A Market Note: Reality Distortion Field… (TLT, SPX, INTC, DAC)

There are a few things I want to cover in this week's *Note,* including some technical setups that are rather pressing. But first, here's my obligatory take on the FOMC.

As expected, the Fed raised by 25bps. No biggie there. It can be argued that the committee sent a somewhat hawkish signal by including a statement saying they remain resolute in their quest to get rates above 5%.

The market glossed over that part and chose to give the meeting a dovish read. Not surprising, as this is how the Narrative Pendulum swings.

Last summer, we were at peak hawkishness with global food shortages, expectations for a crippling energy crisis in Europe, and a consensus on runaway inflation — even though the leads on inflation had clearly rolled over and were strongly suggesting otherwise.

These narratives swing back and forth and develop a momentum all their own. Right now, the narrative is "immaculate disinflation" with a Fed that is about to reverse course. It's not quite consensus, but it's quickly heading in that direction.

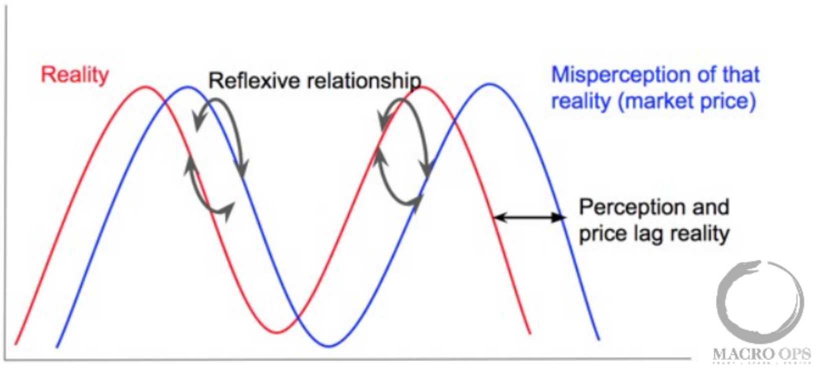
So the evidence contrary to this dominant belief is mostly being ignored or misinterpreted for now. That's just how these things work.

These narratives become self-reinforcing for a time. The momentum behind them drives increasing confirmation bias and a distorted interpretation of the facts. The data and news which gets reported on and talked about is the data and news that supports the popular belief.

This process can be sustained for a while, even when it's a completely bad take. But at some point, the incoming evidence (or unfolding reality) becomes so overwhelmingly contrary to the popular opinion that the pendulum *can't* sustain further momentum. The gravity of the unfolding reality is too strong for it to escape its grasp, and the pendulum gets pulled back in the other direction, ad infinitum.

Soros calls this the Boom/Bust process and talks about how the market *always* reflects a distorted view of objective reality. Sometimes this distortion is minimal…And other times, it's JPEGs of Apes in Sailor Hats selling for more than a Picasso off the mark wide.

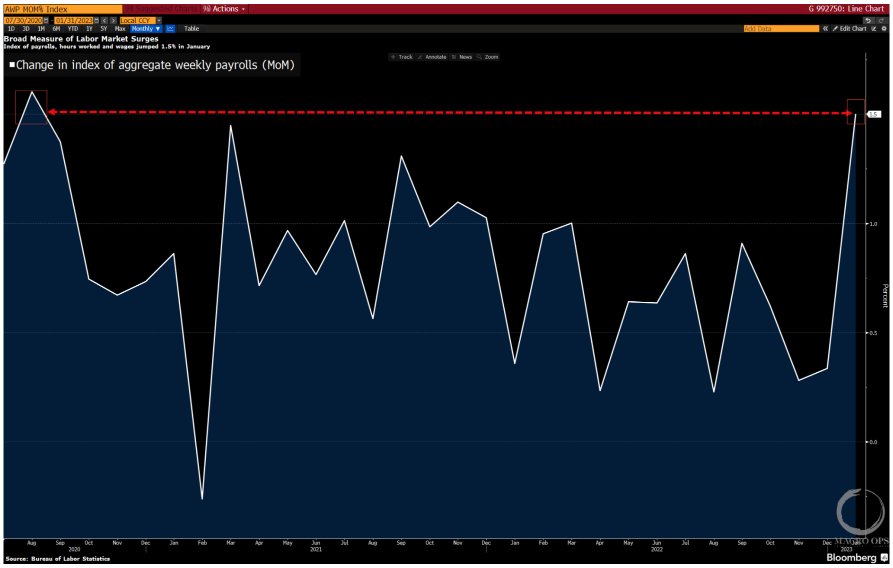
This is all a part of what we call the Reality-Perception Lag.



Currently, the weight of inbound evidence *isn't* strong enough to kill this dovish and arguably overly optimistic (on disinflation) narrative. And that's bullish for the market because it's a bullish narrative. And, as we've been saying for the past three months, the bearish economic narrative had far outrun the data.

This is why we're seeing a bullish impulse that's likely to run for another month or two. An impulse that is being ridiculed as a sign of "frothy speculation" by bears who've been too slow to change their views, which is *always* the case in the beginning of a bull advance.

Last week's blowout jobs data is a good example of inbound evidence *not* confirming the popular narrative, which in this case is that the US is headed for a "slight" recession in the first half of the year.



The 517k rise in payrolls for the month of January was quite literally off the charts, walloping the median estimate of 188k. Now, yes, there were a number of revisions and seasonal adjustments to this print. But even accounting for these, it was a very strong, and *significantly* better than expected, print.

This Labor Market Impulse gauge from BBG, which includes payrolls, hourly earnings, and hours worked, surged to its highest monthly advance since 2020. Not exactly bearish…

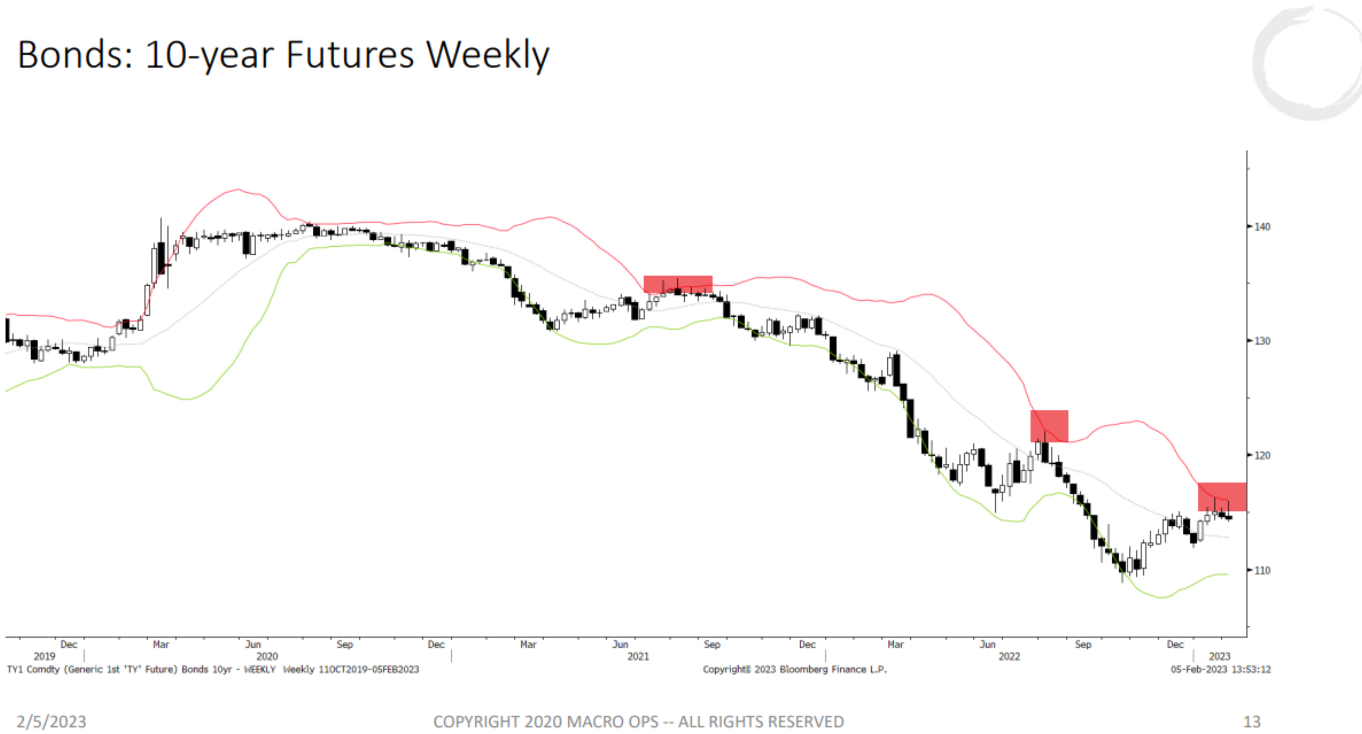
We will see increasingly more inbound data like this, evidence which suggests the recessionary bears had gotten over their skis, and the *dis*-inflationistas are doing the same now.

This brings us to our non-consensus higher for longer rate take.

Bonds about to go no-bid…

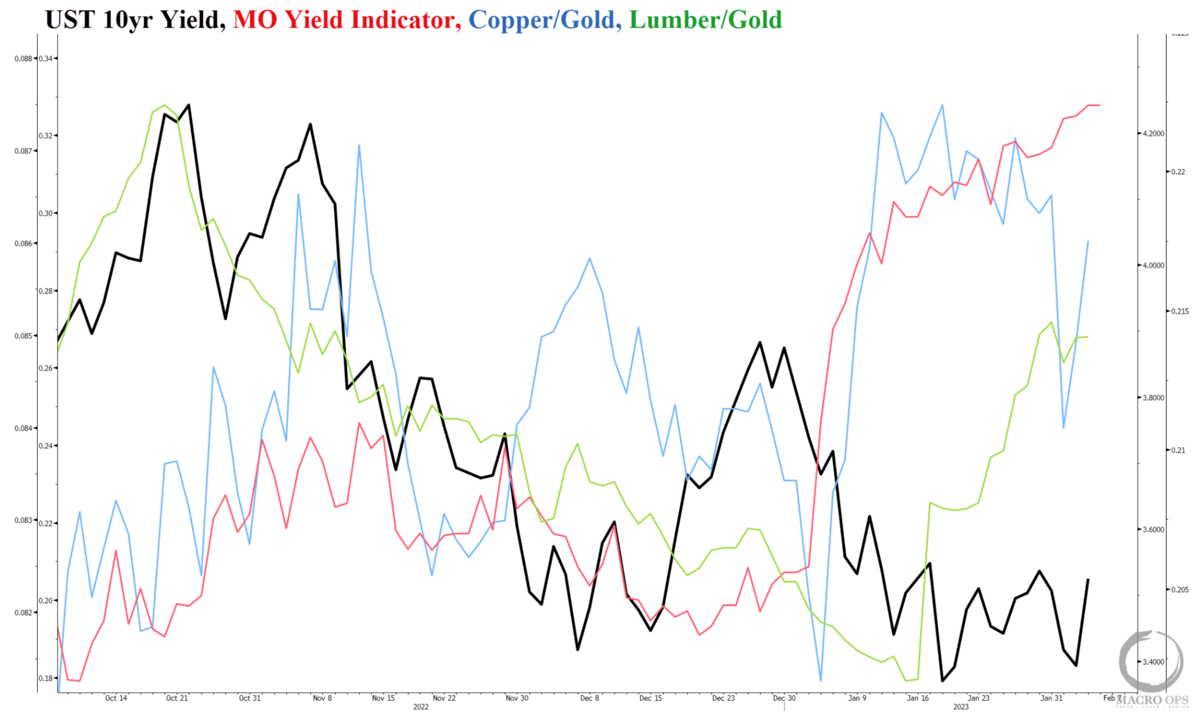
10-year bonds have been rejected by their upper weekly Bollinger Band (chart below is a weekly). The upper weekly band has proven to be a significant resistant level since the bear market in bonds began back in early 21'.

Since trends in motion tend to stay in motion, as 80% of trend reversals fail, we should expect bonds to keep trading in line with the trend, which is down.



Here's an update on our Yield Indicator chart, which I showed the other week.

The leads keep leading higher (yields up = bonds down). Page 15 of this week's *Trifecta Chart Pack* shows more bearish confirming evidence. The US Citi Economic Surprise Index, which tends to have a strong lead on yields, has turned positive again. And JPM's UST Client Short Positioning Index is at levels which have preceded large moves higher in yields in the past.



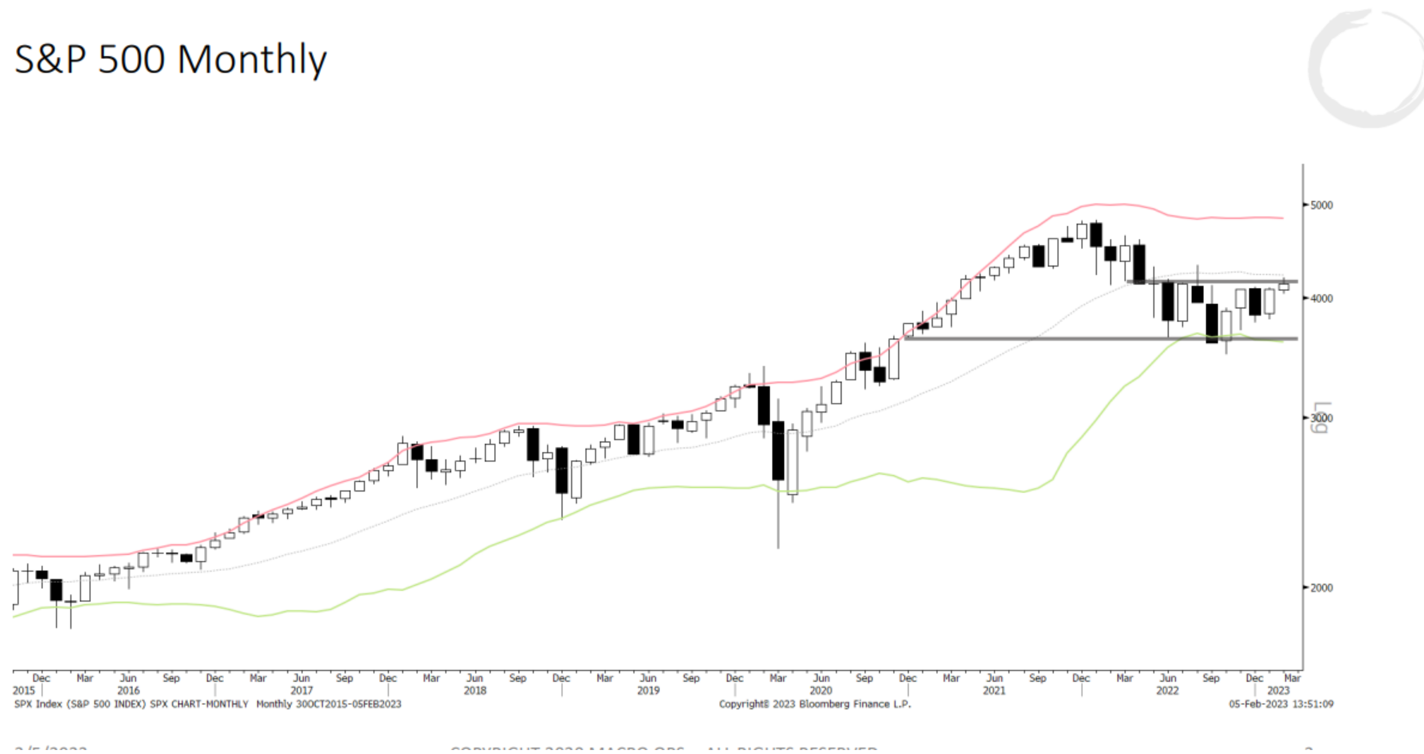
10s are trading at their lower Bollinger Band. How they react here will be a big tell, but my strong bias is that they'll start trending back down to their October lows, bringing the yield back up to the 4.3% range.

This is a solid setup, with strong odds, and we'll be getting short bonds this week

SPX to sputter this week…

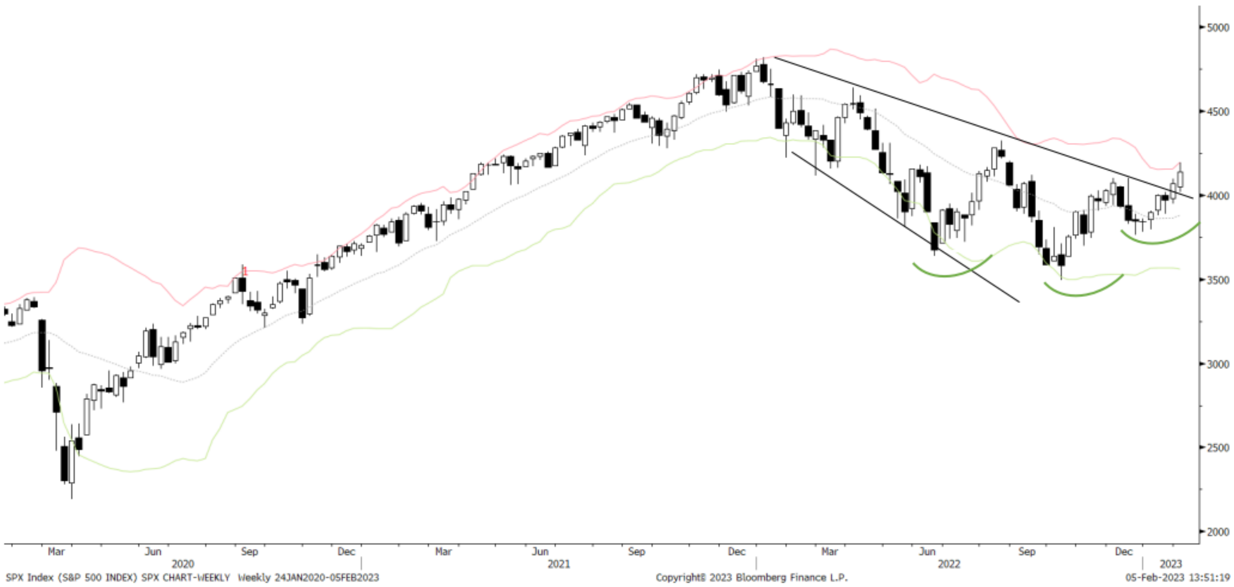
Moving onto the SPX, <u>we should expect a bit of a pullback or consolidation this week </u>as the result of price running into a confluence of significant levels and overextension.

The monthly chart shows that price is bumping up against its Bollinger Band midline, which is a level its tried and *failed* to clear multiple times since May 22'. This time it's going to clear it, but we'll likely see some consolidation first.



The weekly chart shows it's also up against its weekly Bollinger Band, or over 2stdev above its 20-week moving average (midline).

S&P 500 Weekly



Our multi-chart dashboard tab shows that its price to moving average spread is extended on multiple timeframes. While at the same time, our short-term Net Speculative positioning oscillator for both SPX and e-mini futures shows that specs are above the 80% bullish positioning level and are begging to reverse course (grey line in the top left chart).

This is a short-term contra signal and aligns with our other evidence for a bit of a pullback here.

Longer-term net speculative positioning is still quite bearish at just 23% of its 5yr OI adjusted average (orange line).

The key here is not to be overreactive to the coming shakeout. The evidence strongly favors bullish continuation. We'll look for a pullback reversal at the midline or a breakout from a tight consolidation range before we add any additional risk exposure.

And remember, we continue to keep overall risk levels very low as we believe this move is part of a larger topping process. So our cash level is at 60% of NAV and we'll aim to keep this above 40%.

It's so bad, it's good…

One stock I'm thinking about adding to our portfolio is Intel Corp (INTC).

One of my favorite setups in widely followed large-cap stocks is when a STRONG consensus is no longer reflected in the movement of the tape. It can either be a bull narrative and a heavy tape or a bearish consensus and a stock price that suddenly becomes Teflon to bad news.

It doesn't happen often, as these big names tend to be reasonably priced the majority of the time. But, occasionally, we'll get a Dec 18' situation where a wildly popular narrative drove AAPL to trade for less than 7x EV/EBITDA, which I wrote about at the time in my note *Total Sentiment Capitulation*.

Well, I'd argue that the bearish consensus against INTC today is even more extreme than it was against AAPL in late 18'.

When INTC whiffed on earnings the other week, commentators and analysts alike began trying to one-up each other on knocking the report, the stock, the management, and its future. There was nothing positive said about the stock in that entire week. Trust me, I looked.

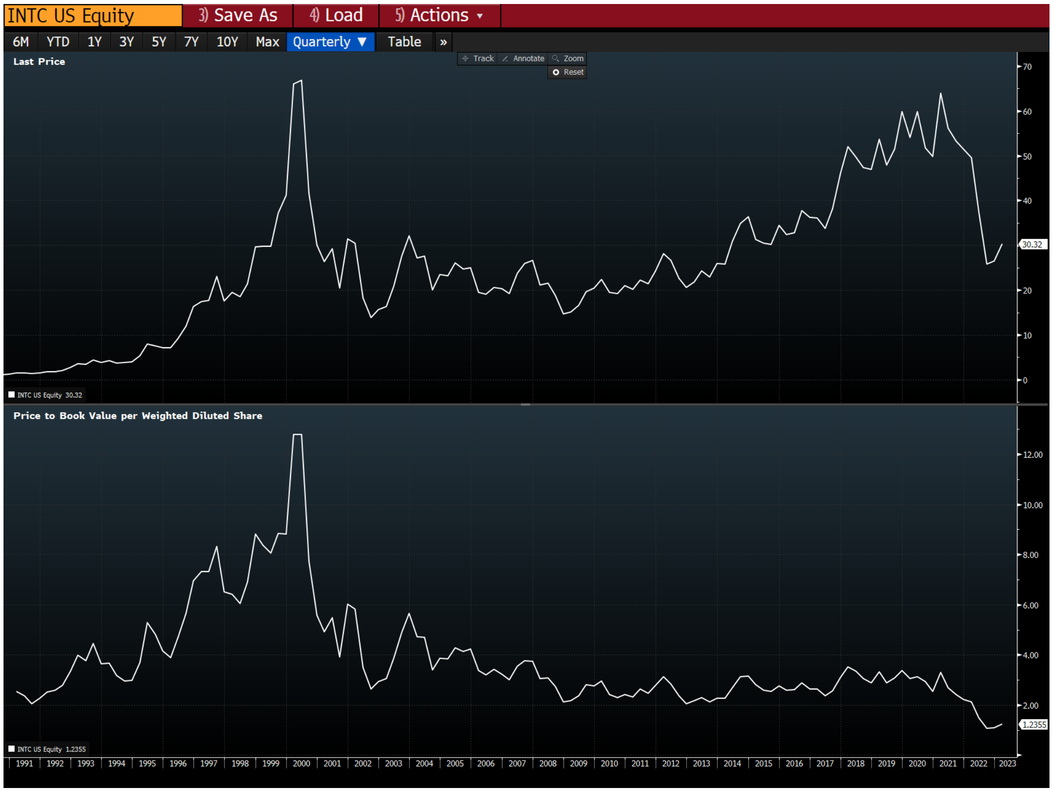
Yet… the stock has traded up since the initial selloff following the release… something, something, expectations are instantly embedded into prices…

The chart below is a weekly. INTC has put in a potential double bottom. It's trading in a 5-month compression regime. We may put on a position here with a stop near the lower bound or wait for a confirmed breakout to the upside. The pattern gives us a natural place to put our stop, right below the lower bound.

I'll be watching net block order flow (tan line) to see what the big money is doing. We can see that they led on the way up in 2017 and started selling out well before the 2021 top. A turn, or at the least an abatement in the selling from this cohort, would be a strong positive signal that the lows are in.

Source: Macro Ops

INTC has been through countless crises over its long and storied history. And no doubt that it faces a tough road ahead, one that's rife with execution risk. But it's also **a strategic geopolitical asset,** and the powers that be have plenty of vested interests in seeing them succeed. Plus, with the stock trading at an all-time low of 1.2x its book value, a LOT of bad potential outcomes are already well-priced into the stock.



Look out for more later this week where we'll be taking a look at crude, which is nearing a big inflection point. And discuss the likely near-term path for the USD.

Now here's Brandon with a look at a well-run shipper trading for dimes on the dollar in an industry few investors are tracking, and that we think has a reasonable 2x upside from current levels, and potentially much higher.

Your Macro Operator,

Alex

Portfolio Intelligence Report (PIR): Hello Shipping, My Old Friend …

My favorite Aswath Damodaran quote comes from his podcast with Patrick O'Shaughnessy (emphasis mine):

> *"I'm going to say something that traditional value investors might view as sacrilege.* ***At the right price, I will buy any company.*** *No matter how damaged it is, how terrible …*
>
> *At the wrong price, you could be the greatest company on the face of the earth. And I'm not jumping on the ship with you because the price is not right.*
>
> *We spend a lot of time assessing company quality and management quality,* ***we need to think about as much as what the price we're paying*** *for that is.* ***We're looking for mismatches****, a company that is of great quality that the rest of the world thinks is crappy.* ***That's what a great investment is.****"*

This weekend we explore the shipping space by diving into **Danaos Corporation (DAC)**.

DAC trades at a 45%+ discount to NAV, has little debt, and boasts nearly twice its current market cap in backlogged revenues out to 2028. And you can buy it right now for 2x FCF.

The shipping industry is notoriously run by, let's just say, a less than shareholder friendly cast of characters. DAC though isn't like that. They've paid down debt, issued dividends, and bought back stock. Aligned incentives drive this as insiders own over 40% of the company with only 20M shares outstanding.

DAC is down 30% over the past year after running +4000% from 2020 to mid 21'. So an extended twelve month 30% correction is healthy price action, considering the incredible run they had in the previous year and the fact that the market was down +20% over the same time period.

Despite this correction, there are three reasons we believe the stock is worth between $100-$200/share :

1) DAC has deleveraged its balance sheet, allowing more cash for dividends and buybacks.
2) Long-term contracts out to 2028 (in some cases) at even higher charter rates than current contracts.
3) Healthy supply/demand balance when adjusting for DAC's more significant proportion of smaller TEU vessels

Consensus currently expects very low Q1/Q2 growth with a recession likely. We expect much more resilient and rebounding growth in the first half of this year combined with robust cash flow from DAC's contracted revenues.

Profitable shipping companies historically trade around 1x NAV. Given DAC's strong balance sheet, contracted long-term revenues, and a management team that doesn't abuse shareholders, 1.25-1.5x NAV is reasonable. **That gets us ~$150+/share or nearly 200% upside from the current stock price.**

And if global demand increases while supply stagnates, we could easily see freight rates revert higher, allowing DAC to print half its market cap in cash annually, giving us a fair value of nearly $250/share.

To paraphrase Damodaran, DAC is now at that “right price.”

I’ll explain why starting with a business description and our downside protection.

DAC: Business Overview & Asset Valuations

DAC owns ~71 containerships of various sizes and ages (average 14.4 years), expressed in TEUs, shorthand for “twenty-foot equivalent shipping containers.” For example, a 5,500 TEU ship can hold around 5,500 standard containers.

The company charters its ships to other parties called “liners.” Examples of liners include Maersk, COSCO, Evergreen, and Hapag-Lloyd. You’ve likely seen one of their boats if you live near the ocean. Companies like Maersk charter (read: rent) ships from DAC for predetermined rates called “charter rates.”

Liners sign charter rate contracts anywhere from 12 months to five years. Customers like Maersk choose longer-term contracts because it locks in a large portion of their operating costs. DAC also enjoys long-term contracts because it provides greater revenue visibility than short-term, spot market contracts.

We’ll expand on charter contracts later.

Back to our downside protection … You can see the company’s 71 vessel distribution by size and age below.

I scraped together various data points on vessel sales for each cohort size (TEUs). Some data I got from 2013, with others from 2018 - 2022. The average recorded per ship value was $61M, with new 13,100s TEU fetching $130M per vessel and 2,200s TEU selling for $6M.

We adjusted DAC's vessel NAV based on the age of its fleet versus the age of the recent sales. For example, we discounted DAC's five 13,000 TEU vessels by 70% and their twelve 4,300 vessels by 30%.

That brings the **total NAV of DAC's current fleet to $3.0B.** Remember, this is an *average* based on *historical* sales data. Replacement costs are likely much higher, given the current inflationary environment and recent ESG investment headwinds.

For example, last year, DAC sold two of its 6,400 TEU vessels for a combined $130M (or $65M each). One year earlier, DAC bought *both* ships for a *combined* $73M (or $36.5M each). Historical costs for these smaller vessels are likely well undervalued.

That means that **$3.0B is likely the low end of DAC's NAV.** Here's another way to think about it. Cut DAC's NAV by ~50% and you **still get today's current market cap** of ~$61/share.

Ship Size (TEU)	Num of Ships	% of Fleet	Avg. Age (yrs)	Avg. Sale Price ($M)	NAV
2200	11	15.49%	24	$6	$66
3300	8	11.27%	15	$44	$352
4300	12	16.90%	16	$25	$300
5500	6	8.45%	8	$109	$654
6400	11	15.49%	15	$65	$715
8500	13	18.31%	14	$29	$371
9600	5	7.04%	13	$80	$400
13100	5	7.04%	10	$130	$650
Total Ships	71				
Avg. Age	14.375				
Total NAV	$3,508				
Current EV	$1,638.00				
NAV Discount	**53.30%**				

A 1x NAV valuation would put shares around $150. Another way to think about it is you're buying DAC's 6,400 TEU, 9,600 TEU, and 13,100 TEU ships and getting the **remaining ~50 boats for free**.

There are two main concerns with this downside protection:

- What is the value of these ships if they lose money?
- Wouldn't new supply drag prices down and thus lower NAV?

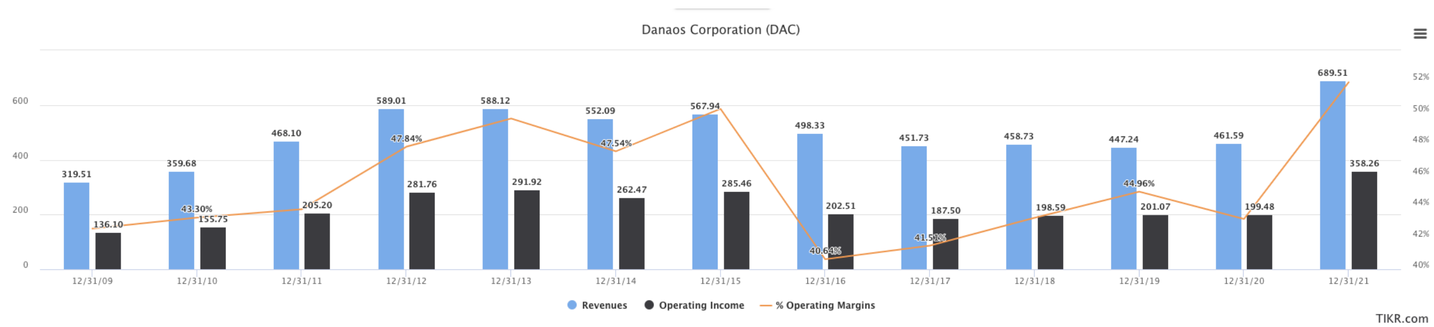
Let's address both concerns.

DAC Is Not A Flash In The Pan Shipping Company

DAC's ships make money, and lots of it, the higher charter rates climb. For example, the company generated $955M in revenue last year with $580M in EBIT (61% margins).

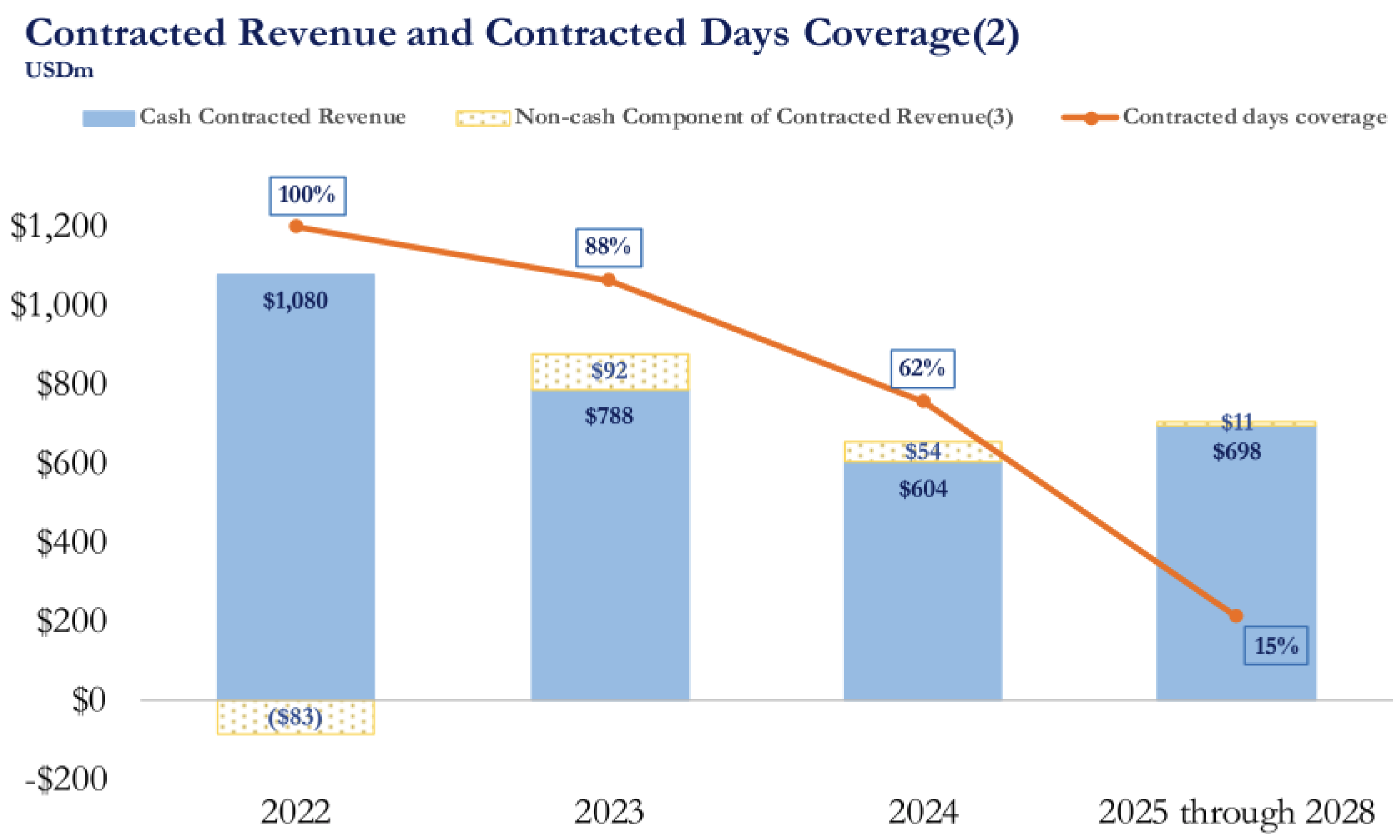
These ships are aquatic cash cows.

The company isn't a one-hit COVID wonder, either. DAC has a long history of generating outsized profits. The chart below highlights revenues, EBIT, and margins since 2009 (via TIKR).



DAC emerged from the Great Recession as one of the few operating shipping companies and has **generated positive FCF since 2013.**

The company can produce consistent revenues and profits because of its long-term charter contracts. DAC has ~$2.3B in cash contracted revenues *through* 2028 as of November 2022. You can see the breakdown of those contracted revenues below.



Even more impressive is the company's "Contracted Days Coverage" ratio of 62% through 2024. Things get more opaque beyond 2025, but that doesn't really matter. You've got a runway of ~2 years to print cash while your share price remains 50%+ below NAV and trading for 2x profits.

One encouraging note from DAC's latest presentation is that they're signing contracts at higher prices than previous ones. Check out the slide below. Notice the price increases for certain TEUs:

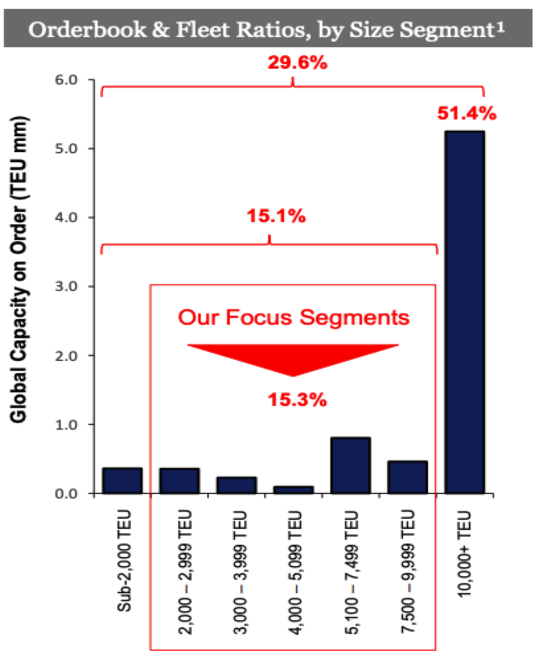
- 8,000: $23,000 → $56,000
- 9,600: $22,000 → $58,000
- 4,300: $31,000 → $48,000

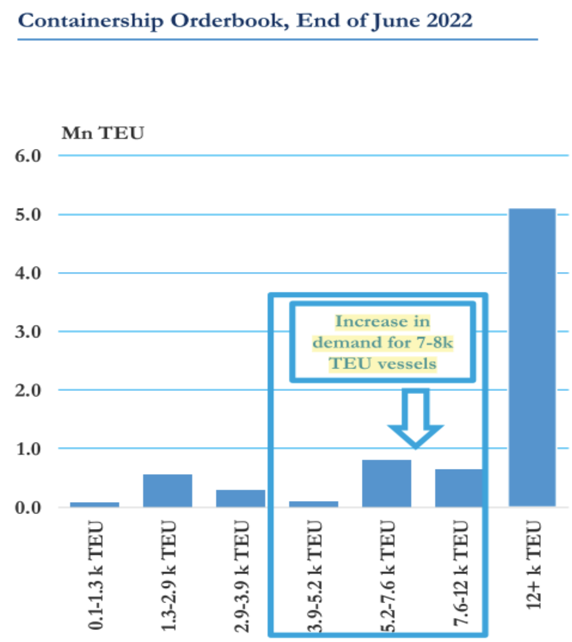
DAC can either further reduce debt, pay large dividends, or buy back a ton of stock at highly accretive prices. Remember, management owns over 40% of the common.

This brings us to supply. If DAC can make consistent 40%+ EBIT margins, why aren't other companies adding ships to take their gains?

The current Orderbook-to-Fleet ratio sits at 30%, up from 10% two years ago. This means that there's **more** supply coming online compared to the existing vessels on the ocean. And these supply changes create gluts that lower utilization/charter rates and destroy profits.

Fortunately for DAC, driving Orderbook-to-Fleet ratio growth is the 10,000+ TEU ships. As Global Ship Lease (GSL) explains in its pitch deck (below left), DAC's core ship segment (between 2,000 TEU - 9,900 TEU) has a **15.9%** Orderbook-to-Fleet ratio.





Older age is another benefit of DAC's smaller fleet. According to the company's presentation, the average age of the industry's sub-12,000 TEU vessels is ~14.4 years, compared to ~6.2 years for 13,000+ TEU ships.

This matters because shipping companies scrap vessels at around 25 years. Which acts as a natural headwind against supply growth. GSL estimates that scrapping 100% of 25+ year vessels by 2025 would result in a net supply increase of only 5.9% over the next three years. Easily coverable by global demand.

Finally, let's discuss valuation and how current prices offer one of the market's highest asymmetric risk/reward payoffs.

A Highly Asymmetric Risk/Reward Valuation

We've already mentioned that DAC trades at a 45%+ discount to NAV and that if it were to trade at ~1-1.25x NAV, the stock would be worth at least $150/share. Even at 75% of NAV, you get over $100/share, nearly double the current price.

Over the next three years, let's call **it $100/share DAC's base case**. As we mentioned above, our bear case is **~$60/share.**

We can estimate the company's revenues and cash flows in a bull scenario. We don't need fancy math. The company has ~$1.4B in contracted revenue through 2024. Assuming historical EBIT margins of 45%, we get $630M+ in cumulative pre-tax profit over the next two years or **half** of DAC's current market cap.

The cumulative FCF generation would flip DAC from $400M in net debt to $400M in **net cash**. At that point, it could retire all long-term debt and use 100% of its post-2024 profits to buy back stock or pay special dividends.

Historically, DAC (and other shipping companies) have traded as high as 17x EBIT and as low as 2x EBIT, which is where DAC sits today.

By 2024, DAC could be a world-class shipping charter with no debt, buying back stock and paying a 5% dividend yield. Plus, its history of generating 40-50% EBIT margins and positive FCF since 2013.

Why can't DAC command a 7-10x EBIT multiple in that scenario? That would value DAC around $200/share or **<u>300% higher than the current stock price</u>**.

Our downside is protected by a fleet of highly valuable ships insulated from order book growth trading at $0.50 on the dollar at today's price.

Your Value Investor,

Brandon

Portfolio Performance Update (as of 02/03)

- February: -1.08%
- Q1 2023: +8.17%
- YTD: +8.17%