Weebles Wobble

While not quite as catchy as the 1-877-KARS-4-KIDS jingle, I cannot get the "Weebles wobble but they don't fall down" marketing slogan out of my head.

It seems somewhat applicable to markets, of late.

Stocks, in particular, got off to a weak start, but rebounded strongly this week. Now the Dow, the S&P 500, and Nasdaq are basically unchanged on the year (the Russell 2000 and Chinese stocks are still down around 4%).

So, we "wobbled" but didn't fall down. Not just on the year, but also there were a few times (like early on the 9th and the 11th) that stocks struggled out of the gate, only to rebound during the course of the day.

The bounce in some market leaders helped, as did some earnings, but two things seemed to drive the performance this week:

- **Hope and faith in the Fed** taking action that might propel stocks higher.
- Talking about, but **largely ignoring, Geopolitical Risks**.

Can "We" Hedge for Geopolitical Risk?

Without a doubt Geopolitical Risk is high and is a major topic of discussion:

- Academy's 2024 Geopolitical Outlook Webinar is a case in point. Rachel Washburn led a fascinating discussion with Generals (ret.) Ashley and Robeson and me. We covered some of the existing "hot button" issues but got to touch on other areas like Turkey and Venezuela that have been a little off the radar.
- The pace of SITREPs (and the need for them) has (unfortunately) ratcheted up this year. Thursday's analysis of U.S. Strikes on Houthi Targets in Yemen is just the latest piece.
- Last weekend's An Eclectic Mix includes some Geopolitical risks (and several others worth considering), but The Times Are A-Changin' is the focal point of the market risks posed by geopolitical threats and risks.

Brent crude, the most "obvious" one to be affected by the Middle East, is at $78, roughly where it averaged during the first few months of 2023! I think that there are many reasons for this. The fact that the global economy was showing signs of weakness even before the invasion hasn't helped oil prices. In addition, China not managing to jumpstart its economy is weighing on oil prices. Efforts to work with Venezuela to improve their production also seem to be a major risk. Finally, last year, so many investors betting on higher oil prices (only to see them struggle) has muted the enthusiasm of speculators.

Lots of other factors outweighed the geopolitical risk in the Middle East.

But does that mean we should ignore it? Or maybe we aren't ignoring it, and the **other factors legitimately outweigh the geopolitical risk**, making it appear as though geopolitical risk is being ignored, while it is in fact being priced in.

If everyone is talking about geopolitical risk, but not doing anything about it, there are some really interesting opportunities out there. If, on the other hand, people are treating it with the respect it deserves, then it will require a "surprise" of some sort to really shake things up.

I suspect that the truth is somewhere in between.

While investors and corporations are well aware of geopolitical risks, they seem so binary, are so difficult to time, and haven't always played out as expected, that relatively few decisions are being made around geopolitical risk.

It is the nebulous, binary, and erratic nature of Geopolitical risk that makes it difficult to quantify and act on in advance.

My working premise is that some, but only a small portion, of the geopolitical risk out there is getting priced in.

As a result, **I continue to like commodities and commodity producers**. While I am not upbeat on the domestic economy (or even the global economy), we could yet see stimulus out of China (inflationary) or more severe geopolitical disruptions (likely inflationary, if not stagflationary). **My number one choice** on that front is that something happens where the U.S. cannot be seen to allow Iranian oil shipments above any official sanction levels (which seems be occurring right now).

Academy is well prepared to continue to help our clients navigate through the evolving geopolitical landscape, but I'm trying to think of ways to make it even more strategic and less reactionary.

On that point, the geopolitical risk that is the most important, and has been the most important for years, is with respect to our **"Strategic Competition" with China.** Getting that right will be what determines winners and losers over the next few years and decades. It seems like we could see an easing of tensions (for economic and political reasons), but over the longer term, it is difficult to imagine a world where there is less competition. It just doesn't seem to be in the cards, **despite all those who pound the table saying that China needs us as much or more than we need them**. I just don't think that is true (if you define "need" from China's perspective, and not from "our" perspective).

The final problem with hedging Geopolitical risks is that Treasuries may not be an effective tool for that.

We have all learned **"flight to safety"** as a response to geopolitical risk. Something bad in the world happens and investors flock to the dollar and to Treasuries. While we still see some evidence of that, the response function has been muted. The main reason for that is the almost "Pavlovian" response of "geopolitical risk means buy Treasuries" has been tainted by "geopolitical risk means more weapons spending, which means higher deficits (which are already high)."

That is **why I am comfortable betting on higher yields**, even with so much geopolitical risk. Not much higher yields (4.3% on 10s), but higher nonetheless. I cannot be fully committed to that view with so much geopolitical risk, as we could get a "flight to safety moment" but I think that would be a "knee jerk" reaction and would likely fade it, hand over fist.

In conclusion, geopolitical risk isn't being fully hedged, but the best opportunity is likely to own some hedges via long positions in commodities or commodity producers/processors.

FOMC Policy as a Campaign Issue

We have already argued that **optimism about rate cuts and the end of quantitative tightening helped spark a rally in stocks.**

We can tackle all the reasons why I believe too many cuts are being priced in and the timing of the end of quantitative tightening is further away than the market currently believes. But you already know

many of those reasons from prior T-Reports, and I'm sure that they will come up again and again, so let's go with **the one risk to monetary policy that almost no one seems to be talking about**.

My view on the presidential election campaign is the following (it is currently predicated on the assumption that it will be Biden vs. Trump again, but I'm not sure any other match-up changes my view much):

- It will be a divisive and aggressive campaign.
- Social media will play a major role, which will only "enhance" the divisiveness.
- Everything, and I mean quite literally everything, will become a black or white issue, rather than some shade of grey.
- Almost nothing that gets promised will give anyone any comfort about the trajectory of the deficit.

I think that we can all safely agree that the Fed is apolitical in theory and seems to work very hard to maintain that political independence. The Fed wants to do what is right for the economy (based on their mandates) and use their skills and tools to accomplish that. They don't always get it right, but they try.

I just think that everything they do will come under much greater criticism than it ever has in the past. I tried to use the word "scrutiny" rather than criticism, but I don't think that it will be "scrutiny." Scrutiny implies a level of thought and intellectual curiosity. I think that we will just get criticism.

The second component of my theory is that the criticism will attract much more attention than in the past. If ZIRP taught Americans anything, it was that easy money means bigger 401(k)s! While Wall Street always talked about the Fed Put, it is not part of popular culture. Everyone "knows" that rate cuts mean higher stock prices (it is debatable if that should be the case, but I don't think it is debatable that this is a wildly popular consensus right now). So, there will be many avid readers, listeners, and "bots" ready to link Fed actions to the stock market (and maybe the economy) and therefore to the election.

If the Fed cuts and stops quantitative tightening and markets rally, the opposition will likely portray it as an effort to help the incumbents. They will warn (or rant and rave) about taking unnecessary steps that risk reigniting inflation.

If the Fed doesn't cut and continues with quantitative tightening and markets slump (or even worse, employment data deteriorates), then the incumbents will be the ones voicing their theories that the Fed is sabotaging their re-election efforts.

The Fed will do their utmost best to stay above the fray, but I think that we are going to witness monetary policy becoming a campaign issue and I'm not sure we've ever seen that, or what that could do to the Fed or to the economy or to markets. **Uncharted territory.**

My current Fed view (as I expect a weakening, but not horrible economic data):

- 3 cuts. 25 bps, 50 bps, and 25 bps.
- I think that the timing will be the April/May meeting, the June meeting, and the July meeting for those cuts.
- The September and November meetings are so close to the election, that I suspect by the time

we get there, the Fed will be reluctant to do anything if it doesn't have to (predicated on my view that FOMC policy will be making almost daily headlines on the campaign trail as we near the election).

- So, if those meetings are unlikely to do anything, maybe the Fed does the cuts in March, April/May, and June, but the current data, along with many of their recent promises, make that seem unlikely (according to WIRP, the market is pricing in a 79% chance of a March cut, which seems a tad high, but plausible).

If I am right about this, I do not envy anyone senior at the Fed as their already difficult job will be made that much more difficult.

Bottom Line

On rates, I think that **10s should head towards 4.3%**. I am nervous about a "flight to safety" trade, so while I have very high conviction on this trade, I prefer some options, rather than a fully committed outright bet. Looking for **less and less inversion**, and even possibly a "normal" curve between 2s and 10s as the year progresses (we've gapped from -37 to start the year, to -20 already).

On credit, I think that I still like credit. If there is one trade that literally everyone seems to agree with, it is that "credit spreads are too tight" or some variation of the theme "we are at the low end of the range." Yes, we are at the low end of the range, but how likely is it that what everyone believes (and is potentially positioned for) comes true? **I could see some weakness in credit markets, but am looking for an incredibly large and obvious outperformance of credit versus equities.**

On stocks, bearish almost across the board, except for the commodity space as previously mentioned. We haven't "loved" the laggards universally for some time, and all I can convince myself of in the "laggards" (which had a great run) is the commodity space.

Bitcoin got interesting with the launch of the ETFs. Expect more weakness as too many people bet too much (some using leverage) on the enthusiasm that ETFs would create for Bitcoin. For now, the unwinding of older positions in other products seems to be the overwhelming trade, triggering stop losses. Expect that to continue next week (though we could see a pop on Tuesday morning if some big allocations come into the ETFs). Only once that settles down, will we figure out what the ETFs really mean. The thing I find most ironic (or maybe it is paradoxical – which reminds me of some complaints about the Alanis Morissette song) is that Bitcoin is supposed to be "better" than money, but is it so "good" that it is much easier to own it as an ETF than outright? That will be glossed over in the marketing, and might be a bit pedantic on my part, but **if Bitcoin is so great, why do so many need an ETF to own it? Yes, things like gold, high yield bonds, and foreign stocks all are much easier to own via ETF than outright, but those assets were never meant to replace money!**

While Weebles wobble but don't fall down, I think that the equity markets will fall.

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