Macro Report 4-8-2023

****NOT INVESTMENT ADVICE

Macro/Cyclical Regime:

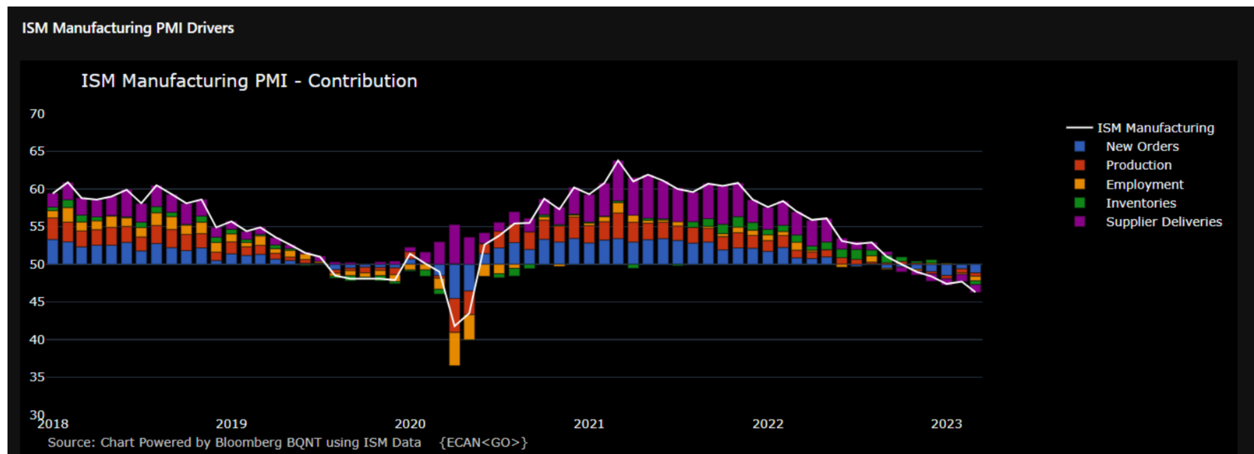
We remain in a regime where growth is skewed to the downside on a cyclical basis. We experienced a marginal acceleration and surprise to the upside in growth during Q1 of 2023. However, this “goldilocks” is proving to be transitory as expected.

The most recent ISM releases (both manufacturing and services) surprising to the downside are one of the indications of this:

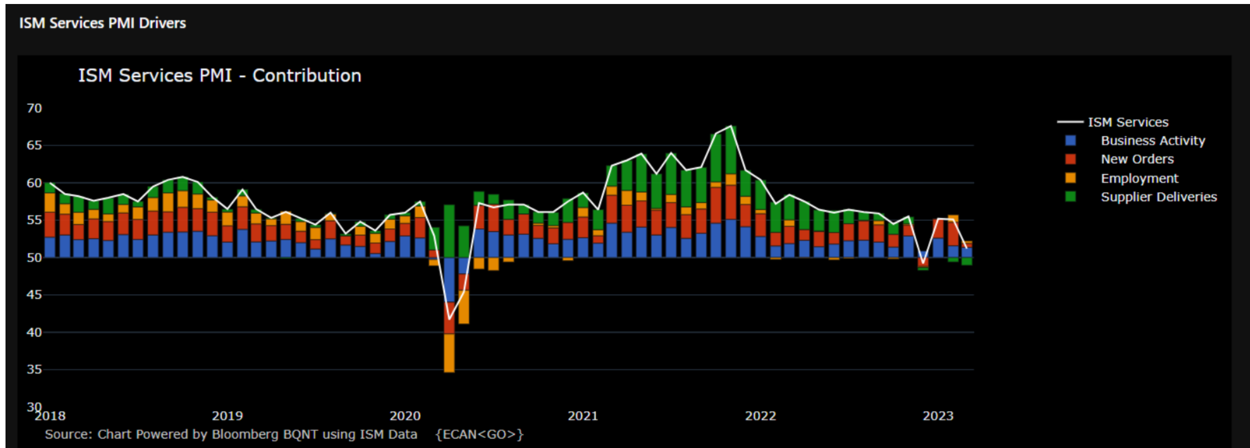
	Date Time	A	M	R	Event	Period	Surv(M)	Actual	Prior	Revised
21)	04/03 09:45				S&P Global US Manufacturing PMI	Mar F	49.3	49.2	49.3	--
22)	04/03 10:00				Construction Spending MoM	Feb	0.0%	-0.1%	-0.1%	0.4%
23)	04/03 10:00				ISM Manufacturing	Mar	47.5	46.3	47.7	--
24)	04/03 10:00				ISM Prices Paid	Mar	51.1	49.2	51.3	--
25)	04/03 10:00				ISM Employment	Mar	--	46.9	49.1	--
26)	04/03 10:00				ISM New Orders	Mar	47.5	44.3	47.0	--
27)	04/03				Wards Total Vehicle Sales	Mar	14.50m	14.82m	14.89m	--

	Date Time	A	M	R	Event	Period	Surv(M)	Actual	Prior	Revised
40)	04/05 10:00				ISM Services Index	Mar	54.4	51.2	55.1	--
41)	04/05 10:00				ISM Services Prices Paid	Mar	--	59.5	65.6	--
42)	04/05 10:00				ISM Services Employment	Mar	--	51.3	54.0	--
43)	04/05 10:00				ISM Services New Orders	Mar	--	52.2	62.6	--

Here is the manufacturing ISM which is in contraction:

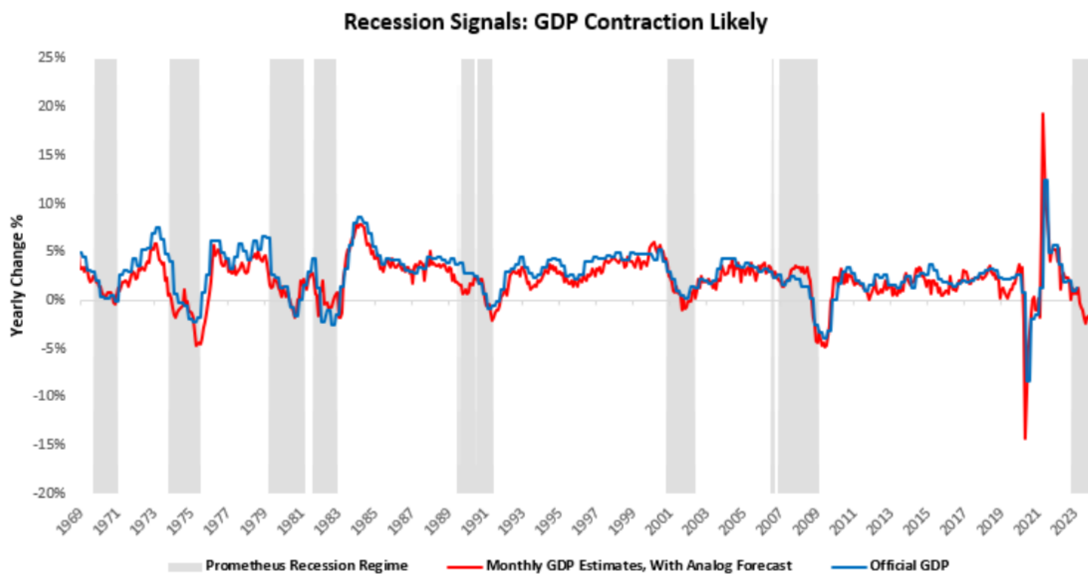


Here is the services ISM which is still marginally positive but the most recent print surprised to the downside:



Here is the Prometheus nowcast indicating recessionary territory:

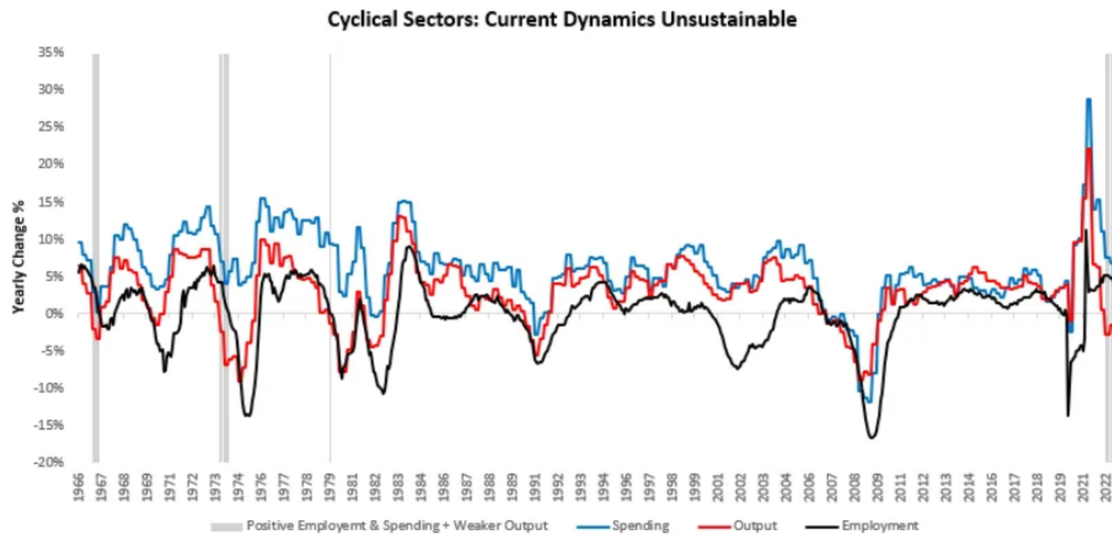
As noted in our headline takeaways, our systems now place the economy in a recessionary regime:



Based on our estimates, GDP will enter a contraction in H2 of this year, creating an opportunity for our Prometheus Cycle Strategies in equity markets.

We have seen a considerable slowdown in cyclically sensitive parts of the economy due to rate hikes and negative real corporate profits that are exerting pressure on real output. However, the negative implications of these dynamics have timelags that are yet to be felt. We are likely nearing the end of this timelag where we will begin experiencing revisions in earnings and deterioration in the labor market.

Zooming out, the gap between activity in cyclically sensitive parts of the economy and their employment remains large, and therefore the pressure on employment remains in place:

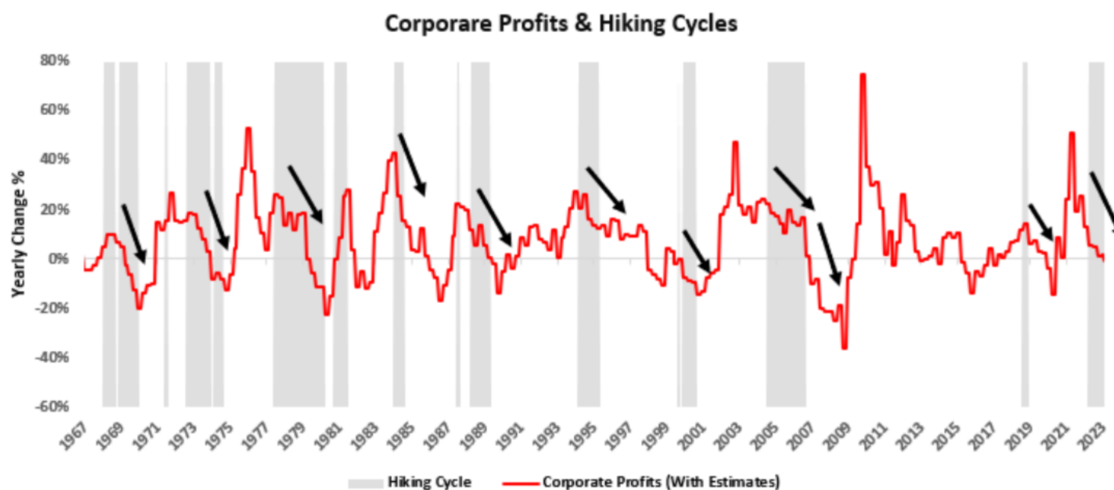


Spending on the cyclical sector remains positive in nominal terms, but the output is contracting. The purpose of employment is output, and as real demand continues to weaken, employment is likely to follow.

Another great chart by Prometheus:

Pressures On Business Activity Will Drive Activity Lower

Economic cycles generally follow cause-and-effect templates, and this cycle has been true to the archetype. Late in the economic cycle, as nominal activity rises, these nominal gains flow to companies, benefiting from higher revenues and potentially improved margins. As this nominal activity has a large inflation component, policymakers step in to try and tap the brakes on the economy. This usually takes the form of a hiking cycle in interest rates. Over time, this increase in interest rates leads to pressure on the economy, which results in a contraction in profits. These profit pressures eventually lead to lay-offs, which precipitate a recession. Below, we show the big-picture view of how hiking cycles have typically preceded profit contractions:



The key thing to note in this type of situation is that by the time actual revisions in earnings take place and the unemployment rate rises, financial markets have already priced in this reality. Therefore, we need to correctly identify the current conditions in order to determine if they are preconditions for a potential future move. From this framework, we can identify if specific asset markets are “mispriced” compared to what is likely to take place.

When we look at the economic surprise index, we can see it has been chopping with a marginal surprise to the upside during Q1. As we move forward, we want to look for surprises to the downside across economic data, specifically labor market data:

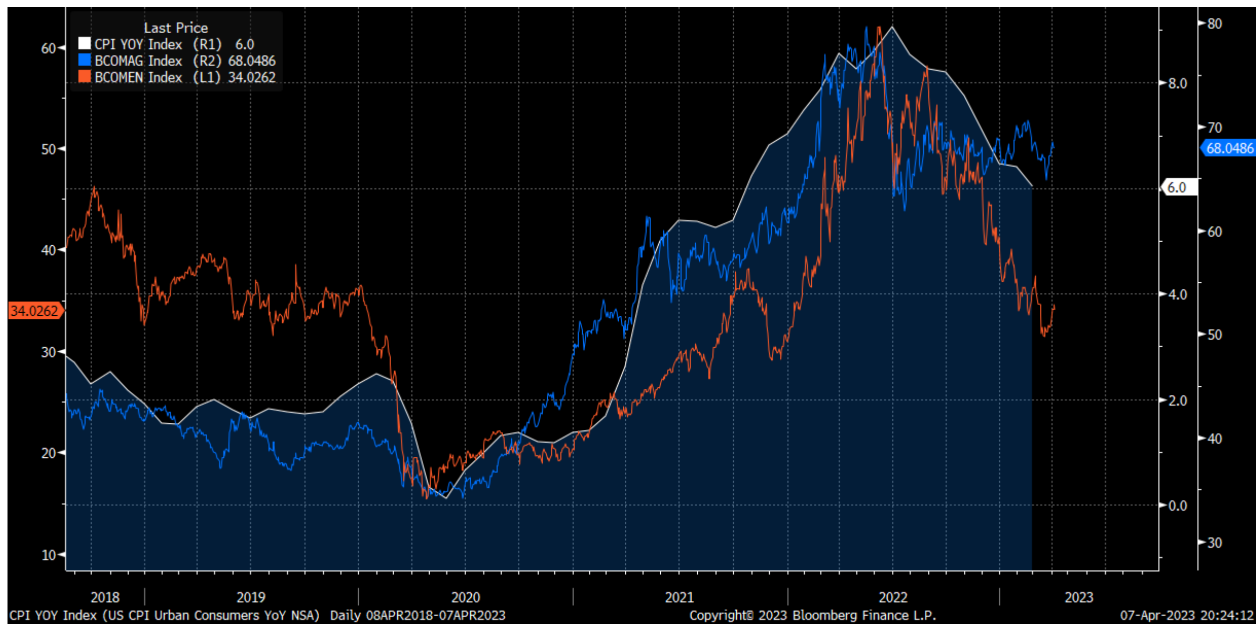
Bottom line, growth is skewed to the downside on a cyclical basis and it appears that there is a high probability of it surprising to the downside in H2.

Inflation:

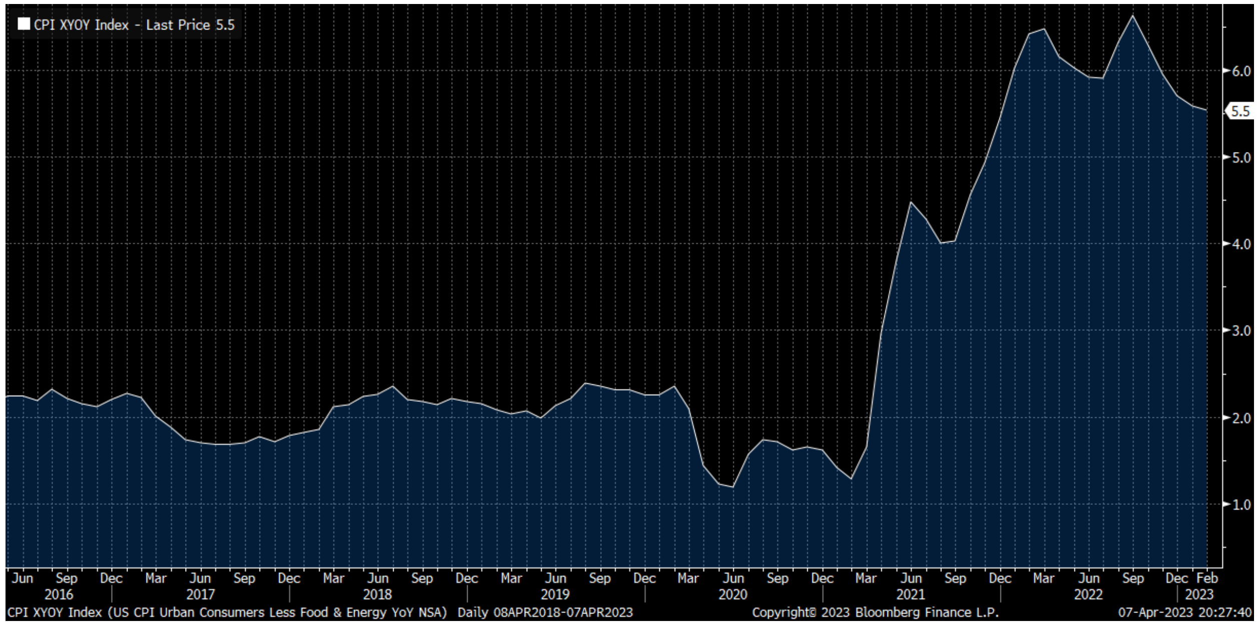
There are two key things to note with inflation:

First, headline CPI has decelerated due to food and energy costs falling. This was part of reason why we had a marginal reacceleration in growth during Q1, food and energy prices fell which allowed the consumer to spend more on discretionary items.

While the demand side of the equation is decelerating, we still need to monitor any potential supply shocks that could cause an acceleration in headline CPI.
If core CPI remains elevated and another shock occurs to the commodity complex, a reaccelerttion is likely. Therefore, monitoring the upside risk for inflation is still important in this regime. Chart: headline CPI (white line), Bloomberg Ags index (blue), and Bloomberg Energy Index (orange).

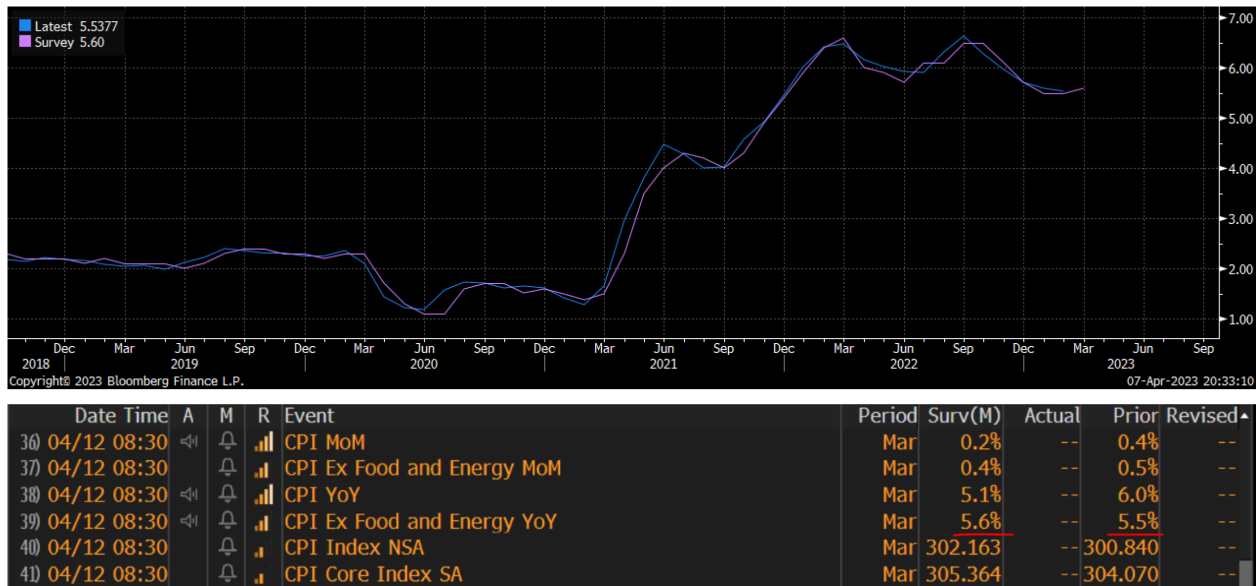


Second, headline CPI is still very elevated due to the underlying drivers.



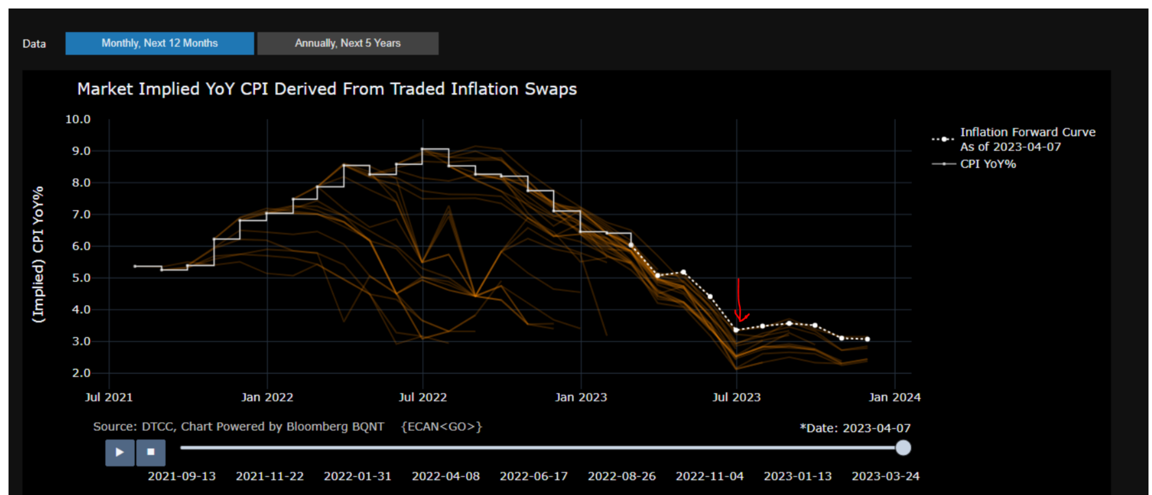
Due to the nature of inflation in this environment, the FED and the market have focused on the core portions of CPI. This is evidenced by the top in yields occurring when core CPI topped as opposed to headline.

These underlying drivers in core CPI take longer to process price changes which means dramatic and quick drops in core are unlikely. Consensus is actually expecting a marginal increase in YoY core CPI at the next print.

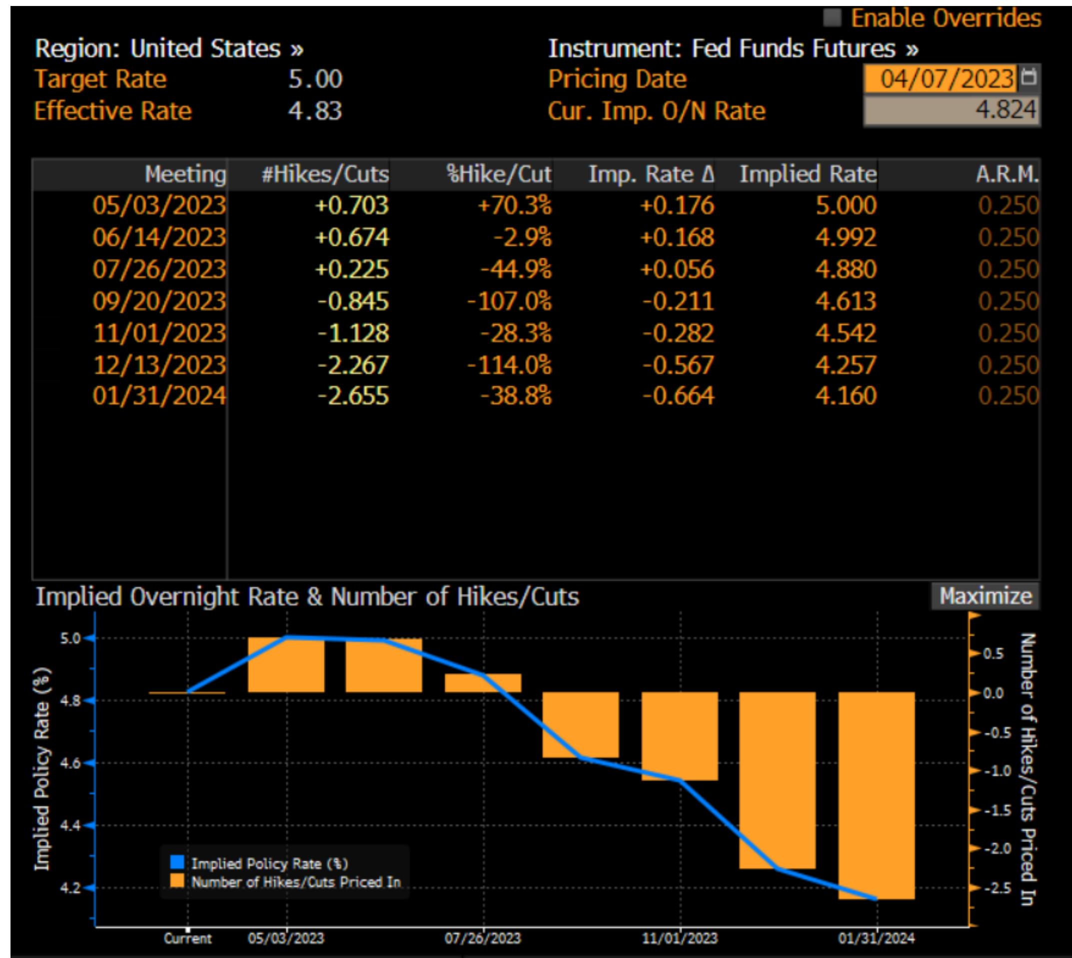


	Date Time	A	M	R	Event	Period	Surv(M)	Actual	Prior	Revised
36)	04/12 08:30				CPI MoM	Mar	0.2%	--	0.4%	--
37)	04/12 08:30				CPI Ex Food and Energy MoM	Mar	0.4%	--	0.5%	--
38)	04/12 08:30				CPI YoY	Mar	5.1%	--	6.0%	--
39)	04/12 08:30				CPI Ex Food and Energy YoY	Mar	5.6%	--	5.5%	--
40)	04/12 08:30				CPI Index NSA	Mar	302.163	--	300.840	--
41)	04/12 08:30				CPI Core Index SA	Mar	305.364	--	304.070	--

As we consider this situation with both growth and CPI, there are several things we need to consider that lead us to asset markets:

1. Due to the core CPI dynamics, we are unlikely to see fast deceleration in CPI. However, the market is pricing a considerable deceleration. Just above 3% by July.
    a. 

2. Ever since the SVB banking crisis, the market has priced the probability of cuts into the end of the year via the forward curve. Given the NFP data we saw Friday and CPI print we are likely to see next week, a 25bps hike at the next FOMC is likely (excluding additional credit stress occuring).

a. 

Enable Overrides

Region: United States » | Instrument: Fed Funds Futures »

Target Rate 5.00 | Pricing Date 04/07/2023

Effective Rate 4.83 | Cur. Imp. O/N Rate 4.824

Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.
05/03/2023	+0.703	+70.3%	+0.176	5.000	0.250
06/14/2023	+0.674	-2.9%	+0.168	4.992	0.250
07/26/2023	+0.225	-44.9%	+0.056	4.880	0.250
09/20/2023	-0.845	-107.0%	-0.211	4.613	0.250
11/01/2023	-1.128	-28.3%	-0.282	4.542	0.250
12/13/2023	-2.267	-114.0%	-0.567	4.257	0.250
01/31/2024	-2.655	-38.8%	-0.664	4.160	0.250

3. We are moving into a recessary regime with inflation still very elevated. This introduces additional risks for possible reacceleration of inflation if the FED cuts rates to relieve credit stress. Additionally, since Powell is unlikely to cut preemptively due to the level of inflation, there is likely a window of time where risk assets face a considerable downside risk as credit spreads expand but Powell doesn't cut immediately. However, if Powell does cuts, the market is likely to wipsaw with incredible speed since it has become so leveraged to FED actions. Any equity shorts held during this time could get squeezed depending on the degree of credit stress occurring.

As we look at risk assets within this framework, equities are priced for a soft landing and bonds are priced (or have the initial pricing) for a recession. The expectations of stocks and bonds appear to "contradict" one another.

Equities:

- When we look at the S&P500, earnings have not been revised down yet and we are at a short term overextension in terms of valuations and momentum:

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- When the forward curve repriced during the SVB crisis, this provided a considerable boost to the valuation component of tech stocks. When we look at the NASDAQ and Semiconductors, they are both considerably overextended.

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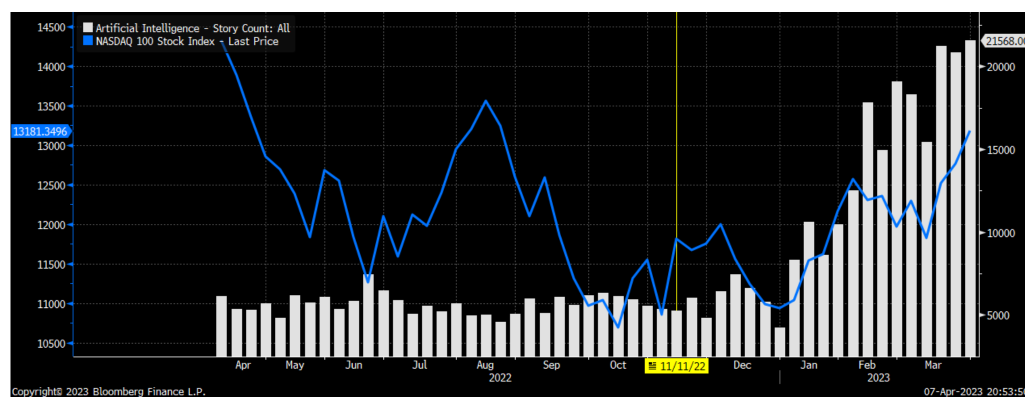
- The artificial intelligence narrative has only added fuel to the rally: here is AI story count and the NASDAQ



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- In sum, equities are priced for a very optimistic scenario that appears unlikely given the current skew of growth and corporate profits.

Bonds:

Given the price action of the forward curve, bonds have priced an initial deceleration in growth. However, there is a caveat with bonds. The forward curve is pricing cuts and a sharp fall in inflation. If we don't see a dramatic deterioration in the labor market, earnings and credit, then bonds could have a very chopy trend (even if that is an upward trend). Additionally, any significant bid in bonds is likely to occur as the FED cuts rates during considerable credit stress. If Powell lags in his action of cutting rates during a potential credit event, bonds could get ahead of themselves and have vicious pull backs.
Bottom line, the forward curve of rate cuts/hikes and inflation swaps needs to be monitored with the growth and credit situation.

One more note on price action: since the SVB crisis up to the most recent NFP print, we have seen longer duration bonds have greater positive momentum than the short end. It is likely that we see more of a pull back in the short end during the coming weeks. If at any time between now and the May 3rd FOMC, the market prices a high probability or perceived certainty of a 25bps hike, that is likely a short term bottom in bonds that should be bought.

This would express itself by the May contract going to 25bps:

Scenario Analysis: when we approach the scenarios that are likely to unfold there are several things to keep in mind and specific catalysts watch:

- Scenario 1: growth begins surprising to the downside across cyclical data points AND the labor market. Corporate profits decelerate and revisions occur during this earnings season. Credit spreads expand as the yield curve marginally steepens. The tech and AI narrative peak.
- Scenario 2: growth doesnt surprise to the downside or only surprises in cyclical components of the economy as the labor market remains strong. In this scenario earnings might remain flat and dependent on the inflation picture, some sectors might surprise to the upside. Credit spreads in this scenario are likely to fall or simply remain at their current level.
    - Inflation will be an important variable to monitor in connection with earnings to confirm whether the primary driver of asset markets is credit risk or duration risk.

Based on the evidence provided above, the risk/reward favors scenario 1. However, if we do not see clear confirmation of these signals in price action, the economic data, and earnings then the thesis should be reevaluated.

Catalysts:

There are 3 primary catalyst to keep in mind for realizing the price action provided in the scenarios above:

- The first catalyst is earnings during April and May: Here is the earnings calendar:

United States X | Earnings Rel... X | SPX Index X

Daily | Weekly | Monthly

Monday	Tuesday	Wednesday	Thursday	Friday
04/03/2023	04/04/2023	04/05/2023 1 Earnings Release	04/06/2023 2 Earnings Release	04/07/2023
04/10/2023	04/11/2023 1 Earnings Release	04/12/2023	04/13/2023 2 Earnings Release	04/14/2023 7 Earnings Release
04/17/2023 4 Earnings Release	04/18/2023 9 Earnings Release	04/19/2023 19 Earnings Release	04/20/2023 23 Earnings Release	04/21/2023 8 Earnings Release
04/24/2023 7 Earnings Release	04/25/2023 33 Earnings Release	04/26/2023 48 Earnings Release	04/27/2023 62 Earnings Release	04/28/2023 25 Earnings Release

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United States X | Earnings Rel... X | SPX Index X

Daily | Weekly | Monthly

Monday	Tuesday	Wednesday	Thursday	Friday
05/01/2023 8 Earnings Release	05/02/2023 30 Earnings Release	05/03/2023 47 Earnings Release	05/04/2023 45 Earnings Release	05/05/2023 28 Earnings Release
05/08/2023 2 Earnings Release	05/09/2023 8 Earnings Release	05/10/2023 8 Earnings Release	05/11/2023 2 Earnings Release	05/12/2023 2 Earnings Release
05/15/2023	05/16/2023 2 Earnings Release	05/17/2023 4 Earnings Release	05/18/2023 6 Earnings Release	05/19/2023 3 Earnings Release
05/22/2023	05/23/2023 3 Earnings Release	05/24/2023 6 Earnings Release	05/25/2023 3 Earnings Release	05/26/2023 4 Earnings Release
05/29/2023	05/30/2023	05/31/2023 3 Earnings Release		

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- We can see that the majority of earnings are in the last week of April and the first week of May.
- Watching OPEX on April 21st and 28th are likely to be important for option flows during this period of time as well:

- The second catalyst is the monetary policy releases. This includes the FED minutes on April 12th after CPI, and FOMC on May 3rd:

United States | Browse | 11:11:31 | 04/08/23 - 04/15/23
Economic Releases | All Economic Releases | View Agenda Weekly

	Date Time	A	M	R	Event	Period	Surv(M)	Actual	Prior	Revised
21)	04/10 10:00				Wholesale Trade Sales MoM	Feb	0.6%	--	1.0%	0.9%
22)	04/10 10:00				Wholesale Inventories MoM	Feb F	0.2%	--	0.2%	--
23)	04/11 06:00				NFIB Small Business Optimism	Mar	89.3	--	90.9	--
24)	04/12 07:00				MBA Mortgage Applications	Apr 7	--	--	-4.1%	--
25)	04/12 08:30				CPI MoM	Mar	0.2%	--	0.4%	--
26)	04/12 08:30				CPI Ex Food and Energy MoM	Mar	0.4%	--	0.5%	--
27)	04/12 08:30				CPI YoY	Mar	5.1%	--	6.0%	--
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30)	04/12 08:30				CPI Core Index SA	Mar	305.364	--	304.070	--
31)	04/12 08:30				Real Avg Hourly Earning YoY	Mar	--	--	-1.3%	--
32)	04/12 08:30				Real Avg Weekly Earnings YoY	Mar	--	--	-1.9%	--
33)	04/12 14:00				Monthly Budget Statement	Mar	-$302.0b	--	-$192.6	--
34)	04/12 14:00				FOMC Meeting Minutes	Mar 22	--	--	--	--

Calendar 2023

	Announcement Date	Time	Rate (%)	For	Against	Policy Concern
1)	February 1	14:00	4.50 - 4.75	12	0	--
2)	March 22	14:00	4.75 - 5.00	11	0	--
3)	May 3	14:00	--	--	--	--
4)	June 14	14:00	--	--	--	--
5)	July 26	14:00	--	--	--	--
6)	September 20	14:00	--	--	--	--
7)	November 1	14:00	--	--	--	--
8)	December 13	14:00	--	--	--	--

  - Especially around FOMC, there is a concentration of catalysts given the end of month OPEX and high concentration of earnings releases.
- The third catalyst is the economic data:
  - CPI is released this week and will likely push around the May SOFR contract for a 25bps hike at FOMC.

- Industrial production is released on Friday the 14th. If the CPI print comes in hot thereby pushing the May contract to a higher probability of 25bps, a surprise to the downside in industrial production could set a short term bottom in bonds. However, we will have to watch the data as it gets priced in.
- We also have inventories, durable goods orders and building permits releases the following week. The GDP and personal income and outlays data during the last week of April could be important depending on how the intermediate data prints occur.

Bottom line: there is a concentration of catalysts in the last week of April and first week of May. These should be monitored to confirm or falsify the thesis that growth is slowing and earnings are likely to be revised.

Signals and Flows to Monitor:

Stock Bond correlation: the stock bond correlation on the weekly timeframe remains positive. Watching this correlation as the catalysts above occur will be key for confirming or falsifying the base case scenario.

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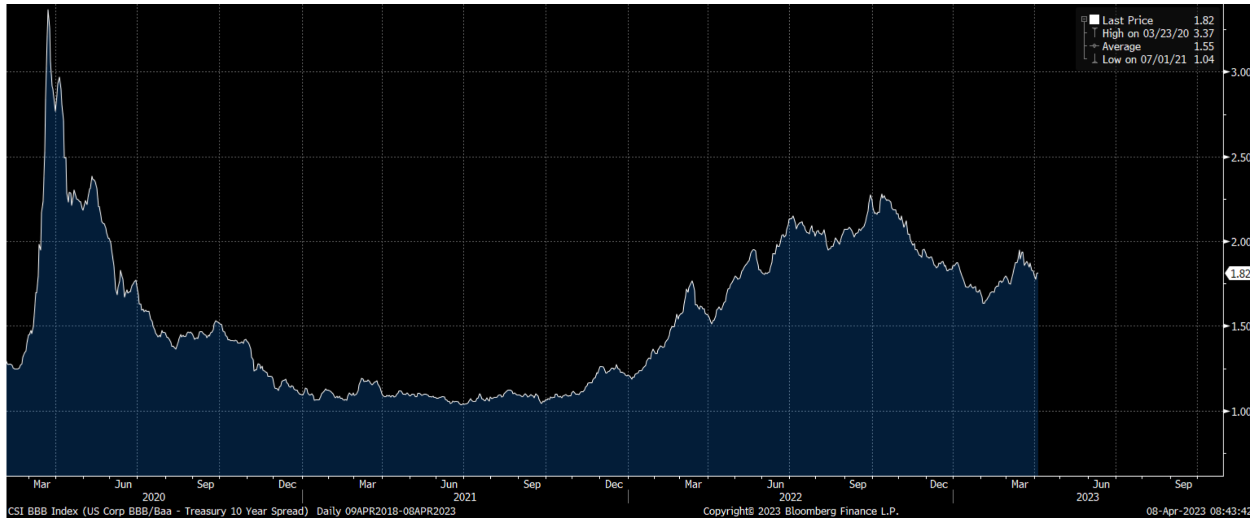
Credit risk: one of the primary things we want to see for scenario 1 to occur is the stock bond correlation turn negative AS credit risk increases. Since inflation remains elevated, we want to see credit risk in the market exert greater force than duration risk.

- BBB spreads increased during the SVB crisis and have remained marginally elevated since then:



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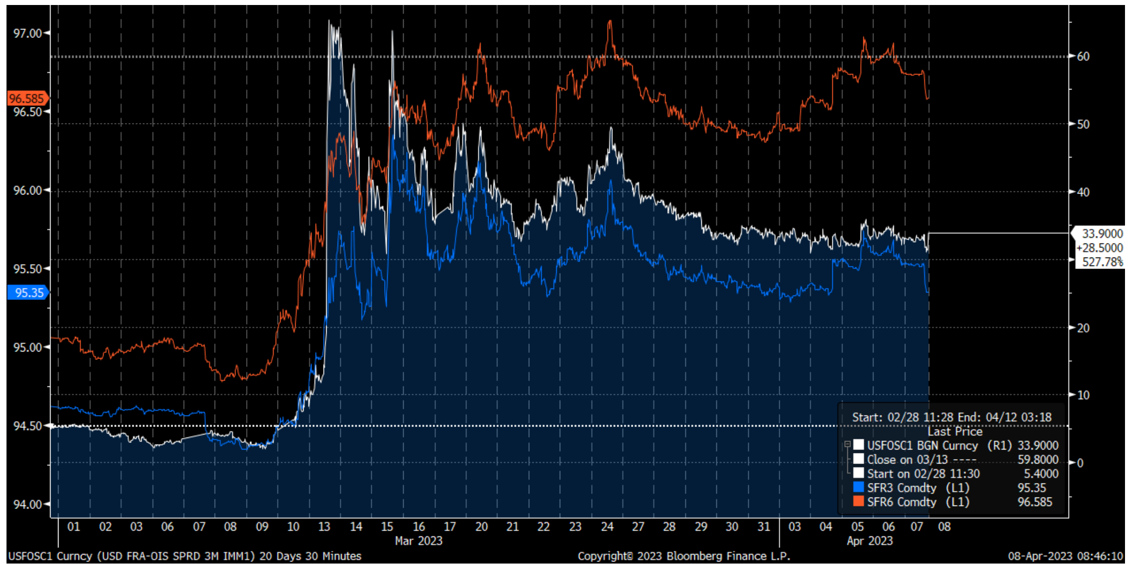
- A key relationship to monitor is the FRA-OIS spread with the SOFR contracts. As we had the spike during SVB, SOFR moved in lockstep. This is showing that as credit risk increased, there is a marginally dovish shift taking place on the forward curve. For a significant bond bid to occur, we need to see considerable credit stress take place that constrains the FED to cut.



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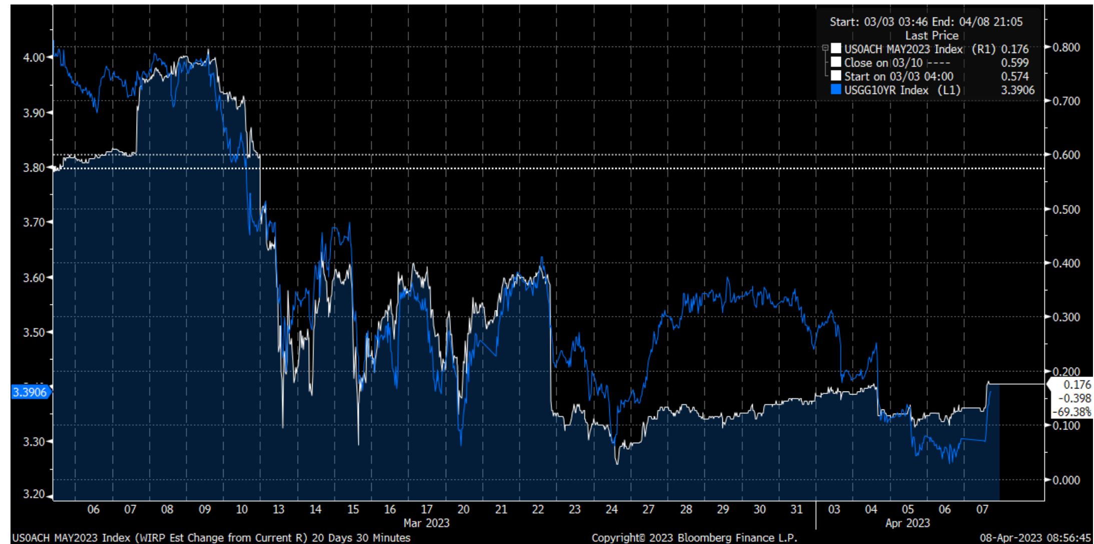
  - The 2nd and 3rd order effects of cutting while inflation is still elevated should be considered as we hit some type of extreme in credit stress.

Trades:

- **Long Bonds:** If we have a marginal pull back in bonds this week during CPI while the May contract prices a high probability of 25bps, this is likely a good entry for bonds. Here is the 10 year yield and the pricing of the May contract. An important thing to remember is that recent NFP was released on a holiday. Therefore, watching price action on Monday market open will be important.
  - 

- **Short equities:** we have not received a technical signal indicating a reversal in SPX yet which means entering a short is not prudent. However, when we see a reversal in SPX, shorting equities is likely to have an exceptional risk reward set up.
  - The primary signal I am looking for is the beginning of negative price action in the index with credit risk driving the VIX. I would want to see this price action be confirmed through an entire Globex session on high volume indicating larger players selling.
  - Watching for confirmation or falsification of the thesis above with the catalysts provided will be important for knowing if the trades are confluent with the macro view.

The quantitive strategies I am running will provide the specific buy and sell signals when they actually occur.

The big picture idea to end with is that cash/short term T-Bills remain the best place to allocate capital too given the current yield and skew of risk assets.

****NOT INVESTMENT ADVICE