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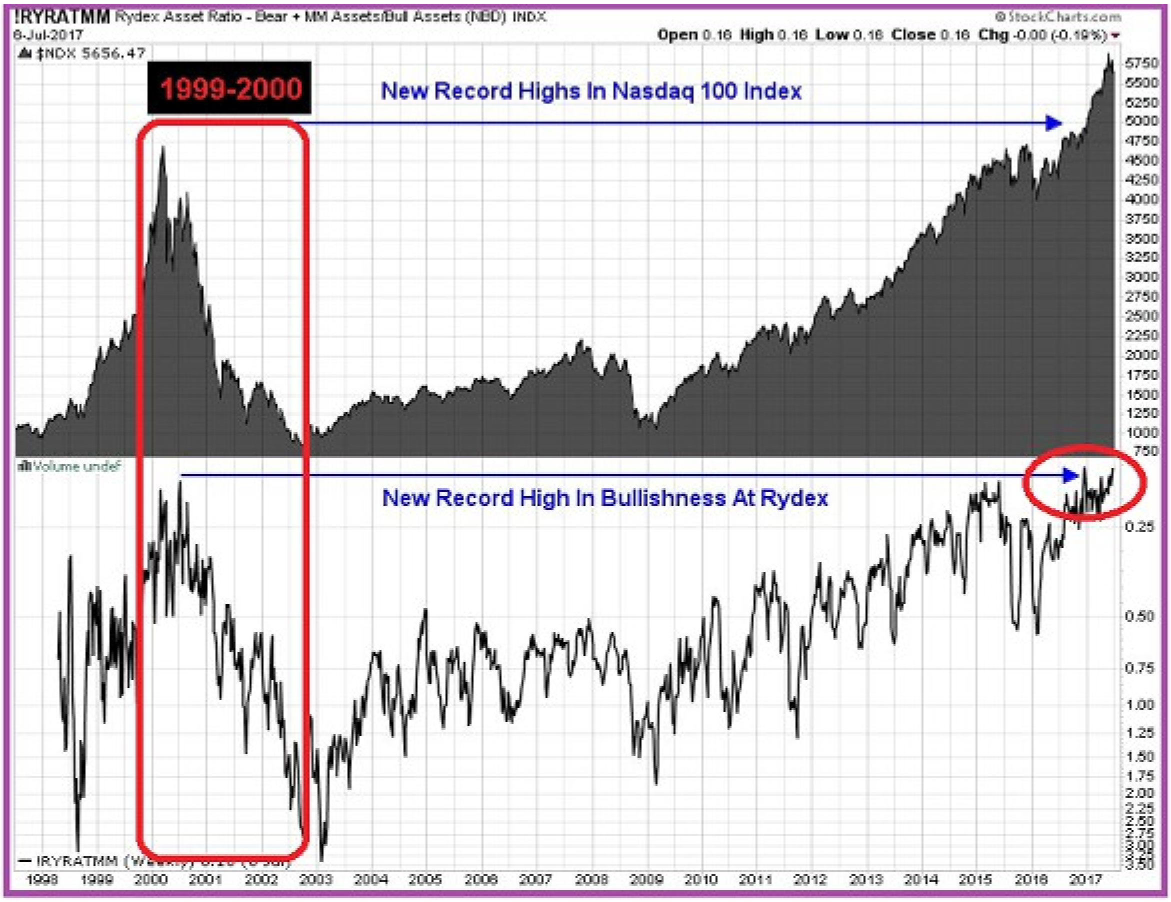
Is The Stock Market Finally Topping Out?

The S&P 500 had 3 down-days and 2 up-days from the previous day's close, including the last two days of the week. On Thursday and Friday, large drops in the SPX early in the day were "miraculously" saved from turning into large declines I don't know if the Fed/Plunge Protection Team throws a big bid into the S&P e-mini futures pit and the hedge fund algos "see" that bid and front-run it by buying S&P big futures or if, simply, hedge fund algos are still programmed to buy the SPX when there's a drop of more than 5-10 points.

In the chart above, the SPX appears to be "curling" back down to the 50 dma. You can see that the RSI has been diverging negatively since March 1st. Ordinarily, this is considered bearish as it indicates that, on average, there's more selling than buying of either the individual SPX shares or of the SPX ETFs. At this point, I have no idea if the Fed is trying to keep the SPX from dropping at all costs or if the hedge funds and ETF inflows are preventing the market from falling.

According to Strategas Research Partners, it has been 268 trading day since the last 5% pullback in the stock market. This is the fourth longest streak since 1950. Two of the streaks that were longer occurred in the 1990's. In the 1990's, Robert Rubin's Treasury Department colluded to with the Greenspan Fed - collectively known as the plunge protection team - to significantly expand the "market stabilization" mandate of the Exchange Stabilization Fund to include pro-active intervention in the stock and bond markets (the ESF was original established in the mid-1930's to support the U.S. dollar.

The current stock market mania resembles the 1999-2000 tech bubble top. The all-time new highs in the Nasdaq, occurring almost daily now, have been accompanied by an all-time high in investor bullish sentiment:



Investor sentiment is measured by the Rydex fund complex based on the amount cash flowing into its index funds. The fund flow, in general, comes from high net worth retail investors and small institutions. The graph above is the Rydex Asset Ratio. It is based upon an analysis of where investors are actually putting their money (vs. taking a sentiment survey). It's calculated by adding the Rydex Bear Fund plus Rydex Money Market Assets and dividing that sum by the assets in the Rydex Bull Fund.

As the ratio declines (the scale in the bottom panel above is inverted), the amount of money in the Bull fund is expanding relative to the amount of money in the Bear fund plus cash. At extreme levels such as the current, this Rydex sentiment signal historically has been an unusually accurate contrarian signal. There's no telling how accurate this indicator will be this time around if the market is being held up by official intervention. However, if the inexorable rise in the market is a product of unbridled investor cash inflows - and I'm beginning to suspect that this is the case more everyday - this stock market is setting itself up for the greatest crash in U.S. financial history. The only question is timing.

The good news for bears, though, it that beneath the "veneer" of the major indices, plenty of stocks are falling in price. Because of the extremely overvalued condition of the market, stocks that disappoint for whatever reason give short-sellers an elevator shaft gap down.

Amazon's Big Miss

Speaking of companies that disappoint, AMZN reported its earnings Thursday after the market closed. It stunned the market by missing the consensus estimate for its earnings per share by over $1/share. AMZN reported EPS of 40 cents vs the consensus estimate of $1.42. It was the biggest earnings miss in the Company's history. It was down from its reported Q2 2016 EPS of $1.78. The stock dropped $25.96 (2.5%) to $1,020. It traded as low as $1001.00 on Friday. The $1,001 print was down (7.6%) from the $1,083 all-time high tick hit literally about 24 hours earlier. Interestingly, if you recall from the July 16th issue, with AMZN at $1,002 I suggested a small short in the shares with a stop-loss at $1,020.

Given AMZN's proclivity for extreme GAAP accounting manipulation, I took a look "under the hood" at its 10-Q - something which highly paid Wall Street shills forget to do. As I'll show, AMZN's numbers were far worse than the headline reports.

AMZN's net income in Q2 2017 imploded from Q2 2016, dropping 77% from $857 million to $197 million. On a fully diluted basis, EPS plunged from $1.78 to 41 cents. The biggest culprit was costs: cost of sales and cost of fulfillment. I have argued for years that AMZN loses money on its Prime membership because of the costs incurred with 2-day free shipping and free MP3 and movie streaming.

This fact has been showing up in the e-commerce profit margins for several years. For some reason I seem to be the only analyst out “there” who has noticed. AMZN's total operating margin – e-commerce + AWS (cloud) combined – plunged in Q2, from 4.2% in 2016 to 1.7% in 2017. It's been falling every quarter sequentially for quite some time. The cost of fulfillment – getting the product from the warehouse shelf to the end-user's front door - as a percentage of sales jumped from 18% in Q2 2016 to 20.6% in Q2 2017.

AMZN Q2 by segment

	Three Months Ended June 30, 2016	Three Months Ended June 30, 2017
North America		
Net sales	$ 17,674	$ 22,370
Operating expenses	16,972	21,934
Operating income	$ 702	$ 436
International		
Net sales	$ 9,844	$ 11,485
Operating expenses	9,979	12,209
Operating income (lo	$ (135)	$ (724)
AWS		
Net sales	$ 2,886	$ 4,100
Operating expenses	2,168	3,184
Operating income	$ 718	$ 916

The e-commerce business produced a $288 million operating loss.

The sales growth rate has been declining for years. From Q2 2015 to Q2 2016, e-commerce sales grew 23.3%. AMZN's total sales (e-commerce + AWS) grew 31.6%. From Q2 2016 to Q2 2017, the e-commerce sales growth rate declined to 17%. Total sales growth fell 700 basis points to 24.7%.

The AWS business, which has been touted aggressively, if not obscenely, by Wall St as AMZN's “holy grail,” is also experiencing a rapid decline in sales growth and profit margins. From Q2 2014 to Q2 2015, sales grew 81%; from 2015 to 2016 sales grew 58%; and from 2016 to 2017 the salesgrowth rate fell to 42%. The operating margin of AWS declined from 25% in Q2 2016 to 22.3% in Q2 2017. Sequentially, quarter to quarter, the slow-down is even more dramatic.

Retailing and grocery sales have always been a low margin business. While the world of make believe is touting AMZN as the new "grocery killer," competitors like Walmart, which is 3x larger than AMZN, Target, Bed Bed Bath, et al have 4-5% operating margins with which they can throw into pricing strategies to attack AMZN's product and grocery model. Walmart has already introduced 2-day free shipping in it's online business. And the customer does not have to pay an upfront membership fee to get the 2-day free shipping.

AMZN is for sure noticing the cost pressures on its business model. When I've ordered from Prime in the last couple of months, including last week, I noticed that AMZN was offering a $5 credit to fund a gift card with $100 and it was offering a $5 credit to switch from 2-day shipping to 5-day ground delivery. An analysis of the true cash flows shows why. I have always maintained that the Free Cash Flow (FCF) promoted by Jeff Bezos every quarter in his earnings presentation slide show was highly, if not intentionally, misleading. If fact, in the SEC-filed 10-Q/10-K's, Amazon has to make this disclosure:

Non-GAAP Financial Measures

Regulation G, Conditions for Use of Non-GAAP Financial Measures, and other SEC regulations define and prescribe the conditions for use of certain non-GAAP financial information. Our measures of free cash flows and the effect of foreign exchange rates on our consolidated statements of operations, meet the definition of non-GAAP financial measures.

That disclosure explains why the Jeff Bezos FCF metric is not bona fide based on GAAP. Here's the true cash flows produced by AMZN on an LTM (last twelve months) basis:

AMAZON.COM, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in millions)

	Three Months Ended June 30,		Twelve Months Ended June 30,	
	2016	**2017**	**2016**	**2017**
Net cash provided by (used in) operating activities	3,578	3,829	13,049	17,885
Net cash provided by (used in) investing activities	(2,439)	(5,051)	(6,360)	(13,410)
Purchases of property and equipment, including internal-use software and website development, net	(1,711)	(2,501)	(5,395)	(8,207)
Net cash provided by (used in) financing activities	(1,152)	(1,263)	(4,570)	(3,769)
Property and equipment acquired under capital leases	1,422	2,724	4,676	8,019
Property and equipment acquired under build-to-suit leases	231	748	870	2,575
True Free Cash Flow			**-2,476**	**-4,685**

The above graphic is a consolidation of the Statement of Cash Flows from the latest 10-Q. The actual account entries which produced the "net cash provided/used in" entry for each category are not relevant except as noted below. The Bezos FCF metric takes the "cash provided by operating activities - $17.885 billion – and subtracts the Capex entry in the "investing activities" section - $8.207 billion (not shown above) – to arrive at the $9.678 billion FCF flow that is promoted by Bezos and his Wall Street and financial media zombie sycophants. But this is emphatically not remotely close to the free cash flow produced by AMZN's business model.

In the graphic above, take the cash from operating activities (+$17,885), the cash spent on PP&E (-$8,207) and the cash from financing activities (-$3,769). (Note: the difference between the net cash from investing activities (-$13,410) and PPE is the amount from selling and buying money market securities, which are the same as cash; for purposes of this analysis, it's a cash “neutral” activity and would not be included in a Free Cash Flow analysis). But there's more. You'll note that at the bottom of the graphic there's two entries, “property and equipment acquired under capital leases” and “property and equipment acquired under build-to-suit leases.” These are non-capex capital spending items that, because they fall under the guideline of “leases,” are not considered CAPEX that needs to be disclosed as CAPEX in the cash flows from investing activities of the cash flow statement. But it is cash that is spent and GAAP requires the disclosure to be made “below the line” on the statement of cash flows.

Ordinarily, this would not be considered “CAPEX” as defined because it is supposed to be a non-recurring, shorter term financing vehicle. That's why GAAP does not require accounting for it as CAPEX. But with Amazon, this number has been recurring and growing in size at a rapid rate for several years. If the SEC were doing its job, it would force AMZN to account for this capital spending as CAPEX. While the SEC does not do its job, I like to do mine. The graphic on the previous page shows, in red, the TRUE free cash flow generated by AMZN's business model on an LTM basis. It's cash burn, not cash flow. **On a year over year LTM basis, the amount of cash burned by AMZN has increased 89.2%, from negative $2.476 billion to negative $4.685 billion.**

This is why, from the end of 2016 to the end of Q2 2017, AMZN's cash + marketable securities have dropped from $25.9 billion to $21.4 billion. Theoretically, if AMZN is truly producing Free Cash Flow, it's cash balances should be growing every quarter. This is also why AMZN is offering sales credits for customers to fund gift cards and why AMZN is trying to cut cash expenses by incentivizing Prime customers to switch to ground shipping from 2-day air delivery. Gift cards, as I meticulously demonstrated in the AMZN dot Con research report every subscriber has, is a significant source of cash for AMZN. It's cash upfront received and the typical gift card holder takes a year to use it. This enables AMZN to operate like a bank by taking in cash upfront that it can use immediately to fund cash outflows. This is another Ponzi aspect to its business model.

AMZN's cloud business (AWS) is also under attack from better capitalized and traditional software development companies including Microsoft, Google, Oracle and IBM. IBM recently announced it would be spending more money and focusing on its cloud business. The good news is for the end users, as cloud services pricing will decline rapidly. AMZN's cloud margins have been declining every quarter for several quarters. Eventually, as with central processing units (memory and chip processing), storage, software and fiber optic networking, the price of cloud computing will eventually fall toward zero.

How to take advantage of seeing the facts about AMZN – as many of you know, shorting AMZN has been quite hazardous since the beginning of 2015, when it was a $300 stock and still extremely over-valued at that price point. A big part of the problem is that Wall Street will never report the facts about Amazon because AMZN is a huge source of revenues for the big Wall Street firms. The financial media will never report the truth about AMZN because a large portion of the ad revenues at CNBC, Fox Biz, Bloomberg, etc comes from Wall Street advertising and guest Wall Street analyst appearance fees. CNBC on Friday hosted UBS' crazy-eyed equity analyst, Eric Sheridan, who was imploring viewers to ignore Amazon's results this quarter. I kid you not.

I honestly don't know what the trigger event will be that will force reality on Amazon's stock. It's become a cult stock that has maintained unique longevity with the myth vs. the truth. As long as Amazon can maintain a model in which “cash in” - primarily in the form of continued revenue growth which is immediate cash in – exceeds immediate “cash out” - expenses, the Ponzi model can sustain itself. This is why Bezos is constantly announcing new business add-ons. He HAS to keep revenues growing with no regard to the actual profitability of those businesses.

“Faith” is defined as “belief without evidence.” AMZN is a stock investment that thrives on investor faith. Investor greed transforms into irrational faith when the faith is rewarded with stock gains. This will ultimately burn out but it's impossible to predict timing. The stock is trading at 178x TTM net income. This is an insane multiple for a company with a deteriorating business model that is under attack from all angles by large, well-capitalized competitors who specialize in Amazon's business segments.

Having said that, I continue to believe that money can be made trading AMZN from the short side but it requires discipline and diligent capital management. Amazon is one of those stocks in which you need to maintain some short exposure because, when it finally goes, it will go quickly and you'll be waiting for a big bounce to short that will never materialize.

If you short the stock, use a stop-loss. I think with AMZN a good spot is 20% above your entry-price. You can also short the stock and hedge it with calls. Use deep in the money, near-expiry calls so you don't burn capital on premium. If you short 10 shares, you only need 1 call to hedge.

Another way to play it is to use extremely out of the money calls with a long expiry. I'm looking at the January 2019 $500's right now. They were offered at $3.80 on Friday but traded at $3.50. There's nearly 1800 of open interest, so they are liquid. Make no mistake, this is a highly speculative play. But a year ago AMZN was trading at $750. It doesn't need to fall to $500 or expirein the money for you make money. If we get a protracted sell-off in the market, AMZN will fall much more quickly than the market and the January 2019 $500 puts will make money.

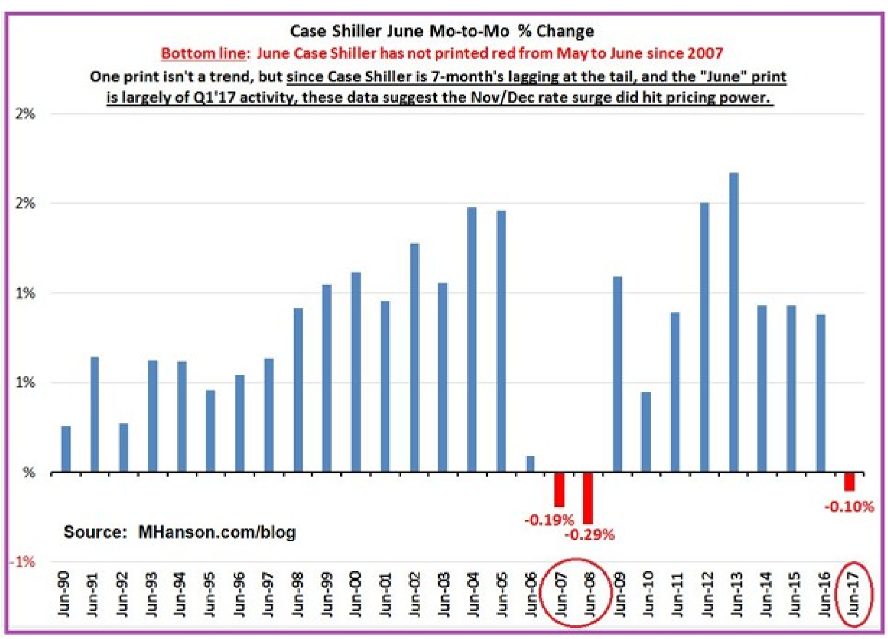
The Amazon analysis and presentation always takes a lot longer to put together than I intend when I begin work on it. I have to sift through several 10-Q's, and the most recent 10-K and quarterly earnings slideshow. It requires triple-checking both the numbers and my assessment of the accounting relative to GAAP accounting. Then I have to figure out an intelligible, concise format for presenting the key material. As such, I'll briefly review the past week's key economic data and finish with a couple follow-up ideas.

On Friday the Government released its “advance” estimate of Q2 GDP. It was reported to be 2.57% annualized, which was in line with consensus estimates. The estimate for Q1 was revised lower. The best way to interpret the GDP is with this quote from John Williams:

The GDP (or the broader GNP detail headlined in earlier decades) simply remains the most worthless of the popular government economic series, in terms of determining what really is happening to U.S. business activity. The series is the most heavily modeled, politically massaged and gimmicked government indicator of the economy. It has been so since at least the 1960s, and that reporting quality deteriorated [with the latest historical revisions and current report]... - John Williams, Shadowstats.com

Despite the weekly private sector data showing a marked slow-down in all areas of consumer spending, the primary driver of the increase in GDP from Q1, according to the Bureau of Economic Analysis statisticians, was personal consumption expenditures. I don't know how to address this with a rebuttal other than to point to the data presented in the weekly SSJ's during Q2. Given the serial declines in auto sales, restaurant spending and retail spending, I have no clue how the Government can present a report that shows GDP increased at a 2.6% annualized rate in Q2.

Last Monday existing home sales for a June were released. The SAAR declined nearly 2% from the May SAAR. There's no question, the housing market is rolling over. Unless the Government once again reduces its lending standards, which this time around would mean direct cash subsidies of down payments and interest payments, the “universe” of available bodies that can qualify and maintain a home purchase is reaching its limit. I want to show this chart of the Case Shiller home price data from Mhanson.com/blog:



The graphic on the previous page shows the May to June price change as reported by Case Shiller going back to 1990. As you can see, the Case Shiller June index declined from July. As Mark Hanson notes, the June Case Shiller report has not shown a month to month decline since June 2007. This is a crucial point because June is supposed to be the peak sales for housing. If prices were going to drop, we would expect the drop to occur in seasonally slower month.

But, because Case-Shiller data lags by as much as 7 months (it's a function of the methodology that Robert Shiller has admitted in the past is a draw-back in the index data presentation), that price decline is largely reflective of contracts closed in during Q1 2017. It means that the housing market is likely even weaker than is conveyed by the current headline data. I refer you back to the comment from a subscriber who is a real estate professional here in Denver: “it felt like from January to March someone pulled the plug.”

New home sales also missed expectations, although they – unbelievably I might add – showed and increase from May. May's number was revised lower. Calatlantic Group (CAA) was short idea from the June 25th issue at $34.50. The stock ran up to as high as $38.56 ahead of earnings and in correlation with falling 10yr Treasury and mortgage rates. It missed the Street estimates when it reported on Thursday. The stock plunged $1.95 (5%) on Friday.

The Company's average selling price and gross margins both declined. Since the end of 2016, the number of homes CAA has put under construction has increased 34%. The value of its inventory has soared by $218 million. It's debt has soared by $343 million. It's funding its home development using debt. This is going to end badly for all homebuilders but especially for builders like CAA.

If you shorted CAA after the June 25th issue, hang in there. If you used puts, roll them further out. When the homebuilders begin to implode, it will happen very quickly. They'll be stuck with $100's of millions in inventory that will need to be written down and several of them will choke to death on the debt that has been issued over the last 5 years – debt that would have never been issued in the absence of Federal Reserve and U.S. Government intervention in the housing market.

You can see in the graph above, CAA plunged from a double-top formation at $38.50. The RSI plunged from an overbought condition along with the stock. Smart institutional holders, if such a thing exists anymore, will be selling their positions. Shorting the stock outright is the best play, but if you use puts, I like the December $35's, offered on Friday at $1.85. I believe CAA will be at $30 or lower by then. At $30 these puts are worth $5.

One last point on housing. Mortgage purchase applications were down 2% per the weekly Mortgage Bankers Association mortgage applications report. Mortgage purchase applications have been declining 3 out of every 4 weeks since March. This is another great indicator that the unit home sales volume, in reality vs. the massaged NAR and Census Bureau reports, is declining.

For the rest of last week's economic reports, I defer to John Williams' summary in one of his newsletters late last week:

- Amidst a Faltering Economy, Political Discord Perils the Dollar and Intensifies Risk of Major Market Turmoil;

- Freight Index Continued in Low-Level Non-Expansion, Down 11.7% (-11.7%) from Its Pre-Recession Peak;

- June Gain in and May Upside Revisions to New Orders Reflected Surges in the Irregularly-Unstable Monthly Reporting of Commercial Aircraft Orders, Which Were Up by 131.2% in June and Revised Higher by 11.7% in May;

- 6.5% Gain in June New Orders Was Just 0.2%, Net of Commercial Aircraft;

- Net of Commercial Aircraft and Inflation, Orders Were Down 10.0% (-10.0%) from Their Pre-Recession Peak;

- Consumer Related: Motor Vehicle Orders and Shipments Declined in June;

- Decimated Second-Quarter 2017 Home Sales and Related Construction: Quarterly;
- **Contractions in New-Home Sales (-12.3%), Existing-Home Sales (-3.7%)**, Building Permits (-13.0%), Housing Starts (-21.9%), Single-Unit (-7.0%), Multiple-Unit (-47.3%);

- Monthly Existing-Home Sales Declined in June, Small Gain in New-Home Sales Was Unchanged Net of Revisions;

- June Existing-Home Sales Were Down by 24.1% (-24.1%) and New-Home Sales Were Down by 56.1% (-56.1%) from Pre-Recession Peaks;

I wanted to bring your attention to the 2nd-quarter's quarterly contraction in new home sales (-12.3%) and existing home sales (-3.7%). You'll note that this significantly worse in appearance than the monthly SAAR data reported by the NAR and the Census Bureau. Williams' metric is based on the quarterly rate of change in home sales for Q2 vs. Q1.

This brings me to Lending Tree (TREE). This too has been an extremely difficult stock to short, as it has been a favorite stock for hedge funds to pile into when it starts to head higher. TREE also reported last week. Its stock spiked higher despite missing the consensus estimate for net income. It did beat revenue estimates. I'm not sure why the stock spiked higher, other than a likely short-squeeze effort, because the details in the numbers show deteriorating fundamentals.

The graph above is a 1-yr daily with the RSI. You can see the huge spike up after it reported earnings. This stock trades at 100x p/e. It's revenues year over year for Q2 were up 62%. BUT sequentially from Q1 to Q2 revenue growth dropped to 15%. The Company's SG&A, mostly marketing expenses, soared by 70% in Q2 2017 vs 2016. It spent a fortune on marketing, which is why sales jumped, BUT, operating income year over year for Q2 plunged 30%.

TREE made a big push into promoting auto loans over the last couple of years – right as auto sales were cresting. A significant portion of its revenue growth is attributable to this business segment. As auto and mortgage lending declines, which is happening currently, it will hammer TREE's revenues. It had to literally throw dollars into advertising in order to generate revenue – revenue in the form of "clicks" on the lender links on its website. At its core, TREE is a digital advertising company. When the economy struggles, businesses cut back on ad spending. Proctor & Gamble announced last week that it was cutting $100 million from its digital ad spending. I suspect that by the end of the year. TREE's numbers will have taken a huge decline.

I think now is a great time to try shorting TREE again. You can see in the 5-yr weekly graph above that TREE stock experienced a similar spike up in price after its Q2 earnings in 2015 and then sold off. I believe the same thing will occur this year.

With help from the overall stock market, I can see this stock easily trading back down to its 50 dma (yellow line, currently at $172) before the end of September. If you short the stock, I'd put a stop-loss in up 20%. Again, with help from the market, your stop-loss won't come close to triggering before you have a chance to book a short term “swing” profit.

The short-interest in the stock is 26% of the float. I'm highly confident that the spike up last week after a mediocre earnings report was short-covering. The puts have a huge degree of premium in them. The October $180's have an implied volatility of 40%, which means the puts are priced to include the possibility of a 40% drop in the stock. If you want to speculate with puts, I'd go out to January and try the $150's. They last traded at $4.60. Before you think this is nuts, consider that 3 ½ months ago, this stock was trading at $117. If it retraces just half of that move within the next 2 months, those puts will throw off a nice rate of return. Obviously if if they retrace the entire move over the next 4 months, they'll have an intrinsic value of $33.