Weekly Update

1-June-2022

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- May was a positive month, who would have guessed
- Hardly a mention of the Fed
- Subprime lending is back
- More selling low and buying high
- Retail Positioning is bearish, we think it persists
- Negative Earnings Revisions explained more simply
- Business Spending is still ok, but mgmt. teams are telling us not for long
- Housing is still slumping
- No real change in inflation
- Inventories are still climbing – uh oh
- The Fed really does want to slow the economy
- Quick Hits
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	4,101	3.1%	-13.7%	-1.2%
QQQ	$306.00	4.8%	-23.2%	-8.1%
US 10 YR	2.92%	2.75%	1.51%	1.59%
USD/DXY	102.6	102.1	96.0	89.9
VIX	25.7%	28.4%	17.2%	17.5%
Oil	$114.84	4.1%	53.3%	70.2%

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

The month of May ended with the market in the green much to the surprise of even the biggest bulls. The headline narratives supporting the positive momentum revolve around China, market rebalancings, market technicals, and other points of cognitive dissonance. For China, the easing of lockdowns is being celebrated along with some targeted stimulus to boost the economy. Checkpoints, mandatory testing, and quarantines do not sound like freedom to us (the irony of the US behavior during 2020 and 2021 is not lost on us). And one idea of the communists' s stimulus is reducing the taxes on car purchases. Never mind that this is as foolish as the US and Europe's view of subsidizing rich people toys (the Chinese subsidy goes up to cars that cost $47k). But considering the Chinese are not allowed to drive freely nor can the factories staff themselves for normal production, we think this "stimulus" will likely fall flat. We have talked about the month-end rebalancing by pension funds and the like. This is short-term by definition.   Market technicals (reading the chart leaves, aka mumbo jumbo) are fine for incremental decision making on entries and exits. But the dart-throwing monkey has a better chance in the medium to long-term. And lest we forget, hedge fund performance has been terrible this year. They shorted the bottom and are now chasing the rally.

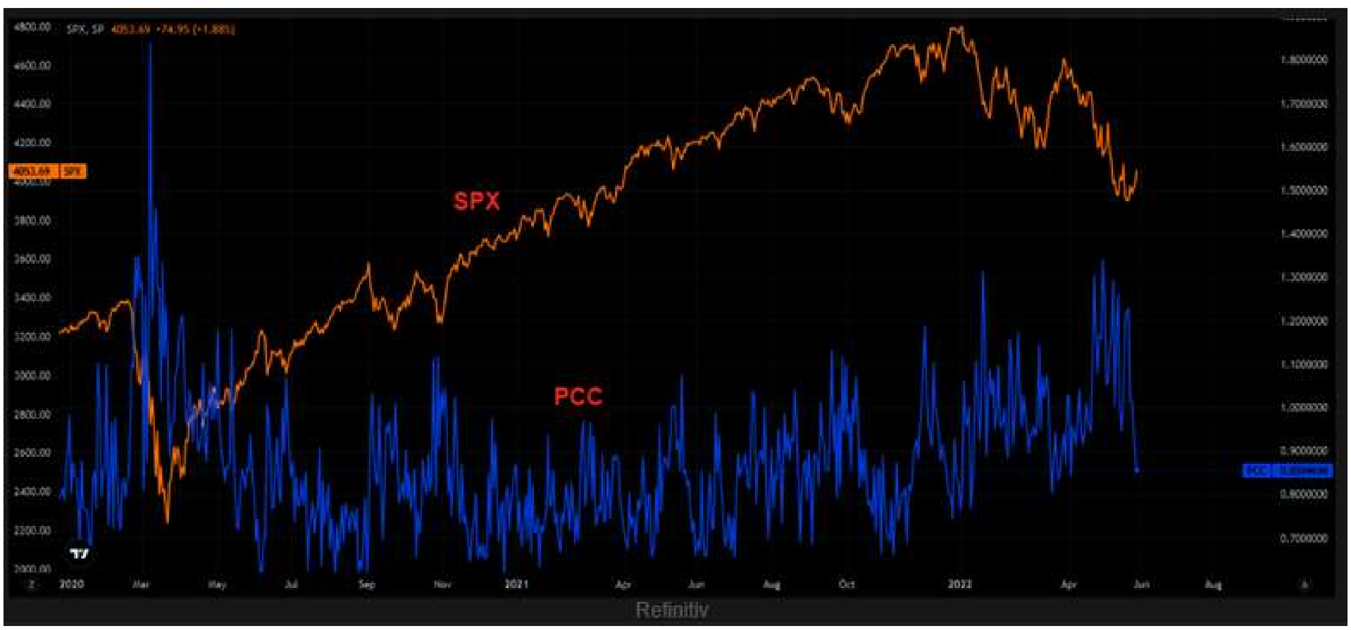
What is glaringly absent from the pundit jibber-jabber is the notion of a Federal Reserve pivot. To us, this would be the only logical reason to ramp up our bullishness (especially in Tech and other "long duration" assets that rely on low interest rates). And yet, most commentary from Fed members continues to point to repeated 50bps (0.50%) hikes until inflation is under control. While we have hinted at some cooling of inflationary pressures in some segments of the economy, we maintain that in the segments that really matter…food and energy…people are suffering. Perhaps traders will start listening to the likes of Jamie Dimon, the CEO of JP Morgan, who said "an economic hurricane" is approaching. And oh yeah, if we need one more reason to be cautious: Cramer has called the bottom.

- ➢ Subprime lending is back

Transunion classifies 43% of Buy Now Pay Later (never) customers as subprime borrowers. Affirm's delinquency rate has jumped from 1.4% to 3.7% over the last year. One survey had 43% of all BNPL customers missing at least one debt payment. 43% and 43%. Must be a coincidence! Affirm and the other BNPL scam artists are having more trouble funding themselves (at least cheaply). They mostly sell their loans or float them via Asset Backed Securities. The rates on these products are going higher and fast. And yes, any company or industry that promotes predatory lending as "free money" on Tik Tok is a scammer.

- ➢ More selling low and buying high

Put Call parity dropped precipitously this week (blue line). This means traders bought Puts last week during stress and sold them as the market rallied. This is selling low and buying high at its finest.

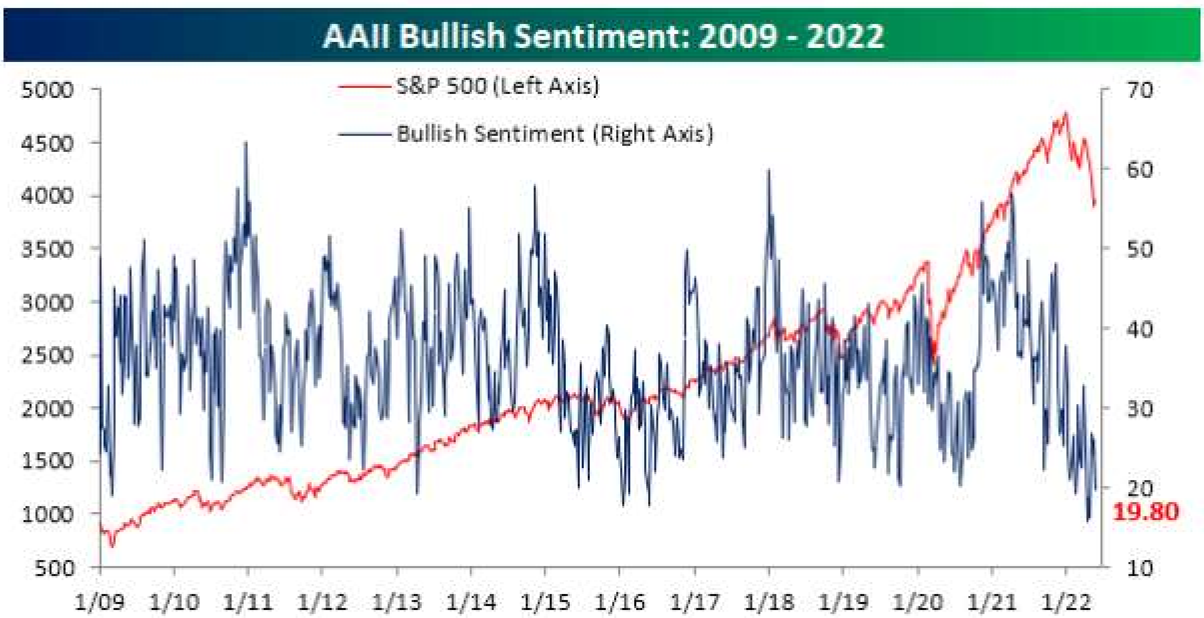


- ➢ Other technical tidbits
  - Bond Volatility (the MOVE index) continues to compress sharply.
  - Dealer Gamma is estimated to be neutral around the 4100 level which is just about where we sit.

- There is talk of "Volatility Control" funds being on the verge of buying equities. The premise is that as Vol goes lower, these funds can own more equities. Pretty simple. But unless the market is stable and trending, these kinds of strategies usually end up whipsawing themselves. Again, another Sell Low Buy High.
- We are starting to see "mentions" counted again as meme stocks try to join the rally.

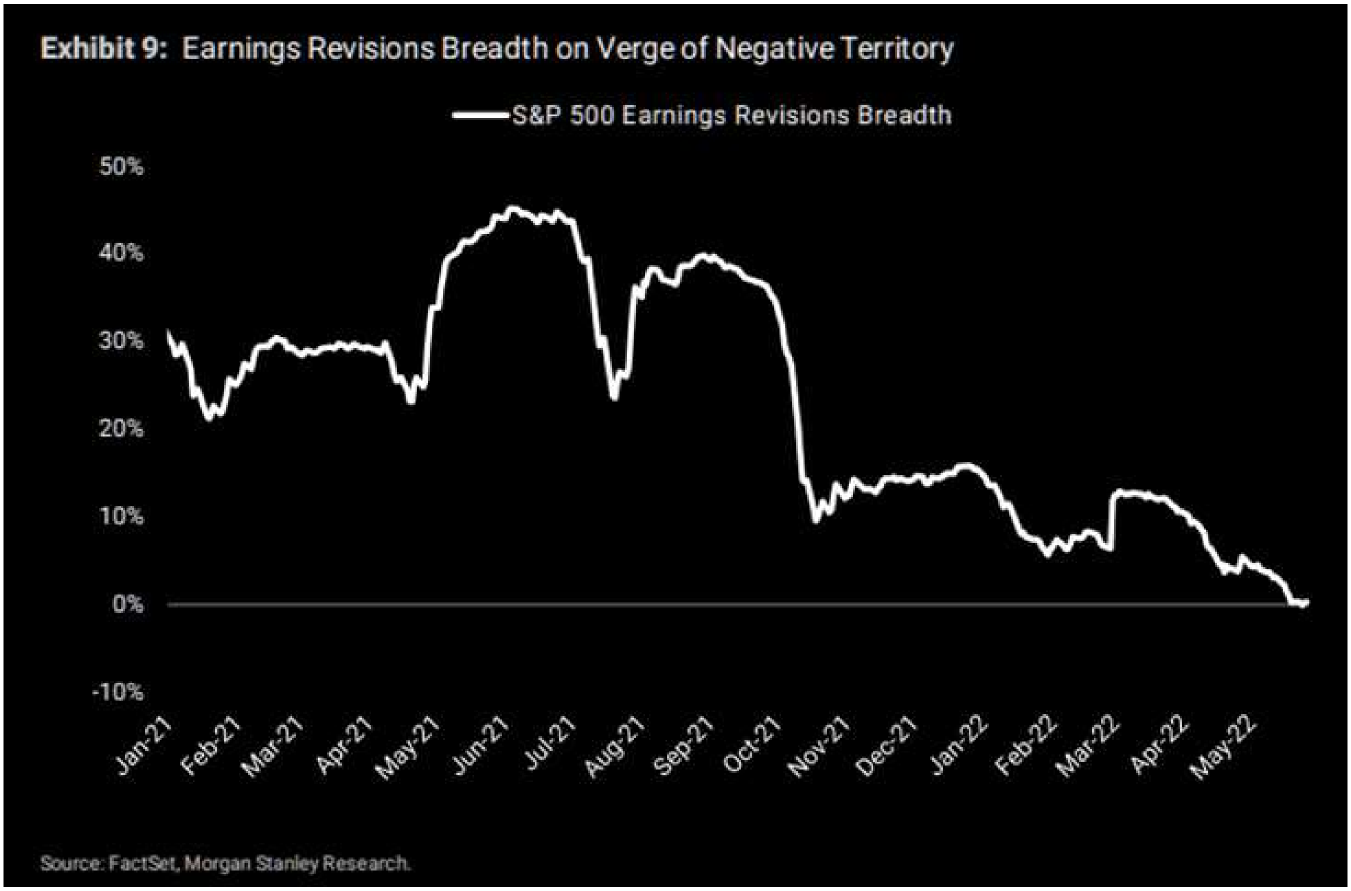
➢ Retail Positioning is bearish, we think it persists

The negative sentiment is being sited as a contrarian driver of the market. But we think the decline in bullish sentiment (chart) is more structural. Of course, there will be bounces as always. But if for no other reason, heightened Volatility usually has a depressing effect (mentally and physically).



➢ Negative Earnings Revisions explained more simply

Last week we showed a few Earnings revisions charts (and how the central market narrative misses the mark in terms of not excluding the outsized gains in Energy). Morgan Stanley has had it right, but their charts have been hard to read. They must have heard me, because they now have a super simple chart. It is almost too simple in that the chart does not tell us for what period they are referring. But the point is still clear, there are now more negative than positive revisions.



➢ Business Spending is still ok, but mgmt. teams are telling us not for long

Durable Goods Orders in April continue to grow albeit at an ever-slowing pace. This is something we keep noting, and we keep thinking there is a top forming. But business spending (core Capital Goods component of this data) remains resilient. This is a risk to our “recession is coming” theory.

The two PMI Manufacturing surveys for May split along unexpected lines, but the overarching theme remains intact. The Markit PMI dipped as it sags back near its 18-month low. But the ISM survey rebounded a touch. We use “unexpected” lines because the Markit survey is more domestically oriented while the ISM has more international exposure. However, the internals of the ISM are not as healthy as the headline. While Prices Paid dipped a touch, Employment fell dramatically and is now squarely in negative territory. Layoffs are coming.

The Kansas City Fed Manufacturing Index dipped slightly. The level is about in the middle of the range. The Dallas Fed Manufacturing Index for April unexpectedly slipped into negative territory. The components were split with the Production outlook looking strong. But New Order and the growth of orders were large drags.

Construction Spending ticked up slightly in April. Per the usual pattern, multifamily housing was the strongest segment while public construction spending was a drag (apparently shovel-ready projects are not ready yet).

The Chicago PMI (which is surveys both Manufacturing and Services) increased strongly by almost four points to over 60. But considering this index was at 73 last July, there is not too much to celebrate.

➢ Housing is still slumping

Pending Home Sales in April fell 3.9% vs March. It was a 9.1% decrease from last year. This was the 11th month in a row of negative growth (annual growth) over the last year.

Mortgage Applications for the week ending May 27 fell over 2% vs the previous week. High prices and low inventory are killing demand.

As we have noted, when the Fed stops hiking interest rates, we will want to be long Housing stocks.

- No real change in inflation

PCE inflation in April slowed to 6.3% in April vs 6.6% in March. The "core" rate slowed to 4.9% vs the 5.2% seen in March. Per our usual sentiment, this "slowing" is not really helping people buy food and energy and pay the rent. And oil and natural gas prices are much higher than when this data was captured. But have no fear, the Congressional Budget Office expects this PCE inflation to cool to about 2% by the end of this year. This would be the first accurate government prediction ever.

- Inventories are still climbing – uh oh

Retail Inventories during April continued their climb to another all-time high. The Inventory to Sales ratio is still rather low, but it does have an upward trend. Wholesale Inventories are also climbing. We expect this trend to continue as the "strong consumer" is not so strong in the face of raging inflation.

- Other Economic data leans negative

Q1 GDP was revised lower to -1.5% from -1.4%. This is not terrible relevant. But Personal Consumption Expenditures were revised higher to 3.1% from 2.7%. We think this only sets us up for more disappointment.

The JOLTS report (Job Openings and Labor Turnover) shows that Job Openings remain elevated at 11.4mm. We still maintain that this number will start to shrink. Or to put it differently, many of these openings will never be filled because of the changing demographics and skill sets.

Consumer Sentiment (not Consumer Confidence, Sentiment is more geared towards inflation so this one is the one to watch) rebounded a bit. But this is still wallowing near its all-time low. Merrill has its own Consumer Confidence indicator which just hit an historic low. Consumer Confidence slipped a touch but still maintains a strong level (the survey that focuses on employment).

- The Fed really does want to slow the economy

Last week we commented that the market was curiously relieved when the Fed's FOMC minutes showed a unanimous voice in its desired interest rate path: Higher. Some pundits took this further and said it was a relief that the language was not more aggressive/hawkish. We still think it was all the other technical things driving the market and chasers were just backfilling their own narrative on top of the Fed's rather obvious goal (hammer the economy). To wit: Fed Governor Christopher Waller said, "I support taking interest rates past neutral." Not to leave too much to the imagination, he wants to continue hiking by 50bps (0.50%) at each meeting until inflation is under control. And the Fed's Beige Book (collection of data before meetings) showed signs of economic weakness developing across the country.

And overseas, much attention has been paid to the European Central Bank's slight hawkish tilt. Specifically, it no longer wants to have negative interest rates. But as LL Cool J said, don't call it a comeback. The ECB is not ready to start reducing its balance sheet. This is one reason why have been buying European government bonds (via an ETF). This also supports our long USD (short other FX) position.

- Oil powers higher through the negative headlines

The Chinese are now doing ship-to-ship transfers to quietly get more Russian oil. But it is not just the Chinese. Total Russian oil exports are now estimated to be 3.6m. Some estimate this to be above the pre-war levels (data outside of the US and western Europe is always murky)

The UK is instituting a "windfall" tax against the oil & gas industry. We can only imagine PM Boris Johnson is unveiling this policy 180-degree reversal because photos surfaced of his boozing at a party during Covid times. Obviously, oil rallied on the news. Politicians will never learn.

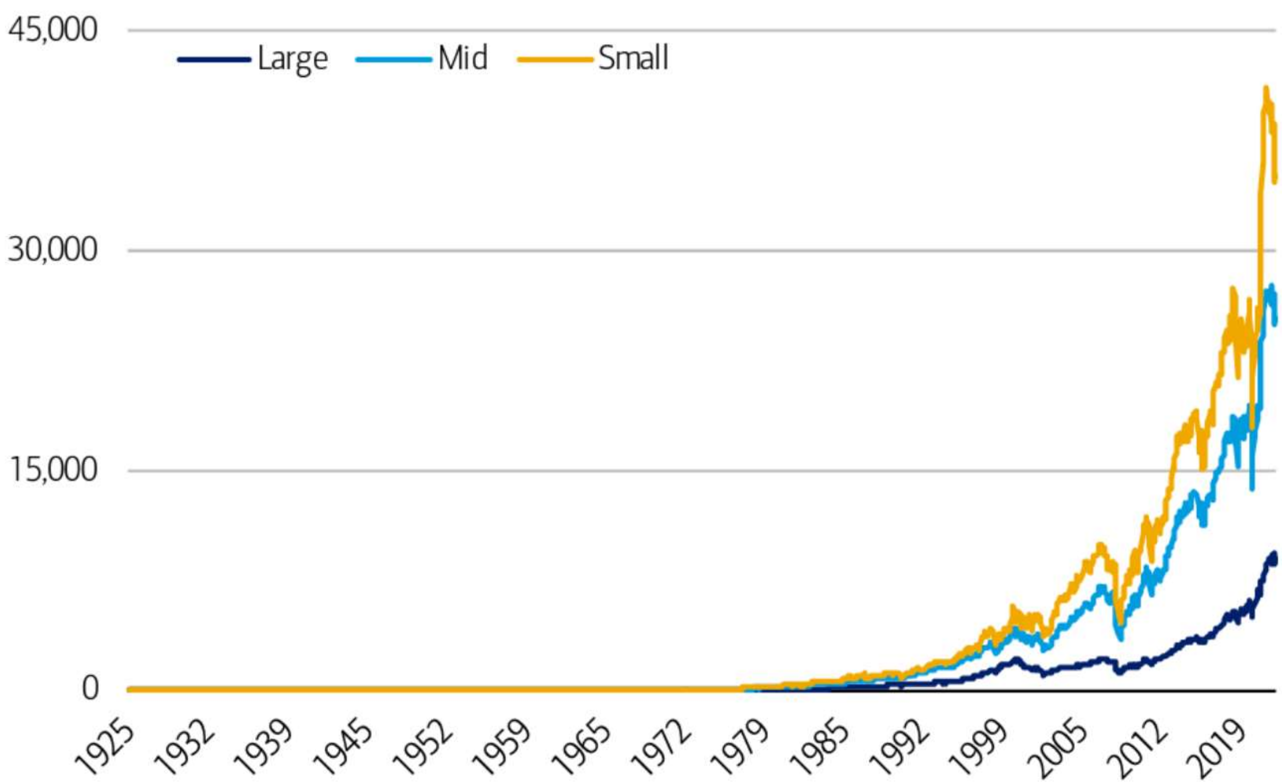
The EU has been talking about new sanctions on Russia, but Hungary remains the holdout. But there are some reports that Hungary is backing sanctions on seaborne exports…oil exported via pipeline from Russia will still be allowed. And it is worth noting that much of Asia is running out of capacity to refine Russian URALs oil. In other words, many of those willing to ignore Russian sanctions (or just peer pressure) are no longer able.

OPEC gave its first indication that it might try to slow the rally in oil. Details have not been released (likely on Thursday), but it seems that Saudi and the UAE will start to pick up the slack from other members falling short of their production quotas. At least that is the message they are trying to convey. There are some real doubts if Saudi can ramp up production quickly (the UAE is thought to be willing and able). The US producers, of course, will hold steadfast in their discipline as long as the political environment is against them. This might be the best "Fox Butterfield, is that you?" we have ever seen.

- Chart Crime of the week

Why! Why does this chart start in 1925!

Exhibit 53: Small Caps has outperformed other size segments historically
12/31/1925-3/31/22 monthly returns for Small, Mid, and Large Caps



- Quick Hits
    - Twitter shareholders voted out one of the current directors. The board decided to ignore that vote. Most shareholder votes for directors are nonbinding.
    - Just Eat Takeway* paid $7.3b for Grubhub in June of last year. There are reports that the company is trying to dump the struggling asset for $1.3b.
    - Marc Benioff did his Salesforce conference call from his yacht (proudly).
    - According to the Fed, it might lose money on its assets if it raises interest rates too high (if it lowers the prices on things it owns).

Trading: We slowly added to out shorts (via Puts) with the market bounce. We focused on the usual suspects (overvalued Tech, Fantasy Tech, E-Commerce nonsense) along with some High Yield. We trimmed a touch of our oil long (for no other reason than it's been great…maybe not the best reason but we tend to follow this pattern). We added some bonds. We trimmed the edges on some of our Trading positions (mostly in Retail which we added to on dramatic dips). In other words, we trading against the grain which we like doing.

To be clear, we are still long the market. But we are concentrated in the traditional defensive sectors or those spots that can weather the inflation storm (or, of course, benefit from it). We have a heavy cash position some of which is in USD vs a basket of Fx (hence we are "long the dollar"). We are long Gold and long Treasuries and some European sovereign bonds.

TSLAQ: Musk will now commit more equity to his pursuit of Twitter according to a regulatory filing. There are no real details as to how or from where he is getting the extra $6.25b in cash. But the market took it to mean that he would no longer be borrowing against his Tesla shares. This is something we have covered and presumed to be the only way out for Musk (his bankers are more than skittish when it comes to extending more margin loans). Alas, do not forget that Musk is being sued by the SEC for submitting false regulatory filings with respect to his intentions with Twitter.

*We like to reminisce about our time in London. Ordering food at lunch, we would always say "it is to go." The Jay-Cutler-dumb-look of bewilderment from the cashier always struck a nerve with us. How could the workers not understand "to go" was analogous to "takeway?"

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