



## Weekly Update

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- The market continues to drift on rate hike fears/expectations
- The Ukrainian situation will end in more rate hikes or more inflation (and thus more rate hikes)
- Hedge fund positioning does not tell the full story
- The media is often late to the Recession party
- Inflation keeps ripping, even if this is the “peak,” it could be painful for a while
- The Fed is going to start hiking 50bps at a clip
- There is no spare oil capacity
- Quick Hits
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	4,481	-0.8%	-6.4%	9.1%
QQQ	\$346.35	-2.0%	-12.8%	3.4%
US 10 YR	2.73%	2.59%	1.51%	1.63%
USD/DXY	99.8	99.6	96.0	91.7
VIX	21.8%	22.1%	17.2%	17.0%
Oil	\$104.25	8.3%	38.6%	73.2%

\*10yr, DXY, and VIX are levels not changes

\*\* Oil is front month futures, beware

Today's bounce notwithstanding, the market continues to work lower. As we have been writing, we think the central driver is the slowing economy coupled with the Federal Reserve's resolve in stomping out inflation. Recall that the invasion of Ukraine tempered Fed action during its last meeting. So, the best-case scenario according to some (Putin retreats, loses, or gets “removed”) will result in *more* rate hikes. If Putin keeps the pedal to the metal, sanctions will start to bite, and inflation might accelerate. And while most Americans have virus-fear fatigue (and rightfully so), the communists in China do not. The resultant thumb on the human scale will result in either supply chains getting backed up all over again (thanks to the shutting of factories, ports, or even whole cities...) or domestic (Chinese) demand will shrink. We are seeing evidence of the latter already.

If anyone doubts the slowing economy in the US, just look at JP Morgan's earnings report. Other than write-downs because of Russia, soft warnings on supply chain risks, and a lower capital base, the most noteworthy item was an increase in the net credit reserve (provisions for loan losses). This means the bank is worried about higher defaults. The \$900mm increase is pretty small, but considering the bank has been *decreasing* its credit

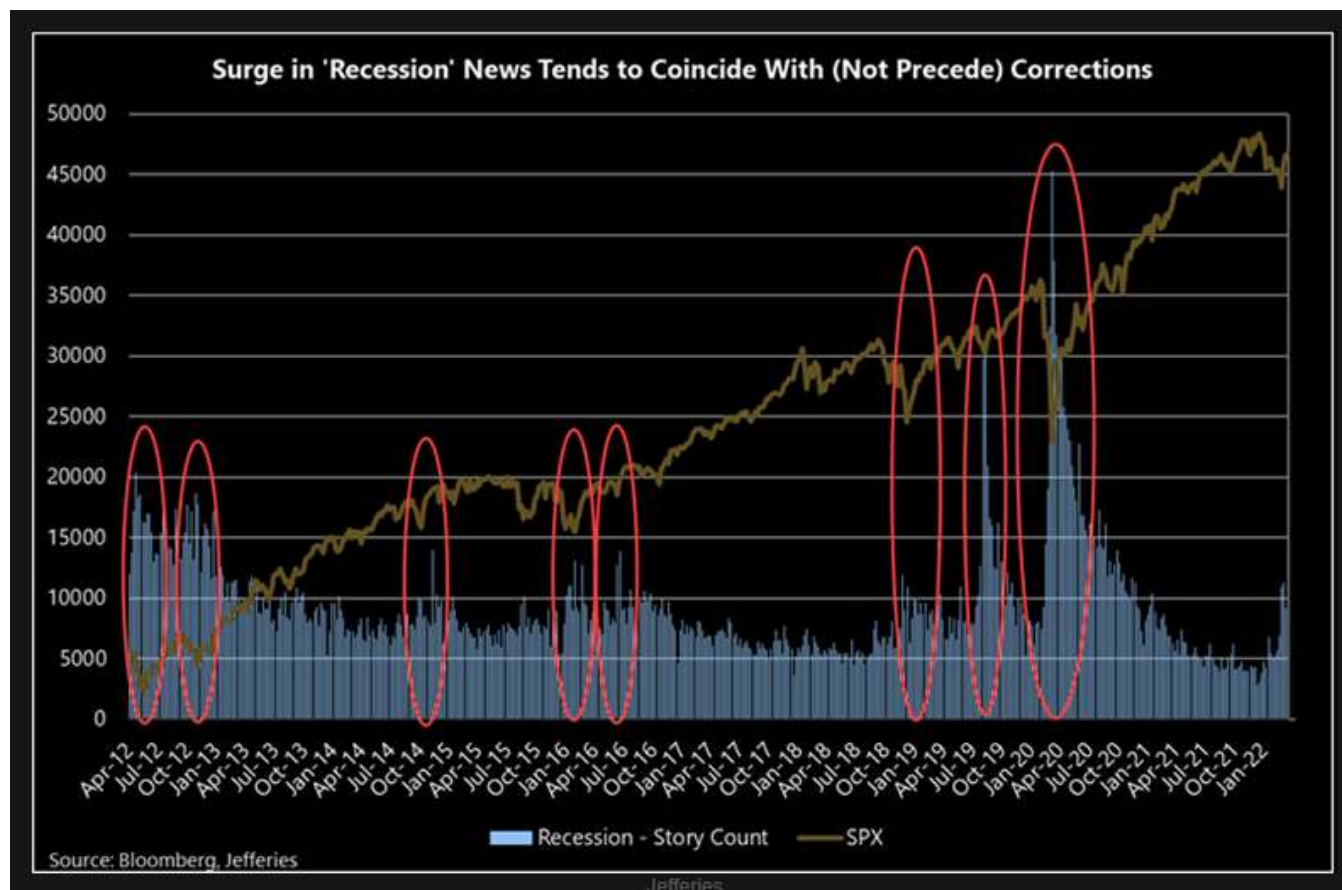
reserves for a year, the change in direction is a warning sign. All told, net income dropped 20% in Q1 vs Q4 (people can quibble all they want with adjusting earnings etc, but the trend is clear).

➤ Hedge fund positioning does not tell the full story

JP Morgan tells us that leverage deployed by hedge funds is back to making 18-month lows. We find this hard to believe especially juxtaposed to their strategist telling investors to sell the recent rally (you typically want to buy underleveraged markets and sell over leveraged ones). Then again, we know the recent rally was fueled by panicky (perhaps forced) short-covering. And the longs were led by retail meme traders and YOLO option maniacs. Just because prime brokerage data (from only one prime broker, too) tells us there has been some deleveraging, the rest of the market could still be wound tighter than a drum.

➤ The media is often late to the Recession party

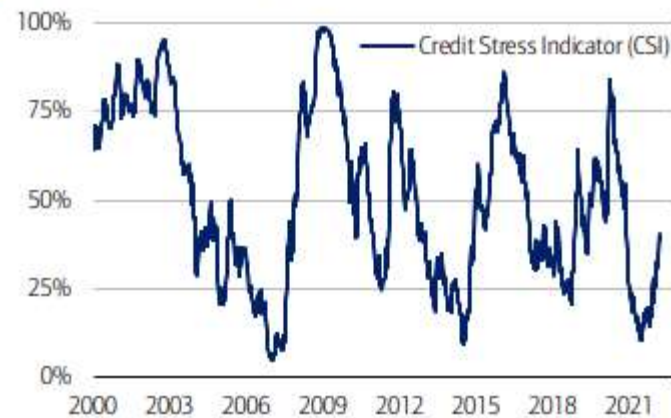
One worry we have in our expectation for a recession is that the media and their professional guesser sources (economists) are now onto this theme. This cohort tends to start spouting about recessionary pressures once the economy is already slowing (and not ahead of time).



Similarly, credit spreads (the amount of additional risk the market places on corporate bonds vs Treasuries) do not tend to widen until a recession is underway. We got to thinking about this because Merrill research notes that spreads have only just started to move higher (chart below). While we often think the bond market is the best indicator of economic health, that does not mean it is always right. The maximum pain threshold is almost always concurrent with recessions. We have a small short in High Yield Bonds and we will hold on to it for now.

**Figure 1: Credit Stress Indicator (CSI) – as published 3/18/22**

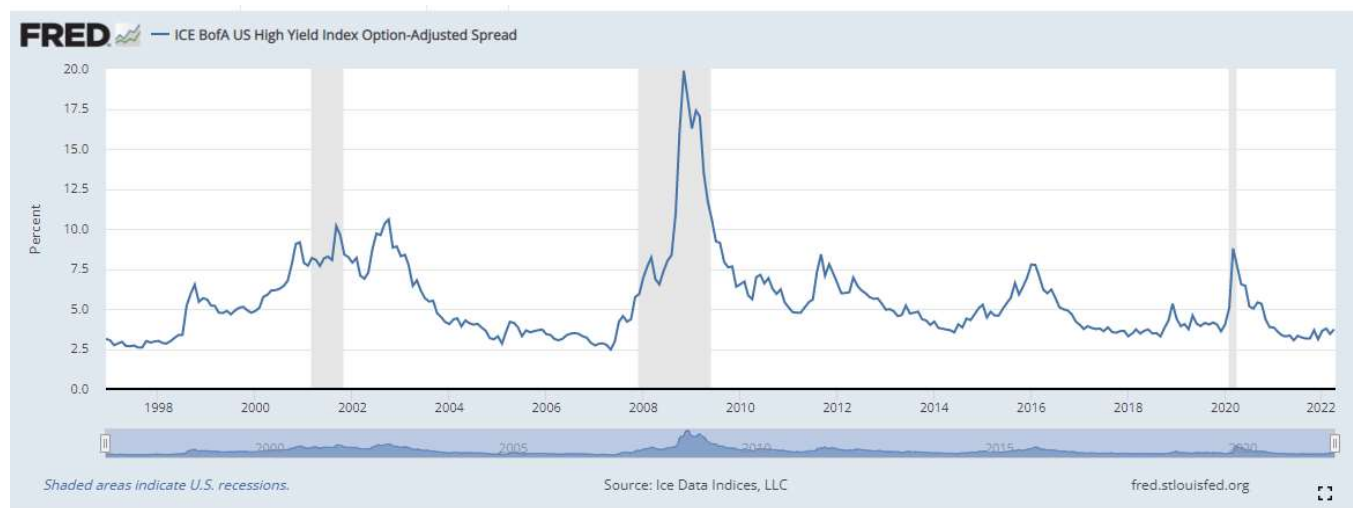
Aggregate CSI is based on high-frequency components leading defaults



Source: BofA Global Research

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The sample size is small obviously (we have not had that many recessions recently!). But the 2008 financial crisis is a perfect example of what can happen to credit spreads under real stress.

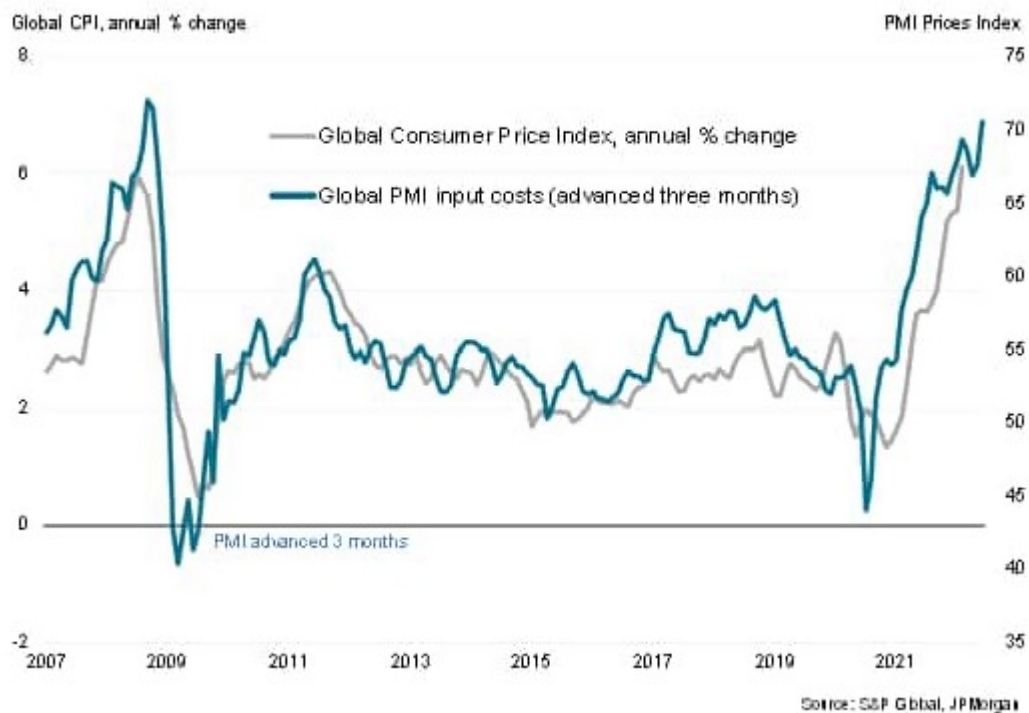


- Inflation keeps ripping, even if this is the “peak,” it could be painful for a while

The Consumer Price Index (CPI) increased 8.5% in March. The “core” experienced a 6.5% increase. These price levels are roughly in line with the expectations. The Producer Price Index (PPI) for March jumped to an 11.2% annual rate. The monthly increase was a whopping 1.4%.

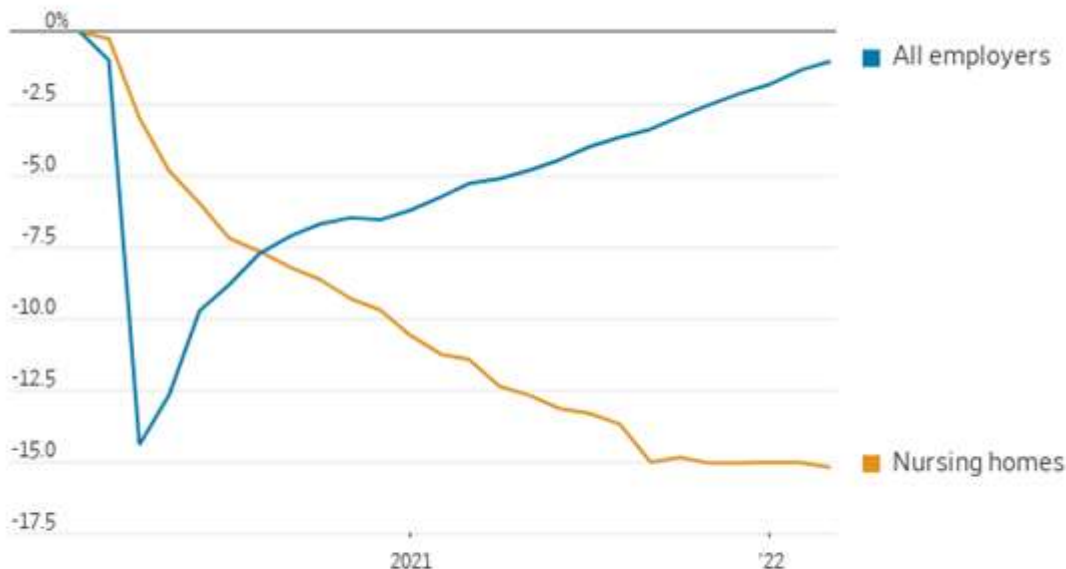
We have noted recently that consumers’ expectations are starting to ramp higher while business’s are remaining anchored. The latest Business Inflation Expectations from the Atlanta Fed supports this as it remained steady at 3.8% (the guess for the next year). But globally, things look a little more ominous. Below is the Input Prices component of the JP Morgan Global PMI (for Manufacturing and Services). It is adjusted to be three months ahead. This tells us that inflation is expected to start making new highs after a current dip.

## JP Morgan Global Composite PMI input prices



Back to the consumer price side, interestingly, Healthcare Services is experiencing the slowest inflation. This flies in the face of our of Healthcare inflation theme...at least on the surface. But we think this is a positive as the headline will keep congress off the backs of staffing companies. And staffing companies will still be able to charge exorbitant prices while the rest of the sector experiences a mild pricing environment. The chart below shows the difficulty in finding nursing home workers.

Change in employment since February 2020



Note: Seasonally adjusted  
Source: Labor Department

- The Fed is going to start hiking 50bps at a clip

Chris Waller of the Fed's Board of Governors (different than the regional Fed presidents) reiterated his desire to front-load rate hikes. He thinks the current inflation situation warrants 0.50% (50bps) hikes at least during the next two to three meetings. He pushed back on the idea that the Fed was late to the party. He noted that the market was already pushing rates higher thanks to the Fed's guidance. Again, he emphasized that fighting inflation was the number one priority.

- There is no spare oil capacity

The headlines (real or otherwise) are fast and furious in the oil patch lately. Here are some bullet points:

- Vitrol, the world's largest oil trader, is not going to enter into any more purchase or transport contracts for Russian oil and crude products.
- Apparently, there is 20mm barrels of oil sitting off the coast of China. The O-Covid policy disaster is doing just what it should do...destroy the economy. But signs of easing restrictions helped lift oil back above \$100 a barrel for WTI. Who knows what is next, but it seems clear that China is not going to be the rescuer of Russian oil.
- OPEC's monthly production report for March showed the cartel is still failing to produce what it desires. The members of OPEC (excluding Libya, Venezuela, and Iran) only increased production by 81k barrels per day vs the target increase of 254k.
- Russian refineries are reportedly starting to cut "runs" because of softening demand. But Shell and other companies might be buying Latvian blend.

We think the bottom line is the market is still structurally short capacity. The Russian situation obviously makes things worse (even with the cheaters like India taking Russian oil). We are comfortable with our Energy longs. (The giant caveat is that if the Fed sends us into a deep recession, Energy will suffer.)

➤ Chart Crime of the week

Not to be outdone by last week's Spanish television bias, we present you French television. Compare the size of the Gauche percentage in the top bar to that in the lower bar. We have no idea why this show is trying to downsize the left-leaning nature of French teachers.



➤ Quick Hits

- The Masters golf tournament receives no money for its domestic TV production.
- A Credit Suisse executive was fired for holding a client event at the National Golf Links club in the Hamptons. Women are not allowed in the dining room. They were cordoned off in a side room called "The Birdcage."
- The NCAA would not pay for St Peter's to send their cheerleaders to March Madness. St. Peter's only has four which is below the minimum required for reimbursement.
- Germany produces 6x more emissions per unit of electricity than France.
- France spends 59% per unit of electricity of what Germany spends.

**Trading:** Trading activity was light as we are still in the middle of the trading range. But given that we have to be tactical with options (since we are always fighting time/decay...sounds like life), we will likely unwind some protection on the next downdraft. We did start a new long in the Defense sector. This has obviously been a hot one this year. But we think there is more to go given the Biden administration's pivot towards increasing funding for the DoD. We also started a small position in REITs. This is not something we like long-term, but the sector does well in this particular macro environment.



**TSLAQ:** Last week we noted that only Elon could by a chunk of stock (Twitter), forget (ignore?) to file the proper paperwork with the SEC, and go about his merry business. Well, apparently Elon has changed his mind again. He has turned down a board seat at Twitter. This could be hugely positive or negative for the stock (hostile takeover or change of mind about wanting it?). Who knows, of course. It just underscores the weird nature of Musk. To say his focus is anywhere but on Tesla would be an understatement. The last company to suffer from a CEO with too many hats in the ring was...Twitter.

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