Weekly Update

15-November-2023
Carlisle C. Wysong, CFA
Managing Partner

- The market only cares about inflation
- Hacking is the new shrinkage
- Will the US lose its AAA status?
- Nobody is hedging
- Volatility is giving mixed signals
- Commercial Real Estate foreclosures are ramping up
- Inflation cools, but prices are still high
- Retail Sales turn negative
- China data is mixed
- Quick Hits
- Where did all the crypto money go?
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	4,504	2.8%	18.6%	15.6%
QQQ	$385.64	3.4%	45.5%	36.0%
US 10 YR	4.54%	4.50%	3.75%	3.69%
USD/DXY	104.4	105.5	104.5	106.3
VIX	14.2%	14.5%	22.9%	24.1%
Oil	$76.50	2.0%	-4.5%	-10.0%

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

It was another week of twists and turns. First, we had Fed chairman Powell delivering the same remarks he did last week with a different reaction. These were the remarks that reinvigorated the soft-landing narrative. But a week later, these same remarks spooked the market. The most glaring comment is that the Fed members "are not confident" that "monetary policy is sufficiently restrictive to bring inflation down to 2% over time." However, another week later, a 0.1% drop in Core inflation was enough to change the mind of the Fed…err we mean the market. We are not too worried about small moves in prices (higher or lower). We think the preponderance of economic data is pointing to a slowdown (not necessarily a recession, but the rate of change is what matters). Last week we discussed a deteriorating labor market (if you look at the correct Household Survey data) and the poor lending landscape (both tightening lending standards and weakening demand). This week, we can add negative Retail Sales (probably not a coincidence with student loan repayments starting -

even with the enormous percentage of carve-outs from the creditor side and deadbeat-nonpayments from the debtor side), more Commercial Real Estate foreclosures, weakening demand signals from the oil market, and another warning about the creditworthiness of US government debt. The bond market knows the economy is weakening. That is why it can rally in the face of all the supply coming down the pipeline (this Monday will be an important 20-year auction). But the equity market still forgets that non-emergency rate cuts are a *bad* thing historically.

Nonetheless, our base case still calls for mild economic weakness (we have learned not to rely on the government declaring an "official" recession or not). Quality companies with strong balance sheets can likely weather any storm. But the lower end of the Quality spectrum will not be so fortunate. Term premiums on junk bonds will not shrink with slightly lower US Treasury yields (recall the chart detailing the difference in effective interest rates across the size spectrum).

- Hacking is the new shrinkage

Thursday's bad 30-year Treasury auction was dismissed as being a one-off thanks to a Russian hack of a Chinese bank (sounds like a bad Netflix show). Oddly, there might be some truth to the story. ICBC, a large state-owned Chinese bank had its NY office hacked by Russians. With their systems down, the Chinese could not participate in the auction. Then again, this tale smacks of blaming Target's bad sales on theft or packaged goods companies's troubles on the diabetes shots. These are all bogus narratives with the intent to deflect.

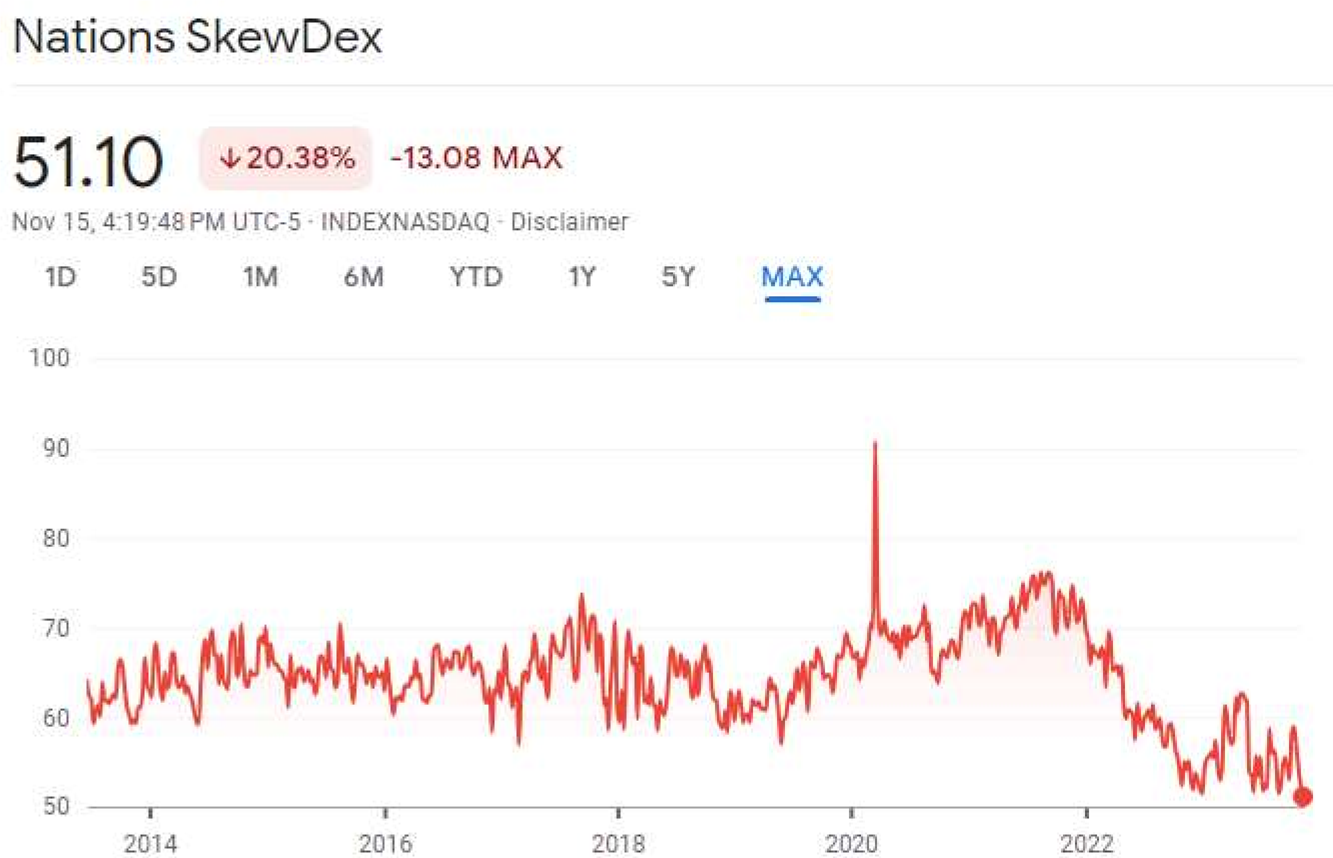
- Will the US lose its AAA status?

Moody's has shifted its outlook on US government debt to Negative from Stable. Moody's still has the highest rating on the US (AAa, equivalent to AAA). The rating agencies are never ones to be on the cutting edge of change. And given the way collateral contracts have been restructured since 2011, it is unlikely to cause a liquidity crunch.* But the signaling to the market is still relevant. The US is no longer a bastion of pristine credit quality.

*Bianco Research points out that after S&P downgraded US debt to AA+ back in 2011, many financial contracts reliant upon US credit ratings were altered. That is, contracts for trades that use US debt as collateral no longer were contingent upon the US being rated AAA. Rather, the collateral simply had to be labeled as "backed by" the US government. This saved companies/counterparties from having to post more collateral in the event of a debt downgrade. The old contract system posed a serious threat to market liquidity.

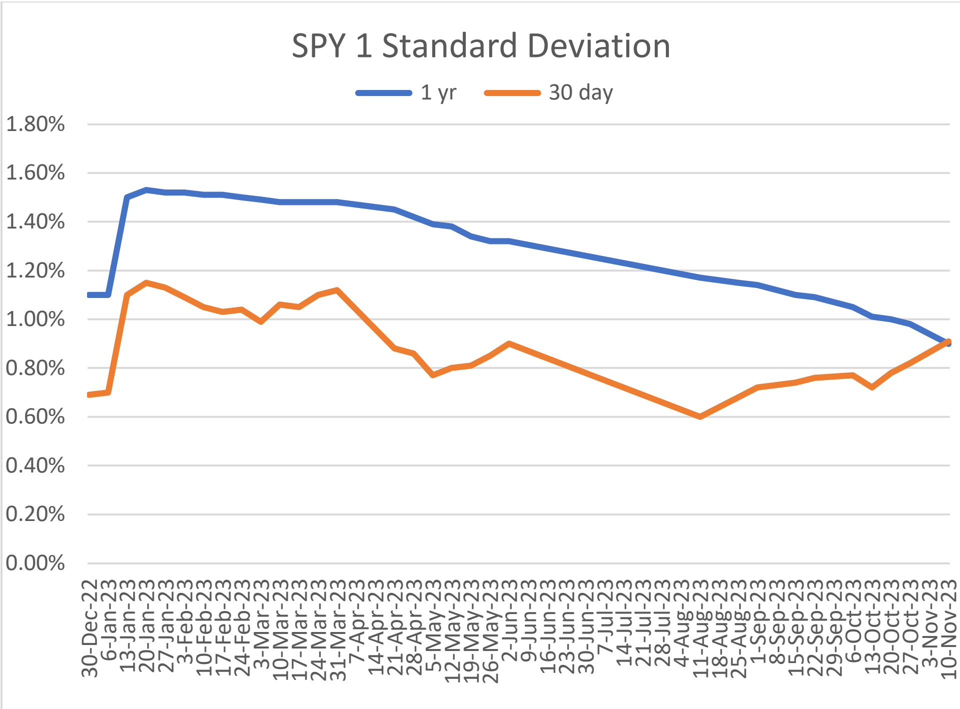
- Nobody is hedging

We often go down the rabbit hole of positioning. While we like many of these data points and the contrarian signals they can deliver, they are too many that often collide with each other. But one of the purer ways to monitor the mentality of the market is the SkewDex. It is an index quantitatively derived from market prices : It measures the level of Skew in the options market. That is, what is the difference in implied volatility between at-the-money options (ATM) and out-of-the-money options (OTM). The lower the Skew, the more risk the market is willing to bear (measured at 1 standard deviation). Put another way, people just do not want to buy protection (and thus OTM options are cheap). Skew has been low all year, but it is making new lows now (not the best chart in the world).



- Volatility is giving mixed signals

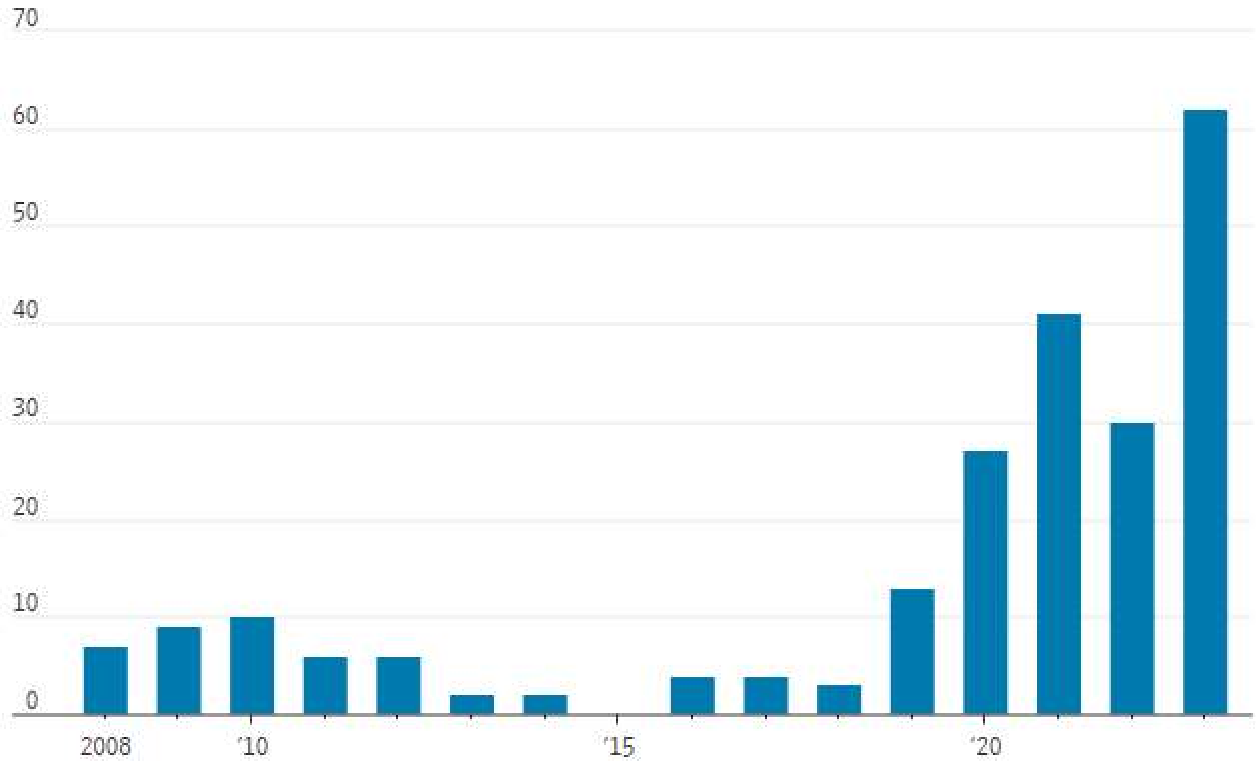
An interesting observation in the Volatility market is the crossing of the 1-year and 30-day standard deviations. We have talked about these two coming close, but they have finally crossed. On the flip side, the VIX futures curve is still in contango (lower Vol levels in the near term, higher Vol levels out in time) which is the opposite shape. Translation: The market's expectation of Vol is different (too low) than the actual Vol in the market. We think this will make for a good set up to buy protection (but we will wait for the euphoria to calm down). Volatility is important but not getting run over on price trumps all.



- Commercial Real Estate foreclosures are ramping up

The Wall Street Journal ran a story about an increase in foreclosures on commercial real estate projects. These UCC loans (Uniform Commercial Code) are often mezzanine debt. The catch here is that when these loans are not repaid, they do not have to go through the rigorous process of a formal foreclosure. The WSJ acknowledges the data is not terribly robust as it could only find the number of foreclosures (which has jumped) but not the value of these busted loans. But the real meat of this story is that these loans are often (if not always) layered on top of preexisting debt. And this layering goes on more than once. This is the kind of stuff that can knock down all the dominoes. Regional banks hold the bulk of the original loans. But private equity and other nontraditional lenders are heavily exposed, too.

Number of UCC foreclosure sale notices for commercial property loans



Note: The Journal counted uniform commercial-code foreclosure-sale notices for commercial property loans published in national and regional newspapers between Jan. 1, 2008, and Oct. 31, 2023. When a loan had multiple notices, we counted only the first.

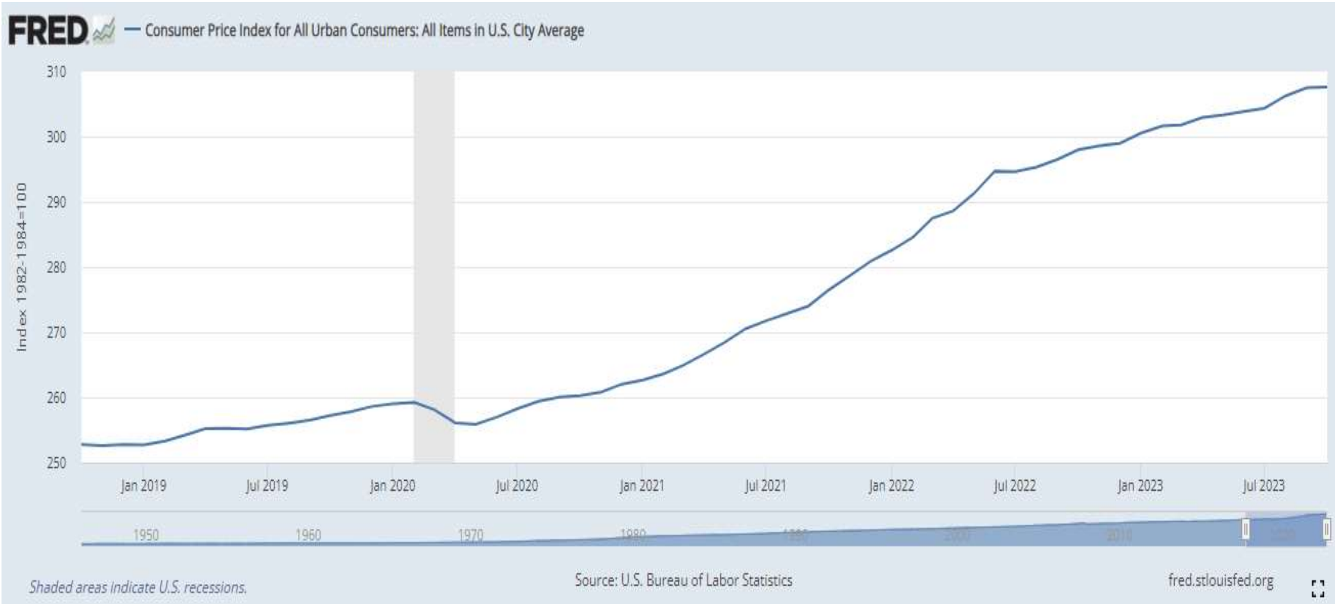
- Inflation cools, but prices are still high

There was no growth in Consumer Prices (CPI inflation) in October vs September. This 0% inflation compares nicely, obviously, to the 0.4% growth last month. This brings the annual increase down to 3.2%. The Core CPI is still increasing with a 0.2% gain. But this was cooler than the 0.3% September increase. The annual increase is 4.0%.

Core Services ex-Shelter, the carve-out that the Fed has said it watches closely, accelerated from 3.74% to 3.85% (annual rates in Sept and Oct). Shelter slowed from a 0.6% gain in Sept to a 0.3% gain in Oct. To be clear, the Fed is looking at a subset making inflation look *higher* than it really is.

Other than decreasing Energy prices (except for Electricity which is still on the rise at 2.4%), the deflationary standouts are Used Cars, Airfares, and Medical Care. Food prices have an interesting split. Food at Home is increasing at a notably slower rate (+2.1%) than Food Away from Home (+5.4%).

For reference, here is a simple chart of the Consumer Price Index. Price growth might be slowing, but the index Is still up about 20% in five years.



On a side note, some of the vocal bears (and suffering bears…we sit somewhere in the middle with our barbell approach) out there are pointing to the 34% drop in Health Insurance prices as a warning signal that this inflation data has been manipulated. For sure, it seems outlandish. And this drop accounts for a drag of 0.18% on inflation. And we know the government has revised down its labor data for nine straight months…so it is wise to be skeptical. But the fact of the matter is that this 34% drop is for Health Insurance administration costs. This is not meant to represent the price of the monthly premiums we pay.

- Retail Sales turn negative

Retail Sales in October fell 0.1% vs September. This was the first negative monthly reading since March. But September Sales were revised higher to a gain of 0.9% from 0.7%. Not much has changed in the industry breakdown. Health & Personal Care stores (like CVS) were the biggest gainers. Home Furnishings are still the weakest. Electronics did report a better showing with a small gain. Apparel was flat which is an improvement.

- China data is mixed

China data is all over the board. Retail Sales had a strong bounce in October with a 7.6% gain (vs 5.5% annual gain in Sept). Industrial Production improved a tick to 4.6% growth. But Fixed Asset Investment decelerated to 2.9% from 3.1%. Inside of this data, Manufacturing was strong with a gain over 6%, but Real Estate plunged over 9%. And ominously, deflation is taking hold.

- Where did all the crypto money go?

There is a good chance this is parody. Then again, that could be said for most things crypto. An enthusiast spent $43k (real money) to buy Springfield Punks (fake money). Apparently, the Springfield version of the CryptoPunks was born out of an episode of the Simpsons. The show lambasted all things NFT and crypto. But this spotlight was supposed to follow the PT Barnum maxim. Alas, our crypto enthusiast was less enthused. (For what it is worth, as much as we laugh at crypto things, we have always valued the idea of the blockchain. Even NFTs, nonfungible tokens which are mostly pure lunacy, could serve a real purpose in authenticating all sorts of property like photographs and artwork.)

Pinned

BatDad
@realbatdad

I bought 50 Springfield Punks at .45eth (~43k) because I saw the Simpsons episode and thought these would be the next Cryptopunks.

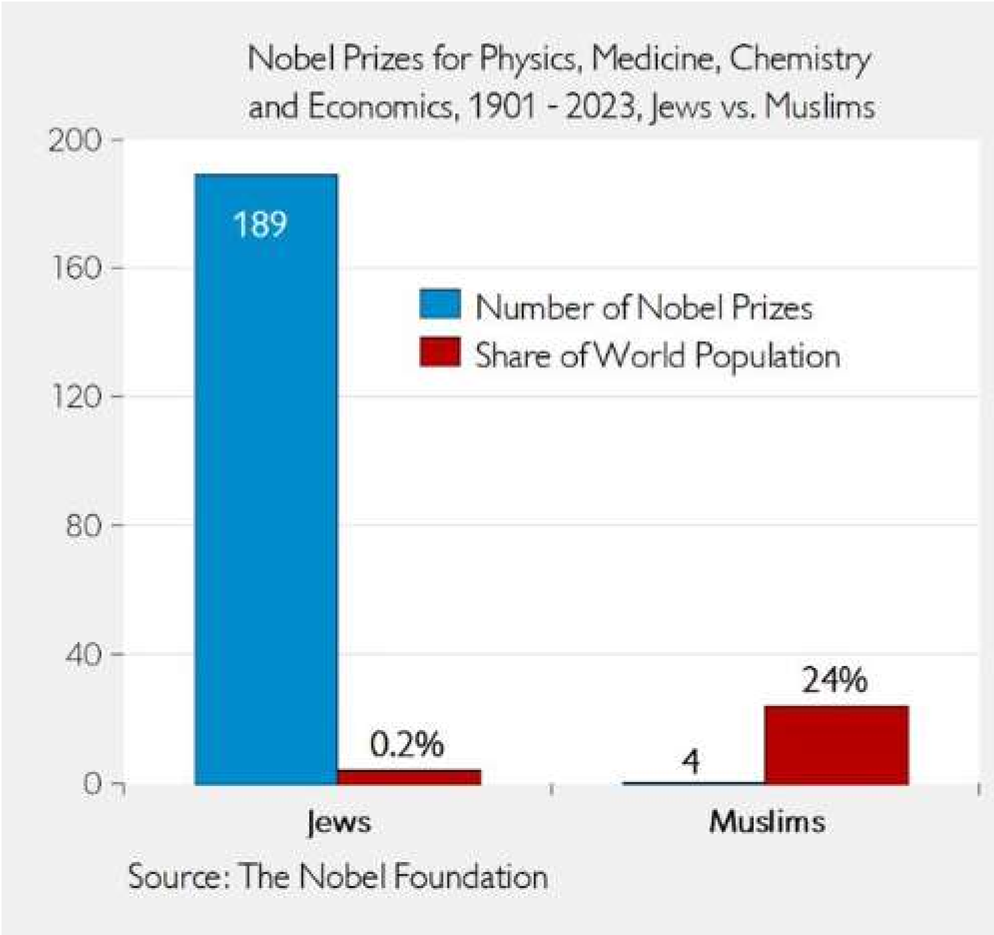
I just sold them for 0.07eth each (~6.6k).

NFTs need regulations, this is ridiculous.

7:45 AM · Nov 7, 2023 · **212.8K** Views

- Chart Crime of the week

We are not sure which side of the Gaza war debate this data falls (not that we think there is a debate at all, of course). We highlight it because of the awful scaling and combining of the units.



- Quick Hits
  - In response to the idea that the carcass of FTX might be sold and revitalized, the chairman of the SEC, Gary Gensler, said, "it could operate successfully provided it adhered to the law." What would we do without him.
  - Multiple attendees of ApeFest, a Bored Ape Yacht Club NFT event held in Hong Kong last week, have been diagnosed with photokeratitis. The festival tried to replicate the "laser eyes" associated with NFTs and crypto holders on Twitter. The lesson: don't stare at UV laser lights at Ape festivals.
  - The media reported "ChatGPT eats away at Google search's dominance." Google traffic fell 0.4% and its market share remains flat at 91.6%. "Eats away…"
  - The coffee bean futures market is making a rule change. In the past, one could only keep coffee at the exchange warehouse for a fixed amount of time. After all, the exchange had to ensure the freshness of the beans it was obligated to deliver. But one could remove the old coffee beans and resubmit them for "certification." They were instantly fresh all over again!
  - UK cabinet members must be a baron to serve if they are not an elected MP (member of parliament).
  - The Rutgers football team takes the field to the Soprano's theme song.
  - Crocs is making a series of Grimace clogs.

- K-Mart Australia was selling a refrigerator bag for Christmas hams. K-Mart is no longer selling this product after it was pointed out that the bags read, "Merry Ham-Mas."\
- California Governor Newsom on Chinese communist leader XI's visit to San Francisco: "I know folks say, 'Oh, they're just cleaning up this place because all those fancy leaders are coming into town.' That's true because it's true."

Trading: We used the blip in the market when people thought Powell was being hawkish to unwind some Put protection. We obviously did not expect the insane rally in the profitless crap that unfolded. And of course, we wish we had unwound more as we lost money on every single bit of protection that we still held. But this was more than offset by our longs in select Big Tech. Our riskier longs also benefited. But we still have a cash drag. But we continue to deploy this on dips (for longs) or crazy rallies (with Puts). Energy is the one area in which we are flummoxed. We like the supply side challenges and the strong management teams with whom we have invested. But we also know the market is telling us there is a demand problem. So while we added a bit last week, we will continue to be very selective.

TSLAQ: One of the big advantages Tesla has enjoyed over the years is nonunionized workers (the other big advantage has been zero marketing dollars…if you exclude the $44b Musk dumped into Twitter.) But that might be coming to an end as Biden declared that all US auto manufacturing should be unionized. We are not sure what the administration can do directly. But Biden can certainly make life more difficult. He already tried to prevent Tesla from receiving subsidies created in the Inflation Act. Given Musk has been walking on the razor's edge for quite some time now (he first started to really speak his mind during the Virus Fear), we think there is a nonzero chance of this happening (the union heat being turned up).

Check out our website to learn more about Chalk Creek Partners

Carlisle's Twitter Financial List

Carlisle's LinkedIn