Chalk Creek Partners LLC

Registered Investment Advisor

Weekly Update 1-July-2020

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- Market shakes off virus fears
- Earnings expectations continue to deteriorate
- The strong trend in Housing continues
- The Fed's balance sheet has shrunk two weeks in a row, but do not be fooled

	Last	6d %	YTD %	1yr %
SPX	3116	2.1%	-3.6%	5.1%
QQQ	250.5	2.8%	17.8%	32.4%
US 10 YR	0.68%	0.68%	1.88%	1.98%
VIX	28.4%	33.8%	23.2%	12.9%
Oil	39.74	4.6%	-34.8%	-32.6%

*10yr and VIX are levels not changes

** Oil is front month futures, beware

The daily news flow continues to ebb and flow from euphoria to doomsday and back. Of course, the market has started to do a good job in muting or dampening the headline effects. Economic data continues to improve. But people know that government's fiscal stimulus checks might be ending soon. For every virus outbreak story (the source of weakness last week) there is a virus vaccine story (today it was Pfizer (PFE)). Lockdowns and masks get a lot of attention in the media, but people are trying to get back to life with some semblance of normalcy. The Fed is undoubtedly propping up some zombie companies and municipalities. But that is seen as ok for now. Trade spats are still percolating, but most view this as political theater. Ultimately, any new trend in any of these could be the swing factor. That is why we are mostly sitting in the middle looking to sell rallies and slowly buy dips. Put another way, we are trying to avoid pre-conceived notions since most dynamics seem to be teetering on the fulcrum. When any of the balances tip, we will be more informed and ready to act. This sounds reactive instead of proactive, but pretending to know the outcome of every one of these decision-tree-paths is for the Dave Portnoy gamblers.

One fear last week was the upcoming stress tests on the banks by the Fed. For the most part, banks are able to keep paying dividends, but they will have to submit to more tests in the fall. Moreover, the hodge-podge of government agencies that regulate the banks are mobilizing to revamp some provisions in the Volcker Rule (which was part of Dodd Frank in the aftermath of the last financial crisis). Banks will be allowed to invest more directly in Venture Capital funds which will facilitate lending to upstart companies. And the requirement to post margin on swaps made with their own affiliates is going away. The loosening of other similar restrictions is likely.

- Earnings expectations continue to deteriorate

We continue to find it astonishing that the market could stage such a massive rally int the face of unprecedented earnings destruction. On April 1, earnings for 2Q were expected to drop about 11%. Today, that expectation has dropped to -43%. Revenues were looking to fall 1-2%. Today the expectation is for -11.8%. Of course, the overwhelming narrative is that 2Q earnings do not matter. That sure is convenient. Moreover, 40% of the S&P 500 have pulled any sort of earnings guidance. We always note that analysts's earnings expectations are notoriously soft just so the company can then beat expectations. But without the companies blowing their dog whistles, the analysts have no solid footing upon which to base their estimates. Point being, we should not expect to see the Under-Promise-over-Deliver theme from the past.

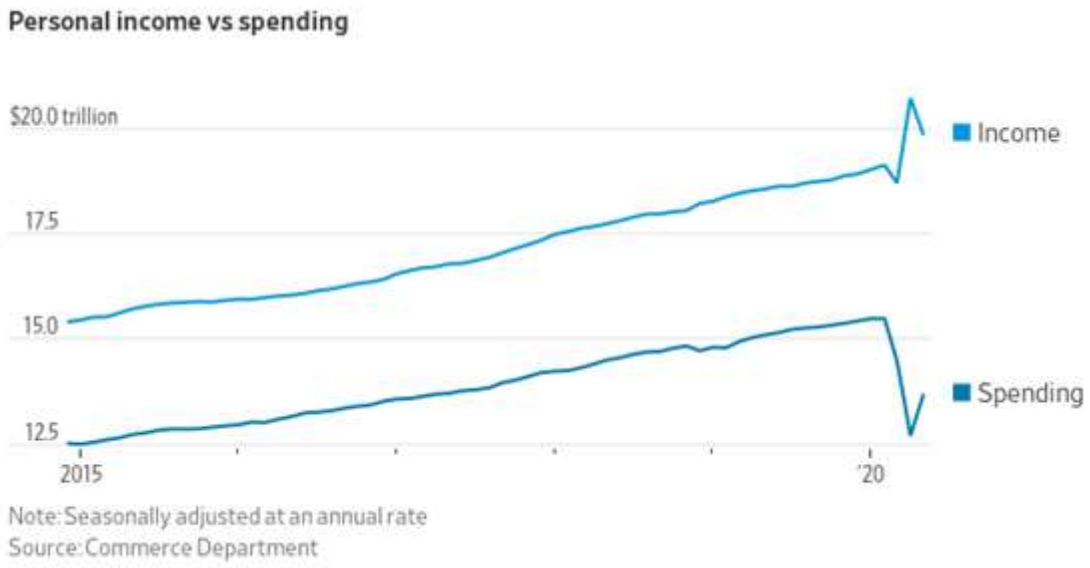
- The strong trend in Housing continues

Pending Home Sales had a massive jump in May vs April with a 44% increase (April -22% vs March). This metric tracks signed contracts for existing homes. It somewhat bridges the time gap between Existing Home Sales (which lag) and New Home Sales (more current) which we discussed (Existing follows contract closings and New follows contract signings). Sales are still down about 6% vs May of 2019. Regionally, the West had the largest increase at 56% while only being down 2.5% vs last year. The Northeast had a nice 44% jump, but this number is still down 33% vs last year. Separately, the Federal Housing Finance Agency (FHFA), a regulator that oversees the government sponsored entities (GSEs) Fannie Mae, Freddie Mac, and Federal Home Loan Banks (these GSEs primary purpose is to boost the housing market by buying mortgages and then repackaging them into Mortgage Backed Securities (MBS)), will be extending forbearance programs for multifamily apartment owners from three months to six months. For not having to pay their mortgage payments, apartment owners will not be able to evict any tenants for their missing rent payments. Fannie and Freddie support about half of the apartment segment of the housing market (and about 20% of the population lives in apartments). What does this all mean: Housing strength continues to surprise us. More forbearance is positive. But we are still watching for when forbearance ends and government checks stop flowing. We might be late to the party in that scenario. But that is better then being too early in the other scenario (housing gets crushed as unemployment stays elevated and incomes stay depressed).

The ADP Employment Report showed a large revision to May Jobs and a decent gain in June. The headline revision of +5.8mm jobs is eye-popping (a swing from -2.7mm to +3.1mm). But recall that last month's Unemployment Report showed a huge swing to the upside because of the way some workers have been classified. The ADP is just realigning itself with the actual data. In other words, never look at ADP revisions. As for tomorrow's Unemployment Report for June, the market is looking for gains of about 3mm jobs. But given all of these classification problems, it is hard to glean too much form this. Jobless Claims are still a better read at this point (although they are loaded with their own reporting problems).

Jobless Claims dipped slightly again. They are still registering about 1.5mm a week. There were also another 700k Initial Claims under the federal Pandemic Unemployment Assistance program. This number always seems to be forgotten – perhaps because this is where the slippages and loopholes reside. Continuing Claims fell below 20mm, but we suspect that is where they will sit for a while. Indeed, the job site company, said they have not seen hiring pick up despite the fall in Jobless Claims. And Homebase, a software HR company, said it saw job activity decline in the second half of June once some lockdowns started taking effect. Any strong indication from the Employment Report might be stale.

Consumer Spending rose 8% in May vs April. This ties into the strong Retail Spending figures from May. But it (Consumer Spending) was still down 12% from February levels. Somehow inflation still managed to move higher by 1% vs May 2019 (y/y). The monthly increase was 0.1% (m/m). Personal Income in May fell 4% after an 11% gain in April. April was boosted by one-time government checks.



Durable Goods Orders had a sharp rebound in May…just like every other economic indicator. The move can be almost entirely explained by the increase in transportation products…auto sales (surely not planes or cruise ships). The headline number increased 16% while Ex-transportation only increased 4%. Furthermore, business spending, the Core Capital Goods component, increased by 2.3%. This does not sound like much, but business spending growth was one thing we thought would be slow to recover. As a side note, the chart from the St. Louis Fed Economic Data department (aka FRED) has the current recession having ended back in March.

The third and final release of the Q1 GDP came out at -5%. Nobody cares. But it leads us to the Atlanta Fed's running tally for Q2 GDP (aka GDPNow): -39.5%. This is up from -46% last week. The NY Fed, however, is only predicting a 16% drop. This is up from -19% last week. The median guess among professional guessers (economists) is -37%. Guesses for the 3Q are just as varied ranging from 0% growth to +20%. This echoes a

point we have been trying to hammer home…the market does not deserve a premium multiple (Price/Earnings) in times of uncertainty. But then again, the Fed does not care about multiples…it just throws money at the problem.

The China Manufacturing PMI continues to show a rebound in that sector. But until we start to see the Chinese consumer turn the corner, we will reserve judgement. Our recent refrain has been that the communists can make factories build stuff, but they cannot make people buy stuff.

- The Fed's Balance Sheet has shrunk two weeks in a row, but do not be fooled

We probably are burying the lede here as the reduction comes as foreign liquidity needs continue to ease. That is, foreign central banks had been entering into USD swap agreements with the Fed to meet their own USD funding needs. But that USD crunch has eased (the Bank of japan and European Central Bank were and still are the biggest users of these swaps). The other asset declining is the Fed's Repo facility. Recall this is the way the Fed can inject liquidity into the system…it buys securities that banks hold on their balance sheets. The banks get Excess Reserves which they can then lend out in theory. As more actual lending, the Fed has yet to make a single loan under its Main Street Lending Program. We suspect this is another case of the mere presence of the Fed is enough to bolster private lending. Then again, it has been awfully quiet on this front after the hyped yet slow rollout. The Fed is still buying $120b a month in bonds ($80b Treasuries and $40b Mortgage Backed Securities, MBS).

Of course, the assets still sit at over $7.1 trillion up from $4.1t in February and $1t in 2008.

The Fed's actions have also spurred foreign buying of US corporate bonds. With the comfort of the central bank backstop, foreigners are more than comfortable buying the better yielding bonds. Moreover, the cost for foreigners to convert USD denominated bonds back into their home currencies has shrunk dramatically. A couple of years ago, the theory of foreigners supporting the US bond market was debunked after a simple analysis of the hedging costs involved. Put simply, because US interest rates were so much higher than foreign rates, it was expensive to execute a currency swap. The foreign bond buyer would sell the USD forward against the YEN or EUR (or whatever Fx). As this exercise is basically a function of interest rate differentials, it was costly. But now that the US has slashed rates to 0%, this cost has dropped from around 2.8% to 0.7%. This entire storyline illustrates how the global bond and Fx market is all about relative value.

- Quick Hits
  - 1.1mm dead people have received $1.4b in stimulus money.
  - Chuck E. Cheese parent CEC (not public) filed for bankruptcy. The Wysong kids do not know yet.
  - Chesapeake Energy (once CHK, to be CHKAQ) had no budgets, owned $110mm in parking lots, had a hidden wine cave behind a broom closet, was the largest season ticket holder in the NBA, and was the largest user of Net Jets in the US. It finally declared bankruptcy.
  - That ridiculous, giant-ipad seller, Mirror, masquerading as an "in-home" fitness company sold itself to Lululemon (LULU) for $500mm. Mirror is thought to be selling 700 "mirrors" a month. That is about $13mm in annual revenues (our best, random guess). God help us.

Trading: We bought back the Calls on QQQ (Nasdaq 100, mostly Big Tech) which we have traded around. We suspect this type of action will be with us for a while. The market will be reluctant to zoom much higher with more economic trouble looming ahead (when the government's fiscal stimulus runs out or slows down). But the Fed will also be there steadily buying securities inflating the value of all other securities. We also bought some outdoor leisure-good makers. These have had the big bounce like everything else. But this seems to be one area in which the new behavioral patterns might stick (more outdoor activities). We also sold some of our more

discretionary positions. We replaced these with defensive consumer names. All in all, we are still long the market, but we have a mix of factors which provide good balance. And we have used some of our large cash position to start buying Volatility (Calls not to miss the rally and Puts for the inevitable fall).

TSLAQ: If nothing else, The Bond Villain sure is consistent. Per his usual end-of-quarter game plan, he leaked to his mouthpiece, Electrek, an "internal" email about trying to ramp up deliveries to hit "breakeven." Other than the obvious securities law violation and the more specific SEC settlement decree forbidding him from disseminating information not vetted by his Twitter-Sitter, what are investors supposed to do with this? Nobody knows what "breakeven" means. But another tweet explains his motives. Tesla is considering splitting its stock price. This has no economic value whatsoever. Some have made the argument that more investors are able to buy lower priced stocks. But with fractional shares somewhat common (Robin Hood and Schwab among others), it is irrelevant. Unless you want some silly boost to the stock right before deliveries are released. And in case we forget the mindset of Musk, here is a random tweet mocking one of his adversaries, Amazon founder Jeff Bezos. Of course, the real humor here is that Tesla charges for a self-driving software package that does not exist.

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