Bills Only Policy

Risk-Off, trading a bounce, Fed put strike, bills only policy, China eases

Barry C. Knapp Jan 22

Risk-Off!

The equity market pullback broadened to most of the reflation cyclical sectors on Tuesday and Wednesday, while the sharp drop in concept stocks and negative cash flow technology drew in the higher quality free cash flow tech companies as well, as Nasdaq is down 13% and S&P 500 down 9% from the highs. There are some missing pieces of a typical risk-off episode, examples include energy stocks, commodities and the Chinese yuan that have been resilient. Recall our work on Fed hawkish pivot uncertainty shocks, where pre-QE correlation across equity market sectors and asset classes was much lower than the eight monetary policy related shocks last cycle. Additionally, the magnitude of the move is still less than the average of Fed policy normalization uncertainty shocks (10-12%), despite an expected policy path that is increasingly looking like the '94 cycle when the Fed increased the policy rate from 3% to 6% in a year despite the CPI remaining stable at 3%.

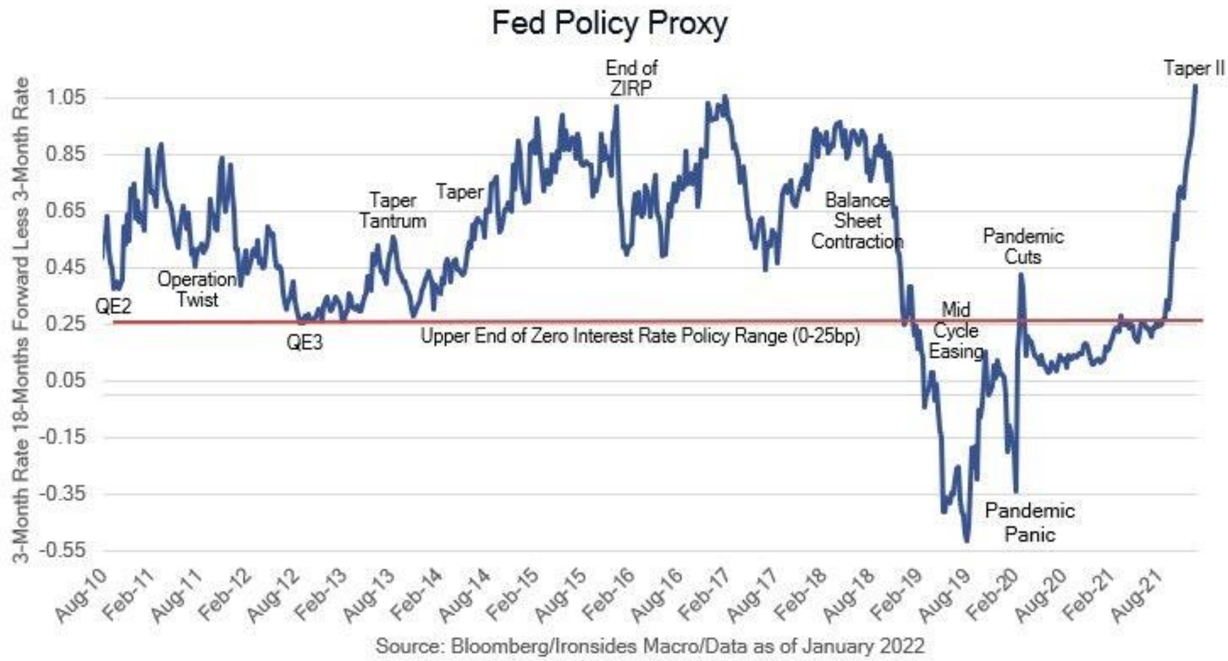

Figure 1: The 3-month rate, 18 months forward less the current 3-month rate is a proxy for the Fed policy path over the next 18 months. This curve is steeper than any point last cycle, for good reason. It can steepen further if wage and inflation data continue to beat expectations.

We are getting close to our S&P 500 down 10-12% 'fat pitch' target, along with elevated measures of risk including the VIX above 30, the VIX futures curve (6-month less 1-month) inverting by a couple of hundred basis points, and VVIX above 140, to deploy fresh capital or trade the market from the long side. In other words, down 10-12% is a necessary, but not sufficient condition for an attractive entry point. We will look for confirmation from our measures of risk to confirm that positioning is better balanced.

Measures of Risk	Median	Standard Deviation	Max	Min	Current	Z-score	Implied Risk
S&P 500 Volatility Index (VIX)	17.33	8.09	82.69	9.14	28.85	1.42	High
S&P 500 Vol of Vol Index (VVIX)	90.35	16.60	207.59	59.74	149.50	3.56	Extreme
S&P 500 Term Structure (6m-1m)	2.84	4.21	10.85	-40.45	-0.29	0.74	Above Average
S&P 500 Skew Index	118.83	9.37	170.55	103.82	127.58	0.93	High
S&P 500 Implied Correlation Index	49.00	14.89	87.10	23.32	49.07	0.01	Average
Treasury Vol (MOVE)	87.91	28.24	264.60	36.62	81.03	-0.24	Average
FX Vol (JPMVXYGL)	9.88	2.44	27.02	5.18	7.30	-1.06	Low
BB&D Policy Uncertainty	83.49	78.50	807.66	3.32	84.57	0.01	Average
Lehman Corporate OAS	1.13	0.77	6.18	0.51	0.98	-0.19	Average
Lehman High Yield OAS	4.46	2.51	19.71	2.33	2.98	-0.59	Below Average
EEM Volatility Index	20.98	6.32	92.46	13.28	27.60	1.05	High
Median Across Asset Classes						**0.51**	**Above Average**

Source: Bloomberg/Ironsides Macro/Data as of Jan 21, 2021

Figure 2: Equity measures of risk are elevated with the exception of the term structure. The S&P 500 is down 9% from the high and is below the 200-day. We are likely getting close to a decent buying opportunity.

One quick note, we don't know if the trade will set up attractively, but when we get high velocity pullbacks, S&P 500 ratio call spreads can work well to capitalize on rebounds. Buy a 60-delta call and sell marginally more (1.2-1.4) 40-delta calls. As the market recovers, the implied volatility on the calls you are short is likely to contract faster than the call you are long, such that you make money on direction and volatility. This is lower risk than selling puts outright or risk reversals (selling puts and buying calls, both out-of-the-money). We suggest taking a look at this trade early next week. The move in expectations for the Fed policy path — while far more aggressive than at any point in the prior cycle — may not be complete as inflation and wage data are unlikely to offer much relief between now and liftoff at the March FOMC meeting. With President Biden shifting responsibility for whipping inflation to the Fed, political pressure to act aggressively will build further as mid-terms approach. We wouldn't be surprised if the market bounces following the Fed meeting; however, Friday's employment cost index and personal consumption deflator reports could reset the Fed policy path again.

Fed Policy Normalization Corrections	S&P 500 Peak to Trough Return	Trough to Recovery Return	Peak to Recovery Return
1994 Correction	-8.69%	8.33%	-1.09%
2004 Correction	-6.80%	7.41%	0.11%
QE1 Ends 2010	-15.24%	9.12%	-7.51%
QE2 + Budget Control Act 2011	-16.94%	14.29%	-5.07%
Operation Twist Ends 2012	-9.93%	14.68%	3.29%
Taper Tantrum 2013	-4.97%	8.50%	3.11%
End of QE 2014	-7.36%	11.43%	3.23%
End of Zero Rate Policy 2016	-11.99%	14.94%	1.16%
Balance Sheet Contraction 2018	-8.82%	5.56%	-3.74%
Global Quantitative Tightening 2018	-19.63%	18.93%	-4.42%
Average	-11.04%	11.32%	-1.09%
Standard Deviation	4.80%	4.23%	3.90%
Source: Bloomberg/Ironsides Macro			

Figure 3: The average duration of these corrections is close to 60 days; the current pullback has occurred over three weeks but is getting closer to the average decline. We will be watching for signs that sentiment is extreme.

Incongruous Narrative: Slowing, Not Slow Growth

We have been hearing a considerable amount of discussion about the Fed tightening into a slowing economy. From an intermediate term perspective, we continue to maintain that while nominal and real output, income, corporate earnings and revenues will slow in 2022, they will not be slow. Next week brings January Flash PMIs from Australia, Japan, France, Germany, UK, Europe and the US. The trajectory illustrates this point: they are rate of change indicators that have passed their peak reopening velocity. They are likely to contract through 1H22 as global supply chains clear and export growth slows. The deceleration is likely to be most pronounced in export dependent economies.

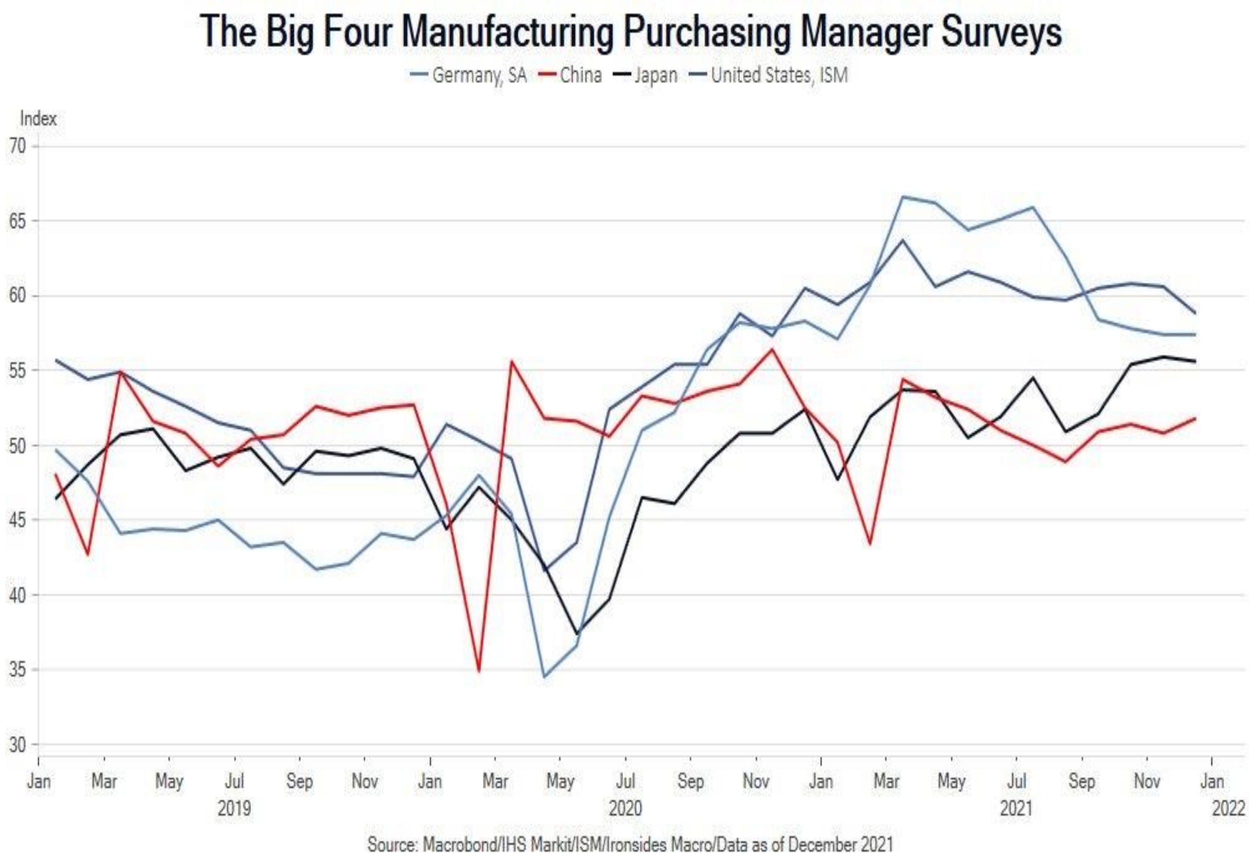

Figure 4: Maximum manufacturing momentum occurred last spring during vaccine optimism.

In the near term there is a certain incongruousness to work-from-home stocks getting smashed (Peloton and Netflix for example) as Omicron cases peak, with the narrative that the Fed is tightening into slowing growth. A core view of ours is that the mix of growth matters for earnings, revenues, margins, stock prices, and bond yields. Stronger capital investment relative to consumption leads to faster productivity growth and fatter profit margins. This is the crucial question for 2022: we think there will be capital deepening due to a capex boom, faster labor productivity due to the surge in dynamism, and an increase total factor productivity due to technology innovation adoption. In other words, all three components of productivity will be improving. That will be evident in profit margins and an increase in the market implied terminal policy rate as it becomes evident that reasonably aggressive monetary policy normalization is not slowing output, income or earnings. If our view that the pandemic was a positive productivity shock is incorrect, this will be a very short business cycle.

Figure 5: The weaker than expected Empire State Manufacturing Survey prompted some to conclude the Fed was tightening into slowing growth, however, 6-month forward capital investment plans surged underscoring that the mix of growth matters. The Philly Fed capital spending plans measure also improved.

Lowering the Fed Put Strike

We heard a number of strategists and market participants this week leaning heavily on the theoretical Fed put as a reason to buy the dip. We believe the strike price on the Fed put is much lower than last cycle and the tolerance for tighter financial conditions is much higher for three reasons. First, the financial crisis was a deflationary shock, the pandemic was an inflationary shock. Secondly, although the Fed's framework set a higher bar for liftoff for their inflation and employment mandate, the labor market blew through NAIRU. The final issue is vastly improved household balance sheets from the post-financial crisis environment. Household net worth fell 16% from 2007 to 2009 and took 3 ½ years to recover. During the pandemic net worth rose 5% in 1Q21, fully recovered the drop in 2Q21 and now sits at $145 trillion, 24% above the pre-pandemic level. House prices fell 35%, finally bottomed in 2012 and didn't fully recover until 2018. The S&P 500 did not exceed its 2007 high until 2013. Little surprise that consumption averaged 1.8% for the first five years of the recovery, far below the 3.4% post-WWII trend. The drops in equities in 2010, 2011, 2012 and 2013 risked a significant deceleration in tepid household demand and another recession.

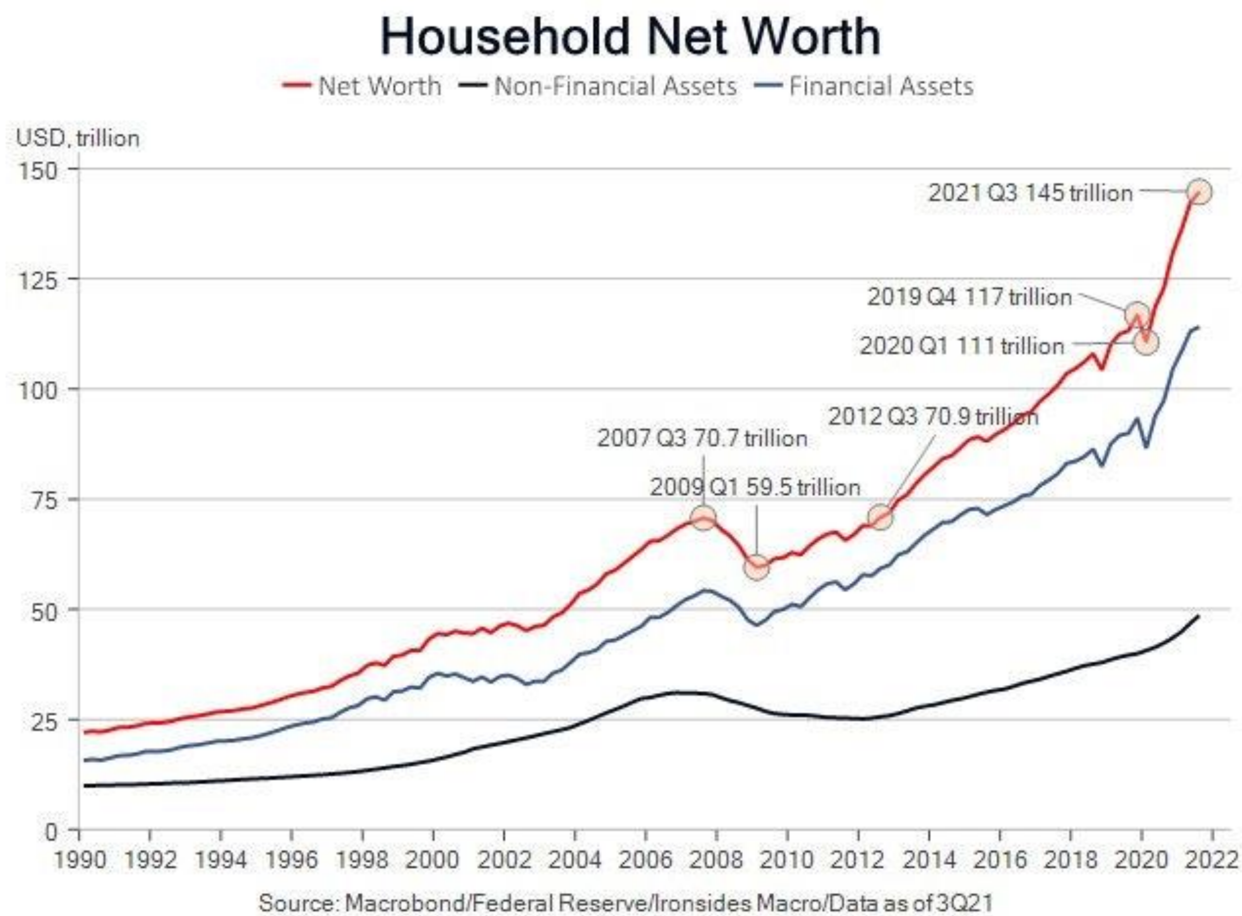

Figure 6: Some argue that the economy is increasingly sensitive to asset markets, while that may be true, double digit nominal growth offers the Fed a large cushion before a stock market decline triggered a recession. Here is a thought exercise, household financial assets are 114 trillion, assume 70% are stocks, and the stock market falls 25%. Most wealth effect analysis concludes a 3% impact on consumption over two years. Given the forecast for 7.6% 2022 nominal GDP, the negative impact would be 1.25%. This is an acceptable risk for the Fed.

The contrast of impaired household balance sheets and associated negative wealth effects with the current environment couldn't be starker. There is little reason for the Fed to be concerned about a 10-15% decline in equities or slowdown in house price appreciation from the current 20% rate. The greater recession risk in the '20s is inflation that gets embedded in expectations leading to profit margin compression. Consequently, the Fed put strike is likely to be far lower than last cycle.

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Third, over the intermediate term, the exit strategy would involve returning the SOMA to holding essentially only Treasury securities in order to minimize the extent to which the

Federal Reserve portfolio might affect the allocation of credit across sectors of the economy. Such a shift was seen as requiring sales of agency securities at some point.

FOMC Minutes April 26-27, 2011

Consistent with the previous normalization principles, some participants expressed a preference for the Federal Reserve's asset holdings to consist primarily of Treasury securities in the longer run. To achieve such a composition, some participants favored reinvesting principal from agency MBS into Treasury securities relatively soon or letting agency MBS run off the balance sheet faster than Treasury securities.

FOMC Minutes December 14-15, 2021

In our note The Case for Ending Reinvestment we published prior to the December FOMC meeting, we made our case for altering the sequencing of policy normalization. We would prefer beginning with balance sheet contraction, our expectation is that they will begin one meeting after liftoff (May 4) at a pace of $100 billion per month. In short, the most efficacious channel to tighten financial conditions and slow what is likely to be the largest contributor to inflation in 2022, housing, is widening mortgage spreads and raising mortgage rates. There are some important issues to be considered with respect to the Fed's mortgage holdings. We absolutely agree with the long-term goal of reducing mortgage holdings to zero. The Fed should not be in the credit allocation business, during the financial crisis they were acting as lender of last resort in a sector that was the cause of the crisis. During the pandemic they were supporting mortgage spreads that widened in part due to poorly constructed regulatory policy. The result was akin to throwing lighter fluid on a smoldering fire, thereby driving house price appreciation and the correlation across the country to levels far above the housing boom in the mid '00s. One unintended consequence was to create an attractive environment for financial buyers of single-family homes, crowding out first time buyers. To reduce Fed mortgage holdings to zero it is quite likely they will need to sell securities outright, not just stop investing paydowns. They should, and likely will, begin by reinvesting mortgage paydowns into Treasuries as they did in 2011. Mortgage spreads widened sharply this month, though from all-time tights. Mortgage REITs appear to be expecting a more hostile environment, the Van Eck Mortgage REIT ETF (MORT) is 18%

off its June 2021 high with an ugly looking chart. Six turns of leverage with spreads coming off all-time tights is an unfavorable setup for 2022.

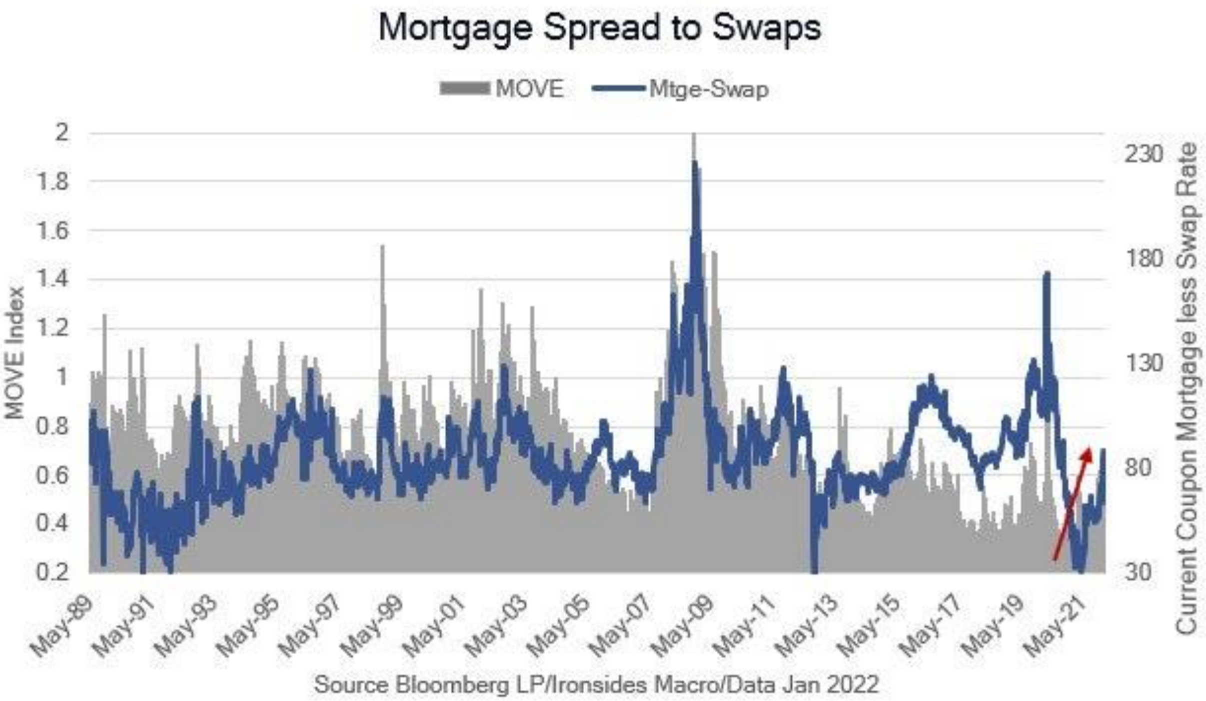

Figure 7: The spread between the Fannie Mae current coupon mortgage and interest rate swap rates widened sharply this month, from all-time tight levels. Interest rate volatility remains low.

China Eases, So What

Over our holiday weekend China reported 4Q21 GDP and December industrial production, retail sales and fixed asset investment. Shortly thereafter, they marginally eased monetary policy. There was a brief rally in equities led by banks and real estate that stalled quickly. Naturally the GDP numbers exceeded expectations, they are little more than Central Committee advertising for 'socialism with Chinese characteristics.' Retail sales missed badly as a consequence of zero-Covid policy. Any rebalancing of the economy from Mercantilism will have to wait until at least after the Olympics, and in reality, we suspect there is little the Central Committee can or will do to correct the imbalance between the exports and domestic demand. Industrial production beat, though electricity production was negative likely due to heavy industry (steel, cement and coal) falling sharply perhaps to reduce pollution ahead of the Olympics. Fixed investment marginally beat but real estate was weak. It should be noted that industrial production and investment are well below last cycle's trend rates. Watch CNH (offshore yuan) closely, it should start to soften, and as global trade slows this year the Central Committee is likely to face some difficult policy choices. Sell all rallies in Chinese stocks.

Figure 8: Chinese producer prices, earnings and sales have turned down. We expect a very difficult year for Chinese state-owned enterprises.

US Equity Market Valuation Index/Sector	PE	Fwd PE	P/S	P/B	EV / Sales	EV / EBITDA	Z-score	Ironsides Strategic Recommendation	ERP	ERP Z-Score
SPX	24.02	19.94	2.93	4.50	3.35	16.33	1.65	Market	5.62%	-0.34
Discretionary	36.33	26.99	2.58	10.70	2.96	19.99	2.52	Market	4.31%	-0.25
Financials	13.27	14.46	2.68	1.64	2.86	7.52	-0.21	Overweight	7.53%	-0.57
Technology	31.08	25.88	6.90	10.62	7.23	22.16	1.90	Market	4.47%	0.00
Comm Services	22.52	18.07	3.64	4.06	4.38	14.35	1.83	Market	6.14%	-0.32
Industrials	29.67	20.06	2.33	5.44	2.71	16.31	1.88	Overweight	5.59%	-0.43
Materials	19.04	15.77	2.32	3.19	2.81	12.27	1.21	Market +	9.09%	-0.98
Energy	22.84	11.79	1.35	2.08	1.79	11.54	0.46	Overweight	9.09%	-1.34
Healthcare	20.64	15.74	1.97	5.03	2.21	16.88	0.24	Overweight	6.96%	-0.62
Staples	22.98	21.98	1.74	7.03	2.00	16.61	1.76	Underweight	5.16%	-0.47
Utilities	21.08	20.10	2.91	2.32	4.93	14.74	2.54	Underweight	5.58%	-0.06
Real Estate	52.52	46.24	8.58	8.58	11.61	25.79	1.57	Underweight	2.77%	0.62
Russell 2000	107.62	22.38	1.25	2.51	448.57	2.12	1.60	Overweight	4.75%	-1.00

Source: Bloomberg/Ironsides Macro/Data as of Jan 2022

Figure 9: The equity market is reasonably attractive relative to 10-year Treasury inflation adjusted rates; however, we expect those to rise further.

Key Investable Themes & Beneficiaries:

- ***Capital Spending Boom: Industrials, Semis, Software***
- ***Reflation: Materials, Financials, Energy, Small Caps, Inflation Breakevens, Short Duration, Yield Curve Steepeners, Long Fixed Income Volatility (PFIX)***
- ***Overweight US equities, underweight export dependent economies (China, Germany, Japan)***
- ***Overweight equities, underweight fixed income, use cash as your risk reducer***

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