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BOTTOM LINE: Systemic opacity in AI "circular financing" and spiking credit default swaps have triggered acute credit distress signals, precipitating a historic nine-day liquidation in the semiconductor complex. While pristine mega-cap balance sheets absorb rising long-duration debt premiums, structural margin compression from capex trajectories and highly restrictive monetary policy are paramount for investors, despite counter-cyclical resilience in early Holiday retail data.

1) The CDS market is rarely the focus of equity investors' attention, but that market has now taken center stage, impacting all AI-related stocks. The poster child, of course, is CRWV. At one point, those CDS spiked to 1140 before dropping by 100 bps but still signaling intense credit distress. Its 9.75% notes of '31 are now yielding a shade under 16% so the pressure is visible in the cash bonds as well as the CDS. ORCL's move is less extreme in absolute terms but still notable with a record intraday level. While the pricing of these CDS cannot be dismissed, the more relevant issue for investors is the opaqueness of "circular financing" and the immersive interlocking of AI investments within the supply ecosystem. Every time I read about an AI financing, I find it virtually impossible to glean and separate all of the companies enmeshed, and, what exactly is on a company's balance sheet or hidden in some esoteric off-balance sheet vehicle. I think the Street has done a poor job of clarifying the manner in which the issuer of the debt can be another company's investor, supplier, customer and competitor simultaneously. It behooves analysts and the companies themselves to give investors a clearer and more coherent understanding of these arrangements; instead we have a situation now where there is a blatant lack knowledge of the implications on other companies of the ominous distress levels at which certain CDS and bonds are being traded.

2) The above discussion certainly explains the over 10% crushing this week for SMH. This etf has now fallen 9 days in a row; the last time SMH declined 9 days in a row was over 20 years ago in May, 2006. Provocatively this decline coincided with Fed Chairman Bernanke's inflation-hawkish comments. Bulls will be hopeful for a repeat of the move following this 9 day debacle as the semis rallied in the second half of 2006 and very smartly into 2007.

3) It is also critical to mention the performance of the CDS of GOOGL and AMZN. While these reached multi-year highs, they remain tightly contained in comparison to the neocloud names. No intelligent investor would suggest that these 2 companies will default on their debt loads, but rather the concern for investors is whether or not the projected impressive ROIC will be realized. Given GOOGL's significant debt issuance, there is also a contraction in free cash flow yields relative to the cap ex trajectories. Thus CDS writers are demanding higher premiums to cover long duration debt, yet GOOGL's pristine balance sheet keeps the absolute CDS pricing low. Observe that GOOGL is now testing its 200 day moving average.

4) Continuing with the theme of the impact of the fixed income market on equities, I wrote last week that the technicals in the Treasury market "suggest a forthcoming bounce in government bonds." Without repeating those technicals, indeed we saw a consequential rise in governments with the yield on the all-important 10 year declining to a shade below 5.10% with lower yields across the spectrum. Equity bulls will claim the declining yields suggest improvement fundamentals (see #5), while the bears are adamant that this reflects a flight to safety. Should the y/t/d low in the TLT etf be broken or should the yield on the 10 year rise back above 5.35%, it would have ominous implications for equities, particularly for the financial sector. As for financial equities, the out-performance of the group the week of October 5th was noted last Sunday which continued this week across all subsectors of the group with the exception of the private equity companies. Note APO has become the go-to arranger for marquee AI-infrastructure and chip-backed debt including SPCX and Anthropic. Bears are expostulating with glee that the stock price of APO has declined 24% from this summer's high as an ominous sign of the whole financing arrangements in AI.

5) As for further comments on the repercussions of the fixed income on equities, Paul Shea, the Miller Tabak Economist, published a piece this week entitled "Housing Data is Creating an Inflation Mirage" (your inbox late Wednesday US/early Thursday UK/EU). He succinctly reasons that the CPI data does not indicate the start of sustained inflation. At almost 100 bps above neutral, he affirms that monetary policy remains "highly restrictive" and inflation will therefore continue its longer-term downward trend. By 2q 2027, it will be apparent that the fed funds rate has been too high. Furthermore, if one substitutes a better indicator for shelter rather than the badly measured one currently used in the CPI, core inflation is below 2%. With mortgage rates now at a staggering 7.4%, there is little if any chance of a near-term housing rebound. Shea continues to refer to Warsh's fed funds increase as a "blunder."

6) Physical gold/digital gold: The dreadful performance of GLD this summer is inextricably tied to the strength of the US$ and higher interest rates, which I have been emphasizing for weeks. It appears the DXY may have peaked mid-week as it closed off those highs and lower yields have been highlighted above.

Technically, GLD is certainly entitled to at least a relief rally after 7 weeks in a row of a lower high and in which 3 of those week the high tick did not penetrate the previous week's close. A peak in the DXY would also certainly be a relief to EU investors in US equities. As for digital gold, BTC advocates are hoping that the new SEC regulations, of which the Chairman is an advocate of crypto, will stir minimal debate and become effective. Final comments on the SEC proposals are due this Wednesday. The fact that the AUD$/JPY ratio rose at the week's end may also be taken as a positive for crypto as a rise in this ratio is an indication of "risk on."

7) The Upcoming Holiday Shopping Season: I made an initial stab last Sunday as to what equities are telling us about the vital Christmas Season, citing the performances of WSM/WMT/DG . All 3 continued strong performances this week with WMT up 6.7%, WSM trading at a new y/t/d high and DG up 5.6%. This portends well for a strong Christmas in all income brackets. Please also note the retail sales figure reported on Thursday handily beat the estimates despite awful consumer sentiment figures.

Jeff

Have a productive week.

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