MORNING BRIEFING
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On Bonds & Europe

Check out the accompanying chart collection.

Executive Summary: Bond yields aren't determined as much by supply and demand as they are by investor expectations regarding inflation and the Fed's likely response to it. But it's helpful to stay aware of the latest supply-and-demand-related developments in the bond market, which we review today. … Also: The EU has been doing a remarkable job of finding alternative fuel sources to replace energy imports from Russia. If a war-provoked energy crisis this winter causes a recession in Europe, chances seem good that it'll be mild and brief.

US Bonds: Supply & Demand. Once again, we are learning that supply and demand aren't as important in determining the bond yield as are inflation and the anticipated reaction of the Fed to the inflation problem. In other words, the bond yield is mostly determined by the shape of the yield curve. It tends to rise when the yield curve is upward sloping and the Fed is raising the federal funds rate. This scenario suggests that investors aren't convinced that the Fed has tightened enough to bring inflation down. Once they are convinced of that, the yield curve starts to flatten and then inverts. At that point, investors believe that the Fed's monetary policy tightening cycle is almost over because short-term rates are probably high enough to bring inflation down by slowing the economy or pushing it into a recession.

Let's review the latest supply and demand developments in the bond market:

(1) *The federal deficit.* The US federal budget deficit remains large at $1.3 trillion over the past 12 months through October (*Fig. 1*). However, that's a significant improvement from the comparable record high of $4.1 trillion through March 2021, when federal government spending on pandemic relief was soaring. The 12-month sum of government outlays soared from $4.6 trillion in February 2020 to a record high of $7.6 trillion through March 2021 (*Fig. 2*). It was down to $6.2 trillion through October.

Another important development since the start of the pandemic is that federal government receipts soared, especially over the past year as inflation boosted incomes and thus inflated taxes owed by individuals and businesses. Over the 12 months through October, receipts rose to a record $4.9 trillion, up from $3.5 trillion through February 2020.

While inflation has been boosting tax revenues, the resulting increase in interest rates is causing net interest paid by the federal government to soar. Over the past 12 months through October, it rose to a record $488.2 billion, up from $383.7 billion through February 2020 (*Fig. 3*). We calculate that the federal government is currently paying an average effective rate of 2.0% on the debt (*Fig. 4*). If that rate rises to 3.0%, the government's net interest bill would rise over $700 billion.

(2) *The Fed's QT2.* Meanwhile, the Fed has implemented QT2. The Fed's holdings of securities peaked at a record $8.5 trillion during the May 18 week. It was down by $309 billion through the November 30 week (*Fig. 5*). Over that same period, the Fed's holdings of US Treasuries fell $235 billion, while mortgage-backed securities fell $74 billion (*Fig. 6* and *Fig. 7*).

Arguably, the jump in the 10-year Treasury bond from 1.63% at the start of this year to a peak of 4.25% on October 24 was exacerbated by the anticipation and implementation of QT2 (*Fig. 8*). The same can be said for the 30-year mortgage rate, as evidenced by the doubling of the spread between the mortgage yield and the 10-year Treasury yield (*Fig. 9* and *Fig. 10*).

(3) *Commercial banks.* QT2 has weighed on commercial bank deposits since the summer (*Fig. 11*). Meanwhile, commercial bank loan demand rose $1.1 trillion ytd through the November 23 week to a record high. To fund these loans, the banks sold $346 billion in their securities holdings from the February 23 week through the November 23 week.

(4) *Bond funds.* Also selling bonds have been bond mutual funds and ETFs. On a 12-month basis, their net collective sales totaled $136.1 billion through October (*Fig. 12*). That's not much, but keep in mind that's down from a record high of $1.0 trillion through April 2021!

(5) *Foreign investors.* The outflows from all the domestic accounts reviewed above have been largely offset by massive net foreign capital inflows into the US bond market. The *Treasury International Capital* data posted September data for net capital inflows (*Fig. 13*). Over the past 12 months through September, private inflows jumped to a record $1.7 trillion. Foreigners' net purchases of US bonds soared to a record $1.1 trillion. Meanwhile, foreign investors sold $265.5 billion in US equities over the 12-month period through September. For contrarians, this is a bullish signal since foreigners tend to get in (out) at stock market tops (bottoms) in the US.

We believe that global investors continue to view the US as a safe haven for their

investments in a world that has been going quite mad. Their mantra is “TINAC” (there is no alternative country!).

European Economy I: Gas Relief? More frightening than a forthcoming economic recession for many Europeans is the prospect of being left in the dark and cold should the war-provoked energy crisis worsen. Europeans are prepping by taking courses on what to do in the event that “nothing works” anymore, *wrote* Reuters on November 11.

So far, the lights are still on in Europe. An unseasonably warm autumn has allowed the region to preserve more energy than usual; storage is currently 95% full, *reported* the November 24 *The Economist*. Soothing financial markets, natural gas prices also have fallen from the summer.

The Economist article was part of a cover feature warning that the worst is yet to come in Europe’s energy crisis. As we have noted in the past, cover stories tend to be contrary indicators because by the time journalists have done the work to devote a cover story to a trend, investors have already moved past it. So European investors likely have discounted the worst already, notwithstanding Monday’s negative developments.

Here's what happened on Monday and our take on the current situation:

(1) *Ban and cap show.* Starting on Monday, December 5, EU member states have *banned* seaborne imports of Russian crude and prohibited EU companies from financing or insuring Russian oil shipments to third countries. That same day, a separate price cap from the Group of Seven, EU, and Australia took effect, aiming to reduce Russia’s profits from energy sales. (The 27-member bloc also said a ban on imports of refined petroleum products will be enforced starting February 5.)

While that sounds dramatic, the $60-per-barrel price cap is close to where Russian oil was already trading. So it won’t do much to reduce Russian revenues from oil sales in the short run, *observed* the *Financial Times* editorial board on Monday. It’s also notable that the December 5 ban does not include Russian oil imported into the EU by way of pipelines.

Nevertheless, if Russia refuses to sell oil subject to a cap, as it says it will, the energy market could be disrupted by skyrocketing prices—unless OPEC+ *mitigates* the effects by increasing production. Already, Russia has shifted much of its oil exports to other buyers such as China and India who are not likely to adopt the EU-G7 policy. Russian oil in Asian markets was *selling* well above the price cap on Monday.

Importantly, not all—or even most—of Europe's oil imports are at stake. Last month, Russian crude oil exports to Europe remained steady, reported the Paris-based International Energy Association (IEA) *according* to the November 15 *WSJ*. Russia's total oil exports rose by 165,000 barrels a day in October to 7.7 million barrels a day. Russian exports to the EU were 1.5 million barrels a day (mbd). With the energy ban in effect, about 1.1mbd would be halted, said the IEA.

(2) *Sourcing from other sources. The Economist* noted that Russia used to provide 40%-50% of the EU's imports of gas, but now provides only 15% as Russia abruptly cut off supplies over the summer. Until now, Europe has been able to replace its energy stores with fuel from other suppliers, including the US. Infrastructure in Germany to import liquified natural gas has been built and will start operating in January. And other European pipelines have opened.

Long term, the hope is that climate-friendly strategies will reduce both Europe's reliance on oil and gas and its *consumption of fossil fuels broadly*; but they won't be operational anytime soon. For now, Europe is sourcing gas just fine without them. In an *interview* yesterday, the European Central Bank's (ECB) Philip Lane said: "I do think there's a very difficult period to come, but also a faster transition to a more sustainable economy."

(3) *Europe's great energy sucking sound.* Our hunch is that it might not be Europe that suffers the brunt of the energy crisis caused by the war. While European households and businesses can expect to make sacrifices—energy rationing, high energy prices, inability to use plants' full capacity—they won't literally be left in the dark and cold this winter. Europe has been hoarding enough energy to sustain itself out of a major crisis.

The trouble is that hoarding in Europe is creating a *shortage* of natural gas in developing economies. That's where it could get dark.

Europe II: Recession Relief? Many of Europe's economic indicators suggest that the region soon could tip into a recession. A contraction in real GDP for at least a couple of consecutive quarters isn't hard to envision after ever-so-slightly-positive growth for the past few quarters.

Energy prices are likely to rise with the western pressure on Russian oil. Broadly, prices already have been squeezing consumers. Retailers may find consumer demand dwindling as consumers use up their stores of savings and fiscal handouts built up during the pandemic. And manufacturers could start to see demand decline as a post-pandemic order

backlog evaporates, especially for automakers.

Fueling inflation, fiscal policymakers have aimed to rescue their political bases with energy subsidies and public handouts. To curb these effects, European Central Bank (ECB) monetary policymakers are aggressively raising interest rates (*Fig. 14*).

Recently, we've begun to believe that a European recession next year is more likely than not. The ECB's hawkishness is testing Europe's economic resilience. But any recession could be short lived. Even the ECB expects economic conditions to normalize by 2024. Just yesterday, the ECB's Philip Lane said in his interview: "Our current thinking is that if there is a recession it will be relatively mild and relatively short-lived."

Previously, we wrote that the lifting of Europe's Covid restrictions could offset some of the Ukraine war's negative economic impacts. Indeed, economic data have not been overly worrisome (except for inflation data). Belying alarmist media headlines, analysts' estimates for Eurozone revenues and earnings remain upbeat. European stocks have taken such a beating since February that overweighting them over the long term, or at least holding onto current positions, might be prudent.

Here's a look at the latest economic indicators, which have worsened but still aren't too bad:

(1) *Growth.* Eurozone real GDP expanded a mere 0.7% q/q on a seasonally adjusted basis during Q3, slightly lower than in Q2 but higher than the war strained Q1 growth rate of 0.4%, the slowest in a year. On an annual basis, growth managed to stay above 2.0% y/y, driven especially by strong household spending (up 4.2% y/y) (*Fig. 15*). The household lift could dissipate soon if high inflation persists and savings fall, but the strong job market could offset any savings shortfall.

(2) *Inflation.* Inflation is expected to remain very high in the coming months because of the energy crisis. Presumably, however, inflationary pressures should ease over the longer term as the war-related, energy-related, and supply-chain challenges abate. Eurozone CPI soared 10.6% y/y during October, surpassing the previous several months' record highs (*Fig. 16*). Excluding energy, food, alcohol, and tobacco, the CPI also advanced at a record pace, of 5.0%. (Flash estimates for November predict a slowing in the headline rate to 10.0%, with core rate holding at 5.0%.)

(3) *Unemployment.* Unemployment in the Eurozone, now at 6.5%, has dropped well below even pre-pandemic levels (it was 7.2% when the pandemic began in March 2020) (*Fig. 17*).

Europe’s labor market never took a dramatic hit during the pandemic largely because job-retention schemes maintained worker-employer bonds. The labor market remains exceptionally strong considering Europe’s challenges.

(4) *Industrial production.* Europe’s industrial production data for September was strong, indicating a full recovery from the pandemic and no sign of struggle from the war (*Fig. 18*). However, this series might take a breather once the sanctions on Russian energy kick in. German manufacturing orders—a leading indicator for production—are falling too. Industrial companies are likely to suffer the most from further energy conservation efforts, as they are subject to energy curbs before households and small businesses.

(5) *German orders & auto production.* Incoming orders for manufacturers in Germany, the EU’s largest economy, fell during September for the second consecutive month, but ticked up slightly during October (*Fig. 19*). Yet German automakers so far this year have remained surprisingly healthy (*Fig. 20*). That’s mainly because they still have a backlog of orders from the post-pandemic supply-chain pileup. Automakers could be in for a rougher road ahead as gas prices rise and as the US Inflation Reduction Act subsidizes US energy-efficient automakers, denting demand for European ones.

(6) *Economic sentiment.* Economic sentiment in Europe dove in October, dropping below its long-term average (*Fig. 21*). It edged up in November. And it isn’t as depressed as during the pandemic—at 93.7 now on the European Economic Sentiment Indicator (ESI) versus 60.9 at the April 2020 record low. However, Europeans clearly are not very optimistic. That’s especially true of European consumers: The consumer index weighting on the ESI fell significantly in recent months but has recently turned upward (*Fig. 22*).

(7) *Retail sales.* Retail sales have held up since recovering from the pandemic (*Fig. 23*). Main Street European retailers are *discounting* their products to boost sales amid a discretionary income squeeze for European consumers. Luxury retailers are successfully raising prices by tacking on energy and logistics surcharges. But how long these supportive tactics will remain feasible is questionable.

(8) *Stock prices & valuation.* The Europe MSCI Index was down 11.1% from January’s post-pandemic high when the Ukraine war began on February 24. The index recovered somewhat before bottoming at a 22.4% bear-market low on September 29 (*Fig. 24*). The index has bounced back some, reflecting improved energy prospects for Europe since this summer.

But our Blue Angels Implied Price Index shows that European valuations still are quite attractive (*Fig. 25*). Analysts have been raising their earnings expectations despite all the bad headlines (*Fig. 26*).

(9) *Caution & silver linings.* A word of caution: There's always a possibility that the worst is yet to come. "Only a few degrees Celsius, or a few windless days, are what separate Europe facing blackouts from having enough power to make it through the winter," *wrote* a self-proclaimed pessimistic *Washington Post* report.

Investors should also be mindful of a couple of global issues unrelated to the Ukraine war.

For example, US subsidies for cars, clean energy, and semiconductors outlined in President Joe Biden's Inflation Reduction Act could *threaten* demand for these industries in Europe. But Europe could mitigate the effects by introducing subsidies of its own.

Another example is China's ongoing national response to Covid and the lockdown protests within its borders. Further Covid lockdowns there could further strain supply chains, and China is an important trading partner to Europe. But China already seems to be softening its Covid stance amid the protests.

For now, we are looking on the bright side.

Calendars

US: Wed: Nonfarm Productivity & Unit Labor Costs 0.6%/3.1%; Consumer Credit $28.3b; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. Thurs: Initial & Continuous Jobless Claims 230k/1.60m; Natural Gas Storage. (Bloomberg estimates)

Global: Wed: Eurozone Employment Change -0.2%q/q/1.7%y/y; Germany Industrial Production -0.6%; Italy Retail Sales -0.6%; UK Halifax Home Price Index -0.2%; Japan GDP -0.3%q/q/-1.1%y/y; Japan Leading & Coincident Indicators; Canada BOC Rate Decision 4.25%; Lane; McCaul; Panetta. **Thurs:** France Nonfarm Payrolls; China CPI & PPI 1.6% & -1.5% y/y; Lagarde; Wuermeling; Kozicki. (Bloomberg estimates)

Strategy Indicators

S&P 500 Growth vs Value (*link*): As of Monday's close, the S&P 500 Value index was out of correction territory, at 6.6% below its record high, while the S&P 500 Growth price index was still in a deep 26.9% bear market. Growth's underperformance relative to Value began on November 30, 2021 when its price index peaked at a record high. Since then, Value's price index has risen 1.3%, while Growth's is down 24.1%. Growth made a new low for the year on October 12, while Value remained above its September 30 bottom. At that October 12 low, Growth was down 20.1% from its recent high on August 15 to 32.8% below its December 27, 2021 record high. Value was down a lesser 14.6% on September 30 from its August 16 high to 19.2% below its January 12 record high. Looking at their ytd performance through Monday's close, Growth has tumbled 25.9% ytd, well behind the 5.2% decline for the S&P 500 Value index. Looking at the fundamentals, Growth is expected to deliver stronger revenue growth (STRG) than Value over the next 12 months, but their earnings growth (STEG) is similar now. Growth has 5.2% forecasted for STRG and 4.4% for STEG, while Value has forecasted STRG and STEG of 2.6% and 4.4%, respectively. Growth's forward P/E peaked at a 20-year high of 30.4 on January 26, 2021, and tumbled 40% to a 27-month low of 18.4 on June 16. After rebounding to 23.3 in mid-August, it tested the June with its 18.5 reading on October 12. It was back up to 21.2 on Monday. Value's forward P/E fell 24% from 17.6 in January 2021 to 13.4 on June 16. It made a new 30-month low of 13.0 on September 30, and has since risen to 15.3 as of Monday's close. Regarding NERI, Growth's and Value's were negative for a fifth straight month in November following 26 positive monthly readings. Growth's dropped to a 29-month low of -16.7% in November from -13.4% in October, and Value's was down to a 29-month low of -14.7% from -12.2%. Growth's forward profit margin of 17.5% is down 1.6ppts from its record high of 19.1% in mid-February and compares to its prior pre-Covid record high of 16.7% during September 2018. Value's has held up better, dropping to 0.6ppt to 10.8% from its record high of 11.4% in December 2021.

US Economic Indicators

Merchandise Trade (*link*): The *real merchandise trade deficit* widened for the second month to -$112.6 billion in October after narrowing steadily from a record -$135.8 billion in March to -$97.1 billion in August. October's deficit is wider than the average monthly deficit of $101.5 billion last quarter—suggesting that trade could be a drag on Q4 real GDP growth after being the biggest positive contributor during Q3. Real exports contracted for the

second month in October, by 2.5% m/m and 3.6% over the period, after rising five of the prior six months by 11.3% to a new record high. Real imports climbed for the second month, by a total of 3.7%, after falling the prior five months by a total of 8.6%. Looking at *exports*, real exports of industrial supplies & materials sank 5.6% during the two months ending October, after shooting up 21.4% during the six months through August to a new record high. Exports of nonfood consumer goods ex autos plunged 9.5% in October after fluctuating in a volatile flat trend near the top of the range most of this year. Meanwhile, capital goods orders ex autos dipped 0.4% in October after a three-month surge of 7.1% to its highest level since March 2019. Auto exports remained in a volatile flat trend, though increased 8.1% over the two months through October, moving to the top of the range. Foods, feeds & beverages' exports recovered 4.6% after plunging 13.1% in September to its lowest level since summer 2014. As for *import trends*, the upswing in capital goods ex autos has stalled recently, but is just a few ticks shy of September's record high, while real auto imports remained in a volatile uptrend, reaching a new record high in October. Real imports of foods, feeds & beverages soared 7.6% during the three months through October to a new record. Meanwhile, real imports of nonfood consumer goods ex autos has plunged 16.5% from its March record high through October, while real imports of industrial materials & supplies has dropped 6.0% since its recent peak in March.

Global Economic Indicators

Germany Factory Orders (*link*): Orders in October were stronger than expected, rising 0.8% (vs 0.1%), though had contracted seven of the prior eight months, by 11.4%, to its lowest level in two years. *Foreign orders* rebounded 2.5% following a two-month drop of 6.8% from July's 5.0% gain, while *domestic orders* fell for the third time in four months, by a total of 7.5%. *Foreign orders from within the Eurozone* climbed 2.6% after a two-month drop of 9.2%, while *orders from outside the Eurozone* increased 2.5% following a two-month slump of 5.2%. Here's a look at the ytd movements in domestic orders, along with the breakdown from both inside and outside the Eurozone for the main industry groupings, respectively: consumer durable goods (-5.4, +16.6, -10.6), consumer nondurable goods (-6.2%, -15.9%, -4.2%), intermediate goods (-9.7, -13.5, -14.7), and capital goods (-20.6, +2.2, +4.2).

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