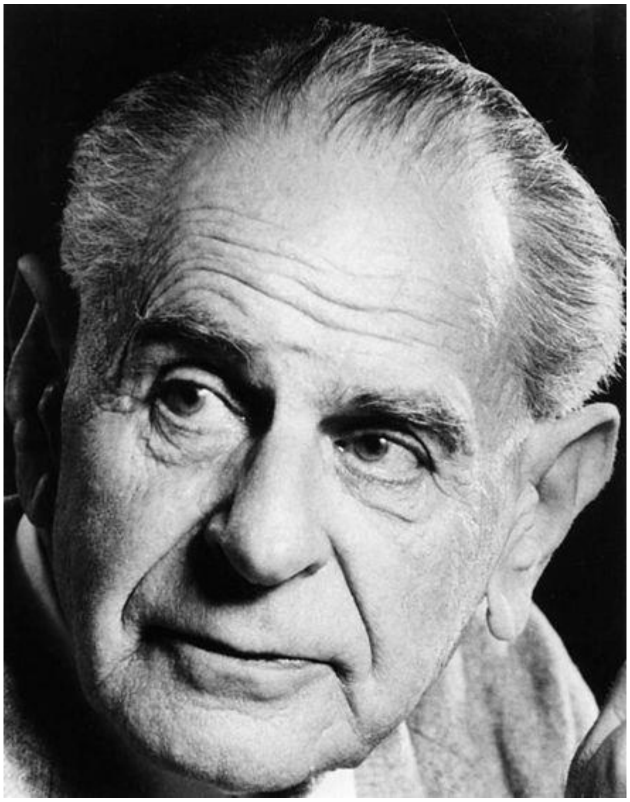
MARKET BRIEF

Invert, Always Invert



“Our knowledge can only be finite, while our ignorance must necessarily be infinite.” ~ Karl Popper

One of the more profound trading insights I’ve had over the last five years is the value of multivariate critical thinking (MCT).

MCT is the practice of considering multiple hypotheses and outcomes and dispassionately applying critical judgement to each. It requires updating their probabilistic weighting as new information becomes available — practical Bayesian analysis.

This seems simple and easy, and on the surface it is, or at least should be. But the difficulties come in its application. Specifically concerning the “dispassionate” part.

The problem is, at least it was for me, is that we’re naturally linear thinkers inhabiting a non-linear world. And to top things off, we have a stubborn ego-sensitive brain that wants simple answers and to always “be right”.

It’s a tough circle to square for sure. But not impossible.

If you wonder if you suffer from ego dominated linear thinking (let's call this EDLT), just think back to the last time you were wrong on a trade or a market call. And ask yourself, did you get upset? Did you not enjoy the process of "being wrong"? Did the most dangerous four letter word in trading, "HOPE", become a part of your thought process? If the answer is yes, and it will be for the majority of people, then you're practicing our instinctual EDLT.

When operating in EDLT mode the brain latches onto a hypothesis and then focuses in on "being right". It doesn't do this through objective assessment but rather by employing a tool kit full of anchoring, biases and heuristics to cherry pick information that supports it in "being right".

The irony is that by focusing on "being right", it more often than not ends up "being wrong".

This is an important habit to break. Doing so will lead to better outcomes.

Practicing MCT is invaluable because it focuses the brain on finding the errors in its own logic. Because the brain no longer has to defend a single thesis, but instead is analyzing and weighing numerous theses, its focus switches from trying to "be right" to figuring out how it's wrong. This makes you better at "being wrong". And being better at "being wrong" is vital to making money.

The trader who most fully practices MCT is George Soros. He said the following about this process:

> *The Secret to my success is that I'm always wrong. I'm ALWAYS wrong. And I try to correct my mistakes. That's the secret of my success.*

And

> *My approach works not by making valid predictions, but by allowing me to correct false ones.*

Most read these statements from Soros and think he's being glib. That's because they're playing the "being right" game. They're too busy looking for some "secret" that's going to help them "be right" more. But all they need to do is "invert, always invert!" their thinking process.

Soros adopted this unnatural mode of analyzing the world from philosopher Karl Popper. Popper established the epistemological philosophy of critical rationalism. He took these ideas from David Hume, who took them from Pyrrhonian skepticism, which evolved out of the ancient school of Indian Philosophy, Carvaka. At the foundation of all of these schools of thought is that "nothing can be known for certain".

Since nothing can be known for certain we need to be good at being uncertain. The practice of MCT is the framework that does just that. The *Philosopher* from Drobny's *The Invisible Hands* discusses how this works (emphasis mine).

> *I try to develop a hypothesis about how the world is working and how it could work in the future. Therefore, information to us is a collection of theories and ideas, together with evidence that either supports or falsifies these theories and ideas. Information can come from fundamental economic drivers, such as growth, inflation, and other variables, or it can come from more technical, market-based factors such as flows, liquidity, etc.*

> ***We are not engaged in what I describe as "vision macro," whereby one tries to work out some kind of single truth about how the world works.*** *Rather,* ***we form a probabilistic set of hypotheses about how the world could look and what might drive markets going forward****, focusing on the market impact in all scenarios and looking for good risk-versus-reward trades around these hypotheses.*

"Vision macro" is standard EDLT. Current examples of EDLT are people like Raoul Pal and John Hussman. These are guys who are locked onto a "single truth" and have taken up the torch of "being right". They have made themselves champions for their "truth". As a result, they've blinded themselves stupid and have been horribly wrong.

The old Wall St. adage that it's not about being right but about making money is an adage for a reason. You only need to be "right" at the right time and the way to do that is by being good at "being wrong". Critically assessing multiple hypotheses with MCT is the way you get there.

EDLT is centered around seeking out confirming evidence. MCT looks for disconfirming information. EDLT is fragile while MCT is robust. Most people utilize the former because practicing the latter is tough.

If you find yourself latched onto a "single truth", Karl Popper would ask you "how would you disprove yourself?"

Invert your thinking.

The Macro

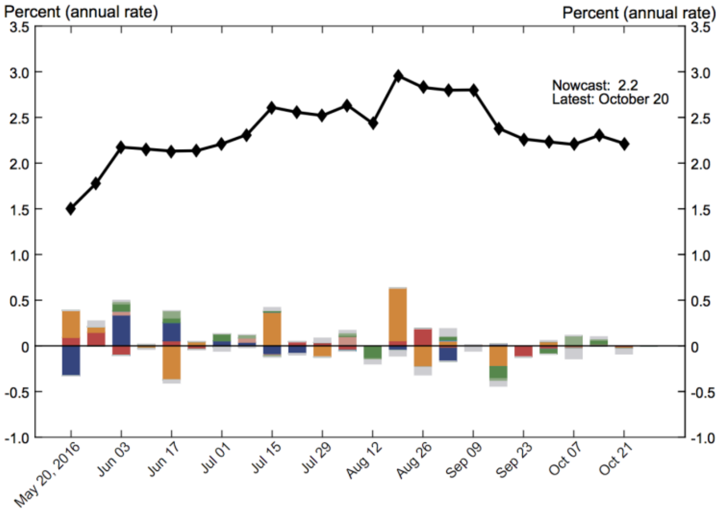
If there ever was a time to utilize MCT, it is now.

Macro is at a complete crossroads. No one scenario "has" to happen. The macro picture (economy & market) can go in many different directions from here. Which direction is dependent on a number of black boxes that we simply can't see into. These are:

- When the Fed decides to raise rates next
- China's management of the yuan (managed deval, break the peg, or fight to maintain peg)
- Presidential and down ballot elections (which parties control the house, senate, and executive branch)

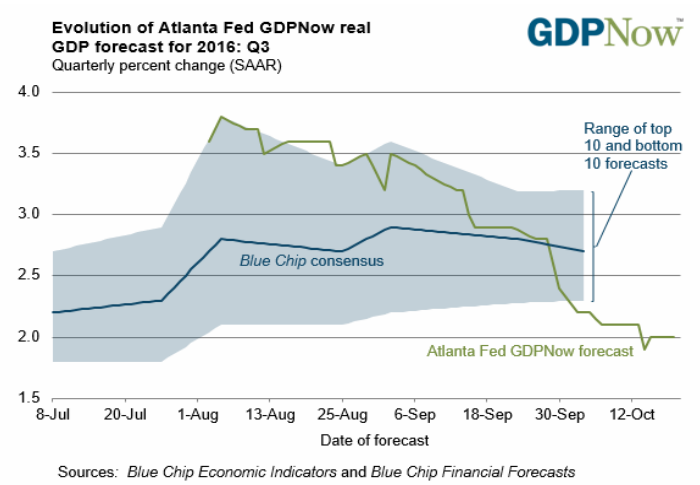
We can't know the outcome of any of these. But as we've discussed, we don't need to. We just need to form multiple hypotheses for different outcomes and update them as new information becomes available.

The Fed is playing a commendable game of mixed signaling. Some Fed members claim a hike is imminent while others say they will let things run hot. Their intent is keep the market on its toes; cooling speculation while buying time to raise rates.



The market is currently pricing in a rate hike in December. I believe a December rate hike is also likely but the weighting given to that hypothesis could drastically change over the next month depending on how econ data looks.

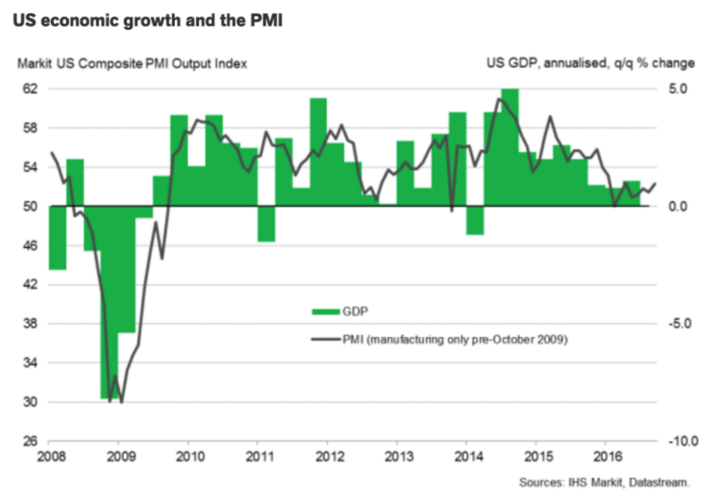
One of these data points is GDP, which comes out this Friday.



Both the New York Fed Nowcast and Atlanta Fed's GDP Now are pointing towards 3rd quarter growth coming in at around 2%.

This is below the blue chip consensus which is expecting GDP to be between the 2.5-3% range.

And here's Markit's take on its expectations:



In the second quarter, the US economy grew 1.4%, with inventory investment subtracting 1.2 percentage points from real GDP growth. IHS Markit predicts an expansion of 1.8% in the third quarter as the drag from inventories will subside and official data point to US industry seeing signs of renewed life. However, the trend in consumer spending weakened in the third quarter and latest PMI results signal that there remain some downside risks to the outlook.

I don't think we see too much of a surprise in either direction. But if we do, then it could have a sizable impact on the market's expectations for a hike. And this would affect the dollar and global markets.

The Chinese Yuan is within spitting distance of levels not seen since 2010. This is what's been driving the bullish action in the dollar. If this trend continues unabated it will have big implications for global markets.

But there's no way of knowing if this is the start of the devaluation we've been looking for all year. I've been hearing reports that China's been hitting the gas on its resource binge. It's buying up and storing astronomical amounts of commodities. There are some reports of large coal shipments coming in, only to be bulldozed right into the harbor; presumably because storage everywhere else is full. This is interesting considering the country has a supply glut problem.

The artificial demand they've created has reversed Chinese pricing for commodities. You can see to the right that steel has been leading the charge. This Chinese buying could also be one of the reasons for recent strength in emerging markets and oil.

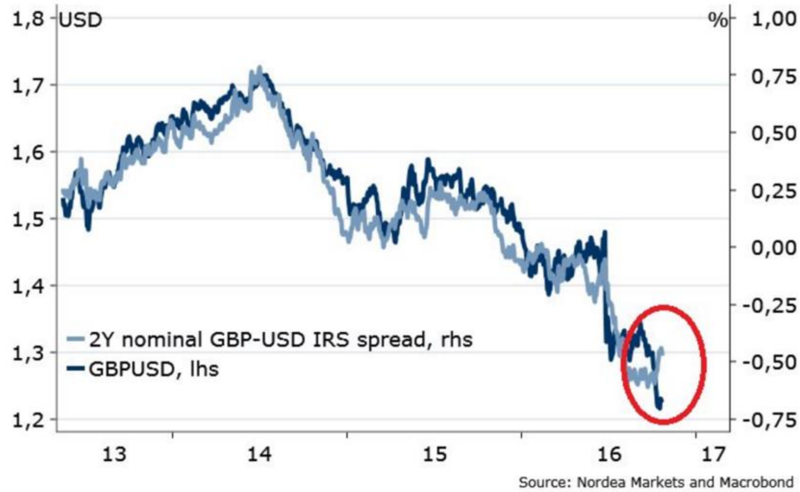
The Chinese may be doing this as a way to diversify their holdings into hard assets. It could also be a strategic move. The Chinese might be concerned about future international conflict and want to store up essential resources in case their Pacific supply line gets cut. There's no way to know for sure, but it's interesting to postulate nonetheless.

Finally, markets seem to be assuming the elections are a lock for Clinton. I think she probably wins. However, I think the market is dangerously underweighting the possibility of a Trump upset. It may be a good time to buy some insurance over the next week. We may put on a strangle, since volatility is selling for a surprisingly cheap amount at the moment.

I'm looking forward to getting through these elections. Once they're out of the way we should see some action return to markets. And hopefully some decent asymmetric trade opportunities.

Tactical

I remain a very reluctant dollar bull. We have long dollar positions on, simply out of respect for price action. But everything is telling me it's too soon and this is a false move.



Charts like these from Nordea markets only strengthen my reluctancy.

The two year interest rate spread (the difference between each country's rates two years out the curve) for both the GBPUSD and EURUSD suggest this dollar rally will be short lived and that we may see a violent reversal.

The 2 year IRS spread is hardly a perfect indicator. Both the pound and euro moves are due to longer term market expectations for each economy. But, markets move by being pulled and pushed by both short and long term expectations; which are often at odds with one another. And I get the feeling that the short term IRS spread will matter more in the coming weeks than the possibility of a dissolving euro or a hard Brexit pound.

Speaking of the euro, the land of disunion seems to be experiencing a bit of an economic bounce recently. And with many European stocks priced for catastrophe, there's some decent opportunities for short term trades.

Take Deutsche Bank for example — probably the most hated large cap stock in the world just a few weeks ago. Near the end of September every pundit with a tie was screaming on CNBC about how DB was going to blow up any day now. On September 29th, I tweeted the following and got a LOT of flack for it.

MacroOps Sep. 29 at 6:03 PM
Alex

$MACRO When everybody saying something is doomed, it usually means it will be fine. **$DB** is a mess 4 sure, but will prob rebound from here

September 29th, just by pure luck, happened to be the <u>exact</u> low of the DB selloff. It has since rallied roughly 30% off its bottom.

I have no position in it at the moment. I'm being patient and waiting for the elections to be over before I start getting more active in the Strategic portfolio. But if the macro picture looks positive in a few weeks, DB might be something I play for a short term trade. NYU finance professor, Aswath Damodaran, wrote a good piece on its intrinsic valuation that I mostly agree with. You can find the [article here.]()

Because of the hazy dollar picture it's best to mostly steer clear of energy and precious metal stocks at the moment. The positioning in both remain overly bullish. When there's a market consensus around something it's best to stay out or go the other way. I still think some gold miners will be a good shot to the long side in the future, but they'll likely have a bit further to fall in the near term.

Sito Mobile (SITO) is a stock I like. I'm still digging into the company but I like what I see so far.

The company specializes in mobile location-based advertising. It sends targeted ad campaigns to potential customers based on geolocation. Apparently it's doing something well because YoY sales growth was 168% this last year.

The company is run by an experienced and talented management team. There's been a lot of recent insider buying, the stock has a small float of 17 million and volume has increased substantially these last few weeks. This company is in a hot new area of the advertising tech market and if the tech sector gets popular again, a stock like SITO could shoot the moon.

Once price action presents a clear setup we'll probably start building a sizable position in SITO should everything check out.

That's all I've got this week. Good luck in the markets!

- Alex

Portfolio Snapshot

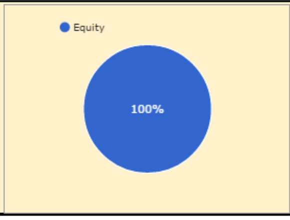
Macro Ops Strategic Portfolio

NAV $1,050,880

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)	5,000	6.60	5.68	$4,600.00	16.50	1.87	$50,000
Equity	PayPal (PYPL)	2,900	43.81	40.45	$9,744.00	50.00	1.26	$124,932

Metrics

Exposure Breakdown	
Equity	$18,194.00
Commodity	$0.00
Fixed Income	$0.00
Forex	$0.00



Total Open Risk	Portfolio Beta
$18,194.00	0.29
1.73%	

*Updated 10/25

Macro Ops Income Portfolio

NAV $1,080,203

Asset Class	Position	Size	Cost Basis	Max Profit
Option	SPX Dec 15 2045 Put	-10	$15.38	$15,380.00
Option	SPX Dec 15 2215 Call	-10	$8.08	$8,080.00
Option	SPX Dec 15 1600 Put	10	$1.06	Hedge

Scenario Analysis/Stress Tests

Worst Case	Worst Drawdown
SPX-10%	-$88,800
SPX-20%	-$300,000

**Updated on 10/25

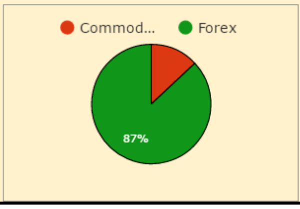
Macro Ops Tactical Portfolio

NAV $932,840.00

Asset Class	Position	Size	Cost Basis	Risk Point	Market Price	Open Risk	Target 1	Notional
Commodity	Gold (GCZ6)	-1	1272.37	1311	1275.20	$3,580.00	1209	$127,020
Commodity	Soybean Oil (ZLZ6)	12	36.02	35.05	35.93	$6,336.00	44.43	$258,624
Forex	Dollar Index	6	97.917	96.65	98.780	$12,780.00	100.350	$588,391
Forex	Euro	-7	1.10858	1.1173	1.09070	$23,275.00	1.0470	$963,349
Forex	Pound (6BZ6)	-5	1.2750	1.2875	1.21770	$21,812.50	1.2184	$718,087
Forex	CAD (6CZ6)	-11	0.75007	0.7565	0.74900	$8,250.00	0.70870	$824,868

Metrics

Exposure Breakdown	
Equity	$0.00
Commodity	$9,916.00
Fixed Income	$0.00
Forex	$66,117.50



Total Open Risk
$76,033.50
8.15%

*Updated 10/25