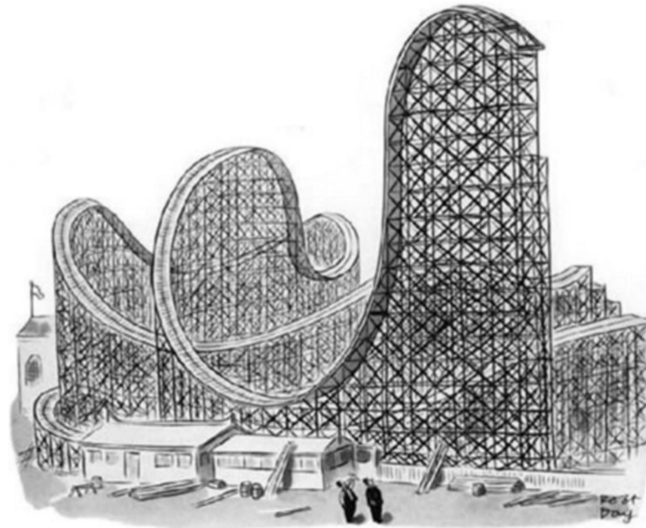
Macro Ops Hub
Target. Deploy. Profit.

Market Brief – Looking Into The Future



> "This is a time full of peril and repositioning that heralds either the start of a new market reality (i.e. inflation and too much liquidity) or the beginning of the liquidation." ~ John Burbank of Passport Capital (in a recent letter to investors)

I agree with Burbank, we are on the cusp of a paradigm shift in markets. We've been in the eye of the storm for the last year but that is now coming to an end.

Inflation and too much liquidity is in our future but we will go through a period of volatile liquidation first. It is this deflationary collapse that will finally spur political leaders to enact the debt fueled fiscal spending that will bring about inflation and outright debt monetization — this is how it almost always plays out historically, as inflation is considered the lesser of the two evils.

The last six months of market dissonance and false signaling is finally starting to clear and I am now getting more confident in the bearish deflationary scenario that I think will kick off this summer — within the next month or so.

In this week's Brief we're going to conduct a thought exercise on how I think the next 18-months will play out. The idea is to not try and nail down the small details or dates (that's impossible and pointless) but rather to paint with a broad brush the important economic linkages and their weak points —

and hopefully give a thoughtful look into how they may unfold so we can be better positioned to profit from them.

To note: this is my current highest probability scenario. But markets are dynamic and complex so as traders/investors we must also be dynamic and flexible. If new information comes in persuading me I am wrong, I will quickly dismiss this scenario and work on becoming right.

Three Stages

I foresee this cycle playing out in three stages. Each stage inexorably linked to the next and all propelled by the same three primary drivers. These three drivers are:

1. Diverging monetary policy and global risks drive the dollar higher
2. The rising dollar pulls commodities lower (increasing bankruptcies and widening fiscal deficits). A yuan devaluation spurs contagion devaluations; creating a stronger dollar feedback loop
3. The stronger dollar causes massive illiquidity and elevated asset prices crater into a deflationary storm

The backdrop of this macro story is of course a world that is at its most leveraged point in history. Total debt to global GDP is somewhere between 250-350%. It is such a large number and the picture is so convoluted that nobody really knows… but it's bad.

This large amount of debt, combined with deteriorating demographic trends (especially in the developed markets), and a turning business cycle has created an extremely fragile situation to put it lightly. It is on this precipice that the stages below will transpire.

Stage One: From Cooperation to Competition

The Shanghai Accords (the secret agreement amongst nations to hold off on easing in order to keep the dollar at bay and under the threat of a China devaluation) reached earlier this year will begin to unravel this coming summer.

The success of the Shanghai Accords in driving the dollar lower will also be its undoing. International cooperation in the best of times is fickle, and when economies begin to sour it quickly becomes everyman for himself. And with

the bullish dollar trend “appearing” to be over, international actors will think they have the all-clear to act.

The Fed will not hike rates in June but signal that a July hike is likely.

Japan will be the first ones to move at their next policy meeting in June. Japan is in the worst shape out of all the advanced economies due to astronomical debts and a quickly expanding market for adult diapers (terrible demographics). With elections coming up in July and the May G7 summit behind them, Prime Minister Shinzo Abe will push for action.

The Bank of Japan and Ministry of Finance are going to introduce something radical (and in reality, inevitable considering the situation). They are going to restructure the JGBs owned by the BOJ — which is roughly 40% of the Japanese bond market — into zero-coupon perpetual bonds.

What are zero-coupon perpetual bonds? Well, perpetual bonds are just that, they’re perpetual meaning the principal is never repaid. They’ve been issued a number of times throughout history and aren’t as radical as they may seem. Zero-coupon perpetual bonds are radical though, because they are a just a not-so-disguised form of outright debt monetization. Zero-coupon perpetual bonds would allow the Japanese government to immediately erase nearly half their debt… needing never to pay the principal or interest on it. It would essentially disappear on the BOJ’s books.

This debt monetization would free the Japanese government to go on a fiscal spending spree. Most likely, they will increase their spending on defense — since relations with China have been souring — as well as boost wealth transfers to senior citizens.

The yen will spike lower on the news but then settle as the market takes time to digest and figure out what it really means.

The Japanese government will cover themselves politically, by couching the move in terms of fiscal necessity, calling on other countries to boost fiscal spending to stave off global deflation, while also spouting platitudes on international cooperation and the need to keep currencies stable.

By the end of July, the uncertainty over what this move means will have cleared up and the yen will give back the majority of its gains against the dollar over the previous year.

This will break the back of the emerging market, commodity, and junk bond rally of the last two months. All will begin to slowly turn over.

Due to disappointing economic numbers and a rising dollar, the Fed will not hike in July and revert to a more dovish tone.

The EU technocrats, scared by the growing popularity of anti-immigrant/anti-eurozone parties begin to see the writing on the wall — spelling the end to the very institutions that employ them — and will step up their actions. The ECB will boost its QE in order to drive the euro lower, and put pressure on Germany and other countries to boost their fiscal spending.

Cooperation within the EU will continue to slowly disintegrate. The UK will vote to stay within the euro — though the vote will be much closer than many predict. We will experience some "deja-vu" with another round of "Greece in Crisis" this summer. The Greeks will narrowly miss default on their July debt repayment... only being saved at the last minute by the IMF. The problem will again be far from solved but the can will be kicked a bit further down the road.

The euro will turn lower, putting further pressure on the dollar bull trend that by July is really starting to get going. US equities will also be back near their February lows, and moving in a wild chop-chop fashion.

Stage Two: Unravelling and Feedback Loops

"A tree cannot grow up to the sky—high leverage will definitely lead to high risks… Any mishandling will lead to systemic financial risks, negative economic growth, or even have households' savings evaporate. That's deadly." ~ From an "authoritative person," printed on the front page of the *People's Daily* (mouthpiece of CCP) on May 9th

That "authoritative person" is most certainly either Xi Jinping himself, or his right-hand man Liu He. For this statement to be printed on the front page of the *People's Daily,* means that reigning in the credit bubble is now top priority amongst the party leadership.

It is likely that there continues to be a growing disconnect between what party leaders at the top want and what leaders at the local and provincial level are doing. The lower-level leaders are judged on their economic growth

and ability to maintain order — they are also enriched by allowing leverage to be lent to and created by SOEs. Expect Xi to start cracking the party whip in order to get local level leaders more in-line.

Also, expect increasingly confusing and disjointed policy and signaling to arise out of China as the economic situation there worsens. The party apparatchik's ineptitude will slowly be revealed and Xi's aura as "mysterious and wise leader" will evaporate, showing him as just another clueless brutal leader in communism's long history of failures.

China has the problem of "having a cake and wanting to eat it too." They have an Everest of non-performing loans sitting in their banking sector which has kept alive growth-sapping excess capacity in the form of government subsidized zombie-corporations… And they want to maintain their currency strength by keeping the yuan mostly pegged to the dollar. Well, as anybody who is familiar with economic history can tell you, these two situations cannot coexist for long.

Here's what's going to happen.

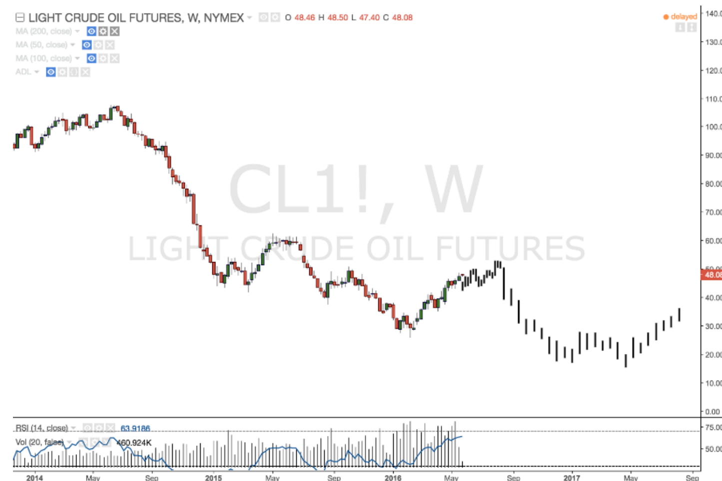
With both Japan and the EU easing and the dollar beginning to move higher, China will start back up with its "controlled" devaluation of the yuan. China will know that it needs a weaker yuan but it will be reluctant to let it float for two reasons. One, it's scared of the geopolitical repercussions (ie, trade sanctions) and it'd be a huge boon for anti-China political candidates like Trump and Sanders (whom the Chinese desperately don't want to win the Presidency). So they are inclined to push off the thought of a float until after the US elections. And secondly, the CCP is fragile and they're afraid of the unknown that a yuan free-float would bring.

So the Chinese are going to try to manage and control because that's what communist parties do.

Since China owns the large majority of its debt, they are unlikely to have a true illiquidity style banking crisis like the one we experienced in 08'. What's much more likely is that they will transfer their debt from the private sector to the public. They've already begun doing this; they've been setting up asset management companies (AMCs) all around the country to transfer bad debt from banks balance sheets and warehousing it —- essentially sitting on it and taking it out of the economy.

All the while, China will continue with their small “controlled” devaluations against the greenback. But by this time, around mid-September, each bit of devaluation will not only spur greater capital flight out of the country, it will also strengthen the dollar — negating any benefit of a small relative devaluation.

Meanwhile, bullish pressure on the dollar from the euro, yen, and yuan, will be driving commodities to new lows. By October, oil will hit new lows, bottoming in the teens and then chopping around, doing a whole lot of nothing for the next year.



With the inflationary narrative temporarily put to bed, gold will fall to near new multi-year lows — though its decline won’t be as swift as other commodities — considering the flight for safety that’s building by this point.

Commodity exporting countries like Brazil, South Africa, and Saudi Arabia will be in full-blown crisis by winter.

Unrest will be building and governments will be challenged by their populace. By November we will see our first major currency blowout… as one of these countries loses complete control and there's a rush of capital flight.

This will act as a nitrous-oxide boost for the dollar and it will be the straw that breaks the camel's back on the Chinese yuan-dollar peg.

China will lose control of the yuan and it will fall over 30% against the dollar from November to early spring of 2017.

This will create the "Mad Max" scenario (as fund manager Hugh Hendry put it). The dollar will go through the roof, and deflation will spread across the globe. International tensions will rise and trade wars will begin.

By the end of the year, US equity markets will be down over 35% and falling.

The Fed will have cut back to zero and will be discussing another QE package but will be unable to act at that point due to the election cycle.

Stage Three: Complete Capitulation

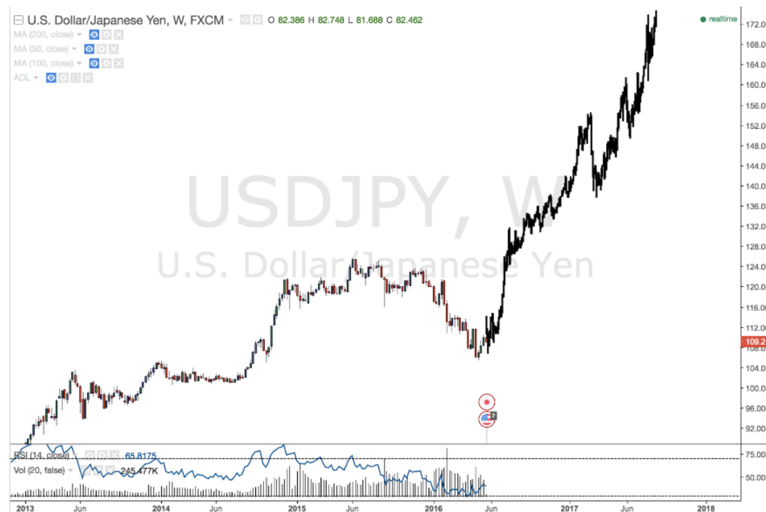
At the start of 2017, the market will be in complete free-fall. Donald Trump will have been elected President (propelled along by the worsening economic situation and growing dissatisfaction with the status-quo). This will increase the already high global economic uncertainty.

The bear market will not be of the illiquidity banking variety that we had in 08'. This time the banks are much better capitalized, though there will certainly be some major failures and blowups. This bear market will be much more like the one the SPX experienced in 00' and will hit every sector of the economy.

Deflation will be widespread and crushing.

Energy and the private tech space will experience a massive culling. All the fraud and bad business models that have been plastered over by the easy money policies of the last 8 years will be exposed. A more recent version of an Enron or a Madoff will come to light. The bear market in the US will last until the fall of 2017.

Europe will be in dire straits and it will mark the beginning of the end for the euro. Japan will experience something akin to hyper-inflation. The yen will trade at 200 to the dollar by the end of 2017.



China will resemble something of a mix between post 89' deflationary Japan and early 90's Russia. The CCP will turn inwards, and the government will become more brutal in order to reign in unrest. The two decade "China Miracle" will officially be over for the foreseeable future.

The potential for conflict will arise with hot points between Russian and Turkey flaring up, as Russia looks to gain full control of the Black Sea. China may invade Taiwan, bringing the country completely under its control.

The effects of large scale fiscal spending, combined with QE4, will finally begin to take hold towards the end of 17' and the dollar bull market will officially be over. The US will begin a new stage of the long-term debt cycle, as yields start their 20-year upward trend from the zero bound. Inflation will hit the US by the end of 2017 and gold will finally have its time in the sun.

Conclusion:

Too much doom and gloom? I admit it sounds pretty bad but historically speaking it's not far-fetched at all. We'll go through this deleveraging and come out of it better than before — though it will be a painful few years. As traders and investors, it will be a "target rich" environment for those willing to play it.

The obvious trades in this scenario will be long the dollar against a number of currency pairs and buying long-dated US treasuries. These will be epic trades.

Also, shorting certain equity indexes will give huge payouts over the next two years if this unfolds. We're currently looking at buying LEAPs and going naked-short against the S&P futures as well as the Russell — once price action signals it's time.

When I talk to other investors about the possibility of this happening, I often get asked, "well, what stocks should I buy?" I find that question to be completely perplexing. You shouldn't be long any risk assets if you had high conviction this was going to happen. It's okay to hold cash for periods of time. And it's even better to be long volatility and make a killing it you think the turds about to hit the fan.

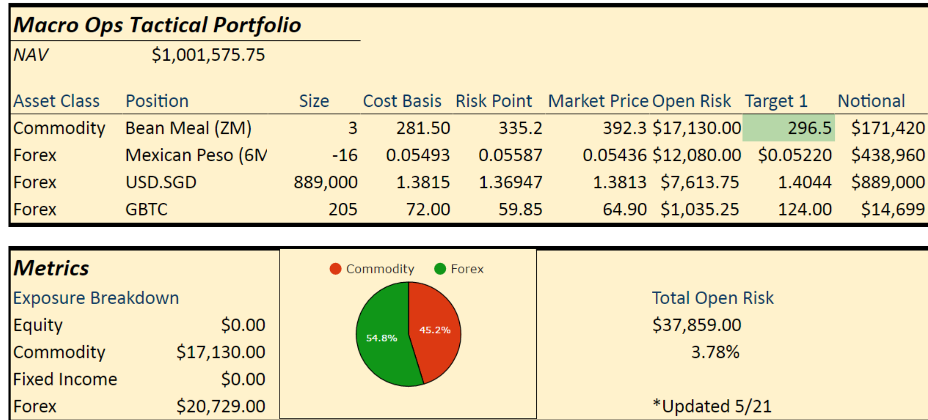
That old Wall Street axiom about how "it's impossible to see a bear market or crash coming," is a bunch of nonsense peddled by ignoramus's who are trying to protect their mediocrity. Look, I can't "predict" a crash. I don't have a crystal ball and don't know how to read any tea leaves. But, I do keep both of my eyes open and have my ears glued to the ground. And when I hear what sounds like a runaway locomotive bearing down on me… I'm smart enough to step aside.

Right now, I can hear a rumbling. It's still faint… but it's definitely there. The profits that can be made over the coming two years (if executed correctly) are of the variety that make careers — or let you retire from yours.

Portfolio Update

This week in the Tactical account we took a few forex trades. The only one that lasted for a weekend hold was USD/SGD (short Singapore dollar against the greenback). We took a small shot in EUR/GBP but exited on Friday after a strong rally put the position under water. Choppy market conditions call for extra cautious risk control. There is a time to make money in the markets and there is a time to keep money. While there is a lack of sustained trends and suppressed volatility one should focus on keeping money rather than making it. We also took off the rest of our platinum position as it hit a trailing stop.

Another thing to note is that we added a "Market Price" column to the tactical portfolio table. The purpose of this is to better measure the potential drawdown if all positions were to hit their risk points. Since drawdowns are always measured from the high water mark of the portfolio, including unrealized profits is an improved technique.



Macro Ops Tactical Portfolio

NAV $1,001,575.75

Asset Class	Position	Size	Cost Basis	Risk Point	Market Price	Open Risk	Target 1	Notional
Commodity	Bean Meal (ZM)	3	281.50	335.2	392.3	$17,130.00	296.5	$171,420
Forex	Mexican Peso (6M	-16	0.05493	0.05587	0.05436	$12,080.00	$0.05220	$438,960
Forex	USD.SGD	889,000	1.3815	1.36947	1.3813	$7,613.75	1.4044	$889,000
Forex	GBTC	205	72.00	59.85	64.90	$1,035.25	124.00	$14,699

Metrics

Exposure Breakdown	
Equity	$0.00
Commodity	$17,130.00
Fixed Income	$0.00
Forex	$20,729.00

Total Open Risk
$37,859.00
3.78%

*Updated 5/21

As expected in a low volatility environment, the Income Portfolio had a good week. We always expect this portfolio to do well in tight consolidating ranges. It continues to perform well. Both the puts and the calls are now showing profits.

Macro Ops Income Portfolio

NAV $1,029,135.30

Asset Class	Position	Size	Cost Basis	Max Profit
Option	SPX June 16 1960 Put	-10	10.80	$10,800
Option	SPX June 16 2155 Call	-10	14.80	$14,800
Option	SPX June 16 1520 Put	10	1.00	Hedge

Scenario Analysis/Stress Tests

Worst Case	Worst Drawdown
SPX Down 10%	-$58,000
SPX Down 20%	-$252,861

The Strategic Portfolio remains in cash. Many money managers have a hard time sitting in cash for extended amounts of time. Clients get antsy when their money isn't being "put to work." Having the patience to resist that urge and wait for the fat pitch is a big edge in the markets.

We are eyeing the long 30-yr and short SPX trade but are waiting for more confirming price action. Chop persists in both markets. While our long bonds position will be executed outright through the futures market (TLT ETF is the other option), our short SPX position will likely be executed through LEAP options struck about 18-months out.

Macro Ops Strategic Portfolio									
NAV	$966,479.17								
Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target 1	Beta (1yr)	Notional

Metrics				
Exposure Breakdown			Total Open Risk	Portfolio Beta
Equity	$0.00		$0.00	0
Commodity	$0.00		0.00%	
Fixed Income	$0.00			
Forex	$0.00		*Updated 5/15	

Trade Update

We've finally begun to see some clarity in markets as the dollar puts in a bottom. The recent break of major support levels in the dollar index threw many traders off. They went short and were immediately rebuffed as the greenback rebounded strongly. We too were stopped out of a few of our positions.

But as the dollar rebounded, we were given a number of other setups to play its renewed strength. These positions are more in line with our fundamental outlook for the USD over the next few years. We understood the recent correction was only temporary and were waiting to once again hit some long dollar trades when the trend resumed.

All the trading below occurred in the tactical account.

Short Peso

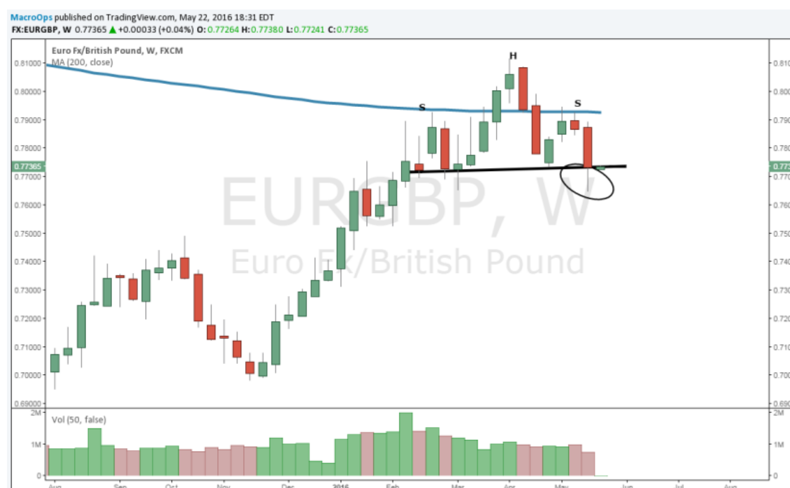
Our short Peso position continues to work in our favor. The position had a 90 basis point profit mid-week and gave a little of that back on Friday. We will

continue to hold until our target of 0.0522, where we will reduce our position by half.

USDSGD

The strong breakout of a 10-week cup in the Singapore dollar has held up nicely. The Sing is a great proxy to play a yuan devaluation.(USDCNY has a large negative carry) It follows the yuan closely due to a majority of Singapore's economy being export related. If the Chinese devalue, Singapore will be forced to follow suit to stay competitive.

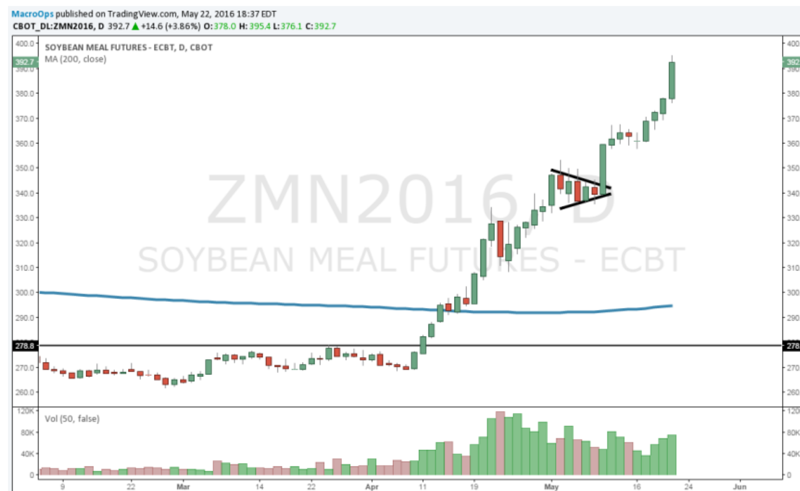
EURGBP



We tried to play the EURGBP pair on the "Brexit" theme with the understanding that Britain would likely not exit the Eurozone and the Pound

would strengthen. Unfortunately we were not able to achieve a strong weekly close on the chart, as you can see by the large wick in last week's candle. This prompted us to act conservatively and exit our position.

Soybean Meal



Soybean meal continues to shoot higher. This is a great example of why taking *only* half profits at a profit target can be so lucrative. Leaving the other half of your position on leaves you the opportunity to exploit a tail event trend such as this.

Platinum

Platinum is a good example of why you *should* take half profits at a target. You aren't always going to get massive trends like in soybean meal. In Platinum's case, we were able to take half profits right before it started to

turn around. This week it finally broke down to the point where we took the other half of our position off.

Scaling out creates a smoother equity curve plain and simple.

GBTC

If Bitcoin is still weak by the end of this coming week, we will exit our position.

S&P 500

We're waiting for a break of the neckline on the S&P's recent H&S pattern to short the index. We will short it outright with E-mini futures in our Tactical Portfolio. But in our Strategic Portfolio we will be making a longer term play by purchasing LEAPs against the index.

For portfolio details you can see it all [here in the hub.]

Comm Center Highlights

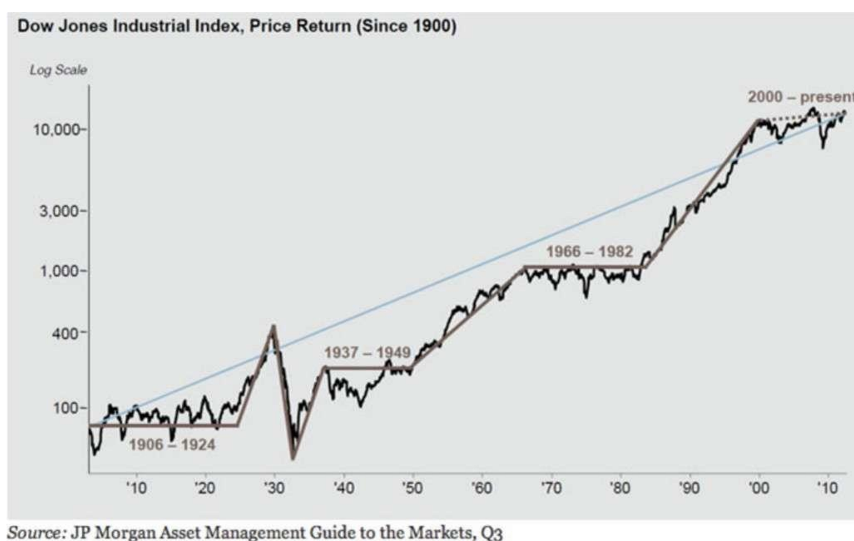
30 Year Bear Markets

At the recent SALT hedge fund conference, Milton Berg explained his belief that a new bear market was forming which would last for the next 30 years…

Who is Milton Berg? He's been around since the early 80's and has worked with a number of legends including Soros, Druckenmiller, and Steinhardt. He has a great track record and is highly credible.

He believes that current super-extended valuations coupled with our position at the end of a long-term cycle will lead to this extended bear market. His ideas line up with the idea of long-term debt cycles which we've discussed at length in our previous articles.

Now a 30 year bear market may be hard to imagine, but that's because most investors have a short-term memory. Check out the historical graph of Dow Jones returns below:



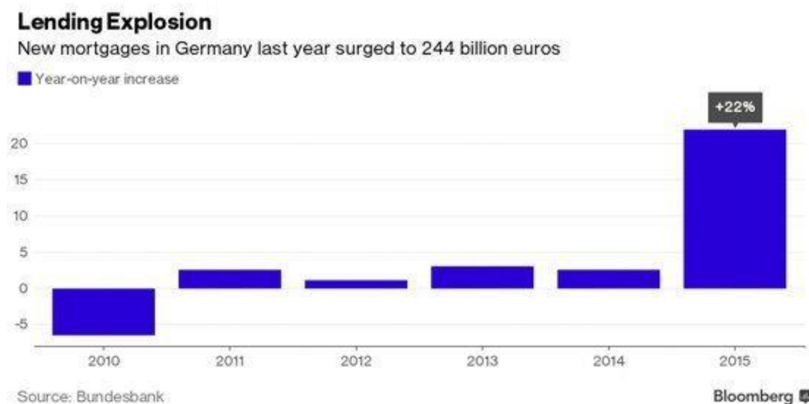
Source: JP Morgan Asset Management Guide to the Markets, Q3

There are multiple years of stagnant, bear markets. Take 1966 – 1982 for example. 16 years of straight sideways movement. Your annualized return from January 1966 to January 1982, including dividend reinvestment, after adjusting for inflation, would be -1.42%.

These periods are horrible for passive investors, but great for those with an active strategy like global macro. A 30 year bear market will be no problem for us.

Housing

The conversation started with one of our posts on Twitter regarding the spike in German mortgages starting in 2015:



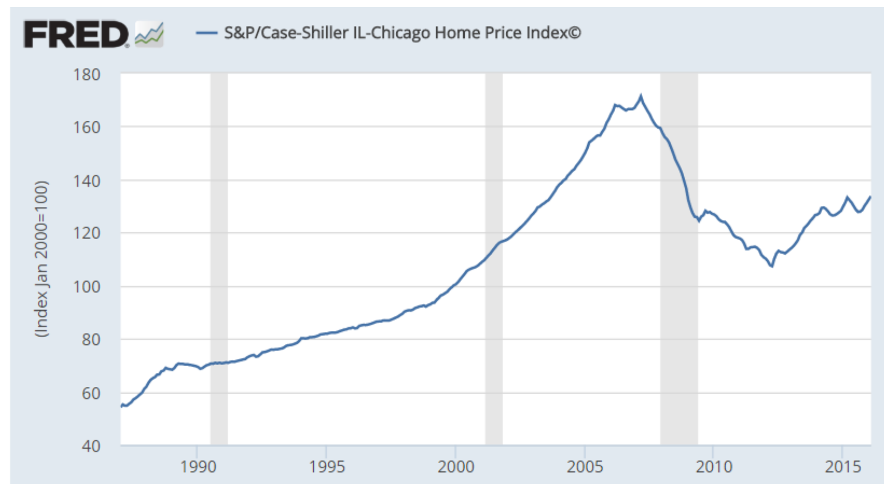
This got Jamie thinking about housing, which represents half the world's wealth, equaling the total value of the entire world's equities, bonds, and commodities combined. Some estimate that total property value is about 3-times world GDP. Housing is a big deal.

The question becomes whether housing data like this is a sign of excess leverage or an actual signal of pick-up in housing. A few factors that may support a bullish housing case including Lowe's and Lumber both making new highs.

Chintan chimed in with his experiences in Seattle and San Francisco where he saw first-hand the explosion in housing prices. According to his analysis, the growth has come from two sources: wealth and purchasing power created from the tech boom and foreign investors (Chinese) buying property hand over fist. (Which is most likely another means to move their money out of China.)

Seattle inventories are very low this year due to all the buying — 70-80% lower than last year. There are bidding wars everywhere with buyers paying 20-25% above asking prices. Chintan sees Seattle and San Francisco

continuing to boom over the long-term, but also points out that Chicago and a lot of the mid-west / east-coast cities are suffering.

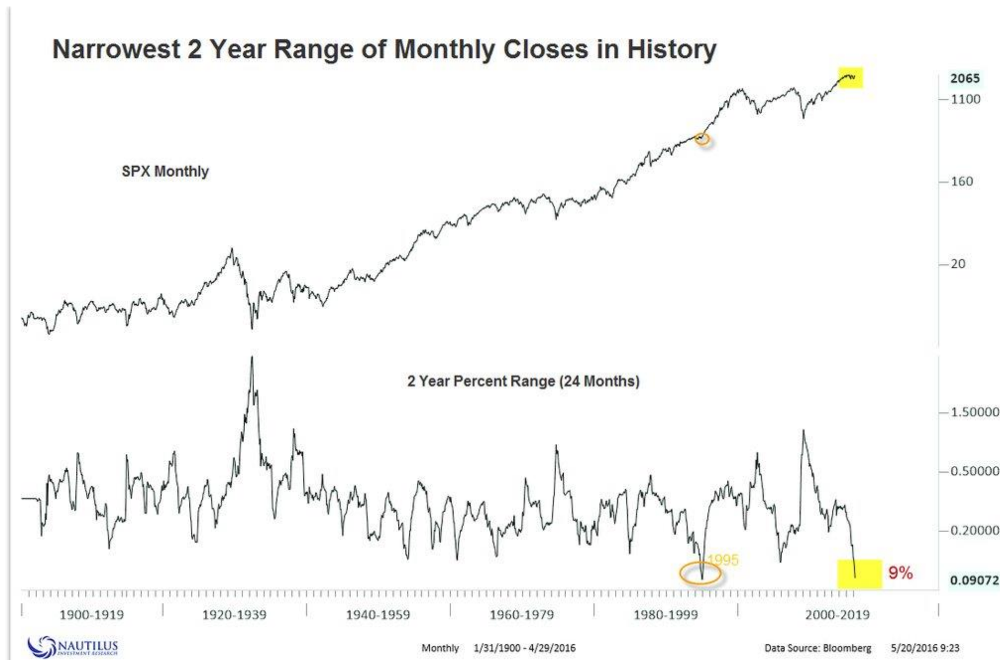


James also shared his experience in South-Eastern Pennsylvania where a number of new home developments are being built in what looks like a small building boom.

So far it looks like increases in housing are concentrated within pockets of wealth. For a real boom, we would likely need a broader buying which is difficult to achieve with a slowing economy and private debt at high levels.

Volatility

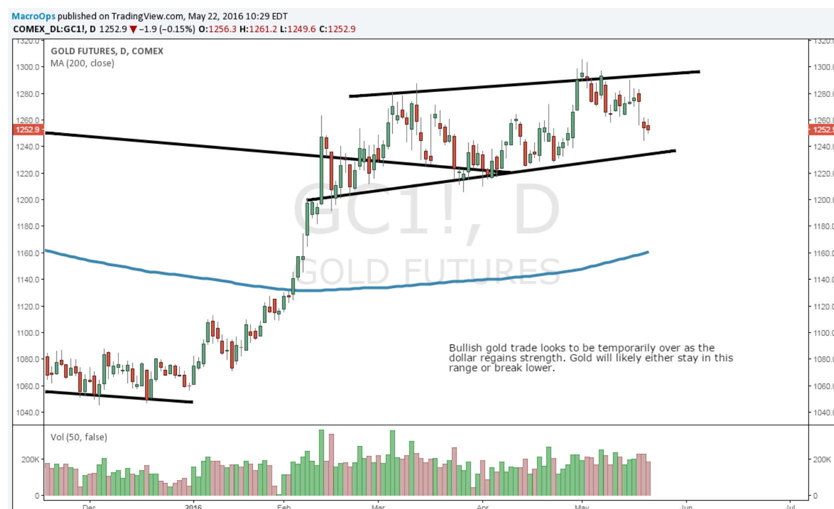
Jamie posted the interesting chart below showing how SPX has had the narrowest 2 year range in its history. As Tyler explained, volatility always mean reverts. The amount of suppressed vol we've had over the last few years will lead to hyper vol. The pendulum is due to swing back. A large breakout in the indices is coming that will kick us out of this range-bound malaise.



Hub Spotlight

You can check out the updated IMINT here. And the updated HIT List can be found here.

What caught our eye in the charts this week was gold's failure. Could this be the start of a retest to prior lows?



If the dollar index continues its rally from a failed breakout below this summer will be a fun one.

Other than that the markets have been pretty quiet since last week’s brief. None of our other models in the hub had any changes.

See you in the hub,

Alex