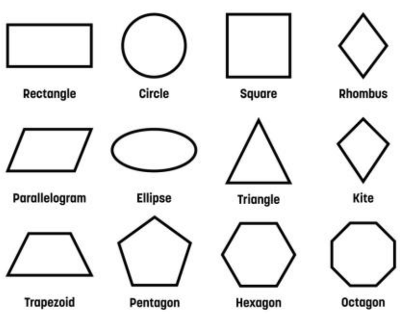
Friday, May 27, 2022

am FX

Brent Donnelly

bdonnelly@spectramarkets.com
(212) 398-6230



Which shape has the smallest perimeter?

Current Views

Short NZDCHF @ 0.6240
Stop loss 0.6365
Take profit 0.6085

17JUN 157/154 GBPJPY put spread
Cost around 37bps
Spot ref. 160.20

Miami Trip Notes

I am back from two days in Miami. Man, the hedge fund community in Miami is thriving! Tons of hedge funds doing well, expanding, opening, hiring, and so on. Performance seems good, generally, and the mood was sunny. We did a dinner with Jens Nordvig Wednesday night, so I will go over the broad takeaways from the trip and also single out some of Jens' particular views and commentary.

Theme 1: The fed and interest rates

The vibe on rates was pretty subdued as many feel the rates trade has played out somewhat in the US particularly. Recession odds in the next 18 months were generally viewed as high to very high and the only real theme in terms of positioning was small received in the US vs. paid rest of the world.

Two main scenarios for the Fed were dominant:

1. The scenario that is priced in, which is 50 June, 50 July, then 25 September as the Fed slows down to gauge its impact on FCI and the real economy. You can see from the grid below, that is pretty much what is priced in. I show how Fed pricing has evolved since January as a reminder of just how far we have come and how small the pullback is from the extreme reached in early May.

   The evolution of Fed pricing, January to now
   Number of hikes priced for each meeting

	2022					2023
	JUN	JUL	SEP	NOV	DEC	FEB
Now	2.0	1.9	1.3	1.0	0.9	0.5
1-May	2.4	2.0	1.7	1.1	0.9	0.6
1-Mar	0.8	0.5	0.5	0.5	0.6	0.3
1-Jan	0.5	0.3	0.5	0.3	0.4	0.2

   This soothing scenario is contingent on financial conditions remaining tight, CPI and wages coming off somewhat (important to focus on 3-month changes), and continued evidence of hiring weakness (higher Initial Claims, etc.)

   We can see by the price action this week that the tiniest recalibration of Fed expectations leads to looser financial conditions and higher oil, and that is why I am not convinced that scenario holds.

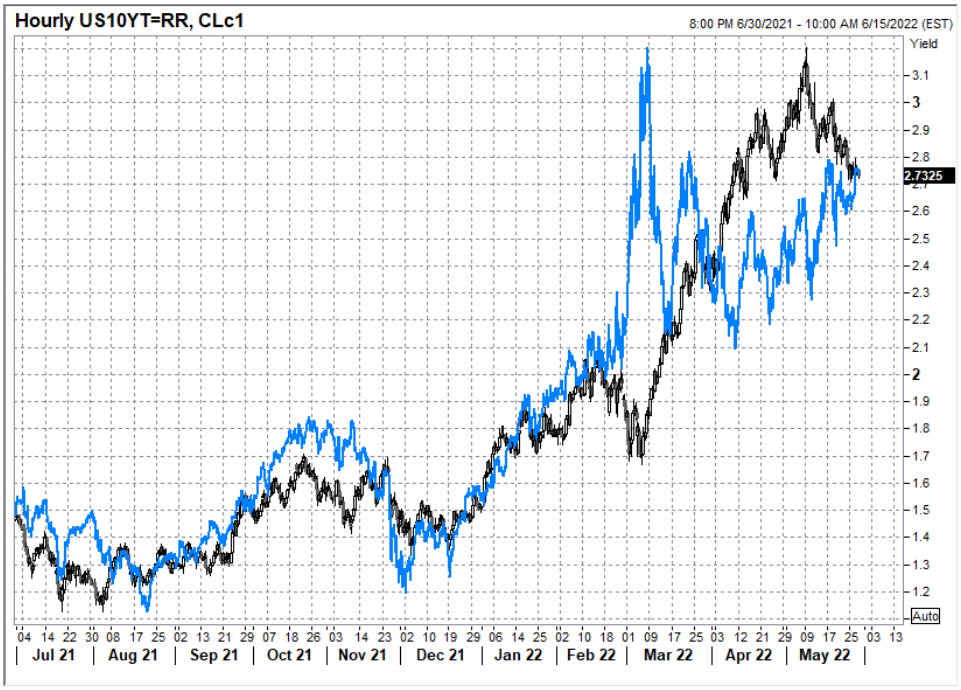
2. The second scenario is that every time the Fed talks a tiny bit dovish, or the market recalibrates dovish, oil ratchets higher and FCI loosens and the dance continues as the Fed sounds more hawkish again and things tighten up and oil cools. One of the most astounding (and concerning) aspects of the 2022 price action has to be that risk aversion and global demand destruction have not impacted the price of oil.

   While some might argue this is evidence that the Fed can't do anything about a supply side commodity shock, you could also speculate on the counterfactual: Where would oil be if the Fed hadn't ripped FCI tighter? I'm not a huge fan of counterfactuals since you can use them to support whatever bias you had going in, but really I have no bias here and my guess is that oil would be at $150 if the Fed was still running the ludicrous policy it was running as recently as February.

You can see in this chart that oil and rates generally move together, though the Russia shock created some noise in the relationship in March. This chart suggests to me that further rises in oil will make it difficult for us to see further falls in yields.

US 10-year yield vs. NYMEX crude

Hourly since July 2021

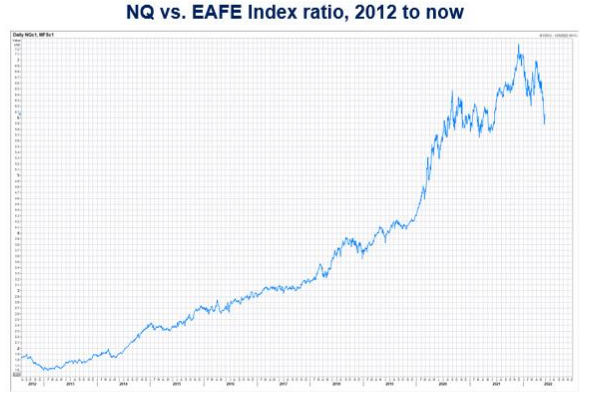


Theme 2: The Death of TINA

Throughout the rip-roaring tech rally of 2016-2021, a common acronym was TINA, which stands for "There Is No Alternative". This was the idea that all the innovation and exciting stuff was happening in tech and tech was set to eat the world. This accelerated in 2021 as the disruptor and Web3 bubbles kicked into high gear and YOLO call buying created even more upside convexity. Now, TINA is dead.

This is best captured by the ratio of NASDAQ to EAFE equities. EAFE is an index of 900 stocks from 21 countries that I like to use more than EEM, because EAFE is more balanced and less China-centric. Chinese equities have a litany of weird idiosyncratic risks like regulation, Xi's turn away from economic reform, real estate defaults, and so on. As such EEM isn't a good proxy for the health of global demand or global equities. At right is the ratio, back to 2012.

NQ vs. EAFE Index ratio, 2012 to now



The view in Miami was close to unanimous that this has more to go (downside). US tech was borderline manic by the time the Fed dropped transitory and the ratio peaked that same day (!) Talk about global macro! Amazing.

This end to US equity exceptionalism is one of several reasons there is a growing cohort of USD bears out there. You can see in the data that global central bank tightening is triggering direct selling of megatech by quasi-governmental organizations. I looked at the holders of Apple, for example (HDS function on Bloomberg), and sorted by largest change in position in the past quarter. **GPIF** (The Japan pension giant) **and Norges Bank are the two largest sellers of Apple**. And GPIF was the largest seller of TSLA. We had a generational rally in US tech over the last ten years and the unwind of that could go anywhere from here.

Theme 3: Where to invest

If TINA is dead, that means there are alternatives. What are they? One of Jens Nordvig's main themes at the dinner was the re-emergence of FX carry. Carry/vol ratios and EMFX valuation strongly support the idea of EM carry as a viable alternative for medium-term investors. The strong performance of EM in 2022 despite significant tightening in financial conditions and a stronger USD is evidence that EMFX is more resilient to shocks.

Two other ideas for areas of outperformance:

- European equities. The doom loop brought on by negative rates could reverse as the ECB hikes and this is bullish EU banks and perhaps (counterintuitively) bullish for European corporates. Negative rates were depressing profitability and sentiment and creating distortions that will be less problematic if Lagarde and Co. can manage to get away from the ZLB.
- China proxies. Pressure is building on Chinese authorities and Li Keqiang's comments are spurring a ton of questions about what the heck is going on in China. Is it possible that Xi is allowing more consensus on economic issues? If so, that could mean more aggressive stimulus and less draconian tech measures. Bullish KWEB, and potentially bullish AUD or other China proxies. If everyone says China is uninvestable, maybe that means it's a great time to invest there?

Theme 4: What the heck is going on in China?

The most consensus view on the trip was short CNH. Reasons include the carry situation, the overshoot of the CFETS in 2021, the momentum (which shows authorities are happy with CNH weakness), and some signs of political instability in China. The preferred expression is short CNH vs. a basket as nobody is raging bullish USD against G10 anymore.

Li Keqiang's statements on the economy have raised some eyebrows as he seems to be going a little off script. Furthermore, Keqiang visited Yunnan University last week maskless and that meeting and the masklessness went unreported by China State media. It looks like a bit of a passive/aggressive power play, but it's hard to say. In the meantime, rumors of Xi Jinping's illness swirl. Jens Nordvig said we cannot rule out that there is infighting and there is potential for political instability in China going forward. The general vibe at all the meetings was: "Something weird is going on in China politics, but we don't know what. Keep this story on the radar."

Unifying Theme : The anti-2010s

A framework that brings many of the varying discussions and themes in Miami together is that the current environment is the mirror image of the 2011-2021 period. Gittins pointed this out a few times. For example:

- QE fueled a risk parity trade for the ages. Now QT triggers the unwind.
- Secular stagnation is now structural inflation.
- Globalization is now deglobalization.
- Raging bull in tech is now overvalued megatech unwind.
- Lower wages and higher profits have morphed into higher wages and margin squeeze.
- Free money is gone, and we have much higher mortgage rates and VC's struggling to raise cash.

And so on. This is a simple and useful framework, I think. And I don't think it's a four-month thing. A secular 10-year party can deliver a pretty nasty and long-lasting hangover. The economy was highly mean reverting for the past 10 years. Maybe it is less so now.

Final thoughts and short-term views

Themes that were notably absent: USDJPY (nobody cares about it), gold (too hard to explain it), and strong USD views (very few USD bulls). Jens' view was that further upside in the dollar is going to be increasingly difficult (sell USD calls) but there isn't a super clear USD-bearish thesis yet. Certainly, the chart breakdowns in the USD are attracting some technical interest, as is the underperformance of US equities, but there isn't yet a big cohort of USD shorts out there.

One random tidbit that could be useful: **Jens said watch Schnabel on the 25bps vs. 50bps debate at the ECB as he thinks her vote will carry huge weight in July.**

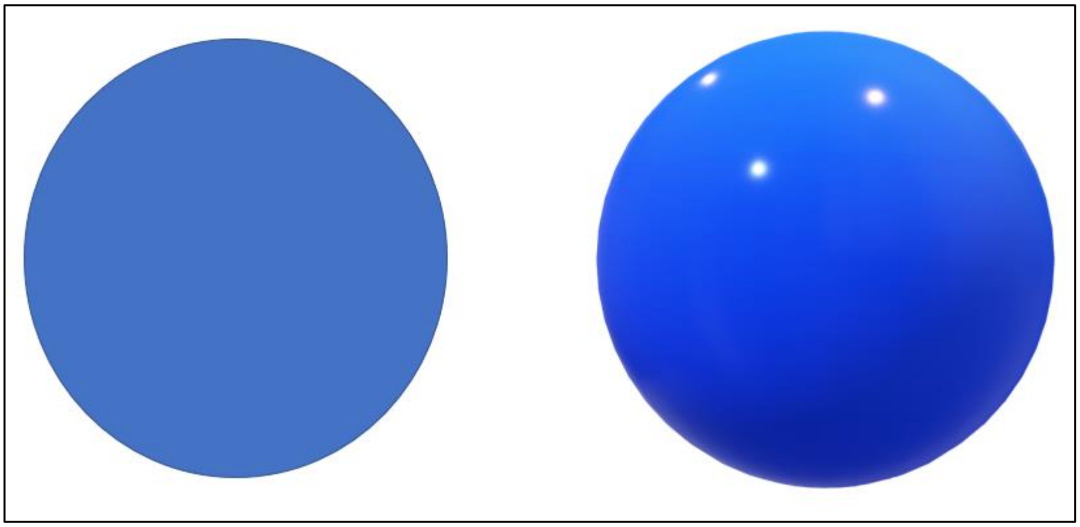
My view on stocks (bearish) has been wrong this week as the modest change in Fed pricing has triggered a relief rally. At some point I will give up on the bearish equity view, but not yet. I don't think Fed pricing can come off much from here as the price of oil refuses to cooperate and the tech layoffs will take a while to filter through to the data.

If we are in a structural repricing of US equities, which I think we still are, you want to keep selling rallies in stocks. My GBPJPY and NZDCHF are both smalls out of the money though it could be worse given the explosive move higher in stocks. I stick with both, while I will admit they feel a bit stale at this particular moment in time. Riding out short squeezes in bear markets is always a challenge. That's what I'm trying to do here.

One final point. This Economist cover just came out. If you're not familiar with my empirical work on the Magazine Cover Indicator, please click here. This would suggest to me it's time get bullish on China stimulus!

Have a square weekend.

good luck ⇅ be nimble



I want to touch that sphere

Among all shapes with same area, a circle will always have the smallest perimeter.

Similarly, for a fixed surface area, a sphere will always have the greater volume than any other shape.

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