A Market Note: The Reluctant Throes of Death…

Vetus opinio was an ancient Roman term used to describe a stubborn adherence to dated beliefs and a reluctance to change one's perspective due to a strong attachment to past practices.

It's an important factor in how market regimes change, a process we call the "Soros Cycle"; a derivative of the "Kuhn Cycle" which is a model of how paradigm shifts occur in science. I wrote about this years ago. Here's a snippet from that piece that's applicable to our discussion today.

> The Soros Cycle plays out like this:
>
> - An established regime exists and is comprised of a few dominant narratives. These narratives drive entrenched and overly optimized behavior —>
> - Narrative drift begins as information starts to challenge accepted fact, which leads to data cherry-picking and growing cognitive dissonance —>
> - Narrative crisis hits because reality has diverged too far from the dominant narrative — and the entrenched overly optimized behavior — for the regime to be sustained (narratives always lag shifts in reality) —>
> - Narrative revolution finally happens when reality forces the majority of people who were reluctant to admit they were wrong or change their behavior to adopt a new narrative/behavior set —>
> - Regime change occurs when a new narrative becomes dominant and accepted by the majority of market participants. It's reinforced by reality which eventually brings us full circle back to the established regime.

A narrative crisis is the stage of the Soros Cycle where vetus opinio is most clearly visible. This is because it's here where the overly optimized behavior of the past is *most* at odds with the unfolding reality.

This takes shape as an equivalent of death throes in the markets. And it's why tops tend to be a process and not an event.

> *If a self-reinforcing process goes on long enough it must eventually become unsustainable because either the gap between thinking and reality becomes too wide or the participant's bias becomes too pronounced. Hence, reflexive processes that become historically significant tend to follow an initially self-reinforcing, but eventually self defeating, pattern. That is what I call the boom/bust sequence.* ~ George Soros

We're in the midst of these death throes now. This is the most challenging and unprofitable market regime, as it's characterized by high vol and little trend direction.

This will eventually change as the narrative crisis shifts into its revolution phase, which will take the shape of an accelerated bear market wash out, as participants are forced to

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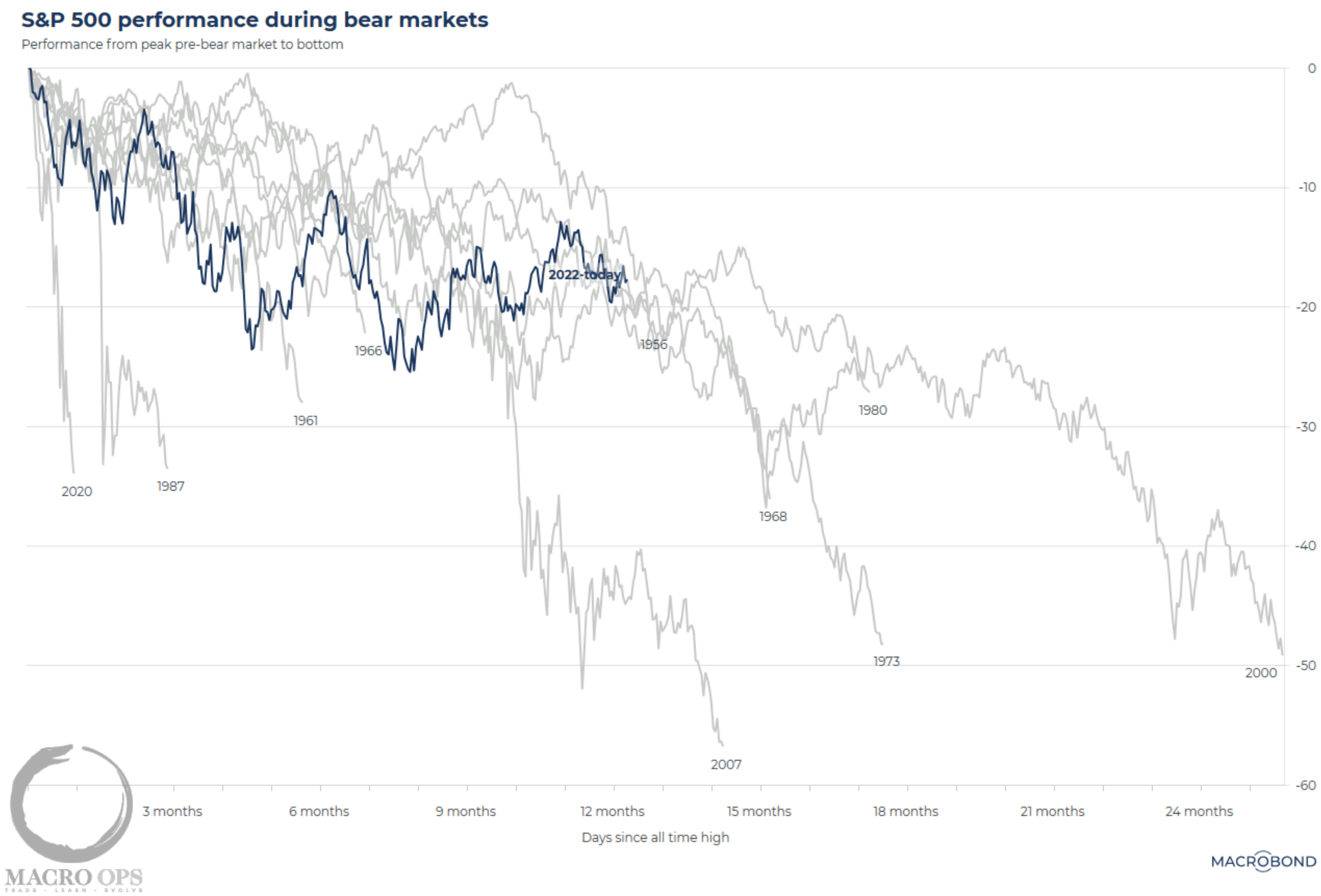
acknowledge the new reality.

And this reality is: increasing illiquidity, a Fed hamstrung by persistent inflation, a late summer demand shock due to the exhaustion of consumer excess savings, and an unwind of the labor market, driving us into a hard landing recession.

Let's go through some charts…

Here's every SPX peak-to-trough bear market over the last 70 years. The blue line is where we are today, which is very much in line with the average run so far. Because of US vs RoW capital concentration levels, I expect this bear to follow a path in duration and manner, most similar to the 2000 unwind, as it has a number of macro parallels to today.



The spread between the BofA MOVE index (a measure of bond volatility/orange line) and the VIX (a measure of equity volatility/white line) is at its widest level since the 07'-09' bear.

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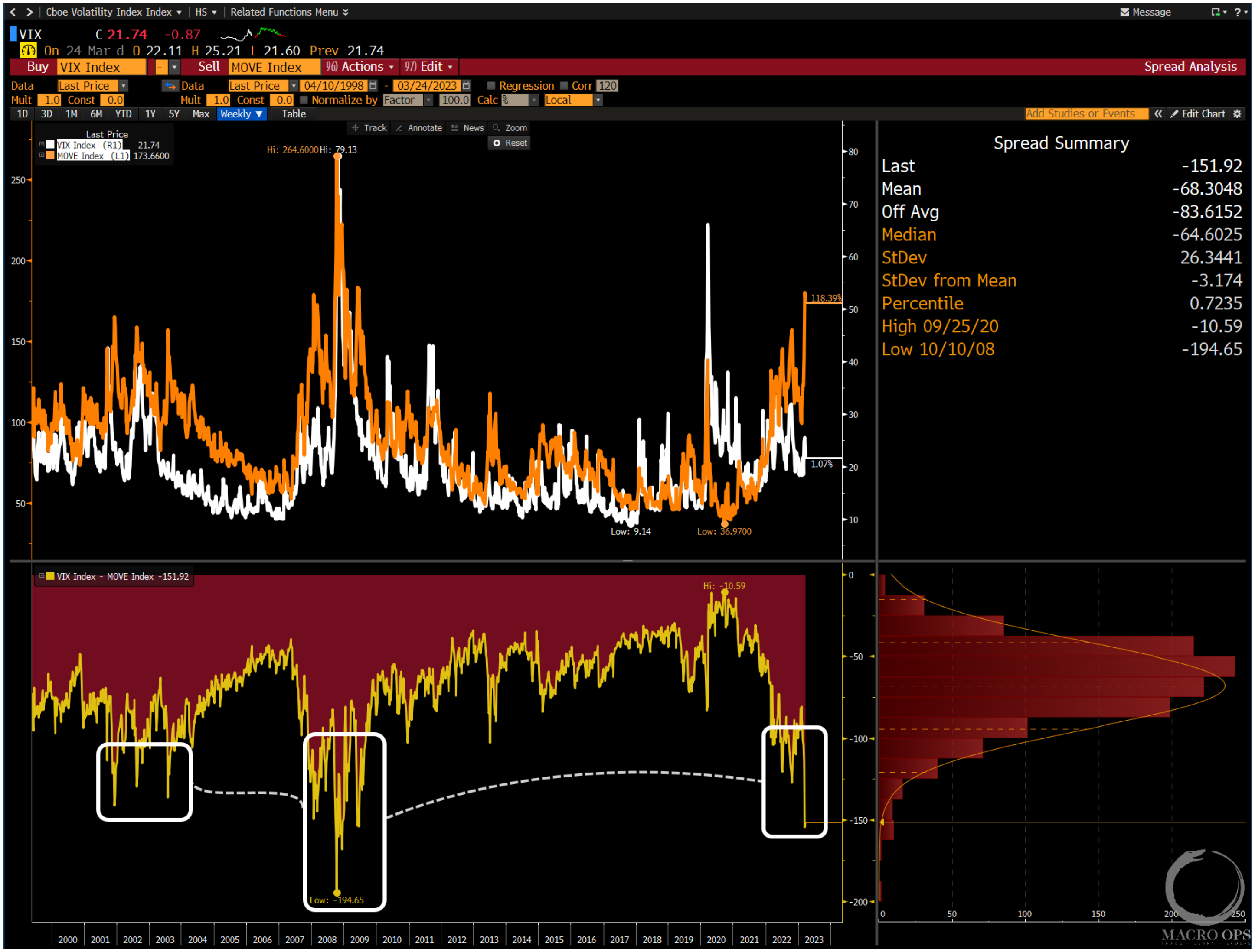

This next graph shows how rare this wide of a spread is. The purple dots are the most current instances.

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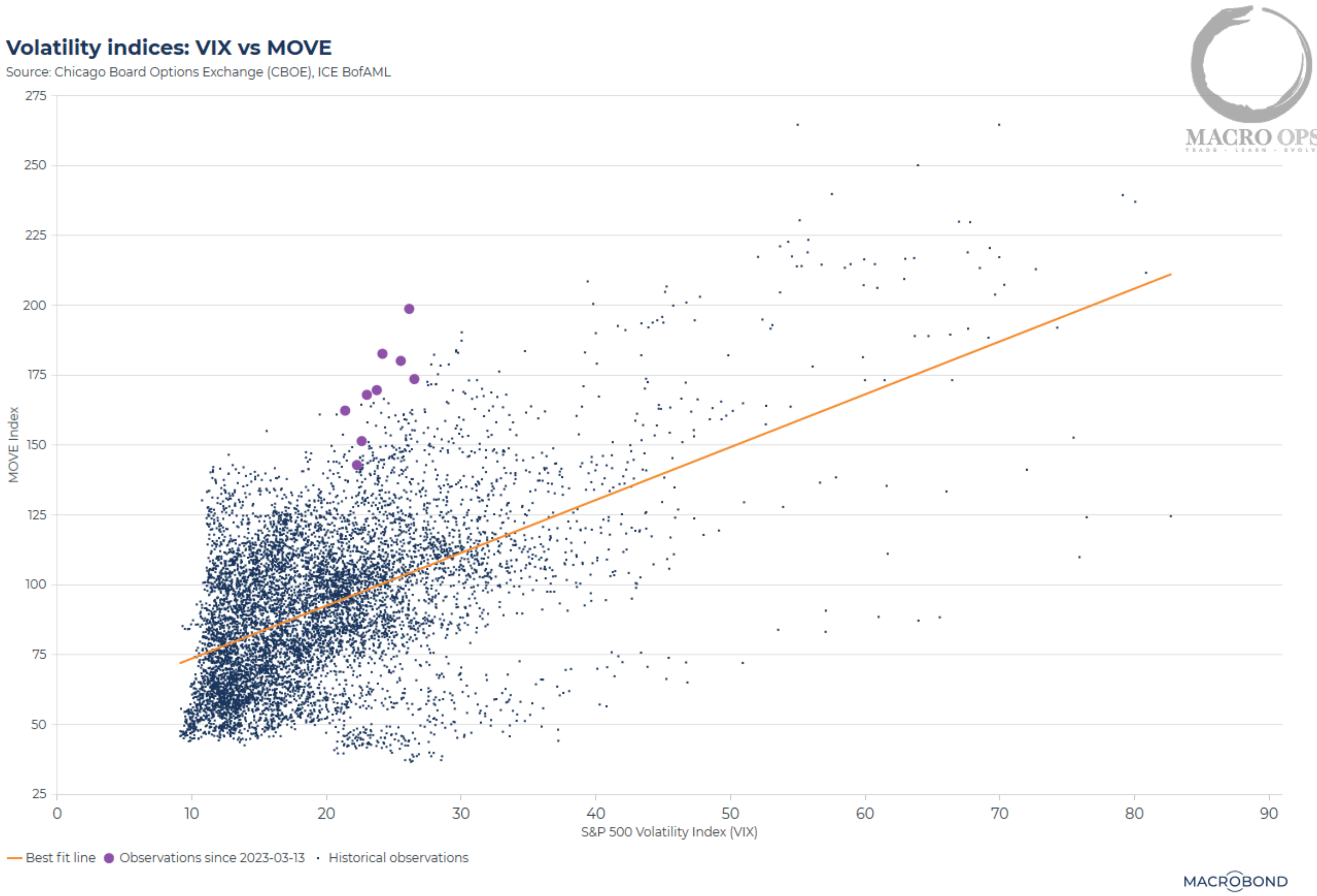

Why is this important?

Everything in markets is relative. Bonds set the foundation for the pricing of everything else. High volatility in bonds leads to increasing amounts of uncertainty in the broader market. Historically, this gap is closed by equity volatility catching up to bond vol.

The thing that will drive this spike in equity vol is the same thing that drives all major bear markets, tightening financial conditions. You know, the whole Buffettism of “you never know who’s swimming naked until the tide goes out.”

Well, we’ve already seen a few players caught without their trunks; FTX, SVIB, Signature, etc… And we’re going to find out there were plenty of others as liquidity is going to get much tighter over the following two quarters.

This chart shows the Fed Senior Loan Officer Opinion Survey (SLOO) for tightening lending standards. A higher reading means tightening financial conditions.

The bottom chart shows the aggregate of all responders who said they’ve “tightened some” in

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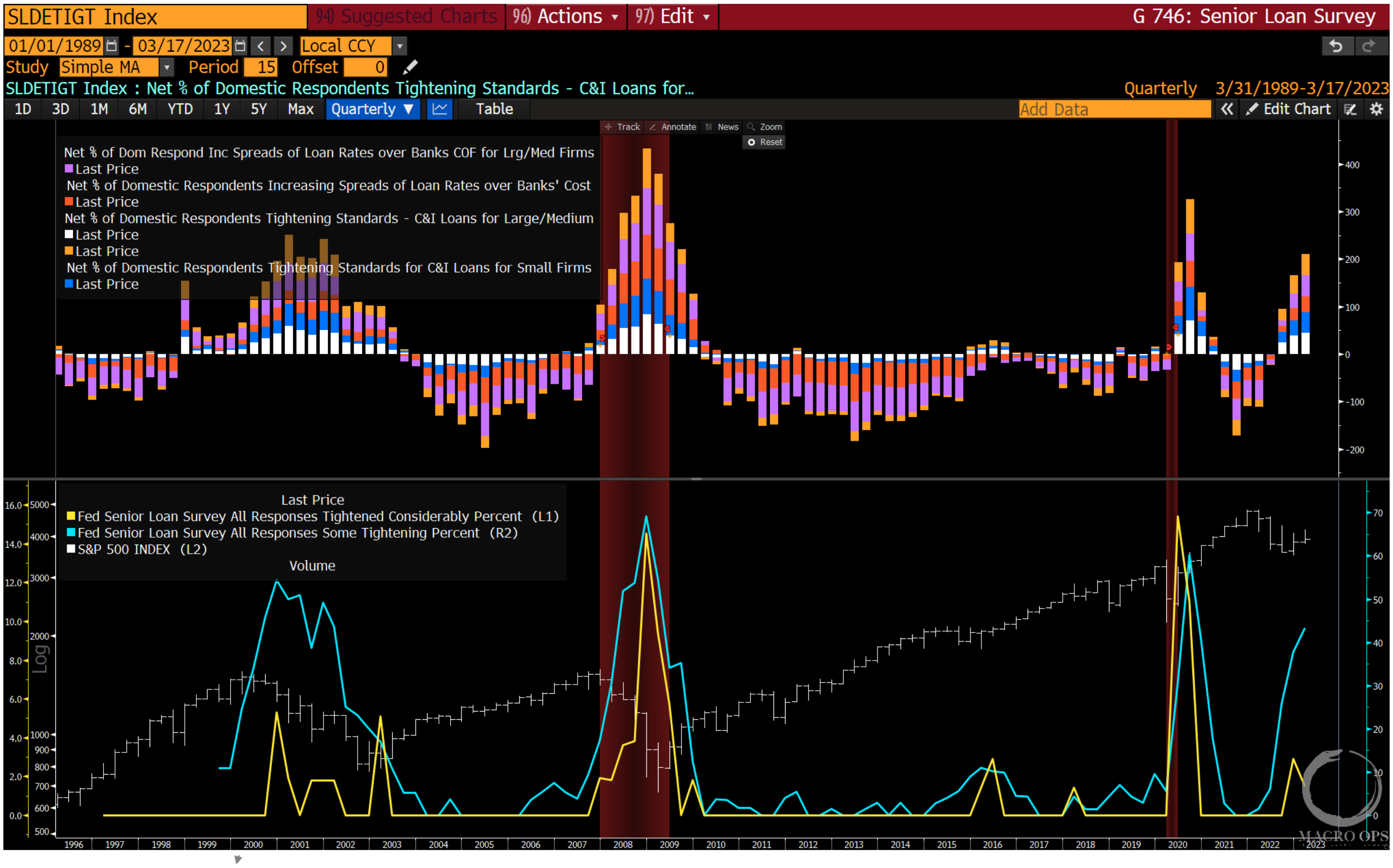
turquoise and those who said they've "tightened considerably" in yellow. We can clearly see there's a lead/lag relationship between the two, which makes sense as this process is quite reflexive by nature — there's a feedback loop where "some tightening" eventually leads to greater "considerable tightening".



The last three times the "tightened some" line was this elevated, the economy was in or soon entered a recession. There's little reason to believe this time will be any different.

Here's a similar chart but with the SLOO C&I tightening loan survey (blue line) overlaid against that of high-yield spreads (green line). This is vetus opinio at work.

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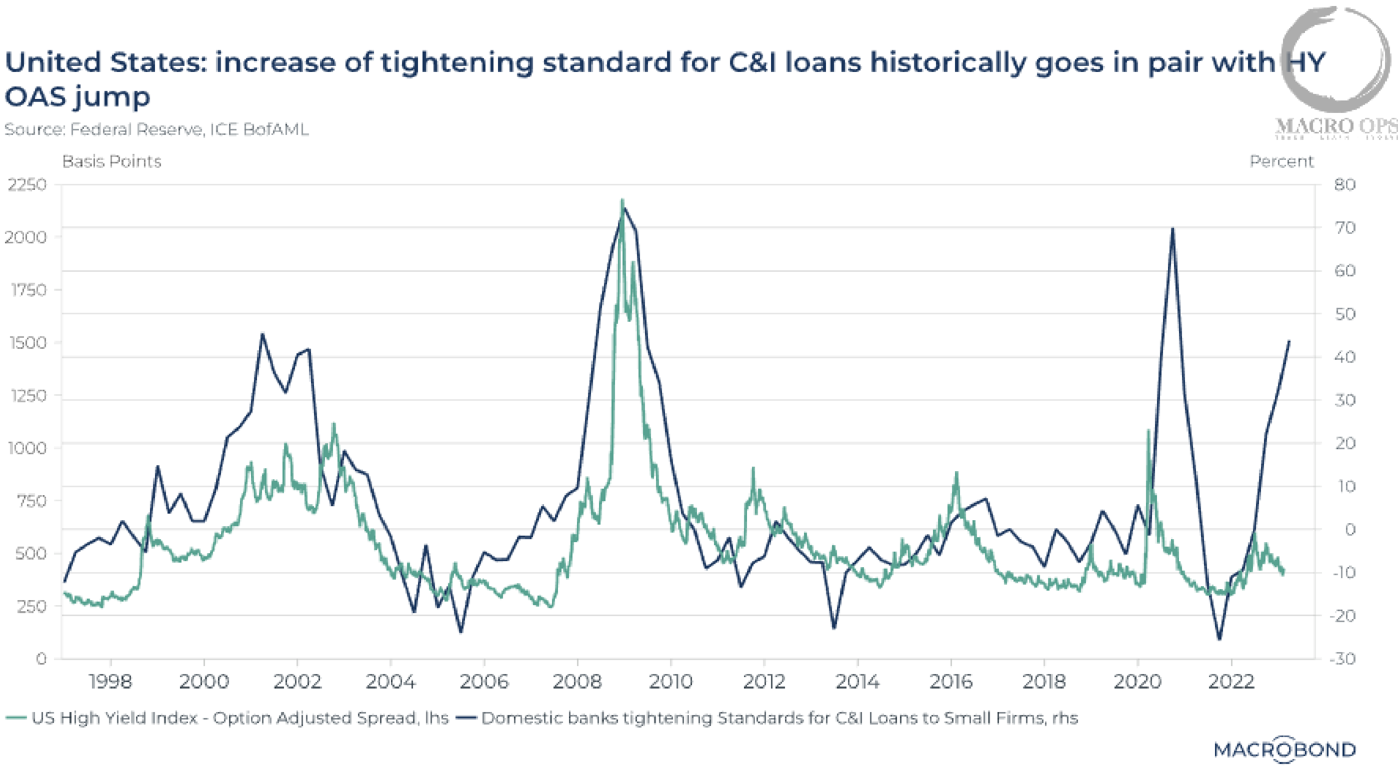
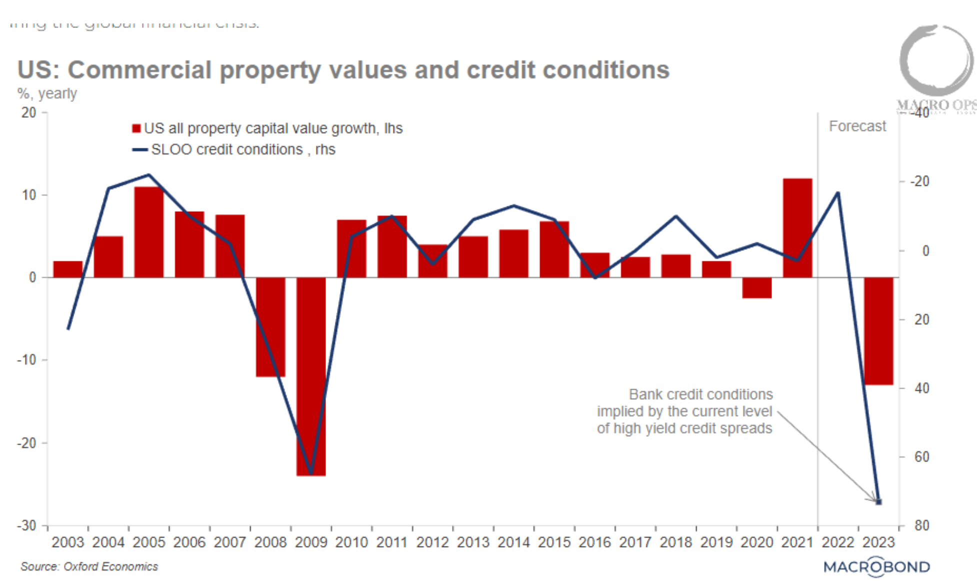


Here's SLOO credit conditions (inverted) overlaid against all US property capital value growth.

Current survey values project a 15% drop in commercial property values this year. That would be the largest annual decline since 09'.

This is why the bond market is now pricing in over 200bps of cuts from the Fed over the next 24 months (chart below). Realistically, it's likely going to be much more than that but at least the bond market is waking up to what's going on here.



As one of my mentors likes to quip, "if it looks like a duck…" We can hope this time is indeed different but that would be at odds with the growing weight of evidence suggesting that it is in fact, not.

And since we're in the game of making data-backed probability-weighted decisions, there's no reason

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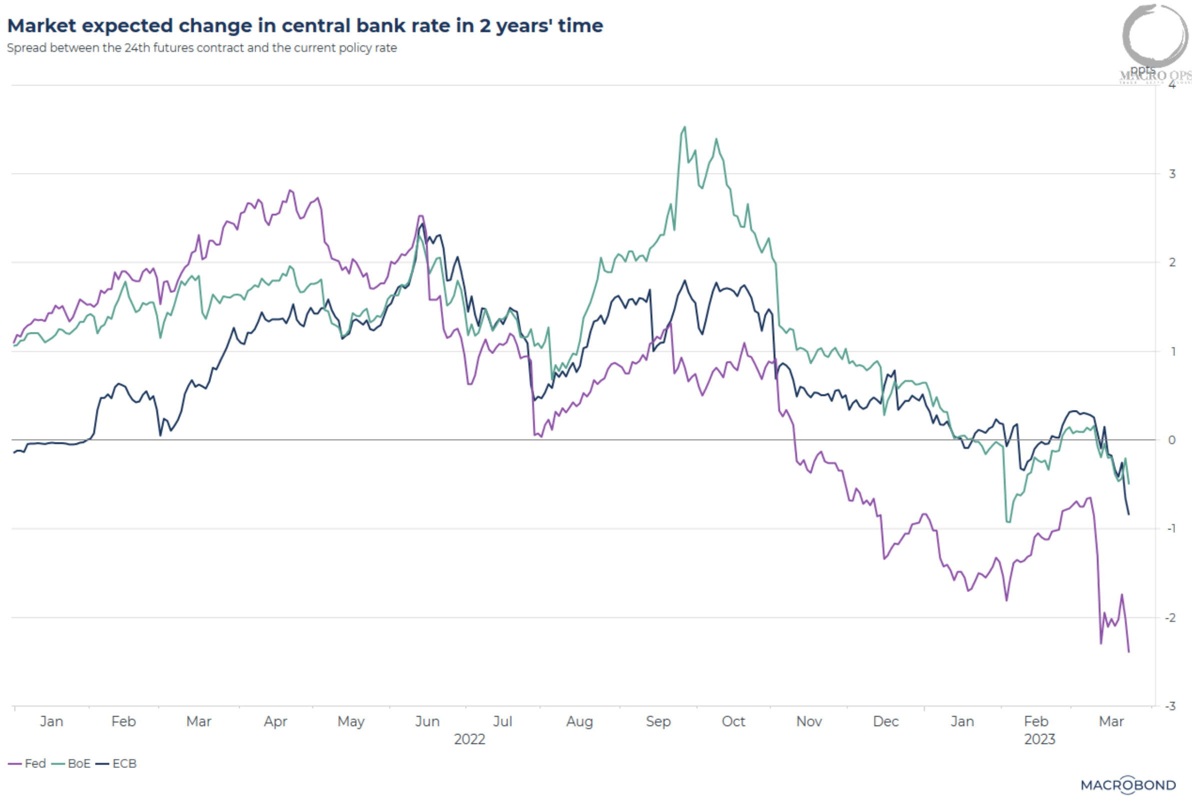
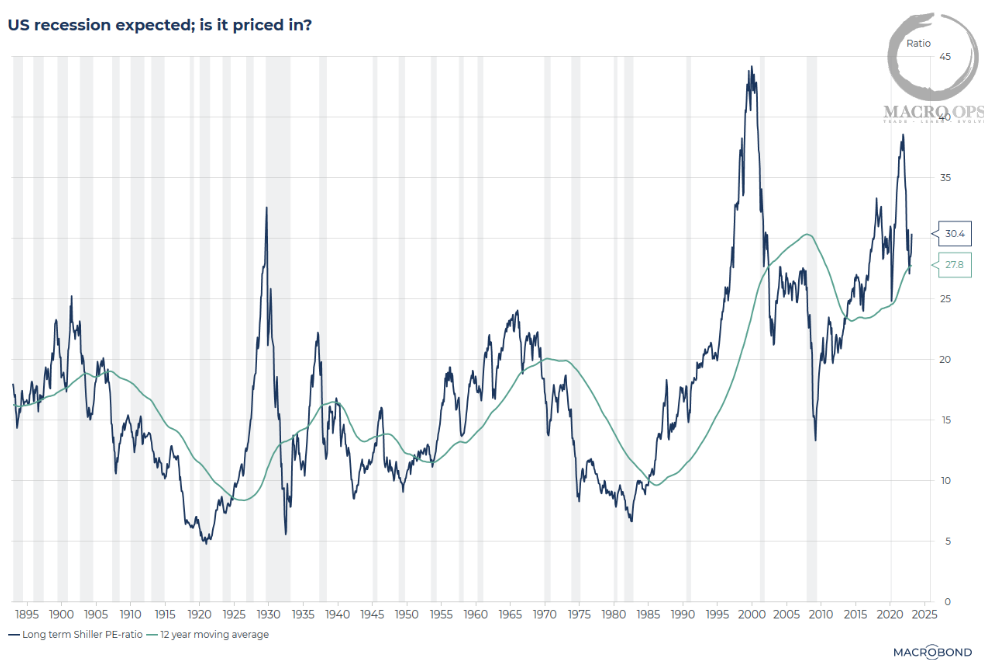
for us to think this isn't a duck until there's a catalyst (major policy intervention of some kind, maybe) that dramatically changes the trend in the data. But until that moment comes we have to play the game in front of us and not simply bank on a dramatic rule change coming on the horizon.



And it should not be forgotten that the backdrop of this quickly deteriorating liquidity / high bond volatility environment is one of <u>aggregate valuation metrics for the broader equity market still in the 88th percentile.</u>

Here's the Shiller CAPE. It currently sits at 30.4x, well above both its historical and 12-year average. This is not what bottoms are made of.

Those who are of the more bullish bent may point to decelerating inflation and a Fed pause/pivot as reasons for this being a cyclical bottom.



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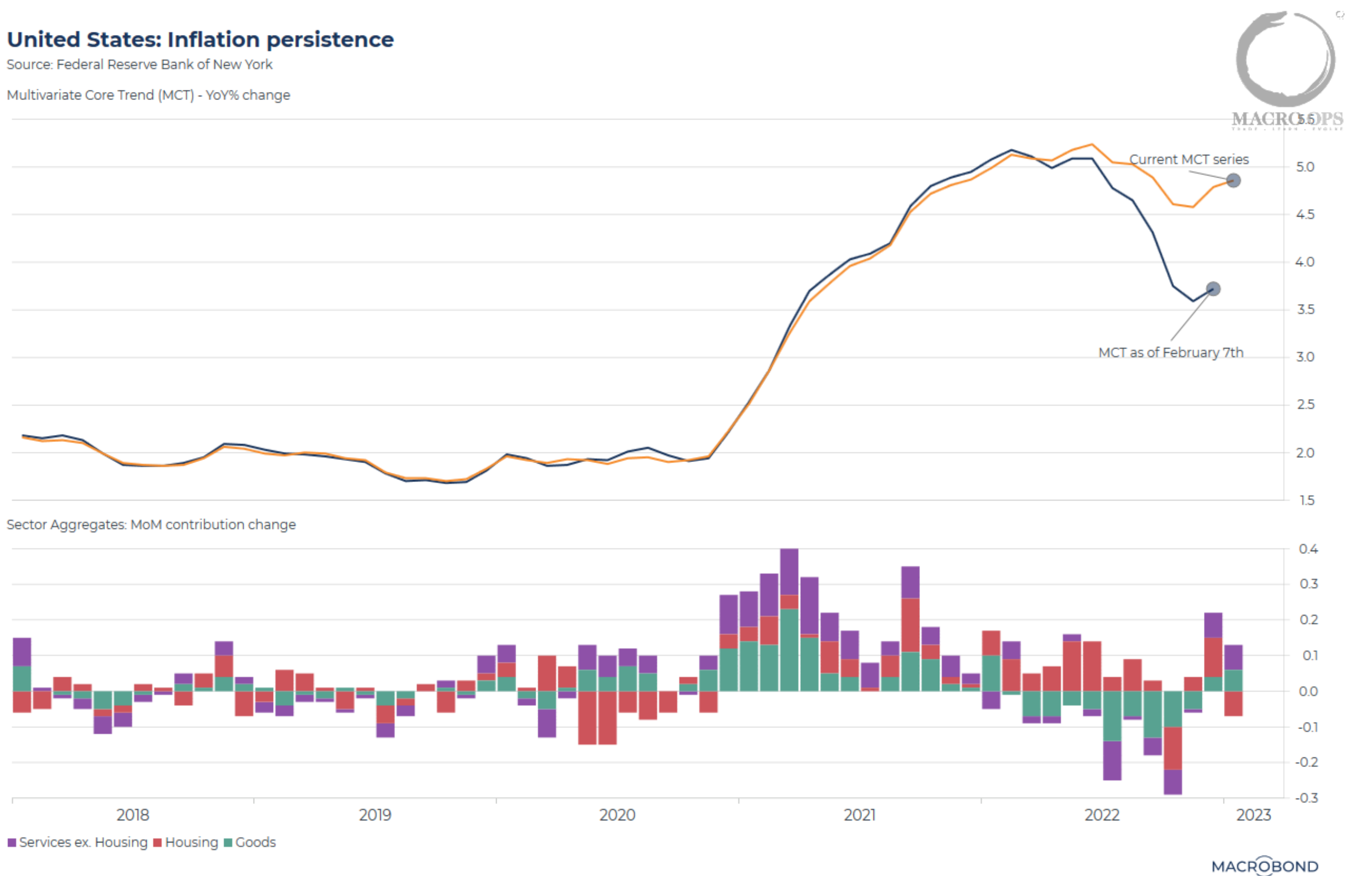
This is nonsense for the simple reason that liquidity is going to tighten considerably over the coming quarters, as noted above. And yes, CPI will come down and the Fed will pivot — eventually — but that will be due to accelerating demand destruction caused by a recession unwind of the labor market.

And while inflation is coming down, its components are proving to be more persistent (sticky) than many have expected.

This chart is a Multivariate Core Trend PCE Inflation model developed by the NY Fed as a means to measure the persistence and broadness of price gains for the seventeen major sectors of the personal consumption expenditures (PCE) price index.

The aim of this model is to decompose "each sector's inflation as the sum of a common trend, a sector-specific trend, a common transitory shock, and a sector-specific transitory shock" which in plain English means it measures how much sticky structural inflation there is in the economy and whether it's going up or down. You can read more about its construction here.

The blue line is the old numbers before the data was revised upwards. The orange line shows that "inflation persistence" has started to pick up again after a decline in the Fall of last year. Not exactly a good look for Team Transitory if that's even still a thing.



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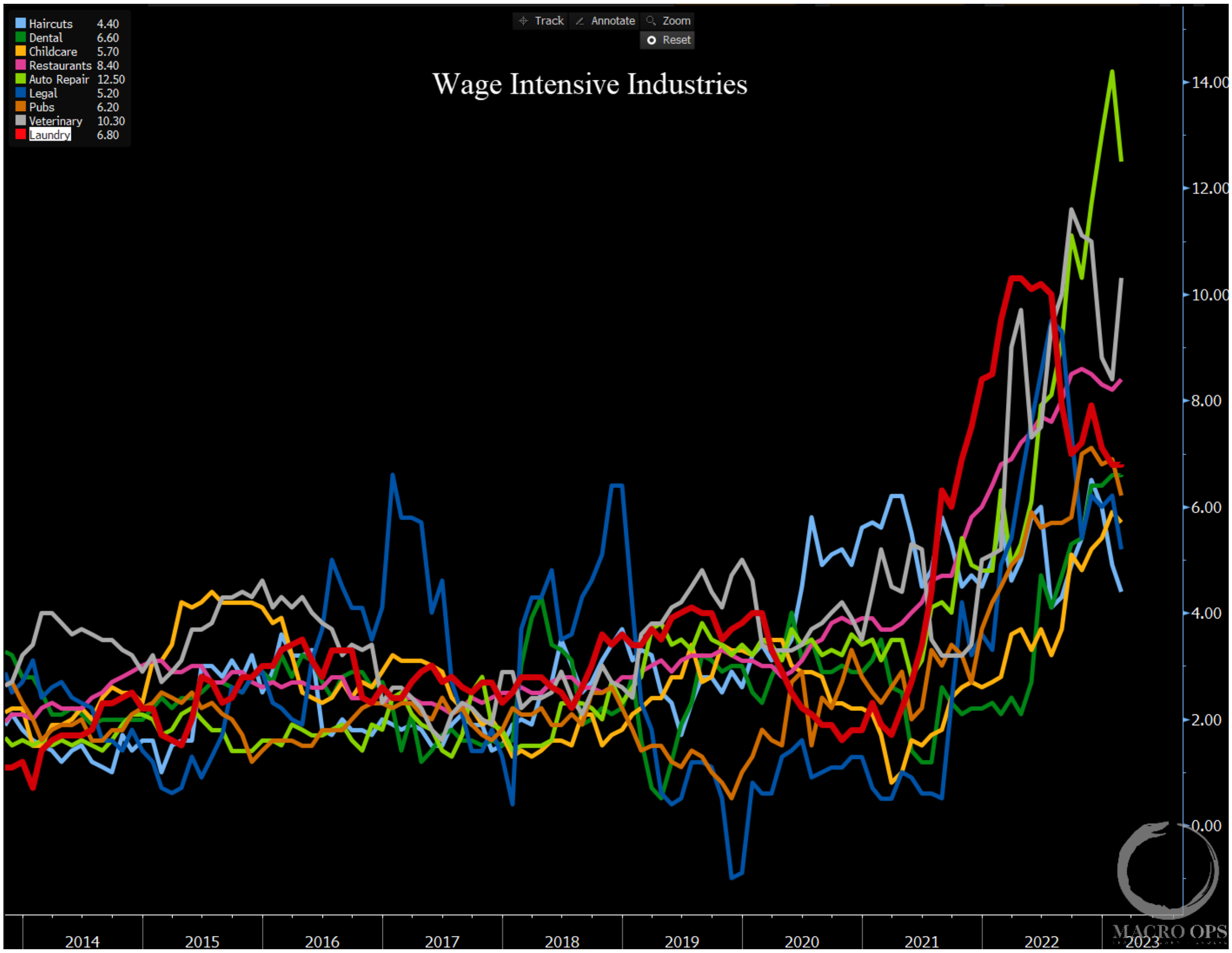
There are a number of structural reasons for why this is and why we're *not* going back to the deflationary secular regime of the past 40-years. One of the major reasons for this is the changing dynamic in the labor market. This dynamic, which is a factor of both demographic splits and labor vs capital power, means persistent wage pressures are here to stay.

Here's a chart showing the CPI trends for the most wage-intensive industries (h/t Vincent Deluard).



This is broad-based accelerating wage pressures. Yes, these will eventually come down. But they will only do so once the Fed drives the economy into recession. In fact, putting the economy into recession, is one of the Fed's stated objectives right now Their recent economic projections predict an unemployment rate of 4.5%. It currently sits at 3.5%.

Two things about this (1) the Sahm Recession indicator, which has a perfect track record indicating recessions, signals the start of a recession with the 3-month moving average of the unemployment rate rising by more than 0.5% from its 12-month lows and (2) the unemployment rate never rises by just 1%. Labor market unwinds are highly reflexive in that

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once a certain level of workers are laid off, demand drops, which causes more companies to cut costs and layoff more works, and so on and so forth.

In light of these developments, we have more conviction today in the thesis we've held since early 22', that the US economy will enter a recession in the second half of this year and it will be a hard landing as equity holdings as a percentage of total financial assets still sit near record all-time highs.

And this doesn't make any sense in light of the changing regime. It's simply a reflection of vetus opinio… players who've only played the game one way and lack the imagination, the will, or both to understand that it's now an entirely different game, a new regime, it's the Soros Cycle turning on and on…

Actionable versus setting up…

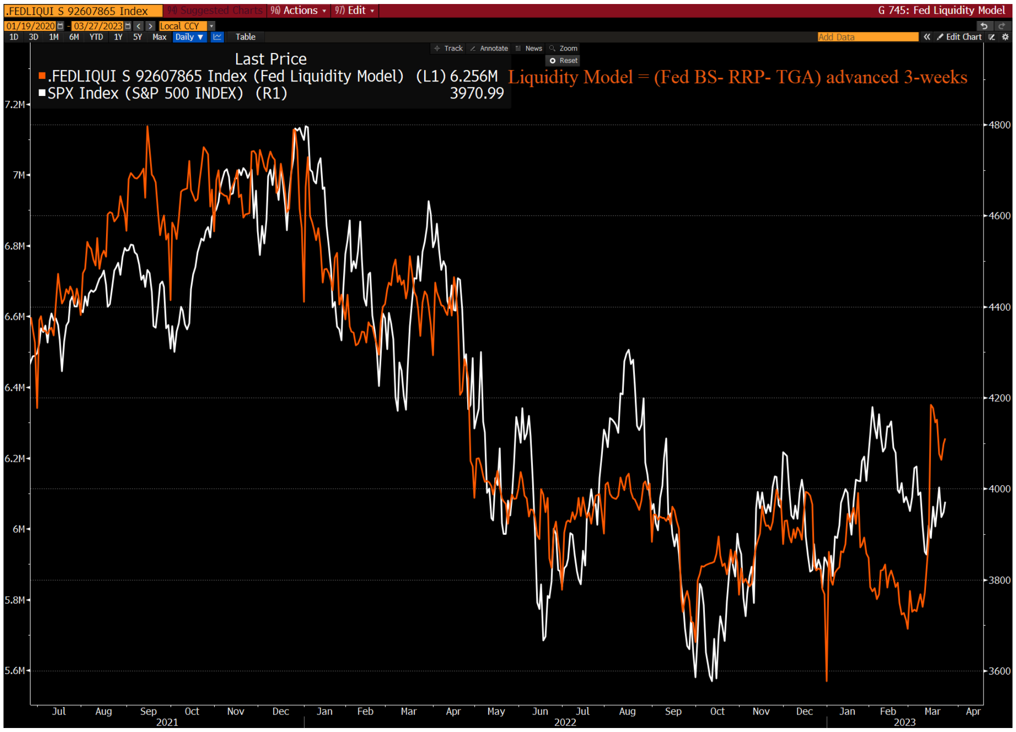
One of the many difficulties in trading these markets over the past few months is the contrast in signals to timeframes, which is something I've been commenting on.

While we're convicted the bear market has a long way to go, it's still quite possible for the market to continue on this counter-trend bull rally for another month or two.

While we think the probability of this rally continuing much longer than another month or so, is quickly becoming slim. We have to remain open to it.

Here are a few things I'm watching to gauge this.

The Liquidity Model (h/T DH) is an aggregate of the Fed's BS, RRP, and the Treasury General Account (TGA). It's the orange line along with the SPX in white.



A big positive driver of liquidity over the past year or so has been the drawdown of the TGA (essentially the government's checking account), which has more than offset the negative impact of the Fed's QT to date.

Absent a raising of the debt

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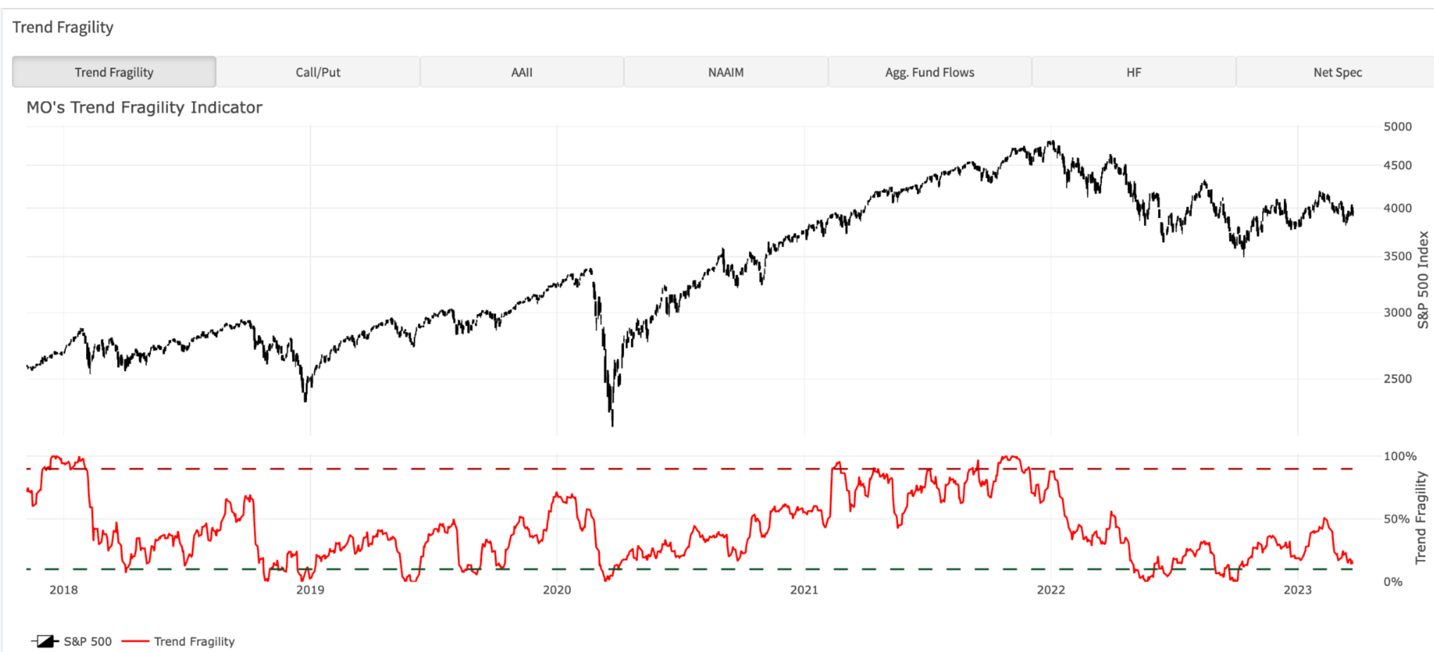
limit, the Treasury will draw down its TGA sometime in June, which is only a few months before households are expected to spend the last of their excess savings.

But I digress… We can see in the above chart that this Liquidity Model has a strong leading correlation to equities. It's currently perking up.

This is in line with what we've seen in cyclicals vs defensives and consumer discretionary vs stapes over the past month. These are not bearish short-term signals so they need to be respected, especially since our [Trend Fragility indicator]is in the 14th percentile and heading lower.

It's difficult for the market to fall when sentiment and positioning are this bearish. I should caveat that with though this is true most of the time, there are the occasional times when sh*t just starts breaking… and those times happen in illuiqidity-driven Contraction Regimes, which is where we're soon headed.



We only have five more trading days left in the month. We'll wait to see where the indices close for March.

I pointed out last week that I'm closely watching the monthly chart of the Russell small-caps index. Where it closes should be a good tell for where things will trade over the following few months.

There's a lot of coiled energy in this market. Which tells me there's a big move (up or down)

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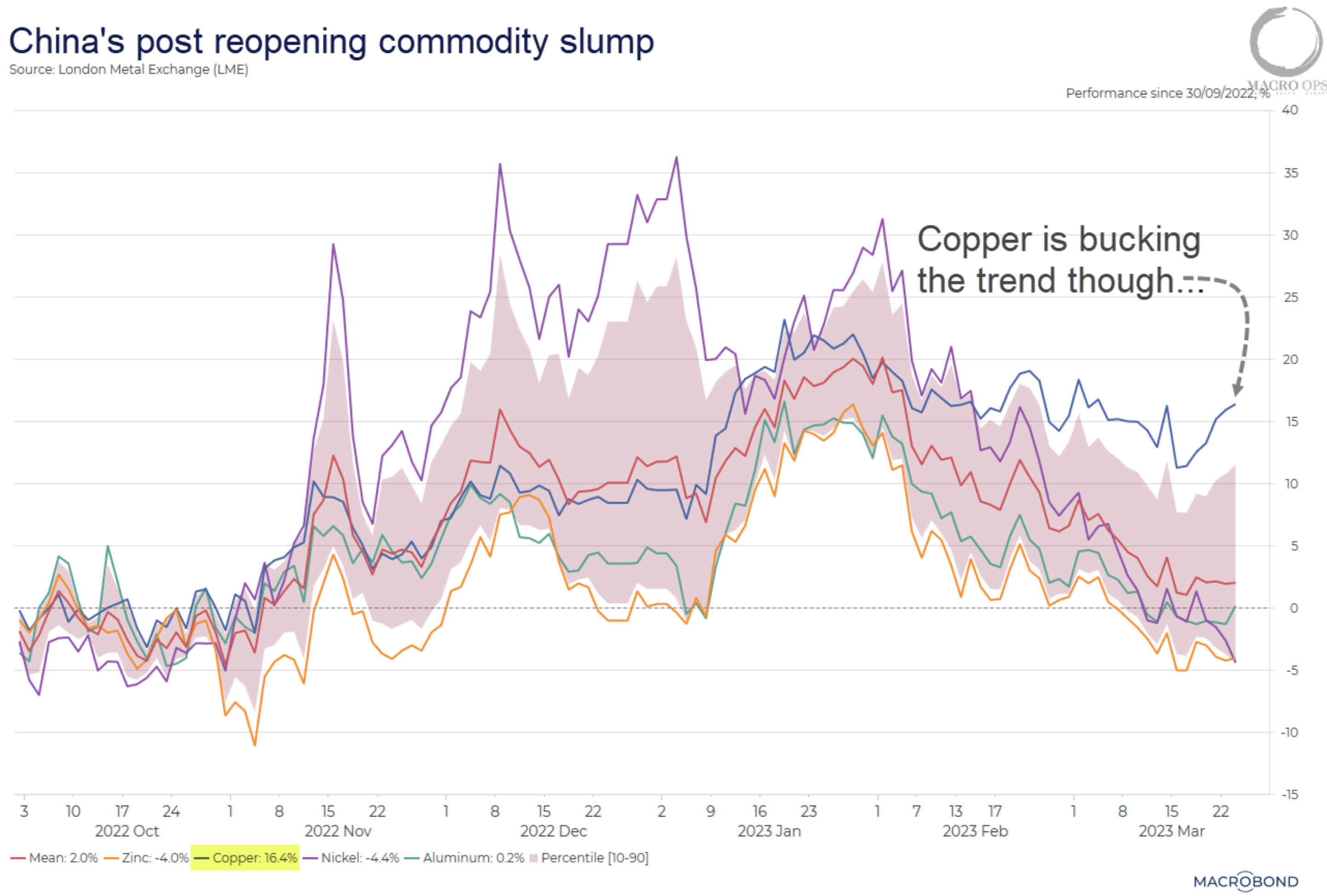
coming soon. So we'll want to be nimble here, wait for confirming signals, and act when appropriate.

Until then, we'll keep sitting on lots of cash. Stay long only the names that are working. Aggressively manage risk and keep our heads on a swivel…

A few last points of interest…

It's notable how short-lived the China reopening commodity bump has been. Arguably the result of a rising probability of recession elsewhere. Below is a chart of industrial metals. Copper though appears to be bucking this trend and proving more resilient than its peers.



Copper will certainly fall some more if/when we enter a recession later this year. But, it along with oil and gold, will likely bottom well before the stock market does.

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The reason again, is just the regime we're headed into. It's one where the world is very short commodities (due to [CAPEX cycle dynamics](#)) and very long government largesse and their plans to build lots of physical stuff, whether it be "greening the grid" or repairing physical infrastructure with the magic of deficit-financed money.

The mining billionaire Robert Friedland was interviewed by the FT last week about the state of the copper market. He told the FT that "it took him 28 years to develop the vast Kamoa-Kakula mine in the Democratic Republic of Congo, which is ramping up to supply 650,000 tonnes by the end of next year."

And because of how difficult and time intensive it is to get a copper mine into production, along with how much global demand is expected to grow over the rest of the decade (S&P Global estimates 40mn tonnes by 2030 versus 25mn now), he told the FT "we are heading towards a train wreck."

We at MO agree, which is why Foran Mining (FOM.TSX) is our largest position. You can read our full [writeup here.](#)

To use the 01'-02' bear market analog again. Look at how much earlier copper, gold, and oil bottomed before stocks (copper 11 months, crude 10 months, and gold 18 months). I expect gold will be just as valuable a lead this time around.

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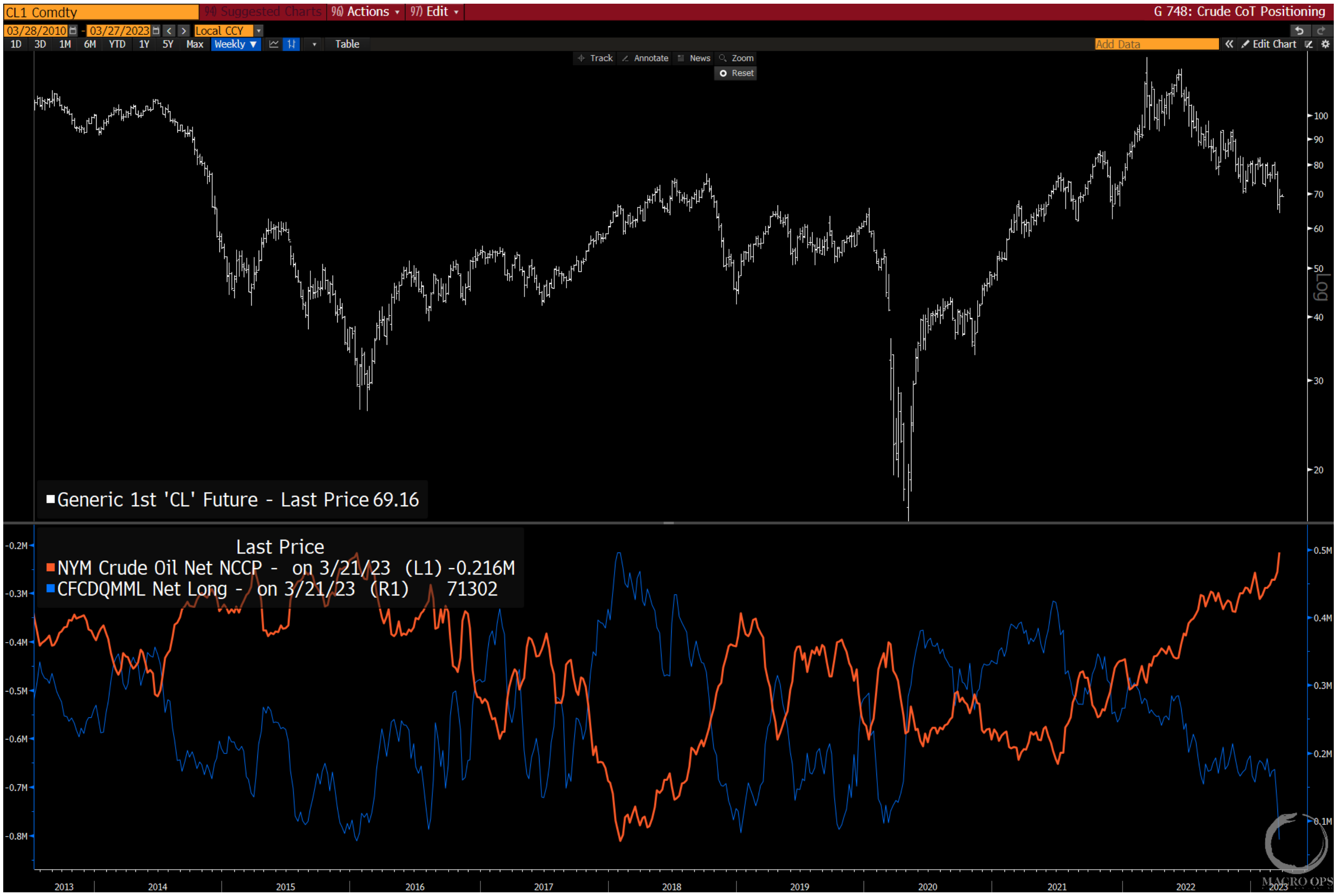
Speaking of oil (we're short on a purely tactical/hedging basis right now as we're long the equities), the positioning picture is setting up quite nicely for a long term bottom. Here's net commercials (orange) versus net managed money (blue).

Commercials have their most bullish positioning (hedgers are always short the oil market) since the 15' bottom. And conversely, managed money is at its most bearish positioning since then, as well.



There is little doubt that crude, copper, and gold are shaping up for monster trends that'll play out over the next few years, at least. But, patience is required here… Illiquid Contraction Regimes are noisy and difficult to trade… And positioning is never reason enough to buy something. We have to wait for the tape to confirm.

We'll keep the group updated on what we're tracking here.

And with that, let's turn to Brandon so he can walk us through the latest updates on our energy

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holding, TDW, followed with a deep dive on the E&P JOY.

Your Macro Operator,

Alex

PIR: TDW Update & Journey Energy (JOY) Investment Thesis

Before we dive into JOY, I want to quickly update you on Tidewater's (TDW) latest earnings report. TDW is one of our largest winners over the past year, with the stock up ~45% from our cost basis. We've taken partial profits and currently hold a ~3.5% notional position.

You can read our most recent TDW deep dive here.

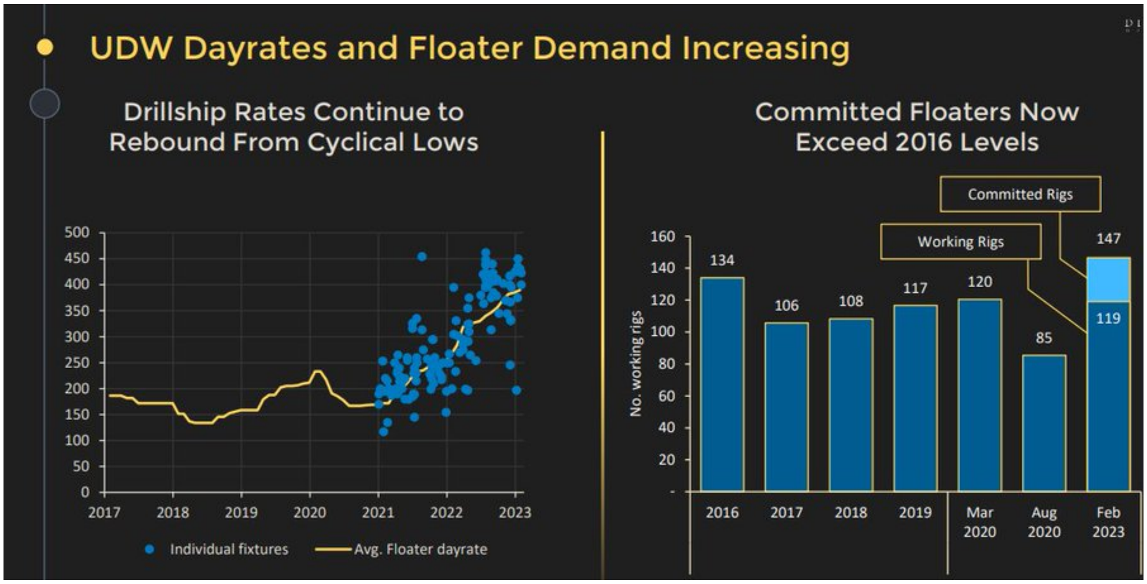
We must *now* ask ourselves, "*what will this stock do for me this year?*" It's been one of our better performers but what about the next 18-24 months?

TDW released Q4 earnings on 02/27 and confirmed our initial offshore bullish thesis: **structural underinvestment since 2014 + increased demand for TDW's assets = higher day rates = higher profits.**

The company generated ~$650M in revenue and $167M in EBITDA for a ~26% margin during 2022.

Here's why we own TDW and want to add to our position: **the next two years will likely be much better than 2022.** Let me explain.

Management estimates they'll do ~$900M in revenue and $360M in EBIT (50% margin) this year. They also expect 2024 to outpace 2023.



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TDW will grow revenues by ~25% (due to higher day rates versus 2023) and maintain a ~50% EBIT margin (due to low incremental costs). We'd end 2024 with over **$1B in revenues and $500M+ in EBIT.**

The stock trades at a $2.3B market cap or a 28% 2024E EBIT yield. TDW is a **$100+/share stock within three years** as the company benefits from structurally higher day rates, 50%+ operating margins, and a robust macro backdrop.

If we're right, TDW is a $100+ stock within 12-18 months and still a double from today's price.

Journey Energy (JOY.TSX): Trifecta Setup + Jockey Bet

Journey Energy (JOY) is a ~CAD 300M Canadian E&P producing ~13,000 boe/d of oil and gas annually. The company has three main avenues for value creation:

- **Existing asset production (13,000 boe/d)**
- **Rolling up smaller E&Ps at accretive multiples**
- **Selling electricity through its newly bought power plant**

These three strategies combined should create over **CAD 20/share in NAV** compared to the company's current stock price of **CAD 6/share** (300%+ upside).

This opportunity exists for a few reasons:

- JOY's size ($300M) prevents larger institutions from buying/noticing.
- Investors view JOY's roll-up strategy as "riskier" than the more conventional policies of dividends, buybacks, or debt repayment.
- You're betting on one man's (Alex Verge) ability to effectively allocate capital

Let's dive in.

Existing Asset Production: ~$500M+ Value at $80 Oil

JOY's oil and NGL production business is also the most common E&P cash generator. The company produces ~13,000 boe/d and generates Netbacks of ~$25/boe. Netbacks include sales revenue (net of transportation), less royalties, production taxes, and cash operating costs.

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	Operating Highlights	2019 Actual	2020 Actual	2021 Actual	2022 Estimate(1)	1H 2023 Forecast
Production	Average (boe/d)	9,372	8,379	8,004	9,800 – 10,000	13,000 – 13,500
	Oil and NGLs (%)	48%	46%	47%	49%	54%
	Corporate Decline Rate (%)	16%	17%	14%	14%	12%
Reference Prices	Natural Gas AECO ($/mcf)	$1.80	$2.24	$3.64	$5.40	$4.00
	Oil WTI ($US/bbl)	$57.02	$39.40	$67.91	$94.00	$80.00
	F/X ($CAD/$USD)	0.75	0.75	0.80	0.77	0.75
Operating Results	Revenue (Before Hedging) ($/boe)	$31.92	$22.15	$42.39	$66.00	$56.35
	Netback (Before Hedging) ($/boe)	$13.12	$6.94	$18.89	$33.50	$24.20
Capital	Including A&D ($millions)	$20.80	$7.1	$11.0	$190	$15
Wells Drilled	Gross/Net	7/7	–	–	14/10.9	–
Financial	Realized Hedging gain (loss) ($millions)	($0.3)	$7.9	–	$6.4	–
	Adjusted Funds Flow ($millions)	$28.40	$13.5	$46.3	$103 – $105	$47 – $50
	Period End Net Debt ($millions)	$124.20	$90.4	$57.0	$99 – $101	$67 – $70
	Weighted Average Basic Shares (millions)	40.2	43.2	45.4	52.7	57.9
	Adjusted Funds Flow/Share ($/Share)	$0.70	$0.31	$1.10	$1.95 – $2.00	$0.81 – $0.86

The company expects to make ~$50M in Adjusted Funds Flow in 2023, assuming $80 oil and $4 natural gas prices. You can see a complete breakdown of JOY's financial model below.

Like every E&P, profits live and die by commodity prices. Anything higher than $4 natty and $80 oil mean *even more* cash flow for JOY.

The other primary lever is a reserve's decline rate. Decline rates measure the annual reduction in the production rate from a particular field or a group of fields after a peak in production.

We want low decline rates, like JOY's, at 12%. Low rates signal a healthy reserve base with long production life and higher free cash flow potential. Higher decline rates reduce future free cash flow streams and the value of the reserve asset.

Then there are JOY's oil reserves. There are four ways to view JOY's reserve assets, as shown below from the company's investor presentation.

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Company Gross (WI) Reserves[1] / Value (July 1, 2022 3 Consultants Pricing)							
Reserve Category	Oil (Mbbl)	Gas (Bcf)	NGLs (Mbbl)	Mboe	RLI	NPV10 ($million) Before Tax [1]	FDC ($ million)[2]
Proved Developed Producing	17,552	104	3,485	38,318	8.8	507.1	24.9
Total Proved	22,958	133	4,750	49,942	9.6	670.2	123.3
Proved + Probable Producing	22,698	134	4,283	49,375	10.7	622.8	25.2
Total Proved + Probable	36,560	209	7,645	79,112	12.6	1,020.7	271.7

I want to highlight "Proved Developed Producing" reserves or "PDP." PDP is the most reliable estimate of JOY's *existing producing* resources. These are barrels that are currently coming out of the ground.

The company has 17.5M barrels of PDP oil with 38,000/Mboe per day in production capacity for an 8-year reserve life.

Suppose we *only* get JOY's PDP reserves and assign zero value to its proved and probable producing reserves.

We'd still get over $500M in NPV. That's nearly 1.5x the current market cap while getting the rest of the reserves for **free.**

JOY would trade at >$20/share if it traded closer to 1x.

Small-Cap E&P Roll-Up Strategy: >100% IRRs

JOY's second value-creating strategy involves rolling-up small-cap E&Ps at cheap enough prices where the assets pay for themselves in <1 year.

This path, when done correctly, creates more shareholder value than the traditional dividend/buyback/debt reduction plan most E&P CEOs follow.

CEO Alex Verge knows this playbook well. He completed 160+ acquisitions at Bonavista and generated 850%+ shareholder returns during his tenure (1998-2003).

Alex's strategy is simple: **buy quality, low-cost, and low-decline assets at cheap prices (~2-3x cash flow).**

JOY's acquisition of Enerplus is an excellent example of Alex's roll-up strategy. The company bought Enerplus for $140M effective May 1 with some creative financing:

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- ➢ **$30M** in cash flow from Enerplus's operations between May 1 and the close date (October)
- ➢ **$45M** in vendor take-back financing with scaled 10% interest payments
- ➢ **$14.16M** in JOY equity (3M shares at $4.72/share)
- ➢ **$50.84M** in cash from JOY

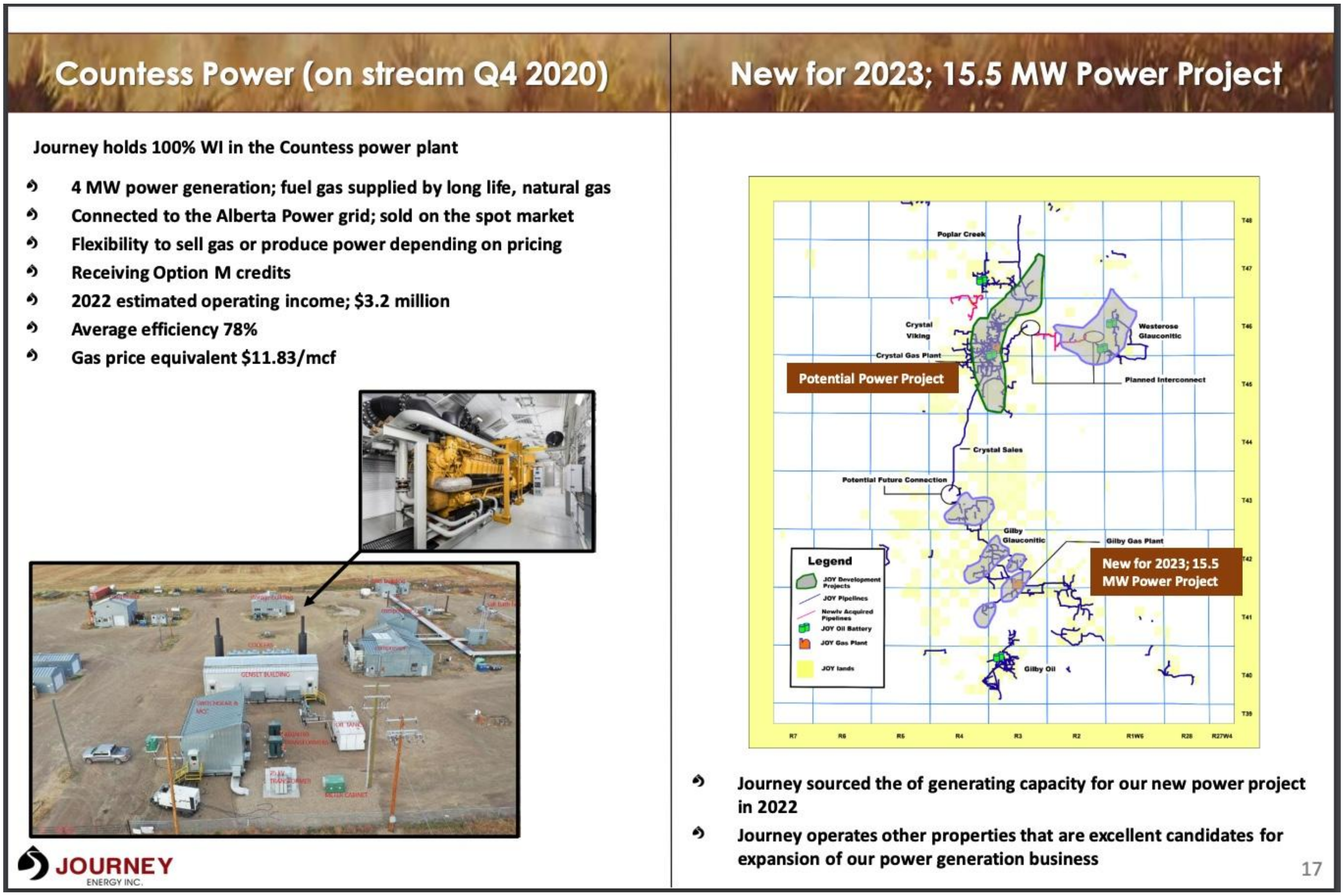
Alex paid $51M in cash for an asset generating ~$60M in annual cash flow.

JOY could quickly generate its market cap in FCF in a few years if Alex finds more deals with oil at $80 or higher.

Let's discuss JOY's final value-creating strategy, its powerplant operations.

Power plant: Turning Cost Centers Into Profit Centers

Alberta power prices have risen 154% since 2021 and are a high variable cost in JOY's operations.



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The company consumes ~20MW of power per day.

JOY bought two power plant assets that produce ~20MW/day of power, nearly fully offsetting JOY's energy costs (asset breakdown below).

Our friend Josh Young at Bison Interests estimates these assets are worth ***at least* $3-4M per MW** (using comparable transactions and heightened energy scarcity in Alberta).

That's another **~$60-$80M in asset value** you're not paying for at the current market price. The power plants also have additional upside potential as investors ascribe higher multiples to steady utility-like businesses versus E&P assets.

Follow The Leader: Betting On Alex Verge

A bet on JOY is a bet on Alex Verge. The roll-up strategy works if Alex buys low-decline, high-cash-flow assets at low prices.

This isn't Alex's first rodeo. He employed the same strategy at Bonavista and generated a nearly 900% shareholder return from 1998-2003.

Second, Alex has all of his and his family's net worth in JOY stock. He mentioned in one interview that he plowed $20M of his life savings into JOY at $12/share.

Moreover, he survived the latest bear cycle. He saw his family's savings fall over 90% as JOY stock fell below $0.12/share in 2020.

Alex is a 40-year veteran with a repeatable, value-creating strategy to deploy in the early innings of a structural energy bull market. The runway is long for him to execute his roll-up plan and grow NAV by 25-50% annually over the next few years.

We're buying JOY at a fraction of its reserve NAV with an energy production business for free. If oil stays around $80/barrel over the next few years, JOY will be a $20+/share stock, and we'll make 3-5x our money, at least…

Your Value Operator,

Brandon

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