MAY 12, 2023

IT'S IN DA PRICE

1654 words – a 4 minute read.

Given the ever-thicker curtain of FUD (Fear, Uncertainty & Doubt) and the swirling cross currents of economic data here in the US and elsewhere we continue to lean on the markets themselves to tell us what's happening – the old adage of: let the market tell us rather than we try to tell the market what's happening.

We think the stock market in particular is telling us quite a bit these days, information that can be boiled down to the vernacular saying that we choose for today's Musings: it's in da price. Today's title came to me after yesterday's close when I checked to see how the US regional banks had fared, using KRE as my proxy.

We do not have a position in the regionals in our Global Multi Asset (GMA) flagship model portfolio but we do hold XLF and EUFN. Yesterday was interesting because I had the opportunity on BTV's The Open show to speak with host Lisa Abramowicz right at the 9:35 am slot; the pre open focus was on a regional bank, PACW, that was down 25% or so pre open. The chatter was about all regional banks and crisis and what does this mean for the broader market etc.

Asked for my take, I said that we are not concerned about systemic risk, that one could argue as we did in Firebreak that regional bank concerns would keep the Fed from overtightening and thus reduce the risk to the broader economy. We also argued that credit spreads (HY over FFR) were calm at 200 bps over vs 400-500 in systemic risk off moves, that XLF remains about the key $30-31 level, that the VIX & MOVE indices show no sign of unease and thus neither should we. We noted the same applies for the debt ceiling negotiations which we stated would be one of the last, best buying opportunities should there be a pullback related to worries about default which, notwithstanding some wingnuts in Congress, is highly unlikely. You can see my interview here - I come on at the 29 min mark. https://www.bloomberg.com/news/videos/2023-05-11/-bloomberg-the-open-full-show-05-11-23?sref=ftskAWJe

So at the close we noted that KRE was down about 2.5%, very close to where it opened. We also noted that volumes were roughly 40% below the 10day average suggesting that the selling pressure is ebbing - that's the tell. The regional bank crisis is over two months old – everyone worried about this who wants to sell, has sold. Here is the evidence to back that statement up: as of today's open, KRE is 5% above its recent 52 week low & the S&P is UP over 2% since the Friday, March 6th close before SVB kicked off that next Monday. So for all the drama and all the ink spilled and breathless chatter about bank crisis and 2008 etc. etc. the S&P is UP, yes UP. It's in da price.

Here at TPW Advisory, we continue to tread the Middle Path between fears of high and sustained US inflation and deep economic recession. We believe we are early cycle in a US and global economic recovery as the main drags on US growth over the past year – housing and inventory destocking - have bottomed & are likely to become growth additive in the 2H. We expect the US Manuf ISM to bottom in short order (has been bouncing around 46-47 for past four months) and to rebound back above 50 by YE (Barclays sees 53 @ YE) driven by inventory restocking especially around housing and autos. This, combined with the EV and semi fab buildouts, continue to drive non residential construction and investment – both running at multi year highs.

We believe the market is telling us that this thesis is correct and intact. As evidence we offer that the top two positions in our GMA over the past period were Housing (XHB) and Transports (IYT – just added last month). Both are early cycle sectors not late cycle – the fact that homebuilders are hitting new ATHs is not consistent with imminent recession. Nor of course are job gains of roughly 225k pm which is about what the US has averaged over the past three months, a clear downshift from roughly 550k in the year ago period, but a pace emblematic of our Middle Way thesis – a cooling job market is good, a collapsing one is not. On that note layoffs.fyi, the website that has been tracking tech layoffs, noted recently that they peaked in January, have fallen for three months in row and April's tech layoffs were roughly the same as last October while tech stocks seem to be doing pretty well.

The ever present FUD curtain continues to obscure four major, global, policy changes that are unfolding in the background. They are: major DM Central banks validating the high nominal growth world by accepting a slightly higher inflation rate (think 3% instead of 2%); the return of US Industrial Policy for the first time in 70 years coupled with its expansion in Europe; the end of YCC in Japan as the country finally exits structural deflation (something we think will unleash a significant domestic investor asset allocation from bonds to stocks – note that EWJ just hit a new 52 week high while April's Composite PMI stood at 52.9) and finally the shift to a domestic demand led economic growth engine in China.

We believe we have traversed beyond the Covid Age (WHO just declared the global health emergency to be over) and are exiting its subsequent inflation spike as US CPI peaked almost a year ago in June 2022. Typically, a recession soon follows but as is clear we are far from that with the Atlanta Fed Q2 GDP Nowcast signaling 2.7% growth mid way through the quarter. LPL notes that the one year return post 9% inflation peaks averages over 20% - again our environment is ahistorical given that the S&P is up only 3% over the past year.

We believe what comes next is NOT a return to the low growth, low inflation world of 2010-2020 but the high nominal growth world we have discussed; blessed by major CBs & sustained by a global cap ex boom to deal with the 3 Cs of Covid, Climate & Conflict as global supply chains regionalize & accelerate the shift to the Tri Polar World. Mexico is the clear winner here in the Americas with MXN at a 6 year high vs the USD and EWW breaking out to a new 52 week high.

We were asked on BTV yesterday what would cause us to rethink our outlook for the stock market to break out and UP at a time when so many are so fearful. In response, we noted forward earnings estimates & corporate guidance – both of which are positive – suggesting that were they to shift to negative we would certainly rethink our views. Q1 US EPS have come in roughly +6% Y/Y way BTE with profit margins expanding to average 12%. If XLF where to sharply break below the important $30-31 level or credit spreads were to blow out or the VIX surge we would pay attention. We think the question should be asked of the bears and have them answer when will they throw in the towel on one of the most widely heralded recessions of all time and if the October low was not THE low, one of the longest bear markets in US history.

As we see it bonds are priced for recession while stock market investors are positioned for the same. A catalyst is needed to reprice & reposition both assets for a non-recessionary outcome, an early cycle earnings and growth recovery led by Asia, incorporating Europe with the US pulling up the rear. Perhaps the June Fed meeting will provide that catalyst though writing this reminds us of a year ago when the inflation peak argument was used by us and others as to suggest markets had fully priced in inflation risk.

FFF now price in a pause in June and July and rate cuts in September and through YE. We concur with the pause but do not expect rate cuts as we do not expect recession. The Fed is set to meet again on June 14, and by then they will likely have further room to pause. The May CPI report is released the previous day and is expected to show a significant decline in the inflation rate, with the Cleveland Fed model currently forecasting a move down to 4.1%. We expect the Fed to both pause in June and raise its 2023 GDP estimates, now at 0.4% Y/Y, validating our Middle Way thesis & sell side analysts rising 2H EPS estimates but NOT recession and rate cut calls. Perhaps the Fed can pull the curtain of FUD aside & bring the positive policy shifts noted above into the spotlight.

Our portfolio concerns are not US regional bank risk but rather why China growth and stock prices are diverging so much, as analysts raise 2023 GDP estimates to 6%+, Caixin April Composite PMI comes in at 56.4 and yet FXI is down 2% YTD. Weak China inflation suggests some excess capacity and thus potential margin & earnings issues. China tech acts even worse with KWEB down 12% vs QQQs in new bull market, up over 20% YTD & exiting the longest bear market since 08. AI appears to be kicking off a new innovation cycle – one only the big players can partake in given the huge sums to get in the AI computing game. Commodities and Climate are also struggling and offsetting some of the outperformance we have generated by our OW of Europe and Japan equity. As a result, we made some changes to our models this week (reach out if you would like to learn more).

Happy Mothers Day to all the Moms out there!

Next
AS THE TRI POLAR WORLD TURNS: FORWARD