Positioning Recommendations – February 4th, 2022

The Most Dangerous Chart on Wall Street?

Yes, I admit it. The following image doesn't look very scary--especially not compared with many of the market valuation charts such as the one immediately below it showing the towering price-to-sales ratio for the S&P--but please allow me to explain my reasoning.

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The first visual illustrates how remarkably ~~naively~~ complacent the Wall Street consensus is on the likely future path of inflation. A die-hard, no-worries, markets-only-go-up, type of person might blow this off as a mere survey. However, the reality is that a very important marketplace, one which prices in future inflation expectations on a second-by-second basis, agrees with this benevolent view…or at least it was.

The $30 trillion government bond market has been every bit as relaxed as the survey participants displayed above despite the CPI running in the 6% to 7% range. Yields bouncing between 1.25% to 1.75% on the key 10-year T-note are clearly assuming that inflation is truly transitory, even though the Fed has, belatedly, retired that word from its lexicon. They also imply a most unconcerned attitude toward the very belated—like insanely delayed—cessation of the Fed's latest multi-trillion-dollar money fabrication scheme.

In fact, this fourth sequel to its original Quantitative Easing (QE) experiment, which was supposed to be "transitory" when QE I first launched in 2008, is almost certain to go into reverse gear soon. This reversal, or balance sheet shrinkage, is popularly known as Quantitative Tightening (QT). What this means in plain English is that instead of buying trillions of treasuries and government-backed mortgages, all financed by the Fed's magical computer-generated money, it will now be a seller.

As a result, the treasury bond market will soon be experiencing the double-whammy of losing by far its biggest buyer which will now become a major de facto seller. Given the Fed's ultra-cautious nature, it is more likely to let its bonds simply mature versus actually selling them. Yet the impact is similar. This is particularly the case when the federal government has a continuing need to raise over $100 billion a month, due to its voracious burn-rate--despite that its revenue in-take is at record levels. A non-reinvesting Fed (i.e., not recycling the proceeds from its maturing bonds back into new ones) may well create some serious upward pressure on longer-term interest rates.

The implications of this massive shift may suddenly be dawning on the bond market. As of today, the 10-year yield is pushing toward the critical 2% level. This is contrary to what the many vocal bond bulls have been predicting. Personally, I believe it will soon be penetrated to the upside, just like I don't think the $100 ceiling will hold in the oil market (and there is a connection; exploding energy costs put upward pressure on inflation and, in turn, on bond yields).

This is why the extremely cavalier attitude of Wall Street toward inflation later this year could lead to such a seismic shock. If instead of smoothly gliding down to near 2%, it remains, as I believe, sticky around 4% to 5%, or even higher, the market reaction could be volcanic. When you combine that with the price-to-sales chart shown above, it could spell, like that old Elvis Presley hit, T-R-O-U-B-L-E.

If so, the Pavlovian investment reaction to any market weakness that has worked so well for 13 years—Buy The Dip!—might also need to do a flip—as in, Sell The Rip!—similar to the looming inversion of the Fed's QE. For instance, the Nasdaq's spirited 7.3% rally since last week's trough, when it had tumbled 18% from its late November high, could be a chance to reduce exposure to still very expensively valued growth stocks that appear to be, in many cases, breaking down in a material way. Despite the recent bounce, bad news, such as with Meta yesterday, seems to be producing much more downside than good news is creating upside, like Amazon today.

Once again, this environment reminds me more and more of 2000 when the 1990s tech bubble had popped but there were a number of powerful snapbacks on the way to the Nasdaq's eventual 78% peak-to-trough meltdown. My best advice in this regard: don't get sucked in by these alluring rallies and remain focused on the long-term trend. In my mind, that is a relentless shift of trillions of dollars into value stocks, particularly those in overseas markets. However, some former growth names have been so badly pummeled that they now are looking very GARP-like—as in, Growth At a Reasonable Price. These are much more in my comfort zone than the COPS—the Crazy Over-Priced Stocks—that are suddenly not nearly as over-priced as they once were.

Positioning Recommendations

As I discussed at the end of the introduction to our *EVA PR*, there has been such large number of former growth stocks that have had 2 for 1 splits, even 3 for 1, but without the additional shares, that growth-at-a-reasonable price (GARP) situations have proliferated. Thus, it's time to do some gradual buying of these names—emphasis on gradual. A certain mega cap-tech name that is trying to capitalize on what it believes to be a meta-opportunity is one example. Another is the leading digital payment company which is now down 60% from its 2021 zenith; thus, it has been no pal to its shareholders lately. However, there has been enormous technical damage done to issues like these. Accordingly, the eventual recoveries are likely to be drawn out affairs.

LIKE

- **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

- Select international blue chip oil stocks
- 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

Many of the MLP-like Renewable Yield Companies have come down hard of late. They may not be strong buys at this point, but they are probably worth some nibbling.

NEUTRAL

- Uranium and uranium producers
- **Renewable Yield Cos**
- A wide range of high-income securities, including preferred stocks
- Intermediate-term investment-grade corporate bonds, yielding approximately 2.25%
- Mid-cap value
- Emerging stock markets; however, a number of Asian developing markets look undervalued
- US-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

Taking a shallow bow here: our persistent warnings on longer-term treasuries and corporate bonds has proven to be justified. At some point, there should be a counter-trend rally but the long-range outlook for extended maturity fixed-income debt is not encouraging.

- The Indian stock market
- **Intermediate-term Treasury bonds**
- Small-cap growth
- **Long-term treasury bonds**
- **Long-term investment grade corporate bonds**

- Most municipal bonds
- US 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.