Tilting the Scales

As we wrote on Friday afternoon (here on zerohedge), Powell was given the opportunity to speak in a format that let him sound like the inflation hawk that he probably really isn't. What he really did was **tilt the scales**.

Prior to Friday, the market had once again managed to convince itself that the Fed would overrespond to "bad" news. If the news was bad (on a scale of 1 to 10, say at 5) the market was beginning to think that the Fed would respond as though the news was a 7 (i.e. the Fed would err on the side of providing the market put we have all grown used to and some can't even remember a time when it didn't exist). After Friday, the market (at least for a bit) probably needs to assume that bad news on a scale of 5 will be responded to as though it was a 3. **The Fed put isn't gone, it has just been struck a bit further out on the calendar and at a slightly lower strike price.**

Basically, Powell has me convinced that **the Fed will still put pressure on the scales, but they will err on the side of letting markets and the economy slow** (more than the market was pricing in).

Did the market get too pessimistic Friday? That really depends on whether you think that the market was too optimistic going into the week or was realistically priced. From my previous notes, I was leaning towards the markets being too optimistic, but we must respect (or more accurately, be deathly afraid of) the lack of liquidity. Anything can and will happen in this sort of illiquid market. I still like owning the tails on equities (long out of the money puts and calls) and trying to trade in and around exuberance and doom.

From a rate hike perspective, the market is close to rational now (which is good from a risk perspective), but it is going to be **far more difficult for us to get the "bad news" is "good news" trades** as we cannot expect the Fed (or other central bankers) to come to the rescue quite as quickly or as aggressively.

Quantitative Tightening is NOT Equivalent to a Rate Hike – It is Worse!

We are going to see more and more headlines as quantitative tightening increases in size in September. An academic report came across my desk and I agree with what the summary seemed to suggest - central bankers need to be cautious with QE as QT is difficult to control.

Please read our April Report – QT Does Not Act Like a Rate Hike. It argues why trying to translate balance sheet reduction into some equivalent of rate hikes is not only an exercise in futility, but why going in that direction will likely lead to risk management mistakes. The Newton's cradle theory of how QE and QT work continues to be my base case and we could see pressure on risk assets not just because QT is getting more aggressive, but because the media is going to be focusing on it (adding to the fear).

In terms of "tilting the scales," I think that we will see more weight put on the problems that QT causes and that will be a strong headwind for markets in the coming weeks (until it gets priced in).

Crypto, Energy, Semi-conductors, Web Services, Advertising, and More

Now that Powell came out standing firm on inflation, the probability of a crypto crash (bitcoin going below $7,500) has increased to 25% in the coming weeks. Bitcoin has broken $20,000 again this weekend and if it breaks below $17,000 then that probability increases even more.

Tilting the Scales

Please read last weekend's [Why a Crypto Crash Would Hurt Markets and the Economy]() for why I think this is something mainstream companies and investors need to be worried about (and it might not be just some "niche blow up" like it would have been a few years ago).

How are the Scales Tilted?

As we start this week and get ready for what could be an "interesting" September, I try and do a quick summary of what I think is the likely "weighting" on various subjects versus what I see the market currently sizing up those risks to be.

- **European Recession and Energy Crisis**. FX markets seem to be pricing this in as a near certainty. I'm probably close to an 8 out of 10, but the market is more certain. Without some increased intensity in fighting or some extraordinary action by Russia on the energy front, the bleakness (and it is bleak) is largely priced in. It is a bit scary, but on the Hopium™ front, the best hope is weather – rain, wind, and warm temperatures.
- **Jobs**. We get JOLTS and NFP this week. The market seems to believe the Establishment data, and views jobs remaining strong (call it a 6 or 7 out of 10). I'm looking for a rude awakening in the data and think jobs might be a 2 or 3 and the market has to reprice a lot of risk into the job market. **After Friday, negative jobs data will hit markets harder as we cannot assume (at least not this soon) that the Fed will come out sounding dovish in the event of bad data on the jobs front.**
- **Inflation**. The Fed, politicians, and the media are still treating inflation as though it is a 9 on the problem front. However, the market has discounted it to a 5 or 6 on the problem front (i.e., it already peaked and is rolling over). My view is that later this year we will be talking as much about deflation as inflation, so there is more downside here. Can we rally on lower inflation? Yes, and that is still the most likely response, but I'd fade those rallies as my narrative for the economy is more doom and gloom and I don't think this time is different – basically commodities, the economy, and markets will all go down together if we maintain our current strategies.
- **Inventories**. I think that the inventory build has possibly hit generational levels. The risks are severe and under-rated. These risks are one of the main reasons why China is going to struggle to export their way out of their current problems – our shelves are already stuffed to the gills with excess inventory. Markets see this risk as a 2 or 3 and barely worth the conversation, especially after some major companies downplayed the risk. I think it's a 7 or 8 in terms of economic risk and if it becomes a mainstream/daily headline, markets will be forced to react – negatively for risk.
- **China**. I will do a full update on China later this week and I think that the risks are high, but the markets are pricing most of those risks in.

Bottom Line

Nothing very different from Friday, though the selling into the close was strong enough that we had to suggest nibbling at risk for now.

Rates. I'm looking for more flattening (or more inversion as the case may be). I'm probably neutral on the front-end (rather than bearish). So much hiking pressure is being priced in that I could see some of that backing off. I like the long-end (because clearly, as a whole, we will get more bad news that hasn't been priced in). The 20-year seems intriguing to me as it has finally caught a bid and the yield seems incredibly high relative to anything else in a market where not much jumps out as being "obvious".

Credit. Look for spreads to widen. **Leveraged loans make me nervous** here as does high yield. **I like lower dollar priced bonds, almost regardless of spread**, as there are many non-traditional credit players still intrigued by owning anything at low dollar prices. This is best played using the longest-dated bonds issued at low coupons (i.e., BBB+ and above issuers). There are some lower rated issuers that qualify too, but if the economy is turning, they won't get the ratings upgrades that would help and might attract some doom and gloom narratives. The narratives will be overdone, but that won't stop them from working at least for a bit. Remember there is an entire cottage industry of pundits who know absolutely nothing about credit and love to spin "credit is doomed" narratives, which is bad and weird enough, but they shockingly continue to get media attention as everyone hopes to be early on the **"next" big short**.

Equities. Maybe we bounce a bit as Friday's reaction might have been a bit much, but I think with QT, the risks that I see on the data front (relative to what is priced in), and my concerns about the ramifications of extreme crypto weakness, I'm bearish here. However, owning some upside optionality makes sense given the lack of liquidity. I expect that if CTAs have really switched back to short (I'm hearing that is possible), then we will get some complaining about fundamentals versus technicals if we go lower (though no one was saying that when CTAs were busy buying and helping fuel what looked like a bear market rally that has finished). It was a big bear market rally, but it is looking more like that than a true bottom.

Data dependent. I'm expecting worse than expected (or priced in) data and that drives my current views. Please remember that I'm in the NYC Taxi Lurch camp rather than the Town Car Smooth Ride camp. I'll react to the data, but I am really convinced that we cannot get the "bad news is good news" trades after Friday and that is a relief to me as I struggle with those trades!

In any case, let's hope this week isn't so long that it wrecks our much-needed Labor Day long weekend! If you get a chance, start the week off right as Academy will be on Bloomberg TV at 7am ET on Monday!

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