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Market Brief – Cross Asset Contagion

This chart shows the contagion across global markets and asset classes. Credit Suisse, who created the index, has said that global markets are at their highest correlation since the index was created.

What's interesting is that correlations are at record highs while many global markets are still in an old cyclical bull. Generally, they rise in bear markets when forced selling pushes correlations up.

These high linkages are why, on Friday's sell-off, there was hardly a drop of green in any market around the world. Take a look at the heat maps below.

If you wanted to find safety on Friday, then you should've loaded up on Czech 5yr notes… Czechoslovakian notes are the new UST, apparently.

This cross asset contagion is concerning but not at all surprising.

It's the direct result of central banks tickling investors into a yield frenzy, where little to no regard is being paid to credit quality, or any other risk factor for that matter. This has resulted in an increasing amount of capital crowding into already extended assets.

And the correlations are further exacerbated by the prominence of quant driven funds whose algos are all positioning (making buying and selling decisions) off of the same metrics.

Speaking of which, there's a great post on the systemic risks created by quant funds, from Global Slant, here's an excerpt below and you can find the whole article here (emphasis mine):

> *While in Greenwich Ct. one afternoon I will never forget a conversation I had with a leading quantitative portfolio manager. He said to me that despite its obvious attributes "Black Box" trading was very tricky. The algorithms may work for a while [even a very long while] and then, inexplicably, they'll just completely "BLOW-UP".*
>
> *To him the most important component to quantitative trading was not the creation of a good model. To him, amazingly, that was a challenge but not especially difficult. The real challenge, for him, was to "sniff out" the degrading model prior to its inevitable "BLOW-UP". And I quote his humble, resolute observation "because, you know, eventually they ALL blow-up"…as most did in August 2007...*
>
> *…I asked "why do they all "BLOW-UP"? What are those common traits that seem to effect just about every quantitative model despite the intellectual and capital fire-power behind them? And if they all eventually "BLOW-UP" then why are we even doing this?"*
>
> *He answered the second part of the question first…and I paraphrase **"We are all doing this because we can make a lot of money BEFORE they "BLOW-UP". And after they do "BLOW-UP" nobody can take the money back from us."***
>
> *He then informed me why all these models actually "BLOW-UP". "**Because despite what we all want to believe about our own intellectual unique-ness, at its core, we are all doing the same thing. And when that occurs a lot of trades get too crowded…and when we all want to liquidate [these similar trades] at the same time…that's when it gets very ugly.**" I was so naive. He was so right.*

That's a problem; "we are all doing the same thing" leads to crowded trades. Crowded trades *don't* tend to work out well, because "when we all want to liquidate… at the same time" things get ugly. If Friday is any indicator, we should expect a buffet of ugly or as Hillary would say a "basket of deplorables" sometime in our not so distant future.

Do you, like me, find the increasing chatter about the "death of macro" and what seems like daily closures of seasoned macro funds to be coming at a conspicuous time?

Macro funds (and active funds in general) have found themselves in a "killing field", as Dan Loeb recently put it. Alpha is tough to produce when every asset acts the same. And investors are pulling their money because the dominant narrative of the day seems to be that levered passive is the "intelligent" thing to do and active managers aren't worth the fees.

One only needs to go back to the tail end of the tech bubble for the last time macro fund managers were so out of fashion. That's when even the greats like Soros and Robertson called it quits — of course we all know how that party ended.

I don't know… maybe the popular passive crowd is nailing a cyclical bottom here and we're about to experience a long and profitable bull market making everybody rich…. Or perhaps this is just another sign that the cycle is growing old…

So crowded positioning and algo selling begetting more algo selling is the cause of the severity of Friday's selloff.

The reason for it though, if one can ever divine a reason for a single day of price action, has everything to do with rates.

Specifically, the Fed's drive to put the rate hike narrative back on the table and then disappointment over recent ECB and BOJ action — or I should say inaction.

Let's discuss the ECB and BOJ first.

Take a look at the yields of both the Japanese and German 10yrs. Germany is now positive again and Japan is a hair below zero.

The recent spikes in yields are driven by three things [1] both central banks are nearing the limits of what they can purchase (there's not many qualified bonds left) [2] they're both wising up to the fact that negative rates, especially further out the curve, hurts financial institutions and is by its very nature, deflationary, and then [3] investors who bought negative yielding bonds only did so because of hopes for capital gains (greater fools theory at work) and now that both central banks appear to be letting off the QE gas a bit, holding NIRP'ed bonds makes less than zero (nirped?) sense.

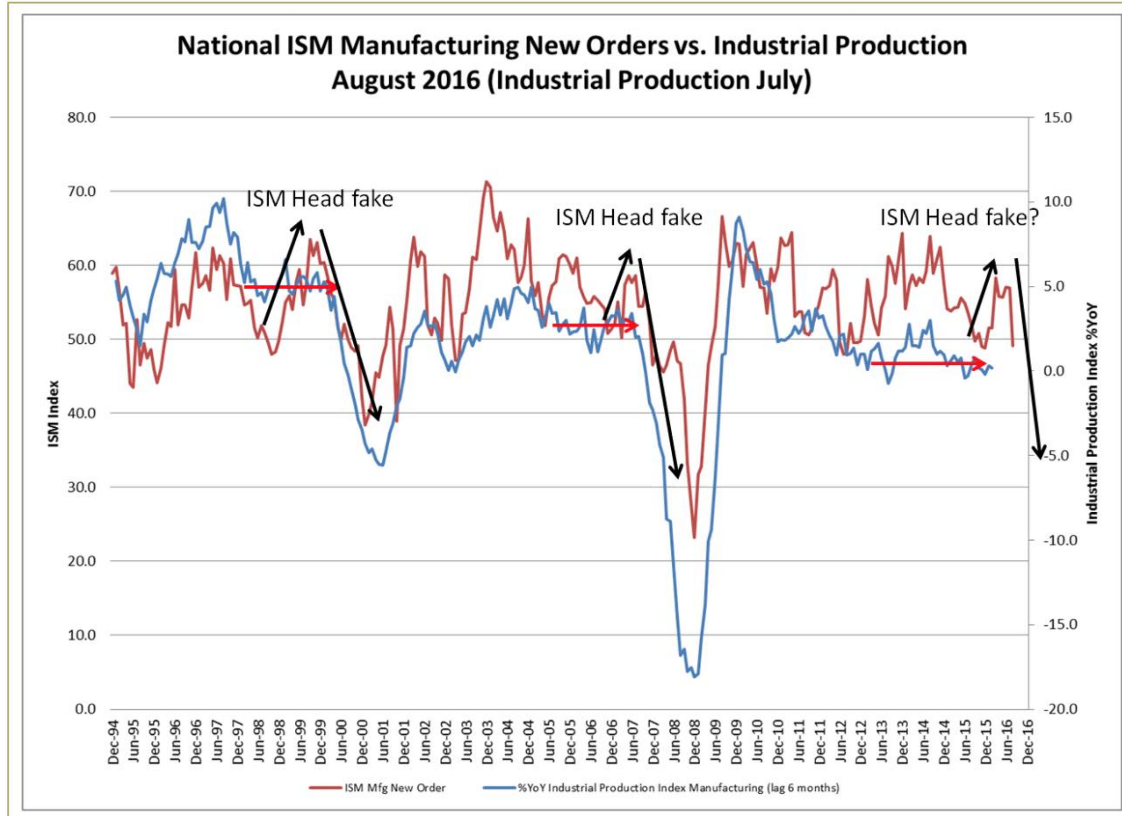
Because of the crazy things that happen with bond math when at zirp and nirp, the "fools' who bought into Japanese and European negative coupon bonds late in the game have taken large losses over the last couple of weeks.

These losses, combined with rising rates, are no doubt causing a *bit* of repositioning within portfolios that should continue to affect equities into next week.

The Fed meanwhile has been on a coordinated media blitz, trying to get the market to buy into the potential for a rate hike before the end of the year. Many attributed Friday's selloff to Fed President Eric Rosengrens hawkish speech on Friday, where he warned that a "reasonable case" can be made for it to keep the economy from "overheating".

Any "reasonable" person looking at the recent economic data could in no way be worried about the economy overheating. If anything it should be the opposite.

The latest ISM print was horrible and nominal GDP and inflation are well below where the Fed wants them. Speaking of ISM, here's an interesting chart (via Acting-man) showing the correlation between ISM and industrial production.



And here's a list from Charles Gave showing other (but not all) economic indications that the economy is not exactly in escape velocity:

> *1) Private sector GDP: The 12-month rate of change stands at 1.3% YoY, a level which since 1968 has always coincided with a recession.*
>
> *2) Industrial production: The six-month moving average of the 12-month rate of change has been negative for a good while, which since the 1930s has never occurred outside of recession conditions.*
>
> *3) Non-financial profits (national accounts): Since the 1950s these have not been lower than three years ago without a recession (save 1986-87).*
>
> *4) Capital spending: The two-year rate of change is negative and (save for 1987) this situation has always coincided with a recession.*
>
> *5) New home building permits: The 12-month rate of change has swung negative, which has often been a recession signal.*
>
> *6) Exports: The six-month moving average of the 12-month rate of change has gone negative, which has almost always coincided with a recession (there have been recessions with export growth).*

7) Industrial sales: The Year-over-Year (YoY) change is in negative territory, which has usually been associated with a recession.

8) Tax receipts: The six-month moving average of two year variations is negative, which has never happened outside of a recession.

9) Employment: Variations on a 12-month basis remain positive, but are decelerating. This tends to lag economic growth by about a quarter.

10) Consumer spending: Real retail sales are generating about 1% growth, yet consumer spending above 2% YoY (Obamacare impact?).

Also consider the following (non-output related) base data.

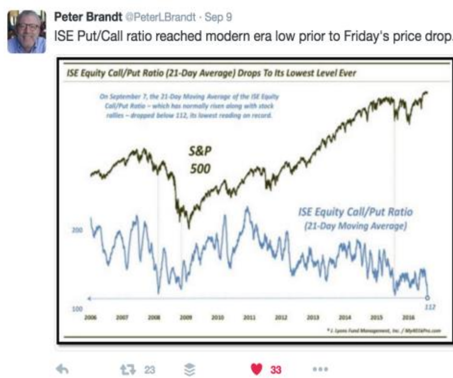
1) US real monetary base: The 12-month variation is negative, which has always coincided with a recession (there have also been quite a few recessions when real base money was rising on a YoY basis).

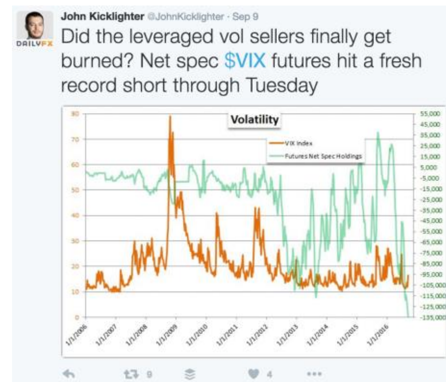
2) Corporate spreads: There has been a massive narrowing since February with Baa and junk bonds yields falling faster than economic activity.

Of course, the bullish argument is that we did experience a quasi-recession that was short lived at the beginning of the year and now things are turning up again. I don't find this argument very compelling because of where we're at in the credit cycle. It would take a globally concerted fiscal spending effort to keep this old bull galloping along and the politics of the moment don't exactly lend towards getting things done.

No, it's much more likely the Fed narrowly avoided recession at the beginning of the year by backing off its tightening path and was helped by liquidity injections from the other major central banks of the world. This boosted markets and put the economy at a slow stall speed and what we're seeing now is continuing divergence between the two (a 98' or 99' scenario like we've discussed).

The Fed knows this but is worried also about creating asset bubbles and dangerous speculation. Looking at recent positioning in short VIX and long equity indexes, the Fed *should* be worried.





The Fed is simply trying to temper risk enthusiasm. At the same time, they can't be happy that corporates have used the low rates to invest in buybacks instead of productive assets. The Fed now finds themselves stuck with a slowly deteriorating economy that can't stomach a rate hike and an increasingly speculative market that needs higher rates to cool its jets.

The question is, which concern pushes the scale for them?

The number two-man at the Fed, Stanley Fischer, said at a speech in January, that

> *"when policy makers say the economy is overheating, they may well be considering the behavior of asset prices as a critical part of that phenomenon and part of the reason to tighten monetary policy. Thus, I believe that the real issue of whether adjustments in interest rates should be used to deal with problems of potential financial instability is macroeconomic, and that if asset prices across the economy—that is, taking all financial markets into account—are thought to be excessively high, raising the interest rate may be the appropriate step."*

Fischer has Yellen's ear as much as anybody at the Fed but it's difficult to speculate what the Fed will do.

I've said it before that I won't trade off Fed speculation (I don't have an edge there) but my personal opinion is that the Fed is jawboning about raising rates because it knows that it can't. The FOMC doesn't have a lot of confidence in the economy's strength and they don't want to stir up unnecessary trouble in an already contentious election year.

FOMC member Lael Brainard, a notable dove, is giving a speech on Monday. It'll be telling about how tight the message unity is at the Fed. If she comes out hawkish then we should expect some interesting action in markets.

Tactical Section

Let's first look at the SPX, which fell over 250bps (2.5%) on Friday.

The S&P has been bouncing up against the 2200 level the last few weeks, an area which has been serving as solid resistance. It's normal for indexes to experience sizable retraces when testing new highs near large round numbers.

When markets close at their lows they typically see follow

through the first few days of the following week. Especially with the FOMC meeting on the horizon, I would not be surprised to see the SPX fall to the 2050 level before finding a potential bottom to this move.

Interesting fact, Friday was the 10th worst breadth day for the NYSE since the 1970s and the VIX recorded its 11th biggest spike since inception, all on no real news — good job computers.

The large long speculative position in index futures (an all-time record high) will also act as further fuel for the sell-off going into next week.

Just another example of an inflated amount of money (cash+credit) crowding into too few opportunities in a rush for return in a highly correlated low return world.

We'll have to keep a close eye on yields in the weeks ahead. People like Gundlach are saying we've hit a secular bottom in yields. We cut our position in long bonds on Friday cause we've likely hit an intermediate bottom but I think US bond yields move lower before this cycle is finished.

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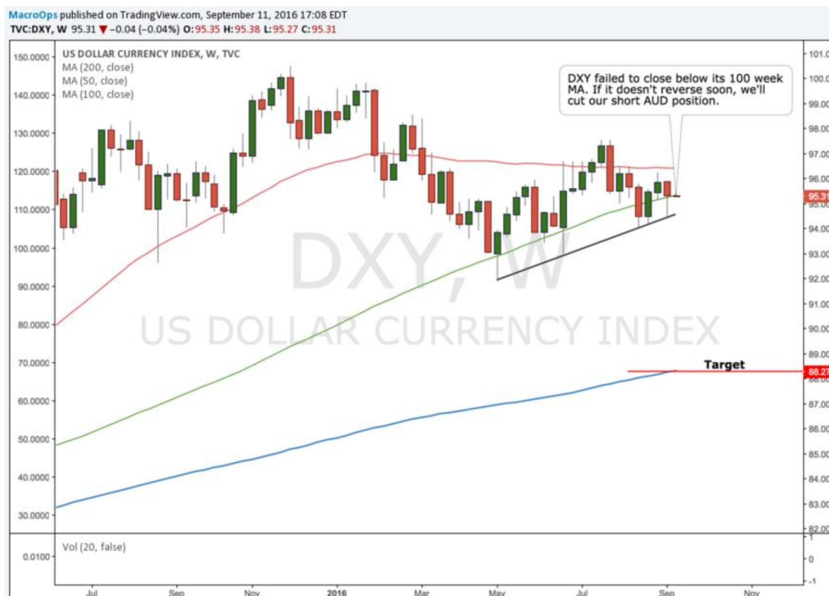
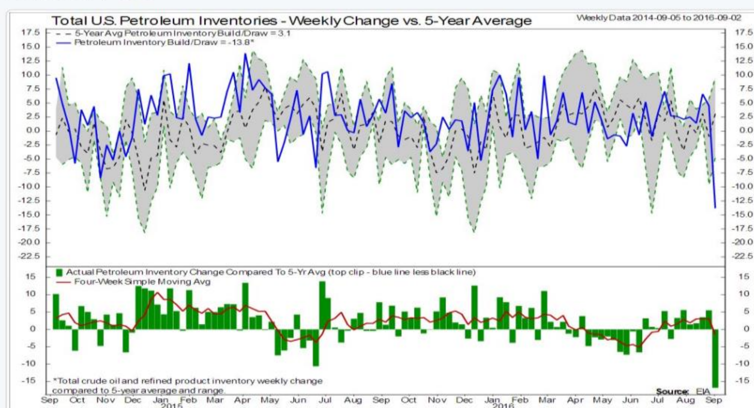
The dollar failed to close below its 100 week moving-average. FX volatility has fallen to one of its lowest levels in history. High vol follows low vol so it'll be interesting to see where things end up. The dollar is getting squeezed between its 50 and 100 week MAs at the moment, I think whichever side it breaks too will be the direction of the intermediate trend — my money is still to the downside but the market may disagree and knock us out of our long AUD position.



And the direction of the dollar will determine the direction of crude.

Crude finished up for the week but retraced a bit on Friday, along with everything else.

There was a massive draw on oil inventories this week that surprised just about everybody. It was the largest draw on supply since 1999 — a year that I see popping up more and more.



Crude also was turned away by its 100 week moving average. I've been noticing over the last few years that moving averages have been having a greater and greater effect on price action. Would not be surprised if they

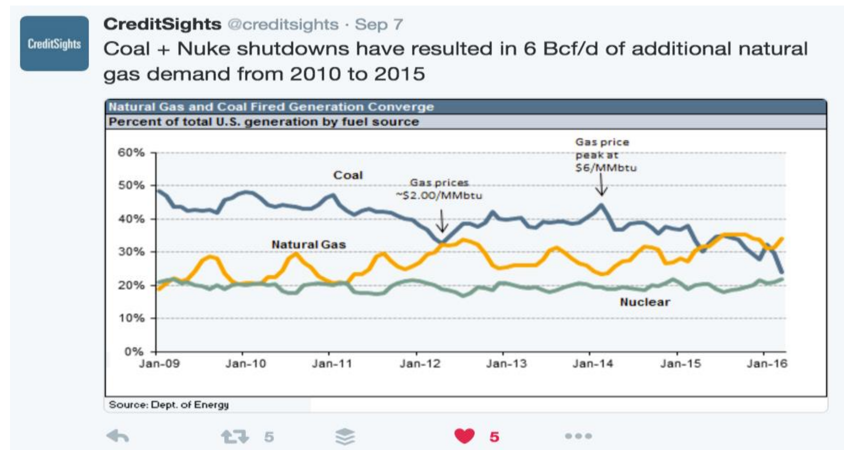
play an important role in the popular quant methods at the moment, that would definitely explain a lot.

European banks are enjoying the higher rates which is increasing their NIM (net-interest margins). Deutsche has clearly broken out of the bottom we pointed to a number of weeks ago and now looks like it could run for a bit. DB could very well rise over 20% to near $20 in the coming weeks. I'm not putting on a position but it's worth watching as an indicator of European sentiment.

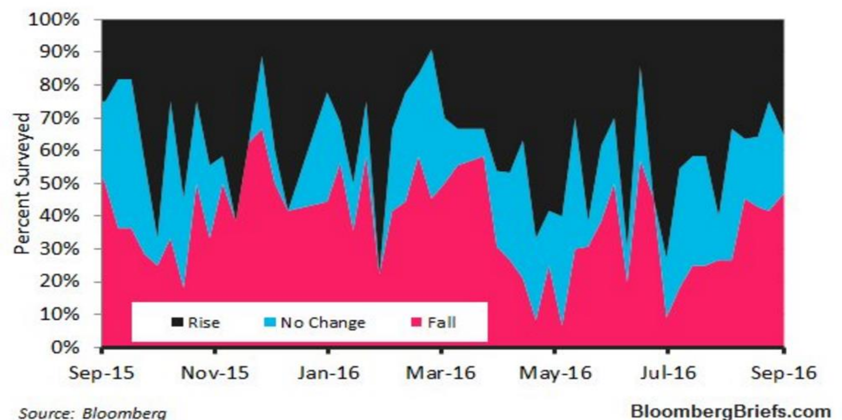
AMZN has completed 12+ month long ascending triangle pattern. It's trading at a whopping 189x earnings. I wouldn't dare short the stock but it's worth keeping an eye on. AMZN has been amongst the clear group of leaders for this bull market. And when the bull market leaders turn, it's a good indication that trouble is brewing. Friday's selloff is just a blip though and the stock will likely turn back to new highs soon.

I am liking natural gas more and more. Price action has been strong, though I expect a sizable retrace in the coming weeks, at which point we'll add to our position.

The shift away from coal combined with diminishing support for nuclear power are creating strong structural tailwinds for natural gas moving forward.

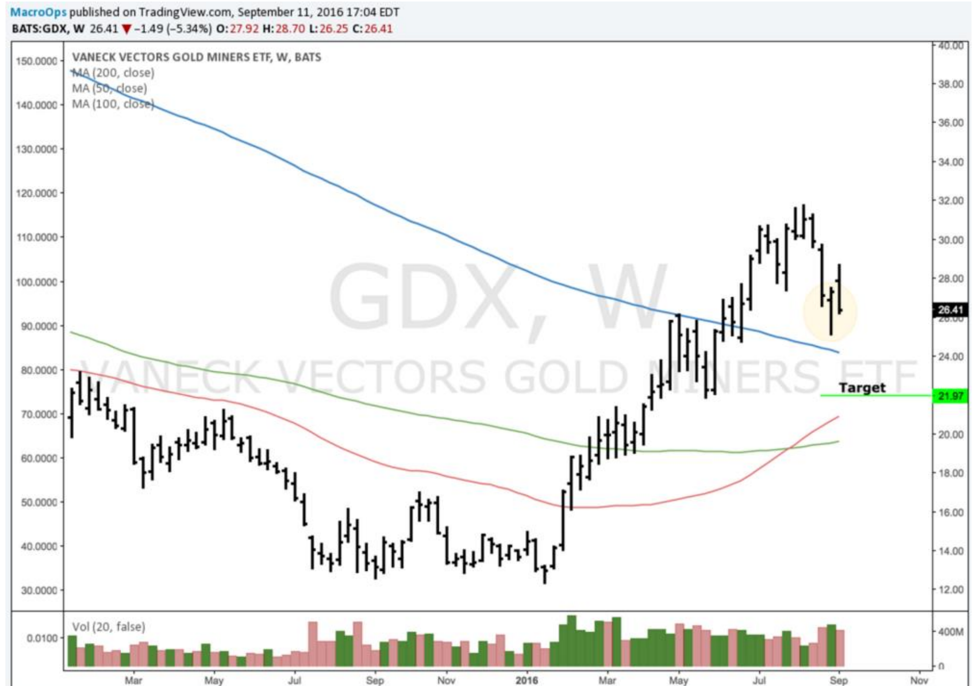


Sentiment is still predominantly bearish on natty which is good for our position.



We are entering a potentially strong La Nina' winter. Natty production will decline once oil turns over again (and it will go lower) and debt fueled rigs are taken out off the market. I think we're at the very beginnings of what will be a multi-year nat gas bull market and we're getting in at the ground floor.

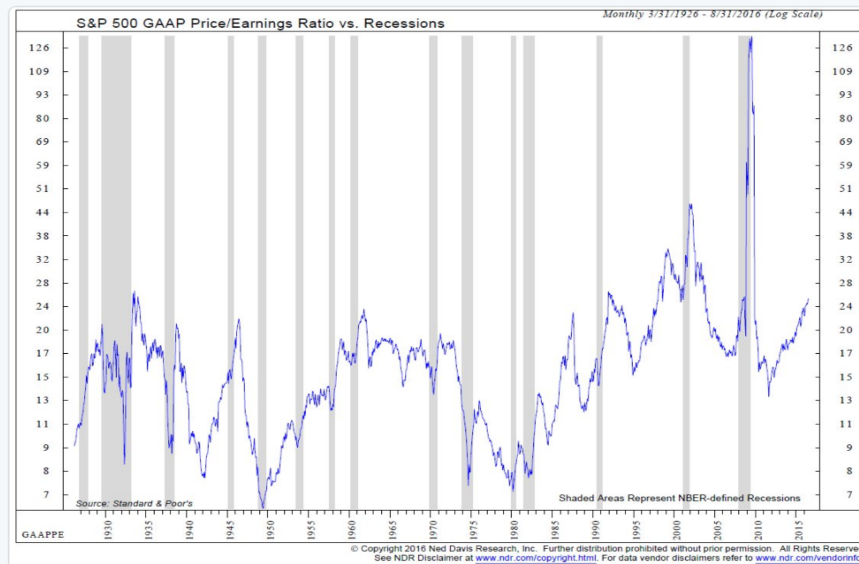
Gold is a tough one here but because of the still extremely strong consensus on owning it. I think it goes lower. And if it does, I would think it could be a big move lower. I would not be surprised to see gold futures sell below 1275. If they do, I may consider buying some. Like oil, we'll have to see where the dollar goes.



Finally for the tactical section I'll leave you with the following two charts; both showing valuations.

Ed Clissold @edclissold · Sep 6

GAAP PE has never been higher except .com bubble and recessions, when earnings have been depressed @NDR_Research



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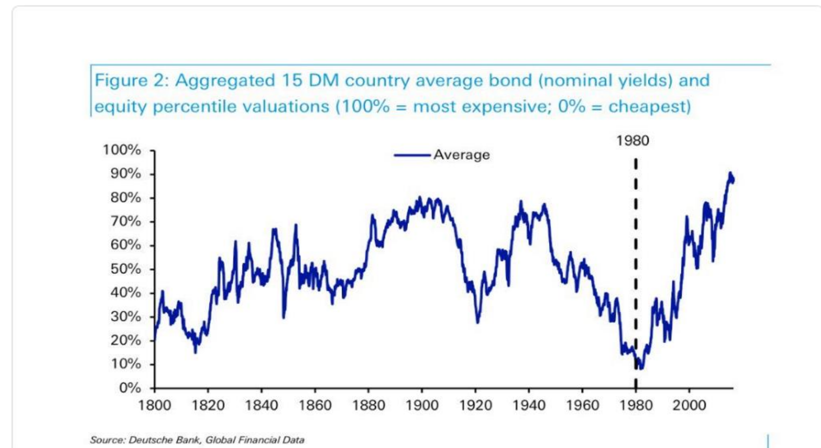
The above chart from Ned Davis Research shows the GAAP P/E ratio of the S&P 500. The only other time over the last 100 years it has been higher was during the tech bubble. The other spikes are from recessions, where the denominator (earnings) collapses, making the ratio spike.

And then the chart to the right from Deutsche shows that developed market average bond and equities are at their highest percentile valuations ever.



Just some food for thought in case you were thinking about throwing money into a passive long index here and going on vacation for the next decade. There likely wouldn't be much money left when you get back.

Conclusion

We have and will continue to keep our books light and nimble. We've been quick to cut positions over the last few months and are holding lots of cash. We'll continue to trade stocks that we think offer decent R/R opportunities so we can take part in whatever upside is left in this market, but cash is still one of my favorite positions at the moment.

A lot of investors think it's crazy to have large cash holdings. They think of it as a dead asset. Buffett views it differently. He thinks of cash as a perpetual call option because of the liquidity it gives you when great opportunities arrive. I agree, and with cross asset correlation at all time highs, there probably isn't a better time than to be sitting with a lot of dollars.

I think markets reverse this decline in the next few weeks and move on to new highs — possibly driven along by a Fed that sits pat in two weeks. I expect the market and economy to continue to diverge into the end of the year and my base case is that the US enters recession sometime in the first half of next year.

The direction of emerging markets, oil and high yield bonds is all dependent on which way the dollar breaks in the coming weeks. With FX volatility nearing historical lows we should see a swift move in either direction and this will set the stage for global markets as a whole moving forward. If the dollar starts it's bullish run then I will become considerably more bearish in the intermediate term and we'll start positioning to take advantage of the coming cyclical change.

That's all I've got for the Brief this week. Have a good one!

-Alex

P.S. Check out this FT Punk economics video by economist David McWilliams. He nails what's going on in the political sphere and how this will have a large impact on economics and markets moving forward. I'm in agreement with everything he says. The next decade will be a great one for commodity traders.

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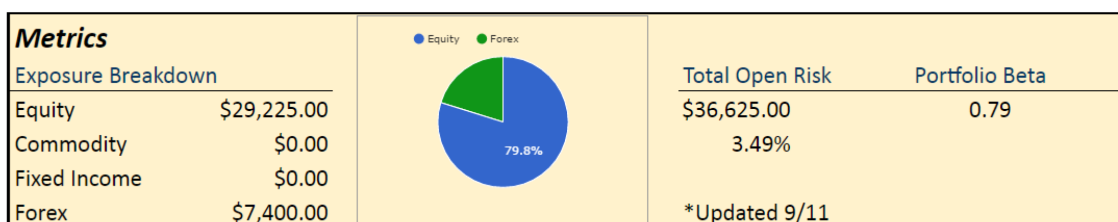
Portfolio Snapshot

Macro Ops Strategic Portfolio

NAV $1,050,421

Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target 1	Beta (1yr)	Notional
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	Comstock (CRK)	14000	6.60	5.68	$12,880.00	16.50	1.87	$96,880
Forex	AUD.USD (6AZ6)	5	0.7663	0.7515	$7,400.00	0.8484	0.42	$376,550



Metrics

Exposure Breakdown	
Equity	$29,225.00
Commodity	$0.00
Fixed Income	$0.00
Forex	$7,400.00

Total Open Risk	Portfolio Beta
$36,625.00	0.79
3.49%	

*Updated 9/11

Macro Ops Income Portfolio

NAV $1,054,606

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

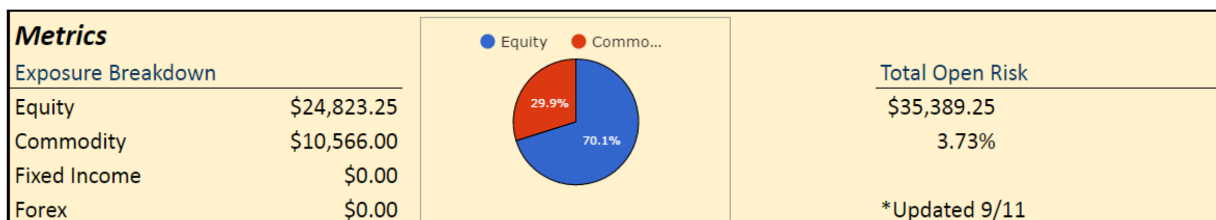
Worst Case	Worst Drawdown
SPX-10%	-$87,000
SPX-20%	-$250,000

**Updated on 9/11

Macro Ops Tactical Portfolio

NAV $948,645.77

Asset Class	Position	Size	Cost Basis	Risk Point	Market Price	Open Risk	Target 1	Notional
Equity	Goldman Sachs (GS)	2,300	169.57	166.39	169.25	$6,578.00	194.80	$389,275
Equity	Targa Rsrcs (TRGP)	3,975	46.01	44.13	46.52	$9,500.25	54.33	$184,917
Equity	Semgroup (SEMG)	3,300	33.84	31.66	34.31	$8,745.00	40.27	$113,223
Commodity	OJ (OJX6)	12	196.23	191.93	197.8000	$10,566.00	216.10	$355,410



Metrics

Exposure Breakdown	
Equity	$24,823.25
Commodity	$10,566.00
Fixed Income	$0.00
Forex	$0.00

Total Open Risk
$35,389.25
3.73%

*Updated 9/11