MARKET BRIEF

School of Athens

Plato, using Socrates as his mouthpiece, wrote the following condemnation of Athenian democracy in his *Republic*:

> *[The citizens] contemptuously rejected temperance as unmanliness… Insolence they term breeding, and anarchy liberty, and waste magnificence, and impudence courage… The father gets accustomed to descend to the level of his sons and to fear them, and the son to be on a level with his father, having no shame or fear of his parents… The teacher fears and flatters his scholars, and the scholars despise their masters and tutors… The old do not like to be thought morose and authoritative, and therefore they imitate the young… Nor must I forget to tell of the liberty and equality of the two sexes in relation to each other… The citizens chafe impatiently at the least touch of authority, and at length…. They cease to care even for the laws, written or unwritten… And this is the fair and glorious beginning out of which springs dictatorship… The excessive increase of anything causes a reaction in the opposite direction;... dictatorship naturally arises out of democracy, and the most aggravated form of tyranny and slavery out of the most extreme form of liberty.*

Plato reduced the evolution of political regimes to a sequence of monarchy, aristocracy, democracy, and dictatorship. In the excerpt above he's commenting on the fraying democracy in Athens that was driven by a widening gap between the rich and poor… sound familiar?

The wealth disparity drove the poor to try and enlarge their cut of the pie through legislation, taxation, and revolution. The rich banded together to protect themselves and their money. This division fractured Athenian society and opened the door for Philip of Macedon to invade and conquer Greece.

Greeks had grown so despondent with their political system that many actually welcomed his conquest. Greek democracy transitioned to dictatorship.

Nearly 300 years later we saw a similar sequence play out in Rome. The Roman Republic from its vast control and exploitation of foreign lands, enormous wealth was created. The new aristocrats curried favor with the leaders in Pompey through bribes and political support. In return, the government began to work for the special interest of the few.

In response, the commoners supported Julius Caesar who took power and established a popular dictatorship. He was then stabbed in the back (literally) by the aristocrats and replaced by another dictator, Gaius Octavius. Democracy became a dictatorship which then became a monarchy. And the political regime wheel continued to spin.

Political regimes like all of nature seem to oscillate between extremes (democracy and autocracy), where each extreme sets the conditions for the inevitable transition towards the other. And how a nation's wealth is divided amongst its people is one of the biggest drivers of this constant transition.

In Will and Ariel Durant's *The Lessons of History* they write that "inequality is not only natural and inborn, it grows with the complexity of civilization. Hereditary inequalities breed social and artificial inequalities: every invention or discovery is made or seized by the exceptional individual, and makes the strong stronger, the weak relatively weaker."

This fact keeps the political system in oscillation between extremes. Where, again to quote both Durants "...freedom and equality are sworn and everlasting enemies, and when one prevails the other dies. Leave men free, and their natural inequalities will multiply almost geometrically, as in England and America in the nineteenth century under laissez-faire. To check the growth of inequality, liberty must be sacrificed, as in Russia after 1917. Even when repressed, inequality grows; only the man who is below the average in economic ability desires equality; those who are conscious of superior ability desire freedom; and in the end superior ability has its way."

When economic prosperity is relegated to a few, society's desire for political freedom becomes merely a conciliatory afterthought. This arises not so much through the wealthy's direct exploitation of the poor but rather due to the increasing complexity of the economy and government. This complexity puts an additional premium upon one's superior ability to navigate it. And this further exacerbates the concentration of wealth and political power.

Running under all of this is the Bridgewater style long-term debt cycle. The wealthy are the creditors that hold the assets, the poor the debtors who hold the liabilities. The larger the balance sheet grows, the more complex the economy and the more enriched the wealthy and the more financially strangled the masses become. Until of course, a natural limit is hit… equality pushes back at freedom… and democracy inches towards autocracy.

The Durant's note that when "our economy of freedom fails to distribute wealth as ably as it has created it, the road to dictatorship will be open to any man who can persuasively promise security to all; and a martial government, under whatever charming phrases, will engulf the democratic world."

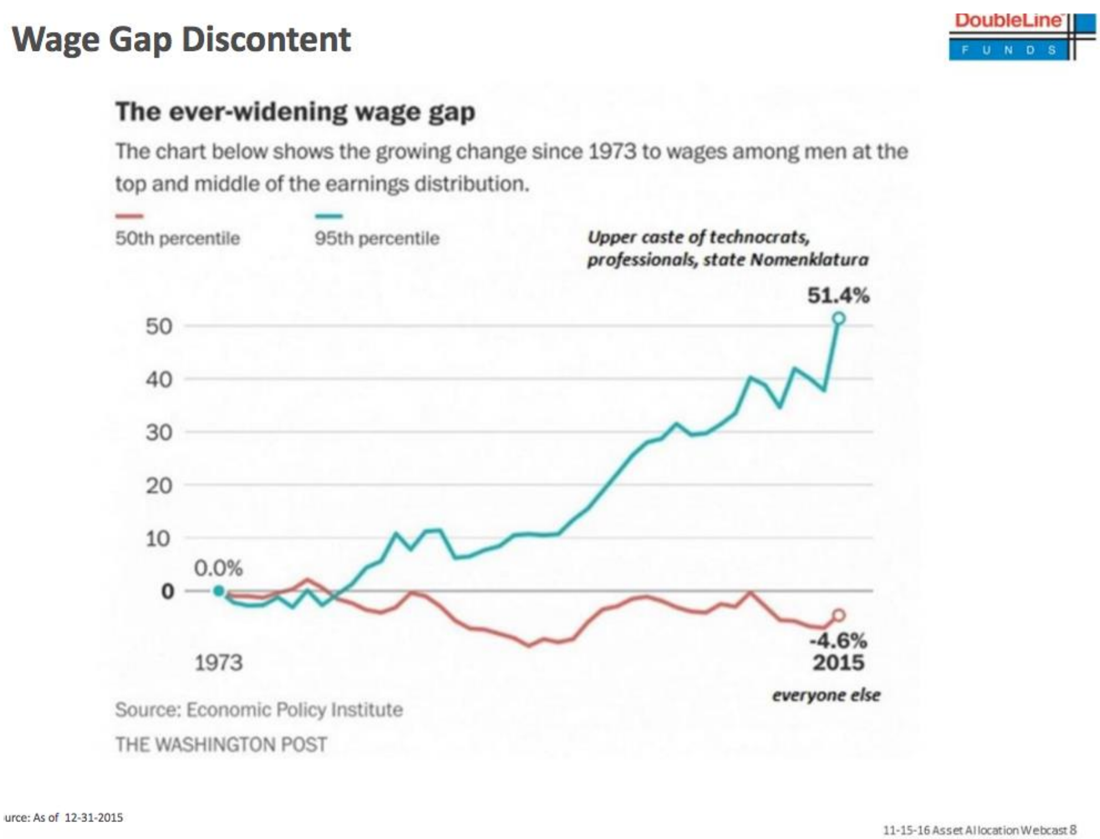
The interesting political events of late (i.e., Brexit, Trump, the rise of nationalist parties in Europe etc.) are not causes but rather effects of the debt cycle and the natural evolution of the political sequence as described by Plato, some 2400 years ago.

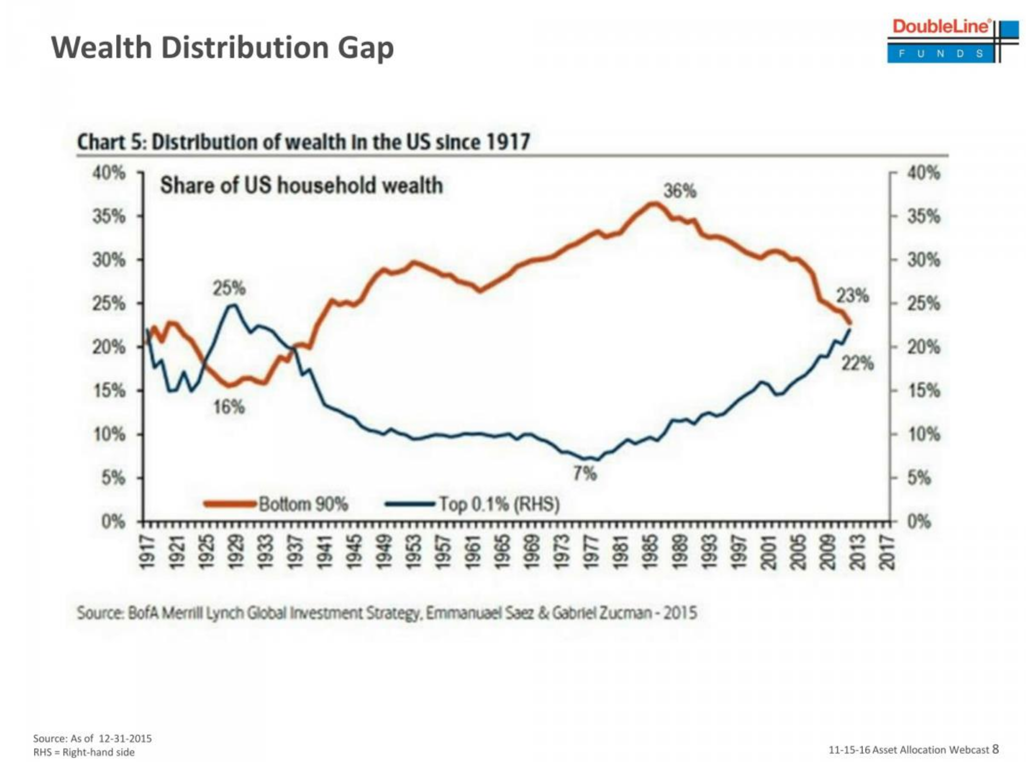
That is not to say we are going to see a shift to dictatorship or anything of the kind in the near future (we aren't)… nor am I saying that is what Trump in any way represents (he doesn't). Rather, I'm talking about the large tidal forces at work; the historical cogs that are turning and driving this rise in populist sentiment; and which will play out for many years to come.

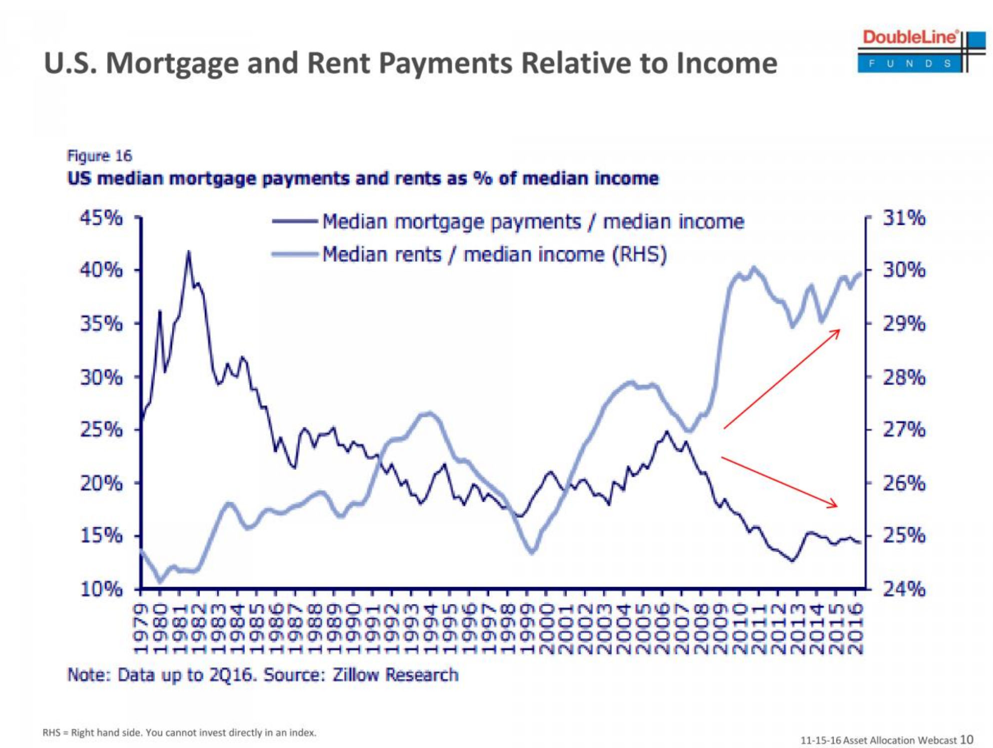
We are witnessing the natural battle between two opposing forces of political and economic nature unfold. Neither is good or bad, they both simply are. Each is embedded in the evolution of our natural system where equilibrium is merely a concept and constant change is a reality.

It is with that understanding that we must judge and assess things to come. Taken in this context, the current insanity of the world begins to make a lot more sense.

Gundlach put out the following charts that show exactly how we got here.







These charts show a completely unsustainable course. The rise in populist politics is *only* just beginning. And with that let's evaluate where we are.

Our first take on Trump

Consensus around what a Trump presidency would mean for markets went quickly from “it’d be an unequivocal disaster” to “it marks the beginning of a new and lasting economic expansion”.

Like usual, reality will be more mixed and nuanced.

To start, the following should be noted:

- Presidents and political parties don’t drive business cycles, they simply enhance or dampen them
- There are still unknowns around what exact policies Trump wants to and will be able to push forward

Liquidity is still the most important factor in today’s market. Thus we must remain focused on the Fed and the action in the US dollar. We’ll discuss both in a bit.

The extremely bullish narrative around Trump’s prospects is based on the belief that his across the board tax cuts, deregulation and massive fiscal spending plan will bring renewed and lasting economic growth.

By themselves, these are economically positive moves. But we need to remember that this isn’t the 1980’s, we are not at the start of a long term leveraging cycle. Demographics, globalization, and technology have changed the macro dynamics and so we should not expect quite the same results.

Here’s what Bill Gross’ (former bond king) wrote recently about the limitations of government policy here.

> *Republican pleas for tax reform are centered around the argument that America has one of the highest corporate tax rates in the world at 35%. Not so. Of the S&P 500’s largest 50 corporations, the average tax rate (including state, local and foreign regulations) is 24%. U.S. corporations rank among the world’s most lightly, as opposed to heavily, taxed. Trump policies also appear to favor the repatriation of trillions of dollars of foreign profits at extremely low cost under the logic that the money will be spent for investment here in the U.S. Doubtful.*
>
> *The last time such a “pardon” was put into law in 2004, no noticeable pickup in investment took place. Of the $362 billion that earned a “tax holiday”, most went to dividends, corporate bonuses, and stock buybacks. Apple or any other large U.S. corporation can borrow the money they need here in the U.S. at historically low interest rates to fund investment. A few have, but over $500 billion annually in recent years has gone to the repurchase of corporate stock and the increase of earnings per share, instead of earnings and GDP growth. Why would they need to repatriate anything for investment in the real economy?*

Suggesting that the US is the “world’s most lightly” taxed country is a bit of a stretch on Gross’ part. Our statutory rate is one of the highest in the developed world but in reality, after deductions and other exclusions are taken into account, the US sits at about the middle of the pact of advanced economies. But Gross does have a good point about the realistic impact of such cuts and foreign profit repatriation. We will likely experience some short-term benefits of such moves but it's doubtful to move the needle much. More importantly, these tax reforms will disproportionately benefit the wealthy over the struggling lower working class that elected Mr. Trump.

The most significant policy put forth by Trump is his large fiscal spending and infrastructure plan. If enacted in full, it will undoubtedly produce demand driving gdp growth. It will also be a boon to the construction industry and benefit those who are employed in that sector. But even here it's not all cigars and whiskey.

The bipartisan and independent Committee for a Responsible Federal Budget estimates that Trump's programs will add an additional $3-4 trillion to our outstanding public debt. The Tax Policy Center suggests that by 2020 we will run a deficit of around 5.5% of GDP.

Combined with tax cuts, these policies will lead to large twin deficits which will need foreign financing from countries such as China. A country he has threatened with protectionist measures.

So things are not as straightforward as some may think. Reagan had to quickly reverse course on his tax cuts after just two years when the deficit got out of hand. And he responded with policy that constituted the biggest tax increase ever enacted during peacetime. Reagan's move was buffeted by secularly falling interest rates… Trump will face the opposite.

All in all Trump's policies — the ones likely to be passed at least — are equity positive but they are also not game changers in and by themselves.

The most important takeaway from this election and the backlash we're seeing around the rest of the world is that the austerity narrative is now dead.

The concern over public debt that put many "Tea Party" republicans into congress has now clearly been supplanted by the "growth at any costs" narrative. We are seeing a global shift from fiscal austerity to a call for free spending.

This is a massive regime change that will impact markets over the coming decade.

Ray Dalio of Bridgewater wrote the following this week.

> *As far as the ideology part of that assessment goes, we believe that we will have a profound president-led ideological shift that is of a magnitude, and in more ways than one, analogous to Ronald Reagan's shift to the right. Of course, all analogies are also different, so I should be clearer. Donald Trump is moving forcefully to policies that put the stimulation of traditional domestic manufacturing above all else, that are far more pro-business, that are much more protectionist, etc. We won't go down the litany of particulars about the directions, as they're well known, discussed in my last Observations, and well conveyed in the recent big market moves. As a result, whereas the previous period was characterized by 1) increasing globalization, free trade, and global connectedness, 2) relatively innocuous fiscal policies, and 3) sluggish domestic growth, low inflation, and falling bond yields, the new period is more likely to be characterized by 1) decreasing globalization, free trade, and global connectedness, 2) aggressively stimulative fiscal policies, and 3) increased US growth, higher inflation, and*

rising bond yields. Of course, there will be other big shifts as well, such as pertaining to business profitability, environmental protection, foreign policies/alliances, etc.

...All this, plus fiscal stimulus that will translate to additional economic growth, corporate tax changes, and less regulation will on the margin be good for profitability and stocks, though for domestically oriented stocks more than multinationals, etc. The question will be when will this move short-circuit itself—i.e., when will the rise in nominal (and, more importantly, real) bond yields and risk premiums start hurting other asset prices. That will depend on a number of things, most importantly how the rise in inflation and growth will be accommodated...

We've been remarking on this coming regime change for weeks now. Dalio thinks "there is a good chance that we are at one of those major reversals that last a decade (like the 1970-71 shift from the 1960s period of non-inflationary growth to the 1970s decade of stagflation…)" and we believe he's right. We can see on the graph below (*via Bridgewater)* how asset returns can vary between different market regimes that typically last a decade.

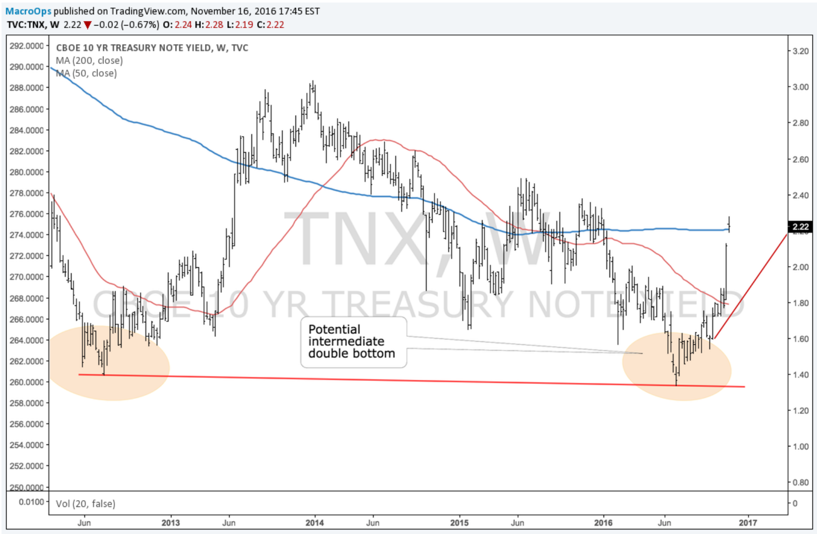
Asset Class Real Returns by Decade

	1920s	1930s	1940s	1950s	1960s	1970s	1980s	1990s	2000s	2010s
Stocks	15%	0%	3%	17%	5%	-1%	13%	15%	-3%	11%
Bonds (at Eq Vol)	9%	14%	4%	-3%	-5%	-1%	11%	8%	10%	7%
Commodities	0%	0%	3%	0%	1%	14%	5%	1%	3%	-12%
Gold	0%	7%	-4%	-4%	-3%	24%	-8%	-6%	12%	0%

But like all large transitions the process is unlikely to be quick or smooth. In the near term I expect volatility to increase across the board. The 30 year bond bull market is over, but that doesn't mean rates will move straight up. I expect we see a topping process play out over the coming months that will be dominated by violent swings — as we've seen recently — in both directions. Equities and currencies will all key off of this.

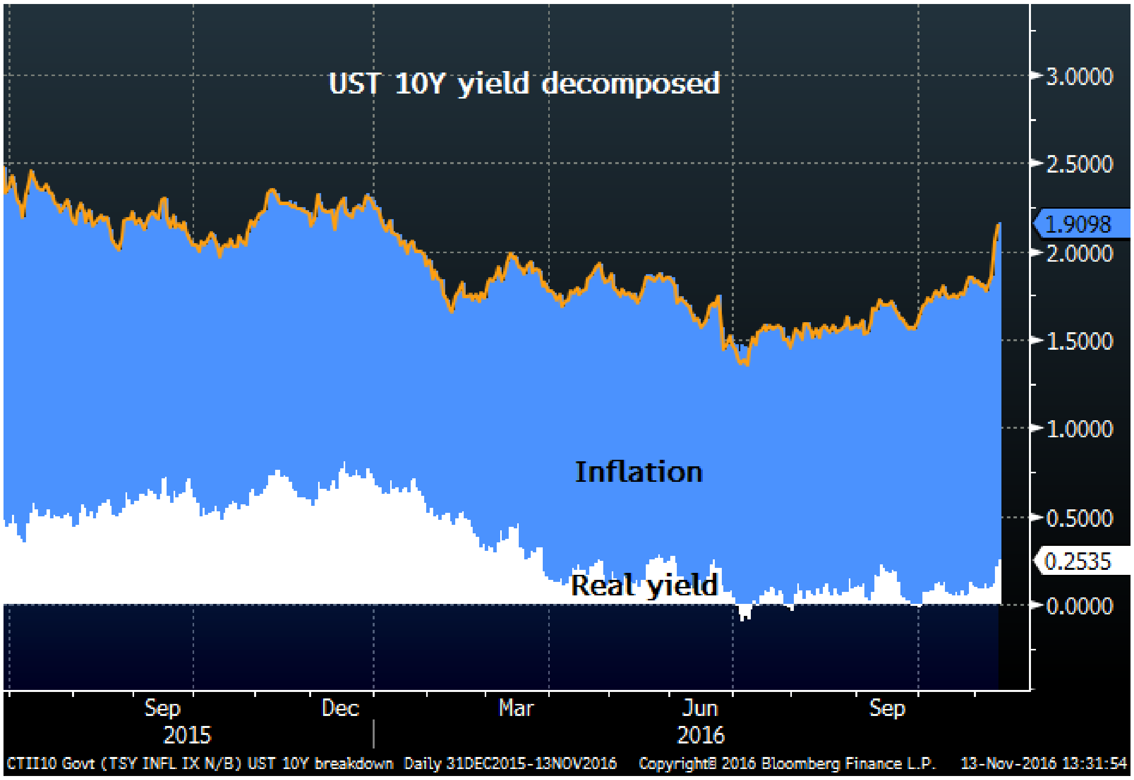
Macro and Tactical

I put out this chart in late September noting a potential double bottom on the 10-year treasury. It has since climbed up to 2.2%. A level not seen since late 2015.

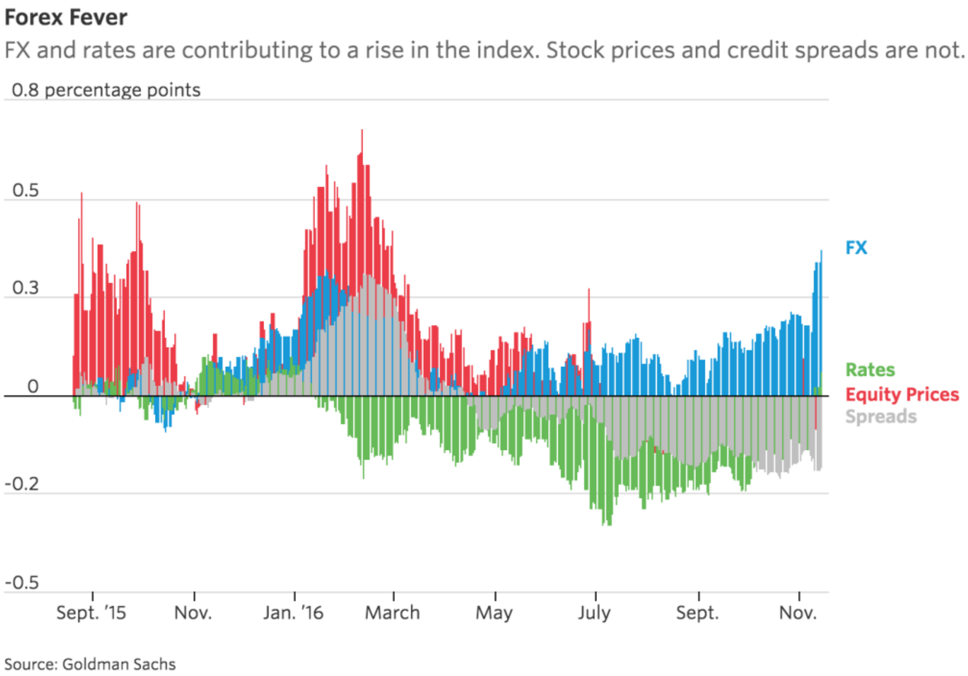


Though I think the bottom in rates is in, I believe this selloff is overextended and for those looking for a swing trade, buying the long bond might be worth a look here.

The rise in rates is driven not only by inflation expectations (which have skyrocketed since the election) but also because of an overall tightening in financial conditions, which you can see on the chart below.



And here's a financial conditions chart via Goldman that shows the recent tightening in liquidity is being primarily driven by Forex. Forex is referring to the rising dollar.



So even after Brexit and the surprise election of Donald Trump as the next US president we still come back to where we started. The US dollar.

For those of you interested in reading more about the dollars role in global finance and how it has in ways unseated the VIX as a gauge of investor fears, read this excellent [article from the FT](). Also go back and read what I wrote on the strange things going on in covered-interest-parity in the Brief "[Chaos Is A Ladder]()"… it's some interesting stuff.

The dollar continues to be driven by diverging monetary policy (US on a tightening path while ROW still easing) and the accelerating depreciation of the Chinese yuan.

I have written extensively about the yuan over the last year. One of Trump's first initiatives is to label China as a currency manipulator. Though this isn't true it plays well politically. And it looks like China may use this as cover and to let the market take over its pricing.

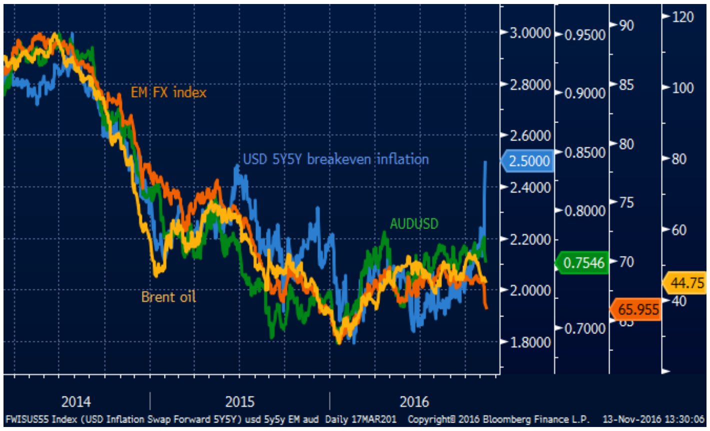
If we don't soon see a reversal in the yuan then there's a good chance the CCP will soon let it run.

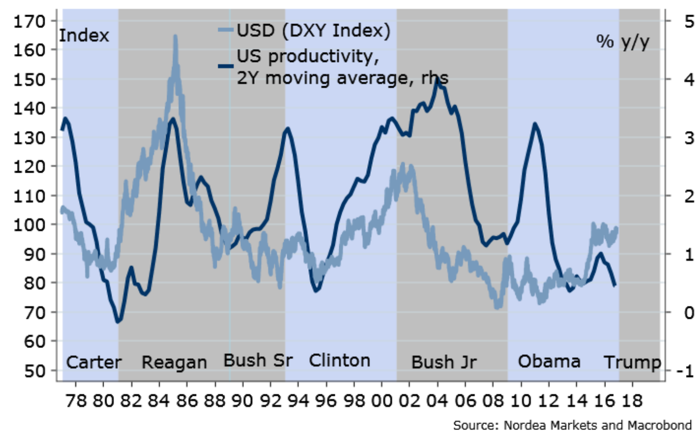
And like I've written about countless times now, if this happens the dollar will shoot through the roof, commodities will collapse and equities will spiral down. Deflation will spread around the world.

The dollar is close to experiencing significant technical breakouts in multiple crosses at the moment. My belief is that we see the dollar retrace soon but since it's nearing a critical juncture, price action has to be respected. A confirmed breakout would drastically alter my short-term positioning.

Yellen will be speaking on Capitol Hill this Thursday. Following the presidential election and the recent rise in rates, I would not be surprised if Yellen puts on her dovish hat in an attempt to cool the selloff in bonds.

The two charts below from Nordea Markets, show the correlation between US productivity and the dollar as well as inflation expectations in relation to Brent oil, AUDUSD, and EM FX Index. You can clearly see there's a growing divergence. Either the dollar needs to reverse from here or inflation expectations inflation expectations should collapse.





Which way this divergence resolves will have big implications for various markets moving forward.

If we do see the dollar reverse then it may be a good opportunity to load up on some miners — gold and silver are both at short-term oversold levels.

I added a number of starter positions in the Strategic Portfolio on Tuesday. All of the stocks are beaten down value plays that should benefit from the Trump reflation narrative.

NMM, LPG, and GASS are shipping companies which have been going through a violent repricing these last few days. I've been watching the shipping sector for a few months now, patiently waiting for a buying opportunity. I'm not convinced that this is the start of a new bull market in shippers but I like the price action nonetheless. I'll be quick to cut should price reverse from our entry point.

There's a number of other potentially lucrative trades I'm watching but am waiting for market confirmation on where things are headed in the near term first. I remain patient, but as volatility picks up you'll see the Strategic Portfolio get a lot more active than it has been over the previous few months.

Conclusion

Markets are going through a big change. Volatility is picking up and is here to stay. There remains a large number of uncertainties but these should be resolved in the coming months.

Inflation and higher rates are definitely in our future but it won't be a direct path there. The speed at which the consensus switched from "rates will remain low for long" to "we're in a rising rate environment" makes me think we'll likely see a good deal of chop in both directions. In other words, the bond bull is dead but the top is still playing out and will for some time.

The big tech multi-nationals have been getting kneecapped and rightfully so. Many of them are grossly overvalued and Trump's protectionist talk does not bode well for their outlook. As populism becomes a more dominant force in our politics, expect our leaders to turn their attention to the large tech companies that are automating away jobs. This story has played out repeatedly throughout history and will do so again.

I've long been amazed how this possibility was being completely disregarded in large tech valuations. That oversight is now being repriced and we should expect that narrative change to impact their pricing well into the near future.

Until next week; watch the dollar, watch the dollar, watch the dollar.

Markets are getting interesting again.

Have a good week.

-Alex

Portfolio Snapshot

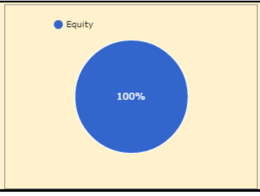
Macro Ops Strategic Portfolio

NAV $1,034,274

Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target 1	Beta (1yr)	Notional
Equity	Stealth Gas GASS	7,800	$3.90	$3.27	$4,914.00	$6.00	2.26	$30,186.00
Equity	Goldfield GV	6,300	$3.10	$2.52	$3,654.00	$4.50	1.81	$19,530.00
Equity	Intrepid IPI	45,000	$1.32	$1.09	$10,350.00	$3.50	-0.37	$56,700.00
Equity	Dorian LPG	9,500	$6.99	$6.15	$7,980.00	$9.59	2.33	$69,445.00
Equity	Whiting Petroleum WLL	5,000	$9.18	$8.10	$5,400.00	$16.42	2.94	$45,750.00
Equity	Navios Maritime NMM	7,600	$1.75	$1.36	$2,964.00	$3.33	4.46	$18,544.00

Metrics

Exposure Breakdown	
Equity	$35,262.00
Commodity	$0.00
Fixed Income	$0.00
Forex	$0.00



Total Open Risk	Portfolio Beta
$35,262.00	0.45
3.41%	

*Updated 11/16

Macro Ops Income Portfolio

NAV $1,081,422

Asset Class	Position	Size	Cost Basis	Max Profit
Option	SPX Dec 15 2045 Put	-10	$15.38	$15,380.00
Option	SPX Dec 15 1600 Put	10	$1.06	Hedge
Option	VIX Dec 20 15 Puts	800	$1.21	~

Scenario Analysis/Stress Tests

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

**Updated on 11/16

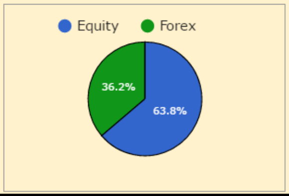
Macro Ops Tactical Portfolio

NAV $956,972.00

Asset Class	Position	Size	Cost Basis	Risk Point	Market Price	Open Risk	Target 1	Notional
Equity	First Solar FSLR	-2,000	$32.49	$37.00	$28.77	$16,460.00	$19.66	$64,000
Forex	Euro (6EZ6)	-7	$1.0859	$1.0941	$1.07130	$19,950.00	$1.0470	$937,431
Forex	Yen (6JZ6)	-3	$0.9224	$0.9434	$0.91920	$9,056.25	$0.8738	$344,737
Equity	Natrl Resource Prtnrs NRP	1,000	$36.00	$29.32	$38.40	$9,080.00	$61.12	$38,400
Equity	Transports IYT	844	$154.00	$145.81	$157.45	$9,824.16	$176.43	$132,888
Equity	S&P 500 (ESZ6)	6	$2,156.25	$2,138.00	$2,176.25	$11,475.00	$2,221.00	$652,950
Equity	GDX	-2,820	$20.85	$23.31	$21.81	$4,230.00	$13.75	$61,617

Metrics

Exposure Breakdown	
Equity	$51,069.16
Commodity	$0.00
Fixed Income	$0.00
Forex	$29,006.25



Total Open Risk
$80,075.41
8.37%

**Updated 11/16