## Rubbernecking

Markets did little last week as bonds and stocks seemed to get caught "rubbernecking" the debt ceiling "drama" (for lack of a better word).

2-year Treasuries moved a few bps higher, along with a slightly increased probability of a hike at the next meeting. The 10-year, the S&P 500, and Nasdaq barely budged on the week as debt ceiling discussions sucked up all of the oxygen.

The "interesting" part is that despite all the debt ceiling chatter and analysis, virtually no one thinks that we will default. So why all the rubbernecking? Unless, just maybe, there is a nagging doubt that this time around the "inevitable" passing of legislation to raise the debt ceiling could run into complications.

We discuss this topic and our thoughts on how any default might play out in Debt Shilling. We also got to discuss this subject, the issues facing banks, and the transition from "made in China" to "made by China" on Bloomberg TV on Friday.

While I hope that the U.S. does not default, the CDS market is pricing in around a 5% chance (which may even be low). In any case, if we do default, I hope that it is on June 16th because Academy will be a guest host from 6am ET to 7am ET on Bloomberg Surveillance that morning and it would make for one heck of a show!

On the other hand, maybe we make some progress and we can stop the rubbernecking and move on to what major themes will drive markets and the economy next.

## CONsumer CONfidence was the Anti-Goldilocks

CONsumer CONfidence has never been a report that I take a lot of stock in (please see T-Report we published back in 2021). More often than not it seems to track some combination of the S&P 500 (for conditions) and gas prices (for inflation).

Friday's numbers were quite interesting as sentiment plummeted (57.7 was a drop from 63 and pulls us back to levels from last autumn). Current conditions and expectations also fell, which continues the trend. Given the historical correlation with the equity market, that move was a bit surprising.

On the other side of the coin, 1-year inflation expectations remain at 4.5% (well above where the Fed would like to see them) and longer-dated inflation expectations increased to 3.2%. The last time expectations for 5-10 year inflation were that high was back in May 2008!

This data is quite literally the "anti-Goldilocks". **Rising inflation with weak growth has a name – stagflation.** While there were far too many mentions of stagflation on Friday, it does seem to fit a theme of an economy that is weakening while many continue to raise prices. Danger Will Robinson!

Again, CONsumer CONfidence isn't something that I rely on, but this one caught my eye because it spun a negative story (and I remain bearish, so who doesn't love some confirmation bias). However, it wasn't accompanied by lower stock prices and higher energy prices, which likely means something.

## Neither Life nor Markets Are Like a Video Game

Last weekend, we cautioned that the market seemed to be in a mood where we can "solve" complex issues in a very short period of time. For example, we could find and solve a "banking crisis" in a week (see Life in a Video Game).

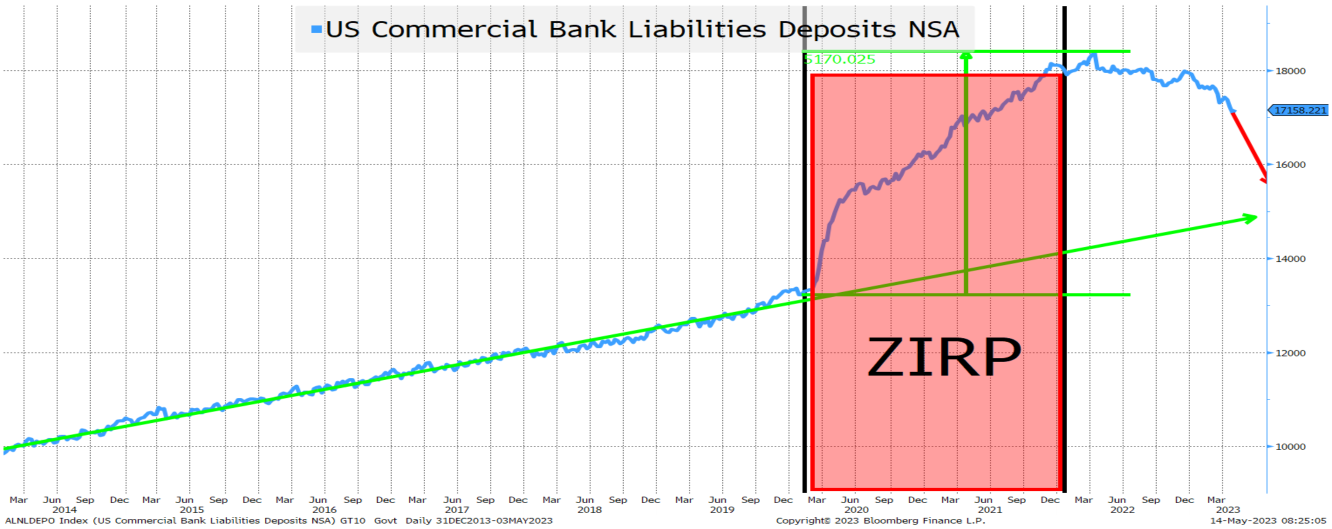
## Rubbernecking

Last week the market was focused on the SLOOS report, which I can readily admit is one of the few times that I can remember anyone even mentioning SLOOS (let alone focusing on it as a potential market moving event).

**The most important part of that report, from my perspective, was the decline in loan demand.**

Sure, the willingness to lend might be shrinking, but there are alternatives to borrowing from banks. The drop in demand for lending seems more problematic as it reflects companies (and individuals) seeing either a smaller opportunity set or increasing concern about their ability to pay off such debt.

**Ultimately, I still think that this is the most important chart for the banking sector.** Please see I Know what You Did Last Winter for more analysis in this vein.




Historically, bank deposits grew at a steady pace of $500 billion per year. **Then in less than 2 years, banks took in $5 trillion.** While that could be a positive, it came during the midst of ZIRP (large scale asset purchases/QE, low interest rates, and lots of stimulus).

**This flood of deposit money came during a period of extremely low yields.**


It should surprise absolutely no one that **some institutions would make bad decisions when it came to navigating the 5 Circles of Bond Investor Hell.**

Banks, like any other investor base, will behave on a continuum, with some chasing yield and NIM by taking on excessive risk, while others are more cautious and patient.

The risk is that as certain banks (that made the worst decisions) have their portfolios scrutinized, it lowers prices and potentially shines a light on the next level of "least prudent investors". The "**tail risk**" is this event occurring, which we tease in Mommy, Where Do Bond Losses Come From. This report is all about forced selling and almost nothing about default.

**This will take time to play out and will be a headwind for markets and the economy!**

## China and the Yuan

We are having more and more conversations about China where "**reserve currency**" is addressed.

This does warrant a full T-Report, which will come later on this week. I'm on the road seeing a lot of clients with multiple members of Academy's Geopolitical Intelligence Group.

Ahead of those meetings, we can make three quick statements (some of which were highlighted in Locking in Some Themes and in our China's Increasing D.I.M.E. Prowess webinar).

- **The "re-opening".** Overhyped as China didn't go from 0 to 100 mph (more like 70-90). Also, China's focus is increasingly domestic and on working with the resource rich nations of the world. This limits the impact on the global economy.
- **From "made in China" to "made by China".** Increasingly, I am looking for China to exercise their levers of power (primarily diplomatic and economic) and shift from merely being the manufacturing hub for goods made on behalf of multi-national corporations to trying to make goods to sell on behalf of Chinese companies.
- **More like a "dark web" than a reserve currency.** I don't see the status of the dollar as the world's reserve currency being threatened. However, more trade will occur outside of the dollar's sphere of influence and some countries will shift to a system that gives the yuan some elements of reserve currency status. **Increasingly, I'm concerned that I'm too sanguine on this matter.** China is showing great skill at starting to "roll up" some of the weaker global players and I can't help but frame this in military terms. While they may not be close to launching a frontal assault, they are taking out some units that may let them outflank us if we are not careful.

## Bottom Line

I am still bearish on credit and equities (-4 on a scale of -10 to 10). Largely neutral on rates, though there is the increased risk of a short squeeze.

**The "new" thoughts are:**

- **Don't expect a big relief rally in stocks if the debt ceiling is raised** (without too much pain) because little fear is actually priced in.
- **If you need to issue debt, issue now**. Summer and the debt ceiling will likely dry up liquidity at least for a few weeks at the start of the summer.

**Happy Mother's Day** and celebrate friends and family today, but remember, we should really celebrate friends and family every day!

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