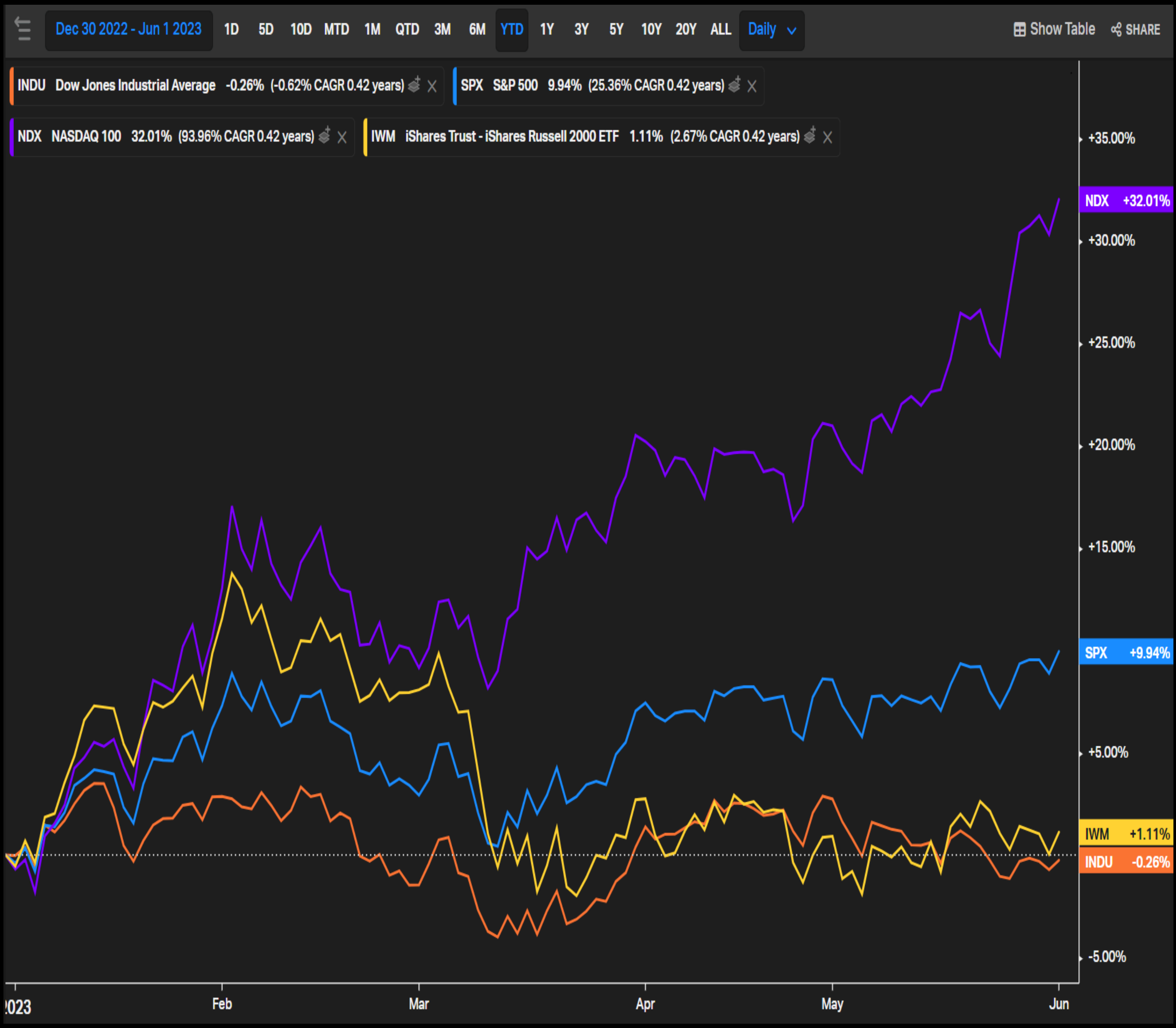
May 2023

Stuart thank you for being a subscriber

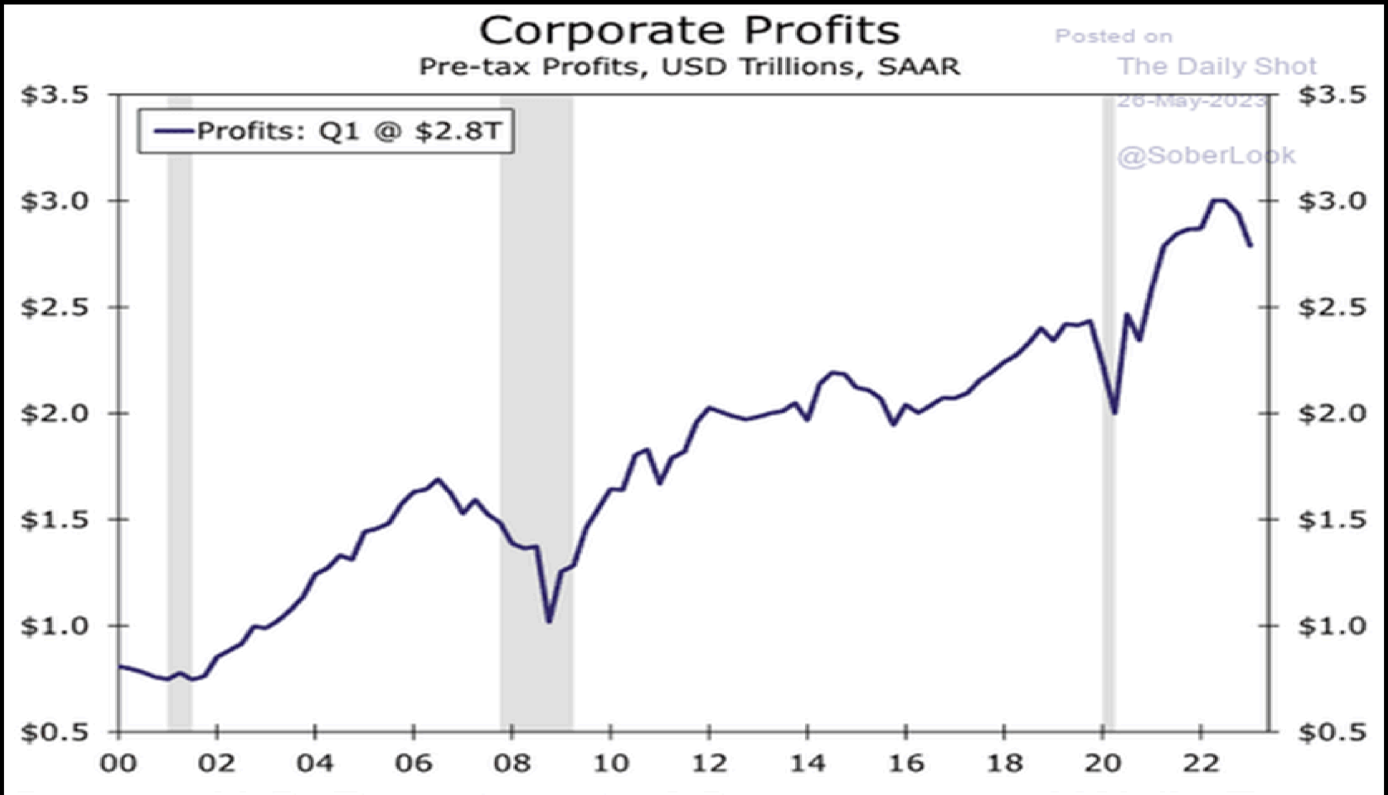
Blue = their thoughts, Orange = mine

Nina and I have gotten to enjoy some great weather in the UK and spend time with family. My brother and his teenagers flew in from St Louis and my sisters and their boys, who live in the UK, all gathered at mother’s place last Saturday for lunch and photos. A great day had by all. Nina and I are off to Norway next to meet a friend of mine who runs a family office there. I have also been very busy meeting investment bankers, attorneys, and tax structuring folks in the UK for something I'm working on. More on that later.

There is a massive dislocation in the markets. As you can see below, the NDX is powering ahead, but only 7 companies leading that charge. Hedgeye published the following yesterday morning. "As of the end of May, the top seven components of the Nasdaq 100 – Nvidia, Alphabet, Microsoft, Tesla, Amazon, Meta Platforms, and Apple – were up $3.4 trillion in market cap in the YTD. For those that are counting, that's more than the annual GDP of the United Kingdom. Meanwhile, the bottom 93 components were only up some $630 billion." So 7 companies are boosting the NDX, and since 20% of the SPX is technology, it is boosting it up as well. The Russel and DJIA have little growth at the end of Q2. Now last Friday was a big day when all markets celebrated that the USA could continue to pay its bills, some pull back is now expected.



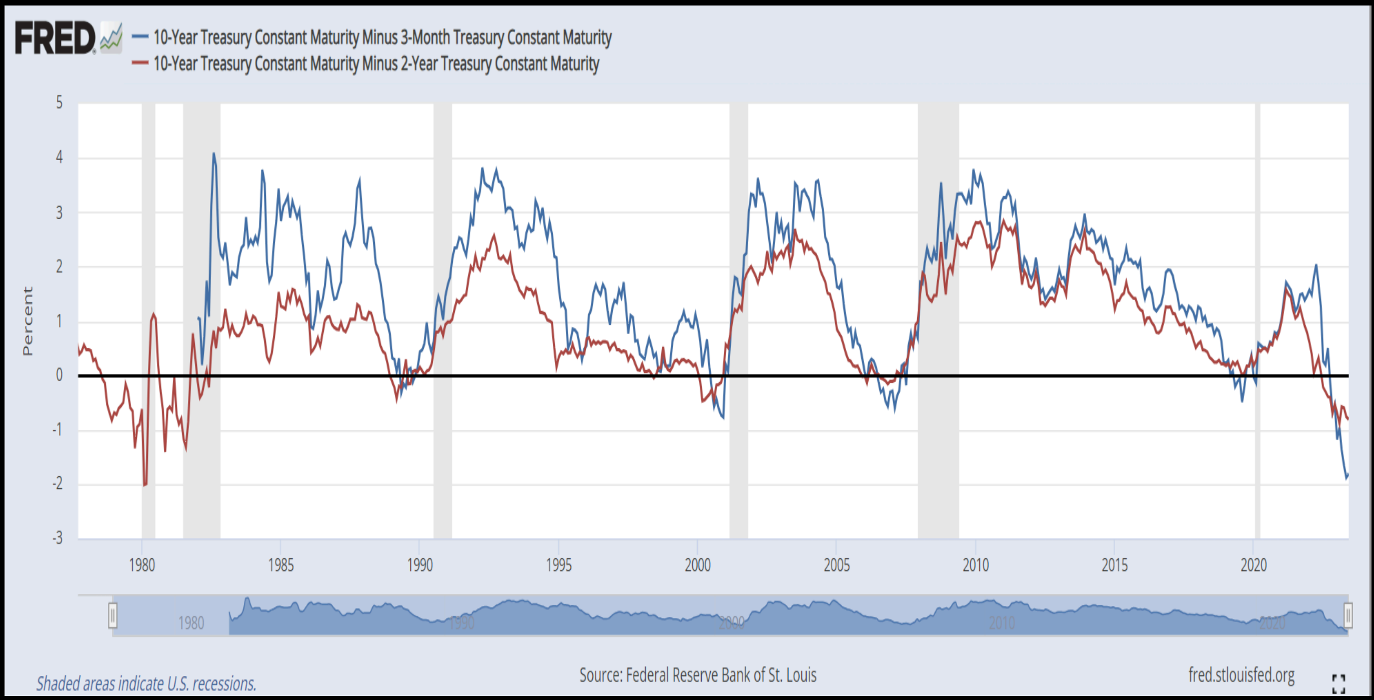
I am concerned about the lack of rebound in China's economy, and Germany simi entering into a recession. Another concern, US corporate profits are starting to receed, see below.



Source: U.S. Department of Commerce and Wells Fargo Economics

Source: Wells Fargo Securities

Then there is one of my favorite indicators, how bond investors invest their funds. The chart below shows that the 10-Yr. minus 3-Month Treasury has always predicted a recession. It is more inverted today than any time in its history. I do not know if that means bond investors think it will be the deepest recession in history, but they have voted with their dollars buying short term paper, as we have sitting in money markets. Thinking Jim Reid might be correct, see below, longer term paper is starting to look appealing.



In item 1 below Jim Reid at DB talks about the top 10 mega cap stocks of the S&P. In item 2 below, Jim has done some good thinking around when the Fed will start to lower rates. If he is correct, for those of you that missed the fixed income trade referenced in the February Update, if the 10-Yr. TNX gets close to 4% again it might be a good time to buy long paper.

There is much discussion that we might avoid a recession, I'm not sure that will be true for reasons mentioned above. Also, speaking with the investment bankers here in the UK, they do not see the markets turning around until next year at best and that we are not done with this bear market. While folks like Harry Dent are screaming big recession almost depression, we do not see those types of markets without a catalyst. So, where is that black swan going to come from? No idea at this point and many others I talk to agree. But no one seems to be able to articulate why markets should go up, and this in of itself is an issue.

Strategy Update:

- ST NDX redeemed itself in May, posting a profit of 82.64% on 38 trades. This now makes up for the losses from last month, netting 18.28% profit for the last two months. When I get back, at some point I need to calculate the profits with TradeStation and add that to Multicharts so I can report a YTD number. Different platforms and separate brokers to calculate. Anyway, the month of May had trends and my systems tend to do well with any trend.
- RST NDX SIM strategy delivered a loss of (24.85%) on 78 trades. That is disappointing for a trending market and so that strategy will be shut down.
- JTMA NQ is another SIM strategy I built last month. May was very encouraging, delivering a profit of 142.1% on only 16 trades. This strategy I designed to pick up larger directional movements with less trading. We will see how it does over the next few months.

In The News:

1.

We are strongly of the view that AI will change the world. The things we've seen from chatGPT and read about with regards to the technology suggests its going to be a game changer. ChatGPT was launched on November 30th last year and as you can see this closely coincides with the surge in the ten US mega-cap tech stocks.

Stocks associated with AI such as Nvidia (+108% YTD), and Microsoft (+30.6% YTD) have surged and have taken tech along for the ride (lower yields have helped a bit too). These ten are up +33.3% YTD and have helped the S&P 500 be +8.0% YTD so far. (Price only moves).

Many people have asked why equities aren't pricing in a recession if people like us think it's so likely. The main answer is two-fold; a) Equities tend not to fall much (if at all) in advance of a recession, but fall sharply in the first half of its arrival, and b) mega-cap tech has such a dominant weight in the S&P 500 that it can help the index march to a different beat.

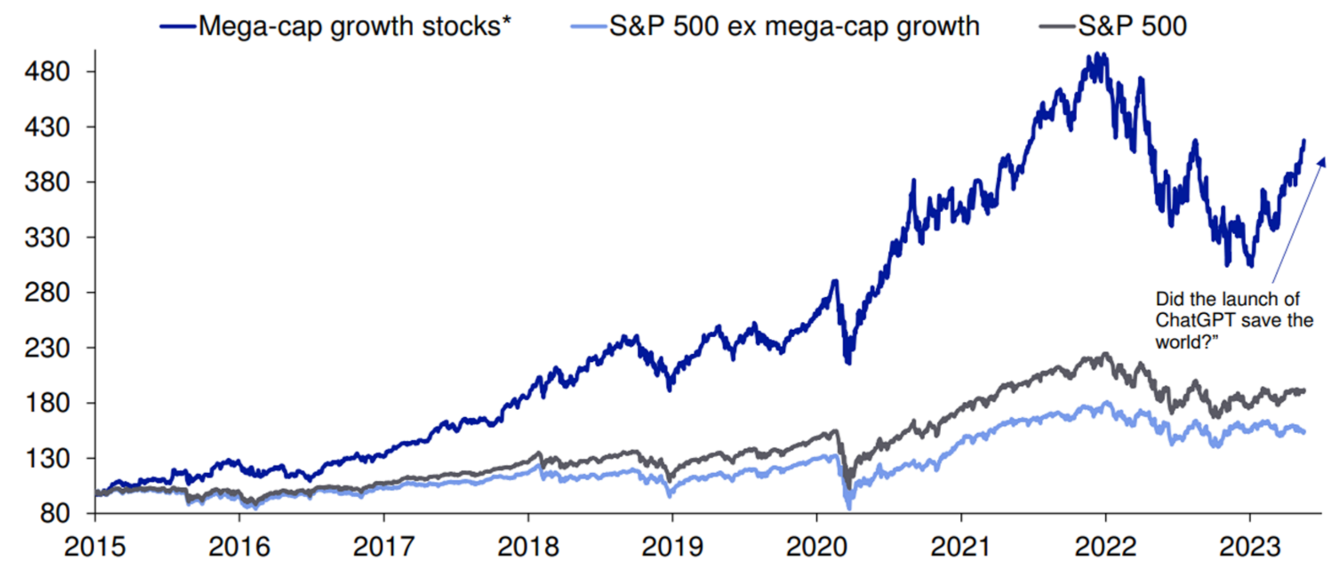
However if you strip out these 10 mega-cap tech stocks, the "S&P 490" is actually -0.5% YTD. So those ten mega cap tech stocks have increased the return of the index by 8.5pp so far this year and have turned a potentially disappointing year into a very decent one for trackers and those who simply view the S&P 500 as a bellwether for global risk.

You could read this two ways; 1) that the "real" economy stocks are treading water and reflecting the risk of tougher times ahead, or 2) that the surge in tech is helping keep financial conditions from tightening as much as it should be on a cyclical basis.

If you believe the second point could it help avert a recession?

Doubtful in our eyes but it is something to keep an eye on. As discussed at the top we are very enthusiastic on the impact of AI on productivity in the years ahead. However this is likely to play out comfortably beyond the immediate cycle.

Figure 1: Ten mega-cap tech stocks vs. S&P 500 and S&P 490 (ex-mega cap tech). Re-indexed, Dec 31 2014=100)



*MSFT, AAPL, AMZN, GOOGL, GOOG, FB, V, MA, NVDA, NFLX, ADBE

Jim Reid Deutsche Bank

2.

How Many Months on Average Between the Last Fed Hike in Cycle and the First Cut Thereafter

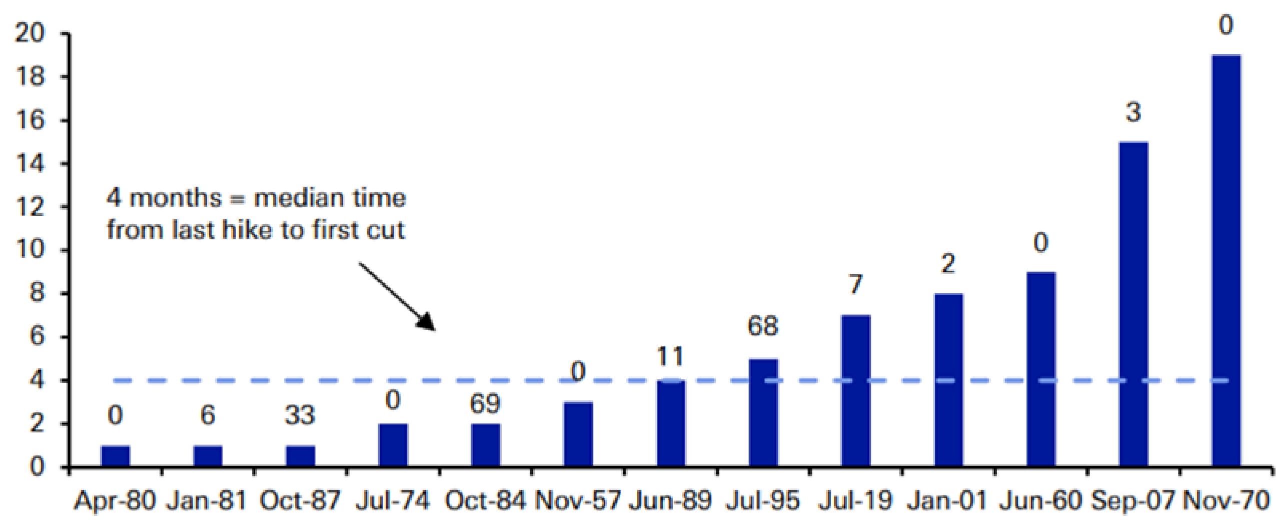
Jim Reid Deutsche Bank I've done a lot of thinking recently as to whether the market has been crazy or not after the SVB collapse to price in imminent Fed cuts when the hiking cycle hasn't yet officially finished. The reality is that the market probably got ahead of itself in the immediate aftermath, but more recently has been closer to being in line with history.

Today's CoTD shows (in order) how many months there were between the last Fed hike in a cycle and the first cut thereafter. There is quite a wide bid-offer and every cycle is different, but the average gap is around 6 months, with the median 4 months. So if May was the last hike then median/average history would take us to September/October. Given the first cut is now fully priced by the November meeting (no meeting in October) it's hard to criticize too heavily. DB thinks it'll be in Q1 2024.

Of the 13 Fed cycles we've analyzed here the annotated numbers on the graph show that 5 first cuts occurred when the recession had already started. A further two within 3 months. 2 more saw the recession start 6-7 months later, 1 more 11 months later and 3 outliers where the recession only started 33-69 months later. So most but not all (7/13) saw the first cut occur within 3 months of the subsequent recession.
Given where inflation currently is it's hard to see the Fed cutting without a recession being imminent or obvious to them. Although that's not the case at the moment, given the house view of it starting in Q4

we are probably in the right ball park for pricing in the first cut even if you could argue over the finer details.

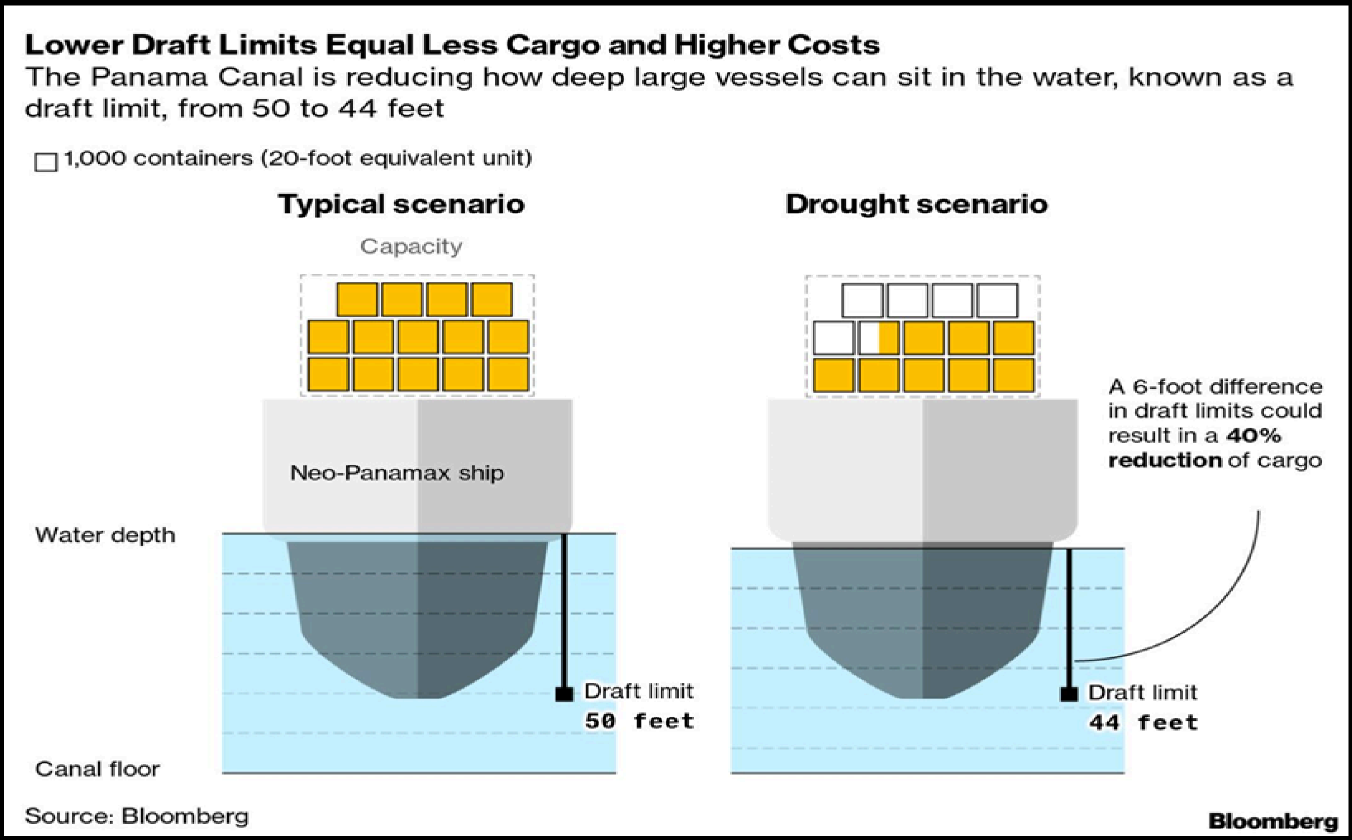
Figure 1: Months from last hike to first cut (bars), and from first cut to recession (labels)



Source: NBER, Bloomberg Finance LP, Haver Analytics, Deutsche Bank

3.

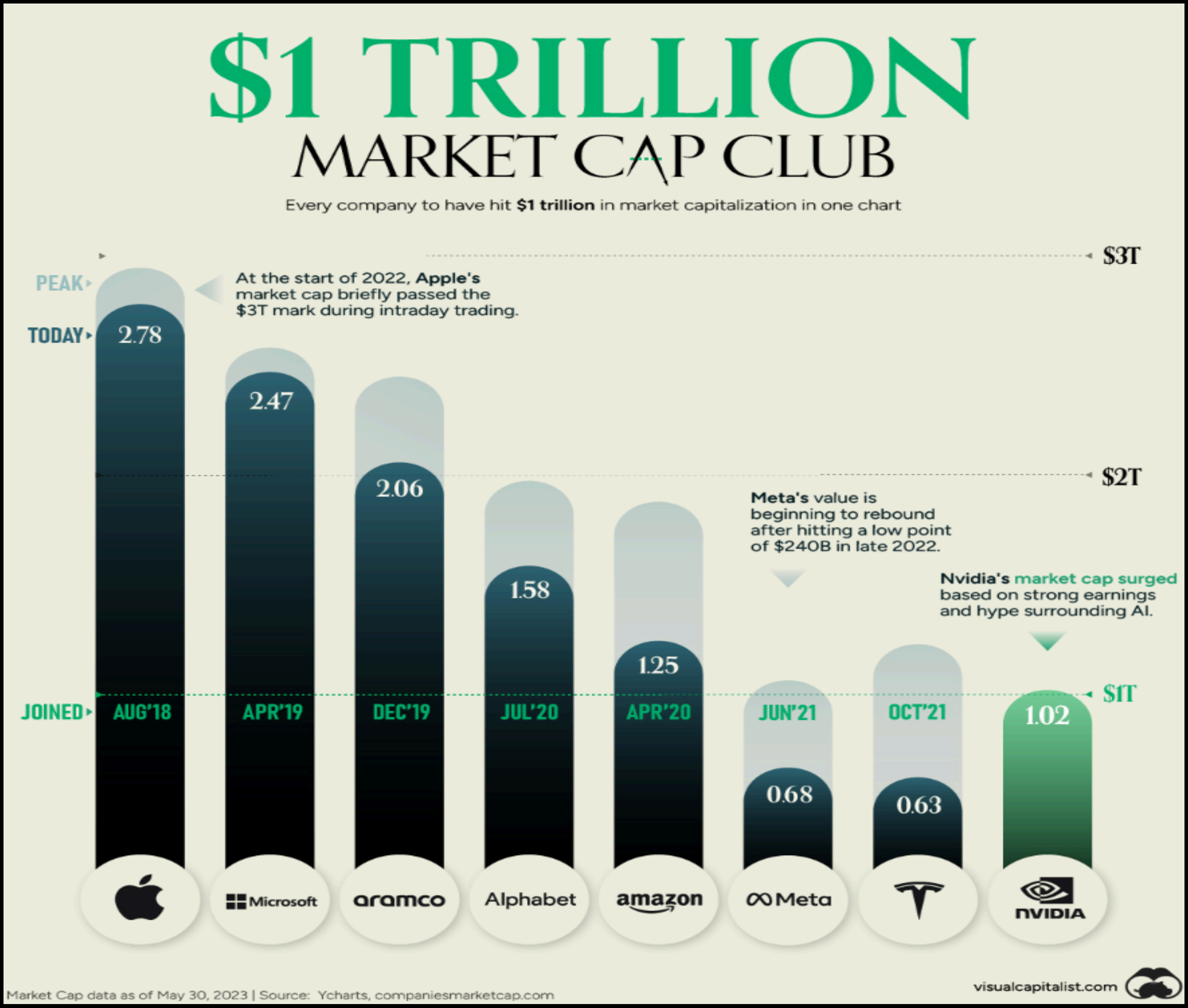
A new source of inflation is coming from the Panama Canel due to drought there it is not deep enough for a fully loaded cargo ships. Panama has been used more of late due to the labor disputes on the west coast ports, now ships might have to go to the Suez Canal, which takes longer and is risker.



[Supply Chain Latest: Panama Canal and West Coast Dockworkers Strike - Bloomberg]()

4.

While Visual Capital does a good job of presenting a bull and bear case for big tech, looking at their second chart below (P/E and Net Profit Margins), it seems to me that Nvidia is a good short.

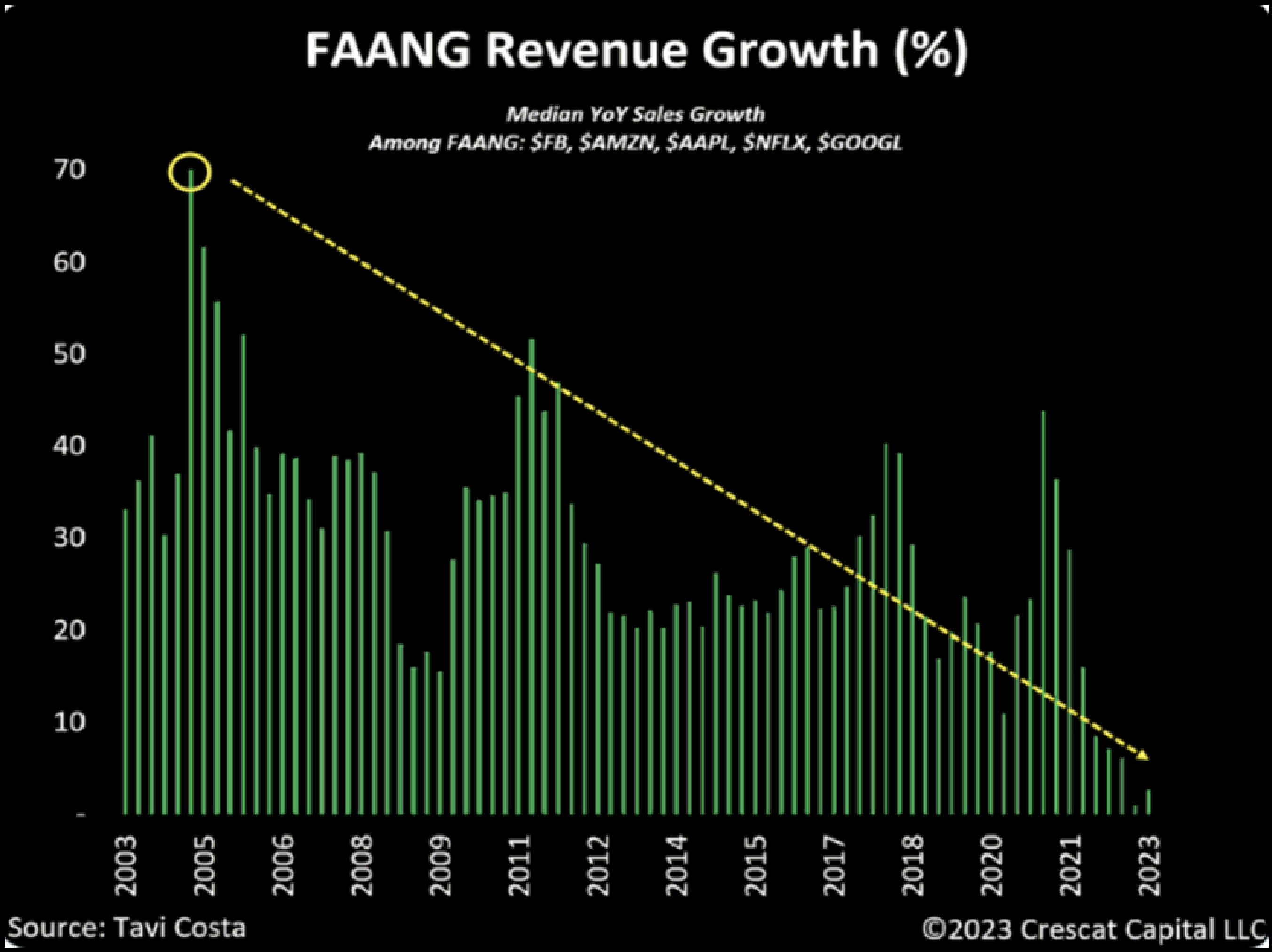


[Nvidia Joins the Trillion Dollar Club (visualcapitalist.com)]

	P/E Ratio	Net Profit Margin (Annual)
Apple	30.2	25.3%
Microsoft	36.1	36.7%
Aramco	13.5	26.4%
Alphabet	28.2	21.2%
Amazon	294.2	-0.5%
Meta	33.9	19.9%
Tesla	59.0	15.4%
Nvidia	214.4	16.19%

5.

Here is an issue. FANG stocks keep going up in value but the growth in their revenues does not account for the growth in valuation.



Source: Otavio Costa at Crescat Capital
https://twitter.com/search?q=crescat%20capital&src=typed_query

6.

The world appears to all have low unemployment rates.

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Unemployment Rate

World Europe America Asia Africa Australia G20

Country	Last	Previous	Reference	Uni
Singapore	1.8	2	Mar/23	%
Switzerland	2	2	Apr/23	%
Mexico	2.4	2.7	Mar/23	%
South Korea	2.7	2.6	Mar/23	%
Japan	2.8	2.6	Mar/23	%
United States	3.4	3.5	Apr/23	%
Australia	3.5	3.5	Mar/23	%
Netherlands	3.5	3.5	Mar/23	%
Russia	3.5	3.5	Mar/23	%
United Kingdom	3.8	3.7	Feb/23	%
Saudi Arabia	4.8	5.8	Dec/22	%
Canada	5	5	Apr/23	%

[Unemployment Rate - Countries - List (tradingeconomics.com)]

7.

The USA is again the largest oil producer.

TRADING ECONOMICS Calendar News Markets Indicators

Crude Oil Production

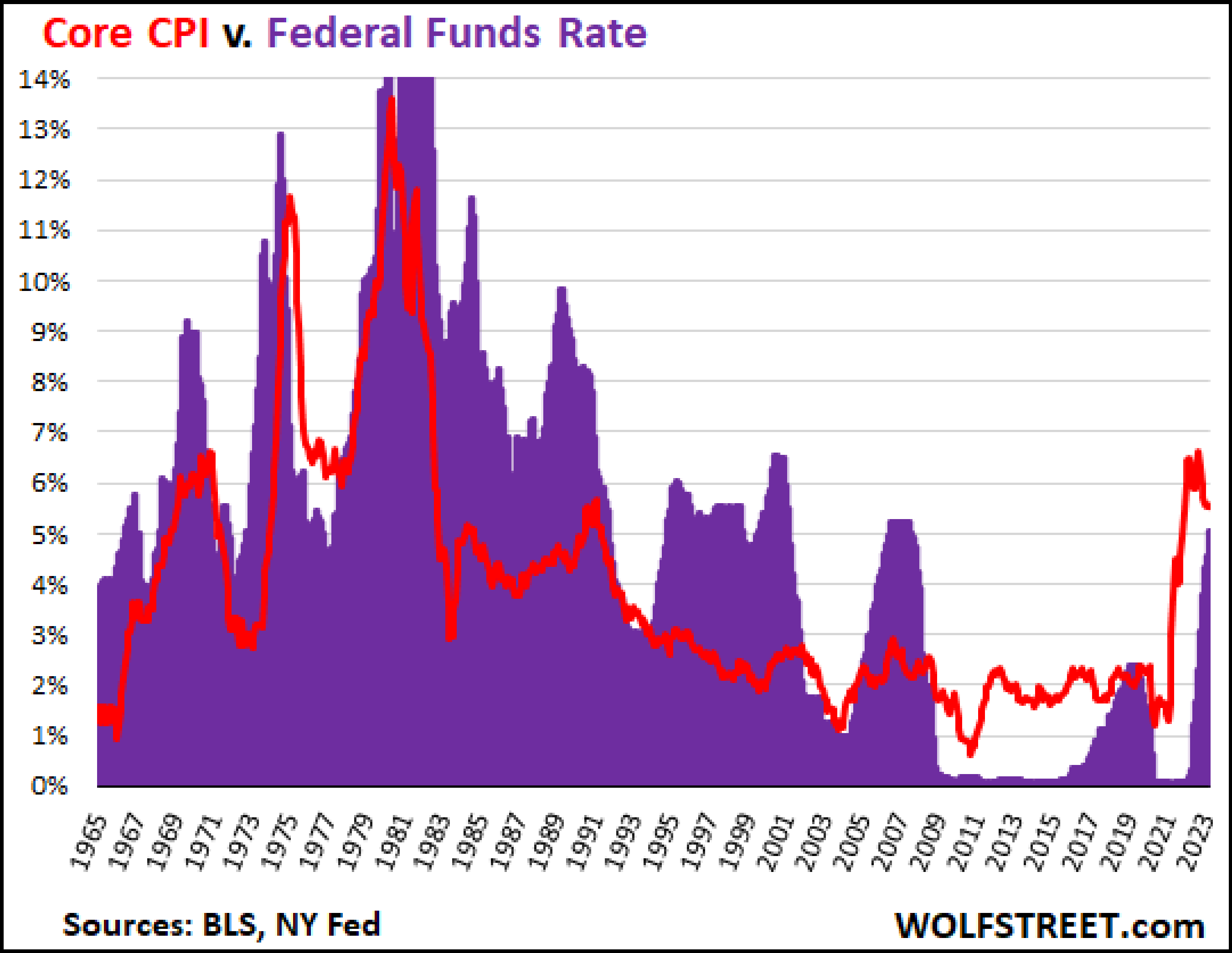
World Europe America Asia Africa Australia G20

Country	Last	Previous	Reference	Unit
United States	12483	12462	Feb/23	BBL/D/1K
Saudi Arabia	10464	10450	Mar/23	BBL/D/1K
Russia	10327	10352	Jan/23	BBL/D/1K
Canada	4642	4627	Jan/23	BBL/D/1K
Iraq	4200	4339	Mar/23	BBL/D/1K
China	4168	3973	Jan/23	BBL/D/1K
Brazil	3274	3074	Jan/23	BBL/D/1K
United Arab Emirates	3045	3041	Mar/23	BBL/D/1K
Kuwait	2676	2676	Mar/23	BBL/D/1K
Iran	2567	2574	Mar/23	BBL/D/1K
Kazakhstan	1935	1948	Jan/23	BBL/D/1K
Mexico	1803	1751	Jan/23	BBL/D/1K
Norway	1790	1797	Jan/23	BBL/D/1K
Qatar	1322	1322	Jan/23	BBL/D/1K

Crude Oil Production - Countries - List (tradingeconomics.com)

8.

The chart below does a good job showing the history of how the Fed tackles inflation, they raise rates above inflation to stamp it out. Therefore, either the Fed will keep raising rates, or inflation will come down enough they do not have to.



[The Fed's Interest Rates Are still Fueling Inflation rather than Dousing it, and People Getting Used to this Inflation | Wolf Street]

Food for Thought:

Dangerously Misleading Debt Data

The most powerful form of lie is the omission – George Orwell

Debt poses a serious problem in most developed countries, and in many developing ones. But statistical omission and obfuscation hide the true problem. Rapidly rising numbers of old age dependents plus unfunded pay-as-you-go social security schemes are already causing unrest. More is likely to follow as state backed promises of medical and old age support become impossible to fulfil.

The problem is far greater than official debt figures suggest. Government debt data in most countries massively understates the real situation. Almost all commentary on country debt is focused on official

Government country debt as a percentage of GDP. But this number represents only a fraction of real country indebtedness. More than 20 years ago the problem was illustrated vividly by Kotlikoff and Burns, in a book presciently called The Clash of Generations:

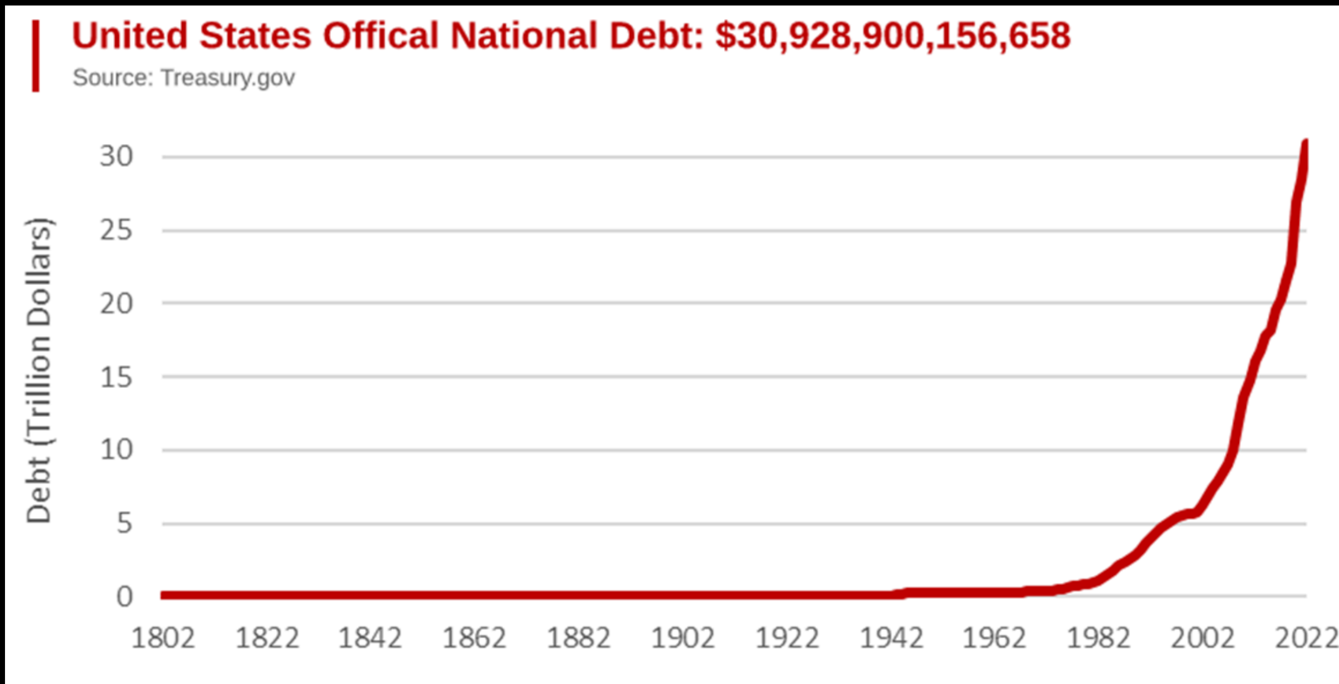
"Virtually all of Uncle Sam's IOU's are off the books. They are unofficial, informal, implicit, hidden away in odd places like alcoholic's bottles. But call them what you will, paying 78 million baby boomers their Social security, Medicare and Medicaid benefits is a very real obligation."

Kotlikoff and Burns calculated actual indebtedness when unfunded obligations are included (they called it the Fiscal Gap) to be many times the official debt level that generates so much angst, and far above the 100% public debt-to-GDP level that has often been thought of as the road to perdition in debt terms. They acknowledged that many heroic assumptions have to be made to produce such calculations, not least the level of economic growth and inflation either or both of which can reduce the debt burden. But the "fiscal gap" is clearly large under any set of assumptions.

As Nouriel Roubini pointed out in his 2022 book Megathreats, "...unfunded liabilities deriving from aging and a pay-as-you-go welfare system for the elderly - pension, health care, disability benefits and other services - are huge and exploding over time, especially in advanced economies, but also in some aging emerging markets ... Longer life expectancies and new medical technologies, once a dream, now pose a nightmare."

Put simply, rising longevity plus static levels of retirement around 65, coupled with rapid reductions in family size, are producing an ever larger percentage of old people dependent on benefits, (to be paid for by a shrinking workforce), the cost of which already far exceeds current social security taxes. Yet opposition to potential solutions is fierce. Even a very modest attempt at raising the retirement age from 62 to 64 in France recently produced massive opposition including street riots. Solutions are unlikely to include faster economic growth to augment the size of the economic pie for a variety of reasons. Not least that rising interest rates are increasing the funding costs of official debt to levels that are already consuming big chunks of taxation in many countries, so reducing income might otherwise have been used to foster faster economic growth.

See more data...



The End

Cheers,

Stuart 415-674-4004 3 R's of life – **R**ethink, **R**eevaluate, & **R**eallocate

"Bulls make money, bears make money, pigs get slaughtered."
Economics-List

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