The Fed Blinked and So Did We

Last weekend, I was extremely worried that we were in the process of Cutting Off Our Nose to Spite the Face! We seemed to be on a path where:

- The Fed was going to fight inflation at all costs, even if that pushed us into a recession.
- The Fed was going to fight inflation even in areas where Fed policy wouldn't be expected to have much of an impact.
- The inflation fear was so palpable that signs of inflation rolling over (along with the economy) would be missed, or were already being missed.

That narrative seemed to shift over the course of the week, which helped propel the S&P 500 to an almost 7% gain and the Nasdaq popped 9%!

The 10-year Treasury yield also dropped from 3.23% to 3.13% during the week.

Congress Focused on Recession Risk

Finally, it seemed like many in D.C. became aware of the fact that while inflation is bad, a recession is worse, especially for those seeking re-election!

Chair Powell spent two days testifying on the Hill and the market (correctly) reached a few conclusions:

- Recession risk would balance inflation fighting. Sure, inflation fighting is still outweighing the risk of pushing us into a recession, but there was a semblance of balance.
- Powell couldn't fully contain his "inner" dove. Whatever message he was trying to convey, there were just enough hints of "dovery" in his answers to give markets comfort.

Both his testimony and D.C.'s realization that recessions aren't good helped markets.

A Tough Week for Commodities

While Brent held its own, **WTI fell 8.5% on the week** and is down almost 12% from its peak of $121 on June 14th! (XLE, an energy ETF, is down 22% since June 8th!)

Metals performed poorly with copper leading the way (it was down 6.5% on the week, is down 13% since June 7th, and is down a whopping 22% since early March). Nickel actually did worse, but that market seems so devastated by a lack of liquidity that I ignored it. What is particularly interesting **in the metals space is the fact that most are now negative year to date!** So, unlike energy prices (WTI is up 43% YTD), which have mostly just given up some of their "Russian invasion" premium, the metals have fared far worse! (XME, a metals and mining ETF, is down 19% since June 7th and is down 30% since April 20th!)

While **corn, soybeans, and wheat** are still up nearly 20% on the year, they tumbled anywhere from 5% to 15% last week!

The commodity story could be telling us something about supply chains, but I think that the story is much more about how rapidly the slowdown is hitting the economy! "Dr. Copper" is often used as a leading indicator for economic activity and it isn't sending a good signal!

The fact that the metals got hit so hard (and started their swoon much sooner) can likely be attributed to real estate and construction being the first areas hit by higher rates (mortgage rates spiked first).

So, the "good" news is that commodities may be rolling over and providing inflation relief, but the bad news is that it seems to be hinting that recessionary fears should be real and worrisome!

All Hail the Recession!

In the previous section we discussed commodity price declines, some of which are viewed as leading indicators of the economy.

If we want to look at more signals on how rapidly the economy may be rolling over, all we have to do is look at data from last week! Almost any data point will do!

Existing home sales dropped for the fourth month in a row.

Initial jobless claims have moved higher, still small by "traditional" measures, but they are heading in the wrong direction.

S&P Global US Manufacturing and Services PMI both declined, missed expectations, and are barely above 50.

The University of Michigan's Consumer Confidence survey largely deteriorated from already low numbers, though the fact that inflation expectations dropped (3.1% for 5-10 year inflation from 3.3%) may give the Fed some latitude as it has been successful in reducing inflation expectations.

New home sales did bounce, but that is a volatile series and is the second lowest number since October.

For now, the evidence of slowing economic activity is taken to mean:

- The pressure on prices across the board will ease (which is normal if we have tipped the scales already into a recession).
- The Fed, seeing the data, will be able to take their foot off the brake, which is also true and a reason we never expected the follow through the market was pricing in. It is interesting that the market is now pricing in rate cuts next year, basically assuming the Fed will make a mistake and push too far (our "cutting off the nose" risk), but maybe the Fed will now try to avoid making a mistake and give existing hikes time to work their way through the system, while likely hoping for some supply side relief from China.

The "bad" news is "good" argument always makes me nervous as I'm concerned about its staying power!

Correlations

Markets are always driven by correlations. Investors and corporations of all shapes and sizes look for signals from one market to the next. Algos have entrenched many of those correlations, at least for short periods of time.

In the coming weeks, it will be important to see how a couple of key correlations play out:

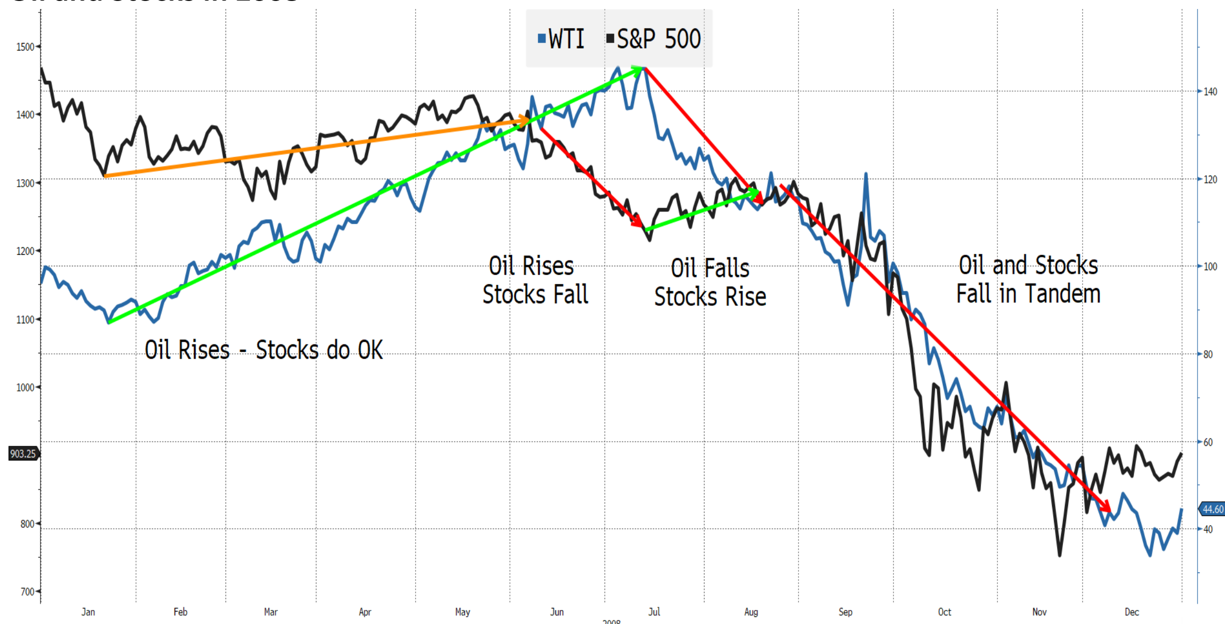
- **Low yields are great for stocks in general and tech in particular**. That was a theme that seemed to play out for much of last week. When yields declined (on recession fears), stocks bounced on lower yields. That has been the reaction, off and on, for most of the past year. It is part of the overall narrative and is reinforced by algos, which will trade that correlation until they get proven wrong.
    - I am in the camp that lower yields, because of a potentially rapidly declining economy (one that forces the Fed to hold back on hikes), should not be a catalyst for stocks to

soar, even from current valuations. That seems like a "trade" rather than an "investment".

- **It was encouraging that stocks showed so much strength on Friday even as yields rose!** That is the sort of correlation that is very "traditional" and can provide enduring strength to stocks.

- **Lower commodity prices are great for stocks!** Yes, inflation has been a huge concern. Yes, inflation has hit consumers, which in turn has hurt some companies as consumers couldn't buy as much with their hard-earned dollars! Yes, lower commodity prices will reduce the Fed's zeal for hiking, which should help the economy. **All those are good things for markets!** But, if commodity prices are dropping because the economy is slowing rapidly (my concern) rather than due to supply chain excesses, we may once again be "cheering" for something that is bad – back to the "Be Careful of What You Wish For" argument.

Oil and Stocks in 2008



Admittedly, there are a lot of difference between now and 2008. I am not arguing that point and I've been nowhere near that bearish on markets or the economy (even when I've been "beared" up). However, the conviction (bordering on certainty) that stocks should rally because commodity prices are falling seems too simplistic. Since so much of this year's stock market weakness can be tied to inflation, both directly (lower consumer purchasing power) and indirectly (the Fed turning hawkish), it is natural to get some relief. But, if we've already tipped the scales and "Dr. Copper" is correct, then that correlation could break down.

It did seem that last week, especially overnight, the market traded like it was pricing in a recession (lower stocks, lower commodities, lower yields) but the U.S. managed to turn the lower yields into a reason to buy stocks.

Positioning and Flows

There were some reports (which seemed to buoy the market) that retail had exited stocks at a record setting pace (which I am still not seeing in the more speculative ETFs).

There has been a lot of chatter that pension fund rebalancing (especially for those that rebalance

quarterly) will create a lot of buying for equities. As of last weekend, the S&P 500 was down 19% on the quarter, but now it is down "only" 13.5%. On a monthly basis, it was down 11% at the end of last week and it is now down "only" 5%. Regarding long-dated bonds, TLT (used for simplicity) is down about 14% on the quarter.

So, depending on what duration your bond portfolio is or your mix of Treasuries versus corporate credit (LQD is down only 8% on the quarter), much of the re-balancing may have already taken place or has become unnecessary.

Insider buying versus insider selling has apparently turned into a bullish signal (which I'm told by some people who do a very good job tracking this). We have also ended the blackout period which has coincided with speculation that stock buyback programs are in full force! Many of the cash rich companies are able to buy their stock back at the cheapest levels in years in some cases, **though some companies may be exploring bond repurchases as so many bonds trade below par and can offer a quick boost to earnings!** I'm skeptical of the "re-balancing" flows playing a big role next week, but the corporate buying and month-end buying, etc., all seem helpful.

Bottom Line

I will start with my highest conviction views and work from there.

Lower yields, especially at the long-end (with some risk of a spike to much higher yields).

- **Ongoing pressure in commodities**, especially as speculators get taken out.
- More weak economic data.
- The **ECB** seems to be willing to act to curtail rising Spanish and Italian bond yields, which was a force behind higher U.S. yields and the **BOJ** is not being tested in a meaningful way on its yield curve targeting program.
- So little liquidity that after the recent squeeze, something could trigger yields to move much higher. This should be covered with option premiums rather than heavily influencing positioning.

So, I've got lower yields and lower commodity prices. Given the correlations last week, that should be somewhere between good and great for stocks!

I am not sure that I can get there, but fighting the correlations, which are ingrained into our collective nature at this point and reinforced by the unemotional/omnipresent algos, doesn't seem like a smart decision either. Where do we stand on the need to rebalance or cover shorts or has that all been taken care of?

I'm kind of balanced on stocks here and in any case, I am moving my view on the economy and markets back to DEFCON 3 from DEFCON 2, which is a wary status, but far from any sort of panic.

It ultimately seems to boil down to the following question: Is the data enough to spark recession type trading, or is it just weak enough that it isn't too bad and is more than offset by easier central banks across the globe?

Bitcoin held its own last week, though I think it isn't out of the woods yet as the ecosystem has allowed some of the risks to be highlighted and I don't see them as having been adequately addressed.

Not sure what news means for markets, **but here's to hoping you all have "good" news that is actually "good" news in your lives** because in this instance, it is difficult to spin bad news as good!

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