Chalk Creek Partners LLC

Registered Investment Advisor

Weekly Update 15-July-2020

Carlisle C. Wysong, CFA *Managing Partner*

- Market is all about a vaccine now
- Trading revenues highlight strong Bank earnings, but are defaults looming?
- Are Jobless Claims really improving?
- The Fed continues to shrink the balance sheet
- Merrill's Fund Manager Survey: cautious but still long Big Tech
- OPEC to increase production but US inventories drop

	Last	6d %	YTD %	1yr %
SPX	3227	1.8%	-0.1%	7.0%
QQQ	260.9	0.4%	22.7%	34.4%
US 10 YR	0.63%	0.66%	1.88%	2.11%
VIX	27.9%	28.1%	23.2%	14.0%
Oil	40.97	0.3%	-32.5%	-30.9%
*10yr and VIX are levels not changes				
** Oil is front month futures, beware				

The dominant market narrative at the moment is that the magic elixir for the virus is just around the corner. Even the once fearful Dr. Fauci thinks we can have a vaccine by the end of the year. With multiple candidates vying for the fame and riches (or just the riches), the chances are increasing. And most people are starting to realize…as we have been saying…that an increase in cases does not necessarily translate into an increase in hospitalizations or deaths (we need to be vigilant in watching the data, of course). Moreover, earnings have started off strongly with the Financials mostly beating expectations. Economic data continues to handily beat expectations albeit against putrid expectations. The Fed is still poised to lend our money to those of its choosing. And apparently a second round of stimulus is still a real possibility. Of course, none of this can account for the millions of jobs lost and countless business shut for good. Along these lines, the market is still vulnerable as evidenced by its sharp reversal on Monday. California spooked the market by reinstituting some of the lockdown measures. If it were not for positive vaccine stories on the heels of this, the focus would likely be on the staggering unemployment still.

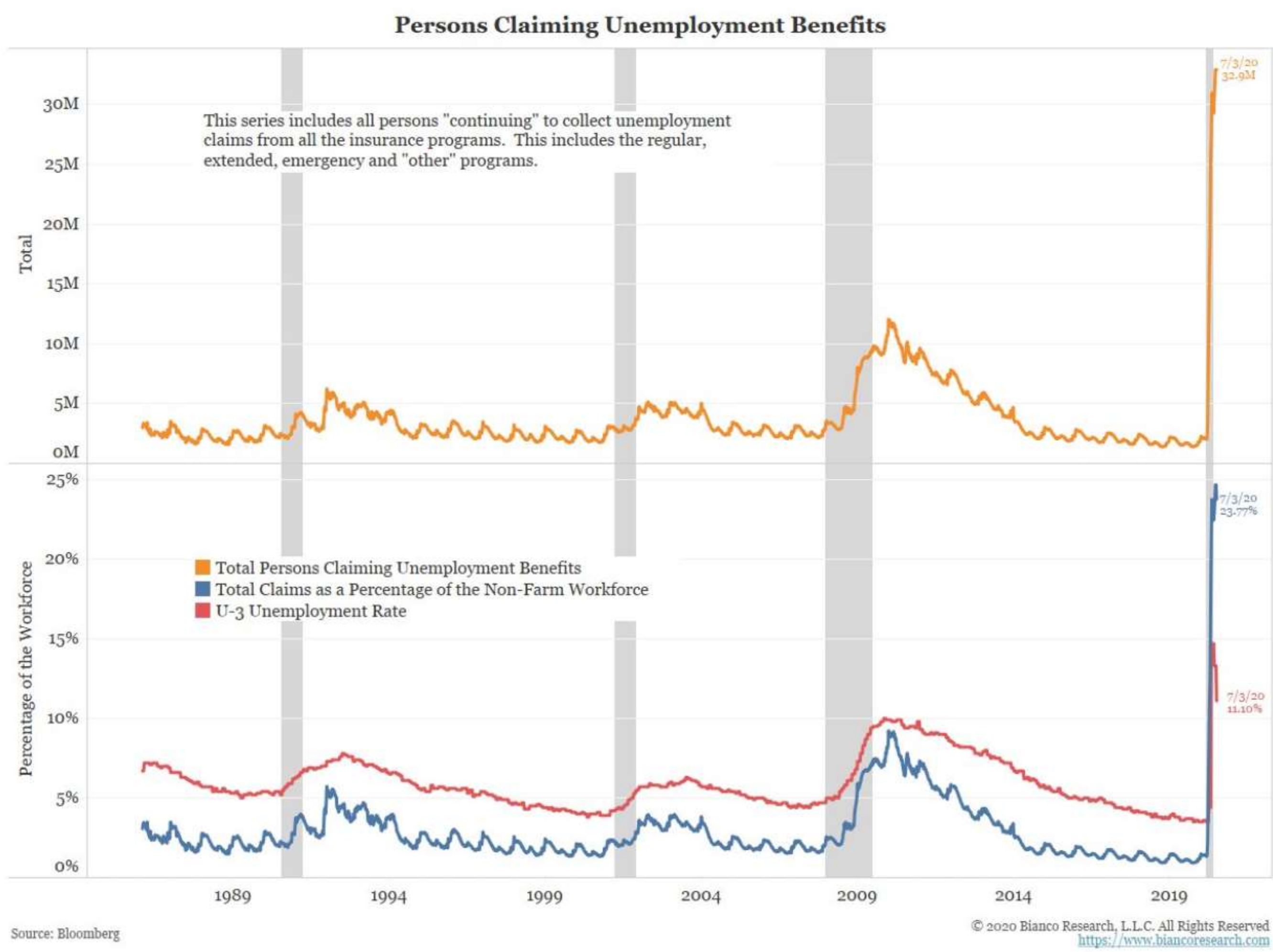
Fiscal stimulus is back in the news. Mnuchin said the aim was to get more direct payments into people's hands before the end of July when the PPP grants come to an end. He also added that the government is working on removing the disincentive for some to go back to work…people will not be allowed to get checks for more money than their jobs were paying them. As for extending PPP loans/grants, there is hope for another program, but the next one will be more targeted.

- Trading Revenues highlight strong Bank earnings, but are defaults looming?

Earnings season has officially kicked off with the large banks reporting. It is mostly a tale of two worlds. The investment banking divisions had near-record profits with super-charged trading and unparalleled fees from debt and equity issuance. The traditional lending side of the banks suffered as the majority of them increased their provisions for bad loans much more than expected. All told, share reactions were volatile. The bulls say the increase in provisions is merely prudent behavior (not to mention an accounting move which can be reversed if defaults do not happen). The bears say it is a sign of things to come. And the bears dismiss the trading revenues as unsustainable. It is highly unlikely that Goldman (GS) will be able to buy oil at negative prices again (that is the rumor anyway). Then again, Goldman probably will not suffer the credit losses for which they have provisioned. We like the banks as a contrarian play believing they have provisioned adequately.

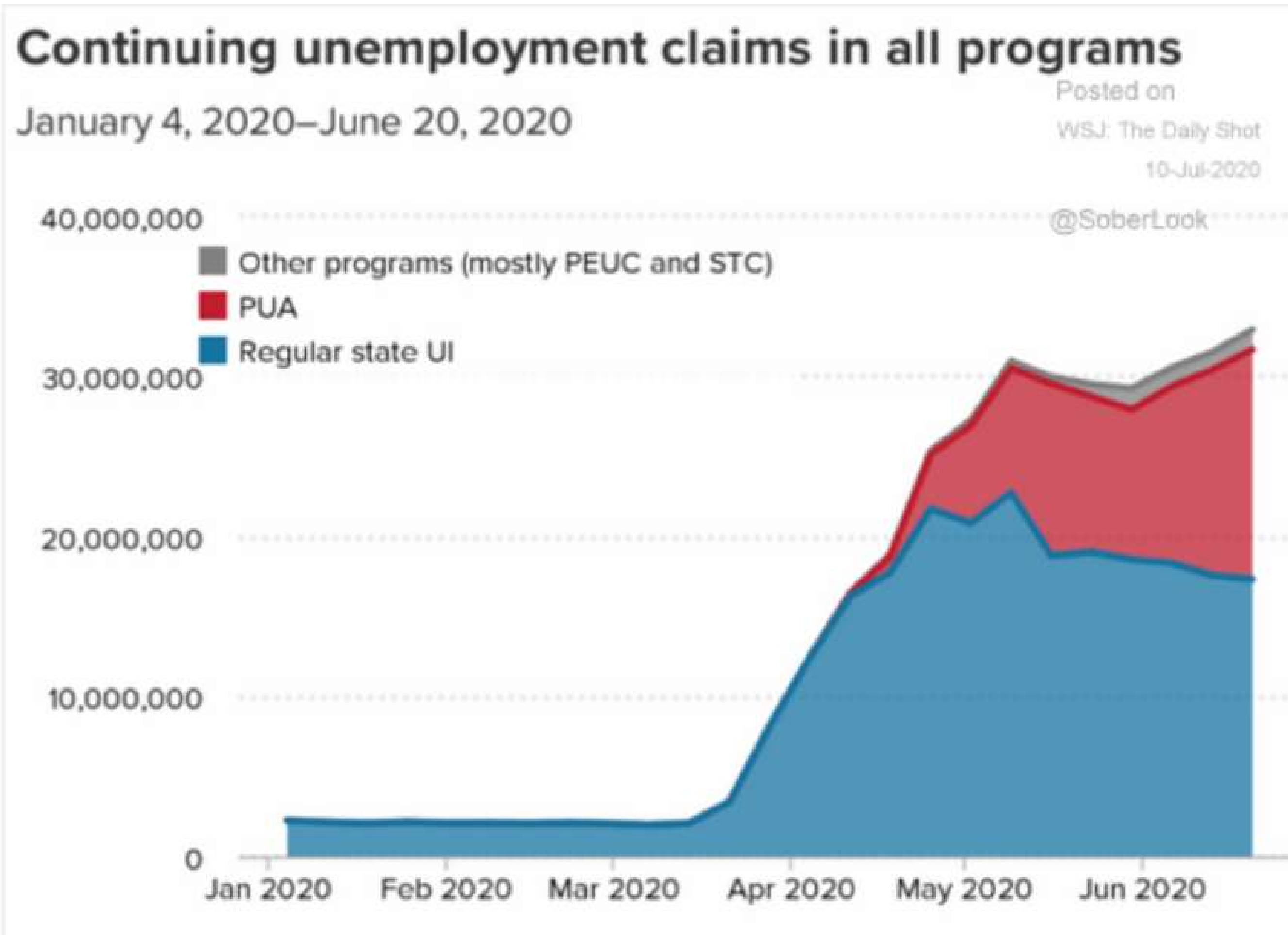
- Are Jobless Claims really improving?

The weekly Jobless Claims declined to 1.3mm. Continuing Claims also dropped nicely by 700k to reach 18mm. We thought 20mm would be a sticking point, so this is noteworthy. However, claims under the federal Pandemic Unemployment Assistance program increased by over 1mm. The charts below show the aggregate data. The Unemployment rate is 11.3% but 23.7% of workers are receiving unemployment benefits of some sort?



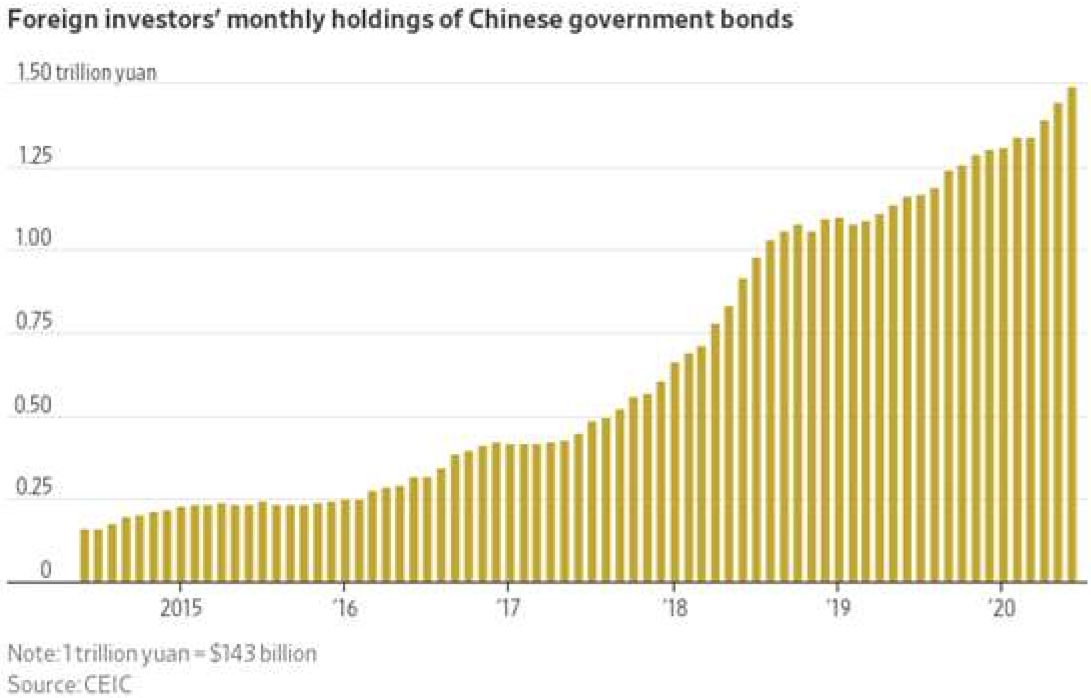
And the chart below shows that while traditional unemployment benefits are dropping, the federal PUA benefits are increasing. We think this data is terrifying. But this PUA data is just as muddled as the employment classification situation. Continuing Claims are around 13mm. But the cumulative tally for Initial Claims is around

8mm. So, do we have a phantom 5mm people getting Continuing Claims? Thankfully, no. PUA benefits allow for backdating and the states are backlogged. So, some benefits for March, for example, are just now being counted. Effectively, the same person shows up for multiple claims. But even at 8mm, (the true number is likely somewhere in between the 8mm and 13mm), this is an expanding trend. So, it is still terrifying.



China reported surprising strength in its June Trade Balance. The headline shows a drop in the Surplus. But this is function of imports improving more than exports. Obviously, more trade is a sign of an improving economy. Of course, Imports can be much more easily manipulated than Exports (the communists can just buy stuff like frozen pork for their reserve).

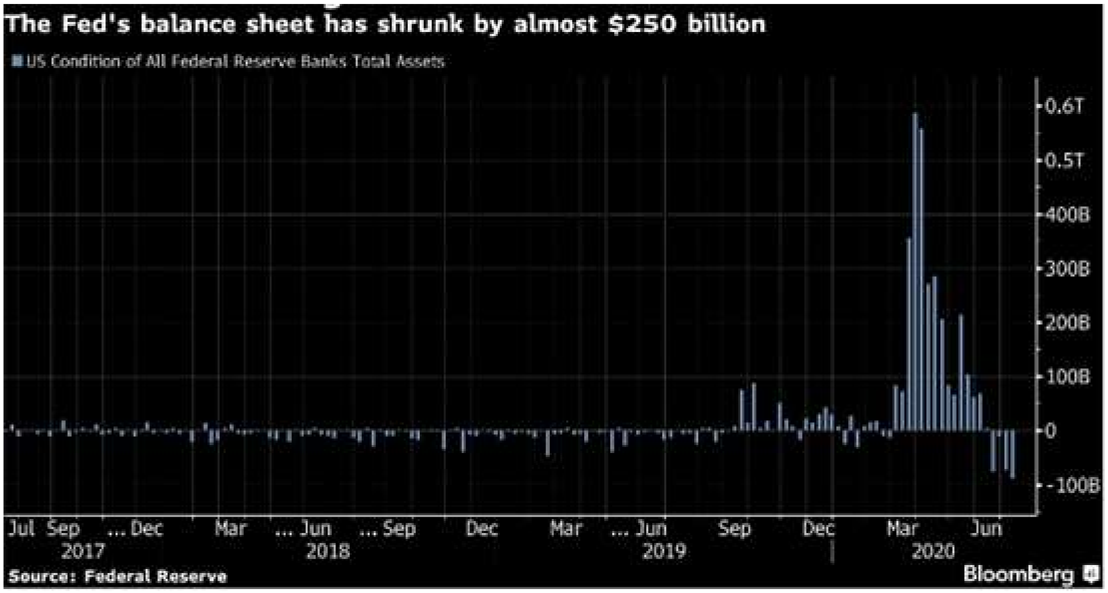
Speaking of China, foreigners's holdings of Chinese government bonds have been getting a lot of airtime lately: Apparently Chinese government bonds are considered the new flight to safety. Since the communists will always lie about the strength of their economy, they will also always be there to pay off their debts, or so the thought goes. Moreover, to make sure the economy stays on stable footing (or to at least have the appearance of stability), the central bank (PBOC) will likely keep cutting rates and thus make outstanding bonds more valuable. We will add to this that with the state-controlled currency stabilizing (USDCNY has fallen back to 7, remember this is a direct currency quote referencing the USD. so if it goes down, this is the USD weakening and the CNY strengthening), there is even less risk. All of this can change on a dime, but the communists are usually very committed to their stances and actions (except for the massive reversal in their view towards pumping the stock market recently, see below). Here are the bond holdings:



Last week we mentioned China as a source of bullishness spreading the globe. We left out that the communists were actively pumping the market higher by directing the state-run media to espouse the gifts and glory of the stock market. Well, the ever-meddlesome central planners decided to reverse course. The communists directed some state-run funds to sell stocks…and do it publicly with an announcement *preceding* these sales. You would think they would be smart enough to announce it *after* the sales. But hey, they are communists.

- The Fed continues to shrink its balance sheet

The Fed's balance sheet shrunk in size again last week. This makes four weeks in a row, and it is $250b lighter. Of course, the shrinkage comes in the same form in which the bloating started. The Fed is pulling back its USD swap lines (giving USD to foreign central banks that need it for USD financing needs in their countries) and its daily repo operations (buying securities from banks to inject short term liquidity…these are different than standard Quantitative Easing purchases because the repos are reversed in a day (or other pre-determined short amount of time). Alas, the total assets are still $6.9t. Here is a good chart from Bloomberg showing the weekly actions of the Fed:



The Fed's Beige Book (data recap by the regional Fed banks heading into the next FOMC interest rate meeting) did not offer many surprises. New York City real estate is collapsing. Sporting Goods sales are booming even in places like Chicago. Apparel sales have rebounded but only with large promotions. Meat packing plants are still experiencing supply chain issues which have impacted beef prices the most (higher). Auto sales have been strong in general. When it comes to expectations for unemployment, the regional banks did not offer much guidance. To wit: "Contacts (businesses) in nearly every District noted difficulty in bringing back workers because of health and safety concerns, childcare needs, and generous unemployment insurance benefits. Many contacts (businesses) who have been retaining workers with help from the PPP said that going forward, the strength of demand would determine whether they can avoid layoffs." Fox Butterfield would be proud.*

Eric Rosengren of the Boston Fed spoke about a possible second wave of corporate retrenchment. Most of the focus has been on what happens to individuals when unemployment benefits or emergency disaster relief stops. But Rosengren said the same fear is applicable to corporates. When the PPP money is gone and if the economy is still struggling, will they be able to go back to the banks (or capital markets) to obtain more financing?

Lael Brainard, one of the Fed's Board of Governors (recall the Fed has 12 regional banks with presidents that rotate on the Fed's interest rate committee while the Board of Governors always vote on interest rate decisions), sounded more caution. She thinks the ramp up in hiring in May and June may not be sustained. More fiscal stimulus is imperative. This sounds scary, but then again, it means she wants to keep the Fed buying everything in sight (or lending as it likes to say).

Jim Bullard of the St. Louis Fed sounded a much more optimistic tone. He thinks Unemployment can get to as low as 7% by the end of this year. We suspect Bullard is not in the majority.

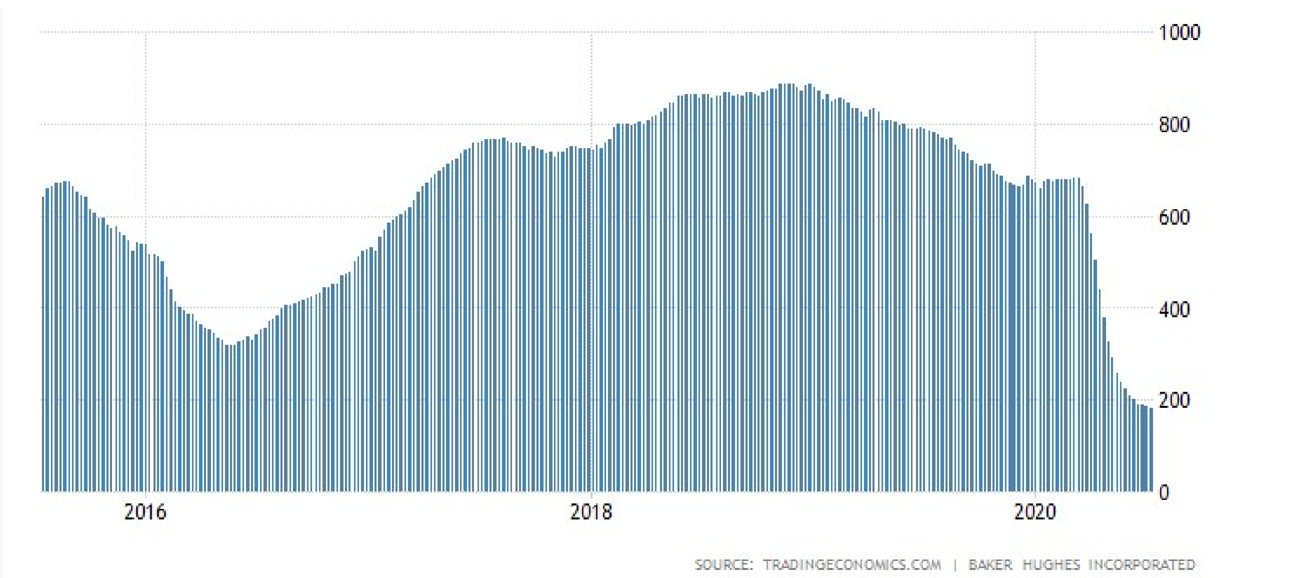
- Merrill's Fund Manager Survey: cautious but still long Big Tech

Merrill categorizes the consensus view as cautious with positioning biased towards impending bad news from the virus, economy, and election. Given this bearish stance, the most crowded long trade is still Big Tech. Health care is another consensus long as are bonds. The shorts reside in Energy, Banks, and Industrials. Interestingly, the two sectors that have seen some of the most ETF inflows are Energy and Financials. But these same sectors have seen large outflows in single stocks.

As we always say, we hate to be with the crowd…namely Big Tech. But the caveat to being contrarian is 1) riding momentum on short-term trades or 2) very long-term trades where there is a distinct and growing change in consumer behavior. We think the large QQQ names (Apple, Amazon, Microsoft, Google, and Facebook now account for 47% of the index up from 40% at the beginning of the year) all fit into this long-term bucket (and have obviously been in the bucket for a while!). That is not to say there will not be hiccups along the way. To this end, we bought a good amount of protection on our large QQQ position this week.

- OPEC to increase production but US inventories drop

We expect oil volatility to increase with contrasting news stories taking shape. The Saudis and Russians have decided to curtail their production cuts from 9.7mm barrels per day to 7.7mm bpd. This was well telegraphed as the Russian oil companies had already started to literally prime the pumps for production to increase come August. On the flip side, crude inventories in the US fell by a large 7.5mm barrels last week compared to 2mm expected. This large drop was driven by the Saudis stopping exports into the Gulf of Mexico. In other words, the Saudis were trying to put pressure on US Shale without taking too big of a hit themselves (the bulk of Saudi oil is not sold in the US). On the fringe, there is more trouble in Libya as the rebel Libyan National Army has successfully shut down all the oil infrastructure (production and exporting). Interestingly, the Libyans are blaming the UAE and Russian backed mercenaries, the Wagner Group. Libya is exempt from the production cuts as its 300k bpd production just came back online a month ago after pushing back the rebels. Also, on the fringe, apparently Iraq and Nigeria have actually been holding to their cut pledges. Ultimately, we think production will continue to increase keeping a lid on oil prices. Further to this, it looks as though the Baker Hughes Total Rig Count has stabilized. But there are rumblings of more production cuts in the Bakken and Eagle Ford. The Bakken is still battling the court-ordered shutdown of the Dakota Access Pipeline while the Eagle Ford was in decline even before the virus.



Actual	Previous	Highest	Lowest	Dates	Unit	Frequency	
181.00	185.00	1609.00	98.00	1987 - 2020		Weekly	NSA

- Quick Hits
  - Apparently, some of the Italian mafia's "receivables" were sold to a bank that repackaged them along with other healthcare receivables into a fixed income structured product.
  - Amazon warehouses have a "Time off Task" policy which limits the number of unproductive *minutes* in a day. Handwashing no longer counts as an unproductive minute.
  - Connecticut has had the worst state GDP since 2007 at -0.4% per year.
  - Idaho's annual GDP growth since 2007 is +4.1%.
  - Lumber prices increased 60% in 2Q.
  - Chinas claims they found the Wuhan virus in imported shrimp.
  - The Chinese shrimp farming industry has shrunk dramatically recently because of…disease.
  - CNBC reported that cyber crimes involving the virus have increased 330% since March. How many were there before the virus was around?
  - TLSA stock surged 40% at one point this past week thanks to Robinhood traders and their inherent dyslexia (or laziness or stupidity). TLSA=Tiziana Life Sciences…not Tesla (TSLA).

*Fox Butterfield is known as the master of the obvious in some journalism circles.

Trading: On QQQ, we bought out-of-the-money Puts and sold an out-of-the-money Call Spread. Volatility, one of the inputs of option pricing, has been relatively subdued while the ETF marches higher. This made the Puts a little bit cheaper. But Vol is still not cheap outright, so we wanted to offset this by selling the Call Spread. Moreover, if QQQ has a sharp pop higher, we will be happy to sell some of our position. The Spread feature of this position means we will still have long exposure if it really rallies higher. Buying this protection afforded us the ability to buy some more of the single stocks we like – a mix of recovery stocks (airlines, energy) and work from home stocks (cyber security, guns, and health care).

TSLAQ: A month into the life of the Model Y, the overwhelming demand has resulted in a $3k price cut. This comes on the heels of a price cut for the Model S and X back in June. But this is silly talk. Auto margins and valuation mean nothing. The bulls are now saying that a $100 monthly subscription service is in the cards. Another cheerleading analyst wrote that he had to adjust his Discounted Cash Flow model because of the surging stock price. That is not how this is supposed to work (the value of the future cash flows of the company lead to the current share price…not the other way around). And it would not be a week without a funny Bond Villain tweet. Yes, of course, he was hacked. But it is funny that the bitcoin scammer targeted the twitter account with the most amount of, shall we say, naïve followers.

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