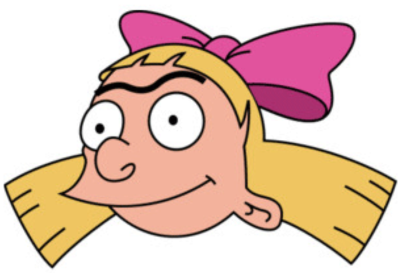
MACRO VIEW: Crappylocks

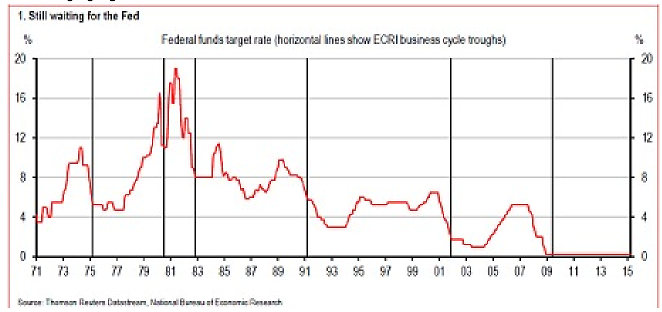
Our readers who hate central banks may like this Macro View more than the prior, in which we reflected on bigger picture drivers (i.e. bigger than central bankers) behind the general ugly state of things. To recognize there are deeper tides than monetary policy is not to deny the bad or dumb stuff that central bankers are doing. It of course further remains true that, if central bankers are firemen who provide emergency liquidity, Wall Street banks – who enjoy the protection and cover of central banks by grand design – are the greedy jerk pyromaniacs who typically start fires in the first place. The response to the 2008 financial crisis was unquestionably an unbridled orgy of greed, incompetence and corruption… costing taxpayers still untold trillions (not least in missing savings)… the entire crisis itself fueled by corruption. **So yes, we are thoroughly disgusted by central bankers…** to about the same degree we are disgusted by politicians in general. There are rare "good" central bankers (Volcker) and epically awful ones (Greenspan), just as there are good and awful politicians. It is an ironic twist of modern democracy, and modern markets, that we cannot "throw the bums out" without simultaneously finding other bums to replace them.



Her name is Helga Pataki in the "Hey Arnold" cartoon series, but let us dub her Crappylocks. She is the butt-ugly sister of Goldilocks, and her presence is due to central bank policies. **While technology and globalization trends are structurally widening the divide between "haves" and "have nots," the policy of central banks is making that divide <u>far worse,</u> even as artificially low interest rates keep markets propped up.**

This is roughly how it works: The Federal Reserve keeps rates near zero to help stimulate the economy. For lack of better policy tools, this is their best trick. The maneuver then winds up stimulating Wall Street instead of Main Street. As icing on the cake, **the near-zero interest rate itself helps <u>perpetuate economic stagnation</u>… which further keeps Wall Street "up" and Main Street "down."** To the degree that the recovery is slower and weaker than it should be, Wall Street enjoys an artificial stimulus that lasts longer than it should. The central bank then <u>continues</u> to keep rates low because the recovery is weak. We call it a "Crappylocks" market, as opposed to a Goldilocks market, because the crappy situation for workers is just right for paper assets. Until it all goes to hell that is.

1. Still waiting for the Fed



Holding a key interest rate near zero for years on end is not a very wise thing to do. It is the forest ranger equivalent of zealous fire suppression while failing to clear a massive build-up of dead dry underbrush, resulting in an all-but guaranteed inferno of larger proportions later. But the Fed surely feels it doesn't have a choice: It is just responding to crisis conditions with the tools it has on hand. If you trace cause and effect back far enough, you wind up with greedy politicians bought off by Wall Street, happily allowing commercial banks and investment banks to combine (the end of Glass Steagall), embracing self-supervision and so on. What's done is done, so the Fed says "Welp, here we are" and has to make the best of a bad situation… which means managing in the moment as best they can (while waiting for the next domino to fall). It is certainly a dumb way to run things… but there are so many big winners in the present system it will almost certainly not change – especially when the losers (taxpayers, workers etc) don't understand the games being played in the first place.

Ed Yardeni argues that artificially low interest rates screw up the US economic recovery in at least three ways:

• **Risk averse savers increase their saving (to compensate for lack of yield).** Yardeni notes the pace of personal saving post-2008 has been double that of the 1990s and 2000-05. This is the "money in a mattress" effect: Reduced velocity is deflationary as worried savers hoard cash rather than spend.

• **"Ultra-easy money" led Wall Street investors to bid up US home prices, making them unaffordable for 1st-time buyers.** If home prices are rising because Wall Street is hoovering up inventory with cheap financing, the US middle class faces rising costs without the benefit of home equity appreciation.

• **Low corporate bond yields encourage share buybacks and M&A far more so than investments in plant & equipment.** Near-zero rates facilitate cheap blue chip borrowing, which means corporate America has decided to invest upwards of 95% of its total profits in buying back stock, financing big mergers, paying out dividends, and so on. This is wonderful news for investors, not so much for US workers. If profits are spent on plant and equipment, jobs are created. Financial engineering to boost a share price is just not the same thing.

Idealized economic theory says that it doesn't matter where the money goes… that in the end it's all the same, one man's savings is another man's spending and so on. This idea never really made much sense. If an extra thousand dollars goes to Bill Gates, it is likely to sit in his accounts (or get reinvested in already overvalued risk assets). If that same $1,000 goes to a strapped single parent working two jobs, it is more likely to be spent on goods and services. Monetary velocity is roughly the speed at which money moves through an economy. The more readily that capital is spent, earned and respent, the more it contributes to growth. To the degree it simply sits in bank vaults or passive index funds, on the other hand, it's like a stagnant pool of water. In theory, at least, invested dollars should be deployed by companies receiving the investment. **But this is exactly what is NOT happening, via near-zero rates and rampant financial engineering to satisfy activists.**

As of May 29th, Reuters reports, US dealmaking had seen its strongest start to the year since records began in 1980, up 52 percent year-on-year to $746.9 billion from Jan 1st 2015. At the same time, activists are driving the financial engineering binge to get shares up. As the *Wall Street Journal* reports:

U.S. businesses, feeling heat from activist investors, are ***slashing long-term spending and returning billions of dollars to shareholders,*** *a fundamental shift in the way they are deploying capital.*

Data show a broad array of companies have been plowing more cash into dividends and stock buybacks, while ***spending less on investments*** *such as new factories and research and development.*

Activist investors have been pushing for such changes, but it isn't just their target companies that are shifting gears. More businesses sitting on large piles of extra cash are deciding to satisfy investors by giving some of it back. ***Rock-bottom interest rates have made it cheap to borrow to buy back shares,*** *which can boost a company's stock price…*

Historically speaking, JP Morgan's global chief economist reports, capital spending by businesses has accounted for an eighth of all spending in the US economy, making it a critically important driver. As the WSJ notes, that capital often orients to "payments to contractors and suppliers who pay wages to middle and low-income workers." If the same capital is diverted to stock gains and dividends, that is nice for those who own equities… but not the same thing. **Central bank distortions, deliberately intended to cause "wealth effects," wind up propping up paper assets while <u>suppressing</u> low and middle income wages and savings rates…** not to mention shutting out small business borrowers (as banks would rather lend to the blue chip hogs at the trough, taking all they can at hurdle rates above zero, simply because why not, buybacks and mergers will help keep the activists at bay).

Nor is it just the US worker / consumer feeling repressed. "It would be difficult to overstate the recent downside surprise in <u>global</u> consumer spending," observes JP Morgan senior economist Joseph Lupton. "<u>Something has gone wrong with the global consumer</u>, and the course of the global expansion over the next year depends on whether the recent stumble in spending growth a temporary soft patch or indicative of underappreciated headwinds."

Might we suggest what has "gone wrong" with today's global consumer also has to do with artificially low interest rates, now a reality world-wide? In emerging markets in particular, there is newfound worry over a lack of consumer spending via the low-price "oil windfall." Cheaper crude oil should've unleashed new waves of spending across the globe by now – but by and large it has not. A head-scratching lack of global productivity has further been blamed. **Consumers aren't spending as they "should," and productivity levels are stagnating… thus incenting the perpetuation of low rates for longer, which fuels more "money in the mattress" type deflationary saving, cash hoarding, financial engineering and so on.** Crappylocks indeed…

The "winner take all" effect as recently described, in which a few players win huge via technology and globalization, is part of the equation too. A new paper from the National Bureau of Economic Research argues that, from 1982 to 2012, the divergence between top 1 percent wages and those at the middle of the pack was not due to superstar workers, but rather "super firms" where everyone in the company earned better pay. "There's this view out there that the main reason inequality is rising is because of super managers," one of the paper's co-authors tells *Bloomberg*. "We're arguing that it's the rise of super firms." This dovetails with what's happening in markets. One is not likely to find disgruntled workers at the likes of Google, Apple, Microsoft or Facebook. Everyone across the board is paid far better than average, with better than average benefits – a result made possible by the world-beating efficiency of these companies (in serving a world-wide customer base with a relatively tiny base of workers). **Nor is it surprising that the rise of "super firms" would lead to lower productivity economy-wide, or the appearance of such, as more competitors are put out of business (and workers' hands idled who don't work for the "super firms").** Technology on the whole is deflationary, in the sense that innovation and efficiency means falling prices (or delivering significantly more value at comparable price points, a similar thing) while displacing human workers. This somewhat harsh reality is reinforcing the Crappylocks trend.

So how, then, does Crappylocks end? That depends on which happens first: Profit margins contract… real inflation makes a comeback… or the world slips back into crisis or recession.

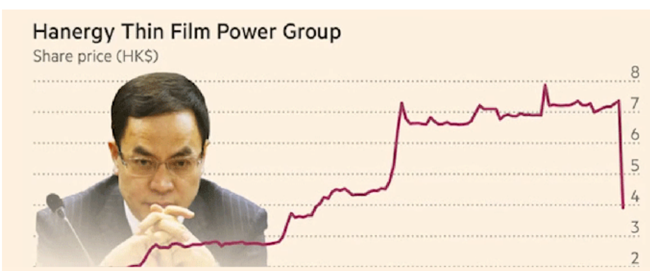
THEMATIC VIEW: Reversal of Fortune

No one sheds tears for billionaires. But China is giving the following group of rich guys a fairly rough time of it.

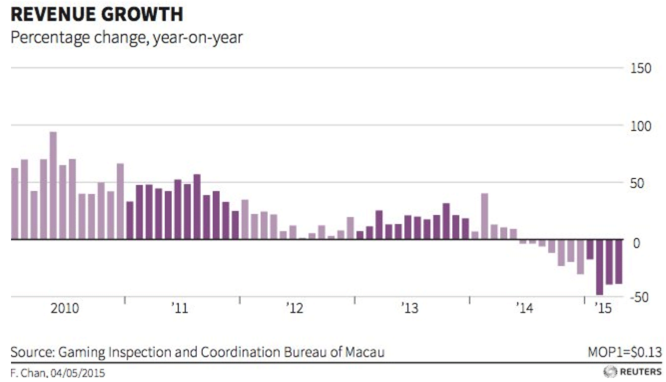
First is Crispin Odey, a legendary money manager in Europe. Odey's flagship European fund, which holds more than $3 billion in assets, saw a gut-wrenching 19.3 percent drop in the month of April. That is on par with the 1987 crash, and was the worst monthly drop since the fund's launch in 1992.

Odey blamed the "bloody" month on China, *Reuters* reports, saying that his bet on a weakening Chinese economy had been "attacked on all sides," leading to simultaneous losses in foreign exchange, oil, and short emerging markets. Ouch.

Odey has been vocally bearish in recent months, apocalyptic even. He sees many of the same things we've written about in these pages: Gray swans, potential for massive carry trade unwinds, unsustainable valuations, and so on. But as the old Keynes saw goes: "The market can remain irrational longer than you can remain solvent." In April the US dollar corrected sharply, even as emerging market assets and oil shot higher. Odey must've been oversized in all the wrong places. The ferocity of China's stock market rally surely played a role.



Li Hejun, China's richest man, also took a hit to the wallet when shares in the company he controls, Hanergy Thin Film Power Group, collapsed 47% in a single day, wiping billions off the founder's net worth. The whole deal is just incredibly sketchy. It isn't clear that Hanergy Thin Film Power actually makes solar panels, let alone profits. The company is a shell that sells to its parent company, Hanergy Group, at incredibly wide (fake?) profit margins. Pictures taken at the main facility show almost no activity. The whole odd show has the general feel, as the *Washington Post* put it, of "Enron with Chinese Characteristics." Yet Hanergy Thin Film Power was trusted enough to be the largest holding in the popular TAN solar ETF, leading to a mini-collapse of TAN when the news hit. It isn't clear that Hanergy was ever legit in the first place. In this it serves as a microcosm for the entire China situation, as the Chinese government now abandons all pretense of fiscal discipline and orders banks to continue lending to deadbeats (lest the capex-driven economy collapse too quickly, under the weight of epic capital misallocation and an estimated $28 trillion worth of debt, $9 trillion of that linked to real estate.)



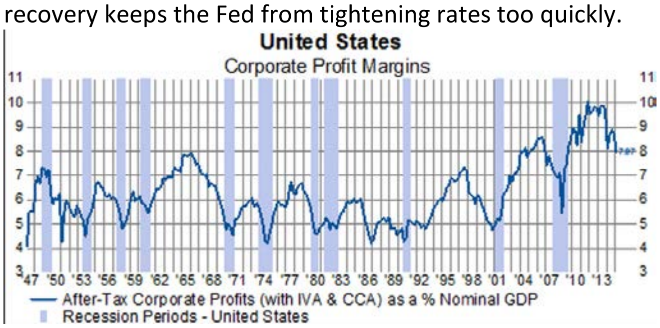
Sheldon Adelson and Steve Wynn, the founders of Las Vegas Sands and Wynn Resorts, are two other billionaires getting hit by China – specifically the revenue downturn in Macau. LVS and WYNN have been whacked by a 38% year-on-year contraction in Macau gambling revenue, as wealthy Chinese now stay away and chastened bureaucrats swear off Macau permanently. The optimistic Adelson puts on a brave face: "Supply will create the demand… we are making Macau into another shopping city," he says. But shopping simply doesn't bank revenue like gambling… Macau casino earnings are still 90% gambling-driven. WYNN in particular has been schmeissed: From a high just under $250 per share in March 2014, the stock is now flirting with $100 as of this writing…

There is plenty of gambling in mainland equity markets, however, with Shanghai volatility increasing after a seven-year-high and 6.5% drop. Analysts have not been able to pace the market, as liquidity-driven demand (buyers at any price) make a mockery of valuations. China Railway Group, slated for a 19 percent gain this year, instead rose more than 700%. The IPO for Shandong Shihua Shenghua Group was nearly 826 times oversubscribed. China's equity markets are now Greater Fool Theory on steroids. There is no longer even the pretense of rational valuation. "You need to touch upon company fundamentals in your research notes," a Shanghai-based analyst complains. "We can't write baseless reports, so the current market makes it more difficult for us." Indeed.

As we have said before in these pages, China is the mother of all Gray Swan risks. You don't know when the dislocation will be coming… but it is certainly coming. Meaningful China slowdown, beyond the point of fakery, will have significant (and dangerous) impact on the global economy. China will "export deflation" to the rest of the world, meanwhile, via low-priced exports to help shore up its deflating growth.

George Soros sees an even darker possibility: World War III. At a Bretton Woods conference, Soros laid out the ultimate geopolitical doom scenario. He openly worried that, if China's attempted transition to a domestic demand economy fails, Beijing could stir up conflict to distract the populace (while uniting them behind a common enemy), leading to The Big One. "If there is conflict between China and a military ally of the United States, like Japan," Soros warned, "then it is not an exaggeration to say that we are on the threshold of a third world war." Talk about a bearish market scenario…

On the United States front, economic data came in between "meh" and "yuck" as first quarter GDP was revised down from 0.2% to negative 0.7% (a contraction). This downward revision failed to have major impact on the market for at least two reasons: First, because the ugliness of first quarter GDP was already more or less priced in; and second, because more economic weakness strengthens the "Crappylocks" effect described in this week's Macro View, in which a struggling recovery keeps the Fed from tightening rates too quickly.



While US equity bulls can blow off the GDP report – maybe it helps by staying Yellen's hand somewhat – they were given real reason to fret in the form of contracting corporate profit margins. Whether or not record corporate profit margins are sustainable is one of the sixty-four trillion dollar questions, along with other doozies like "What happens with rates near zero if the world heads back into recession." Gavekal Capital observes that **corporate profit margins have dropped below 8% for the first time since 2009,** to current levels of 7.97%, after hitting an all-time record of 10.06% in fourth quarter 2011. As the above chart (via Gavekal Capital) implies, if corporate profit margins are now peaking… even as interest rate yields are set to rise off the floor from zero… that would be a very momentous thing indeed, and a tidal sea change that could usher in years (!!) of equity multiple compression…

Across the pond, **the euro (via EURUSD) may have ended its liquidity spike,** shaking out weak hands (or overly exposed hands – ahem, Odey, cough) before resuming a long-run trajectory towards par (US $1.00) or below. As usual, Greece is saying and doing a bunch of stuff, while Germany and the ECB et al are saying and doing a bunch of other stuff. Back and forth with Greece brings to mind Churchill's description of Russian politics: Bulldogs fighting under a carpet. We are seeing some interesting "tells" as to the state of Europe though, and the potential return of crisis: The willingness of IMF head Christine Lagarde, for one, to simply state flat-out that Grexit is a genuine likelihood. "It's a potential" was the IMF head's chosen phrasing via interview with a German newspaper, Frankfurter Allgemeine Zeitung, further adding that "It's very unlikely that we will reach a comprehensive solution in the next few days," and that a Greek exit would not end the euro. This is the powers that be telling Greece: **"We're tired of your games. Come to the table or jump."** At the same time, **mini-earthquakes are shaking the political landscape in Poland and Spain,** as more nationalist, populist and anti-euro sentiments gain ground via the ballot box. In Poland's presidential election, the candidate for the Law and Justice Party, Andrzej Duda, won a "stunning" victory in a surprise beat for the incumbent. This is "a significant lurch to the right in Polish politics," the FT reports, and the sentiment shift could "ultimately topple the ruling party in October after eight years in power." Duda's victory was powered by voters in the poorer Eastern regions of Poland, while more affluent Western regions went for the pro-euro incumbent. Another "shock to the status quo" has occurred in Spain, with Podemos and Ciuidadanos, **populist parties who have been compared to Syriza in Greece,** dealing the incumbent pro-euro establishment its worst electoral blow in 20 years. Like Poland, these results are lead-ins to a likely big general election in the Fall. "If we extrapolate [these] results to the coming general election, Spain could become very difficult to govern," says Dukic. What's happening now at the periphery is **more or less exactly what we expected:** The downtrodden disenfranchised of Europe are preparing to give Germany, and possibly the euro itself, a giant middle finger. Stay tuned.

SPOTLIGHT: Not Tesla For Burgers

If you want to make $100,000 in a single afternoon, it's not hard to do it. All you have to do is borrow $100K… take it to a Las Vegas blackjack pit or craps table… and then get lucky. Of course, if Fortuna abandons you that particular afternoon, the plan might not work out. We mention this because there are many equity names, particularly near the tail-end of easy money bull markets, with worse risk-reward expectation than the typical house-advantaged game on the casino floor. Shake Shak (SHAK) is one of those names with laughably poor reward to risk. Buying SHAK is not smart. Carefully shorting it, on the other hand, could be a positive expectation play.

Jim Cramer has dubbed SHAK "Tesla for Burgers," in homage to the crazy cultlike devotion of SHAK investors mirroring the same attitude in Tesla. We wholly get Cramer's point that wild-eyed sentiment is driving the upside in both names. But we still consider the comparison grossly unfair… to Tesla. While the current Tesla valuation veers into fantasy land, one can at least make a long-range "paradigm shift" Tesla case. It is not out of the question that Tesla could forever change the automobile industry… or the large battery industry… or both. As such Tesla investors have multiple ways to win. The stock could hypothetically "grow into" its insane valuation over time… or its founder, Elon Musk, could prove as capable a long-term showman as Jeff Bezos at Amazon.com, a company which has sustained its silly season stock valuation for two-decades-plus on the strength of a forever future vision.

Shake Shack, on the other hand, is just another burger joint… and not even best of breed at that. There is a relatively new Shake Shack on the Las Vegas strip, a stone's throw from City Center and the MGM Grand. We had lunch there Memorial Day weekend, spending a hefty $31 on food for two people. We ordered a Shak Stack, a chicken dog (some kind of chicken apple sausage), cheese fries, and a milkshake of some kind. The burger was "good"… but not "amazing" or anything at all close. The shake was good (but not all that special), the fries forgettable, and the chicken dog flat-out rubbery. Truth be told we have consumed many better burgers – larger size, more flavor and texture – from an array of competitor chains.

On burger quality alone, we would rate In N' Out, Five Guys, Smashburger, and even Carl's Junior all significantly higher than Shake Shack… and most of those competitors are better priced to boot. Not to mention Chili's and other sit-down fast casual chains charging roughly the same prices as SHAK, while providing more burger for the buck. SHAK certainly beats the pants off McDonald's and Subway... but so what?

SHAK is a "hot name of the moment," benefiting from 1) wild sentiment in the trendy burger space and 2) buyer's remorse for those who missed Chipotle (CMG). We have witnessed a powerful multi-year sea change in fast food, in which new breed competitors put heavy emphasis on high food quality and natural ingredients. It wasn't clear at first that Americans would pay premium prices (e.g. seven to ten dollars) for an everyday burrito or burger. Now that the shift is obvious, a full-on fad rush has taken hold. But this is a harsh industry, heavily populated, with a very high cost of ingredients to boot. Ycharts (see chart at top) shows SHAK trading at 517x forward earnings estimates, having peaked above 850x. Current earnings do not exist because SHAK is not quite making money: The company posted a fourth-quarter loss of $1.4 million – a larger than expected 5 cents per share – in part due to higher beef costs. What will make this easier?

As a further form of sanity check, burger joints do not just compete against other burger joints. They also compete with burritos, salads, noodle bars, artisinally crafted sandwiches, buffalo wings, mini-pizzas, and so on. The restaurant business is historically a "hard-to-make-money" business, due to constant cost pressures and a barrage of competition. SHAK, a fad-of-the-moment name in a crowded field, is priced like a tech stock with a compelling growth angle. But no differentiation exists here. It is just another fancy burger.

Perhaps this is why SHAK short interest is 40% of float as of this writing. Shorts are not often that aggressive – unless a case exists that rationality has completely left the building. Put options do not yet trade for SHAK… but tactical entry in the aftermath of squeeze play run-ups might be warranted.