Weekly Update

15-June-2022

Carlisle C. Wysong, CFA

Managing Partner

- The market, mostly, finally gets it
- Subprime here, there, and everywhere?
- The Labor market is still ok, but we think it is slowing
- Inflation is getting worse where it counts
- Onshoring could be the answer to the Business Spending conundrum
- PMIs are eroding, Europe holding in there
- Fed credibility…ugh
- The European Central Bankers are not exactly channeling their inner Volcker
- Oil supply is still the story
- Quick Hits
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	3,790	-7.9%	-20.2%	-17.7%
QQQ	$282.80	-8.1%	-28.2%	-17.5%
US 10 YR	3.29%	3.02%	1.51%	1.58%
USD/DXY	104.9	102.5	96.0	91.1
VIX	29.6%	24.0%	17.2%	18.2%
Oil	$116.34	-4.7%	53.3%	59.9%

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

** Oil is front month futures, beware

Wednesday notwithstanding, the last two weeks have started (continued?) to reveal the cracks in the rote investment thinking. Our simple refrain is still that only bad things happen when the Fed tightens monetary policy into a weakening economy. We are not sure if people are suddenly worried about inflation or the impending recession. But the market, despite being down massively already, has finally come to its senses regarding what the Fed must do. Of course, all the side narratives (real or imagined) have withered away into the CNBC ether. It does not matter what Musk does with Twitter (we have argued that it had a necessary but oversized influence on the market in the short term). Congress can do its best to resuscitate voo-doo economics – but, no, more drunken-sailor spending will not help inflation. More stories are unfolding about "smartest guys in the room" hedge funds imploding because of leveraged bets on private equity investments (this almost makes crypto leverage look sane…almost). Just because the media has moved on from the war in Ukraine does not mean that the food supply chains have opened or that oil is trading freely. China seems to be waffling on a weekly basis to lockdown various cities. We suspect this behavior will persist until the autumn when the "elections" take place. Ergo, our baseline is we will not see renewed global demand stemming from China. And oh yeah, crypto is intrinsically worthless (but you can still make money trading it…including on the short side!).

But Wednesday, the market rallied because the Fed hiked interest rates *more than expected*. Ok, sure, this week the Fed had leaked that it was going to be more forceful. But as the Fed wrangles with evaporating credibility, it decides to change course from its previous message cemented in stone (six weeks ago)? And the market likes this? Not to mention, the market believes that the Fed has the power to stop the inflation wheels already in motion by simply adding an extra 0.25%? The funniest reaction we heard was that the market was happy to pull forward the recession! Once this folly sinks in, we suspect Wednesday's market reaction will be like Lubbock…best viewed in the rearview mirror.

- Subprime here, there, and everywhere?

Last week we noted that Subprime lending was back. We were referring to the Buy Now Pay Later scams. Well, we have another zombie from the past making a comeback (don't call it a comeback?). Adjustable-Rate Mortgages…ARMs…are back. These mortgage with low teaser rates in the early years blew up many a borrower back in the Housing crisis (World Financial Crisis…whatever). Last year, ARMs accounted for 4% of all mortgage applications. This year, they are almost 10%.

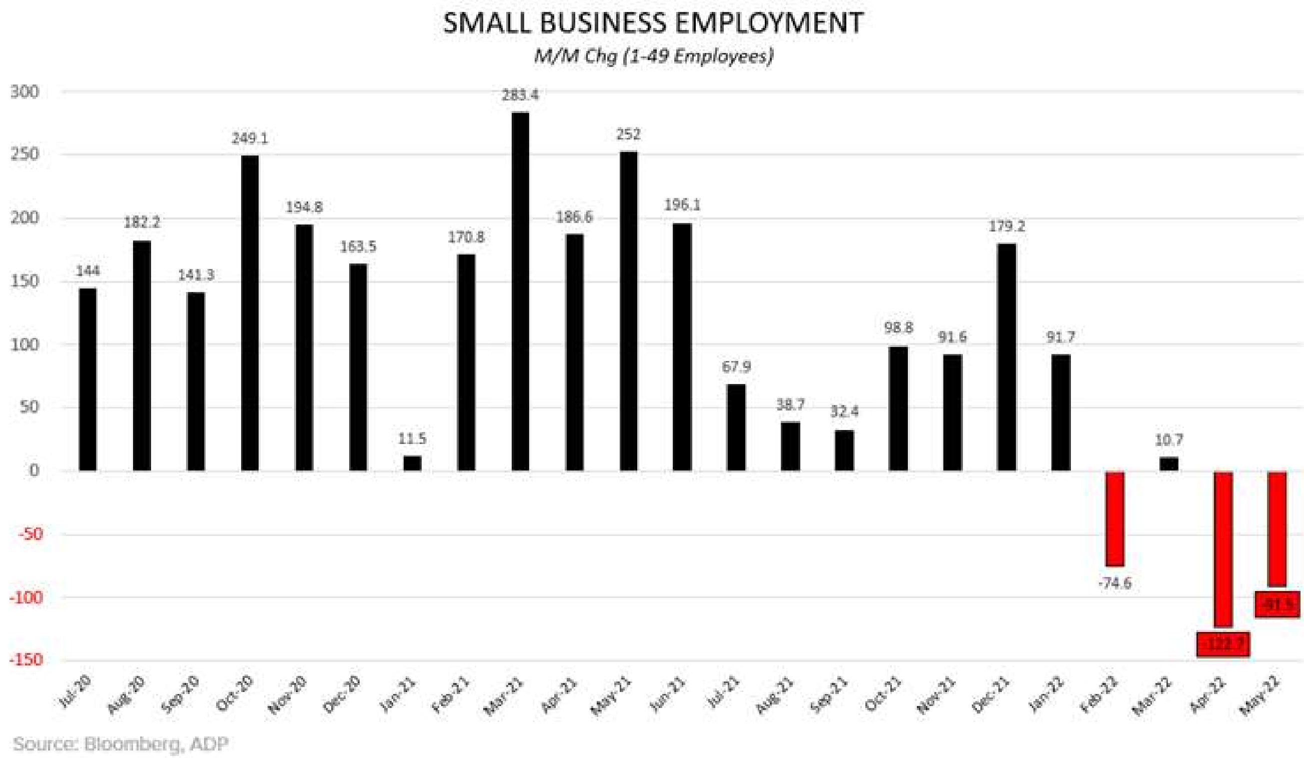
- The Labor market is still ok, but we think it is slowing

The May Employment Report surprised on the upside with a gain of 390k nonfarm payrolls with 333k being private. The report was particularly strong in light of the weak ADP guess of only 128k new private jobs. But it is also worth noting that revisions for the last two months resulted in fewer job gains than first thought (22k lower). And the trend in job gains is a slowing one. Manufacturing jobs were a bit light (+18k). Leisure & Hospitality was the strongest gainer again (+84k). But do not be fooled as this sector is still down over 1.3mm jobs since the virus-fear started. Retail was the lone outright loser (-61k). The Labor Participation Rate ticked up a notch to 62.3% (equivalent to 330k people reentering the workforce). But the prime-age participation rate set another post-virus-fear high of 82.6%. The Unemployment Rate moved higher to 3.6% because of the increased workforce. Average Hourly Earnings slowed to 5.2% annualized vs 5.5% in April.

As we are squarely in the "good news is bad news" camp now, the market reacted poorly. The Fed will take comfort in its interest rate hiking process with this data. Of course, we think the data is disinflationary (adding more workers with slowing wage gains) so the Fed *should not* be emboldened by this data. But we also know this will not be the case.

Goldman Sachs thinks the huge Job Openings number (11.4mm) is fake news. That is, they think there is double counting loaded into the numbers. We have long guessed that the openings are stale. We think Goldman's reasoning makes sense, too. They point to geographic duplication now that the work force is more remote.

Small Business Employment is not as rosy as the JOLTS or the Employment Report like to project. This chart is courtesy of Hedgeye.



- Inflation is getting worse where it counts

The official Consumer Price Index (CPI inflation) increased 8.6% in May vs last year. This is the highest inflation since 1981. This was a monthly increase of 1.0% which is accelerating. The so-called "core" inflation was "only" 6.0%. Its monthly increase was flat at 0.6%. As for the contributors, oil and gas went from a negative in April to a sharp positive (not in a good way) in May. Used cars actually reaccelerated, too. We noted earlier in the year that the comparison would get easier…but this has barely translated into slowing price increases.

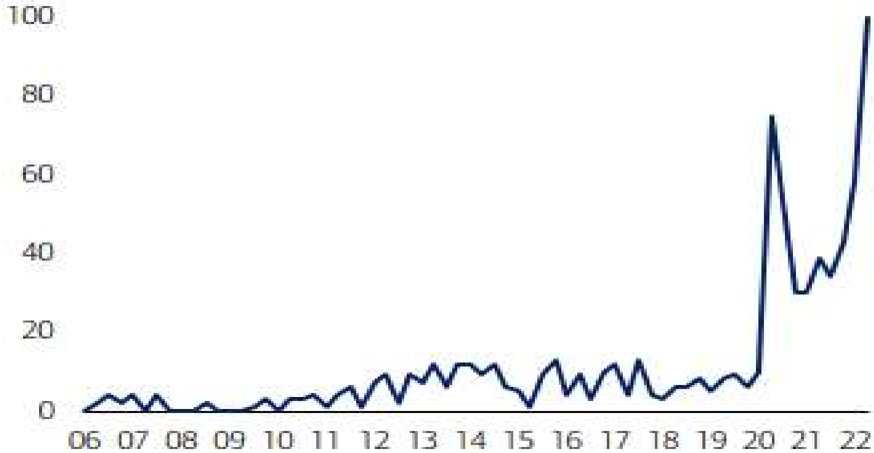
The composition of the inflation has changed in just a few months. In March, 31% of the acceleration was in Shelter, 43% in Transportation, and 13% in Food & Beverage. In May, Shelter has moved up to 47%, Transportation is down to only 11%, and F&B is up to 30%. None of this is shocking. But the pattern seems to bely what we have been thinking lately: Inflation is redhot in the hypersensitive areas (like Food and Housing), but it is cooling in more elastic areas. So, we have surging inflation coupled with disinflation. This is a bad recipe. And, of course, Real Wages are still falling (wage gains are not keeping up with inflation).

The Producer Price Index (PPI inflation, or wholesale/input prices) slowed in May to 10.8% from 11% in April. Not exactly comforting. And the Fed cannot take much solace in the "core" number which excludes Food & Energy.

- Onshoring could be the answer to the Business Spending conundrum

We have been perplexed at the strong and steady Core Capital Goods segment inside of the Durable Goods report. Merrill might have the answer. Companies are being serious about their reshoring efforts away from China. While much of this will flow to Vietnam, India, Mexico, etc, some will undoubtedly come home to the US. Check out the "mentions" of Reshoring during Q1 mgmt. conference calls.

Exhibit 34: Mentions of re-shoring skyrocketed
Companies mentions of re-/near-/on-shoring (2006-1Q22)



Source: AlphaSense, BofA Global Research

BofA GLOBAL RESEARCH

➢ PMIs are eroding, Europe holding in there

The ISM Services Index slipped over a point in May. This business survey is heading back towards the pre-virus-fear levels. The PMI Composite (Manufacturing and Services together) is also trending in the wrong direction. The Eurozone PMI Composite is holding in better than the US data. This does not mean the economy is doing better, but the relative view is more stable in Europe. This is surprising to us considering the war on their doorstep and its impact on energy prices.

➢ Other Economic data is bad and getting worse
- Mortgage Applications fell again last week with a 6.5% drop. But this week they bounced 6.6%. The trend is still undoubtedly negative.
- Credit Card debt is surging, fastest increase in 25 years.
- Consumer Sentiment makes another all-time low.
- The NFIB Small Business Sentiment is at a record low (well below previous troughs).
- Redfin tells us that luxury homes sales (through April 30, so somewhat stale) were down almost 18% compared to nonluxury which were only down 5% (3-month rolling average vs last year, and luxury is top 5% of the market with nonluxury being the middle of the market).
- Retail Sales in May went negative. Recall this data is not adjusted for inflation. The consumer is not ok.
- The Housing Market Index (homebuilder survey) dropped again.

➢ Fed credibility…ugh

Going back to the notion of the Fed losing credibility, the single line that overly optimistic traders latched onto was chairman Powell saying that 75bps hikes will not be "common," but one could happen in the July meeting! Somehow, Powell thinks the consumer remains strong with spending at robust levels, and that growth remains healthy. The not-so-soothsayers adjusted their economic projections. They collectively boosted their own interest rate outlook from 1.9% to 3.4% for this year. And for next year, the outlook was boosted from 2.8% to 3.8%. Of course, the Fed maintains that inflation will be back to its target rate of 2% in 18 months.

Previously, the vice chair of the Fed, Lael Brainard, said she wants to keep hiking until inflation is under control. Moreover, she does not think inflation has started to peak, nor does she see a scenario that would warrant a pause.

Merrill writes, "It is easier for central banks to manage slowdowns if they are the cause of the slowdown." We are not so sure about this considering this group pivots like the Titanic. And we will throw in a good Mark Twain quote (courtesy of the economist John Mauldin who we refence on occasion): "It ain't the things that you don't know that get you, it's the things that you know for sure, that ain't so." We will call this loose Rumsfeld-speak.

For what it is worth, Merrill predicts that the Fed will not stop hiking interest rates until the Employment Report turns negative. This is probably a good marker to watch.

- The European Central Bankers are not exactly channeling their inner Volcker

The European Central Bank showed its true wishy-washy colors over the last two weeks. It first announced its monetary policy tightening plans. As expected, the ECB said it will hike interest rates by 25bps in July with another hike in September. Of course, the ECB is still actually buying assets. It will not end its bond buying until the end of June. And deposit rates are still negative at -0.50% (you pay to lend money!). And proving it is never too late to say you are sorry, the central bank has upgraded its inflation forecasts for 2022 from 5.1% to 6.8% (May print was 8.1%). And it lowered its growth forecast from 3.7% for 2022 to 2.8%.

But a week later the ECB called an emergency meeting to work on the "fragmentation" in the market. While it is a work in progress with committees tasked to work on the specifics (what could go wrong), the idea would be to reinvest some bond proceeds into other bonds that have experienced higher jumps in yield. This would be like taking municipal bond proceeds in Texas to pay off Illinois or New York debt.

- Oil supply is still the story

It looks like OPEC+ is working its way back to just being OPEC (without Russia). Russia is still in the expanded group, but OPEC is planning on increasing production to offset the declines in Russian exports (despite the wavering data). The UAE oil minister said it succinctly with, "oil prices are nowhere near their peak" as Chinese demand is still being suppressed through lockdowns. Maybe most importantly, he voiced what we have been espousing: spare capacity is virtually nil. There have been some reports that Saudi has told the US it will pump more if Russia production continues to decline. This attempted gladhanding towards the US is also seen in prices. Saudi just increased prices to Asia (second highest premium ever) and Europe but held US prices the same (these prices are always relative to benchmarks). Elsewhere, Libyan oil production has fallen from 1.2mm barrels per day last year to about 100k bpd currently. Once production outages were resolved, terrorists forced more shutdowns. Of course, we are starting to see the recession narrative impact oil prices. We suspect this is more profit taking than anything else. We do fear a global recession's impact on energy demand, but we think the supply side is much more challenging in the short to medium term.

- Chart Crime of the week

Here is a Bitcoin fanatic's attempt to use a log scale y-axis to prove that there is no pain in crypto land. This chart is hard to read, but the first y-axis number is $0.02. Considering 99% of Bitcoin owners first bought around $30k, this chart is a bit misleading…dare we say criminal.

➢ Quick Hits

- The owner of the Elvis brand, Authentic Brands, is no longer allowing Vegas chapels to use the icon's likeness during weddings.
- About 10% of recent SPACs have warned that they might be out of business within a year. These grifts include air-taxis, EVs, and scooter rentals.
- The cryptocurrency Solana had an "outage" on Thursday after the network had a "bug in the durable nonce transactions feature led to nondeterminism when nodes generated different results for the same block." We all have that friend that tries to sound smarter than he is. And we all know he is fool of baloney.
- The median house price in Nashville is about 25% higher than the national average. They were equal seven years ago.
- "Toilets and sinks are in short supply" in Russia accordingly to the Wall Street Journal. We suspect they mean new toilets.
- The US has thrown away more than 82mm Covid shots.
- The new Ford electric F-150 comes with an adapter to charge a stalled Tesla.
- Gallo is now the official wine of the NFL.
- One of the government financial regulators (FINRA), has an application with a physical description section. It now limits your physical weight to 699 pounds and height to 7 feet 11 inches.
- Soccer fans at the World Cup in Qatar caught with drugs will face the death penalty.
- Electric Last Mile Solutions, once a pillar in the Fantasy and Fraud sector(s) of the market, has filed for bankruptcy as it pursues new financing. The company was valued at $5b last year.
- Biden is discharging $5.8b in student loans related to the now-defunct Corinthian Colleges. Recall that Obama drove the for-profit college network out of business. *

Trading: Despite the chaotic markets, it was a normal two weeks of trading. This is mostly due to us being comfortable in our positions. We do not feel compelled to aggressively buy dips, chase rallies, or sell dips for that matter. But we are still selling rallies. We think the "feeling" of the market always gives way to the math or the hard facts: the Fed is hiking! So, we continue to trade around the edges. But our core longs of defensive and inflation sectors remain intact. We have still have short exposures in the Fantasy and Fraud sections of the market (as well as some general market protection). We have held this a little longer than we expected. We might look to trim this if we see another down draft.

TSLAQ: Lots has happened since we last reported on the Musk files. The Villain announced he is firing 10% of his workforce (10k of the 100k). And he said he has a "super bad feeling" about the economy. But he quickly reversed course saying no assembly line workers would be fired. He called off the Twitter merger then said it was back in the due diligence stages (even though he agreed from the beginning that there would be no due diligence…not so smart). Larry Ellison, a long-time shareholder and confidant of Musk, abruptly quit the Tesla board with a Friday night news dump. Tesla sales in China continue to underwhelm even with the factories back open (or maybe not, either way it is not good for Fantasy projections). The company is trying another stock split. Fool me once…Speaking of fools, we cannot wait to see the Bitcoin write-down on the Tesla Income Statement.

*Corinthian Colleges was also the stock involved in one of the all-time screw-jobs by the Nasdaq exchange/regulator. Back circa 2003, COCO stock dropped precipitously on "fake news." At the end of the day, the powers that be decided to cancel all trades below a certain level. Never mind that that left many traders short the stock. Here is the path: COCO trades from $100 to $30 in a flash. Trader A bought COCO at $30 and then sold at $50. COCO keeps rallying back to $100. The Nasdaq wipes out all trades below $40. Did Trader A make $20 a share? Nope, he is down $50 a share with his new, naked short.

Check out our website to learn more about Chalk Creek Partners

Carlisle's Twitter Financial List

Carlisle's LinkedIn