Larry Cheung, CFA: Patreon Investment Community Research Updates
December 1st Half Strategy Report (12.1.22 - 12.15.22)

Premium Strategy Report - December 1st Half Strategy Report

Date: 12.1.22-12.15.22

Title & Thesis: Our thesis that Bears would be surprised by a rally of this magnitude back in October/November has materialized. Favorable Risk/reward has moved away from U.S equity bulls and we now re-enter a holding period. I see any revisit to 4100 SPX again as opportunities to set a trailing stop-loss to reduce exposure again. I'm not interested in additional long positions across my coverage universe until at least 3700 SPX. I always use the market as a proxy before entering or exiting single names. Powell's latest speech regarding smaller rate hikes was encouraging, but I believe the market will soon start paying attention to how long rates will stay higher for longer. If interest rates stay terminally high, the S&P 500 rally has its limits.

Dear Members & Friends,

We have a number of new friends in our Community, and I want to just take a moment to re-emphasize a couple things regarding your investment strategy.

- As investors, I firmly believe that we need to be able to deeply understand our own personality AND then choose the proper time frame and strategy from which we transact.
- The shorter the time frame you choose to transact, the more extreme the discipline that you must have (in addition to the more time you must also spend monitoring the position). I choose to not transact in short time frames. First, because my experience has told me this timeframe isn't compatible with my personality. And second, I simply have far more success with intermediate-term investing.

For me personally, I want to have Investments be a place where money is working for you, rather than you working for your money.

As a result, my timeline is typically intermediate-term or long-term when it comes to traditional stock positions. To reiterate: there are many investment strategies out there. You must choose the one that fits your personality and your character. Choosing a strategy that is not parallel with your natural

character will cause unnecessary stress because it may be incompatible with your emotional and psychological tendencies.

In this environment, I'm personally very happy with 7-30% returns on names selected over a 2-6 month period. Most of my guidance on names over the last several months that have been successful are gains in this region. In this market, I'm not looking for home runs or trying to time the exact bottom. Those of you who know my style know I like to execute in Tranches while I accumulate in regions that I like to reduce in areas that I think are vulnerable/expensive.

I'm trying to select very solid ideas with a high-probability of success. If no good setups are present, then I will keep waiting.

When the market pulls back materially, I'll be monitoring companies that have good risk/reward for us here.

Helpful Update: In the meantime, given that my research is organized chronologically, and I know that many new members will most likely not read my oldest previous reports, I've asked my analyst team to compile the best educational learning points from all my Bi-Weeklies into a summary of bullet points.

These insights and educational pointers will be shared inside Discord in a neat, organized Channel before the end of the year under the folder Investor Education.

This way, if you haven't had the chance to get all the evergreen insights from my previous reports, they will be laid out in Discord for you in the coming month ahead.

For my Substack Members who do not use Discord, I will put the summary in the Bi-Weekly Report folder.

Okay, now onto research.

Dear Members and Friends,

Before reading this December Research Note, make sure to read my previous reports where I highlighted the opportunity for a bounce into SPX 4000 when the index still traded 3800-3850, which has since materialized. Now that the level has been reclaimed, we discuss where we likely go next from both a near-term standpoint and a longer-term standpoint.

We're going to start off this December Research note by going over key inter-market data that I believe should be on your radar:

- The Dollar Index (DXY) is trading near a multi-month low. The last time the DXY reached today's level was at 105-106 was back in early November, and then back in August. The recent drop in the Dollar has been a large tailwind to the S&P 500.
- The Treasury Yield curve has inverted substantially. I will show 3 charts of what the yield curve looked like in September, October, and then now in late November/early December in the appendix at the bottom of this report. You will see the inversion has been quite extreme, indicating that a recession is very likely coming in the coming 12 months.
- Energy prices (via Crude Oil) has traded lower for most of November relative to previous months (below 80/bbl). This degree of lower oil prices may lower inflation CPI but comes at the signaling of very soft global demand.
- The 30-Year Mortgage Rate seems to have peaked at the 7% region, indicating that there is a very strong signal that Real Estate demand cannot be sustained with rates this high.
- Black Friday reported 9.2 Billion of Ecommerce Sales, but in the context of high inflation, in real terms, retailers are actually behind on their profit margins compared to last year. In-person shopping was relatively muted, according to Adobe Analytics. I expect consumer discretionary names to have 1-2 more challenging quarters before any meaningful rebound in business fundamentals, and therefore the stock prices.

My Quick Conclusion: As we head into the final 30 days of the year, I believe it's likely that the S&P 500 will remain range bound between the 3700 and 4100 region, with slight offshoots that occur temporarily here and there. Powell's recent speech on smaller rate hikes is welcome, but this isn't exactly new information, and the index is simply positioning at the upper end of the range I stated.

The reason that I believe we will defend 3700 on the S&P 500 by year end is that this was the level that formed value for several sessions before the cooler-than-expected inflation report from October. Assuming that Inflation CPI does not return above 8%+ for the November report, I don't see us revisiting 2022 Lows in December. Can we get to 3700 on a large sell off? Sure, but at this point, that's

a 6-7% drawdown in 30 days, and would represent a bounce area for investors who want to tactically target that area. Any lower lows beneath 3500 will happen in 2023, and not so much in December.

What we should not fear are large impulsive sell-offs that happen in a short period of time. We should be far more worried about slow, painful grinds down to lower lows. The first type of price action represents institutions overreacting to a catalyst event, which is usually later reversed.

The second type of price action is representative of aggregate institutions selling into the rallies and having retail investors provide all the liquidity. These market reversals are the best signs that deeper troubles loom. In the past 2 weeks, we fortunately have not seen this type of price action.

In early 2023, if we see price action that is constantly characterized by rallies in the morning followed by selloffs in the afternoon, use the rallies as an opportunity to reduce risk and ensure that your portfolio is not incurring margin interest if you use margin. These market patterns are a MUST watch for a sign that the selloff is about to get worse.

Margin rates are ~10% now on most brokerages (with the exception of Interactive Brokers), and this makes leveraged investing a losing battle in this environment.

On Inflation & Macro

Generally speaking, with core items within headline inflation such as Housing, Auto, and Energy coming down, I would personally be surprised if we saw a large shock to inflation on the upside for the November CPI report.

I am of course monitoring inflation volatility, but with Energy Oil Prices trading below 80/bbl for most of November and Housing Data largely soft, I would rate the probability of November CPI data showing a CPI print above 8% to be less than 50%.

Here are some S&P 500 levels that I have in the back of my mind in terms of scenario analysis:

- Base Case: A CPI reading of 7-7.5% will likely price the S&P 500 to be around the 3900-4050 range
- Bear Case: A CPI reading of above 8% will price the SPX below 3800 in my opinion (the price range before October CPI)
- Bull case: A CPI reading below 7% could send the S&P 500 to ~4070-4200, a key supply zone level (where many institutional limit sell orders are in place) that has not been tested in the last 6 months.

Should we test the upper end of the bull case, I will be reducing positions because while a < 7% reading is encouraging, I believe the 6-7% CPI region is where the inflation data may bump up and down - resulting in markets erratically reacting to every hint of inflation volatility.

Conclusion on Inflation:

- With macro conditions as they are today, the biggest pain point for inflation is the Food Component and Energy prices. Most other components should be trending downward. Or at least be stable.
- Inflation should see mostly a downward trend from the 8% to 7% region.
- Inflation will likely see choppiness in the 7% to 6% region, meaning that CPI could fall from say 7% to 6.5% in one month, only to then bounce back to 6.8%
- I view the Fed doing a clear pause communicated to the markets once CPI is projected to be trending towards ~5%.
- With the way CPI is calculated and my view on its weighting components, I view 4-5.5% inflation to persist for a very long time, and do not believe that the Fed's target of 2% will be achieved anytime soon. They know this as well, and so does the Bond Market (as we can see from the pause in the Bond Market Selloff. TLT ETF has stabilized).

With inflation now structurally higher, my research has a hard time supporting the case to rally back to all time highs from a fundamental standpoint.

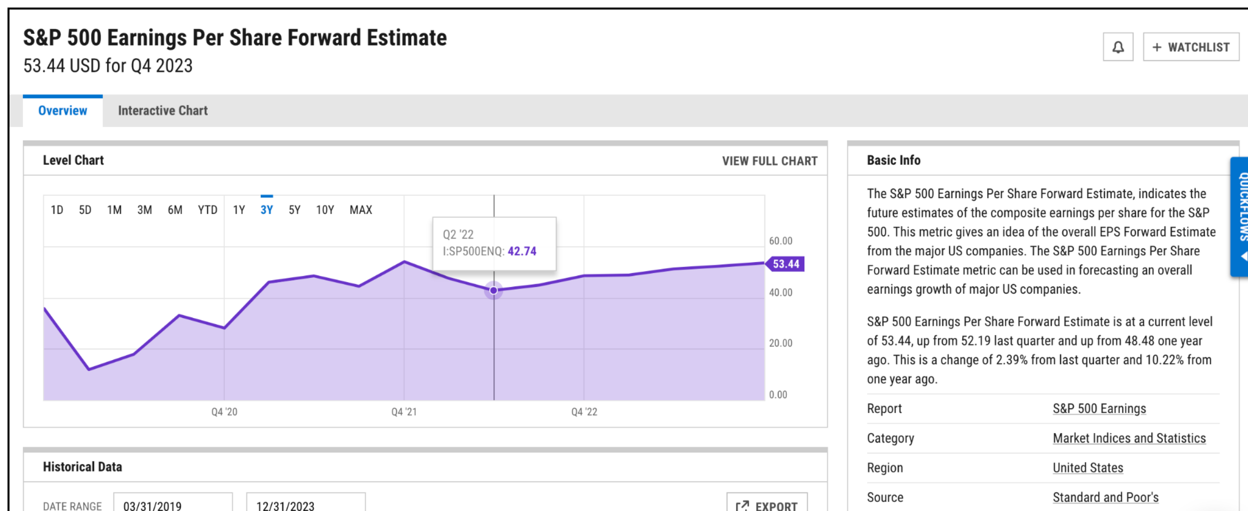
The biggest card that Bulls have right now is investor positioning, where investors have low equity exposure and cash is ample on the sidelines.

Outside of Investor Positioning, my investment framework finds very little evidence that the S&P 500 can be sustained durably above an 18X+ forward multiple (which is equivalent to 4100+ and a valuation premium relative to historical norms of 16X forward).

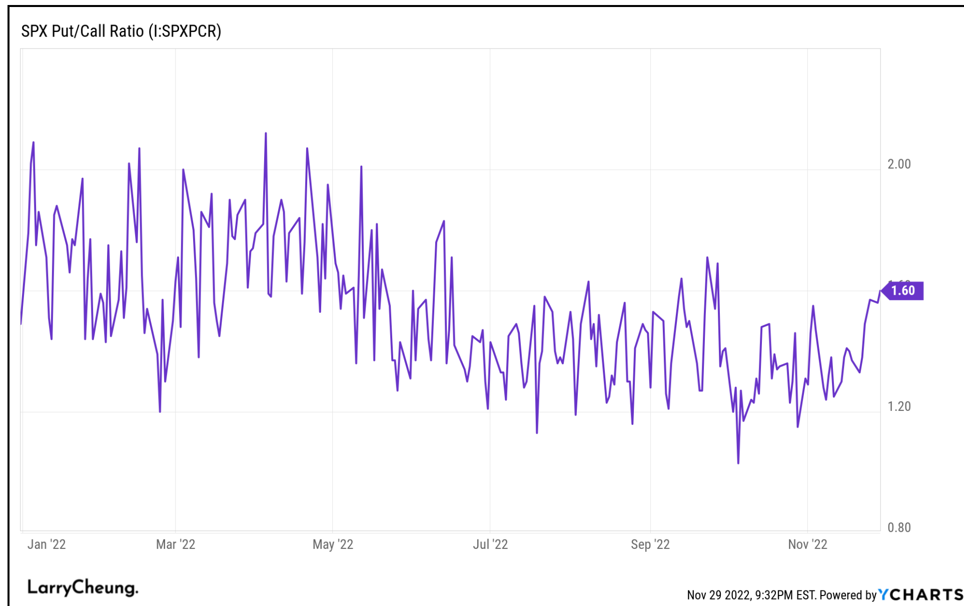
<u>A brief overview of the 3 Framework Components that I use:</u>

- **Fundamentals (Bearish):** Analyst estimates for the S&P 500 suggest that fundamentals bottomed in Q2 2022. I'm not sure I agree with this assessment as some analysts still have put price targets on hyper-growth companies like Zoom or Coinbase materially higher than their current levels, and have constantly needed to revise downward. Additionally, the leading FAAMG Companies and their layoff activity does not suggest that the earnings recession bottomed in Q2 2022. If anything, I think Wall St. Analysts are still too optimistic about their

projections and relying too heavily on management guidance, which in itself has an inherent optimistic bias.



- **Technicals (Somewhat positive):** The recent bear market rally has shaken out a lot of new Bears who entered short in the 3600-3800 region where the high Put Call Ratio in October failed to properly pay out Bearish speculators. With the S&P 500 Put Call Ratio elevated again, investors are bracing for higher volatility. If Sellers are unable to drive down the S&P 500, the natural decay of the Put Options (bets against the market) will incrementally add pressure to close these positions. Activity from Institutions that close these Put Options will potentially drive stability into the market, solidifying the current range I stated above (3700-4000 with a +/-1.5% room for variance) for the rest of 2022. Any new range durable breakouts or breakdowns will most likely happen in 2023, not in 2022.



- Macro (Mostly negative for the U.S.): Inflation CPI may be on its way down, but another issue is lurking, and that is the "amount" of time that rates will stay higher for longer. In Wall Street DCF (Discounted Cash Flow) models for the companies that the Investment Banks cover, the discount rate (also known as WACC - Weighted Average Cost of Capital) will stay elevated for longer due to a higher terminal Fed Funds Rate, which lowers future cash flow projections. This will therefore hold down equity prices for longer on a structural standpoint (bear market rallies can occur - but how sustainable are they?). On top of this, higher rates for longer will result in slower growth projections in these DCF models. These Wall Street Models tend to be very sensitive to a few key inputs, with revenue growth rates and WACC being among some of the more important areas.
    - Note: Financial modeling and DCFs are areas that I will make a separate course/program on outside our Community in the future in 2023 when I have the capacity to do so. I do not cover DCFs in our Community because it is a bit too advanced for folks who have not had the training, and difficult to apply appropriately unless you know how to build the model from scratch.

With the U.S. consumer structurally impacted by higher credit card balances and more expensive mortgages, I view any significant U.S. rally as an opportunity to lower equity exposure. Any market participant who becomes impatient and decides to get more aggressive in the hopes of a significant and durable breakout will be disappointed, in my opinion. In the meantime, I will continue to alert you to significant tactical bounce opportunities when they occur. But the structural picture is still challenged.

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HOUSEHOLD DEBT AND CREDIT REPORT (Q3 2022)

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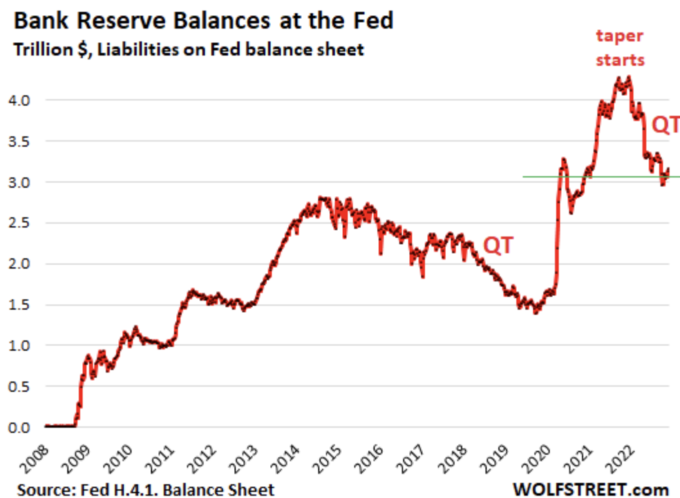
Household Debt Rises to $16.51 Trillion on Higher Mortgage, Credit Card Balances
Total household debt rose by $351 billion, or 2.2 percent, to reach $16.51 trillion in the third quarter of 2022, according to the latest Quarterly Report on Household Debt and Credit. Mortgage balances—the largest component of household debt—climbed by $282 billion and stood at $11.67 trillion at the end of September. The 15 percent year-over-year increase in credit card balances marked the largest in more than twenty years. The share of current debt transitioning into delinquency increased for nearly all debt types, following two years of historically low delinquency transitions.

For more details:
Report: Q3 2022
Blog: Balances Are on the Rise--So Who Is Taking on More Credit Card Debt?
Press Release: Total Household Debt Reaches $16.51 Trillion in Q3 2022; Mortgage and Auto Loan Originations Decline

The full effects of Quantitative Tightening have not yet played its full course in stocks, and this slow drain in liquidity is an area of high-risk in 2023. I will continue to monitor the situation.



To reiterate, I believe that we could see a December multi-week timeframe of stability and possibly an advance from today's levels. Upon any large advance close to the 4070-4200+ region without any change in Fed policy, I will be using this opportunity to reduce my equity positioning relative to my net worth. In other words, I am ready to sell a technical rally. If the rally is fundamental/macro based, I'll hold. I'm not going to be doing any buying at all north of 4100. I've said this repeatedly, but I'll say it again - there is very little fundamental margin of safety for the S&P 500 trading at 18X forward when Inflation CPI is north of 7% and Fed Funds Rates set to be higher for longer.

I believe that negative earnings revisions in Q1 2023 will start to be priced in January-February. When the revisions kick in, it will be very difficult for most market participants (largely retail investors) to get out of the market at a price they like in a timely fashion. In other words, sell-offs may start to emerge in 2023 seemingly out of nowhere, and retail investors will not be able to exit at favorable prices.

Of course this is my opinion, but this is also my plan, and this is how I will invest during this period of time. Please ensure that you are doing your own due diligence, and that my research is simply one data point in your overall decision making.

Top Forward-Looking Actionable Ideas in this environment:

- As markets grind higher in December (if they do), I will be increasing my cash level relative to my net worth. The time to buy was back in October/November when my tone/language in my research was much more favorable. This isn't the time to add.
- Among the equities I still prefer, I believe previously guided companies with fortress balance sheets such as Berkshire Hathaway, Costco, and Microsoft keep my attention as "buy and hold" forever candidates upon better pricing from here (10-15% lower). These companies actually earn significant interest income from simply having so much cash on their balance sheet.
- I will be looking to reduce Alibaba in tranches and related names in the 95-110 share range (even though it's a loss for me) as I believe the China rally may get overextended at that point and there will be opportunities to re-enter upon a retracement. For now, I'm firmly holding China.

That's my personal plan, and it reflects that I'm hyper focused on capital preservation at this point in time based on what I see in Fundamentals, Technicals, Geopolitics and Macro.

Should the market rally blast towards all time highs, I will still have significant sums in the market - it's just that it's a lower % of my overall net worth.

I ultimately believe that the best buying opportunity will come in 2023, and today as we speak is Not the ultimate buying opportunity yet.

Any market participant who feels FOMO and wishes to buy the market on leverage on a breakout must resist these feelings and emotions. The media will do what they can to paint a rosy picture if the SPX hits 4070-4200+.

Those who cave in to these feelings of FOMO will likely regret it in 2023.

The unemployment rate in the U.S. is going up, not down.

Consumer spending has not yet reflected the forward looking direction of the unemployment rate.

And Consumer spending is 70% of the U.S. GDP.

Keep your equity positions for now, but a longer period of terminally high fed funds rates will be a force of gravity that will weigh down on stocks once we get to certain levels.

On China: A series of macro updates on Zero Covid reaffirm my personal stance to have positioned 70/30 (U.S. / China). I am comfortable with my allocation, and I will not be increasing my China exposure beyond 70/30 (U.S. / China).

(If you're new to my Community, make sure to read my previous 2-3 reports on China to understand the context and my thought process leading up to this one)

The Chinese government is singing a different chorus on their message for Zero Covid since my last Bi-Weekly report - in a positive way.

We are seeing signs of attractive valuation starting to play its hand in the Chinese Internet Sector and one powerful example is that Pinduoduo (PDD) saw its shares skyrocket after the company beat low revenue and profit expectations.

PDD has been a small position in my retirement 401K for quite some time - I don't discuss this company much because its volatility is quite unsuitable for our general community here, in my opinion. Peak to trough, PDD traded from 190 all the way down to 25 before bouncing back to ~80. This type of volatility is simply unacceptable for most retail investors, and even intermediate-term Analysts like myself who have spent significant time studying the Chinese Internet sector will not be able to spot the right entry or exit points with great precision on names like PDD which have large gap ups and downs depending on the economic climate.

PDD does in fact challenge Alibaba's market share in E-commerce now, but their growth projections are often very difficult to properly estimate with the constantly changing business

environment in China. I've reviewed PDD's earnings transcript, and management has stated that they don't believe that this past quarter's profitability will likely be sustained given that the company needs to continue to heavily reinvest in its R&D.

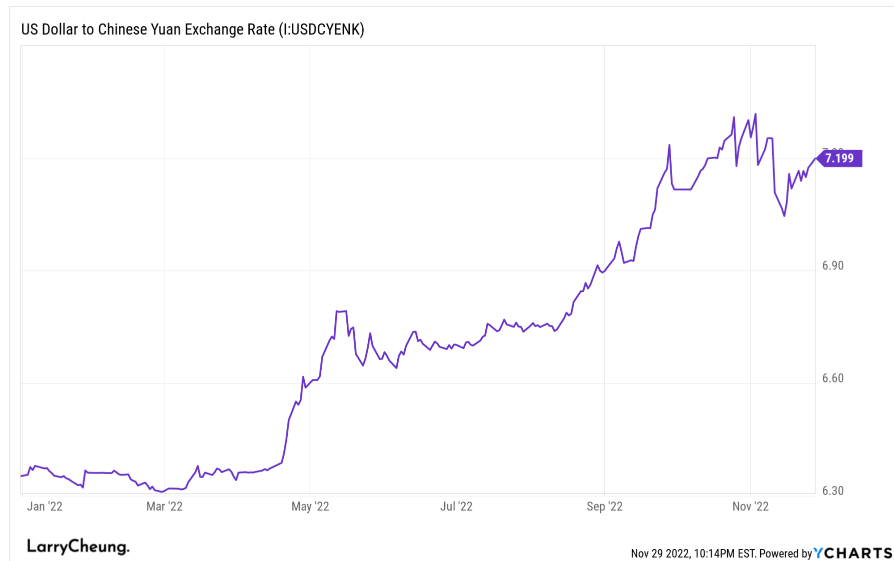
Any significant further advance for PDD from today's ~80/share level is likely momentum driven, and is not necessarily a reflection of the company's realistic fundamental outlook in the coming quarters. The company now trades at 26X P/E and the margin of safety is thinning as we march higher. Alibaba's valuation is much more friendly.

That said, Pinduoduo is a reminder of what can happen to Alibaba, JD, Tencent, and KWEB once things brighten up from a fundamental standpoint. I continue to favor TCOM, BABA, JD TCTZF, and KWEB over the more volatile PDD.

In another sign of supportive macro development, China's People's Bank of China (PBOC) has once again cut the Banks Reserve Requirement Ratio (RRR) by .25%, which now makes weighted average RRR to be 7.8% across the banking system. This is a quasi-form of QE that is designed to help provide more liquidity across the financial system.

While this is encouraging, we need to temper our expectations with how far the PBOC can cut the RRR given that significant cuts in the RRR can weaken the Chinese Yuan, the same way how the U.S. Fed cutting rates will weaken the Dollar.

With the Chinese Yuan now trading at roughly 7.2 RMB to 1 USD, I believe the PBOC will have to be much more delicate with their handling of rate cuts if they wish to lessen the effects of currency devaluation.



China's recently stated vaccination strategy for the elderly population is likely to lower the "market risk premium" across the Chinese Internet Sector as perception of significant risks to the business environment is slowly and incrementally improving. For the valuation models that Onshore China Traders and the Foreign Investors use, this news development is likely to lower the discount rate or the "weighted average cost of capital" (the WACC) as the market risk premium is quite a significant component of this calculation.

I've included a brief description of what market risk premium means in this context.

How is risk premium calculated in WACC?

The market risk premium can be calculated by **subtracting the risk-free rate from the expected equity market return**, providing a quantitative measure of the extra return demanded by market participants for the increased risk.

https://www.investopedia.com › ... › Fundamental Analysis

What Is Market Risk Premium? Explanation and Use in Investing

The last item I will discuss surrounding China is U.S. companies that have strong dependence on China for its business model, namely Apple given its significant importance in the 3 U.S. indices and the dependence of the semiconductor ecosystem on Apple's health.

The recent supply chain disruption at Foxconn manufacturing site highlights how dependent Apple has become on its China infrastructure. Analysts estimate that the covid disruptions at Foxconn could make the company miss its production targets and be in a deficit for up to 6 million iPhone pros.

In other words, to make it simpler to understand, that means the semiconductor ecosystem that was supposed to support and source the inputs for those 6 million additional iPhone Units will now potentially have to be revised out of revenue projections.

To inflame worries further, Foxconn (formal name Hon Hai Precision Industry) is a Taiwanese multinational manufacturer that has angered Beijing with its treatment of Chinese workers in the past. Many analysts who consider the political angle of the Zero Covid disruptions of the Foxconn plants and the subsequent employee walk-outs may speculate that there may be consequences from Beijing for how Hon Hai managed the recent employee protest situation. Whether that will happen remains to be seen, but what is clear so far is that Hon Hai is likely to have its margins squeezed as it has promised to pay its 200,000 workers bonuses to continue working. This is a promise that I'm nearly certain that the Chinese government will be monitoring to see if Hon Hai follows through.

This means that Apple's most important supplier in China may be under greater scrutiny from the central government. This matters because it is nearly impossible for Apple to redevelop its supply chain infrastructure in nearby regions like Vietnam or India in a short period of time. *At the minimum*, it would take several quarters to recreate its supply chain efficiency in other geographies outside of China.

For this reason, given the amount of clout that Apple has on the S&P 500, and the semiconductor ecosystem that depends on Apple, I believe China watchers should be more concerned about Apple than say Alibaba.

China is 20% of Apple's total revenue, and I personally believe that the company's growth potential/prospects in China represents a meaningful portion of Apple's premium valuation in the market. Supply chain disruptions at Foxconn (Hon Hai) will force analysts to do several things:

- Lower the growth projection in the China geography revenue segment
- Increase the market risk premium associated with its China business
- Overall Discount Rate (WACC) will likely rise
- Assign a lower terminal value to Apple based on a smaller EBITDA multiple
- Production unit forecasts are likely to fall, which in turn will make analysts cut revenue estimates in subsequent quarters.

Apple trades at 23X Forward P/E (140/share), but this valuation multiple is questionable if its growth premium is reduced due to their current supply chain production issues in China.

Bottom Line: The Zero Covid situation in China is likely to affect the S&P 500 more than you think. Because of Apple and the ecosystem of semiconductors that depend on it.

Unless Foxconn's supply chain issues go away, any significant rally in Apple is likely technical in nature and not a reason to buy the company. Purchasing Apple today is essentially a view that Foxconn's working conditions will resume back to normality when most of its workforce is very upset over working conditions.

I'm interested in owning Apple again at some point at significantly better prices. I believe I'll have that chance in 2023.

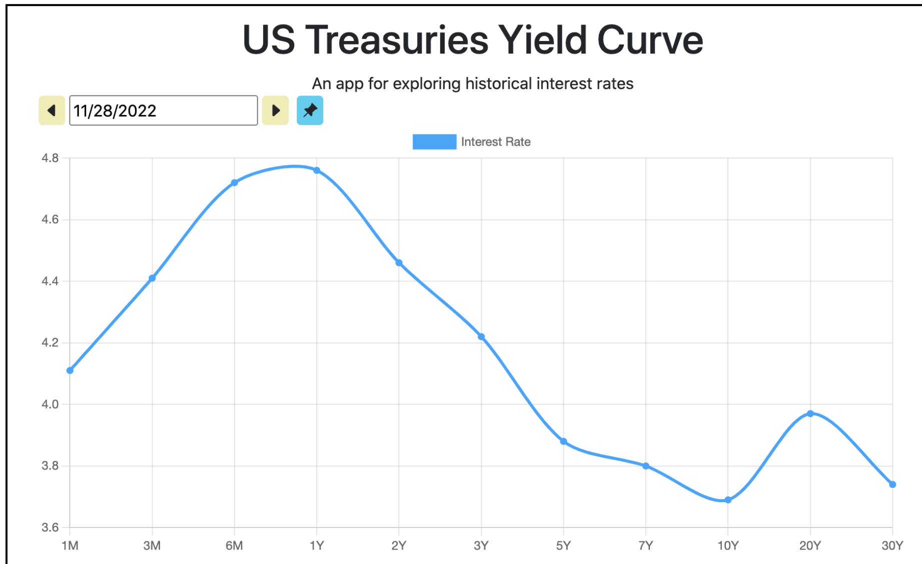
Final Note: I am spending a significant amount of time learning and applying new powerful analyst and portfolio management strategies in the background. I believe 2023 will be a year of great challenges, and I am rapidly building expertise on new areas relating to investments. More commentary on this in the future.

My next mid-December research note will likely be shorter and concise given that trading volumes will likely be lighter during the holiday season. If anything critical comes up, I'll write a Patreon or private Substack post on it.

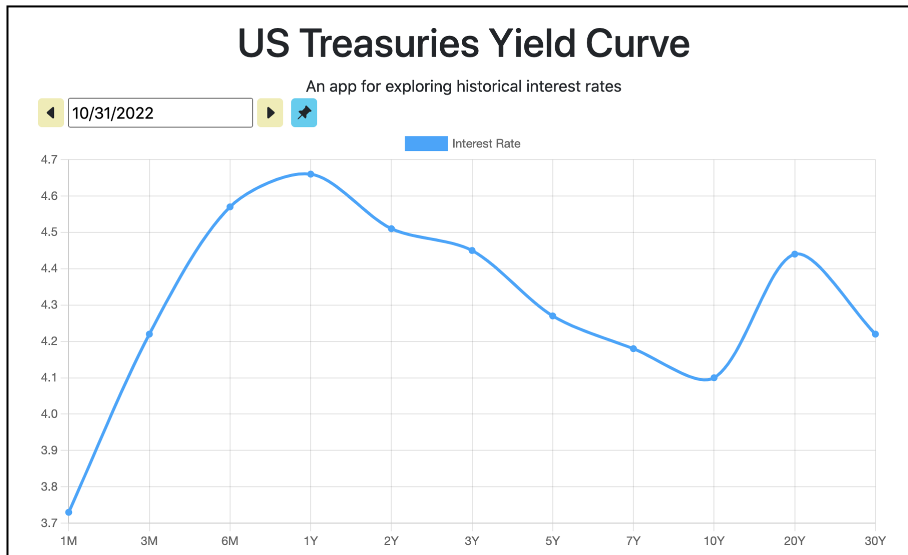
Enjoy your holiday season
-Larry

Appendix

Yield Curve Today



Yield Curve in late October



Yield Curve in Late September