Weekly Update

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- China's Xi cares more about his politics than your capital
- Is the Fed's balance sheet still a form of stimulus?
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	Last	5d %	YTD %	1yr %
S&P 500	4,187	-3.0%	10.3%	12.0%
QQQ	$350.39	-3.6%	32.2%	26.7%
US 10 YR	4.96%	4.91%	3.75%	4.01%
USD/DXY	106.5	106.6	104.5	110.6
VIX	20.2%	19.2%	22.9%	27.3%
Oil	$85.25	-3.5%	6.4%	0.1%

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

The market remains under pressure as the bullish narratives are running out of steam. Fed chairman Powell was overtly hawkish in a speech and Q&A this week. The pundits claimed he delivered a "mixed" view on monetary policy, but the market disagreed. Last week's notion on interest rates was summarily dismissed: High interest rates hurt borrowing and risk taking regardless of whether the Fed steered them higher or not. There was a slight reprieve in the benchmark interest rate (the 10-year Treasury note) when an equity hedge fund manager proclaimed on twitter that he had closed his bond short. The market quickly realized this was the same guy that cried on TV during the Virus Fear so he could get the max juice out of his equity shorts. The underlying rationale

for the soft-landing narrative has been that earnings have troughed, and they will start to grow again. It is early in the season, but "misses" are being punished at a record clip and "beats" are not being rewarded. This means expectations have been too high. Reality might bite (never saw the movie). We are still positioned conservatively. But our base case is still just a mild recession during which some large companies will be able to increase margins and become even more entrenched. Companies (and stocks) that rely on low interest rates and a strong consumer will likely remain under pressure.

- China's Xi cares more about his politics than your capital

We have noted recently that some economic data in China is stabilizing a bit. This is probably an optimistic spin given the disastrous state of the real estate market. But even if we were to stipulate an economic improvement, we just need to remind ourselves that the communists are led by a hardliner. Xi's latest maneuver has been to clamp down on Foxconn with office raids and "investigations". Its founder is running for president of Taiwan. Of course, Foxconn is based in Taiwan, but it employees millions of people in mainland China. Crossing Xi will get you disappeared. The same probably goes for your money invested in this country.

- Is the Fed's balance sheet still a form of stimulus?

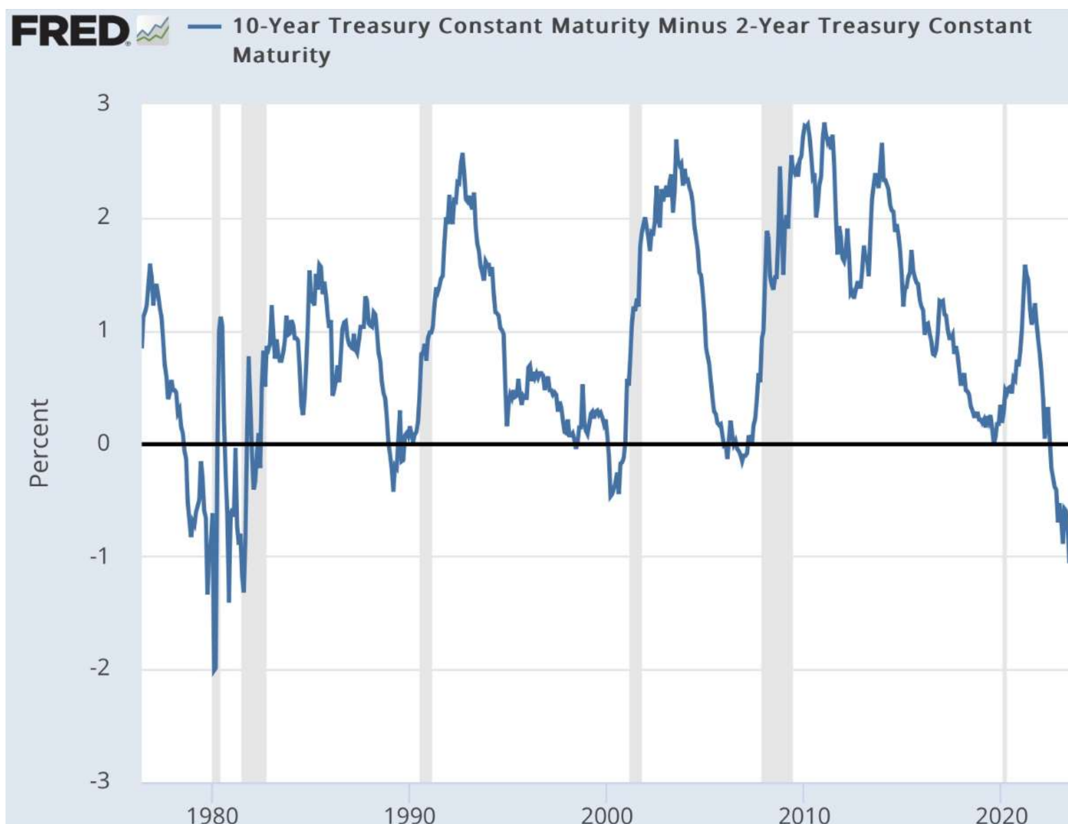
David Zervos of Jefferies (one of the better strategists who can piece together bonds and equities) is doubling down on his theory that the Fed's balance sheet continues to act as a form of stimulus. The idea is that the Fed absorbed billions of dollars of losses when rates skyrocketed…and thus the market did not suffer these losses (makes sense). We believe this contributed to some support in risk assets (fancy Wall Street word for equities and higher yielding credit). But we are still not sure how this translates into stimulus now. Do investors acknowledge what they would have lost without the Fed's interference, and now they are spending that not-lost money? Seems like a stretch to us. That said, the Fed is committed to taking its time in winding down the balance sheet. At a clip of only $90b a month, it will take years to get back to whatever one might consider to be the neutral size (general ballpark is $4t-$5t compared to today's $8t…yes those are trillions).

- Healthy spending is not necessarily healthy

One of the talking heads on CNBC made an obvious but good point: Do not conflate healthy consumer spending with a healthy consumer. The co-founder (and former COO) of Capital One commented that bloated credit card spending cannot continue, and delinquencies and chare offs are going to rise further. We listen to professionals who are no longer in the position…unshackled freedom can speak volumes. Along these lines, the credit card companies that have reported earnings are generally saying that card spending is slowing, but loan growth is accelerating. That is not a good sign for the consumer (nor the credit card companies…we are short).

- The Yield Curve does matter

Many are pointing to the steepening of the yield curve as evidence that a recession has been averted. We have tried to make the point that a recession typically starts after an inverted yield curve (10yr -2yr is negative) starts to steepen (becomes less negative and/or turns positive). Here is a pretty simple chart from the Fed database. The shaded areas are the recessions.

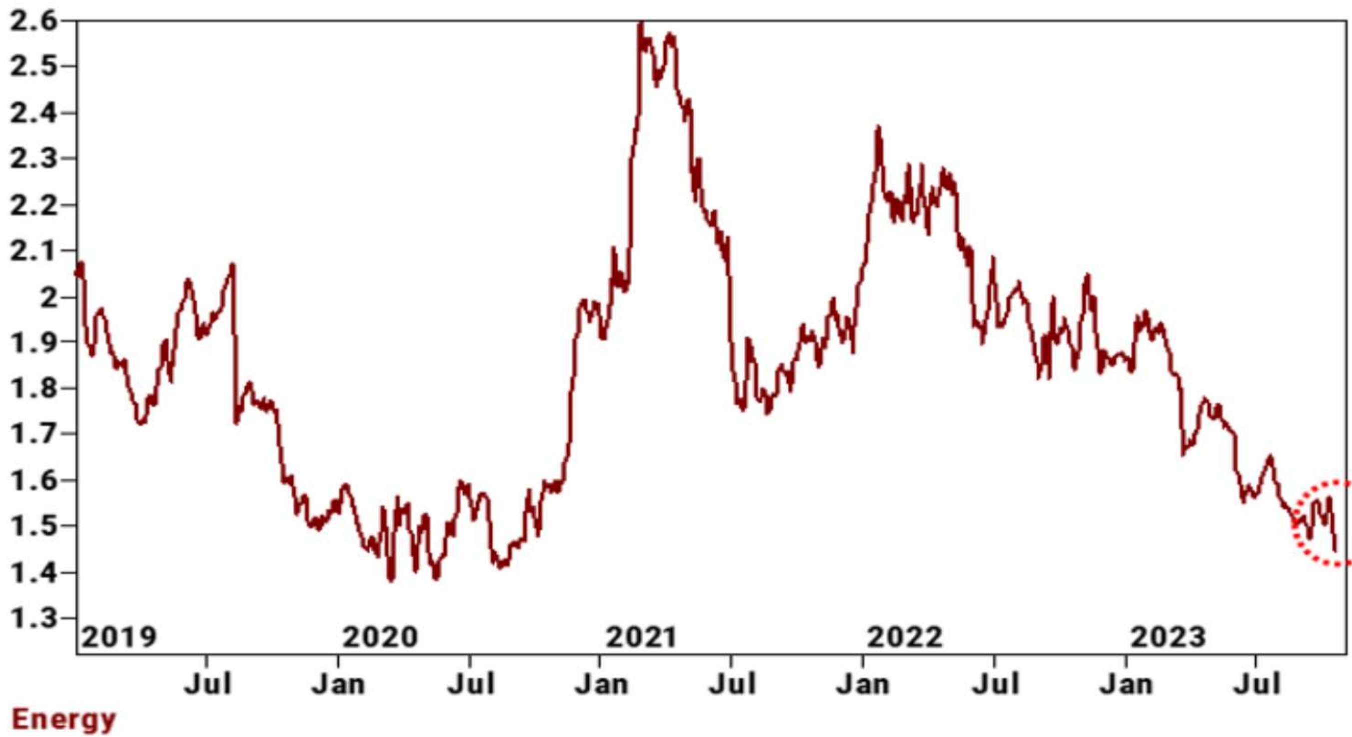


- A divergence in Volatility

An interesting observation is that the standard deviation in the market continues to fall despite the increase in Volatility. Said another way, the pricing of Vol in the market is about 50% higher than the realized or historical Vol. This means the market is not showing panic, but players are preparing for panic. This is somewhat rare. Put buying (Vol moving higher) usually happens in the middle of panic…or too little too late. We have a hard time believing the market is actually prepared for weakness. But if nothing else, we will use this as a tie-breaker to sell some Puts before the crowd does.

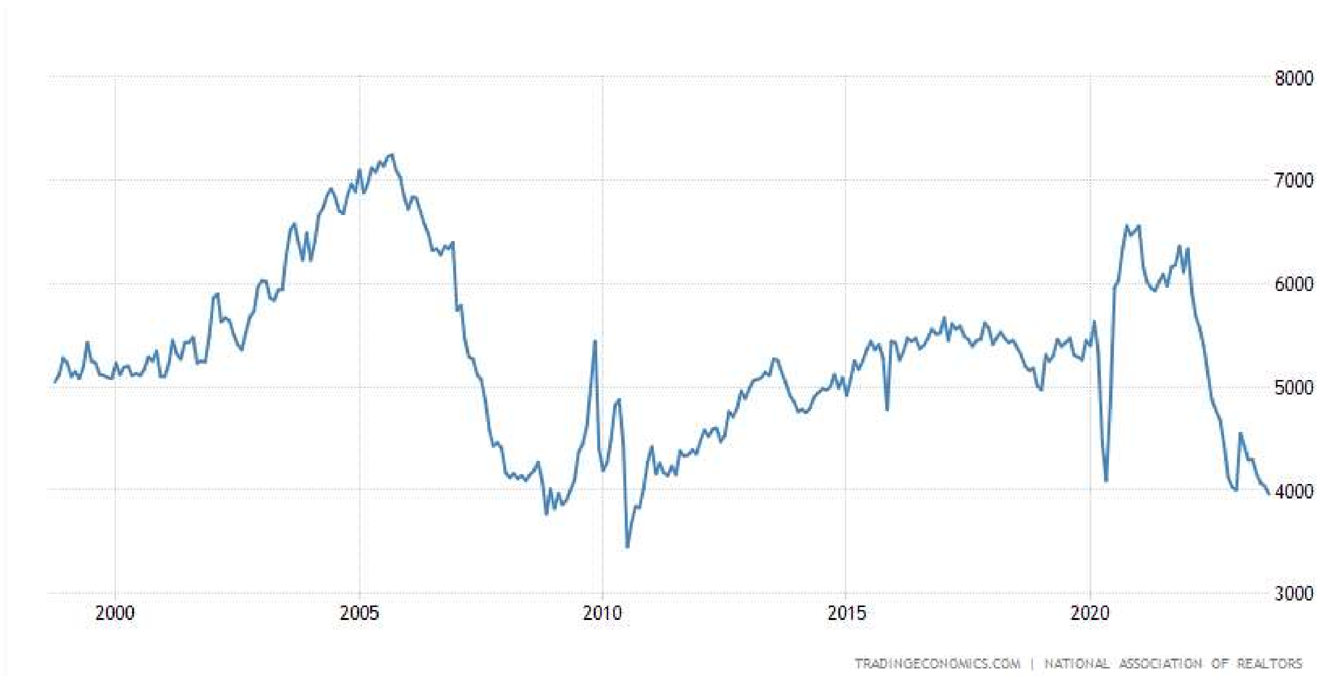
- Energy is a crowded (relative) short…we did not see this coming (but we like it)

Goldman reports that hedge funds, "sold Energy at the fastest pace in 7 months led by short sales. This week's net selling in Energy ranks in the 98th percentile vs the past five years." We find this shocking. We thought funds were piling into the trade on the long side. CTAs (momentum traders) probably have done this. But Goldman's prime brokerage client base is the biggest (along with Morgan Stanley and probably JP Morgan now). We can understand the draw to being contrarian and betting on the Saudis (or Russian or whichever rogue nation) increasing their production of oil along with demand slowing (economy slowing). But we still have a high degree of confidence in the long oil trade, and we are happy the panicky types are taking the other side of the bet. (To be fair, funds are still long Energy, they have just reduced their holdings quickly, significantly, and steadily.) We will also add that this data might be skewed by the mega deals taking place lately (Exxon buying Pioneer and Chevron buying Hess). Goldman typically accounts for these things, but we cannot say for certain.

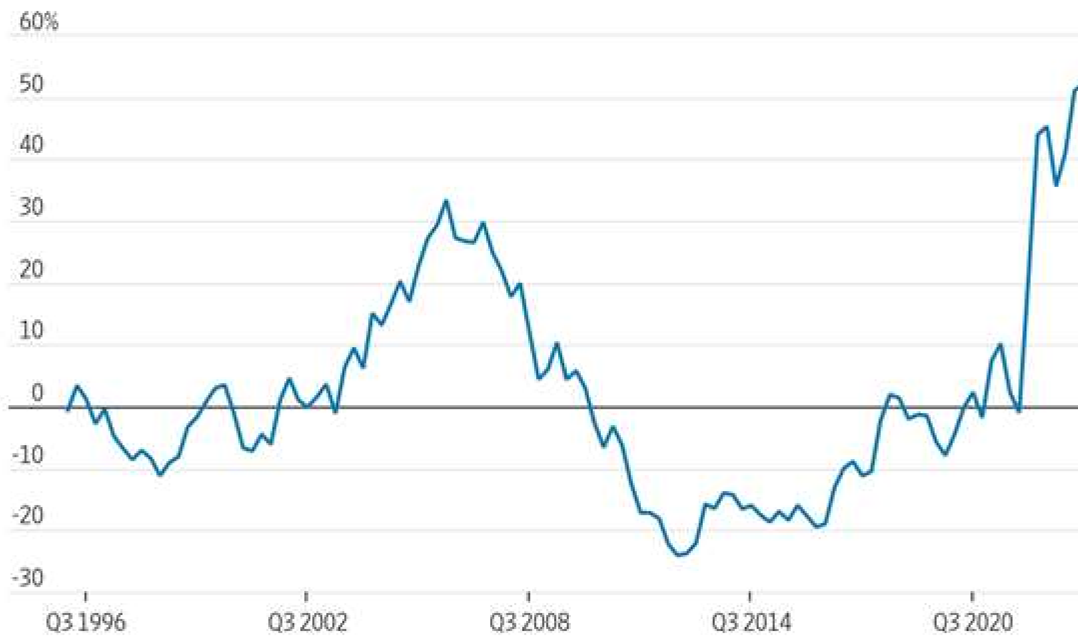


- Houses are still not selling unless they are New

Existing Home Sales in September fell 2% vs August. They hit their lowest levels since 2010. Supply is obviously the culprit with only 1.1mm homes for sale which is down 8% vs last September. This notional supply is the lowest figure since the data started being tracked in 1982. And the median price increased to $394k (up 2.7% vs last September). The months of supply has ticked higher…but that is only because the overall Sales number is falling faster than the supply. Anecdotally, there are lots of sob stories on Twitter talking about the plethora of rental homes that now have a negative carry despite having a low mortgage rate (insurance, taxes, maintenance, and of course lower rents! – see below). Please excuse the lack of labeling, but this chart is Existing Home Sales over the last 25 years:



While home prices remain stubbornly high (low supply, employment holding up despite cracks), rental prices have been collapsing. Obviously, something must give. Our baseline expectation of lower growth (with or without an official recession) lead us to believe Housing prices will follow rental prices.

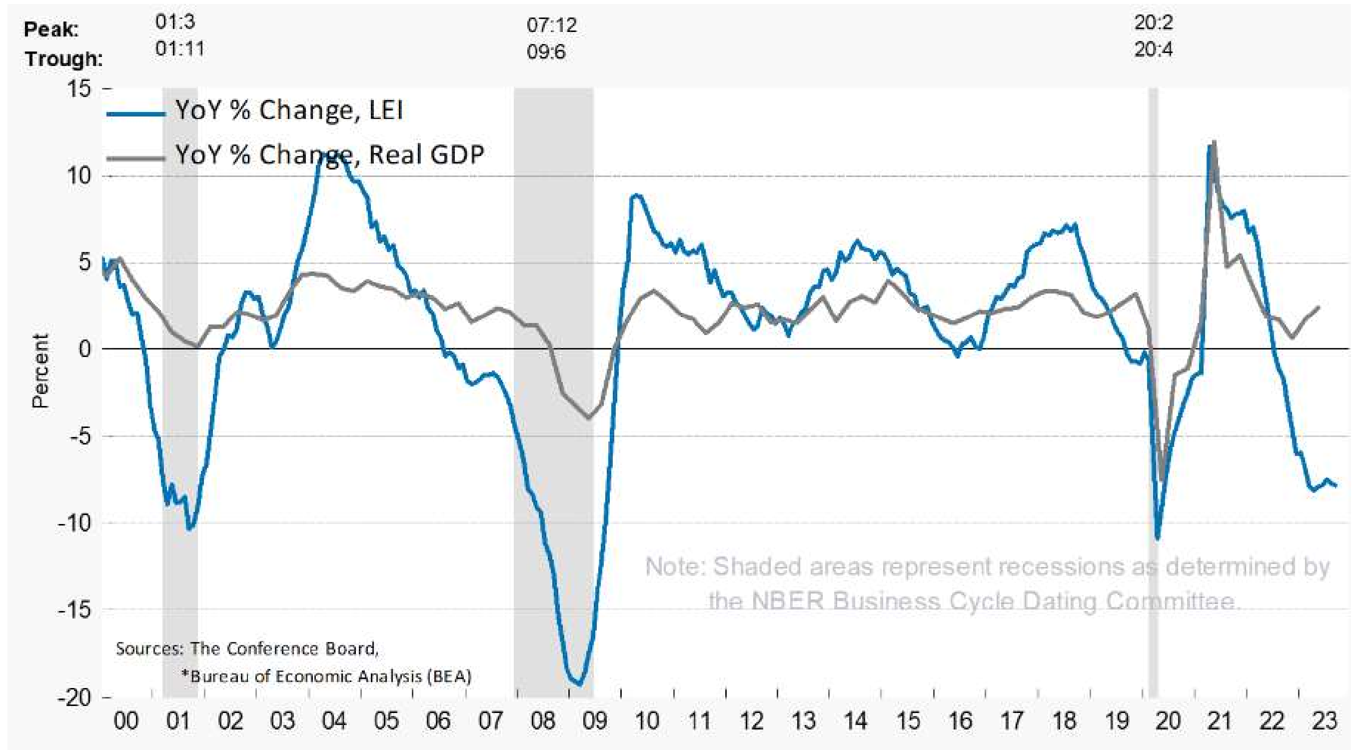


However, New Home Sales continue to buck the trend as they increased over 12% in September vs August (and +34% vs last September). The average price is down about 12% over the last year to $419k (but still up over 26% from pre-Virus Fear). Moreover, builders are increasing their use of incentives (as we know from last week's

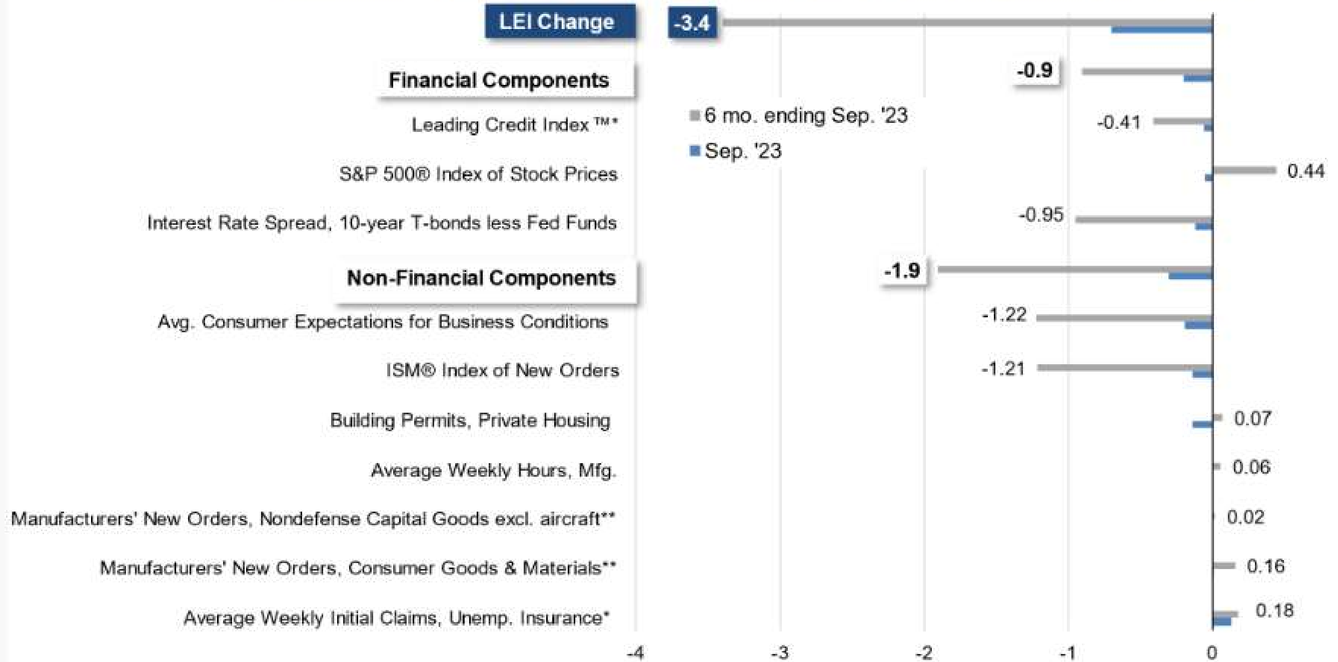
Housing Market Index). Mortgage “buy downs” are increasing in popularity. A consensus guess is that 5.50% is the mortgage rate offered by builders (compared to about an 8.5% rate on the average 30-ye mortgage). Also, Building Permits are sluggish. Perhaps this means builders are exhausting their ability to offer incentives. Inventory is down to 6.9 months.

- Leading Economic Indicators are still indicating trouble

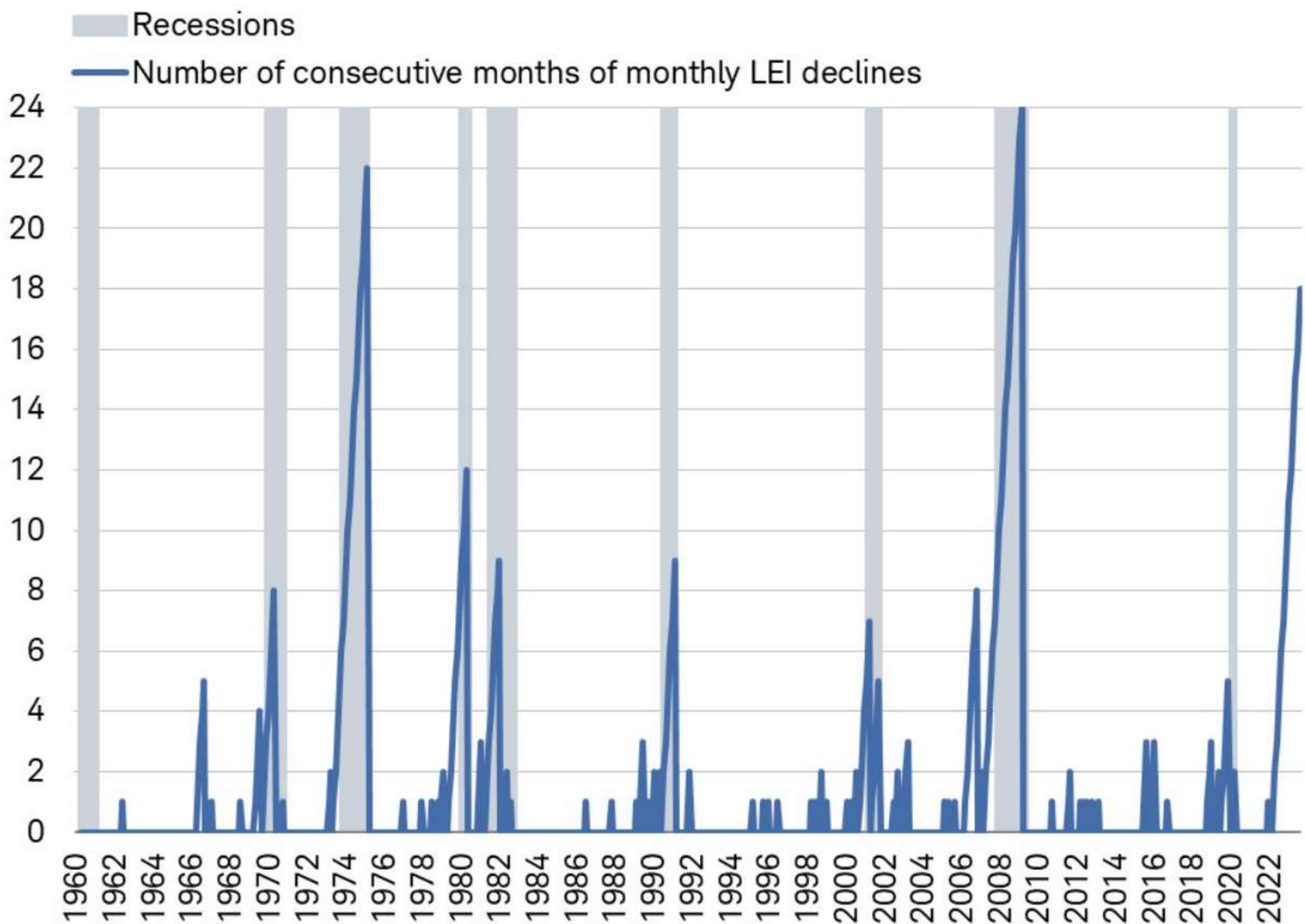
The Leading Economic Indicator index is still negative. Again, it is pretty obvious that a move lower in this index is a prelude to slowing GDP.



Below are the components of the index and their contributions. For September, nine out of 10 were negative, with Jobless Claims being the only positive reading. Looking at the six-month trend, Stock Prices are the only significant contributor.



Here is a chart from Schwab that tells us that it is the duration of negative readings that matters most. This is obvious (we always note that trends are what matter not single data points). This chart also tells us that it would be remarkable to avoid a recession with the current economic backdrop.



➢ Business Surveys improve slightly

The S&P Global PMIs for October (the Flash or early read) both improved. Manufacturing was a small move, but it did reach the breakeven point of 50. Services increased more to 50.9. The Composite sits at 51.

The Philly Fed Manufacturing Index improved in October vs September. But the headline remains deeply negative. There has only been one positive reading over the last year. Perhaps this is a good sign…meaning this survey data has not been accurate.

The Richmond Fed Manufacturing improved a touch. It has now been positive for two months.

➢ Powell is not cutting interest rates

Fed chairman Powell gave a speech with a length Q&Q session. Here are some snippets:

- Maybe rates have not been high enough for long enough.
- Additional evidence of a strong economy may merit more rate hikes.
- The Fed wants to maintain “sufficiently restrictive policy.”

As we stated in the intro, somehow some pundits perceived this to be mixed or even leaning dovish (looking to cut interest rates). For those that think the Fed *should* cut interest rates, we remind them that nobody cares what anybody thinks the Fed *should* do.

- Oil headlines are positive for prices on the margin

The US government has decided to start restocking the Strategic (Tactical?) Petroleum Reserve (SPR) now that the war is intensifying in the Middle East. Without being too political, the point of the SPR is to have it stocked *before* war strikes. On war, the market has discounted any interference from or excursions with Iran. While we think Iran knows they are better served disrupting life from afar, we do not think the chances of an escalated war are zero.

Venezuelan sanctions were officially lifted as expected. Naturally, oil rallied on the move (this is sarcasm, but the point is government actions typically have plenty of unintended consequences). But seriously, Venezuelan exports are expected to increase from 800k to 1mm over the next year. The US consumers about 20mm barrels per day.

Russia has denied stories that it will ease gasoline and diesel export bans (they will resume exports). It is hard to tell what is true these days in Russia. We suspect the original communists are exporting petroleum products, but they do not want the world to know they are (both for sanctions reasons and pricing reasons).

- Where did all the crypto money go?

We have talked about Voyager Digital before. It was one of the platforms (do not call it an exchange!) that promised outrageously high interest on crypto deposits while proclaiming to be insured by the FDIC (nope).

It has come to light that Voyager's version of due diligence on the firms to whom it was lending its customers's crypto was somewhat…nonexistent. Voyager officially declared one counterparty "low risk." But the CEO wrote to an unnamed, famous athlete (presumably an investor? Maybe Brady?), "My biggest fear is that (the firm labeled "low risk") is a house of cards. Not for us but will blow up the industry." Obviously, this firm went bankrupt and took Voyager's customer's money with it.

- Chart Crime of the week

This week's entry is a chartless story involving crypto. In the Sam Bankman Fried trial, the prosecution is requesting the judge to throw out 13 charts that the defense has submitted as exhibits. The prosecution claims, "none of these charts identify the sources on which they are based, and the Government has not been able to connect the numbers on these charts to any evidence in the case." Moral of the story: The government will stop you from using chartcrimes to get out of real crimes.

- Quick Hits
  - United is going to start boarding passengers by seat (window-middle-aisle) instead of row.
  - We are now being told that one "has obesity" instead of "being obese."
  - Here's another fat headline in Elemental (whatever that is): "The Bizarre and Racist History of the BMI (body mass index)."
  - Burger King is being sued for allegedly misrepresenting the size of its burgers in advertisements. The same plaintiffs had a suit against Wendy's dismissed last month.
  - An Amazon employee was fired (and might be investigated by the FBI) for claiming $350k of food & beverage expenses during *virtual* employee events.

Trading: As our short delta positions increased in size (options become more valuable the more they work), we took the opportunity to book some profits. But we also had a mini rally when interest rates head-faked people for a day. We used this lapse in sanity to add to our shorts…especially those that really should not be affected by a 0.15% move in the 10yr. We are slowly buying our select Big Tech names. The macro factors are lining up aggressively against any kind of risk taking, but we like the medium-term prospects of these companies (not to mention the long-term).

TSLAQ: One of the big bulls on Tesla, Gary Black who used to be in the c-suite at Goldman (oh how the mighty have fallen) had this to say about its earnings, "The conference call was lousy, earnings were lousy as they missed on their most important metric Automotive Gross Margin, and the quality of the earnings was light because they were based on reg credits and a lower tax rate." When asked about the price cuts and the sales trajectory, he said, "yeah there has been no demand elasticity." And Gary is a bull! His argument for owning the stock is that it is cheap trading at 52 P/E (and he is being generous with this low of a forward P/E…it is probably more like 85x if you assume flat earnings from here).

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