that were unchanged in April. Prices of all imports from China are 4.6% higher than a year ago. Import prices from Japan are 1.9% higher than last year. The fact that America imports inflation too makes the inflation battle that much harder for the central bank.

Net, net, import prices slowed their advance this month, but it is too early to declare victory. Nonfuel import prices surged 7.2% the last year making inflation even more persistent and the Fed's job that much harder. Too much focus in the markets has been on whether inflation has peaked, where the real danger to the economy will come from the level where inflation settles in at, after this outbreak due partly to temporary factors like commodity shortages and supply chain issues. If inflation comes back down to 3% and sits there, that will be small comfort to the working class and seniors living on fixed incomes in America. Inflation of 3% will seriously erode the value of financial assets over the next decade if Washington regulators don't bring back risk-free interest rates that match the rate of inflation.



Consumers still complaining, when will they stop shopping (Friday)

The U.S. should already be in a recession if the consumer sentiment index had any predictive power. Real consumer expenditures in GDP were still normal at 2.7% in Q1 2022. After the bounce in sentiment to 65.2 in April, we are back down to 59.1 in May's preliminary survey with a May 11 cut-off date. Maybe the new low in stocks hurt consumer confidence.



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