Weekly Update

7-June-2023

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	Last	5d %	YTD %	1yr %
S&P 500	42,680	2.1%	11.6%	5.3%
QQQ	$348.82	0.2%	31.2%	14.4%
US 10 YR	3.80%	3.60%	3.88%	3.02%
USD/DXY	104.1	103.6	103.5	102.5
VIX	13.9%	15.7%	21.7%	24.0%
Oil	$70.11	3.4%	-9.6%	-39.3%

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

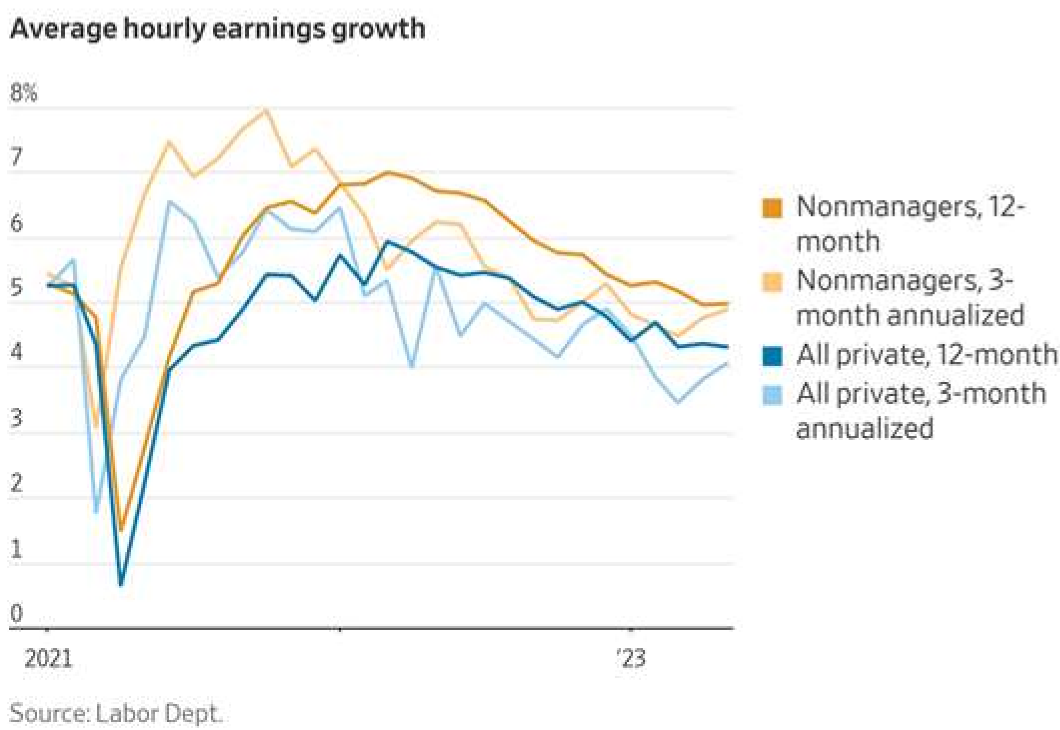
Through all the Artificial Intelligence hoopla and narrative-based trading, it appears we are entering one of the tried-and-true periods of late cycle investing: The dreaded Death Rotation. Right now, it seems AI stocks have run out of steam (just using Nvidia as the proxy) right after every analyst and pundit has promoted the latest wave of the future (we like Nvidia, but it seems richly valued). Just as the voices calling for a recession are getting louder, the most economically sensitive sectors/factors are performing the best (Energy and small-caps). Fueling this rally in small-caps are the regional banks. Somehow, the notion of rising interest rates is now good for small banks (the realization of declining asset prices brought on by rising interest rates was the cause of the banking crisis back in March). And while there is some weird action in the highly shorted names, short interest is not a factor for the broad sector moves. And this bizarro market is still ever present when juxtaposing the equity market and bond market. Equities hailed the latest Employment Report as Goldilocks…hot enough to keep the economy going but also cool enough to prompt the Fed to ease the breaks on the monetary tightening. But the bond market strongly disagrees with this notion. Short-term rates are moving higher (rate hikes coming) and the curve is still deeply inverted (recession fears).

None of this chaotic market action changes our view on the economy. Free money to consumers is being cut. Dollar General blamed the reduction in SNAP benefits for its unusually bad earnings. The student loan forbearance was eliminated in the debt ceiling resolution. Payments will resume August 30. Corporate defaults are on the rise as there were 10 in May with a notional amount of $7.2b. This equates to a 7.3% annualized default rate compared to 2.3% over the last year. Daily Grants estimates the recovery rate on these bonds to be only 27% which would be near the very bottom of history (5th percentile). And crypto is back in trouble as the two major platforms (do not call them exchanges!), Binance and Coinbase, are being sued by the SEC for operating as unregistered brokers (among a laundry list of other outlandish violations). Crypto is obviously not mainstream for the economy, but there is a wealth effect impact on the market.

- Labor market continues to give mixed signals

The Employment Report was strong on the headline as jobs gains were 339k vs an expectation of 190k. The real time expectation was probably higher considering the strong ADP guess earlier in the week. April jobs were revised higher by 39k to 294k (and March was revised higher by 51k also). But the Employment rate moved higher to 3.7% from 3.4%. This equates to a loss of 310k jobs. Recall the difference in these surveys is jobs being worked vs people with jobs. (There are other nuances including how self-employed and workers on leave are counted.) So, comparing the surveys is tricky. Labor Participation remains at 62.6%. The prime-age participation is back above the pre-Virus Fear trend. Health Care and Government saw the largest job gains. Information and Manufacturing experienced job losses. Construction employment has hit an all-time high (not adjusted for population).

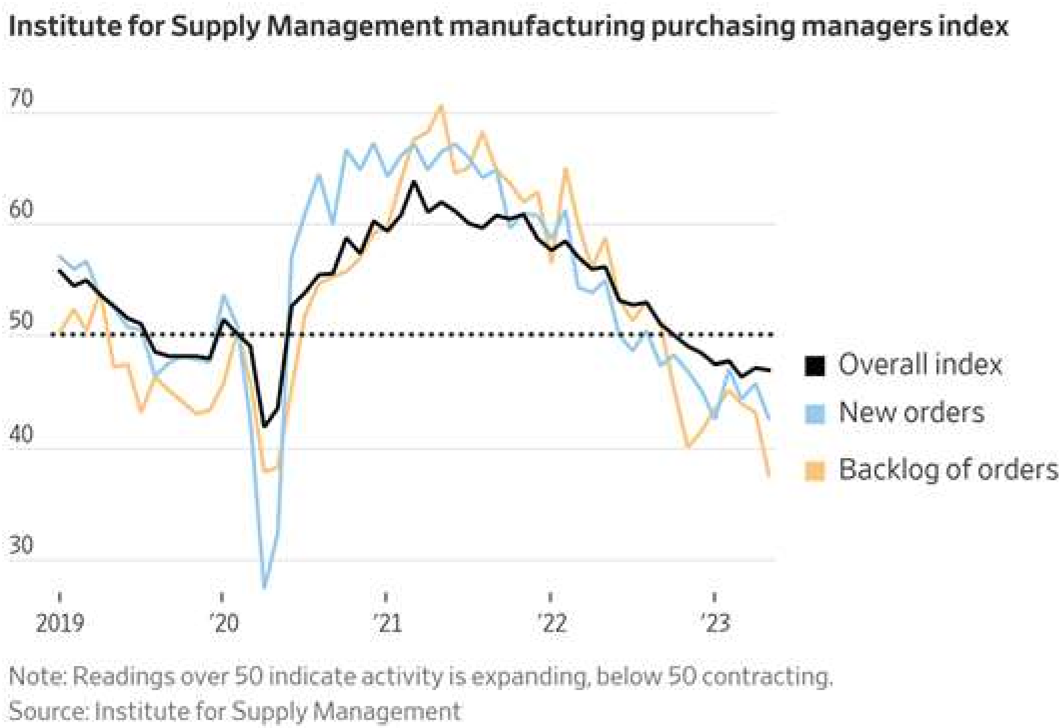
Wage growth is mixed, also. The headline showed 0.3% monthly growth which is down from 0.4% in April (which was revised down from 0.5%). But there is a divide in this data between management wages and nonmanagement. The latter is accelerating more quickly with a 0.5% increase which equates to a 4.9% annual increase. The headline annual increase was 4.3%. The WSJ thinks 3-3.5% wage growth is the desired target for the Fed. Also, the Average Workweek shortened a bit. Here is the WSJ's chart showing the recent steadiness in wages.



Despite being mixed, we would have thought this data would increase the chances of a rate hike in June as the labor market remains tight with wage increases well above the target. But the market remained about the same – around 33% for a hike. We guess the recent "pause" indication from the Fed (at least Powell via Jefferson) along with the hopes for Goldilocks carry more weight. Or equity market momentum perhaps is spilling over into the Fed Funds market (usually it is the other way around!).

- Leading indicators for Manufacturing are getting worse

Last week we briefly noted that the Manufacturing PMI's were still both negative. But some on Wall Street cheered the ISM survey calling it "better than expected." But this cursory view ignores the internals of the data. Namely, New Orders and Backlogs are the leading indicators. And both are very bad. (The other subcomponents of the index include Inventories, Deliveries, Prices, Production, Employment, Exports, and Imports.)



- Other economic data is still weak
    - Home purchases by investors fell by almost 50% in 1Q2023 vs 2022. They fell by 16% vs last quarter.
    - The ISM Services (PMI) for May fell to just above the breakeven level. The Markit Services PMI fell slightly. The ISM is almost back to its recent low. The Markit reading is steadily improving. Recall the ISM is more large-cap and globally oriented. Markit has a domestic focus with a greater mix of company sizes.
    - Factory Orders for April slowed to an increase of 0.4%.
    - The Eurozone PPI (wholesale and input prices) continues to be deeply deflationary as prices fell -3.2% in April vs March (-1.6% in March vs Feb).
    - Eurozone Retail Sales clawed back to flat in April. This data is highly volatile month to month.
    - Chinese Exports fell 7.5% in May (year over year) while Imports fell 4.5%. This is a clear sign of a slowing global economy…and no Chinese reopening!

- Japan taking its cues from California?

The Japanese equity market has quietly been a strong performer this year (especially in Yen terms…being short the Yen against the equity…DXJ is the best proxy at +23% YTD). We have noted that its economic data has been stronger and getting better. Some had feared its easy monetary policy would change when the head of the Bank of Japan (BOJ) changed hands (from Kuroda to Ueda back in April). But the BOJ has emphasized that there would not be any major shifts in policy. But some think that might be changing. An opposition lawmaker floated the idea of generational wealth redistribution using the BOJ's gigantic holdings of equity ETFs (the BOJ owns about 5-10% of the entire equity market through its 80-90% share of the ETF market). The BOJ would sell the ETFs to the government who would then give the equities to young people. It sounds a little kooky. And we doubt it happens (at least not any time soon as Ueda said they have a long way to go to attain their monetary policy goals). But the market was shaken a bit. We have been waiting for the elusive dip to buy some Japan. We did today. But we will watch this story closely. We do not want to be long if it gains any traction.

- Oil and oil stocks are diverging

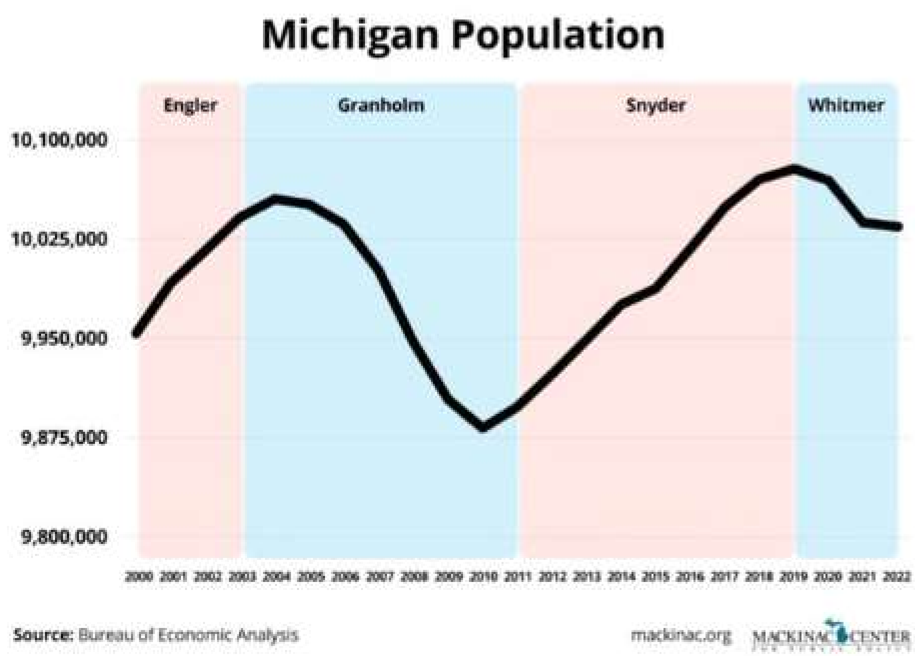
Reinforcing our view about the chaos in the markets is the behavior in the Energy markets. OPEC+ announced more production cuts with the Saudis pledging an extra 1mm barrels per day in cuts. Ultimately the Saudis will be producing only about 9mm bpd. The pales in comparison to the 12.4mm bpd that the US produces. But the crude oil market did not really buy the move. Recessionary fears are still dominating short-term supply issues. But Energy equities are being bought. This disconnect happens frequently. But rarely do the equities buck the fundamental trend if that is the prevailing narrative in the market.

- Where did all the crypto money go?

Of all the allegations against Binance (mostly fraud) and Coinbase (mostly lacking the proper regulatory framework), the best one pertains to the trading of tokens or coins or whatever they are called. The SEC alleges that 99% of all volume for most crypto stuff (ex Bitcoin) is fake! We have been saying for years that volumes are inflated and that it is likely just a small number of players pushing and pulling the market as they see fit. But we did not have this number pegged at 99%. This supports the case that most crypto-related equities should be zeroes. But that is different from saying Bitcoin will be a zero.

- Chart Crime of the week

Michigan Republicans are trying to make the claim that the state does better when they are in charge. Perhaps this is true, but we are not sure population is the ultimate signal of prosperity. More importantly, the data below has a margin of error of about +/-3%. The chart has swings of about +/-1%.



- Quick Hits
  - A judge in the Disney/Florida lawsuit blasted DeSantis for "judge shopping" and "cherry-picking language from these cases (sited to show the judge was biased)." The judge then recused himself for a conflict of interest.
  - Brazil's president Lula is appointing his personal attorney to the Brazil Supreme Court.
  - California is trying to pass a law that prohibits shop workers from trying to prevent shoplifting.

Trading: We are still mostly on the sidelines. We have not wanted to fight against AI (we believe there is some merit to the technology, especially the ones that are part of the selling of the dream) despite the crazy valuations. The short squeezes in the F&F's are still manic. We have added extremely slowly and selectively, but even that has not been working. We have changed our focus to betting against the "economy is strong" stocks like Energy and small-caps (despite having a bullish view on Energy in the medium term). But we know the pain felt during these death rotations can last. We would rather live to fight another day than get too mixed up in the wild swings.

TSLAQ: The New York Times is reporting that US ad revenues at twitter were down 59% in April and 56% in May compared to last year. Musk has recently claimed that all the advertisers that left the platform after his purchase have returned. He also claims the company is "about breakeven.". We are not ones to believe the NYT…especially not in reporting against a stated enemy in Musk. And the data can obviously be sliced and diced to fit any narrative. But we suspect the trend is bad which ultimately hurts Tesla. Twitter's debt is expensive, and Musk can hardly pledge more Tesla stock to cover more financing. It will not be pretty if he must sell stock. That said, we think the price cuts and lack of demand at Tesla are more pressing issues at the moment.

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