Chalk Creek Partners LLC

Registered Investment Advisor

Weekly Update 12-August-2020

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- The market seems to be going through one of its rotations while still grinding higher
- Earnings beat lousy expectations
- The Global Economy continues to improve while ignoring the unemployed
- Commercial Real Estate has more problems
- The US *exported* oil to Saudi Arabia in June
- https://www.americanwarriorassociation.org/
- Annual music recap from the summer road trip

	Last	5d %	YTD %	1yr %
SPX	3380	1.6%	4.6%	17.2%
QQQ	271.9	0.3%	27.9%	47.5%
US 10 YR	0.68%	0.56%	1.88%	1.70%
VIX	22.3%	23.0%	23.2%	17.5%
Oil	42.56	0.9%	-30.1%	-22.3%

*10yr and VIX are levels not changes

** Oil is front month futures, beware

The market seems to be going through one of its rotations while still grinding higher. This is quite remarkable as by definition, rotations lead to broad market weakness. The high-flying Nasdaq/Big Tech stocks have finally started to slow. The rotation seems to lack any real nuance…people are selling the winners and buying the losers. This applies to the Recovery stocks vs the Work From Home stocks, too. Of course, just when it looks like the S&P 500 is going to make an all-time high and Nasdaq is going to faulter, Big Tech comes roaring back!

The main headlines in the market continue to be the US stimulus talks, tit-for-tat with China, and earnings. These all swing back and forth. But the market knows better than to listen to the Schumer-McConnell banter. Neither side wants to be the one to stop the free-money party. Tik Tok and WeChat are garnering all sorts of attention, but it is a sideshow really. Huawei and the broader trade deal are much more important. On this note, China has recently canceled some soybean contracts with Brazil and has started buying the more expensive US product. What is missing from the headlines…but obviously not forgotten…is the Fed and its $7t balance sheet.

Further to the rotation theme, there is all sorts of talk about large institutions throwing in the towel: they are selling bonds and buying equities. We have highlighted this as an upside risk. This equity buying is probably one of the reasons the market is going higher despite the rotation. It is also why we have a negligible weighting in fixed income (asymmetric risk/reward). The massive sell-off in Gold on Tuesday is a perfect example of this cross-asset switch. The fact that the futures exchange hiked margin rates did not help (traders must post more $, many just sell future instead).

- Earnings beat lousy expectations

About 90% of the S&P 500 have reported earnings so far. Over 81% have beaten expectations. This is far above the average 70% and the early-in-the-quarter run-rate of 60%. We know the market leaders all produced great relative earnings. The market growth rate is 10 percentage points better than the July 1 expectation. Alas, earnings have still dropped about 34% as a whole. Only Health Care (+5.5%), Tech (+2.2%), and Utilities (+6.4) have shown positive growth. Revenues are much more inline with expectations with a -9.5% drop.

Exhibit 3. 2020Q2 Blended (Reported & Estimated) Earnings Growth

Sector	Today	1 Jul	1 Apr	1 Jan
Consumer Discretionary	-77.7%	-114.1%	-33.0%	9.7%
Consumer Staples	-7.8%	-15.7%	0.7%	5.0%
Energy	-168.5%	-153.7%	-92.6%	10.5%
Financials	-54.1%	-47.7%	-9.4%	0.7%
Health Care	5.5%	-15.1%	0.7%	3.9%
Industrials	-84.1%	-89.5%	-32.8%	21.5%
Materials	-28.6%	-38.0%	-11.0%	11.1%
Real Estate	-15.0%	-14.9%	1.8%	6.9%
Technology	2.2%	-8.0%	2.0%	7.6%
Communication Services	-16.7%	-29.7%	-4.1%	8.7%
Utilities	6.4%	-2.3%	3.6%	5.7%
S&P 500	**-33.8%**	**-43.0%**	**-11.7%**	**7.2%**

Source: I/B/E/S data from Refinitiv

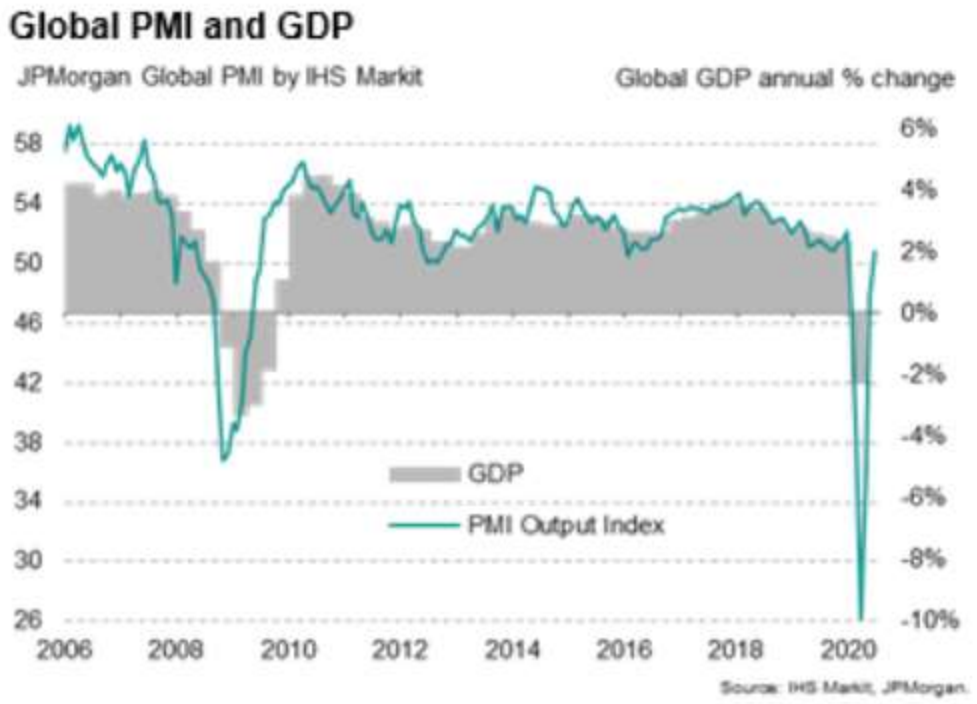
- The Global Economy continues to improve while ignoring the unemployed

Jobless Claims fell to 1.2mm which is the lowest of the virus panic. Continuing Claims also fell by over 800k to sit just above 16mm. Both of these drops reverse the recent uptick in Claims. Pandemic Unemployment Assistance (federal benefits under the Cares Act) dropped to about 650k. This line of assistance ceased on July 31. The stat that sums up all of this largesse (some justified as painful as this is for us to say): Spending by the Unemployed has increased 10% while Spending by the Employed has decreased 10%.

Nonfarm Payrolls increased by about 1.8mm in July. This dropped from the 4.8mm jobs gained in June, but it was expected. Unfortunately, Government jobs accounted for a sizeable 300k. The Unemployment Rate dropped to 10.2% vs 11.1% in June. The highlight of the report was the Average Hourly Earnings which increased 0.2%. Earnings dropped -1.3% in June and were expected to drop again in July. The classification problem has mostly been resolved. Recall that the surveys were having a hard time determining the difference between a temporary layoff and permanent one. Temporary job losses dropped to 9.2mm from 10.5mm. Permanent job losses remained steady at 2.9mm. As a whole, the total number of employed stands around 143.5mm which is down about 15mm from the pre-panic level. This simple metric is probably best as it is immune to the biases and missteps in surveys and adjustments.

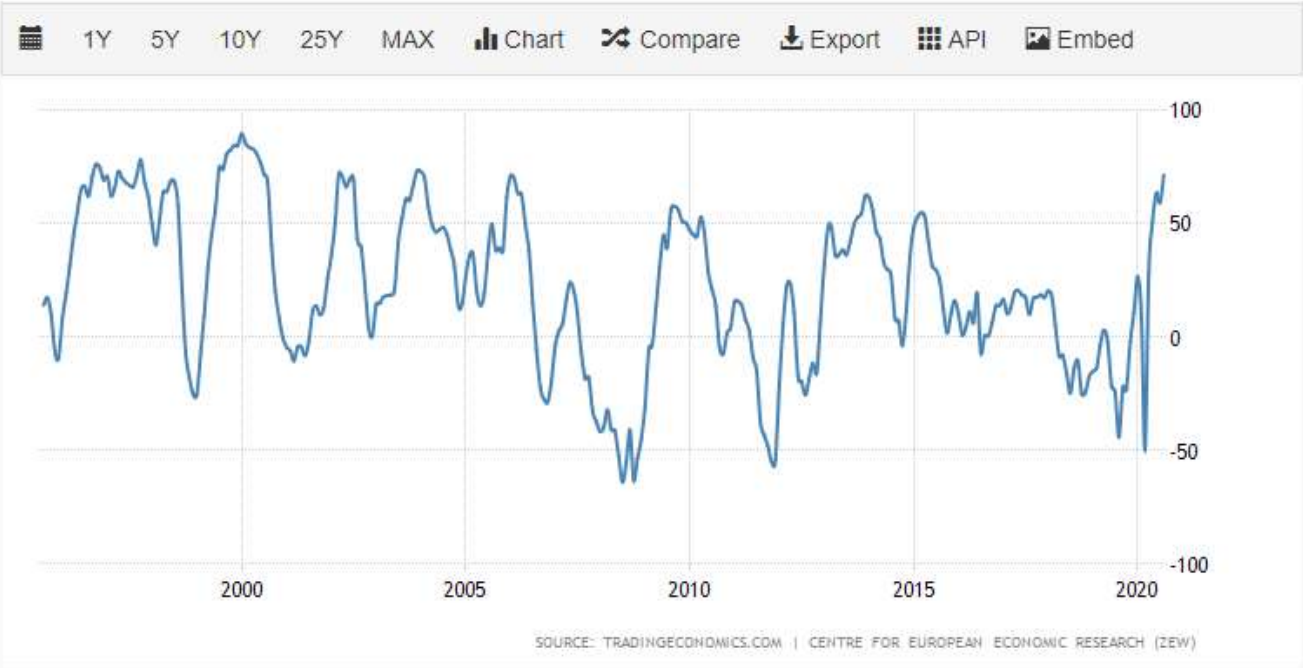
The JOLTS report for June (Job Openings and Labor Turnover Survey) is a bit lagging but it did show a nice increase in Job Openings. It also showed that within Separations, the Quits rate rose while the Layoffs rate remained the same. Healthcare and Social Assistance had the most amount of Quits. These sectors also had the largest drop in Layoffs. The broad theme here is that some job mobility is coming back (at least in theory, we think this trend will be hard to maintain).

The Global PMI reading for July moved above the 50 breakeven point (50.8) for the first time since January. Obviously, this is positive on the margin, but as we always note, this is a diffusion index which naturally reverts to 50 (that is, it measures the monthly change so 50 is always the baseline). The current survey level correlates to an annual GDP growth rate of about 2%. This is roughly the low mark during the last 10 years.



The US has now seen two months of higher trending inflation. The July reading for the "Core" (for those people that do not eat or use energy products) increased 1.6% vs last year. This is still near the lows of the last nine years. But we need to avoid the Japanese style deflation. Of course, all of this runaway spending will lead to inflation of some type.

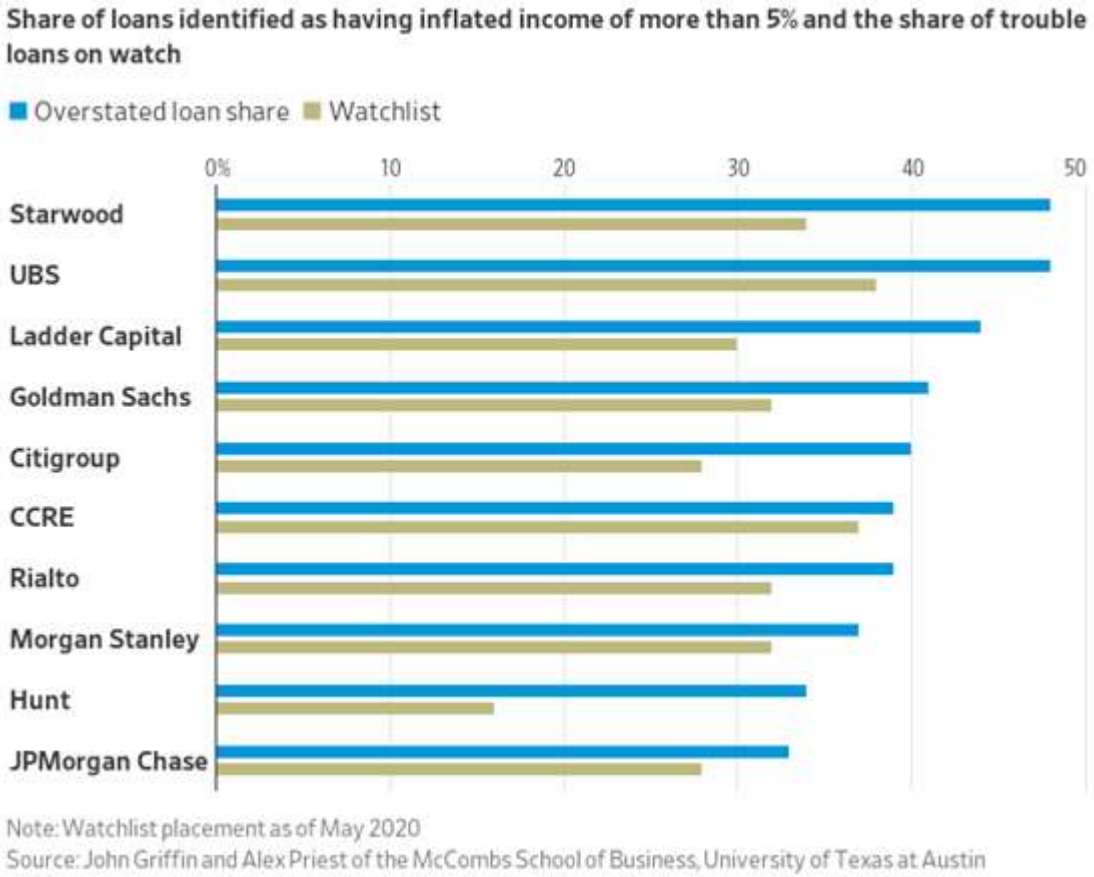
Looking at Europe, German business confidence is torn. Current Conditions as measured by the ZEW survey remained at rock-bottom lows. But Business Expectations surged to their highest level in 15 years! But as you can see in the chart below, the Germans are pretty fickle when it comes to optimism.



Actual	Previous	Highest	Lowest	Dates	Unit	Frequency
71.50	59.30	89.60	-63.90	1991 - 2020		Monthly

- Commercial Real Estate has more problems

It seems the virus is not the only thing holding back commercial real estate. A study by the University of Texas shows that net income was overstated by at least 5% on almost 30% of all commercial mortgages. This does not sound like a lot…until the whole market shrinks overnight. Here is a table that shows the difference between what has been flagged as a troubled loan and the actual number of loans that are overvalued. The silver lining here is that JP Morgan (JPM) seems to be the most prudent in its underwriting standards. We are still long JPM. We are also long Goldman, but its loan portfolio is tiny.

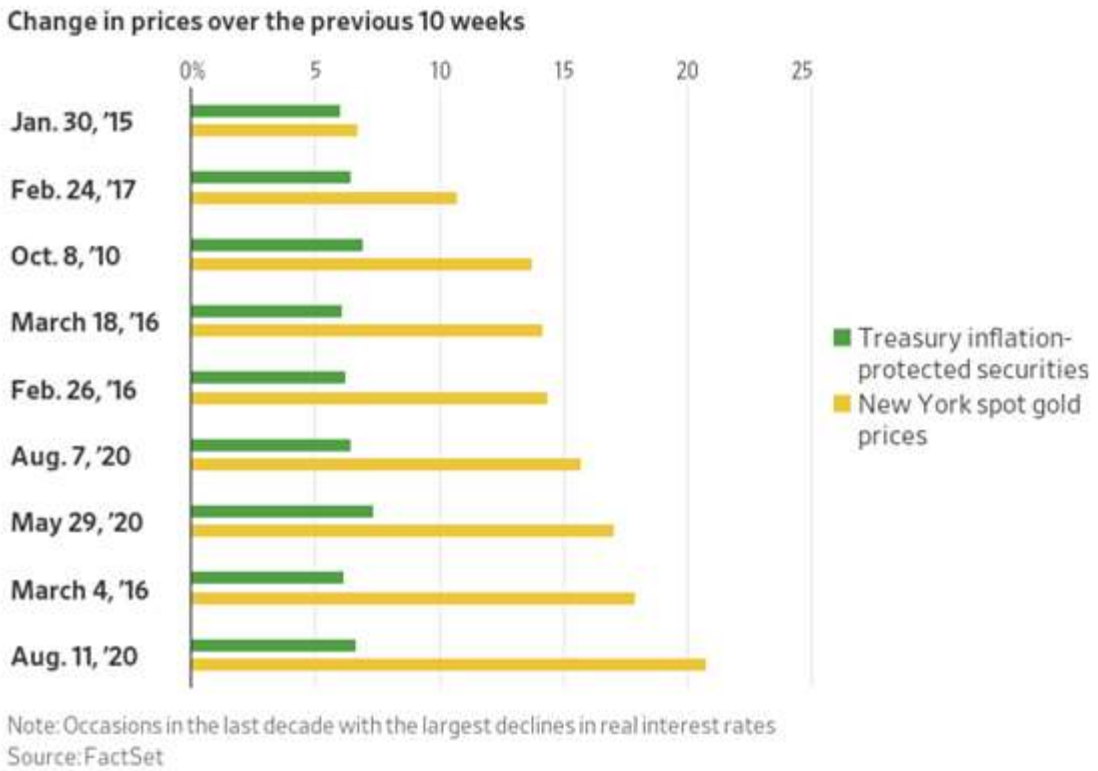


- The US *exported* oil to Saudi Arabia in June

In a strange twist, the US actually exported oil to Saudi Arabia in June. The 550k barrels shipped was the second time the US has sent any oil to Saudi with the other instance being back in 2002…and that was only 1k barrels. However, this story does not mean much from the export side as the oil was probably just stopping in port before going elsewhere. Nonetheless, it does prove that Saudi has stopped dumping oil here as has been reported (and we believed). Of course, Saudi has simply diverted shipments to Asia. This helps explain why the Chinese have only bought 5% of the energy products it promised to buy in the "trade deal" with the US. It is also important to remember that Saudi only accounts for about 9% of US oil imports during normal times (2019). Canada accounts for over 50%:

1. Canada: US$66.3 billion (50.1% of total US crude oil imports)
2. Mexico: $12.3 billion (9.3%)
3. Saudi Arabia: $11.5 billion (8.7%)
4. Iraq: $7 billion (5.3%)
5. Colombia: $6.5 billion (4.9%)
6. Nigeria: $4.4 billion (3.3%)
7. Ecuador: $4.3 billion (3.3%)
8. Brazil: $3.7 billion (2.8%)
9. Russia: $3.5 billion (2.6%)
10. United Kingdom: $1.54 billion (1.2%)
11. Libya: $1.45 billion (1.1%)
12. Venezuela: $1.4 billion (1.1%)
13. Norway: $1.3 billion (1%)
14. Kuwait: $1.1 (0.8%)
15. Trinidad/Tobago: $921 million (0.7%)

Jeff Curie of Goldman Sachs said something interesting: Oil hedges unexpected inflation and equities hedge expected inflation. Cutting to the chase, his point was that bond asset managers will likely start to diversify/hedge their long bond positions with oil. If inflation comes and starts to eat away at the real yields (nominal yield minus inflation), these bond managers (including pension funds and insurance companies) will feel more than a pinch. Interestingly, he thinks gold is a bad hedge against inflation. The chart below would disagree on the surface. But he also said that TIPS (Treasury Inflation-Protected Securities), which theoretically do what their name states, are a bad hedge against inflation. As far as the massive outperformance of Gold lately (Tuesday's pullback notwithstanding), we would argue that some of the move can be attributed to social unrest (on top of the inflation hedge).



India has dramatically increased its oil imports. (India has refining capacity but very little production. In fact, India's Reliance Industries has the largest refining complex in the world. The country only produces about 500k barrels per day. In June, India imported 2.82mm bpd. July saw this jump to 5.14mm bpd. The 2019 average was about 4.5mm bpd. An economic recovery is the central force driving the rebound in demand. But also, refineries used the huge slump in demand to pull forward planned maintenance into June. There has also been a massive shift away from public transportation.

- https://www.americanwarriorassociation.org/

A group of friends gathered in northern Colorado to learn more about the American Warrior Association which helps military veterans and civilian first-responders transition to everyday life. Participating in Field Training Exercises with airsoft rifles against and alongside some of our nation's most outstanding military warriors was incredible. Hearing some of the obstacles these heroes face was sobering. Check out the link to learn more about this deserving charity (we have no affiliation other than being a supporter). And if you hear Carlisle start a sentence with "back when I trained with Navy SEALs," you will know about what he is talking!

- Annual music recap from the summer road trip
  - The most played artists on the radio during our drive to Colorado were Guns N's Roses, Billy Joel, INXS, Police, Led Zeppelin, and AC/DC.
  - To be fair, there is not a lot of Hip Hop / Pop / Alt rock stations in the Panhandle of Texas or the mountains. There is plenty of country music, but nothing seems to be repeated. But Hayes Carll's "Bad Liver and a Broken Heart" is a good one.
  - Somehow, Carlisle's 7yr old daughter knows the lyrics to AC/DC's "TNT" and "Highway to Hell." Proud dad?

- Toto's song "Hold…the…line" enters the annals of misheard lyrics. BS Wysong thought it was "Po…ke…mon!!" The reigning champ is still mistaking the Go-Go's "Our Lips Are Sealed" for "I'm a S-Seal."
- As for Billy Joel, the last time we heard him this much was when Old Man Wysong was rocking this beauty:

- Quick Hits
  - Bankrupt Hertz sold $29mm of stock in June before the SEC suspended further stock sales.
  - California received $38.4b in federal money to supplement Unemployment Insurance.
  - South Dakota received $177mm.
  - California received 217x the money while having only 45x the population.
  - A Vanderbilt professor published research on the impact of financial aid on students working part-time jobs. Not so astonishingly, grants have the same effect as loans in reducing hours worked.
  - There were 10 brands of hard seltzer in 2018. There are over 65 now.
  - France has a backlog in virus testing because the labs are all on summer vacation.
  - It is a federal crime to sell diced pineapples in a can unless they are reasonably uniform cube-shaped pieces (lifted this from @crimeaday on twitter).
  - The Nasdaq 100 has closed up over 60% of the days in 2020. This is the highest in 34 years.
  - CMBS (Commercial Mortgage Backed Securities) 30-day delinquency rates are approaching 10% vs the usual 2% rate.
  - Charles Ponzi was arrested 100 years ago today.

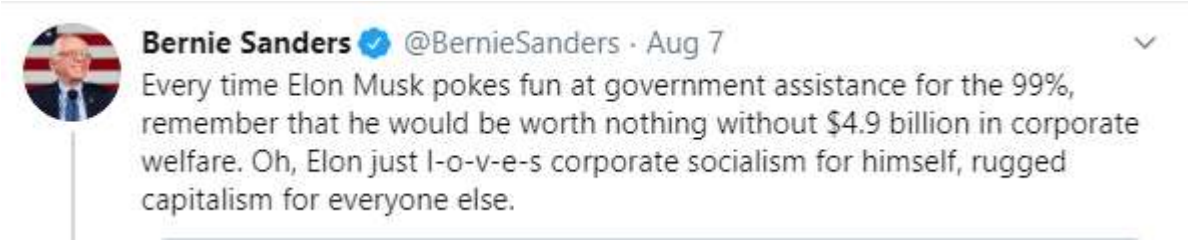
Trading: We trimmed a little gold and a little Amazon as the market roared on. We still like both long-term. We added a small bit to our airline long. We also added to our cyber security long exposure as it has dipped recently. In general, we have not done much trading which has served us very well. We have been riding our longs. But we will likely add to our small S&P Put position as it approaches the all-time high.

TSLAQ: We had the usual chaotic news flow in Tesla: Korea is looking to adjust its EV subsidy program, another Chinese EV company is coming public, there is another whistleblower at the Freemont factory, insiders are dumping stock left and right, and more accounting fraud charges have been leveled by a short-seller. Of course, they are right, Tesla deferred employee compensation, did not recognize depreciation on the China factory, and basically stopped reporting R&D costs - all so it could report a profit in the hopes of gaining inclusion in the S&P 500 index. This same short-seller, Greenlight Capital (who called the Lehman debacle 12 years ago but has had miserable performance ever since) also highlighted the makeup of the recent earnings. That is, these so-called earnings are completely comprised of regulatory credits. On top of this (which we have highlighted/lowlighted before), Greenlight points out that Tesla recognized $782mm in 1H2020 while its main counterparty in this shell

game, Fiat Chrysler, only recognized $370mm of regulatory expenses. We cannot believe we just wrote about Tesla fundamentals for a whole paragraph!

Tesla rallied 13% after announcing a 5:1 stock split. God help us (stock splits mean nothing in economic terms especially in today's world of fractional share buying). We are still steering clear of this one until the decision on joining the S&P 500. We will short it then regardless of the news.

Moving on, the highlight is the brewing feud between The Villain and Bernie Sanders. This is pretty much a lose-lose battle, but we do side with Bernie on this one:



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