# Aviator Update – September 2023
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AVIATOR CAPITAL

## What's Working?

Early morning on the 3rd of October I did my brief scan of overnight market action. With a modest degree of amazement, I saw the following summary of U.S. markets:

| | | |
|---|---|---|
| **$DJA** DOW COMPOSITE | 11002.85 | -117.30 **-1.05%** |
| **$TRAN** DOW TRANSPORTS | 14773.42 | -195.35 **-1.31%** |
| **$UTIL** DOW UTILITIES | 783.78 | -32.77 **-4.01%** |
| **$NDX** NASDAQ 100 | 14789.42 | +74.17 **+0.50%** |
| **$OEX** S&P 100 | 2013.26 | +3.53 **+0.18%** |
| **$MID** S&P 400 MID CAPS | 2464.12 | -38.00 **-1.52%** |
| **$SML** S&P 600 SMALL CAPS | 1132.53 | -18.73 **-1.63%** |
| **$VLE** VALUE LINE | 8819.13 | -131.65 **-1.47%** |
| **$FTW5000** WILSHIRE 5000 | 43070.54 | -178.76 **-0.41%** |

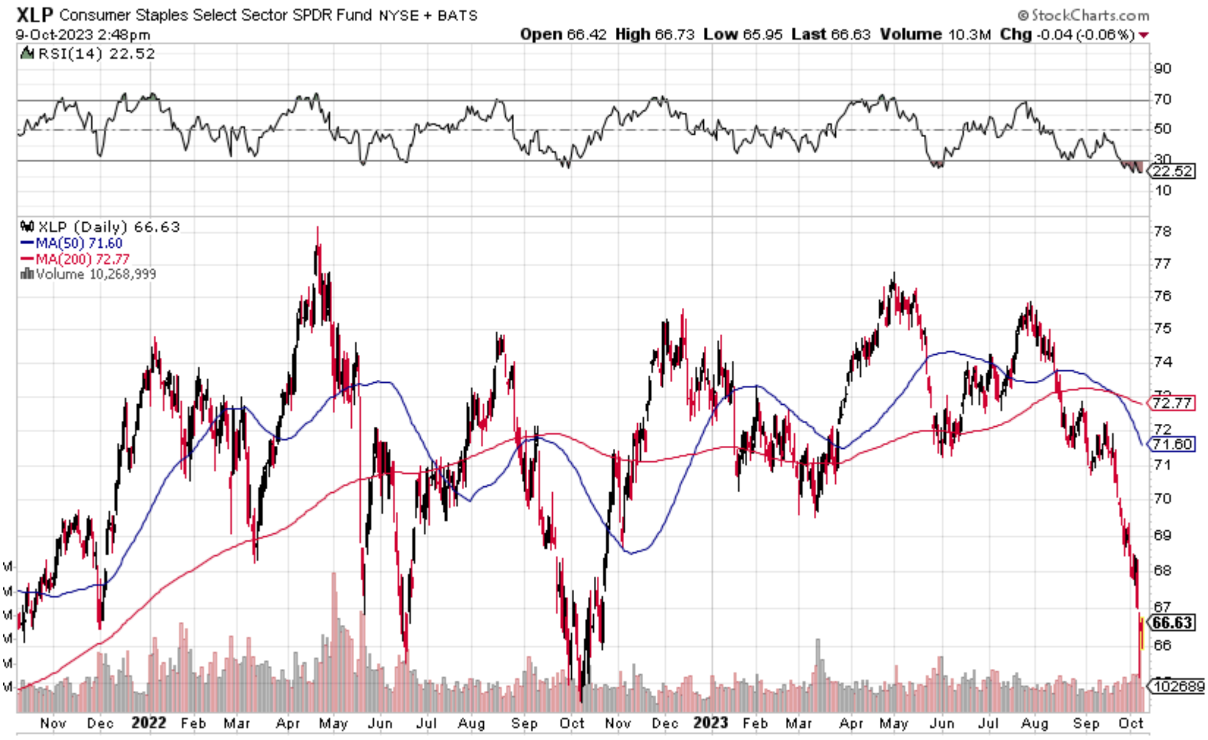
The Dow down over 1%. Transports down 1.3%. Utilities – yuck.

The Nasdaq 100… up half a percent…

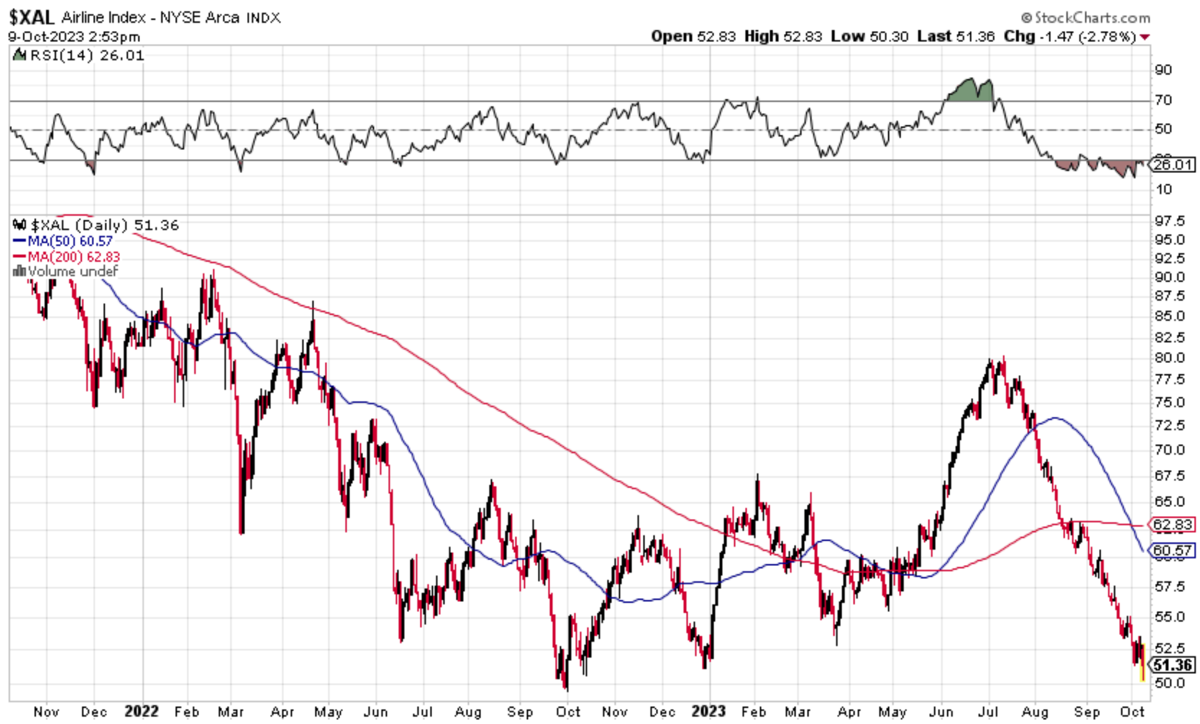
What's "working" lately? Big tech. What's not working? Pretty much everything else.

Let's have a look over some charts of the U.S. markets – all of these are daily bars over2-years:

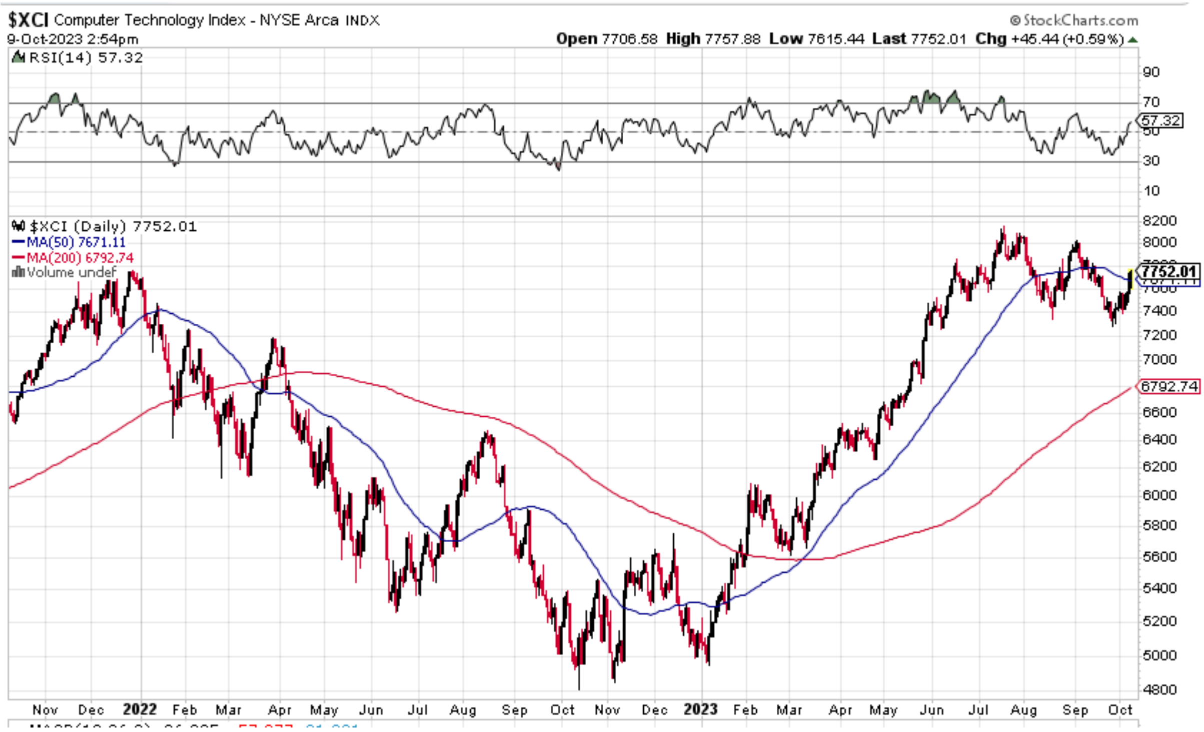
**Consumer staples** – selling those shares seems to have been a staple for investors over the last few months:



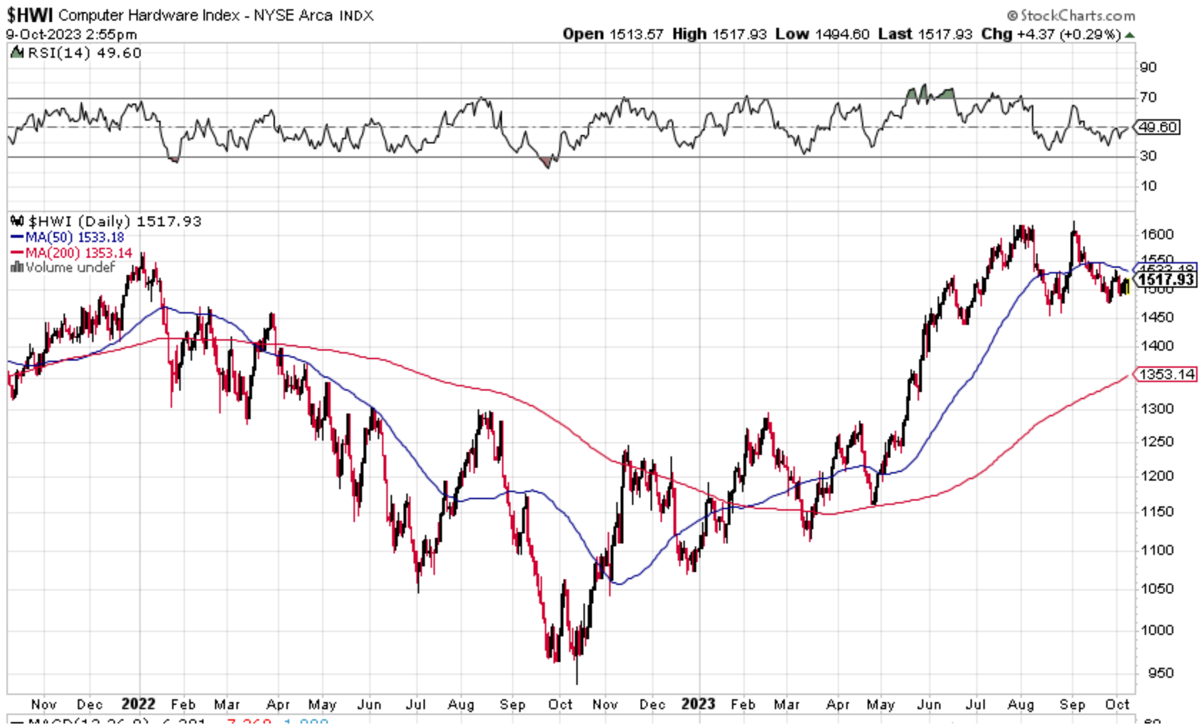

**Airlines** – one-way ticket to losses:



**Computer-related** stuff.  Now we're talking!  Little progress over the past 2 years, but this year has been kind:

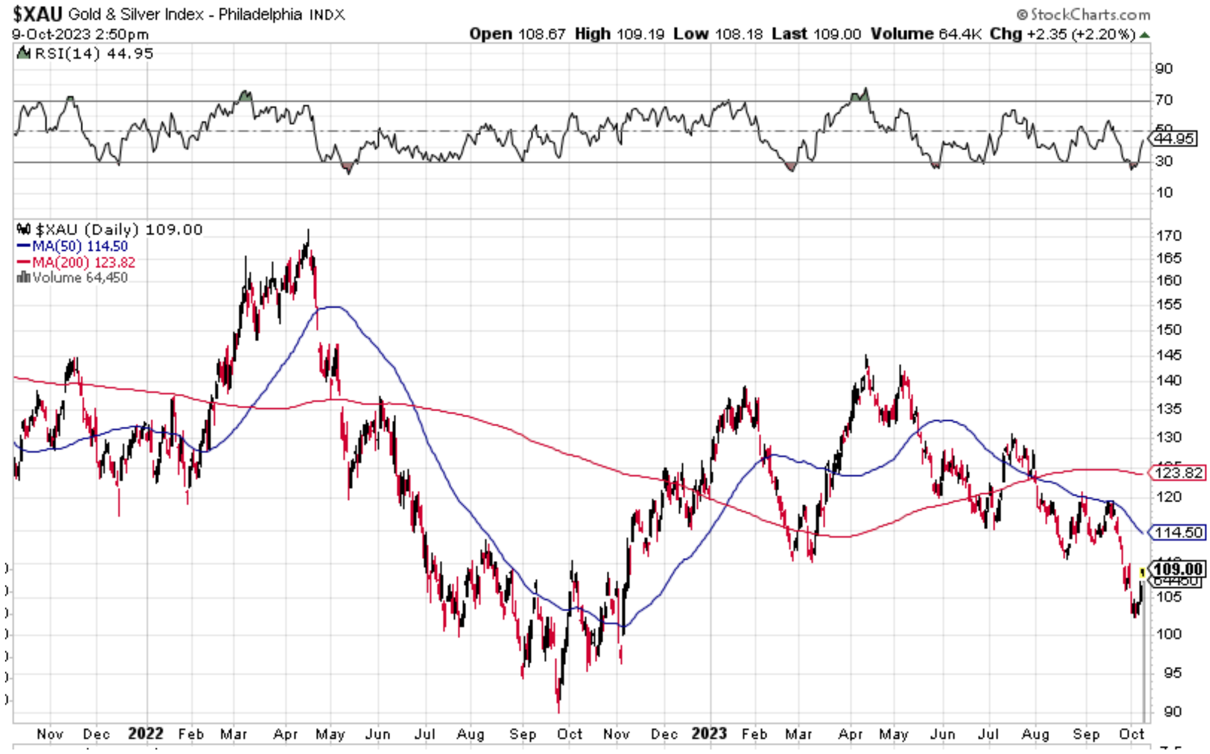



**Computer hardware** a similar picture:

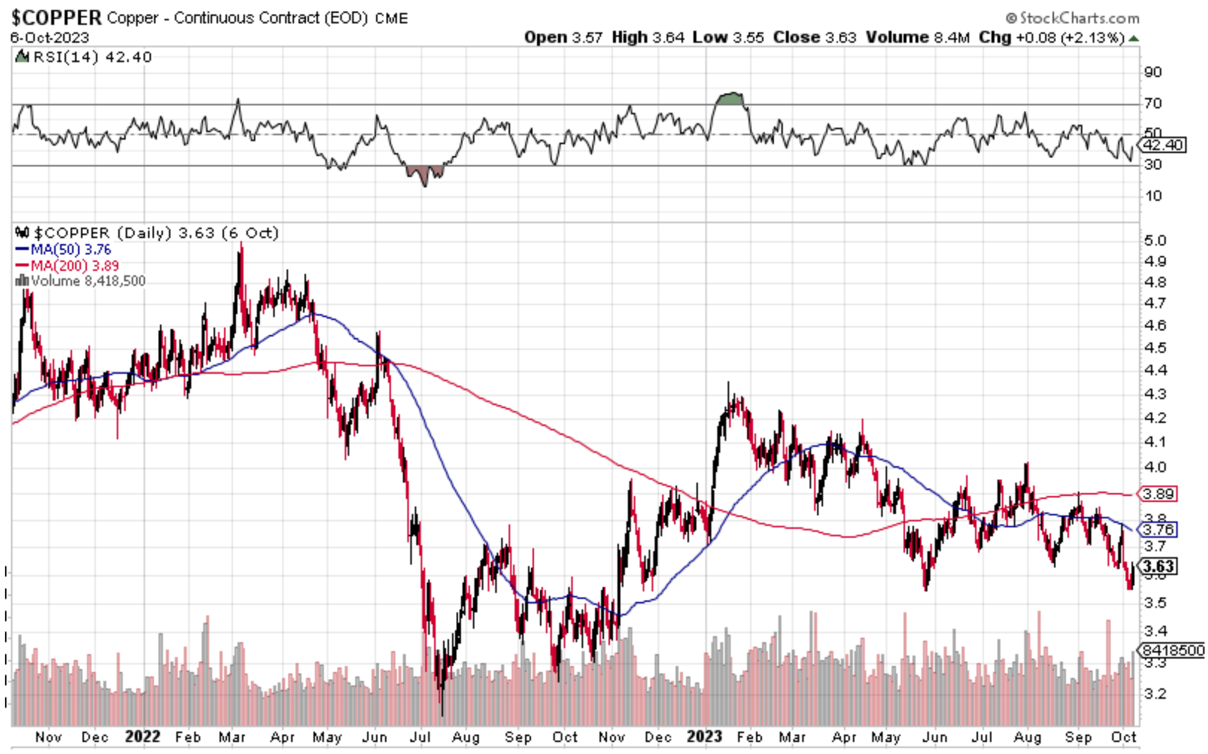


How about some other things…

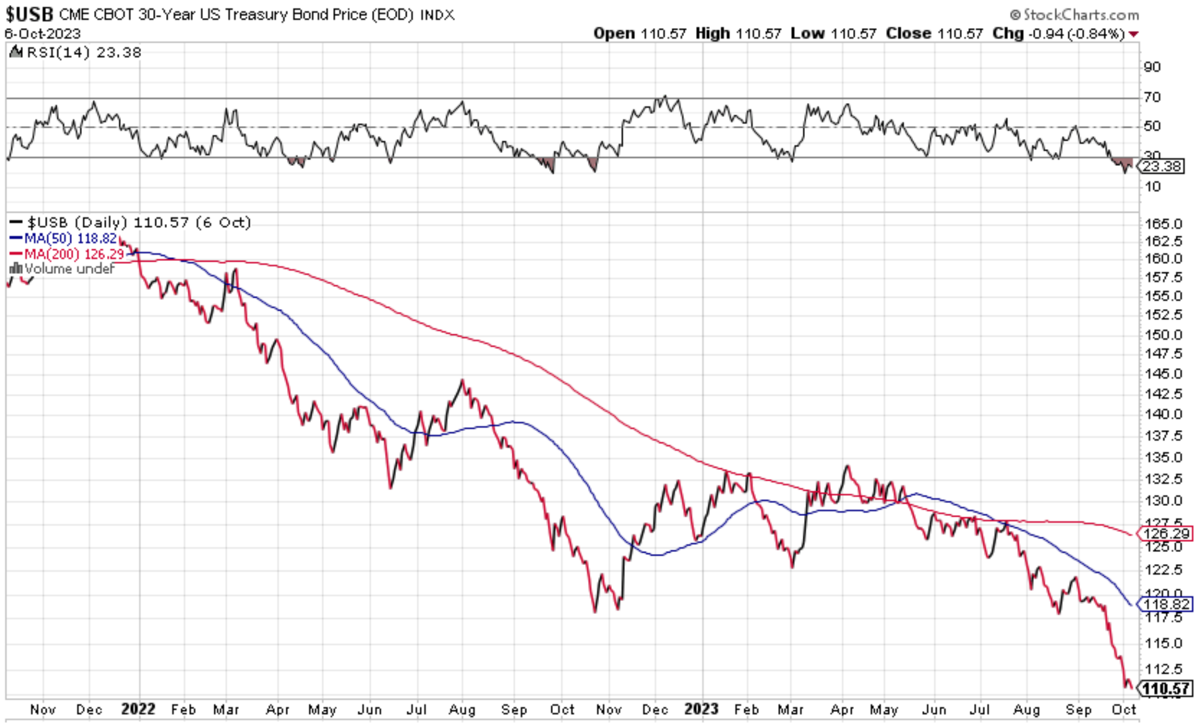
## Gold and silver:



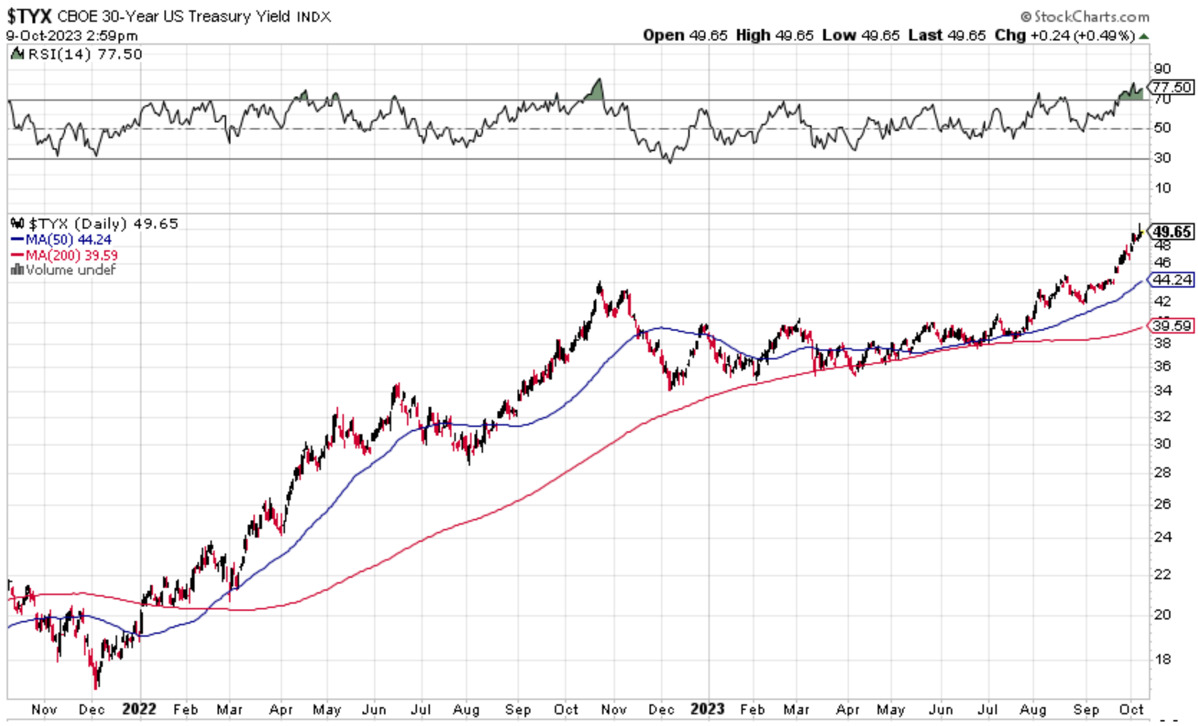

## Copper:



And now for the big one.  Here's 2 years' worth of price-action on the **U.S. 30-year bond**:




And the inverse being the 30-year yield:




If you've followed my missives for a while, you'll know that I'm a huge advocate for understanding how the financial system and capital markets work.  Part of that means understanding how "money is run".  About understanding how "narratives" exert significant influence over humans and, by extension, the markets.

Here at Aviator, when it comes to managing our capital markets portfolios, we're unashamedly part-timers. I believe that's actually how it should be for more market participants. I truly believe that many professional money managers would perform better by thinking (and doing) less.

We're active managers, not active traders. We place trades principally based on "bigger-picture" macro views. Opportunities in that space don't normally come along every day or week. There's no need for us to seek out trading opportunities every day.

**"When the music stops in terms of liquidity things will be complicated. But as long as the music is playing, you've got to get up and dance…"**

This infamous quote was made by Chuck Prince, the CEO of Citigroup, during a brief interview with the Financial Times just before the Global Financial Crisis. It was made in relation to financing leveraged buyouts, but it's come to epitomise the attitude to risk on Wall Street that ultimately led to the GFC.

But even more broadly, it basically epitomises the attitude of investment professionals in general.

You see, if you're a hedge fund trader, or investment manager, or a stockbroker, or an investment bank trader or salesperson… or even many-a private investor… it's your job to "do stuff". All day, every day…

You can't really call up the boss in the morning and say "hey boss my portfolios are all in order…I'm comfortable with my stance and positioning… I'm just going to go play golf today…"

No – you get yourself to work. You "do stuff". That's your job.

This requirement has many participants focusing on "what's working".

**"AI" – real or hype?**

As you probably understand, artificial intelligence has been a key narrative for much of this year. Stocks associated with AI have therefore been the focus for all those investors required to "do stuff" every day.

Nvidia has been one key beneficiary. Any adviser or manager that deals in direct shares wants to be able to say "yeah, yeah… we have NVDA in our model portfolios!"

Legendary investor Stanley Druckenmiller has commented in the media in recent months how he has large positions in AI stocks. Simultaneously, he's expressed that he feels they are very over-valued.

He's clearly been channelling the mantra of another famous investor, George Soros. George has been quoted as saying; "when I see a bubble I run towards it".

Hey, if it's your job to "do stuff" every day, then that's what you do – chase what's working.

There's surely a lot of investors that are planning to sell when the music stops. Don't worry about Stan – he'll be fine – his decades of success can be partly attributed to knowing he needs to sell during the encore. Just worry about yourself…

**Change in the air?**

With all of that as somewhat of an introduction, I want to talk about some things I've read over the past month that have really captivated my attention. A number of smart investors that I have quite some respect for are convinced things are set for a change. In their view, "what's working" is set for a fairly profound change. Not necessarily this week or next, but on a larger macro viewpoint – the same general viewpoint we take when looking at the financial world.

Their level of conviction is the most striking aspect.

Whilst I've had my thinking stimulated by at least 4 authors during the past month, I want to focus on Crescat Capital's mid-September missive titled "A clarion call to macro and value investors".

The opening paragraph provides a succinct summary of their views:

*"The set-up is the most exciting macro and value combination play on both the long and short sides of the markets that I have seen in my career. It is what I have been calling the Great Rotation.*

*Two factors are conspiring to set this major investor shift into motion:*

1. *A capitulation selloff in deeply undervalued, high-quality precious metals exploration stocks ahead of a likely new secular breakout and run in gold that presents a generational buying opportunity.*

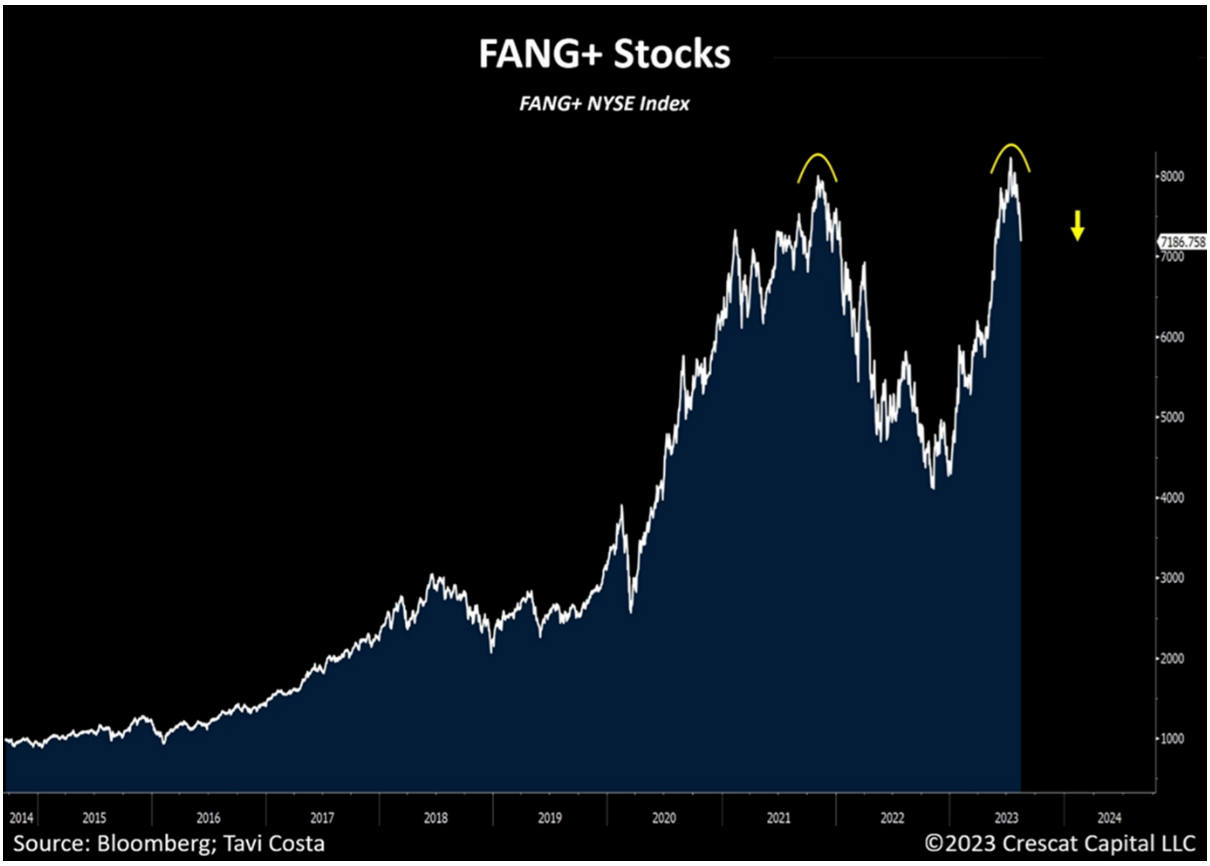
2. *A highly speculative double-top fizzling out of hyper-overvalued mega-cap tech stocks that presents a timely selling and/or shorting opportunity ahead of a likely stagflationary profit squeeze and recession."*

Whilst I am intrigued by point-1, their views on point-2 are of greater interest and overlap with our own thesis.

They continue:

***"Megacap Tech Headed for Wreck***

*"The short opportunity in overvalued megacap tech stocks and other short themes that we are expressing in our Global Macro and Long/Short Funds is equally compelling. The double-top formation in the NYSE FANG+ index is a bearish technical sign. The historically tight risk premia (low earnings yield relative to Treasuries) for this group of former winners combined with the Fed tightening is the bigger fundamental and macro setup. The trailing aggregate P/E for these ten megacap companies is a historically high 45 times. In this case, analysts' highly questionable year-ahead earnings growth projections fuelled by "AI" euphoria are contributing to ludicrous mispricing.*




*"Our research shows these companies' forward 12-month combined earnings are doomed to disappoint while their stock prices should become the subject of a violent repricing. For the roadmap, refer to the performance of large-cap tech stocks during the 2001 recession in the wake of the Internet bubble.*

***"Stagflationary Hard Landing Looms***

*"In my strong view, based on my firm's deep macro analysis, the popular notion that the economy is headed for a disinflationary soft landing will be proven completely wrong on both*

*counts over the next year. In other words, we have the macro setup for both the re-emergence of rising inflation and a downturn in inflation-adjusted GDP directly ahead of us.*

*"Supply-shock vengeance from critical commodities, such as energy, food, and shelter, and the metals at the core of all of these, should trigger the next inflation wave. In turn, inflation will drive the hard landing for both the real economy and overvalued financial assets. Furthermore, we believe the true cost-of-living increase for basic needs is already hitting hard across the broad middle and lower-income classes. It is setting off increased labor strife that will only feed an ongoing wage-price spiral that in our view could be the bane of policymaker existence for years to come.*

*"For now, because of the likely incorrect macro narrative being spun by Wall Street cheerleaders and the financial media, and the correspondingly lopsided market positioning, there are incredible value-oriented, contrarian investment opportunities that abound on both the long and short side of the market."*

Interesting… Again, their level of conviction is what captured my attention the most.

Our own macro thesis has been fairly consistent now for several years. It goes something like this:

Over the past 100 years or so, the markets have been within "normal times" probably 85 or 90% of the time.

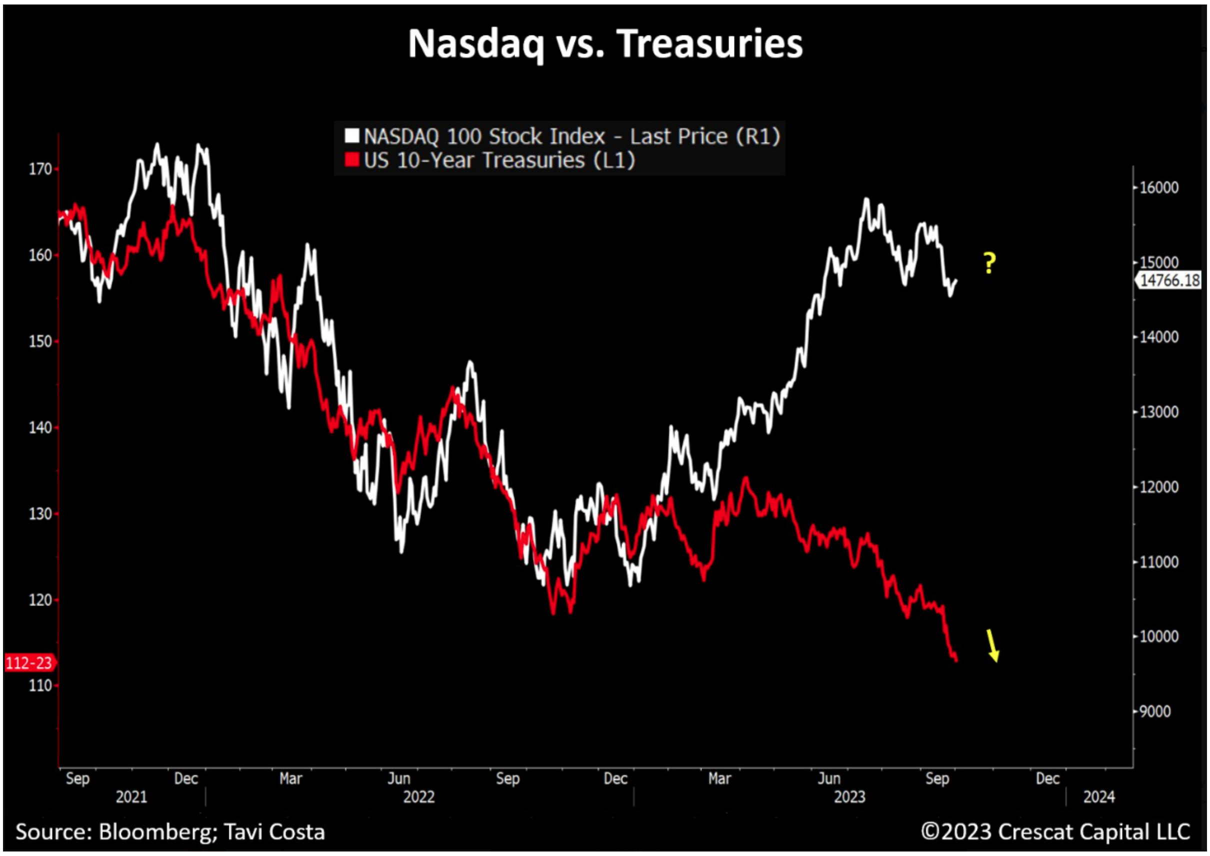
The rest of the time, well, the markets have deviated significantly away from anything resembling "normal" when viewed from a trend valuation perspective.

Our thesis is that several years ago, U.S. equities markets entered an "abnormal period" of extremely extended valuations. In fact, reliable valuation models show that the highs reached in 2021 have never been seen before – it was the most over-valued in the last 100 years.

This doesn't mean imminent collapse. It means "high risk" and an extremely high probability that average returns over the coming 5 to 10-year period will be low.

As I've repeatedly said, *it's really hard for investors right now*.

We've witnessed a significant selloff in bonds since the post-covid bubble. Stocks on the other hand are doing just fine:




The key narrative "justifying" the above is that the Fed will soon cut interest rates meaningfully. Bonds will rally and the jaws on the chart above will therefore close without shares going down. Hence the "bring on the recession!" narrative – allowing the Fed to cut rates.

Aside from the reality that recessions are always bad for stocks, the thesis of Crescat (and many others) is that, whilst recession is likely coming, it won't bring the welcome relief to inflation that most expect. The Fed will need to hold rates higher for longer.

The markets are never "right" or "wrong". They are what they are. But a significant disconnect has emerged in the markets – between stocks and bonds. It will resolve – in some way, at some time… It's going to be fascinating to watch…

It should be no surprise to anyone to see a 20% "correction" in share markets – perhaps over a very short timeframe. Not a prediction, just a simple observation.

In the meantime, long-bond yields are now higher than when banks were blowing up earlier in the year. Not just in the U.S. but Europe also. Someone big is surely insolvent. Will some form of relief come before they need to admit it?

To paraphrase what Stan Druckenmiller recently said "there's never been a time when we had free money for 14 years and then the Fed raised rates 500 basis points in 6 months… there's no historical precedent to drawn from".

The European Central Bank continues to hike rates into what surely looks like a recession. We're going to see whether China can defy "economic gravity". Major disconnects in major markets.

Truly interesting times…