A Market Note: Reading Chicken Bones…

Okay, the Fed meeting fell into the neutral camp. Yesterday people were saying Powell was dovish because the market was up. Today they're saying the meeting was hakwish because the market is down.

The peanut gallery reading chicken bones is all it is. The Fed's 50bps hike and the kicking off of its balance sheet roll-down next month is largely inline with what the market was pricing.

Boring. Not interesting stuff. Let's move on…

What's up with the wild action the last two days?

If I had to guess, this smells of forced liquidation. There's some big funds trapped holding bad businesses that were the story stocks of the last few years. They've round-tripped, some of these funds are now down big, and we'll hear about some closing up shop over the next few weeks.

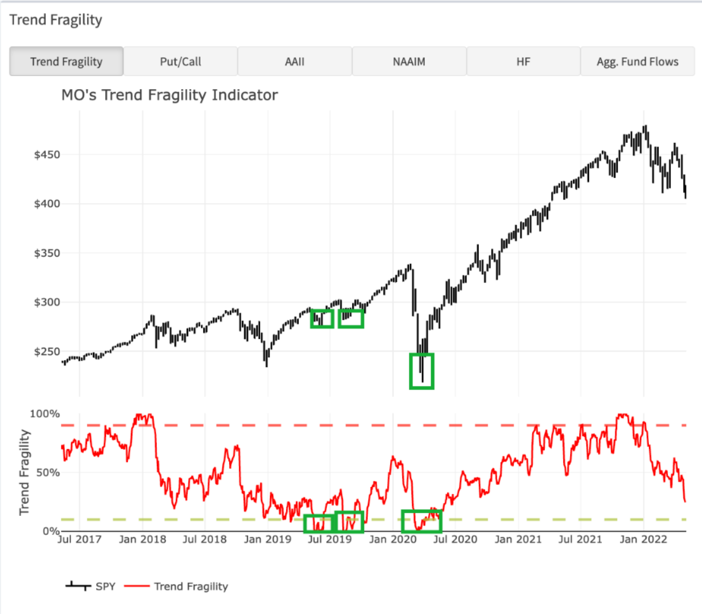
That's just a story though. My best guess. But it doesn't really matter. What matters is that stocks were floored yet bonds still didn't catch a bid, plus the dollar was up.

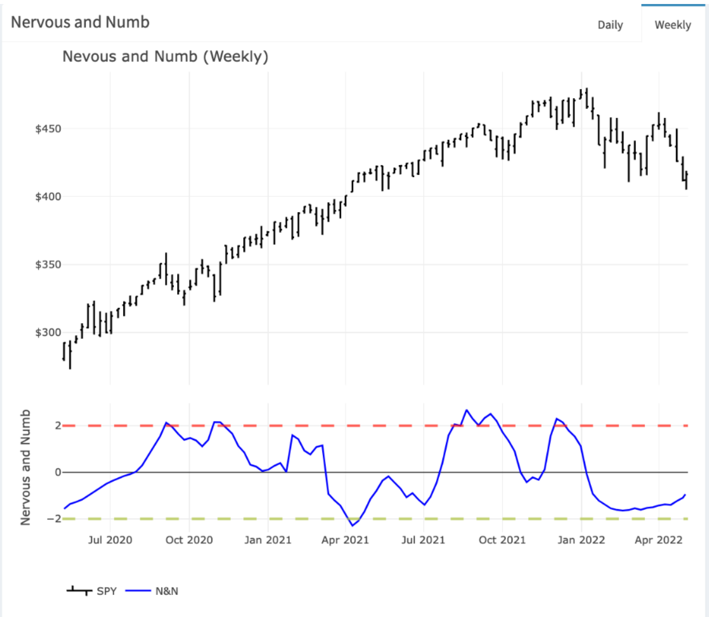
In an environment like this, bonds are *supposed* to act as a release valve, a sort of container for risk-off, to keep it from spreading and accelerating. When this inverse correlation flips, trouble happens… air pockets, flash crashes, uncle points are hit, etc…

It looks to me like we're seeing the start of the washout capitulation that we've been waiting for these last few weeks. Ideally, we get a quick drop lower that lasts maybe a couple weeks followed by a strong reversal. If not, and we wee a slow back and forth grind down instead… to me, that raises the odds we're in for a bit of a larger and longer bear market.

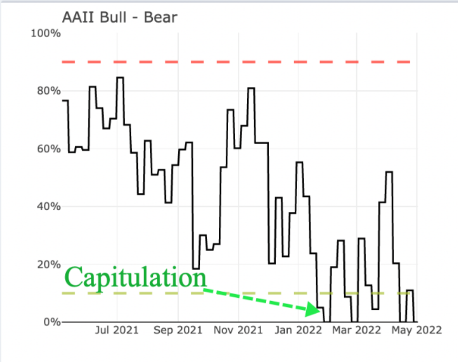
I don't know, this is just speculation. We'll be playing the market as it develops and waiting for it to tip its hand, giving us a signal.

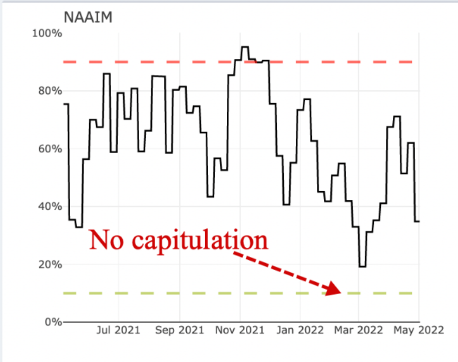
The signals that we'll be looking for over the coming days and weeks are three-fold (1) a sentiment & positioning washout (see charts below). We don't need to see all indicators trip the lower green line but half would be good (2) yields *need* to slow their roll and find at least a temporary ceiling and (3) multiple breadth thrusts need to fire following a reversal in the tape (see charts below).


Trend Fragility
Trend Fragility
Put/Call
AAII
NAAIM
HF
Agg. Fund Flows
MO's Trend Fragility Indicator
Trend Fragility
SPY
Trend Fragility


Nervous and Numb
Daily
Weekly
Nevous and Numb (Weekly)
Nervous and Numb
SPY
N&N

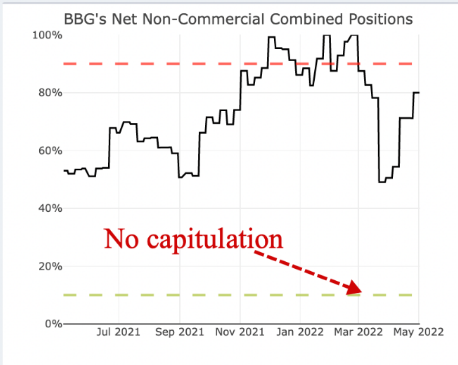

Put Call Ratio
No capitulation

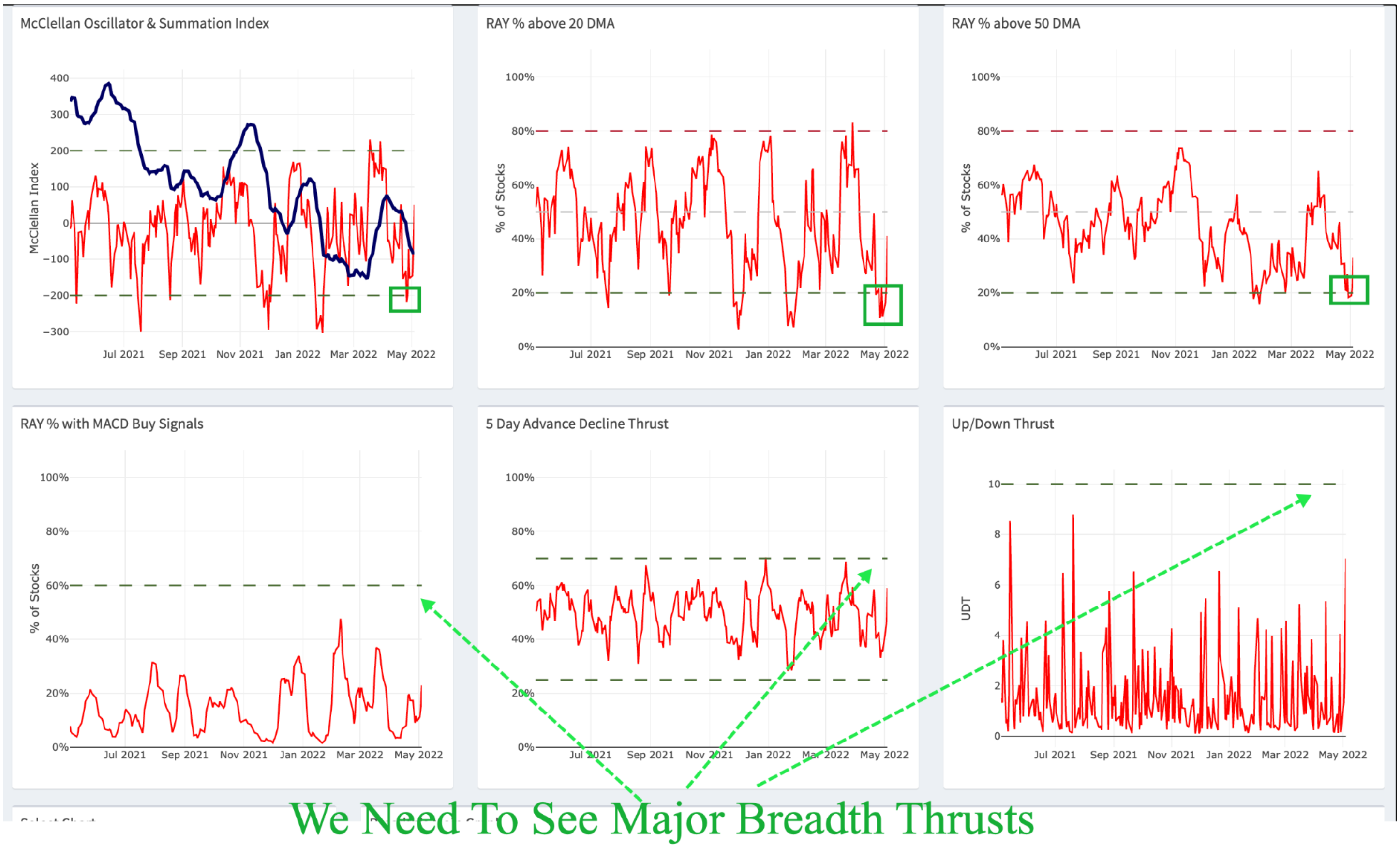

AAII Bull - Bear
Capitulation


NAAIM
No capitulation


Aggregate Fund Flows
No capitulation


Hedge Fund Positioning
No capitulation


BBG's Net Non-Commercial Combined Positions
No capitulation



But let's pull back real quick as it's important to keep this market action in context.

The recession callers have been coming out of the woodwork again, talking yield curve inversions and hard landings, etc…

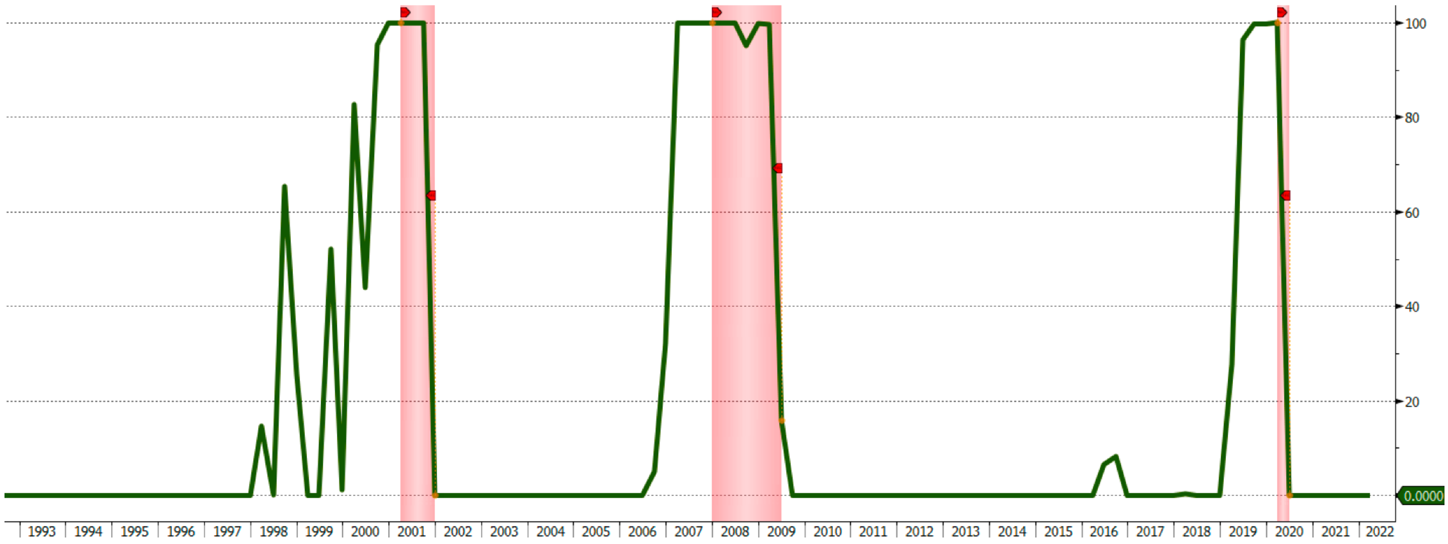
This isn't going to happen and these people should be ignored.

Demand is strong. Household balance sheets are strong. The housing market is nowhere close to peaking for the cycle. I can go on but let's not waste time.

Our Recession Probability model says recession risk is 0% over the next 24-months. This model looks at a wide range of various data points; RoC in corporate profit margins, delta on business conditions, housing permits, avg hourly earnings, interest cost profit ratio, yield curves, etc…

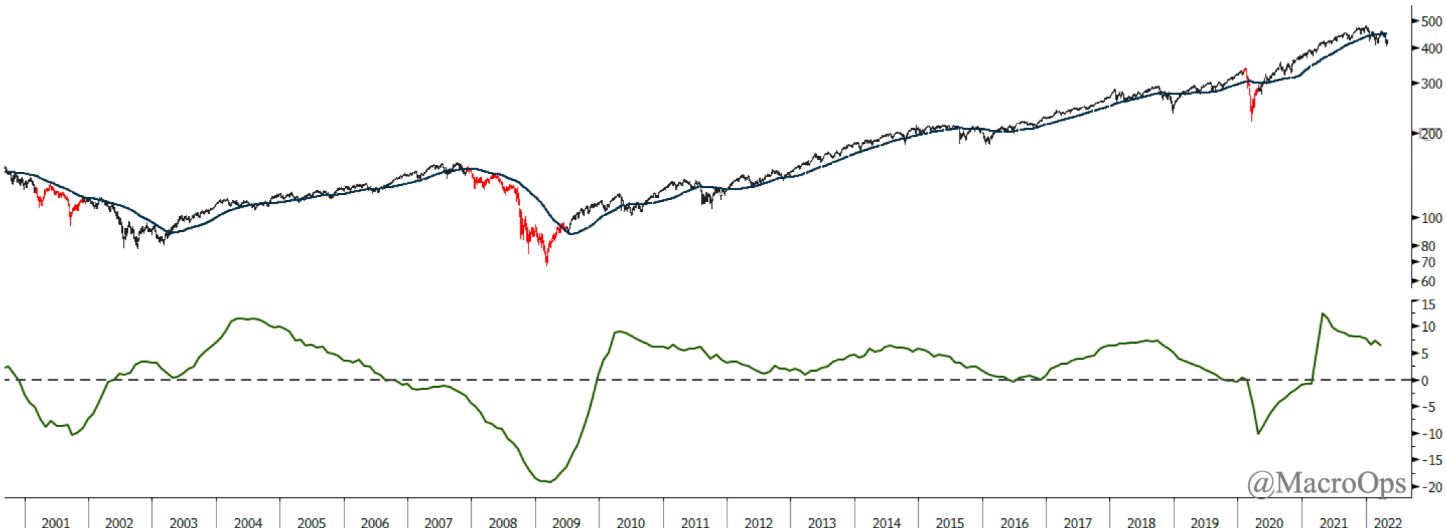
It has a solid track record of giving a good lead.

Recession Probability Risk is LOW



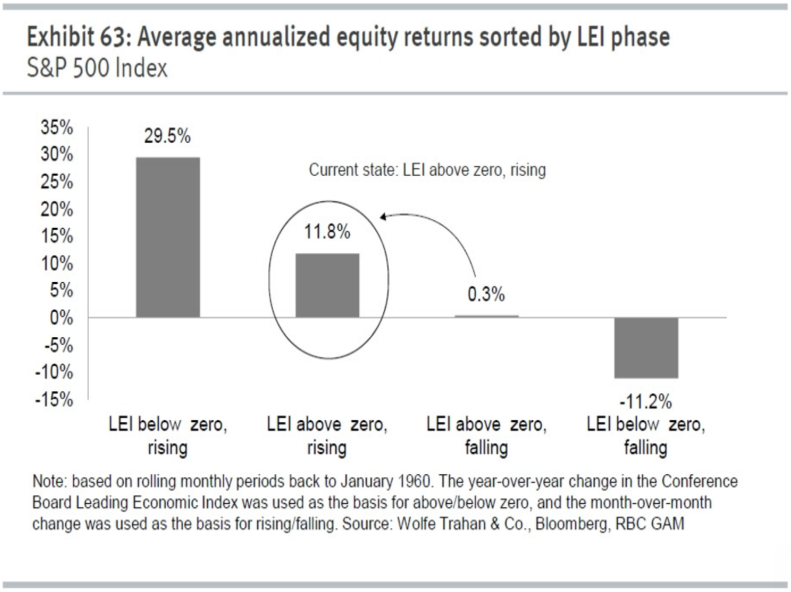
The Conference Board LEI YoY%, which is still quite elevated, typically turns negative around the start of a major bear market and recession.

Conference Board Leading Economic Index



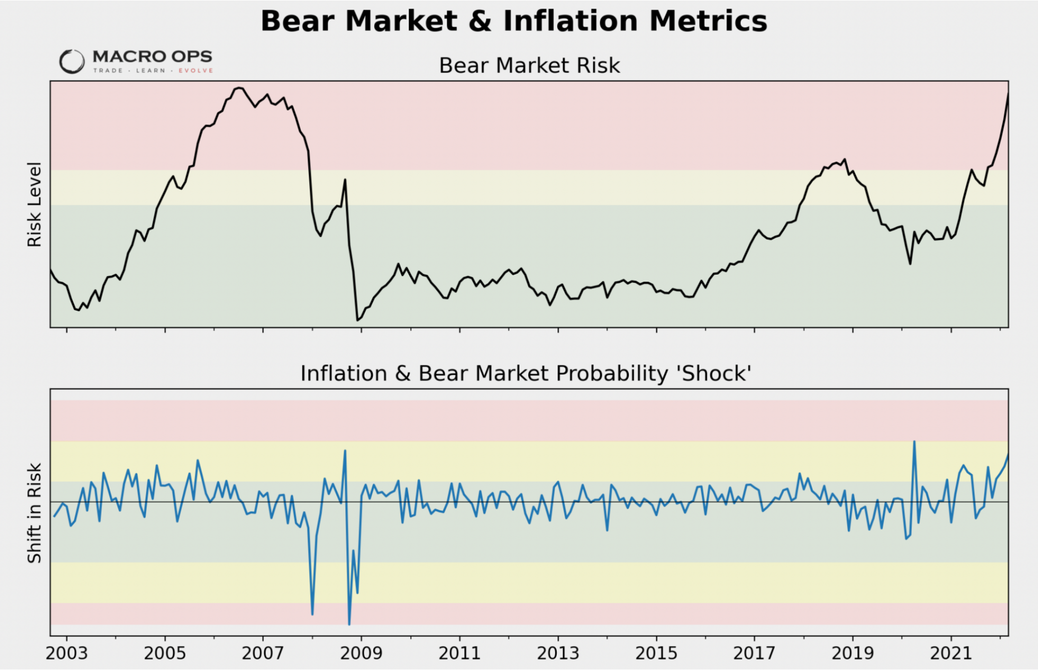
But… The LEI *is* above zero and falling which historically leads to average annual market returns of just 0.3%. This is still well above those seen in a recession, when the LEI is below zero and falling.

The historical risk of a greater than 10% annual (not intra-year) decline in the stock market outside of a recession, is just 4% according to GS. So it's possible the market heads lower and stays lower into the end of the year, but it's not likely since a recession is not going to happen anytime soon.



Can we still see a technical bear market (peak-to-trough decline > 20%) over the next few months?

Yes, certainly. The SPX is already off around 13% from its highs. We're in a fast rate hiking cycle, inflation has peaked but will remain elevated for the time being. And all of this is driving a large rotation (see "[Bubble Rotation]") in investor preferences and relative factor performance. Bear market risk is at its highest level since 2007 (this model looks at RoC in inflation and liquidity).



Also, valuations remain elevated, especially considering the macro backdrop. It would be healthy to see this come back down to its 20-year average (red line).

Clear as mud?

I get it. It's a difficult backdrop. Has been all year.

The macro environment remains incredibly noisy, there's literally something to confirm every bias. Volatile sideways regimes can be a pain in the ass to trade, especially for those stuck operating in the standard binary bull or bear market framework.

Looking through all the above my takeaway is the following:

Recession risk is low to non-existent. This means I want to continue to look for good stocks (positive growth, FCF producing, good BS, etc…) to buy that are in technical uptrends or showing signs of bottoming. But, since bear market risk *is* elevated and we haven't yet seen broad-based capitulation or bullish confirming breadth thrusts. I want to keep a nice cash cushion, my risks balanced, and my stops tight.

Our base case is still for sideways volatile chop with risks for further downside but we're getting closer to a major bottom. Have your shopping lists ready because the bottom can come any week.

If we get a technical washout and some confirming breadth thrusts, we'll use that opportunity to backup the truck on our favorite names that are trading on sale — personally, I'm *really* hoping SQ drops below $80 a share so I can buy every share that's not nailed down.

The key is to stay patient and wait for the signals. No need to guess. The market will tell us when the regime has changed.

Portfolio moves:

We're reapplying the 5-day moving average trailing stop for the remainder of our long DXY position. If we get a daily close below the 5dma, we'll take full profits.

We're doing the same with our long natty (NGZ2022) trade. We'll take full profits on a daily close below the 5dma.

That’s it for tonight. Let me know if you’ve got any questions or comments.

Stay frosty and keep your head on a swivel.

Your Macro Operator,

Alexander