Weekly Update

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- Market Volatility is not going anywhere
- After Ukraine comes the Fed worries (all over again)
- Positioning has reversed quickly, it might again
- Strong Job gains might be a head fake
- Will the Fed get Inflation right this time?
- The Fed does not want a repeat of the 1970's
- Quick Hits
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	4,278	-2.5%	-10.2%	13.4%
QQQ	$334.99	-3.5%	-15.8%	12.2%
US 10 YR	1.94%	1.88%	1.51%	1.51%
USD/DXY	98.0	97.4	96.0	91.4
VIX	32.3%	30.7%	17.2%	22.6%
Oil	$110.26	-0.3%	44.5%	86.5%

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

We think looking at a few performance data-points and their root causes sums up the recent action in the markets. The NASDAQ 100 (QQQ) rallied 3.6% today but was still down 3.5% for the week. Last week it rallied 3.8% after a 7.5% drop the prior week. More importantly, the down days are on *reports* of bad news like bombings, nuclear facilities being compromised, sanctions, inflation spikes, etc. Meanwhile, the positive days are based on *rumored* hopes and dreams like Venezuela being able to pump oil, Putin's lieutenants potentially turning on him, China coming to the rescue, etc. Did some of the excess need to be taken out of the oil market when it hit $130? Surely. But just because Ukraine voices its desire for peace does not alleviate the overriding tightness in the oil market. And if the hopes for peace somehow become reality, this probably emboldens the Fed to proceed with its interest rate hiking plan. And stock splits should not lead to 10% rallies in mega-cap stocks (Amazon announced a split tonight to much retail fanfare…this quasi-financial engineering worked for Tesla and Apple during the raging Covid reflation market…but it should not do a darn thing in a normal or down market…or ever).

One economic worry about the war in Ukraine is the lingering effects on inflation. If Russia were to back down immediately, it is unlikely that the sanctions would end immediately. And for all the concrete sanctions, the

knock-on effects of the sanctions are potentially more severe. It is already reported that tanker ships doing normal cargo runs are balking at doing business in Russia or are dramatically increasing their fees considering the elevated risks involved. We do not think Putin playing nice for a few days or weeks or even months will bring comfort to anyone sailing into Russian waters (physically or fiscally). And all these knock-on effects create more knock-on effects for financial institutions involved (John Mauldin, an economist/pundit we follow and respect, has noted that the financial "plumbing" is being talked about again…that is never a good thing). Even if Putin is disappeared, the continuing uncertainly will cast a shadow over the country for the foreseeable future.

Another knock-on effect involves China. The communists elevated their global partnership with Russia right before the invasion. The new axis of evil included in their communique that human rights should never be a consideration in trade negotiations. This is about as clear as it gets in terms of thumbing their nose at the West. And now the Chinese are providing workarounds for US sanctions (Chinese payments systems like Alipay are being used instead of Visa and Mastercard). Some are suggesting that Xi is having buyer's remorse and that he will help solve the current problems. We think this is highly unlikely, and Xi is quietly celebrating.

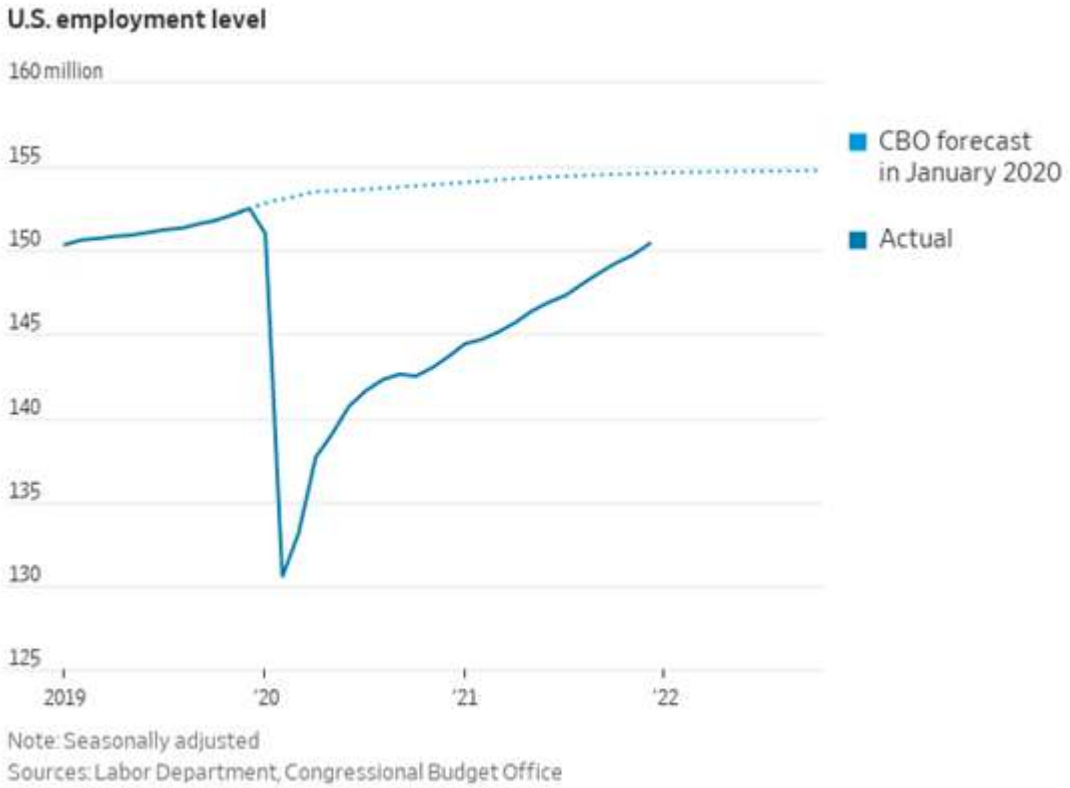
- Positioning has reversed quickly, it might again

We have been writing that positioning is still extremely stretched despite the market performance. We have cited JP Morgan's prime brokerage (custody for hedge funds) data, Merrill's full-spectrum client database, equity index futures data, etc. And we think the action this week supports this idea. Tuesday felt like a capitulation day, while Wednesday felt like a panic rush to get back into the market. And the action in the Volatility Index (VIX) also supports this. We think this is nothing but a bear-market rally. These are often the most violent of rallies that only sucker in the last "FOMO" chaser before the rug gets pulled again. While we "feel" this to be true, we also know the economic landscape has not changed (probably gotten worse thanks to more inflationary pressures coming out of Ukraine) and that the Fed is still hell bent on hiking rates (they should have done this a year ago!). We do not want to have high beta long exposure to this market.

- Strong Job gains might be a head fake

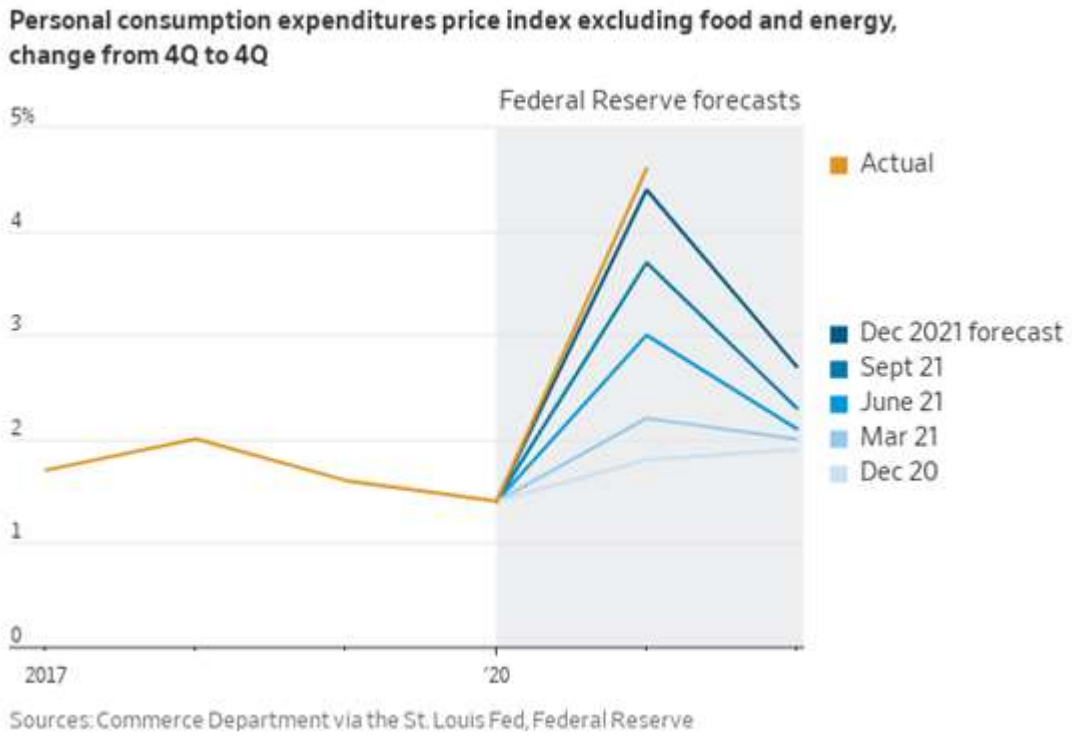
The Unemployment Repot surprised on the upside with 678k jobs added. The guess was for about 400k. Private Payrolls were the source of strength. Manufacturing jobs increased more than expected, but the largest gains were in Leisure & Hospitality. The Unemployment Rate ticked lower to 3.8% from 4.0%. And this was accompanied with a slight uptick in the Labor Participation Rate (these usually wag in opposite- directions, so this is good). The Average Workweek ticked higher. But the Average Hourly Earnings remained flat. This obviously is not good in this inflationary environment. In a sign that some of the virus-fear is still lingering, men have led the charge in getting back to work (600k more men in the labor force than before the virus-fear). There are 1.2mm fewer women in the labor force. This surely is a function of childcare duties taking precedence. Whatever the case, it underscores the choppy nature of the recovery

Labor gains are the ultimate late-cycle indicator. If the economy starts to slow, these Labor gains turn into Labor losses very quickly. There are also 4.2mm people who said they were not able to work because their employer closed. Perhaps this could be seen as a positive if these 4.2mm are still eagerly looking work. But considering there are 11.26mm job openings according to the latest JOLTS report (Job Openings and Labor Turnover Survey), they must not be looking to aggressively. Moreover, those job openings could evaporate if more businesses close. As for the businesses that continue to cut jobs, Health Care takes the top spot (we remain long Health Care inflation).



- Will the Fed get Inflation right this time?

Here is a chart showing the Fed's past and future guesses for inflation (the PCE it uses to track price increases, not the more common CPI). The left side of the triangle spike shows the Fed was under-guessing inflation since the beginning of 2020. The right-hand side of the triangle spike shows the Fed's forecasts looking ahead. Will the Fed get it right on the backend? (Hint: it never has before. Not to mention the orange line continues to go higher into 2022 and not lower…so these forecasts are starting off in a hole.)



Nonetheless, we do think inflation will start to ease into the spring and summer. Obviously, the Ukraine situation has poured gasoline on a wide array of prices which will not help things. But some of the media narratives are exaggerated. Sure, Ukraine is a top global supplier of neon which goes into semiconductors. But neon comes from the air (and earth's crust). A separation unit can do the job quite effectively. But if you want that vintage Coors Light neon sign refurbished, this could be costly. And this is not to downplay the problems with nickel and other Soviet dominated metals. Inflation is very real. It is just not in the runaway stages for every good and service in the economy.

Jumping back to wage inflation, it is important to understand that low-wage earners are the ones seeing the biggest increases. These are the most ephemeral of price hikes since these jobs can be eliminated outright the most easily. We suspect the medium and high-wage price increases are more sustainable and thus more representative of true wage inflation.

Note: Wage cohorts reflect less than $22/hr for low-wage, $22-30/hr for middle-wage, and more than $30/hr for high-wage. Source: BLS, Morgan Stanley Research

- Other Economic data
  - The US Trade Deficit hit almost $90b in January up from $81b in Dec.
  - The pace of increasing consumer credit slowed dramatically in January. Credit card debt shrank while non-revolving credit (like student loans and auto financing) increased slightly. The slowing in revolving credit is a sign to us that the consumer is starting to tighten his belt.
  - The weekly Redbook Retail Sales slowed again (still a +13.1% yearly gain, the but the trend is slowing).
  - Wholesale Inventories in January showed a marginal uptick of 0.8% compared to the trailing three-month average of 2.2%. Businesses are not replenishing as quickly.
  - The final GDP reading of 4Q2021 for the Eurozone was an increase of 0.3%. The US grew 7% in the same quarter. Neither will sniff these numbers in the current quarter.

- The Fed does not want a repeat of the 1970's

In chairman Powell's follow up testimony to the Senate (in what used to be called the Humphrey Hawkins monetary policy report), he was asked whether the Fed would follow in the footsteps of former Fed chief Paul Volcker. Volker famously squashed inflation in the 70's by hiking short-term interest rates to 19% in the early 80's. Powell answered that the Fed will do it what it takes to "protect price stability." Interestingly, 10-year treasury rates peaked at about 16% back then. Now that is yield curve inversion! The point here is that Powell sounds like a man committed to raising interest rates regardless of any impending recession.

Charles Evans of the Chicago Fed expects interest rates to increase back towards the perceived neutral rate of 2.5% (this is always a moving target). He acknowledged the Fed's job can be to forcefully combat inflation. But

at the same time, he does not think the Fed needs to hike at every meeting this year. We think this last bit was throw in as an equivocator. His overall hawkish tone on inflation stands out as he is perceived to be the second most dovish member of the Fed (behind Kashkari of Minneapolis).

- Russian oil is coming off the market (sorta)

Last week we wrote that the market was already weening itself off Russian oil. According to shipping data and conversations with large trading houses, it appears that Russian exports have dropped about 2.5mm barrels per day. Russia produces about 11mm bpd (just below the US and Saudi). It uses about half of that domestically. So, its exports have been roughly cut in half. The discount of Urals oil to Brent has widened to $25 from last week's $14. And this is mostly theoretical…not many people are taking Urals. Now the US and the UK have made it official in terms of not buying Russian oil (the UK will still buy its gas). Of course, as we covered earlier, the Chinese are ready to step up to buy all the Russian oil they can get (China is a net importer).

And for all the politicians claiming there really is spare oil capacity, the international Rig count fell in every region: Europe, Latam, Africa, and Asia. Even rigs in the Middle East fell. In the US, the CEO of Conoco said it takes about 9-12 months to ramp up production on a new oil well.

- Chart Crime of the week

This is from a presentation by The Aaron's Company. We are not sure what to make of this. The first three columns are negative numbers. Is the company trying to downplay recent growth or overstate past performance? The former is illogical, and the latter is unethical. Both are bad.

- Quick Hits
  - Used car dealers are charging higher prices for cash deals instead of financed ones.
  - Cheryl Sandberg, the COO of Facebook, said, "No two countries run by women would ever go to war."
  - The Department of Health and Human Services (HHS) has issued documents encouraging the use of "they" as a singular pronoun. This is under the guise of complying with the Plain Writing Act of 2010.

Trading: We continue to take down our long exposure in the high beta sectors. We do not have much Tech or Consumer Discretionary left in the portfolio. And we think we are close to a good balance. But we will buy Energy and other inflation-specific themes on dips. Our other long exposures are in Staples (the ones with pricing power) and Health Care. As we wrote last week, whether we are experiencing stagflation or deflation does not really matter. Being out of Tech and into defensives is appropriate. Of course, we always want to know how we could be wrong. We think if supply chains opened up, Covid disappeared in Asia (same as the first thing really), Russia opted for the infamous "reset," inflation retreated, and the economy picked up steam leading to earnings growth…we could be alright. That is too many low probability events having to be strung together for our liking.

TSLAQ: We must give Musk his due. He is calling for the US to increase oil & gas production immediately, "Extraordinary times demand extraordinary measures." And he wants Europe to rekindle its mostly dormant nuclear energy capabilities. Now only if he would admit that his cars run on electricity fueled by burning natural gas and coal…

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