CLOCKTOWER GROUP

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All Along the Clocktower

VOLUME I – GLOBAL MACRO & GEOPOLITICS REVIEW

Is The Fed Put Gone Forever?

Key Takeaways:

- The ongoing tactical selloff is *different* as it suggests that the Fed put may be gone forever. There is no need to bottom fish or try to catch a falling knife.
- In addition, it suggests a rapidly rising risk of a recession, one that is catalyzed by unelected technocrats spooked by a 6% CPI print.
- Investors are overstating how much "misery" inflation is bringing to the median voter. Homeowners have seen their real estate assets appreciate, savers have seen equities and crypto appreciate, and wages are rising. If American consumers were so depressed and worried about prices, why are they quitting in droves?
- Don't fall for the "inflation is a political risk" narrative. A *recession* is a much greater risk. The Fed will therefore pivot away from hawkishness in early 2022, if not within weeks.
- Policy inflection is afoot in Beijing, with China about to put a floor to domestic and global growth. *That* is the most important macro issue going forward.
- Remain bearish tactically. Our view will need time to play out.
- Cyclically, remain bullish equities and expect rotation out of US assets in 2022.
- Go long China / short India in anticipation of the shift and remain long iron ore and iron ore producers / short oil.

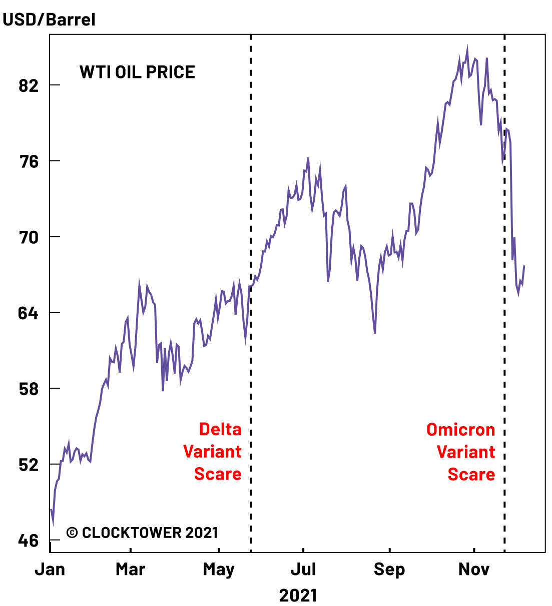
Two extraordinary leads graced major news outlets over the past week... First, *Reuters* carried an article titled "WHO chief scientist urges people not to panic over Omicron."[1] Second, *Bloomberg* led with "Jerome Powell Ditches 'Transitory' Tag, Paves Way for Rate Hike."[2]

What do both news items assert in common? An egregious example of institutional failure.

For the WHO, the failure is in its initial response to the news of the new variant out of South Africa. The organization could have flagged any number of facts that would have alleviated the initial panic. Instead, it ignored the comments from South African scientists and doctors – who almost universally have suggested that hospitalization rates are not increasing with the latest surge and that the symptoms of the new variant appear to be mild – or the fact that current vaccines are highly likely to have some effect on the ominously dubbed Omicron. Think we are too harsh on the WHO? The market agrees with us, selling off crude oil much harder than following the ascent of the Delta variant (Chart 1).

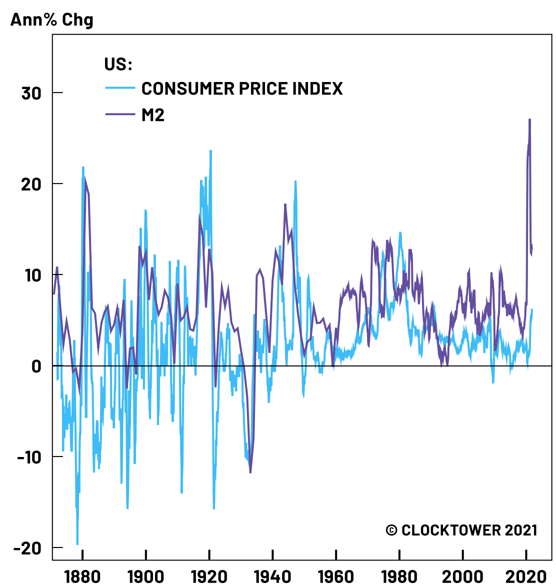
For the Fed, the failure is in its belated reaction to inflation. If there is anything the Fed ought to get right, it is movement in prices. That is, after all, its mandate! We are not even asking the Fed to *predict* inflation, just to explain it. But apparently it took until late November for Jay Powell to realize that COVID-19 is not deflationary. We have been writing about this since the pandemic began,[3] reinforcing our inflationary view with a view on the labor market early in 2021,[4] and concluding last month with a structural view that the geopolitical factors underpinning inflation are not transitory.[5] In the end, perhaps all we needed on the inflation front was a simple M2 chart (Chart 2).

CHART 1 | Omicron a Bigger Deal Than Delta?



SOURCE: MACROBOND.

CHART 2 | Inflation Is a Surprise? Really?



* PRIOR TO 1947 SOURCED FROM ROBERT SHILLER ONLINE DATA.
** PRIOR TO 1960 SOURCED FROM US CENSUS BUREAU. FROM 1960 UNTIL 1980 SOURCED FROM FRED.
SOURCE: MACROBOND.

We do not simply pile on the technocrats in charge of the un-democratic institutions that make liberal democracy run smoothly. That is too easy and there is plenty of it in other publications whose moniker rhymes with *Gyro Wedge*.

Rather, there are two broader points investors ought to take to heart. First, the world is continuing to experience a degradation of institutional quality that will leave the door wide open for populism. Second, we should fade the delayed, panicked, reactions of scared, old, (mostly) men as they are woefully backward looking and non-predictive of the future.

[1] Please see *Reuters*, "IMF chief says Omicron could dent global economic growth," dated December 3, 2021, available at Reuters.com
[2] Please see *Bloomberg*, "Jerome Powell Ditches 'Transitory' Inflation Tag, Paves Way for Rate Hike," dated November 30, 2021, available at Bloomberg.com.
[3] Please see Clocktower Group *All Along the Clocktower*, "Coronavirus, Coronavirus, and More Coronavirus," dated April 2020, available on request.
[4] Please see Clocktower Group *All Along the Clocktower*, "Transitory Shmansitory," dated May 2021, Volume I, available on request.
[5] Please see Clocktower Group *All Along the Clocktower*, "Geopolitics Is Not Transitory," dated November 2021, Volume II, available on request.

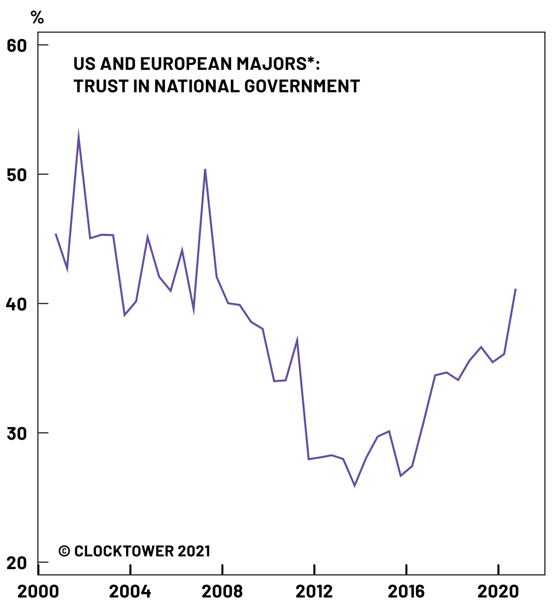
The bedrock of modern democracy is legal authority, one that most investors take for granted. The idea of "legal authority" – as opposed to other forms of authority – was first introduced by Max Weber in 1922. Weber's seminal essay, "The Three Types of Legitimate Rule," argues that legal-rational authority comes from the institutions and laws that define it, not the individuals holding the office or the ideological purity of the party in charge of the country.[6]

Investors prefer the legal-institutional authority because it reduces uncertainty, although they also tend to take it for granted. Investors can predict the behavior of policymakers by simply learning to navigate the set of laws that govern the behavior of governing regulatory and legislative institutions. Developed markets are almost universally made up of countries with such norms of "good governance." Day-to-day politics becomes noise in these ordered systems.

The other two forms of authority outlined by Weber in his original essay are "traditional" and "charismatic." Traditional authority refers to dynasties and monarchies whereas charismatic authority is derived from the extraordinary characteristics of an individual. The last decade has seen a revival of charismatic authority, from emerging markets like Russia, Turkey, Hungary, and the Philippines to the established democracies like Italy and the US.

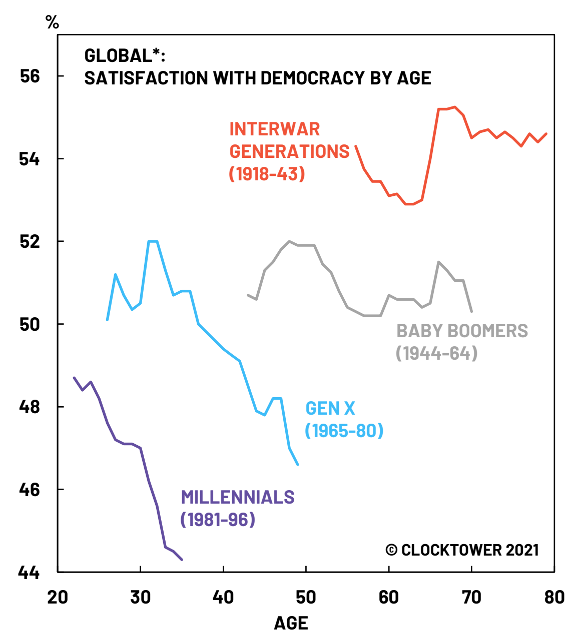
There are many reasons for the decline of the legal-rational authority. Elites that manage governing institutions have been discredited by the 2008 Great Recession and a decade of low growth, "jobless," recovery that followed it. Discontent with government is widespread in the developed world (Chart 3). Elevated levels of income inequality from the US to Chile to China remain persistent. Also persistent is elite corruption. Francis Fukuyama, perhaps America's greatest political theorist, flagged in his 2014 book *Political Order and Political Decay* that US institutions had devolved into a "system of legalized gift exchange, in which politicians respond to organized interest groups that are collectively unrepresentative of the public as a whole."[7] Finally, political gridlock in the US and other DM economies is forcing politicians – even those who respect legal authority – to take matters into their own hands to cut corners and govern.

CHART 3 | Trust in Government Remains Low...



* EQUALLY-WEIGHTED AVERAGE OF US, GERMANY, FRANCE, ITALY, SPAIN, THE NETHERLANDS, GREECE, AND AUSTRIA.
SOURCE: PEW RESEARCH FOR US, EUROBAROMETER FOR REMAINING COUNTRIES, MACROBOND.

CHART 4 | ...As Millennials Abandon Democracy



* INCLUDES 75 COUNTRIES ACROSS THE WORLD IN ALL REGIONS.
NOTE: DATA AGGREGATED TO THE COUNTRY-AGE LEVEL FOR EACH COHORT, AND THEN AGGREGATED GLOBALLY BASED ON COUNTRY POPULATION-WEIGHTING. SOURCE: FOA, R.S., KLASSEN, A., WENGER, D., RAND, A. AND M. SLADE. 2020. "YOUTH AND SATISFACTION WITH DEMOCRACY: REVERSING THE DEMOCRATIC DISCONNECT?" CAMBRIDGE, UNITED KINGDOM: CENTRE FOR THE FUTURE OF DEMOCRACY.

[6] Please see Max Weber, "The Three Types of Legitimate Rule," *Berkeley Publications in Society and Institutions* 4 (1): 1-11 (1958). Translated by Hans Gerth. Originally published in German in the journal *Preussische Jahrbücher* 182, 1-2 (1922).
[7] Please see Francis Fukuyama, *Political Order And Political Decay* (New York: Farrar, Straus and Giroux, 2014).

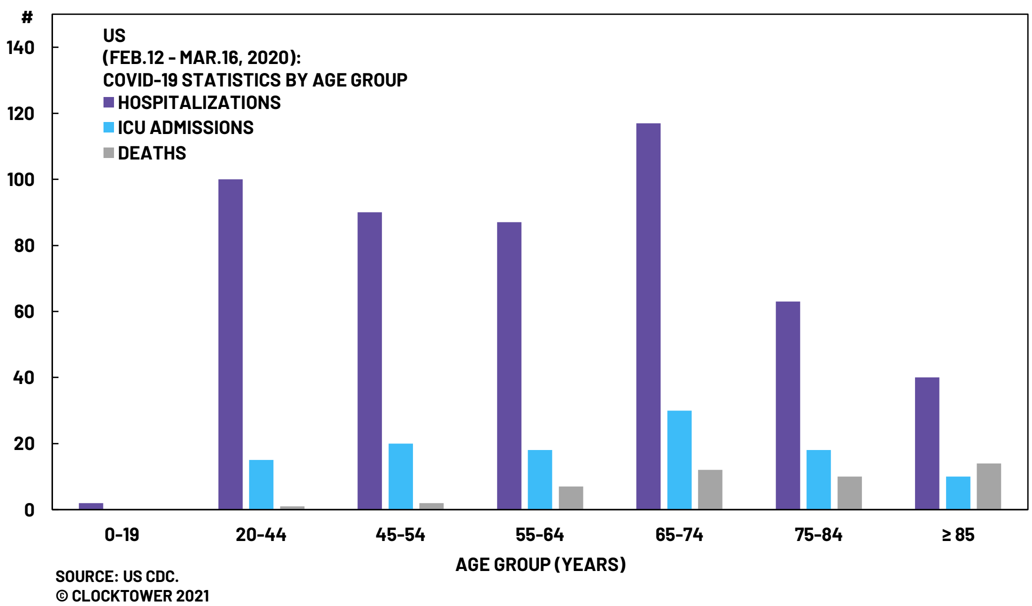
There is also a generational component, one that we have expanded on significantly in developing our Buenos Aires Consensus framework.[8] Millennials (and younger cohorts) are beginning to lose respect for liberal democracy, particularly in the West (**Chart 4**). For now, most younger voters have stuck with centrist politicians – except in France, where Marine Le Pen did well with the youth vote in 2017. But the future may not be as rewarding for moderates.

There are two ways to incorporate Weber's timeless thoughts into investment decisions. First is rather obvious: expect more charismatic authority, i.e., populism.

A more nuanced perspective is that investors ought to also expect the representatives of the legal/rational authority to act like scared children. Politicians and technocrats running the legal/rational institutions can feel the hot breath of populism on their necks. They are competent enough to understand that the plebs have been aroused, barricades stacked, and guillotines sharpened.

Two examples are the reaction to COVID-19 and now inflation. Our thoughts on the COVID-19 response are well known to our readers from 2020. We got a lot of things wrong, but also many things – now in retrospect – right. One thing is clear: policymakers overreacted once they were afraid of being accused of underreacting. To the point that sober institutions like the Center for Disease Control and Prevention began ~~falsifying~~ creatively representing data to scare the public into compliance with half-baked guidelines. Prime example of that is **Chart 5**,[9] replicated without any modification from the CDC website and so egregiously manipulated that if it were published by the *Clocktower Group* Strategy Team, the offending analyst would be summarily fired.[10]

CHART 5 | The CDC Essentially Thinks that a Majority of Americans Are Idiots and/or Math Illiterate



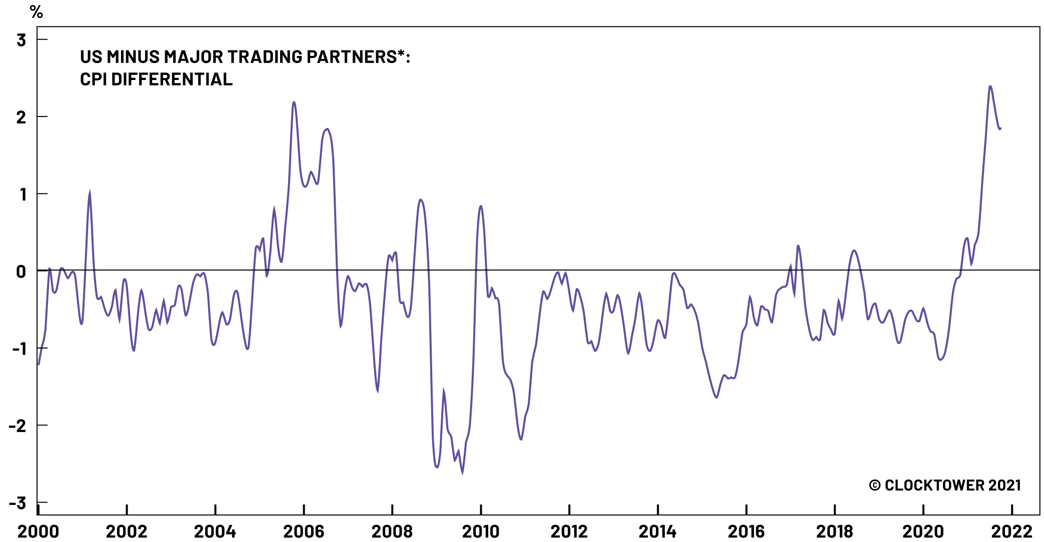
The Fed's reaction function to inflation is another example. The Fed has spent over a year trying to convince investors that inflation is transitory, even as US prices began to outpace those in other major economies at a level at least not seen since 2000 (**Chart 6**). But now that *#inflationfears* have become a Twitter hashtag, politicians are scrambling to react.

We failed to predict this shift and therefore some "crow eating" is in order. Over the course of the year, we cautioned investors that central bankers would remain woefully behind the curve. In a way, we were correct. The latest US CPI annualized print is at 6.2%, the Fed funds rate is at 0%, and the Fed is still buying $105 billion worth of assets every month.

At the same time, it is undoubtedly true that the Fed has turned more hawkish since the June FOMC, culminating in Powell's belated reaction to historically elevated inflation prints.

[8] Please see Clocktower Group *All Along the Clocktower*, "Welcome to the Buenos Aires Consensus," dated June 2020, Volume II, available on request.
[9] Not sure why we think **Chart 5** is so egregious? Look closely... Here is a hint: take a careful look at the X-axis. Email us if it is not clear.
[10] We manipulate charts much more creatively than that!

CHART 6 | Even *If* Inflation Is Transitory, Does its Uniquely American Experience Not Matter?

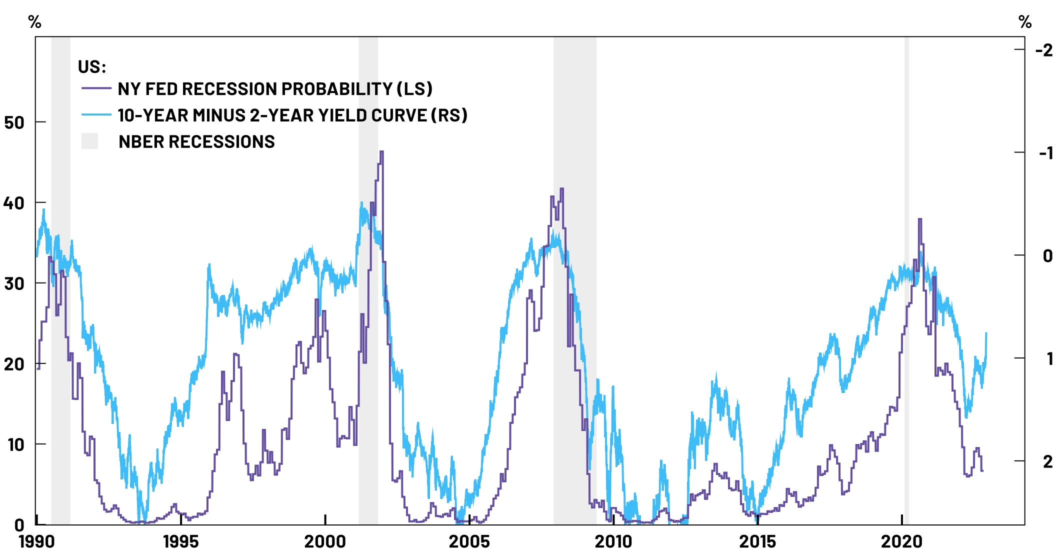


* AVERAGE OF THE HEADLINE CPI OF CHINA, CANADA, MEXICO, AND EURO AREA.
SOURCE: MACROBOND, BCA RESEARCH.

However, just as with the belated overreaction to COVID-19 – which ultimately proved to be unsustainable considering its economic costs – the Fed may be crying wolf to justify its previous complacency. Let us be clear on one thing, the bond market is signaling that the Fed hawkish turn is likely to be a policy error. In our mind, there is no doubt on this fact. The 10y/2y Treasury yield spread is 75 basis points away from inverting and has been falling like a brick. If we graft the 10y/2y Treasury yield spread on the NY Fed recession probability model, it predicts that the probability of a recession in the next 12 months will rise to ~25% imminently (Chart 7). Now, the model itself is not updated on the NY Fed website and relies more on the 10y/3m spread. But it has *rarely* risen above 20% and *not* produced a recession. It does happen, but only when the Fed makes an about turn on policy as a result of a market carnage.

The astute strategists, analysts, and investors who *did* predict the Fed's hawkish turn – and who therefore ate our lunch on the USD call – will counter that inflation print at above ~6% requires a response. And that inflation has now become a political problem.

CHART 7 | This Chart Is Suggesting that the Fed Is Comfortable Causing a Recession



SOURCE: MACROBOND.
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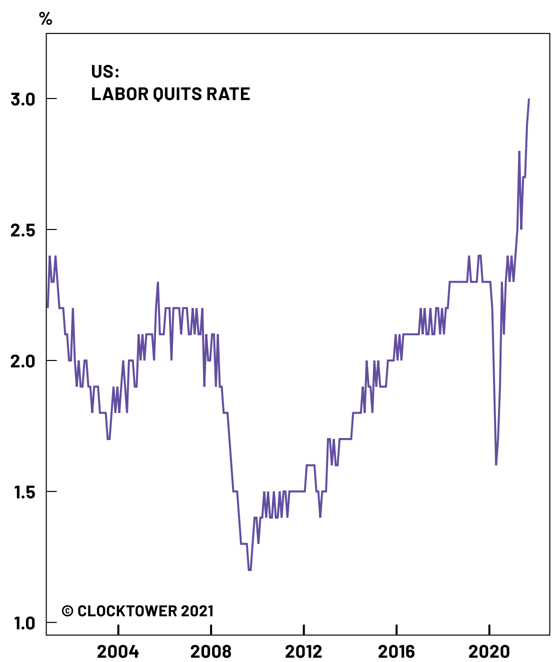
Fine, we concede this point. Just as COVID-19 hospitalizations and ICU bed shortages were once the most imminent problem of the pandemic. But eventually, policymakers adjusted to the political risks that repeated lockdowns generate through economic pain. The political pain point evolves through time and space.

Today, inflation is a political problem. The President of the United States does not make speeches about inflation lightly, as Joe Biden did on November 11. (Although, we would point out that President Biden's solution to inflation cited in the speech was more capex spending and to sue oil companies, which kind of sounds inflationary to us).

But how much of a problem is inflation really? Real estate prices in the US have risen 14% in 2021, with 65.4% of Americans owning homes. Equities are up 21%, Bitcoin 90%. The quits rate remains at a record level, with 3% of the labor force of the US summarily resigning from their jobs in the month of September (Chart 8)! If the median voter was at a breaking point over inflation, you'd think that they would hold on to their jobs to pay the rising bills!

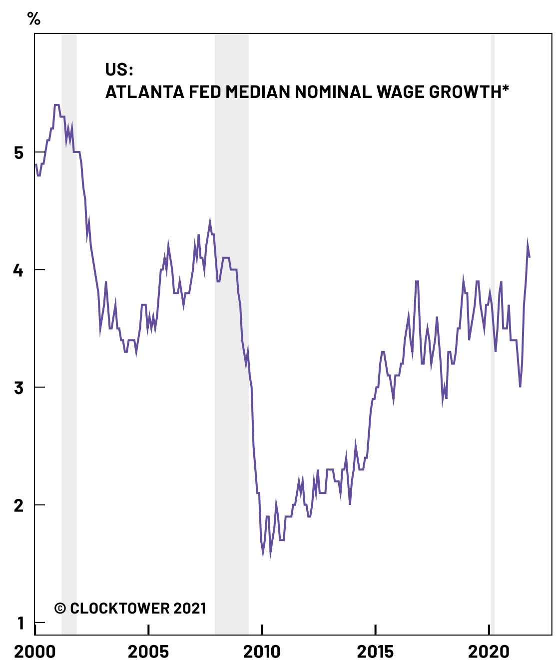
Furthermore, wages continue to rise and offset at least some of the pain of inflation (Chart 9). Fans of Irving Fisher's "money illusion" concept – and we count ourselves as some of his biggest fans – will know that nominal gains are more important to voters than real ones. So, while we accept that a bunch of financially literate investors may be aware that inflation is eroding their wage gains, we are not certain that the median voter is.

CHART 8 | If the Median Voter Is Scared of Inflation...



SOURCE: MACROBOND.

CHART 9 | ...Why Are They Quitting?



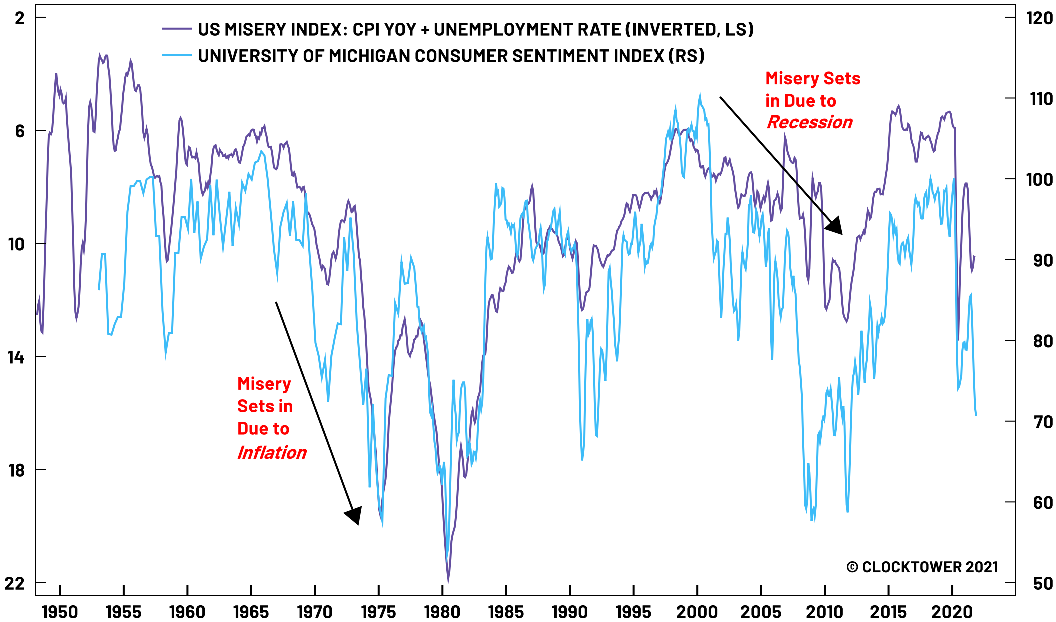
NOTE: SHADED AREAS DENOTE NBER RECESSIONS.
SOURCE: MACROBOND.

But ok, inflation matters politically. We get it. The oft-cited University of Michigan Consumer Sentiment Index is at its lowest point since the early years of the secular stagflation cycle, 2012 to be precise. That said, the *misery index* (CPI YoY + unemployment rate) is rising but held back by a solid employment number (Chart 10). It *could* appreciate to the lofty heights of the 1970s thanks to double digit inflation. In our view, the more likely path to appreciation of the misery index (and certainly of misery itself!) would be a recession induced by a belatedly inflation-centric Fed.[11]

Perhaps that is precisely the design of Jay Powell, the sole Republican of note in the Biden administration. A story could be told that Biden made an error in reappointing Powell out of fear of inflation, an error that will cost him his presidency.

[11] Please see Clocktower Group *All Along the Clocktower*, "Stagflation vs. Hydrogen," dated October 2021, Volume I, available on request.

CHART 10 | Misery Can Dawn on America Due to Inflation *or* Recession



NOTE: BOTH SERIES SHOWN AS A 3-MONTH MOVING AVERAGE.
SOURCE: MACROBOND.

However, investors should not forget that Biden has an out: *three* appointments remain open on the Fed Board of Governors (Table 1). President Biden has promised to appoint them in early December. The first is Treasury Secretary Janet Yellen's seat left vacant in February 2018. In addition, Richard Clarida and Randal Quarles will both resign over the next few months, giving Biden two more appointments to make. In addition, the resignation of Eric Rosengren may potentially allow the Biden administration to further shape next year's FOMC, although regional Fed heads are not appointed by the President directly. Other than Rosengren, most of the Fed vacancies are left over by "centrists." Although with the CPI at 6.2%, "centrists" are the new "hawks."

TABLE 1 | Will Chair Powell Swim in the Morass of Doves Next Year?

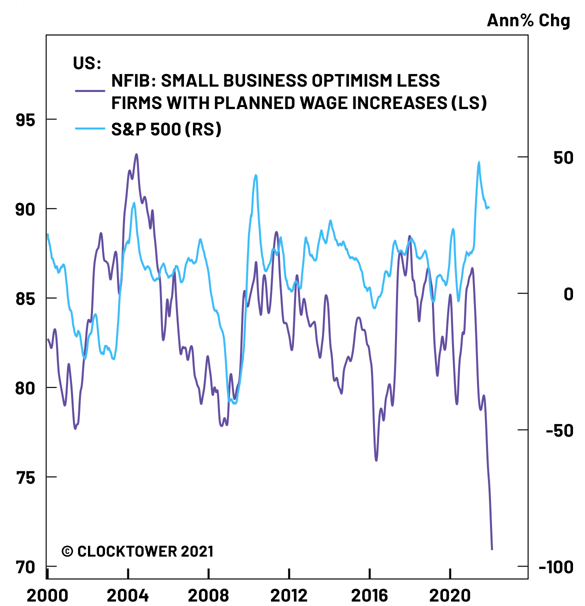
FOMC VACANCIES TO FILL					
Name	**Current Title**	**Date of Replacement**	**Stand on Monetary Policy**	**Voting Status**	**Political Party**
Richard Clarida	Vice Chair of the Fed Members of the Board of Governors	Clarida's term will expire in January 2022	Centrist	Permanent voting member	Republican
Randal Quarles	Vice Chair for Supervision Members of the Board of Governors	Quarles will resign from the Fed at the end of the year	Centrist	Permanent voting member	Republican
Vacant Seat	One open board seat, with a term that expires in 2024	Vacant since February 2018	-	Permanent voting member	-
Robert Kaplan	Dallas Fed President	Kaplan retired from Fed on October 8. Dallas Fed is searching for replacement	Centrist	Do not have a vote in 2022	-
Eric Rosengren	Boston Fed President	Rosengren retired from Fed on October 21. Boston Fed first Vice President has taken over as interim president while the search continues for Rosengren's successor	Hawk	Have a vote in 2022	-

SOURCE: FED, REUTERS.

Powell's appointment may have given President Biden political cover to do two things. First, pass his "Build Back Better" infrastructure agenda by giving Senator Joe Manchin (West Virginia) the comfort of knowing that a centrist is heading the Fed. Second, to craft the membership of the Fed Board without having to expend political capital on a dovish Chair.

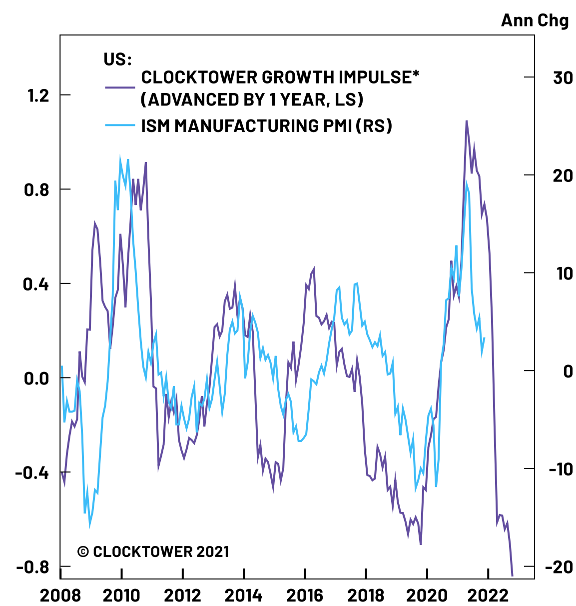
Last month, we pointed out that we remained cautiously bullish on equities on a cyclical time horizon despite our unease over a flattening yield curve, "but with an eye towards near term volatility and a tactical selloff."[12] Aside from the generally stretched environment, poor breadth, and lofty valuations, we were concerned that investors were ignoring souring animal spirits (Chart 11) and increasingly worrying growth prospects, both in the US (Chart 12) and globally (Chart 13 and 14).

CHART 11 | Markets Were Ignoring Mounting Risks...



NOTE: BOTH SERIES SHOWN AS A 3-MONTH MOVING AVERAGE.
SOURCE: NFIB, MACROBOND.

CHART 12 | ... From the Real Economy



* BASED ON COMMODITY PRICES, US YIELD CURVE, AND US REAL INTEREST RATE.
SOURCE: CLOCKTOWER CALCULATIONS, MACROBOND.

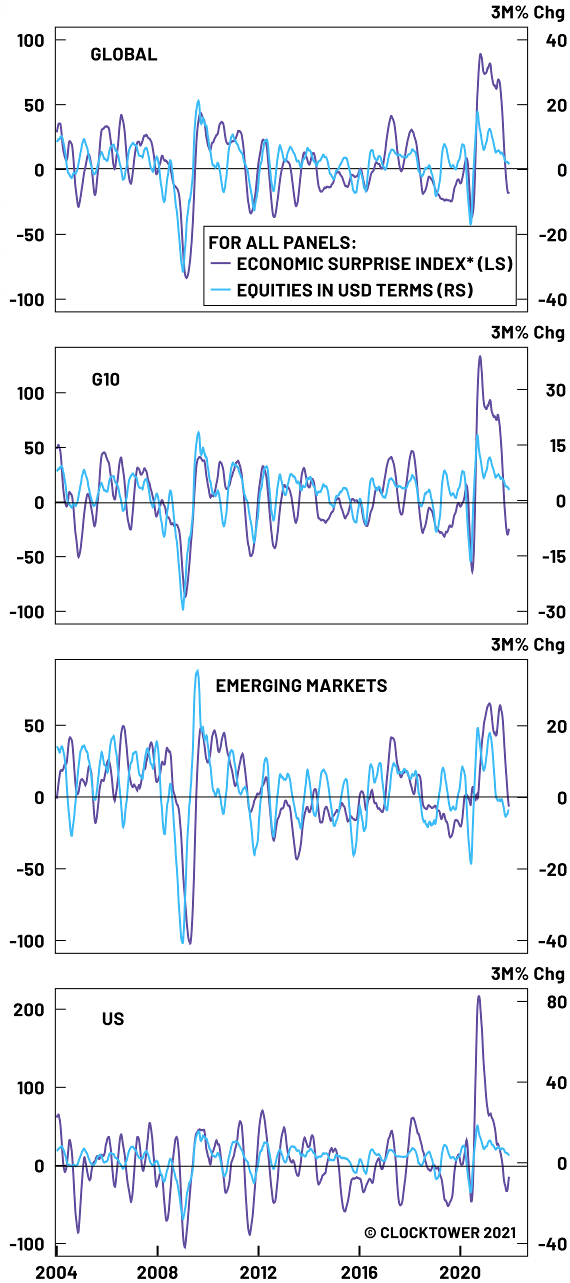
Where do markets go from here? We have been maniacally bullish since March 2020. We turned cautious only twice, in August 2020 and last month. This correction seems different. First, enough smart managers and strategists we have spoken to are of the view that "the multi-decade Fed put is gone... forever." In other words, the Fed will not pivot away from hawkishness as it did following the 2018 correction as inflation is today at 6.2%, not at 1.5% like in early 2019. We disagree as 5% is the new 2% when it comes to inflation.

What does that mean? First, the Fed is driving with the rear-view mirror instead of looking out the windshield. It is overreacting to inflation because A) it was wrong all year, B) is facing political pressure across the ideological divide, and C) has an FOMC make-up that favors such a reaction function for another few weeks/months. But we are not in the camp that inflation will print double digits in 2022. One could argue that inflation has already surprised to the upside given the oil price decline. Assuming that gasoline prices *merely move sideways* for the next 12 months – and they are likely to fall – inflation is likely to peak in Q1 next year (Chart 15). To be fair, Chart 15 suggests that inflation has dislodged from energy prices as structural factors have now taken over. We are obviously very sympathetic to this view and expect inflation to settle at well above 2% this cycle. Nonetheless, energy prices and easing of supply shortages (Chart 16) are likely to allow prices to peak early next year.

Second, as the Fed digests the message from the yield curve and the rising risks of a recession, it will adjust its narrative sometime in early 2022 (if not within weeks!), particularly as the new FOMC is reformulated with a dovish tilt. This narrative will essentially adopt the "5% is the new 2%." Instead of "transitory," inflation will have "peaked," or been "stabilized," even if the Fed mandate will still suggest that a hawkish response is in order.

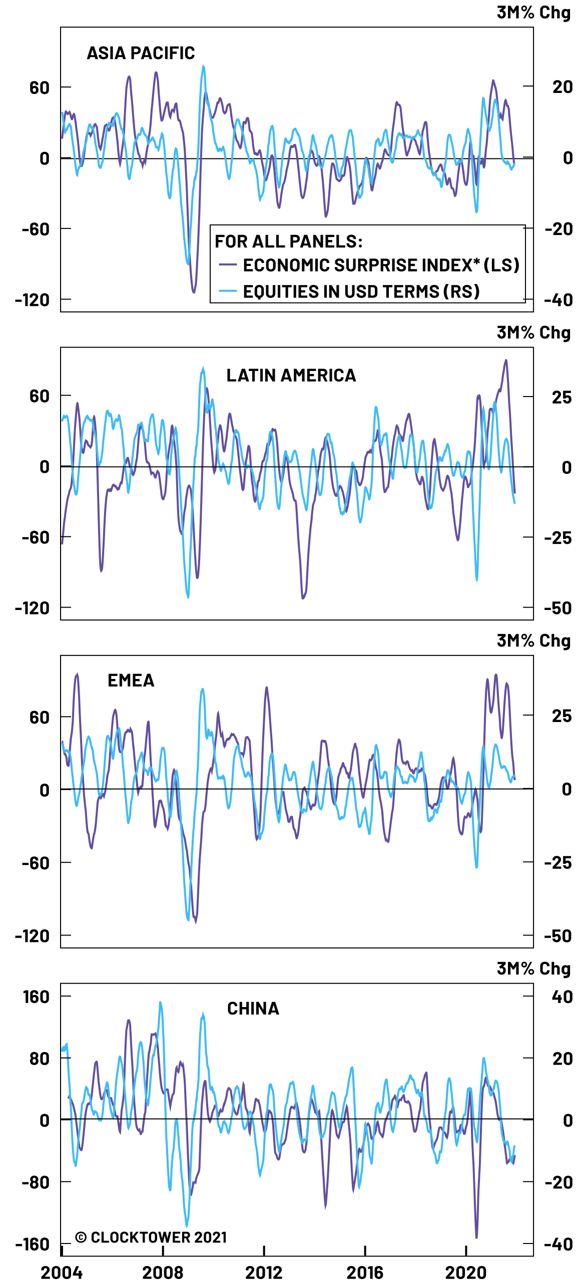
[12] Please see Clocktower Group *All Along the Clocktower*, "A Cornered Fed, Transatlantic Drift, & China," dated November 2021, Volume I, available on request.

CHART 13 | Global Economic Surprise Indexes...



* ROLLING 3-MONTH STANDARD DEVIATION OF DATA SURPRISES.
NOTE: ALL SERIES SHOWN AS A 3-MONTH MOVING AVERAGE. EQUITIES FOR SECOND PANEL INCLUDE G7 ECONOMIES.
SOURCE: CITI, MACROBOND.

CHART 14 | ...Are Universally Weak



* ROLLING 3-MONTH STANDARD DEVIATION OF DATA SURPRISES.
NOTE: ALL SERIES SHOWN AS A 3-MONTH MOVING AVERAGE.
SOURCE: CITI, MACROBOND.

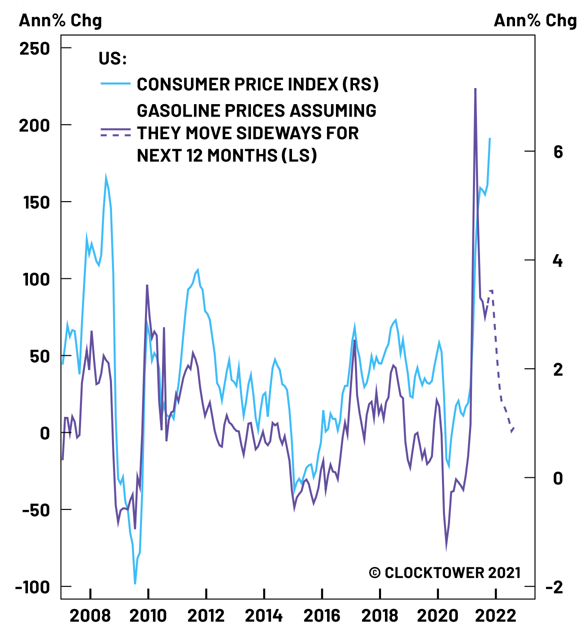
On the other hand, we may be missing the plot completely. The Fed may simply be overly anchored to the last 40 years of institutional history. As such, it will repeat the 1973-1975 error and cause a deep recession while fighting a supply-driven inflation that requires an extraordinary amount of capex to resolve. We have been known to be wrong in the past, so anything is possible! But if that is the case, investors should prepare for a lot more than just a selloff. If unelected technocrats cause a painful recession, the political consequences for US domestic stability – given the context of polarization and radicalization[13] – will be dire. And we do not mean for your portfolio.

[13] Please see Clocktower Group *All Along the Clocktower*, "America: The Next Four Years," dated December 2020, Volume II, available on request.

Bottom Line: The lesson from how policymakers have reacted to the pandemic and inflation is that they overreact belatedly to yesterday's news. As they do, material constraints to the overreaction build, forcing an about turn.

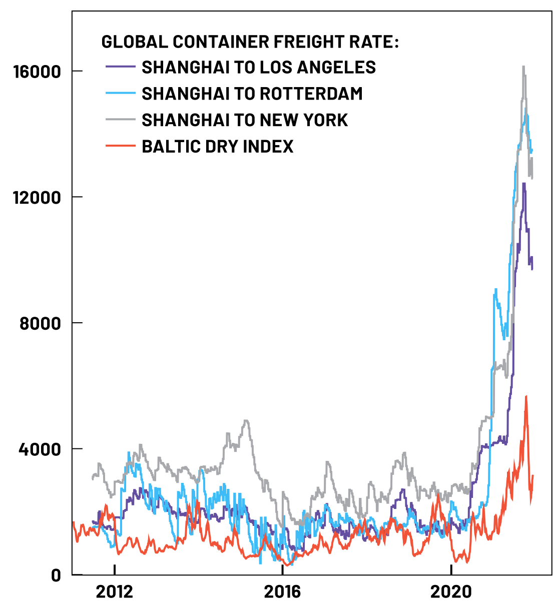
In the context of the Fed's uber hawkish pivot, our conclusion suggests that a dovish pivot is coming in 2022. We are taking the other side of the view that the "Fed put is gone." Why? Because no matter how much inflation hurts the median voter – and we maintain that the actual level of pain is overstated – a recession will hurt more. The current Fed trajectory, given the peak in growth this cycle, will cause a recession. And a recession is unacceptable in the current US political and macro context.

CHART 15 | The Fed Has Retired the Term...



SOURCE: MACROBOND.

CHART 16 | ..."Transitory" Just as it Proves Correct



SOURCE: BLOOMBERG FINANCE L.P., MACROBOND.
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So What? Investment Positioning for the 2022 Context

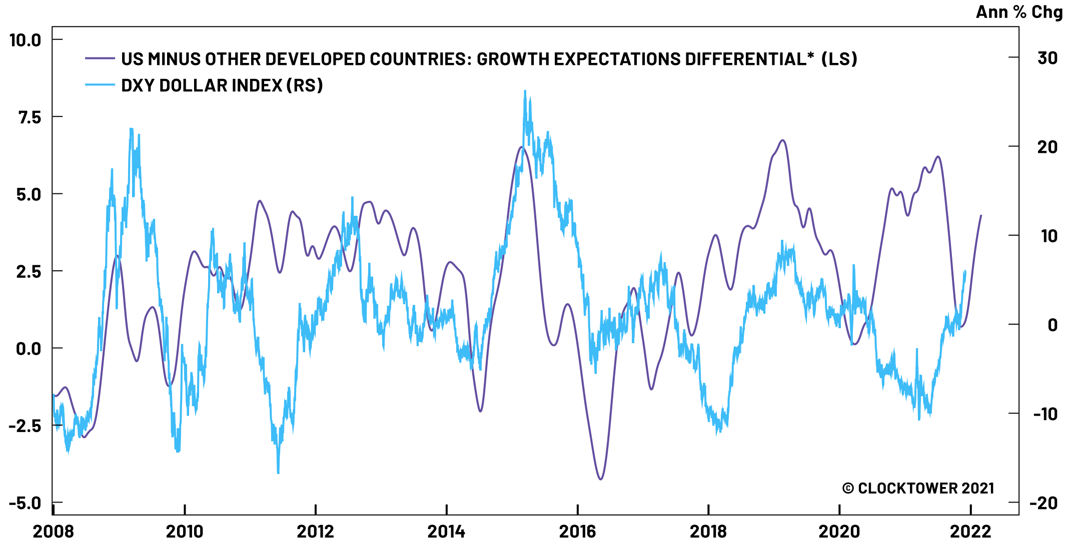
In 2021, we got a lot of things right. First, we got inflation right. Second, we got the equity market rally and commodities right. There were other, smaller, wins. Our Green China, Inc. index outperformed CSI 300 by 118%.[14] Our metaverse analysis flagged the rise of a new investment thesis.[15] The sanguine Russia call – both geopolitical and market – has proven correct, thus far[16] as did our sanguine Mexico call.[17] And our US-China geopolitical call has been correct since we launched the Strategy Team in 2019, but particularly in 2021 when our flagship trade recommendation from that thesis – long semiconductor capex index – surged 152%.[18] Our big miss? Dollar bearishness.

There are two reasons for the miss. First, we should have heeded the message from **Chart 17**. After all, we published it in early 2021 as a potential reason for the greenback to rally. But we then proceeded to publish another dozen bearish charts and make the case for a bear market. In the end, the USD responded to a classical growth differential story, inflation and the Buenos Aires Consensus be damned! The second reason is that the Fed pivoted in June to a more orthodox response to US fiscal profligacy, buoying King Dollar.

[14] Please see Clocktower Group *All Along the Clocktower*, "Green China, Inc.," dated February 2021, Volume II, available on request.
[15] Please see Clocktower Group *All Along the Clocktower*, "Enter the Metaverse," dated August 2021, Volume II, available on request.
[16] Please see Clocktower Group *All Along the Clocktower*, "Is Russia About to 'Flip' Sides?," dated July 2021, Volume II, available on request.
[17] Please see Clocktower Group *All Along the Clocktower*, "Mexico Net Assessment – In a Nice Shade," dated March 2021, Volume II, available on request.
[18] Please see Clocktower Group *All Along the Clocktower*, "China's Three Traps & Macro Trilemma," dated October 2021, Volume II available on request.

Where do we go from here? While we think that the Fed is crying wolf on inflation, it is going to take a significant equity market correction to shift its thinking. As such, investors should prepare for a deep correction over the course of December. The mid-December FOMC meeting – December 14-15 – may be an opportunity for the FOMC to change course. But if the underway correction eases by then, we doubt that they will change course so quickly. As such, investors should approach the current selloff with the "no pain, no gain" mentality. More pain is needed to set up the rest of the cycle.

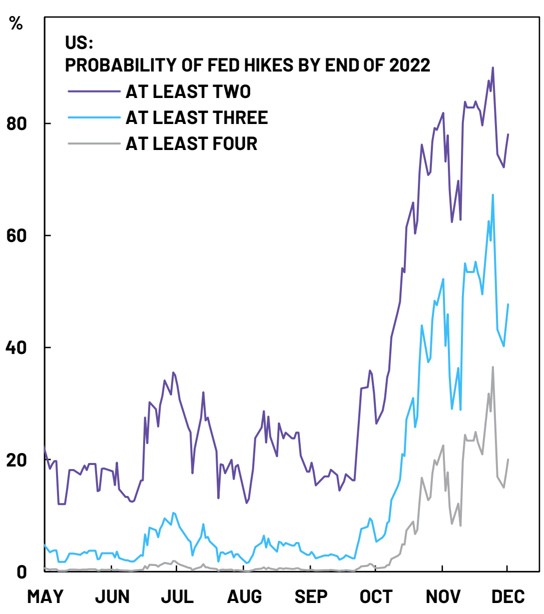
CHART 17 | Sometimes the Simplest Charts Are the Most Correct



* OTHER DEVELOPED COUNTRIES INCLUDE EURO AREA, JAPAN, AND UK. GROWTH EXPECTATIONS PROXIED BY MANUFACTURING PMI.
SOURCE: MACROBOND.

As such, investors should prepare for more USD strength in the near term, particularly if the market starts pricing in *further* rate hikes in 2022 (Chart 18). The US 10-year yield could decline further, taking risk assets – especially commodities and *especially* BTC (Chart 19) – further with it.

CHART 18 | Look Out Below for Commodities...



SOURCE: CME FEDWATCH TOOL.
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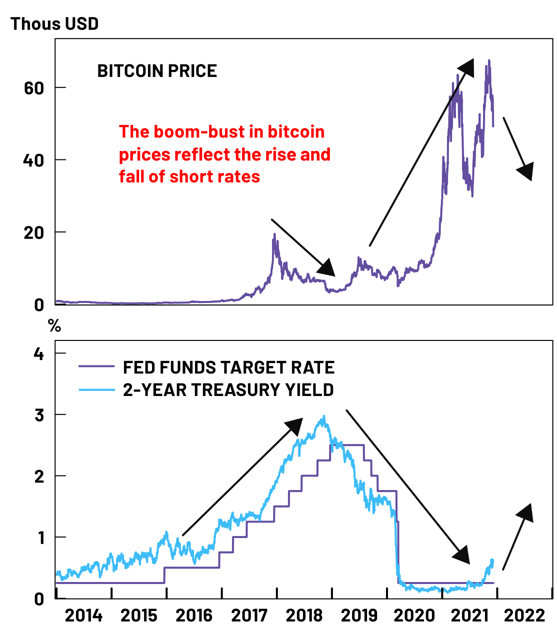
CHART 19 | ...And Especially Crypto in this Context



SOURCE: MACROBOND.
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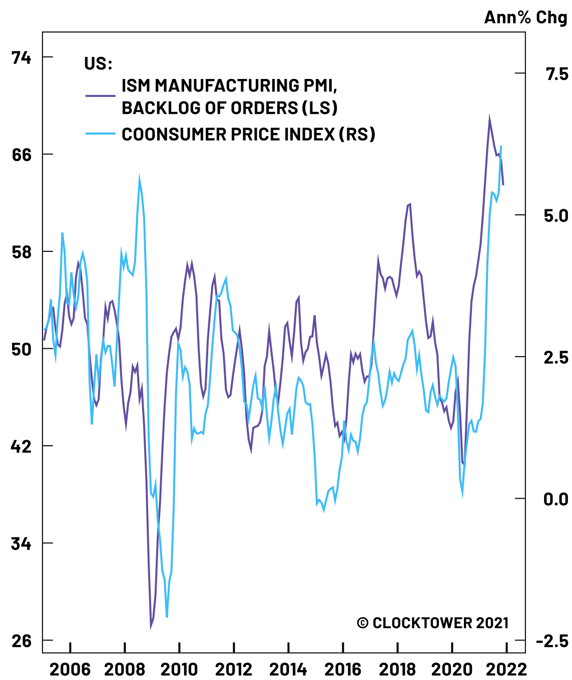
However, we expect a big macro context reversal sometime in early 2022, potentially in Q1.

First, as we discussed above, inflation will ease. Don't get us wrong, we remain in the *inflationista* camp. To be clear, the membership in the ~~sane~~ *inflationista* camp carries a low threshold. One simply has to assume that the long-term inflation expectations rise above ~2.3%. Given our structural view that *geopolitics is not transitory*, we are in *that* camp.

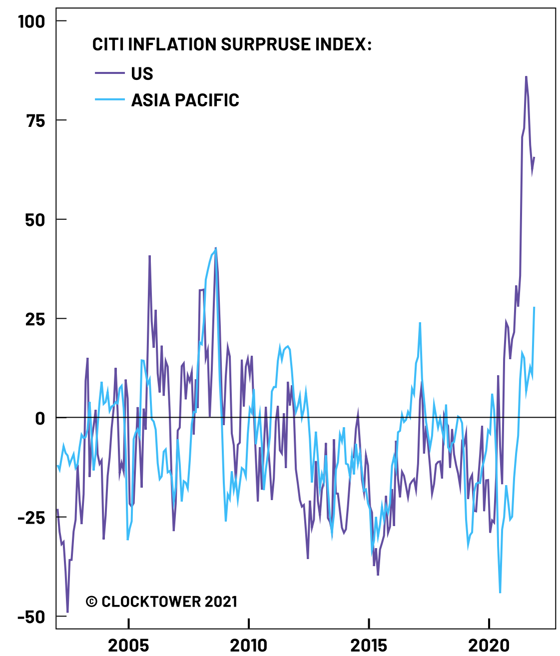
But with the most severe supply shortages easing and with the Fed clobbering commodities with its hawkishness, prices will ease further, both in the US (Chart 20) and abroad (Chart 21). This will allow it to pivot to the "5% is the new 2%" view elucidated in this missive. In other words, inflation will prove to be "transitory" just as the Fed capitulates that it is *not*.

CHART 20 | The Fed Begins to Panic...



SOURCE: MACROBOND.

CHART 21 | ...Right as Inflation Peaks



SOURCE: CITI, MACROBOND.

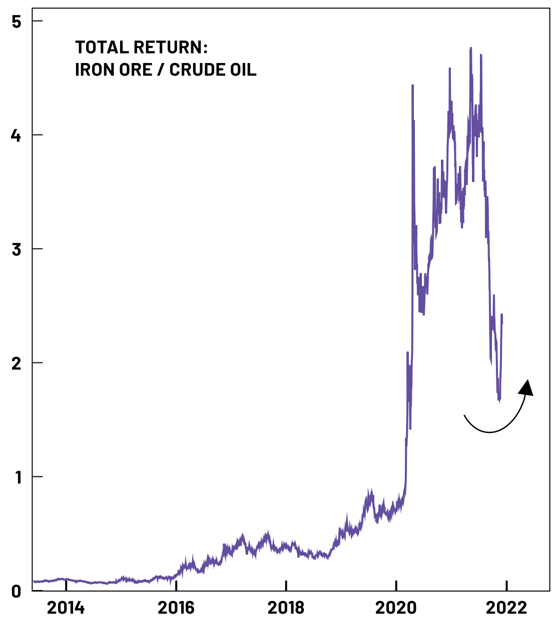
Second, Chinese policymakers will wake up to the risks of a severe deleveraging campaign. As we posited in the latest *China Macro Watch*, the policy inflection is already upon us.[19] We have played this thesis by going long iron ore relative to oil, a trade that has already netted 19% since publishing our missive on November 23 (Chart 22). More importantly, a China that puts a floor to its own growth will put a floor on global growth as well (Chart 23). Given Europe's high beta to Chinese imports and growth, a shift in Beijing calculus should have a meaningful implication for the USD (Chart 24) and commodity prices.

A moderation – if not outright reversal – of Fed hawkishness combined with Beijing policy inflection should allow the US 10-year yield to resume its higher trajectory. In 2021, a number of big trades were essentially correlated to the "one big trade:" the path of US yields (Chart 25). And to our chagrin, the path of the US 10-year bond yield has been influenced by the relative COVID-19 response between the US and the rest of the world (specifically Europe in Chart 26).

Next year, we expect our COVID-19 desensitization thesis to continue as antiviral medication becomes widely available and as investors and the public realize that viruses have a Darwinian logic in mutating into a highly infectious but less virulent forms. This will allow the combination of a Fed dovish pivot and Beijing policy inflection to take over as the major macro catalyst and lead bond yields, globally, higher.

[19] Please see Clocktower Group *China Macro Watch*, "Policy Is at an Inflection Point," dated November 23, 2021, available on request.

CHART 22 | The Market Has Proven Our China...



SOURCE: MACROBOND.
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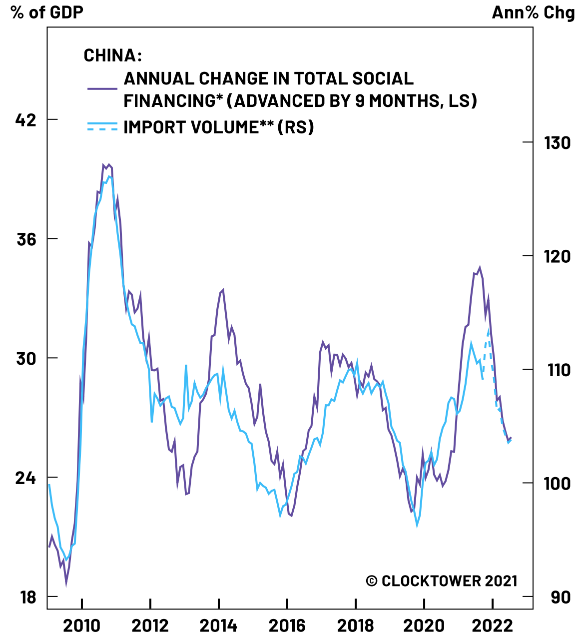
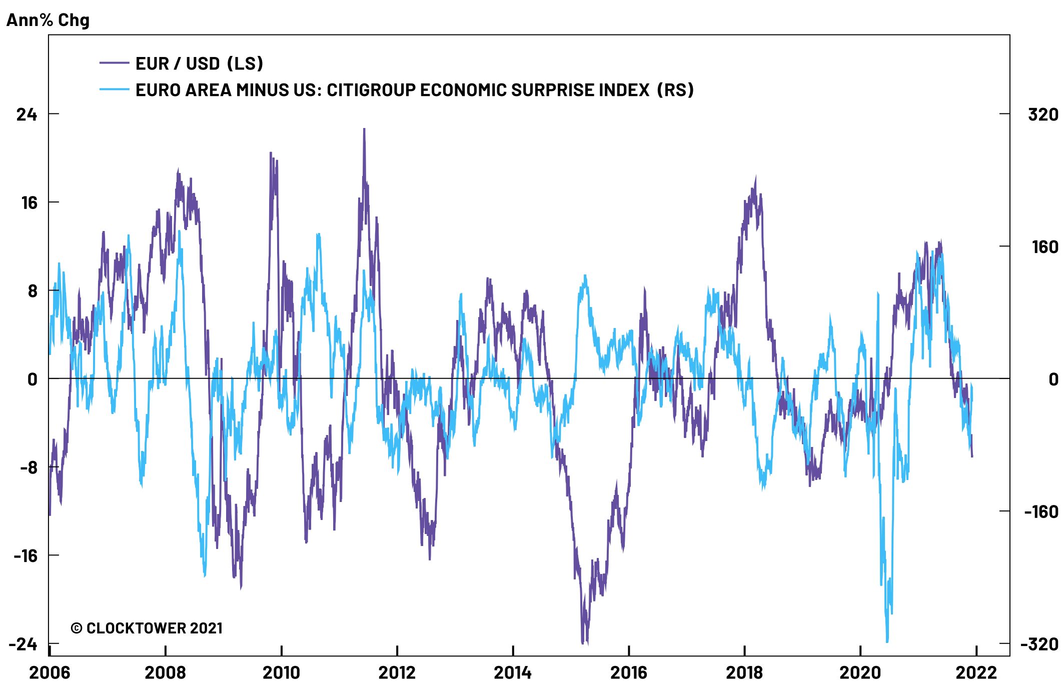
CHART 23 | ...Analysis Correct (*Thus Far*)



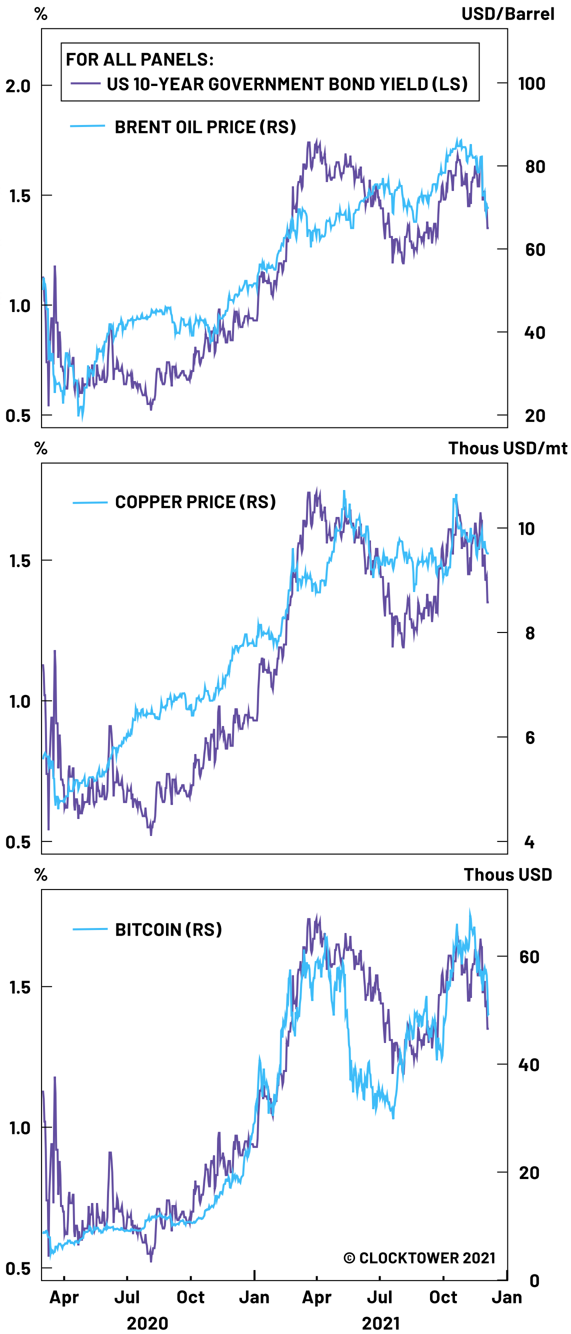
* INCLUDES LOCAL GOVERNMENT BOND, EXCLUDES EQUITY ISSUANCE.
** SHOWN AS A 12-MONTH MOVING AVERAGE.
SOURCE: MACROBOND.

CHART 24 | Bottoming of ROW Economic Surprise Index Will Buoy non-USD FX in 2022



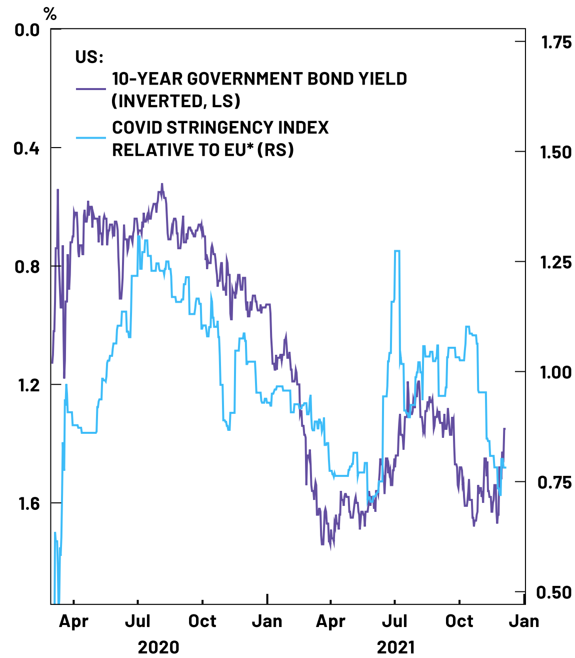
SOURCE: CITI, MACROBOND

CHART 25 | The 10 Year Yield Was *the* Trade



SOURCE: MACROBOND.

CHART 26 | COVID-19 Did Matter in 2021



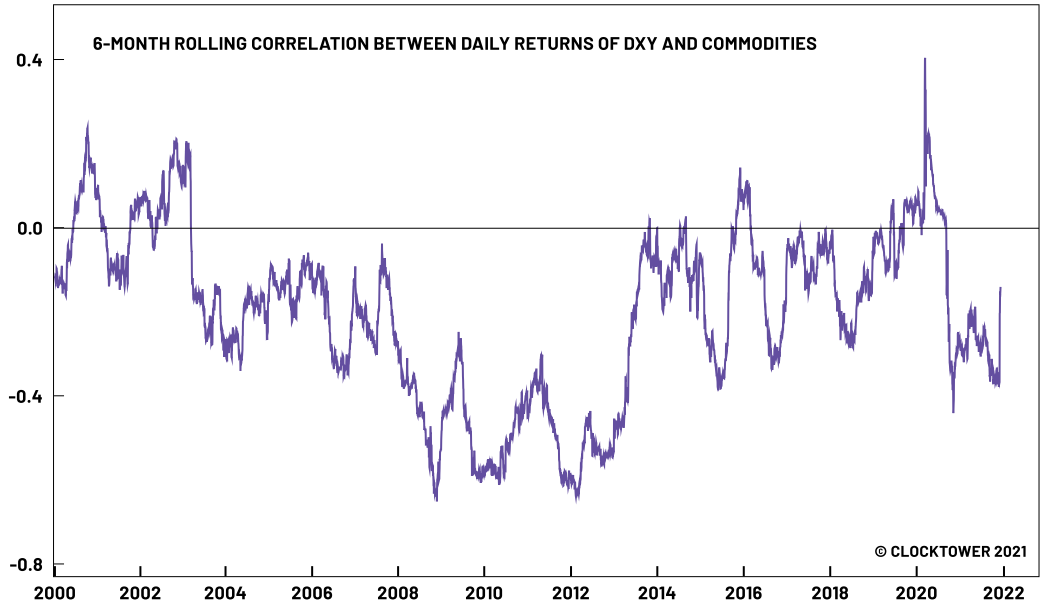
* AVERAGE OF GERMANY, FRANCE, ITALY, SPAIN, AND THE NETHERLANDS.
SOURCE: MACROBOND.

In this environment, investors should expect more commodity strength. If commodities managed to outperform in a year defined by a USD bull market, they will be absolutely set alight in 2022. And no, the correlation between the two has not changed. In fact, the correlation of their daily returns has been as negative as ever (Chart 27).[20] What that means is that commodities would have gone even higher had USD been weak in 2021.

A macro context defined by Chinese policy inflection and high commodity prices should also see the star performer of 2022, India, lose some of its shine. Already this year, India's outperformance relative to EM was historically illogical given commodity strength (Chart 28). While the overall setting would obviously be positive for EM, India would be the biggest loser. In anticipation of this shift, investors may want to tactically go long China relative to India (Chart 29).

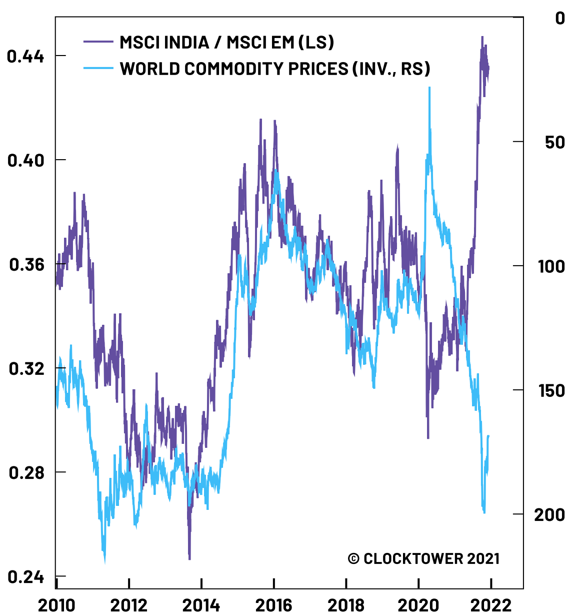
[20] A big thank you to our friend and former colleague Mathieu Savary of BCA Research for this tip!

CHART 27 | Somewhat Surprisingly, Correlation Between USD and Commodities Remains Negative



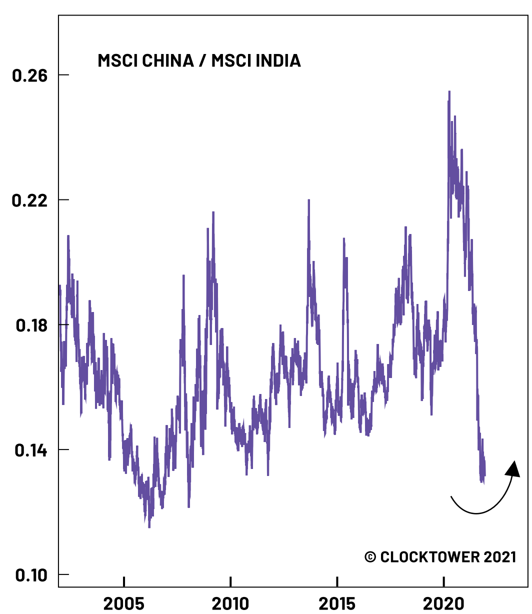
SOURCE: MACROBOND.

CHART 28 | India Outperformed Despite the...



SOURCE: MACROBOND.

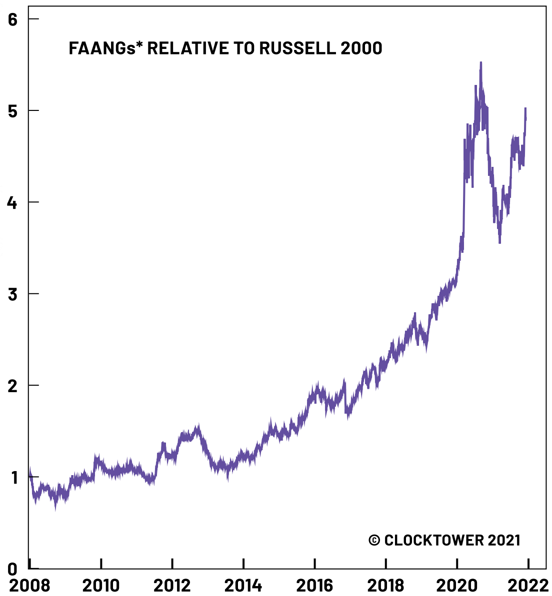
CHART 29 | ...Massive Commodity Rally



SOURCE: MACROBOND.

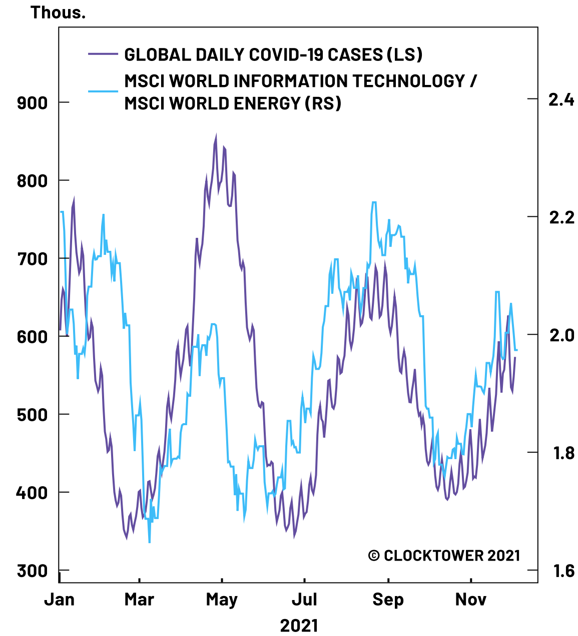
Another reversal in 2022 should be the outperformance of tech, particularly US FAANGs, which have been the "only game in town" for a decade, a decade extended by the pandemic (**Chart 30**). This year, global tech / global energy has tracked COVID-19 data. Next year, combination of a higher inflation regime, Chinese policy capitulation, and easing of the pandemic should allow energy – and value sectors in general – to finally catch alight (**Chart 31**). This should also ease capital inflows into the US, a tech heavy economy and market, inflows that in 2021 reached the highest level since pre-GFC 2007 (**Chart 32**). Given the current net longs in the USD, a macro context reversal should see the greenback peak and ease in 2022 (**Chart 33**). Then again, why anyone would take our USD call seriously after our call in 2021 is unclear to us!

CHART 30 | FAANGs Are on Borrowed Time...



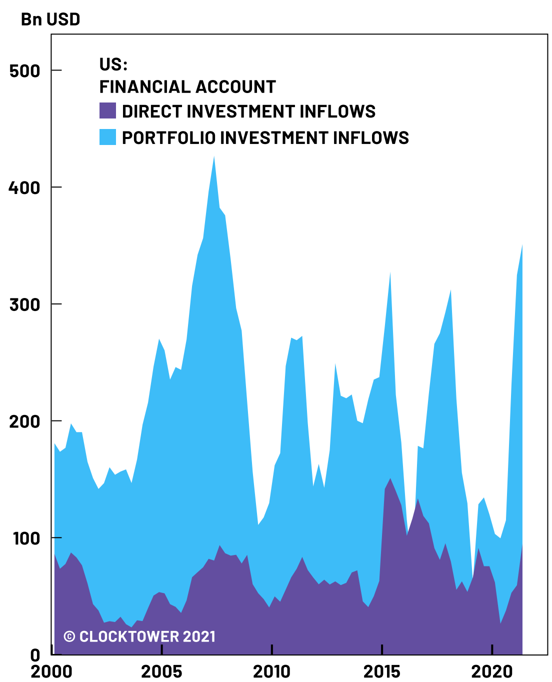
* MARKET-CAP WEIGHTED INDEX OF APPLE, ALPHABET, AMAZON, MICROSOFT, AND META.
NOTE: BOTH SERIES REBASED TO JANUARY 1, 2008 = 100.
SOURCE: MACROBOND.

CHART 31 | ...If COVID-19 Stops Being Relevant



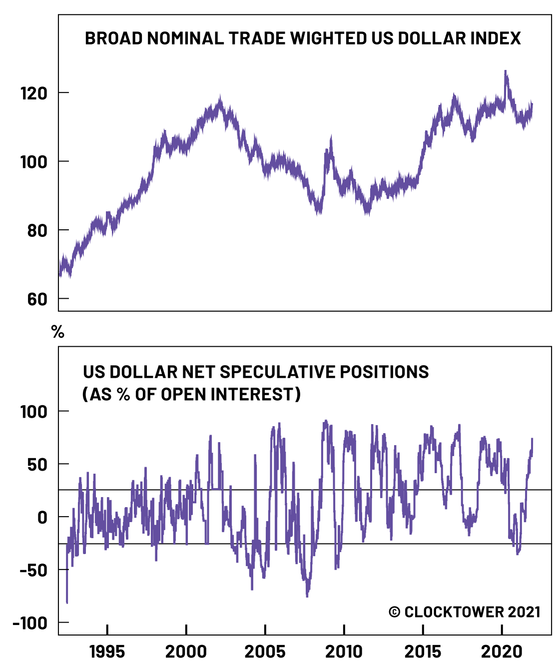
SOURCE: MACROBOND.

CHART 32 | Inflows into the US Surged in 2021...



SOURCE: MACROBOND.

CHART 33 | ...Buoying King Dollar



SOURCE: FED, CFTC, BCA RESEARCH, MACROBOND.

Bottom Line: Tactically, the pain and carnage must continue. Investors should avoid risk assets, commodities, and crypto assets in particular. Cyclically, nothing has changed. The Fed has turned hawkish belatedly due to a policy error on inflation. But it will have to back off as asset prices decline, yield curve approaches inversion – a telltale sign of a recession, and as inflation eases in early 2022. The narrative that the median voter hates inflation only works up to the point of a recession. Because we may not know everything about geopolitics and politics, but one thing we know is that the public *hates* a recession. And a recession catalyzed by unelected, millionaire, technocrats is a recipe for *la Terreur*. Meanwhile, the greatest macro development of November is neither the new COVID-19 variant nor Powell retiring the term "transitory." Rather, it is the policy inflection in Beijing, which should put a floor on Chinese and global growth in Q1.

Cyclically, we remain commodity bulls. In 2022, the biggest call for investors may be emerging markets. They remain deeply unloved by institutional investors, as we discuss in this month's Volume II. And yet, they would be the prime beneficiaries of a set of circumstances that sees the Fed ease its hawkish rhetoric, Chinese growth bottom, and dollar peak.

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