

Good morning,

What's in this week's Report:

- Weekly Market Preview: Focus Shifts to Earnings (And Tech Earnings Need to Be Strong)
- Weekly Economic Cheat Sheet: Flash PMIs on Friday the Key Report
- "Volatility Reset" or the Start of a New Volatility Cycle?
- Are Tricolor and First Brands "Cockroaches"?

Futures are modestly higher on China optimism and as investors look ahead to an important week of earnings.

Chinese GDP beat estimates (1.1% vs. (E) 0.8%) implying that global growth is stable. At the same time, a meeting between Treasury Secretary Bessent and Chinese Vice Premier Lifeng on Friday could lower U.S./China trade tensions.

Politically, there was no substantive progress towards ending the shutdown over the weekend.

Today there is only one economic reading, Leading Indicators (E: 0.01%) but it shouldn't move markets.

Turning to earnings, there are two notable reports today, CLF (\$-0.48) and CCK (\$1.98), but the key reports come later this week (NFLX, TSLA and INTC all report this week among other notables).

Market	Level	Change	% Change
S&P 500 Futures	6,722.50	20.00	0.30%
U.S. Dollar (DXY)	98.55	0.12	0.12%
Gold	4,310.94	97.64	2.32%
WTI	56.73	-0.42	-0.73%
10 Year	4.004%	-0.006	-0.15%

Stocks

Last Week (Needed Context as We Start a New Week)

Stocks remained volatile last week amid fluid trade war headlines and renewed concerns about credit/regional banking risks; however, a mostly solid start to Q3 earnings saw the broader market end the week with moderate gains. The S&P 500 rose 1.71% on the week.

The stock market began last week with a sizeable rally Monday as President Trump meaningfully dialed back his aggressive rhetoric regarding 100% tariffs on China, which prompted the prior Friday's pronounced risk-off money flows. Trump posting "Don't Worry About China, It Will All Be Fine" on Truth Social prompted a massive relief rally leaving the S&P 500 up 1.56% Monday.

Volatility returned in a big way on Tuesday after China began to investigate U.S. shipping industry subsidiaries in South Korea to potentially issue fresh sanctions, a direct attack on American trade operations in the APAC region. Sharp early losses were essentially reversed as government officials from both the U.S. and China reiterated communication channels remain open and the Trump-Xi meeting was still on for later this month. Strong bank earnings were well-received and the S&P 500 ended the day down a modest 0.16%.

The wide price swings continued on Wednesday as early gains on the back of strong earnings from luxury retailer LVMH and semiconductor materials provider ASML sparked fresh risk-on money flows in early trade, which were further supported by dovish remarks from the Fed's Miran. Negative government shutdown news saw the S&P 500 close off the high but still up 0.40%.

Solid earnings from global semiconductor giant TSM ahead of the bell on Thursday initiated a new tech-led advance in early trade. However, increasingly heavy price action in financial stocks, specifically regional bank names amid two notable fraud-related write-offs were announced by ZION and WAL prompted a wave of risk-off money flows. The S&P 500 finished down 0.63%.

Stocks stabilized Friday as strong Q3 earnings from regional banks TFC, HBAN, and FITB helped steady the financial sector, as did news that analysts from Baird upgraded ZION with a price target increase of 30%. Easing trade war tensions added to the risk-on money flows leaving the S&P 500 to end higher by 0.53%.

Economic Data (What You Need to Know in Plain English)

Last Week

The ongoing government shutdown kept economic reports sparse last week but the data we did get pointed to continued solid growth and consistent price pressures and implied a run-hot economy remains the most likely economic outcome. The two notable reports from last week were the first looks at October economic activity. While their headline readings were a bit conflicted, both gave the same message about manufacturing activity in their regions: Activity remained generally solid.

Empire Manufacturing, which measures manufacturing activity in the New York region, rose to 10.7 vs. (E) -0.9 and turned positive. In contrast, Philly Fed, which measures manufacturing activity in the mid-Atlantic, declined to -12.8 vs. (E) 7.5. But the Philly Fed headline reading is not a composite of the sub-indices. Despite the negative Philly headline, the details in both reports were solid and implied stable manufacturing activity in both regions. New Orders are the leading indicator for both reports and they rose to 3.7 from -19.6 in Empire and to 18.2 from 12.4 in Philly. Other details (employment and shipments) were also generally stable and solid. Prices for both indices, meanwhile, also rose as price pressures didn't spike higher but did remain consistent.

Empire and Philly are regional manufacturing reports and they aren't indicative of the entire U.S. economy, but they are the first look at October economic activity, and given the shutdown, some of the few economic reports we're receiving right now. And the message from both, while a bit disjointed, was the same: Manufacturing activity remains solid, price pressures remain in place and we are not seeing any type of sudden drop in activity that would imply increasing economic risks, and that was generally a positive message for stocks last week.

The only other notable economic event last week was the Fed's Beige Book, which is a collection of anecdotal observations on the economy and the results there were largely consistent with expectations. The Beige Book did note some mild deterioration in some of the Fed districts, but nothing that changes the current economic outlook.

Finally, Fed Chair Powell's comments last week were slightly dovish, in that he reiterated that risks to the labor market (that it weakens) were now greater than that of higher inflation. That's Fed speak for "we're going to cut rates," although Powell didn't say anything to cause markets to expect more than 50 bps of cuts between now and year-end. Instead, he reinforced expectations (Powell would need to hint at 75 bps to make Fed expectations a tailwind on markets).

Important Economic Data This Week

The government shutdown is still ongoing and unless that changes during the week, we will continue to get only a few private measures of the U.S. economy. The most important of which this week is the flash composite PMIs on Friday. This is always the first "big" report of any month but because of the lack of other economic data, it'll take on more importance. Markets will be looking for a Goldilocks number that implies solid economic activity (especially in the services PMI) but that is not so strong that the market rethinks the expectation for two rate cuts before year-end.

Also due to the government shutdown, typically lesser-followed economic reports will take on some added importance including Thursday's Chicago Fed National Activity Index and Existing Home Sales. As stated, these aren't normally reports that will move the markets. But given the dearth of any other economic reports this week, we'll still be watching these mainly to see if there are signals of sudden economic weakness.

Bottom line, markets have to trade off the data we have, not the data we should have. As such, the October flash composite PMIs will be a potentially significant report because if it does run "Too Hot" (and reduce rate cut expectations) or "Too Cold" and imply that the economy is softening more than expected, it will cause market volatility.

Special Reports and Editorial

"Volatility Reset" or the Start of a New Volatility Cycle?

The VIX started to catch our attention in recent weeks, specifically due to the emergence of historically non-typical positive correlation between the VIX and the S&P 500 that lasted for a record five straight days coming into last week. And while the streak was broken last Monday as the VIX fell and the S&P 500 rallied, the general trend of the VIX and S&P both moving higher persisted through Thursday of last week, remaining a source of concern that highlighted potential derivatives market dynamics that could amplify a move in volatility.

In addition to the unusual positive VIX-S&P correlation, the so-called "Short-Volatility" trade had become increasingly crowded with "greed emotions" dominating investor psychology into early October. Short-volatility is specifically a risk to stocks because options dealers buying volatility exposure from speculative short sellers (providing the liquidity) are required to buy long S&P 500 exposure to meet risk-management parameters as their long-VIX positions tend to lose value, their long-S&P 500 hedged appreciates. However, when the short-volatility trade becomes overcrowded like we saw last week, a short-squeeze in the VIX results in mechanical, often automated, selling pressure on the broader stock market as long S&P 500 hedges are abandoned by options and derivatives dealers who are closing long-VIX positions.

Those two dynamics materially amplified the selloff in the broader market on Friday, Oct. 10, and while a rebound in stocks the following session and hefty 12% pullback in the VIX were encouraging, they were far from signaling the bout of volatility is definitively over. That is the case even though many financial news outlets rekindled conversations about the TACO trade (Trump Always Chickens Out), which appeared to be the reason for the President's Truth Social posts regarding China over the weekend.

Looking at the daily chart of the VIX, the Oct. 10 VIX surge resulted in a five-month closing high that brought the 21-day moving average up to its highest levels since early July, underscoring the emergence of an uptrend in the VIX underway. Furthermore, the best liquid proxy for the “Short-Vol” trade is the term structure of the VIX futures market, which inverted (like a yield curve inversion) on Friday amid the massive squeeze effect the overcrowded position led to. To start the week, the VIX printed an “inside candle” on the daily chart (lower-high, higher-low), ending at 19.03, comfortably below Friday’s close of 21.66. Inside days are consistent with trader indecision and market consolidation and typically leave the path of least resistance in the direction of the existing trend. Ultimately, what that tells us is we are not yet out of the woods regarding this flare up in volatility that accelerated meaningfully on Friday.

Looking ahead, VIX extremes will be important to watch as a move above last week’s closing high of 25.31 will likely see follow through and bring Friday’s high of 28.99 into focus, leaving material downside risks in play for equities. Conversely, a drop below intraday lows in the VIX of 18.61 should trigger a further volatility contraction with support near 17.25 coming into view. Bottom line, which way the VIX breaks from here should offer a clear signal of whether stocks return to all-time highs or are poised for a more pronounced and prolonged pullback.

Are Tricolor and First Brands “Cockroaches”?

Famed JPMorgan Chase CEO Jamie Dimon issued a warning of sorts about potential stress in some credit markets when he stated, “When you see one cockroach, there’s probably more” in regards to the bankruptcy of subprime auto lender Tricolor Holdings. That warning, along with the collapse of auto-parts manufacturer First Brands, is causing some investors to worry about contagion in the credit markets.

Given the coverage in the financial media of these two events (which have become even more prominent given Dimon’s comments on the JPM earnings call), I wanted to cover the Tricolor and First Brands bankruptcies, so we all 1) Understand what happened, 2) Examine the possibility that these two events could be the harbinger of more credits stress that could impact the markets and 3) Identify indicators to tell us if contagion risks are spreading.

Tricolor and First Brands: What Happened. For ease of media coverage and because both were mentioned in bank earnings calls this week, the financial media has grouped these two events together. But beyond being in the same general industry (automotive), they are not related to one another and should be considered stand-alone events.

Starting with Tricolor Holdings, the company was a subprime auto dealer and lender. In a recent bond filing, Tricolor revealed that 68% of its borrowers didn’t have a credit score, while more than half of the borrowers didn’t even have a driver’s license. Put plainly, this was a car dealership and affiliated financing company that sold cars to lower income individuals, many of whom could not get auto loans at traditional banks (for various reasons). These loans, which carried much higher interest rates, were then packaged and sold via CLA (collateralized loan agreements). Tricolor declared bankruptcy in late September very unexpectedly (its CLOs plunged nearly 80% in a day in secondary markets) telling us the banks that traded them were blindsided.

Turning to First Brands, this company manufactured and sold auto parts (spark plugs, windshield wipers, brake pads, etc.). The company filed for bankruptcy in early September when it was unable to secure needed financing to continue operations. While also a surprise, concerns about First Brands were present before the failure.

Why Did Tricolor and First Brands Go Bankrupt? As usual, it's the "why" in markets that matters and if Tricolor and First Brands went bankrupt for reasons related to credit markets or the economy, it could be a harbinger of trouble ahead. Tricolor's sudden bankruptcy could have been the result of sudden underperformance of its loan portfolio. In plain-English, people stopped paying their auto loans in such numbers that it caused a cash crunch and the company was not able to secure debt to fund operations. If that was the reason, it could mean that the lower end of the economy is buckling under tariffs, inflation and slower hiring and that could mean subprime loans across industries could be at risk (and anyone who remembers 2008-2009 knows how bad that can go!).

For First Brands, the concern isn't so much about the normal economy (demand for spark plugs and windshield wipers isn't the primary concern here). Instead, it has to do with the potential bubble in private credit. First Brands relied heavily on private credit, or money loaned from investment funds such as hedge funds and private equity, to finance operations. In fact, there was so much money funneling into private credit over the past decade-plus that fear grew it was all chasing return and ignoring business risks to get a high yield. The First Brands bankruptcy could be the first domino to fall and if that's the case, then a lot of private credit investments may be worth much less than we think, which could cause market stress.

Those reasons are legitimate causes for concern, because they are both substantially negative for the markets and the economy. Positively, it does not appear that either of those are the reason for the Tricolor or First Brands bankruptcies. Instead, the reason for both appears to be the same, and a familiar one, fraud.

In the case of Tricolor, there are investigations into the practice of "double pledging" where a portfolio of loans is pledged as collateral twice to two different financial institutions. For instance, a portfolio of \$50 million in subprime auto loans is sold to "Bank A" for \$50 million. Then the same loan is sold to "Bank B" for \$50 million, creating a \$100 million liability on just \$50 million in assets (if they all perform). If that sounds fraudulent, it is, and Tricolor is being investigated for it.

Turning to First Brands, this was a company run by a man named Patrick James, who over several decades had left numerous bankrupt companies in his wake (and angry investors). Yet thanks to the boom in private credit, he successfully borrowed billions of dollars to grow his auto-parts businesses. While First Brands was a legitimate auto parts manufacturer, it appears it was saddled with lots of off-balance-sheet leverage and potentially engaged in "rehypothecation" of collateral that backed its financing. Similar to the story with Tricolor, it is suspected that First Brands used the same collateral (potentially receivables or inventory) to secure multiple loans from different financing partners and either concealed or failed to disclose the practice. The result was an overleveraged company that cracked as soon as business slowed.

So, while the Tricolor and First Brands bankruptcies could have signaled potential contagion or economic/market stress, it appears, for now, that the real reason was old-fashioned fraud and perhaps a lack of sufficient due diligence from investors. While unfortunate for investors and the employees of these companies, these appear to be mostly isolated incidents and not some larger market problem.

What Would Signal a Larger Problem? Just because Tricolor and First Brands appear to be, for now, isolated incidents of potential fraud, we can't totally dismiss that reality that there may be stress in the lower income portion of the economy that could trickle "up" and impact credit markets, stocks and the economy. But beyond watching for more corporate bankruptcies, a macroeconomic indicator to watch is the Baa over Treasuries credit spread. Baa bonds are high-yield bonds and if we start to see hints of systemic stress in the credit markets, junk bonds will get sold hard and the Baa over Treasuries spread will rise, sharply.

As we referenced in Wednesday's Report, 2.00% in the Baa over Treasuries spread is definitely a wake-up call on economic/credit concerns, so that's a level to watch. Currently, the Baa over Treasuries spread is at 1.72% and if that moves steadily higher, it's a signal that, perhaps, Tricolor and First Brands aren't isolated. We'll continue to watch this and if this metric gets close to 2.00%, we will let you know because that will increase downside risks in stocks.

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