Weekly Update

14-Sept-2022

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- This market denies facts until it cannot
- Celebrity financial-inanity is the ultimate tell
- Volatility is acting strangely
- Market Insurance (or lack thereof) is another example of bullish positioning
- Inflation is not going away (not yet anyway)
- Employment really is a lagging indicator (again, not just us saying this)
- China is a mess
- The Fed beat goes on, the ECB joins in
- Oil really is being manipulated
- Quick Hits
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	3,946	-0.9%	-16.6%	-10.4%
QQQ	$296.01	-1.0%	-25.4%	-20.9%
US 10 YR	3.41%	3.27%	1.51%	1.30%
USD/DXY	109.7	109.5	96.0	92.6
VIX	26.2%	24.6%	17.2%	18.2%
Oil	$89.06	8.6%	17.6%	25.6%

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

The theme imbedded in the market over the last two months has been one of denial until slapped in the face. The latest iteration was the market bouncing after some market weakness following Fed chairman Powell's hawkish Jackson Hole speech (higher rates for longer until we squash inflation…recession be damned). The narrative had twisted back into: "The market has priced in all the pending rate hikes. Inflation was cooling. The Fed will come to its senses and "pivot"". Of course, all of this was contrary to Fed statements, and none of this was based on facts. And then we got the August inflation data which served as the third-handed slap across the face. None of this is too shocking considering the buying has been emotional: Panicky short-covering, "this time is different," even peace in (the) Ukraine! But the selling is more fact-based: Profitless companies will remain profitless, Employment is a lagging indicator, Personal Savings has plummeted while credit card usage has skyrocketed, Earnings are slowing, the European winter is coming, etc.

- Celebrity financial-inanity is the ultimate tell

Barron's long-running column "Up and Down Wall Street" highlighted celebrities's uncanny ability to buy the top in fields outside of their "talents." Kim Kardashian starting a venture capital firm very well could be the straw that breaks the camel's back (her sister Chloe at least sells a ton of products).

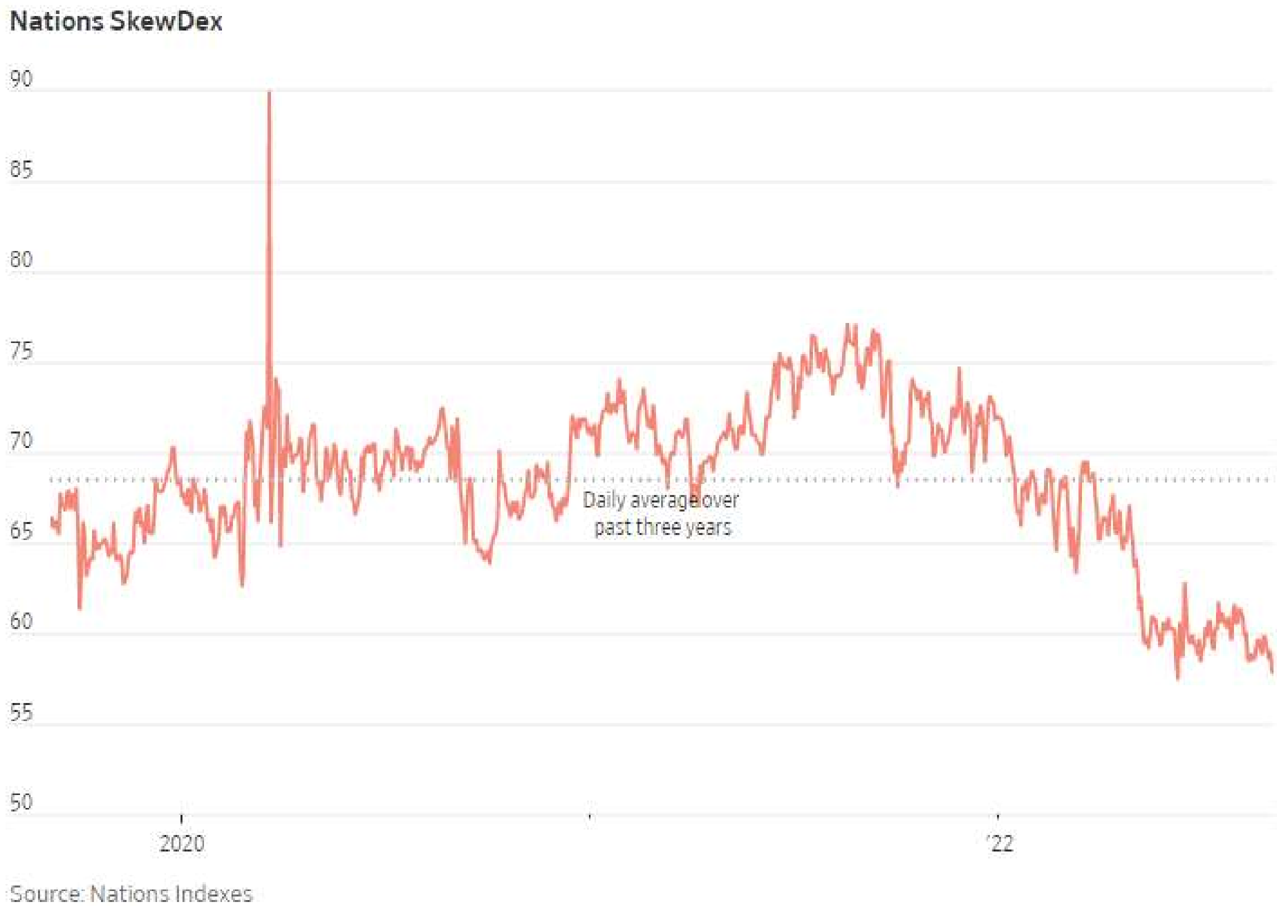
- Volatility is acting strangely

We had two anomalous occurrences in the Volatility world this week. On Monday, we saw the VIX (Volatility index) move higher by over a point while the market was moving 1% higher. This is rare as the VIX represents fear in the market…they should be inversely correlated. And the next day we got the 4.3% drop in the S&P. And this was the largest drop in the market ever with the VIX below 30. Experience tells us something is awry. (The VIX in its current firm has only been around since 2004. Recall Mark Cuban is credited for its creation insofar as he was the first to want to trade such an instrument.)

- Market Insurance (or lack thereof) is another example of bullish positioning

There has been lots of talk recently about the market having loaded up on Put options along with lower exposures. We found two good refutations of this false narrative. For starters, the data is lopsided in only showing single-stock put options. Index options are a giant piece of the pie to omit. And the other left-out angle is this increase in Put buying is mostly on at-the-money or in-the-money options. These options cost more in terms of premium (the misleading narrative chart showed net premium exposure), but they provide no real optionality. That is, they do not protect against tail risk. In other words, people are making relatively flat bets – equal risk/reward with small percentage payoffs – as they are not afraid of a steep decline. They are positioning for a shallow trough or at least a slow bleed. We think there is a decent chance at the latter and very little chance of the former.

Here is the Nations SkewDex which shows the price of Put options on the S&P 500 that are far out-of-the-money (ie they protect against tail risk or outlier moves). It's the lowest in three years and near the lows since 2013 (when the index was created).



➢ Inflation is not going away (not yet anyway)

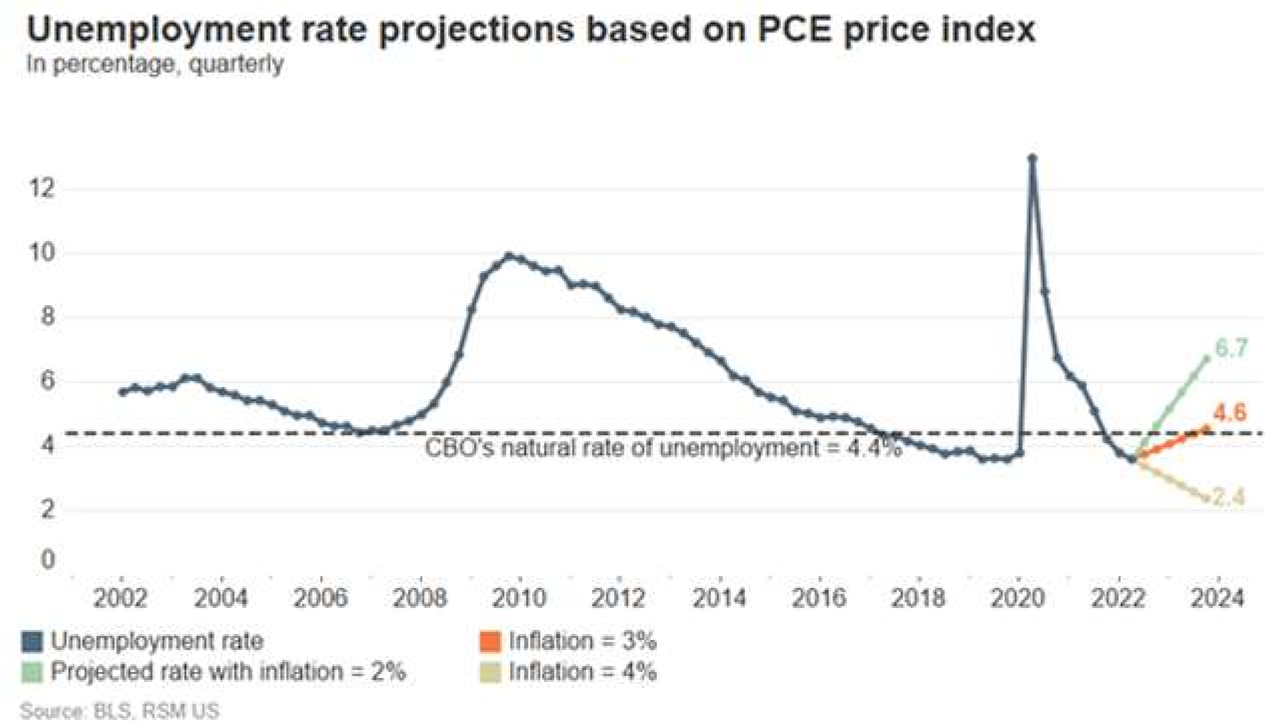
August Inflation as measured by the CPI came in slightly hotter than expected. Prices grew 8.3% annually and 0.1% vs July. This annual rate is a slight cooling from the 8.5% in July, but that is not much solace. The "core" inflation rose 6.3% annually with a 0.6% increase vs July. Basically, gasoline prices are falling while everything else is still increasing (more below on oil/gas). This is a slight exaggeration as used car prices and airfares have both come down also. But prices for food, shelter, electricity, natural gas…you name it…are all higher.

The PPI (wholesale/input prices) led consumer prices as is usually the case (much of this relates to there not being a shelter component in PPI…shelter prices often lag). Energy prices cooled pulling down the headline from 9.8% in July to 8.7% in August. But the "core" increased from 7.1% to 7.3%. We often poke fun at the notion of "core." But the last few months are the reason it exists. The Volatility in food in energy is extremely high. We still think the headline is more important (but the Fed disagrees, and that is what counts).

The Atlanta Fed's Business Inflation Expectations survey for September does provide some hope with the 1-year expectation being 3.3%. This is obviously relatively low, and it is dropping (3.5% in August). Alas, conversely, the Cleveland Fed's 1-year inflation expectation (not survey based but rather market based) is 4.2% and rising.

➢ Employment really is a lagging indicator (again, not just us saying this)

RSM, an economics research shop, has plotted what they perceive to be the balance between Inflation and Unemployment. The more the Fed hikes rates to squash inflation, the higher Unemployment would have to rise (logically). If the Fed is hell bent on getting inflation back to their 2% target, then Unemployment will likely rise to around 6.7%. This would not be a mild recession. Of course, we call economists "professional guessers" for a reason. Nonetheless, RSM does serious work and while the direct spots on the curve are crapshoots, the direction of the curve is undeniable.



Jobless Claims ticked lower again. One funny explanation for this improvement was that all the Crypto Bros had to get back to their real jobs.

We often say that employment is a lagging indicator. Last week we showed the data supporting this insofar as the bottom of the market was roughly 13 months after the first uptick in Unemployment. Adding to our thinking (we believe it is becoming more mainstream), John Mauldin (an economist we often read and cite) explains that one component of the Employment survey is flawed almost by design. When the government goes to count jobs at businesses, it must estimate jobs at new businesses (the government does not know who to call) and failed ones (nobody to call). This is called the birth/death model. According to Mauldin, "the model will understate jobs during the beginning of a recovery and overstate jobs early in a recession."

- China is a mess

China's CPI turned negative in August. The annual rate is now 2.5%. The PPI (wholesale/input prices) remained negative on the monthly reading. The annual rate fell to 2.3%. Energy prices are the main contributors to the slowing prices. Do not be fooled by this data. This disinflation (soon to be deflation) is a result of the economy being ground to a halt. The Covid lockdowns were not based on Covid at all. That was convenient cover for the government's attempts to control inflation. Nothing leads to disruption among the masses like inflation. Being able to blame the lockdowns on Covid and the West was gravy. But the point is, to be experiencing quasi-deflation while the rest of the world has exploding prices means your economy is really suiffering.

China Evergrande has promised to resume building all its stalled projects. Basically, customers stopped paying for their unfinished homes and were protesting in the streets. This is completely uneconomical for Evergrande. But it clearly got tapped on the shoulder (profits don't matter, just stop the unrest).

- The Fed beat goes on, the ECB joins in

More Fed speakers joined the piercing chorus. For starters, chairman Jerome Powell reemphasized, once again, his desire to keep hiking rates. He cannot be any clearer.

Fed Governor Christopher Waller chimed in saying he supports another "significant" rate increase next week with the context being that the inflation has not cooled "meaningfully and persistently." Specifically, he thinks rising rents might not really kick in until next year, and the labor market has to see a dramatic decrease in jobs to affect wages. He indicated that 4% (on the Fed Funds effective rate which can vary slightly from the target rate) seems to be the pivot point (2.33% as of yesterday).

Esther George of the Kansas City Fed delivered some Fed-speak with, "economic constraints pushing inflation are likely to be with us for some time." She highlighted the decline in Labor Participation pushing wage inflation in addition to structural changes in many Services post-virus-fear.

And Loretta Mester (aka Carol Burnett) of the Cleveland Fed reiterated her call for short term rates to hit 4% "sooner than anticipated."

One of the holdouts among the ranks of the professional guessers was Goldman Sachs. It persistently refused to accept that the Fed would keep hiking rates into a recession. GS finally cried uncle and upped its rate-hiking forecast.

In Europe, the central bank (ECB) hiked 75bps. We once thought this was impossible. But the impossible situation is only getting worse. And the fallout will be worse. We discussed this last week – the energy shortage is about to wreck sovereign balance sheets across Europe which will outweigh any modest interest rate moves. The electricity subsidies across Europe are just another fiscal boondoggle that will not be able to prevent any recession. We are comfortable with our long USD position.

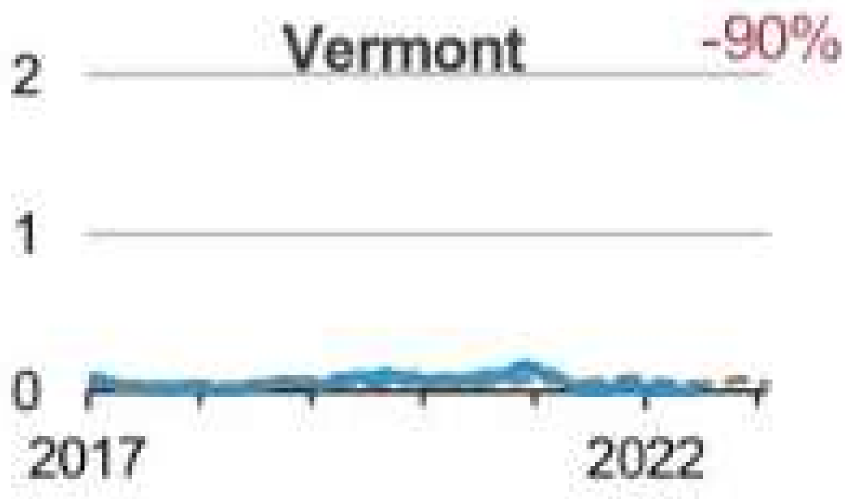
- Oil really is being manipulated

The media is finally catching on to the reason behind the falling gas prices: The government's thumb on the scale. About a third of the Strategic (Tactical) Petroleum Reserve's 650mm barrels of crude oil have been sold into the market. This is part of the government's stated plan to push down gasoline prices. Coincidentally (or not), this program is slated to sell 1mm barrels of oil per day through October…right before the midterm elections.

Of course, some of this oil being released must be bought back by the government since the sales were executed as swap agreements. And much of the oil sales that were done on an outright basis still need to be reversed to get the SPR back to a comfortable level. But the market was overlooking this obvious fact (emotions in control again). Well, at least until the government could not help itself and started blathering about buying back oil around $80. So, what happens immediately? $89.

- Chart Crime of the week

This "chart" was presented as evidence that petroleum distillate inventories in some New England states have fallen to low levels. Perhaps the proper context should have been that some states have always had low stocks of distillates?



- Random Quote of the week

When Anthony Scaramucci was asked why he wanted to sell part of his firm to a crypto platform:

He said he proposed lunch to discuss the possibility of a partnership, as well as to avoid going to a water park with his children. He was initially looking to sell just 15 per cent of his fund group.

- Quick Hits
    - Revlon bondholders who were accidentally paid back by Citigroup have seen their fortunes reversed in court. Recall Revlon and Citi were trying to screw over certain bondholders...the ones they accidentally paid. They had to give the money back.
    - Oberlin College has agreed to pay a bakery just under $37mm for defamation from false racism claims.
    - Piper upgraded Carvana along with the line, "we know that bankruptcy is a real possibility."
    - The US government and the crypto analytics firm Chainalysis are touting their recovering of $30mm in stolen crypto from online video game Axie Infinity. They have $590mm more to go.
    - The Netherlands is enacting (enforcing?) a five-minute limit on showers.
    - Li-Cycle, a lithium battery recycler, reported negative revenue in its most recent quarter. We thought Plug Power had the market cornered on negative revenue.
    - The CEO of RH (fka Restoration Hardware) commented on his earnings call that "if you do not think we are in a recession, then you are crazy."
    - The White House is looking into banning Bitcoin mining.
    - Ethereum, the rival to Bitcoin in crypto land, has "merged" into a new blockchain. It is now centralized with unlimited supply. Some call this thesis drift (original benefits were decentralization and limited supply).

Trading: Before the CPI print, we bought some Puts on European banks, Big Tech, and Consumer Discretionary. These were all incremental moves. We will add more if this recent bout of selling somehow turns into another bounce. Having written this, we will also monetize some of the more fringe bets if the market remains under pressure. One of our mistakes from July was not taking some profits when presented with the opportunity. We also added a small bit to our Energy long right before the do-do birds turned over their cards. We also bought a little more Twitter (more below). This is still a small position because we do not underestimate Musk's ability to squirm out of any hole.

TSLAQ: Bob Iger, the former CEO of Disney, chimed in on the Twitter battle. He said that DIS backed away from its courting of TWTR because of the excess bot issue. He did not quantify "excess." And there is a new revelation in the "whistleblower" out to get Twitter. In late June, he agreed to a $7mm settlement with Twitter after being fired in January. He signed an NDA (non-disclosure agreement). He then filed the whistleblower claims just a few days later which gave him the legal protection for violating the NDA. And the much-ballyhooed congressional testimony by the whistleblower (who told congress most people call him Mudge) revealed pretty much nothing: Twitter is a bad company with loose internal controls. That is probably why 98% of shareholders voted to sell it to Musk. We bought more Twitter. As for Tesla stock itself, almost $20b worth of Call options expiring in two days traded today. We suspect one day it will come out (in court) that Musk was behind much of the option shenanigans in this stock.