MARKET BRIEF

Blood From A Stone

This company looks cheap, that company looks cheap, but the overall economy could completely screw it up. The key is to wait. Sometimes the hardest thing to do is to do Nothing.
~ David Tepper

One of the hardest things to do in investing, is to do Nothing at all…

Markets fluctuate between periods of clarity, where profits and risks are easily visible, to times of dissonance where possibilities are murky at best.

When the future path of the market is unclear, trying to extract profits is about as fruitful as trying to squeeze blood from a stone — you won't get one drop but you'll surely tire yourself out in the effort.

Soros said "when you are confused it is best to do nothing. You are just going for a random walk and that is when you are liable to get mugged…"

Most traders can't do *nothing*. They're in the game for entertainment/action/excitement and the prospect of sitting with few to no positions on for weeks or months at a time is torturous. Traders who maintain that mentality are destined to stay pikers; chopping up their P&L by entering into too many sub-par trades — willingly taking a random walk.

Ralph Waldo Emerson said to "adopt the pace of nature; her secret is patience", Lao Tzu asked "do you have the patience to wait… till your mud settles and the water is clear? Can you remain unmoving… til the right action arises by itself?" and Michelangelo declaimed that "genius is infinite patience."

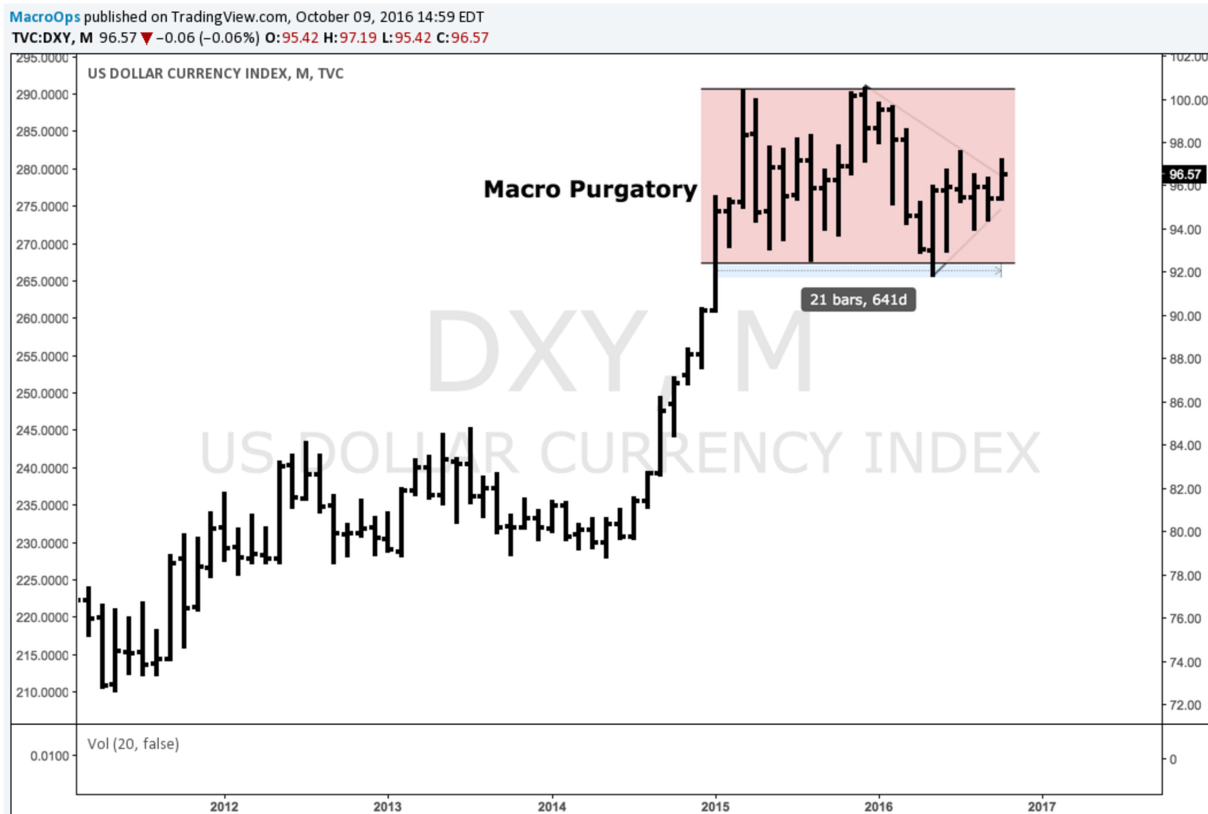
Livermore referred to the importance of patience in trading as learning to “sit tight”. He attributed his money making skills to this ability.

For much of this year sitting tight has been the right move. Asymmetric risk adjusted opportunities have been few and far between and the macro backdrop has been dominated by one of the most indiscernible environments imaginable… murky, murky, murky.

This will change and we’ll soon enter a target rich environment where volatility reigns supreme.

The mechanism that will get us there is the US dollar. We’ve been saying, pretty much all year now, that the dollar is the fulcrum of the current global macro regime; where the dollar goes the rest of the world’s markets will follow.

And the reason why markets have felt like they’ve been spinning wheels (moving a lot while going nowhere) the last 12-18 months is because the dollar has been coiling into a tighter and tighter range during that time.



The above monthly chart of the DXY is what macro trader’s purgatory looks like… not a pretty sight.

That’s one of the reasons why you’ve been reading about macro funds shuttering their doors in the papers, nearly every day. We’ve been in a macro holding pattern for 641 days.

Until there's a clean break in one direction or the other, it's nearly impossible to have much conviction on the near and intermediate term direction of the market. Without a dollar break it's likely markets keep churning and burning in their present random walk range.

There are multiple hypotheses for which direction the dollar breaks that are convincing. And it will ultimately be decided by a number of factors, such as:

- **Central bank moves:** Do we see increasing wage inflation in the US and improving economic data that pushes the Fed to hike in December (dollar bullish)? Or do we see continued mixed data, that keeps the Fed talking like hawks but pushing the hike back while their credibility is questioned by markets (dollar bearish)? Does increasing inflation expectations in Europe combined with the need to raise the long end of rates for banks, pension and insurance companies push the ECB to play a balancing act? To tighten the long end while keeping rates negative on the short, similar to Japan (dollar bearish)?
- **Presidential Election:** Is a Trump Presidency, or the perception that he could/will win, dollar bearish because of what he's said in the past about reneging on US debt? Along with his proposed tax cuts combined with his enormous stimulus spending plans? And would a Clinton Presidency be dollar bullish because she's perceived by the market as a steadier hand? Will we see some type of bullish relief rally in the dollar because of how tight the race is at the moment?
- **China's yuan:** The yuan is near its lowest level in over six years against the dollar and doesn't seem to be slowing down. Accelerating devaluation of the yuan is definitely dollar bullish but it's hard to believe the CCP would risk setting off a currency storm before the US election (the Chinese government does not want a Trump Presidency). But maybe they're near their tipping point. Or is the lag time between their large credit injections into the economy finally surfacing and they'll continue to enjoy a temporary relief rally (dollar bearish to neutral)?

Simply put, we're at a macro crossroads.

I'm trying to remain agnostic over which way the dollar moves in the shorter term. My bias is that we see it puke lower, forming a large bear-trap before exploding higher into the final leg of its larger bull market.

If this happens, we'll see:

- Commodities go on a tear with oil and gold much higher
- Emerging markets will rally in-line with commodities and easier credit conditions
- US bonds will sell off, which would cause some uncertainty over US equities, but US indices would still primarily benefit

Of course higher commodity prices (specifically oil) will translate into higher inflation and thus eventually force the Fed's hand to tighten. This would throw all that market action into reverse.

And if we see the dollar move higher from here, then you can kiss the global bull market good bye. Something like this will happen:

- Commodities fall through the floor (oil in the teens)
- Lower commodities + tighter credit conditions squeeze emerging markets, causing bank and currency crises

- New wave of defaults within the US among energy companies, which has contagion effects
- China, Saudi Arabia and a host of other developing countries lose control of their currencies which creates the stronger dollar feedback loop and deflation engulfs the world

There's also the hyper-inflation scenario where the Fed stays easy while the new President enacts expansionary fiscal policies right out the gate. We would see a secular bond market top resulting in higher volatility in equities, while stocks mostly rise on a nominal basis.

And, then there's the worse option of all, which would be more time in macro purgatory.

I have a feeling we'll see a bit of every scenario over the next few years.

If you haven't yet, I suggest you read the transcript of the speech Ray Dalio gave recently at a gathering of central bankers. Here's the link.

Dalio remarks on how central bankers have reached the effective limits of orthodox monetary policy — they're now pushing on a string — and because of where we are in the secular debt cycle, they will need to utilize more unorthodox monetary policies (ie, helicopter drops) soon, as the downside risks have grown increasingly asymmetric for the global economy.

He also thinks that the US is closer to the middle of its short-term debt cycle than the end, because of where measures of the GDP gap are currently at.

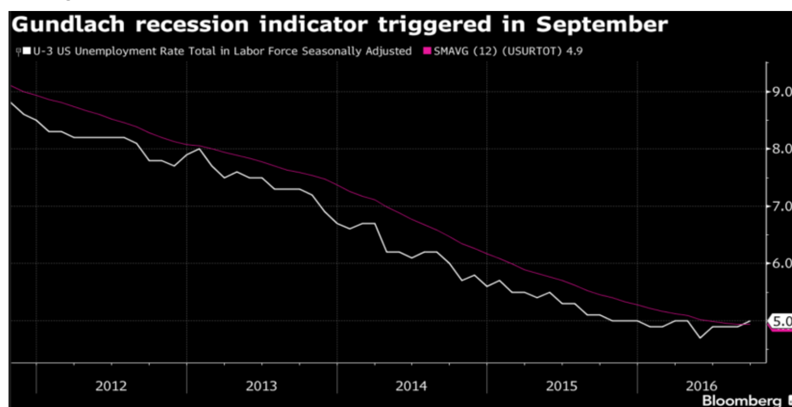
Measurements of GDP gap or output gap, are simply measures of where the productive output of an economy is in relation to its believed full capacity.

There's many ways you can measure this (and you can get really advanced here), but I have found the best way to gauge this is simply looking at measurements of the labor market (ie, total NFP/civilian labor force).

I agree with Dalio and continue to think that barring any exogenous shock, the US economy sputters along until it enters recession sometime next year. Again, it's dependent on which of the above scenarios play out.

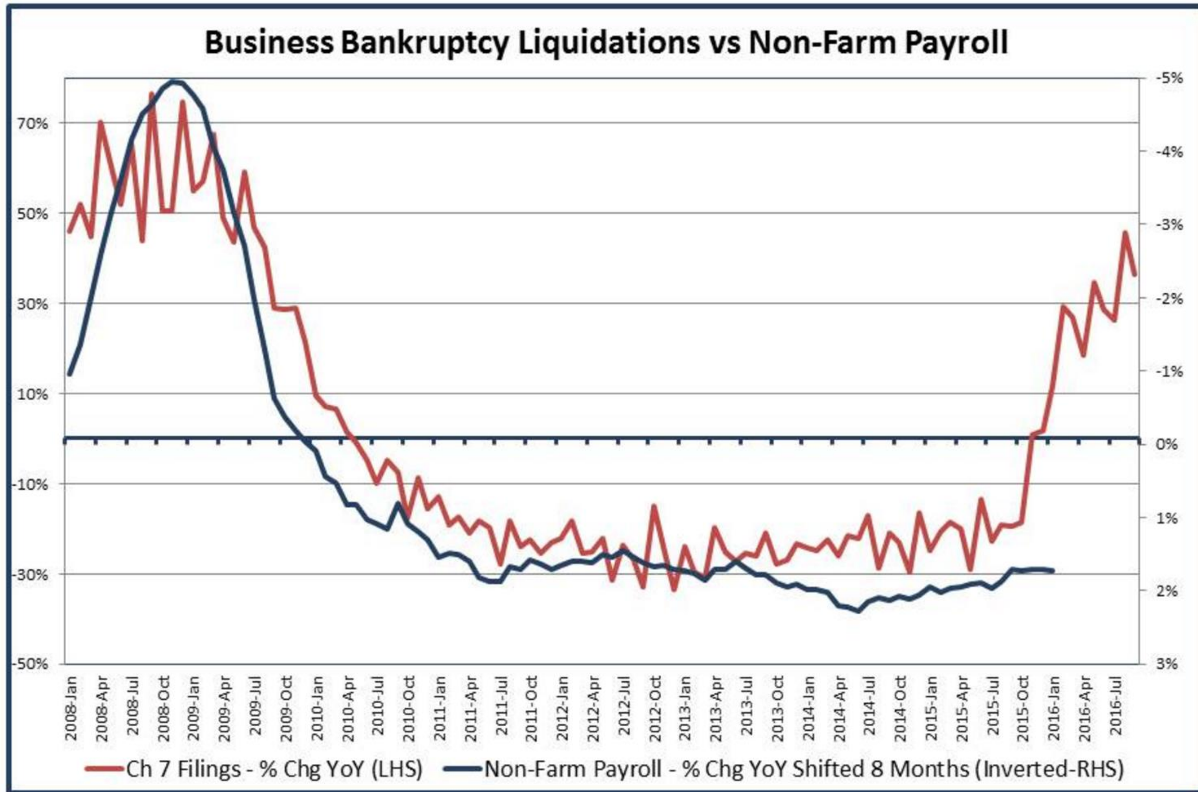
On that note, there were some interesting data points this week.

The unemployment rate crossed its 12-month moving average. This indicator has triggered at the start of every recession over the last 100-years. It's also given a few false positives. A better indicator, with a 100% hit rate, is the unemployment rate crossing its 36-month moving average — and there's still a wide gap between the two at the moment.



The 2015 average for monthly non-farm payrolls was 229,000 while 2016 is running well below, at around 180,000.

The rate of change in Ch. 7 bankruptcy filings is slowing the pace of labor tightening. Despite credit being easy the business cycle still exists on some level. Rising bankruptcies lead to a loosening in the labor market. I expect mostly weaker jobs numbers going into the end of the year (which is dollar bearish).



And finally, there's this from Sentiment Trader.

The chart shows where every weekly double inside bar has occurred over the last 20 years. A weekly double inside bar is just three subsequent weekly bars that have a tighter range than the one before it… the weekly price moves within the range of the week prior.

Things like this don't "mean" anything in regards to future market direction. It just means there's lots of indecision in the markets and very little action. So it's no surprise that they typically occur at market tops — indecision is

highest at turning points. Whether this is a turning point or not remains to be seen. Just some food for thought.

And I suppose I'd be remiss if I didn't mention the mini flash crash in the cable (British pound) on Friday.

The pound crashed from 1.2609 to 1.948 in just four minutes. That's over a six handle move, on no news, in one of the more liquid currencies. That's not supposed to happen.

We've yet to hear the exact reason why but it was likely caused by one of three things: [1] An algo glitch caused a flash crash [2] a trader from a large bank fat-fingered a trade or [3] a large hedge fund was forced to liquidate a titanic long cable position because he was getting squeezed by margin calls and investor redemptions.

That's all I've got for this week. There's a number of stocks that I kind of like but I don't see much of a point in acting until we see a dollar move.

I'm trying very hard to sit tight and wait for clarity. I think we're close.

In the meantime, put down that stone and go and read a good trading book or do some market research. I just finished re-reading *The Invisible Hands* by Steven Drobny, which is an excellent read — I actually like it more than his *Inside the House of Money*, which is also very good.

Here's a passage from one of my favorite interviews in the book, *The Philosopher*:

By sentiment I do not mean some kind of vague general feeling or emotion. I mean the reflection of people's beliefs, which are based on something real and tangible, which will change their actions. Although beliefs tend to be driven by fundamentals, people and markets are very slow to fully incorporate macro information, and when they do the results can be overly dramatic.

The uncertain nature of the economic future and our flawed attempts to understand it are a permanent source of market mispricing. The economy is not easily predictable, but the reactions of policy makers and the persistent errors in human expectations are. The natural extension of Keynes' beauty contest is that animal spirits are not irrational and because they are not irrational they can be anticipated.

To illustrate this idea let's imagine there are two states of the world, and although each is quite reasonable, one is more likely than the other. Unfortunately, the human brain is not wired to understand probability very well. We are particularly bad at understanding low probability events, which we tend to think of as either inevitable or impossible. Therefore, a very small change in the underlying fundamental probability can sometimes cause wild swings in sentiment because the potential outcome went from impossible to inevitable, whereas the underlying fundamentals did not move substantially. Shifts in sentiment cause markets to move much more frequently and violently than shifts in fundamentals do.

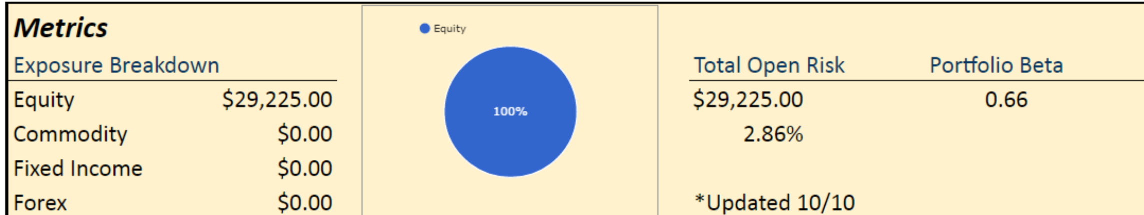
Have a great week!
-Alex

Portfolio Snapshot

Macro Ops Strategic Portfolio

NAV $1,022,944

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



Metrics

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

Total Open Risk	Portfolio Beta
$29,225.00	0.66
2.86%	

*Updated 10/10

Macro Ops Income Portfolio

NAV $1,079,009

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

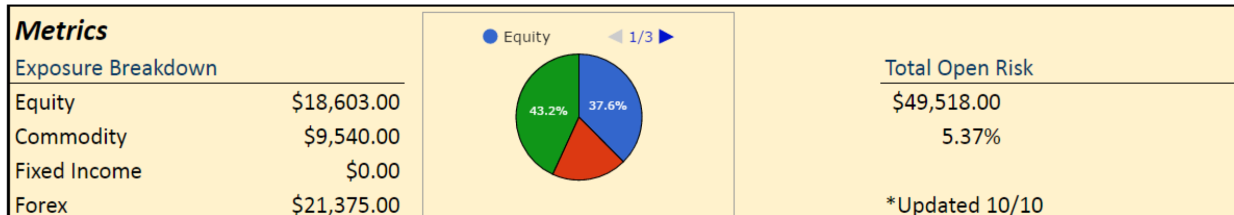
Worst Case	Worst Drawdown
SPX-10%	-$87,000
SPX-20%	-$250,000

**Updated on 10/10

Macro Ops Tactical Portfolio

NAV $921,582.00

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	48.81	$18,603.00	54.33	$184,917
Commodity	Gold (GCZ6)	-1	1272.37	1311	1261.80	$4,920.00	1209	$127,020
Commodity	Nat Gas (NGX6)	7	3.195	3.099	3.165	$4,620.00	3.497	$221,060
Forex	Pound (6BZ6)	-9	1.2750	1.2875	1.24950	$21,375.00	1.2184	$718,087



Metrics

Exposure Breakdown	
Equity	$18,603.00
Commodity	$9,540.00
Fixed Income	$0.00
Forex	$21,375.00

Total Open Risk
$49,518.00
5.37%

*Updated 10/10