Weekly Update

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- Crazy month of July
- A hedge fund implosion followed by an earnings-led relief rally
- AI fears persist, then they don't, then who knows
- Earnings remain great
- The Fed leaves rates on hold, and Warsh does not say a thing as promised/warned
- A new view on the K-shape
- Inflation turns into Deflation (Disinflation is the trend)
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- Where did all the crypto/AI/Name Change!/prediction market money go?
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The crazy month of July finished with a bang. That bang was a hedge fund implosion followed by an earnings-led relief rally (which has extended into August). So, if you are going to skip down to Quick Hits or Chart Crimes, all you need to know is that recent market weakness came from forced selling, and the newfound relief stems from a fundamental improvement in the big spenders in the Artificial Intelligence world (notably the hyperscalers). This improvement in AI naturally spills over onto much of the ecosystem. This includes what we call the AI sellers (semiconductors, infrastructure, and power) and the AI buyers (mostly just software, but also segments of the hyperscaler businesses). The usual back-and-forth in Iran swung oil prices around. And that affects inflation on the margin…we are likely to see the disinflationary trend (deflation in June!) slow in July and maybe August. But this will likely just be a blip assuming the situation in Iran does not reverse again. (Time does help the cause as alternate energy routes and sources become more plausible…but the Houthis ratcheting up the conflict in the Red Sea is a big setback if it persists.) Kevin Warsh made his debut at a Federal Reserve press conference after a monetary policy meeting (FOMC). And he did disappoint. Or at least his insistence on removing all forward guidance (or even vague Fed-speak) became a harsh reality. The market sold the long-end of the Treasury curve in protest. Some professional guessers (economists) are noting that tariffs are back, refunds have been paid but not actually refunded, and tax cuts are in Lubbock (the best view…the rearview mirror). And oh yeah…we even had a Yen-carry trade unwind! First, the Japanese Finance Minister talked the Yen lower (stronger). Then the US Fed actually bought Yen to support it (against selling Euros, so the Fed sold EURJPY).

Of course, the forced selling was born out of the accelerating AI capex while not showing a commiserate acceleration in revenues. In other words, the doubts in AI were real as "token-maxing" (businesses spending on AI) was on the way out, open-source models were on the way in, and software might actually be a beneficiary of the AI evolution instead of a casualty of it. But it is one thing for the market to have doubts. It is a recipe for a disaster to give a 24-year-old with no investing experience the keys to a giant hedge fund with excess leverage with no risk management. (We have joked in the recent past how ludicrous it was that Leopold and his Situational Awareness fund had become so large…apparently the bankers extending the leverage did not have the same reservations as us. Ultimately, he received a margin call on his entire public equity portfolio. He sold it for about $10b after reaching a peak of $45b just a few weeks ago.)

Even without the Leopold induced Volatility, the market was still struggling with AI narratives. One day, the hyperscalers were seen as the long-term winners holding the durable economics. They were the tollbooth providers of AI adoption (cloud services). And the rapid scaling of the infrastructure buildout was already priced in, and the growth was going to fade into the abyss. This included the memory chip makers…governments everywhere are hell-bent on rapidly increasing supply. The South Koreans have announced a giant spending plan to help Samsung and SK Hynix. The Chinese now have CXMT which Apple wants to use (this stock just IPO'd in China with a 500% gain and it is now the largest "public" company in mainland China). And Micron in the US is pursuing multiple factories to increase its production. Separately, there are stories about China developing a chip-making machine to challenge ASML, the market leader. But with Google's earnings report, the narrative swung back the other way. The super-sized capex was going to burden the business and the industry. Revenue growth was good but not good enough. The same was true for Meta. Without any clear plan about reselling some of its compute (Zuck acknowledged it but did not elaborate), its capex was the main story. Even price hikes from Taiwan Semi were met with skepticism. Throughout all this, the circularity concerns reemerged. Between Nvidia, Softbank, OpenAI, Google, and Anthropic, new datacenter deals were struck with accompanying equity investments (also fueled by new debt). When the market is bullish, these deals are great! When the market is on edge, fears of dot.com vendor financing troubles bubble to the surface. Fortunately for Amazon, it reported its robust revenue growth after Leopold had been forced out of the market. So spending was all good again! The buyers of AI were going to monetize it. And the sellers of AI were going to keep selling it. Even Microsoft joined the party. That tells you what a volatile market it has been!

Through all this, Earnings remain great. Headline Earnings growth so far in Q2 is +46%. This is incredible but distorted as it includes large private equity gains held by public companies. But even after stripping out these gains (mostly Anthropic, OpenAI, SpaceX at the time), growth is still an incredible 28%. Obviously Big Tech skews the data higher. But the median EPS growth is still an impressive +12%.

- The Fed leaves rates on hold, and Warsh does not say a thing

The Fed left rates on hold as expected (but three members did vote to hike). But the real story was Fed Chairman Warsh making good on his promise to cut down on communication. He reiterated that the Fed would be removing forward guidance. Other than saying the Fed still primarily watches the PCE inflation gauge, he did not expand upon any of his other action items (how he and the task forces plan to reshape the Fed including what other inflation measures to consider). And Warsh concluded the presser with, "The Committee will deliver price stability." Unsurprisingly, the market was confused. The short-end rallied (rates lower) because the Fed did not hike (even though there was only a 38% chance of a hike). But the 30-year weakened (rates went higher). We think this is largely a function of mounting debt fears. Without any guidance, the market is doubting the Fed's ability to reign in the ever-increasing supply of bonds and/or its ability to accomplish its inflation goals (of course, fiscal policy drives this bus, and there is no end in sight there, either). Warsh did add that he believes the market can control interest rates. We shall see if he actually wants this to happen. But clearly the bond vigilantes rejoiced (this is catch-all term for the market selling bonds to force an outcome). Overall, one pundit summed it up with, "What we have here is a failure to communicate."

Bullet points:

Approximately 1.2mm retail accounts in Korea received margin calls on their leveraged ETFs (mostly single stock ones on Samsung and SK Hynix). Recall that the Minister of Finance recently lamented legalizing these devils of destruction.

Apple is suing OpenAI.

OpenAI and Anthropic continue to "accidentally" hack their customers.

Before the Leopold saga unfolded, retail investor sentiment was plummeting (no dip buying when your leverage ETF products are imploding).

We have said tariffs are back. One of the bigger ones is that generic drug manufactures will face 100% tariffs.

An index comprising Big Tech momentum stocks moved more than +/-7% in 10 of the 22 days in July.

OpenAI revenues in July were better than all of Q2.

The DOJ is appealing the decision that allows Google to keep paying Apple to be the default search engine. Google is also appealing the decision!

- A new view on the K-shape

Barry Knapp presents a different take on the root cause of the K-shaped economy. Basically, it is the unintended consequence of the divergence between the two methods the Fed has used to implement monetary policy. Since the 0% interest rate era following the GFC (Housing crisis of 2007-2008), the Fed has hiked interest rates. But the Fed has also kept buying long-term bonds. This means people using short-term variable interest rates for financing (credit cards!) have been penalized and have suffered. Meanwhile, banks, homeowners, and other investors have benefitted from the downward pressure on longer-term rates. Voila, the K was born. Knapp concludes that this is why Warsh will be able to cut short-term interest rates (to help the bottom of the K) while at the same time removing the accommodation on the long-term rates (the Fed will finally stop buying bonds) which will help with the inflation mandate. This is all easier said than done (cutting short-term rates can also fuel inflation). But we think it makes sense – that Warsh will do it and that it might work.

- Inflation turns into Deflation (Disinflation is the trend)

CPI inflation in June (change in the Consumer Price Index) went negative with a -0.4% dop vs May. This brings the change over the last 12 months to +3.5% down from +4.2%. The "Core" change was flat at 0.0%. Its annual move dropped to +2.6% from +2.9%. Obviously, the collapse in Energy prices drove the headline lower – Energy was -5.7%. But prices fell across many non-Energy categories including Motor Vehicle Insurance (not for us), Communications, Apparel, Medical Care (ha, right), and Used Cars. Shelter Prices increased…but only +0.1%. Food prices increased at +0.2% (At Home and Away from Home were both +0.2%). Importantly, (at least to the pre-Warsh Fed) Non-Housing Services inflation ("super-core") showed deflation as these prices fell -0.1%. They are down to +2.7% on the year.

We might see some reversal higher in July as Energy prices jumped higher. But we think the disinflationary theme is broader than just Energy.

The Producer Price Index (PPI, wholesale or input prices) showed similar deflation with a -0.3% drop. "Core" PPI increased +0.2%. The annual rates are +5.5% and +4.7%.

Inflation, according to the change in the Personal Consumption Expenditure index (PCE), also showed deflation at -0.1%. This is a huge drop from +0.5% in May. The annual rate dropped to +3.7% from +4.1%. The "Core"

PCE increased +0.1% which is a slowdown from +0.3%. The annual rate dropped slightly from +3.4% to +3.3%. (The PCE was once considered to be the Fed's main inflation gage even though the market tended to trade more on the CPI release because it comes out before the PCE. But new Fed Chairman Warsh has indicated he wants to use new measures…we shall see what those are at some point.)

Personal Spending normalized in June at +0.3% (May had a large +0.9% jump). Real Personal Spending was stable at +0.4% (this is the inflation/deflation effect). Personal Income also slowed to +0.2% (down from +0.7%).

The U-Michigan 5yr inflation expectation remained steady at +3.3% (down from +3.9% in May). The 1yr inflation expectation dropped to +4.2% from +4.6%.

- Retail Sales remain strong

Retail Sales increased +0.2% in June. This is a drop from the +1% increase in May. Auto sales were the strong point. Stripping these out, the headline fell -0.2%. But the Control Group increased +0.5% (which only counts sales that contribute to GDP, it strips out Food Services, Auto Dealers, Building Materials, and Gasoline Stations). This is a slowdown vs +0.8% in May, but it is still a strong number especially since this data is not adjusted for inflation. E-commerce, Sporting Goods, and Electronics & Appliances were all strong. Health & Beauty fell the most at -0.8%.

Redbook Retail sales dropped to +8.2%, +7.8%, +8.3%, and +8.7% over the last four weeks. This is a notable slowdown from the +11.5% jump around the 4th of July. But ~+8% growth is still strong, and the rate of change slowdown can be attributed to some large pull-forward shopping (Amazon Prime Day, 250th 4th of July, and the general mid-summer slowdown).

Total Vehicle Sales jumped to 24.1mm from 16.5mm (this is a seasonally adjusted annualized run-rate).

- Other economic data is mostly better

Small Business Sentiment (NFIB) improved in June (95.3 to 97.4).

The U-Michigan Consumer Sentiment for July increased from 49.5 to 54.4.

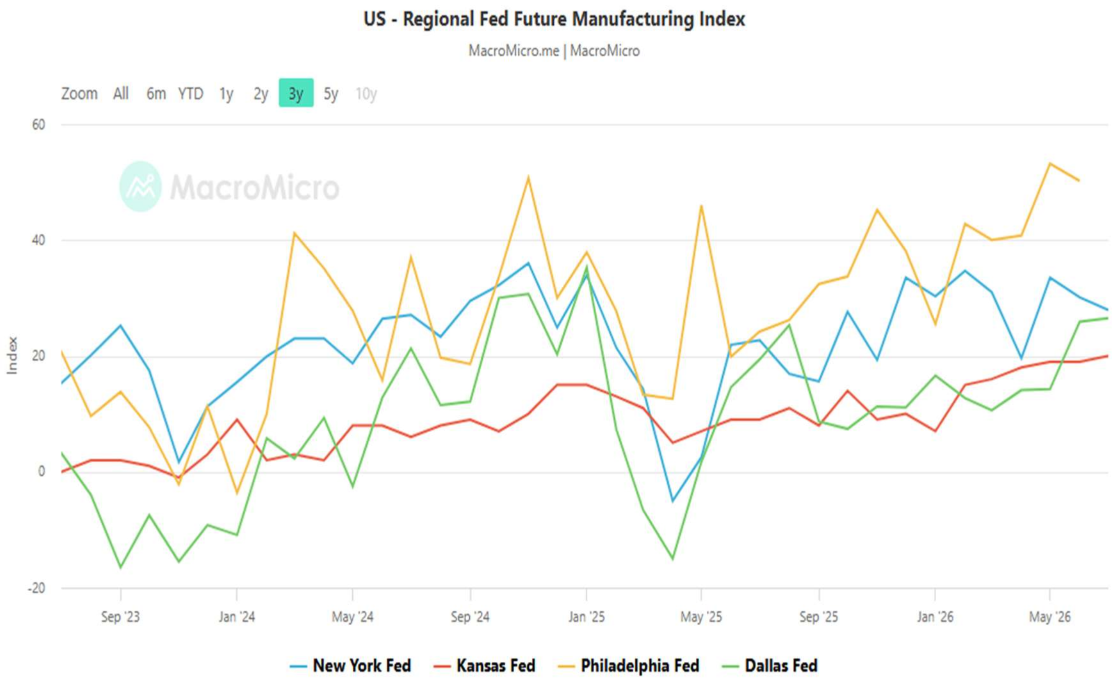
The first reading (Advanced) of Q2 GDP showed growth of +1.5%. This is slower than Q1's +2.1%, and it was originally expected to remain at the same level. But Domestic Sales increased +2.2% which was an acceleration from Q1's +1.9%.

The ISM Manufacturing PMI in July increased from 53.3 to 55.6. This extends the seven-month rally of strong readings. Employment and New Orders were strong while Prices eased a bit. The S&P PMI remained flat at 53.9. The ISM Services PMI ticked up from 54 to 54.1. New Orders were strong, but Employment was weak. The S&P Services PMI increased over three points from 51.2 to 54.6. Putting this together, international, large-cap Manufacturing did better than domestic companies of mixed sizes. But domestic, all-cap Services did better than international large-caps.

The NY Fed Empire Manufacturing index jumped from 5.7 to 15.6. The Philly Fed Manufacturing index also burst higher from 10.3 to 41.4. New Orders were strong despite current Business Conditions being weak. The KC Fed Manufacturing index slipped slightly from 19 to 17. Dallas Fed Manufacturing ticked up from 0 to 1.3. The

Richmond Fed Manufacturing index also nudged higher from 4 to 5. Industrial Production in June increased +0.1%. Manufacturing Production was flat.

Here are the four regional Fed banks that publish a Future Manufacturing index. This data is lumpy, but the trend is there.



Durable Goods Orders in June only increased +0.3% vs an expectation of +2.5%. May was terrible with a -4% drop. But this was revised higher a bit from -4.5%. The Core Capital Goods Orders (aka business spending) increased 0.9% which is a touch better than the +0.8% expected. This is still slower than May's +1.9% (which was revised higher from +1.6%). The trend remains solid, as well.

The early guess for July Private Payrolls from ADP is for 44k new jobs. The expectation was for 70k. June added 98k jobs. This data typically tracks the official BLS Private Payrolls data. But there has been some divergence lately (with ADP outperforming the BLS).

Job Openings (JOLTs) declined modestly in June to 7.36mm. Quits ticked higher to 3.23mm. There are hints at an improving trend in both series. But we will need to see bigger and more sustained moves to confirm this.

Initial Jobless Claims have broken below the 215k level at which they sat for months. The latest reading is 197k. But we do not read much into this (a low level but probably not falling much more…there was some statistical noise). Continuing Claims are down to 1.78mm (same dynamic, low but probably not going too much lower).

Pending Home Sales fell -5.4% in June. Building Permits fell 3% in June. Housing Starts jumped 19% after a fall of -15% in May. The annualized run-rate is 1.43mm which is about where it has bene for the last six months (ex-May). New Home Sales increased slightly in June +1.6%. The run-rate is 628k (which means virtually no growth in seven years…except for the crazy Virus spike in home building).

The Housing Market Index (aka homebuilder survey) dropped two points to 34. All components are weak.

Mortgage Applications dropped to their lowest level in a year. Purchases are slightly better than Refinancings, but both are lousy.

The average 30-year mortgage rate now stands at 6.81%. It has obviously tracked long-term Treasuries higher. It was 6.09% at the end of February.

The Leading Economic Indicators (LEI) slipped -0.2% in June. We do not pay much attention to this one.

- Where did all the crypto/AI/Name Change!/prediction market money go?

There is a restaurant company in Malaysia that specializes in "chicken hotpot." Somehow, this $4mm market capitalization company is listed in the US on the Nasdaq. It has $10mm in revenues and loses about $2.5mm a year. What to do? Pivot to AI! It has announced a $50mm services agreement to "provide data center maintenance." Voila… a nice 800% gain in a day.

The Financial Times ran a study on "Name Change!" companies. They identified 27 that have added "AI" or related terms to their names or business focus since 2023. Many of these retail stocks, "experienced an initial share price surge." But the FT concludes, "most…have failed to sustain their valuation gains." We hope the FT did not pay a lot for this analysis.

A crypto criminal who was found guilty of fraud and money laundering in 2021 is being charged with more crimes. This guy helped launder the fruits of a standard eBay scam that asked for payment and never sent the product. While in jail (he was sentenced to nine years), he re-stole almost $300k that had been seized by the government. Who needs razor-thin garlic, lobster and red wine in prison when you can break into the government accounts and take whatever you want.

The original crypto derivatives platform is shutting down. BitMEX, the company that pioneered the perpetual future along with 100x leverage, said it can no longer compete with the plethora of decentralized derivatives exchanges (platforms!). BitMEX used to handle a $1trillion of volume a year. But it got busted for anti-money laundering violations (AML), Bank Secrecy Act violations, and a whole slew of other fines and missteps. To think that these guys were the good guys that cannot compete with the new decentralized platforms…oh boy.

Crypto theft is still considered pedestrian when compared to political hijinks. In New Hampshire, a former candidate for governor has been indicted for stealing investor money. Instead of the Lamborghini or personal concerts, he spent the stolen $50mm on his wife's "luxury skincare business" and alimony payments. We did not dive deep enough to see if these were to the same woman!

There is a cypto security company called Coinkite. It has a device called a Coldcard which, in theory, protects your cold wallet crypto. The idea is that holding the keys to your own crypt away from a platform is more secure. Of course, the theory breaks down when hackers are able to guess the passwords generated by the Coldcard because they are merely routine phrases…not actually secure random digital passcodes.

Matt Levine highlights a new financial product on the market. It is an ETF that sells Puts (deep out of the money or "crash" Puts) on leveraged single-stock ETFs. This means that you are providing insurance to the bank that extends leverage to the maniacs that buy these super-charged, hyper-concentrated ETFs that are structurally short gamma and must buy high and sell low on a daily basis. Got it?

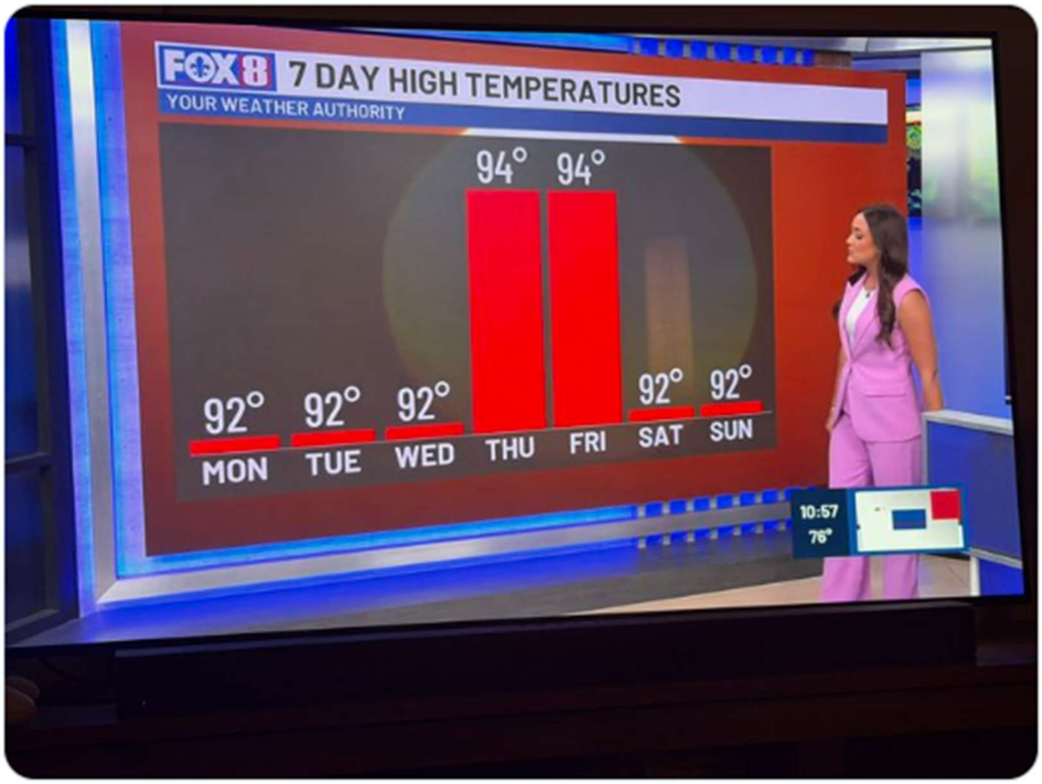
We missed this one back in February. But Matt Levine thankfully has brought it to our attention. George Santos, the bizarre, former congressman who was expelled from the House in 2023, decided to make some quick side money by betting on whether or not he would attend the State of the Union Address. He played the market both ways: He bought the Yes contract and then asked online what he should wear at the event. He sold into the rally. Then he bought the No contract and followed that with a video of him saying he would not be able to make it to DC. He pocketed about $20k. This is in the news now because he has settled with the CFTC (commodity version of the SEC) for market manipulation (not inside trading). He had to give up his gains and kick in another $18k in penalties.

An FBI agent has turned himself in after stealing $1mm in crypto from an "adversarial nation."

Sometimes, the money finds its way back! Coinbase was sued/investigated by the SEC for various violations. One of these included improper record keeping. Coinbase turned the tables on the SEC and obtained a Freedom of Information Act enforcement requiring the SEC to release its record keeping. In particular, Coinbase wanted to see the head of the SEC's personal text messages. The SEC claimed these were lost. The SEC lost the case! And had to pay Coinbase! (The background here is that the SEC has relentlessly and aggressively sued investors and banks for not properly maintaining records of text communications.)

- Chart Crime of the week

Thursday and Friday must have felt so much worse than the rest of the week.



- Quick Hits
  - Janik Sinner sits at 4th on tennis's career prize money list.
  - The NY Post reports that Greta Thunberg's sister is a "risqué pop singer who's got nothing to say about climate change." The story is sponsored by Ford and its F-150.
  - Marie Antoinette did not say "let them eat cake." The philosopher Rousseau did when Marie was still a child in Austria.
  - Walmart's pharmacy customers spend 5x as much as other customers outside of the pharmacy.
  - In response to the SEC's proposal to lengthen the reporting periods for public companies from every three months to every six months, Exxon said it wants to report earnings every four months. (If we could make the rules, we would mandate that every company must use a calendar year reporting cycle regardless of the frequency.)
  - There are approximately 19,400 working turbines in Texas.
  - Iowa has the second most turbines in the country with 6,300.
  - According to CoPilot, Bob Seger, The Eagles, and Fleetwood Mac are three of the most played artists on the radio.
  - According to Gemini, the top three are The Beatles, Rihanna, and Michael Jackson.
  - From our cross-country driving experience (not through a lot of big cities), CoPilot is correct!
  - A map used during a State Department presentation at a conference in Brazil mislabeled every single country in Africa. OpenAI was to blame…and the worker who relied on it.
  - Kody Clemons is the 15th major leaguer to hit an "ultimate grand slam" with two outs.
  - An ultimate grand slam is a walk-off homerun with the bases loaded when trailing by three runs.
  - There have been 24 perfect games pitched in MLB.

- Wisconsin was the first state to have an income tax. Nine states currently do not have one.
- Only 4% of homes in the UK have air conditioning.
- There are over 100,000 "agentic trading accounts" on Robinhood. These are retail trading accounts that are automated and run on AI (in theory designed by the human creator).
- An upstart AI company offered instant interviews to anyone that got a company tattoo.
- A professor at Cambridge who is already under investigation for plagiarism is now being questioned about his resumé. He claims to currently be a visiting professor at Ohio State in the Office of Diversity and Inclusion. OSU has no record of this person ever being an employee at the school. And the DEI office closed last year.
- Only three Congressmen have been expelled since the Civil War. Michael Myers (Halloween!) in 1980, James Traficant in 2003, and George Santos in 2023.

TSLAQ: More rumors have circulated regarding the potential merger of Tesla and SpaceX. While Musk denied any specific claims, he vaguely hinted that a combination could be beneficial. The latest story has Tesla selling its Chinese operations. SpaceX conducts business with the US government, so the Chinese would want to untangle any potential conflicts (not to mention the US would want to do the same). This would not be a positive for Tesla as its Chinese operations account for almost 45% of its global operating profit. Tesla does not disclose the number specifically, but this seems to be the fair estimate from analysts (Tesla China, unsurprisingly, has the cheapest cost structure). We have blasted Tesla China for years as most people do not understand the contract between the company and the communists…we have stated flatly that the Chinese are the ones in control of the factory and the business. That might be a reality soon enough.

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