

## Level Four Capital Management



## WEEKLY INSIGHT

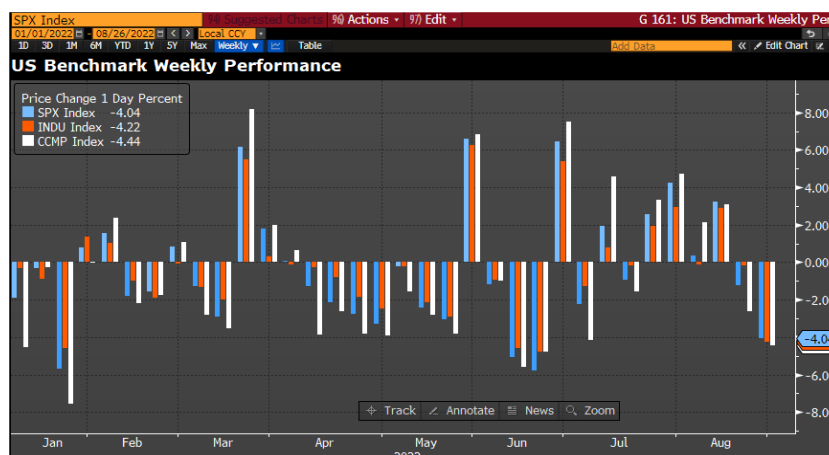
## Highlights

- US equities finished lower on the week, with the S&P 500 and Nasdaq both posting their worst weekly loss since June 17th, following hawkish comments from Fed President Jerome Powell, after the Federal Reserve's Jackson Hole Symposium.
- The central bank remained unified in their stance, reiterating the need for higher interest rates in order to kill inflation, adding that they will keep at it until the job is done, which will bring some pain to households.
- -Following the comments, the message was clear, interest rates will stay higher for some time, reducing the possibility of a soft landing. Odds for a 75bp hike now stand at 73% as of Monday, up significantly from Friday when they stood at around 60%.
- Treasuries were mostly weaker with a big curve flattening move as the 2Y/10Y spread stood around -37 bp after falling to around -25 bp late last week.
- Growth underperformed value for a 3rd straight week with Tech and Communication Services coming under the most pressure.
- Hedge Funds continue to build their largest ever bearish bet on higher US rates, holding a record net short position of 1M SOFR futures contracts.
- BofA's Flow Show report highlighted the risk off tone in markets last week with US equities posting outflows for the first time in 3-weeks, while Tech outflows were the largest since November.
- Despite the negative narrative underpinning markets with higher interest rates, company earnings and margins appear to be intact with a measure of aggregate profit margins for companies improving to 15.5% (the most since 1950), meaning the higher costs are being bared in a large part by US consumers.
- The China Securities Regulatory Commission announced that it has reached an agreement with the U.S. Public Company Accounting Oversight Board (PCAOB) regarding the audit inspection of Chinese ADRs listed on U.S. exchanges
- In Tokyo, Japan, inflation excluding food climbed 2.6%, the fastest pace since 2014. Energy prices rose 2.9% year-over-year.

## Market Commentary

## U.S. WEEKLY

US equities finished lower on the week, with the S&P 500 and Nasdaq both posting their worst weekly loss since June 17th. Dragging stocks lower were the hawkish FOMC comments out of Friday's Jackson Hole symposium, in which the Federal Reserve reiterated their hawkish monetary policy stance, squashing hopes of a dovish pivot. Ultimately, equity markets posted their worst day since June at the end of the week with the Nasdaq falling 3.94% and the S&P declining 3.37%, as almost all members in the S&P 500 closed lower.



Source: Bloomberg as of 08.31.22

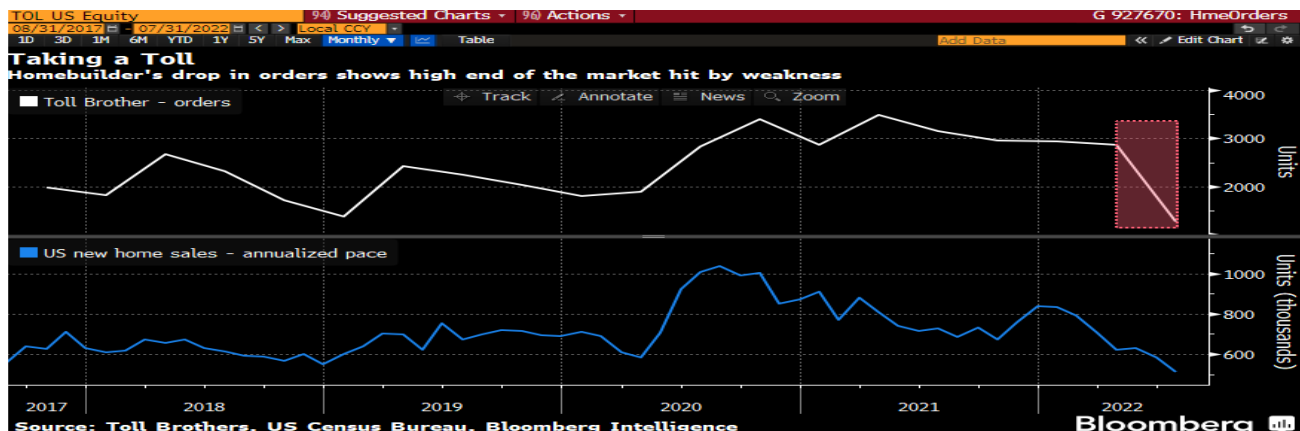
Following the comments, the message was clear, interest rates will stay higher for some time, reducing the possibility of a soft landing. Major averages dipped below their 100-day moving averages and on a one-month percentage price change, all major indexes remained negative, bringing into focus that the recent winning streak for stocks may be over.

Treasuries were mostly weaker with a big curve flattening move as the 2Y/10Y spread stood around -37 bp after falling to around -25 bp late last week.



Source: Bloomberg as of 08.31.22

Growth underperformed value for a 3rd straight week with Tech and Communication Services coming under the most pressure. Semis (SOX -5.2%, NVDA -8.9%) and Mega-cap Tech (NFLX -7.4%, GOOGL -5.9%) were among the largest underperformers, followed by Consumer Discretionary and Healthcare. Retail names also came under significant pressure (XRT -5.6%) following a batch of poorly-received earnings including William-Sonoma, Nordstroms, and Dollar Tree. Homebuilders also fell more than 5%, following Toll Brothers plunge in quarterly orders, causing them to cut their sales outlook.



Source: Bloomberg as of 08.31.22

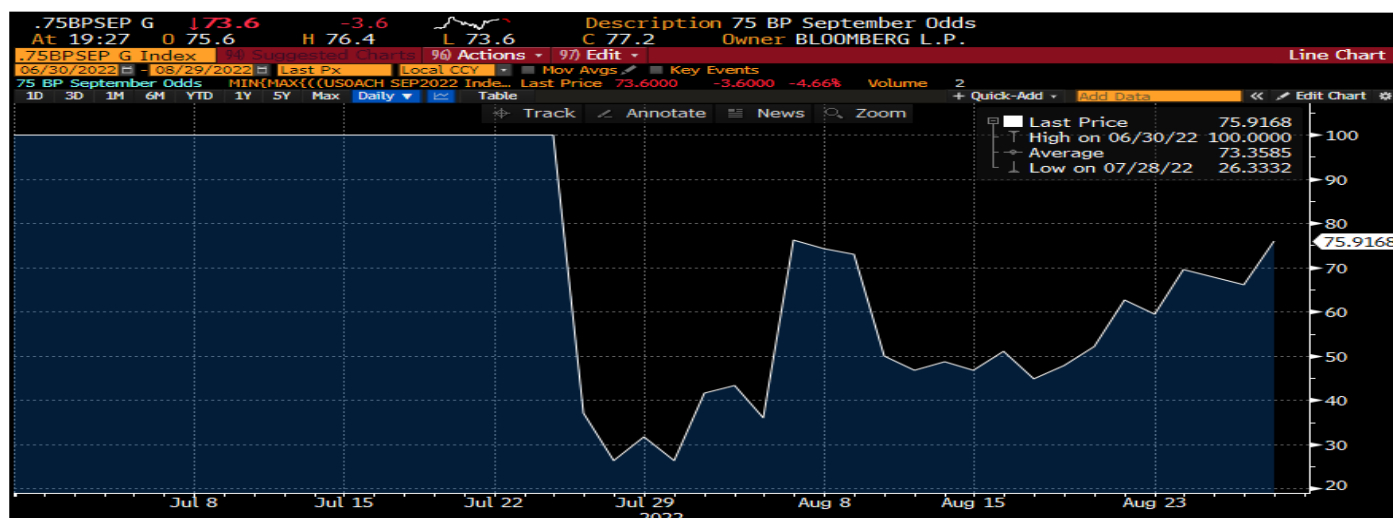
Energy was the best performing sector, with WTI Crude jumping over 2% on the week. Gold and Bitcoin both dropped after the Hawkish FOMC comments dented risk assets and soured investor hopes of an early end to rate hikes

## JACKSON HOLE SYMPOSIUM

The market narrative throughout the week had been mixed until Friday with some positives from corporate buybacks and resilient earnings, out dueling the potential for a hawkish Fed. Following Friday's speech from Chairman Powell, the central bank confirmed their stance remained unchanged given the most recent data. Below are a few key takeaways from the meeting.

- The Federal Reserve reiterated they will likely require restrictive policy for some time, adding that they "will keep at it until the job is done" which "will bring some pain to households".
- Continued to signal once again that the Fed would risk recession to kill inflation, saying there will likely be some softening of labor market conditions
- Reiterated that it is too early to call it quits-saying history cautions against prematurely loosening policy. For reference the past 5 fed hiking cycles have lasted an average of 21 months and never before has the US registered its lowest unemployment levels during a recession. Which would contradict the theory that a recession is already underway, since the unemployment rate ticked to its lowest levels in more than 50 years
- Echoed that employment and inflation data will both continue play a key role in determining the size of the next hike at September's meeting

While most market participants had hoped this Fed meeting would provide a softer outlook for future rate hikes, and bring into focus the end of their tightening cycle, Jerome Powell, and various members remained a unified front in their hawkish message. In fact, following the press conference, odds of a 75bp hike at the next meeting jumped slightly and now stand at more than 70% as of Monday.



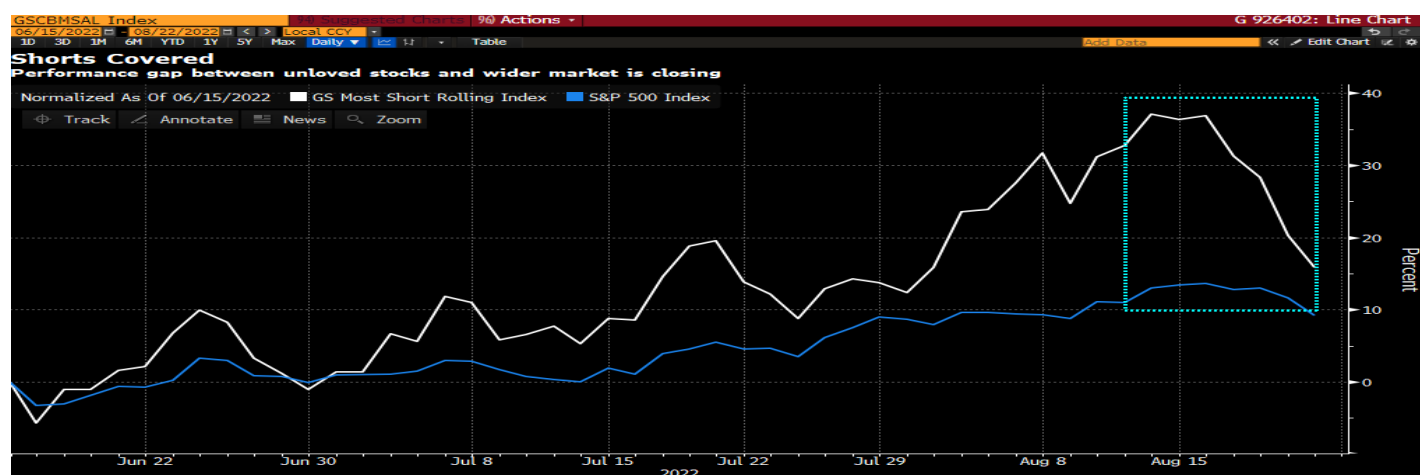
Source: Bloomberg as of 08.31.22

It is worth noting that economists remain at odds with one another as to the size of the hike with Goldman seeing a 50bp hike, while JPM wrote in a letter to clients that they see this as the last outsized rate hike. Currently, the market is pricing in a Fed Funds rate of 3.75%-4.0% by year end.

## MARKET POSITIONING

Until Friday's big leg lower, there were mixed signals on positioning and sentiment. Ultimately, investors took some risk-off the board in Friday's session, with:

- BofA showing the first outflow from US equities in 3-weeks, with Tech posting its largest outflow since November and HY bonds registering its biggest notional drawdown in over 2 months.
- Some short positions being added after 15-straight days of short covering according to JPM.
- Hedge Funds building their largest-ever bearish bet on higher US rates- Holding a record net short position in "SOFR" rates futures of almost 1 million contracts, virtually doubling in the past month according to Commodity Futures Trading Commission data).
- Just 38% of investors plan to increase their equity exposure, a record low, according to JPM latest investor survey

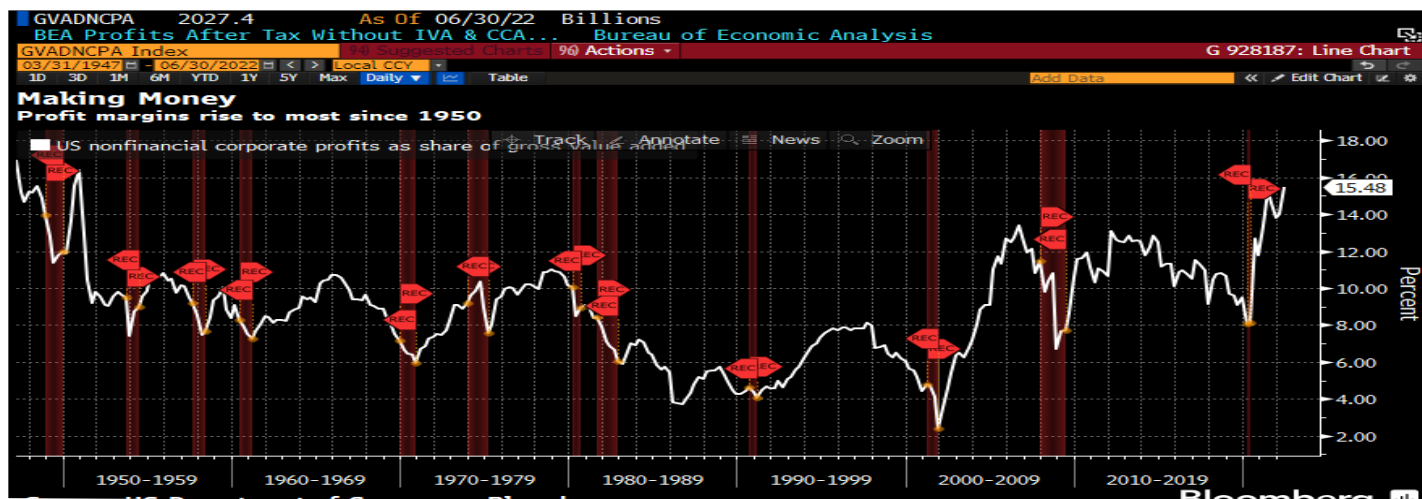


Source: Bloomberg as of 08.31.22

On the positive side of things, inflation is broadly seen as a diminishing headwind, with core PCE, the Fed's preferred inflation metric rising by only 0.1% month-over-month, a notable slowdown from the prior month's 0.6% gain.

Additionally, buybacks are near some of their highest levels since January according to Bank of America, while earnings estimates which are lower, continue to be better than feared. S&P 500 companies are still expected to grow earnings by 8.5% this year, with the governments

latest GDP showing companies are increasingly passing along higher costs to consumers, with adjusted pre-tax profits increasing 6.1% in the 2nd quarter, the fastest pace in a year. A measure of aggregate profit margins for companies improved to 15.5% (the most since 1950) from 14%.



Source: Bloomberg as of 08.31.22

## INTERNATIONAL

The Bloomberg World Index declined 2.88% last week, with growth down 4.01% and value down 2.67%. Brent crude oil futures bounced 4.41% last week after Saudi Arabia announced possible reduction to production in September. The Bloomberg Commodity index gained 1.86% during the same period despite the Dollar rally. Economists surveyed by Bloomberg cut China's growth forecast to 3.5% this year, down from 3.9% previously. The median estimate for China 2023 growth remained unchanged at 5.2%.

## EUROPE

11 European Central Bank (ECB) members flew to Wyoming to attend the Jackson Hole Economic Symposium. In separate interviews to the media, most members set the stage for a significant rate hike at the next meeting to fight inflation. Kazaks, who is known to be one of the "hawks", said the ECB should not rush to ease policy if month-over-month core inflation weakens. He added that the ECB should raise interest rates by at least 50bps. Another inflation worry is the weakening of the euro. Last week, the euro closed below parity with the dollar, a rare occurrence for the pair. In equity markets, the Euro STOXX index dropped 2.58% last week, with retail down 9.14% and real estate down 5.18%. Energy was the best performing sector, up 3.46%.



Source: Bloomberg as of 08.31.22

The European Union will organize an emergency energy meeting as the bloc is dealing with the worst energy crisis in decades. Governments already spent close to 250 billion euros in subsidies and various stimulus programs to help businesses and consumers deal with the surge in energy prices. The Czech Republic currently holds the EU's rotating presidency and is pushing for this meeting to take place as soon as possible. Petr Fiala, Prime Minister of the Czech Republic since 2021, is trying to gather support for a pan-European price cap. France said it is reticent to adopt a bloc's energy price cap as its government has taken measures offering protection against inflation. The CAC 40 index dropped 3.41% last week.

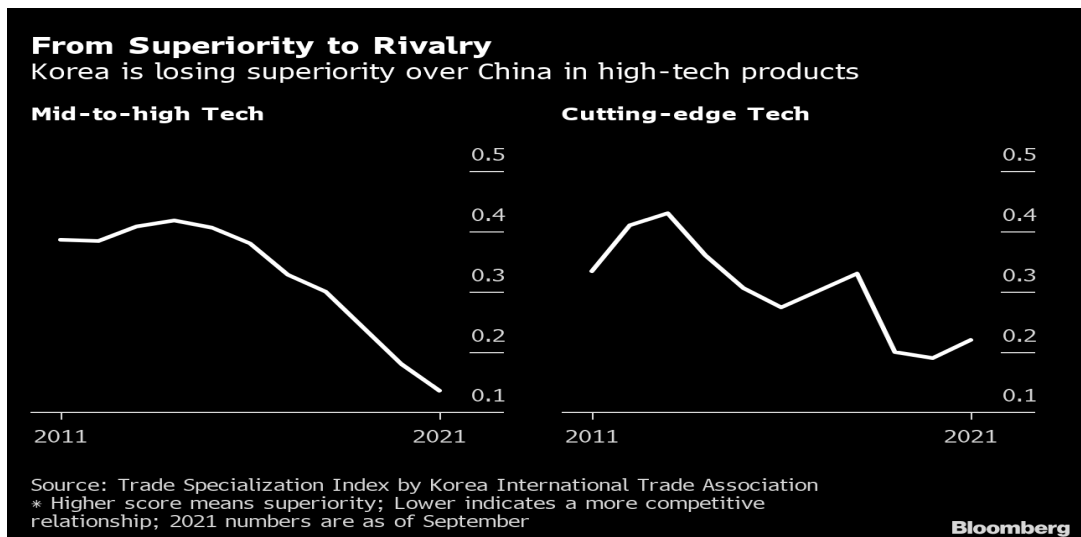
## APAC

The China Securities Regulatory Commission announced that it has reached an agreement with the U.S. Public Company Accounting Oversight Board (PCAOB) regarding the audit inspection of Chinese ADRs listed on U.S. exchanges. Goldman Sachs analysts estimate that the risk of Chinese companies delisting halved following this agreement. The PCAOB will send inspectors to China in September and assess if transparency requirements are met in December. More than 200 Chinese ADRs risk delisting if they fail to comply with PCAOB rules. Five state-owned companies already initiated their delisting from the New York Stock Exchange earlier in the month. The Shanghai Composite index declined 0.67% last week.

In Tokyo, Japan, inflation excluding food climbed 2.6%, the fastest pace since 2014. Energy prices rose 2.9% year-over-year. Bloomberg economics commented "We see Tokyo's core inflation hovering around 2.5% in 3Q and then rising slightly in 4Q. A weaker yen could buoy prices of processed foods and other imports". Prime Minister Kishida recently announced a \$7.5 billion increase in regional governments' grants to support anti-inflation initiatives. The yen tumbled near 140 per dollar after Jerome Powell comments at Jackson Hole on Friday. According to CFTC and Bloomberg data, asset managers boosted net-bearish yen bets by a record last week. The NIKKEI 225 index declined 1% last week.

## EMERGING MARKETS

In South Korea, Bank of Korea (BOK) Governor Rhee Chang-yong gave an interview to Bloomberg TV at Jackson Hole in which he said that BOK was ready to raise rates aggressively "if prices remain out of control". In the past 8 months, policy makers increased the benchmark rate from 1% to 2.5% as inflation climbed from 0.61% to 6.3% during the same period. Policy makers will also be cautious about broader consequences of rate hikes as competition with China increases. Data from Korea International Trade Association show that Korea is losing superiority over China in high-tech products. This rivalry could reshape their bilateral trade relations as China remains Korea's largest trade partner. The KOSPI index declined 0.47% last week.



Source: Bloomberg as of 08.31.22

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