

Valuation Comeuppance

QT credibility, goods, house prices and wages peaking, valuation comeuppance



[Barry C. Knapp](#)

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Quantitative Tightening Credibility

After some reflection on the whirlwind events of last week, we are most surprised, but probably shouldn't be, by market participants' underappreciation of the impact of quantitative tightening evident in the 23bp steepening of the 2s10s Treasury curve following the Fed meeting. When we wrote [Returnless Risk](#) two weeks ago and [Relief Rally](#) last week, we made our case that the Fed policy path was fairly priced in both the front-end of the Treasury and equities market, but that long term Treasury yields were still too low given a negative term premium and zero real rates (TIPS yields). On the day of the meeting, the balance sheet contraction plan was more tentative than we expected, however, like the reaction to the soft release of the plan in the March meeting minutes three weeks ago, long term Treasury prices plunged as investors began to seriously consider just how far those prices were from fundamental fair value due primarily to the massive Fed pandemic purchases. As much credit as Chairman Powell gets for his anti-Greenspan obfuscation communication, when he says things like "we don't really know balance-sheet shrinkage effects", if you consider that the pandemic response was 150bp of rate cuts and \$5 trillion of balance sheet the expansion, the rate equivalent of ~250bp, their credibility is questionable at best, at least in our view. Consequently, our explanation for the quick reversal of the relief rally following the as expected policy steps and removal of 75bp rate hike optionality, was the sharp move in longer-term rates attributable to investor concerns about the implications of QT exacerbated by the Fed's lack of confidence in the implications of balance sheet

contraction. Even after the 134bp increase in 10-year real rates and 50bp increase in the 10-year term premium (see definition and link below), those rates remain well below our assessment of fundamental fair value given the longer-term outlook for inflation, growth, demand for capital and monetary policy.

On the plus side, our outlook for inflation is improving, goods prices and wages appear to have peaked and in this note we will make a case for how house prices, the source of inflation the Fed has the most control over, are also likely to slow considerably. The implications of peak inflation are that the Fed is likely to be able to slow the rate hike process in the fall. At that point QT will be the primary source of policy tightening and while we think longer term yields are headed higher, the private sector is well positioned to absorb those hikes. Additionally, as we explain later in the report, the implications for the equity market are smaller than Thursday and Friday's price action implies. Given the 15% decline in the S&P 500, any further drop would approach the scale of the 2011 and 4Q18 Fed policy corrections, in both of those cases the markets were also absorbing significant policy shocks. In 2011, the markets had to deal with the possibility of a US sovereign default during the debt ceiling and budget showdown on Capitol Hill that led to a US ratings downgrade. In 2018, the trade war was in the early stages of triggering a global manufacturing and export recession. No such shock exists today. We expect the equity market to stabilize and recover in the coming weeks.



Figure 1: Fed easing cycle cycles prior to the QE era caused the 2s10s term premium curve to steepened as policy suppressed short term rates, spreads and premia. QE suppresses premia in the price for longer term finance, this distorts the capital allocation process and leads to malinvestment in housing and a range of longer duration assets.

"The term premium is the compensation that investors require for bearing the risk that short-term Treasury yields do not evolve as they expected."

[Treasury Term Premia: 1961-Present](#) NY Federal Reserve Liberty Street Blog

Inflation Rate of Change - Housing

Goods prices, the origin of two decades of disinflation and the supply shock price to a four decade high in inflation, likely peaked amidst a flood of imports and a clearing of domestic supply chains as evidenced by plunging spot freight rates in the month of March.

Bottlenecks and shortages resulting from the Russian Invasion and misguided Chinese pandemic policies remain acute. Furthermore, we do not expect a return to the post-China WTO admittance goods price disinflation as supply chains are restructured for resilience. That said, it seems highly probable that the 12.4% February reading for CPI core goods prices was the cycle peak. It also seems probable that house price

appreciation also peaked in February with the record Core Logic 20 Cities 2.39% monthly increase. Our view that house price appreciation has peaked is intuitive, given the 2.22% increase in the current coupon Fannie Mae par coupon rate and 1.07% widening of the spread to swap rates underscoring the sharp increase in mortgage financing rates for both homeowners and investors. More importantly, our favorite indicator of house prices, the 3-month average covariance of the 20 Cities that comprise the Core Logic Index, has fallen sharply from the record level of a .98 r-squared from February 2021 through August to .68. This measure was integral in determining when the housing market cleared in 2011. At the time, there was a divergence between metropolitan statistical areas where mortgage debt was nonrecourse, which were clearing, and those where foreclosures required lengthy legal proceedings, which were not, and national prices bottomed. During 2021, when the Fed was accumulating 1/3 of the agency mortgage-backed securities market driving mortgage rates and spreads to all-time lows, the incredibly high correlation was a strong signal that accommodative monetary policy was the prime suspect in the 20% house price appreciation. In looking through the 20 Cities charts, the decline in correlation is evident and we would categorize price appreciation into three categories: still surging — Atlanta, Charlotte, Dallas, Miami and Tampa. Losing momentum — Chicago, Denver, Detroit, Las Vegas, Los Angeles, Phoenix, Portland, San Diego, San Francisco and Seattle. Past peak appreciation — Boston, Cleveland, Minneapolis, New York and Washington DC. Given the way CPI and PCED capture house prices, it will take roughly 6 months for the loss of house price momentum and rents to feed into their shelter costs, however, the comps when rent moratoriums were depressing these measures will begin to fall out of the annualized rates.

S&P Core Logic 20 City House Price Correlation & Prices

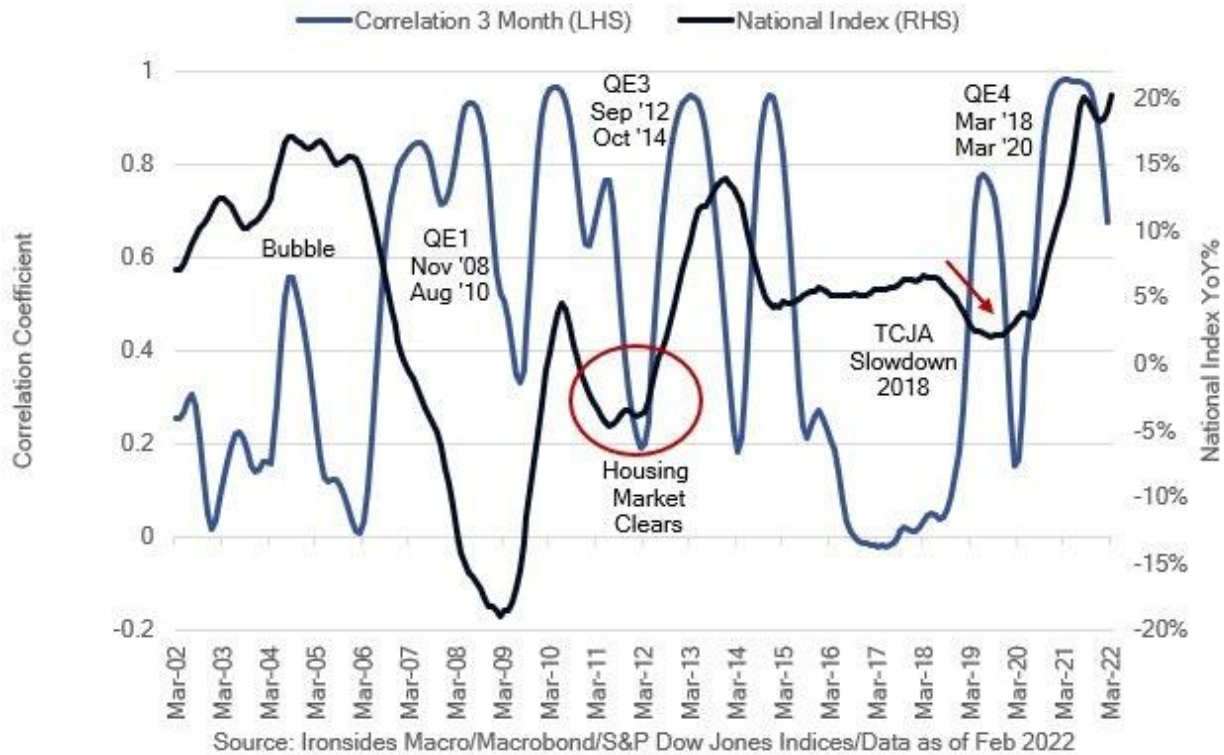


Figure 2: House price correlation was never higher than when the Fed was accumulating 1/3 of the agency MBS market driving rates and spreads to all-time lows. Correlation doesn't prove causation, but if it looks like a duck...

Wages Peaking

Unlike many of the employment reports during 2021, this report was weaker than the headline. The more volatile, but occasionally leading, household survey lost 353,000 jobs amidst a drop in the labor force of 363,000. The number of workers that went from employed to out of the labor force came in at 5.04 million, which was the highest number since the depths of the pandemic, and well above the 2021 average of 4.59 million. Measures of slack from this report that are components of our slack index, U3 unemployment and the duration of unemployment, were at best unchanged. The others, including, participation rates, employment ratio, U6 underemployment, and short term and long-term unemployment, indicated additional slack. The drop in the participation rate was widespread, there was a drop in both prime age and over 55 workers. Even with the drop in participation the establishment survey's 428,000 increase, if it holds up after revisions, implies there is additional slack notwithstanding our index being at all low

levels of slack. It all comes down to price and there the news was favorable in terms of the Fed's inflation process. Nonsupervisory average hourly earnings were 6.39% from 6.59% in March, a downward revision from 6.75%. Service sector earnings peaked at 7% in January, in April was 6.6%. Manufacturing, despite decent hiring gains and a large open job to hiring gap in the March JOLTS report, slipped to 5.5% from 5.6% in March. Consequently, if wage growth continues to ease there is every reason to expect the Fed to slow the rate hike process in 3Q.



Figure 3: Wages were rising pre-pandemic and we suspect the settle to a higher trend post-pandemic. The key is whether we get the productivity boom we expect. In a related note this week's 1Q productivity report was as distorted as the prior week's GDP report. It is of course a residual of GDP and hours worked.

Price Stability

Our broadest measures of price stability, namely the standard deviation of headline inflation and inflation surprise, has peaked, while our measure of breadth, persistent and policy effects, correlation, has likely peaked. While we do not expect a return to the '00s and '10s disinflationary ~1.5% core personal consumption deflator trend, nor do we expect the Fed to push as hard from above their 2% target as they did from below, we also do not think they should. The Fed's mandate is price stability, and concerns about

policy limitation at the effective lower bound for the policy rate (floor of zero) led to a single point 2% target that we believe was a mistake. Two of the longest business cycles with the strongest capital investment and productivity were the '60s and the '90s. In both cases inflation volatility was low, trend inflation in the '60s was roughly 1.5%, while in the '90s trend was closer to 3.5%. In other words, it is not the level that matters, it is price stability. Ultimately, what ended price stability in the '60s was fiscal policy, but for some reason (politics), fiscal policy seems to be getting a free pass in terms of complicity in creating price instability. Congress and the Administration are responsible for the March 2021 \$1.9 trillion stimulus package that ignited demand in supply constrained interest rate sectors. The Treasury for their part injected an additional \$1.7 trillion into the banking system by reducing issuance and running down their account at the Fed. The Treasury issuance plans are now reversing that impulse by reducing coupon issuance by less than the Fed's QT plans. The Fed, Treasury, Congress and the Administration overreaction to the pandemic caused price instability, opposition to Build Back Better, Treasury issuance that adds duration, Fed balance sheet contraction are all more direct approaches to unwinding the policy mistakes than simply raising the policy rate.

Price Stability - CPI Volatility

— United States, Consumer Price Index, StdDev(All Items, 12)

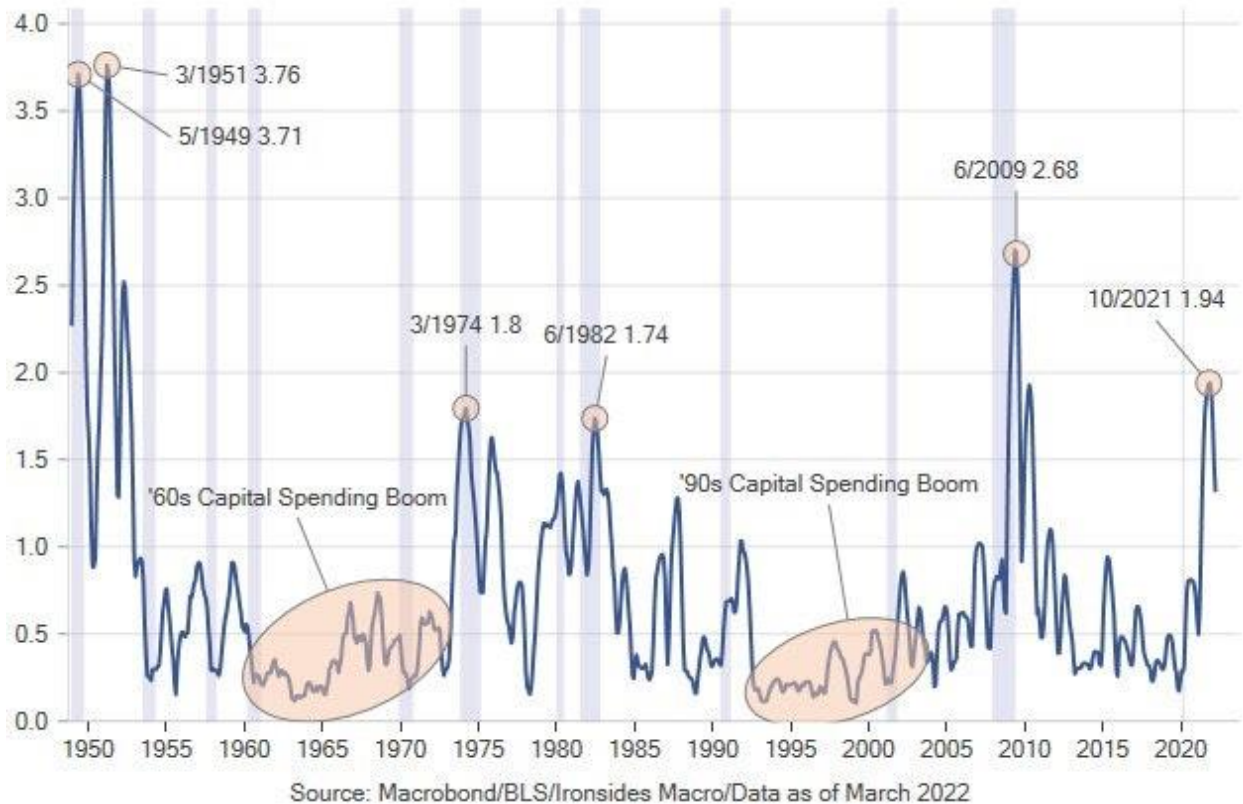


Figure 4: Next Wednesday's April CPI report is likely to show further goods prices deceleration.

Valuation Comeuppance

During the '22 Fed policy normalization related correction, equity market valuation has compressed from a 4.4% earnings yield to 5.5%, however our credit spread equity risk premium deflated with the University of Michigan 5-year inflation survey, has contracted from 4.1% to 3.5%. Although we removed TIPS yields from this model to mitigate distortions from Federal Reserve large-scale asset purchases (100% of net supply during QE4), the impact of Fed purchases on investment grade credit explains the smaller equity risk premium despite the sharp increase in the earnings yield (lower PE ratio). It also appears that the QE era contributed to a higher equity risk premium, this is likely to be attributable to transitory QE effects. In other words, QE also suppressed yields on investment grade credit. Much as consumption-based fiscal stimulus (checks) pulls demand forward but doesn't structurally increase the longer-term trend, QE does not appear to structurally change equity market valuation. This was evident during the '10s

over the eight monetary policy normalization corrections, every prior business cycle had only one Fed normalization shocks. Said differently, the equity risk premium exhibited mean reversion characteristics until the QE era increased the implied risk of equities relative to credit. This is not how the portfolio balance channel is supposed to work, and it appears that the effects are more significant in fixed income than equities. Following the 15% correction, equity standalone valuation is marginally richer than the 30-year median while the risk premium is above the median, and marginally below the trend. If the QE era is really ending, the equity risk premium may actually become useful.



Figure 5: Earnings yields always look low in recessions; the exception was the most extreme valuation in history during the TMT bubble.

The valuation comeuppance, while brutal for holders of the 'megacap' technology platform companies, the technology, consumer discretionary, communications services, staples and utilities sectors have not yet erased their premium relative to the equal weighted S&P 500 and economically sensitive sectors. Given our view that the equity market has had an appropriate adjustment to monetary policy normalization, the overvalued sectors are likely to grow into their multiples without further price declines. Given our views that inflation has peaked, the private sector is relatively immunized against the effects of higher financing rates and the Fed is likely to slow the rate policy

path before the reach our estimate of the neutral rate in 3Q22, we continue to prefer cyclical sectors.

US Equity Market Valuation Index/Sector	PE	Fwd PE	P/S	P/B	EV / Sales	EV / EBITDA	Z-score	Ironsides Strategic		ERP	ERP Z-Score
								Recommendation	ERP		
SPX	20.79	18.14	2.56	4.10	3.01	14.36	1.02	Market	5.27%	-0.14	
SPW (equal weight)	19.88	16.23	1.75	3.11	2.29	13.11	0.75	Overweight	5.88%	-0.40	
Discretionary	33.71	24.91	2.19	9.13	2.57	17.42	1.87	Market	3.77%	0.06	
Financials	12.52	13.16	2.38	1.53	2.57	7.22	-0.41	Overweight	7.30%	-0.45	
Technology	26.47	22.76	5.97	8.87	6.42	19.11	1.40	Market	4.17%	0.12	
Comm Services	16.98	15.57	2.78	3.15	3.61	11.36	0.85	Market	6.17%	-0.32	
Industrials	24.51	19.03	2.04	5.01	2.46	15.02	1.34	Overweight	4.98%	-0.08	
Materials	15.68	14.23	2.07	3.09	2.55	11.16	0.80	Market +	6.67%	-0.85	
Energy	14.84	10.06	1.39	2.59	1.64	8.93	0.51	Overweight	9.85%	-1.60	
Healthcare	18.75	15.73	1.83	4.86	2.08	15.03	0.03	Overweight	6.09%	-0.28	
Staples	22.55	22.29	1.70	6.82	1.99	16.37	1.67	Underweight	4.27%	0.21	
Utilities	22.18	20.89	2.73	2.31	4.62	14.94	2.49	Underweight	4.58%	0.66	
Real Estate	43.94	40.83	7.66	7.66	10.54	23.67	0.47	Underweight	2.20%	2.95	
Russell 2000	62.49	20.41	1.17	2.39	61.12	2.07	0.32	Overweight	4.70%	-0.78	

Source: Bloomberg/Ironsides Macro/Data as of May 2022

Figure 6: The equal weighted S&P 500 and cyclical sectors are cheap on a PE basis.

Measures of Risk	Standard		Max	Min	Current Z-score	Implied Risk
	Median	Deviation				
S&P 500 Volatility Index (VIX)	17.46	8.12	82.69	9.14	31.40	High
S&P 500 Vol of Vol Index (VVIX)	90.70	17.11	207.59	59.74	117.57	High
S&P 500 Term Structure (6m-1m)	2.80	4.23	10.85	-40.45	-1.80	High
S&P 500 Skew Index	119.01	9.42	170.55	104.09	128.65	High
Treasury Vol (MOVE)	88.42	28.32	264.60	36.62	122.72	High
FX Vol (JPMVXYGL)	9.83	2.44	27.02	5.18	11.05	Average
BB&D Policy Uncertainty	83.96	78.35	807.66	3.32	111.59	Average
Lehman Corporate OAS	1.14	0.77	6.18	0.51	1.34	Average
Lehman High Yield OAS	4.41	2.51	19.71	2.33	3.92	Average
EEM Volatility Index	21.04	6.49	92.46	13.28	31.31	High
Median Across Asset Classes					0.91	Above Average

Source: Bloomberg/Ironsides Macro/Data as of May 6, 2022

Figure 7: The VIX term structure reached the key 300bp inversion (backwardation) level a couple of times last week.

Key Investable Themes & Asset Allocation:

- **Deglobalization & Capital Spending Boom: Industrials, Semis**
- **Reflation: Materials, Financials, Energy, Small Caps**
- **Technology Innovation Diffusion: Healthcare, Industrials and Financials**
- **Fed Balance Sheet Contraction: Short Duration, Curve Steepeners, Long-term Fixed Income Volatility (PFI)**
- **Global Equity Allocation: Overweight US equities, underweight export dependent economies (China, Germany, Japan)**

- ***US Asset Allocation: Overweight equities, underweight fixed income spread products, use cash as your risk reducer. Reduce cash, add equities.***
- ***Portfolio Hedging: Credit protection***

Barry C. Knapp

Managing Partner

Director of Research

Ironsides Macroeconomics LLC

908-821-7584

bcknapp@ironsidesmacro.com

<https://www.linkedin.com/in/barry-c-knapp/>

@barryknapp

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