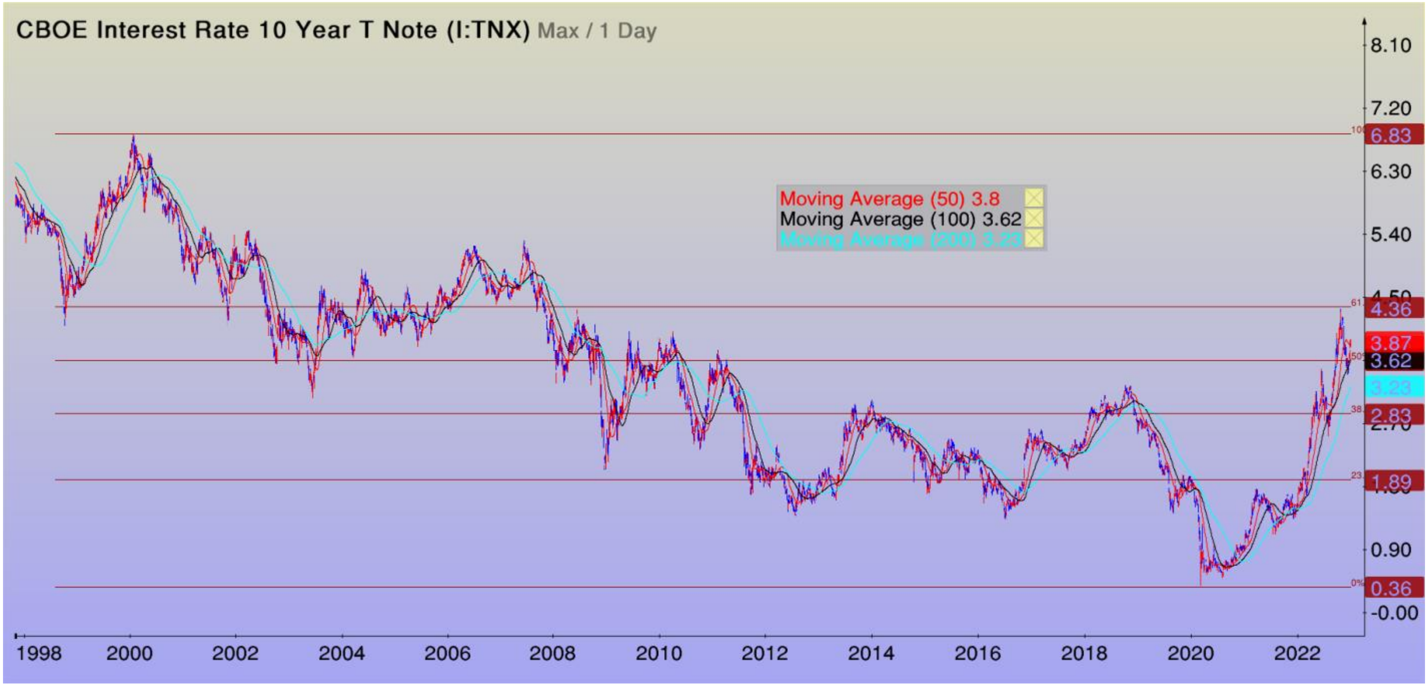
MACRO THOUGHTS

RESEARCH / MARKET COMMENTARY / CONSULTANCY

<u>What good is production without consumers? Part one: USA</u>

At the end of 2021, the Fed was starting to turn the screw on financial conditions and other central banks were being forced to follow. However, as financial conditions were tightening, so were households' balance sheets and consumers' spending power withered as prices rose, yet forecasts for 2022 were based on a consumer spending spree, as every asset class shifted by the weight of speculative money….all would suffer sharp corrections, making most start-of-the-year predictions look plainly silly.

Forecasts made during 2022 by a number of investment banks included Bitcoin at $100,000, Oil at $380, Fed Funds to 9% and S&P at 5500. As is often the case, most of the forecasts were framed by what the forecasters wanted to happen, or hoped would, yet markets accepted and followed. M2 money supply shrank in 2022, the first time in more than 60 years, as the Fed led a 61.8% correction of the entire down move in Treasury yields of the past two decades.



So, with high expectations and with the supply chain recovering, orders were placed in anticipation, despite higher prices, and started to arrive. Many failed to take into account the inflationary impact on Retail Sales data, PMIs raced higher, producers produced, but nobody had considered that, if real earnings are 3% negative, shelves would remain full and, by the end of the first quarter, it was clear discounting would be necessary to, hopefully, tackle the growing, unsold stockpiles.

'Though supply chains have been improving since August, with central banks tightening, and consumer activity subdued, producers can expect profit margins to be cut, while being threatened by higher taxes; we anticipate global growth will fall below 4%.... Any forecasts will depend on energy prices….', Macro Thoughts, December 31, 2021.

There were regular attempts to encourage buying equity market dips, and regular attempts to correct, but with retailers' earnings warnings made in March regularly repeated, to us, 4800 for S&P seemed a reasonable level to sell - over $8.3tn would be wiped out of US stock markets in 2022.

The warning signs were therefore being ignored and markets were not prepared in their equity market forecasts, as we said 12 months ago: '*S&P record year needs consideration – take out the big five and not all equities have had a good year'.* During 2022, S&P performance fell -20%, Euro Stoxx -13%, FTSE was flat, while India's stock markets gained around 4%. **According to one report, global funding for start-ups in Q2 fell by 23% yoy, and Retail tech funding dropped 11% in Q1.**

In October and into November we anticipated bond yields falling to 3% and possibly below in 2023; we were therefore prepared for, and yet surprised by, the sharp fall of close to 100bp, from 4.30% at the time of our forecast, within weeks. We had predicted, including on CNBC, that US CPI would surprise by slowing at a faster rate than consensus, and that the December meeting of the Fed could be the last for rate hikes, particularly as the tone of FOMC voters will be slightly less hawkish.

	FOMC VOTERS		
2022		**2023**	
Permanent	Powell	Permanent	Powell
	Brainard		Brainard
	Barr		Barr
	Cook		Cook
	Jefferson		Jefferson
	Waller		Waller
	Bowman		Bowman
	Williams		Williams
Rotating	Collins	Rotating	Harker
	Mester		Goolsbee
	Bullard		Logan
	George		Kashkari

We also warned of the large treasury auctions during the final week of the year, $142bn in Treasuries and FRNs and $133bn in T-Bills, which added pressure on higher yields.

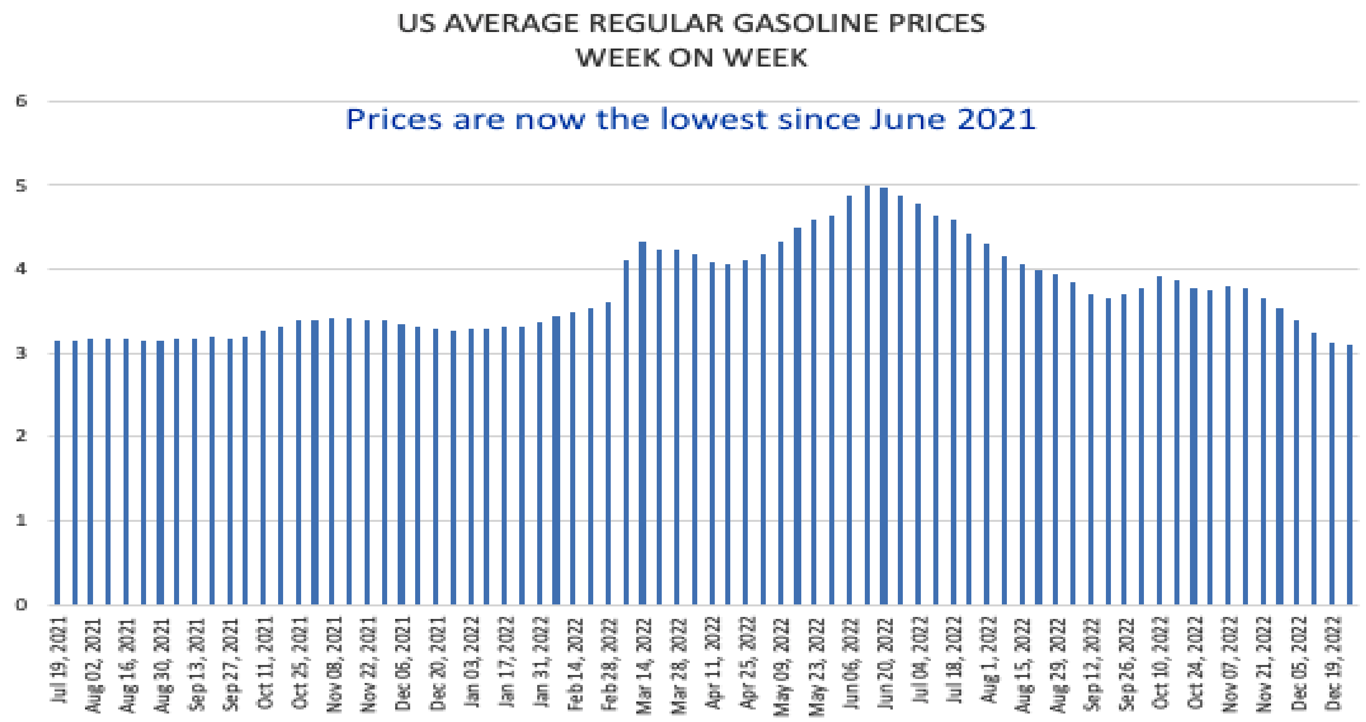
Yields have since bounced 50bp following central bank announcements by the ECB and BOJ, but as we said in 'The Week Ahead', December 26: '*Markets may have been surprised by, and therefore reacted to, more aggressive tightening by the ECB and BOJ, however with US inflation and economic activity slowing, central banks that have been slower to tighten may now fear the Fed will end tightening while they are forced to continue - Japan's inflation is at a 41 year high.* ***We believe some GDP forecasters will have to revise higher their growth expectations and lower their CPI expectations, because of the fall in energy and commodity prices.'***

The BOJ almost immediately announced an unscheduled bond purchase operation, offering to buy back approximately ¥1.325tn ($10bn) of JGBs and to buy ¥650bn worth of bonds with maturities from 3 to 5 years, as well as ¥675bn with maturities from 5 to 10 years. They have since added further bond purchases on three consecutive days, as they manage the JGB curve. While some may find this confusing, we are not surprised (re our comments on the changes to their bond restrictive band) and in October we favoured selling USDJPY, circa 20 big figures higher.

With 17 of 19 Fed policymakers predicting the Fed funds rate will be above 5% by the end of next year (with no rate cuts projected), making the suggestion that the Fed may be close to ending its tightening cycle may seem way off; however, the Fed is still six months off the economy, but as swiftly as they switched from complacency over transient inflation to tightening at the fastest pace on record, they have equally ignored the slowdown in PPI, the warnings from CFOs, and the fact that they are now adding to inflation pressures.

Energy prices will again be key in 2023. Many forecasters are now making a 180 degree reversal from their far too optimistic views of 12 months ago, but we anticipated a drop in oil prices, and that the Fed should already be considering ending rate hikes and have therefore moved in the opposite direction since June; inflation is already falling faster than consensus expectations and we expect growth will recover during the second half of 2023, from a gloomy and volatile first half of the year.

No one would have predicted the conflict in Ukraine, and although reactions in markets were predictable, the levels at which markets will finish the year are somewhat different to many expectations. Therefore, whilst there will always be a slew of start-of-the-year forecasts filling in-boxes, there is a tendency for many to be simultaneously too overdone and also too generalised.



Over optimistic forecasts and assumptions for 2022 and extreme positioning would impact on every asset class at some cost to markets, but an even greater cost to the economy, as commodity and energy prices were pushed higher, and the Fed tightened financial conditions, pushing shelter costs, particularly rents, higher.

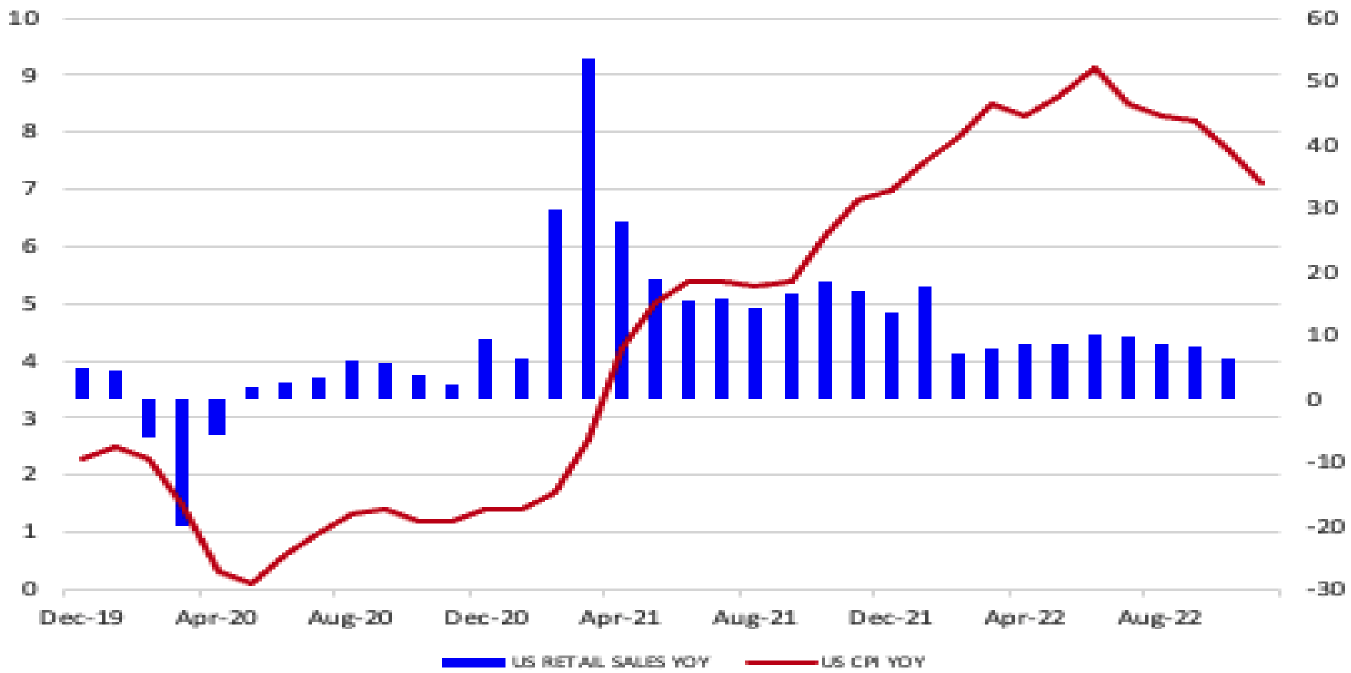
By March, supply chain inflation had improved, but had been overtaken by corporate inflation, yet Walmart, Target and others warned that the consumer was pulling back on spending, leaving them to deal with stockpiles, having over ordered while supply chains were disrupted. In November, we highlighted, '*Walmart, who have been tackling their elevated stockpiles all year, have given some startling trend insights, as the CFO said people are buying hotdogs and peanut butter, rather than expensive meats, for protein and 75% of their market share gain on food came from households with incomes over $100k.* ***This is what the Fed should be responding to.'***

Following the intervention and threats by the Biden administration in August 2021, supply chain issues continued to improve during the spring of 2022 and with the introduction of the Biden-Harris Administration Inflation Reduction Act, such 'encouragement' should do the same during the spring of 2023, especially as retailers continue to tackle their inventories. Latest data for November and the beginning of December showed that Trucking Freight rates and demand continued to collapse during the second half of the year.

Trucking Freight Conditions (November 2022)		
	Month-on-Month	Year-on-Year
Total Capacity		15.40%
Spot Market Loads	-13.30%	-53.80%
Van Load to Truck	-7.80%	-48.20%
Flatbed to Truck	-25.30%	-75.20%
Reefer to Truck	-3.40%	-58.60%
Spot Rates		
Van Load to Truck	-1.60%	-18.40%
Flatbed to Truck	-1.70%	-7%
Reefer to Truck	0.10%	-18.70%

Supply drives inflation, but demand drives growth. It is easy to understand why productivity has remained so low in the West for the past two decades, and wages kept under control, when China's urbanisation has meant workers moving from agriculture to factory employment increased China's productivity by 20%.

For markets, ultra-low interest rates and the overpowering influence of central banks has prevented a free market and kept volatility relatively low, but now central banks are withdrawing trillions as they reduce their balance sheets, and the impact on the economy is only now starting to be felt. While zero interest rate polices may have started as emergency measures, few central banks have managed to disengage completely. Central banks' balance sheets have been reduced by approximately $3.3tn, while US Tech stocks' market cap has fallen by over $4tn.

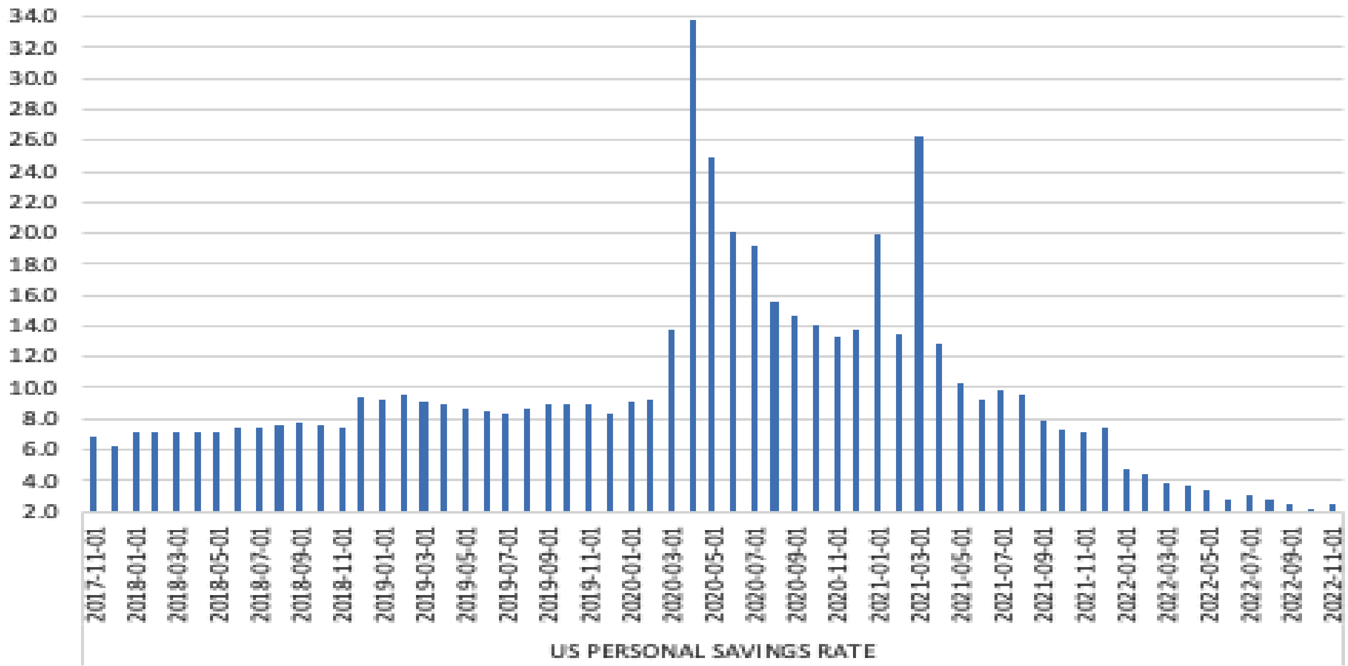


Rate increases and the reduction in the Fed's balance sheet, along with the strength of the Dollar, have yet to feed fully into the US economy, while the drop in commodity prices has yet to be felt in construction and manufacturing. Therefore, while CPI and PPI can be expected to continue to improve, and turn negative, not least because of base affects (which also exaggerated year-on-year data in 2020), we have expected both PPI and CPI to soon turn negative month-on-month.

Focusing purely on the headline numbers for Retail Sales, and ignoring that they are not price adjusted, highlights the failure to understand the issues households are facing. In July, there was a 10.03% yoy rise, yet CPI in June was 9.1% and July's was 8.5%, and gasoline was costing over $5 a gallon. Extract CPI from Retail Sales, and monthly sales have been negative for most of the year. **However, the annual inflation rate in the US slowed for a fifth straight month to 7.1% in November 2022, the lowest since December 2021, and below forecasts of 7.3%.**

Without doubt, the slowdown in gasoline and gas prices will help households, but only to a limited degree - with rent and food prices still high, credit cards maxed out, and savings depleted, there is a risk that consumer confidence will take months, or even years, to recover.

The drop in Core PPI to the level of Core CPI is a caution of how much businesses are experiencing sharp squeezes in earnings margins, so while unions may try to hold out for higher wage deals, they also risk job losses from companies already engaged in economising.



There was too much optimism built up by overblown forecasts of an active consumer-led period of spending and as retailers dealt with 90-day lead times, they placed too many orders when there were supply chain challenges. With consumer activity smashed by high prices, as corporates tried to get back the profits lost over lockdowns, businesses are now sitting on a glut of inventories and share prices have reacted accordingly.

By the second quarter, US retail inventories were said to be higher by 31% yoy, and November's Consumer Spending data was virtually flat on a like for like basis, despite early discounting going into the holiday sales period. Cost cutting is inevitable and the lay-offs have begun. Around 20 well known retailers in the US are on the bankruptcy watchlist, reminiscent of conditions before COVID.

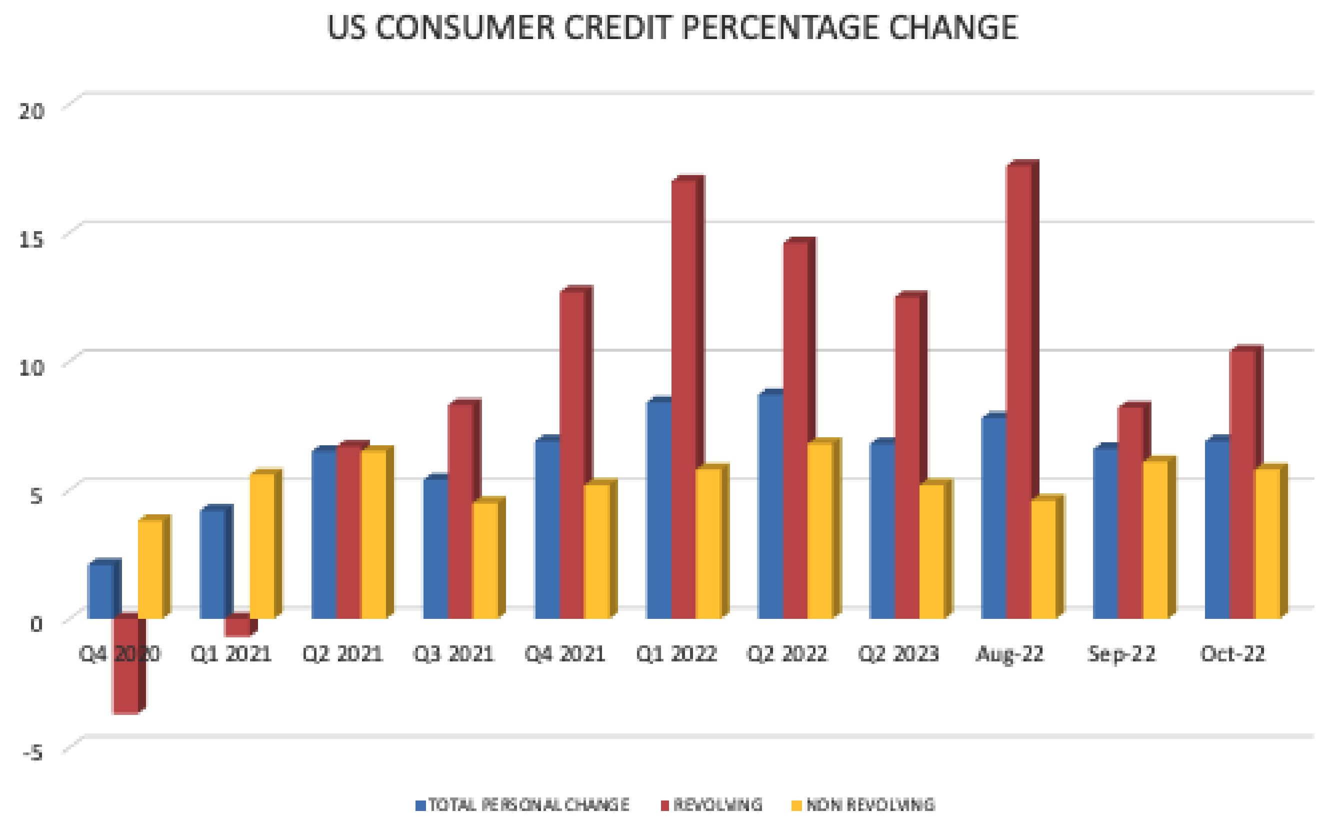
In May, Walmart announced a big miss on earnings, and their shares reacted by falling 8%, yet Walmart was one of those who managed the supply chain shortages more proactively. They could see first-hand that the consumer wasn't there and admitted they had problems with excess inventories, which would lead to discounting, as well as raising their workers' minimum wage, as they know that if they raise their employees' pay, this will boost, or at least support, their own sales. In July, Walmart warned profits were 'tanking'.

At the same time, Target shook up the retail world with its Q1 results and, in June, they warned that Q2 earnings were suffering from dealing with oversized inventory levels, as they were making 'rapid revisions to sales forecasts, promotional plans and cost expectations by category.' In August, Target chief Brian Cornell said there was a need for 'bold decisive actions' and a 'decisive path'.

Despite higher interest rates on savings, the Personal Savings rate has been revised *down* for each month during the second half of the year, has been below 2.4% for the past three months and below the level of 2.8% released for Q3 GDP. This is a significant difference from the elevated levels at the beginning of the year, which was built up with the help of government benefits, and delays to regular annual bills, such as school fees.

The Federal Reserve may be underestimating the damage done to the property market, which could take until well into 2024 to recover. Naturally, as mortgage rates rise and the property market continues to spiral down, Consumer

Credit will look as if it is under control when considering the 6.9% overall rise in October. However, non-Revolving Credit, largely mortgages, slowed to 5.8%, despite the rise in the overall cost of funding, while Revolving Credit, which includes credit cards, rose 10.4%, emphasising the stresses household balance sheets are under, when the Savings Rate has fallen to a level that must be considered as being recessionary. Therefore, despite the fall in gasoline prices and rent rises appearing to have stabilised, there has been little let up on non-discretionary spending.



Chief Economist of the NAHB, Dietz, echoed our comments that US property has become unaffordable, and this is putting pressure on renting. Rents were rising in tandem with Fed rate hikes, and building the average new house in the US was costing $25k more in Lumber alone, so it was no wonder the US property market would deteriorate all year. Mortgage rates had moved up by 2% since August 2021, and applications had fallen by 5%, and as we highlighted, *'**While overall construction costs have been increasing rapidly, growing 22% yoy to February 2022, contractors' selling prices were only up 17% during the same timeframe. Only twice has this happened in the past, and one of those occasions was as a result of subprime and the financial crisis.'***

The costs for builders continue to rise; added to the increases in prices for construction materials, such as copper, lumber and cement, are the added costs of running equipment, from tower block cranes to bulldozers, all heavy users of diesel. As we highlighted in our pre-CPI report at the time, gasoline prices peaked on US garage forecourts in mid-March at an all-time high of $5.25 per gallon. This was a 33% increase in five weeks, on top of an around 240% increase between April 2020 and February 2022. On top of this, between April 2020 and February 2022, steel mill products were up +113%, lumber and plywood +101%, copper and brass mill shapes +52%, plastic construction products +45% and gypsum or drywall +29%.

This was unsustainable and, as we predicted, a correction in commodity markets was due.

- Lumber would repeat a similar pattern of 2021, rising from $340/thousand board feet in September 2021 to $1,500 in May 2022, while the turnaround would bring prices back to where they started
- Copper prices had been rising since the beginning of 2021; by March, they had reached $5 per pound, before the trend reversed in May, dropping almost $2 in two months, with an only limited recovery

In June, it was oil prices that would correct, following the OPEC+ meeting. Despite predictions of a rise, including to $380 a barrel from one US investment bank, we said to expect WTI oil to fall, returning to prices of the start of the year, circa $80, and *despite September's announcement of a 2mio barrel production cut by OPEC+ (prompting more forecasts for $120 and higher), major storms in the US and Japan late in December, and the relaxation of lockdowns in China, oil did finish the year where it started, below $80.*

The US average 30 year Mortgage rate has fallen from 7.14% (roughly the highest since 2001 & 3% higher year on year) at the end of October, to 6.34% for the week ending December 16, the lowest since the beginning of September, and Applications have reacted by being positive for four of the previous six weeks.

However, bond yields have risen since the last weekly data release and the deterioration in the property market continues, after some stability, and many of those that bought during lockdowns will now be suffering negative equity, making it harder to move to another area for employment. The Home Price index has not seen a rise of more than 0.1% during the second half of the year, and was negative -0.6% and -0.7% in July and August.

- Building Permits (a proxy for future construction) fell -10.6% in November, 1.35mio, compared with 1.879mio units in April
- NAHB Housing Index has been falling month on month for every month all year, from 84 in December 2021, to 31 in December 2022, the lowest since 2012 (apart from during COVID)
- Existing Home Sales have fallen month on month throughout the year, from 6.490mio in January, to 4.090mio in November (while dropping -7.7% mom), the lowest since 2010, while December's may have dropped below 4mio for the first time since 2020
- Housing Starts have fallen from 1.805mio units in April, to 1.377mio in July, and were at 1.427mio units in November. Single family housing starts have been worst hit, while rising rents have helped to support the building of units of five or more, until recently. Single Family starts fell -4.1% (828k), but were offset by a 4.8% rise in units of five or more (584k), being the highest since April 2022
- Although over the year to October New Home Sales have been positive for just three months, sales have been relatively the same mom since April during the second half of the year (between 540k and 640k)
- Pending Home Sales fell -37.8% yoy in November, following a similar fall of -37.09% in October, the eighteenth consecutive monthly decline. Month on month sales fell -4%, following October's -4.6% fall, considerably below consensus forecasts of -0.8%

<u>End of rate hikes may seem a big call?</u>

'*We have been commenting for a considerable length of time that the strength of the consumer is being exaggerated, that seasonal sales were weak, and that higher prices are pressuring household balance sheets…..We first warned of higher inflation 18 months ago, and said that the Fed should have acted in June 2020; now, with more hawkish Fed voters, they will try to catch up, despite clear evidence that economic data is already deteriorating. US Investment Banks (the usual suspects) are now targeting 8 & 9 rate increases. We said in 2020 that there needs to be a change of mindset from the Fed and that adjusting policy should be totally dependent on data, or they will make the same mistakes they made in 2018,'* Macro Thoughts, 'The Week Ahead', January 23, 2022.

Q3 GDP data for the US showed the PCE Price Index at 4.2%, closer to our forecast of 5%, but considerably below the previous quarter's 7.3%, while market consensus expectations were for a rise of 10.5%. We had been seeing a slowdown in inflationary pressures since the end of May and this was evidence of how quickly the economy was deteriorating. With retailers continuing to warn of a slowdown in consumer activity, we made the assumption that the Fed must be close to ending rate hikes, as even they must see it was not demand that was driving prices higher.

At the end of October, we forecast the Fed would slow, and may even signal ending, their tightening cycle and as the first meeting isn't until the end of January, data releases by then should make raising further even more difficult to justify.

The Raise the Wage Act of 2021 may have been one of the reasons the Participation Rate and Population to Employment ratio have not recovered, as the unemployment rate fell below 4%. Although this only phases in a $15/hr minimum wage by 2025, it will impact on 32 million workers, but the current rise in inflation is already causing a contraction in the budgets of households and small businesses. ADP data all year has shown falling employment in small businesses.

The rise in the minimum wage may also account for the slow recovery in official data, as it may be underestimating those employed, and overestimating average wage growth. Hospitality and Leisure led the increase in December's NFP (88k). This includes Food services, including deliveries, which can be cash in hand (potentially one of the reasons the Participation Rate has not recovered) and will be in demand over the holiday period. Nevertheless, employment in Hospitality and Leisure is still almost 1 million jobs below pre-COVID levels, and increases in 2022 are half that of 2021, therefore, there being fewer lower paid jobs, this starts to account for the higher level of Average Hourly Earnings (AHE).

Lower oil prices are already having a considerable impact on gasoline prices globally; in the US, prices are now back to the level of June 2021, the impact of which will continue to affect future CPI data and more acutely on second derivatives, such as food, production, manufacturing and transportation costs - which is why Producer Prices will continue to cap and drive down inflation, and why over pessimistic growth forecasts may need to be revised higher.

	Selection of strategies to leverage reports in 2022
January / EOY Carry Over	Sell UK 10 yr 0.50%
	Sell RX GER 10 year 170
	Sell TY$ 129.50
	Sell GRK/Buy ITL 5bp or Buy ESP
	Sell China 10 yr 133bp
	US Curve Flatteners ref 5yr-10yr 50bp target into negative
	Sell S&P 4662
February	ED US STIR Futures spread Sell EDZ3 Buy EDZ4 @3tic
	ED US STIR Futures B'fly Sell EDM3 Buy EDM4 Sell EDM5 @3tic
March	Sell S&P 4800
April	Buy USDCNH 6.42
	Buy USDTHB 33.50
	Sell EURUSD 1.08
May	Sell Commodities (Lumber, Copper, Soybean etc.)
	Buy Option Vol RX Bunds & TY$
	Buy USDINR 77.32
June	Buy US 10 year /Sell 10yr 3.40%
	Sell Oil WTI $120
August	Buy VX 20%
September	Sell UK 10yr 3.06%
	Sell ITL 3.88%
	Sell EM Currencies
	Sell EURUSD
	Spread widener ITL-GER 2.27
October	Buy US 10 yr 4.30%
	Buy Investment Grade Bonds
	Sell Fixed Income Option Volatility
	Sell USDJPY
	Sell GBPJPY
November	Buy GBPUSD
December	Sell UK 10 yr
	Buy ED June 23 Futures (re CNBC)
	Fade Extreme TY$ Put/Call Skew

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