Weekly Update

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Carlisle C. Wysong, CFA
Managing Partner

- Interest rates are setting the tone
- Rate cut expectations are dropping
- The European Central Bank is waffling
- All eyes are back on D.C. (for other reasons now)
- CPI was higher, but some details point to a lower PCE
- Retail Sales remain robust
- Some China data looks better, but not where it counts
- Quick Hits
- Where did all the crypto money go?
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	4,739	-0.9%	-0.6%	20.3%
QQQ	$407.21	-0.3%	-0.6%	45.9%
US 10 YR	4.11%	4.04%	3.88%	3.37%
USD/DXY	103.4	102.4	101.3	102.4
VIX	14.8%	12.7%	12.5%	20.3%
Oil	$72.87	2.2%	1.3%	-9.5%

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

The market mostly treaded water this week as Interest rates are setting the tone. With a modest increase across the curve, higher rates are doing what we thought they would do: Not much to big, profitable companies. But smaller, less profitable ones are reverting to being under the gun (not being bailed out by interest rates going back to zero). Of course, this is still mostly an unwinding of some of the excesses to end last year. But the Fed has done its part, too. It is trying to talk down the prevailing narratives of a rate cut in March and the six rate cuts expected for the year. NY Fed president Williams and Fed governor Waller, two of the more prominent voting members, both emphasized the need to wait for the 2% inflation target. Economic data has been stronger on the margin which is helping the cause of these Fed hawks (not wanting to cut rates too quickly). And even if we see lower inflation (Housing might be a driver of this), Waller emphasized the speed of rate cuts will be much slower than the rapid pace of the hikes. And while we did not hear more on the potential demise of the Fed's Quantitative Tightening program (letting bonds on the balance sheet mature instead of

being reinvested), we suspect that is in the works. The Fed can keep enough liquidity in the system to balance not cutting rates.

Unfortunately, D.C. politics are back in the fray. Between budget problems, a huge Supreme Court case, and the Republican primaries, all sorts of noise are swirling…most of it negative for markets (hopefully not the SCOTUS ruling, more below). Internationally, right when Europe starts to see better economic data, inflation starts to reaccelerate. This is creating some central bank pushback on their rate cut narrative. The Japanese will likely hold off on their rate *hikes*. But this stems from slowing wages and generally weaker data. The Japanese equity market continues to run hot, and the Yen continues to run cold (USDJPY hot). But we see this inaction by the Bank of Japan (BOJ) as a last gasp. We have been selling our long equity/short Yen position.

Our base case is for mild economic weakness (high credit card debt, student loan repayments, plummeting leading indicators, no bank lending, etc). But we think the large, Quality companies (strong balance sheets, consistent earnings and revenues) should still be able to shine. The opposite holds for companies with crappy balance sheets and no earnings. Does not seem like a stretch!

- Rate cut expectations can be fluid

The current probability of a Fed rate cut in March is 57%. This is down from 65% last week and 91% three weeks ago. The chances of six rate cuts had been holding steady in the 80-85% range. But this dropped to 56% today. There is still a huge divide between what the Fed expects and what the market is pricing. However, the Fed speakers appear to be sounding the right notes when appropriate. That is, when "financial conditions" are too loose (strong equity and bond markets), the Fed tries to walk back the market. When market conditions tighten, the Fed is able to force a tac in the other direction.

- The European Central Bank is waffling

European markets got excited when the head of the central bank (ECB), Christine Lagarde, delivered some seemingly dovish remarks. The gist was that the recession was *not that bad*. And the headlines have her saying, "the fight against inflation is over." But the actual quote is, "*If* we win the battle against inflation…then rates will start to decline." While some on the ECB governing council have echoed some of her perceived dovishness, others have started to pushback publicly. These voices are becoming louder as inflation data starts to creep higher again.

- All eyes are back on D.C. (for other reasons now)

Another thing to watch in D.C. is a Supreme Court case (actually it is two cases with one likely outcome). The ruling will determine the power of federal agencies. Known as the Chevron Deference, a decision in front of the court in 1984 established that if a particular law "has not spoken to the precise question at issue," then the agency is best suited to interpret that law. Ironically, the original case argued that the EPA should have more power and not less.

From the oral arguments made today, it seems the five "conservative" justices are leaning towards dismantling the precedent. Many court watchers expect at least a partial change.

Of course, we are strongly in favor of tossing the Chevron Deference into the dustbin of history. On top of removing regulatory burdens from the economy, it (the removal of the precedent) would force lawmakers to write laws with specific intent in mind. But we do fear the unintended consequence of giving more power to judges who wish to legislate from the bench.

As for the budget talks, there is another angle not getting much airtime. If the government is running under a Continuing Resolution (CR) come April 1, then the 2024 budget automatically gets cut by 1% across the board (including military, we are not sure about entitlements). This seems somewhat paradoxical to us…how could the budget get cut if there is not even a budget in place. Nonetheless, we expect more political turmoil. Friday at midnight is the deadline for the first expiring CR.

- CPI was higher, but some details point to a lower PCE

Digging into last week's CPI data we see many of the same trends. With the headline rate increasing 0.3% (compared to the 0.1% increase in Nov), Energy, Shelter, and Medical Services were the outsized gainers. Energy bounced back from depressed prices. Electricity prices continue to run hot (inside the Energy segment). Shelter was the surprise…many had expected the lagging Rent and Owner's Equivalent Rent (OER which is based on a survey of what you would rent your house for…we think this is one of the worse economic datapoints) to rollover…but the category accelerated higher with a 0.5% increase. Food continues to run cooler than headline inflation. But the divergence between Food Away from Home (+0.3%, 5.2% on the year) and Food at Home (0.2%, 2.7% on the year) is still apparent. (FYI, Food at Home has twice the weight in the index.)

Many economists (professional guessers) think this CPI will translate into a milder PCE (which the Fed prefers…at least when it fits their narrative). Basically, Housing has not come down as many expected. But Rent/OER has a smaller weight in the PCE composition. So, the number will look better on the surface.

The PPI (Producer Prices, wholesale or input prices) points to a slowing in inflation. The headline has been negative in five of the last 10 months with December being -0.1%. The annual rate is 1%. The Core did tick higher to 0.2%. But this is still only a 1.8% annual rate.

The Red Sea chaos is causing some inflation problems. But analysts at Hedgeye say that shipping disruptions usually only contribute to inflation problems 12-18 months down the road. And we suspect that the Western powers (maybe more UK than US) will put an end to the Houthi antics (if they do not run out of ammo first, there are reports that the Iranians are not resupplying them…who knows).

Similarly to the notion of rolling recessions, there are obviously rolling pockets of inflation and deflation. Remember when Home Depot gifs and lumber barons were thought of as ruthless price gougers? The US's largest lumber producer, West Fraser Timber, is taking a $50mm charge to close a sawmill and trim back production at another.

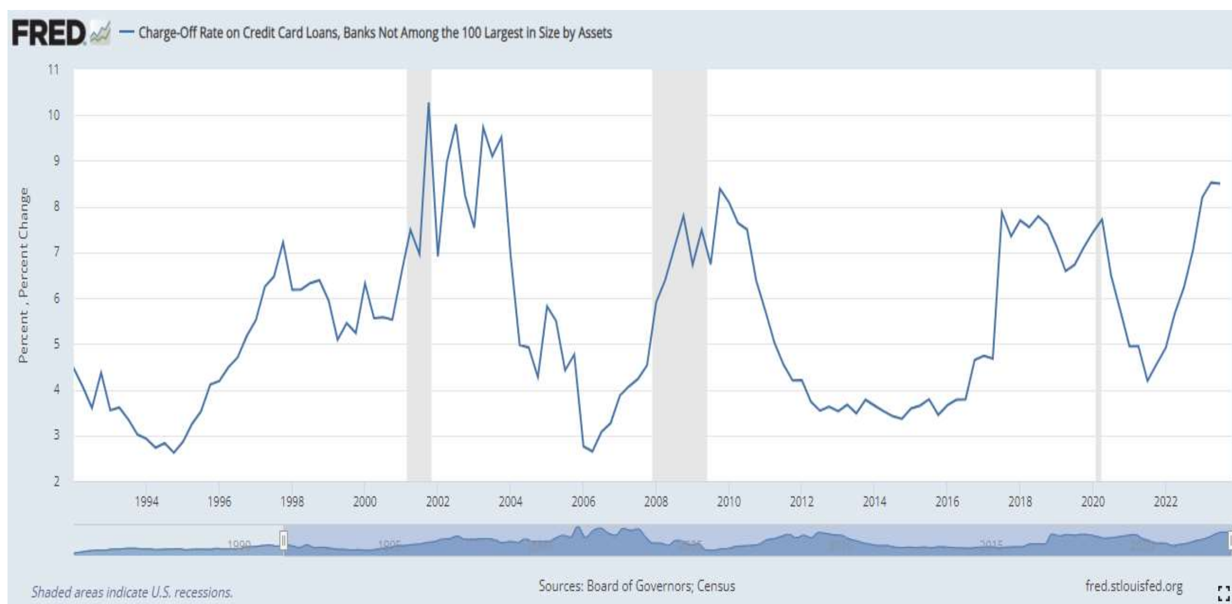
➢ Retail Sales remain robust

Retail Sales increased 0.6% in December on the month. The yearly increase was 5.6% which was the biggest in a year. Category strength was broad based: Apparel +1.5%, Department-store +3%, General Merchandise +1.3%, E-commerce +1.5%. The two negative surprises were Health and Personal Care -1.4% and Restaurants and Bars at 0%. Both of these had been running hot. Furniture is still bad. Electronics is still making a comeback albeit slowly.

Weekly Redbook Retail Sales increased 5% which is down from 5.9% last week. But growth is still steady.

It is worth adding that none of this data is adjusted for inflation. Of course, much of this has been incurred through credit card debt. This is one of the big risks to our muddle-through base case. We are seeing this in delinquencies and charge-offs which are on the rise…especially at the banks that target the lower-end consumer.

Here is a chart of the Charge-off rate at small banks (not top 100 in size). 8.5% is pretty scary. We wanted to add the Retail Sales data to this chart…is there a correlation to increased spending and higher defaults? But the darn Fed database is down for maintenance. Suspicious.



➢ Other economic data mixed to better

Industrial Production increased slightly in Dec (which was its best yearly gain in a year). Manufacturing was the source of the relative strength.

The NY Fed's Empire Manufacturing index dropped to its lowest level ever excluding the panic at the onset of the Virus Fear. The leading new Orders was also the second worst reading ever. Conversely, the Services index improved on the month (still negative but more in line with historical range).

Weekly Mortgage Applications increased again. This is a combination of the lingering bounce back from the holiday period, and, of course, lower mortgage rates.

Business Inventories and Retail Inventories both fell in December. Business incorporates Retail, Wholesale, and Manufacturing. Retail Inventories are dropping more than the others.

- Some China data looks better, but not where it counts

GDP in 4Q showed 5.2% growth. This is slightly worse than expected, but it is an improvement from the 4.9% growth in 3Q. Retail Sales in December increased 7.4% vs last Dec, but this was a miss vs the 8.0% expectation and the 10.1% increase in Nov. This was the 12th straight monthly gain (in yearly terms). Fixed Asset Investment in January increased 3% which was an improvement and better than expected. But unemployment also ticked higher to 5.1%. Recall the communists no longer publish the Youth Unemployment data.

Consumer prices fell in China for the third straight month in December (-0.3% y/y). The monthly rate did tick up to 0.1%. But producer prices remain negative both monthly and yearly.

China's trade surplus increased for the third straight month thanks to increasing exports (+2.3% y/y). Imports only inched up 0.2% y/y. The easiest read from this data is that the global economy is showing signs of life while domestic China is not (despite the repeated half-stimuli).

To cap it all off, Housing prices fell again. They have been negative (in yearly terms) every month since June of 2022.

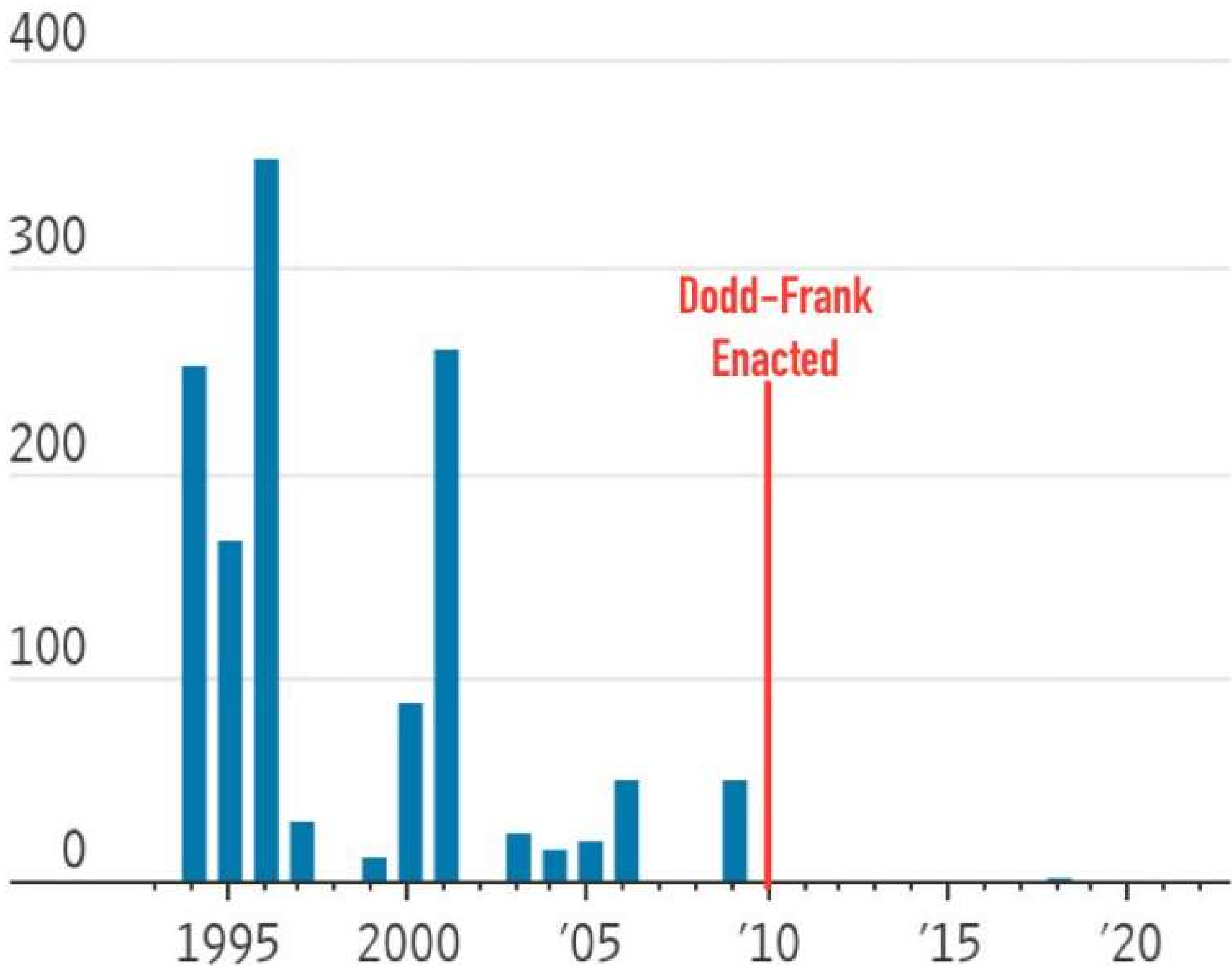
- Where did all the crypto money go?

The long-awaited Bitcoin ETFs have finally launched. There is a laundry list of products being offered by some of the biggest names in asset management. These firms (which include Blackrock, Invesco, Van Eck, etc) are racing to the bottom in terms of the fees imbedded in their products. And unlike traditional stock or bond ETFs, there are real costs involved with the custody and trading of Bitcoin. Which leads us to Grayscale. These guys created a Bitcoin Trust (GBTC) way back in 2013. They have been lobbying for the ETF classification for years. Recall that the GBTC structure was used by the crypto hedge funds to create obscene leverage. The basic mechanics: A hedge fund like Three Arrows (3AC) would buy Bitcoin (or borrow Bitcoin) and then deposit them into the Trust. Only certain institutions could do this. With GBTC trading at a premium to the assets (Net Asset Value or NAV) in the Trust, funds like 3AC would lock in giant, free arbitrage. The catch was that 3AC had to wait 6-12 months to cash out of their GBTC shares. 3AC and others kept pushing this trade aggressively…making more and more money on paper. When the price of Bitcoin turned south and the GBTC premium to NAV turned into a discount, 3AC and others were evaporated (or rather, their customer money was evaporated).

The point here is that Grayscale is slippery and is always chasing the quick buck. Unlike the cheap fees from their competitors, Grayscale is charging 5-7x the amount to run the GBTC. The idea is that Grayscale is going to milk every dollar while they can until the Bitcoin ETF world is commoditized and they eventually die under the hand of Blackrock (and probably Fidelity and the other giants). If you want a Bitcoin ETF, don't pay these guys the extra vig for nothing.

- Chart Crime of the week

Who knew banking regulation could have such a profound impact on airline safety! Raymond Babbitt could quote this one!



- Quick Hits
  - Hertz is selling 20k EVs to buy…ahem…gas powered cars.
  - 21% of adults in the US say they are not drinking alcohol this January (we do not believe this).
  - 29% of adults say they will drink on fewer days during January (we do believe this).
  - NBC paid the NFL $110mm to stream the Chiefs-Dolphins playoff game exclusively on Peacock.

- The average rent for studios to two-bedroom apartments in the largest 50 metro areas in the US has been down seven straight months. The median rent is now $1,717.
- The claim that a dog in Portugal was the world's oldest on record is now being challenged. The dog died last year at supposedly 31 years old.
- The Emmy's on Monday drew 4.3mm viewers.
- Supreme Court justice Neil Gorsuch's mother was the EPA administrator at the time of the original Chevron Deference case.
- Quantas Airlines had 14 fatal crashes between 1927 and 1951.

Trading: We bought some more in Mexico after the peso was hit after Trumps big win in Iowa (USDMXN jumped almost 2%). We think this move is overdone. With fighting China being the only common ground between Repubs and Dems, we think Mexico is a winner. We also think India is a winner, and we bought more of that. On the flip side, we continue to sell our long in Japan.

TSLAQ: Old Elon just cannot help himself. Feeling slighted and unloved, he took to X to lay out his claim to be gifted (not to be confused with *grifted*) another $90b by Tesla. His rationale was that he needed more control for him to comfortably build out the company's AI and robotics businesses. Without a 25% stake, he might just do this "work" outside of Tesla. We do not think Elon meant to make this tacit admission that Tesla had not achieved any progress in these areas. All this comes as a court in Delaware is due to rule on the legality (?) of his past compensation plans (the last one paid him $50b).

Whatever the case, it is an odd move for a CEO to hold his own company hostage with threats of creating competition for its own businesses! And lest the board of Tesla forgets, Elon had a 22% stake before he started selling shares in the last 1-2 years…so he could fund another company that distracts from his work at Tesla! Fool me once…

Check out our website to learn more about Chalk Creek Partners

Carlisle's Twitter Financial List

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