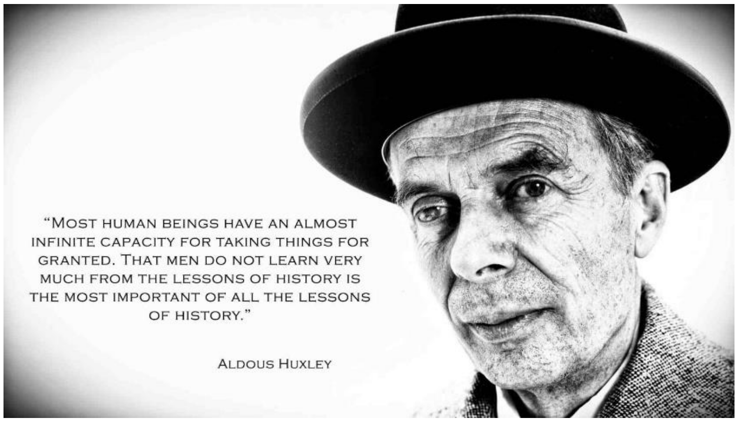
MACRO INTELLIGENCE REPORT

October 5, 2016

Market Overview: Brave New World



In this Issue:

Huxley understood the folly of man well, having lived through both world wars and the Great Depression.

I don't think he'd be surprised to see that leaders today seem hell-bent on repeating the mistakes of the past.

We are still in the very early innings of a turning long-term debt cycle. A deleveraging, where governments and consumers will pay the bill for decades of debt spending that brought future consumption forward. These typically last 15-20 years and are always accompanied by an increase in international conflict.

The last long-term deleveraging started in 1929 and culminated in the second world war.

This time around there is significantly more debt and it's not just the West, but the entire world.

Debt has barely begun to unwind and things are already looking shaky. Populist and strongman leaders are gaining power. There's rising tensions and mini-proxy wars being fought between global powers that are at risk of devolving into something larger. And long standing political unions that have kept the peace for the last 75 years are fraying and slowly falling apart.

Because of political disunion, ineptitude and distrust, we're left placing our economic future into the hands of a few central bankers — the very people who helped create the current mess. And though well intentioned, these academics know little of how the world *really* works and are laughably ill-equipped to navigate us through these stormy waters.

But it looks as though they will continue to try until either the ship sinks or sprouts wings and flies...

As they continue to double-down on their repeatedly failed policies, the gap between markets (prices) and economics (reality) should continue to widen. All this means is that when the straw that breaks the camel's back finally does land, the fall will be swifter and more painful than it otherwise would have been.

The wider the disparity grows between prices and reality, the more difficult forecasting and investing becomes. Because instead of markets moving by fundamental logic, they're driven by crowd beliefs (narratives) and the decisions of a handful of politically minded central bankers.

The only forecast that I can make with absolute certainty is that over the next decade massive amounts of wealth will be destroyed. On a whole, the world will become a much poorer place than it is today.

Whether this occurs through currency debasement, deflationary deleveraging, taxation and government seizure, or outright physical destruction through armed conflict, is dependent on the actions of our political and monetary elites over the next fews years.

On a personal level I don't find that very comforting. As a trader, I have a somewhat morbid excitement about the unique challenges it'll bring in not just capital preservation but also opportunities to profit.

Though we live in a world where most "do not learn very much from the lessons of history", it does not mean we must blindly suffer the same fate. Now more than ever it's important to stand apart from the crowds, to be a smart contrarian and deploy our capital in a thoughtful and protective way.

Current Thematics

The Bank of Japan (BOJ) is the avant-garde of monetary policy. This is simply because they are the furthest along in the long-term debt cycle; followed by Europe, the US and then China.

Since they're at the fore, it's important to pay attention to what they're doing. It's a preview of what we can expect from central banks both in Europe and here in the US down the road.

That said, we should be concerned with the BOJ's latest move to target a rate of 0% on 10-year Japanese bonds.

On the one hand, this is a form of stealth tightening since it steepens the yield curve, which is Kuroda's intent in order to give banks and insurers some relief.

But on the other hand, the real reason for this move may be far more radical and could have big implications for global finance.

By adopting a long-term interest rate target, the BOJ is essentially handing over control of its balance sheet to the market. This is because no institution, not even a central bank, can set both the quantity *and* price of an asset. So by setting the price of 10-year Japanese government bonds at zero percent, the bank is effectively saying it will contract or (more likely) *expand* its balance sheet to whatever size necessary to keep prices at that level.

That in itself is pretty extraordinary, but the reason why the BOJ is doing this may be even more so.

Saddled with over 500% in total debt-to-gdp, Japan has backed itself into a corner in which there's only one way out: inflation… and lots of it. It's coming to grips with this but has been slow to reach acceptance. But this looks like it's finally changing.

The BOJ, by agreeing to backstop JGBs, and accept an inflation target higher than 2%, is essentially paving the way for outright monetary financing. We've talked in the past about how Japan is likely to eventually issue a perpetual zero coupon bond. This would allow the government to spend freely while also devaluing the yen (by a lot), thus monetizing the country's debt. This is the first step in that direction.

By keeping the long-term rate pegged at zero, the BOJ is allowing the Abe government to conduct large scale fiscal stimulus while taking away the risk of triggering a death-spiral in bonds that would lead to higher interest rates — since the BOJ will just buy whatever 10-year JGBs the market sells.

Japan will finally get its inflation, but probably a lot more than it bargained for.

The yen may look a lot like Zimbabwean dollars in a few years time.

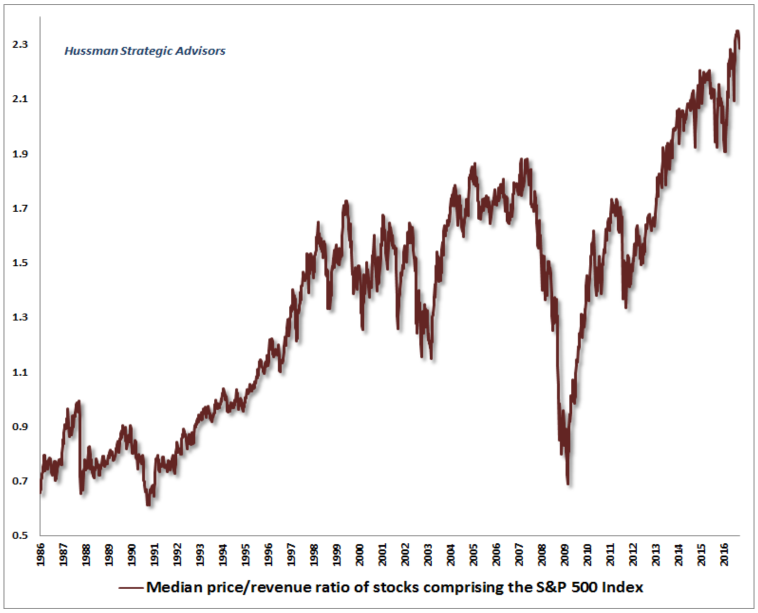
A move like this will certainly reignite the currency war and other "beggar thy neighbor" policies that we've enjoyed a nice respite from over the last six months since the Shanghai Accords.

And Japan is only laying the foundations for Yellen and Draghi who will surely follow suit with outright debt monetization in the future — though it won't be until after some significant economic pain that gets political leaders to give the necessary authorizations to enact such policies.

The current economic/market regime has been characterized by low volatility and little to no inflation.

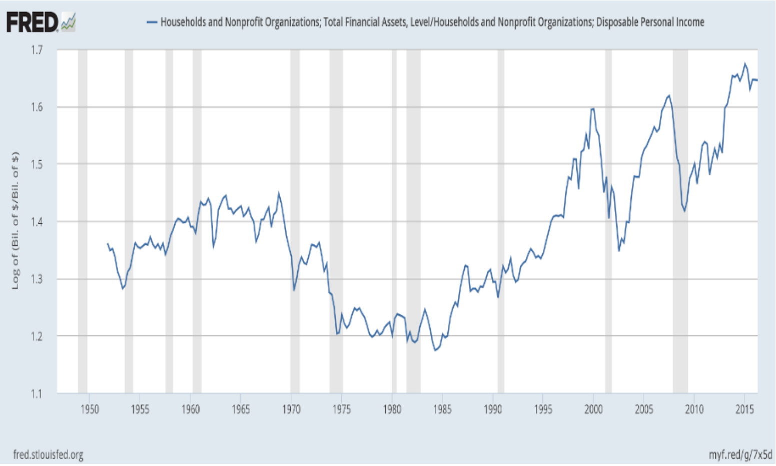
The regime we are moving into will be marked by high volatility and wild swings from deflation to inflation.

Valuations of the S&P index, on a median price-to-sales basis (one of the most reliable indicators of future returns) are now at their <u>highest</u> levels **ever**.



Also, the valuation of US-held financial assets (ie, stocks, bonds, and cash) relative to income are at their <u>highest</u> levels **ever** — the extremes of which typically mark turning points of cycles.

Investors need to be traders in these markets and traders need to be short-term, selective and operate on a barbell basis; with a fat cash position balanced by small capital deployments in higher-beta vehicles.



The US dollar continues to be the lynchpin of global markets. The dollar has been trading sideways in a range now for over 18 months and it has been coiling into a tighter and tighter band. This type of price action usually precedes very large moves. The direction in which the dollar breaks will determine the trend for the majority of global markets going into the end of the year.

It is imperative to remain patient in this environment. Capital preservation trumps returns for the time being.

A Look Around The World

U.S.

We can't talk about the US without first talking about Yellen and crew.

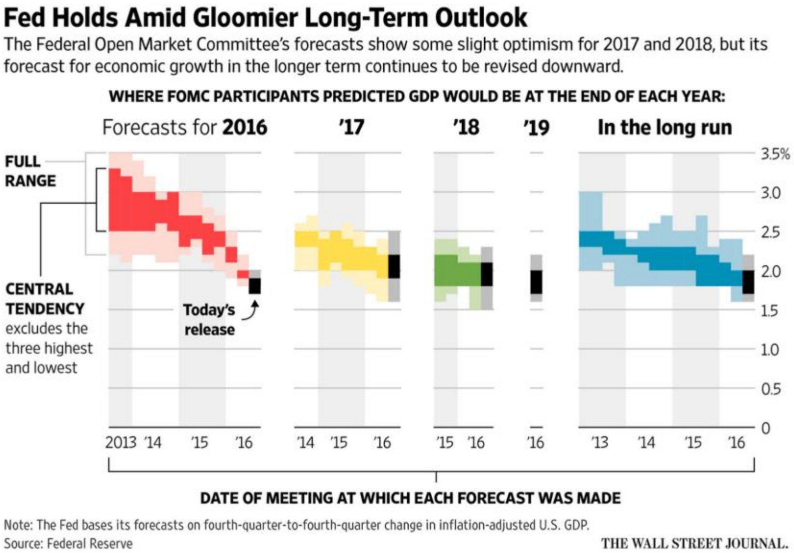
It was no surprise that the Fed stood pat at its last meeting. It will not risk a rate hike before the presidential elections and so is confined to issuing empty threats about raising in the "future".

The Fed's strategy is still the same — try to talk down the markets by threatening future rate hikes. But that doesn't work so well when you lose credibility. And that's exactly what the Fed is struggling with now.

The organization is *supposed* to be data dependent. And according to the data, there is no way they should be hiking in December.

The main measure they use to gauge inflation — core PCE — is trending down along with real GDP. And not only that, but the Fed reduced their own growth forecast over the next few years.

The Fed is stuck between a rock and hard place. While market speculation *is* getting excessive, a hike now could completely derail the economy.



A recent Bridgewater note to clients describes 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.

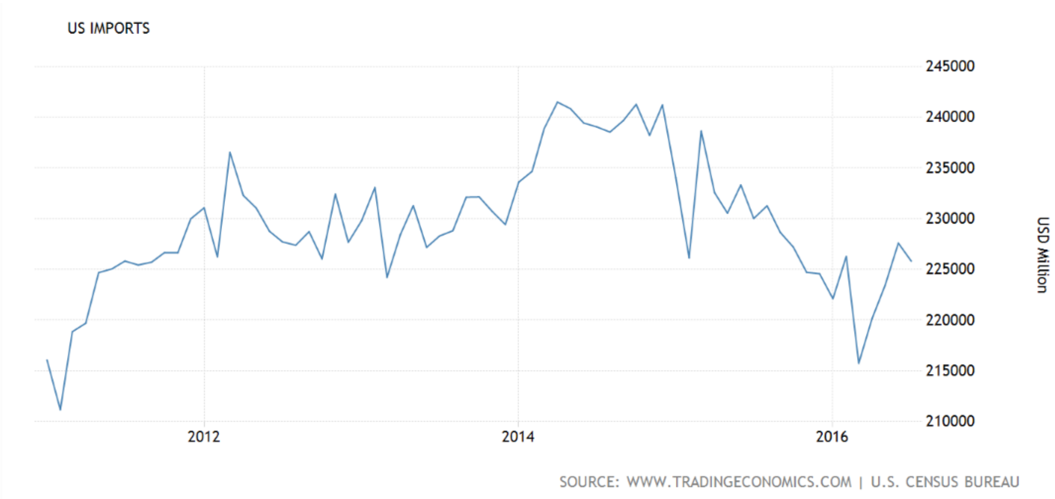
The note explained:

> *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.*

We'll wait to see what the Fed does in December. It's important to remember that as an academic institution, they're far more concerned with their own reputation than anything else. And part of their reputation comes from their credibility. This means there's a decent chance they go ahead with a hike in December to preserve their image regardless of the current environment. This is especially true if Trump comes into the presidency with his hostile, anti-Fed rhetoric, including his accusations of their politically-fueled interest rate manipulation.

Another interesting data point to note in the US is the continual decline in the country's imports.

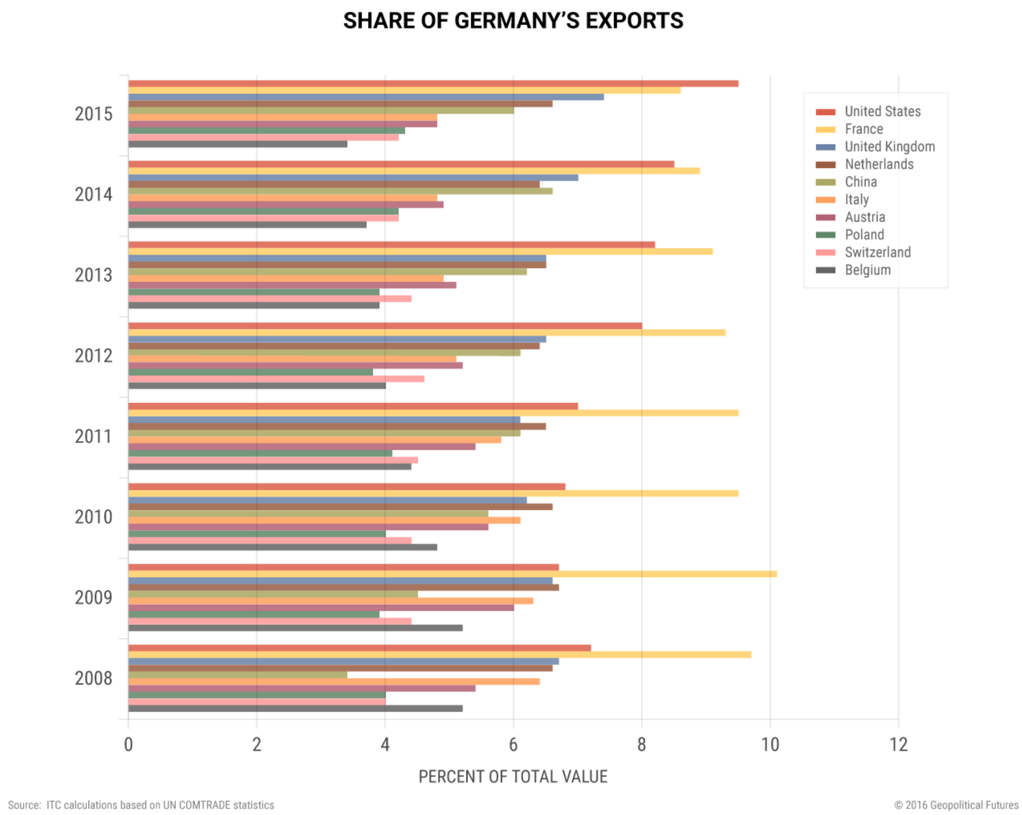
The trend lower began in 2014 and continues today as U.S. Census data has shown that overall imports each month this year are lower than the same period in 2015. In July 2015 imports came in at $187 billion, and now in July of this year they're only $182 billion.



As the world's largest economy, the US is also the largest importer of goods. In 2015 it accounted for 14% of all global imports — meaning it has the biggest effect on countries with export oriented economies. Germany in particular is one of these countries that is beginning to struggle because of the US slowdown.

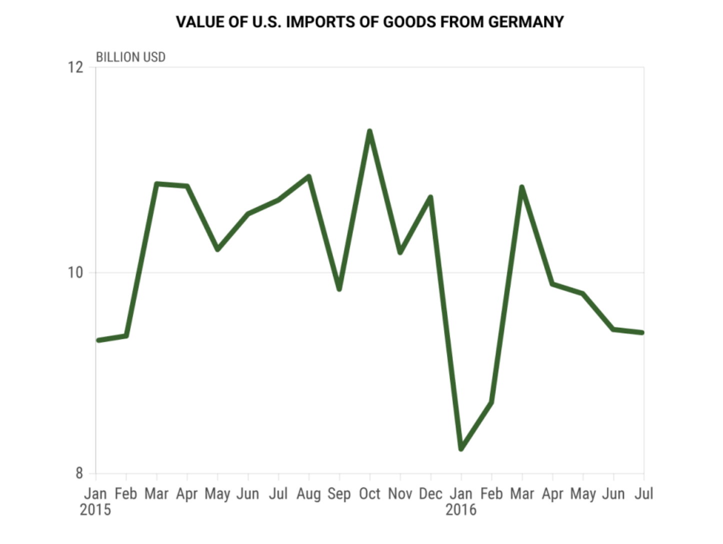
Germany & The Eurozone

US imports are extremely important to Germany’s economy. In 2015, the US surpassed France to become the number one importer of German goods, with 9.5% of Germany’s exports going straight to the US. These exports include everything from cars to machinery and pharmaceuticals.



But these imports have now declined for 4 months straight, with the latest data in July showing a 12.2% drop compared to a year ago.

The US slowdown is in turn the main cause of *total* German exports falling 10% year-over-year in July. This is a large problem because 47% of Germany’s GDP comes from its exports. Though they’re the 3rd largest exporter in the world after China and the US, their dependence on exports is much greater than either country. China’s exports only account for 22.6% of GDP and the US has



only 12.6% of their GDP coming from exports. And while both China and the US have reduced their reliance on exports over the last decade, Germany has increased theirs. It has now reached a point where every 10% drop in exports is equivalent to a 5% reduction in GDP for the country.

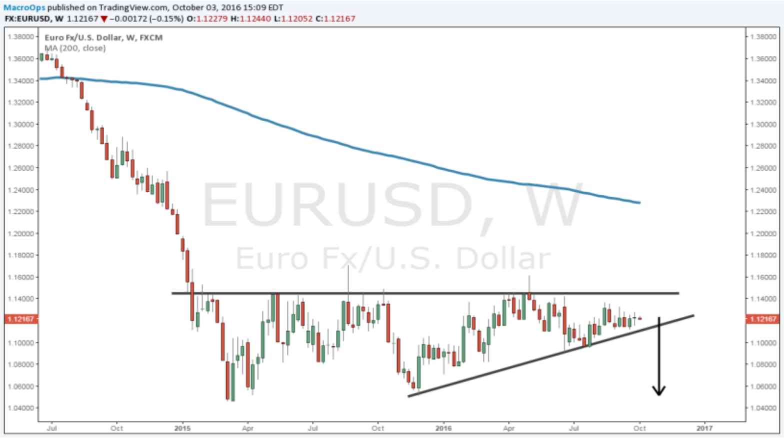
This strong dependence on exports has made the country a large risk factor to the Eurozone. This may seem counterintuitive because Germany has always seemed to be the strongest member state, but in reality they too are very fragile.

25% of their GDP is made up of exports to the rest of Europe. But because of the general European slowdown, they've been relying more and more on external sources like the US and China to support their economy. But now that these sources are slowing down too, Germany has few options left for growth.

A slowdown in the German economy will put even more pressure on their banks which will eventually be forced to deal with non-performing loans from struggling exporters. This is coming at a time when these banks are already deeply exposed as net creditors to other struggling member states in the Eurozone. Deutsche Bank is one of the best examples of this situation.

It's ironic that the country known for financial prudence and efficient government might be the catalyst that sends Europe spiraling into a financial crisis.

The best way to play still looks to be the Euro, which has nowhere to go long-term other than down. We're waiting for a break of the 1.112 level to short it.



Russia

The trouble in Germany and the rest of the Eurozone has created a short-term advantage for Russia.

A few weeks ago, US Vice President Joe Biden made a statement that unless Ukraine fixed its internal corruption by the end of the year, current sanctions on Russia would be lifted. This basically gives the Ukrainian government a few short months to completely rehaul a deeply corrupt and entrenched political system — not gonna happen.

So what's the real reason the US is close to dropping sanctions?

For one, the sanctions have been effective at impacting Russia's economy, but have done little to thwart Putin's aggressive foreign policy. If anything the exact opposite has been the result. This is what happens when the "enforcer" fails to back up its verbal threats, as the US has done on multiple occasions. This has only worked to embolden Putin even more.

Secondly, and more importantly, Eurozone members are suffering from these same sanctions as Russia is a major trade partner with many of them. It's rumored that a number of European countries are planning to veto the sanctions' renewal at the end year anyway, which would reopen trade between the EU and Russia.

Easing sanctions on Russia would bolster various European economies. As the EU's 3rd largest trading partner, Russia imports a number of items including agricultural products and machinery from the EU. When the union is this fragile, every bit of relief matters.

The US understands the dire situation in the EU and does not want to cause any more trouble for them. A financial crisis overseas would be detrimental to US markets. This is why they're willing to lift sanctions, but to save face they've used Ukraine's corruption as a reason for their decision.

Our long-term view on Russia is very bearish. The country is a mess and is on a steep path to becoming a disaster. Putin and his thugs are doing their best to destroy the capitalist system and install a soviet era command and control economy.

But in the very short-term there are some positives that could boost some Russian stocks significantly higher from here, making them attractive trades. The biggest two being the potential for lifted sanctions as well as the possibility of Trump getting elected. Trump is a fan of Putin and has close ties to his inner-circle. It's no secret that Putin is actively meddling in US elections to elect Trump because of the benefits this would portend for Russia from an economic and foreign policy standpoint — the end of NATO being the biggest one.

One option is to go long the the Russian index ETF RSX which has already broken the $17.80 level.

Another play is the Russian miner MTL which has broken the $2.92 level. Remember, these are purely speculative trades, not investments; which is how Russia should always be approached.

Italy

In the last MIR we discussed what a mess Italy has become. Now the question is how an Italian banking crisis would affect the US.

One of the potential risks to the US are of the contagion kind, which would come from significant exposure to both France and Germany. Both these countries have deep financial ties to Italy.

CONSOLIDATED POSITIONS ON COUNTERPARTIES RESIDENT IN ITALY

	TOTAL (claims on an immediate counterparty basis)	TOTAL (ultimate risk basis)	DERIVATIVES CONTRACTS	GUARANTEE EXTENDED	CREDIT COMMITMENT
Australia	609	699	138	220	18
Austria	6,276	6,566	75	151	257
Belgium	8,192	9,169	-	-	-
Brazil	927	-	-	-	-
Canada	1,200	1,301	372	-	-
Chile	2	2	-	-	-
Chinese Taipei	225	220	-	6	40
Finland	-	-	-	-	-
France	**278,091**	**279,965**	**11,620**	**14,817**	**31,913**
Germany	**91,573**	**92,717**	**12,466**	**33,324**	**1,463**
Greece	310	311	19	-	-
Ireland	1,718	1,759	-	-	-
Italy	-	-	-	-	-
Japan	29,588	30,474	15	1,000	4,901
South Korea	438	418	-	193	1
Mexico	12	-	-	-	-
Netherlands	28,230	28,458	-	-	-
Panama	5	-	-	-	-
Spain	48,573	49,360	2,270	5,584	5,454
Sweden	639	496	641	414	299
Switzerland	20,603	19,656	6,605	7,229	1,582
Turkey	76	98	-	-	-
U.K.	31,916	32,892	12,138	46,355	6,989
U.S.	**50,224**	**47,744**	**22,419**	**83,932**	**9,468**

MILLION USD

Source: Bank for International Settlements

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French bank Crédit Agricole, for example, stated that in 2015 Italy made up 26% of its total default exposure — no small amount. Italy also makes up 15.4% of BNP Paribas gross exposure at default.

US banks have large exposures to both these countries. France and Germany combined make up 21.1% of JP Morgan's foreign country exposures, 10.6% of Bank of America's, and 12.3% of Citigroup's. French bonds make up 12% of the US insurance industry's total investments and German bonds make up 4%. Prime money market funds also hold $168.4 billion of French securities which is the largest allocation after US equities. Trouble in France and Germany would directly hurt the US.

And the kicker to all this are the derivatives, credit default swaps, and off balance sheet items intertwined in this mess. Take the present state of Deutsche Bank for example. They have the largest derivative book in the world, and as we know from the 08' crisis, none of these banks are doing their accounting properly. Things will only get worse for them.

What's more troubling, if you refer back to the chart above, is that the US has more derivative and extended guarantee exposure to Italy than both France and Germany combined. This hefty amount of direct exposure will make the crisis even worse for the US when it plays out.

U.K.

In the aftermath of the referendum, there was still a question of whether there would would be a "soft" or "hard" Brexit.

A soft Brexit would be a long, drawn out process where most of the UK's agreements with the EU would be kept in place — the most important being Britain's access to the European single market. Good and services could be traded freely across the block without tariffs and financial firms could continue to operate their branches anywhere in the EU. The benefit of a soft Brexit would be the greater probability of no disruption occurring from the split, enabling the economy to stay intact.

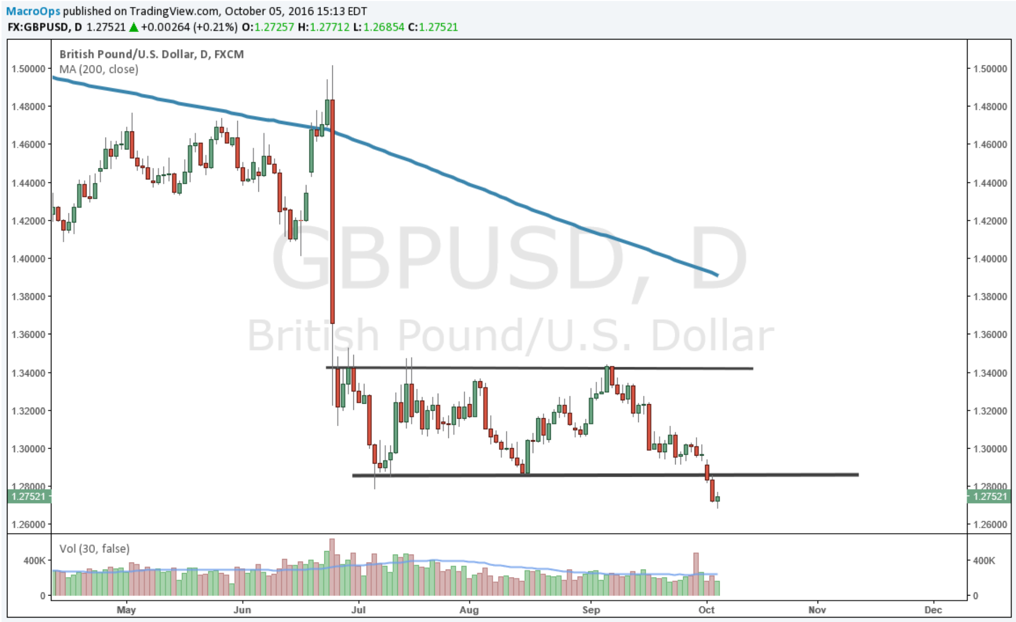
A hard Brexit on the other hand would involve the UK giving up access to the EU's single market. They would instead make their own trade deals with the rest of the world and likely return to the WTO's trade rules when dealing with the EU. The hard Brexit is where uncertainty comes into play. And markets hate uncertainty. No one knows exactly what the trade situation will look like after renegotiations. Will the cost of exports increase for the UK? Will protections against cheap foreign exports be taken away? How will this affect British firms?

From the market's perspective, the soft Brexit is the way to go, because it's a continuation of what's already in place. There's more certainty there. But Prime Minister Theresa May's recent actions have increased the probability of the opposite occurring.

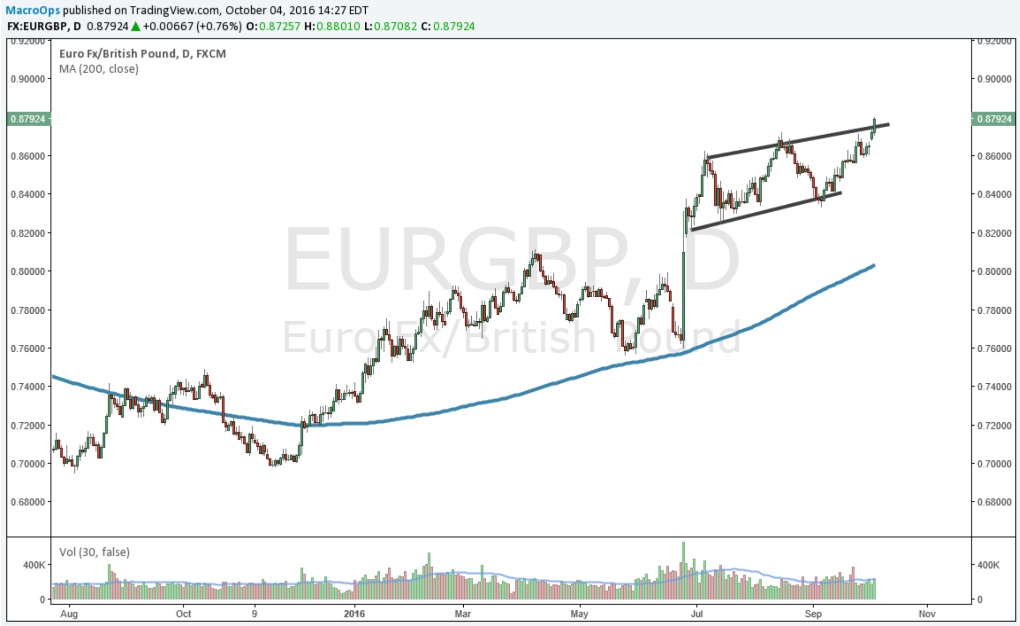
May has confirmed that she will trigger the activation of Article 50 (an official legal notification to leave the EU) by the end of March 2017. Once Article 50 is triggered, the EU and Britain will have two years to negotiate the terms of Britain's exit from the bloc, with an extension only available via bilateral agreement. The hard date she set in place to trigger Article 50 in addition to her comments at the recent Conservative conference helped convince investors that May wants a hard Brexit:

> *"Let me be clear. We are not leaving the European Union only to give up control of immigration again. And we are not leaving only to return to the jurisdiction of the European Court of Justice."*

The pound reacted by immediately breaking post-Brexit lows against the dollar.



Pound weakness was also confirmed by multiple breaks in other cross currency pairs like EURGBP.



The pound has a good chance of continuing its trend lower with the new level of uncertainty in place for the UK with a hard Brexit. We recently entered a short position in the pound December futures contract, but there's also the ETF FXB that investors without access to futures can play.

Oil

The main driver of oil right now is sentiment. Investors *want* to be bullish on the commodity and liquidity conditions are in its favor. That's why prices are rising. This is key to understand.

A lot of pundits will try and pin oil's recent rise on the latest OPEC "deal" to cut production from current levels, but this deal is honestly a joke.

There was only an "understanding" put in place. No details have been worked out as to who's cutting and by how much and these discussions won't start until the next OPEC meeting at the end of November. The chances for an *actual* agreement and resulting cuts are slim.

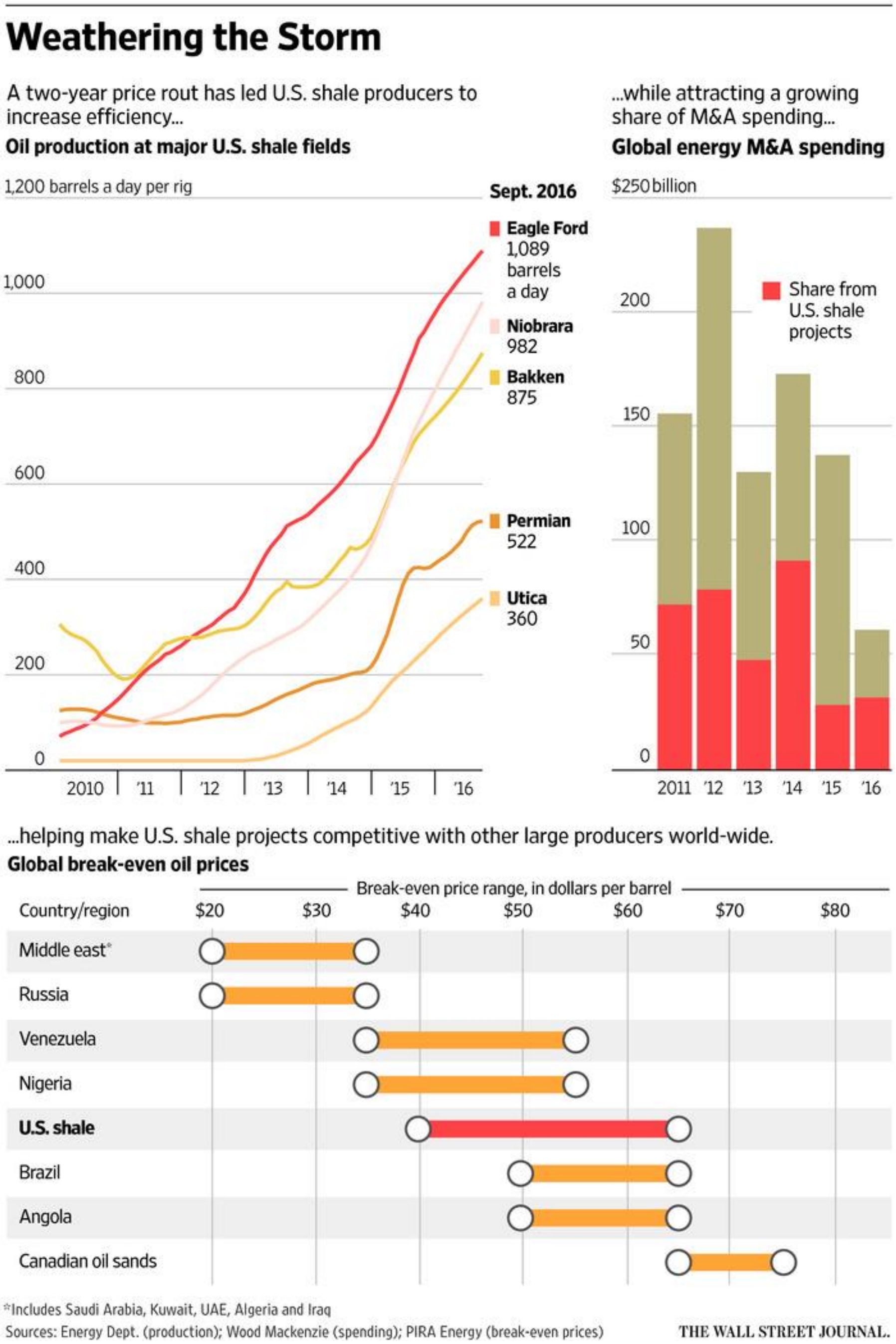
Oil producers will always act solely in their self-interest, regardless of any "understandings". OPEC is a dead organization because of the classic "prisoner's dilemma". Each country could say they'll cut, but they'll still produce as much as they can to steal market share because they rightly know that if they don't, the others will and they'll lose.

But the OPEC propaganda is happening because many of the bigger producers are directly feeling the pain and are nearing "crisis" points. Saudi Arabia had to recently inject $5.3 billion in time deposits into its financial systems to keep the engine from seizing up. The Kingdom is also preparing for its first international bond sale to cover its ballooning deficit and to keep its currency pegged to the dollar.

Also, from a fundamental perspective, higher oil prices now mean lower oil prices in the future. Consider this from the 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.



Oil will likely complete its current head and shoulders bottom and head higher over the short-term. But long-term the commodity will continue to stay low due to the broader fundamental picture.

Apart from playing oil itself to the long-side on a move above $51.50 level, there are a few equity names that could double or more during this temporary price recovery. ATW on a move above its 200-day moving average and WLL above the same level are some of the most attractive.

Deep Dive: Coal

In keeping with our barbell strategy of maintaining large cash positions balanced by high-beta assets, we need to find stocks that are so mispriced that they have the potential to appreciate in multiples.

This means we need to search out hated sectors of the market where good assets have been left for dead.

No sector better fits this description than dirty air polluting coal and the companies that mine the black stuff.

Since 2011, the coal mining etf (KOL), fell over 90%. The sector was littered with bankruptcies and mine foreclosures… making it a literal killing field for investors.

But while seemingly nobody was paying attention, KOL has rallied 140% off its bottom in just the last seven months.

The bearish market narrative surrounding coal is simple, and like all narratives, contains some truth. It goes something like this:

- Coal is a dying energy source due to aggressive government environmental regulation and the push for clean energy.
- Fracking has created an abundance of natural gas (which is coal's largest competitor as a base load power source) that has led to lower gas prices. And since natural gas is cleaner, coal doesn't have a future in the US as a power source, which is what it's primarily used for.

Some of this is true… but a lot of it's overblown.

And this overreaction combined with evolving macro fundamentals are preparing the runway for some of these coal mining stocks to rise another couple hundred percent over the next few years.

Let me explain why.

First off, coal is not going away. It can't. It remains the most cost effective energy source in the world. It was, until this last year, the dominant source for electricity in the US; accounting for just under 40% of electricity production.

Yes, there is a global push to move to cleaner energy sources. But unless somebody figures out fusion, there's little chance green energy is going to take away much market share from carbon based fuels any time in the near future.

In addition, since the Fukushima disaster, many countries such as Japan and Germany have been moving away from nuclear power and as a result have had to build new coal fired plants to provide the bulk of their electricity.

But more importantly the story of US coal miners is a domestic one and the truest driver behind the collapse in coal has been falling natural gas prices.

The price of natural gas has a large impact on coal; the two are highly correlated. When natural gas cheapens it becomes more economical for utilities to burn gas versus coal — over 90% of US coal is used for electricity generation. So lower natural gas prices portend lower coal prices and vice versa.

With natural gas near 20 year lows, it's no wonder coal miners have performed so poorly.

The good news is that the supply/demand picture for natural gas is turning a corner (we are long some nat gas plays) and the commodity is possibly at the beginning stages of a cyclical bull market.

If this ends up being the case, it means a drastically different picture for coal and coal miners moving forward. There is a completely different demand profile for coal when natural gas is trading below $2 per MMBTU versus when it's trading above $3 per MMBTU. And it's this turnaround in natural gas that is the biggest driver in the reversal of coal over the last six months.

The change to coal's true supply picture is difficult to see. The US coal market is highly fragmented and comprised of numerous small and mostly private operations, so it's tough to know when a mine goes idle or closes for good. And the pertinent supply data often doesn't come out until many weeks later. But with the numerous coal miner bankruptcies — including that of Peabody, the largest producer in the world at one point — and the longer term decline in production, it's probably a safe assumption to say that the supply picture moving forward looks good for higher prices.

The coal mining sector has been leaned out and only the lowest cost producers with *relatively* healthy balance sheets have survived. Many of these companies have long-term agreements with utilities that give added safety in the source of a dependable revenue stream. With less competition, the miners should be able to really boost their market share.

And the final kicker to the long coal theme is the possibility of a Trump Presidency — something we think the market is largely underpricing.

Republican Presidential nominee Donald Trump does not believe in climate change and has stated on numerous occasions that he would attempt to abolish the environmental protection agency. Furthermore, he has said that he would end the "war on coal" and work to boost the coal industry.

We have no idea whether he'd actually follow through on any of this, but that's almost unimportant. It's the optics and the drastic shift in market narrative that would occur for coal miners should Trump win, that matters.

When a market overreaction combines with a changing fundamental landscape that is in direct contrast to the overreaction, an extremely valuable mispricing occurs. This is when value, sentiment, and price action all line up and very powerful and durable trends develop. That is exactly the opportunity we have in coal and it's why coal miners can be a homerun play over the coming year.

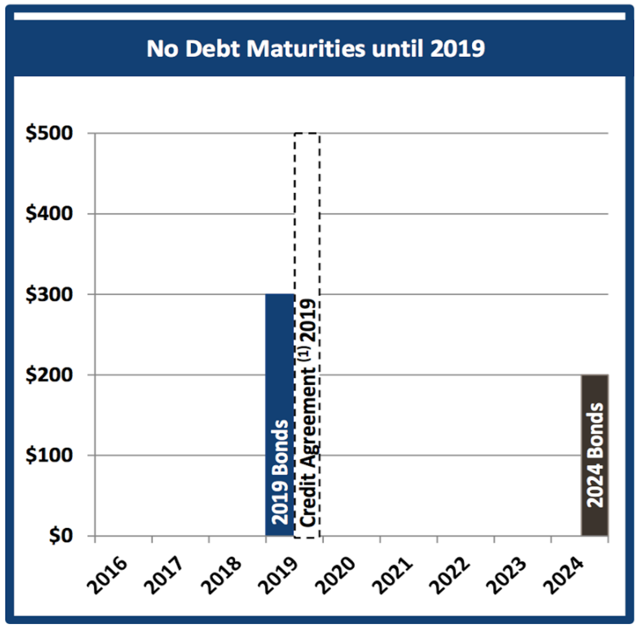
To play this you can buy the KOL ETF directly or our preferred individual coal stock, Cloud Peak Energy (CLD).

CLD is up more than 400% since the beginning of the year, which is a lot, but if the price of coal continues to recover (and we think it will) it could very well rise another 200% or more over the next 1-2 years.

Cloud Peak Energy is the premier coal producer in the Powder River Basin. This coal company has a number of benefits over other coal stocks, the primary one being its balance sheet. CLD has a strong balance sheet relative to its struggling peers and will be able to deftly weather a more prolonged low coal price environment.

Liquidity & Obligations
(as of June 30, 2016, in millions)

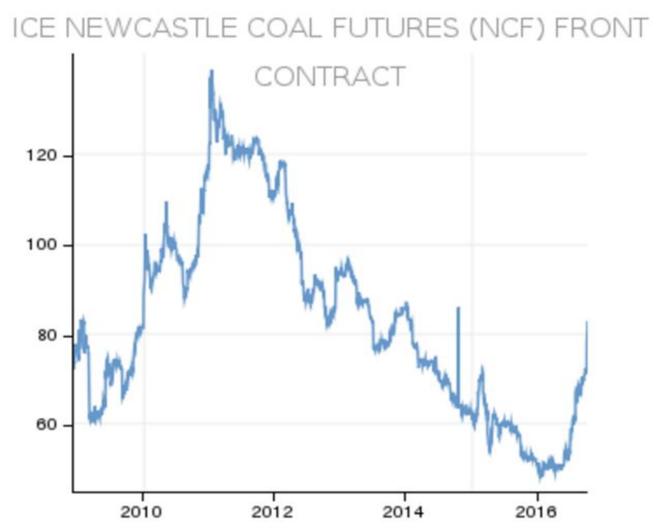
Cash and cash equivalents		$ 64
Credit Agreement capacity	$ 500	
A/R securitization	25	
Available borrowing capacity [1]		525
Letters of credit issued [2]		(66)
Total Available Liquidity		**$523**
8.5% High-Yield Notes due 2019		$300
6.375% High-Yield Notes due 2024		200
Senior unsecured debt (B+/Caa1 rating)		$500
Capital leases		8
Total Debt		**$508**
Total Debt / Adjusted EBITDA [3]		**5.5x**
Net Debt / Adjusted EBITDA [3]		**4.8x**
Surety bonds outstanding		$439
Self-bonding (WY)		190
Total Bonding Obligation		**$629**



The company has a debt-to-equity of 0.5, with the earliest debt not coming due until 2019. It produced positive EBITDA on a TTM basis and is currently trading at a third of book value.

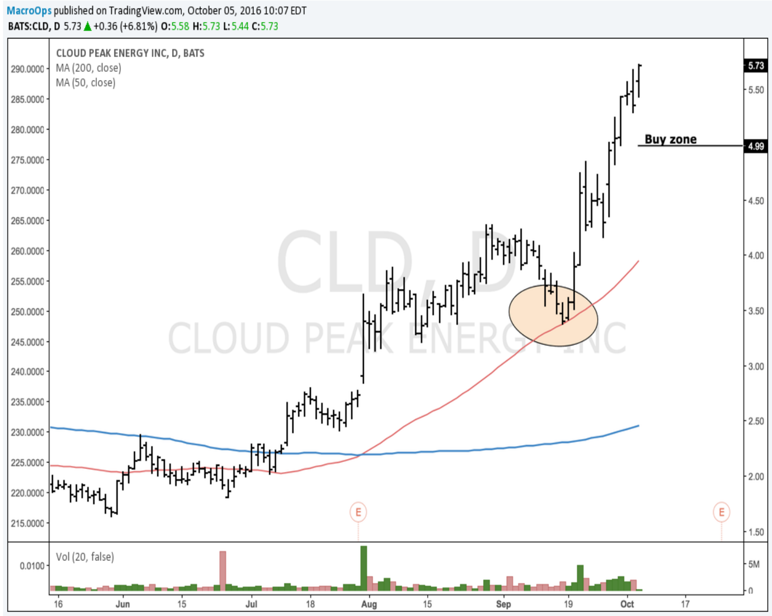
It's a well-managed operation with one the highest safety records in the industry. The company has proven and probable reserves of over 1.1 billion tons.

The price of coal has had rallied hard over the last few months. If this continues and prices rise to 2013 levels between 90 and 100 — which are in eyeshot right now — CLD's earnings will rise to a very conservative estimate of $1.5 per share. If we assign even a historically low P/E ratio of say 7, that would give us a share price of $10.50, which would be nearly a 100% increase from where the stock is trading currently. Now if we throw in the Presidential Trump scenario on top of the improving sector dynamics, we can easily see an environment where the stock doubles that or more.



CLD has run considerably so it'd be wise to wait for a pullback and then slowly build on small positions over time.

We will be building positions around pullbacks near the 50-day moving average. The stock is overstretched in the near term and a good entry would be on a pullback near the $5.00 area.



Quantitative Take

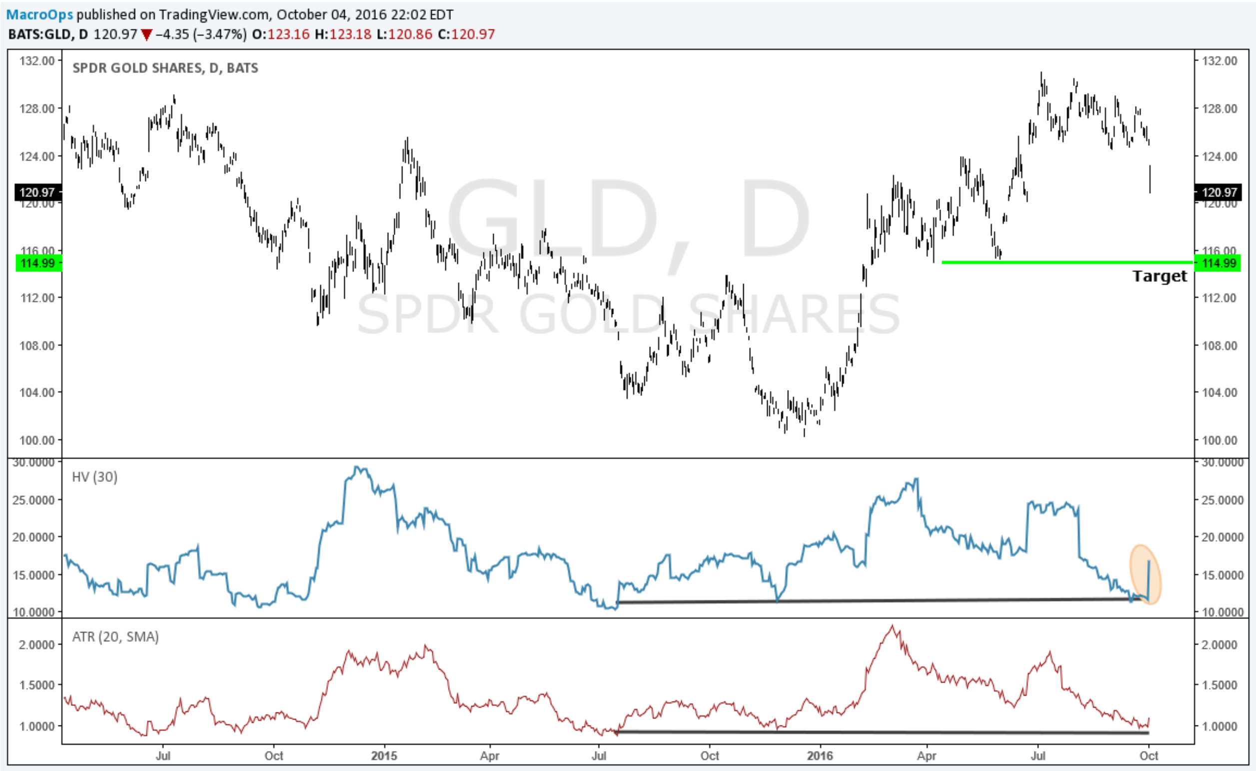
Moves Are A Coming In Metals And Currencies

Markets have been in paint dry mode for the last few months. Macro data keeps rolling in without any significant surprises and the Fed meeting went exactly as expected. We're going to need a significant beat or miss in the data to catalyze another significant trend somewhere.

It's common for markets to oscillate between malaise and significant directional conviction. We can't expect good action each and every month.

But what we can do is use volatility to anticipate when a move is about to occur. Volatility is mean reverting, which means markets in the lower end of their volatility range are prone to breakout. And markets that are in the high end of their vol range are prone to enter equilibrium and start moving sideways.

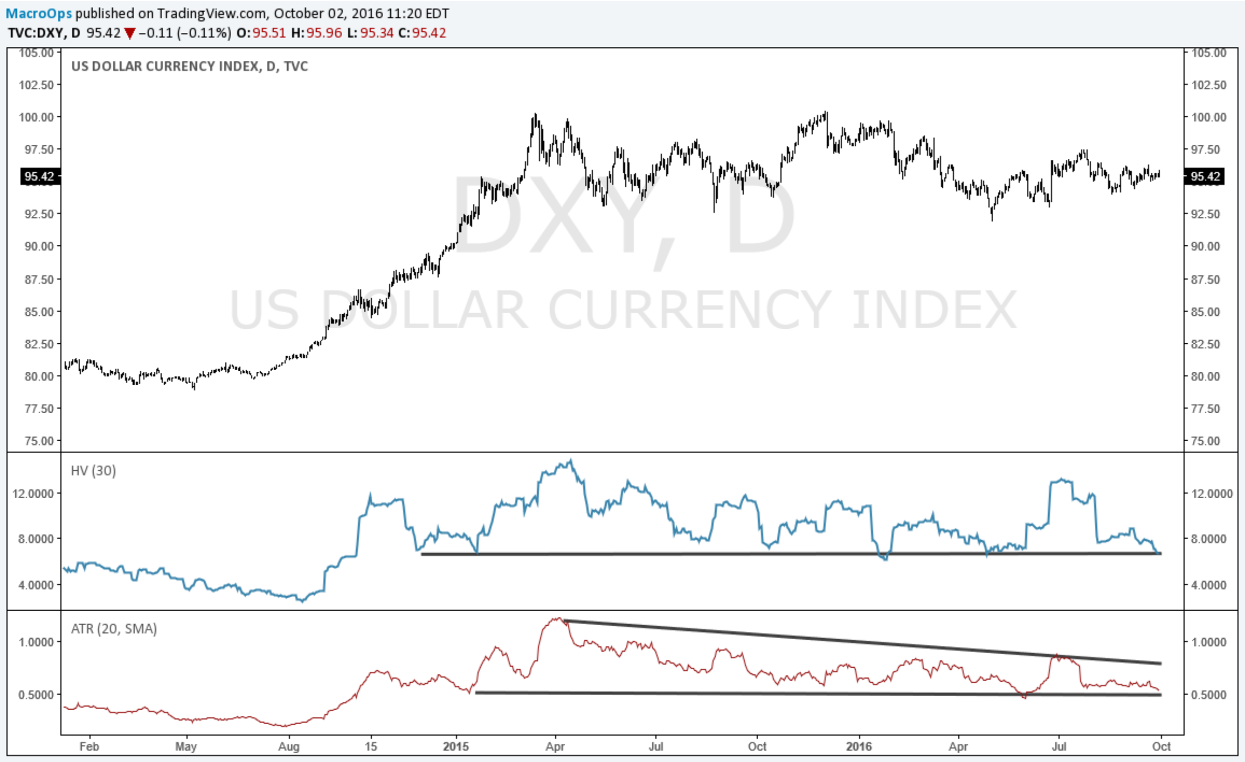
Just the other day we saw this phenomenon play out in gold.



You can see volatility, represented here by 30-day historical vol (blue line) and 20-day ATR (red line) have been testing the lower end of their ranges. This set gold up for a big breakout. Since long gold is a crowded trade, it makes sense that the break occurred to the downside.

With gold vol up trending again we can expect the metal to continue its move down to the $115 range where the it found support earlier this year.

The same type of setup is happening in the US dollar index.



Historical volatility is once again back near its lows and the ATR has been steadily down trending.

This makes for treacherous currency markets especially if you're a macro trader looking for big trends. When volatility contracts you get a ton of false moves that cause nothing but stop outs. Trends fizzle out way before you'd like to take profits.

But low volatility also means that juicy moves are on the horizon, just like we saw in gold.

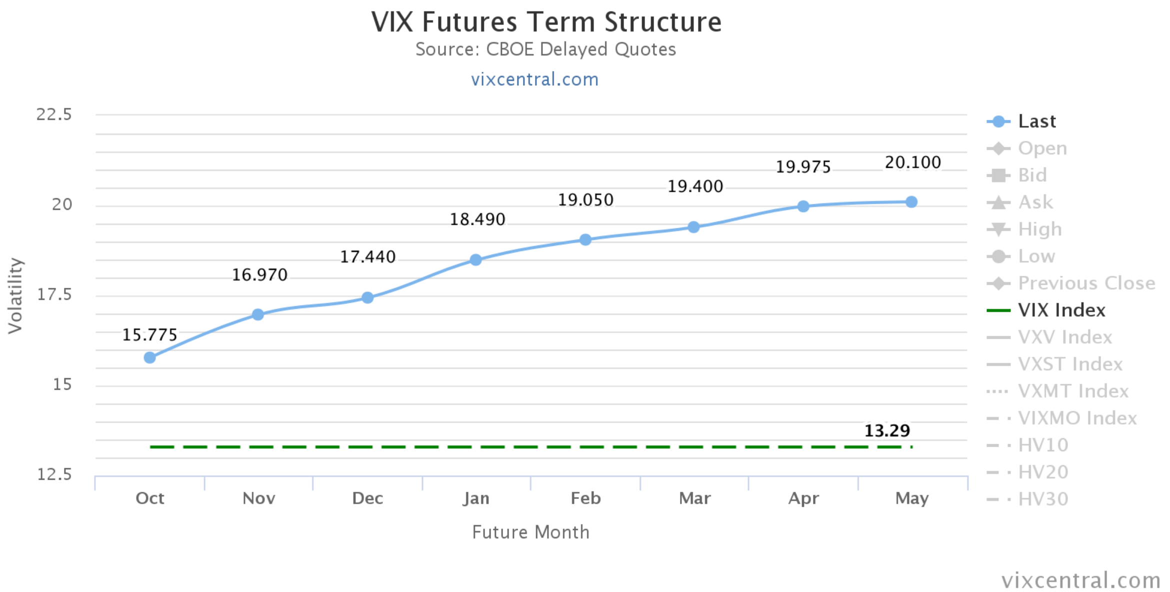
With dollar index volatility currently compressed we can expect some explosive moves in the index going into year end. Spend some extra time watching the currency markets in the next couple of months, a tradeable move is likely.

An Unrelenting Bull

With the dollar bull trend on hold and an army of dovish central bankers circling markets, U.S. equities have been able to continue their levitation act. And in the short to mid-term the market is not showing any quantitative characteristics of turning over.

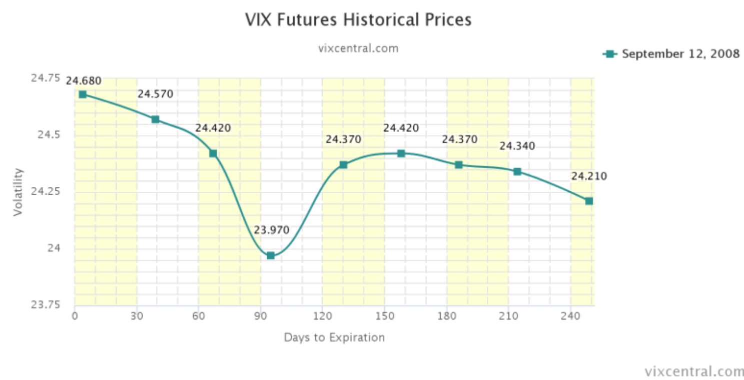
First off, the VIX shows no warning signs of immediate downside in the markets. We had a little scare in early September, but that was quickly erased.

And when we take a look at the VIX futures curve, all we see is a nice upward sloping line otherwise known as contango.



When the term structure of the VIX is in contango, markets will drift sideways to higher. We don't have to worry about a significant sell off (20%+) until this curve goes into backwardation, meaning the blue line goes from the top left of the graph to the bottom right.

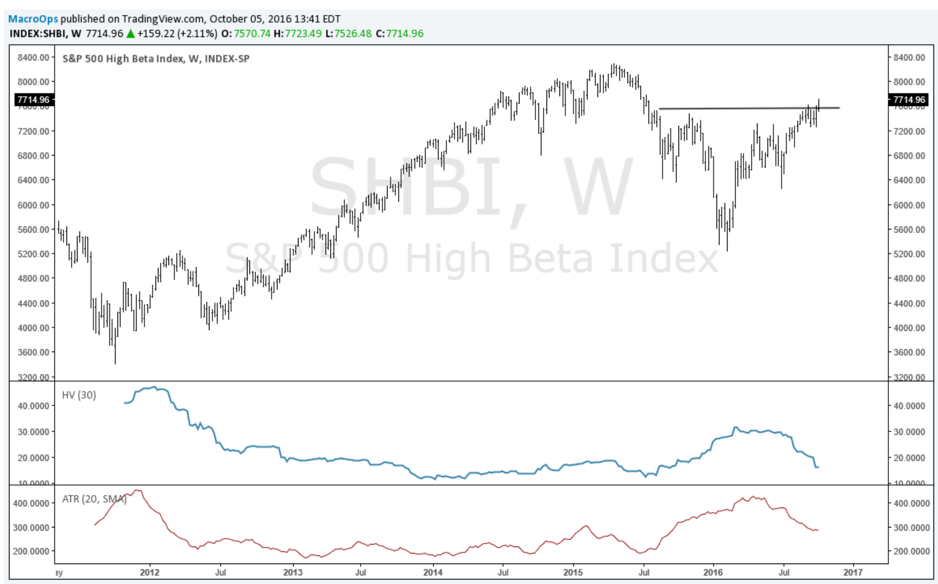
Here's what the curve looked like on Sep 12, 2008 right before the market fell off of a cliff.



Keep this in mind before leaning too much to the short side. The big moves always come when the vol curve goes into backwardation. It doesn't happen often, but when it does the market will move swiftly as everyone rushes to unwind their exposure and investors panic sell.

Apart from vol, we also see more evidence for the bulls by looking at high beta stocks.

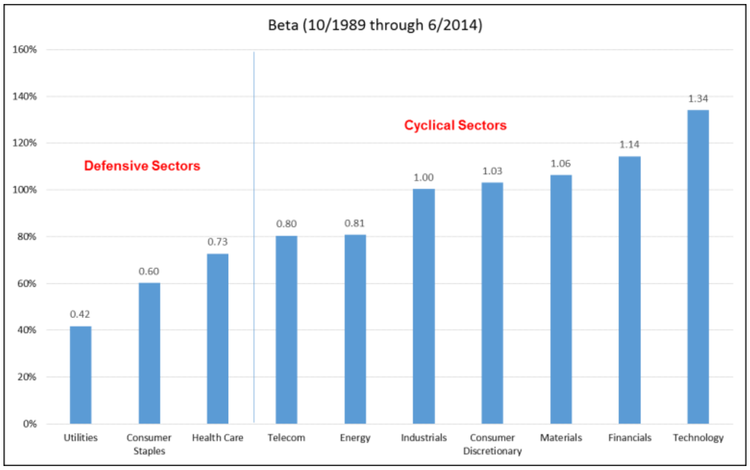
The SHBI (S&P500 High Beta Index) remains strong and is now past last summer's highs. It's tough for the market to generate any significant downward momentum with high beta holding up nicely.



Another interesting view comes from plotting the relative performance of high beta stocks over low vol stocks. Take a look at the graph below:

This ratio is starting to break out after bouncing hard from a bottom earlier this year. High beta outperforms low vol when we enter "risk on" periods. If this ratio continues to make its move off a potential cyclical bottom we must respect the bulls.

If you remember back to the beginning of the year, utilities were all the rage. XLU was ripping as the market was plummeting. Most institutional money managers can't short stocks so if they fear a bear market they'll overweight defensive sectors and underweight cyclical sectors. When they're optimistic again they rotate back into cyclical and high beta sectors.



The latest rotation has been into the tech sector, which carries the highest beta of them all. If you look at the graph below, the XLK:SPY ratio is undergoing a massive multi-year breakout.

The relative strength in tech is something we have been watching since the post-Brexit breakout and is further evidence for continued equity market strength.

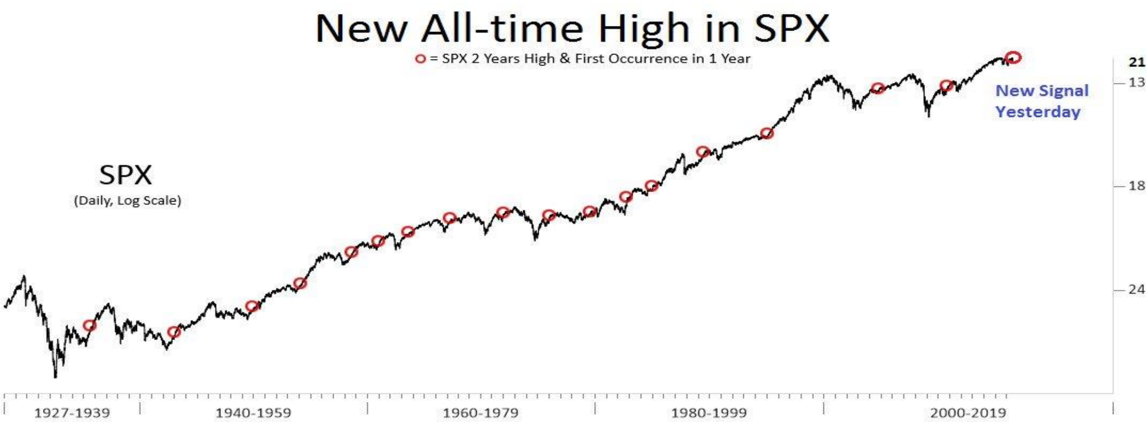
The Mother of All Buy Signals

And finally, to sum up our quantitative view for U.S. equities, we have to look at the mother of all buy signals: a multi-year breakout on the S&P 500.

The official closing all-time high occurred on July 11th of this year. Contrary to what many investors believe, new 52- week highs are actually great buying points for traders with 6-12 month holding times. There is strong statistical evidence for stocks hitting one year highs to be even higher one year later.

But what's even more bullish is when stocks hit multi (2+) year highs for the first time.

Check out the research graphic from Nautilus on the next page:



SPX forward returns after 17 events 12/30/1927 - 7/11/2016

Event Dates	1Mo	3Mo	6Mo	1Yr
09/10/1935	-2.95%	10.79%	21.92%	37.35%
02/01/1943	4.56%	12.74%	11.41%	12.17%
01/09/1950	0.88%	3.92%	1.41%	24.06%
03/11/1954	3.33%	6.18%	15.14%	36.57%
09/16/1958	2.49%	8.55%	14.16%	14.93%
01/27/1961	3.59%	6.65%	9.01%	11.32%
09/03/1963	-0.50%	1.57%	7.43%	13.28%
05/04/1967	-6.24%	1.42%	-1.71%	4.86%
02/04/1972	3.82%	1.69%	5.31%	8.39%
01/29/1976	-0.09%	2.02%	2.82%	1.68%
08/13/1979	0.37%	-5.50%	9.03%	16.16%
11/03/1982	-2.93%	0.25%	14.31%	14.54%
01/21/1985	3.40%	3.12%	10.91%	18.43%
07/26/1989	3.98%	1.67%	-2.30%	5.63%
02/14/1995	2.67%	9.46%	15.75%	36.88%
11/04/2004	2.46%	3.56%	0.83%	5.02%
11/04/2010	0.17%	7.36%	9.76%	3.28%
07/11/2016				
Avg after Signals	1.12%	4.44%	8.54%	15.56%
Average All Periods	0.61%	1.84%	3.64%	7.54%
T-Statistic	0.71	2.37	2.98	2.81
# Events Up/Down	12 / 5	16 / 1	15 / 2	17 / 0
Significance	76%	99%	100%	99%

NAUTILUS INVESTMENT RESEARCH Daily 12/30/1927 - 7/11/2016 Data Source: Bloomberg 7/11/2016 8:24

This study calculates the 1-12 month returns of the SPX after it makes a new 2 year high. Since 1928 this has happened only 17 times. And after each occurrence the market finished higher 1 year later *every single time*. The average return was 15.56%.

That's highly significant. Now nothing is guaranteed, the market can still finish lower a year from now, but fading the market and playing the short side in the near to medium term against that statistic is a fool's errand.

The closing print for the SPX on this most recent multi-year high occured on July 11th at a value of 2137.2. So far, the one-month return from that point has been 2.27% — meaning the pattern has already begun to play out…

Keep an eye on this stat. We'll be commentating on it to see what happens in upcoming MIR issues.

Systemic Risks

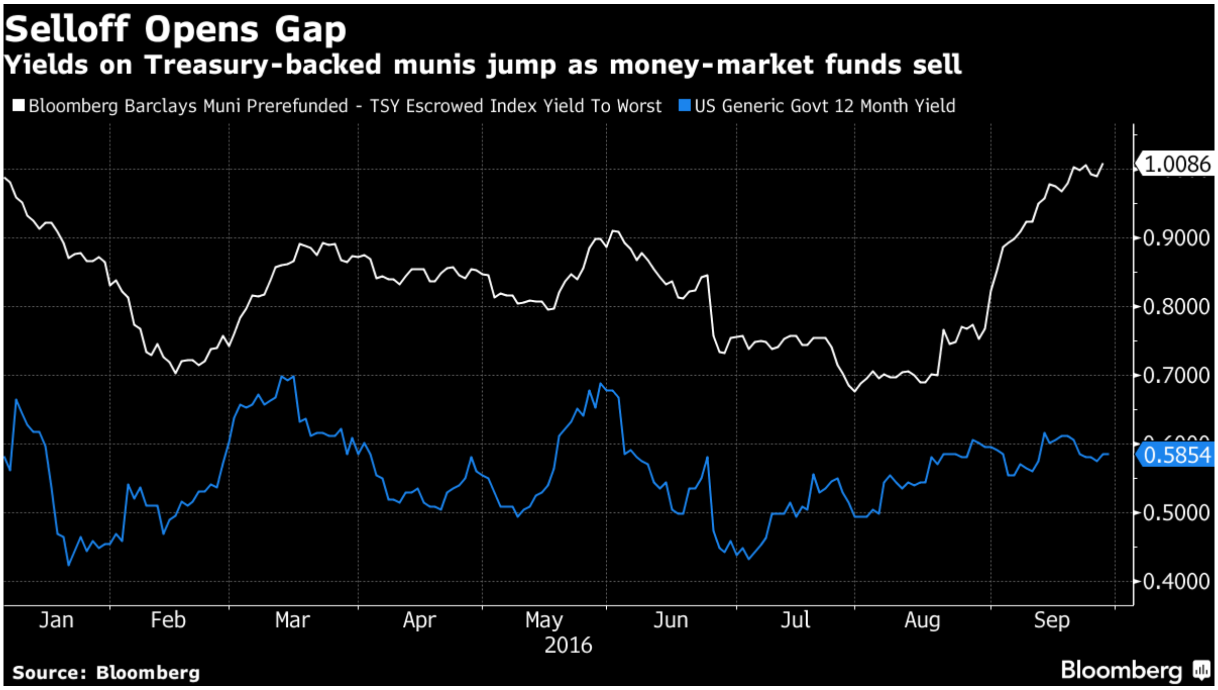
New SEC Money Market Regulations

As the October 14th deadline approaches, the distortions in the financial system continue.

The latest squeeze is in the Fed's reverse repo market where rates are soaring.

Quarter-ends are usually hectic as banks tighten up collateral lending to brush up their balance sheets, forcing money market funds to park their cash elsewhere. One option for this cash is the repo market where rates temporarily rise due to the influx. But this quarter rates have risen significantly higher than normal because this standard transition has been coupled with the mass exodus already occurring from prime funds to government funds. This unusual rate rise is now in turn hurting liquidity in the system.

But even though the money market transfer hurts liquidity, it also creates some opportunities. The movement of cash away from prime funds is creating opportunities in the treasury backed municipal bond market where yields are now 1% — double what one-year federal government securities return. This market is becoming very attractive for investors searching for yield.



We've frequently gotten questions from the Macro Ops community on how they should protect their own money market fund investments. But the key to remember here is that these changes have more of an effect on the overall liquidity in the financial system than personal accounts. Our team isn't moving any of our personal money market investments. What we're doing is watching liquidity closely and how the distortions caused by these SEC rules affect it, whether it be through a USD squeeze or something else. Based on the movement we see, we'll be taking positions in our active accounts.

For further information on the new SEC rules and their effects, read our article here.

Global Bond Market Bubble

You know a bubble has formed when assets with yield are traded like assets without yield. And that's exactly what's happening with bonds.

Normally if you buy a bond, you're buying it for the coupon it pays over time — the yield. The price appreciation that comes with it is from others looking to earn that same yield, which pushes prices higher.

But what coupon are you getting when yields are near zero? At this point investors are buying bonds purely for the potential increase in price. This is the same thing that happened in the real estate bubble. Instead of looking to earn rent from a property, investors were looking to flip it. It plays directly into the greater fool theory. As long as you're not caught holding the bag when things go bust at the end, you'll come out alright. Not a great strategy… One asset class you do trade solely for price appreciation is commodities. It’s interesting to compare how commodities are now trading versus bonds. The chart below shows spot gold in red compared to the PIMCO 25-year zero coupon treasury ETF in blue.

We have a bond and a commodity, trading in step with each other. This is not a good sign.

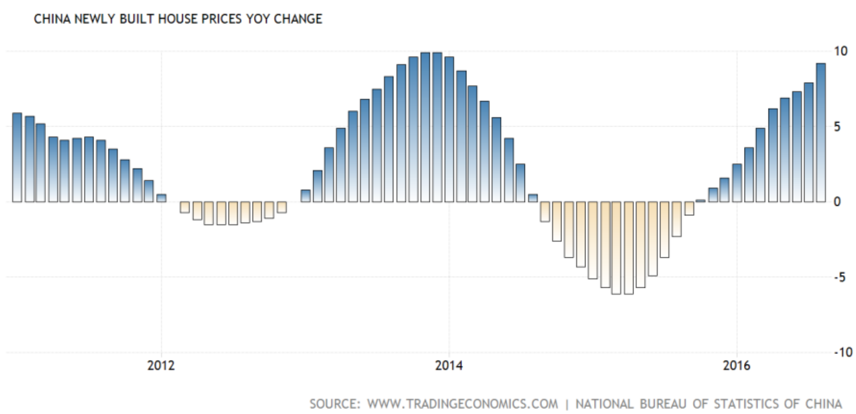
Yuan Devaluation

The yuan has been and continues to be the largest systemic risk to global markets.

A Chinese yuan devaluation is not a question of if, but when. China will experience a twin banking and currency crisis sometime within the next two years — we think it will be sooner rather than later. The yuan will likely fall well over 30% against the dollar which will unleash a tidal wave of deflation across the world.

The yuan officially became a reserve currency after being added to the IMF's special drawing rights last week. This basket originally only consisted of the dollar, euro, yen, and pound. The Chinese government could very well use this event as political cover for a devaluation. The large selling we've seen recently in US, German, and Japanese government bonds has likely been the Chinese dumping their FX holdings as they try to manage an orderly devaluation.

Keep an eye on the Chinese housing market. This is the most speculative area of the Chinese market and also where a majority of Chinese wealth is stored. Once the housing market turns over again, capital flight out of the country will increase to a rate that the Chinese government will be both unable and unwilling to try and stem.



Get Paid To Hedge The Systemic Risks

There are many ways to protect a portfolio from downside risk, but most do more harm than good over the long-haul. The most common thing for people to do is buy expensive puts on the SPX and slowly grind their account down as theta (time premium) eats them alive.

We prefer cheap or free hedges. And sometimes there is even the opportunity to *get paid* to hedge downside risk if you're crafty enough. In today's markets we've identified one of those rare cases where the market will pay you to protect yourself.

Here's the trade:

Buy 65 shares of TLT against the purchase of 1 Jan. 2018 HYG (high-yield) put struck at $60

In this trade you benefit from the carry. The distributions on the long dated bonds will pay for the theta decay in the high yield puts. If the market has a liquidity event, the spread between TLT and HYG should widen dramatically and you'll see a large spike occur similar to the one shown in the graph below during 2008.

Here is the math behind the trade:

- 1 put of HYG (which represents 100 shares) is equal to 65 shares of TLT on a notional basis
- Long 1 HYG put stuck at $60 for $.65 for protection up to Jan 19 2018
- Long 65 shares of TLT which averages $.25 per share distribution each month
- Months between now and expiration (16 months total) (.25) (65) = $260 of income from TLT, HYG put only costs you $65 per 1 lot

The HYG put could 10x in a liquidity event.

Scenario Analysis:

- If the market continues to grind higher this trade will break even. The TLT distribution will cover the theta decay on the HYG puts.
- If a liquidity event occurs in the next 16 months, large gains will be made on both TLT and the HYG put. Investors buy treasuries in risk-off events and sell their speculative high yield holdings.
- If we enter into a high growth, high inflation period then we'll see TLT/HYG spread reverse and the trade will lose. But we are okay with this potential downside because it is our least likely macro scenario at the moment.

Outlook

	Short Term (1-3 Months)	Long Term (1-3 Years)
US Stocks	Bullish	Bearish
US 30 Yr Bonds	Bullish	Bullish
Gold	Bearish	Bullish
Oil	Bullish	Bearish
Coal	Bullish	Bullish
Nat Gas	Bullish	Bullish
Emerging Markets	Bullish	Bearish
US Junk Debt	Bullish	Bearish
US Dollar	Bearish	Bullish
Canada	Bullish	Bearish
China	Bullish	Bearish
Japan	Bullish	Bearish
Eurozone	Bullish	Bearish
Germany	Bullish	Bearish
U.K.	Bullish	Bearish
Italy	Bearish	Bearish
Venezuela	Bearish	Bearish
India	Bullish	Bullish
Russia	Bullish	Bearish
Colombia	Bullish	Bullish
Mongolia	Bearish	Bearish

Portfolio Snapshot

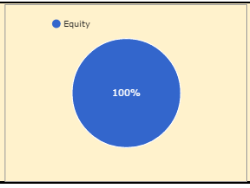
Macro Ops Strategic Portfolio

NAV $1,031,146

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
2.83%	

*Updated 10/5

Macro Ops Income Portfolio

NAV $1,077,216

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 10/5

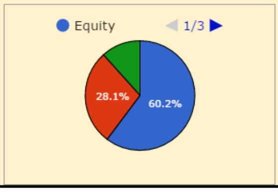
Macro Ops Tactical Portfolio

NAV $919,813.00

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	49.31	$20,590.50	54.33	$184,917
Equity	Mindbody Inc (MB)	5,492	19.88	18.60	20.36	$9,665.92	27.08	$111,652
Commodity	Corn (ZCZ6)	19	345.00	338	348.50	$9,975.00	372.50	$330,838
Commodity	Gold (GCZ6)	-1	1272.37	1311	1269.50	$4,150.00	1209	$127,020
Forex	Pound (6BZ6)	-9	1.2750	1.2875	1.27710	$5,850.00	1.2184	$718,087

Metrics

Exposure Breakdown	
Equity	$30,256.42
Commodity	$14,125.00
Fixed Income	$0.00
Forex	$5,850.00



Total Open Risk
$50,231.42
5.46%

*Updated 10/5

For more information about real time portfolio updates please email alex@macro-ops.com