Weekly Update

23-Mar-2022

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- Short covering has run amuck
- Quick Hit
- A student loan cliff could be coming
- Positioning is already ramping higher
- Investors say they are scared but do not act like it
- Inflation is still scorching hot
- The Labor market is fundamentally different now
- Interest Rates are starting to hit housing demand
- The Fed is hiking but not selling just yet, this could be the real tightening
- Quick Hits
- Chart Crime of the week
- Spring Break leads to a LONG note

	Last	5d %	YTD %	1yr %
S&P 500	4,456	2.6%	-6.2%	14.6%
QQQ	$351.83	3.5%	-11.5%	11.0%
US 10 YR	2.29%	2.18%	1.51%	1.61%
USD/DXY	98.6	98.5	96.0	92.5
VIX	23.6%	26.7%	17.2%	21.2%
Oil	$114.57	20.6%	52.8%	99.0%

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

The market bounce continues with the Nasdaq gaining about 10.5% in about two weeks. In isolation, this does not make a lot of sense as there has been no clear catalyst. When juxtaposed with other asset classes, news, and data, it is utterly befuddling. The Fed has started to increase interest rates and has cranked up the tightening rhetoric, oil prices are back within earshot of the recent highs, economic data is worsening, and Putin is still a madman. So, what gives? Some point to technical mumbo jumbo in the charts. Others have a renewed faith that the Fed will be able to thread the impossible needle (hiking rates into a decelerating economy). The communists in China have seemingly eased their assault on capitalism (as always, they do what is "best" for their belief system which includes shutting Disneyland but reopening Foxconn's iPhone assembly plants). China has not overtly sided with Putin, so the threat of a real WWIII has eased. And Putin even made some interest payments on dollar bonds, so maybe he is not so crazy after all (yes, he is). Ultimately, we think the extreme

action in both directions has been a function of lopsided investor flows. Specifically, hedge funds were forced to sell at the lows ("forced" is used loosely), and now they are racing back to the FOMO game. But none of this changes the fundamental backdrop of a weakening economy with staggering inflation (which may or may not turn into deflation…as we have written, it does not really matter in broad terms).

- Quick Hit

Here is a Quick Hit more worthy of front-page reading: There have been 12 recessions in the post-war period (since 1946). 11 have followed notable rallies in the price of oil. Most of these were major spikes (eight of the 11).

- A student loan cliff could be coming

We often write about government handouts and the unintended consequences of this largesse. One area that was loudly cheered by the media was the moratorium on student loan payments. There has not been much talk about it recently, and that is probably because the moratorium still exists (hush hush to keep it going). May 1 is current end-date, but this is likely to be extended. Whenever this data hits, it could be ugly. Private student loan borrowers who have not had the pleasure of the gods wishing away their debts have had a rough time. They have a 33% higher delinquency rate on all their other debt (nonmortgage).

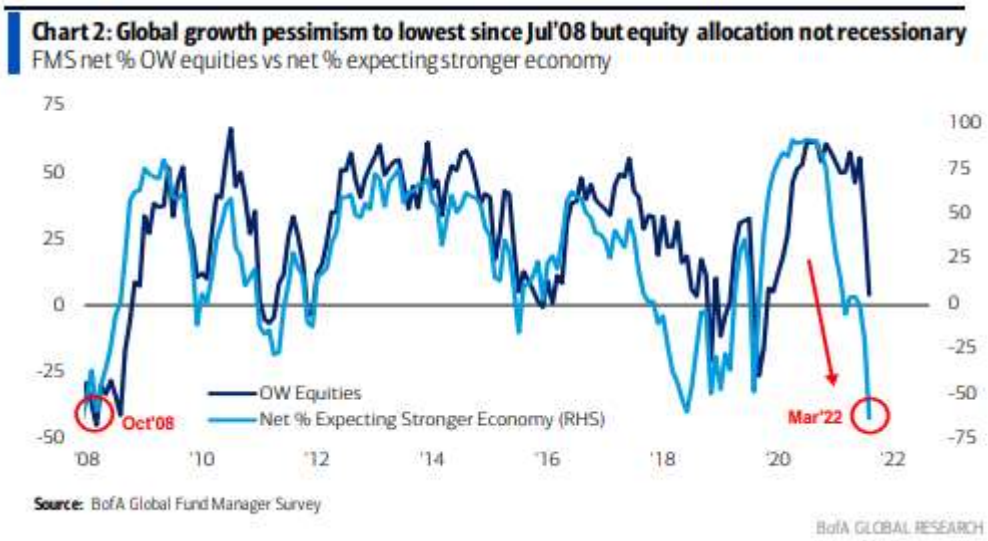
- Positioning is already ramping higher

Morgan Stanley tells us that we have just seen the largest bout of short covering since June of 2020. Gross Leverage (longs plus shorts) and Net Leverage (longs minus shorts) both surged in the last week. Goldman Sachs says the selling in February and early March was one of the strongest on record (close to peak virus-fear and World Financial Crisis selling). Quizzically, MS states that this buying could be a positive signal for the market as it could make investors more "comfortable" adding "risk." If there ever were a reason to "add risk," it is to "feel comfortable."

Further to the question of sanity, the "meme" stocks are apparently back en vogue. Some of the largest option volumes have been in AMC and GameStop. And, of course, the maniacs buy the weekly options which only work if there is a sudden burst of momentum. Or perhaps if the chairman announces he has increased his stake a whopping 0.1% - GameStop rallied 31% on Tuesday and then the chairman announced he had increased his position…nothing to see here.

- Investors say they are scared but do not act like it

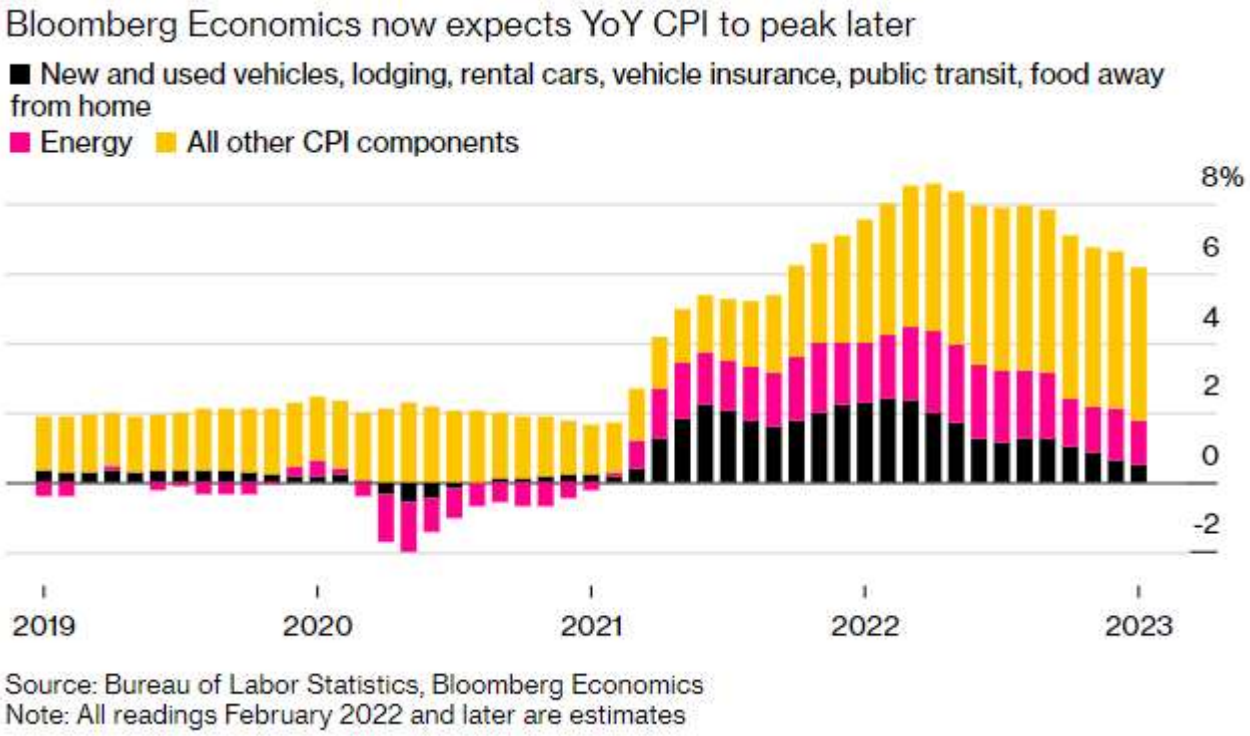
According to the Merrill Lynch Fund Manager Survey, stagflation is the predominant expectation for investors. Growth expectations are at a 14-year low, and inflation is expected to be "permanent." Long oil is thought to be the most crowded trade (although other Merrill data shows inflows into Energy stocks have barely been positive). None of this is too surprising (except for the Energy flows part). But what we do find odd is that the Ukraine situation is considered the #1 tail risk. Considering this is out in the open (tail risk usually implies something hidden or low probability), we are not sure in what the extended worry is rooted (nukes being deployed?). The other tail risks are recession and inflation (not really tail risks, either). The largest factor rotations were out of Financials and Tech and into Staples and Utilities (and small-cap to large-cap, and Europe to US…basically everything safe and/or inflationary). Alas, for all this voiced concern and factor rotation, investors are still overweight equities (albeit less so) and even buying Cyclicals (more exposed to the swings of the economy). One of our favorite Merrill charts shows the discrepancy clearly:



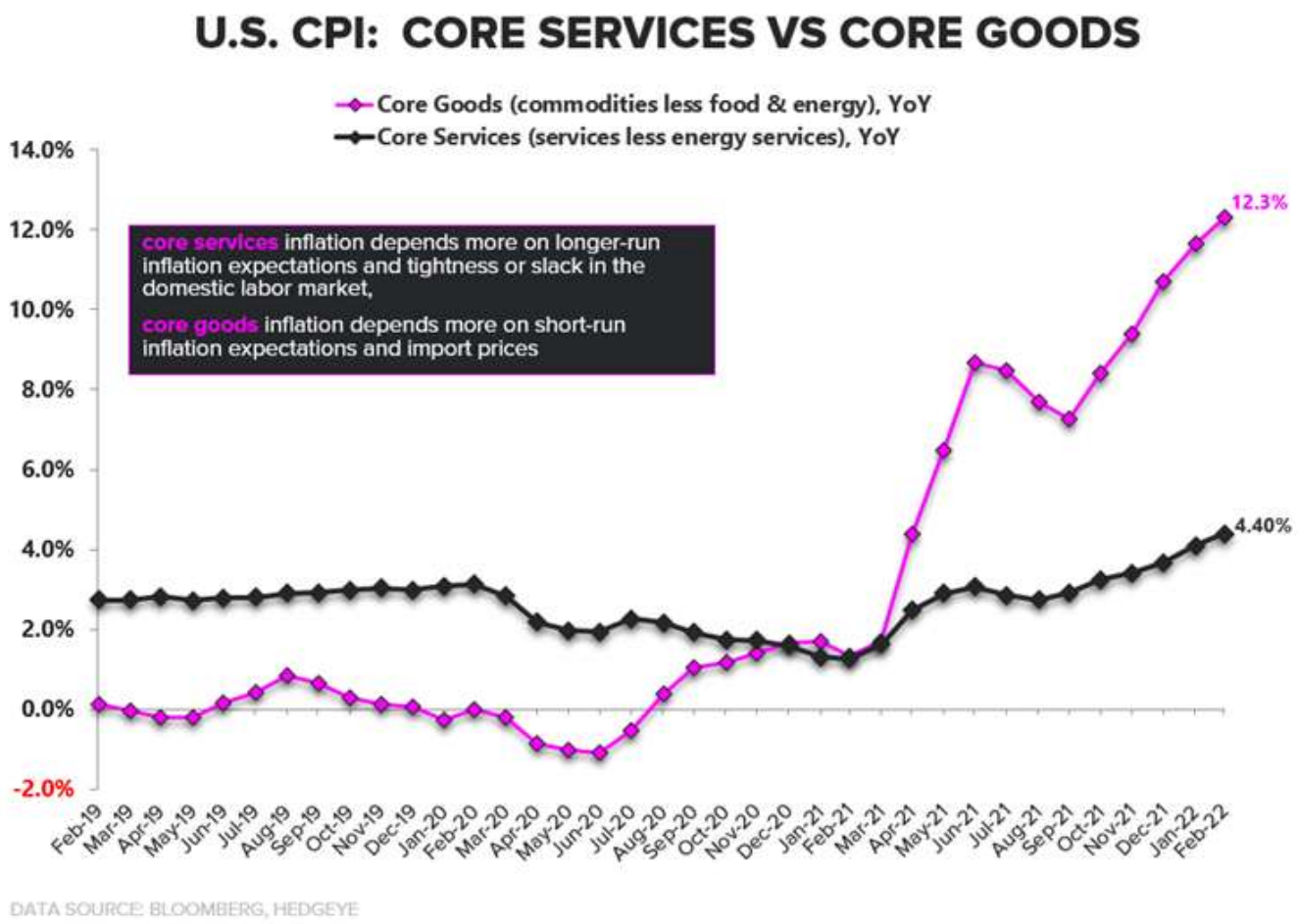
- Inflation is still scorching hot

The CPI for February came in hot as expected. The annual increase was 7.9% and the "core" set of prices increased 6.4%. These amount to monthly increases of 0.7% and 0.5%. Both are a tick lower than the January increases.

We mentioned last week that wage inflation is starting to trail that of headline inflation. Moreover, it is the low-wage workers that have seen the sharpest increases. The Moody's chief economist makes a good point with respect to labor wages of today relative to the 1970s: union membership is a fraction of what it was then, so continued wage escalation is unlikely. Of course, this is another double-edged sword. If wages cannot keep up with inflation, that will squeeze the consumer that much more. And as you can see from the inflation chart below, sectors that were once exhibiting inflation pressures will likely start to ease. But other areas are ready to take their place. Damned if they do, and damned if they don't…

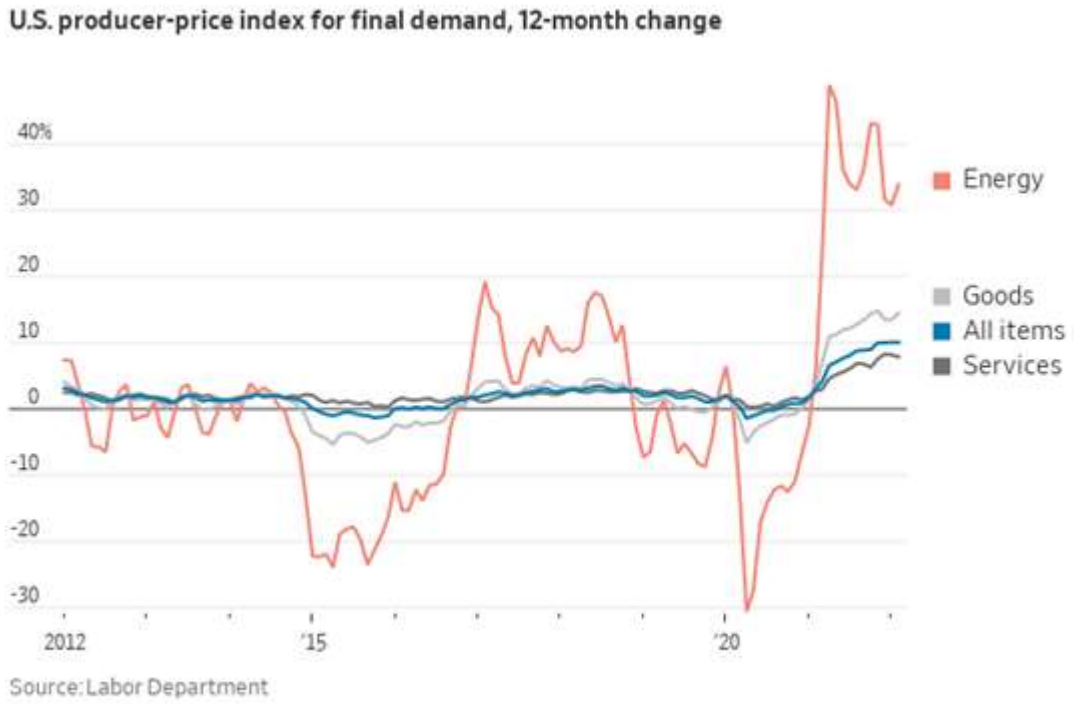


Here is another way of looking at inflation (courtesy of research shop Hedgeye). Goods inflation is far outstripping Services inflation. And you can see their legend: Goods prices are usually short-term in nature and Services are longer-term. Hedgeye is very loud in its "inflation has peaked" position. They know it Is not "transitory," but they also see cracks in the vertical ascent.



Of course, theory does not mean a lot on main street. The percentage of small businesses raising prices is hitting a modern day high.

Producer Prices (wholesale prices or input costs) in the US are also screaming. The PPI in February grew 10% vs last year. This is a 0.8% monthly gain. This is a deceleration, but January's increase was revised higher. While oil has pulled back from its recent high, it is still way above the February prices. So, the PPI is going higher in March. The "core" PPI is just as nasty with an 8.4% annual increase.



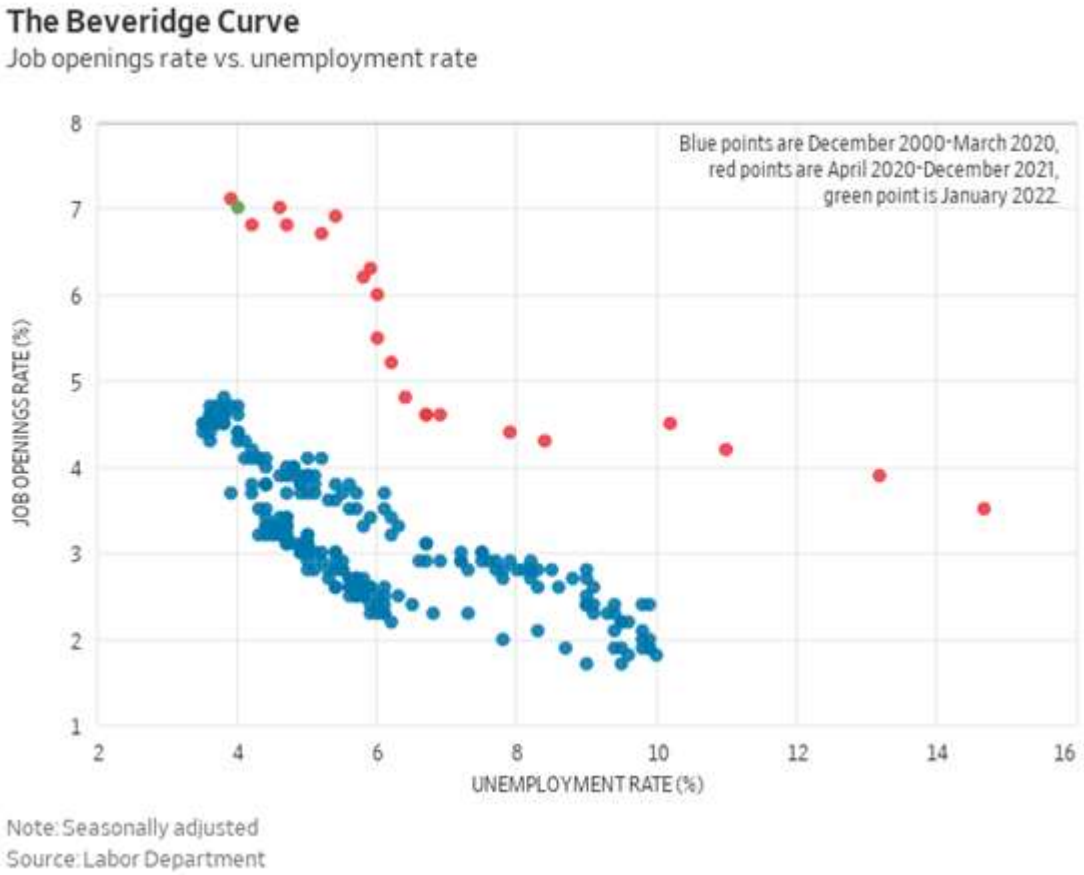
Business Inflation Expectations according to the Atlanta Fed continue to climb. The 3.8% reading in March is the prediction for inflation over the next year. This obviously is lower than the current inflation (7.9% CPI and 6.1%

PCE). But the Fed still only expects inflation of 2.7% at the end of 2023. Of course, the Fed only expects 4.2% this year, too.

This is all very difficult through which to sift. There are some many data points with different historical precedents and caveats. Ultimately, we think Hedgeye is right that price increases will start to slow. But we think this could be a slow process and inflation equities could remain strong. We still like be long Energy and commodities.

- The Labor market is fundamentally different now

Even if the Unemployment rate and Labor Participation both tracked back to their pre-virus-fear low and high (respectively), there would still be 7.4mm job openings vs the 11mm openings today. And the ratio of job openings to unemployed would still be at a pre-virus-fear all-time high. Our takeaway is two-fold: We will not confuse a huge slug of Job Openings with pent-up demand in the economy. And this mismatch in job seekers and job openings can lead to wage inflation. Another way of saying this is that the Goods segment of the economy did not have enough workers. As you can see below, today's unemployment rates have much higher job openings. Tito did not make this chart.



- Interest Rates are starting to hit housing demand

Mortgage applications are starting to respond to the increase in interest rates. With the increase this year of 1.05% in the average 30-year fixed mortgage (3.11% to 4.16%), Applications for new mortgages are starting to fall (refinancings are falling faster). As most buyers are monthly-payment sensitive, this increase in interest translates into about a 11% decrease in home cost to keep the cost of a house the same (vs before the increase in interest rates). Of course, house prices are not falling. The narrative has been that demand remains robust,

but the supply is constrained. While the second half of this statement is certainly true, we are not sure demand remains the same.

The Housing Market Index (homebuilder survey) seems to support our twist as it continues to backtrack as the March reading was the third monthly decline. The sharpest drop was in the future expectations component (a six-month outlook). Present Sales remain ok. Traffic of Prospective Buyers is still lousy.

The theme continues as Existing Home Sales fell sharply in February compared to January with a 7.2% drop. And New Home Sales also underwhelmed with a drop in February vs January.

Housing Starts and Permits in February are the outlier data indicating demand is still strong. But this month is against the easiest comparable month of 2021. So, all the "growth" will start to fade in the coming months (remember this data is annualized on a monthly basis, so anomalous readings are exaggerated despite being seasonally adjusted.)

While the ever-shrinking supply makes the headlines, distressed supply is starting to appear after sharp increases in foreclosures. With the moratorium on foreclosures long gone, the numbers are mounting. January foreclosures were up 29% vs December and up 139% vs last year (this number doesn't mean much because of the moratorium). And these numbers continue to climb according to analysts using proprietary data.

With respect to Housing, we still believe in Work-From-Home, warmer climate migration, warmer political atmosphere migration, etc. But a weakening economy and higher prices will likely trump these positive themes. We remain on the sidelines in housing stocks.

- Other Economic data is predominantly weakening
  - Regional Fed Manufacturing surveys are mixed with NY being abysmal, Philly being ok, and Richmond bouncing strongly. But, all show longer delivery times and high prices. And Richmond's Expectations gage was still lousy.
  - Industrial Production in February slowed to a 0.5% increase. Manufacturing Output continues to grow offset by slumping utilities and mining. We are not too worried about mining, but slowing utility usage is certainly an ominous sign.
  - Weekly Redbook Retail Sales continue to slow with five straight weekly declines (from 15.4% to 12.4%).
  - Monthly Retail Sales in February only increased 0.3% vs January's 4.9% ramp.
  - Business Inventories increased in January as expected which was a slowdown vs Dec.
  - The (non)Leading Economic Indicators showed a 0.3% increase in Feb after dropping in Jan.
  - The Chicago Fed National Activity Index contracted sharply in February.

- China headline data is misleading (as always)

The recent data in China point to a strengthening economy. China's PPI slowed in February to "only" 8.8%. But this compares to the 9.1% increase in January and the peak of 13.5% in October. Industrial Production and Retail Sales both surprised strongly to the upside in January and February. But this data has been rendered moot given the massive lockdowns going on thanks to the flailing 0-Covid policy. Elsewhere, housing prices have slowed nine months in a row. The communists wanted to slow the housing market…and they are getting it done (be careful what you wish for).

- The Fed is hiking but not selling just yet, this could be the real tightening

The Federal Reserve hiked its Fed Funds target rate by 0.25% as expected (Fed Funds is the rate at which banks lend to each other, the Fed's target rate just sets the basic guardrails). The Fed signaled that there would be seven hikes in total this year which would bring the target range to 1.75% - 2.00%. There is no balance sheet reduction yet (selling the bonds they just finished buying!), but it appears imminent (an announcement in May is likely). Fed chief Powell even said 50bps hikes would be possible in the future if the data warranted such action. Powell continued, "moving to a level past the perceived "neutral" interest rate (some call this 2-2.5%) might be necessary." He said there is a risk that long-term inflation expectations could move higher. This is a long way from the halcyon days of inflation being "transitory." Of course, he also thinks the Fed is nowhere near a recession.

Basically, the Fed has shifted from a "Jobs at any cost" platform to "Kill inflation at any cost" platform (we lifted this phrase from someone, but we honestly forget from whom). Powell reiterated these comments a few days after the rate hike announcement. This time around the market reacted negatively…but only for half a day or so.

Fed Governor Christopher Waller commented that he would like to see a steeper rate hiking to combat inflation. He thinks the data has supported this. Bostic of the Atlanta Fed thinks the Fed should get moving quickly on the balance sheet reduction. We suspect it will be very gradual at first.

While we agree that the inflation side of the equation certainly calls for strong action, the slowing economy side of things calls for a more measured pace. So, again, we think the Fed is damned if they do and damned if they do not.

- Central Banks are becoming more hawkish

The ECB moved up its schedule to reduce its asset purchases. The ECB plans to stop buying bonds sometime in the 3Q. The logic goes that this would allow the ECB to hike interest rates shortly thereafter. Recall there has been some back and forth between members of the ECB. Any time some hawkish (rate hiking) comments were made, more dovish (no rate hikes) comments followed. But this explicit changing of the bond buying trumps these comments. Obviously, the situation in Ukraine can change this in a heartbeat. But it sounds like the ECB will be making the same policy mistake as the Fed: hiking into a slowing economy resulting in a recession. We have been slowing building a short position in Germany.

The Bank of England (UK Central Bank, BOE) raised its benchmark interest rate by 0.25% as expected. This is the third hike in a row (three meetings) reaching 0.75%. The market expects at least two more hikes in the next two meetings with rates ultimately hitting 2% by the end of the year.

- Oil capacity is still constrained and Russia is making it worse

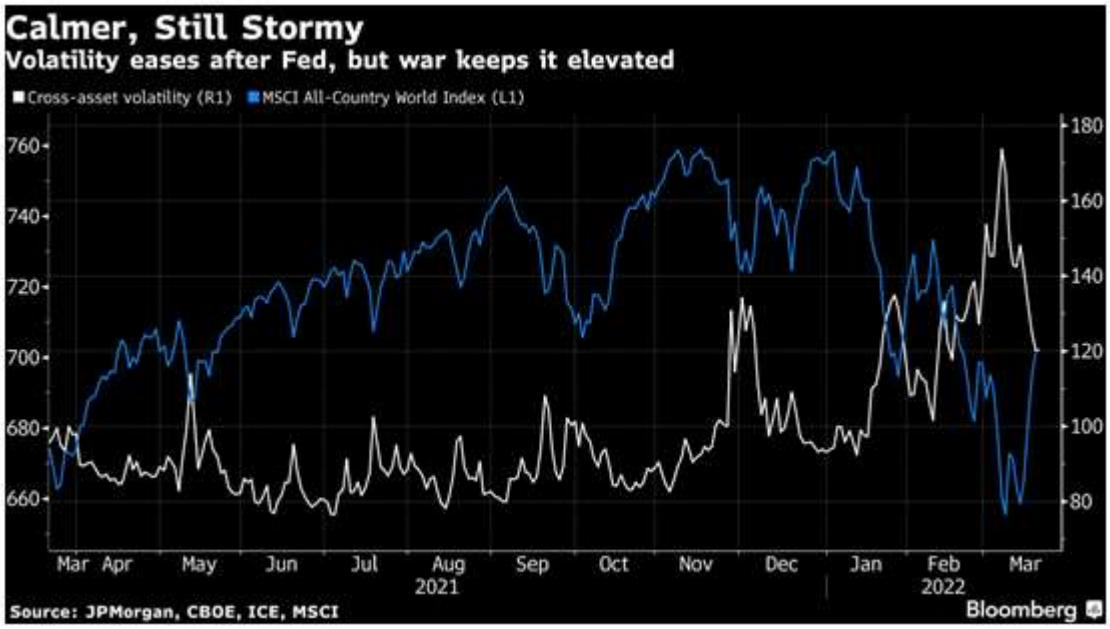
The fluffy headlines in the oil world point to more supply and easing prices. These include OPEC finally hit its production quota in February. And the UAE is starting to break ranks with the Saudis in terms of keeping oil production restrained (UAE wants to pump more). Even Russia, comically, wants to produce more.

But the facts on the ground tell a different story. Despite one month of increased production, OPEC has been struggling to use its limited spare capacity. The group is still far behind its desired aggregate production target. Libyan oil has fallen dramatically in the last two weeks as militia have attacked the country's export facilities. The Houthi rebels in Yemen continue to attack Saudi oil facilities. And most recently and notably, the Russians have closed the pipeline that exports a large chunk of Kazakhstan's oil production. This was done under the auspices of fixing some damaged terminals in one of Russia's ports on the Black Sea. Uh huh.

Oil is volatile and we do not want to trade the headlines. But we think the structural shortages and resilient demand (leisure travel has been quite strong, to name one factor) paint a strong picture in the medium term. Of course, a recession will fix high prices (or high prices will fix high prices as we like to write). But we think there I smore runway for Energy (but we will not be chasing/adding until/unless we get a pullback to buy).

- Chart Crime of the week

This one is pretty boring, but the idiocy is still supreme. The charts seem to start at the exact same spot and then shuck and jive in perfectly inverted tandem. Of course, the starting point is completely arbitrary with completely different scales (somehow a Vol level of 95 equates to an index level of 675?). Sure, we know that easing Volatility and market strength go hand in hand. But this chart gives us zero perspective on how much.



- Quick Hits
  - The average American uses 60 barrels of oil a year.
  - The five biggest investment banks have earned $645mm in capital markets fees this year (doing IPOs, debt issuance, etc). The same period last year brought in $5.3b.
  - Only 20% of the cost of a loaf of bread is wheat.
  - 10% of the blood plasma collected in the US comes from Mexicans on tourist visas. They are paid $50 to donate.
  - Ukraine is about the size of Texas (86%(.
  - GameStop's earnings conference call lasted 11 minutes.
  - Time will likely be changing come the end of 2023 as there is bipartisan support to move to daylight savings time permanently. We wonder what Arizona and Indiana will do about this.
  - The daylight savings bill passed in the Senate by "unanimous consent" because its opponents did not know there was a vote.
  - Cowen had a positive note on the restaurant sector with the not-so-mild-caveat which warned "input costs will be broadly challenged by surging oil prices, consumers's disposable income will take a hit, and higher freight and labor costs are margin headwinds."

- There is a Welsh rugby player nicknamed Sausage.
- Death row inmates in South Carolina can now choose to meet their maker via firing squad.
- Modelo Especial is the second-best selling beer in the US.

Trading: We added to our Put protection during the market rally. Some of the profitless Fantasy stocks seem to be moving higher again. Most of these have high short interest (fancy lingo for heavily shorted). We think some of this has been cleared out, so we are more comfortable adding. Moreover, Volatility levels have compressed making the Put options cheaper. We have added a bit of long exposure to one of our event driven names (theoretically idiosyncratic but we are not naïve to think this is true during times of stress). We still like our inflation longs (Energy and Health Care staffing). Staples with pricing power should perform well despite some taking hits from Russia. We have added to our long gold position. We also like adding to Treasuries…the sacrilege! But if the Fed over-hikes or war intensifies in Ukraine, Treasuries will be a safe-haven again (this is a tricky timing game, no doubt, so we want to be slow…probably very slow).

TSLAQ: Despite not being able to issue debt backed by its leasing business, the Tesla pump and pump game is back on. Somehow the fanbois think building a factory in Germany is somehow good for margins. It is one of the most expensive places on earth to manufacture. Sure, they will save a bit on shipping from China, but the demand is nowhere near enough to warrant a large-scale operation. China is the only place the company makes money (other than the fleeting business of selling EV credits). The conspiracy theorists out there say since the Chinese own the Tesla factory and associated business, so it is largely irrelevant. We do not go this far, although it is plausible since China did finance the factory…not to mention the communists could change the rules of the game whenever they want. Whatever the case, we mentioned that junky stocks have been rallying like mad. Tesla: Exhibit 1.

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