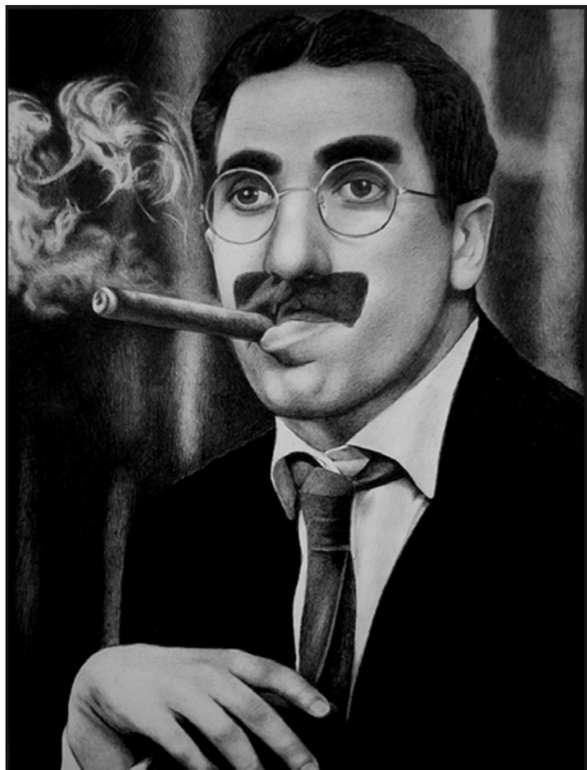
Market Brief – Reputation Dependent



Those are my principles, and if you don't like them… well, I have others. ~ Groucho Marx

Groucho Marx would've made a great Fed Chairman.

I could see him holding an FOMC presser saying "these are the data points on which we set our policy, and if the market doesn't like those… well, we have others."

In essence, it's no different than what Yellen and crew have been doing, if only a bit more candid.

Markets remain in the grips of confused central bankers and this will be a telling week of what their true "principles" are.

The BOJ and Fed are both releasing statements this Wednesday.

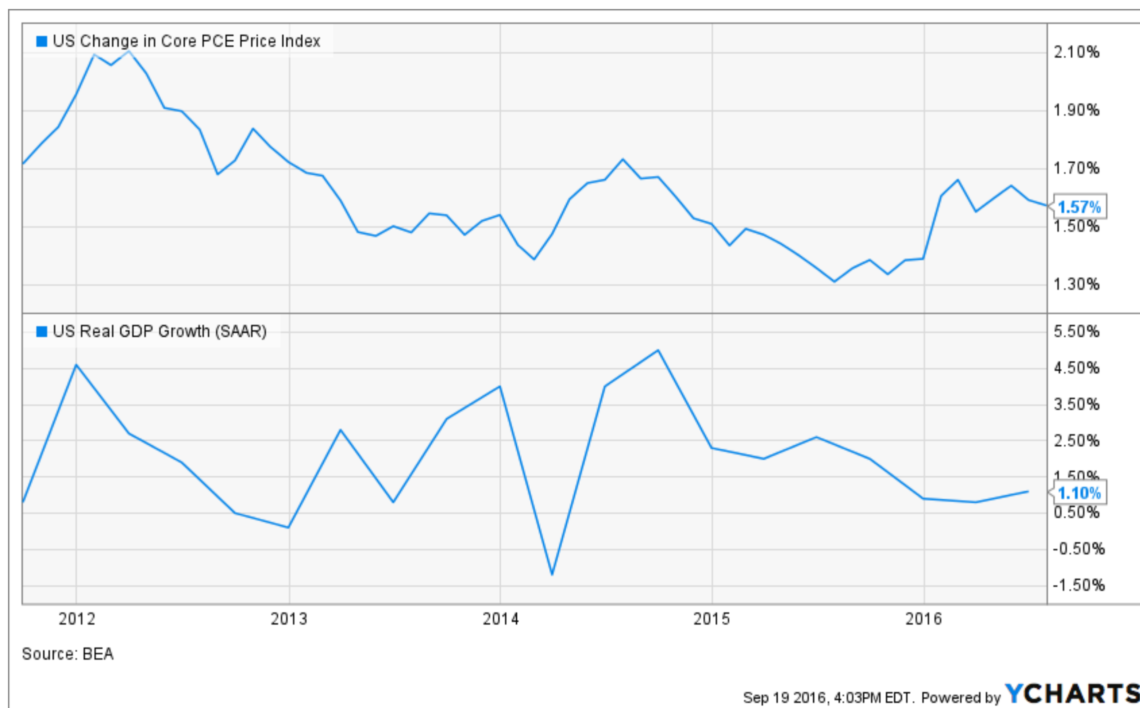
Opinions are mixed on what the BOJ will do. Some are expecting the bank to change the targeted maturities on its QE program in an attempt to steepen the yield curve. This would keep the short end low while raising the long end.

The hopes in doing this are that it would keep credit conditions loose while still providing some relief for pension funds, insurers and banks who have been getting pinched by the negative rates.

If this happens it will affect the optics over negative interest rate policy, since it's a kind of half-admittance that nirp equals a deflationary trap. Because of this, we could see some interesting action in the yen, euro and swissy (negative yielding currencies) possibly driving the dollar lower; so this is an important meeting to watch.

And then there's the Fed, whom appears to be in the grips of an existential crisis.

On the one hand, the data they say guides their policy clearly does not call for a rate hike. The chart below shows that the trend in both core PCE (Fed's favorite measure of inflation) and real GDP do not paint the picture of an economy at risk of running hot.



Fed member Lael Brainard agrees that according to the Fed's stated objectives, the evidence isn't there to support a hike, saying last week:

> *Although wage growth has picked up to about a 2-1/2 percent pace in recent quarters, this pace is only modestly above that which prevailed over much of the recovery and well below growth rates seen prior to the financial crisis.*
>
> *My main point here is that in the presence of uncertainty and the absence of accelerating inflationary pressures,* ***it would be unwise for policy to foreclose on the possibility of making further gains in the labor market.***

And on the other hand, you have a number of Fed members calling for higher rates. The most notable being Fed President Rosengren, who said rate hikes are needed to keep financial speculation under control, citing the booming commercial real-estate market as an area of growing concern.

Both camps are right.

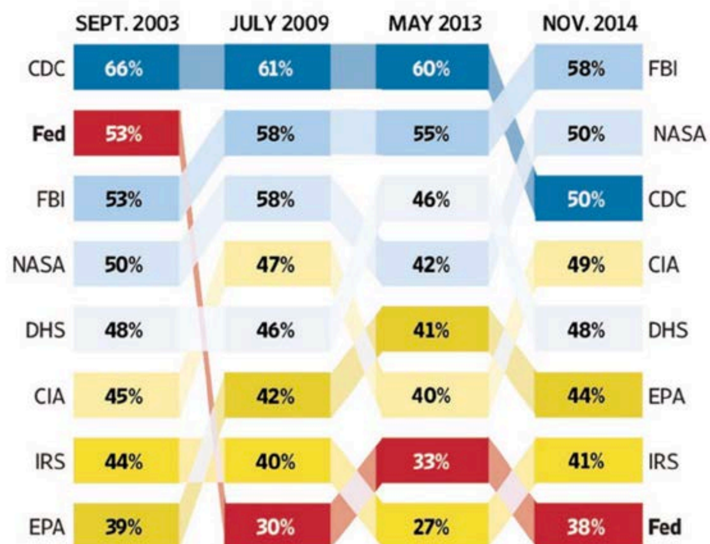
It looks like central bankers are learning the lesson most of us learned as kids, that "you can't have your cake and eat it too."

The choice is either let the economy improve and allow market speculation to inflate asset bubbles or dampen speculation but reverse the growth we've seen in the economy.

Ben Hunt, over at Epsilon Theory, has an interesting take on the Fed's thinking here:

> *As an organization, the Fed doesn't really care whether or not markets go up or down, and as an institution it's not motivated by making money (or whether or not anyone else makes money). Like all research universities, the Fed at the organizational level is motivated almost entirely by reputation. Not results. Reputation. A choice between "markets up but reputation fraying" and "markets down but reputation preserved" is no choice at all. The Fed will choose the latter 100% of the time. I can't emphasize this point strongly enough. From a bureaucratic perspective, the Fed absolutely Does. Not. Care. whether or not the market goes up, down, or sideways. When they talk about "risk" associated with their policy choices, they mean risk to their institutional reputation, not risk to financial asset prices. And today, after more than two years of a "tightening bias" and "data dependency", there's more reputational risk associated with staying pat than with raising rates in a one-and-done manner.*

That the Fed is driven by concerns over its reputation shouldn't be surprising to anybody who's spent any time around academics. Whether or not this reputational risk translates into immediate rate increases is another story.



The Fed's approval rating which was once higher than both NASA and the FBI is now below that of the IRS. And presidential nominee Donald Trump has accused the Fed of using monetary policy to support democrats during this election year and has stated that he would have them audited if elected (whatever that means).

The Fed has to be concerned about not only its reputation but its future survival. The central bank knows raising rates could lead to the popping of the third Fed created market bubble in under 20 years. And taking this risk in a contentious election year where the Republican Presidential candidate is openly hostile to the organization's existence, in my view, makes the chance of a Wednesday hike slim.

Bridgewater, wrote in a note to clients last week about the large asymmetric risks premature tightening poses to markets. They compare today to several other cases in history where

tightening during deleveragings led to depressed conditions such as: the UK in 1931, the US in 1937, the UK in 1950, Japan in 2000 and 2006, and Europe in 2011.

The note went onto say:

> *In nearly every case, the tightening crushed the recovery, forcing the central bank to quickly reverse course and keep rates close to zero for many more years… normally, a mistake in monetary policy is not that big a deal because it can be reversed… the risk now is higher than normal because a tightening mistake is harder to reverse today when the ability to ease is more limited.*

Even economist Larry Summers has been piling on the heat, accusing the Fed of being naive with their threats of hiking, saying "if a greater than one-third chance of a rate increase in September was not in markets, the cost of credit for small business would be lower and mortgage rates would decline. Employers would be more confident about hiring. And pressures would be removed from emerging markets." Adding "we should be extremely worried… we are essentially on a fairly dangerous battlefield with very little ammunition."

It's a kind of damned if you do, damned if you don't for the Federal Reserve. A direct result of enacting policies under the belief that wealth can be created out of thin air rather than through productive means.

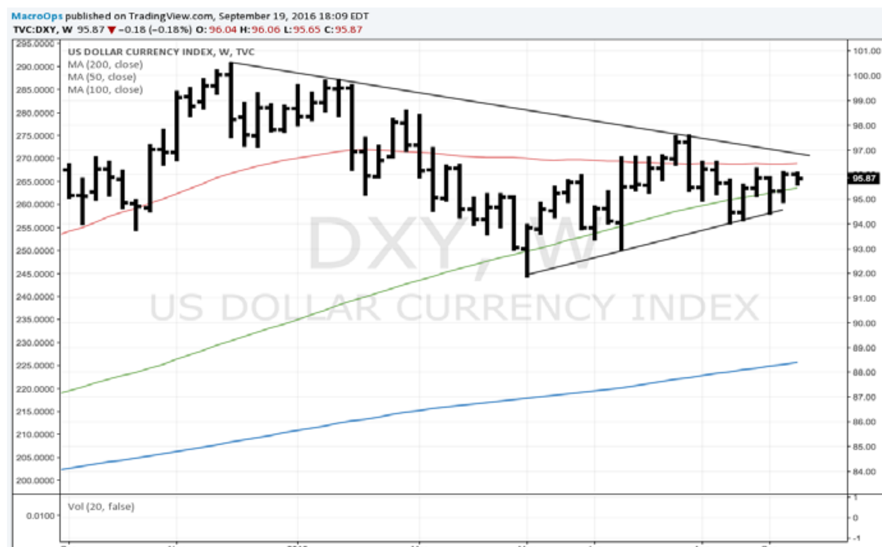
And the reality that instead of being "data dependent" they are "reputation dependent".

Wednesday is the Fed's last realistic chance to hike until its meeting in December. Whatever the Fed decides to do, tighten or stay easy, the result will be the driving narrative going forward into the end of the year.

The media makes the mistake of deeming every FOMC meeting as "the most important one", this time it really is.

We'll be putting out a note Wednesday night covering the decision and its implications for different markets.

Tactical Section



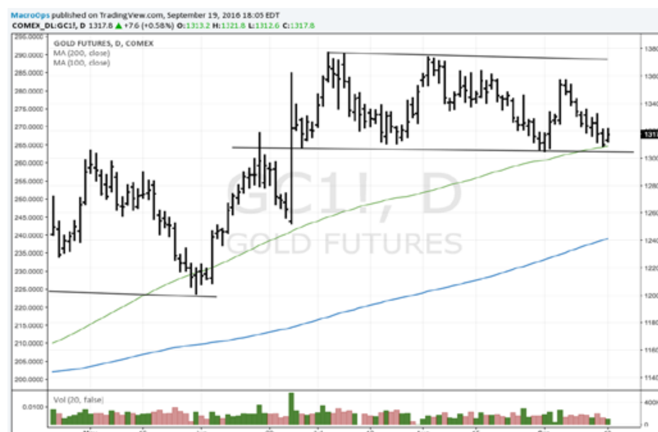
The dollar continues to be the linchpin of global markets. It's been coiling into a tighter and tighter band (you can see it's being squeezed by its 50 and 100 week MAs) which signals a high volatility move coming in the near future.

If the Fed stays pat on Wednesday and the BOJ moves to steepen its yield

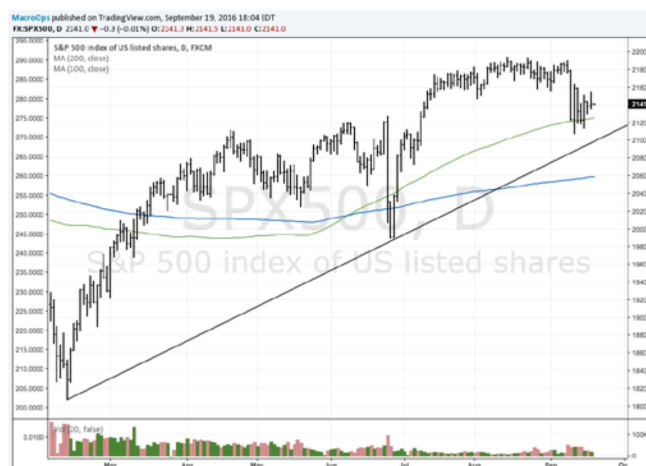
curve, then the dollar should break out to the downside in the large bear trap that I've been writing about for the last two months. If the Fed hikes, then it should resume it's cyclical bull market. Either way, the dollar breakout trade has the potential to make your return for the year. We'll be keeping a very close eye on it and will be ready to act.

OPEC is holding an informal meeting on the 27th. I don't expect anything of substance to come out of it. What's more important are the optics that the market applies to the results. And this will mostly be driven by the narrative following the Fed meeting and its impact on the dollar.

Gold is in the same boat as crude and many other commodities; it's prisoner to the narrative of the Fed and the dollar. My bias is that it moves lower in the short-term primarily because of crowded positioning. But that could quickly change depending on what the Fed decides to do and I would view a substantial move lower as a good buying opportunity. If it breaks out of this range to the downside, its next support level would be at 1280.



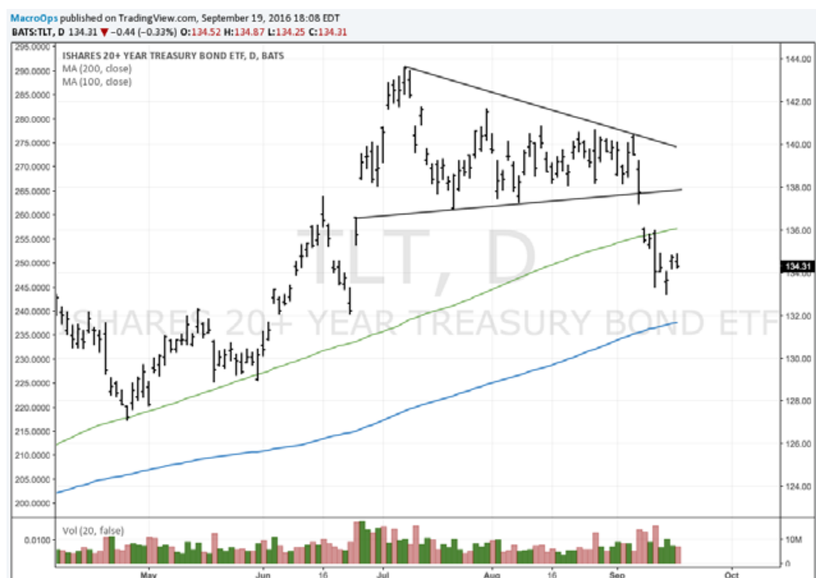
Despite the volatile back and forth in the indexes over the last two weeks, the trend remains up and breadth continues to be strong. Tech and small-caps are leading this advance and I expect them to continue to outperform lower beta and large cap stocks going forward. Of course, this could all change after Wednesday (I long for the day I don't have to write about the Fed so much).



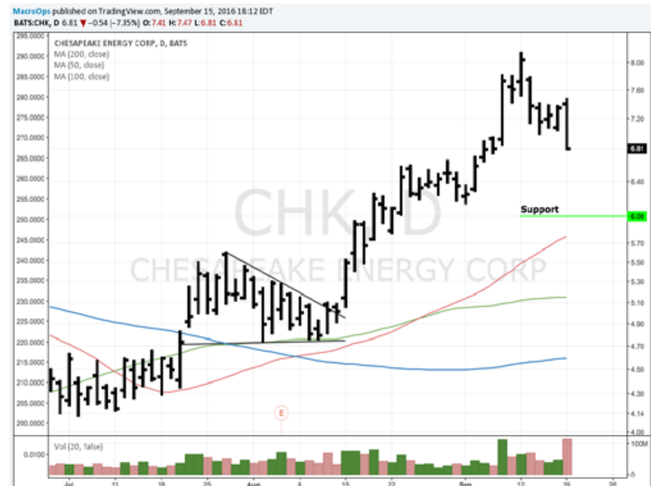
BofA's recent fund survey results also suggests higher highs for US stocks.

Fund managers remain underweight US equities. The BofA fund survey should mostly be interpreted as a contrarian signal. When fund managers are overly bearish on US equities, it generally means there's some gas in the tank for US stocks to move higher.

TLT (the 20+ year UST ETF) has remained weak after its collapse lower two weeks ago. I'm bullish on longer dated treasuries but I think this retrace can continue lower over the short-term. It's not unusual for yields on the 10yr to fluctuate 1% in the context of a broader trend and long bonds were due for a pullback on a timing basis. We may re-enter our position in TLT should it fall considerably lower.



I expect a small pullback in our natty holdings over the next week. Both stocks have had a strong run and it'd be healthy to see a sizable retrace. This forces us as traders to ask the question "do we take profits, partial profits, or hold". To which, there are no easy answers and I don't have a systematic approach to this part of trade management — I prefer to keep it discretionary. I took partial profits on MIFI because of the intensity and speed of the run; this led me to believe that the retrace could be substantial.

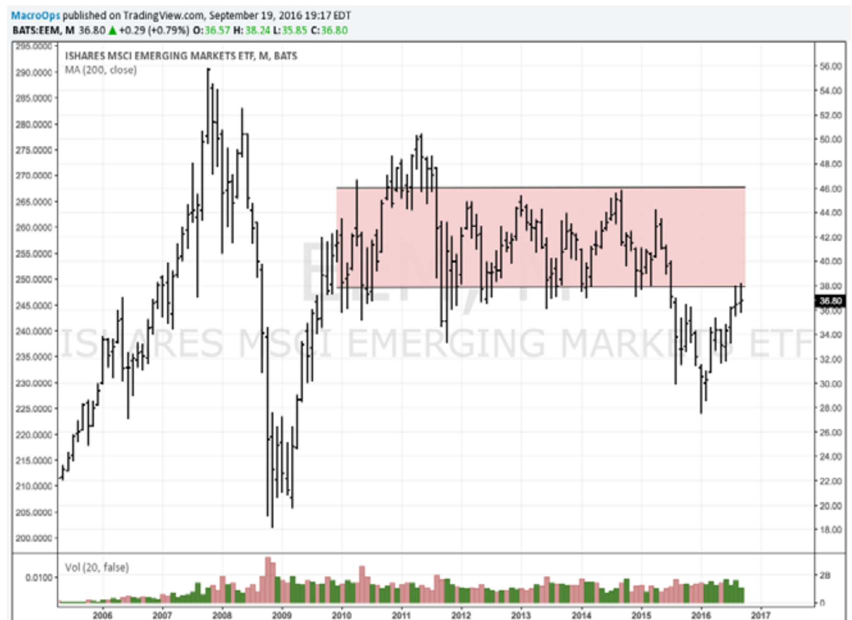


I'm keeping on the full positions in both CHK and CRK because I really like the underlying fundamentals behind the natty bull theme. I could be wrong or my timing off and we could give back all of our profits here. Or we could get a decent sized pullback, like I expect, followed by a move higher, hopefully with another opportunity to add to our positions. There's no way to know but I like to play for big trends with size on when my conviction levels are high and natural gas is one of those moves.

If market conditions remain favorable (ie, the Fed stays put) I'll be looking to add back to our MIFI position in the coming weeks, preferably on a further pullback to its 50 day moving average.

JO, Bloomberg's coffee ETN, has put in a possible cyclical bottom. It's wrestling with its 100 day moving average at the moment but we'll be putting in a small starter position on a wide stop should it close above it.

Emerging markets are hitting a heavy zone of resistance in the form of its six year consolidation zone which it broke down from last year. Emerging markets are seeing a sizable amount of supply hit as stocks try to push back into this territory. Whether or not they're successful is largely dependent, again, on the Fed's actions and what the dollar does. I don't particularly like emerging markets here and would wait for more clarity before opening or adding to any positions.



Conclusion

I'm mostly focused on smaller cap stocks that have little to no correlation to the broader market and the Fed narrative. Some companies I'm digging into at the moment and which we may be putting positions on for the Strat portfolio in the coming week are OCN, CONN, and NRP. I'll be doing write ups on them if I like what I see.

The barbell strategy of having a large cash position balanced by undervalued high-beta positions continues to be my favorite way to play in this environment. Because of the secular and cyclical forces at work and the large central bank intervention, it's not wise to be sitting with heavy positions and expecting to hold for the long-term.

If the Fed doesn't hike Wednesday, the markets should enter a period of risk-on frenzy; in which case we're going to add to our risk exposure in some select areas

If the Fed does hike, then the dollar should breakout and we'll go heavy long dollar and start building up a short book against emerging market, energy companies and some overvalued tech with no cash flow.

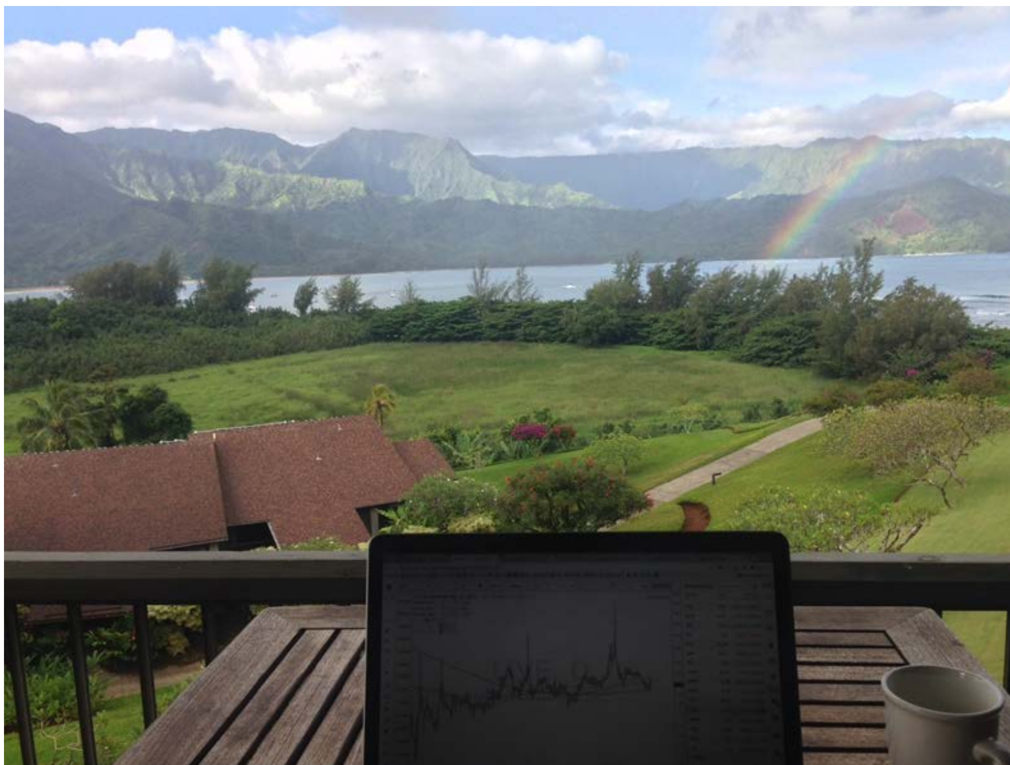
That's all I've got for now. I'll be sending out an email Wednesday after our market overlords speak.

Have a great week!

-Alex

P.S. I'm writing this week's Brief from Princeville, Kauai. I'm out here for the week celebrating my Father's retirement after a distinguished 40-year career as a CPA. Congrats Pops and thanks for introducing me to the markets!

Here's the view from my "work desk".



Let me know if you any of you have recommendations for some good food/drink spots on the North Shore to check out while I'm here. I've been told Bubba's Burgers is a must. In between market research, I'll be doing a lot of spear fishing, scuba, and surfing over the next week. If history is any indicator, the market should rip in one direction or the other, as they always tend to do when I'm on vacation.

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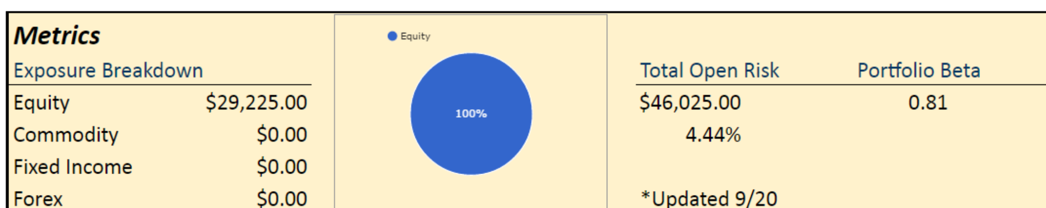
Portfolio Snapshot

Macro Ops Strategic Portfolio

NAV $1,036,435

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
Equity	Conn Inc (CONN)	5,000	10.07	8.88	$5,950.00	22.00	1.16	$50,350
Equity	Ocwen (OCN)	35,000	3.46	3.15	$10,850.00	7.50	0.89	$121,100



Metrics

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

Total Open Risk	Portfolio Beta
$46,025.00	0.81
4.44%	

*Updated 9/20

Macro Ops Income Portfolio

NAV $1,064,352

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

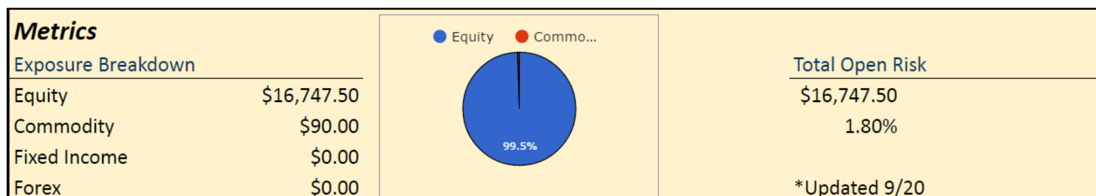
Worst Case	Worst Drawdown
SPX-10%	-$87,000
SPX-20%	-$250,000

**Updated on 9/20

Macro Ops Tactical Portfolio

NAV $929,311.00

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	46.99	$11,368.50	54.33	$184,917
Equity	Semgroup (SEMG)	3,300	33.84	31.66	33.29	$5,379.00	40.27	$113,223



Metrics

Exposure Breakdown	
Equity	$16,747.50
Commodity	$90.00
Fixed Income	$0.00
Forex	$0.00

Total Open Risk
$16,747.50
1.80%

*Updated 9/20