Aviator Update – March 2020
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AVIATOR CAPITAL

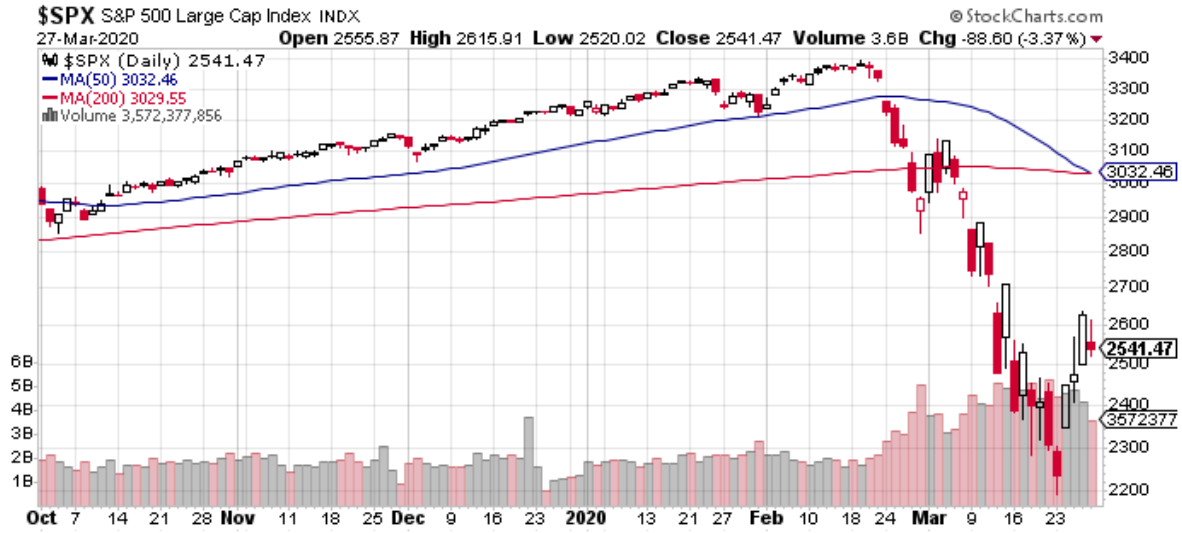
Okay, now what?

Before I start, I want to acknowledge there's a lot of people doing it tough at the moment. Most obviously those that are gravely ill and even passing away from this virus. There's also those financially hurting. Indeed, the key issue we're trying to get a handle on now is the financial fallout from this event. I need to say however that trying to figure out how to profit from these events feels a bit wrong.. a bit crass…

I'm distraught that I can't go to the gym – something that's been part of my daily routine for well over 20 years. But I'm grateful that this is the "worst" effect this event has had on me and my direct loved ones. I really hope that doesn't change and I hope the effects on you are much the same as me.

With that said, financial markets have been my life and passion for nearly as long as I've been going to the gym every day. I need to be honest and say that this turmoil is rather exciting to me!

What a month! I don't think I need to try and describe what's transpired – it's a case where a picture best tells the story:



This is my favourite market – the US S&P500 – as at the close Friday March 27. 3400 to 2200 in a handful of sessions – the fastest crash like this in its history (bigger/faster than during the global financial crisis, the 1987 crash and the 1929 pre-great depression crash).

The week that ended on the 27th was declared by the Wall St Journal as the fastest bull market in history – up 21% in just four days.

Unsurprisingly, at the moment 4% daily swings are simply part of everyday life. Look at the size of those recent candlesticks on the chart – incredible. We haven't seen volatility like this since the last time we saw volatility like this.

That deliberately flippant comment is meant to highlight that although there's a lot of "unprecedented" things going on right now, there's also a lot of precedents to draw on as we navigate our way.

Of course, almost all that any of us care about now is what happens next. I feel that the best place to start is in reviewing what's transpired in the last little while – looking back before the current meltdown.

I want to acknowledge that the Aviator Macro fund has managed to post a positive return so far year to date. Substantially positive. The fund has been positioned net short equities for some time now. And it has been uncomfortable in the face of continued gains. Whilst there have been various factors driving our conviction that this was the appropriate stance, there has been one key driving factor – valuations.

Valuations are the key driver of future returns. You don't need a PHD in economics to understand that. The higher the price you pay for an asset, the lower the prospective return you stand to experience from holding that asset.

Equity markets have broadly just experienced the longest bull market in history – the beginnings being back in the depths of the Global Financial Crisis. In doing so, the US markets in particular have worked their way into becoming the most over-valued in modern market history. In addition, we have seen various signs of divergence and instability creep in – much of which I've discussed over the past 12 months or so.

I've been describing the markets as "fragile" for some time now. It has been this backdrop coupled with a conviction that valuations invariably "normalise" which provided us the conviction that sensibly-sized short positions were a good strategic bet.

As I mentioned last month, we didn't predict this coronavirus thing. But the catalyst doesn't matter – the conditions for a significant correction were in place.

Financial planners and the like can console their clients with how totally unpredictable this event was. True, it was. But this is the third time in the last 20 years this has happened and its largely been the same every time; - markets work their way into an unsustainable position fuelled most of all by nothing bad happening. They get massively overstretched and then something – anything – happens and down it comes.

Predictions are hard – especially about the future – but if you work in financial markets that's what I believe you are taking on – a willingness to study and work hard in an effort to try and predict unpredictable things.

As we begin to read the tea leaves to see what lies around the corner, checking in on valuations is a good starting point.

I could post any number of valuation charts – most of which will tell a similar story. Below is one that's credited as being Warren Buffet's favourite valuation metric – US total market capitalisation compared to GDP. This was posted in a mid-March note by Crescat Capital and is therefore current (perhaps even a bit "low" now):

Again, various other reliable valuation models tell a similar story. Prior to recent falls the markets were so overvalued on a historical basis that even the substantial falls experienced have not restored them to any sort of "normal" valuation. Historically-speaking, markets remain over-valued. *Very* over-valued.

There's one key takeaway here… Remember this in the months to come – if you believe the US S&P500 will soon rally back to 3000…3200…3400, what you're indirectly saying is "I believe that the markets will revert back to being the most over-valued in history!" In fact,

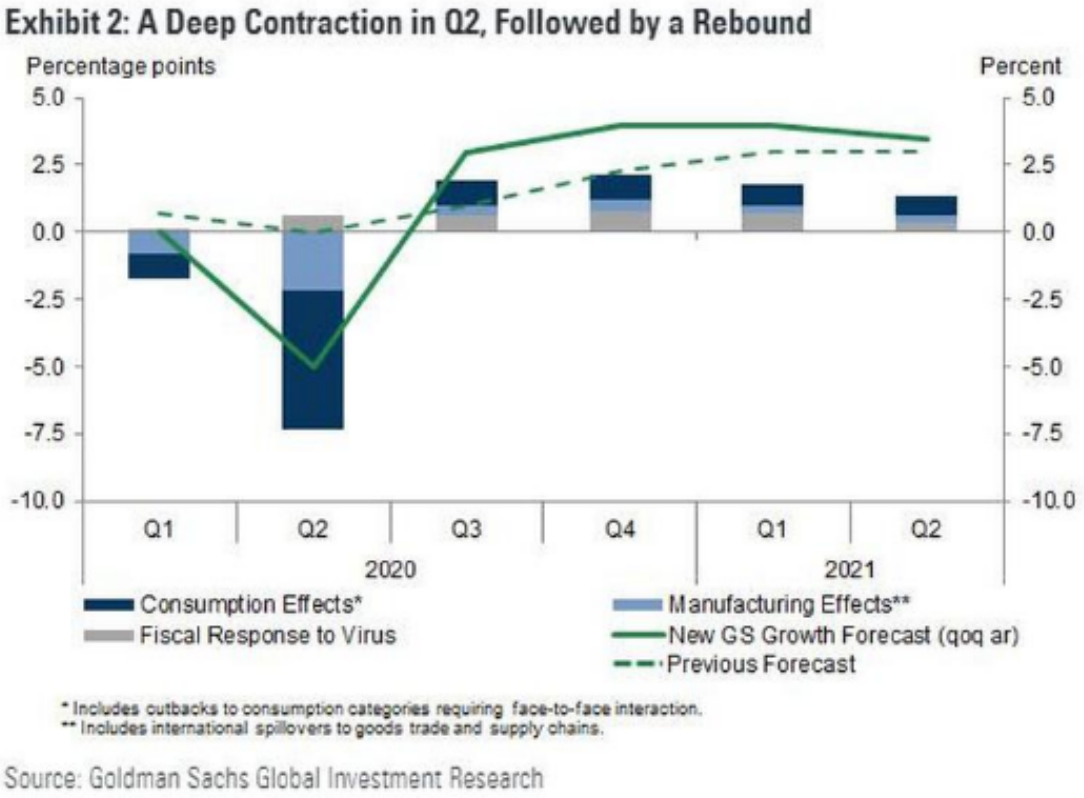
they'd likely be more over-valued because it's probable that the denominator in your formula – be it GDP or earnings – has declined owing to the economic fallout currently going on.

I'm certainly not saying it's impossible. I just want you to appreciate that is the reality.

Economic Impact:

This is the big issue. What's going to be the economic fallout from this?

As is always the case, the major investment banks have the unenviable task of reporting in real-time to their clients on what the economic implications are going to be. Goldman Sachs' New York office released a note mid-month on their thinking. The glass remains half-full as far as they are concerned. They are warning to brace for a shocker in the second quarter – predicting US GDP to crater -5%: but never fear… they predict a V-shaped recovery with +3% in Q3 then +4% in Q4 and expects the gains to continue into 2021.



Their guess is as good as anyone's. Things are moving so quickly that this is probably already out of date. My guess is this will prove "optimistic".

Government stimulus is obviously a big piece to the puzzle, and the announcements have been pretty significant. I'll be honest and say that at the time of writing this I haven't looked closely at the stimulus packages announced – there's been too many to keep up with. But my sense is that the financial impact is going to be greater – and longer-lasting - than the

stimulus response. In other words, it will help soften the economic blow, but it won't totally offset it.

I believe that we here in Australia need to have our focus firmly on the original source of today's woes – China. I've written ad-nauseam about China for over a decade. They saved us in the Global Financial Crisis and I believe our near-term economic path is tied to theirs.

To quickly recap the GFC events, the world entered a major economic downturn (Similarities to today?). China, whose economy is largely tied to tradeable goods and investment, saw a massive decline in demand for "stuff" (Similar to today?). Facing factory closures and rising unemployment, China's central government leaders walked into their control room and pulled with all their might on the lever marked "build stuff".

It worked amazingly – across the country there was a tidal wave of new construction projects – offices, apartments, trains and other infrastructure… even factory infrastructure despite capacity being nowhere near fully utilised.

This had the flow-on effect of spurring a boom in natural resources prices and demand. Australia sold more and more *dirt* at higher and higher prices. This, coupled with a debt-fuelled property boom, "saved" Australia from the GFC and left many an Australian feeling pretty smug.

Of course, all that new building in China was fuelled by debt. For a number of years now it's been widely acknowledged – including by the Chinese leaders themselves – that debt has become a major problem.

So here we are again. Parallels to the GFC – the global economy is in turmoil and demand for Chinese "stuff" has surely collapsed.

How will they respond?

The trajectory of the Chinese economy was not great leading into this mess. 2019 data showed their manufacturing and industrial sectors struggling. Data also showed this beginning to trickle down into consumer and services sectors – examples being a decline in car sales and even data such as a decline in food delivery app usage.

How will China manage its declining economic growth? Will they reach for that same lever they did in 2008? Even if they do, will it even work? Debt levels have become so high that it becomes increasingly harder to increase investment.

We all need to be keeping a close eye on China. I believe investing in Australia is difficult until there is some confidence that China is stable. Or at least until valuations are clearly very favourable, which they certainly aren't at present. This includes the Australian Dollar, which has the potential for further downside.

Financial Plumbing:

A feature of the market turmoil has been blockages in the financial plumbing system. Some of these issues were already well-known and we have discussed in recent months.

One we have discussed has been the corporate bond market. Looking a little further down the track, I still can't help but think this market could be a real source of problems.

As economies weakens, defaults will rise. Around half the US investment grade corporate bond market is rated BBB, around 15% of the market being BBB-. That's just above junk. A modest number of downgrades would swamp the market as holders not permitted to hold junk debt exit positions.

Even after the extraordinary measures announced by the US Federal Reserve and other central banks, closely-watched measures of credit market pressure still indicate things are not functioning as normal.

As at the time of writing this, it's fair to say that credit conditions have improved from where they have been in recent weeks – which is in no small part why the equities markets have had a good bounce. But my view is that as the true economic fallout from today's events starts to move through the economy and markets, stresses will likely return.

There's just so many moving parts to all of this – different layers…multiple parts with multiple layers. And things are changing quickly enough that it's hard to know what the next day will bring.

If I had to pick three verbs to describe what I believe most people are feeling at the moment they would be disbelief, frustration and hope. Or maybe that's just what I'm feeling.

I'll end with a few thoughts – current at the time of writing this in the final couple of days of March and possibly out of date already:

- I sense that there's going to be more economic disruption globally than investors collectively think.

- Related to this, I sense that investors collectively still have far too much "hope" – many people have remarked to me that as soon as the virus gets under control they expect markets to zoom back to where they came from.

- I sense that the economic disruption is going to result in further strains to credit markets and the global financial plumbing system.

- Valuations remain historically high – especially for "the bottom".

- Putting the above together, I do not believe most major equities markets have yet seen their lows.

As always, we'll do our best to adapt our thinking and positioning as events unfold. What this may mean is doing a lot of watching – after all, most of the time you should only trade when you feel you have an "edge". Again, by the time you read this we may have already changed our views!