Spectra Markets

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am FX

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Landlocked Salmon!

Current Views

Short GBPUSD @ 1.2230
Stop 1.2361

1-month 0.99 EURUSD digital put at 18%
Spot ref. 1.0210
Expires August 18

Seven Maine Takeaways

I am back from four days at Camp Kotok in Maine. Camp Kotok is an invite-only gathering of prominent economists, policymakers, central bankers, traders, asset managers, and journalists that has taken place on the first Friday of every August for more than 20 years. It is part economics conference, part debate-o-rama, and part summer camp for adults who like to fish, drink wine, and play poker. Here are my takeaways.

One: Inertia

The US economy appears to have considerable inertia despite slowdowns in tech and housing, falling commodity prices, rising Initial Claims and so on. Some economists simply wrote off Friday's jobs number as an aberration. Given the level of noise in the series, the divergence between the household and establishment surveys, the outlook suggested by Claims, JOLTS, ISM employment, and Conference Board data (for example) that's not unreasonable.

On the other hand, the economy is particularly confusing and complex right now (much more confusing and complex than I have ever seen) so there are other possible explanations. One explanation is that the US economy has considerable inertia and the massive labor shortage witnessed since 2021 is now finally starting to grind towards equilibrium and this is what payrolls are reflecting. The considerable number of job openings is acting as a buffer to layoffs as those who lose jobs can find other ones.

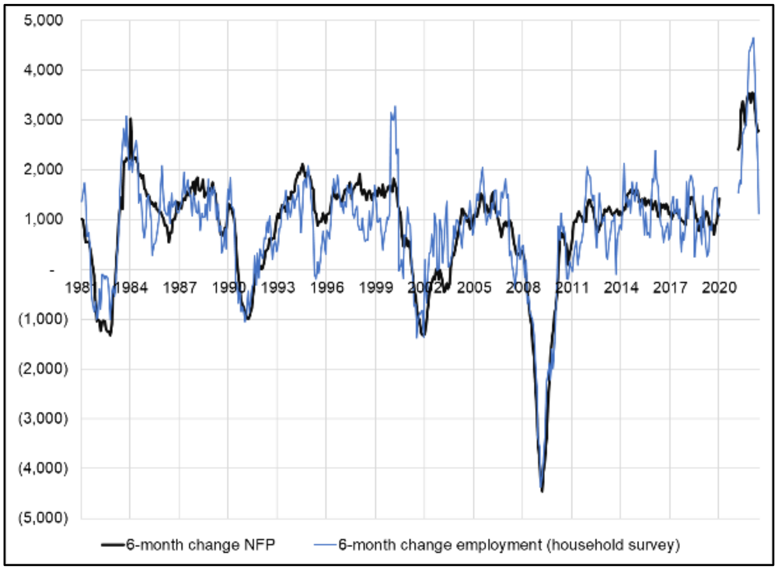
Remember that NFP has become less of a demand indicator in this cycle, and much more of a supply of workers indicator. In this context, the epic fall in JOLTS suggests that employers are finally finding employees. On my drive to Maine, I saw "Help Wanted" signs everywhere, with most fast food and gas stations still looking for workers.

The more bearish economists suggested this is more of a Wile E. Coyote moment as the labor market has clearly turned and this month's release is simply a reflection of a) noise and b) the final matching of supply and demand before we finally see a demand shortfall kick in for the first time in years. Still, even if that's true, it would seem to me that this finding of equilibrium could last more than one month given the epic level of JOLTS and anecdotal signs that low-paying service jobs are still hard to fill.

Multiple people told me that when there is a big divergence in the establishment vs. household survey, that can also be a sign of a turning point, so I figured I'd have a look. I found the evidence unconvincing, no matter how I tried to slice and dice the relationship. Here is how I see it…

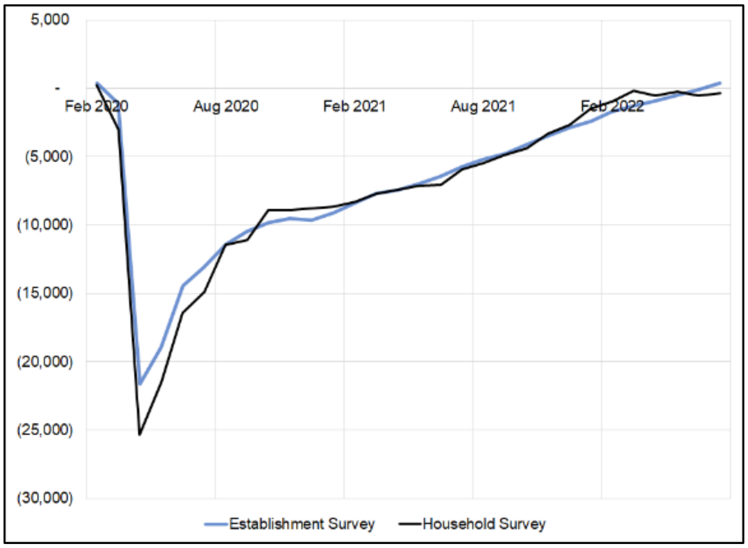
You have to smooth the data somewhat because there is a TON of noise, especially in the Household Survey. Here's the 6-month change in each series (sans 2020):

6-month change in NFP and Household Survey Employment since 1981



2020 cut to avoid y-axis dilation

Cumulative change in US jobs since the pandemic started (NFP vs. Household Survey)

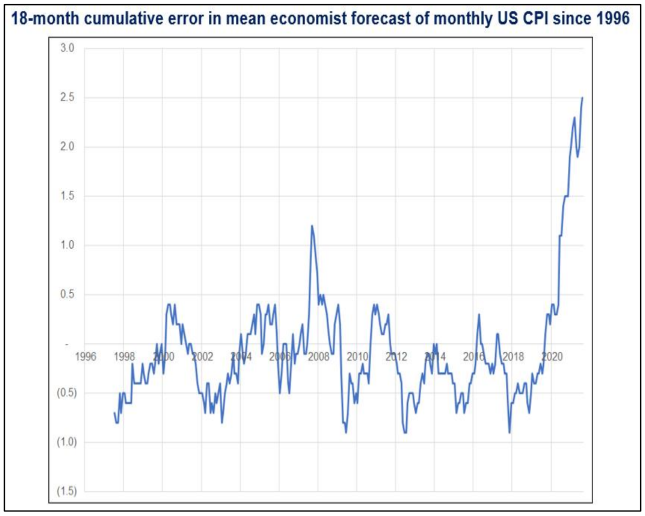


If you look at prior turning points, the household survey doesn't look like a particularly prescient indicator. It turned lower at the same time as NFP in 2008, and it was shooting higher in June 2000 even as the economy hit the wall (i.e., household survey divergence was exactly wrong). To me, it looks like a noisier coincident indicator with no exceptional or unique signaling power. Reading recent economist comments on this, there seems to be this very loud "look what has happened since March!" kind of vibe, but nobody mentions that the Household Survey was massively outprinting NFP for the eight months before that. Again, it all seems like noise.

Happy to hear divergent views on this, because maybe I've missed something, but to me the jobs report is not really an aberration, it's probably just a result of jobs finally getting filled. There are still plenty more to fill. Meanwhile, there is plenty of inertia in inflation too, and my view remains that official data will stay sticky for a few more months as OER offsets softening commodities and rising inventories. We'll see how this theory plays out in tomorrow's data.

Two: Complexity

Economists and Fed PhDs are struggling to explain and forecast the economy. NFP was a demand story for decades, now it's a supply story. Inflation has been mean reverting for decades, now it's trending. Take a look at the cumulative error in economist forecasts of US CPI since 1996 (at right).



The main takeaway is that it's good to be humble when making forecasts. Nobody truly knows what the heck is going on right now. While it's obvious that many inflationary inputs have reversed, the upward inertia of inflation and wages is hard to estimate. And when it actually turns, CPI could crash back to 2% or hit a floor at 5%.

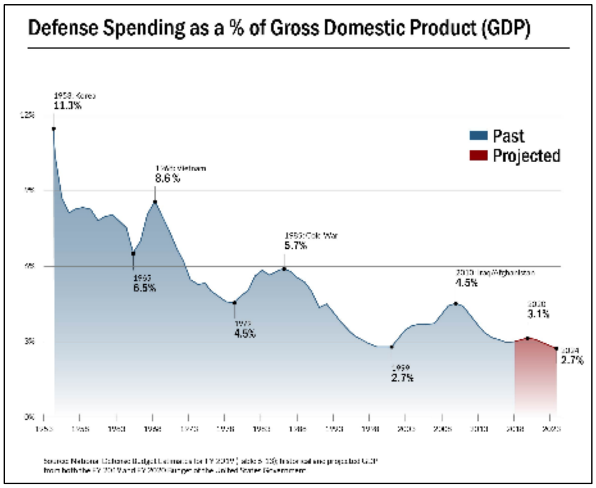
The longer you study economics, the more you realize we still don't have any sort of useful model that can reliably predict the real world. Every regime is different. We are now in a different regime from last decade's lowflation and secular stagnation. While economists had no trouble forecasting most of the economic data pretty accurately from 2010 to COVID as economic volatility remained low, it's best not to lean too heavily on anyone's forecasts right now (including your own!)

Three: Russia / Ukraine

There was a panel Friday night featuring an ex-senior Fed economist and Byron Callan. Byron is an MD at Capital Alpha Partners[1]. Byron covers the defense sector and issues related to national security. He's been covering aerospace and defense since 1984 (!) Also he is in the "Defense News 100 Most Influential People in US Defense." He was the type of guy where you listen and learn as he is clearly mega expert on the topic.

A few takeaways from the panel and subsequent discussions. These are my aggregation of everyone's comments and views; they are not necessarily Byron's views.

1. Base case is stalemate that continues well into 2023. Russia's intent is hard to read, and Putin's actions cannot necessarily be evaluated or predicted through the lens of what a rational actor might do. As such, non-base case scenarios like a move into Moldova or even a NATO country cannot be ruled out. See map.
2. Overweight XAR (the defense and aerospace ETF) as defense spending has been falling as a % of GDP just as substantial foreign threat from Russia and China has increased. This disconnect should close as threats rise. See chart at right from US Department of Defense.
3. Many people don't fully appreciate the damage sanctions are doing to Russia's economy. See a recent study from Yale, for example. This link is for the comprehensive slides. Full study here: Business Retreats and Sanctions are Crippling the Russian Economy.
4. One way the conflict might end: Increased NATO aid to Ukraine eventually leads to Russian troop morale collapse.
5. Fears of the foreign direct product rule are keeping China from engaging too actively or visibly.



[1] *I am using his name with permission. Camp Kotok follows Chatham House Rules.*

Four: Passamaquoddy History!

One of the places we regularly have lunch at Camp Kotok is an island that is part of the Passamaquoddy Reservation. We were there with permission (of course) and the Chief Tribal Historian, [Donald Soctomah](), joined us for lunch and gave us a briefing on Passamaquoddy history. They have found Passamaquoddy petroglyphs in that area that go back about 3,000 years but the Passamaquoddy are estimated to have lived on that particular section of North America for more than 13,000 years. I find that statistic pretty mind-boggling.

The tribe's population peaked ~6,000 years ago and was near 20,000 in the year 1500 (before Europeans landed). Shortly after contact, the Passamaquoddy population collapsed to a low of just 200 individuals as war and disease ravaged every tribe in the area. The current population is ~3,600. *Twenty thousand down to two hundred. Horrendous.*

Donald brought a bunch of cool weapons and crafts that show the creativity and efficiency of resource utilization by the Passamaquoddy. There he is above right, talking to us as the Maine guides in the background prepare fire for fish for lunch.

This is a badass club-style weapon made from a beechwood stump and its roots.

Five: Fed

There's always a ton of Fed talk given a good percentage of the attendees are economists. Main Fed views I heard:

- New lows for Fed credibility. I have been going to Camp Kotok since 2014 and the vibe is generally fairly supportive of the Fed (with some notable exceptions!). There are always several ex-Fed governors, economists, or staffers in attendance. This year though, the trading scandals, Powell's rigid adherence to "transitory" until he was renominated and immediate flip thereafter, the MBS buying in the teeth of a housing rager, and the 3-day forward guidance from Nick Timiraos have completely shattered their credibility. Not many Fed apologists left. A risk could be that if the Fed knows their credibility is shot, the temptation might be to stay hawkish longer if they think that could help their tattered reputation.
- Several commented that the recent wave in meme stocks shows there's still way too much money sloshing around and financial conditions are far too loose.
- Most expect a Fed on hold through most of 2023. Danielle DiMartino Booth (ex-Fed, and author of "Fed Up"), thinks 2s/10s goes to -50 and stays there for a prolonged period. Historically, moves below zero in 2s/10s have been pretty zippy and short-lived but perhaps sticky inflation means sticky 2s/10s. She thinks Powell will stay tight in what will amount to a controlled demolition of the BBB corporate bond market.
- Fed cuts are much less likely in the minds of attendees than current pricing suggests.
- 2.5% was the old inflation ceiling in the US and now it's the floor.
- Waller is the most important voice to listen to, other than Powell. Lots of turnover at the Fed as Evans and George leave in January 2023. New names like Lorie Logan (Dallas) and Susan Collins (Boston) will take a while to figure out and will likely add to the deafening cacophony of comments that sound like forward guidance but are actually not forward guidance. This Brookings Institute piece on upcoming changes in Fed personnel is useful.
- Automobile repos and defaults are becoming a big enough story to capture some attention. See here for some news items on the rapid rise in repos. Lucky Lopez YouTube on this topic is fun and interesting. He's an auto dealer and dude who tracks repo lots and auto repossessions.

Six: EM peeps know inflation

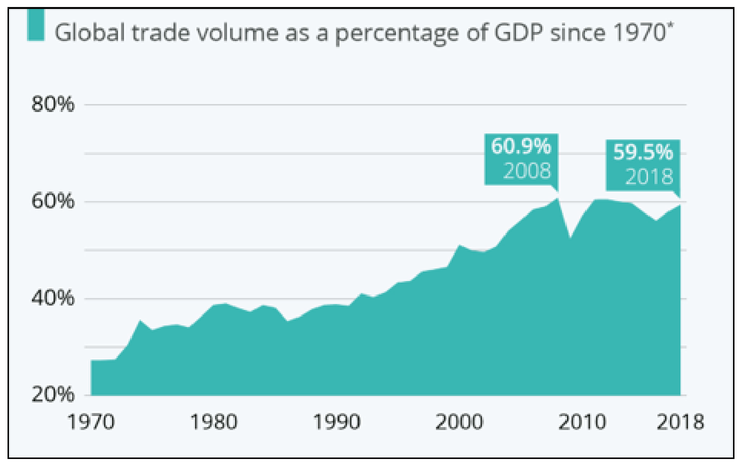
Talking to some people with EM backgrounds and people who live in inflationary regimes like Argentina, there were a few interesting quotes:

- "In Argentina, you hold your money in your hand like an ice cream cone and try to use it up before it melts."
- "In EM, inflation is never transitory."
- "You can have a nominal boom and a real depression at the same time."

Seven: Deglobalization

I did a panel Saturday night with Leland Miller of China Beige Book. We talked about deglobalization and its impact on China, the global economy, and the US dollar. Main points:

- There is no monolithic deglobalization theme to trade. There *is* geopolitical fracturing, populism, increased tariffs, a war in Ukraine, and intensification of China/US tensions. On the other hand, there *is not* much evidence yet of any reshoring. It is more likely that manufacturers will move production out of China and into other low-cost countries like Vietnam and Mexico simply because it is too expensive for most companies to reshore production to the USA. This will be a slow process as companies will mostly realize that despite the COVID supply shock and its dire outcomes, the cost of buying insurance for the next supply shock is too high to justify. As such, deglobalization is not an actionable theme on most time horizons.
- The worse the Chinese economy performs, the greater the pressure on Xi Jinping and the greater the risk of military action in Taiwan. As Xi looks to secure a 3rd term, the success or failure of China now rests fully on his shoulders and if he's feeling weak, the old "wag the dog" approach is always possible. Taiwan could be a pressure valve if things deteriorate for Xi.
- Global trade peaked in 2008 and you could argue that globalization peaked then too. As such, the idea of less globalization is not really a new theme. See chart at right.
- None of this has particular relevance to the dollar. The oil-and-commodity-driven terms of trade shocks that have weakened the EUR and JPY are a good example of how geopolitical fracturing (the war in Ukraine) is something best viewed as a series of idiosyncratic shocks, not a monolithic theme. Each quake and aftershock that occurs as we move away from liberal internationalism / Davos Man and towards protectionism, nationalism, and geopolitical polarization has a specific impact and the dominoes will fall in idiosyncratic ways. You can't say "deglobalization is bad for the dollar" or make far-reaching claims about how it might impact inflation, commodities, or currencies. Instead, each shock that emerges needs to be evaluated on its own.
- The "inevitable demise of the dollar" will have to wait another year. SWIFT sanctions and the weaponization of the dollar have been a nothingburger so far and the total domination of the USD as the fiat onramp to crypto shows that the death of the dollar continues to be a fun thing for people to talk about but a worse-than-useless framework for both traders and investors.



Source: World Bank

Final thoughts

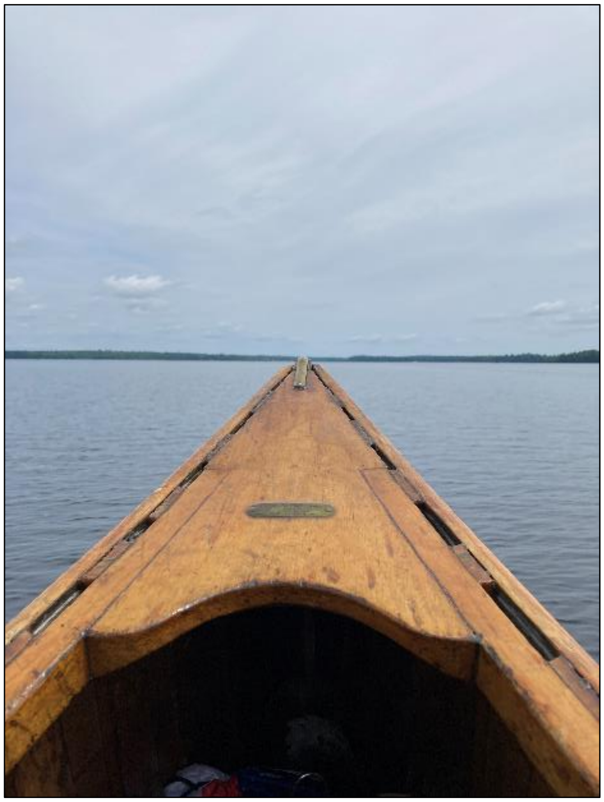
I listened to an excellent audiobook on my trip: "Extreme Ownership: How US Navy SEALs lead and win." By Jocko Willink and Leif Babin. Topics include leadership, tactics vs. strategy, decision-making under uncertainty, how to prioritize and execute when you have many competing priorities, how to operate under extreme bureaucracy, and the concept of "finite leadership capital." *HT:BB*.

I await CPI, like everyone else. Sticking with short GBPUSD and bearish equities as I continue to believe inflation inertia will remain surprisingly strong for now despite encouraging disinflationary signals form commodities and supply chains.

Thank you for reading my notes. Have a calm week, and if you don't receive am/FX at any point going forward, please check your spam and quarantine.

good luck ⥮ be nimble

Thank you to David, Jill, the GIC, Bill and everyone else who does the work to make Camp Kotok happen. See you all in 2023.



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