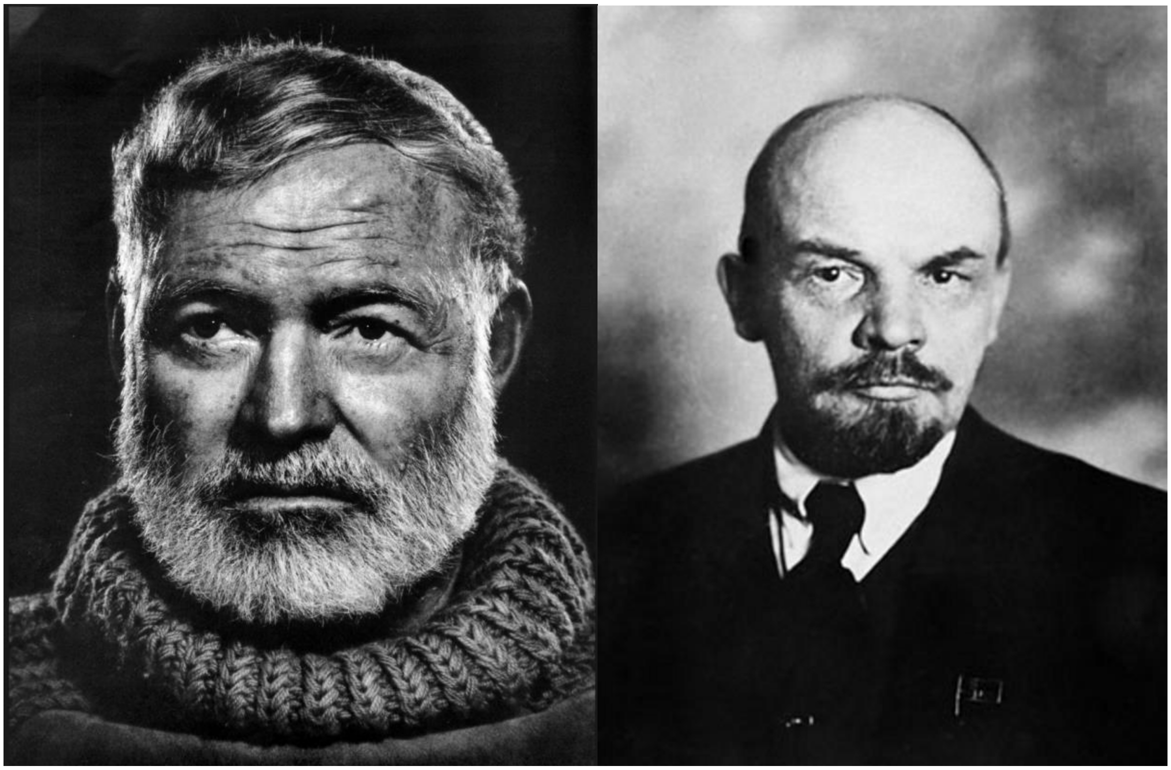
MARKET BRIEF

Crush The Bourgeoisie

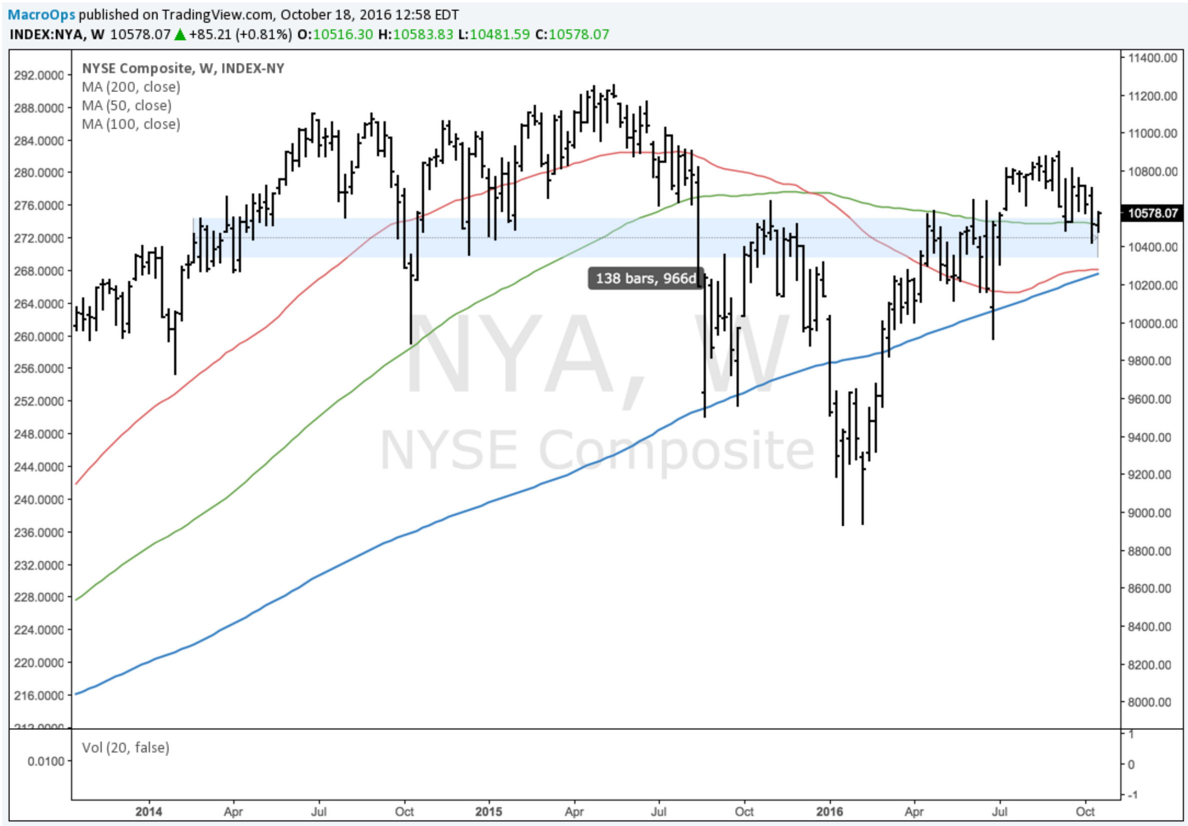


The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin. But both are the refuge of political and economic opportunists. ~ Hemingway

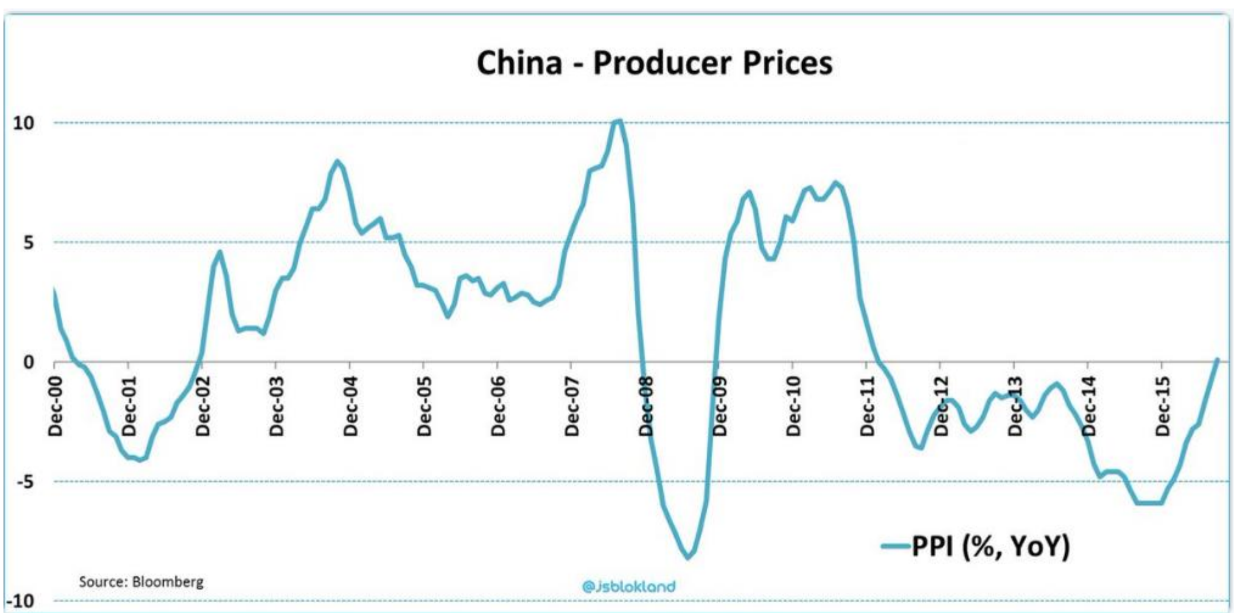
The way to crush the bourgeoisie is to grind them between the millstones of taxation and inflation. ~ Lenin

Inflation is coming back into focus in the macro game as we see a rebound in slumping prices in many economies around the world. If this is the start of a new trend, then it may be what finally kicks us out of this “go nowhere” market and into a tradable environment with better risk-to-reward prospects.

To note just how lame these markets are, look at how little we’ve traveled in the broader index after many ups and downs. The NYSE is exactly where it was 966 days ago and continues to drift sideways; so any news that brings volatility back is welcome news.

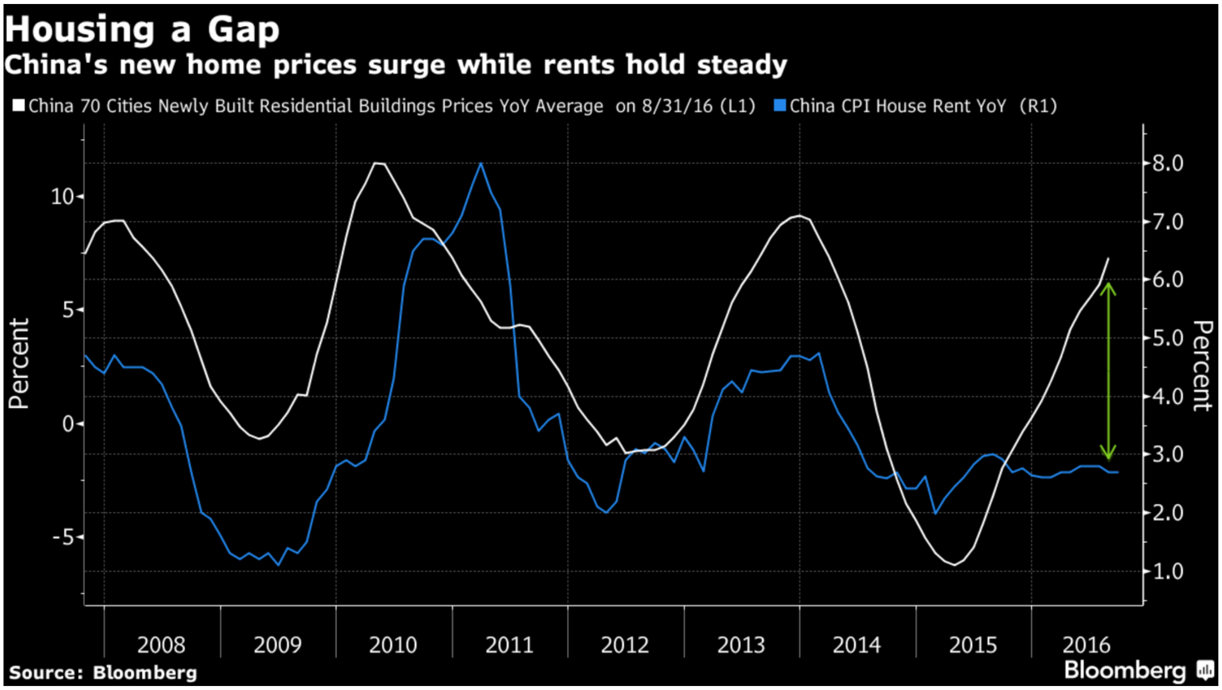


The most significant data suggesting that higher prices may be in our future are the inflation numbers coming out of China. China's producer price index turned positive on a YoY basis for the first time since 2012. This is a big deal because China's supply glut has been a large drag on global pricing, so rising producer prices suggest they've worked through some of their excess capacity.

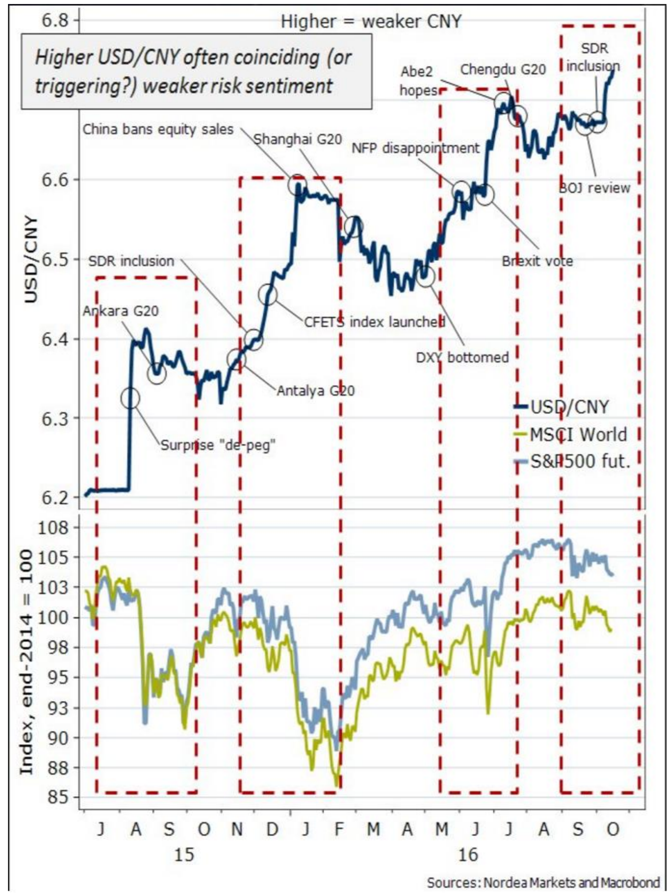


This rise is being driven by the considerable amount of credit injections carried out by the government since the beginning of the year. The new credit has flowed largely into state owned enterprises and the real estate sector, reigniting an already frothy real estate bubble.

The Shanghai real estate price index has risen over 700% in the last decade and a half. This is of course an incredible and unsustainable amount. Leading indicators such as price to rent ratios suggest the real estate market is nearing its tipping point.



In addition to credit, real estate prices are also being driven by Chinese fears of holding a devaluing yuan. This is causing a frantic grab for hard assets. The yuan reached a six year low against the dollar this past week.

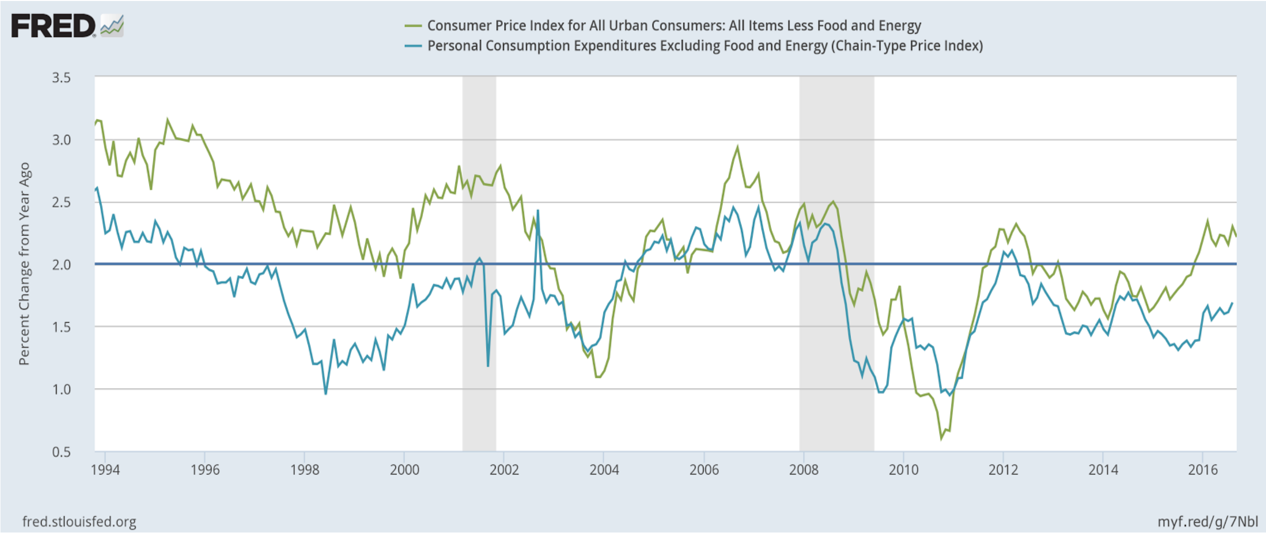


The biggest question in macro right now is whether or not this weakening in the yuan is going to accelerate. If it does, then we're likely nearing a tipping point where the CCP loses control and we see a currency crisis. We can expect a devaluation in the realm of 30-50% if this happens, similar to the 97' Asian crisis. This is Hugh Hendry's "Mad Max" scenario and something I've written a considerable amount about over the last six months.

This would be extremely dollar bullish and would unleash a wave of deflation across the globe. I view this as inevitable but believe it's still too early to start loading up on long dollar positions. However, if the yuan continues its slow slide lower against the dollar, then we'll likely enter a period of risk-off in the near term.

Either way, the rising prices in China are beginning to drift into the rest of the world. We have seen rising inflation growth over the past few quarters in both Europe and the US. While many central banks will point to the improving inflation numbers as evidence that their policies are working, they should not be taken as a reason to be bullish equities. In fact, it's the opposite.

Paul Tudor Jones was right when he said “every bear market… basically occurs because of an uptick in inflation and an uptick in interest rates.” This time will be no different.



The Fed’s favorite inflation measures are at or near their 2% targets; but still well below numbers during past hiking cycles.

And this leads us to our current market doldrums. We have been in this goldilocks situation with the economy running not too hot nor too cold, leaving the market in the grips of guessing what the Fed is going to do next.

The Fed has taken full advantage of this by using forward guidance with the threat of imminent rate hikes to keep markets in check, while sitting pat when the time comes to make a decision.

But what the Fed *actually* does next will have big implications for markets. This is because a rate hike would spark a new dollar bull market, forming a deflationary USD feedback loop — something we talked about last week.

I’m still of the belief that we will continue to see a weakening in the labour and GDP growth numbers going into the end of the year. If that’s the case then it’s important to understand the thinking of both Yellen and Fischer on their preconditions for hiking. And for that, Tim Duy over at Fed Watch gives the best explanation (emphasis mine):

> *There is nothing here to suggest that Yellen looks to generate a high pressure economy. She holds the commonly held view within the Fed that policy makers need to prevent the unemployment rate from sinking too low because they cannot just nudge the rate higher. If anything, with the unemployment rate dancing on the edge of Fed estimates of the natural rate, she would almost certainly react to an acceleration in activity with an acceleration in the pace of rate hikes. So too would Fischer.* ***But with growth around 2 percent per tracking estimates, labor force participation rising to meet job growth, and inflation below target, we do not have a high pressure economy and hence the need for immediate rate hikes dissipates. Yellen will let it play out a bit longer.*** *But if the labor force participation rate stalls out and unemployment starts heading back down, Yellen would become nervous that the Fed is poised to fall behind the curve.*

Bottom Line: The key debate within the Fed at the moment centers around the need for preemptive rate hikes. The hawks prefer more preemption, the doves favor less. Federal Reserve Lael Brainard pulled the FOMC to the dovish camp, primarily through her influence at Constitution Ave. Yellen is probably somewhat more sympathetic to Brainard than Fischer, but [as I said last week](), Fischer has moved substantially in Brainard's direction.

The market is currently pricing in a 64% probability for a rate hike in December. This means a hike is already being priced into markets, something we can see with the recent bullish action in the dollar. Because of this, should the data disappoint, and the narrative swing back to dovish, the switch will have a larger impact on markets, specifically the dollar.

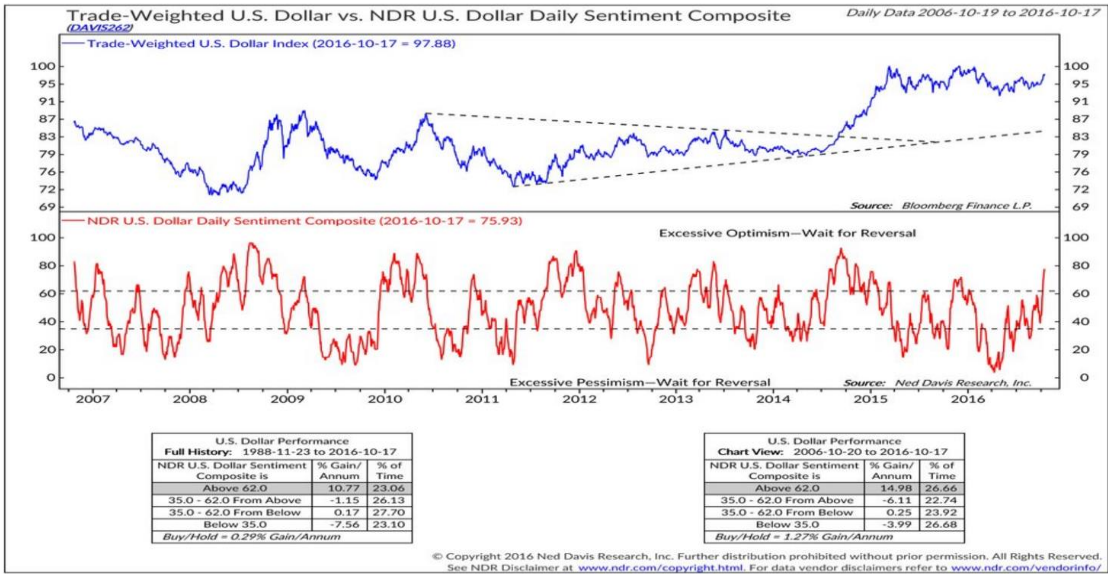
I still think that we see bearish action in the dollar before its bull trend resumes. We've put on some small long dollar positions over the last week out of respect for price action in the case we're wrong. But should my thesis of the economy undershooting expectations into the end of the year hold, and the dovish narrative come back to the fore, then I will quickly flip positioning and go short the dollar.

As far as the rest of market, I'm still not seeing much to get excited about. The macro picture is extremely convoluted at the moment and because of this we see few good risk/reward opportunities at the moment. We agree with hedge fund manager David Tepper, who said this week that his fund is "pretty light in the stock market right now and we have a lot of cash… I just don't see the market having the ability to move up that much. I think the upside/downside is not the most favorable I've seen. It's not a great environment."

Hopefully once we get these nasty elections out of the way we'll get a bit more clarity on the big picture and perhaps markets will start to trend again. Until then, it's the same game of sitting in a lot of cash and playing a few select trades here and there.

<u>Tactical</u>

The dollar is bumping up against a solid resistance area. If it closes above this line on the weekly, we'll start aggressively adding to our long dollar positions. But the sentiment data seems to confirm my short dollar thesis, as positioning in long dollar is at excessive levels that generally correlate with short-term reversal points.



U.S. Dollar Performance
Full History: 1988-11-23 to 2016-10-17

NDR U.S. Dollar Sentiment Composite is	% Gain/ Annum	% of Time
Above 62.0	10.77	23.06
35.0 - 62.0 From Above	-1.15	26.13
35.0 - 62.0 From Below	0.17	27.70
Below 35.0	-7.56	23.10
Buy/Hold = 0.29% Gain/Annum		

U.S. Dollar Performance
Chart View: 2006-10-20 to 2016-10-17

NDR U.S. Dollar Sentiment Composite is	% Gain/ Annum	% of Time
Above 62.0	14.98	26.66
35.0 - 62.0 From Above	-6.11	22.74
35.0 - 62.0 From Below	0.25	23.92
Below 35.0	-3.99	26.68
Buy/Hold = 1.27% Gain/Annum		

Gold and gold miners are starting to look attractive to me at these levels — my favorite being Harmony Gold (HMY). HMY has taken nearly a 50% price cut from its recent highs in August. The fall in gold was driven by hawkish talk by the Fed and over-positioning in the market. I will only enter this trade if the dollar reverses and starts to move lower. If the dollar continues higher from here then this short lived gold bull market is over.

Our position in CRK is now up around 30% from our entry price two months ago. It's entering new high territory for the year. Once the dollar situation establishes itself, I may look to add to our position if the macro environment remains favorable to energy stocks. I think we could see CRK go to the $13-16 level.

That's all I've got for this week. Let's hope we get some movement again in markets so we can discuss and execute on some good trading opportunities. Until then, stay patient and protect your capital.

-Alex

Portfolio Snapshot

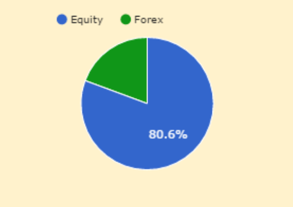
Macro Ops Strategic Portfolio

NAV $1,035,512

Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target 1	Beta (1yr)	Notional
Equity	Novatel (MIFI)	11,000	2.10	1.75	$3,850.00	3.00	1.84	$31,240
Equity	Comstock (CRK)	14,000	6.60	5.68	$12,880.00	16.50	1.87	$122,220
Forex	Yen (6JZ6)	-2	0.96188	0.97795	$4,017.50	0.90460	-0.39	$241,175

Metrics

Exposure Breakdown	
Equity	$16,730.00
Commodity	$0.00
Fixed Income	$0.00
Forex	$4,017.50



Total Open Risk	Portfolio Beta
$20,747.50	0.37
2.00%	

*Updated 10/18

Macro Ops Income Portfolio

NAV $1,080,203

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 10/18

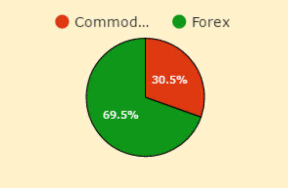
Macro Ops Tactical Portfolio

NAV $929,788.00

Asset Class	Position	Size	Cost Basis	Risk Point	Market Price	Open Risk	Target 1	Notional
Commodity	Gold (GCZ6)	-1	1272.37	1311	1251.70	$5,930.00	1209	$127,020
Commodity	Nat Gas (NGX6)	7	3.195	3.099	3.284	$12,950.00	3.497	$221,060
Forex	Dollar Index	6	97.917	96.65	98.085	$8,610.00	100.350	$588,391
Forex	Euro	-7	1.10858	1.1173	1.09985	$15,268.75	1.0470	$963,349
Forex	Yen	-4	0.96173	0.97670	0.96200	$7,350.00	0.86710	$481,060
Forex	Pound (6BZ6)	-5	1.2750	1.2875	1.24950	$11,875.00	1.2184	$718,087

Metrics

Exposure Breakdown	
Equity	$0.00
Commodity	$18,880.00
Fixed Income	$0.00
Forex	$43,103.75



Total Open Risk
$61,983.75
6.67%

*Updated 10/18