THE GREAT STORYTELLING FOG FROM TESLA, WALL STREET, AND THE D.C. SWAMP

CRITICAL SIGNALS REPORT

WITH MATT PIEPENBURG

Investor's Report
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For: *Critical Signals Report* Members

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Dear Subscriber,

In any era and market, truth (i.e. objective facts, data, and figures) are essential to smart investing. Falsehoods, storytelling, and hype, however, lead to not-so-smart investing…

Today, objective facts are frequently ignored. Markets and tickers are increasingly influenced by tweets, adjectives, declarations, and headlines rather than empirical realty – i.e. actual earnings, profits, sound management, and natural supply and demand.

Indeed, if I had to sum up what's wrong in the current "everything bubble" of debt-driven stock, bond, and real estate assets, the contemporary example of Tesla – and its impending pain – is a fitting metaphor for the absurdity (and "truth decay") of the post-'08 market "recovery" Washington keeps promoting.

In other words: Let's look at Tesla as a broader metaphor for what is wrong, well, *everywhere*…

Tesla Headlines

In August of 2018, ***The Wall Street Journal*** headlined Elon Musk's infamous tweet (the modern-day canon of mediocre communication, attention spans, and eloquence) to take TSLA private. When I saw the news, I literally swore out loud.

Then Tesla's stock rose by 11%…

Why?

A single tweet.

The next day, it fell.

Why?

Reality stepped in *for a minute*.

Sometimes, hypocrisy and dishonesty are so blatantly clear you can just feel it in your core, and like one shot glass too many, your body intuitively rejects the poison.

Musk's 2018 "decision" to *allegedly* take Tesla private (with "financing secured") in order to avoid what he described as the disruptive volatility of market forces (i.e. short-sellers), was such a disingenuous pile of horse-droppings that it compelled me to speak up.

Specifically, what I'd like to share here is not only an economic musing on the metaphorical dishonesty and distortion of the Tesla hype and the broader, Fed-distorted markets in general, but also a reminder to us all that *objective truth* (including balance sheets, cash flow, and LBO requirements) still matters in an era (and market) of increasing spin over facts.

As for Tesla and its mercurial founder, Elon Musk, this company stands out as a screaming homage to form over substance, debt over profits, words over math and, well… lies over truth.

I also feel that the massive rise – and inevitably massive fall – of Tesla mirrors the rise and equally inevitable fall of the broader markets in general. More on that below.

And to bring this point home, let's move from words to numbers. In short, let's do the math, because at least in math, we can all agree that 2+2 still equals 4, right?

First: The Hype

In the last six years, Tesla's market cap skyrocketed eightfold, from $3.5 billion to a whopping $63 billion by the time of his August "tweet."

Such stock-price growth would normally imply that its mysteriously brilliant (or just "well-branded") founder embodied a new breed of creative-thinking genius spawned by millennial élan and courage to revolutionize – and eventually even conquer – the massive and intricately nuanced $2 trillion/year global auto market.

Indeed, Tesla, as it has been headlined over and over again, promised to do for cars what the iPhone did for telecom.

With such astronomical market-cap growth, Tesla was also widely presumed to be selling cars like water to desert dwellers.

Productivity, after all, must have been amazing with such a share-price climb, no? After all, with every earnings call, its founder – some mythic combination of Henry Ford and Howard Hughes – kept promising more and more "growth" and "productivity."

And with every promise, announcement, tweet, magazine-cover shot, and hope-selling forecast from the banks that underwrote, traded, or sold Tesla securities, investors kept buying and buying more shares, all excited about the "Cinderella story" that is/was Tesla.

Indeed, never has so much fairy tale Kool-Aid been consumed by such a wide swath of thirsty speculators and momentum traders.

The Math

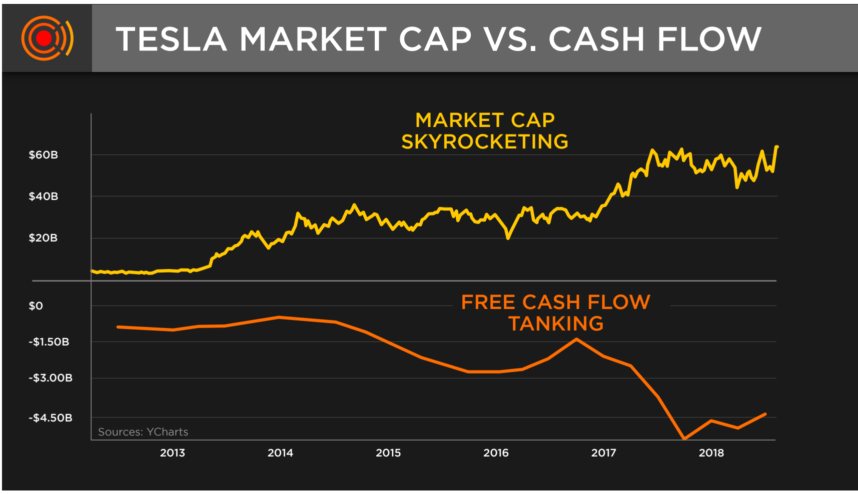
There's hype. There's market cap. And then there's math. And as for us market veterans, we stubbornly have a thing for math…

And here's some *math* I'd like to share. As Tesla's stock price was soaring, its cash-burn was a staggering $11 billion. And since Q2 of 2012, the company consumed an additional *$10 billion in debt*, with a burn rate that increased consecutively, quarter after quarter after quarter.

Stated more simply: Instead of *producing and selling automobiles* to justify record share prices, Tesla (like so many other fairy tale tech companies) did little more than borrow and burn.

Its free cash flow was in the *negative* to the tune of billions, and yet its market cap kept heading bizarrely north…

A picture, of course, is often worth a thousand words. To let this sink in, I recommend you take a long gander at the following picture, which compares Tesla's cash flow (tanking) to its August market cap (skyrocketing).



There once was a time when facts – you know, pesky little things like profits and free cash flow – mattered to smart investors.

In that bygone era, stocks rose because their exceptional management, productivity, debt-levels, and sales *mirrored* their equally exceptional market caps.

But as the graph above plainly reveals, today, *facts* have almost nothing to do with investing…

After all, why would anyone feel safe in a topping and entirely debt-driven (rather than productivity-based) stock market supported by stock buybacks, ex-items accounting, and negative free cash flow?

Or why would anyone feel safe in a bond market that is more than 60% composed of high-yield, junk, and levered loans?

And why would anyone call an economy with an annualized GDP of 1.7%, a debt level of $71 trillion, and nearly half its working-class population living just above the poverty line a "recovery"?

Finally, why would anyone pay top-dollar for a bottom-of-the-barrel balance sheet like Tesla's?

The answer is as sad as it is simple: Investors prefer hype over profits, and Tesla is just a prime example of this.

Take, for example, that other pesky little *fact* of math that investors once relied upon to reward companies with their investable dollars – do you remember *gross margins*?

Once upon a time, investors who traded on facts rather than fantasy used to measure a company's growth, sales, and productivity by an equally growing metric known as gross margins – i.e. the spread between *revenues* and *the cost* of goods.

After all, if Tesla, by way of example, was actually reaching critical mass in productivity, one would normally assume its gross margins were rising as its sales grew from $2 billion per year to $14 billion per year, right?

Wrong.

Instead, the company's gross margins since 2014 and Musk's infamous "tweet" had *dropped* dramatically from 26% to 14% – meaning its *costs* were *rising* and *revenues* were *slipping* while its stock price was ripping north.

As of today, Tesla is finally introducing its long-awaited Model 3, but in order to do so, it is closing physical stores amidst warnings by the company that it won't make a profit for Q1 2019.

A sudden profit warning? Tesla has ***never*** been profitable. Geesh…

This is just silly folks. And I ask you this: Do you need an MBA from a fancy school to see how dangerous such TSLA hype really is? For believe me, Tesla is only one among countless stocks who are all surface, no substance.

In sum: The Tesla myth is precisely that – a myth among a market of myriad myths.

And as for productivity… well, all I can say is, "What productivity?"

For years, Mr. Musk had been declaring that Tesla was building critical mass in production capacity, a meme which he oft repeated to justify the company's long-term prospects and short-term debt obligations as Tesla marched forward to take its rightful place in the global auto market.

But here's the rub: Not one word of this was true.

Tesla's financial statements (for those who bother to read balance sheets rather than headlines) made it ***factually*** obvious that Tesla was not even close to growing toward that funny little thing called "profitability."

In fact, Tesla (and Mr. Musk) had utterly failed to achieve anything even close to volume production on its Model 3 (rhyming ironically with the much nobler story of Ford's Model T).

I can't even imagine what the under-sung executives at "dinosaurs" like Toyota, GM, VW, BMW, and Honda must have been thinking as Musk pocketed a personal fortune while they get ignored by the momentum traders (i.e. "herd followers").

The great auto makers have been perfecting productivity (and even electronic cars/hybrids) for decades, yet there were no magazine-cover shots or skyrocketing market caps for them.

As I wrote as far back as May of 2017…

"Tesla loses more than $4,000 on every car it sells, and burns through more than $350M per quarter, yet trades higher than Ford while selling only 50,000 cars a year against Ford's 9 million+/year. Meanwhile, Tesla blows through debt and FCF faster than a frat boy can crush a Coors Light."

Do readers also realize that at the time of Musk's August, 2018 "tweet," there were over 17,000 Tesla vehicles still awaiting completion, re-work, and delivery in Tesla's inflated storage lots which were *not* in saleable condition to meet Elon's profitability promises?

So, what did Mr. Musk have to say about that? Well, like so many modern CEOs in the current "everything bubble," he just invented fancy phrases to sneak around facts.

That is, he described these broken cars euphemistically as "factory gated" to meet productivity targets. The market loved this phrase, and the stock price rose.

Unfortunately, "factory gated" was just a term Musk pulled out of his tailpipe… like the verbal whipsawing we see daily at the Federal Reserve (whose record for recession forecasting is zero for nine), it literally means nothing.

So again, I ask: Do any of these facts matter anymore? Has truth left the building/markets? Have promises, invented words, and spoken *projections* replaced actual profits, gross margins, production levels, PE multiples, debt levels, and balance-sheet facts?

For the last six years, the answer, at least given by TSLA investors, has been an embarrassing (albeit profitable) "yes."

The Great Con: Taking Tesla Private?

But even the hype-smothered facts as outlined above did not bother me as much as the August 2018 twist in the Tesla story.

As someone who has analyzed companies and traded the same for years (including the pre-'08 era of Enron, AIG, and the infamous dot-com era of 2000), I could see right through the guise of Mr. Musk's dishonesty (and the TSLA myth) like a dentist sees a cavity.

The Hype

First, of course, it all began with Elon's cryptic August tweet: "Am considering taking Tesla private at $420. *Funding secured*."

For veteran investors who know balance sheets, there were so many things wrong with this transparently misleading, desperate, and disingenuous tweet that it's hard to know where to begin…

First, there's Elon's nauseating, and absolutely absurd justification for the proposed pivot from public to private, namely that doing so would "protect" him and his company from the "wild swings in our stock price that can be a major distraction for everyone working at Tesla."

He further whined on about how going private would take away the short-sellers' "incentive to *attack*" his poor little enterprise.

Had this man lost his mind?

That very same "public market" that so "distracts" and "attacks" him is also responsible for pocketing him a fortune in personal wealth during the "good times" (i.e. the hype period since Tesla went public in 2010).

Poor little Elon. The times are changing.

The same public market that drank his Kool-Aid post-2010 is actually starting to question – at long last – the fact that his company has crappy cash flow.

That means the markets are supposed to do what all fair market participants accept: punish (i.e. "attack") losers. In other words, it began to short Tesla.

Mr. Musk, the market can be cruel for folks like you; live by the sword, die by the sword.

Unfortunately, Mr. Musk thought shorting (or as he puts it: "attacking") negative-cash-flowing enterprises like Tesla was ***unfair***… does he not know what a stock market is?

Elon, here's a reminder: Shorting Tesla was not only fair – it was entirely overdue and, for billions and billions of reasons, was completely justified.

And he knows it.

He knows the cash flow is not rising; he knows that even his "factory gated" production achievements were dishonest at worst and unsustainable at best; he knows his debt levels are extreme and profits embarrassing; he knows that eventually the myth will end and the same market that went "long" to make him a hero, will go "short" and reveal him for the goat he really is.

In such a scenario, rats leave sinking ships – or in Elon's desperate case – rats try to "go private" before the short-sellers can catch them.

Stated otherwise, Mr. Musk knew that his company, which was heading toward Chapter 11 rather than the acme of the auto industry, was a lie.

And his tweet was no less so.

Why the Tweet Was, Well… a Lie

Let's turn once again to math rather than tweets in this brave new world where facts mean less than glorified text messages. Let's look *mathematically* at Elon's proposed privatization escape.

Elon's tweet referenced a few, shall we say, "exaggerations."

First, he said he was considering taking Tesla private "at $420."

Okay folks, that means to proffer Tesla up at $420 a share, a private "buyer" was gonna have to cough up $81 billion ($71 billion for the stock and $10 billion for the debt) to buy a *negative-cash-flowing lemon*, which, by the way, would have been the greatest leveraged buyout (LBO) in history for one of the biggest lemons in history.

As I knew (and warned) then, there were no real buyers crazy enough to bite/buy this lemon, which is more of a "brand" than a company. After all, Tesla's debt component is protected by a change-of-control put clause, which means Musk's alleged source of "funding secured" would have had to pay a *premium* for the debt of a company that in my mind is little more than a junk bond.

Crazy.

But for those of you who trade bonds, perhaps you also noticed that the bond market didn't take the bait in 2018… after the infamous tweet, Tesla's debt was under water at 91%, not the needed 101%…

Stated otherwise, the bond jockeys didn't buy nor ride the Tesla mule…

Back in August, I was scratching my head to think of any lender under the sun stupid enough to lend to any Tesla buyer at a $420-per-share valuation. Nevertheless, Mr. Musk had already promised: "Funding secured."

In fact, that was just, well… a lie.

After all, bankers who do LBOs typically look to lend against companies with large and predictable cash flows. Tesla, as we *factually* know, doesn't "flow" any cash at all.

Instead, it burns cash.

And another foreboding FYI: The biggest LBO ever done was with Energy Future Holdings Corp. on the eve of the '08 market crash for $32 billion – which was less than half the size of Elon's fantasy tweet.

And guess what happened to the buyers of that record-breaking LBO? Seven years later, the Texas utility filed for bankruptcy. Prophetic?

Just saying…

In fact, and as per his usual practice, Musk's tweet was little more than another lame attempt to use words rather than math (i.e. facts) to fog the truth that he was not going to meet his otherwise promised/hyped projections.

But in a wider culture and market where lies, "click-bait" tweets, and excuses (i.e. Musk's wimpy declaration that "distracting" and "attacking" short-sellers are picking on him) are increasingly used to hide failures and accountability for companies (or governments, or central banks) in the red, this, sadly, is nothing new.

As for Tesla, the facts and the math are clear: Tesla is *(1) a debt-driven, sham bubble with (2) no productivity and (3) supported primarily by the thin air of hype and (4) promised rather than actual growth*.

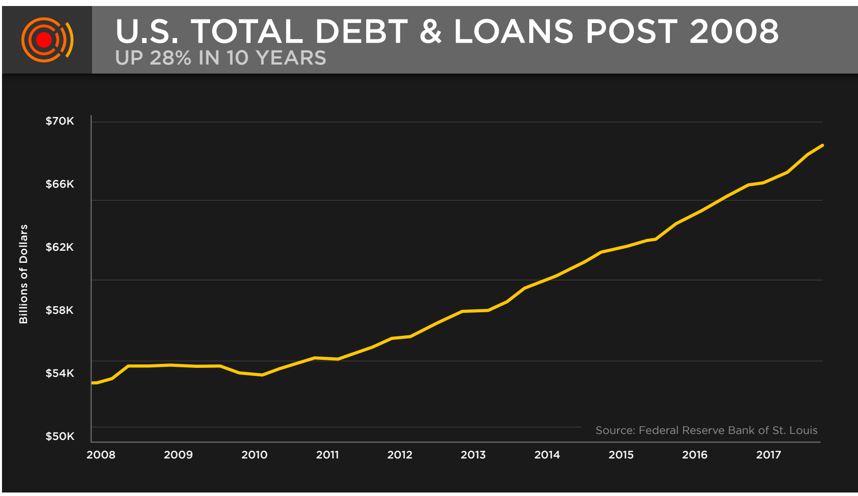
Tesla as Metaphor

If we pause to re-read that last assessment, perhaps it may sound eerily familiar?

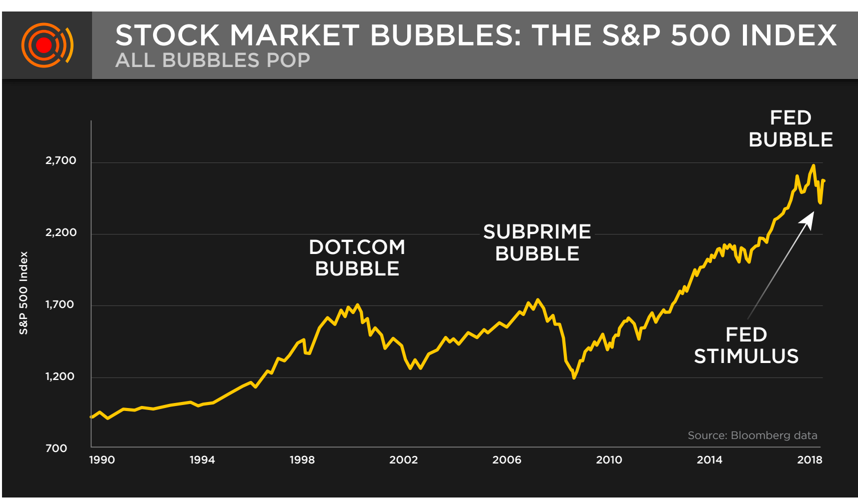
One look at the debt-driven, sham bubble of the overall U.S. debt market, or the *promised* "fantasy-growth" out of D.C. and Wall Street against the *facts* of flat-lined GDP growth (despite trillions in central bank support), and we see that the current overall market bubble "recovery" is really nothing more than one big Tesla waiting to happen…

Again, a picture is worth a thousand words…

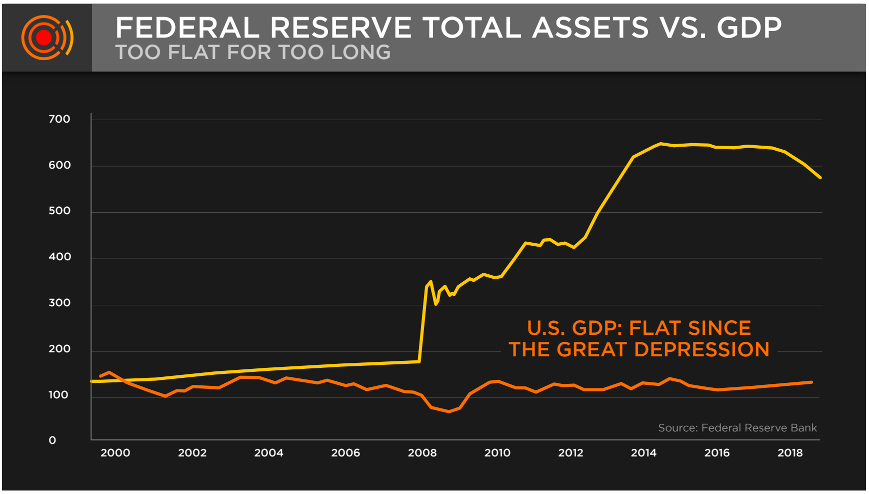
"A debt-driven…"



"Sham bubble…"



"With no productivity…"



Look familiar? Rising prices? Massive debt? And no productivity (GDP)?

Like Tesla, U.S. markets are running on borrowed time, spin, and hope – not facts. Gosh, even the August 2018 cover of ***Fortune*** magazine entitled, "The End is Near" was finally catching on…

How It All Ends?

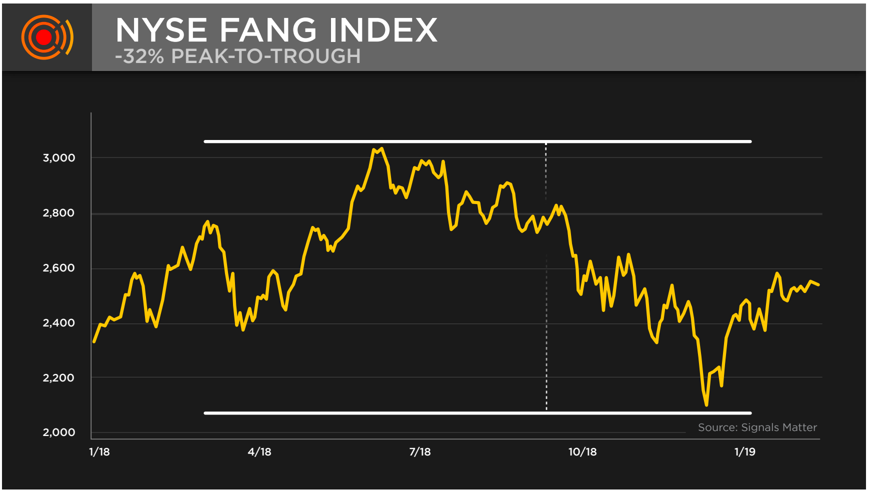
How long before it all ends? And what keeps markets from falling?

Well, we are effectively dealing with many of the very same forces that kept Tesla unfairly above water for longer than it deserves: hype versus facts.

Today's distorted markets are grotesquely (nearly 70% of their volume) supported by trend-following (rather than truth-following) momentum trades passing through ETFs, commodity trading advisor funds, indexed mutual funds, and other passive strategies whose volume and size rise slowly but surely in hype cycles and then fall like bricks when recessionary-reality kicks in.

For years, the power of these momentum and hope-/hype-/greed-based trends have been punishing up the valuations of otherwise obvious lemons because these waves of passive inflows have made stock prices (like Tesla, Amazon, Netflix, Facebook, and hundreds of lesser-known lemons) surge to unprecedented and unearned extremes.

In August, I in fact recommended shorting each of those names, and by the end of that year, they had fallen collectively in price by over 30%.



The simple fact, as we old-school value investors see from our *screens and math*, is that Wall Street is infected with momentum stocks rising on little more than balance-sheet thin air and CEO hot air.

At some point (and we are watching the flows, not the tweets or headlines), such fast money infusions and trend-following fantasies will push securities to an unsustainable high.

But how high can they go before they run out of oxygen?

Traders like my colleague Tom Lott and me feel we have the best (though by no means perfect) tool we know of in the industry to gauge these highs and prepare for the suffocating lows to come.

And at some point – at some ***signal*** we are tracking (including rising rates) – when the broad market crash finally arrives, names like Tesla will fall like rocks into a deep ocean.

At that time, we – and hopefully you – will be prepared rather than suckered.

In the interim, be careful out there – and stick to *facts* not words, numbers not spin.

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