GLOBAL INVESTOR CIRCULAR

Australian Standfirst

A Year Of Phantom Earnings:

Different Risks & Exposures During This Crisis

May 2020 Edition

Invest Now

Discover the Australian Standfirst Platform

Kindly remember that these monthly circulars are for educational purposes only and should not be taken as advice. All views shared within them are Australian Standfirst views and do not represent any other organisation or individual (unless cited accordingly).

THIS MONTH'S CIRCULAR in summary:

- What are company earnings and why they are central to everything we consider regarding economies and related financial markets.
- The ossification of the existing system and why phantom earnings matter.
- "*Creative Accounting*" practises in North America, Asia and globally.
- The US's S&P500 aberrations and how they distort valuations.
- "*Just as the boom accelerated the rate of growth, so the crash enormously advanced the rate of discovery*", Economist John Kenneth Galbraith, '*The Great Crash, 1929'* (1955).

A company's earnings are the predominant determinant of its own equity market share price – the circumstances relating to them can augur whether an underlying business will be profitable and prosperous over the longer term and point out to the global investor in the present, how the company is performing relative to its competitors, sectoral peers and the broader economy en masse.

Earnings cannot live in isolation from an economy – earnings matter and so do valuations.

In a world that has forgotten that life can be as straightforward or as complex as we allow it to be, the nub of the matter is that stockmarkets have and should always be valued by the sum of the collective flow of future company or reference asset earnings, discounted by the appropriate interest rate.

It has never been, nor need be more complicated than that.

Cite:- Equity Market Implosions Imminent: Evidence, Economics And Lead Indicators, 22 April 2020

Cite:- Practical Guide For Australian Investors: 2020 to 2022 Roadmap, 13 April 2020

Australian Standfirst

May 2020 Edition

Australia's Global Investing Specialist Providing Clear Insights And Original Themes For Your Investment Portfolios And Philanthropic Practices.

EDUCATION

FUNDS MANAGEMENT

PHILANTHROPY

However, drawing on a broader dataset, a more comprehensive assessment of the contemporary economic infrastructure which, in turn, determines the political superstructure (Ricardo, Marx), leads us all to accept that the existing system has not only become ossified – precipitated by the ***Global Corona Crisis*** (GCC) – but that this ossification has in turn caused a massive entanglement, which now goes beyond the scope of reason:- ***Great Distortion*** | ***End Of The First American Republic*** | ***Financial Repression*** | ***Price Discovery Subversion***.

January's missive did successfully foresee the current crisis before it unfolded but not because we materially assessed anything specific to the ***Corona Crunch*** but rather because it became evident that the global economy homogenised all of the aforementioned entanglements and had *"priced in"* these manifold risks into one large indivisible valuation.

Individual company earnings during the first quarter of 2020 (Q120) became apparitions – in the US, Europe, Japan and Australia, corporate managements continued to withdraw 2020 earnings guidance and corporate profit announcements, all of which constitute the cashflow of "***Globalisation Inc.***"

This singular, indivisible valuation is why investors saw bellwether Treasury securities march in lockstep with equities, which is the exact opposite of what's supposed to happen (traditionally, '*Risk On*' = equities, '*Risk Off*' = bonds).

In the vernacular, such hyperconvergence is referred to as a ***Delta*** (Δ δ) ***One*** price action.

One of the main rationales for ignoring the absence of company earnings during calendar year 2020 has been that even though during crises, markets generally contend with a range of different risks, China's reported reopening experience suggests that a much quicker pace of recovery is possible and therefore stockmarket valuations (the world over) can temporarily ignore the absence of earnings until a future time when, '*business as usual*' resumes.

Regarding this argument, not only does the Australian Standfirst DDPM team call this out as nonsense, it strongly cautions any investor who is considering affording this proposition any credence whatsoever – Enron and the hordes of many during the 1999-2002 Tech Bubble presented very similar proffers.

With respect to "*creative accounting*" by US corporates across their reported earnings, S&P500 corporate earnings evidence that phantom numbers have been aggrandised, as reported S&P500 constituent profits are thirty-six percent above the profits detailed by the US national accounts.

The adjustment to a new, diminished level of profitability after the crisis does not appear to be a consideration, further evidencing the case for the ***Great Distortion*** underfoot.

Economist John Kenneth Galbraith, explained the American penchant for creative arithmetic, especially during crises, best within his seminal work, '*The Great Crash, 1929*' (1955), "*Americans had built themselves a world of speculative pipe dreams. That world was inhabited, not by people who had to be convinced, but by people who sought excuses for believing.*"

Remembering that *price is what you pay, value is what you get*, it is important to note that S&P500's corporate earnings were frontrunning comparative composites well before the ***GCC*** troubles began.

Following the American aphorism, "*When the wind blows hard enough, even the turkeys fly*", the metaphoric winds subsided in January 2018, which left late-cycle US economic leadership themes airborne, including US defensive, "Large Cap" and growth factors.

Trumponics, financial repression and an increase in the expansion of the US Dollar monetary base, provided a lift to the cyclical, "Small Cap" and value

Australian Standfirst

May 2020 Edition

Australia's Global Investing Specialist Providing Clear Insights And Original Themes For Your Investment Portfolios And Philanthropic Practices.

EDUCATION

FUNDS MANAGEMENT

PHILANTHROPY

"...Price is what you pay, value is what you get"

themes across US bourses, which were proven to be turkeys in the preceding eighteen months.

The recent '*recovery rally*' was not being led by sectors that traditionally move in lockstep with the economy; in other words, when the stockmarket is truly reflecting a rapid turnaround for the economy, these so-called cyclical sectors are normally in front.

The fact that they are not leading raises red flags.

The Dow Jones' Transport subindex actually gained twenty nine percent as the S&P 500 climbed thirty percent from its recent low.

However, these returns pale in comparison to prior bear recoveries: Transports gained nearly sixty percent in 1987 and 2009 as the S&P500 rallied thirty percent then as well.

One might conclude that this time is different because the transports include American Airlines [AAL:US], Delta Air Lines [DAL:US] and other companies directly impaired by lockdowns.

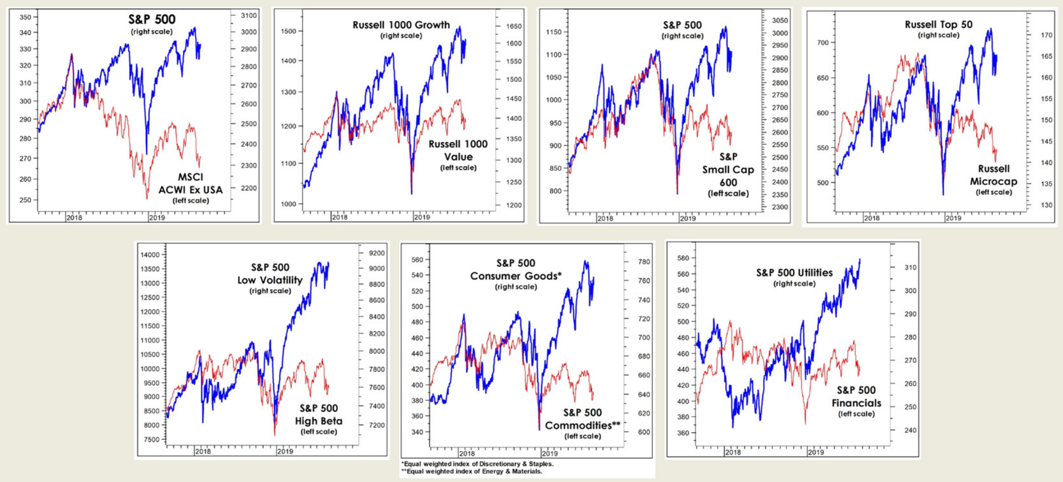
At the same time, US financials also lagged and only once during the last five bull markets — in 1987 — did the sector lag the S&P500 during its initial bounce from the lows.

It contributed roughly half of the S&P500's thirty percent rally this time around and it is not insignificant that [Berkshire Hathaway recently culled stakes in several large US listed banks].

During every bull market since 1987, the Russell2000 benchmark had gained at least forty percent by the time the S&P500 was up by thirty percent.

Notwithstanding, these charts suggest that if the breeze had picked up at all, it was only at the very highest altitudes, leaving the global investor with the most entangled market in forty years according to two of the three High/Low factors exampled below.

In its simplest explanation, the [S&P500 Large Cap and Tech darlings were already flapping ahead of others] well before the incumbent crisis struck.



Australian Standfirst

May 2020 Edition

Australia's Global Investing Specialist Providing Clear Insights And Original Themes For Your Investment Portfolios And Philanthropic Practices.

EDUCATION

FUNDS MANAGEMENT

PHILANTHROPY

australianstandfirst.com

Nonetheless, creative accounting does not solely plague North America, with reports in recent weeks of two notable scandals in Asia; Luckin Coffee Inc. [LK:US], a Chinese Starbucks reproduction and Hin Leong Trading (Pte.) Ltd., a Singaporean energy trader that has allegedly been hiding significant losses.

A big fraud or corporate collapse in America could rock the confidence of the Turkeys and those believing that winds are supporting them – a similar windstorm was seen when the demise of Enron afflicted investors' nerves in 2001 and Lehman Brothers led stockmarkets down in 2008.

What extra uncertainty cost will be baked into all financial markets when it becomes clear that creative accounting practises of the past decade were also '*priced in*' to the large and indivisible valuations, identifying market opportunities will become a process of assessing how market expectations of those key risks have changed.

It is important, afterall, to remember that a company's earnings typically refer to after-tax net income, sometimes known as the ***bottom line*** – economic dislocations are often rooted in after-tax net income misrepresentations.

Earnings risks are being resolved to different degrees and at different points in time by both global investors and regulators that supervise fiscal and monetary mechanisms.

Because assets have different sensitivities to those risks, some assets have seen more relief than others, despite the fact that hyperconvergence *en masse* is driving all asset's price actions in similar quicksteps.

Caution needs to be levied around assets that possess significant exposure to European sovereign risks, escalating Sino-US tensions and oil-related exposures.

There is nothing confusing about the circumstances we find ourselves in and again, Galbraith said it best, "*Just as the boom accelerated the rate of growth, so the crash enormously advanced the rate of discovery. Within a few days, something close to a universal trust turned into something akin to universal suspicion. Audits were ordered. Strained or preoccupied behaviour was noticed. Most important, the collapse in stock values made irredeemable the position of the employee who had embezzled to play the market. He now confessed.*"

Yours,
Stirling R. Larkin
CIO, Australian Standfirst
Asset Management