MARKET BRIEF

How Do You Say “Minsky Moment” In Chinese?

Anybody familiar with Ray Dalio’s theory on the economic machine will notice the influence of economist Hyman Minsky.

Unfortunately, Minsky’s work was largely ignored by mainstream economists during his lifetime (he passed away in 96’). This was because he preferred making logical inferences rather than trying to quantify and abstract the economic system into neat little mathematical models. These models often provided little use in understanding the “real” world, yet they continued to be the method du’ jour.

It wasn’t until the financial crisis of 08’ and the end of the decades long period that economists termed “The Great Moderation” — where it was believed that financial risk had been conquered — that Minsky was “discovered” by mainstream economics.

Minsky’s big contribution to the field was highlighting the importance of the composition of finance. Specifically, the relationship of debt to output. Prior to Minsky economists largely ignored the structure of the financial sector and the role that debt played in the stability of markets.

He came up with the “financial-instability hypothesis” which stated that long stretches of prosperity sow the seeds for coming crises. Economic stability breeds instability.

Minsky understood how recency bias drives myopia in the human decision making process. Economic actors end up extrapolating low volatility into the future which leads to more risk taking in the present through the use of leverage (credit).

The theory was established by defining what investment *is,* and its role in an economy. Which, put simply, investment is the exchange of money today for money in the future. That money (investment) can come from one of two sources: the economic actors' (consumer, company, government) *own* cash flows, or from the cash flows of *others* (lenders). And it's the balance between these two sources of investment that comprises the stability of the financial system.

According to Minsky, the financial cycle typically follows three stages of financing; these are:

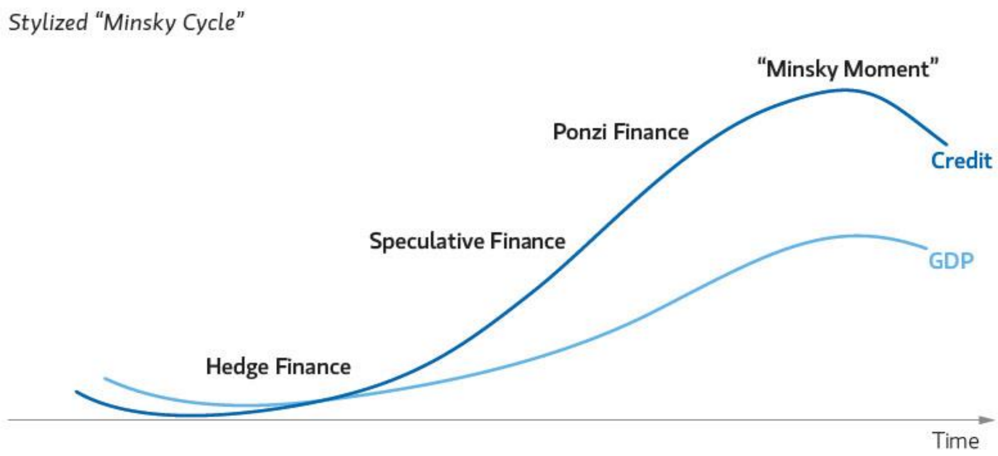
1. Hedge financing
2. Speculative financing
3. Ponzi financing

Hedge financing is the most stable of the three. It's when the economic actor relies on its own stable cash flows to repay any borrowings. It's when the actor's earnings far outweigh its limited borrowings.

Speculative financing is when the actor uses its own cash flow to pay the interest on its debt, but must assume more debt to repay the principal; thus rolling its debt over. This stage of financing is less stable than hedge financing.

And lastly, there's Ponzi financing, which is the most unstable of the three stages of financing. Ponzi financing is where the actor's cash flows do not cover either the principal or interest payments on its debts. The actor is completely reliant on the appreciation of the underlying asset in the hopes that it'll be enough to cover its liabilities.

Minsky argued that financial cycles naturally progress from each stage of financing to the latter; driven by human greed and carelessness. When economies enter the Ponzi stage, they become increasingly unstable and eventually experience a "Minsky Moment" which is a sudden collapse in asset values, leaving both lenders and borrowers exposed. This is the deleveraging phase of the debt cycle as put forth by Bridgewater.

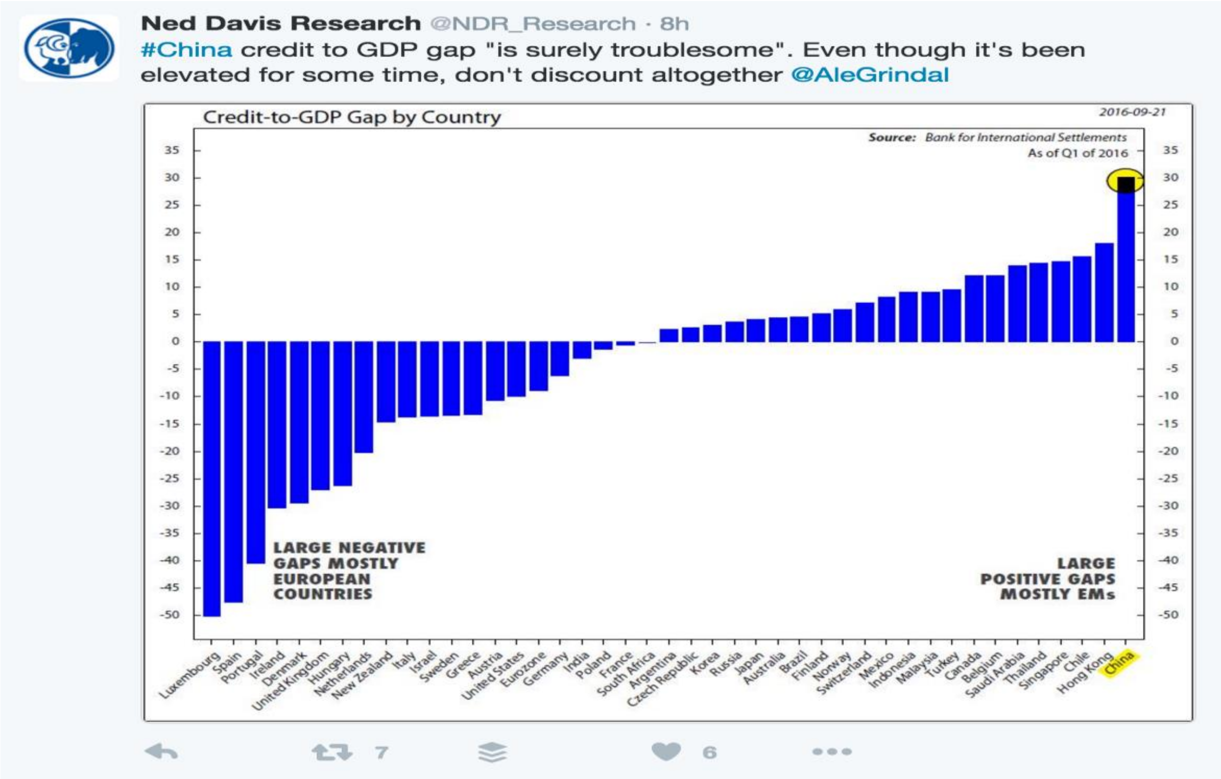


One of the tools Minsky developed to gauge which stage in the credit cycle an economy is in is the credit-to-gdp gap, or credit-gap.

The credit-gap is simply the difference between the credit-to-gdp ratio and its long-term trend. The credit-to-gdp ratio is the ratio of a country's total private non-financial debt to its gross domestic product. The larger the credit gap, the more the economy is at risk of a financial shock.

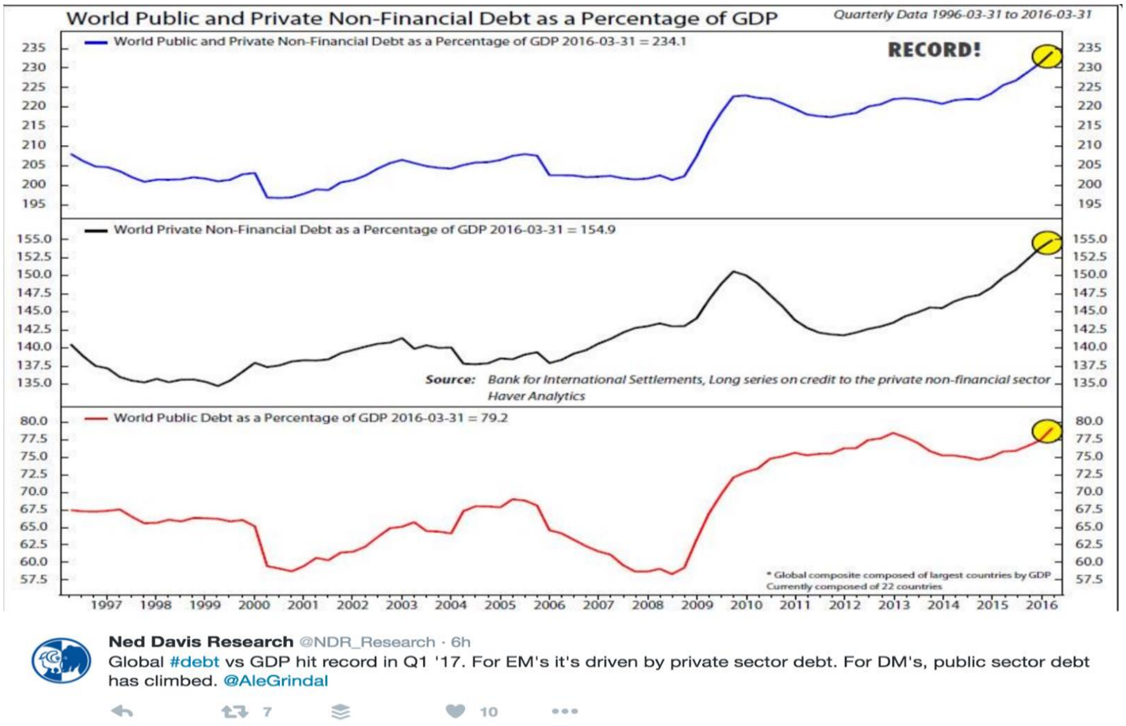
The Bank of International Settlements (BIS) keeps track of the credit gaps for all major countries which you can [find here].

You'll be hearing a lot more about Minsky and his financial-instability theory in the near future because there are a growing number of economies that are at record credit-gaps; meaning they're in extremely advanced stages of ponzi finance.

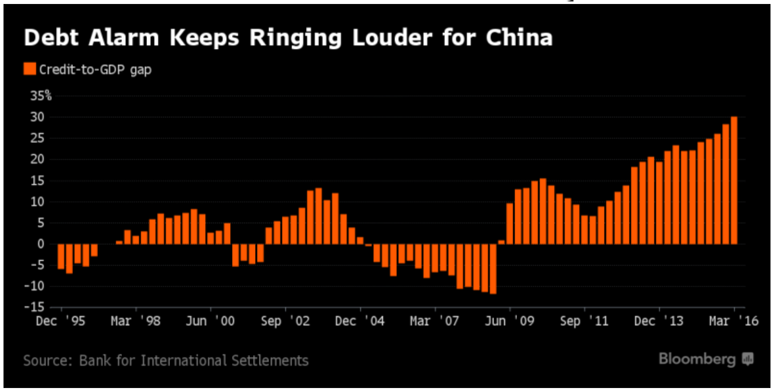


The BIS views any economy with a credit-gap over 10% to be at risk of financial instability. As we can see, the majority of countries above the 10% threshold are emerging markets.

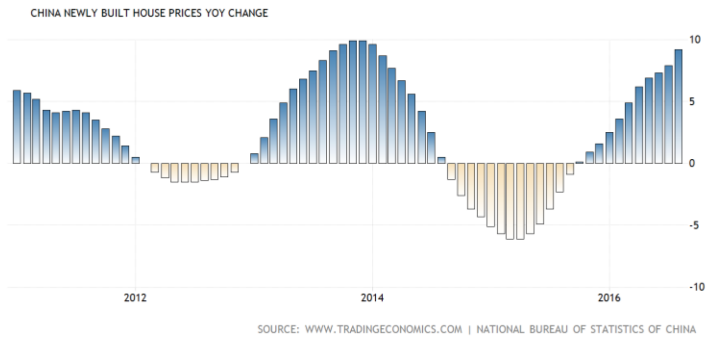
We should expect these credit-gaps to widen further as global debt increases and gdp contracts. Global debt-to-gdp is pushing to record highs.



China is the worst offender by a wide margin and is currently in the latter innings of the most extreme ponzi stage in recent economic history.



China's total credit increased 107% over just the last eight years to 255% of GDP (this is conservative and likely underestimating the true debt amount). These debt-to-income levels are beyond high for a developing economy, making a banking crises all but assured.

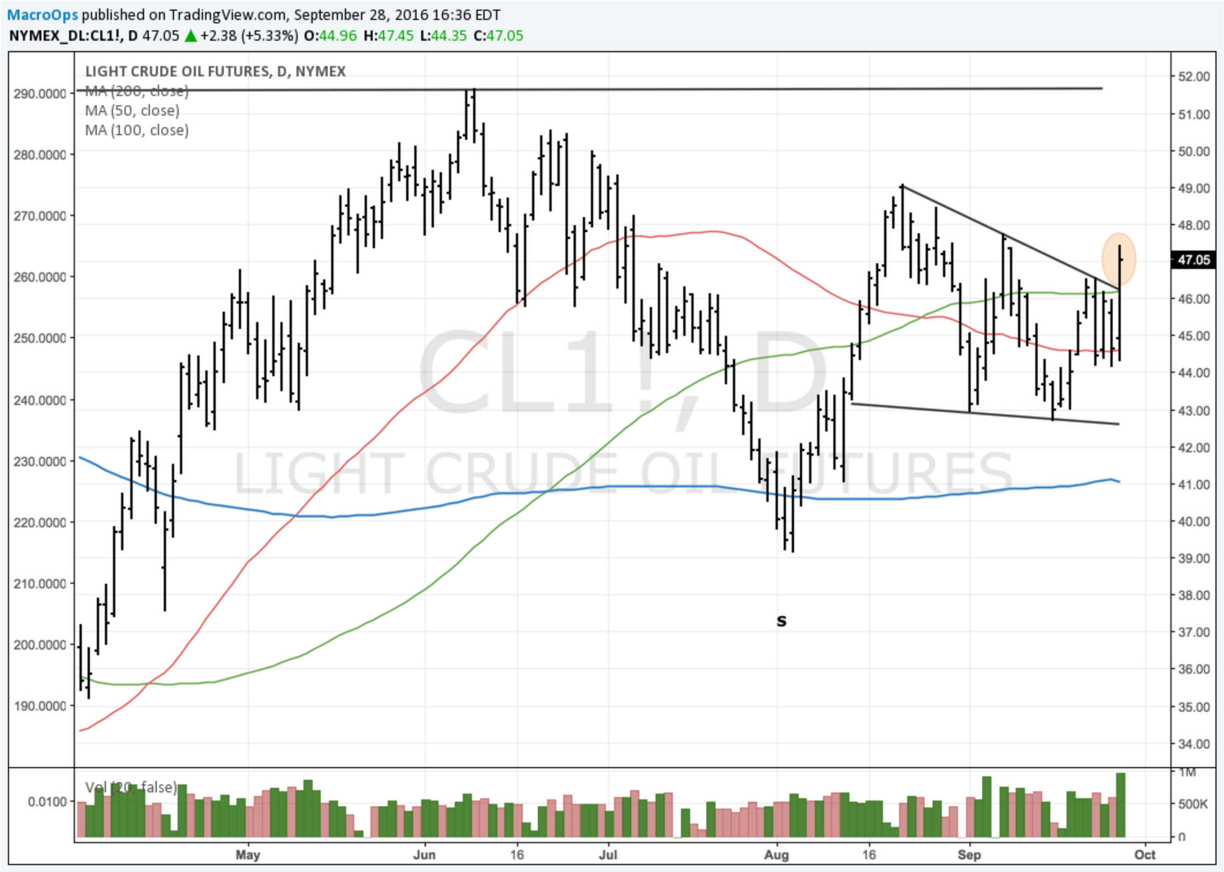


With outstanding loans of $28 trillion, more than that of both the US and Japan combined, the deleveraging is going to be a messy one. It's believed that it will cost as much as 40% of gdp for China to recapitalize its banks and extinguish the bad loans.

And despite promises from leadership to reign in the credit excess, debt continues to expand at a quickening pace.

Remember, the continuation of the ponzi stage relies on the appreciation of underlying assets. For the Chinese, this is primarily the housing sector where much of their worth is stored. Keep an eye out for real estate to turn over again. That's likely when we'll see China finally have its "Minsky Moment".

Tactical Section



Crude had a big breakout, ending the day up over 5% on news that OPEC had reached an output agreement. Reuters reported the following:

> *OPEC agreed on Wednesday to reduce its oil output to 32.5 million bpd from the current production levels of around 33.24 million bpd, two OPEC sources told Reuters.*
>
> *The producing group will agree concrete levels of production by each country at its next formal meeting in November, the sources said.*
>
> *One source also said that once production targets were reached, OPEC would reach out to non-OPEC producers for cooperation.*

This "agreement" is meaningless. Not only is the output ceiling still near record levels, but none of these countries will actually adhere to them. The last comment about reaching out to non-OPEC producers is particularly hilarious. Oil producers will say one thing and continue to act in their best interest… which means high production and a grab for market share.

As we've discussed in past Briefs, it's not so much the reality but the market's optics on the reality that matter.
This is why we've been bullish on oil in the short-term. Liquidity is high and market sentiment is still very much risk-on, and so, investors are looking for a reason to bullishly interpret an OPEC "deal". And OPEC countries were more than happy to deliver the narrative.

The reason why we're seeing this propaganda from OPEC is because the most important producers have been really feeling the squeeze.

Saudi Arabia recently had to inject liquidity into its banks because of an increasing cash crunch.

The Saudi Arabian Monetary Agency (central bank) injected $5.3 billion in time deposits to keep the financial system from seizing up. The kingdom is also now preparing for its first international bond sale to build up its cash cushion and help plug the deficit as oil prices stay low.

Saudi Arabia, along with the other OPEC members, are simply trying to buy a bit of time with this agreement. But the reality is that the seeds for future lower oil prices are sown in higher prices today. Here's the following from WSJ:

> *When oil prices began to plunge two years ago due to a global glut of crude, experts predicted U.S. shale producers would be the losers of the resulting shakeout.*
>
> *But the American companies that revolutionized the oil and gas business with hydraulic fracturing and horizontal drilling are surviving the carnage largely unbowed.*
>
> *Though the collapse in prices caused a wave of bankruptcies, total U.S. oil production has only fallen by about 535,000 barrels a day so far this year compared with 2015, when it averaged 9.4 million barrels, according to the latest federal data.*
>
> *As the oil markets ponder where production will resume when prices pick back up, one clear answer has emerged: America. Goldman Sachs forecasts the U.S. will be pumping an additional 600,000 to 700,000 barrels of oil a day by the end of next year—making up for every drop lost in the bust.*

I think we see oil complete its 13-month H&S bottom and move higher over the short-term. How long this move lasts is a tougher question. It's mostly dependent on the action in the dollar (which we'll discuss below) as well as when the ponzi stage completes in China; which will result in an eventual yuan devaluation. I don't think this happens until next year, but like I said we'll need to keep a close eye on China's housing sector.

There're some lucrative trades to play this bullish oil theme for those of you with a more speculative bent.

High cost oil producers have been slaughtered over the last two years. Their current equity prices reflect companies that were expected to go bankrupt from low oil prices.

But if oil runs higher from here we will see a sharp narrative shift, and many of these stocks will double or more in price over a short period of time.

Here's some of the safer stocks to play this theme. These companies are cash flow positive and have quick scores over 2; meaning they are at less of a risk of going bankrupt (ATW is one of the ones I like most).

If you really want to speculate, you can go long some of the more leveraged drillers whose equity have been written off as worthless. Stocks like SDRL and REXX are some of the most hated stocks by analysts in the market right now and for good reason. They're saddled with debt and when the price of oil collapses again, the equity in these companies will go to zero. But these stocks will move significantly higher than their less leveraged counterparts in the near term.

When playing these highly speculative themes it's important to trade extremely small position sizes and get out as soon as the basis for the trade appears to be wrong. We'll likely be putting on some of these trades later in the week should oil stay strong.

Onto the global lynchpin.

The dollar is continuing its tight coiling and will have a large breakout in one direction or the other very soon. My bias is that it breaks lower in a large bear trap before it eventually resumes its cyclical bull market. If this happens, the long oil trade will rip to the upside. Long AUDUSD continues to be my favorite vehicle to play this and we'll put on a trade if/when it breaks out.

Things are not looking good across the Atlantic. Europe's banks are toeing the line of full-blown banking crisis. Below's a chart showing the bloodletting going on in European financials.

Negative Price Return	Members (26)	Return	Positive Price Return
	ESTX Banks € Pr	-29.01%	
	Best Performing		
	11) RAIFFEISEN BANK INTERNATIONA	-2.32%	
	12) BANKINTER SA	-4.78%	
	13) ERSTE GROUP BANK AG	-7.94%	
	14) KBC GROEP NV	-10.73%	
	15) ABN AMRO GROUP NV-CVA	-11.66%	
	16) ING GROEP NV	-13.01%	
	17) BNP PARIBAS	-13.49%	
	18) BANCO SANTANDER SA	-15.31%	
	19) NATIXIS	-20.92%	
	20) BANCO BILBAO VIZCAYA ARGENTA	-21.40%	
	Worst Performing		
	21) INTESA SANPAOLO	-36.92%	
	22) COMMERZBANK AG	-38.22%	
	23) BANK OF IRELAND	-48.82%	
	24) DEUTSCHE BANK AG-REGISTERED	-53.16%	
	25) BANCA POPOL EMILIA ROMAGNA	-55.37%	
	26) BANCO POPULAR ESPANOL	-59.12%	
	27) UNICREDIT SPA	-60.43%	
	28) BANCA POPOLARE DI MILANO	-63.97%	
	29) UBI BANCA SPA	-67.19%	
	30) BANCO POPOLARE SC	-79.29%	

The biggest story as of late has been Deutsche Bank, which continues to fend off questions about its solvency. DB's market cap is now less than 100th of its asset base. This is troubling because as we've talked about in past briefs, DB has the largest derivatives book in the world, equating to roughly $46 trillion dollars.

That number is large, but is only its notional derivative book. What matters is its derivative exposure; the open risk the bank actually has.

The problem here is that nobody really knows this number because the bank is such a large and complex beast that it's tough to gauge its true derivative exposure.

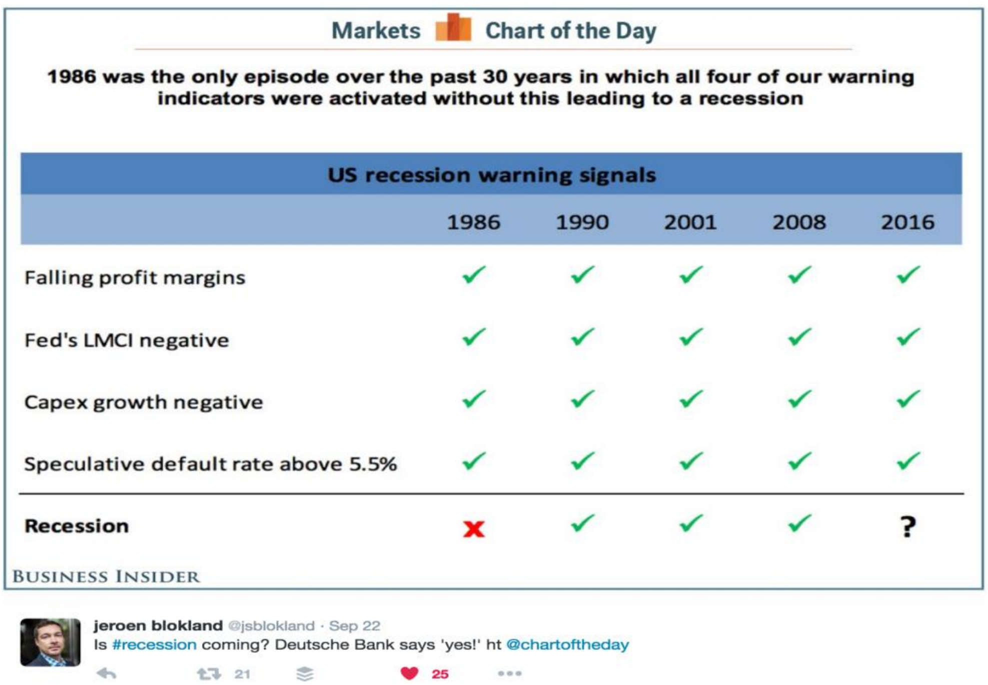
What's important is that the market tends to think this risk is quite large, which is why DB stock is down over 50% since the start of the year.

A lot of this has to do with the US recently fining Deutsche $14 billion — nearly its entire market cap — for shenanigans the bank pulled with mortgage securities during the last financial crisis.

I've long been saying that the shock for the next bear market will not come from within the US, but will stem from either China or Europe, or more likely both. A collapse of the European financial system surely fits this bill so we'll have to monitor it closely.

DB is the very definition of "too big to fail", and it will eventually need to be recapitalized either through a bail-in or bail-out. I don't see this theme hitting red alert levels in the next few months though. Germany's leaders will quietly work with the US to get that fine reduced. This narrative will disappear into the background, and will re-emerge sometime next year.

Conclusion



Markets Chart of the Day

1986 was the only episode over the past 30 years in which all four of our warning indicators were activated without this leading to a recession

US recession warning signals	1986	1990	2001	2008	2016
Falling profit margins	✓	✓	✓	✓	✓
Fed's LMCI negative	✓	✓	✓	✓	✓
Capex growth negative	✓	✓	✓	✓	✓
Speculative default rate above 5.5%	✓	✓	✓	✓	✓
Recession	✗	✓	✓	✓	?

BUSINESS INSIDER

The chart above is from Deutsche and shows there has only been one other time (1986) in the last 30 years where all of the above indicators were flashing red and the economy did not enter a recession. Of course, the market did experience one of its most volatile crashes in 87'.

I expect the divergence between economic fundamentals and US equities to continue to widen into the end of the year. A temporary recovery in oil and a weaker dollar will keep credit markets calm and drive risk assets higher.

I will continue to seek out beaten down contrarian value plays for the strat portfolio; preferably ones with little correlation to the broader market.

We'll be putting out the monthly MIR next week where we'll discuss our current macro hypothesis in much greater detail.

That's all I've got for this week, good luck in the markets!

-Alex

Portfolio Snapshot

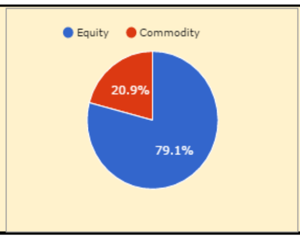
Macro Ops Strategic Portfolio

NAV $1,038,310

Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target 1	Beta (1yr)	Notional
Equity	Chesapeake (CHK)	14,700	5.15	4.30	$12,495.00	8.66	4.7	$89,376
Equity	Novatel (MIFI)	11,000	2.10	1.75	$3,850.00	3.00	1.84	$41,140
Equity	Comstock (CRK)	14,000	6.60	5.68	$12,880.00	16.50	1.87	$96,880
Commodity	Coffee (JO)	8,400	23.22	22.30	$7,728.00	27.71	0.78	$187,656

Metrics

Exposure Breakdown	
Equity	$29,225.00
Commodity	$7,728.00
Fixed Income	$0.00
Forex	$0.00



Total Open Risk	Portfolio Beta
$36,953.00	0.79
3.56%	

*Updated 9/28

Macro Ops Income Portfolio

NAV $1,074,470

Asset Class	Position	Size	Cost Basis	Max Profit
Option	SPX Oct 20 2070 Put	-10	$15.20	$15,200.00
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

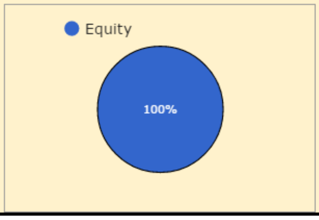
**Updated on 9/28

Macro Ops Tactical Portfolio

NAV	$932,667.00							
Asset Class	Position	Size	Cost Basis	Risk Point	Market Price	Open Risk	Target 1	Notional
Equity	Targa Rsrcs (TRGP)	3,975	46.01	44.13	49.26	$20,391.75	54.33	$184,917
Equity	Radisys Corp (RSYS)	17,000	5.61	5.20	5.41	$3,570.00	6.76	$95,710
Equity	Twilio (TWLO)	1,317	66.17	60.80	68.49	$10,127.73	Trail	$84,380

Metrics

Exposure Breakdown	
Equity	$34,089.48
Commodity	$0.00
Fixed Income	$0.00
Forex	$0.00



Total Open Risk
$34,089.48
3.66%

*Updated 9/28