

## THE WEEK IN THE MARKETS. WHEN GOOD NEWS IS BAD NEWS.

*A memorable week which saw the biggest daily dollar fall for a share price – Meta - only to be followed later by the biggest daily dollar gain in a share price- Amazon - and then not to be outdone, the biggest employment miss in living memory. The thought that comes to mind, “has anyone seen the rudder”.*

I will concentrate on profits in this article but would like to begin with the big surprise in the Job Numbers announced on Friday. It was worth watching Bloomberg TV when the employment situation was released just to witness the incredulity on the faces of the broadcasters. Expectations had ranged from +250,000 to -400,000 and definitely not the +467,000 figure. The Household Survey was even higher with a gain of 1.2 million jobs, all full-time because part-time work actually fell. And yet this is what the BLS had to say in its Household Survey: *“In January, 6.0 million persons reported that they had been unable to work because their employer closed or lost business due to the pandemic –that is, they did not work at all or worked fewer hours at some point in the 4 weeks preceding the survey due to the pandemic. This measure is considerably higher than the level of 3.1 million in December.”* So an additional 3 million workers lost their jobs or worked fewer hours, but total employment rose by nearly half a million. The ADP Employment Report released two days earlier seems to be closer to the mark estimating 301,000 fewer jobs in the private sector. The BLS is clearly lost in the woods. Its compass - its seasonal adjustments - is way off. It's positively Ukrainian. And yet the markets lapped it up uncritically. So much for perfect markets. <https://www.bls.gov/news.release/empsit.nr0.htm> <https://adpemploymentreport.com/>

So definitely to be taken with a pinch of salt or cocaine if you work on Wall Street. Whatever the case, speculators did not like this anticipated 'good' news. Stock futures which were trading higher prior to the announcement fell precipitously into negative territory. The speculators were hoping a weak release would take the pressure off the FED. The opposite was the case, not only were December employment figures revised sharply upwards but average hourly earnings rose 0.7%. In fact, employment increased in the final quarter above the average for the year, at a time when final sales grew by only 1.9% excluding the 500 container ships worth of returns in November and December. Seems the capitalists can't help themselves from hiring excess workers. Like the statisticians they too appear to have lost their rudder.

Prior to the employment release, Q1 GDP forecasts were very weak. The Dallas FED cut its GDP forecast to 0.1%, Goldman Sachs to 0.5% and the more optimistic Bank of America cut its forecast from 4% down to 1%. Thus in the space of a few weeks, analysts had been converted from presenting Q1 as a strong quarter into a weak quarter. Jeff Cox reporting for CNBC summed it up: ***“After a huge year for growth, the U.S. economy is about to slam into a wall.”*** <https://www.cnbc.com/2022/02/01/after-a-huge-year-for-growth-the-us-economy-is-about-to-slam-into-a-wall.html>

I agree with the headline. I remain firm in my conviction that an inventory correction is building and that it will be brutal. This is beginning to be recognised: *“Inventories are roughly back to where they should be.”* So said Mark Zandi, chief economist at Moody's Analytics. This week's Census Bureau release of manufacturing shipments and inventories confirmed this. Inventories were up 8.9% annually in December giving an inventory to shipment ratio of 1.46. Within that report, manufacturing orders fell 0.9% and capital goods fell 2.4%. So much for the much heralded increase in investment. Unfilled orders, measured annually, rose by +7.4%, which when compared to the rise in the Producer Price Index of 9.7%, represents a volume fall. This sets the scene for the crucial release of January inventory & sales figures (Feb 16). <https://www.census.gov/manufacturing/m3/adv/pdf/durgd.pdf>

It is too early to be certain about Jan retail sales, but the Chicago FED CARTS current estimate of Jan retail sales growth is 0%. It excludes January auto sales which are down 9% in volume terms but not value terms.

To understand how the covid stimuli interacted with supply shortages enabling the larger corporations to game the system, we need to turn to UPS's Earnings Report. The highlights are - revenue up 11.5% and profits up 38%. How was this possible? Well the '*consolidated average revenue per piece*' went up 11.3%. In other words they charged more to move parcels. This means that overall, UPS's volumes were flat, its revenue and profit boost was only due to its pricing leverage. The question that arises is what happens when volumes collapse? What happens if prices follow suit? This is why I have maintained an inventory correction will be brutal for both producers and distributors. <https://investors.ups.com/news-events/press-releases/detail/2064/ups-releases-4q-2021-earnings>

### **The GAMNAF become the AAM.**

Once there were 6 behemoth corporations, Google (Alphabet), Amazon, Microsoft, Netflix, Apple, and Facebook. These 6 galloping stallions dragged the market to dizzying heights. Now there are only 3, Google (just), Apple (courtesy of the act of vandalism against Huawei) and Microsoft (the solid granddaddy of them all).

It may seem strange that I exclude Amazon from the list, especially on the day its share price is buoying up the Nasdaq when all the other indexes are down. The reason I hold this view is that the report issued by Amazon on Thursday evening was actually very weak. While total revenue increased from \$125.555 billion in Q4 2021 to \$137.412 billion in Q4 2022, operating income fell from \$6.873 billion to \$3.460 billion squeezing operating margins which were 5.5% down to 2.5%. In terms of its product sales, revenue grew only by 0.5% resulting in a loss of \$1.833 billion. And this loss would be bigger if Amazon was not a tax dodger and paid its national taxes. History will record, the company that devastated our city centers, could only do so because it did not pay its fair share of taxes. (However, it did allow its boss to take delivery of his \$500 million yacht this month.) <https://ir.aboutamazon.com/quarterly-results/default.aspx>

Here's the problem with Amazon, it does not know whether it is a retailer, an entertainer, a computer host or plain and simply an eavesdropper. Now that competitors have caught up in ecommerce, such as the likes of Walmart, its long term core product business is under siege. The markets reacted positively to Amazon for two reasons. It sold off its shareholding in Rivian Automotive at \$170 a share yielding an unexpected profit of \$11.8 billion (Rivian's share price is currently \$60). Without that one-off profit, Amazon's whole year net income would have been \$21.6 billion compared to \$21.3 billion the year before and this is a company that hit a valuation of 2 trillion dollars in 2021! And secondly, it proposed a hike of \$20 in its Prime Membership which the markets loved, because they did not see it for what it was, a sign of weakness. It is not the rise in wage and fuel costs that threatens Amazon, it is the fact that it is no longer the only ecommerce company in town which is why it has to find profit where it can leveraging Prime.

I also qualified Google. Like Facebook, Alphabet is dependent on advertising and has not been able to wean itself off this dependency. But what Meta (Facebook redesigning itself because of its unsure future) showed, is that the major advertisers are fickle. Internet advertising is no longer newly born, it is an adolescent amongst adolescents who have grown up with this medium and don't give a fig about advertising messaging. In the past, the benefit of throwing advertising money into cyber space in return for the equivalent of stolen behaviors was dubious, but now, after so many years, why advertisers persevere with this nonsense is difficult to discern, except to say capitalist herds move in mysterious ways.

In the not so distant future, especially when producers cut their advertising spend because of collapsing margins, Alphabet will be in the firing line as the world's largest recipient of internet advertising.

The markets will still have a MA, Microsoft and Apple, but that is all. And even that depends on Huawei not making a comeback, something I believe Apple fears, which is why it discounted its phones in China to consolidate its market share while the going was good.

Returning to the present. The magnitude of the beats, with the exception of Meta, were of a sufficient order so as to stabilize the markets, and to a degree, offset concerns about this quarter and future rate rises. It will not last, speculators have short memories, especially when the outlook dims.

The largest corporations with their monopoly positions may have outperformed, but the underlying health of the sector as a whole is less rosy. In Table 1 below are the details of productivity and labour costs for the nonfinancial corporate sector in Q4. Revised productivity changed direction by 1.5% resulting in unit labour costs rising by 1.5% to 6.2%. Provided these revisions are real and not distorted by the seasonal adjustments discussed earlier, this is a big negative for aggregated corporate profits in Q4.

Table 1.

| Sector                 |                      | Labor productivity | Output | Hours worked | Hourly compensation | Real hourly compensation | Unit labor costs |
|------------------------|----------------------|--------------------|--------|--------------|---------------------|--------------------------|------------------|
| Nonfinancial corporate | Revised              | -0.8               | 5.2    | 6.0          | 5.4                 | -1.2                     | 6.2              |
|                        | Previously published | 0.7                | 6.8    | 6.1          | 5.4                 | -1.2                     | 4.7              |

<https://www.bls.gov/news.release/prod2.nr0.htm>

#### After sustained Central Bank CPR, interest rates finally revive.

The over egged employment release, together with the second rate rise by the Bank of England, together with the European Central Bank's harder monetary stance, has lifted the key 10-year yield for the first time above the rates found in 2019, a year in which the US economy would have stagnated were it not for the stimulus of rising share prices.

Graph 1.



[TNX Interactive Stock Chart | Treasury Yield 10 Years Stock - Yahoo Finance](#)

The second leg up on Friday, closing in on the psychologically important 2% barrier is significant. Previously the lethargic 10 year yield could be interpreted in one of two ways. Firstly, bondholders did not take the FED's commitment to raising interest rates seriously. Secondly, bondholders who have a longer perspective than shareholders, were not enthusiastic about the medium term prospects for the US economy. I think the former outweighs the latter currently. After the release of the employment statistics the dot plotters were back to predicting 7 rates rises. Bless them.

The 10 year yield is very influential for mortgage rates as well as corporate bond rates. I expect that if the rate hovers above or close to 2% over the course of February it will do considerable damage to the residential housing market in the US, both in terms of construction, sales and above all prices.

Moving away from the Tech headlights, it is clear that investors do not have much faith in the solvency of the smaller listed corporations which form the Russell 2000. This index, unlike the Nasdaq, fell during the week in response to higher interest rates. Standing currently at 2002 it is down 19% from its November high of 2443. Although it escaped from bear territory in January (27<sup>th</sup> January was its current low point) it remains suspended just above the dividing line of 20%.

**Graph 2.**



<https://www.google.com/finance/quote/RUT:INDEXRUSSELL?window=1Y>

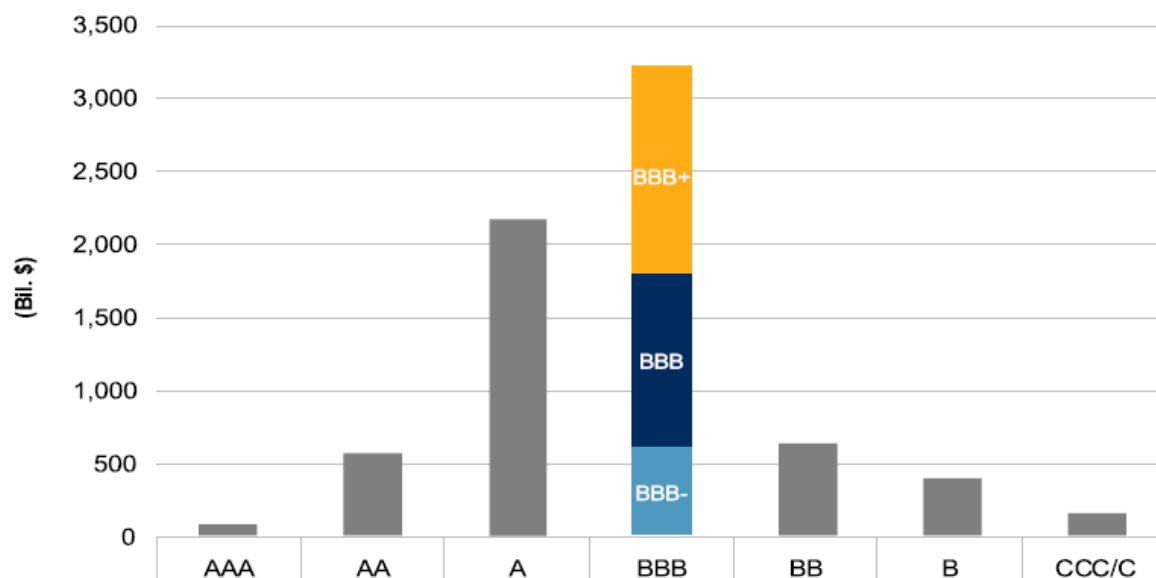
HIS Markit reported this week that risk aversion to junk bonds had grown both in the US and in Europe due to the ECB's firmer stance. At 106.37% Markit's Index was the lowest since Nov. 2020. Blackrock's index fell back to May 2020 levels. Earlier this week Bloomberg released its analysis for the junk bond market in January. *The Bloomberg U.S. Corporate High Yield Bond Index lost 2.73% last month on a total return basis, the biggest January decline on record and the worst month of any kind since the pandemic rocked markets in March 2020.* Conditions were worse in the junk-bond market *"The highest-quality part of the junk-bond market, BB rated debt, bore the brunt by falling 3.29%. Among sectors, food and beverage saw the steepest loss at negative 4.18%, according to data compiled by Bloomberg."* In addition, Bloomberg announced that: *"While the primary market has held relatively steady, signs of weakness are beginning to emerge as junk-bond issuers struggle to find buyers."* This lack of buyers is key. <https://www.bloombergquint.com/markets/worst-january-ever-for-junk-shows-fed-s-surprise-impact-on-bonds> As the link indicates the junk bond market experienced its worst ever January.

And if this is followed by the worst ever February then the entire market will be in trouble. Volatility is increasing and the stresses are beginning to appear. It is worth focusing on the best of the cross-over bonds - BBB rated – which has one leg planted in the speculative sector and one leg planted in the investment grade sector. BBBs are the biggest bond class. At \$3.2 trillion they represent 53% of all investment grade issuance. Globally BBB bonds issuance amounts to \$7 trillion.

**Graph 3.**

Chart 1

### U.S. Corporate Bond Debt Rated 'BBB' Exceeds \$3 Trillion, Dwarfing Speculative Grade



Note: Chart shows the face value of U.S. corporate bonds rated by S&P Global Ratings. Includes bonds from financial and nonfinancial corporates; excludes term loans and revolving credit facilities. Data as of Jan. 1, 2019. Source: S&P Global Fixed Income Research. Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

<https://www.spglobal.com/en/research-insights/articles/the-bbb-u-s-bond-market-exceeds-3-trillion#:~:text=%27BBB%27%20debt%20represents%2058%25%20of%20the%20total%20investment-grade,this%20period%2C%20with%20%24585%20billion%20%28see%20chart%204%29.>

Clearly in a world where the majority of corporate bonds are rated borderline, any interest rate shock will resonate loudly throughout this asset class. The bond market has been fragile since 2008, its brittleness will withstand few shocks. That shock will be the question of solvency as final sales start to fall sharply, and the rate of turnover decelerates requiring additional capital at a time of rising interest rates. That is what is making 2022 different to 2016 for the time being.

### Conclusion.

The majority of S&P 500 companies have now reported, especially the big hitters. FactSet has upped its blended earnings for the quarter though earnings surprises remain in line with historical averages both in terms of numbers and divergences. More importantly its profit forecasts remain subdued. *“For the full*

*year, the blended earnings growth rate for CY 2021 is 47.0%. Looking ahead to the first half of CY 2022, analysts expect earnings growth of 5.6% for Q1 2022 and 4.4% for Q2 2022.” And this is before adjustments for inflation and share buy backs. <https://insight.factset.com/sp-500-earnings-season-update-february-4-2022>*

For the rest of February profit releases will play a smaller role in determining share prices. What will become more important for the rest of February will be the economic releases especially retail sales in the third week of February. By the end of February we and the markets will know the current extent of the inventory correction.

What is crucial is whether future releases will undermine the markets view of imminent rate rises. Here next week's CPI release will be important. If it dips, as expected, that will restore confidence to the markets. If the dip is significant, which cannot be ruled out, it may encourage the view that the worst of inflation is behind the economy. Of course that view would temporarily eclipse the more important view, that this is a byproduct of a rapidly weakening economy, which in the longer run is the more important and detrimental development.

But if rate rise expectations remain high, despite deteriorating economic data, then the markets are in deep trouble. It all depends on whether bad economic news is good news for the markets, at least in the short run.

Brian Green, 5<sup>th</sup> February 2022.