Weekly Update

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- The equity market remains confused, the bond market is not
- Why is headline Volatility (VIX) so low?
- Short covering math
- Are Growth stocks now cyclical (and thus susceptible to a down cycle)?
- The age of delusion continues
- Retirement funds are being tapped early under emergency measures
- Banks are tapping measures to shore up liquidity, too
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	Last	5d %	YTD %	1yr %
S&P 500	4,118	0.0%	7.2%	-6.7%
QQQ	$304.37	1.1%	14.3%	-13.7%
US 10 YR	3.62%	3.42%	3.88%	1.95%
USD/DXY	103.5	101.2	103.5	95.5
VIX	19.6%	17.9%	21.7%	20.0%
Oil	$78.44	2.1%	-2.2%	-12.2%

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

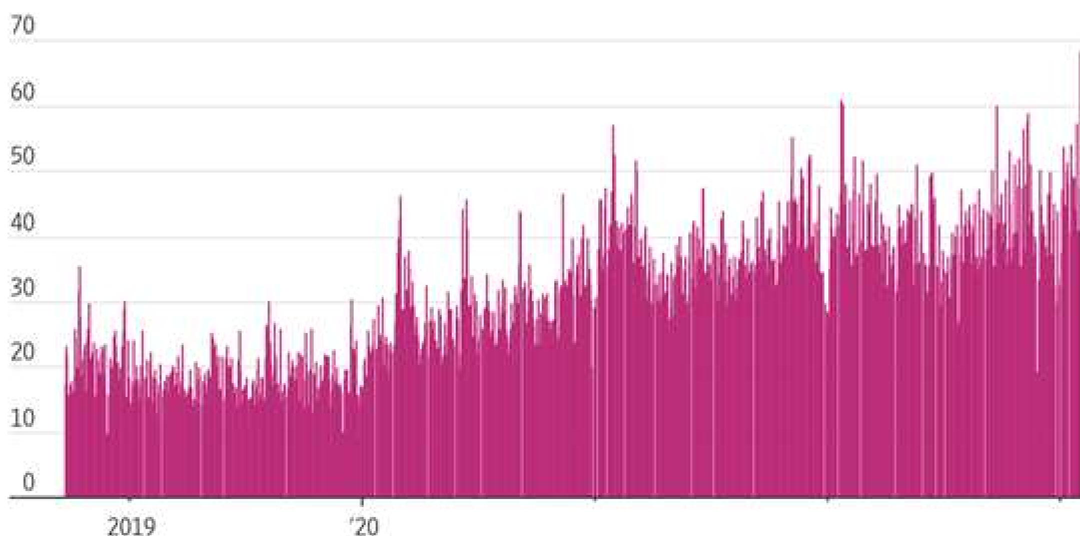
Fed comments and economic data have the equity market twisting and turning recently. After Fed chairman Powell's press conference last week was deemed dovish by the pundits, the market was fully embracing the soft-landing narrative. But then a shockingly strong labor report made everyone think twice about how the Fed would interpret the data…would it necessitate a more aggressive tightening of financial conditions? In a follow-up interview, Powell surprised even the most bullish investors by not backtracking from his stance last week. Powell mentioned disinflation, and like a made-up pronoun, the soft landing was deemed to be so. Of course,

he threw in a few caveats about maybe having to hike rates more than expected if wage increases persist (specifically in Services ex-Housing). But the immediate-reaction narrative was set. However, instead of getting more manic short-covering in the garbage stocks, it was the blue chip, mega-cap names that rallied higher. Alas, this proved fleeting, as other Fed members swooped in and beat back the loosening conditions narrative. Interest rates most definitely are going higher.

Throughout this equity zig-zag, the bond market signal was as loud and clear. The yield curve inverted back to its recent negative lows (2yr – 10yr is about -0.80%) with the 2yr Treasury yield moving aggressively higher (not quite back to the November peak, but a 0.30% move in less than a week is still eye opening). This is the market agreeing with the Fed's stated mission…more rate hikes are coming (2yr yield higher), and these will result in a softer economy…not a soft landing (10yr yield lower).

- Why is headline Volatility (VIX) so low?

One phenomenon still at work is the crazy 0-DTE option trading (zero days to expiration). A strange byproduct of this increase in volatility is it might be suppressing the headline volatility, VIX. The jury is still out, but some buyers of short-term options might be selling longer dated options. Since the VIX is a construction involving 30-day options on the S&P 500, the VIX could be artificially low. Also, the Volatility of Volatility, the VVIX, has been increasing. Even if there is no weird math quirk, there are still signs that the market is on its heels rather than its toes. Put more simply, this kind of option trading usually ends badly.



- Short covering math

Morgan Stanley attributes 45% of the S&P 500's return this year to short covering. The attribution is even higher for the Nasdaq's return at 55% short covering. MS adds that the bounce has been quicker and more robust than previous short-covering rallies (27 days vs 33 days and 32% vs 24%).

- Are Growth stocks now cyclical (and thus susceptible to a down cycle)?

One refrain we have been hearing more frequently is that Tech is now cyclical. Unlike the last 10-12 years during which it was considered Quality, Growth, and Defensive all at the same time, now it more resembles Tech post the internet bubble. We certainly agree. But despite the louder echoes, the market is dismissing the notion entirely. Or, of course, the market thinks we are about to embark on an upward move in the economic cycle.

- The age of delusion continues

Crazy Cathie Wood, aka the The Woodchipper, declared her flagship fund, "the new Nasdaq." At the time she shouted this from atop Mount Sinai, ARRK's performance for the last five years was +10%. The Nasdaq was +87%.

- Retirement funds are being tapped early under emergency measures

People are increasingly taking early distributions from their retirement accounts under so-called hardship withdrawals. Vanguard reports that 2.8% of their 401k participants have tapped their funds early (before age 59.5). This compares to 2.1% in 2021 and 2% before the Virus Fear. One can take money from their retirement account freely to avoid foreclosure/pay rent, pay medical bills, etc. (otherwise you must pay the tax on any gains and a 10% penalty). We do not think this 2.8% is overly alarming at this point. But it is another sign that the consumer is not as strong as everyone says.

- Banks are tapping measures to shore up liquidity, too

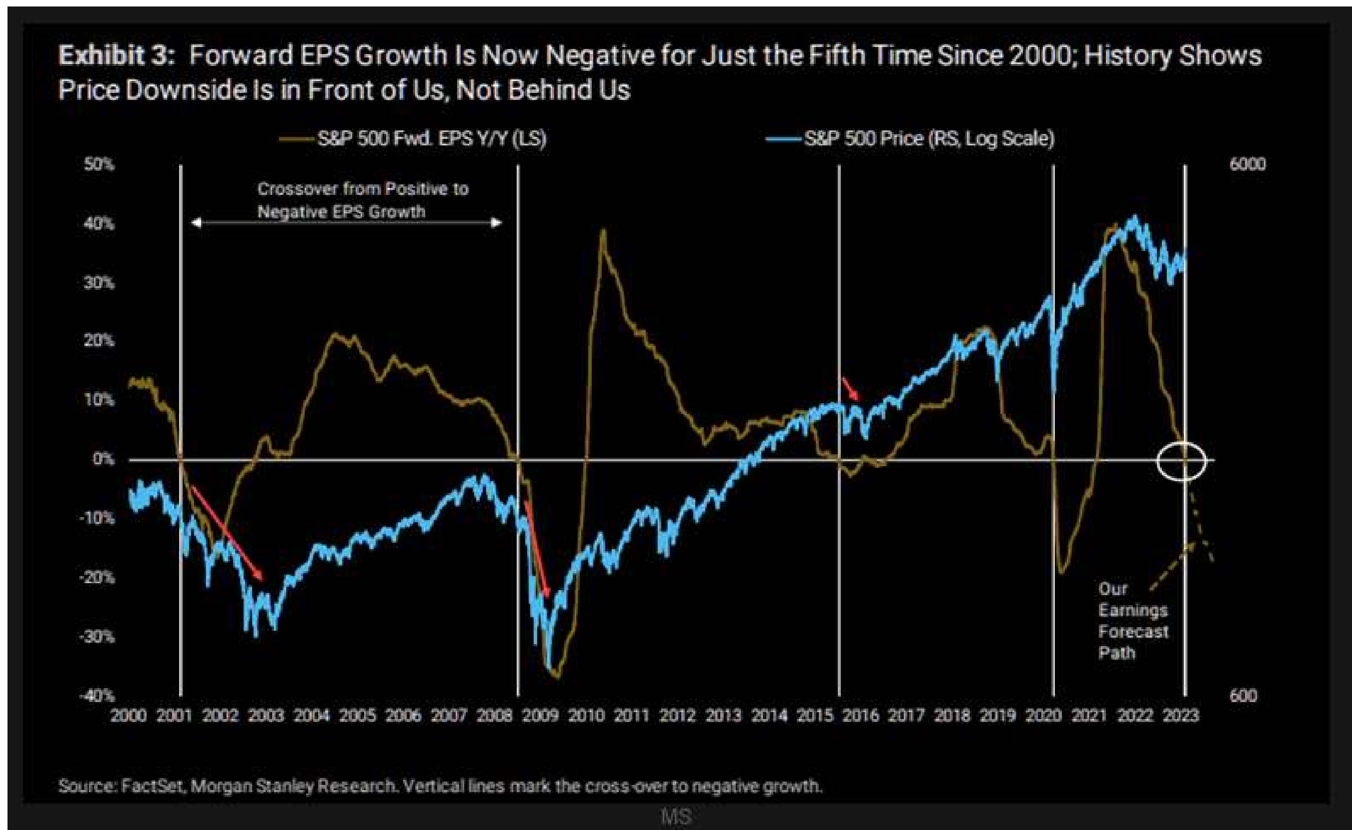
Banks borrowing in the Fed Funds market hit a record $120b at the end of January. Banks are losing customer deposits at a rapid pace. The narrative is that people are moving their savings to higher yielding money market funds (not to be confused with money market accounts). But these funds have had relatively stable assets over the last few years (after a big jump in 2018 and 2019). We think it is people drawing down their savings. Banks need to have deposits backing their loans, so they go to the Fed Funds marketplace. Here, Federal Home Loan Banks (there are 11 of these FHLB government sponsored entities) make short term loans to commercial banks (sometimes called wholesale deposits). The experts say this has not reached a point at which we should worry. But many trades are pricing above the effective Fed Funds rate (the median of all the daily bidding) in a clear sign of stress. Silvergate, the fraudulent crypto bank that helped FTX steal billions, has borrowed from the FHLB system. A bipartisan group of senators is up in arms over how a government entity meant to provide mortgage or community assistance is bailing out a crypto scammer. While this is absurd to us, we think the problem runs much deeper.

- Earnings are all about efficiency

Bespoke had an interesting tidbit about buzzwords being mentioned in company earnings calls. "Efficiency" is all the rage now as companies struggle to maintain margins. In the beginning of 2022, there were zero mentions. So far through earnings season, there have been 33 mentions. A similar pattern has emerged with "AI" although it has been hot for a few quarters now. Conversely, "metaverse" mentions are dwindling. This will never reach zero as Zuckerburg was dumb enough to rename his company and change its focus (at least until he fully abandons the ill-fated decision). But the idea of adults playing dress-up inside their computers has gone the way of the buggy whip. While we think AI might eventually suffer a similar fate (or at least the hype around it will cool), we think "efficiency" might be with us for a while. That does not bode well for revenue growth.

- Negative earnings growth leads to negative stock prices

Last week we noted that earnings growth had moved back to positive. That move was fleeting and obviously a byproduct of the earnings calendar. EPS growth is now back to negative at -3-4%. Morgan Stanley, the most vocal bear on earnings, notes that when growth flips from positive to negative it presages the biggest downward move in stocks. (Chart courtesy of themarketear.) Put another way, negative earnings growth does not happen very often. But when it does, stocks react in kind.



➢ Employment surges despite the layoffs

The Employment report showed that 517k new jobs were formed in January. This is a huge number and obviously a surprise against the 185k expectation (which was likely much lower after the smaller prediction from ADP). There was also an upward revision to the December number. But many dismiss revisions that cross the calendar year (quirky counting). But only the David Rosenbergs (super smart, usually right eventually, but always bad timing) of the world can call this a bad employment report. Private Payrolls accounted for the bulk of the surprise. The Unemployment Rate fell to 3.4%. The Participation rate budged up a tick (62.4%).

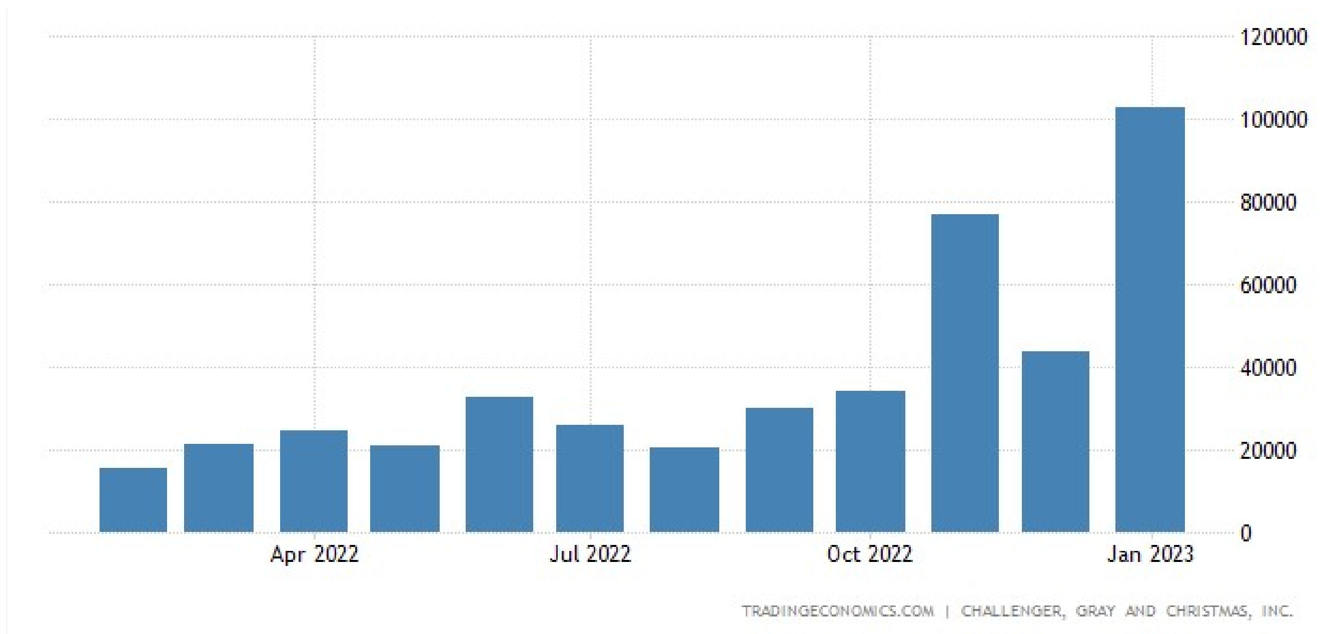
Leisure & Hospitality, Health Care, and Government accounted for almost all of the job gains since November. Temporary workers continue to be reduced (we commented two weeks ago that declines in Temp work usually lead overall employment). It is worth noting that daycare workers are still scarce. There are 58k fewer now than before the Virus Fear. This is certainly a contributing factor to the tightness in the labor market.

Average Hourly Earnings increased 0.3%. Technically, this was a slowing vs December's 0.4% increase, but this was revised higher from 0.3%. Whatever the case, wages are not really cooling as they seemed to be in 4Q. More to this point, the Average Workweek moved higher. This had been trending lower in a sign that

productivity was shrinking, but employers were worried about losing workers and not being able to replace them. An increase in the workweek is a positive for productivity.

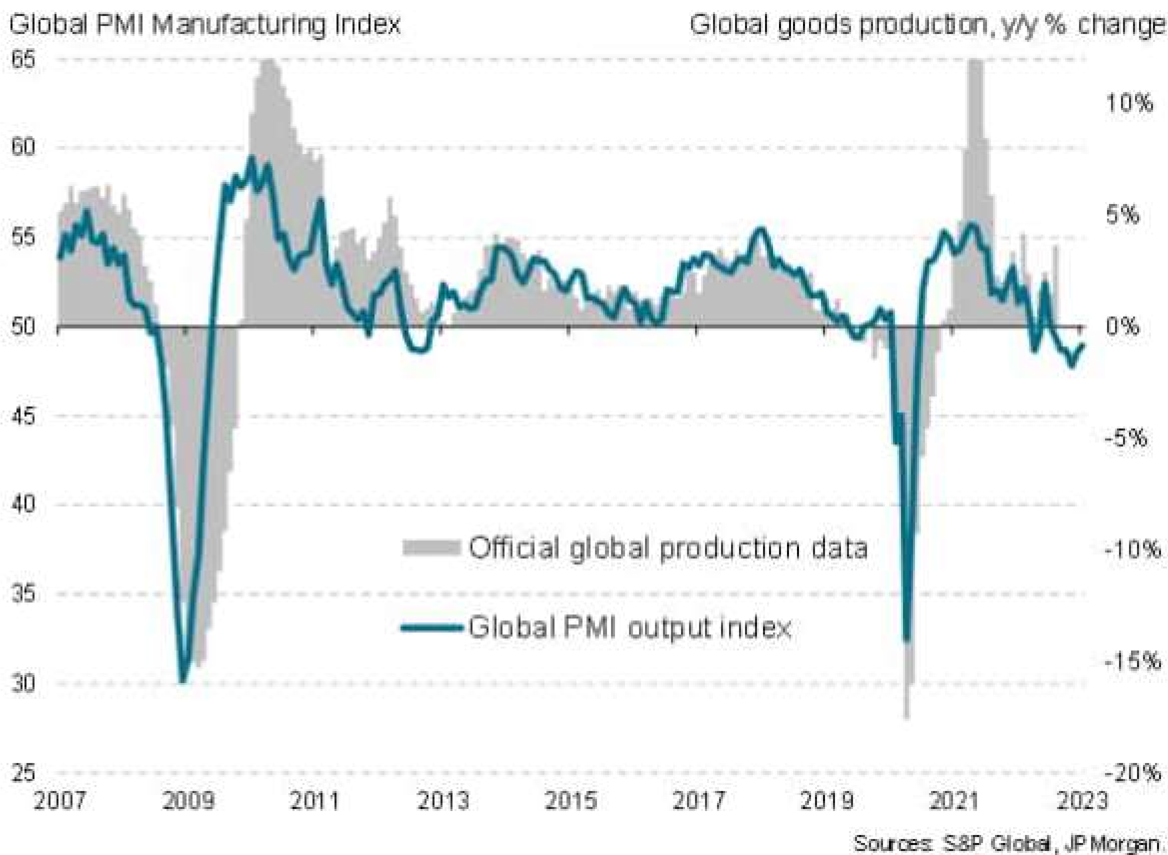
Jobless Claims ticked lower again to 183k. Continuing Claims also ticked lower; these had been on the rise since last fall. This was one of the reasons we have been concerned about the labor market softening. But if the Continuing Claims are flattening…we seem to be back to square one with our confusion.

We also talk about the layoffs mounting despite the strong labor market. Despite the Virus Fear mostly being in Lubbock now (rear view mirror), the economy is still doing the Covid unwind. Services jobs have been coming back to life after being left for dead. And many of the short-term solutions that were going to be permanent have receded like Homer back into the bushes. This unlabeled chart gives us the view from the layoffs perspective and not jobs gained. It also skips over the Jobless data as many of the people being laid off are not filing unemployment insurance claims. We would add that the economic impact from the typical, current layoff is probably 5x that of the typical new job being created.



- Business surveys bounce back

The Markit Composite PMI for January improved; it was led by Services. It was a two-point jump to 46.8 on both Services and the Composite. Manufacturing ticked up less than one point. The ISM Services PMI for January had a huge jump of almost six points to be squarely back in positive territory. This most likely was just a normalization from the terrible December number. But it does mean there is some stability. The same is true for the Global Manufacturing number. It has started to inflect higher as you can see from the following chart. This one is directly impacted by the China reopening.



On China, the private Caixin Services PMI jumped similarly to the official government survey: 48 in December to 52.9 in January. New Orders increased for the first time in five months. Along the same lines, input costs increased for the first time in five months.

- The ECB might be the new Fed

The European Central Bank (ECB) is now the most hawkish central bank. It hiked 0.50% this week and forecast another 0.50% hike in March. The ECB has been much slower to move than the US, but it appears resolute in catching up. The narrative is that the European economy is on stronger footing to handle the tightening monetary policy. That seems like a sketchy supposition. Maybe they escape the winter without any cold weather. But if not, look for inflation to roar back.

- A new use case for SPACs

We are going way into the weeds on this one. We stumbled across a fascinating story of how a company engineered a short squeeze in its own stock by making an odd adjustment to its capital structure. The parent company (SRNE) merged its subsidiary with a SPAC, so the subsidiary was now a separately listed entity (SCLX). Then the parent, which still owned the vast majority of the subsidiary, issued a stock dividend consisting of the subsidiary. These new shares would be restricted/untradeable for five months. Traders that were short the parent stock were now short the subsidiary, too (when you are short a stock, you become short all the dividends paid by the company…cash, stock, or even another company's stock in this case). The size of the stock dividend was 7x larger than the free float of the subsidiary shares (free float means shares not owned by the parent, and the new shares are not tradable so people cannot cover their new shorts). The parent company had also quietly purchased about 20% of the outstanding warrants on the subsidiary. If you can follow this, beers are on us. (Kudos to Yet Another Value Blog for this one.)

➢ Where did all the crypto money go?

Wow, we have nothing to add here. A whole week without a crypto scam. We can probably hold our breath until the next unravels. Or we might start including the travails of Bed Bath & Beyond retail shareholders who keep getting suckered.

➢ Chart Crime of the week

We might be bearish, but we don't just draw random lines on a 90 year chart.

➢ Quick Hits

- Super Bowl ads will generate over $500mm for Fox. The average for a 30 second spot is over $6mm. Some spots have sold for over $7mm. No crypto ads this year. But we will be on the lookout for the dumbest use of money.
- The Council on Environmental Quality, a policy board serving the president, has instituted new guidance. It includes a few vaguely worded provisions including: "Agencies should incorporate environmental justice considerations into their analyses of climate related effects."
- Why is the Save button still a floppy disk icon?
- Two bank robbers in Vegas went on a spree heisting nine banks in 20 days. They got away with…$6100.
- The WSJ reports that the UK's National Health Services, its socialist medical system, "is in crisis." As a friendly reminder, we have been saying this for years. When Mrs. Chalk Creek gave birth to our son in London, we were given the good news that if she were to die, the cost of the delivery and hospital stay would be free. Oh, what a relief.

Trading: We continue to tip toe along with our strategy. We added to our long Gold position. We added to our new long China exposure. This is very much a trade as we think the communists will collapse upon themselves eventually. But the data is undeniably positive in their economy right now (simple covid reopening trade). We added to some of our shorts. We are trying to steer clear of the manic squeeze stocks. But some of these will

surely be bankrupt and the market is not pricing that right now. We added to some consumer discretionary shorts, as well. We also added long exposure to long dated Treasury bonds. We think this recession trade looks good after a slight pullback. But we will be the first to admit we have gotten the timing wrong on bonds for much of the last year (despite being right in theory…that amount to nothing).

TSLAQ: Tesla announced it will be releasing its Master Plan 3 on March 1. Most people just call this an investor day. And most companies outline how they will make money for their investors (to be fair, not all). Musk plans on giving details "on the path to a fully sustainable energy future for planet Earth." As a refresher, Master Plan 2 (or Part Deux as he called it) back in 2016 raved about making money with your robotaxi while you were sleeping (among other unfulfilled promises).

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