Chalk Creek Partners LLC

Registered Investment Advisor

Weekly Update 9-September-2020

Carlisle C. Wysong, CFA *Managing Partner*

- Is the Big Tech momentum over?
- The market is overvalued, and we think valuation will matter again
- Unemployment Rate drops, but the glass is still half empty
- US Trucking Freight Volumes and Prices are increasing
- The Fed buying mortgages has a compounding effect
- Are the Saudis back pressuring the oil market?

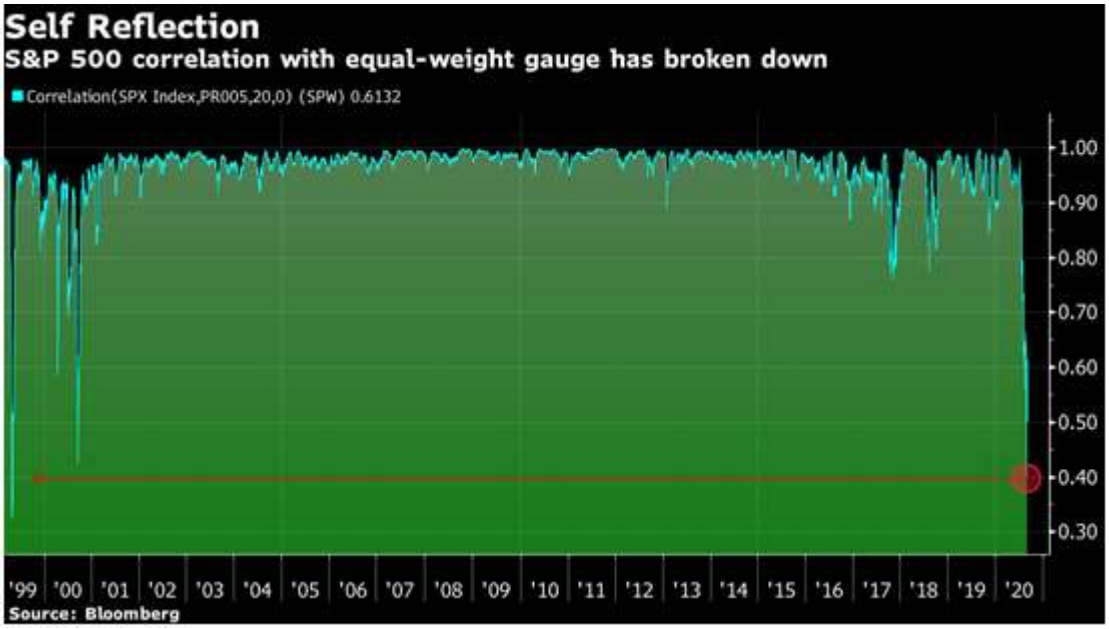
	Last	5d %	YTD %	1yr %
SPX	3581	-5.1%	5.2%	14.1%
QQQ	302.8	-8.2%	30.7%	45.3%
US 10 YR	0.70%	0.64%	1.88%	1.73%
VIX	28.8%	26.6%	23.2%	15.2%
Oil	41.63	-9.3%	-37.7%	-34.2%

*10yr and VIX are levels not changes

** Oil is front month futures, beware

It was only a matter of time until something derailed the non-stop upward trajectory of the market. Little did we know or suspect that the blame would fall on the specific investor that is best known for bloated valuations and generally awful investment acumen. Of course, we are talking about Softbank of Japan which was the force behind the WeWork debacle last year. Softbank allegedly was buying Call options on Big Tech names and essentially goosing the market higher.* Who knows if this is true…there are lots of conflicting reports. But the mere notion of its possibility highlighted what is undeniably true: the euphoric momentum had gotten out of hand. Whether it was Robinhooders, free commissions, government stimulus money, a dearth of betting opportunities, or some idiot in Japan playing day-trader with billions of dollars…it does not matter. This is not to say the market is going to implode. Rather, we think the market will look more carefully at valuations and not get caught up in stupidity.

Here is another chart showing the outsized leadership of the mega-cap stocks. It shows the extremes to which the mega-cap stocks have taken a hold of the entire index. The S&P 500's correlation with the underlying members of the index has broken down to the lowest level in over 20 years. Bloomberg said it well: "The index is becoming uncorrelated with itself."

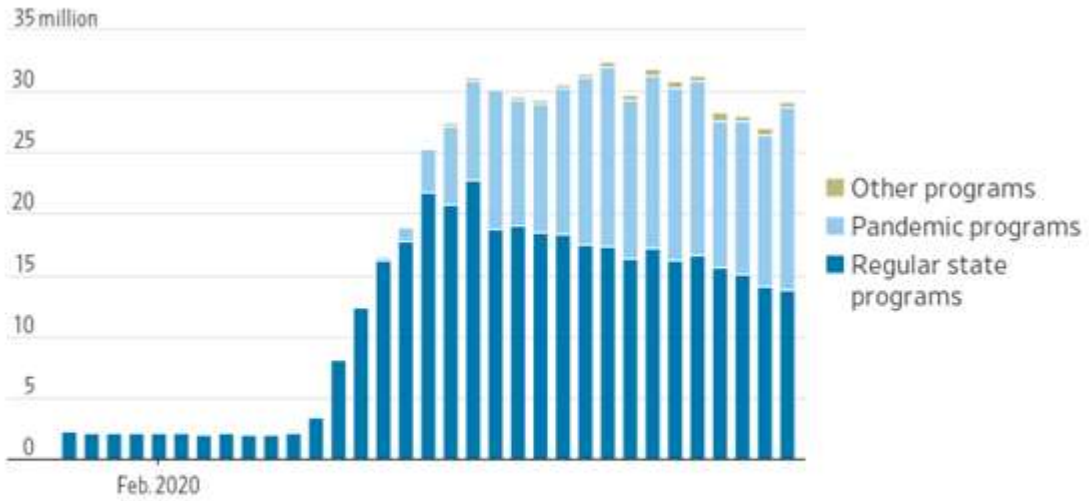


- Consensus Earnings seem way too high

Consensus earnings for this year for the S&P sits around $130. With today's closing price of 3400, this means the current year Forward P/E is 26x (this is more of a blended P/E or combo of trailing and forward earnings). Next year's consensus is about $166. This expected 27% growth means the next year Forward P/E is about 20.5x. In the past 25 years, this has trended in a range from 25x (dot.com bubble) to 13x (World Financial Crisis). The average probably sits around 17-19. And there is always slippage in Forward Estimates because they are literally just guesses. But no matter how you slice it, this market is not cheap. (For reference, 2019 index earnings were $163.)

- Unemployment Rate drops, but the glass is still half empty

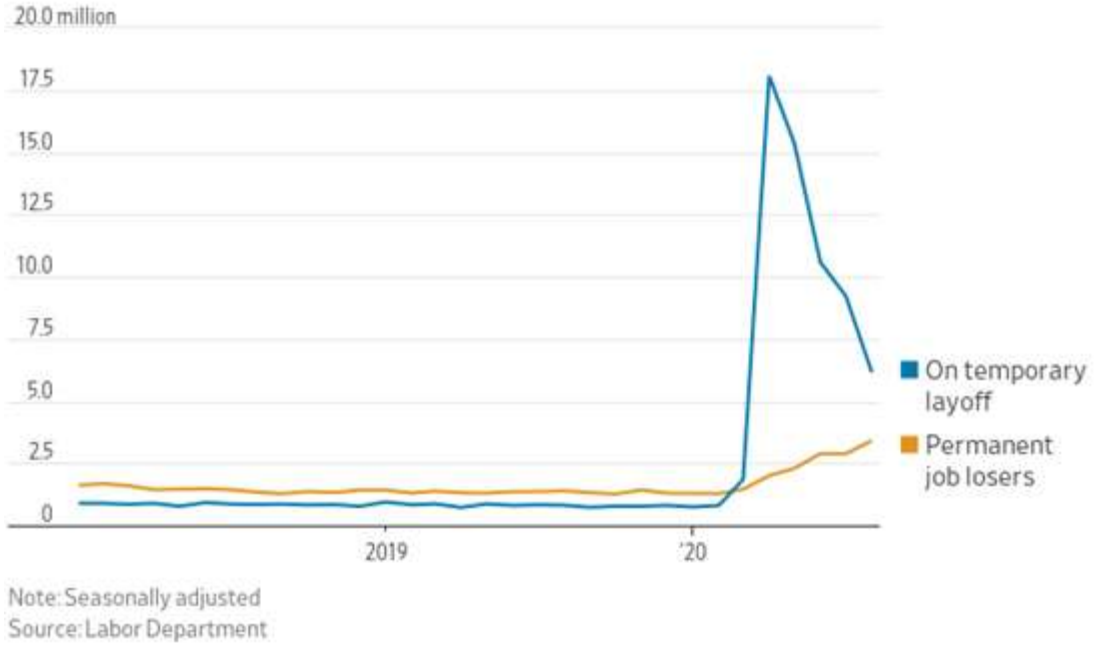
Jobless Claims fell again with the total registering 881k. Part of the drop was due to a change in the way the Bureau of Labor Statistics (BLS) calculates the seasonal adjustment (a good thing since the traditional seasonal patterns are no longer as relevant). This was applauded as a great number, but it is still larger than any pre-virus number. Moreover, it ignores the uptick in federal Initial Claims. Continuing Claims fell, also, which is more comforting. But when including the federal claims, the number of people getting benefits is still over 29mm (this figure is lagging by two weeks). This does not fill us with optimism.



Note: Pandemic programs include Pandemic Unemployment Assistance and Pandemic Emergency Unemployment Compensation
Source: Labor Department

The monthly Employment Report for August sent mixed signals. On the one hand, the Establishment survey showed a smaller gain in job growth at 1.4mm. And almost a quarter of the jobs gained were census workers (ugh). But the Household survey showed a large gain in jobs and an accompanying drop in the Unemployment Rate to 8.4% (10.2% in July and 9.8% expected). Many of the jobs gained here are merely a function of self-employed people no longer receiving federal unemployment benefits (a quirk to this survey that is not in the Establishment survey). The number of temporary jobless fell, but the number of permanent job losses increased. Again, gaining back low paying, wage-based jobs in exchange for higher paying, salaried jobs is not a good trade off (chart below). And this is not to slight the lower paying jobs…it is just that these job gains will reverse lower if the overall employment situation worsens.

Refresher: The core difference between the two surveys is the Household survey includes people with jobs but are not getting paid (and the above referenced self-employed quirk). The Establishment survey excludes anyone not getting a paycheck (which does not include self-employed). In other words, in this environment, the Establishment survey is more important, and it showed weaker gains. We still think the glass is half empty in terms of the employment situation.



- US Trucking Freight Volumes and Prices are increasing

Last week we noted the strength in the Shanghai Containerized Freight Index. This week, the Wall St. Journal ran a piece on the strength in the US trucking freight prices. A friend of ours in the trucking logistics business directed us to an industry website (Freight Waves). Trucking volumes in the US are way up over the last two years. This data is skewed a bit to the upside because of "rejected tenders" which can create some double counting of volume. But "rejected tenders" are a sign of pure excess demand. Trucking companies are opting out of contract prices (optionality is built into contracts) and fetching higher spot prices. Some of this can be attributed to backlogs. But clearly there is real demand.

- The Fed buying mortgages has a compounding effect

The Federal Reserve now owns about one third of all US mortgages. Actually, it owns about one third of all mortgage backed securities (MBS), but the point still stands. Other than the absurd notional amount of mortgages owned, $1t with a T, it is also import to understand that the Fed is not a normal buyer of assets. That is, if any other entity had bought this much MBS, they would be hedging the interest rate risk (selling

Treasuries). Considering mortgage prepayment is the biggest source of interest rate risk in the market, this buying by the Fed has a compounding effect.

- Are the Saudis back pressuring the oil market?

Oil has come back into the spotlight with a quick contraction back below $40. A rise in European virus cases is supposedly the driving force. With more virus fear comes a decreased demand for energy. There is also some surprise at the speed at which the US has ramped back up its shale production. But Saudi Arabia slashing prices to Asia and the US is probably the real blow. Recall it was the Saudis that hammered oil into negative territory back in April (not exactly but they deserve the blame). We continue to believe oil will be range bound.

- Quick Hits
    - Suzano, a Brazilian paper company, is issuing bonds with interest rates that vary with the company's emissions.
    - The only trucking freight "lane" that has remained cheap is DFW to LA.
    - The Kentucky Derby wanted to charge Las Vegas casinos 10.5% of all bets placed in the pari-mutuel pool. Vegas declined and ran their own books for the race.
    - The Kentucky Derby tv viewership dropped 49% vs last year.
    - Billy Beane, the much-heralded baseball GM despite never going to the World Series much less winning one, has launched a $575mm SPAC that will look to "effect a merger in sports, media, and data analytics."
    - In San Francisco, gyms for public employees remain open while all private gyms are closed.
    - FATMAAN is a great new market acronym (Facebook, Apple, Tesla, Microsoft, Amazon, Alphabet, Netflix).
    - August saw the most insider selling since 2015. 1042 insiders (CEO, CFO, Directors) made sales of $6.7b.
    - The Swiss Central Bank owns over $120b in US stocks.

*All the pundits now love talking about "gamma" with respect to options trading. We have talked about this at length in the past. Mathematically, it is just the second derivative impact of the stock price movement on the option price. In practice, this means people short options have to buy stock high and sell stock low to remain hedged. Not fun. Back in the day, we had bought some Call options on KOF. We were short the stock, so this was protection in case something whacky happened. We kept seeing weird volatility in the stock after we bought the Calls. One night, we had dinner with some guys from Merrill. It just so happened that one of them was the trader that was short the KOF Calls. He was angry at us for "running him over." We explained that we were short the stock, so all of the crazy, momentary spikes higher were much worse for us than for him. He then fessed up that it was he that was buying the stock so manically…he had to cover his short gamma whenever the stock traded higher. Because the stock was not super liquid, he would move the stock 5-10% at a clip. We politely offered our assistance in managing his book. Every time KOF would start to run on him, he could call us. We would be happy to make another sale up 5-10%. Of course, as soon as the gamma buying was over, the stock would fall back from whence it came. This went from a tortured position to a wonderful position.

Trading: We did not trade that much despite the volatility. We obviously benefitted from our Put options (on the market and Tesla). But we do not think the Volatility is over. After all, the Nasdaq is still up over 30% this year. We will not be too greedy, but we do think the situation warrants more patience. On the single stock front, we added some small slices to some of our long Value positions. We cut some of our Trading longs in the

discretionary space because of bad news. It also seems that the momentum has run out of steam in this outdoor/sporting goods segment. We will likely dump these, too. We still like the big box retailers. If Gold or Treasuries get hit because of broad deleveraging, these might be good buys.

TSLAQ: It all makes a little more sense now. Not just the demand side with SoftBank trying to manipulate the market with Robinhooders happily following along. But the supply side, too. Tesla deciding to sell $5b of stock right before the company was *not included* in the S&P 500 was no coincidence. Kimball Musk (dopey brother) and other Directors were unloading their stock after the split but before the S&P announcement. The TSLAQ crowd is calling for an SEC investigation, but we all know this will never happen. Consumer Reports slammed Tesla's quality. Its harshest criticism was directed at the so-called "Full Self Driving" feature: "unreliable" and essentially fraudulent because consumers were paying for something that did not exist as advertised. The bulls like to point to the "lead" Tesla has in EVs. With GM taking a stake in Nikola (the new EV truck maker that has never made a car), this narrative is losing steam. Whatever the case, the song remains the same. The stock is still insanely overvalued. We got lucky in our perfectly timed short. We will likely trade around the position since the stock should remain volatile. We have learned it is never a bad thing to take profits in Tesla!

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