Welcome to Thunderdome!!!

This weekend, which is highly religious for many across the world, I wish I could think of something more uplifting than Mad Max and Thunderdome. However, after another brutal week of war in Ukraine and extremely volatile markets, this is where I am.

Two Men Enter, One Man Leaves!

Since our last war update, we have seen an escalation of the trends.

- Russia's Black Sea flagship was sunk and Ukraine continues to achieve military victories.
- Russia continues to hammer Ukraine as it sent in long-range bombers for the first time since the war began and there are allegations of war crimes and inhumane tactics.
- Ultimately, we are still left with this problem:
    - Putin continues to have difficulty "winning", but
    - Putin cannot afford to lose.

Peace looks like it is a long way off as too much blood has been shed and too much progress has been made by the Ukrainians to agree to Russia's terms. Putin needs better terms to declare "victory" and seems intent on testing whether their new concentrated military strategy will yield better results.

Maybe we will be pleasantly surprised with a ceasefire, but:

- Expecting the war to drag on is the base case.
- Second order effects around production, supply chains, etc., will begin to be felt and will hit the European economy hard (especially if Europe gets more serious about banning Russian commodity exports, which seems more likely by the day).
- Food is an issue that is getting more attention and could be extremely problematic.

While China's support of Russian commodities wasn't surprising, many (including me) were surprised that India stayed the course. That does not look like it will change any time soon and will be something that affects planning as we see that country after country will act in (what they view as) their best economic interests regardless of pressure from the global community.

I am very interested to see May's TIC data which will show us whether any countries responded to our actions against the Russian Central Bank by decreasing their Treasury holdings, which is something that I think is occurring and is weighing on the front end.

Get to the Weapons, Use Them Any Way You Can!

This could apply to Russia, but I am going to link this to central banks and the Fed in particular.

The ECB's Lagarde made comments on inflation and bond buying that helped spook markets on Friday. This is in addition to the increasing fear that the Fed, with a combination of rate hikes and balance sheet reduction (two weapons), may hit the economy and risky assets.

We discussed how little we know about rate hikes and how we know even less about quantitative tightening in last weekend's T-Report. It is a long read (by T-Report standards), but is well worth thinking about as we start prepping for the May meeting.

To me, the extraordinary pressure being felt in the mortgage market is directly caused by the fact that the Fed will likely announce sales of mortgages as they cannot achieve their balance sheet reduction goals merely through run-off.

Mortgages, for that reason, might actually be getting cheap as more is getting priced in there than in other markets. That makes some sense as it is the market most affected, but:

- From a relative value perspective, other fixed income assets are starting to look expensive and we could see shifts as investors reduce risk to get similar returns (again, belaboring the point, I think QE forces people out the risk spectrum and QT does the opposite).
- High mortgage rates are likely to impact the economy, likely far more quickly than anything rate hikes can do, which might be good for the inflation fight, but bad for the economy and markets.

I continue to worry that the Fed is reaching for these "weapons" right at the moment that they should be concerned about doing more harm than good.

I Know You Won't Break the Rules. There Aren't Any!

I could discuss how the Nasdaq 100 rose 17% in two weeks from the post FOMC meeting lows on March 14th. I could then discuss how that index dropped over 8% in a little over a week. I could also talk about how on Tuesday that index was up about 2% on the open and was more than 2.5% negative later that afternoon.

I could find so many other markets to show that things aren't "normal" or behaving by the rules that this T-Report could be 20 pages long (18 of those pages could be filled with anomalies in the commodity markets alone).

But I will just point this out:

- 10 Year US Treasury Yield today is 2.84%.
- The 10-year forward yield of the 10 year is 3.42%.
- The 20-year forward yield of the 20 year is 2.41%.

Maybe, as we discussed in Oh Behave!, there is some elaborate strategy that can explain 10 year yields rising steadily for the next 10 years, only to plummet thereafter? Or, maybe, the 20-year Treasury bond is "orphaned" and the "off the run" Treasuries have become proxies for forced selling or buying rather than a reflection of rates? I have so much difficulty making sense of this part of the yield curve that I have to discount much of what the yield curve is supposedly telling us.

Maybe the market is a rational game being played by adults right now, but I cannot help but see this as a market being chased around by the weak hands. Those who get stopped out on a specific trade or don't have the fortitude to see their trades work against them (which is somewhat rational in a market which seems to have only two modes – bid without or offered without).

I keep thinking of those Brazilian steakhouses where you get a little disc that is green on one side for yes please, serve me more, and red on the other side for wow, I need a minute to digest. The only difference is that at the churrascaria, you might have an easier time guessing which way a person is going to flip their disk than you can in this market.

The Consensus is Always Wrong is a Consensus Trade

Okay, I deviated from the Mad Max theme because this is where I'm coming out:

- I'm bearish risk assets, which seems to be consensus (though consensus and positioning around it seem to swing rapidly).
- As a contrarian, that would make me bullish, but:
    - Consensus is always wrong and can't always work (thinking like a contrarian), so this could be one of those times when the consensus can work.
    - Consensus trades often do well into year-end and sometimes (though with less frequency) can work as we enter into the summer and desks prepare for less staff and have lower risk tolerance.
    - So yes, I'm cautious on risk.
- I expect credit to significantly outperform equities in any sell-off. Credit risk has plenty of cushion but also benefits from overall high yields keeping the yield "bogey" buyers in play.
- I like the 2 to 5 year part of the rate market. That is based on two main themes:
    - The hikes and QT will slow the economy (along with the war) and we will see some backpedaling on those calling for multiple 50 bp hikes after the May meeting.
    - If foreign central banks have been reducing their balance sheet, that should slow as they have had ample opportunity to reduce positions now.
- On the longer part of the yield curve, I'm torn. From a "fundamental" standpoint, I'd bet yields will drift lower, but from a positioning standpoint, ahead of QT (as we saw on Thursday) the trend has been to higher yields. I'm much more comfortable with 2s than 30s, which probably means steepeners are interesting.

For stocks, my target is a test of the March lows, which for several indices is a test of the May 2021 lows. Look for those lows to be tested and possibly broken in the coming weeks.

Credit spreads would have to widen, but I don't think they will get back to their March wides.

On a Lighter Note!

Ukrainian Catholic Easter falls on April 24th this year (something to do with the Gregorian vs Julian calendars) and if you haven't seen Ukrainian Easter Eggs, they are something to behold. They are died in increasingly dark colors (no dies, to yellow, to orange, to red, etc.) and anything you want to show in that color is protected by a layer of melted beeswax which prevents the next color from setting. Ultimately, the beeswax is melted off and you have quite spectacular looking eggs (or fun looking ones if the kids give it a try – as you can tell from this photo of my mis-spent youth).

Have a great weekend and let's hope that things become a bit simpler in the coming weeks and that I can turn bullish again! Mad Max did win in the end! (I think?)