Why is DEFCON 1 Higher Than DEFCON 5?

I came across this line watching the latest season of Ozark this weekend. Somehow it seemed appropriate given Friday's economic data and the fact that Andy Robinson, Rachel Washburn, General (ret.) Kearney, and I recorded a podcast on Friday focused on nuclear weapons, proliferation, and nuclear power. It was not the most "uplifting" podcast I've been a part of (as you will hear next week when it is released), but it is necessary to think about. Friday's data and price action also didn't do anything to raise one's spirits.

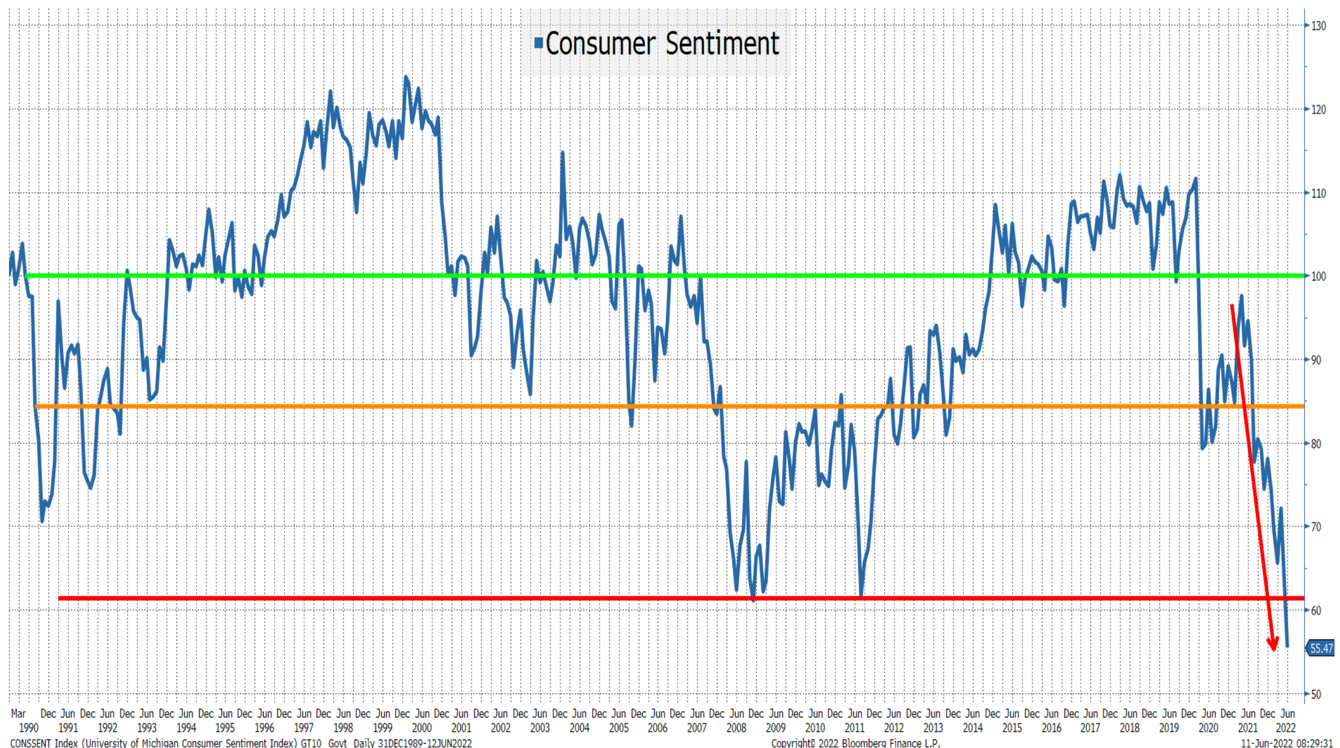
The one bright spot, for me, was being able to really **introduce the concept of "energy transformation" rather than "energy transition."** One of the energy companies Academy works with got me fixated on the difference between energy transformation vs energy transition. The difference seems subtle, but it is actually quite profound.

In the meantime, I'm writing this T-Report having chosen to buy the dip on Friday (T-Report link). Since the S&P 500 hit almost 3,900 by 10:25 am and finished there, I haven't been hurt by that **tactical trade.**

While I think that it is the right trade coming into the Fed, I'm very nervous now about the state of the economy and markets. I highlighted many of those issues in Friday's note and the more I dig into them, the worse it looks.

CONsumer CONfidence

I tend to ignore CONsumer CONfidence (I give credit to Bob Janjuah for putting the CON in consumer confidence), but Friday's number was so brutal that it is impossible to ignore. As Ian Burdette (Academy's agency trader) pointed out, Friday's University of Michigan report was the worst report going back to 1990, which encompasses several periods that we now refer to as "crises". I don't think anyone has said that we are "currently" in a "crisis" but maybe the data tells a different story?



That trajectory makes even Phil Mickelson's recent career decisions look good.

When digging into the data, I went straight to the breakout by political affiliation.

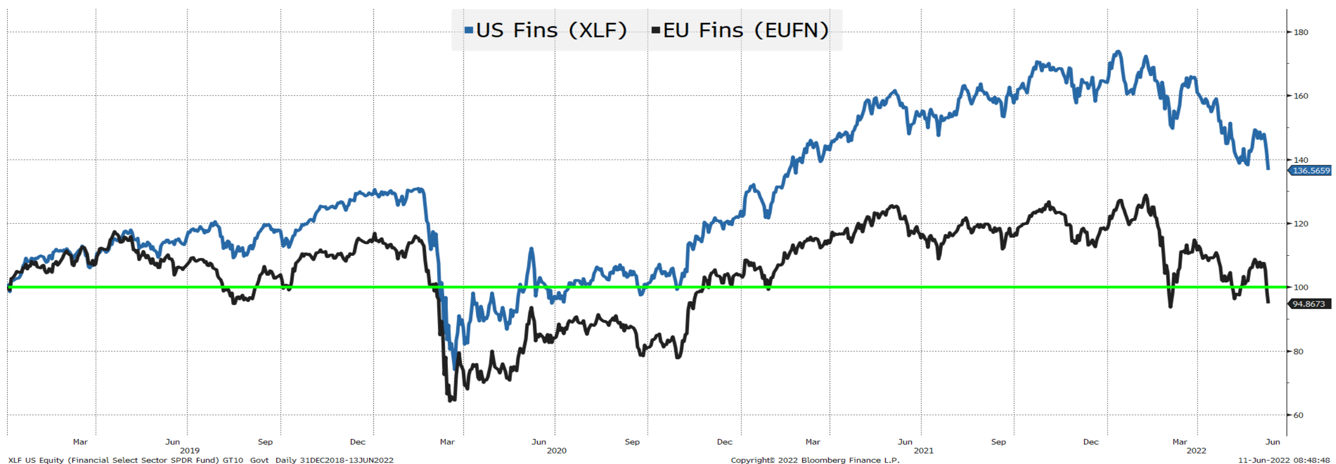
One year ago, Democrats were at 104.2 and Republicans were at 60.3. While that large disparity still exists, the gap has narrowed as Democrats are down to 71.3 and Republicans are at an almost shocking level of 33.5. I do like looking at the "independent" breakout as well, which was 83.5 a year ago and is down to only 46.5 right now! None of that is any good.

The Economic Horserace Scenario

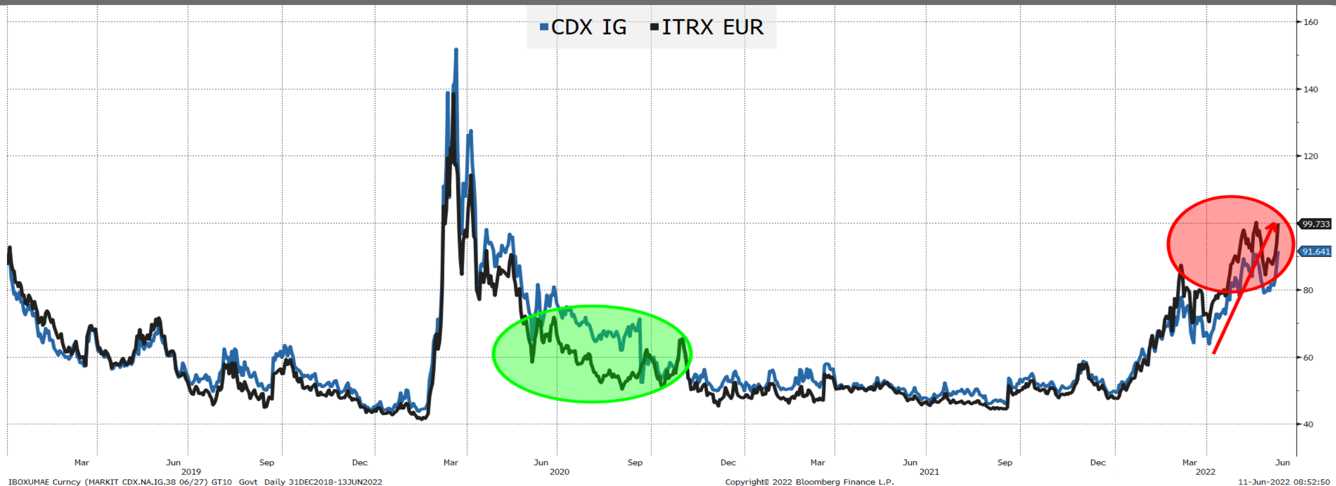
As discussed on Friday, **Soft Landing** has fallen off the lead with **Recession Next Year** looking strong, but from deep in the pack, **Summer Recession** is making a move! I remember during the financial crisis that we only "found out" we were in a recession AFTER the group that provides such calculations revised their data. It is, sadly, not unchartered territory to be in a recession and not "officially" know it. Every person living during that time knew it, but the data gods were a little behind. I'm increasingly worried that is the case right now.

Just look at the rest of the field in the economic horserace.

At this point, **European Recession** looks like a sure bet to place or show. **Bigger Problems in Europe** (a late entry) also seems to be gaining momentum (I don't like what is going on in financials, especially in Europe where the iShares MSCI Financial Index ETF is below where it was at the start of 2019).



Relative credit spreads aren't exactly making anyone feel warm and cozy in Europe.



Europe is trading wider than the U.S. which has not been the norm of late. Something to watch.

The commodity stables have two contenders with **High Energy Prices** (an early betting favorite and still running well) starting to look nervously at his stablemate, **High Food Prices**. They chose not to enter **Food Crisis** because it seemed too early for that horse to have a shot, but I'm sure the owners are reconsidering that decision now. **Inflation** was scratched because no one wanted to race against it, but I do believe that **the theme of high prices will be even more important than inflation in the coming weeks and months** because even if inflation were to slow, prices are still too high!

Sadly, **China Rebound**, after a brief recent surge, has given up a lot of ground. Maybe it can shake off this latest setback and change the trajectory of this race.

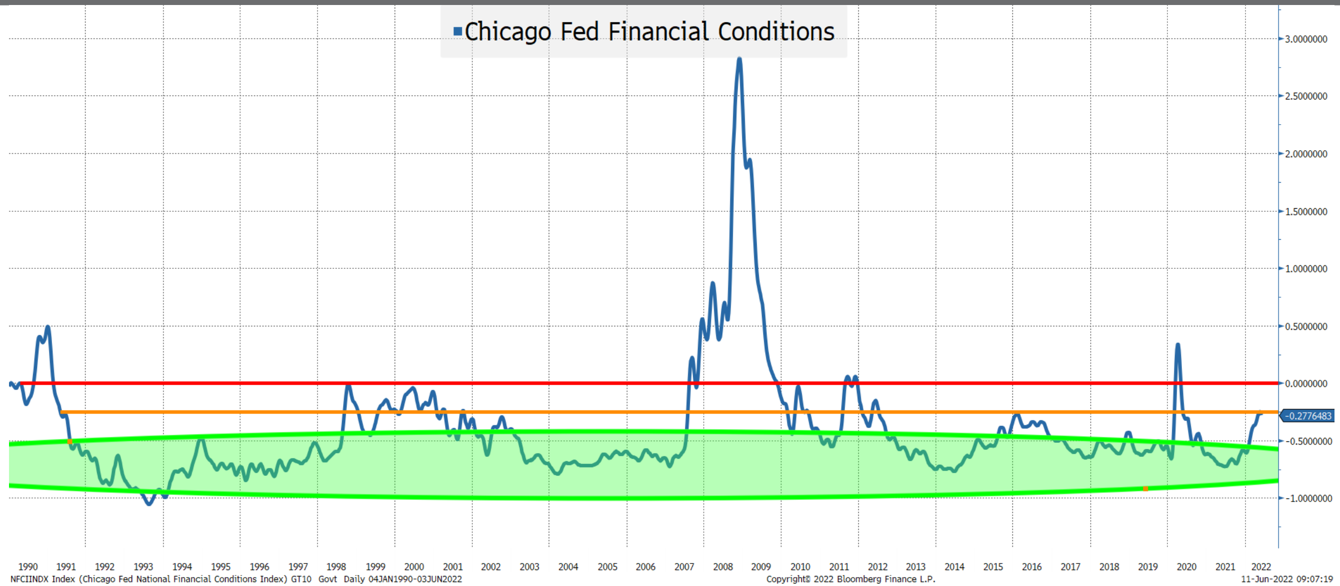
Finally, **Peace in Ukraine** has pulled up lame and it is beginning to look like that horse will have to try again next year.

Job Growth is still running near the top of the pack but seems to be suffering right now. I can't tell what is wrong with the horse, but it just doesn't look right from this announcer's perspective.

The race isn't over, but looking at the horses that are rising versus those that are faltering, it doesn't bode well for the markets or the economy.

The Fed and Financial Conditions

All else being equal, financial conditions are reaching levels where the market might start to expect support. **"Easy" financial conditions have been the "norm" for most of the past few decades.**



In the Chicago study, financial conditions were only "tight" (above 0) in the early 1990's, during the financial crisis, and during Covid. Certainly from 2007 until 2010, the Fed did everything possible to ease financial conditions. Ditto with Covid. While we still are "easy" (-ve on this chart), the market has been doing a lot of tightening and is far ahead of the Fed already (mortgage rates, in particular, scare me because of what that means for the economy).

I understand that the Fed has to fight inflation, so we will get QT and will see hikes, but that seems awkward given what has happened to financial conditions. Remember, the Fed continued with QE all last summer, often pointing to aiding liquidity. Based on financial conditions alone (and yes, I'm aware there are other factors, but sometimes I'm stubborn), the Fed should be more worried about liquidity today than they were last summer. Truly caught in the Damned if You Do, Damned if You Don't cycle.

I won't even bother drawing a chart showing the number of 1% or more intraday moves the stock market has seen in the past few weeks because it would take too long and we are all (sadly) too well aware of it.

The Bond Yield "Glass" Ceiling

I'm not there (yet) on this subject, but how high could bond yields go?

This fear of much higher bond yields that I'm developing has little to do with central bank policies and everything to do with positioning and lack of liquidity.

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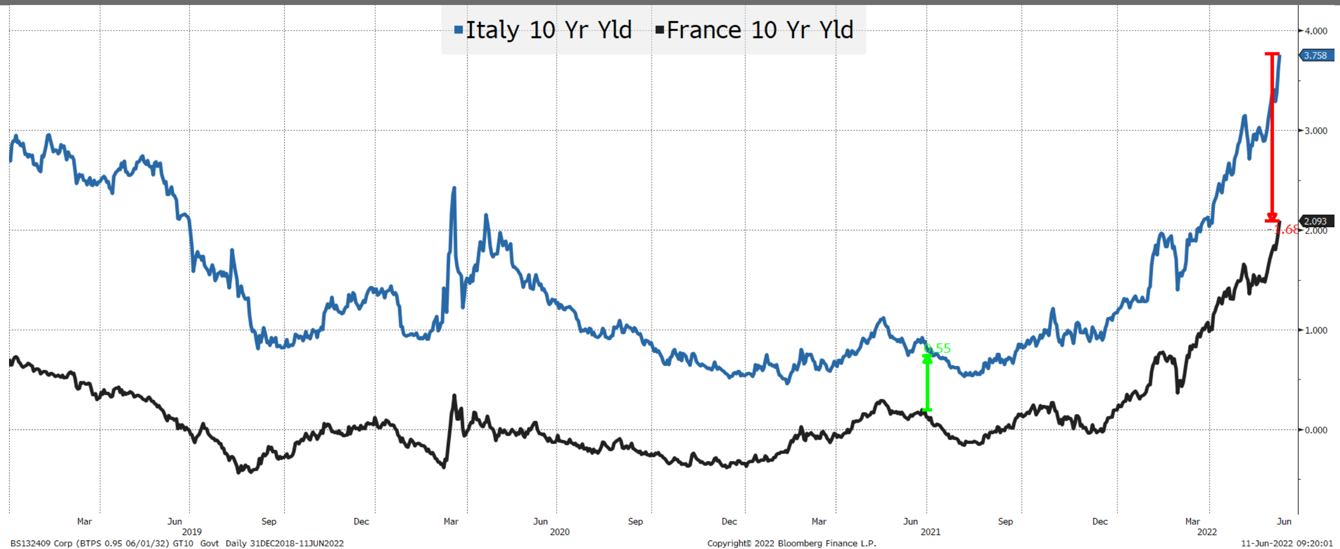
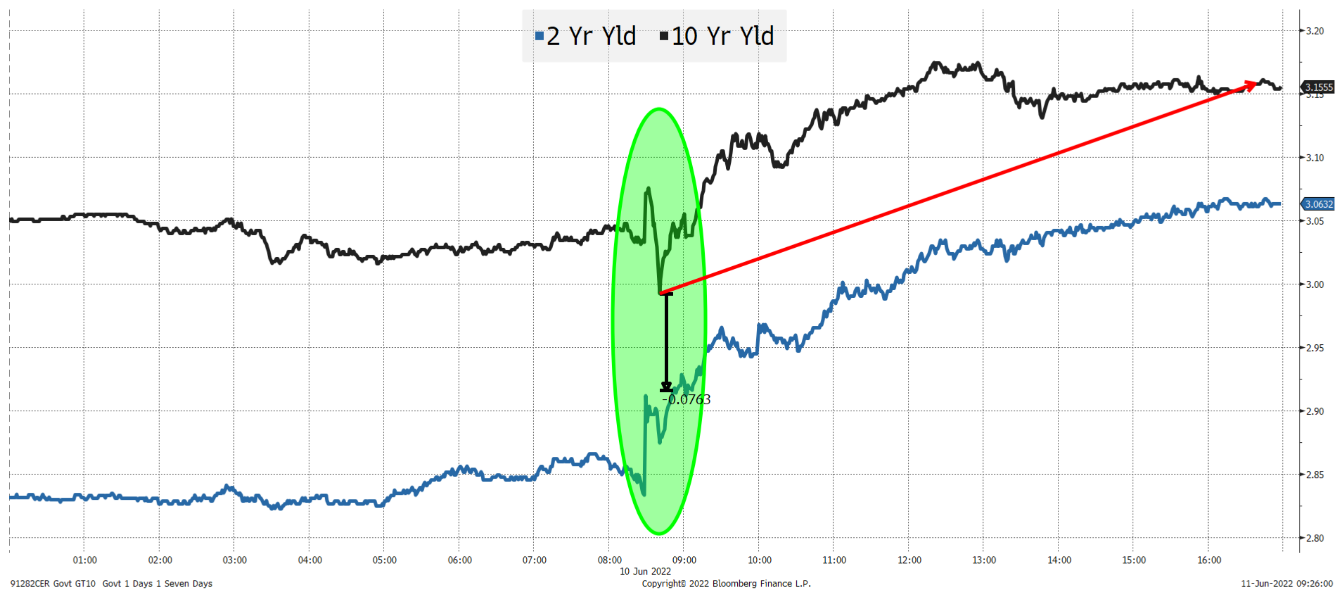


European bond yields are rising rapidly and changing the "we are the only game in town" narrative for Treasuries. **What concerns me more than rising bond yields** is the underperformance of Italy versus France. Last summer, the yield difference was ~50 bps. Now it is almost 170 bps. That, coupled with the chart showing credit spreads in Europe versus the U.S., is not comforting.

However, I don't like how Treasuries traded on Friday.



Immediately after the CPI number, 2-year yields spiked (more rate hikes). The 10-year yield dropped briefly. Presumably, slower economy, so longer yields are protected. But that didn't last.

Over the course of the day yields crept higher and higher and the 10-year closed at 3.16%, its highest closing yield since 2018.

DEFCON 3

I was probably sitting at DEFCON 4 and now have to move us to DEFCON 3. I don't like what I'm seeing out there. Yes, I'm long for a trade (if markets were open right now, I'd probably close that out), but I'm increasingly concerned that there is a lot more downside for the market.

I am less worried about inflation than I am about high prices (similar, but not the same).

I am more worried about central banks stifling the economy as they fight the last battle (inflation) when they may need to be focusing on the next battle (an economy wedded/addicted to low yields and leverage may not behave "normally" as those things are taken away).

I've always felt that QT has the most impact on asset prices and shouldn't be "translated into some number of hikes" (Rube Goldberg on Translating QT to BPS) and we are now in a period of QT.

Bottom Line

I want to own **Treasuries** here at the wide end of the range, but for the first time, I'm scared that we could break out of this range (big problem).

Credit spreads should outperform equities here, though both may be weak.

Equities could be hit by the double whammy of earnings concerns and multiple reduction. Did I mention I'm regretting buying Friday's dip?

Crypto should remain under pressure. I think bitcoin will be sub $20k before it reaches $35k.

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