Insights
Market Outlooks

Q2 2022

Why Cash Is King

Quarterly Cash Commentary

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The world seems a bit upside down right now. We are seeing an accelerated business cycle, accelerated inflation pressures and negative market returns that rival some of the worst in the last 50 years.

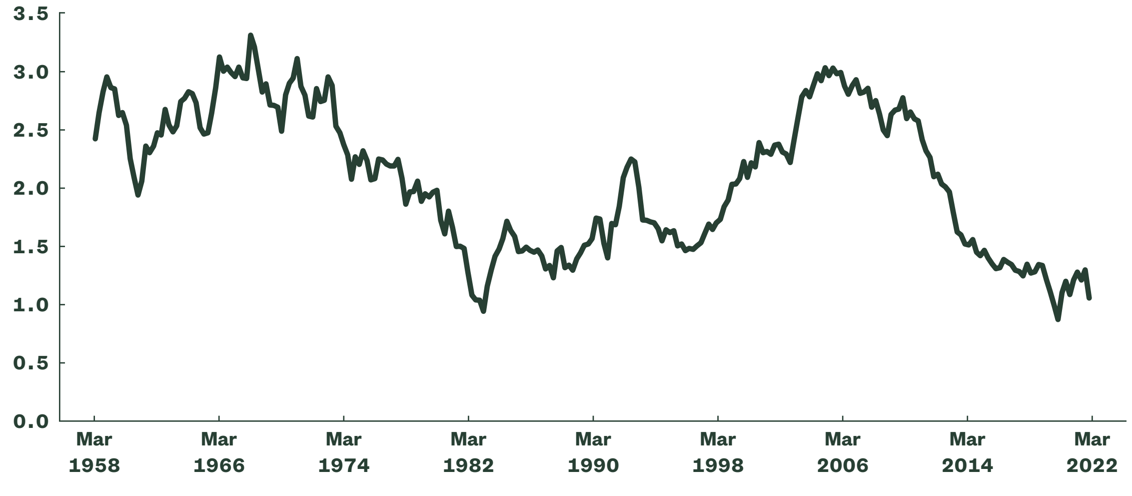
So let's take a step back. What has changed? A secular trend remains in place: aging demographics and a decline in US workforce participation (equivalent to about 5%) that has been consistent since 2000.

Figure 1
US Labor Force Participation Rate SA

Source: Bloomberg, as of June 27, 2022.

The growth in the global workforce has also slowed and "near shoring" one's supply chain could further jeopardize the abundance of labor experienced over the last 40 years. An improvement in workforce productivity could save the day and make up for the decline in labor but the trend there is not pointing in the right direction.

Figure 2
Productivity Growth



Source: BLS, Bloomberg, as of June 27, 2022.

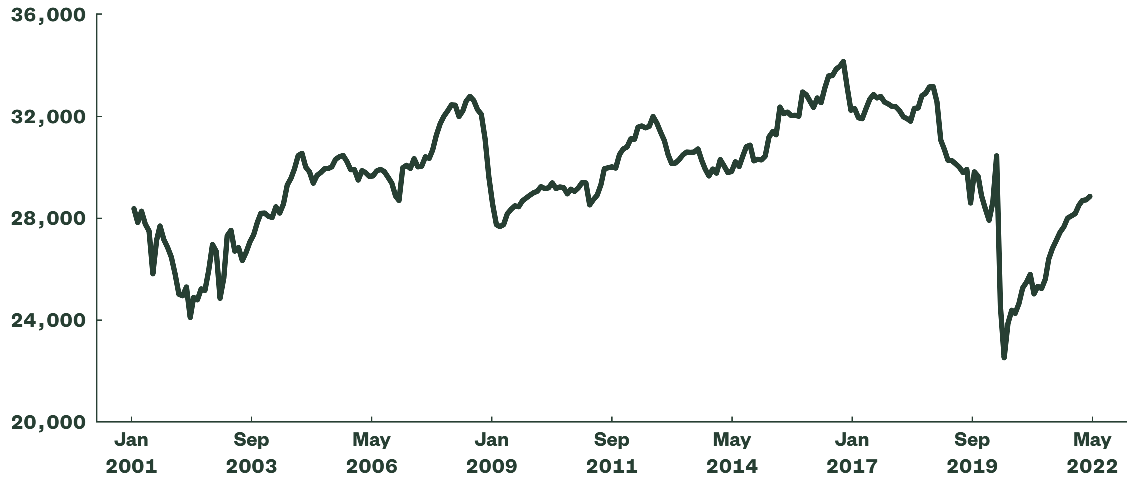
All this considered, it's possible we are left with higher structural labor inflation over the longer term. Central banks will have to grapple with this and potentially have a higher terminal policy target rate, raising their target rates and challenging the businesses with a higher cost to borrow. The real estate sector is already experiencing this and it's evident in the S&P Home Builders' index decline since the beginning of the year.

Figure 3
S&P Home Builders Index

Source: Bloomberg, as of June 27, 2022.

Cyclical trends remain stubbornly persistent. Though they give the appearance of being transitory, they are causing considerable consternation. We understand that higher inflation has, for the most part, been driven by disruptions in the supply chain. Energy has experienced the most notable disruption (**see Figure 4**) with OPEC production still not back to pre-COVID production levels.

Figure 4
Total OPEC Production



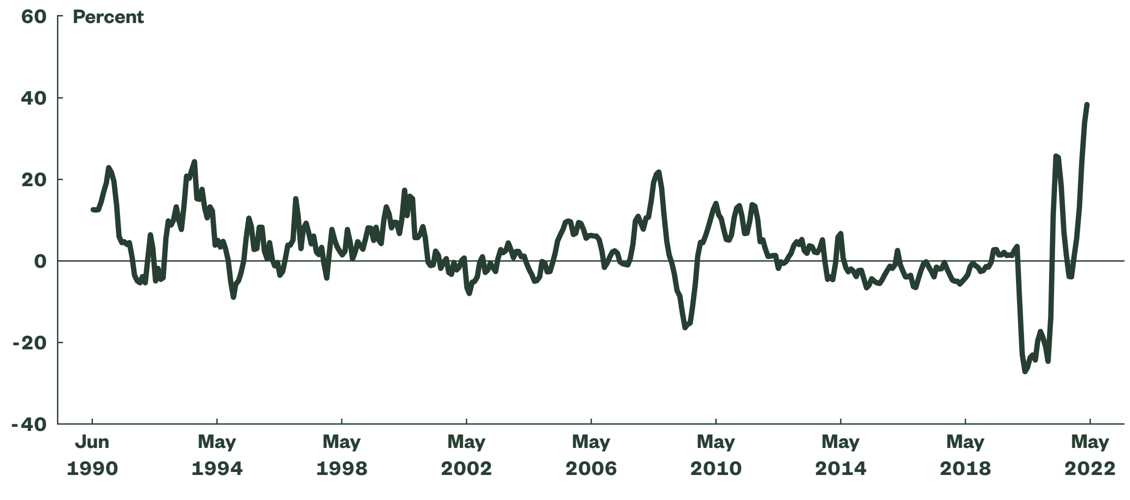
Source: Bloomberg, as of June 27, 2022.

It's very difficult and expensive to turn an oil well off and on! The distribution of goods has also had consistent challenges. The supply of goods from Asia and bottlenecks at major shipping ports receiving the most headlines. Additionally, labor shortages have led to pay hikes across almost every industry. Finding and retaining talent has become more and more critical to the success of companies and organizations. The Federal Reserve's response to all of these supply disruptions has been to push interest rates higher in order to generate "demand destruction". Higher interest rates make it very difficult for businesses to maintain operating margins, with real estate being the most obvious example. The question remains: what pattern will the US consumer follow? Will they continue to spend? Can they afford to? Will "revenge spending" persist? Looking at confidence indicators (**Figure 5**), it appears they will not, but that is not what airline ticket prices are showing (**Figure 6**). Demand is strong.

Figure 5
University of Michigan Consumer Sentiment Index

Source: BLS, Bloomberg, as of June 27, 2022.

Figure 6
CPI Airfares YOY

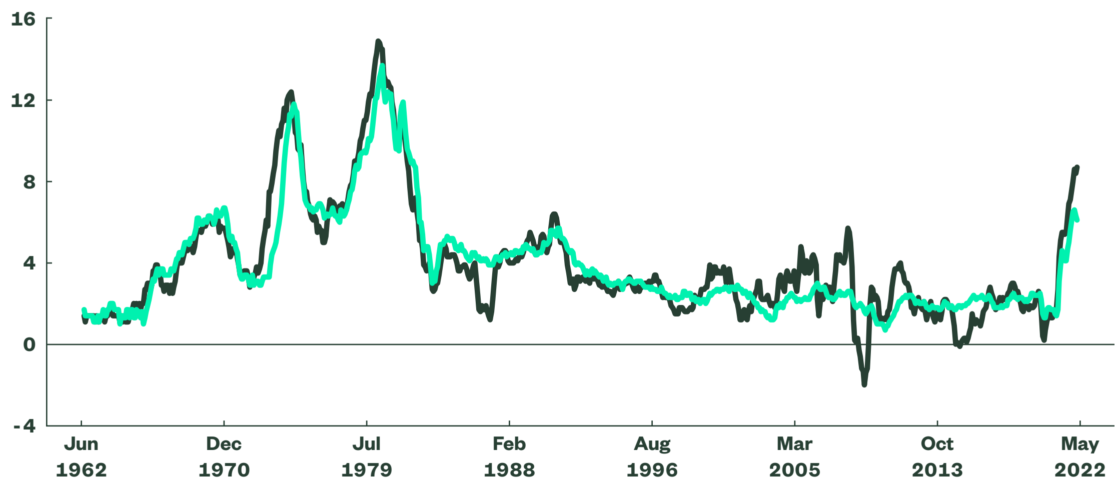


Source: BLS, Bloomberg, as of June 27, 2022.

So, tactically, how should one position themselves in light of all this? If there was ever a time when cash was king, it is now. Jim Reid at DB reports this is the worst start for the US Treasury market since 1788. Yes, 1788! That seems extraordinary and almost unbelievable, but we should consider where we started. US 10yr Treasuries were yielding 1.5% at the start of the year. They are now over 3%. Starting from such a low level has certainly played a part in these dismal returns. The Bloomberg US Treasury index is down almost 10% in the first half of 2022, while the Bloomberg Investment grade corporate bond index is down over 14%. Equity returns are within bear market territory with the S&P 500 and MSCI Europe both down approximately 20%. This all sounds pretty dreary and yet we still might not be at the bottom. The acceleration in prices (inflation) is like nothing we have seen in more than 40 years (**Figure 7**) and the Fed is awfully far behind on tightening monetary policy, so much so that it is likely we have not seen the worst of the repricing in the equity and bond markets. So, at the risk of repeating myself, I have three words for you: cash is king. Cash balances continue to be at record levels. ICI reports total MMF balances of approximately $4.5 trillion, hovering close to the record high levels we saw in 2020.

Figure 7
Consumer Price Index

CPI Headline
CPI Core



Source: BLS, Bloomberg, as of June 27, 2022.

Here is your silver lining: there is a lot of cash waiting on the sidelines. Whether this is corporate cash, municipal cash, or personal cash, balance sheets are, on average, in good order. Banks remain well capitalized and highly liquid. This leads one to believe that if there is a pullback in growth or a recession, it might be shallow and short lived. There could be opportunities for investment.

There will be a few things to keep a close eye on as we move into the 2H of 2022. First, and most obvious, will be inflation data. We will absolutely need to see a trend of declining inflation data. Personal Consumption Expenditures is a measure the Fed watches closely (**Figure 8a**) — expect the Fed to want to see a trend lower in this and other inflation measures.

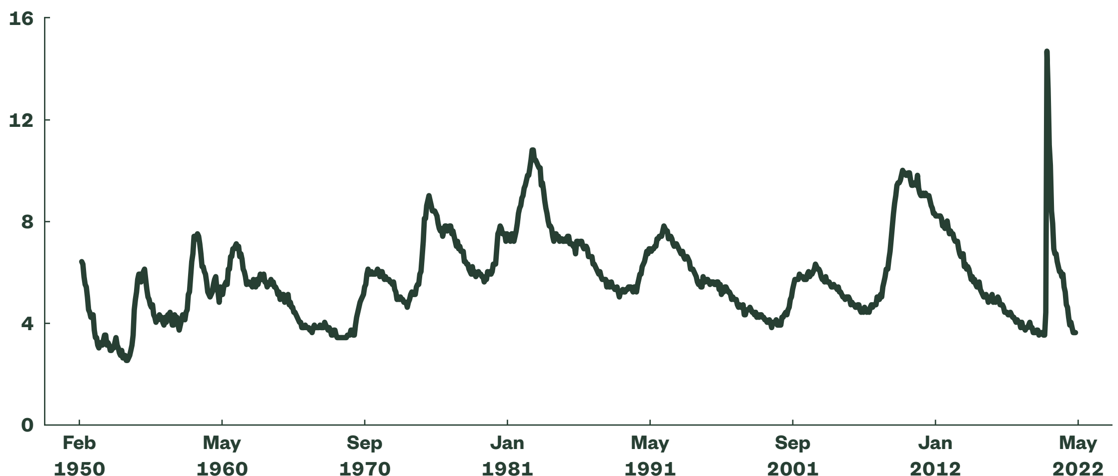
Figure 8a
Personal Consumption Expenditures, 20 years

PCE Core YOY%

Source: BLS, Bloomberg, as of June 27, 2022.

Second will be jobs. Unemployment and payroll data will once again become a critical measure in gauging the efficacy of the Fed's desired "demand destruction". We have been averaging over 500k in job gains for the past five months and the unemployment rate sits at almost a record low of 3.6%. In fact, the last time the unemployment rate was below 4% for any extended period of time was 1966–1969 — and then we had the seventies (**Figure 8b**).

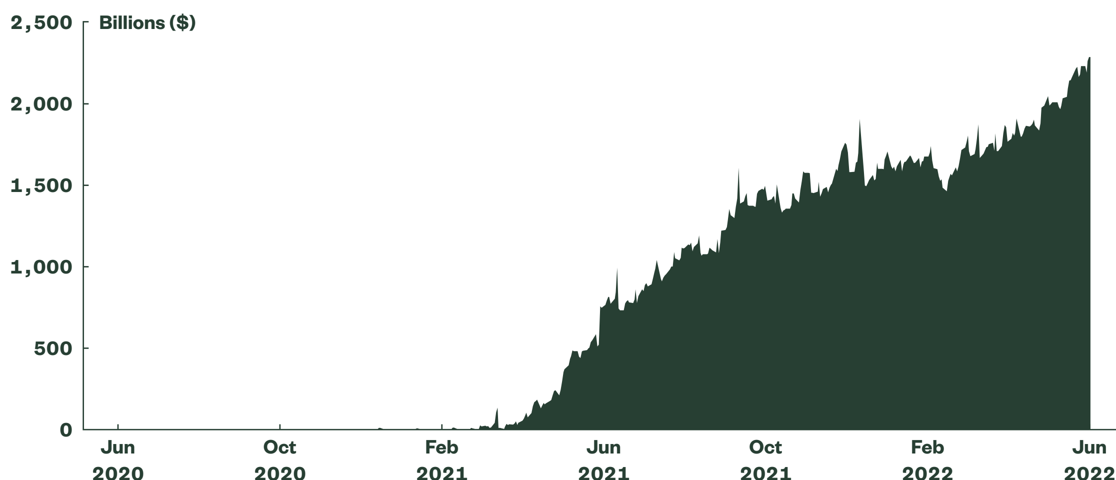
Figure 8b
U3 Unemployment Rate



Source: BLS, Bloomberg, as of June 27, 2022.

Lastly will be market liquidity. The Fed's Reverse Repurchase Program (RRP) has been taking over $2 trillion in cash for the past several weeks (**Figure 9**). This is a clear indication there is too much money in the system that no one wants to or is able to take.

Figure 9
Fed's Reverse Repo Allotment



Source: Federal Reserve, Bloomberg, as of June 27, 2022.

The Fed allowed their quantitative easing program to run too long, meanwhile quantitative tightening (QT) will take time. By some estimates it could take upwards of two years for the Fed's QT to drain the excess of liquidity from the system. In the meantime, we should see bank deposits shrink as the pace of rate hikes will make money market funds more attractive.

As I have said previously, hang on it's going to be a bumpy ride and remember who's king.

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* Pensions & Investments Research Center, as of December 31, 2020.
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