Aviator Update – April 2021
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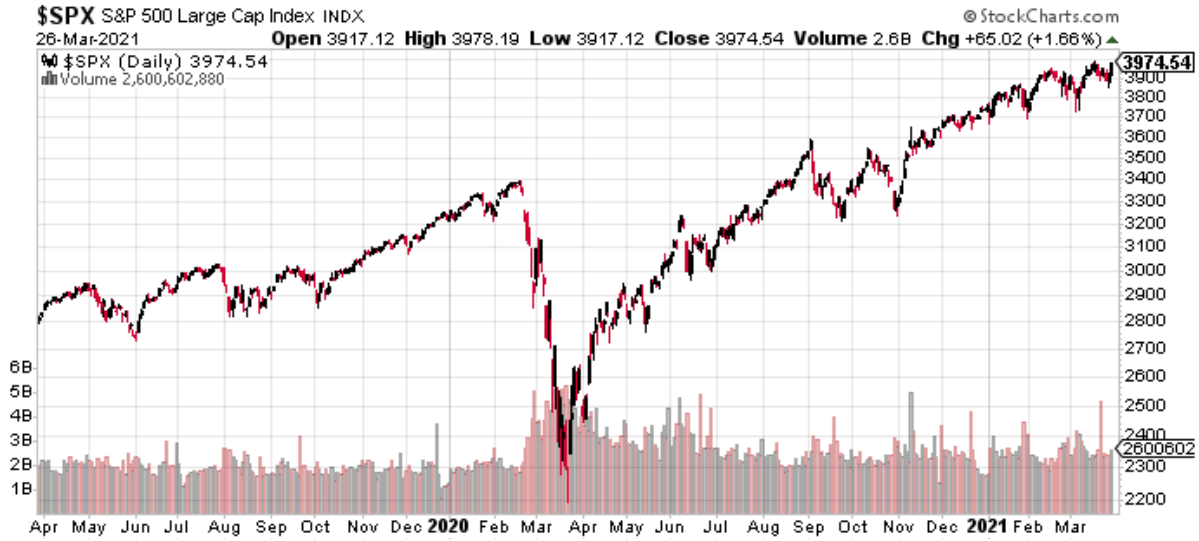
Keepsakes, Regrets and Predictions

I've often noted that one of the reasons I write about financial markets is because the process requires me to collect my thoughts – to really think about things. There's another aspect – it allows me to look back and reflect on things. What was I thinking? What unfolded afterwards? There's surely been a few things I'd rather wish I hadn't written. There's been plenty that I'm proud to have my name on. Sometimes right. Sometimes wrong. Always honest.

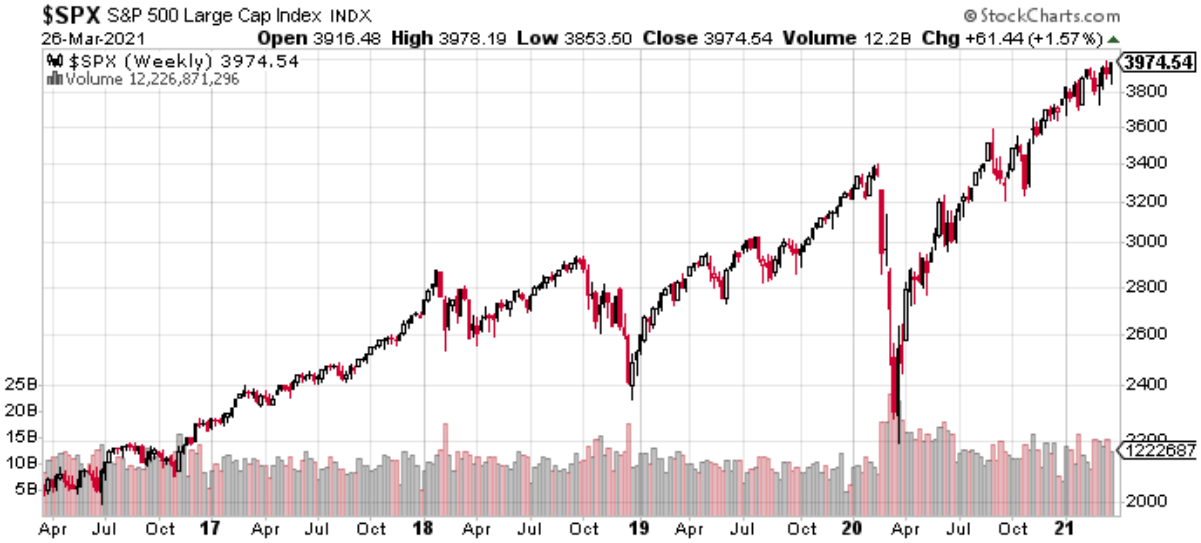
Today, this note really is for me. I want to assemble a collection of anecdotes from this point in market history. Something that we can look back and reflect on in the years ahead. I'll refrain from commenting too much on any specific anecdote and then end by capturing some of my candid thoughts and opinions from this point in time – again, something to reflect on in the years to come (and possibly regret).

What's happening in finance-land here in the early months of the year 2021?

Let's begin with a snapshot of equity markets. Here's 2 years worth of daily action for the US S&P500:

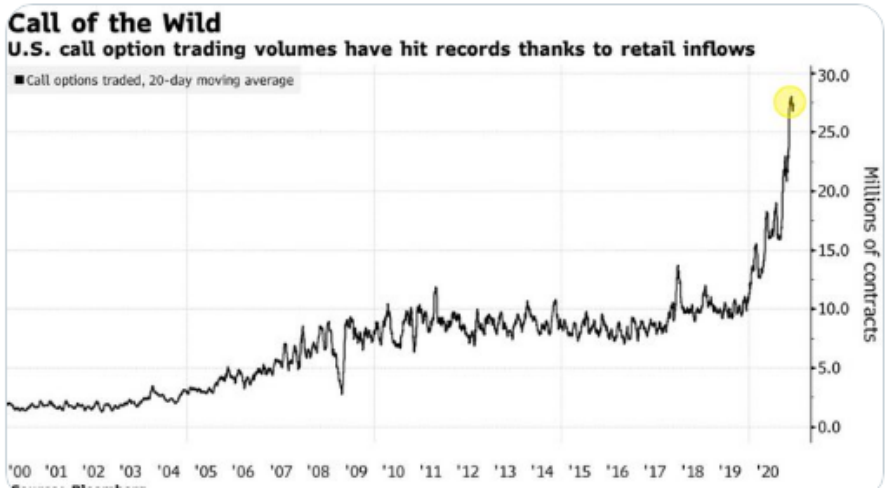


5 years worth of weekly action is equally impressive:

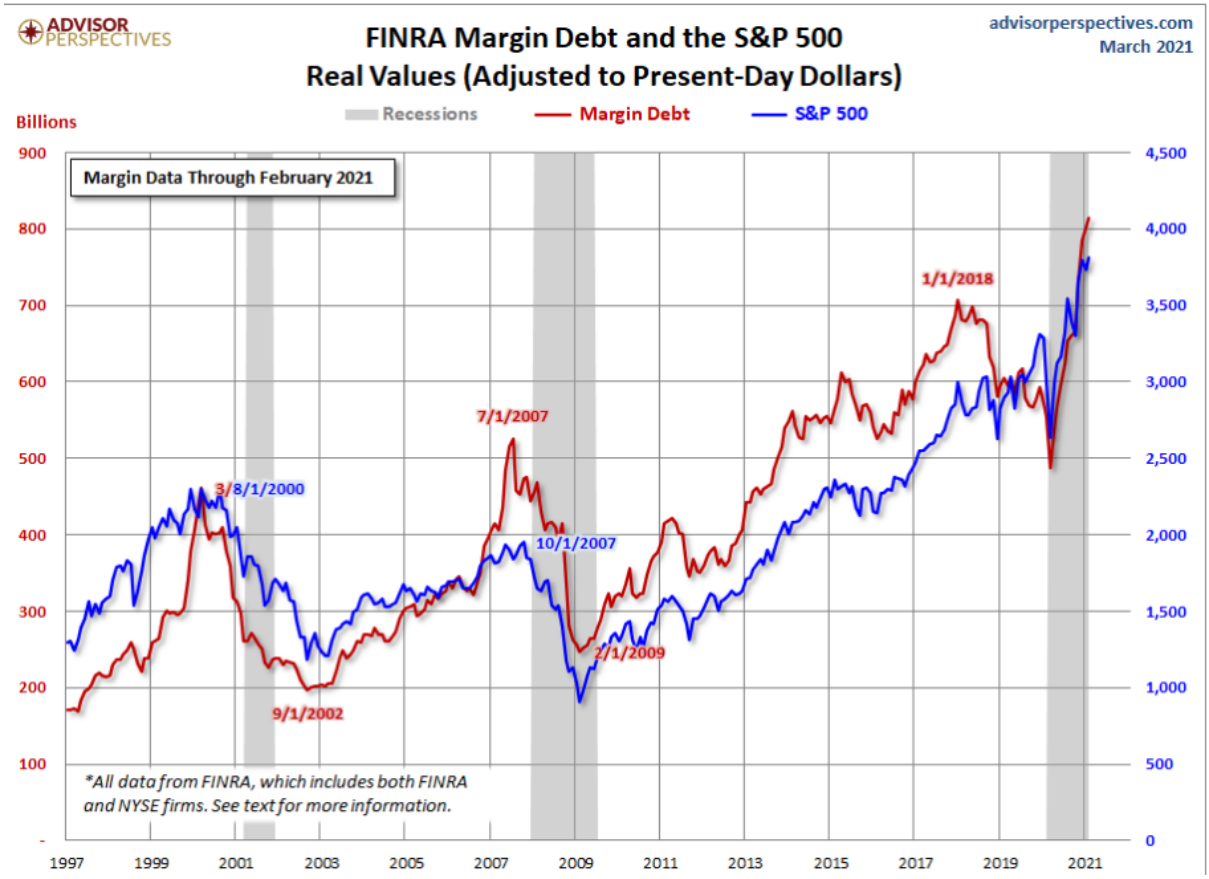


"Quality" doesn't necessarily seem to be on many investors' minds:

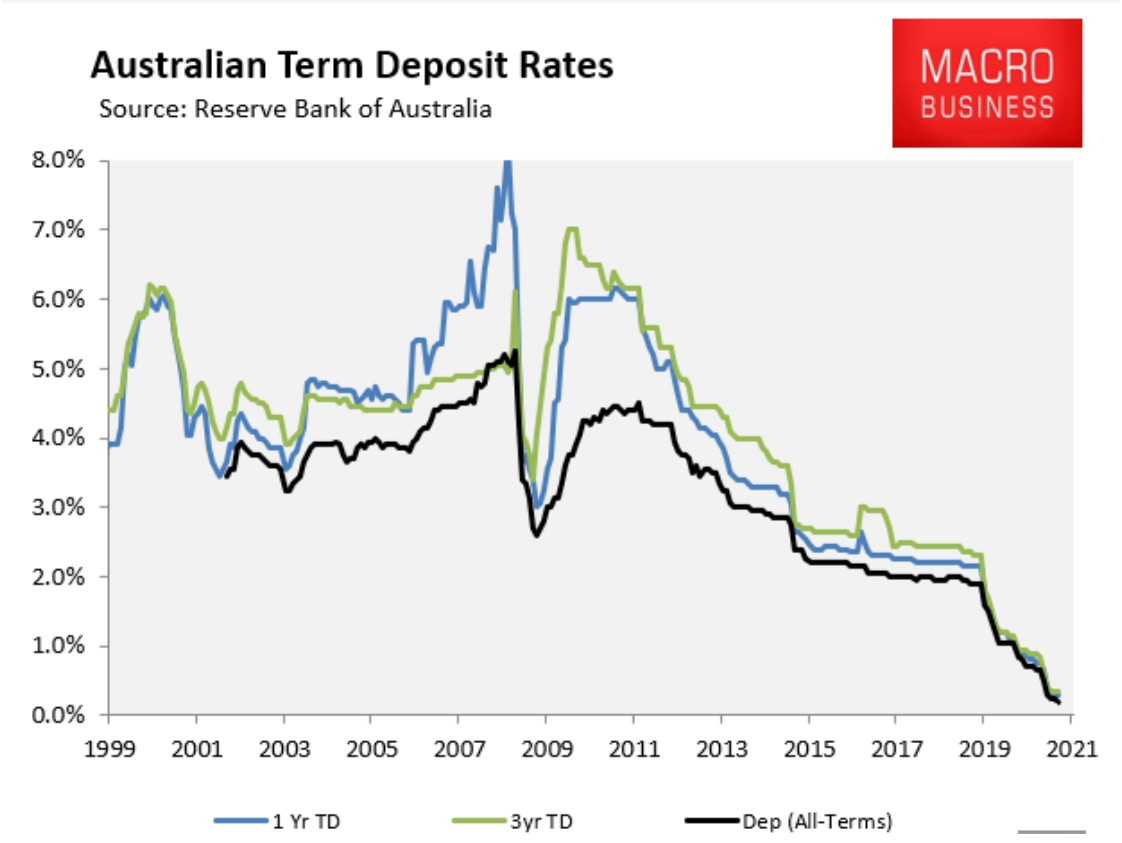
And what better way to take advantage of the rising market than with leveraged derivatives:



As well as using borrowed money:

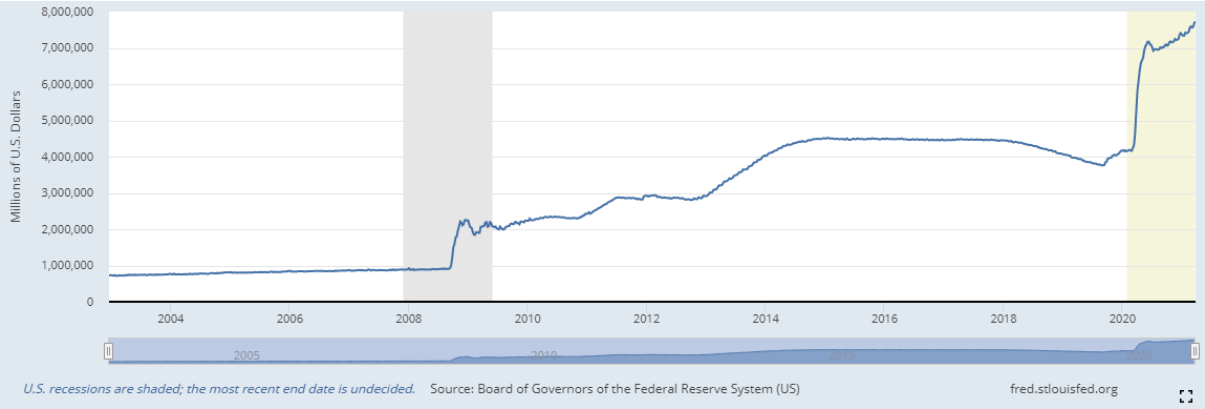


There's no alternative, right?

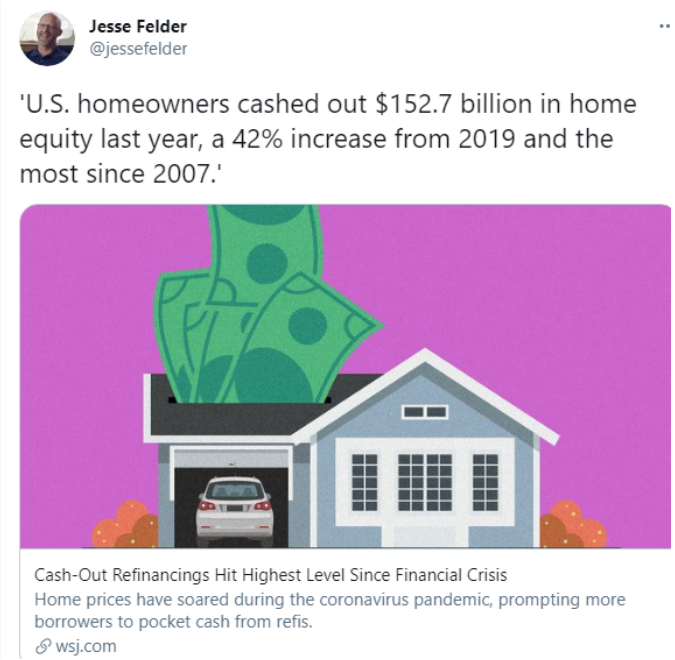


And the fuel is this:

US Federal Reserve Balance Sheet:



With asset prices rising and interest rates falling, why not take advantage:



Speculating on equity markets isn't enough for many of today's investors. Observers note in early March that the entire cryptocurrency market cap is in the order of US$1.65 Trillion, with around 60% being bitcoin.

Here's 12 months' worth of Bitcoin price data in USD:

Tesla bought US$1.5billion worth of bitcoin in early 2021, news of which helped push the price up. This prompted a strange SEC announcement by Tesla:

"Effective as of March 15, 2021, the titles of Elon Musk and Zach Kirkhorn have changed to Technoking of Tesla and Master of Coin, respectively. Elon and Zach will also maintain their respective positions as Chief Executive Officer and Chief Financial Officer."

Non-fungible tokens

These are a novel idea built around the same "blockchain" technology used by cryptocurrency.

When you buy a bitcoin, you buy a "fungible" token – although there is a limited supply, every bitcoin is the same as one another – they are "fungible".

Not "non-fungible tokens".

When you buy an NFT, you're buying a data file that, just like crypto, is recorded on this decentralised blockchain network. However, the NFT contains a unique digital signature that makes it unique – it's unlike any other file – its "non-fungible"!

An example might help explain things:

Likely with the assistance of some other tech nerds, Twitter CEO Jack Dorsey created an NFT from his very first tweet:

So, the NFT is a data file recorded on the Ethereum blockchain that contains exactly what's above. HOWEVER, the data file contains unique identifying data that signifies it is indeed this first tweet created by Jack.

Apparently, the way you're supposed to think about it is like artwork. Owning the above NFT is like owning an original Andy Warhol. Yes, there might be tonnes of copies floating around, but they are just that – copies of the original. You own the original! For NFT's, unfortunately you can't hang it on the wall but you can show it to your friends on your computer screen – they will be impressed.

That tweet of Jack's? He auctioned it off. It sold for over US$2M!

An NFT of Lebron James making a historic dunk for the LA Lakers sold for over US$200,000.

A blockchain company bought a piece of art from a New York gallery by the celebrated street artist, Banksy. They then live-streamed the burning of the screen print on twitter. Then they auctioned off the NFT created from the video…. selling it for US$380,000!

The artist, Beeple, auctioned off some digital NFT works. These included a digital collage piece. The sale price? US$69 million.

The top three NFT marketplaces - NBA Top Shot, OpenSea, and Beeple did a combined US$342 million in trading volume in February.

Turning back to equity markets, Exchange-Traded Funds (ETFs) continue to be very popular. And for good reason – they are a useful tool for getting inexpensive exposure to a market or sector. However, instead of "passive" ETF's designed to track a certain index, "active" ETF's are the most popular at the moment.

One new ETF to launch is "BUZZ". The Buzz ETF "uses AI to analyse investor sentiment across over 15 million online posts per month" and then "the BUZZ NextGen AI US Sentiment Leaders Index is optimised with the goal of maximising profits".

In other words, the BUZZ portfolio comprises of stocks people are talking about a lot on the internet.

The funds management company behind it has managed to enlist the support of Dave Portnoy – AKA “Davey Day Trader” – somebody that has become a major figure in the online investment community since Covid lockdowns. Davey is the champion of the amateur day trader.

Although clearly a fairly wealthy guy, he’s become hugely popular and influential from his expletive-laden videos ranting about how much money he’s making trading shares, how shares only go up and how the markets are rigged against the little guy by “the suits” (finance professionals).

It looks like Davey has sold out to “the suits”. I hope it works out well for him.

A separate funds management company has very recently lodged a filing with the U.S. markets regulator to create the “FOMO ETF”.

Named after what’s become the catchcry of the bull market – “Fear Of Missing Out” – the active ETF plans to invest in pretty much anything – developed-market shares, developing-market shares, SPACs, other ETF’s, derivatives, volatility products, leveraged and inverse funds.

Asset allocation is courtesy of a “proprietary tactical model”. Sounds compelling…

Finally on ETF’s, one of the current market darlings is Cathy Wood whose ARK ETF’s have produced spectacular results post-Covid crash. Their focus is on “disruptive innovation” – cool buzzwords in today’s markets and essentially represents companies that don’t make any money now but may one day make a lot of money.

One of her biggest holdings is Tesla – a company she very recently presented some analysis with a 4-year price target of between $1,500 and $3,000 per share! (Shares are currently around $650 and seen by many analysts as already grossly over-valued.)

Those targets will surely be music to Elon Musk’s ears – they will likely make him by far the richest person on earth instead of having to jostle with Amazon CEO Jeff Bezos for the title.

If you prefer, you can probably get some indirect exposure to the ARK funds via the BUZZ or FOMO ETF’s!

Speaking of Tesla, they are not the only market-listed electric vehicles company named after Nikola Tesla.

Nikola

Nikola Corporation is a business engaged in developing electric vehicles. Or at least they aspire to be a company that’s engaged in developing electric vehicles.

In the years up to its market debut, the young founder, Trevor Milton, and the company made numerous claims about its progress and achievements. They had achieved, according to them, “the holy grail” – a zero emission semi-trailer truck. It was powered by 6 electric motors with battery power fuelled by a generator running on compressed natural gas (hardly “zero-emission” but anyway). They even claimed to own a number of natural gas production wells. Then the story was tweaked – it would ultimately be powered by a hydrogen fuel cell instead of gas. They updated the world about the results of their extensive testing program – the damage to tyres they were experiencing… even a promotional video of it in action.

They listed via a SPAC in mid-2020 and with sales orders flooding in along with a partnership with General Motors, their market capitalisation eclipsed that of Ford.

The only thing is that it was basically all lies. All the rigorous testing? They didn’t even have a completed truck to test! The promotional video of it in action? Well, they did have the shell of a truck they had built… rolling down a sloping piece of road!

The lies were exposed and the founder was ousted. The partnership with GM was lost. The shares predictably plunged however here in March 2021, the market is still assigning a valuation for the company in the vicinity of US$6 billion. For a company built on lies and a long way off production of its first truck.

Aussie investors haven’t been shy about bidding some assets to levels that are totally unjustifiable. Here’s our market darling Afterpay – making its way from below $10 post-Covid selloff to over $160.

Analysts were expecting it to record its first ever profit for the first half of this financial year ended December… alas it recorded a net loss (again) of $76.5 million. Reflecting on analyst commentary and valuations from around 15 months ago, Morgan Stanley were considered “the bull” with high hopes for expansion into the US and other markets. Their valuation in late 2019 - $39.

Did somebody say SPAC?

"Special Purpose Acquisition Companies". These have become a popular "theme":

Exhibit 1: SPAC IPO volumes have continued to surge in early 2021
as of February 26, 2021

Year	Raised ($ billion)	No.
2013	$1	10
2014	2	10
2015	4	17
2016	3	11
2017	11	33
2018	9	35
2019	13	52
2020	77	228
YTD 2021	56	175

Source: Dealogic, Goldman Sachs Global Investment Research

A SPAC is a newly-listed company – an IPO. However, it's very different from your traditional IPO.

Under a normal IPO, a certain existing company is being publicly sold to investors – divvied up into shares which will then trade on the market. Take food delivery company DoorDash which listed in December 2020 – jumping 86% on the first day from its IPO offer price to a market capitalisation of US$72 billion… for a company which lost US$667 million in 2019 and had lost a further US$149 million during the first 9 months of 2020 leading up to the IPO.

When a company "goes public" via an IPO, the company, with the assistance of a bunch of Wall St bankers, puts itself up for sale. It's the task of the bankers to "sell it" – attract interest from investors – predominantly major institutional investors capable of buying a large parcel, rather than bothering with thousands of retail investors wanting $2,000. The final sale price is therefore a bit of an unknown during the process as it will be determined by "market forces" at a time when it is yet to actually trade on an open market.

In the DoorDash example, the massive pop on the initial trading day demonstrates the IPO price ended up too low. The company loses in this instance as it should have raised more capital from the same of the same number of shares. But initial investors are ecstatic – they are handed an immediate windfall gain and the opportunity to get out at a handsome profit if they wish. The bankers are pleased as they collected handsome fees on a successful deal and the magic of instant IPO riches makes selling their next IPO deal to

investors a bit easier. Given the original owners generally hold large parcels of the newly-listed company, they aren't too disappointed either.

A SPAC is an IPO, except there's no business being sold. The company is raising capital from investors for the purpose of then buying a business. So basically, investors are forking out money to invest in a business when they don't even know what that business is – it's a surprise!

SPAC investors are basically backing the people behind it – the "sponsors". The capital proceeds raised are placed in a trust account and the sponsors generally have 2 years to find a suitable acquisition target and complete a purchase. Retail investors have been pouring money into SPAC's and sponsors have discovered that a celebrity endorsement is a powerful way to help ensure a successful capital raising.

Basketballers Shaquille O'Neal and Stephen Curry are involved in SPAC's. So too are tennis star Serena Williams, pro baseballer Alex Rodriguez and NFL star Colin Kaepernick. Oh, and R&B star Ciara sits on the board of Bright Lights Acquisition Corp, just in case that makes you more likely to invest in the company.

Realistically, SPAC's are not totally silly. The rules governing them provide some good protections for investors – ways to redeem their initial investment if they don't like the proposed deal. For a business, being acquired by a SPAC can provide a superior pathway to becoming a public company when compared to a traditional IPO and even result in a better sale price given negotiations are done "behind closed doors".

Regardless of this, there's a boom in SPAC's which is to say there's a boom in IPO's. As a side-effect of this, there's now a huge bunch of cashed-up SPAC's out shopping for a suitable business to buy.

Inevitably, there's going to be more than a few Nikolas coming out of this SPAC frenzy. The coming 12 months will also see a massive flood of shares hit the market – the shares of the already-listed SPAC's – the original "sponsors" and owners. Once the lockup periods expire, the flood of insiders seeking to cash in on their riches will be interesting to watch.

Greensills:

Another big story within financial circles here in March 2021 is the collapse of Greensills. It's a big story in finance-land however broad media coverage has been limited given its one of those complicated cases that sails over the heads of the general public.

Greensills was a financial services firm headed by Lex Greensill – a charismatic young Aussie from Bundaberg. The firm, based in the UK, was engaged in what can generically be called "alternative assets". Broadly, its business was a variation of what's known as "factoring" or "supply chain finance". In essence, it bought companies' accounts

payables/receivables, packaged them up and sold them to investors – securities that would deliver a solid cash flow as the underlying companies' payments came in.

The receivables were packaged up with an insurance contract that provided coverage in the event that the underlying company defaulted on payments. Australia's IAG was a major source of the insurance. Luckily for them, it appears they sold their interests in relevant business entities about 12 months ago. "Lucky", because the magnitude of the defaults involved might have wiped them out!

Greensills sold a lot of their product through Credit Suisse, which packaged them up and sold them on to investors as rock-solid investments. As it turns out, some of the underlying companies that Greensills financed weren't all that "rock-solid". The insurance company refused to extend the cover beyond the current period of insurance and this resulted in Credit Suisse ceasing to sell the product. Ultimately, its now evident that the underlying company cash flows backing these securities are not there and the holders of the structured products face significant losses – there in excess of US$10 billion in product in the hands of investors. A lot of this is yet to unfold, but at this point it seems the losses might be 70 or 80%.

Does this story sound familiar? Investors, starved for yield by relentless suppression of interest rates by global central banks, desperately seek options that can deliver them a pickup in returns. A major investment bank pitches this "product" – these "AAA-rated" securities that have been packaged together from who knows what underlying assets, supposedly backed by an insurance company.

I'm getting flashbacks to 2007 and the subprime mortgage mess. I'm certainly not suggesting this current event is the tip of an iceberg anywhere near the size of the subprime mortgage crisis, but I'm sure many sophisticated funds managers are now having a much, much closer look at the "alternative assets" in their portfolios.

What do I think?

Now to foolishly write down and date-stamp some of my current thoughts:

I believe we're nearing the end of this long bull market that began after the Global Financial Crisis of 2008. My reasoning for this is because I'm a student of the markets. There are certain hallmarks observable throughout market history during each "phase" of the market. We are witnessing basically all the hallmarks that have preceded major tops.

Valuations are extreme yet there's a sense that the markets can't fall. An ingrained view that whilst central banks continue to engage in "QE", the market simply can't fall. Nonsense. As I've noted repeatedly, QE is nothing more than an "asset-swap" where the central bank swaps zero-yielding cash for negligible-yielding government bonds. Creating a sea of excess liquidity is surely "market-positive" but the asset market levitation effect is

mostly a confidence trick – there's no physical mechanism whereby the newly-created bank reserves are automatically routed to asset markets.

There's also a perception that there's no plausible catalyst to trigger a fall – "why would the market roll over?" But history shows that there need not be a triggering event – hugely overvalued markets have tended to roll over when the economic outlook remains excellent… but not quite as excellent as it did the week before. In other historical cases, it's the market rolling over that has exposed the economic fragility lurking under the surface – the "cause" is assigned after the fact.

A major hallmark of historical market peaks has been silly behaviour on the part of investors. Plainly, I believe that some of the anecdotes presented above are just silly. I think investors will look back and wonder "what were we thinking?"

Major blow-ups, frauds and scandals are also a feature you tend to see towards the end of bull markets – the culmination of years of "risk-on" behaviour. A huge surge in IPO's is also a hallmark. A good dose of hubris and invincibility on the part of investors is a feature.

Investors are currently heavily leveraged and trades frequently overlap. I commented above about how you could probably get exposure to Telsa or ARK or various other leveraged plays via an ETF like "BUZZ". It's true. This should highlight the instability built into the markets. An unwind may look something like this:

Over-leveraged investors decide it's time to reduce leverage.
They, the former buyers, begin to sell some of their holdings – which were based on momentum: Names that they have done great on such as Tesla.
If Tesla goes down, ARK goes down.
If ARK goes down, they get a wave of redemptions and are forced to sell Tesla into the hole, thus pushing it lower.
Leveraged investors that didn't sell are in margin call and are forced to sell.
All the charts are "breaking down".
All the Call option positions expire worthless and market makers dump all their hedge positions.
Stop-losses are being triggered.
Momentum-based traders, including thousands of computer-based algorithms are now betting on the new trend – downwards.
Buying Put options is now popular among the surviving retail trading crowd, bringing accompanying selling pressure as market makers get short to hedge their sales.
More margin calls. More forced selling.

This is how it works. This is what has happened during the completion of every market cycle and is what lies ahead for investors. Although the role of computer-based algorithms has the potential to be much greater than in the past.

The only question is when.

I don't think we're there just yet. I sense the markets can continue to find dip-buyers for a little longer. We're overdue a "correction" – the typical 8 to 12% retracement, which will "feel real". But I sense it will once again be met with a solid bid, just like every other dip for the past 10 years. Maybe even some new highs afterwards. But my guess is that the markets won't properly "recover" – won't revert to the same uniform, indiscriminate, frenzied buying we've seen.

Building on this timeline, my guess is that the second half of this year might mark "the top".

Picking tops is a silly game. Full of career risk for professional money managers where relative performance is all that matters. For this reason (and others) few try – there's nothing being "wrong" with everyone else but being "wrong" on your own is bad and unnecessary.

But for me, I need to acknowledge that trying to pick this top is becoming a bit of an obsession. I believe this cycle might well be one of the biggest events in my investing lifetime – both prior and future. Channelling sentiments recently expressed by legendary investor Jeremy Grantham, I feel privileged to be a witness and participant to all this.

A lot of people will lose a lot of money. Some will make a lot of money. This will happen quickly given the fall from the top will be swift and brutal. That's the appeal. History shows markets fall much quicker than they go up. This presents exciting opportunities.

As a student of history, I believe that markets will "revert to mean" – that they will find their way back towards "fair value". Reliable valuation models indicate "fair value" for the S&P 500 is probably 65% or more below current levels.

But peering into my crystal ball, I don't really foresee a fall of this magnitude. I sense that the reversion to mean might play out over a longer period of time and essentially involve two cycles – a fall of perhaps 40 to 50% then a relatively short-lived bull market, followed by another fall of perhaps 40%. This might be over a period of 4, 5 or 6 years.

I think I've said enough for now – there's plenty here for me to look back on and regret. For now, I excitedly look forward to the opportunities that await, although the excitement is tempered by a sense of sadness in knowing that if I'm roughly correct, the next few years will bring significant financial loss and pain to many.

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