Darkest Before the Dawn?

First, let's hope that the recovery from the devastation caused by Hurricane Ian goes as well and as quickly as possible!

Second, let's address just how nasty markets (and the economy) are behaving. Fear is permeating in almost every discussion now. Last week's Braking, Breaking, Broken, Broke report seems too optimistic (in hindsight). Maybe we **should have just gone with Broken & Broke?**

Bonds tried to rally on Friday. Some weak economic data and a large month-end extension trade buoyed bonds allowing the 10-year to trade as low as 3.68%. However, that strength evaporated as we neared the 3pm ET closing for bond markets driving the 10-year to 3.82%. If it weren't for the "ringing of the bell," who knows where we would have ended up? **Bond market liquidity, or more specifically the lack of bond market liquidity, was THE story this week!**

Stocks, which managed to post a strong gain on Wednesday, gave that up (and more) on Thursday and limped into the close on Friday with the **Nasdaq 100 and S&P 500 hitting new lows for the year!**

Bond Market Liquidity?

There was no story more important this week, from my perspective, than bond market liquidity!

Not only was it punishing bond markets, but it was a key reason that equities got hit on the week.

The Gilt market effectively breaking in the past 10 days is just one part of that! The fact that it took renewed QE to "save" that market is telling!

We saw very weak auctions this week where tails were large and non-dealer demand was limited. There were also concerns about countries selling Treasuries to support their currencies and **all of this fueled the fear that was palpable in the bond market.**

Let's be honest, it should be clear to everyone that **quantitative tightening (and easing) behave NOTHING like rate hikes and cuts**. See:

- QT vs Stagflation and How & Why The Fed Should Tweak QT (for snippets)
- The Rube Goldberg Nature of Translating QT to Hikes (for a deeper dive)

QE and QT change investment opportunities in real time. Hikes and cuts take time and to a large extent can be prepared for (issuing longer-dated bonds last year, for example). There is little that can be done when assets are taken out of the system or put back into the system. QE is more impactful than QT because it includes buying duration each and every day, while QT is relying on run-offs of maturing bonds, which isn't as impactful, but it still hurts.

More banks are noticing that the profit engine (that the Fed was for DC) is no more. They are probably running at a negative carry now given the average yield on the portfolio and the rise in Fed funds.

Could we see an Operation Twist? Something that would allow for balance sheet reduction to occur, while possibly supporting the longer-end of the bond market? It wouldn't be as far as the BOE had to go to support Gilts, but it would be something.

The bond market is in disarray, and we are paying the price for distorting yields and liquidity with unnecessary QE! **QE is the "nuclear" option and yet has been treated like a peashooter.**

Bond market liquidity is scary and that is concerning!

What is the Inflation Rate for Someone Who Loses Their Job?

Policy makers seem quite comfortable (and even eager) to see the unemployment rate rise. They want to force job losses to reduce inflation.

There are 158,000,000 Americans employed (via BLS). A 1% rise in unemployment would mean about 1,580,000 Americans lose their jobs.

I don't know how you calculate the inflation rate for someone who loses their job. It depends on what they were making and how much is covered by unemployment insurance (and for how long), but I have to believe that **from the perspective of the person who loses their job, the inflation rate looks really high!**

I'm not saying that policy makers are callous, but I suspect that we will all realize that jobs with inflation is better for the country as a whole than job losses with deflation.

We get a lot of jobs data this week. We start with JOLTS, move to the "revised" ADP (which I'm not sure anyone knows how to interpret), and finish with NFP. Jobs, almost universally, are still viewed as a bright spot for the economy. That has been supported, if not confirmed, by recent jobless claims filings.

Will the strength of the job market continue? I suspect not and that we will get some "payback" in the Establishment vs Household battle that has been raging. However, in this world of GoodBad, some weakness in jobs would be viewed as a "good" thing for markets (and even the economy, which I find so perverse).

Willfully Ignorant Regarding the Data?

I do worry that we are either acting blindly in the face of the data or we just aren't skilled enough to offset algo driven reactions to the headlines. Probably the latter given how awful liquidity is!

A case in point was the August PCE data. On September 30th, we got "official" data from August. It painted a mixed picture on inflation. Data that also came out on September 30th basically painted a much worse picture. The data that is timelier seems to get treated almost the same (in terms of signal to noise) as the data that isn't as timely.

Yes, maybe the policy makers are forced to look at PCE. However, if we "know" or are reasonably sure that it is not portraying the current reality, do we still have to trade on it just because policy makers will be relying on it?

It hurts my head to write that! However, this could also be due to having been to my first football game at The Grove (and a night out in Memphis).

But seriously, why do we have to treat "old" data with more respect than it deserves? Is it because that is what the politicians, the media, and maybe even the policy makers are looking at?

Bottom Line

Markets are cracking. The Tacoma Narrows Bridge comes to mind (certainly the last three days of the week had an awful back and forth feeling that does not seem sustainable).

The economy is rolling over. The data that I see as most up to date and most reflective of where we are heading is showing up as weak. I am really curious to see the used car index for the full month of September when it comes out this week (as I have harped on in various T-Reports). Earnings reports, announcements, and pre-announcements seem to be pointing in the same direction (think CarMax and Apple headlines just this past week).

The "redeeming" feature for the market is that so much bearishness is priced in, and that while I think we've already launched an unstoppable chain reaction of weakness in the economy, it may appear for a moment that "slowing" is what we were looking for. This could be enough to avert the fears that are becoming more and more commonly held and (sadly) more and more well founded.

This is a critical moment for the markets. It may be less critical for the economy (only because we may already have passed the trigger point).

The messaging we get from central bankers this week will be a key driver for returns.

If they stick to the "pre-determined" script as liquidity vanishes and bad data comes tumbling in, we will be in for a world of hurt!

Hopefully, positioning is enough to stem the pain, but we all know that "hope" is rarely (never) a good investment strategy.

Maintain small positions and focus on options. It is really all that can be done to navigate these choppy markets. Markets where even if you knew the outcome for the economy, you could still take some serious losses in the interim. There was a reason that **Stop Loss and Gamma** won one of the coveted Trader of the Year Awards!

Despite hitting new lows on stocks this week, my view remains that we won't hit the lows of the year until we have a true risk-off moment (lower yields and lower stocks). That is not what is happening (at least not last week), and any potential bounce still leaves that risk on the horizon.

Stay safe!

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