Duck and Cover

Even I am not old enough to have done "duck and cover" drills in school, but it somehow comes to mind this weekend as we digest the latest market action and the ongoing Russian nuclear threats.

Markets

On the week, stocks didn't do too badly. The Dow was almost unchanged and even the hard-hit Nasdaq "only" dropped 1.4%. Based on that, last weekend's Bad to the Bone seemed overly dramatic. But the weekly change isn't reflective of the market mess. From its lows on Wednesday (ahead of the FOMC), the Nasdaq 100 rallied over 5% only to plunge almost 8% at its lowest point on Friday morning! While we expected many stocks to try and rally post FOMC (largely because it worked extremely well back in March), I had no expectation that the rally would be this strong and fast! Nor did I expect it to be so short lived and to turn so ugly, so quickly.

Markets, largely, remain broken. Liquidity is abysmal. Stock indices seem to move 0.5% on a whim and the trading this week made me think back to the days when the TARP legislation failed, which I discussed on TD Ameritrade.

There were some bright spots, like energy, where XLE was up almost 10% on the week! (Barron's included Academy's view that "The energy companies of today are also the energy companies of the future"). Bitcoin, on the other hand, is back below $35,000 as I type and had a miserable week dropping more than 10%.

I remain concerned that the "non-virtuous circle" described in last week's report highlighting the linkage between "disruptive" stocks and crypto isn't over (though TQQQ had large inflows last week, including a huge inflow on Friday, as some investors bet heavily on a bounce, using leverage). ARKK, which I also highlighted, had inflows on the week, but had a significant outflow on Friday which is something to watch.

As much as I want to be full on bullish at these levels, **the only "capitulation"** that I have seen is the capitulation of **shorts and hedges on Wednesday afternoon!**

"Duck and cover" seems to apply when trying to manage risk in these markets.

Rates and Credit

Much of the blame for last week's markets can be placed on the Treasury market, though that is a bit too simplistic. Yes, the 10-year Treasury went from 2.94% on Wednesday to 3.13% by Friday, but it did move 5 bps higher on Monday (while stocks rallied) and even on Friday stocks and bonds were not moving in lock-step, which sets us up (potentially) for a "risk-off" type of day when stocks sell-off as Treasuries rally.

The yield curve actually steepened (at least 2s vs 10s) which should, if anything, be encouraging.

Credit, as expected (or at least as hoped) did very well! The Bloomberg corporate bond spread actually tightened from 135 to 134 on the week. That seemed almost too good to be true, but LQD (a longer-dated IG ETF) had spreads go from 172 to 169. The CDX index didn't fare as well, but that is linked (via algos) to the stock market almost as much as to the bond market.

Lower prices and overall higher yields are attracting money to corporate bonds! That has been very supportive for spreads.

I think there are some key takeaways from the credit markets:

- **Credit is holding on, which should support equity prices**. Equities should not go into freefall while credit is holding on. What we are seeing is the closing of the gap between high equity valuations and credit. There is a large buffer between credit risk and equity risk for most firms and that is what is getting priced in. Even some "distressed" investors are buying IG bonds as the dollar prices are so attractive (buying bonds below par solves a lot of credit concerns).

- **Watching the leveraged loan market closely**. Leveraged loans and CLOs had done very well, especially versus high yield bonds. That, to me, indicated that the movement was primarily rates related and there wasn't much concern about credit spreads. But these markets (BKLN, SRLN, and JBBB are some ETFs to watch) are back to their March lows (or even worse than that). There is at least a hint that in the high yield market, credit risk is becoming more of a concern! This "metric" or signal has gone from comforting to mildly disturbing.

Russia's Endgame?

We continue to go in circles on Russia. Russia and Putin are not winning by any "traditional" measure. However, they are "winning" in terms of creating a wasteland that separates the West from Russia (at least in that part of the world). But Russia (and Putin specifically) cannot afford to "lose." More time and energy are being spent on figuring out how Russia might ratchet up their nuclear threat! Russia is already being treated differently than it would be if it didn't have nukes (the West would already have sent troops and rolled up the Russian forces), but it seems likely that Putin would like to get even more leverage from his nuclear arsenal. No one has really come up with a plausible way for him to ratchet up that threat without incredibly severe consequences, but it is something that I cannot stop thinking about. Putin's disdain for any world "norms" has been evident and should not be dismissed out of hand when considering how he might escalate things.

For now, any escalation seems incredibly remote, but "duck and cover" drills keep popping into my head.

Market Strategy - Duck and Cover

As we head into this week:

- **Expect more volatility**. I cannot think of any reason why volatility would decline dramatically. Last week's extreme price action will likely feed into VAR (value at risk) models and cause traders to reduce positions. Liquidity, with summer coming, is likely to remain poor or get worse as traders won't have the stomach for large positions with reduced staff as people take their vacations.

- **Buy dips on credit and rates.** Unless we see signs of credit fears (either IG bond spreads widening or leveraged loans catching up to high yield bonds) I like buying dips on credit and rates (but very cautiously).

- **Watch Quantitative Tightening in action**. When a bond matures, the issuer often issues new debt. That applies to Treasuries as much as anything. Often, the holders of an existing bond "roll" into the new bond. There is, to some extent, a list of ready-made buyers. They are receiving cash for the bond that is maturing and may be inclined to re-invest that money in bonds of the same issuer. Simplistic (yes) and somewhat true (also yes). So, when the Fed holds bonds that are maturing and is NOT planning to re-invest those proceeds, new buyers have to be found. **I think that we will see investors in every asset class reduce risk to get similar expected returns**, which is why I think the selling in the riskiest assets isn't quite over yet.

- **Sell rips on risky assets**. I'm stuck thinking that we have another 10% downside on risky assets (and more than that on crypto). It doesn't mean that we won't get vicious "bear market" rallies. But I just don't think this "valuation re-evaluation" is over. It is getting close to being done, but I would really like to see capitulation, which I still don't think we've seen.

Stay nimble. Duck and cover was meant to be a way to protect yourself, and I think we have to trade this market with that perspective in mind.

Longer-term, the level of discussion about **"securing" supply chains** is high and I'm certain is going to result in action as companies (and countries) focus on ensuring that their supply chains are robust and "secure."

I am the least bearish I've been (and even expecting some sort of a rally), which may mean I've become part of the problem and markets will face a rough start to the week!

Happy Mother's Day!!!! (At least we can all agree on that!)

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