The Baby Needs New Shoes!!!

Maybe I'm the only person that this market seems to be turning into a degenerate gambler. In some back alley, blowing on some dice, saying "Baby needs new shoes" as I toss the dice, hoping for the best? Or maybe, it is because I'm heading to Las Vegas on Sunday for the Structured Finance Association conference and I'm dreading the heat? On a serious note, if you are in Vegas for the conference, please look Academy up as we are hosting several events and it should be a good/informative time (despite the heat). Also, I've promised not to mention (at least not during my presentation) that there seems to be some irony that we are discussing environmental issues in Vegas (of all places) in the middle of the summer, but that's another story!

In the meantime, back to the latest dice roll. As discussed in last week's piece, sadly, or aptly, titled UGH!! the market is flip flopping between various themes. Those themes are not only causing markets to change direction on a moment's notice, but are shifting correlations rapidly.

- **Inflation is under control. Soft landing. The Fed is almost done tightening**. This horse has made a comeback in the past week as PPI (rarely reliable) and some consumer data along with the ongoing sell-off in commodities (WTI is down 7% in the last 5 days, copper is down 8%, etc.) pushed this narrative along. The week started with a debate of 75 bps or 100 bps, but ended with who cares as long as the Fed might be nearing the end of the tightening cycle. I agree that we are nearing the end of the tightening, but largely because I'm in the camp that the economy has already been pushed over the edge.
- **Recession.** Everyone is now "pricing in" a recession. The debate seems to be focused on when it will start, how long it will last, and how deep it will be. For now, I'm in the **Wile E. Coyote** camp that the economy (much like Wile E.) has hit a wall hard and the data is only starting to trickle into the economy. We discussed many of the issues (or "clouds") facing the economy and markets in You're So Vain. The **wealth effect** remains my biggest concern.
  - Many push back on the wealth effect concerns because the wealth effect was created so recently that it won't impact spending as much as I think. I continue to believe that there is a large number of people who got very wealthy on stock options and/or invested in the Disruptive Portfolio and spent a lot of money (thinking they would have even more to spend) and are now having to seriously question that. I plan to discuss the **Long Duration Stock Fallacy** this week, after all, I need to do something while hiding from the heat in Vegas.
  - **The wait list economy**. I had an interesting discussion this week about the "wait list" economy. I've argued that part of the reason why we had an inventory buildup was that companies were mistaking pragmatism for wanton spending. Consumers were buying the bike and skis because they were worried that one or the other might not be available when they went to buy it. That pulled forward demand. Customers were searching for items they couldn't buy because they were out of stock so they bought something else, erasing the demand, that maybe, just maybe, companies thought was still there. I even mentioned, half-jokingly, that the wait time for Lambos had allegedly dropped from 18 months to 6 months (which is what the "wait list" idea suggests might be more prevalent). There were many hard to get (often expensive) items that had large wait lists. What we don't know is how many people were on multiple wait lists, how many people were on wait lists expecting to be able to flip the item or sell their spot in line,

and finally, how many are in a worse economic position now and may not accept delivery if it is offered? I have to dig into this, but the concept resonates with me.

- **How are job postings tracked?** We've already had the Establishment versus Household debate on the state of the job market. However, I've been following some threads which discuss that in this day and age of electronic job postings, we may be heavily overstating the demand for jobs. It costs next to nothing to have a job positing outstanding. There seems to be little downside to leave job postings out there because there is a chance that some extremely good candidate applies, which would be a win even if the need is low. Electronic applications have created a "free option" for corporations. I'm not convinced that this is having a material impact on JOLTs data, for example, but it is something to dig into (when I'm not staring at screens hoping the next move on the market is green, or red, as the case may be).
- **EARNINGS!!!** Earnings have been more on my radar screen in 2022 than I can remember. I'm less focused on the current earnings than I am on the messaging coming out of companies. This seems like a quarter that every CEO can downplay growth expectations and highlight risks without being crushed. Some of that negativity is even priced into the market, but I am betting that earnings (and more specifically earnings calls) will act as a significant headwind for stocks in the coming weeks. This will be particularly relevant for my **Long Duration Stock Fallacy** thesis. Yes, the Fed is important, but earnings will be a daily driver. The banks that announced seemed to be cutting back on share repurchases. I suspect that is unique to the industry given their strict oversight, etc., but that is a trend that would be disturbing because much of the market's seasonality around earnings season has been buoyed by share repurchase. For now, not a concern as I do expect it to be industry specific, but worth keeping a close eye on.
- **Geopolitical**. Iran, Saudi Arabia, Sri Lanka (see SITREP), Mexico (SITREP coming), Brazil agreeing to buy Russian diesel (while the Hungarian leader is visiting), India, Turkey, etc. All across the globe there are issues and opportunities bubbling up that were not a major focus as all eyes were turned to Russia/Ukraine and China/Taiwan. As companies really do start digging into their supply chains and how they want them to look over time, we are seeing these "secondary" topics rise to the forefront. **Mexico** and addressing the opportunities and obstacles is a high priority for Academy's Geopolitical Intelligence Group and many of our clients, both on the corporate side and the asset management side.
- **Liquidity**. I've often described markets as having **"faux" liquidity** – i.e. we have a **shark and minnow** type of market structure. The analogy I like to use is that when you are snorkeling and you reach your hand towards a school of fish, they instantly disappear, only to reappear somewhere else. That is how I view electronic driven market structure. It seems like there is an immense amount of liquidity (the minnows), but any time a shark moves in for size, they disappear. The reality is that some portion (I'd argue a very large portion) of what seemed like liquidity providing market depth was just there to scalp some tiny amount of money and move on. Right now, that seems like an enviable amount of liquidity! A lack of liquidity makes every move bigger than it would be otherwise, allows "false" signals or "noise" to seem like real signals, and makes an already difficult environment to manage risk even more difficult.

Lots to think about, but little clear direction.

I do think that earnings and earnings calls will drive markets as much as the Fed (and the soft landing versus recession theme) in the coming days and weeks.

Bottom Line

I like Treasuries across the curve as I think talk will shift from inflation to a slowdown. It was a little bit of a sideshow this week, but Congress is finally noticing that the Fed can be a profit engine but also possibly require additional funding. As rates rise, the accrual accounting method used by the Fed for their portfolio will shift from generating positive net interest income to having losses. Selling of mortgage securities, for example, would cause realized losses (on Treasuries, they plan to rely on maturities). I'm not sure if there are any near-term market implications, but look for more noise out of D.C. on the **Fed's balance sheet** and expect much of it to be ill-informed and meant to score political points at home rather than addressing any real risks or concerns. This is occurring while some are speculating that the Fed might slow down their balance sheet reduction in the face of volatile markets and recession risks.

I even like **steepeners** (which is very dependent on my view that we are getting a lull in inflation), but only because of a fast slowdown in the economy.

Credit seems attractive relative to equities, but there are opportunities in the equity space. One thing that could happen is that equities could rally on lower yields, but that would be a mistake, I think, as this is not the same market that we had in late 2020 or even early 2021. The argument that all stocks are long duration assets and should rally when yields go down is not correct for the current environment (which I will try and explain more clearly in the "Long Duration Stock Fallacy").

In the meantime, I'm told "**it's a dry heat**" which sounds more like wishful thinking than reality, but I do hope to see many of you in Vegas this week!

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