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RESEARCH | MACRO

Macro Thoughts

15 August 2022

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Thought to ponder…

"Every time I read a management or self-help book, I find myself saying, 'That's fine, but that wasn't really the hard thing about the situation.' The hard thing isn't setting a big, hairy, audacious goal. The hard thing is laying people off when you miss the big goal. The hard thing isn't hiring great people. The hard thing is when those "great people" develop a sense of entitlement and start demanding unreasonable things. The hard thing isn't setting up an organizational chart. The hard thing is getting people to communicate within the organization that you just designed. The hard thing isn't dreaming big. The hard thing is waking up in the middle of the night in a cold sweat when the dream turns into a nightmare. The problem with these books is that they attempt to provide a recipe for challenges that have no recipes. There's no recipe for really complicated, dynamic situations. There's no recipe for building a high-tech company; there's no recipe for leading a group of people out of trouble; there's no recipe for making a series of hit songs; there's no recipe for playing NFL quarterback; there's no recipe for running for president; and there's no recipe for motivating teams when your business has turned to crap. That's the hard thing about hard things—there is no formula for dealing with them.. "

The Hard Thing About Hard Things
Ben Horowitz

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The View from 30,000 feet

With Q2 earnings coming better than expected and largely behind us, the markets are focused on economic data releases. Last week was “inflation week”, with ISM Prices survey, CPI, PPI, Import and Export prices rolling across the tape, showing signs of cooling inflation tied to energy and food price moderation, but investors should be careful not to extrapolate the current trend to a view that our days of battling inflation are coming to a close. The bottom line is that there is a long way to go to contain inflation, the employment market is too tight for comfort, the Fed continues to be on a path to raise rates to restrictive territory and the economy is still weakening.

- Across the board, August’s first pass at inflation data shows sharp declines setting off a robust rally to the top end of the equity market trading range.

- The majority of the improvements in inflation and confidence data can be directly attributed to falling gasoline prices.

- Economic data continues to show signs of softening and the Fed has given no indication of changing course.

- The most *Frequently Asked Question* from client’s this week: Do the better-than-expected inflation readings change our view?

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Inflation data shows sharp declines setting off a rally to the top end of the equity market trading range

- In a heavy week of inflation data reports, virtually every data point show signs of inflation easing faster than consensus expectations, driving investor optimism.

Data	Consensus	Actual	Previous
ISM Prices Paid	74.3	60.0	78.5
Headline CPI MoM	0.2%	0.0%	1.3%
Headline CPI YoY	8.7%	8.5%	9.1%
Core CPI YoY	6.1%	5.9%	5.9%
PPI MoM	0.2%	-0.5%	1.1%
Import Price Index MoM	-1.0%	-1.4%	0.2%
Export Price Index MoM	-1.0%	-3.3%	0.7%

- With Q2 earnings season concluding earnings came in ahead of expectations
  - With over 90% of the S&P500 having reported, Q2 EPS growth was up 6.7% YoY, well ahead of the pre-quarter end estimate of 4.0% (Factset)
  - However, 2023 FY estimates dropped from $252 per share to $243 per share
  - Of the $47.7b in S&P500 estimated earnings, $31.1b was attributed to Energy, with just two companies (Exxon and Chevron) together combining for $20.9b of the earnings… nearly half of the earnings of the index were two companies
  - Aramco (the Saudi national oil producer) posted a record $48.4b in profit, eclipsing the profits of the entire S&P500

- S&P500 is approaching resistance levels both on technical (4,300) and fundamental basis (21x current year P/E)

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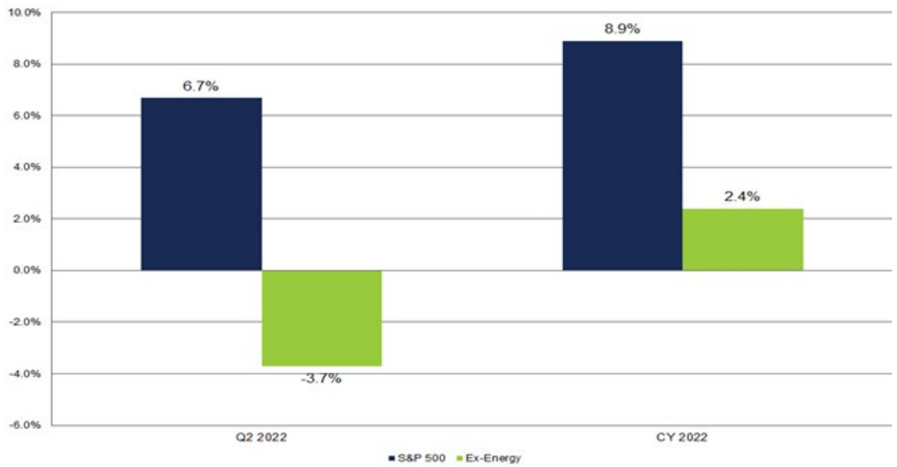
Better than expected inflation and earnings sets off rally but earnings lopsided and resistance looms

S&P500 EARNINGS GROWTH: EX- ENERGY
EARNINGS GROWTH FOR Q2 NEGATIVE W/O ENERGY



Source: Factset

S&P500 MOVING AVERAGE AND FIBONACCI LEVELS
TECHNICAL RESISTANCE LEVELS AROUND 4,300

Source: Bloomberg

Improvements in inflation and confidence data can be directly attributed to falling gasoline prices

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- University of Michigan Consumer Sentiment Index rebounds off its lows, beating expectations after gasoline prices fall at the fastest rate since 2020 and 2008.
- Since April of 2021 the University of Michigan Consumer Sentiment Index has had a high correlation to Average Gasoline Prices with a correlation of 0.86.
- Not to be outdone, since May of 2020, Headline CPI has had an even more near perfect correlation to Average Gasoline Prices with a correlation 0.94.
- Correlation of CPI ex-Food and Energy isn't much better with a correlation of 0.91 to Average Gasoline Prices since May of 2020.
- The strong correlation of Consumer Sentiment, Headline and Non-Headline CPI with Average Gasoline Prices makes the Fed's job extremely challenging, because the driver of CPI is less about interest rates than gasoline prices, and the only tool the Fed has to lower gasoline prices is to raise interest rates sufficiently high to destroy demand.
- This problem is made complex because Gasoline Prices tend to be surprisingly inelastic until its not, meaning demand does not change much in relation to prices, until it hits thresholds.

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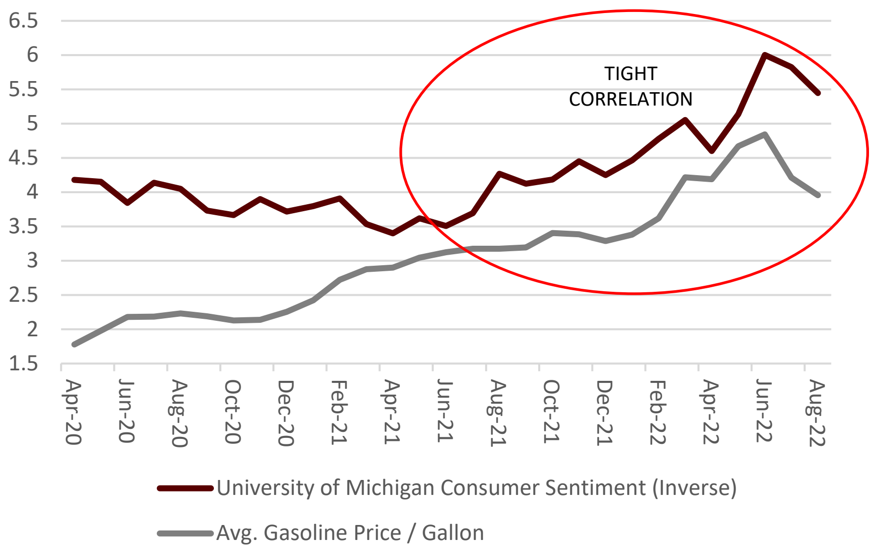
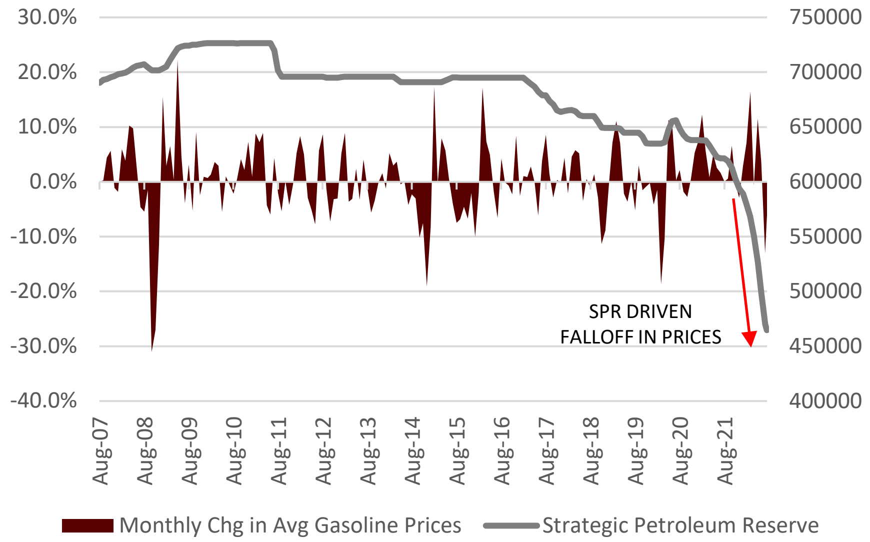
Fed's job becomes challenging when sentiment and inflation tied to drawdown in SPR

GASOLINE VS. UNIV OR MICHIGAN CONSUMER SENTIMENT - GASOLINE AND SENTIMENT HAV TIGHT CORRELATION



Source: Bloomberg

DAILY AVERAGE GASOLINE PRICES – MONTHLY CHANGE VS SPR: FALL IN GASOLINE PRICES TIED TO DRAWDOWN IN SPR



Source: Bloomberg

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Economic data shows signs of softening and the Fed has given no indication of changing course

- According toe the Mortgage Bankers Association, the Refinancing Index was down 82% over the previous year, which means refis are pretty much non-existent, other than for those whose ARMs are resetting and are being forced to lock in higher rates.
- The Purchase Index for homes was down 19% from the previous year.
- National average inventory for homes was up 30.7% YoY, according to Realtor.com.
- The number of active listings reducing price hit another all-time high of 9.7%, with areas such as Phoenix, Austin, Denver and Las Vegas now indicting that 30% to 40% of homes are reducing price.
- Nationwide, Redfin agents found fewer and fewer buyers who are competing for homes, with only 44.3% of homes receiving multiple offers, the lowest share in the history of Redfins dataset, outside the pandemic.
- Total home sales have declined for six consecutive months, dropping 14.9% YoY. Increased mortgage costs are driving would be buyers into ARMs at the fasted pace in eight years, according to CoreLogic.
- The Drewry World Container Index has dropped for 24 consecutive weeks, now 38% below the peak in September 2021, but still 78% higher than the five-year average.

Prices of homes are being slashed and new buyers are being driven into ARMs

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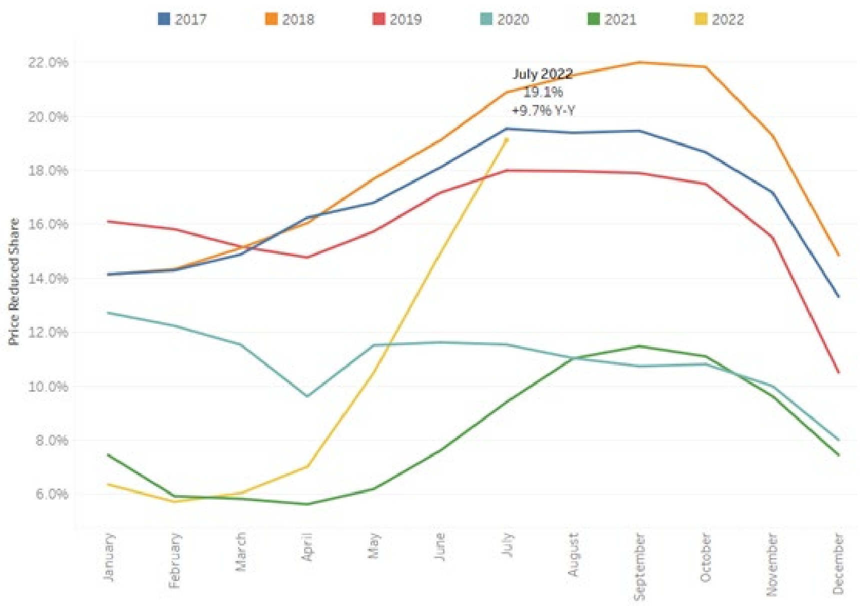
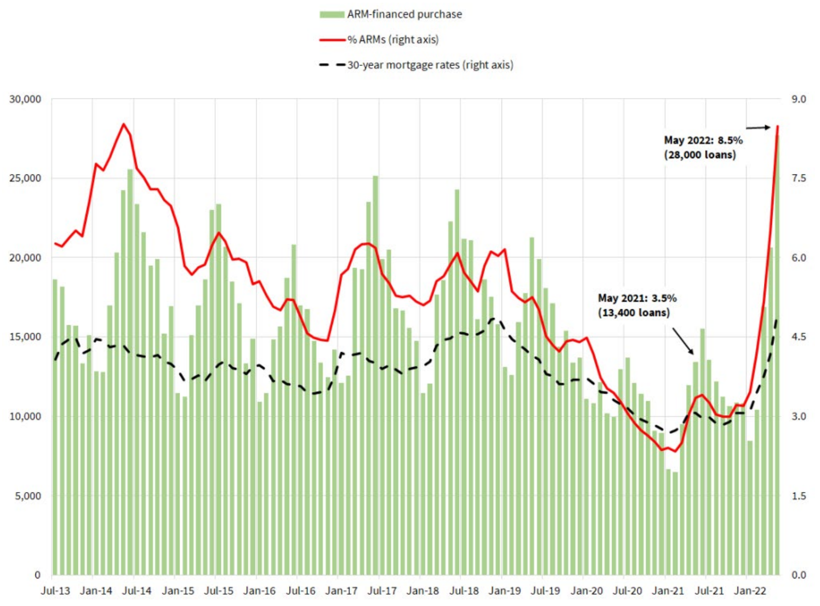
PRICE REDUCED SHARE OF HOMES FOR SALE
PRICES ARE BEING REDUCED AT FASTEST PACE IN HISTORY



Source: Realtor.com

PERCENTAGE OF NEW BUYERS UTILIZING ARM FINANCING
NEW BUYERS FORCED INTO VARIABLE RATE PRODUCTS



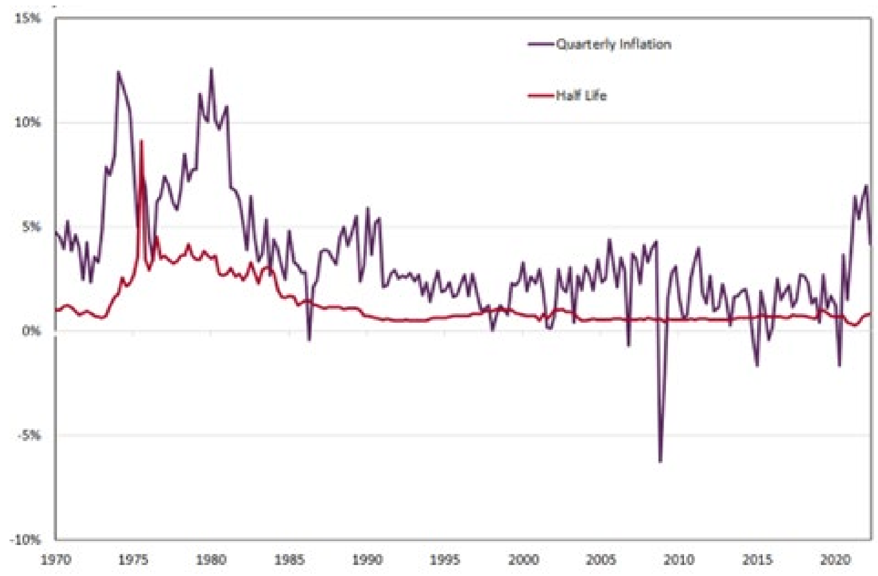
Source: CoreLogic

FAQ: Do the better-than-expected inflation readings change our view?

- In short, No.
- There are three ways to think about the future course of the Fed: Market Pricing, Fed Governor Statements, Fed Papers
    - Market Pricing measures for Fed Funds Futures showed signs of prolonged interest rate environment with Eurodollar Futures, a proxy for Fed Funds rates in the future, indicating expectations for rate cuts over are shifting out from Q2-2023 to Q3-2023.
    - Comments last week from the Fed:
        - Richmond Fed President, Barkin, "We're happy to see inflation start to move down. I'd like to see a period of sustained inflation under control. And until we do that, I think we're just going to have to continue to move rates into restrictive territory" (CNBC)
        - Minneapolis Fed President, Kashkari, "There's a disconnect between me and the market…I think much more likely scenario is we will raise rates to some point and then we will sit there until we get convinced that inflation is well on its way back down to 2%" (Aspen Economic Strategy Group annual meeting)
    - In a recent Economic Brief published by the Richmond Fed, they indicated that it would take between five and twelve quarters for CPI to normalize to the Fed's target range.

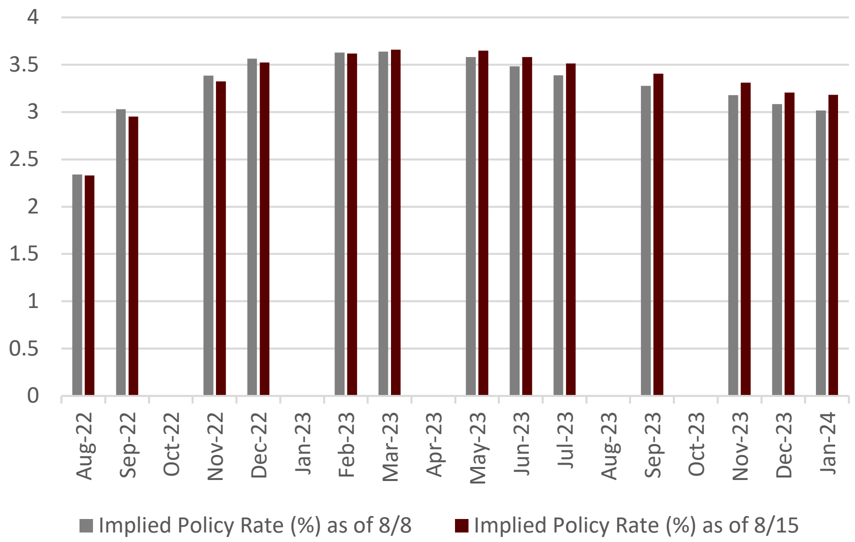
Getting back to the 2.0% PCE range will be a process that's measured in quarters and years

HALF LIFE OF INFLATION AS COMPUTED BY THE FED
HALF LIFE 1-2 QTRS, BUT FULL RECOVERY 5-12 QTRS



Source: Richmond Federal Reserve Economic Brief – How Persistent is Inflation

FED FUNDS RATE EXPECTATIONS
RATE CUTS MOVED OUT FROM Q2 TO Q3 2023



Source: Bloomberg

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Putting it all together

- The equity markets have been staging a rally ignited by relief over Q2 earnings and a data dependent Fed that has been fed by better-than-expected inflation numbers.

- Although these are all positive developments there are caveats to each:

  - Earnings have been propped up by the Energy sector, which only represent about 4% of the marketcap weight of the S&P500, while the rest of the S&P500 is languishing in subpar or negative growth.

  - Better than expected inflation number are were almost entirely driven by lower gasoline prices, which have now dropped 21% since mid-June off expectations for slower growth (less demand) and releases from the Strategic Petroleum Reserve (more supply). Both of these drivers are baked-in, which will serve to dampen further price and CPI drops.
  -
  - Unfortunately, beginning in June the Fed began to confuse the markets:
    - The Fed moved to talking about Headline CPI and University of Michigan Consumer Sentiment in June, redirecting Fed watchers from being focused on PCE.
    - Then the Fed abandoned forward guidance in July, opening the door for Fed watchers to try and self-determine the path for interest rate policy.
    - The result has been that Fed watchers have mistaken lower gas prices, which drive Headline CPI and University of Michigan Consumer Sentiment, for expectations for a more dovish Fed.
    - This conclusion is riddled with flawed assumptions, and likely means the rally has gotten ahead of itself, with equity markets now trading close to technical and fundamental resistance levels.

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