AIRACOBRA
CAPITAL MANAGEMENT

Calling the Ball

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Domino

As we go into the Holiday Season, market volatility is again rearing its head and negative pressures continue across all asset classes. Is this just a correction, trade war talk, or something more nefarious? We say no to the individual reasons the Cheerleaders are currently throwing around, but we do project this is a longer-term trend that will compound as prior unresolved economic problems come to light as market and economic conditions worsen. Market conditions will worsen more than economic conditions since the market has had an abnormal accretion rates over the past 10 plus years while the economy, despite headline reports from the Cheerleaders, has barley improved over the same time frame; markets and economics are disconnected – they are beginning to finally reflect each once again from an historic and fundamental standpoint.

Are markets finally experiencing the reality of poor economic growth over the past 10 years masked by non-market forces such as, but no limited to, the unnatural suppression of interest rates, accounting smoke and mirrors (buybacks, etc.), mis-interpretation of reports by the Cheerleaders, and an Algo lead market? Yes, they are, but fear not, after we clear the baffles - which will take several quarters without government interference, longer if there is governmental interference - the US economy will be repaired, rebuilt, and stronger. Hence, back to a time where markets reflect projected valuations based on fundamentals, human experience, and critical thinking not by pushing asset valuation through the roof via rigging the markets, Alogs and AI, group think, and companies that focus on customer service and products instead of social justice.

What does this new-found reality look like? Here are our projections, and no, this is not doom porn. When you look back at prior letters, we called the flattening/inversion of the yield curve in an increasing rate environment – a harbinger to nasty things for the economy and markets; this does not mean we are correct going forward, but our experience and knowledge of not only economics and markets but of history provides a roadmap as to what is going to occur next. By the way, the economy and the markets has not even begun to experience the true reality of a hollowed-out production base, a capitalist environment that has turn to a socialistic tilt with the added benefit of social justice, and a lack of economic, let alone historical knowledge. Here is how we see the dominos fall, not in any specific order but one thing will lead to another. The economy is a holistic environment, not compartmental. One pull of one lever places pressure, some greater than others within said compartments; however, the effects ripple through the entire environment. The Fed and government(s) are basically out of ammo and will either have to let things fall as they may or try to attempt something like a QE or other newfangled idea(s) to "fix" the markets; both options are not good for the short-term economic outlook; with one being worse that the other - you should be able to figure out our opinion on that one.

Domino #1: Employment numbers continue to turn over – minus the Cheerleaders' headline numbers. Auto makers are getting the headlines for job cuts; however, next time you drive through your local business district look at the number of empty stores, lack of business, and the number of men/grandparents taking care of children (not a sexist remark, a truism regarding employment). For all the bluster of the Cheerleaders, economic growth is not occurring by any real measures. By the way, required increases in minimum wages will not help the employment or economic picture, it will cause additional unemployment leading to a worsening employment picture as further individuals are forced to the sideline due to training and/or downsizing of jobs that grow the economy grow and provide the stepping stone to better jobs, careers, and wealth development.

Domino #2: The current infrastructure of the market was developed to reduce transaction fees and facilitate financial organizations to combine products and balance sheets to sell to investors but at what cost. Prior to the dismemberment of Glass-Steagall, Algos/dark pools trading programs, and changes in regulation/market rules such as trading equity in pennies instead of eights, the markets where run by individuals having earned experience in a marketplace that separated the banker (still the banker), the house (the market), and the gambler (Hedge Funds and et al) providing an infrastructure that protected investors, markets, economic and competitive perceptions having "Honor Among Thieves" mentality That is all but gone, when markets change, as they are now, this new infrastructure to will fail and expedite to process of negative pressure and loss of confidence.

Domino #3: Inflation leading to Stagflation – look to the late 1970's for a primer on this. Inflation is, and has been, out of the bottle even though it has and still is underreported. Stagflation comes from increasing inflation, a lackluster employment environment, and stagnant consumer demand; economies around the world have been bordering on this scenario – which we is already occurring, e.g. Venezuela, - with a few limited ways to reverse course: (i) bankruptcy; (ii) increase rates at an unbelievable, to current standards, degree while attempting to revitalizing the economy; or (iii) war.

Domino #4: Lending across the board will continue to decrease or cease. Just look at GE in the Commercial Paper market as well as the new issue calendar. Household and governmental debt is at nosebleed levels and continues to increase. This colossal accumulation of debt is not and has not been used to enjoy and/or improve lifestyles; it has been used to supplement income. Add the amount of leverage in the market including the unrecognized and unintended leveraging in every broker's/passive investors' favorite buy list security – whatever ETF of the Day - and the lending environment looks ready to implode.

Domino #5: Housing will continue to be bifurcated between renters and owners with an increasing slowdown at an exponential pace as interest rates rise, savings decrease due to lack of career type employment, and local taxes increase to facilitate increase budget deficits and want to provide additional services- you know, for the children.

Domino #6: Pension Plans across the board are, to put it nicely, a flaming cluster. Some corporations have offloaded their pension problems to third parties, which should bode well for said corporations but combined with public pension plans and the stage is set for a major economic disaster as retirees, a growing portion of the population, will not receive anywhere near expectations requiring Joe Public to bail out said pension plans all the while the Pension Plans sell into a decreasing market. This has been brewing for years as administrators and employers have played the accounting games of adjusting market returns (most have been unrealistically unachievable), length of benefits to be received, and age of employees to pretty up the balance sheet. Unions and corporate management are at fault here by not having realistic conversations during labor negotiations.

Domino #7: QE, which we have believed would be unwound resulting in a disastrous market/economic scenario, will not be unwound but continued, more than likely and without pomp and circumstance, in its current form with the added benefit of rising interest rate movements. A little clarification here, we hear the Cheerleaders discussing the use of the Fed to control market volatility. The Fed's mandate is maximum employment, stable prices (not stock prices), and moderate long-term interest rates. This is an outright call to manipulate the market instead of allowing market participants to value to the market based on the Fed following its mandate via the Federal Reserve Act. This is just another way to state the markets have stugotz to combat what is here and can no longer be kicked down the road. Inactivity or misuse of the Fed/Monetary Policy will result in further and more complicated problems as well as loss of confidence in a free market.

Domino #8: Algos fail as volatility increases and markets fall. Most generally have a long-only bias given the mandate of Algo driven funds and ETFs. They also tend to be based on very short-term data developed by individuals with no true knowledge of markets, only how to code. They do not understand the characteristics or mood(s) of negative markets. Additional fun will be to see how Algos try to flip and short stock. Meaning, giving their volumes, how do they get the borrows in an efficient manner, if they get them, and will it really matter and just short without borrow approval. Will the regulators even care or figure any of this out? This will be another enormous problem with the infrastructure issues discussed above.

Domino #9: Society continues its downward spiral. The U. S. is at war with itself and is gather speed with every passing day. Historically, things tend get worse prior to getting better and we are afraid this is the case with this domino. Markets do not like upheaval and given the current social/geopolitical environment the U.S. could push further into a socialist environment. Lack of education and critical thinking is compounding this at an exponential rate.

Can this all be stopped? No, except for maybe Domino #9. Economics, mathematics, and science always win in the end. All markets move in cycles. This current cycle, set-up since the late 1980's but gained speed during the past 10 plus years through various interventions, looks more and more like the 1970s, which, if we recall, took hard decisions and years to correct, but lead to one of the greatest economic growth periods across the board for the U.S.

Do we still have the capabilities to rebuild as in the 1980s? A good question which we would like to believe the answer is yes and sooner rather than later; however we are not sure due to the hollowing out of our manufacturing base, widespread corruption/lack of rule of law, a younger society not believing or lacking belief in the U.S. and capitalism nor do we have a large swath of leadership that has the knowledge, critical thinking, or balls to make the hard decisions required to properly address issues as large, complex, and far-reaching as what is facing the economy. Fixes can be started in relatively short-order, though with a great amount of short-term pain, if the market is allowed to work out its issues by itself and the government sticks to its knitting.

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Airacobra projects the following: *Please note these projections are general in nature and should not be deemed investment advice nor an offer to buy or sell, just how we view the world.*

- **Macro:** Economic Projections:

  (i) employment and other economic indicators continue slight short-term headline improvement; gains tempered by increases in interest rates, minimum wage (required by some states), and inflation; (ii) continued domestic/international social and geopolitical unrest; (iii) increasing interest rates and costs past throughs leading to: (a) increases in delinquencies and bankruptcies; (b) continued bifurcated/decreasing environment in home ownership; (c) continued lending down the credit rating spectrum to maintain growth, (d) decreased discretionary income, (e) repricing risk premiums across all assets classes, and (f) increased cost to finance current and rolling amounts of private/public debt.

- **US Sovereign Debt**: ***Change***

  We have been projecting a continued flattening of the U.S Treasury curve which would lead to inversion; however, given the current environment we no longer feel it proper to state a continued flattening of the curve but project an outright inversion. Rates increasing across the curve leading to: (i) a decrease in price of already issued debt; (ii) increased governmental costs; and (iii) risk premium repricing across all asset classes. Strongest possible chance of stagflation since the late 1970s which Reagan reversed with a large jump in interest rates and decreasing income tax rates. These actions took several quarters to take effect; U.S. could be in the same type of cycle but has the added weight and negative effects of QE, government debt/spending, increasing rates/inflation. Redevelopment of the Fed Fund "hinge" to reprice markets.

  - Comfortable being net short US Treasuries – specifically the short-end where we project a continued and substantial repricing with follow thru to the long-end of the yield curve.

- **Investment Grade Debt**: ***No Change***

  Credit spreads continue to widen to U.S. Treasuries from a basis point standpoint due to increasing interest rates and repricing of risk premiums. Issuers, in general were able to strengthen balance sheets given the long, low interest rate environment over the past 10 years assisted in stemming the tide of decreasing consumer spending; however, the overall corporate credit market has become rife with covenant light paper with some issuers, just like consumers, becoming overextended. Continued downgrade of credit ratings.

  - Comfortable being neutral to selective from a long/short perspective.

- **High-Yield Debt**: ***No Change***

  Credit spreads continue to widen to US Treasuries from a basis point standpoint with a distinct gap wider than investment grade debt. A sector historically reserved for issuers having high potential with higher risks will face a major repricing of risk leading to increasing pressure on market prices. Continued downgrade of credit ratings with reduction of new issues/funding.

- Comfortable being net short but believe there are some solid companies from a long perspective.

- **Equities**: ***No Change***

  Repricing of risk premium, effects of increasing interest rates on consumer debt/discretionary income, and increasing cost pass-throughs will cause equities, in general, to experience decreasing prices. Hard to fight the tape, passive investors, and Algos but comfortable being net short; believe there are some solid companies from a long perspective.

- **Municipals:** ***No Change***

  Not an investable asset class for Airacobra. However, the effect of higher rates, overextended state/city pension funds and the possibility of some states/cities seeing a reduction in "revenues" will have a general negative effect on credit, U.S. markets, and the U.S. economy. We project munis to be the canary in the coal mine regarding regulation and governmental activity/intervention.

- **Currencies/Commodities**: ***No Change***

  Not an investable asset class for Airacobra. However, project flat to increasing U.S. dollar strength given an increasing interest rate environment and growth potential of the United States compared to the rest of the global economy. U.S. dollar is the "Best of the Worst." If Trade War(s) saber rattling continues or said wars become "hot" (not only in the sense of economics) than all bets are off and expect things to get unpleasant across all asset classes.

Thanks for reading and as fellow Pittsburgher Dennis Miller use to say, "But of course that's just my opinion, I could be wrong." Look forward to your comments and never hesitate to contact us.

Be good

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