Financial Markets This Week

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RECESSION AROUND THE NEXT CURVE

The yield curve is inverting again, time to bet on a recession coming right around the next corner. Bet on it, if you can. Too late really. The stock market already fell as much as 24.5% from the record high in January which is a recession magnitude loss. The recession is here, the stock market says. The S&P 500 only fell 20.4% during the 1990-91 recession. The 2-year to 10-year Treasury yield curve inverted again after the Fourth of July, after going negative for a couple of days at the start of April, and it looks like July will be the first month in this interest rate cycle for an inverted curve.

The chart here shows the historical track record of the 2s/10s spread on a monthly average basis. Monthly average because an inversion needs time to become meaningful. The average over July 1-22 is 2.94% for the 10-year note, 3.07% for the 2-year note, for a spread of -13 bps. This will be the first time the curve has gone negative since the February 2006 episode.

The 3-month to 10-year curve has been more accurate than 2s/10s historically. This yield spread will not be going negative in July. The average over July 1-22 is 2.94% for 10-years, 2.23% for 3-months, for a positive spread of 71 bps. It is possible the spread will go negative if the Fed pushes rates up 75 bps to 2.50% on July 27. On Friday, July 22, the 3-month maturity was 2.49%, expecting a lot more tightening since the current Fed funds rate is way down at 1.75%.

We will focus more on the 3-mo/10-yr curve with its perfect track record. An inverted curve doesn't tell how deep or long a recession will be. It is just a mindless statistic subject to the whims of market forces. Social media chatter has gotten more heated and aggressive with rate outlook views since the last big recession in 2007-09, so the yield curve may be narrowing driven by a raucus crowd that gets more carried away than it ever did in the Greenspan years.

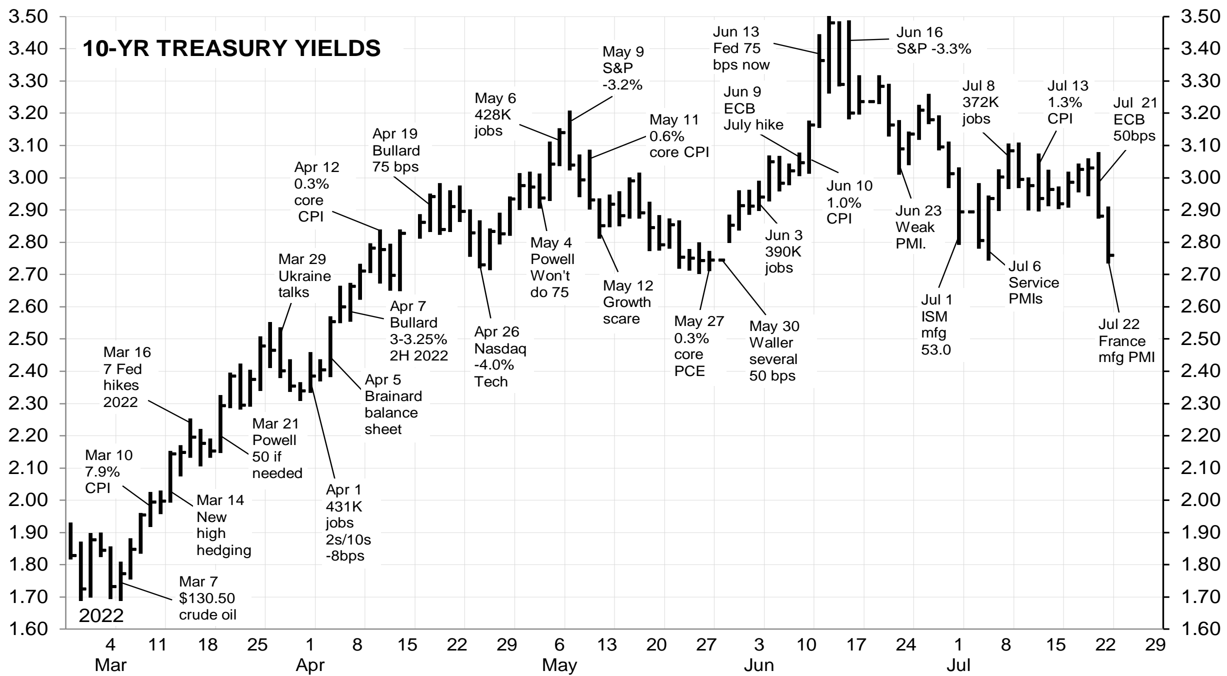
The 3-month maturity may be a better choice for recession forecasting because it is more closely tied to the Fed target rate. The level of the Fed funds rate helps us judge whether policy is tight. The 2s/10s curve is going recession negative in July with a 2.5% Fed funds rate, a level the Fed says is neutral for the economy, not even a restrictive monetary policy yet. Maybe the markets and the twitter crowd has got us all ahead of ourselves. On the other hand, some of the data, manufacturing industrial production, May real consumption expenditures, jobless claims, France PMI (joking) show darkening skies over America so maybe recessions are developing faster just like climate change.

The 3mo/10yr yield curve is just a mindless statistic that doesn't read the newspaper so let's run through again what was happening before a couple of the last four spot-on recession signals. In the 1990-91 recession, the curve inverted in June 1989 13 months before the July 1990 start date. The Fed tightened to 9-3/4% in February 1989, but backed it down to 8-1/4% by December 1989. There was a commercial real estate crisis, but the recession trigger was likely Iraq invading Kuwait in August 1990 that spiked the price of oil.

Before the 2020 recession, the twitter mob drove Powell out of a tightening regime after pushing the Fed funds rate to "neutral" 2.5% in December 2018. The curve went negative in June 2019 as the market discounted rate cuts and Powell didn't disappoint cutting rates 25 bps in July, September, and October 2019. The Fed funds rate was 1.75% before the pandemic struck in February 2020, and the recession was a short two months long.

In conclusion, the 3-month/10-year curve is more accurate historically at inverting before each of the last four recessions with no false signals. The curve inversion cannot tell us how severe a recession will be. The curve doesn't need to stay negative to keep the recession coming; once it goes negative the die is cast and we are doomed. If the Fed hikes rates 75 bps at next week's meeting, and another 50 bps at the September 20-21 meeting to 3.0%, the 3mo/10yr curve will likely go negative signaling a recession. Prior recession signals gave an advance warning of 8 to 16 months, so you have more than enough time to get your affairs in order.

INTEREST RATES

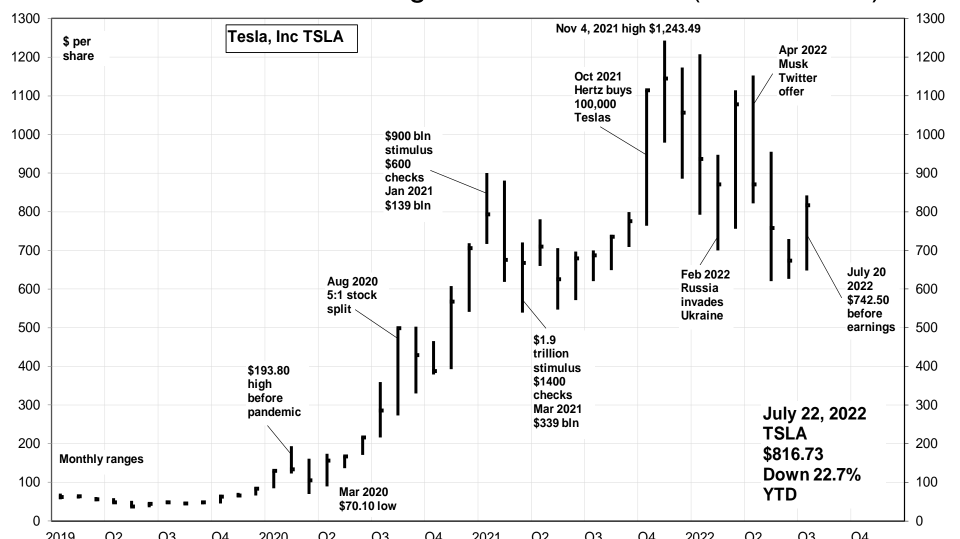


Recession level jobless claims Thursday 830am ET brought bond yields down from the 3.07% high for the week, 15 minutes after the ECB 50 bps surprise, closing Thursday at 2.88%. Incredibly, for a second straight month, you had to be up at 315am ET Friday for France manufacturing PMI, falling below 50 (contraction) to 49.6 from 51.0 expected. Bonds were rallying big time before the 945am ET July US PMI for services at 47.0 versus 52.7 in June. Market is thinking recession will stop the Fed rate hikes. Stocks broke higher this week until Friday. Snap earnings Thursday after the close sent the stock down 39.1% on Friday (slowing demand for the online ad platform), dragging down tech; the S&P 500 fell 0.9% on Friday, down 16.9% YTD. The market's worst close this year was 23.1% on June 16. Things are looking up for bonds and stocks, with the economy heading down, for now.

Tesla, Inc. down 22.7% after week's earnings rally

Tesla jumped 9.8% on Thursday, after earnings Wednesday afternoon, although the S&P 500 was up 1.0% to a new rally high as well. Adjusted EPS was $2.27 versus $1.81 expected. The company announced weaker production/deliveries earlier in the month (Shanghai) due to "ongoing supply chain challenges and factory shutdowns." There was noise on selling 75% of its Bitcoin ($936 million).

Mln $	Revenue	Operating Income	Model 3/Y Deliveries
Q1 2020	5,985	283	76,266
Q2 2020	6,036	327	80,277
Q3 2020	8,771	809	124,318
Q4 2020	10,744	575	161,701
Q1 2021	10,389	594	182,847
Q2 2021	11,958	1,312	199,409
Q3 2021	13,757	2,004	232,102
Q4 2021	17,719	2,613	296,884
Q1 2022	18,756	3,603	295,324
Q2 2022	16,934	2,464	238,533



FEDERAL RESERVE POLICY

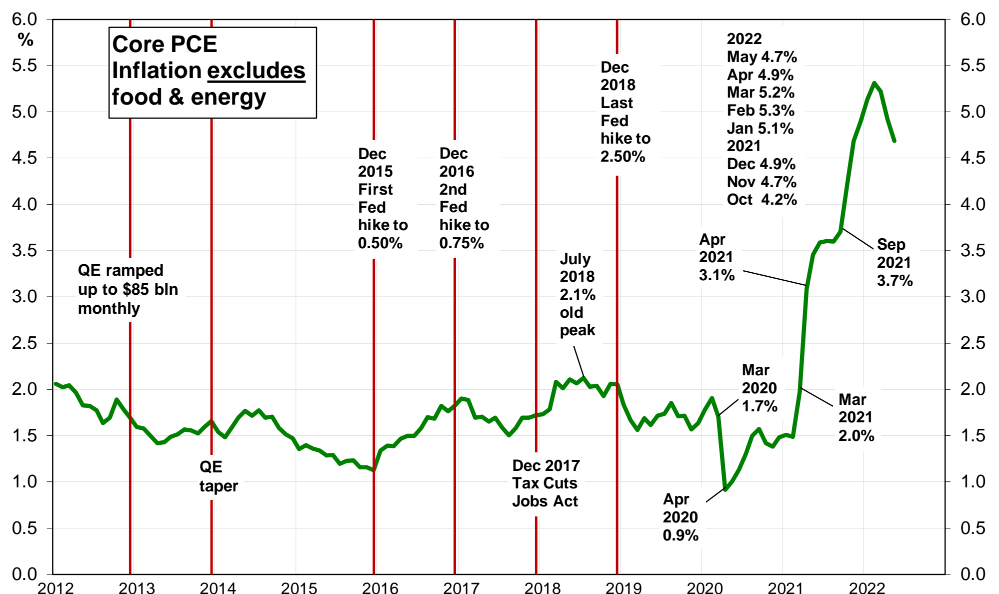
Selected Fed assets and liabilities						Change
Fed H.4.1 statistical release						from
billions, Wednesday data	20-Jul	13-Jul	6-Jul	29-Jun	3/11/20*	3/11/20
Factors adding reserves						to Jul 20
U.S. Treasury securities	5733.027	5745.528	5744.344	5763.933	2523.031	3209.996
Federal agency debt securities	2.347	2.347	2.347	2.347	2.347	0.000
Mortgage-backed securities (MBS)	2726.261	2709.337	2709.336	2709.328	1371.846	1354.415
Repurchase agreements	0.000	0.002	0.000	0.001	242.375	-242.375
Primary credit (Discount Window)	3.064	2.570	1.765	3.604	0.011	3.053
Paycheck Protection Facility	16.855	17.201	17.628	18.082		
Main Street Lending Program	26.038	26.414	26.401	26.387		
Municipal Liquidity Facility	5.546	5.544	5.543	5.541		
Term Asset-Backed Facility (TALF II)	2.181	2.180	2.179	2.198		
Central bank liquidity swaps	0.195	0.185	0.347	0.184	0.058	0.137
Federal Reserve Total Assets	8949.0	8945.6	8941.5	8962.2	4360.0	4588.939
~~3-month Libor %~~ SOFR %	1.53	1.53	1.54	1.51	1.15	0.380
Factors draining reserves						
Currency in circulation	2275.924	2279.838	2284.935	2281.158	1818.957	456.967
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000	0.000
U.S. Treasury Account at Fed	616.348	618.740	687.943	759.845	372.337	244.011
Treasury credit facilities contribution	17.940	17.940	17.940	17.940		
Reverse repurchases w/others	2240.204	2155.290	2168.026	2226.976	1.325	2238.879
Federal Reserve Liabilities	5713.793	5639.069	5718.575	5843.636	2580.036	3133.757
Reserve Balances (Net Liquidity)	3235.172	3306.518	3222.930	3118.611	1779.990	1455.182
Treasuries within 15 days	85.856	81.810	82.799	93.370	21.427	64.429
Treasuries 16 to 90 days	322.875	342.128	335.728	325.023	221.961	100.914
Treasuries 91 days to 1 year	816.212	808.230	813.570	810.874	378.403	437.809
Treasuries over 1-yr to 5 years	2053.774	2057.281	2056.844	2084.018	915.101	1138.673
Treasuries over 5-yrs to 10 years	1019.129	1023.618	1023.242	1019.834	327.906	691.223
Treasuries over 10-years	1435.181	1432.461	1432.162	1430.814	658.232	776.949
Note: QT starts June 1	Change	20-Jul	1-Jun			
U.S. Treasury securities	-37.752	5733.027	5770.779			
Mortgage-backed securities (MBS)	18.815	2726.261	2707.446			
**March 11, 2020 start of coronavirus lockdown of country						

The Fed meets on July 26-27, 2022 to consider its monetary policy. Powell said at the press conference on June 15 they could move 50 or 75 bps. The market has discounted a 75 bps rate hike to 2.5% for weeks now and we aren't looking for a sudden change by Fed officials. The ECB was the latest central bank to float the idea of a more aggressive move, 50 bps in this case, in the days before the meeting.

For the Federal Reserve, there is likely to be less need for fireworks in the future now that the aggressive rate hikes have moved interest rates up to the so-called neutral level of 2.5%. There are tentative signs that the economy is slowing from some of the early warning economic indicators like job layoffs and home sales, so the central bank is less behind the curve in its inflation fight than they were at the beginning of the year. It's time to switch to a more measured approach in its policy tightening. They are likely to keep with the June meeting forecast of moving interest rates to 3.5% by the end of the year which in this case would mean 50 bps in September, 25 bps in November, and 25 bps in December.

The Fed's inflation number is Friday, July 29 830 ET after the meeting. Core PCE is still running much less than CPI in the last four months of monthly percent changes.

Fed funds futures call Fed hikes		
Current target: July 22 -- 1.75%		
Rate+0.17	Contract	Fed meetings
2.52	Aug 2022	July 26-27
3.105	Oct 2022	July, Sep 20-21
3.525	Jan 2023	July, Sep, Nov, Dec
75	July 27 to 2.5%	
50	Sep 21 to 3.0-3.25%	Currently
25	Nov 2 to 3.25-3.5%	discounted
25	Dec 14 to 3.5-3.75%	

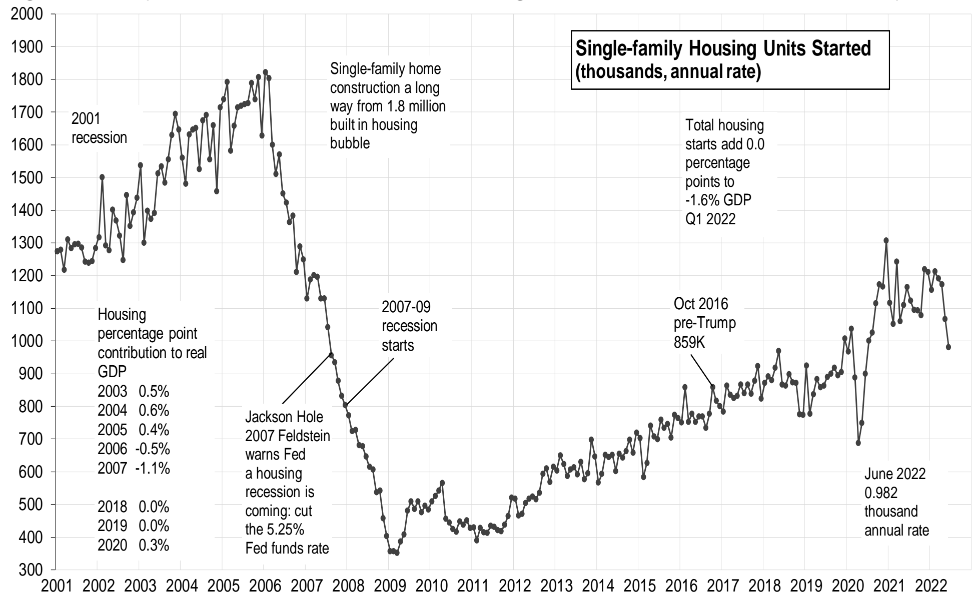


Core Consumer Inflation and stickier services prices ex-energy																
Monthly	2022					2022	2021									2021
% Changes	Jun	May	Apr	Mar	Feb	Jan	Dec	Nov	Oct	Sep	Aug	Jul	Jun	May	Apr	Mar
Core CPI inflation	0.7	0.6	0.6	0.3	0.5	0.6	0.6	0.5	0.6	0.3	0.2	0.3	0.8	0.7	0.9	0.3
Services x-energy	0.7	0.6	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	0.3	0.5	0.5	0.5	0.5	0.2	0.3	0.3	0.5	0.6	0.6	0.4
Services x-energy		0.3	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

OTHER ECONOMIC NEWS

Cycle starting to turn in the housing market (Tuesday)

Breaking economy news. Housing starts fell 2.0% in June to 1.559 million at an annual rate, but most of the construction was in multifamily units as single-family housing starts tumbled 8.1% to 982 thousand at an annual rate. Home builders are growing more cautious about whether buyers can afford what they are putting up, and you can see this most clearly out West in the most expensive region of the country where single family home construction plunged 25.4% in June. The cycle is starting to turn in the housing market with a sharp decline in home builder confidence and a fall-off in single-family home construction. A downturn in home prices isn't captured in the data yet, but that would be the next shoe to drop. Interest rates, the famous blunt tool of monetary policy, are hitting the housing market right between the eyes this summer and home builders are running for cover.



Net, net, we're beginning to see the first signs that the housing market is starting to crack under the weight of soaring mortgage rates from the Federal Reserve's front-loaded, aggressive rate hikes starting in March this year. Home builders are downright pessimistic and single-family permits and starts have fallen below a 1 million annual rate. Surveys are showing a sharp decline in buyer traffic, but there is still a housing shortage in America and it is unclear if slowing construction will rein in the new bubble in home prices that are up about 20 percent from last year.

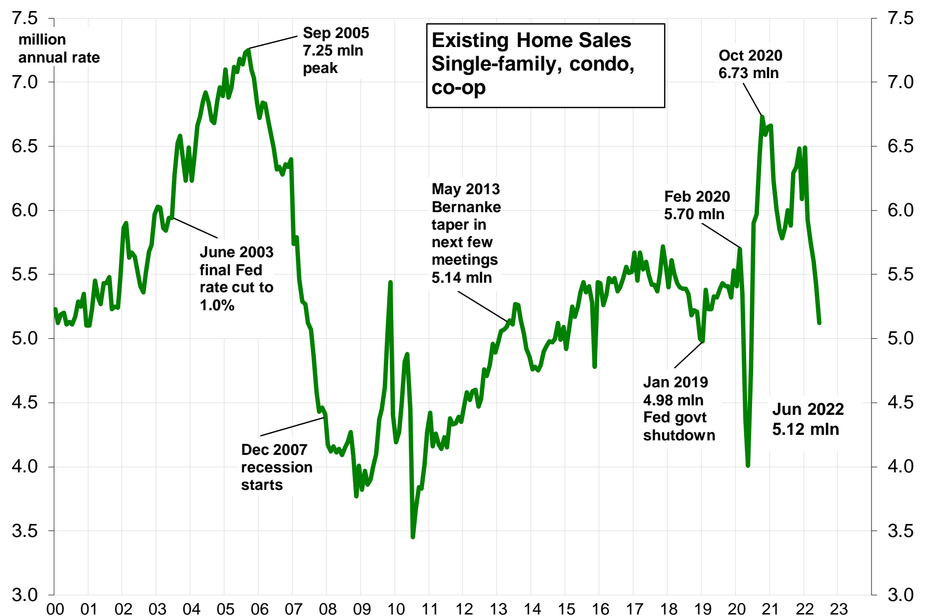
Housing Starts Total, Single-Family, Multi-Family

	United States			Northeast		Midwest		South		West	
000s	Total	1 unit	Multi	Total	1 unit	Total	1 unit	Total	1 unit	Total	1 unit
Jun 2022	1559	982	568	156	48	215	147	825	599	363	188
May 2022	1591	1068	494	141	55	233	144	867	617	350	252
May 2021	1664	1165	488	149	81	198	130	873	668	444	286
% Chgs											
Jun/May	-2.0	-8.1	…	10.6	-12.7	-7.7	2.1	-4.8	-2.9	3.7	-25.4
Jun/Jun	-6.3	-15.7	…	4.7	-40.7	8.6	13.1	-5.5	-10.3	-18.2	-34.3

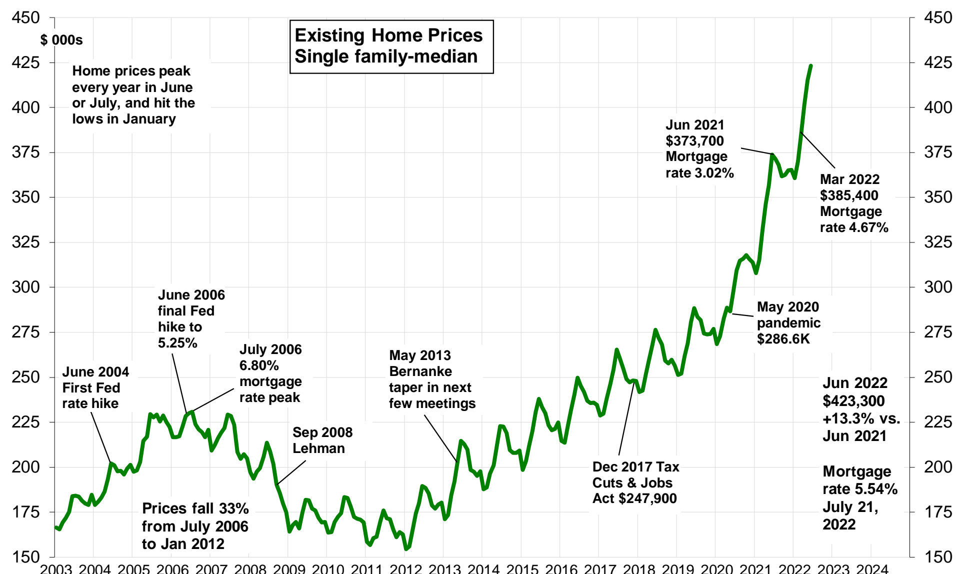
Some Fed officials were waiting on the residential housing construction data before fine-tuning their call for a 75 or 100 basis point hike in rates at next week's meeting. Tighter monetary policy is working and single-family home construction is falling, so there is unlikely to be a need for an unprecedented 100 bps rate hike from the nation's central bank that is supposed to be a measured, deliberative policy-making institution. August Fed funds futures (adjusted) are trading 2.55% after the housing starts data this morning and the market is clearly in the 75 bps rate hike camp. The market is telling the Fed not to panic. Bet on it.

Pandemic gold rush to buy a home is over (Wednesday)

Breaking economy news. Existing home sales tumble again this month by 5.4% to 5.12 million at an annual rate. June sales are 14.2% lower than a year ago. The housing market is cooling, so the Fed can cool it on the need to shock the markets with a 100 bps rate hike next week. Sales are down this year, but overall activity is back to where it was in 2019 before the pandemic at least in the Northeast, Midwest, and South. Sales in the West are weaker, falling 11.1% in June to 960 thousand at an annual rate which is 14.3% weaker than the 1.120 million sold on average in 2019. The pandemic gold rush to buy a new home is over.



The housing market is slowing down with a sharp reduction in buyer traffic, but housing isn't doomed until prices crack and that is just not happening. This isn't a rerun of the 2006 housing bubble. There is a shortage of housing, affordable or otherwise, and we aren't sure home prices are going to go into reverse as they often do in periods of monetary policy tightening. Home prices didn't fall when the Fed lifted rates to 6.5% in 2000 even with the bursting of the stock market bubble. Stay tuned. Single-family home prices are 13.3% higher than a year ago and at $423,300 in June they are 54.2% higher than the $274,600 average in 2019. The housing bubble in prices continues to inflate for now.



Net, net, the rush to buy a new home is over as stay-at-home workers grudgingly go back to work and no longer see home values as good as gold. With soaring mortgage rates, talk of recession in the air, and prices over 50 percent higher than before the pandemic, it is no wonder home buyers are stepping back.

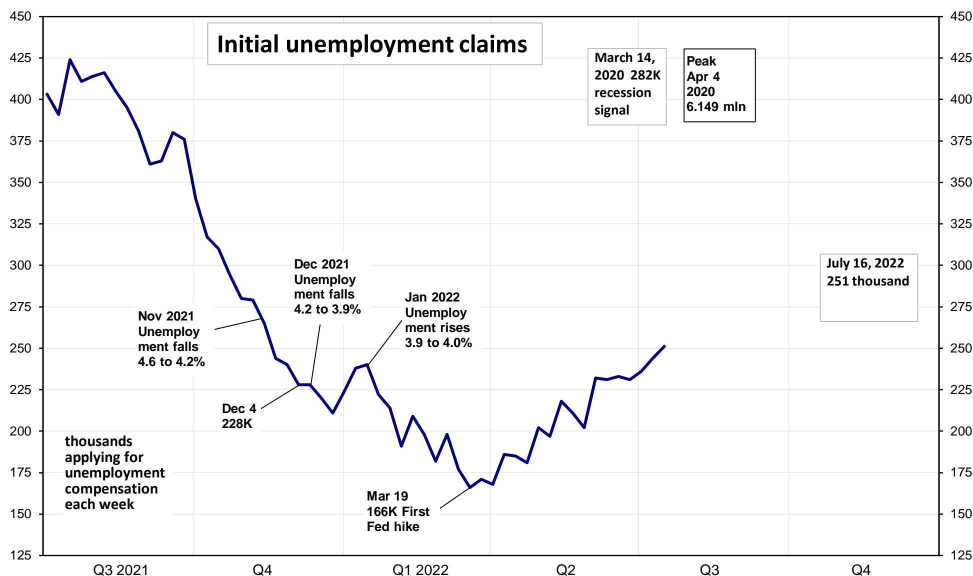
More layoffs signal recession (Thursday)

Breaking economy news. The recession storm clouds offshore moved in closer this week. You can forget that picnic on the beach. Every time weekly jobless claims rise by this magnitude, the result has been a recession: 251 thousand in the July 16 week up from 166 thousand in the March 19 week. This is a dream come true for those analysts saying we were already in recession because now they have the data in hand to back up those early, wild claims. Fake news no longer. Joblessness is increasing. You can't have a recession without job losses and we're got them.

For a second week, the data look odd though with many states seeing declines in unemployment claims. In the last report, the not seasonally adjusted increase was 21,384 to 241,314 for the July 9 week, but half of the rise (10,209) was all from New York state. With today's report the not seasonally adjusted increase was 7,853 for the July 16 week, and while New York state fell back 7,059, Massachusetts layoffs surged 14,136. The Blue states may be having some seasonal problems, or have trouble counting, or something, in addition to their other woes.

Net, net, job layoffs have reached recession magnitude and it will be a miracle if the economy manages to keep growing with the headwinds facing it. Gasoline prices, mortgage rates, financial markets, inflation, everything is an impediment to economic growth. Fed officials have got what they wanted, the economy is slowing and companies don't need as many workers since the Fed lifted rates the first time in March.

The economy certainly doesn't need 100 bps next week. There is still uncertainty whether the layoffs will keep rising, showing the downturn is worsening, but at the moment, the first signs of deterioration in the labor market should be enough to keep the Fed on track for a 75 bps rate hike to 2.5% next week. A 2.5% rate is supposed to be neutral for the economy, but instead, the economy is sitting at the edge of a cliff. Whether it can be rescued at this point depends how quickly the Fed shifts gears once again and trains their guns on battling unemployment rather than inflation. The economy is often said to turn on a dime, and boy is that ever true this time. The labor market is going down. Bet on it. More layoffs signal recession.



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