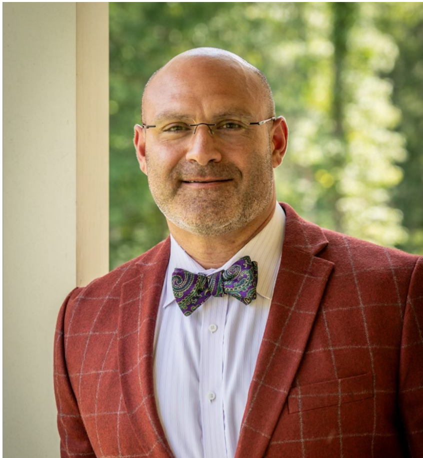
OTHER SIDE
ASSET MANAGEMENT



Luffing...

Luffing

I grew up in a small little lake community within a much larger town in northern NJ by the name of Wayne Township. When one mentions the township of Wayne to an outsider, you're often met with the response, "I know Wayne, it's the one that always floods"!

Yes, there is an EXTREMELY small portion of lower Wayne that does flood, yet we're literally talking a few block out of a 25.14 square mile area.

Located roughly 20 miles outside Midtown Manhattan via Route 3 towards the Lincoln tunnel, Wayne would be considered both, a NYC suburb as well as a bustling commercial "Hub" of North Jersey commerce.

At the Northern tip of Wayne, bordering up against Bergen County's, more well-known Franklin Lakes, lies a quaint lake community by the name of Pines Lake.

Summers were spent outside riding our bikes down to South Beach (our south beach, not Miami), in order to participate in a day of constant activity ... from basketball, softball, tennis, running bases, swimming, diving, wall ball, fishing and for the purposes of this introduction ... sailing!

Learning on the rudimentary "pelican" or "sunfish" sailboats, eventually graduating up to the much faster "Lasers" and if lucky, we got to occasionally

IN THIS ISSUE:

- Luffing
- Inflation
- Final thoughts

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work the catamaran! Sailing was definitely an activity I thoroughly enjoyed (most of the time)!

Let's be honest, sailing on a windless day is much like playing outfield in a baseball game in the dead of summer when no one is hitting the ball! Bu-bu-bu BORING (hence the "most of the time" comment) … but when there's a constant breeze, sailing can be invigorating!

When sailing, there may come a time when slowing your boat down may be advised?! An example of this might be when your sails are filling with an abundance of wind and the boat begins to heel over (which sends the boat leaning nearly sideways, pushed by the wind). The initial solution is typically to hurl your body halfway over the windward side (high side) of the boat in an effort to provide a counterbalance (which is a LOT of fun) … BUT!

Should the wind become too strong, and your body weigh not be enough to provide a sufficient counterbalance, "Luffing" is a tactic that can be used. Luffing is the act of turning the bow of the sailboat upwind (windward) in an effort to reduce speed! (one could also ease the sheet controlling the sail past "optimal" trim allowing air to flow over the sail creating the luff).

The more your vessel is positioned heading directly into the wind, the more the sails will "luff" … or simply flap back and forth … which will either bring the vessel to a stall or tack (the act of flipping your sails to the other side of the boat, filling them from a different angle, thus … sending you off in a different direction?!

We have discussed the chop of markets in our last handful of notes, with markets trying to find a direction, from our December 2024 note:

"December's weakness in equity markets has led our models to hold a larger than normal cash position (which has been beneficial).

All of this could change as the calendar flips … as we noted last month:

"*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."*

The above quote remains true … at the same time, the dynamics of passive always exist and can become much more prevalent at certain times for many different reasons!"

February brought with it a slightly different dynamic than initially anticipated, but as we also said last month:

"Regardless of the investing regime, as clarity comes … and markets are typically very good at sniffing things out, we'll continue to remain disciplined to our models."

As always, this month we'll discuss the data, what we got right, wrong (likely temporarily), but more importantly … how and why we "luffed" heading straight into wind after its shift in directionality … just as we said we would per the underlined quote above from last month.

Inflation

Earlier this month we got more inflationary data out of the BLS on both the Producer Price side (PPI), as well as in Consumer Prices (CPI).

Headline Producer Prices (PPI), per the BLS, were up +0.40% MoM and +3.51% YoY for DECEMBER vs. +3.48% YoY previously, it's eight consecutive monthly acceleration!

With both "Goods" and "Services" accelerating … as "Goods" prices increased +0.59% MoM and +2.28% YoY vs. +1.86% YoY prior, while Services prices accelerated +0.32% MoM and +4.14% YoY, which was a slight deceleration vs. the previous months +4.28% YoY.

What were the drivers?! Well … Food prices jumped, again … this month being a +1.08% MoM acceleration and +5.55% YoY rip (which was a significant rise over last month's +4.08% YoY), as did Energy price, which accelerated, +1.65% MoM and +0.36% YoY vs. the negative -2.38% YoY previous month's report, too! This had CORE PPI increasing +0.28% MoM and +3.61% YoY

As is often the case, what happens at the producer level often flows through to the consumer…

Which had Headline CPI increasing +0.47% MoM, which was another acceleration vs. last month's +0.40% MoM and blew Wall Street expectations away as they were looking for a -0.30% MoM data point.

Headline data also accelerated to +3.0% on a YoY basis vs. +2.89% in the previous month, with the street looking for +2.90% YoY (a miss of 100 basis points)! Energy prices also accelerated at the consumer level, up +1.08% MoM and +0.97% YoY. Similarly to the PPI, this was also an acceleration off of the previous month's negative year over year data point of -0.52%.

This was also the case with Food prices, they too, accelerated +0.36% MoM and +2.50% YoY … a rounding error within the previous reading of +2.51% YoY.

STILL … Ex-Food and Energy, CORE CPI came in up +0.45% MoM with a di minimis acceleration year over year coming in at +3.26% vs. +3.24% as Shelter remained elevated, up +0.37% MoM and +4.40% YoY … and while a mild YoY deceleration off the previous report of up +4.57% YoY we sit at EXTREMELY ELEVATED levels, relatively speaking.

While housing has taken some punches over the past few months, as a reminder, it takes nearly 18 months for "Shelter" to have an impact on the CPI data given their lead/lag into the data series. That being said, Insurance costs alone are up nearly 25% for homeowners and landlords over the last 2 years! While we're not saying they won't come down due to a build in supply, this expense will be passed along to someone … OR a LOSS is looming for some investors should we see disinflation in rent.

A large contributor to the acceleration in the CPI data came from used cars, which saw prices increase +2.19% MoM, and +1.03% YoY … which was a significant acceleration from the previous data point of -3.25% YoY! But it's never just one thing… Hedgeye's Director of Research, Daryl Jones stated after the CPI print:

"The problem isn't just inflation – it's that it's everywhere. 10 of the 13 major CPI categories accelerated, with essentials like eggs (+50% Y/Y), vehicle insurance (+9% Y/Y), and meat (+10% Y/Y), leading the charge. Consumers feel the pain, especially with wage growth lagging behind." ~ Daryl Jones, February 13, 2025, Hedgeye Early Look

As he also noted, it doesn't stop there… Frozen drinks (+8.00% YoY), Condiments (+10.00% YoY), Textbooks (+10% YoY) … as Jonesy said … *"it's everywhere"* and we'd add … poorly measured by the BLS!

While we don't put a whole lot of credence in most Fed surveys, the Philly Fed Manufacturing Business Outlook survey for February did see the current activity index FALLING by -26.2 points to +18.1 … we won't delve into the subcategories, as we cap off the inflation discussion … but Prices Paid within this particular index increased +8.6 points to +40.5 with Prices received increasing +3.2 points … just more signs that the inflation dragon has NOT been trained just yet, especially not by anyone at the Fed.

As is typically the case, the Federal Reserve is late to the game with Fed Chairman, Jay Powell trying to paint a rosy picture while admitting what we've been saying for nearly a year … when we noted that inflation would be *"reaccelerating into the back half of 2024"*.

Here's how Jay Powell recently tried to soften things … per the Wall Street Journal:

Federal Reserve Chair Jerome Powell said Wednesday's inflation report offers the latest reminder that the central bank has made "great progress" towards bringing inflation closer to its goal but, "we're not quite there yet."

"So, we want to keep policy restrictive for now," he told lawmakers at a House hearing on Wednesday morning.
Wall Street began the year expecting 5 interest rate cuts for 2025 … today they sit with expectations of 2, which is MUCH closer to what we suggested to readers for the majority of last year … HOWEVER!!

Final thoughts

As we've noted in many notes, markets are a forward discounting mechanism which chew through data in real time while looking at Rate of Change data and Year over year base affects.

With this in mind, Hedgeye's monthly inflation NOWcast model, which has been extremely accurate over the last year … picked up a slight shift in the directionality of the wind given most recent data!

With December and January's data being reported in February, the next few months are now more likely to see a slight decelerating in inflation, before reaccelerating! Coupling this with a decelerating growth (GDP) figure, the oscillating "stagflation" (or quad 3) to "reflation" (quad 2) that we were anticipating appears to have turned into a mild "disinflation/deflation" monthly (quad 4), with March quite possibly flipping to a "goldilocks" (Quad 1)?!

So, lets quickly circle back to our introduction:

"Regardless of the investing regime, as clarity comes … and markets are typically very good at sniffing things out, we'll continue to remain disciplined to our models."

The last few weeks of February saw a shift in where the wind was coming from … bond yields sank, and the model shifted us in a *"luffing"* position, then positioned us overweighted in Utilities (a bond sensitive proxy) taking advantage of the decline in yields … following the strength in markets has us calm at a time where many are uneasy sitting in the more overweighted tech sector.

Inflation remains elevated, with a short term set up to the disinflationary side over the next few months … and growth is sending mixed signals, with quite a bit of uncertainty out of Washington, especially pertaining to labor markets … what was most probabilistically a stagflationary investing environment has (at least for the short term) pushed into a disinflationary one.

If we were to look at stocks as "baskets" representing what performs best in their respective "quads", the stagflationary regime had been leading the way higher over the last 30 trading days, only to be overtaken from a performance standpoint by a disinflationary basket (bonds, bond proxies like utilities, etc.), with the Goldilocks and reflationary regimes having rolled over, as Tech has led the way down.

The markets will either confirm a shift to Goldilocks in the days moving forward or they won't?! To this point, we'll look to follow the strength in markets while continuing to remove the weaknesses.

Over the years, as we've discussed numerous times, in the spirit of Evolve or Die, what could or should happen based solely on the data isn't always what does happen … which is why we've worked diligently through our failures and successes to not only follow the data, but allow signals from the markets lead the way in both up and down markets … as we stated in June 2024:

"while we remain engulfed in the data, we've adjusted our modeling for more stringent rules tied to the signals markets are providing; maintaining more rigid rules to get us back into markets after we've protected from the larger drawdowns."

Protecting downside has been a strength, while capturing the rebound from the weakness has been a challenge throughout the Covid years … with the help of the entire @Hedgeye team and our good friend @thousandairefx (Chris Moir) we've largely rectified our deficiencies as we saw last year.

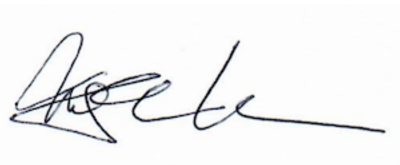
All this being said, we DO expect inflation to reaccelerate alongside growth after a short disinflationary pause, but we still have to risk manage the time and space between now and then. When we see a reacceleration in inflationary data, depending on the growth side of the equation, we'll either bear witness to a reflationary or stagflationary regime?!

OTHER SIDE
ASSET MANAGEMENT

Regardless of which regime ultimately appears, the process is now the same … we'll more than likely "luff" until that clarity or confirmation of the directionality comes, revealing where the strongest trending momentum lies … at which point we tack, looking to fill our sails with a force strong enough for our ship to heel!!

In its most simple of forms, the goal is to run with the wind at our backs filling our sails, luff with a shift in directionality … tack … rinse, repeat … that being said, as is the case with most things, nothing is ever so simple! Even with sailing, crosswinds can keep waters choppy with a challenge in finding directionality, if this becomes the case, we will simply luff (risk mange) for a little bit longer until a clear direction is established!

As always … Good investing!



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