PROVIDING THE BIG PICTURE ON MACRO AND CREDIT SINCE 2009

Martin Tixier – Strategist

PLAN

THE RETURN OF THE BIG BAD WOLF

1

EXECUTIVE SUMMARY – 11TH OF MAY

MACRO THOUGHTS

- *"You can play and laugh and fiddle. Don't think you can make me sore. I'll be safe and you'll be sorry when the Wolf comes through your door!" – 1933 Disney cartoon Three Little Pigs*
- We continue to think that Europe is in a very bad spot. ECB is in a worse position than the FED given the weight of energy in its imports and the weakening of the EUR currency making matters worse. For instance France trade deficit recently broke the record of EUR 100 billion.
- We still expect a "Carthaginian peace" deal between Russian and Ukraine. It refers to any brutal peace treaty demanding total subjugation of the defeated side. This is what Russia we think, will ask from Ukraine.
- Throughout 2021 we called for the risk of a stagflationary outcome. In that context "fixed income" must be avoided. More pain to come and corporate credit is already feeling the heat. Our credit canary aka US CCCs is starting to sing. Watch credit spreads.
- Energy will continue to thrive. We recommended you coal stocks last year and GALP and SHELL. We continue to recommend going overweight Energy. Don't forget gold and gold miners but add cautiously given Mack The Knife is still on its murderous rampage.
- ***Our usual reminder:*** For a bear market to ensue as we have repeated on numerous occasions, you need inflation to "accelerate". Past history has shown, what matters is the "velocity" of the increase in the oil prices, given that a price appreciation greater than 100% to the "Real Price of Oil" has been a leading indicator for every US recession over the past 40 years

MACRO THOUGHTS

- Why our title The Return of the Big Bad Wolf?
- Throughout our presentation we warned you that for a bear market to ensue, you would need to see a return of inflation. A “stagflationary” outcome has long been our prognosis and our inflation call from early last year has been vindicated given the latest US CPI coming hotter than expected at 8.3%.
- The popular song "Who's Afraid of the Big Bad Wolf?" written by Frank Churchill originally featured in the 1933 Disney cartoon Three Little Pigs. It was sung by Fiddler Pig and Fifer Pig as they arrogantly believe their houses of straw and twigs would protect them from the Big Bad Wolf (beta players such as Cathie Wood and her ETF ARKK). The beta game played by the "yield hogs” was a “duration” game (TECH, NASDAQ, Crypto…). Obviously, the Big Bad Wolf is a sudden burst of inflation, which is taking down their "credit" houses of straw and twigs. The rise in inflation clearly change the central banking game and now liquidity is being pulled from under the beta and leveraged players. We warned about it throughout our presentations but it seems many didn’t want to listen.
- Now a bear market is unfolding and we are watching with interest what credit spreads are doing.

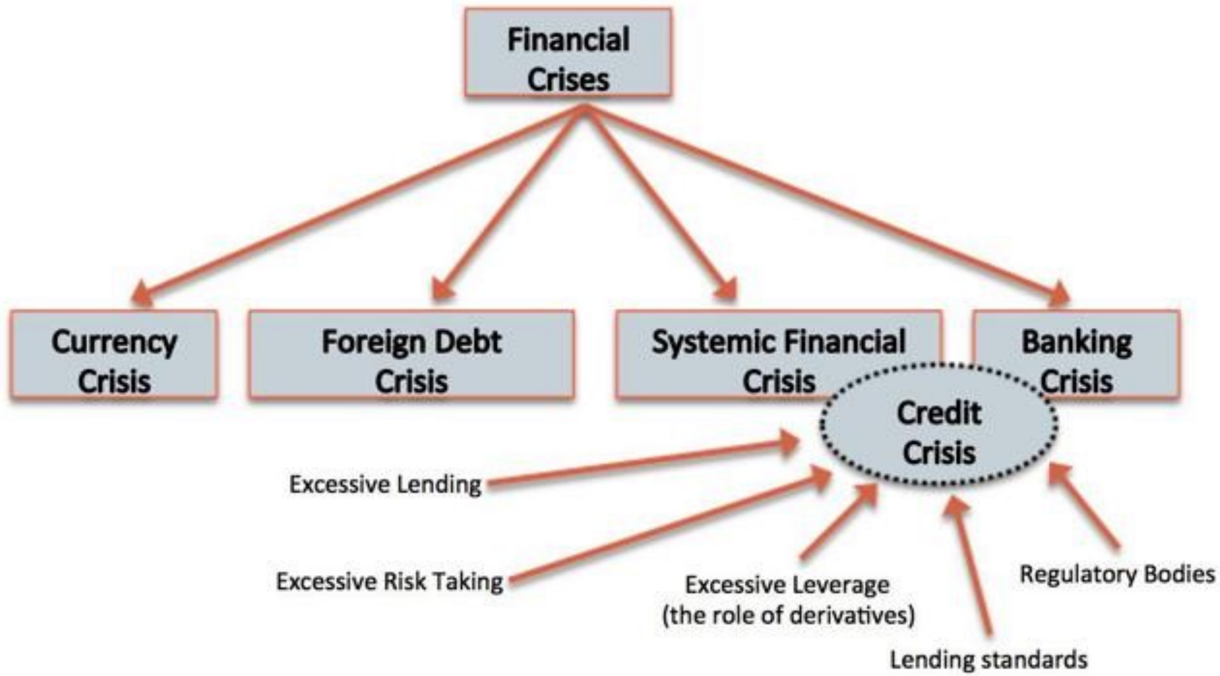
"You can play and laugh and fiddle. Don't think you can make me sore. I'll be safe and you'll be sorry when the Wolf comes through your door!”

MACRO THOUGHTS

- What the Fed has effectively been doing in recent years is playing the hand of aging populations by creating inflation in asset prices and in particular bond prices. Aging savers buy future goods (securities) rather than present goods. As we wrote in our past musings during our blogging life, the issue we are seeing in both Japan and the rest of the world is that the older generations is averse to inflation eating away their assets while the young generations are more comfortable with relatively high wages and the resulting inflation.
- Unfortunately, rentiers seek and prefer deflation. They prefer conservative government policies of balanced budgets and deflationary conditions, and until now, the money was flowing downhill where all the fun was namely the bond market and particularly beta (the carry game), which can be illustrated by the outperformance in the CCC bucket in High Yield versus the BBs bucket which we illustrated in our presentations.
- Higher inflation expectations in the US means a steeper yield curve with a rise in long-duration yields overall, and it is leading to higher rates volatility down the line. A bear market needs a wolf, and this wolf materialized in a return of inflation hence our title. Not that we haven't been warning you about it.
- Tightening of credit conditions leads to higher equity volatility in our investing book and this is exactly what has been playing out.
- The only issue is once the "Inflation Genie" is "Out of the Bottle" as warned by Fed's Bullard in 2012, it is hard to get it back under control: "***There's some risk that you lock in this policy for too long a period," he stated. "Once inflation gets out of control, it takes a long, long time to fix it"***

MACRO THOUGHTS

- The most predictive variable for default rates remains credit availability. The SLOOS (FED Quarterly Senior Loan Officers Opinion Surbey) report does a much better job of estimating defaults when they are being driven by a systemic factor, such as a turn in business cycle or an all-encompassing macro event. Leveraged players and Carry traders do love low risk-free interest rates, but they do love even more low interest rate volatility.

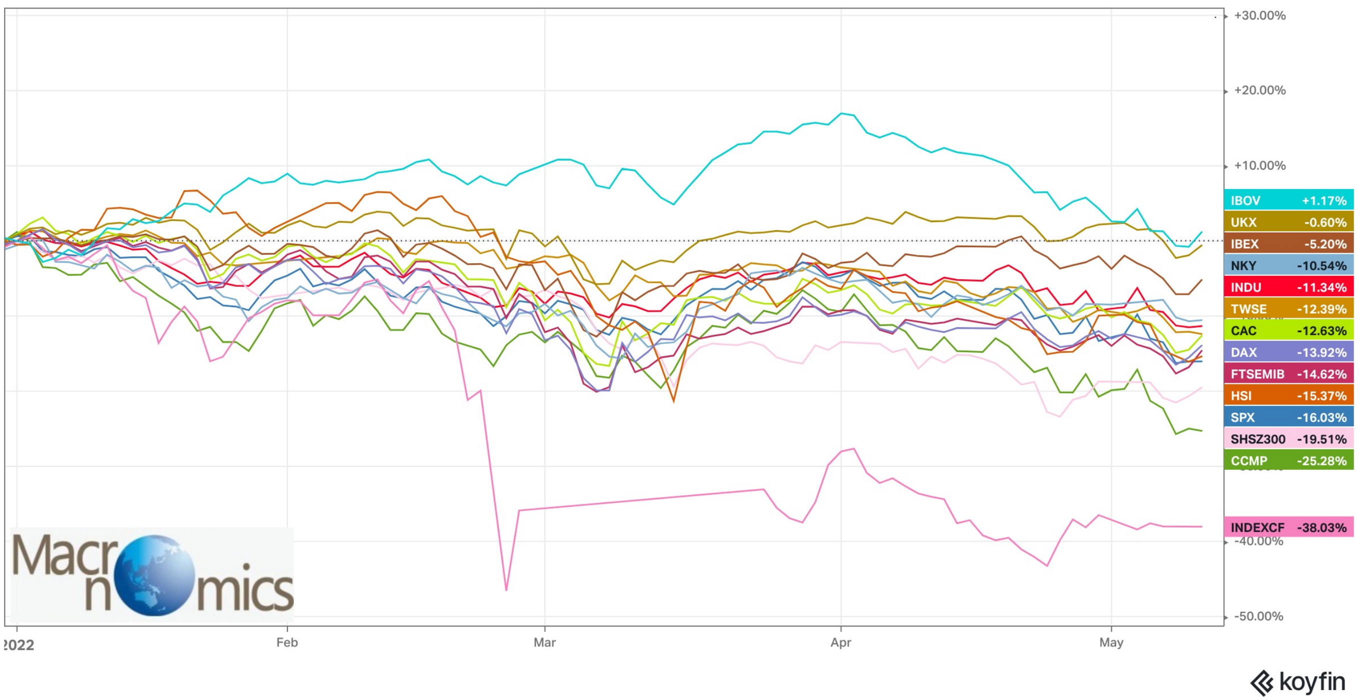


- "It never troubles the wolf how many the sheep may be." - Virgi

2 THE RETURN OF THE BIG BAD WOLF

THE RETURN OF THE BIG BAD WOLF

- Since our previous presentation Brazil's lead has fallen to 0.3% YTD given "Mack The Knife" has put a dent in the surge of commodities. War in Ukraine has also taken its toll on the MICEX index in Moscow down 37% YTD. Hang Seng is down 15.4% YTD. Shanghai is down by 16% YTD with rising lockdowns. Overall a very weak tone on the back of China rising troubles with COVID. Credit spreads have been as well weakening since the beginning of the year and weakening even more. Again not a good environment.



Graph source – KOYFIN - Macronomics

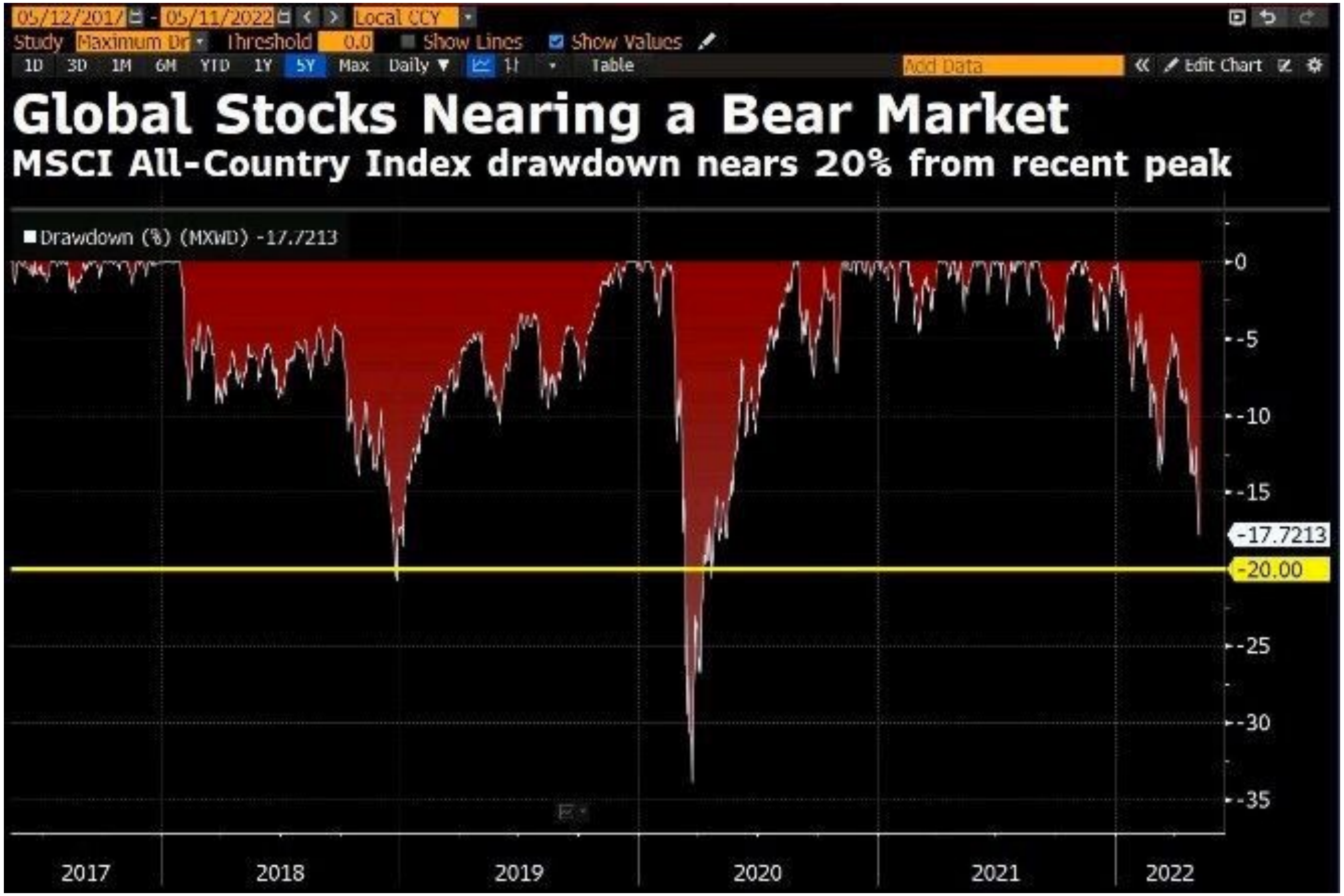
THE RETURN OF THE BIG BAD WOLF

- "The MSCI gauge for China stocks has fallen 28% since October. Instead of seeing opportunity in lower valuations, many big investors still aren't buying, even those who were formerly bullish on the region." – Lisa Abramowicz

Graph source – Lisa Abramowicz - Bloomberg - Twitter

THE RETURN OF THE BIG BAD WOLF

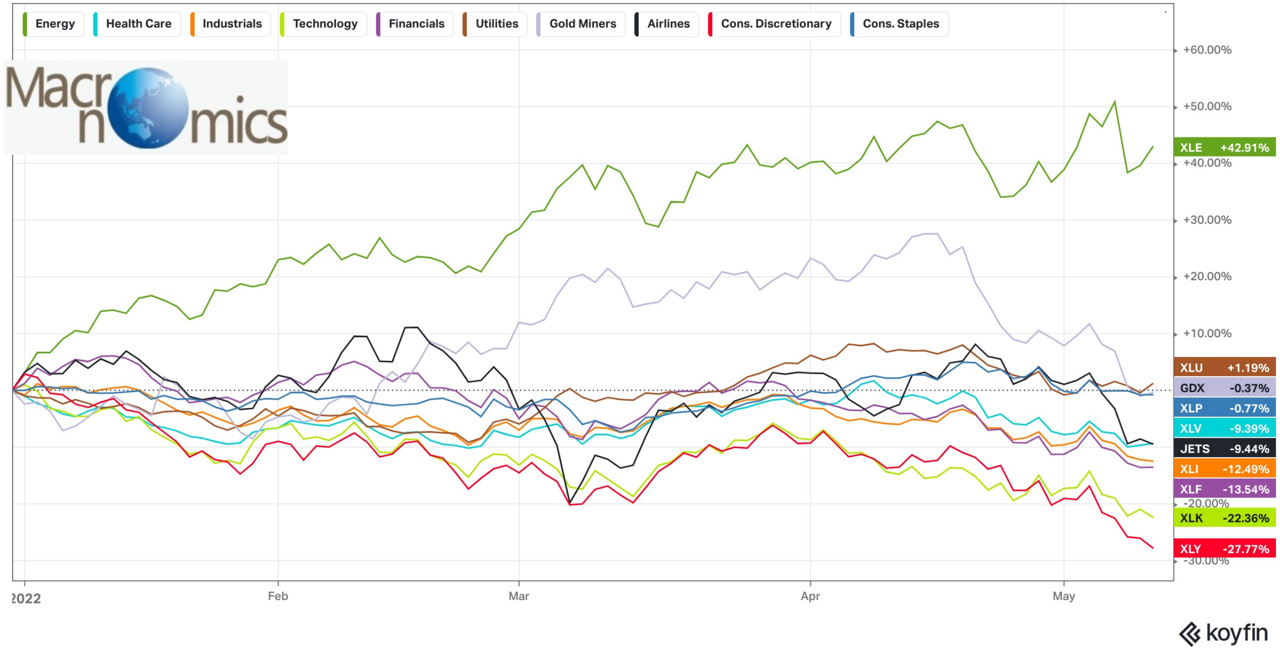
- The last few days have seen some dramatic price action, particularly on Monday where there were it seems nowhere to hide. Selling was heavy and no one was spared.



Graph source - Bloomberg - Twitter

THE RETURN OF THE BIG BAD WOLF

- **<u>US Sectors performance YTD:</u>**
- Energy (XLE) is still leading the pack +42.78% (it was up +34.55% YTD in our last presentation before Mack The Knife started his murderous rampage)
- Gold retraced due to Mack The Knife. Gold miners as well. We continue to like the sector (flat YTD) but until Mack The Knife calms down no reason to “buy the dip”.
- TECH is down by 23% YTD. Rising US yields is impacting “duration” trades.
- Consumer Discretionary is down by 28% YTD (last presentation down 18% YTD). Consumer Discretionary is in the cross-hair. As we said last time and we were right, more pain to come



Graph source – KOYFIN - Macronomics

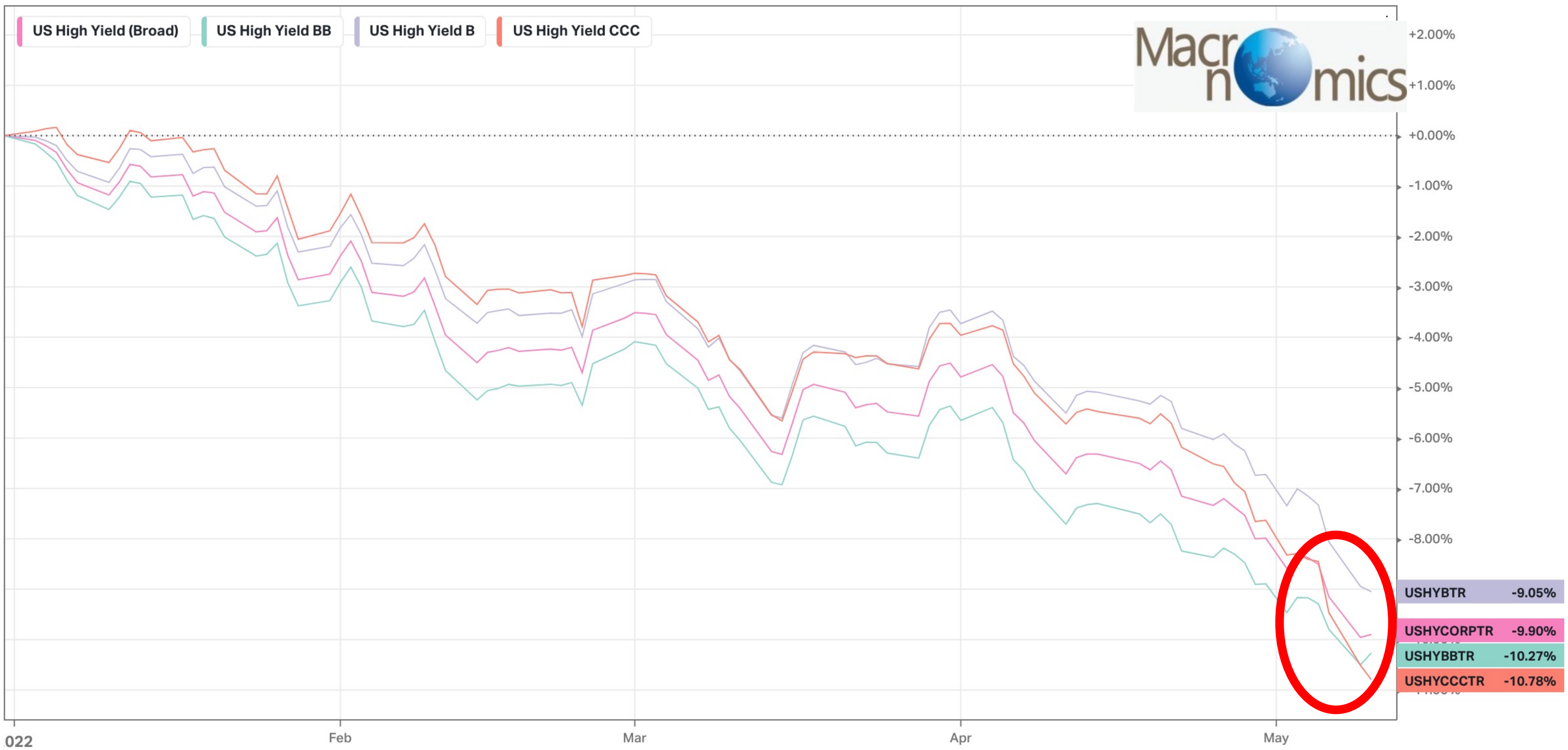
THE RETURN OF THE BIG BAD WOLF

- U.S. consumer staple stocks relative to consumer discretionary stocks are having their best run since 2008.
- Consumer Staples are a defensive play (low volatility).

Graph source - Bloomberg - Twitter

THE RETURN OF THE BIG BAD WOLF

- High beta US High Yield is in negative territory.
- Bond volatility affected high beta due to the FED and rising “real yields”
- As we said in our last presentation CCCs should be down more vs BBs. Now it is happening. We are starting to see weakness in credit, which is never a good sign. Watch this space.



Graph source – KOYFIN - Macronomics

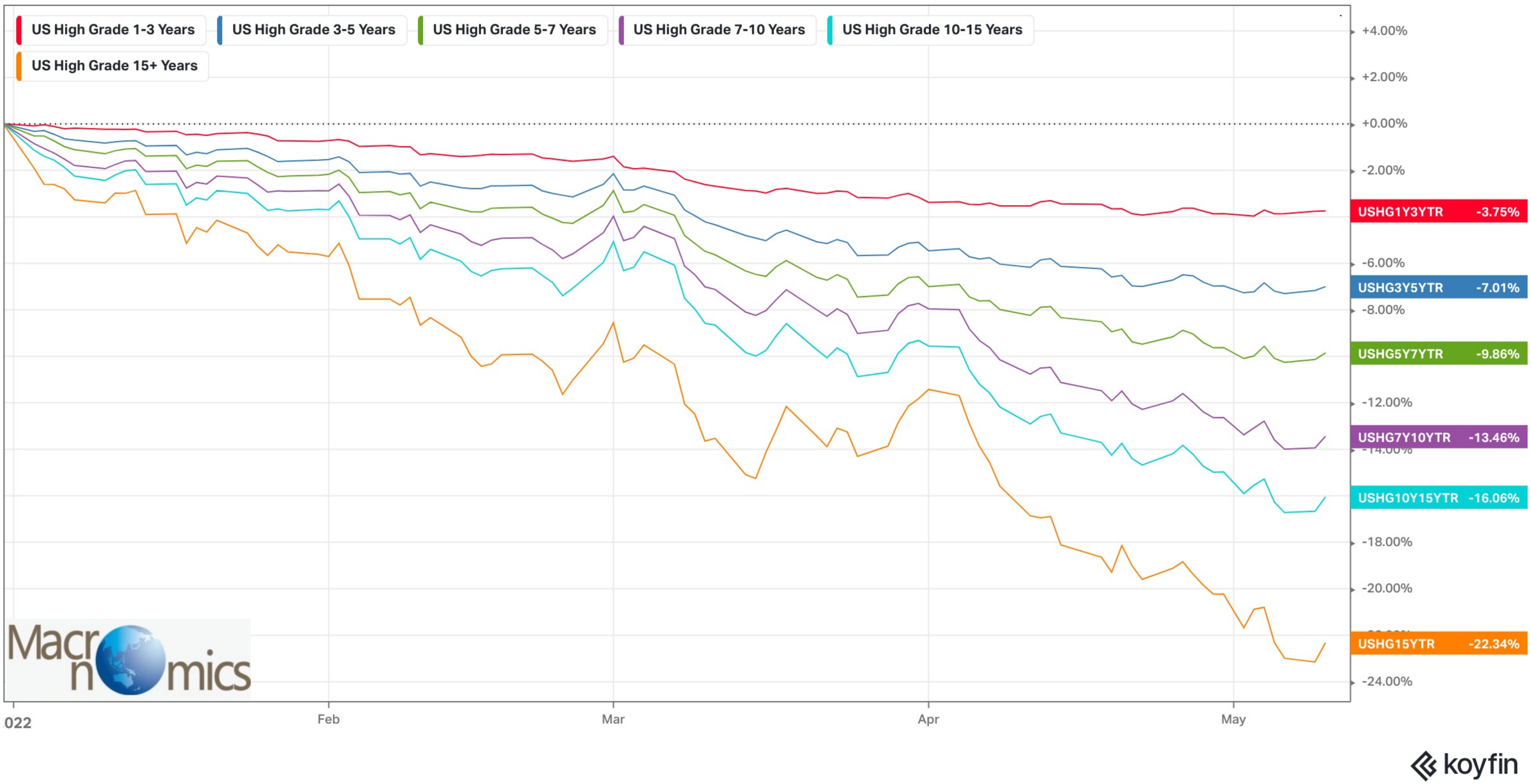
THE RETURN OF THE BIG BAD WOLF

- "A gauge of U.S. credit risk surged yesterday to the most since November 2020. Spreads on U.S. high-yield bonds popped higher, to 4.37 percentage points above benchmark rates, leaving all-in average yields now the highest since May 2020, at 7.51%.." – Lisa Abramowicz
- Cheapening yes, but not yet cheap enough, we think…

Graph source – Lisa Abramowicz - Bloomberg - Twitter

THE RETURN OF THE BIG BAD WOLF

- You know by now that we continue to dislike fixed income in an inflationary environment. Overall rising real yields in conjunction with global sovereign yields weight heavily on Investment Grade. Convexity is starting to bite and fast. Long end is down 22.34% YTD!



Graph source – KOYFIN - Macronomics

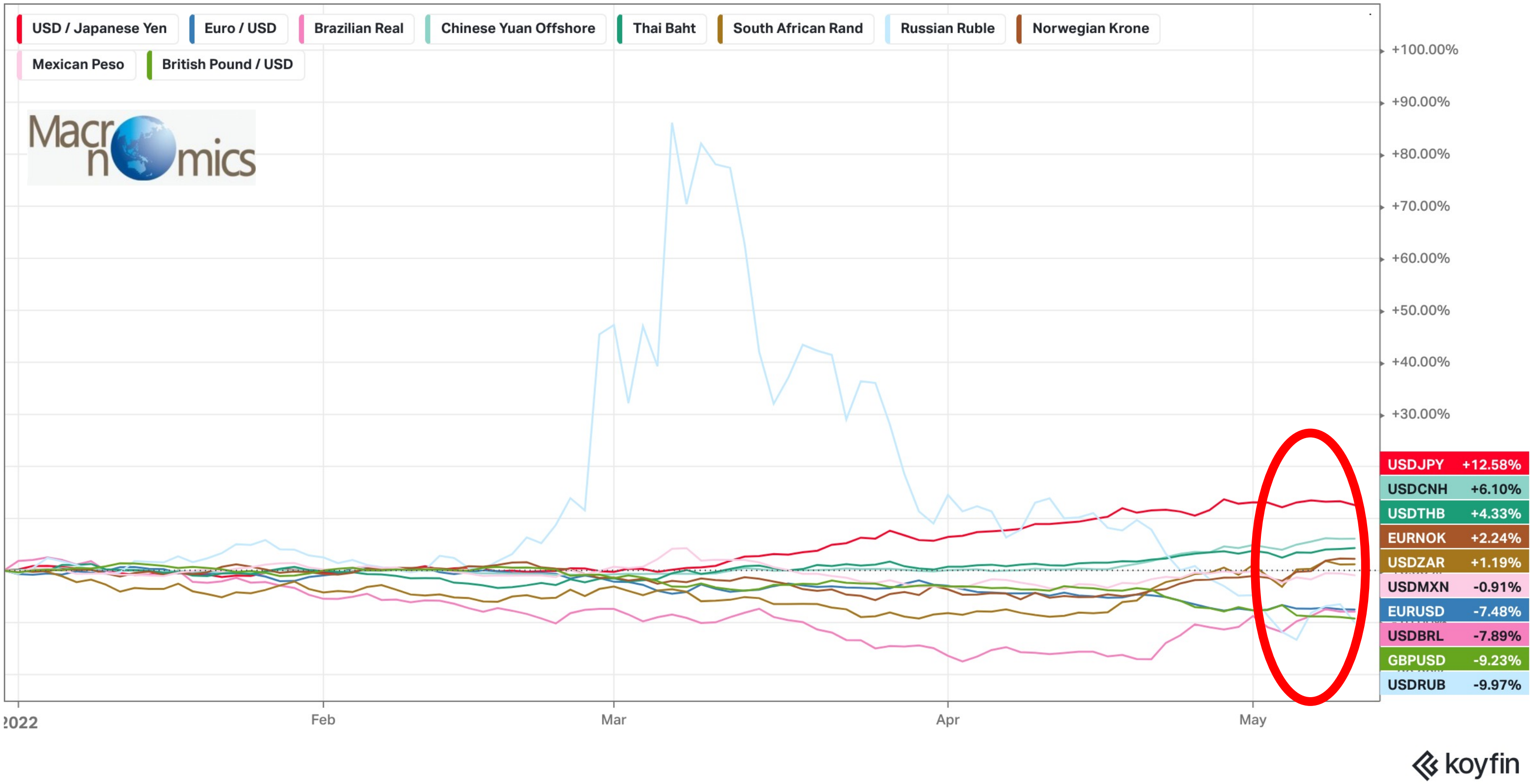
THE RETURN OF THE BIG BAD WOLF

- Do you remember that 100 year bond issued by Austria at 2.10% yield in 2017?
- That bond traded at a price of $240 (when total value of global negative yield bond touched $17 T).

Graph source - Bloomberg - Twitter

THE RETURN OF THE BIG BAD WOLF

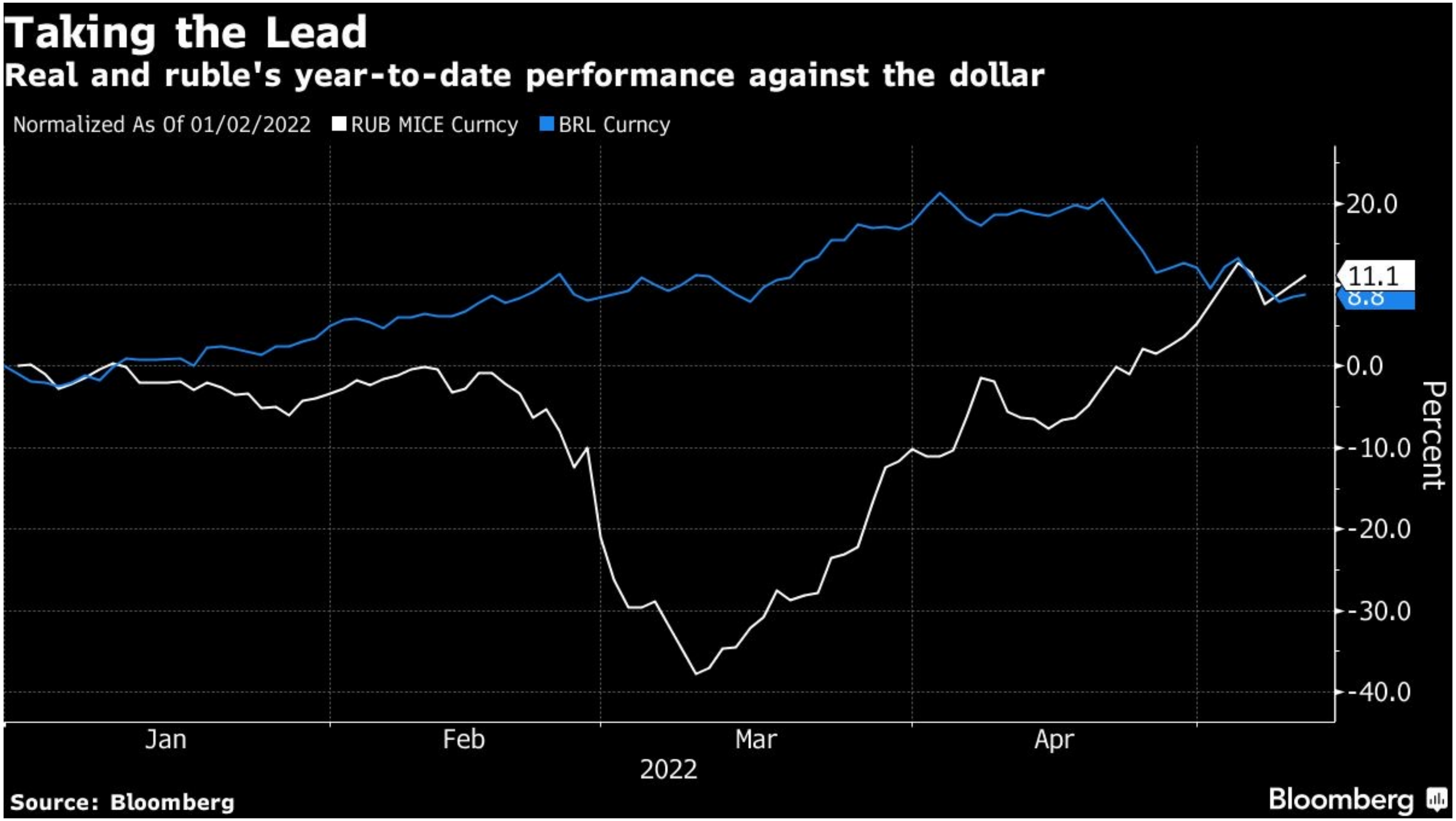
- RUB against the USD has not only recovered from its low but is now up 9.97% vs USD.
- BRL is up by more than 7.89% YTD against the US dollar. Both equities and FX are standing out but since our last presentation Mack The Knife has knocked down both.
- The US Dollar index has breached the 100 level while the JPY is experiencing more pain. We still like shorting the JPY via ETF YCS. It's down 12.63% YTD vs the USD



Graph source – KOYFIN - Macronomics

THE RETURN OF THE BIG BAD WOLF

- So much for the willingness of the West to “destroy” the Russian currency.
- Macroeconomics 101: Commodities matter



Graph source - Bloomberg - Twitter

THE RETURN OF THE BIG BAD WOLF

- A look through history does show that in an environment where US 10y yields go up and equities go down, the USD tends to go up sharply versus the AUD and the JPY.
- The JPY loses out more from higher US yields than it gains protection from the retreat in risk appetite.
- In a higher 10y yield, lower equities environ, the USD has historically traded near flat versus the EUR, but in aggregate this still leaves the USD up moderately on a TWI basis.
- The relative perception of the risk of high vs low inflation regimes – i.e. 70s stagflation vs. Japanese deflation – is likely to be the underlying driver of the equity/yield correlation. When higher inflation is negative for growth (e.g. the 70s), one would expect bond yields and equities to be negatively correlated. A positive shock to inflation would coincide with a negative shock to growth, leading to higher bond yields and lower equities.
- Moreover, as higher inflation will coincide with lower growth, bonds will not be a good hedge for an equity portfolio. As a result, they should command a higher risk premium. We therefore observe a higher risk premium in bond markets and a negative correlation between bond yields and equities.

THE RETURN OF THE BIG BAD WOLF

- "The broad dollar index has risen to its strongest since 2002. ." – Lisa Abramowicz
- Short EUR vs USD. We expect parity and below as per our last presentations.

Graph source – Lisa Abramowicz - Bloomberg - Twitter

THE RETURN OF THE BIG BAD WOLF

- Given our stagflationary stance, you now understand our chosen title. Inflation is indeed running hot and the big bad wolf for asset prices is inflation in our book.

- Difficult to see a reversal until Mack The Knife stops its rampage. For cues watch the US Treasury Notes 10 year yield.

- You should:
  - Continue to short EUR vs USD.
  - On our Short JPY vs USD via ETF YCS (up 25.42% YTD) Time for a pause we think.
  - Continue to short European Consumer Discretionary (The SPDR MSCI Europe Consumer Discretionary UCITS ETF is already down 23.47% YTD, last presentation it was down by 20% YTD.).
  - Reduce your exposure to European Credit: Investment Grade in General and European High Yield in particular.
- With inflation hitting levels not seen for four decades, short sellers should focus on consumer discretionary names. Remember US CPI will continue to run hot for the coming months with a big risk coming from rising rents which are a big component in the composition of the US CPI.

THE RETURN OF THE BIG BAD WOLF

- Japan is facing headwinds hence the rapid depreciation of the Japanese yen over the US dollar. As such, there is an ETF out there, ETF YCS which enables you to play the depreciation game. We like this short but right now it might stay in a range.

Graph source –Trading Views - Macronomics

THE RETURN OF THE BIG BAD WOLF

- In the current high energy prices context and with the burst of the ESG bubble making "Coal" look enticing again. We continue to like the sector. BTU is highly volatile but can continue to deliver outsized gains in the current context. We continue to like both names.
- BTU YTD is +87% YTD. Again BTU is highly volatile. You might prefer ARLP to sleep at night… (YTD +38%). We continue to like both names.

Graph source –Trading Views - Macronomics

THE RETURN OF THE BIG BAD WOLF

- Nasdaq, ETH and BTC have moved in synch in recent months. It all depends now on the trajectory of the Fed. Duration assets are again suffering as real yields matter in the end. Rising US 10 year yields present a threat to the crypto darlings we think. More downside in our opinion going forward as indicated in our last presentation and which was vindicated.

Graph source –Trading Views - Macronomics

THE RETURN OF THE BIG BAD WOLF

- BTC and MSTR (Microstrategy) are moving in synch. Given MSTR is a leveraged play on BTC, we view it as its second derivative. As such the prospects do not look good for the CEO and his company, him being a big crypto fan.

Graph source –Trading Views - Macronomics

THE RETURN OF THE BIG BAD WOLF

- Gold has been spanked by Mack The Knife (+2.4% YTD), yet some miners such as RGLD and GOLD are more resilient than others. We continue to like the sector nonetheless.
- In the current state of the world we continue to view very positively gold and gold miners given inflationary pressure and high level of geopolitical uncertainties.

Graph source –Trading Views - Macronomics

THE RETURN OF THE BIG BAD WOLF

- Luxury sector good smacked down big time in 202. Asian markets remain the hot spot for French luxury brands. Continuous worries relating to Chinese lockdowns on COVID issues will continue to weight on the sector. As well if we are indeed facing a downturn, this will impact the luxury sector as a whole. Avoid for now and we are not that convinced by the most recent small bounce.

Graph source –Trading Views - Macronomics

THE RETURN OF THE BIG BAD WOLF

- TECH in US and much more in Asia have been seriously beaten down. US Tech's path is depending on the Fed's normalization path. Asia TECH while enticing from a valuation perspective we continue to remain underweight as indicated in our previous presentation. Avoid for now.

Graph source –Trading Views - Macronomics

THE RETURN OF THE BIG BAD WOLF

- GALP vs SHELL. SHELL took the lead recently but we continue to like both names. GALP has been overall more volatile than big player SHELL. We continue to like both names.

Graph source –Trading Views - Macronomics

THE RETURN OF THE BIG BAD WOLF

- Some shipping stocks are still doing very well. EDRY, GLNG are relatively stable, SBLK as well is doing ok. See our last presentation for an overwiew

Graph source –Trading Views - Macronomics

3

NOWHERE TO HIDE?

NOWHERE TO HIDE?

- US CPI came hotter than expected at 8.3%. This lead to additional pressure on duration exposed assets such as TECH, CRYPTO and long dated Investment Grade credit. As well in the high beta land, High Yield has started to reprice accordingly. As such US CCCs do not benefit anymore from their exposure to the Energy sector and have finally started to underperform BBs.
- Clearly liquidity withdrawal has already blown in 2022 the house of straw of the crypto pigs, the house of sticks of the Fixed Income carry tourists pigs as well, and it seems that as of late the house of bricks of the credit pigs have lost a few.
- U.S. retail gas and diesel prices rallied to new all-time highs, of $4.374 & $5.50 a gallon respectively: AAA data. This is another headwind for the US Consumer.
- Rates volatility: is extremely high, at 99th percentile of its historical range, as such Fixed Income and Risk Parity strategies which are using leverage are in the crosshair.
- Key element to watch is USTs yield. Today we have seen some retracement. If indeed we continue to see some sort of rally, then indeed it would mean that Mack the Knife murderous rampage is about to dampen, meaning less bond volatility going forward and less pressure on credit. The jury is out there.

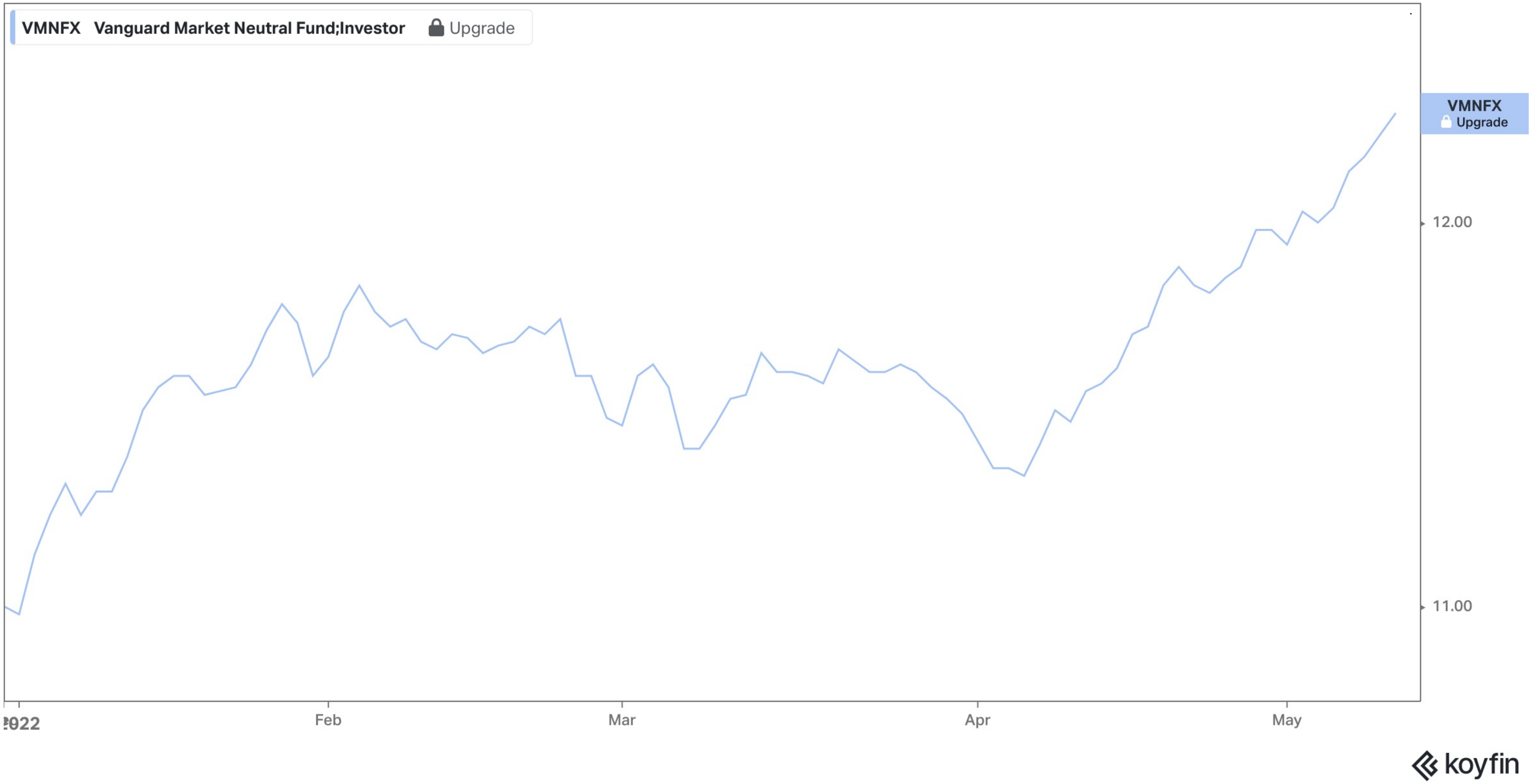
NOWHERE TO HIDE?

- We told you "ARKK" was a beta game, meaning a duration trade. Below you hade US 10Y Real (inverted) and $ARKK.
- Game is up for the beta players.
- Interesting enough, the inverse ETF of ARKK, aka SARK was set up close to the high of the ETF ARKK. The rest is as we say "history".

Graph source –IZ @siddiqi71- Twitter

NOWHERE TO HIDE?

- Where to hide?
- We know a little place: Vanguard Market Neutral Fund Investor Shares – VMNFX and it is up 12% YTD.



Graph source - Macronomics - KOYFIN

NOWHERE TO HIDE?

- The VMNFX fund has a unique and complex investment approach, compared with other Vanguard funds. Its goal is to “neutralize,” or limit, the effect of stock market movement on returns. Because of this, the fund’s return is often uncorrelated to that of the stock market. Unlike other Vanguard funds, this fund uses long- and short-selling strategies, which involve specific risks not apparent in traditional mutual funds. The fund may be appropriate for a small portion of an already well-diversified portfolio.
- “According to hedge-fund index company HFRI, the average “equity market neutral” hedge fund has done much worse than the Vanguard fund over one and three years and so far this year, too.” - Marketwatch
- “The managers employ a systematic process to identify companies that can consistently grow earnings, have solid balance sheets, and are trading at reasonable valuations via a five-factor model that includes valuation, growth, quality, momentum, and management decision signals. High-ranking stocks are held long, and low-ranking stocks are shorted. The portfolio is structured to be market-neutral across the 24 GICS industry groups with the goal of generating positive absolute returns with almost no correlation to equity markets. The model generally finds more-attractive opportunities in smaller names and is designed to be sensitive to valuation, so the portfolio tends to tilt toward small- and mid-cap value names on the long side and small- and mid-cap growth on the short side.” – Morningstar
- This is of course a “tactical play” in our book given we are seeing not only in credit rising dispersion but as well rising dispersion in equities sectors such as energy relative to consumer discretionary. We view this fund as a nice tactical tool you can add to mitigate your overall exposure or outright ride the current volatility.

4 FOOD FOR THOUGHTS

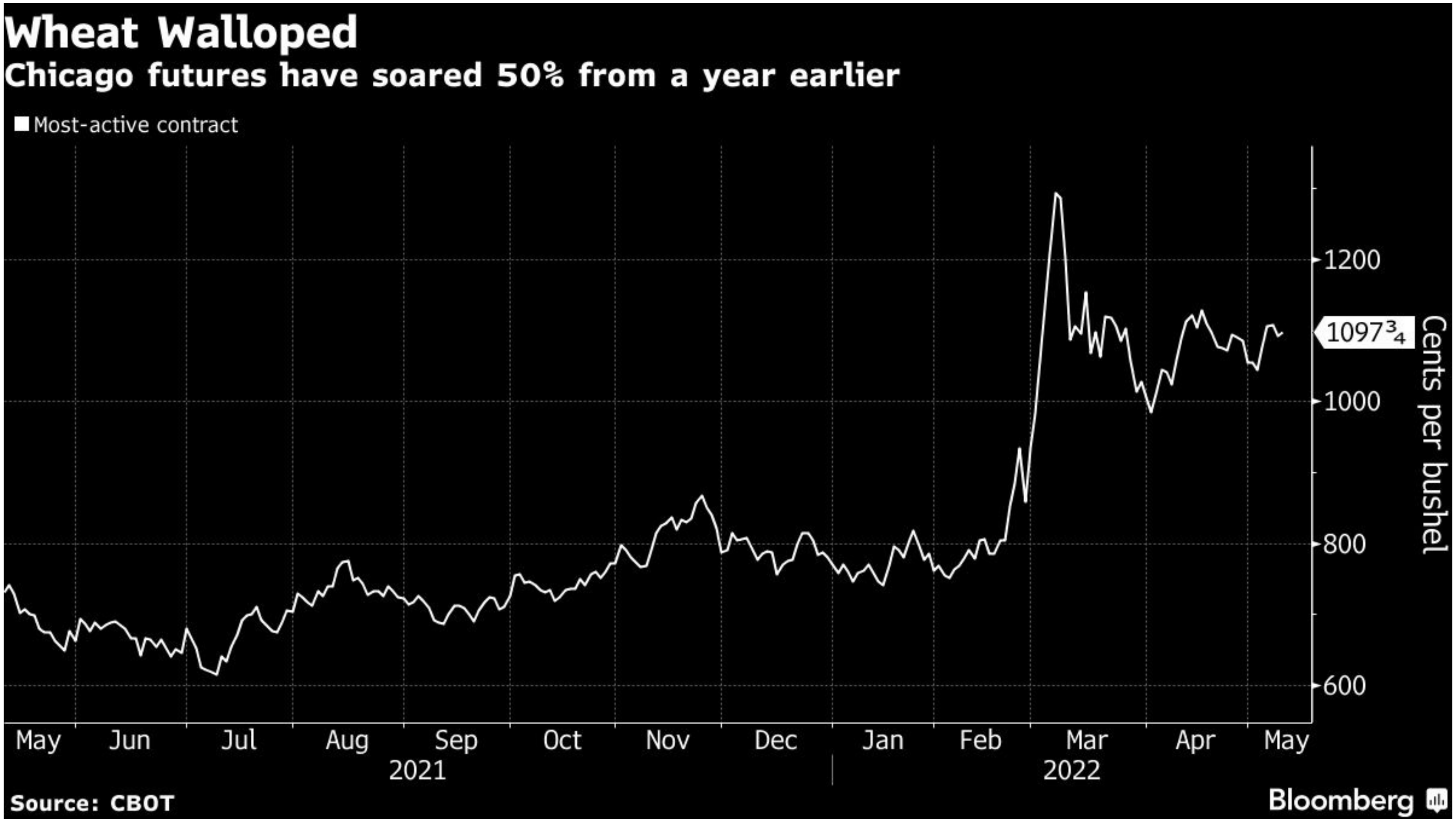
FOOD FOR THOUGHTS

- Aramco vs Apple. When “energy” trumps “tech”

Graph source –Bloomberg - Twitter

FOOD FOR THOUGHTS

- Thoughts for Food….
- Droughts, flooding and heatwaves are threatening wheat output from the US to France and India, compounding shrinking production in Ukraine



Graph source –Bloomberg - Twitter

FOOD FOR THOUGHTS

- Pitchfork risks remain very elevated.
- We expect more unrest in the global world such as the ones unfolding in Sri Lanka

Graph source – Bloomberg - Twitter

FOOD FOR THOUGHTS

- After this week's selloff, all of Cathy Wood's ARK Innovation Fund gains of the last five years have evaporated.

Graph source - Bloomberg - Twitter

5 CONCLUSION

CONCLUSION

- Harpex index is now receding, but the level will continue to put pressure on prices and corporate margins. We continue to watch the Harpex index very closely for cues on global trade. Harpex has closed around record level of 4395. Last was 4407 level.
- Oil We continue to like Energy and Uranium as a long term play. Gold miners will continue to shine provided Mack The Knife murderous rampage quietens a bit.

Theme	Day	Week	Month	Year	# Assets
Disruptive Innovation	-10.14%	-22.76%	-39.93%	-64.30%	22
IPOs	-5.57%	-19.58%	-34.79%	-51.31%	1
Genome	-7.80%	-18.10%	-34.98%	-62.75%	12
E-commerce	-5.65%	-16.31%	-31.52%	-62.44%	4
Fintech	-4.67%	-16.28%	-28.15%	-48.08%	4
Solar	-4.28%	-14.37%	-21.12%	-18.47%	11
Uranium	-3.30%	-13.13%	-29.74%	-10.37%	2
Cannabis	-4.49%	-12.91%	-26.27%	-65.33%	15
Cloud computing (SaaS)	-4.10%	-12.63%	-25.93%	-32.34%	17

Table source – CMC Markets - Optp Thematic ETF Screener

CONCLUSION

- We continue to view negatively Investment Grade. Convexity is biting with rising government bond yields. **Avoid**.
- While we continued to like China Tech over US Tech from a valuation perspective, the latest lockdowns are weighting on the market in general and TECH in particular. We stay clear for the time being.
- Inflation has not been "transitory". We do not buy the receding narrative for 2022 as pressure in energy prices has yet to meaningfully recede at least in Europe. ECB is in a bind with inflation and rising real yields. **Short EUR**
- **Short JPY, because we told you why.**
- Rising food prices and prices of ammonia, continue to be on our radar and a cause for concern. This could lead to more social unrests in 2022. This issue is still building up.
- We continue to like VALE. We continue to like ARLP and BTU in coal miners but BTU is more volatile (only for the brave). If you were brave enough to add BTU, then you made good money and will continue to do so. We like GALP and SHELL. Oil producers are the only bright spot YTD.
- Gold receded but we still like it. It might be worth adding more gold miners exposure.
- US High Yield is weakening. Something to take into account in the current set up. Energy is not supportive anymore of the CCCs bucket so watch what credit is doing.
- Crypto is getting whacked. High beta is getting slaughtered by Mack The Knife and know the Big Bad Wolf aka inflation.

- That's all for now. Don't be shy and don't hesitate to reach out / comment. Happy trading to all !

ON A FINAL NOTE

- **On top of the on-going crisis we are seeing very important shift in geopolitics with alliances shifting all over the world and being redrawn. To name a few:**
- More dissension in Europe with Russian oil and gas imports
- Sweden and Finland about to join NATO
- Sri Lanka going through total melt down
- France ejected from Mali with Russia stepping in.
- Son of a former dictator Marcos won Philippines election in a landslide amid early speculation he may seek accommodation with China
- More trouble looming in Emerging Markets and in Europe with high inflation and rising US dollar.
- More sanctions from Europe and more diplomats being expelled on both side with Russia.
- We do not see any kind of willingness in de-escalating, on the contrary.
- Russian military operations are continuing in Eastern Ukraine for the second phase.
- In the fog of war, it is very difficult to distinguish the facts.

- ***"The ship of democracy, which has weathered all storms, may sink through the mutiny of those on board." - Grover Cleveland - 22nd and 24th President of the United States.***

BIOGRAPHY

- **MARTIN TIXIER** is the author and founder of the blog "Macronomics"
(http://macronomy.blogspot.com) launched in December 2009 and focusing on Macro trends in general and credit in particular. His blog was in the top 20 economic blogs in the United Kingdom (http://uk.labs.teads.tv/top-blogs/economy) and received around 20,000 views per month. Mr Tixier also published many articles on Seeking Alpha, the leading financial site.

- Mr. Tixier previously served as Senior Fixed Income Investment Specialist in the asset management industry for CANDRIAM, a leading pan-European multi-specialist asset manager managing €80B AUM at end of December 2014, following a career in the sell-side in London

- Mr. Tixier was awarded the highest accolade for a Six Sigma project in 2006 for Bank of America where he worked 7 years in various positions. He won the coveted Best of Six Sigma Award (top 15 projects out of 1500 submitted globally).

- Mr. Tixier graduated from the top ranked ESSEC BBA as well as ISC in Paris where he obtained a Master degree in Business Engineering and International Trade. Martin is a certified CISI Level 3 FCA (Financial Conduct Authority) in Regulation, Securities and Derivatives and also has the ACI Dealing Certificate with distinction and is as well as a certified Six Sigma Green Belt.

- Mr. Tixier has also been lecturing at IAE Lille, Toulouse Business School and ESAM Paris for post graduate students dealing on the subject of banking regulations and accounting practices and the role of credit in the economy as well as interest rates and credit trading strategies.