Weekly Update

12-Oct-2022

Carlisle C. Wysong, CFA
Managing Partner

- Even with the more bearish positioning, bounces are getting smaller and shorter
- Global Money Supply is shrinking
- The market does not think Credit Suisse is failing
- Core Inflation is still accelerating
- Business Sentiment is still lousy
- The Fed still thinks this Jobs data is good
- Europe's inflation is accelerating
- The Fed's message is clear
- Quick Hits
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	3,577	-5.5%	-24.1%	-16.7%
QQQ	$262.66	-6.9%	-33.7%	-26.3%
US 10 YR	3.91%	3.76%	1.51%	1.54%
USD/DXY	113.3	110.1	96.0	94.1
VIX	28.6%	33.6%	17.2%	18.6%
Oil	$86.99	-0.8%	16.0%	13.0%

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

The market continues to follow the prescribed path of a recession with the Fed hiking interest rates: Down. We are getting smaller and smaller doses of short-covering. But we do seemingly get the rubes chasing the "Fed pivot" narrative every so often. Last week we had a roaring market for two whole days…because Australia hiked rates less than expected? Or was it because the UK turned tail and ran from its much-needed attempts at supply side reforms? New Zealand put the Australia nonsense to rest because it is leaning towards more hikes. (As an aside, it was reasonable for Australia to slow their hikes because its economy is heavily skewed towards Housing and 65% of its mortgages are variable). And the UK is surely no paradigm of what to do as it teeters on a pension fund meltdown with the Bank of England daring the market. Or was it the bad economic data that keeps appearing? Is bad news good again? Or should we just listen to what the Fed is telling us: There will be no pivot until the job is done…which will not be anytime soon. In fact, all we have to do is look at the bond market. When the equity market got excited (Oct 3-4), the two-year Treasury barely budged 0.05% lower. More importantly, even with a Fed pivot, we would likely only be looking at another short-covering rally. Perhaps it

would have some legs like the July/August one. But ultimately, history tells us that typical recessions last well past the initial rate cuts. In other words, normalized interest rates will hardly reverse the earnings recession that is underway. But as we wrote two weeks ago, we do think the positioning is finally starting to catch up with reality. The caveat to this caveat is that it is likely that people are voicing concerns while still being heavily weighted towards risky assets. Throw in some North Korean missiles, Russian nukes, China Covid, China-Taiwan, and Elon Musk…and we have the perfect recipe for continued Volatility and factor rotations.

- Global Money Supply is shrinking

Morgan Stanley, accurate bears for a while now, point to this simple chart about the direction of US equities. Overlooking some of the chart-crime here (different scales and rolling returns), the correlation does seem robust. And the Fed has barely begun to drain liquidity via selling bonds, so on top of the projected pace, there might be some catch-up to do!

Exhibit 1: If global M2 (in USD) continues to fall at this pace, it does not bode well for stocks

Source: Bloomberg, Morgan Stanley Research

- More evidence that positioning is getting negative

Two weeks ago, we commented that sentiment and positioning might be getting negative enough…or at least properly reflecting the trajectory of the economy and interest rates. The large banks are starting to echo this sentiment. Goldman, DB, and Morgan Stanley all have recent reports with various metrics showing the bearish positioning. A lot of this data can be cherry picked (intentionally or not) to fit the narrative. We try to rely on the data-driven statistics as well as a blend of sources. Some of the ones that stand out: MS says hedge funds's Net Leverage is at 12-year lows at 33%. DB says Volatility Control funds (the short gamma guys that seemingly buy high and sell low) have an average equity allocation back near the bottom of the 12-year range (ex the virus-fear plummet). And Goldman says CTAs (overtly momentum-based funds) have short exposure close to their "historical max but still sellers." Also, the Put/Call ratio has hit a two-year high (we have noted the recent spike

in Put option buying, some impactful and some not). Lastly, the pundits are starting to look at large derivative trades like the bogey man. This finger wagging is classic behavior during volatile times. The recent, large rebalancing of the JPM mutual fund (the one that hedges on preset dates) somehow spooked the market despite being know three months in advance (every three months!). And then on the flip side to this, a Wall Street strategist claimed a giant, bullish option trade moved the market higher. But the simple math showed it was a large trade in notional terms but not in delta (this means one part of the trade looked large but there was an accompanying trade that mostly offset the other one).

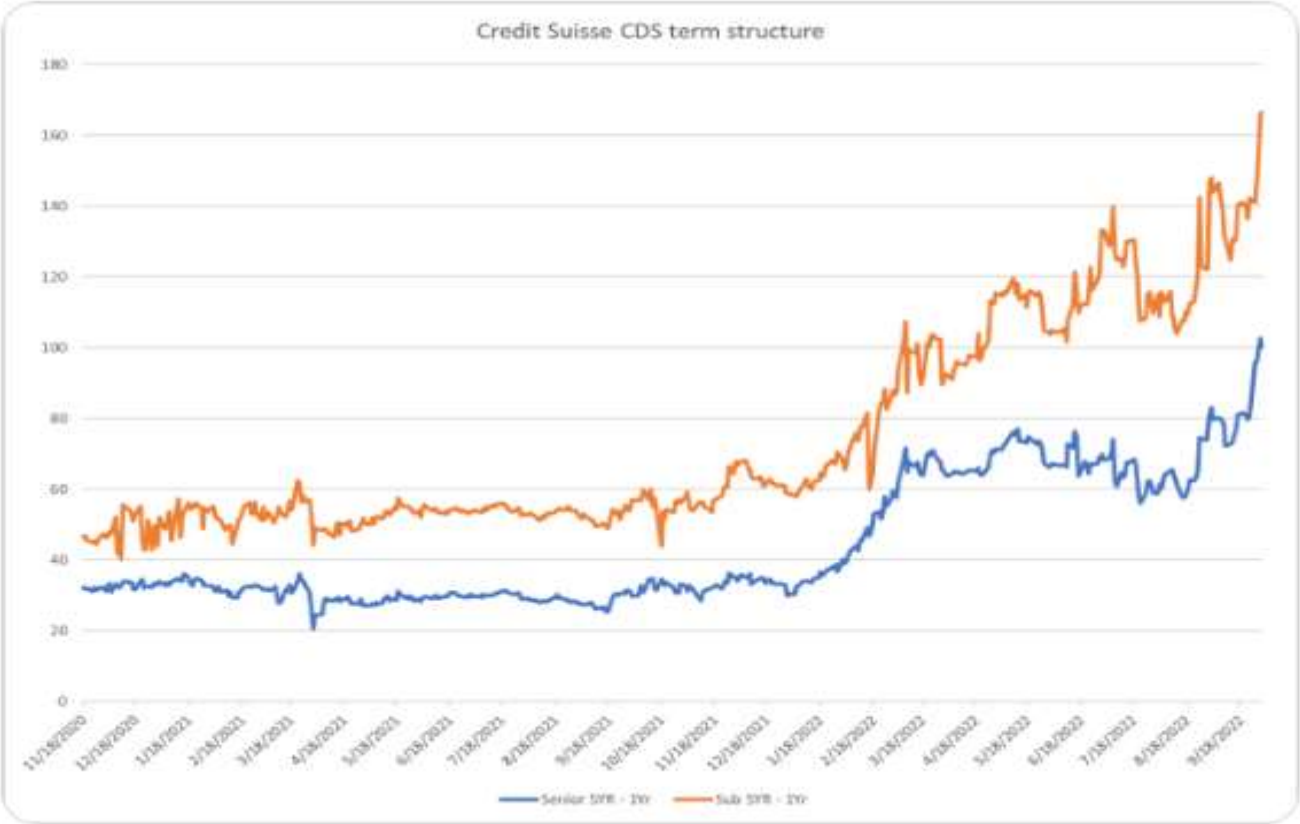
- But has the sentiment already been overwhelmed by the old "Buy The Dip?"

As for the Merrill Lynch data we like to reference, the firm saw buyers across all non-corporate segments this past week. It has been rare that hedge funds, institutions, and retail are all aligned. Furthermore, the inflows were evenly distributed across sectors and factors. Of course, this flies in the face of the point we were just trying to make…that people are bearish! Have the once-bears already started buying the dip? We suspect this buying was concentrated on the two up days.

We know nailing down positioning is impossible and there will always be loads of back and forth. But that is our point. We will try to go against these emotional waves when we can.

- The market does not think Credit Suisse is failing

The latest popcorn-chomping, fin-twit material is that Credit Suisse or some other European bank is on the ropes. The pundits cite the bank's 5-year Credit Default Swap (CDS) price of about 335bps which is up from about 60bps at the beginning of the year. A CDS is an insurance product against default. The higher it goes, the more stress there is that the bank/issuer might default. Many analysts peg the CDS Mendoza Line for banks at 300bps. While we think Credit Suisse has been a poorly run bank ever since the Brazilians relinquished control (back when we worked there…no correlation!), we think the term structure of the CDS curve tells us more about its solvency prospects. That is, the price for default insurance is not spiking higher in the short-term. In fact, the curve is *steepening* sharply. Any sort of fear gage (the VIX and CDS being the two most prominent) should see a backwardation in the curve…higher stress in the immediate term. But the math is telling us the opposite. We got the chart below from a good Twitter follow (Andy Costan). The orange line is the price of CDS on subordinate debt 5yr minus 1yr while the blue line is senior debt. It is a week old now, but the theme is intact. However, just because we do not think Credit Suisse is blowing up imminently does not mean it is out of the woods. We are short a basket of European Financials. We would be happy with an implosion; we just do not think it is coming all else being equal.



- Core Inflation is still accelerating

The Personal Consumption Expenditures Index, aka PCE inflation, grew by 0.3% in August vs July's mild deflation at -0.1%. This brings the annual rate to 6.2% which is down from July's 6.3%. But the "Core" PCE moved higher to 4.9% from 4.6%. The monthly increase was 0.6%. As we often write, we mock the notion of "core." But what we think does not matter…it is the Fed's view that counts (but we will add that the Core is showing its true value now given the massive volatility in Food and Energy prices).

Here is another way to look at inflation. The Atlanta Fed has a "sticky" CPI made up of items that might take longer to show price increases, but when they do, they are harder to reverse. Clearly this trend is going in the wrong direction.

The PPI (wholesale/input prices) in September accelerated on a monthly basis with a 0.4% increase vs the deflation of -0.1% in August. The annual rate dipped from 8.7% to 8.5%. The same trends hold for the "Core" inflation with a slight increase in the month (0.3% vs 0.2%) vs a decrease on the year (8.1% to 7.2%).

The Atlanta Fed's Business Inflation Expectations for October remained steady at 3.3%. This is a one-year expectation.

- Business Sentiment is still lousy

The ISM Manufacturing PMI for September fell about two points and sits just above the breakeven level. But the New Orders and Employment components both sank sharply into negative territory. Markit's Manufacturing PMI remained about unchanged sitting two points above the breakeven level. This slight mismatch makes sense as the ISM is more global. And we know Manufacturing in Europe and China has nearly come to a halt.

And as the regional vs national trend goes, the Chicago PMI fell sharply into negative territory. It is near the lows for the past 10 years ex the virus panic.

Services remain mixed. The ISM is well above the breakeven level at 56.7. The Markit reading is below breakeven. This discrepancy is a bitter harder to square. But Markit has research showing their index tends to lead GDP better than ISM (obviously they would say that).

Construction Spending fell in August, and the negative reading in July was revised lower. Most telling was the 2.9% drop in Single Family Housing juxtaposed to the 0.4% increase in multifamily. We remain short Housing and related Housing Retail.

- The Fed still thinks this Jobs data is good

The Employment Report for September matched expectations with a gain of 263k jobs. August was 315k and July was 537k (which was an aberration on the high side), so the trend is slowly going lower. Leisure and

Hospitality accounted for almost a third of the job gains. And of this segment, the bulk was in Food Services and Drinking Places (funny name for bars). The flip side to this is the Unemployment Rate dipped to 3.5% from 3.7% with a lower Labor Participation Rate of 62.3%. Average Hourly Earnings remain hot with a 5.0% gain. But this is slightly lower than August's 5.2%.

The Labor Department's Job Openings and Labor Turnover Survey showed Job Openings dropped by over 1mm which is about 10%. This is August data, so it is even more lagged than other already-lagging employment indicators. But we have been calling for this trend for a while. These fake Job Openings will shrivel up and die. And the real ones will just fade away as the economy slows. The Quits data is a little more muddied, however. White collar workers (Professional and Business Services is the technical segment name) are sticking with their jobs longer (about 0.5% fewer are quitting which is a relatively large number). Meanwhile, everyone else continues to quit at a record pace (especially in Leisure and Hospitality, L&H). We expect this to rollover and follow the Job Openings data. And this Quits trend was obvious and logical. Gains in Average Hourly Earnings in L&H far outpaced all other private workers's earnings to the tune of about 2:1 (L&H earnings are still up about 10% while all others are up about 5%).

- Other economic data is still deteriorating

University of Michigan's Consumer Sentiment (the one more reflective of inflation) for September was revised slightly lower. Sentiment is still lousy albeit off the trough lows of June and July.

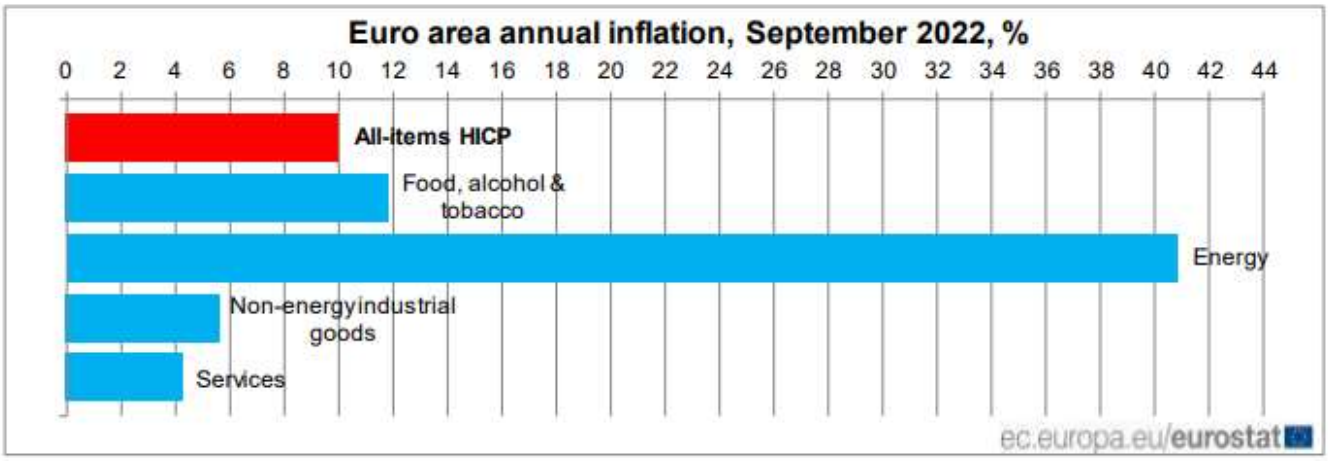
The US's Trade Deficit for August decreased for the fifth straight month.

Fannie Mae's Home purchase Sentiment Index hit an 11-year low with only 19% of respondents saying now is a good time to buy a house.

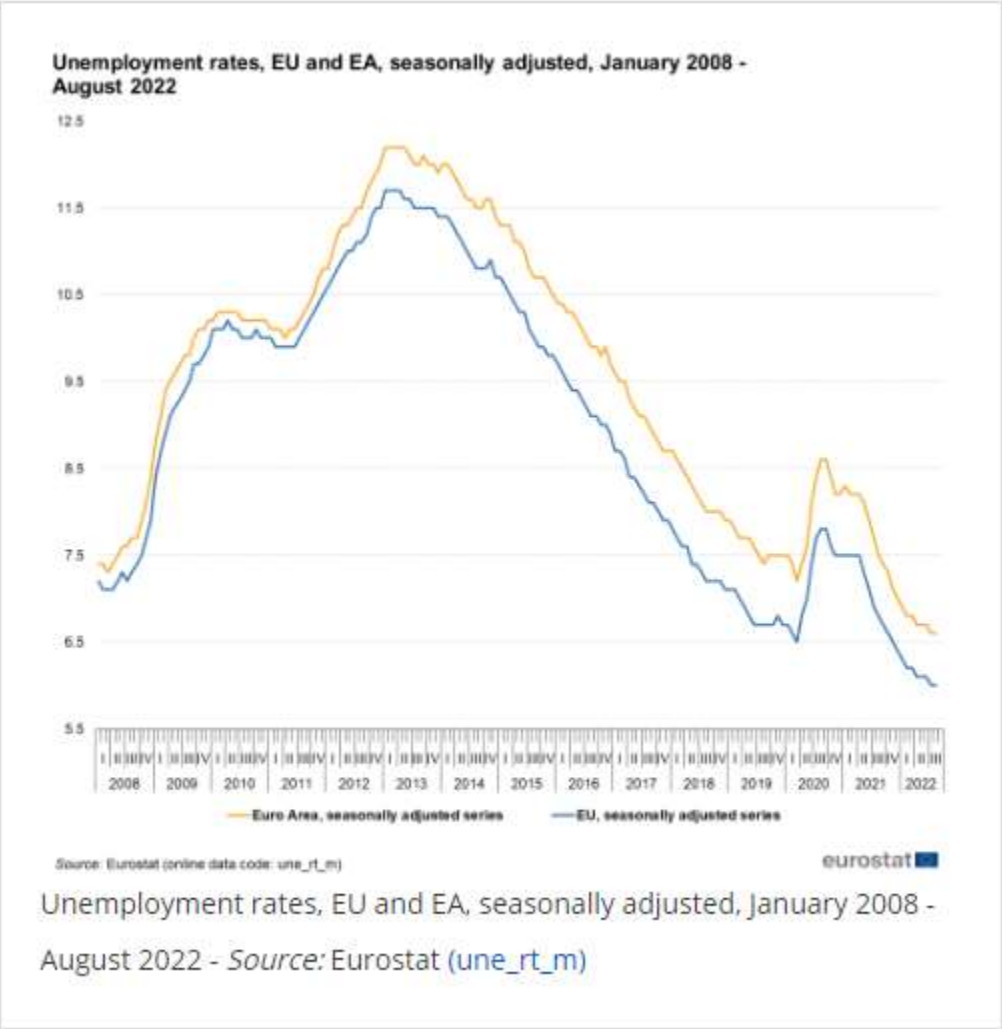
Mortgage Applications for the week fell again.

- Europe's inflation is accelerating

The Flash (early look) reading of Eurozone inflation (HCIP) moved up to 10% in September from 9.1% in August. Here is a very simple breakdown that is not shocking given the energy crisis.



Surprisingly, Unemployment in the Eurozone continues to fall. We have no idea what this means or why it is happening. We suspect it is government at play one way or another (fake jobs or fake jobs numbers).



- BOE to the rescue? Depends on who you ask

The Financial Times had an interesting follow up to the near-blowup in UK pension funds. Actually, their reporting tells us that there were blowups. And the irony of it all was the Bank of England (BOE) intervention is what caused the blowups! More cruelly, it was the smallish pension schemes (as they call them in Britspeak) that suffered since they invest in the LDIs (Liability Driven Investments) in pooled vehicles. And many of these structures have knock-out language that essentially implodes the funds at the exact worst time (akin to the Short Volatility funds that blew up in early 2018, they were shut down at the absolute peak of Vol). To sum it up, the market got a short respite from interest rate pressure. But small pension funds suffered irreversible losses and now have an asset/liability mismatch in the idiotically designed defined-benefit "schemes."

- The Gilt market is back in trouble

And rescue is probably the exact wrong word. The yield on the 10yr UK Gilt (government note) is back to about 4.5%. This is the point at which the Bank of England started to intervene two weeks ago (although the intervention is in the 20yr or longer notes, the 10yr is the most widely watched). The bond-buying program was to last just two weeks, but with rates retreating higher again, the government indicated there would be further intervention measures. But then the governor of the BOE came out and said the pension market had until Friday to unwind their schemes as the central bank would stop propping up the market that day! Perhaps the BOE was annoyed at how little uptake there was to sell bonds back to the BOE. Who really knows, but next Monday will be interesting. We hope the Fed is not taking notes.

- The Fed's message is clear

Fed members must be getting tired of the "Fed is going to pivot" talk all the time. Because each time the voice in the echo chamber gets louder (ie short covering in the garbage stocks), various members of the Fed come out and put the market back in its place. This time around was Fed newcomer Philip Jefferson (he is the latest Fed Governor, he joined in May): "Restoring price stability may take some time and will likely entail a period of below-trend growth."

John Williams of the NY Fed used uncharacteristically straight forward talk: "Interest rates are not yet in a restrictive place for growth" and we "still have a significant ways to go."

Raphael Bostic of the Atlanta Fed chimed in with the same rhetoric. The Fed should remain, "purposeful and resolute" in fighting inflation which is still in "the early days." He thinks a restrictive level will be in the 4-4.50% range (currently 3%). And he addressed the notion of cutting rates which the market tends to cling to every so often (every fake rally): The Fed should not be quick to cut if the economy weakens. But somehow the CNBC narrative was that Bostic was in favor of a pause…a pause is halfway to a pivot!

And just to make sure CNBC was listening, Neel Kashkari of the Minneapolis Fed said he was not comfortable pausing rate hikes until there is evidence that inflation has cooled.

Fed governor Christopher Waller was a little less hawkish than most others. But he still wants to be hiking rates into early next year. But he thinks there is some evidence that the economy is slowing which will ultimately tame inflation.

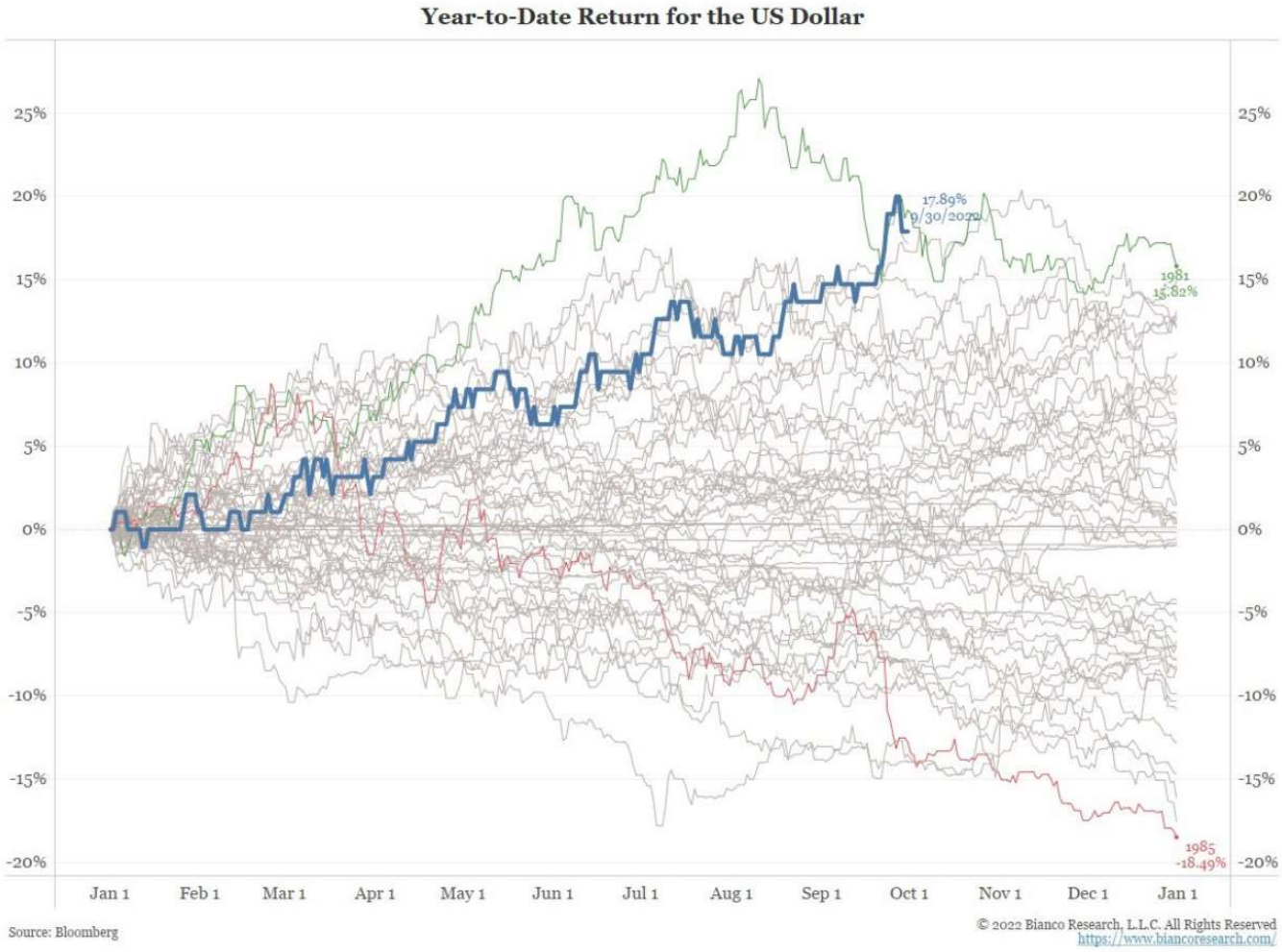
Another new Fed governor, Lisa Cook, joined the chorus with, "we need to keep rates at restrictive levels until we are confident that inflation is firmly on the path toward our 2% goal."

- OPEC is now matching the US's SPR releases

OPEC+ announced they would be cutting 2mm barrels a day of production with a carve out for Russia. This amounts to around 1mm bpd. Biden has pushed back hard against the Saudis. But the Saudis have said they do not want to be a part of any US political drama. Whatever the case, this is just another example of the limited spare capacity in the world. We cannot wait for the US to start refilling the Strategic Petroleum Reserve the day after the midterms.

- Chart Crime of the week

We get the point is to show the USD has rallied strongly this year. But otherwise, this looks like an Etch A Sketch.



- Quick Hits
  - The National Council of Supervisors of Mathematics convention was entitled "Lets Talk about Bias and the Mathematics Classroom."
  - Drake, the actor/rapper/whatever, has allegedly wagered over $1b on some site called Stake in the last 10 months.
  - Voting in Brazil is mandatory. Penalties for not voting include losing one's passport and being forced to work for the government. Ouch.
  - Kamala Harris wants hurricane Ian relief to be based on race.

- The Seahawks beat the Lions 48-45 last week. This was the first time this score has happened in NFL history.
- Turkey inflation has hit 83%.
- Germany's largest utility, RWE, is spending $6.8b to buy ConEd's US renewable portfolio. The deal will be partially funded by Qatar.
- There are about 1,200 "listed" crypto tokens that have not traded for over a month.
- A guy was busted for stealing $300mm in crypto. His encrypted wallet (aka a cold wallet) was seized by the police. Ho hum. The interesting twist is that the criminal's brother then stole the crypto from the confiscated wallet. The first brother, the original criminal, turned state's evidence against his brother than committed the second crime.
- The United Nations has called on central banks to stop the interest rate hiking. This makes us feel a little better about the interest rate hikes.
- Shell's outgoing CEO expects/wants more taxes on oil companies to fund subsidies on people's energy bills.
- Amazon is scrapping its robot delivery service, a video calling device for kids, and its teleheatlh service.
- Crypto.com accidentally refunded a customer $10.5mm of crypto instead of $100. A year later, the woman has been arrested for not returning the "money."
- Tyreek Hill, newly of the Miami Dolphins, says he chose Florida over the NY Jets because of state taxes.

Trading: We took the cue from the increasing bearish positing, and we reduced some bearish bets During the silly "Fed pivot" spike higher, we added back some Put protection. And then we took some back off. This might seem silly, but it is the best way to trade on the short side via options. Things have to be done incrementally, quickly, and in contrarian fashion. We also sold some Energy as it rallied on the OPEC news. We also trimmed one our healthcare name most exposed to nursing inflation…this pressure seems to be abating.

TSLAQ: Hell has frozen over. Elon Musk has admitted he was wrong or at least that he was going to lose his court battle vs Twitter. He has sent a settlement letter to Twitter and the judge (she is our hero for the way she handled this) and his has filed the same letter with the SEC. We sold our Twitter position on the news. We doubt this is the last we will hear of this drama.

Tesla held another "AI Day" (farcical Artificial Intelligence). It was the follow up to Elon's promise that a working "humanoid robot" would be completed by the end of September. And the fans cheered wildly as Optimus waved and twitched its knees. The near-term goal is to have the humanoid work the assembly line at Tesla factories. We are quite confused as robotics have been used for over 40 years in auto manufacturing. Of course, Tesla does assemble cars by hand in a tent (as we have described many times). Of course, the timing of this craptactular was to overshadow the disappointing 3Q delivery numbers the company announce on Sunday afternoon. Not exactly a normal time to release market information.

As for other ridiculous Elon pumps, we saw that it has been 1051 days since Tesla announced the Cybertruck. But that's not stopping Elon. In the aftermath of hurricane Ian:

And there was another pump of Muskian proportions. Tesla is pursuing a supercomputer called Dojo. It is apparently behind all its AI dreams. During the presentation, the Dojo computer showed images of a Cybertruck and Semi "running on Mars using stable diffusion made possible through Dojo." The market will not crash until people come to their senses about this clown show.

As a funny aside, spell-check changes Cybertruck into Cybercrook. Now that is Artificial Intelligence!

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