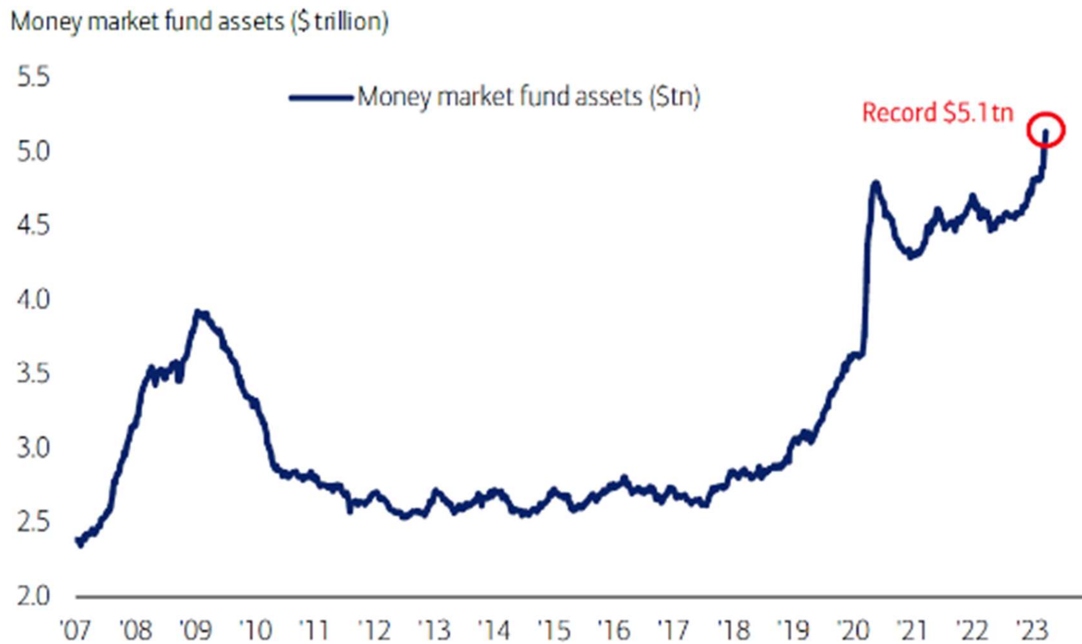
Monthly Insights

1st Q, 2023

March 2023

Where is all the Cash Going?

Cash has understandably been finding its way to money market funds over the past year as they began to offer more attractive yields. However, as we see below, assets in money markets has spiked in recent weeks. This has likely been due to general market fears and more recently the bank crisis.



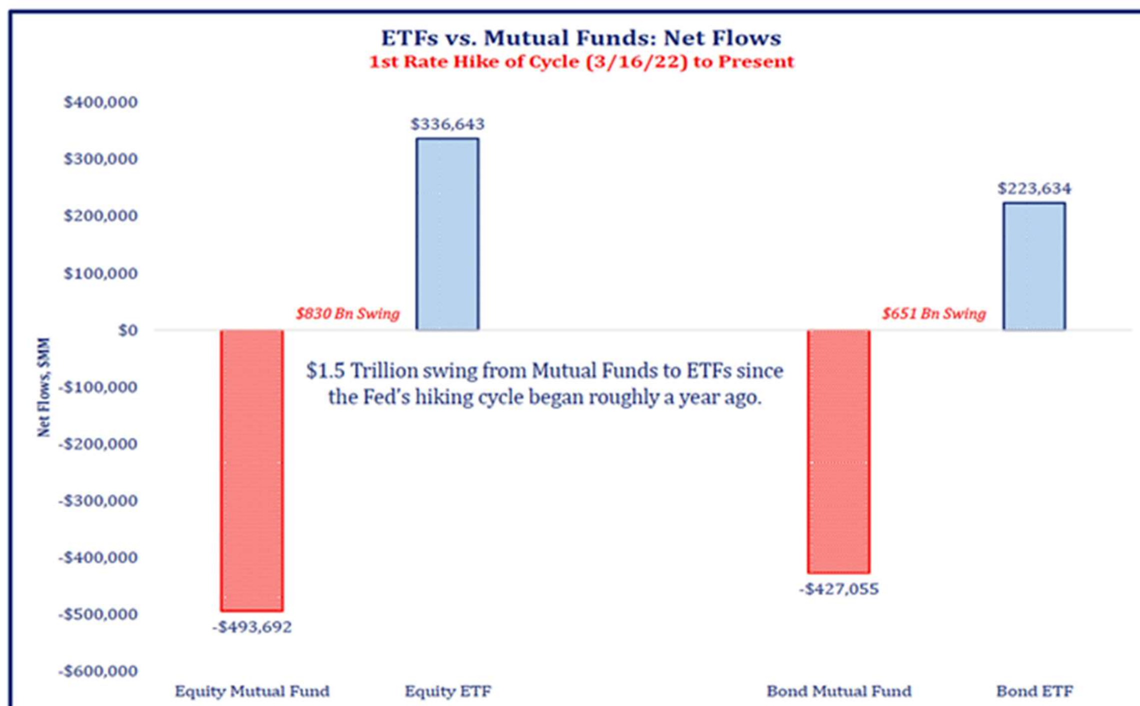
What we find interesting is that the spike in money market assets peaked in 2009 and 2020, which turned out to be the low point for stocks. It is not uncommon when the point of most pessimism and flight to safety turns out to be one of opportunity. Of course, we will only know in hindsight at what level money market assets peak in this cycle. They could still go higher from here, just as stocks could go lower. However, current sentiment is negative enough that any positive surprise could catch some off guard.

The Shift from Mutual Funds to ETFs Continues

Since the pandemic stock market lows of March 2020, $3.4T has shifted from mutual funds to ETFs. Of course, this trend was not new, but some of the reasons for the shift have changed.

Originally, ETFs were mostly passive strategies as many investors were shifting assets to track an index. However, in recent years, ETFs have become available in a variety of asset classes and many more of them being actively managed. In fact, since the March 2020 lows, actively managed ETFs have increased by more than 200%.

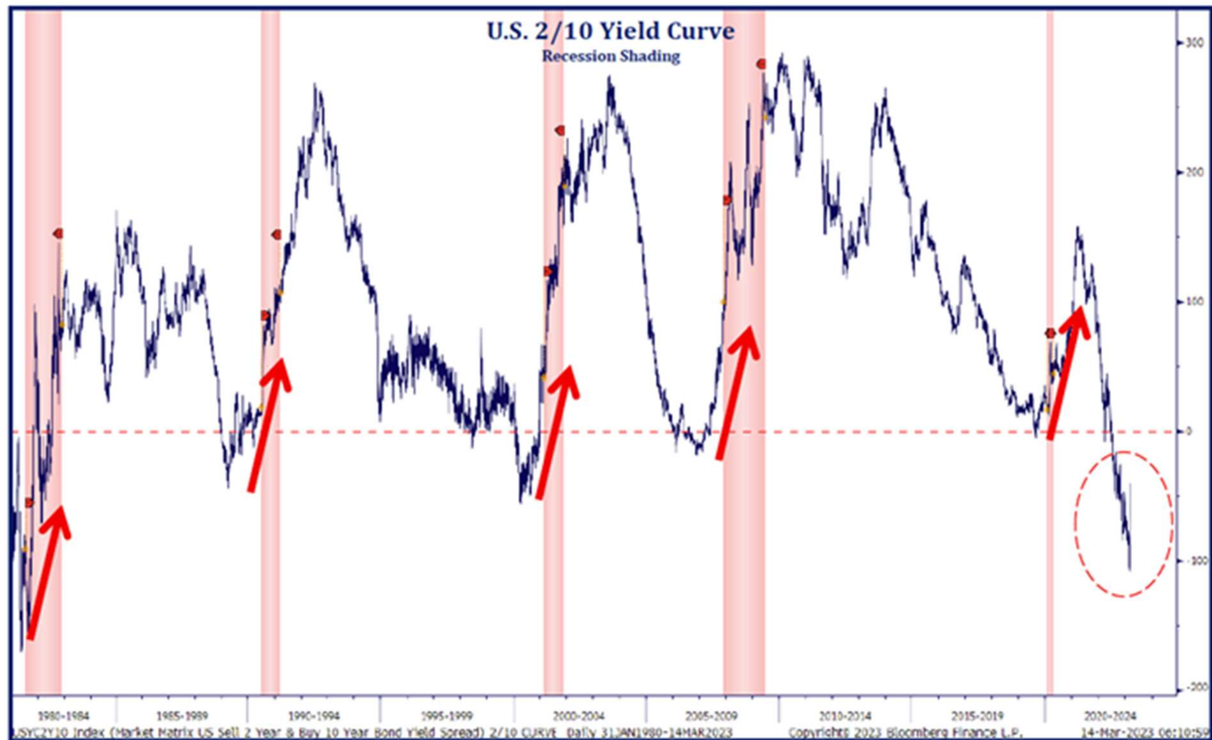
Additionally, more actively managed fixed income ETFs have become available. Since the Fed's rate hike cycle started a year ago, $651B has shifted from fixed income mutual funds to ETFs. Likely, a sizable portion of that went into active ETFs.



Tax efficiency and ease of trading also tend to be advantages of ETFs over mutual funds. That does not mean there is still not room for the occasional mutual fund in a portfolio. There continue to be plenty of quality mutual funds that have yet to make the transition to ETFs, but many more will make that shift in the years ahead.

The Potential Signals from a Steepening Yield Curve

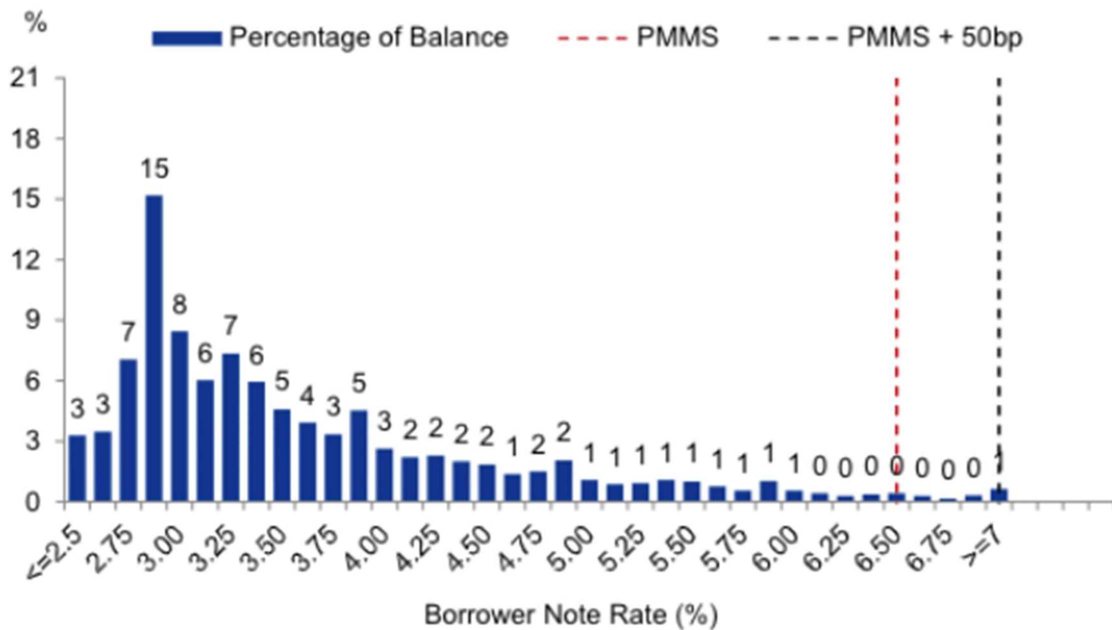
Since the recent bank failures, interest rates have seen a dramatic decline. The majority of the decline has been in the shorter end of the curve. At first, this might seem like a positive event as we heard over and over last year about the dangers of an inverted yield curve. However, a steepening curve (see chart below), often portends a recession.



We have reiterated many times that the economy is currently strong, and any potential recession would be further out. However, we are now more alert to any declines in economic activity related to the bank failures. It could be small business owners and even larger company CEO's that see this as a reason to tighten spending further, resulting in a slow down. Ultimately, the U.S. consumer drives much of the economy with spending. Therefore, the jobs data could be the signal to monitor if the economic strength is slowing.

Why Real Estate will Continue to be a Grind

Much is working in the favor of residential real estate. The large millennial population is of the age where their families are growing and they want larger homes. Not far behind is Generation Z. Combine these populations with a very strong job market and it would seem the housing market should still be very active. However, offsetting this is the fact that 99% of existing mortgages are below the current mortgage rate.



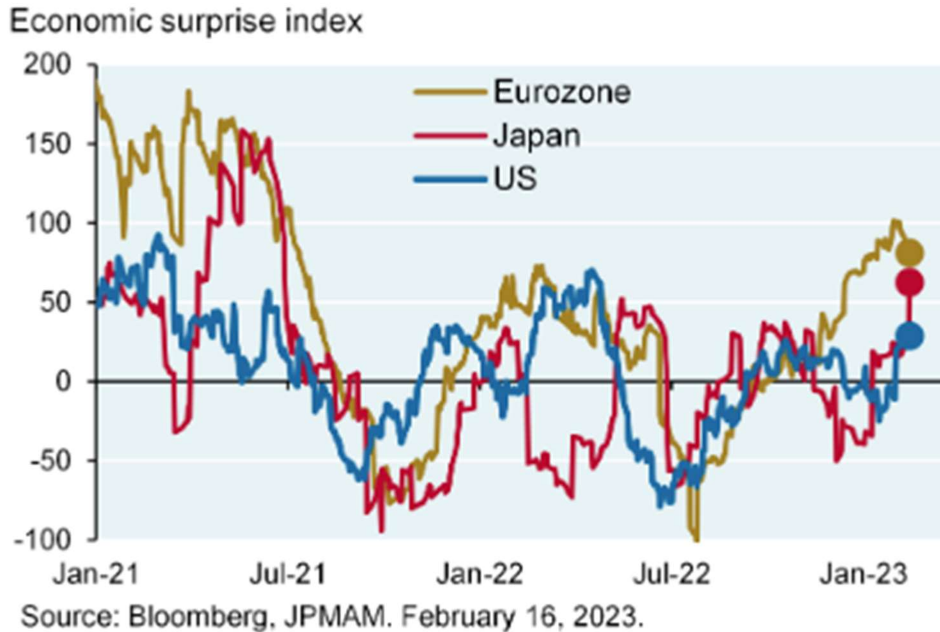
Source: eMBS, Goldman Sachs Global Investment Research

With so many holding mortgages below 4%, it seems that this demographic would need a real push to sell and move to a new home. Additionally, homebuilders that continue to be disciplined on new home builds could keep inventory lower for longer. A side note that could play into this - *the fact that the quantity of apartments in the pipeline is fairly large.*

Interest rates will continue to have a large impact on the housing market and will likely keep many people in place, unless rates decline.

Better than Expected

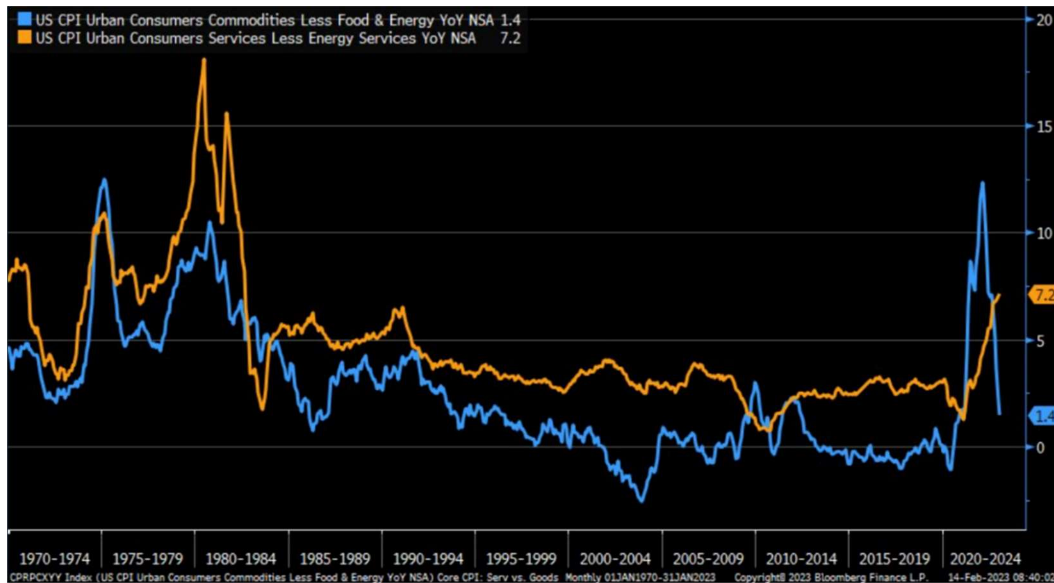
So far this year, the major economic zones of the U.S., Japan and Europe economic data has been coming in much better than expected. Just a few months ago, nearly all economists thought the U.S. and especially Europe would be in recession by now.



At times, strong economies are not always a good thing. The Fed is clearly concerned that growth and the job markets are too strong to allow inflation to come down to their desired levels. They will likely keep pushing rates higher and/or leave them higher for longer. Will this eventually cause the recession that many have predicted? That is a possibility. Has the stock market already factored that in with last years sell off? That is a significant unknown and will be a very important over the next year with respect to bringing down inflation.

Goods Versus Services Inflation

Drilling down a couple layers into the Consumer Price Index isn't most people's idea of fun, but inflation and its various details remain a hot topic. The blue line below is a representation of goods. These physical products have seen a sharp drop in inflation to bring the rate back nearly in line with the norms from recent decades. However, the orange line of services continues to be very elevated.



For anyone that has gone to a restaurant, booked a hotel, or flown in recent months the services inflation might not be a surprise. However, those factors are much smaller than the shelter component which is dramatically pushing the orange line higher. As we have mentioned several times, the way CPI factors in shelter is very slow to recognize the downshift in rents.

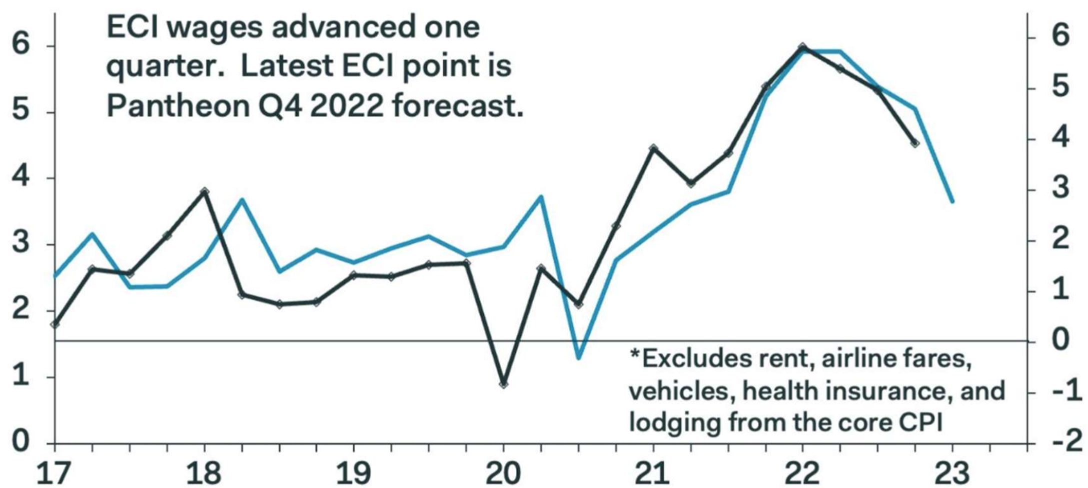
Inflation, as a whole, is moderating with more decline likely. However, the rate of decline has slowed with the job market while the broader economy remains strong. This is likely to cause the Fed to raise rates further and/or keep rates elevated for a longer period.

Bison Wealth – Charlotte
532 Governor Morrison St. Ste. 200
Charlotte, NC 28211

An Important Slowing of Wages

Inflation has cooled enough for the Fed to slow rate increases. However, with the continued health of the job market and strong wage increases, the Fed has kept their tone hawkish with concerns inflation could rebound.

We recently received the latest wage data that the Fed monitors closely. While wages are still climbing, they are doing so at a much slower rate as shown in the blue line below. More importantly, this can also indicate Core-CPI (the black line) will fall further soon.



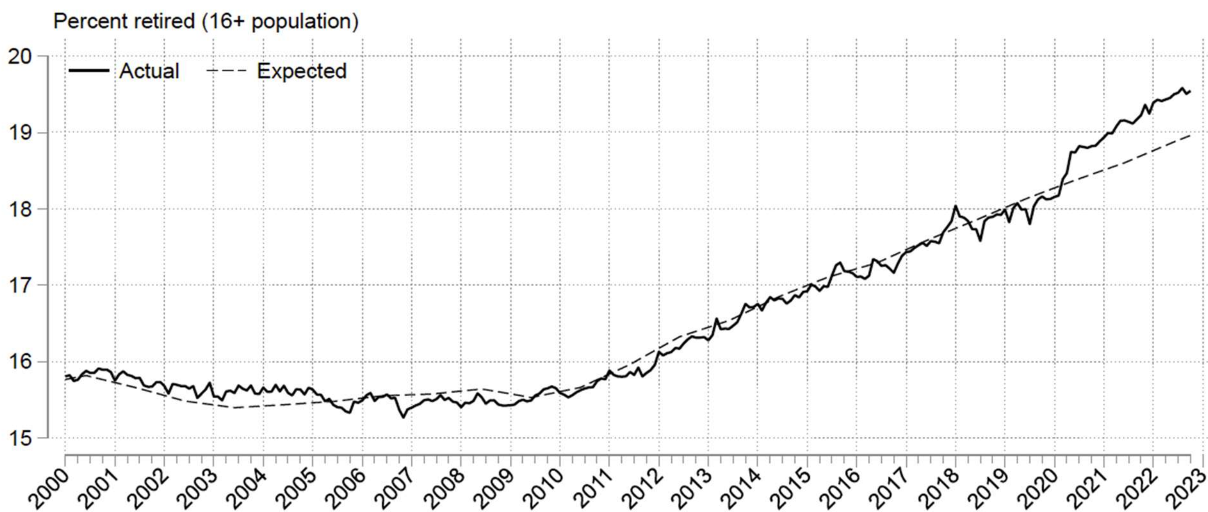
The Fed will be making another rate decision soon and more importantly offering guidance. Inflation and job data will inevitably have moves in both directions, but for the time being it seems to be indicating that the Fed can soon pause rate increases.

January 2023

A Problem for the Fed

All of us have been closely watching the inflation data and we know that it is instrumental in what action the Federal Reserve will take with respect to interest rates. What is less discussed, is how closely the Fed is watching the jobs market. While softening some, it remains exceptionally strong which is concerning to the Fed. They know that that the American consumer with a job will spend and therefore make inflation stickier.

That brings us to the below chart. The dashed line represents the percentage of the population *expected* to be retired based on age alone. This began to climb about a decade ago, as the large Baby Boomer population started to hit retirement age. The solid line indicates the actual percentage of the population that retired. Notice how it began to deviate from the *expected* at the beginning of Covid in 2020. In other words, a much larger than expected percentage of people have retired.



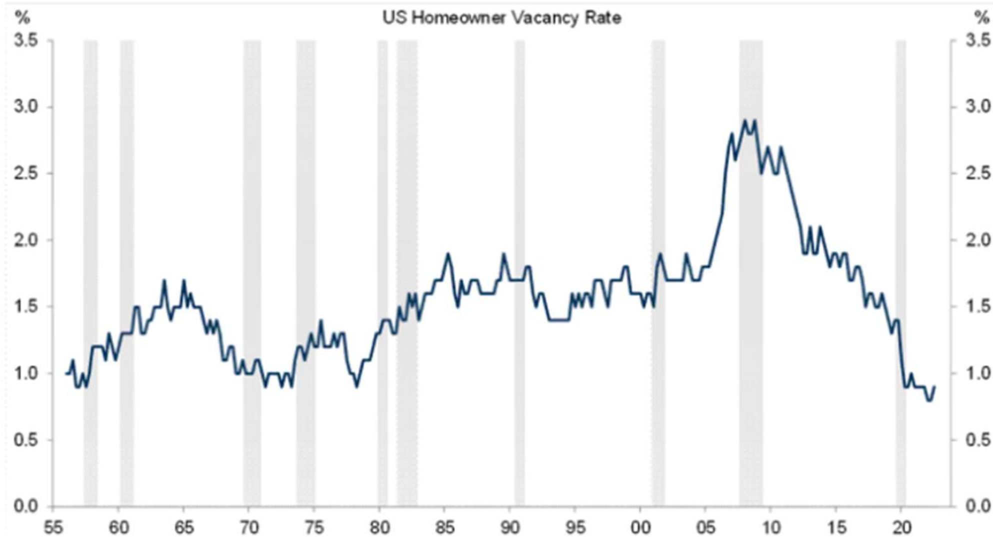
Source: Federal Reserve

There are also a number of other factors of why the available workforce has declined. All of them, combined with the unusually high percentage that have retired, could make the Fed's job more difficult. As odd as it seems, they want and may need to punish the job market to get to their desired inflation level.

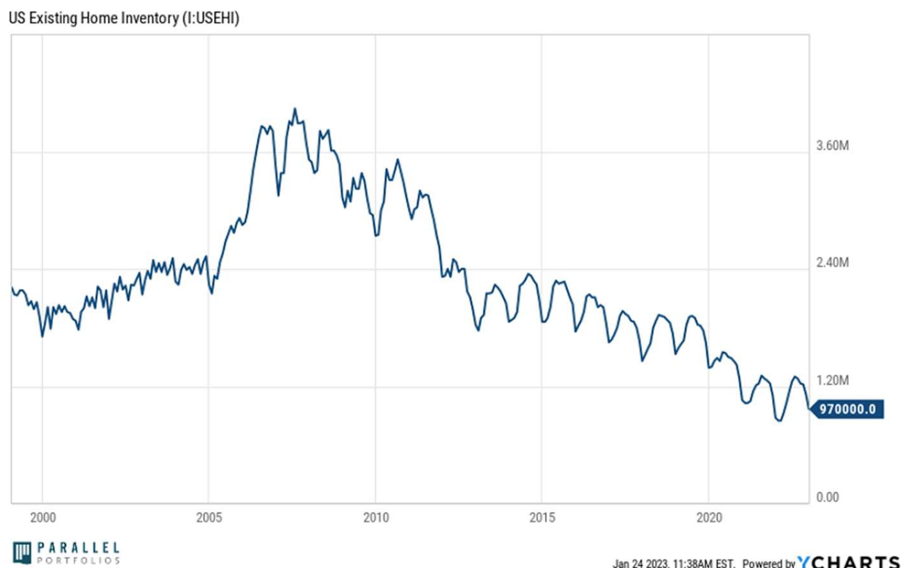
The State of Housing

The residential housing market tends to be a favorite conversation. It also happens to be a large driver of the economy. The housing market boomed during the first couple years of the pandemic but came to a screeching stop last year when the period of ultra-low mortgage rates came to a halt. This understandably caused many to think back to the housing collapse that caused the Great Financial Crisis. While we don't think house prices are set to accelerate higher soon, we also do not believe a collapse is coming.

If we look at homeowner vacancy rates, we can see that they are now near all-time lows. During the last housing bubble, they moved to double the normal rate.



Next, let's look at existing home inventory for sale. Not only is inventory near lows, but it is substantially lower than during the prior housing bubble.



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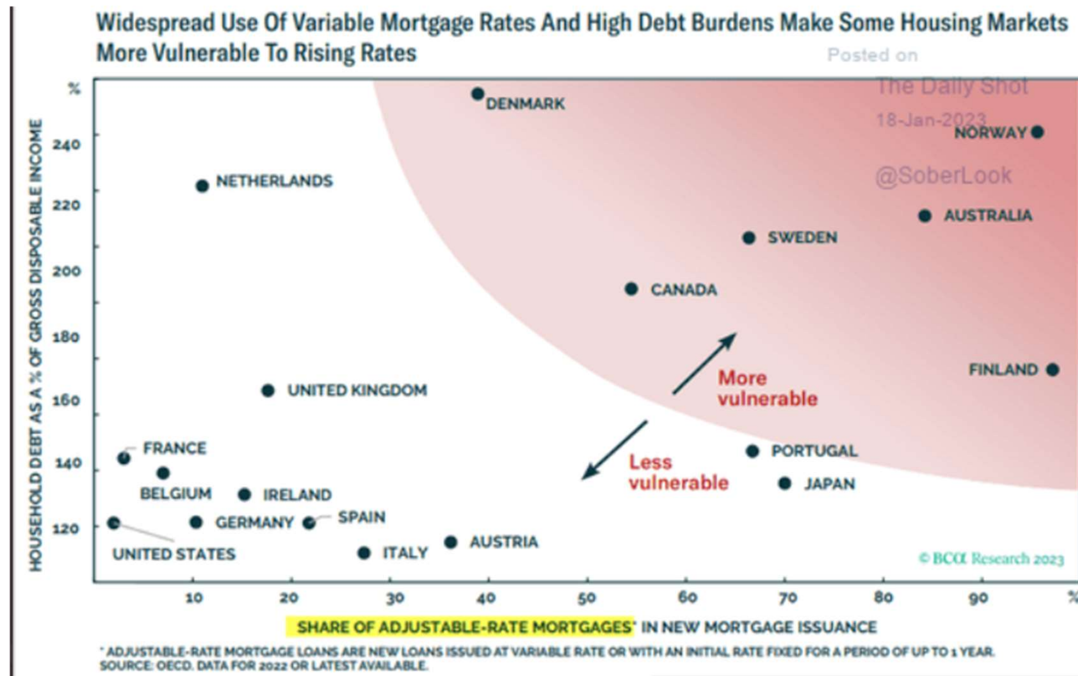
Lastly, we thought that the view of how various countries are positioned was rather interesting. Those with adjustable-rate mortgages could find their monthly payment moving notably higher with the rise in rates. However, we see the U.S. positioned in the bottom left corner indicating a low level of adjustable-rate loans and a very low consumer debt level as a percent of their income.



Source: Federal Reserve

There is little question that the housing market got ahead of itself during the pandemic, for a variety of reasons. Now, like so many other aspects of financial markets, the housing market is normalizing. This process will take time as buyers and sellers find a new middle ground to meet. However, most importantly, the current housing market cycle does not appear to be in a high-risk position of collapse like that of 15 years ago.

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