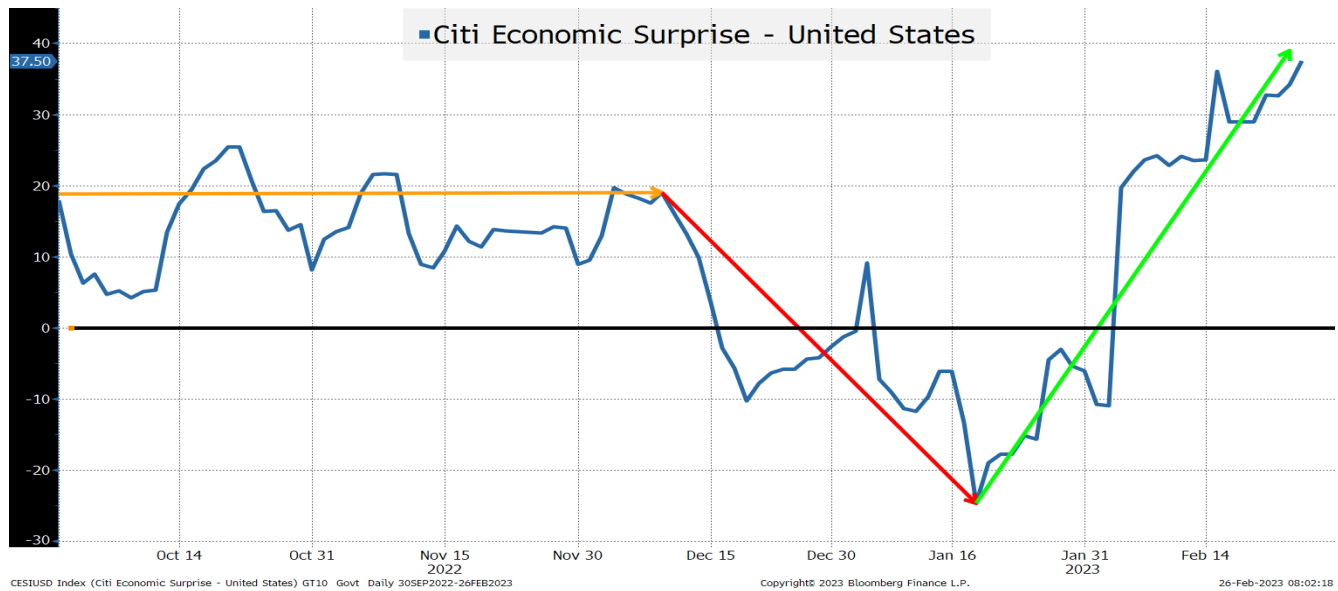


Surprise, Surprise!

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There is one chart I keep turning to and that is the Citi Economic Surprise Index.



The surprise index started rolling over during the middle of December. For a month, no matter what expectations were, the actual data was worse. Then, since the middle of January, the data has started outperforming expectations. **Part of that is because expectations were lowered, making them easier to beat.** That also happens with earnings estimates, which are usually lowered to the point where typically 70% or more of companies beat their expectations (though Q1 has been at the low end of the range). **Most of the data was simply good, especially on the jobs front.**

What signs did I miss as the economy turned? That is the question we explore today (along with how markets will respond to this ongoing “surprise”) as many missed this turn in the economy.

Geopolitical “Surprises”

As Academy prepares to host its 2nd annual Geopolitical Summit West (in Del Mar, CA) there are a lot of very interesting things to discuss.

- Friday’s [Around the World](#) piece provides updates on the **War in Ukraine**, China and **Unintended Consequences** (also explored in [999 Luftballons](#)), **Iran** and its relationship with China, and the tragic **Earthquake in Turkey**.
- The topic of chips and rare earths/critical minerals (and their processing) was discussed in [World War v3.1](#) (as opposed to World War III).
- Finally, we address [China’s 12-point plan](#) for peace. The 1st point “Respecting the sovereignty of all countries” seems to be written in such a way that Taiwan might not benefit from China adhering to this point. It is an interesting way of trying to paint the West as war mongers (rather than Russia). **For me (and I suspect for markets) the big question is will China start selling weapons to Russia?** Any final questions about the direction that China really wants to go will be shed if they go down that path. There is a wide range of opinions (even within our Geopolitical Intelligence Group) on the subject, which makes for exciting conversations. I believe that this “plan” is the air cover China needs to sell weapons. They can tell the world that they are calling for peace (and it isn’t their fault that there isn’t peace) so they have to sell Russia

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weapons to balance the situation. Probably, from preliminary discussions on the topic, the most contentious issue is how much would this action hurt the Chinese economy. For that part of the engagement, I’m sticking with [Who Needs Who](#) from almost a year ago.

	U.S.	EU	Russia	China	India
Buys Food	✓	✓	✗	✓	✓
Sells Food	✓	✓	✓	✗	✓
Buys Raw Resources	✓	✓	✗	✓	✓
Sells Raw Resources	✓	✗	✓	✗	✗
Buys Finished Goods	✓	✓	✓	✓	✓
Sells Finished Goods	✓	✓	✗	✓	✓

Yes, this is crude and simplistic, but wherever Russia has an “x”, China has a “check” (and vice versa).

It seems to me that either we get the “surprise” of peace talks being announced in the very near-term (which would be a surprise because Zelensky does not seem open to them and Putin really can’t afford to “lose”) **or after some “appropriate waiting period” we get the “surprise” of China selling arms to Russia.**

Back to the Economy

With the economic data taking a turn for the better (both on an absolute and a relative basis), what is next?

I guess, as a curmudgeon, that we can start by questioning some of the data.

- **Inflation measures have ticked higher.** That is undeniable. Does it mean that inflation is about to return to prior levels? Is this just a “normal” bounce in the data which is rarely smooth? Does the bounce preclude inflation turning back down in the coming weeks and months? No, in fact, while respecting the uptick in inflation, I remain more concerned that we’ve pushed too hard on the inflation fight already (and are about to push harder) which will turn out to be a mistake.
- **Don’t fight the American consumer.** That is probably the biggest area of contention right now. On one side, spending remained robust. The services side hasn’t shown any evidence of slowing down. Last Tuesday, Global Services PMI popped above 50, which also helped keep the composite PMI above 50 (almost 3 points higher than consensus). That was important and could contradict my view that this wave of pent-up services demand (similar to the goods demand wave of 2021/early 2022) will fade.
 - **On the other hand, credit metrics are not looking great for the consumer.** Credit card debt has been rising rapidly. For a while it was still below trend because consumers had reduced debt during Covid, but it now seems to be back above trend. Delinquencies, especially in certain segments of the auto lending category, are ticking up. **Could the consumer be tapping out?**

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- **Inventories are still an issue.** Despite all the hype about consumer spending (where the bulls tend to conveniently pick and choose when to use nominal versus inflation adjusted data) inventories remain above trend. **I'd be more concerned about inflation if we didn't have this inventory overhang coupled with the evidence that consumers have reached their limits.**
- **Jobs.** The most "surprising" data of the year (at least for me) was the Non-Farm Payroll data for January. It was a [Simply "Stunning" Report](#). **I still have difficulty reconciling much of that report with anything else.** I'm betting on some major disappointment in February (or more likely some substantial revisions). In any case, the February report tends to be "cleaner" than the January one, so we will see.
- **Earnings season is almost done,** meaning that we will have to find something else to focus on every day. There is no shortage of economic data this week, but we will all miss the daily excitement around earnings.
- **Volatility, Liquidity, and ODTE.** We clarified some of our views on zero day to expiration options in the piece titled "[Is 4,000 More Than Just a Round Number?](#)". Daily options have become the #1 topic of discussion (after Fed policy) for more and more of the market likely because they really amplify moves.

Back to the Markets (and the Fed)

It is difficult to extricate markets from the Fed at this point. But as we wrote on Friday, we may have entered the [5th Stage of Rate Hike Grief – Acceptance](#).

Have we entered the "acceptance" stage?

- Markets held their own on Thursday (even with some inflation fears) and while they sold off on Friday, stocks managed to bounce on a key technical level and never seemed to panic.
- **There is no denying that the Fed will be more cautious on hikes.** The size and timing will be data dependent. Yes, inflation has ticked higher, but a lot has been accomplished and there is still a "lag" effect that hasn't fully impacted the market.
 - **We might get some "negative" surprises in the data.** As economists ratchet up expectations, we could get some "disappointing" data on a relative basis. We might also see some disappointing data on an absolute basis as well. **I am convinced that coming into the week we are in a "bad news" is "good news" mode for the market, and since I expect some "bad news", I like being bullish on stocks and bonds!**
 - **Has "good" news been "accepted"?** Even if we get strong economic news, will bond markets sell-off hard dragging equities down with them? I don't think so (though with ODTE, we might get an explosive move post the data release, but unless something changes for me, I'd be fading any sell-off).

Bottom Line

I like owning stocks and bonds here. I'm looking for a bounce in both (3.7% on 10s and 4,200 on the S&P 500).

In the meantime, I am heading to San Diego at the only time (maybe ever) when the weather is worse there than it is here in Connecticut! **Now that is surprising!**

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