Weekly Update

18-Dec-2024

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- It was a quiet week…until it wasn't
- Powell cuts rates, freaks out the market, but not much has changed
- Complacency had been building
- Woulda/Coulda/Shoulda
- European corporate defaults are on the rise
- Housing data continues to zig zag
- Retail Sales are choppy but positive
- China data is still weak
- Quick Hits
- Where did all the crypto money go?
- Chart Crime of the week

	Last	5d %	YTD %	1yr %
S&P 500	5,872	-3.5%	24.3%	25.6%
QQQ	$516.47	-2.5%	26.7%	28.3%
US 10 YR	4.52%	4.28%	3.88%	3.85%
USD/DXY	108.3	106.7	101.3	102.2
VIX	27.6%	13.6%	12.5%	12.5%
Oil	$70.00	-0.5%	-1.5%	-2.6%

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

It was a quiet week…until it wasn't. The market freaked out today after the Fed increased its inflation forecast and lowered its rate cutting projection. Of course, the Fed did cut its target range for Fed Funds to 4.25%-4.50% as expected (down 0.25%). But now only two cuts are on the table for next year. The line underscoring this new projection was, "We can be more cautious as we consider further adjustments to policy rates." The Fed had previously forecast four cuts as recently as September. But in reality, the market had already been reducing its expectation…about three was the guess last week. And the 2-year Treasury yield (the best proxy for Fed Funds despite the nominal mismatch in tenor…Fed Funds is the overnight lending rate between banks) was already at 4.25%. Today's move was a big one-day move of 0.10% higher to 4.35%. But that means the mismatch between the market and the Fed is now completely gone.

To state the obvious, most people were surprised at the market reaction. Fed Chairman Powell did not say anything too far from the recent narrative. Or rather, he did not say much that we did not already know.

Specifically, he noted that inflation was trending higher with the Labor market being looser (weaker). But if the Fed was not going to cut rates and the economy was not as strong…that could certainly stir up the hornets's nest.

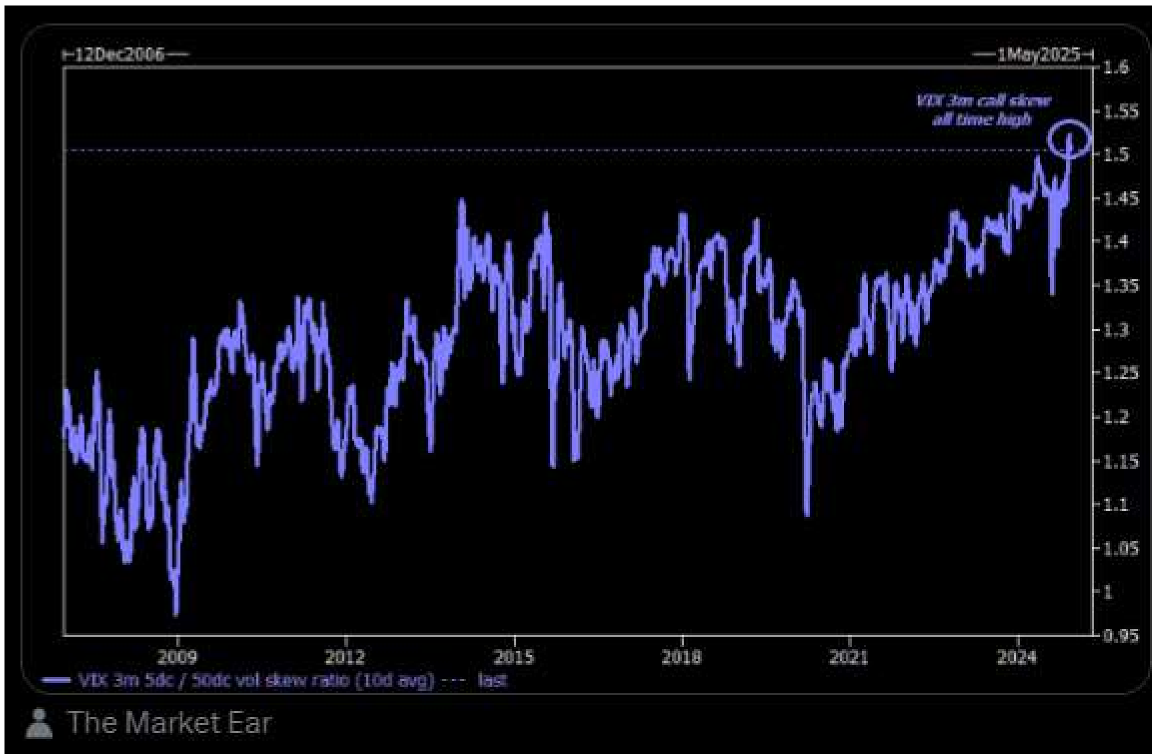
After listening to Powell today, our first thought was the market reaction was reminiscent of Christmas 2018. This was a period of extreme market stress because Powell refused to back down from rate hikes over the previous two years. The market must be expecting another standoff (some are calling it a Trump-Powell feud). We think this is overdone. While Powell did not commit to using the term "recalibrating" with respect to autopilot rate cuts, he did emphasize that current monetary policy was "meaningfully restrictive." And long-term inflation expectations remain anchored. He summed it up with, "we are still on track to cut further."

Ultimately, we think this knee-jerk reaction to the Fed has been in the making. We wrote off some of the recent mini-death-rotations as episodic…because they were at first. But obviously a series of episodic occurrences is no longer episodic! Even if this knee-jerk reaction to the Fed is short-lived or wrong-headed (as the first reaction often is), there still might be an overhang on the market. The Trump trades might be in the wait-and-see camp now. Even with high hopes for DOGE cutting costs, fiscal deterioration is back on the front burner under a higher-for-longer interest rate scenario. Afterall, the government is now facing $1.3t a year in interest expense with more pain to come as rates from pre-Virus Fear need to be rolled over at higher rates. And we will add that everyone thought the market weakness would come next year…nobody likes to realize capital gains taxes late in the year (especially not if there is a chance for a lower rate next year). Of course, the market has a good track record of catching people offsides.

- Put this whole section in the Woulda/Coulda/Shoulda file

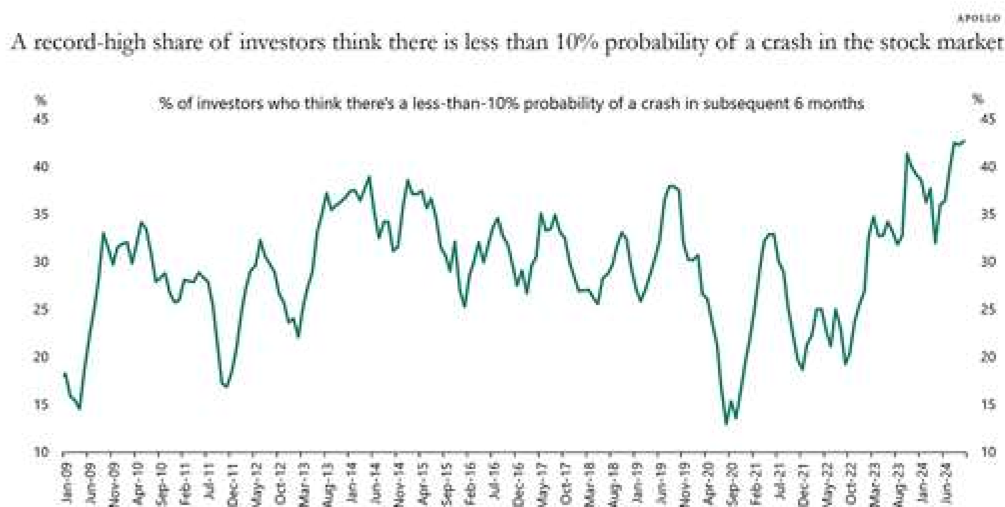
(We wrote this section over the weekend. We would call it prescient, but it is like a tree falling in the woods…)

We have talked about the low Vol levels seen recently (VIX). Specifically, the last time market Vol was this low was late July right when the market had a sharp correction (narrative blame was on the unwinding of the Yen-carry trade). This chart tells us that at-the-money Call option Vol is cheap, but out-of-the-money Call options are expensive. We had previously talked about potentially buying some cheap Put options. But this Call dynamic tells us we should also think about selling out-of-the-money Calls. We would not do this in a "naked" fashion (being exposed to a short squeeze type of dynamic). But it could be useful in generating some income via a covered-call strategy (sells Calls on stocks that we are long). We will also add that our Outlier Rank data set tells us that large moves are not actually happening. We think this is a head fake and some turbulence is coming.



(We also wrote this one before today.)

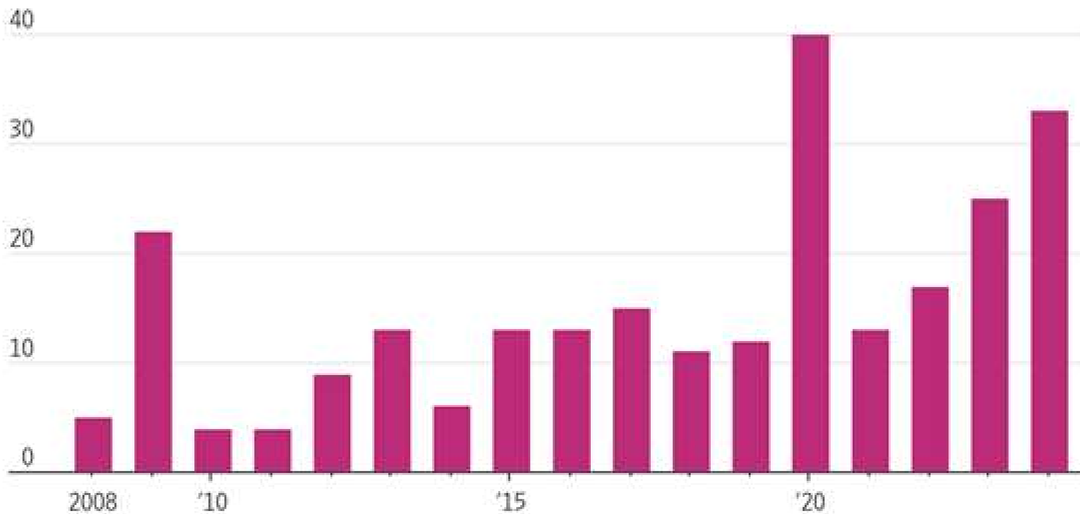
There has been increasing talk of the rich valuations in the market. On the one hand, optimism is running high from Small Businesses to Consumers. Here is a view from Apollo and Yale. The percentage of investors that think there is a less than 10% chance of a crash in the stock market is at a record high. Almost half of investors do not think there is a realistic chance of the market falling 20%. This complacency makes us worry.



Source: Yale School of Management, Robert Shiller, Apollo Chief Economist

- European corporate defaults are on the rise

We have stayed away from Europe for a while now. And the Wall Street Journal has a simple chart as to why. Corporate Defaults are on the rise. And this is during a time when global defaults fell below 2023 levels.



- Housing data continues to zig zag

The Housing Market index (aka home builder survey) for December remained unchanged at 46. Each component held relatively steady, too. Current Sales Conditions are at 48 (unchanged on the month) which is negative but not terrible. Current traffic of prospective buyers is terrible at 31 (-1). But Future Sales Expectations are great at 66 (+3). 60% of current sales are being done with an incentive (mortgage buydown). 31% of builders cut prices again in December (they have been cutting prices about 5% a month).

A recap in the survey release sums it up, "While builders are expressing concerns that high interest rates, elevated construction costs, and a lack of buildable lots continue to act as headwinds, they are also anticipating future regulatory relief in the aftermath of the election."

Housing Starts and Building Permits contained some conflicting data. Starts fell -1.8% in November vs October and missed expectations. But Permits increased 6.1% (Nov vs Oct) and beat expectations. However, Starts for Single Family homes were quite strong (over 6% while Multi-Family Starts were down about 24%). But the beat in Permits was driven by Multi-Family with a 22% increase on the month. Single-Family Permits were flat.

Mortgage Applications fell for the first time in six weeks.

This is all a bit hard to square (as is usually the case with Housing). In general, we think Goldman and JP Morgan are on the right track when they say homebuilders are going to see lower margins and Housing supply is no longer in a deficit. But as always, it is going to come down to Employment and whether Existing homes will be forced to hit the market at discounted prices. We do not believe so. We think the market might have to muddle

through for a while but will ultimately come out on the other side thanks to deregulation and a stable Labor market (despite its spots of softness).

➢ Retail Sales are choppy but positive

Retail Sales increased at a rapid 0.7% pace in November vs October. A 0.5% increase was expected. And October was revised up to 0.5% from 0.4%. The yearly gain stacks up to 3.8% now vs 2.9% last month. After we strip out Autos & Parts, it was only a 0.2% increase vs a 0.4% expectation. Autos & Parts can be lumpy, but we cannot dismiss their strength completely. Using the calendar effect is a lame excuse, but it is worth pointing out that Thanksgiving Sunday and Cyber Monday occurred in December this year (this should have been in the expectation, but you never know).

The e-commerce segment (Nonstore retailers) jumped 1.8% on the month. It has grown almost 10% this year. This strong number meshes with the good Thanksgiving e-commerce sales. Grocery store sales also accelerated strongly at 1.7%. Clothing stores were negative on the month -0.2%. But even this was better than expected. Electronics increased 0.3% (this one has been volatile lately). Food Services and Drinking Places fell -0.4%. As a reminder, this data is not adjusted for inlation.

Weekly Redbook Retail Sales increased 4.8% vs 4.2% last week.

➢ Other economic data is mixed
- The S&P Services PMI for December (Flash/early read) jumped 2.5 points higher to 58.5 (a drop was expected). Manufacturing did dip.
- Right on cue, the NY Fed's Empire Manufacturing index for December dropped from its highest level in three years down to flat.
- Industrial Production fell 0.1% in November. October was -0.4%
- Initial Jobless Claims moved higher to 242k. This is the highest in two months. Continuing Claims also moved higher to 1.886mm from 1.871mm. This one has been trending higher and continues to do so. (Continuing Claims are defined by at least two weeks or unemployment checks.)
- The Producer Price Index (PPI, wholesale or input inflation) increased 0.4% in November. This outpaced the CPI of 0.3%. But the "Core: PPI slowed to 0.2% from 0.3% (and vs 0.3% on "Core" CPI).

➢ China data is weak

We recently discussed Saudi cutting oil prices to Asia. We now have the Chinese data that supports this. Oil refineries processed the lowest amount of oil in five months in November. The excuse points to seasonal maintenance shutdowns. But demand also fell at the same time. It was down 2.1% in the month and is down 3.3% for the first 11 months of the year.

Also, Retail Sales weakened in November with only a 3% gain. This is down from October's 4.8% increase (remember, direction and rate of change are all that matter in China). Industrial Output remained steady at 5.4% which conflicts with the decline in oil demand. But given much of this output is attributed to front-loading before tariffs strike, we side with the oil demand data. Fixed Investment declined a bit.

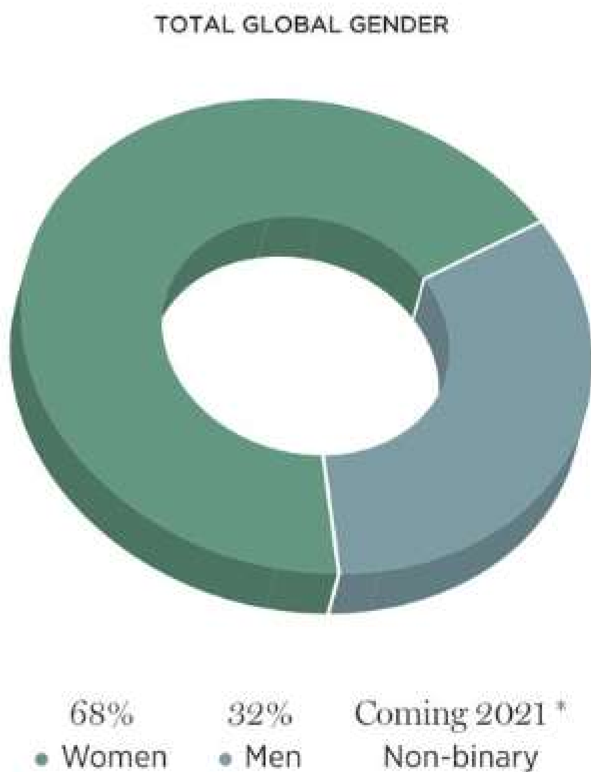
As we have been saying, gimmicky stimulus efforts will do nothing to get people to buy or make things that nobody needs or wants.

➢ Where did all the crypto money go?

We have talked before about crypto token insiders selling their flighty fortunes the moment the protocols allow it. Basically, tokens can be like IPO stock with lockups to prevent the time-tested pattern of pumps and dumps. But now some "researchers" have created a platform called Liquefaction that masks crypto ownership and allows for account sharing, renting, and pooling. The researchers throw in the caveat that their technology might not be used for altruistic purposes. They unapologetically lament, "Liquefaction can also obfuscate transaction histories, enable stealthy wash trading, erode the fidelity of on-chin cryptocurrency analytics and corrupt reputation-dependent systems." In other words, cryptocurrency's main use (other than speculation which is not all that bad), money laundering, will now be even easier and more untraceable.

- Chart Crime of the week

Conde Nast could be on par with The Economist for ridiculous takes. This gem is from 2020. Of course, we have no idea what any of this nonsense was supposed to mean then. But we think they ended up being wrong whatever the case.



- Quick Hits
    - Scorigami! Dan Campbell's boneheaded loss 48-42 to Buffalo was the 1090th unique score in NFL history.
    - Herschel Walker graduated from Georgia this week 42 years after leaving for the NFL.
    - Walt Disney founded his namesake company at the age of 22 (in 1923).
    - The 2001 University of Miami football team would have finished 8-4 if their offense never scored a TD. (They won the national championship 12-0.)
    - Copper Harbor in Upper Michigan is the furthest one can get from an interstate highway in the contiguous 48 states (driving miles…so not as the crow flies).
    - Bitcoin is trading its entire supply every three weeks.

- The Minnesota Satanists have an altar set up (legally) in the state capitol building in St. Paul.
- The crypto Bro that bought the banana artwork for $6.2mm did, indeed, eat the banana.
- An autonomous driving expert (there is one?) thinks Tesla can capture anywhere from 2-70% market share.
- In college, we were once assigned a two-page paper for our final grade. After some bellyaching from a few uptight students…they wanted a more challenging assignment… our professor changed the assignment: The paper could be 2-12 pages.
- The Houthi are planning a seminar and webinar to educate people on "the security of navigation in the Red Sea." The terrorists have literally emailed trade groups asking for discussion points.
- The latest Continuing Resolution to temporarily fund the government includes changing some terms. Criminal "Offender" will be replaced with "Justice-involved individual."

Trading: We added to some longs that stand to benefit from a higher inflation / higher growth environment. These include Financials, Industrials, and Big Tech. We cut some of our defensive positioning to fund these purchases. These do not look like good trades today. But we still believe in the macro backdrop (inflation and growth) over the market's finnicky reaction to Powell. Of course, if the Labor market weakens and growth starts to slow, that would be a game changer to stagflation. The market thinks Powell hinted at that today. Time will tell (but we do not think so, at least not in the near-term.

TSLAQ: We do not have much to add here. Musk is focusing his pumping on DOGE (good for him). Musk is smart and lets the market do the pumping for him on Tesla. The stock is ridiculously priced for a car company, a robotaxi, an energy company, an AI company…whatever you want to call it…but that does not mean we want to stand in the way of this freight train.

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