Inflation Lights a Political Fire

Inflation Politics, QT is not the same as QE, liquidity vs duration, CPI details

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Goods Inflation Peaked, Services and Political Heat Still Rising

As we reflected on Friday morning's events, the more we thought about it the more we concluded that the more important report was the University of Michigan Consumer Sentiment Survey plunging to an all-time low, rather than the hotter-than-expected May CPI report. We have long viewed consumer confidence surveys as far more useful in forecasting elections than consumer spending. Plunging confidence, Presidential approval and direction of the country polls are all being driven by inflation. There's always a crisis in Washington, but this time it's a big one and the public appears to tie inflation directly to 2021 fiscal and monetary policy stimulus. As we will explain later, the CPI report did not significantly alter our view that inflation has peaked. Goods inflation, the direct result of overzealous pandemic non-pharmaceutical interventions, is slowing quickly. However, inflation resulting from the excessive US fiscal and monetary stimulus that turbocharged demand for interest rate sensitive housing and autos drove faster than expected all items (headline) and core inflation. While these sectors are most responsive to monetary policy, it works with long and variable lags. In the meantime, the evidence of a political crisis in the University of Michigan Survey may well, and perhaps should, push the FOMC to accelerate the front-loading of rate hikes.

We have long argued that the evolution of Fed communication strategy has been counterproductive. The 2004-2006 measured removal of policy accommodation exacerbated the malinvestment cycle, forward guidance and QE in the '10s impaired capital investment by creating a series of mini booms and busts in business confidence.

With consumer confidence at all-time lows due to the highest inflation in 4 decades and business confidence on a similar trajectory, the Fed desperately needs to restore credibility following their massive 2021 policy mistake. We suggest channeling the Volcker Fed with a hawkish surprise: not with forward guidance, instead with policy action. We would prefer they pull forward maximum balance sheet contraction caps and sell mortgages outright; but the more likely, though still not probable outcome, would be a 75bp policy rate hike. As we explain in this week’s note, QT is considerably more passive than QE particularly in terms of the impact on longer term rates. The Fed’s balance sheet is a potentially potent tool to cool excess demand in housing and autos if they would only use it.

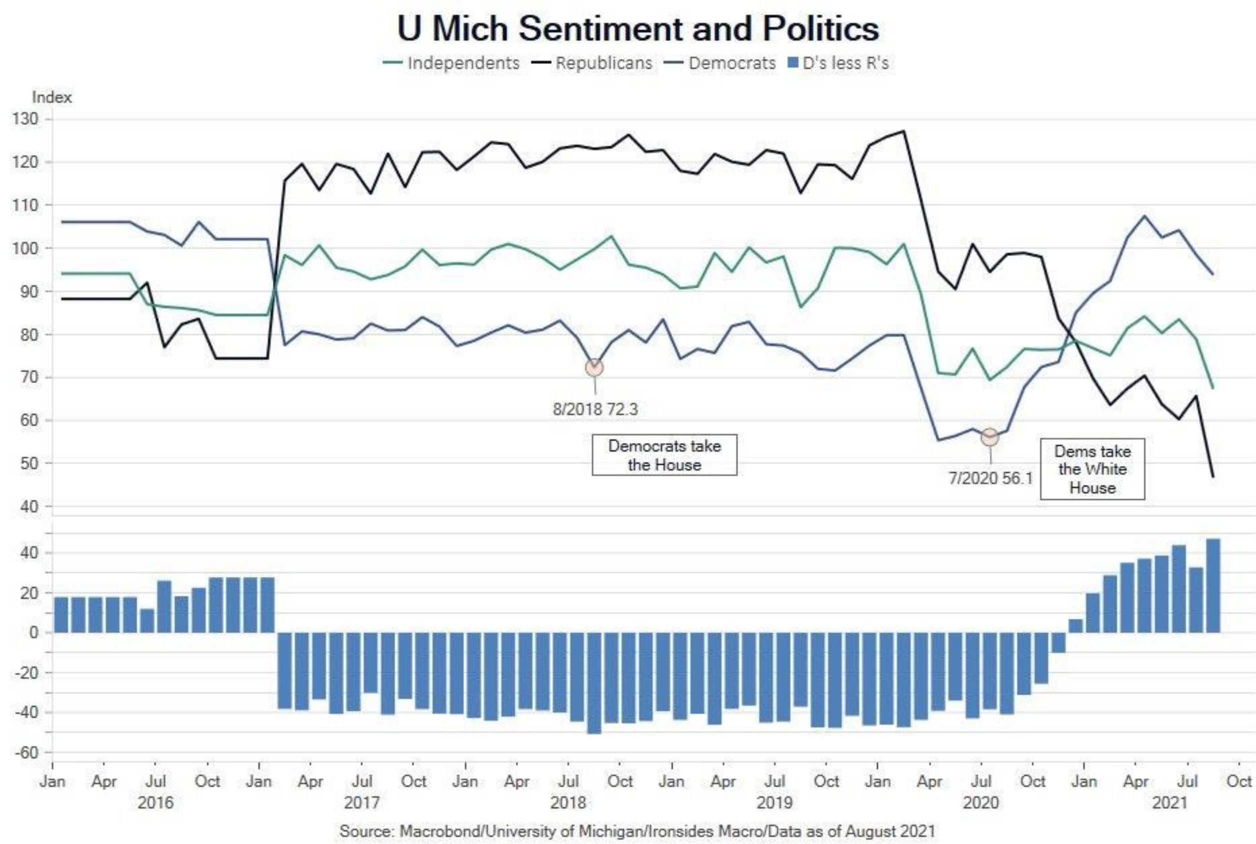

Figure 1: The weakest consumer sentiment amidst the tightest labor market in decades is almost exclusively attributable to inflation and the massive fiscal and monetary policy mistakes that exacerbated pandemic supply shocks. The party affiliation with weaker confidence is generally that one that turns out on election day, the Democrats appear headed for drubbing in November.

The rates market reaction to Friday’s report reflected both an increased probability of a policy response and a peak in direct pandemic related inflation, as well as the impact of tighter monetary policy. Specifically, front-end rates increased sharply, 2-year Treasuries were 24bp higher at 3.05% on Friday afternoon. At the same time, the 2s10s inflation curve disinverted further by 19bp to -1.59%. 5-Year, 5-Year forward breakeven inflation (2026-2031) fell 3bp and is close to the Fed's target. Recall, the deep inversion of the 2s10s inflation curve is what drove the brief inversion of the nominal 2s10s curve in early April. In other words, yield curve inversion was predicting peak inflation, not a recession. Despite this evidence that inflation is indeed peaking, the political risk for the Fed is at its maximum since the Volcker, Burns and Martin Feds. The two-day slump in equities at the end of the week and continued increase in earnings estimates put the S&P 500 forward multiple at 17.1 and for the equal-weighted index, 15.4. The 30-year medians are 16.7 for the cap weighted and 16.6 for the equal-weighted S&P 500 indices, underscoring how mega-caps remain rich ahead of a massive annual Russell rebalance (~$120 billion) on June 24th. This is where the largest stocks will come under pressure as they are sold to fund purchases of additions to the index with larger market capitalization than the stocks being deleted from the index. We brought this up for strictly tactical purposes, our strategic approach to equities is unchanged. We expect the equities to recover their 1H22 losses in the second half led by economically sensitive cyclical sectors. Given our outlook for inflation, this week's FOMC meeting is likely to mark a peak in tightening expectations, equities could and should bounce following the meeting.

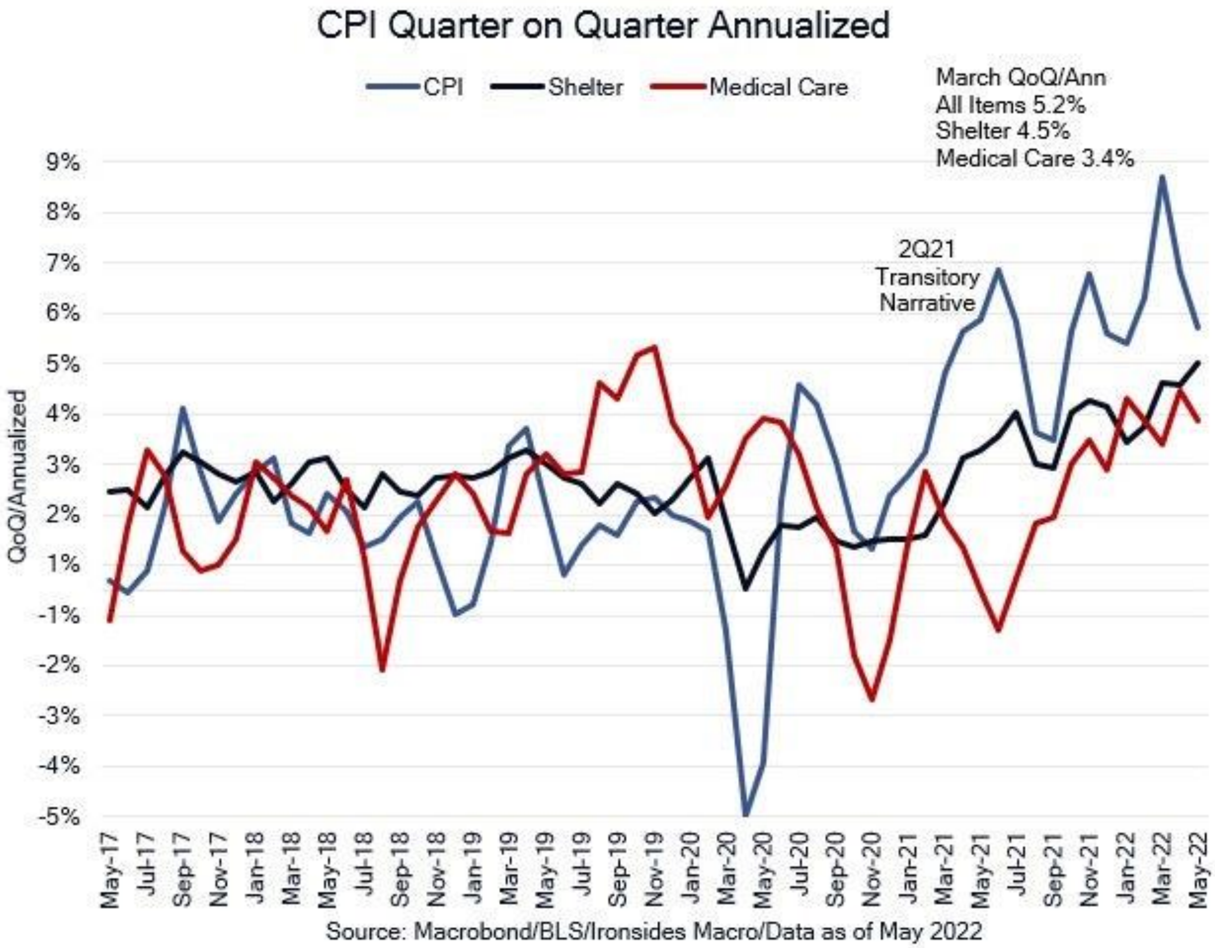

Figure 2: In 2Q21, the transitory narrative was crushed by strong momentum. A year later, momentum has turned down sharply but has some ways to go due as the long and variable lags in policy are pushing up housing inflation due to last year's ill-advised QE.

Central Banks and Yield Curves

With the ECB preannouncing their first hike in 11 years in July and the end of negative rate policy in September, the Bank of Japan is the final remaining major central bank hanging on to unconventional policy easing. This, despite a major squeeze on the Japanese economy as the price of crude rises sharply in dollars and the yen depreciates. BOJ policy is seemingly oblivious to the end of the era when Japan ran large merchandise trade surpluses and benefited from a weaker dollar/yen exchange rate, though on Thursday night there was verbal intervention from the Ministry of Finance, Financial Services Agency and BOJ. In Europe, as the ECB began the process of ending their counterproductive (weak bank profitability and liquidity traps) negative rate policy, periphery spreads (Italy) widened sharply. ECB President Lagarde responded to questions on sovereign spreads by stating 'we will not tolerate fragmentation that would prevent monetary policy transmission throughout the Euro region'. Weak Treasury auctions in the US, sovereign spread widening in Europe, and weakness in the yen are all indicative of the prisoner's dilemma that is driving central banks that eased during the pandemic using QE, to tighten using rate policy. In the US and Europe, even as the Fed and ECB hiked rates, both banks continued to reinvest maturing bonds from their massive holdings and BOJ has defended every attack on yield curve control. As we discussed two weeks ago in our note [The Misunderstood Macro Environment], in a section titled, 'Let the QT Commence', the primary liquidity shock in the US resulting from the actions of the Treasury is behind us and the Fed's QT, even at nearly twice the pace of the '17 and '18 process, is rather passive.

"Furthermore, there is some evidence that increases in longer-term interest rates may have smaller effects on macroeconomic outcomes when they originate from increased term premiums than when they originate from increased expectations of the policy rate."

[Substitutability between Balance Sheet Reductions and Policy Rate Hikes: Some Illustrations and a Discussion]

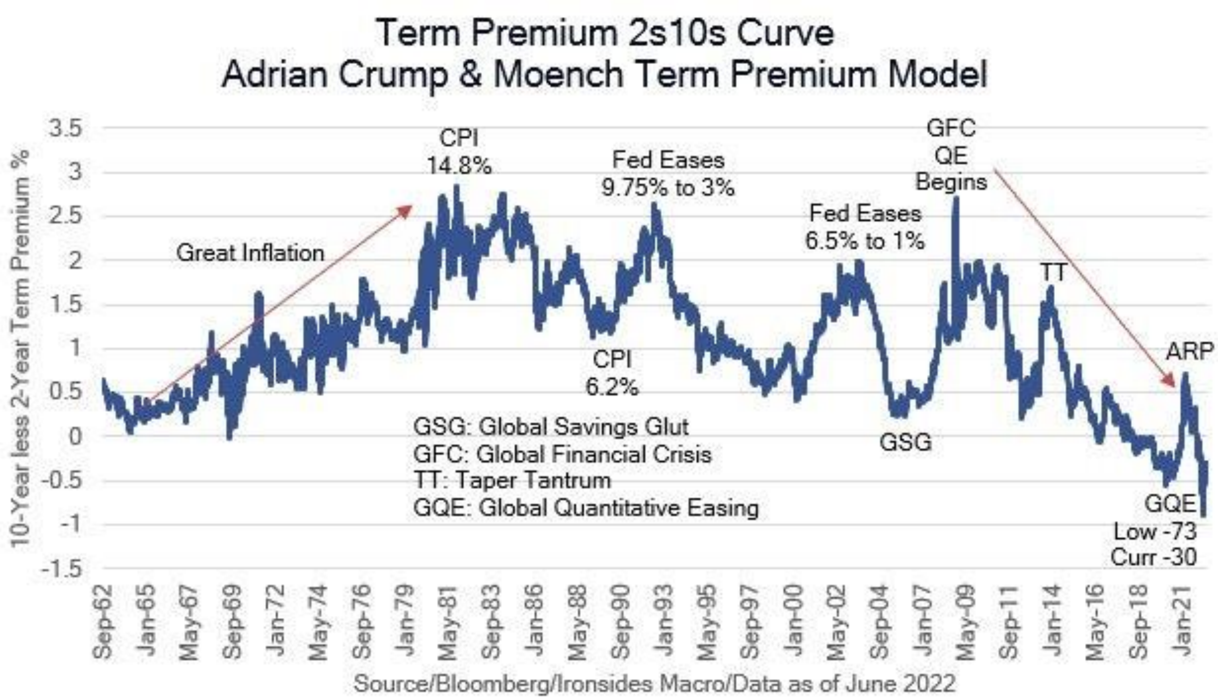

Figure 3: In the Fed Research note above, staff estimates that a 1% of nominal GDP reduction in Fed

holdings will increase 10-year term premium by 10bp. During the post-financial crisis QE era, 2-year term premium declined from 80bp to -75bp, 10-year term premium plunged from 275bp to -118bp.

QT: Liquidity and Duration

When Fed researchers conclude that QE is more efficacious than QT, their logic is circular in that the impact on financial conditions is a function of differences in how QE and QT are implemented. QE, while structured and transparent, is anything but passive with respect to duration. The average duration of pandemic QE purchases was 6 years for Treasuries and 7 years for agency mortgage-backed securities (MBS). Said differently, during QE the Fed aggressively removes duration from the market. QT does effectively sell duration, but only from MBS paydowns estimated at a current linear pace of $15-$20 billion per month due to ~95% of the MBS universe having a negative refinancing incentive. The Fed's Treasury holdings duration shortens linearly with time, but the portfolio is only reduced by allowing securities to mature. While this may seem obvious, QE flattens the yield curve through large duration asset purchases, and the QT curve effect is asymmetric in that maturing Treasuries puts upward pressure on short term rates and the slower pace of mortgage prepayments and the Fed's balance sheet caps puts far less upward pressure on long term rates than QE. In other words, QT is unlikely to reverse the yield curve flattening effect of QE. Since monetary policy works best through reducing demand for interest rate sectors, their approach to QT is misguided and likely to be inefficacious. Given the passivity of balance sheet contraction 'running in the background', we suggest when considering the effects of QT, differentiating liquidity - short duration interest bearing assets - from duration.

Figure 4: Mortgage spreads are wide and implied volatility is high reflecting market expectations of QT. Unless the Fed is willing to restructure QT and more aggressively unwind QE, mortgages are attractive.

As we detailed two weeks ago, liquidity injections from the Treasury in 2021 were 25% greater than total Fed asset purchases in half the time. In the first 4 months of 2022, the Treasury drained $900 billion, and while the Fed plan is for $523 billion over 6 months, more likely they will remove closer to $400 billion. The Fed actually removed $1.54 trillion of securities with an average duration of 6-7 years in 2021, in 2022, at current prepayment rates the Fed's mortgage portfolio will only contract by roughly $125 billion. Were the Bank of Japan to follow the Fed and ECB down the passive path of reducing their bond portfolio by ending yield curve control they would still likely continue buying and reinvesting maturing securities. We are negative Treasuries, they remain exceptionally overvalued due to central bank asset purchases. That said, the central bank bark is way worse than their bite. We expect rates to grind higher during QT, but the liquidity shock and repricing of the rate policy path is likely to prove significantly more impactful than the effect of passively unwinding duration on risky assets and more specifically, equity market valuation.

Despite our aversion to Treasuries, the mortgage market looks more attractive. We were sent a street note recommending mortgage REITs (MREITs), and we also read a thoughtful analysis on the favorable convexity (interest rate risk) of the mortgage index by the creator of the MOVE Index and Simplify Interest Rate Hedge ETF (PFIX), the Convexity Maven Harley Bassman. Given the sharp widening of the mortgage spread to swap rates, passive nature of QT, convexity profile of the mortgage market. limited leverage and valuation, MREITs are worth a look. This week's Fed meeting may provide a decent entry point as they are likely to reach peak hawkishness.

Total Bank	Prior Year Growth	YTD Change	YTD Annualized	Prior Quarter Growth	Current Quarter Change	Current Quarter Annualized
Total Assets	9.41%	-0.10%	-0.22%	-0.38%	0.39%	1.56%
Bank Credit	9.39%	3.46%	7.81%	2.01%	1.33%	5.30%
Securities	22.46%	1.82%	4.11%	2.31%	-0.43%	-1.72%
Loans	3.29%	4.36%	9.86%	1.84%	2.30%	9.19%
C&I Loans	-5.39%	4.97%	11.24%	1.48%	3.05%	12.21%
Real Estate Loans	2.91%	3.73%	8.43%	1.46%	2.04%	8.18%
Residential Loans	0.64%	3.86%	8.73%	1.30%	2.38%	9.53%
Consumer Loans	8.35%	6.24%	14.11%	3.77%	1.49%	5.97%
Cash	15.81%	-24.88%	-56.26%	-17.57%	-9.88%	-39.51%
Deposits	11.97%	0.95%	2.16%	0.69%	0.30%	1.22%
Loan/Deposit	-7.75%	3.38%	7.63%	1.14%	1.99%	7.95%

Source: Macrobond/Fed/IM

Figure 5: The contrast between growth in securities, cash and loans in 2022 relative to 2021 sets the banks up for higher return on assets and equity.

Last year's massive liquidity injections were counterproductive for the banking system due to monetary and regulatory policy working at cross purposes. Bank cash assets increased from $1 trillion pre-pandemic to $2.9 trillion in August 2021, the loan to deposit rate fell to the lowest level in at least 50 years, bank securities holdings surged, and large banks were forced to raise expensive debt capital after the Fed ended the pandemic exemption of cash and Treasuries from the supplementary leverage ratio. In 2022, reserves held at Federal Reserve Banks have declined by $1 trillion mostly due to the Treasury. Based on the growth of the Fed's reverse repo program assets, it seems that banks are happy to let deposits flow to money funds. Bank credit is growing at a similar rate, though rather than building cash assets and securities, loan growth has tripled with commercial & industrial, consumer and real estate all growing rapidly. This is very similar to the last aggressive rate hike cycle in 1994. In '95, banks rallied sharply.

The Consumer Price Index

Despite the faster than expected monthly and annualized all items (headline) and core rates, the peak inflation thesis due to a rapid deceleration in goods prices remains intact. Core goods price inflation, despite a strong month for auto prices, slowed to 8.5% from a peak of 12.4% in February. On Thursday night, China reported May manufacturing PPI of 6.4%, down from 8% in April and an October 2021 peak of 10.8%. In short, inflation resulting directly from pandemic disruptions of global supply chains is falling. Faster than expected all items and core inflation are attributable to the surge in energy prices, and excess demand in housing and autos resulting from the excessive pandemic fiscal and monetary policy response. Shelter inflation, reflecting white hot house prices and rents, are increasing 4.5% quarter-on-quarter annualized. Transportation, largely reflecting vehicle prices, has slowed from 23.6% q/q annualized to 6.5% in May despite a 2% monthly increase. The good news is that these are also the most interest rate sensitive sectors, implying tighter monetary policy will slow inflation in these categories in coming months. A year ago, when the transitory narrative was collapsing, the quarter-on-quarter numbers were surging, now quarter on quarter annualized headline CPI has fallen from 8.2% in March to 5.2% in May. Our bread measure, derived from our covariance matrix, the 3-month average of correlation of the 20 largest contributors to CPI continued to decline from the February and March peak of .36 to .30 in May. This reflects peak goods inflation and the waning effect of the excessive 2021 fiscal and monetary stimulus that turbocharged aggregate economic demand. In summary, inflation has peaked, however questions about how whether the underlying trend is above or below our key threshold of 4% will linger at least through the summer. The biggest risk to our longer-term forecast that the ‘20s are likely to follow the ‘60s reflation analog, and not skip straight to the ‘70s, is a renewal of energy price pass-through of that era.

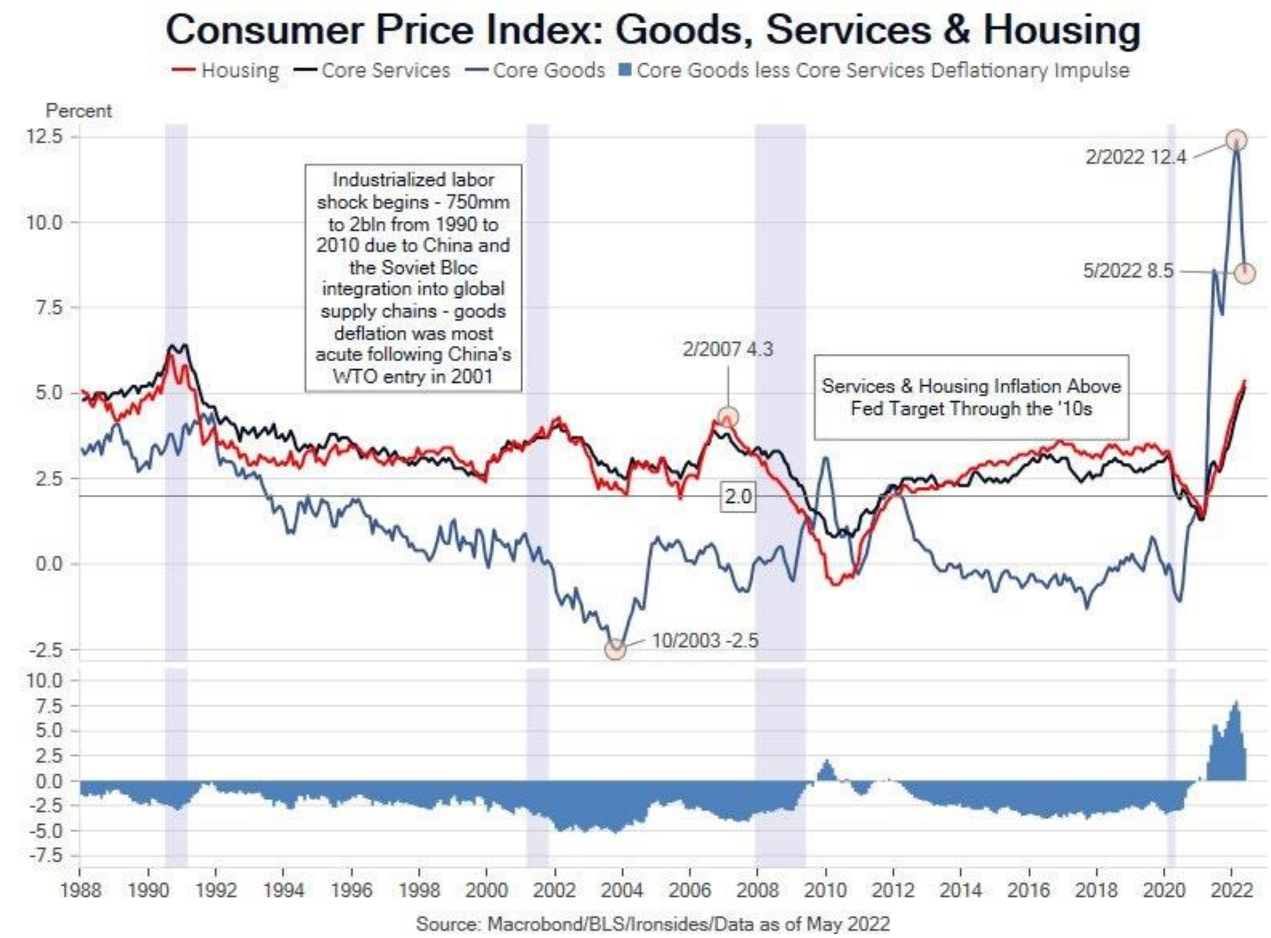

Figure 6: Goods prices are coming down quickly while the lagged effect of 2021 easing is still putting upward pressure on housing and core services prices.

Measures of Risk	Median	Standard Deviation	Max	Min	Current	Z-score	Implied Risk
S&P 500 Volatility Index (VIX)	17.52	8.13	82.69	9.14	28.70	1.38	High
S&P 500 Vol of Vol Index (VVIX)	90.89	17.12	207.59	59.74	101.73	0.63	Above Average
S&P 500 Term Structure (6m-1m)	2.80	4.23	10.85	-40.45	0.79	0.47	Above Average
S&P 500 Skew Index	119.06	9.40	170.55	104.09	120.66	0.17	Average
Treasury Vol (MOVE)	88.67	28.34	264.60	36.62	105.29	0.59	Above Average
FX Vol (JPMVXYGL)	9.83	2.44	27.02	5.18	10.68	0.35	Average
BB&D Policy Uncertainty	83.99	78.23	807.66	3.32	104.24	0.26	Average
Lehman Corporate OAS	1.15	0.77	6.18	0.51	1.32	0.22	Average
Lehman High Yield OAS	4.39	2.50	19.71	2.33	4.28	-0.04	Average
EEM Volatility Index	21.16	6.50	92.46	13.28	25.95	0.74	Above Average
Median Across Asset Classes						**0.48**	**Above Average**

Source: Bloomberg/Ironsides Macro/Data as of June 10, 2022

Figure 7: The 2-day slump in equities raised measures of risk but not to levels near their 2022 peaks. We suspect this is attributable to broad derisking of equity portfolios.

US Equity Market Valuation Index/Sector	PE	Fwd PE	P/S	P/B	EV / Sales	EV / EBITDA	Z-score	Ironsides Strategic Recommendation	ERP	ERP Z-Score
SPX	19.55	17.13	2.42	3.89	2.87	13.72	0.76	Market	5.47%	-0.25
SPW (equal weight)	18.85	15.38	1.67	2.98	2.22	12.63	0.34	Overweight	5.98%	-0.49
Discretionary	30.63	23.45	1.97	8.47	2.36	16.09	1.54	Market	3.90%	0.00
Financials	11.69	12.55	2.24	1.44	2.39	6.77	-0.53	Overweight	7.60%	-0.60
Technology	24.28	21.06	5.49	8.18	5.97	17.79	1.16	Market +	4.38%	0.04
Comm Services	16.14	15.20	2.64	3.00	3.47	10.95	0.70	Market	6.22%	-0.34
Industrials	23.35	17.99	1.94	4.77	2.39	14.53	1.12	Overweight	5.19%	-0.18
Materials	15.16	13.40	2.00	2.99	2.48	10.67	0.63	Overweight	7.10%	-1.07
Energy	15.57	9.80	1.48	2.75	1.80	9.76	0.71	Overweight	9.84%	-1.58
Healthcare	18.06	15.27	1.77	4.71	2.04	14.53	-0.06	Overweight	6.19%	-0.31
Staples	20.94	20.77	1.56	6.44	1.85	15.38	1.17	Underweight	4.45%	0.08
Utilities	21.52	20.76	2.73	2.33	4.68	14.73	2.42	Underweight	4.45%	0.76
Real Estate	39.41	36.24	7.14	7.14	10.15	22.43	-0.21	Underweight	2.39%	1.97
Russell 2000	47.84	18.94	1.10	2.25	46.19	1.95	0.09	Overweight	4.68%	-0.66

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

Figure 8: Cyclical sector valuation is exceptionally attractive.

Key Investable Themes & Asset Allocation:

- ***Deglobalization & Capital Spending Boom: Industrials, Semis***
- ***Recession Resistance: 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 (PFIX)***
- ***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***

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