CHALK CREEK PARTNERS

Weekly Update

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Carlisle C. Wysong, CFA
Managing Partner

- Interest rates are back in the spotlight
- Inflation and politics are the worries
- Is the Fed listening to the market
- Small-caps look vulnerable
- More negatives on auto loans
- Earnings beats are being rewarded
- Retail Sales improve, but food inflation is the driver
- Housing is still stuck in the mud (but not pricing)
- Even if Inflation cools, prices are still high
- Quick Hits
- Where did all the crypto money go?
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	5,797	-0.8%	22.7%	39.1%
QQQ	$489.23	-0.3%	20.0%	38.9%
US 10 YR	4.24%	4.02%	3.88%	4.83%
USD/DXY	104.4	103.6	101.3	106.3
VIX	19.3%	19.6%	12.5%	19.0%
Oil	$71.01	0.7%	-1.2%	-15.7%

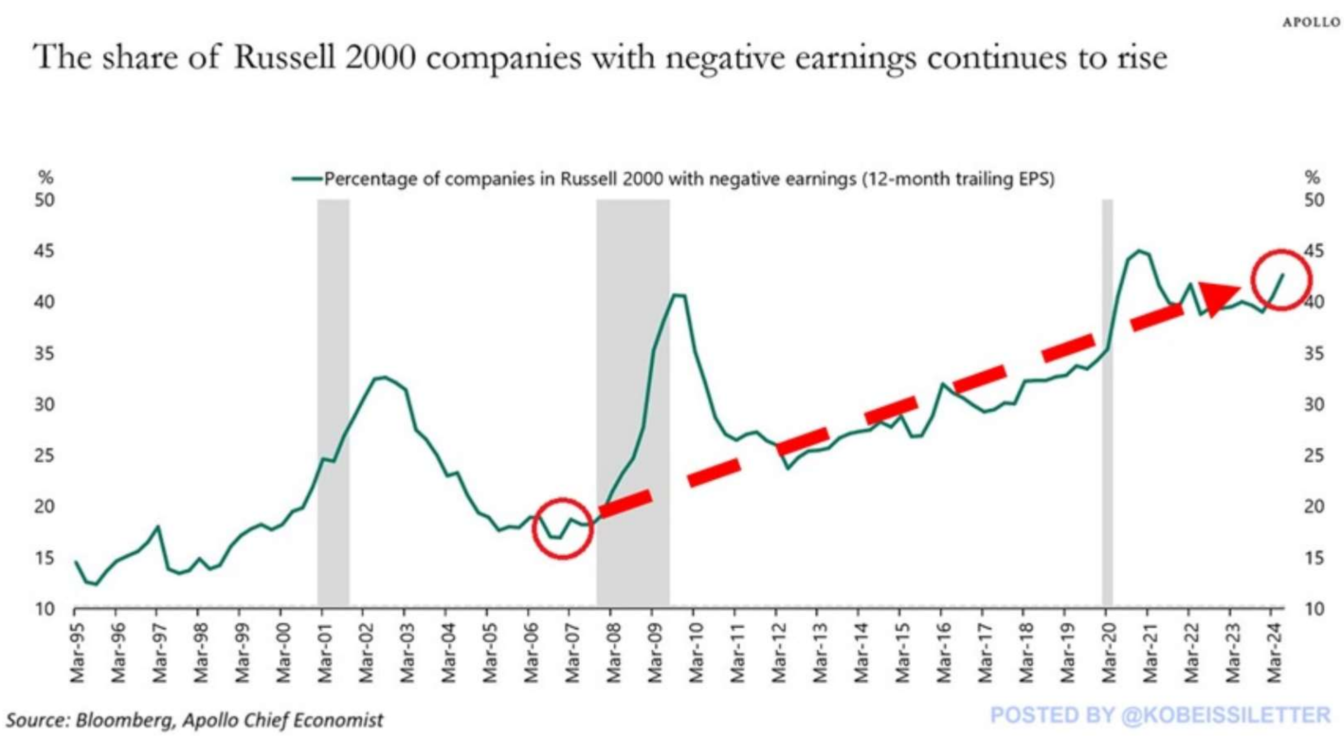
*10yr, DXY, and VIX are levels not changes
** Oil is front month futures, beware

Interest rates are back in the spotlight. But unlike two weeks ago when a strong Employment report hit bonds (yields higher), increasing market rates are now starting to hit equities. Renewed signs of inflation and no end to runaway spending are stoking the fears. Even though the last few inflation reports have been benign, Food prices and commodities in general are moving higher (ex-Energy which is signaling recession). Some attribute this move in rates (and the mild pause in equities) to the "Trump trade" accelerating. That is, it was a positive thing when bank spreads were widening, regulation worries were subsiding, and tax cuts were staying (the Trump tax cuts are due to expire at the end of 2025). But Trumpism is increasingly seen as more inflationary (notably his "love" for tariffs…even though Biden/Harris kept his tariffs in place). And his populist leanings on spending will only give rise to more government debt at higher interest rates (a vicious cycle, indeed). It turns out, the Fed might be thinking twice about its path for interest rates, too. Of course, the question is whether they have the same inflation concerns, or do they think the economy is not as strong as previously thought? We think the Fed will continue to "recalibrate policy," but they will be on the lookout for any of these inflationary trends. If the Fed does continue cutting rates as the economy expands with increasing inflation, that will be a good bubble to buy (before it bursts!). In the meantime, we think politics are playing an outsized role in the recent rotations. While we like our limited inflation trades, we do not want to go overboard (especially given a divided Congress is still the base case).

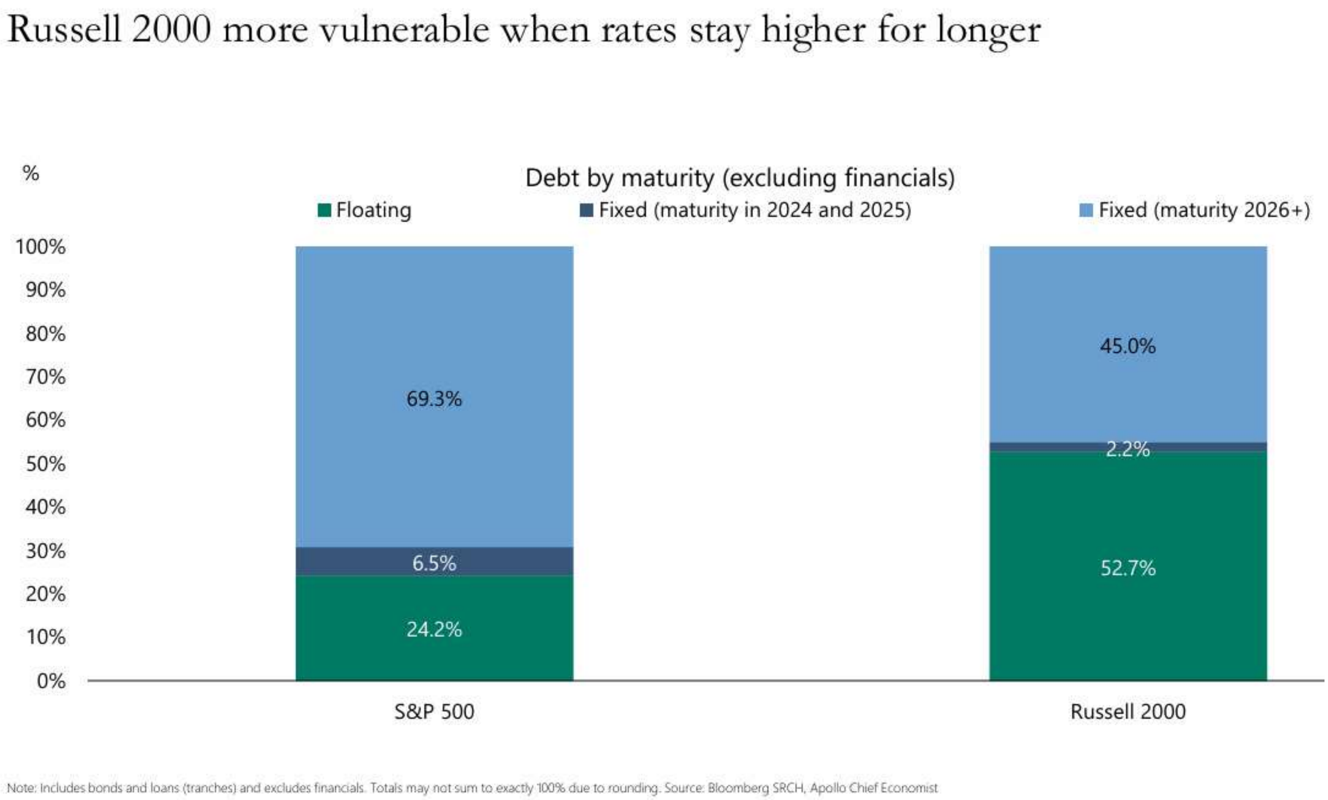
It was not long ago that we appreciated the market finally getting in sync with what the Fed was saying…do not expect an onslaught of rate cuts. Now the tables have been turned. The market is shifting further from rate cuts this year, and now the Fed is following this price action. The new Kansas City Fed president, Jeffrey Schmid, supports a "cautious and deliberate" approach to cutting interest rates. Neel Kashkari, president of the Minneapolis Fed, is "forecasting some modest cuts over the next several quarters." There are still some outliers like Mary Daly (San Fran Fed) who does not "see a reason to stop cutting interest rates." The Fed Funds futures market has gone from a 100% chance of two rate cuts by the end of the year (as of one month ago) to 85% last week to 67% today. As we mentioned above, we expect the Fed to continue on its stated path. This Fed has proven stubborn if nothing else. We still have concerns about the K-shaped economy (lots of examples below), but we also think the top of the K can power the economy as a whole.

- Small-caps look vulnerable

We have two charts from Apollo outlining potential trouble for small-cap stocks (loosely defined as greater than $500mm but less than $2b in market capitalization). 43% of small-caps are unprofitable. There is some inverse survivorship bias at play here (stronger companies graduate to being a midcap while new small-caps entering the index are likely not profitable yet). But the trend is accelerating.



And in a world of higher interest rates for longer (regardless of the short-term path of rates, they most assuredly are not going back anywhere near the 0% level barring another meltdown), small-caps have twice the floating rate debt of the large-cap stocks.



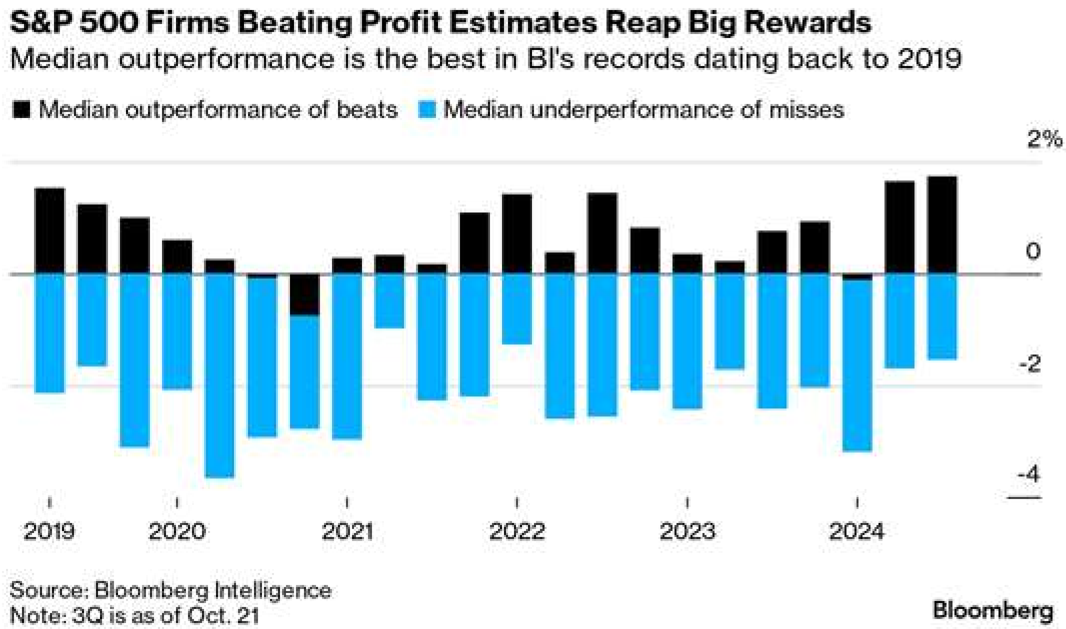
Lots of people buy the small-cap index (IWM) as a way to play an economic expansion. We would rather buy the top of the small-caps instead of the group as a whole.

- More negatives on auto loans

Last week we mentioned that delinquency rates were increasing for auto loans. This week, Edmunds tells us that not only are consumers falling behind on their payments, but the amount of "negative equity" is rapidly increasing (and top heavy). Using trade-in values, the number of car loans with negative equity is up to 24%. This compares to 15%-19% in the last three years (2021-2023). This number had spiked to 32-34% in 2019-20. But the average negative equity back then was around $5100. It is now up to $6500. And 22% of these troubled loans have a deficit over $10k. 7.5% have a $15k pill to swallow. This could be a sore spot for the market (not Big Short type of stuff, but certainly an overhang for the K-shape recovery).

- Earnings beats are being rewarded

Bloomberg tells us that companies that beat earnings estimates are seeing their biggest stock gains in five years. This is obviously a short-term datapoint, but it (the reaction) does tend to set the tone for the medium term. What stands out to us is that this is the second quarter in a row with these kid of reactions (and misses are not as bad as in the past).



- Retail Sales improve, but food inflation is the driver

Retail Sales in September increased 0.4% vs the 0.1% gain in August. This was a little better than expected (+0.3%). After stripping out Auto sales, they increased 0.5% vs 0.2% in August. 0.1% was expected. The biggest surprise/outlier was Food which jumped 1%. But this probably should not be too big of a surprise given Food inflation increased in the month (and Retail Sales are not adjusted for inflation). Apparel and Restaurants were other strong categories. Conversely, Electronics had a big dip (-3.3% on the month). E-Commerce gained much less than the recent trend at only +0.4%.

The weekly Redbook Retail Sales slipped to 4.6% from 5.6%. This data can be choppy (it is weekly, after all). We will watch for a trend.

- Housing is still stuck in the mud (but not pricing)

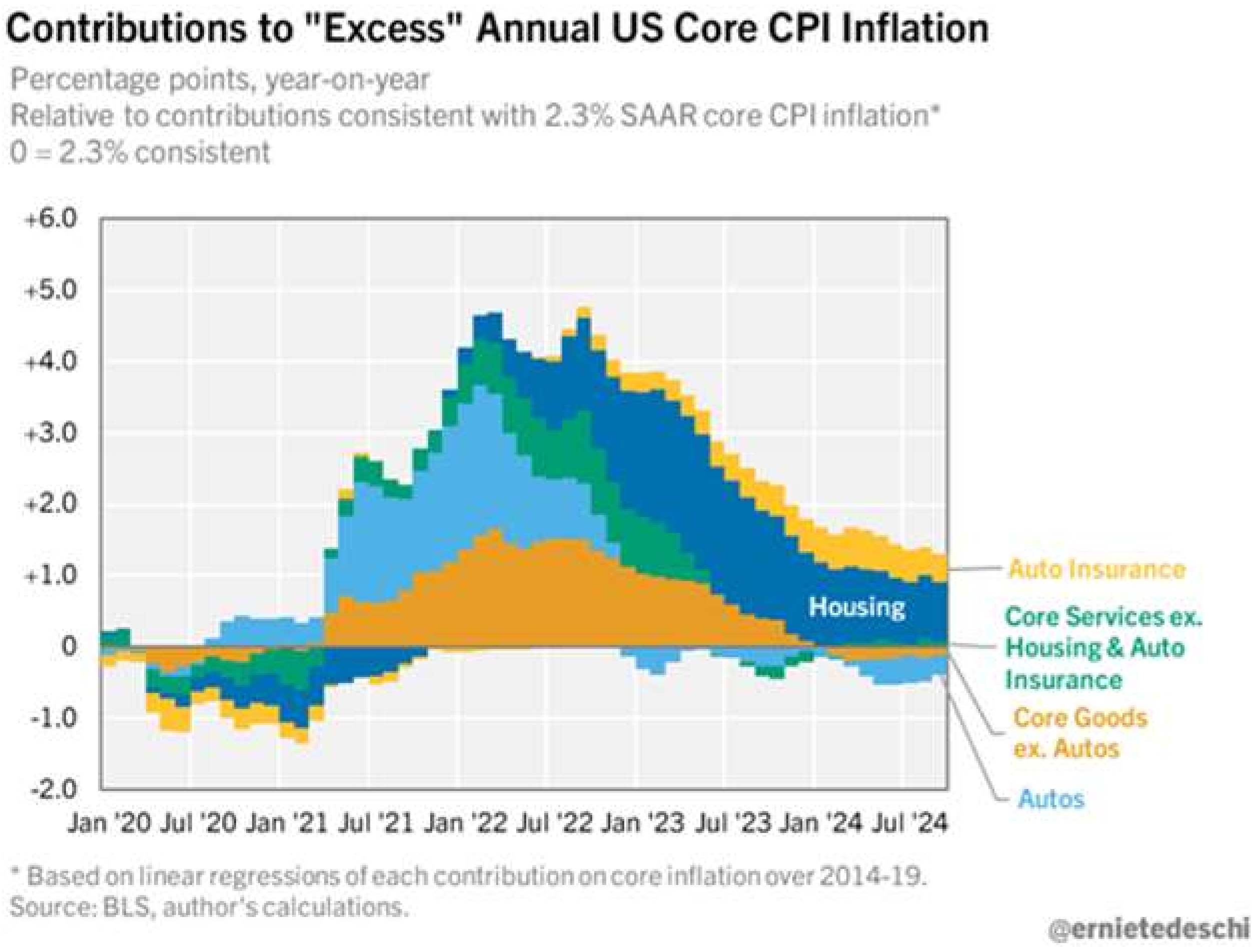
The Housing Market Index (aka homebuilder survey) ticked up a bit in October (41 to 43). Current Sales moved up two points as did Buyer Traffic. Sales Expectations (six months) moved up four points. This latter category is the only one in positive territory. Builders still expect lower rates in the near future.

Housing Starts declined -0.5% in September vs August to hit an annualized run-rate of 1.35mm new homes. Building Permits fell a little more (-2.9%) to hit 1.43mm. Both of these continue to be near four-year lows and well below the pre-Virus Fear trend.

Existing Home Sales fell 1% in September vs August. The annualized run-rate is 3.84mm homes down from 3.88mm. This is the lowest number since 2010. The median price increased 3% (vs last Sept) to $404,500. The amount of inventory is slowly creeping higher. It stands at 1.39mm homes which is 4.1 months of supply (math does not work because of seasonal adjustments). The “experts” say six to seven months of supply is healthy. Average Days on the market has increased to 28 days vs 21 days last Sept. Cash buys are now up to 30% of total sales. First-time buyers are still at an all-time low of 26%.

Weekly Mortgage Applications fell for the fourth straight week. Refinancings were the source of the recent boost (August and September). These have now reverted back to their early August levels.

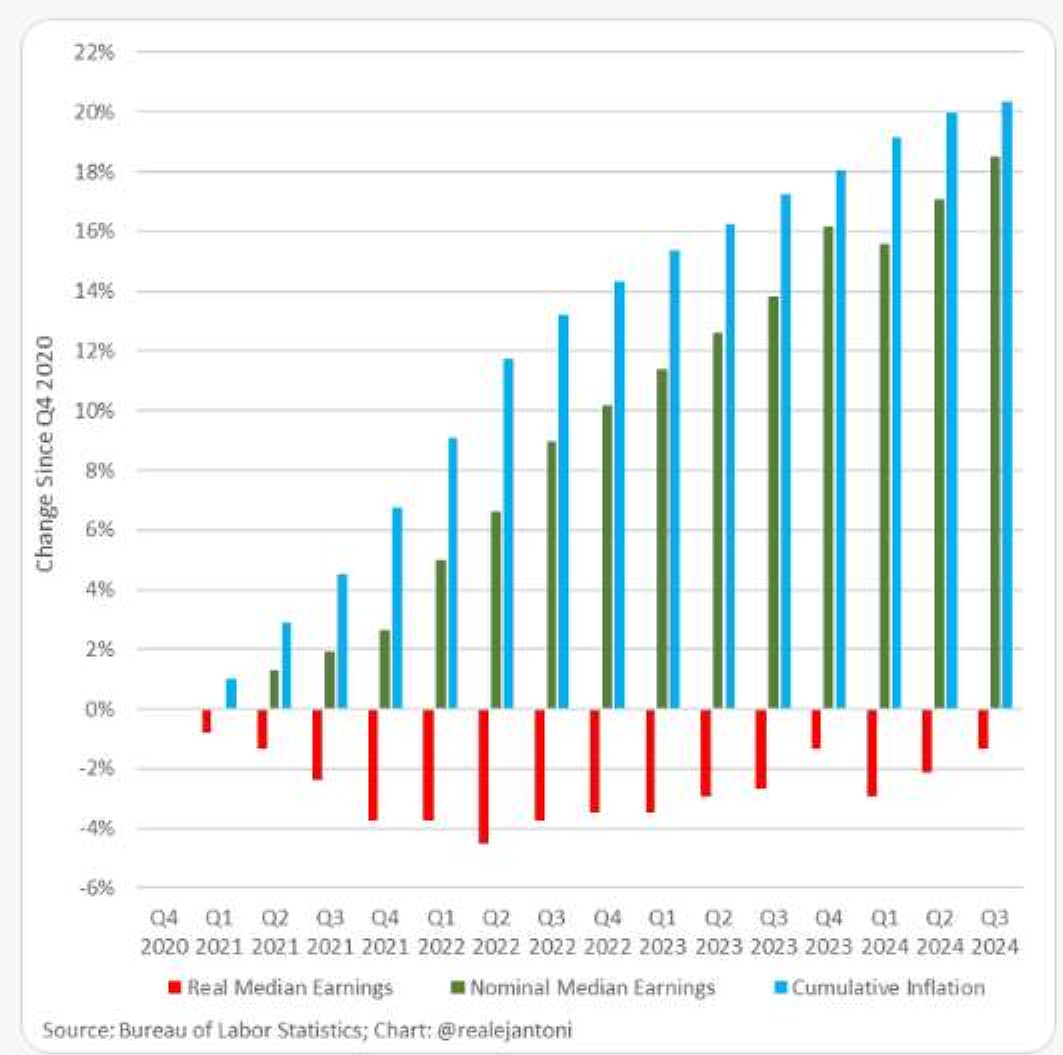
In case there was any doubt about the affordability of Housing…here is Housing inflation broken down on a relative basis compared to the other broad components. And this is after the recent downtick!



Source: Ernie Tedeschi

- ➢ Even if Inflation cools, prices are still high

We comment on this or post it every so often. But we need to remind ourselves that prices are still outpacing wages. This is from Heritage which definitely has its biases, but the data does not lie.



➢ Other economic data is better

- Initial Jobless Claims fell to 241k. This is higher than the recent average, but it might mean the spike higher to 260k last week was an aberration. Continuing Claims inched up to 1.867mm.
- The Philly Fed Manufacturing index increased from 1.7 to 10.3. New Orders were strong with Employment weak.
- The Richmond Fed Manufacturing index improved but remains in negative territory (-21 to -14)/
- Industrial Production fell -0.3% in September vs August.
- The Leading Economic Indicators declined again in September. This aggregat3d data set has been wrong for about two years now. Its composition is skewed towards surveys which we know have been horribly unreliable.

➢ China data is not improving yet (but the lies will come)

GDP for 3Q increased by 4.6%. Since the government growth target is 5% for this year, that tells us they are in recession. Capacity Utilization in the industrial sector fell to 75.1% vs 75.6% (3Q last year). House Prices fell

5.7% in September after a 5.3% drop in August. Retail Sales improved to 3.2% as did the Unemployment rate (5.3% to 5.1%.

Given all the announced stimulus measures (monetary and fiscal), the data will surely start to “look” better. Of course, the communists do not want to wait around for actual data to change. They added to their direct purchases in the equity market. We are not buyers (not short either).

- In case you need a reminder about China

China reports that it is now importing 1.5mm barrels of oil a day from Malaysia. Malaysia produces 350k barrels per day. Meanwhile, China reports that it imports 0.0 barrels of oil from Iran.

- Where did all the crypto money go?

A startup crypto platform (do not call it an exchange!) wants to bring to the US what got Binance and FTX busted. Bitnomial is aiming to list perpetual futures in Chicago. These are the crazy securities that require very little money paid up front (massive leverage…ie 125:1) and never expire. These guys might not be dumb enough to steal your money outright, but opening pandora’s box never ends well.

- Chart Crime of the week

Bitcoin and the McRib…of course! Although this one might make more sense than those crazy elliptical charts the Bitcoiners randomly draw.

- Quick Hits
    - Some Facebook employees have been fired for using their in-office meal credits to buy items for home use (detergent, toothpaste, etc.).

- One fired Facebook employee responded, “It was almost surreal that this was happening.” She had a $400k salary.
- New York state has the most ski resorts in the US.
- It is rumored that Uber is looking to buy Expedia. The current CEO of Uber was the CEO of Expedia from 2005 to 2017. He still holds $30mm of Expedia stock.
- Data centers consume 26% of Virgina’s power.
- The US government spent $882b on interest payments in 2024 (fiscal year Oct 1 to Sept 30).
- The US Treasury highlights (brags) that interest as a percentage of GDP was only 3.9% (second highest ever behind 1991’s 4.7%).
- The last full-size K-Mart in the country closed this past weekend. It was in the Hamptons of all places.
- TGI Friday’s was created by a guy who wanted to meet women. The original singles’s bar, as it was known, created the “happy hour.”
  40% of owner-occupied homes in the US do not have a mortgage.

Trading: We continued rotating out of some Big Tech and redeploying this across Energy and other inflation plays. Despite Big Tech traditionally performing well in this kind of macro environment, (expanding growth, global monetary easing, and potential reemergence of inflation) we want to book some more profits after a big run. Valuations have crept higher as the sales trajectory starts to slow (still strong, just not as strong). Inside of Big Tech, we also rotated some names. We did the same in Health Care.

TSLAQ: Tesla is facing another probe by the National Highway Traffics Safety Administration (NHTSA not to be confused with the NTSB) for flaws in its “Full Self Driving.” The NHTSA has an Office of Defects (sounds like it should be in an Austin Powers movie). These type of investigations are nothing new, but apparently this one will include a review of 2.4mm Teslas using “FSD.”

Musk is also facing an inquiry into his scheme to give away $1mm a day until the election. Who knows what the legalese is here. But we think he is crazy to toe this line.

Europe is considering fining Musk’s X for free speech violations. They have warned that it might calculate the potential fine based on all of Musk’s empire and not just X’s.

Tesla earnings are just out. It looks like the bottom line is better along with gross margins improving. But revenues are slowing. We will wait for the details and conference call, but the press release did hint at large regulatory credits. Tesla has been the king of clipping government coupons, but that business is dying considering every other car company in the world is producing EVs of some sort (and thus they will not have the need to buy EV credits from Tesla…what a silly concept). And naturally, Tesla is pumping the new mass market car which will be introduced in the first part of next year. We will bet against this (but we might have to wait for the fluff to pass).

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