fwd: Bonds

Global Macro Hedge Strategy EconomicsTrading

Financial Markets This Week

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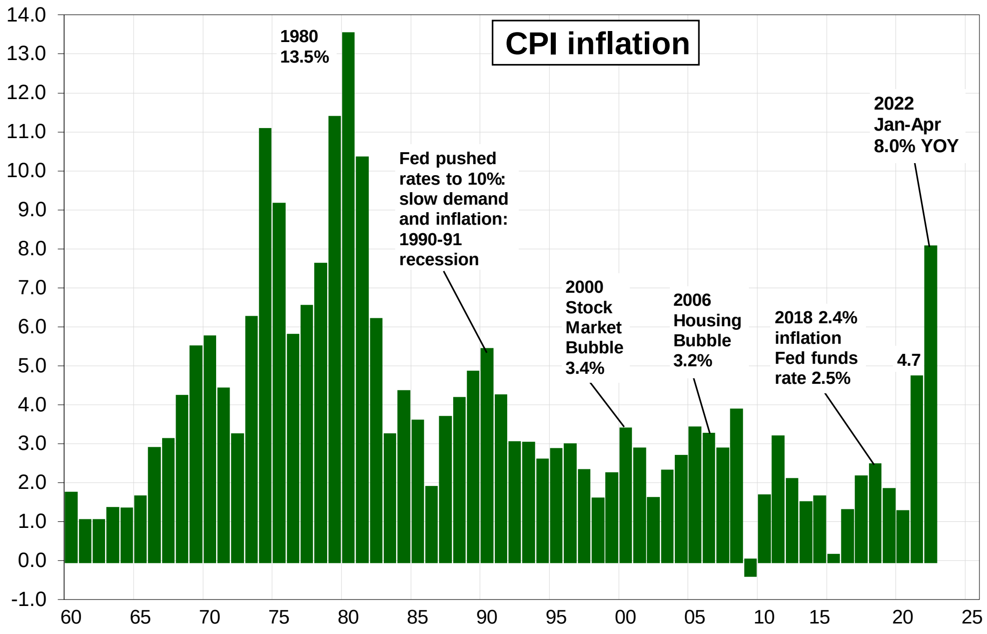
FED INFLATION FIGHT



Interest rates have to go above inflation to slow the economy. Real rates must be positive.That would be a hike. It took a while for the Federal Reserve to get interest rates that high in the early 80s. Volcker talked more about restraining the money supply rather than curbing economic demand. Kind of hard for a central bank today to talk about their actions leading to job losses after the FedListens tours, but Powell attempted to do that on Tuesday and the Thursday before in riveting interviews. Back to Volcker the dragon-slayer of inflation. A simpler time when there were no complainers on Twitter: nobodies who now have the power to change monetary policy. Two recessions in the 80s: short one January to July 1980, long one July 1981 to November 1982. Before each recession, interest rates rose high enough to break the economy. Could interest rates soar again to unprecedented levels in the current Fed inflation fight. Not unprecedented exactly. Interest rate tightening cycles starting in the 1990s went to 6% twice. The Fed funds rate is just 1.0% today even with two more 50 bps rate hikes on the table at the June and the July meetings. When Powell says the Fed won't hesitate, is this 6 number the one he has in mind for interest rates? In an interview Tuesday, Powell said, “We will go… until we see inflation coming down.” CPI year-year was 8.5% in March, 8.3% in April, and Powell would probably like to see it coming down further from the peak.

Back to the 1980s. Two recessions with hard landings for the economy and huge job losses. What did these anti-inflation tightening cycles accomplish? It was a different era, inflation built up steadily starting around the Vietnam war in the 60s. It was harder to break. Here's what we see as the problem with the hard-landing scenario: back in the early 80s inflation didn't slow as much as certainly this Federal Reserve is looking for today with their 2.0% target. CPI in the graph above slowed to 3.2% in 1983, 4.3% in 1984, 3.6% in 1985 (all too high for today's Fed officials) and then 1.9% in 1986 for one year when the price of crude oil crashed after OPEC opened the spigots sending the Great State of Texas into a recession.

The hard landing in the early 80s still left the country with 3-4 percent inflation. If that is the goal, even 3% inflation will be a real problem for those living on a fixed income without a risk-free investment return like interest paid on a good old-fashioned bank savings account that pays the same rate as the Fed funds rate. Forget the private client invitations with a dedicated team and eligible $2,000 offer, just pay interest on people's savings accounts.

This inflation is a very different inflation than that in the 80s which built up over a decade of neglect. It was harder to change something that was entrenched for years. Today's inflation appeared virtually overnight with 4.7% in 2021 and 8.0% in the first four months of 2022. We will see. It is true that services prices are rising now which argues for a more persistent inflation trend, but commodity prices do famously swing up and down and maybe some relief from the supply side will bring overall inflation back down.

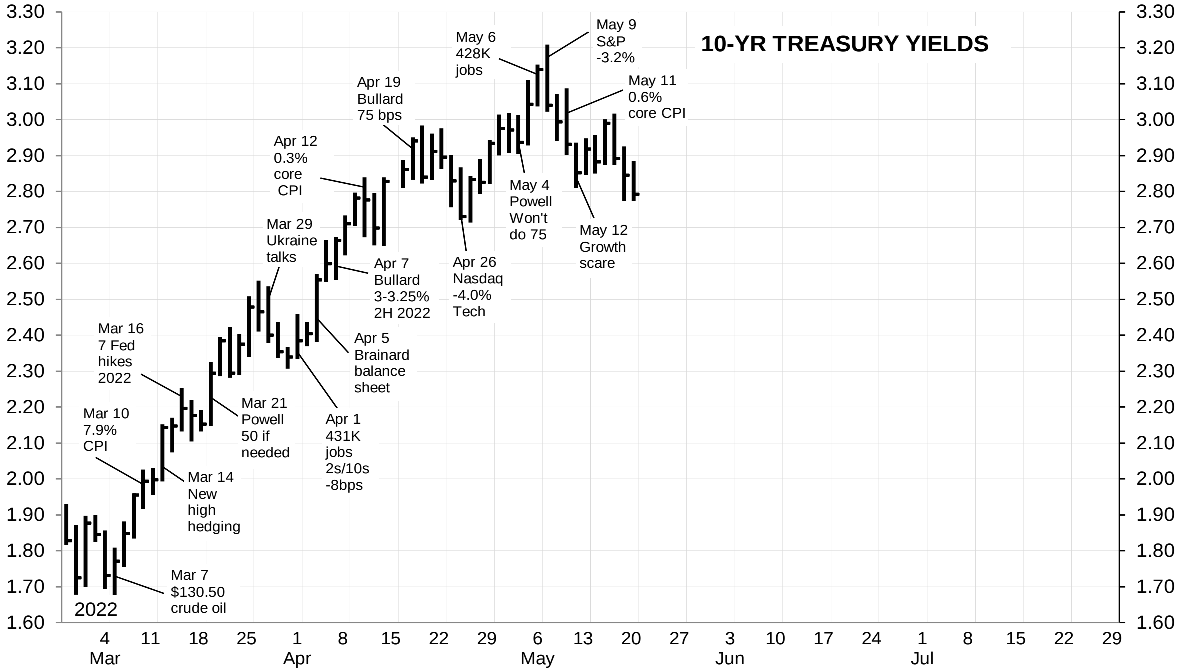
Dec 2021		Year-Year Inflation		
Weight		Dec 2020	Dec 2021	Mar 2022*
100.000	PCE inflation	1.3	5.8	7.9
0.077	Food at home	3.9	5.7	15.7
0.030	Energy goods	-15.0	46.4	149.2
0.016	Electricity/Gas	2.4	9.8	19.0
0.875	Core PCE	1.5	4.9	4.3
0.141	Durable goods	1.4	10.6	2.5
0.025	New vehicles	2.0	11.9	2.5
0.015	Used vehicles	9.3	48.4	-24.6
0.033	Furnishings	3.2	8.8	20.1
0.040	Recreational	-0.9	1.4	1.5
	Nondurable goods			
0.033	Clothing	-4.6	5.0	10.7
0.035	Prescription drugs	-2.4	-0.2	5.8
0.011	Personal care	-0.3	0.3	10.8
0.726	Services ex-energy	2.0	4.2	3.8
0.040	Rents	2.3	3.3	6.3
0.127	Home prices	2.2	3.8	5.4
0.181	Health care	2.6	2.7	3.4
0.034	Transportation	-2.6	8.9	10.4
0.039	Recreation	1.8	4.5	7.5
0.067	Food services	3.8	4.5	5.5
0.011	Hotels/Motels	-7.5	21.6	5.5
0.090	Financial/Insurance	1.5	3.5	-2.7
0.088	Other services	1.3	2.9	4.0
0.035	Nonprofits	4.0	11.3	-1.0

* Mar 2022 is SAAR off Dec 2021
Weights to PCE except weights relative to Core PCE
for all its spending categories

We get the Fed's PCE inflation for April next week on Friday, May 27. Through March this year, this measure of consumer inflation is increasing an alarming 7.9% at a seasonally adjusted annual rate (SAAR) as food prices, energy goods like gasoline and your good old household utility expenditures on gas and energy (check your bill) jumped after Russia invaded Ukraine. Durable goods prices have slowed to 2.5% in 2022 with new car prices slowing and used vehicles dropping nearly 25%, however, we are watching the jump in furnishings inflation to 20.1% this year. Nondurable goods like clothing and personal care products are up over 10% this year which helps keep core PCE inflation running high at 4.3% in 2022. There are warnings inflation has spread to services ex-energy which is running 3.8% in 2022. This is slightly lower despite large increases in most services prices that was offset by a 2.7% drop in financial services prices with a large 9% weight of core PCE.

To conclude, the focus is on achieving a soft landing, but the hard landing in the 80s didn't bring down inflation enough. We actually started out this week to take yet another look at the soft landing for the economy after the Fed pushed rates to 6.0% in 1995, except that we forgot that inflation barely budged during that time. Commodities swing high and low, but services ex-energy is where inflation will go. The Fed's inflation fight isn't over yet.

INTEREST RATES

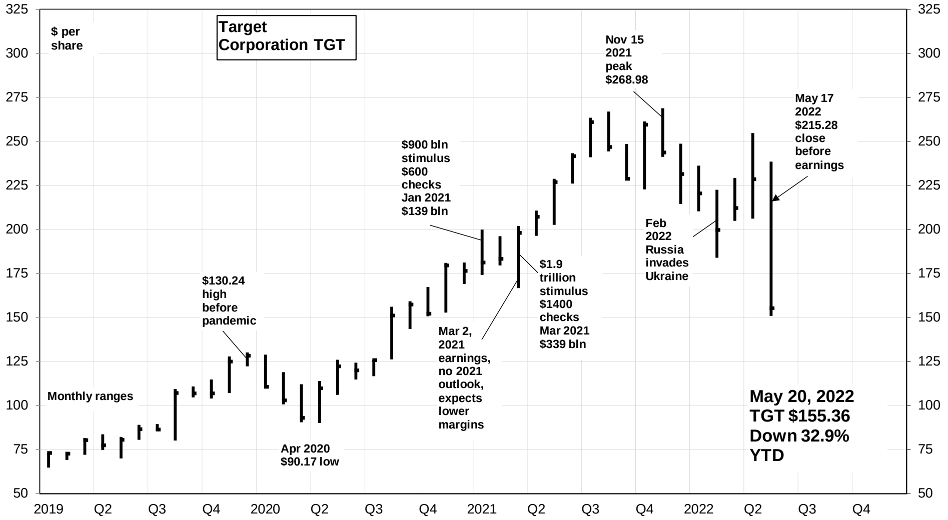


Bond yields closed 2.79% on Friday down 13 bps from 2.92% the week before and are down from the year's 3.20% high on May 9. Yields came down following the tumbling stock market as both bonds and stocks respond to the greater risk of recession. The inverted yield curve recession signal disappeared long ago, but cratering stocks elevate fears for the economy's future. The spread only went negative for a couple of nights at the start of April yet the market can't rest. On Friday, stocks fell to a new low, down 20.9% from the high of the year where 20% is a recession magnitude loss. Stocks did manage to erase the 2.3% intraday loss on the day before closing barely positive (0.01%) versus Thursday's close. Many closed down Friday: NVDA -2.5%, GOOGL -1.3%, TSLA -6.4%.

Target Corporation TGT down 32.9% on year

After reporting earnings this week, Walmart fell 11.4% on Tuesday, and Target fell 24.9% on Wednesday and TGT news seemed to take the entire market down with it. Target comp sales slowed to 3.3% year-on-year back to the pace of 2019 before the pandemic. The consumer isn't done, but they aren't buying a ton. EPS was $2.19 versus $3.07 expected. The company said there were higher freight and transportation costs and inventories were high with the wrong merchandise on the floor.

Comparable Sales % YOY					
	Q1	Q2	Q3	Q4	Annual
2022	3.3				
2021	22.9	8.9	12.7	8.9	12.7
2020	10.8	24.3	20.7	20.5	19.3
2019	4.8	3.4	4.5	1.5	3.4



FEDERAL RESERVE POLICY

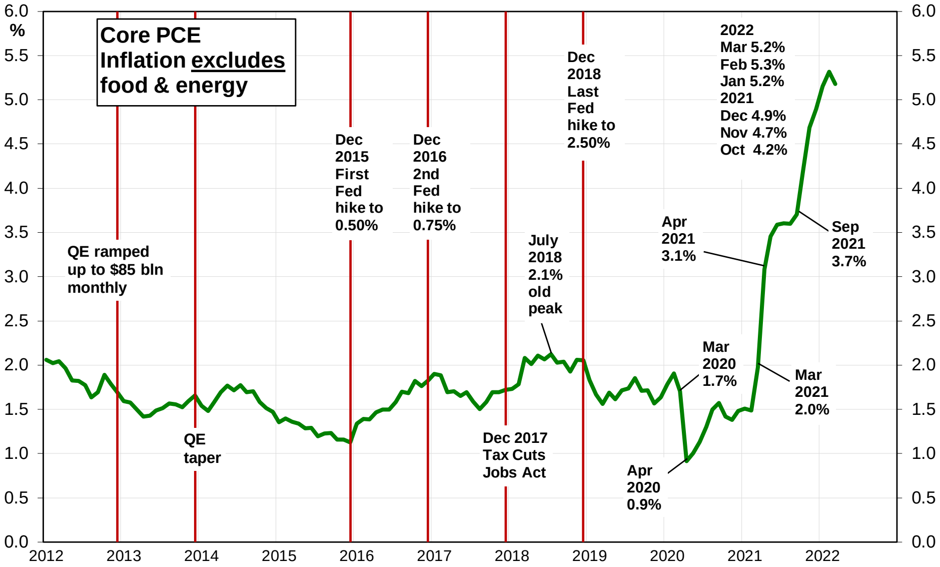
The Fed meets on June 14-15, 2022 to consider its monetary policy. 50 bps is on the table at this meeting and the following July 26-27 meeting. Not sure how many more times Fed governors and presidents can communicate this to us. The Fed funds rate will be 2.0% by August if the economy doesn't crash first. October Fed funds futures are 37.5 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.

Selected Fed assets and liabilities Fed H.4.1 statistical release billions, Wednesday data	18-May	11-May	4-May	27-Apr	March 11 2020** pre-Covid
Factors adding reserves					
U.S. Treasury securities	5768.021	5766.625	5765.229	5764.013	2523.031
Federal agency debt securities	2.347	2.347	2.347	2.347	2.347
Mortgage-backed securities (MBS)	2733.823	2715.021	2715.020	2715.012	1371.846
Repurchase agreements	0.000	0.000	0.001	0.000	242.375
Primary credit (Discount Window)	0.856	0.834	2.606	2.917	0.011
Paycheck Protection Facility	20.537	20.929	21.229	21.791	
Corporate Credit Facility (CCF)	0.000	0.000	0.000	0.000	
Municipal Liquidity Facility	6.661	6.660	6.659	6.657	
Main Street Lending Program	28.438	28.651	28.640	28.486	
Term Asset-Backed Facility (TALF II)	2.466	2.466	2.465	2.513	
Central bank liquidity swaps	0.219	0.222	0.225	0.214	0.058
Federal Reserve Assets	8995.5	8991.6	8989.5	8988.2	4360.0
~~3-month Libor %~~ SOFR %	0.79	0.78	0.30	0.28	1.15
Factors draining reserves					
Currency in circulation	2273.025	2273.743	2272.695	2270.662	1818.957
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
U.S. Treasury Account at Fed	866.726	919.331	964.412	957.419	372.337
Treasury credit facilities contribution	21.258	21.258	21.258	21.258	
Reverse repurchases w/others	1973.373	1876.119	1815.656	1803.333	1.325
Reserve Balances (Net Liquidity)	3297.142	33295.680	3313.993	3327.548	1779.990
Treasuries within 15 days	82.052	125.895	131.150	78.805	21.427
Treasuries 16 to 90 days	346.689	286.505	281.662	328.227	221.961
Treasuries 91 days to 1 year	768.924	802.274	801.777	773.813	378.403
Treasuries over 1-yr to 5 years	2116.508	2123.737	2123.221	2158.802	915.101
Treasuries over 5-yrs to 10 years	1027.982	1018.099	1017.659	1017.134	327.906
Treasuries over 10-years	1425.865	1410.114	1409.760	1407.233	658.232

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

Not sure what more we got from the Tuesday 2pm ET Powell media interview. The first question was you treated the pandemic as an emergency with rapid-fire rate cuts, what do you say to those who say you aren't treating inflation like an emergency? His answer was they had done a lot and financial conditions have tightened (door is shut to 75 or 100 bps rate hikes now with the Fed funds rate at 1.0% surely), then came the first of many Powell comments on inflation, "What we need to see is inflation coming down in a clear and convincing way and we're going to keep pushing until we see that."

Fed's preferred PCE inflation measure
Friday, May 27, 2022 8:30am ET



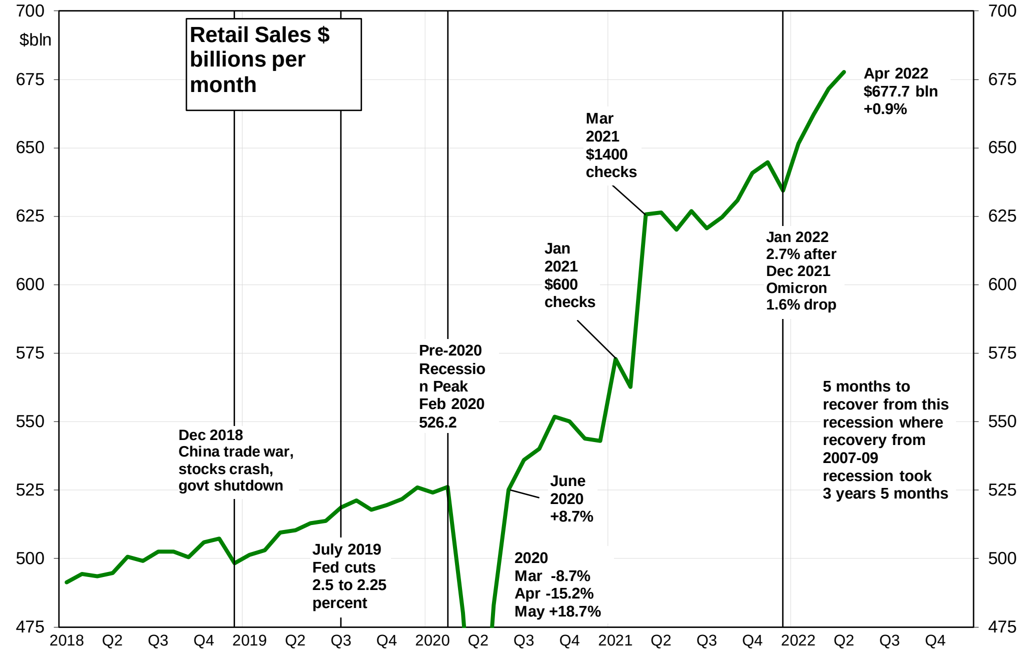
The Fed's biggest anti-inflation gun is rates and we would assume Powell is in agreement with ex-Fed Vice Chair Clarida who spoke candidly recently, now that he's gone, about the need for a 3.5% Fed funds rate which is 100 bps above 2.5% normal. There's too many unknowns like what happens if core PCE inflation (Fed can't fight food and energy prices) at 5.2% year-year in March comes back down to 3.5% and just sits there. Can't answer that for a while. So, what do they do-how high do rates go? Our best guess is the Fed will get it wrong again, they over-eased during the pandemic, and all the tough talk and aggressive rates messaging will tank the economy and lead to job losses long before the end of the year. Job losses won't be good despite what Powell says and with the unemployment rate rising, the Fed will pause or be patient with additional rate hikes just like they did in January 2019. Stay tuned.

OTHER ECONOMIC NEWS

Retail Sales haven't hit a wall yet (Tuesday)

Breaking economy news. Retail sales jumped 0.9% in April after annual revisions. There is a question about just how much of this spending is real because retail sales were 8.2% higher than last year while CPI inflation is also 8.3% higher than a year earlier, so maybe the number of goods going out the door at the shopping centers across America isn't as robust as these cash register sales say. Nevertheless, consumers aren't backing off, so either will Fed officials and those 50 bps rate hikes on the table at the next two meetings this summer are likely to be deployed. The consumer has been bummed out for months in those surveys of behavior and attitudes, but they are still charging ahead.

Retail sales are soaring which paints a picture of economic demand that is strengthening not slowing down and this will make the job of Fed officials even harder. Retail sales haven't hit a wall yet with all the uncertainty and war and stock market crashes coming the consumer's way. Consumers say they are less confident but that isn't stopping them from taking more trips to the mall.



Retail Sales $ billions per month

Apr 2022 $677.7 bln +0.9%

Mar 2021 $1400 checks

Jan 2022 2.7% after Dec 2021 Omicron 1.6% drop

Jan 2021 $600 checks

Pre-2020 Recessio n Peak Feb 2020 526.2

5 months to recover from this recession where recovery from 2007-09 recession took 3 years 5 months

Dec 2018 China trade war, stocks crash, govt shutdown

June 2020 +8.7%

July 2019 Fed cuts 2.5 to 2.25 percent

2020 Mar -8.7% Apr -15.2% May +18.7%

Total retail sales were up 8.2% the last year and the only down sectors for consumer purchases on the same year-over-year basis are motor vehicles -1.7%, Electronics and appliance stores -5.2%, and Sporting goods, hobby, musical instruments and book stores -5.4%. In April, falling gasoline prices temporarily reduced gas station sales by 2.7% which enabled consumers to take a night off with bar and restaurant sales up

Retail spending, actual dollars, each month

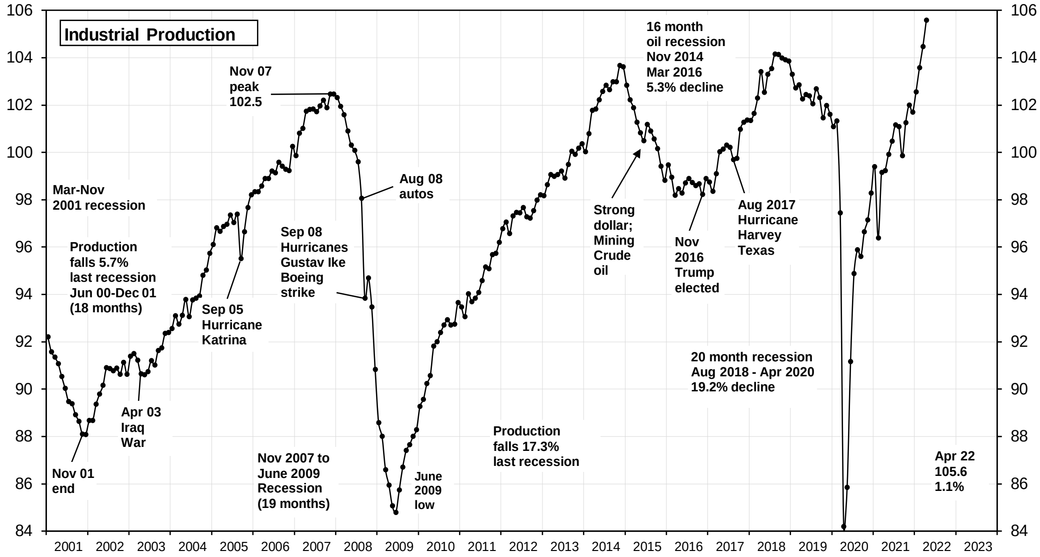
	$million	% to	Percent Changes %		
	Apr 2022	Total	Apr	Mar	Year/year
Total Retail Sales	677,711	100.0	0.9	1.4	8.2
Motor vehicles/parts	132,192	19.5	2.2	-1.6	-1.7
Furniture/furnishings	12,173	1.8	0.7	-0.1	0.8
Electronics/appliances	7,798	1.2	1.0	2.7	-5.2
Building materials/garden	42,572	6.3	-0.1	0.7	1.7
Food & beverage	76,977	11.4	-0.2	0.8	7.1
Health/personal care	32,986	4.9	0.7	0.9	2.1
Gasoline stations	62,291	9.2	-2.7	9.6	36.9
Clothing/accessories	26,199	3.9	0.8	2.0	8.0
Sporting goods, books	8,917	1.3	-0.5	0.6	-5.4
General merchandise	69,140	10.2	0.2	2.1	1.2
Department stores	11,514	1.7	1.1	0.0	2.9
Miscellaneous retailers	15,951	2.4	4.0	2.4	18.6
Nonstore retailers (internet)	106,774	15.8	2.1	0.4	12.7
Eating & drinking places	83,741	12.4	2.0	1.9	19.8

2.0%, and the consumer even got online with internet sales, so-called nonstore retailers, up 2.1% in April.

Net, net, the economy is still running hot whether it is fueled by inflation or not, and this puts central bank officials even further behind the curve in their efforts to rein in runaway economic demand. It looks like real consumer expenditures are running 2.7% normal in the second quarter with just April data on the table. The April spending splurge is keeping the recession winds at bay for now, but for how long is the question. Gasoline prices are going back up in May and that will likely hold back consumers from making discretionary purchases or taking a night out with fine-dining. Stay tuned. Story developing.

Another month another all-time high for factory output (Tuesday)

Industrial production is extremely strong this year despite omicron, the Russian invasion of Ukraine, and the stock market crash. Corporate bond yields are much higher with Treasuries so it is more costly for companies to borrow as well even though short-term borrowing costs are tied to the still-low 1.0% Fed funds rate. Industrial production jumped 1.1% in April and is at a new record high. The only weakness in the major market groups was a component of consumer durable goods: appliances, furniture, and carpeting fell 1.5% which appears tied to softer home sales. This isn't a chart that says recession is on the way. Production can't be said to even be slowing.



Percent changes			Industrial Production Apr 2022		
Feb	Mar	Apr	YOY		Weight
1.0	0.9	1.1	6.4	Total Index	100.0
1.3	0.8	0.8	5.8	Manufacturing	74.5
0.2	1.9	1.6	8.6	Mining	13.7
0.0	-0.3	2.4	7.5	Utilities	11.8
			Manufacturing payroll jobs 12.7 million +489K YOY 9.9% of Private Payroll Jobs		

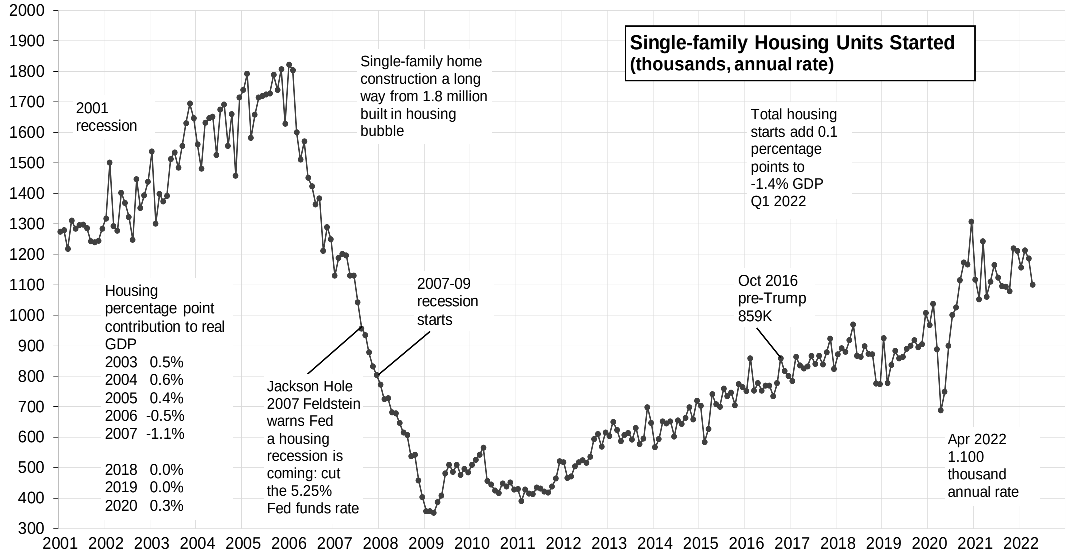
Home construction firm, so more Fed rate hikes on the way (Wednesday)

Breaking economy news. Housing starts fell 0.2% in April to 1.724 million at an annual rate. In April 2021 housing starts were 1.505 million. The data were revised back to 2017. The Fed is waiting for inflation to fall or they will keep raising interest rates and inflation isn't likely to fall very far unless interest-rate sensitive sectors of the economy start to decline like every other economic cycle. Homebuilders haven't got the message yet that they are on the front-lines of the Fed's inflation battle. Fed Chair Powell said the central bank won't hesitate to raise rates higher and with today's housing starts data holding up, it looks like rates will indeed be going much, much higher. 50 bps rate hikes are on the table at the June and July meetings, but we wonder if even more 50 bps rate hikes will be necessary as the nation is growing weary with the higher prices everywhere they see. You can't even get away from the inflation because the cost of air tickets and gas to put in the car have shot up seemingly overnight. No wonder consumer confidence is down in the dumps. The Fed's two rate hikes this year and talking of more to come hasn't made a dent in residential housing construction yet.

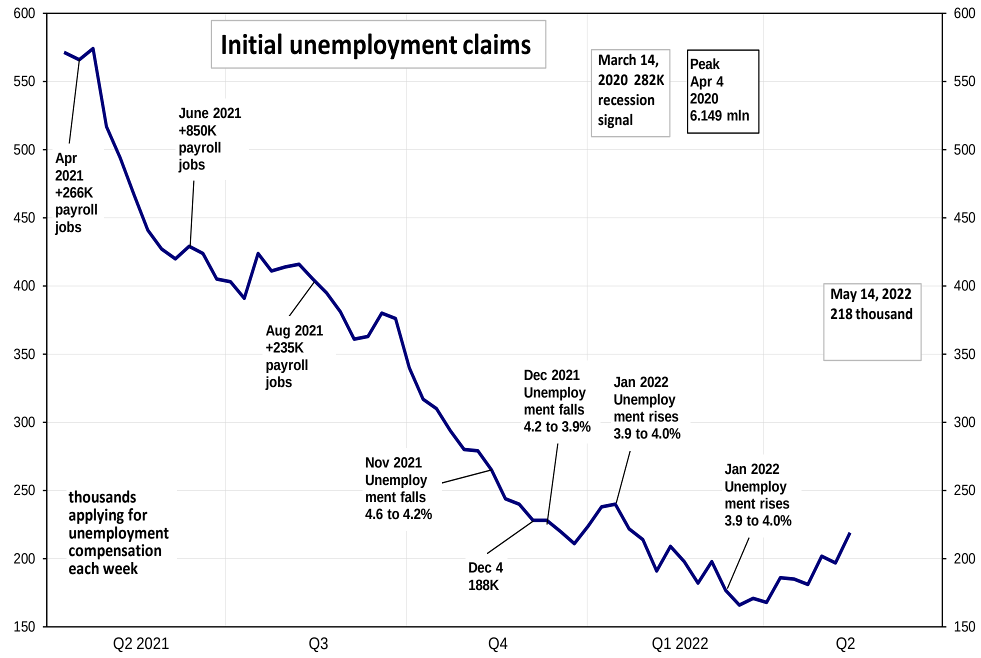
Housing Starts Total, Single-Family, Multi-Family

	United States			Northeast		Midwest		South		West	
000s	Total	1 unit	Multi	Total	1 unit	Total	1 unit	Total	1 unit	Total	1 unit
Apr 2022	1724	1100	612	182	60	184	140	926	604	432	296
Mar 2022	1728	1187	524	237	63	236	162	837	670	418	292
Mar 2021	1505	1061	430	156	74	180	145	782	586	387	256
% Chgs											
Apr/Mar	-0.2	-7.3	…	-23.2	-4.8	-22.0	-13.6	10.6	-9.9	3.3	1.4
Apr/Apr	14.6	3.7	…	16.7	-18.9	2.2	-3.4	18.4	3.1	11.6	15.6

Net, net, there are tentative signs of a slowdown in the construction of single-family housing starts, but total construction activity is holding up due to the off the charts construction of rental housing. Housing starts of units of 5 or more were 612 thousand in April at an annual rate, up 42.3% from a year ago. This is April data and the Federal Reserve just stopped their quantitative easing purchases and hiked interest rates the first time a month ago in March so it may be early for homebuilders to scale back their construction plans. Home builders should have read the writing on the wall though because mortgage rates are increasing faster than anytime in the last two decades certainly. You better have cash because mortgage rates are sky-high. The cost of buying a new home is soaring with 30-year mortgage rates of 5.30% up from 2.94% a year ago. It's a good thing mortgage rates are no longer counted as inflation because then we would really be in trouble. Stay tuned. Story developing.

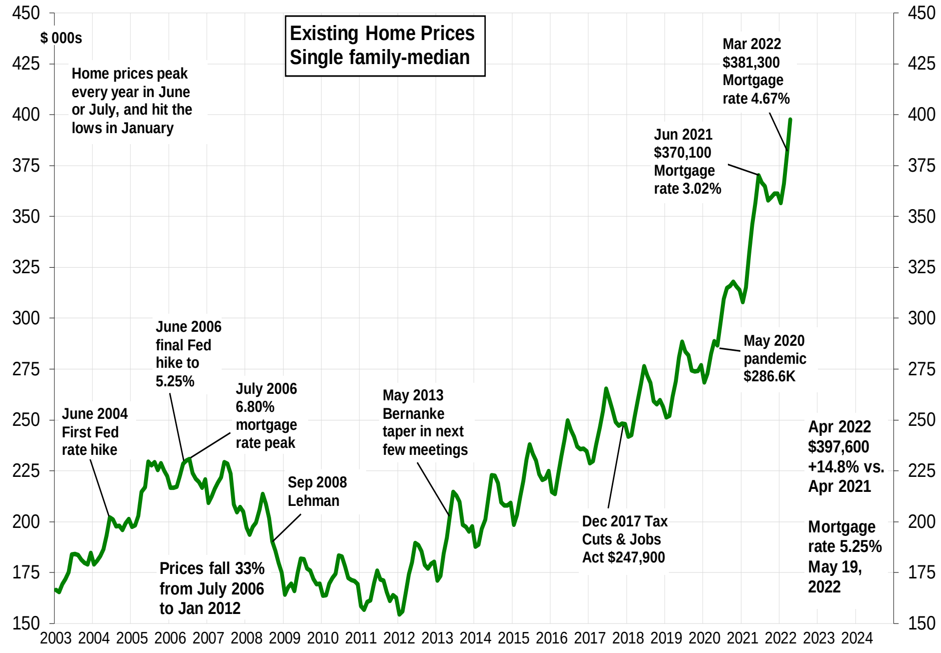


Job layoffs are up. Maybe you will be one of them soon (Thursday)



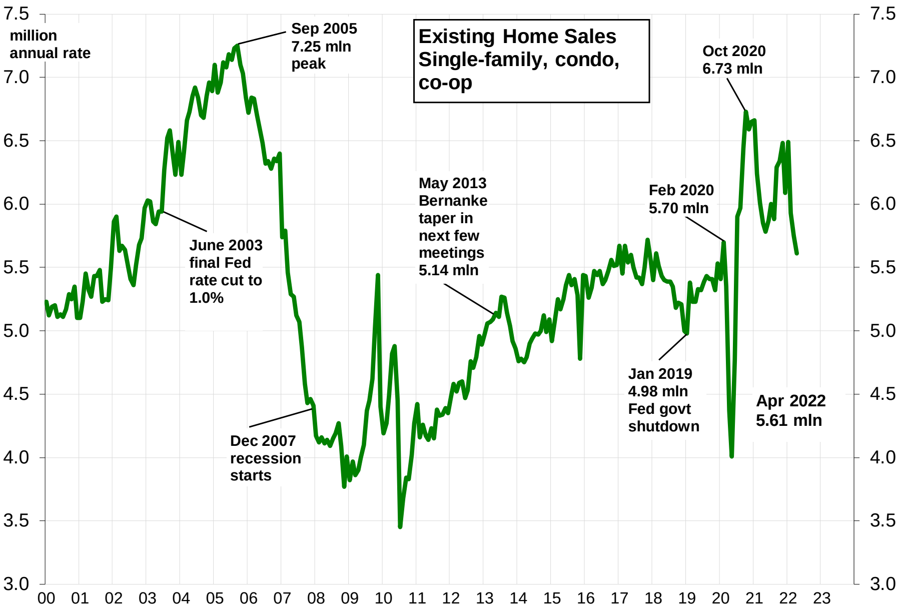
Breaking economy news. Jobless claims are rising. Here comes the economic slowdown. The Fed's rate hikes may be over in a hurry if the job layoffs continue to mount. First-time filings for unemployment compensation jumped 21 thousand in the May 14 week to 218 thousand. There is a noticeable and worrisome uptrend in job layoffs since 166 thousand in the March 19 week which is an increase of over 30 percent. IMF managing director Georgieva is out on the wires this morning warning it is getting harder for central banks to bring down inflation without causing recession. Gee, that's rough for them. Heck, that's exactly what the Federal Reserve is banking on. Stay tuned. Let's see if the Fed's aggressive messaging on the forward path of interest rates brings down the value of my home as well with existing home sales data at 10am ET this morning.

Existing home sales starting to crack (Thursday)



Breaking economy news. Existing home sales are down 2.4% this month to 5.61 million at an annual rate and over one million lower than the peak of sales activity in the stay-at-home economy back in Q4 2021. The sharp slowdown in home purchases is an early sign that existing home sales are starting to crack under the relentless rise in mortgage rates this year. The Federal Reserve has raised rates 75 bps this year but 30-year mortgages are over 200 bps higher at 5.25% this week up from 3.11% at the end of 2021.

The Federal Reserve's restrictive policy is working on housing sales where the cost of borrowing for a home purchase is sky-high, but monetary policy tightening hasn't stopped the inflation in home



prices yet. The latest bubble jumpstarted by the pandemic continues to inflate. Single family homes were $397,600 in April which is 14.8% higher than a year ago. It took a Fed funds rate of 5.25% under the Bernanke Fed over a decade ago to stop the last housing price bubble, so the job of current Fed officials isn’t finished yet. Like many prices of goods in the economy, the reason home prices are accelerating is in part due to supply shortages. Fed policy works on the demand side of the economy, not the supply side. Based on both sales and prices of existing homes today it looks like the Fed’s policy tightening is still in the early innings. Stay tuned. Story developing. Existing home sales are starting to crack showing the economic expansion may be more vulnerable than Fed officials believe.

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