A Market Note: The Reluctant Throes of Death…

As promised, we're sharing our latest premium **Market Note** with you. Our Collective members receive these reports weekly. They contain critical macro information to assist you in positioning your portfolio.

> **Note: The Collective is our premium service that offers institutional-level research, proprietary quant tools, actionable investment strategies, and a killer community of dedicated investors and fund managers from around the world.**
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> **Enrollment opens next week on Monday, April 24th. This is the best time to learn about the Collective and what it can do for your investing by clicking here.**

Vetus Opinio was an ancient Roman term used to describe a stubborn adherence to dated beliefs and a reluctance to change one's perspective due to a strong attachment to past practices.

It's an important factor in how market regimes change, a process we call the "Soros Cycle"; a derivative of the "Kuhn Cycle" which is a model of how paradigm shifts occur in science. I wrote about this years ago. Here's a snippet from that piece that's applicable to our discussion today.

"The Soros Cycle" plays out like this:

- ➢ An established regime exists and is comprised of a few dominant narratives. These narratives drive entrenched and overly optimized behavior —>
- ➢ Narrative drift begins as information starts to challenge accepted fact, which leads to data cherry-picking and growing cognitive dissonance —>
- ➢ Narrative crisis hits because reality has diverged too far from the dominant narrative — and the entrenched overly optimized behavior — for the regime to be sustained (Narratives always lag shifts in reality) —>
- ➢ Narrative revolution finally happens when reality forces the majority of people who were reluctant to admit they were wrong or change their behavior to adopt a new narrative/behavior set —>
- ➢ Regime change occurs when a new narrative becomes dominant and accepted by the majority of market participants. It's reinforced by reality which eventually brings us full circle back to the established regime.

A narrative crisis is the stage of the Soros Cycle where vetus opinio is most clearly visible. This is because it's here where the overly optimized behavior of the past is *most* at odds with the unfolding reality.

This takes shape as an equivalent of death throes in the markets. And it's why tops tend to be a process and not an event.

> *If a self-reinforcing process goes on long enough it must eventually become unsustainable because either the gap between thinking and reality becomes too wide or the participant's bias becomes too pronounced. Hence, reflexive processes that become historically significant tend to follow an initially self-reinforcing, but eventually self defeating, pattern. That is what I call the boom/bust sequence.* ~ George Soros

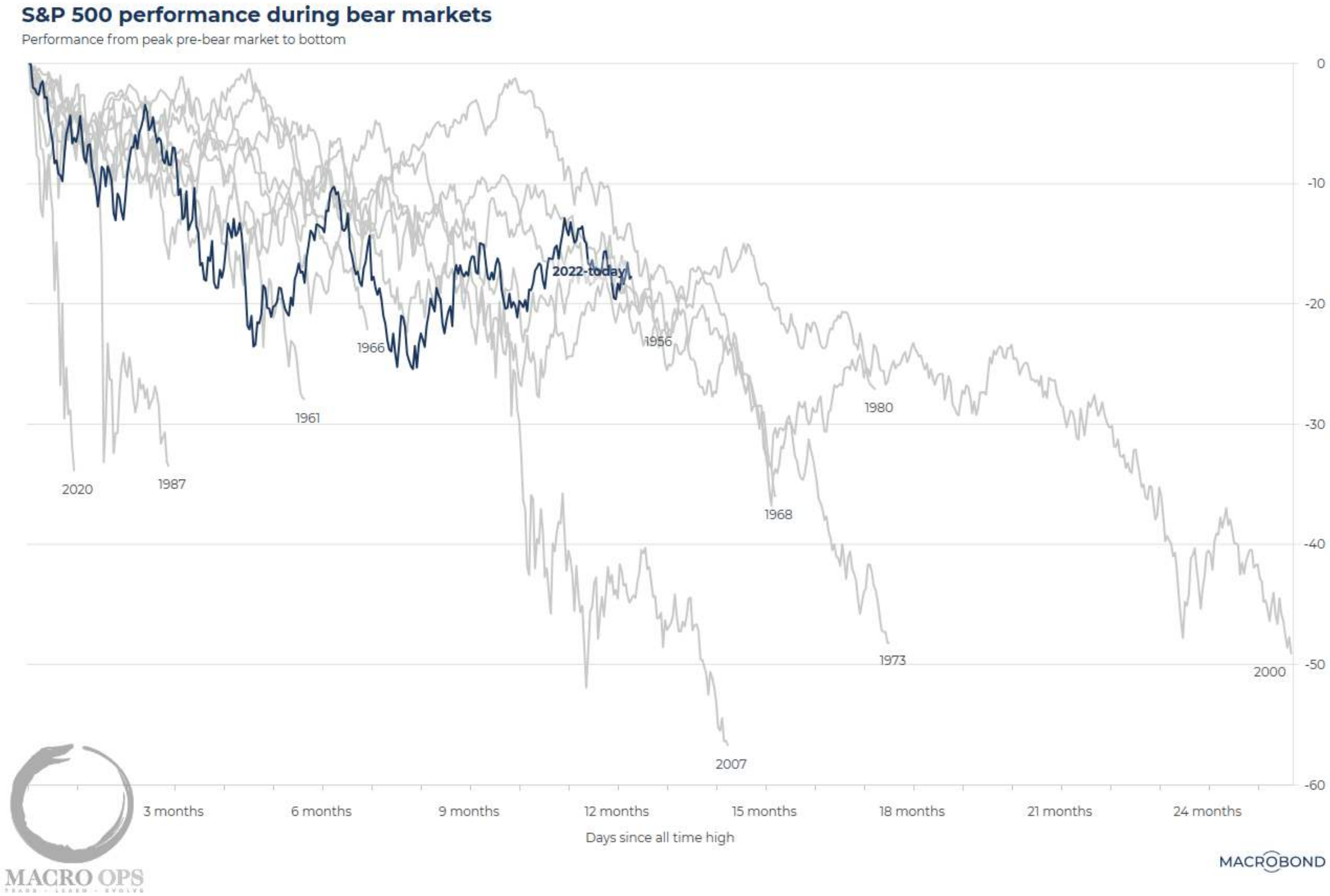
We're in the midst of these death throes now. This is the most challenging and unprofitable market regime, as it's characterized by high volatility and little trend direction.

This will eventually change as the narrative crisis shifts into its revolution phase, which will take the shape of an accelerated bear market wash out, as participants are forced to acknowledge the new reality.

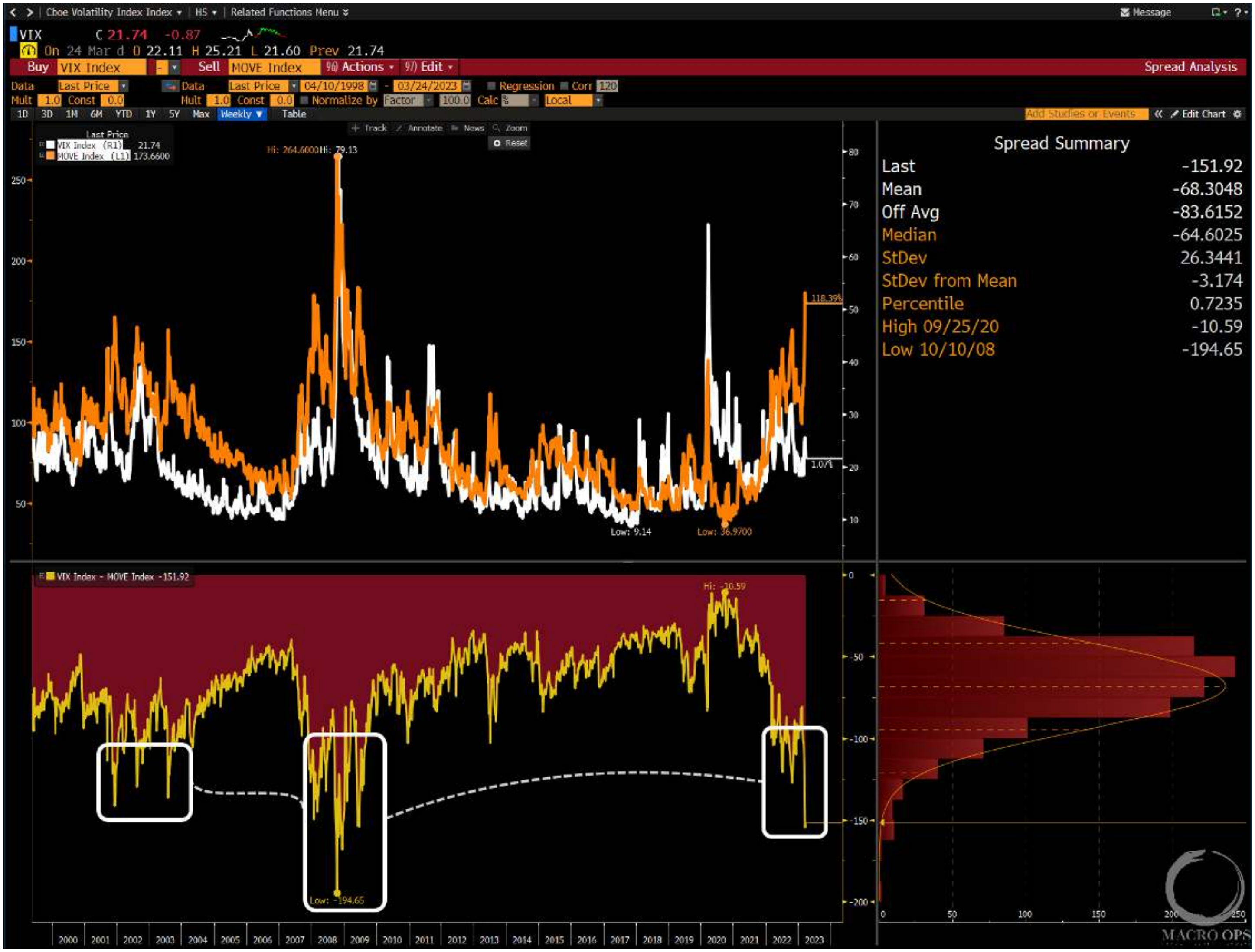
And this reality is: increasing illiquidity, a Fed hamstrung by persistent inflation, a late summer demand shock due to the exhaustion of consumer excess savings, and an unwind of the labor market, driving us into a hard landing recession.

Let's go through some charts…

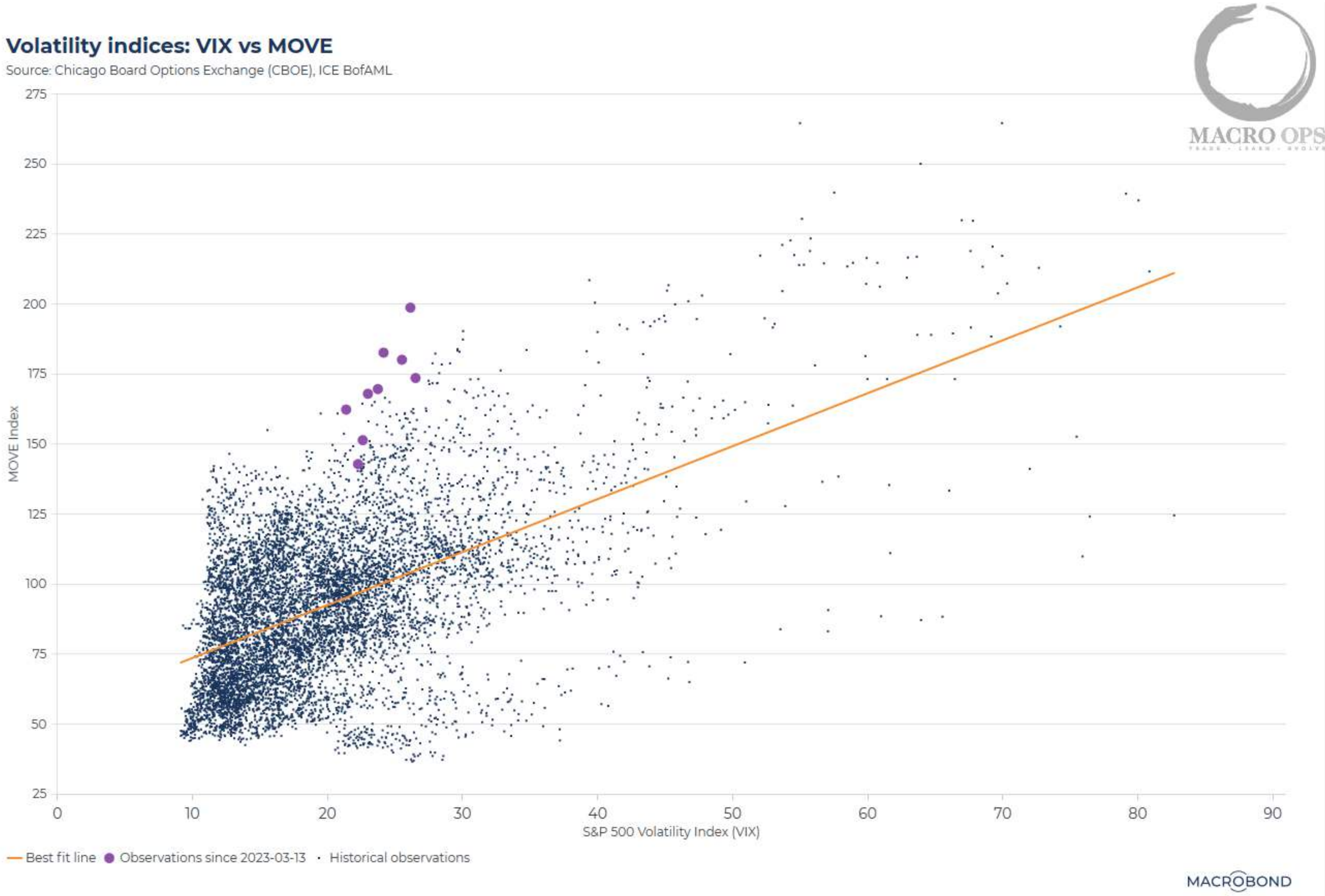
Here's every SPX peak-to-trough bear market over the last 70 years. The blue line is where we are today, which is very much in line with the average run so far. Because of US vs RoW capital concentration levels, I expect this bear to follow a path in duration and manner, most similar to the 2000 unwind, as it has a number of macro parallels to today.



The spread between the BofA MOVE index (a measure of bond volatility/orange line) and the VIX (a measure of equity volatility/white line) is <u>at its widest level since the 07'-09' bear.</u>



This next graph shows how rare this wide of a spread is. The purple dots are the most current instances.



Why is this important?

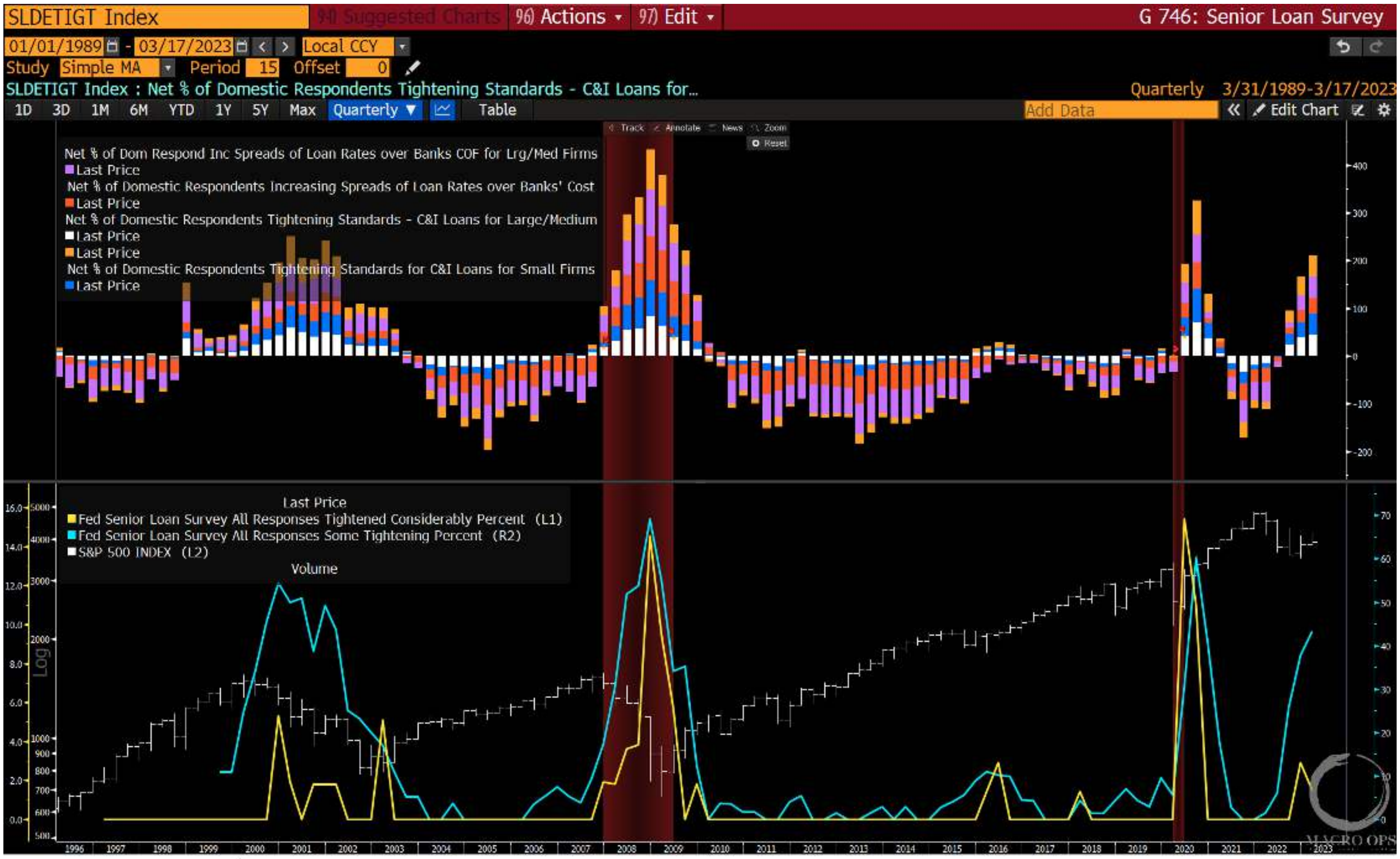
Everything in markets is relative. Bonds set the foundation for the pricing of everything else. High volatility in bonds leads to increasing amounts of uncertainty in the broader market. Historically, this gap is closed by equity volatility catching up to bond vol.

The thing that will drive this spike in equity vol is the same thing that drives all major bear markets, tightening financial conditions. You know, the whole Buffettism of "you never know who's swimming naked until the tide goes out."

Well, we've already seen a few players caught without their trunks; FTX, SVIB, Signature, etc… And we're going to find out there were plenty of others as liquidity is going to get much tighter over the following two quarters.

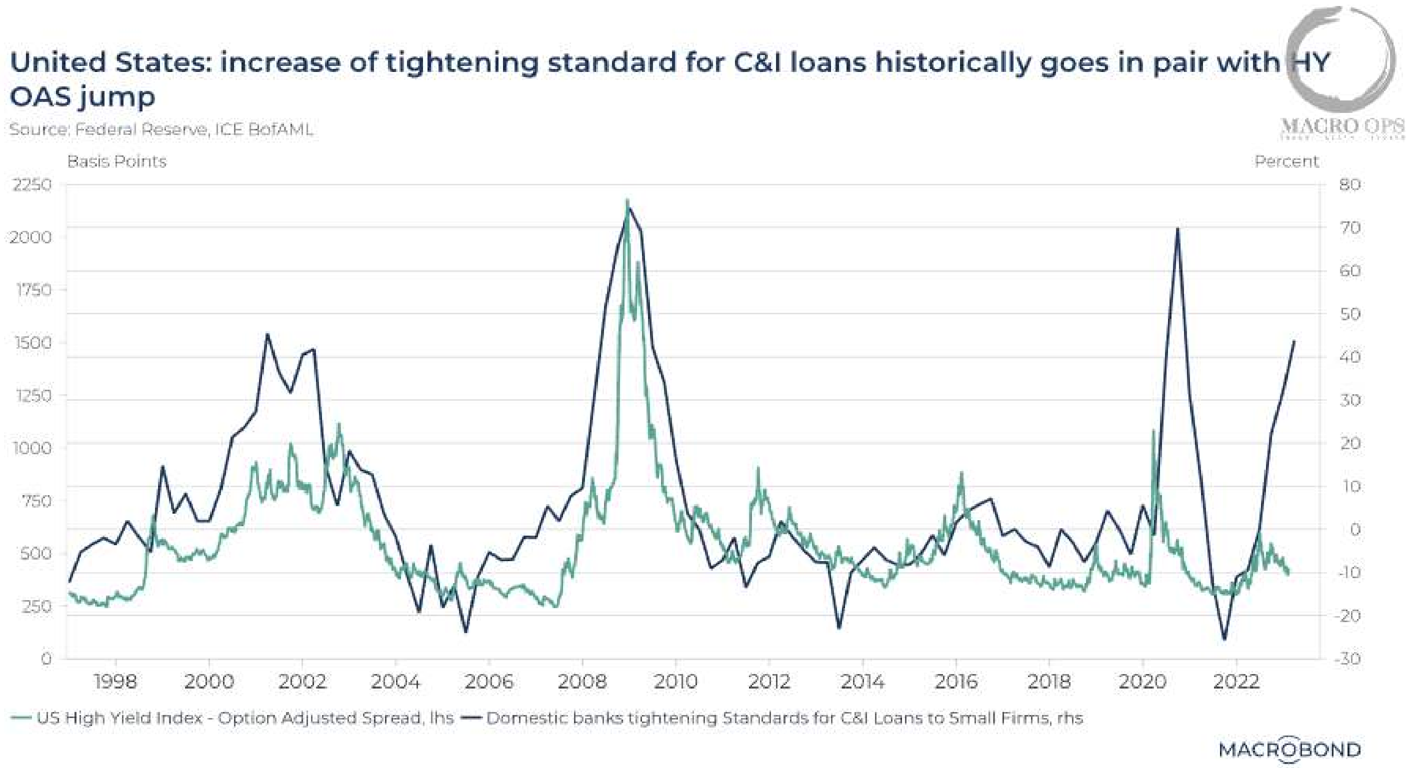
This chart shows the Fed Senior Loan Officer Opinion Survey (SLOO) for tightening lending standards. A higher reading means tightening financial conditions.

The bottom chart shows the aggregate of all responders who said they've "tightened some" in turquoise and those who said they've "tightened considerably" in yellow. We can clearly see there's a lead/lag relationship between the two, which makes sense as this process is quite reflexive by nature — there's a feedback loop where "some tightening" eventually leads to greater "considerable tightening".



The last three times the "tightened some" line was this elevated, the economy was in or soon entered a recession. There's little reason to believe that this time will be any different.

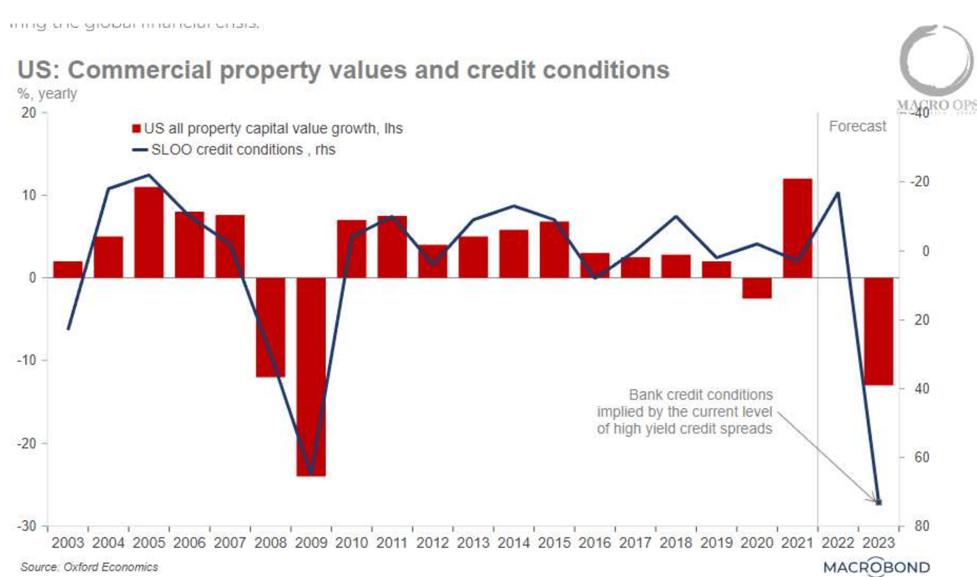
Here's a similar chart but with the SLOO C&I tightening loan survey (blue line) overlaid against that of high-yield spreads (green line). This is vetus opinio at work.



Here's SLOO credit conditions (inverted) overlaid against all US property capital value growth.

Current survey values project a 15% drop in commercial property values this year. That would be the largest annual decline since 2009.

This is why the bond market is now pricing in over 200bps of cuts from the Fed over the next 24 months (chart below). Realistically, it's likely going to be much more than that, but at least the bond market is waking up to what's going on here.



As one of my mentors likes to quip, "if it looks like a duck…" We can hope this time is indeed different but that would be at odds with the growing weight of evidence suggesting that it is in fact, not.

And since we're in the game of making data-backed probability-weighted decisions, there's no reason for us to think this isn't a duck until there's a catalyst (major policy intervention of some kind, maybe) that dramatically changes the trend in the data. But until that moment comes we have to play the game in front of us and not simply bank on a dramatic rule change coming on the horizon.

And it should not be forgotten that the backdrop of this quickly deteriorating liquidity / high bond volatility environment is one of <u>aggregate valuation metrics for the broader equity market still in the 88th percentile.</u>

Here's the Shiller CAPE. It currently sits at 30.4x, well above both its historical and 12-year average. This is not what bottoms are made of.

Those who are of the more bullish bent may point to decelerating inflation and a Fed pause/pivot as reasons for this being a cyclical bottom.

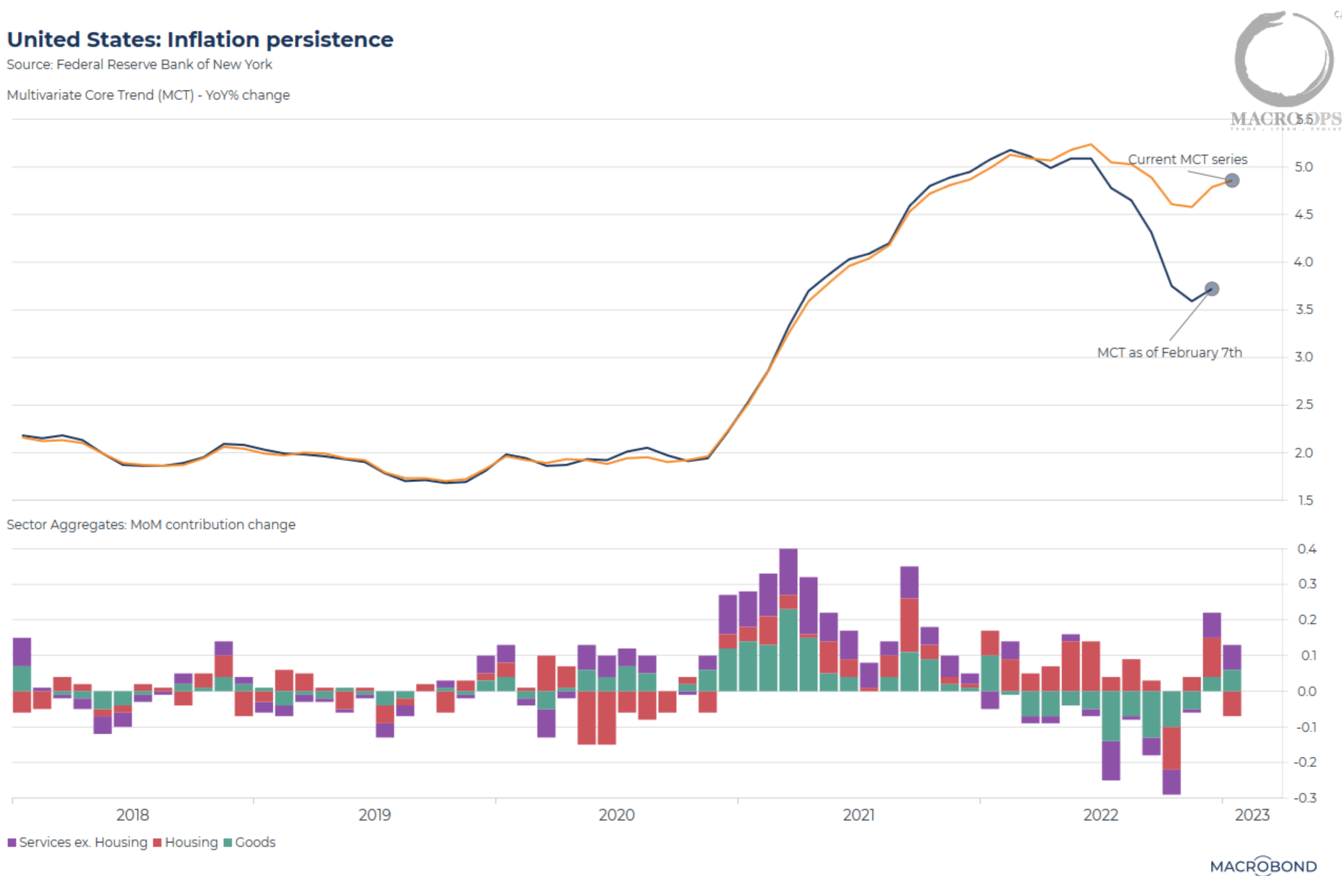
This is nonsense for the simple reason that liquidity is going to tighten considerably over the coming quarters, as noted above. And yes, CPI will come down and the Fed will pivot — eventually — but that will be due to accelerating demand destruction caused by a recession unwind of the labor market.

And while inflation is coming down, its components are proving to be more persistent (sticky) than many have expected.

This chart is a Multivariate Core Trend PCE Inflation model developed by the NY Fed as a means to measure the persistence and broadness of price gains for the seventeen major sectors of the personal consumption expenditures (PCE) price index.

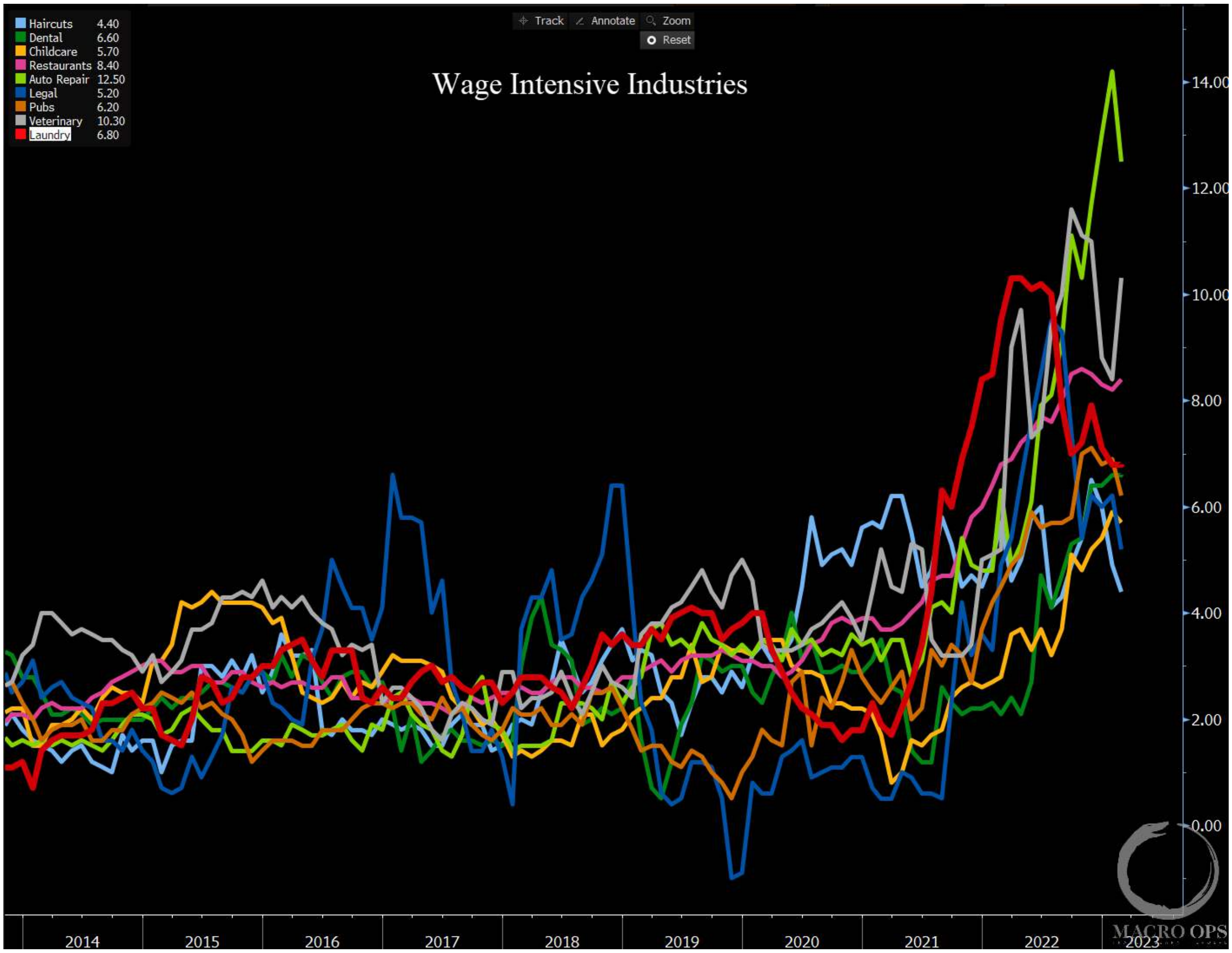
The aim of this model is to decompose "each sector's inflation as the sum of a common trend, a sector-specific trend, a common transitory shock, and a sector-specific transitory shock" which in plain English means it measures how much sticky structural inflation there is in the economy and whether it's going up or down. You can read more about its construction here.

The blue line is the old numbers before the data was revised upwards. The orange line shows that "inflation persistence" has started to pick up again after a decline in the Fall of last year. Not exactly a good look for Team Transitory if that's even still a thing.



There are a number of structural reasons for why this is and why we're *not* going back to the deflationary secular regime of the past 40-years. One of the major reasons for this is the changing dynamic in the labor market. This dynamic, which is a factor of both demographic splits and labor vs capital power, means persistent wage pressures are here to stay.

Here's a chart showing the CPI trends for the most wage-intensive industries (h/t Vincent Deluard).



This is broad-based accelerating wage pressures. Yes, these will eventually come down. But they will only do so once the Fed drives the economy into recession. In fact, putting the economy into recession, is one of the Fed's stated objectives right now Their recent economic projections predict an unemployment rate of 4.5%. It currently sits at 3.5%.

Two things about this (1) the Sahm Recession indicator, which has a perfect track record indicating recessions, signals the start of a recession with the 3-month moving average of the unemployment rate rising by more than 0.5% from its 12-month lows and (2) the unemployment rate never rises by just 1%. Labor market unwinds are highly reflexive in that once a certain level of workers are laid off, demand drops, which causes more companies to cut costs and layoff more works, and so on and so forth.

In light of these developments, we have more conviction today in the thesis we've held since early 22', that the US economy will enter a recession in the second half of this year and it will be a hard landing as equity holdings as a percentage of total financial assets still sit near record all-time highs.

And this doesn't make any sense in light of the changing regime. It's simply a reflection of vetus opinio… players who've only played the game one way and lack the imagination, the will, or both to understand that it's now an entirely different game, a new regime, it's the Soros Cycle turning on and on…

Actionable versus setting up…

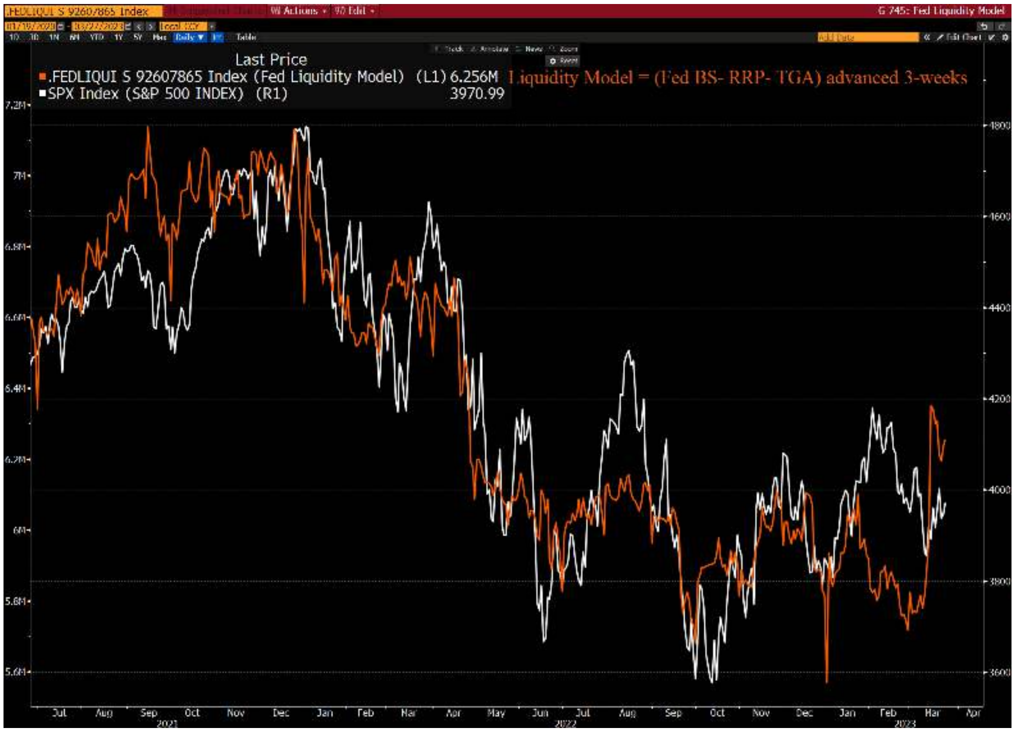
One of the many difficulties in trading these markets over the past few months is the contrast in signals to timeframes, which is something I've been commenting on.

While we're convicted the bear market has a long way to go, it's still quite possible for the market to continue on this counter-trend bull rally for another month or two.

While we think the probability of this rally continuing much longer than another month or so, is quickly becoming slim. We have to remain open to it.

Here are a few things I'm watching to gauge this.

The Liquidity Model (h/T DH) is an aggregate of the Fed's BS, RRP, and the Treasury General Account (TGA). It's the orange line along with the SPX in white.



A big positive driver of liquidity over the past year or so has been the drawdown of the TGA (essentially the government's checking account), which has more than offset the negative impact of the Fed's QT to date.

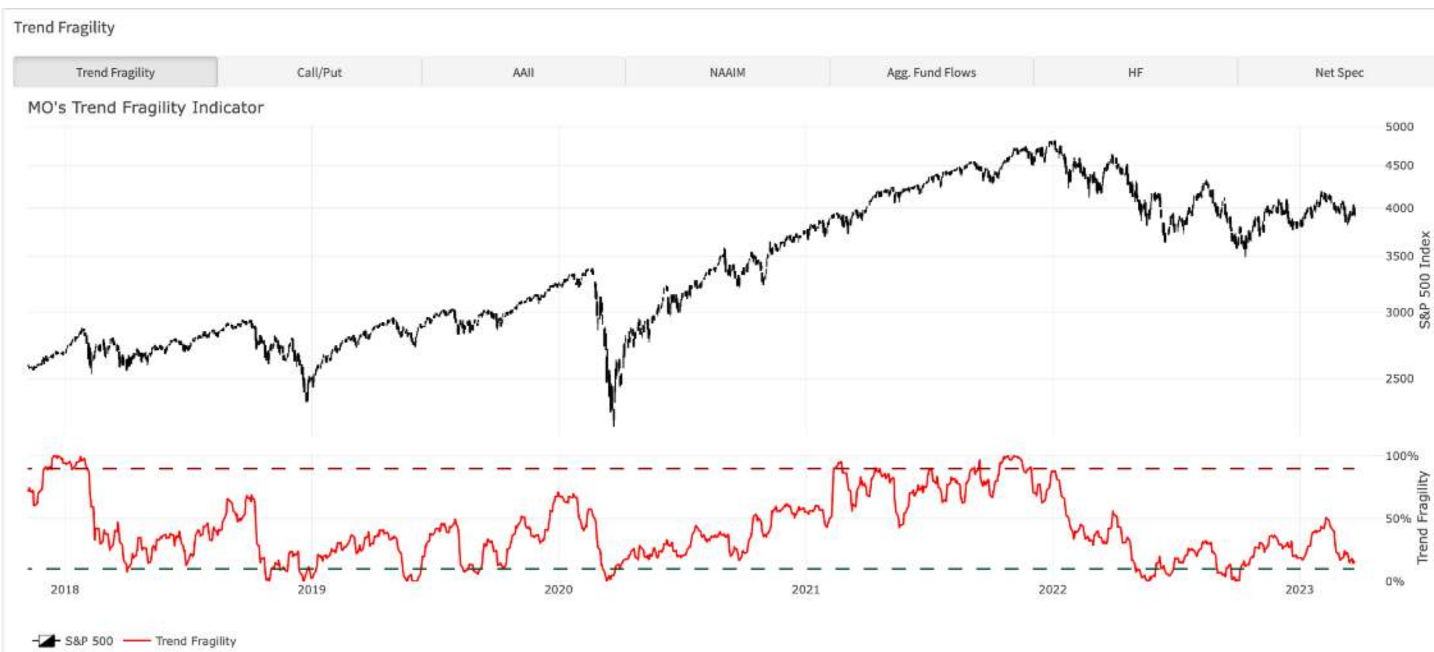
Absent a raising of the debt

limit, the Treasury will draw down its TGA sometime in June, which is only a few months before households are expected to spend the last of their excess savings.

But I digress… We can see in the above chart that this Liquidity Model has a strong leading correlation to equities. It's currently perking up.

This is in line with what we've seen in cyclicals vs defensives and consumer discretionary vs stapes over the past month. These are not bearish short-term signals so they need to be respected, especially since our Trend Fragility indicator is in the 14th percentile and heading lower.

It's difficult for the market to fall when sentiment and positioning are this bearish. I should caveat that with though this is true most of the time, there are the occasional times when sh*t just starts breaking… and those times happen in illuiqidity-driven Contraction Regimes, which is where we're soon headed.



We only have five more trading days left in the month. We'll wait to see where the indices close for March.

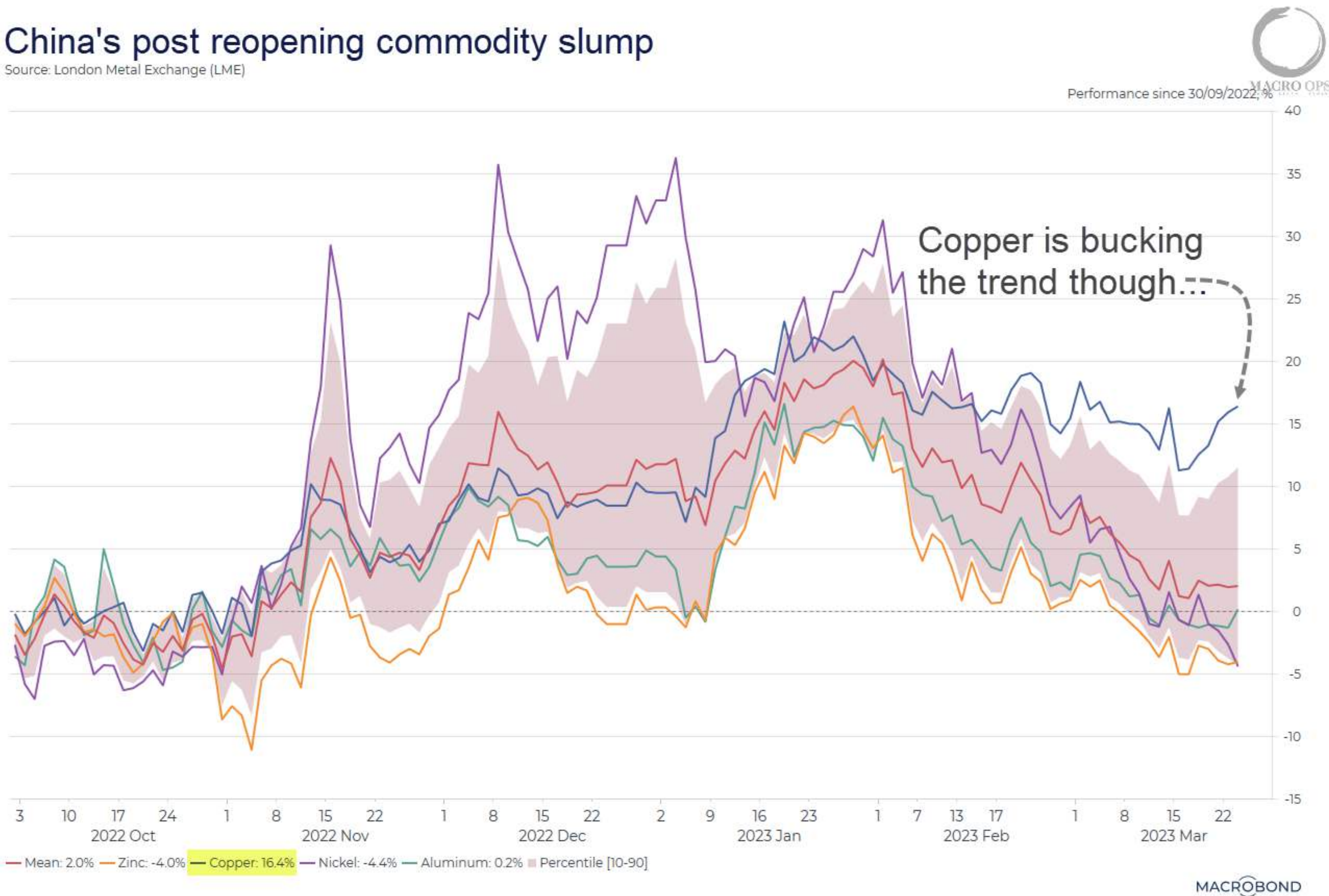
I pointed out last week that I'm closely watching the monthly chart of the Russell small-caps index. Where it closes should be a good tell for where things will trade over the following few months.

There's a lot of coiled energy in this market. Which tells me there's a big move (up or down) coming soon. So we'll want to be nimble here, wait for confirming signals, and act when appropriate.

Until then, we'll keep sitting on lots of cash. Stay long only the names that are working. Aggressively manage risk and keep our heads on a swivel…

A few last points of interest…

It's notable how short-lived the China reopening commodity bump has been. Arguably the result of a rising probability of recession elsewhere. Below is a chart of industrial metals. Copper though appears to be bucking this trend and proving more resilient than its peers.



Copper will certainly fall some more if/when we enter a recession later this year. But, it along with oil and gold, will likely bottom well before the stock market does.

The reason again, is just the regime we're headed into. It's one where the world is very short commodities (due to CAPEX cycle dynamics) and very long government largesse and their plans to build lots of physical stuff, whether it be "greening the grid" or repairing physical infrastructure with the magic of deficit-financed money.

The mining billionaire Robert Friedland was interviewed by the FT last week about the state of the copper market. He told the FT that "it took him 28 years to develop the vast Kamoa-Kakula mine in the Democratic Republic of Congo, which is ramping up to supply 650,000 tonnes by the end of next year."

And because of how difficult and time intensive it is to get a copper mine into production, along with how much global demand is expected to grow over the rest of the decade (S&P Global estimates 40mn tonnes by 2030 versus 25mn now), he told the FT "we are heading towards a train wreck."

We at MO agree, which is why Foran Mining (FOM.TSX) is our largest position. You can read our full writeup here.

To use the 01'-02' bear market analog again. Look at how much earlier copper, gold, and oil bottomed before stocks (copper 11 months, crude 10 months, and gold 18 months). I expect gold will be just as valuable a lead this time around.

Speaking of oil (we're short on a purely tactical/hedging basis right now as we're long the equities), the positioning picture is setting up quite nicely for a long term bottom. Here's net commercials (orange) versus net managed money (blue).

Commercials have their most bullish positioning (hedgers are always short the oil market) since the 15' bottom. And conversely, managed money is at its most bearish positioning since then, as well.

There is little doubt that crude, copper, and gold are shaping up for monster trends that'll play out over the next few years, at least. But, patience is required here… Illiquid Contraction Regimes are noisy and difficult to trade… And positioning is never reason enough to buy something. We have to wait for the tape to confirm.

We'll keep the group updated on what we're tracking here.

Your Macro Operator,

Alex

Note: Our team is currently fine tuning our tools and strategies for the 2023 Macro Regime Shift.

If you'd like to join us and make sure your portfolio benefits from a global macro strategy this year, then make sure you enroll in the [Macro Ops Collective].

The [Collective] is our premium service that offers institutional-level research, proprietary quant tools, actionable investment strategies, and a killer community of dedicated investors and fund managers from around the world.

If you have any questions about our service and what it can do for you, make sure to click here to schedule a free call with us.