THE STOCKMAN *letter*

10 STOCKS TO DUMP NOW

Before Sundown in America

By David Stockman

Even the Keynesians in the Eccles Building have finally recognized that their money-printing gig is up.

The Federal Reserve has to reload dry powder with all deliberate haste before the next crisis of its own making hits.

Without the ability to pose as the economic savior in the event of a recessionary purge of the decades of rot that has built up in the U.S. economy, the Fed's enormous power to control the Main Street economy through a crooked Wall Street financial system could be fatally jeopardized.

In a word, institutional self-preservation is the real reason for the Fed's abrupt pivot to "quantitative tightening" after decades of "easy money."

It means the Fed is draining cash from the bond market at a $600 billion annual rate as of October 2018.

Permabulls used to say, "Don't sweat it. We know it's coming." You'd hear whole herds of them on Bubblevision, every day.

"It" is the Federal Reserve's normalization campaign. It promised surging yields.

Now, they're here…

Rising market yields mean higher interest expense for the S&P 500.

And it's happening in the late stages of the second-longest period of uninterrupted growth in history.

There's an important truth embedded in all this "priced in" chatter.

It's more proof that the Fed's heavy-handed monetary central planning has completely destroyed honest price discovery.

Stocks levitated on momentum and "technicals," as gamblers extrapolated the very short-run past into the indefinite and endless future.

Were Wall Street really in the business of discounting the future, we wouldn't have seen record high after new record for the major equity indexes all the way into late September.

Wall Street is only now beginning to discount rising yields.

And there's only the remotest sense at all that a recession will ever hit earnings numbers in the relevant future.

In 2016, the yield on the benchmark 10-year U.S. Treasury note averaged 1.84%. After-tax interest expense for companies in the S&P 500 Index was $16.50.

The yield on the 10-year Treasury note is around 3.15% in the early fall of 2018. That's an increase of more than 70% in a little more than a calendar year.

At just 3%, after-tax interest expense would be about $31 per share. That's about 69% higher than in 2016.

If we take Jamie Dimon's genius at face value, the benchmark yield is heading for 4% or beyond. Then interest expense would be about $42 per share.

Now, let's talk about our "yield shock" scenario. It's not exactly crazy. It's actually quite logical.

It's what happens after federal deficits explode and central banks pivot to "quantitative tightening" *en masse*.

And it translates to 4.75% yield on the 10-year U.S. Treasury note.

Remember, we've also seen a massive corporate borrowing binge of the past seven years.

All told, after-tax interest expense would triple relative to 2016 to about $50 per share.

Between 2014 and 2017, it was basically flat. And S&P 500 earnings grew from $102 per share to $110 per share. That's just 2.3% per year.

Let's be generous. Let's say this cycle makes it to an all-time record of 130 months. That would beat the 119-month 1990s-era expansion.

It would still take a volcanic eruption of economic activity to offset baked-in higher interest costs.

Our generous assumption does imply the next recession will hit by early 2020.

Even a modest downturn will take $40 out of the $117 per share of earnings reported for the 12 months ended March 31, 2018, by S&P 500 companies.

Accounting for higher interest costs, we're looking at S&P 500 earnings of less than $65 per share in 2020.

The S&P 500 is now priced about 42 times that. The long-term average price-to-earnings ratio is 15.7.

Even a current valuation of 24 times trailing-12-month earnings makes no sense.

We're in the second-longest economic expansion in history. We face a roaring headwind of rising interest expense.

And Wall Street, aided and abetted by Imperial Washington, still carries on like there's no tomorrow.

Part I:
The New School

The average stock is overvalued – somewhere between tremendously and enormously. If you don't know whether "enormously" is greater than "tremendously" or vice versa, don't worry, I don't know either.

But this is my point exactly: When an asset class is significantly overvalued and continues to get overvalued, quantifying its overvaluation brings little value.

There's no better proof than the absurd run of the FANGMAN stocks that drove the Nasdaq 100 to within tenths of percentage points of new all-time highs as recently as the first week of October 2018.

Meet FANGMAN

That's **Facebook (NYSE: FB)**, **Amazon (Nasdaq: AMZN)**, **Netflix (Nasdaq: NFLX)**, **Google/Alphabet (Nasdaq: GOOGL)**, **Microsoft (Nasdaq: MSFT)**, **Apple (Nasdaq: AAPL)**, and **NVIDIA (Nasadaq: NVDA)**.

Each one of these seven stocks is still wildly overvalued, for slightly differing reasons.

But, taken together, they epitomize an utterly false narrative.

This booming tech sector does not reflect organic, sustainable "growth." Current valuation multiples are not well justified.

The "growth" in question isn't even all that impressive.

And it certainly doesn't come close to justifying the $4.6 trillion of market cap affixed to these poster boys for the Federal Reserve's third great bubble of the last 20 years.

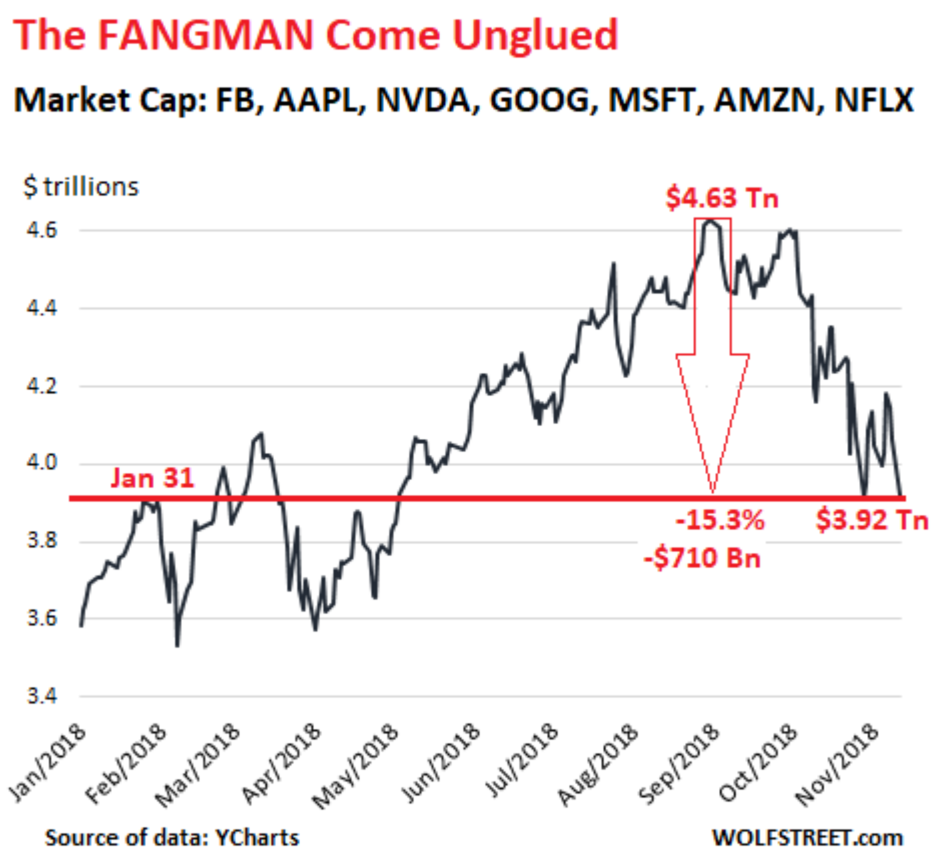
The FANGMAN stocks more than doubled in value from February 2016 through the summer of 2018. And they quadrupled since June 2013.

Yet their 100% gain in market cap over the 29 months ended in August 2018 was accompanied by only a 13% gain in operating free cash flow.

Likewise, the 30% per year gain in market cap since June 2013 was generated at a time when free cash flow grew at barely 10% per year.

A valuation growth rate three times the growth rate of actual free cash flow is not a sustainable equation.

It's evidence of rampant momentum chasing.



The FANGMAN companies are already huge.

Their respective technologies and product lines are mature. Indeed, most of them are embedded in the very culture. So, their market positions are indeed solid.

But there simply isn't enough "blue sky" available to justify what we might call "prepaid market cap."

That's rewarding them right now in the hope they'll eventually grow into today's elephantine valuations.

Accordingly, their current free cash flow multiples are downright absurd.

As a group, FANGMAN is trading at more than 30 times free cash flow. If you exclude the giant cash flows of Apple, it's more like 40 times.

Sooner or later, equity values depend upon free cash flow.

And these companies can't possibly grow at anything close to the rates implicit in their current cash flow multiples.

For instance, the group's huge combined sales of $720 billion through June 2018 increased at just a 13.7% annual rate since June 2013.

But even that's sustainable on the pure math of it.

Ten more years of that growth rate would result in $2.6 trillion of sales, and 20 years would generate nearly $10 trillion.

That's an arithmetical reminder that neither trees nor even great companies can grow to the sky.

Their free cash flow margin is a healthy 18.7% at present. But, as happens with all maturing companies, that margin has eroded from 22.1% five years ago.

FANGMAN's sales growth rate will soon bend toward the trend of nominal GDP growth, around 4.0% per year. And margins have already topped out.

There's simply no prospect of "growing" into multiples of 30 or 40 times free cash flow.

That assumes, of course, that there's any real bite to FANGMAN anyway.

Behemoth and Leviathan

Consider Amazon.

It's the poster child of profitless growth. And now it's planning two "HQ2" outposts, one inside Imperial Washington's famous beltway, the other just a subway's ride from Wall Street.

In mid-2018, AMZN was valued at 156 times its meager free cash flow of just $5.4 billion for the 12 months ended March 31, 2018.

Of course, there's nothing to debate about a 26-year old company with $193 billion in sales that absolutely has not and cannot generate any measurable free cash flow.

It's a runaway sales growth predator that's been enabled by the Federal Reserve's Bubble Finance regime.

Indeed, it’s plain as day that the only profitable part of Amazon is its cloud business, which allegedly makes AMZN a tech company. But that’s exactly the skunk in the woodpile.

When you set aside the AWS cloud business’s sales and operating income for 2017, Amazon’s e-Commerce business generated $160 billion of sales. But it posted operating income of negative $200 million.

That’s right. The monster of the retail midway posted no profit whatsoever last year…

Stripped of all its techno-fan-boy-gilding, AWS is just a giant, capital intensive server farm.

Pure and simple, there’s no way to pretend that Amazon’s valuation is the work of a functioning capital market or any other process that’s remotely rational.

Is It Even “Tech”? And Is It Really “Growth”?

The death of two-way markets is no less apparent in the other two “growth” champions of the FANGMAN set.

That’s Facebook and Google, of course. The problem here too is that their towering market caps stem from free cash multiples that can’t possibly be sustained.

At the end of the day, both companies are digital world billboards that employ some fancy technology behind the ads that flash on top of your screens.

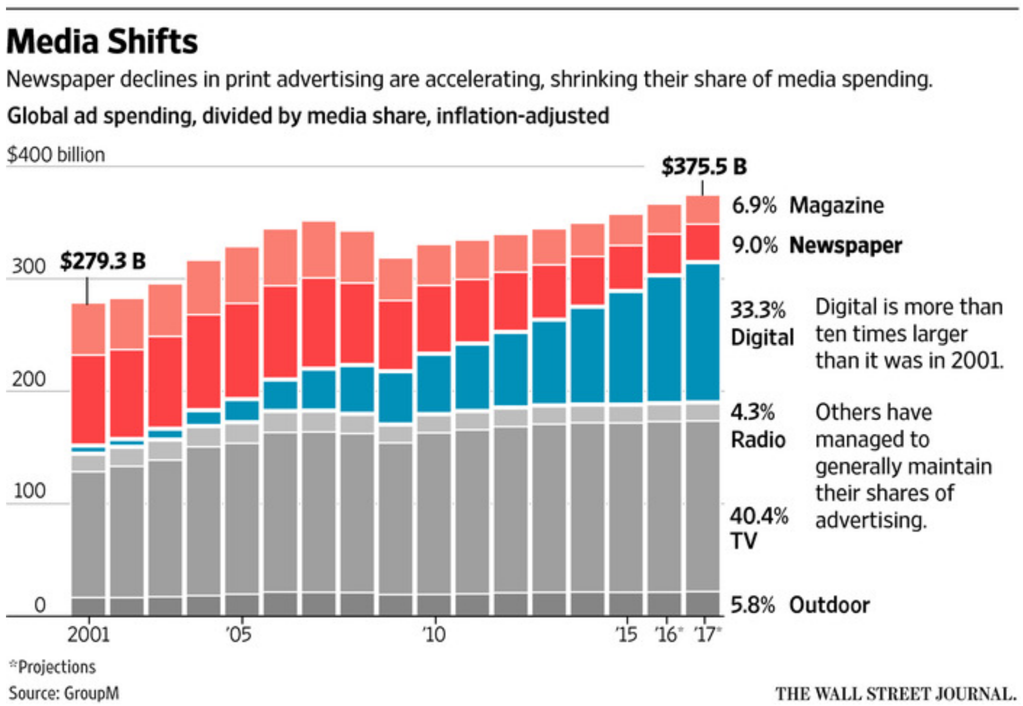
Either their growth arcs will soon bend to the mundane curve of the advertising industry or they must totally change their revenue model to one of subscriptions or other forms of sales.

In that case, all bets are off.

FB and GOOGL soared owing to a one-time shift in ad venues that’s now passed into substantial maturity. Accordingly, their free cash flow multiples are utterly unsustainable.

More importantly, they’re completely misidentified as high-growth tech companies.

They simply won the digital ad lottery by being early, innovative, and persistent. And they can't possibly grow into the combined $1.5 trillion of market cap being award by today's unhinged market.



Netflix is another Amazon – absurdly valued at an infinite multiple of free cash flow.

From 2016 through the summer of 2018, its market cap quadrupled.

Its free cash flow more than quadrupled too: That is, it went from negative $425 million per year to negative $1.8 billion for the 12 months ended March 31, 2018.

In this case the pure mania isn't even ill-disguised by claims of impenetrable moats or quasi-monopoly. Amazon's own massive foray into content could alone keep Netflix in the red as far as the eye can see.

And that's to say nothing of the rest of the entertainment industry that's barging into the "over the top" on-demand space...

The ultimate case of growth that isn't lies in a recycled high-flyer from Tech Bubble 1.0. During the last five years, Microsoft's free cash flow growth rate has been just 6.2% per year.

That's par for the course for an aging big cap giant of the tech sector.

But its market cap has risen by nearly 200%.

Indeed, Mr. Softy got re-adopted by the momentum crowd in the late stages of the current bubble.

Accordingly, its age- and performance-appropriate free cash flow multiple of around 10 times soared to 25 times.

Needless to say, the home-gamers who got lured back into this bubble trap for the second time will most surely not enjoy the trip home.

Apple, of course, is headlining Bubblevision's coverage of the Post-Midterm Election Selloff of 2018 on Bubblevision. It's down more than 20% from its peak, signaling the stock's "officially" in bear/correction territory.

And, at last check, NVIDIA was taking a 17% swan dive in the after-hours on a mid-November evening, putting more touches on a slide from $289 on October 1 to $168 as of right now…

Part II:
The Old School

During the late, late stages of what will be known as the Trump Bubble, Wall Street turned to reliable stalwarts with massive "moats" of their own that have survived the test of time.

Here are three names you'll recognize because you fly in their aircraft, eat their food, and immerse yourselves in their content… That doesn't mean you should allocate capital to them at these levels.

And when these roll over – the names that have led the last leg up in the biggest bubble of all time – it's time to find cover…

Grounded

Bubblevision called it a "blowout" quarter when **Boeing (NYSE: BA)** reported third-quarter 2018 results.

When I checked the company's press release – and then re-checked it – I found that pre-tax earnings during three months ended September 30 were $2.133 billion. I looked twice because Boeing reported pre-tax earnings of $2.583 billion during the comparable quarter of 2017.

So, what passes for "blowout" on Bubblevision these days is a 17.4% slide on the line of the income statement that best reflects business performance.

The "headline" number was $4.07 per share of net income, which does indeed represent a robust and impressive 36.1% increase over the $2.99 posted last year.

So, sure, let's give it up for Boeing's far-flung defense, aerospace, and commercial aviation businesses and its 141,000 employees. But let's not forget the lawyers and the accountants.

Last year, Boeing provisioned for a tax in the amount of $773 million, representing a 30% tax rate. That more or less was right down the fairway of the allegedly onerous pre-Trump tax regime.

This year, the tax "provision" was, well, actually a positive $230 million.

That $1 billion tax swing transformed Boeing's punk pre-tax earnings into $2.363 billion of consolidated profit – exactly 30% more than last year's $1.810 billion of after-tax net income.

On top of that, Boeing bought back 26 million shares from September 2017 through September 2018, bringing the overall gain to 36% on a per share basis.

And that's the way we shuffle.

When Boeing reported third-quarter 2017 earnings, its market cap was $154.43 billion. Today, it's up to $210.51 billion – on fundamentally worsening numbers.

So, maybe there's some "noise" in the net income.

Let's take a look at free cash flow, or what's better known these days as "buyback fuel." That's why they back up the trucks on Wall Street these days.

Well, Boeing posted operating free cash flow of $11.3 billion for the 12 months ended September 30, 2017. And it was priced at 22.6 times that free cash flow.

This is, of course, the mother of all cyclical stocks. And last fall is starting to look more and more like the cyclical peak.

That's to say nothing of the fact that Boeing's biggest growth market is China, and, as you know, we're starting a Trade War with the Middle Kingdom…

So, during the third quarter of 2018, Boeing posted free cash flow of $13.5 billion. That's a 19.4% increase.

I question, however, whether it supports an increase in Boeing's free-cash-flow multiple to 26.1 times. Especially when this is about as good as it will likely get.

The Mother of All Yield Shocks is going to have a massive impact on defense budgets.

And Boeing is going to feel it.

"Mickey Mouse" Is an Adjective, Too

Bob Iger had to hit a home run with his turn at the "direct-to-consumer" bat.

Given the content properties he brought to the plate, he couldn't help but land on second.

And that's just about what he did.

Disney (NYSE: DIS) reported earnings on November 8, 2018. And it introduced "Disney+" to the world.

I'd say neither is worth the 2% bounce the stock price saw in the overnight market following the press release and conference call.

Then again, DIS had already pushed out to new highs at the forefront of the market's post-Midterm Meltdown relief rally.

So, it was more senseless market cap expansion after more senseless market cap expansion…

DIS had pushed out to new highs in anticipation of its Netflix competitor. It also benefitted as investors sought some familiarity amid the October 2018 Midterm Meltdown.

But it's like one of those roller-coasters at its theme parks: There's a deep dive dead ahead, only we can't see when or which way this one turns…

Disney did report record annual revenue for its fiscal 2018, and reported net income was up 33%. Management reported solid progress on the integration of the recently acquired 21st Century Fox assets.

There aren't many catalysts left for Disney, but there are plenty of open questions, No. 1 among them the impact of "cord cutting" on the bottom line.

ESPN is already shedding bloat. Nobody wants to pay anymore for content they don't watch. That means its "moat" is drying up.

"Disney+" – or "Disney Plus" – is set to launch in late 2019. Netflix and its shareholders should be scared. Iger noted early signs of success for the ESPN+ plan: "We believe it bodes well for our overall, global DTC strategy."

Disney's near century of near total ubiquity helps it. But it's still hard to forecast how that competition with Netflix – and Amazon – will play out. Creating content that meets the market is a matter of shifting with already hard-to-pin-down tastes.

But it's not hard to forecast how DIS – and NFLX and AMZN – will react to the Mother of All Yield Shocks.

Where Malnourishment and Malinvestment Collide

Another “comfort” name pushing to new highs as FANGMAN and its ilk buckled?

How about **McDonald’s (NYSE: MCD)**?

Well, Mickey D’s bottomed out during the first week of March of 2018.

From there, though? Wall Street was “lovin’ it.”

MCD has run from $148 to $186 and is still holding $183 a few weeks into the first real signs of trouble the stock market’s experienced in months… years, probably…

And, yet, even its numbers are cooked up like its fries, only not so golden.

Mickey D’s is the poster boy for head fake perpetrated in late 2018 by sell-side crooks and their handmaidens in the financial press. Nearly all the ballyhooed earnings gains the company posted in recent quarters are due to currency effects, share-count changes, and favorable tax cuts.

Needless to say, you can’t capitalize those types of gains because they are non-recurring and non-sustainable.

Nevertheless, the questions recurs: When Wall Street hyperventilates about a 22% headline gains that arise from the zero growth economics evident in even a company’s own two-page press release, you’re dealing with some heavy-duty mendacity.

Indeed, the Wall Street narrative has been so completely dumbed down to grotesquely manipulated (“adjusted”), short-term headline deltas that anything that once resembled fundamental analysis was lost long ago.

Its affinity for Keynesian beer goggles has only compounded the financial myopia. That is, it sees close-up items (last quarter) in sharp focus. But most time-distant matters (one to 10 years back end up in a complete blur.

Wall Street has been conditioned to assume that economies and profits never stop growing.

That’s what monetary central planning has done.

It’s coming to an end, though.

And it’s called the Mother of All Yield Shocks.

DEEP STATE DECLASSIFIED

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