Weekly Update

10-May-2023

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- This market has a very short memory
- Strong-on-the-surface economic data has done nothing to squash the rate-cut crowd
- The USD correlations are breaking down
- Earnings still need to catch up with the economy
- Lending standards are still tightening
- Employment is still trending lower despite the headlines
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- Small businesses are feeling the crunch
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	Last	5d %	YTD %	1yr %
S&P 500	4,091	0.9%	7.0%	0.1%
QQQ	$325.14	2.5%	22.3%	10.3%
US 10 YR	3.45%	3.34%	3.88%	3.00%
USD/DXY	101.4	101.3	103.5	103.9
VIX	16.9%	18.3%	21.7%	32.6%
Oil	$72.86	6.3%	-9.6%	-27.3%

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

This market has a very short memory. Last week's banking crisis has all but evaporated from the market narrative. Some rumors about FDIC changes kickstarted a rally in the reginal banks. But nothing has materialized from the regulators. Moreover, even if deposit insurance were enhanced, this would not do much for the giant holes in many of the balance sheets. Rightly, at least for now, the regional banks have drifted lower again. But the market has all but forgotten this looming credit crisis. Speaking of crisis, the debt ceiling is nowhere near being resolved. The clock is ticking.

Strong-on-the-surface economic data has done nothing to squash the rate-cut crowd. In fact, the chances of a rate cut in July are now up to 42% (from 35% a week ago). By the end of the year, the market is pricing a 79%

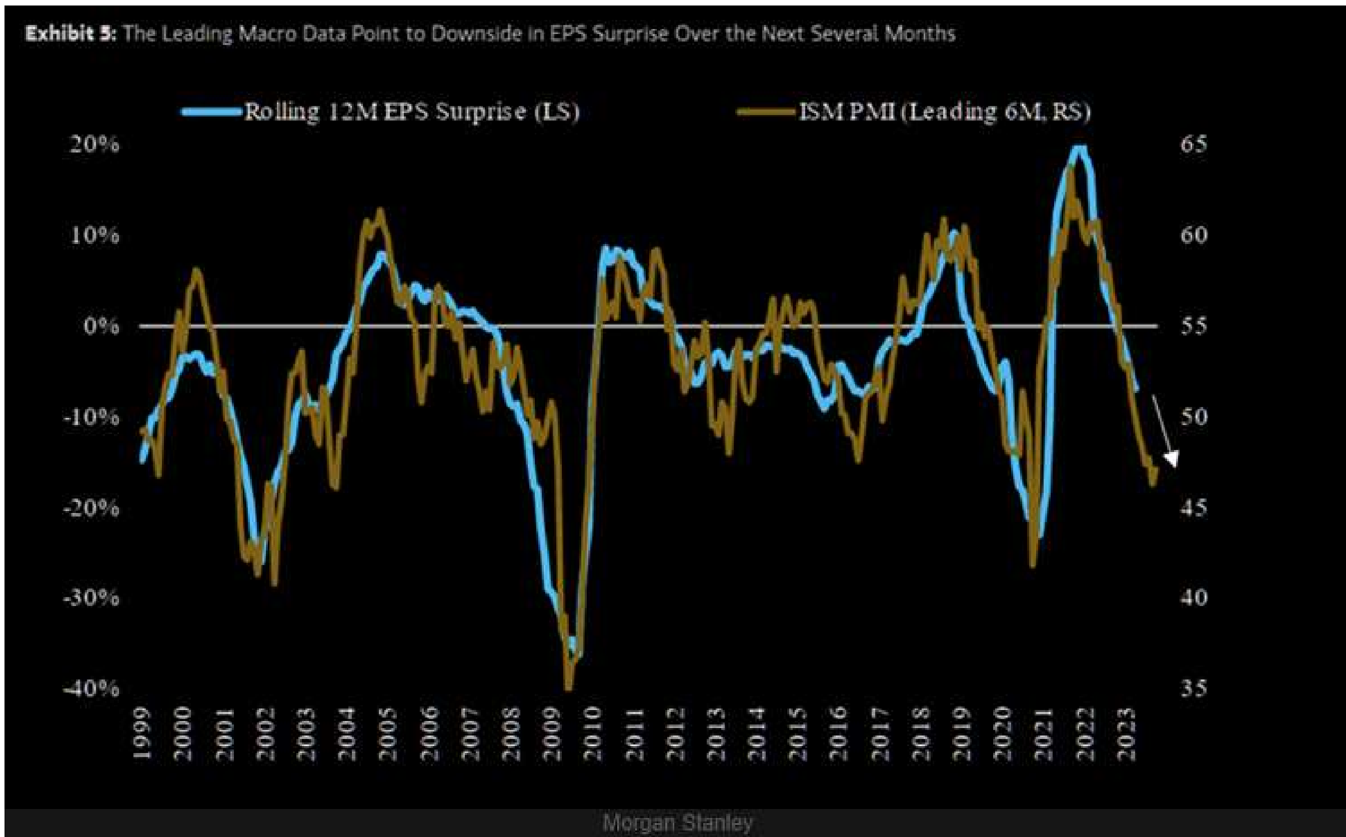
chance of at least three rate cuts (with a 28% chance of four). Perhaps people are coming around to our view that this strong-on-the-surface economic data is not that strong after all. But we are also hearing more voices note that a rate cut would signal that something has gone very wrong very quickly. But these confusing narratives might not be that confusing when looking at the different factors of the market – the most obvious being size. The base case might be shifting to a slowing of the economy without any economic or financial calamity (regional banking crisis notwithstanding…which says a lot). This could mean the mega-caps maintain their Quality status while the traditional equity pain of a recession would be felt elsewhere.

- The USD correlations are breaking down

Long running USD correlations are shifting away from their norms. Traditionally, the S&P 500 has a negative correlation to the USD. Simply put, if the USD strengthens, then the equity market weakens (-1 to +1 is the correlation scale). The six-month correlation is -0.74. And the percentage of time it has been negative over the last year is 87%. But now the correlation is positive at 0.32. Gold, which we do not consider a commodity but rather a currency (hat-tip to Hedgeye for elucidating this) remains negatively correlated to the USD. But the connection has weakened dramatically. The inverse correlation usually sits in the -0.90 range. But now it has increased to -0.45 (it never turns positive, so this is a big move). The main takeaway for us is that it underscores the volatility in the markets. Normal expectations are out the window. In practice, it means our allocations to macro factors can be more rooted in fundamentals not just traditional relationships. This is more typical during market stress. More to the point, we do not need any big moves in the USD to move equities (lower) or gold (higher).

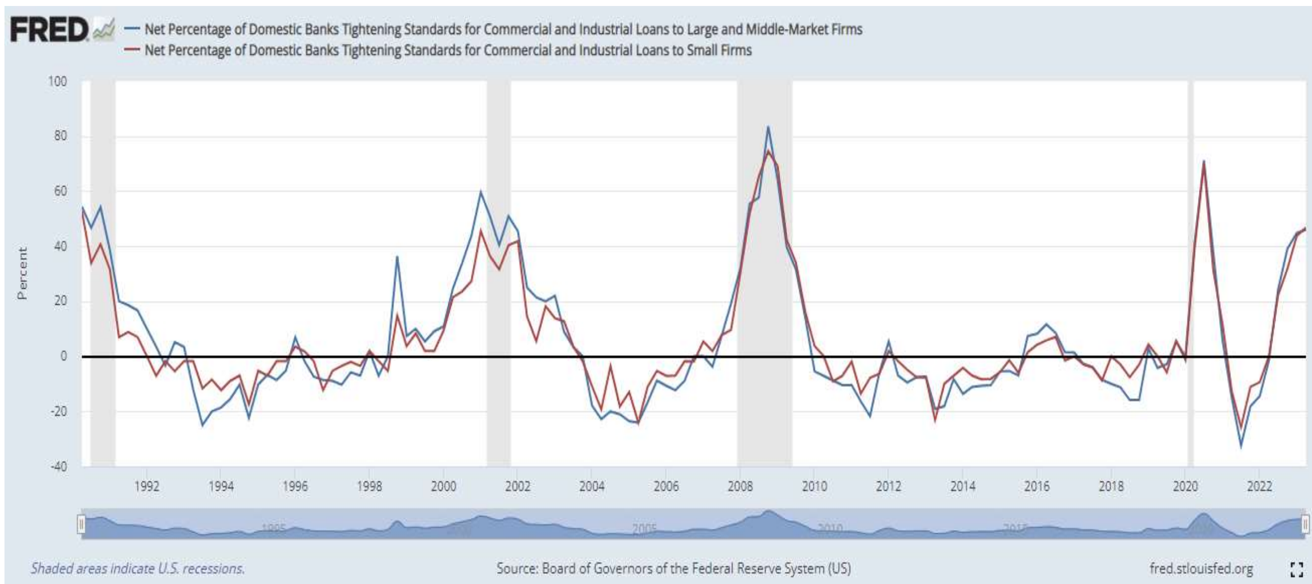
- Earnings still need to catch up with the economy

Earnings season is almost over with about 95% having reported. The cleanest takeaway for us is the contraction in earnings for the Nasdaq 100 companies vs those of the S&P 500. The Nasdaq 100 has seen earnings contract 8.5%. The S&P 500 has seen its aggregate earnings drop 3.2%. (To be clear, these are not mutually exclusive as there are stocks in both. But the Nasdaq is more representative of high growth despite this factor being muted over the years.). Guidance as a whole has been strong. As we noted last week, this contradicts the view of global companies. For US companies, it is interesting to note that positive guidance is not being rewarded in the market. Performance is about half as good on the "beats" and about twice as bad on the "misses" vs the traditional reactions. We think this can be explained by management teams providing more optimistic macro scenarios than most investors believe to be likely. Morgan Stanley points out (again) that leading macro indicators are highly correlated to earnings (MS uses EPS surprise). And the macro (MS uses the ISM which leads by six months) is pointing down (that tiny blip higher notwithstanding). In other words, companies are saying one thing to the financial marketplace while doing the opposite in practice. (MS chart courtesy of themarketear.) We maintain that the mega companies can probably weather any economic storm better than small or mid-caps (not to mention profitless companies).



- Lending standards are still tightening

The Senior Loan Officer Opinion Survey continues to show tightening lending standards. This is true for small and Large firms. This data is focused on Commercial and Industrial loans. Some bulls are noting that the survey was not as bad as feared. But the trend sure looks bad to us. Spikes and recessions are perfectly synced. And recent data (NFIB credit expectations) reflects the worsening trend.



➢ Employment is still trending lower despite the headlines

The April Employment Report was stronger than the official expectation. But some aspects of the data have underlying trends that are weakening. Recall that the ADP private payrolls surprised to the upside. The Bureau of Labor Statistics (BLS) report showed a nice beat with 253k jobs vs 178k expected. The Private Payrolls portion saw a gain of 230k jobs. But the ADP report had this pegged at 296k. More importantly, the March data was revised lower from 236k to 165k (and February was revised down by 78k jobs, also.) So, the headline jobs gain shows a reversal of the declining trend. But the three-month average shows new jobs hitting the lowest level since January of 2021. Temporary workers have been declining steadily for a year. These cuts obviously occur before cuts in permanent workers.

The Participation Rate remained steady at 62.6% while the Unemployment Rate fell to 3.4% which is back to its lowest level in 54 years (same as in January). Average Hourly Earnings accelerated higher from 0.3% to 0.5% (monthly gains). This brings the annual gain to 4.4%. One twist to the wage data is that the spread between non-managers and managers narrowed. Non-manager wage gains have been faster than the average wage gain since the Virus Fear reopening. But this trend appears to be normalizing.

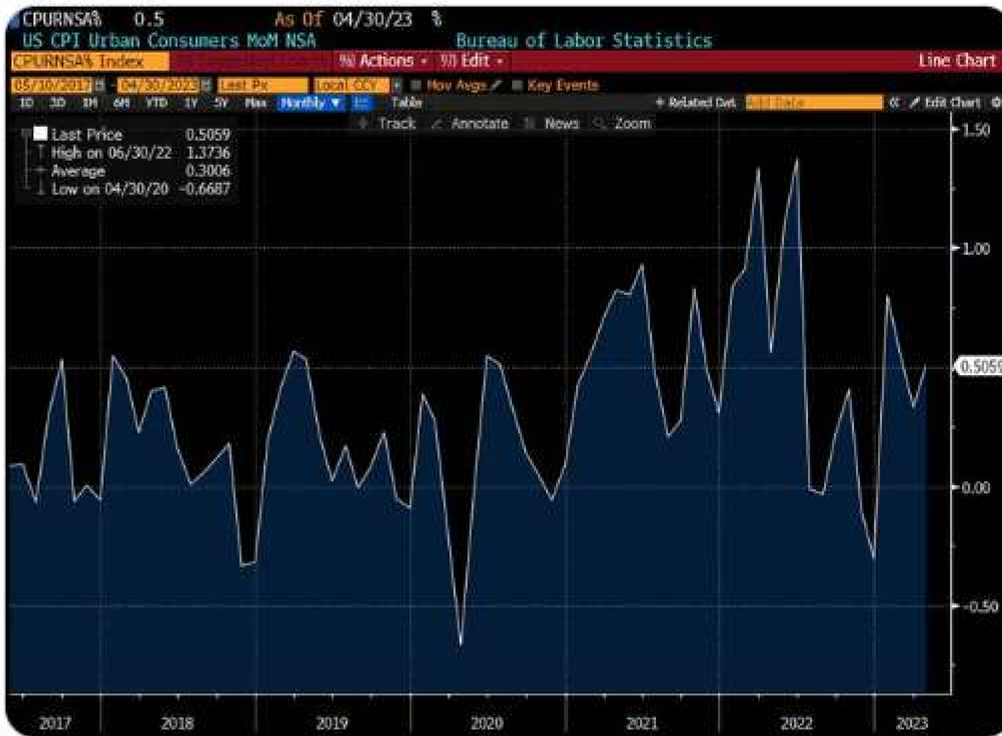
This data reinforces our view that the labor market is slowly deteriorating. And the Fed will make sure it keeps doing that.

➢ Inflation is not really falling (at least not yet)

The Consumer Price Index (CPI inflation) accelerated in April as expected. The monthly change went from 0.1% to 0.4% to bring the annual change to 4.9% (this is a slight drop from 5.0%). The "core" reading increased at the same pace as last month which was a 0.4% increase. The annual increase dropped a tick to 5.5%. Used car prices are back to being the biggest mover on the upside. Shelter is still contributing to increases, but the rate of change is finally starting to slow (this datapoint has the longest lags of any CPI component). Food prices

increased 7.7% vs last year (unchanged on the month). Food at Home slipped while Food Away from Home increased.

It is worth noting that this data is seasonally adjusted. This is the economists and statisticians' s way of smoothing out the data. But one byproduct of the Virus Fear is that much of this traditional seasonality has evaporated. If we look at this CPI data without seasonal adjustments (NSA), the headline monthly increase would have been 0.5% (chart below). This makes the case for cutting interest rates that much more difficult.

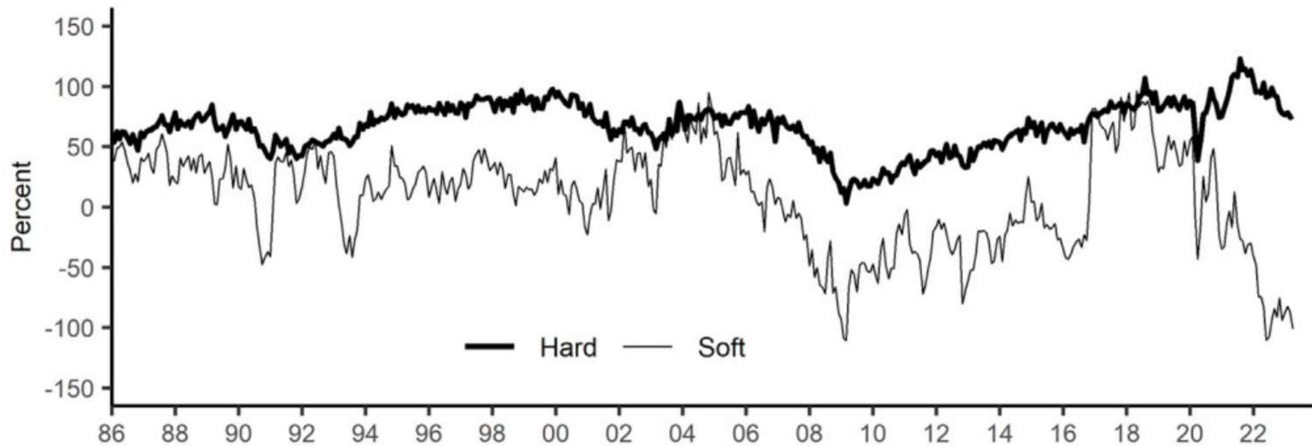


Also, the Atlanta Fed's Business Inflation Expectations ticked higher to 2.9%. This for the next year.

- Small businesses are feeling the crunch

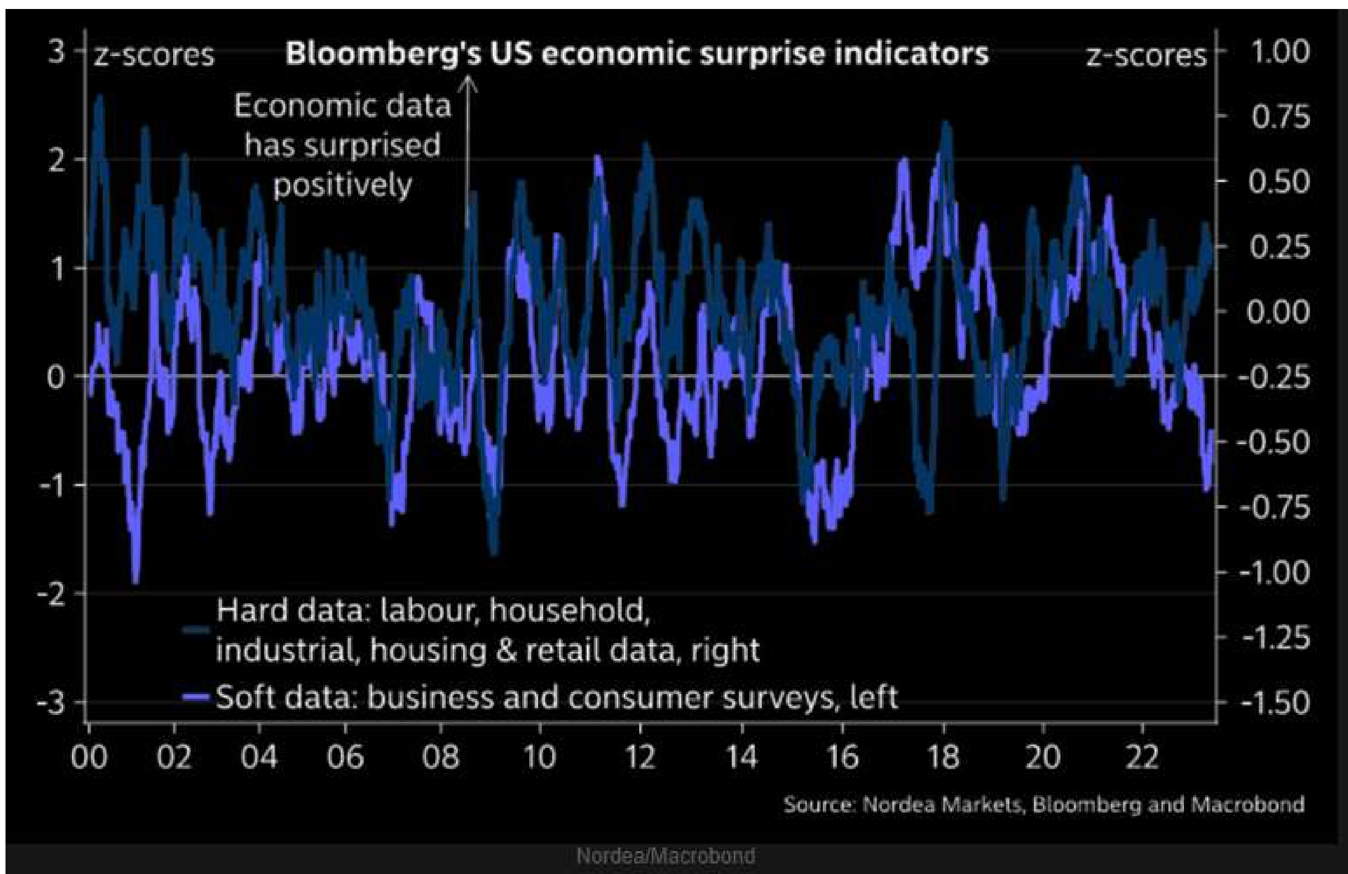
The NFIB Small Business Optimism hit its lowest level in 10 years. But there is an interesting twist to the data as it is split into two segments. The "hard" data is surprisingly resilient. Meanwhile, the "soft" data is at the lowest level in over 35 years. As you can see in our next section, this is a quandary throughout current economic data. For this small business data, we know that hard data has had a stronger correlation with business performance. But we also know there have not been many recessions in the past 20+ years, so there was not an overwhelming "feeling" of bad things to come or any dramatic shifts in the economy (abnormal shocks like the GFC and Virus Fear aside). We believe these cautious thoughts turn into actions. If nothing else, these two sets will meet in the middle.

Elsewhere in this survey, labor quality and rising costs are noted as the focal points of worry. Labor quality (or lack thereof) is on the rise. Input costs are extremely elevated but are starting to fall.



- Is Hard data better than Soft data?

Following up on the split in the NFIB Small Business Optimism survey results, we see a similar dynamic across economic data as a whole. We understand the inclination to rely on actual data vs surveys and the like. But in terms of aggregate economic data, most of the "hard" data is lagging. And "soft" data is almost always leading. We will hang our hat on the 100% hit ratio of a negative Leading Economic Indicator index resulting in a recession. That said, this split in data is interesting. It might also be lopsided with Employment and Housing beating expectations despite still showing signs of slowing. We suspect both of these will continue to decline. Hence, the lead/lag relationship between soft/hard data might be more obvious.



- The China reopening might be over

China's trade surplus for April showed sharp decelerations in both imports and exports. Imports fell -7.9% on an annual basis vs -1.4% in March. Exports still increased, but the rate fell from +14.8% to +8.5%. So, while this shows a headline expansion of the trade surplus (imports down and exports up), the slowing trend on both is what matters. Actually, the headline trade surplus is bad for tensions with the US. It is bad data any way you slice it.

- The ECB is following in the footsteps of the Fed (and perhaps then some)

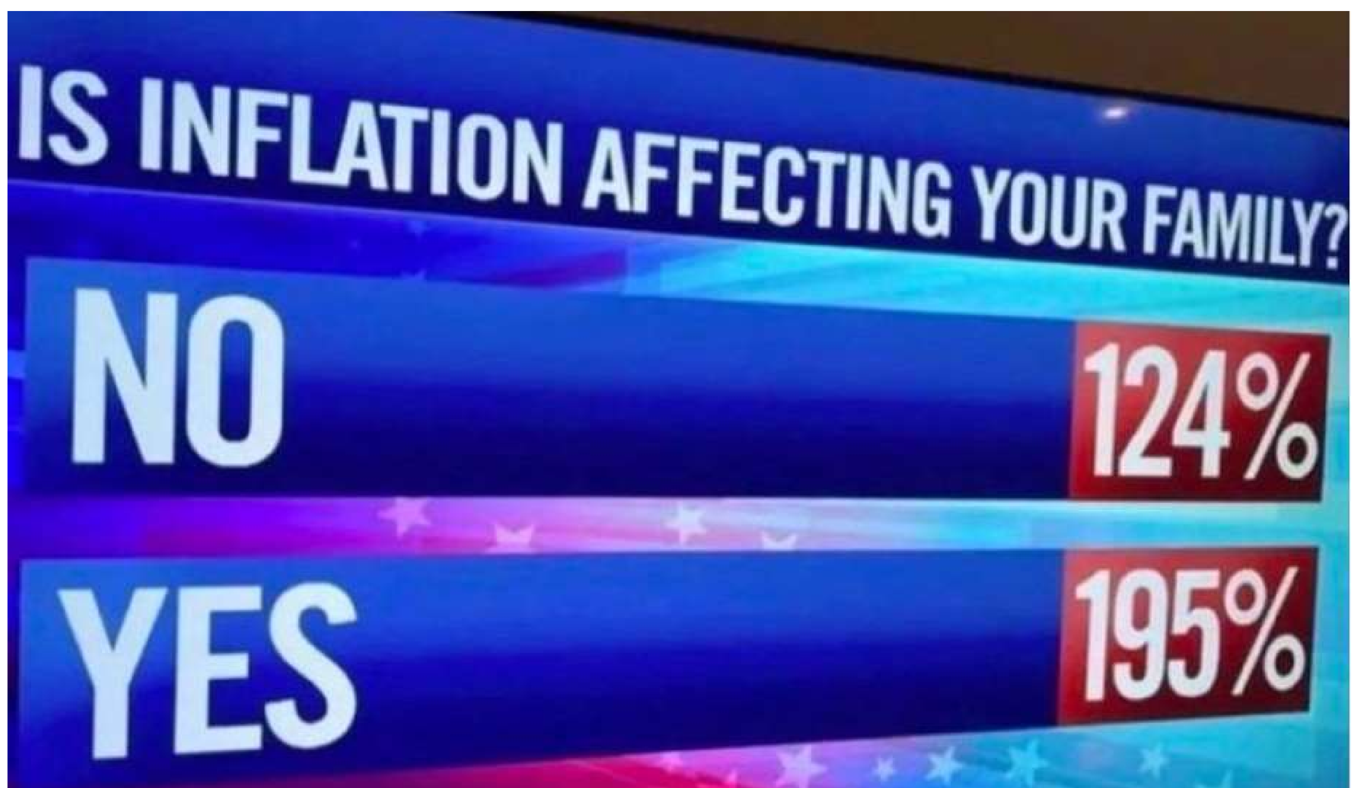
The European Central Bank (ECB) hiked 25bps as expected although there were some votes for a 0.50% increase. This brings the benchmark deposit rate to 3.25% up from -0.50%. The ECB did not give guidance but rather used a page out of the Fed's playbook with the "data dependent" line. But the central bank did announce it would speed up its Quantitative Tightening to stop all reinvestment of maturing bonds. This is about $25b a month up from $15b (the Fed's QT is $95b a month). While inflation is still a problem in the US, we have noted that it is moderating. In Europe, wage inflation is a much trickier problem given the power of the unions. Moreover, KBW (a strong research firm specializing in financials) points out that there is mounting social pressure to reward savers with higher rates (we are hearing this to a lesser extent in the US). In other words, the ECB is going down the same path disregarding the potential pitfalls of bank asset erosion. And we would add that rate hikes are having a greater impact on lending and growth already. The ECB denotes the higher rates are "restrictive but not yet sufficiently restrictive." KBW uses one of our favorite lines, "Be careful what you wish for."

- Where might more crypto money go?

We stumbled across this while surfing the Twitter. The tagline is “Just as Bitcoin has limited supply, so does this Bitcoin PEZ dispenser. WHILE SUPPLIES LAST!” And just to make sure this is a perfect representation of throwing your money down the drain, this one costs $29.99 at Walmart. The Hello Kitty one costs $2.08.

- Chart Crime of the Week

Perhaps we have used this one before. But it is too good not to use again.



- Quick Hits
  - 80% of the world's gum arabic is produced in (the) Sudan. This acacia tree byproduct is used in Coke, chocolate, and red wine among other consumer products.
  - The University of Alabama head baseball coach has been fired for allegedly betting against his team.
  - A little league in New Jersey is forcing any unruly parents to be an umpire for three games if they wish to continue attending games.
  - Carthusian monks created and are still the only ones that can produce the liqueur chartreuse (the recipe is a secret).
  - The color chartreuse is named after the drink.
  - Sony's first product was a rice cooker.
  - Foot traffic in US downtowns was down about 25% in April vs 2019.
  - A record $412mm was wagered on the Kentucky Derby (full program).
  - The Wall Street Journal is the first public voice pointing out the absurdity of companies asking for tips at self-checkout machines.
  - A Lehigh University professor who wrote a book on tipping says that tips collected by machines do not have to be 100% distributed to employees as otherwise would be the case in manually collected tips.
  - Robert De Niro, 79 years old, has seven kids ranging in age from 51 to a new born.
  - A plate of nachos (served four) in a suite at the Miami F1 Grand Prix cost $275.

Trading: Not much has changed in our positioning. We are still long the defensive sectors. And we have shorts against some Fantasies & Frauds as well as more economically sensitive companies (victims of the cycle vs the

F&F which only thrive on zero interest rates). We trimmed our long in Energy a bit more. It is really suffering in the headwinds of recession fears. Despite thinking Tech is overvalued, we are not proactively betting against the big names (at least not yet). We unwound a few small shorts which had run their course. We think we might get another chance at more F&F as some of the poster children are having a resurgence. The relief rally is based on the notion that they will not go bankrupt. The short case would be based on them being profitless businesses without access to fresh capital.

TSLAQ: Recently, we chuckled at Crazy Cathie's, aka the Woodchipper, $2000 price target on Tesla. Not to be outdone, Morgan Stanley and its lead lackey have broken down how they get to their $200 price target (trading at about $169 today…not a lot of juice for being one of the big bulls ex ARK). $88 a share is for the actual auto business which assumes 7.9mm cars sold in 2030 (compared to less than 2mm per year today). The "mobility" business…aka robotaxis, is worth $9 which assumes $1.7/mile driven by 425k cars in 2030. Tesla as a 3rd party supplier is worth $28. Its Energy business is $33. The insurance is worth $8. And Network Services, whatever that is, is worth $33.

In other words, just like how a Patek Philippe watch is worth $50 in a Philadelphia pawnshop, Tesla is worth $88 today.

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