September 2019

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Performance Summary: On the surface, September looked like a rather tame, listless month. Stocks, at least in terms of the indices, were up small as the rotation out of bonds finally took hold and supplemented some interest in stocks.

But, there is some real anxiety taking place in the fund world right now. September saw some vicious rotation out of growth and newly minted IPO stocks, even as the overall indices remained placid. We have more on this below, but let's just say that the damage done and fear created is a lot more palpable than it appears from the headlines.

September was our first red month of 2019, and while that is never a good sentence to write. Our only solace is the fact that we were able to minimize the damage in a month that saw few things right in terms of positioning.

This month Trade Desk, which we no longer have a position in, dropped a stunning 20% in September alone. Twitter fell a paltry 1.8%, Snap dropped less than 1%, and Rubicon Project shed 10.3%.

To add to the frustration, our shorts did little to help offset the decline in our long side of the book. Also, our Bitcoin Trust position, which is very small, fell almost 18% - even though it still remains profitable from our entry point.

So overall, it was a month when seemingly nothing went right. These types of periods do happen, and they do admittedly lead to periods of reflection and added scrutiny for our strategy and positions. But, the good news, if there is any this month, is that we cut our losses quickly as we saw the rotation unfolding and have kept all remaining positions, aside from the Bitcoin Trust, option-based. This keeps our risk defined and allows a 20% drop in Trade Desk to only inflict some minimal damage.

Also, our trading side of the book remains steady and profitable, which this month helped in offsetting the position losses. Going forward, we do see the action this month as a precursor for volatility; combine that with an always unpredictable October and plenty of news catalysts (trade deal, Fed meeting, impeachment process) to deal with and we would envision the final quarter of 2019 as being a very active one. One we enter with high levels of cash and ready to pounce on any lurking opportunities.

Dangerous Undercurrents: On the surface, September appeared to be a rather benign month. The major equity indices slowly ground their way back to near all-time highs and bond yields reversed their slide and at least hinted at returning to some sort of normalization.

But, under the surface there were a *lot* of currents and ripples percolating. For starters, we saw an attack on a Saudi Arabian oil fields by a set of drones that subsequently affected a third of the world's oil supply and was responsible for a nearly 20% surge in prices, which was the single biggest one-day spike ever. However, such a seemingly negative headline as that is, the stock market, sans the energy sector, hardly reacted to the news that would have sent markets reeling just years ago.

The main reason for the placid response is that America has become a net exporter of oil rather than an importer, mainly due to the Permian Basin and the surge in fracking in our country. Also, there was speculation that Saudi Arabia would be able to get their supply back on line within 2-3 weeks, versus the months some thought it would take.

The short-term supply disruption looks like it likely will be eradicated and allow for a return to normalcy, but longer-term it just adds to the already increasing geo-political tensions. Keep in mind that these attacks were committed by a series of drones and missiles, all costing less than $15,000, with zero risk for human death by the perpetrators. That in itself is a reason to be concerned with the future for this region and any others that are subject to constant enemy aggression and with market implications attached.

So, this month we saw a rise in geo-political strife and the subsequent risk attached to it. That isn't exactly a new development, but it was a sharp reminder to all market participants that there is still a fair share of hot spots across the globe that can flare up at any time and cause sudden dislocations to various markets. Again, nothing new here, there has been global political risk since the Roman Empire, but we did get a sudden reminder that it's still here this month.

In the last week of September the Democrats decided to finally begin formal impeachment hearings on President Trump based on his conversation with Ukraine officials. Few believe he will be impeached due to the Republican control of the Senate, and the fact that the most of the recorded conversation has been released and examined exhaustively. Regardless, the proceedings will add another layer of uncertainty to an already confused marketplace.

Another interesting development this month, somewhat painful for us, as detailed above, was the sudden rush out of growth and momentum stocks and into value-based stocks. All this seemingly took place in in mid-September, but the damage was breathtaking. Let's take a look at some of the pullbacks we saw in high-flying growth stocks and just how quickly it occurred:

- Trade Desk **-20%** in September
- GW Pharmaceuticals **-19.5%** in September
- Slack **-17.4%** in September
- Lyft **-10.1%** in September
- Shopify **-18.8%** in September
- Pinterest **-21.7%** in September

- Crowdstrike **-30.3%** in September
- Netflix **-7.4%** in September

The reason for pointing this out is to demonstrate how quickly the disdain for any high-multiple stocks evolved in September. Some are pointing to the We Work (more below) debacle and the extremely disappointing IPO's of Uber, Lyft, and Slack, as the catalyst for the sudden reversal in disregarding these stocks.

It also could just be some old-fashioned "risk-off" as we approach the fourth-quarter and funds look to trim gains or protect their downside-especially with memories of last year's fourth quarter calamity still fresh in their minds. But whatever the case, those moves noted above created a lot of consternation amongst funds this month.

The only question left is what that latest shellacking holds for future downside and re-evaluation of what we are willing to pay for growth? Or is it just a one-off event that could have been sparked by a number of motives including some rumored fund liquidations.

A third development this month was the postponement and likely eventual cancellation of the WeWork IPO. WeWork is essentially a landlord of office space that appeals to younger companies looking to stay portable and keep costs low. They offer airy spaces, free coffee and Kombucha, and are very popular here in San Francisco. The problem is, they are extremely unprofitable, had a controversial CEO, and yet still at one point sported an eye-popping $47 billion dollar valuation.

We say at one time because as the road show progressed and more financial details were unearthed, the disdain from potential investors grew and the valuation dropped…by a lot. Some are now estimating the valuation at $17 billion (which is still crazy) and their IPO, which was set for mid-September, has been pushed back to "sometime", and there are many who think it will never come public with the current financials attached.

You may be wondering why an overpriced IPO with shaky financials being shelved amounts to anything for the general markets? And to be fair, maybe it doesn't. But it also could be the preverbal "shot across the bow" for unprofitable stocks trading at absurd valuations, in which there are currently many-especially in the cloud space. It may also have been a catalyst for the abrupt shift out of momentum and into value we discussed a few paragraphs ago.

Bloomberg may have summed it up best in an article from September 19th:

"In fact, with over $47 billion in lease liabilities, WeWork is already one of the world's largest lessees, trailing only oil exploration giants Petrobras and Sinpec, an astonishing feat for the flexible office space provider "which was founded less than a decade ago, bleeds cash, and doesn't plan to become profitable any time soon."

The ramifications of a WeWork complete implosion could be devastating for tech powerhouse Softbank, and specifically their Vision Fund, which is a majority investor (at lofty levels) in WeWork and also has significant stakes in Uber, Diddi, and Slack.

A total collapse in this fund would lead to significant levels of forced selling and a complete re-set on current valuations. The ramifications will be felt throughout the world and especially here in Silicon Valley land.

The third item to discuss is the unusual activity we saw this month that was in the repurchase market or Repos. Repos are essentially the daily cash available to banks and financial institutions; it is the vehicle they all use for daily funding operations. There has not been a need for the Fed to intervene in this market for nearly ten years, which made this news even more unusual.

Think of Repos as the plumbing that keeps the system moving sinuously. Obviously, no one wants to see the plumbing clog up (in any scenario) and especially when it involves funding for institutions. So this is just another thorn in the Fed's side as they deal with trade war shocks, negative yielding bonds, a critical President, all with less and less ammunition to fight.

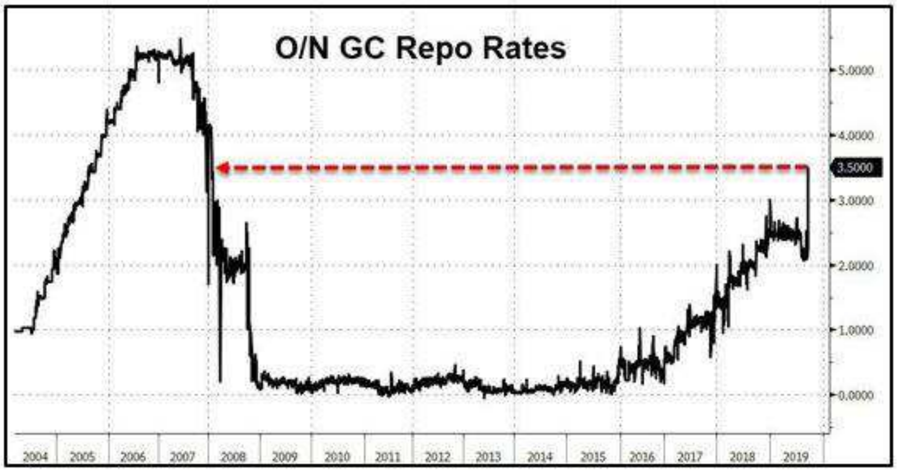
In fact, the mini-Repo crisis we witnessed actually pushed the Fed Funds rate above the targeted 2.0-2.25 range the Fed has been trying to preserve. The rate hit 2.3% on September 18; ironically just hours before the FOMC met and decided to slice rates another 0.25%. Confusing? Yes, yes it is. But these are the times we live in.

It looks like September 18th turned out to be the peak in liquidity concerns however. After hitting 2.30%, the daily rates slowly succumbed to the Fed's actions and retreated back to the 1.90%-2.10%. So it appears for now at least, that the "crisis" is over.

Some of the reasons being cited for this unusual move are quarterly tax bills, and an increase in treasury supply to help fund our ever-growing deficit. Keep in mind the Repo market currently stands at a shade over two trillion dollars.

But before we equate with these events as an automatic negative, let's look at what the ramifications would be if this liquidity spigot continues to dry up. The most obvious is an attempt to increase liquidity from the Fed as they try and stave off a potential bigger crisis. This leads to an expansion of their balance sheet which is akin to quantitative easing (but not the same), something that has been very accommodating to assets over the past ten years.

It's a perverse way to look at the situation for sure, and there is no guarantee that any of this will take place. It may just have been an odd week for funding with a confluence of factors that hit simultaneously. But in the end, it's just something else to add to the list of concerning items.



The chart above is a bit opaque, but it clearly demonstrates that we haven't seen Repo rates this high since the 2008 crisis.

That does not mean we are going back to crisis time at all – but it is another metric to keep on the growing radar of items to monitor as we close out 2019.

On September 18th, the Fed cut rates for the second time in 2019, and for only the second time since 2009. They lowered the Fed Funds target by 0.25% to 1.75%-2.0%.

They decided to go ahead with a cut despite the SP-500 within 1% of an all-time high, GDP humming along at a steady 1.8% clip, unemployment hovering at 50-year lows, Wal-Mart and Target stocks hitting all-time highs just weeks ago, three days after one of the biggest oil shocks we have seen, and finally, on the heels of a 8-point straight drop in the long-end of the curve after hitting year highs in late August along with a temporary short-term funding crisis in the repo markets.

Someday in the future, if anyone was to read that above paragraph he or she would surely believe it was either made-up or transcribed by a science fiction writer. But this is the world we must tread in and navigate, despite the occasional bouts of absurdity.

Chairman Powell justified the cut at a news conference after the meeting that the United States economy remained strong and unemployment low, but that "there are risks to this positive outlook." *If the economy weakens, he said, a "more extensive sequence" of rate cuts could be appropriate."*

"Our eyes are open, we're watching the situation," Mr. Powell said, explaining that the Fed would stop cutting rates to sustain the expansion only "*when we think we've done enough."*

Loosely translated (by us): *"We cut rates due to political pressures and continued insanity from the ECB and BOJ. It doesn't make much sense really, but we will likely cut again at the October 30th meeting, especially if any key data begins to weaken. Also, we are tired of the President brow-beating us no matter what we do."*

We fully expect the Fed to kowtow to all political pressures that will continue to be heaved on them (mostly unfairly) and we have now fully conceded that they have done a complete 180 in policy from one year ago (hawk to dove). Also, as insanely negligent as it is, and as much damage as it will wreak "someday", the Fed is ready to expand its balance sheet at even a hint of softness in the economy.

But the multi-trillion dollar question we must now ask is: Will the dovish tone endorsed by the three biggest central banks in the world be enough to keep market participants happy and comfortable in equities and other assets? The answer, as always, is we will see. But, considering that the US markets have done very little since the July cut, and the fact that these cuts are highly telegraphed, we are starting to have our doubts.

We found this quote from one of our favorite weekly macro reads and though we would share it:

"One wonders how we have put ourselves in the hands of these outright incompetent economists and central bankers with all their Ph.Ds and wealth of experience who keep reiterating "we don't see anything yet" only to change their tune one month later, confused as to what to do. Perhaps central banks should be run by portfolio managers or macro specialists -- at least people who have a grasp of what is happening underneath the surface rather than call it after the fact." – Maleeha Bengali, CEO MB Commodities

Looking Forward and other Market Commentary: October figures to be the busiest month for the remainder of 2019. Not only do we have the resumption of earnings season beginning around the middle of the month when the big banks begin to report, we also have three more important central bank meetings from the ECB, Fed, and BOJ, respectively.

As much as we are tired of droning on about central bank policies, they unfortunately have never been more important (just ask our President). So we have the ECB meeting on October 24th, the Fed on the 30th, and the BOJ on the 31st.

Currently, there is approximately a 45% chance of yet another rate cut from the Fed on the 30th. In theory, that decision will be data dependent, but it seems pretty obvious that the trend is lower for rates and the Fed. Maybe they will surprise the market and hold steady, but we have our doubts.

What we don't doubt is another round of dovish commentary from the ECB. It will be Mario Draghi's last time at the microphone and we are sure he will go out as irresponsibly and unhelpfully as he was coming in. Apparently, he will let the new chief Christine Laggard deal with the mess that he and his governors have created – which is awfully gentleman-like of him.

On October 11-12, there are low-level meetings scheduled to take place between trade representatives from China and the US in Washington DC. We won't go much deeper into the never-ending trade talk news except to reiterate that we don't expect any deal anytime soon; and that is becoming more and more the general consensus for most market participants. Our views were solidified on September 24th, when President Trump spoke at the UN and essentially mocked the Chinese for being charlatans for all these years.

Turning away from the macro side and focusing on more micro, mid-October will usher in the final earnings season of the year. Once again, the focus will be on guidance and margins. And after all the trepidation we have had to obsess over concerning global macro data, inverted yield curves, and accommodating monetary policy, it will be refreshing to actually focus on some good old-fashioned profits and gross margins.

The banks will kick things off around mid-month. They have been on a nice run as of late, gaining 5.1% since September 3rd, even with the contraction in yields. Therefore, it will be interesting to see just how this wild summer of bond moves has affected their bottom line.

One name we are very curious to see how they fared is Netflix. We have been commenting on how Netflix, despite its popularity, has some real troubling balance sheet and competition hitches. This month they decided to pay in the neighborhood of $500 million dollars for the rights to all the *Seinfeld* shows. Seems a bit excessive for a show that ended 20 years ago and has been on cable ever since – but Netflix has never been one to shy away from spending money and is also why their balance sheet is far from pristine. It's also likely a reaction to the intense competition on the way from Disney, Apple, and others; something that has been talked about for a while now but is finally here. Disney launches their streaming service on November 12th and Apple's on November 1st.

Here is what Pivotal Research Group had to say when they downgraded the stock on September 24th:

Big Internet players appear to be ramping their spend significantly on advertising as highlighted by Sunday nights Emmy as they seem to believe we are entering the inflection point where OTT growth accelerates materially (mostly at the expense of traditional PayTV), against this backdrop of accelerating industry spend we believe the right move for Netflix management is to also materially accelerate their spend (potentially temporarily pressuring margins/free cash flow) to keep its sizeable content lead on its peers, increase the barriers to entry for new potential entrants, reduce churn and maintain subscriber growth.

We have had some nice success this month shorting Netflix off and on. Obviously, we just wish we had stayed short and not tinkered with the position, but that is just another perfect example of the intense currents we are seeing underneath the seemingly placid surface of all these markets.

The second-half of October will be very earnings heavy and we look anxious to hear from the usual suspects such as: Twitter, Snap, Apple, AMD, Trade Desk, Facebook, Amazon, Tesla, and Google, and some other assorted names that we keep our eyes on daily.

In general, according to FactSet, the U.S. is already in an earnings recession, having posted slightly negative earnings growth for the S&P 500 for both Q1 and Q2. Earnings growth for Q3 is now estimated at -3.8%, which would be a more significant contraction than the pedestrian declines realized over the first half of the year.

We would like to think FactSet is a little more pessimistic on the general earnings theme than we are. Especially, when in September we saw some blow-out numbers from Nike, Cintas (uniform suppliers), Synnex Corp., Steelcase, Herman Miller (office furniture), and Restoration Hardware (home furniture). It's a rather small sample size for sure, but we believe it does point to a healthy US consumer and strong trends in the workplace.

This month was a tough one for our Bitcoin trust position, as we briefly mentioned above; the even more troubling aspect, at least in our minds, there was some pretty good news in the space. Namely, on September 22nd, the NYSE launched its long-delayed market for Bitcoin futures.

The new futures contracts are part of a venture called Bakkt (pronounced "backed"), their stated goal is to make cryptocurrencies transparent and regulated for retail purchases. This is the first contract that is physically backed by Bitcoin itself and ensures physical delivery as you would see in the cattle, metals, and grain markets. In effect, it legitimizes Bitcoin as an actual commodity-like market and in theory should ease some of the concerns of fraudulent markets and opaque trading.

Investors in the Bakkt venture include Microsoft, Starbucks, NYSE, and the Boston Consulting Group.

However, this launch did not help the price of Bitcoin as it has dropped 12% since that launch date. But we need to keep in mind that Bitcoin has doubled this year and is the best performing asset (percentage wise) on the planet in 2019.

Also, cryptocurrencies and block chain technology are an undertaking to digitize almost every facet of our lives in the future. Movements like that take years to materialize and there surely will be some extreme peaks and valleys along the way. But in the long run this is an area that you want to make part of any portfolio.

Finally,

Senator Warren, who is now slightly ahead of Joe Biden in most polls for the Democratic nomination, has proposed a 15% payroll tax for all those earning over 250K per year if elected. She also said she will halt all fracking in the USA the day she is elected via an executive order.

On my first day as president, I will sign an executive order that puts a total moratorium on all new fossil fuel leases for drilling offshore and on public lands. And I will ban fracking—everywhere. –Senator Warren, 9/6/2019 via Twitter

There is little doubt, based on her rhetoric, that she will attack (i.e. tax) Wall Street via transaction taxes and capital gain taxes in effort to "punish" the rich and distribute to the lesser-off, especially those burdened by student loans, even though they chose to take on that debt.

This modern-day Robin Hood may have best intentions in mind, but her proposed polices would result in an economic calamity – and not just for the rich.

Wall Street is often vilified, and often they it's well-deserved. No one comes to Wall Street to help the poor, save the planet, or teach kids to read. But Wall Street does, for better or worse, manage and oversee funds used for retirement plans for teachers, firefighters, auto workers, and a plethora more of folks that rely on their pensions to eventually hang up their uniforms and begin the good life.

A transaction tax imposed on every trade will not only increase costs for all (any guess to who is going to be paying those extra fees in the end? Hint: you) but more importantly it will constrict liquidity. That in turn, will hurt price discovery and very well may hinder overall returns for those funds so many are relying on.

Senator Warren may have good intentions in mind, but her plan is tremendously flawed and incredibly dangerous for the everyday Joe she is so adamant about helping. Her attack on Wall Street will hurt Main Street, by a lot more than she apparently understands.

And as for halting all fracking and drilling on day one? We don't need to explain how much that would "help" the average worker do we?

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