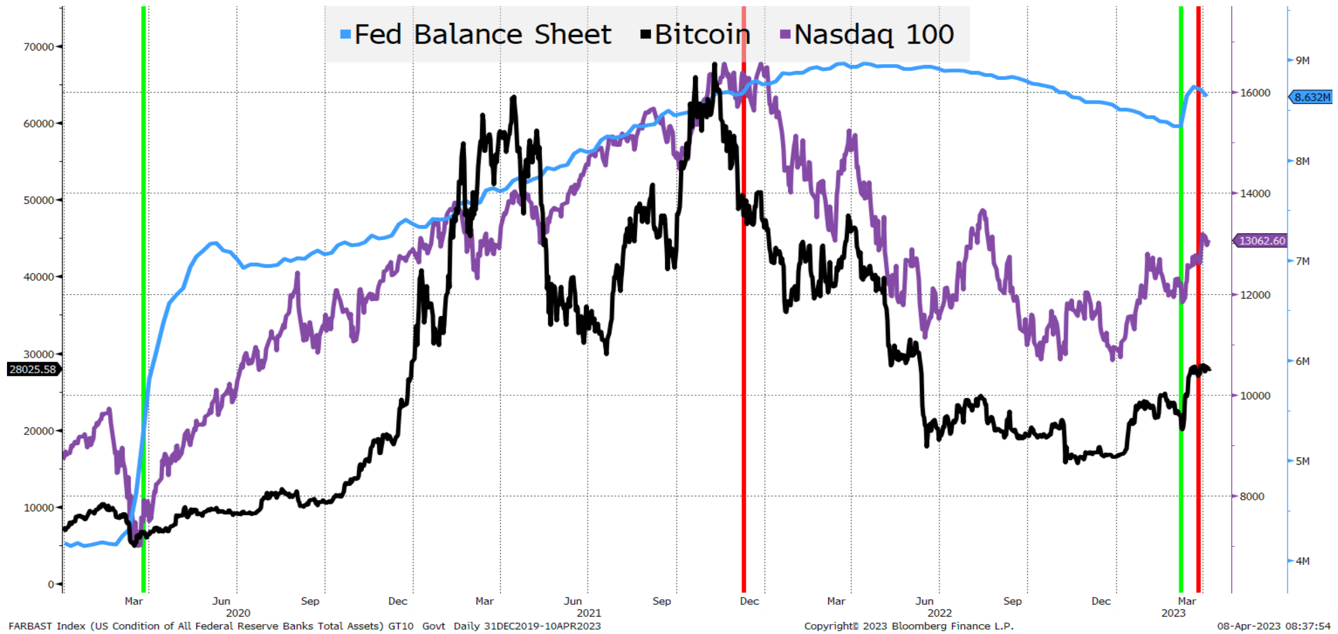
Davy Jones and the Six

Spoiler alert – if you started watching Daisy Jones and the Six thinking that the ending might be more uplifting than the description of the show, it isn't. **While I'm not quite as bearish as the title suggests** (Davy Jones Locker isn't good)**, I remain cautious on risky assets.**

An Almost Embarrassingly Bad Chart

This chart is so simplistic (and has so many spurious correlations) that I'm almost embarrassed to publish it, yet here it is.



I am not sure if we are witnessing a Pavlovian response here (algos responding to a trend), or the policy that is in place (that creates larger balance sheets) is helping risky assets, or there is just a direct correlation (less likely). Regardless of the reason, we have seen risky assets (stocks, bitcoin, etc.) respond well recently. This has occurred as banks have started borrowing heavily again (mostly at the discount window).

In Friday's other data release (we sent the NFP "Instant Reaction" at the time), we learned that the Fed's Emergency Loans to Banks Fell. That (in theory) is good because it indicates that there is less pressure on banks. However, this trend has been accompanied by a slowdown in bank lending (see Bank Lending Slumps by Most on Record). This could signal that the decline in emergency lending usage is as much about banks reducing their lending as it is about stabilization.

While I admit that this chart is weird (and has lots of potential flaws), it is useful to think about the resumption of quantitative tightening, the shrinking of the Fed balance sheet, and what it could mean for risky assets. **Certainly, QT is a headwind for risk in general.**

Bank Deposits

The second article that I cited above contained not only the concerning news on the decline in lending, but also the statistic that **bank deposits dropped by $64.7 billion last week.**

As discussed in detail in I Know What You Did Last Winter, my concern for banks is that we have shifted from the safety of deposits (a fear that was incredibly overdone) to investors examining the potential yield that they can get from parking their cash in other assets. Bank deposits, which grew on an average

of $500 billion per year from 2014 through 2019, jumped $5 trillion in 2 years. I expect to see pressure on deposits until yields become more competitive. There will always be a gap, but it is very high right now.

It is true that some banks view themselves as having too much in deposits (versus other forms of funding). However, **I don't see that as a reason to be bullish on this trend because we have seen deposits decline for 10 weeks in a row**.

Cost of capital is increasing and access to capital is deteriorating for many companies (not good).

Oil

WTI jumped 8.5% this week and is 20% higher than it was as recently as March 17th.

I'm normally less concerned about the inflationary risk of oil, because:

- The Fed tends to treat it as transitory, which fits my view that it is self-correcting.
- When oil prices rise because economic activity is increasing, risky assets get a bump regardless of what is going on with inflation and bonds (the old-fashioned "risk on" trade).

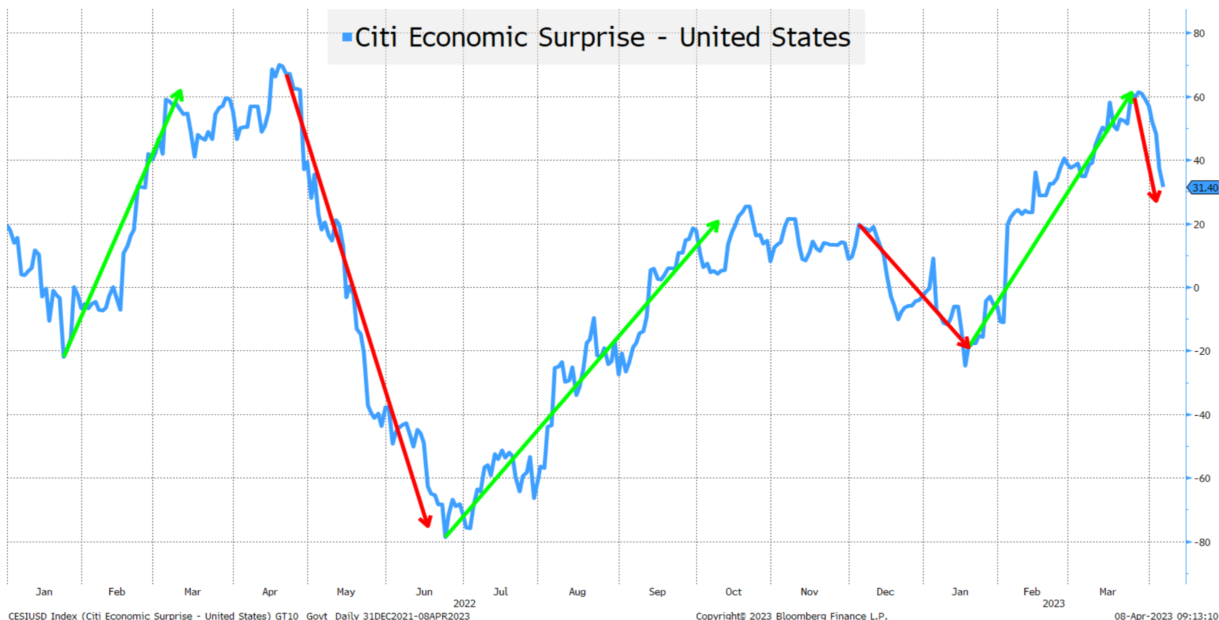
But…

- Oil increased largely because OPEC+ cut a significant amount of production. Yes, recession fears peaked with the so-called banking crisis and some of that has reversed, but the cut seems to have played an important role.
- We have seen problems in shipping, freight, and inventories and I believe that OPEC+, which is much closer to the demand side of the energy equation, has seen disturbing trends of late (supporting recession fears).

Higher oil prices, for the wrong reasons, will be a headwind for the economy and risk.

Economic Data

We highlighted the recent data in Slowing, Slowing, Gone. Today, we will focus on the Citi Economic Surprise Index.



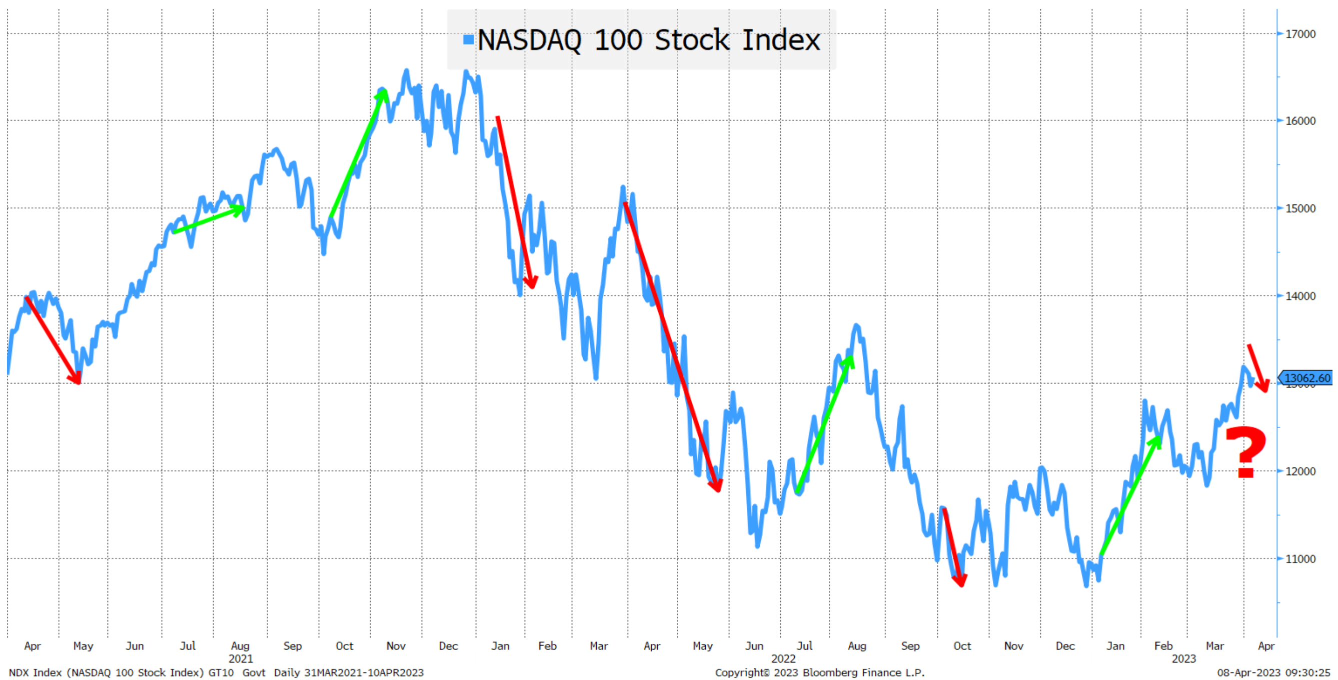
This data series tends to have sharp moves higher and lower. It makes sense in many ways as it compares data to analyst expectations. Analysts are often reluctant to update forecasts or just don't bother to update them (they have better things to do than tweak every expectation on every data point). **So, they have a built in "lag" effect, where expectations reflect the last trend for too long.**

I am very concerned that while the index is at a "good" value today, we could see it drop rapidly.

We went from "soft landing" to "no landing" in record time (5 weeks of better-than-expected data). Can we reverse that just as quickly?

Earnings

Earnings season has been mixed for stocks over the past couple of years.



The Q1 earnings season in both 2021 and 2022 were negative. 2022 was heavily affected by the shift from easy money to a tougher Fed.

A few weeks ago, it seemed easy to argue that earnings estimates (and market positioning) were too negative and it wouldn't take much to "pop" post earnings. Micron, which surged 8% the day after their earnings, is a prime example.

Everything is less clear as positioning has become more bullish and the economic outlook has started to turn. Are nice "pops" on ok reports still possible?

Markets will be looking for stock buybacks (there seems to be a belief that the blackout period for discretionary buybacks weighs on individual stocks and reverses after the earnings release). Those buybacks could help, but first we need to get through the discretionary buyback blackout period.

Finally, what will companies say?

Will we see concerns about borrowing costs? Concerns about expenses? Will we get more signs that the labor market is less stable than it appears to be from some of the headline data?

Will there be optimism? Will there be talk of China re-opening?

Anything can happen, but reading the room, I expect that earnings (and more importantly, the outlooks) will act as additional headwinds for broad indices.

Geopolitical Optimism?

I see a divergence between geopolitical risks and market optimism on those risks.

- **Russia/Ukraine peace.** No one is really pricing in "real peace", but few are pricing in an escalation of risk. Many believe that this will be an ongoing grind and a war of attrition. The market seems more skewed towards the lower probability event of peace, rather than the higher probability event of a relentless grind of lives, money, and global political rifts.
- **China.** Whether it is Taiwan (more maneuvers coming), weapons to Russia, or deals with the Saudis, I hear more optimism about the re-opening and how Xi "needs" us or "cannot" let the friction between the U.S. and China continue. Far fewer people want to talk about the clear alignment of autocratic/resource rich nations with China and the rapidly increasing portion of the global economy that is trading directly in Yuan. The market seems to be tipping the scales in favor of cooperation and better times ahead, while much of Academy's Geopolitical Intelligence Group (and me) see the scales tiled in the other direction.
- **Middle East.** In addition to OPEC+ snubbing the U.S. (cutting production) and the Saudis signing deals away from the U.S., we have an additional U.S. sub being sent to the region as tensions with Iran increase. While immediate threats of escalation are not clear, we will likely see market volatility in the region.

While investors "talk a good game" on geopolitical threats, they seem to be very willing to expect good outcomes over bad outcomes even if the signs are pointing in the other direction.

Bottom Line

Rates.

- **I think that we could see marginally higher yields**. It would take a geopolitical event to create a large move to lower yields (25 bps or more). Conversely, I see many easier paths to going 25 bps higher on yields. So, **maybe the outlook for yields is that there is a chance of "stable to slightly lower" yields, but there is a much better chance of a significant move to higher yields**. This is leading me to become slightly bearish on Treasuries. However, at some point, I could become potentially more bullish (but with some options to hedge the risk).
- **2s vs 10s to invert more.** These negative curves confuse me (especially using terms like steepening or flattening). 2s vs 10s moved from -108 to -40 last week, finishing at -53. I expect that the market will price in rate hikes (not what the Fed should do, but what they will signal). More importantly, markets will start believing that the Fed will be higher for longer (which I think is the message that the Fed is trying to send). **Fairly low conviction on my part because the market is fighting the Fed, and the market is winning so far.**

Equities.

- **Too many headwinds to be constructive.** On a scale of -10 to 10 where -10 is extreme bearishness and 10 is extreme bullishness, I'm about a -3 or -4. That would translate to small to medium underweight/short positions on equities. So, I'm bearish, but not going to pound the table. I need to see more than a week of stocks ramping up to convince me that much has

changed. **Positive responses to mediocre earnings/outlooks would change me to bullish in a flash.**

- **Reversion to the mean trades.** I generally like "reversion to the mean" trades in areas like QQQ (up 20% year-to-date), versus IWM (0%). ARKK up "only" 23% YTD seems low versus QQQ as well. Obviously, a lot is going on, but I like some mean reversion. Still dabbling in banks on the long end, but it is a "tiny to small" range of positioning until we see how the deposits situation evolves. **One big problem with "mean reversion" is what mean are we reverting to?** Sure, mean reversion makes sense, and I like the symmetry of the year-to-date numbers, but we may well be reverting to some other mean (shorter or longer-term). **This would coincide with a mildly bearish outlook.**

Credit.

- **I find it difficult to advocate for high yield** (or leveraged loans) when the Russell 2000 has been so weak. I always think about IG/S&P 500 and high yield/Russell 2000 as having some degree of correlation. High yield has done extremely well and there will be little new issuance (much to the chagrin of big banks as this is a high profit margin business for Wall Street). I'd skew slightly negative on high yield and leveraged loans even as banks extricate themselves from commitments that went "pear shaped". Both the economic outlook and recent performance has me leaning negative on this subset of the market.
- **Investment is ok, at best.** This is more of a "carry trade" than spread tightening, but IG is reasonably well positioned to outperform even if the recession talk increases. Senior unsecured bank credit risk, even after rebounding, offers some value. I am really not concerned about the credit quality of banks. I'd skew my long positions into actual bonds and keep shorts in CDX because CDX will correlate more with stocks than the actual bond market.
- **Munis.** I still like munis here. Yes, they trade expensive, etc., but since it is clear that tax refunds are smaller this year than usual, we should see affluent investors continue to embrace munis.
- **Structured Risk.** Move up the cap structure. Virtually every type of structured product has been skewed in favor of senior debtholders. When I look at the broad landscape of where risks reside (real estate, auto loans, etc.), many fund in the structured market. Our structured credit team may or may not agree, and in any case, they have trade ideas across structured products and the cap structure, so please reach out to them on how to implement (or fade) my view!

I hope that you enjoy the rest of the long weekend and I look forward to starting the week off right with Bloomberg TV and radio at 7am ET on Monday!

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