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RESEARCH | MACRO

Macro Thoughts

12 September 2022

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Thought to ponder…

"Human beings care about more than the day-to-day pleasures and pains of daily existence. We want purpose. We want meaning. We want to belong to something larger than ourselves. We aspire. We want to matter. These overarching sensations—the texture of our lives above and beyond what we call happiness or everyday pleasure —define who we are and how we see ourselves. These longings are at the heart of a life well lived. "

Wild Problems: A Guide to the Decisions That Define Us
Russ Roberts

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The View from 30,000 feet

A light holiday week of economic data in the U.S. was dominated by reaction to the ECB's hawkish tilt and a resurgence in investor optimism that the Fed can steer the U.S. economy towards a soft landing. Investors should be cautious in getting attached to extreme optimistic or pessimistic views, because the markets are likely to oscillate with data and Fed rhetoric until there is a cohesive argument that inflation is moving definitively lower.

- Structural changes in employment market may signal long-term worker shortages, making Fed's job containing wage pressures challenging
- Housing market continues to deteriorate, with markets starting to wake up to the question of how bad it will get?
- Some historical perspective on asset class returns, with some interesting take-aways
- The most *Frequently Asked Question* from client's this week: What are the key variables to watch that may signal a Fed pivot is imminent?

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Structural changes in employment market may signal long-term worker shortages

- At last count there were 11.2m job openings posted in the U.S. versus the 6.3m people who are officially labeled as “unemployed”. Creating a ratio of 1.8 Job Openings to Unemployed, a key measure the Fed is trying to lower.
- There are eleven categories of job opens and unemployed, with the largest four categories making up about 70% of the job openings. These categories include:
  - Education and Health Services
  - Leisure and Hospitality
  - Trade and Transport
  - Business Services
- Matching job openings against unemployed we find that while 19.4% of the job postings are for Education and Healthcare, only 12.1% of the unemployed are in this category. This means that as lopsided as 1.8 Job Openings to Unemployed is at the aggregate level, it’s even worse as the industry level with Education and Health Services topping out at 2.9.
- According to the Gallup Poll Survey of Full-Time workers, 44% K-12 teachers say they are burned out. A recent study from the National Center for Education Statistics found that 44% of schools reported openings for teachers, signaling a crisis level shortage for teachers.
- According to the USA Ipsos Poll of Healthcare workers, 52% reported being burned out, with almost 25% saying they plan to leave Healthcare in the near future. With hospital costs up 37% between March 2019 and 2022 (Kaufman Hall), the industry faces significant pressure to hire a burnt-out labor force in a rising cost environment. And with more than 25m American’s reaching the age over 65 in the next 20 years, there is likely to be a chronic shortage of healthcare workers.

The Fed has hitched its wagon to measuring their success by eroding job openings

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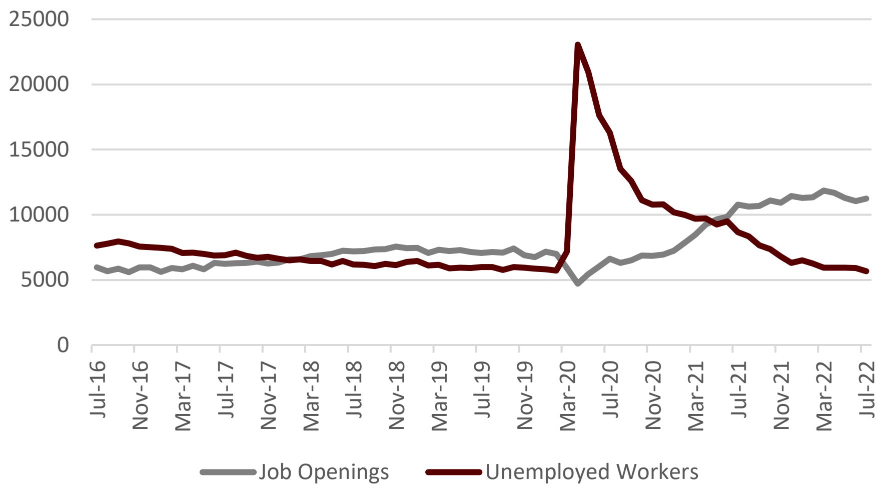
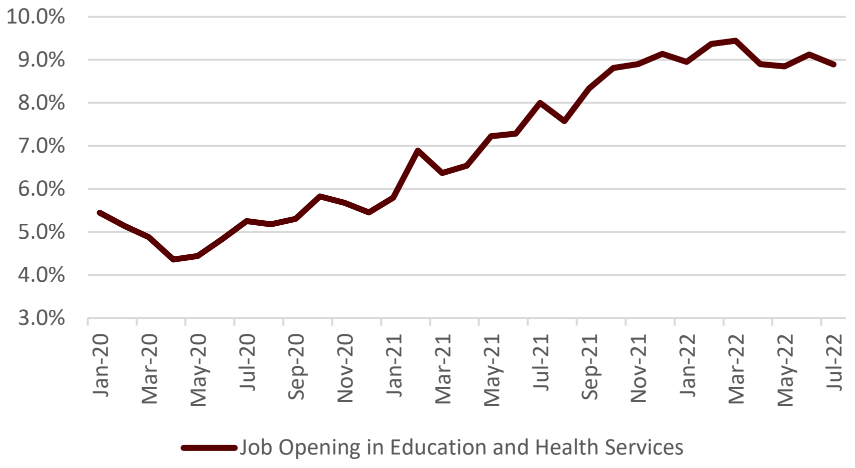
JOB OPENINGS VS. UNEMPLOYED WORKERS FED'S MEASURING SUCCESS BY CLOSING THIS GAP



Source: Federal Reserve, Bureau of Labor Statistics

JOB OPENINGS FOR EDUCATION AND HEALTH SERVICES AS A PERCENTAGE OF JOB OPENINGS NEARLY DOUBLED



Source: Federal Reserve, Bureau of Labor Statistics

Housing market continues to deteriorate…how bad it will get?

- The housing market is in a severe state of deterioration. What we know:
  - Existing home sales down -5.9% year over year
  - Pending home sales down -19.0% year over year
  - Housing inventory up 31% year over year
  - Weekly showings of new homes down -40.4% since the beginning of the year
  - Mortgage Bankers Association Purchase Index down -23% year over year (measures home loan applications)
  - Zillow expects existing home sales to decrease by -14.1% in 2022
  - Median home price down -2.42% from June to July
  - Monthly mortgage payments based on averages calculated by Zillow are up 76% since June 2019
  - Equity gains in home ownership were estimated by Corelogic to have increased 27.8% in the year ended June 30, which is a total of $3.6t.- U.S. households sitting on windfall in property value
- The projections:
  - Mortgage Bankers Association, home prices are projected to rise 3.1% in 2023
  - Zillow, home prices are projected to rise 2.4% in 2023 (lowering their previous estimate, which was 6.9%)
  - Corelogic, home prices projected to rise 3.8% in 2023
- How bad will it get:
  - There seems to be a disconnect between what's going on and what's being forecasted. With the housing market in freefall the Mortgage Bankers Association, Zillow and Corelogic all expect housing prices to rise next year, unrealistic. More realistic is a decline, but it's not clear how significant it will be.
  - This is probably not a 2008/2009 scale problem. In the Great Financial Crisis was a perfect storm, propelled by lower rates, overbuilding, low credit standards and excess leverage. This same cocktail of ingredients is not present today.

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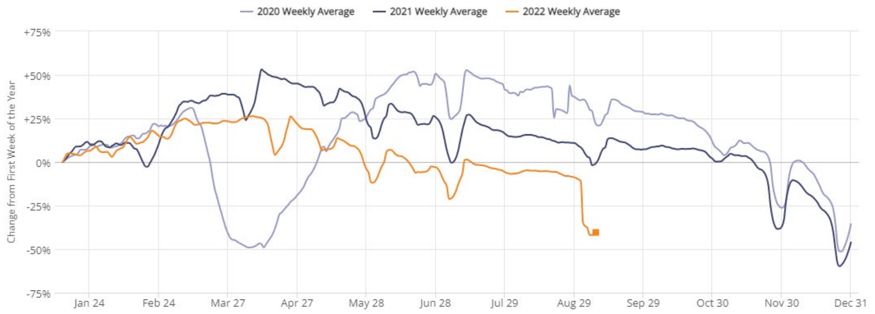
Zillow's rent gauge, which is a leading indicator, has already rolled over

RENT GROWTH – YEAR OVER YEAR PERCENT CHANGE
ZILLOW RENT INDEX, WHICH LEADS IS SHOWING WEAKNESS

Source: Zillow, Mortgage Bankers Association

7-DAY MOVING AVERAGE OF WEEKLY SHOWINGS
SHOWINGS DROPPING OFF AT SAME PACE AS MARCH 2020



Source: ShowingTime

Some historical perspective on asset class returns, with some interesting take-aways

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- Some historical perspective, since 1976 (the beginning of the Bloomberg Agg Bond Index, 46 years of history):

	Bloomberg Agg Bond Index	CPI	Bloomberg Commodity Index	S&P500 Index	Bloomberg Treasury Index
Number of Up Years	41	46	28	35	40
Number of Down Years	5	0	18	11	6
Average Year	6.71%	3.68%	2.69%	9.47%	6.54%
Average Up Year	7.99%	3.68%	12.47%	16.34%	8.15%
Average Down Year	-3.77%	N/A	-14.69%	-12.36%	4.22%
Best Year	32.62%	13.30%	56.25%	34.11%	27.84%
Worst Year	-11.56%	0.10%	-36.61%	-38.49%	-10.74%
Average when CPI above 2.0%	7.11%	4.60%	7.88%	9.46%	6.75%
Average when CPI below 2.0%	5.70%	1.35%	-10.49%	9.51%	5.99%
YTD (through 9/9/22)	**-11.56%**	**8.30%**	**19.51%**	**-14.66%**	**-10.74%**

Source: Bloomberg

- Things to consider:
  - The Fed's stated target for inflation is 2.0%. Since 1976, year over year CPI measured monthly, has been above the stated target 73% of the time. This leads to the questions, why 2.0% and is it realistic?
  - The total return of the Aggregate Bond Index and Treasury Index over the time are less than 20 bps apart, suggesting that there is little compensation for taking credit risk and nearly all the return is driven by rates. Will this hold?
  - The top 20 years of highest CPI had average S&P500 returns of 7.53% (compared to 9.47% for the entire period), with negative performance 25% of the time, suggesting investors should prepare for lower than average returns and higher than average volatility.

Commodity performance the last 3 months is the inverse of 2022

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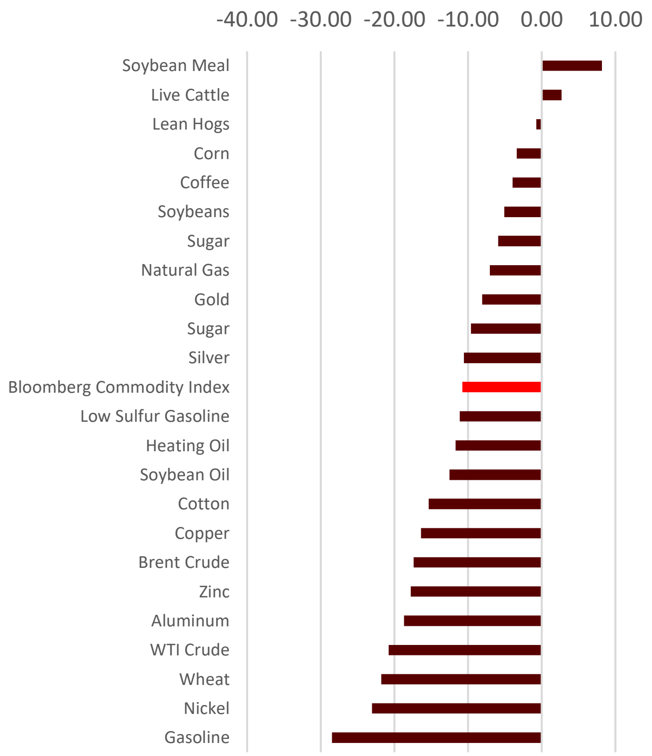
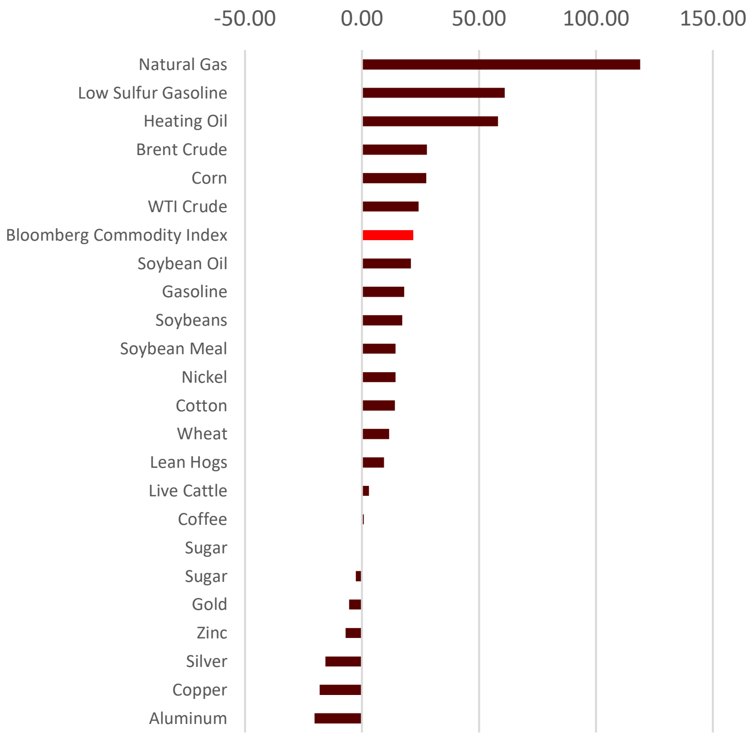
BLOOMBERG COMMODITY INDEX CONSTITUENTS LAST 3 MONTHS, 92% OF CONSTITUENTS ARE DOWN



Source: Bloomberg

BLOOMBERG COMMODITY INDEX CONSTITUENTS YEAR TO DATE, 71% OF CONSTITUENTS ARE UP



Source: Bloomberg

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FAQ: What are the key variables to watch that may signal a Fed pivot is imminent?

- The Fed's communication has been very clear. Their **number one concern is the de-mooring of inflation expectations**.

- It's not just the movement of inflation towards 2.0%, but more importantly, it's inflation expectations that matter because the Fed's view is that if inflation expectations become entrenched, consumers and business begin factoring their expectations for higher inflation into decisions, at which point inflation becomes self-reenforcing and it becomes **very** challenging to bring inflation down.

- It's the Fed's belief that raising rates quickly to restrictive levels and holding them there will build confidence in their resolve and keep inflation expectations moored to near 2.0%, giving them time to have the sticker components of inflation come back into reasonable levels.

- The biggest risk is if long-term inflation expectations move higher because it will force the Fed to step harder the brake pedal to cool expectations. This is a dangerous set up because it could put the Fed in a position to be overly restrictive against otherwise falling signals of inflation.

- When and what to watch remain a moving target. I like to refer to the situation as the ultimate game theory problem. Markets are trying to forecast the Fed's path as the Fed is changing the variables that are important to them and unsure of their exact timing. Forecasting the Fed's moves in this environment is likely a fool's errand. I believe it's better to focus on the data and implications for the markets and economy.

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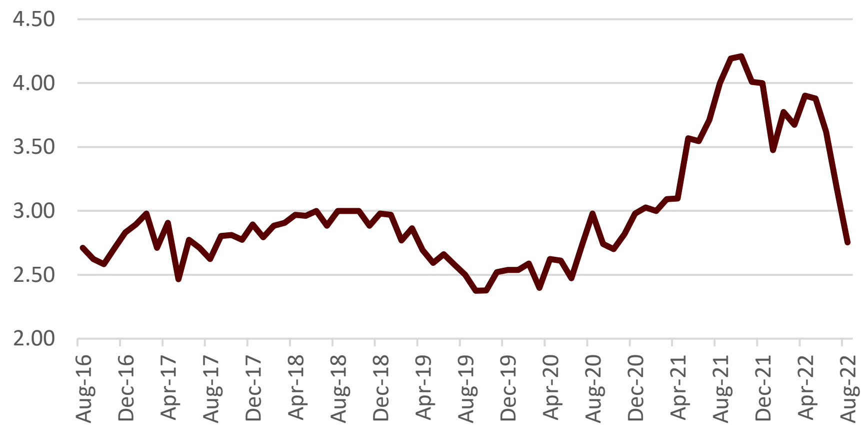
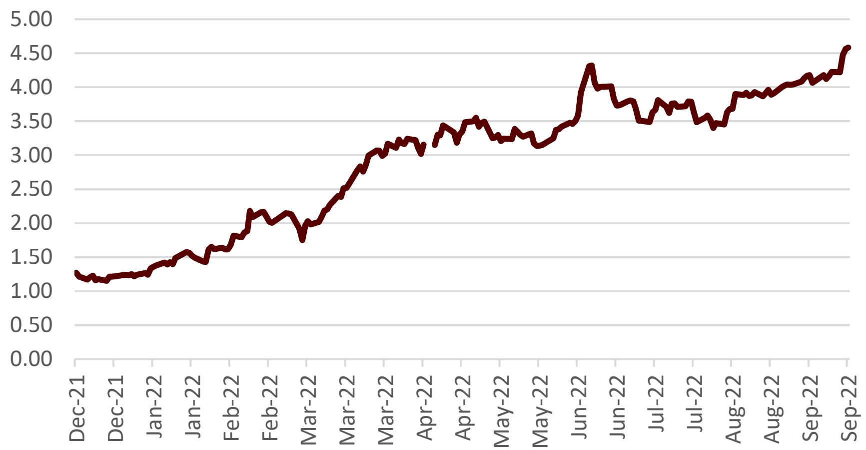
The Fed is getting what it wants – reduced inflation expectations founded in rate hike confidence

FEDERAL RESERVE BANK OF NEW YOUR MEDIAN 3 YEAR AHEAD INFLATION EXPECTATIONS – REMAIN MOORED



Source: Federal Reserve

EURODOLLAR FUTURES MARCH 23 INTEREST RATE EXPECTATIONS HAVE CLIMBED TO NEW HIGH



Source: Bloomberg

Putting it all together

- Many of the factors that have been driving inflation are subsiding:
    - Monetary policy has turned hawkish
    - Fiscal support had dropped off
    - Money supply growth is falling
    - Financial conditions have tightened significantly
    - Supply chains are healing with inventory building
    - Commodity prices are coming in at a rapid pace
    - Speculative corners of the market have corrected
- There are persistent structural changes that may make taming inflation quickly challenging:
    - The structure of the employment market has changed with persistent shortages in key areas of the labor force
    - Years of under building and increased interest rates combine to lower volume of homes available
- The largest costs for most businesses are Labor and Materials. Although Material costs will become less of an issue as commodity prices fall and supply chains heal, persistent labor shortages could keep the labor market tight. Additionally, services are still coming back online from the pandemic, which will increase demand and keep price pressures elevated.

- It's unlikely that inflation will drop quickly, which will mean that rates will need to remain high long enough to reduce demand sufficiently to lower inflationary pressures. As the Fed said, this comes with "pain" for many areas of the economy.

- Although market expectations for inflation and rates are aligned with the Fed's message, expectations for corporate earnings and jobs may not yet reflect this reality.

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Investment Cases

BULL CASE	***Soft-ish Landing*** This is the Fed's targeted goal. Rates move from the current neutral range (there is a hot debate of what *neutral* means when inflation is at almost 9%) to restrictive by yearend and then hold at there, with the economy growing below trend, until inflation works its way lower over the next year or so. In this scenario, the roughly 2:1, ratio of job openings to unemployed workers is reduced back to 1:1, with only a mild increase in unemployment, while the economy chugs along in low gear. This has been affectionately called "fantasyland".
BASE CASE	***Persistent Inflation and Shallow Growth*** Rates move from neutral to restrictive, but inflation remains persistently high (not in the 8% to 9% range, but perhaps something more like the 4% to 5% range), driven by falling Goods prices, stymied by sticky Services and Energy costs, making it difficult for the Fed to do anything but pause and leaving the economy wallowing in the doldrums (an area with no wind in the sails, languishing in the hot sun on a desolate sea) and flirting with recession. This is similar to a Soft-ish landing but with higher inflation, lower growth and extends out over a longer period, and can best be characterized as stagflation.
BEAR CASE	***Hard Landing*** The three-leg stool (Earnings, Jobs, Balance Sheets) crumbles under central bank pressure. ***Earnings*** fall 20% to 30% (in-line with typically recessionary earnings reductions) based on falling demand and higher costs. ***The Job Market*** deteriorates faster than the Fed expects. The consumer can no longer live off their ***Balance Sheet***, propped up by pandemic government handout money and cheap debt, because they are both gone, except for the wealthy, who are immune from inflationary pressures, leading to increased wealth disparity and greater social unrest, further polarizing the political environment. A potential controlled burn in the housing market threatens to turn into a raging inferno. The good news is inflation comes down relatively quickly because the economy is so weak, providing the Fed with flexibility.

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Long-term Thematic Views

- Fractured World Order
  - Russia's invasion of the Ukraine put an exclamation mark on the East (Communist) vs. West (Capitalist) divide that has been growing for decades.
  - Russia's economy is dominated by energy exports. China's economy is dominated by manufacturing exports. With signs of the world moving to alternative energy and China's initiatives switching to domestic growth as labor cost differentials are reduced with the West, both countries feel an urgency to reduce their multi-decade stances of placating the West and pushing aside ideological differences while they still have leverage.
- Reducing Over Dependency
  - Europe foolishly allowed their economy to become dependent on cheap Russian energy and is now being held hostage by Putin, who has borrowed tactics from Hitler, wanting Europe to turn a blind eye to the Ukraine, the way Hitler tried to hold it over Europe during the early days of the Holocaust by threating to exterminate all European Jews if Europe acted to save German Jews. Unlike Hitler, Putin's threats will lead to increased European resolve to free themselves of Russia's energy.
  - The United States, is now taking a hard look at their own dependencies and rightfully concerned. Although energy doesn't represent the same risk for the U.S. as for Europe, the U.S. has become addicted to cheap Chinese goods and the Taiwanese semiconductor market. It's no coincidence that the U.S. just passed the $52.7b CHIPS and Science Act designed to re-shore the semiconductor industry.
- Scarcity
  - The Inflation Reduction Act was hallmark legislation partially designed to propel the alternative energy industry forward at a radical new rate.
  - The problem with the Bill is that it highlights Scarcity. It's incentivizing building solar arrays that are manufactured in China with metals that are mined Africa controlled by countries potentially hostile to the U.S.
  - Similarly, it's incentivizing and providing tax credits for EV vehicles where production still needs to be on-shored to get the tax credits and are built from materials mined in other countries.
  - People are another Scarcity. The combination of baby boomers aging out of the work force, fewer immigrants and changing lifestyle choices after the pandemic will lead to chronic shortage of workers while GDP continues to expand.

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