CHALK CREEK PARTNERS

Weekly Update

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- Macro hits the market, will Earnings save it?
- Volatility is still compressed, but there are signs of quantitative unrest
- First Republic is not the only one lying
- Are treasuries still riskless?
- There is still trouble in the banking system
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	Last	5d %	YTD %	1yr %
S&P 500	4,056	-2.4%	6.0%	-4.0%
QQQ	$311.87	-2.2%	17.3%	-4.7%
US 10 YR	3.45%	3.59%	3.88%	2.83%
USD/DXY	101.5	102.0	103.5	103.0
VIX	18.8%	16.5%	21.7%	31.6%
Oil	$74.40	-6.0%	-7.4%	-26.9%

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

With a pause in earnings season, the macro factors were in the spotlight. The banking system was front and center, again. This time it was First Republic lying about the erosion of its deposits. Adding insult to injury, the company conducted a 12-minute earnings conference call with no Q&A. Whether Frist Republic survives is not the question. Knowing the system is still fragile is highly relevant. As for economic data, the headline was the second straight month of the Leading Economic Indicators being negative. This is a tried-and-true hallmark of an impending recession. While the mega-cap-led equity market mostly shakes off these warning signs, the bond market does not. The yield curve is still deeply inverted. Industrial commodities are under pressure. Saudi's attempts at propping up the oil market have fizzled after three weeks. Copper is back to the lows of the year (albeit it has traded in a tight range). Looking back to equities, Transports and small-caps – these are historically the most economically sensitive - are down 15% from their February highs. Internationally, the Chinese have indicated their stimulus programs will not be extended. They are trying to meddle with Europe in its support for Russia. Angst from and between the Biden administration is increasing. There is even talk of another covid wave hitting! In the US, the debt ceiling is still an issue (we doubt this amounts to much despite the House passing its own relief bill today). Mortgages might become more expensive for the people that can afford them. 3M is cutting another 6k jobs. The Federal Reserve is still on the inflation warpath. But have no fear, Microsoft reported good earnings, so all is well. Joking aside, we think it is plausible that while most of the economy suffers, the rich companies can get richer. We want to see more evidence of this. But this might suggest we alter our positioning (adding some long mega-caps and short small-caps and companies with ancillary services/products).

- Volatility is still compressed, but there are signs of quantitative unrest

The ever-compressing Volatility (VIX) in the market might just be masking some percolating variance in the market. Anecdotally, Mizuho thinks the low Vol is a byproduct of investors not knowing what to do. On the math side, the CBOE SKEW index has been starting to move higher. It sits near its highest level in the last year. This is still low compared to the silly rally of 2021. But it is higher than the 35-year average. (The SKEW index, published by the CBOE exchange, is a measure of tail-risk Volatility…how likely is an outlier move. The higher the SKEW, the more the market is worried about a fat-tail move.) Additionally, the CBOE's Implied Correlation Index has been moving back near its five-year low. This means stocks are not acting in a coordinated fashion. The perfect single-stock example of this is Tesla. When it plummeted 10% after its earnings, the market was ok.

- First Republic is not the only one lying

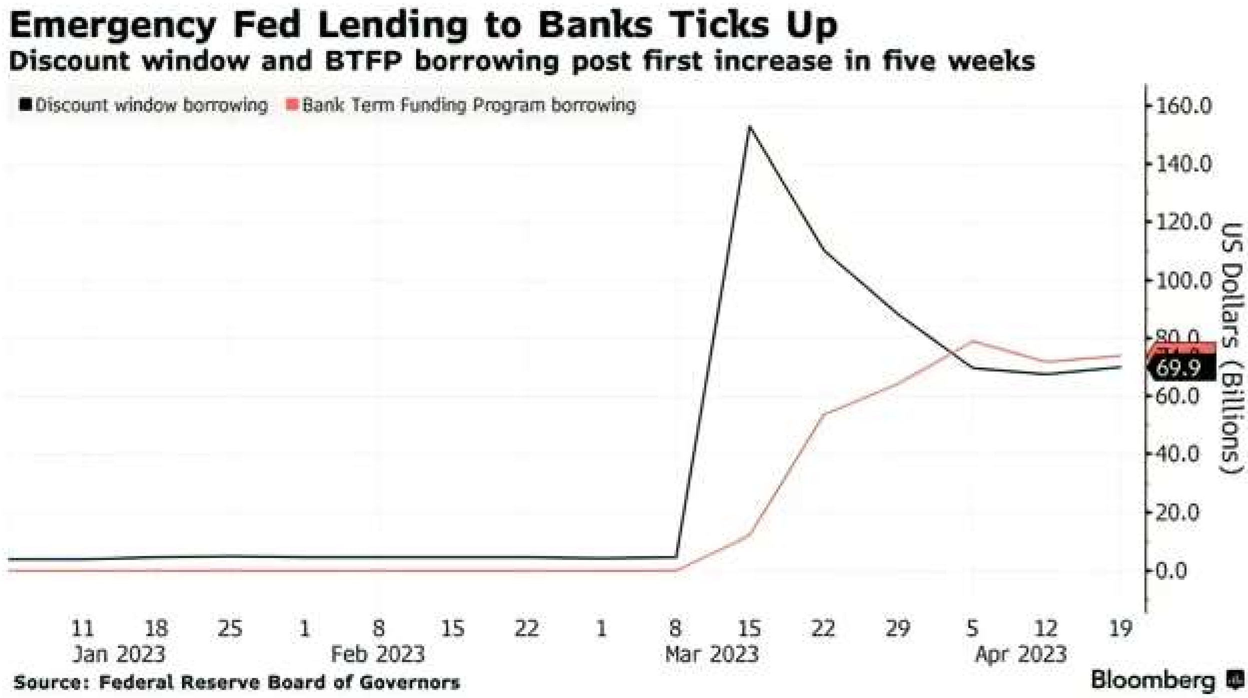
Blackstone, the giant private equity firm which has a huge real estate portfolio (the one that shut down withdrawals to its retail clients) said tighter credit will be helpful for commercial real estate. The idea is that this worsening environment will reduce supply enough to make the current infrastructure more valuable. Yogi Berra could not have said it any better.

- Are treasuries still riskless?

An obvious warning sign that is not getting very much attention is the surging price of credit default swaps on US treasuries. CDSs are insurance against default. Of course, US debt is traditionally if not causally considered "risk free." But it costs almost 1% to insure against the US defaulting over the next year. We would not normally put a lot of faith in this. It is a small market and CDS are governed by a committee who decide what constitutes a default…so there could be overwhelming political bias in these instruments. Nonetheless, the move higher is startling.

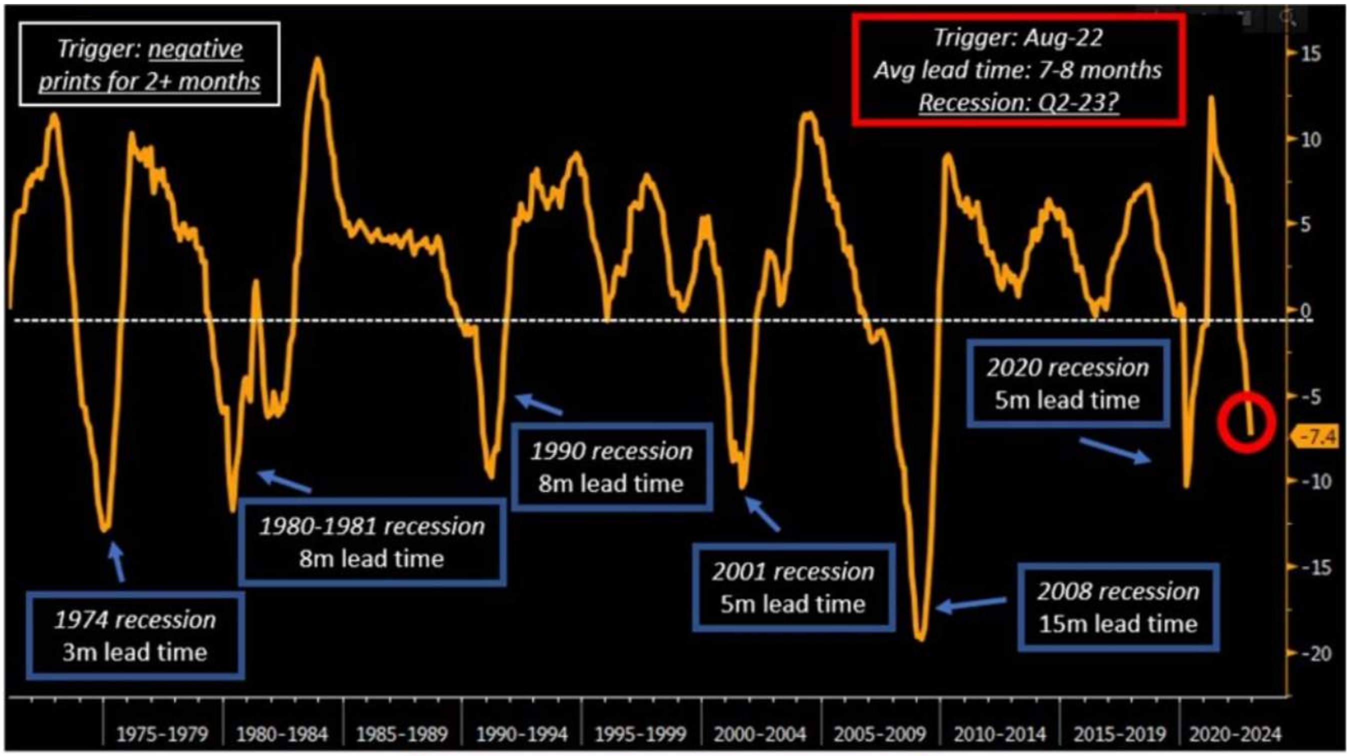
- There is still trouble in the banking system

Emergency leading from the Fed to banks has ticked higher. Mid-March saw emergency lending skyrocket thanks to the failures of Silicon Valley Bank and Signature Bank. In fact, a new lending program was created which allowed banks to borrow using their devalued assets. Moreover, these assets (primarily treasuries and mortgage-backed securities) were valued at par when determining collateral. Overall, we would normally not even consider this slight uptick relevant. But considering this is emergency lending…it should be reverting to 0 rather than moving higher.



- Leading Economic Indicators are leading

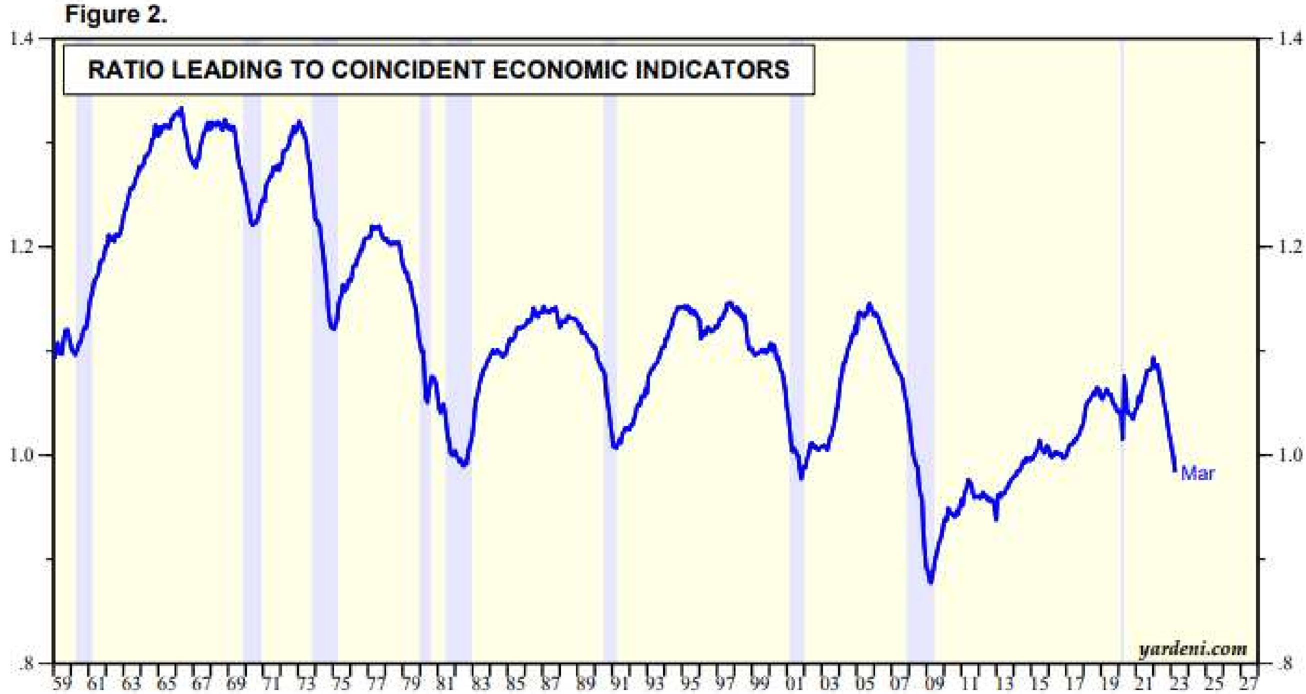
The Leading Economic Indicators (LEI) fell again in March. This is 12 straight months of declines. We often joke about the LEI not being some sort of magic elixir since all the data is already released. But it does aggregate things nicely. And it has not been wrong since the 1970s. Once this index hits negative territory (for two months), it has about a 7-8 month lead time before the recession. (We got this chart from a good twitter follow @MacroAlf).



Source: TheMacroCompass.com, Bloomberg

Yardeni Research observes that the ratio of Leading indicators to Coincident indicators also has a near-perfect record in predicting recessions. This ratio frames the expectations of the market vs today's data.

Figure 2.



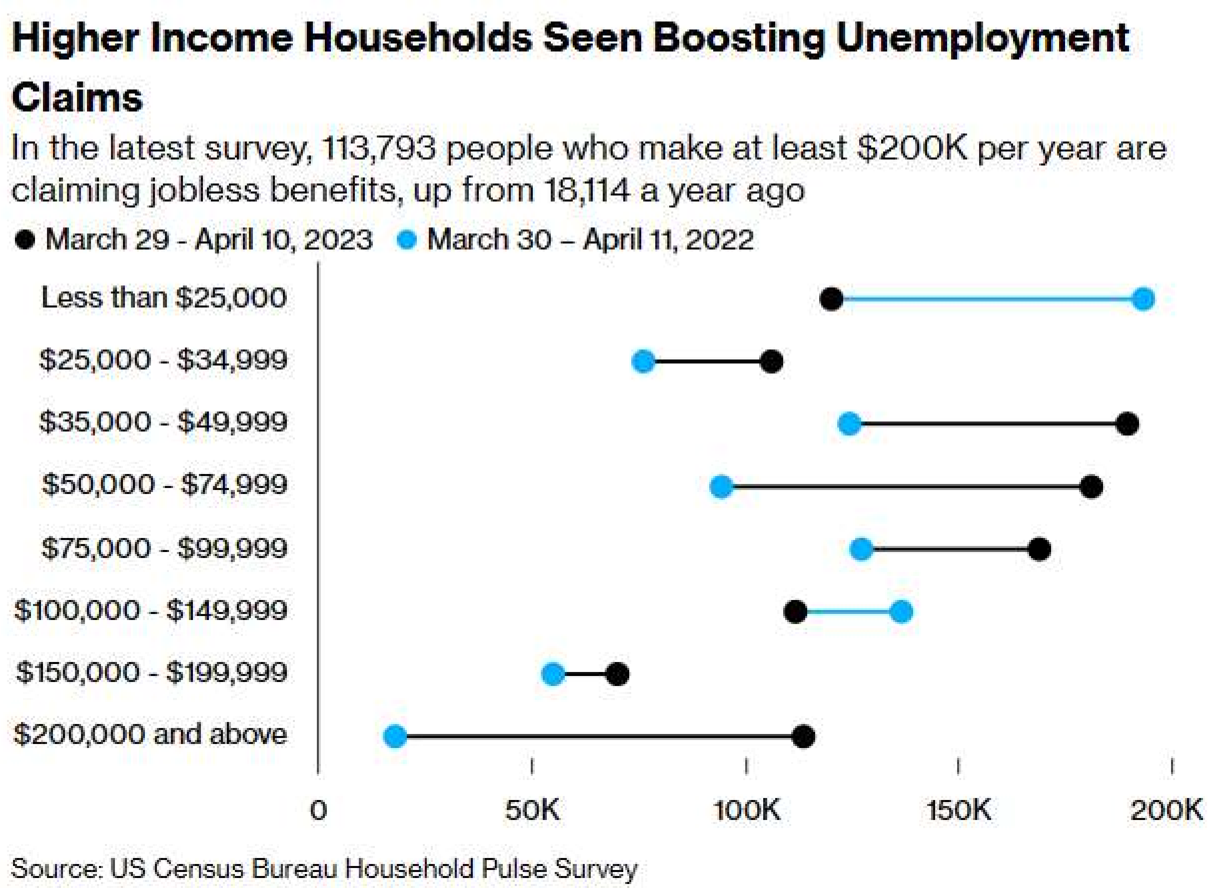
Note: Shaded areas denote recessions according to the National Bureau of Economic Research.
Source: Conference Board.

➢ Housing prices are trending lower

Existing Home Sales in March fell 2.4% vs last month. February saw a sharp increase, so this is a small normalization lower. More importantly, prices fell for the second month in a row in annual terms. While these declines are small (-0.9% in March), this was the only back-to-back monthly drop in 11 years (again, annual terms – monthly has been negative since the middle of 2021). $375,700 is the latest median price which is down from the record of $413,800 in June 2022. Homes in the $1mm+ range are the ones seeing the biggest slowdown in activity. We still expect the housing market to deteriorate (not for new builds but existing) because of a weakening labor market. Ultimately, this leads to more selling inventory – the current low level has kept prices artificially high despite the new normal of mortgage rates. This leads to a negative wealth effect which further erodes Retail spending and the economy writ large.

➢ The shifting Jobless Claims is ominous

Jobless Claims continue to tick higher albeit slowly. Of course, the data is still 25% higher than was first reported (the government adjusted the data recently to very little fanfare). We have been commenting that the change in the makeup of the Labor market underscores the weakness brewing. That is, high paying tech and finance jobs have been on the chopping block. Meanwhile, waiters and other blue collar service jobs have remained in high demand. This fits the slow reopening theme. More importantly, the white-collar layoffs have a much bigger impact on the economy given the compensation levels. Do not get us wrong, there is little doubt that late'-sipping, yoga-pant-wearing Facebook "coders" needed a dose of reality. But this shifting in labor dynamics is ominous. Bloomberg breaks down the change in Unemployment Claims by compensation level which supports our thesis.



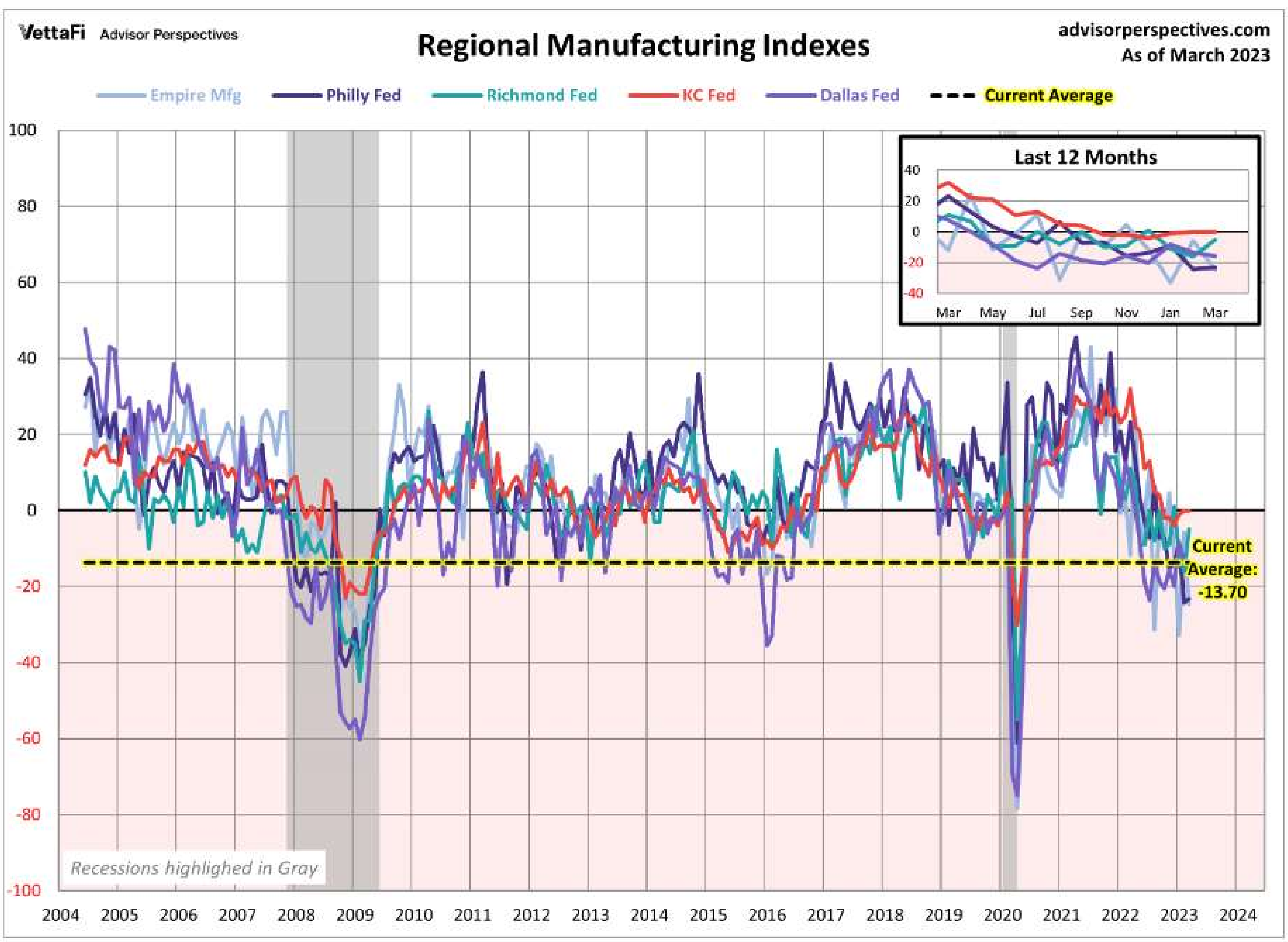
Anecdotally, we will add that we are reading more about the unwinding of the "labor hoarding." That is, during the Virus Fear, companies feared losing employees and not being able to replace them. Hence, companies were more accommodative and forgiving than normal. Needless to say, these same companies are now realizing they can do without quite a bit of the excess baggage.

- National business surveys are showing surprising strength, but regional ones are not

The Flash read (early estimate) for April on the Markit PMI showed surprising strength. Manufacturing moved back into positive territory with services moving two points higher than expected to its highest level in a year. This will be the fifth month in a row of improvement on Manufacturing and the fourth on Services. This data is surprising to us given the plethora of other negative-pointing data. PMI's correlate strongly with GDP (with a lead), but so do the LEI, Retail Sales, Business Spending, Inventory changes (Retail ones building, Wholesale ones shrinking), etc.

On the flip side, the regional Fed surveys are not nearly as rosy. The Philly Fed Manufacturing index dropped further into negative territory. New Orders are the biggest drag. The Dallas Fed Manufacturing survey also sank deeper into negative territory. The Future Outlook component also fell. This is after it mounted a small comeback in the last two months. Below is a composite of the regional Fed manufacturing indices.

When these surveys/indices have diverged in the past, usually it was short-lived. Alas, that does not tell us which ones are off kilter right now. Given most of the other data is pointing to a continued slowdown, we will stick with this basis for now. But we are cognizant of data changing (Microsoft's earnings are duly noted, again).



➢ Business Spending is slowing

Durable Goods Orders in March surged higher. A rebound was expected, but the 3.2% monthly gain was surprising compared to the 0.9% expectation and the -1.2% move in February. However, as always, the real story is in Core Capital Goods, aka business spending. It fell -0.4% vs a small gain expected. Moreover, the small gain in February was revised lower to -0.7%.

➢ Fed speakers still point to higher for longer

John Williams, the head of the NY Fed which is the most important of the reginal Fed banks, said it bluntly, "Inflation is still too high, and we will use our monetary policy tools to restore price stability." That said, he is not worried about the banking sector. He thinks excess borrowing from the Fed's emergency lending programs should not have a stigma to it. And while the excess labor tightness might cool a bit, inflation will hit 3.25% this year and there will not be a recession. Look no further for your soft-landing sherpa.

Loretta Mester of the Cleveland Fed, aka Carol Burnett, thinks, "inflation remains too high." She invoked Volker insofar as to not quit the fight too early. She does not want to "declare victory before the job is done." Her most positive spin was that "we are much closer to the end of the tightening journey than the beginning." Not sure that is much solace.

Harker of the Philadelphia Fed echoed the same sentiment, "Some additional tightening maybe needed to ensure policy is restrictive enough…"

➢ Where might more crypto money go?

Bankrupt crypto lender/exchange/thief Celsius Network is going to become a publicly traded entity in June. Its new owners, the creditors, found a loophole in the bankruptcy code that will allow them to publicly list the "stock" on the blockchain without having to get the SEC's signoff. The company is supposedly going to be filing its financial statements with the SEC going forward. We think exploring different ways to list, trade, and settle securities makes sense. To have your test balloon be the carcass of a bankrupt lender that only had $167mm in cash against almost $5b in customer deposits seems ill advised.

➢ Chart Crime of the week

It is not just the BBC and NPR crying about being accurately labeled as government funded. The CBC in Canada gets into the denial action. They use one of the chartcrime classics of adjusting the y-axis. The CBC revenue data is a few years old which only means they have been denying reality for a long time.

- Quick Hits
    - No Canadian hockey team has won the Stanley Cup in 30 years. Even the CBC cannot make up a stat to disguise 0-for-30.
    - 16,000 Americans still live in (the) Sudan.
    - On April 2, the NY Times said it would not pay Twitter for verified status. The NYT is now the sheepishly proud owner of a verified check mark.
    - The Global Times, the communist-run media in China, has changed its Twitter description from "China's national…newspaper" to "The largest newspaper in China."
    - The percentage of new cars that sell for under $25k has dropped from 24% in 2018 to 4% today.
    - California is proceeding with its plan to price utilities based on consumers's income and not actual utility usage.
    - Bed Bath & Beyond sold 622mm shares of common stock after warning the market that it might be bankrupt. After the legion of meme-fools bought this stock to which the proceeds explicitly

went to pay down debt, the company officially filed bankruptcy. We will see if BBBY tries to sell stock now (Hertz tried and was shut down by the courts).

- Venezuelan oil auctions have been rigged for the last 15 years. In other news, dog bites man.
- The first player ever selected in the NFL draft decided to be a foam rubber salesman instead. (Not to be confused with being a latex salesman!)

Trading: We added more of our recessionary positioning. We added to gold and treasuries. We unwound some long USD (been a bad trade after being a very good trade, so we are trading around the exposure when given the opportunity). We added to Defense (a new position). We shifted some of our Health Care exposure taking advantage or relative performances. We did the same with some Energy. We monetized some of our Tesla Puts by rolling them forward. We still believe in the short. A car company that cannot increase sales while slashing prices will not buck the 100-year trend of the car business being cyclical.

TSLAQ: The SpaceX rocket that was being hyped by Musk as part of his Operation Deception (to move the focus away from the disastrous Tesla earnings) experienced a "rapid unscheduled disassembly." It exploded.

Tesla increased the prices for the high-end model S and X (these are ~$100k cars) a day after lowering them. Perhaps the 10% drop in the stock impacted his decision making? Whatever the case, the S and X are now irrelevant for the company. Or as Musk says, they are "of minor importance." We personally think the Model S is a cool car.

With many of the higher profile fanboys starting to get frustrated with Musk, (Gerbs and Gary Black most notably), ARK Invest's Crazy Cathie Wood felt the need to serve up a fresh round of lunacy-laced cool aid. The Woodchipper published new "research" detailing her $2,000 price target for 2027 (that's a 1300% return). Leave it to ARK, but they still believe in the fake news of the robotaxi. They expect 67% of the $6T of expected value to come from $440b of driverless car fees.

The Tesla 10-Q filing with the SEC is usually where the raw meat is exposed (as opposed to the fluff put forth in the press release). This quarter's filing shows capex going up by $1b to $7b-$9b range. At the same time, the balance sheet shows $4.9b of "construction in progress" which is "primarily comprised of construction of Gigafactory Texas and Gigafactory Berlin-Brandenburg." These facilities are considered finished! As one of the long-term TSLAQ guys notes, "It seems pretty obvious it's inflating "earnings" by not properly amortizing its overcapacity." In other words, this is a giant red flag in the accounting world.

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