The "R" Word Rears Its Ugly Head

Markets yesterday really started to trade on **recession fears**.

We had a major "risk-off" day with broad stock indices dropping 4% to 5% (noticeably, small caps outperformed). The 10-year Treasury yield dropped 10 bps. Credit spreads were also in disarray with CDX IG gapping 7 bps higher and high yield bonds down on the day, despite the Treasury rally. So, this move had nothing to do with higher rates and "long-duration" stocks. It was good old-fashioned fear and that fear was that we are either on a collision course with a recession, or already there.

Target (TGT) seemed to set the day in motion as the stock dropped more than 20% after earnings. Unlike some large market cap companies that have had wild, post-earnings swings, this is a company with a well-defined and well-understood business model. From an "efficient" market perspective, it is almost preposterous that this company could experience such a wild move. But it did, which tells me three things:

- Liquidity is abysmal.
- We have not seen "capitulation" yet.
- Recession risk, which had been discussed but largely ignored, is something that now has to be considered seriously.

I also highlighted, in a quick note, that some of the giant tech names that had become "cash equivalents" to some subset of investors (see Traditional vs Disruptive Portfolios) underperformed. Crypto, I have to admit, held in reasonably well, at least by crypto standards.

The Fed's Impossible Task

How do you fight supply chain driven inflation with rate hikes?

How do you encourage new production when you are raising the cost of production?

How do you slow demand on the "necessities" without crushing the economy?

How do you deal with the fact that the poorest segment of the population is hurt most by rising food and energy prices, but they are also hurt most by job losses? (That is if fewer jobs and even job losses are the end result of the hikes).

Who really knows how quantitative easing worked? Who knows how tightening works, other than that it seems to impact asset prices rather quickly?

There is increasing concern that we have painted ourselves into a corner and there is no way out, something that I've been concerned with as I've struggled with the issues above for the entire year.

Some Bright Spots

ARKK and TQQQ both had reasonable outflows yesterday. There was very limited to no "dip" buying, which breaks with recent behavior. That may leave us with more downside, but it is a sign of potential capitulation.

The Fed, with a myriad of speakers, has the ability to tweak their message. So far, it has been a string of "we can and will fight inflation," but maybe that needs to be tempered a bit. Perception can become reality very rapidly, so maybe they will want to cut some of this recession talk off at the pass. (2s vs

10s are not negative, so they have some room on that measure).

More and more of the losses in the broad indices seem to be attributed to fewer companies. The Dow lost 1,164 points yesterday, but the worst 5 names contributed 40% of that point loss. Small caps outperformed, with Academy's equity trader, Jamie Atwell, always watching closely for signs of a true bottom. Even ARKK did relatively well, showing signs that the "disruptive" sector, which has been hit so hard and so often, led the way down (maybe finding a bottom).

Nasdaq 100 futures bounced at 11,700 overnight, which was where support kicked in last Thursday.

Allegedly, and I'm not certain it still exists after yesterday's move, there are so many S&P options expiring tomorrow with a 4,000 strike that it could act like a magnet, at least into tomorrow morning.

Bottom Line

I can be convinced that we can trade for a bounce, but I still have 11,000 on the Nasdaq 100 as my target for equities.

Rates should continue to trade well.

Credit should rebound more easily than equities as this is not a credit problem.

What I'm watching carefully:

- **Crypto** – risk assets will not do well if crypto cracks. I think it will, but it is solid since yesterday afternoon.
- **The Fed** – any hint of softening their stance would allow for a much bigger and more sustained rally in all assets.
- **Option expiration**. If the OpEx color is accurate, we should have some support into that, but then all bets can be put back on the table.

I think Europe will face a recession, but that is very driven by the impact of the war in Ukraine and trade with Russia.

I think that it is premature to talk recession here, but we do need a different message from the Fed to avoid that. I think that as much as politicians believe inflation won't get them re-elected, they forget that job losses and recessions get them kicked out of office even faster.

In any case, hopefully we are nearing the end of this crazy volatility, because it is exhausting for everyone and is making it difficult for investors and companies to act strategically when the day-to-day tactical decisions seem so important.

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