Weekly Update

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- The market is not falling for the narratives (as much)
- Investors might have to sell what they can
- Regional Fed surveys leading (down)
- The headline on Retail Sales is misleading
- Housing might be collapsing
- Powell and the Fed are missing the point on employment
- Quick Hits
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	3,790	-3.6%	-19.6%	-11.7%
QQQ	$283.56	-4.0%	-28.4%	-22.0%
US 10 YR	3.53%	3.41%	1.51%	1.31%
USD/DXY	111.4	109.7	96.0	93.5
VIX	28.0%	26.2%	17.2%	20.9%
Oil	$83.04	-6.2%	10.3%	17.6%

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

The market is getting a bit smarter when it comes to eschewing the false narratives and sniffing out the next real indicator or news bit. As for the eschewing, neither the fake railroad strike nor the administration's proclamations on inflation (there is not any?) did anything to dispel the fact that the economy is weakening. And anyone that believed (the) Ukraine was about to win the war was shocked back to reality with Putin not-so-funnily joking about the literal winds of nuclear war. As for actual data, FedEx provided some commentary that should scare any market watcher: The macroeconomic environment was deteriorating quickly. The Housing market continues to collapse with mortgage rates averaging around 6.25%. And this is before the Fed has actually sold any of its giant trove of mortgage-backed securities (MBS). Business Surveys are still deteriorating. Inflation might have peaked but it is far from the Fed's target (sticking to its 2% target – yikes). And yet, the Fed hiked another 0.75% to bring the Fed Funds target range to 3.00%-3.25%. And chairman Powell did not mince his words about continuing along the same course. A month ago, the market was pricing a 0% chance that the Fed would hike another 1.25% by December (so 2.00% in total since August). That percentage is now at 67%. Yes, the Fed is going to be speeding up its hiking. Other than clinging to a hope-filled narrative that the Fed is going to "pivot" and cut rates, we are not sure about what there is to be bullish. But our bearishness is mostly born out in our sector and factor positioning and put exposures…we are still net long the market. We still like Consumer Staples, Health Care, and Energy. And our bearish bets remain centered on Tech (Big and Fantasy) and Consumer Discretionary. And we have a heavy dose of cash.

- The fake railroad strike

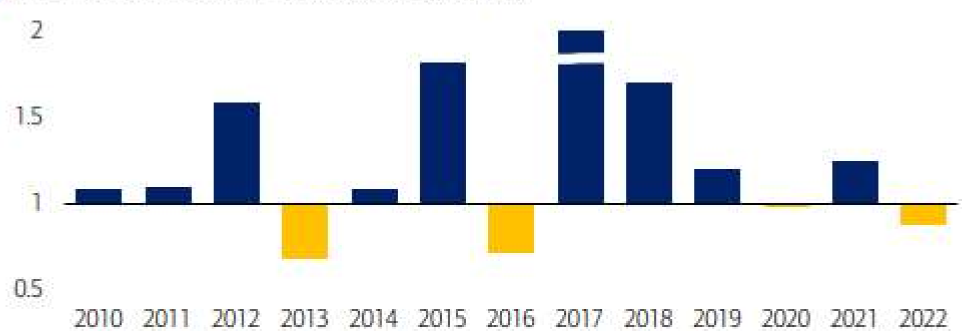
The railroad strike was averted to much media fanfare. But this strike was never going to happen. The Railway Labor Act explicitly forbids it. We guess the workers could strike and then they would be forced back to work – this happened in 1992. But this was not the apocalyptic scenario many had envisioned. Of course, a skeptic out there might think the whole story was conjured up as a win for the market (and thus the government). Conspiracy theories aside, you know the market is nervous and on its heels when it tries (and fails) to celebrate when bad news does not develop.

- Investors might have to sell what they can

Merrill has an interesting piece on where the passive money is hiding…and what this means. The first answer is obvious…the S&P 500 which is where the gigantic swath of passive money always resides. But Merrill notes that the Volatility of the S&P actually increases during times of stress more dramatically than for other market factors (namely small-caps but they also write “other high beta benchmarks”). Furthermore, large institutions have barbelled (bought two opposite ends of a spectrum) this supposedly low-Vol exposure against other “illiquid long duration private equity.” The outcome during stress? Investors sell what they can…large cap stocks. We are biased to sell the large-cap Tech and Discretionary stocks (more sensitive to slowing growth), but the idea is the same. We do not think the data set used is the most exhaustive (and 2018 is a stark anomaly as it was an interest rate hiking period), but the rationale does make sense.

Exhibit 2: S&P 500 volatility beat Russell 2000 volatility amid macro risks (13 taper, 16 Brexit, 20 COVID, 22 rates) despite being lower beta

Ratio of Russell 2000 vs. S&P 500 Average 30-day volatility



Source: BofA US Equity & Quant Strategy, Bloomberg

BofA GLOBAL RESEARCH

Elsewhere, Merrill highlights that its clients were broad-based buyers for the first time in a month. In other words, traders chased the mini-rally higher right before the rug was yanked. Merrill notes most of the buying was in cyclicals and not defensives. Nomura echoes this tangentially highlighting that quantitative funds were large buyers ($31b) of equity futures last week. Recall this cohort chases tops and sells bottoms.

However, counter to this, the Merrill Fund Manager Survey (FMS) says sentiment is “super-bearish.” The infamously obtuse “cash level” is at near-record 6.1%. The three biggest risks are logical: Inflation, monetary policy tightening (rate hikes and bond selling), and geopolitical risk. The most crowded traded is long the USD. As we have noted before, we hate being with consensus (we are long the USD). The perception that the long-oil trade is still crowded has shrunk drastically. About 40% thought it was the most crowded trade in June. That percentage is now about 10%. As a whole, investors have slashed allocations to equities while increasing the tilt towards defensives.

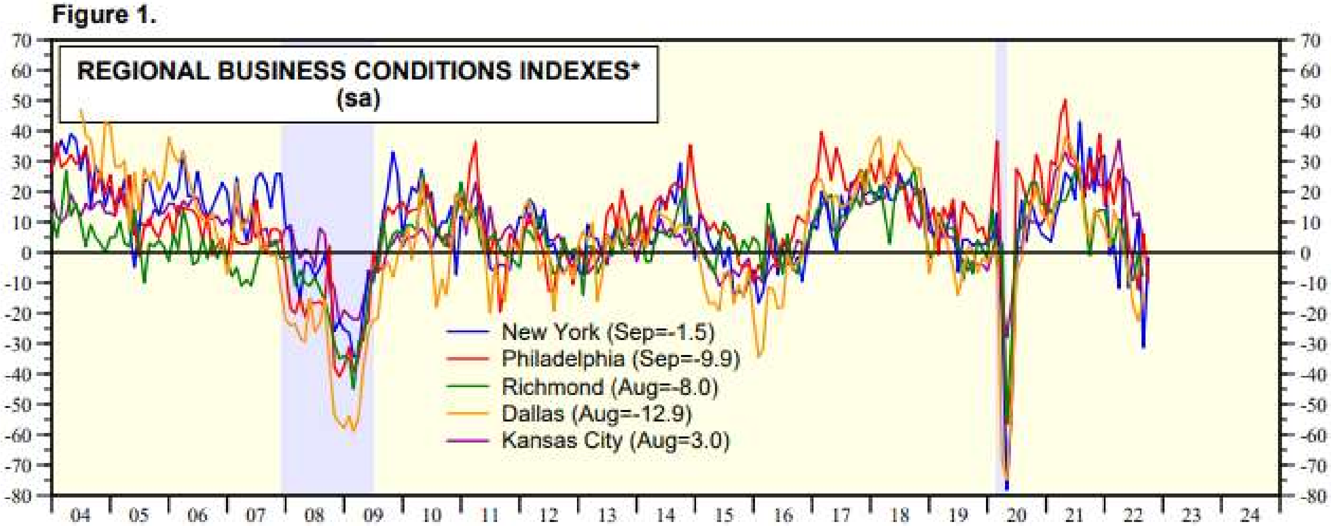
Obviously, this data is conflicting. We are inclined to believe the data (actual positioning that Merrill reports) vs the sentiment (the surveys always seem to be more of a pseudo-validation). Moreover, this FMS was released on the day high beta stocks fell over 5% - clearly investors are not defensively positioned! (For what it is worth, we like Merrill's positioning data because they have insight into retail, institutions, hedge funds, and corporates.)

- Regional Fed surveys leading (down)

The Philly Fed Manufacturing Index dropped sharply into negative territory. The Empire Manufacturing Index from the NY Fed rebounded in September from its dismal reading in August. But it is still negative.

These indices bounce around. Afterall, there is a large human element imbedded in them. And sometimes the different regions can zig while others zag. Yardeni Research helps out with this and aggregates some of the business surveys. The granular data might be hard to read, but the aggregate trend is clear. Oddly enough though, the national PMI surveys are still in positive territory. We are not sure what to make of this…traditionally the national surveys include more internationally exposed companies (particularly the ISM). We would think these would be worse given the disastrous energy crisis in Europe and the virus-fear lockdowns in China. We need to do more digging to discern any real implications in this data divergence.

Figure 1.



- The headline on Retail Sales is misleading

Retail Sales in August increased 0.3% which was better than the flat expectation. This translates into a 9.1% gain for the year. But this number is garbage. Auto sales are inflating the headline number because their massive backlogs are just now starting to loosen. More importantly, this number is not adjusted for inflation. Restaurant sales were one of the bright spots. But this comparison is against a time last year when lockdowns (or more broadly, fear) were still a thing. Furniture was the biggest loser category. This fits with the slowing-housing theme.

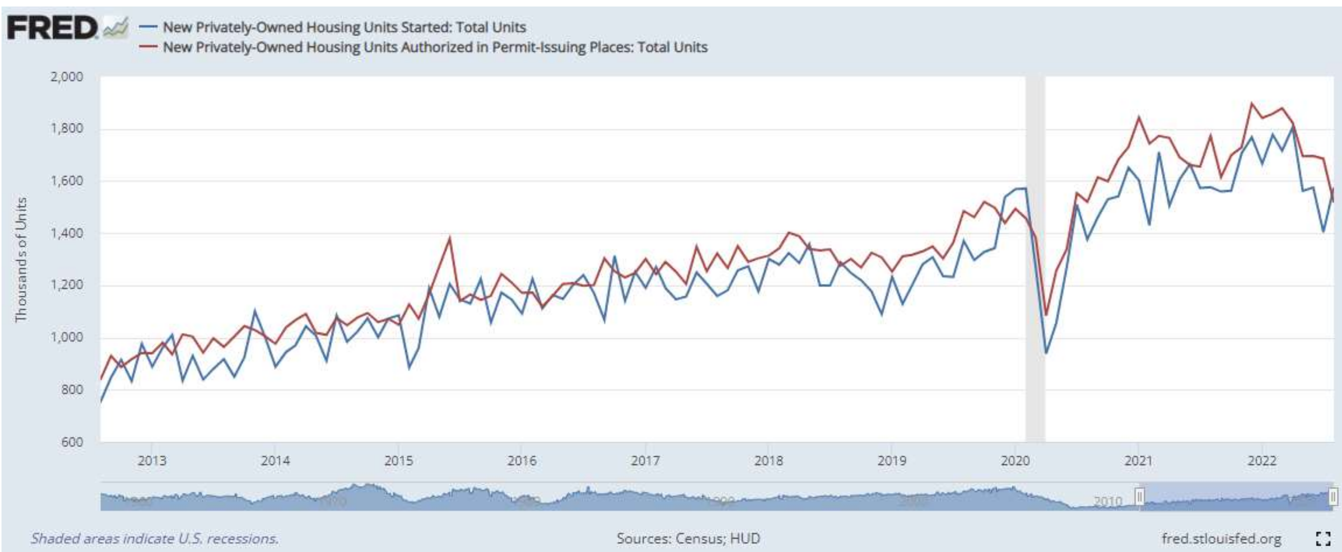
- Inflation follow-up

According to Haver Analytics, Inflation dispersion (among its major categories) is near its all time high. This is something we have observed anecdotally. We think the market gets too focused on one category moving and fails to note the other moves. We were believers that used car prices falling would be the first sign of disinflation. We quickly abandoned this thinking (back in the spring) when we saw every other category rocketing higher. The same can be said of gasoline now (it is falling while everything else is rising). The point is the data must be broad and conclusive for the Fed to change paths. An outlier here or there does not mean much.

- Housing might be collapsing

The Housing Market Index (aka the homebuilder survey) dipped again. Sentiment on Current Sales, Future Sales, and Prospective Buyers all fell. The decline of this index is sharper now than during the housing crisis of 2006-2008 (not as deep yet, but certainly falling faster).

Housing Starts and Permits had some diverging revisions and new numbers. Starts were revised lower in July but bounced back decently in August. Conversely, Permits were revised higher in July but fell in August. All told, Permits are deteriorating faster than Starts. And the poor builder sentiment certainly feeds directly into the Permits. We are inclined to believe the Starts will move back lower again next month. Lennar reported mixed earnings tonight. But we think their New Orders tells the story (a decline of 12%).



Existing Home Sales slipped a touch on a monthly basis. But this still represents a 20% drop annually. Other than the virus-fear period, this is the lowest rate in 10 years.

Mortgage Applications had a big jump this week. New Purchases were up 1% but Refinancings were up over 10%. This might be a calendar effect since the week with the rebound was the week after Labor Day.

- Other data is mostly negative

Consumer Sentiment in Michigan looks to have risen to 59.50 in September (preliminary reading). This is the third monthly increase in a row. Of course, the index is still wallowing compared to the pre-virus-fear range of 90-100.

Industrial Production turned negative in August while the subcomponent Manufacturing eked out a small increase. Electricity generation was the drag on production. That is an ominous sign. Petroleum output increased 3.5%. Auto Production (and Parts) fell 1.4%. This ties in well with our thought that Auto Retail Sales are only strong because of the backlog.

German PPI (wholesale/input prices) increase 46% in August. 46%!

- Powell and the Fed are missing the point on employment

Today's FOMC meeting was most notable not for what the Fed did but for what the Fed is missing. Chairman Powell noted the strong Job Openings and Quits as proof that the labor market was "resilient." As we have been saying, we think this datapoint is bogus. Most of these Job Openings are not real (many are duplicated or simply stale). And the only drumbeat we see is that of more companies announcing layoffs. Moreover, many of the "real" Job Openings are jobs that will never be able to be filled again (changing demographics, changing work/life balance preferences, state immigration patterns, etc.)

The Wall Street Journal produced some good reporting with his inside scoop on the Fed's reaction to the market's positive reaction to the 0.75% interest rate hike in July. That is, the Fed was miffed and wanted to do something about it. Specifically, chairman Powell tore up his Jackson Hole speech and replaced it with a more forceful rendition of his hawkish bent. In other words, the Fed wants the market to go down! "Do not fight the Fed" has never been truer. Today's Q&A backed up this story.

- Random day

We thought this "On this day" note in the Wall Street Journal was interesting since we worked at Barings back in the 1990's. More interestingly, the bank had these Argentinean bonds with the unclipped coupons framed and adorning the walls. Ironically, when Barings went belly up in 1995, an office staging company came and took most of the art off the walls (but not the bonds).

- On this day in 1890, Baring Brothers, one of England's leading investment banks, disclosed that loans to the likes of Argentina and Chile had gone bad and that the firm would go bust unless the Bank of England came to its aid. The bank stepped in, rounding up a rescue syndicate of other investment banks and assumed £28.5 million worth of Barings' liabilities.

- Chart Crime of the week

This one is random with no real bearing. But perhaps there is some bias in the sampling when polling people at the airport about willingness to travel.

- Quick Hits
  - CNBC is pushing the narrative that working in the office is bad for "climate change."
  - The new Treasurer of the US (not to be confused with the Treasury Secretary…we have no idea what the Treasurer does), previously the chief of the Mohegan Tribe, declared that her appointment "demonstrates respect for tribal sovereignty."
  - The Office of Tribal and Native Affairs is a new unit of the Treasury department.
  - Rio de Janeiro is planting a 27-acre crop in the middle of the poorest neighborhoods with the aim in feeding 50k people. Our guess is it turns into another avenue of gang revenue.
  - California is suing Amazon for inflating prices (which Amazon are they using?).
  - The Phoenix Suns owner has ben suspended for "racially insensitive language," yet his behavior was "not driven by racial…animus."
  - The Phoenix Suns owner bought the team for $400mm in 2004. He is now selling the team – he will likely get close to $2b.

Trading: It was a busy week. The only equity longs we added to are event-driven trades. These are theoretically impervious to the market gyrations. This never turns out to be the case, but we think we have a good buffer until the events play out. We continued to rejigger a lot of our short exposure (Put options). We added some in Retail (partially doomed because it is heavily influenced by Fantasy E-commerce and partially under pressure because of the recession). We trimmed a bit of our EV short (not Tesla). This is going to be a hard space to fight with the new subsidies in the poorly named Inflation Reduction Act. We extended some of our Fraud bets out further in time (booking profits for now but keeping the exposure alive just smaller for now). We added to other Fraud bets outright (these are the one with more interest rate / debt exposure.) We added to our Housing short as well as our Europe short. We trimmed a bit of our generic Tech short while rotating more into crypto-crap. We also heavily trimmed our bet on the speculative LNG exporter (in the making). Basically, management failed to finance the construction of its export facility and has said it is unlikely to meet its target delivery date in 2026. They lied to us. We still have a small position because there is still some optionality in the name. But for this mgmt. team not to be able to capitalize on the LNG crisis around the world is disheartening to say the least.

TSLAQ: Not much new to report here. The real fireworks will come next week as Musk gets deposed by Twitter. Maybe they will ask him about the progress of Full Self Driving, the Semi, the Cybertruck, the Robotaxis, the Neuralink, the Dancing Robots, the Hyperlink, and any of the other fantasies he has blurted out. Otherwise, The Villain took to twitter to proclaim that butter should be stored at room temperature. We still have nightmares about having to buy dairy products at room temperature while living in London.

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