Weekly Update

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- The virus-fear is killing small-caps
- Some Valuation is still nasty
- Small-cap earnings are not what we thought they were
- GDP underwhelms, Inflation not accelerating, Employment still not recovering quickly
- PMIs point to US Manufacturing and European Services
- Housing continues to moderate
- More dissention among the Fed, but does it matter?
- Chart Crime of the week
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	Last	5d %	YTD %	1yr %
SPX	4403	0.0%	18.0%	35.6%
QQQ	367.3	0.4%	17.4%	37.1%
US 10 YR	1.18%	1.23%	0.92%	0.56%
VIX	18.0%	18.2%	22.8%	23.0%
Oil	67.99	-5.9%	40.5%	63.4%

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

One of the concepts we tend to harp on is the movements underneath the surface of the market. Now that the virus-fear is back, these gyrations are becoming more violent. Unlike during the previous waves of fear induced by the media and political cowards, the demarcation is not as blunt as Work From Home or Reopening. Rather, the rotations are more traditional in the sense that the more economically sensitive stocks are stumbling. But there is not a lot of nuance (so there is still plenty of bluntness). Small-caps continue to underperform in an ugly fashion. Value is moderately underperforming Growth in general. Large-caps (Growth and Quality) have been the winners. On one hand, it seems the market is eschewing the Inflation trade. The bond market is certainly doing this as the 10-year interest rate remains near a six-month low. But we think the market is still unsure about the path of inflation. What the market seems to be sure about is that we are past peak growth. The questions seems to be: does the economy enter into a prolonged period of Stagflation (low growth with high inflation) or outright Deflation (low growth and negative inflation). The difference is extreme. But ultimately, we want to position between these two scenarios as we do not think the market is ever as cut and dried as some (most) want it to be.

- Some Valuation is still nasty

We try to avoid making too many decisions based on valuation alone. But here is a pretty good cautionary tale about having too many companies trading at 20x Sales (the market cap is more than 20x annual sales). We wish this chart was adjusted for the size of the market considering today's market is about 3x the size of that in 2000. But $4.5t today is still about 10% of the total market. This pales in comparison to the 25% back in 2000. But that is why we do not expect a crash of that proportion. But a healthy correction in the overvalued stuff which has started could continue (virus-fear notwithstanding).

- Small-cap earnings are not what we thought they were

With about 75% of companies in the S&P 500 having reported, we are seeing the highest combination of earnings and revenue "beats" since 1Q2008. That is a bit ominous. 78% of companies have raised guidance. All of this should be great news for the market, but Inflation continues to dominate earnings conference calls. Labor inflation is the biggest worry (or at least the most mentioned by mgmt. teams). But supply chain price increases are nipping at labor's heals.

Earnings "misses" are being punished more than beats. Those beating on both EPS and revenues have moved 0.9% higher and those missing on both have dropped 2.6%. These datapoints can be silly at times because they do not incorporate what the stocks have done going into earnings (not to mention measuring anything in one day performance can be useless). But this type of reaction is not very surprising given the rotations and lower correlations. We think it lends credence to the view that Quality stocks will outperform. We still have junky names that are bets on the Reopening, but we have culled these. In light of the renewed government panic over the virus-fear, we might continue this. Interestingly, small-caps (generally associated with Junky names vs Quality large-caps) have been beating expectations by the same amount as large-caps (14%). But Inflation "mentions" are much lower for small-caps. Moreover, small-caps are experiencing more "pricing power." This margin expansion is the exact opposite of what people fear in small-caps right now. This contradiction is not lost on us. We will continue to be very selective in our allocation to small-caps.

- GDP underwhelms, Inflation not accelerating, Employment still not recovering quickly

The first look at the 2Q GDP underwhelmed expectations (+8%) with growth of only 6.5%. That sounds a bit silly to write, "only 6.5%." And some of this shortfall was expected after the recent trade data (GDP = Consumption + Govt Spending + Net Exports). But 2Q is going to be the peak growth period during the virus-fear recovery. On the bright side, Personal Consumption Expenditures increased 11.8%.

The June inflation numbers per the Personal Consumption Expenditures Price Index (PCE infaltion) remained about flat compared to May. The headline was 4.0% while the "Core" was 3.5%. These are obviously high numbers compared to the Fed target of 2%. But the rate of change just might be slowing.

Jobless Claims remained above 400k as the 4-week average is moving higher. Continuing Claims ticked higher by 7k. And the ADP prediction for the increase in Non-Farm Payrolls (NFP) this week missed the market's guess badly (only 330k vs 700k expected). We still believe in our *Johnny Paychec*k theory (people will stop saying Take this Job and Shove it). And we have been saying time will tell. Obviously, time is working against us here. And the renewed moratorium on evictions just gives the *Family Guy on the Couch* people more time to lay around instead of looking to get one of the 9mm+ available jobs. We have to admit, we never thought the CDC would be establishing mandates to screw landlords out of rent.

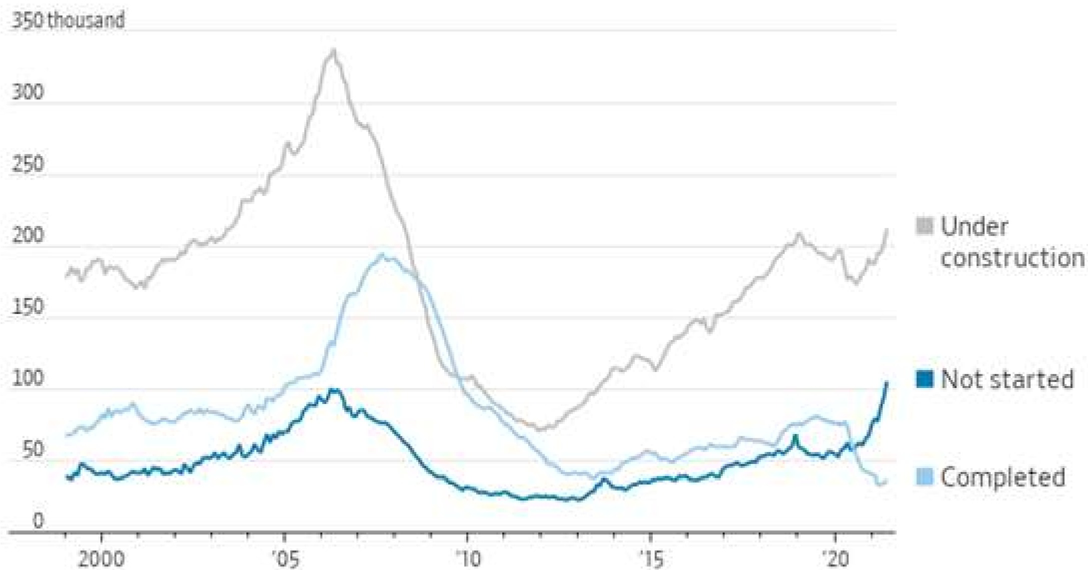
- PMIs point to US Manufacturing and European Services

The final reading for the July Markit PMI for Manufacturing increased over a point to 63.4. This survey has been ramping higher for nine months. Conversely, the ISM PMI for Manufacturing is at the same level it was nine months ago (October) after a one-off jump in March. On the Services side, the Markit reading was just as expected 3.5 points *lower* than Manu. But the ISM Services jumped over 4 points (all-time high of 64.1) to be more than 4.5 points *higher* than Manu. We know that the difference in the surveys is that Markit includes small and mid-cap companies (ISM is just large-cap) and, thus, has a more US-centric focus (ISM is more international). The interpretation: Manufacturing in the US is leading the recovery while Services in Europe (and to a lesser extent Asia) are bouncing back. We think this follows the timelines of recovery: Services are first to bounce because there is less inertia than in Manu (restarting a factory is much more difficult than restarting a chatroom or even a restaurant).

- Housing continues to moderate

Pending Home Sales fell 1.9% in June compared to May. They also fell 1.9% vs June of last year (strange coincidence). May was a strong month for Pending Sales which halted a slid coming off the peak from last August. It is yet to be seen if this is the resumption of that slide. We expect it will be until pricing normalizes.

Going back to last week's New Home Sales, here is a chart that shows that New Homes are backlogged. This is certainly a silver lining to the cloud of falling sales. But the touch of grey is the historical perspective…that last time Under Construction homes surged well ahead of Completed homes was right before the housing crash of 2006-8 (and subsequent World Financial Crisis).



Construction Spending (as a whole) increased slightly in June (+0.1%) and was revised substantially in May (from -0.3% to +0.3%). This data series does not tend to move too much on the headline. But the components do move, and the recent trends are obvious. Residential constructions spending rose 1.1% in June, public construction fell 1.2%, and private commercial (non-residential) fell 0.7%. Over the last year, Residential Spending is up 28.8% while non-Res is down 6.6%.

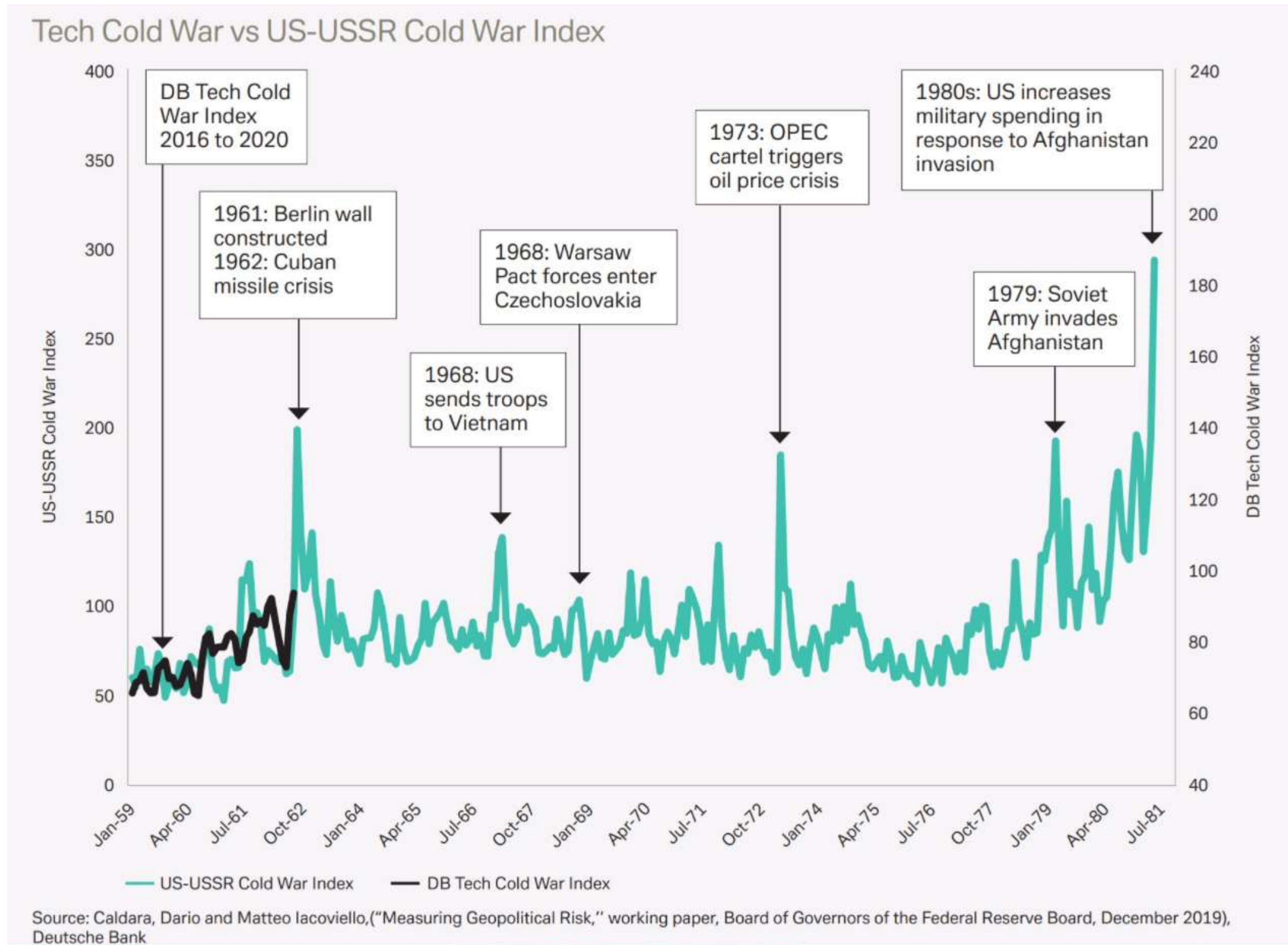
- More dissention among the Fed, but does it matter?

Chris Waller, one of the under-the-radar Fed members (on the Board of Governors, not a regional Fed president), broke rank with the chairman Powell wing of the Fed. He said if the next two job reports are strong, he would likely be in favor of starting the bond "tapering" (the slowing of bond buying) immediately in September. This would logically lead to increasing interest rates in 2022. These are similar comments to what St. Louis Fed president Jim Bullard has voiced. This is not surprising considering Bullard and Waller worked together for many years. But it is surprising to hear it from Waller. We are sure Powell will snuff out this dissent. We get the July Employment report this Friday.

Richard Clarida, vice-chair of the Fed and mostly aligned with Powell, said conditions to change the interest rate policy will not be met until the end of 2022 (yes Fed members speak in verbose language). The economy will likely have made enough progress later this year to lay out the timeline for tapering. This sounds like we will get an announcement late in the year (Dec 14-15 is the last Fed Open Market Committee meeting) with the actual slowing of bond buying early in the new year. Of course, he said inflation is still transitory. In what could be the line of the year, he said it is taking longer to reopen the economy that it took to shut it down last year. Generalissimo Franco is, indeed, still dead.

- Chart Crime of the week

It might be a German thing. We are accustomed to the buffoonery from the Welt, but now we have this absurdity from Deutsch bank. In seven years, we can expect the Tech equivalent of Warsaw Pact forces entering Czechoslovakia?



- Quick Hits
  - Robinhood (HOOD) is the latest stock to enter the meme-geist thanks to…Robinhood traders.
  - HOOD was below its IPO price for a week until options were listed. Option volume was massive today…when the stock rallied 50%.
  - Ohio's $1mm lottery prize for getting vaccinated increased the inoculation rate by 1.5%.
  - The two largest teachers's unions in the US oppose mandatory vaccinations.
  - Archegos, the hedge fund that blew up because it held huge, concentrated positions with different prime brokers (fancy word for custodian), was thought to be a rogue operator that kept its extreme risk a secret. It turns out that the prime brokers knew all about the outsized risk and just didn't do anything about it.
  - The infrastructure bill is 2,702 pages.

Trading: We increased our longs in our Stagflation positioning. Since we expect inflation to run hot for a bit, we are happy to take the contrarian view (inflation names have been flailing lately). We increased our longs in

Energy and sold some of our Financials. We cut more of our junky Retail (still have exposure and it is hurting us). We increased our hedges in the small-caps. On the flip side of the inflation trade, we increased our long in Big Tech. We added to our event-driven trades (theoretically impervious to market moves…not in practice). Our LNG-exporting project got hammered on the news of a stock offering. It is trading like it will never have any customers or financing to build its Louisiana super-terminal. Never mind that the company signed its third customer last week (Shell) which brings it to the point of feasibility. Welp (not the German website kind of welp).

TSLAQ: The then-director and now-chairman of Tesla took the stand in defense of a lawsuit against Tesla. She answered almost every question with "I don't recall."

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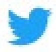 Carlisle's Twitter Financial List

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