Financial Markets This Week

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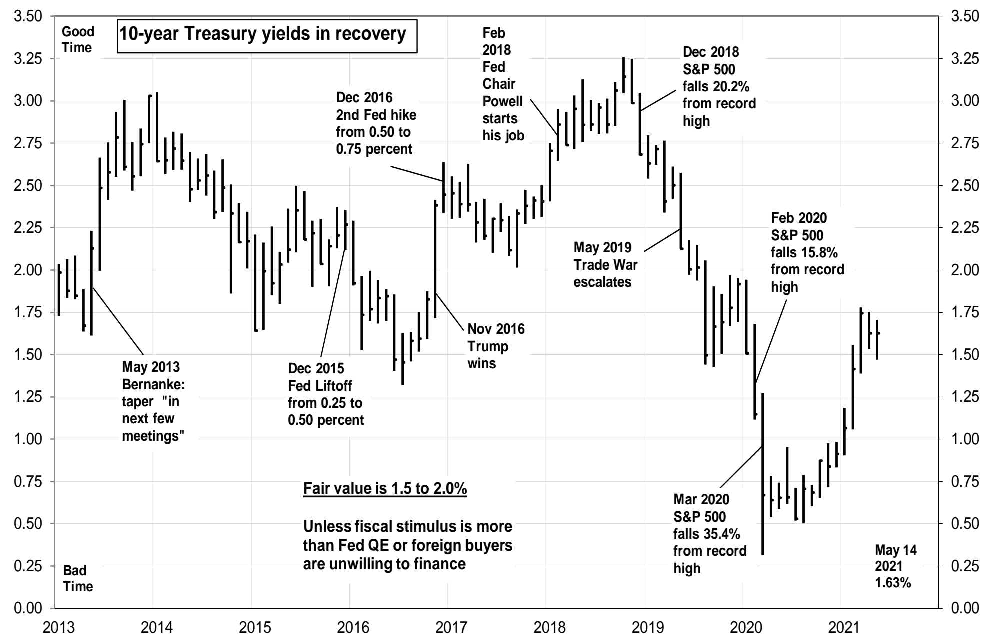
Bond Market Valuation



We were going to do a stock market valuation newsletter this week, but we are economists, a 1990s CFA notwithstanding, and do not understand current valuation markers in stocks like the sky-high PE ratio. Bonds are much easier to understand especially when you have helpful former Fed officials forecasting 3 or 4 percent bond yields once the economy gets back to normal. Bonds were last at 3.25% in late 2018 when the Fed was pushing rates to 2.5%.

For bond valuation there is Fed policy, the backbone of bond yields being the Fed funds rate always which is just 0.25% at the moment. There is inflation: more inflation then higher bond yields. The bond market vigilantes disappeared as a force for higher yields in the early 1990s; they were always concerned the Fed was behind the curve in fighting inflation. There is supply and demand of Treasury securities, how many auctions, how many securities versus demand including foreign investors (owned 42.7% or $7.071 trillion of our privately held debt in Q3 2020) and the Federal Reserve's QE which is $80 billion per month and a substantial $960 billion per year.

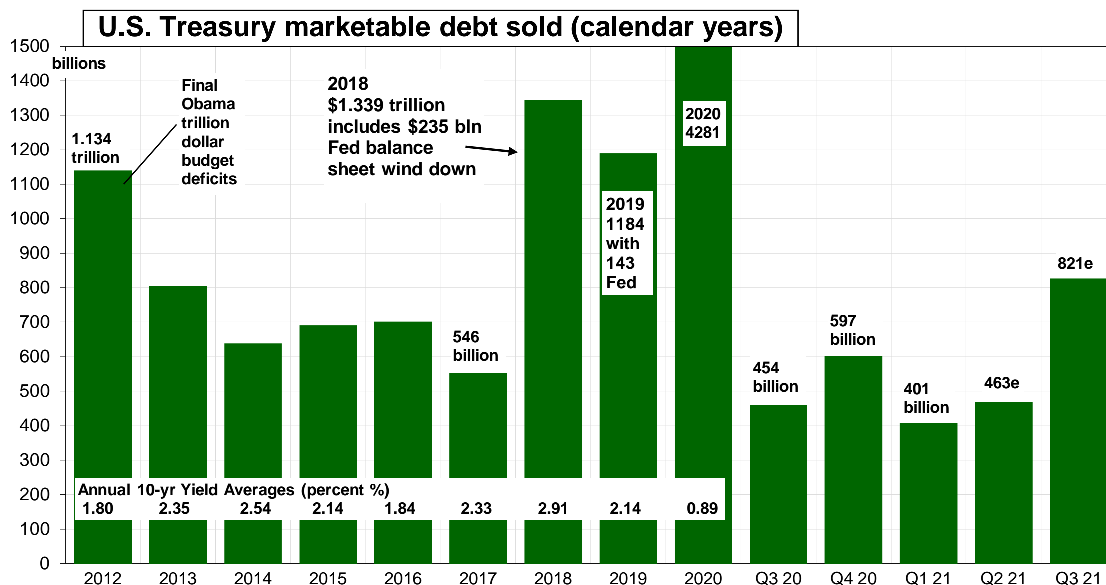
The model 60/40 weighted stocks/bonds portfolio is suffering with the rise in bond yields from the depths of the pandemic recession where the Fed threw in everything they had during the financial panic. They cut interest rates 150 bps in March 2020, two separate announcements in between regularly scheduled meetings no less. In modern history, only Bernanke cut interest rates nearly as fast which shocked the financial world at the time. 125 bps of rate cuts in ten days at the start of the Great Recession in January 2008 led to cries of "What on earth is he doing?" In March 2020, Powell also said in addition to unlimited QE Treasury/MBS purchases, they would buy corporate bonds as well the first time and that seemed to stop the plunge in the stock market and bond yields.

Bond yields are rising in 2021 and closed at 1.63% Friday. How did we get here? 10-year Treasury yields jumped 1.0% the first time on the news Democrats had won the Senate by picking up the two Georgia elections so additional fiscal stimulus was on the way. The $1.9 trillion Biden relief plan with the $1400 checks meant either a stronger rebound in the economy or more auctions of Treasury securities that the government couldn't sell without dangling higher yields in front of investors.

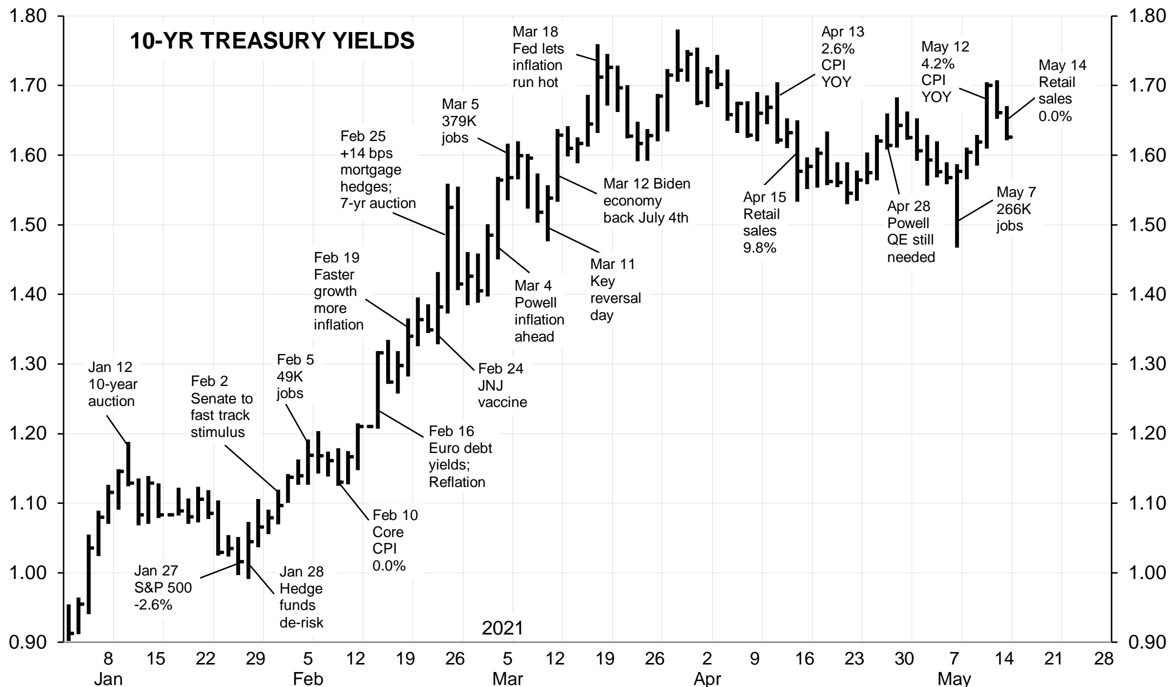
	10-yr Treasury Yield	Core CPI	Real Yield bps
2002	4.61	2.4	221
2003	4.01	1.4	261
2004	4.27	1.8	247
2005	4.29	2.2	209
2006	4.80	2.5	230
2007	4.63	2.3	233
2008	3.66	2.3	136
2009	3.26	1.7	156
2010	3.22	1.0	222
2011	2.78	1.7	108
2012	1.80	2.1	-30
2013	2.35	1.8	55
2014	2.54	1.7	84
2015	2.14	1.8	34
2016	1.84	2.2	-36
2017	2.33	1.8	53
2018	2.91	2.1	81
2019	2.14	2.2	-6
2020	0.89	1.7	-81
2021	1.40	1.8	-40

2021-to April

To summarize, abruptly maybe before we really got started, bond yields have come a long way in the recovery from recession. The economy up, bond yields up, and yet the Fed hasn't raised interest rates yet and has not even hinted when they will talk about talking about stopping their monthly $80 billion purchases of Treasuries "that allows the nation to live beyond its means." Maybe the economy is heating up with more demand-boost inflation (this week anyway) with the CPI report, but we expect economic growth to slow and believe the fastest growth is behind us in the rearview mirror. The only risk we continue to worry about given our 60/40 stocks/bonds portfolio is the 40 side. Longer run risks of higher bond yields could come from an even more expansive fiscal policy once the baby boom generation fully retires and social security and medicare payments shoot to the sky and bankrupt the nation. The baby boom generation is 57 to 75 years old today and will be fully retired in 2029. Crunch time could come by 2039 when the baby boom is 75 to 93 years old and the money paid to them from government coffers could be at its maximum pain point. Pain as in can the country afford it or will bond yields need to go to 6% to entice investors to pay for our national debt.



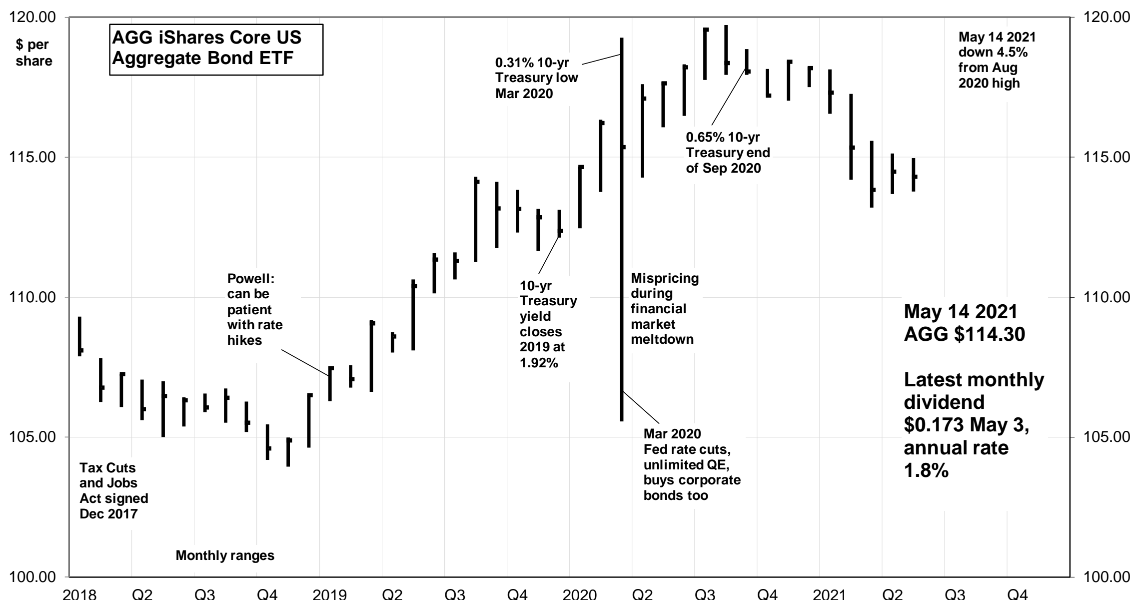
INTEREST RATES



The technical charts are messy near the top in yields. The 2021 yield high was 1.78% on March 30. We guess it is an uptrend for bond yields, but the picture isn't very decisive after the big upward move in yields in February and March. Easy story line this week. The surprise jump in CPI inflation Wednesday, brought yields to 1.70%. Yields fell back especially on Friday with unchanged retail sales in April. If growth is slowing, then inflation won't keep going. 10-year yields closed 1.63% on Friday.

40 SIDE OF 60/40 PORTFOLIO NOT DOING A LOT THIS YEAR

If you are supposed to have 40% of your investment portfolio in bonds, it isn't doing well lately. The iShares Core US Aggregate Bond ETF (AGG) closed at 114.30 Friday and is down 4.5% from the August highs when of course 10-yr Treasury yields were still relatively low. You get a dividend of course, $0.173 in May, but it is not enough to make you whole. Not sure what we would do. This is when you start to get nervous in coming years about the size of the national debt.



FEDERAL RESERVE POLICY

The Fed meets June 15-16, 2021 to consider its monetary policy. They will issue new forecasts of the economy and interest rates. In the March forecast, four out of eighteen Fed meeting participants looked for a rate hike in 2022, that's by the end of 2022, no indication of when within the year.

Market got some news on Wednesday, what did Fed officials say about it (this should be good). Inflation, core CPI inflation jumped 0.9% in April, the biggest monthly increase since April 1982 if you can remember back what you were doing then in 1982. At your age, maybe you can't. Headline CPI inflation is 4.2% year-year (get ready social security beneficiaries) and bond yields, 10-year Treasury yields just 1.63% at Friday's close. Bonds not compensating for inflation so buy tech stocks.

Selected Fed assets and liabilities

Fed H.4.1 statistical release billions, Wednesday data	12-May	5-May	28-Apr	21-Apr	March 11 2020** pre-Covid
Factors adding reserves					
U.S. Treasury securities	5054.395	5040.418	5014.762	5000.306	2523.031
Federal agency debt securities	2.347	2.347	2.347	2.347	2.347
Mortgage-backed securities (MBS)	2191.325	2191.325	2191.305	2246.989	1371.846
Repurchase agreements	0.001	0.000	0.000	0.000	242.375
Primary credit (Discount Window)	0.581	0.545	0.731	1.084	0.011
MMLF	0.000	0.000	0.000	0.000	
PDCF	0.000	0.000	0.000	0.000	
Commerical Paper Funding Facility	8.556	8.556	8.556	8.556	
Paycheck Protection Facility	79.922	76.453	72.394	68.212	
Corporate Credit Facility (CCF)	25.901	25.996	25.970	25.975	
Municipal Liquidity Facility	11.125	11.123	11.121	11.418	
Main Street Lending Program	30.668	30.659	30.894	30.892	
Term Asset-Backed Facility (TALF II)	4.922	4.922	5.284	5.283	
Central bank liquidity swaps	0.587	0.653	0.703	0.673	0.058
Federal Reserve Assets	7879.8	7859.6	7829.3	7870.0	4360.0
3-month Libor %	0.15	0.17	0.19	0.17	0.77
Factors draining reserves					
Currency in circulation	2169.384	2167.663	2163.465	2160.352	1818.957
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
U.S. Treasury Account at Fed	864.253	946.134	932.287	1003.443	372.337
Treasury credit facilities contribution	50.278	50.278	50.278	50.278	
Reverse repurchases w/others	209.257	162.800	166.732	81.329	1.325
Reserve Balances (Net Liquidity)	3955.864	3900.803	3889.018	3767.454	1779.990
Treasuries within 15 days	118.774	124.849	100.168	104.693	21.427
Treasuries 16 to 90 days	283.706	278.205	327.552	326.195	221.961
Treasuries 91 days to 1 year	630.986	630.363	628.477	625.269	378.403
Treasuries over 1-yr to 5 years	1948.027	1942.674	1902.633	1899.030	915.101
Treasuries over 5-yrs to 10 years	910.943	906.238	906.047	900.697	327.906
Treasuries over 10-years	1161.958	1158.090	1149.886	1144.423	658.232

**March 11, 2020 start of coronavirus lockdown of country

MMLF: Money Market Mutual Fund Liquidity Facility: loans secured by assets bought by banks from money market funds

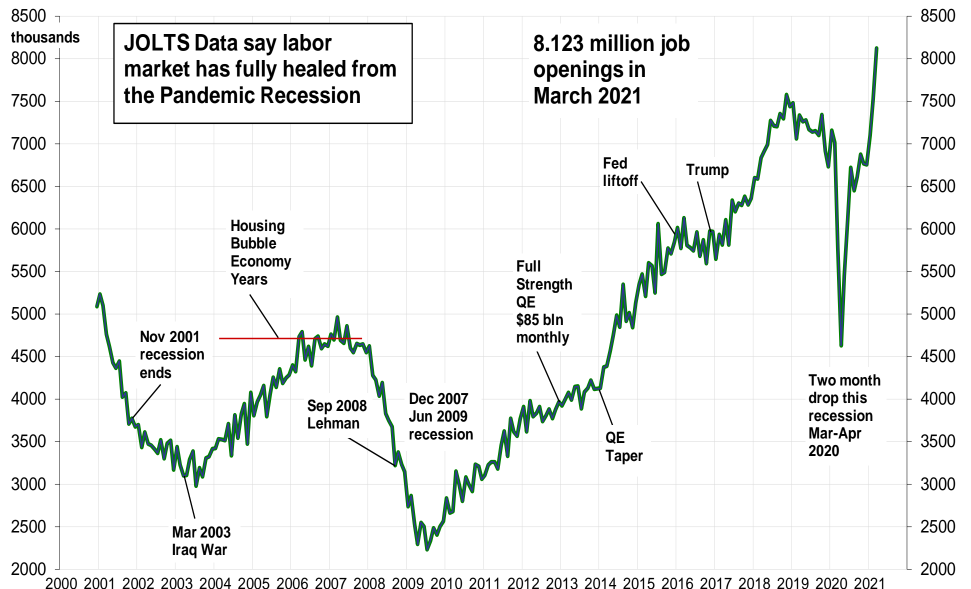
PDCF: Primary Dealer Credit Facility: o/n and term funding with maturities to 90 days

CCF: Corporate credit facility: Primary market (PMCCF) and Secondary Market (SMCCF)

Fed officials since Bernanke was a Fed governor have often downplayed inflation until they can see the whites of its eyes. Bernanke thought inflation was often caused by a one-off event of jumping commodity prices even if he later in the middle of the recession in 2008 warned about inflation… a recession where there should be downward demand pressures that keep inflation from moving higher. True to form then on Friday, new Fed governor Waller said something about not wanting to chase inflationary ghosts, but if we saw 4% inflation every month he would be very concerned. Doesn't sound like he wants to talk about talking about whether to cut the QE purchases back. On Wednesday, Fed Vice Chair Clarida said he was surprised but still expected this rise in prices. His prepared remarks for an outlook discussion were out just a half-hour after the shock CPI report, and he seemed to anticipate more inflation so he downplayed the report. The Fed's framework allows for more inflation especially when the unemployment and labor force drop-out rates remain high. In his remarks he said, "Over the next few months, 12-month measures of inflation are expected to move above our 2 percent longer-run goal, largely reflecting, I believe, transitory factors such as a run of year-over-year comparisons with depressed service-sector prices recorded last spring as well as the emergence of some supply bottlenecks that may limit how quickly production can rebound in certain sectors." For the moment, the Fed is treating this April inflation jump as a one-off due to transitory factors like supply bottlenecks.

OTHER ECONOMIC NEWS

Only in America could there be record job openings not even a year after the economy hit bottom (Tuesday)

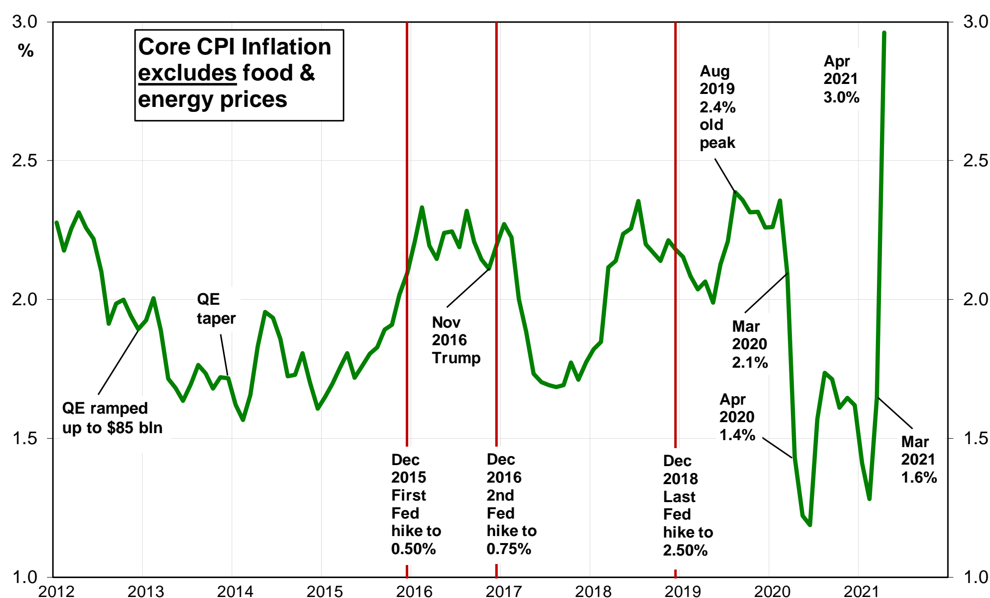


Breaking economy news. The Jolts employment data are out: Job Openings and Labor Turnover Survey. These data are always released with a one month lag relative to the April employment report on Friday, so the record openings correspond to March when payroll employment was reported at 916 thousand initially before getting revised down to 770 thousand in Friday's employment report. The puzzle over just how tight labor market conditions are returns with a vengeance. Job openings in March were a record 8.123 million, a jump of 597 thousand more jobs out there from February, with plenty more jobs for hotels/motels and restaurants, 185 thousand increase, state and local governments, 155 thousand increase, and Disneyland, and recreation jobs, an 81 thousand increase.

Net, net, we have never seen such a change of fortunes for jobs for hire before; the new all-time high in openings is even more plentiful than it was coming out of the last recession. There are almost more openings than there are unemployed out there is what the data from the Bureau of Labor Statistics is saying. Unbelievable. In March, there were 9.710 million unemployed behind the 6.0% unemployment rate, and the Jolts data are saying there were 8.123 million job openings at the end of March. President Biden is taking some heat on those extra $300 weekly unemployment benefits reminding the country yesterday that his Administration maintains the rule that if you are receiving unemployment compensation and you get a job offer, you have to take it. We suppose there are still laid off workers who are gun-shy about returning to the labor force even as the new virus case count is dropping.

Economy runs hot just like the 1980s with the Fed hopelessly behind the curve (Wednesday)

Breaking economy news. The April CPI inflation report. Actually, we are surprised to learn of the bond and stock market's interest in these inflation data today as it isn't the Fed's preferred measure of inflation that comes out with the April personal income report on Friday, May 28. CPI isn't the Fed's preferred measure but who the heck cares as the inflation outbreak is positively scary and there isn't a lot to suggest it is temporary.



Headline inflation rose 0.8% in April and is 4.2% year-to-year. Okay, it's bad, but energy prices are up 25.1% which is something the Federal Reserve cannot control. But hold on. Core CPI inflation is up 0.9% in April and is rising 3.0% year-on-year. Whoa. Now a lot of that is the spectacular 10.0% jump in used car and truck prices in April. Just one-month, get that rusty pickup truck out of your driveway and onto Craig's List or call Carvana, because year-year used cars and trucks are up 21.0%. Sounds like our house the last year in the suburbs of New Jersey up double-digits. And sure enough, shelter prices are starting to tick up by rising 0.4% in April, following a 0.3% rise in March. Falling rent prices were holding the "home price index" down, but now the trend is turning. The only good news is that the cost of your meds and doctor visits are still under control. You're going to need them as your 401K stock holdings are plummeting in value on the inflation scare. Medical care commodities are up 0.6% in April but still down 1.7% from last year. Medical care services were zero in April, no change, and are rising 2.2% the last year.

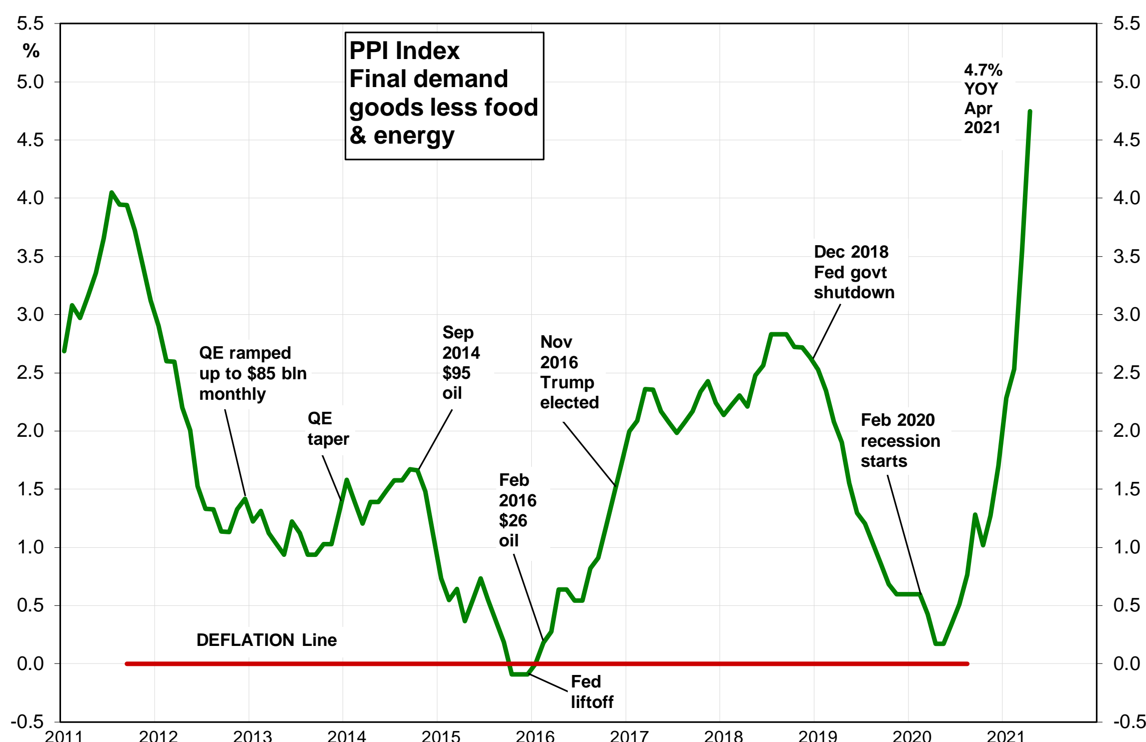
Net, net, supply chain bottlenecks have caused the inflation genie to pop his cork. Or something has and inflation is out and running wild again. The largest core CPI monthly change since 1982. Wow. It may have taken decades for inflation to hit double-digits in the 1970s, but this one-month inflation spike is just as pernicious as it deepens the gulf between the haves and have-nots in society and worsens the increasing trend of income inequality that contributes to political instability.

Inflation is back with a bang this month and is making a mockery of the Federal Reserve's easy money monetary policy that might as well be pouring gasoline on the fire. Stay tuned. Story developing. Inflation is hot, hot, hot, and the trend is at the starting line with the race hardly begun. The Fed is behind the curve. Bet on it. Who was it who said a sudden jump of inflation could slow the economy as consumers back away from the sky-high prices they see at the shops and malls across the country. It could happen again. This isn't a one-off, or something to do with the base effect of the CPI index, this jump in inflation is as real as it gets and it is something that keeps the bond market yield rally alive. 2% 10-year Treasury yields here we come. Yee-haw.

Record inflation at the producer level (Wednesday)

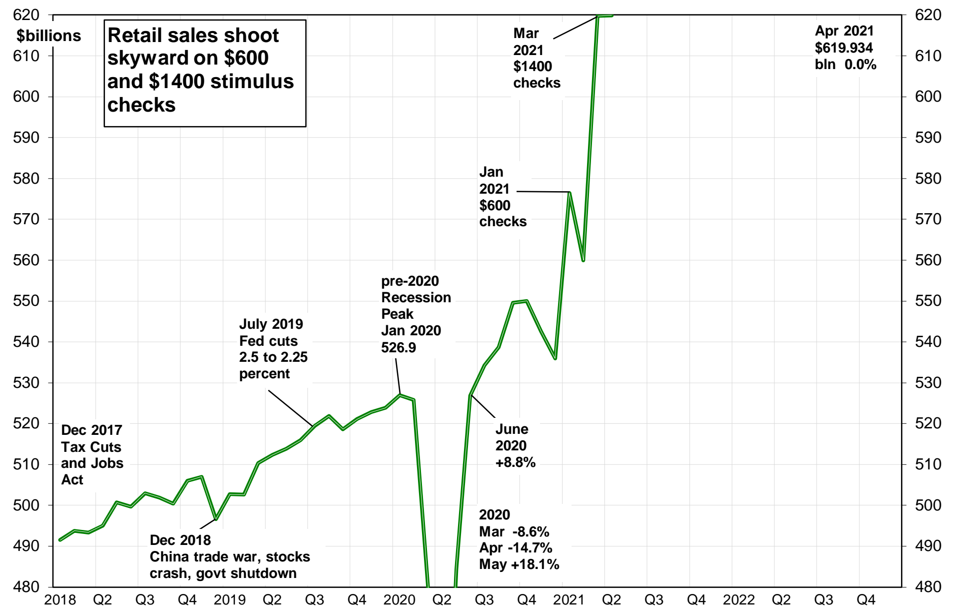
Breaking economy news. Inflation at the producer level is out of control just a day after the biggest monthly jump in core CPI inflation since the 1980s. Good thing the Fed target is PCE inflation and not CPI inflation. Good thing social security benefits are indexed to CPI inflation not PCE inflation. Okay. Slow down, take a breath. The record of PPI inflation we are looking at is PPI of final demand goods less food and energy. This inflation is up 4.7% year-year in the graph below which beats the prior record of 4.1% coming out of the last recession hit in August 2011. The "record" is based on limited data which goes back only about a decade when the Bureau of Labor Statistics (BLS) went crazy and revamped the tried and true PPI report. The same PPI inflation report that was more factory goods and commodities based that was once, along with the monthly trade balance, one of the two biggest market-moving economic indicators on the planet.

Net, net, long-story short, the BLS added some other services-based producer prices to the index in its revamp over a decade ago which muddies the waters of the public's understanding in our view. We will focus on the final demand goods less food and energy and the inflation in these prices look problematic in this recovery from the pandemic. The Fed might argue this surge is a one-off as this is what Bernanke always said over 15 years ago. They might not take their foot off the gas. But Bernanke was arguing there was no need to fight a one-off surge in commodity prices (if it keeps going up a second year that presumably would be a problem), no need to increase interest rates. The difference now is the current Fed under Powell has to dismantle the $120 billion monthly QE purchases before ever getting to rate hikes that would help the millions of retiring workers in the baby boom generation aged 57 to 75 years old. Just for the record, different times of course, the Fed under Bernanke started tapering its $85 billion monthly QE in December 2013 and the Fed under Yellen didn't hike rates from zero the first time until December 2015. Stay tuned. Story developing.



Retail sales were nothing in April as consumers left it all on the field in March (Friday)

Breaking economy news. Retail sales were unchanged in April after that gigantic fiscal stimulus boost in March pushed up sales 10.7% in March. Markets should be grateful consumer spending didn't actually fall and the only reason it did not is because the Federal government's $1400 checks hit bank accounts starting March 17 and had not been fully spent yet.



In fact, retail sales ex-autos did fall 0.8% in April as motor vehicles and parts are still rising 2.9% due to pent-up demand from long, home-bound consumers. Other increases this month were electronics and appliance store sales up 1.2%, grocery stores up 0.6%, health and personal care stores for those working from home and still taking showers rose 1.0%, and eating and drinking places up 3.0%. We will still see a further rebound in dining out as the $64.872 billion of sales at restaurants and bars is still short of the record $66.344 billion in January 2020 before the pandemic and there is probably some pent-up consumer demand there. But we are still worried that the economy's best days are behind us and growth will settle back to 2%-something starting in the second half of 2021. We doubt there will be a new age for consumer spending that drives the economy in this recovery for long.

Net, net, this isn't a normal economic recovery, this is a recovery that Washington bought and paid for by stuffing consumers' pockets and purses with cash. $600 checks in January and $1400 checks in March pushed sales to the sky, but once the money is gone, retail sales are going to fall. There will be momentum going into the second quarter for economic growth because sales at the shops and malls were off the charts in March, but the second half of 2021 is going to see one of the most rapid slowdowns in economic history. The $1400 checks first were deposited into consumers' bank accounts starting on March 17, but once it is gone, it is gone. We still have questions about the prospects for strong multiyear growth once the effect of the Washington handouts starts to fade. This pandemic turned normal supply and demand in the economy upside down, and much of the economy's strength from extraordinary stay-at-home spending will turn into a drag as time goes on. We doubt that additional trips to Disneyland and to bars and restaurants this summer is going to offset the coming decline in consumer spending on hard goods like computers, communications equipment, furniture and even games and toys and books. Stay tuned. Story developing. The economy's best recovery days are behind it. Bet on it.

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