SuperMacro

Mirada Asset Management Limited
71-73 Shelton Street
London, WC2H 9JQ
contact@super-macro.com
www.super-macro.com

5th February 2024

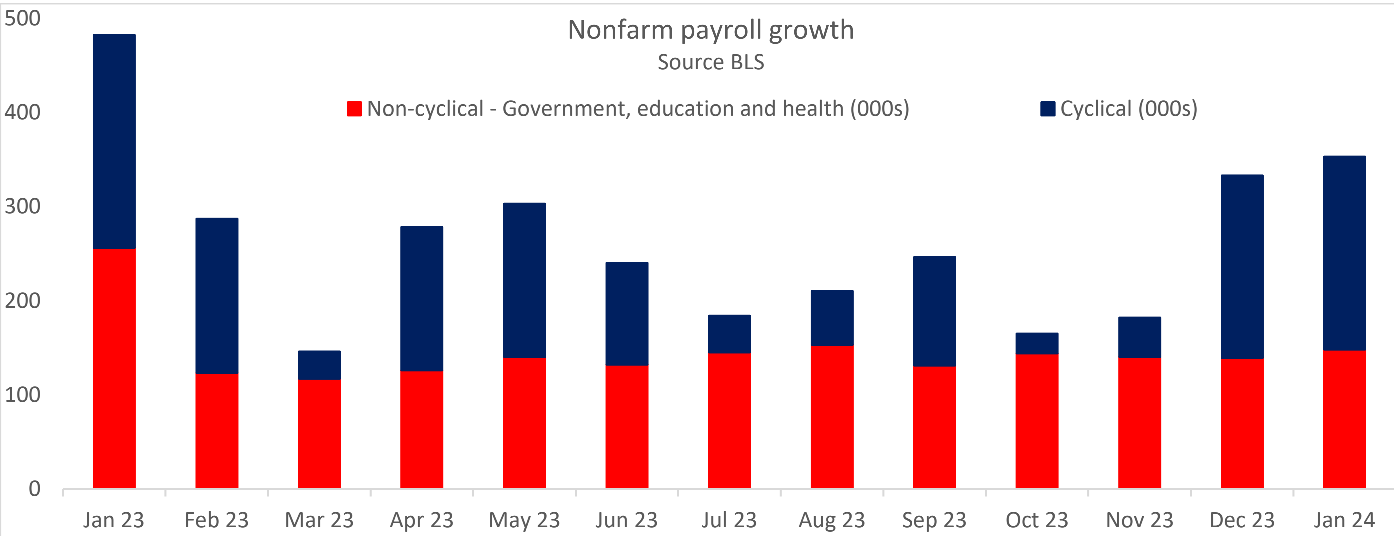
"*They have a lot of capability, I have a lot more*" – US Defence Secretary Lloyd Austin after striking Iran-backed militias in Syria and Iraq

Fixed income investors brushed aside the hints of economic resilience throughout most of last week, with many traders convinced economies can only stay afloat with central bank stimulus. Until Friday's US employment data blew past every analyst's estimate of pay growth and job gains in the Bloomberg survey. Evidence of labour market resilience was not confined to the US, with European unemployment remaining at a record low in December, while stubbornly elevated services inflation bore the hallmarks of high wage growth.

Analysts suffering from recency bias still believe the neutral rate of interest is pinned to the floor, but the economic landscape has changed, and economies are fine with policy that looks tight only by comparison to the post-GFC decade. Cutting rates to prevent the real rate from increasing as inflation declines runs the risk of reigniting the problem, and there was little in last week's data that suggested any need for it. Naturally there are plenty who disagree, but we are now in season 9 of "the oncoming recession" and the script is getting repetitive.

US

US nonfarm payroll growth of 353K in January was roughly double the estimated 185K, and the prior month's increase was revised more than 100K higher. The private sector accounted for 317K of the job gains, with broad job growth among industry sectors. Importantly, after a few months with non-cyclical sectors accounting for most of the job gains, January's growth in cyclical sector jobs was the highest in a year, following a strong December.



Growth in average hourly earnings of .6% was also double the estimated amount, bringing year over year growth from an upward revised 4.3% pace to 4.5%. The figure was skewed higher by a sharp drop in the

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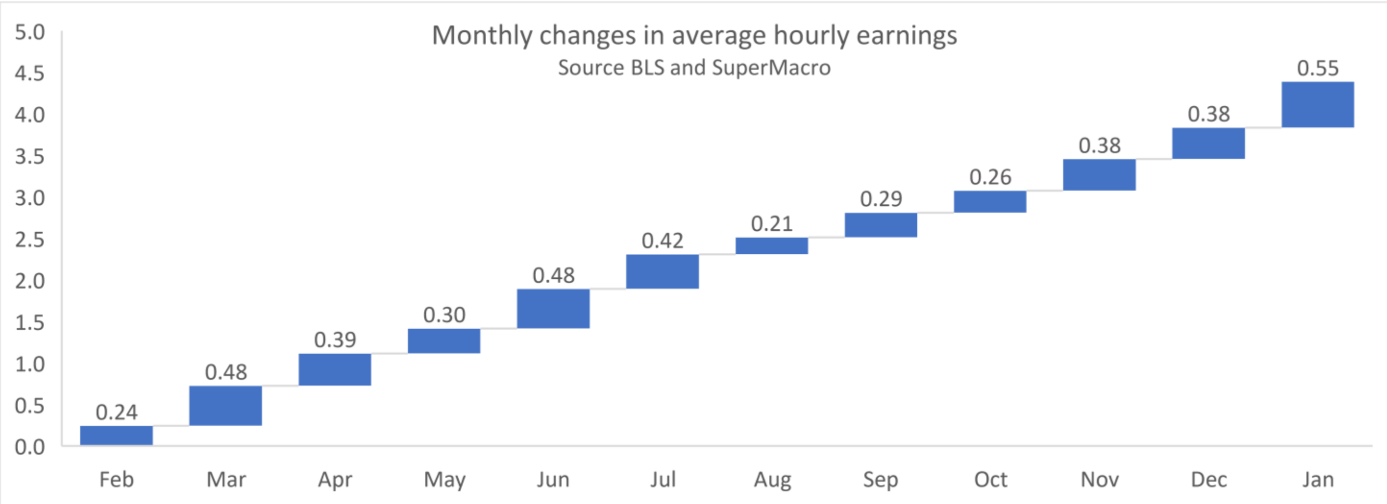
number of hours worked to a four-year low of 34.1, as bad weather in the reference week led to a sharp rise in absences and total weekly pay was unchanged (hours worked * average hourly pay).

Leaving aside the distortion in hourly pay in January, monthly pay increases have been accelerating after a soft patch in the Autumn, and the annualised rate of pay growth has jumped to 5.4% over the past 3 months.



The annual benchmarking of the Establishment survey – which takes unemployment insurance records from the tax system to make a comprehensive revision to the past year's data – resulted in last year's average monthly job gains being revised up from 225K to 255K. In addition, the Census Bureau made its annual update of population estimates, throwing a wrench in the Household Survey calculation of January's changes in the number employed and the workforce size. The revised estimates showed a 31K decline in the number of people employed in January compared with December, and 175K fall in the size of the labour force, leaving the unemployment rate unchanged at 3.7%.

Analysts can always torture the data enough to support a theory of collapsing labour demand, but the three-month average rate of job growth has accelerated from a low of 211K in August to 289K – the highest since last April.

Aside from payrolls, the footprints of a resilient labour market were found in many of last week's other economic releases. Job openings in December's JOLTS survey were above 9m, those saying jobs were "*hard to get*" in the Conference Board's consumer survey fell to the lowest in 2 years, and compensation plans in the January NFIB survey were the highest since last May.

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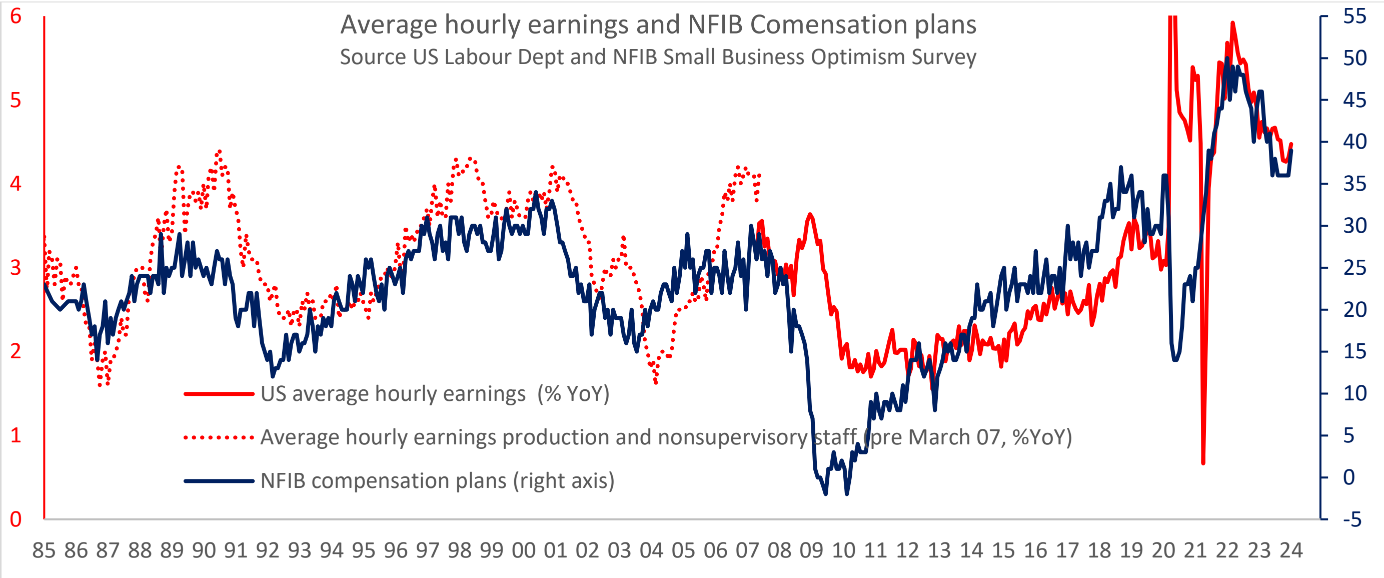
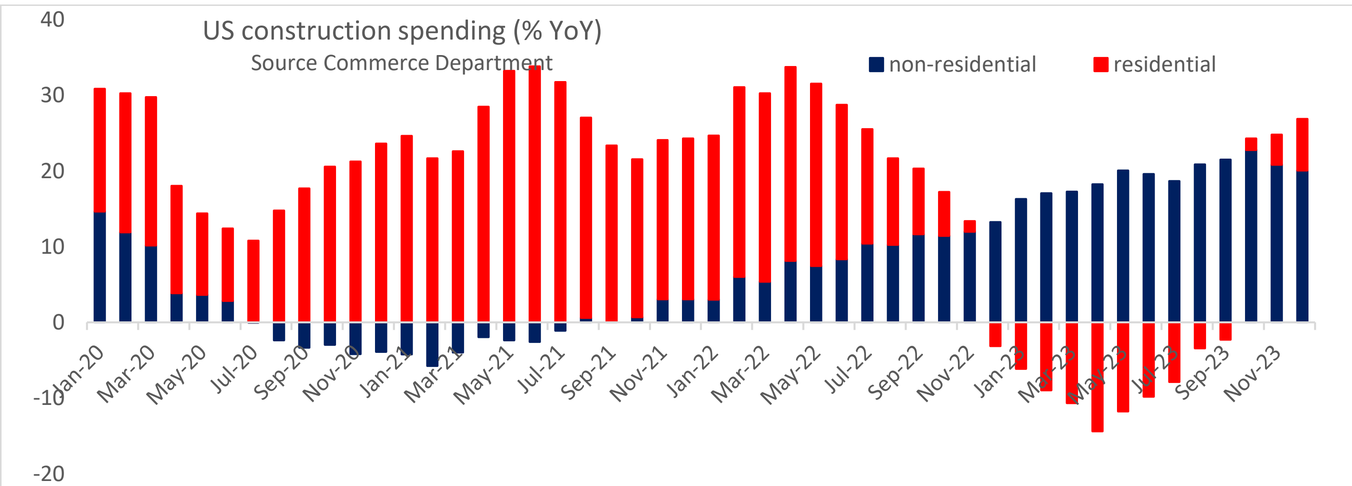


Other economic reports last week echoed the strength in the labour data, and even without taking account of Friday's payroll print, the Atlanta Fed GDPNow estimate for Q1 was lifted to 4.2% The manufacturing ISM index jumped 2 points with the New Orders component at the highest in almost two years, confirming the signal from the prior week's S&P PMI which was revised higher. S&P noted that manufacturing optimism was "*the highest since early 2022*" with new orders "*rising at a pace not seen for a year and a half*".

Construction spending - which is one of the most rate-sensitive sectors - made a solid monthly gain of .9% in December following a similar-sized gain in November, with non-residential spending supported by fiscal policy, while soaring builders' confidence and ongoing housing demand has lifted growth in residential construction.



During Powell's press conference after Wednesday's FOMC meeting, he acknowledged that "*in theory, real rates go up as inflation comes down*" but he warned "*that doesn't mean we can mechanically adjust policy*". Powel made clear the Fed looks at "*more than just the fed funds rate*" – officials also "*look broadly*

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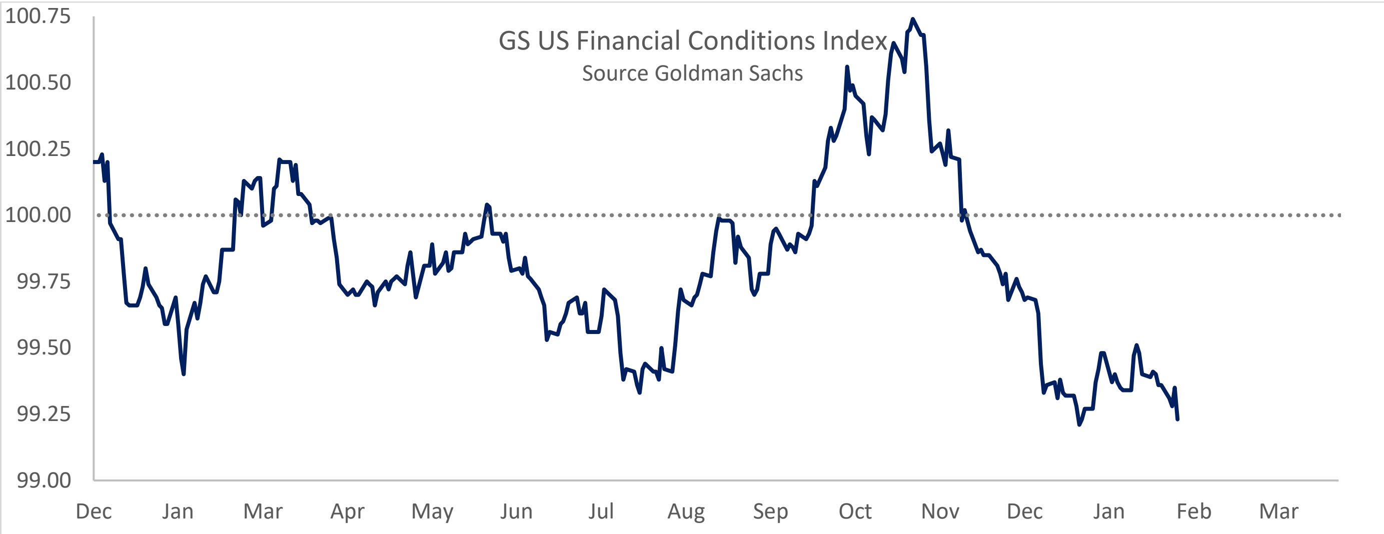
at financial conditions". ***On that basis and with the Goldman Sachs FCI showing financial conditions have already eased by the equivalent of 75bps of rate cuts, the Fed can safely sit on its hands for many more months.***



Speaking after the employment data on Friday, Fed Governor Michelle Bowman said that reducing the policy rate too soon "*could result in requiring further future policy rate increases*" to get inflation back to target, while the most dovish Committee member – Chicago Fed President Austan Goolsbee - claimed the drop in hours worked showed labour market strength "*wasn't as strong as that headline number suggested*".

EU

The eurozone dodged a technical recession in Q4 and although growth was flat, it was far higher than many of the worst predictions. Growth in Italy and particularly Spain, was much faster than expected and both countries look set to maintain the outperformance in January, with manufacturing PMIs that were 3 points higher than December and more than a point above expectations.

The industrial performance of France and Germany has been dismal over the past year, but France on Friday reported a 1.2% monthly increase in December manufacturing production that was six times stronger than estimated, adding to signs of an end to the global manufacturing slump.

Record low unemployment, high rates of pay growth and inflation that was above estimates at the core and headline levels in January put the final nail in the coffin of a March ECB rate cut. Services inflation ticked higher in France and Germany and has been stuck at 4% in the eurozone for the past three months. Headline inflation will likely continue to undershoot the ECB forecast, but the hawks' obsession with wage growth will throw obstacles in the way of any immediate easing.

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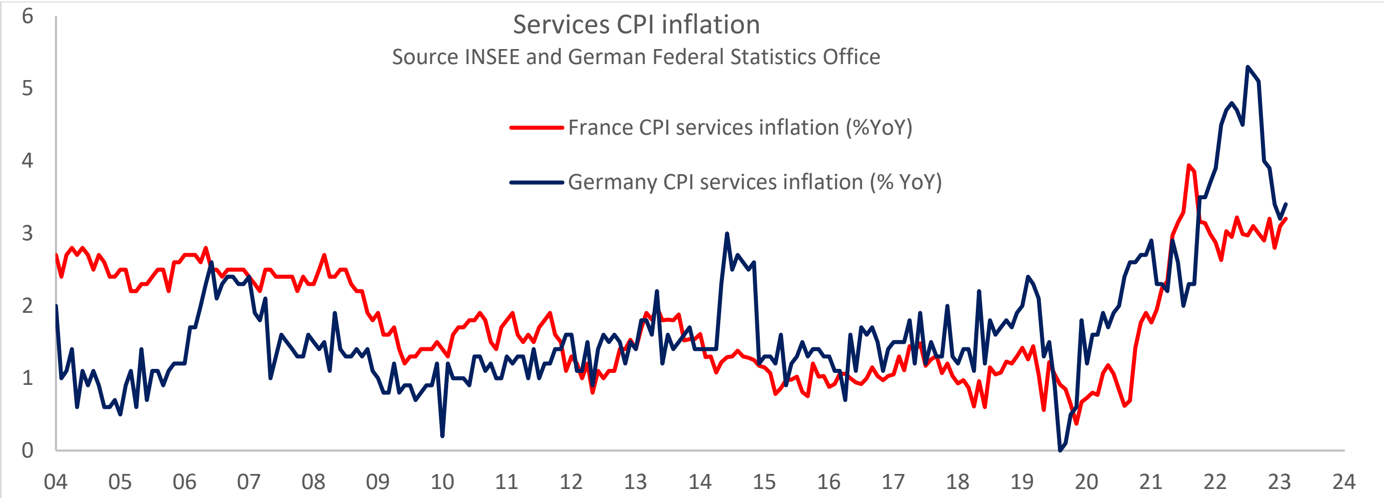

UK

The BoE left its Bank Rate unchanged but with core inflation still 2½ times its target and headline inflation expected to remain "*above target over nearly all the remainder of the forecast period*", it had little choice. It was a light week for UK data, but Nationwide reported its house price index unexpectedly jumped .7% in January, bringing the year over year decline to just -.2% from -1.8% in December. If BoE rate hikes have failed to halt house price inflation, despite UK mortgages typically having only a short-term fix – it is unlikely they will bring the rest of the economy to its knees.

China

China's official manufacturing and non-manufacturing PMIs and the Caixin services PMI were all around the 50-level in January and roughly as expected, suggesting the economy is muddling through. Growth is still being held back by the collapsing real estate sector, but authorities are reluctant to fire the kind of fiscal bazooka that followed the GFC and the 2015 currency devaluation. Officials are balancing the need to prevent a complete meltdown with the drive for "common prosperity" - which rules out reflating asset bubbles - leaving a piecemeal stimulus approach as the chosen solution.

Hong Kong's winding up order for Evergrande and the suspension of its stock and dollar bonds were more symbolic than catastrophic, but the H-share China Enterprises index resumed is southbound journey towards the 14-year low touched in October 2022. China may be following the well-trodden path of other Asian economies such as South Korea, Taiwan and Japan, with double digit rates of growth when the country industrialised giving way to a more pedestrian pace once the growth sprint exhausts itself.

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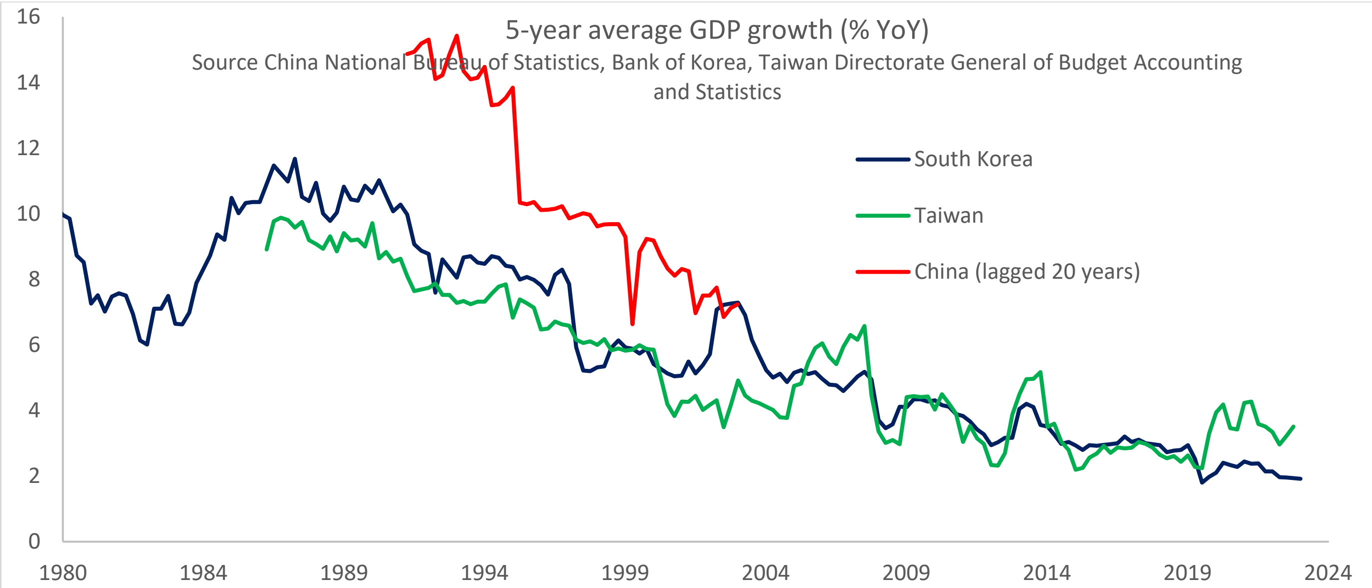
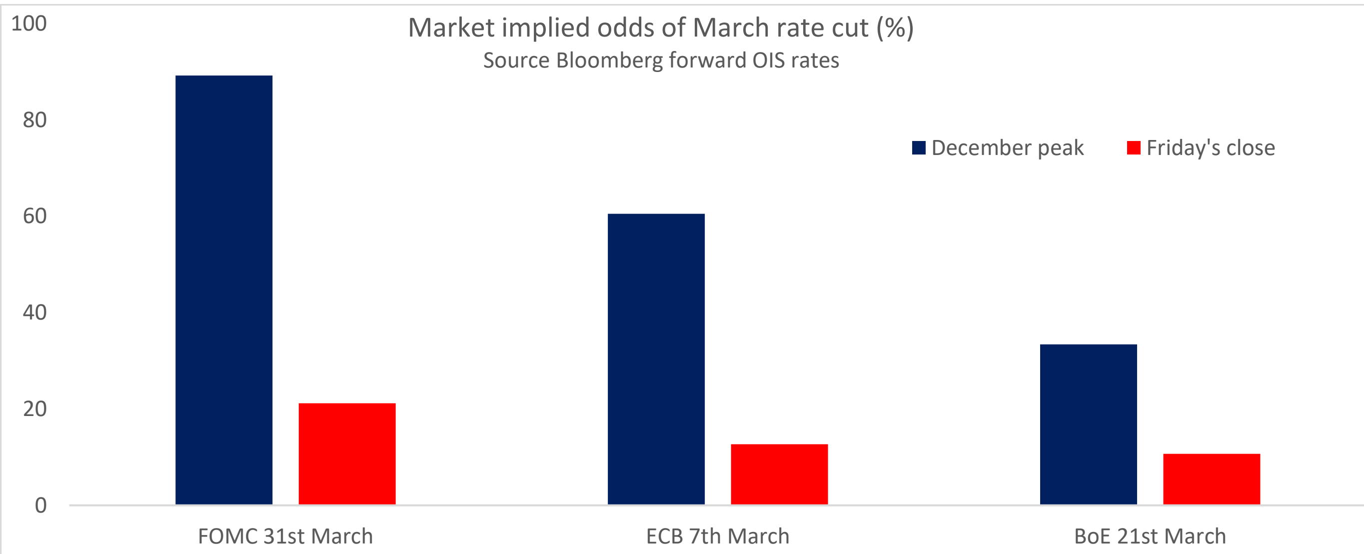


Markets

March rate cut hopes are now on life-support, with the market-implied percentage probabilities for the ECB and BoE falling close to single figures, while the probability of a March FOMC cut is down to 20% after previously being a near certainty at the end of last year. March SOFR futures printed a record volume 1.4m contracts on the day of the Fed meeting, with open interest plunging as traders with long positions threw in the towel.



The rate cut expectations were not abandoned – simply postponed – and despite the rise in short-term rates, longer tenor yields ended the week lower. The ten-year treasury yield hit a midweek low of 3.81% before Friday's payroll print stopped the rally in its tracks, with the futures plunging 1¼ points – the biggest daily decline since the March contract was listed last June.

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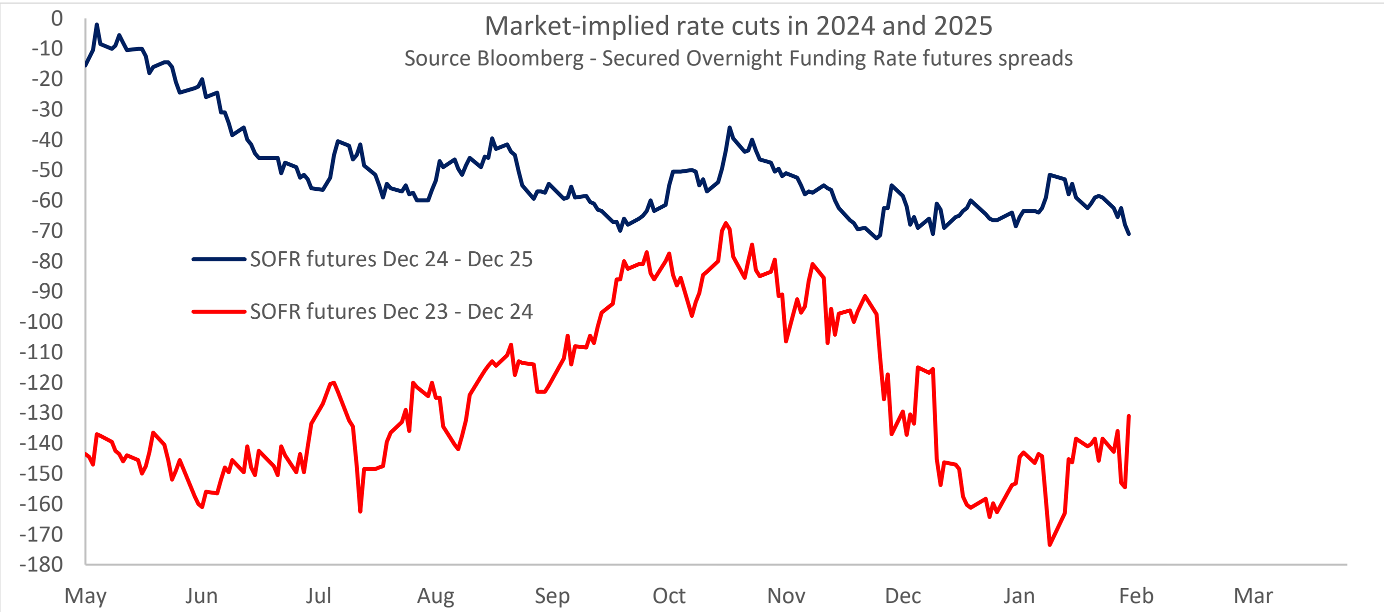
Some of this year's expected US rate cuts were just pushed into next year as the Dec 23/Dec 24 SOFR futures spread tightened 8bps to 131bps while the Dec 24/Dec 25 spread widened from 59bps to 71bps.



Last week's SuperMacro warned of the event risk in the week ahead and highlighted the low level of S&P 500 implied volatility. On the same day the FOMC helped crush rate cut expectations, the regional banks unexpectedly found another banana skin to skid on. After the most volatile week for the S&P 500 since last May (realised 5-day volatility was 21%), the index still managed a 1.4% weekly gain for another record high close. Earnings announcements from Alphabet and Apple led to a combined $243bn loss in market cap that was offset by a near $200bn increase for Meta and $140bn for Amazon.

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		price change last week	Mkt Cap ($b) 02-Feb	mkt cap change ($bn)
META US	META PLATFORMS INC-CLASS A	20.5%	1,211	198
AMZN US	AMAZON.COM INC	8.0%	1,785	140
MSFT US	MICROSOFT CORP	1.8%	3,056	53
MA US	MASTERCARD INC - A	5.0%	430	19
UPS US	UNITED PARCEL SERVICE-CL B	-11.0%	121	-15
AAPL US	APPLE INC	-3.4%	2,870	-105
GOOGL US	ALPHABET INC-CL A	-6.4%	1,777	-137

In Europe, there was a similar dispersion in price reaction following earnings from the larger banks. Spanish economic health was reflected in solid results from BBVA and Santander while even Deutsche Bank shares rallied, despite the much higher than expected CRE loss reserves. However, disappointing earnings from BNP and ING’s warning of lower interest income ended up dragging the pan-European banks index .2% lower on the week.

ticker	name	price change last week	Mkt cap change ($m)
BBVA SQ	BANCO BILBAO VIZCAYA ARGENTA	10.8%	5,479
SAN SQ	BANCO SANTANDER SA	6.3%	4,033
DBK GY	DEUTSCHE BANK AG-REGISTERED	6.2%	1,642
INGA NA	ING GROEP NV	-7.0%	-3,479
BNP FP	BNP PARIBAS	-10.4%	-8,034

The SuperMacro portfolio has a small exposure to the sector, but the P&L is dwarfed by the rates trades. Despite disappointment from a couple of bad apples, the low valuations and high capital ratios should keep confidence in the sector intact, and for now we will keep the faith.

US equity investors seem convinced that rate cuts will come without slower economic growth depressing earnings, and the S&P 500 has notched up 13 weeks of gains in the past fourteen. This upward momentum kept implied volatility low, but last week’s mid-week meltdown in the KRE provides a reminder that risks of a pullback are increasing. There are two obvious ways of protecting a long position – with out-the-money puts or with a collar that sells upside calls to finance the put purchase – as adopted by the JP Morgan Hedged Equity fund (JHEQX). The chart below shows the relative performance of these strategies compared with an outright long in the S&P 500.

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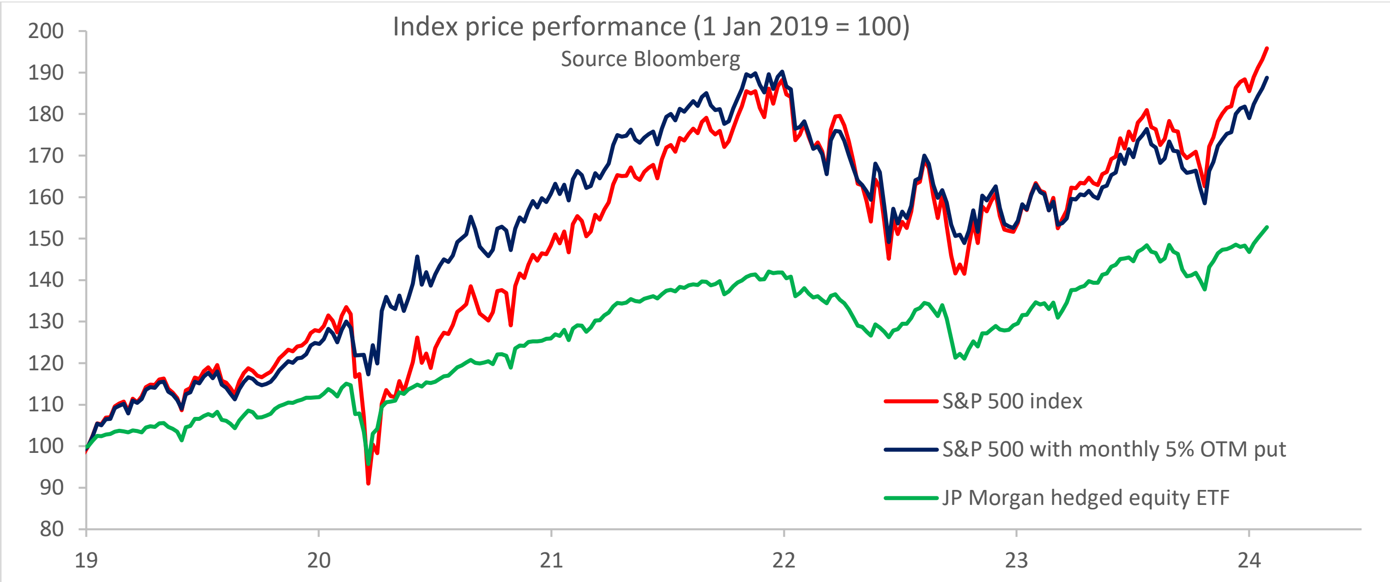

Implied volatility is too low to make it worthwhile selling options that limit the upside performance of the JHEQX, which has underperformed significantly over the past five years. The 5% OTM puts provided valuable protection during the pandemic and more than 25% outperformance at the time, with only a marginal drag on performance recently.

Portfolio Update

In last week's portfolio update we said we would protect the short position in treasury futures with upside calls, but the price ran higher from Monday's open. The midweek drawdown as rates declined was painful and although we prefer highlighting the trades in advance, we used Friday's pullback to buy a risk reversal (112 call/111 put) expiring this Friday to protect the whole position.

We had already taken profits on two-thirds of the March SOFR futures and will leave the balance to cash out on settlement in June. For the Dec 23/ dec 24 futures spread, we are targeting 100bps or four 25bp rate cuts this year.

The S&P 500 put spread finished was out the money even after paying another 4 ticks to roll the upper strike higher but we are not deterred and will but another put spread expiring this Friday – some like the 4900/4825 for around 8 ticks for a payout of over 9X.

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Live Positions		notional	trade	trade		yr end pric	current price	
Description	code	/capital	date	price	closed	29-Dec	02-Feb	P/L YTD
Stoxx 600 Banks ETF	SX7PEX	0.5	20-Nov-23	15.98		16.66	16.57	-0.26%
SOFR Z3/Z4 futures spread	SFRZ3Z4	10 ticks = .5%	04-Dec-23	-1.35		-1.628	-1.310	1.59%
GBPUSD 4th March $1.30 call		1.0	04-Dec-23	0.52%		0.49%	0.22%	-0.30%
SOFR March futures	SFRH4 (	10 ticks = .5%	15-Jan-24	94.985			94.800	0.93%
Treasury futures	TYH4 Cc	-1.5	15-Jan-24	112 13/32			111 21/32	1.00%
S&P 500 Feb 2nd 4825/4650 PS				11			0	-0.48%
Feb 9th TY 112 call/111 put		1.5	02-Feb-24	3/64			3/32	0.06%

Live positions P/L	**2.54%**
Closed trades	1.83%
TOTAL YTD	**4.37%**

The week's macro agenda

Monday 5th February
China Caixin services PMI January
Italy and Spain services PMIs January, Germany trade balance December, eurozone Sentix investor confidence February, PPI December
UK Labour Force Survey September to November 2023 - revised methodology, new car registrations January
US ISM services PMI January, Senior Loan Officer Opinion Survey Q4

Tuesday 6th
Japan labour cash earnings December
RBA rate decision
UK BRC retail sales January
Eurozone retail sales December, Germany factory orders December, Italy economic sentiment and consumer confidence January

Weds 7th
Germany industrial production December, Italy retail sales December
US trade balance December, weekly MBA mortgage applications

Thurs 8th
China CPI and PPI January
UK RICS house price balance January
US weekly initial and continuing claims

Friday 2nd

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Italy industrial production December