Weekly Update

28-July-2021

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- The market is schizophrenic
- Who you calling dumb (money)?
- Corporate Mgmt. Teams: Do as we officially say, not as we casually say
- Continuing Claims continue to fall
- Housing is slowing
- Business Surveys (PMIs) weaker overall, Fed surveys mixed
- Business Spending is better than what businesses are saying
- The Fed is not changing course
- Chart Crime of the week

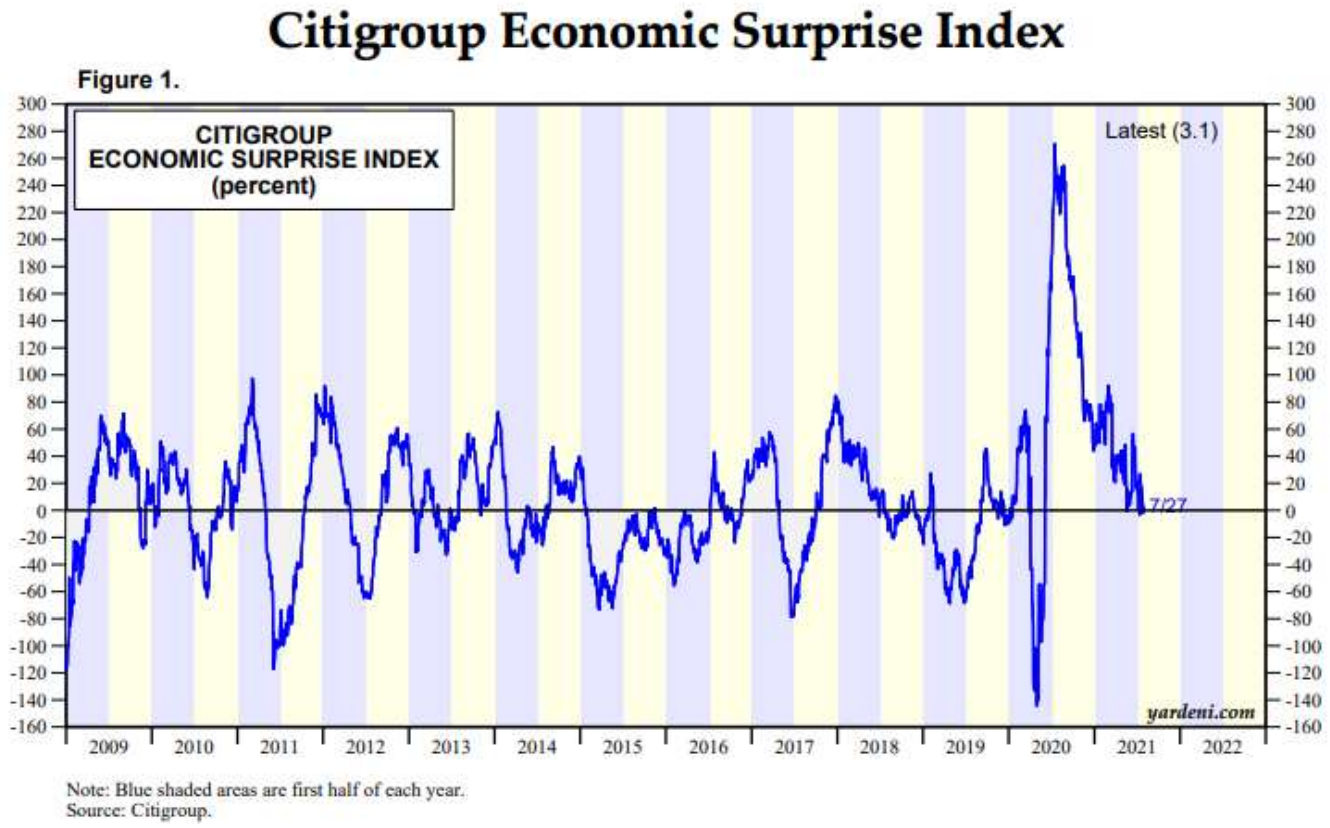
	Last	5d %	YTD %	1yr %
SPX	4401	1.0%	17.9%	31.4%
QQQ	361.6	1.2%	16.9%	41.4%
US 10 YR	1.23%	1.35%	0.92%	0.57%
VIX	18.2%	17.9%	22.8%	24.5%
Oil	72.26	2.9%	49.2%	76.4%

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

The schizophrenia of the market continues to be front and center. It is a battle between strong earnings and a seemingly strong economy against the virus-fear bubbling up in the media. Throw in some heavy-handed communism out of China, and rotational volatility continues. Earnings continue to be amazing, but the market has been pricing in these huge "beats" (running higher into earnings and then pulling back a bit). The surprise factor on economic data (according to the Citi Economic Surprise Index) is exactly zero. That is not to say there are no surprises. But they all balance each other out. In general, the levels of economic activity are strong (mostly above pre-virus-fear). But as we have recently noted, the rate-of-change of the growth is slowing. But the market has not moved on to this second derivate just yet. All is still good (and the bond market has calmed down a bit, but we suspect that is a calm before the next storm). As for the virus-fear, 367 people died in the US yesterday with the tag "with Covid." The other 7,500 that died yesterday did not have Covid. The Chinese have decided to wipe out a few industries that did not meet their central-planning guidelines. This crackdown comes on top of the intensified regulatory environment on their Big Tech. There might be some value to be found somewhere in the rubble, but we certainly are not going to be first ones to engage in the financial equivalent to

Tiananmen Square. Speaking of standoffs, the US infrastructure bill appears to be closer to becoming reality. We have been skeptical. However, we think the market upside far outweighs the downside. That is, most people have discounted it. So, a real compromise (an infrastructure bill that actually aims to improve infrastructure) would be welcomed by the market.

Overall, we think the market will continue with its upward drift but have random days/bouts of shocks. This is not exactly an earth-shattering prediction since this has been what the market has done for 13 years. We also think the sector and factor rotations will continue. Most of these moves will depend on whether people go back to work and whether the manic inflation continues. These are obviously correlated (inversely, that is). While we do not think the rout in Small-caps reverses in whole, we do think there are pockets of potential strength. This depends on a full, economic Reopening and pricing-power. We are betting on these.



- Who you calling dumb (money)?

According to an outfit called Vanda Research (never heard of it, but the publication Grant's references it), retail investors/traders in the US bought $2.18b worth of stocks during last week's mini stock rout (virus-fear/treasury rally). This is the largest net purchase amount on record. The largest in the last five years was $1.5b in June of 2016 (the money is not adjusted for market cap, but it is probably close enough). Hedge funds used to call Retail "dumb money." Oh, how the tables have turned.

- Corporate Mgmt. Teams: Do as we officially say, not as we casually say

Earnings continue to be robust against the easy comparison of a year ago. Under the surface, there are some conflicting signals. The "mentions" of wage inflation during management conference calls has doubled vs last year. This is not surprising (deflation last year and inflation this year). But most do not see commensurate increases in end-product pricing. This would obviously be terrible for margins if this played out. On the flip side, corporate guidance (on future earnings) continues to be well above historical levels (3.5x as many positive guides as negative, historically there are more negatives than positives). Future business spending (capex) is one area in which management teams do not yet have confidence. But overall, we think companies are more accountable to actual guidance vs casual "mentions" during conference calls.

- Continuing Claims continue to fall

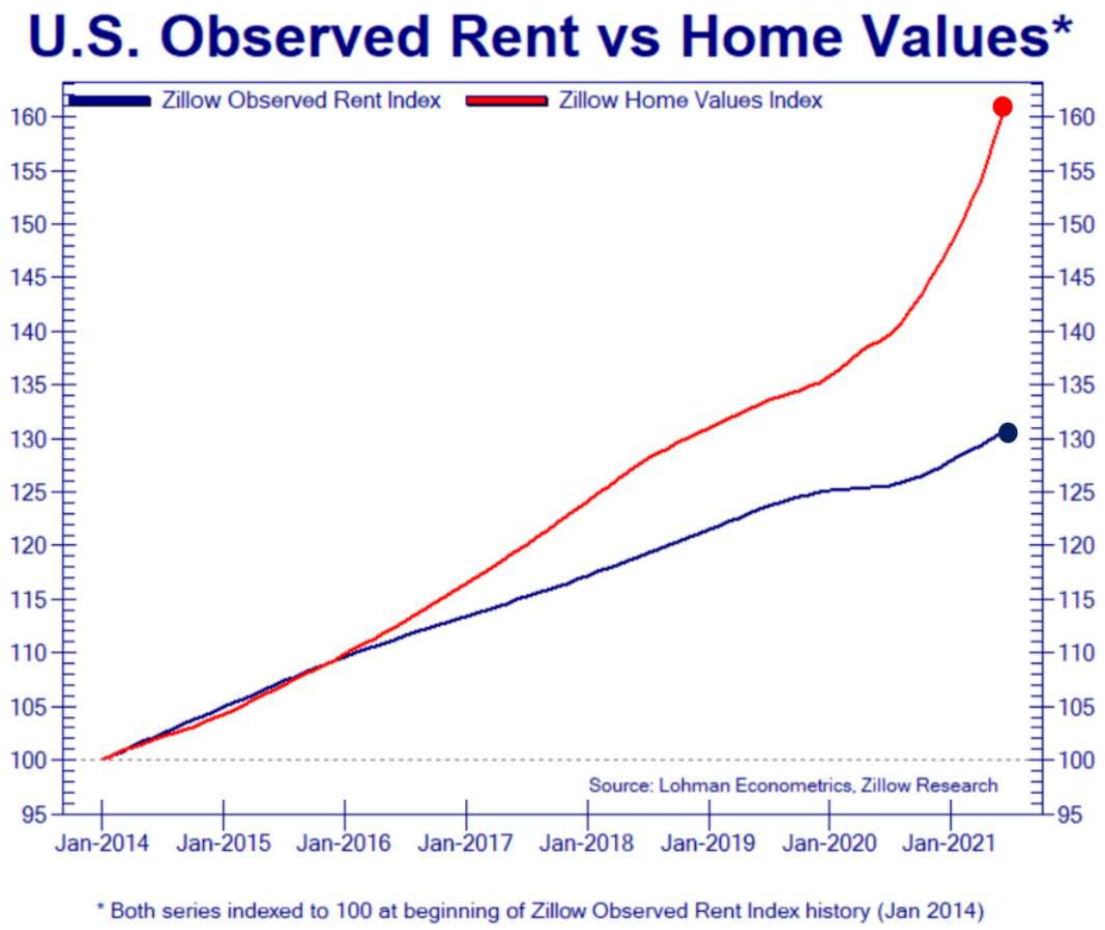
Jobless Claims reversed course contrary to our Johnny Paycheck theory. But Continuing Claims hit a new post-virus-fear low. And these are released with a lag. Plenty of biased pundits have been clamoring that the states off the dole are only moderately outperforming the others (as though that were a bad thing). But this casual observation overlooks the built-up Household Savings coupled with laziness. Time will tell.

- Housing is slowing

Existing Home Sales increased in June albeit ever so slightly. The annualized sales rate (5.86mm per year) is still strong by historical standards. But it is well off the virus-fear peak of 6.73mm in Oct of last year. This fits our thinking. Housing is still better than it was, but it is cooling. We do not think the Housing stocks can thrive unless the rate-of-change is accelerating. Of course, this data is for Existing Homes, but the same trends apply to new construction.

On that note, New Home Sales in June dipped below pre-virus-fear levels. Inventory of new homes climbed to over six months. Prices are still the main impediment. Housing stocks have showed some signs of life lately. We think this has been driven by lower mortgage rates and some renewed interest in the Work-From-Home trade as the media is driving the virus-fear narrative again. We do not think Housing stocks can sustain any rally unless our political leaders lose their minds again (entirely possible, no doubt). We will stay on the sidelines for now.

Here is a chart that shows the rapid increase in home prices compared to rent prices. Despite the rental data having some flaws (leases are naturally lagging), the more steady nature of the prices seems to reinforce the Fed's opinion that the spike in housing prices is just temporary (or rather, the extra spike in prices…there clearly was a boost in demand during the peak virus-fear/work-from-home time).



- Business Surveys (PMIs) weaker overall, Fed surveys mixed

The early read for the PMI Composite (Flash for both Services and Manufacturing) for July fell abruptly and missed the expectation for an unchanged reading from June. In what could be a dose of virus-fear, Services slipped five points while Manufacturing increased half a point. Oddly Europe flashed the exact opposite with a better headline reading driven by better Services.

Regional Fed Manufacturing Surveys for July: Kansas City 30 vs 27 in June, Dallas slipped from 31 to 27, Richmond saw June revised higher with July sustaining that higher level (26).

- Business Spending is better than what businesses are saying

The Durable Goods report was hard to read with lots of revisions, but ultimately, we think it was pretty good. The headline New Orders dropped in June. But May was revised higher. The important Core Capital Goods (business spending) was revised higher in May and continued to increase in June. This hard data refutes the hesitance uttered by mgmt. teams during their earnings conference calls (less optimistic about capex spending). Or at least it tempers some of the negativity. This should bode well for Value and Cyclical names.

- The Fed is not changing course

The Federal Reserve left rates unchanged and bond buying intact just as expected. The market expected a dovish Fed communication and that is what Chairman Powell delivered during his press conference. He unequivocally said rates will stay at zero and bond buying will continue until "further substantial progress has been met." He demurred on providing details, obviously. But he did say there was "more ground to cover on the labor market." Powell reiterated that the Fed has started talking about tapering. But reading between the lines tells us that this is unlikely to start until later this year or perhaps next year (some in the market like Goldman and JPM had expected an August announcement). Powell wants to see how the labor market shapes up with the end of all the pandemic relief packages. He also has his eye on how schools reopen this fall which should allow working mothers to actually go back to work.

Powell was also sure to point out the parts of the economy are doing well. Household Spending is rising at an "especially rapid pace." Business Investment is rising at a "solid pace." And most specifically, the Housing sector remains very strong. To this end, the one other detail Powell provided was that the Fed was not going to reduce the purchasing of Mortgage-Backed Securities (MBS) before Treasuries. This will ruffle the Fed naysayers (of which we are one at times) as it points to a contradiction: why is there a need to buy mortgages if Housing is doing so well? (The Fed's answer is that influencing the mortgage market is more about influencing the interest rate market than Housing.) Of course, Powell used his favorite adjective in describing inflation: transitory. He laid out his rational well: supply side problems causing price shocks do not constitute inflation. This is not much relief to someone looking to buy a house or a used car. And Powell knows this. But he clearly stated that these shocks will come to pass. The big caveat is if they are slow to unravel and thus inflation expectations readjust. We agree with him. But we are not going to act like David Rosenberg and dry a (red) line in the sand. We want to ride the inflation narrative while the labor situation unfolds.

The European Central Bank (ECB) has officially joined the Fed in the "lower for longer" mindset. Specifically, the ECB said it could cut rates below the already negative 0.50% until inflation moves above its 2% target rate. The old policy wording was "near but below 2%" inflation. Europe has not seen the knee-jerk inflation that we have seen in the US. The Euro economy is not as strong (bulls would add "yet"). June's reading was 2.5% compared to 5.4% in the US.

- Chart Crime of the week

The first inductee into the Chalk Creek Chart Crime of the Week Hall of Fame is back at it. Our German reporter who likes to compare everything to the Fed balance sheet has shifted gears slightly. Other than his predicted usage of different scales, Holger makes the claim that the Fed will not let the stock market go down because that is bad for employment. Never mind the effect population growth has on Total Employment. [Fox Butterfield, is that you?]

- Quick Hits
  - The Tokyo Olympics were supposed to cost $7.5b. They cost $20b.
  - Brisbane, the newly announced host of the 2032 Olympics, says its games will cost $3.7b.
  - The New Orleans Saints sold the naming rights to the Superdome for $138mm (20 years) to Caesars.
  - The Saints do not own the Superdome.
  - A digital horse racing company, Zed Run, has more than $30mm of transactions. These are make-believe horses.
  - The four largest auto lenders reported profits after repossessing and selling cars with defaulted loans in the second quarter. This has not happened in over 20 years.
  - The gamified trading app, Robinhood, is going public with a value around $38b. it was valued at $12b a year ago.

Trading: We continued to adjust our portfolio around the edges. We cut some more of our long Small-Cap exposure. This factor does particularly poorly in a stagflation type of environment (low growth with high inflation). While we do not think the recent inflation levels are here to stay, we do think the market is jittery on

this potential combination. But as we have said, we think there are pockets that have sold off unjustifiably. We added to these. We also added to our long Energy exposure. We cut this back in early June as the inflation narrative was getting out of control. With it now being discounted, we are adding it back. We added a few more shorts (always via Put options). One is a brick & mortar retailer that is losing its warranty sales business because of online sales (warranty sales are about 40% of the operating income). We are also leery of the regional financials. If the Fed hikes short-term rates in a low growth environment, these banks will get killed. Not our base case, so this is more of a hedge than an expected outcome.

TSLAQ: The headlines tell us that Tesla had record sales and profits. But the company never discloses how these profits were made until after they have filed what is called their 10-Q (or 10-K for the annual filing). But the real takeaway was that many people yawned at the results…perhaps with a chin-rub they muttered, "it really is just a car company." Along these lines, the most telling part of Musk's conference call was that he said, "We need to make full self-driving work to make it a compelling value proposition." Yep, Musk admitted that the "service" the company has been charging consumers for five years still does not work. Of course, the Teslarati was quick to rush support Musk with comments like "even though I am disappointed in my FSD not working, I will continue to subscribe to the (fantom) service to support Elon's mission." Yep, the world's third richest person needs support.

Here are some of the fine-print highlights: Tesla excluded interest *expense* but included interest *income* in calculating its operating earnings. 35% of the Net Income was from regulatory credits. The Semi production has been pushed back to 2022 despite recently saying it was happening now. Accounts Receivables grew by $240mm to reach $2.1b. Skeptics believe much of this is front-loading of the vaporware sold as Full Self Driving (it confuses the moon for stop lights). Cash Flow was -$600mm despite slashing R&D $100mm.

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