Market Brief – Book Of Five Rings

There is timing in the whole life of the warrior, in his thriving and declining, in his harmony and discord. Similarly, there is timing in the Way of the merchant, in the rise and fall of capital. All things entail rising and falling timing. You must be able to discern this. In strategy there are various timing considerations. From the outset you must know the applicable timing and the inapplicable timing, and from among the large and small things and the fast and slow timings find the relevant timing, first seeing the distance timing and the background timing. This is the main thing in strategy. It is especially important to know the background timing, otherwise your strategy will become uncertain.
~ Miyamoto Musahi

Miyamoto Musahi was a renowned Samurai and Ronin (meaning he served no master) in Japan during the early 17th century. He had a unique style of fighting with double blades which was apparently quite effective; he racked up an undefeated record of 60 duels. In his later years he wrote *The Book of Five Rings* — a work similar to Sun Tzu's *Art of War* that covers strategy, tactics, and philosophy through the scope of sword fighting, but that's also applicable to life in general.

In *Five Rings*, Musahi talks about the importance of timing and maintaining one's awareness of the ebb and flow inherent in life and war.

Timing, as we know, is as critical an input to a deadly Ronin Samurai as it is to a Master Trader. Musahi's wisdom on the differences of time and the warrior's manipulation of such, is a subject that every trader needs to understand and practice at the deepest levels.

I've been increasingly thinking about Musahi and timing because of the macro environment we now find ourselves in. It's in this type of environment where understanding the difference of applicable and inapplicable, as well as, background and distance timing, becomes ever more crucial. Let me explain.

As traders operating in markets we're fighting in multiple timeframes. In these different timeframes there's varying levels of signal to noise. We're left to discern what timing is applicable to our trade objective and what's not. We need to learn from experience which timeframes we can have relevant conviction in and which we simply can't.

For instance, one cannot simply be bullish on stock XYZ. That is a meaningless statement. Are you bullish on the stock over the short term (ie, next 4-8 weeks) because of factors a, b, and c? Or do you really think the company is undervalued and price should rise at some point over the next couple of years; but you have no conviction on where it will go in the near term?

Discerning your trade objective and reasoning is vital to understanding what your "relevant timing" is. Meaning, you understand the relevant time and the factors applicable to your thesis — every timeframe has its own unique drivers.

Musahi talks about the importance of "first seeing the distance timing and background timing." The trading equivalent to these are price action and macro. Price action (distance timing) signals where things stand now and where they're possibly headed in the near term (1-3 months). Macro (background timing) tells us where the larger forces and imbalances are. It provides us with a gauge of where the risks and opportunities lie in the future. Both sections of time affect one another, so the ebb and flow of the battlefield (market) is constantly evolving.

But, as Musahi says, it is "especially important to know the background timing" because that is the more powerful force that will eventually bend and dominate the near-term. It's when these different timeframes line up that you get the most powerful and profitable trends.

Livermore (the Musahi of markets) understood the importance of timing in speculation better than anybody and talked about this lesson repeatedly in *Reminiscences of a Stock Operator*:

> *"The way to make money is to make it. The way to make big money is to be right at exactly the right time. In this business a man has to think of both theory and practice. A speculator must not be merely a student, he must be both a student and a speculator."*
>
> *"There is a time for all things, but I didn't know it. And that is precisely what beats so many men in Wall Street who are very far from being in the main sucker class. There is the plain fool, who does the wrong thing at all times everywhere, but there is the Wall Street fool, who thinks he must trade all the time. "*
>
> *"Obviously the thing to do was to be bullish in a bull market and bearish in a bear market. Sounds silly, doesn't it? But I had to grasp that general principle firmly before I saw that to put it into practice really meant to anticipate probabilities. It took me a long time to learn to trade on those lines. "*
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> *"I think it was a long step forward in my trading education when I realized at last that when old Mr. Partridge kept on telling the other customers, 'Well, you know this is a bull market!' he really meant to tell them that the big money was not in the individual fluctuations but in the main movements — that is, not in reading the tape but in sizing up the entire market and its trend."*
>
> *"...the point is not so much to buy as cheap as possible or go short at the top prices, but to buy or sell at the right time."*

"I had made a mistake. But where? I was bearish in a bear market. That was wise. I had sold stocks short. That was proper. I had sold them too soon. That was costly. My position was right but my play was wrong."

"That is what happened. I didn't wait to determine whether or not the time was right for plunging on the bear side. On the one occasion when I should have invoked the aid of my tape-reading I didn't do it. That is how I came to learn that even when one is properly bearish at the very beginning of a bear market it is well not to begin selling in bulk until there is no danger of the engine back-firing."

Current "Distance Timing"

According to the WSJ, the S&P's realized volatility over the last 30 days has been lower than in any same such period in more than two decades. Volume has also been near record lows for this time of year.

As I write this (Tuesday morning) the market looks like it's finally breaking out to the upside of this range. If it holds, I'd expect to see some increased bullish action going into the start of next month.

With the SPX trading at 2190, it's bumping up against the significant level and round number of 2200. And according to Urban Camel, the SPX has had a "consistent tendency to react as it nears each new "round number" milestone for the first time. The smallest reaction (2%) was in 2013 at 1800. Most often the reaction is more than 3%. The last two were 10% (at 2000) and 6% (at 2100)."

I keep looking for price action weakness, but I fail to see it anywhere. The trend, though slow, is still strong with this one. And most importantly, credit continues to get its perpetual bid. Until I see sizable weakness in credit, I won't look for a retrace.

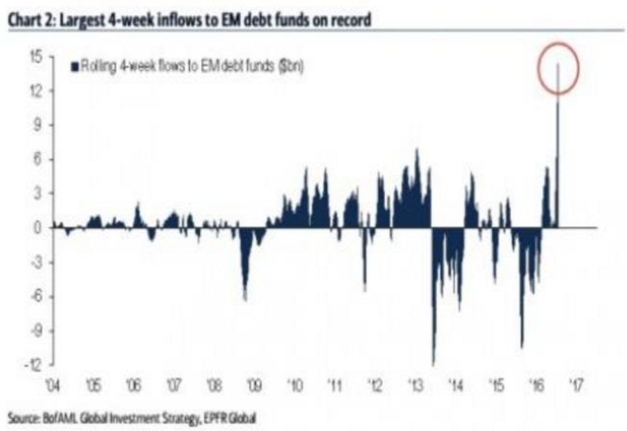
Yellen will be exercising her pie hole on Friday where she's set to give a speech on Fed policy at Jackson Hole. There seems to be a renewed attempt to talk the market down in recent weeks by Fed officials; two of the Fed's troika (Stanley and Dudley) have warned that a rate hike is pretty much imminent. So I wouldn't be surprised to hear maybe a slightly more hawkish tone from Yellen, but historically there's been little market moving news to have come out of Jackson Hole.

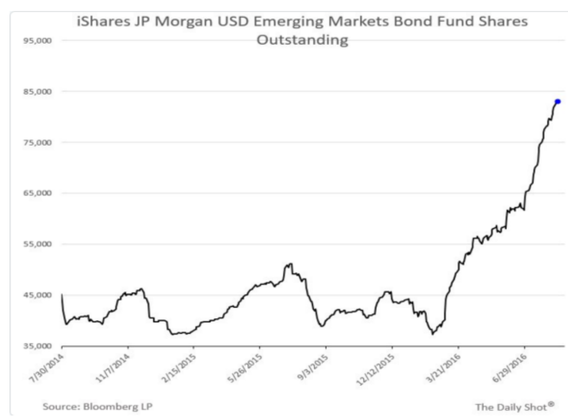
I don't care to try and divine what the Fed will do or won't do. I think it's mostly a waste of time. I have my opinion, which is that they probably won't get another hike in this cycle. But I won't attempt to trade off that opinion as my conviction levels are fairly low on its validity. Martin Enlund, of Nomura, wrote a good piece on the evolving optics at the Fed that you can [find here](). It's worth a read.

I get the sense that the market has largely written off the Fed's jawboning. It's not buying into the threat of a rate hike. The Fed has burned through its forward guidance credibility and is going to either have to hike to regain narrative control or accept increasingly inflated asset prices and market complacency. The Fed finds itself in a catch-22, which Enlund from Nomura notes well:

> *At the risk of sounding as if we have, finally, lost our marbles, we feel compelled to add a kicker: when was the last time the Fed talked seriously about financial stability? Risk sentiment has recently been soaring, while hedge funds and the European pension industry appear to have jumped - or be jumping - headlong into EM currencies and assets. The difference between a grab for yield and a "dash for trash" is merely one of degree, and the Fed should definitely not seek the latter…*

Looking at the record breaking flows in search of yield, I think it's safe to say that we're well into the "dash for trash" phase.

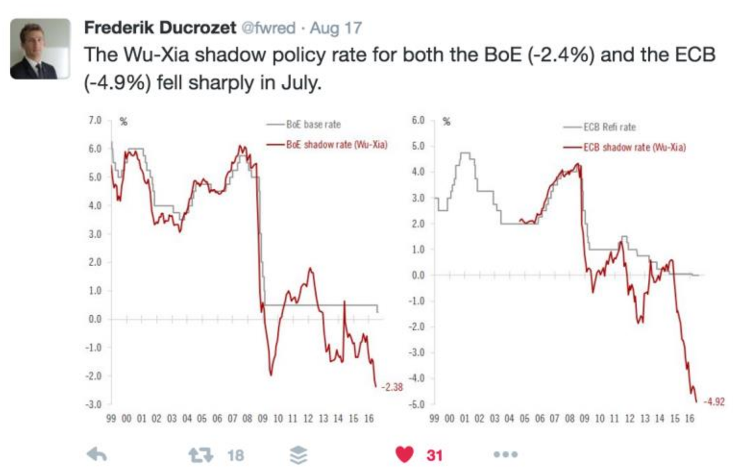




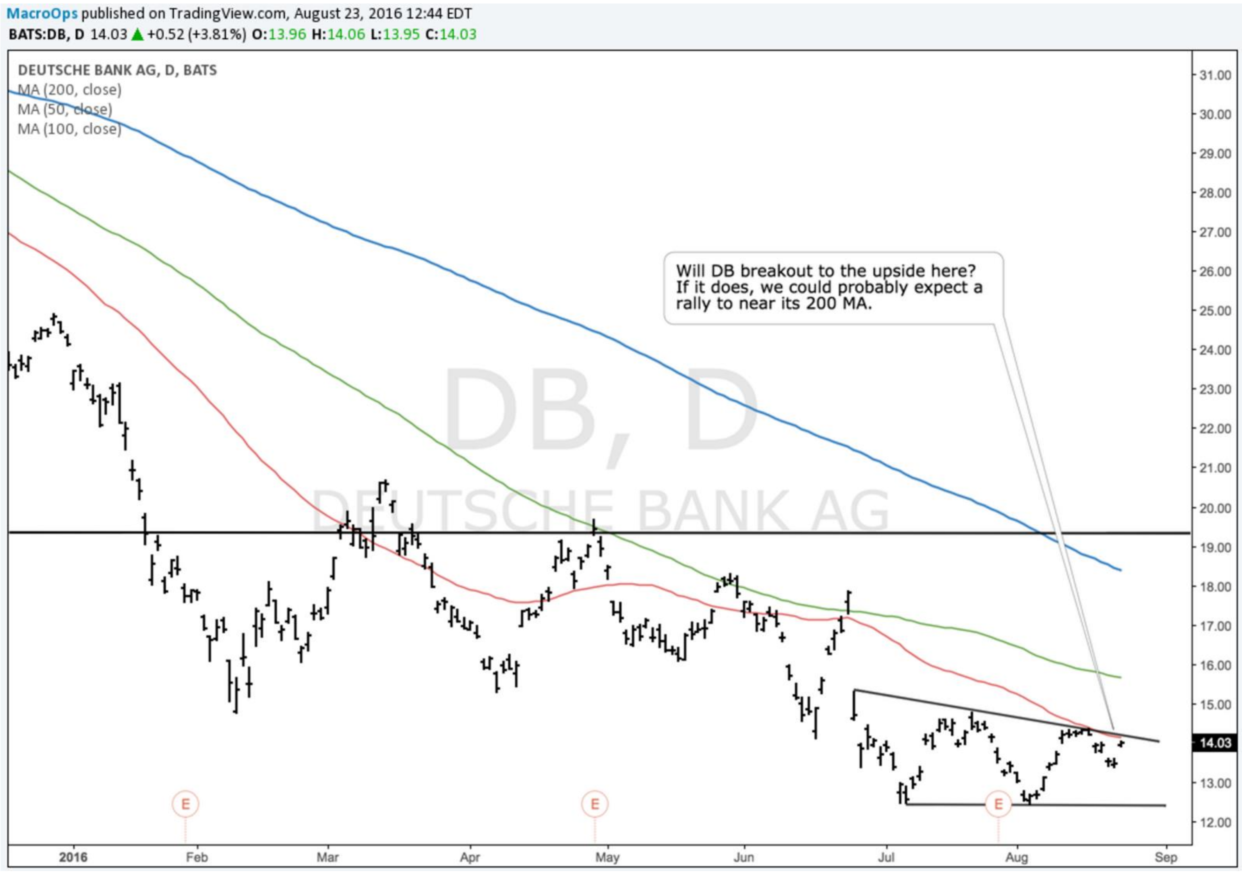
Though honestly, I don't see this ending over the next few months. When large money flows into credit like this, it tends to have very positive near-term impacts on both economies and markets. You guys hear us talk about liquidity all the time — it's the most important market driver — and this is strong liquidity.

Just look at the Wu-Xia shadow rates for both the ECB and BoE below.

The shadow rate shows the *effective* central bank rate when rates drop below zero. The further it falls, the more stimulating it is to credit… at least to a point.



But if global markets — which are now more interconnected than ever — are going to have a sustained rally, then we're going to need to some improvement in European bank price action. And looking at Deutsche's chart below, I think we might be seeing a temporary shift in sentiment.



Sentiment has been strongly negative on European financials lately, and rightly so. Their NIMs (net-interest margins) — the lifeblood of banking — have been squeezed out of existence by negative rates. Some large banks are now actually exploring storing customer's physical deposits (cash) in large vaults.

Banks will be storing money under the mattress… this is what we've come to.

In the long-run, I don't see how the ECB backs itself out of the NIRP trap. What they're finding is that NIRP is deflationary because it forces savers to save more. But… Draghi has hinted at a possible increase in QE next month. This may be enough to shift the bearish sentiment for a time.

Opec is meeting next month and we're already hearing talk about a possible "production freeze". This is a perfect example of the news being shaped by market sentiment. The market wants to be bullish on oil, so the news interprets information as bullish.

First off, OPEC is a dead organization. Any agreement reached would last as long as it benefited each individual member. There is no loyalty to the group.

Secondly, a production freeze is meaningless because nearly all parties are pumping at record levels! So really any freeze near their max capacity would still be bearish with oil currently at record levels.

With that said, I remain bullish on oil over the next month. And this is because of two reasons: [1] market sentiment and liquidity are driving a bullish narrative on oil that should last until at least the OPEC meeting and [2] the almighty dollar still looks like it's going to spike lower (we'll cover this in the tac section).

Background Timing

Paul Singer (hedge fund legend from Elliot Management) recently wrote in a letter to clients, that he now "regards the global bond market as 'broken' ".

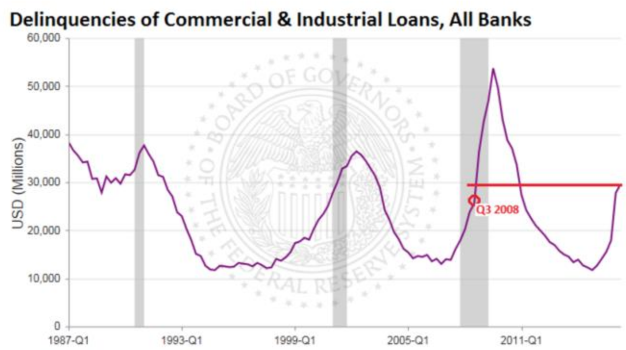
He went on to say that we're in "the biggest bond bubble in world history" and now "is in many ways the most peculiar period we have faced in 39 years". And "One by one, traditional asset classes are falling into realms of 'un-investable' and investors and savers are being forced to take ever more risk just to achieve a return… the ultimate breakdown (or series of breakdowns) from this environment is likely to be surprising, sudden, intense and large".

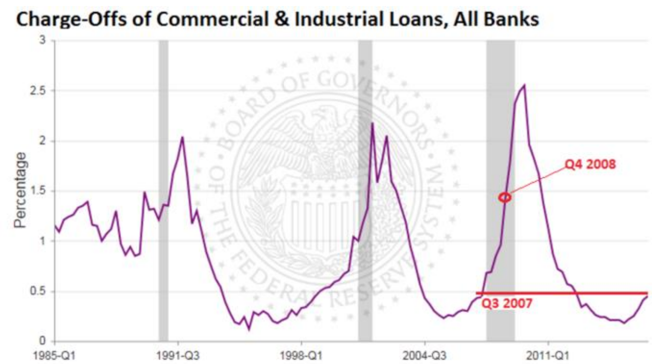
This is the "Background Timing". We cannot forget that we're in the largest bond market bubble in history. As a devout economic history nerd; I'm in awe every day by what's currently going on in markets. I have no doubt that in 50 years there will be whole chapters in economics books detailing the unbelievably stupid ignorance of policy makers during this time.

Bonds sit at the top of the capital structure and their pricing affects everything on down to equities. I cannot conceive of any pleasant outcome for how this thing unwinds… perhaps I'm just not imaginative enough.

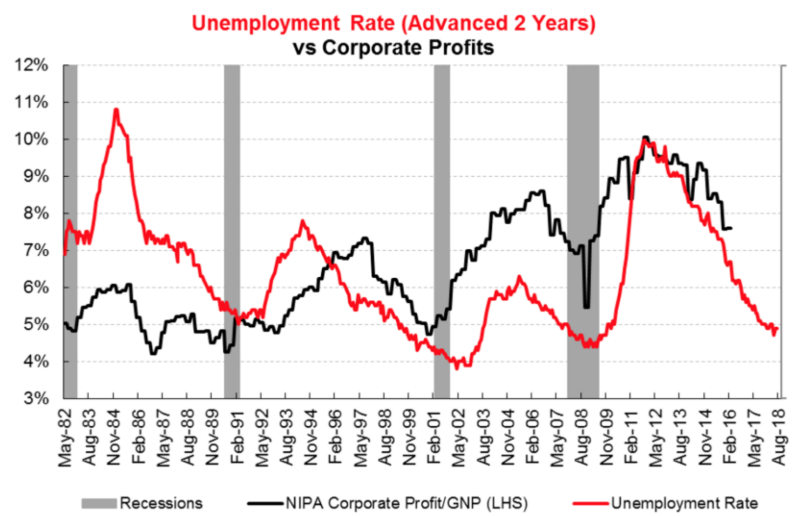
But since it is the largest bond bubble in history it will probably go on longer than anybody expects it too. That's just the way markets work. How long, I have no clue. All we can do is remain cognizant of the risk and keep a finger to wind.

Right now the data tells me we're still in the middle to late stages of a credit cycle. So barring any exogenous shock, this market should continue to rise for at least another 3-6 months.

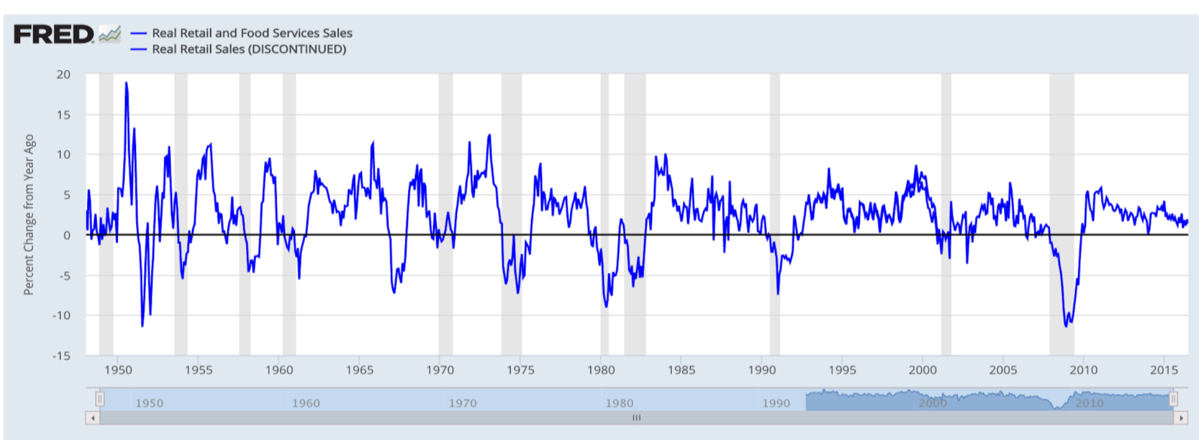




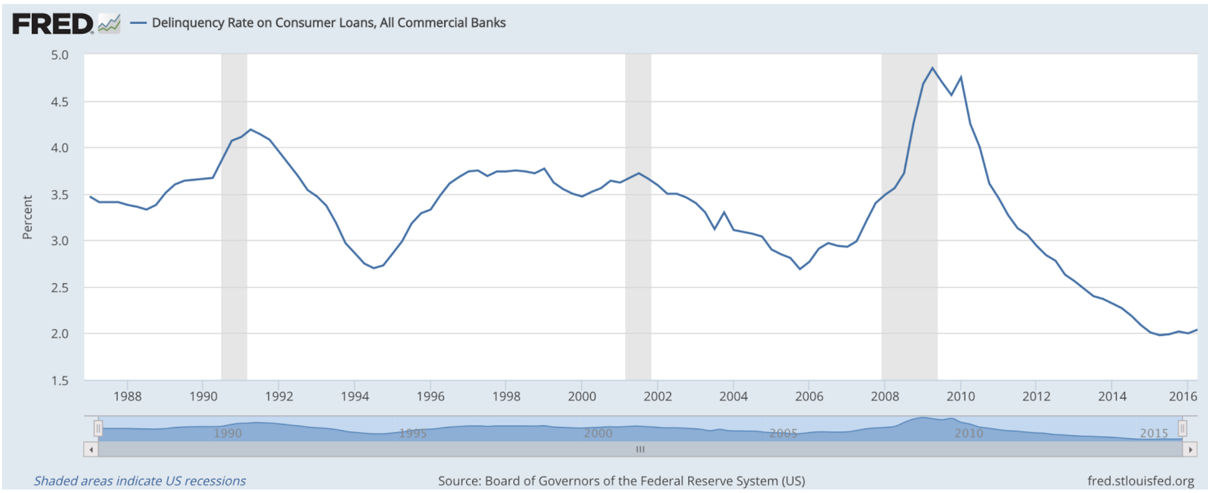
The chart below which shows the unemployment rate advanced 2 years against corporate profits suggest that margins should continue to contract as labor cost rise — labor makes up the majority of a company's expenses.



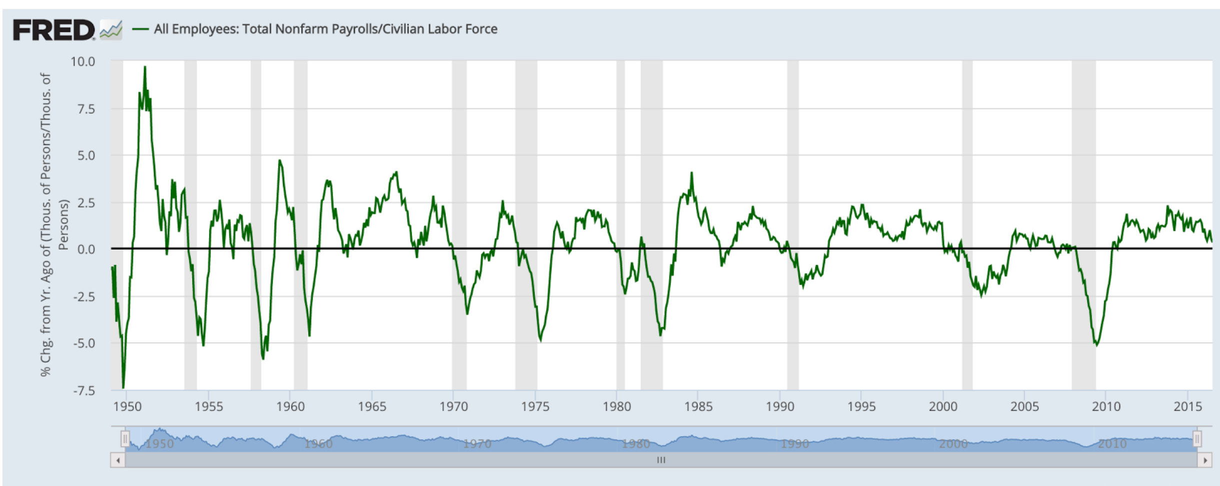
Real retail sales continue to stay positive; though only barely. This suggests that we shouldn't see recession until at least sometime next year.



Delinquency rate on consumer loans has started to tick up but is still well below the point which usually signals recession is imminent. Of course, this is also being helped by record low interest rates.



And then All Employees to civilian labor force (a fairly reliable recession indicator) is still hovering above the demarcation line. Doesn't look great… but still slightly above its danger zone.



The distance timing (next 1-3 months) looks relatively good for markets. The background timing however is increasingly dangerous, and to quote Singer one last time, "Whilst this dynamic can keep markets buoyant and, probably, encourage further gains, it is a dangerous game."

Tactical (Head and Shoulders Everywhere)

Here’s the logic chain in price action that I’m looking at the moment.

The dollar still looks like it’s going to fall down. And if it does, it should fall fast due to positioning.

If this happens it should push oil to complete its H&S bottom pattern. And oil too would likely experience a swift sentiment driven run upwards.

Higher oil prices will further boost the chase for yield or “dash for trash”, driving JNK bonds higher and emerging markets higher as well.

One emerging market that I really like and think could experience a shift in sentiment soon is Colombia.

Colombia has long had a bad rap for being the home of Pablo Escobar and suffering from violent FARC narco-terrorist during the “cocaine cowboy” days of the 80s and 90s. But anybody who has been to that country in the last decade knows that times have changed for the better. Personally, it’s my favorite place to visit in Latin America.

Not only has FARC been essentially dismantled and the drug trade mostly shifted to other countries, but Colombia is also run by one of the most capable and pro-market governments in South America — behind Chile.

Colombia has been hit hard, like all emerging markets, over the last two years due to the collapse in commodities. Colombia is not highly dependent on exports — they only account for 16% of GDP — but as Lat-Am’s 4th largest energy producer; oil accounts for just over half of all export revenue. It’s estimated that for every dollar drop in the price of oil, the Colombian government loses $200 million in state revenue.

If the dollar and oil trades play out as I outlined above, then Colombia should see a significant shift in sentiment and price action over the coming months.

Take a look at the USD/PESO cross below. The pair looks to be near completion of a H&S top. Meaning if it completes, the dollar should fall and the peso appreciate. This would be good for Colombian equities on many levels.

One of the ways I may want to play this, other than the above ETF, is through Grupo Aval (AVAL) and Ecopetrol S.A.

AVAL is Colombia’s largest financial services company with a controlling stake in four of the country’s largest banks; as well as its largest fund manager.

Colombia has one of South America’s healthiest financial sectors and its banking is largely oligopolistic; meaning the five largest banks hold over 75% of all banking assets, enjoy close ties to the government, and thus have large moats to protect them from competition.

AVAL enjoys healthy margins and a low NPL (non-performing loan) ratio so that if there’s a continued shift in the macro outlook — and I think there will be — the bank’s stock should recover to levels last seen in mid-2015.

And then there's Ecopetrol S.A., Colombia's largest energy producer and refiner.

This stock is a pure energy play. If oil doesn't rise in the near-term then I don't care to be in it. But if it does, then I think its advance will likely outpace crudes.

EC recently completed an expensive modernization project on its largest refinery (Reficar). The project was plagued by cost overruns and typical Lat-Am corruption and scandal; which led to a 100% cost increase to the tune of $8B. But now all of that's behind it and the company possesses the largest and most efficient refinery in Latin America — making it competitive with the major refineries in the US (where it exports a lot of its product).

With the major one-time capital expenditures out of the way, the company should see improving margins moving forward, bolstered by the better throughput efficiency of the modern refinery.

If the dollar falls, oil rallies, and Colombia sees a shift in sentiment; then AVAL and EC should shoot the lights out. We will be adding positions here if there's solid price action into the end of the week.

I'm still keeping a close eye on shippers but haven't been too impressed with their price-action as of late but will continue to monitor.

I really like the positioning in the Strategic Portfolio at the moment. MIFI has been terrific and it seems we took ⅔ profits at just the right time. I'll look to add back to it if it comes down and touches its 30-day MA. Stocks that shoot straight up like that, tend to correct even faster so watch out.

I’m getting more and more bullish on natural gas plays. I really like CHK; and CRK is another one I’m looking at. We will probably be adding to our natural gas position towards the end of the week.

And lastly, I like the price action in sugar (SGG) and coffee (JO). These are volatile and tough instruments to trade but can be extremely profitable if managed correctly. Timing of course being the hardest component to get right.

That’s all I’ve got for this week. Good luck in the markets and I’ll see you in the hub!

-Alex

Portfolio Snapshot

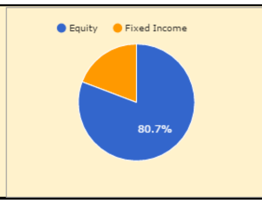
Macro Ops Strategic Portfolio

NAV $1,045,336.00

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	$349,500
Equity	Cliffs (CLF)	6450	6.13	4.55	$10,191.00	14.66	2.44	$40,184
Equity	Chesapeake (CHK)	14700	5.15	4.30	$12,495.00	8.66	4.7	$89,376
Equity	Vale-SA (VALE)	9000	6.04	5.39	$5,850.00	8.58	2.91	$52,020
Equity	Novatel (MIFI)	11000	2.10	1.75	$3,850.00	3.00	1.84	$41,140
Equity	Gafisa (GFA)	40000	1.69	1.48	$8,400.00	2.04	1.34	$64,400

Metrics

Exposure Breakdown	
Equity	$40,786.00
Commodity	$0.00
Fixed Income	$9,725.00
Forex	$0.00



Total Open Risk	Portfolio Beta
$50,511.00	0.69
4.83%	

*Updated 8/23

Macro Ops Income Portfolio

NAV $1,059,076.31

Asset Class	Position	Size	Cost Basis	Max Profit
Option	SPX Oct 20 2070 Put	-10	$15.20	$15,200.00
Option	SPX Oct 20 2245 Call	-10	$8.30	$8,300.00
Option	SPX Oct 20 1680 Put	10	$1.40	(Hedge)

Scenario Analysis/Stress Tests

Worst Case	Worst Drawdown
SPX-10%	-$87,000
SPX-20%	-$250,000

**Updated on 8/23

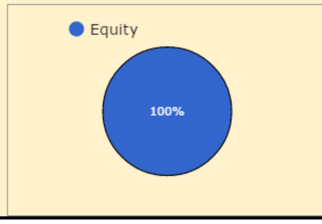
Macro Ops Tactical Portfolio

NAV $995,205.00

Asset Class	Position	Size	Cost Basis	Risk Point	Market Price	Open Risk	Target 1	Notional
Equity	Cliffs (CLF)	6,780	6.12	5.00	6.27	$8,610.60	10.02	$42,511
Equity	Peru (EPU)	3,035	32.09	30.80	34.76	$12,018.60	36.14	$105,497
Equity	Novatel (MIFI)	10,000	2.12	1.75	3.14	$13,900.00	3.00	$31,400
Equity	Gafisa (GSA)	46,875	1.64	1.48	1.57	$4,218.75	2.04	$73,594
Equity	Electromed (ELMD)	4,900	4.85	4.44	5.15	$3,479.00	6.00	$25,235

Metrics

Exposure Breakdown	
Equity	$42,226.95
Commodity	$0.00
Fixed Income	$0.00
Forex	$0.00



Total Open Risk

$42,226.95

4.24%

*Updated 8/23