Weekly Update

29-September-2021

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- The Fed is going to tighten, and it shows
- Positioning is long and everybody puked last week...and probably again this week
- China Evergrande will point to slower growth
- We know China matters, but here is why it really matters
- Jobless Claims ticking higher
- Business confidence is slipping, but not business spending
- New Home Sales remain sluggish, but Existing Home Sales are looking up
- Natural Gas is on fire (not literally with flaring being reduced)
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
SPX	4359	-0.8%	17.2%	31.9%
QQQ	378.1	-2.8%	14.9%	30.3%
US 10 YR	1.51%	1.31%	0.92%	0.68%
USD/DXY	94.3	93.4	89.9	93.9
VIX	22.6%	20.9%	22.8%	26.7%
Oil	74.67	3.8%	54.0%	90.4%

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

We have tried to emphasize the importance of the Treasury market on the stock market recently (or always). We thought Fed chairman Powell was semi-hawkish last week after the FOMC meeting (with tons of caveats and variables, for sure). And the market seemingly shrugged this off…until the bond market said otherwise with the 10-year Treasury moving up about 25bps over the week…0.25% on a 1.30% base is a lot. And we do not think the heightened rhetoric around the debt ceiling was a real negative catalyst (do not tell that to CNBC). The change in the Yield Curve over the last week is, perhaps, more telling. The difference between the 10-year and the 2-year before the FOMC meeting was about 0.87%. It now sits at about 1.25%. Thus, cyclical stocks (those tied most heavily to the economy in the short-term) outperformed. This seemingly debunks the growing theme of stagflation (high inflation coupled with low or "stagnating" growth). But we suspect this is a market rotation masking the underlying fundamentals. That is, the market is jittery (we have heard the term "fully invested bears" used a few times recently) because of the stretched long exposures (more below). The natural, knee-jerk reaction is to sell winners and cover shorts (or buy underweights) in a de-grossing exercise (reducing exposure or reverting to the benchmark while things are Volatile). People had given up on the cyclical rebound a while

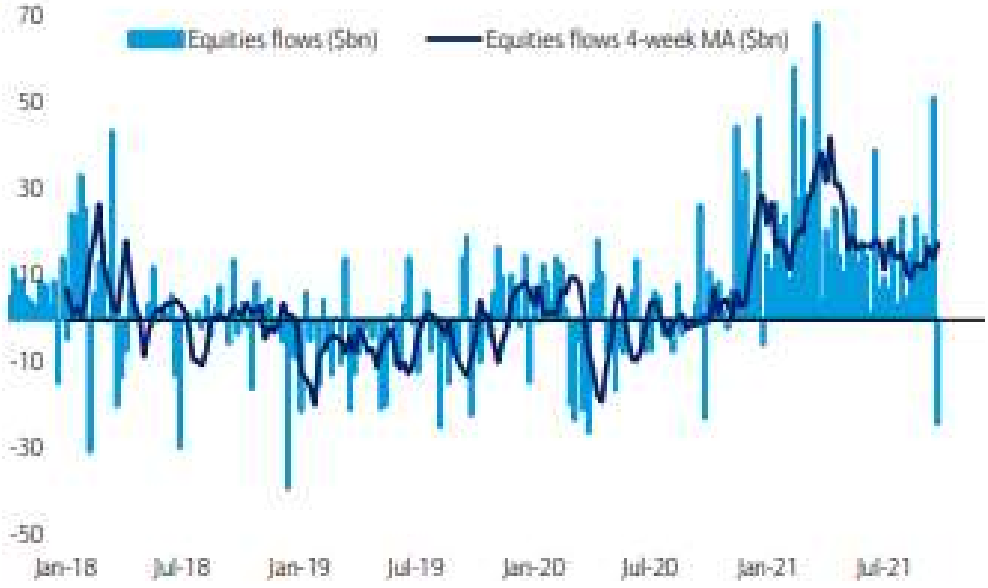
ago. And Big Tech has been the darling forever. And we must admit, for as much as we thought that inflation might be transitory but stretching out a bit (be it prolonged supply chain issues or delays in the Family Guy getting off the couch), it sure feels like it is going to be stretching out longer. We will still need to see the next few Employment Reports. This will not adjust our portfolio too much in that we are long inflation currently. But we had been leaning towards trimming this exposure. We might just have to hold on a bit longer. But ultimately, we think growth takes a hit which changes the game.

- Positioning is long and everybody puked last week...and probably again this week

We have noted (and lamented) the over-stretched positioning (long) by hedge funds. Some people naively point to the large short positioning in S&P futures thinking this is an indication of short positioning. But futures are typically used for hedging (another common use is for extremely time sensitive tactical trading…the spring of 2020 saw a huge increase in short futures positioning). When investors are extremely long or want to increase their leverage, they overlay their portfolios with short futures. This is especially true when stock picking is coming back in vogue (Merrill customer flows tell us this is exactly what is happening except for Energy which is a more thematic bet). And last week's fund flows show us that everyone sold the dip last week (the light blue bar). And Merrill tells us that the correlation between global equity flows and global equity performance has been greater than 90% since 2002. This is rather obvious, and the correlation certainly feeds on itself. WE suspect we will see the exact same outflows for this week when we get the data next week.

Chart 5: 1st outflow for global equities in '21 ($24.2bn)

Equities flows (weekly and 4-week MA, $bn)

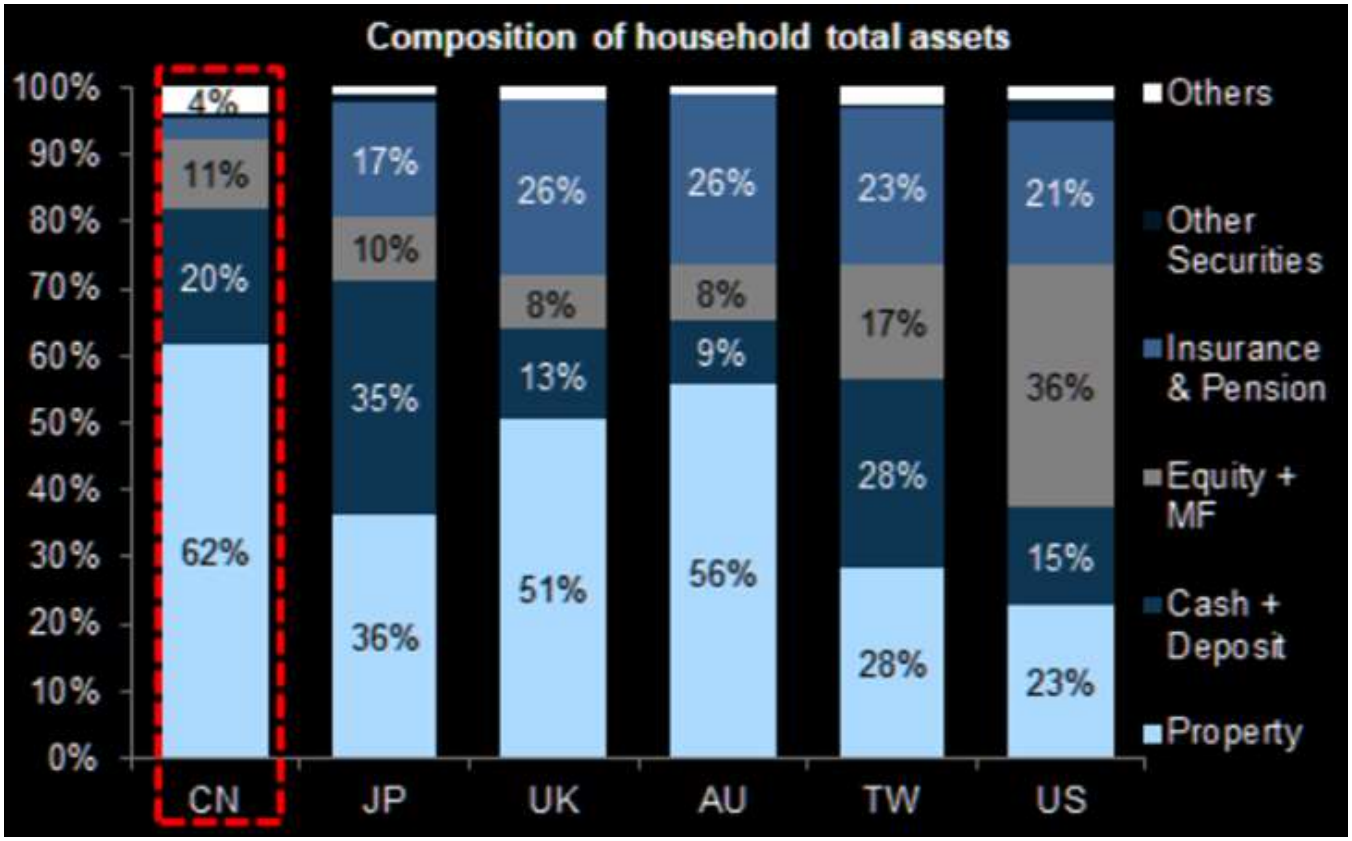


Source: BofA Global Investment Strategy, EPFR

- China Evergrande will point to slower growth

As a follow up to the China Evergrande story, here is a breakdown as to why real estate in general is so important in China. It is a much higher percentage of household assets. We still do not think there is systemic risk. But we do think this will expose and amplify the slowing growth in China. For its part, the Chinese central

bank (PBOC) has injected liquidity nine days in a row. The stated reason is to prepare for October tax payments. But reality is to cool the nerves and keep liquidity fresh.



- We know China matters, but here is why it really matters

Merrill has some interesting research that shows China GDP now matters more to the S&P 500 earnings than US GDP. This is a bit misleading as the math-based correlation is based on the increased globalization during the last 20 years. And China has been responsible for about 30% of the global GDP growth during this time (compared to the US's 21% share of growth). But it is clear that China matters. This is especially true in Big Tech and Materials (we wrote about Materials and Mining last week).

Exhibit 3: China GDP has increasingly mattered more to S&P 500 earnings than US GDP

5-yr rolling correlation between S&P 500 TTM EPS YoY vs. China nominal GDP and US nominal GDP (1997-present)

Source: Bloomberg, Haver Analytics, BofA US Equity & Quant Strategy

BofA GLOBAL RESEARCH

- Jobless Claims ticking higher

Jobless Claims ticked higher for the second week in a row. Last week (the week ended 9/18, there is always a five-day lag) saw 351k new claims up from 332k. The four-week average is 336k, so we are starting to go the wrong way. Some of this weakness has been attributed to Hurricane Ida. Whatever the case, the slipping trend is one to watch.

- Business confidence is slipping, but not business spending

The PMI Composite was slightly better than expected in September. But business sentiment still experienced a dip compared to August. Manufacturers remain more confident than Services.

The regional Fed Manufacturing surveys are all disappointing. The KC Fed Manufacturing Index fell sharply in September. The Dallas Fed Manu Index missed expectations and fell to the lowest level since the summer rebound in 2020. And the Richmond Fed survey sank into negative territory.

Durable Goods Orders for August increased along with a higher revision in July. The important Core Capital Goods Orders, aka business spending, also continued to improve. They hit their all-time high (again). The rate of change is very low which can be a warning sign. But it sure seems that it is more of a steady stream vs a rolling-over.

- New Home Sales remain sluggish, but Existing Home Sales are looking up

New Home Sales in August increased to 740k (annualized rate) from a revised (higher) 729k in July. But this is still a sluggish number compared to the 950k range the market experienced this past fall and winter. 740k is about the pre-virus-fear run rate. The median price for a New Home sold in July was almost $391k which is obviously another record.

Pending Home Sales for August, this tracks signed but not closed contracts for Existing Homes, surprisingly jumped 8% vs July. Alas, this is still an 8% drop vs August of last year. There was strength across all the regions. The National Assoc of Realtors (they run the data) says “rising inventory and moderating price conditions” are

bringing buyers back to the market. We are not sure what supply or pricing trends they are watching considering the median price for an Existing Home is still about $357k ($363k was the all-time high in June). Whatever the case, this positive number might prove to be an inflection point after three straight months of drops.

Anecdotally, demand for second homes fell 19% in August according to Redfin. This is still above the pre-virus level thanks to a surge in people fleeing the cities. We suspect this rate-of-change number will revert back to its mean.

- The Fed wants to tighten but politics might slow the process

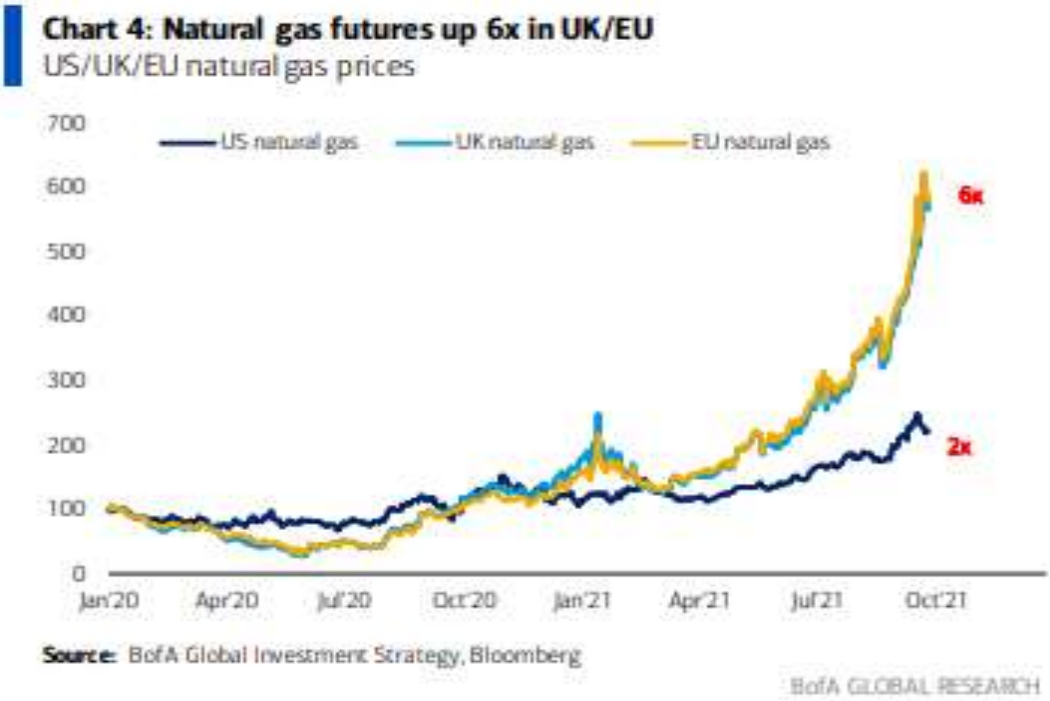
The pressure on Powell to be remain dovish (easy money) intensified as the scandal involving the trading of Fed members grew. The two most egregious violators (they actually did nothing illegal…just poor optics) bit the bullet (Rosengren of Boston and Kaplan of Dallas). But the pressure remains on Powell. Elizabeth Warren of Mass declared, to his face, that Powell was a "dangerous man." Fortunately, nobody else in the Senate is as petty (or wrong) as Warren. But the beltway soothsayers put his renomination prospects at about 50/50. A new chairman will undoubtedly be a politically biased academian (just like Trump tried to appoint an ally but she got rejected by the Senate).

- Global Central banks are not unified

Japan's central bank (Bank of Japan or BOJ) announced it would be keeping its ultra-easy monetary policy intact with short-term interest rates at -0.1% and its 10-year target at 0%. And they will keep buying government bonds (JGBs) ad nauseum. On the flip side, the Bank of England (BOE) might start to hike rates as soon as November. In Emerging Markets, Brazil has hiked rates again totaling 4.25% since the beginning of the year to reach 6.25%. Brazil is battling doble digit inflation and a weakening currency. Alas, the slowing growth will be hard to reverse with such monetary tightening (exporters will start to lose any advantage they had from the weak currency).

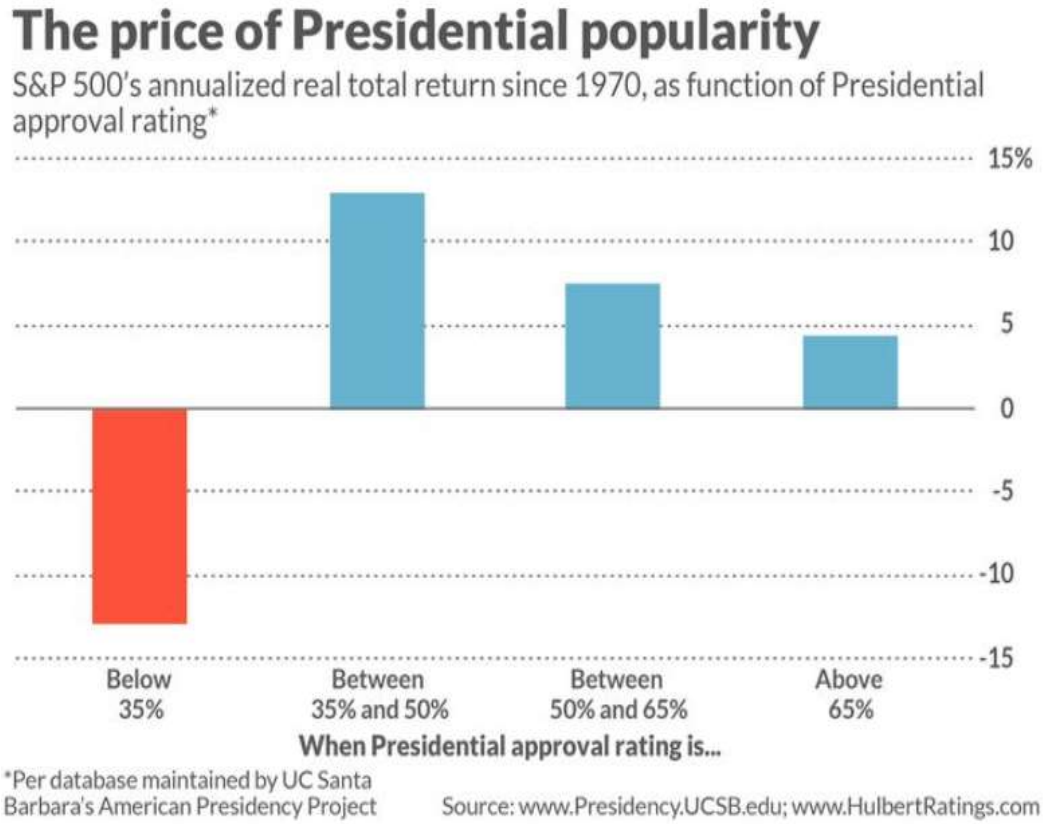
- Natural Gas is on fire (not literally with flaring being reduced)

Natural Gas prices continued to exacerbate inflation and the supply chain issues across the globe. Americans think natgas at $6 is bad. But prices of $30 in Europe and Asia are economy-crushing. Some of the blame goes to a lack of truck drivers in Europe since there is not the regional pipeline infrastructure like in the US. Russia controls most of the gas flowing into Europe, and they are oddly experiencing difficulties (actually, they are holding Europe hostage). In Asia, China is sitting on coal reserves. This is partially to fake their climate emissions ahead of the winter Olympics in Beijing just 3-4 months away. It is also out of fear of running out of energy in the coming winter (supplies and prices are much worse in the northern/cold parts of China).



- Bad President means good stock market apparently

A great stock pickers almanac fact: the Presidential approval rating is inversely correlated with the stock market assuming it is not a rock bottom approval.



- Chart Crime of the week

Usually, these cockamamie charts are homegrown by the Bitcoin evangelists. But this guy is predicting the price falls from the current 42k down to 5k. Then it rockets back to 100k. Then it goes to 0. We can all be rich.

- Quick Hits
  - The US govt owns about 28% of all land in the US.
  - The US govt owns about 2% of all land in Texas.
  - The projected damage (insured losses) from Hurricane Ida is expected to be about $37b which would put it in the top five of the costliest storms in US history (Katrina, Sandy, Harvey, and Irma).
  - The US has blacklisted a crypto exchange, SUEX OTC, for catering to criminals. Generalissimo Franco is, still indeed, dead.
  - The UK's top three uses of CO2 are to "make fizzy drinks, stun animals for slaughter, and cool nuclear power plants."
  - When the mayor of San Francisco was asked why she was not wearing the mandated mask at an indoor party recently, she quipped, "We don't need the fun police to come in and micromanage and tell us what we should or shouldn't be doing."
  - US border patrol agents can no longer ride horses because the media thought the reigns were whips.
  - The European Commission wants to mandate standardized charging ports for devices.
  - The "infrastructure" bill that has stalled in the House after passage in the Senate uses a budget gimmick called "pension smoothing" which allows for corporations to make smaller contributions to their pension plans. This boosts tax receipts in the short-term and increases pension liabilities and decreases tax receipts in the long-run.
  - Mango TV is the second most watched network in China.

- An International Monetary Fund (IMF) study concludes that government owned firms were 30% less productive than privately owned firms. In other news, dog bites man.
- Rare Pokemon Oreos are selling for $1000s on eBay (or at least listed for that much).
- A Danish artist commissioned to paint two pieces of artwork, delivered two emptied frames with the name, "Take the Money and Run."
- The Taliban has banned women from attending university.

Trading: We still believe we have reached or are nearing peak growth. In this kind of late cycle environment, we still want to run a barbell strategy: a combination of Quality large-caps (like Big Tech and Pharma) and more aggressive small-caps. But specifically on small-caps, we want long exposure to margin expansion (and still Quality). Risky names tend to underperform. We have culled most of our junkier names (to a smattering of success and failure). We will be tempted to add to longs on weakness, but we will be patient and look for the right spots. We will weave these buys according to how much Put Protection we have (a moderate amount right now).

TSLAQ: Tesla is trying to "gamify" driving by introducing a "Safety Score" that tracks your driving behavior. Unfortunately for mankind, the system penalizes stopping at yellow lights, slowing down for cyclists or pedestrians in crosswalks, and making full stops at stop signs. This is not a joke.

In other Tesla news, Institutional Shareholder Services (known as ISS) recommended Tesla shareholders vote against Elon's brother, Kimbal Musk, for director. The nepotistic conflict of interest is obvious. Instead of biting his tongue or showcasing Kimbal's credentials (whatever they may be), he thought calling the proxy advice company "ISIS" was appropriate.

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