LOGIC INVESTMENTS

US Macro Pulse

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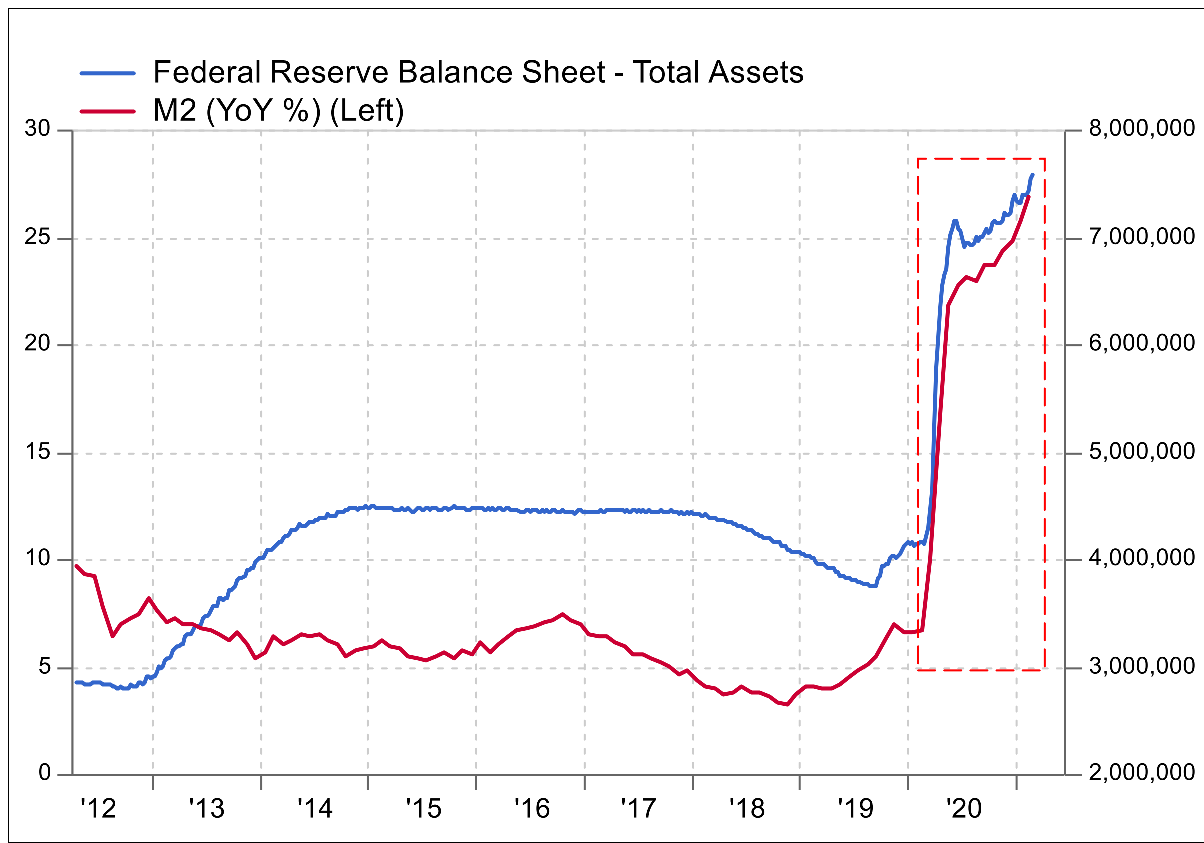

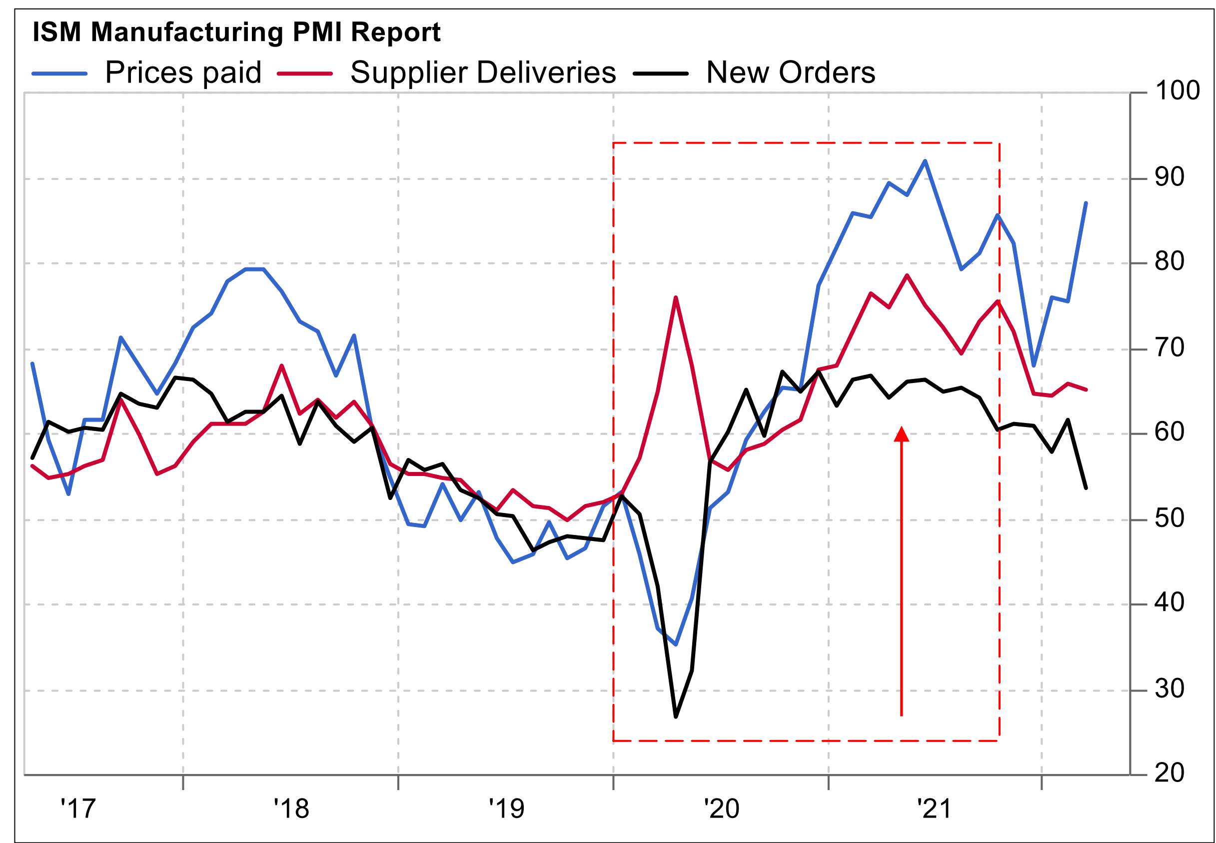

Fig 1. A recap: The deep economic downturn triggered by the pandemic forced the Federal Reserve to take unprecedented action. Ultra loose monetary policy and emergency lending facilities became the life support for the economy. Over $5 trillion worth of liquidity was pumped into the economy (M2 money supply growth) in the the form of stimulus cheques, unemployment benefits and business and agency support.

Fig 2. As economies reemerged from lockdown, businesses, anticipating a surge in demand from stimulus-rich consumers, were now competing to replenish inventories (new orders). Supply chain disruptions ensued, and order backlogs and supply bottlenecks intensified (rising supplier delivery times). This was further compounded by the increasing prices paid for inventories due to high input costs as a result of the scarce supply and high demand for raw materials.

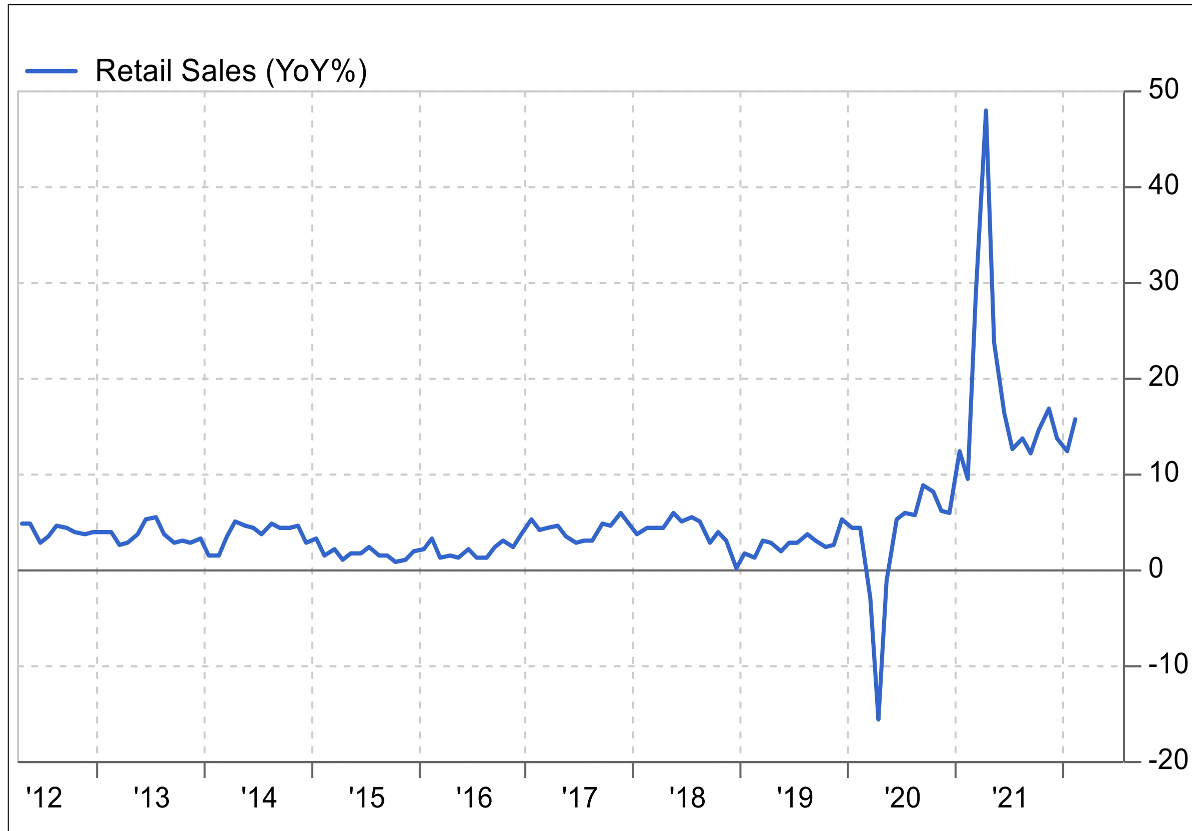

Fig 3. Pent-up demand unleashed a surge in buying activity, as the retail hordes hit the high street, placing more strain on the already congested supply chains.

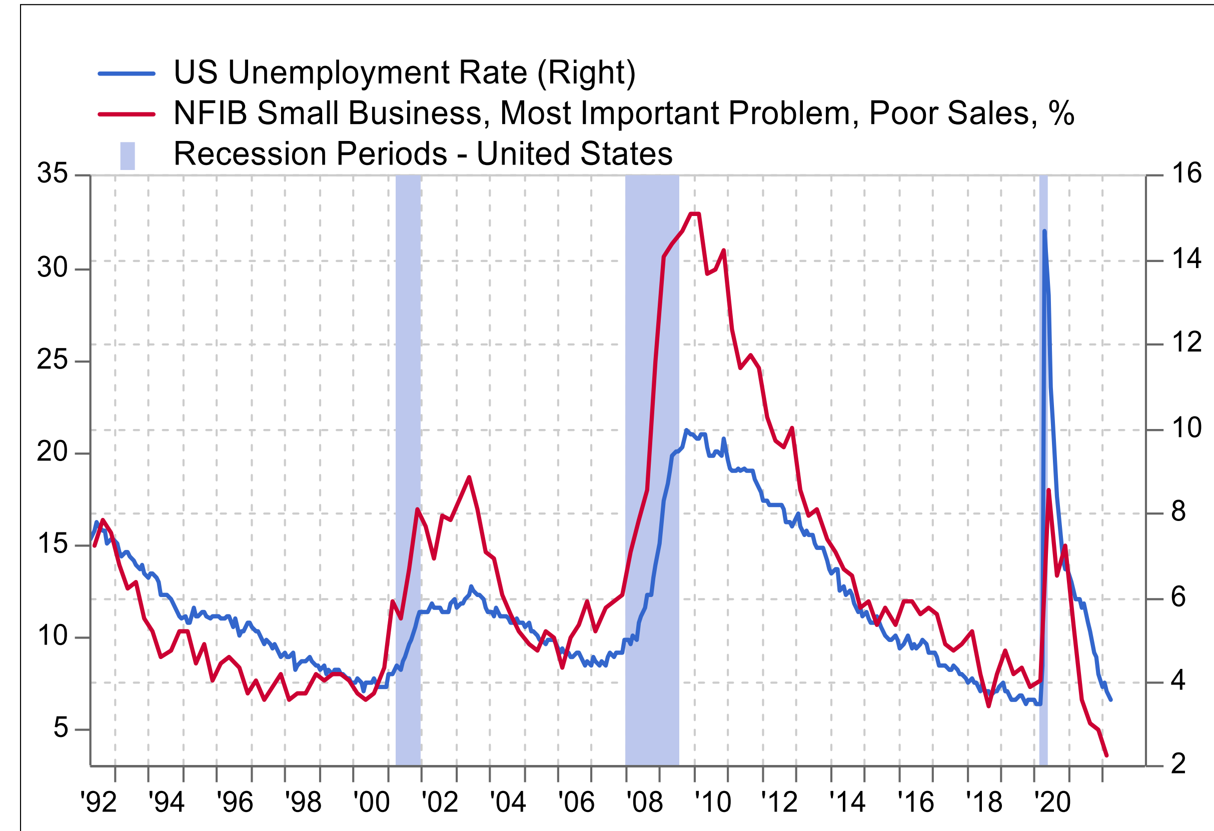

Fig 4. However, despite the recovery in employment and the strong sales reported from small businesses, the chart suggests late cycle positioning…

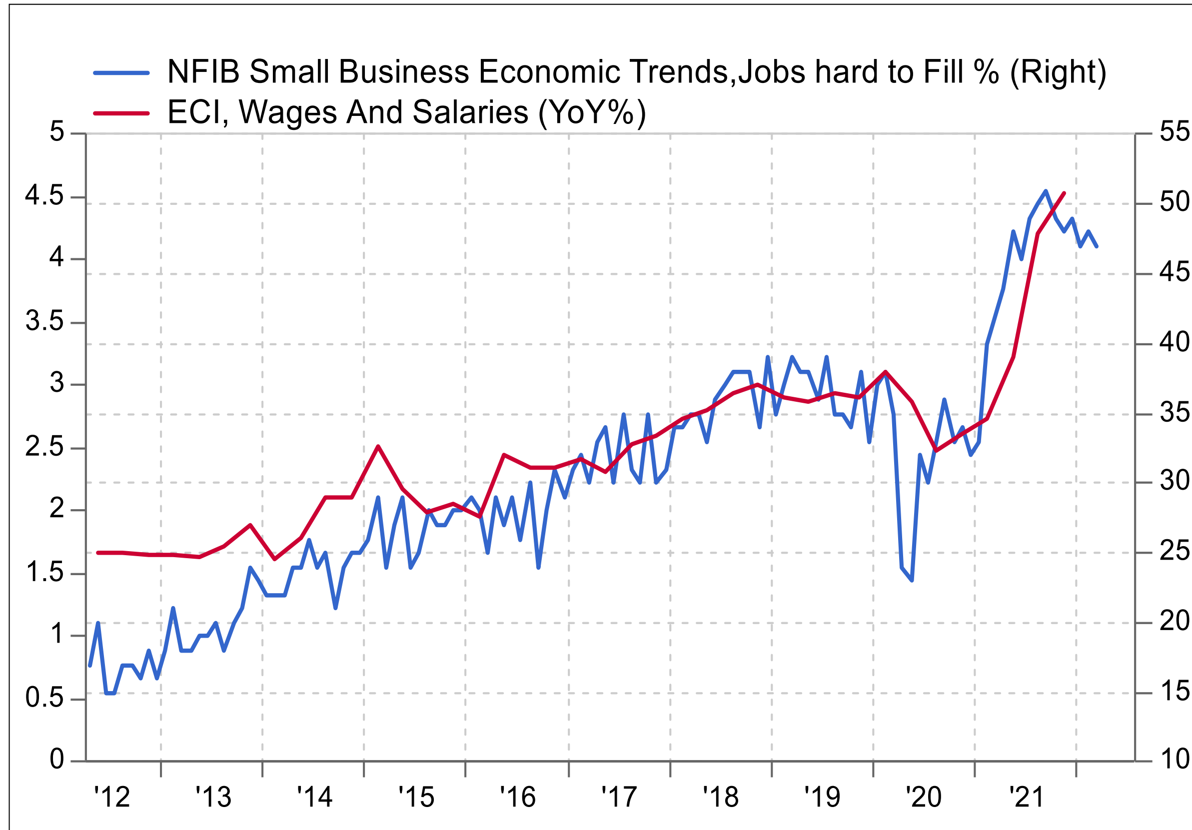

Fig 5. A 'late cycle' phase is characterised by rising inflation, peaking economic expansion and a tight labour market (labour shortage). Businesses are forced to increase wages, to either, attract labour or meet demands from employees to compensate for the increased cost of living. Rising labour costs may prompt businesses to hike prices to protect margins – 'wage-price spiral'. The chart above suggests that the balance of power between the labour force and employers is shifting. Faster wage increases could in store for 2022.

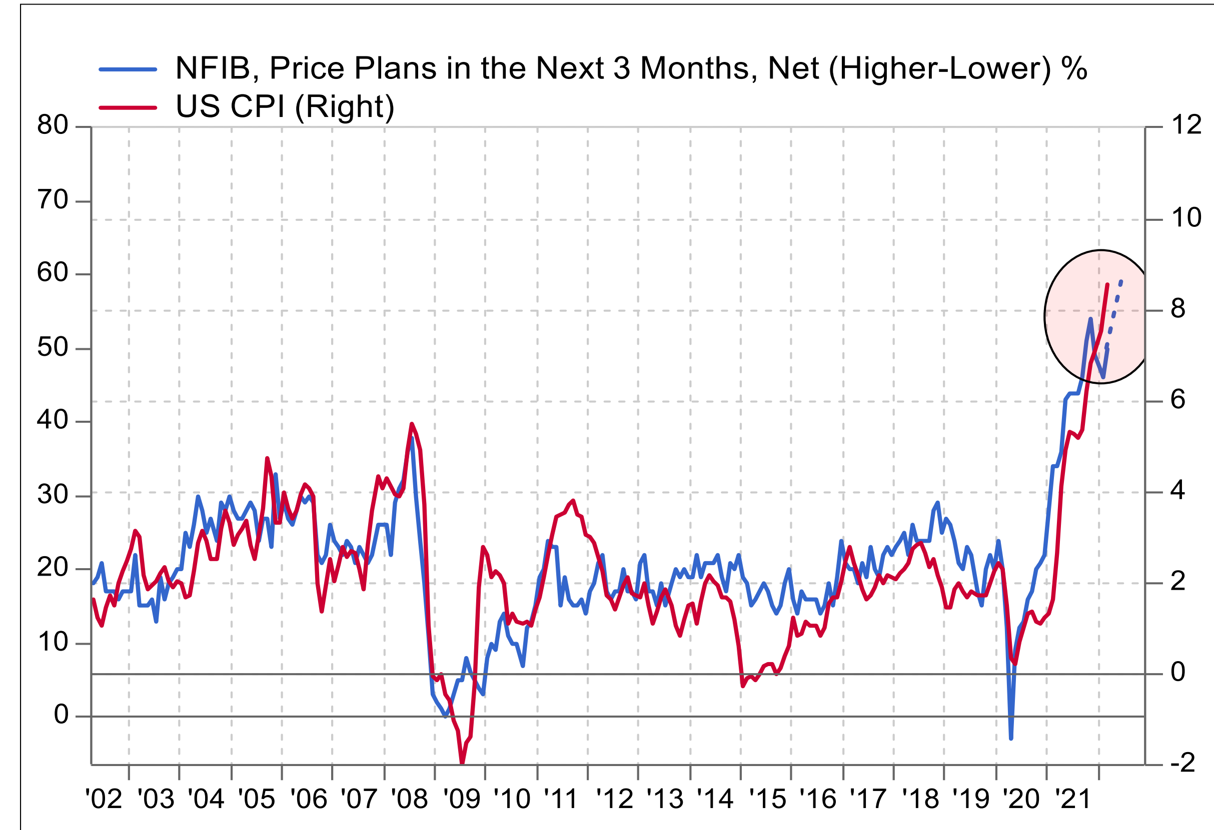

Fig 6. As inflation continues to trend higher, more companies will be forced to increase prices in the future to mitigate increasing margin erosion from higher wages and inputs costs.

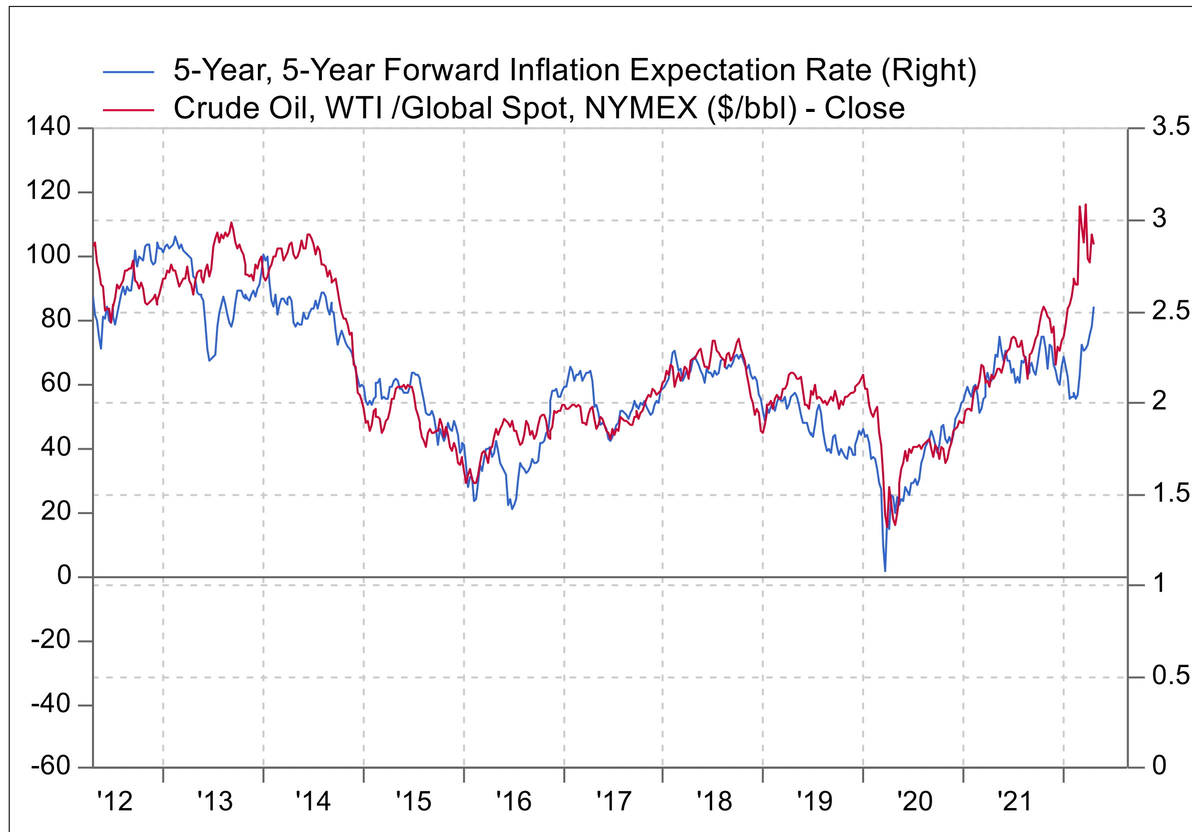

Fig 7. Just as supply chain pressures were beginning to ease, two recent developments have reignited inflationary pressures. Firstly, the Russian invasion of Ukraine and the proceeding sanctions, has pushed up the price of oil and agricultural commodities. Increasing energy and food costs will have a material impact on both profit margins and disposable income. Long-term inflation expectations could rise, suggesting a more persistent inflationary outlook.

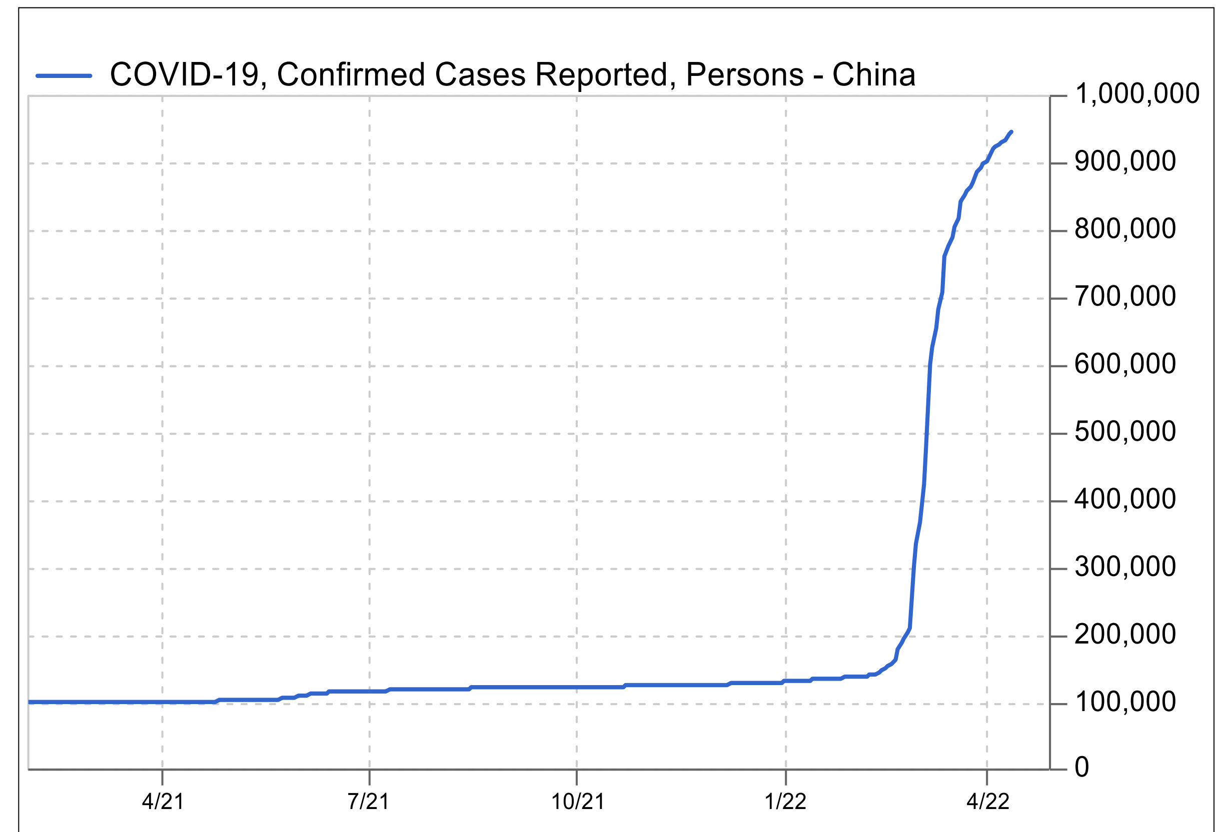

Fig 8. Secondly, China's draconian 'zero-covid' strategy in response to the recent outbreak, has forced the suspension of key manufacturing zones, adding more pressure to existing supply chain constraints. Supply shortages will increase inflation over the short-term. Further, China's response is motivating companies to consider shifting operations to other countries. This would be expensive and reduce supply chain efficiency. Costs would be passed onto the consumer.

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US Macro Pulse: CPI & Inflation Expectations

Fig 9. The highest inflation reading since 1982. Created by a perfect storm of excessive liquidity, geopolitical turmoil and supply chain disruptions.

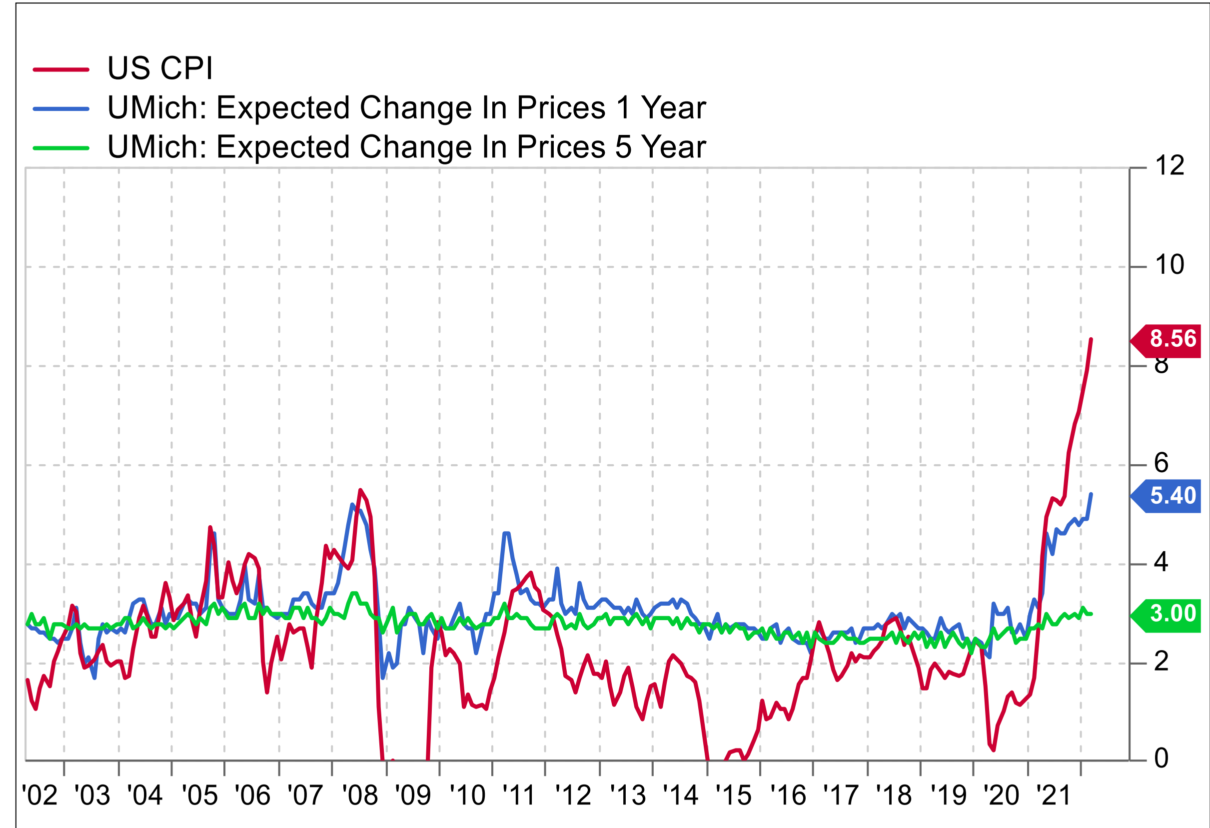


Fig 10. However, consumers are still confident that inflation will be temporary, with expected inflation falling to 5.40% next year. Inflation expectations have stabilized, and as the charts suggest in the proceeding slides, inflation expectations could dampen even further.

US Macro Pulse: Inflation & Yield Curve vs Fed Funds Rate

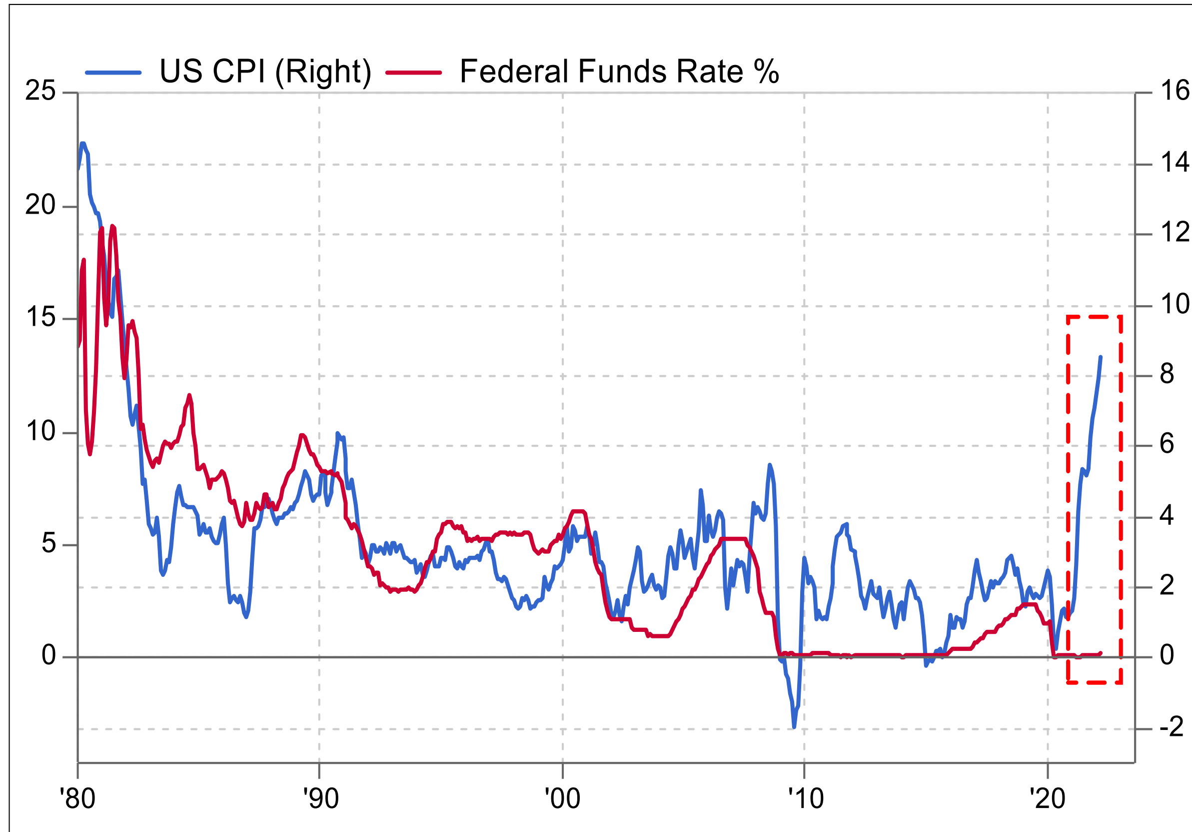


Fig 11. To combat inflation, the Federal Reserve has communicated that they will begin to raise interest rates (blue line), targeting between 2% - 2.25% by the end of 2022, and with the potential terminating rate expected to fall between 3.25% - 3.50% in 2023. The current divergence (see red box above) between inflation and interest rates suggest the Fed would have to raise rates to at least 5%, to make a meaningful impact on the current inflation rate.

The Fed's fear is that if inflation is left unchecked, it could spiral higher, forcing them to hike more aggressively in the future. This would place more pressure on the economy and could prompt a steep rise in unemployment.

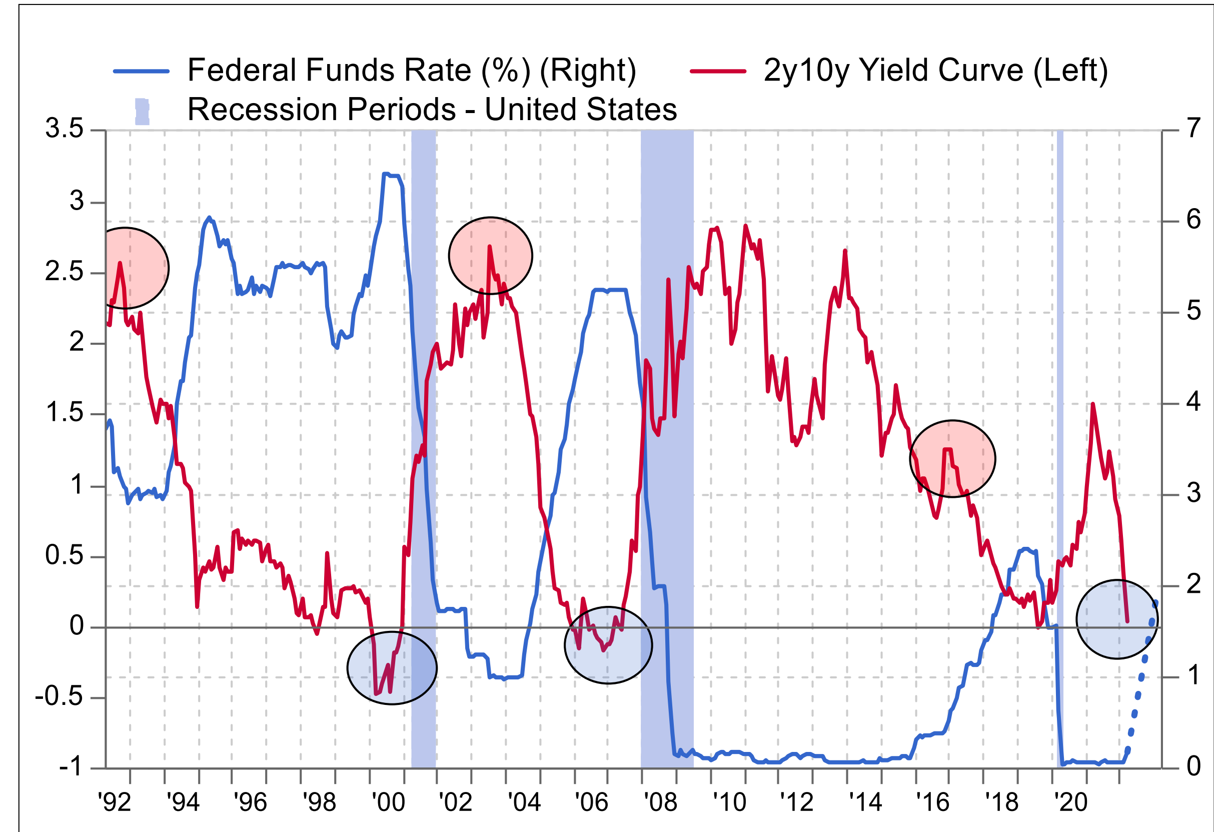


Fig 12. As the economy heats up, longer dated yields rise (due to selling pressure) to compensate for the loss of purchasing power of future cash flows due to inflation. When the yield curve is at its peak (red circles), the Fed initiates a rate hiking cycle to cool down the economy. This forces the yield curve to flatten and eventually invert – a signal that usually precedes a recession.

The Fed is looking to increase rates at a time when the yield curve is already close to inversion. Rates should have peaked by this stage, but the Fed is just getting started…

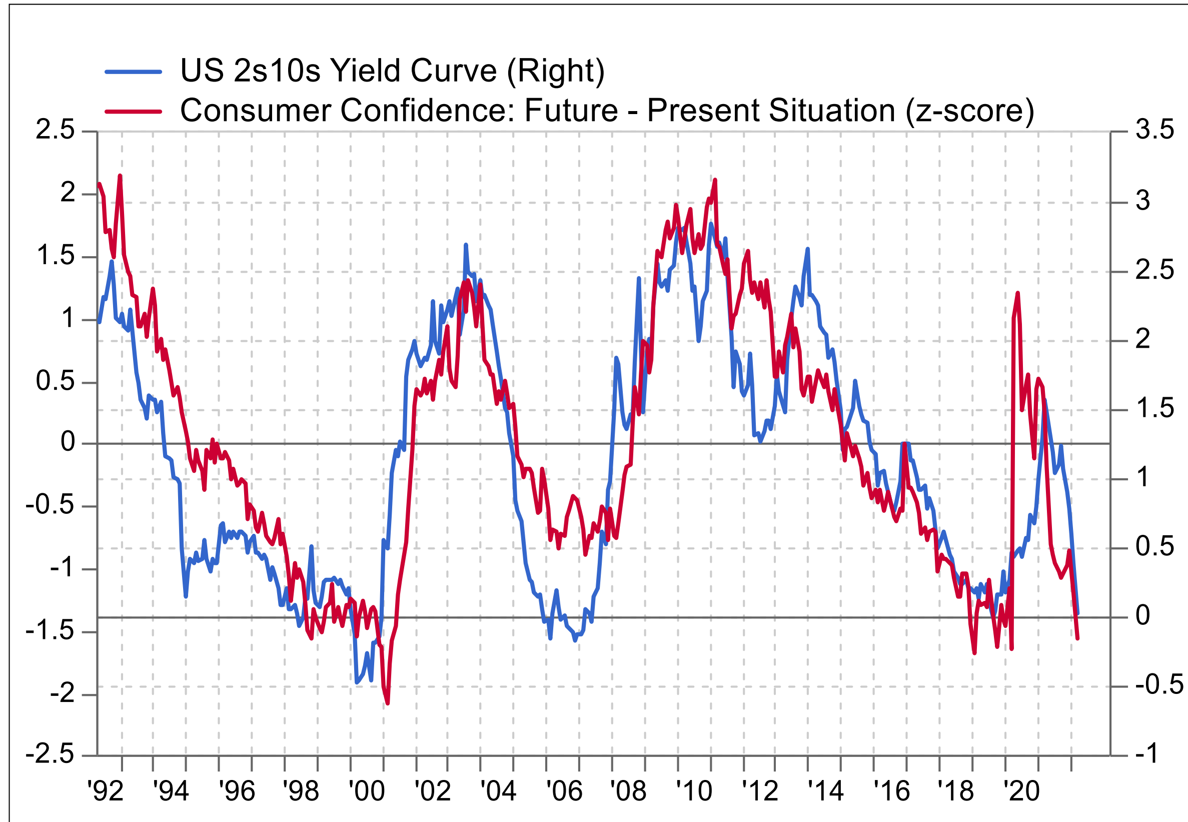


Fig 13. The chart above shows how in previous cycles, consumer confidence for the future, correlates perfectly with the yield curve. Economic expansion raises the consumer outlook for the future, relative to the present.

With high inflation and increased costs of living, consumers are beginning to feel the pinch and the outlook for the future has plummeted. Dark clouds are forming on the horizon. This low level of sentiment is usually associated with peak interest rates.

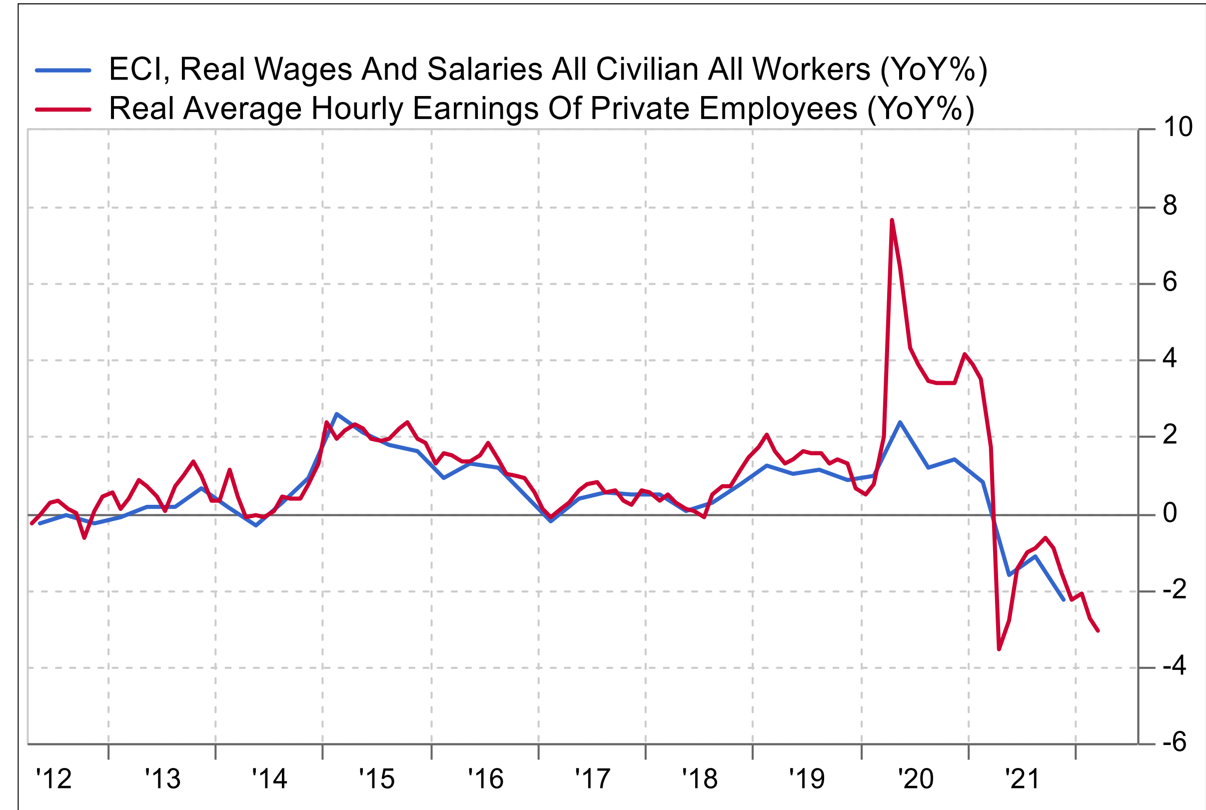


Fig 14. Here lies the problem. Inflation is rising faster than wages and consequently real income growth is negative. This means that the purchasing power of income is being eroded, placing more pressure on household finances.

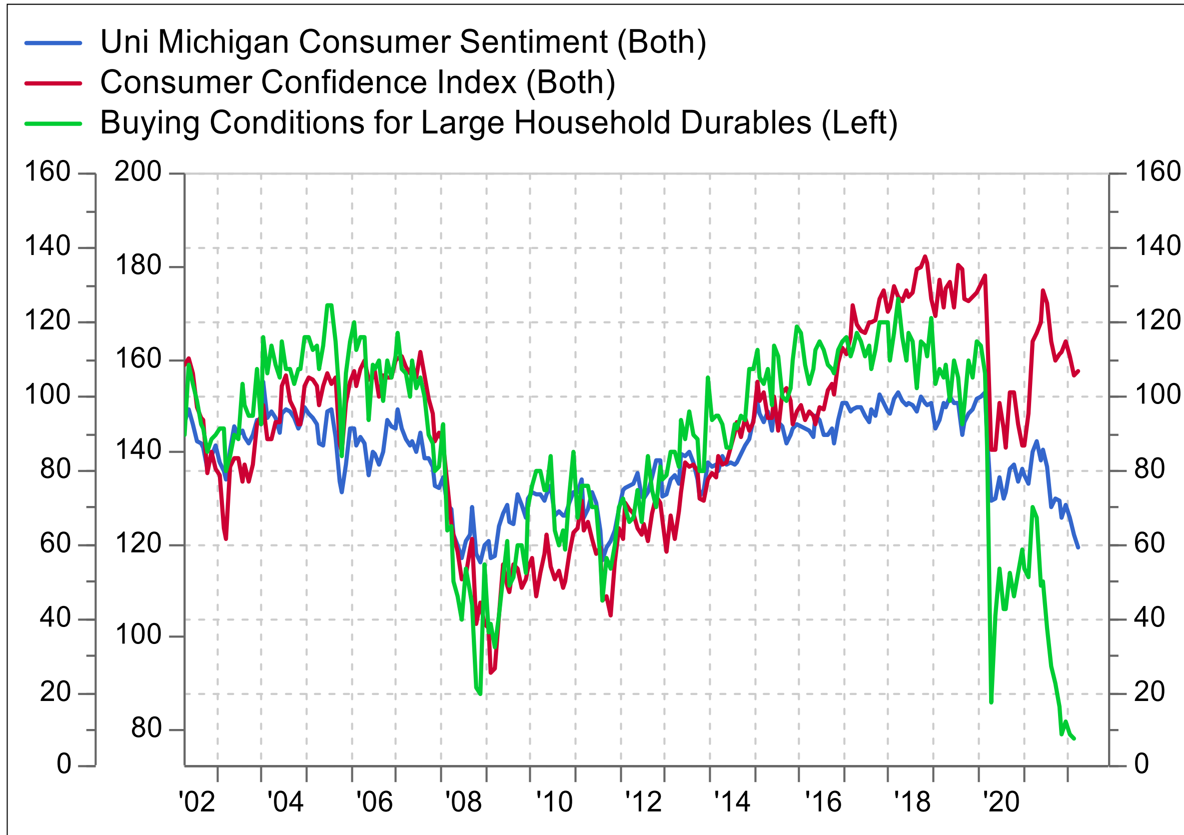


Fig 15. This fall in real income has led to a growing divergence between consumer confidence (employment and labour conditions) and consumer sentiment (personal financial situation).

Clearly, consumer confidence is lagging. This is due to the fact changes in labour markets tend to occur after financial conditions and real activity have turned.

Given the plunge in buying conditions for big ticket items, one would expect both consumer confidence and sentiment to play catch down.

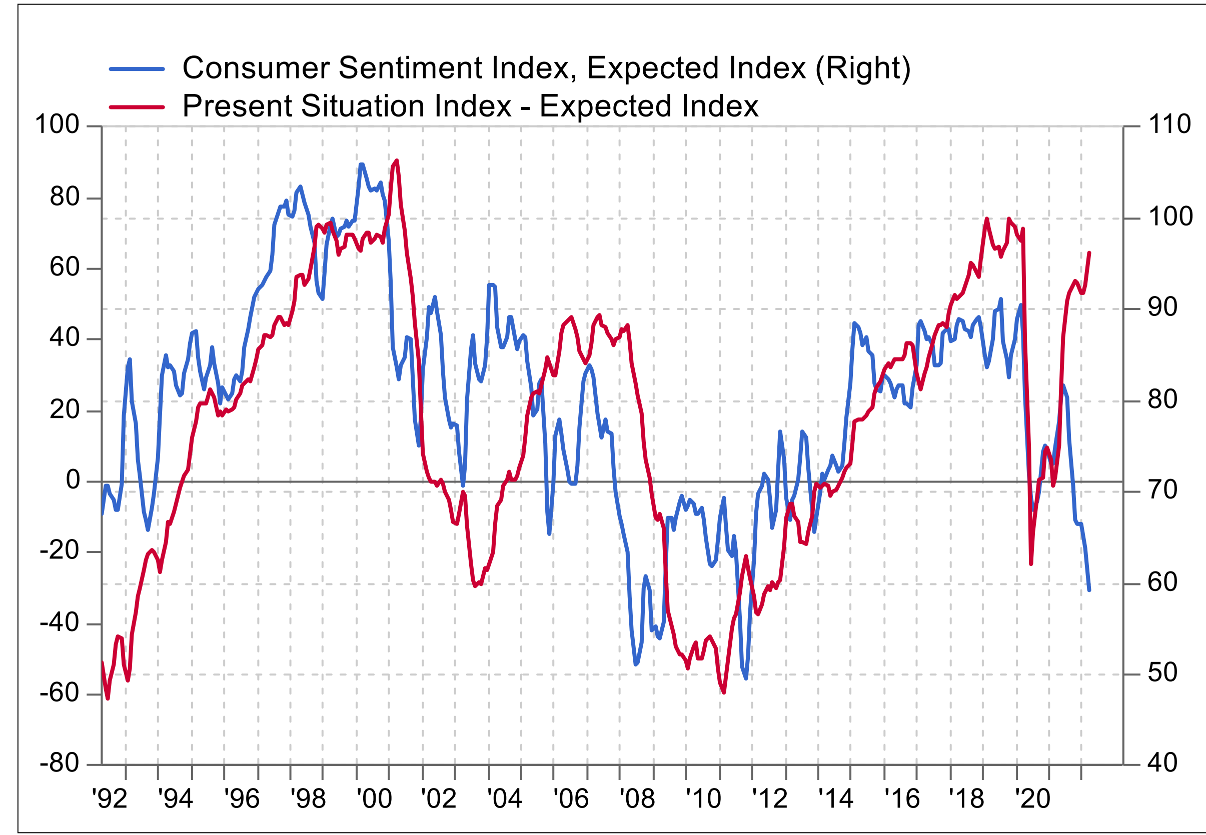


Fig 16. American hope is dramatically lagging their current exuberance. Consumer expectations for the future are plummeting, as rising energy and food costs reduce disposable income and increase uncertainty.

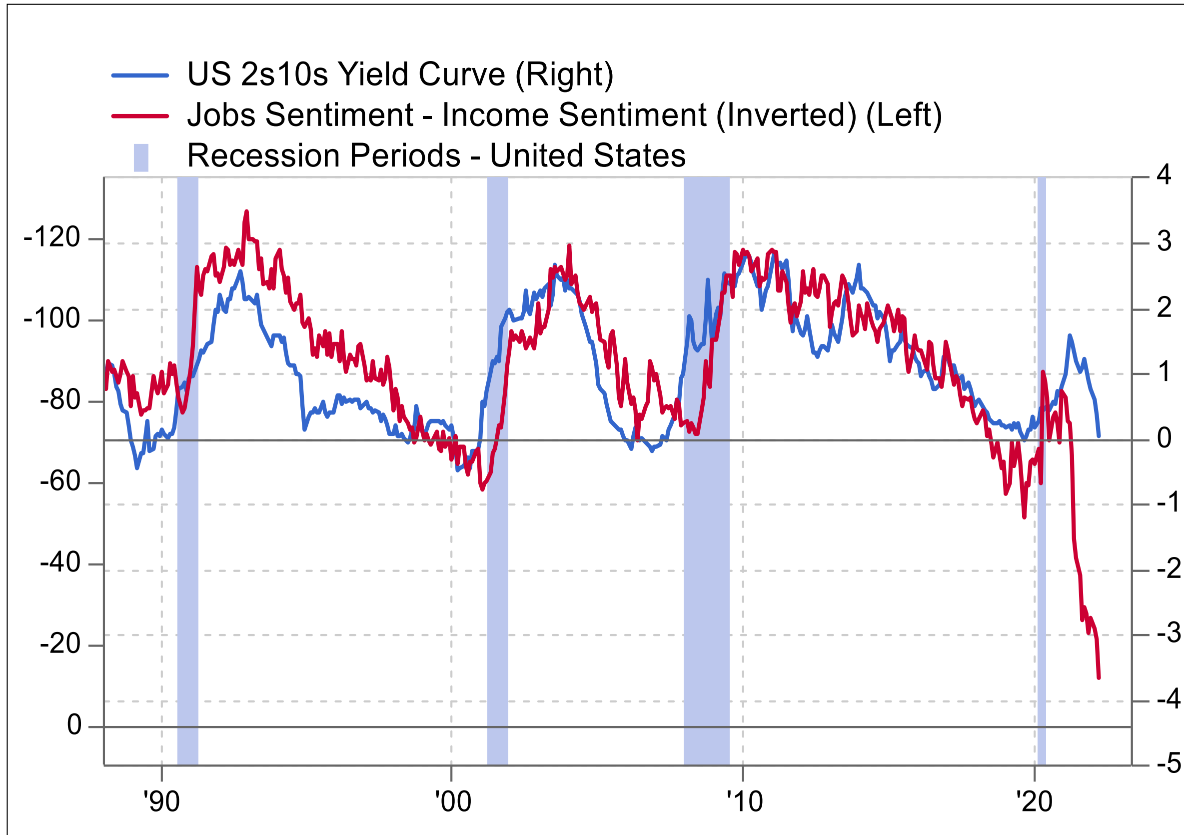


Fig 17. With income sentiment plummeting, the yield curve inversion could still fall even further. To recap:

- Inflation is rising due to a confluence of factors that include a tight labour market, Russian sanctions and reinstated lockdowns across China.
- Inflation is beginning to squeeze the consumer and the Federal Reserve has signaled that they will increase rates, gradually over the forthcoming quarters, to combat inflation.

But the problem is that Federal Reserve has committed itself to raise interest rates, just as the economy is beginning to slow down…

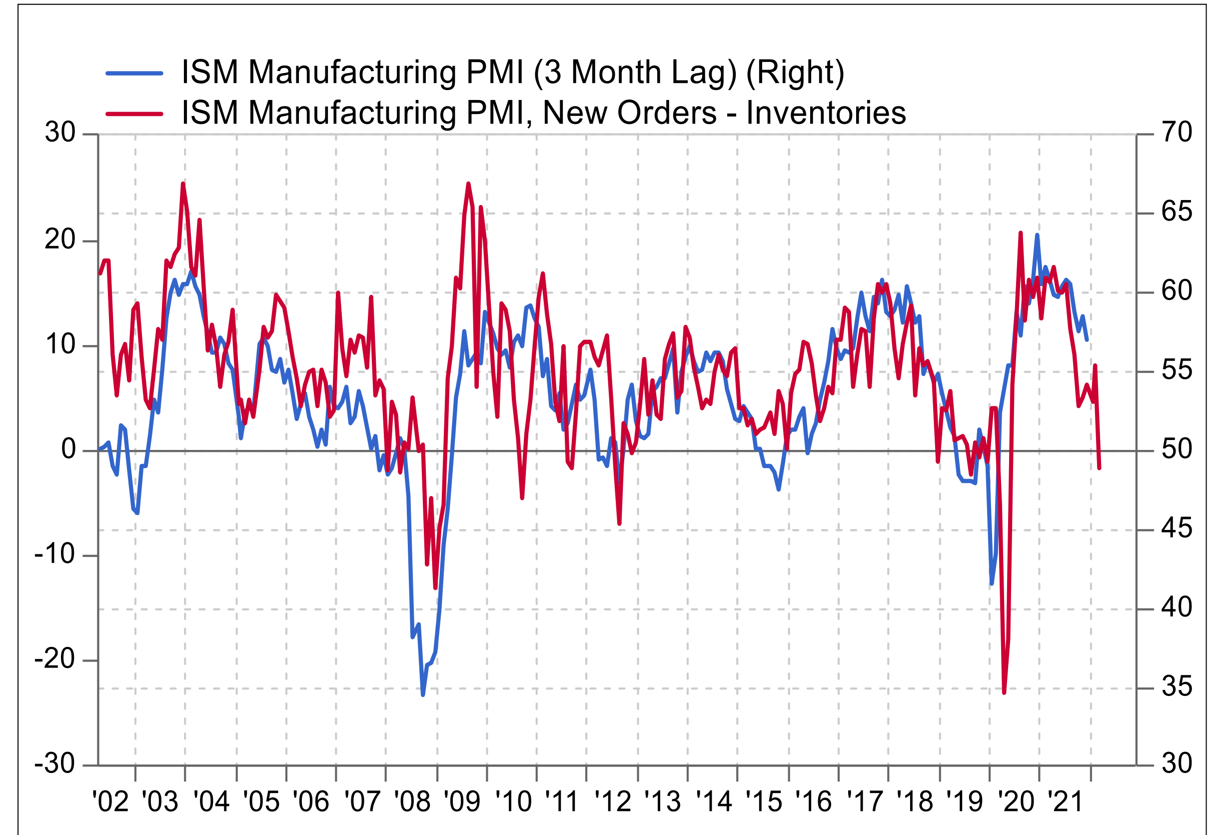


Fig 18. ISM manufacturing purchasing manufacturing index, is a monthly indicator of US economic activity. It measures changes in production levels from month to month.

New orders are beginning to slow down as inventory levels are restored, placing less demand on manufacturers. But it also indicative of a slow down, and judging by the contraction on new orders, ISM Manufacturing PMI will likely fall to 50.

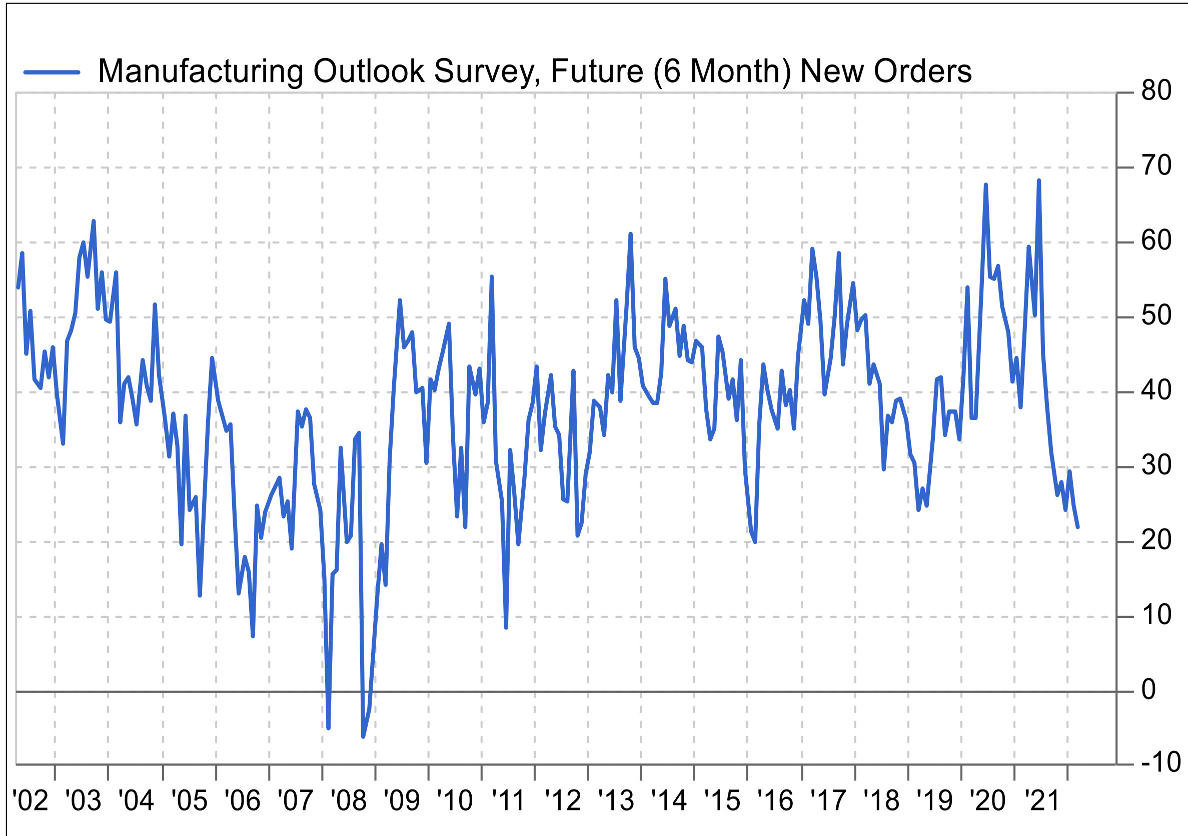


Fig 19. Another view of future new orders. This chart is indicating that economic growth will slow in the coming months.

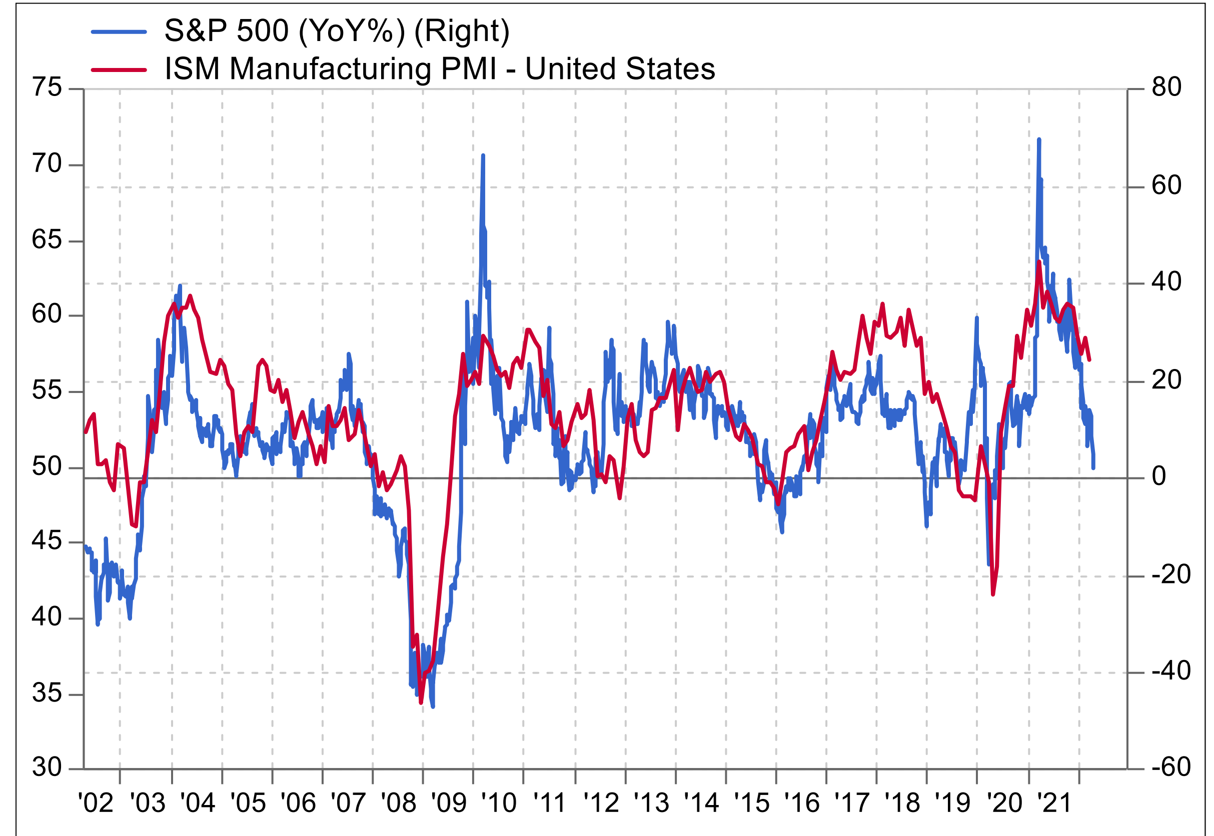
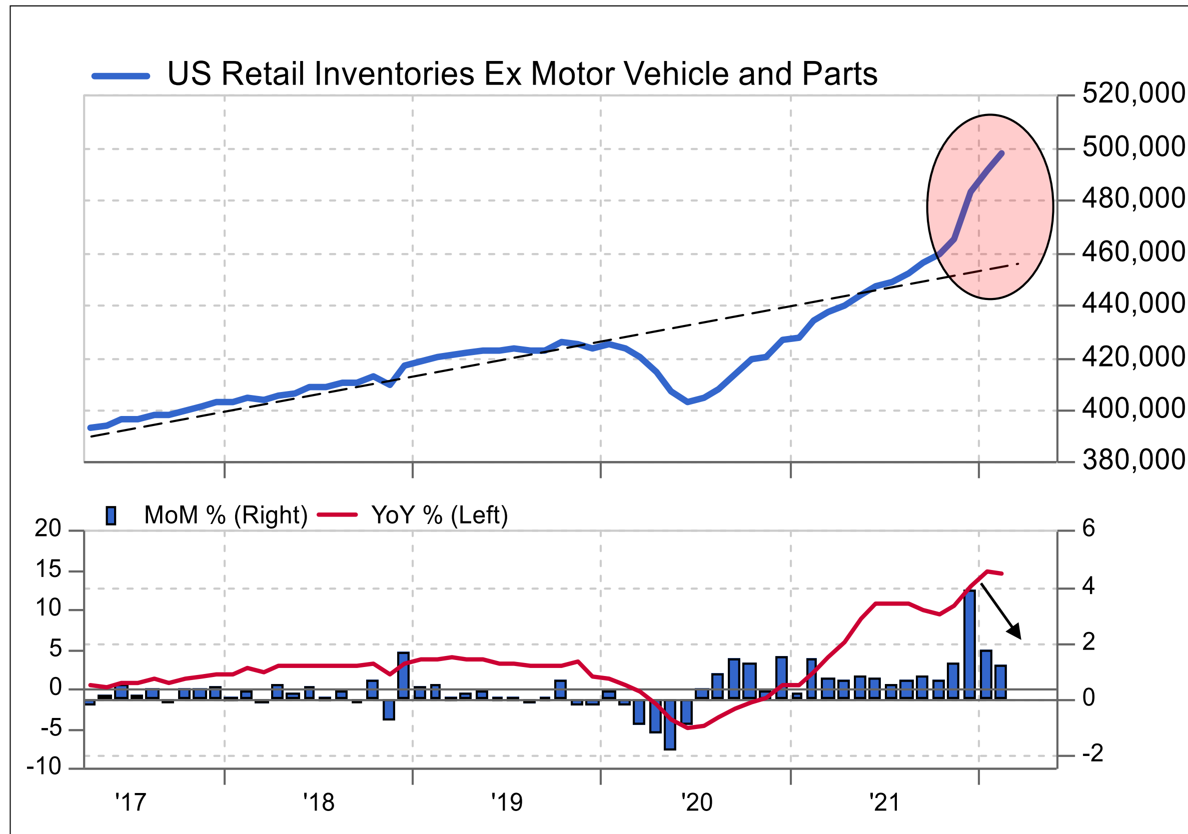


Fig 20. Comparing the S&P 500 to ISM, suggest that equity markets are pricing in a slowdown in manufacturing to the 50 level.



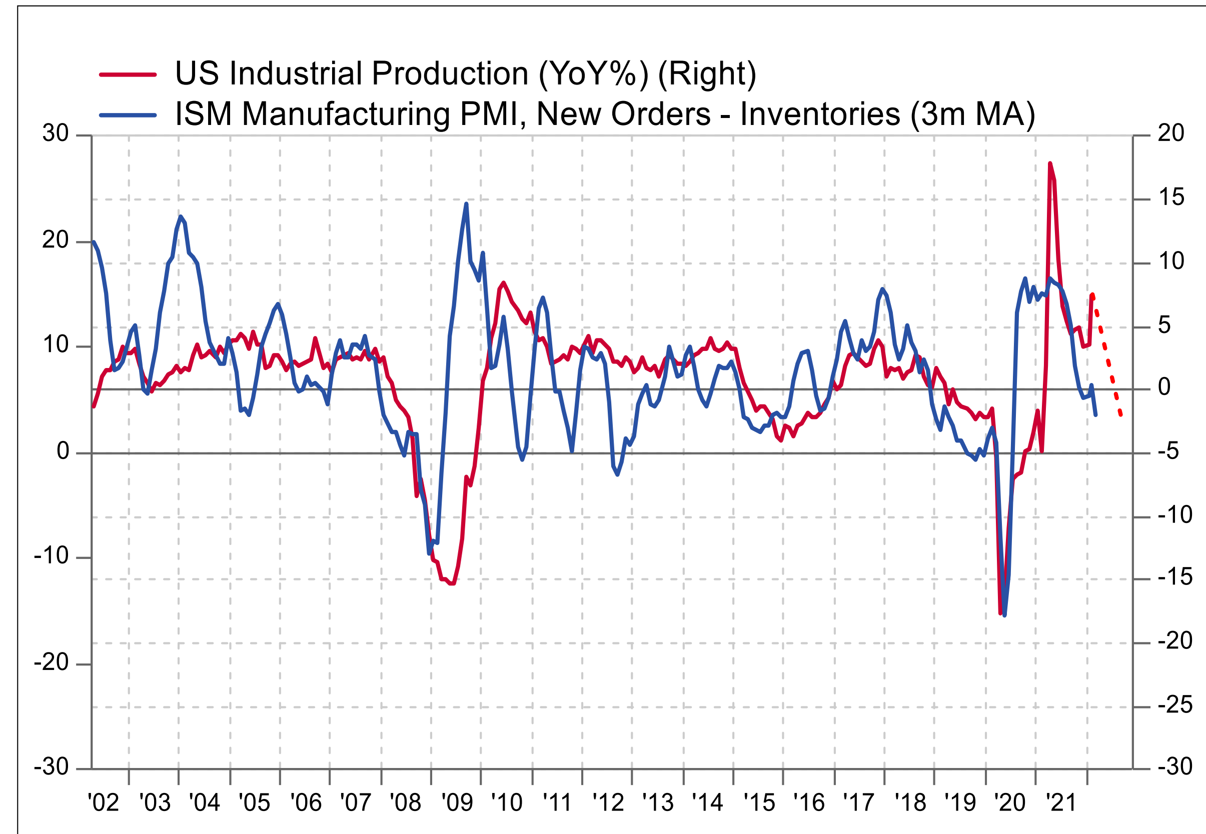
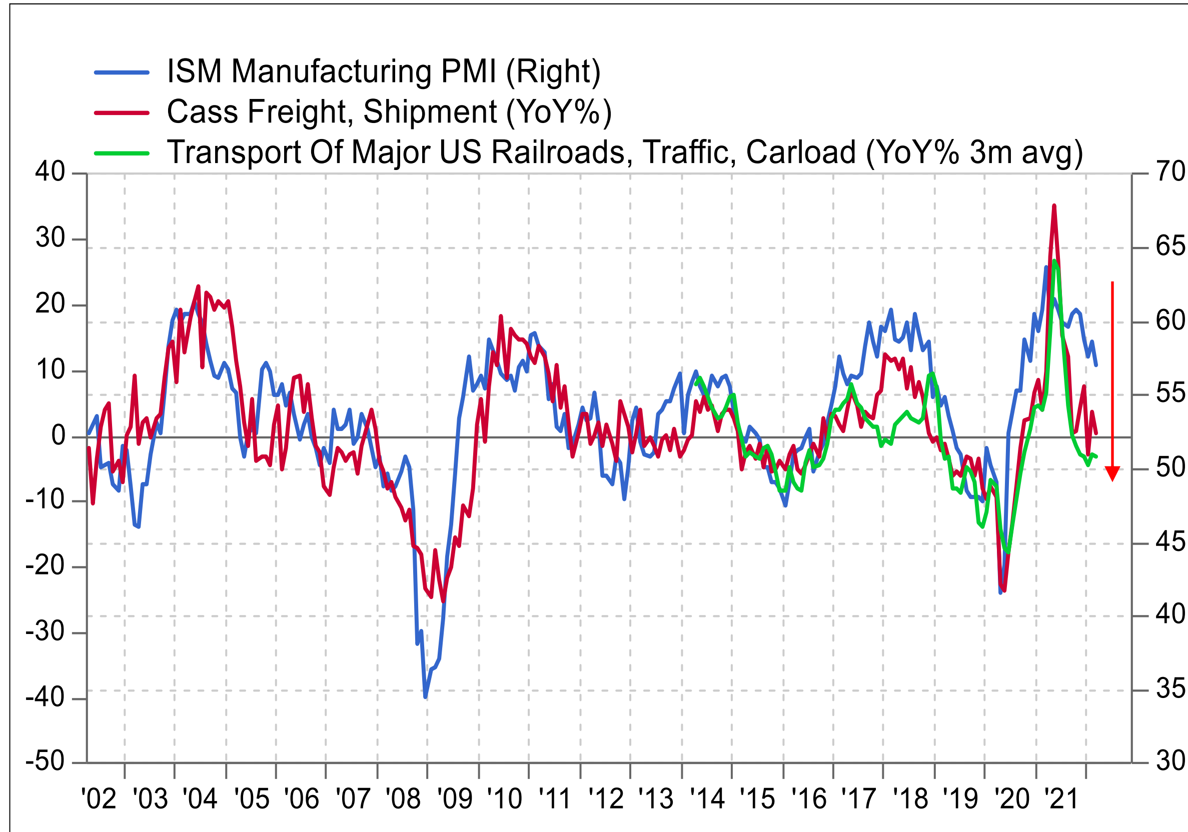


Fig 21. The huge build-up of inventories is a consequence of companies overcompensating to mitigate potential supply shocks in the future.

The issue facing companies now is a potential inventory glut. Too much supply and falling demand. This would force companies to either reduce prices or recognise inventory write-offs as stock becomes obsolete. Both would certainly dent company earnings.

Fig 22. With the rate of inventory expansion beginning to contract and demand for new orders falling, industrial production is beginning to look vulnerable.



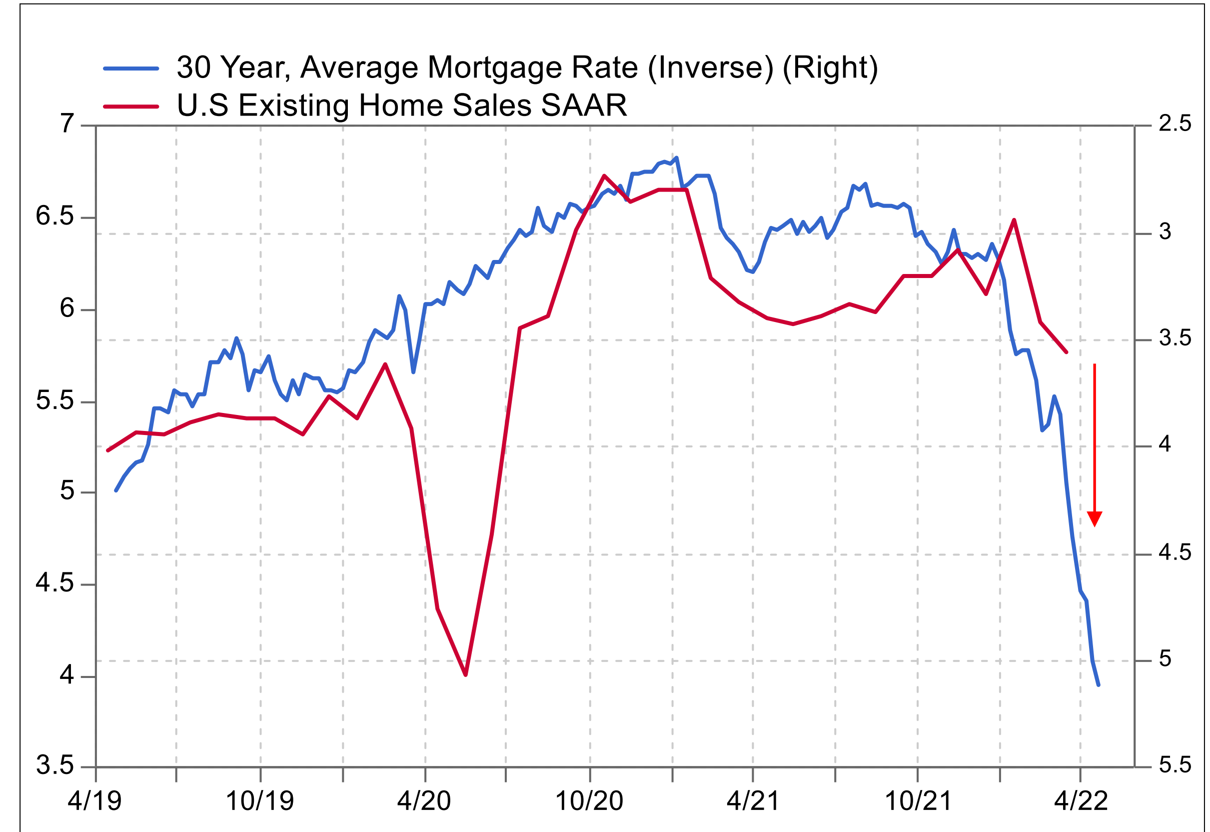


Fig 23. This evidence of a slowdown is further confirmed by falling demand for transport distribution services. The wheels of commerce are slowing, and this will impact the manufacturing sector.

Fig 24. Housing market is beginning to look vulnerable. Rising mortgage rates could impact demand for housing – existing home sales is looking precarious, and this will put pressure on housebuilders and homeowner equity.

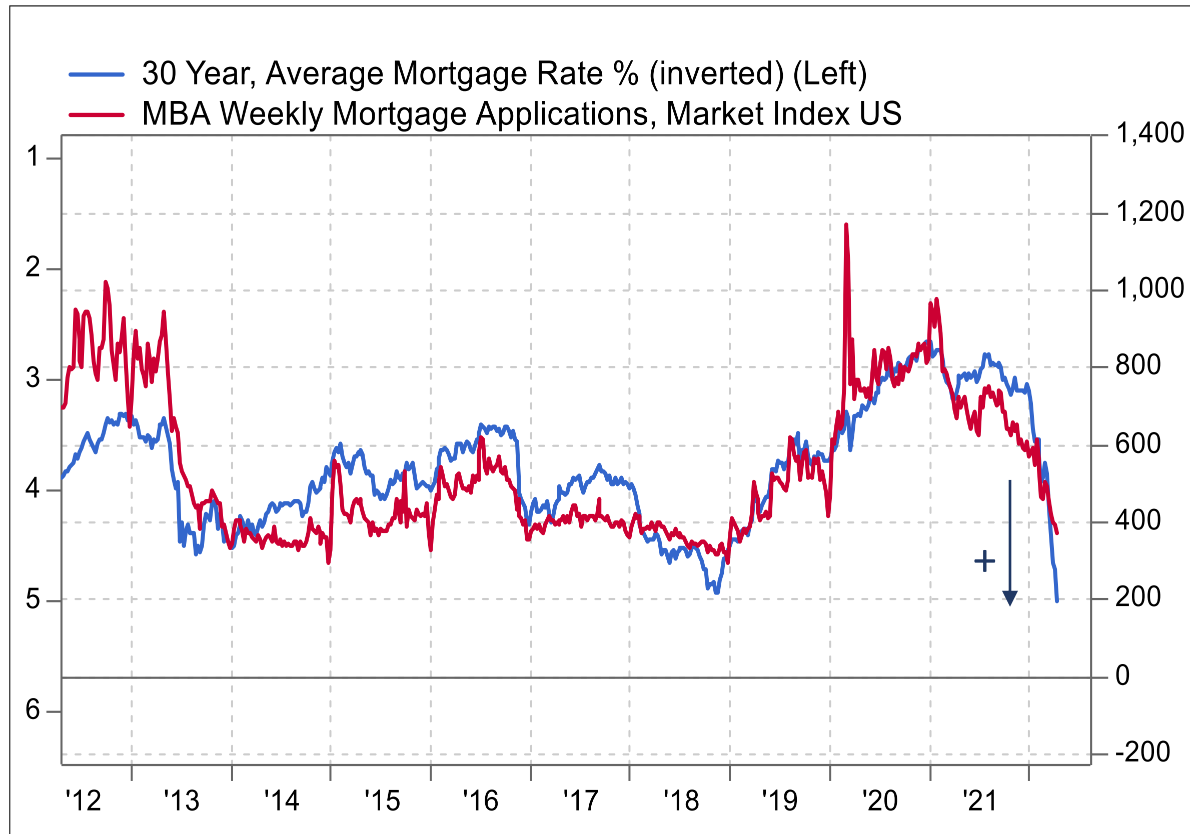


Fig 25. Mortgage rates have surged due to inflation and expected interest rate hikes from the Federal Reserve. Higher mortgage rates have had a huge impact on mortgage applications, which have plunged in recent weeks…

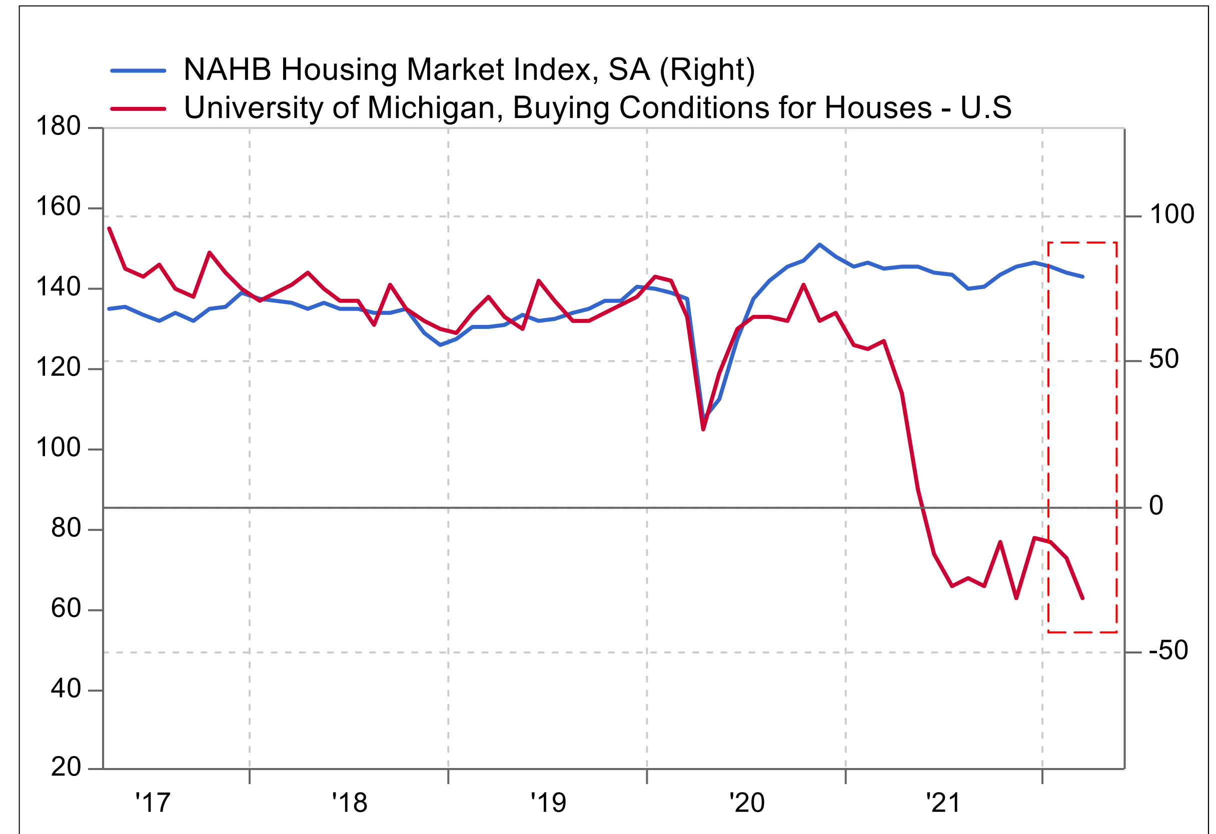
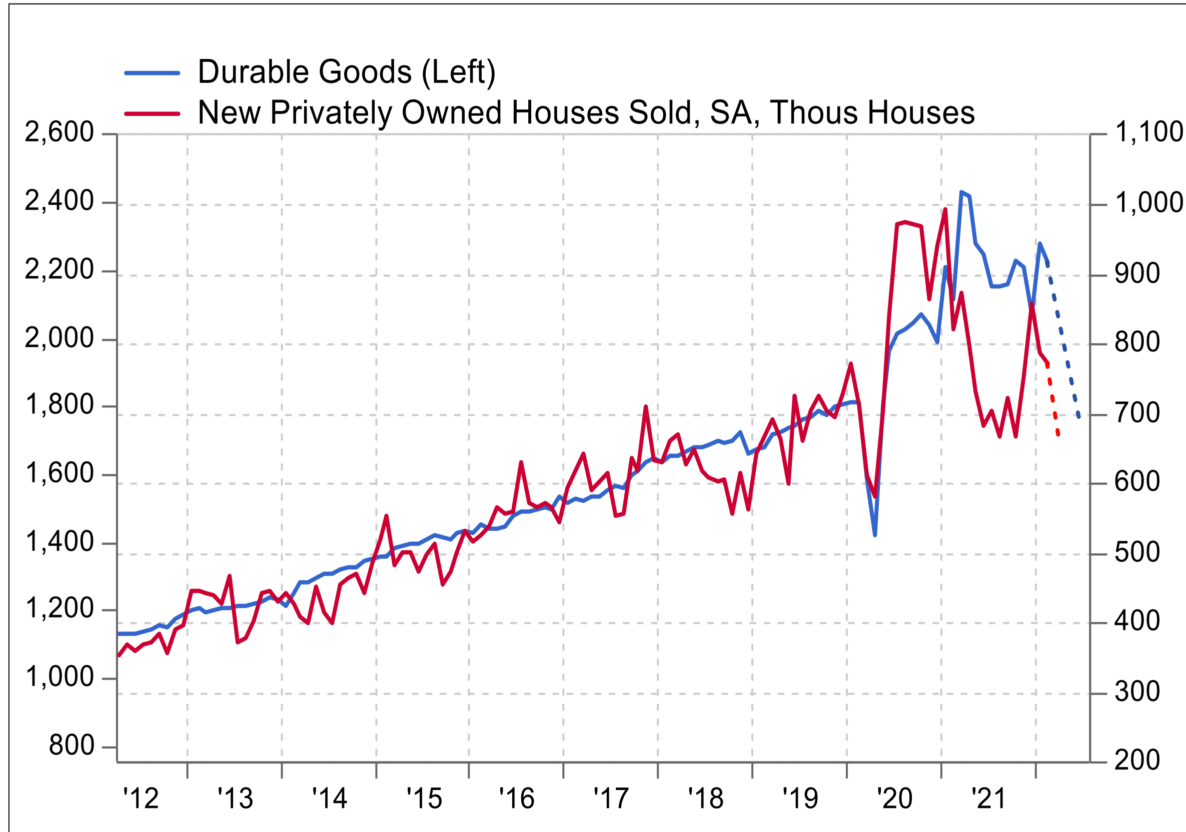


Fig 26. As buying conditions for housing (a consumer sentiment gauge) continues to deteriorate, the Housing Market Index looks to be on borrowed time. House prices begin to fall as demand wanes.

*NAHB Housing Market Index is based on a monthly survey of NAHB members designed to take the pulse of the single-family housing market



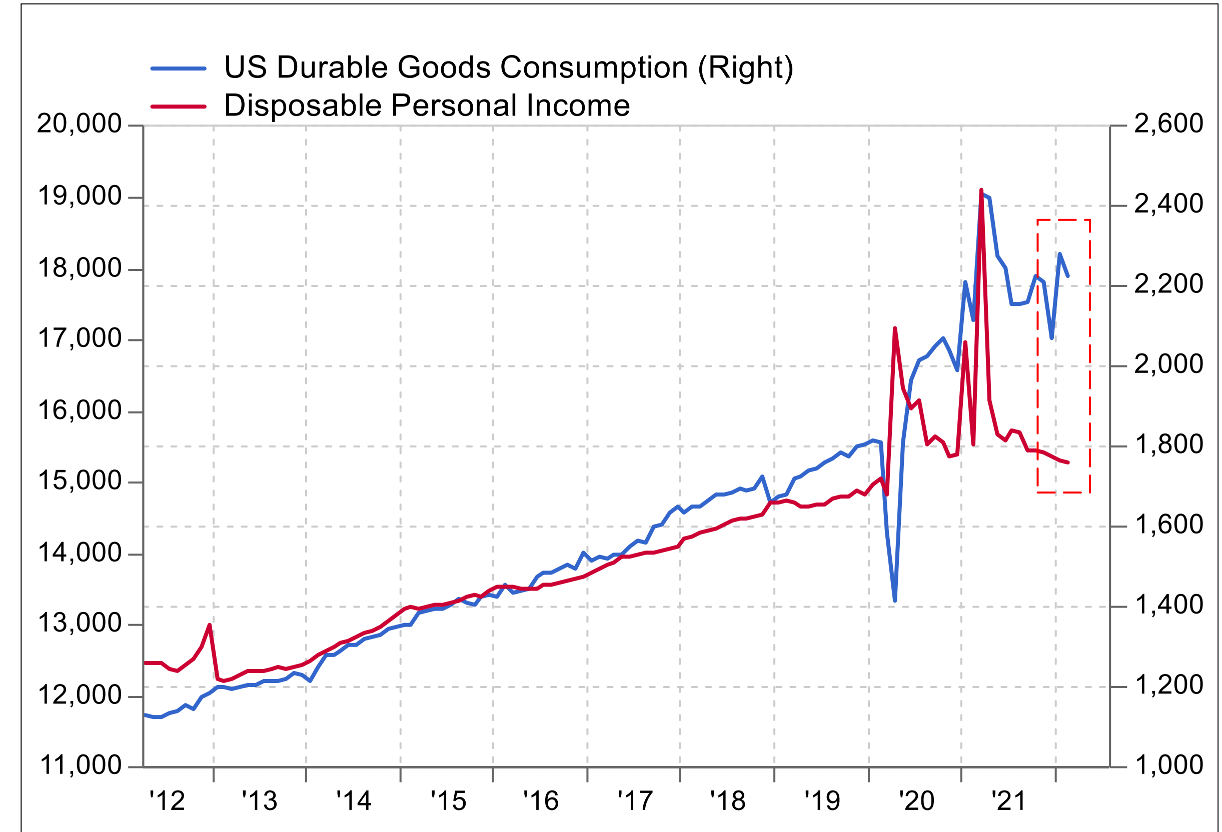


Fig 27. If mortgage rates continue to climb, then slowing home sales could drive durables sales lower, adding to the list of factors that could weigh on inflation over the coming months.

Fig 28. Remember, the spike in consumption was mostly due to stimulus cheques and savings, acquired during lockdown. With disposable income on the decline, demand for durable goods will most likely take a hit. But could personal savings provide a buffer?

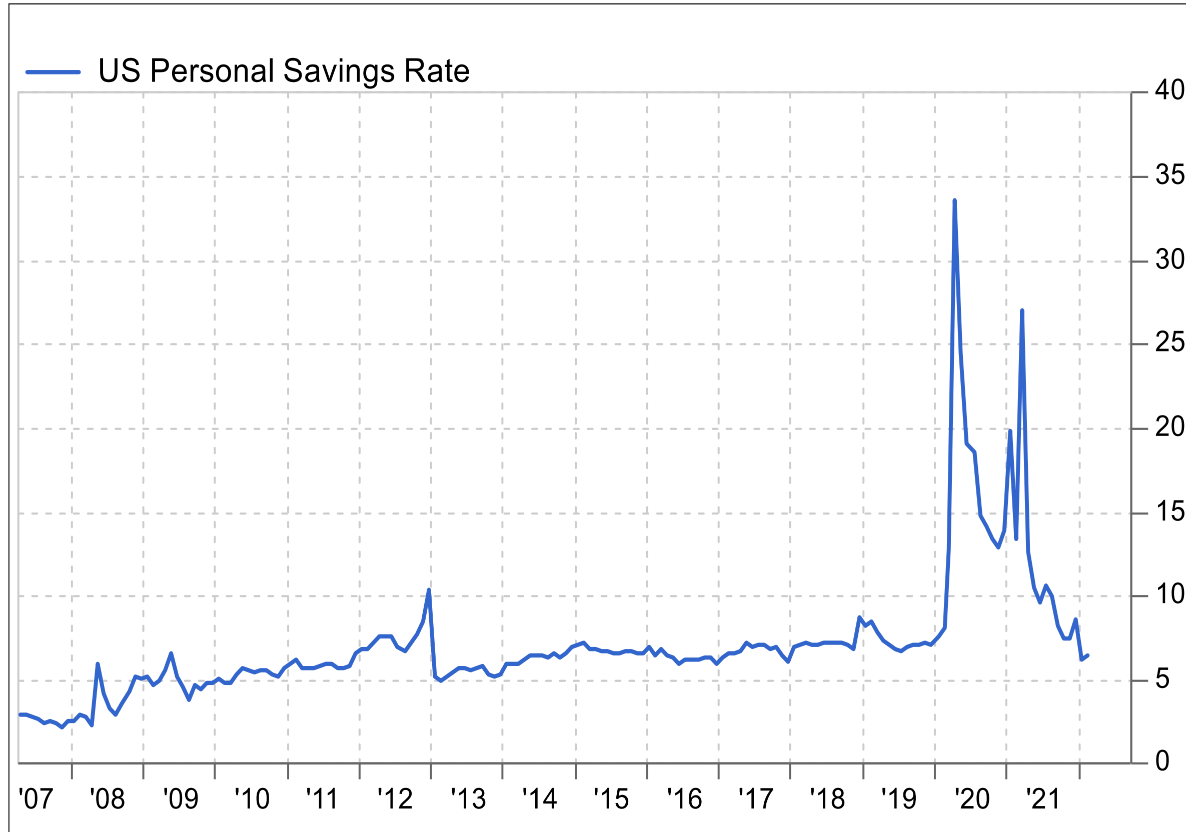


Fig 29. Unlikely. Any excess savings accumulated by the US middle class are long gone, so the chances of a recovery in demand, once prices fall, looks limited.

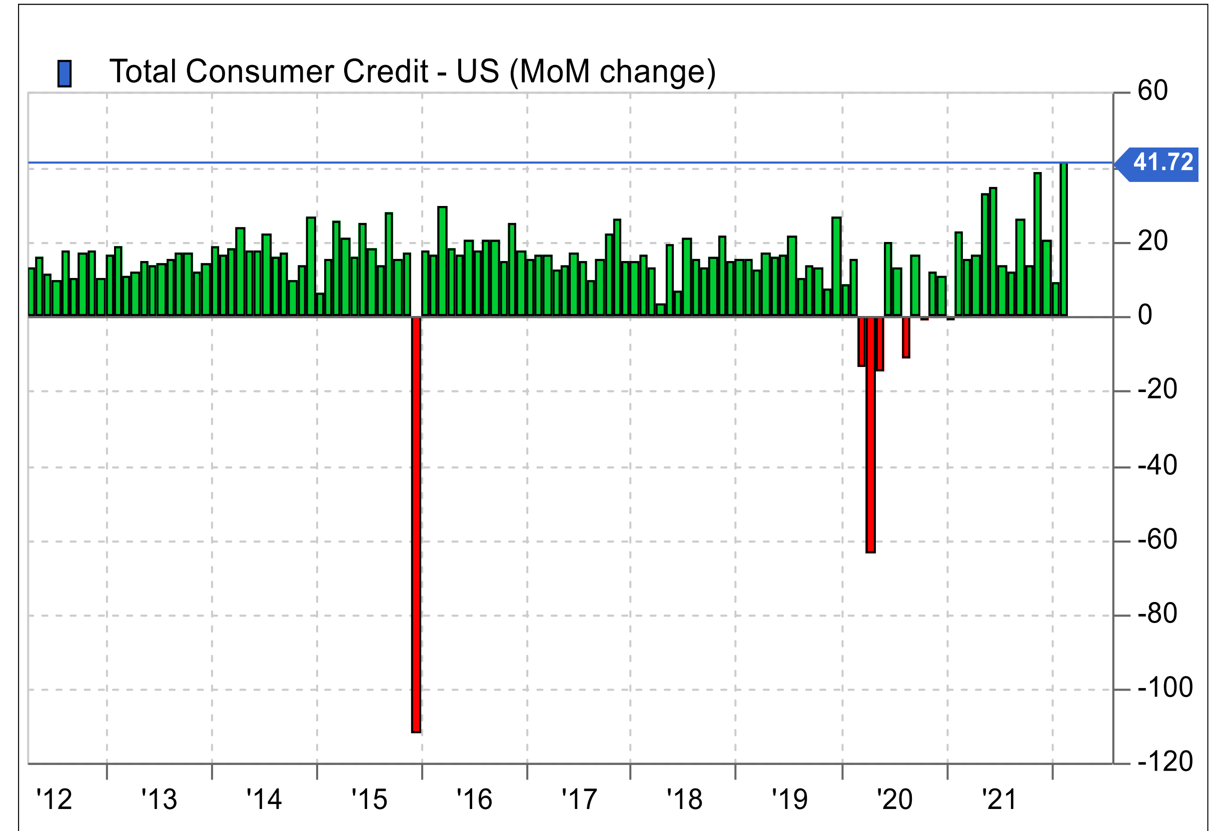
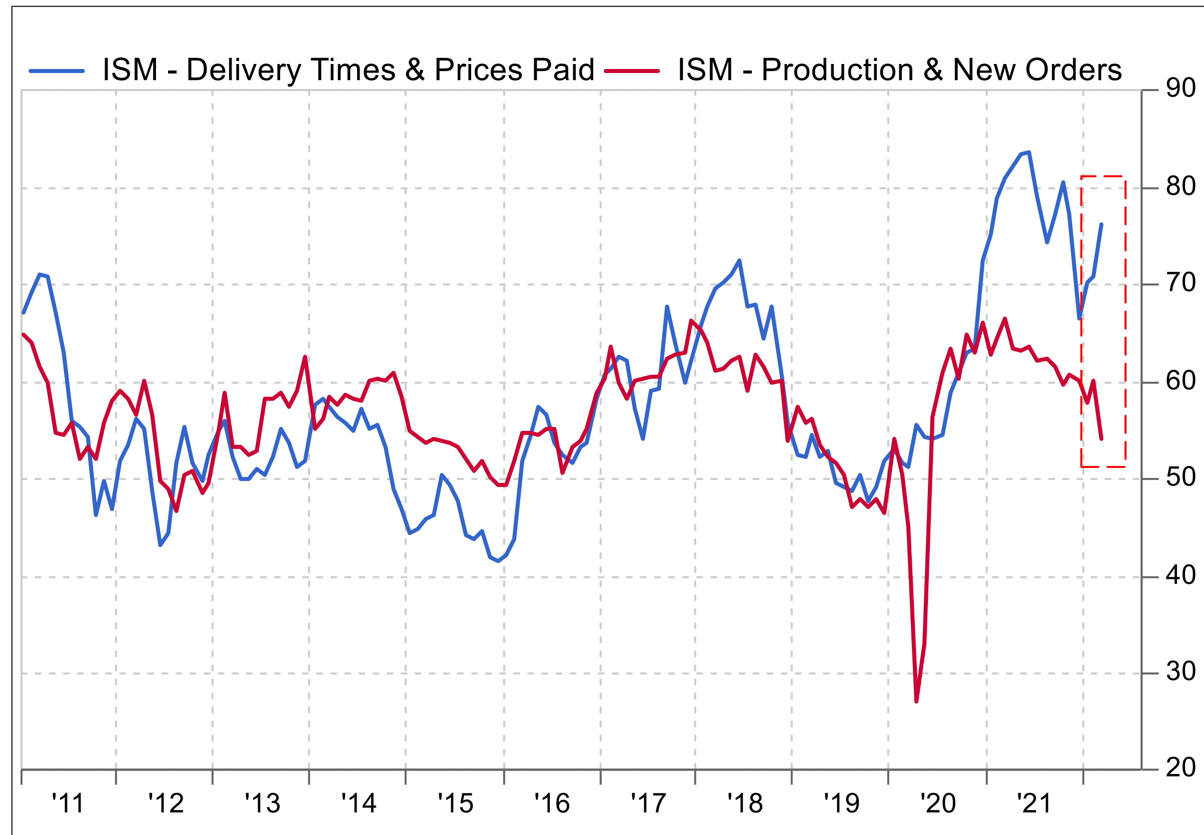


Fig 30. With savings diminished, consumers are turning to their credit cards, with total consumer credit continuing to expand at record rates. The big question is how sustainable is this credit-card fueled spending spree? I'm not so sure…



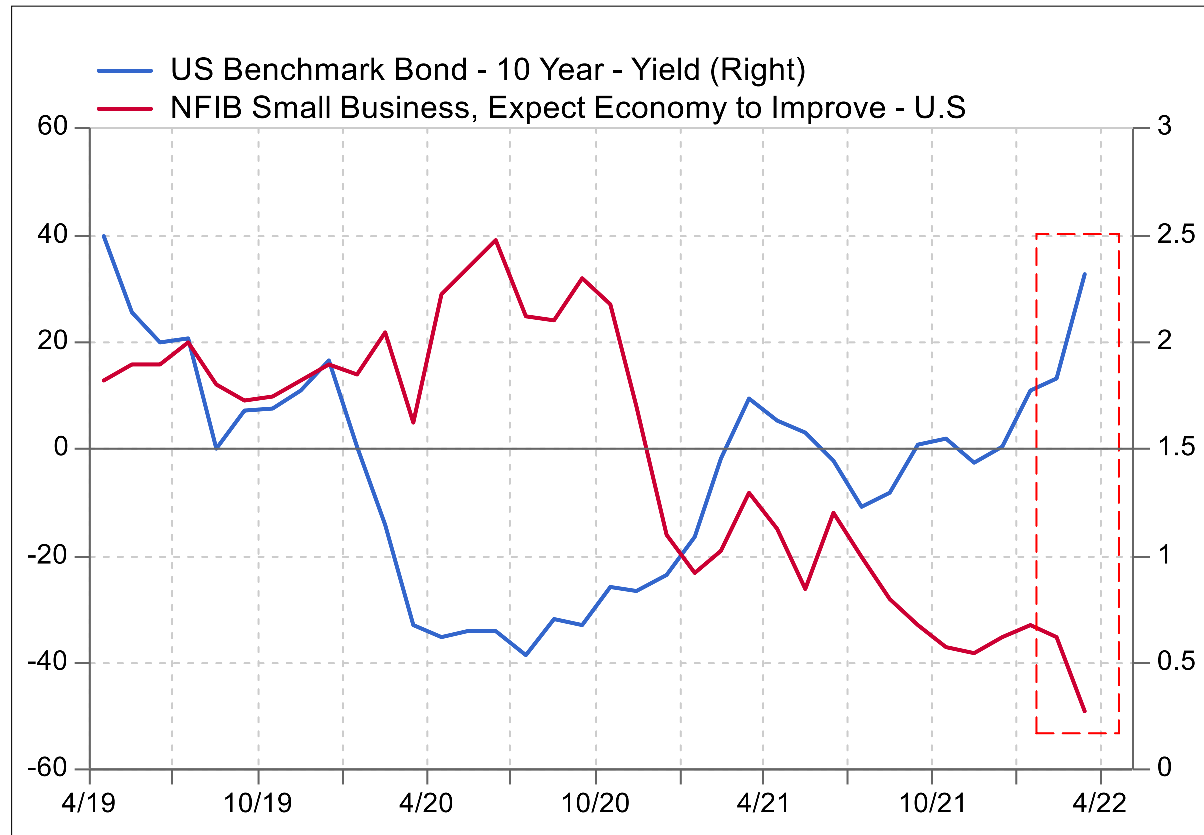
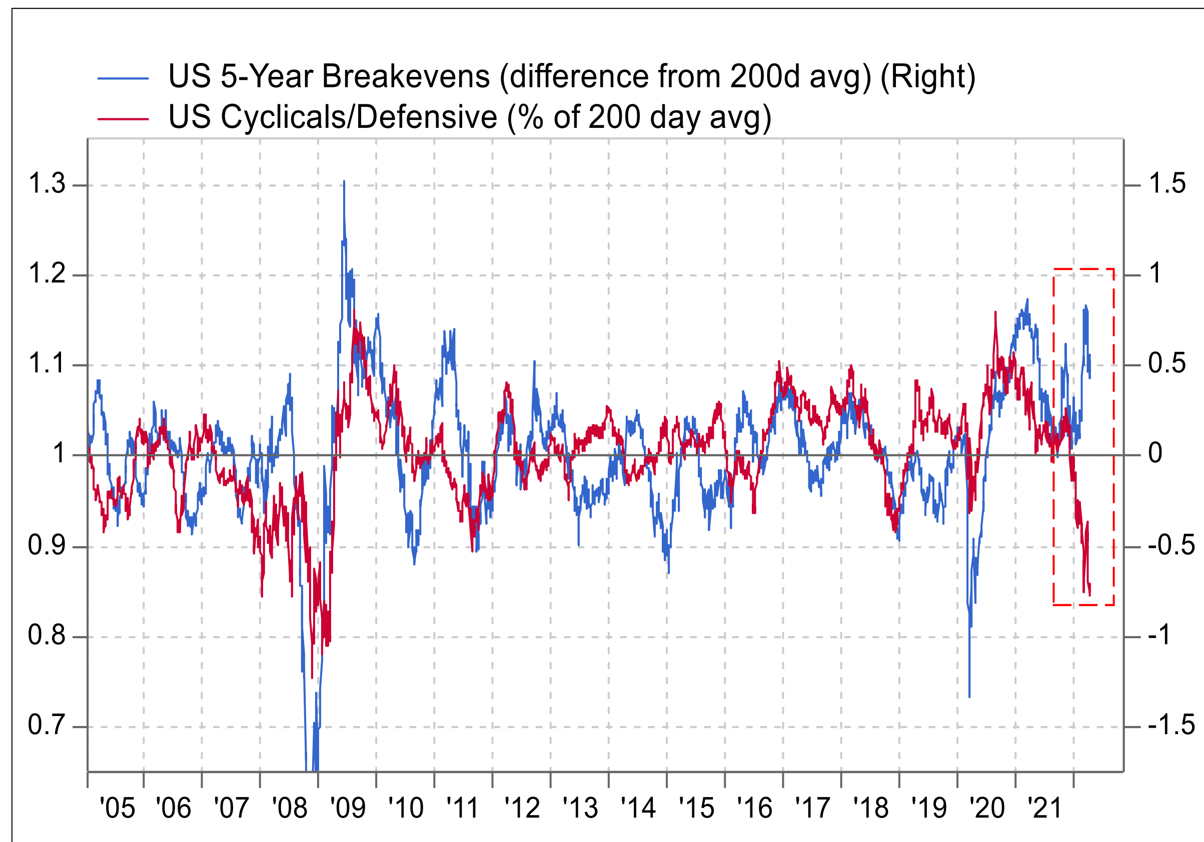


Fig 31. With higher prices and worsening supply chain disruptions, manufacturing growth is declining. These are the ominous signs of stagflation – high prices, falling growth.

Fig 32. Higher borrowing costs will have a greater impact on smaller businesses, and this will hurt the economic recovery.



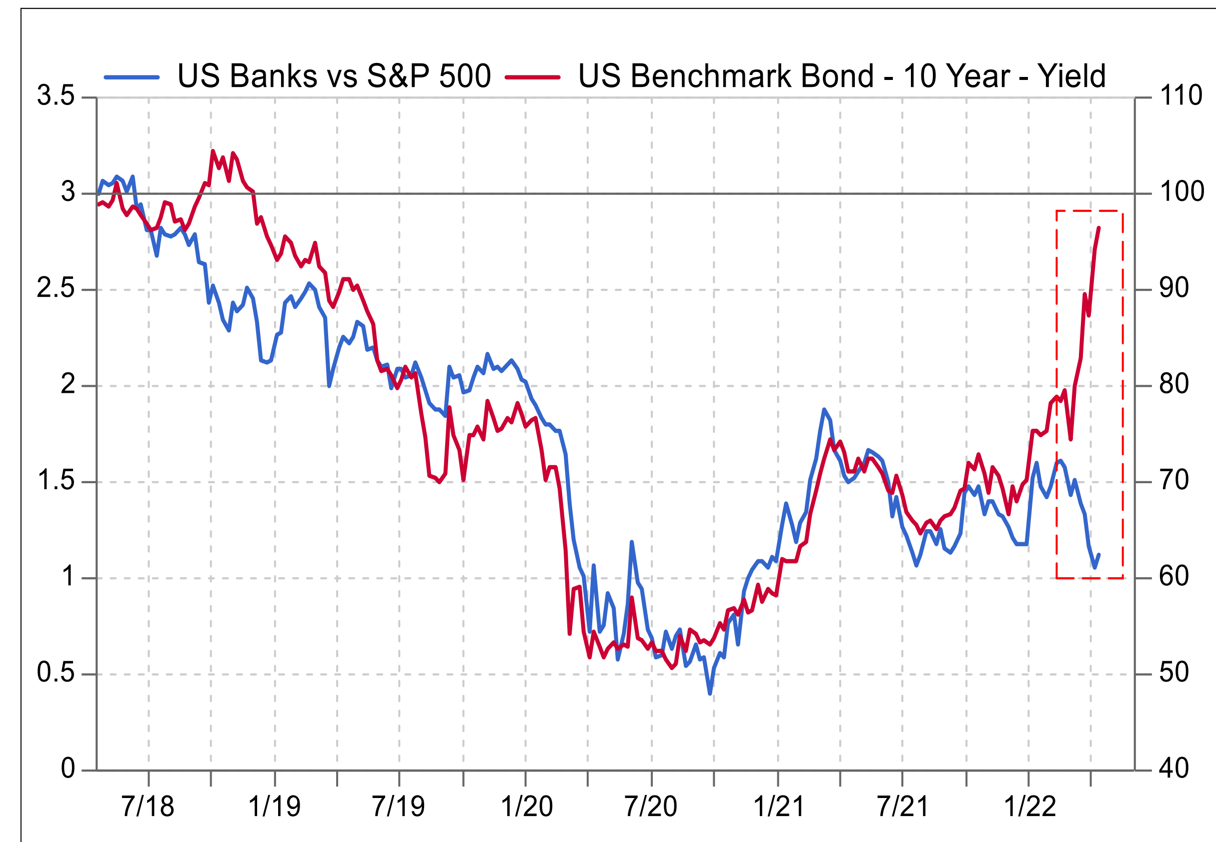


Fig 33. Higher prices are mostly due to cost-push inflation - a consequence of supply-chain disruptions. If this was demand-pull inflation, then cyclicals would be outperforming defensives, as inflation pressures would be symptomatic of a growing economy.

But as the chart above shows, cyclicals aren't following inflation expectations (as defined by the 5y breakevens). This suggests that the stock market is expecting inflation to fall as growth concerns continue to build.

Fig 34. The financial sector usually performs well in a high interest rate environment - higher borrowing costs increase banks profits. Yet again, the same setup. Bank stocks aren't pushing up with treasury yields – like they should do. This could be a sign that markets expect inflationary pressures to recede over the coming months, which means that any forthcoming interest rate hikes may be short lived, as the Federal Reserve is forced to reverse monetary tightening to prevent the economy sliding into a deep recession.

US Macro Pulse: Consumer Confidence vs S&P 500

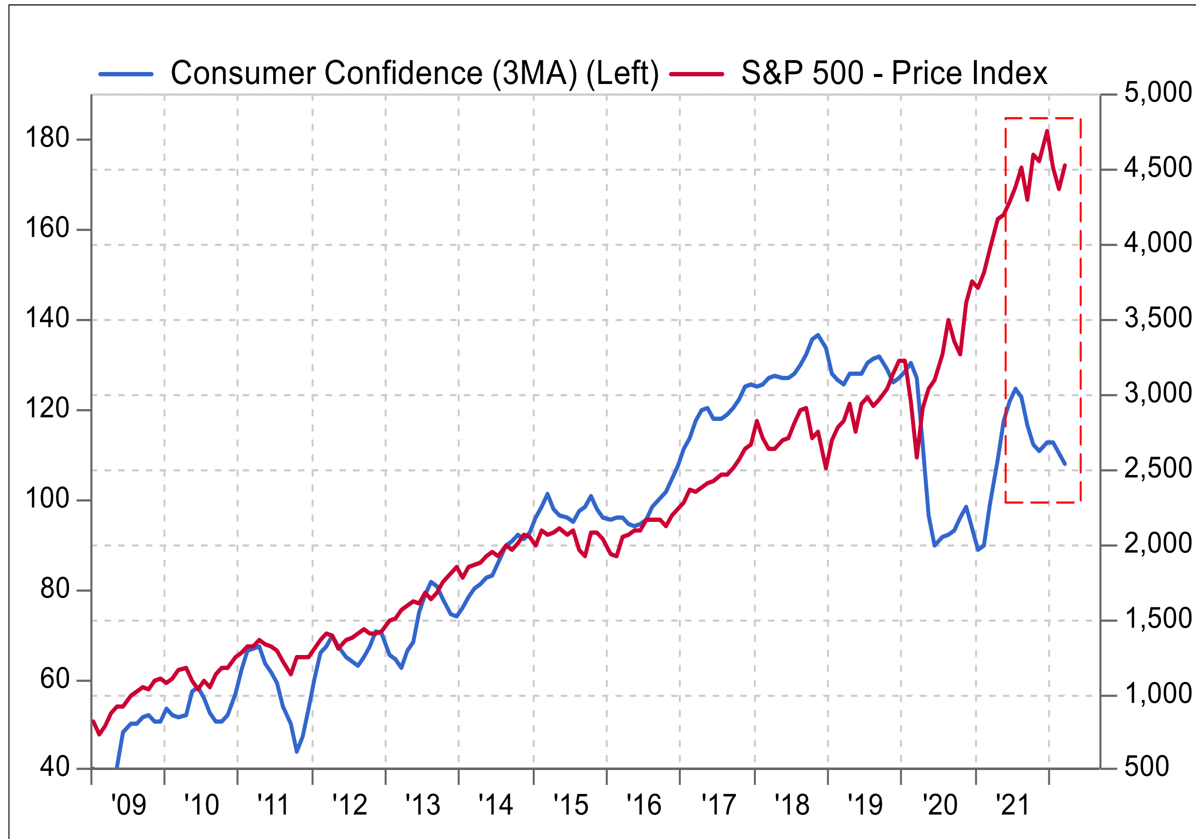


Fig 35. Over the past two years, a growing disconnect has emerged between Wall Street and Main Street. Wall Street has been conditioned to buy the dips – due to the confidence that central banks will jump to the rescue with additional liquidity, if required – otherwise known as the 'Powell Put'.

But with consumer confidence waning and looking ready to tip over, will the financial markets finally wake up to reality?

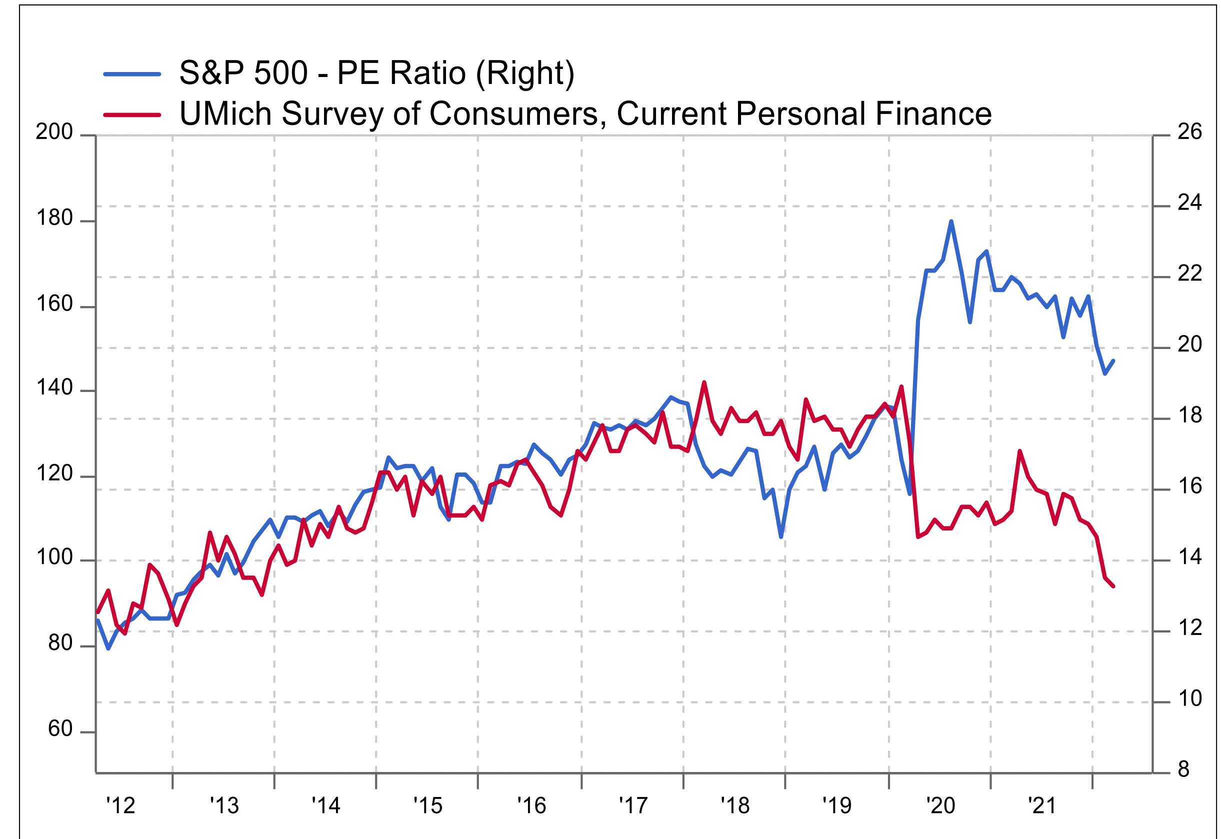
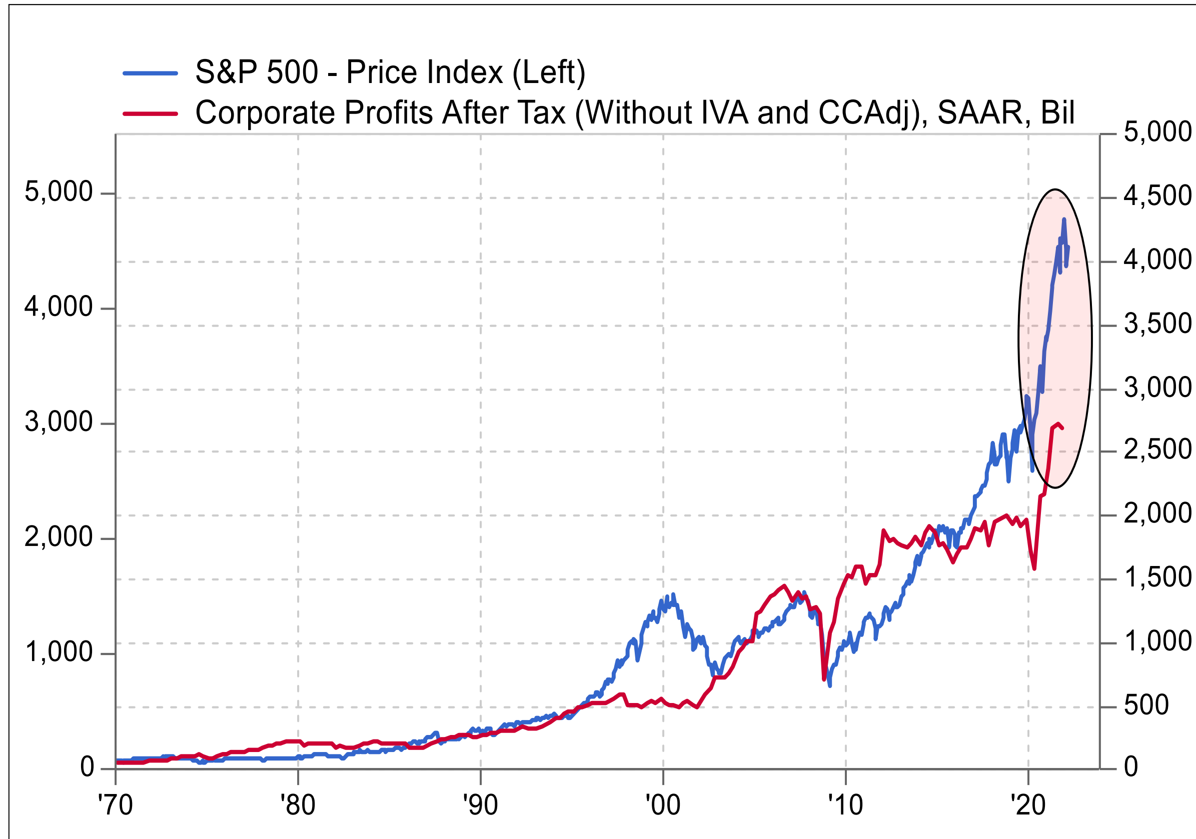


Fig 36. Because current personal financial conditions are continuing to sour, and this presents problems for future business earnings…



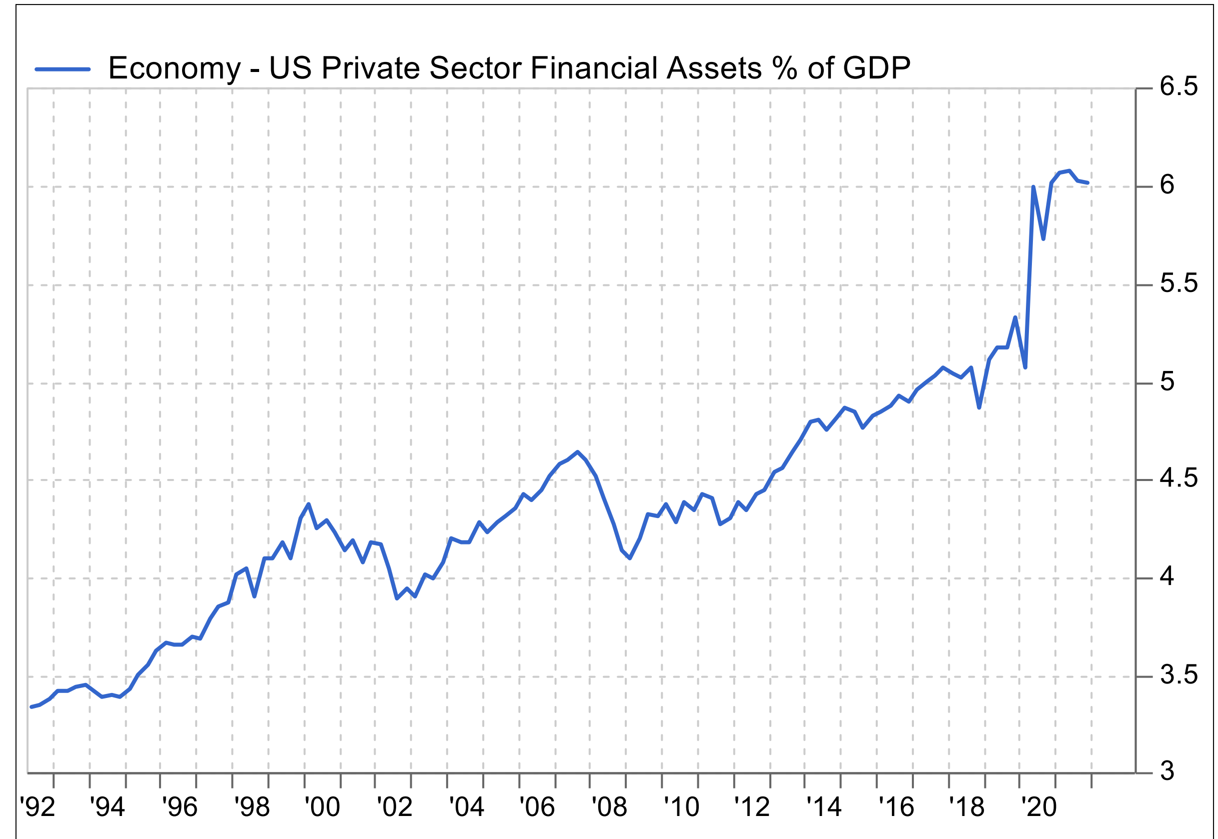


Fig 37. Corporate profits would need to be 45% higher to justify current valuations. Stock market prices have completely detached from economic reality, and this is due to several reasons:

- Excessive liquidity.
- Suppressed interest rates forcing institutions to allocate more capital to higher yielding equities.
- High inflationary environment increases demand for equities that can provide better protection than fixed income.
- Confidence that central banks will continue to provide support for equity markets.

Fig 38. Financial assets are now worth 6x GDP. The Federal Reserve has created the biggest asset bubble in history due to excessive monetary policy. This has greatly increased systemic risk. If the Federal Reserve were to really increase rates inline with inflation, then the system would break. The asset bubble would pop, and pensions would crater.

The Fed will try, and fail (again) to lift rates, and if the falling macro trends continue, then inflation should begin to ease over the coming months. But geopolitical uncertainty will keep inflation elevated. We expect the inflation target rate to be lifted from 2% too 3%, to account for this.

But here's the big question – is lifting rates really going to help contain inflation when the pressure is mostly due to supply constraints? I think it's unlikely.

Risk Warning

The value of investments can fall as well as rise; you may not necessarily get back the amount you invested. Past performance is no guarantee of future performance. Changes in exchange rates may also cause your investment to go up or down in value. Tax laws may be subject to change. Please ensure that you fully understand the risks involved. If in any doubt, please seek independent financial advice. To read our full Risk Warning please visit: www.logicinvestments.co.uk/risk-warnings

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