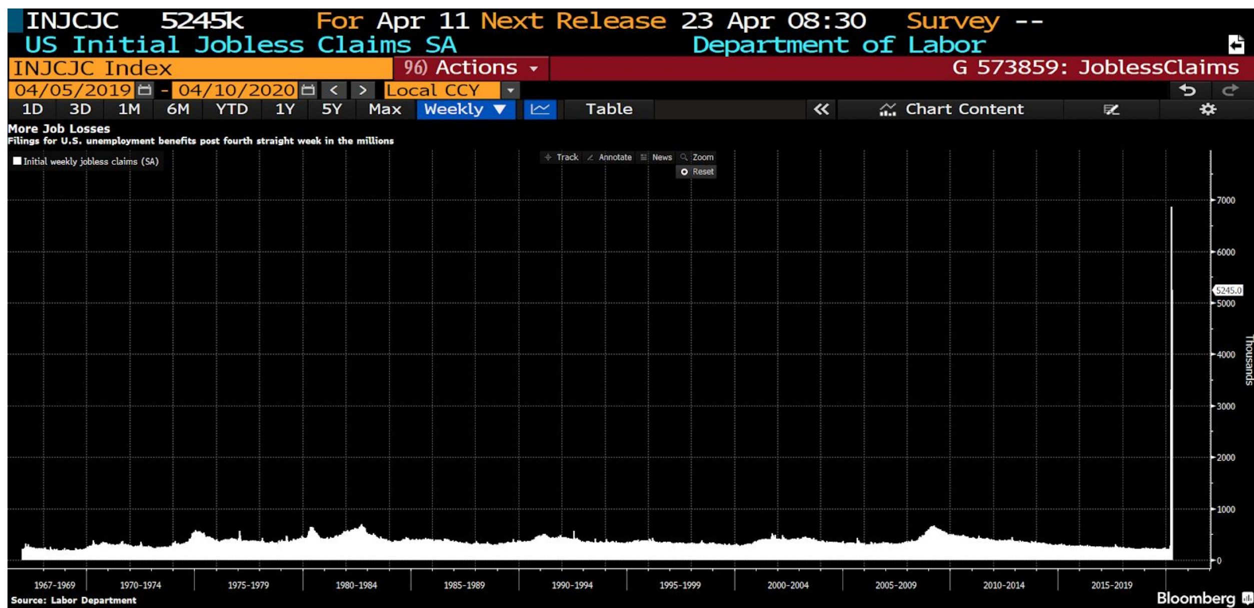
Inverted Balance Sheets...

22 million in initial US jobless claims over the last four weeks wipes out the total number of jobs created since the Great Financial Crisis 10-years ago.

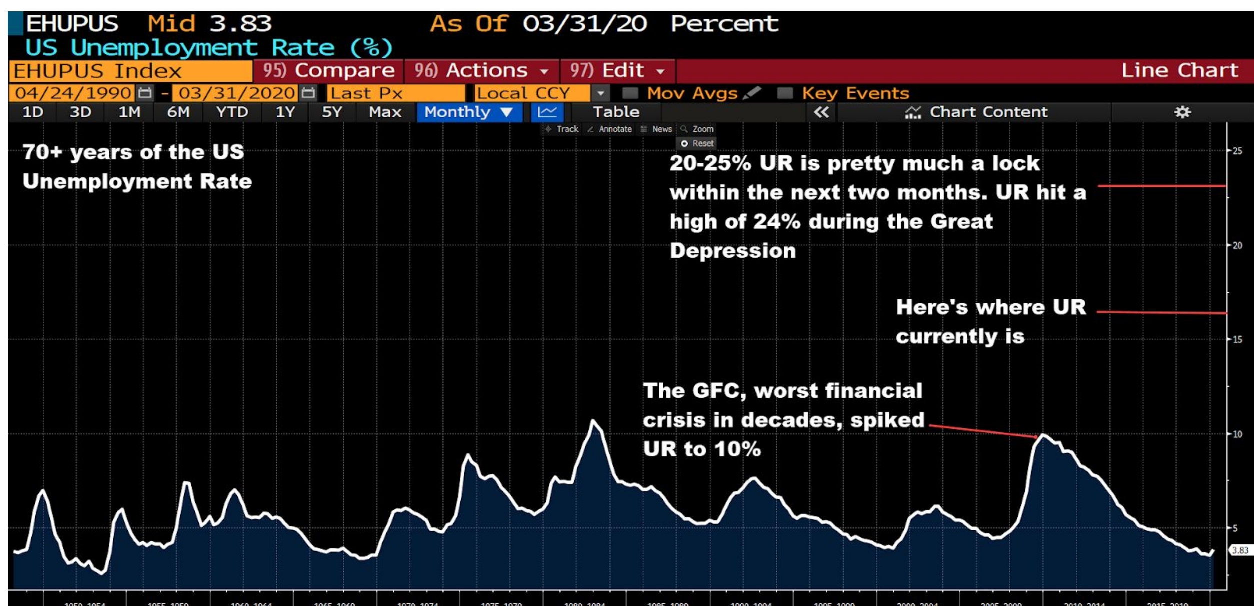
There are roughly 152 million workers in the US, or rather there *was*. With the unemployment rate now around 16% that number is considerably lower.

Let that marinate for a bit….

Here's another visualization. This chart of initial claims goes all the way back to the 1960s. The size of the recent spike is so large it's practically meaningless. Like large numbers that are beyond our comprehension, the speed of the devastation this virus has brought upon our economy is so severe it's literally unimaginable.



Maybe this will help cement the point. 70+ years of the US unemployment rate.



How about some color from a recent survey of more than 5,800 small businesses done by NBER with emphasis by me (link here).

➢ Small businesses employ almost fifty percent of American workers. In our sample, we found that 43 percent of businesses were temporarily closed, 1.8% are already permanently closed, and that <u>employment has fallen by 40 percent.</u>

- This represents a shock to America's small firms that has little parallel since the 1930s.
- Our results suggest that many of these firms have little cash on hand, which means that they will either have to dramatically cut expenses, take on additional debt, or declare bankruptcy.
- The median business has more than $10,000 in monthly expenses and less than one month of cash on hand.
- **75% state they only have enough cash on hand to cover two months of expenses or less.**
- Firms in particularly exposed industries - such as restaurants, tourism, and personal services - project that they will find it extremely difficult to stay in business if the crisis lasts for longer than four months.

Roughly one-third of BofA's small business loans are now in deferral. That's massive… whether these loans end up being "money good" or not depends almost entirely on the duration of this epidemic. The length of which is still a complete coin toss.

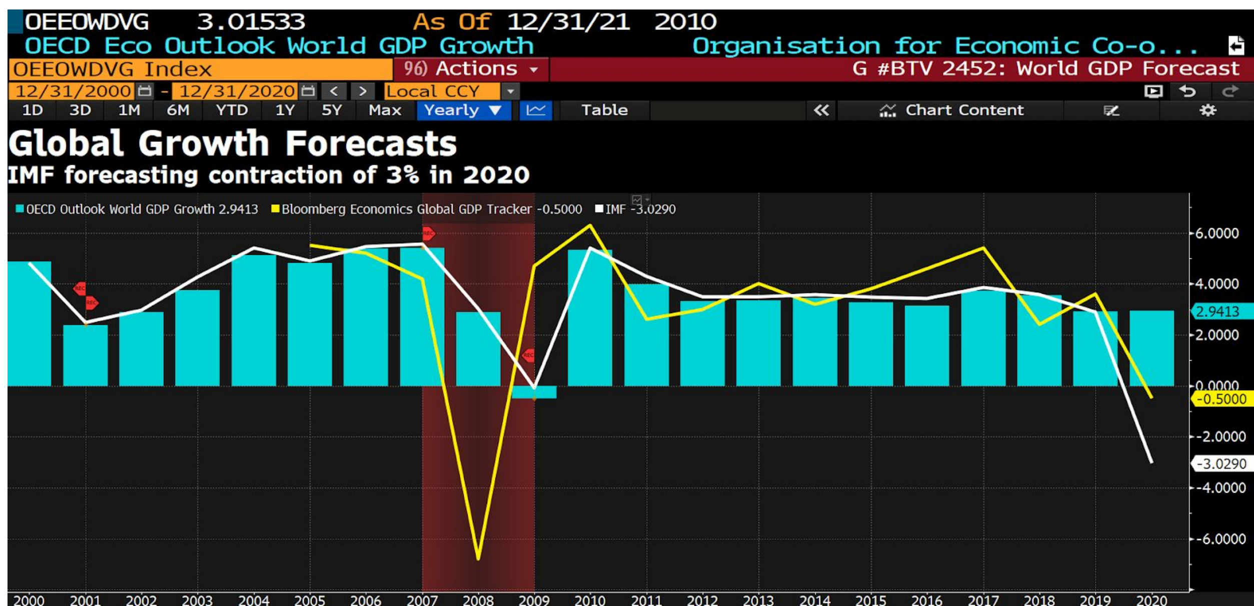
	% of Accounts with Deferrals	% of Balances with Payment Deferral	General program details [1]
Consumer and small business card	3%	5%	Deferral of 60 days for Consumer, 90 days for Small Business; interest continues to accrue and added to principal balance when deferral ends
Small business loans and lines	16%	32%	Deferral of 90 days; for loans, interest continues to accrue and deferred payment added to end of loan; for lines, interest continues to accrue and added to principal balance when deferral ends
Mortgage	5%	7%	Deferral of up to 90 days; interest continues to accrue and deferred payment added to end of loan
HELOC	3%	6%	Deferral of up to 90 days; interest continues to accrue and deferred payment added to end of loan
Consumer vehicle lending	3%	3%	Deferral of 60 days for Consumer, 90 days for Small Business; interest continues to accrue and deferred payment added to end of loan
Total	**3%**	**7%**	

The columnist Martin Wolf pointed out the direness of our economic situation in the FT this past week, writing (emphasis by me).

> "In its latest World Economic Outlook, the IMF calls what is now happening, the "Great Lockdown". I prefer the "Great Shutdown": this phrase captures the reality that the global economy would be collapsing even if policymakers were not imposing lockdowns and might stay in collapse after lockdowns end. Yet, whatever we call it, this is clear: it is much the biggest crisis the world has confronted since the second world war and **the biggest economic disaster since the Depression of the 1930s**. The world has come

into this moment with divisions among its great powers and incompetence at the highest levels of government of terrifying proportions. We will pass through this, but into what?

"For what any forecast is worth, the IMF now suggests that **global output per head will contract by 4.2 percent this year, vastly more than the 1.6 percent recorded in 2009**, during the global financial crisis. **Ninety percent of all countries will experience negative growth in real gross domestic product per head this year, against 62 percent in 2009**, when China's robust expansion helped cushion the blow."



Considering the above, it's amazing to see the boldness of calls coming from Wall Street banks saying the bear market "has concluded" and all "pullbacks should be bought".

It's funny how confident they all become once the SPX has rallied 30%+ off its lows. Where was this bullishness two weeks ago?

The economist and punk rock music producer Michael Pettis twittered out an important thread recently which is worth reviewing, as it ties into our running commentary over the last few weeks on the fragility of our economic system. He says:

> "One of the great benefits of Hyman Minsky's balance-sheet approach to economics is that it forces analysts to consider how the structure of balance sheets can either dissipate or reinforce underlying conditions, and we may get another lesson in this as the economic impact of COVID-19 evolves.
>
> "The problem is that when an economy goes through many years of rising real estate and asset prices, surging debt, and loose monetary conditions, business balance sheets tend to get structured in highly speculative ways that effectively "bet" on more of the same.
>
> "For example, businesses that leverage up, that shorten debt maturities, that buy more real estate than they need for current operations, or that otherwise increase the riskiness of the liability side of their balance sheets, on the assumption that future conditions will be "more of the same" – in my 2001 book [The Volatility Machine] I referred to these as "inverted" balance sheets – will outperform businesses who manage their balance sheets more prudently.

> "As a result over many years, the less prudent ones will either displace their more prudent competitors or will force them to adopt riskier balance sheets. This is the business equivalent of getting up and dancing as long as the music is playing. Over time the whole economy "shifts" towards riskier balance sheets. This is likely to be a problem nearly everywhere, and especially in China, where decades of artificially high growth, soaring real estate prices, excess liquidity and surging debt have transformed the balance sheet structures of nearly all businesses.
>
> "Inverted balance sheets are highly pro-cyclical. As long as underlying conditions are brisk, they allow businesses to boost operating profits with balance sheet structures that embed a great deal of speculative activity, but when underlying conditions reverse, instead of higher-than-expected profits, these businesses suffer higher-than-expected losses, with lower revenues being reinforced both by rapidly rising borrowing costs and, if the risk of insolvency rises, by rising financial distress costs.
>
> "Economies and businesses with highly inverted balance sheets tend to surprise on the upside when conditions are good, often developing a reputation for smart management, and then destroy this reputation when conditions reverse. Call it the "Enron" syndrome or, for some of my more mature followers, the "Orange County" or even the "Japan bubble" syndrome."

Global leverage is the highest its ever been, both from a private and public standpoint. The global balance sheet is inverted with a Capital I.

This makes financial stress non-linear. Conditions can deteriorate much more rapidly than they can improve. And this financial gearing makes suspect the real value of all assets, both financial and real. What are businesses, real estate, artwork, "bananas duck-taped to walls" really worth if our balance sheets were to begin to unwind, causing borrowing costs to skyrocket, and lending to dry up?

Nobody really knows but since we're at or near the end of our Long-term Debt Cycle I suppose we'll soon find out.

You know… if you talk to any business operator, from small to large, or any VC/PE guy with their fingers on the pulse of their portfolio companies, they are scared… and I mean *really* scared.

The contrast between the fear of those actually operating on the frontlines and the head-in-sand nonchalantness of the Street saying "the bottom is in" has perhaps never before been so stark.

There's a massive disconnect. Like a Grand Canyon wide disconnect between financial markets and the real economy right now… But, hey, I guess that's to be expected in a major regime change. Total utter dissonance from the herd.

The majority is still operating off of the old rules, with the old assumptions, expecting the old results. They haven't noticed we're in a new paradigm, playing a new game, with new rules.

Charlie Munger gave a great interview in the WSJ over the weekend (link here). He's always been my favorite of the Berkshire duo. At 96 years of age, he's lived through his share of market cycles, likely more attentively so than anyone else alive today. Below are a few of his key takeaways.

> "Nobody in America's ever seen anything else like this, This thing is different. Everybody talks as if they know what's going to happen, and nobody knows what's going to happen."
>
> "Of course we're having a recession. The only question is how big it's going to be and how long it's going to last. I think we do know that this will pass. But how much damage, and how much recession, and how long it will last, nobody knows."
>
> "I don't think we'll have a long-lasting Great Depression. I think government will be so active that we won't have one like that. But we may have a different kind of a mess. All this money-printing may start bothering us."
>
> "I do think, sooner or later, we'll have an economy back, which will be a moderate economy. It's quite possible that never again—not again in a long time—will we have a level of employment again like we just lost. We may never get that back for all practical purposes. I don't know."

When asked if whether he and Warren are getting inundated with calls for help, similar to the GFC, Charlie says:

> "No, they aren't. The typical reaction is that people are frozen. Take the airlines. They don't know what the hell's doing. They're all negotiating with the government, but they're not calling Warren. They're frozen. They've never seen anything like it. Their playbook does not have this as a possibility. Everybody's just frozen. And the phone is not ringing off the hook. Everybody's just frozen in the position they're in."

It's like the market is a deer, frozen, staring wide-eyed at the headlights of a giant semi that's about to flatten it at 70mph and it hasn't decided yet whether it's going to hurt.

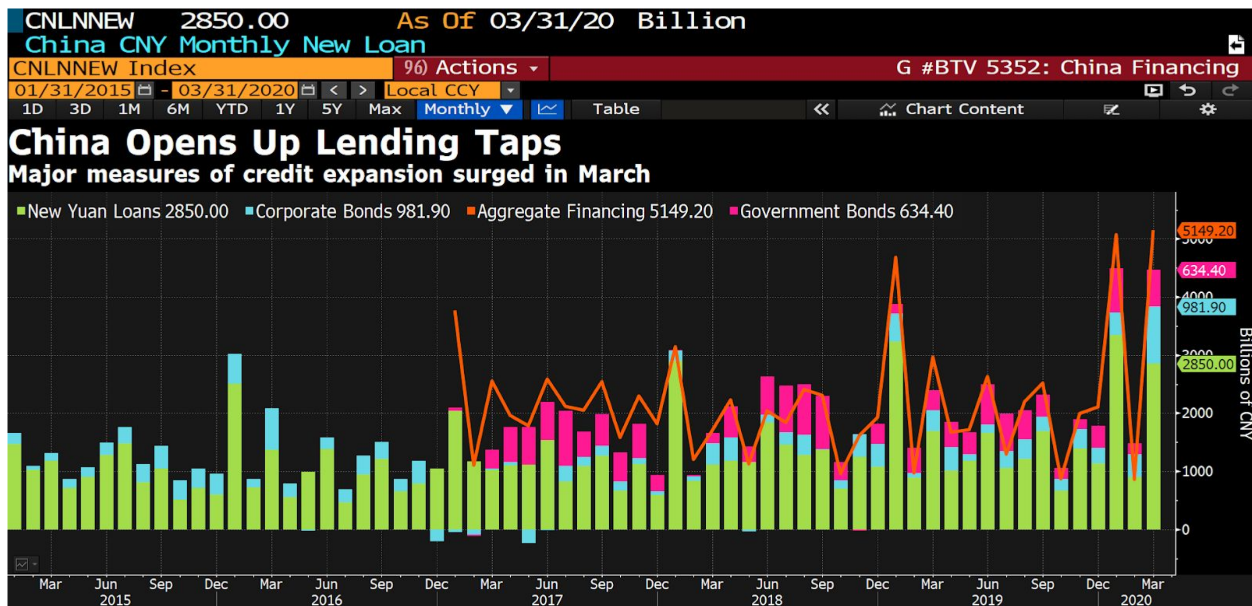
While the damage to the real economy is undeniable the Game Masters (central bankers and governments) have so far done an incredible job acting to provide a bullish counterbalance.

The number of new Fed Liquidity Programs is nearly too long to list and other central banks have followed suit. The size of the collective monetary injections we've seen to date dwarf anything that's been done before — and we're likely just getting started.

With China facing its highest levels of unemployment in decades it appears the CCP is shifting gears from doing only "targeted measures" to now calling for "broad-based economic support".

This is an incredibly important development.

China remains the biggest driver of macro and what happens there will either prolong this cycle or stop it dead in its tracks. The latest measures of credit suggest they may be going with the "kick the can" option, though it's still too early to call a trend. I'd turn more bullish if we started to see this show up in accelerating China M1 growth.



The fact that excavator sales by Chinese OEMs just hit "record levels" suggests they're turning to their old-growth levers of building unneeded and unproductive infrastructure en masse.

If this is the case, we should expect China's Q2 GDP to be significantly higher than expected. Not to mention it'll help build a floor under commodities.

Morgan Stanley recently projected that China will soon see 80mn-100mn workers out of a job. That's a lot of citizens not at work with plenty of idle time. The CCP knows all too well that idle hands are the devil's workshop which explains why they may blow their hard-fought plans for deleveraging and de-risking the economy.

This would, of course, be very bullish over the short-term. Especially for commodities, EM, shippers, and gold.

But even so, we're left with the uncertainty around the virus itself.

Take this recent comment from Morgan Stanley's lead Biotech analyst Matt Harrison (emphasis mine).

> "Over the past week, it has been striking to see how investors have reacted to the first signs that new COVID-19 cases in New York are starting to stabilize. While we understand the desire for optimism, we also caution that the US outbreak is far from over. **Recovering from this acute period in the outbreak is just the beginning and not the end. We believe the path to re-opening the economy is going to be long.**

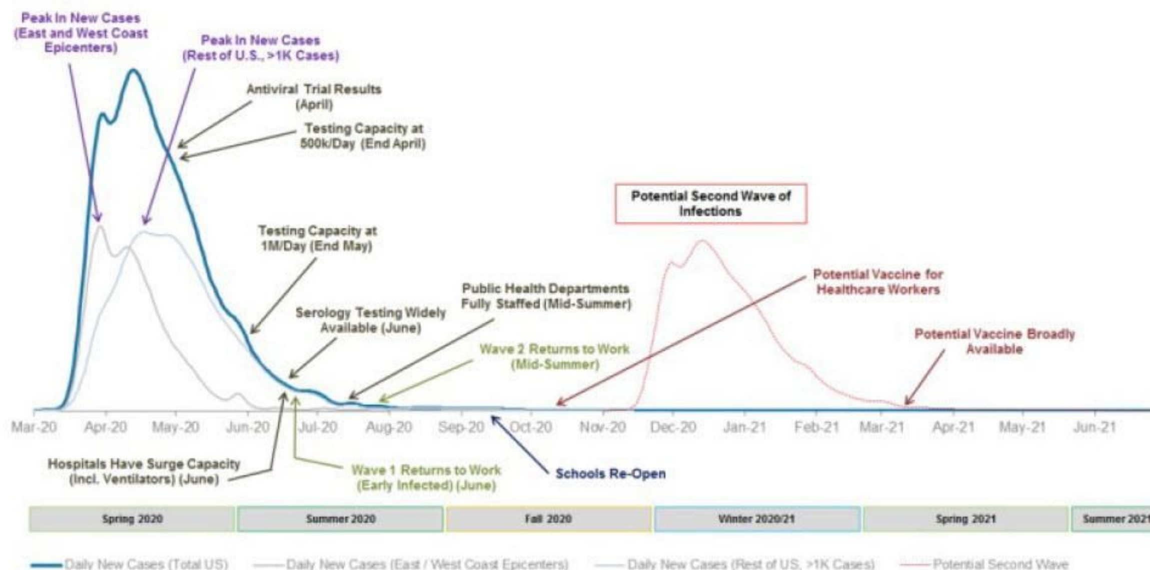
It will require turning on and off various forms of social distancing and **will only come to an end when vaccines are available, in the spring of 2021 at the earliest.**

"This would put an initial re-opening on track for mid-to-late May at the earliest. Investors should realize this won't be a 'normal' reopening… We see this happening in waves starting in mid-summer. Unfortunately, we think there **will still be a large number of workers not able to go back to work until a vaccine is abundantly available** as social distancing cannot be fully relaxed until we have herd immunity (~60% of people vaccinated). Furthermore, large venues such as sports stadiums, concert halls and theme parks are also likely to remain shut or have attendance capped at 10-25% of prior levels.

"This view on the delayed peak and slow return to work has led our US economists to revise their US forecast **a return to pre-COVID-19 levels not until 4Q21**".

Exhibit 1: Projected timeline and milestones for a return to work in the US

Actual/Estimated New Case Count (United States, Non-Cumulative)



Source: Morgan Stanley Research

This seems like a very reasonable take to me.

Sure, there's a chance we develop and mass-produce a cure such as Gilead's Remdesivir in the near-term — though there seems to be a wide gap between hope and probabilities.

There are also signs that asymptomatic cases may be significantly higher than first thought, in which case the death rate is much lower and we're that much closer to herd immunity. Though there's issues with trusting this data as well.

The takeaway here is that nobody knows diddly squat. I side with legendary market technician Walter Deemer on this when he recently said: "The only thing I have strong conviction about right now is that nobody should have strong conviction about anything right now."

Many falsely believe that the future already exists, somewhere out there. And they just need to do enough deduction to figure it out. That's wrong in normal times. It's doubly wrong now.

The future is multi-path dependent. It's knowable only to a certain degree of confidence and within a cone of probability. That cone is still wide as hell today.

Market review

The current retrace is still well within the normal range of bear market retraces. My original target of 3,000-to-3,100 on the SPX should be hit within the next week or two.

At these levels, the SPX will also hit its 50-week MA (chart below is a weekly) and run into a huge supply overhang marked by the red channel below. Around this time the Put/Call ratio 5&10 moving averages should trigger another sell signal.

An extended sideways volatile range for the SPX with a downward bias remains my longer-term base case.

Gold closed heavy on the week. The yellow metal is testing its inverted H&S neckline (chart is a daily). As well as battling some crowded spec positioning and technical overextension in the short-term. The primary trend is clearly up but its possible we see another period of consolidation here. I'd close out my long gold position and wait for another re-entry if we see a close below the 1,650 level.

There's a lot of attempted hole poking into the shipping thesis but for all of the short-term volatility, the longer-term charts of many tankers still look really good. Below is Teekay Tankers

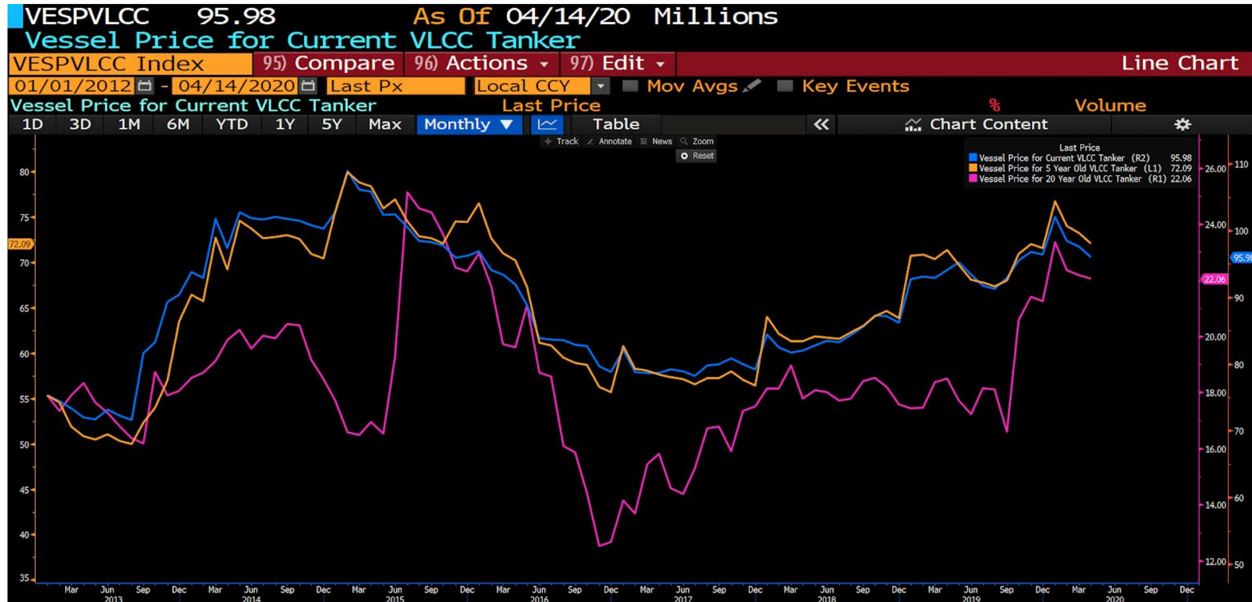
(TNK), which we have a position in (chart is a weekly). It's in a clear uptrend and is coiling in a tight bull wedge.

This is an asymmetric chart setup. A close well below the wedge would nullify the bull case, while if the bull case plays out there's incredible upside to be had.

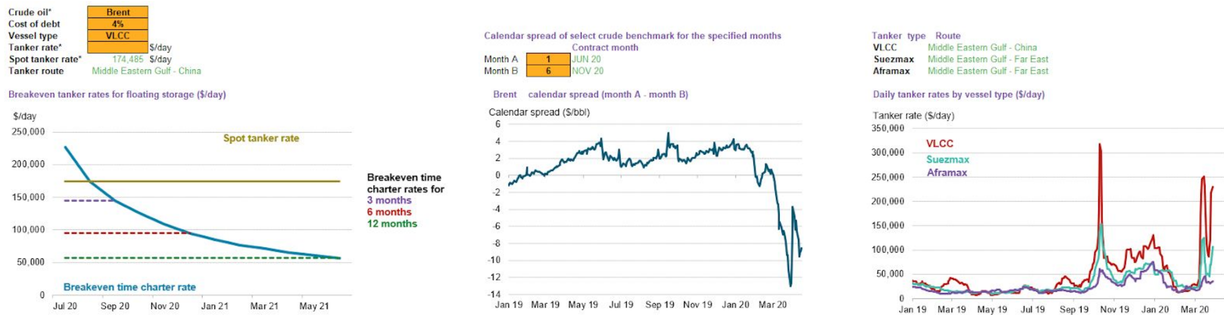
The naysayers seem to be missing the forest from the trees.

Tanker rates are making decade highs.

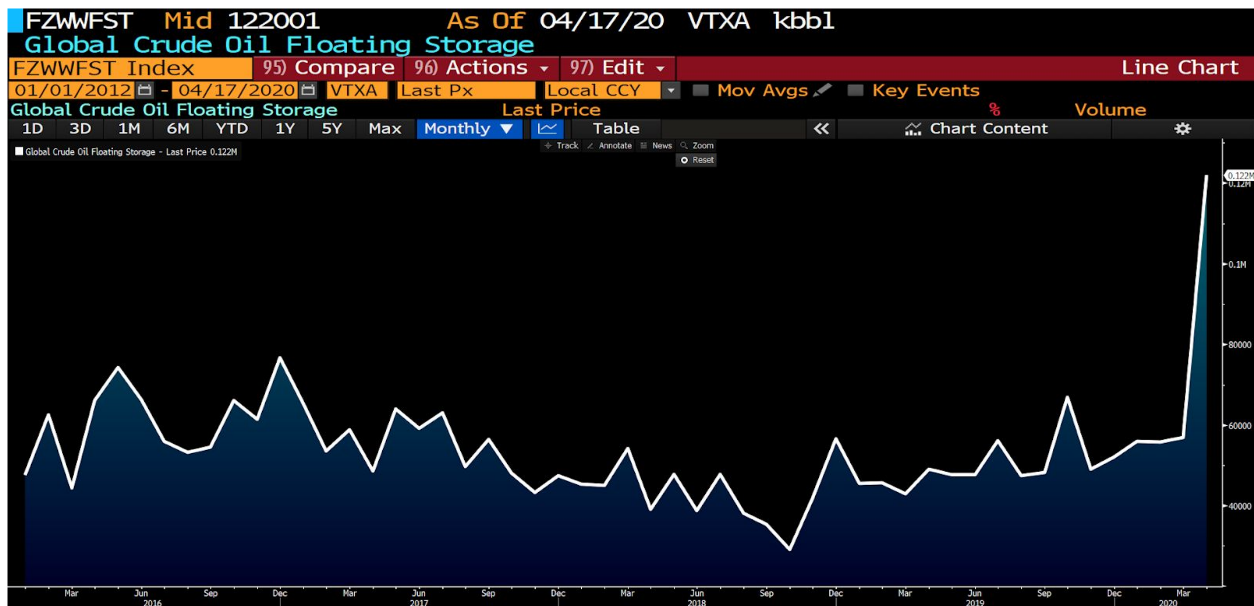
Vessel prices are trading up and to the right and are nearing decade highs (read: rising NAV).



The current brent curve puts the tanker charter rate at which the floating storage play becomes breakeven for commodity traders at roughly \$150k for a 3-month charter, \$100k for a 6-month, and \$60k for a 12-month charter. This means lots of money is going to be flowing to tankers.



The Global Crude Oil Floating Storage Index shows this trade is picking up. The index, which measures the barrels of oil being stored at sea, is hitting multi-year highs.



I will look for technical setups to continue to add to this trade.

Portfolio

Our starter position in Uranium producer Cameco Corp (CCJ) is up a little over 30% since we entered a couple of weeks ago. The uranium cycle may finally be starting to turn though it's too early to say for sure. There's been a number of significant events over the last few weeks that could pull forward the beginning of the bull cycle — something I wasn't expecting until 2021. I'll be sharing my thoughts in a writeup later this week.

I'm also currently working on a write-up on our other position, Overseas Shipholding Group (OSG). It's a shipping company that specializes in the Jones Act trade and has a monopoly on certain US niche markets. The company is coming off the backend of a large CAPEX cycle and recently locked in nearly the entirety of its fleet into long-term charter rates at high margin levels. This translates to OSG producing boatloads of FCF starting in 2021.

I'm excited about this one and hope to get the report out to the group soon.

The Four Pillars Portfolio		YTD Return				
		10.03%				
The Core	Allocation					
Large Cap Equities (/ES_H or VOO)	0%					
Short-term Bills (/ZT_M or VGSH)	25%					
Long-term Bonds (/ZB_M or TLT)	25%					
Gold (/GC_M or GLD)	25%					

Big Bets	Thematic	Cost Basis	At Risk	Notional %	Risk Point	Last Price
Teekay Tankers (TNK)	Deep Value/Cyclical	$20.30	100bps	4%	$15.20	$19.94
Overseas Shipholding Group (OSG)	Deep Value/Cyclical	$2.27	200bps	9%	$1.70	$2.39
Cameco (CCJ)	Deep Value/Cyclical	$7.25	100bps	10%	$5.80	$9.74

Finally, I highly recommend giving this short post from Marc Andreesen of Andreessen Horowitz fame. It's about how we as a society can use our current economic and health crisis as a positive force to help springboard us into the future. His answer: BUILD.

Shoot me an email or hit me up in Slack if you've got any comments/questions. Stay safe out there and keep your head on a swivel.

Your Macro Operator,

Alex