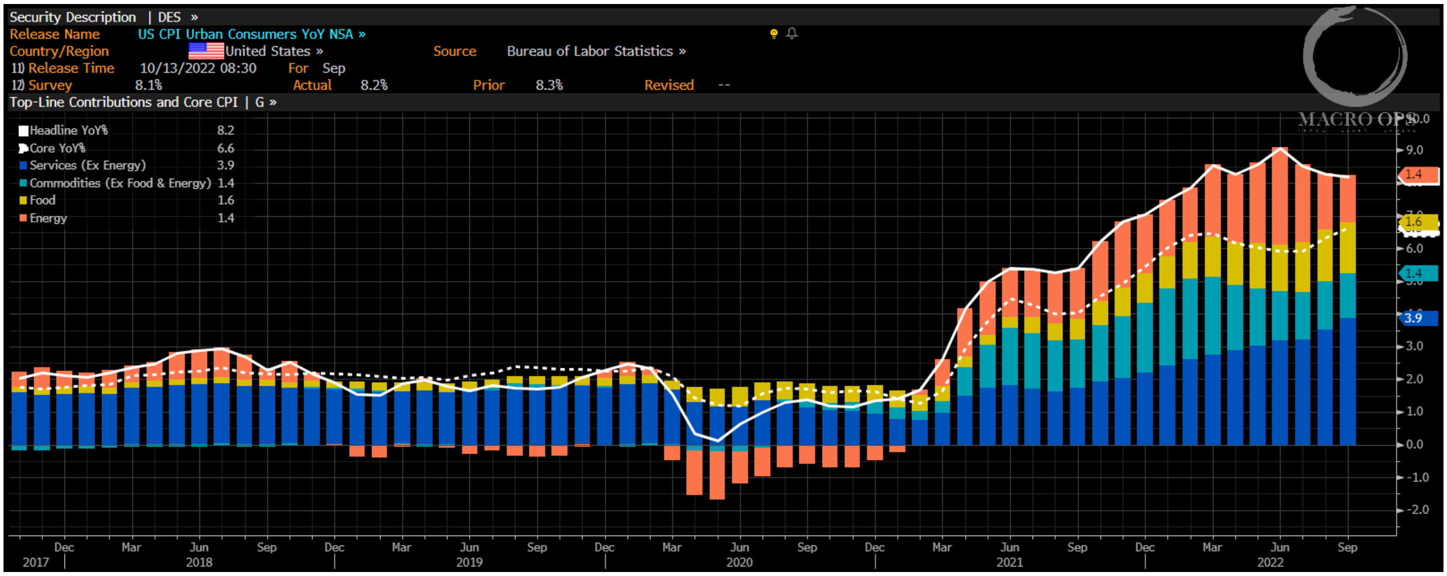
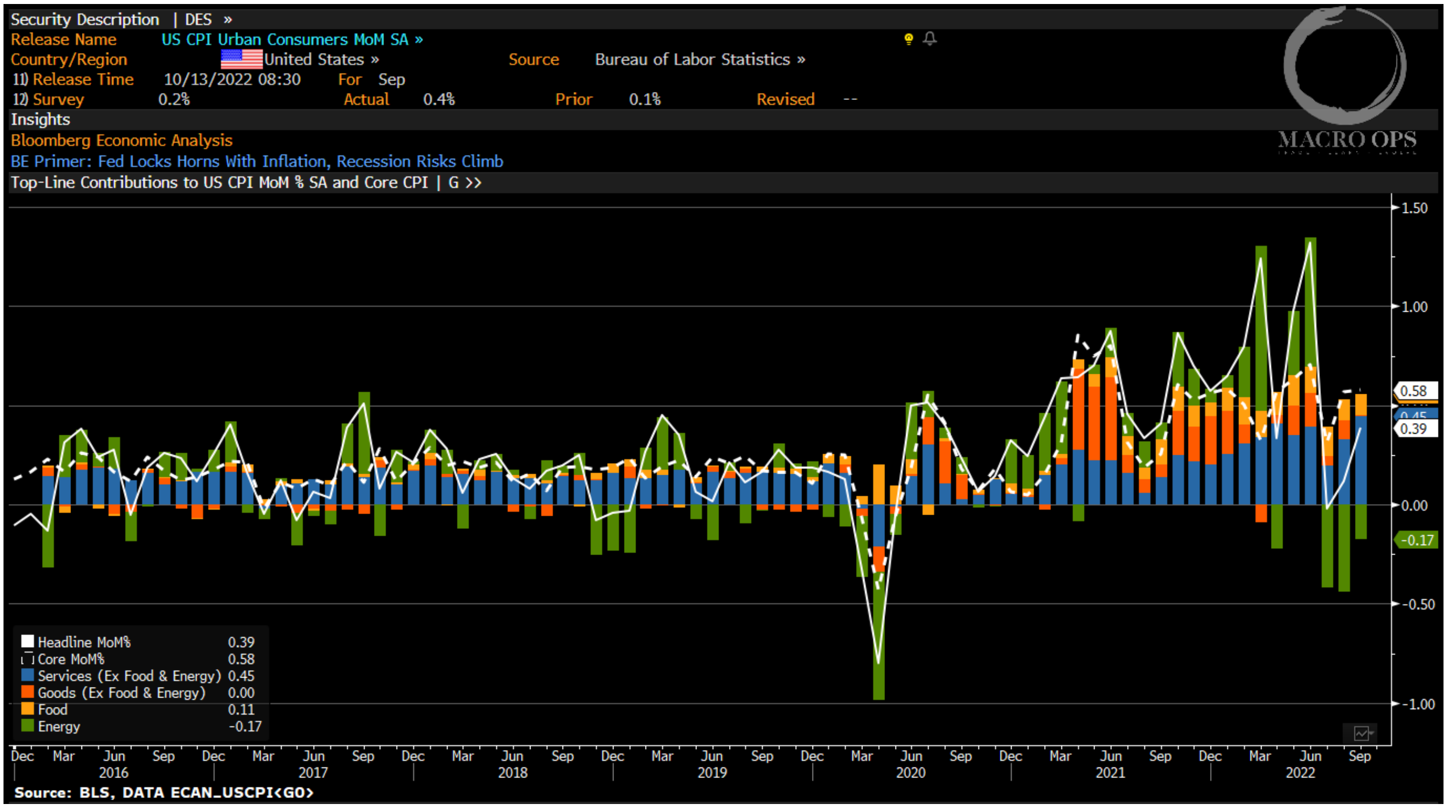
A Market Note: A Toxic Mix…

Some quick thoughts on CPI and markets.

CPI came in hot this morning, beating expectations. Headline YoY% was **8.2%** versus 8.1% expected. MoM was **0.4%** versus a consensus for 0.2%. And core CPI hit a new high of **6.6%** versus 6.5% expected (see charts below).





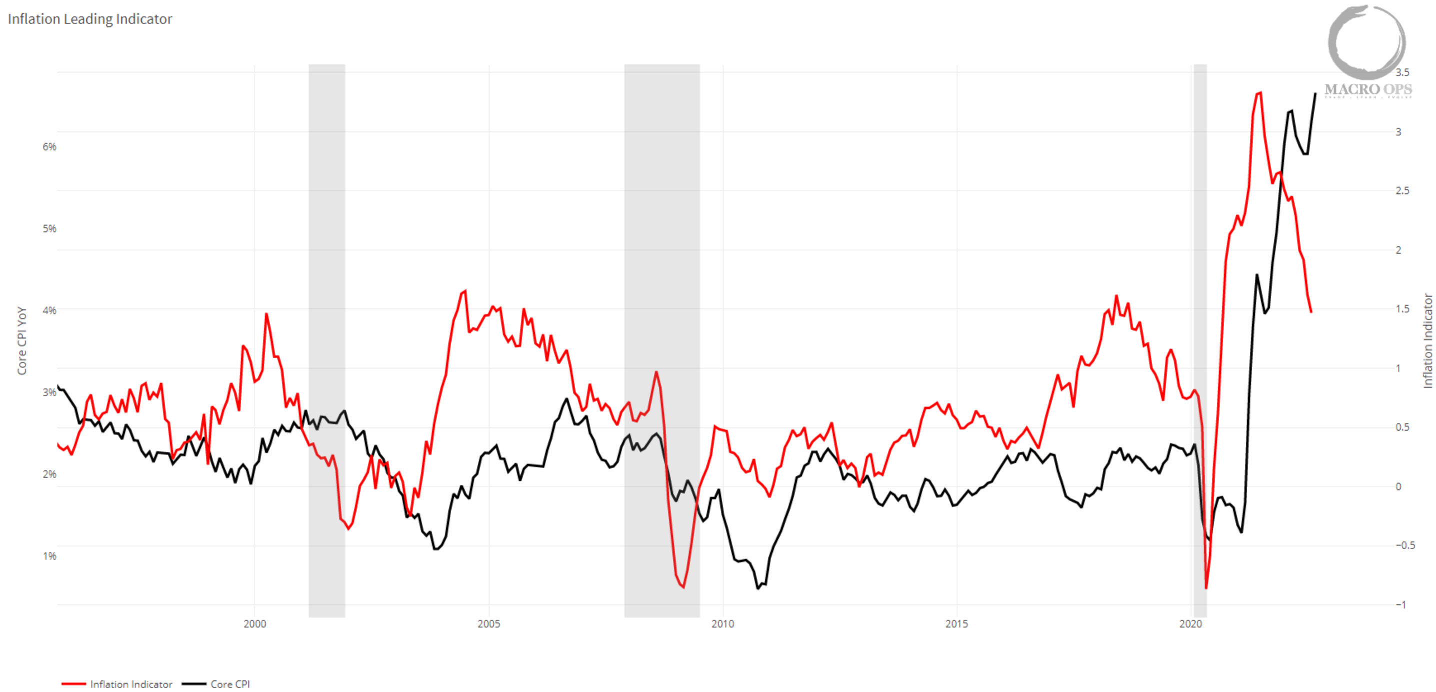
If you were given this information before today's open, you'd likely bet the market would be down considerably. And you would have been right for about 30-minutes following the hot print when the market sold off roughly **3.3%**. But then you would have been wrong as the market quickly reversed and ran straight up **4.3%**.

Markets operate by their own logic. This is why knowing how to read the tape, sentiment, and inter-market signals are vastly more important than playing the CPI prediction game, or any [prediction game for that matter.]

The main takeaway here is that these are unhealthy markets. This is the tape of a market that is captured by policymakers. <u>Policymakers who are now trying to unscrew their previous screwup.</u>

Here are some quick high-level thoughts on inflation.

Everybody knows inflation is going to come down over the next few quarters. Most leads, such as our composite leading indicator (you can find this on the [HUD's Inflation tab here](). Username: collective, Password: livermore), point to decelerating core CPI over the next 6-months.

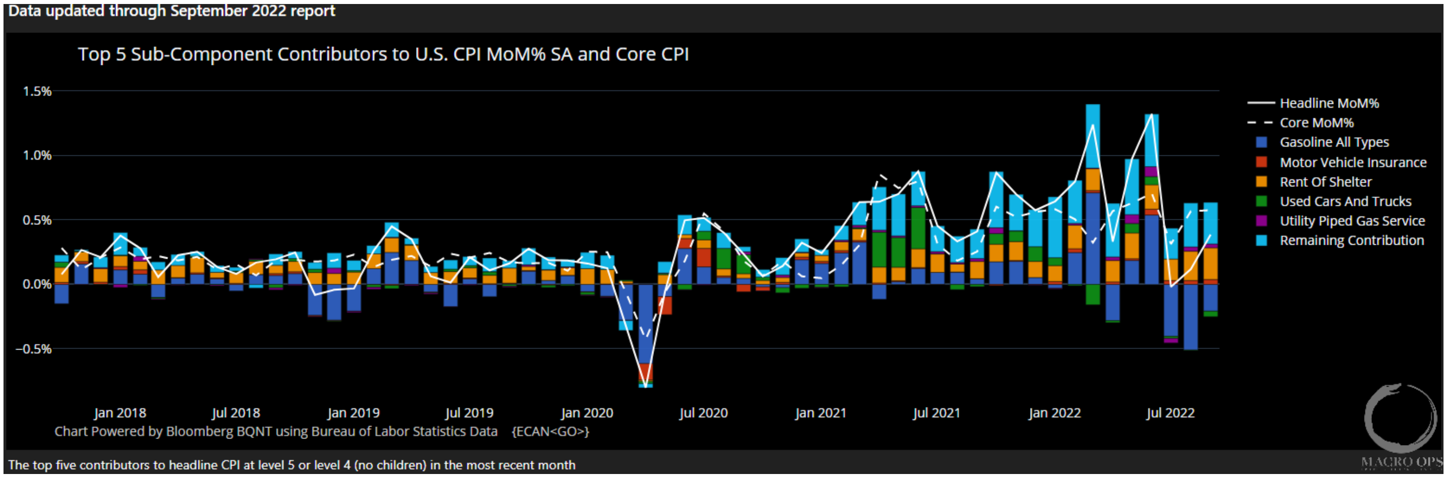


But, importantly, these leads are really only good for trend direction. Not levels or rate of change. And when it comes to CPI and reactive central bank policy, it's the latter two that really matter.

So let's take a quick look at the subcomponents of inflation, so we know what we need to watch to get a better handle on inflation's future path and rate-of-change.

The following chart shows the top five subcomponent contributions to CPI on a month-over-month basis. . If you have a BBG terminal, you can find this graph, along with some other nifty tools in BQuant on {ECAN<GO>}.

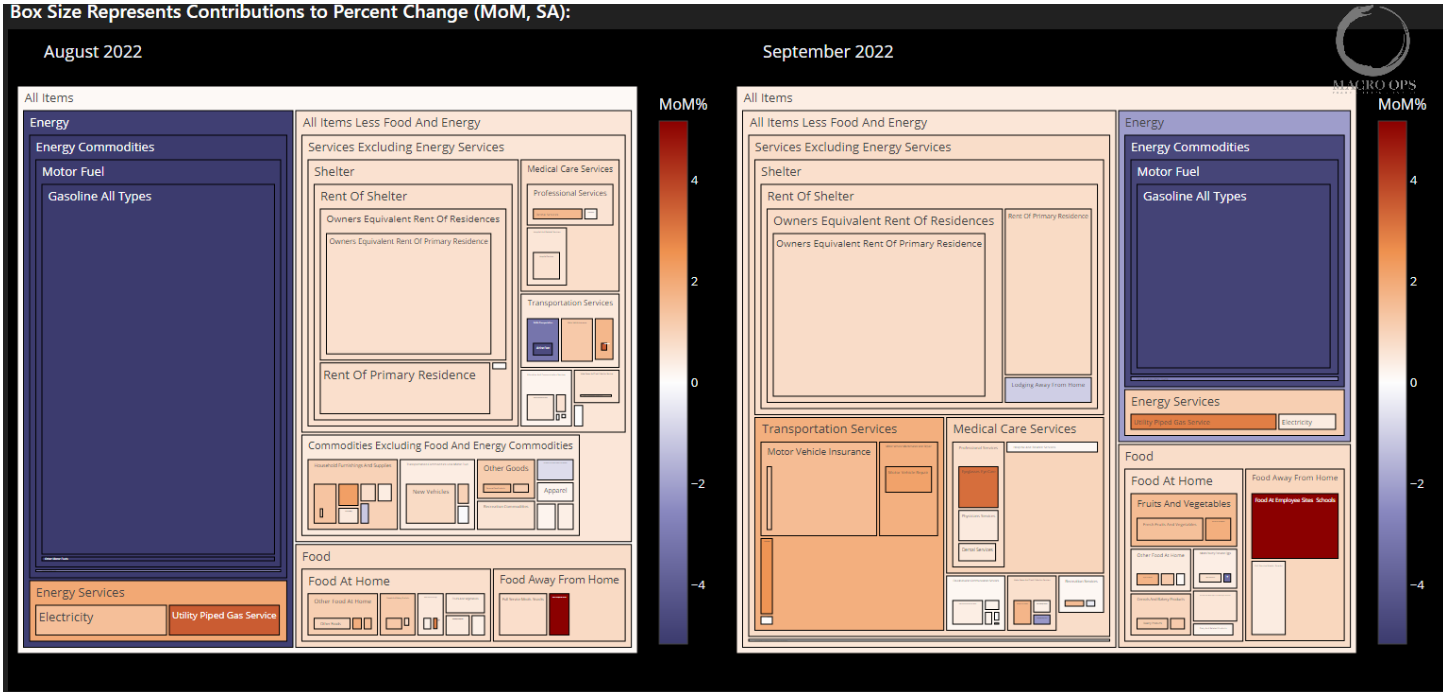
Transportation costs (ie, motor fuel, gas, etc…) have been the largest detractors from the headline print over the last few months. This isn't surprising as Biden's SPR releases, along with slowing global growth, have sent crude and gas prices down **27%** and **37%** since June, respectively.



But the decline in energy was more than offset by rising prices in services, with the big one being shelter/rent costs.

The graph below is a good illustration of each component's contribution percentage and MoM % change between August and September.

Again, in September, the decline in fuel prices was the big detractor. But fuel costs weren't down as much as they were in the previous month. While at the same time, nearly all of the other subcomponents went up, more than offsetting the decline in energy.



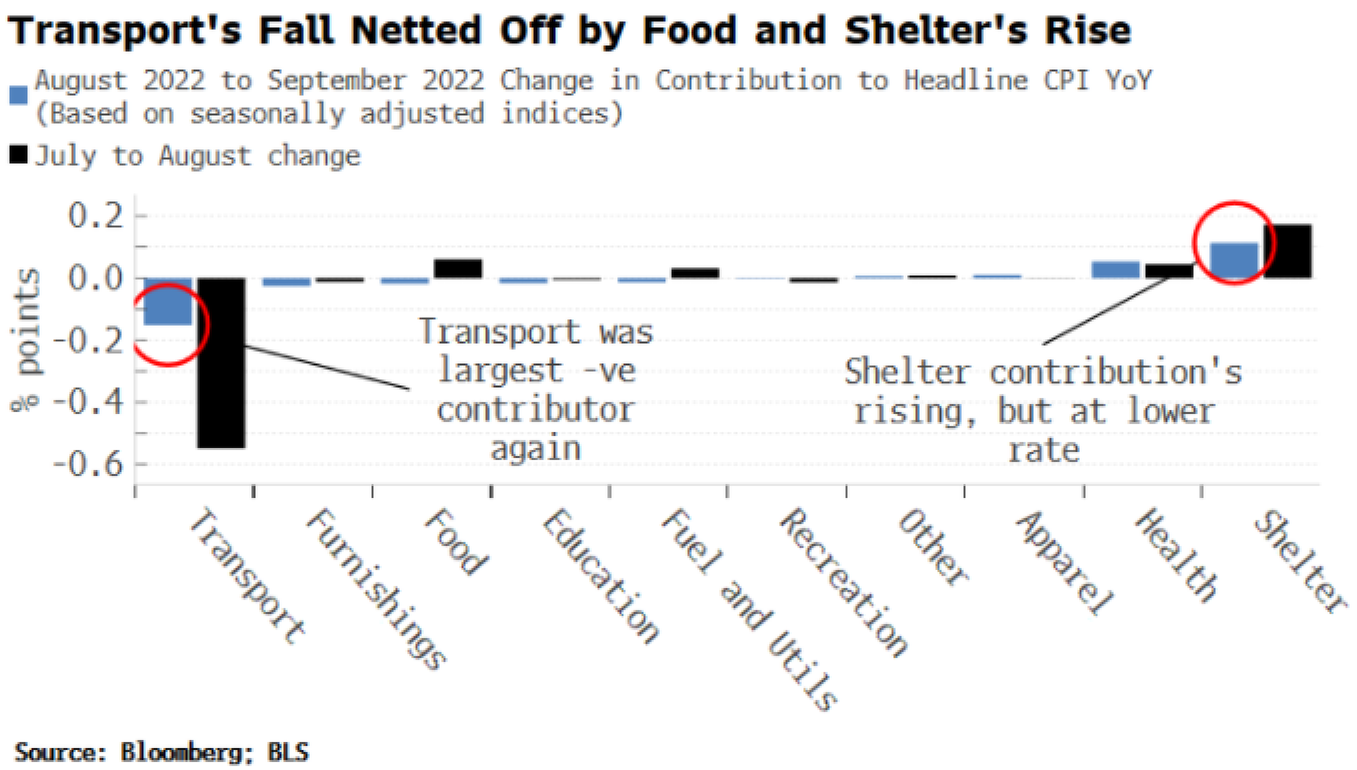
Here’s another way of looking at the month-over-month changes.

Contributions to Percent Change (MoM, SA) in U.S. CPI Table

Filters Show Levels All 1 2 3 4 5 6 7 8 Value Min -0.22 Max 0.45

Weight*	Name	09/22	08/22	07/22	06/22	05/22	04/22	03/22	02/22	01/22
100.00	All Items	0.386	0.118	-0.019	1.322	0.974	0.332	1.241	0.798	0.645
13.63	Food	0.107	0.107	0.147	0.133	0.157	0.116	0.133	0.136	0.117
8.47	Food At Home	0.058	0.063	0.111	0.085	0.120	0.086	0.119	0.113	0.080
1.10	Cereals And Bakery Products	0.010	0.013	0.019	0.022	0.016	0.011	0.016	0.011	0.019
1.91	Meats Poultry Fish And Eggs	0.007	0.010	0.009	-0.007	0.022	0.026	0.018	0.023	0.005
0.80	Dairy And Related Products	0.002	0.003	0.013	0.013	0.022	0.019	0.009	0.015	0.009
1.41	Fruits And Vegetables	0.022	0.007	0.007	0.009	0.009	-0.005	0.022	0.033	0.013
0.97	Nonalcoholic Beverages And Beverage Materials	0.006	0.005	0.022	0.007	0.016	0.019	0.011	0.015	0.000
2.28	Other Food At Home	0.010	0.025	0.041	0.039	0.035	0.016	0.043	0.016	0.035
5.16	Food Away From Home	0.049	0.044	0.036	0.048	0.038	0.030	0.013	0.023	0.034
2.40	Full Service Meals Snacks	0.011	0.018	0.013	0.019	0.019	0.022	0.017	0.015	0.017
0.05	Food At Employee Sites Schools	0.023	0.008	0.000	0.008	0.000	0.000	0.001	-0.001	0.000
0.17	Other Food Away From Home	0.001	0.000	0.001	0.003	0.001	0.000	0.000	0.001	0.000
8.24	Energy	-0.174	-0.441	-0.419	0.652	0.322	-0.224	0.831	0.258	0.066
4.57	Energy Commodities	-0.216	-0.521	-0.428	0.539	0.220	-0.265	0.757	0.268	-0.024
0.23	Fuel Oil And Other Fuels	-0.006	-0.006	-0.021	-0.002	0.032	0.009	0.033	0.013	0.007
4.34	Motor Fuel	-0.210	-0.516	-0.407	0.543	0.188	-0.272	0.723	0.255	-0.030
3.68	Energy Services	0.041	0.074	0.004	0.120	0.103	0.044	0.061	-0.015	0.098
2.69	Electricity	0.012	0.040	0.041	0.044	0.034	0.018	0.055	-0.028	0.102
0.99	Utility Piped Gas Service	0.029	0.034	-0.036	0.076	0.070	0.027	0.005	0.013	-0.004
78.12	All Items Less Food And Energy	0.450	0.441	0.242	0.550	0.494	0.446	0.256	0.400	0.463
21.29	Commodities Excluding Food And Energy Commo...	0.004	0.097	0.049	0.166	0.147	0.039	-0.093	0.096	0.216
3.95	Household Furnishings And Supplies	0.022	0.041	0.022	0.020	0.004	0.021	0.042	0.030	0.061
2.43	Apparel	-0.007	0.005	-0.002	0.019	0.017	-0.019	0.014	0.018	0.026
8.57	Transportation Commodities Less Motor Fuel	-0.013	0.035	0.011	0.093	0.119	0.036	-0.153	0.009	0.075
1.48	Medical Care Commodities	-0.001	0.004	0.009	0.006	0.004	0.001	0.003	0.005	0.013
1.88	Recreation Commodities	0.000	0.011	0.004	0.007	0.002	0.010	-0.002	0.017	0.019
0.76	Education And Communication Commodities	-0.004	-0.005	-0.006	0.002	-0.013	-0.021	-0.005	-0.006	0.002
0.87	Alcoholic Beverages	0.000	0.003	0.004	0.004	0.004	0.003	0.004	0.007	0.003
1.35	Other Goods	0.005	0.015	0.005	0.007	0.011	0.005	0.008	0.013	0.011
56.83	Services Excluding Energy Services	0.447	0.328	0.198	0.395	0.350	0.411	0.341	0.307	0.254
32.47	Shelter	0.243	0.222	0.173	0.196	0.198	0.166	0.167	0.171	0.097
1.08	Water Sewer And Trash Collection Services	0.008	0.006	0.004	0.004	0.003	0.003	0.001	0.006	0.011
6.86	Medical Care Services	0.068	0.053	0.028	0.050	0.030	0.036	0.043	0.010	0.043
5.86	Transportation Services	0.111	0.030	-0.027	0.122	0.074	0.174	0.115	0.078	0.057
3.11	Recreation Services	0.005	-0.001	0.011	0.008	0.017	0.012	0.014	0.020	0.026
5.27	Education And Communication Services	0.009	0.012	-0.004	0.008	0.010	0.011	-0.005	0.006	0.004

Here's the thing, energy is more volatile while services (shelter/rent costs, etc…) are stickier and tend to lag due to the way they're measured.



So what can we make of this?

Here's the thing… because shelter is a lagging funky number (read this excellent thread from @ModeledBehavior on the issues with properly analyzing this data), we can't, with any true level of conviction, model out its near-term path. A lot of people try, and a lot of people get it wrong. It's a crapshoot.

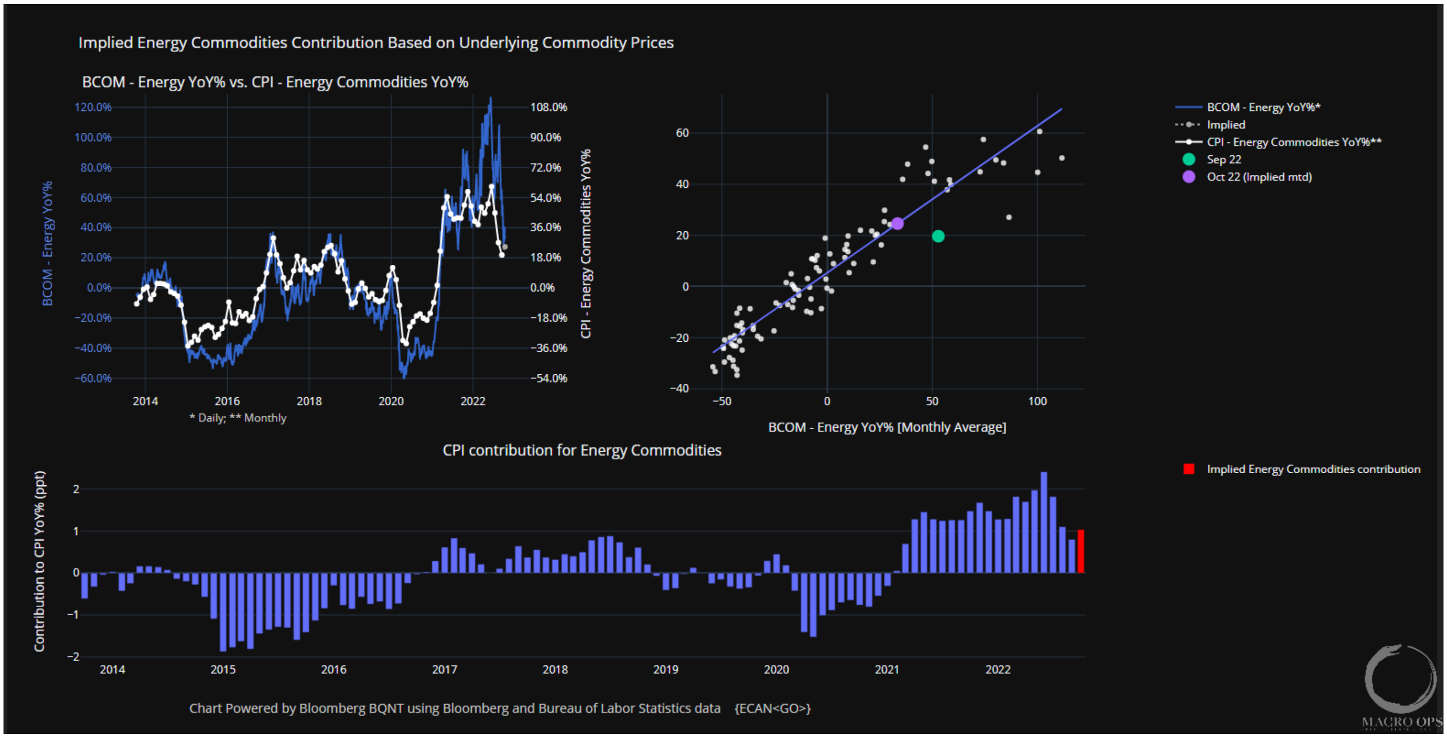
All we know is that shelter costs have been accelerating over the past few months, and this isn't good.

Likewise, it's reasonable to assume we've reaped most of the benefit of lower energy prices over the last few months. Since energy has been the big detractor, it's likely to be less of a drag on CPI going forward.

Not to mention, the Biden admin faces a physical limit on how much oil they can sell into the market. You can't drain the SPR below 0.

What would be really bad for the Fed *and* markets is if energy prices start going up again.

If energy becomes a positive contributor and lagging shelter costs hide the true slowdown in economic demand, then it's almost certain that the Fed pulls a Thelma and Louise and steps on the financial tightening accelerator right as the global economy cliffs it.

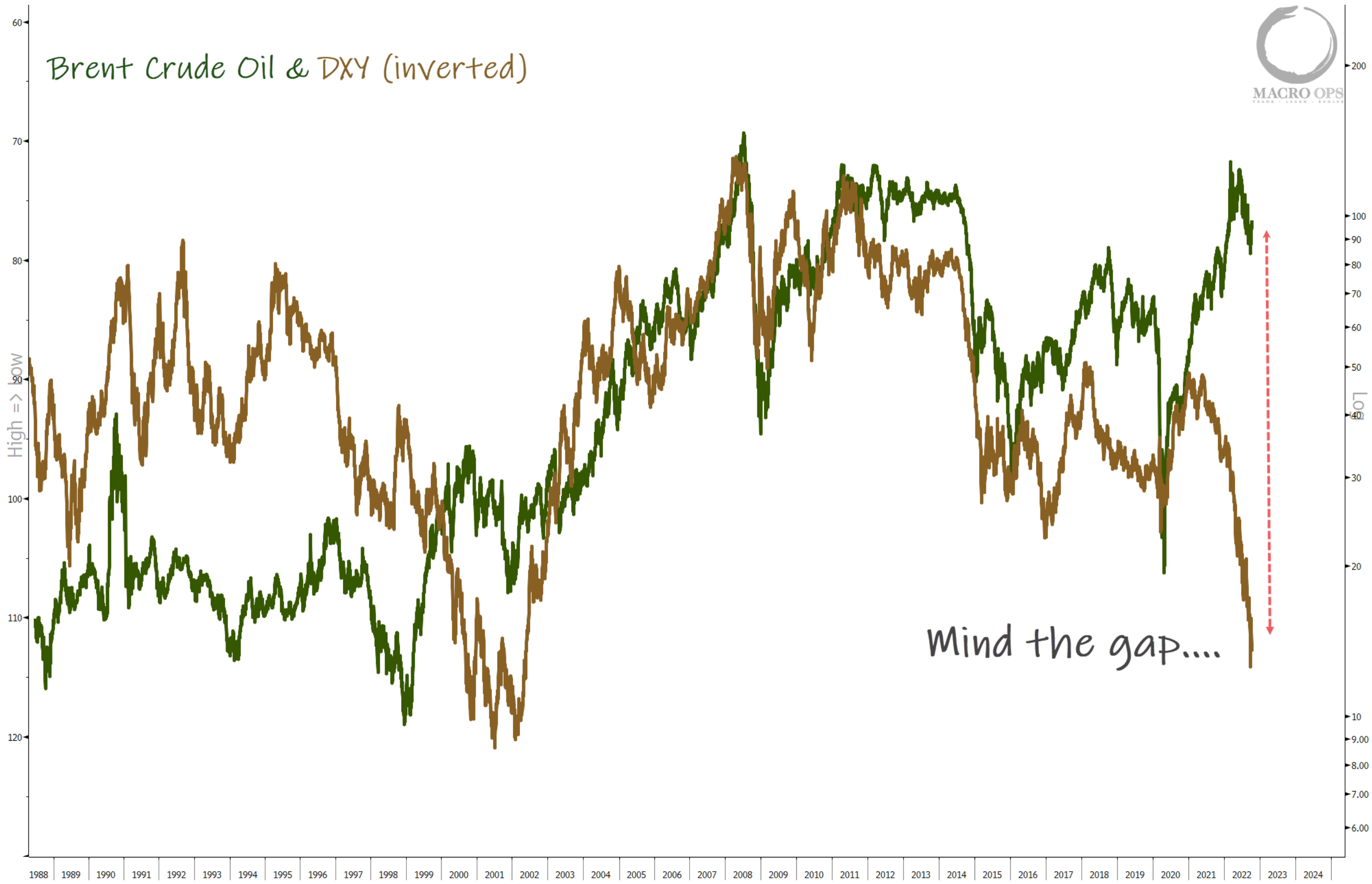


I'm just riffing here as I want to get this note out. But here are a few other things on my mind…

Look at how much oil prices have deanchored from the US dollar (inverted). This is true for much of the commodity complex.

<u>This is an important signal.</u>

Crude prices remain in a strong bullish primary trend *despite* significant parts of the Chinese economy being locked down, *despite* the Fed hiking rates at one of the fastest paces in history, and *despite* the US dollar jumping more than 2std above its rolling 3-year average (next chart below).



This has to make you question the Fed's ability to drive inflation significantly lower without cratering the economy. It seems to me that the soft-landing juice has all been squeezed…

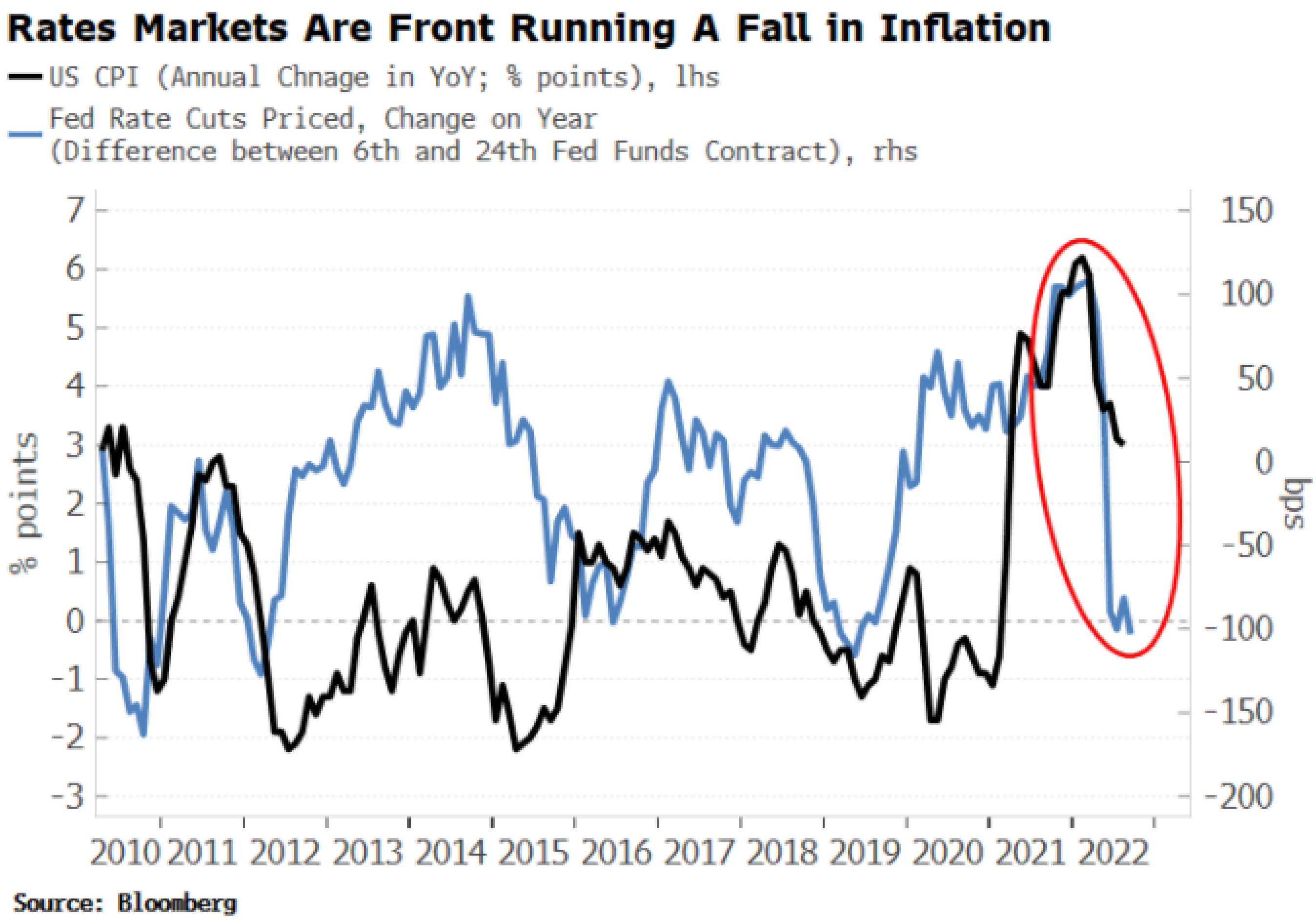
<u>The US dollar has already risen nearly 20% year-to-date</u>. A rate-of-change that is rarely surpassed, with the one exception being Volcker raising rates to 19% in 81', effectively putting the US economy into a stranglehold.

What happens to commodities (and thus CPI) when the US dollar finally rolls over?

And here's another thing.

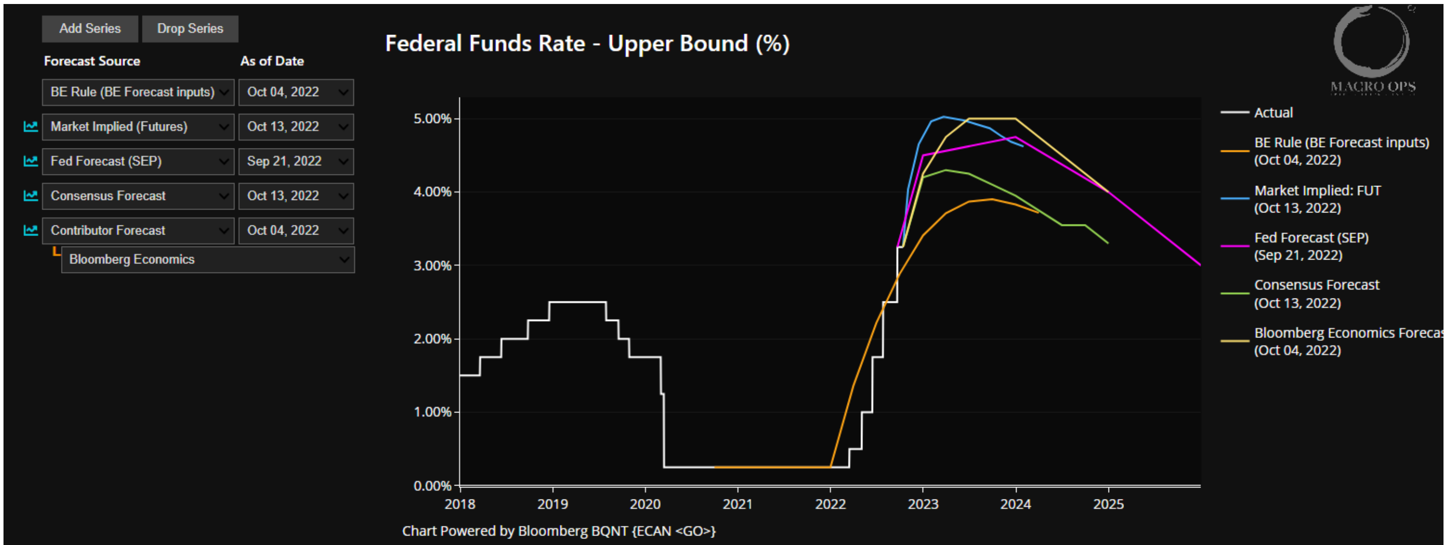
The market has been front-running an accelerating decline in inflation for the last few months. We can see this in the Fed Fund Futures curve.

The blue line shows the time spread between the 6th and 24th Fed Funds contracts.



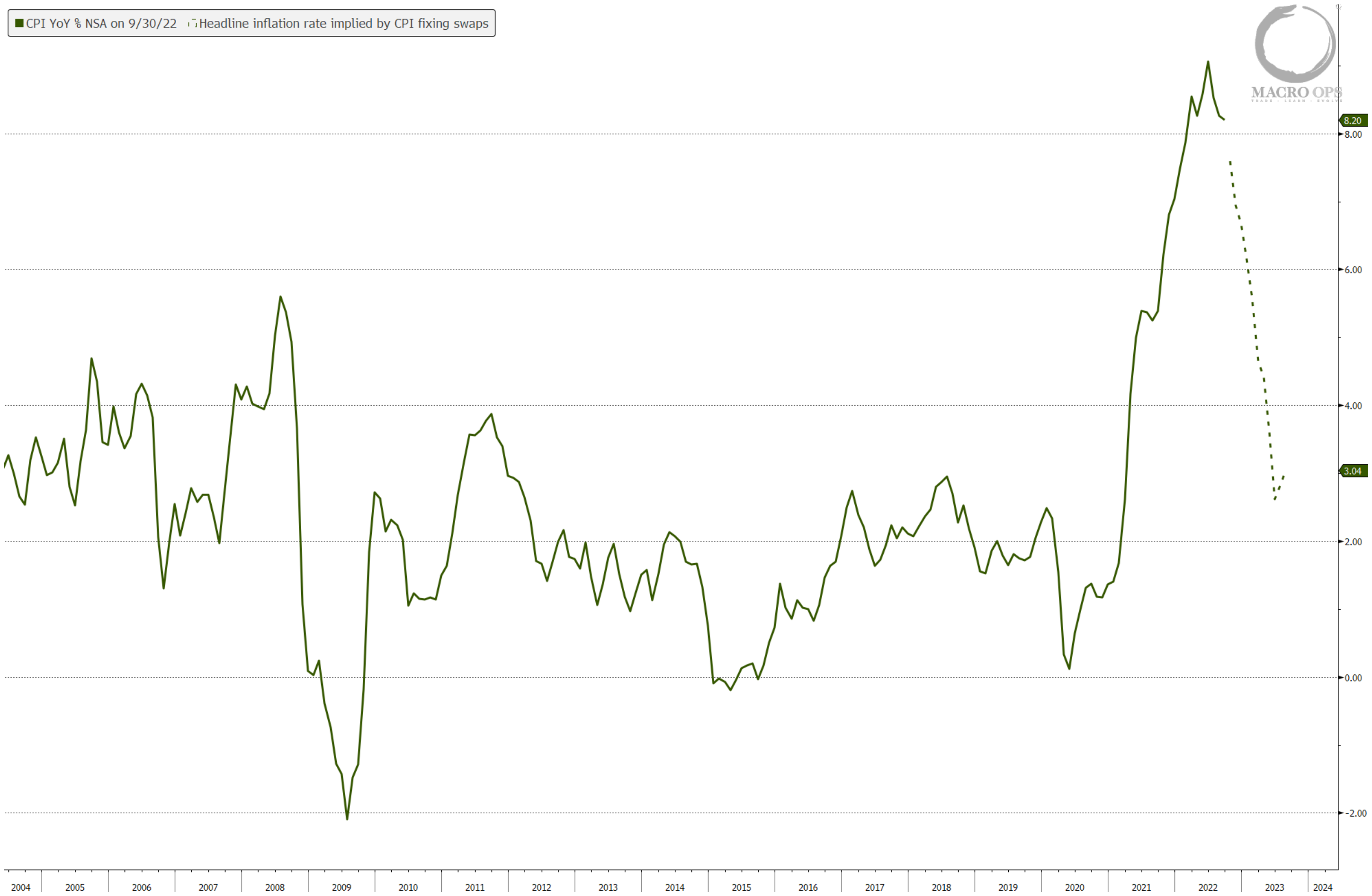
Here's another way of visualizing it.

The market is pricing in a reversal in Fed policy starting in the second half of next year, followed by a quick succession of cuts (essentially a recessionary scenario).



Series	Q3 2020	Q4 2020	Q1 2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022	Q1 2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	Q2 2024
BE Rule (BE Forecast inputs) (Oct 04, 2022)	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	1.36%	2.22%	2.89%	3.41%	3.71%	3.87%	3.90%	3.83%	3.72%	
Core PCE Inflation (Oct 04, 2022)	1.31%	1.39%	1.73%	3.48%	3.89%	4.72%	5.33%	4.98%	4.70%	4.50%	4.00%	3.70%	3.50%	3.20%	3.10%	
Unemployment Rate (Oct 04, 2022)	8.84%	6.77%	6.20%	5.90%	5.10%	4.23%	3.80%	3.60%	3.70%	3.90%	4.10%	4.20%	4.40%	4.50%	4.60%	
Market Implied: FUT (Oct 13, 2022)										3.98%	4.99%	4.99%	4.90%	4.73%	4.62%	
Fed Forecast (SEP) (Sep 21, 2022)										4.50%				4.75%		
Consensus Forecast (Oct 13, 2022)										4.20%	4.30%	4.25%	4.10%	3.95%	3.75%	3.55%
Bloomberg Economics Forecast (Oct 04, 2022)										4.25%	4.75%	5.00%	5.00%	5.00%	4.75%	4.50%

We can also see these expectations baked into the CPI fixing swaps curve. The dotted line below shows the market's implied path for inflation over the next 12 months.



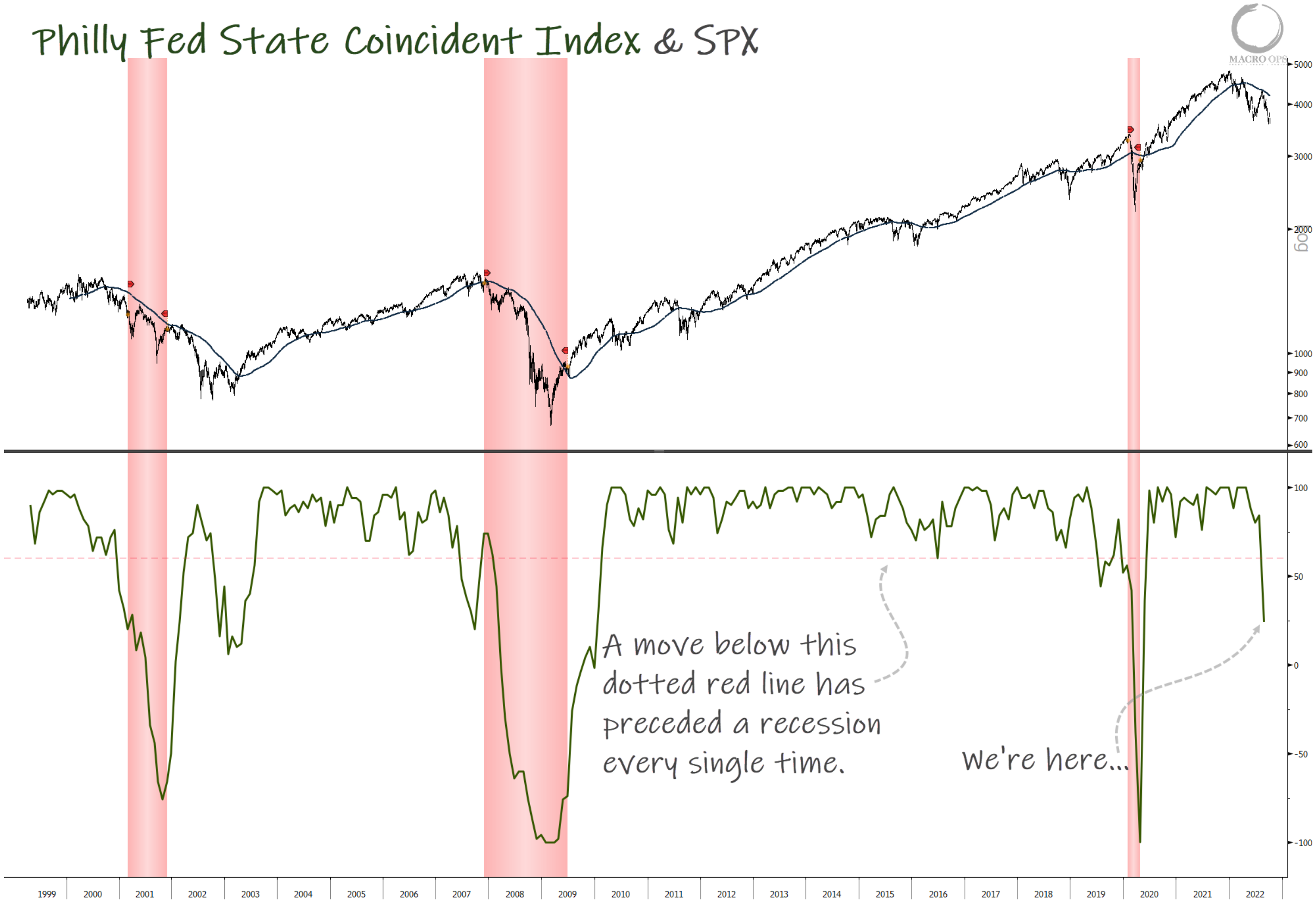
Considering all of the above, this path seems way too aggressive.

If energy prices start rising and services inflation proves sticky, then the market is *very* offsides. Its expectations are too optimistic, which means its expectations for Fed policy are too optimistic.

In this scenario, the Fed would have to stay tighter for longer, which means financial conditions are likely to deteriorate meaningfully from here.

This is pretty interesting from a macro perspective. There is zero precedent for where we are and where we're likely headed.

We've never had the combination of an incredibly leveraged system and a Fed being forced by inflation to jack up rates aggressively, with the intention of killing the economy and raising unemployment. It's a toxic mix for risk assets if there ever was one.



This is going to play out for another 6-12 months. This means we need to continue to favor defense over offense. Cash over market risk. And weak opinions over strong ones.

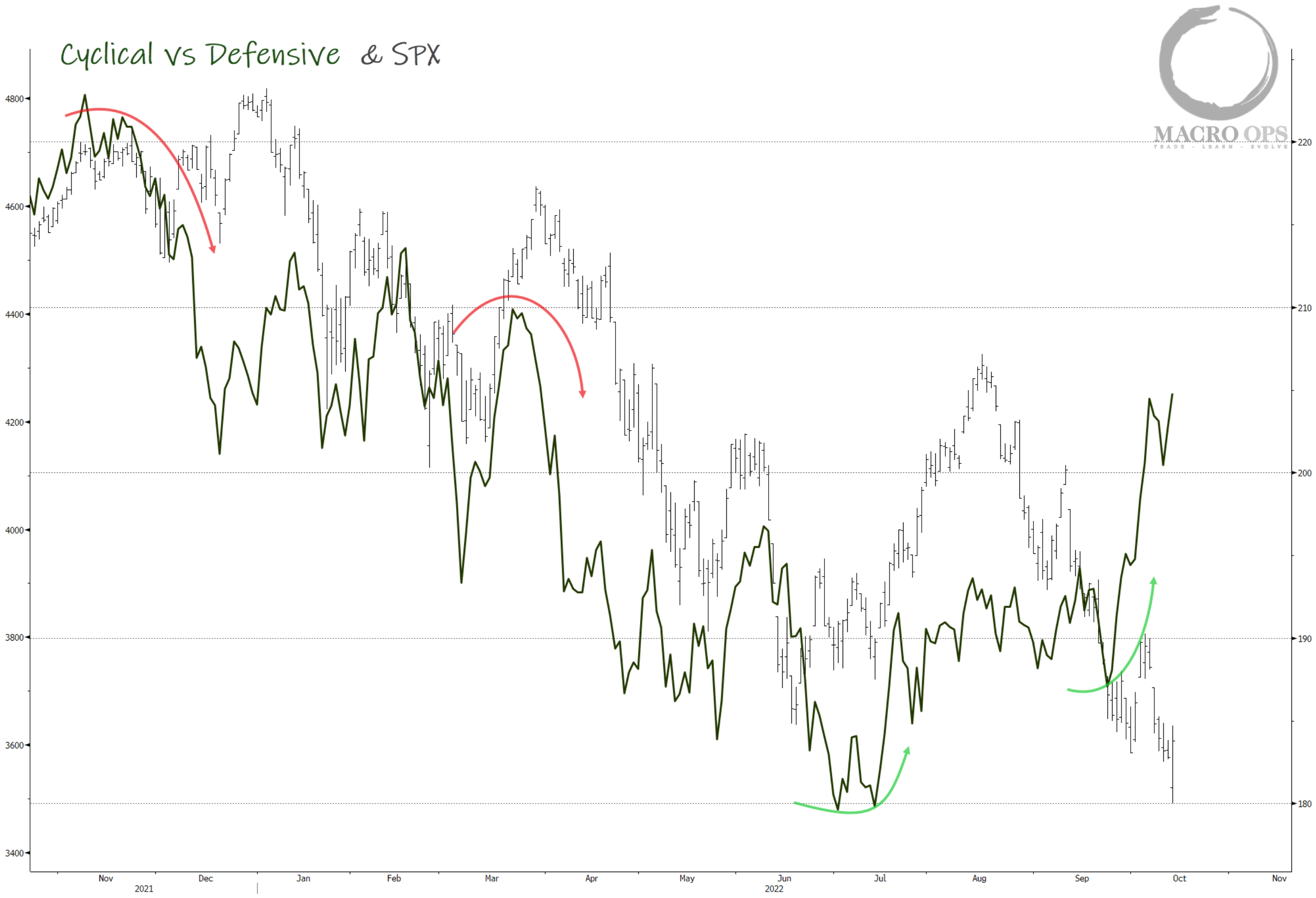
However, we'll continue to position for the secular bull market in commodities, which we expect to play out over the next 5-7 years. Our focus is on oil, gas, and nuclear. So we'll keep building up our position in those spaces and balancing them out with tactical hedging in the still very overvalued areas of the market (ie, expensive tech).

As I finish up this note, it looks like the market is going to close strongly in the green today.

There's no sense in trying to make sense of the moves in a bear market like this. Macro drives the primary trend but positioning, levels, and sentiment drive the short-term swings around that trend.

I pointed out in this week's *Monday Dozen* how a rare Buy Signal in tech triggered last week. Another interesting data point is that Cyclicals have been materially outperforming Defensives for the past month.

This indicator led the market on the way down. And it may now be leading it on an oversold rally up.



Three forces drive the tape **(1)** trend **(2)** momentum and **(3)** mean reversion. Markets don't move in a straight line for long. At some point, the price gets too extended from the averages, and buyers/sellers step in and drive reversion.

We don't want to spend too much time or effort trying to pick local lows within a primary bear trend. But, as I've been writing for the past two weeks, the setup is there for a considerably counter-trend rally.

Take a look at the SPX breakdown from our HUD. **Net speculative (3yr adjusted OI) long positioning is in the 9th percentile** (dotted orange line). But speculators are starting to buy again, which we can see on the solid lines (orange, red, blue) which adjusts for positioning changes across a shorter timeframe. These have started turning up, and this is *exactly* what you want to see if you're looking for a rally. Positioning aggressively turning up from off the floor.

Next, there's seasonality which turned hugely positive this week. This seasonality tailwind is even more impressive when adjusted for midterm years.

And lastly, the three charts on the bottom right show the SPX is at or near 2std below its 20, 50, and 200-day moving averages.

Again, we don't want to get overpositioned playing for a countertrend rally. But it does help to keep a balanced book, in order to benefit from one if it occurs. As always, yields need to cooperate for any rally to have staying power.

Sidenote: there's a common investing belief that one shouldn't check on their portfolio too often.That's nonsense. It's good advice if your a passive investor. Not if you're a professional or active.

Checking on your portfolio everyday, especially in an environment like this, gives you a necessary feel for how balanced you are to risks and opportunity, to where you may be over or underexposed, and so on. This is incredibly valuable feedback in a bear market.

If you're bleeding too much, stem the bleeding (cut). If you're underexposed to positive trending factors/markets (such as oil and gas now), add some positioning.

The key is not to be emotionally reactive, which is a necessary precondition to playing this game successfully.

That's it for now.

Tomorrow I've got a note coming out explaining how I use the FX tab on the HUD to analyze currencies. We'll walk through a couple of setups I see setting up right now. I'll also be sharing a doc on a new short-term hedging strategy we'll be tactically employing going forward.

Let me know if you've got any questions or comments!

Your Macro Operator,

Alex