Market Brief – We Got It!

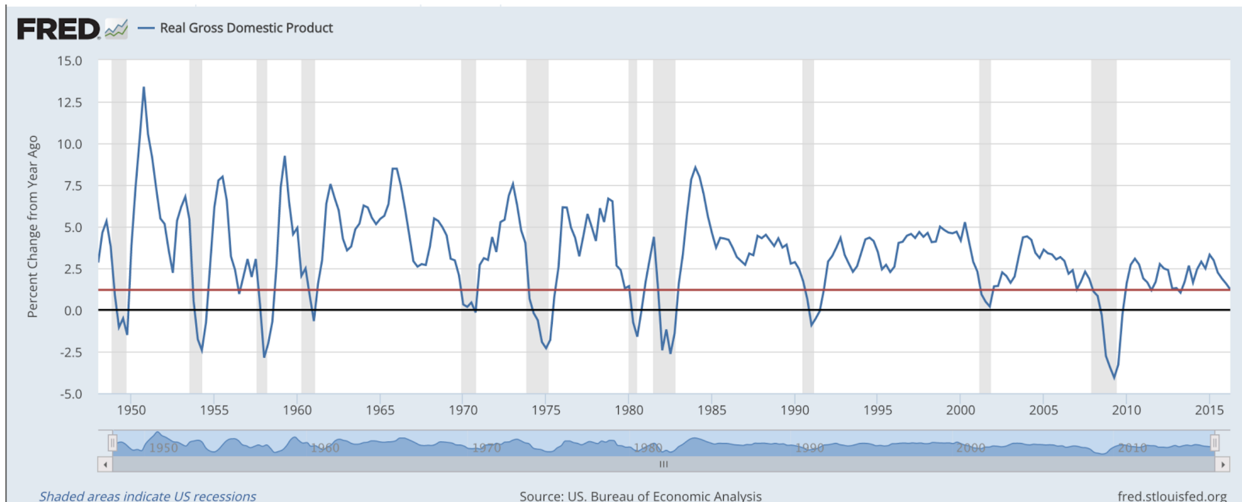
Three econometricians went out hunting and came across a large deer. The first econometrician fired, but missed, by a meter to the left. The second econometrician fired, but also missed, by a meter to the right. The third econometrician didn't fire, but shouted in triumph, "We got it! We got it!"
~ Bad Joke

Last Friday the GDP print for the second quarter was another... swing and a miss!

The print came in at 1.2% versus 2.6% the year prior. The commerce department also revised the 1st quarter down to 0.8%. Here are the numbers behind the numbers:

- Inventories fell for the first time since the 3rd quarter of 2011. They dropped $8.1B, down from a $40.7B increase in the first quarter.
- Consumer spending was responsible for nearly all of the pathetic QoQ growth. C-spending accounts for over ⅔ of domestic output and increased at a rate of 4.2%. Pretty good, right? Not so fast Kemosabe. If you dig into the numbers you can see they've been propped up over the last year by Autos, Rents, and Healthcare.
    - Rising rent and healthcare costs are a drag on the consumer, and autos looks like they have peaked. Two of the big three automakers recently reported a sizable decline in light-vehicle sales.
- Bad Capex… Bad! The most disappointing section of the print was the weak capex numbers. Companies continue to borrow and "invest" in their buybacks, but not their businesses. There was weak spending on new plant and equipment and also a notable uptick in stockpiling — both of which don't bode well for future growth and production.

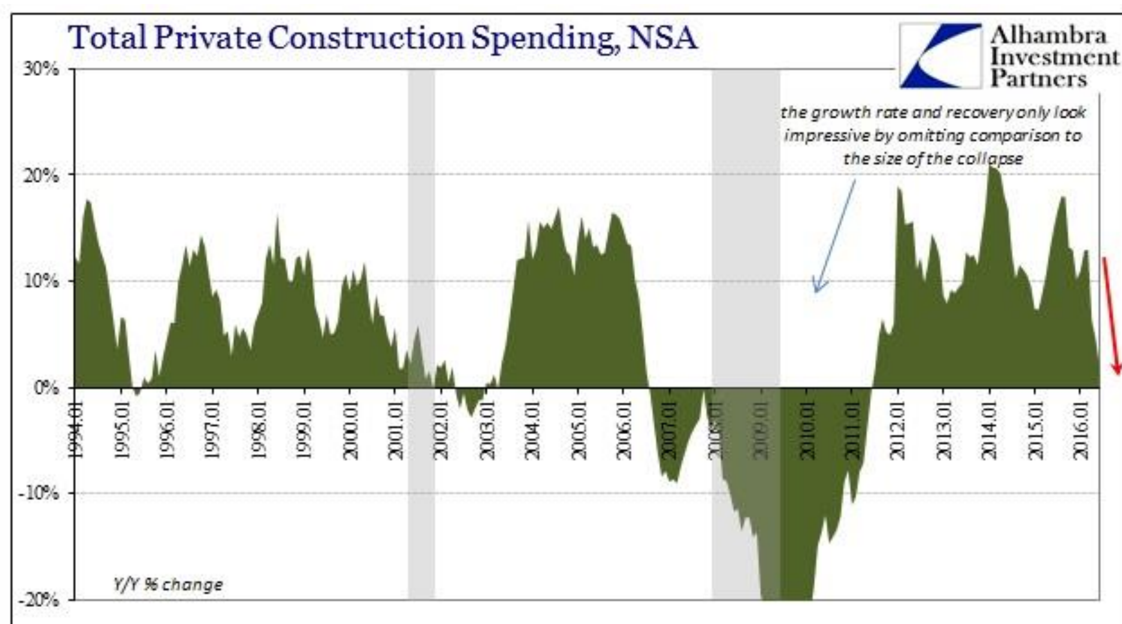
With that said, let's look at where our recent GDP growth puts us…



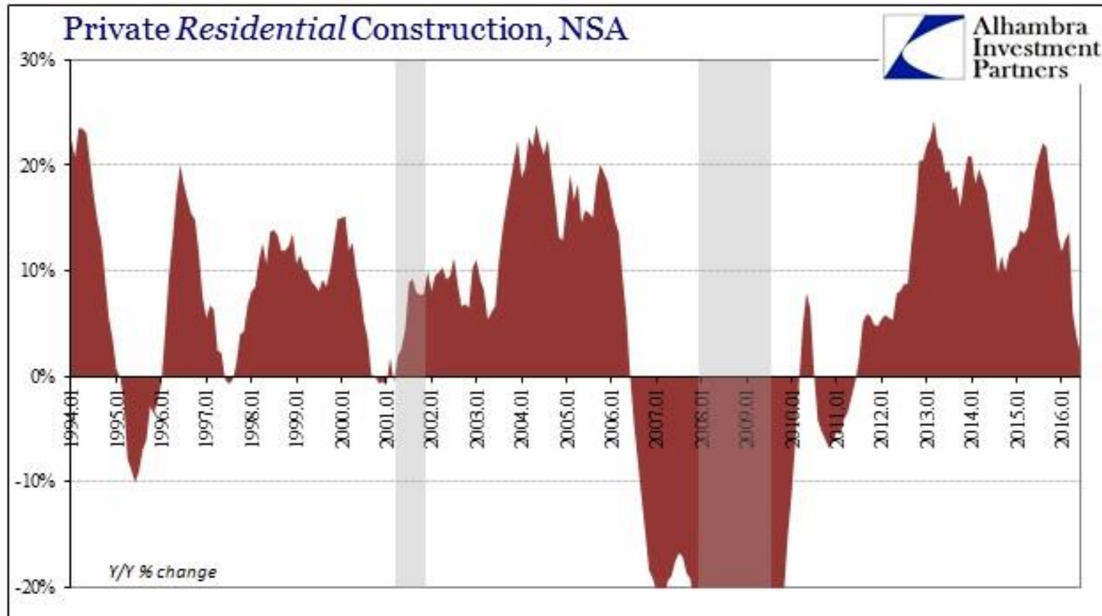
The chart above from FRED shows the Y/Y change in real GDP. Going back to 1958, there have only been three instances where the one year GDP growth rate was at or below the current level (red line) with *no* recession. Two of the three times were 2011 and 2012; both instances that were accompanied by massive QE injections, which righted the ship.

But what does this mean for markets right now? Since the start of the year we've been living in an economic twilight zone, where a bad economy is good for markets because it stays the Fed's hand on raising rates. I don't see this sentiment changing over the near term. But… If this market is going to have some staying power, then GDP will have to show real improvement in the coming quarters. If not, then it just confirms that we're in a late-cycle rally (this is our highest probability scenario at the moment).

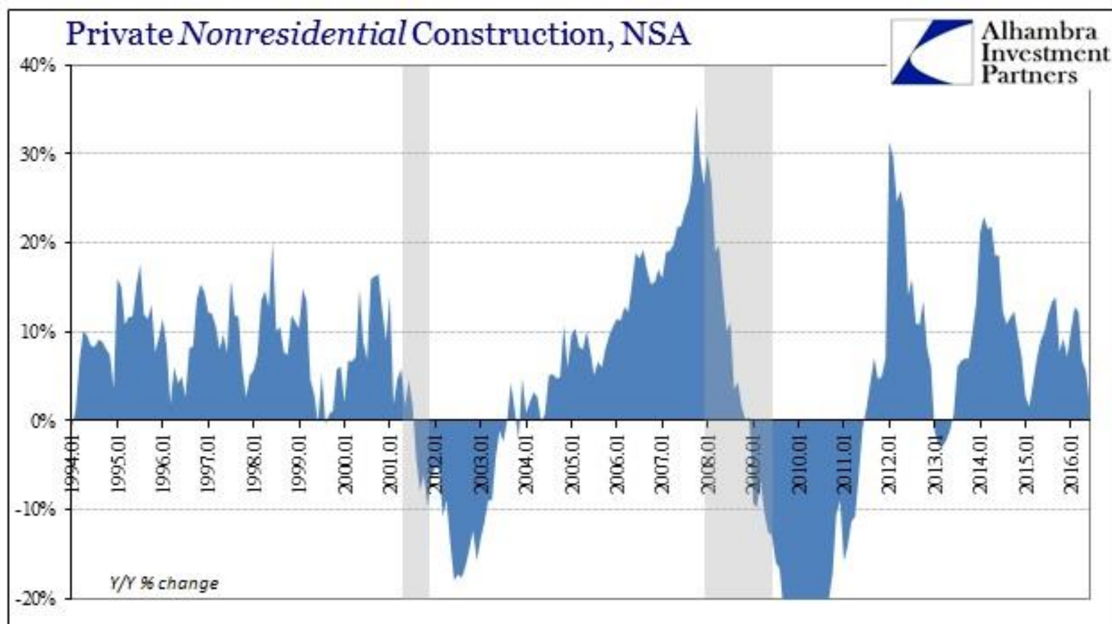
And to add to the plethora of data showing a growing rot under the surface of this US "recovery", here's the following from Snider at Alhambra:



Residential construction spending, reflecting housing market and analysis from other data points, has slackened significantly since September but really in the past few months. Residential spending was just 2.2% more than June 2015, also the lowest since summer 2011.



What really suggests a meaningful change, however, is that non-residential construction has also dipped; meaning that for the first time both sectors of the construction industry are experiencing sharp deceleration at the same time and to the same significant degree.

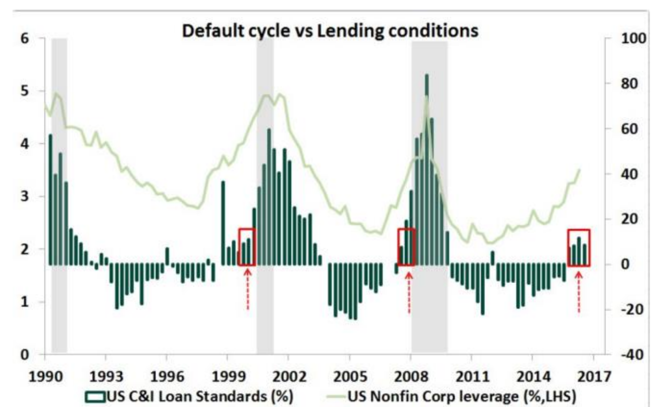


These estimates flow into the GDP figures in the Non-residential Fixed Investment segment, which [already suggested]() unusual weakness in overall productive investment and capex.

That means there are three important elements exhibited in construction spending that make it noteworthy where it had not been, in my view, before. The first is the connection of non-residential construction spending with the GDP non-residential FI as further confirmation of erosion and serious weakness in business investment. The second is the sudden synchronization of residential construction with non-residential, pulling overall activity lower in combined fashion that might alter real economic outlooks beyond the construction industry (higher risk of spillover). The third is that these trends unify around September 2015, once more suggesting that "something" really changed in the middle of last year concurrent to the eruption of "global turmoil" that was and is the most acute outbreak of "dollar" strangulation since 2011.

Don't worry, it's not quite time to sell all your holdings and bury your gold under the shed. Construction spending tends to lead the rest of the economy a bit — but only a bit.

And then there's the Fed survey of loan officers that was just released. The survey reported that lending standards continue to tighten; suggesting that we're in the latter stages of a credit cycle, as liquidity slowly recedes.



This is all troubling data. I've been trying to put my bull suit on in the hopes that I can jump

head first into risk assets… but the numbers keep telling me the pool's shallow and filled with turds (so I prefer to only toe the water for now).

If we are only in the fifth (or earlier innings) of this bull market, then capex, lending standards and construction will need to signal a massive change of trend — and soon.

If it was only the US that looked like it was struggling to reach escape velocity, and the rest of the world (ROW) looked fine, then I'd have a bit more hope for things moving forward. But unfortunately, Europe is starting to look like a dumpster fire and sub $40bbl oil is signaling, "all is not well with the world".

Sprechen Sie Deutsch?

The IMF, not too long ago, referred to Deutsche Bank as the "most important net contributor to systemic risks in the global banking system."

Here's a monthly chart of the bank's stock. Looks pretty bad, doesn't it?

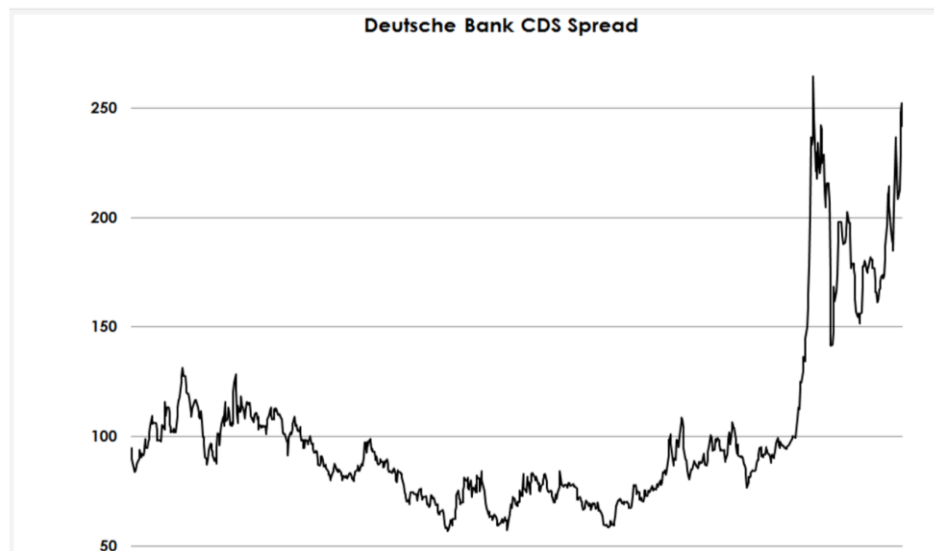
The stock has fallen over 90% from its 2007 highs and is trading below its 2009 lows. Something is really wrong here. The markets are signaling that Deutsche may be, "insolvent".

Here's why this is a big deal. Remember Lehman Brothers, the bank that went under in 08' and sparked a giant liquidity squeeze that helped propel the world into total utter chaos?

Well DB is many times more important to the global financial system than Lehman.

DB is Germany's biggest bank (also its oldest, it actually predates the country by a year). And though Deutsche is technically a private bank, it's tied very closely to the German government and all of German industry. Wherever DB goes, you can be sure the rest of Germany will follow, as well as Europe. There really is no good historical antecedent to show DB's significance… but it's that important.

The chart below shows the spread on DB credit default swaps. A CDS is essentially insurance on a default. The higher the spread, the greater the likelihood of defaulting.



So when the market is pricing in a significant probability that Deutsche may be insolvent, we should be concerned. The bank holds over $48 trillion (that's not a typo) on its books… so we tend to agree with the IMF on this one. DB most definitely represents massive "systemic risks to the global banking system".

And can I just point out the obvious irony here? Isn't Germany supposed to be the poster boy of prudent financial dealings? I suppose it's just a sign of our times. What was once the capital of "astute business" may end up being the spark that sets off the next global crash… just some food for thought.

Oh, and it's not just DB, but nearly every other large European lender is in trouble as well. Keep a close eye on these Euro-financial stocks. If the US market rally is going to have any legs, then we'll need to see these banks find a bottom and turn around soon.

Oil, Oil, Oil

A while back when oil was in free-fall from its heady days in triple-digits, The Bond King Jeffrey Gundlach commented "I hope it does not go to $40 because then something is very, very wrong with the world, not just the economy. The geopolitical consequences could be — to put it bluntly — terrifying."

Well said, Jeff.

Don't listen to people who tell you that really low oil prices are a boon to consumers and a net positive. It's not true. Oil below $40bbl *actually* means increasing defaults in the energy space, which will in turn have plenty of second and third order impacts in the credit markets and the real economy. And just as importantly, it vastly increases the likelihood of a sovereign default

(looking at you Russia), or a large currency devaluation (Saudi Arabia's FX reserves are dwindling), which would send USD skyrocketing and risk assets plummeting.

Oil crossing the $40 mark on Monday is just not a good sign for global economic health. What's even more troublesome about the recent price action is that it's occurring in conjunction with USD weakness. If oil continues to fall with the dollar falling, then we've got a big problem on our hands.

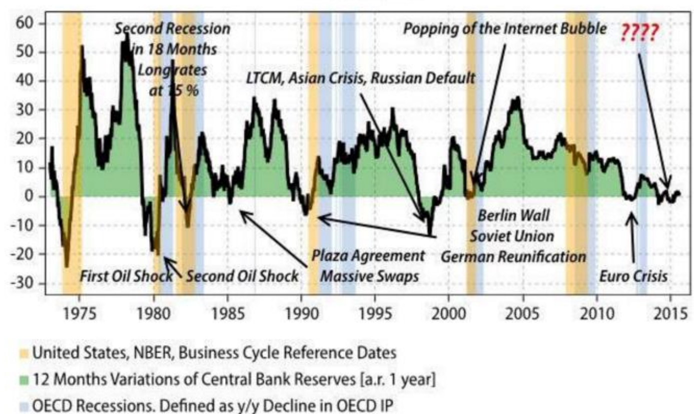
We think oil will eventually bottom in the teens and probably stay there for a long while as the deleveraging process unfolds. But we're not eager to short energy here. There's going to be a lot of volatility in both directions and we're fine staying off that ride.

A quick aside on the dollar. We would not be surprised to see some significant dollar weakness over the coming weeks. In the past, during mid-cycle consolidations, the dollar has often sprung a large bear trap before resuming the last leg of its trend. We've talked about this in the last few months. We may or may not be in the middle of that correction now, we'll have to wait and see. Positioning in USD is still a bit stronger than we like, so it'd be great to get a shakeout of the weak hands before the next move higher.

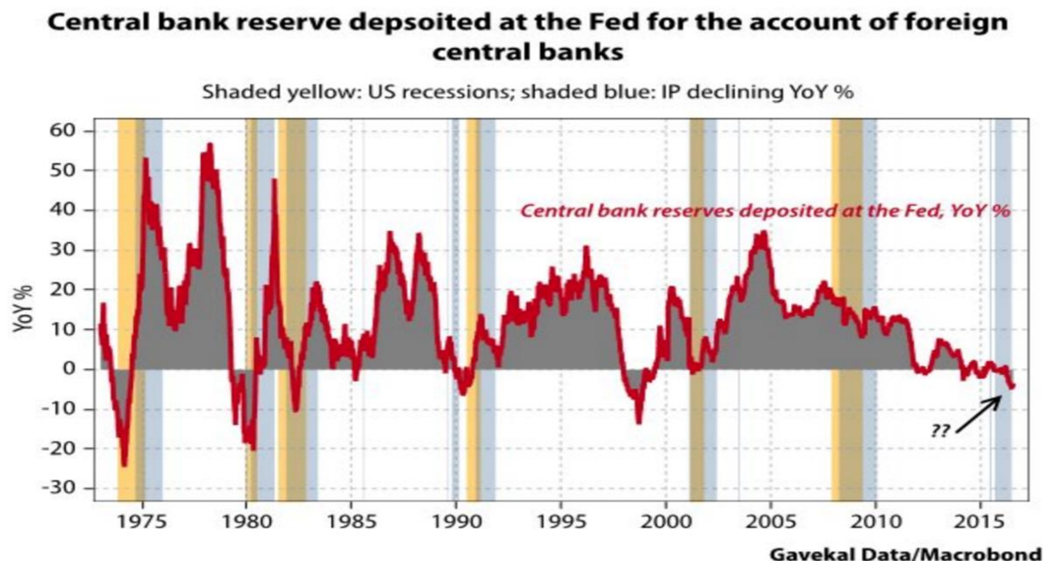
And one last tidbit of interesting macro data.

This chart shows other central bank reserves that are deposited with the Fed. When reserves go up, it generally means that global finance is healthy and countries have an excess of savings, some of which they keep at the Fed. When reserves contract severely, it means that countries are in trouble and are liquidating assets so they can raise cash.

In fact, every time this CB reserve measure has fallen below zero on a Y/Y basis over the last 50 years, it has coincided with a major global economic event (as annotated on the chart to the right).



Look at the updated chart below… it's below zero.



There's no way to know exactly why, but we can presume that it's probably connected in some way to commodity producing countries (Saudi Arabia, Norway, Russia etc) liquidating some of their US holdings to free up cash to in order to cover their expanding budget deficits.

Macro Conclusion

I look at momo stocks, the credit markets (specifically high-yield), and various breadth indicators (A/D and some indexes), to get a sense of short and intermediate term strength. It's a pretty reliable system and it preceded the selloff that we saw on Tuesday. It looks like we'll see a bit more weakness in the next few days.

But over the next couple of weeks, the path of least resistance is still up.

We're still willing to get long certain assets that we believe offer superior R/R setups both fundamentally and technically. But we do so fully aware that the market can shit the bed and reverse trend at any time.

Natural Gas Bottom?

The last three times Natty hit the $1.60-$2.00 level, it marked a cyclical bottom and rallied many multiples off its lows.

Signs now indicate that it's about to do so again, a fourth time.

Natural gas has been in an extended bear market driven by a record surplus in inventories due to fracking and historically warm winters (last December was the most unusually warm month of the last 25yrs). But now this narrative looks like it has peaked.

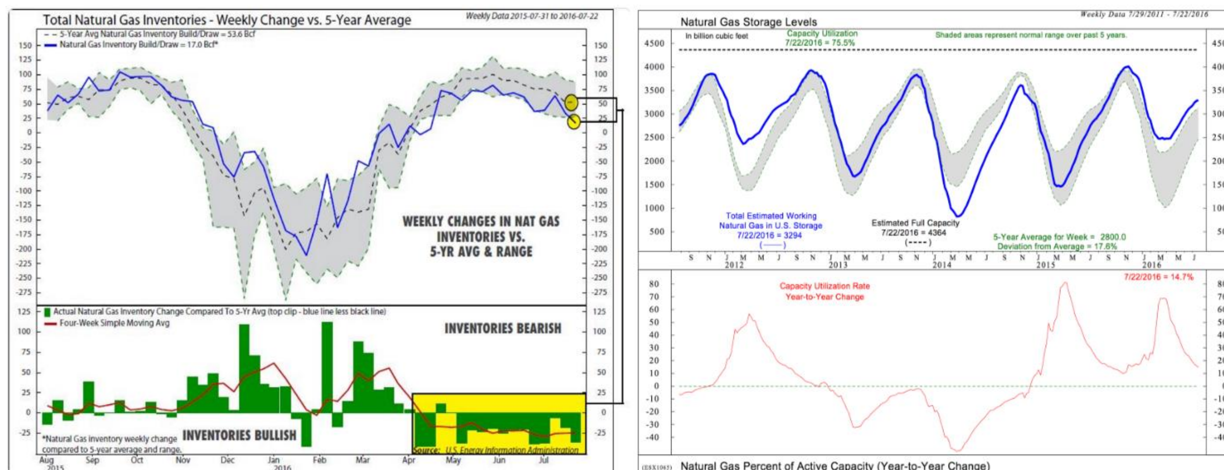
Here's the skinny.

Last Friday, US natty gas inventories expanded to 3,294 BcF — a record surplus for this time of year. But the markets rallied. Why?

They rallied because markets are forward looking and participants are slowly coming around to the realization that the bear thesis has been over-discounted and future structural changes suggest much higher prices.

The bullish gas thesis which is slowly being recognized by the market (and which we intend to be ahead of), is based on these three fundamental drivers:

1. Declining "associate" gas production
2. Growing export volumes
3. Regulatory headwinds



Let's start with numero uno. Natural gas is one of the largest benefactors from collapsing oil prices. This is because, "associated" natural gas, which is gas that is produced as a byproduct of oil drilling, accounts for over 15% of US supply. So less oil drilling, less gas production. If oil stays below $40bbl (which we think it mostly will) then we should see a large source of gas production diminish. Here's the following from NDR:

> *The EIA's Drilling Productivity Report, which incorporates historic decline curve data to estimate current and future hydrocarbon production from seven major shale basins, projects that associated natural gas produced from the Bakken, Eagle Ford, and Permian basins peaked last summer and will decline by more than .7 Bcf/d through next month. This is equivalent to roughly 1% of total U.S. natural gas supply. We expect associated natural gas production will continue falling in sympathy with crude oil production through the better part of 2016.*

Next up we have growing export volumes. Did you know that the US is now a gas exporter? We shipped our first LNG tanker out of Sabine pass (run by Cheniere Energy), back in February. And now we're expected to become one of the three largest gas exporters in the world by 2020. This is very good for US natty, since the rest of the world pays significantly higher prices for their gas. It should pull a lot of our excess inventory down and push gas prices up.

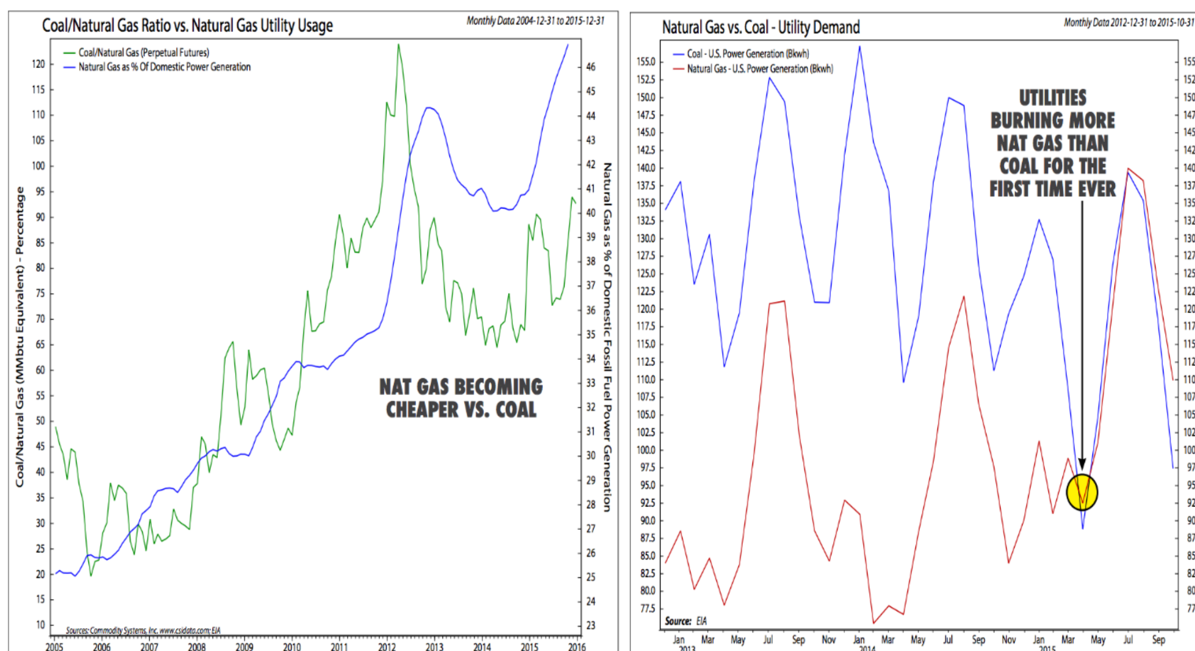
And finally we have regulatory headwinds.

Good ole' Uncle Sam has been meddling in our "free" markets, making it expensive to use smoky coal.

This has resulted in utilities increasingly transitioning over to natural gas. This is a long-term structural change that is unlikely to reverse.

The EIA estimates that operable coal-fired electricity generating capacity fell by over 5% in 2015.

The EIA expects it to fall another 5%, through 2017. This structural shift from coal to gas can already be seen in the data. Last year, for the first time in the US's history, utilities burned more natural gas than coal. And this trend has only been increasing since.



So instead of a massive supply glut, which is what the market is pricing in, we have a situation where natural gas supply is falling and structural demand is climbing. This presents us with a pretty good asymmetric trade opportunity.

We'll be playing this through futures (there's some ETFs available too) and we already have exposure to some gas E&Ps, which we'll add to when technical setups present themselves.

The End

We got a number of new members in the group this week that we're really excited about. So, welcome guys! Hop into the Comm Center and introduce yourselves when you get a chance and start sharing your thoughts and critiquing ours.

August is a big month for the service. We're rolling out a killer macro dashboard that will be available to you guys before the end of the month. And we're also moving to another (better) forum platform where we'll be able to embed pics and video directly. Exciting things...

Have a great week!

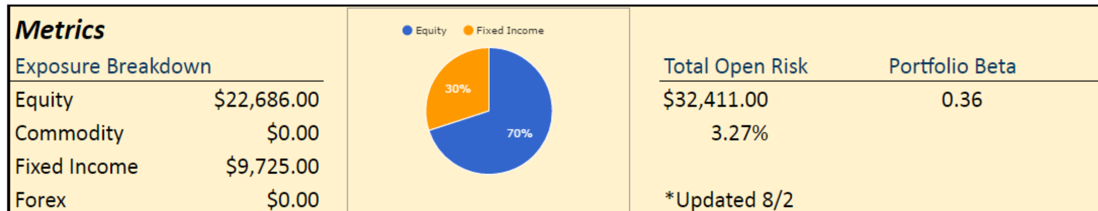
-Alex

Portfolio Snapshot

Macro Ops Strategic Portfolio

NAV $990,334.00

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	$332,175
Equity	Cliffs (CLF)	6450	6.13	4.55	$10,191.00	14.66	2.44	$39,345
Equity	Chesapeake (CHK)	14700	5.15	4.30	$12,495.00	8.66	4.7	$78,654


Metrics

Exposure Breakdown	
Equity	$22,686.00
Commodity	$0.00
Fixed Income	$9,725.00
Forex	$0.00

Total Open Risk	Portfolio Beta
$32,411.00	0.36
3.27%	

*Updated 8/2

Macro Ops Income Portfolio

NAV $1,054,314.00

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

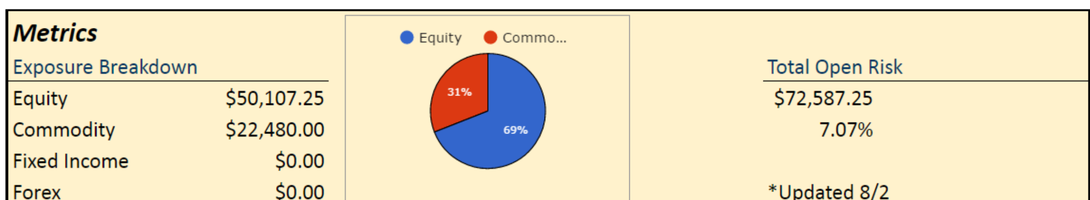
Worst Case	Worst Drawdown
SPX-10%	-$100,000
SPX-20%	-$250,000

**Updated on 8/2

Macro Ops Tactical Portfolio

NAV $1,026,336.00

Asset Class	Position	Size	Cost Basis	Risk Point	Market Price	Open Risk	Target 1	Notional
Equity	Pampa Energia (PAM)	3400	24.40	23.31	27.69	$14,892.00	27.76	$174,896
Equity	Cliffs (CLF)	6780	6.12	5.00	7.96	$20,068.80	10.02	$41,358
Equity	Peru (EPU)	3035	32.09	30.80	34.47	$11,138.45	36.14	$190,454
Equity	Chesapeake (CHK)	16700	5.15	4.69	4.93	$4,008.00	6.90	$90,347
Commodity	Cotton (CTZ16)	4	67.84	65.88	73.92	$16,080.00	77.00	$247,730
Commodity	Silver (SIN6)	1	17.05	19.38	20.66	$6,400.00	18.47	$173,300


Metrics

Exposure Breakdown	
Equity	$50,107.25
Commodity	$22,480.00
Fixed Income	$0.00
Forex	$0.00

Total Open Risk
$72,587.25
7.07%

*Updated 8/2