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HALL OF MIRRORS

1325 words - a 4 minute read.

A Bruce Lee fan, I have used his work before (Be Like Water). In thinking about today's Musings, the term "hall of mirrors" came to mind. It refers to an epic fight scene in Bruce's breakout movie, Enter The Dragon, shot in 1973, where Bruce & his enemy fight in a hall of mirrors, in what Vanity Fair has called: "a fight scene still revered today as one of the best in film history".

Investing in today's markets seems a lot like fighting in a hall of mirrors to me – maybe it's the down 6 days of the last 7 or down 10 of the last 11 weeks. Maybe its the S&P experiencing 90% down days in 5 of the last 7 trading days - the most aggressive selling seen in the past 100 years. Throw in the Fed raising rates in a bear market for the 1st time ever & one sees lots of enemies, coming at one from all angles.

Perhaps this helps explain all the examples of tremendous gaps between sentiment and reality, gaps that exist across the spectrum. A few examples might suffice: the gap between record low consumer confidence (think what that means – worse than GFC, Covid, 9/11, 1987, 2000) & robust consumer spending (Pantheon sees 2.8% consumption in Q2). Or the huge gap between how individuals see their situation – 40 year high vs how they see the country – 40 yr. lows. MS notes that consumer sentiment bottoms usually precede strong stock market performance.

Here's another: small business owner confidence – record low – small business hiring plans – remain elevated. Here's a third, CEO conference falling sharply vs insider buying strongest since Covid low. Watch what they do, not what they say.

There is also this tendency to act as if issues the market has been dealing with for some time have just arrived. It's maybe more accurate to say they are just now making it to the top of the media attention pile. Just this week I have seen references to inflation as public enemy # 1 (Axios) or today's NY Times headline: Welcome to the End of the Everything Bubble – really?

As Fin Twit technician Helene Meister noted recently: "I keep saying the bull market peaked in Q1'21. Peak speculation, peak new highs, peak volume, peak sentiment. Most stocks have been in a bear market since early 2021. This year the index movers caught up".

I am not sure what all this dissonance means to be honest. I do know that I struggle to recall a period when it was so great. Perhaps it has to do with our media which grabs on to an issue, devours it and moves on; perhaps it ties into our current market structure of illiquidity, algo driven trading & an unprecedented macro backdrop leading many to focus intently on technical levels.

I have focused for the past several years on the importance of speed and how Covid speed, Climate speed, Analytical speed and Conflict speed are changing the world around us. Maybe its all this speed leading to collective disorientation .

Many are starting to worry if the Fed is having its own hall of mirrors fight. From a near assurance that June & July would see 50bps hikes to a semi shock 75 bps hike, from a shift in focus from the core to the headline, to a renewed focus on 2% inflation and from a solid growth outlook to one now well below the pre Covid av growth of 2.3%, even as the Fed says the economy is strong & able to handle rising rates. The Fed has given us a lot to chew on.

Equity markets as is their want sell first and will ask questions later, one presumes. Bond markets don't seem to know what to make of it, first rates rose and then they fell, now down somewhat sharply with the 2 yr. rate down some 30-40 bps in less than a week. Same with the USD – up, then down.

What struck me about the Fed is its focus on the headline, the renewed focus on the 2% inflation level, the worries about unmoored inflation expectations and the sharp cut to growth estimates this year and next. Together it suggests higher stagflation risk; in the latest BofA FMS poll that's exactly what 83% voted for. None of it is particularly supportive of our "middle path" between high inflation and recession. Real yields and mortgage rates have spiked higher; housing is clearly rolling over while the labor market softens. Nor it is very supportive of our longer term outlook focused on a new, new world of high nominal growth led by a public – private funded global cap ex boom to address the 3Cs of Covid, Climate & Conflict.

As a result, our focus is on the energy space as it epitomizes the inflation factors the Fed has little impact on via rates. Should gasoline and oil prices continue to rise in the months ahead it will make it much harder for the Fed to see the clear signs of inflation slowing that will allow it to slow its roll a bit, thereby reducing policy mistake /recession/earnings risk. JPM argues that US and EU equities have already priced in close to 90% chance of recession.

So what is the state of energy right now? As I write, Brent crude is down 5% on the day to roughly $113, well down from its $135 spike peak back in March. This is the case even as Russia punishes European countries for backing Ukraine by cutting gas exports to them, sending EU Nat gas prices up sharply (but still some 30% below its March spike peak).

What about gasoline – we all know the issue is refining capacity or lack thereof. Lo & behold, front month gasoline futures are off 6% today & off roughly 15% from its peak several weeks ago. Refiners are cranking given huge profit margins (crack spread averaged $10.50 per barrel between 1985 – 2021; now it is roughly $60 – an ATH).

$5 gas at the pump may be starting to create some demand destruction and while the peak summer driving season just began and extends thru Labor Day, the energy experts at Vortexa are starting to question the upside: "Taken together, this suggests that rather than crude prices getting a persistent lift from record product cracks, the situation could reverse, leading to weaker refining margins and range-bound crude prices".

It would be perfect for some of these prices to roll over just as everyone has become an inflation fighter par excellence & for the Fed to announce its hawkish sense of urgency at the peak. Of course, I recognize that many, including us, have been calling for just that; I believe a big reason for the aggressive equity selloff of the past week or so is due to folks losing hope on this front given May's unsatisfying inflation print. Giving up at the turn is emblematic of bear market investing.

So what are we doing on the investment front? Not too much to be honest – its too volatile. We are watching the non US equity space with significant OP over the past month for Japan (May PMIs BTE), Europe and especially China as May's BTE data suggest the economic low should be in. China tech continues to sharply OP US tech.

We continue to watch the Innovation space carefully – it led us into the bear market back in Q1 2021 – amidst all the turmoil of the past few weeks, ARKK, the poster child of the space, has not made a new low. The Climate space has also held up well on a relative basis, perhaps in the recognition that $5 gas, Russian blackmail attempts etc., reinforce the multiple rationales to go green.

Enjoy the long weekend & the Hall of Mirrors fight scene: https://youtu.be/KybPsLcInso

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