Weekly Update

6-April-2022

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- The Fed ends the squeeze
- Valuation matters more when inflation is hot
- Russia is losing the economic war
- Positioning gets longer…right at the wrong time
- Employment Report: more jobs, more workers, more lookers, more money
- Inflation may not be everywhere, but it is in the minds of consumers
- Fed-speak tightens the markets some more
- Oil is still supply constrained do matter what governments tell you
- Quick Hits
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	4,481	-2.6%	-5.7%	11.3%
QQQ	$353.26	-3.8%	-11.1%	7.2%
US 10 YR	2.59%	2.35%	1.51%	1.67%
USD/DXY	99.6	97.8	96.0	92.5
VIX	22.1%	19.3%	17.2%	17.2%
Oil	$107.47	-10.0%	28.0%	62.2%

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

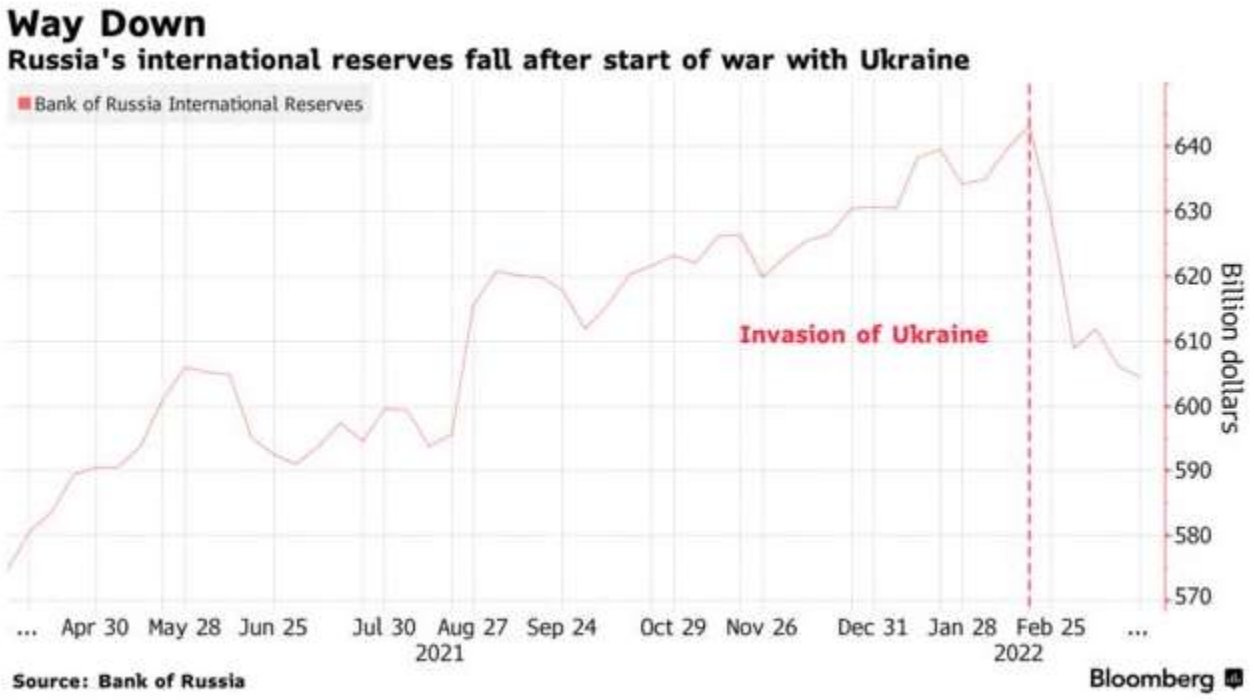
It sure seems like the market squeeze is over as the market finally wobbled a bit. We still are not sure why there was the sudden two-week surge in buying. Not much has changed in Ukraine…either to drive the market higher or to hit stocks lower. But what has changed is the Fed's rhetoric on interest rates: More rate hikes are coming, and aggressive unwinding of the balance sheet (selling bonds) is imminent. People say the market hates uncertainty. But what it really hates is the certainty of negative actions. And it is likely that much of the equity buying and bond selling was quarter-end rebalancing and other technical factors at work. While these flows are certainly real, they by nature are not sustained.

- Valuation matters more when inflation is hot

Morgan Stanley research shows that over the past 70 years, when the CPI runs between 6% and 8%, the S&P 500 P/E averaged about 12x. Today we are closer to 20x

- Russia is losing the economic war

Despite sky-high natural gas and metals prices, Russia is still hemorrhaging international reserves. It has a large stockpile, of course. But pressure from the West is mounting. The US has essentially frozen all USD deposits in the US belonging to the Bank of Russia (the central bank). The idea here is to force the government to miss international debt payments. We are not trying to get into the political weeds here. But if the West wants to win the war, it will have to tolerate some economic pain in the form of inflation (more on this below).



- Positioning gets longer…right at the wrong time

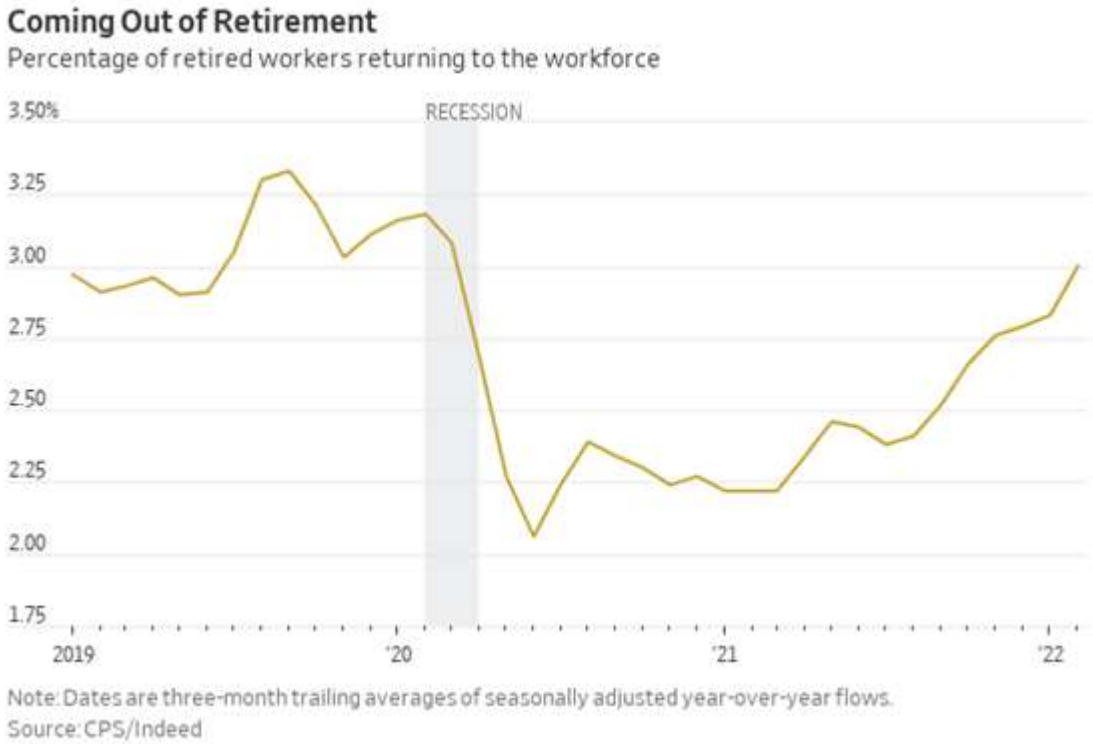
Just before the market started to rollover, sentiment indicators were working their way back to neutral territory. Goldman's indicator is back under 1 z-score of historical positioning- broadly neutral. Equity Inflows had their strongest week in a while with the percent of assets increasing by double the recent level (0.11% vs 0.06%). And JP Morgan, who called the short squeeze correctly, continues to say positioning is light and there is more room to the upside. And right on que…right when everyone capitulates and says things are just fine, the bottom falls out again (this might be overstating the recent correction…we shall see.)

- Employment Report: more jobs, more workers, more lookers, more money

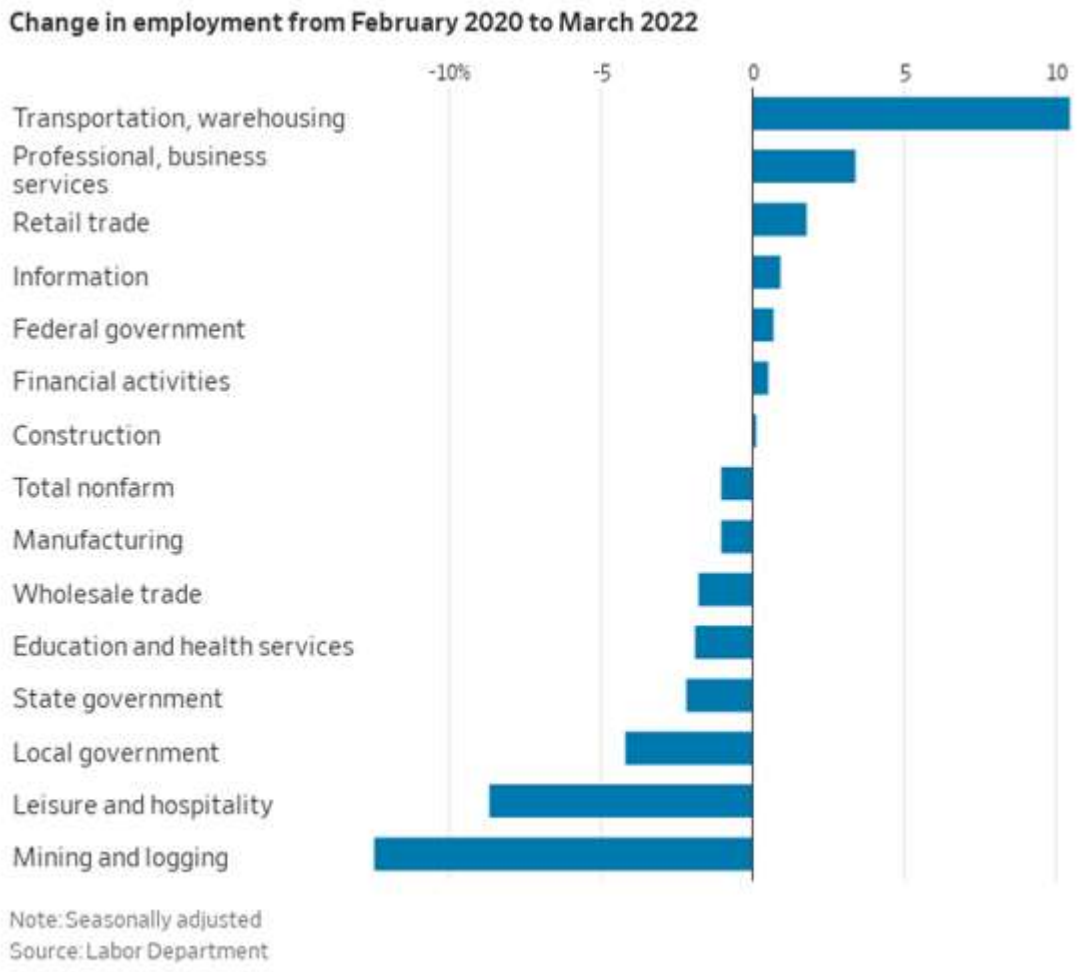
The Employment Report showed more job gains, more people back to work, more people looking for work, and higher wage gains. The headline number of new jobs did miss expectations (431k vs 490k), but there were positive revisions to January and February numbers (+95k). The Unemployment Rate dipped to 3.6% from 3.8%. The Participation Rate ticked higher to 62.4%. And Average Hourly Earnings moved higher to hit a 5.6% annual increase. The Average Workweek shortened a touch as the only real negative in this report.

The number of people that are out of work because they are "sick" or caring for someone who is "sick" has plummeted in two months. In January, the number was 8.8mm. In early March, this number fell to 2.8mm. Women made up a large part of the increase in the Participation Rate. Maybe, just maybe, the ridiculous virus-

fear policies forced upon schools and working moms might finally be lifting. And the Great Resignation might have just been a temporary thing after all (Family Guy!).



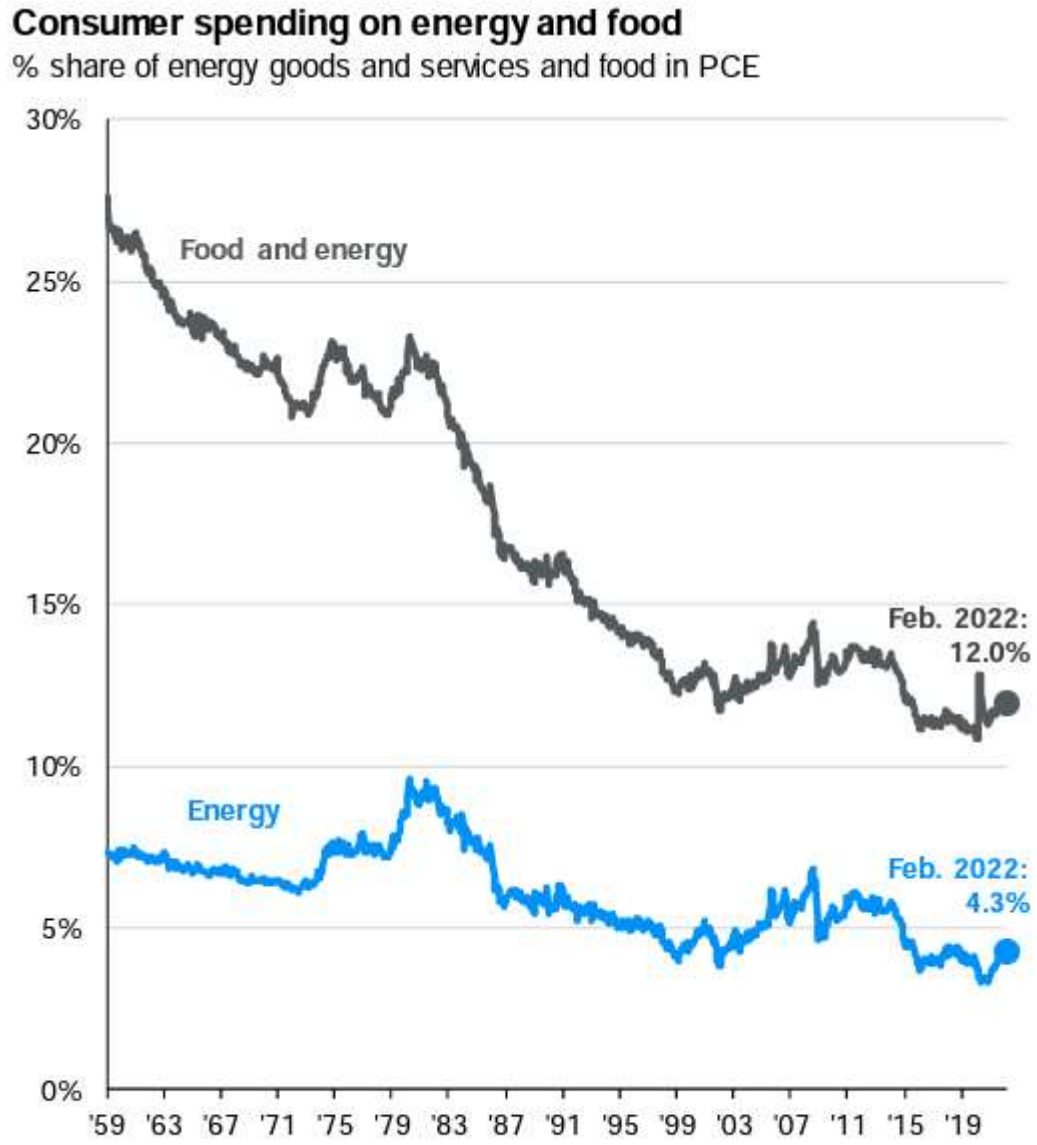
Overall, this report reads very positively. But as we have noted, the Labor market always lags the economy: Employers hire high and fire low. We think the Labor market is another example of a cannot-win situation. More potential workers might be emerging, but this could depress wages. This is especially true as the Savings Rate remains below the pre-virus-fear level (6.3% now vs 8.5% then vs 33.8% at the peal of the April 2020 fear). And with the disconnect between lost jobs and open jobs, inefficiencies might remain. Think of it this way, that out-of-work waiter cannot easily transition into a truck driver.



- Inflation may not be everywhere, but it is in the minds of consumers

Inflation is still running hot to nobody's surprise. The Fed's preferred inflation gage, the Personal Consumption Expenditures (PCE) Price Index, increased 6.4% in February vs last year (it increased 6.1% in January). The monthly increase was 0.6%. The "core" reading (which strips out food and energy, ha!) increased 5.4% which is up from 5.2%. But the monthly gain edged a touch lower to 0.4% from 0.5%.

But there continues to be data pointing to some relief. For starters, consumers spend much less on Food and Energy today compared to modern history. And Merrill tells us that only 22% of "core" prices are above their pre-virus-fear levels. 72% of prices are "close to trend." This is similar to the trimmed mean and other adjusted inflation figures produced by regional Fed banks. And the broad based CRB Index of commodity prices has flattened out over the last month (while still elevated with heightened levels of Volatility).

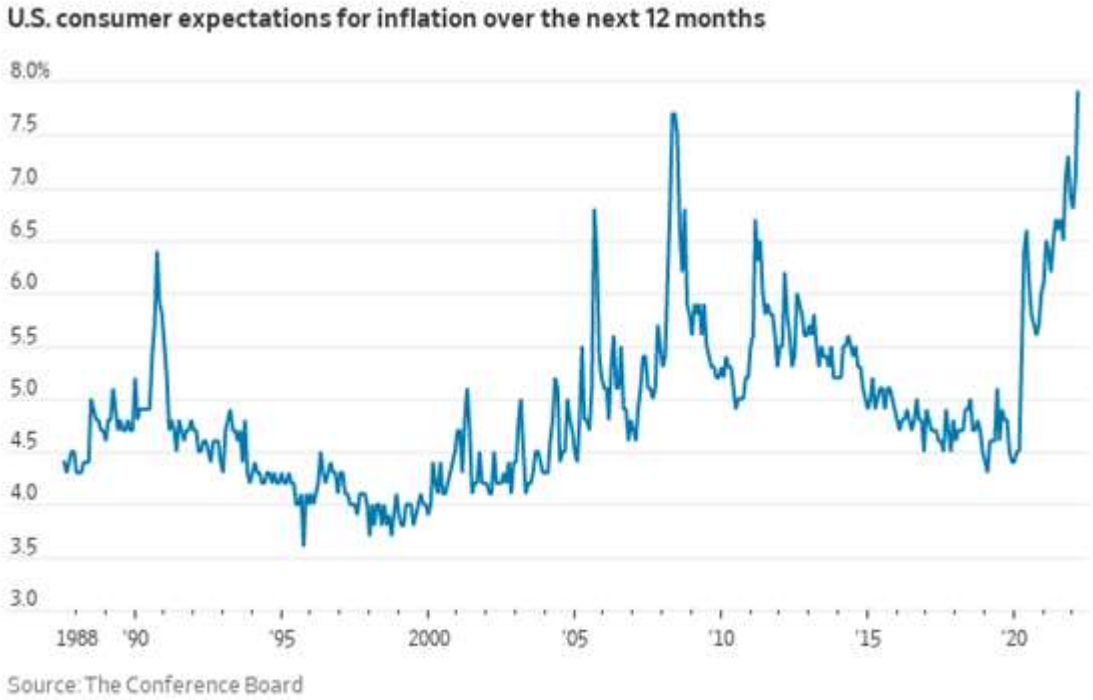


Source: BEA, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of March 31, 2022.

And the much talked about semiconductor shortage appears to be easing a bit. Bloomberg highlighted that GPU prices are finally starting to ease…or at least some of the specialty items used in gaming (they all tend to move in tandem). The price for these microprocessors has been cut in half over the last year.

NVIDIA GeForce RTX 3080 Founders Edition Graphics Card.

But do not tell consumers this. For starters, Food and Energy prices matter more for the psyche than the percentages would indicate. And politicians are doing their best to keep inflation roaring – they are the kings of unintended consequences. From gas-rebates to the extended moratorium on the repayment of student loans (there have been four extensions, two under Trump), free money will always support inflation. And the doom and gloom cycle has all sorts of anecdotal evidence. Over 11mm egg-laying chickens have recently died from the bird flu (about 3% of the flock) obviously boosting egg prices.



- PMIs diverge

The two main Purchasing Managers Indices diverged in March. This is no surprise as the Markit survey is more domestically focused while the ISM incorporates more global businesses. The Markit Manufacturing PMI for March was strong as expected (the early Flash reads are more important now as they have been proven to be pretty accurate). The ISM reading slipped and missed expectations. Both surveys point to higher input prices and longer delivery times. But we are still surprised at the relative strength of the US-focused Markit survey. Given other recent economic data (slowing housing sales, slowing auto sales, inflation…pretty much everything except the labor market), we suspect March will prove to be an anomaly (and sentiment will reverse lower).

- Europe and China are in the same boat still

Eurozone inflation hit 7.5% in March. But the "core" inflation in Europe is about 3%. This is a much wider spread than in the US. This should be obvious as Europe is short Energy and Food. The European Central Bank (ECB) expects inflation to be 5.1% for the year. Despite utterances from the ECB that rates will stay negative, the market is pricing in 50bps of rate hikes.

China's Manufacturing PMI in March (the private, real one not the fake government numbers) fell more than two points to sit solidly in contraction territory. This is not a surprise given the rolling lockdowns across the country.

- Fed-speak tightens the markets some more

Lael Brainard, the Fed's vice chair, commented that the Fed should raise rates "methodically." This harkened people back to Jerome Powell's use of "autopilot" which caused severe market pain back in the fall of 2018. In fact, Powell has admitted that was a mistake. But now, the Fed is going back to that old playbook. The FOMC Minutes echoed this by pointing towards 0.50% rate hikes (up from 0.25%) if inflation persists. In fact, the only reason why the Fed did not hike 50bps in March was due to the Russian invasion. The Fed will also start to reduce the size of the balance sheet in May. The target reduction is $60b in Treasuries and $35b in Mortgage-Backed Securities (MBS) each month. It will likely take the Fed some time to ramp up to this size/speed. Whatever the case, the Fed intends to squash inflation. Our guess is that it will do what it usually does and swing the pendulum too far in the other direction.

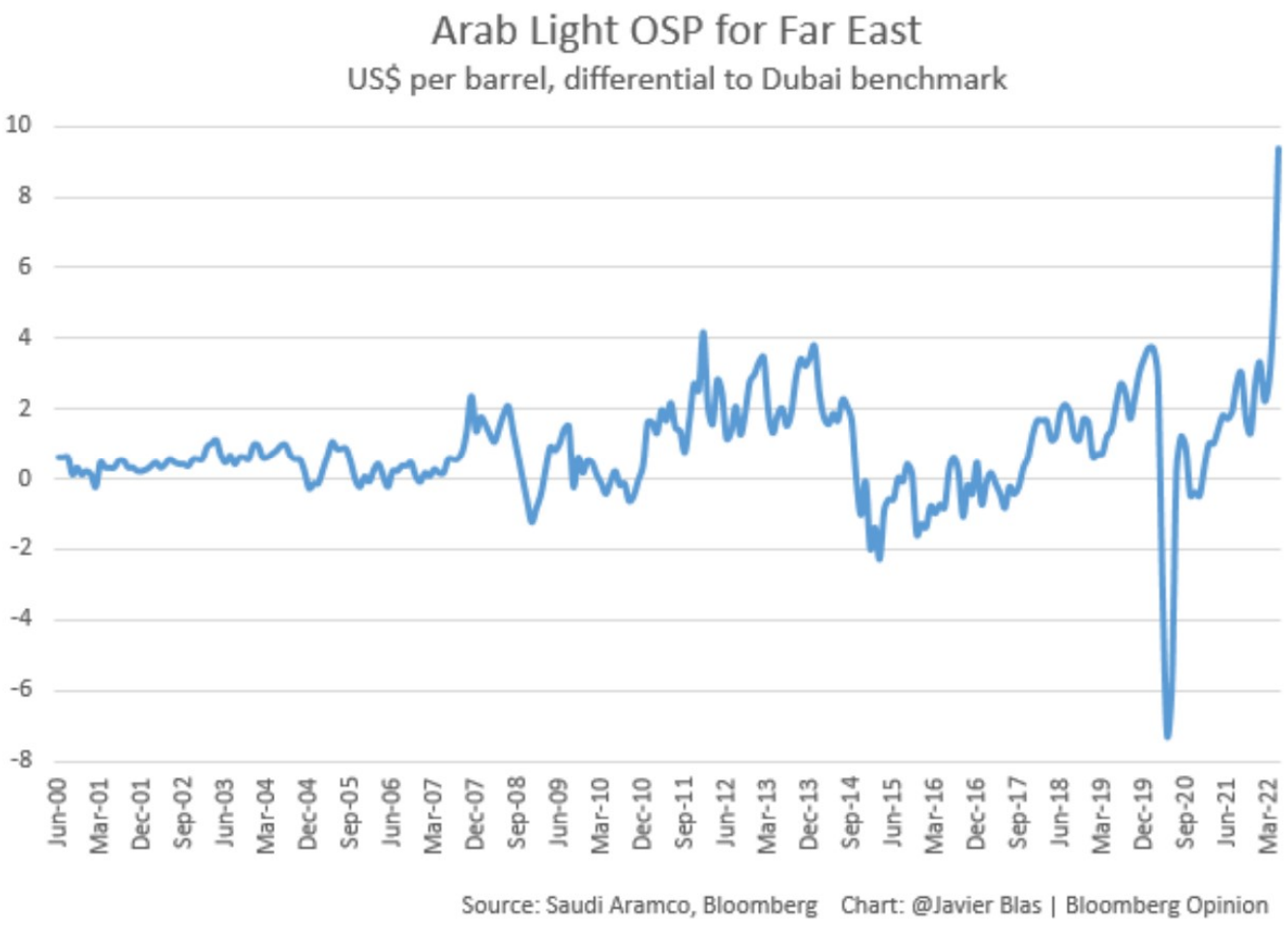
- Oil is still supply constrained do matter what governments tell you

Biden still thinks it is a Tactical Petroleum Reserve instead of Strategic one. But according to oil experts (namely Rusty Braziel), the current infrastructure is not set up to absorb an instantaneous burst of an additional 1mm barrels per day. That is, pipelines and refineries are near capacity. Moreover, the government has not indicated what kind of oil will be released (sweet or sour) and from what storage tanks (there are four large ones along the Texas and Louisiana coasts). All of this matters as the government will technically be auctioning off the inventory. Also, this whole exercise reinforces the position of the large oil producers. Why would they dive in headfirst to produce more right now when the government is actively fighting against them to lower their product's price? It is also worth noting that the price of oil futures out the curve actually *increased*. Other than the market doing the opposite of what government intends, it is quite basic when you consider the government must refill the storage tanks! If the US sells the 180mm, it will be below the level of reserves that the US must maintain following an agreement with the IEA dating back to 1974 (International Energy Agency…the same group that announced a coordinated release of 60mm barrels from global reserves!). Goldman went a step further writing that artificially boosting demand in the short term will only exacerbate the structural supply shortages in the medium to long term.

It is more difficult than ever to believe anything OPEC says. The cartel decided to increase the production growth by 32k a month which brings the target up to 432k. OPEC, led by Saudi Arabia, said the market was "well

balanced" and that the recent price increases were driven by geopolitical events. Most importantly, OPEC/Rogue still expects Russia to be producing about 10mm barrels a day in May. Recall about half of this is used for domestic use (this assumes normal economic activity which is a stretch). And 60% of the other half has been sanctioned (or self-sanctioned). There is no way Russia is going to produce 10mm barrels of oil a day any time soon. Even China said it would not be importing more Russia oil after its current contracts end in the next month. Gas is another story since most of Europe has not sanctioned Russian gas supplies.

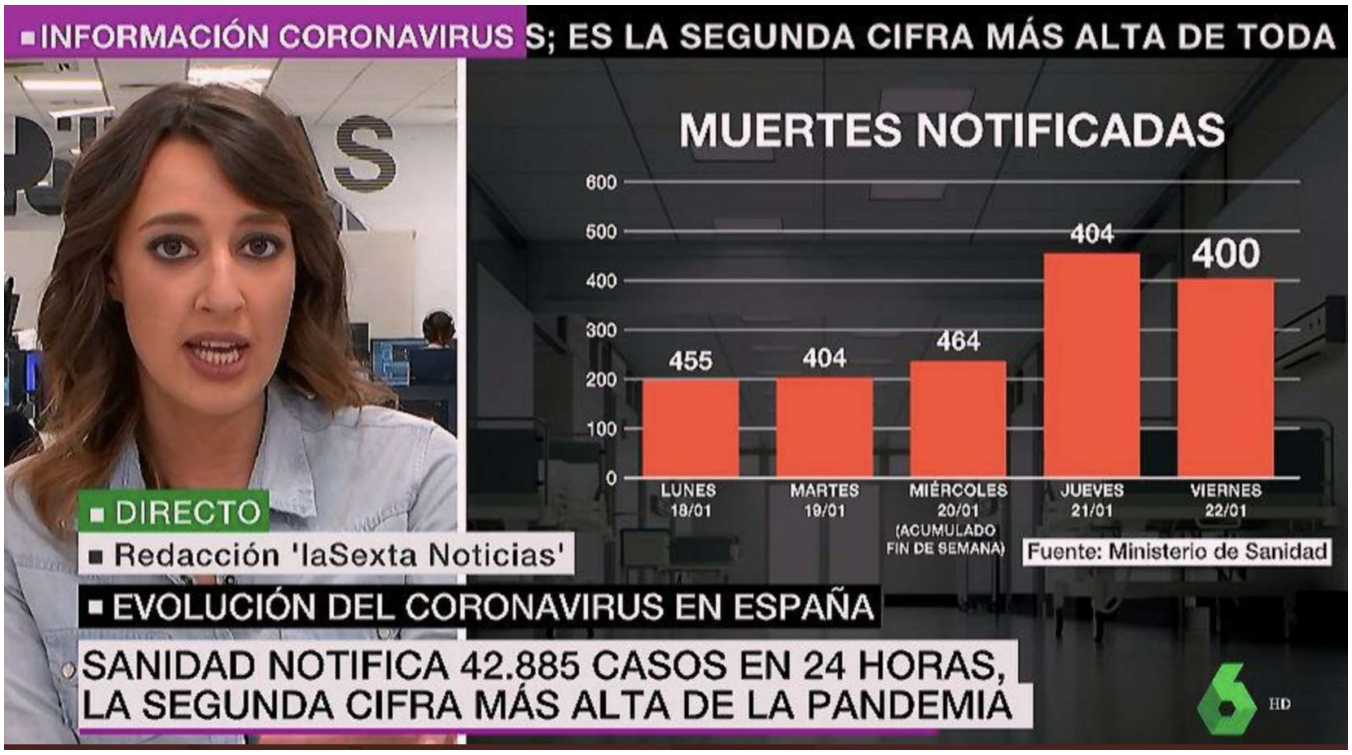
Saudi Arabia thinks that the market is so well balanced that it can increase prices to Asia to a record premium of $9.35 over the Dubai benchmark price!



The Department of Energy's monthly production report for January showed a decline of 200k barrels per day down to 11.4mm bpd. We will not extrapolate too much from this….one could say it is the start of demand destruction from a weakening economy. We are not there yet. But it is something to watch.

- Chart Crime of the week

And we thought the media in the US was dishonest. Spain might be making the Chinese media look unbiased.



- Quick Hits
  - Europe excludes alcohol and tobacco from its “core” inflation reading (in addition to food and energy).
  - The SEC thinks (and is enforcing) that cryptocurrency exchanges should treat customer holdings as unsecured loans.

- The pimento cheese sandwich at The Masters costs $2.17.
- Women's college basketball players earned more through NIL (the loophole allowing college athletes to be paid outright) than men's college basketball players this season.
- Applications for life insurance in 2020 increased at the highest level in 10 years.

Trading: We added a touch more short exposure in Big Tech. We added to some of our risky long names as they deflated quickly. We sold some Call options in Energy. We will likely buy these back if its sinks lower. We got long the Defense ETF as it pulled back from its recent peak. But we suspect war will last longer than peace. But given that we think we are in the middle of the broad trading range, we did not trade very much.

TSLAQ: Only The Bond Villain can get away with filing the wrong paperwork with the SEC and nothing happens. After he bought 9% of Twitter (a new short candidate for us!), he filed a "13-G" which indicates it is a passive stake. He has no intention of trying to influence the company. Apparently, and that is the only way he is legally allowed to do this, he changed his mind the very next day and changed his filing to a "13-D." This means his stake is active and he intends to influence the board or enact change. It is good to be the king.

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