

Market Brief – M Is For Momentum



When the speed of rushing water reaches the point where it can move boulders, this is the force of momentum. When the speed of a hawk is such that it can strike and kill, this is precision. So it is with skillful warriors — their force is swift, their precision is close.

~Sun Tzu

There's not much new happening in Macro Land at the moment. The dollar looks more and more like it might break to the upside soon. And Japan is getting closer to the helicopter money we've been talking about for a few months now, where they issue zero-rate perpetual bonds to the BOJ.

This week we're not going to talk macro, but instead go over a favorite strategy of mine that works great in market environments like this one — high-beta momentum trading.

Momentum stocks tend to breakout and never look back. They have the potential to run 50%, 150%, or even 500% in the matter of a few weeks or months — before typically blowing out and reversing in extraordinary fashion.

Here's a few of the names we're looking at:

OCLR, FONR, VALE, JOY, KMI, RIG, X, CLF, BTE, TGB, NWPX, DNN, BAA, JO, MU, LFDN

We'll be exploring these companies further in the coming weeks. We'll let you guys know what we find.

Is this momo strategy dumpster diving? Absolutely! Some of my best trades ever, the ones that went up hundreds of percent, looked like flaming turds when I bought them — which is why they were so underpriced. The thing is, after really digging into the fundies of each company, I could see a positive path forward for the business. The stock offered an extremely asymmetric opportunity.

These stocks are normally driven by a catalyst, a complete 180-reversal in narrative, that attracts the momo crowd. These traders start driving prices higher as the momentum becomes a self-reinforcing energy until the advance reaches unsustainable levels.

A key part of this approach is to identify IBD (Investor's Business Daily) stocks before they pop up on IBD screens. For those unfamiliar, the IBD approach to investing (known as the CAN SLIM strategy) is a popular method created by Market Wizard William O'Neil. It's been adopted by a number of other Market Wizards in slightly different forms to produce huge returns, especially during the 90's bull run. Many of the tenets of the CAN SLIM strategy are still used today by momentum traders to make their picks.

To get a head start on these IBD/momo traders, we have to screen equities a little bit differently than most. Being successful in this strategy relies on being able to peer into the future and see where a stock/company can go, not analyzing things solely on where they are now. The market is pretty good at pricing the present, but horrible at pricing the future.

Here are the fundamental factors that you typically find in a major momentum stock:

- **Priced under \$15:** IBD screens don't scan for stocks under \$15, which means we need to get in under that level. Ideally our momentum stock will appreciate considerably before IBD picks up on it. That gives us the opportunity to start selling our position into the additional boost of momentum that comes from IBD followers. We also generally want companies with low market caps. It's a lot easier for a \$100 million company to 5x its market cap — in a short period — than it is for a \$1 billion company to grow to \$5B.
- **Annualized PE run rate of 15 or less:** We want to identify value plays that have been driven into the ground by excessive negative sentiment. This is sentiment that may have been warranted in the past, but not anymore as prices no longer consider the improving fundamentals of the company. It doesn't matter what the PE is right now. You want to model annualized earnings yourself and find equities that are being priced incorrectly according to your estimate.
- **Low float:** Conventional wisdom says that you want to buy stocks with sizable floats. But conventional wisdom only gets you conventional results. We want stocks that have small floats. The float is just a company's total outstanding shares minus closely held shares and restricted stock. Stocks with small floats mean there's little supply, so when demand picks up, they have the tendency to appreciate quickly.
- **Insider Buying:** This is an important one. The best momentum stocks all have lots of insider buying. No matter how much research you do, you'll never know as much as the people on the inside. If they're buying substantial amounts of stock relative to their pay and the stock's float, then that's a clear signal that they know something the market doesn't. Another thing I've found with the best momentum names is that management tends to be very conservative. They don't hype their earnings or give overly optimistic projections about the company's future. They just give the numbers straight with realistic estimates — they don't feel the need to pimp their stock.

- **Easy Comps:** In the theme of finding turnaround plays, we want stocks that have low hurdles to improvement. So stocks with poor or negative EPS in previous quarters are great. Improved earnings will look that much better when viewed on a QoQ and YoY basis. Momentum traders will see the large QoQ% increases and jump in, snatching up the limited float and sending the prices screaming higher.
- **Operating Leverage and Margins:** Operating leverage is how much a company's earnings will increase per each dollar of additional revenue. Companies with high operating leverage tend to have low levels of variable costs relative to their fixed costs. A company whose costs are primarily fixed will see greater margin expansion per revenue growth. This equals faster earnings growth.
- **Increasing Backlog:** A lot of companies will include their backlog figure in their earnings release. My best momo trades are usually with companies that have rapidly increasing backlogs. A backlog is just the amount of future business a company has under contract, but has not executed on yet. Growing backlogs are a sign that business is picking up.

Here are the technical factors that make up a major momentum stock:

- **Base Breakout:** The best momo stocks have been dead in the water a long time. They've been forgotten, have little analyst coverage, and have just been doing a whole lot of nothing for a long while. These long basing periods signal that all active and potential sellers are out of the picture. At this point the stock is only being held by long-term steady hands. There should be low volume during this period. We want to buy right as the stock breaks out of this consolidation, preferably on high volume. A breakout on high volume means the stock is starting to draw some attention. The longer the basing period, the longer the stock tends to run. These long basing periods also offer a natural risk point that clearly signals when a trade is wrong.
- **Weekly Close Above 25 Week Moving Average:** Why 25? No real reason, it could be 30 or 20. I just find that the 25 WMA tends to be a good support/resistance level for stocks that have been basing for a long period. We want to see a strong breakout on a weekly close above these levels. I should also note that you primarily want to screen for stocks on the weekly timeframe. The dailies contain way too much noise. It's the weeklies and above that signal significant moves.
- **Volume Expansion:** We want to see continued volume expansion from the time of the basing period, to the breakout, and also as the stock runs higher. Increasing volume means more interest. More fish are coming to feed. This is the fuel that causes momentum stocks to go parabolic.
- **High Angle Trend:** The goal with momentum stocks is to make the most amount of money in the shortest amount of time. This means we want the stock to follow a high-angle trend path once it breaks out of its base. A good momentum stock does not have a weekly close below its initial trend path once it's established. When it does, that's usually a good time to look at selling the stock.

These are the primary factors for identifying major momentum stocks — at least the ones I look for. You'll rarely find a stock that checks all these boxes. But ideally, you'll want it to check most of them. Some other things I look for are stocks that have an intriguing theme with the potential to capture the public's attention (tech is generally better than basic metals). Companies that have little direct competition, high insider ownership, and a good ticker that's easy to remember are always a plus too.

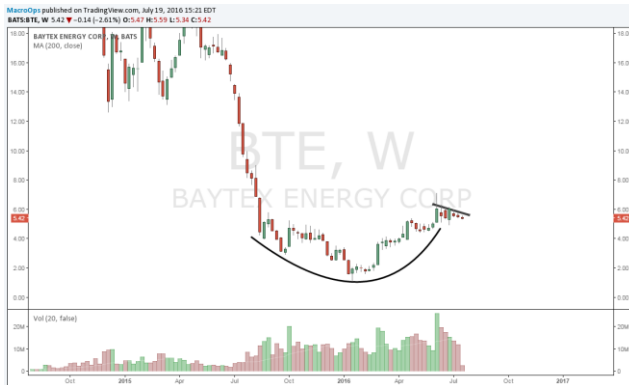
These stocks aren't easy to trade — they're high-beta after all — but they can be extremely rewarding. There's a very specific way to play these momentum style trades using moving averages and things like ATR expansion to signal profit and risk taking points. If you guys are interested, we can write up a much more in-depth report on this momentum strategy we use.

For your viewing pleasure, here are the chart setups of the momo names I mentioned above.

OCLR, FONR, VALE, JOY, KMI, RIG, X, CLF, BTE, TGB, NWPX, DNN, BAA, MU, LFN

Some of them are overextended at the moment. We're waiting for future consolidations to potentially enter.







Portfolio Snapshot

Macro Ops Strategic Portfolio

NAV \$1,000,418.47

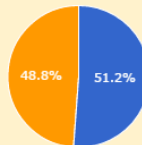
Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target 1	Beta (1yr)	Notional
Fixed Income	TLT	2500	132.87	128.98	\$9,725.00	146.00	-0.32	\$332,175
Equity	Cliffs (CLF)	6450	6.13	4.55	\$10,191.00	14.66	2.44	\$39,345

Metrics

Exposure Breakdown

Equity	\$10,191.00
Commodity	\$0.00
Fixed Income	\$9,725.00
Forex	\$0.00

Equity Fixed Income



Total Open Risk

\$19,916.00
1.99%

Portfolio Beta

-0.01

*Updated 7/16

Macro Ops Income Portfolio

NAV \$1,044,471.36

Asset Class	Position	Size	Cost Basis	Max Profit
Option	Aug 18 1960 Put	-10	\$19.08	\$19,080.00
Option	Aug 18 2016 2175 Call	-10	\$9.18	\$9,180.00
Option	Aug 18 2016 1465 Put	10	\$1.56	(Hedge)

Scenario Analysis/Stress Tests

Worst Case Worst Drawdown

SPX-10%	-\$100,000
SPX-20%	-\$250,000

**Updated on 7/16

Macro Ops Tactical Portfolio

NAV \$1,040,737.21

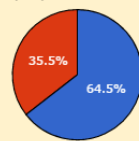
Asset Class	Position	Size	Cost Basis	Risk Point	Market Price	Open Risk	Target 1	Notional
Equity	Pampa Energia (PAM)	3400	24.40	23.31	27.29	\$13,532.00	27.76	\$174,896
Equity	Cliffs (CLF)	6780	6.12	5.00	7.04	\$13,831.20	10.02	\$41,358
Equity	Peru (EPU)	5935	32.09	30.80	32.87	\$12,285.45	36.14	\$190,454
Equity	Lifevantage (LFVN)	5000	15.47	13.93	15.64	\$8,550.00	20.80	\$76,450
Equity	EBIX Inc. (EBIX)	2106	52.89	49.18	53.13	\$8,318.70	62.58	\$113,345
Commodity	Cotton (CTZ16)	4	67.84	65.88	73.39	\$15,020.00	77.00	\$247,730
Commodity	Silver (SIN6)	1	17.05	16.36	19.98	\$18,100.00	18.47	\$173,300
Commodity	Coffee (JO)	5650	21.31	20.00	22.30	\$12,995.00	24.30	\$118,932

Metrics

Exposure Breakdown

Equity	\$56,517.35
Commodity	\$31,095.00
Fixed Income	\$0.00
Forex	\$0.00

● Equity ● Commod...



Total Open Risk

\$102,632.35
9.86%

*Updated 7/19