Macro Ops *Hub*
Target. Deploy. Profit.

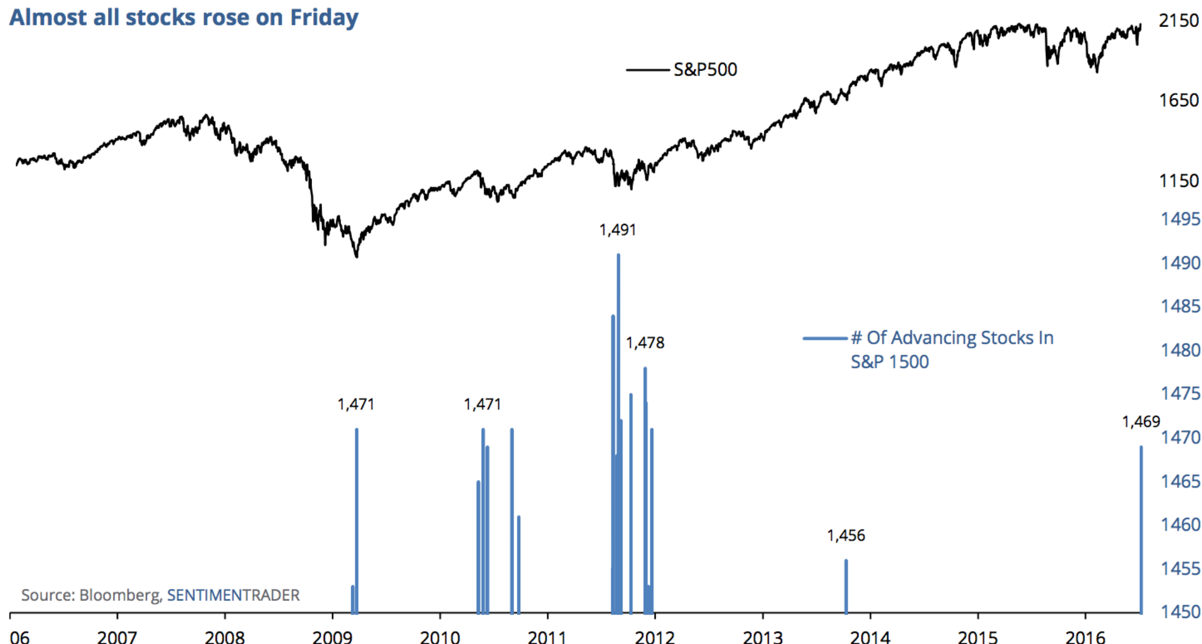
# Market Brief – Tant Pis Pour Les Faits

> "An enthusiastic philosopher, of whose name we are not informed, had constructed a very satisfactory theory on some subject or other, and was not a little proud of it. "But the facts, my dear fellow," said his friend, "the facts do not agree with your theory."—"Don't they?" replied the philosopher, shrugging his shoulders, "then, *tant pis pour les faits*;"—so much the worse for the facts!" ~ Charles Mackay, Extraordinary Popular Delusions and the Madness of Crowds

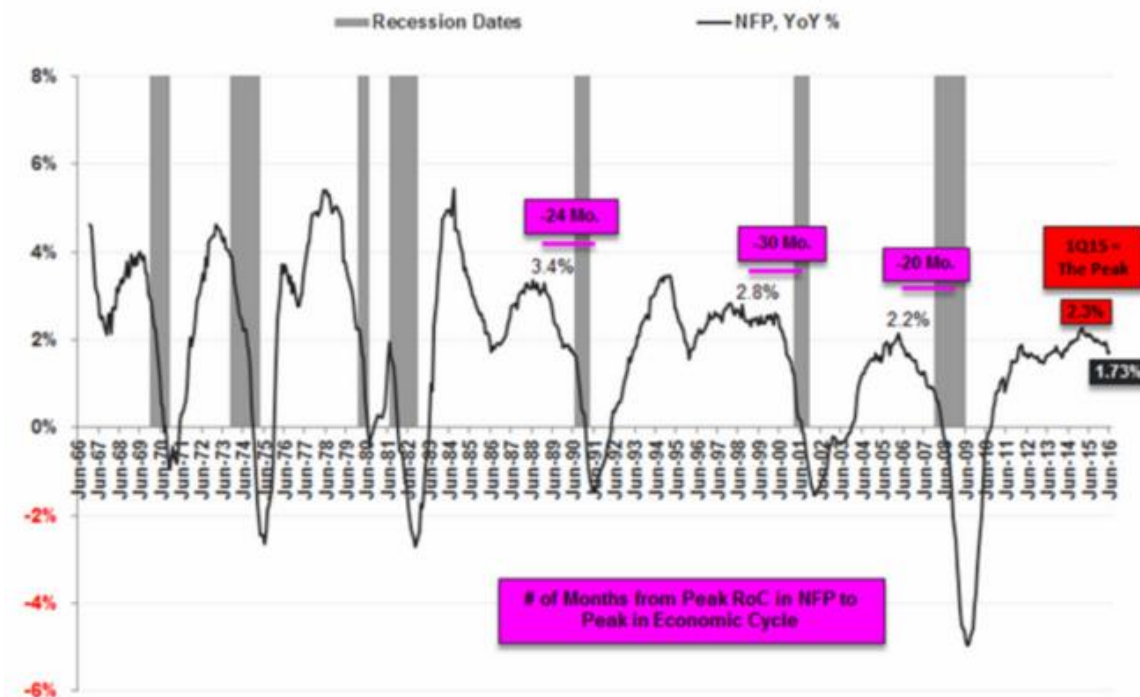
We're finally entering some exciting times in the macrosphere. The choppy doldrums of the first half of the year appear to be over as we enter a target rich environment.

As I write this (Tuesday morning) the SPX is at a record high 2154 with all US markets advancing on very strong breadth that began last Friday. Here's a quick look at what's going on under the hood of this rally:

1,469 stocks from the S&P 1500 advanced on Friday, confirming new highs with solid market breadth. Only August 8, 2011 had more stocks advance on a single day. This is a very positive short-term technical point. It means this rally may have some legs to it.




The financial media reported that Friday's rally was in response to the jobs number beat, with payrolls increasing by 287,000. This was significantly better than the prior month, which was just atrocious. But these numbers should be put into perspective. The chart below shows the annual rate-of-change for nonfarm payroll growth — not something to get overly excited about.



Either way, if this rally holds for the next few weeks, it will raise the likelihood of a prolonged and significant advance. Anytime there's a breakout from a consolidation period of nearly two years, it has to be respected.

Looking at charts for various sectors ranging from semiconductors to materials to some select emerging markets, it's tough not to get excited about some of the bullish price action setups.

**Here's what I think is going on.**

This rally is being driven by three things:

1. Typical late cycle sentiment: As the credit cycle peaks, it's typical for retail and mutual funds to start getting more aggressive in the markets and drive price action. This has been one of the stranger cycles in economic history, so in a way it would only be fitting for it to end with a prolonged euphoric blowoff.
2. Equity Risk Premium: ERP is the difference in the risk premia spread between assets, most notably 10yr treasuries and the equity markets (for more info, read It's All Relative). Falling rates around the world continue to make equities the only game in town.
3. China's Massive QE: China has been conducting a MASSIVE hidden QE over the last 6 months through their repo markets. This is likely having a large impact on commodity demand and boosting some emerging markets.

**Let's look at sentiment first.**

> *"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one."* – Charles Mackay, Extraordinary Popular Delusions & the Madness of Crowds

Sentiment is a tough thing to gauge directly. So we're left with a lot of anecdotal and indirect evidence.

Over the past month we've been seeing greater and greater signs of more retail enthusiasm and participation in the markets. For example, articles like this from the WSJ show the natural endpoint of the Central Bank "Put" narrative (emphasis added by me):

> *The fallout from the U.K.'s vote to leave the European Union last week battered the stock market, dragged sterling to its lowest level in decades and sent investors fleeing to haven assets.*
>
> *But it didn't scare 71-year-old Dene Alden.*
>
> *"We see it as an opportunity," said Ms. Alden, a retired graphic designer who trades stocks from the computer in her bedroom in Loveland, Ohio. "**When we see a selloff, that's like a 'for-sale' sign going up."***
>
> *Since the U.K. voted Thursday to leave the EU, major indexes in the U.S. wiped out weeks of gains in two days, before rebounding. **As indexes were diving Friday and Monday, some individual investors—from retirees such as Ms. Alden to college students to small-business owners—used the so-called Brexit as a chance to buy.***

*"We're putting our ear to the ground and looking for deals," said Ms. Alden on Monday. She described herself and her husband as conservative investors who mainly hold high-dividend stocks. The couple keeps on top of the markets by reading The Economist and tracking their portfolio's performance in an Excel spreadsheet. Ms. Alden said she bought shares of software company Red Hat Inc. on Friday. The stock lost 11% Friday and Monday; it has since gained 4%.*

*Retail brokerages reported seeing an uptick in trading on Friday, after the U.K. referendum results were released—and the bulk of action wasn't from investors fleeing.*

***At Scottrade Inc., trading volume was up more than 136% from the average day for the month, with about twice as many buyers as sellers, according to Shea Leordeanu, spokeswoman for the firm. For Fidelity Investments, Friday marked the third-highest trading volume in its retail brokerage's history, said spokesman Joseph Madden. Customers made 2.25 buys for every sell that day.***

*For some investors, the Brexit-fueled drop was a chance to snare coveted stocks at a lower price.*

*Gary Glein, 72, a retired Blue Cross executive and small-business owner from Gig Harbor, Wash., said he took advantage of Friday's selloff to boost his positions in stocks with limited international exposure—some of which he had been watching for months.*

*As prices slid Monday, Mr. Glein bought additional shares of used-car dealer CarMax Inc. Its shares gained 5.1% Tuesday and Wednesday after falling 2.7% the previous two sessions.*

*Mr. Glein said he was looking forward to discussing events in the U.K. and the market's response with fellow members of his local investing club.*

*"Now's the time to have a wish list and wait for them to come to you," Gil Oren said from his home office, where he begins watching markets at 7 a.m. each day. Although he loses money some months, Mr. Oren says he has made as much as $2,000 or $3,000 a month trading stocks and sets most of the money aside for his mortgage, car payments and a college fund for his 3-year-old.*

*Nicholas Stratigos, 56, a chief financial officer at a Pittsburgh-based trade association for graphic artists, said on Monday he bought shares of software developer Simulations PlusInc., which was up 3.4% Tuesday and Wednesday after falling 4.2% in the previous two sessions.*

***"With two down days like we had," Mr. Stratigos said, "I wish I had more to invest."***

Not to disparage the investors mentioned in this article — I'm sure they're all very nice people — but they aren't the "smart money". They don't win by actively investing in the stock market over time. And I don't think they're right in their pavlovian dip buying here. We haven't reached some permanently high plateau…

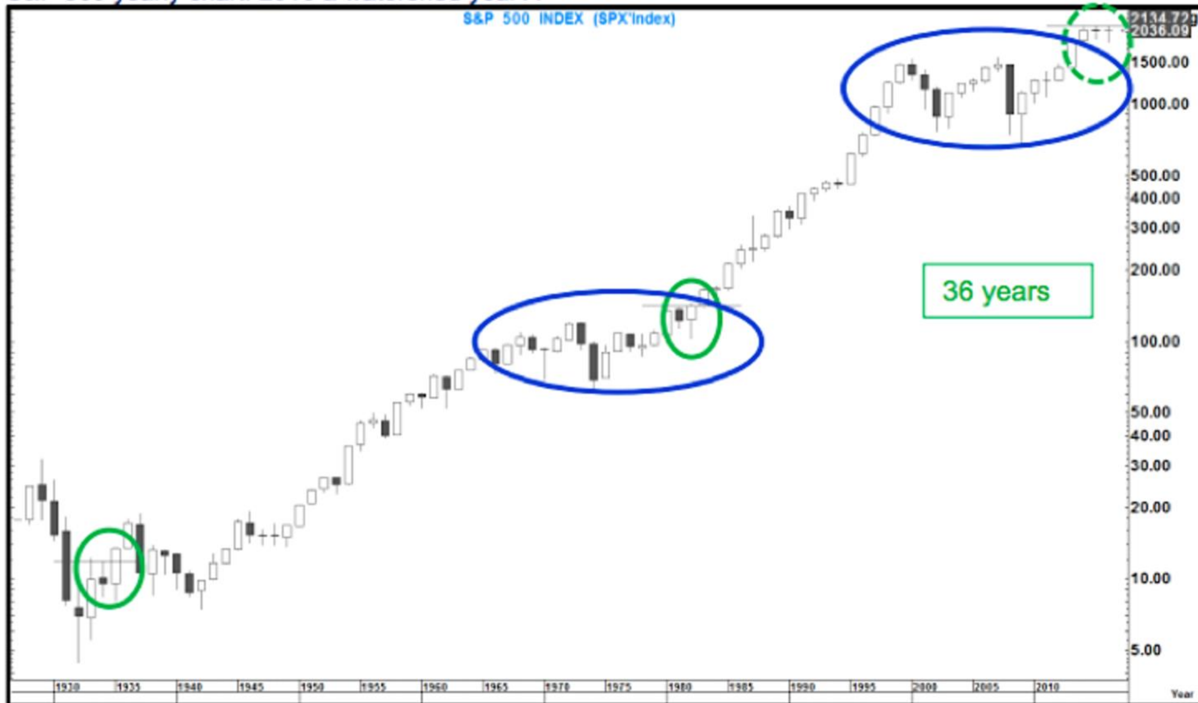
The increase in retail market participation is indicative of late cycle action. Retail always starts piling in when the market is in its last stage.

Over the last month we've also seen a big uptick in the number of emails we receive from the very novice retail crowd asking about the best penny stocks to buy and how to make a lot of money fast.

The people who gravitate to our site and read our stuff generally tend to be the more advanced trader/investor… so unless our articles have a new distribution channel that we don't know about, I'm moved to think that we're reaching a euphoric stage in investor complacency — peak central bank "buy-the-dip" narrative.

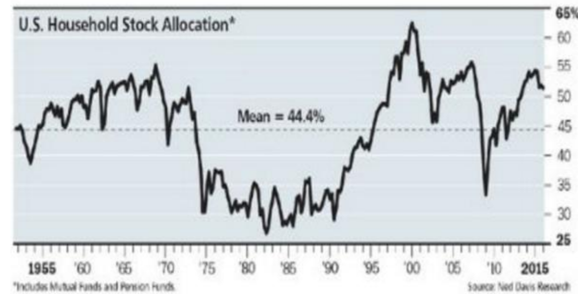
The chart below has been making rounds on the financial blogosphere. It's a chart of a potential yearly outside bar. This is a technical analysis term that describes a bullish or bearish engulfing pattern where the candlestick's (whatever timeframe) high and low price exceed both of those of the previous bar. If the bar closes and engulfs the previous candlestick then it's considered bullish and vice-versa for bearish.

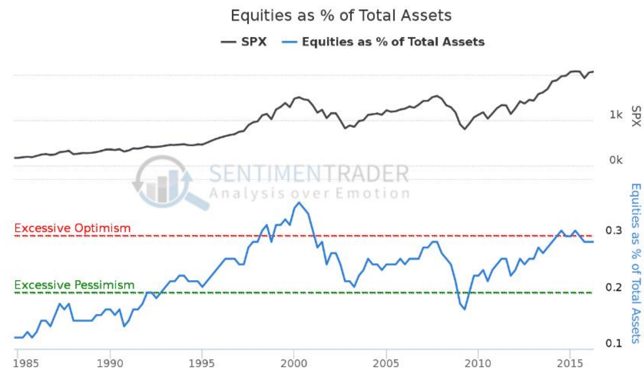
It shows that if we continue up and end the year above where we're currently at, then we'll have a bullish engulfing yearly candlestick. If this happens it'll be only the third year in history the S&P 500 posts a positive outside year, the last two times were in 82' and 35'.



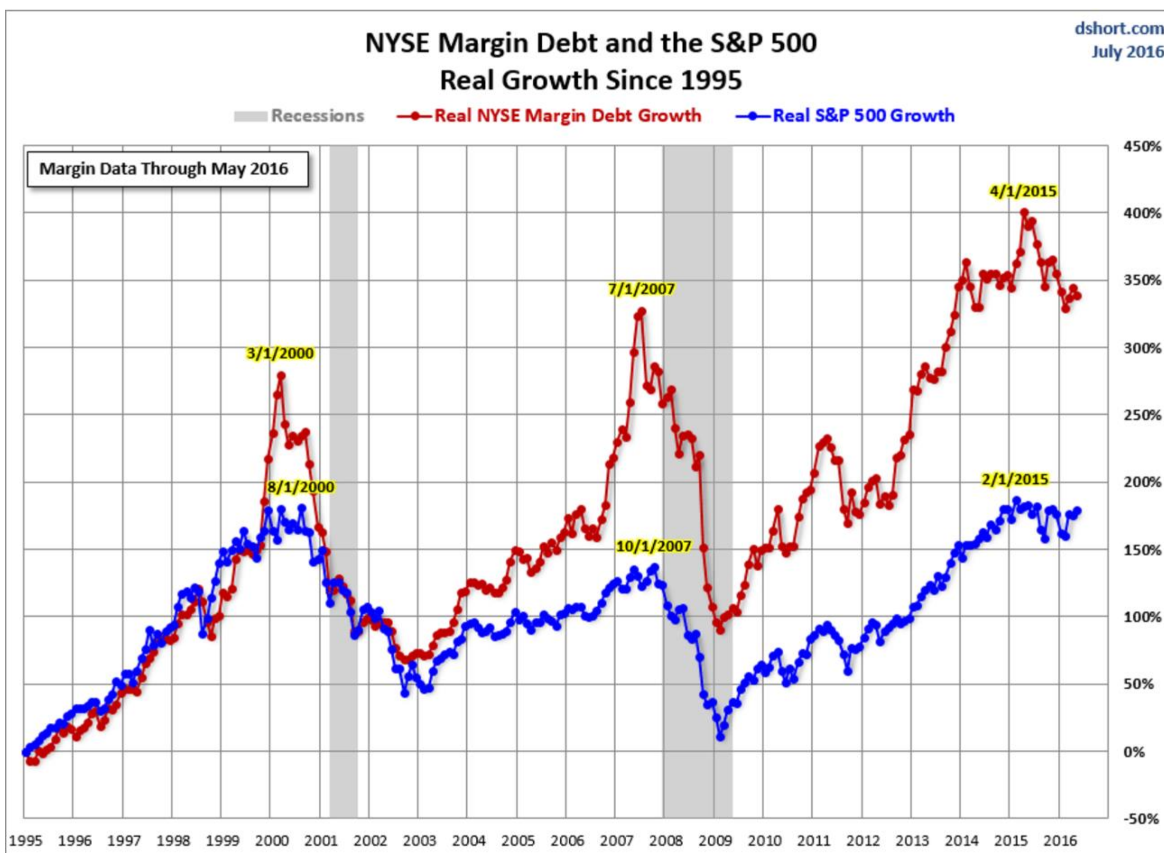

I don't think we can pull much from this chart, but it's interesting nonetheless. As this final bull rally continues, we will likely see more and more of these pieces of "evidence" being shopped around in the media in an attempt to give weight and meaning to the sentiment driven rally — to make it seem more concrete and legitimate.

Household equity holdings are near historical highs which also suggests a potential blow-off top.




And finally for sentiment; margin debt, which measures the amount of securities purchased on credit, is near historical highs and has started to reverse — another indication of the final throes of a market top.




How long can sentiment carry a market? Well it's impossible to model the madness of crowds. Runaway sentiment will either eventually exhaust itself or get popped by an external shock. A bullish euphoric run in markets could last one more week or another 18 months. Due to the size of the congestion zone we're currently breaking out of I would think this rally could have some legs and go for a couple of months… we will see. All we can do is play the price at this point.

**The Equity Risk Premium Driver**

You've heard us talk a lot about liquidity and spreads. These are the two most important factors to markets — always.

As the yield on long bonds continues to move lower, the risk premium on equities widens, making equities more attractive.

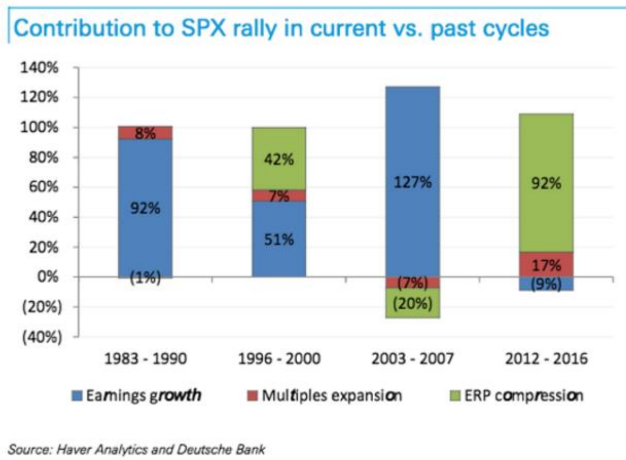
Long bonds have been one of our highest conviction trades this year, and have performed as hoped. They're being driven by global relative value. US bonds are cheap in comparison to the rest of the world at NIRP. We're also the cleanest dirty shirt, economically speaking.

Here's a note from Deutsche on the subject of ERP and equities:

> *One should also look at how the equity risk premium has evolved to get an appreciation for the role it plays in supporting equities. From 1982 to 2009 it behaved fairly predictably, staying in a range between zero and 4 percent. The ERP climbed even as earnings increased because investors start demanding more from equities over the risk-free rate for protection against higher inflation and a maturing business cycle. In the two decades preceding the early 2000s, the ERP had seemed to be trending down ever so slightly, perhaps because of steady declines in inflation from levels observed during the 1970s. The dot- com boom saw the ERP reach a near-record low, and the subsequent market decline pushed it back up nearly to historical highs, which had prevailed for most of the 2000s.*
>
> *After the SPX lost nearly 60 percent of its value between 2007 and 2009, the equity risk premium reached new highs. Investors demanded as much as a 7 percent premium from stocks over government bonds as late as 2012, even as the general outlook was steadily improving. It wasn't until the last couple of years that the ERP began to decline, supporting equities even as earnings slowed. Currently at 3.6 percent the ERP is at its lowest level since the recession but still sits above the upper bound of its pre-crisis historical range. The important takeaway is that to the extent the ERP still has room to fall back to its historical average of 2 percent, it could provide roughly another 200 points of upside to the SPX.*

The chart to the right from DB shows just how much impact ERP compression has had on this bull market.

This is no surprise to us. The bull market of the last few years has been almost entirely driven by rate reduction and ERP compression. It started with QE and has been carried on by global CB meddling and rising economic fears spurring a flight to safety.



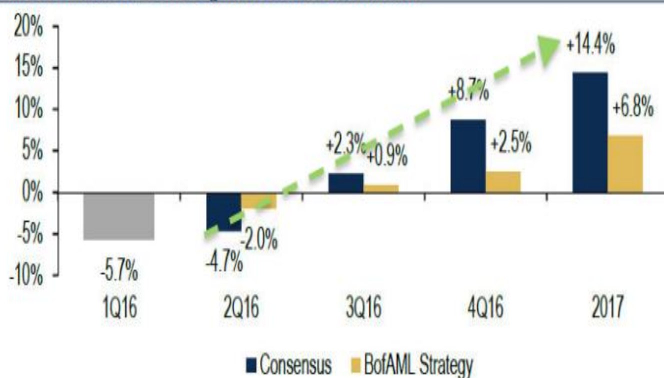
Source: Haver Analytics and Deutsche Bank

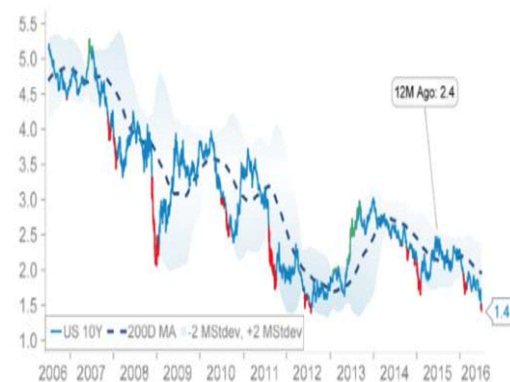
As long as US bonds continue to rally and no external shock occurs, it's very likely that equities continue higher. Of course, the more that ERP gets squeezed, the more susceptible it becomes to violent risk premium expansions (equity selloffs).

ERP is comprised of treasury rates and earnings expectations. All it'd take is either a rise in interest rates or a hit to earnings estimates to kick off an ERP unwind. And the longer rates fall and the more unrealistic earnings expectations become, the higher the probability of this occurring. Here's SocGen on the matter:

> *A double-digit equity market correction is possible should the equity risk premium fall 1-standard deviation below the long-term average. The chart below shows the equity market return in the 12 months subsequent to the equity risk premium falling 1-standard deviation below the long-term average level. Except for the 2000-03 period, such an event (ERP falling below 2.9%) has triggered an equity market correction of 10% to 30%.*

Look at the two charts below and you can see how real this risk is. The chart on the left shows the dramatic earnings increases expected by analysts and the chart on the right shows how the yield on the 10yr has now fallen more than two standard deviations below its 200 day moving average. The rubber band is stretched tight, just waiting to snap back.




**China's Stealth QE**

China has been and continues to be the biggest market wildcard for both the bullish and bearish argument.

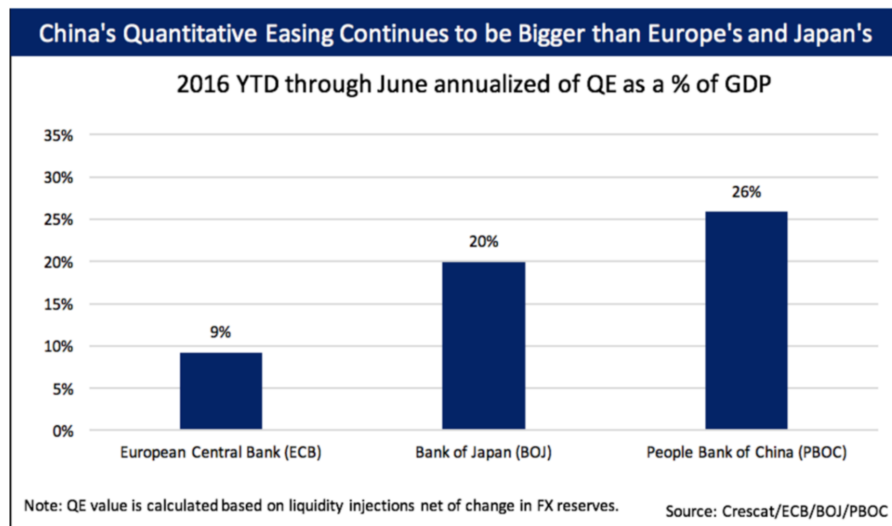
It's the largest bearish wildcard for global markets because of the inevitable yuan devaluation, which has been steadily picking up steam over the last few weeks.

It's also the largest bullish wildcard for global markets because it's been injecting more cash into its system as a percentage of GDP than any other country in history. Here's the following from Crescat Capital (h/t to James for the find):

> *The PBOC has injected over $1.6 trillion of cash into the Chinese markets this year through the repo market. This intervention (net of foreign reserve changes) is*

*approximately $2.8 trillion annualized, or about 26% of its nominal GDP. This annualized net level of QE is beyond any other major central bank stimulus program today. It exceeds both that of the European Central Bank (ECB) and the Bank of Japan (BOJ).*

*Credit bubbles can continue as long as banks are willing to lend and borrowers are willing to borrow. When either side falters, credit stops growing, and the economy collapses. In 2015, the annual M2 money supply grew by 16 billion CNY — the highest annual change in history. What suggests the possibility of a peak level is the fact that year to date, relative to prior years during the same period, this value has begun to decline. Similarly, total social financing has already begun to decelerate its annual growth. This broader measurement of money supply increased by 15.3 billion CNY in 2015, which is 2 billion CNY smaller than the 2013 figure.*



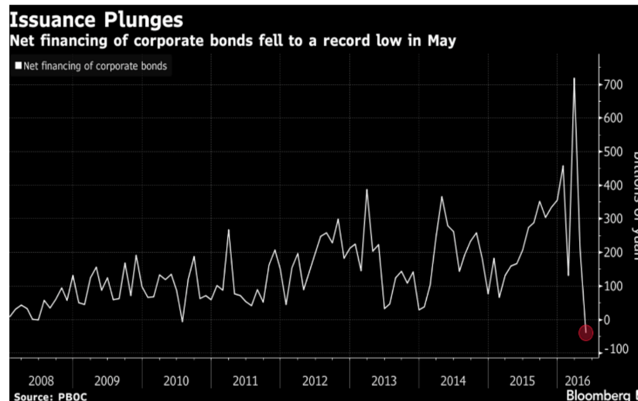

$1.6 trillion in monetary injections in just six months… That is nuts. There's just no way to know what this means for China over the short and medium term.

We agree with Kyle Bass that this monetary expansion means an eventual large yuan devaluation. But in the meantime, this could lead to increased infrastructure and other wasteful gluttonous Chinese spending. It's already been blowing up Tier 1 property prices (again).

And that could be why we're seeing an uptick in a lot of the commodity emerging markets.

I wrote about this possibility in our 1999 redux piece two months ago, where I talked about the credit reflation going on in China since the start of the year and noted that it generally takes 6 months for that liquidity to be reflected in the economy. When I wrote that, I had no clue that the easing would be on such a massive scale, but this could very well be what we're seeing now.

How long can China's monetary/credit expansion prop things up? No way to know. This is completely unprecedented and there's conflicting signals everywhere. China's corporate bond market has completely tanked, but at the same time, there's some Chinese equities that look positively bullish from a price action perspective.



## Global Catalysts for the Climax

Late cycle sentiment driven rallies can be extremely profitable. Markets have a tendency to run vertical during these periods. But they can also be very volatile. So we have to press on as aggressive, but maintain tight risk management — a tightrope walk of sorts.

There's no shortage of potential sentiment popping catalysts we need keep an eye on. Here's just a few:

- Italian Banking Crisis: Italy's banks hold roughly $400 billion in NPLs and the Italian government is restricted by Eurozone rules from bailing them out (the situation is near crisis).
- Deutsche Bank: One of Germany's oldest banks (one year older than the country itself) is sitting on a pile of bad debt and carries a derivatives book of $41 trillion (not a typo). There's lots of systemic global risks stemming from Europe at the moment.
- End of Shanghai Accord: With the yuan falling and yen rising, it's just a matter of time before the central banks break cooperation and act purely in self-interest, resuming the currency wars and driving up the dollar.

If you haven't been the Comm Center lately, I suggest you jump in there and read the debate Jamie and I had on where we are currently in regards to the economy.

Jamie makes a very compelling argument that we're at the beginnings of a new business cycle and that this bull market will likely last for years, not months. He could very well end up being right… we will see.

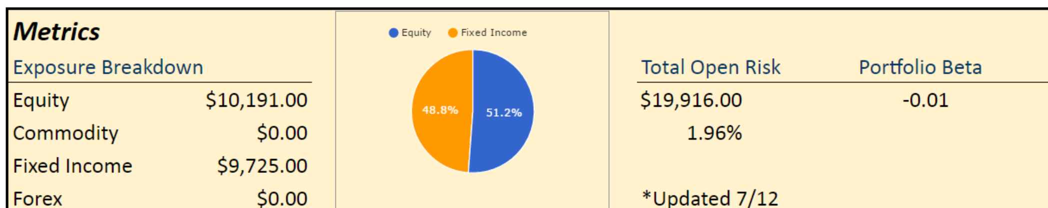
Macro Ops Hub
Target. Deploy. Profit.

# Portfolio Snapshot

## *Macro Ops Strategic Portfolio*

*NAV* $1,014,248.61

| 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 |



| Total Open Risk | Portfolio Beta |
|---|---|
| $19,916.00 | -0.01 |
| 1.96% | |

*Updated 7/12

## *Macro Ops Income Portfolio*

NAV $1,050,815.16

| 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*

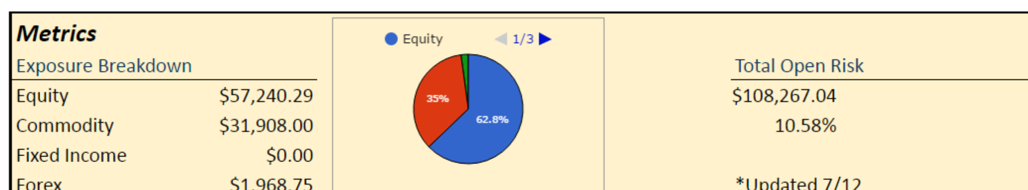
| Worst Case | Worst Drawdown |
|---|---|
| SPX-10% | -$100,000 |
| SPX-20% | -$250,000 |

**Updated on 7/12

## *Macro Ops Tactical Portfolio*

*NAV* $1,023,526.31

| Asset Class | Position | Size | Cost Basis | Risk Point | Market Price | Open Risk | Target 1 | Notional |
|---|---|---|---|---|---|---|---|---|
| Equity | Pampa Energia (PAM) | 3400 | 24.40 | 23.31 | 27.66 | $14,790.00 | 27.76 | $174,896 |
| Equity | Cliffs (CLF) | 6780 | 6.12 | 5.00 | 7.32 | $15,729.60 | 10.02 | $41,358 |
| Equity | Peru (EPU) | 5935 | 32.09 | 30.80 | 32.51 | $10,148.85 | 36.14 | $190,454 |
| Equity | Lifevantage (LFVN) | 5000 | 15.47 | 13.93 | 15.29 | $6,800.00 | 20.80 | $76,450 |
| Equity | EBIX Inc. (EBIX) | 2106 | 52.89 | 49.18 | 53.82 | $9,771.84 | 62.58 | $113,345 |
| Commodity | Cotton (CTZ16) | 7 | 67.84 | 65.88 | 70.78 | $17,150.00 | 0.77 | $247,730 |
| Commodity | Silver (SIN6) | 1 | 17.05 | 16.36 | 20.12 | $18,800.00 | 18.47 | $173,300 |
| Commodity | Coffee (JO) | 5650 | 21.31 | 20.00 | 22.32 | $13,108.00 | 24.30 | $118,932 |
| Forex | British Pound (6BU6) | -3 | 1.3040 | 1.3390 | 1.3285 | $1,968.75 | 1.0345 | $242,000 |



### *Metrics*

| Exposure Breakdown | |
|---|---|
| Equity | $57,240.29 |
| Commodity | $31,908.00 |
| Fixed Income | $0.00 |
| Forex | $1,968.75 |



| Total Open Risk |
|---|
| $108,267.04 |
| 10.58% |

*Updated 7/12