Weekly Update

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- Rough start to the year…with the dip already being bought
- Bernanke predicted this High Growth slaughter
- China is not out of the woods yet.
- We still think Inflation will start cooling (however slowly)
- Business Surveys are a bit softer but inflationary pressures continues to ease
- China is experiencing monthly deflation
- Jobs are coming back, and people are still quitting for other jobs
- There is no slowing Retail Sales
- The oil market sees supply issues remaining
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	4726	0.5%	-0.8%	26.1%
QQQ	387.4	0.8%	-2.6%	23.8%
US 10 YR	1.75%	1.71%	1.51%	1.09%
USD/DXY	95.0	96.2	96.0	90.4
VIX	17.6%	20.2%	17.2%	22.2%
Oil	82.81	6.4%	9.9%	55.3%

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

The market had a rough start to 2022. The Fed's Open Market Committee (FOMC) minutes from the December meeting spooked traders with talk of a sooner start to rate hikes, faster rate hikes, more rate hikes, and balance sheet reduction (not to be confused with the slowing of balance sheet expansion which has already started). Needless to say, the committee has completely reversed course on its inflation prediction. Here is the quote:

> It may become warranted to increase the federal funds rate sooner or at a faster pace than participants had earlier anticipated. Some participants also noted that it could be appropriate to begin to reduce the size of the Federal Reserve's balance sheet relatively soon after beginning to raise the federal funds rate. Some participants judged that a less accommodative future stance of policy would likely be warranted and that the Committee should convey a strong commitment to address elevated inflation pressures

The reaction was predictable and swift. Long duration equities were hit hard along with bond prices (higher interest rates). Value stocks were rewarded for their more predictable cash flows. The pain (other than the Value beneficiaries) was compounded when the Employment Report was taken hawkishly despite some dovish aspects. Oddly, much of the commentary (CNBC pundits, twitterverse, etc) kept declaring that the market was going to be surprised when the Fed hikes rates. For starters, the Fed Funds futures already predict four interest rate hikes next year. Secondly, this rotation had already started before the FOMC minutes! The market was front-running the Fed. Sure, there was another shoe to drop. And there might be a few more. But we do not see the market being drastically fooled by any Fed actions. Actually, we think there is now upside to Fed actions. That is, if the economy were to slow rapidly (from rate hikes, virus-fear, China tensions or lockdowns, US politics, etc), the Fed might cool its tightening policy. Moreover, the slope of the yield curve has actually steepened since late December (flattish the last few days). This is the market's way of saying that interest rate hikes will lift bond yields but not enough to crimp economic growth. We do not expect rip-roaring growth, but the economy is still in good shape (jobs, housing, retail sales, business confidence). Thus, the yield curve should sit around here. Alas, the market has rebounded along with the Tech names that were hit hard. The CEO of JP Morgan, Jamie Dimon, helped the cause by commenting how strong the economy was and the consumer could weather measured interest rate hikes. The market also got a lot of positive company commentary (including diminishing fears over Omicron) from large Retail and Health Care conferences. Even Fed chairman Powell pushed back a bit on the idea that a rate hike was automatic come March. Not even a red-hot inflation report derailed the bounce (because it was expected and thus already priced in).

We remain constructive on the market. We think a washout of Fantasy Tech (not sure who coined this, but it is perfect…we also like Tech of Hopes & Dreams) was warranted and will be difficult from which to recover. But Big Tech with its strong Cash Flow should be beneficiaries. 30x on a P/E basis might be expensive, but it is nothing compared to 50-100x Sales with no Earnings! (To be fair, some Fantasy Tech will survive and thrive, and we are always looking for ideas that resonate.)

- Bernanke predicted this High Growth slaughter

Ben Bernanke, the originator of all things modern-day Fed (zero interest rates, massive balance sheet expansion through bond buying, mortgage-backed bond buying, communicating to the markets about future Fed actions, etc) had this to write on Jan 4, 2010, "QE was specifically meant to lift stock prices…In reverse, the response should not be a surprise." And those stocks going in reverse lately were previously the big beneficiaries. Sure, we could see some multiple contraction on the Quality names. But earnings and cash flows should provide a good buffer.

- China is not out of the woods yet.

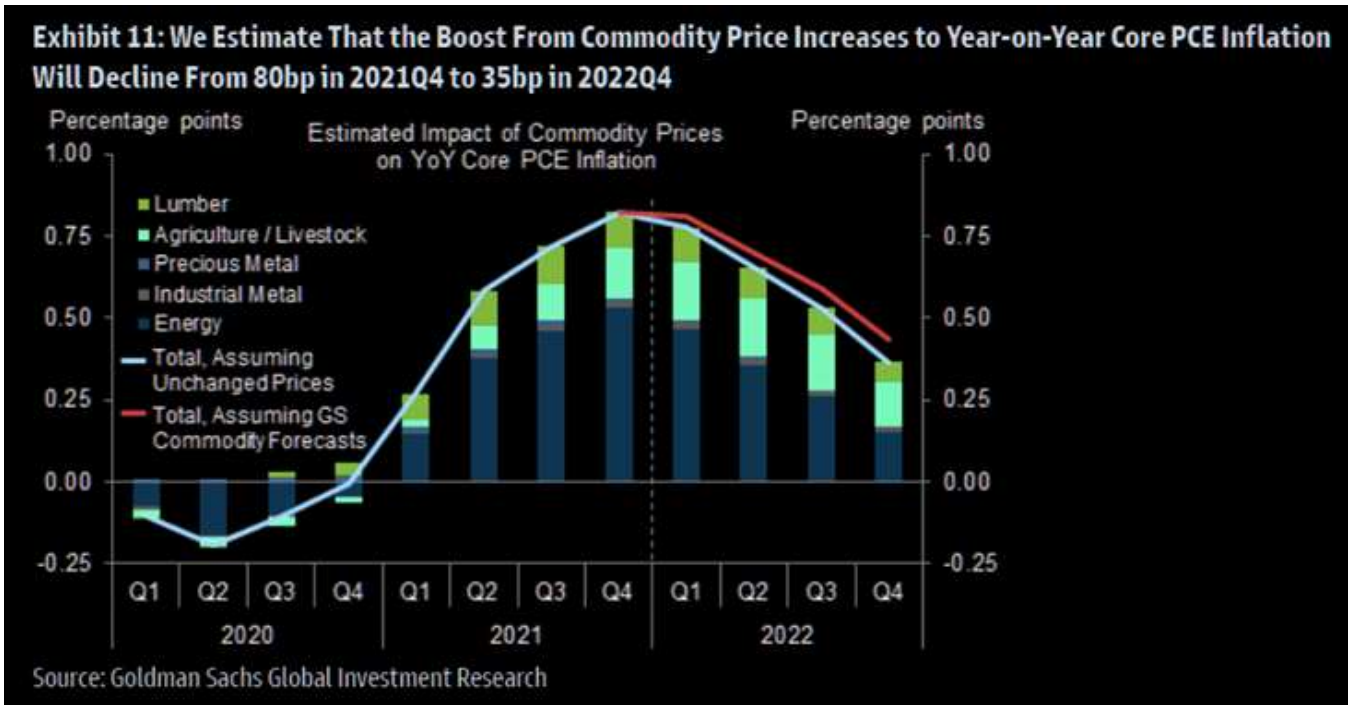
China Evergrande continues to bubble beneath the surface. One of our original (and steadfast) themes was that foreign debt holders would be the ultimate bagholders. But Evergrande has started to tiptoe on the line that we thought was uncrossable. Among its many debts are wealth management products sold to retail investors. And Evergrande just changed the repayment schemes. We are sure the communists will not allow a default, but this is something to watch. Moreover, the Zero-Covid policy has to be undermining the recovery despite some incremental upticks in recent data (the recent deflation data shows this slowing after some decent Manufacturing data previously).

- We still think Inflation will start cooling (however slowly)

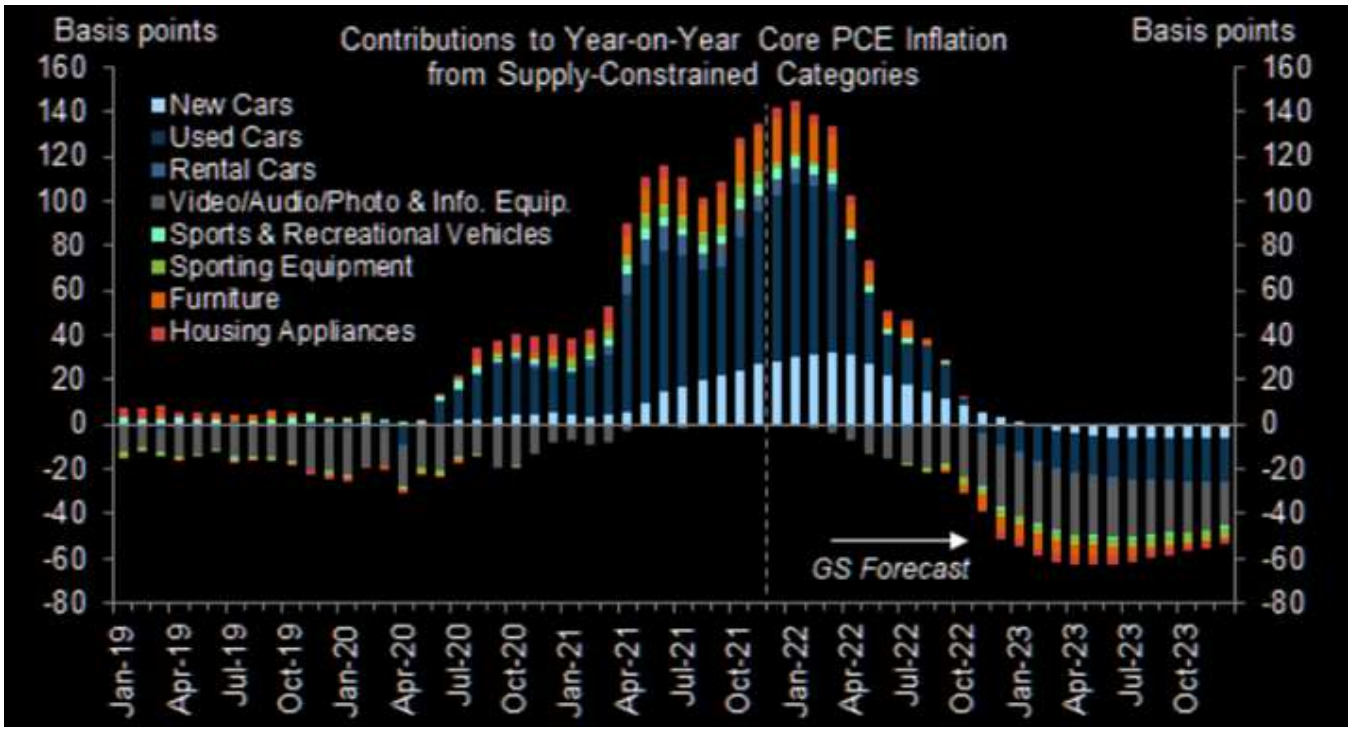
This morning's Consumer Price index (CPI inflation) showed prices increased 7% in December vs a year ago. The rate of change of the monthly increase slowed a bit to 0.5% (compared to the 0.8% increase in November vs

October). Merrill Lynch, who expects four rate hikes next year and is bearish on the market, summarized their view on this CPI thinking it will "land closer to 3% than the Fed's 2% target." We think most people would be relieved to have only 3% inflation (assuming the economy is still strong).

Here is a chart from Goldman showing their expectation of the impact of commodity prices on inflation. This jibes with our view that commodity price increases have likely peaked. This does not necessarily mean inflation as a whole has peaked, but the correlation is high.



And here is another Goldman chart (courtesy of themarketear). This shows the expected inflation impact from some of the bottlenecked items like used cars. Economic predictions are often just guesses (hence our term for economists = professional guessers). But plotting inflation is typically a little easier since it is rooted in base effects. We know that used car prices were increasing at an epic pace for much of 2021. These high prices make it more difficult for the rate of change of prices to continue higher.

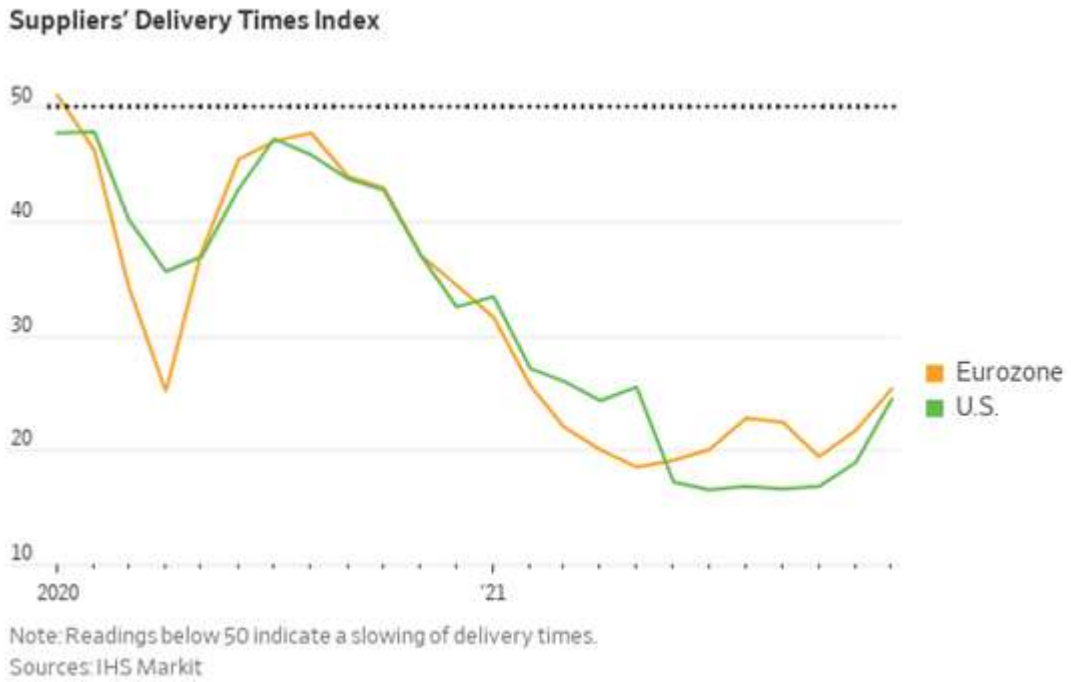


And while consumers's expectations have started to climb in the near term, business expectations for inflation next year remain at 3.4% according to the Atlanta Fed. Furthermore, the market's expectation for the five-year inflation rate starting in five years sits at 2.2%. Five years is a long way off. But tomorrow's price increases are already in the rearview mirror (Lubbock). We think the 3-3.5% middle ground makes sense.

- Business Surveys are a bit softer but inflationary pressures continues to ease

The ISM Manufacturing PMI fell about 2.5 points to 58.7. This is still a decent level indicating growth, but it is also the lowest level in a year. But the numbers under the surface are more interesting. The biggest subcomponent movers were Prices and Delivery Times both of which dropped dramatically. Moreover, Employment is improving meaning it is easier to hire workers. Markit's Manufacturing PMI also had a static

headline number. But its underlying data showed easing supply chain problems, as well. The chart below shows Delivery Times in Europe and the US are both starting to improve (moving higher means times are shortening).



The NY Fed chimes in with, "More recently, the Global Supply Chain Pressure Index seems to suggest that global supply chains pressures, while still historically high, have peaked and might start to moderate somewhat."

- China is experiencing monthly deflation

The Chinese CPI in December decreased -0.3% vs November. The annual rate fell to 1.5% from a 2.3% increase the prior month. The monthly PPI (wholesale prices) fell even more with a -1.2% drop. The annual increase is still running hot at 10.3%. Much of this deflation could be the new government-mandated lockdowns. And this could reverse the recent easing of the supply chains. For now, we know it means the communists will keep monetary policy easy to prop up the economy.

- Jobs are coming back, and people are still quitting for other jobs

The December Employment Report showed another jobs gain albeit lighter than expected (199k vs 400k expected and 249k in November which was revised higher along with October). But the Unemployment Rate dipped to 3.9% from 4.2%. This equates to 480k fewer unemployed people. This is another example of the different surveys giving us different results. Last month we emphasized the strength in the Household Survey (which produces the UE rate) because it was more important to have more people working vs more people having multiple jobs (the Establishment Survey which produces the Nonfarm Payrolls number counts jobs not people). The Labor Participation Rate ticked a notch higher to 61.9%. This is still lousy. Average Hourly Earnings increased 0.6% on a monthly basis. This is accelerating compared to the 0.3% in November. This equates to an annual gain of 4.7% which is a slight slowdown compared to November's 5.1%. All told, employment is still 4.5mm jobs below where it was in February of 2020 (after adjusting for population growth)

The Job Openings and Labor Turnover Survey (JOLTS) showed that Job Openings fell in November. The total stands at 10.56mm openings compared to the 11.1mm in October. But this level is still off the historical chart. And the six-month trend is still flattish. The largest declines by sector were Accommodation and Food Services,

Construction, and Nondurable Goods Manufacturing. Financial job openings increased. Moreover, Quits continue to far outpace layoffs. But Job creation continues to outstrip job losses.

- There is no slowing Retail Sales

The weekly Redbook Retail Sales data continues to impress. Three weeks ago, we liked the 16.4% annual increase in the face of the virus-fear. Since then, we have had increases of 21.4%, 18.8%, and 14.4% last week. So that is a slight downtick in the most recent data, but we suspect this is attributed to teachers and pilots taking advantage of the system. For context, 5% was the pre-virus average gain.

This is a little more backward looking, but Holiday Sales increased 8.5% compared to last year according to Mastercard. This holiday period is measured from November 1 to December 24. Apparel had the largest jump of 47% (we are long a shoe company on this theme, but this is not a broad trend as we suspect much of this explosive growth was fueled by one-offs or pull-forward). Online Sales increased 11% while department store shopping grew 21%. As we have been saying, despite all the noise and virtue signaling, most people are going about their lives.

- Construction Spending still led by Residential

Construction Spending continues to muddle along with a 0.4% gain in November. But the recent trend continues with strength in residential construction leading the way and government spending lagging (Private construction makes up about 78% of all Construction Spending).

- The oil market sees supply issues remaining

Since OPEC+ decided to hike production back in July, the cartel has added 1.2mm barrels a day. The plan was for an addition of 2mm. In October, OPEC+ missed its production targets by 16% (too little production). And November slid to a 17% miss. In December, production only increased 70k bpd compared to the 400k target. We are sticking with our claim that there is not as much spare capacity as some of the oil bears claim. And even OPEC agrees with this despite the unseemly acknowledgement of imperfection by the Saudis. Just last month, Saudi thought the oil market was oversupplied by 3mm bpd in the short run. Now they think it is only 1.4mm. Algeria and Gabon are the only countries able to hit their monthly quotas. Nonetheless, the group increased its planned production in January by another 400k as expected. The one contrasting data point is Saudi cut prices to Asia.

The other factor that has been leading to controlled supply is the discipline exhibited by US shale drillers. Company mgmt. teams have reiterated that their mission is returning capital to investors and not the old "production growth at any cost" which cost them dearly in the past. However, the most recent Dallas Fed survey of oil company mgmt. teams tells a different story...at least on the surface. About 50% of the 88 companies stated they wanted to "Grow Production!" Fortunately, the data is misleading as it is not filtered for size. The small companies want to grow production while the large ones (10,000 barrels per day is the marker) want to reduce debt.

- Chart Crime of the week

We are not sure if this is an intentional crime or just pathetic labeling. The large label is clearly wrong…as every stock in the S&P 500 is well over $1b. The median market cap of the Russell 3000 is about $3b. The smaller legend has the qualifier "meeting some simple growth criteria." If we are to follow this legend…what exactly is this criterion?

- Quick Hits
  - Amazon's Alexa told a child to stick a penny in an electricity socket.
  - Agents for players in FIFA (soccer, yawn) made $500mm in transfer fees last year.
  - There are about 300 SPACs looking for acquisition targets. These SPACs have already collected about $300b.
  - France will likely fire up some of its idled coal plants to help alleviate the winter energy crunch.
  - The Boston marathon bomber received Covid relief funds on death row.
  - A German utility, Uniper, has sold 90% of its 2022 power in the forward market at EUR$49/MWh. The current futures prices is about EUR$273/MWh.
  - A British utility, Ovo Energy, recommends, "cuddling with pets, performing hoola hoops, and avoiding chili as key steps to tame household energy bills this winter."

Trading: We bought the dip in a small way. We still think the Fed's new path could cause some jitters. If the market shakes it off completely, we will lighten up or buy some Puts if the VIX (Volatility Index) comes down (already starting to). We also bought some Fixed Income when the 10-year Treasury yield hit about 1.80%. We still have some inflation positions (energy and financials). But we also have the other end of the spectrum like Health Care, Staples, and Utilities (a new position along with buying Fixed Income).

TSLAQ: Not much to report other than Musk is raising the price for Full Self Driving while still noting that Teslas still do not self-drive.

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