

You're So Vain

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You probably think this song is about you

The song, to be honest, does seem to be about him, but that thought probably just demonstrates how little I know about emotions and cathartic expression. Though, like the song, I don't intend to mention anyone by name and there may be more than one person or group that I'm thinking about.

Clouds in My Coffee

I have no idea what clouds in my coffee are, but it sounds cool, and I do (unfortunately) see a lot of clouds in my economic and market outlook.

Recent T-Reports have highlighted the risks to the economy and the potential that "summer recession" will win the economic horserace ([DEFCON 3](#)). The fixation on inflation, at the expense of other factors (like avoiding a recession), was the main theme in [Cutting Off the Nose to Spite the Face](#). In last weekend's [The Fed Blinked](#), we latched on to some signals that the Fed might tone down their hawkish rhetoric while warning that the "bad news" is "good" for the market trading pattern was unlikely to hold. **What we seemed to learn this week was:**

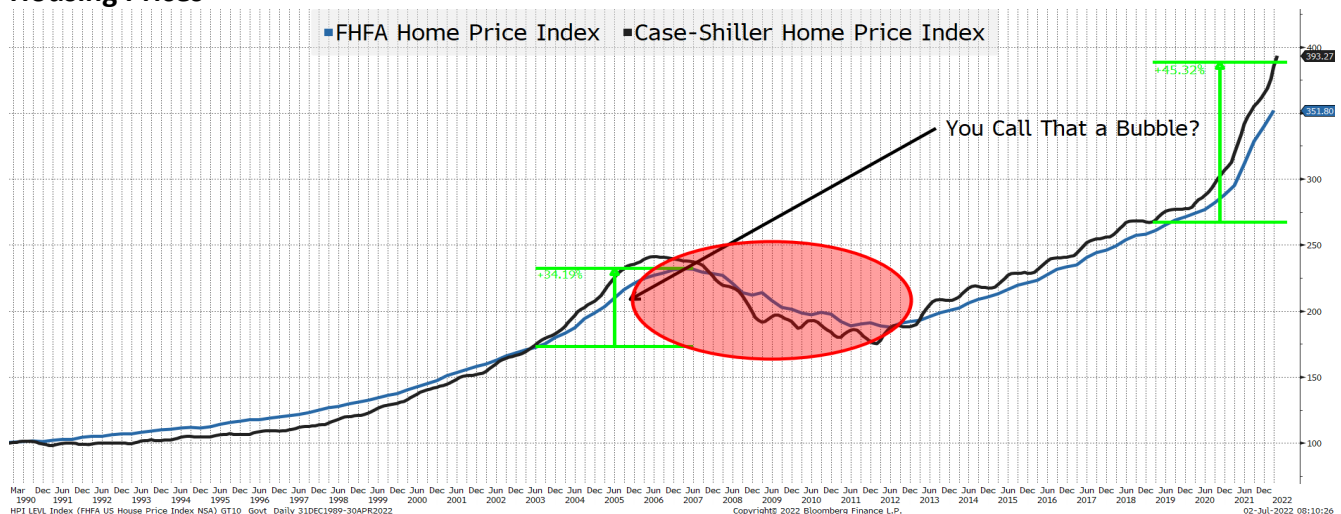
- **The Fed and central banks across the globe are continuing to send the message that nothing other than inflation matters** and that they are largely on pre-ordained paths for the coming few months regardless of anything (except the most extreme shifts in data).
- **Bad news was no longer good news for markets** as the S&P 500 tumbled 2.2% on the week and the Nasdaq dropped by 4.1% (despite a myriad of "seasonal" factors that promised more for stocks), while the 10-year Treasury dropped from 3.14% to 2.88% (**the 10-year yield has dropped 60 bps since it peaked on June 14th – 60 bps in 2 weeks!**)

So, let's get to the business at hand - clouds in the economy and markets.

Clouds in the Economy - Housing

"Housing prices, on a national average basis, have never had an annual decline." That might not be an actual direct quote, but during the mortgage market and housing bubble of 2005 to 2008, you likely heard that argument made somewhere between one and ten thousand times!

Housing Prices



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Depending on what metric you look at, housing prices have risen more rapidly in the past few years than they did before the Great Financial Crisis.

Yes, housing has contributed greatly to inflation. If anything, the use of Owner's Equivalent Rent (OER) in CPI calculations has understated the rise of housing prices in official inflation data. We know all that, but **we also know what happened when housing prices dropped across the nation!**

I cannot think of another greater "wealth" effect than housing. My understanding (which means I was too lazy to Google it), is that home ownership levels in the U.S. remain high relative to other countries (around 65% of households own a home). For many, their home is their largest asset. It is an asset so large that they can't help but take comfort from it when its value rises (and many are tempted to spend against that perception of wealth creation).

For most, it is also their most leveraged asset. People borrow to buy homes.

National Mortgage Rates



Mortgage rates, depending on which ones you look at, have moved anywhere from 2% to 3% higher in 6 months! Mortgage rates have fared worse than other rates, partly because as part of quantitative tightening the Fed may have to sell mortgages. On the Treasury side of the equation, they can just let them mature, but on the mortgage side of the balance sheet, actual sales are likely. It doesn't take a trading genius to figure out that if you have one of the largest buyers (who is not price sensitive) become one of the largest sellers, you want to be careful taking risk in that space.

I am told that housing formation supports home prices, that scarcity remains an issue, that all cash buyers make up more of the market, and all sorts of other reasons why housing prices cannot go down. **But I see the combination of rapid price acceleration and the gap higher in financing costs as a toxic mix.** Maybe that is why this article about [Home Sellers Slashing Prices](#) caught my eye, and why I won't even peek at my house on Zillow.

I think, much like in 2007, those that rely on official data to model their forecasts are going to be behind what every person in the country knows: their home is worth less than it was a couple of months ago and the outlook for appreciation is not good!

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Clouds in the Economy - Stocks

I will only spend a few moments on stocks because this seems so obvious to everyone.

I found one statistic that purports to be the total market cap of U.S. equities. It was above \$54 trillion in November of last year and has dropped to \$40 trillion today. An intense hit (especially when you consider that most bonds have also provided negative returns on the year). It isn't like most people can take consolation in their broader holdings either (the very popular 60/40 asset allocation, with 60% in stocks and 40% in bonds, hasn't done well – I believe an index of those funds is down ~20% on the year).

But it is important, though not important enough to Google, **that pretty much every Fed Chair, from Greenspan, to Bernanke, to Yellen, and dare I say Powell, has talked about the importance of the wealth effect in the past.**

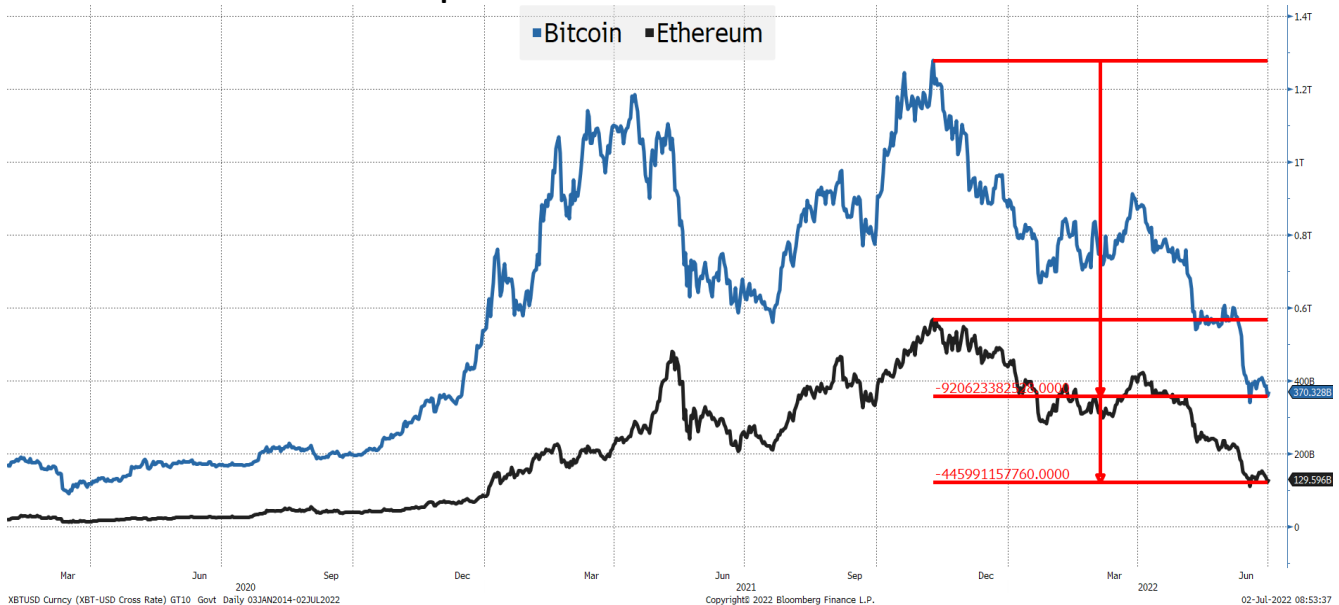
Housing hasn't cracked (at least not in official data), but stocks and bonds certainly have.

In defense of equity wealth destruction, I will admit that it is still above the \$36 trillion it reached in early 2020, and that many have held on to stocks for so long that maybe the wealth effect won't be that pronounced.

Clouds in the Economy - Crypto

I've discussed my views on how [Disruptive Portfolios](#) have been risk-managed. I won't focus on SPACs, IPOs, or other stocks that in the past two years have seen epic rises and falls. I won't discuss what will happen to all the money those companies were spending to grow. I won't question the job situations at those companies as many (especially those that are cash flow negative) are under extreme pressure to reduce expenses. I will totally ignore the negatives there and fixate on crypto, though I suspect my arguments here are a microcosm of a much broader issue.

Bitcoin and Ethereum Market Cap



Bitcoin has dropped over \$900 billion in market cap this year. Ethereum has dropped \$450 billion and almost disappeared into obscurity. **That is \$1.3 trillion of wealth that went “poof” in a matter of months.**

That doesn't include the losses in “alt-coins” or what are often referred to “affectionately” as July 3, 2022

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“sh*tcoins.” I have no idea what the losses in NFTs are. Maybe pixelated bored apes are still trading for millions of dollars, but I suspect not. Heck, I cannot remember the last time someone mentioned [NBA TOPSHOT](#). I suppose I could ask my kids, but I can't remember the last time that they were staring at a screen, hitting refresh, hoping to get some “drop” that would create some instant \$\$\$ for them!

Let's say, conservatively, \$2 trillion of wealth has been lost in crypto this year.

What scares me is that the bulk of this was newfound money! Since early 2020, when the charts I found start, the combined value of bitcoin and Ethereum was about \$200 billion, compared to a peak of \$1,800 billion, and it is now back to \$500 billion. That is a huge amount of recent wealth that has disappeared. **I expect that the bulk of the wealth created and destroyed sits with a relatively small handful of the population.** A small, but meaningful part of the population.

We have a decent sense of stock market wealth ranging from some families that sit on trillions of dollars in trust funds, to those with a decent (but still too small amount) in their 401ks, to the day traders. I don't have a sense of how the wealth effect in crypto is split, but I suspect it is a younger and more aggressive group.

I do suspect that a huge part of the wealth that still remains is “controlled” by the whales! Those early adopters who have worked diligently to get more buyers of crypto, but still own so much that they have truly created the generational wealth that others now aspire to create.

So, from a wealth effect perspective, I think the crypto losses will hit spending far faster than either housing or stock losses!

It might be easy to dismiss this and point out that Lambo (formerly known as Lamborghini) wait times dropping from 2 years or something to 6 months might not be bad, but that is far too dismissive.

The lost wealth is bad, but there will also be a slowdown in spending by crypto firms (as well as hiring).

Pseudo-randomly, I picked one of the **well-known crypto miner stocks**. Its valuation has dropped from just under \$2 billion to just over \$200 million. Another one dropped from \$2.6 billion to \$0.25 billion. I don't know exactly what they spend their money on, but **I assume they buy semiconductors for their mining operations and I suspect they have to be more cautious here.** This is just one example of how the massive change in valuations of crypto companies will filter into the world most of us are more familiar with examining every day.

I am not even sure what crypto.com is exactly (it doesn't seem to be a public company) but without it, I'm not sure what commercials would have aired during the NBA finals and I might be able to dissociate Matt Damon with those “Fortune Favors the Brave” commercials. Sadly, I think that link, once seen, can never be wiped from one's mind. Those commercials and “you're so vain” do seem to go hand in hand!

That is a lot of ad spending that will presumably be curtailed. Who knows how many crypto conferences there are (or were) but that lavish spending seems likely to dry up as well as people focus on earnings and protecting themselves.

It looks like Three Arrows Capital has entered liquidation ([WP article](#)). My experience in high yield and distressed always associated higher recovery values for companies that were “unique” and that it was more a question of capital structure than the business model. If one company in an industry goes bankrupt because of problems they created, then there is value to their assets. If multiple companies go down at the same time, the value of those assets comes into question. Similarly, during the tech

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bubble, tech company recoveries were often lower because it was more a question of the validity of their technology and IP rather than needing a better cap structure. Albeit some of the assets of those high yield issuers that defaulted in the tech space became the backbone of some incredible companies, but that took time. In any case, given reports swirling about other companies, this doesn't seem likely to be the only company in trouble. That is particularly true given that many companies seem to play multiple roles, which wouldn't normally be combined in a regulated environment.

The crypto wealth effect is:

- Going to hit consumer spending and consumption faster than other wealth effect losses.
- Going to hit corporate spending, ranging from bandwidth use, cloud storage, accounting and legal services, advertising, semiconductor spending, etc., rapidly. I also have to add that the other problems that a lot of disruptive companies (public and private) are facing right now are adding to this risk.
- Traditional economists, many too dismissive of crypto, are way behind on identifying this risk.

You can laugh all the way to the bank if you hate crypto, but you better be running because this time around, the repercussions to the economy will be felt, and will be felt quickly, if they aren't already being felt!

There seems to be a battleground forming in this \$18,000 to \$21,000 range on bitcoin, but if it fails, and I expect it to fail, I think we could see a very rapid (think weeks) decline to \$10,000 or less as more leverage gets squeezed out of the system.

You're So Vain – Inflation versus Recession

As politicians and the mainstream media have made inflation public enemy #1, there are a few things that I cannot help but think about:

- **Inflation is bad, but job losses and recessions are worse** (at least that is how I see it, and Bush senior is the best example of how quickly a weak economy can impact presidential popularity and reelection chances).
- There seems to be a level of concern around **missing that inflation was NOT transitory and that traditional policies can "fix" supply side issues.**
- **No second guessing our past strategies, practices, regulations, laws, etc.** It seems obvious to me that many of our own policies, especially as it pertains to the energy industry, are more to blame than even Putin's invasion of Ukraine for our current predicament (but I see little to no progress addressing those issues). Increasingly, as we discuss geopolitics, supply chains, and the competition for natural resources, the conversation devolves into seeing D.C., on both sides, with their heads stuck in the sand, ignoring the things all around us where we do have the ability to shape our own destiny. I continue to believe that we will spend more on both sustainable and traditional energy sources in the years to come, though I'd like to move beyond the windfall tax and asking former enemies (Iran and Venezuela for example) for help phase to get this ball rolling!

Haven't We Had Capitulation?

That is the question we all have to ask ourselves given current levels. I'd like to say yes, and the [AAI Sentiment Survey](#) is only 23% bullish and 47% bearish. They themselves admit their survey is a

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contrarian indicator (though I'm not sure that is how they imagined it when they started) and their model is at -24, which is set to Greedy (but that is far less negative than it has been, meaning the signal is weak, and is quite close to neutral – the prior week's reading was 18% bulls and 59% bears). The [CNN Fear and Greed](#) Index has crossed into "Extreme Fear" from "Fear." Another potentially contrarian signal, but there is room to go (the Index is at 24, with 0 being the lowest possible score) and the direction is steadily getting worse and is not showing signs of turning.

I think there is yet to be capitulation because:

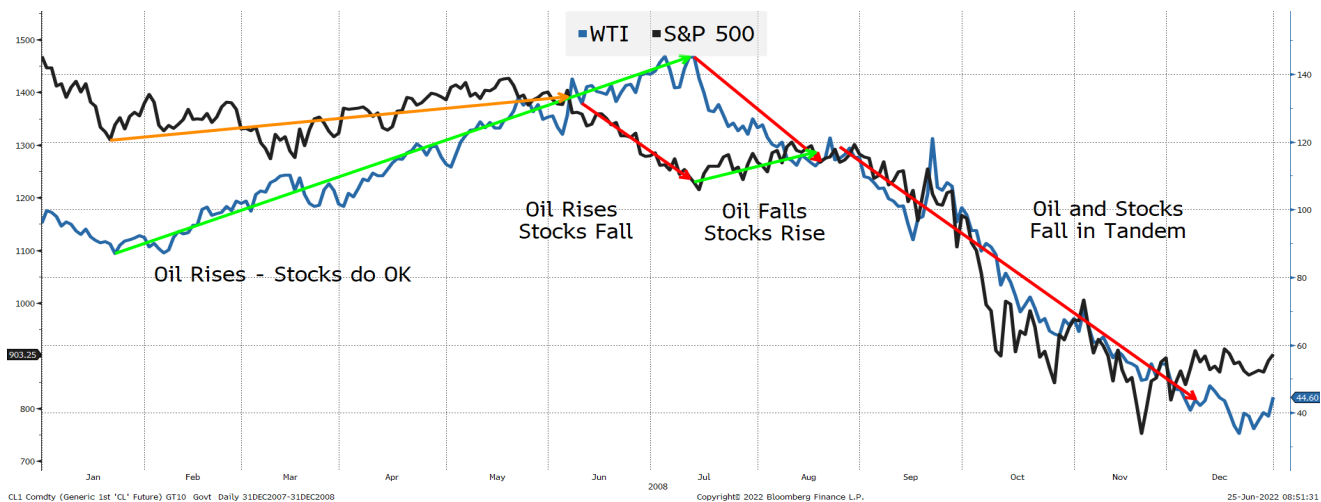
- We just had a lot of factors that pushed people to be bullish and all we got was some little pop on Friday after the bond market had gone home – seems to me like this is a set-up for trapped longs.
- ARKK and TQQQ are still trending towards inflows, meaning that people are still trying to be on fast trades that can reward you quickly. I understand the appeal, but it doesn't scream "capitulation" to me.
- The "bad news" is good news trade started to fail. The "lower yields (regardless of the reason) are good for stocks" trade started to fail. As algos lose money in those trades, they will be shut down. That will let the correlations break much easier.

Maybe this song is about me, but I cannot help but think positioning has not seen capitulation.

Bottom Line

I've never watched the movie *Thelma and Louise*, but I can't help but replay the final scene, which I have seen, over and over, because that is where we are right now on many levels! The investment themes from last week remain largely intact, with a more bearish bias. **I like lower yields** as recession fears grip the streets (Wall and Main). It is, unfortunately, too early for central banks to pivot despite my glimmer of hope last week. **I think crypto will remain weak and will impact the stock market and economy** as the magnitude of the problems and the scope of the wealth destruction filters through the economy.

I cannot be comfortable on risk assets here, including commodities.



This chart from last weekend's T-Report keeps me awake at night, and I must move back to DEFCON 2.

Have a great 4th of July, and maybe I should have started this report with a warning that if you want a great 4th of July (and Canada Day) weekend, you shouldn't open this report until Tuesday!

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