DAVIS COMMODITIES LLC

March 2023 Macro Commentary

After feeling like Chicken Little for several months, the cracks that had me concerned are starting to appear. In March we saw the demise of Silicon Valley Bank and Signature Bank. While their failure certainly had to do with their growth rate, management, and investor base, the biggest issue is the one affecting all banks. They are simply borrowing short and lending long in an inverted market. As long as the short-term rates stay over long-term, the banks will struggle to make money. The Fed's recent actions to stem the tide appear to have worked, but the financial world continues to stay on edge.

The yield steepening theme remains one of the core tenets of the program. Between the bank failures, slowing manufacturing, and now slowing services, it is becoming more likely that the Fed is just about done with their hiking cycle. While they might raise one more time in May, it appears that will be their last hike for the foreseeable future. Unemployment ticked slightly higher to 3.6% last month. My bias is that it will be slightly higher again this month. If unemployment continues to move higher, that will be a key event in allowing a normalization of the yield curve. History shows that once we start steepening, the market tends to go to the ten year at least 150 basis points over the two year. With the curve currently at 50 bps inverted, there is still a lot of room to this trade.

With the likelihood of the US economy slowing and the Fed nearing the end of the hiking cycle, our bias is to sell rallies in the dollar. The current trade on that theme is long the Japanese yen. The reasoning for the yen long is two-fold. First, it appears that the years of yield curve control there are coming to an end. Second, the majority of SE Asia has been able to buy Russian crude at ~30% discount to the rest of the world. Cheaper energy generally leads to outperformance vs. competitors. With Europe eschewing Russian energy and pushing into high-cost green alternatives, the euro doesn't seem like a good bet for outperformance. While Japan has not been able to buy extensively from Russia, the relative strength of their neighbors should allow some butterfly effects to enhance growth.

The other core idea has been to own crude oil, however that is getting a few dings in the thesis. Crude oil has rallied sharply this week on the back of cuts by OPEC+. However, it begs the question as to why they cut their production. There are two main schools of thought on it. The prevailing theory is that the US government refusing to refill the Strategic Petroleum Reserve angered OPEC, so they cut production. The other is that OPEC is seeing a slowing of demand and decided to get ahead of the curve. My bias is toward the latter. As the interest rate hikes start to truly bite into economic growth, we should move into a recession later this year. That recession should slow demand for crude and its products. While the base case is a relatively shallow recession, the amount of financial engineering seen over the past decade could cause a sharp recession.

Sincerely,

Stephen Davis
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9047 Poplar Ave; Suite 101
Germantown, TN 38138

sdavis@daviscomllc.com

T: 901-766-4446
F: 901-766-4406