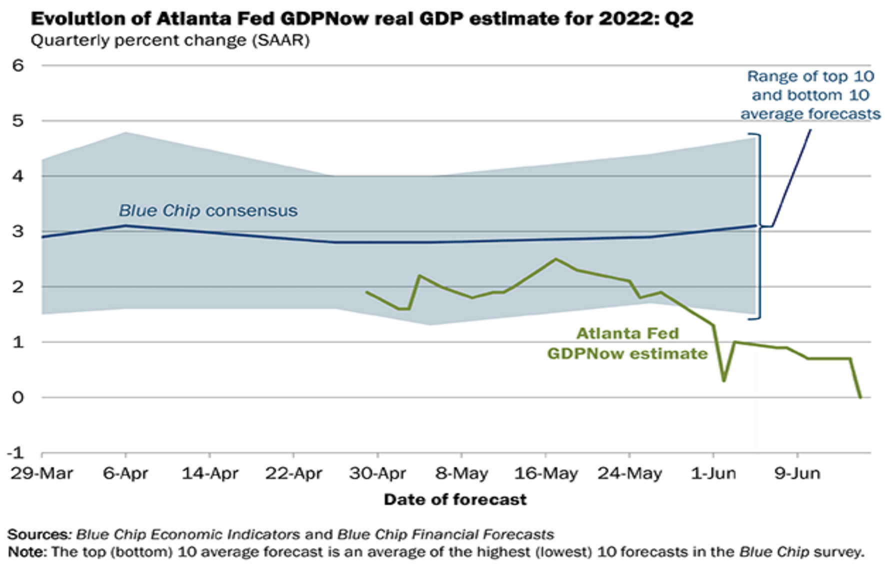
HOW STUPID CAN THE FED GET?

Having been accused, correctly, of initially under-reacting, the FED has now over-reacted with its 0.75% increase in the Federal Funds Rate. As the saying goes, an under-reaction added to an over-reaction does not make a right. The fact is, the US economy already in recession, cannot wear this rise.

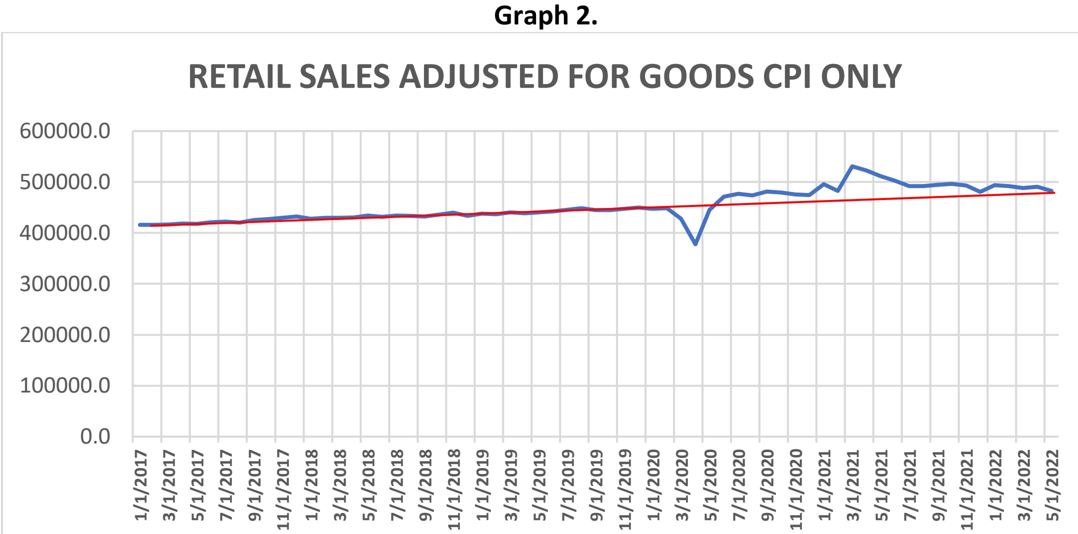
The FED Minutes state that: "*Overall economic activity appears to have picked up after edging down in the first quarter."* Picking up, really! This is how the GDPNow forecast released Wednesday saw it.

Graph 1.



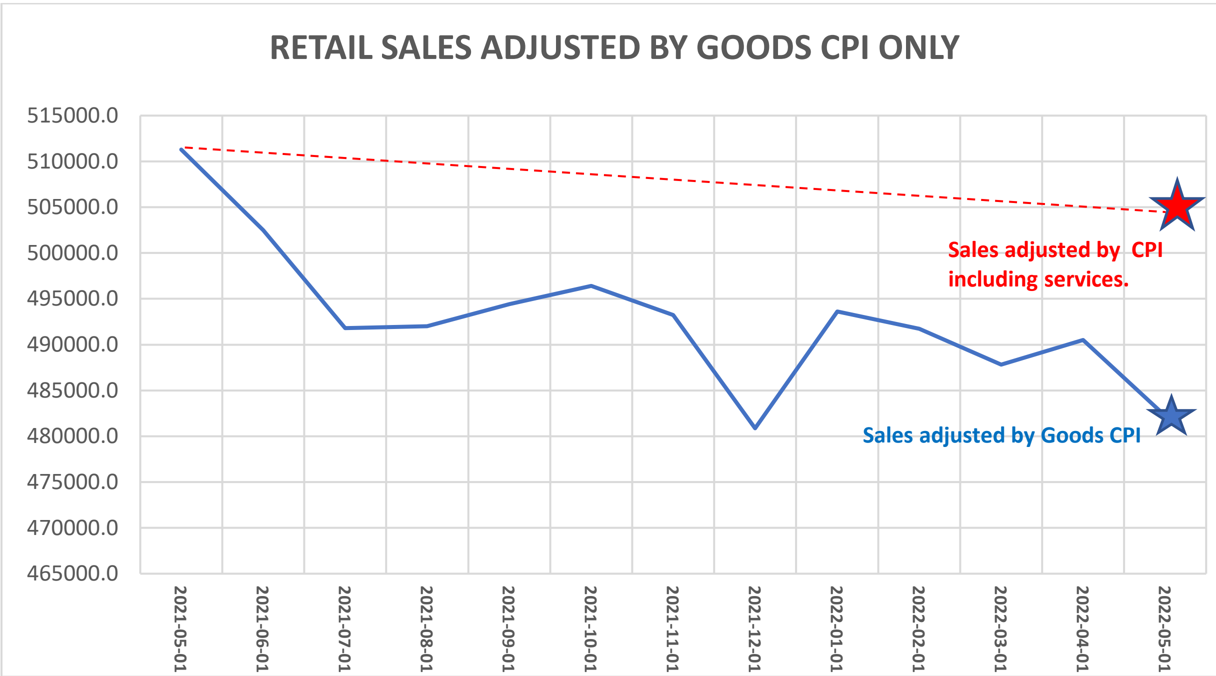
ZERO, is its forecast in GDP growth. (Rounding up prevented it from going negative on the 16th following dismal housing starts.) Alongside this forecast, Wednesday's release of advance retail sales showed sales falling by 0.3%. MARTS. Retail sales are getting so bad that even the 'behind the curve' Census Bureau can no longer cover up for the falls. It seems inflated official data has resulted in a confused FED FOMC.

Graph 2.



As we see in Graph 2, the retail sector is now dipping below its five-year trend, and it will further deteriorate this June based on high frequency data. To demonstrate the fall in greater detail here is the one-year trend. It shows a real 6% slide in annual sales based on the Goods only CPI. The red line/star is included for educative purposes only to demonstrate the importance of selecting the correct CPI.

Graph 3.



(Sources: See attached worksheet 'working paper May 2022 retail sales.)

Demand is collapsing everywhere. If inflation is too high this is not because demand is too high. One event summarises why the FED is acting like a quack, misdiagnosing patients, while overdosing them with the wrong medicine. Today Gas Prices spiked in Europe. Not because demand was too high but because of sanctions on Russia. GAZPROM had to reduce the pressure in its pipelines because compressors which were being reconditioned in Canada could not be returned because of the Canadian Government's embargo on Russia. "*Because of repair by Siemens ... and technical engines' malfunctions, only three gas compressor units can currently be used at the Portovaya compression station,*" Gazprom said.

This is poetic justice. The warmongering USA is being hung on a rope it has woven for itself. So too the warmongering British where the Bank of England just announced a half percent rate rise bringing interest rates to their highest in 13-years. The only way to reduce inflation is to end the embargoes on Russia and China. But this route is closed to the Biden and Johnson Administrations. So instead the FED is adopting a scorched earth policy. The US is going to pay dearly for its belligerence and unless US and British workers stand up, they will be the fall guys and gals. The Yankees are about to learn that economic damage always exceeds military damage. Shelling your economy with 155 mm rate rises will lead to amputations.

The housing markets.

Housing being one. Two days before Powell commented in his Press Briefing about how resilient the labour market was, estate agents (or realtors) were firing their workers in droves. "*Redfin CEO Glenn*

Kelman said that demand in May was 17% below expectations and that "we don't have enough work for our agents and support staff." Well what do you expect from a company whose shares once trade above $90 dollars before falling to below $10 dollars. Following down the same path "*Compass said on Tuesday that it was cutting its workforce by around 10%, or 450 workers, as part of a plan to cut costs, along with reducing US hiring and not filling roles when staff leave.*" Finally, Zillow the darling of the sector, had already laid off 25% of its staff.

The why of it all is explained by the two graphs below. Buyer sentiment has collapsed.

Graph 4.

Bloomberg

As a result buyer footfall has fallen back to the 2019s, and it will fall further. This coincides with mortgage applications slipping to their lowest level in 22 years as 30-year rates move above 6%. Yesterday mortgage rates jumped by the highest amount in 35 years. Housing is currently the most unaffordable ever.

Graph 5.

And so finally, the official data has caught up. Thursday's release of housing starts and permits was a stunner. Housing starts were expected to decline modestly by 1.85% MoM and permits by 2.5% instead of which they plunged by 14.4% and 7.0%. As the Graph below shows that brings us back to pre-pandemic levels and given a similar expected fall in June, this will bring starts back to 2019 levels.

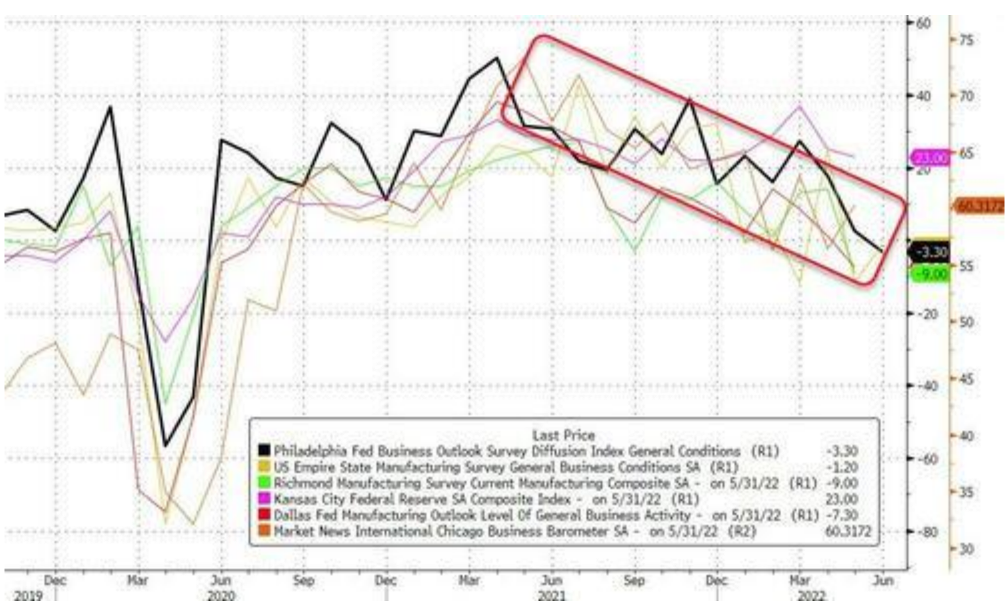
Graph 6.

Bloomberg.

And its not only the housing market.

I do not normally comment on surveys or soft data so called, because it can be unreliable due to sampling limitations. But in the context of the FOMC minute claiming that the economy is picking up, when the regional FED's own surveys show the opposite, the question of honesty arises. Today the very important Philadelphia FED survey was released. Instead of rising by an expected 5% it fell by 3.3%. The new orders component cratered. Are you paying attention Mr Powell to your own staff, or will you still insist the economy is picking up when you speak on Friday morning.

Graph 7.



It would be one sided to say the FED was duped by its own data. Another factor behind the reckless rate rise on Wednesday was the FED being cornered by influential market players and makers. Over 90% of investment banks, starting with Barclays, punted for a 0.75% rise. Anything lower they said would be an act of capitulation by the FED. This became the noisy narrative which the FED could not ignore. The bankers' advice to the FED was not benevolent. It never is. With every avenue to making a buck being closed off to the banks because of collapsing markets, they are having to fall back on good old banking practise by borrowing cheap and lending dear. The higher rates move, the bigger their margin, and it was this hunger which was behind their baying for 0.75%.

The fact they could not see beyond the margin, that a 0.75% rise would crater the economy was immaterial to them. They insisted the market could take the pain. And it seems the markets supported them on the day, rising in admiration of the decisive FED. Except that it is at night when the nightmares begin. Overnight, whatever gains were made on Wednesday, were more than wiped out in the futures market as sanity dawned.

It remains a recurrent theme to talk up the economy. The paid economists and all those like Kevin O'Leary who are overinvested in the markets, know their jobs and their capital depend on the market performing not collapsing. *"You're all wrong," O'Leary said. "This is a more productive, higher gross margin economy, and nobody wants to give it any credit." "Show me where this recession is. Show me in the employment numbers. Show me in the sales numbers of private companies. Show me, where is this recession?"* I was trying to remember who Kevin O'Leary, star investor, sounded like and then I twigged, Dr William Jeffries and his remarkable view of US profitability.

Like the war in Ukraine the rising creep of approaching explosions can no longer be denied. The bad news is accelerating and getting worse. Even Bloomberg is now inviting guests who no longer talk of a recession in 2023, which previously seemed to be obligatory for an invite, and who instead are talking of a recession this year. As the narrative shifts to a closer time-frame, the message is still being massaged – "*but it will be short and shallow*" - because you see the underlying economy remains healthy. The enduring narrative remains that a soft landing is possible despite the FED having cratered the runway with its 0.75% rate rise this week coupled to the firm promise of future significant rate rises.

Europe.

Today the major EU leaders are visiting Kyiv by train. Will they be able to convince President "*I will not cede one square centimetre of Ukraine*" Zelensky to approach the negotiation table. Russia has won the battle for the Donbass. The Ukrainian army is surrounded in a number of areas. The Ukrainian army has lost the ability to mount a counter-offensive blaming the West for the lack of heavy weapons despite the fact that Western Armouries have in some cases been depleted. It is likely that the Ukrainians have lost over a quarter of their active soldiers to death, serious injury, or capture. Its army is ruined.

In Europe and the US war weariness is already pervasive. Leaders like Biden and Johnson, by blaming all the shortages and problems on Putin, are not arousing their populations, instead their populations are drawing the opposite conclusion; if all of this is due to the war, end it. We shall see if the European leaders, no doubt backed by the Ukrainian general staff, can convince this clown turned leader to face up to the reality on the ground. Hopefully they will because the slaughter of Ukrainian soldiers must stop.

The European Central Bank, no doubt convinced of an impending 0.75% FED rate rise, called an emergency meeting to defend the Euro and weaker Sovereign Bonds from the impact of this rise. According to Bloomberg it is likely that the ECB will keep the aggregate amount of bonds it holds stable, but will shuffle them by selling bonds in safer countries such as Germany then use the proceeds to buy bonds in overstretched countries like Italy and Spain. This will have the effect of reducing the spread between say German Bonds and Italian Bonds by raising the interest rates of German bonds through selling while reducing the interest rates of Italian Bonds through buying. An announcement is expected shortly.

In the UK which cannot afford more rate rises, the Financial Times reported on a discussion initiated by the *New Economic Forum* which proposed that the Bank of England (BOE) no longer pay interest on the £1 trillion held at the BOE by commercial banks in the form of reserves. This represents a significant bung to the banks amounting to £57 billion by 2025 should the BOE bank rate rise to 2.5% as expected. It should be remembered that these excess reserves are the equivalent of fraud on the British taxpayers as they represent the money generated by Quantitative Easing. Or to put it another way, the Bank of England bought treasury bonds from its holders, mainly the commercial banks, who then deposited these proceeds (really excess reserves) back with the Bank of England who in turn paid them interest for having sold the bonds in the first place, which meant that the Bank was effectively replacing their lost interest revenue with a new revenue stream. So what was the purpose of this round-trip? To drive up the price of these bonds so the holders, the rich rentiers could earn a windfall profit (capital gains) upon selling them.

As expected both the Treasury and the Bank of England, these servants to the rich, and custodians of their wealth, refused. Better to cut services and benefits to workers rather than deprive the banksters of a lucrative income stream especially when the banks are in for a torrid time as the economy tanks.

Finally, rising interest rates in the dominant economies will impact the economies of the dominated economies hard (the so-called emerging markets which with the exception of China have and will never gain the velocity to escape the claws of the dominant economies). With the prices of imports such as food and energy, mainly denominated in a rising dollar, soaring, they are finding it harder to meet their foreign obligations. No wonder the majority did not support the USA, Britain and the EU's warmongering in the Ukraine. They knew what the blowback from the war on their economies would be. They are not masochists. They knew they could end up being put through the IMF wringer in due course.

Conclusion.

All three major stock markets; The Dow, the S&P 500 and the NASDAQ, hit 52-week lows at the close of business on Thursday evening in New York. They are now down respectively by 19.6%, 24% and 34.5%. It is also likely that all three will end the week down. By how much cannot be determined because tomorrow is the witching hour when derivative contracts to the tune of $3.4 trillion expire. It is almost worth delaying publishing this article to see its impact on the markets.

What is clear is that the belligerent stance of the FED is not only advancing black swan events but is itself endangering a fast-weakening economy. The eye of the storm has passed and now the stronger tailing winds are here. It's not about the swirling bad news, but because this news can no longer be denied, and it is relentless. Given that June is looking worse than May it is difficult to see how the US can avoid a fall in GDP in the Second Quarter, meaning the US is and will remain in recession and so will profits.

Brian Green, 16th June 2022.