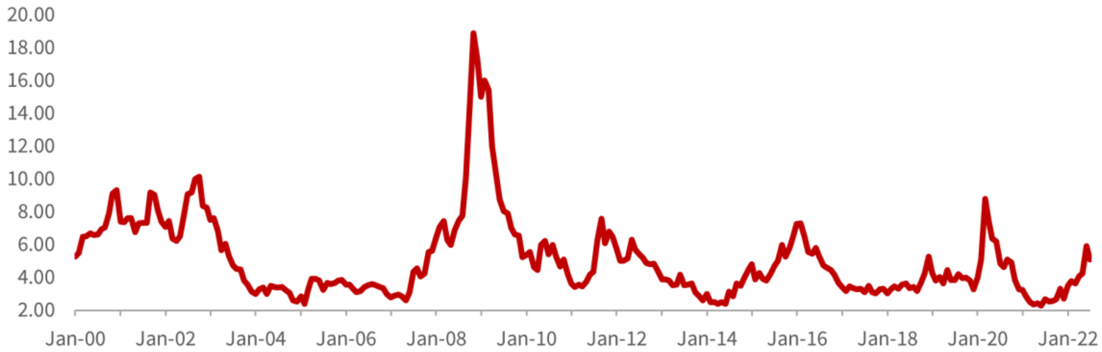
The true pain trade is coming

The true pain trade is coming

Of all the pithy cliches designed to spark market conversations, the one I truly despise is "where is the pain trade?". If you're accurately defining a pain trade, it will be the market's direction that inflicts the most harm to investment portfolios. Conventionally, however, it is used by pundits and financial media to describe lost opportunities either for benchmark managers or discretionary tactical traders, generally when markets rally. Given that over 95% of asset pools are long only or long biased, the true pain trade is when asset values fall. The majority of investors are negatively impacted by falling equity valuations, wider credit spreads, or declines in house prices. The notion that a pain trade exists when under-exposed speculative investors make less money than they should in a rising market does lose sight of the big picture. While relative performance is important in many circles, it is difficult to digest that making less money is more harmful than losing it. It depends on where you sit, but for tens of millions of investors across the globe, relative underperformance can't be compared to capital destruction.

The pain trade phrase has been bandied around recently as market participants debate whether this recent bounce in risky assets is a bear market rally or the commencement of something more sustainable. Growing evidence of peak inflation driven by softer energy prices, a resilient US labour market despite two negative GDP quarters, and a self-reinforcing narrative driven by a 25% rally in US high yield spreads and a 20% rally in the NASDAQ have seen the consensus framework migrate. Eight weeks ago, the conventional thinking was a near-term recession. Today, the Goldilocks scenario of a soft landing despite the Fed raising rates by 150bps cumulative at two consecutive meetings appears to be the base case for many. This has prompted a slew of commentary discussing whether the pain trade is a continuation of rising asset values at a point in time when many portfolios are extremely defensive. For me, this is less about financial pain and more about the mental anguish which lies at the heart of every bear market rally.

US High Yield: The most aggressive Fed tightening in 30 years and spreads are second quartile



Source: Bloomberg

By **Paul Krake**, paul@viewfromthepeak.com.hk;
Published and distributed by **VFTP Financial Publishing LLC**. Our disclaimers and disclosures are at the end of the report.

(Note that I removed the 2008 spike when assessing the range for credit spreads)

Bear market rallies are designed for mass confusion. A new dawn or a correction in the downtrend? Confirmation is only achieved with hindsight; hence, trading in bear market rallies is where great tactical investors prove their worth. In 2000, post the bursting of the previous tech bubble, the NDX rallied 20%, the equivalent of a "bull market" on seven occasions in 12 months, while producing a peak to trough return of -77%. Each occasion had its own narrative switch where valuations and the economic and corporate outlook improved at the margin, which promoted thinking that the worst was over.

It takes bravery to sell into strength, particularly when the positive narrative gets reinforced with upward price momentum. It is all well and good to talk about wanting to sell the SPX at 4200 to 4400 when the market was trading below 3800. However, as we have reached these levels and the consensus narrative has switched from glass half empty to something much more constructive, executing those original intentions becomes more difficult.

To quote another old trading truism:

Everyone has a level that they want to execute at up until the point that we get there.

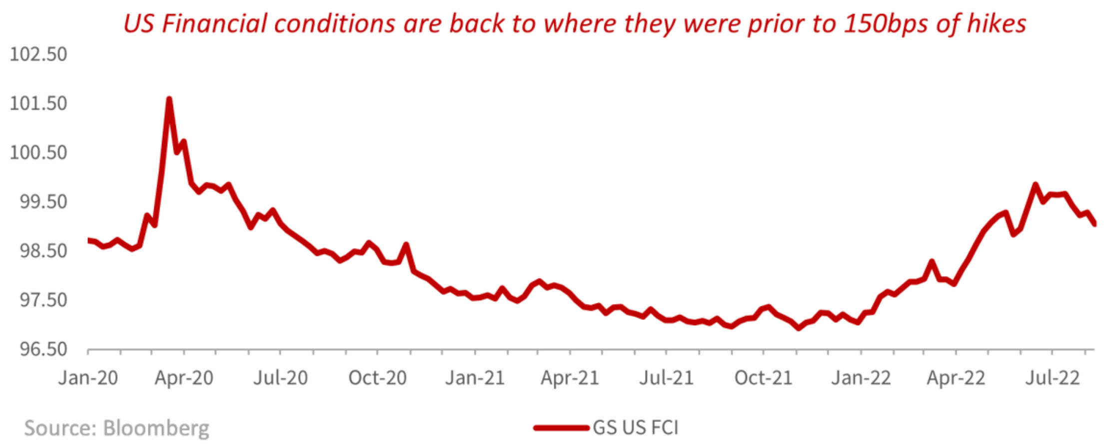
Price changes the narrative

While I do disagree, the framework that the worst is behind us is simple, elegant, and in some ways, tough to argue with.

With clear evidence that inflation has peaked, it can be implied that the most aggressive period of Fed action is behind us. We operate in a world dominated by the rate of change; we are on a pathway of less tightening and an eventual pause. With labour market resilience a precursor to continuing consumer strength, there is an increasing likelihood of a soft landing for the US economy and the avoidance of a profit recession needed for equity markets to make new lows.

As we stand today, the policy and market framework has improved.

1. The terminal rate is well off its highs of close to 4%, implying that the end of Fed tightening is in sight over the next six months.
2. While this may not please the Fed, financial conditions have eased, predominantly due to a significant tightening of credit spreads, higher equity values and a VIX below 20. Financial conditions are easier now than in Early June before 150bps of tightening.
3. Q2 earnings proved to be more robust than most expected, underpinning the thinking that an appreciable deterioration in SPX earnings is unlikely. If earnings are not going to deteriorate further, and interest rates are not a threat to the multiple paid for stocks, particularly growth equity, what is the catalyst for stocks to make new lows?



Why do I believe this is nothing but a bear market rally?

My rationale that this is nothing more than a bear market rally comes down to several basic points:

This is the most aggressive Fed tightening in nearly 30 years. Historically the Federal Reserve has a terrible track record of avoiding a consumer/labour market recession amid an aggressive tightening cycle.

My base case is that we are in the third quarter of eight quarters of negligible economic activity for the US and EU. Even though we appear to be redefining the definition of recession, the labels are irrelevant for activity and corporate profits. I believe there will be another six quarters of negligible growth in the US and EU, on top of the two quarters we have already experienced. Whether we refer to this as a recession or not is mute.

This economic stagnation will be due to Europe's energy crisis, a declining US fiscal deficit and the removal of the support given to the bottom 70% of income earners, collapsing real incomes, high mortgage costs, an eventual softening of the labour market and the strength of the US Dollar.

I believe the markets have underestimated the impact of dollar strength on the US and global economy. While the trade-weighted dollar has come off its highs, further USD strength is likely in the face of further aggressive Fed action and the evolution of a policy blunder from the ECB. While the dollar's strength is in its late innings, an EU recession and the unwinding of 2023 rate hike expectations will see the dollar continue to be strong. Euro below 0.95 is my base case by year-end.

The Fed is approaching what is conventionally thought of as neutral. It will continue to tighten aggressively between now and the end of the year, with the upper bound likely being near 3.50%, the current terminal rate. Rate cuts are now being priced with 50bps of easing 12 months forward.

Despite softer economic activity and the prospect of eight quarters of negligible growth for the US and EU, the botched handling of the energy transition and no prospect of respite in Ukraine implies that energy prices and food will be elevated over the medium to long term.

We live in a world where the rate of change matters for financial markets. A definitive Fed pivot, something that has not happened as yet, would be incredibly optimistic for stocks and credit. For the Fed to pivot and end this tightening cycle, I believe that inflation will need to be on a trajectory to be lower than 5%. We are nowhere near this.

Consensus 2023 SPX earnings expectations are down only 1.6% in the past four weeks, remaining at an incredibly optimistic $244.20. Is it possible for global risky assets to stabilise before earnings expectations have calibrated lower? It is difficult for me to envision a scenario where global equities bottom for the cycle before earning expectations are revised lower from effectively peak expectations for 2023.

This is the primary reason I believe that recent equity strength should be viewed as nothing more than a bear market rally.

If this is a bear market rally, where to short?

This is hardly groundbreaking, but my rule of thumb for corrections is to reestablish positions between 50% and 61.8% retracement of the entire move. For the SPX, this is precisely where we are, and while the NDX is 2% away from a 50% retracement, we are also heading into a range where if you believe that the worst is not behind us, it would be a compelling location to lighten up or short.

There are two glaring short opportunities over the next eight weeks. Credit spreads have tightened substantially in recent weeks and are simply not reflective of the forward outlook for credit quality. Private lending vehicles and credit managers are seeing signs of the early stages of credit deterioration and with US high yield spreads at less than 500bps over (460bp for the Barclays US High Yield Index), this is certainly not reflective of my elongated below trend economic environment.

The tactical model portfolio will be shorting the HYG on Monday.

The second compelling short is US equities. We are in the middle of the 4200 -4400 range, which has been my target. While price momentum, changing attitudes towards recession risk and compelling evidence that inflation has peaked, my base case remains that economic activity and corporate profits will underwhelm incredibly rosy expectations in the quarters ahead. I won't deny that negative September seasonality, aligning perfectly with my price targets, has given me renewed confidence in this strategy.

The SPX December 3800/3600 put spread for $27 is compelling and will be executed on Monday.

Disclaimer

Note: The terms of this report are subject to and qualified by the terms of the Subscription Agreement between VFTP Financial Publishing LLC ("VFTP") and client receiving this report. Unless otherwise specified herein, in the event of any conflict between the terms of this Disclaimer and the terms of the Agreement, the terms of the Agreement shall govern. Defined terms not otherwise defined herein shall be as defined in the Agreement.

All Sources Bloomberg unless stated

Analyst Certification

The analyst(s) named in this report certifies that (i) all views expressed in this report accurately reflect the personal views of the analyst(s) with regard to any and all of the subject securities and companies mentioned in this report and (ii) no part of the compensation of the analyst(s) was, is, or will be, directly or indirectly, related to the specific recommendation or views expressed by that analyst herein.

Required Disclosures

The analyst named in this report (or their associates) does not have a financial interest in the corporation(s) mentioned in this report. Additional information will be made available upon request.

Global Disclaimer

This report is for the use of intended recipients only and may not be reproduced, in whole or in part, or delivered or transmitted to any other person without our prior written consent. By accepting this report, the Recipient agrees to be bound by the terms and limitations set out herein. The information contained in this report has been obtained exclusively from public sources believed by VFTP to be reliable and the opinions contained herein are expressions of belief based on such information. Except as otherwise set forth herein or in the Subscription Agreement, no representation or warranty, express or implied, is made that such information or opinions is accurate, complete or verified and it should not be relied upon as such. Nothing in this Report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances or otherwise constitutes a personal recommendation. It is published solely for information purposes, it does not constitute an advertisement, a prospectus or other offering document or an offer or a solicitation to buy or sell any securities or related financial instruments in any jurisdiction. Information and opinions contained in this report are published for the reference of the recipients and are not to be relied upon as authoritative or without the recipient's own independent verification or taken in substitution for the exercise of the recipient's own judgment. All opinions contained herein constitute the views of the analyst(s) named in this report, they are subject to change without notice and are not intended to provide the sole basis of any evaluation of the subject securities and companies mentioned in this report. Any reference to past performance should not be taken as an indication of future performance. Except in the case of fraud, gross negligence or willful misconduct, or except as otherwise set forth herein or in the Subscription Agreement, VFTP does not accept any liability whatsoever for any direct or consequential loss arising from any use of the materials contained in this report.
Distribution or publication of this report in any other places to persons which are not permitted under the applicable laws or regulations of such places is strictly prohibited.