CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

February 9, 2023

Some Things are Quite Uncertain, Some are Rather More Certain

The strikingly high jobs number from last week is dubious. It is contradicted by the companion ADP report and by other employment reports of recent months.

We will only know how accurate it is after we see the reports in the next couple of months.

Quite Uncertain: On Friday of last week, the Bureau of Labor Statistics (BLS) issued its monthly employment report. Its headline number showed 517,000 new jobs created in the previous month, a staggeringly large and utterly unexpected increase. It was unexpected because, in recent months, numbers of new jobs were decreasing and aggregate hours worked were falling. Moreover, the other monthly jobs report (compiled by payroll service company ADP and issued on the Wednesdays before the Friday BLS reports) showed private payroll job increases of 106,000. Note that the historical correlation between ADP numbers and BLS numbers is 98%. (100% reflects complete correlation and 0% means complete non-correlation.) Something is probably wrong here, either the BLS number or the ADP number. I suspect strongly that the BLS number is the outlier. An additional point: the jobs reports reveal that all the growth in new jobs since May 2022 has been in part-time jobs. There have been, according to the Labor Department, no net new full-time jobs since May. The reports also show very large numbers of people working part-time because of economic necessity. It seems that many folks who seek a full-time job cannot find one. This does not augur well for the general economic health of our country. I suggest that last Friday's employment report has significant uncertainties. We shall see.

What are the odds of a recession this year? Although the stock market has traded this year as if only sunny skies are ahead, the bond market indicates that a recession is at hand.

Rather More Certain: A recession. There is a very good indicator of future economic activity: the difference between the yield on the 10-year Treasury bond and the 3-month Treasury bill. Normally, as you will not be surprised to read, the yield on a long-term bond, e.g., the 10-year Treasury note, exceeds that of the yield on short-term borrowing, e.g., the 3-month Treasury bill. As a creditor, one wants to earn more on a loan that will not be repaid for a long time, because of the uncertainties about the future. Even the world's most credit-worthy borrower, the United States, generally pays more to borrow money for a long time than it does to borrow for three months. At present, however, the yield on the 10-year Treasury bond is 3.65%, whereas the yield on the 3-month T bill is 4.59%, almost a full percentage point higher than the Treasury bond. What gives?

The Federal Reserve Board has been raising the short-term rates it directly controls very aggressively since last March, in order to bring down the rate of inflation. A year ago, the 3-month T bill yielded 0.28%. The Fed has deliberately pushed it far higher in order to slow economic growth. Slower growth cuts demand for goods and services; as demand falls, price pressures for those goods and services fall as well. The rate of inflation comes down. But wait! If demand for goods and services falls, isn't our economy weakening? Aren't people going to lose their jobs in a weaker economy? If the economy weakens and people lose jobs, will not the cost to borrow for the long term come down? Yes, because the demand for that long-term borrowing goes down. As the demand for it goes down, so does its yield.

By

Jack Mayberry

We recently changed our post office box in Sausalito to PO Box 866.

Consider the inversion of the 10-year to 3-month yield curve.

Recessions always follow such an inversion, and there has never been a recession in the last fifty years except after inversion of this yield curve.

A pretty good economic indicator.

Back to this 'good indicator' referred to above, the difference between the yield on the 10-year and the yield on the 3-month. It is 'inverted' now, that is, the yield on the 3-month bill far exceeds the yield on the 10-year. Has this happened before? Yes, eight times since 1968. After each of the eight 'inversions' came a recession. And, guess what, there have been only eight recessions since 1968. Every inversion preceded a recession and no recession occurred without the inverted yield curve. Thus, it is a fair inference—no, no, a rather certain inference—that the American economy is headed into a recession. (Another indicator of recession is that the Conference Board's Leading Economic Indicators has fallen for each of the last ten months, at an annualized rate of -7.1%. Has this ever happened before? Yes, but only when a recession was at hand.)

In short, I think the very robust jobs report last Friday is probably not a terribly good representation of the health of US employment market, whereas the inversion of the 10-year to 3-month yield curve suggests that a recession is quite certain.

It's simple:

Bond prices rise in recessions.

Stock prices fall in recessions.

What does a recession portend for Core's investments? Two things. Firstly and as discussed above, the yields on long-term bonds fall in recessions. Because prices of bonds move inversely to their yields, as yields fall, bond prices rise. It is worth pointing out that the level of inflation does not matter. Bond prices rise when inflation is high in recessions, as in the 1970s. Bond prices rise in recessions when inflation is low, as in the Great Financial Crisis of 2007 to 2009.

We are not there yet. Bond prices are rising and they will rise further. Stocks have risen in the early weeks of this year, but a trap door will open beneath the stock market.

The Fed will keep tightening, recession will unfold; the stock market will fall a good deal lower.

Secondly, stock prices always fall in recessions. This makes perfect sense: as economic activity falls, people buy less, businesses cut prices for their goods and services, and corporate profits fall. With falling profits offering less support for the ownership interests in the businesses, their stock prices fall. As of this week, more than half the 500 big companies of the S&P 500 have reported their most recent quarterly profits. The profits are down by five percent from a year earlier. Wait until we have a recession and see how far profits fall.

The role of the Fed. As noted above, the Fed began to tighten monetary policy in March last year. The Fed has raised the Fed funds rate—a short-term rate it controls directly—from the range of 0% to 0.25% where it subsided since the onset of Covid, to the present range of 4.50% to 4.75%. This is the most forceful bout of monetary tightening since Paul Volcker's term as Fed chair in the early 1980s, when inflation was very high, partly as a result of the Arab Oil Embargo in the 1970s. As Jerome Powell, the present Fed chair reminds us, Mr. Volcker's Fed was successful in lowering inflation. He is quieter about some aspects of his inflation fighting, namely back-to-back recessions in 1980 and again in 1981-1982 that cost many people their jobs and caused a brutal bear market in stocks.

As discussed in previous letters, the Fed will, in time, pause its relentless rate increases. After that, presumably in the context of much lower inflation and a recession, the Fed will begin to cut rates once again. (These are cycles, after all, economic cycles and monetary easing and tightening cycles.) The Fed's pause and its subsequent pivot to rate cutting will give rise to sharp, if brief, stock market rallies. History shows us, however, that ultimate lows in bear markets like this one do not occur until we are deep into recession and deep into the Fed's easing cycle. Fed chairman Powell and other Fed governors make it clear that the Fed's tightening that began last March will continue all this year and into 2024. Perhaps monetary easing will come sooner than the Fed says; most market participants expect that. However that may be, it is quite clear that the Fed is still tightening. That means that lower stock market prices are ahead of us. Core is still cautious in our investing.

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