Larry Cheung, CFA: Patreon Investment Community Research Updates
October 2nd Half Strategy Report (10.16.22-10.30.22)

Title & Thesis: We are still fundamentally in "Lower Lows, Lower Highs" market structure until the Fed pauses rates. That being said, I see an opening for Bulls to squeeze Bears IF Republicans can take the House AND Senate away from Democrats in the Midterms elections on November 16th. There is significant bearishness in the market, and although I'm also fundamentally negative on equities, I believe there may be tactical opportunities for the markets to bounce significantly. That being said, until the Fed changes their tone and inflation data improves, significant market bounces MUST be used as a window to reduce risk and raise cash. This continues to be a highly uncertain environment.

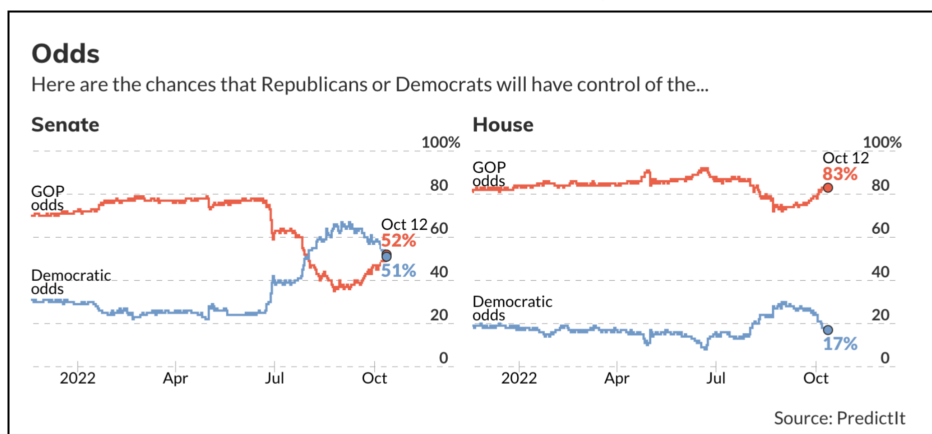
For context, please make sure to read my previous updates leading up to this one so that you understand my thought process.

Conclusions of October Mid-Month Update (Read below for research and process)

- **On Inflation:** At this point, I believe that Inflation has peaked (9.1% was peak). There is evidence to suggest that the current environment makes it nearly impossible for real-time Housing values or New/Used Car values to continue to increase. Therefore, these components will later serve as downward pressure factors to bring down CPI in 2023. Core Inflation is going higher, but an extremely large component of Core Inflation is the Housing segment (which is lagging indicator). Real-time rents and housing values are falling and this will be reflected in the Core Inflation index by 1H 2023. Patience will be key to allow for the reported data to reflect that Inflation is moving in the right direction.
- **On Rates:** I believe that the Fed does not have the political willpower to raise the Fed Funds Rates much past 5%. There is much commentary that the Fed will raise rates well beyond their stated policy rate in 2023 (and perhaps match the CPI rate). I do not believe this will be the case with the U.S. Federal Deficit being so large. Of course, it will take approximately 1-3 quarters to change the tone, but we are closer to a pause in rates with the 2Y Yield now at 4.5% (inside the 2023 Fed Funds Rates Target Range of 4.5%-5%).
- **On Politics:** A Republican win for the House AND Senate could be **very supportive** for the U.S. Equity Bulls. This will be discussed below.
- **On Semis:** US-China relationships are souring more quickly than I have anticipated (even with a defensive & proactive mindset). I believe Investors should take any significant strength

in Semis that rely on China to reduce exposure to the rallies. My Patreon Post published to you on 10.10.22 regarding Export Bans discusses this in detail.

- **On China-Related Companies:** Companies that have large supply chain operations in China or rely heavily on China should be positioned more lightly than other aspects of the portfolio
- **On China Internet:** While I am still bullish on China (at these levels or lower) because of its depressed valuations, I also believe Investors should take any 30-50% gains from today's levels to reposition into other best ideas. The geopolitical relationship between the U.S. and China is proving to be extraordinarily unpredictable, and as a result, I believe the risk premium in this sector is not something that will allow the sector to return to all-time highs. Alibaba should be able to reclaim a 13-15X Forward Multiple (currently 10X Forward), which is equivalent to about ~110-120/share anytime from now to end of 2023, but I do not believe the Street will allow Alibaba to be priced at a premium compared to the S&P 500 as long as the key policies of Zero Covid is in place and the Chinese Property Market is still sluggish.
- **On the S&P 500:** "Lower Lows, Lower Highs" structure is still in place. Major market rallies are obviously positive and a nice welcome for our community, but I would suggest using 250-400 SPX point rallies as an opportunity to raise cash. Until the 2Y stops rising (which pressures valuations lower), the S&P 500's rally durability will be in question. Fundamentally speaking, higher rates will be a large burden on profit-less tech balance sheets, which is a substantial portion of the S&P 500. **The one key area that I believe can unleash a wave of buying interest is if Republicans take both the Senate and the House, which will gridlock Washington and give Biden far greater difficulty in his campaign to aid Ukraine**. At this moment, I personally believe the probability that the Republicans take both the Senate **AND** the House is around 40-45%, although polls show that the split is near 50/50.



More Research & Process below.

Dear Friends, Members, and Patreon Investment Community,

Welcome to another mid-month report.

The focus of this report will be assessing how to view inflation going forward, a note on the upcoming Mid-Terms, and a note on China as the 20th Party congress begins. Towards the end I'll share ETFs that I think may be suitable for this environment if you would prefer indexes compared to single-name companies. Given the many different variables that I'm following, I will produce additional intermittent Patreon Posts if necessary to help you with guidance.

I will shorten this note, make it more actionable, so that ultimately you can plan ahead with focused information. I will also make the inflation portion of this note very educational.

Let's begin.

The first half of October continues to be characterized by high-volatility, weakening sentiment towards risk-on areas (Semis/Internet/China), and restrictive macro data points (high yields, strong dollar, elevated inflation prints).

My core opinion from my October opinion continues to be the same: that we are currently in the depths of a Bear Market which has light at the end of the tunnel once the Fed begins pausing their interest rate hikes. The sharp rally and subsequent selloff that we saw post-CPI is an incredibly, incredibly important reminder that attempting to time this market from a day-to-day perspective is not something that most people should do. I have some friends (outside our Community) who placed exotic put spreads on the SPX on CPI day to bet on market carnage and they all expired worthless as the rally took out all their spread targets. Their positions were not able to take advantage of the next day's retracement and the entire position went to 0. This is a very good lesson and reminder of the value of a longer-term focus on investing.

First, let's recap what happened on CPI Day, which I think offers clues into the very fragile sentiment among both bulls and bears.

Even though the CPI print was discussed by media headlines and the initial market reaction (Dow down 500, Nasdaq down 300, SPX down 100) as negative, I am going to help you look at the situation

with a more objective lens. This trading day is perhaps one of the most important (and largest range) trading days that I've witnessed over the past 12 months.

As I shared on Twitter on CPI Day 10/13 at 10:30am, we saw the 2Y get close to 4.5% for first time in a long time, which is also the lower end of the range of the 2023 Fed Funds Target of 4.5% to 5%.

With the 2Y at the lower bound of the 2023 Fed Funds Rates Target, I do believe that the upside for yields is now around 50BPs or so with that upper end at 5% likely to be an area where yields start to pause their advances (or at least consolidate).

The implication behind this is that the bond market has tightened on behalf of the Fed. The 75BPs that we're expecting in Nov? And the 50BPs we're expecting in Dec? Yes, that is now mostly priced in.

After all, 125 BPs (1.25%) of tightening in Nov and Dec + Fed Funds Rates of 3-3.25% is 4.5%.

Remember: the Fed Funds Rates is currently 3-3.25%. The 2Y yield (which is driven by monetary policy) is now at 4.5%. This means that all of the tightening (and a bit more) of the 125BPs left this year has been priced in.

My conclusion is that the 2Y is now within a range where the interest rate that the U.S. has to pay on interest is going to become dangerously high for the U.S. Government.

I reiterate my opinion that after my reading of the September CPI, yields will most likely peak **within** the next 3 quarters. I view an eventual CPI in the **6% region** is enough to make the Fed pause rates.

The 2023 Fed Funds Target is 4.5%-5%, which makes borrowing from the U.S Government standpoint very expensive. To make expectations clear, based on my readings of Fed Speeches, I believe the minimum number of months where they need to see inflation progress is 3 months of official CPI data well below 8% before changing their tone. That is an absolute minimum, based on the word choice I observe.

One month will not change the Fed's official stance, but it may inspire traders to start speculating on a 2nd good month of data and a subsequent 3rd good month of data.

As always, getting in early comes with the most risk, but also comes with the most reward.

Given that our Investment Community includes all walks of life with many friends from different ages, risk tolerances, and timeline, **I cannot afford to be too early with my investment opinions.** It is my intention to help us survive this Bear Market so that we can experience the rewards of the eventual Bull Market.

I would rather wait for confirmation (like seeing CPI under 8% at the very least) first before acting aggressively. In other words, I will do my best to give my opinion on the green light to buy stocks as soon as I see the macro situation supporting my case. But I would rather be a bit late than be too early.

What I will be looking for (reminder that these are my personal opinions of when I believe buying more stocks becomes appropriate):

- **MINIMUM** of 2 months of inflation under 8%. 3 months of inflation under 8% would be ideal because that will be the beginning of a change in the Fed's tone. If Investors do not have the patience to wait for inflation to at least go under 8%, they are taking unknown risks with their positioning. **It is the Inflation Rate that determines the future Fed Funds Rate.** I believe that by the time the Inflation rate gets to ~6%, the markets will have already priced in partially a powerful recovery. This is because headline CPI at 6% virtually assures investors that the Fed Funds Rates will not go much further than the upper range of the 2023 Fed Funds Target of 4.5-5% and that there is light at the end of the tunnel. I believe we see 6%-7% CPI around the mid-point of 2023 as the lagged effects of the shelter component of the index starts to play itself out and pressures the index lower.
- I need to see the Dollar Index stay under 110-113 and not poke back above it.
- I would like to see the most consumer discretionary parts of the market start to bounce harder than the SPX (we did not see this to be the case on CPI-Day Rally): Travel (EXPE/BKNG), Lodging (MAR), Apparel/Clothing (NKE/LULU), or mega consumer names such as AMZN

- I will need to see the 2Y Yield stabilize and stay under 5% (this is critical). If 2Y goes above 5%, the markets will be risk-off as financing costs for a significant portion of the S&P 500 becomes extremely unfavorable.
- Ideally, I want to see the Real Estate sector (VNQ ETF) and Auto Sector (F, GM, TSLA, etc) start to stabilize. This is a powerful proxy to understand 23-26% of U.S. GDP AND consumer sentiment at the same time. Housing is responsible for 18-21% of U.S. GDP and Auto is another 5% of GDP.
- The Fed uses the words “Inflation risks are Balanced”, “Inflation Risks have moderated”, or “Inflation is elevated but we are making progress”. Something that isn’t as hawkish as “Inflation is much too high” or “Inflation risks are tilted to the upside.”

Let’s dive into the recent inflation report to see if the Fed’s policies are working. Focus on the “Sept 2022” column and the last column called “12-months ended Sept 2022” for the year-over-year figures.

	Seasonally adjusted changes from preceding month							Un-adjusted 12-mos. ended Sep. 2022
	Mar. 2022	Apr. 2022	May 2022	Jun. 2022	Jul. 2022	Aug. 2022	Sep. 2022	
All items	1.2	0.3	1.0	1.3	0.0	0.1	0.4	8.2
Food	1.0	0.9	1.2	1.0	1.1	0.8	0.8	11.2
Food at home	1.5	1.0	1.4	1.0	1.3	0.7	0.7	13.0
Food away from home(1)	0.3	0.6	0.7	0.9	0.7	0.9	0.9	8.5
Energy	11.0	-2.7	3.9	7.5	-4.6	-5.0	-2.1	19.8
Energy commodities	18.1	-5.4	4.5	10.4	-7.6	-10.1	-4.7	19.7
Gasoline (all types)	18.3	-6.1	4.1	11.2	-7.7	-10.6	-4.9	18.2
Fuel oil(1)	22.3	2.7	16.9	-1.2	-11.0	-5.9	-2.7	58.1
Energy services	1.8	1.3	3.0	3.5	0.1	2.1	1.1	19.8
Electricity	2.2	0.7	1.3	1.7	1.6	1.5	0.4	15.5
Utility (piped) gas service	0.6	3.1	8.0	8.2	-3.6	3.5	2.9	33.1
All items less food and energy	0.3	0.6	0.6	0.7	0.3	0.6	0.6	6.6
Commodities less food and energy commodities	-0.4	0.2	0.7	0.8	0.2	0.5	0.0	6.6
New vehicles	0.2	1.1	1.0	0.7	0.6	0.8	0.7	9.4
Used cars and trucks	-3.8	-0.4	1.8	1.6	-0.4	-0.1	-1.1	7.2
Apparel	0.6	-0.8	0.7	0.8	-0.1	0.2	-0.3	5.5
Medical care commodities(1)	0.2	0.1	0.3	0.4	0.6	0.2	-0.1	3.7
Services less energy services	0.6	0.7	0.6	0.7	0.4	0.6	0.8	6.7
Shelter	0.5	0.5	0.6	0.6	0.5	0.7	0.7	6.6
Transportation services	2.0	3.1	1.3	2.1	-0.5	0.5	1.9	14.6
Medical care services	0.6	0.5	0.4	0.7	0.4	0.8	1.0	6.5

Table of September CPI (Bureau of Labor Statistics)

From now on, it will be impeccably important to know how to read this table above which breaks down the components within CPI. Spend some time this weekend (or coming days) to understand how to assess the major components of this table, and you will turn yourself into a more knowledgeable person on inflation than the typical macroeconomic analyst. I will help you do this with the following guide below (made as easy to understand as possible)

Here is a broad overview of how I am tracking the components within CPI to get an edge for my Community (you). This is the same methodology that I used to make a projection that the Used Car/New Car component is coming down, which it did in September CPI (down -1.1%)

A Powerful Guide to Understanding CPI like Buyside Investors

CPI Categories by Weight, August 2022

Group	Weight
Housing	32.2%
Commodities	21.2%
Food	13.5%
Energy	8.8%
Education	7.6%
Health Care	6.8%
Transportation	5.9%
Other Expenses	4.0%
Total Expenses	**100%**

- **On Housing:**
  - Note: Understand that this indicator is a lagging indicator based on my education piece on Owners-Equivalent-Rent (OER) discussed in my previous October strategy report. The way to assess Housing in real time is to understand the single-family rents market, which is moderating their price appreciation significantly. This WILL show up in the CPI index within 6 months as market-value for rents start to get reflected in the index.
  - Macro Data Points (top-down): Case-Shiller home Price Index, Core Logic Price Index, Construction Data, New Home Sales, Mortgage Applications
  - Equity Research (bottom-up): Earnings data / corporate news from Home Depot, Vanguard VNQ REIT ETF, Home Builders ETF (XHB ETF).
- **On Autos:**
  - Macro Data Points: New car vehicle sales (Manheim), used car vehicle index (Manheim), Steel/Rubber/Plastics/Aluminum Commodity prices (Input costs for cars)
  - Equity Research (bottom-up): Carmax (proxy for used cars), AutoNation, Ford, GM, Tesla (high-end consumers pricing proxy)

- **On Food:**
  - Macro Data Points: Food/Wheat/Poultry/Fertilizer prices
  - Equity Research: Kroger for the "**Food <u>at</u> Home"** CPI Component. Follow the restaurant stocks such as McDonalds, Darden Restaurants, Yum Brands, and Texas Roadhouse, and Restaurant Brand International (owner of Burger King, Popeyes, Tim Horton, and Firehouse Subs) for the **"Food <u>Away</u> from Home"** component
- **On Energy:**
  - Macro Data Points: The evolving relationship between the U.S. and the Middle East/Russia. The usage of the U.S Special Petroleum Reserves.
  - Equity Research: How Warren Buffet views Energy via Berkshire Hathaway (BRK.B). Because I'm a tech/consumer analyst, I yield to Warren Buffet as to how he views energy incorporated with my view of markets. I'm not a sector specialist on energy but I understand the general direction
- **On Transportation:**
  - Macro Data Points: Understand Public Transportation and Private Transportation
    - Public transportation definition by Bureau of Labor Statistics: "includes fares for mass transit, buses, trains, airlines, taxis, school buses for which a fee is charged, and boats"
    - Private Transportation definition by Bureau of Labor Statistics: "purchases made by households on new and used motor vehicles; motor fuel; motor vehicle parts and equipment; motor vehicle insurance; and motor vehicle fees"
  - Equity Research for Public Transportation: Airline Stocks (American Airlines, Southwest Airlines, Delta) and Plane Ticket Fees
  - Equity Research for Private Transportation: Advance Auto Parts, GoodYear Tires, LKQ corporation, O'Reilly Auto Parts (These companies tell us the cost to upkeep motor vehicles)
- **On Medical Care Services (see appendix for more info at the end of report since Medical Care Services is not something I typically discuss):**
  - Macro Data Points: Health Insurance Rates (UnitedHealth Stock as a proxy)
  - Equity Research: Publicly traded health care providers - Examples include HCA Healthcare (HCA), Community Health Services to understand hospital services pricing.

From this information, I believe there are certain things that **have a high likelihood** to happen from here on out.

- Housing (32-35% weighting of headlineCPI) will become even **LESS** affordable as mortgage rates go higher from here and STAY at those rates for some time. Unfortunately, this part of CPI has a multi-month lag. Housing will eventually help CPI go lower.
- Auto (8-9% weighting of headline CPI) is **likely to become weaker** as consumers have to contend with higher auto loan rates AND elevated car prices
- We have 40-44% of the CPI Index constrained by the Fed's interest rate policy. The current environment makes it very difficult for the marginal consumer to buy a home or buy a used/new car. This will be beneficial for inflation in the months ahead.
- Transportation costs and Health care services costs are likely to remain sticky
- Education costs (higher education) are likely to also remain sticky.

Because Inflation is so stubbornly high, I do not believe an outright pivot (cutting rates) is likely to occur anytime soon. **However, I do believe that the Fed is getting closer and closer to pausing rates with the 2Y (now 4.5%) so close to the 2023 Fed Funds Target (4.5%-5%).** Given that the marketplace represents an assortment of views from investors, some investors may decide to front-run when that pause is likely to happen. I will wait until we see confirmation first based on the criteria laid out above. That is my plan.

This is why we are seeing such dramatic moves on the upside on certain days where macroeconomic data is released. I also want to remind our Community that an abrupt "Fed Pivot" to cut rates may not necessarily be good for the market. If S&P 500 earnings are plummeting and the unemployment rate soars to 8-10%, the Fed cutting rates by 50BPs/75BPs/100BPs will not meaningfully help the economy by that much. **Back during COVID in March 2020, it was NOT the Fed cutting rates to 0% that made the market rebound.**

It was the tremendous QE program ADDED with the immense Fiscal Stimulus (stimulus checks for all) that was provided that made the market rebound possible.

Thinking that cutting rates to 0% was the reason the market made the remarkable recovery it did is a mistake. For the average consumer, cutting rates to 0% doesn't benefit that much while raising rates to 5% hurts them quite a lot.

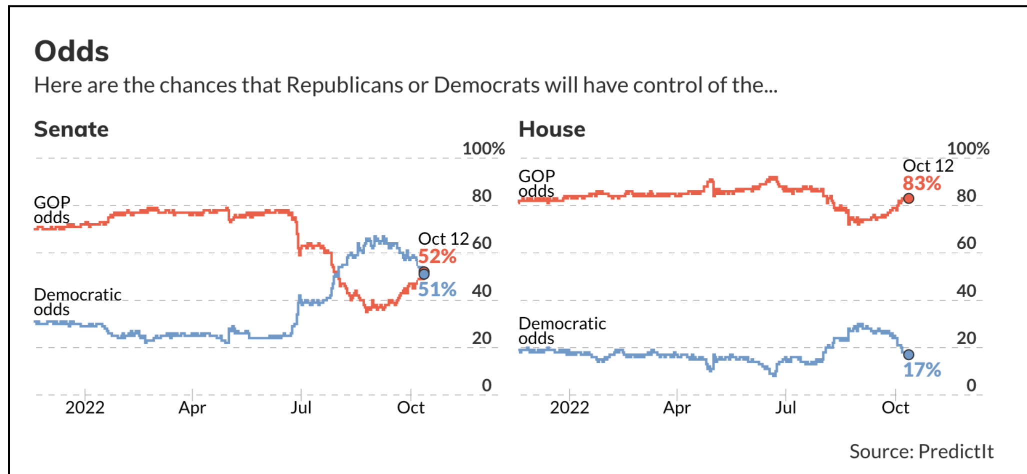
Corporations are not going to re-hire the same folks they laid off just because the Fed cut rates by 1-3% points. **The best possible course from here is that inflation moderates, S&P 500 earnings do not outright collapse, the Fed pauses rates, and the markets begin recovering since all the froth has been removed.**

You should not hope for an abrupt Fed Pivot to cut rates - because it would mean that the economy is in shambles. In such a case, the Fed could cut rates to 0% and it is my opinion that the market will still fall further. They would need to restart QE and implement a large money printing operation.

And should they do so, Inflation would get the last laugh as the genie would be let out of the bottle (again), causing even greater mayhem down the road.

Mid-Term Elections (Date: November 16th) and Geopolitical Analysis

I want to take a moment to discuss the U.S. political landscape that may go through a change on November 16th (midterm elections). Specifically, I want to discuss what may happen if Republicans are able to secure BOTH the House and the Senate. As of right now, it's likely that Republicans will take the House. The Senate is a toss-up. (See chart below)



Many analysts underestimate the influence that former President Trump still has on the Republican party from a behind-the-scenes perspective. As of a recent poll, **Republicans who support Trump more than they support the GOP itself climbed to 41% in August, up 7% points from May. That is a significant percentage of support given that Trump is no longer in office and has been mired in controversy.**

Roughly 50% of Republicans say they support the GOP more than they do Trump, down from 58% in May.

For our friends who are from Europe and Asia-Pacific and may not be entirely familiar with the U.S. political system, I'll include a brief list of bullet points below on what are the selling points of Democratic Politicians vs. Republican Politicians.

Republican politicians typically have the following ideology:	Democratic politicians typically have the following ideology:
• Smaller government • Power of free markets • Lower taxes • Fewer regulations	• Larger government • Higher taxes • Stronger regulation • Social Security / Accessibility to health care

This of course is very simplified, but it is enough to showcase the appeal of Republican politicians to the marginal voter at a time when the U.S. is facing slowing job prospects, high inflation, and a tighter outlook for future consumer finances. At the same time, Republicans lost a bit of momentum among voters after the Supreme Court overturned Roe vs. Wade earlier this year.

That said, if Republicans can win both the House (expected based on polls) and the Senate (still Uncertain based on polls), I believe that the GOP may be influenced by Trump's current views on geopolitics.

To put it simply, Trump does not support the Russia-Ukraine conflict and is calling for a truce and immediate ceasefire. He has been very vocal about this for quite some time, but his thinking may have an actual impact on U.S. foreign policy if Republicans are able to grid-lock Congress.

It is my opinion that Republicans will potentially set greater roadblocks for the Biden Administration to continue their support of the Ukraine conflict in order to reign down federal spending.

One of the reasons that Ukraine has persevered for so long against Russian forces is that they have received nearly $15 **billion** of U.S. aid in order to keep funding their military resources to continue supporting their defensive infrastructure. A country's success in war is highly dependent on the financial support to keep military resources replenished when used up.

However, it is my opinion that if U.S. aid funding for Ukraine begins to stall or dry up, Ukraine's defense infrastructure will begin to show less resilience and Russia will gain momentum in the conflict. A subsequent ceasefire (or surrender) may be coming in 2023 if this is the case.

After all, you cannot fight a war effectively if you have no more resources to keep fighting.

The net result of Republicans winning both the House (likely) AND the Senate (still uncertain) is a large substantial positive for equity markets, in my opinion.

The end of the Ukraine-Russia conflict (regardless of who wins) would likely spark an intense rally in the S&P 500 and Nasdaq. In order for the Chinese Internet sector to benefit, it has to be a Russian victory. This keeps China's security borders confirmed with its allies - namely Russia. It also discourages the White House from pursuing further escalation on China after a military loss.

Net/Net Conclusion:

- If Russia were to remain victorious, I see the U.S. markets staging a remarkable rebound from today's levels as investors celebrate the end to the conflict. **Investor positioning is so light at the moment that this geopolitical event may even be enough to end the bear market as food inflation is likely to come down and investors will front-run this development.** China will likely rally (how sustainable though, I do not know given that domestic issues in China still matter) as well since its security borders with Russia are left intact and the U.S. will have (somewhat) less political support within the White House to be as hawkish in foreign affairs.
- If Ukraine were to remain victorious, my official guidance is to **buy** U.S. equities and **reduce** Chinese equities as soon as possible. The U.S. is likely to leverage its victory and press their economic sanctions on China. I see no good obvious outcomes for China if Ukraine were to remain victorious, and the U.S. would be emboldened to take their next targeted economic campaign to China or stir-up the Taiwan Question.

As a reminder, my opinion is based on investment strategy and my view on how markets may move. I do not discuss politics, and do not have any political leaning. I form these conclusions based on my understanding of how countries are likely to interact with each other based on the outcomes. I have reasonable levels of confidence behind my researched opinions, but please remember, these are simply my researched opinions.

If the Republicans take the House but are unable to take the Senate, then I do not believe the markets will make a large move because it is the Senate that has the ability to heavily influence Biden's Foreign Policy.

On China: The Risk Premium for the Chinese Internet Sector is starting to get altered by external Geopolitical forces. Fundamentals and the technical setup suggest a strong tactical bounce once Covid case counts moderate, but U.S. macro pressure on China's technology supply chains mean that any rally has limits and will be on-watch.

If you are new to my Community, I would encourage you to read the last 3 months of China coverage I have provided in the Bi-Weekly updates folder so that you understand my thought process and the context leading up to my most recent reports. The Chinese Internet sector is one of the most difficult sectors to evaluate given that the sector is so heavily influenced by geopolitics, so having context to understand my research conclusions is important.

We are now officially entering a new chapter for China where the 20th Party Congress has started and Xi Jinping is almost certain to get re-elected for a lifelong term.

Because the event is starting as we speak (begins on October 16th), I will most likely follow up with a Patreon post in the coming weeks if there are critical details that come out. At this moment in time, the details are still scarce so this update on China will be briefer than usual. That said, I do have certain updates I want to provide you.

Earlier this week, I wrote an extensive note on the Semis export ban on China which you can read inside Patreon if you haven't already (or if you're new to my Community).

Here are some follow-up conclusions that I would like to share to this note on the export ban:

- I now believe that the Semis Theme Basket (where most names have 25-40% of their revenues coming from China) is now essentially a China trade. In other words, you can't be bullish on Semis without being bullish on China's economy AND the US/China relationship. In my opinion, that is a harder and harder hurdle to overcome and this is why I adjusted my rating for Semis from Weak Buy to Hold on my October 10th Note.
- At this point, I do not believe the Zero Covid policy is going away in the near-term. This isn't because China wants to restrict reopening, it's because China's hospital and health care system logistically cannot handle a covid surge. It would overwhelm the healthcare system as only a small percentage of the population has achieved herd immunity.
- Given that Alibaba and the Internet Sector have seen such dramatic valuation cuts **without** a covid surge, I do believe that any covid surge could press Alibaba well under 70/share and bring the KWEB under 20/share. So in some ways, the Zero Covid policy significantly limits Chinese

Internet upside, but it also prevents a covid surge from happening, which could lead to a significant selloff from here - even at these depressed levels.

- Therefore, we should actually look for the Zero Covid policy to stabilize covid case count and have the reopening be a slow and gradual process. I do sincerely believe another severe lockdown in Shanghai or Beijing could send Alibaba to under <10X forward multiple (under 70/share) because their revenues will shrink in coming quarters if this happens. At this stage in the game, **I paradoxically view the Zero Covid policy as a positive backstop against further losses in this sector. Believe me, you will want China's Zero Covid policy to succeed.** Because if covid case count gets out of hand and China's healthcare system is overwhelmed with patients, we could see society disorder occur (Shanghai lockdown serves as a good reminder) and we could see losses deepen further from here.

As a result, this is one of the most difficult investing environments I have ever seen for China. Investors are presented with a situation where having Zero Covid in place limits business and commerce activity. On the other hand, walking back the Zero Covid policy leads to an immediate bounceback of business activity yet exponentially increases the risk that Covid cases will start ticking higher, which then restarts the lockdown process again. The Chinese Internet Sector closely follows the behavior of the Covid case curve.

To complicate the situation, risk premiums across the Chinese Internet sector are rising to account for the U.S. & China heightened geopolitical relationship. Like I mentioned in a previous Patreon Post, the Semis Export Curb would nearly "eliminate the growth premium attached to cloud segments."

Within the KWEB ETF, the largest companies that rely on Cloud infrastructure for their future growth is Baidu and Tencent. Alibaba's core business is still ECOM (90% of revenues). This explains why the pure-play internet names like Baidu have fallen further than Alibaba on a relative basis.

In a previous report, I highlighted my view that inter-province travel is likely to at some point resume and this would eventually be supportive for Trip.com (ticker: TCOM). I discussed that the 28-30 level for TCOM has a premium valuation associated with it and that a 23-25 level was a better range for intermediate/long-term investors. I have patiently waited for this range to play out.

Within the KWEB ETF, along with my Alibaba/Tencent opinions, I now officially like TCOM (at 23.5/share or lower) for the following macro reasons:

- At some point China will allow inter-province travel to normalize which will benefit their bookings business
- At some point, international travel to/from China will also resume (this is a matter of when and not if)
- TCOM is a non-controversial business when viewed from the Party's perspective. There's no social media content they need to censor (Bilibili), no algorithms that they need to review (Baidu), no financial complex structures they need to review (Ant IPO - Alibaba).

I now believe that TCOM is priced attractively and has outperformance characteristics in comparison to the general KWEB ETF. Geopolitical worries impact TCOM less than say the B.A.T Companies (Baidu/Alibaba/Tencent). Domestic China regulations also don't impact TCOM as much.

The U.S. Semis export curb bans on China also do not impact TCOM given that it does not rely on semiconductors to run its travel business.

The thesis behind Trip.com is simple: Once China reopens its borders to international travelers and allows its citizens to freely travel across province to province (not a difficult ask, in my opinion), Trip.com will be the clearest beneficiary.

I have started a position at 23.5/share with a Tranche 1 position (see my execution style in my previous October report) after patiently weeks waiting for the premium at the 28-30 range to be removed. My 2nd Tranche for Trip.com would be in the 18-19/share region (if it gets there).

With the latest U.S. & China geopolitical situation just getting started, I believe any entry into tech-focused names such as Baidu need to be viewed as a tactical bounce and not yet a long-term investment.

Many companies in the Chinese Internet sector are now oversold (near RSI 30), but further entries need to be done with great care and thought with conservative sizing. This selloff in tech-focused names in China such as Baidu has global macro and geopolitical support. The more the firm depends on semiconductors, the more you should shy away from the name. To go against this macro trend right now is considered to be deeply contrarian and is only suitable for a short-term recovery trade.

Thoughts on China long-term post US semi export ban:

- The U.S. push to ban export curbs will accelerate China's push towards semiconductor self-reliance. Caixin reports have seen reports of local Chinese GPU chip manufacturers get "swamped" by consulting requests from potential customers.
    - I will look for any potential beneficiaries of this export ban. At least for now, it is not easy to find any beneficiaries. Most companies involved are negatively affected by the export curb. The potential beneficiaries may be local Chinese semi companies that can pick up the lost business from Lam/AMAT/ASML, but at this moment, I'm not an expert on China's semi companies and do not believe many of them are easily accessible to U.S./Canadian/Euro/Australian investors.
- China currently has figured out the 7 nanometers (NM) Chips technology, but at this moment is unable to produce at scale. Nvidia chips A100 and H100 also run on 7 and 4 nanometer technology. AMD MI100 GPUs which also fall under the ban also use 7 nanometer technology.
- Caixin reported that effective immediately after the U.S. export ban, vendors could not even send non U.S. supplies to China based factories without licenses if U.S. companies or people are involved. This highlights why I had to immediately issue a warning on October 10th. Even though my style is intermediate-term/long-term investing, this shift was important enough for me to send a broad timely warning to our Community.

I now believe the risks in China are elevated due to the new macro policies being set.

There is no reason to sell China at these valuation junctures, however, any purchases need to be sized very carefully.

If Alibaba enters the 60 region or can stabilize at low 70s, I will add a very small addition here. But the new tranche position will be modest, and will not be material.

(Update: I will provide an update on my opinion on China's 20th Party Congress once I finish reviewing the materials)

Special Segment on ETFS

ETFS that I am personally familiar with	**My observations and personal notes**
SPY/ QQQ/ DIA /IWM	The best U.S. based ETFs to track the market
VNQ	My proxy to understand Real Estate (through REITs)
SOXX (or SMH)	Best way to gain exposure to Semiconductors
KWEB	Chinese Internet Focused
PGJ	Large Chinese EV exposure
VUG	Best Growth ETF
VTV	Best Value ETF
XLY ETF	Consumer Discretionary ETF
TLT ETF	Best ETF to gain exposure to the long-end of Treasury Yield Curve.
AGG ETF	Best ETF to gain exposure to Government bonds
LQD ETF	Investment Grade Bond ETF
GLD ETF	Gold ETF

Make sure to check the top holdings in the ETF before investing. The website of each of these ETFs will always disclose the top 10 holdings. If you are not comfortable with the individual companies taking such a large weight, I suggest either avoiding the ETF or choosing another one.

In this environment, I believe that the VTV Value ETF is more suitable for most investors with moderate risk tolerance. Until the Fed pauses rates, Value is likely to outperform Growth. Once inflation data softens below 8%, I believe the Growth ETF will gain more momentum over Value.

From a macro perspective, I believe out of all these ETFs, the clearest winner when the Fed cuts rates is the TLT ETF.

As mentioned above, the Fed cutting rates may or may not be good for equities. But it's certainly good for Bonds because it will force investors to consider locking in the current yields in the market, putting upward pressure on the TLT ETF.

Appendix of additional information.

Note 1: Further evidence of U.S. hawkishness on China document from National Security Strategy.

Out-Competing China and Constraining Russia

The PRC and Russia are increasingly aligned with each other but the challenges they pose are, in important ways, distinct. We will prioritize maintaining an enduring competitive edge over the PRC while constraining a still profoundly dangerous Russia.

China

The PRC is the only competitor with both the intent to reshape the international order and, increasingly, the economic, diplomatic, military, and technological power to do it. Beijing has ambitions to create an enhanced sphere of influence in the Indo-Pacific and to become the world's leading power. It is using its technological capacity and increasing influence over international institutions to create more permissive conditions for its own authoritarian model, and to mold global technology use and norms to privilege its interests and values. Beijing frequently uses its economic power to coerce countries. It benefits from the openness of the international economy while limiting access to its domestic market, and it seeks to make the world more dependent on the PRC while reducing its own dependence on the world. The PRC is

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also investing in a military that is rapidly modernizing, increasingly capable in the Indo-Pacific, and growing in strength and reach globally – all while seeking to erode U.S. alliances in the region and around the world.

At the same time, the PRC is also central to the global economy and has a significant impact on shared challenges, particularly climate change and global public health. It is possible for the United States and the PRC to coexist peacefully, and share in and contribute to human progress together.

Our strategy toward the PRC is threefold: 1) to invest in the foundations of our strength at home – our competitiveness, our innovation, our resilience, our democracy, 2) to align our efforts with our network of allies and partners, acting with common purpose and in common cause, and 3) compete responsibly with the PRC to defend our interests and build our vision for the future. The first two elements— invest and align— are described in the previous section and are essential to out-competing the PRC in the technological, economic, political, military, intelligence, and global governance domains.

Competition with the PRC is most pronounced in the Indo-Pacific, but it is also increasingly global. Around the world, the contest to write the rules of the road and shape the relationships that govern global affairs is playing out in every region and across economics, technology, diplomacy, development, security, and global governance.

In the competition with the PRC, as in other arenas, it is clear that the next ten years will be the decisive decade. We stand now at the inflection point, where the choices we make and the priorities we pursue today will set us on a course that determines our competitive position long into the future.

Many of our allies and partners, especially in the Indo-Pacific, stand on the frontlines of the PRC's coercion and are rightly determined to seek to ensure their own autonomy, security, and prosperity. We will support their ability to make sovereign decisions in line with their interests and values, free from external pressure, and work to provide high-standard and scaled investment, development assistance, and markets. Our strategy will require us to partner with, support, and meet the economic and development needs of partner countries, not for the sake of competition, but for their own sake. We will act in common purpose to address a range of issues – from untrusted digital infrastructure and forced labor in supply chains and illegal, unreported, and unregulated fishing. We will hold Beijing accountable for abuses – genocide and crimes against humanity in Xinjiang, human rights violations in Tibet, and the dismantling of Hong Kong's autonomy and freedoms – even as it seeks to pressure countries and communities into silence. We will continue prioritizing investments in a combat credible military that deters aggression against our allies and partners in the region, and can help those allies and partners defend themselves.

We have an abiding interest in maintaining peace and stability across the Taiwan Strait, which is critical to regional and global security and prosperity and a matter of international concern and attention. We oppose any unilateral changes to the status quo from either side, and do not support Taiwan independence. We remain committed to our one China policy, which is guided by the Taiwan Relations Act, the Three Joint Communiques, and the Six Assurances. And we will uphold our commitments under the Taiwan Relations Act to support Taiwan's self-defense and to maintain our capacity to resist any resort to force or coercion against Taiwan.

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Note 2: Core inflation vs. Headline inflation Thoughts

Just a quick note that the Fed tends to focus on Core Inflation. In the short-term, the market cares about headline inflation. In the long-term the fixed income bond market tends to price assets based on core inflation.

Note 3: The Fed DOES understand that Housing is a lagging indicator. They are smarter than you think. But they must use verbal communication to keep inflation expectations of the future low which is why they are so verbally hawkish.

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As I mentioned earlier, rent growth has been very high recently. The housing services component of the PCE price index rose a bit above 0.7 percent in August, which was slightly above the previous three-month average. And I expect a similar pace to continue for a while, well into next year. Why? Shelter inflation measures the rents actually paid by households. Only a fraction of households sign a new lease in a given month or renew their lease each month. So, when monthly shelter inflation is calculated, it includes a large share of homes under lease where rents did not change. As a result, changes in market conditions show up in the inflation statistics only over a period of several months. In addition, the inflation statistics use a six-month average when calculating rent growth. Asking rents and rents on new lease contracts—which do reflect contemporaneous rental market conditions—have been rising at a fast pace for more than a year. These increases have fueled shelter inflation so far this year, and they should continue to do so for at least the next six months. That said, there is a glimmer of hope in the most recent readings of asking rents, where the rate of increase has stepped down a bit. This slower pace should eventually contribute to a slowdown in shelter inflation, although that might not be seen until later next year.

https://www.federalreserve.gov/newsevents/speech/waller20221006a.htm

Note 4: Understanding the Medical Care Services Component of CPI (an area that most analysts don't focus on, but is relatively important in the index)

Table A. Definitions of published medical care indexes and relative importance as of December 2021.

Item	Definition	Relative importance (percent)	Percentage of the Medical Care Index
Medical care	Medical care commodities and medical care services	8.487	100%
A. Medical care commodities	Prescription drugs, nonprescription over-the-counter-drugs, and other medical equipment and supplies	1.524	18%
1. Medicinal drugs	All prescription and over-the-counter drugs	1.422	17%
a. Prescription drugs	All drugs dispensed by prescription. Mail order outlets are included. Prices reported represent transaction prices between the pharmacy, patient, and third party payer, if applicable.	1.044	12%
b. Nonprescription drugs	All nonprescription drugs, including topicals	0.378	4%
2. Medical equipment and supplies	Nonprescription medicines and dressings used externally, contraceptives, and supportive and convalescent medical equipment (e.g., adhesive strips, heating pads, athletic supporters, and wheelchairs)	0.103	1%
B. Medical care services	Professional medical services, hospital services, nursing home services, adult day care, and health insurance	6.962	82%
1. Professional services	Physicians, dentists, eye care providers, and other medical professionals	3.585	42%
a. Physicians' services	Services by medical physicians in private practice, including osteopaths, which are billed by the physician. Includes house, office, clinic, and hospital visits. (Excludes independent lab work and ophthalmologists. See Eyeglasses and eye care.)	1.900	22%
b. Dental services	Services performed by dentists, oral or maxillofacial surgeons, orthodontists, periodontists, or other dental specialists in group or individual practice. Treatment may be provided in the office or hospital.	0.924	11%
c. Eyeglasses and eye care	Services and goods provided by opticians, optometrists, and ophthalmologists. Includes eye exams, dispensing of eyeglasses and contact lenses, office visits, and surgical procedures in the office or hospital.	0.371	4%
d. Services by other medical professionals	Services performed by other professionals such as psychologists, chiropractors, physical therapists, podiatrists, social workers, and nurse practitioners in or out of the office. Also, includes independent lab work and imaging services.	0.390	5%
2. Hospital and related services	Services provided to inpatients and outpatients. Includes emergency room visits, nursing home care and adult day care.	2.573	30%

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Thank you for an amazing Community.
-Larry