Chalk Creek Partners LLC

Registered Investment Advisor

Weekly Update 28- October-2020

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- Market weakness turns into a relative bloodbath
- Election uncertainty is the biggest risk
- Corporate defaults are ugly
- Earnings continue to shine but nobody cares
- Housing: The Song Remains the Same
- Oil succumbing to demand and supply fears
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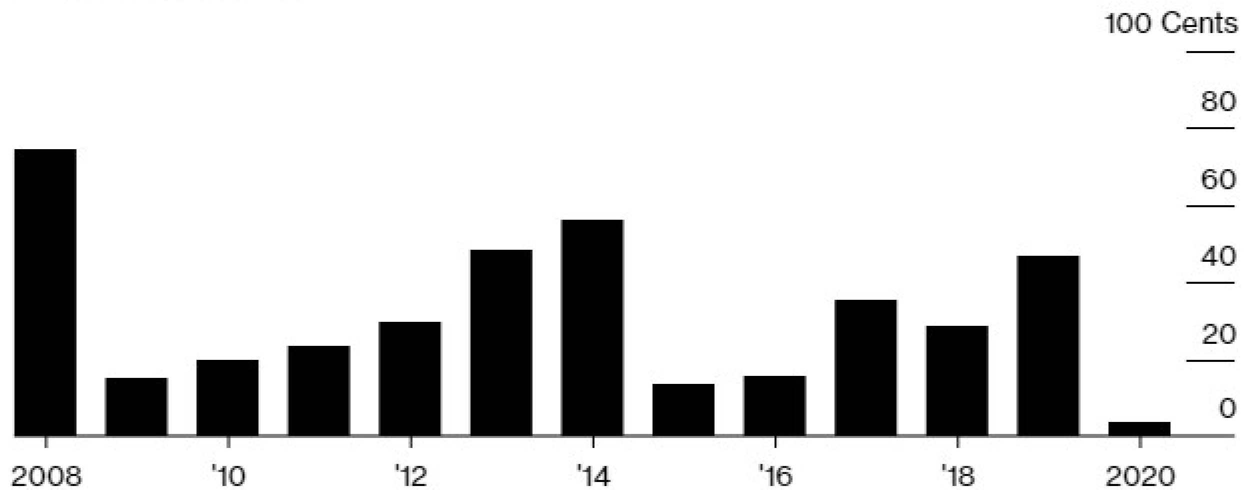
	Last	5d %	YTD %	1yr %
SPX	3271	-4.8%	1.3%	7.6%
QQQ	284.2	-4.4%	27.8%	37.5%
US 10 YR	0.77%	0.82%	1.88%	1.84%
VIX	40.3%	28.7%	23.2%	13.2%
Oil	40	-6.6%	-38.8%	-29.1%

*10yr and VIX are levels not changes
** Oil is front month futures, beware

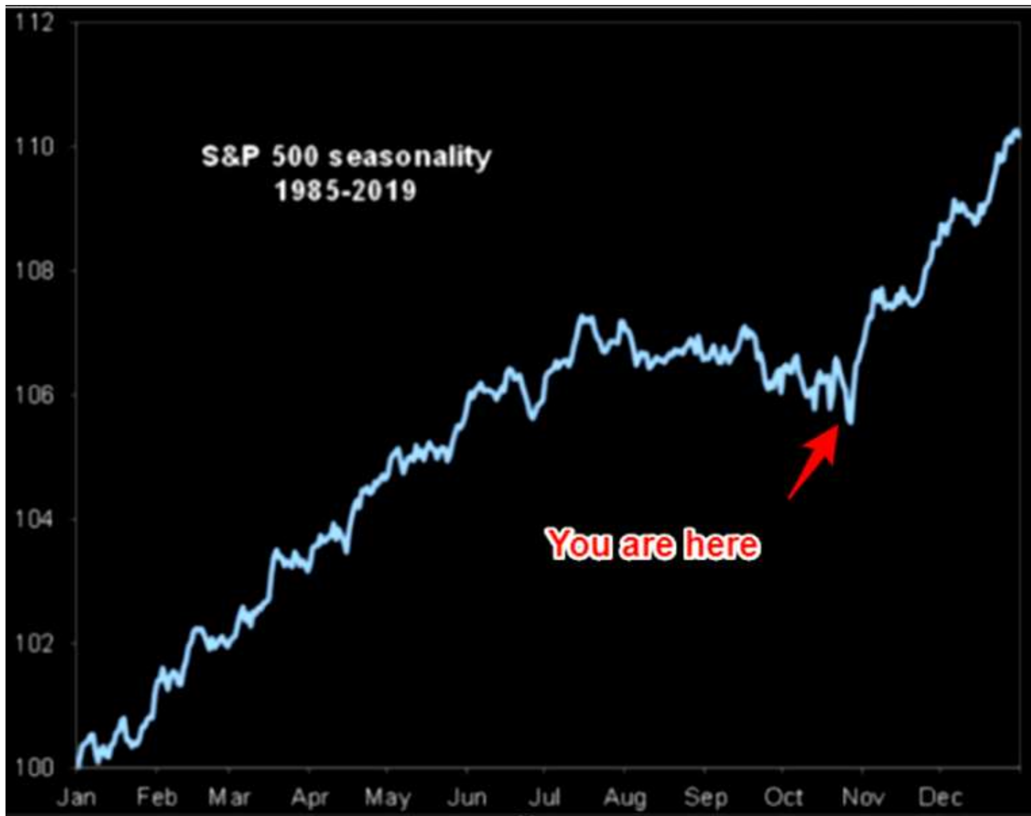
Market weakness turned into a relative bloodbath. The three-pronged narrative continues to dominate. Higher virus counts globally and lockdowns in Europe are the major source of concern. Even the naysayers understand that the fear of the virus can drive economic behavior. Stimulus talks are all but dead with congress having taken leave to campaign down the stretch. And obviously the election is still top of mind. On this note, we think the market has priced in a Biden victory along with a democratic sweep in congress. On the margin, we think the market likes Trump slightly more than Biden hence the (previously) mild weakness. But with some new swing state polls showing the election might be closer than the nationwide polls are indicating, we think the extended selling today reflects renewed nervousness over a contested election outcome. This is still the central political risk in our view. Even if a contested election is plainly political theater, this will delay any chances of a lame duck session of congress passing any stimulus.

With the bearish arguments dominating the narrative recently, it is important to remember the bullish argument. Tom Lee of Fundstrat does a good job of summarizing. Remember, Tom Lee is an uber-bull, but he has been dead right: We are in the early stages of recovery. The credit outlook remains strong. Most hurdles are short-term in nature (no-stimulus/virus/election). Strong corporate profits will ultimately prevail over short term market fluctuations. We agree with this medium-term view. But we are still concerned about the short-term economic backdrop. But we are also on the record saying the longer the economy hangs on, the more likely it is to fully recover. That is, the virus fear will dissipate one way or another (vaccine, immunity, subconscious behavioral patterns). Time even heals all market and economic wounds.

We have often broached the chasm between consumer debt and corporate/government debt. Consumer savings is up; household debt is down. Government debt is outrageous but that is a hopeless cause for now. Corporate debt defaults look steady on the surface thanks to forbearance and other temporary measures. But the price of defaulted bonds shows real solvency trouble. Credit Default Swap (CDS) auctions are a price discovery mechanism for defaulted bonds. In the past 12 years, the average price of these auctions has moved between 10% and 60% (10% means a bondholder will only receive $0.10 for each $1 of debt held). The average for 2020 is 3.5%. Here is a snapshot from Bloomberg. To sum it up, companies that are defaulting are not just failing on the margin, they are failing in historic fashion with virtually no assets relative to their liabilities.

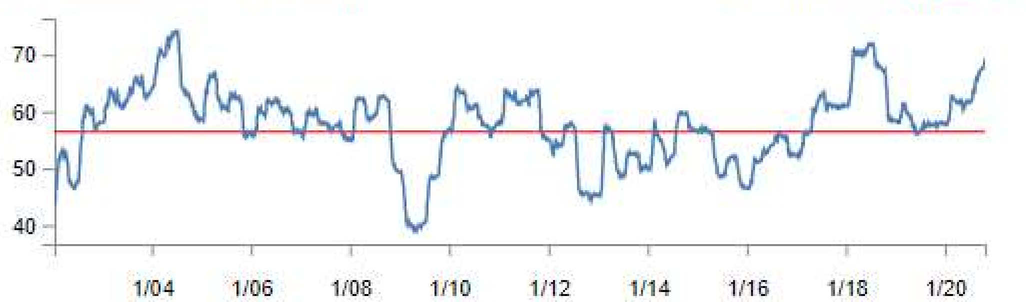


Here is a simple chart showing the seasonality of the performance of the S&P 500. The performance is similar in close presidential election years (this is sort of crime-esque because "close" seems subjective, but we will let it go). The "marketear" (a pretty good chart package subscription) has a whole slew of these charts grouped as "Everybody expects the melt-up." One of them is another form of the Gross/Net Leverage chart we showed last week – it still shows Leverage levels at five-year highs. The bottom line, the market usually does well at the end of the year, and everybody expects it to happen again! So…Sell! (And this is what is now happening).



- Earnings continue to shine but nobody cares

Earnings continue to shine. Last week we mentioned the record high "beat" levels (actual vs expectations). The chart from Bespoke below shows the extreme levels. The average beat vs consensus is about 18%. Financials account for about half of this beat. And the percentage of companies beating on the top and bottom lines (revenues and net income) is a record setting 69%. However, the bad news is that stocks are not reacting well to these better than expected earnings. The 69% that have pulled off the earnings exacta are *underperforming* the market. And the stocks that have missed expectations have *outperformed* the market. Merrill Lynch points out that the last time we saw this phenomenon was right before the tech bubble burst back in 2001. Looking ahead, tomorrow is the busiest earnings day of the year with the rest of FATMAAN reporting. Microsoft's good earnings were not enough to support the market today. We doubt the others will have much effect, either. It is a macro market right now (a macro "tape" as they say). But these strong earnings should provide the foundation for the market going forward.

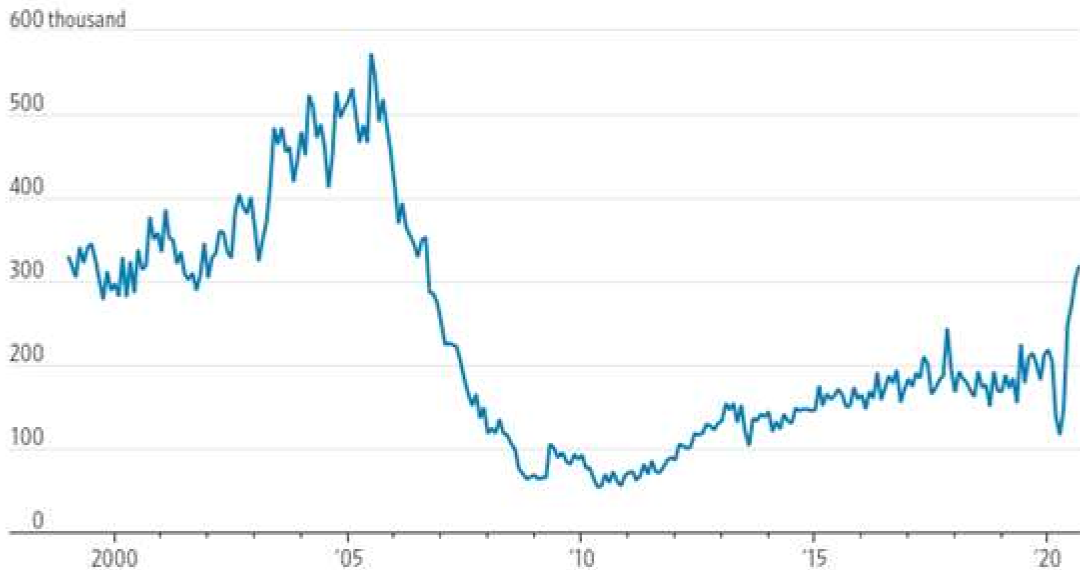


- Housing: the song remains the same

Existing Home Sales surged again with 9.4% monthly growth in September and 20.9% vs last year. The annualized run-rate hit 6.54mm which is the high since the housing bubble (May 2006 when that bubble was deflating). Supply dropped to 1.47mm homes for sale which is down 19.2% vs last year. This equates to 2.7 months of supply which is the lowest on record (tracking began in 1982). Conversely and logically, the median price jumped 14.8% to $312k. This is also the highest price on record (tracking began in 1968). Homes are only sitting on the market for 21 days (another record). The number of sales over $1mm doubled vs last year. Regional breakdown of monthly increases: Northeast +16.2%, Midwest +7.1%, South +8.5%, West +9.6%. Another telling stat is that vacation home sales increased 35% vs last year.

New Home Sales in September slipped a touch and missed expectations. But the annualized number of 959k homes still dwarfs last year's rate of about 700k. Supply dropped 32% vs last year which is probably why sales "slowed" marginally. Supply is also short in this segment as it sits at 3.6 months. The median price increased 3.5% vs last year; it hit $327k.

One area of concern in the summer was that perhaps much of the New Home Sales were being driven by "spec" houses (builders taking the risk without a buyer in hand and using leverage to do so). But the number of New Homes being sold without construction having started has been climbing rapidly. Builders can sometimes inflate their abilities unreasonably…they could be still be building spec houses despite an increased pipeline for already sold homes. But in this case, we think they are happy making the money that is flowing in without an increase in risk.

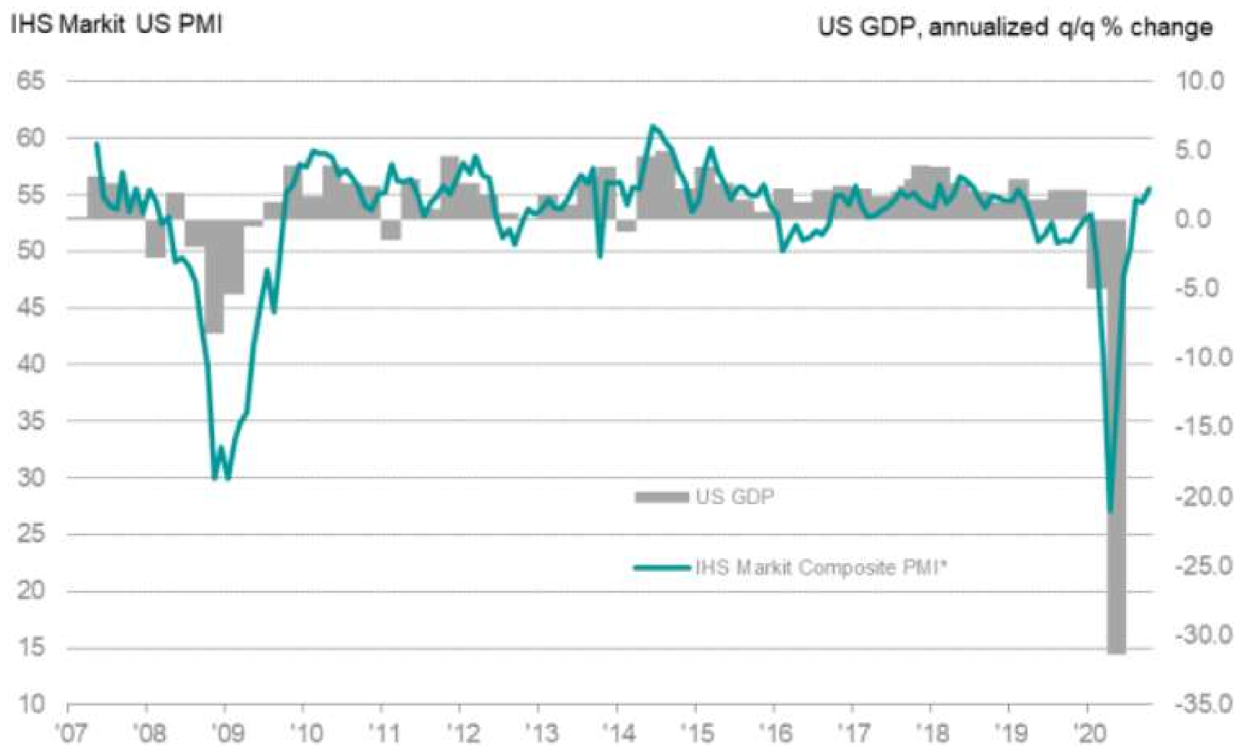


Our enthusiasm for the Housing sector is still tempered by the impending end to forbearance (millions of people have not paid their rents in six months). And we will add that building Input costs are going up, so the increased demand is not translating directly into great profit margins.

- Durable Goods and PMI Surveys strong, too

Durable Goods Orders (products seen lasting at least three years) showed surprising strength on the headline in addition to strong transportation orders (these are stripped out because they can be volatile). The ever-important Core Capital Goods (aka business spending) also showed continued strength. The level of output is now back near the last peak in 2015 (oil prices plunged then, too).

The Flash PMI from Markit continued its march higher. Private sector business activity in October increased at the fastest pace in almost two years. Services are leading the charge (present tense because this is an early look at October data), but Manufacturing is expanding at a healthy clip, too. Manufacturing indices published by the KC, Dallas, and Richmond Feds all showed continued strength. The downside to this data is that New Orders seems to be lagging. Just like in Housing, Manufacturers are feeling a slight pinch from increased input costs. But, perhaps, the most telling indicator is that business optimism was strong across the board. We think Markit tends to overplay the leading relationship the PMI has on GDP growth. But we do think its fortune telling ability is pretty good in this environment.



*Manufacturing only pre-October 2009

Sources: IHS Markit, U.S. Bureau of Economic Analysis

- Oil succumbing to demand and supply fears

Oil fell back to the bottom of its recent trading range with a perfect storm of negative headlines. Inventories in the US jumped. The renewed virus fear is squashing travel plans aka oil demand. And Libya has finally regained control of its oil facilities, so it will likely be bringing 1mm barrels of oil (equivalent) per day back on the market. And, of course, the Biden factor is hurting all things oil as he has promised to do away with certain tax breaks in the oil & gas sector. Oil traders are momentum guys at their core, so they will be watching closely to see if WTI futures can break down through $37.

- Quick Hits
    - Reebok was founded in the UK in 1890.
    - California has mandated against singing and playing wind instruments.
    - Part of China's plan to cut emissions includes planting trees.
    - The latest Barbie doll is the "Elton John barbie."
    - The University of Conn has settled a pay discrimination lawsuit. One of the violations: a women's team associate head coach made $313,000 and a men's team assistant coach (both were second in command) made $312,600. Both coaches were men. Title or Raise?
    - The CEO of a psychedelic mushroom company said with a straight face, "no mushrooms were harmed' in creating the company's product.
    - Turkey criticized France's treatment of Muslims after a French teacher was beheaded by an Islamic extremist. Turkish President Erdogan said French President Macron needed "mental treatment."

- Turkish President Erdogan still believes that high interest rates cause inflation, and he still believes in ESP.
- ETF managers are creating knock-off ETFs of their own funds.
- Scientists are studying murder hornets by attaching mini-GPS devices to them.
- 10% of all Twitter users post 92% of all tweets.
- One of the reasons there are so many political robo-texts stems from a pissing match between the FCC and FTC.
- Chinese banks are offering retail investors in China 33x leverage to participate in the Ant IPO.
- The European Central Bank's interbank settlement system failed on Friday causing $500b to "disappear" briefly.
- MLB lost $3.1b this year as revenues dropped from $10b to $3b (expenses dropped $4b).
- The Vegas Strip's "gaming win" dropped 39% in September vs last year. Lake Tahoe's "gaming win" jumped 35%.

Trading: We added another new short this week. It is one of the social media names. This is a short-term mean reversion play. But just like our anti-cloud play recently, we did not get to size this one up before it started to reverse. We cut it for a small profit. We will look to put it back on. We also added a touch to our long Treasury bet. Again, this is a short-term trade banking on the Fed buying UST's giving support to the 10 year around 0.85% (not that we are buying the 10 year outright, it is just the simplest way to measure long term rates). One could argue that it is also a hedge for our long financials position…but that it a bonus not the intent. We cut another long position in our Trading model. It was a healthcare name that we thought could double as a momentum play, but it appears to have stalled out (we cut for a small profit). We added slightly to our core defensive names. Despite these names not being cheap, they should hold up better in case of continued market turbulence.

TSLAQ: The ML analyst summed up his bullish view on Tesla with this: "TSLA…may or may not be dominant in the long-term, but that does not matter." It is still worth about the same as all the other auto companies in the world. But somehow dominance is not priced into the valuation?

30,000 Teslas are being recalled in China for a suspension defect. Tesla disputed the claims but is choosing not to challenge the recall. Tesla claims Chinese drivers are particularly rough on their cars. Toyota made similar claims back in 2004 only to have to pay a fine of $1.2b eight years later. And remember, the TSLAQ crowd has claimed for years that Tesla does not account for its warranty expenses correctly.

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