Financial Markets This Week

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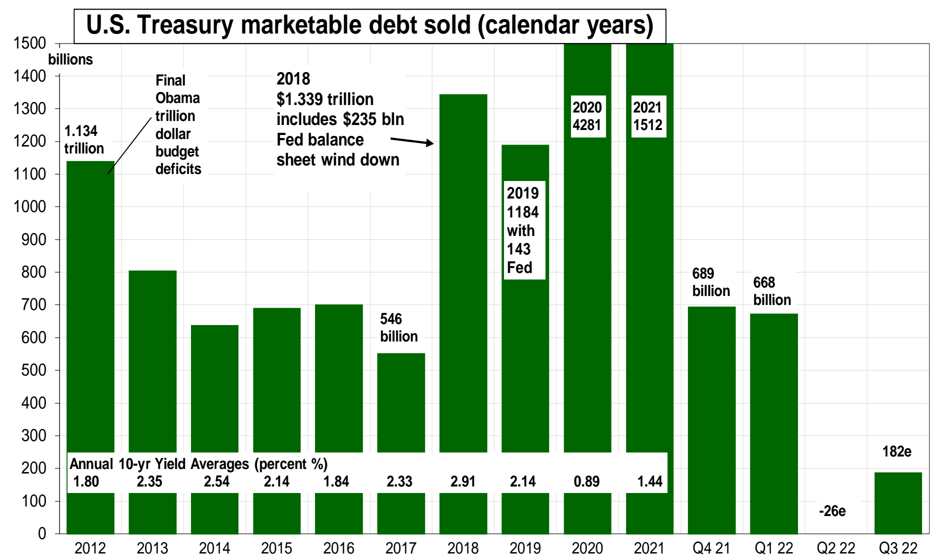
BOND MARKET VALUATION

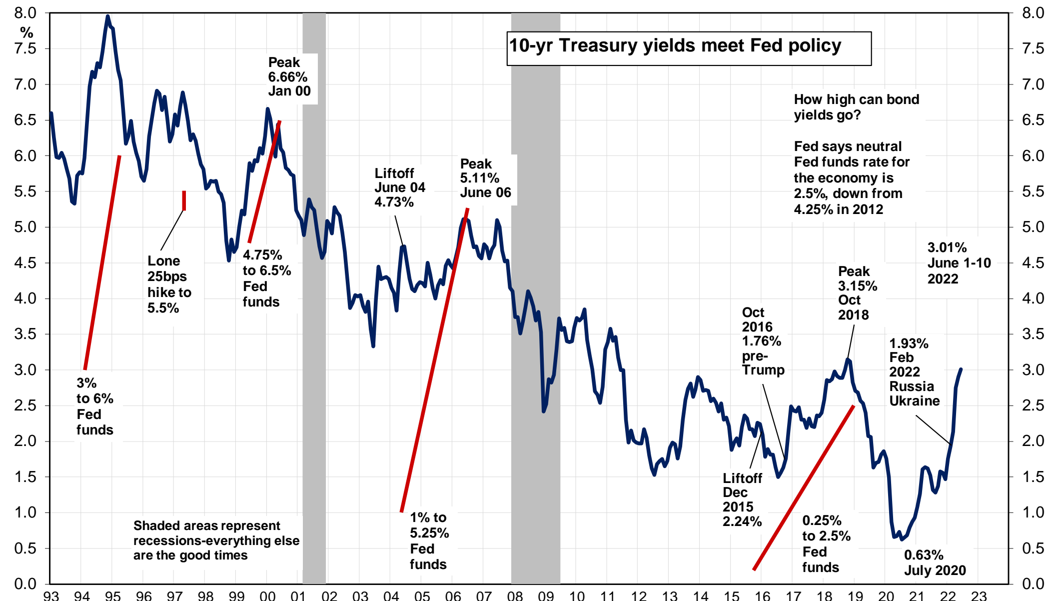
The future of bond yields depends on how high the Fed is going. Former Fed officials now that they are out are more than happy to speak and speak and squawk about the need for a tighter anti-inflation policy with a Fed funds rate 100 bps higher than neutral or 3.5%. With the worst inflation since the 80s we are afraid of the Fed returning rates to the 5.25% peak under Bernanke in the housing bubble. This assumes the rate hikes don't crack the economy first and lead to recession and job losses.



To move forward you have to remember the past or at least try to explain it. Bond yields are headed on up with the aggressive Fed fight against inflation trying to make up for lost time. But what about supply and demand, thinking mostly on supply. This graph has the calendar year new cash raised by the U.S. Treasury in auctions each year. Looks like quite the disconnect between Treasury new cash needs of $1.339 trillion in calendar year 2018 from only $546 billion in 2017. Lots going on with the Tax Cuts and Jobs Act in December 2017 depressing corporate tax collections and the start of Fed QT the last time around (not sure we called it QT back then did we?). The 2018 new cash need sky-rocketed to $1.339 trillion, where $235 billion of that was from QT. Bond yields did what they were supposed to do with more supply, moving to 2.91% on average in 2018 from 2.33% the year before, although don't forget the Fed with a 2.5% Fed funds rate in December 2018 (the peak) versus 1.5% in December 2017 the year before.

This graph reminds us of the brave investors that bought the $4.281 trillion of debt sold in 2020 during the pandemic to fight the economy's return to a second Great Depression, investors who have now been sacrificed. Take the 30-yr bond auctioned in August 2020 (1.375s Aug 2050), the yield high of 1.406% and price 99.25 call it, where can you sell it today? The bond was $65.05 on Friday, June 3, a 34.5 percent loss, given the current 30-year bond yield is trading at 3.20%. And if the Fed needs to push overnight rates to 5.25% with long-term Treasury yields matching that, you can forget about the

loss on your 30-year bond: you will have to hold it for your children when it matures on August 15, 2050.



Inflation is pretty important to price long bond yields, although where it settles in at eventually relative to the Fed's 2% target is another unknown with implications for monetary policy. Let's just stick with trying to get it to move consistently down as a first step. Fed Vice Chair Brainard said the other week she was looking for a string of decelerating monthly prints and other Federal Reserve's have done something similar focusing on monthly changes and 3-month and 6-month annual rates.

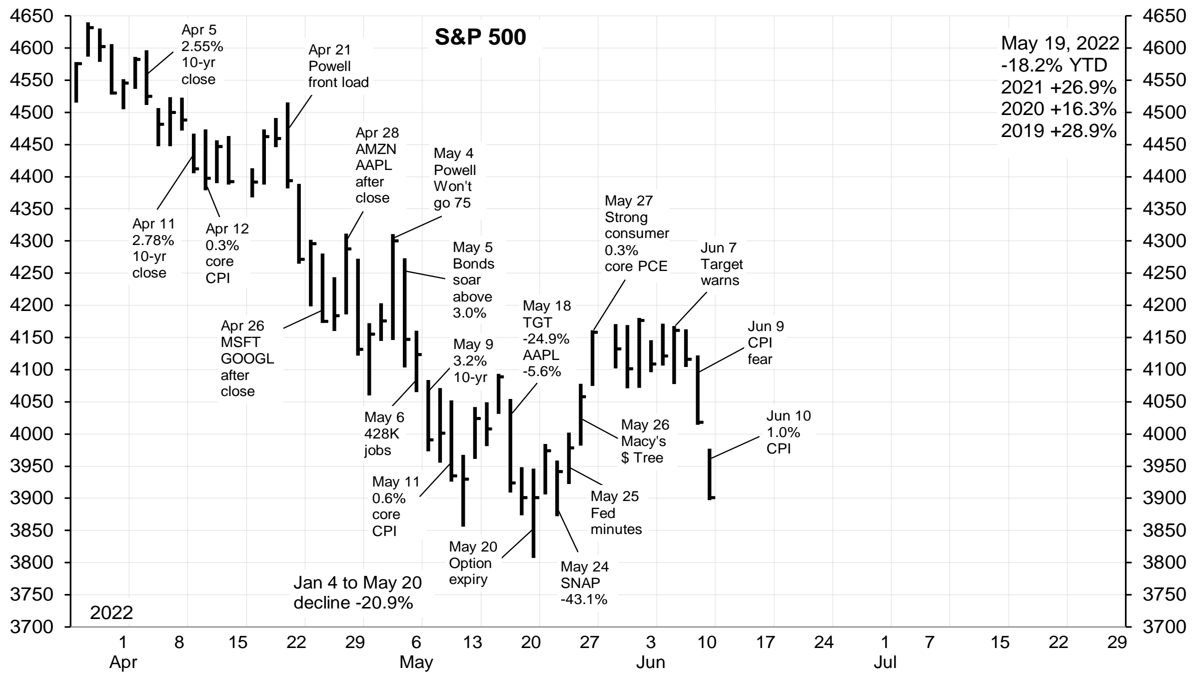
Core Consumer Inflation and stickier services prices ex-energy

Monthly	2022					2022	2021									2021
% Changes	Jun	May	Apr	Mar	Feb	Jan	Dec	Nov	Oct	Sep	Aug	Jul	Jun	May	Apr	Mar
Core CPI inflation		0.6	0.6	0.3	0.5	0.6	0.6	0.5	0.6	0.3	0.2	0.3	0.8	0.7	0.9	0.3
Services x-energy		0.6	0.7	0.6	0.5	0.4	0.3	0.4	0.4	0.2	0.1	0.3	0.4	0.4	0.5	0.3
Core PCE inflation			0.3	0.3	0.3	0.4	0.5	0.5	0.5	0.2	0.3	0.3	0.5	0.6	0.6	0.4
Services x-energy			0.4	0.4	0.3	0.3	0.4	0.5	0.3	0.2	0.3	0.4	0.4	0.4	0.4	0.5

We will leave food and energy out of the monthly inflation monitor. The Fed says it can't affect these prices, but obviously food at the grocery store and gasoline in the car is what consumers see most often and it feeds inflation expectations and leads everyone, businesses and consumers, to move prices higher. We will put core PCE and core CPI in the monitor and sticky services prices as well. It is possible consumer goods prices fall at some point and bring down the core consumer inflation monthly changes, but services prices may keep going up. Have to watch. The CPI report Friday doesn't look much different from the month before in this table of core rates above, despite all the shouting on the internet on Friday, ourselves included.

To conclude, supply/demand matters for interest rates and don't forget to look at Treasury deficits and planned QT of $60 billion monthly once the Fed gets up to speed. $85 billion QE and now $60 billion QT to take it back out. One possible risk scenario is we don't get out of this inflation mess for years if for example, job layoffs soar, the Fed pauses, even cuts rates back 50 or 75 bps, then has to send interest rates even higher again as inflation doesn't come down much. The danger is that inflation becomes entrenched for a decade. Especially with persistent energy shortages and higher prices. We are still worried about the possibility of a 5% 10-year yield like we saw last in the housing bubble years.

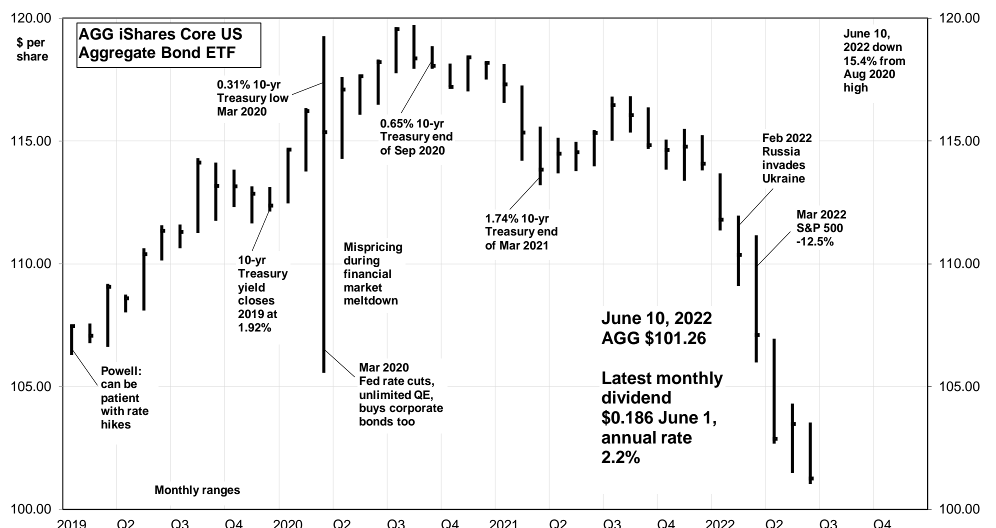
INTEREST RATES



CPI was worse than the market expected and short-term yields went up sharply, discounting more Fed tightening and higher rates. One dealer changed to a call for 75 bps at next week's Fed meeting. Just on Friday, the 2-year Treasury note rose 27 bps to 3.07% from 2.80% on Thursday. October Fed funds futures, which discount the next three Fed meetings, had been quiet all week and then lifted 19.5 bps on Friday to 2.49%. The S&P 500 fell 2.9% after CPI to match the closing low this year on May 19 when the index was down 18.2% YTD. The 10-year Treasury yield rose from 3.05% Thursday to 3.16% on Friday which is priced pretty well for a 3.5% Fed funds rate down the road. Market thinks inflation is no longer peaking even with core CPI of 6.0% in May down from 6.2% year-year in April.

AGG iShares Core US Aggregate Bond ETF down 11.2% YTD

The 40 side of a balanced and safe 60/40 equities/fixed income portfolio not doing well with the sharp jump in bond yields this year. The AGG ETF closed at 101.26 on Friday where the peak was 119.73 in August 2020. Another thing to blame the Fed for and too depressing to calculate how far the decline has been. It's a good thing the loss is just a number on a piece of paper unless you sell. For an index composed of the total U.S. investment-grade bond market, we didn't realize 40.54% of its holdings were low-yielding US Treasury securities. Seems to be a lot of different dividend yields on the AGG ETF available in googled internet news stories. The last June 1 dividend was $0.1861 X 12 over Friday's $101.26 close is 2.2%, good enough for us.



FEDERAL RESERVE POLICY

The Fed meets on June 14-15, 2022 to consider its monetary policy. Market yields went up further this week on inflation, fears of inflation, the ECB saying its first rate hike is July. A lot of rate hikes are discounted this summer. October Fed funds futures settled at 2.495% up 23.5 bps from 2.26% at last week's close. Take 2.495% and add 17 bps (the amount the daily effective Fed funds rate trades below the top of the current 1.0% Fed target), and the market is saying the Fed funds rate will average 2.665% in October which is a little more than 50 bps per meeting: the June 15, July 27, and September 21 decision dates. Why don't Fed officials try to blow the doors off of market expectations and go 100 bps next week to show they are fighting inflation even harder after Friday's broad-based CPI inflation that seems to be spreading. Volcker was once told privately by Wall Street executives that gradual rate hikes weren't cutting it, and he listened.

What else could go wrong for bond investors at 2pm ET Wednesday, June 15? The Fed forecasts. At the moment, the forecasts see the Fed funds rate going to 2-7/8% down the road. Well, inflation is worse than 2018 and in 2018 the Fed forecasts saw the need to eventually move rates to 3.5%. At the moment, there is just one forecast of 3% at the end of 2022 and Bullard raised his hand and said he was the one. The question is whether 10-yr bond yields will adjust higher and match the higher Fed forecasts in the outer years.

Selected Fed assets and liabilities					March 11
Fed H.4.1 statistical release					2020**
billions, Wednesday data	8-Jun	1-Jun	25-May	18-May	pre-Covid
Factors adding reserves					
U.S. Treasury securities	5771.393	5770.779	5769.417	5768.021	2523.031
Federal agency debt securities	2.347	2.347	2.347	2.347	2.347
Mortgage-backed securities (MBS)	2707.446	2707.446	2707.446	2733.823	1371.846
Repurchase agreements	0.000	0.000	0.000	0.000	242.375
Primary credit (Discount Window)	1.191	0.870	0.913	0.856	0.011
Paycheck Protection Facility	19.536	19.792	20.204	20.537	
Corporate Credit Facility (CCF)	0.000	0.000	0.000	0.000	
Municipal Liquidity Facility	5.537	5.536	5.535	6.661	
Main Street Lending Program	26.687	26.676	26.665	28.438	
Term Asset-Backed Facility (TALF II)	2.196	2.195	2.288	2.466	
Central bank liquidity swaps	0.183	0.183	0.209	0.219	0.058
Federal Reserve Assets	8967.9	8964.6	8963.8	8995.5	4360.0
~~3-month Libor %~~ SOFR %	0.76	0.80	0.78	0.79	1.15
Factors draining reserves					
Currency in circulation	2278.876	2280.223	2275.926	2273.025	1818.957
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
U.S. Treasury Account at Fed	683.892	780.575	801.714	866.726	372.337
Treasury credit facilities contribution	17.940	17.940	17.940	21.258	
Reverse repurchases w/others	2140.277	1965.015	1995.750	1973.373	1.325
Reserve Balances (Net Liquidity)	3292.602	3357.395	3315.018	3297.142	1779.990
Treasuries within 15 days	55.157	67.188	74.558	82.052	21.427
Treasuries 16 to 90 days	369.205	331.056	349.105	346.689	221.961
Treasuries 91 days to 1 year	807.534	833.614	774.087	768.924	378.403
Treasuries over 1-yr to 5 years	2083.436	2083.210	2117.024	2116.508	915.101
Treasuries over 5-yrs to 10 years	1026.805	1026.609	1028.423	1027.982	327.906
Treasuries over 10-years	1429.257	1429.102	1426.220	1425.865	658.232
**March 11, 2020 start of coronavirus lockdown of country					

QT started June 1 with no change in Fed holdings this week. Coupons mature and roll-off the balance sheet on the 15th and last day of the month. QT Govts $30 bln monthly for now.

Fed Individual Forecasts				
Fed funds rate at year-end				Longer
Votes	2022 End	2023 End	2024 End	run
1	1.375	2.125	2.125	2.000
2	1.625	2.375	2.125	2.250
3	1.625	2.375	2.250	2.250
4	1.625	2.375	2.375	2.250
5	1.875	2.375	2.375	2.250
6	1.875	2.625	2.375	2.250
7	1.875	2.625	2.625	2.250
8	1.875	2.625	2.625	2.375
9	1.875	2.875	2.875	2.500
10	2.125	2.875	2.875	2.500
11	2.125	2.875	2.875	2.500
12	2.375	3.125	3.125	2.500
13	2.375	3.125	3.375	2.500
14	2.375	3.375	3.375	3.000
15	2.625	3.625	3.625	3.000
16	3.125	3.625	3.625	
17				
18				
Median	1.875	2.750	2.750	2.375
Meeting	Mar 22	Mar 22	Mar 22	Mar 22

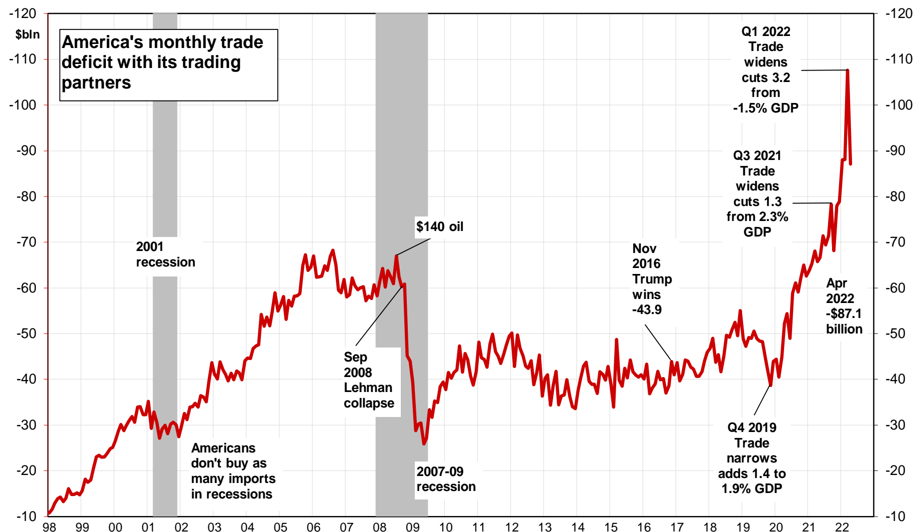
Fed Meeting	2018	2019	2020	2021	2022	2023	2024	Longer run
Mar 22					1.9	2.8	2.8	2.4
Dec 21				0.1	0.9	1.6	2.1	2.5
Sep 21				0.1	0.3	1.0	1.8	2.5
Jun 21				0.1	0.1	0.6		2.5
Mar 21				0.1	0.1	0.1		2.5
Dec 20			0.1	0.1	0.1	0.1		2.5
Sep 20			0.1	0.1	0.1	0.1		2.5
Jun 20			0.1	0.1	0.1			2.5
Mar 20	No meeting: 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

Fed Policy-key variables				Long
	2022	2023	2024	Term
Fed funds	1.9	2.8	2.8	2.4
PCE inflation	4.3	2.7	2.3	2.0
Core inflation	4.1	2.6	2.3	
Unemployed	3.5	3.5	3.6	4.0
GDP	2.8	2.2	2.0	1.8
March 2022 median Fed forecasts				

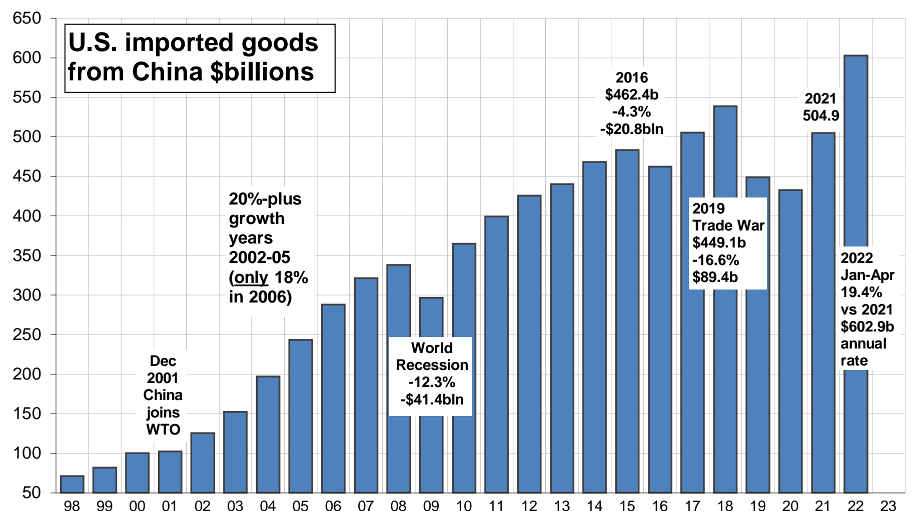
OTHER ECONOMIC NEWS

Trade deficit reverses last month's record (Tuesday)

Breaking economy news. The trade deficit fell sharply back to where it began and then some at $87.1 billion in April from $107.7 billion in March. Exports hit a new record at $252.6 billion up $8.5 billion this month as imports fell $12.1 billion to $339.7 billion. American industry has heard the call to make it here, but they are also increasingly sending what they produce to markets overseas as well. No manufacturing executive worth his or her salt would welcome a retreat from the globalization trend the last two decades as billions and billions of U.S. manufactured goods are sold to America's trading partners which creates thousands of jobs here in the USA.



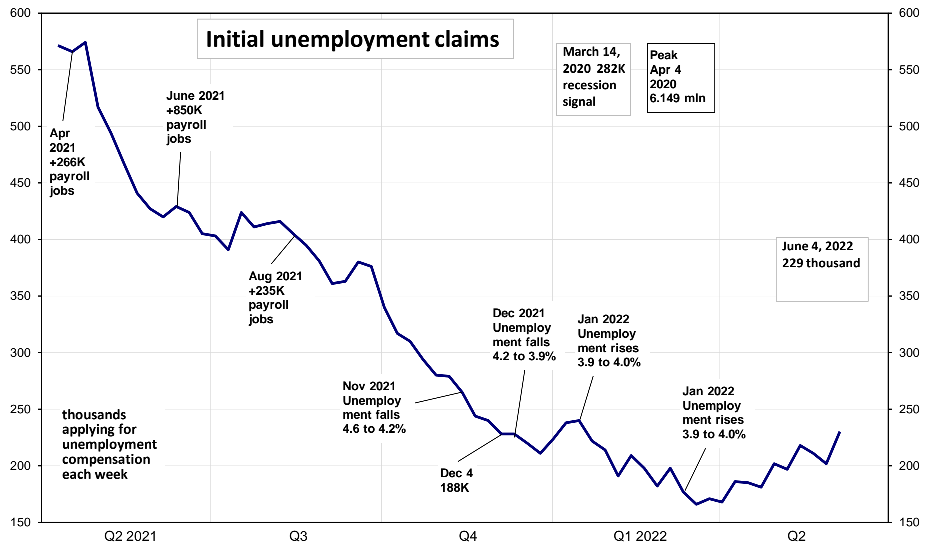
The market has been closely monitoring the economic data for signs of a slowdown in growth if not recession, and while it is true that the trade deficit declines in recessions as the U.S. consumer goes on a buying strike, today's drop in the April trade deficit looks like a correction for the unexpected widening in March. Consumer goods did drop a sharp $6.3 billion in April with $2.5 billion of it being Toys, games, sporting goods, and Other textile apparel and household goods. This matches up with a decline in imports from China, possibly covid lockdown related, with $41.8 billion imported in April versus $47.4 billion in March. Energy prices didn't seem to have much effect this month, and these are certainly going higher into early June. Trade in crude oil still is not in tune with the administration's desire to get the cost of living crisis under control with imports of $17.5 billion in April while the country exports $9.3 billion.



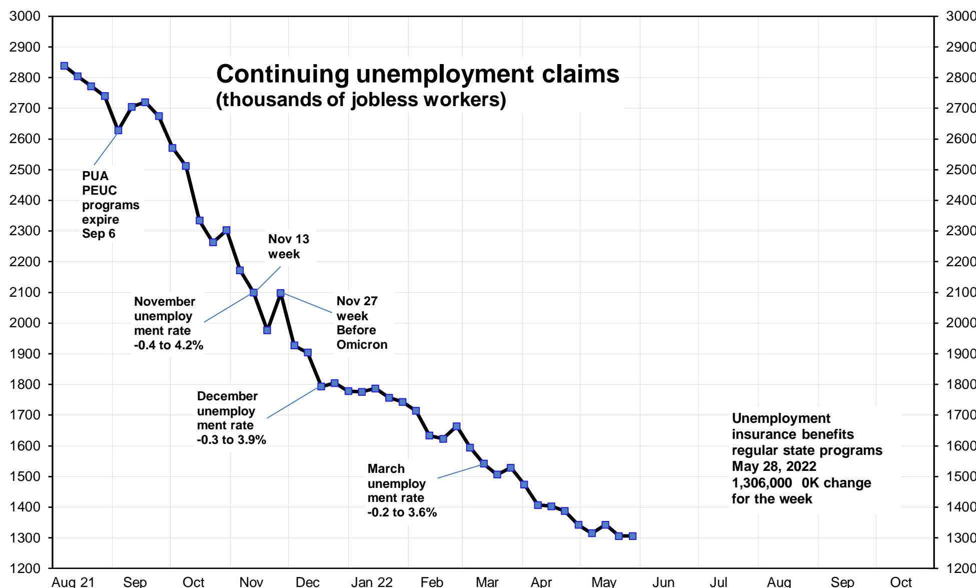
Net, net, in April the deficit in trade shrank dramatically from all-time record levels, but this is not likely to herald the start of a new era where countries produce more locally and rely less on their global trading partners. Globalization cuts both ways where withdrawing from world trade on imports could have a negative spillover effect on exports. You won't buy from us then we won't buy from you, tit for tat, is the stuff of global trade wars where U.S. exporters and U.S. factory production has the most to lose if America retreats from the world stage.

Jobless claims jump this Memorial Day (Thursday)

Breaking economy news. Jobless claims jump 27 thousand to 229 thousand in the June 4 week. The Memorial Day holiday week sometimes sees a drop in filings, but not this year. Not seasonally adjusted claims were 184,604 June 4 versus 183,596 May 28. Jobless claims are an early warning sign if the economy is about to get hit by mounting recessionary hurricane winds so we cannot discount the rise today. However, more data will be required over the next few weeks to make the call that the economy is in trouble.

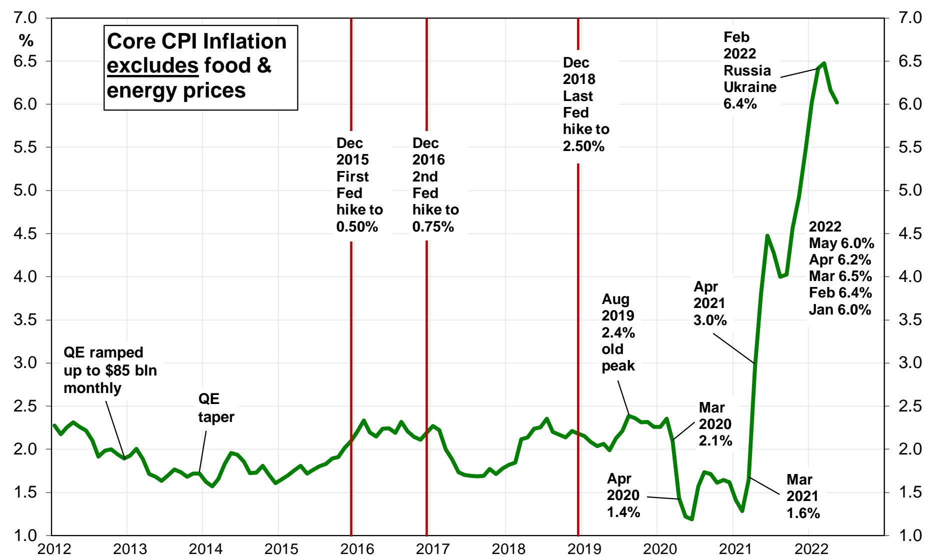


Net, net, we cannot be sure if the June 4 holiday week's jump in new jobless filings is real or not as the seasonal factor boosting not seasonally adjusted claims was a little aggressive. The rise of initial unemployment claims does fit with anecdotal evidence provided by CEOs that they are closely watching their headcounts which often covers up for their actions where they are quietly giving out pink slips. One thing is for certain, joblessness has nowhere to go but up with inflation boosting costs for every company across the country and cost control measures must be implemented which will likely fall on the backs of labor. Stay tuned. Story developing. Jobless claims say the economy is slowing down, but there is uncertainty about whether this recession indicator is making the right call.



No relief on inflation (Friday)

Breaking economy news. May CPI inflation jumped 1.0% and is 8.6% higher than a year ago. May core CPI inflation jumped 0.6% and is 6.0% higher than last year. Too much inflation. Whatever Washington has done to try to fix the cost of living crisis in America, it isn't working. This isn't just Russia and Ukraine anymore. The price increases are too broad-based and the inflation fire is literally everywhere we look. Broad-based means we cannot find any goods or services prices that are actually going down. It looks like the worsening outlook for inflation gives the Fed the greenlight for a third consecutive 50 bps rate hike at the September meeting, but we wonder if even that will be too late. With inflation running 8%, how is a 2.5% Fed funds rate restrictive enough and high enough to slow down economic demand?



Forget about the inflation peak story for now. Airline fares 12.6% in May after 18.6% in April. Shelter costs, the roof over your head, rose 0.6% the most since March 2004. No relief on the inflation front. None. The relentless climb in energy prices is forcing up the costs of businesses everywhere from manufacturing to services. Companies have no choice but to pass on their higher costs if they want to survive and this is why the inflation fire will be so incredibly difficult to put out.

Whatever markets thought of today's inflation report, better buckle up for next month as gas prices went up another 50 cents the last four weeks to nearly $5 nationwide. Gasoline prices climb seasonally with the start of summer each year but this year they have yet to show any sign of coming back down once the demand peak of the driving season is reached.

Net, net, The cost of living is going higher for everyone in society, it isn't just goods prices, supply shocks, or oil, or food, or Russia and Ukraine. Washington just doesn't get it and doesn't have the tools to combat it if they did. It's the central bank that did this with too much money printing. Inflation peaking at 8 percent was never the point anyway because the Fed's battle is with bringing inflation back down to its 2% target which means higher rates, much

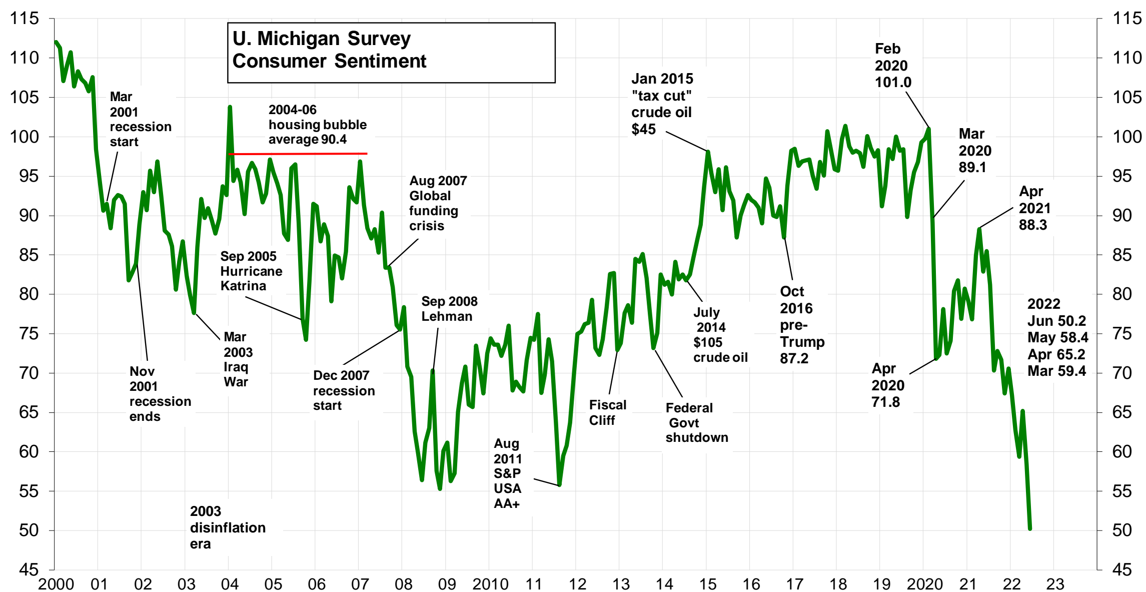
Apr 22		Monthly Percent Changes			YOY %
Weight	CPI inflation	Mar 2022	Apr 2022	May 2022	May 2022
100.0	Total	1.2	0.3	1.0	8.6
13.421	Food	1.0	0.9	1.2	10.1
5.117	Food away from home	0.3	0.6	0.7	7.4
8.255	Energy	11.0	-2.7	3.9	34.6
78.324	Ex-food & energy	0.3	0.6	0.6	6.0
4.031	New vehicles	0.2	1.1	1.0	12.6
3.992	Used cars/trucks	-3.8	-0.4	1.8	16.1
2.489	Clothing	0.6	-0.8	0.7	5.0
1.492	Medical care goods	0.2	0.1	0.3	2.4
32.437	Shelter	0.5	0.5	0.6	5.2
23.782	Owner equiv. rent	0.4	0.5	0.6	5.1
5.829	Transportation	2.0	3.1	1.3	7.9
6.869	Medical care services	0.6	0.5	0.4	4.0
	Special: Where inflation might come back down to				
56.921	Services ex-energy	0.6	0.7	0.6	5.2

higher rates in the years, not just months, to come. The central bank may pause if and when inflation peaks, but inflation isn't coming back down and this means interest rates eventually will need to be higher.

Inflation has reared its ugly head before every recession since at least the 1970s, and we are hard put not to believe the economy is nearing the edge of the cliff again as price increases continue to sting consumers and businesses alike. Stay tuned. Story developing badly.

Michigan survey of consumer sentiment at all-time low

Michigan consumer sentiment fell to 50.2 in June from 58.4 in May. The cutoff date for survey responses was June 8, so the stock market's return to the old closing low, down 18.2% YTD on Friday didn't have an effect. Inflation is the concern for consumers. The kind of inflation that can trigger a recession as the consumer steps back from spending when store-bought goods prices soar.



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