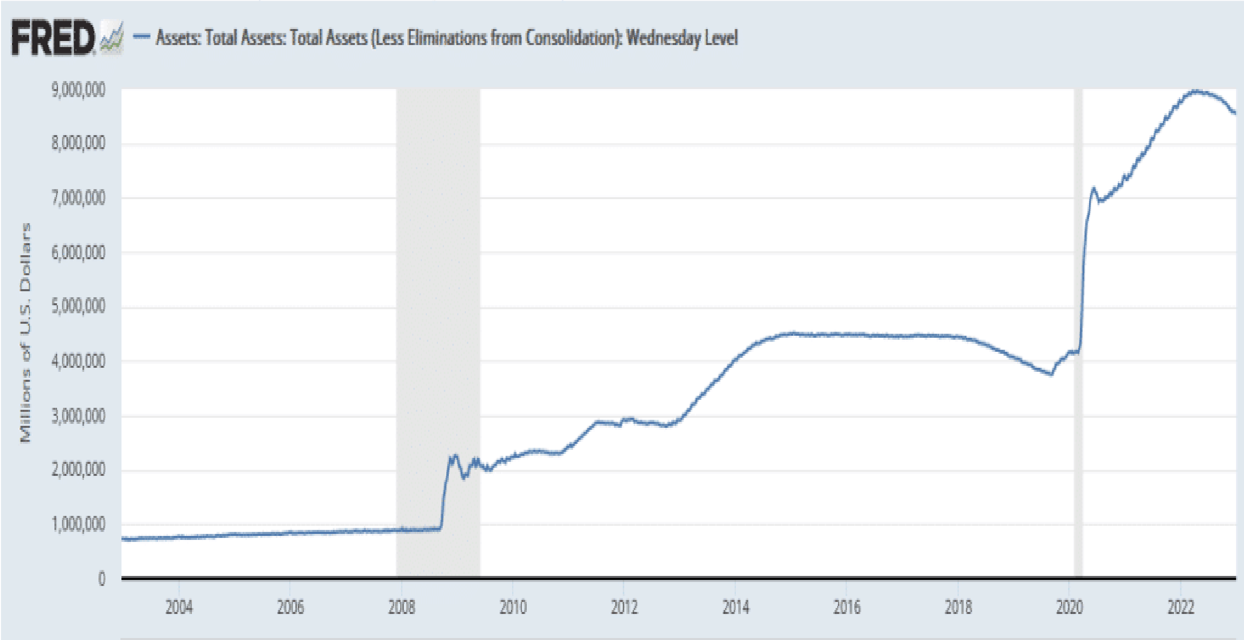
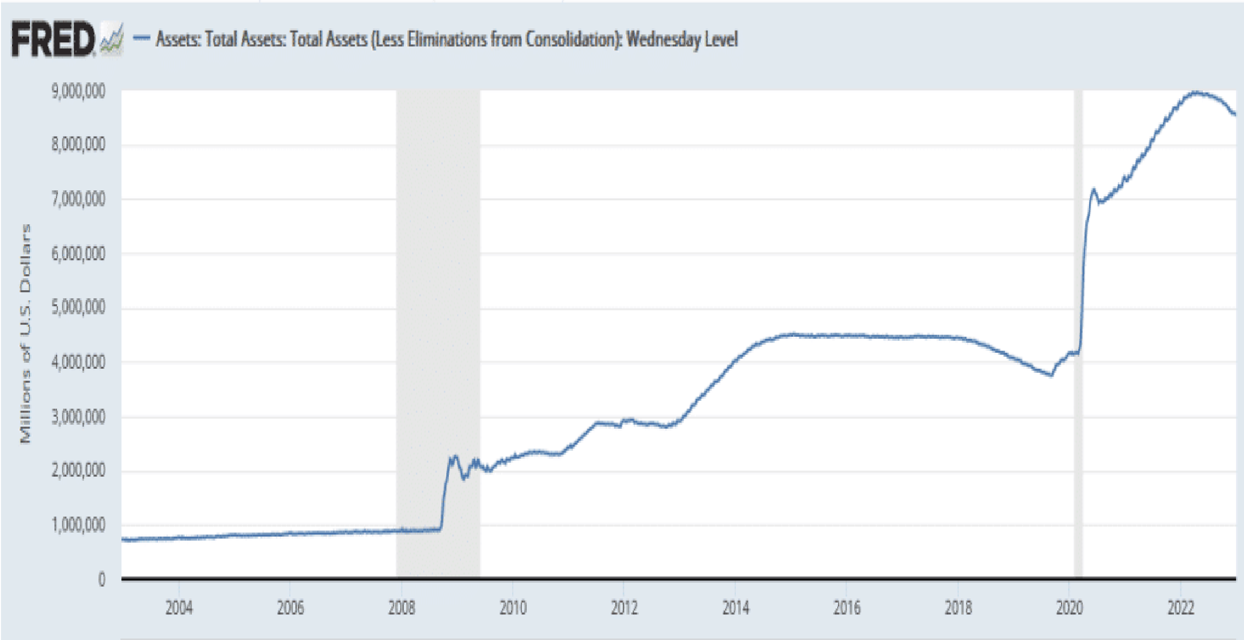
# The Elephant In The Room -QT

Entering 2023, investors seem to singularly focus on the Fed?s interest rate policy, not the elephant in the room. The media pontificates on whether the Fed should hike by 50bps or 75bps. They continually debate whether they will hold rates around 5% for the remainder of the year or when a pivot might occur. While essential topics, they are missing the massive elephant in the room, QT. The Fed is scheduled to let its balance sheet fall by $95 billion per month. QT removes liquidity from markets and, over time, creates financial instability.

The last time the Fed embarked on QT was in early 2018, it took almost a year for problems to emerge. By the summer of 2019, after about $700 billion of balance sheet reduction, hedge funds were forced to reduce leverage, resulting in funding difficulties and the Fed reversing course and doing QE and lowering rates by 75bps. Remember, that was in 2019, before the covid crisis hit.

The Fed is trying to reduce its assets by $95 billion a month, albeit coming up short most months. The Fed?s balance sheet has shrunk by under $500 billion since June. While less than 2018-2019, it is catching up quickly. Further, the Fed is not mentioning slowing or stopping QT. While rates matter, investors best not forget the elephant and the ramifications of the Fed removing significant amounts of liquidity from the financial system.

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## What To Watch Today

### Economy

- 7:00 a.m. ET: **MBA Mortgage Applications**, week ended Dec. 30
- 10:00 a.m. ET: **ISM Manufacturing**, December (48.5 expected, 49.0 prior)
- 10:00 a.m. ET: **ISM Employment**, December (48.4 prior)
- 10:00 a.m. ET: **ISM New Orders**, December (47.2 prior)
- 10:00 a.m. ET: **ISM Prices Paid**, December (42.9 expected, 43.0 prior)
- 10:00 a.m. ET: **JOLTS Job Openings**, November (10.050 million expected, 10.334 prior)
- 2:00 a.m. ET: **FOMC Meeting Minutes**, Dec. 14

**Wards Total Vehicle Sales, December** (13.40 million, 14.14 during

### Earnings

- *No notable earnings releases today.*

## Market Trading Update

That wasn?t a great way to start the New Year. Going into the market open yesterday, futures were up as much as 300 points on the Dow. However, it didn?t end well, with markets sliding lower at the open and staying lower all day. The good news, if you want to call it that, is the market did hold the uptrend from the October lows. The market looks to be trying to trace out a higher bottom which would put the downtrend line from all-time highs as the key resistance level. A break above that trend line should set the stage for a decent move higher.


TradingView

As noted yesterday, there is a lot of resistance right at 3900, where several moving averages converge. Getting above that level will be challenging without some catalyst to incite the bulls. For now, remain risk-averse until we get some clarity on where the market is headed next.

## What Can We Learn From Options Trading

The graph below shows a big difference between the positioning of institutional and retail investors. SPY options, traded mainly by individual investors, show significant bullish positioning. Conversely, institutional investors often use options on futures via SPX and have a solid bearish bias. Will the so-called smart money institutional investors (SPX) be right this time?

# Top Flow

Stocks with the most bullish or bearish options flow

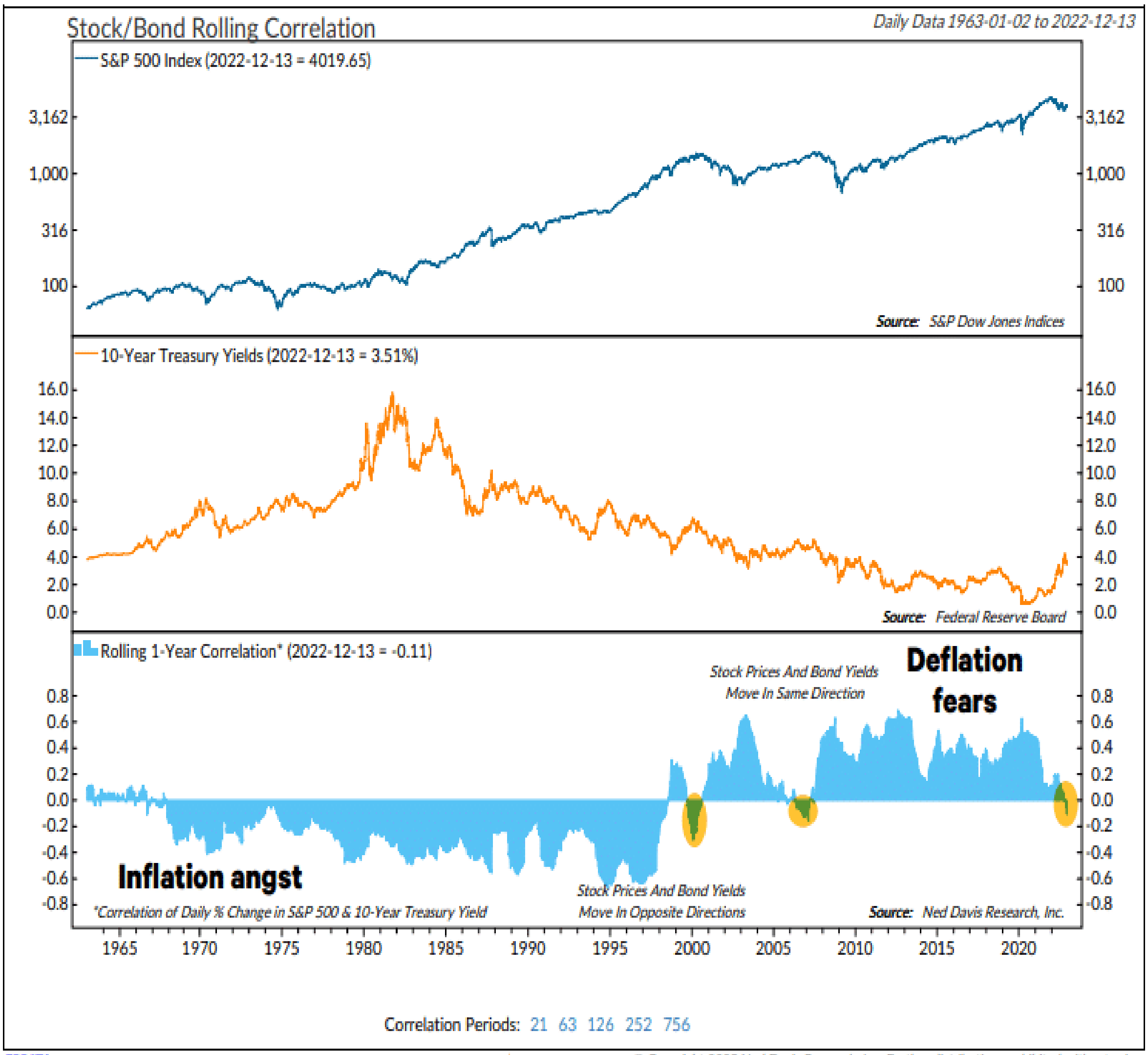

# Top Flow

## Correlation Warning

The graph below from Ned Davis Research (NDR) highlights that since 2000, the correlation between stock prices and bond yields has been positive most often. Typically during this period, stock prices trended higher and bond yields lower. However, as circled in yellow, there are a few instances where there one-year rolling correlation was negative. These proved to be warnings for the stock market. While it?s easy to conclude that the current instance may be a similar signal as in 2000 and 2007, we must remind ourselves inflation is still running hot. Unlike those periods, the Fed is not in a position to reverse its monetary policy.

The graph below shows that before 2000, inflation was a more significant market concern than deflation. The graph?s title asks if the Fed has raised rates too much, like in 2000 and 2007, or are investors truly concerned inflation will run higher than the Fed?s target for quite a while longer?

# Negative stock/bond correlation: sticky inflation or policy error?

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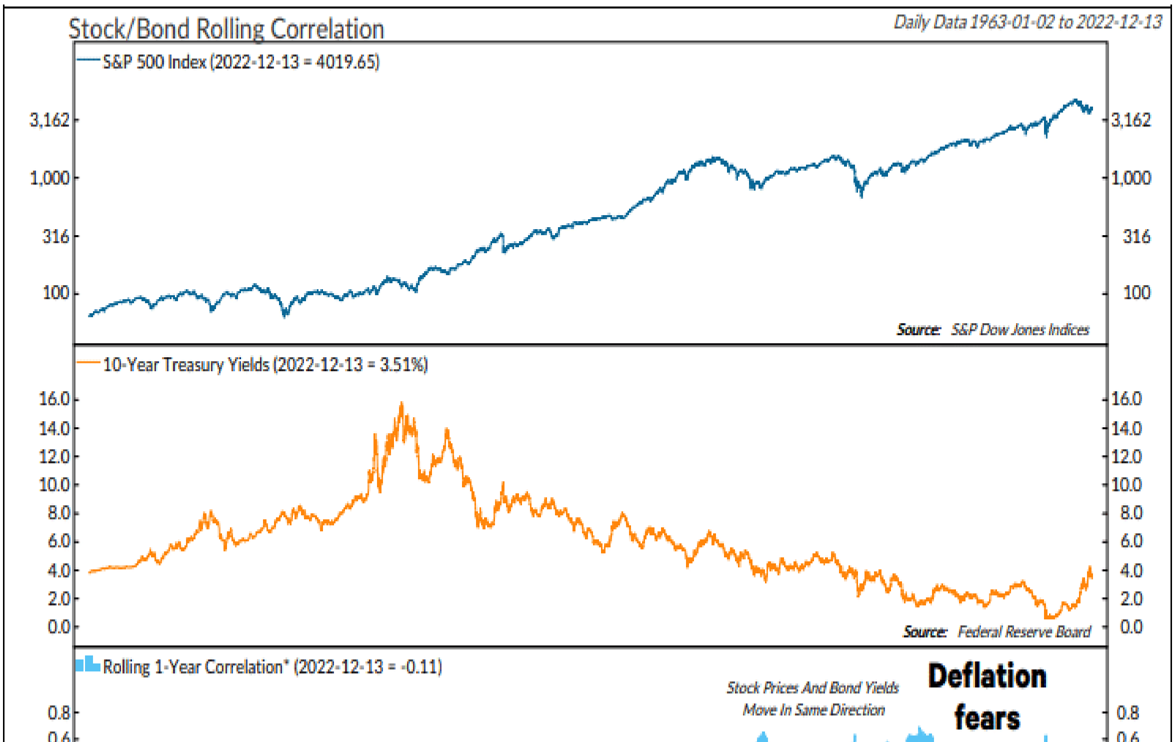
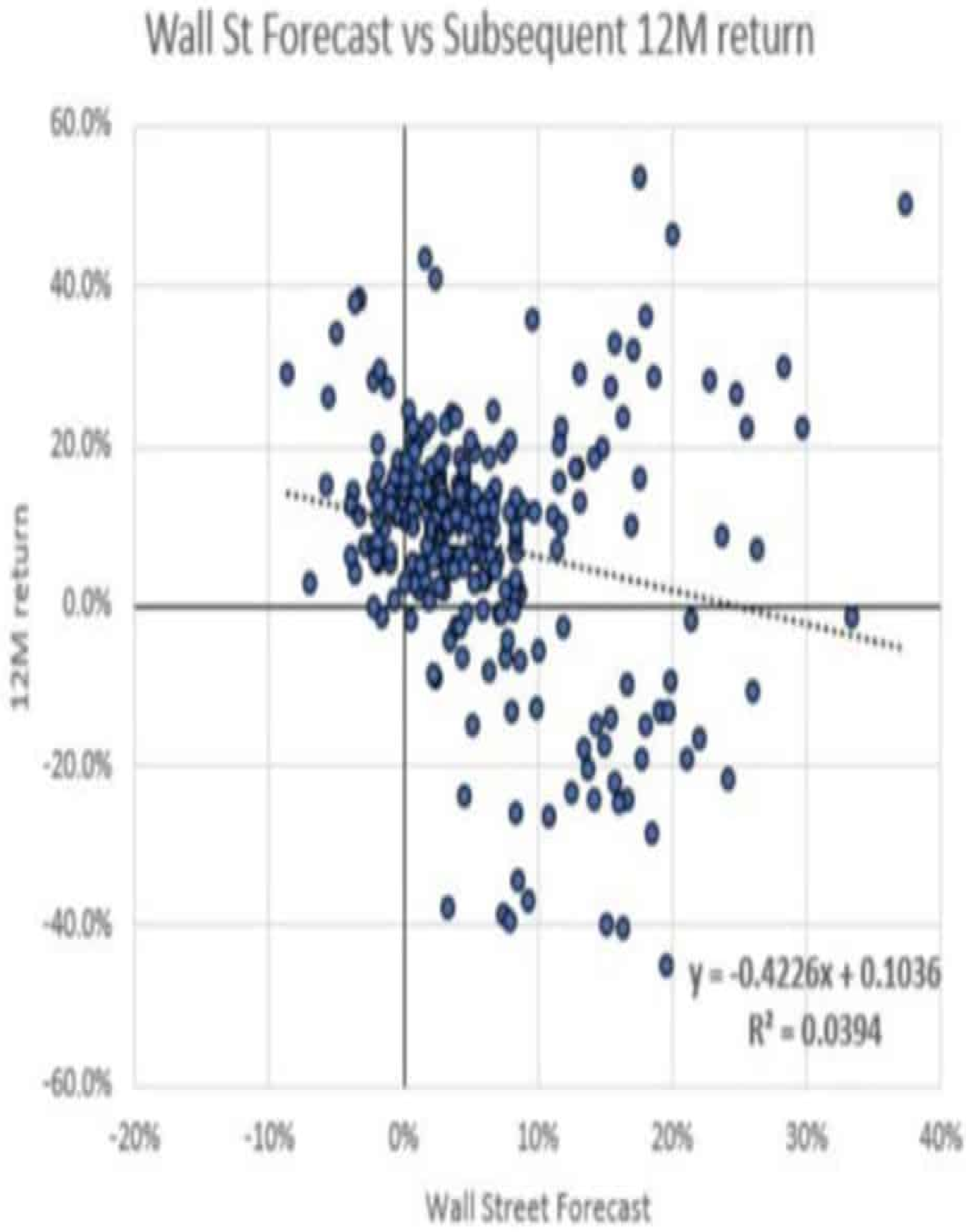
# Negative stock/bond correlation: sticky inflation or policy error?

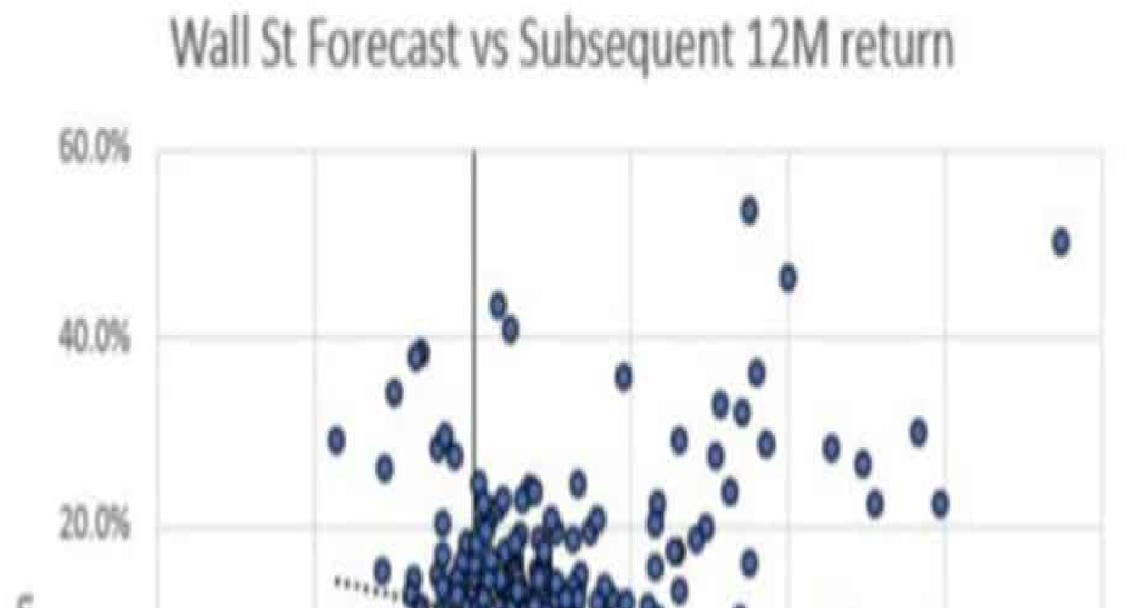


## Wall Street Predictions- Take ?em or Leave ?em?

The following analysis from @macroalf should serve as another reminder to take the latest round of 2023 Wall Street predictions with a grain of salt.

> *Your kind reminder that Wall Street massively sucks at predicting markets*
>
> The average investment bank forecast for the S&P500 price at the end of 2022 was at 5,000, *and instead, it closed 2023 well below 4,000.*
>
> *The impeccable track record of investment bank analysts below:*


Wall St Forecast vs Subsequent 12M return
60.0%
40.0%
20.0%
0.0%
-20.0%
-40.0%
-60.0%
12M return
y = -0.4226x + 0.1036
$R^2$ = 0.0394
-20%
-10%
0%
10%
20%
30%
40%
Wall Street Forecast


Wall St Forecast vs Subsequent 12M return
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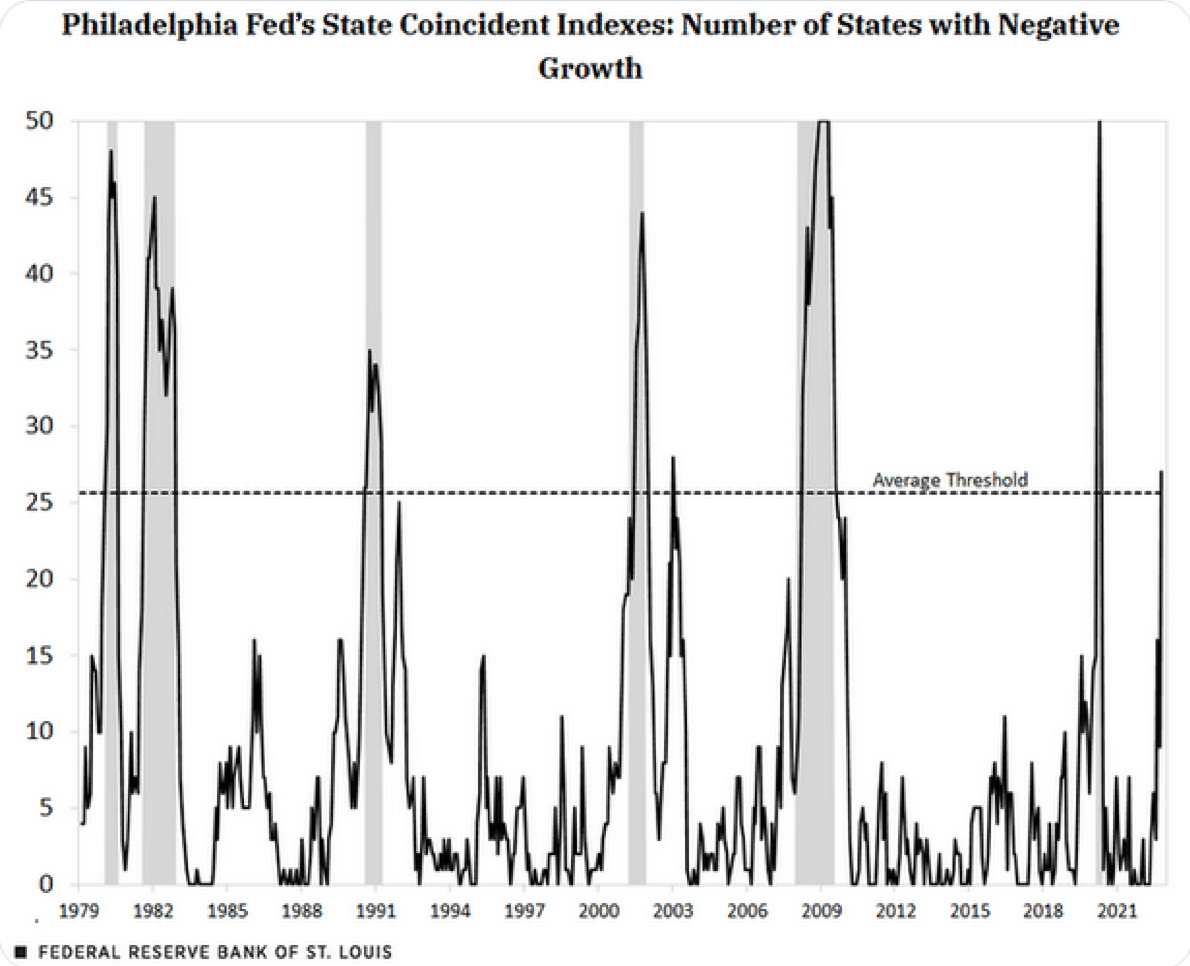
## Tweet of the Day

**True Insights**
@true_insights_

Don't shoot the messenger, but
The Federal Reserve is telling us a recession is coming over and over again!

true-insights.net

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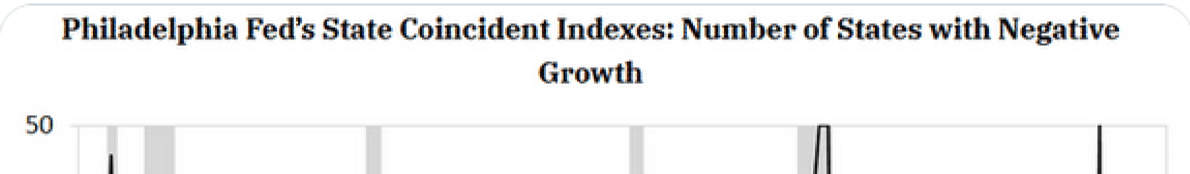

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