Weekly Update

1-December-2021

Carlisle C. Wysong, CFA
Managing Partner

- Last week was not the perfect storm…this week is
- It is still all about Positioning
- The Volatility market shows little more than short-term panic
- Housing seems to be reigniting
- Online Retail Sales are booming
- Leading Indicators look better than Current ones
- Business surveys remain flattish (but still positive)
- Mixed bag of Manufacturing data in Asia
- Oil traders's scars run deep
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	4513	-4.0%	21.3%	26.4%
QQQ	398.8	-2.9%	23.8%	29.9%
US 10 YR	1.41%	1.64%	0.92%	0.94%
USD/DXY	96.0	96.7	89.9	91.1
VIX	31.1%	18.6%	22.8%	21.2%
Oil	65.7	-16.1%	35.1%	47.2%

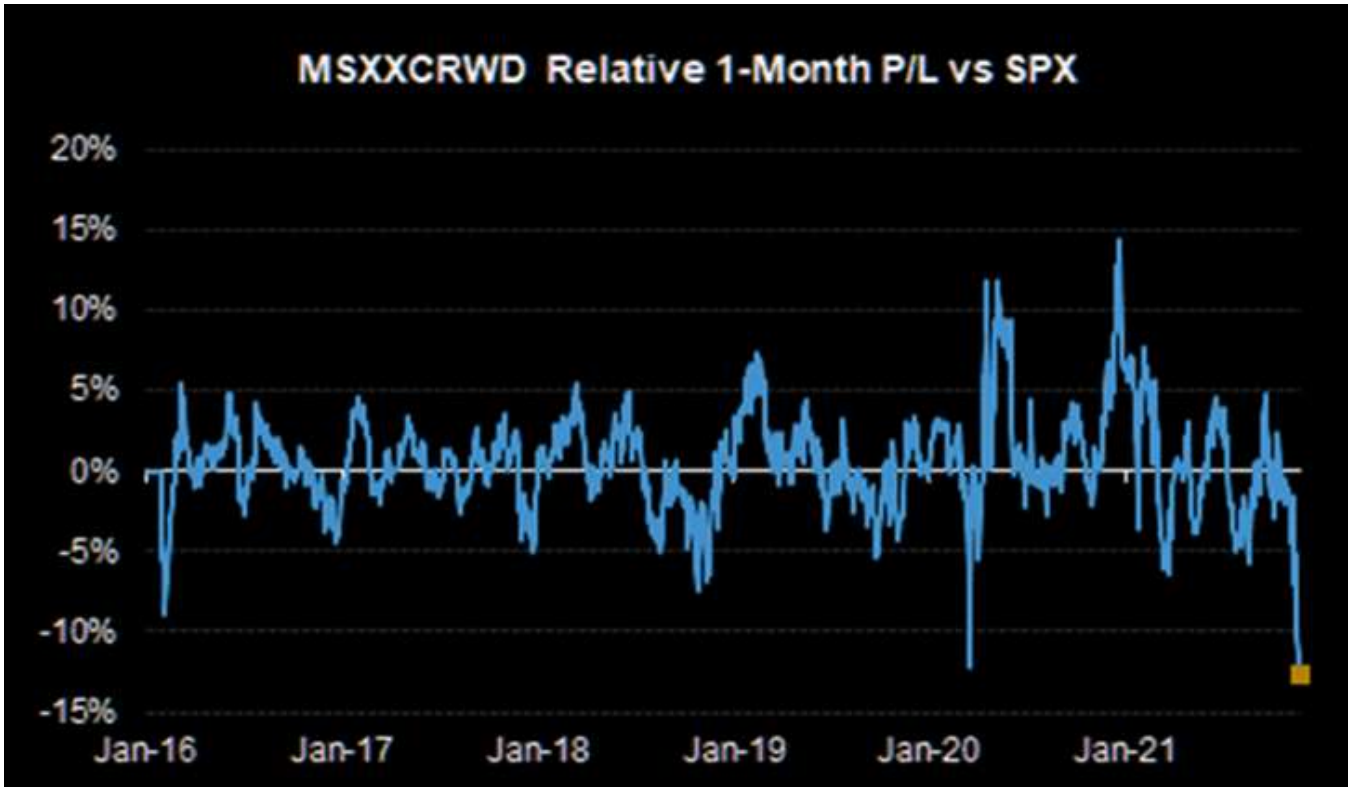
*10yr, DXY, and VIX are levels not changes
** Oil is front month futures, beware

Last week we thought we had a perfect storm of negative narratives. Little did we think that the headline factors would intensify further: The latest virus-fear might slow the economy, and the Fed will not be there to backstop the market. All the pundits say they will wait for the scientific data before drawing any conclusions about the omicron variant, but the market never waits (which often presents opportunities, we think this is one). There was a bit of a reprieve as the market thought this environment would give the Fed some wiggle room to not tighten monetary policy so quickly. But the Fed chairman surprised almost everyone with his hawkish tone. Not only will the Fed not reverse course, but it will look to *speed up* the tapering of bond purchases. Moreover, chairman Powell acknowledged it was time to dispense with the term "transitory" with respect to inflation (ironically right before we expect to see some cooling in price changes). Naturally, he did not come out and say that inflation was here to say, but rather people had been misinterpreting the Fed's definition of "transitory." Whatever the case, the market thinks the Fed will act more forcefully to squash inflation. The

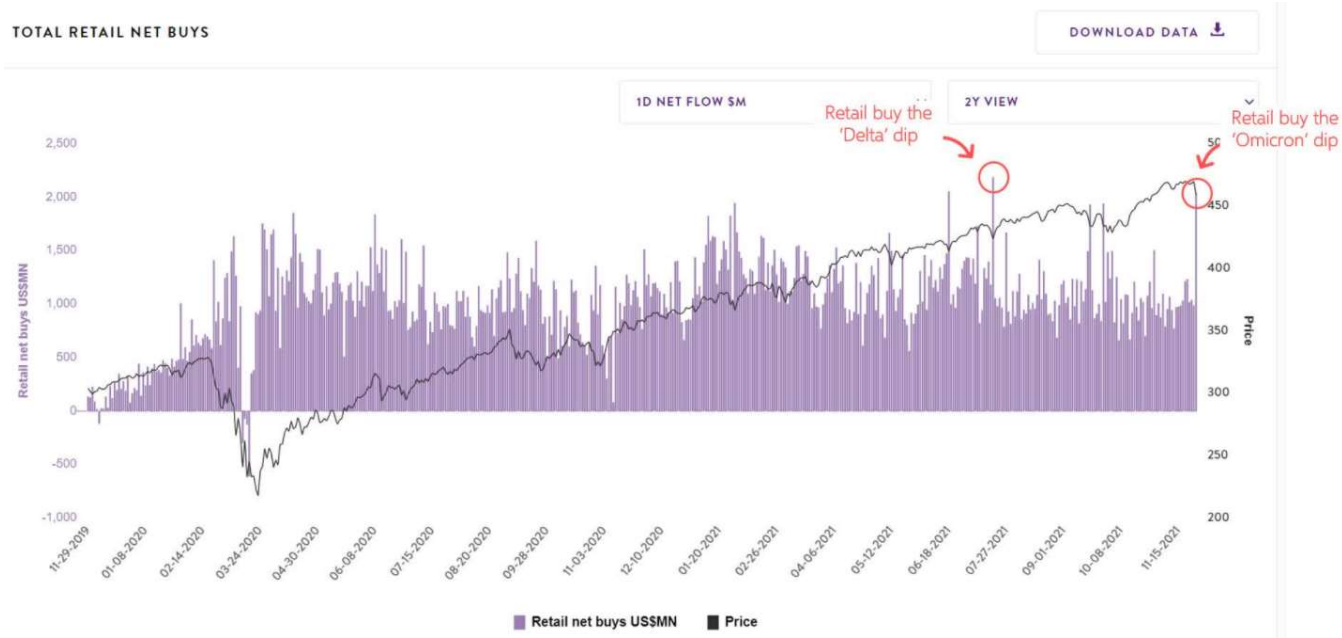
probability of the first interest rate hike in June reversed higher. A week ago (pre-omicron), there was a 74% chance of a June rate hike. Monday, there was 59% chance (the moment of reprieve). Today, it is back to a 75% chance. More importantly, long-term interest rates have actually been sinking (see the 10-yr yield in the table above.) We have reentered that "curve flattening" mode which signals the market's fear of a slower economy. We still do not think this is case. We will look to add to our longs levered to the economy. But we also have learned that these bouts of virus-fear can last longer than rationally expected, so we will take our time.

- It is still all about Positioning

We have been writing that hedge funds are extremely leveraged both on a gross basis (borrowing money to increase the size of the portfolio) and net basis (extremely long instead of more market neutral). Morgan Stanley has a "MS Crowded Long basket" which tracks the biggest names. The chart below shows the performance of these longs before Friday's panic unwind (and subsequent selling). Amazingly, the performance has been worse than when the virus-fear first struck! To be fair, we do not have the matching short positions. But clearly hedge funds have been wrong and are very likely puking (at the wrong time).

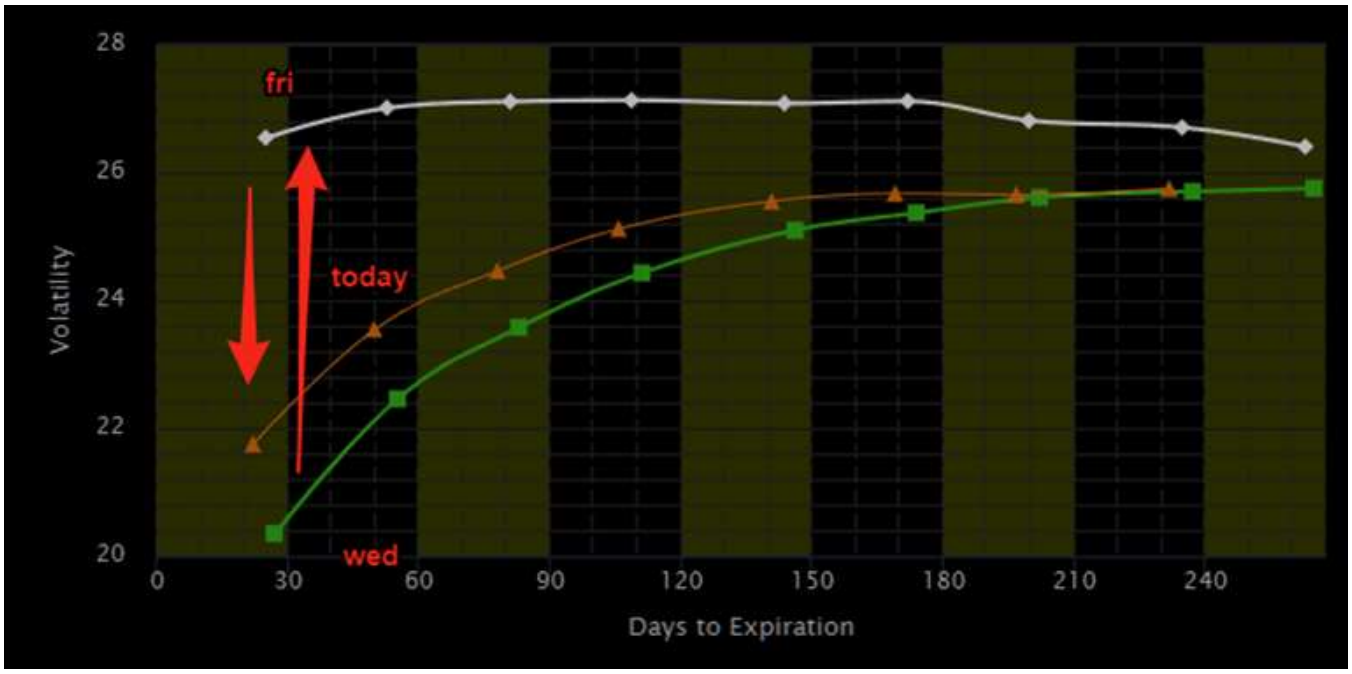


Conversely, retail investors "bought the dip" during the Friday weakness. As you can see, retail always buys the dip! Retail once used to be called "dumb money" and hedge funds were the "smart money." During the last 10 years, it is fair to say this has flip-flopped. (We think it will continue.)



- The Volatility market shows little more than short-term panic

The Volatility futures curve shows us how the Friday bombing was pure panic. The green curve was the pricing of Volatility the day before Thanksgiving. The white line was the shift on Friday. The point is that the far end of the curve (out in time to the right) barely nudged higher. But the short end of the curve (left end) rocketed higher. As you can see from the orange line (Today = Monday), things normalized quickly. Today's Vol (the real today) levels are higher, but more to the point, the curve is inverted with the highest levels of risk in the front month. Risk is typically priced higher further out in time. So, any time there is a knee-jerk reaction in the short end, it is considered panic.



- economy

- Housing seems to be reigniting

Pending Home Sales (signed contracts but not closed) had a large 7.5% jump in October compared to the 2.4% drop in September. The annual change in Oct vs 2020 was a slight dip of 1.4%. This is still a good number considering the surge in Housing last summer and fall. The National Association of Realtors, the aggregator of this data, says much of the monthly uptick stems from higher rents and the prospects of higher mortgage rates.

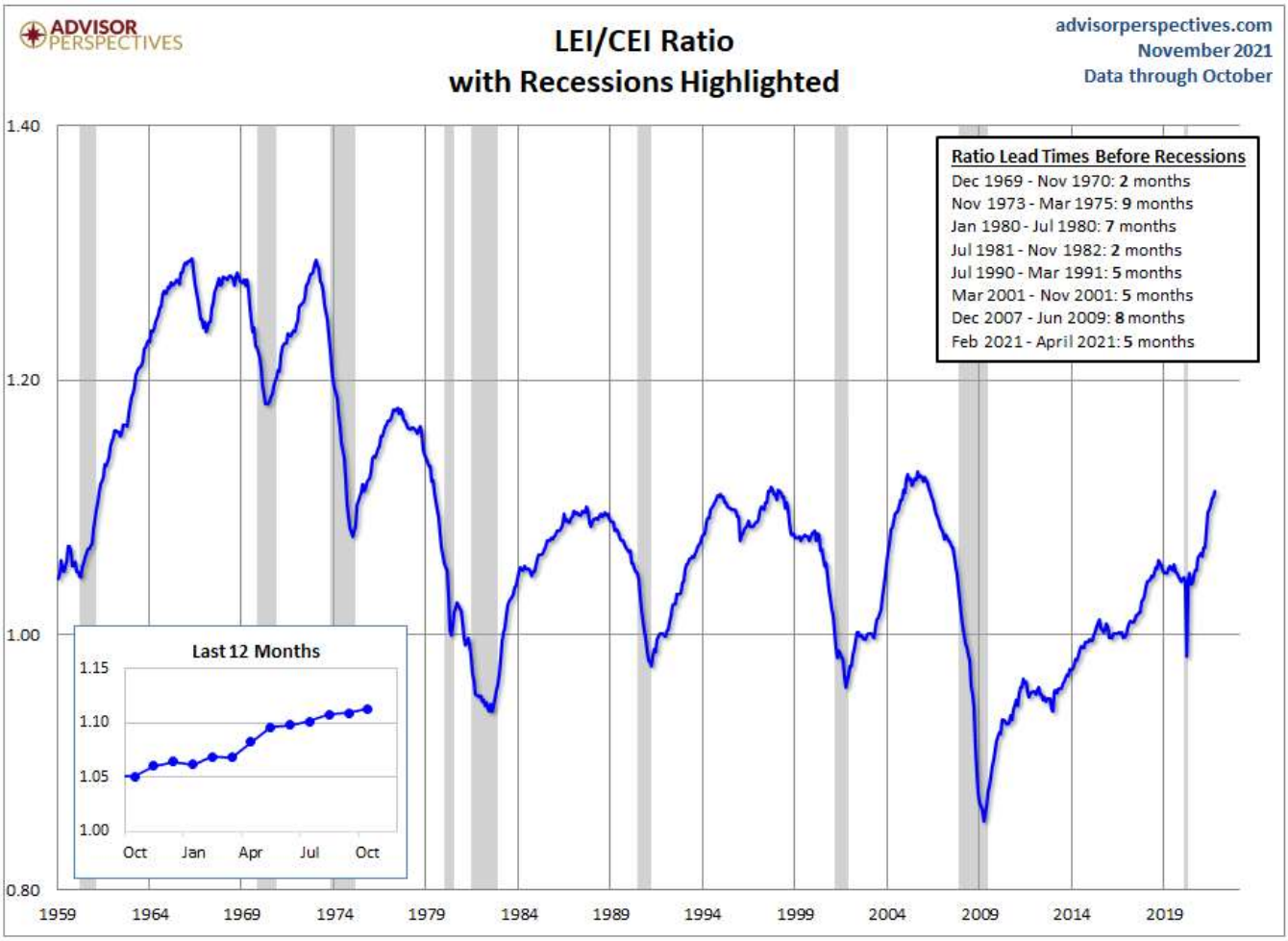
We have been waiting for Pending Home Sales to trend higher before we get long Housing again. This data has been volatile all year long. We will need to see this good number become a trend.

- Online Retail Sales are booming

Black Friday sales figures are always hard to aggregate and compare from year to year. This year is no different. Total Sales on Friday dropped to $8.9b from $9b last year. But 2020 was a banner year for shopping. 2019 sales were $7.5b. Shopify sales (essentially an ecommerce platform provider for smaller businesses) increased 21% vs 2020 which was up 75% from 2019. Cyber Monday sales also fell from last year's record levels. But probably the best metric to use is online shopping starting November 1. It has tallied almost $110b which is up 12% vs last year.

- Leading Indicators look better than Current ones

An economist/pundit that we follow, John Mauldin, recently pointed out that the forward-looking economic indictors have been stronger than indicators that are simply current. We often mock the Leading Economic Indicators (LEI) since it is released after its components have been released. Nonetheless, there does seem to be a trend when the LEI reverses compared to Current Economic Indicators (CEI). With the LEI still, in fact, leading the CEI, the economy does appear to be on good footing (sharp downturns in the LEI/CEI ratio typically foretell recessions).



- Business surveys remain flattish (but still positive)

The Markit Manufacturing PMI for November dropped a touch and the ISM Manufacturing PMI moved up a touch. The Dallas Fed Manufacturing survey showed mixed results. The General Activity subset was weak. But the Production Index reversed a three-month slide. The one outlier was the Chicago PMI which fell sharply. All these levels still represent solid growth.

- Mixed bag of Manufacturing data in Asia

The official China Manufacturing PMI was able to regain the middle line of 50 in November. Alas, the private PMI (the Caixin) sank back below 50. We know which to believe. South Korean Industrial Production in October slipped further into negative territory. But Japanese Industrial Production in October moved back into positive territory. We think watching Asia for their reactions to the new virus-fear will tell us a lot about global growth. We expect some initial fear followed by a resumption in activity.

- Oil traders's scars run deep

The latest virus-fear inflammation clearly spooked the oil markets. Financial and commercial players alike still have scars from last April's negative price action from the evaporation of demand. Goldman tries to quantify this current reaction: "the market is pricing a 7mm barrel per day negative demand hit over the next three months with no offsetting OPEC+ response." Of course, OPEC+ will likely reverse course and *not increase*

production as previously planned (an additional 400k barrels per day per month was the plan). This slowing of production was going to happen in response to Biden's release of crude oil from the Strategic Petroleum Reserve (SPR). But the new virus-fear gives the cartel perfect, political cover to help boost prices. Another analyst comment: "The markets look to be ahead of the risk even though we are not even close to understanding how bad this variant might be." As we wrote above, the market does not wait for the science.

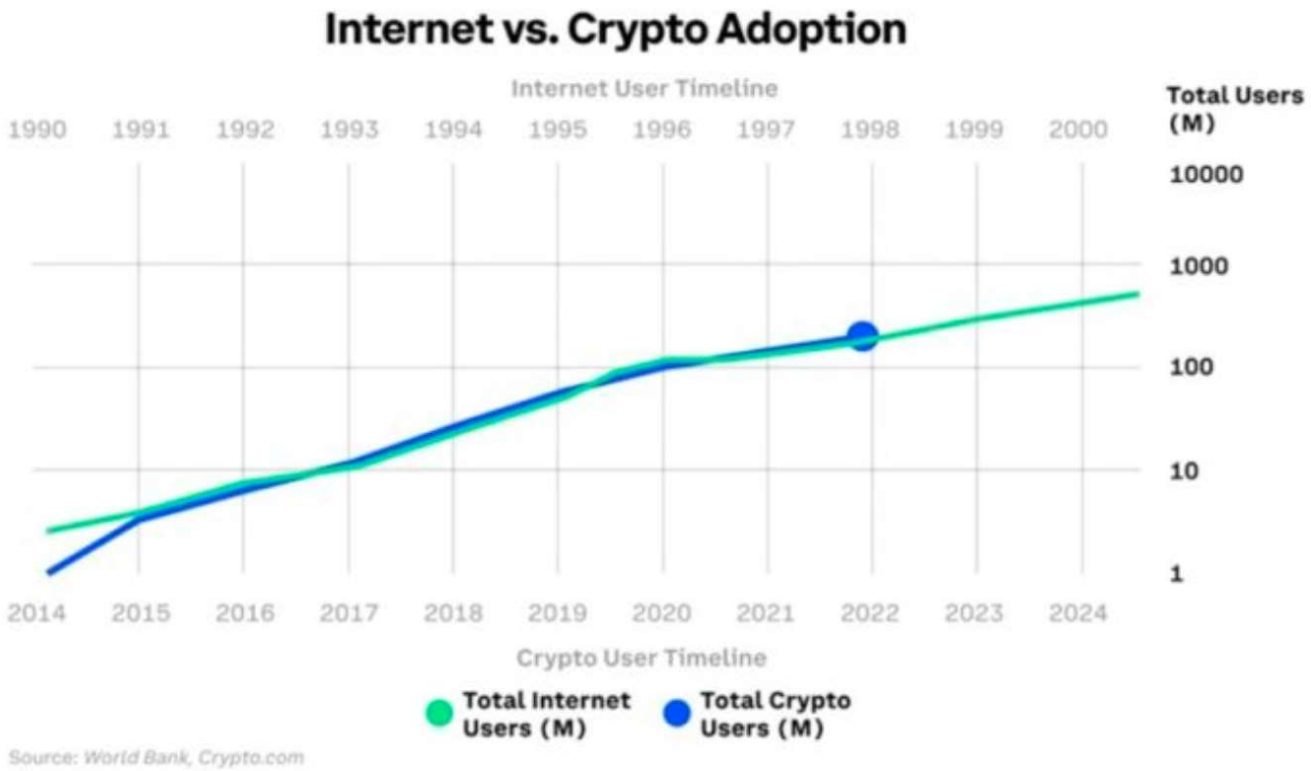
Last week we joked about the oil companies doing an arbitrage by selling the SPR crude for today's prices and buying them back in the futures market at a ~$15 discount. It turns outs, the SPR crude quality is even worse than we though. We noted it was low-grade, sour crude which could only be exported. But when this sour crude sits in storage caverns for years, it increases the salt content which devalues the crude even more. All told, the arbitrage disappears. The net result is the same…the SPR exchange has very little affect on pricing. All it really does it make oil trading (the actual buying, delivering, and selling of oil, not financial trading) much more difficult. And it turns out, this all might be moot. The Deputy Energy Secretary said the SPR release might be off the table now that oil prices have fallen. Seems more like a Tactical Petroleum Reserve than a Strategic one. And this same government official publicly floated the idea of banning crude oil exports. He clearly does not understand that this helps refiners's margins and has little to do with the end price of gasoline. Then again, the Energy Secretary does not know how much oil the US consumes. (Rick Perry sure was right when he wanted to get rid of the Department of Energy…alas he forgot he wanted to get rid of it In more ways than one.)

Also pressuring crude prices is the resumption of talks with Iran. The NOIC (National Oil Company of Iran) has stated that it wants to ramp oil production back to 4mm barrels per day. The current production rate is about 2.5mm bpd. 4mm was the peak back in 2016.

In natural gas, Germany committed to including natural gas as a transition energy en route to a "carbon free" economy. Currently, 27% of Germany's energy comes from coal.

- Chart Crime of the week

This ridiculous chart reminds us of our opposite view on crypto. Buying cryptocurrencies is not akin to adopting the internet. The development of the blockchain is akin to using the internet. Buying cryptocurrencies is akin to buying Pets.com (it was bankrupt nine months after its IPO).



- Quick Hits
  - Frank Sinatra and Dean Martin invented the beverage cart in golf.
  - The White House is changing how it leases oil rights on federal lands in part to stay, "steadfast in the pursuit of environmental justice."
  - TAN, the largest solar ETF, is valued at 100 years's worth of earnings from the underlying companies.
  - NYC is opening drug injection facilities in Harlem. You must bring your own heroin.
  - Last week was the 50th anniversary of the disappearance of DB Cooper. He definitely survived the jump.
  - 27% of Americans have applied for a credit card in the last year. It was about 16% in the proceeding twelve months. Astonishingly, or at least to us, the 27% is back to the pre-virus average.

Trading: We rotated some of our long equity exposure. During the weakness, we added to some of our small-cap names. We took the opportunity to sell some of our low profit, low quality names which outperformed. We also added to our high quality names. We have been making this shift (out of low quality into more high quality) for a while now, so there was nothing to drastic to do. If this panic continues (assuming it continues to be unjustified, too), we will use some of the cash reserve we have built up to buy more.

TSLAQ: The Bond Villain never sleeps. First, he essentially warned about 4Q deliveries at Tesla as he said the company should not rush to meet a delivery target. Nobody cares. Secondly, Musk admitted his SpaceX company is close to bankruptcy. He made up some story about the company having 25 space flights next year which will save it. In April of 2019, Musk told analysts that Tesla was close to bankruptcy. He then told these lemmings that Tesla would have 1mm robo-taxis on the road in 2020. Just in case anyone is confused, there are

zero robo-taxis on the road. Elsewhere, Tesla announced it is selling a $50 whistle shaped like its fake cyber truck. Musk is imploring people to become "Tesla whistleblowers" in a not-so subtle jab at the SEC.

Check out our website to learn more about Chalk Creek Partners

Carlisle's Twitter Financial List

Carlisle's LinkedIn