Weekly Update

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- Fed pivot is manifesting itself in all the wrong places
- Bank lending slowing
- The bond market does not believe global central banks, but the yield curve does
- Momentum guys are panicking
- Earnings will be deteriorating
- The Fed probably shrugs at the strong Employment Report
- The pessimism on growth increases
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- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	3,970	3.0%	3.4%	-13.6%
QQQ	$277.55	4.4%	4.2%	-26.4%
US 10 YR	3.55%	3.69%	3.88%	1.75%
USD/DXY	103.1	104.3	103.5	94.9
VIX	22.0%	21.1%	21.7%	17.6%
Oil	$77.70	5.4%	-3.2%	-4.4%

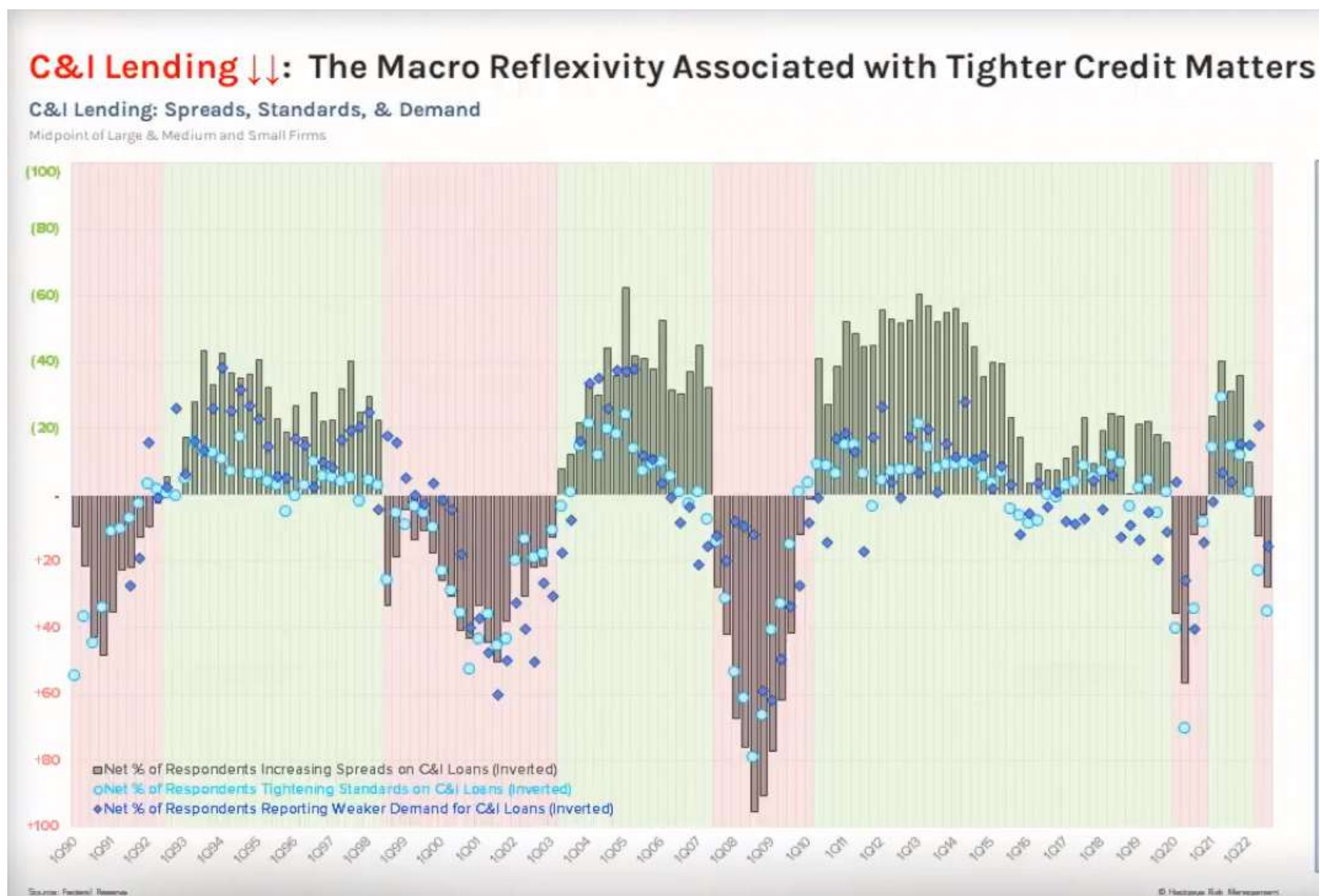
*10yr, DXY, and VIX are levels not changes
** Oil is front month futures, beware

The recently battered "Fed pivot" strategy is back. Whether it was spurred on by cooling inflation, a worsening economy, a reversal of tax-loss selling, peace in Europe, or simply the good weather, the buyers are back. While the market has been strong, the junky segments of the market have been rising in parabolic fashion. The junkier, the better as far as the market is concerned. Bed Bath & Beyond is likely to declare bankruptcy in the coming weeks. But that has not stood in the way of a 166% rally in three days. With this price action has come the altering of market predictions as previous caution has quietly been tucked under the rug – behavior finance at its worst. Of course, we think the market is setting itself for another failure. That is not to say we have a specific view on tomorrow's inflation or whether the market will like JP Morgan's earnings report on Friday. Rather, we still believe that the economy is deteriorating, cooling inflation is not always a good thing (and it is

certainly not absolute in its cooling ie some Services are still running hot), and the Fed will continue hiking rates. For those that say the market has priced in a recession, we say the market has priced in interest rate hikes. But the market is not prepared for a credit event or a dislocation in earnings. There has been barely a mention of the largest operator of Burger King franchises filing for bankruptcy. This ownership group was touted as one of the top BK franchises in the country as recently as 2018. Overleveraging during the good times will bite even the most stable of businesses in the butt during the bad times. (For what it is worth, BK has lost some brand value in recent years along with its slide to the #3 hamburger chain behind McDonald's and now Wendy's.) Moreover, nobody seems to be talking about the Fed's Quantitative Tightening. This alone will keep financial conditions tight even if the Fed were to pause its hikes.

- Bank lending is slowing

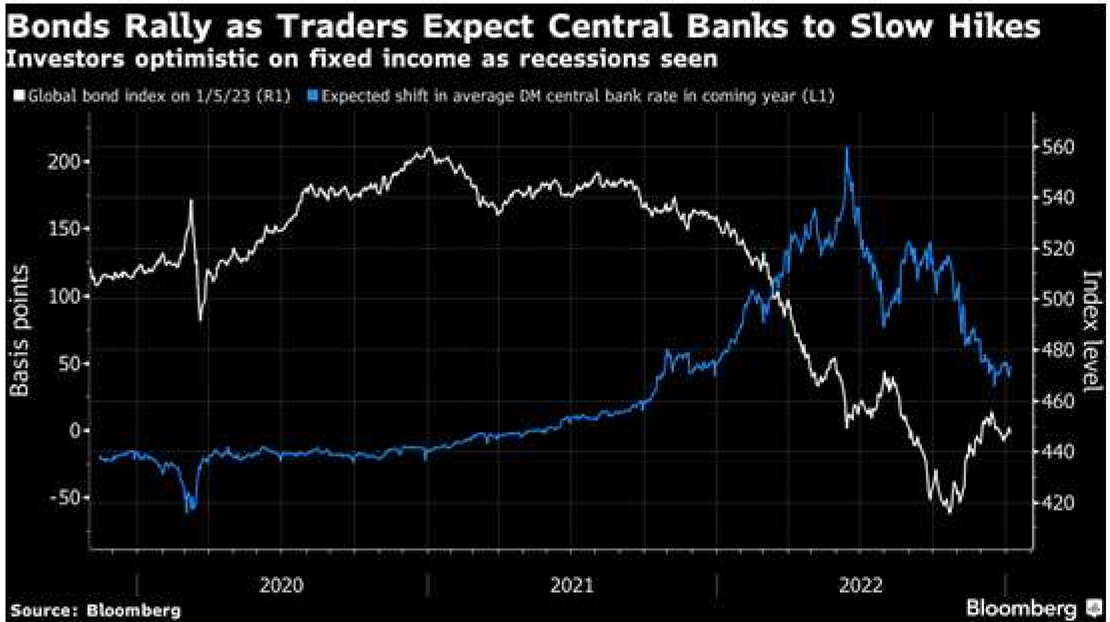
Perhaps the best barometer of the economy and its prospects is bank lending. Below is a chart from Hedgeye plotting the historical responses to the Senior Loan Officer Survey for Commercial & Industrial lending. In a nutshell, interest rates are higher (shown as the negative grey bar), lending standards are tightening (light blue circle), and loan demand is weaker. The notion here is that these three factors all feed on each other creating worse and worse conditions. The ultimate negative feedback loop.



- The bond market does not believe global central banks, but the yield curve does

The easiest place to see the global version of the "Fed pivot" narrative is in the global bond market. The expectation for rate hikes in developed markets, DM, continues to drop in the face of Fed and other central

bank commentary. (DM is carved out separately from emerging markets, EM, because this latter cohort has been ahead of the curve on rate hikes because of earlier inflationary pressures.) Bonds, logically, have rallied. While we agree that the bond market is right more often that pundits or central bankers, this analysis leaves out the shape of the yield curve. With short rates staying elevated and long rates cooling a bit, this reflects what we think to be reality. Yep, the Fed is hiking (higher short-term rates) into a recession (lower long -term rates).



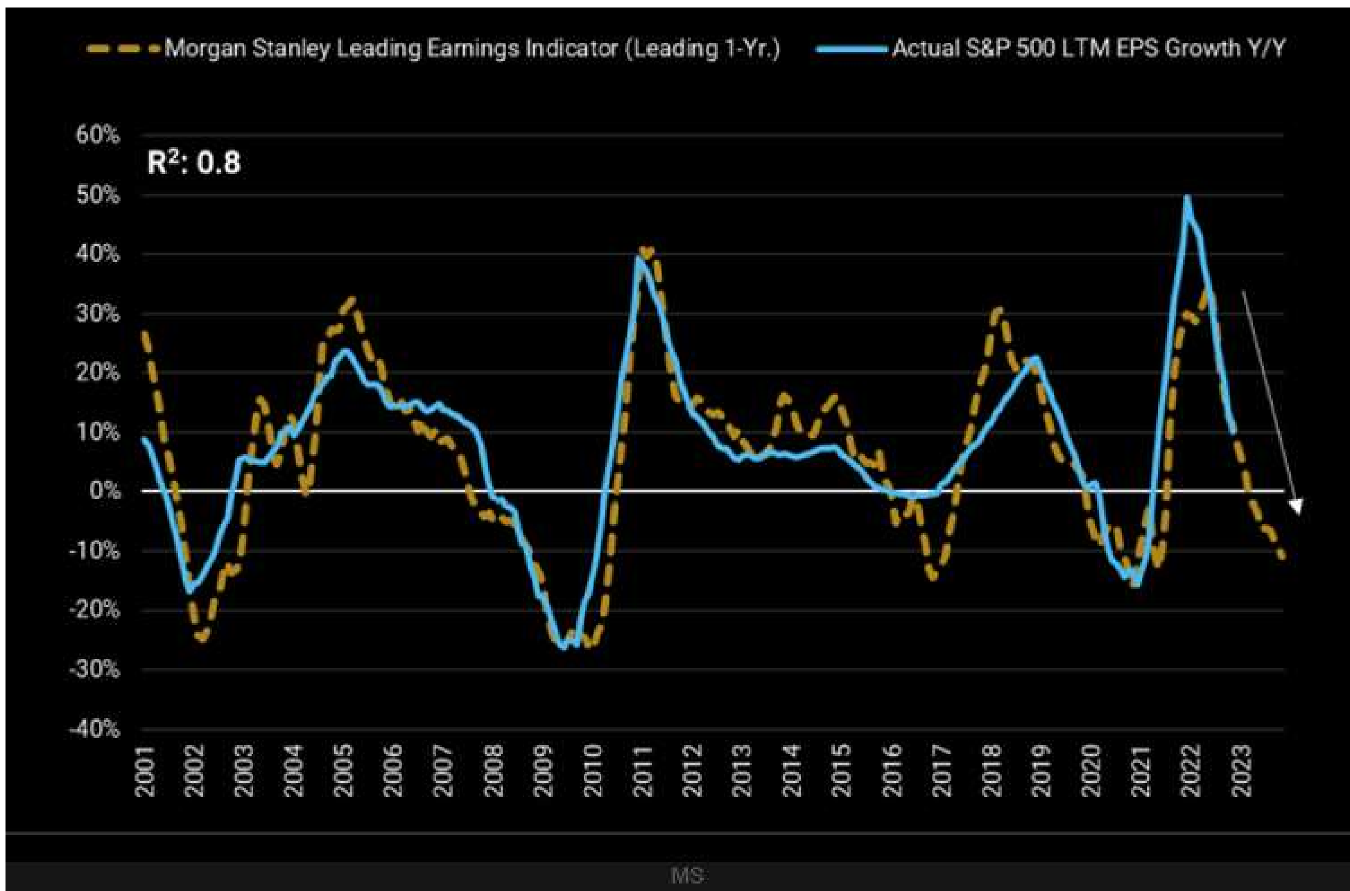
- Momentum guys are panicking

Merrill reports that 2022 saw the largest buying by its huge private client base since 2017. Last week we mentioned that the window for companies to execute buybacks had closed for the earnings season (and thus one source of strong buying had been removed from the Santa rally hopes). But this was more of the norm for the year as the total buybacks in the market decreased vs 2021 and 2019. And this is ahead of the 1% tax on buybacks coming into play this year (somehow this was part of the Inflation Reduction Act).

One segment of the market that does appear to be overly short is the CTA crowd (momentum traders). Both Merrill and Goldman have reports out detailing the short positions of these funds. Merrill estimates the size of the shorts to be one standard deviation below the "model" flatline. Goldman quantifies it as $42b short. Both banks conclude that a sharp move higher will result in these funds capitulating and covering. We suspect this has already happened to a certain extent. These are the kind of events/actions we like to trade against especially in a volatile environment.

- Earnings will be deteriorating

We have used this Morgan Stanley chart before. It shows MS's Leading Earnings Indicator (which has a correlation of 0.8 which is very strong) diving to the -10% growth area without a sign of moderating. The MS strategist, Mike Wilson, has been spot-on about this market. We think his expectations for earnings is logical given how strong they have been. (This is a nuance of quantifying growth patterns, their rate of change is more important than the outright levels).



- The Fed probably shrugs at the strong Employment Report

The Employment Report for December is being deemed a "Goldilocks" report representing strong growth and low inflation. The headline Nonfarm Payrolls number was 223k new jobs. The ADP report guessed this correctly as the NFP consensus was for 200k jobs. The Unemployment Rate dropped to 3.5% from 3.6%, and the Participation Rate ticked higher to 62.3. Health Care and Local Government had the largest increases in employment from 1H2022 to 2H2022. Leisure & Hospitality, Retail, and Temp workers had the largest declines. There is plenty of debate about how to interpret changes in Temporary Workers. And Second Jobs are on the rise. We cannot dismiss all the perceived strength in some of the Jobs numbers. But the same goes for others ignoring some obvious deterioration underneath the headline. Perma-bear Dave Rosenberg thinks the real Payrolls number was closer to a loss of 260k.

The real needle mover for the pundits (at least for the short-term reaction which is usually wrong) was the lower-than-expected Average Hourly Earnings. It dropped from a monthly gain of 0.4% to 0.3% (with expectations in the 0.4%-0.5% range). This translates to a 4.6% annual increase vs 4.8% last month and 5% expected.

We think this data is good on the surface or in isolation. But we still believe the labor market is ripe for a reckoning (more layoffs, a vanishing of the fake Job Openings, increasing Continuing Jobless Claims). And it will take months and months of this data (if not quarters) for the Fed to change its course.

- The pessimism on growth increases

Flying in the face of the euphoria around the Employment Report (Goldilocks, remember), the ISM Services PMI fell sharply. But narrative traders allow themselves to cherry pick their data. So, while the good data from the Employment Report was good, this bad PMI data was good. We think this bad data tells us that the recession is coming regardless of what the Fed does.

- Inflation expectations are cooling, but nowhere near the 2% target

The Atlanta Fed's Business Inflation Expectations fell again to 3%. This is a one-year expectation. April was the peak at 3.8%. While Consumer Inflation Expectations (also one-year) are cooling, as well, they are at a much higher level. December's number was 5% which is down from the peak of 6.8% in June. Tomorrow is the Consumer Price Index release (CPI inflation). Expectations have dropped from about 6.7% to 6.5%. November's reading was 7.1%. The Cleveland Fed's one-year inflation expectation is 2.9%. This is a composite of survey, market data, and "models." This last factor is worrisome with respect to our level of confidence. But the overriding point to all of this is that these expectations are not even within earshot of the Fed's 2% goal.

- Other economic data is mostly weak

One anecdotal follow-up to the recent Construction spending and Durable Goods: An increase in business spending is being seen in semiconductor plants and EV/battery manufacturing.

Factory Orders in November fell 1.8% from October (which had a 0.4% increase).

NFIB Small Business Optimism fell a few points back near its low for the last 10 years.

Wholesale Inventories for November climbed 1% as expected.

Weekly Redbook Retail Sales fell sharply back to 5% (annual number). This is the lowest level in 18 months. The end of December was 10.2% This data is not adjusted for inflation.

Mortgage Applications ticked higher after last week's large drop. The index is at the lowest in 20 years.

- China removing more economic hurdles

China is extending its stimulus measures to the economy (not just allowing humans the freedom to walk around). The latest is a reversal of the strict "three red lines" that the communists imposed upon the real estate sector. Reverting back to the old policies will allow for more leverage by developers. Other stimulus measures (or easing of restrictions) that have been instituted or considered include boosting the semiconductor business through input subsidies, allowing coal imports from Australia, and removing the stranglehold on internet platforms (like raising capital for Ant Group, approving gaming development for Tencent, etc). We still are not sold on whether this is all too little too late. But we also do not want to be short this mania until it shows signs of cooling.

- Fed speak sounds the same

Fed chairman Powell's gave a speech which mostly avoided monetary policy. But his high level talk did reiterate that "price stability is the bedrock of the economy" and "restoring price stability can require unpopular policies."

Bullard of the St. Louis Fed seemingly changed his tune a bit and said interest rates are getting "near to high enough." But this is more of a nod to keeping rates higher for longer. Bullard was the first to call for the 0.75% hiking.

Esther George echoed this sentiment when said rates should get to above 5% and stay there "well into 2024." Again, that 2% inflation goal seems to be the sticking point.

The Atlanta Fed's Bostic: The Fed is willing to overshoot.

Mary Daly of the San Francisco Fed seems to be the only member calling for a slowing of policy. She said, "more gradual steps does give you the ability to respond to incoming information and account for those lags." But we would add that if this is the most dovish sentiment out there, that is saying a lot about the hawkishness of the rest of the Fed.

- Where did all the crypto money go?

Some twitch streamer named "DNP3" founded several crypto projects named Goobers NFT, Gridcraft Network, and CluCoin. Whatever these things are, DNP3 raised money from outside investors. In an unshocking development, all the money is gone. The streamer admits to gambling it all away at some crypto casino called Stake.

This reporting is courtesy of CoinDesk. CoinDesk is owned by Digital Currency Group (DCG) which you might recall owns the Genesis exchange which is struggling to survive as it is owed money by FTX and owes money to other crypto platforms like Gemini. And DCG owns a stake in Coinbase which is a listed stock (COIN). The point of regurgitating this soup of nonsense other than to highlight the circular nature of these Ponzis is that Coinbase derives about a third of its business from Fantasy NFT trading. In a rational world, this trading of make-believe things will slow if not disappear.

- Chart Crime of the week

This was posted by a commodity guy. The idea is that oil prices are tracking the same path as 16 years ago. Then you realize there are two completely different y-axes.

- Quick Hits

- China and Afghanistan (Taliban govt) are close to signing an oil exploration deal.
- A Wells Fargo executive has been fired for urinating on a passenger on a flight to India.
- Gerard Finneran still holds the crown for the most outlandish plane behavior.
- The parent of a disgruntled men's World Cup soccer player for the US decided to dig up dirt on the coach that benched the player. The mom, who was friends with the coach 31 years ago, said she saw the coach kick his girlfriend in the leg. That coach and girlfriend have been married for 25 years.
- ChatGPT is looking to raise money at a $29b valuation.
- The US government is considering banning gas stoves (this already appears to be fading).
- The city of Seattle is suing some social media companies for intentionally harming children.
- The president of Mexico, AMLO, took 28 minutes to answer a single question at a press conference alongside Biden and Trudeau.

Trading: We are glad we trimmed a lot of short exposure in late December. The short squeeze has been manic and would have been painful (or more painful, as it is still painful). We started to add some more short exposure into this rally. But we are trying to go slowly. Even though the duration of these episodes has been shortening over the last year, we still want to be cautious. We balance how much we can make if things go right (based on our "delta") against how much we can lose (our option premium…we can never lose more than we paid for the options). With this short covering rally has come a rotation out of Staples and Health Care. So, we have been adding to these longs. The USD remains under pressure (same Fed pivot theme). We added a small bit here. We already have a large position. We will likely trim this in a rally. We expect the USD to be more volatile compared to the straight-line run-up for most of last year (until the end of year weakness). But we still believe in it given the growth and inflation trajectory.

TSLAQ: Tesla is cutting prices in China…again. On top of this, there are new price cuts in Japan, South Korea, and Australia. It is a demand story! There is plenty of social media video of customers in China lining up to buy the cheaper Teslas, or so we were led to believe by the fanboys. The reality was that these crowds were there to protest the high prices they had paid for their Teslas in recent months. Laughably, Tesla's PR campaign to thwart the epic slide in the stock (and its list prices) was to tease out more manufacturing capacity. Somehow spending more money on factories to sell more unwanted cars is the key to Tesla's success.

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