# Weekly Update

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- Market Volatility keeps compressing, data keeps getting worse
- Tightening credit leads to falling sales
- Positioning is bullish
- Earnings might be slightly better than expected, but they are still bad
- Producer Prices are deflating, that is not necessarily a good thing
- Retail Sales are falling as inventories build
- Housing has stabilized but expectations are still low
- The Fed is getting its recession
- Quick Hits
- Where did all the crypto money go?
- Chart Crime of the week

| | Last | 5d % | YTD % | 1yr % |
|---|---|---|---|---|
| S&P 500 | 4,155 | 1.5% | 8.6% | -3.8% |
| QQQ | $318.71 | 1.8% | 19.9% | -5.2% |
| US 10 YR | 3.59% | 3.41% | 3.88% | 2.84% |
| USD/DXY | 102.0 | 101.6 | 103.5 | 100.4 |
| VIX | 16.5% | 19.1% | 21.7% | 20.3% |
| Oil | $79.07 | -5.0% | -1.4% | -22.8% |

*10yr, DXY, and VIX are levels not changes

** Oil is front month futures, beware

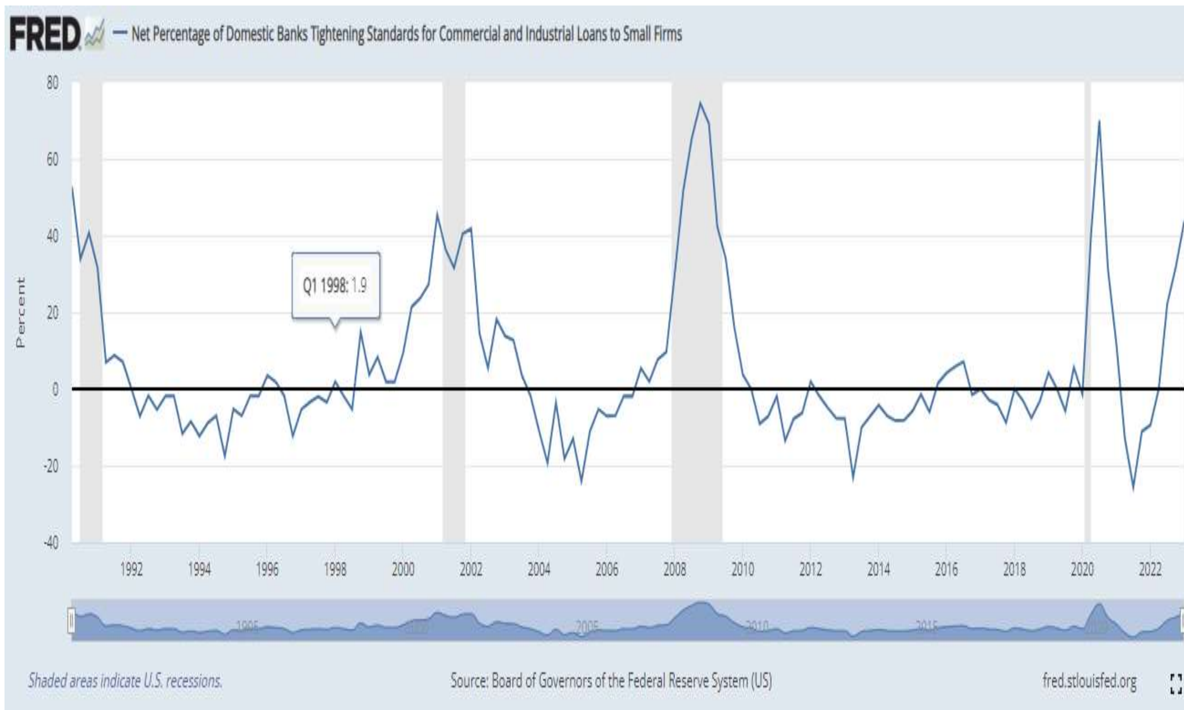
The market continues to be dominated by splashy headlines and compressing Volatility. But we think the data and hard news continue to be negative for the economy. JP Morgan had great earnings, but the rest of the early earnings season reports are less rosy especially looking at the cyclical industrials. Amazon and the credit card companies talk about the resilience of the consumer, but Retail Sales are running negative. The soft-landing crowd still expects the Fed to *cut* interest rates in the back half of this year. But a May rate *hike* is being priced with an 85% probability. And the 2-year Treasury yield (the best market indicator for Fed moves) has moved 0.75% points higher in the last three weeks. High Yield Spreads have tightened by 0.85% which is contrary to our thinking – the bond market usually sniffs out economic trouble ahead of the equity market. We can rationalize this by observing that high yield prices are just a few percent off the lows. But we are more comfortable with the signaling from the spread. Of course, commercial real estate is signaling enough trouble all by itself. Brookfield defaulted on another $160mm mortgage which covered 12 office buildings in the DC

area. Internationally, China GDP might have surprised to the upside, but this was entirely driven by domestic consumption (the one part of the China reopening in which we have believed). There is a ticking time bomb in the European financial sector as its version of Quantitative Easing is set to unwind in June. But unlike the US version of Quantitative Tightening which currently just involves the maturing of debt held by the Fed, European banks will have to repay over $500b in cheap loans to the European Central Bank.

- Tightening credit leads to falling sales

This is the credit data we referenced last week. Small-business owners are having a harder time getting financing.

And this is the Fed's Senior Loan Office Opinion Survey on Bank Lending Practices. It is the net percentage of domestic banks tightening lending standards for commercial and industrial loans (C&I). it is lagged but widely encompassing.




And Merrill tells us why this matters. Tightening credit conditions tend to lead Sales by two quarters. So even if the tight credit conditions we see now somehow are alleviated, we should still see weakening Sales for the next six months. Merrill does offer a caveat by adding that capex-sensitive companies today (the ones most impacted by tighter credit) have underspent in recent years, so the impact could be less severe. We would argue that credit conditions are becoming tighter and not just stagnating. Thus, Sales will continue to weaken.

- Positioning is bullish

The narrative keeps building that everyone is bearish. If true, this would be a powerful contrarian indicator for the short-term. It would not make us alter our view on the Fed or the economy (and thus our view on the market). But obviously it would impact trading decisions today. But as usual, there are a multitude of swirling datasets and surveys that cloud the picture.

Goldman Sachs says their prime brokerage data (just hedge funds) is screaming bullish. Gross exposure is at 187%. Net exposure is at 51%. These are in the 100th and 83rd percentiles over the last year.

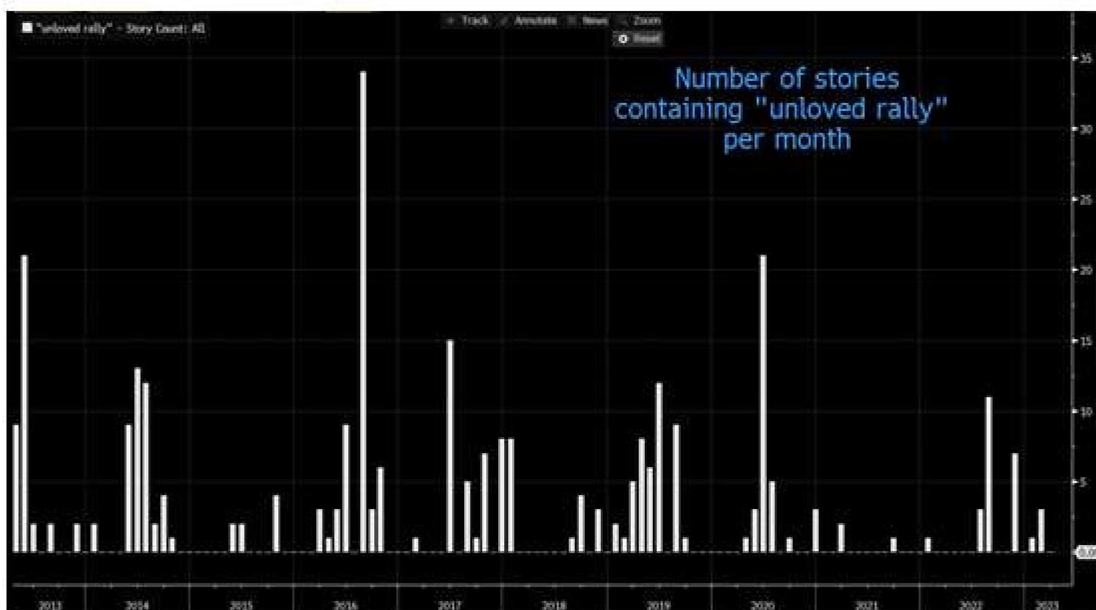
AAII (retail sentiment) has bearish sentiment still outstripping bullish sentiment, but the gap is closing.

Investor Intelligence (newsletter writers…doubt we make the cut) is sitting about in the middle of the 45-year range.

JP Morgan has a survey that shows the percentage of investors that plan to increase their equity exposure is at a low 26%. To be fair, we do not know much about this survey. A reluctance to buy could just as easily mean everyone is already over-allocated.

The Merrill Fund Manager Survey is headlined with "most bearish of 2023." Yet, 84% of survey respondents say inflation is heading lower and 72% predict lower short-term rates. There might be heightened fears of a credit crunch or another banking episode, but the expectation of lower rates is not indicative of bearish sentiment (at least not when the narrative is that inflation is falling and not the economy). Allocations to bonds have increased. This is understandable given where yields stand. Big Tech is back to being the most crowded trade.

Bloomberg gets in on the action by scraping the number of stories that mention some sort of variation of "unloved rally."




The pundits are also talking about the super-sized, net-short positioning in the S&P futures (the CFTC releases this data weekly). But these talking heads do not realize that a large net-short position in futures typically means investors are bullish! They have grossed up their books and they cannot find good short ideas. So, they must overlay the long portfolio with futures.

Ultimately, we think this collection points to bullish positioning with nobody wanting to admit it.

- Earnings might be slightly better than expected, but they are still bad

We are early into Earnings season, but the narrative is numbers are much better than expected. About 90% of companies have beat on the bottom line with about 72% have beat on the top line. But this spin ignores the simple fact that expectations have been lowered for this quarter. Moreover, the beat is only 0.30%. And beating estimates does not erase the fact that earnings are still slated to drop in the -6-8% range. More importantly, expectations have not been lowered looking ahead. And we think this is where the rubber hits the road. As far as the companies beating, the largest (and only) contributor was the performance of the large banks (led by JP Morgan).

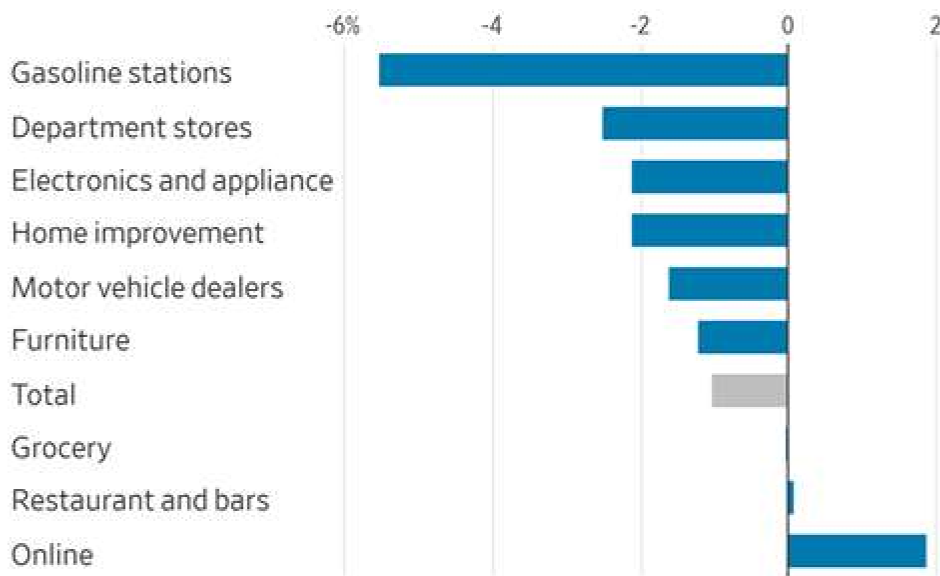
- Producer Prices are deflating, that is not necessarily a good thing

The Producer Price Index (PPI inflation, wholesale or input prices) showed a continuation of the deflation seen in February. And it, the deflation, increased from -0.1% to -0.5%. "Core" prices also declined albeit more slowly at -0.1%. Many assume slowing PPI is good. But it usually means demand is waning (Merrill unequivocally considers it a negative in its "Global Wave" basket of indicators. Hedgeye writes it can only be a positive if consumer demand remains high. Etc.)

- Retail Sales are falling as inventories build

US Retail Sales in March fell 1%. This was the second month in a row of decreasing sales after January's 0.2% drop. Gasoline sales fell over 5% mostly due to lower prices. E-commerce saw the biggest boost in sales with a 1.9% increase.

This data meshes with the latest Business Inventory data. Retailer inventories are increasing while manufacturers are reducing inventory.




- Housing has stabilized but expectations are still low

The Housing Market Index (aka the homebuilder survey) moved higher for the fourth month in a row. Of course, the headline is still about half of what it was at the peak of the post Virus Fear rebound. Current Sales Conditions and Sales Expectations (next six months) are both back in positive territory (albeit still well below long-term trends). But Perspective Buyer Traffic is still very low.

Housing Starts and Permits both slipped modestly in March. The numbers are near three-year lows. But they are also still above the pre–Virus Fear levels.

We maintain that Housing will slow: Lower prices will kick in once transactions pick up.

- Other economic data is mixed

Industrial Production in March increased 0.4%

Empire Manufacturing rebounded sharply from a deep negative number in March to a decently positive number in April.

U Michigan's Consumer Sentiment survey shows a slight bounce. But this inflation-centric indicator is still 40% off its higher just before the Virus Fear.

China's exports surprisingly surged 14.8% in March. One of the reasons we have been torn on China is the lagging Manufacturing sector because of softening global demand. Something changed in March. And that was Russia. Exports to its new, cozy neighbor more than doubled vs March of 2022.

Germany inflation continues to run at a 0.8% monthly clip. Although the annual number is looking better because last year's super-spikes are rolling out of the data. No cause for celebration yet.

UK inflation also came in at a 0.8% increase. This is down from February's 1.1% increase. But the annual mark is still above 10% which was surprising.

- The Fed is getting its recession

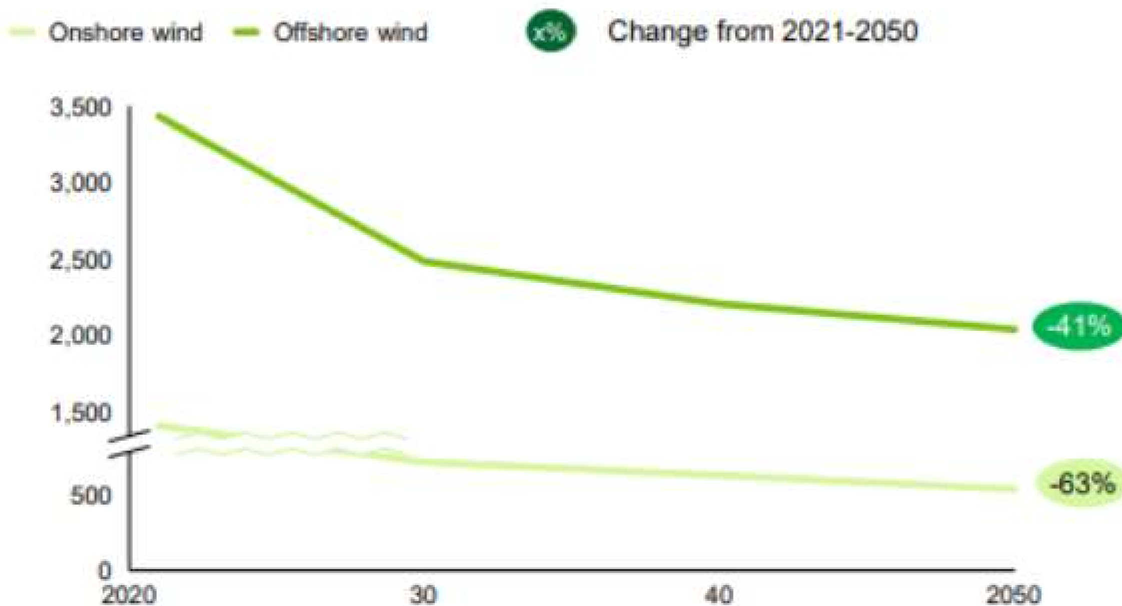
The Fed Beige Book, the collection of data from the regional Fed banks ahead of the next Fed meeting, supports what we already know: Bank lending standards are tightening, inflation is slowing but prices are still high, consumer spending is slowing, and "overall economic activity was little changed in recent weeks." These observations mesh with the Fed's quiet acceptance of an impending "mild recession."

- Where did all the crypto money go?

This one is up there with our favorites. In 2012, a University of Georgia student was trying to buy cocaine with crypto. While withdrawing his bitcoin from the "Silk Road" website (which was essentially a gateway for criminal transactions using crypto…the founder was arrested and sentenced to two life sentences), the student accidentally hit the "withdraw" button twice. Much to his surprising delight, he was able to withdraw twice the amount of bitcoin that he had initially deposited. He decided to create some fake accounts, and per the WSJ, "within a few hours of work stole 50,000 bitcoins worth around $600,000." Alas, he was arrested in 2021 since the blockchain is forever. The $600k was not.

- Chart Crime of the week

This one doubles up with a crime on both axes. On the y-axis, there is that convenient break in the data between 1500 and 500. And the x-axis…there are few things as comical as forecasting anything 25 years out…much less the cost of energy…much less anything related to the wind.




Source: NREL ATB 2022

Figure 29: Onshore and offshore wind costs decline 40–60% by 2050.

- Quick Hits
  - Budweiser had a perfect score on the “Corporate Equality Index” before this latest marketing campaign.
  - The Texas Rangers are going to extend beer sales by an inning given the quick pace of games (after the 8th inning or after two and half hours of game time).
  - A “tech executive” has been arrested for murdering the creator of Square’s Cash App in San Francisco. Apparently the two had shared a taxicab just before the murder.
  - NPR is “quitting Twitter” because it objects to the label “government-funded media.”
  - On the NPR website, it reads, “Federal funding is essential to public radio’s service to the American public.”
  - The same man invented Cheetos and Fritos.
  - McDonalds is changing their buns and grill tops.
  - Netflix is still in the business of delivering DVDs by mail (until September of this year when it will cease).
  - A US Appeals court has struck down Berkeley, California’s ban on new natural gas installations for houses.
  - Germany shut down its last three nuclear reactors hours before Finland opened its latest nuclear power plant.
  - EV car makers are going to stop putting AM radios in their cars.

**Trading**: We added to some of our macro recession exposures: Long USD and long treasuries. We rolled a small bit of Put protection (this one was actually a winner which we partially monetized). But with Volatility compressing, it is hard to sell too much. And we want to see the market turn before we add too much more. We do not like being back-footed like this. But when the market trends steadily, that is a hard fight to fight. We rotated a touch of our Energy exposure. We had been trimming, but we are probably in a good spot so we can add more if the sector dips.

**TSLAQ**: Musk has been on quite the PR tour as Tesla heads into earnings. If we have learned one thing over the years, Musk loves to practice the art of deception. Be it a SpaceX launch, a two-night interview on Tucker Carlson about AI, tweeting up a storm about the BBC, or announcing more price cuts, these things usually mean earnings are gonna miss the mark (dare we say announcing more price cuts was the ultimate tell…and not really deceptive). And that is what happened. Despite the company declaring in January that the price cuts would not lead to a gross margin falling below 20%, they did. Of course, the market still believed they would hold margins above 22%. But 19.3% was the reality. And this does not include the price cuts that have taken place everywhere else in the world during April. All told, Tesla, has cut prices in the US six times this year. It has also cut prices in Mexico, Europe, Israel, Singapore, Japan, Australia, South Korea, and China. Ultimately, the combination of lower prices, lower margins, higher inventories, Chinese price wars, and the need to refresh the outdated models should not inspire a lot of confidence in the Twitter-distracted Tesla. But Tesla did offer this nugget as it "expects that product pricing will continue to evolve, upwards or downwards."

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