# Weekly Update

16-Feb-2022

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- Rumors are driving the market's short-term moves
- It sure looks like the Fed is damned if they do and damned if they don't
- Small-cap valuations are getting cheap (nut not cheap enough)
- Positioning is still stretched
- Inflation is still heating up
- Sentiment sinks further
- Housing confidence remains stable
- Retail Sales looked great, but they could be slowing
- Mixed messages from the Fed, but we think they are in trouble either way
- Speculators are not driving oil prices
- Quick Hits
- Chart Crime of the week

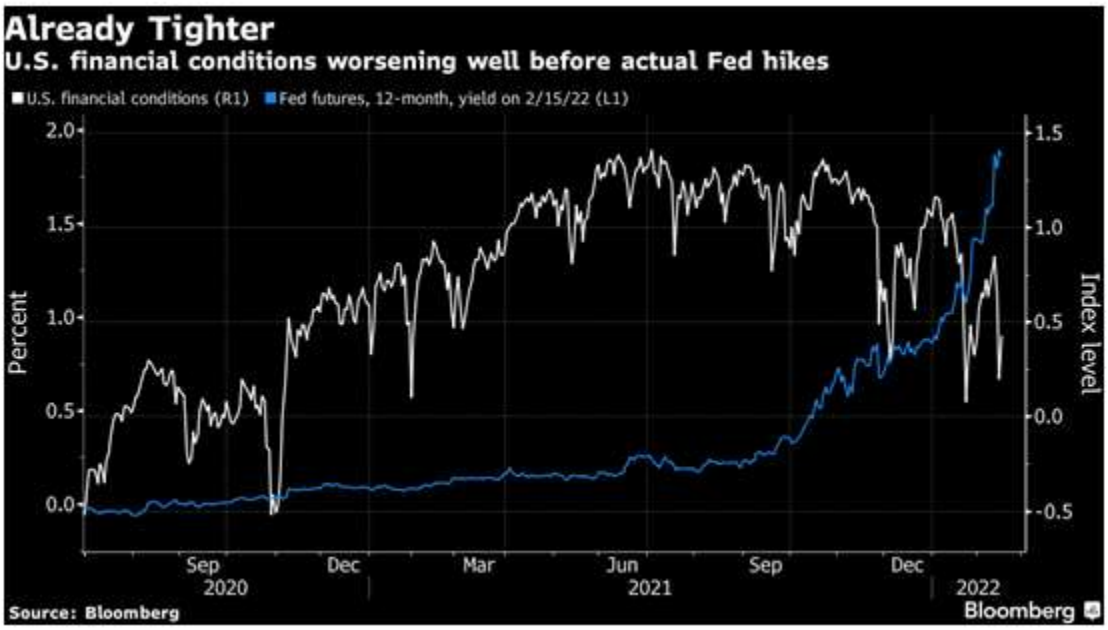
| | Last | 5d % | YTD % | 1yr % |
|---|---|---|---|---|
| S&P 500 | 4,475 | -2.4% | -6.1% | 15.3% |
| QQQ | $356.04 | -2.9% | -10.5% | 6.3% |
| US 10 YR | 2.05% | 1.95% | 1.51% | 1.27% |
| USD/DXY | 95.8 | 95.6 | 96.0 | 91.0 |
| VIX | 24.3% | 20.0% | 17.2% | 21.5% |
| Oil | $90.50 | 0.5% | 24.5% | 56.0% |

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

Rumors are driving the daily action in the market, and that is never a good thing. Whether it be about an intra-meeting rate hike by the Fed, or the status of a Russian invasion of Ukraine, the market is whipping around. We are getting some corporate takeover rumors which are turning out to be true. But these seem more like acts of desperation rather than the usual "animal spirits." On the economic data front, hot inflation is still the central theme. Some members of the Fed are becoming more vocal about the need to control it. This inflation is spilling over into consumer confidence which was already suffering.

A central theme we keep hammering home is the strong probability of the Fed making a mistake. We have also been writing that the Fed has painted itself into a corner. We think these are basically the same idea. The flattening of the Yield Curve is telling us growth is slowing, but painful inflation persists (the dreaded stagflation). Financial conditions (per an index put together by Bloomberg that includes short-term borrowing

rates, High Yield spreads, interest rate Volatility, equity Volatility, etc.) have been tightening since the omicron-fear. And interest rates have been increasing for a couple of months before that. The market needs interest rates to go higher to clamp down in inflation. But higher interest rates will continue to hurt the softening economy. The few escape routes include supply chain relief from Asia and continued growth in the labor force in the US. Both are possible. But it might be a stretch to assume both can happen in the short-term. And leaving the Fed to its own devices will need a John Nash to pick the ugly girl.




- Small-cap valuations are getting cheap (nut not cheap enough)

Small-caps continue to flounder as the index P/E ratio fell to 14.6 (forward for this year which is always full of guesses). This is a 5% discount to its historical average. Of course, equities should trade at a discount if the economy is slowing, and the Fed is hiking. Conversely, the 200 largest mega-caps still trade at a 35% premium to their historic average. Back to small-caps, the Growth segment is clearly the worst. Small-cap Value might be a good place to look. But fighting through the sell-everything mentality is the first obstacle. We will keep our small short in the IWM (small cap ETF) until the fire sale really burns.

- Positioning is still stretched

We have highlighted the dislocation between investors's attitudes about the economy and their positions in equities. Historically and logically, these go hand in hand. But we have noted equities were remaining dear to investors. But it now looks like investors's worries about the economy are finally feeding into equities. This is not a shock given the action in the market…clearly there has been a sea change in sentiment. This jibes with the other data we have been seeing…that investors have reduced their overweight equity positions. But it sure seems like there is more to go to normalize. This is one more reason why we want to sell bounces.


- Inflation is still heating up

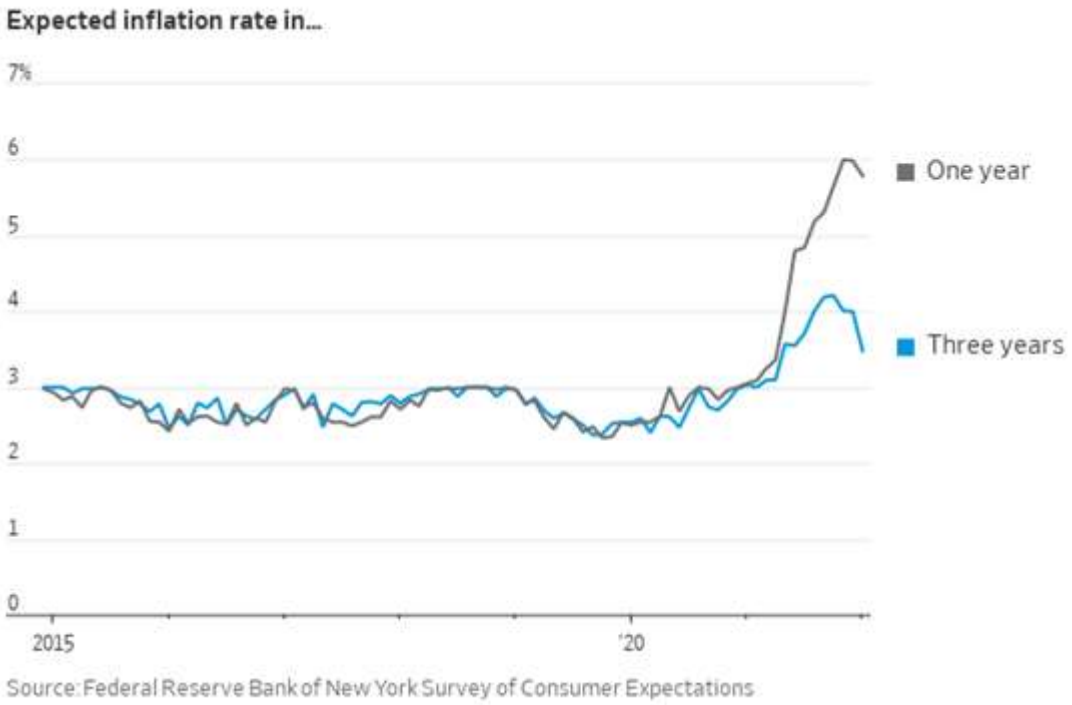
The Consumer Price Index set another 40-year record with a 7.5% increase vs last January. The "Core" also increased to 6.0%. The headline increase was a no-brainer because of energy prices regaining their footing from the mild virus-fear-induced dip in December. But the "Core" is the one to watch. We have been thinking the "comps" will get easier in the spring. But there is no doubt that damage is being done. And the more anecdotal evidence we hear tells us inflation will be lasting much longer than the professional guessers are expecting. Some of our friends in the food service business say their price increases have been in the 15-16% range – more than double the official food inflation in the CPI. Our base case has been that the rate-of-change of the price increases is slowing which is what really matters. But the slowing/easing of price increases is dependent upon the supply chain opening up. China is the giant wildcard here. But a country like Maylasia could shut down again…it controls 13% of the global semiconductor assembly. The trucker disruption on the Canadian border has been a huge headache especially to the auto industry. While the headlines might recede, there could be more outcroppings of similar angst.

The Producer Price Index (wholesale or input prices) for January followed suit with another hot reading: 9.7%. This is a 1% increase from December. The "core" was just as robust with a monthly 0.9% increase. The annual gain was 8.3%.

Import and Export prices accelerated sharply in January, as well. These numbers might be the most startling of all the inflation data: Import prices increased 2.0% and export prices increased 2.9%. These are monthly figures!

Obviously, the supply chain problems have played a huge roll in price increases. Perhaps we are starting to see some light at the end of the tunnel. Maersk, the worlds largest operator of shipping containers with 17% of the global market, thinks the bottlenecks will start to ease starting in July. Conversely, Toyota expects the semiconductor shortage to last the whole year (GM and Ford have said they expect the shortages to ease)

Despite all these runaway prices, consumers continue to think they are only short-term in nature. Below is NY Fed survey of consumer expectations. Not only is the three-year outlook lower, but it is coming down quickly, too. The Atlanta Fed's Business Inflation Expectation remains at 3.4%.




- Sentiment sinks further

The U Michigan Consumer Sentiment for February sunk again thanks to the crushing inflation. Optimism hit the lowest level since 2011 when S&P downgraded the debt of the US from AAA to AA+. The other previous trough levels were during the World Financial Crisis of 2008, the recession of 1990, and the recessions of the early 1980s.

- But the job market still seems ok

Jobless Claims improved again to 223k new claims during the week of February 5. This is the third weekly drop in a row after the mini-spike higher in January.

- Housing confidence remains stable

The Housing Market index (the survey of builders) dropped a bit. Other than the delta-fear dip in the late summer of 2021, this survey has been very stable. Current Sales Conditions remain the highest rated category. Sales Expectations are average. And the traffic of prospective buyers continues to lag. We think this data is generally bullish for housing stocks. But a Fed hiking into a slowing economy will hit housing just like everything else (you will hear this refrain a lot from us).

- Retail Sales looked great, but they could be slowing

Retail Sales in January showed surprising strength with a 3.8% monthly increase. But this monthly increase was still a large annual decrease in rate of change terms. This is the same economic conundrum we have been facing across the spectrum: data looks different from different perspectives. Ultimately, it is when these series get in sync that we know we have hit a slowdown. It will likely be too late then, so we must keep looking for changing trends. The timelier weekly sales released by Redbook showed an annual acceleration to 15.4% vs 13.3% last week (which happened to be the slowest growth in the last year). We thought Retail Sales would start to deteriorate with the slowing growth environment. We expect it still will, but this could push out the obvious point of weakness.

- Other economic data is mildly positive
  - The NY Fed's Empire Manufacturing survey in February improved slightly from the terrible reading in January.
  - Industrial Production for January increased more than expected with a 1.4% gain compared to Dec (Dec compared to Nov was a fall of -0.1%).
  - Eurozone Industrial Production missed expectations and only increased 1.2% vs Nov.
  - Business Inventories for December increased 2.1% monthly.

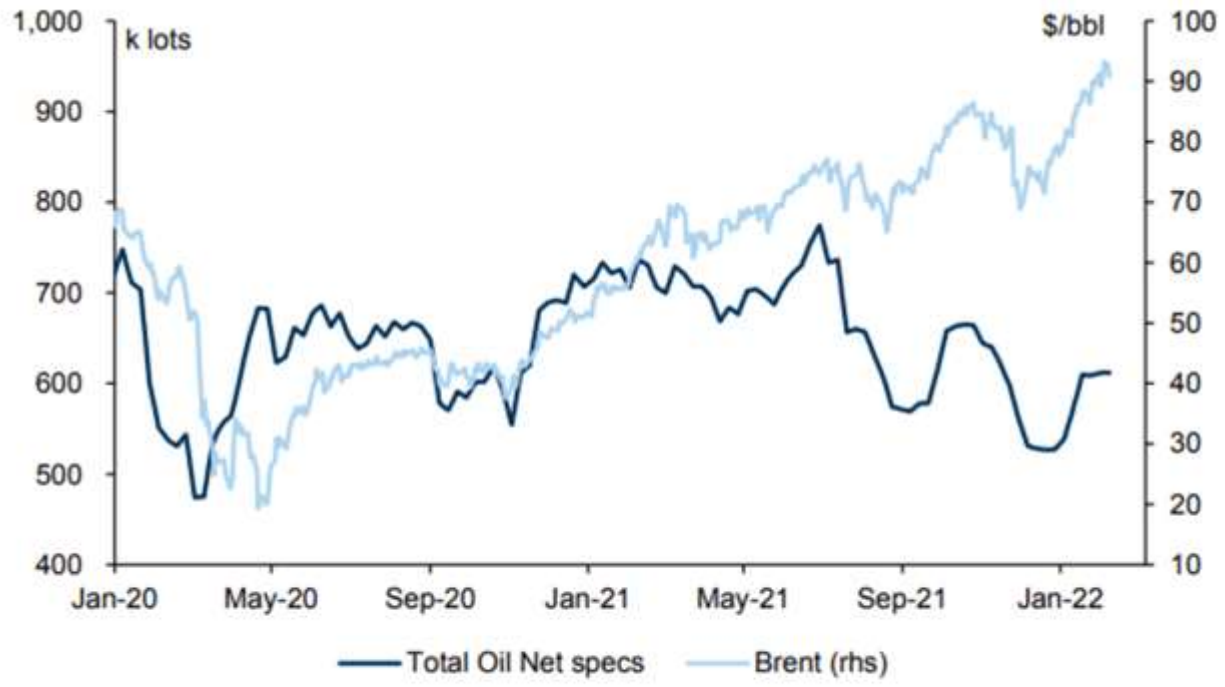
- Mixed messages from the Fed, but we think they are in trouble either way

The most vocal Fed speaker this week was Jim Bullard of the St. Louis Fed: He wants the Fed to have hiked 100bps (1% up from 0%) after three meetings. This boosted the futures-based probability of a 50bps rate hike in March to almost 100%! Some inferred from his remarks that a rate hike might happen before the next meeting. This would be extremely rare, and we are doubtful. Moreover, Mary Daly of San Francisco and Tom Barkin of Richmond both pushed back against the Bullard comments. They think a measured pace is still the prudent path. But another hawk, Esther George of Kansas City, thinks the Fed might have to start selling bonds in the market. Other than being ironic considering the Fed is still actively buying bonds currently, it would be an attempt at yield curve control. The Fed would seemingly avoid the flattening of the yield curve. But this would not help the economy. We think this is a fool's errand. The market will always defeat academics (except for mathematician-turned-quant-investor Jim Simons). One interesting twist to all the Fed-fear is the reaction to the release of the FOMC Minutes. Despite the obvious call for higher rates, the market actually rallied on the news. This might lead one to believe the market has come to terms with the impending rate hikes. We do not think this is the case. Or at least not yet…rate hikes into a weaking economy and all that.

- Speculators are not driving oil prices

OPEC's official production stats for the month of January underscore the supply constraints that the cartel is facing. OPEC is producing 750k barrels per day below the increased quota level. Nigeria was one of the few countries to increase production in January. But it is still producing 250k barrels fewer than desired. Iran's production has increased as we have noted. But most importantly, Saudi Arabia production is still 125k bpd below its target. Russia is failing to produce what it wants to, as well. Further to this, the UAE oil ministry attributed the recent price strength to the Ukrainian tensions. We doubt this is having that much of an effect (some for sure), but the comment underscores OPEC's desire to keep a slow and steady pace in trying to increase capacity (of which there is minimal ability, but the UAE is thought to have some). On the flip side, Nigeria is clamoring about a structural imbalance, and the need to increase capacity to meet the growing demand. This is certainly true for Nigeria who has struggled to produce what it wants. In the US, most producers reiterated their commitments to near zero production growth in 2022 despite the increase in prices.

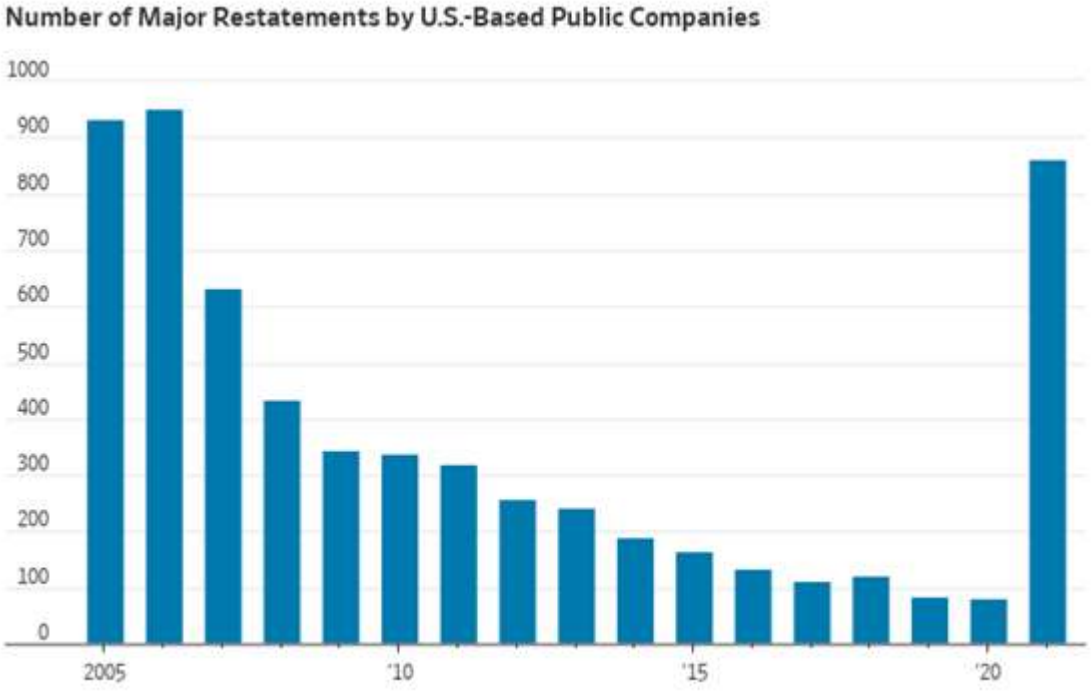
Often, short term price moves in oil can be attributed to speculators pushing their positions. But as you can see in the Goldman chart below, speculation (the dark blue) has been lackluster while oil prices (light blue) have been steaming along.




Source: CFTC, Bloomberg, Goldman Sachs Global Investment Research

- Chart Crime of the week

This is not a chart crime but rather a chart showing what should be crimes. It shows the number of US companies that had to correct their financial information after the fact.




Source: Audit Analytics

- Quick Hits
  - Marijuana stocks are classified in the Health Care sector
  - Geography reminder: Taking the Ambassador Bridge from Canada to the US flows south to north.
  - Saudi Arabia transferred $80b of its Aramco (state oil company) stake from one government entity to another. Diversification was the reason. Perhaps this means something different in Arabic.
  - BlockFi will pay a $100mm fine to the SEC for violating investor protection laws. BlockFi is a platform that enables the lending of cryptocurrency.
  - Apparently there has been an increase in "romance scams" fueled by cryptocurrency. No comment.
  - A twitter account that only posted screen shots of other people's tweets has been suspended.
  - Charlie Munger's latest commentary on Bitcoin likens it to a venereal disease.
  - ARKK: 50% of its NAV is companies with higher interest expense than operating profit.
  - The winner of the French Scrabble Championship cannot speak French.
  - The best-selling NFL jersey in the state of Wisconsin is a Bear's (Justin Fields).

**Trading**: We continued our theme of trimming levered plays to the economy. We added some more defensive exposure as well as more energy when it dipped from the Russia reprieve. But we mostly watched. The market seems to be in the middle of its choppy range. So, we will wait for more of a bounce to sell a little more. And the same goes on the buyside for the Staples, Utilities, Health Care, etc.

**TSLAQ**: We are running out of things to say about Tesla! More recalls. More sexual harassment lawsuits. More government investigations. Nobody cares.

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