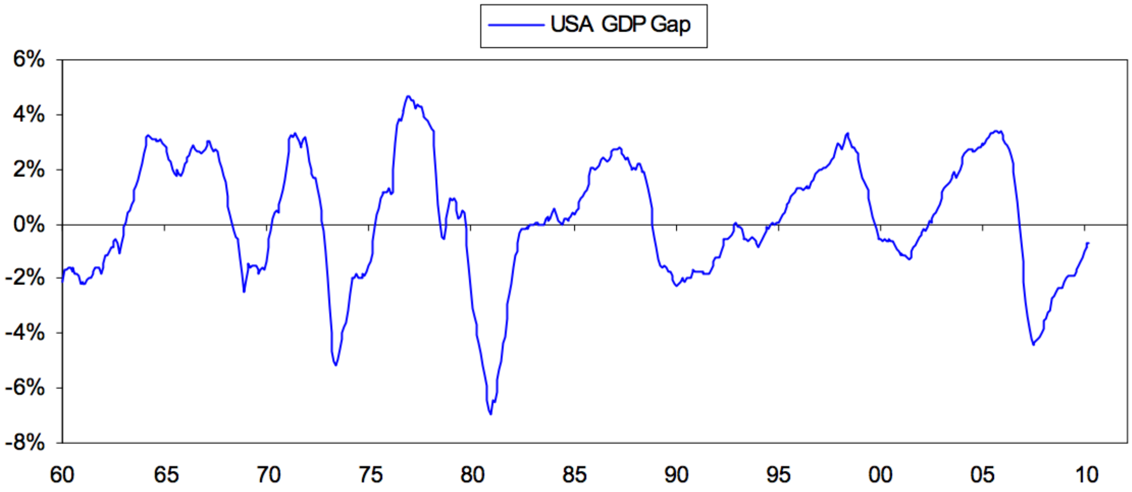
# Mind The Gap


From Bridgewater's *How the Economic Machine Works (emphasis mine):*

> *The short-term debt cycle, also known as the business cycle, is primarily controlled by central banks' policies that a) tighten when inflation is too high and/or rising uncomfortably because there isn't much slack in the economy (**as reflected in the GDP gap, capacity utilization and the unemployment rate**) and credit growth is strong; and b) ease when the reverse conditions exist. The cycles in the U.S. since 1960 are shown below.*




GDP gap, otherwise known as the output gap, is a closely watched model by many economists and central bank overlords.

It measures the difference between the actual output of an economy against its potential. An economy's potential gdp is the theoretical maximum amount of goods and services it can turn out when it's at full capacity.

Here's the IMF on the utility of monitoring GDP gap:

> *Just as GDP can rise or fall, the output gap can go in two directions: positive and negative. Neither is ideal. A positive output gap occurs when actual output is more than full-capacity output. This happens when demand is very high and, to meet that demand, factories and workers operate far above their most efficient capacity. A negative output gap occurs when actual output is less than what an economy could produce at full capacity. A negative gap means that there is spare capacity, or slack, in the economy due to weak demand.*
>
> *An output gap suggests that an economy is running at an inefficient rate—either overworking or underworking its resources.*
>
> *One thing that concerns economists and policymakers about these ups and downs (commonly called the business cycle) is how close current output is to an economy's long-term potential output. That is, they are interested not only in whether GDP is going up or down, but also in whether it is above or below its potential.*

Now there is no actual fixed potential GDP number. Potential GDP is just an estimate that tries to best gauge the most efficient output levels of an economy by looking at things like capacity utilization, productivity, and unemployment.

Economists care about GDP gap primarily because of its relationship to inflation. Here's the IMF again (emphasis mine):

> *Policymakers often use potential output to gauge inflation and typically define it as the level of output consistent with no pressure for prices to rise or fall. In this context, the output gap is a summary indicator of the relative demand and supply components of economic activity. As such, the output gap measures the degree of inflation pressure in the economy and is an important link between the real side of the economy—which produces goods and services—and inflation. All else equal, if the output gap is positive over time, so that actual output is greater than potential output, prices will begin to rise in response to demand pressure in key markets. Similarly, if actual output falls below potential output over time, prices will begin to fall to reflect weak demand.*
>
> ***The output gap can play a central role in policymaking. For many central banks, including the U.S. Federal Reserve, maintaining full employment is a policy goal. Full employment corresponds to an output gap of zero. Nearly all central banks seek to keep inflation under control, and the output gap is a key determinant of inflation pressure.***

That last paragraph is why we as traders need to mind the (GDP) gap.

Inflation and inflation expectations are the primary factors dictating central bank policy and the setting of interest rates.

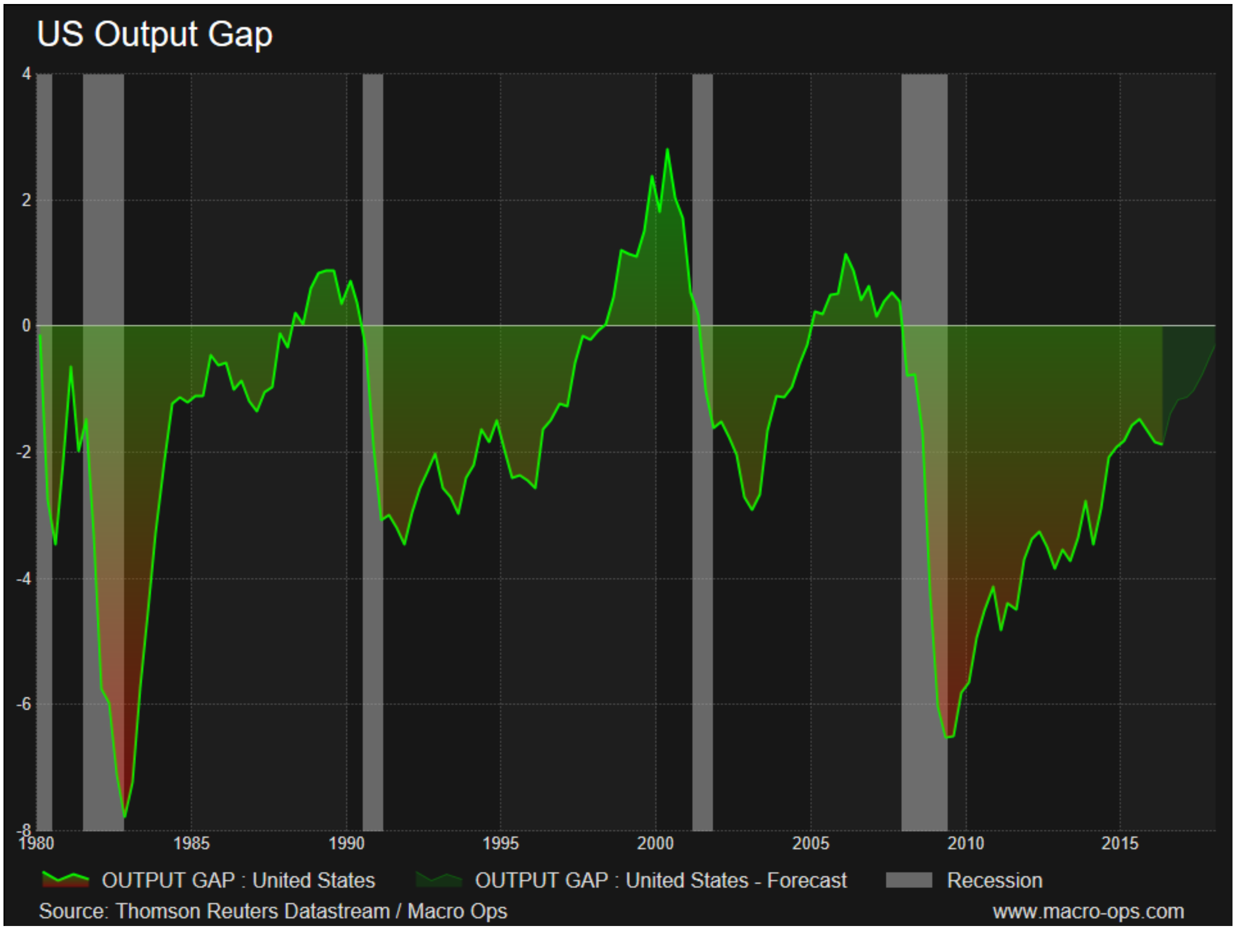
Since liquidity (credit and risk premiums) are the primary drivers of markets, and central bankers are the primary drivers of liquidity, we need to track what they track to anticipate the direction of their policy and its effect on liquidity.

This is why GDP gap is one of the primary data points Bridgewater uses to gauge where we are in the credit cycle. Here's the following from a speech Ray Dalio gave to a group of bankers back in October explaining where we are in the economic cycle:

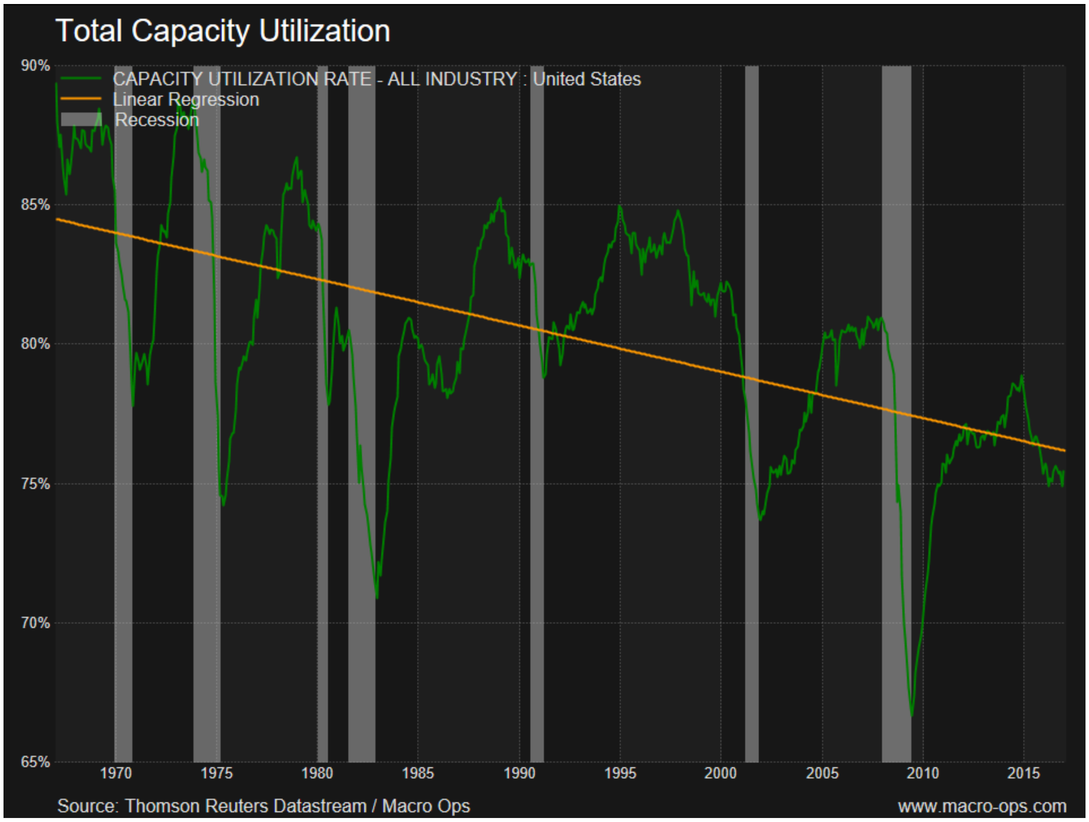
> *The most important differences that will exist in the future that did not exist in the past are that debt will not be able to rise as fast and the capital markets transmission mechanism won't work as well, as interest rates can't be lowered and risk premiums of other investments are low and shrinking. If appropriate risk premiums don't exist, the transmission mechanism of capital won't work as well and the economy will grind to a halt. For these reasons major central banks are facing a "pushing on a string" situation. The last time this happened was in the late 1930s.*
>
> *There are two levers that policymakers use to bring about these equilibriums:*
>
> *1) Monetary policy, which operates via interest rate changes and "quantitative easings", which depend on significant central bank purchases and appropriate capital market risk premiums, and*
>
> *2) Fiscal policy, which depends on political coordination both within the central government and with the central bank's monetary policy.*
>
> *Economic and market movements are like a perpetual motion machine of interactions of these. The most profound differences that now exist are the relative impotence of monetary policy and political fragmentation that makes coordination of fiscal and monetary policies hard to imagine.*
>
> *By and large:*
>
> *1) Productivity growth is slow, though properly accounting for it has never been more difficult*
>
> *2) The short-term debt/business cycles as measured by GDP gaps are closer to their mid-points than to their extremes, and*
>
> *3) The long-term debt cycles are approaching their very late-stages as debts can't be raised much and central banks are approaching "pushing on a string" limitations to their effectiveness.*
>
> *The biggest issue is that there is only so much one can squeeze out of a debt cycle and most countries are approaching those limits. In other words, they are simultaneously approaching both their debt limits and central banks' "pushing on a string" limits. Central banks are approaching their "pushing on a string" limits both because interest rates are approaching their maximum lows, and because the effectiveness of QE is approaching its limits as the risk premiums and spreads are compressing. Also, the wealth gap and numerous other factors make lending to spenders more challenging. This is a global problem. Japan is closest to its limits, Europe is a step behind it, the US is a step or two behind Europe, and China is a few steps behind the United States.*

Take a look at the chart below and you can see what Dalio is talking about. The GDP gap is still below its theoretical level of maximum output but it's forecasted to exceed potential output by the end of this year.

This means that the recent pickup in inflation is mostly due to base effects versus capacity constraints. So we shouldn't see strong demand-pull inflation until later in the year once the slack is rung from the system. But of course this is just the measure of actual inflation drivers. It says little about inflation expectations which are also driven by expectations surrounding fiscal policy.

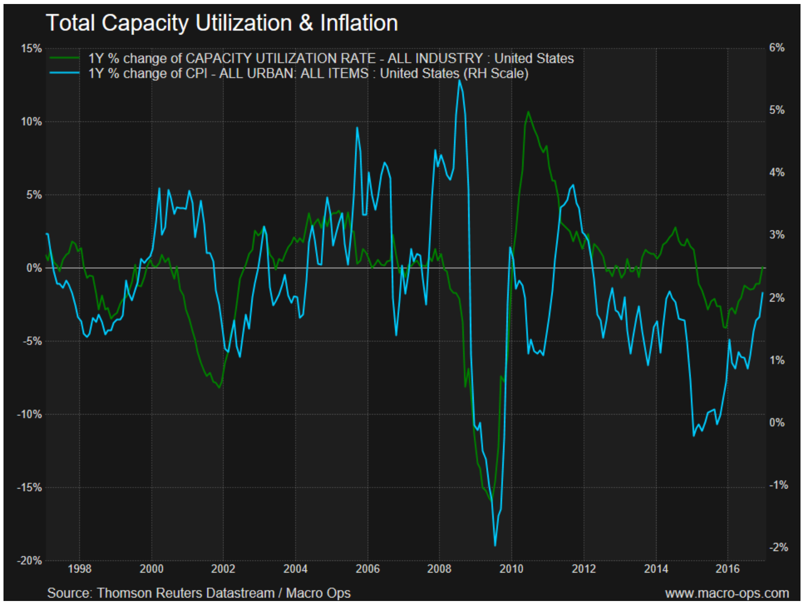



Another leading indicator of inflationary pressures is the total capacity utilization rate. Capacity utilization is the total percentage of US production capacity being used (ie, mining, manufacturing, utilities etc). This is one of the primary indicators used by the Economic Cycles Research Institute (ECRI) in their recession models.




The chart shows a similar picture to that of the GDP gap. We're currently below the 45-year linear regression trendline of our average capacity utilization percentage.

You can see the direct relationship between capacity utilization and the rate of inflation in the chart to the right. When you include the trend in the US dollar and the CRB commodities index, along with corporate and household interest payments relative to income, you arrive at a pretty good model for gauging inflation pressures (I'm going to write a stand-alone piece about this in the future).



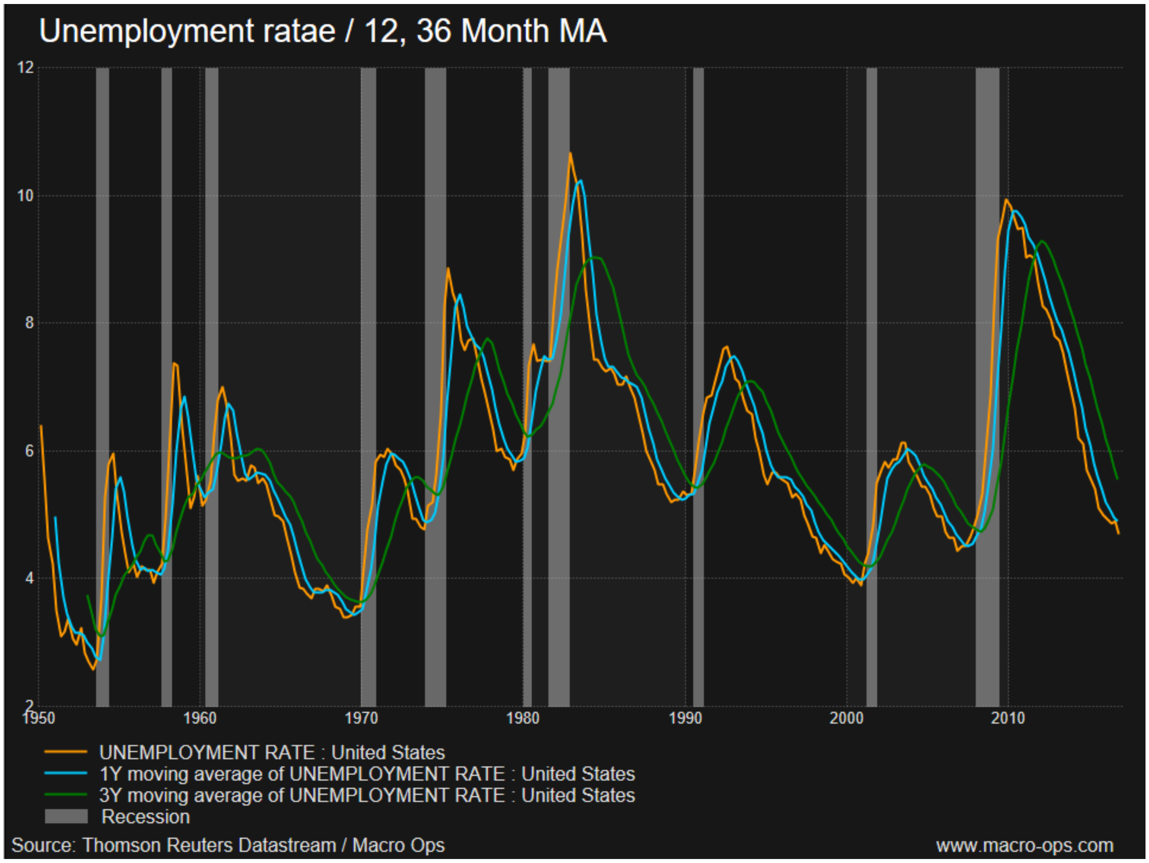

Lastly, to determine where we are in the short-term debt cycle, we can look at one of my favorite charts — the unemployment rate overlaid with both a 12 and 36 month moving average (the same chart that is hung up on our Dashboard).

The unemployment rate is just another way to gauge the economy's capacity utilization since labor is a resource like anything else.

Labor is also the highest cost in producing things. That's why when the labor market tightens inflationary pressures build because slack is removed and companies have to pay more in wages to compete for labor. Those rising costs get passed through to consumers.

The resulting inflation is what drives the Fed to tighten, which pulls liquidity from the system and widens risk-premium spreads. This in turn causes the short-term debt cycle to turn over (bear market) and the unemployment rate to go back up. That's exactly why this is such a good leading indicator of recessions.

The chart right now shows what both the GDP gap and capacity utilization charts show — that we're nearing the final innings of this business cycle but still have a bit more to go.




PTJ hit the nail on the head when he said, "You look at every bear market and they've always basically occurred because of an uptick in inflation and an uptick in interest rates."

Tight capacity leads to inflation, inflation leads to higher rates, and higher rates widen risk spreads and tighten liquidity causing bear markets and recessions.

If we mind the gap, we'll stay one up on inflationary pressures and expectations, and the resulting Fed response to both.

**Macro: Two Opposing Forces**

I went to the presidential inauguration yesterday.

I can think of a million better ways to spend my Friday — like looking at charts and playing around on my new Eikon terminal, or even just staring out my window watching leaves fall off the tree outside my office — but no such luck.

That has nothing to do with the incoming administration in particular. I just don't like political rallies or large crowds of people… or doing anything that takes me away from markets for the day.

I was dragged there by my girlfriend. She works next door to the Capitol building and her company was throwing an inauguration party on the rooftop where CNN was taping from.

I was surrounded by a bunch of lobbyists, bankers, and political types who think themselves very important.

If it wasn't for the open bar… it would have been unbearable.

The one mildly interesting part of the whole day was the group of high-rolling investment bankers getting loaded on bloody marys. I used the occasion as an opportunity to do some market sentiment polling.

On the whole, they couldn't possibly be more bullish. Not just on markets, but on the prospects for bankers in particular. They were all firmly in the camp that the incoming administration was going to be *very* friendly to Wall Street.

It left me wondering if they had just watched the same inauguration address I did.

Trump's strong populist narrative certainly doesn't seem to square with a bright horizon for Wall St. bankers, but maybe I'm missing something.

The big macro wild card of late has been what Trump's actual agenda will look like once his administration gets going; especially in respect to the dollar. Recent remarks from Trump and company are starting to provide some clarity here.

This past week the Trump camp made some notable comments about the dollar. Here's the following via the WSJ (emphasis mine).

> *In his interview with the Journal on Friday, Mr. Trump said the U.S. dollar was already "**too strong**" in part because China holds down its currency, the yuan. "**Our companies can't compete with them now because our currency is too strong. And it's killing us.**"*
>
> *The yuan is "dropping like a rock," Mr. Trump said, dismissing recent Chinese actions to support it as done simply "because they don't want us to get angry."*
>
> *Mr. Trump appears to be breaking with a recent tradition of presidents refraining from comments on the dollar's level.*

> *In another part of the interview,* ***Mr. Trump said the U.S. might need to "get the dollar down"*** *if a change in tax policy drives it higher. "Having a strong dollar has certain advantages, but it has a lot of disadvantages," he added.*

Here's the following from the "Mooch", Anthony Scaramucci, one of Trump's closest advisors via the *WSJ (emphasis mine)*.

> *Mr. Scaramucci said that while "***we have to be careful about a rising" dollar,*** "if you get better than expected growth in the U.S., you can have a strong dollar and robust growth in the U.S. that will lift the global economy. "Growth will solve many of the problems on the table," he said.*

And via the FT.

> ***Without committing to avoid intervention to lower the dollar's value****, Mr Scaramucci said he hoped that if the new administration could create fast growth, it would allow the US to deal with the tighter monetary conditions that come with a higher currency. "The truth of the matter is none of us really know what is going to happen," he admitted. "What I think will most likely happen is that we'll implement an infrastructure policy plan which is fairly dynamic, we'll have a tax plan which is a lot more simple; and there will be a regulatory and executive order roll back very quickly."*
>
> *"You might not like the answer, but if you get better than expected growth in the US, even if the dollar is going up, we saw in the 1980s, you can have a strong dollar and fairly robust growth in the US that will lift the global economy."*

If you remember I wrote the following in last month's MIR:

> *The new administration rode a wave of populism into the white house. Trump's platform is centered around American interest first and doing whatever it takes to bring back jobs, especially in the rust belt.*
>
> *Many of those jobs are manufacturing jobs. US manufacturers don't benefit from a rising dollar. Accusing China of artificially keeping the yuan weak in order to gain export share was a constant focus of the Trump campaign.*
>
> *So it's not difficult to imagine a scenario where the dollar rises enough to cause the Trump administration to intervene and reverse it. Similar to what Reagan's Secretary of Treasury Jim Baker did in 85', with the Plaza Accord.*

It's safe to say that the Trump administration would like a weaker dollar. But they may not care to actively push for a weaker dollar unless they feel it's significantly hurting US growth; especially the manufacturing sector.

So a Vicious Circle is our most likely future, but how quickly it comes is tough to say. And that's because we have a Fed that's becoming increasingly more hawkish.

From the *FT (emphasis mine).*

> *Janet Yellen, the Fed chair, has warned that the US risks a "nasty surprise" if it waits too long to continue raising interest rates, adding that* ***she expects the US central bank to tighten monetary policy a few times a year until 2019.***
>
> *Following the Fed's December decision to raise short-term interest rates for the second time in a decade, Ms Yellen said on Tuesday:* ***"Waiting too long to begin moving toward the neutral rate could risk a nasty surprise down the road — either too much inflation, financial instability or both." Delaying could force the Fed to catch up by raising rates rapidly, she said, which could in turn push the economy into a new recession.***

It's not just Yellen either, other members of the Fed board are beginning to show their talons as well.

The most notable being Lael Brainard who, until very recently, has been the most vocal dove on the board. Since the election of President Trump she has "astonishingly" become more open to running a tighter monetary policy.

Is this more aggressive hawkish tone in some part politically driven? I'll let you decide. But Jesse Livermore (twitter handle) wrote a pretty apt thread on it if you care to check it out here.

Where does that leave us?

Well, we have two opposing forces (1) an administration that openly wants a weaker dollar especially if it starts hindering growth and (2) a Fed that is leaning towards more aggressive tightening (perhaps partially due to political reasons) even though there's still clearly some capacity left in the system.

I'm sticking with my original call in the MIR. We're likely to see a sizable selloff (lasting perhaps a few months) in the dollar over the near-term. This is due to positioning and sentiment (the dollar is one of the most overweighted holdings right now).

The retrace in the dollar will push the "need for a weaker dollar" to the back of the Trump administration's agenda. It will also boost inflation expectations in the short-term and provide more cover for the Fed to be aggressive.

This monetary policy divergence will ultimately lead to a much stronger dollar and an eventual attempt at a Plaza Accord type deal to reverse course much further down the road (think 12-18 months out).

But I should say, when politics becomes a bigger factor in macro, as they have now, the game becomes a lot more unpredictable. This is doubly true when you're dealing with someone like Trump who's a very unpredictable player.

So we'll keep strong opinions *very* weakly held going forward and adjust fire as we move.

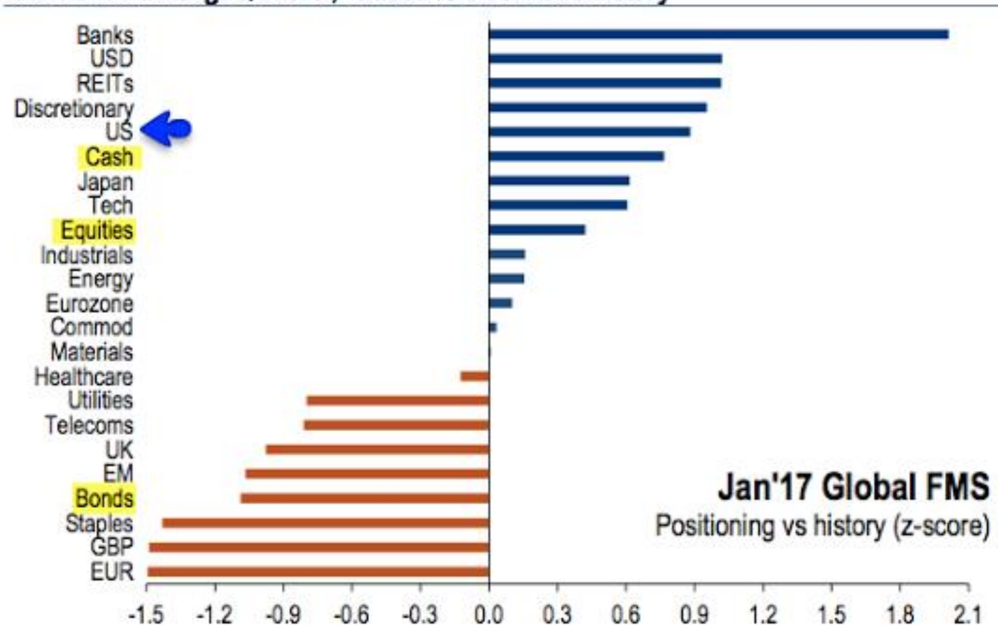
**Technical: A Short-Term Shift?**

BofA's latest global fund manager survey is out. It gives us some key insights into the positioning of many of the big players. You can find the whole rundown of the survey at The Fat Pitch blog [(link here).](#)

The report should be read from a contrarian perspective. When there's one-sided sentiment/positioning in an asset, it typically means there's a lot of people who are about to be wrong.

When combined with technicals, the two assets that stick out the most to me are financials and bonds.

Exhibit 1: The Longs & Shorts, relative to Global FMS history*

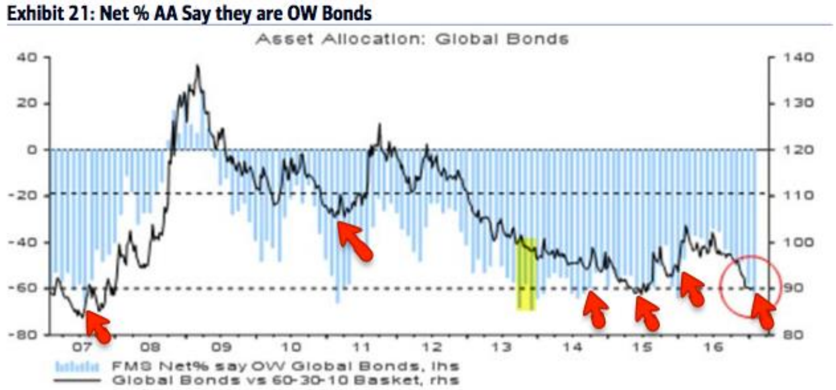



Source: BofA Merrill Lynch Global Fund Manager Survey

Bank stocks have risen on expectations of higher rates and fatter net-interest margins. Bonds have sold off on the belief that we're entering a period of higher growth / higher inflation.

This sentiment may ultimately be right, but trends never play out in a straight line.

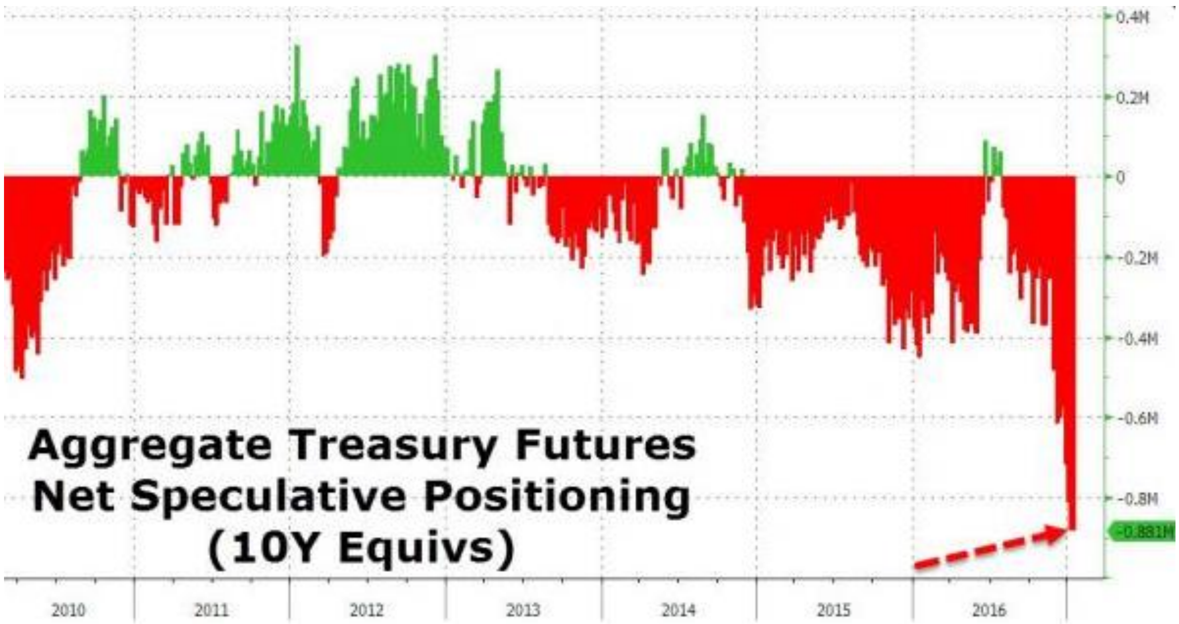
Exhibit 21: Net % AA Say they are OW Bonds




Source: BofA Merrill Lynch Global Fund Manager Survey

Stocks and bonds move in waves. They're constantly being pushed by the trend while being pulled back by mean-reversion.

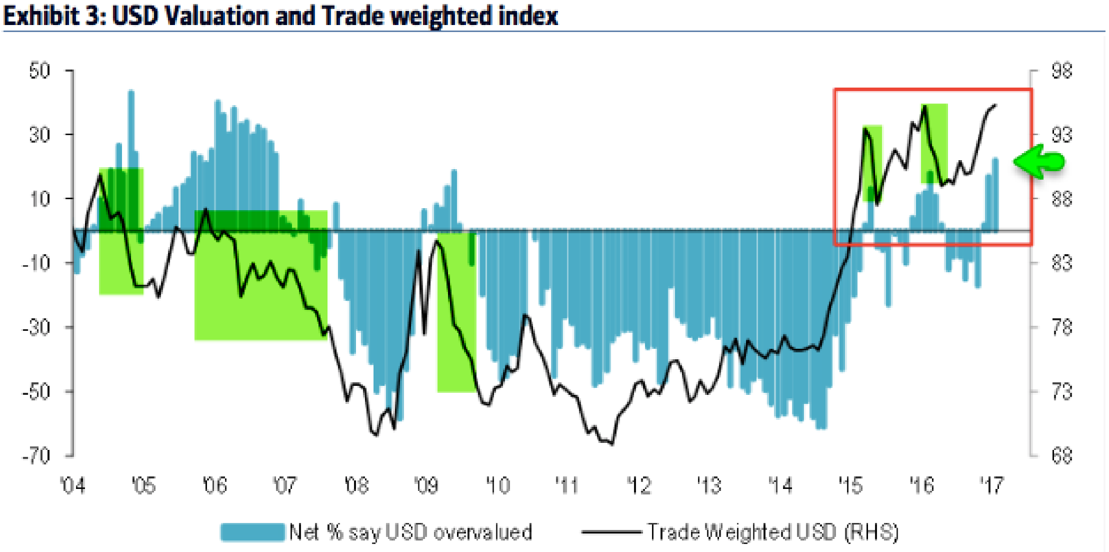
It looks like bonds are nearing the point where mean-reversion will come into play. This case is supported by the extreme sentiment we're seeing against bonds. Speculative net-short positioning is at its highest level ever.




I'd thinking about opening a swing long position in bonds but it's still probably a little early for that. I could see them making another short-term new low on a coming period of risk-on.

The next chart supports the case for a dollar selloff.

**Exhibit 3: USD Valuation and Trade weighted index**

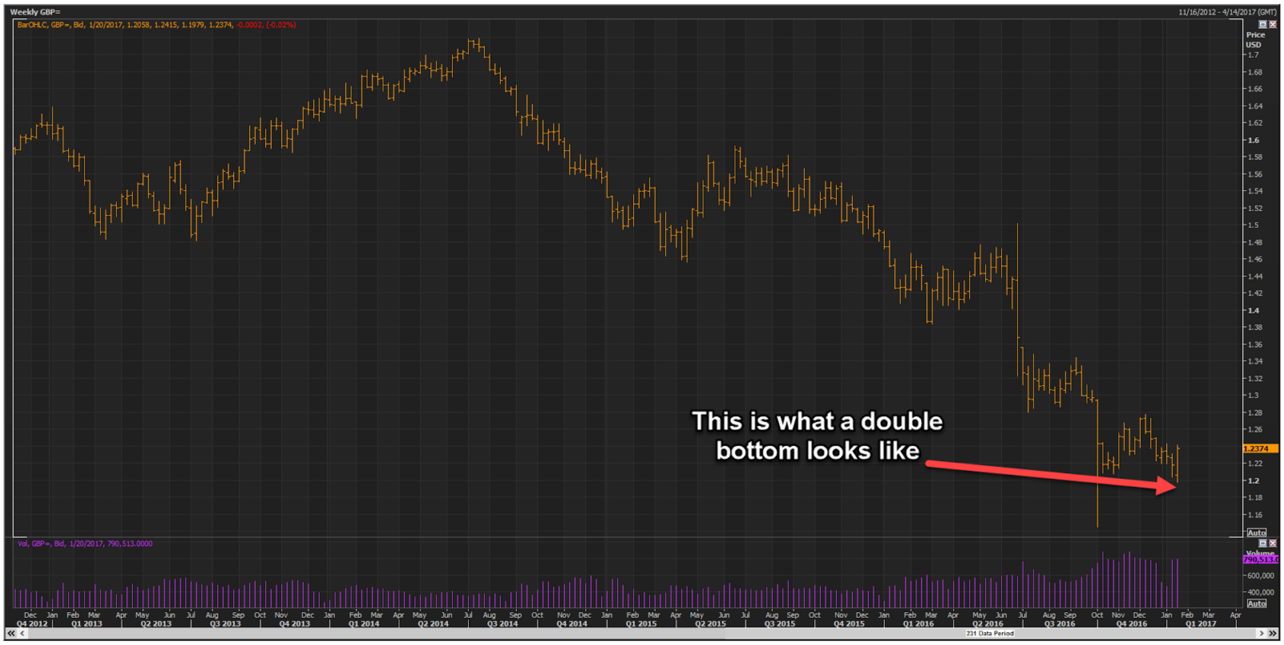



Source: BofA Merrill Lynch Global Fund Manager Survey

Here's Urban Carmel on how to interpret the chart:

*Since 2004, fund managers surveyed by BAML have been very good at determining when the dollar is overvalued. In March 2015, they viewed it as overvalued for the first time since 2009; the dollar index fell from 100 to 93 in the next two months. In late 2015, they again viewed the dollar as overvalued and the index lost 7%. Fund managers view the dollar as overvalued now again (and by the highest amount in 10 years). Under similar conditions (highlighted in green), the dollar has fallen in value in the month(s) ahead.*

This brings us to another potential trade I've been watching closely — long the pound against the dollar.



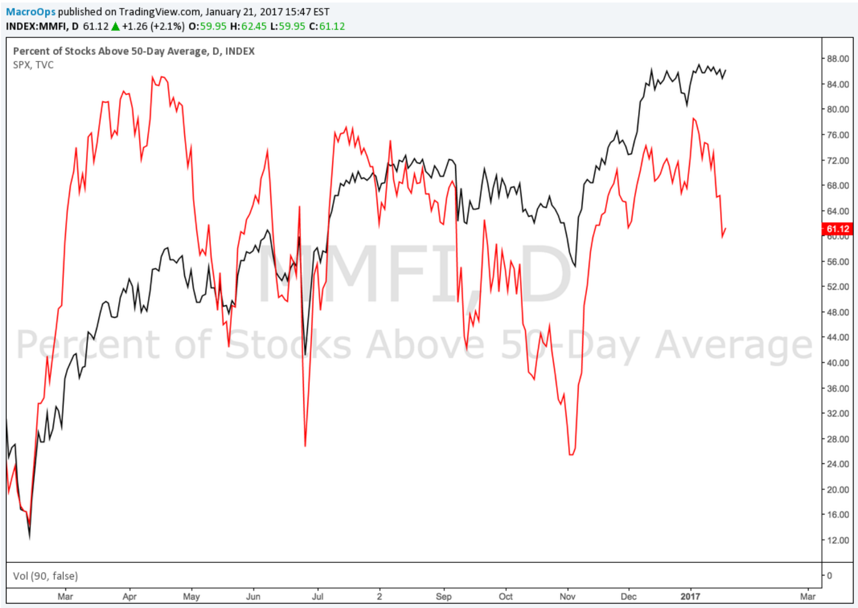

GBPUSD has established a textbook double bottom pattern and looks like it's ready to explode higher. More importantly, the second bottom/reversal was made on news that PM May was planning to move up the date for a hard-Brexit. When you see a strong reversal on what was previously regarded as negative news, it tends to signal that weak hands have been shaken out and the shorts are about to get squeezed.

And according to the BofA fund survey, there's a lot of shorts to run against. To read a good fundamental case for a stronger pound, check out Nordea's take here.


The market (chart of SPX above) continues to trade within its tight range. With the inauguration out of the way, we should finally see it make a move.

This last week I saw some weakness in breadth and credit that came close to triggering a sell signal. But, just as we’ve seen repeatedly over the last two months, things reversed and went back to mostly neutral.

I’m still seeing some negative divergence between the SPX (black) and the percentage of stocks trading above their 50-day MA (red). I’d want to see the red line turn up in order to confirm any market advance from here.



All in all I don't have any conviction on the short-term direction of the equity market. My bias is that we see a sentiment driven pop over the coming week or two and then a reversal. But that's purely speculation, and I'm not willing to place any bets on it.

**Portfolio Review: A Good Kick in the Shins**

Trading in the markets often makes me feel like these guys.

And that's because my profit distribution (and that of nearly all discretionary traders) adheres to Pareto's law — a majority of my profits come from just a handful of my trades each year. I spend most of my time getting kicked in the shin by markets.

It's not fun.

My job as a trader is to grab a straw and suck it up. Take the pain and make sure I'm keeping my losses small. I don't want to risk breaking a whole leg.

I usually have a pretty good idea if I'm in an environment where I have a solid grasp on market action versus when I don't. So I try and adjust my position sizing and trading activity accordingly. I'm thinking about further defining this rule and entering it into my foundational rules checklist because I think there's plenty of room for improvement here.

For instance right now, like I said, I don't have much conviction on markets with only a few exceptions like the pound. And I know I'll still place some select trades because I like to have positions on when I can. But there's no reason for me to put on large risk. I should further reduce my risk per trade to below 30bps when I'm in this kind of an environment.

This won't allow me to capitalize as much as I'd like on the trades that work out in my favor, but it'll reduce my losses when I'm wrong. Keeping losses small is the key to long-term profitable trading. And that's even more true when you're trading in a low-conviction environment.

We took a small loss of 40bps on CCJ this week. It moved against us when the company came out with a pretty bleak outlook for the uranium sector. This kind of talk is typical of bottoms in cyclical commodity stocks, so I don't think we'll see a full trend reversal here.

However, we chased into the entry and paid for it. The stock may resume its move higher from here but I always respect my risk points. If another setup presents itself we can get back in. This is a good example of a trade I should have sized at under 30 bps.

We're up roughly 25% on our CENX position. I like this trade and will look for points to add to it down the road. I think there's a lot of runway here, especially with the increased trade war rhetoric.

GGAL is up nearly 6% from our entry. I cut this position down a little towards the end of the week. It's overextended in the short-term and since it's a low-conviction trade, I'll be moving my stop to above breakeven.

We're up 12% and 5% on our two shipping plays, NM and NMM.

I also reduced the risk on these towards the end of the week. But the technicals look strong and I may increase my position in them if there's continued follow through.

GV and WLL continue to hang in there, but I wouldn't be surprised if we see a pullback in either soon. Our current Strat position in these are small. We've taken a lot of profit on both already, but I continue to like the long-term prospects for both companies. I may add to each position if we see some constructive price action or a strong pullback.

One stock that I'm digging into right now is Cemtrex (CETX). CETX is a technology company that provides solutions to industrial and manufacturing needs. Here's the Reuters factsheet on the company.

It's seen massive top and bottom line growth over the last few years. The chart below shows the stock's price (orange bars) with YoY EPS (grey bars) and YoY revenues (green bars).

Technically it's got a nice stair step pattern that I love to see on these rapid growth stocks. It's pulling back from a recent thrust higher and may offer us a good entry in the coming weeks. The theme also dovetails nicely with the Trump reflation narrative of infrastructure spending.

I'll dig some more and put out a tear sheet in a few days.

That's all I've got this week. I'll leave you guys with these wise words from Ned Davis.

> *We are in the business of making mistakes. The only difference between the winners and the losers is that the winners make small mistakes, while the losers make big mistakes.*

Make sure you're keeping your mistakes small.

-Alex

**Portfolio Snapshot**

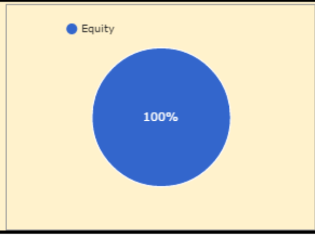
***Strategic Ops***

*NAV* $1,148,588

| Asset Class | Position | Size | Cost Basis | Risk Point | Open Risk | Target | Notional |
|---|---|---|---|---|---|---|---|
| Equity | Goldfield GV | 4,000 | $3.89 | $2.52 | $5,480.00 | $4.50 | $22,750 |
| Equity | Whiting Petroleum WLL | 2,000 | $10.41 | $8.10 | $4,620.00 | $16.42 | $26,300 |
| Equity | Grupo Financiero GGAL | 1,700 | $31.60 | $28.62 | $5,066.00 | $41.65 | $53,635 |
| Equity | Century Aluminum CENX | 1,700 | $11.11 | $7.55 | $6,052.00 | $16.55 | $19,550 |
| Equity | Navios Partners NMM | 28,000 | $1.65 | $1.49 | $4,480.00 | $4.00 | $44,800 |
| Equity | Navios Holdings NM | 30,000 | $1.75 | $1.55 | $6,000.00 | $4.10 | $51,300 |

***Metrics***

| Exposure Breakdown | |
|---|---|
| Equity | $31,698.00 |
| Commodity | $0.00 |
| Fixed Income | $0.00 |
| Forex | |




Total Open Risk

$31,698.00

2.76%

**Updated 1/21

***Volatility Ops***

*NAV* $1,149,283

| Asset Class | Position | Size | Cost Basis | Max Profit |
|---|---|---|---|---|

***Scenario Analysis/Stress Tests***

| Worst Case | Worst Drawdown |
|---|---|

**Updated on 1/21