The New Normal…

There's a number of disparate topics I want to cover today so I'm going to just unload a stream of consciousness here.

To start I'd like to apologize for being a little inactive the last few days (if you've sent me an email, I'll respond by eod tomorrow).

A dear friend of mine passed away unexpectedly and I needed to step away from the desk for a bit. My friend was healthy, in his 40s with a wife and kids. He technically died of a heart attack but had been battling a terrible "flu" — they suspect it was COVID-19, but last I heard they hadn't gotten the test results back yet.

I typically don't share personal news like this but I think it appropriate to do so now. Because of what's going on in the world and all. There's never a better time than now to let those you care about know how much you appreciate them. Life is fragile, you never know when or if you'll get another chance to do so…

The cone has narrowed, somewhat

Brent Beshore of Permanent Equity wrote this great piece on how he's thinking about and preparing for the new world we now find ourselves in. I suggest reading it in full but I'll share some of the key points here.

In response to the question of, "What does this mean for the economy?" Brent writes:

> The short answer is no one knows much of anything with certainty. Duration, regulation, biology, virology, and behavior aggregate too many variables to triangulate with precision. At the same time, we can now say without question that the pandemic has caused an immediate and material retraction in economic activity.
>
> Here's my best guess on what happens next:
>
> As of March 29th, I believe we're headed for three phases: Lockdown, Winter, and a New Normal. The more "flattening the curve" that takes place, the less strain on the hospital system, but also the longer a government-mandated and/or self-imposed lockdown will be necessary. Preparing now will be essential for giving your organization the best chance for survival.

The cone of plausible outcomes that I first talked about back in February has narrowed somewhat. Unfortunately, the narrowing has been due to the more optimistic outcomes becoming improbable while the middle to worse scenarios, more probable.

The Good Judgment COVID-19 Project is now assigning a:

- 54% probability of 53 million to 530 million worldwide total cases by March 31, 2020
- 60% probability of 800 thousand to 8 million worldwide total deaths by March 31, 2020
- 58% probability of 2.3 million to 23 million US total cases by March 31, 2020
- 69% probability of 35 thousand to 350 thousand US total deaths by March 31, 2020

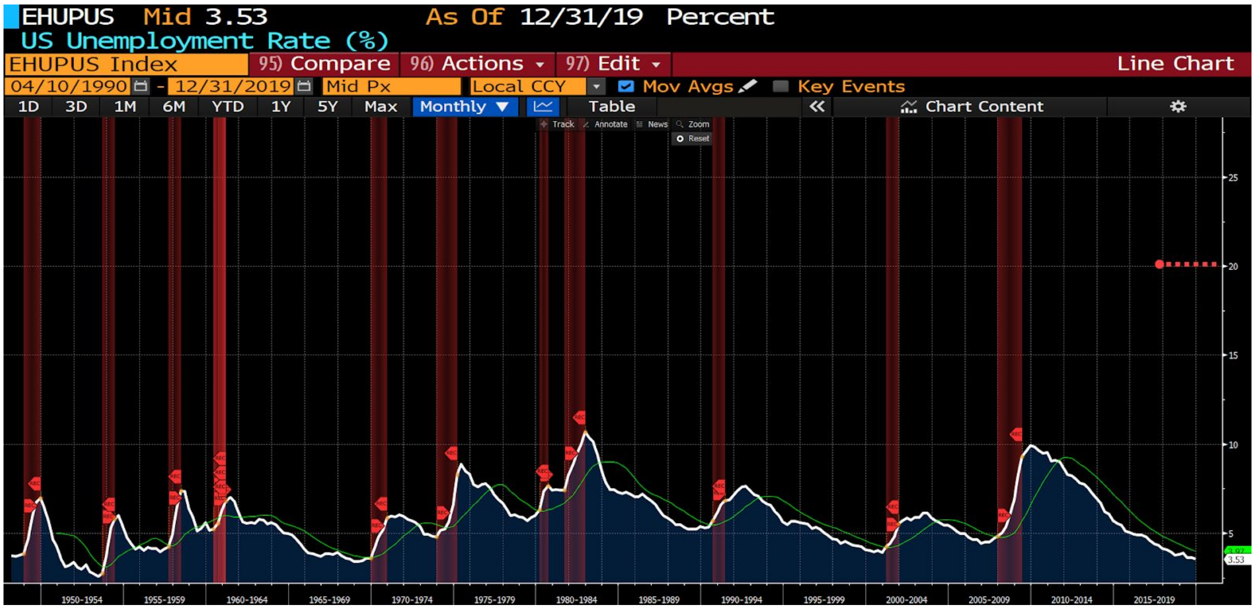
From these projections, we can surmise a few things (1) this “event” is not a temporary exogenous shock (2) varying degrees of social distancing are here to stay for the foreseeable future (3) the paradigm has shifted; the social, political, and economic impact of this virus will be significant and thus we’re entering a “new normal”.

Regarding this “new normal”, Brent writes (emphasis by me):

> My guess would be that 5% of existing companies will remain untouched by the paradigm shift, 5% will feel a tailwind, and 90% will experience at least a medium-term impairment, with 30% no longer having a viable business model due to shifting demand, stop-start problems, and a loss of operating leverage resulting in a high fixed costs burden. **This isn’t creative destruction; it’s just destruction.**
>
> Speaking frankly, we should expect and plan for a tremendous amount of pain personally and professionally. **I believe 20%+ unemployment is inevitable and could rise as high as 30%**. GDP seems set to drop 30-50% and I can’t see a recovery being “V shaped,” at least with the right side of the “V” rising to nearly the same level, without lengthening the time scale. Would we call that a backward check mark recovery? In the near term, **the average business will experience a catastrophic decline and around a quarter of your neighbors will be unemployed**. These are obviously **unprecedented times with unpredictable consequences.**
>
> When does any variation on the “V” begin to take shape? If there is only one period of global lockdown, after which the medical crisis swiftly comes to a close thanks to a vaccine. Then, re-employment and daily activities will have been materially disrupted, but not permanently impaired. If lockdowns continue or cycle, disrupting many months of life, the effects ripple and are likely to sustainably suppress or constrict every level of economic activity, from banking and credit markets to discretionary goods. As WSJ highlighted, consumer behavior hinges on duration: “The longer it goes, the more it hurts.”

The thought of 20-30% unemployment is pretty bleak and tough to wrap the head around.

To give you some perspective, we saw unemployment peak at 10% in the GFC and at 24% during the Great Depression. The chart below has 75-years of the UR. I had to squeeze the y-axis to show what a jump to 20%+ unemployment would look like (red dotted line).



I agree with Brent on all points. He has some unique insight into the matter as he runs a long-term PE fund that specializes in small (sub $15m in annual owner earings) businesses. He's face to face with the economic repercussions of this thing. While much of this will only become more apparent to the rest of us as social distancing rules are relaxed and we find out our favorite restaurant, cafe, bar, gym etc… won't be opening their doors again.

Here's some random thoughts…

- US households are holding more equities as a percentage of total financial assets than at any other time in history, excluding the dot-com bubble when it was slightly higher.
- The majority of these equities are held by aging boomers.
- According to the required minimum distribution (RMD) law, after turning the age of 72 (it was 70.5 but that was recently changed) they have to take a minimum annual distribution from their retirement accounts (ie, cash in their stock holdings).
- This forced selling is about to become a gale forced headwind. According to census projections, the total number of retirees taking RMDs is estimated to swell to 58.7 million investors.
- The recently passed "SECURE Act" requires "the entire balance of the participant's account be distributed within ten years."

- This equates to roughly $10trn in financial assets being withdrawn and converted to cash over the next decade.
- To put that into perspective, the market cap for the entire US stock market is about $23.8trn…
- Now let's do a thought exercise. You're an average US retiree with $195,000 in your IRA. You have to start taking annual distributions from this account. They have to be above a minimum amount (the min amount increases each year) and you have to drain all of the account over the next 10 years.
    - You've been holding mostly equities because low yields have forced you further out the risk curve. Unfortunately, you weren't able to save much for retirement and you have to earn some return on your assets, so you hold more stocks.
    - The recent volatility was painful as you've seen your entire savings cut by over 20%+. But, you learned your lesson in 2009 and know that now is the time to buy, when the streets are filled with blood and panic and all that; just like your boy Buffett does.
    - So you step in and buy some more stocks, up your risk. But the market doesn't turn. Its bounces fail. Maybe, you buy a little bit more only to then see the market puke again and trade like a wet rag.
    - At some point, the bleeding red painted across your IRA statement makes your chest feel tight. Your uncle point is hit. You move into survival mode and cash out of everything that you can, no longer able to withstand the volatility.
- Equities are great to hold when you're young and essentially long labor. Volatility actually benefits you in the long run by increasing your returns as you're able to deploy capital at lower prices (ie, get more bang for your buck).
- But this flips when you're retired. As a retiree, you're now short labor and long consumption. Volatility is no longer your friend because you're forced to sell more in a downturn in order to raise cash for consumption now.
- The implications for the stock market over the coming decade should be clear. Not good.

Now, this is only one small aspect of our "new normal". I can go on about what this will do to profits. There's, of course, the obvious case that profits are about to catch a frying pan to the face because, well, we're all at home and not out shopping. And that's true.

But another long-term hit to profits is going to come from falling CAPEX. Looked at from a Levy-Kalecki viewpoint, the aggregate profits in an economy come from net-investment. That means you need companies borrowing to invest in future capacity. Companies only invest in the future when they think the future will be brighter than it is today. Banks only lend to companies so they can invest in the future when they think they'll be repaid.

A credit-centric system is a giant confidence game. Assets are only worth what the next person will pay for them. These values increase when people are optimistic and they're borrowing to consume and invest more. The reverse happens when optimism fades. This is all just debt cycle dynamics… What we think of as money is mostly credit and credit expands and contracts on the whims of our collective risk preferences.

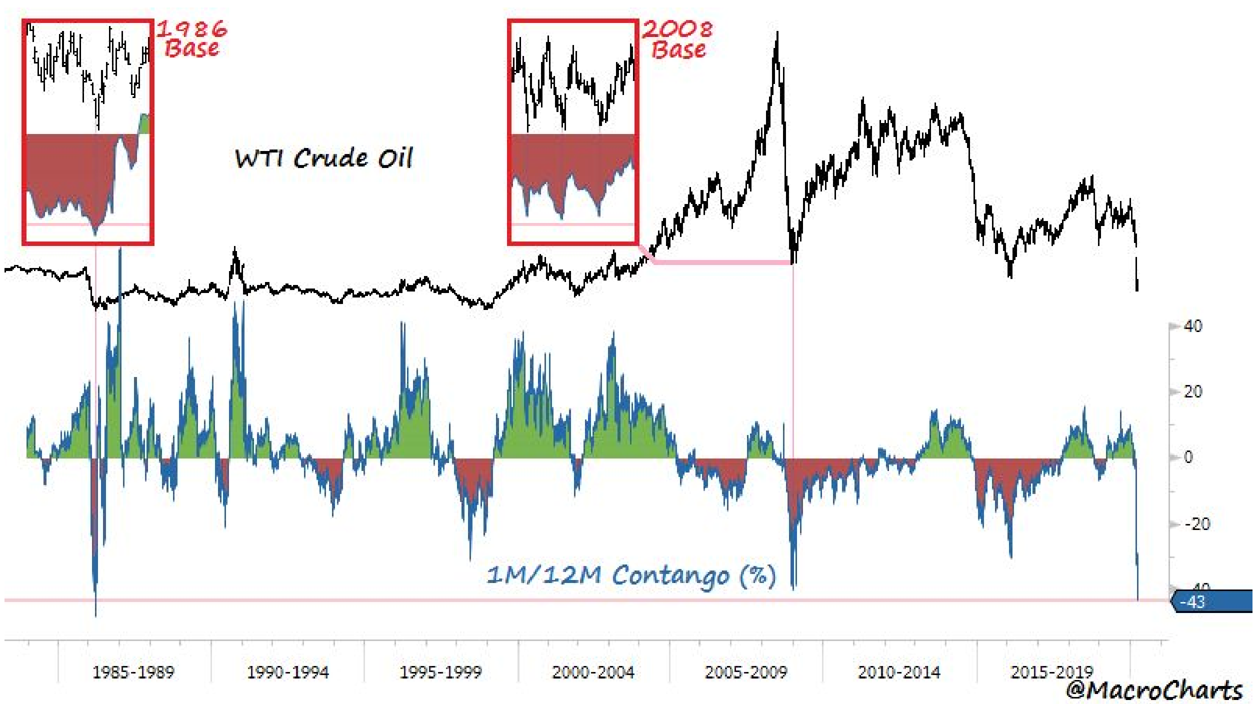
This virus is going to kill our risk preferences. There's no V-shaped recovery back to how things once were. We're in a new normal…

This is not a prediction about markets in the short-to-intermediate term. Financial assets don't trade entirely off the economy. They trade off money supply and relative preferences. And anything is possible when the Fed and Government are both fully behind firehosing cash into the system.

So take this rant as a possibility. Just one of many plausible outcomes. But it's one that isn't being priced in or expected. We're linear thinkers living in a non-linear world and that makes it hard to impossible for us to see major paradigm-shifting change on the horizon.

Oil, contango, and tankers

A few weeks ago I wrote about how the collapse in global oil demand along with the Saudi/Russia price war were leading to a large supply glut which made tanker stocks an attractive play (link here). The chart below from my friend @macrocharts shows the severity of this spread.



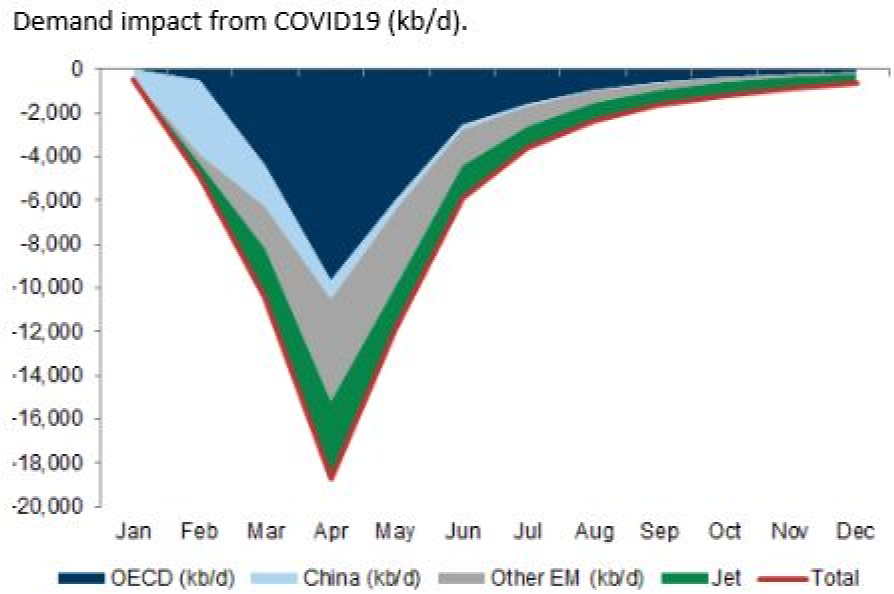
After getting calls and visits from distraught oil execs these last two weeks, Trump took to Twitter this morning to say the following.

A few thoughts on this (1) I put on starter positions in a few tankers earlier this week and they got hammered on this tweet so… thanks Donald (2) One more reason why wide stops and small position sizes are key in this environment… DEFENSE, DEFENSE, DEFENSE (3) Trump often tweets stuff to try and move the market and these tweets are usually not backed by anything of substance plus “hope that they will be cutting…” isn’t exactly strong language.

More importantly, let’s look at the numbers to see what a 10m bpd cut would even mean.

- OPEC+ production is roughly 41m bpd (factoring in the Saudis planned 2m bpd increase) which puts total global oil production at roughly 83m bpd
- So a 10m bpd cut would equate to a 12% drop in production
- Oil demand destruction is currently projected to be around 15%-20%
- The demand side is <u>much</u> larger than the supply side of this equation

note: I'm skeptical of the sharp recovery in this oil demand graph.



So while a 12% reduction in production would help with the balance, we're likely to still end up with glut.

It's also a big "if" of whether the Sauds and Russia are willing to play ball with the US. To that, I've got to say I'm quite skeptical.

First off, you just can't turn on/off production so easily in Russia. The majority of oil produced in Russia comes from Western Siberia where things are swampy in the summer and the average temperature in winter drops to a cool -25 degrees celsius. These winter temps mean that wells can't simply be shut in because you'll get well-damage which means you'd have to re-drill them the following year which isn't economical.

This is why you never see Russia voluntarily cut production.

So this 10m bpd cut that Trump is touting would have to come primarily from the Sauds. And they have no incentive to do it. The US/Saud relationship isn't what it used to be.

The Sauds know that we don't need them anymore. The Sauds have a widening budget deficit to fund. The virus has given them an incredible opportunity. As the world's lowest-cost producer, the Saudis can crank up production. Steal market share from the Russians. And knockout unprofitable US producers in a single swoop.

The alternative is for them to cut and give up market share to the Russians and US frackers while maintaining a firm ceiling on the price of oil.

So, yeah, count me skeptical on Trump's twittering.

About them tankers…

If you haven't already, I recommend you give this short Real Vision interview with our friend Kuppy a watch (link here). He does a killer job laying out the bull case for tanker stocks. Here's a bullet-pointed summary of the chat.

- There's too much oil. Demand has been killed which can lead to a billion barrels of oil building up and a 2 billion bbl surplus in 150 days
- We're going to fill up the land storage within a few weeks and the rest will go into floating storage
- Tankers are going to get rented out by the Glencore's of the world to arb the contango
- The types of vessels that are going to get used for floating storage are old vessels, 20yrs or older. These vessels are probably worth $25m dollars at most.
- So owners are going to make $20m on a $25m investment but because you only have $5m in scrap value you only need $5m in equity to hold onto the thing, so you're making 4x your money and anytime you can make 4x your money in a year, you're going to do it and you're going to do it as much as possible
- So what this is going to do is it's going to take a lot of the older vessels out of the existing fleet bc every guy is going to say I can lock in a risk-free 4x my money investment, I'm going to do it.
- Let's assume the spot rate is $100k a day which is ⅓ of its current going rate
- That means it earns $30m a year net of expenses. The avg tanker is 10yrs old and worth about $50m dollars. And you need about $20m in equity to hold onto it. That means you make 150% of your equity each year.
- At $200k a year, you earn $65m on $20m of equity which means somewhere between current rates and at half of current rates you're going to make 1 ½ to 3x your money this year holding a tanker.
- You can buy many of these tanker stocks at half of NAV

And here's a summary of a recent Q&A panel with top shipping executives. Below are the talking points from EURN and FRO CEOs.

Frontline CEO

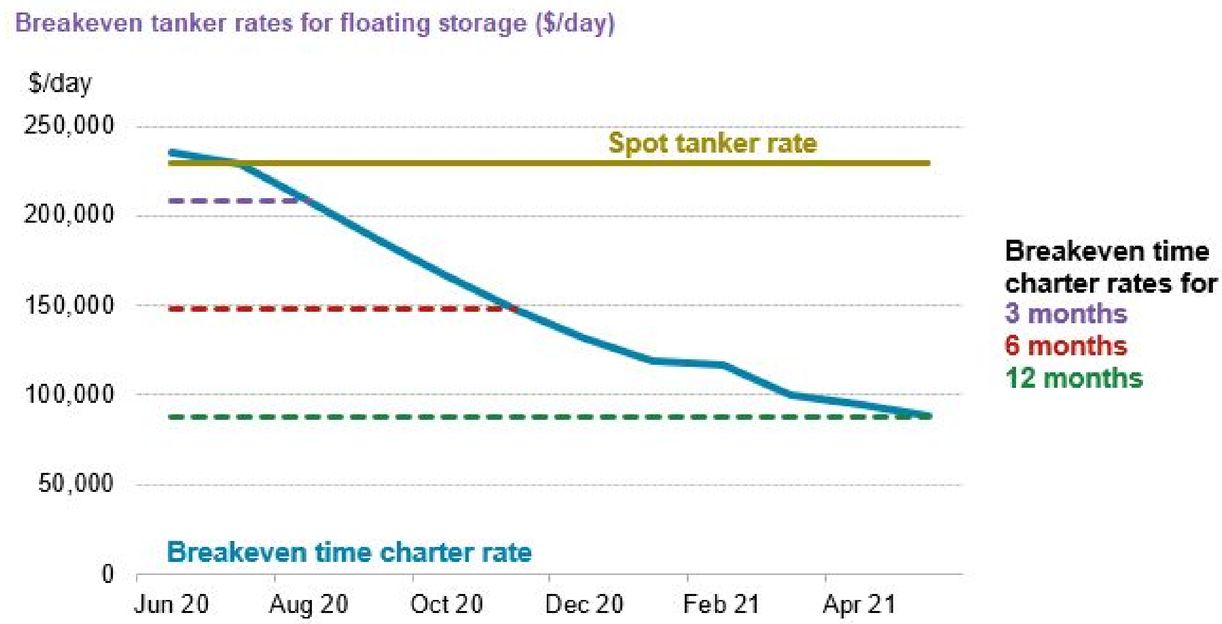
- Once in a generation situation, unprecedented what's happening in oil and tanker markets
    - In addition to the increase in supply of ~4million bpd, there is demand destruction of ~15 million bpd, which puts the total at the moment of ~20 million bpd oversupply
    - Last time around, people expected production cut to be quick, but in **2014 Saudi Arabia carried on for 18 months**, but I have no idea how long it carries on now
    - Inventories are being built 5x times faster or more than 2015
- There is no more than **300 million bbl of commercial land based storage capacity** in the world (excluding China's and US' strategic reserves, which totals up to ~900 million of overall storage capacity included sovereign)
- Storage on ships will change this market and 2020 completely, and he expects **it'll be much more extreme than 2015**
- Supply of ships is being strangled
    - Whether there are 10 mbp or 20 mbp, oversupply doesn't matter
    - US exports will go down likely, but over 60% of 2020 US exports have been hedged
    - Brazil and Norway in terms of exports are huge, so that would compensate
    - Freight is driven by oil production, and we are at all time high

Euronav CEO

- Depending on the rates, the entire fleet of VLCCs can be made available for storage
- The first destination for storage is land storage
    - Corroborates Frontline's 300 million bbl of land storage estimate.
    - Storage is being filled by between **10-20 million barrels a day**, based on slowdown of demand
    - Expects **land storage to be filled out in the next 30-60 days**
- Demand for vessel storage
    - Starts with smaller ships
    - VLCC owners like Euronav are increasingly approached to store for **6-8 months with initial offers of $70-90k/day** depending on:
        - Where they want to store the oil and
        - **Whether you attach trading optionality clauses to the storage contract**
- This is beneficial for the companies who have exposure to the spot market because it constricts the supply of vessels
- Vessels being taken for storage are the old ones; cherry on the cake is that when they are released they will be good candidates to be scrapped when done
    - There is enough remedy to restore the market as quickly as possible when things rebalance in 6-12 months
- Have had a **fantastic Q1; are booking extraordinary rates for Q2**
- As far as 2021 its too far away to predict

For floating storage to be profitable charter rates have to be below breakeven rates (contango spread - cost of debt).

Here's how that currently looks.



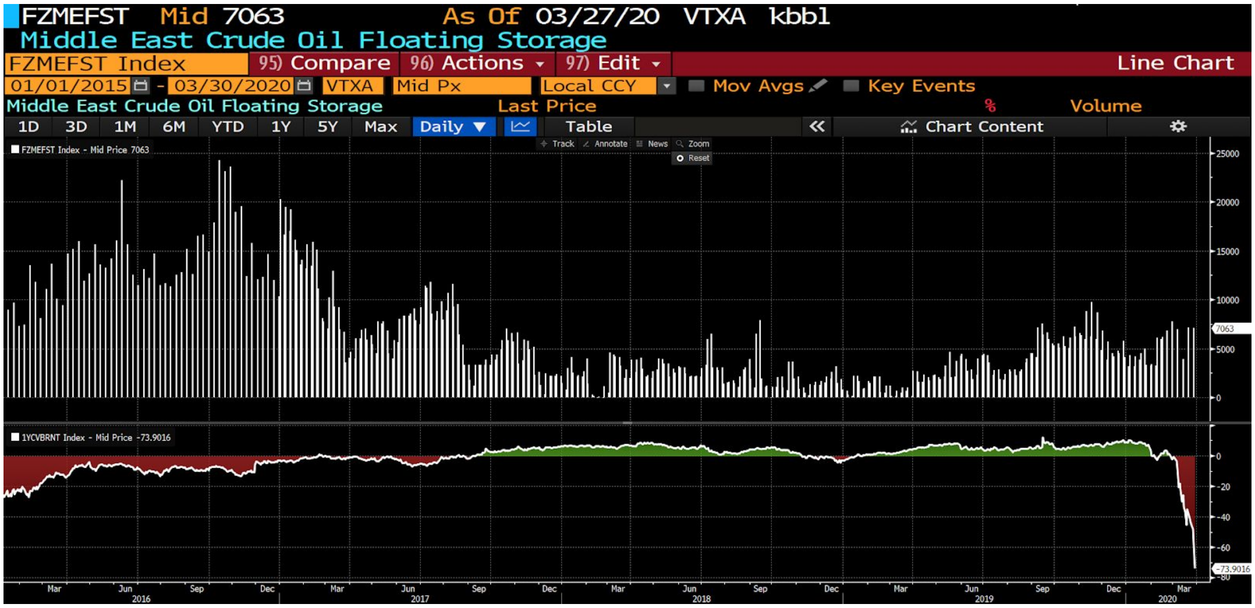
A charter rate of $120k gives essentially a risk-free return of $2.49/bbl over a 6-month period.

Profit margin for floating storage ($/bbl)

$/bbl	May 20	Jun 20	Jul 20	Aug 20	Sep 20	Oct 20	Nov 20	Dec 20	Jan 21	Feb 21	Mar 21
Jun 20	1.73										
Jul 20	3.26	1.52									
Aug 20	3.96	2.21	0.67								
Sep 20	4.00	2.24	0.69	0.01							
Oct 20	3.49	1.71	0.16	-0.53	-0.55						
Nov 20	2.49	0.71	-0.86	-1.56	-1.59	-1.04					
Dec 20	1.25	-0.55	-2.13	-2.84	-2.87	-2.32	-1.29				
Jan 21	-0.07	-1.88	-3.47	-4.18	-4.22	-3.68	-2.65	-1.36			
Feb 21	-0.47	-2.29	-3.90	-4.62	-4.66	-4.13	-3.10	-1.81	-0.45		
Mar 21	-3.04	-4.87	-6.48	-7.22	-7.27	-6.74	-5.71	-4.43	-3.07	-2.62	
Apr 21	-4.20	-6.05	-7.67	-8.41	-8.47	-7.94	-6.92	-5.64	-4.28	-3.84	-1.22
May 21	-5.72	-7.57	-9.21	-9.96	-10.02	-9.50	-8.48	-7.20	-5.85	-5.41	-2.78

Trading houses tend to like free money, which is why we should expect a ramp-up in floating storage. This should keep a bid under tanker rates.

For reference, here's a chart of the ME Floating Storage index. It nearly tripled last time oil was in deep contango.



Here's the thing... Shipping stocks are a jack daniel filled rodeo in the best of the times. These aren't the best of times. Because of that, we have to do a few things:

1. Fallibility: While tanker stocks seem like great values here, they can become better values in the future — by making new lows.
2. We don't want to ever buy and pray and that's especially true in this environment. So honor stops and manage risk.
3. These are volatile stocks so size small and place stops wide and/or sell puts at levels you would be happy to receive the stock in.

General market take

We got the start of the bounce that I said was likely last week. The bulls were able to drive the March candle back above its long-term trendline, creating a long lower wick. This raises the odds that we'll see further sideways to up action over the coming weeks.

These aren't great odds though. We're in a bear market and the primary trend is lower. Your odds and risk/reward is always clipped when you're trading against the primary trend. So while I'm willing to take shots at the longside here, I'm keeping my size small and aiming for singles rather home runs.

Long bonds (TLT / ZB_F) look like they might be setting up for a decent short trade here. That's something I'm watching closely. I'll put out a note if it looks like they're about to crack.

The Four Pillars Portfolio		YTD Return				
		11.08%				
The Core	Allocation					
Large Cap Equities (/ES_H or VOO)	0%					
Short-term Bills (/ZT_M or VGSH)	0%					
Long-term Bonds (/ZB_M or TLT)	0%					
Gold (/GC_M or GLD)	0%					

Big Bets	Thematic	Cost Basis	At Risk	Notional %	Risk Point	Last Price
Teekay Tankers (TNK)	Deep Value/Cyclical	$20.30	100bps	4%	$15.20	$15.20
Euronav (EURN)	Deep Value/Cyclical	$12.20	50bps	3%	$10.00	$12.20
Overseas Shipholding Group (OSG)	Deep Value/Cyclical	$2.27	200bps	9%	$1.70	$2.30
Cameco (CCJ)	Deep Value/Cyclical	$7.25	100bps	7%	$5.80	$7.25

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

When you arise in the morning, think of what a precious privilege it is to be alive — to breathe, to think, to enjoy, to love. ~ Marcus Aurelius