# Weekly Update

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- Can strong mega cap earnings outduel banking implosions?
- Outlier moves are converging
- Earnings typically take a while to bottom
- Disinflation is here
- Employment data is mixed still
- The China reopening is cooling
- The Fed wants to have its cake and eat it, too (redux)
- Quick Hits
- Where might more crypto money go?
- Chart Crime of the week

| | Last | 5d % | YTD % | 1yr % |
|---|---|---|---|---|
| S&P 500 | 4,091 | 0.9% | 7.0% | 0.1% |
| QQQ | $317.29 | 1.7% | 19.3% | 0.4% |
| US 10 YR | 3.34% | 3.45% | 3.88% | 2.93% |
| USD/DXY | 101.3 | 101.5 | 103.5 | 102.6 |
| VIX | 18.3% | 18.8% | 21.7% | 25.4% |
| Oil | $68.12 | -8.3% | -14.5% | -33.0% |

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

The market is still battling with its internal strife across a multitude of factors. On earnings, the headlines are still dominated by the generally strong mega caps. But the more economically sensitive companies, the small-caps, continue to struggle with earnings and their stocks follow. The fragility in the banking sector persists. The government and its private market extension (JP Morgan) have plugged some leaky holes in the dike. This has created a false sense of security in our minds. Goldman Sachs called the First Republic take-under a "clearing event." But, unlike the subplot in Hans Brinker, the government keeps having to plug more leaks. Just tonight, Pac West is supposedly ripe for the picking. As the Kenny Rogers Chicken man says, bank failures are "not gonna be good business."

The Fed hiked another 25bps to bring the Fed Funds target rate to 5%. And while chairman Powell intimated that the Fed would be on hold for now, he certainly did not slam the door on the idea of another rate hike if conditions warranted. And the debt ceiling is still swirling in the background. While we have stated that we do not think this will be an issue in the short-term, we acknowledge it creates fear in the market (the old

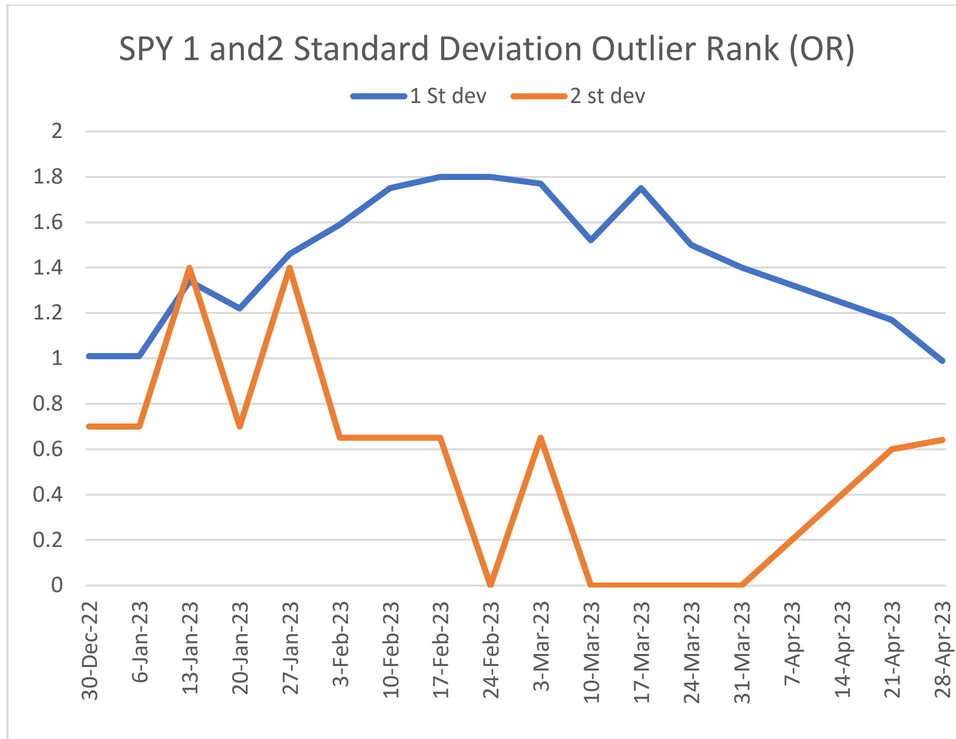
Rumsfeldian "known unknown"). Treasury Secretary Yellen cranked up this fear by adding, "lower than expected tax receipts create significantly greater risk that Treasury will run out of funds in early June." Even the prospect of a meeting between the Republican leaders and Biden did little to alleviate the stress. We are also experiencing the ever-expected tail-chasing embedded in the oil market. Are oil prices plummeting because of the increased recession fears? Or are falling oil prices telling the market that there should be increased fear of a recession? Adding to the push-pull of confusion, central banks around the globe are no longer coordinated. The Fed is pausing. The ECB is going to still be hiking aggressively (not to mention with that giant $500b repayment of stimulus money needing to be repaid in June). And the Bank of Japan surprised the market by keeping interest rates negative. (To be clear, the Fed is still practicing Quantitative Tightening, letting bonds mature and roll off the balance sheet).

All this keeps us on our heels. While we do not want to bet against the mega caps, we do think a broader swath of the market could remain weak. Some of the frothier segments of the market that do not have earnings momentum (or earnings at all) are also a place to avoid (and/or bet against). Staples and Healthcare are outperforming again. Energy has been a dog as it logically follows the price of oil. But the commodity will likely be overextended to the downside soon enough given the chart-chasers that dominate the front month futures contract usually push their luck. Here is a basic chart of the YTD performance of the different market cap sizes. So, our idea is not exactly novel. And it goes against our baseline process of not chasing performance. But rarely is the first move the last move when it comes to large factor rotations.

- Outlier moves are converging

Here is our customized data output for the Outlier Rank (OR) metric we cite. Basically, there are fewer moves outside of the normal expected range (1-standard deviation). But Outlier moves are increasing for 2-standard deviations. This data is not perfect as the sample sizes are not huge (especially on a week-to-week change basis). But thematically it makes sense, and it fits our general exposure backdrop. A declining 1-standard deviation OR is likely a reflection of the mega caps compressing Volatility in the market. But the increasing 2-

standard deviation moves reflect the more idiosyncratic moves like bank failures (idiosyncratic insofar as their correlation to the mega caps, but clearly not to economic weakness or the hangover effect from the excess money days).

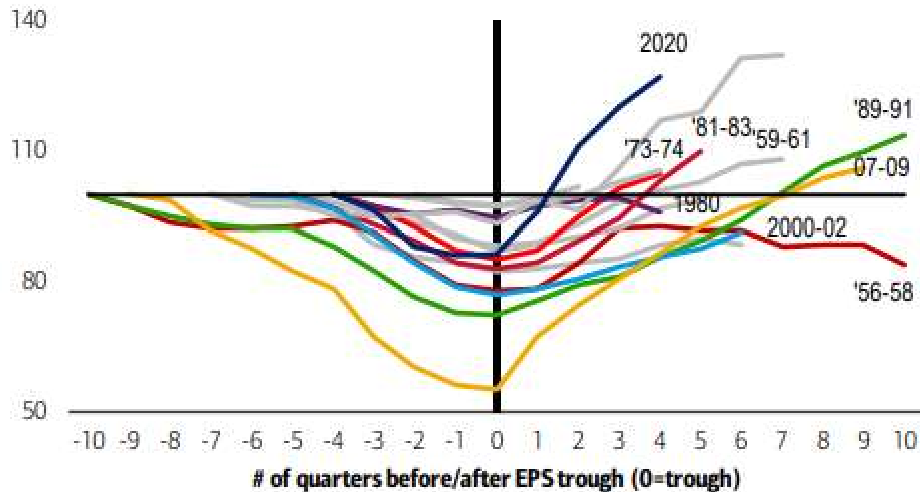



- Earnings typically take a while to bottom

Earnings headlines have been dominated by strong showings from the US mega caps (Microsoft, Facebook, Google). But globally, it is a different story. Specifically, already bad guidance is getting worse. Merrill puts the numbers in context with its Global Earnings Revision Ratio (the idea being that estimates are revised after guidance…this is not perfect of course). In April, it moved to 0.66 from 0.79. 1.00 is the equilibrium for earnings upgrades and downgrades. Downgrades have dominated in all global sectors and regions. Sales estimates have had a similar drop. Europe has the best set up when looking at its three-month trend (notably still negative). Overall, the correlation between Merrill's metric and global market performance (rolling one-year % change) is strong at 0.61 (-1 to +1). We would be guilty of cherry-picking data if we did not point out that US guidance has turned positive. But we also must note that the US has more nuanced data. That is, while guidance seems to be improving, Earnings revisions are still negative and below the historical average. This stuff can be difficult to parse. Until we see a rate of change improvement across Earnings in all style factors (or at least a majority), we will remain cautious. On this note, Merrill adds a chart that shows the variation of lags in earnings recoveries. They present this in a positive light in that Earnings recover to a stronger spot than before the fall (fair enough). But this ignores the long lags heading into the trough. It usually takes anywhere from four to 10 quarters to reach the bottom of the Earnings cycle. We have had only two quarters of negative Earnings growth.

**Exhibit 27: Earnings typically recover stronger than they fall**

S&P 500 TTM EPS before/after earnings troughs (same number of quarters leading to the trough and following the trough; 100=pre-recession peak; 1950-present)




**Source:** BofA US Equity & US Quant Strategy, FactSet, Haver Analytics

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- ➢ Disinflation is here

The growth in Personal Consumption Expenditures (PCE) in March showed inflation continuing to slow. The headline increased by 0.1% on a monthly basis (vs 0.3% last month) which brings the annual change down to 4.2% from 5.1%. The "core" number increased at the same 0.3% monthly rate. The annual figure is 4.6% vs 4.7%. Of course, we always had the qualifier that disinflation is usually not a good thing without economic growth.

The Employment Cost Index for Q1 was a touch higher than expected at 1.2%. But Atlanta Fed research shows that "job switchers" are now commanding less of a premium than last year. They are still seeing their wages grow about 1% faster than "job stayers." But this is down from about 3%. In terms of layoffs, we have more announcements from Gap, Lyft, Uber, Dropbox, Vice Media, and Morgan Stanley.

- ➢ Employment data is mixed still

The Job Openings and Labor Turnover Survey (JOLTS) headline openings fell from 10mm to 9.6mm. Small businesses are seeing the biggest drop in openings. Quit rates are slowing.

ADP's preview to the Employment Report showed a much bigger than expected gain in Private Payrolls (296k vs 145k expected). This will boost the expectation for Friday's official data (a steady slowing in job growth was expected).

We suspect this week's Employment Report will follow the same trend…positive numbers but a declining rate of change. And it will probably not be enough to jar the Fed into reversing policy.

- ➢ GDP was weaker than thought

GDP for the first quarter was much weaker than expected. Obviously, this is backward looking, but 1.1% vs 2.0% expected and 2.6% in 4Q2022 is a big miss/drop. However, Personal Consumption Expenditures were much stronger than expected at 3.7% growth vs 1.0% last quarter. Of course, this is a reflection of higher prices.

- Housing is still stagnant with supply constrained

Pending home Sales in March fell much more than expected with a 5.2% monthly drop (a small gain was expected). This is a 23% drop on an annual basis. 7% mortgage rates are to blame. Sales dropped everywhere but in the South (which includes Texas). This goes against our thesis that home sales will pick up with falling prices. Nonetheless, we still think the stalemate in Housing will break when unemployment rises.

Construction Spending in March bounced back to growth. But Residential spending was still negative. And this was led lower by Single Family Construction (-0.8%). Multi Family is still growing (+0.4%). On the nonresidential side of things, Commercial Construction was the biggest laggard with a -0.8% drop. Manufacturing was the biggest gainer (+4.6%) …the category would have been negative otherwise. Many believe this burst in Manufacturing to be short-lived as it is being driven by one-off reshoring. This seems overly skeptical to us.

- PMIs show weak Manufacturing and improving/stable Services

The final US Manufacturing PMIs for April show lingering weakness. The more US-based survey from Markit (aka S&P Global) sits right around the neutral level. The more globally oriented ISM survey improved a bit, but it is still three points below breakeven. On the Services side, the Markit PMI was flat (53.6) vs March. The ISM moved 0.7 higher to 51.9.

The Kansas City Fed Manufacturing index fell from a flat reading to deeply negative. However, the Chicago PMI surprisingly moved higher by almost five points (but is still below the breakeven level). This ISM survey is Manufacturing and Services, so it more closely resembles the national Composite surveys.

- Other data ticks higher

The U Michigan Consumer Sentiment gage ticked a touch higher in April. The numbers are still light years away from their pre-Virus Fear levels. Inflation expectations (five year) are still anchored at 3%.

Factory Orders for March increased nicely albeit at a slower pace than expected (-1.1% in Fen, 1.3% expected in March, 0.9% actual in March).

- The China reopening is cooling

The China reopening appears to be cooling. The official Manufacturing PMI for April fell back into negative territory. Services are still positive, but they dropped by almost two points. Whether Services slip back or not, our base case seems to be playing out. Manufacturing in China is driven by global demand which is flagging. Services are a reaction to lockdowns. This might have more legs – Macau gambling shows the Chinese are still itching to get out. But domestic consumption in China will not offset the rest of the weakening global demand story.

- The Fed wants to have its cake and eat it, too (redux)

A few weeks back we broke down some comments from Jim Bullard, the chief of the St. Louis Fed. He said the Fed can raise rates and deal with failing banks at the same time. Well, this past Friday, it was reported that the Fed was told about the troubles at Silicon Valley Bank (and others) back in February. Specifically, raising rates were crushing the asset side of their balance sheets (and thus the liability side became more tenuous…depositors ran for the hills). Within three weeks, Powell hiked rates again. One day later, SVB was all but gone. Just this week, First Republic failed three days before the Fed's FOMC rate-setting meeting. Powell and gang hiked rates again. The moral of the story: The Fed does not care about collateral damage in its fight against inflation.

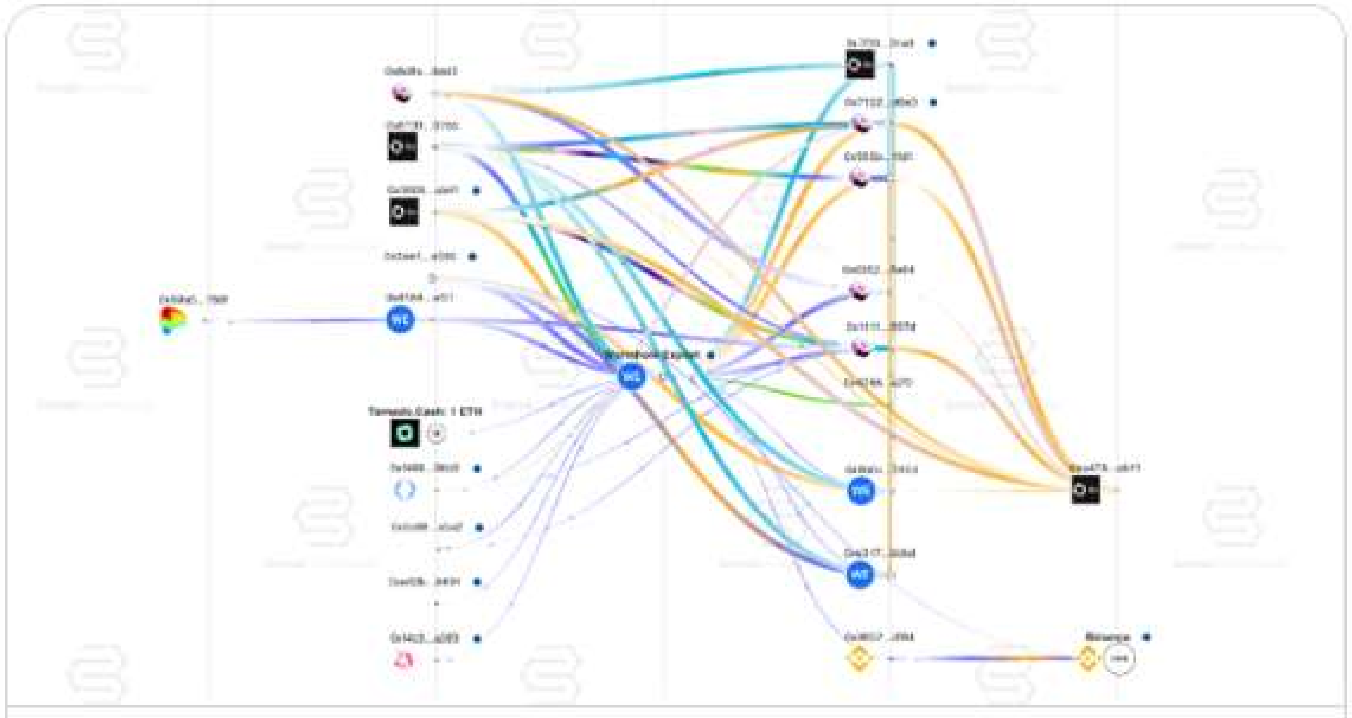
- Where might more crypto money go?

The TerraUSD stablecoin is back! Actually, it never went away. Recall this was one of the first fake-money schemes to crumble when the 1:1 dollar peg broke since, after all, Terra was worthless. But the Terra "community" will have you know that they are bigger and better than ever. According to Coindesk, "community members are describing a model that relies on token buybacks, undirectional swaps, staking and an algorithmic peg divergence fee to address the issues with the original design." Forgive us for not explaining this more clearly. Alas, we have not the first clue as to what they are saying.

- Chart Crime of the week

These are so common they are getting boring. But given the timeliness of banks lying about their balance sheets, we thought this one was worthy (HarborOne Bancorp).

But in case you want something more extreme, we present to you a Twitter advertisement. We cannot read any of it. But we know it pertains to crypto, naturally.

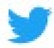



- Quick Hits
  - Argentina hiked interest rates to 91%.
  - New York state has a new law banning gas stoves in new buildings.
  - Nordstrom is closing down its San Francisco stores after 35 years.
  - During the Knicks-Heats broadcast, ABC showed footage of the NYC skyline. It had the twin towers still present. (This is not a conspiracy theory of any kind, we just are not sure why they would use such old, stock footage.)
  - A catholic missionary who visited Houston in 1848 said, “Houston is a wretched little town…infested with Methodists and ants.”
  - The DOJ won its first case of prosecuting insider trading on NFTs. (Remember Non Fungible Tokens? Another form of fake money. We do however believe they could serve a real purpose especially in the art world.)

**Trading**: As we intimated last week, we cut some short exposure on the large caps and started some on the small caps. We also added to some of the Fantasy & Frauds. Much of this space has quietly deteriorated. But a few names continue to buck the trend. We did some short-term trading in macro assets like Treasuries, Gold, and the USD. We basically bought dips and sold rallies.

**TSLAQ**: Very quiet in Tesla land. Most of Musk’s attention has been on the next SpaceX launch (it didn’t blow up). But it is interesting to note that a louder and louder chorus of onetime fanboys are becoming more disenchanted with their previous savior. It is a basic acknowledgement that tesla’s technology is no better than that from the mounting competition. Tesla posted its version of an ad on Twitter. It was touting the ability of the car to sync with driving directions on your phone. This feature has been around for years in the simplest of cars.

Check out our website to learn more about Chalk Creek Partners

 Carlisle's Twitter Financial List

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