9/29/2021: *Losing FAIT…*

We're cutting risk and upping our short exposure today. We're not *yet* turning outright bearish and we'll remain nimble and quick to change our positioning (as always) if market internals firm up. But, recent developments at the Fed and policy shifts in China, combined with stretched technicals and positioning, warrant more defensive posturing here in our view.

The strongest tailwind behind this market has been the Fed's new reaction function, known as flexible average inflation targeting (FAIT). I wrote about it [here.](#)

The idea was that they'd take a more *procyclical* approach to policy and would lean into reflation. As a result, they'd let inflation run above target for a good while. All in the hopes of seeing how tight we could drive the labor market, with an emphasis on raising employment levels amongst the historically most marginalized communities.

Powell had been doing a good job all year of reinforcing this idea. Even with increasing talk of tapering asset purchases, he made a strong effort to delink taper from raising interest rates. And he talked down inflation concerns, continuously marking them as transitory.

But last week something changed. And this change matters.

Powell greenlit a November taper and said he expects it to end by mid-202. This is sooner than first thought and opens the window for a hike at the end of 2022. FOMC participants are currently split on a hike next year, while they raised their 2023 dots, despite only modest changes to their outlook.

More importantly, Powell didn't make an effort to distance himself from the dots nor did he attempt to talk down inflation concerns. Which makes it look like he's moving to make a compromise between the hawks and doves within the FOMC.

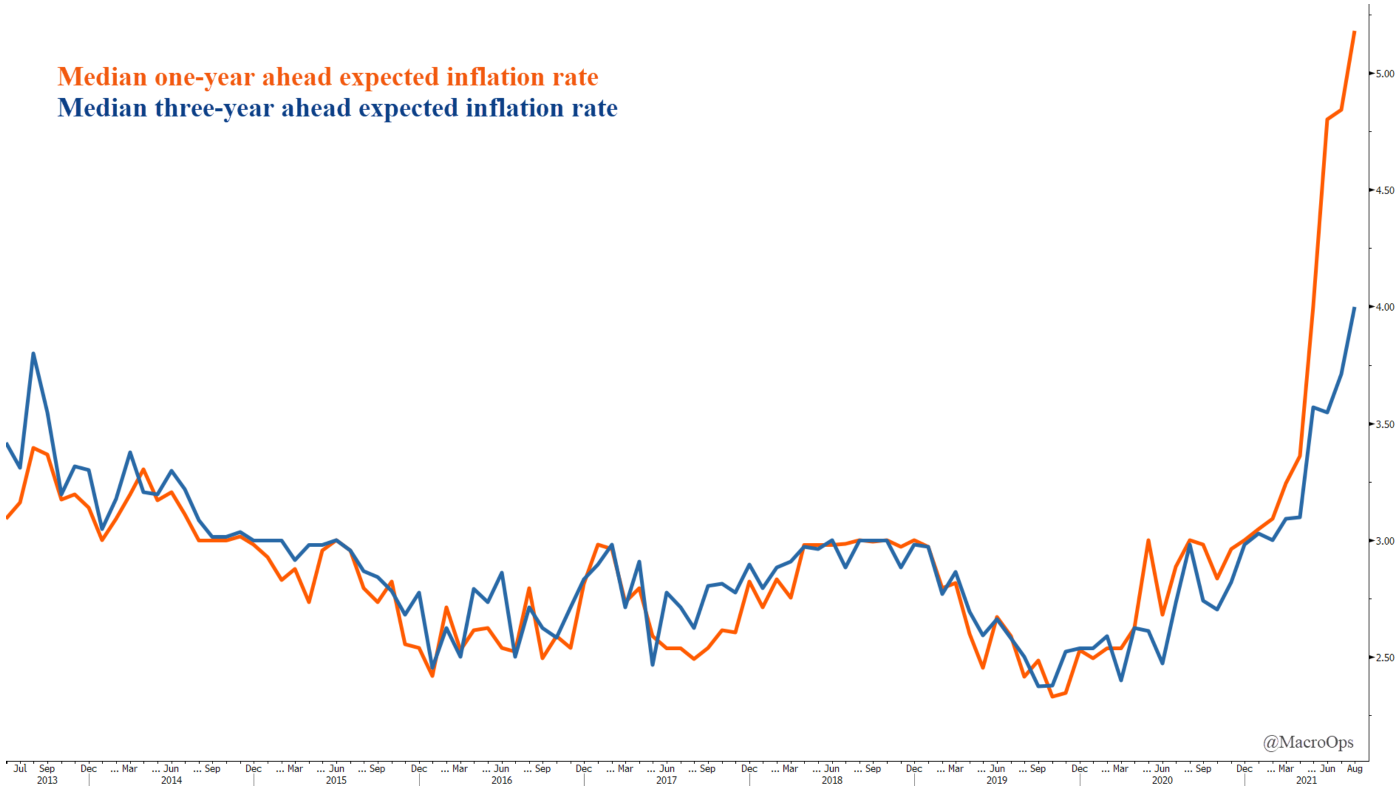
Now, typically a single tentative hike planned for later next year would be a non-issue.

But, it matters here because of what it does to the narrative. When US assets are trading at record multiples and inflation is running well above trend and the primary driver keeping these long-duration assets buoyant, has been artificially suppressed interest rates. Well, it doesn't take much of an imagination to see how things can get squirrely.

Unemployment hit a low of 3.5% before COVID. Originally, the Fed communicated that they thought maximum employment was likely at some level lower than 3 ½. This is why they were signaling FAIT so aggressively.

But with their own forecasts projecting unemployment to only dip below 4% by the end of 22' and into 23. The recent hawkish turn just doesn't square up. And it suggests one thing… The Fed is spooked by inflation.

The chart below is the likely culprit behind the Fed losing FAIT. Inflation expectations for one and three years out are becoming unanchored.

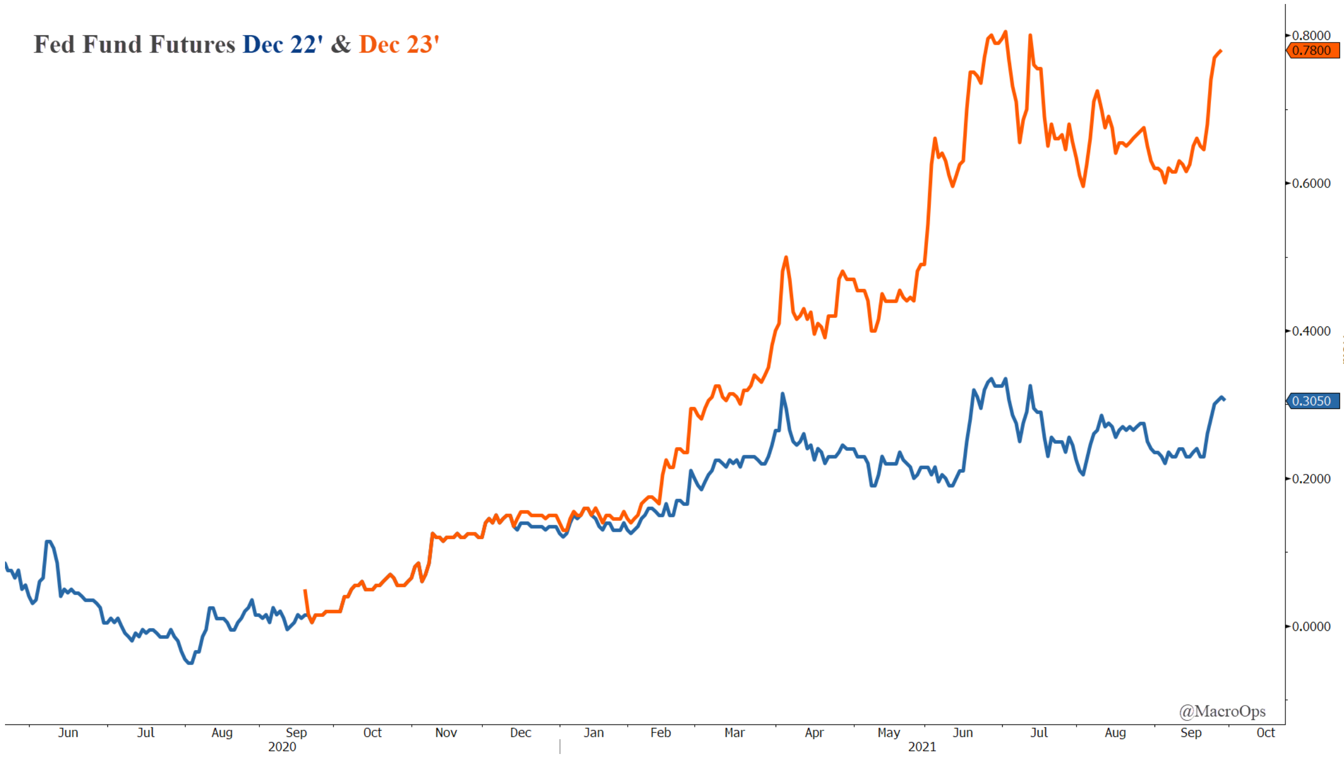


The Fed is concerned about inflation going 70's style, so they're reverting back to their old ways. Stomping demand to manage prices...This hot take is supported by this exceptional piece of Fed research that was published by Fed economist Jeremy Rudd last week — seemingly in response to his more hawkish brethren (link here).

The report contains some quite colorful comments, such as this one:

> *I leave aside the deeper concern that the primary role of mainstream economics in our society is to provide an apologetics for a criminally oppressive, unsustainable, and unjust social order.*

The market is starting to pick up on the changing winds. Fed Fund futures for Dec 22' and 23' both perked up last week and are nearing new highs.



The tightening has started. And with great timing too, just as the delta on global growth is rolling over and we move off the backend of the massive liquidity injection markets enjoyed last year.

This is a good time to reference Druckenmiller on how to think about this shift.

> *Contrary to what a lot of the financial press has stated, looking at the great bull markets of this century, the best environment for stocks is a very dull, slow economy that the Federal Reserve is trying to get going… **Once an economy reaches a certain level of acceleration… the Fed is no longer with you**… The Fed, instead of trying to get the economy moving, reverts to acting like the central bankers they are and starts worrying about inflation and things getting too hot. **So it tries to cool things off… shrinking liquidity…***

The Fed is no longer with us. At least not for the moment…

Good news will be interpreted as bad news. Falling unemployment, strong growth, and non-transitory inflation will continue to nudge the Fed further towards the hawkish side of the spectrum, at least until something breaks, which we expect it will.

And then we have China.

I wrote the other week about how Evergrande wasn't a Lehman, as it was widely being depicted in the press. Rather, it should be thought of as a symptom of a much greater problem. One where the solution boils down to the tough choices facing China of either **(1)** maintain high growth by continuing to leverage or **(2)** deleverage the economy and accept significantly lower trend-line growth.

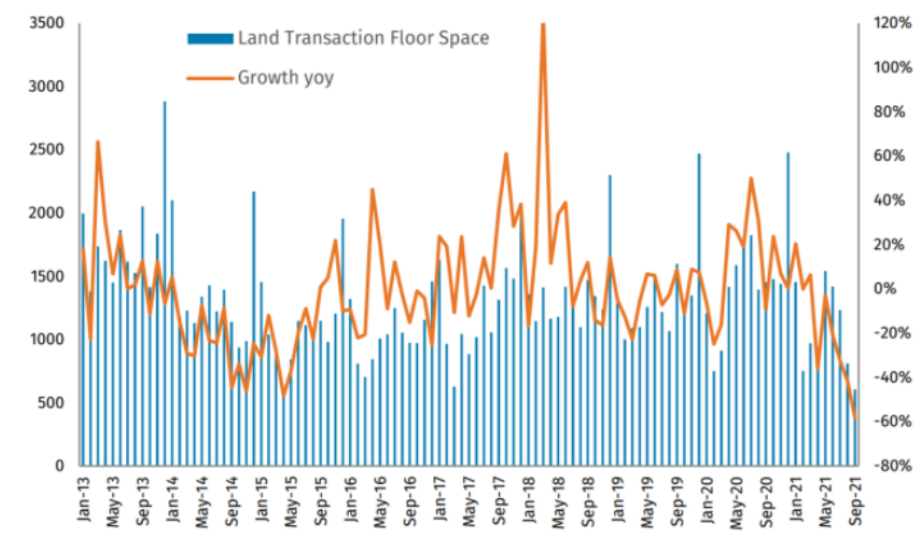
After years of consolidating power and cracking down on rivals, Xi is able to finally do the latter.

What this means, is that China will be shifting over time from its rolling credit-fueled growth cycles to a much lower one (think 1-3% GDP growth).

This will have significant effects on growth and inflation over the long term, especially in select emerging markets dependent on Chinese demand.

Someone shot me this great ChinaTalk interview yesterday with Rhodium Group (link here). The piece is worth reading in full but I wanted to bring your attention to this particular chart, showing the total collapse in land transactions. As I noted in this week's Dozen, we'll need to watch base metals here as they will undoubtedly get hit.

Land Transactions in 100 Cities, Jan 2013 – Sep 2021
10000 sqm; Percent yoy (RHS)



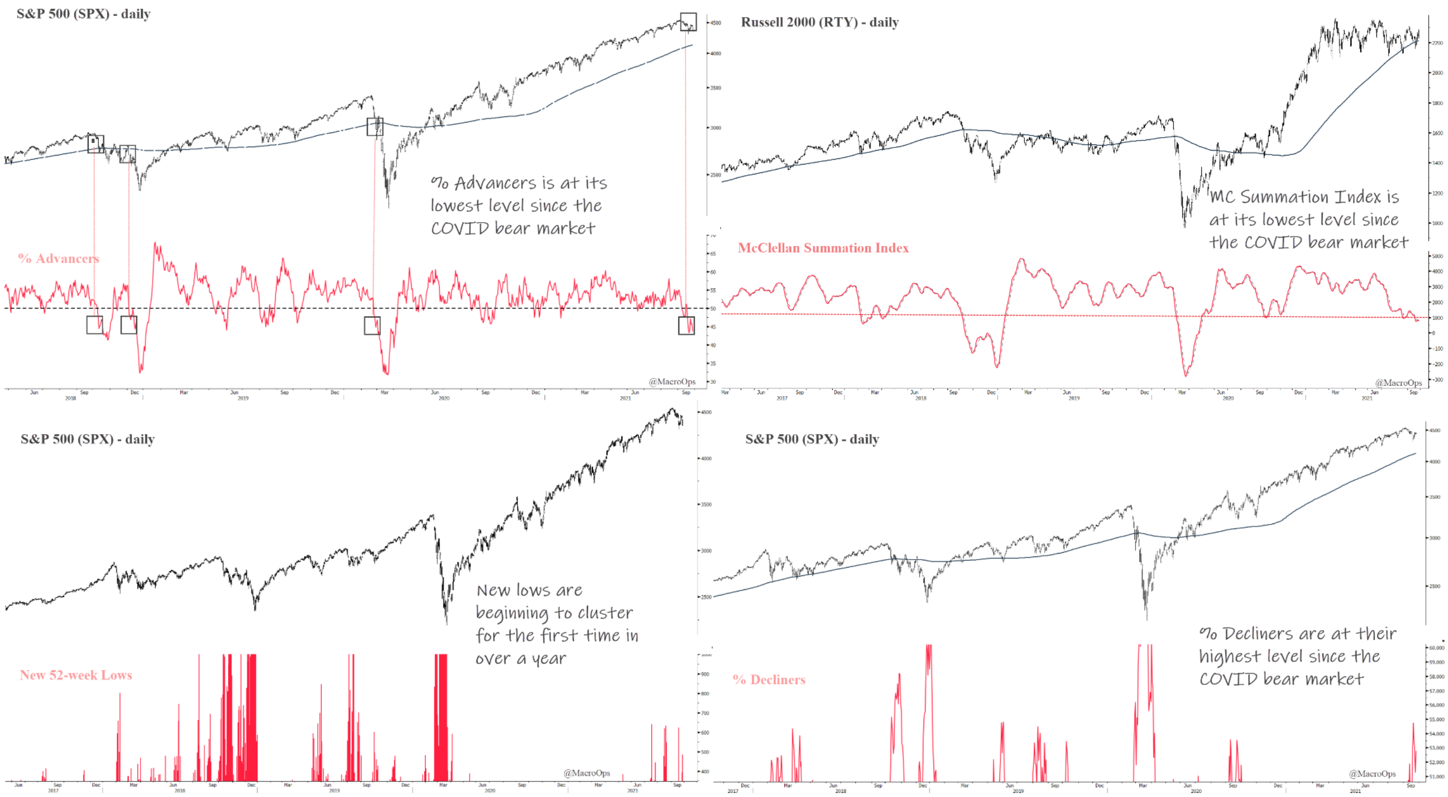
Source: WIND. Calculations for partial months such as Sep 2021 are y/y based on weekly totals.

We'll be diving into the long-term implications of this shift later this week. But, as for right now, these policy changes in China and the Fed will begin to dent growth at the margins. And even more importantly, over the short-term, they'll drag down expectations from arguably elevated levels.

The last few months we've been playing for a final buy climax to top off the SPX's year-long rising wedge. With the expectation that this would lead to a 2-3 month 10-20% correction. As is typical after such an extended run.

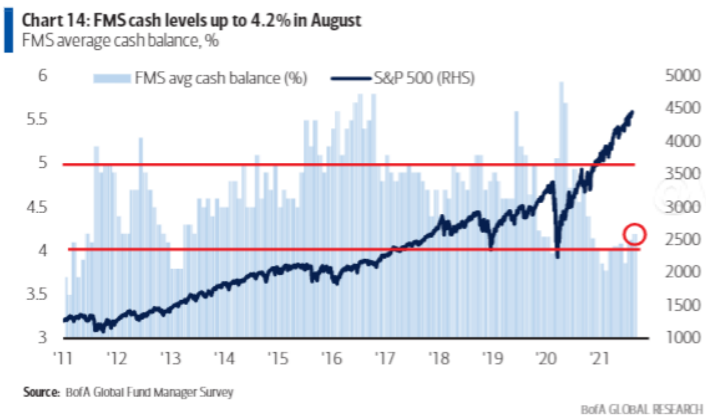
However, we pride ourselves on flexibility above all else. The ability to change views and positioning is a critical advantage that we don't plan to give up. And following the persistent weakness in the market's internals, we're being forced to turn more cautious sooner than we expected. Here's a shortlist of a few of the troubling technical signs:

- **SPX % Advancers at lowest level since COVID bear**
- **McClellan Summation at lowest level since COVID bear**
- **52-week lows clustering for the first time since COVID bear**
- **% Decliners at highest level since COVID bear**



This technical weakness comes amidst an extremely fragile backdrop. One marked by high trend fragility and stretched positioning.

- **Trend Fragility recently hit 90th percentile**
- **Aggregate Fund Flows hit 99th percentile**
- **TD Ameritrade's IMX is coming off its highest reading ever**
- **Our Trifecta Lens Score just flipped to -3 (bearish)**
- **Hedge Fund positioning is at its most long since October 18'**
- **FMS Cash levels are near historic lows**
- **FMS growth expectations have rolled over while equity overweights set to follow**

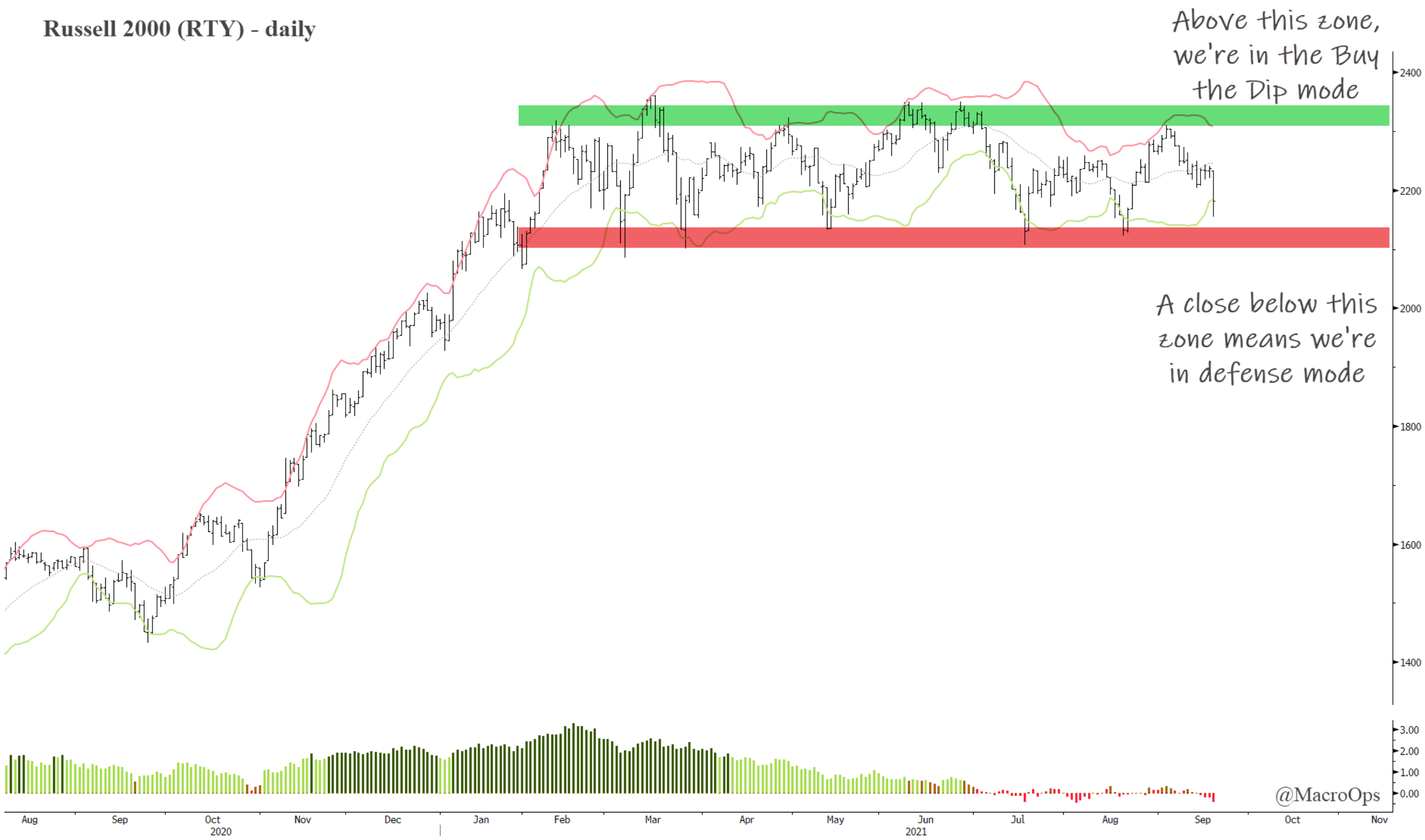


In addition, the US dollar and yields — two previous tailwinds to risk-assets — have broken out to the upside. Another tailwind turned headwind for richly priced US assets.

Looking out over the short term, it's likely that fights over the debt ceiling and infrastructure bills will dominate the news, bringing additional headline risk.

As of now, it looks like the Democrats will separate the debt limit from the government funding bill and pass a stop-gap measure. This will keep the government funded through early December. This *should* pass this week. But there's a chance it doesn't. Either way, it looks as though this circus will be ongoing in the weeks ahead.

Small-caps are holding up well and credit spreads aren't yet indicating risk of major dislocation. The below chart still holds true. We want to be buyers on a move up and out of the range and sellers below. We'll have to keep monitoring this and making adjustments accordingly.



As far as the moves we're making, we're going to reduce risk across most of our portfolio while putting on some opportunistic short positions.

We'll be cutting or strongly reducing our longer duration names and those that are showing technical weakness while keeping and adding to our plays/thematics that continue to work in our favor.

Here are the changes we're making today.

We're cutting/taking full profits on:

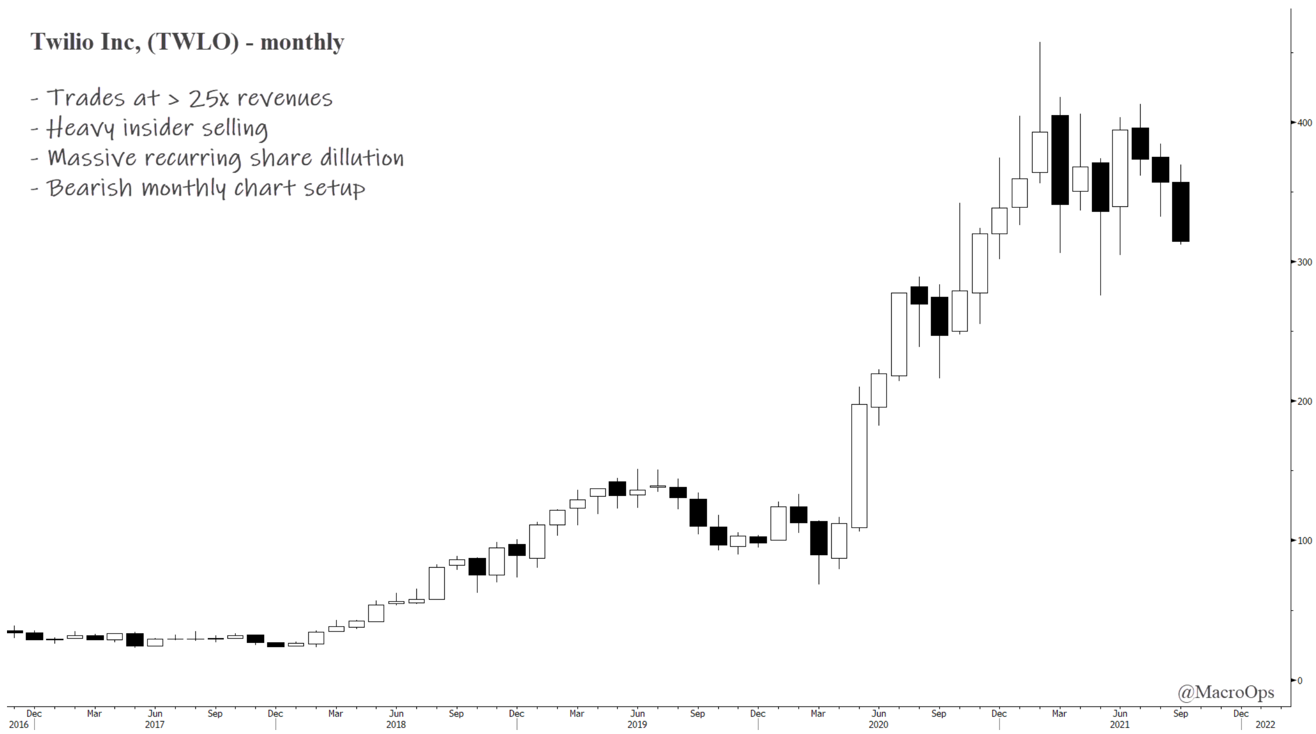
- Murata Manufacturing (6891)
- Square, Inc. (SQ)
- Nvidia, Inc. (NVDA)
- Advanced Micro Devices (AMD)

We're cutting half on:

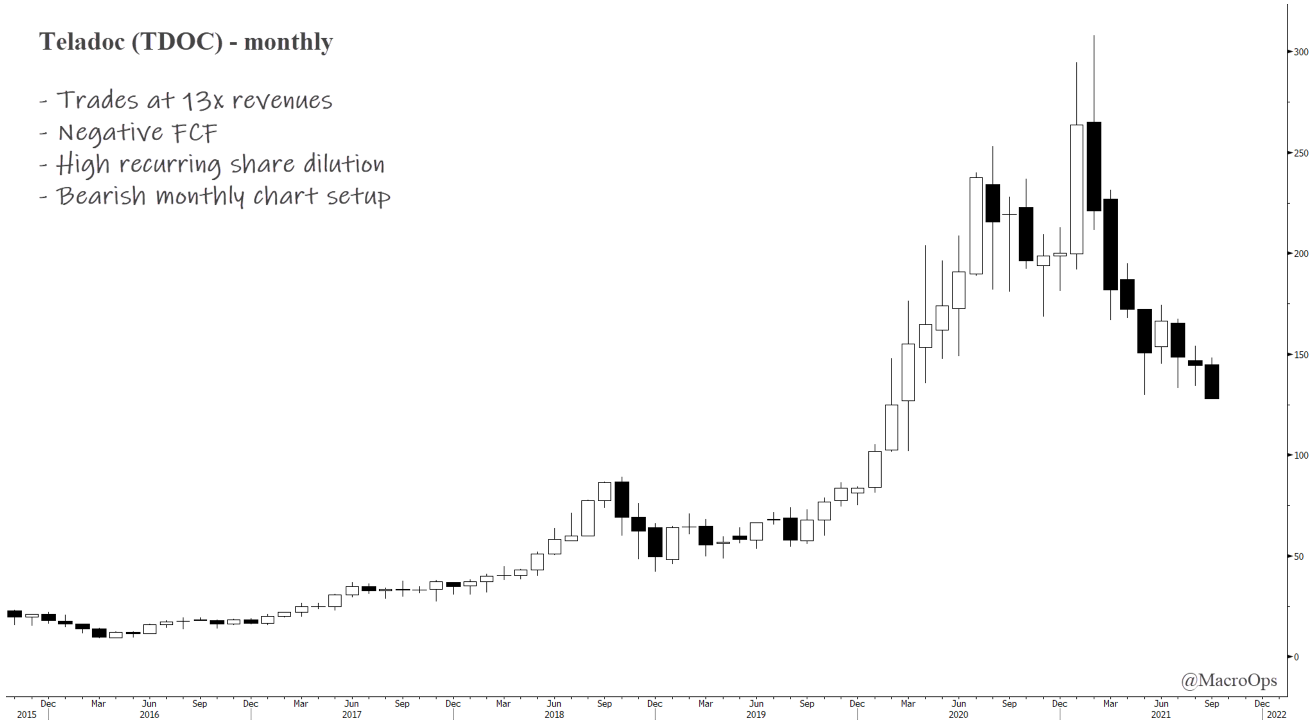
- XP, Inc. (XP)
- Green Thumb Industries (GTII)
- Riskified (RSKD)
- Grayscale Ethereum

We're adding shorts in crowded long-duration assets and ARKK darlings:

- Twilio (TWLO)
    - Entry: $316.01
    - Risk-point: $354
    - At-Risk: 50bps



- Teladoc (TDOC)
    - Entry: $128.53
    - Risk-point: $141
    - At-Risk: 50bps



- Pinterest (PINS)
    - Entry: $ 51.00
    - Risk-point: $58.50
    - At-Risk: 50bps

- E-mini Nasdaq Futures (NQZ2021)
    - Entry: 14,734
    - Risk-point: 15,200
    - At-Risk: 50bps

We're Buying:

- USDMXN
    - Entry: 20.51463
    - Risk-point: 20.0000
    - At-Risk: 50bps

Stay nimble and keep your head on a swivel.

Your Macro Operator,

Alex