All About that Base, No Trouble

Last weekend we published Positioning & Key Drivers. Much of the work on interest rates followed up on the previous week's Rates, Risk & Taylor Swift, but we really wanted to highlight "positioning", aka "the base". Positioning has been forming the "base" for market moves in both directions.

The market's response to Fed Chair Powell finally agreeing with us (they have to be much more cautious on rate hikes going forward) exposed the broader positioning in bonds and possibly equities. The rallies were strong, though I'd argue that the equities rally was less about positioning and more about people finally having to accept that the Fed has little interest in driving the economy into the ground. Powell's message was not contradicted by other Fed speakers and was actually reinforced by them (all good for stocks).

There is some furious debate over Friday's market behavior.

What Did Friday's Price Action Tell Us?

Price action early in the week was quite obvious. We saw weak data come in, which was coupled with the Fed pulling back on their tightening narrative (terminal rate is probably still too high).

Friday saw stocks and bonds collapse after the Non-Farm Payroll data was released. The strong headline data wasn't the key driver (though it had some impact). **What drove the initial sell-off in stocks and bonds was the high and unexpected jump in average wages.** That part is clear. What is less clear is why stocks and bonds reversed course (the 10-year came back from 3.63% to 3.48% and the S&P 500 e-mini futures rebounded from 4,007 back to 4,075 at the 4pm close). There are two competing theories:

- **It's all about the base**. Positioning was so bearish that the market had to rally on news that just a couple of weeks ago would have sent it spiraling down. There is some logic to this, but there is little evidence that the market is so bearishly positioned. We can concede that the market isn't overly bullish, but this "short covering panic theory" leaves a lot to be desired, at least for me.
- **People questioned the data**. For those of you who are sick and tired of reading T-Reports highlighting inconsistencies in the data (big focus on jobs and owners equivalent rent), you may have received many such notes from others this past week. My inbox and social media channels were filled with people questioning the jobs report. There was the now "obvious" discrepancy between the Establishment and the Household Surveys (the Household showed job losses). The data from 2 months ago got revised down (again). There were questions about the birth/death adjustment (was high in a period where other evidence showed that existing small businesses struggled, which isn't typically a sign that new small businesses were being created rapidly). There were also questions about the historically low response rate (possibly due to timing of the survey and Thanksgiving). Finally, many people started to question if the new and improved ADP data isn't the better data to watch.

Maybe neither explanation is correct?

No Trouble?

Maybe there are two other big factors influencing markets:

- **The potential for some form of armistice, truce, détente, or something between Russia and Ukraine**. While many members of our Geopolitical Intelligence Group see the slog grinding through the winter, there are three things that I think have changed, making some sort of peace more likely.
    - **The U.S. election is over.** Whether we like it or not, support of Ukraine was an election issue. This support had already started to break down along party lines. Why? I don't know, but that is certainly my perception. So, with the election over, the ongoing cost of supporting Ukraine with weapons and aid will come to the forefront. The tricky question of "how does this end?" will rise to the top. Can we give Ukraine enough support to push Russia completely out? Possibly, but at what expense and where does that leave Putin and Russia?
    - **Energy.** It is the winter and energy needs are spiking. The West is set to impose more sanctions and there is something about price caps (which I admit I haven't read, because they are so unlikely to work and far more likely to backfire). Russia, by all accounts, has done a much better job than the West in securing transport for their fuel (not shocking as we pat ourselves on the back about sanctions while they are busy working around the issues). The logistics of these new sanctions will cause the amount of transportation needed to skyrocket. Quite simply, energy markets used to be somewhat efficient. A delivered to B and C delivered to D because they were closer. If A has to ship to D and B has to ship to C, the distances are longer. Ships would be at sea for longer, reducing the number of shipments. **For a lot of reasons, addressing global energy concerns may take precedence over what Ukraine wants (and possibly even deserves)**.
    - **Winter.** Winter was already mentioned in the energy discussion, but it plays several other roles. Academy's GIG expects Russia to try to take advantage of frozen rivers to renew their attack on Ukraine. Russia needs to push west and all the rivers run north/south. At the moment, this forces the Russians to cross over bridges in very specific areas which are easily defended by Ukrainians with their highly capable weapons systems. Frozen rivers could help the Russians, but increasingly the efficiency of Ukrainian soldiers will make any Russian advance more difficult. That has led to targeting more and more infrastructure in Ukraine. Ukrainian winters are bleak at the best of times, let alone without the energy and raw resources needed to survive. The human toll will be bad for Ukraine even if they are technically "winning." Finally, the forced migration of Ukrainians into Europe is placing unexpected burdens on the countries receiving those refugees. The longer the war and destruction lasts, the less likely people are willing or able to go "home" when it is all said and done. Winter will crystalize many risks.
    - **China.** China seems to be nudging Putin along. You could almost argue that Xi, when he met with Putin, gave him a "win it, or get out ultimatum." Let's not fool ourselves, China would be okay with a Russian victory, but they are tired of the daily headlines. Since Russia hasn't achieved this victory there could be pressure on Putin (whose health is

being questioned again in some circles) to find some "graceful" way out. **Putin is a bully, but even bullies recognize bigger bullies and try to appease them.**

- **The end of China's zero-COVID policy.** This attracts a lot of attention and seems logical (at least from our perspective). It seems realistic that China will set in motion steps to have fewer and less severe restrictions after the winter (there is that word again). That should be good for global supply chains, but with inventory levels already too high, I'm not sure how much of a bounce can be expected from China shifting their policy.

Of all these narratives, I like the "peace" one the best (as you can tell by the time spent on that subject relative to others). If we get another big rally in stocks, it could be linked to developments on this front.

Mo Trouble?

We've examined no trouble, so what could cause more trouble? We covered this in more detail in Doesn't Goldilocks Get Eaten in the End?, so we will just highlight the key issues.

- **The Fed has already set the dominos in motion**. The wealth effect and higher rates are bringing the economy to a screeching halt in some areas that will in turn impact others.
- **The recession is coming sooner and will be deeper** than expected (we will ultimately recover, but first we need to get through the recession fears).
- **Quantitative tightening** is like a nagging cough. It doesn't seem too bad, but it certainly isn't good, and you have to be worried about whether it will develop into something more severe. Without a doubt the Fed is committed to balance sheet reduction (because they now believe what I've believed all along – that QE affects asset prices directly and that is a big issue and one they want to resolve).

When does bad news become bad? My guess is soon, even after Friday's reversal (remember, Friday's NFP data wasn't really "bad" in any traditional sense, so it's difficult to garner much information on how the market will respond to truly bad economic news, especially on the jobs front).

The Pseudo-Random Wildcard!

I like using the term pseudo-random as opposed to random because it sounds "smart," but is actually appropriate as I'm going to apply it to the trading of daily and weekly expiration options. The prominence of these very short-dated options should not be understated. Report after report comes in showing that volumes in these options are increasing and are a large part of all options trading. This includes not just open interest, but also the back-and-forth trading of these contracts. **This literally sets us up for large gamma moves each and every day.** Any significant move has a greater likelihood of triggering additional buying or more selling, rather than encouraging profit taking or dip buying. It's a minefield out there wondering what price point triggers buying from those who sold options, which in turn risks pushing levels to the next option point. **It is a massive wildcard in trading these days.**

But it is not random. There are clearly strategies involved in trading these and just because I don't understand them (yet) doesn't mean we should ignore them.

I'm reasonably certain of two things about these short expiration options:

- They mostly amplify already large moves.

- They allow markets to shift from seemingly being overbought to oversold in record time (and vice versa).

In terms of learning more, this is an area that requires more study and better understanding.

Bottom Line

If it weren't for my "hopes" that we will see some progress with Russia and Ukraine, I'd be in full anti-Goldilocks mode.

Barring any positive news out of this war, I'd like to be in a "risk-off" position. Long/overweight bonds (especially in the 2-to-7-year part of the curve) and short/underweight credit spreads and equities.

Since this is what I believe most strongly, it is what I should do.

But, if you can't beat them, join them, so I'd also buy some daily or weekly calls to benefit from any headline risk.

Maybe the "everyone is short thesis" is correct, but I'm still not there and don't believe that last week really supported this theory. The moves were rational given the data (and guesstimating the impact of the short-dated expiration options).

On the Fed, I don't expect them to backtrack, and I am looking for the data to drive the terminal rate lower.

It isn't often that you can be in bearish mode with world peace as the risk against you, so **hopefully we get that peace dividend and the daily call options pay off!**

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