Market Brief – See The Signal, Like The Signal, Follow The Signal

Tod des Spartacus. Zeichnung von Hermann Vogel.

Above is a 19th century depiction of the killing of Spartacus; the famous Thracian slave turned champion gladiator, then rebel leader of the Third Servile War (slave rebellions) against the Roman Empire in 73-71 BC.

Spartacus is said to have been a fighter unparalleled in skill and a commander unmatched in war. He used these skills to nearly topple the Roman Empire before finally falling in battle against the armies of Crassius.

He undoubtedly learned much of his expertise while in servitude to the House of Vatia; where he trained at the Ludi Gladiatorium "Gladiator School" of Batiatus in Capua. The Ludi of Batiatus in Capua is one of the most famous gladiator schools outside of Rome due to the exceptional fighting talent that was trained within its walls — Spartacus being just one of the many champions it produced.

While reading about Spartacus and the Ludi of Capua in Barry Straus' book *The Spartacus Wars* this week, I got to thinking about the importance one's environment plays in his/her success.

Spartacus was, I'm sure, a naturally gifted fighter and leader. But without his time spent training with other equally skilled warriors at the Ludi of Capua; I doubt he would have ever became the slave who almost brought down a global empire.

The Ludi experience was essential to his greatness. That's where he was exposed to a variety of deadly fighting styles, was passed wisdom from seasoned gladiators, and most importantly, driven to excellence by fellow comrades who were all keenly focused on the same goal.

It's the whole "iron sharpens iron, so one sharpens another" idea.

Well obviously as I was thinking about this I started thinking what the trading equivalent would be to Spartacus' Ludi.

And the immediate answer, without a doubt, would have to be Commodities Corp (or CC as it used to be called).

For those of you not familiar with CC, I suggest you read this Fortune article from 1981 and then pick up a copy of Mallaby's book *More Money Than God*; which does a good job detailing the story of this unique outfit, as well as that of many other early pioneers in the hedge fund industry.

CC was a trading operation founded by Helmut Weymar and Amos Hostetter during 1977 in Princeton, N.J. The firm was established to raise money which it would then use to trade in the commodities market and hopefully profit.

In many ways CC was one of the very first hedge funds. Its story is so impressive not just because of the unbelievable returns the fund produced (which were astronomical) but even more so because of the long list of legendary traders who came out of it. The CC alumni list reads like a 20th century trader hall of fame inductee roll. Some of the names include:

- Ed Seykota
- Michael Marcus
- Bruce Kovner
- Paul Tudor Jones
- Jack Schwager
- Peter L. Brandt
- Craig Witt
- Louis Bacon

Anyways, I was going down the rabbit hole of the internet in search of CC related things of interest — something I do when markets are as boring as they've been lately (more on that below) — and I came across some pretty cool finds.

The first one is a short (43 page) internal booklet prepared by another trader named Morry Markovitz at CC that summarizes Hostetter's teachings and approach to trading. The booklet is titled *Amos Hostetter; A Successful Speculators Approach to Commodities Trading.* You can find the pdf link here.

I don't know how I'd never come across this before but it's great. The booklet is jam packed with timeless trading wisdom from one of the greats. Paul Samuelson, Nobel Prize winning economist and early backer of CC said Hostetter was "the most

remarkable investor I know, he made money in commodities 50 years straight." That's tall praise coming from a man who was also one of the first investors in a young Buffett.

I suggest you read the booklet in full, but I'm going to share with you one of my favorite takeaways from the piece, which is fantastic in its simplicity and truth. If you were to follow this advice on every trade I guarantee you would see a significant amount of improvement.

To follow are the pdf images of Hostetter's section on questions to ask before entering and exiting a trade:

SOME OBSERVATIONS ON TRADING IN COMMODITY FUTURES

One might assume that profitable commodity trading is a function of being right something over half the time. Starting with a correct idea is, of course, an important first step, but the next one is the more difficult; namely, converting this idea into a credit on the brokerage statement. This is where most failures occur. It is a source of amazement to me how many traders start with a correct idea, and end up with no profit, even though the move occurs just as expected. They are, of course, violating some basic trading rules, which are rather generally known, but not properly applied.

To force the application of sound trading principles to a commodity position, I have prepared a questionnaire to be answered before taking a position and before closing it out once the position is taken.

Questions to Answer Before Taking a Commodity Position

1. Do you think that a major trend has either started or is about to start in the commodity in question?

2. Is the contemplated trade in the direction of this trend?

3. Do you think that the move will be a substantial one (at least 10% of current price) and run for a considerable period of time (3 to 9 months)?

4. Have you selected an actual or approximate stop loss point where you would be willing to admit you are wrong and take your loss?

(At this point summarize your ideas as follows: I believe that ______________________ (commodity and contract month) now selling at ____________ (current price) will advance/decline to ____________ in ____________ months. Meanwhile, I will stop my position at ____________. Now proceed with the questionaire.)

5. Is the potential move that you visualize at least twice the loss you will take if stopped out?

6. Is the loss that you will take if stopped out (on the number of contracts being considered) less than 25% of the equity in the commodity account?

If the anser to all these questions is yes, then make the trade. One negative answer kills it.

Questions to Answer Before Closing a Commodity Position
(Assuming the stop order has not been executed)

1. Does the position show a loss?

2. Has it reached the price objective which you expected when the trade was initiated?

3. Have you held it for the period of time stated above?

4. Are you convinced that the major trend has changed since your forecast?

If all answers are "no", you must hold your position; if the answer to any one question is "yes", you may close the trade, but you are not compelled to do so.

Now for a few comments on the rationale behind these questions. If you are after excitement, jump in and out as often as you wish. But, I am assuming your motive is profit. If so, you should play only when major trends exist and only in the direction of the trend. Never go short to catch a dip in a bull market or buy for a rally in a bear market. Never trade in a "trading market". Leave a market strictly alone until you feel there is a trend going - then play the trend and, what is very hard to do, stay with it! Don't grab a quick profit. Once a position moves in your favor, sit stubbornly until you think the entire trend has run its course. Don't form opinions as to intermediate moves. In fact, don't even watch it too closely. Just hold on. If the 4 point profit shrinks to a 2 point profit, don't panic. Save your fears and panic for the position that started off with a 2 cent loss. On that one, jump out as quickly as you'd like - the sooner the better.

Commodities are fast moving markets with low margins. Hence, you must decide in advance at what point you will limit you loss and stick to your decision. Also this "exposure" on any given trade should not exceed one quarter of the equity in your account. Should a loss equal as much as one half of your equity, it is obvious that two losses in a row ill put you out of business.

On closing out a trade, you will note that our rules say you "may" act under certain conditions. For instance, your price objective may be reached but not your time objectives. If you wish to hold

longer well and good. A position that is going with you tends to keep going with you and your initial estimate of the move may have been conservative. A loss by overstaying a market is not one of the common mistakes. In fact, holding a profitable position a little longer will win far more often that it will lose. The big risk is closing a good position too soon. Hence, the close-out questions are geared to locking you into a position for a substantial profit or until proved wrong.

ABHostetter
4-15-66

Now here's the second trading nugget I found in the far-nether regions of the dark web. This one written by an unknown. I don't think he ever gives his name, but apparently he worked at a broker that filled orders for traders at CC and may have even worked at CC itself for a time.

This one is a 10 page document titled *Commodity Corporation: The Michael Marcus Tape.* It's apparently a compilation of some of Marcus' trading notes along with the author's commentary; including some of his stories about working with Marcus. The PDF link is here.

For those of you not familiar with Marcus, he was profiled in Schwager's original *Hedge Fund Market Wizards.* He's a legendary commodities trader who is said to have turned his initial $30,000 investment into over $80 million in under 20 years — not bad. And he also got his start at CC and is part of the most famous mentor/trader lineage which started with Hostetter, who trained Seykota, who taught Marcus, and who then taught Kovner. Talk about having a Ludi advantage — that's just unfair. And who knows, Hostetter could've trained under Livermore for all we know.

Again, read the entire document. It's short and well worth your time. Here's some of my favorite takeaways from the piece (bolding is mine):

> *Comm. Corp was essentially a trading university where traders learned to trade and perfect their skills. In the course of their employment the traders were asked to prepare their trading philosophy which was archived. Commodities Corporation also made traders do write-ups when they lost money or "got knocked out-of-the-box."* ***" These "knocked out-of-the box" papers focused on how they failed and how they were going to correct their problems.*** *All of these were archived and available to read or watch. In my opinion, these were an invaluable resource for all traders to learn from. I just wish they were now available on a web-site. I will discuss some of these in a later post.*

I think the "knocked out-of-the box" papers are a great idea and "hot damn!" what I'd give to be able to go through those.

Somebody has to know where those docs are and side note: it's really strange that a more in depth book hasn't been written about CC yet. I have Schwager's number — I used to call him under the guise that I was writing an interview style book and wanted to know how to give a proper interview, but I'd just end up pestering him for trading tips and stories (he was cool about it) — I might give him a ring soon and ask him if he knows where these are or if they still exist. If so, they'd be a goldmine.

> ***Trading has two types of capital that must be managed – financial capital and mental capital.*** *In this case, losing a lot or being unsure of your system drains you of your mental capital. You don't want to do that. Losing either your financial or mental capital will knock you out of business. So protect both equally well.*

So true. Both are equally important and you have to protect one to protect the other. And finally:

*Comm. Corp. taught me to **see the signal, like the signal, follow the signal.** If you follow your system /methodology then over time your edge will kick-in and you'll end up ahead.*

"See the signal, like the signal, follow the signal" was an oft used phrase amongst traders at CC, as well as "ride your winners and sell your losers" which was coined by Hostetter. Simple and yet powerfully true. There's also some great stuff in there on adding at "danger points", something we refer to as inflection points and a good discussion on the importance of developing market feel. Take 10 minutes and read it.

Lastly, here's a document (for econ wonks) that summarizes and advances Weymar's original PhD dissertation on forecasting cocoa prices (the theory was the primary reason for CC being created). Here's the link. I used to have Weymar's original dissertation, but I seemed to have misplaced it — but this is close enough.

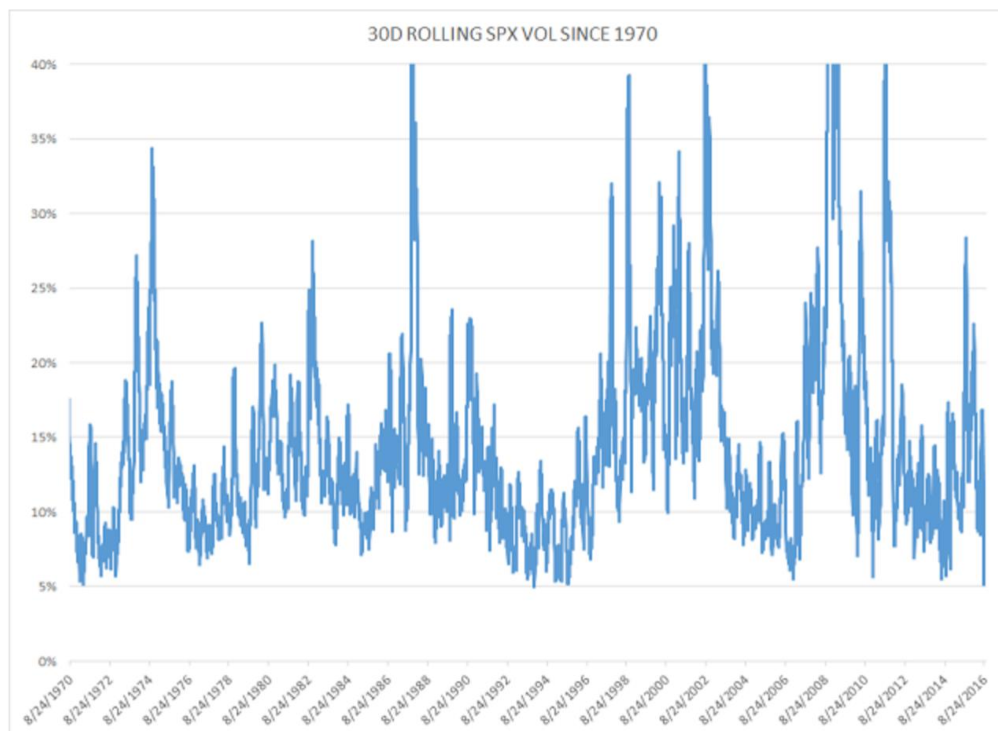
Now onto the absolute boring state of the markets which are the reason for this whole CC tangent.

Summertime Markets

Across the board we're seeing record low volatility and volume in both stocks and bonds. August is typically a slow month, but this is even atypical in how absolutely nothing is moving.

Here's some stats on just how quiet things have been:

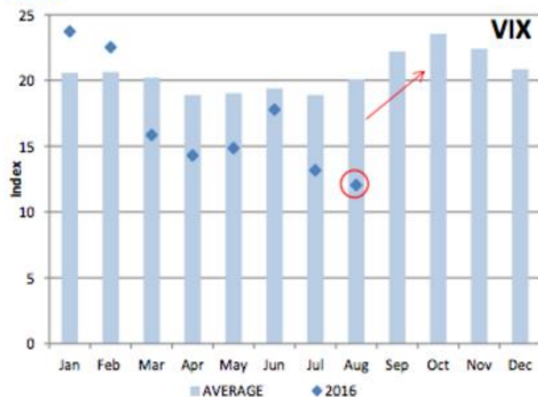
Here's a chart via *Macro Man* showing the 30-day rolling average of the S&P since 1970. In the last 46 years there have only been five other times when volatility has been lower.



Macro Ops Hub
Target. Deploy. Profit.

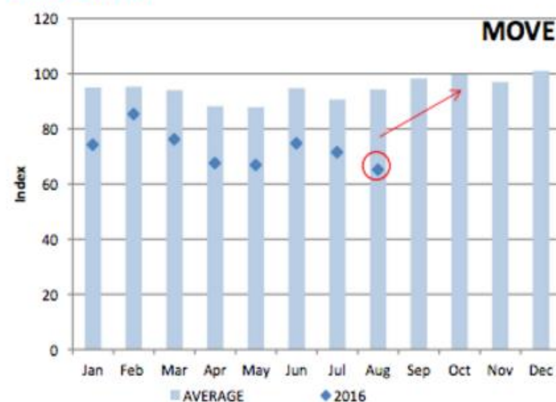
And then there's this from Citi (via FT): *"Current vols are a strong outlier, not just compared to 2016, but against the average for all Augusts since 2000 (see charts 2, 3 below). That should give any trader pause."*

Chart 1. 2016 VIX vs monthly average since 2000



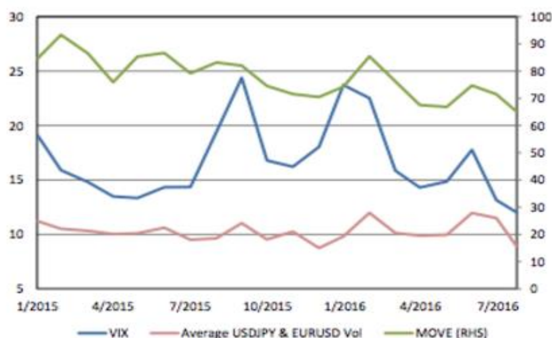
Source: CitiFX, Bloomberg

Chart 2. MOVE (UST vol) monthly average since 2000

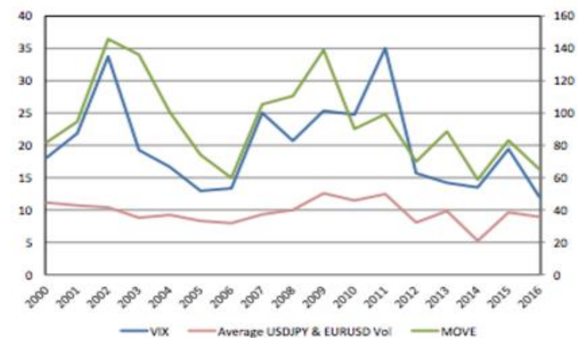


Source: CitiFX, Bloomberg

Again, Citi*: "We have entered the bottom of 10% range across assets. Chart 3 shows that we are approaching lowest vol for the past 12 months across three asset classes. Chart 4 compares August monthly average over 2000-2016 period, VIX is at the lowest ever, with fixed income and FX in the bottom 10%. "*

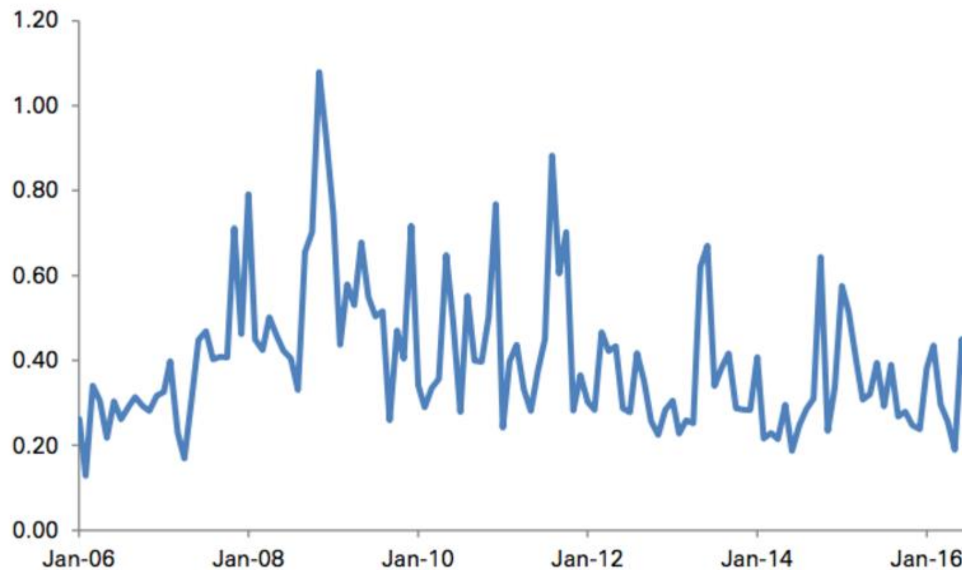


Source: CitiFX, Bloomberg



Source: CitiFX, Bloomberg

And the following from Deutsche: *"the monthly 10y Treasury range which is currently at its lowest for a decade."*



In short: Nothing is happening.

It says something about how quiet things have gotten that Friday's 30 point swing in the S&P felt like market turmoil.

In addition to slow markets, I'm not seeing many actionable or attractive setups at the moment. There's been a number of failed breakouts (which we'll discuss in the tactical section) and some creeping weakness amongst historically overbought stocks, but also some notable strength in other areas like housing and financials.

As an aside; there's an old adage "never short a dull market". Charlie Bolello over at Pension Partners looked into that claim and found it's mostly true. But he also found that it's even more true that you shouldn't ever short an excited market. So he concludes that instead the adage should be *"Never short any market, but be particularly careful shorting an exciting one".* You can find his piece here.

The central bankers of the world met this weekend in Jackson Hole and ran their sucks about their lordship and dominion over ~~free~~ markets.

You can find the text of the Yellen speech here, but below is the only section of her talk worth any note (emphasis mine):

> Looking ahead, the FOMC expects moderate growth in real gross domestic product (GDP), additional strengthening in the labor market, and inflation rising to 2 percent over the next few years. Based on this economic outlook, the FOMC continues to anticipate that gradual increases in the federal funds rate will be appropriate over time to achieve

> and sustain employment and inflation near our statutory objectives. Indeed, in light of the continued solid performance of the labor market and our outlook for economic activity and inflation, **I believe the case for an increase in the federal funds rate has strengthened in recent months. Of course, our decisions always depend on the degree to which incoming data continues to confirm the Committee's outlook.**

So a lot more of the same is the takeaway; which is just what we were expecting. Yellen working with Dudley and Fischer to try and talk the market down from its excesses in an attempt to put the "will they hike" narrative back in front of mind until their meeting in September.

My opinion is this is a bunch of hot air and there's no way in Hades they make a move before the elections unless the data shoots through the roof over the next few weeks (which won't happen).

Anyways, we've got a non-farm payrolls number this coming week and then inflation numbers in a couple more weeks that'll likely be the cold water thrown on that narrative again.

Oh and here's the reason why the Fed is a bit concerned and are trying to talk down markets.

The chart shows the short interest on a VIX ETN. It means that "short volatility" which is really just a corollary to the BTFD (Buy the Dip) trade is becoming extremely crowded; i.e. market is dangerously complacent.

I'm sure that trade will work out great for all involved…ha.

Tactical Section

Let's start with some charts showing possible technical damage that occurred as a result of Yellen's speech. I should note that when a technical signal follows off the back of some government news like a Fed speech, I give its validity much less weight. They often tend to reverse shortly after so it is with great skepticism that I view many of Friday's moves.

Long bonds, from 10s to 30s (TLT, ZB, IEF) all experienced strong breakouts to the downside on Friday, closing near their lows. Technically speaking this is pretty bearish price action and would usually result in me immediately closing out our Strategic bonds position and even considering going short. The narrative behind the move is that Yellen put a rate hike back on the table which is bearish for bonds.

But I don't buy it. Even if the Fed hikes before the end of the year, it would actually be bullish for the long end of US treasuries because a hike is deflationary and would negatively impact an economy that is by no means robust. With that said, we'll close out our position in the Strategic account and look to reenter down the line should bonds close below their 100 day moving average.

The dollar's move on Friday is perplexing and another one that I am highly suspicious of. DXY came down and bounced off its trendline and rallied higher off the hawkish fed narrative. The move leaves me wondering if the price action was not driven by some

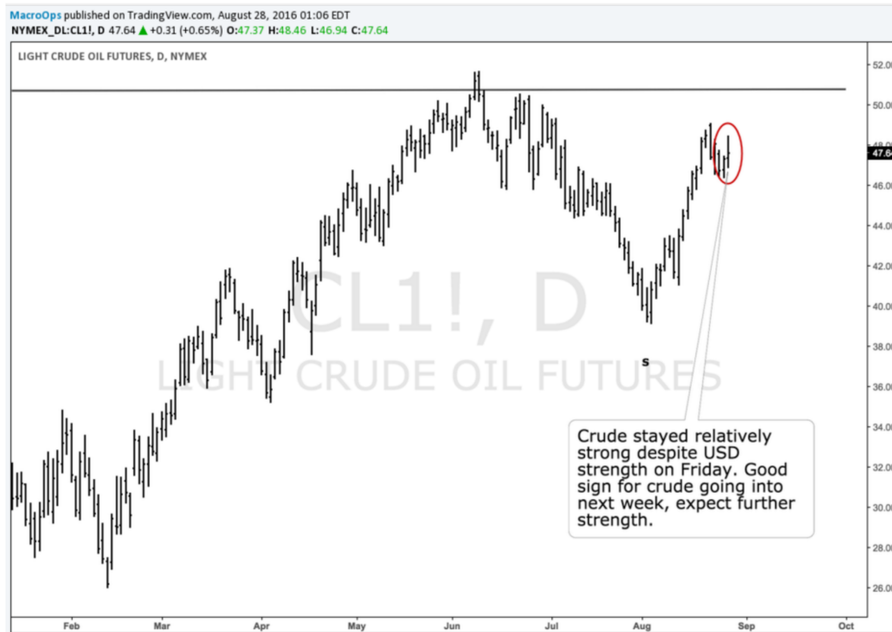
central banks who'd really like a stronger dollar? Maybe Kuroda san was placing long dollar trades in his Etrade account while in Wyoming.

I'm increasingly bearish on the dollar over the short-term which is why I found this move so surprising. If there's continued follow through into next week we'll have to reevaluate the situation. Conversely, if there's a break of that trendline then we'll look to go short the dollar against the Aussie and Euro most likely.

Gold is looking considerably messy to me here and being long gold and gold miners has now become accepted wisdom in the markets — that's never a good sign. We'll likely see a break lower out of the current pennant pattern soon; especially if the dollar continues its strength.

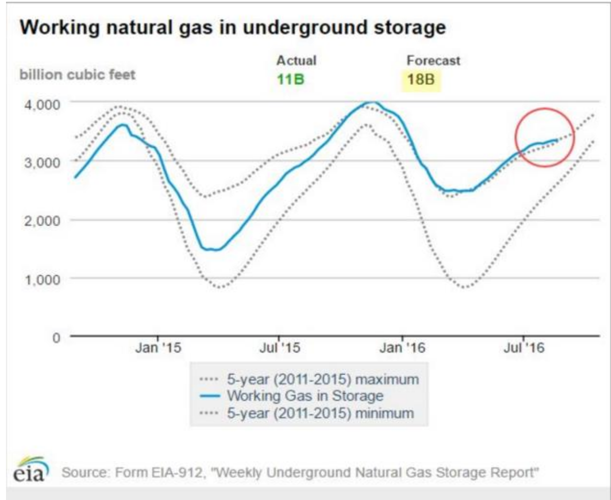
Here's another look at gold and the current COT (commitment of traders holdings). The COT report is only useful when the readings are at extremes, which is what we have here (site with [free COT charts](#)). The blue line on the chart below shows the number of net position of speculators and the red line are commercials. Speculators are extremely long gold and commercials are on the other side. At extreme points like this it generally pays to be on the side of the commercials.

Crude held up well on Friday despite the strong price action in the dollar. This is another signal that makes me question Friday's price action. We're still waiting for a break of the H&S neckline and will look to get long some energy names and perhaps crude itself.



3-month eurodollars broke out to the downside of a long trading range on Friday. The eurodollar market is being squeezed by the SEC money market regulations coming online in October in addition to an increasing perception of risk in the global economy. We will likely be putting on a starter short position in eurodollars this week.

Natural gas continues to hold strong and broke out of a two month bull flag on Friday. I'm becoming increasingly bullish on natty and will look to add to our CHK holdings and perhaps put on a position in CRK, as well as play the outright futures should price action stay strong next week.



JNK (high yield debt) didn't really budge on Friday which is why I don't think the small selloff in equities on Friday is signal. JNK will always lead a significant selloff in the indexes, so the fact that it stayed strong tells me we're still in a "risk-on" environment and we should stick to our long positions.

Here's a weekly chart of AAPL. It has broken out of an 18-month triangle or descending channel depending on how you look at it. AAPL will likely move higher as sentiment shifts on the tech company and it rallies to catch up to some it's more momentous peers. The target on this move is around $132.

We're still watching the shippers closely, but the sector has been sitting heavy. There have been some notable failed breakouts and price action is looking more and more like it might resolve to the downside. This would not be a good reflection on the global economy.

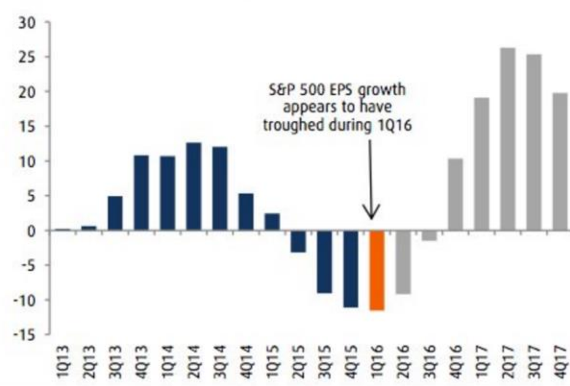
Colombia (GXG) also experienced a failed breakout on Friday so we'll continue to watch from the sidelines and see where things go. If oil continues to stay strong, we should see some better movement in the commodity exporting countries.

Finally, here's a number of charts that I like. We'll be digging into these this week and will send out an email with our findings if we see anything we like.

Conclusion

The markets continue to look relatively strong and we think they'll shrug off the hawkish Fed narrative moving forward. US indexes should continue their trend upward. Libor has been increasing primarily due to the money market regulations coming online in October. This has a significant tightening effect on global liquidity and will have to be monitored closely.

Many of the great bullish setups we were seeing a month ago are now a bit more few and far between, but there's still some promising areas that we're monitoring such as a new cyclical bull market in natural gas.



We've now had five consecutive quarters of negative YoY earnings growth for the S&P. The last time we experienced an earnings recession like this was 08'-09'. There's two ways to look at this going forward: [1] Profit margins are obviously contracting due to rising labor costs and that does not bode well for stocks that are already at high valuations but [2] the contracting earnings growth will give stocks better comparables moving forward (lowering the bar). So barring any external shock and continued accommodative policy, markets will probably continue to rise going into the end of the year.

That's all I've got, have a good week in the markets.

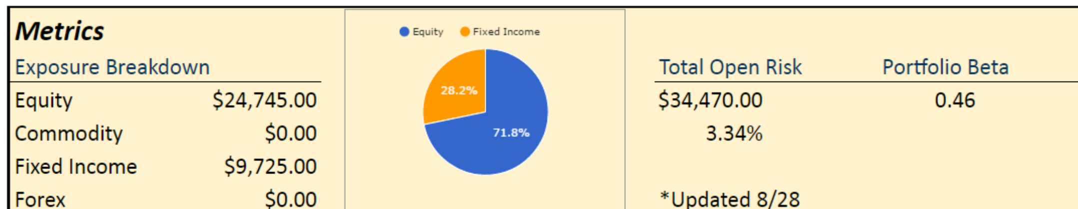
Your Signal Watcher,
Alex

Portfolio Snapshot

Macro Ops Strategic Portfolio

NAV $1,031,040.00

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	Chesapeake (CHK)	14700	5.15	4.30	$12,495.00	8.66	4.7	$89,376
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	$24,745.00
Commodity	$0.00
Fixed Income	$9,725.00
Forex	$0.00

Total Open Risk	Portfolio Beta
$34,470.00	0.46
3.34%	

*Updated 8/28

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

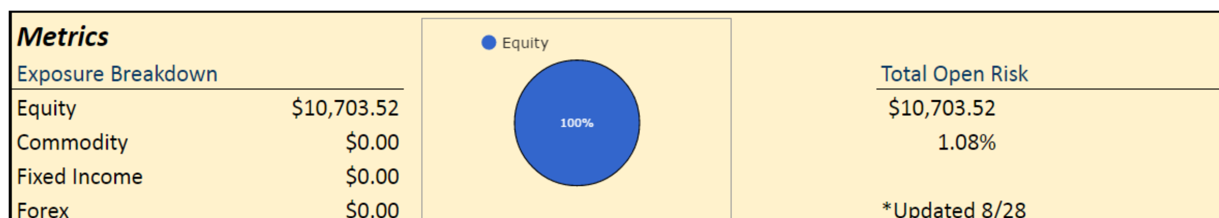
Worst Case	Worst Drawdown
SPX-10%	-$87,000
SPX-20%	-$250,000

**Updated on 8/28

Macro Ops Tactical Portfolio

NAV $987,301.00

Asset Class	Position	Size	Cost Basis	Risk Point	Market Price	Open Risk	Target 1	Notional
Equity	Electromed (ELMD)	4,900	4.85	4.44	5.69	$6,125.00	6.00	$27,881
Equity	Bank of Montreal (BMO)	3,947	67.34	65.62	66.78	$4,578.52	71.10	$263,581



Metrics

Exposure Breakdown	
Equity	$10,703.52
Commodity	$0.00
Fixed Income	$0.00
Forex	$0.00

Total Open Risk
$10,703.52
1.08%

*Updated 8/28