Weekly Update

2-Feb-2022

Carlisle C. Wysong, CFA
Managing Partner

- The market bounces for seemingly ephemeral reasons
- The Earnings party might be over
- Last quarter GDP was strong, do not expect the same this quarter
- Employment data is suddenly mixed (from steadily improving)
- Business Spending is still leveling off
- Housing showing some wobbling signs, too
- Even the Fed's inflation continues to run hot
- Business surveys underscore the softening economy
- International economic data continues to soften, too
- Is the Fed softening its tone? Sell the rally anyway
- Oil demand is strong, and supply is weak
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	4,589	5.5%	-3.7%	23.2%
QQQ	$368.49	6.9%	-7.4%	14.8%
US 10 YR	1.78%	1.87%	1.51%	1.13%
USD/DXY	96.0	96.5	96.0	91.2
VIX	21.2%	32.0%	17.2%	22.9%
Oil	$88.27	1.0%	17.4%	61.2%

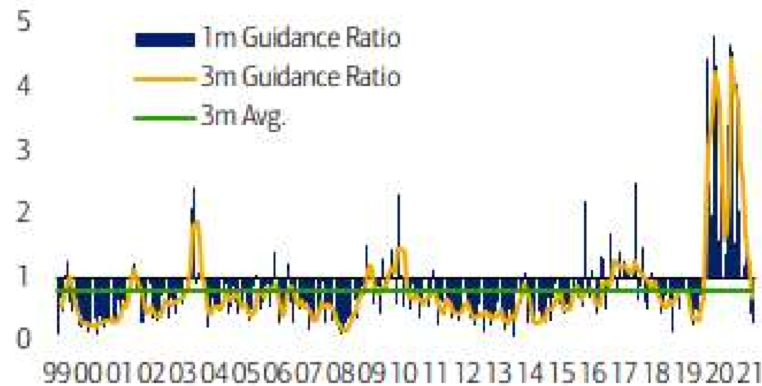
*10yr, DXY, and VIX are levels not changes
** Oil is front month futures, beware

The market has had a strong bounce after last week's pummeling. It seems the change in attitude stems from a few narratives. The esoteric of the bunch include some positive "technical" levels holding (aka mumbo jumbo) and the cooling of the Russian/Ukraine situation (not sure about this one, then again, we were never too worried about it in the first place). The most tangible rationale has been strong earnings from the mega caps like Apple and Google (after last week's strong Microsoft). But Facebook's big miss just now (after hours) might put a dent in that theory (not to mention the rest of earnings). The most likely reason for the bounce is that the Fed might be softening its aggressive rate hike stance. But the market might be overlooking the other side of the macro picture: the state of the economy. Data continues to deteriorate. Paradoxically, this might be good for a short-term bounce since it might lead to cooler Fed-speak (just like we have seen). But since the Fed is basically out of bullets, if the economy is weakening, that spells trouble for the equity market. Put another way,

most of the company and economic strength are from last quarter. Seemingly all the forward-looking news is decidedly more cautious. As you can tell, our ambivalence about the market has started to lean more bearish. Of course, we do not want our view to be clouded by the market weakness we have seen so far this year. Moreover, the market is very good at sniffing out these kinds of shifts well in advance of humans talking about them. Nonetheless, we think we could see more downside. We are still long but being cautious.

- The Earnings party might be over

Despite the aforementioned big beats from some of the mega caps, earnings as a whole have been underwhelming. As of Monday, the aggregate was only 2% better than expectations. In the virus-fear era, after the third week of earnings, the average beat has been 11%. The absence of margin improvement is the primary drag. And forward guidance has come back to earth. This chart from Merrill, despite being hard to read, says it all. Companies are no longer more positive on the future (this does not mean companies are not positive, but this is another case of the importance of the rate of change).



- Last quarter GDP was strong, do not expect the same this quarter

GDP for the fourth quarter of 2021 increased by 6.9% (this is another weird calculation; it is the quarterly change on an annualized basis). This compares to the 2.3% from the 3Q which was derailed by the delta variant of the virus-fear. This is backwards looking, of course. But it serves as a good exercise to show how whippy economic numbers have been thanks to the virus-fear. Looking ahead, the Atlanta Fed is tracking the 1Q GDP increase at only 0.1%. Wall Street is expecting around 3.5%. That Atlanta Fed is a static calculation so it can move around (that is, an obvious outlier datapoint will assume to be leading to other similar readings when this is not necessarily the case). Moreover, the professional guessers (economists) are starting to lower their expectations.

- Employment data is suddenly mixed (from steadily improving)

The ADP guess at Private Payrolls in the upcoming Employment Report showed a surprising loss of 300k jobs vs an expected gain of 225k. Although, the range of guesses was extremely wide at -350k to +350k. This is the market view in a nutshell! We will have to see what the official Employment Report numbers tells us this Friday. If they mirror this surprising shrinkage in jobs, then the rate hike narrative will take a serious blow. Of course, the other half of the equation is inflation which is still running hot (more below). On the flip side, Job openings

in December (more lagging) per the JOLTS report (Job Openings and Labor Turnover Survey) ticked back higher towards the 11mm level. The perspective:

And the Quits to Separations ratio continues to climb. It has been making a new high for 8-9 months in a row. The total number of Quits hit 2.9mm. This is down a hair from the record level in November. And Jobless Claims improved down to 260k for the week from 290k the previous week. This is still above the 4-week average.

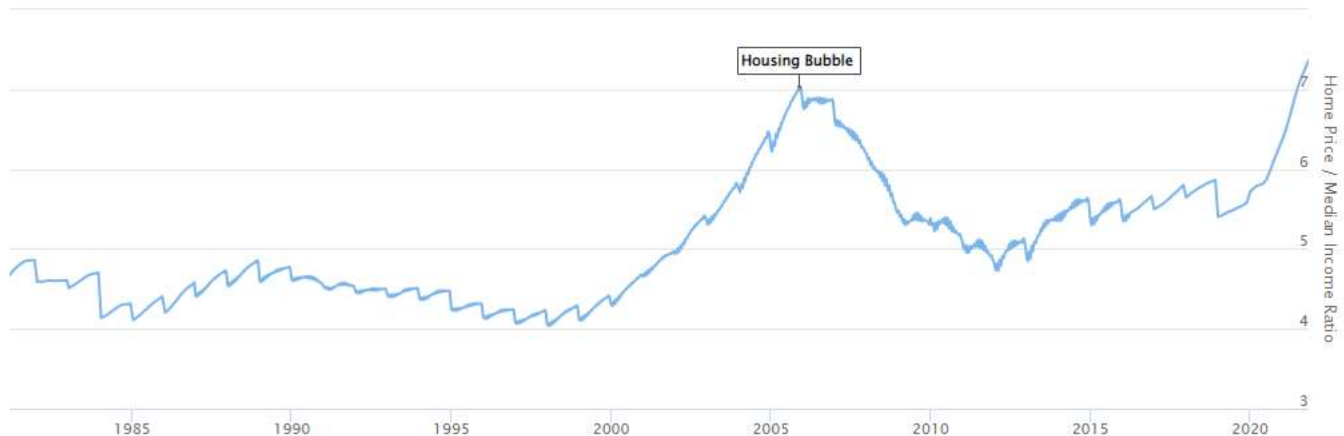
- Business Spending is still leveling off

Durable Goods Orders slipped into negative territory in December, but November was revised higher. And the Core Capital Goods component (aka business spending) registered a flat month vs an expected increase. This is one of those data sets that is near an all-time high yet slowly rolling over. But the slowly rolling over has lasted for almost 18 months now. We expect the economy to slow this year. We will likely see this Spending data move lower.

- Housing showing some wobbling signs, too

Pending Home Sales fell more than expected in December. This fits with the slip in Existing Homes sales that we saw in Dec. And it is the same reasoning: supply is extremely limited. Recall the rest of the recent Housing data has remained strong

Two quotes about Housing jumped out at us this week: “Home prices have risen well above mortgage balances” and “house prices are at the highest multiple of family income ever.” The first is from the giant hedge fund Bridgewater. But we cannot find the data to support this claim. The second is from Jeremy Grantham, the well-known investor who has called for a crash every year since 2000 (he got two correct). Home prices have, indeed, pulled away from median household income. This is worrisome. But we know that rents are even higher than buying prices (relative to income) and the supply of homes is at an all-time low. Of course, higher mortgage rates are never good for Housing. And that is the narrative right now. But we think the low supply and the migration theme will rule the day. But we are not diving in headfirst (our position is moderate at this point).



In related data, Construction Spending in December barely grew which was a disappointment. But the data is split, as usual, with strong private spending and weak government spending. Single family residential spending is still the leader.

- Even the Fed's inflation continues to run hot

Inflation for December as measured by the PCE (Personal Consumption Expenditures Price Index) is still running hot with a 5.8% annual increase. The monthly increase slowed a bit at "only" 0.4% vs 0.6% in Nov. The Core reading (excluding food and gas, do not get us started) is slightly lower at 4.9%. But the monthly increase remained steady at 0.5%. Parsing these numbers can be confusing (especially since there are so many different inflation metrics now). The Fed uses this measure instead of the more commonly followed CPI. The PCE always tends to undershoot the CPI because it measures the costs to businesses more so than the consumer. Ultimately, inflation is still hot with most expecting it to continue for a few more months until the "comps" will be hard to beat (prices started taking off in 2Q2021 making increases more difficult).

Speaking of inflation metrics, the Employment Cost Index showed a slight cooling on a quarterly basis. 4Q2021 showed labor costs increasing 4% vs 4Q2020. Compared to 3Q2021, costs increased 1% vs 1.3% (3Q vs 2Q).

- Business surveys underscore the softening economy

We have been fearing the January (and February) business surveys as there has been a notable downward trend in optimism. And the final Markit Manufacturing PMI was a marginal uptick from the lousy, early (Flash) indication. The same goes for the ISM reading. These slight improvements are nothing to celebrate.

The KC Fed showed a slight uptick, as well (unlike the massive downtick exhibited by the KC Chiefs). But the Dallas Fed disappointed as it is just barely above the breakeven line. The Chicago PMI was the lone survey with meaningful improvement. And this survey encompasses Manufacturing and Services. So, there is a ray of hope in this one.

- International economic data continues to soften, too

China's Caixin Manufacturing PMI for January slipped into negative territory. It has been hovering near the breakeven until this reading. This survey is done by a private entity. The official government Manufacturing PMI

is still (barely) above the breakeven. Some think China has been slowing down manufacturing lately to soften the pollution ahead of the Olympics. This is probably partially true. But it also follows that the 0-Covid policy is taking its toll.

Eurozone Consumer Sentiment has been rolling over since May of 2021 and it continues to do so.

- Is the Fed softening its tone? Sell the rally anyway

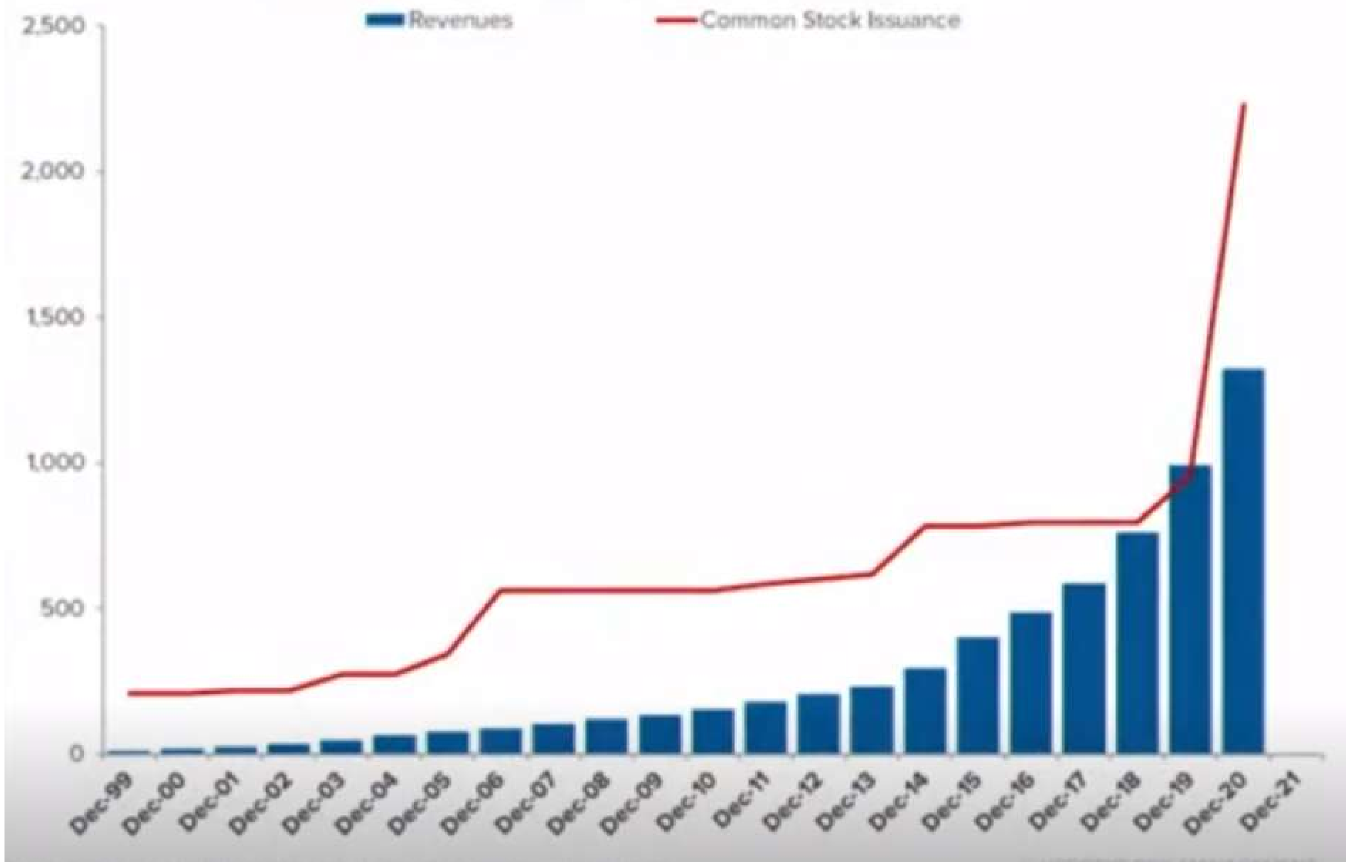
We have long predicted that the Fed would ease up on their tightening plans. They know they held the tightening line too long back in the fall and winter of 2018 and the market suffered badly. But we did not expect the Fed to already be changing their tune. There have been six Fed speakers in the last week, and none of them have called for a 50bps rate hike in March. The most hawkish member, St. Louis Fed president Jim Bullard, thinks five hikes for the year is "not too bad a bet." The turtle dove of Minneapolis, Neel Kashkari, might want to pause all together. Esther George of Kansas City, another hawk, wants to avoid "unexpected adjustments" and prefers to act gradually. Mary Daly of San Francisco emphasized the need to not be disruptive. Even former Dallas Fed president Richard Fisher, who has been calling for rate hikes for over five years (virus-fear hiccup notwithstanding), quoted the late founder of Southwest Airlines, "You can't go from Wild Turkey to Cold Turkey." (Kelleher was also the former chairman of the Dallas Fed; he was a smart guy.) But our take is that the Fed is painted into a corner. The economy is weakening and there is nothing the Fed can do about it. We are selling these rallies on softening sentiment.

- Oil demand is strong, and supply is weak

The CEO of Saudi Aramco made some noise this week when he said oil demand was almost back to pre-virus-fear levels. This is remarkable considering that airline travel is still down 30% domestically vs 2019 and -44% for international travel. Following this, OPEC+ is sticking to its planned 400k barrel per day production hike. The speculation was that the cartel would increase production at twice the planned level. Clearly, OPEC and Russia do not have the ability to increase production. The bears are hanging their hats on Iran coming back online. But the last we heard on that front was a hard stalemate. Perhaps if Russia/Ukraine tensions cool that could ease some of the geopolitical risk premium in oil. We think it is marginal at best.

- Chart Crime of the week

We are twisting this into the fun chart of the week (just for this week). The company Plug Power has sold more stock than it has had revenues. And this is not some start-up…it is a 21-year-old company whose main product is its own stock!



- Quick Hits
  - Billy Andrade, a senior PGA golfer, is sponsored by Major League Baseball.
  - In the UK, buildings with the highest "environmental ratings" use far more power than building with the lowest ratings.
  - The Chinese Olympics were expected to cost $3.9b. The latest estimate is $39b.
  - According to blockchain data platform Chainalysis, the total value of cryptocurrency used for money laundering increased 30% in 2021 vs 2020.
  - The media is reporting that Spotify is facing backlash from musicians over Joe Rogan. The list of the outraged include: Belly, india.Arie, Eve 6, Letters to Cleo. Their music will surely be missed.

Trading: We sped up our selling of Tech on the bounces this week. We still like this category in the long-term (Quality Growth, not Fantasy Tech), but with the economic data deteriorating and rate hikes coming (even if the Fed softens its stance a bit), we think it could remain under pressure for a while. We still like adding to Staples and other defensives on weakness. We also added more short exposure to the Fantasy Tech.

TSLAQ: In response to Biden not being able to utter the word Tesla while he praises GM and Ford for their EV efforts, the Bond Villain took to twitter:

Elon Musk
@elonmusk

Replying to @EvaFoxU and @POTUS

9:24 PM · Jan 27, 2022 · Twitter for iPhone

Check out our website to learn more about Chalk Creek Partners

Carlisle's Twitter Financial List

Carlisle's LinkedIn

The information presented does not involve the rendering of personalized investment, financial, legal or tax advice, and it is intended to be general market commentary. Information presented is believed to be factual and up-to-date, but we do not guarantee its accuracy and it should not be regarded as a complete analysis of the subjects discussed. All expressions of opinion reflect the judgment of the authors as of the date of preparation and are subject to change. Certain information has been provided by third-party sources and, although believed to be reliable, it has not been independently verified and its accuracy or completeness cannot be guaranteed. Past performance is not indicative of future results.