

26/01/2023



Animal Spirits (TMC Tactical Report)

(Macro Reports, Interactive Tools & Portfolios are also available in your Login area at my.themacrocompass.com)

Gold, stocks, bonds, Bitcoin.

It was one and the same trade in 2022: the Fed will hike aggressively.
Sell everything.

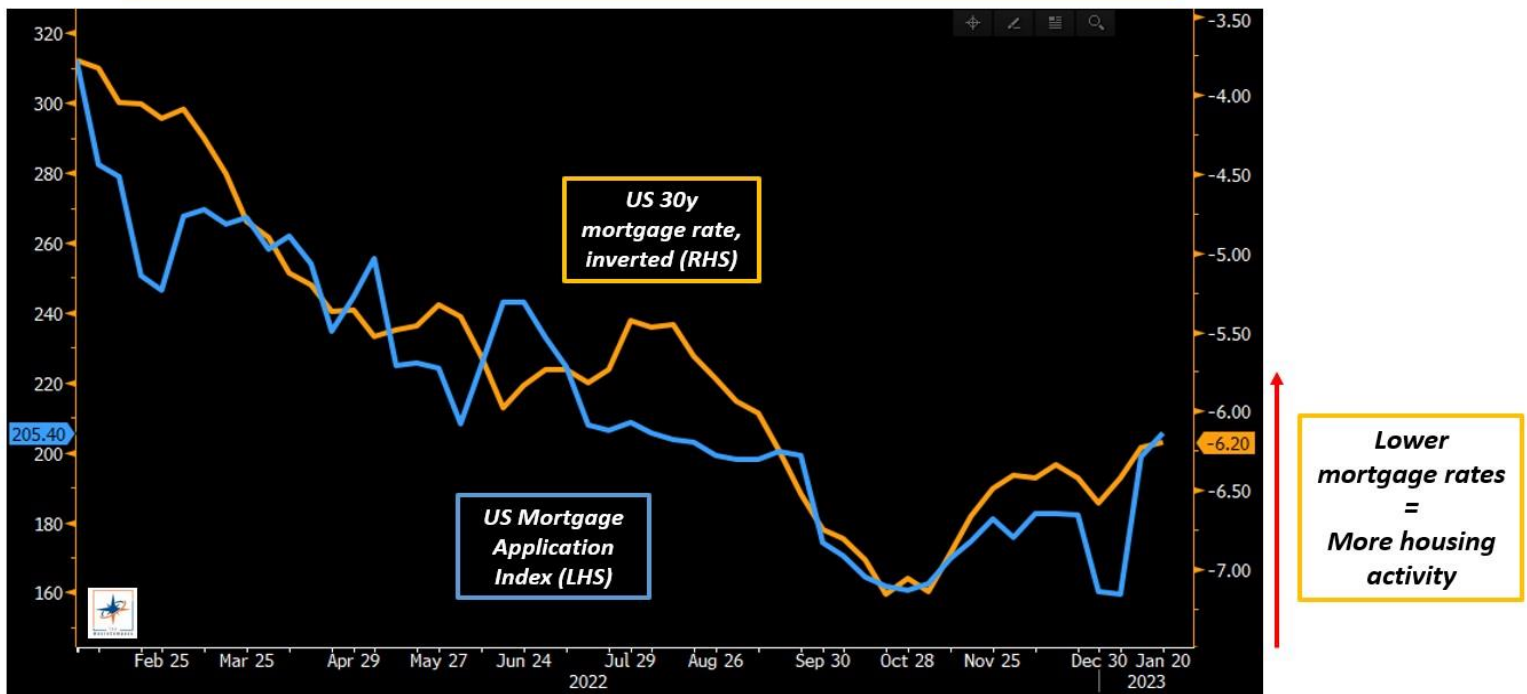
It's been **one and the same trade in 2023 too**: the Fed is done.
Buy everything.

Animal spirits are back.

The difference?

Central Banks were onboard with investors in 2022 – lower asset prices help fighting inflation.
They can't back the 2023 version of this trade – **animal spirits risk fueling an inflation comeback.**

US mortgage rates have already dropped by 100 bps from their peak



Source: TheMacroCompass.com, Bloomberg

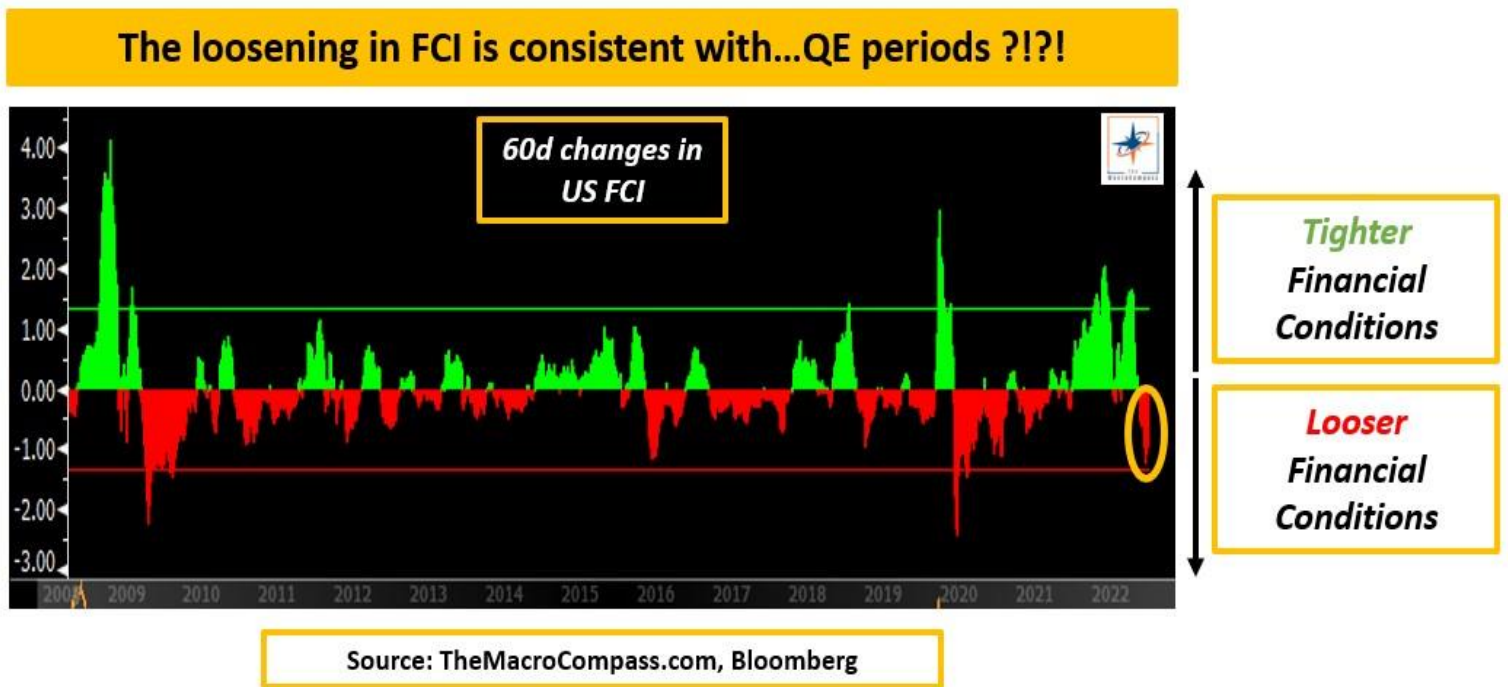
Housing often leads the way in the economic cycle due to its high interest rate sensitivity. In 2022, as mortgage rates skyrocketed and house prices remained elevated new marginal buyers went on strike and the housing market suddenly froze.

Mortgage applications (blue) rapidly declined mirroring the increase in 30y mortgage rates (orange, inverted). But since November, something has changed.

The vicious rally in the bond and credit markets spurred a **100+ bps decline in 30y mortgage rates**, which was fast reflected in a **material pickup in mortgage applications and housing activity**. Still at depressed levels, but you see where we are going here?

Animal spirits are making a comeback, and the Fed can't afford it.

Let's put this in broader context using the **Financial Conditions Index**. It uses equity valuations, credit spreads, rates and the US Dollar as a gauge of broad financial conditions.

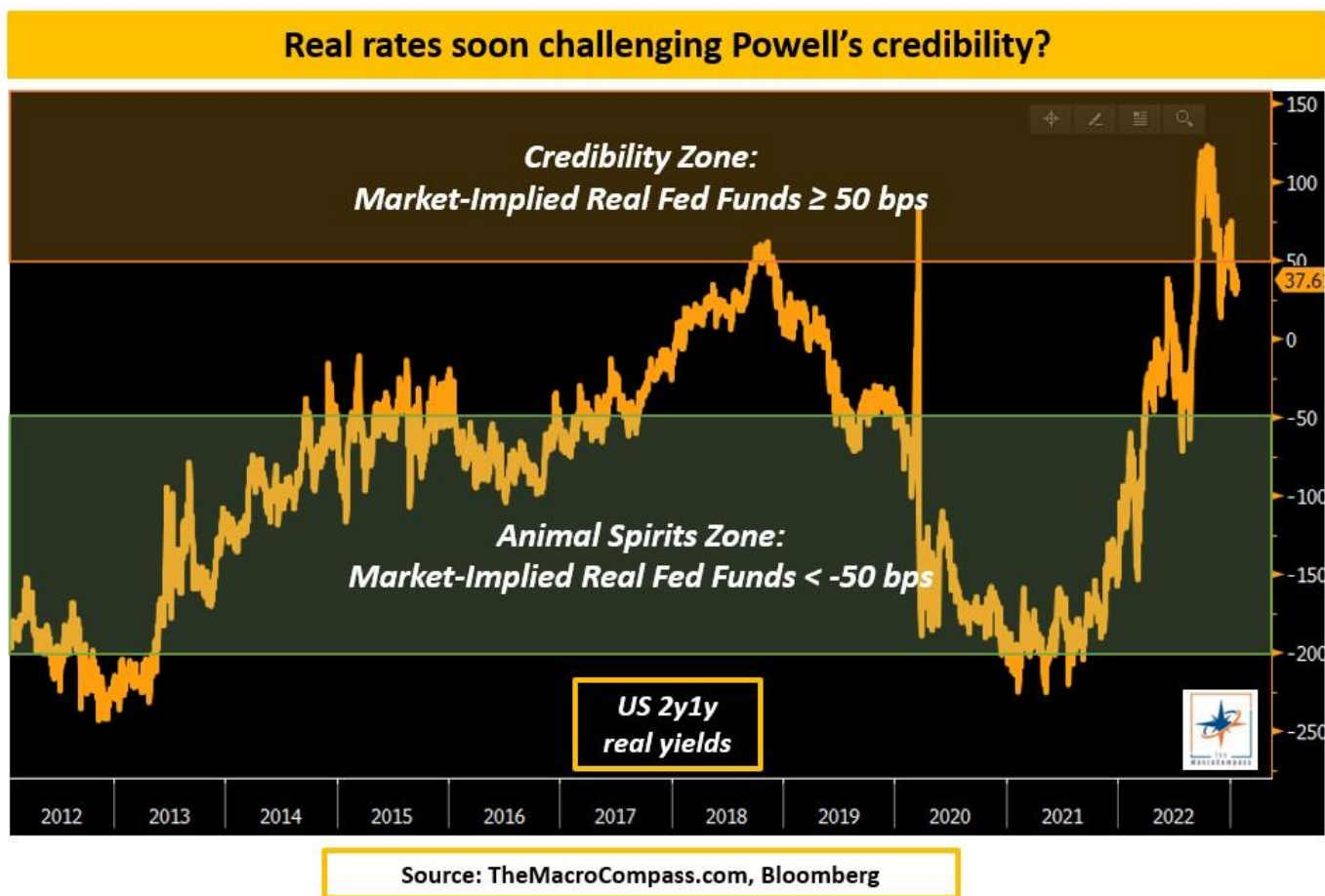


The loosening in US Financial Conditions observed over the last 60 days is the most aggressive since the gargantuan 2020 fiscal and monetary stimulus. More importantly, it's a bigger loosening than during the global Central Bank easing in 2016 and on par with the post-GFC periods.

In other words, markets have behaved as if a **new round of Quantitative Easing (?!)** was just announced.

Yes, you read that right.

The final proof that animal spirits are making a dangerous comeback is offered by bond markets. In particular, by **real rates**. Let's have a quick look.



Market-implied real Fed Funds are quickly projected to drop to only +37 bps in 2 years.

If you want to be credible in your long-term fight against inflation, **history shows real Fed Funds should be in the +50/+100 bps area for 1-2 years.**

We were there for a couple of quarters.

Since November though, **the real yields rally has been challenging Powell's credibility.**

A breach below zero would be the ultimate signal animal spirits are back.

Negative real yields are "the" fuel for animal spirits.

The point here is that the **Fed cannot and will not tolerate** such an early and sharp comeback of animal spirits. Basic risk management imposes the opposite.

In the '70s, the Fed allowed a premature loosening of financial conditions as soon as it seemed like the inflation battle was won.

Few quarters later, animal spirits dominated and **inflation made a nasty comeback.**

It took a much longer and painful Fed tightening cycle to finally slay the inflation dragon.

Powell warned investors he is not going to fall for the same mistake.

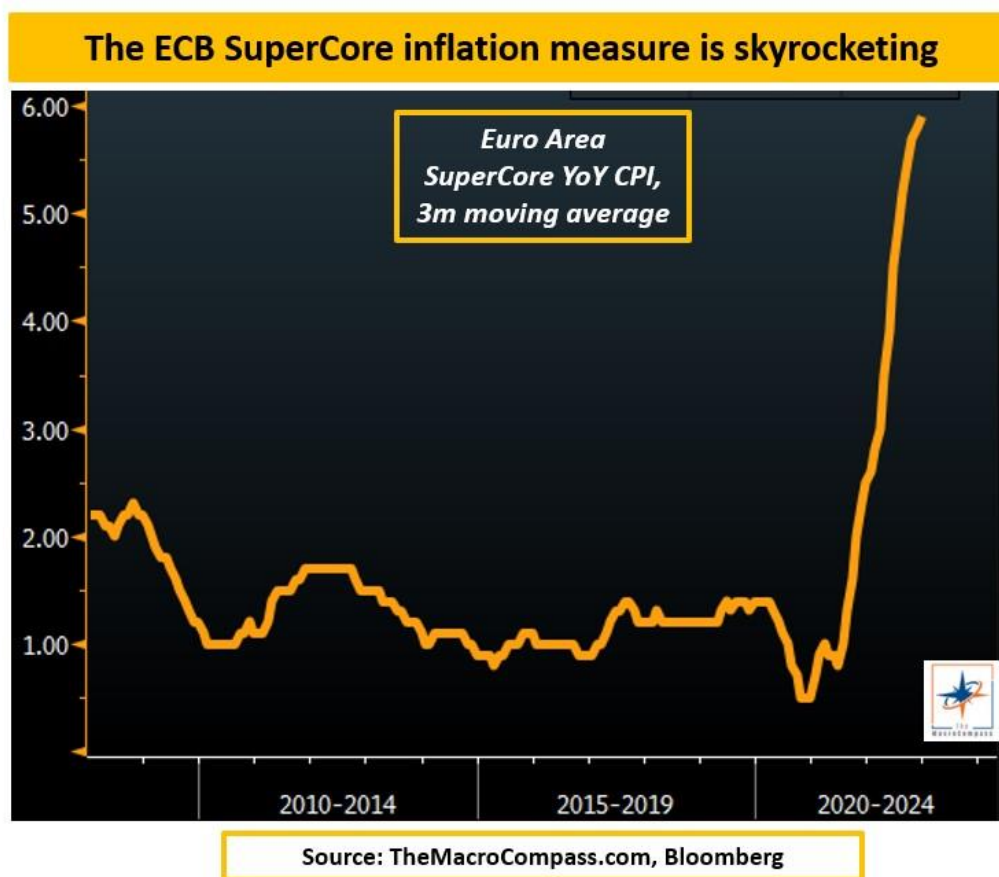
"**Keeping At It**" is the title of a famous Volcker's book.

Powell isn't Volcker, but he sure as hell doesn't want to be remembered as Burns.

Before we jump into what does that mean for our tactical positioning before the big Central Bank week, a quick look at the other elephant: **the ECB.**

Here, one chart to rule them all.

The ECB's measure of SuperCore inflation focuses solely on the stickiest inflationary items in the Euro Area. It basically tells us what's the momentum of CPI items most linked to wages and services. In other words, it measures how "transitory" inflation is likely to be.



This chart doesn't require much explanation: **the momentum of sticky inflation is accelerating, and inflationary pressures are broadening in the Euro Area.**

At the same time, markets are pricing:

- A EUR terminal rate of only 3.4%, in spite of the chart you see above
- European (Core) Inflation to rapidly drop to 2.5% in less than one year
- But at the same time, the Chinese reopening to push European growth higher
- Yet, the ECB to cut rates already in late summer

While all of this might happen, the probability of such a **La-La Land environment** seem to me rather low. China reopening and stronger growth? Then you must reprice the ECB higher for longer. Inflation slows down that dramatically? Then you probably are in a recession.

So, if we think Powell & Co are forced to calm down animal spirits how do we trade this?
Let's have a look to what our **Volatility-Adjusted Market Dashboard (VAMD)** tool is suggesting.

I also released a short video going through the VAMD movements for you.

| Section | Variable | Value | Change | Z-score |
|------------------|-------------------------------|-----------|---------|---------|
| US Rates | US Treasury Yield 2y | 4.41 | -22.0 | -1.0 |
| | US Treasury Yield 5y | 3.55 | -38.6 | -1.8 |
| | US Treasury Yield 10y | 3.46 | -34.4 | -1.5 |
| | US Treasury Yield 30y | 3.92 | -27.3 | -1.3 |
| | US 5y5y Inflation Forward | 2.57 | 4.8 | 0.4 |
| | US 5y5y Real Yield | 67.8 | -36.6 | -1.6 |
| US & EU Equities | S&P 500 Future | 4,037.8 | 6.0 % | 1.0 |
| | Nasdaq 100 Future | 11,930.3 | 10.7 % | 1.5 |
| | Russell 2000 Future | 1,900.6 | 9.6 % | 1.3 |
| | EURO STOXX 50 Future | 4,178.0 | 8.3 % | 1.3 |
| | Germany Future | 15,173.0 | 7.2 % | 1.1 |
| | France Future | 7,092.0 | 7.9 % | 1.2 |
| Credit Spreads | US 5y Investment Grade Spread | 71.6 | -9.3 | -0.8 |
| | US 5y High Yield Spread | 433.6 | -42.6 | -0.7 |
| | EU 5y Investment Grade Spread | 79.4 | -13.0 | -1.1 |
| | EU 5y High Yield Spread | 414.2 | -53.4 | -1.0 |
| | BTP - Bund Spread | 180.2 | -28.9 | -1.0 |
| | EM 5y CDS | 228.5 | -1.8 | -0.3 |
| Commodities | WTI Oil | 80.9 | 2.2 % | 0.0 |
| | Brent Oil | 86.9 | 5.3 % | 0.3 |
| | Gold | 1,937.2 | 7.1 % | 1.7 |
| | Silver | 23.8 | 0.4 % | -0.1 |
| EU Rates | EUR OIS 2y | 2.96 | -13.5 | -0.9 |
| | EUR OIS 5y | 2.56 | -27.9 | -1.4 |
| | EUR OIS 10y | 2.51 | -28.9 | -1.4 |
| | EUR OIS 30y | 2.20 | -12.8 | -0.7 |
| Other Equities | UK Future | 7,732.5 | -3.2 % | 0.6 |
| | Canada Future | 1,243.9 | 6.7 % | 1.2 |
| | Australia Future | 7,432.0 | 5.7 % | 1.1 |
| | Japan Future | 27,380.0 | 5.4 % | 0.9 |
| | Brazil Future | 115,089.0 | 4.5 % | 0.5 |
| | South Korea Future | 326.7 | 6.9 % | 1.5 |
| FX & Crypto | EURUSD | 1.081 | 2.2 % | 1.3 |
| | USDJPY | 129.690 | -0.9 % | -0.5 |
| | GBPUSD | 1.239 | 3.5 % | 1.5 |
| | AUDUSD | 0.712 | 5.7 % | 2.0 |
| | USDCNH | 6.737 | -2.7 % | -1.8 |
| | Bitcoin | 22,977.0 | 35.5 % | 1.8 |
| Volatility | US 3m5y Swaption ATM Vol | 117.3 | -19.6 | -1.8 |
| | US 3m30y Swaption ATM Vol | 96.2 | -18.4 | -1.6 |
| | S&P 500 3m ATM Vol | 17.8 | -21.4 % | -0.7 |
| | EuroStoxx 50 3m ATM Vol | 16.4 | -16.7 % | -0.6 |

Colored boxes highlight YTD moves with a Z-score around 1.5 or higher.

Black is an idiosyncratic move = NatGas down due to warmer weather in Europe.

Blue is a China-related move = CNH itself, AUD (cyclical FX) or South Korean equities (high beta to China).

Red is a "Fed is done" move = rates, US equities, gold, and lower volatility across the board.

The Chinese reopening is real, and it will cyclically push growth higher in places with a high-beta to China.
We don't want to fight that.

Leaving aside idiosyncratic movers, what we want to do is find assets whose recent performance is strongly linked to a "Fed is done = animal spirits comeback" narrative.

The red boxes.

Bonds, US equities, Gold and Bitcoin.

In the end, **it's all one trade.**

Let's look at the equity market more closely.

We are adding a S&P500 put (SPY or ES1 put) with a 3-month expiry with a 3650 strike (~10% OTM).
We invest 1% of capital as upfront to buy this put option.

Implied volatility for a reasonable downside move (10% within 3 months) is trading below its 5-year average, and within its cheapest levels over the last two years. **Skew** is also cheap.

The earnings season has just started, and we might get a nasty surprise or two.

Finally, **Powell** might have to unleash **his inner Volcker** again to **calm down excessive animal spirits**.

SPX puts ranked by most to least expensive using a 5-year lookback

| Asset | Tenor | Strike (% OTM Put) | Implied Vol | Z-Score | Percentile |
|-----------|-------|--------------------|-------------|---------|------------|
| SPX Index | 12M | 0.0% | 20.73% | 0.265 | 60.41 |
| SPX Index | 12M | 2.5% | 21.56% | 0.23 | 58.41 |
| SPX Index | 6M | 0.0% | 19.76% | 0.084 | 57.45 |
| SPX Index | 12M | 5.0% | 22.32% | 0.19 | 56.39 |
| SPX Index | 3M | 0.0% | 18.80% | 0.013 | 56.26 |
| SPX Index | 6M | 2.5% | 20.83% | 0.032 | 56.17 |
| SPX Index | 6M | 5.0% | 21.83% | -0.02 | 54.88 |
| SPX Index | 3M | 2.5% | 20.14% | -0.054 | 54.58 |
| SPX Index | 12M | 10.0% | 23.76% | 0.1 | 53.86 |
| SPX Index | 3M | 5.0% | 21.40% | -0.126 | 52.36 |
| SPX Index | 6M | 10.0% | 23.71% | -0.138 | 51.37 |
| SPX Index | 12M | 20.0% | 26.68% | -0.035 | 48.19 |
| SPX Index | 3M | 10.0% | 23.80% | -0.263 | 46.43 |
| SPX Index | 6M | 20.0% | 27.82% | -0.25 | 42.52 |
| SPX Index | 3M | 20.0% | 29.57% | -0.345 | 38.75 |

Source: TheMacroCompass.com, Bloomberg

If you are into sectors, we ranked puts expensiveness by sectors too.

While Real Estate and Consumer Discretionary might seem obvious candidates at first, their downside vol ranks in the 65-90th (!) percentile using a 5-year lookback: puts are not cheap there.

10% OTM downside puts in Financials and Tech look more attractive on a relative basis.

US equity sectors puts expensiveness ranked by percentile using a 5-year lookback

| Percentile Ranking | ATM 90D | ATM 30D | 10% OTM 90D | 10% OTM 30D | 25% OTM 90D | 25% OTM 30D |
|------------------------------|---------|---------|-------------|-------------|-------------|-------------|
| COMM SERV SELECT SECTOR SPDR | 0.54 | 0.57 | | | | |
| CONSUMER DISCRETIONARY SELT | 0.58 | 0.60 | 0.60 | 0.90 | 0.88 | 0.41 |
| CONSUMER STAPLES SPDR | 0.47 | 0.34 | 0.41 | 0.71 | 0.71 | 0.53 |
| ENERGY SELECT SECTOR SPDR | 0.42 | 0.40 | 0.43 | 0.40 | 0.56 | 0.46 |
| FINANCIAL SELECT SECTOR SPDR | 0.31 | 0.31 | 0.31 | 0.15 | 0.47 | 0.52 |
| HEALTH CARE SELECT SECTOR | 0.45 | 0.47 | 0.25 | 0.11 | 0.49 | 0.20 |
| INDUSTRIAL SELECT SECT SPDR | 0.44 | 0.42 | 0.39 | 0.52 | 0.49 | 0.24 |
| TECHNOLOGY SELECT SECT SPDR | 0.48 | 0.48 | 0.49 | 0.39 | 0.57 | 0.53 |
| MATERIALS SELECT SECTOR SPDR | 0.41 | 0.71 | | | | |
| REAL ESTATE SELECT SECT SPDR | 0.66 | 0.71 | 0.66 | 0.65 | 0.66 | 0.69 |
| UTILITIES SELECT SECTOR SPDR | 0.61 | 0.92 | 0.71 | 0.54 | 0.59 | 0.72 |

Source: TheMacroCompass.com, Bloomberg

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This leaves us with **3 tactical positions**: Short 2-year Italian bonds (FBTS), Long Industrial Metals (DBB) and now Short SPX (via 3m 10% OTM puts).

To conclude, a short reflection on these tactical trades.

Reminder: they are sized to lose maximum 2% of capital if the stop loss you see below is hit.

The Short 2-year Italian bonds position reflects our expectations for an ECB that must react to higher and stickier core inflation. We feel the bond market can't ignore that.

Neither we feel European markets can price the Chinese growth re-rating story while bond markets ignore it. The position is a bit in the red – we keep running it.

The Long Industrial Metals position inspired by our VAMD played for a catch up of Copper, Aluminum and Zinc to the Chinese reopening.

From a beta-adjusted perspective that catch up is almost complete now, but we don't feel the Chinese reopening story has been fully priced yet.

We have moved from page 6 to page 3 of the newspaper, but institutional investors will still keep coming. The position is not far from our first target – we keep running it.