Sometimes I think the world is going mad. But then I remember that it’s always been mad — I find comfort in that.

Depending on who you ask, a yes vote for Brexit will either, [a] unleash the 7th circle of hell upon the world, [b] rain total freedom and awesomeness on the British people, or [c] nothing… just an empty meaningless void will be created. Like most irrational and emotionally heated debates, the real answer is probably much less exciting.

Honestly, I don’t really want to talk about Brexit. I just don’t find it that interesting and think the whole thing has been beaten to a pulp. But since the vote is this Thursday and the market is latched onto the narrative at the moment, I’ll go ahead and give a quick overview.

I have a buddy (due to job restrictions he’ll remain nameless) who runs a credit desk for a large investment bank in London. We met over a decade ago while operating in Iraq (he was a British Marine) where we were temporarily running missions out of the same camp. We became buds when I saw him reading a Market Wizards book and found out he was a fellow trading nut… we also ended up running a secret and fairly large brewing operation together (booze was not allowed on US bases), where we made delicious “Hooch Juice”… it actually tasted like jet fuel and went down like a punch to the gut, but it got the job done, I digress.

I called him up this weekend to get his opinion on the madness that is happening on the other side of the Atlantic. Here’s his take on things (I’m paraphrasing):

*Brexit now looks like a no-go. Just a week ago it looked like a real possibility, but the murder of MP Cox changed everything. It has thrown a wet blanket on the leave party, as you could imagine. And the fact that the killer was a crazed neo-nazi supporter of Brexit, makes the important and large group of undecideds unlikely to go out and cast their vote to leave. On the off chance that we do vote to leave it will be a very very bad deal for us, economically speaking. Not*
only will it throw a bunch of uncertainty over our trade agreements with the EU, it will also probably spell the end of London as the financial hub of the globe. In addition, we are the most vulnerable state in the world on a key measure of short-term debt and if we vote to leave and credit markets seize up — which they very well may do — then who bloody well knows what the f*ck will happen… hopefully we don’t have to find out.

I agree that Brexit looks like a stupid deal. The potential for a Brexit vote to trigger a sovereign debt crisis is real, and would be very bad. Standard & Poor’s, the US credit rating agency, has warned unequivocally that should Britain vote to leave, it will immediately be stripped of its coveted AAA status and could potentially face a double-barreled downgrade.

The agency’s head of sovereign ratings said, “We are categorical about this… There is no clear ‘Plan B’ in the UK and we are not going to wait until we find out what the British position actually is. We could potentially see a two-notch downgrade… The level of debt coming due over the next 12 months is 755pc of the country’s external receipts, the highest for all 131 sovereign states rated by S&P.”

So Brexit is bad… and the politicians behind the leave movement are just trying to climb the ladder of chaos that’s being fueled by the EU immigration crisis and the underlying secular debt cycle.

But the stay camp should win and markets will probably go on a relief rally of sorts, however temporary. If you want to better understand the British psychology behind the “Leave” vote (or you just want a laugh), I suggest you watch John Oliver’s bit on the matter, here’s the link.

The most important chart in the world...

Last week I mentioned this chart and said that this is the most important chart in the world. This week I’m going to tell you why.

First, let me explain some key terms:

- **Forex (FX) swap**: Is a contract between two parties (generally) where one party borrows US dollars and pledges another currency as collateral.
- **Forward rate**: Is the agreed upon exchange rate at which repayment (the closing of the FX swap) takes place. This is the implied US dollar interest rate for the length of the swap.
- **London Interbank Offered Rate (Libor)**: Is the average interest rate estimated by each of the leading banks in London that it would be charged were it to borrow from other banks. Roughly $400 trillion in derivatives are priced directly or indirectly off this rate.
- **Covered Interest Parity (CIP)**: Is the theory that the interest rates implicit in the FOREX swap rate should be consistent with market interest rates (Libor).

Don’t let this financial jargon put you off. What I’m about to tell you is really not that complicated and it’s extremely important to the global economic system — so it’s worth understanding.

Economist Hyun Song Shin presented a paper to the Bank of International Settlements (BIS) two weeks ago titled *Global Liquidity and Procyclicality*.

In it he discussed the breakdown of covered interest parity theory, and said the following:

> There is an intriguing market anomaly in the foreign exchange market right now: the widespread failure of covered interest parity. Covered interest parity, or “CIP” for short, is the proposition that interest rates implicit in foreign exchange markets should be consistent with market interest rates. Before 2008, CIP held as an empirical regularity with very few exceptions worth mentioning. As an academic, I used to tell my students that CIP is about the only relationship that can be relied upon in international finance. I know better than to say this now. Textbooks still say that CIP holds, but it is no longer true.

The chart above. The one that I say is the most important chart in the world right now, shows the breakdown of CIP. The blue line is just the average USD exchange rate against a basket of currencies. A higher blue line means a stronger dollar. And the red line is the average USD swap rate against a basket of currencies. A lower red line means a wider spread — a larger gap between USD libor rate and USD swap rate.

If that chart went back further in time, it would show the red and blue line tracking each other perfectly, just like CIP says it should. Previous breakdowns in CIP were generally temporary and isolated to financial crises. What is interesting now is that the widening in spread between USD libor and USD swap rates has persisted — even gotten wider — in times of relative calm.

Why is this happening?

Hypothetically this divergence should be arbitraged out. Banks should be borrowing USD at the market (libor) rate and lending them out in swaps, thus closing the gap.

Shin explains that this is likely due to increasing bank regulation and risk adversity. From Shin:

> In textbook settings where someone could borrow and lend without limit at prevailing market interest rates, the cross-currency basis could not deviate from zero, at least not by much, and not for too long. This is because someone could borrow at the cheaper dollar interest rate and lend out at the higher dollar interest rate. However, executing such a trade entails a sequence of transactions, often through intermediaries. As such, it makes demands on the risk-taking capacity of dealer banks as well as counterparties.

So there seems to be little appetite for being short a large amount of dollars at this point in time, at least in the swap market. The swaps market is not like the forex cash market, swaps can be very illiquid, meaning that occasionally it can be tough to find buyers, which means they have higher risk. And when
the world is collectively short $8-11 trillion US dollars there is an abundance of rocket fuel for a USD short-squeeze from hell… banks know this, which is why CIP is not working.

What’s really important about all this though are the global and second order effects that a strengthening dollar and higher swap rate are having on the economic system.

It’s not just emerging markets that the dollar is directly impacting but the other hard currency zones as well, most strikingly the euro, yen, and Swiss franc.

The reason for this causal linkage is most likely due to the greenback’s role as the global funding currency and the importance of the eurodollar.

Eurodollars are US dollar denominated deposits held outside of the US. Since they are outside of the US, they are not subject to US banking regulation and the banking costs associated with this regulation. This means that banks in the eurodollar market can operate on thinner margins than US institutions in USD financing. Because of this, along with the secular downward trend in US rates, the eurodollar market has absolutely exploded over the last two decades.

The dollar is used for international hedging, as a bridging currency in cross-border transactions, and for invoicing international trade among many other things. Needless to say, it’s become a very important and integral part of the global financial system.

This has intensified the rate at which dollar recycling flows around the world; which you can see in the chart below.

**US dollar-denominated cross-border claims**

<table>
<thead>
<tr>
<th>In billions of US dollars</th>
<th>Graph 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>2007</td>
</tr>
</tbody>
</table>

The flow of US dollars from here to Europe have increased from $462 billion in 02’ to $1.54 trillion in 07’ (the latest period for which we have data) and from $856 billion in 02’ to over $2 trillion in 07’ for the Europe-US leg.
This matters because it's this round-tripping of dollars between the US and the rest of the world that causes liquidity crises to spread from one country to another. The greater this linkage, the greater the fragility of the whole system — and today this linkage is greater than it ever has been in history.

In 2008, the US subprime crisis quickly spread to Europe because European banks were borrowing dollars at low rates in the US and then buying US equities and subprime mortgages with those borrowed dollars. And it wasn't just Europe, but banks all over the world were doing it, which is one of the reasons the 08' financial crisis was so devastating.

This time however, the key players most exposed to a stronger dollar are not financial institutions, they're emerging market corporates. And the USD borrowing has been done through corporate bonds versus bank funding.

This is extremely important because should the dollar debt unwind occur — and it will, it's just a matter of time — the mechanism by which financial stress will spread through the system will be much faster and more intense because the borrowers are corporates in the real economy and not just banks. Shin says the following:

First, even if the bonds have long maturities, there are other repercussions on the economy if US dollar-denominated borrowing begins to unwind. Non-financial firms are deeply embedded in the economy, and their financial activities spill over into the rest of the economy. Bruno and Shin (2015c) find that dollar borrowing by emerging market corporates has had the attributes of a "carry trade" where, for every dollar raised through a bond issue, around a quarter ends up as cash on the firm's balance sheet. Here, cash could mean a domestic currency bank deposit or a claim on the shadow banking system, or indeed a financial instrument issued by another firm. So, dollar borrowing will spill over into the rest of the economy in the form of easier credit conditions. When the dollar borrowing is reversed, these easier domestic financial conditions will be reversed, too.

Furthermore, even if a country has large foreign exchange reserves, the corporate sector itself may find itself short of financial resources and may cut investment and curtail operations, resulting in a slowdown of growth. So, even a central bank that holds a large stock of foreign exchange reserves may find it difficult to head off a slowing real economy when global financial conditions tighten. Arguably, such a slowdown is part of what we are seeing right now in emerging market economies.

All this goes to show that international financial developments have to be placed in the broader context of past and anticipated central bank actions.

Catch-22

This massive amount of global dollar liabilities has put us into a catch-22.

The dollar needs to weaken in order to stave off dollar denominated debt getting called (which is bullish for the USD).

But the weaker dollar hurts the export countries who are growing increasingly fragile; most notably Japan and Europe.

So a weakening dollar will eventually lead to a break of the Shanghai Accord (the current truce in the global currency war) because these countries will be forced to act in their own self-interest and devalue. And a break in the Shanghai Accord will lead to a stronger dollar.

We are getting near this point now. This is how I think it's likely to play out.

First, let's look at USD price action. Currencies have a very distinct way of moving, especially in larger trends. It's helpful to compare today's price action to past USD bull
trends. 1998 offers a great analog, not just because of the similarities in price action, but also because of the macro conditions of the time.

Look at the chart below of the six year bull market in the dollar index during the late 90s. In 98’ the dollar experienced a sharp retrace of over 11% before continuing on the second half of its run. The entire congestion and correction period lasted for roughly 550 days.

Now look at the chart of the DXY today. It has retraced only around 9% and has been in this congestion period for approximately 525 days.
Here’s the EURUSD chart during the same 90s dollar bull run. The euro chopped around and then violently spiked up over 13% before resuming its longer term trend. The congestion period lasted roughly 550 days.

And here’s the EURUSD today. It’s been consolidating for about 530 days and has only retraced about 11%.
You can go back in time and look at other currency pairs and see similar zones of congestion that last around 18 months. They’re followed by a short and violent counter-trend spike reversal, which then leads into the resumption of the longer term trend.

The dollar has been in its current congestion period for about 18 months now. I’ve been waiting for the counter-trend spike which would bring the DXY to the 88-90 level. The recent admission by the Fed that they have essentially given up on trying to hike rates has laid the narrative for this to happen.

When the Brexit vote fails on Thursday, I would not be surprised to see a risk-on rally where risky assets rise and the dollar falls — with a lot of the driving force coming from a strengthening euro.

This spike lower in the dollar will then force the hands of the BOJ and ECB in resuming actions to drive their currencies lower, thus restarting the dollar bull market in force.

The Japanese Minister of Finance commented last week that if the yen were to hit 100, the BOJ would have to intervene. The yen is currently at 103. Japan is going through elections right now, which will conclude in July, and that is likely the primary reason why the BOJ has stayed put — not wanting to be seen as political. Once these are out of the way, Kuroda-san will be free to hit the yen nuke button once again.

Once the dollar rally resumes, a positive feedback loop will form where a stronger dollar begets a stronger dollar. And we may very well get Hugh Hendry’s Mad Max scenario.

(Note: Nigeria broke its peg to the dollar yesterday. The naira quickly plummeted over 30%. Nigeria is Africa’s largest economy and it’s currently on the brink of recession. This is just the 1st domino to fall, there will be many others. The South African Rand is a prime candidate for next up.)

**Naira Weakens**

*Currency’s value plummets to record low as peg is dropped*

![Graph showing Naira interbank rate, three month forwards, and twelve month forwards versus the dollar.](Bloomberg)

6/13/2016  www.macro-ops.com
Some Things I’m Looking At

I have been digging deep into uranium this past week and will hopefully be putting out my findings to you guys over the next week or so.

I’m getting really excited about this space. There is a ton of hidden value in uranium equities and the whole narrative and sentiment is completely bearish — and completely wrong, in my opinion.

The timing might be a bit early, that’s something I’m trying to get a better understanding of now. But the upside potential is absolutely enormous.

I’m looking at US suppliers because that essentially gives you a call option on geopolitical instability. Nearly half of the world’s uranium comes out of Kazakhstan — which is at risk of becoming the next Ukraine.

Here’s monthly charts of two of the uranium stocks I’ve been looking at:

Many of these stocks have been doing nothing for over 7 years as investors have abandoned the nuclear space. I loooolooove contrarian plays like this where you pick through piles of the dead and find something that still has a pulse.
More nuclear reactors are being built right now than at any time in history. The current supply/demand imbalance will revert and probably very sharply. When uranium turns, these stocks could very well rally 1000%+. I’ll get back to you guys shortly with more on this.

And lastly, there’s this stock that I’m really digging into that could also be a 10-bagger or more. Fonar Corporation (FONR) builds MRIs and has a patented machine that scans a person while sitting down, providing a superior scan.

The stock once traded as high as $300 in the 1980s and is now around $20. The price action is great. It’s formed a 13 year cup and handle with recent breakouts on massive volume. The stock is currently trading at a P/E of 8, has hardly any debt, and has seen a number of consecutive quarterly revenue and earnings growth. This stock could end up being really interesting, but I’m still diving into it. I will be letting you guys know what we find out later this week. That’s all I’ve got for this week. Good luck in the markets and see you in the Hub!

-Alex
## Portfolio Snapshot

**Macro Ops Strategic Portfolio**

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Position</th>
<th>Size</th>
<th>Cost Basis</th>
<th>Risk Point</th>
<th>Open Risk</th>
<th>Target 1</th>
<th>Beta (1yr)</th>
<th>Notional</th>
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<tbody>
<tr>
<td>Fixed Income</td>
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**Metrics**

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<td>Equity</td>
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<tr>
<td>Fixed Income</td>
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<td>Forex</td>
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*Updated 6/19

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**Macro Ops Tactical Portfolio**

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<td>164'19</td>
<td>169'14</td>
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<td>Equity</td>
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<td>Commodity</td>
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<td>21.75</td>
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**Metrics**

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*Updated 6/20

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**Macro Ops Income Portfolio**

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**Scenario Analysis/Stress Tests**

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<th>SPX-20%</th>
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<tbody>
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**Updated on 6/20**