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Q & A Special Report

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POSITION SUMMARY

* Indicates a new position or change in view

MARKET	CYCLE	MEDIUM-TERM *Up to 3 months*
S&P500	Bull Questionable	Correction
30y Long Bond (price)	Constructive	Bullish
Brent Oil	Neutral/Bearish*	Bearish*
Gold	Bullish	Neutral*
EUR/USD	Neutral	Bullish
USD/JPY	Bearish	Bearish*
USD/CNH	Neutral	Sideways

Q & A Special Report

We held a Fireside Chat webinar on May 28, 2024, with special guest Ed Hyman who is the Chairman of Evercore ISI and moderated by David Lin from The David Lin Report. For those who missed the webinar and would like to watch the replay, it was sent out on May 29th. If you for some reason did not receive the e-mail, please reach out to us at info@felixzulauf.com.

In this Q&A Special Report, we are providing answers to some questions from subscribers that we received before, during and after the webinar. The questions are arranged by topic.

Next week, we will publish a more extensive report to update you on our market outlook.

ECONOMIC

Is global liquidity inflecting upwards if all CBs are cutting/easing? Even if the FED doesn't want to cut, they may be forced to cut to maintain stability in the dollar. Inflation may be the sacrifice.

We understand what you mean; when all central banks are easing except the US, the US dollar will strengthen, and the Fed may be forced to cut rates and ease monetary policy to prevent a too strong US dollar.

That could happen if other central banks would ease decisively. But if they only cut rates in mini steps, that is not a problem, at least not for the next few months. The biggest risk is when some major central banks must ease aggressively due to a very weak economy. We see that risk primarily in China, where the situation is moving towards a "Minsky moment" forcing the Chinese authorities to ease aggressively (chart 1). China has a closed capital account and without it, the yuan would already be weaker.

China's economic situation is highly deflationary and getting more so with credit and monetary aggregates falling and lending rates in real terms being far too high. We understand that the world's

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consensus is that China is easing, and the stock market is rallying and that this signals a turnaround is in the making. We disagree and think that investors have been jumping ahead and we expect a relapse that will disappoint investors.

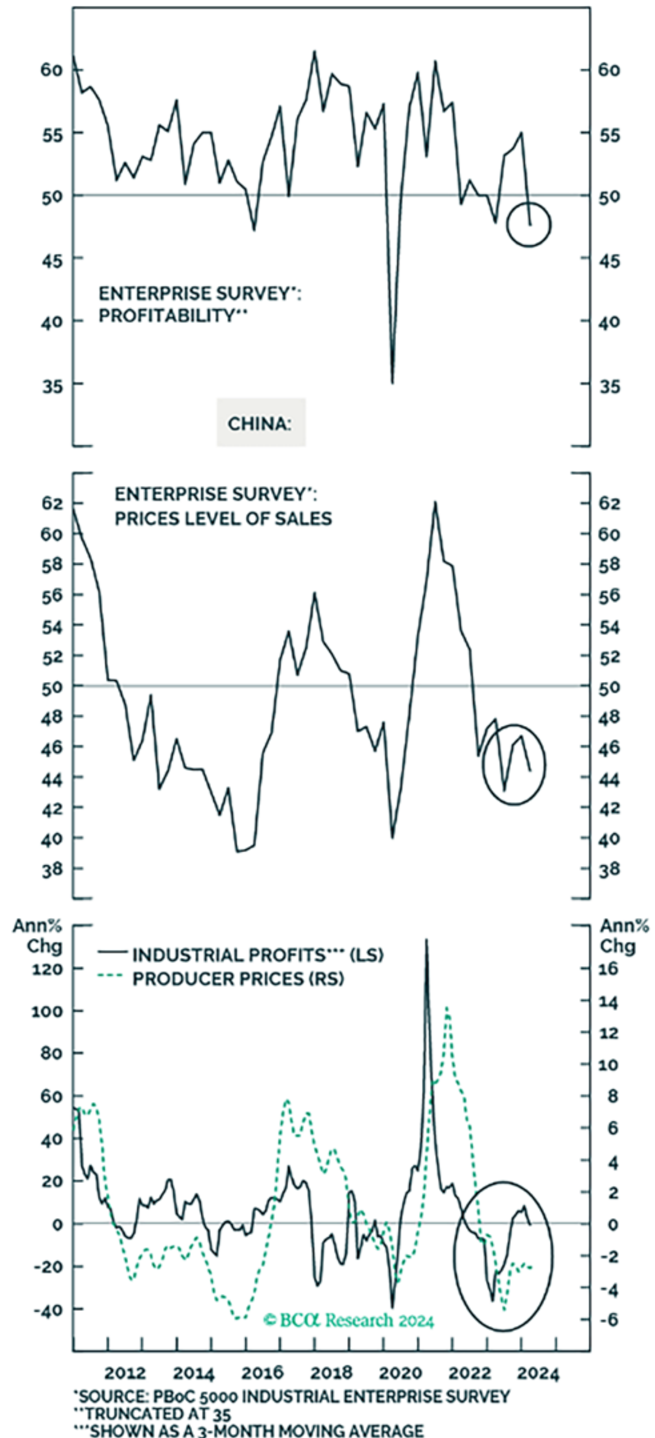
China's economic situation is highly deflationary and getting more so with credit and monetary aggregates falling and lending rates in real terms being far too high.

We would be surprised if China does not face a very serious high-risk crisis within the next 6-12 months that forces the authorities to act much more decisively. That would weaken the yuan. However, China has a closed capital account which means that the authorities will likely be able to manage the currency to a lower level step-by-step in an orderly way.

It is easy to see that China is trying to escape this economic weakness by exporting more of its excess production to the rest of the world, which will result in intensifying trade frictions, particularly ahead of the US elections. And a devaluation of the yuan will hardly be what would make Biden or Trump happy. Watch out for serious problems arriving in China and impacting world financial markets, currencies, fixed income as well as equities and commodities. And it will likely be against what

CHART 1

China Is In A Deflationary Trap



Source: PBoC 5000 Industrial Enterprise Survey

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the consensus is expecting and is positioned for when it arrives.

Can you discuss scenarios if the US growth does not roll over and inflation remains sticky?

Let us look at a scenario where inflation remains sticky and above the targeted 2% and the economy continues to grow at approximately 2%-3% with well supported consumer spending due to a further declining savings rate.

Inflation is dynamic, it will not remain at a low level but either rise or fall. In the scenario described, CPI inflation would likely rise again, and if the Fed does not hike rates (which it does not want), bond yields would then rise and do the Fed's job.

Investors should always become cautious when Wall Street comes up with such rosy scenarios, as that usually arrives near the top and never near the bottom.

In such a scenario there would be a point when the equity market weakens due to rising bond yields. Late in a business cycle expansion when inflation is above target, we always come to a point when something will break. Either inflation breaks higher first, which will force further tightening via either the Fed or the bond market, or the stock market breaks, or there is a credit event. Something would have to give. The "goldilocks dream scenario" is only possible as a temporary transition during one stage of the cycle, not as a permanent path. And investors should always become cautious when Wall Street comes up with such rosy scenarios, as that usually arrives near the top and never near the bottom.

Not that our government would ever lie to us, but is the economic data that we are being fed trustworthy and reliable?

That is a very good question. We are not the experts on this. Recently, Larry Summers mentioned that he and his team did some work on inflation and found that the true inflation for the average Joe peaked last year at 18%, not 9% and that it is now 7%, not 3.2%. The organization "Government Shadow Statistics" has published similar results. Thus, we should be wary of what the government releases and how accurate those numbers are.

In addition, a colleague of ours and a very serious economist told us that he had visited with the people in Washington who put the GDP statistics together. He learned that approximately 80% of the input is estimated or computed by their own calculations but are not figures out of the real economy. This opens the window for cooking the numbers depending on how the political wind blows. It is therefore important to use plausibility checks whenever one can to verify the quality of the numbers released.

Ed Hyman was never more certain that we were going to have a recession. Is he still of that view?

We should have asked Ed during our webinar. What we learnt from his remarks is that he is concerned that the Fed is staying tight for too long and that we could at some point see a weaker economy. But he also said that everything looks fine to him at present and that his contacts with investors show that they are not concerned about anything except what is widely discussed like the wars and trade problems. That by itself resembles the current complacency of the investment community, which always makes us nervous.

If the Fed eases, will inflation come back with a vengeance and how high could interest rates go?

So far, the Fed has not eased. It was rather the Treasury. But it is conceivable that the Treasury and the Fed are cooperating to prevent bond yields from rising above a certain level (we would pick 5% for 10-year T-bonds). This is some new form of yield curve control, or perhaps the first step in that direction.

If the Fed eased prematurely, the economy would continue to grow, and we would see more bottlenecks in employment with wage pressures increasing leading to

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a more serious embedding of structural inflation in the system.

If the Fed eased prematurely, we would see more bottlenecks in employment with wage pressures increasing leading to a more serious embedding of structural inflation in the system.

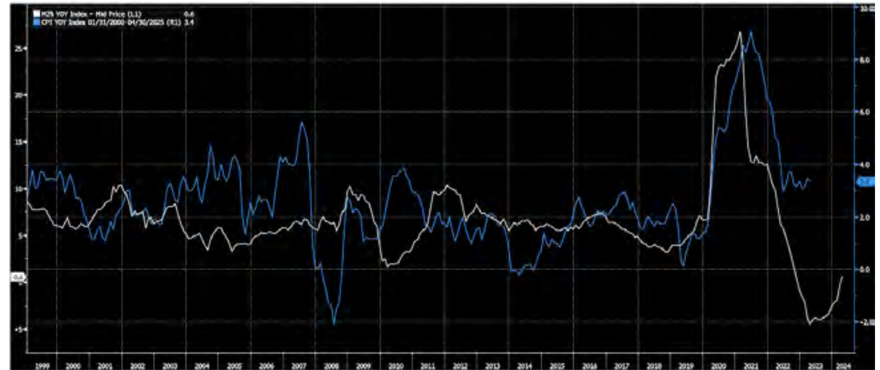
Another risk for the bond market is a Trump presidency as he is campaigning on lower tax rates. This in view of an already 6% deficit in the budget would likely push bond yields higher. Whether the Fed would hike rates and open a fight with the president is an open question. But it would be remarkably similar to Liz Truss, who was PM in the UK for a few weeks only. Her aggressive pro-growth budget with tax cuts made gilt yields jump by almost 300 bp. The bond market ended Truss' leadership within less than two months. In such a context, the 10-year T-bond yield could shoot up to 6% or beyond what the Fed and the Treasury want to keep as an upper limit. 6% or even slightly higher would be a problem for the economy and for the stock market, even in the face of some tax cuts.

Please update us on the chart of the y/y change in CPI vs y/y change in M2, with CPI lagged 18 months.

Chart 2 shows the CPI inflation for the US lagged by one year to the M2 money supply. Both are 12-months rate of change charts. It shows

CHART 2

US M2 and US CPI (both y-o-y) and CPI lagged by 1 year



Source: Zulauf Consulting / Bloomberg

clearly a high correlation that M2 leads inflation by about 12 months. Among economists, they debate whether the lead time is one or two years. But in the current cycle a one-year lead time is obvious. The white line is the money supply (leading) and the blue line is the CPI inflation rate (lagging).

Is the Fed deliberately expanding the monetary base and keeping the economy strong because it is an election year, at the cost of a delay in reaching 2%?

It is obvious that the Treasury would like to keep the economic expansion and the bull market intact going into the election. The Fed, however, should be independent but Powell may have an easier time governing in a Biden than in a Trump presidency. Thus, they may both be trying. But fine-tuning the economic expansion and financial markets may not work as planned.

It is obvious that they both stepped in when 10-year T-bond yield hit 5%. And they were successful. But there is always a price for intervening and manipulating. Trying to prevent the yield from going up will backfire at some point. The free-market rate and the bond yield are important parts of the price setting mechanism in a market economy. The more intervention we have, the more the price signal distorts the message to the economic subjects, and the worse the long-term outcome will be, as we move away from a self-determining market system.

If interest rates and bond yields are not allowed to send the correct signals in a systemic process, what will? A group of a few "experts" at the Fed or at the Treasury setting the "correct" rate? It could not only mean delaying the achievement of the CPI target but also weakening the system decisively.

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FED Liquidity and Unemployment have a decent positive correlation - Do you think if the recent cracks in the job market gather pace, could TGA promises of $750bn be rolled back, in order to put extra liquidity into the system?

The extraordinary maneuver to inject the RRP and TGA money by the Treasury/Fed has largely run its course. From now on, the Treasury must finance its expenditures by issuing Treasury debt paper, which will drain liquidity from the system.

Real income growth is slowing decisively while the savings rate is hitting very low levels and delinquency rates for car loans and credit cards are rising. This is an indication of the consumer slowing down. However, the upper 50% of the consumer base accounts for 85% of the spending and they own equities, and as long those keep rising, the slowdown will not accelerate. A corrective break in the equity market would likely trigger a further slowdown in consumer spending, as it would begin to hit the balance sheets of the upper 50% of the income earners.
The latest data on the TGA stands at $712 billion, below the target of $750 billion. And this happened without any need to support the stock market. Therefore, the $750 billion is a guideline and depending on the challenges of the situation, the Treasury will decide. We should not rely on them sticking to the target, although in view of the election in the Fall and potential unrest causing a possible closing of financial markets, it would be comfortable to have the funds available.

Our point is, however, that the extraordinary maneuver to inject the RRP and TGA money by the Treasury/Fed has largely run its course. From now on, the Treasury must finance its expenditures by issuing Treasury debt paper, which will drain liquidity from the system. Even if they can postpone this by running the TGA lower, it would mean only a postponement by a few months until the equity market correction would unfold. But eventually, supply problems should pop up.

Australia and Canada have a much higher level of Household debt (with large mortgage debt at floating rate mortgages) versus USA. They also run smaller budget deficits. Why have higher rates taken so long to impact these economies and wouldn't we start to see cracks in those economies before the USA?

We have not analyzed those economies in depth. However, both economies are clearly slowing. The consumers' savings rate is decidedly higher than in the US economy, which may delay the biting of rates. But we do see a distinct slowdown in those economies. Interest rates and monetary policies hit with a time lag. Just be patient, these economies are slowing, as is the US. The fiscal support provided did delay the impact, and the percentage of fixed rate financing may also have contributed to the delay.

EQUITIES

It might be interesting to hear how Felix is positioned. Always has some gold but what equity markets is he invested in? Is he short anything?

We are very light in equities and heavy in cash (money market) and also own a heavy position in gold and related investments (long-term holding). Moreover, we still own a decent amount of real estate but no bonds. We also have some trading shorts against the US currency versus Swiss franc.

Our trading may change that allocation from time to time, but we are not interested in long equity investments at present (except gold mining on dips). For trading, we rather think there is a short-selling opportunity at some point in the next few weeks or months that could be quite rewarding, and we want to keep our liquidity high to benefit when the opportunity presents itself. Stay tuned as we will write about this as we see opportunities present themselves!

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If the market has a decent decline, we intend to invest heavily in equities again, but we rather wait until we can call a bottom before going long equities.

Some prominent hedge funds have revealed 'call' option positions in the small caps. Could the unwind of the 'Dispersion' trade cause a big rise in the Small Cap Index while the Nasdaq goes into freefall (Over a short period)?

If you measure small caps in terms of the Russell 2000, or the Value Line Index, we do not see them outperforming in coming months, except in a sharp market decline. Small caps have underperformed in this bull cycle, and we believe the slowing economy and potential stress ahead in the system going into 2025 will rather keep the small caps on the defensive. We expect this segment to remain an underperformer in a rising market until there is a decisive monetary policy change towards major stimulation.

The big long positions exist in the top NASDAQ 100 names, not in the Russell 2000 names. Thus, when the liquidation begins in NDX, it may impact the Russell but to a much lesser extent. Thus, it could become an outperformer on the way down in equity indices – but not on the way up. They could outperform, however, on the way up in the next cycle.

The SPX correction was gobbled up last week. Yes, there are liquidity issues (TGA, RRP), etc.) but there is also a lot of sidelined money and from a technical analysis perspective, it is tough not to look at current market structure as bullish. Interested to hear whether you think last week's correction was it or whether you remain bearish at this point?

We are hearing what you are saying. The market has been bullish since autumn of 2022 and has risen sharply to new highs. Moreover, the breadth in terms of the advance/decline line and in terms of new highs has confirmed until very recently. We see that there are a few stocks that could make a difference in the short-term to push the indices like SPX and NDX to marginal new highs. We allowed in one of our recent reports to around 5500 or upper 19'000 respectively. The same goes for the DAX or the Euro Stoxx 50. However, the small and mid-cap indices like the Russell 2000 Index or the Value Line Geometric Index (1500 issues not capital weighted) are not confirming any longer. This is probably reflecting the deteriorating liquidity that is only beginning now, as the Treasury must finance its deficit by issuing paper that is getting sapped out of cash/savings and not out of sterilized central bank money.

In our view, the global equity indices are in the latter stages of their bull run. They are, however, discounting a soft landing and therefore they remain elevated. It will take a clear deterioration of liquidity and - with a time delay - disappointing earnings. We are not quite there but getting every closer. We cannot force a bear case but warn of the thin air the market is in and turn decisively bearish when the signs or a reversal are presented. Whether that will be in a few weeks or in a few months remains open.

Very short-term, bond yields have ended their bounce and continue their medium-term decline towards our target of about 3.60% in a softer economy. The majority of economic indicators point a slowing economy. The lower bond yields helps some of the large cap growth stocks, particularly in the AI segment to extend their run. But at some point the complacent sentiment of a soft landing will give way to either a series of disappointing corporate statements or higher bond yields when the supply pressure begins in earnest.

The market is driven by an AI mania. Nvidia is the bellwether stock. Our technical view based on trend, momentum and waves theory measures to a potential upside for NVDA of $1300 and measured from its low in autumn of $108. The bull rally in NVDA is not over yet. The AI boom is doing what all the new tech booms did, namely lead to a temporary overinvestment that made the growth numbers astonishing which analysts then extrapolate in a linear way. After the stock has peaked and starts the decline, the boom evaporates or normalizes and

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the numbers get less impressive and the disappointment sets in leading investors to unload the stock. Nobody can project a net profit margin of 85% into the future in a linear way. How extreme the sentiment has gone is best reflected in Chart 3. Just read the plate!

CHART 3

Source: Image found on Google

GOLD & SILVER

Will gold and silver "correct" or "crash" to the same extent as the overall equity market, whenever that happens, or will they be spared because "this time it really is different"?

Chinese investors are realizing that they can protect their savings by buying gold, expecting that if the currency went down 20%, gold would rise the equivalent ceteris paribus.

Gold and silver will have corrections from time to time. And if there were a liquidity squeeze, it would impact those assets negatively. More importantly, however, if the overall equity market has a deep correction, it would force aggressive money to reduce virtually all their positions and that would include all assets they own. That could hit gold and silver, too.

The big buyer of gold is China, both its central bank as well as Chinese individuals. You need to understand that the economic difficulties China is in are extremely serious and will eventually lead to a monetization of the debt, a reliquification of the banking system, etc. This means that the Chinese currency will weaken because in a deflation the central bank needs to devalue the currency or the "denominator" to make the numerator (asset prices) rise again to balance the system.

Chinese investors are realizing that this risk is rising, and they can protect their savings by buying gold, expecting that if the currency went down 20%, gold would rise the equivalent ceteris paribus. That is why the Chinese have been and remain the biggest investors until that procedure is put behind them.

OTHERS

If the Crack-Up Boom scenario materializes over the coming years, would it be the case that buying and holding real assets (stocks, real estate, etc.) would be the best strategy? So passive investors sitting in the index would continue to be the best performers.

A crack-up boom is an economic misery with recession/stagnation in real terms, rising inflation and rising prices of real assets in nominal terms due to constant monetary and fiscal accommodation. It would be sort of an inflationary

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depression. While we COULD get there, we are not there, yet.

In such a crack-up boom it would be likely that capital accounts would be closed, which means that capital cannot leave the country. The only way to protect against the devaluation of the currency (in which the savings are denominated) would be to invest in real assets like land, real estate, and some commodities like gold and equities. Among equities, we would prefer the asset rich companies not fancy fashionable stocks (stock market fashion changes from cycle to cycle). Thus, we would prefer to invest in individual companies or industries that are important to the economy, may get support from the government, may be major employers, may be important to the safety of the economy, and are asset rich, etc. We would not necessarily invest in insurance companies or fancy start-up tech companies, etc.

If one could not select investments with those characteristics, we would choose a blue-chip type of index fund like the Dow Jones Industrial Average for a passive investment. We would combine such an equity portfolio with gold, perhaps even 50/50. Historically, this would get you through such a scenario until we had a new currency system in place.

While such a crack-up boom scenario is conceivable, we are not there yet and not certain that it will materialize. For the time being we prefer trying to play the cycle although that has some pitfalls. Countries trapped in a crack-up boom are Turkey, Argentina and Venezuela. The rising stock market indices in those countries are not a sign of a prospering economy but of economic misery.

Felix - during the Pandemic were there vital companies as we had in the US ... the US had many businesses stay open and operated right through the Pandemic. I have the impression that most companies closed in some or most of Europe ... yes, no?

Europe differed from country to country as in the US the situation differed by State. But in no way did all companies close. This would have led to a GDP of zero! Europe was no different than the US in this regard. If someone reported otherwise, it is simply not true.

PARTIALLY ADDRESSED ON THE WEBINAR BUT MORE DETAILS HERE:

Are you concerned about the EU’s economic stability?

The European Union began with six nations that eliminated all tariffs and opened the way for free trade. That was an excellent idea. Later, the Union expanded and eventually founded a monetary union (EMU). That was the first misstep as the member economies differed completely in structure, productivity and efficiency, in laws and regulations, etc. The same currency and short-term interest rate for very different economies creates imbalances. Therefore, the need of a strong center was born to balance the differences among the individual economies trying to make all nations equal via subsidy payments. This is a Marxist idea, and the current EU is already trapped in neo-Marxism that keeps growing, as the center intervenes more and more.

The history of such entities is that they are against the natural law and the freedom of individuals and nations and will therefore eventually break apart when the centrifugal forces gain momentum, which is usually the case in a severe economic crisis. The Soviet Union is a classic example.

The developments we expect over the next 5-10 years are of such a dimension to the detriment of our economies that a breakup of the EU is a real possibility. But it is difficult to time it precisely. Usually, the problems start when the big donor of the union falls into a crisis and cannot or becomes unwilling to remain the biggest donor. In this case it is Germany that has entered a systemic crisis already that has a long way to go. In that sense we are concerned about the fallouts of such a crisis for the EU but on the other hand, we believe Europe will be better off if a decentralized union were organized. If such a trend would materialize, a deep crisis could become a blessing.

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What short-term trend do you expect for the S&P500?

A number of major equity indices have likely already topped medium-term if not for the whole cycle. Among them are the Russell 2000 or the Japanese Nikkei Index 225. Others like SPX and NDX or the DAX may still attempt for marginal new highs over the next few weeks, whereby the upside will be rather limited and higher highs may remain unconfirmed by many technical indicators.

We have all the ingredients needed for a major decline in equities, as well as the technical weakening underneath the surface. All we need is a trigger factor.

We have all the ingredients needed for a major decline in equities, as well as the technical weakening underneath the surface. All we need is a trigger factor.

I would be interested to know your short-term view on oil.

The physical oil market is well supplied and OPEC+ has decided to continue production cuts for the time being. This is all a sign that the world economy is not as robust as some pundits make us believe.

Crude oil peaked in the current cycle in spring 2022 when Russia attacked Ukraine. From that climax peak, the price declined and then went sideways in the range of the low $60s to approximately $90. It seems to us that this sideways range trading is a consolidation that may eventually lead to a breakdown below $60 and make a low when many other commodities have their medium-term correction low, sometimes this year. The current softness is already part of that decline to beneath $60.

What about tax policy under President Trump and/or Biden? Impact? And implication for markets? Credit/Equity?

Campaignining is different from governing. But we expect Trump to lean towards lower taxes while Biden would lean towards higher taxes and more subsidies. Both candidates would most likely pursue a highly populist economic policy with Trump preferring tax cuts to stimulate investments and spending while Biden would lean towards subsidies to stimulate investments and spending. In both cases, large budget deficits would result, and the government's debt burden would continue to rise quickly.

A pro-business tax cut could be beneficial for corporate taxes but at the same time, the bond market could suffer "a Truss moment" with sharply higher bond yields. The risk is that we could see a brief period when the equity market celebrates the candidate favoring tax cuts but, eventually, we would expect the first year after the presidential election to disappoint for equity investors regardless of who wins the election in November 2024 .

We will publish our regular Investment Comment and market outlook update next week.

Felix W. Zulauf
June 06, 2024

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