OTHER SIDE ASSET MANAGEMENT

I have NEVER liked bullies…

Bullies

"Here's the thing: I can't remember a time where the Fed's forecasts were accurate, the "dots" are literally perpetually wrong! At the same time, in his most recent press conference, Fed Chairman Jay Powell not only would NOT commit to cuts but stated they would raise rates if inflation doesn't reach their 2.0% target.

That being said, how have markets reacted to this information?! Well, they immediately priced in 7 rate CUTS for 2024 … SEVEN; with a 10% chance of an 8th and a 1% chance of a 9th?!

I want to repeat that for you again … the Fed is seeing the "possibility" of 3 rate cuts in the back half of the year (assuming inflation reaches their 2% target), yet markets are telling the Fed that they're cutting rates 7 to 9 times (between 175 and 225 basis-points) with the first cut coming as early as MARCH!

How's that for a disconnect?!" ~ OSAM December 2023 … D.I.S.C.O.N.N.E.C.T

It was our belief then, that the Fed would tap dance around Wall Street's pressure to lower the Federal Funds Rate for some time … at the time, the disconnect between expectations, the data and reality was just too great. Hindsight being 20/20, we know they were able to deflect until September.

Just last month we wrote:

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- NFIB & Retail sales
- But incomes are up?!
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At this moment in time, 98% of Fed funds futures traders are pricing in a 25-basis point cut at the November 7th meeting, along with another in early December … this, as the data we've laid out above clearly suggests a reacceleration in inflation …

Wall Street is trying the same bully tactics …

The bully tactics we referred to last month were the same we wrote about late December of 2023 (quoted above) … and just as markets were overly exuberant on rate cuts to start the year, Wall Street continues their perpetual push for the Fed to aggressively intervene.

This constant pressure has little to do with data and everything to do with necessity. As we've noted in the past, the majority of Wall Street doesn't utilize rate of change math coupled with base effects as their guiding star; understanding this reacceleration in inflationary pressures, as we've mapped out with the help of Josh Steiner and @Hedgeye since the beginning of the year wasn't even a possible outcome (let alone PROBABLE outcome).

And yet, 7 days after we published last month's note, the Fed did respond with a quarter point cut, which, as mentioned above, was EXPECTED … HOWEVER, in a subsequent speaking engagement with business leaders in the Dallas-Fort Worth Texas area a week later, Powell's remarks left many questioning the Fed's future path!

"The economy is not sending any signals that we need to be in a hurry to lower rates" ~ Federal Reserve Chairman, Jay Powell 11/14/2024

Whoopsies … did Jay Powell just signal yellow lights/proceed with caution on rate cuts to Wall Street?!

Markets reacted immediately reducing the probability of a cut in December from roughly 80% to the low 50% range (depending on when we publish) with future percentages falling in kind!

Powell cited stickiness in Core CPI as one of the reasons to remain cautious … nah, you don't say?! (palm meet forehead)

On July 31st, when speaking on CPI we wrote:

On the surface, the report looked "dovish", though similarly to what we described above, ***things under the hood remain a sticky high****.*

For example, while ***Core CPI*** *also decelerated slightly to +3.3% YoY, vs the previous report of +3.4% YoY,* ***+3.3% remains well above the Fed's inflation target as is the Fed's ever so coveted Core Services Ex-Shelter which remains intolerably high at +4.9%.***

We've been discussing the importance of base effects and their easing ***into the back half of the year****,* ***thus a persistently higher inflation for longer*** *… with the help of Hedgeye's Josh Steiner, we've also highlighted the August,*

*September time frame to be the exception to this trend with base effects flat to mildly accelerating, paving the way for a mild easing of the data, which is what we've seen here in this most recent headline number (**yet still a persistently sticky data point**).*

It's nearly August and we've yet to have a rate cut, which shows you how incredibly wrong Wall Street can be, while at the same time, how they also bully the "expectations" markets … had you placed your trust in what Wall Street continues to shill, things wouldn't have panned out well for you.

It is our belief that we're seeing a 'similar' set up …

Should we get the anticipated weakness in the August (and quite possibly the September) CPI data, the Fed may be able to get one, quite possibly even two rate cuts in before inflation reaccelerates; in both September and November?! However, this will more than likely come just before the CPI data reaccelerates, say it with me folks, "into the back half of the year," with the help of both the base effects as well as the lead/lag set-ups (as we've been discussing for months).

Wall Street continues to beg for rate cuts, and given the current set up, and given the likelihood that we see another deceleration in the August, and quite possibly September data, Wall Street is most likely going to get it?!

Though, don't be surprised when you have to jump back on that seesaw?!

So, Wall Street just got their two rate cuts exactly as we said they would back in July, and it took all of a WEEK for Powell to jump back on the "seesaw" given the most recent reacceleration in inflation data.

Most recent headline inflation measured by CPI rose for its 4th consecutive month to +2.60% YoY and +0.3% MoM, reaccelerating from the prior month's +2.4% YoY … with CORE CPI coming in at +3.3% YoY.

Both Shelter and OER (Owner's Equivalent Rent) costs remain elevated with Shelter up +0.38% MoM and +4.88% YoY, this vs. +4.85% YoY the prior month's reading and OER up +0.40% MoM and +5.18% YoY vs. +5.19% YoY in the prior month's data series.

While we won't breakdown the entire report, this came with Food prices increasing +0.16% MoM and +2.13% YoY vs. +2.27% YoY the prior reading … at the same time, this acceleration in inflation came with Energy prices mildly decelerating -0.02% MoM and -4.86% YoY vs. -6.85% YoY in the prior report!

Additionally, October Headline PPI came in at +2.4% YoY, which was greater than consensus of +2.3%, and a reacceleration off last month's +1.8%, while also increasing +0.3% MoM (better than expected) and another reacceleration off of Septembers 0.0% reading.

Core PPI (ex-Food and Energy) jumped to +3.1% YoY, which also beat expectations of +3.0% and is a reacceleration off of last month's +2.8% … Food Ex-Energy, Food and TRADE jumped +0.3% to +3.5% YoY … the data all increased and beat expectations on a MoM basis as well!

As an aside, and we've noted this in the past, we find it troublesome that Wall Street, PhD Fed officials, academia and countless economists cavalierly cite (EX-) Food and Energy from the data?! As if no one eats, put fuel in their cars or heats their homes with things like Natural gas or oil (as we head squarely into Winter)?! Though, I digress…

Our opinion is that this continued pricing pressure will manifest negatively somewhere … the question remains, where?!

Our prevailing thought remains compressed margins at SMID (small to medium sized) enterprises with elevated borrowing costs will have trouble passing price increases along to an already struggling majority of consumers, which will eventually lead to more layoffs.

This is the story the NFIB data has been screaming for 18 plus months and very recently in the retail sales data (as we'll touch on below).

Most who take the other side of this discussion frequently cite the jobs data, suggesting that not only has it NOT cracked, but it remains fairly resilient.

They'll point to the recent initial Jobless Claims data which theoretically supports their argument, coming in at +217K, which was better than Wall Street's consensus estimate of +220k, as continuing claims fell to +1.873mm from the previous week's 1.892mm.

We've spent quite a bit of time detailing the train wreck that is the labor data, and while we don't plan to deep dive all that far into it this month's numbers, what we will say is the Payroll data from earlier this month showed 368k jobs "created" due to the absurdity that is the BLS's Birth/Death modeling … which is beyond a joke at this point in time.

Should you care to understand why it's so ridiculous, feel free to take a more in depth look at it here (when they added 363k in May) or in July when we noted:

Adding insult to injury … of the 2.6 million payrolls "added" in the last 12 months… just about half of them have come at the hands of the BLS's perpetually poor and arbitrary Birth/Death adjustment metric (which we discussed here, at length, in August 2023).

NFIB & Retail sales

Last month when discussing the NFIB data we mentioned the report had us mildly puzzled … having *"made me scratch my head a bit"*. In our mind, some inconsistencies just didn't make sense?!

As we noted:

"*The net percent of owners reporting inventory gains fell four points to a net negative 13%, seasonally adjusted, the lowest reading since June 2020." ~ NFIB press release*

We opined:

"If you were a business, and had the expectation that sales were going to improve, why would you allow your inventories to fall to extremely low levels heading into what should be the busiest time of the year (Holidays/Christmas)?!"

We continued:

"If your largest fear and most important issue in the NFIB survey is, in fact, inflation … which fell by another -1 point to 23%, commodity prices are up and you're outlook for Sales Expectations increased as much as it did, why wouldn't you stock your shelves?

Apparently, the economy and data has small business owners in a quandary, with the ***Uncertainty Index within the survey increasing 11 points to a record high 103*** *… as we've been saying for years … "Hope is not a risk management process"!"*

The mixed bag of recently reported retail sales data for October may be contributing to the NFIB uncertainty index with Headline Retail Sales rising +0.4% MoM which was a tick greater than expectations of +0.3%, however, both were decelerations from the previous month's revised +0.8% MoM.

We also saw minor +0.1% MoM increases in the ex-Auto and ex-Auto and gas subgroups vs. expectations of +0.3% … both large decelerations against the previous months +1.00% and +1.20% MoM, respectively as the control group outright declined -0.1% MoM, which also missed +0.3 expectations and the previous month's +1.2% MoM data.

So, at a glance, it appears as if small businesses are doing what the economy is telling them to do?!

But Incomes are up?!

Sure, the BEA reported its 37th consecutive month of increases in personal income, up +0.59% MoM and +5.29% YoY vs. +4.99% YoY in the prior reading.

Higher incomes equal margin squeezes which accelerate layoffs … which continue as do payroll revisions … so while a portion of the economy may have more disposable income, the lower slant of the "K" we've been describing for over a year has much less money available for discretionary spending purchases.

When coupled with the reacceleration in inflation as described above, we question how much more of this many can take?! We reiterate from last month, that we're currently in the heart of holiday shopping season … Thanksgiving has just passed, and Black Friday deals have been hitting email inboxes for weeks with inventory remaining at uncomfortably low levels.

And while we did see some minor improvements in the NFIB series, it's more of the same…

"Although optimism is on the rise on Main Street, small business owners are still facing unprecedented economic adversity. Low sales, unfilled jobs openings, and ongoing inflationary pressures continue to challenge our Main Streets, but owners remain hopeful as they head toward the holiday season." ~ *NFIB Chief Economist Bill Dunkelberg 11/14/24*

The NFIB Small Business Optimism index did rise to its highest level since July of 2022, prior to that, the last time it saw these levels was February of 2022! That being said, up +2.2% to 93.7 vs. consensus of 92, remains WELL below the long-term average of 98 which has been speaking volumes in regard to labor markets and input costs, which are largely impacted by … INFLATION … which continues to be the most important problem coming in unchanged at 23%.

While the report did show increases in certain areas from Economic Outlook to Credit conditions and yes… Current inventory (which was up a meager +2 points from an anemic low), the UNCERTAINTY INDEX ALSO INCREASED TO A RECORD HIGH 110.

As inflation reaccelerates, it will become increasingly difficult for small businesses to pass these input cost increases on to struggling consumers, which will further compress margins, leading to more layoffs.

On the surface, tight labor conditions and seasonality supports consumer spending … at the same time the NFIB data leans towards record uncertainty and retail sales data shows a deceleration in the consumer's ability to spend.

Additional rate cuts, as inflationary pressures re-accelerate is akin to dropping fuel on an already well-established and spreading wildfire!

The reacceleration in inflation has already sent interest rates screaming higher, in short order as well, as we also discussed last month:

"The Fed cut rates on 9/18/2024, sending bond yields through the roof from 3.61% to 4.29% (as of 10/30/24)"

Touching as high as 4.432% on 11/21/24, though subsequently backing off a slightly.
This adversely affects most everything that ticks, though more specifically all things interest rate sensitive!

For example … recent data out of the Census Bureau showed October New Home Sales in the U.S. cratering -17.3% MoM to a SAAR or 610k homes, bringing New Home Sales DOWN -9.4% YoY vs. -6.3% YoY in the previous reading.

New home inventory currently sits at 481k representing a 9.5-month supply which is also up vs. the previous 7.7-month supply.

The median price of new home sales INCREASED +2.5% MoM and +4.7% YoY vs. +0.2% YoY, while the average home price touched a record high $549k, up +7.0% MoM and +9.4% YoY vs. -8.3% YoY in the previous report.

We are an interest rate sensitive economy and in the face of the Fed cutting the Fed Funds Rate, longer rates have jumped higher sending mortgage rates up along with them.

Anyone care to take a guess as to what else moves higher with longer term rates?! Interest expense for those on revolving credit lines … from small and medium sized businesses to the hobbling retail borrower maxed out on the credit cards.

Layoffs as tracked by MacroEdge, for the month of November are down MoM, resting in the -65k jobs vs. October's -110k + … which should be anticipated as temporary positions are filled for the holiday season as the country also begins to normalize from the impacts of Hurricane Helene. However, we will continue to argue the level of employee losing their jobs being the higher waged employees is doing a tremendous amount of damage under the surface.

The country can't grow GDP long term via copious amounts of government borrowing at generational high interest rates and as noted last month, with an UBER driver army!

Final thoughts

With the holidays in full swing, we kept things relatively short this month. There have definitely been some positive data points since our last note, but in an effort to not sound so redundant … things are boiling down to more of the same … a positive market bias through some choppy trading noise.

With the help of the Fed, their rate cuts and now tempering of expectations, we've been shifting back and forth between a reflationary and stagflationary economic investing regime … described in @Hedgeye vernacular, #Quad 2 or #Quad 3. We know the inflation is accelerating, with the genesis of the choppiness coming from the growth side of the equation.

"Muddy" may be a good way to describe the growth data?! Some accelerating, some decelerating … and until we get some clear signaling from the growth side of things, we may be in this environment for a little while?!

Regardless of the investing regime, our models, by way of what markets are actually doing, tell us where we will be invested vs. what's best to avoid … thankfully, it's been working out well for us!

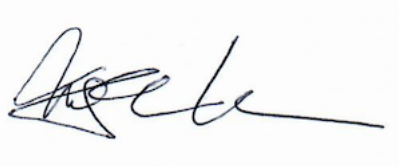
Our risk management process has allowed us to largely mitigate market dips while also capturing significant gains. However, it remains our humble opinion that the real value in the strategy exists for the times when market dips prove to no longer be dips as they turn to crashes.

With the current "K" shaped economy, at some point, something is very likely to break, and no honest individual knows when that will be. What we do know is how we'll react during a dip, which should set us up nicely to mitigate a dip turning into any future crash! In the meantime, we're largely invested and will remain so until markets suggest otherwise.

We won't succumb to bullies regardless of what government agency or large wall street firm they work for nor what job title or position they hold; we'll continue to read the data and call them out for who they are!

At the same time, we also recognize that the economy does NOT always equal market action, making market signals more important today than ever before … we'll continue to follow them accordingly!

As always … Good investing!



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