October 2, 2021

The Weekly Quill INTELLIGENCE BRIEFING

This synthesis of *The Weekly Quill* provides portfolio positioning
and highlights from this week's *Quill*.

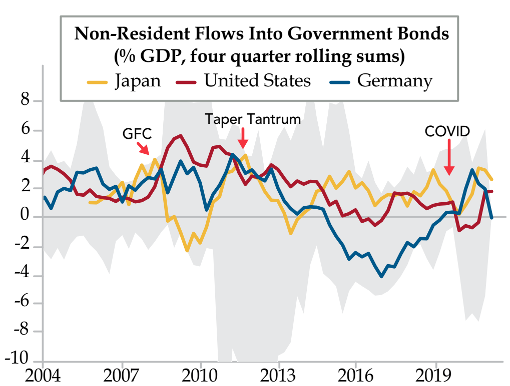
TODAY'S INTELLIGENCE BRIEFING IS DEDICATED TO THE MEMORY OF MY DEAR FRIED, TOBIAS LEVKOVICH, WHO WE LOST TO THIS WORLD YESTERDAY.

The plot is frightfully recognizable to most…well, men. Meathead plots begin innocently enough but quickly morph into "do or die" dilemmas. The stars tend to be of the Daniel Craig or the incredibly preserved Tom Cruise type, but the endings are nonetheless always predictable. Investors have approached the 79th debt ceiling détente since 1960 the same way they would walking in to watch any James Bond or Mission Impossible deposit – they know the ending, so why sweat the middle of the movie aside from the appeal of the adrenaline fueled throughout the film's running time?

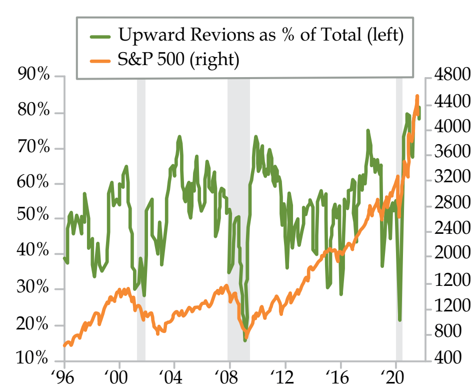
Given how parallelly the insouciance applies to the resolution of the debt ceiling, investors can hardly be criticized for their nonchalance. With all due humility, we reiterate that the GOP is behaving in such a way as to force Schumer to play the bad guy, which meathead movies always feature. OWN the debt limit McConnell says, over and over, with the patience of Job. Perhaps the armies of aides to the GOP leadership have shared with their overlords the chart on the left illustrating that flows into U.S Treasuries aren't what they used to be. Dollar usurpers may not be a figment of our nightmares.

In the nearer term, as Citi data continue to illustrate in honor of the man who put its equity strategy research on the map, upward revisions to S&P 500 earnings estimates have inflected. What we do know from a history that wants so badly to diverge from precedent is that earnings cycle turning points tend to manifest in subtle and slow fashion. Led by the cyclical sectors of Consumer Discretionary, Financials, Industrials and Materials, upward revisions within the S&P 500 have begun to decline after a run for the ages (note the turn in the green line). We shall see if the broader market follows the leads. If there's one takeaway from the last month, it should be that fiscal thrust matters, especially when injected via direct deposit into the veins of U.S. households who didn't need the budgetary boost. The aftermath of the consumption demand pull-forward lurks as the bog unknown as we face down this final quarter of the year. Critically, the Fed ALONE is not sufficient to rescue the economy if it was to suffer given the now-contractionary fiscal thrust.

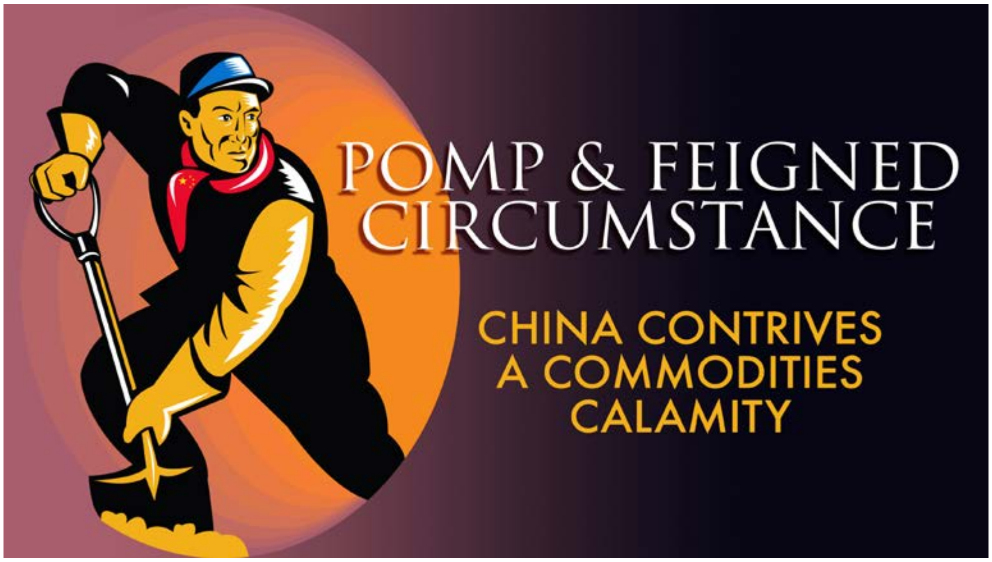
Treasuries Not the "Safe" Haven They Once Were as Nearer-Term Margin Compression Sets In



Source: Haver, IIF



Source: Citi



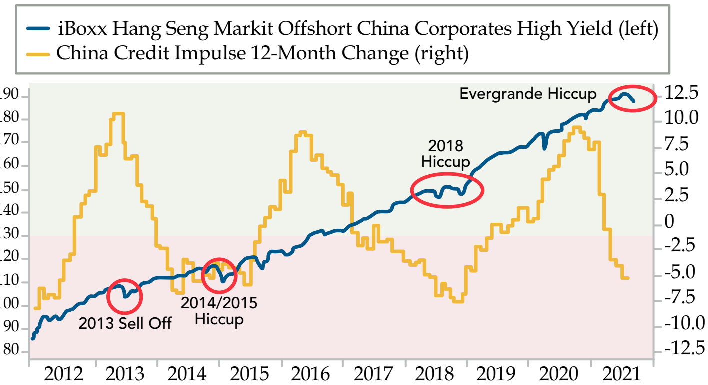
This week is pretty simple. China's economy is no stronger than it was when the calendar year 2019 ended with global trade contracting on the heels of a brutal trade war ignited by the United States. How could it be for an exporting nation reliant on its energy resources via imports? Any yet, somehow, China convinced the world that its economic miracle growth out of the pandemic would miraculously "save" the world economy as it played its traditional role of buyer of last resort of commodities. Disappointing on this perceived front will leave EX-ENERGY commodities investors in a pickle, scrambling for cover.

QI recommends you lighten up on ex-energy commodities through February 2022, which will mark the end of China's having to put on a non-smoggy show in its role as host of the 2022 Beijing Winter Olympics. Katie bar the door come March. Mark your calendar to load up on those shunned commodities after China frantically revs back up its industrial sector to avert a full-on economic stop.

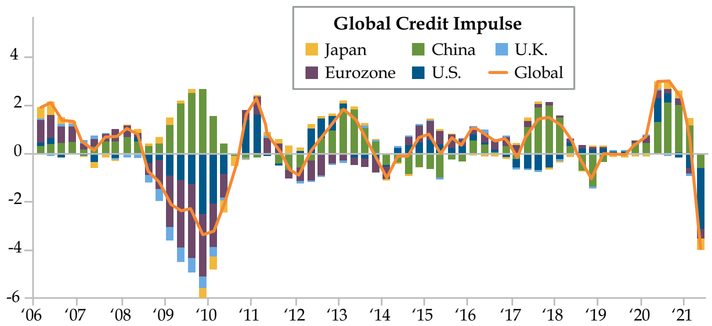
The current "energy crisis" being engineered in China should come as no surprise to outside observers. China's imposed directive to segue to a balanced economy requires forced weakness in its industrial sector, as a means of balancing out the contribution of its services sector. However, when inevitable moments of weakness in domestic consumption appear, the "solution" has been to offset weakness by ramping up manufacturing. The tool to combat reversals in aggregate economic output has been credit -- infuse factories, and by extension exports, with debt whenever growth slows to a sufficient extent to prevent official GDP goals from being met.

Credit seeps into all corners of economies. In China's case, the property sector has been on the receiving end of massive leverage. Real estate speculation was fed to such an extent as to take on a life of its own; with so many roadblocks to sending money out of the country, the hard asset of real estate became a prime target for a country with a middle class still in relative infancy. Ultimately, households came to a juncture at which they were diverting too much of their income into real estate to the detriment of other sectors that would normally be reliant on consumption.

Past Episodes of Slowing Growth Have Induced Credit Infusions



Source: Nordea and Macrobond



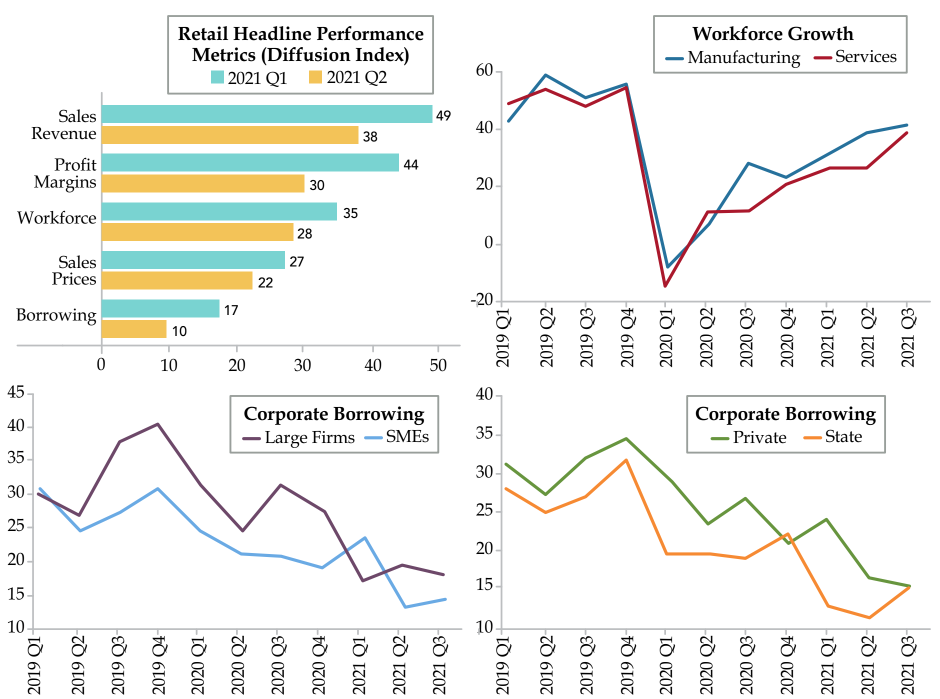
Source: MMD. Calculations based on data from central banks.

In a recent 2022 outlook, China Beige Book (CBB) noted that, "Our data into mid-2021 showed sharply decelerating retail revenue and profits, weakening sales price gains, and the lowest level of borrowing in CBB history. Retail has gone nowhere." The slow burst of the real estate speculation bubble was simply delayed, but ultimately has manifested in what is being witnessed today through the current Evergrande drama.

The CBB's third quarter data also illustrate how weakened the retail sector remains. However, credit directed to ameliorate weakness has not been deployed since the pandemic hit. Aside from China's determination to curtail its property sector, recall that Chinese growth was already at a three-decade low prior to the pandemic. Funds were not as readily available to pull the economy out of slowdown. It's not coincidence, then, that manufacturing's workforce is on similar footing to that of the services sector.

Credit is NOT Being Thrown at China's Factories to Pad Economic Growth

The "energy crisis" in China may have good basis, especially as China remains nearly as deeply dependent on energy imports as they were 50 years ago. As illustrated in that thin yellow proportion in this next graph via the International Energy Agency, the road to energy independence for China must be laid with renewables and other mitigating endeavors to reduce the country's dependence on its allies in the energy space.

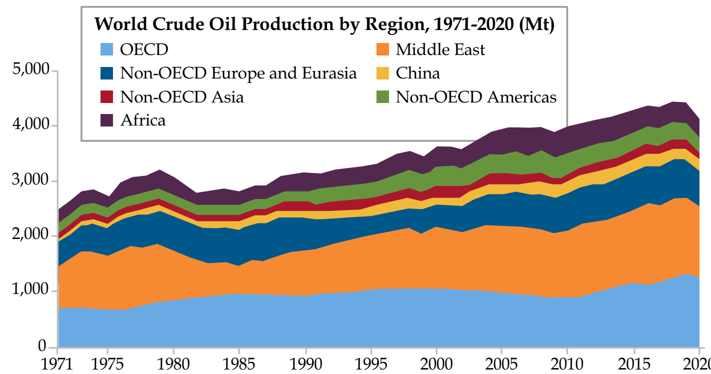


Source: CBD Data Analytics Platform

A glance back at actions taken prior to the 2008 Olympics paints stark parallels that are undeniable. China will continue to slow its industrial sector to reduce emissions before the country is once again on full display for the Winter Olympics in 2022. It's no fluke that China's official factory activity contracted in September for the first time since February 2020 when the country was forcibly in a shutdown mode. August's 50.1 print hinted at what was to come despite forecasts that this month's read would stay at 50.0 rather than the 49.6 reported. It's equally nonaccidental that China's nonmanufacturing activity resoundingly beat expectations, roaring back from August's contractionary reading of 47.5 to a decidedly expansionary 53.2, which we know is exaggerated given the CBB data on the ground are not nearly as strong.

China's Energy Import Dependence Has Not Been Mitigated

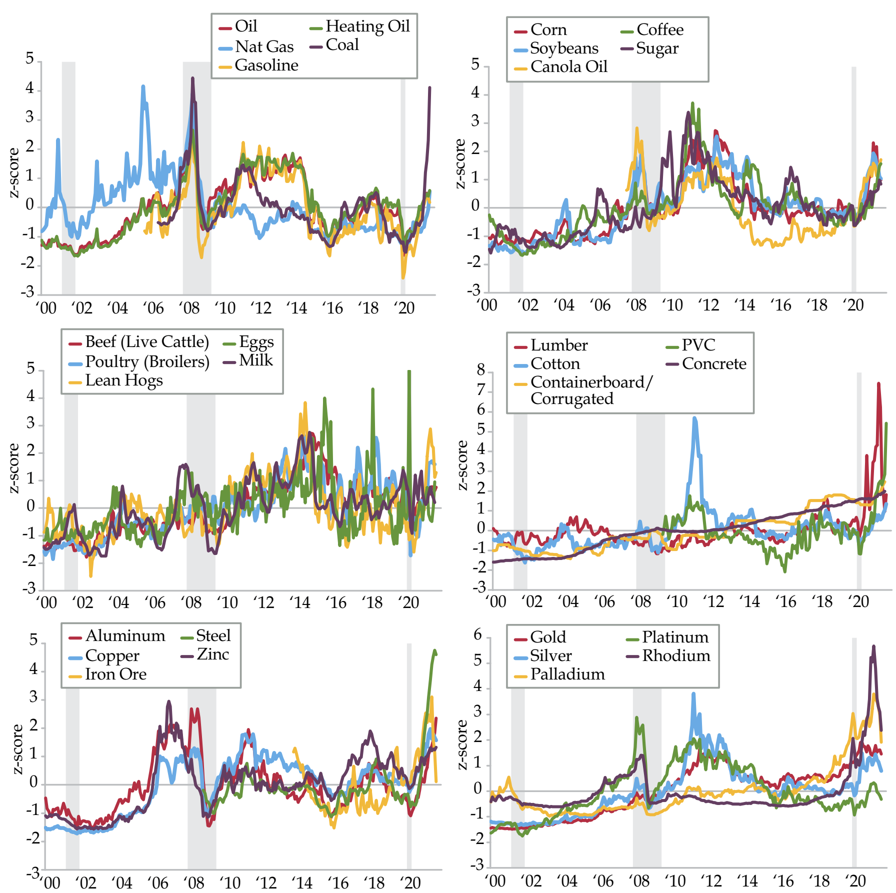
When converted to z-scores, commodities prices can be evaluated more concretely in terms of historical outliers. As hard as it may be to believe, lumber remains that it has traditionally trended is likely to remain so until home builders complete construction. Similar trends can be seen in steel, concrete, and PVC, with PVC electrified by natural disasters bringing North American production offline.



Source: IEA

Note that Rhodium and Palladium are coming back to earth among precious metals. They may best exemplify the reduced U.S. fiscal impulse reverberating across the globe. And don't lose sight of how bizarrely depressed gold, silver and platinum are given stagflation pressuring central bankers to tighten against their will. Policy mistakes in either direction will make these abandoned safe havens that much more attractive to incensed investors.

Can China Force a Commodities Correction Outside Energy?

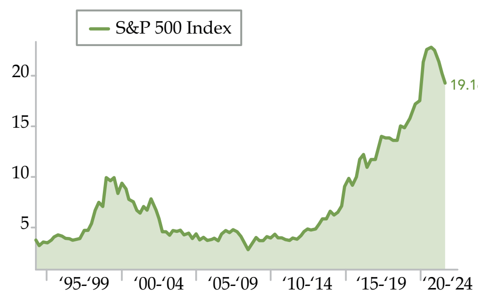


Source: Quill Intelligence, Bloomberg. Recessions shaded.

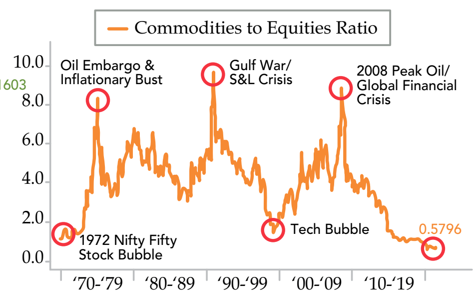
Commodities remain cheap with a capital 'C.' However, with energy and inputs feeding U.S. housing as exceptions, investors must be aware of a purposefully plotted industrial slowdown in the near term in China, the world's marginal consumer of most commodities. Once the 2022 Winter Olympics have come and gone, China will have no choice but to pump up its industrial sector.

Perspective is also in order given how insanely overvalued stocks are thanks to passive investing juicing valuations as never before. Relativity is not as plain as depicted in these dueling, top two graphs, that arguably exaggerate commodities' attractiveness. Some investors have begun to wake up to the reality of global stagflation setting in, evidenced by the first outflows from commodities funds, excluding energy and precious metals, of the post-pandemic era.

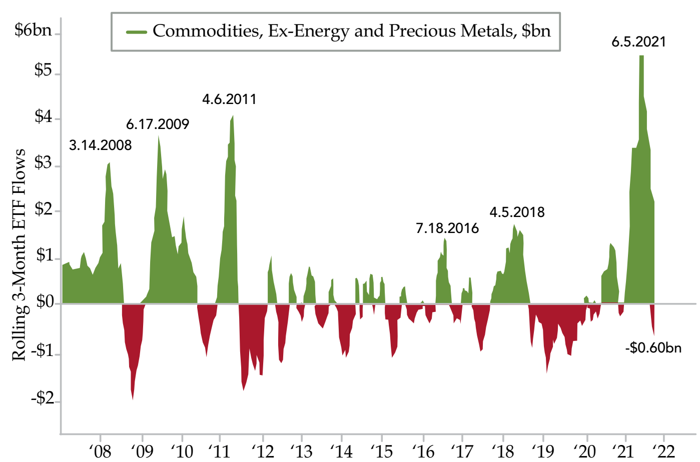
Commodities Remain a Screaming Buy Vis-à-vis Stocks…However…



Source: Peter Boockvar, Bloomberg



Source: Crescat Capital



Source: The Daily Shot

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