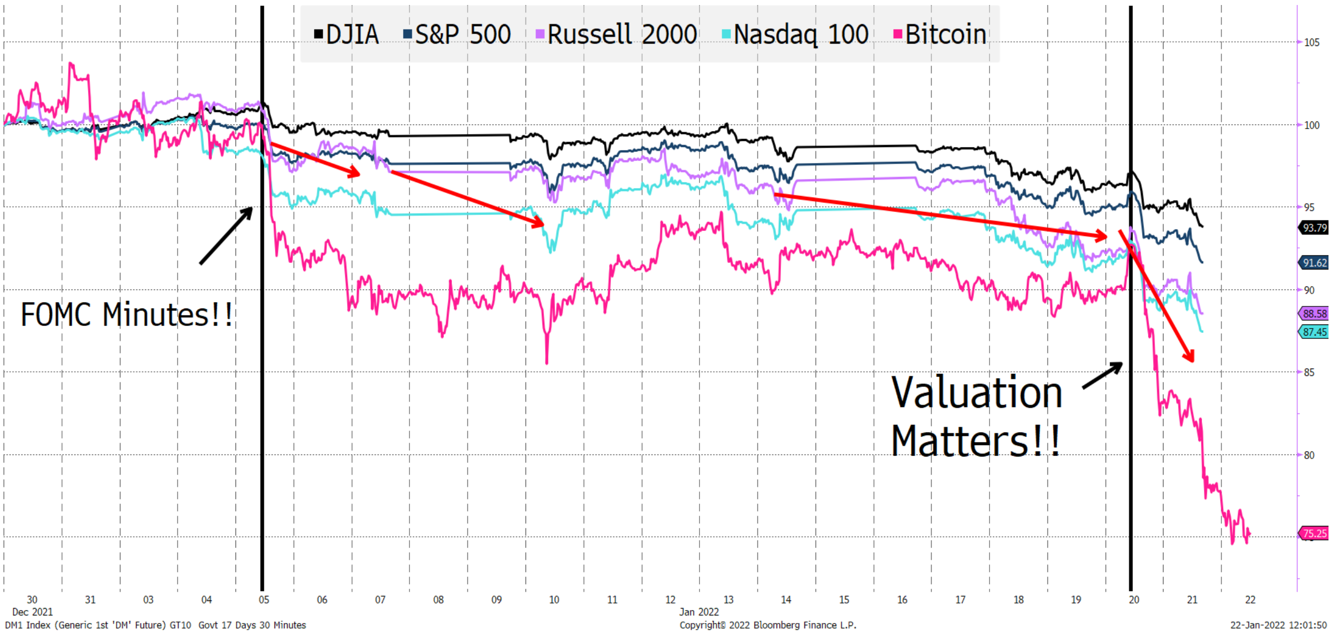
The Year Changed – Yet Again!

I really wanted to sit down and type a cheery report today, like one that talked about buying the dip, but I cannot. If anything, I may now be more bearish than I was at the start of last week, which was pretty darn bearish. Normally, with the big sell-off we had, I'd be less bearish, and that was the case as we limped into the close on Friday. But, given 12 hours to think about it (and watch another crypto crash), I must revert to being more bearish. Taylor Swift will have to wait a little longer to have one of her songs used as a T-Report title (I was thinking Shake It Off was going to be an appropriate title for this weekend).

The Year Changed in Minutes - Revisited

We posted The World Changed in Minutes just after the Fed released minutes the first week of January.



The thesis (at the time) was that the Fed minutes mattered, not so much because they confirmed their intention to hike, but also because they surprised many (including me) with their accelerated timeline to actually reduce the size of the balance sheet (not growing it was largely priced in, but shrinkage was not).

Most people fixated on rates and expected higher yields to drag down stocks. That played a role, but as in last weekend's "Doing More by 9am" T-Report, we highlighted that the **market was not prepared for a "risk-off" move**, and that is largely what we got. The Nasdaq 100 closed down almost 1,200 points on the week (from 15,612 to 13,438) while the 30-year Treasury yield closed 5 bps lower (from 2.12% to 2.07%). While not quite the risk-off capitulation I was looking for, it was closer to that than the "higher yields drag down stock prices" narrative.

Now I believe that there is a new narrative – Valuations Matter!

Valuations Matter

In theory, valuations always matter. We talk about valuations all the time. No one should ever trade a stock, or bond, or cryptocurrency at an "incorrect" valuation. But fund flows, price action, market psychology, and recency all play a role in determining where an asset trades or what it is worth at any given time.

Many have argued that valuations (i.e., various multiples) were too high, but they were wrong, at least until recently (the sell-off in ARKK, which I use as a proxy for FOMO/TINA because it seems to capture that sort of zeitgeist with trackable data, started in early November). It limped into year-end while the Nasdaq 100 and other indices traded at or near record highs.

We will come back to that "index" in a minute as we try and define **this "turning" point where valuations really started to matter, which I think occurred on Thursday afternoon**.

Two things happened that seemed to suck the life out of many bulls:

- **PTON** announced that they were temporarily pausing production of bikes and treadmills. Honestly, it doesn't seem like a big deal. They cut back to let demand and supply get balanced. Seems like a smart and rational business decision. Doesn't seem to make a big difference to revenues in the near-term, but **the stock dropped 25% on the news!** That drop occurred in a stock that was already down 80% in a year! The stock traded up from there and was up almost 10% on Friday, but I think that **the damage to market psychology was done. If what seems like relatively "ordinary course of business" news can cause an already beaten down stock to drop, what does this mean for the market in general?** It seems difficult to look at any holding and not wonder about the downside after something like this happens.
- **NFLX** announced earnings and the stock plummeted. For full disclosure, I bought some after the announcement just above $400 (I did say that I was getting less bearish before this valuation narrative started screaming at me). The earnings themselves didn't seem bad to me (but I'm not a big earnings report sort of person). I'm told that the market fretted about subscriber growth. The stock dropped more than 20% in a day, and **it was already down 25% since its recent highs!** It isn't just that $45 billion of market cap was wiped out almost instantly (though the size of that loss is important to the valuation narrative), but that this company was already hit reasonably hard. **One thing I do for almost any stock that is down is see where it was trading prior to the pandemic.** It was trading around $350 at the end of January 2020. Not only had this stock now dropped 42% from its highs, but it wasn't that much higher than the pre-pandemic level (though much higher than a year or two before that). That scenario is not true for a lot of companies that have been hit hard! There is a long list of stocks that have been hit hard (down 50% or more) that are still much higher than they were pre-pandemic (100% or more gains).

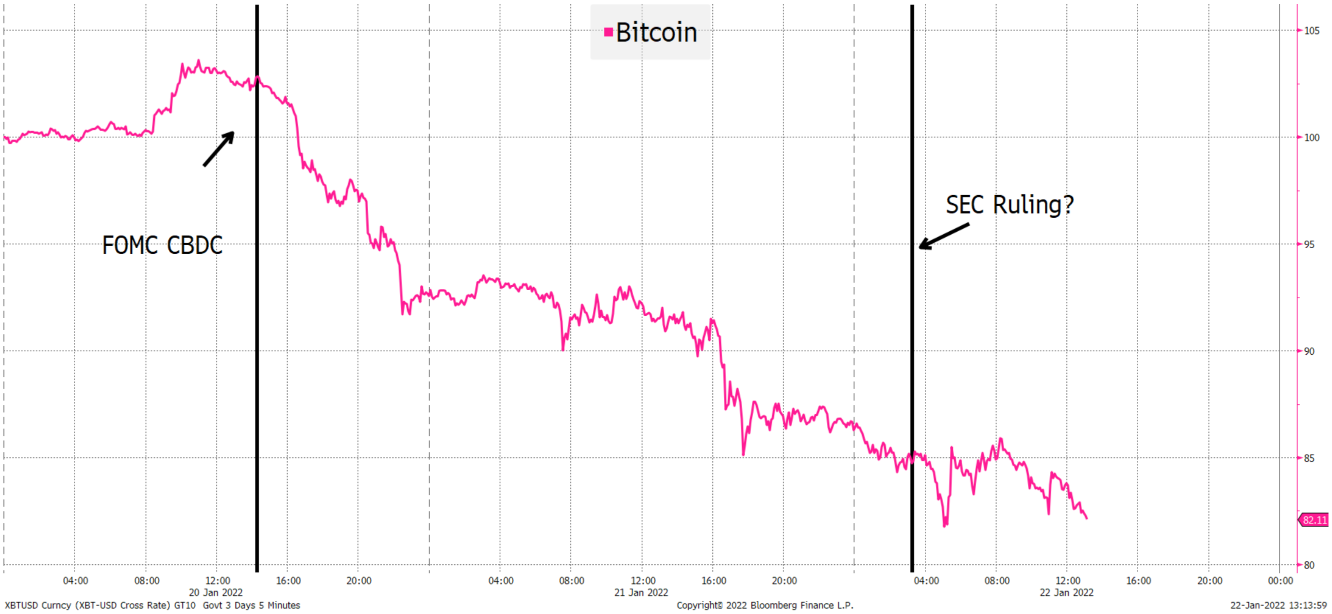
I think, after Thursday, it is difficult not to think in terms of valuation.

- How much higher is this stock than it was before the pandemic?
- Even after some weakness, do the multiples still make sense? (Is X times sales the right number? Is a PE of Y the right PE?)

I sense real fear in valuations and multiples for the first time in a long time!

Not "Just Another" Crypto Collapse

As I type this on Saturday at 12:37 pm, bitcoin is trading at $34,700. It was trading at around $42,000 most of Thursday (in fact it held in reasonably well at the start of the week). Then it slid to about $38,000 on Friday as the stock market closing bells mercifully rang! Then it started another steep decline.



The selling on Thursday coincided with the Fed releasing their publication "Money and Payments: The U.S. Dollar in the Age of Digital Transformation".

This isn't the first time that crypto has sold off shortly after U.S. equities have shut down for the weekend. Supposedly there are all sorts of arguments for why this can (and does) happen. I heard some vague thoughts that a couple weeks ago, the weekend selling was triggered by miners in Kazakhstan shutting down (seems weird, but plausible).

I also look for any geopolitical triggers. During trade negotiations, crypto often helped signal direction (presumably as insiders in China "knew" what was about to get announced). We've also seen crypto act "counterintuitively" to geopolitical risk. It doesn't always happen, but I've seen crypto weaken in response to sanctions or problems (Venezuela, Iran, Turkey, etc.). My assumption is that bad actors respond to sanctions by selling their crypto to avoid dealing in dollars. With the high risk of a Russian invasion of Ukraine (see Sitrep), I immediately checked to see if they picked 4pm ET to invade. They did not.

So, as I try and figure out what may have triggered this selling (realizing that the randomness of crypto trading might make this an exercise in futility), I came across the Bloomberg headline at 3:13pm that read the SEC was rejecting MSTR's accounting strategy. I don't know if this sell-off is a reaction to that. Maybe the accounting ruling impacts other companies holding crypto? I'm not sure if this headline had any impact on the market (I'm not sure why it would), but I figured I should highlight it.

If "crypto" is now trading on valuation, look out below!

All the HODLers (crypto holders who claim they will always hold) are out there touting their diamond hands (meaning that they are so strongly positioned they don't sell into fear). In addition, I haven't seen as much FUD commentary (the usual putdown for any comment negative on crypto).

So crypto has that going for it, but this time seems different:

- There is no new "access" product on the horizon that makes it much easier to trade (yes, there is constant hope of a "physical" ETF, which is ironic since bitcoin isn't "physical" in any way, shape, or form, but let's not be pedantic). There are so many ways to access bitcoin already that I don't see a "physical" ETF being a game changer.
- **GBTC**, an open-ended grantor trust as opposed to an ETF, **is trading at a 30% discount to NAV** as of the close on Friday according to Bloomberg. That discount to NAV is difficult to close (unlike in an ETF), but it is telling! Anyone selling GBTC was taking a 30% discount to the spot price. **I will point out that it got this extreme back in July 2021, which signaled a bottom for bitcoin,** so I need to be mindful of this repeating.
- So many people and companies (and at least one country) that purchased bitcoin since July as it became more accepted and FOMO was still running hot are now underwater. This is a group of late adopters, such as people who were conservative or risk averse, etc. (i.e., not "diamond hands"). How long will they hold? Who will come in next? If you were skeptical before, are you really buying this dip? (Assuming you haven't bought any of the previous dips). Bitcoin, like the ARKK type of assets, started its decline back in November when it hit an all-time high of almost $70,000. For the sake of consistency, it was $10,000 pre-pandemic and didn't really take off until November 2020.
- **Central Bank Digital Currencies**. There are a lot of great things about digital currencies, most of which can be delivered by central bank digital currencies. The less savory uses of crypto won't work with a CBDC, but that is a good thing. Some legitimate uses arise in crypto specifically because they are decentralized, so crypto doesn't go away, but it has serious competition. For most users, a CBDC should be seamless and fluid. The digital yuan (which will be foisted on some visitors to the Olympics, is more about control in China than about making certain transactions easier, but that will not be the case for most other CBDC's).
- **Debt and leverage backed by crypto.** I've seen more creative "capital" structures evolve. Leverage seems to play a big role in crypto (and I assume, much like margin debt outstanding is near the highs, so is debt linked to crypto). This is dangerous if true!
- **The MBA rule**. My first boss on Wall Street laughed as he told me that within two years of every MBA wanting a specific job, that industry would blow up. At the time (1994), he was highlighting mortgage-backed products and high yield and warning me that derivatives trading at Bankers Trust was the hot spot (it took longer than two years to blow up, but not much). This isn't serious, though the number of articles about people leaving Wall Street or tech to go to crypto seems to fit (and I assume MBAs are clamoring for jobs in the space too). NYC's mayor is allegedly taking his pay in bitcoin (hopefully he gets it at a locked in price, but since it was more theatrical, I think that he just takes his dollar pay and buys bitcoin). **This one is more tongue in cheek than anything and I couldn't resist**. Most of the jobs are more about blockchain than crypto and that should do well regardless, and every one of the MBA "blow up businesses" ultimately came back bigger and stronger! (So no hate mail please on this bullet point).

The big problem, at least from a valuation perspective, is **what is the value of a bunch of ones and zeros?** Many of the "use" cases seem great, but are currently costly or impracticable.

With real competition and FOMO simply turning into FEAR, **crypto could have much more downside if the narrative switches from use and access to actual (definable) value.**

I was on the verge of buying back into crypto on Thursday and Friday, but didn't and now have no such desire, and I've already spent too much time on crypto, except that it fits the "valuation" narrative well!

Backing Up the Truck

I'm sure we've all been part of conversations that go like this:

- If XYZ gets back to this ABC price, I'm going to back up the truck and load up!

It is a pretty common discussion in my world. We all miss some price rise on something we came close to buying (or buying more of) but failed to pull the trigger on. We promise ourselves, and anyone who is listening, that if it just cheapens up, we will buy it this time.

But what we really mean is:

- If XYZ gets back to this ABC price, **for no good reason**, I'm going to back up the truck and load up!

It is that caveat that gets missed! **The problem is that almost invariably, by the time it gets back to that price level, it is for a valid reason.**

That may explain why it is easier to buy small dips than big dips. Small dips seem random, while big dips have serious reasons. It may also be harder because all the money got soaked up buying the series of little dips that morphed into the big dip.

If a focus on valuation and traditional metrics is the new narrative, then we could see more downside from here as those seem stretched in many cases.

HCA Loans in 2007 as "Cash Equivalents"

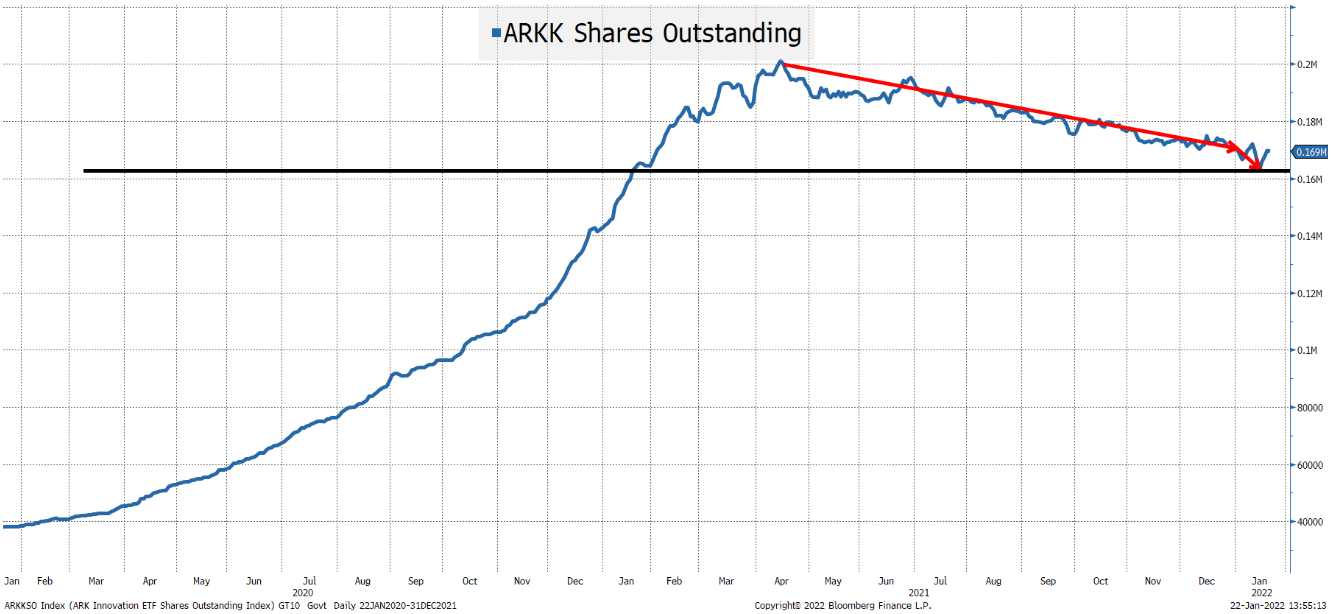
Over time, investors and asset managers tend to view certain holdings as cash equivalents. Back before the credit crisis, many players in the leveraged loan market treated HCA as a "cash equivalent." They didn't want to hold much cash and underperform, and HCA was the biggest, most liquid loan out there. Even 2nd tier market makers could price HCA loans $25MM up in an 1/8th of a point market.

That was precisely the problem! When everyone held the same loan as their source of liquidity, and it was the biggest loan by far at the time (if memory serves correct), guess how long dealers could keep making markets? Even in the heyday, you didn't just stand in place and get run over. If everyone was a seller, you pulled the bid back. Once you got hit enough, despite trying to dodge and weave or hide in the bathroom, you (the market maker) also become a seller (that tap on the shoulder happens surprisingly early at most firms).

I am not sure if asset managers or investors have "cash" proxies right now, though I suspect they do, and those stocks and asset classes could be the next in line to get sold!

What Gets Sold Next?

If you asked me on Thursday (and I did write about it, even if you didn't ask), I was arguing that the names and sectors that had started their decline in November would no longer lead the way down. I am not so certain about that.



This chart was giving me some comfort. We've seen outflows from the ETF (I always assume ETF flows are just the tip of the iceberg of overall flows and I just use them because they are timely). So, a declining number of shares outstanding is some evidence of capitulation. The stock is very difficult to borrow and short interest is high. Price action seemed better than it had been recently (though that might have been wishful thinking). The creation of SARK, a fund that tries to effectively short ARKK, also seems like a good contrarian signal. That fund has grown to $250 million of AUM in less than 3 months – an almost unheard of "success" story for any fund, let alone one that specifically tries to short another fund's strategy. I told you, the lines between "fund" and "index" are getting blurry in this space and that's why I use the ETFs for illustration purposes and not passing judgement in any way, shape, or form.

So that's where I was getting comfortable, and even vs pre-pandemic price levels, there is some encouragement (as I'm typing this, for disclosure purposes, I own some ARKK) but I may not by the time you read this because the shares outstanding doesn't fit the pre-pandemic check that well, and even as shares are declining, it is gradual, with some large inflow days (hardly a capitulation).

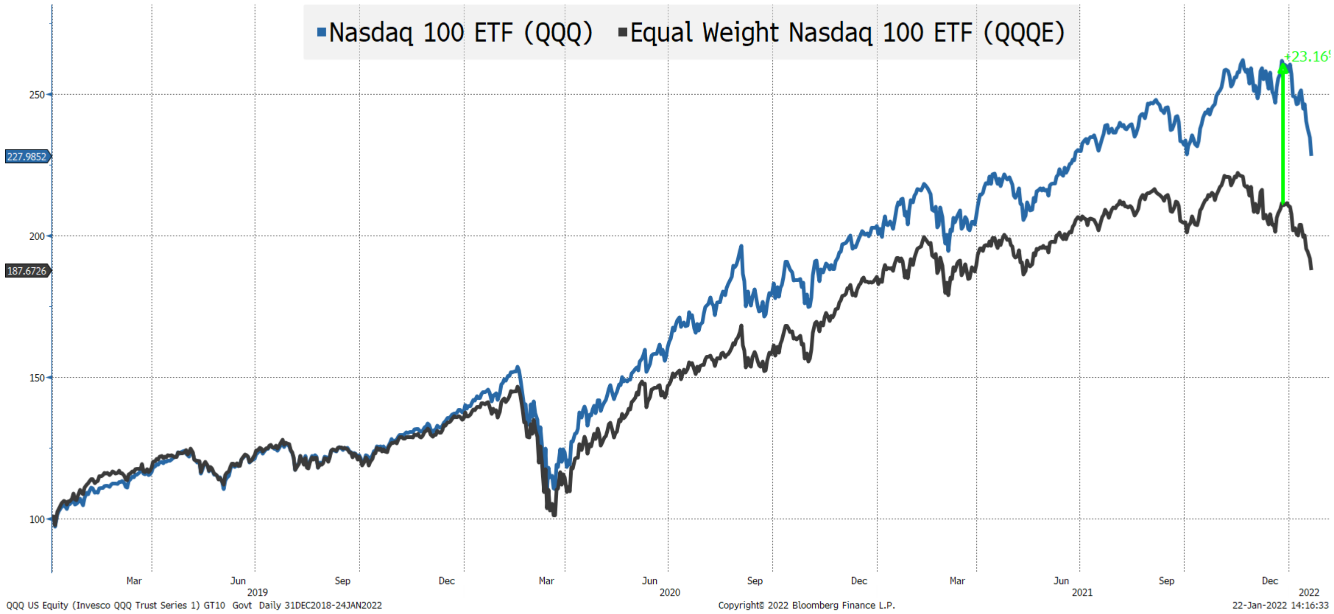
This space tends to exhibit some correlation to bitcoin and given what I just wrote on that, it makes me nervous.

But it is TQQQ that I want to talk about.

QQQ is the Nasdaq 100 ETF. It is wildly successful with $187 billion of AUM. TQQQ is a triple leveraged version of QQQ. So, it attempts to triple the daily return of the Nasdaq 100.

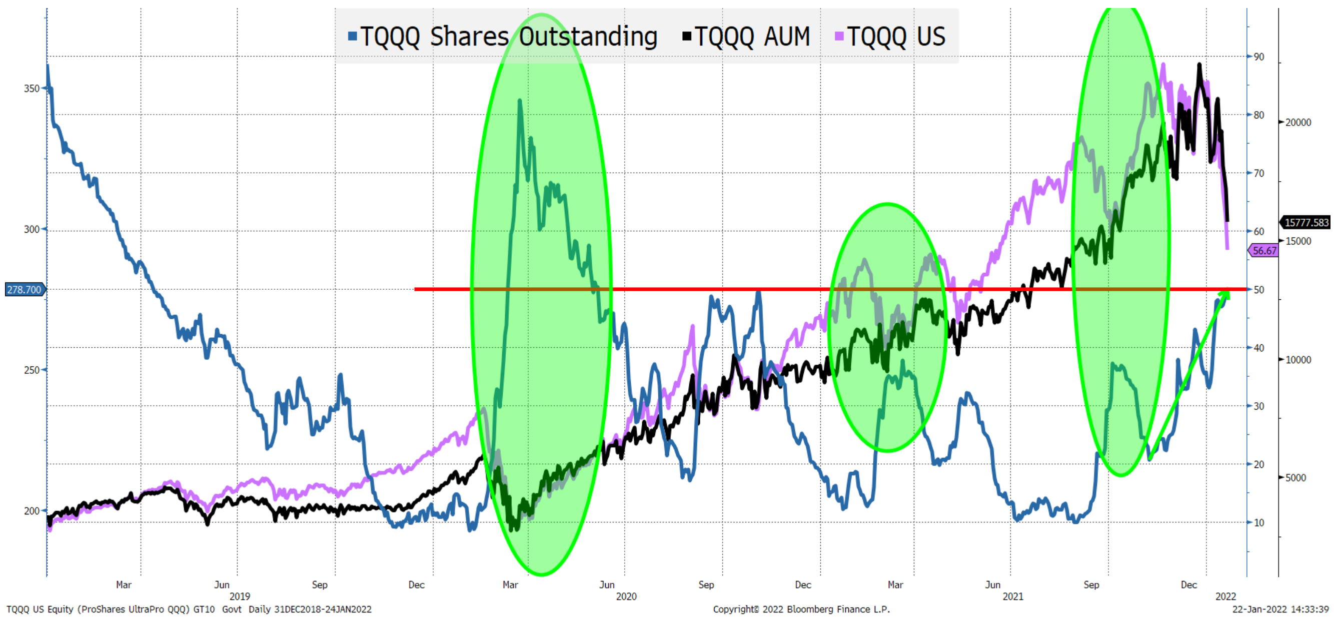
The Nasdaq 100, as many have discussed, has become relatively concentrated in a few stocks. **The top 10 names make up 54% of the index!** That is a very concentrated index no matter how you look at it.

Nothing wrong about the index. That is how market cap weighted indices are done.



The difference between the Nasdaq 100 ETF (QQQ) and the equal weighted Nasdaq 100 ETF (QQQE) was almost 25% just a few weeks ago (and about $187 billion of AUM). That gap narrowed last week to around 18%, but my concern is that if it is at all mean reverting and any of my comments about loans in 2007 or cash proxies are real, then this gap could close.

Which again brings me to TQQQ. The fund had inflows all week and led me to do this very ugly and difficult to decipher chart:



The habit of getting inflows until QQQ bounces has been done before and worked. The "Pavlovian" response to down days has been to buy more. But what if the drawdown is too large? And while shares outstanding have been higher, the fund had its highest AUM recently, so the stakes are higher!

In any case, no evidence of people shying away from triple leveraged TQQQ, which doesn't fit at all with my hope that we've seen capitulation. On the bright side, 5QQQ, a quintuple leveraged QQQ traded in Europe hasn't attracted any AUM, though it is a bit scary that it even exists.

Will the TQQQ dip buyers ($16 billion AUM) be right again, or will this become a pressure point on the market? Remember that $16 billion represents $48 billion of risk, which is non-trivial and highly concentrated.

I've argued that people often start selling what hasn't gone down as selling what is already down a lot is too painful. I'm worried that I may have been premature in that assessment, but this market seems littered with trigger points.

Bottom Line

I am looking for a widespread risk-off event. I will continue to sell into strength (sell the rips) and buy back or nibble at the dips.

Expect FOMO assets to continue to lead the way lower and keep a close eye on crypto as it has become so connected to parts of the equity markets.

The TINA assets might try and take over the lead and will struggle.

Credit should stabilize before equities.

On equities, I'm now fixating on 'equal' weight indices in addition to my safe/understandable/value selections.

I hope I'm wrong and am just overly nervous! A strange thing to say at the end of a report, but I don't like being this bearish (especially after the move we just had), but that's how I see the world right now.

Maybe I should have channeled Taylor Swift's "You Need to Calm Down"! Let's hope so. And it is really difficult to believe that it's only January 22nd!

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