# CRYSTAL WATERS PARTNERS

## Market Outlook

March 2021

# Is Viacom Viable?

CWP experienced higher-than-usual volatility as changes in long-term interest rates continued a rotation into value stocks and a disproportionate selloff in technology and healthcare sectors, including many of our highest-quality holdings. We think the future is not an either-or choice between growth vs. value. Instead, we see a market where growth and value will rise together, but maybe not at precisely the same time. Our view remains that chasing short-term rotation misses one of the most significant transformational changes and investment opportunities currently underway in technology, energy, and healthcare. The market declines in March also saw some of our limited partners making additional investments to strengthen their positions.

In addition to our primary holdings in tech and healthcare, we look deeper at opportunities in undervalued stocks within technology, industrials, transportation, materials, communications, and consumer goods. We highlight one of these this month.

# Market Moves

The market has been going through a transition where investors moved money from growth stocks into value stocks. Initially, this looked like a typical selloff of highly priced growth stocks but has revealed itself as a rebalancing of portfolios with a mix of growth and value. Overall, this rebalancing is very healthy for the stock market. We expect to see both growth and value perform well in the coming months, which should benefit many of our holdings.

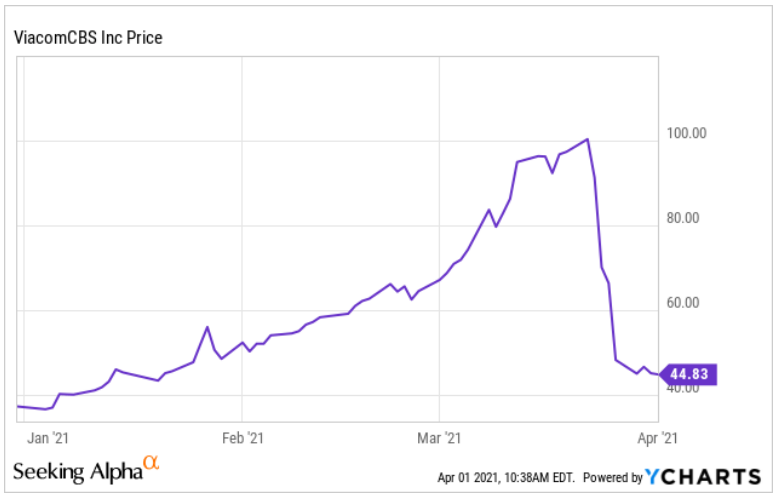
Despite many of the uncertainties in the economy right now, the market's general direction is favorable. We have been putting more cash to work than at any time before, taking advantage of lower prices. The fund has recently received new investment capital from a new limited partner as well as existing LPs. Those investments simply expand our ability to grow the fund for all LPs.

## Fund exposure to China

Crystal Waters Partners started our first long position in a Chinese company in December. We have previously been cautious due to the US-China trade war and other geopolitical dynamics. Still, we are eyeing more exciting opportunities that fit the fund's long-term focus and risk profile.

# Viacom CBS (VIAC)

- **Selloff triggered by a new stock offering**
- **Why is Viacom issuing new shares**
- **Archegos Capital Forced Selling**
- **Is Viacom Viable**




**Stock Offering Selloff**

On March 26th, ViacomCBS Inc.'s stock declined 27% as investors weighed the impact of the recently priced offerings of Class B common stock and mandatory convertible preferred stock. In the five trading sessions that followed, the stock shed 50% of its market value. When a good company experiences extreme investor selling, we look deeper.

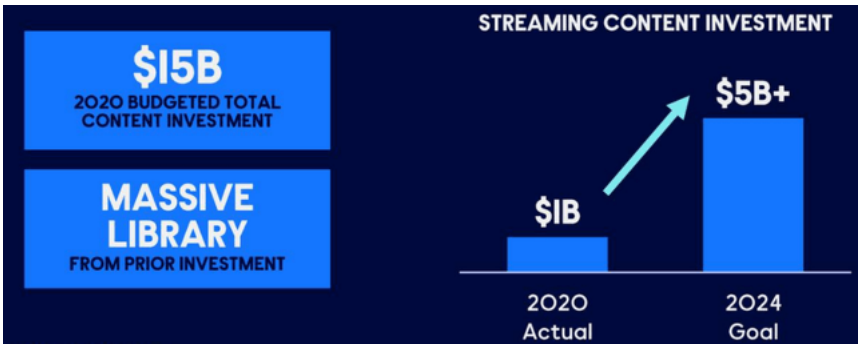
The company, on March 24, announced the pricing of 20 million Class B common shares at $85 per share and 10 million 5.75% Series A mandatory convertible preferred shares with a liquidation preference of $100 per share. The company has also granted the underwriters an option to purchase an additional 2 million shares of Class B common stock and up to 1.5 million preferred

shares within 30 days. The convertible preferred stock will convert into Class B common stock on April 1, 2024. With these offerings, the company will raise at least $2.65 billion, or as much as $3.06 billion, if underwriters decide to exercise the option to buy additional shares fully. According to company filings, the funds will be used for general corporate purposes and in streaming. We would expect some acquisitions to bolster their streaming business.

Immediately following the announcement to issue new shares, Wells Fargo downgraded the company from equal weight to underweight, with a revised target price of $59, which is well below the previous target price of $82. **That $59 price target is nearly 44% above the current trading price.**

**Why is Viacom Offering new Shares**

The stock price surged from the mid $30 range to over $100 in 2021, which presented the company with an excellent opportunity to raise a substantial amount of cash by issuing shares to raise the billions of dollars that would need to be invested in streaming services to compete with the likes of Netflix and Disney+. The graphic below tells the story, Viacom needs more than the $3 billion in cash they have on the books.




**Archegos Capital Forced Selling**

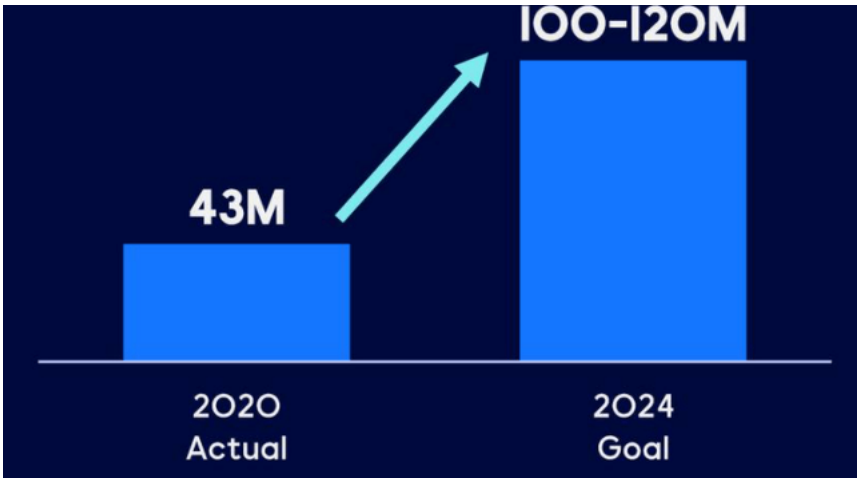
Archegos Capital, a family office run by Bill Hwang was pushed to liquidate his Viacom holdings because the new share's announcement triggered a decline that forced margin calls on his highly leveraged position in Viacom. Hwang was forced to sell more than $20b of stocks to cover all his margin calls. Goldman Sachs emailed clients to inform them it was one of the banks selling, detailing a total of $10.5b in trades, though it didn't identify Archegos or Hwang, according to Bloomberg. The Wall Street Journal began reporting $30 billion in transactions and included that Deutsche Bank was selling large blocks. We soon learned that Morgan Stanley was also involved. Hwang, who pleaded guilty to insider trading in 2012 when he worked for Tiger Asia Management, was deemed such a risk that Goldman, as recently as 2018, refused to do business with him, Bloomberg reported. The billions of dollars in block trades on Friday from Goldman Sachs and Morgan Stanley included ViacomCBS, Discovery, Baidu, and a company identified as a Chinese fraud by several short-sellers, GSX Techedu. According to the WSJ, the Archegos fund was highly levered

and had very concentrated positions in companies and held some via swaps. The fund was estimated to have had exposure to the economics of more than 10% of multiple companies' shares. For perspective, the typical home mortgage is based on an 80/20 rule of debt to equity. That's a leverage ratio of 4:1. Hwang's positions were levered roughly 4 or 5 to 1. The largest banks often carry leverage higher than 5:1. The difference is that Hwang's positions weren't protected; banks and your mortgage are protected by the underlying assets or reserves.

With Viacom's forced selling, the downgrade by Wells Fargo, and the black swan event triggered by Archegos Capitals' levered position, Viacom stock has been hammered, possibly unnecessarily. Crystal Waters is looking closely at the company to see if there is deeper value that investors underappreciate.

**Is Viacom Viable?**

ViacomCBS is one of the largest pay-TV service providers globally, and the company owns some of the most widely followed TV shows and networks. MTV is considered a leading media brand that interacts with younger audiences and reaches 450 million households in 180 countries. Nickelodeon is the number-one entertainment brand for kids with a reach of millions of households, and now in its 40th year, the brand shows tremendous staying power. Nickelodeon has built a diverse, global business by putting kids first in everything it does. In 2020, Pluto TV, the ad-supported streaming television service, reported 43 million monthly active users (MAUs), and we believe MAUs will continue to grow at a stellar pace over the next three years.




As the streaming services gain traction, we're optimistic of a significant expansion in valuation. Comparing the Last quarter to the same quarter a year ago; Net income increased by 413.9%, earnings growth of 386.36%, 38.71% is the gross profit margin, and the net profit margin of 11.78% is above the subsector average for Viacom's peers. We think Viacom may be worth about $52 per share near term but could return to its previous highs around $100 as streaming continues to grow MAU and revenues.

# Economic Outlook

**Forecast**

From a macro-view, everything has changed. We appear to be entering a new bull market and period of economic expansion that will likely last for 2 to 3 years. Our annual letter discussed our view of the market in 2021 and set a $170 year-end earnings target for the S&P 500 or 4,420 by year-end. Due to the rapid progress in vaccinations, significant improvements in productivity, accommodative interest rates, bond yields stabilizing, earlier than expected reopening, significant improvements in the jobs report, and tremendous pent-up demand for traveling and shopping, we think the S&P 500 could rally more than anticipated and potentially reach 4200 by the end of April.

**Economy**

The Institute for Supply Management (ISM) reported that the **Services PMI**, which tracks the economy's service sector, surged 8.4 percentage points in March to an all-time high at 63.7%, exceeding expectations for a 59.2% reading. For March, the **Purchasing Managers Index** report increased 3.9 percentage points to 64.7%, exceeding expectations for a move to 61.3% and marking the tenth straight month of expansion in both the manufacturing sector and the economy overall. The **ADP Employment Report** indicated that private businesses hired 517K workers in March, compared to market forecasts of 550K. While missing expectations, it is the highest increase in private payrolls in 6 months. The **Department of Labor** reported that initial jobless claims for the week ended March 27 were 719,000, increasing 61,000 from the previous week's revised level of 658,000 (down from 684,000 previously reported). The reading missed expectations for 675,000 claims. The four-week moving average for claims (used as a gauge to offset volatility in the weekly numbers) was 719,000, the lowest level since March 14, 2020 (when it was 225,000) and representing a decrease of 10,500 from the previous week's revised average of 729,500 (down from 736,000 previously reported)

**Markets**

Moving on to the S&P 500, the fourth-quarter earnings season is almost complete, with 78.5% of companies reporting a positive EPS surprise. For the fourth quarter, earnings are up roughly 4.2% year over year vs. expectations for an overall 4.1% advance throughout the season. Revenues for the S&P 500 are up 2.7% vs. expectations throughout the season for a 2.7% increase; 78.5% of companies beat EPS expectations, 17.5% missed the mark, and 4.0% were in line with consensus.

According to economists' latest projections, stocks are looking ahead to a stimulus-fueled economy that may expand by 11.7% on an annualized basis in Q2 and by 5.7% for the year as a whole. That makes 2021 potentially the strongest year for growth since 1984. Likewise, that strong GDP growth is expected to translate into stellar earnings growth for corporations. According to FactSet

estimates, profits for S&P 500 companies may surge 25% this year, exceeding pre-COVID levels. And they're expected to jump another 15% next year.

Our traditional metrics tell us that we are currently in an overvalued market but not necessarily at a euphoric top. That last point makes us look more in-depth at valuations. For a bull market to continue over long periods, we need to see real earnings improvement, and as noted above, we have that. We also want to see the transportation stocks continue to improve, and we have that as well.

The long-term, interest rate adjusted S&P 500 Price/Earnings multiple is 26. The current multiple is about 36.65, down from 38 last month. For comparison, the P/E's all-time high was 44.19 in 2000, just before the DOT COM crash; and in 2009, at the bottom of the financial crisis, it was 15. That historical perspective is instructive, but it doesn't tell us the whole story. The next gauge to look at is cash; specifically, is there cash to invest? Yes, there is a record $5 trillion in cash accounts. The third gauge to check is the Inflows/Outflows gauge. Inflows/Outflow is a way of looking at liquidity in the market and where investors are putting their money. According to FactSet's latest data, U.S. listed ETFs pulled in $245.4 billion in new cash during Q1, the largest sum ever for any quarter.

**Inflows/Outflows**

Within the quarter were three solid months, including inflows of $65.7 billion in January, $88.7 billion in February, and $90.4 billion in March. March and February now stand as the second and third-largest months for ETF inflows, respectively, behind only the $91.2 billion pulled in last November. At the current pace, 2021 inflows would approach $1 trillion by year-end, more than double the standing annual record of $476.1 billion set in 2017.

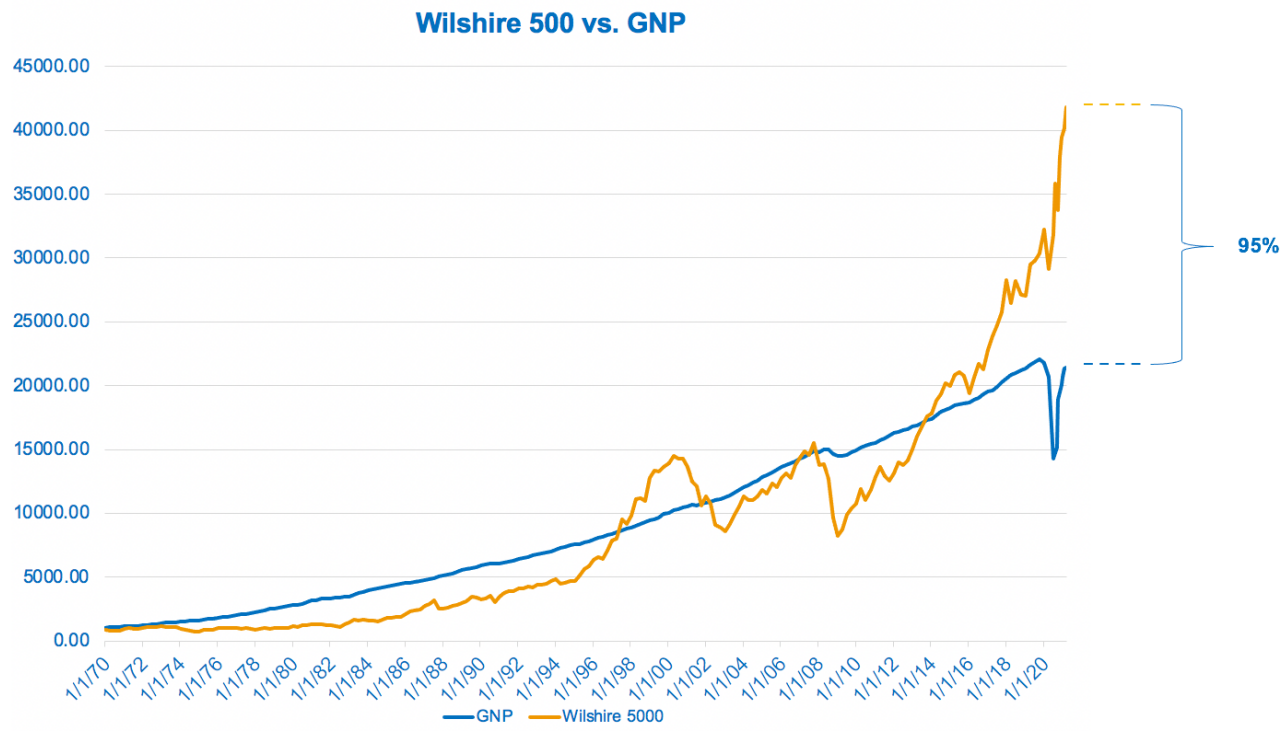
**Bonds**

The iShares 7-10 Year Treasury Bond ETF (IEF), the iShares 20+ Year Treasury Bond ETF (TLT), and the iShares Core U.S. Aggregate Bond ETF (AGG) shed 5.7%, 13.9%, and 3.4%, respectively, during the quarter. Simultaneously, the iShares iBoxx USD Investment Grade Corporate Bond ETF (LQD) and the iShares iBoxx USD High Yield Corporate Bond ETF (HYG) found themselves on the top outflows list for the year, with year-to-date redemptions of $10.4 billion and $4.6 billion, respectively.

# Market Valuation

All indexes rose in March, although it was a tale of two worlds with growth stocks declining sharply and value-stocks seeing significant gains. The Dow Jones Industrial Average gained **+6.1%**, the S&P 500 gained **+3.78%,** the NASDAQ lost **-1.1%,** and the Russell 2000 remained flat. Investors were buying large-cap, dividend-paying value stocks in the Dow and small-cap value in the Russell 2000. A lot of money flowed out of growth stocks into value stocks, but additional money previously held in cash also came into the market, which drove overall indexes higher.

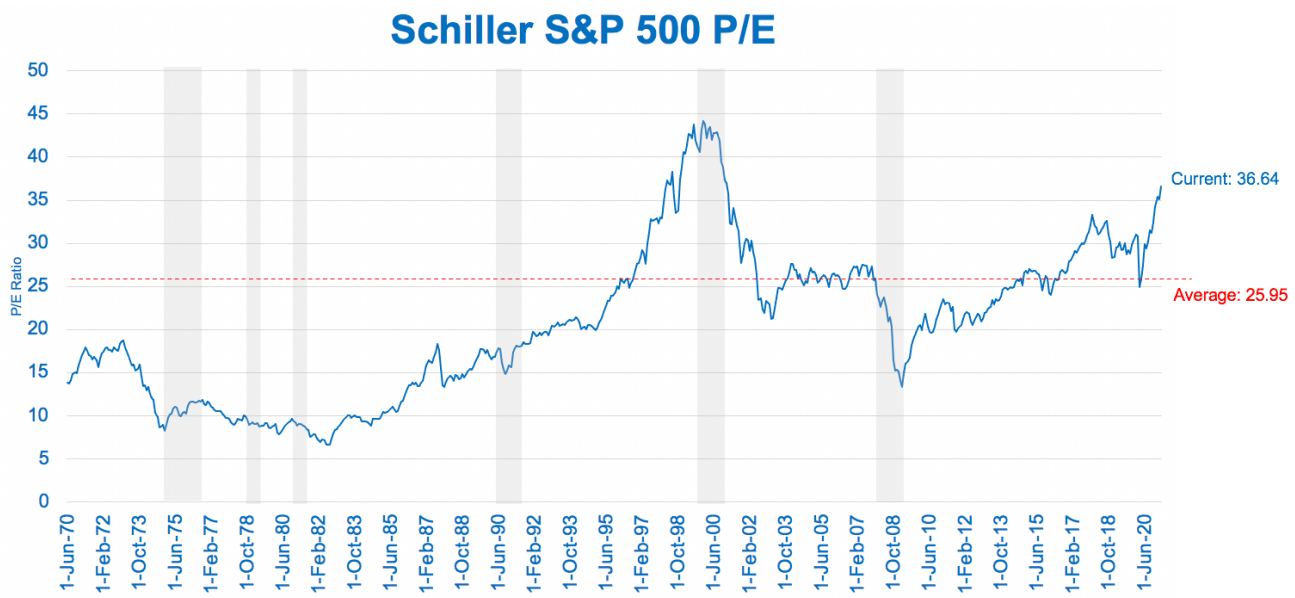
The Wilshire 5000 is now **95%** higher than the US GNP, which compares to a **90%** divergence last month, so by traditional measures, we are in overvalued territory.




GDP projections for this year range between 3.5% - 8%, depending on the rate of vaccine roll-outs, sectors of the economy reopening, and the size of the proposed infrastructure bill currently being debated in Congress. Any number within this range signifies a healthy economy, in parallel with the Federal Reserve pledging to keep interest rates low through at least 2022. These tailwinds for the economy will likely keep markets at elevated levels.

That said, a drastic rise in inflation and an about-turn by the Federal Reserve on keeping interest rates low could trigger a more extensive correction, and we monitor these key macro-economic indicators with priority.

As a second perspective on valuation, we always use price-to-earnings. The Shiller P/E Ratio adjusts earnings for inflation and interest rates, which allows us to accurately compare earnings over periods with differing interest and inflation rates. Times of low rates and low inflation have warranted higher valuations, so normalizing the ratio is essential for historical comparisons. The average adjusted P/E ratio since 1970 is ~26, a level we hit in March last year. Since then, the ratio has been moving up and is now at 36.64, over **35%** above the average, confirming what the Wilshire 5000/GNP shows, although not as extreme.




Expectations for the next couple of years are that aggregate earnings will grow significantly given the economic tailwinds. We would like to see the direction of the ratio plateau or begin to decline. However, for that to happen, earnings will have to grow faster than equity market prices. We expect the market's aggregate growth to begin to slow and maintain that the current environment continues to be best suited for stock pickers. In this environment, the selection of specific equities becomes increasingly more critical for investors.

## What Excites Us

### Economy Reopening

Many of the fund's positions stand to benefit as the economy reopens. While we are thrilled with the short-term growth, we remain focused on the tremendous growth ahead as our major themes continue to unfold. With 70% of the economy dependent on consumer spending, reopening is an essential catalyst for growth.

### Growth at Reasonable Prices

Technology stocks in cloud software and semiconductor spaces have pushed those stocks to astronomical levels. We see tremendous opportunity in several positions where our downside risk is minimal, and the upside could be enormous. Our investment in these companies is equivalent to owning private equity traded on the public exchanges. We hope that we can deliver private equity size returns from some of these holdings. The recent decline in chip stocks presents new opportunities in a large growing market that cannot currently meet demand. All of the most significant growth sectors rely on semiconductors.

### Amount of Money Still on the Sidelines

Many investors are still sitting out in the current market. Last month there was still roughly $5 Trillion sitting in cash accounts. This is over 30% more than the 10-year historical average, and for many institutional investors, earning 1% or less on cash isn't a long-term option. Investors are rightfully careful, but with low interest rates and GDP on the mend, this cash will be invested to the benefit of current investors who are already fully invested. We expect to see significant amounts of idle cash flow into the stock market via individual traders, institutional investors, 401Ks, and pension funds during the second half of 2021.

## What Keeps Us Up at Night

### Tax Policy

Joe Biden has been quickly working on vaccine distribution, manufacturing, and getting a relief bill passed. While the vaccine roll-out is accelerating, Biden has proposed some tax policies that 'may' be detrimental to the national recovery. We think investors are too concerned about corporate tax increases, but we're watching this issue closely.

### Taiwan vs. China

Two things cause the most upheaval in markets and increase inflation, 1) Interest rate hikes, 2) Wars. Taiwan is the largest manufacturer of semiconductors, dwarfing the rest of the world. China is claiming Taiwan as its own and continues to increase military presence with hundreds of ships, airbases on human-made islands, fighter jet flyovers, and political rhetoric. The South China Sea also contains significant deposits of rare earth minerals critical to all advanced technology and China's semiconductor ambitions. The U.S and the EU are supporting Taiwan's military with parts, technology, and equipment. Recently Taiwan's foreign defense minister said, *"We are willing to defend ourselves without any questions, and we will fight the war if we need to fight the war. And if we need to defend ourselves to the very last day, we will defend ourselves to the very last day."*

### The pace of Vaccine Distribution

The Federal government has meddled too much in the distribution process, adding layers of inefficiencies that were already solved and in place for other vaccines. Currently, 20% of the U.S population is vaccinated, compared to 4% of China's. While progress is accelerating, we need to do much more to get the supply up and distribution friction removed.