Weekly Investment Insights

June 6, 2022

Key Takeaways:

- Home prices rise at fastest pace on record.
- Consumer confidence falls narrowly.
- The U.S. economy added 390k jobs in May.
- U.S. equities falter; Asian equities rally.
- Global yields higher on inflation concerns.
- Crude oil shrugs off OPEC+ increased production.

Weekly Economic Recap –

Home Prices Surge; Labor Market Strong

The S&P Case-Shiller Home Price Index showed home prices jumped 21% YoY, a new record high. The gains in March were led by Dallas, Tampa, and Seattle. Chicago and Boston saw the lowest gains.

Consumer confidence as measured by the Conference Board showed confidence fell in May. Confidence was weak in both categories (i.e., confidence of current situation and expectations for the future).

The ISM Manufacturing Index rose in May led by growth in customer inventories and a rise in delivery times (takes longer for deliveries). While employment and prices paid led the weakness, the backlog of orders also fell.

The U.S. economy added 390k jobs in May (328k estimated) and the unemployment rate remained steady at 3.6%. The labor force participation rate rose after its surprising decline last month. There were solid gains in leisure/hospitality, business services, goods producing and the education sector. Wages rose less than expected for the month but the year over year growth rate remains elevated.

The ISM Services Index declined in May but remains solidly in expansion territory. A significant drop in the backlog of orders and supplier delivery times led the weakness. In addition, prices paid fell to an eight-month low. New orders and employment were the main components to rise.

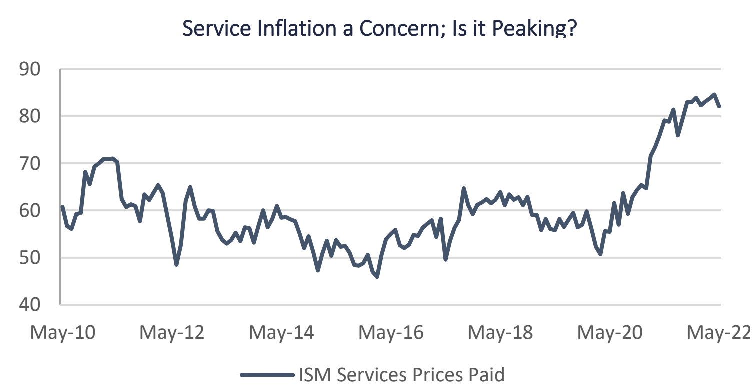
Weekly Market Recap –

All Major Asset Classes Fall

Equities: The MSCI AC World Index fell for the eighth time in the past nine weeks on fears of an aggressive Fed in the U.S. and mixed economic data. All the major equity regions declined except the emerging markets. The emerging markets were boosted by strength in Asian equities as China loosed COVID restrictions. The U.S. and the UK were the weakest developed markets. Within the U.S. all the major indices declined but growth modestly outperformed value (at the large cap level) for the second consecutive week. In addition, small cap stocks fell less than large cap stocks on fears that a strong dollar will weigh more on large cap earnings.

Fixed Income: The Bloomberg Barclays Aggregate Index fell for the first time in four weeks as bond yields climbed on inflation concerns. The only major fixed income sector to rally was municipal bonds. Treasuries took the largest hit of the fixed income sectors.

Commodities/FX: The Bloomberg Commodity Index fell slightly for the week led by weakness in agricultural commodities and gold. Crude oil rallied despite OPEC+ announcing plans to significantly increase output. Agricultural commodities, specifically wheat, has been under pressure as supply has been better than anticipated from Ukraine.



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Key Takeaways:

- Balance sheet runoff set to begin.
- Runoff and rising interest rates has only been seen once in history.
- What will the balance sheet look like at the end of the year?
- It may be time to gear up for more volatility.
- Interest rate sensitive investments should see further downside.

Let the Runoff Begin

The Federal Reserve is beginning their planned balance sheet runoff this week to combat inflation running at multi-decade highs. The Fed is also undertaking one of the most aggressive rate hiking cycles in decades. In October 2017, the Federal Reserve was in a similar situation in which they began letting the balance sheet runoff and were raising the Fed Funds rate. That was the only other time in history that such a tightening cycle was completed. Balance sheet runoff is another monetary tightening tool available to the Federal Reserve. Essentially, they will not reinvest proceeds from securities on their balance sheet as they mature, thus reducing liquidity in the financial system. In this weekly, we look at the last time they reduced their balance sheet and raised rates to get a gauge of what may be in store for the economy and the markets.

- **Schedule of Balance Sheet Reduction:**

  First three-months: $30 billion cap on Treasury runoff/$17.5 billion cap on Agency debt

  Thereafter: $60 billion cap on Treasury runoff/$35 billion cap on Agency debt

The Federal Reserve's balance sheet as of June 1 had ~$8.9 trillion worth of assets on it (not just securities are on the balance sheet), roughly double the size in 2017 ($4.5 trillion). Treasuries account for ~70% of the securities held. Agency and mortgage-backed securities account for ~30%.

The first month of runoff, will look slightly different as there are four Treasury securities set to runoff totaling $48.25 billion, forcing the Fed to reinvest $18.25 billion so they do not exceed the monthly cap.[1]

- **Impact on Balance Sheet:** If the Fed stays true to their plan, they will remove ~$552 billion by year-end, and another ~1.1 trillion by 2023 year-end.[1] If economic conditions warrant the runoff to continue down this path, the securities on their balance sheet would shrink below $7 trillion by year end 2023. According to Wells Fargo, that is equivalent to raising the benchmark rate by ~1%.[1]
- **How did the Market React in 2017:** The S&P 500 rallied in the months after the runoff began in 2017. However, concerns over tighter monetary policy and the economy led to a correction to start 2018 (-10%) and a near bear market to end 2018 (-19.6%). Valuations also contracted due to the tighter policy. The trailing PE of the S&P 500 fell more than 20% from October 2017 to the end of 2018 (from 22x to 17x).
- **Did it Help Inflation?** In 2017, it took nine months from when the Fed started their balance sheet run off for inflation to peak (albeit the peak was 2.9% compared to CPI at 8.3% now). However, tighter policy and higher bond yields (10-year Treasury yield rose 90 bps from Oct. to Dec. 2018) slowed economic growth substantially (from 3.8% QoQ in 4Q17 to 0.9% in 4Q18).

The Bottom Line:

While we can look at 2017 to get some idea of what is ahead, we also must acknowledge that the balance sheet and inflation are demonstrably larger than in 2017. As a result, the Fed will need to be more aggressive to achieve their goals. This is likely going to keep equities volatile throughout this year and bond yields should continue to rise, especially once the runoff gains speed. This puts interest rate sensitive equities (e.g., tech) at risk of further downside. Remain defensive in fixed income (short duration bonds).

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Global Equities Fall on Fed Fears

U.S. Equities	Current	1WK	1MO	3MO	1YR	YTD
Dow Jones Industrial Average	32,900	-0.8%	-0.3%	-2.1%	-3.0%	-8.6%
S&P 500	4,109	-1.2%	-1.4%	-5.5%	-0.6%	-13.2%
Russell 1000 Growth	2,385	-0.9%	-3.9%	-10.0%	-5.6%	-22.1%
Russell 1000 Value	1,559	-1.4%	0.5%	-2.0%	0.0%	-5.0%
Russell Midcap	2,875	-1.2%	-1.2%	-4.8%	-6.6%	-12.9%
Russell 2000	1,883	-0.2%	-0.7%	-7.0%	-16.5%	-15.7%
Nasdaq	12,013	-1.0%	-4.2%	-11.1%	-11.1%	-22.9%

International Equities	Current	1WK	1MO	3MO	1YR	YTD
MSCI AC World (USD)	649	-0.5%	-0.8%	-5.4%	-7.3%	-13.3%
MSCI EAFE (USD)	2,029	-0.3%	1.1%	-2.4%	-11.1%	-11.7%
MSCI Europe ex UK (USD)	2,186	-0.5%	1.3%	-1.1%	-13.8%	-15.6%
MSCI Japan (USD)	3,281	-0.3%	1.4%	-7.8%	-14.8%	-14.0%
MSCI UK (USD)	1,132	-1.2%	0.3%	-0.2%	1.0%	-1.7%
MSCI EM (USD)	1,061	1.8%	-0.5%	-8.8%	-21.5%	-13.1%
MSCI Asia ex Japan (USD)	678	2.1%	-0.5%	-8.0%	-22.7%	-13.6%

Fixed Income	Current Yield	1WK	1MO	3MO	1YR	YTD
U.S. Aggregate	3.5%	-0.9%	0.7%	-5.9%	-8.4%	-9.3%
U.S. Govt/Credit	3.4%	-0.9%	0.5%	-6.3%	-8.6%	-10.0%
U.S. 10 Year Treasury	2.9%	-1.6%	0.5%	-8.7%	-9.4%	-11.4%
U.S. TIPS (1-10YR)	3.1%	-0.2%	0.8%	-2.6%	0.7%	-2.7%
U.S. High Yield	7.2%	-0.3%	0.2%	-4.8%	-5.8%	-8.4%
EM Bonds (USD)	6.4%	-0.4%	0.3%	-5.8%	-13.7%	-13.4%
Municipal Bonds	2.9%	0.3%	1.9%	-4.2%	-6.7%	-7.3%

Commodities	Current	1WK	1MO	3MO	1YR	YTD
Bloomberg Commodity Index	286	-0.02%	4.1%	9.1%	43.9%	35.3%
Crude Oil (USD/bbl)	$119.1	3.3%	16.1%	10.4%	72.8%	54.4%
Gold ($/oz)	$1,851.2	-0.3%	-1.8%	-6.1%	-2.2%	1.1%
Copper	$447.2	3.0%	4.1%	-10.0%	-2.1%	-0.6%
Wheat	$1,040.0	-5.9%	-1.7%	-7.3%	55.2%	42.5%
U.S. Dollar	102	0.4%	-1.5%	3.5%	13.3%	6.7%
VIX Index	24.8	-3.6%	-15.2%	-18.7%	37.4%	44.0%

[1]: https://www.bankrate.com/banking/federal-reserve/how-shrinking-fed-balance-sheet-impacts-your-finances/

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