Positioning Recommendations - March 25th, 2022

Implausible Deniability?

The economic and geopolitical headwinds are blowing much stronger than they were prior to Russia's attack on Ukraine. So, what has been the stock market's reaction to this? Just like in the days when the Fed was in binge-print mode, it has been to head north. The S&P 500 and the Nasdaq are up roughly 4% and 5%, respectively, since Putin's ill-advised incursion.

Bull markets are supposed to climb walls of worry, but this ascent is worthy of Spider-Man. Consider the list of negatives that have intensified since the invasion:

- The yield on the 10-year T-note is up from 2% to approximately 2 ½% today.
- Parts of the yield curve have inverted, a recession warning.
- The risks of global food shortages have risen materially.
- Energy prices vaulted higher from what were already elevated levels.
- The trend toward deglobalization has accelerated, implying higher inflation.
- The Fed is sounding and acting increasingly hawkish.

As I've previously admitted, the forgoing obstacles have been sufficient to warrant my backing away from the "inflationary boom" scenario I have often discussed. This is despite my belief that many areas of the U.S. economy are poised to perform very well. Energy, agriculture, defense, and capital spending beneficiaries are prime examples, as I've written recently. However, the kind of broad-based economic surge I was anticipating later this year seems to me more possible than probable when factoring in all of the above.

Focusing on treasuries, the rate rise this year has been remarkable. The 10-year T-note is now up a full 1% (100 basis points in bond market lingo). That's a 66% increase, and from the yield trough in the summer of 2020 it's been a quintuple, from 0.5% to 2.5%. While it's true that percentage increases off extremely low-rate levels can overstate the move, it nevertheless constitutes a material rise in the cost of money. Of course, real, or inflation-adjusted, yields remain deeply negative. Accordingly, one could argue that monetary policy is still highly stimulative — and inflationary. Actually, you'd get no argument from me on that score.

It remains my view that the real economy can cope with these higher rates, but I'm not so sure about the financial markets. There are already margin call problems flaring up, mostly related to commodities. Additionally, rumors are floating around about a major U.S. bank being in trouble. Hedge funds are notorious for using extreme leverage in trying to goose low yields. These "strategies" can blow up when rates rise sharply, triggering a further proliferation of margin calls. The interconnected nature of this segment of what is known as "the shadow banking system" can cause convulsions in a few funds to rapidly go viral.

Moving on to energy, the widespread fears that surfaced earlier this month when oil first pierced the $100 mark have largely subsided. In fact, the powerful snapback in tech stocks despite oil shooting well north of $100 again and the spike by interest rates is somewhat of a head-scratcher. Both of these negatives are unlikely to meaningfully reverse anytime soon but, again, there seems to be a no-worries attitude on the Street, as has been the case for the last 23 months (i.e., since the pandemic panic subsided).

A major part of the cavalier attitude toward what I've been calling "The Third Energy Crisis" has been due to abysmally poor supply-and-demand reports on oil from the International Energy Administration (IEA). The IEA's data is still heavily relied upon by governments and even large institutional investors. Yet it has been drastically understating demand — and, to a lesser degree, overstating supply — for nearly a decade. This amounted to roughly a 2.7-billion-barrel undercounting, a flaw the IEA has allowed to persist year after year — and is again in 2022. Early this year, it quietly revised its number by 1.9 billion barrels, which leaves it now "just" 600 million barrels off the mark.

Fortunately, our friends at Cornerstone Analytics have been shining a bright light on this for almost as many years as the IEA has been putting out its absurd numbers. In fact, this is such a travesty that I will be devoting a full *EVA* to this subject in the near future. On the unfortunate side, the very same IEA believes sanctions against Russia will lead to a further 2-3-million bpd supply shortfall. I believe it could be even worse, though I hope I'm wrong.   Going into 2022, crude inventories were already perilously low. As the first quarter winds down, it appears there is another deep stock draw occurring. Once more, the IEA is nowhere in the vicinity of accurate.

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(Chart: Cornerstone Analytics; "NA" indicates North America)

Natural gas prices in Europe and Asia have been even more astounding. At one point this winter, natural gas on the Continent was trading at the oil equivalent of roughly $300/barrel. Prices for the blue fuel have also gone postal in China, just as they have for coal.

Because energy filters through to such a wide range of goods, this is a powerful force pushing inflation even higher. One indirect example is with food prices, where soaring natural gas is aggravating shortages caused by the loss of wheat and corn exports from Ukraine and Russia, major exporters of both products. (Nat gas is a critical fertilizer feedstock.)

Diesel prices have already surged to the point that they are posing serious problems for the trucking industry. Because moving freight cost-effectively is such an essential aspect of a healthy economy this is a significant — and, in my view, significantly underappreciated — threat. Due to the potential for shockingly low oil stockpiles later this year, credible observers feel crude could hit $200. Obviously, a stock market back near its highs is not remotely factoring in this nontrivial risk. One could quip that investors are once again proving that "denial" is not just a river in Egypt. Accordingly, I'm calling this a bear market rally, particularly in tech stocks. If you're a large holder of those, I'd be seriously lightening up now, at least with the very high P/E names (i.e., the COPS — Crazy Over-Priced Stocks). On that point, this newsletter has given some timely negative calls on the meme stocks and the two poster kids of that mania have had monster rallies this week. In my view, this leaves them highly exposed to another one of the sickening swoons they have performed multiple times over the last year. To conclude on a parting quip, I'm very much of the view that this "game stopped" being a money-maker for the Robinhood/Reddit crowd many months ago.

Positioning Recommendations

LIKE

To expand on last week's brief mention, for those of you have read Chapter 17 of *Bubble 3.0*, you are aware that one of my strongest recommendations to protect against high and

sticky inflation is the Swiss franc. (If you haven't read it yet, it's being sent out today and it's been up on the Substack website for the last two weeks.) The flight to *perceived* safety by the dollar since the invasion has pushed the "Swissie" down a bit more. Because I believe this decade is destined to turn out a lot like the 1970s, as I've often written, I *also* believe the Swiss franc is a must-include for high-net-worth Americans who share my dollar-debasement concerns. Back in the Disco Decade, it rose by 170% versus the greenback.

- Large-cap growth names at a reasonable price.
- Certain international developed markets, especially Japan
- Publicly traded pipeline partnerships, i.e., MLPs and other mid-stream energy securities.
- Gold-mining stocks
- Gold
- Silver
- **Swiss franc**
- Select international blue chip oil stocks
- Oil field services companies, particularly those well exposed to the Permian Basin
- Short-term investment-grade corporate bonds
- Emerging market (EM) bonds in local currency (focusing on stronger countries, particularly in Asia)
- Large-cap value
- High-dividend equities with *safe* distributions
- Most cyclical, resource-based stocks
- BB-rated corporate bonds
- Canadian REITs
- South Korean Equities
- Certain "Virus Victim" equities, such as refiners, homebuilders, and select retail stocks
- Investment-grade floating rate corporate bonds
- The higher-quality mortgage REITs
- Floating rate bank loans
- Copper producers
- Healthcare stocks
- Capital spending-related companies, mainly focused on the U.S.

NEUTRAL

Based on the global market stock market rally, despite the threats outlined in the introduction section, I'd hold off on accumulating(or even trim back somewhat) on the below equity categories.

- Uranium and uranium producers
- Renewable yield cos
- Intermediate-term, investment-grade corporate bonds, yielding approximately 4%
- **Mid-cap value**
- **Emerging stock markets; however, a number of Asian developing markets remain attractive**
- Emerging market bonds
- U.S.-based Real Estate Investment Trusts (REITs)
- Cash
- Canadian dollar-denominated short-term bonds

- One- to two-year Treasury notes
- Traditionally “safe” sectors, such as Staples and Utilities
- Virus Victors
- **Small-cap value**
- European banks

DISLIKE

The Indian market has rallied back about 10%. In my view, this is another shorting opportunity with it trading at 24x earnings. As I’ve mentioned, before India is highly vulnerable to ripping oil prices. It’s also exposed to spiking food prices.

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- **The Indian stock market**
- A wide range of high-income securities, including preferred stocks
- Intermediate-term Treasury bonds
- Small-cap growth
- Long-term treasury bonds
- Long-term, investment-grade corporate bonds
- Most municipal bonds
- U.S. dollar
- Many semiconductor tech stocks
- Mid-cap growth
- Lower-rated junk bonds
- Green energy stocks
- SPACs
- Most new issues
- Despite a disastrous February 2021, most of the popular Reddit/WallStreetBets meme stocks still have material downside.