MAY 13, 2022

FRIDAY, THE 13TH

1565 words – a 4 minute read.

How apropos is it that today is Friday the 13th? The S&P is likely to close down 6 weeks in a row, something seen only a handful of times in the past 50 years. There are so many rarely, not seen in a decade, hasn't happened in 40 years, type events across assets that its clearly a spooky time.

It's also been a painful time – how painful? Well, I had knee replacement surgery on Monday and my model portfolio performance is hurting me way more than my knee!

Among the most challenging aspects of late has been to try and hold a positive, medium term (1-3yr) view in the midst of very aggressive, downward facing, fast moving, cross asset selloffs. I have pretty strong conviction in my view of a middle path as laid out in last week's Musings and some like Kevin Muir of Macro Tourist fame have joined that view.

Yet every day, my red splattered screen reminds me that few others see it that way. With the winners now being sold (Apple, energy etc.) I can't help but wonder if the depths of negative sentiment plumped of late are right – things are not that bad at present – in either economies or earnings and the future path is unknown yet such depressed sentiment speaks to conviction that things are bad and very likely to get worse.

This week's action reminds me of a hangover as investors were lined up for Wednesday's inflation print to confirm inflation's peak. While inflation does seem to have peaked along with expectations and breakevens the data was opaque & far from satisfying resulting in further equity weakness, even while bonds rallied. We are in the handoff from goods demand related inflation to service demand inflation as the post Covid (ex China) reopening takes place. While many worry that service sector inflation will limit inflation's decline its worth noting that housing is roughly 50% of Services CPI and given that mortgage rates have nearly doubled in the past 6 months housing should cool off.

The bond market response to Fed jawboning coupled with equities response to bonds should reinforce inflation's peak. Inflation's direction of travel is down, thought the pace and angle of that trajectory remains quite uncertain. The rapid tightening of financial conditions coupled with the sharp rise in mortgage rates and the likely hit to animal spirits and spending post some real wealth destruction in financial markets suggests an easing of inflationary pressures in the months ahead. If inflation was really gonna rip why are bonds OPing stocks over the past few weeks? Bond market inflation expectations have been going the opposite way – one yr. forward inflation expectations peaked over 6% in late March, now down to roughly 4.6%.

At the same time the growth is dead camp keeps ratcheting up the volume while recession calls as likely, imminent, hard to avoid, etc. have only grown louder. Fears of Fed tightening into a slowing economy creating a market crash have become widespread even though the Fed does not have to do that.

And in fact, traditional recession indicators like jobless claims are not suggesting any such thing. Bloomberg consensus 2022 US and EU GDP growth forecasts sit at roughly 3% with Japan at over 2%. Earnings are coming in BTE across the globe with JPM reporting that earnings revisions are turning up again in both Europe (record breadth of sales beats) and the US. We are now roughly 80%+ through earnings seasons and there is no wholesale downgrade of 2022 estimates nor 2023 which there surely would be if analysts were hearing from companies that their outlooks were suggesting a near term recession. Ed Yardeni points out the opposite – that S&P forward revenues per share are up 5% ytd to a new record as analysts expect companies to be able to pass through rising input costs.

It seems almost like the recession arguments are there to provide justification for the aggressiveness of the cross asset correction which has now engulfed virtually all assets: stocks, bonds, commodities and FX. Private equity is going to have a heck of few quarters ahead when they mark down their private holding to comport with public market valuations should prices remain close to current levels – take a look at PSP if you want to see what folks think of that space.

Could it all be for the good? We have had a scary, spooky ride, a timely reminder that its not all diamond hands and YOLO mentality – that investing is a serious business and takes discipline and dedication to survive the ups and downs which will surely occur. A Fed that avoids putting the economy into recession also opens the door for the medium term, above trend, high nominal growth path scenario we have laid out, fueled by a cap ex boom driven by our 3Cs: Covid, Climate & Conflict & underpinned by rising productivity. A period of perhaps slightly higher inflation but if its stability rather than level that counts, a period of stable inflation.

Yes, we have had some serious wealth destruction over the past few months, yes layoffs are ahead – Wall ST banks are putting on the hiring freeze and the tech space is abuzz with right sizing and positioning for the long term. But and it's a big BUT, household net worth has soared in the past few years, company balance sheets are in great shape, the credit dog never barked (we initiated a US HY position in our most recent Global Multi Asset (GMA) model update) and tech companies don't employ huge numbers of folks. Yes house prices will soften but that would be a good thing no?

So maybe the Fed can thread the needle – JPow is confirmed and has laid out two 50 bp hikes in the June and July meetings – fine, its great to have some clarity – lets see where we are then. The case for above trend growth in the 2H of the year remain intact on a global basis. Maybe things improve in China – Shanghai is set to relax its lockdown next week while about three quarters of China's top 100 cities by gross domestic product have now either loosened restrictions to pre-Omicron levels or removed them entirely, according to research firm Gavekal Dragonomics. China's credit impulse has clearly bottomed and turned up. Maybe the Ukraine situation improves – time is not Putin's' friend – April auto sales in Russia were down 78% y/y… Russia is making no progress on the battlefield and the energy noose is tightening week by week.

Sure, thats a lot of maybes and yes the price on the screen is the price but is it the right price? That will only be determined down the road which is what makes this among the most fascinating and frustrating of businesses and ways to make a living.

Many sectors and segments of markets are quite oversold, ARKK is back to Dec 2018 levels, TLT (long end of UST) is back to 2018 lows, valuation has come in a lot, Big cap tech is not the tech of 2000, it is cash rich, money printing machines. One of my mistakes in this period has been to be caught out by my own speed angle. We have focused at length on speed – Covid speed, Climate speed, Conflict speed etc. but I expected Big Tech to rollover and in so doing cap US relative performance vs ROW. Instead, it crashed, taking the thematic space which had already had a major correction, down several more levels.

As noted last week, many of our themes are playing out: Big Cap Tech UP, ROW OP the US, SC beat large, Bond bear market, Commodity bull market, Value over Growth etc. But then, why do I feel so bad? The knee pain is actually bearable; the portfolio pain, well lets hope it doesn't persist. As Ben Graham noted back in the Great Depression: the stock market is a weighing machine in the long run but a voting machine in the short run… folks are clearly voting with their feet with April equity outflows most since March 2020 and ytd bond outflows giving back 80% of 2021 inflows according to JPM.

Calling bottoms is a fools' game especially now when the algos in charge know only levels, not math. It's been a bull market in low beta; seeking out opportunities amongst the Commodity pullback, energy anyone, searching amongst the deeply oversold thematic space for arguably cheap growth stories, using weakness to build up non US equity exposure as its recent relative OP vs the US amidst a super strong USD suggests this might be the true turn, all this makes sense to us at TPW Advisory.

The Crypto space on the other hand is less clear as Terra's collapse deepens uncertainty around the stablecoin concept. It's fitting that Saudi Aramco just overtook Apple as the world's largest publicly traded company as we shift from digital back to physical on our way to the singularity. For all its libertarian airs Crypto has been shown to be a creature of liquidity, a levered play on Nasdaq. It is due its bounce for sure but more than that is unclear to our eyes at least.

Ok, PT time… time for some more pain for a good cause! TGIF folks.

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