Weekly Update

2-Nov-2022

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- The Fed does what it has been saying it will do
- FOMO has probably been driving Vol
- Do not look to China for help
- Positioning is no longer bearish…just in time (not)
- Bad Earnings are being punished with more to come
- Inflation is not cooling (just ask the Fed)
- Do not be fooled by the strong GDP in Q3
- Slower Business Spending in real terms is the key
- Is the Consumer really in great shape?
- Surprising Employment data might be a government thing
- Do not get the Fed's Powell started (our live notes)
- Quick Hits
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	3,760	-1.9%	-20.2%	-17.3%
QQQ	$265.68	-4.4%	-32.9%	-31.0%
US 10 YR	4.10%	4.05%	1.51%	1.61%
USD/DXY	112.1	110.5	96.0	93.9
VIX	25.9%	27.3%	17.2%	15.1%
Oil	$88.45	1.7%	19.7%	5.3%

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

"The ultimate level of interest rates will be higher than previously expected" Fed chief Jerome Powell during his post-Federal Reserve monetary policy meeting (FOMC).

Poof! Just like that, the Fed "pivot" was gone. The Fed hiked rates by 0.75% and clearly indicated that the restrictive policy was here to stay until there was solid and lasting evidence that inflation was under control. With the Fed hiking rates and tightening financial and economic conditions into a recession, there is not much reason to celebrate. Economic data continues to deteriorate (domestic and global). Earnings continue to slide –

Amazon's dismal holiday guidance should alarm the last of the "consumer is fine" class. Positioning is no longer extremely bearish (did not buy the dip but chased the rally). Geopolitical stress remains elevated.

We are not quite sure why the equity market hangs its hat on the words of a WSJ reporter…especially one that has shown a penchant for misinterpreting the words of Fed officials. Along these lines, we have the answer to our rhetorical hypothetical from last week about whether the equity market will be the leader this time: No. The bond market has been telling us that there will not be a Fed pivot and that a recession is coming (inverted yield curve). Moreover, on Monday the Treasury announced it is going to issue an additional $150b in debt in Q4. Treasury tries to layout its funding needs in advance, but it is always changing with the wind. August's estimate for Q4 borrowing was $400b. But now that is up to $550b. Add to this on to the Fed's intention of Quantitative Tightening (bond selling) to the tune of $95b a month…that is no magical cowbell. Maybe the market "S*hould* Fear the Reaper."

As for Powell's press conference, what might be most interesting was the changing of his tone as he was asked more questions about potentially pivoting. His preliminary statement hinted at a slowing of rate hikes. But as the questioning continued, his answers veered more hawkish (tighter monetary policy). Perhaps his most nuanced answer was that the pace of hikes was of less importance now. The ultimate rate (higher) and length of time (longer) carry more importance (as they should, most smart market-watchers laugh at the notion of nitpicking over 0.25% here or there).

- Volatility still seems to be an outlier, unless it is the FOMO maniacs at work

One curiosity of the market remains Volatility. Recently we have commented that Volatility continued higher during some rallies. Today we saw Volatility sell off despite the sharp decline (S&P -2.5%). These are counterintuitive moves as Put buying and selling usually wags with the market. But we know there has been a renewed interest in FOMO Call option buying lately. This math works as the Call buyers chased the rally (there is a theme in here somewhere) keeping a bid under Vol as well as stocks. And then these same Call options were puked in the down tape compressing Vol. We will look for some deeper research on this. But this is our gut.

- Do not look to China for help

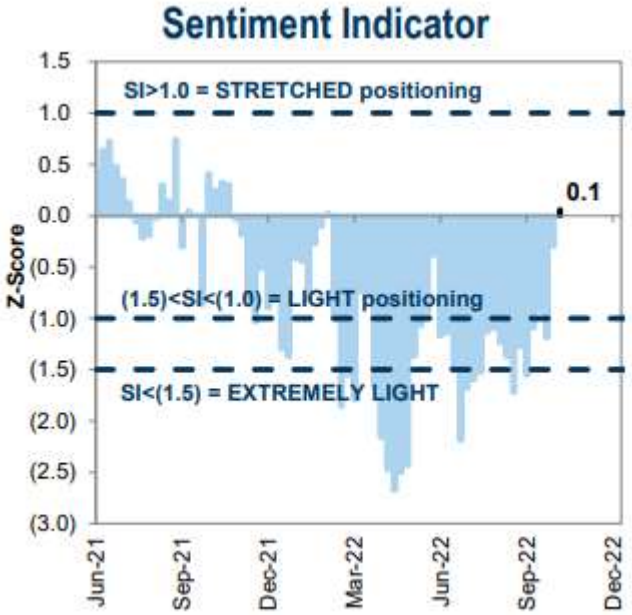
China got a booster shot of relief when a rumor circulated that the Chinese government had a committee looking into the effects of the 0-Covid policy and the potential path forward…the eventual return to normalcy. The government denied this. But is it not obvious that the communists would be planning what to do next? While we revile communism, we cannot accuse them of a lack of planning…they are central planners after all. In the meantime, there are approximately 30 cities in China currently locked down. Approximately 200mm people are affected. And the latest lockdown is in "iPhone City." This is the giant plant operated by Foxconn which assembles the phones. We do not think it is random that an Apple-related, Taiwan-based company is the target of this lockdown. (Foxconn is the largest private employer in China, for what that is worth.)

Also, plans to cut off China from the semiconductor world seem to be accelerating. The Under Secretary of Commerce said a deal with our allies was close. This will loop in virtually the entire semiconductor supply chain.

- Positioning is no longer bearish…just in time (not)

The AAI sentiment indices are continuing to normalize. The percentage of bearish retail investors dropped over 10% points to just under 46%. The bullish percentage is about 27%. The neutral camp increased the most (about 7 points to almost 28%).

Goldman's Sentiment Indictor has climbed back into positive territory for the first time in over a year.



According to Hedgeye, there have been multiple "pods" at hedge funds that have been blowing-up (pods are investment teams that focus on one sector typically). Many of these involve the Tech and Consumer sectors, apparently. This certainly explains the perverse action of mega caps getting slaughtered while the junkier, smaller names have rallied. (When funds blow-up, they sell their "quality" longs and have to cover their junky shorts."

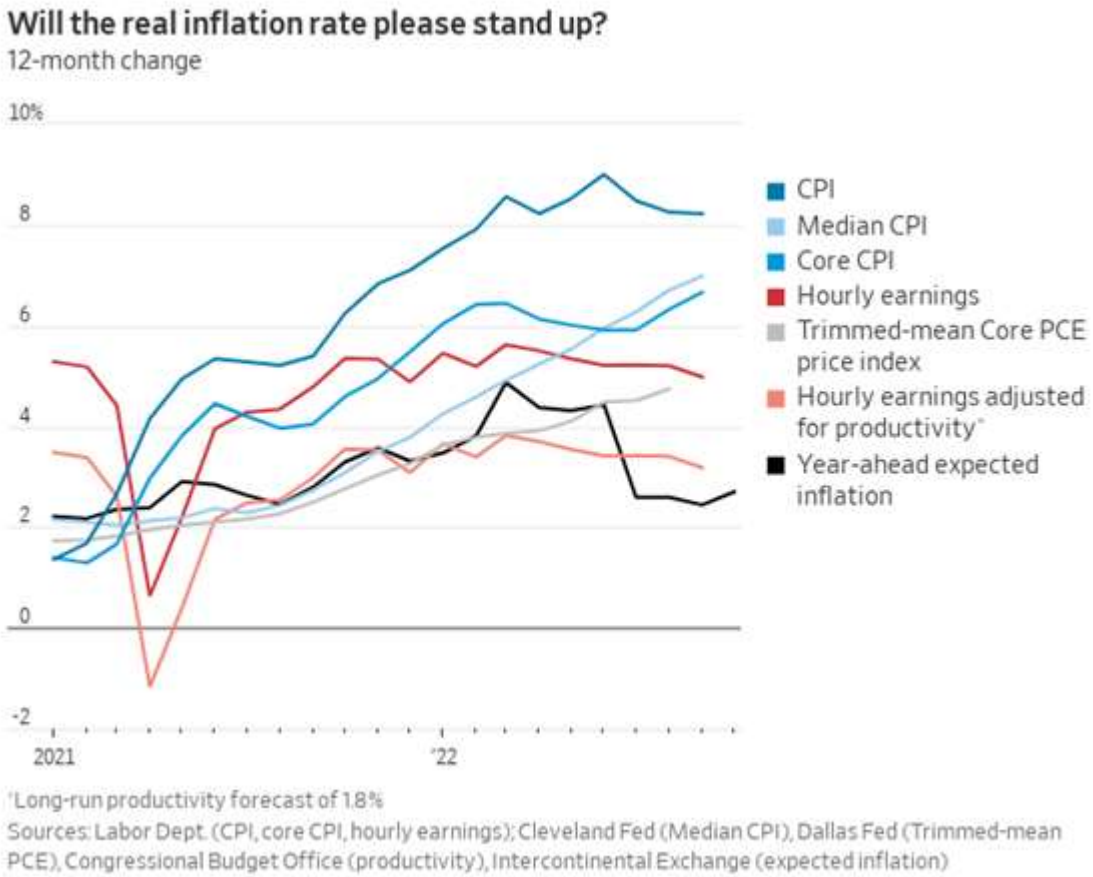
- Bad Earnings are being punished with more to come

What jumps out us during this earnings season is how the "misses" are getting punished. The average reaction to earnings shortfalls is an underperformance to the S&P 500 of almost 7%. This is the largest in history. Moreover, guidance continues to point downwards. So far, the average guide-down is about 4%. But the companies that are yet to report are still expecting only a 2% guide-down. The simple breakdown for sectors is the Consumer Discretionary are performing the worst while Staples are performing the best (for actual earnings, although stock performance is obviously similar).

- Inflation is not cooling (just ask the Fed)

The Fed's inflation gage, the Personal Consumption Expenditures Price Index (PCE), remained elevated in September. The headline reading was an annual increase of 6.2% (same as August) with a 0.3% monthly increase (same as August). The "core" reading ticked higher annually (4.9% to 5.1%), but the monthly pace slowed (0.6% to 0.5%). This does not change much in our view. We believe prices will remain elevated even if official price growth starts to slow. We also think price increases will ebb and flow and move around the economy in a disjointed fashion (based off what we have seen so far). This might not be direct bad news, but it will make the Fed's job harder. If they are constantly seeing new pockets of inflation, they will likely be reluctant to adjust monetary policy. Along these lines, below is a chart of just some of the different inflation metrics that are commonly used. If you break these down further into sectors, the data can be overwhelming

(again resulting in the Fed deferring to their top fear of persistent inflation). Even Powell scoffed at the notion of pinning down any individual inflation metric.

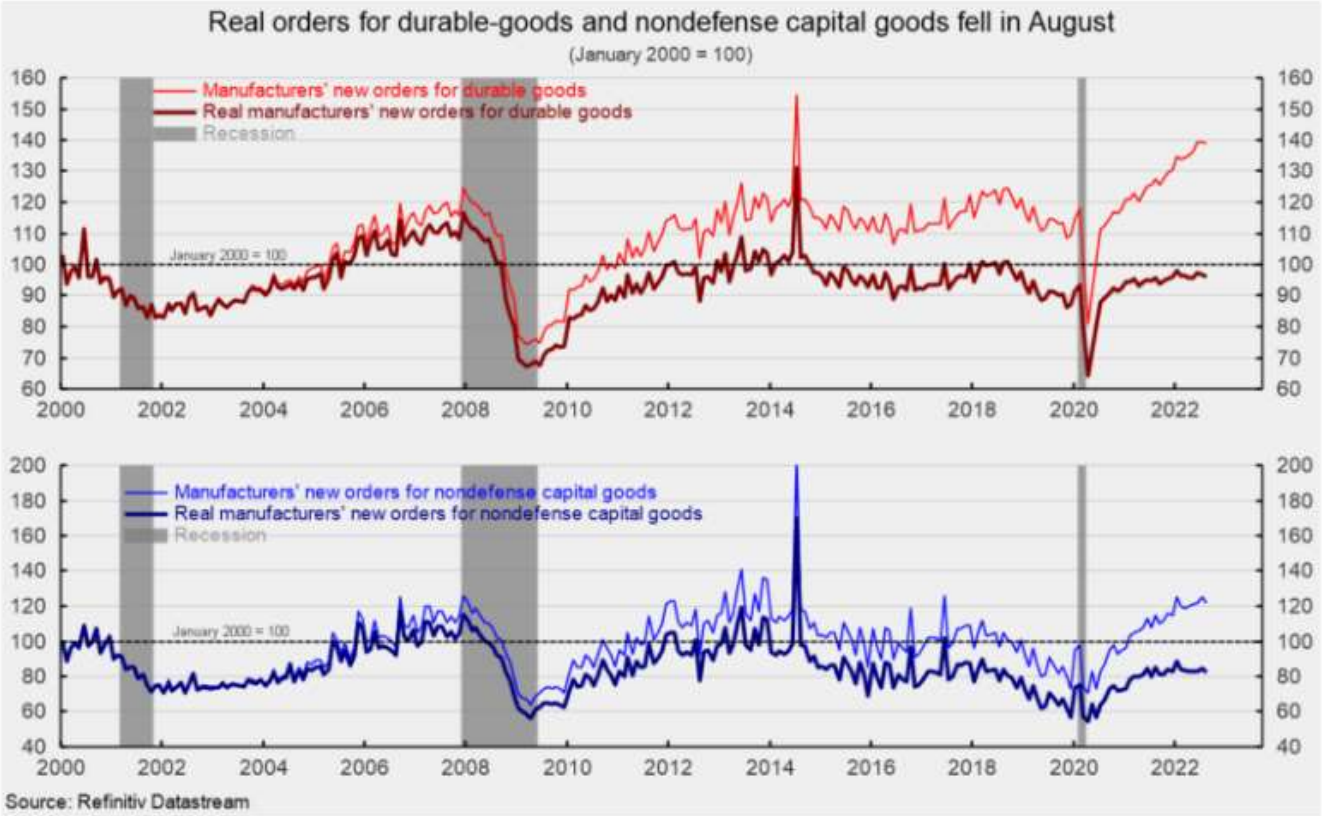


- Do not be fooled by the strong GDP in Q3

GDP in the 3Q moved higher more than expected (2.6% actual vs 2.3% expected and the negative readings in Q1 and Q2). Net Exports made up the entirety of the gain. This is driven by the strength in the USD. Goods Consumption was the laggard. Residential Investment was down over 26%. An alternative measure to GDP, final sales to private domestic purchases which basically strips out inventories and imports/exports, only increased 0.1%. This compares to a 0.5% increase in Q2 and a 2.1% increase in Q1. As always, one can twist and shape economic data to fit any narrative. But we think this data is quite clearly negative.

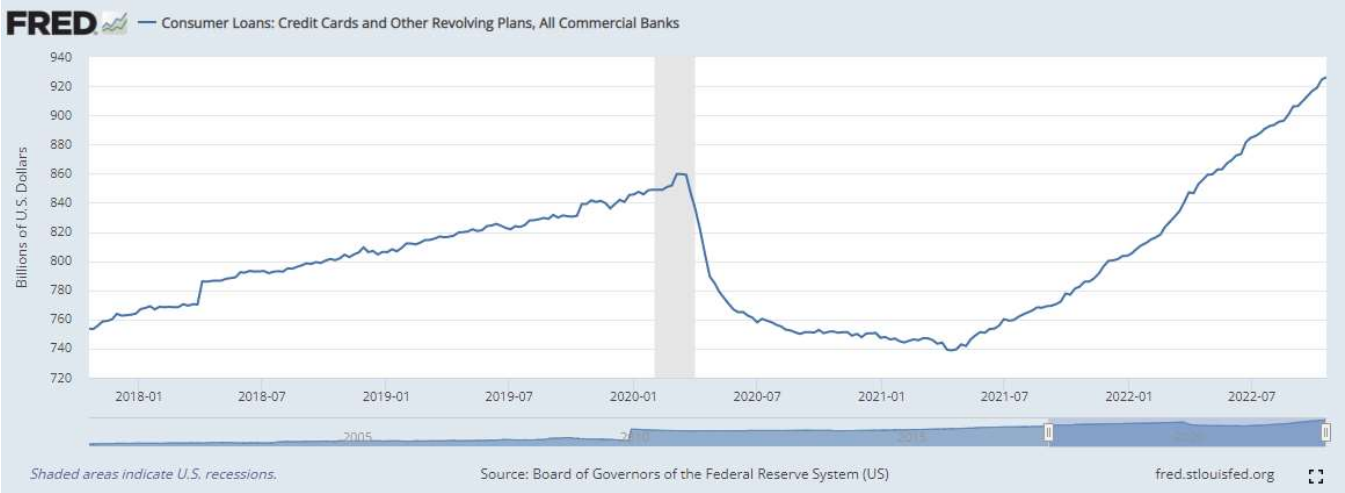
- Slower Business Spending in real terms is the key

Durable Goods Orders for September increased on the headline New Orders but fell in the more important Core Capital Goods (aka Nondefense Capital Goods, or more simply - business spending). New Orders swung modestly from negative to positive vs August (with August being revised higher, too). But business spending went from positive +1.3% to negative -0.7% (in fact the August reading was revised lower to 0.8%, also). We have long admitted that this data has been confounding…business spending has remained steadily growing despite the economic headwinds (the Covid recovery was especially quick). But one thing we must note: This data is not adjusted for inflation. Perhaps business spending is starting to drop.



- Is the Consumer really in great shape?

Consumer Spending moved 0.6% higher in September vs August. Personal Income increased by 0.4%. Simple ocular inspection* tells us this is not sustainable. The Personal Savings Rate is well below its long-term average (currently 3.1% vs 60-year trend of 5-10%). Anecdotally, credit card companies continue to see a surge in loan growth.



Some pundits say the Consumer is in great shape because Personal Savings was so elevated during the virus-fear that it is normal to experience a slower Personal Savings Rate. But the overall amount of Personal Savings is the lowest it has been since 2009.

Some Fed researchers got in on the act by noting that Excess Savings is still well above the pre-virus-fear levels. But this data points to a top-heavy distribution: The rich have more Excess Savings than the poor. We would add that a core tenet of the pandemic relief programs was temporary debt relief. When/if that finally reverses, that could be the death knell for the Consumer.

Consumer Sentiment (per University of Michigan) edged a touch higher. It is still wallowing just off the lows. This is the survey more geared towards inflation.

- PMI data still does not bode well

Markit's Manufacturing PMI for October dropped close to the breakeven point as did the ISM data. These are both sitting at their lowest levels since the virus-fear panic. New orders and the backlog are both slipping. Employment is resilient (for now).

The Kansas City Fed Manufacturing Index slumped into negative territory. The Chicago PMI (a Composite ISM survey, not the Chicago Fed) remains negative without a rebound (which was expected). And the Dallas Fed Manufacturing index sank further into negative territory.

- Global PMIs stinks, too

The China CFLP Composite PMI for October dipped back into negative territory. This is the official data from the government. You know it is bad if they are admitting to it being negative. The privately produced Caixin Manufacturing PMI ticked appoint higher, but it remains in negative territory. The internals are mixed with employment having shrunk during 14 out of the last 15 months. But inflation is starting to cool. Xi has a problem as both have to work in tandem or the masses will get restless. Recall one of our pet theories is that the 0-Covid nonsense is a way to blame the west for inflation. Bu this can only last for so long.

Japan's Manufacturing PMI for October remained just above the breakeven level. But the subcomponents show further deterioration. Order book volumes decreased for the fourth month in a row, and export orders declined for the eighth month in a row.

Korea's Manufacturing PMI ticked a point higher, but it remains negative, as well.

- Surprising Employment data might be a government thing

Job Openings in September per the JOLTS (Job Openings and Labor Turnover Survey) moved higher from 10mm to 10.7mm (with an August revision up to 10.3mm). This data is surprising to us as we expected the downtrend to continue (11.85mm peak in March 2022 to August's 10.3mm). But according to Simplify, there are typical government sampling issues at play here. It involves adjustments to the "birth/death" model which tries to track new firms and out-of-business firms. A similar adjustment for the headline employment numbers caused major disruptions in the data earlier this year. We are still looking for further proof of this. But we are inclined to believe it. Whatever the case, we still think the notion of excess Job Openings (almost 2:1 to unemployed people) is fake news due to duplicate listings, stale listings, diversity/inclusions fluff, etc.

Simplify also points out that the biggest jump in Job Openings was in Construction. This is even more bewildering than the headline increase. However, the separate Construction Spending data in September sheds some light. The headline grew slightly as it bounced back from a lousy August. This was all due to nonresidential spending with a focus on oil and gas well drilling. Single-family home construction was the laggard again (multi-family was up a touch). To us, this seems like a one-off (the oil and gas spending).

We get the October Employment Report on Friday. The guess from ADP (for Private jobs only) is for a gain of 239k jobs. The professional guessers have their monkey darts aimed at 200k which is down from 288k in September. We expect the trend to continue (down).

- Other economic data
  - Pending Home Sales in September dropped over 10% vs August. This is a 30% drop versus last year.
  - Weekly Mortgage Applications fell again.
  - Europe GDP (Flash/early read) grew 0.2% in Q3 (GDP is typically measured on sequential quarters on an annualized basis, seasonally adjusted at that).

- Do not get the Fed's Powell started (our live notes)

The Federal Reserve's Open Market Committee (FOMC) hiked 0.75% as expected. The real story is the hawkish tone of chairman Powell during his press conference. Here are some of our notes to questions asked (pardon the scribble style):

  - Powell will stay the course until the job is done. There is still a need for ongoing rate increases.
  - Do you have to raise rates above the inflation rate? Classic Taylor principal view. But Powell looks at forward view of inflation. Important but also need to look at real rates across the curve. Very few people borrow at the short end of the curve.
  - Is there a risk of inflation becoming entrenched? Powell goes back to the expectations being anchored. The wage-setting process is in play, however.
  - How do you judge those lag effects of monetary policy. They are typically "long and variable." They usually start with financial conditions, then economic activity, then prices (inflation).
  - Lag effects must be considered. A series of down monthly readings is good to see but not necessarily the only indicator to assess the appropriate level of restrictiveness. When asked directly if the Fed was going to slow the hikes in December: His answer was they look at it in three ways: How fast: Fed has clearly done so. How high to go: sufficiently restrictive to reach our 2% inflation

target. And How long: There is still some ground to cover. Unemployment Report and CPI levels are still central focal points. Cumulative tightening and the lag effects. How long to keep restrictive.

- How fast is much less important now. Powell is downplaying the importance of a "slow down pivot."
- We have not over tightened nor moved too fast.
- At some point it will be time to slow the pace of rate hikes. No decision has been made. Very premature to pause rate hikes.
- Housing: significantly affected by these higher rates. Needs to get back into balance. From a financial stability perspective, a very different situation and does not present any financial stability issues. Do lagging govt indicators need to be augmented? All leases are included in CPI, but private indicators tend to focus on new leases.
- Labor market: Job Openings remain elevated to a number of available workers. JOLTS (despite being volatile) - unusually important in this rate cycle. Unemployment Rate shows no real increase in labor supply. Wages appear to be flattening out at a level well above where we would consider stable. Wages are not coming down - they are just trending sideways. Wages are not the principal story…we do not see a wage price spiral. But once you see it, you are in trouble.
- Inflation persisting is much worse than any short-term overtightening.
- Is fiscal spending a headwind to fighting inflation? (no good answer from Powell – he was pushing for fiscal action all during the virus-fear)
- The window for a soft landing has narrowed, but it is still possible. Because we have not seen inflation coming down. Supply side problems have resolved themselves. But goods inflation has not reacted. And now we have Services inflation moving up.

➢ Global central bankers are not all in lockstep

Japan's central bank (BOJ) remains the monetary policy holdout among the major economies. The BOJ left rates in negative territory (0.10%) as it sticks to its prediction that inflation will cool to below 2% next year.

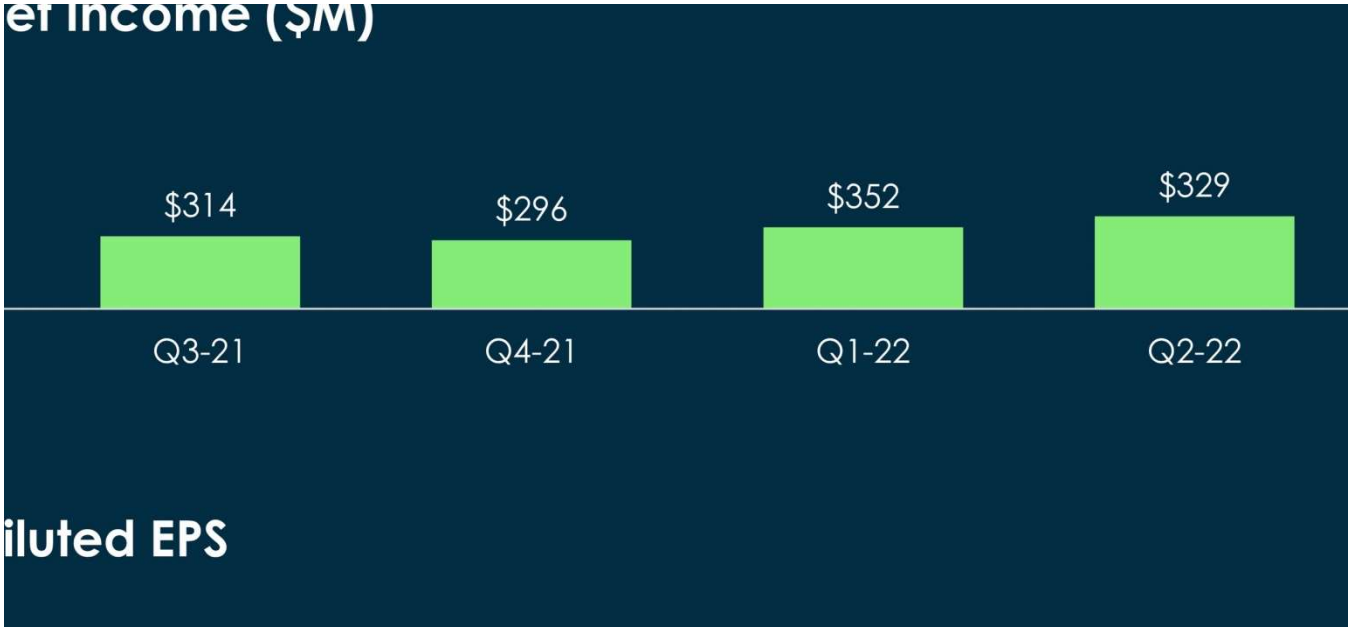
The European Central Bank (ECB) did follow its guidance and hiked 0.75%. It has indicated that it will be data-dependent going forward. Everyone always says this, but we suspect it will be truer of the Europeans than of the Americans.

➢ Oil and Argentine economic policy

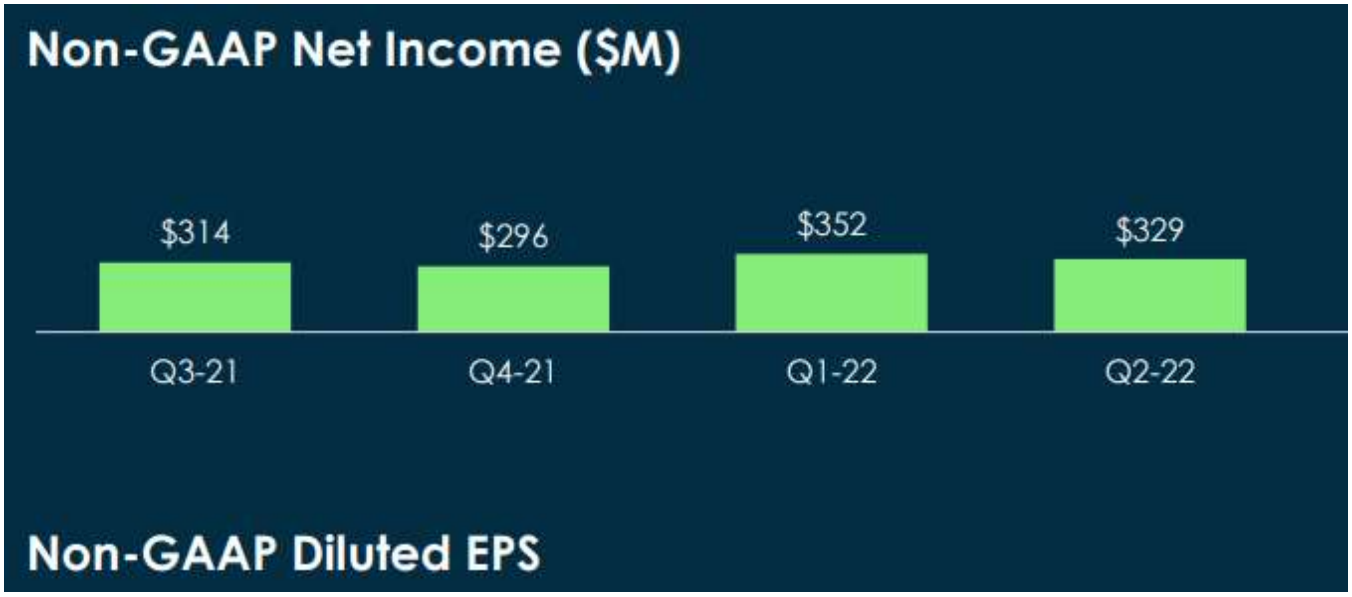
In other "is this Argentina?" news, Biden is suggesting a windfall tax on oil companies for "war profiteering." Never mind that crude oil is right around the price before the invasion of Ukraine. What is most alarming to us is the administration's complete lack of understanding of basic supply and demand, and the role incentives play. If companies are penalized for producing more oil (or is the tax to be on refiners? Gas stations? Pipelines?), companies will do the opposite just as they have done for two years and counting. And oil prices will go higher just as they have done in the wake of the announcement.

➢ Chart Crime of the week

This crime is a tale of two plots. The first *was* a slide in the Service Now earnings presentation. That $329 bar sure seems to be taller than $352. (Hat tip to Walnut Green for sharing this one with us.)



But *now* the slide shows that $329 is, indeed, a smaller number than $352. Busted!



- Quick Hits
  - Mr. Beast, the YouTuber, is looking to raise $150mm at a $1.5b valuation.
  - Potato chips are the least vulnerable to "shrinkflation" blowback (consumers do not notice the change in size). Toilet paper is the most noticeable with the most consumer ire.
  - Natural gas prices have swung by 7% on 30 days this year.

Trading: We added some more Put protection heading into the "no-pivot" Fed meetings. We also trimmed some longs. We remain bearish with a hefty dose of cash. Our projections still have us mired in a recession or sluggish economy for a couple more quarters. But we suspect we will get the chance to buy some good companies at decent prices. We will still likely err towards the defensive names we have favored (Staple, Healthcare and Utilities (which have not been very defensive)). And following Powell's comments, we do not

anticipate buying any meaningful amount of fixed income in the near-term. But when the recession is glaringly here, that will be the time to buy.

TSLAQ: Many people are moving on from the Twitter saga because the deal is closed and done. But we think the saga of the new ownership entity, ie Musk and friends, is only just beginning. From hirings and firings to lawsuits and politics (not to mention the actual running of the company), we think more people will start to see Musk for what he is: a bloviating narcissist. While we find him highly entertaining at times and worthy of praise at others, Musk adding another title and company to run only adds to the risks of his empire. And if the emperor is seen for who he is, the market will suffer.

As for the day-to-day, Tesla announced that the Cybertruck will go into mass production by the end of 2023. As a refresher, the previous announcements as to when Cybertruck production will start: Late 2021, late 2022, early 2023, and now late 2023.

*One of the quants with whom we worked way back in the day would always use this term, "ocular inspection." We would always chuckle and retort "you mean 'looking at it'."

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