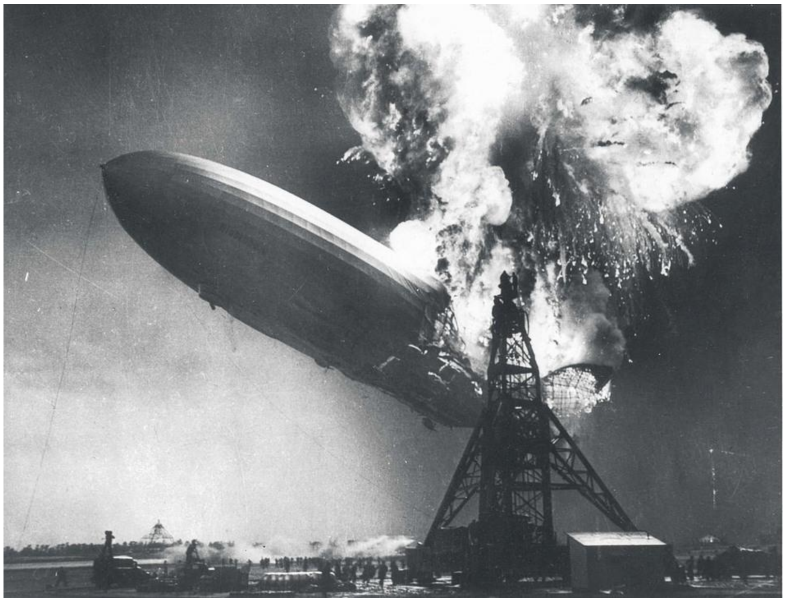
MARKET BRIEF

A Fleet Of Zeppelins



“*I’ve been around long enough to have lived through all sorts of markets. I’ve learned to respect markets, while at the same time being skeptical of conventional wisdom. I’ve lived through a bond bear market and a gargantuan bond bull market. I’ve seen bond yields above 15% and below 2%. I’ve seen inflationary spirals, I’ve seen deflationary threats, I’ve seen deregulation and reregulation. I’ve seen the S&P 500 trade as high as 30 times earnings and I’ve seen the S&P trade as low as 7 times earnings.*

With all this experience, that comes with age I might add, here is what I’m seeing in the markets today. In the credit markets, spreads on the high yield securities are approaching historically tight levels, while key credit metrics such as leverage and coverage ratios are showing signs of weakening. The leverage loan market has been overrun by such massive inflows of capital that you could probably get a loan to buy a fleet of zeppelins at this point in time. With respect to rates, the 10-year treasury note is currently trading at around 2.5%, up from its recent lows, but still well below historic norms. In my view, the mood of these markets is in stark contrast with the many unknown from our current economic and political landscape, both here and abroad. For me, it’s a major disconnect, and it concerns me…The S&P 500 is trading at roughly 19 times earnings, 3 turns higher than the 50-year average of 2016. These valuations make me uncomfortable, especially given the unknowns in taxation, foreign trade, regulation and more.

> *To sum up, in my opinion, the markets are priced for perfection, and they have been that way for quite some time, complacency reign supreme. However, my experience has shown me that this state of affairs won't go on indefinitely. So why am I sharing these thoughts with you? Because I know that some of you have wondered why we bought back relatively few Loews shares in 2016 or why Loews hasn't made an acquisition…It's a tough market in which to be a disciplined buyer."* – Loews *CEO James Tisch (Insurance company)*

The above is from Loews' latest earnings call via *Avondale Asset Management*. They do a great job of aggregating the more interesting snippets from earnings calls every week. If you're not already, I suggest subscribing to their free weekly earnings roundup (link here).

Tisch's comments made me laugh… the dude reminds me of an old salty Marine Gunnery Sergeant who's spent a lot of time fighting in the bush over the years. He's wise and jaded from experience. Typically, these are the people it pays to listen to.

It's safe to say Tisch is a bit skeptical of current market optimism. His comments are reminiscent of Walter Bagehot's remarks, writing in the mid-19th century:

> *One thing is certain, that at particular times a great deal of stupid people have a great deal of stupid money... At intervals, the money of these people — the blind capital, as we call it, of a country, is particularly large and craving; it seeks for someone to devour it, and there is a 'plethora'; it finds someone, and there is speculation; it is devoured, and there is 'panic'.*

Bagehot was talking about the South Sea Bubble. Now we're not at that level of euphoria yet, but the stock market is trucking along, driven by risk-premia spreads and a Fed who can afford to play it loose because of the remaining slack in GDP gap and capacity utilization.

The difficulty in trading (especially in investing) in late cycle periods like the one we're in now is that upside asymmetry is almost non-existent. And it's too early to start playing for asymmetry to the short side.

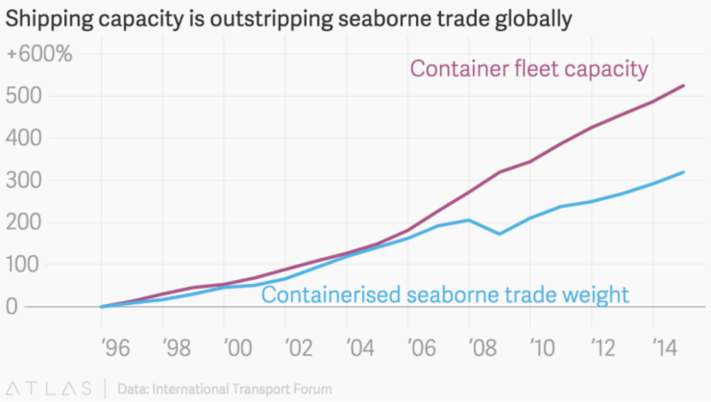
When a deluge of "stupid money" is pouring into every nook and cranny of the economy, it doesn't allow for the "creative destruction" that's essential to a healthy capitalistic system. Because of this we end up with excess capacity everywhere. And excess capacity equates to a ceiling on potential upside.

Everything is so out of whack today because the Fed distorted the normal business/market cycle.

Take cyclicals for example. Sectors like shipping, energy and agriculture experienced a large bear market starting at the end of 14'. Bear markets like these are *supposed* to lead to bankruptcies and plant closures. This clears excess capacity from the system and makes survivors an attractive investment as the cycle starts anew.

Credit spreads widen and liquidity tightens during these cyclical downturns. This makes borrowing difficult and forces unprofitable companies out of business. But this never happened this time. The global credit spigots remained at full bore during this downturn and prevented it.

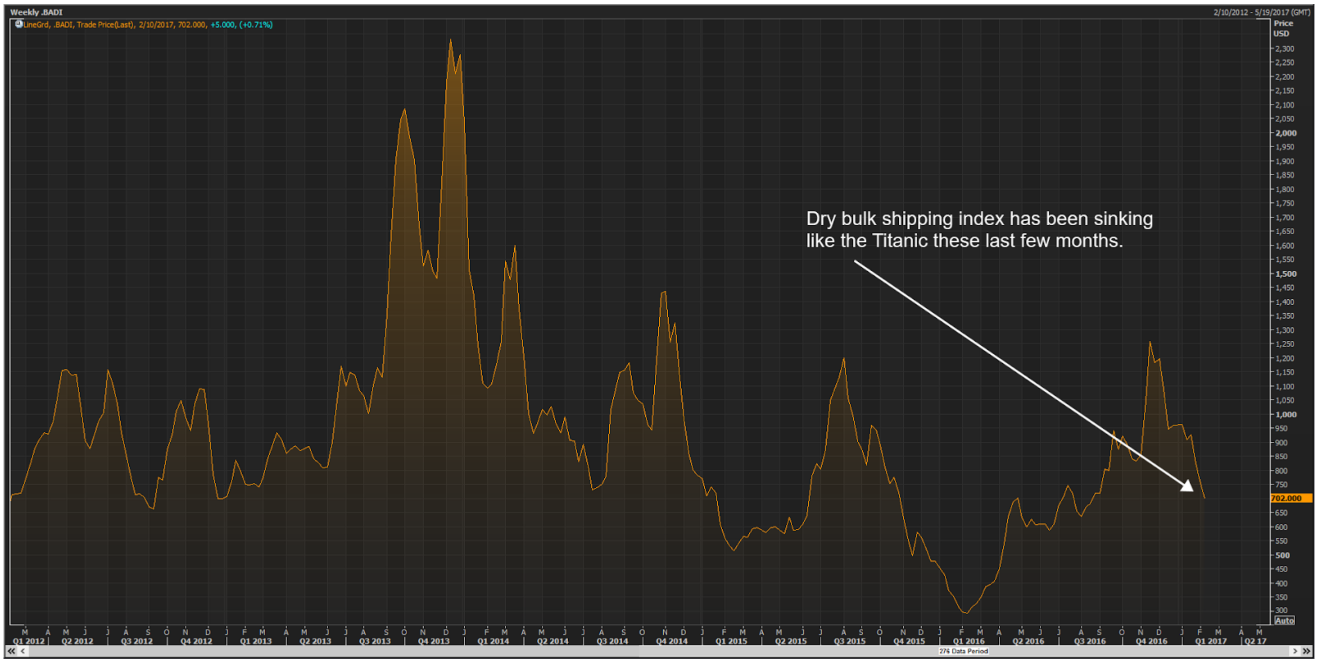
With interest rates so low and the rest of the economic cycle out of step with cyclicals, banks didn't call back bad loans. They instead let companies that should have died borrow more. It's easier to extend and pretend than it is to take a write-down on your balance sheet.



Data: International Transport Forum

The shipping sector is a perfect example of this. If you listen to any earnings call from a shipping company you hear the same complaints: there remains too much tonnage (capacity) keeping prices depressed, ship builds still far outpace those being scrapped, and easy money continues to drive the supply glut in shipping capacity.

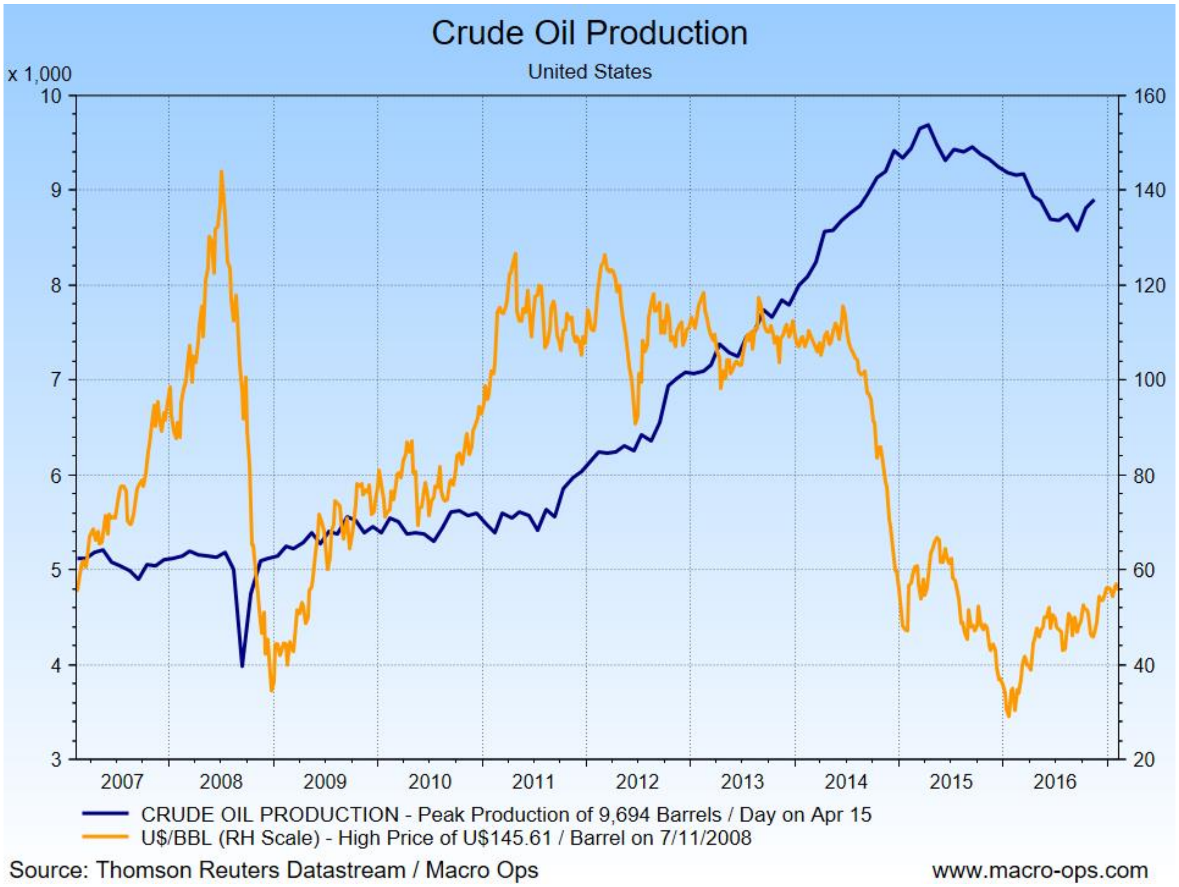
This is why the Dry bulk index has turned over and is dropping like a stone.



Dry bulk shipping index has been sinking like the Titanic these last few months.

Energy is another example where easy money has effectively put a ceiling on pricing.

The price of oil dropped by more than 75% from the end of 14' to the middle of 15'. Despite this massive fall, US production barely budged. It went from 9.5 million barrels a day to 8.6 million, and has since started trending back up.



Source: Thomson Reuters Datastream / Macro Ops

During the downturn a number of drillers went belly up. But because of low interest rates there were a number of well financed players standing by, ready to jump in and take their place in production. This trend is only increasing, as per the *Bloomberg* this last week (emphasis mine). *"**Wall Street is throwing the most money at U.S. energy companies since at least 2000** amid growing confidence that the industry is emerging from the worst downturn in a generation."*

"The worst downturn in a generation" may be true but because the full washout never happened… because there was never a true blood in the streets moment… the recent rebound is more likely a false signal. People trying to be long oil (and judging from the recent COT data it's A LOT of people) are going to get burned.

Maybe oil prices do rise some from here but because of easy money and excess production capacity there's a solid ceiling and how high they can go.

Overcapacity is also plaguing the agriculture sector. Here's the following from the *WSJ* (emphasis mine):

> *Across the heartland, a multiyear slump in prices for corn, wheat and other farm commodities **brought on by** a glut of grain world-wide **is pushing many farmers further into debt**. Some are shutting down, raising concerns that the next few years could bring the biggest wave of farm closures since the 1980s.*

> *The U.S. share of the global grain market is less than half what it was in the 1970s. American farmers' incomes will drop 9% in 2017, the Agriculture Department estimates,* ***extending the steepest slide since the Great Depression into a fourth year.***

The "deluge of stupid money" is not only extending the supply glut by keeping dead companies walking but it's also distorting the incentives of the credit market. Just read the following via the *WSJ* (emphasis mine):

> *The red-hot loan market has enabled many corporations to demand that lenders cut rates or face losing the business to a rival, a sign of how easy financing is enabling large firms to get advantageous terms in debt markets.*
>
> ***Reflecting immense demand for the loans, borrowing costs are actually dropping at present. The risk is that the feeding frenzy pushes spreads so low that investors no longer earn enough income to offset the risk of default.*** *Yet with U.S. and global economic activity showing signs of warming up, defaults remain low and few analysts are concerned that a recession is imminent.*

The overcapacity ceiling has made me rethink my positioning and opinion on much of the cyclical and commodity sector. Previously I was somewhat bullish on shippers because of technical and sentiment reasons. And buying the "bottom" on those in similar circumstances in the past had paid off handsomely. But now I don't think the bottom has completed. I think we're likely to see a double bottom form over the next year or two and in the meantime prices are likely to chop around. There's little point in getting long because the potential for an asymmetric rise is slim to nonexistent. And this applies to uranium, shippers, drillers, agriculture etc.

The fact is, low rates and easy credit have led to capital misallocation and a subsequent capacity glut that will not be cleared out until the full cycle actually completes. That means asymmetric long opportunities won't exist until there's large scale bankruptcies and blood in the streets. We won't see that until rates rise and credit spreads widen.

Until then, we'll continue to see large scale funding of zeppelins.

Macro: An easy Fed but signs of a turning credit cycle

Here's an interesting question: Is the Trump administration's erratic policy and governing style bullish or bearish for stocks?

Lately, I've read a number of analyst notes talking about how the current political uncertainty spells trouble for the stock market. They all include the line "...if there's one thing markets don't like, it's uncertainty about the future." I think that's lame thinking.

I would argue that this "uncertainty" is bullish for equities, at least over the short-term.

I say this because this "uncertainty" is feeding into the Fed's rake hiking decisions. Remember the hawkish tone coming from Fed members back in December? That seems to have been reversed since Trump took office and started significantly shaking things up. Fed members have cited the uncertainty over future fiscal policy as a key reason to err on the side of caution in raising rates.

FOMC member, Neel Kashkari, wrote a post this week explaining his reasoning for voting to keep rates steady at last month's meeting. The whole post is worth reading (link here), but here's Kashkari's concluding remarks:

We are still coming up somewhat short on our inflation mandate, and we may not have yet reached maximum employment. Inflation expectations remain well-anchored. Monetary policy is currently somewhat accommodative. There don't appear to be urgent financial stability risks at the moment. There is great uncertainty about the fiscal outlook. The global environment seems to have a fairly typical level of risk (though that can change quickly). From a risk management perspective, we have stronger tools to deal with high inflation than low inflation. Looking at all this together led me to vote to keep rates steady.

Fed President James Bullard, also cited fiscal uncertainty in a speech he gave this week saying "It is unlikely that fiscal uncertainty will be meaningfully resolved by the March meeting… We don't have to move. We have a lot of fiscal uncertainty. Why not wait until that is more clearly resolved?"

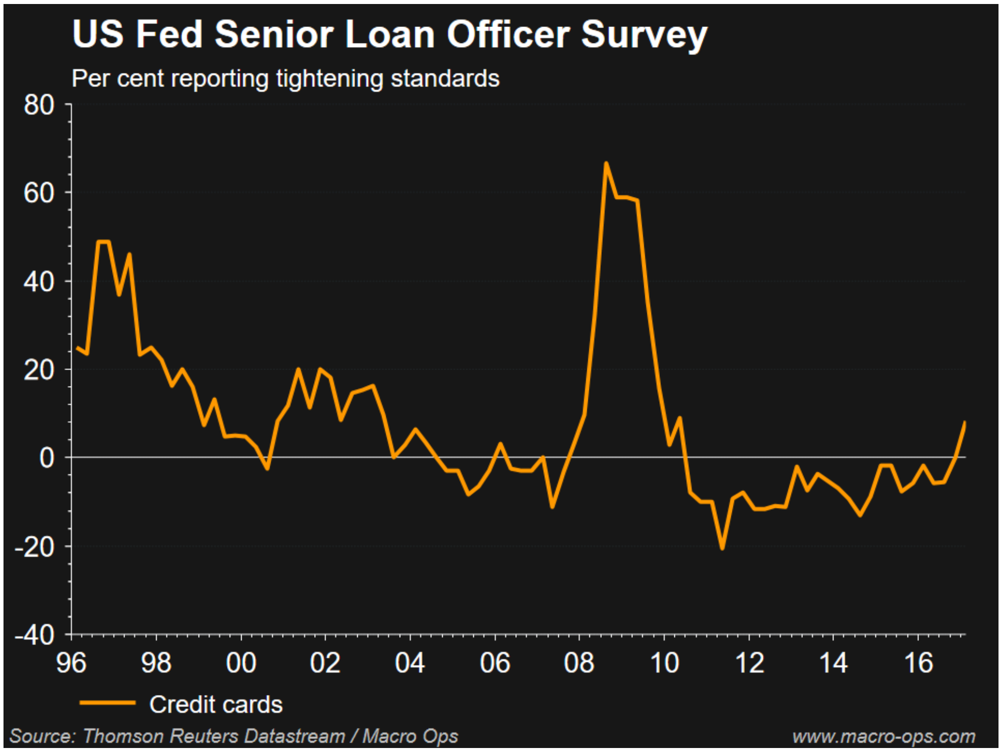
So Trump's unconventional governing style is creating uncertainty over the future which is making the Fed step back from its rate hiking path. This is supportive of equity prices over the short-term. The breakouts this past week in many of the indexes seem to confirm this.

This creates the unusual situation where a steadier governance and a clearer picture of future fiscal policy would likely lead to faster rate hikes and thus be a net-negative for markets.

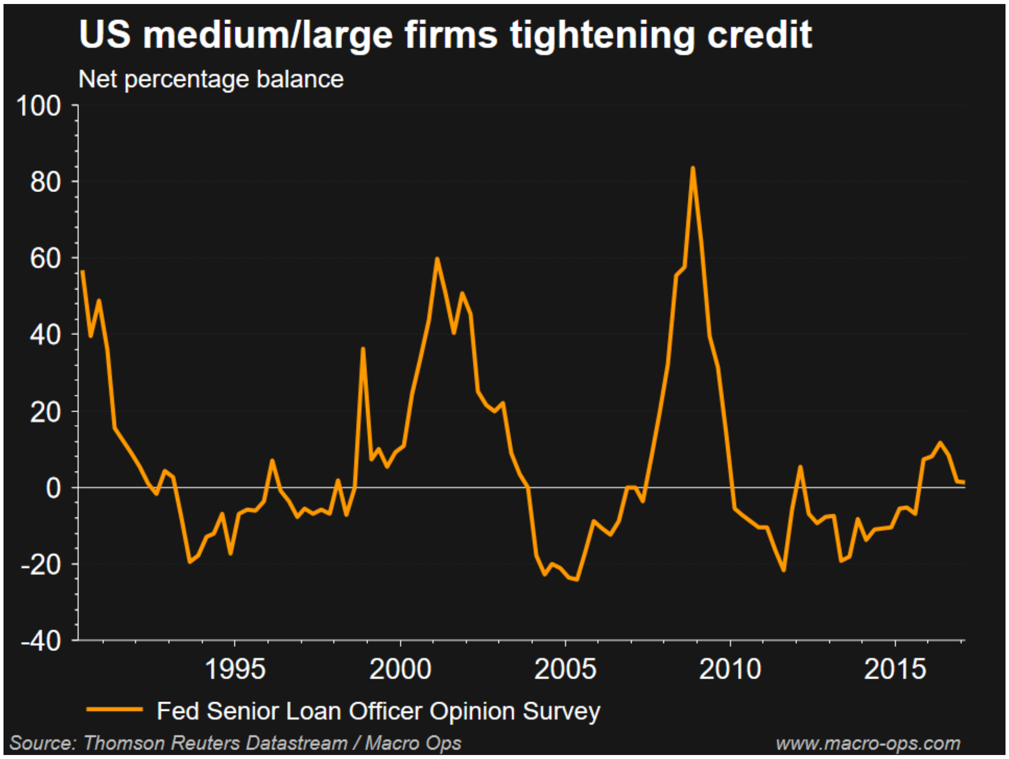
The Fed conducts a Senior Loan Officer (SLO) Report every quarter. In this report they survey roughly 60 large commercial banks and up to 24 large foreign banks with branches in the US. The survey is intended to provide a quarterly update on credit availability and demand as well as developments in lending standards. It's a good barometer of the overall credit market and provides us useful insight into how the credit cycle is developing.

The most recent SLO came out this past week and the data confirms our belief that we're in the later stages of the current business cycle.

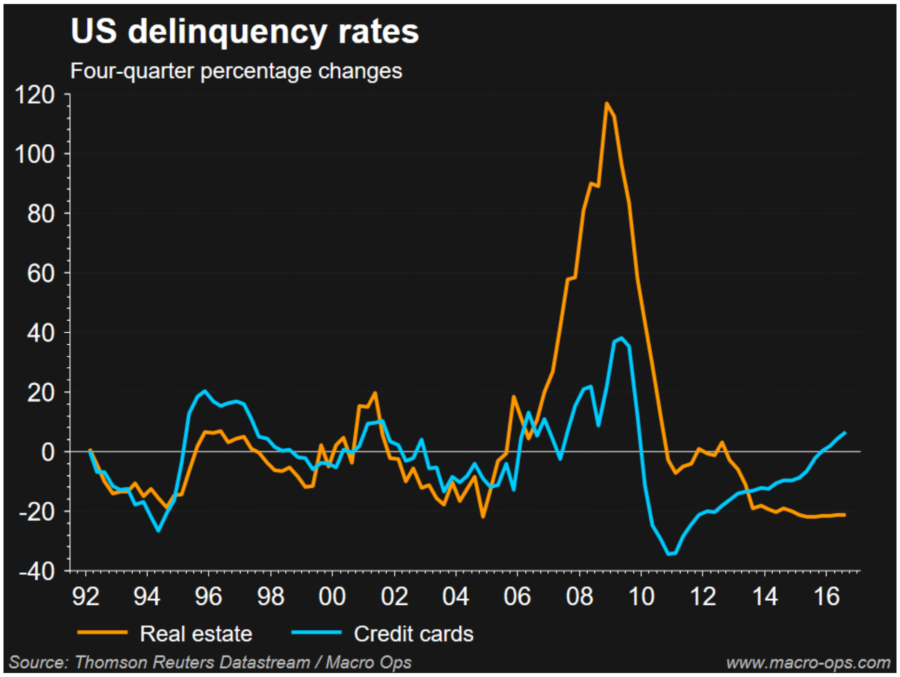
The below chart shows that loan officers are reporting an acceleration of tightening lending standards for credit cards (above zero means tighter credit).



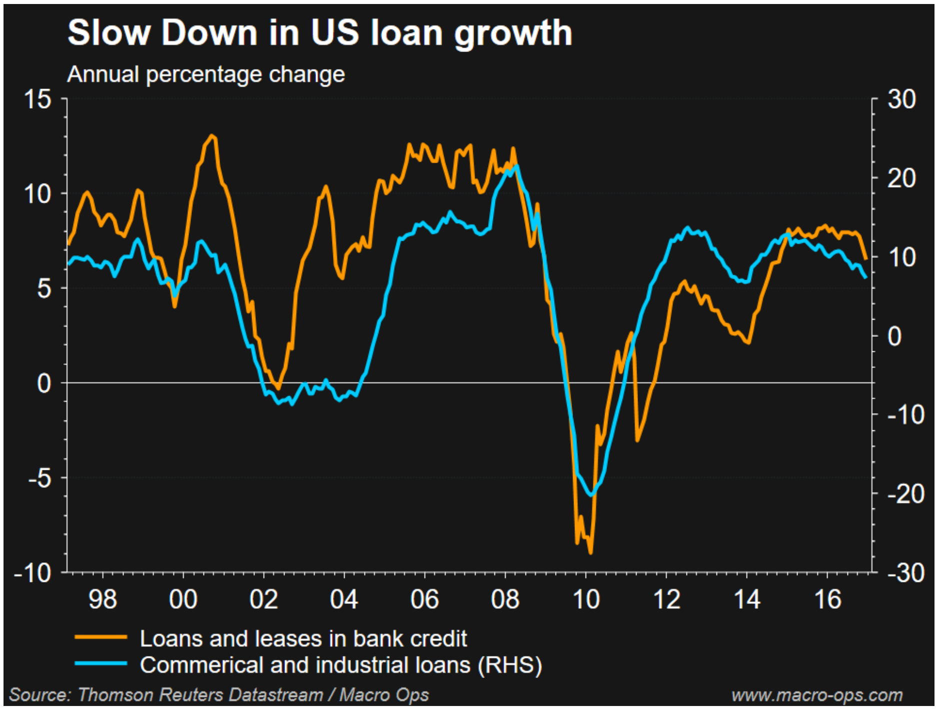
The same is true for medium to large businesses.



Some of this tightening is being driven by rising delinquencies on credit card debt and as interest rates tick higher we should see that trend spread to other areas like mortgages as well.

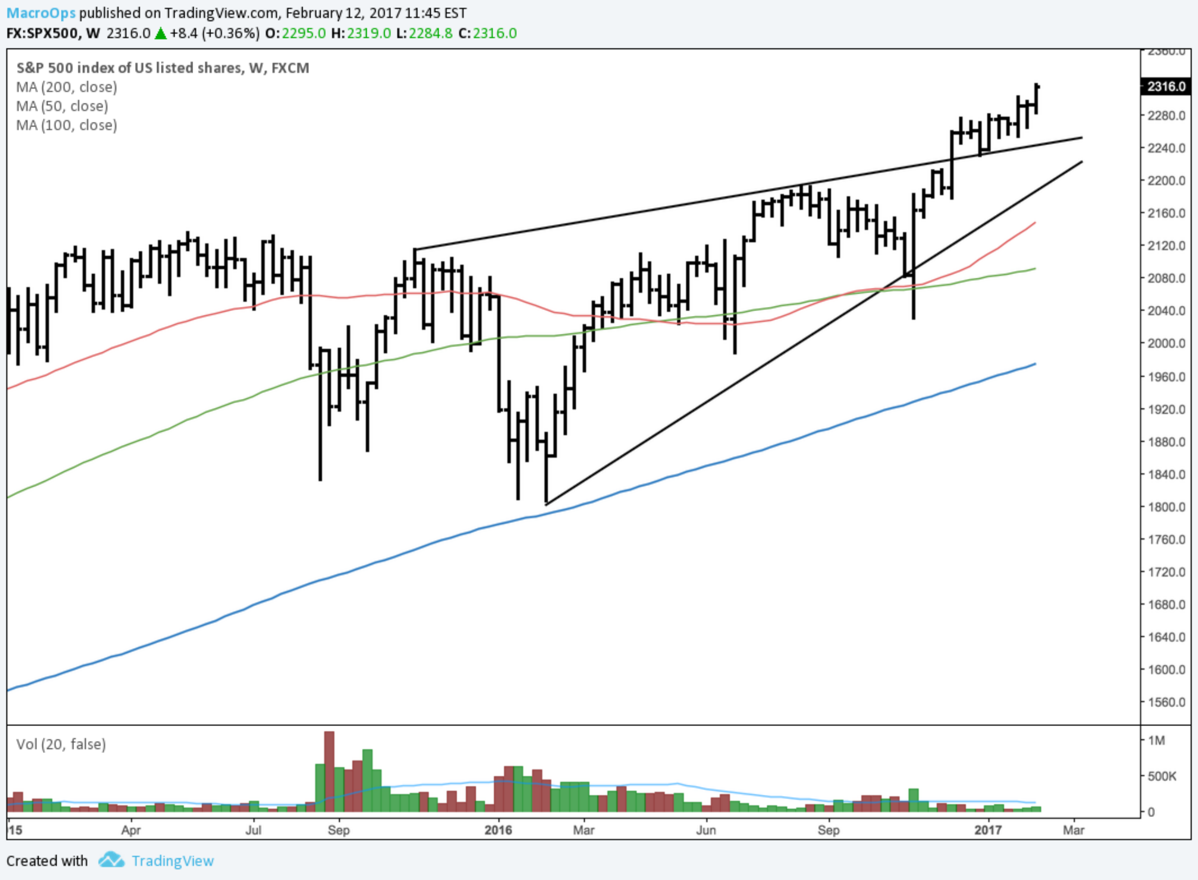


We can see the impact this slight tightening is having on loan growth which has slowed and appears to be turning over. Another sign that is typical in the later stages of a credit cycle.



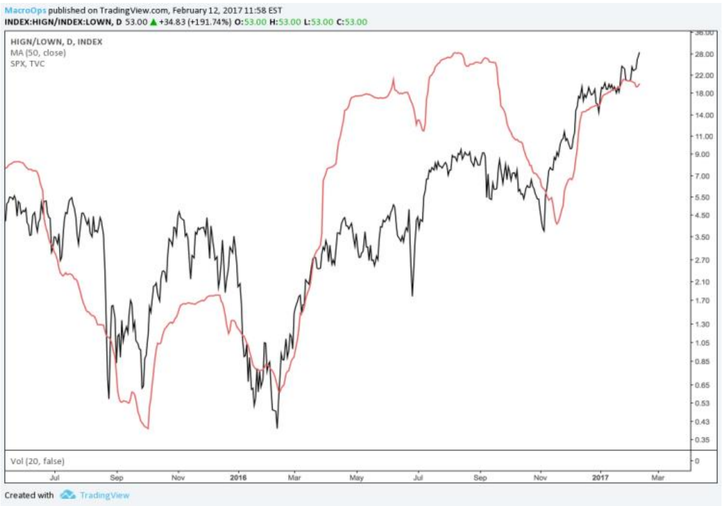
So though credit is still extremely loose and capital is easy to come by, the beginnings of a reversal in that trend are appearing in the lending standards and delinquency data. That means we should see this weakness begin to be reflected in the credit markets in the coming months and things like high-yield debt will start to roll over.

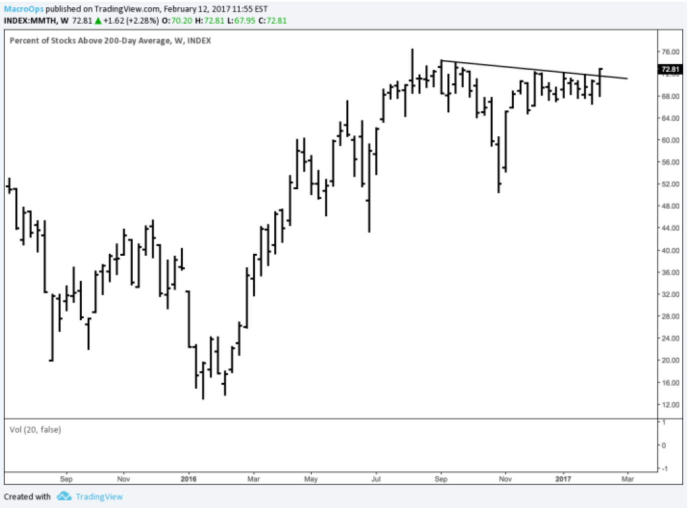
Tactical: Breakouts and a virtuous FOMO loop



Most of the major US indexes saw significant breakouts and strong bullishness at their highs into the end of the week. This push higher is being confirmed by indicators of breadth and strength suggesting we'll see continued follow through into the next few weeks.

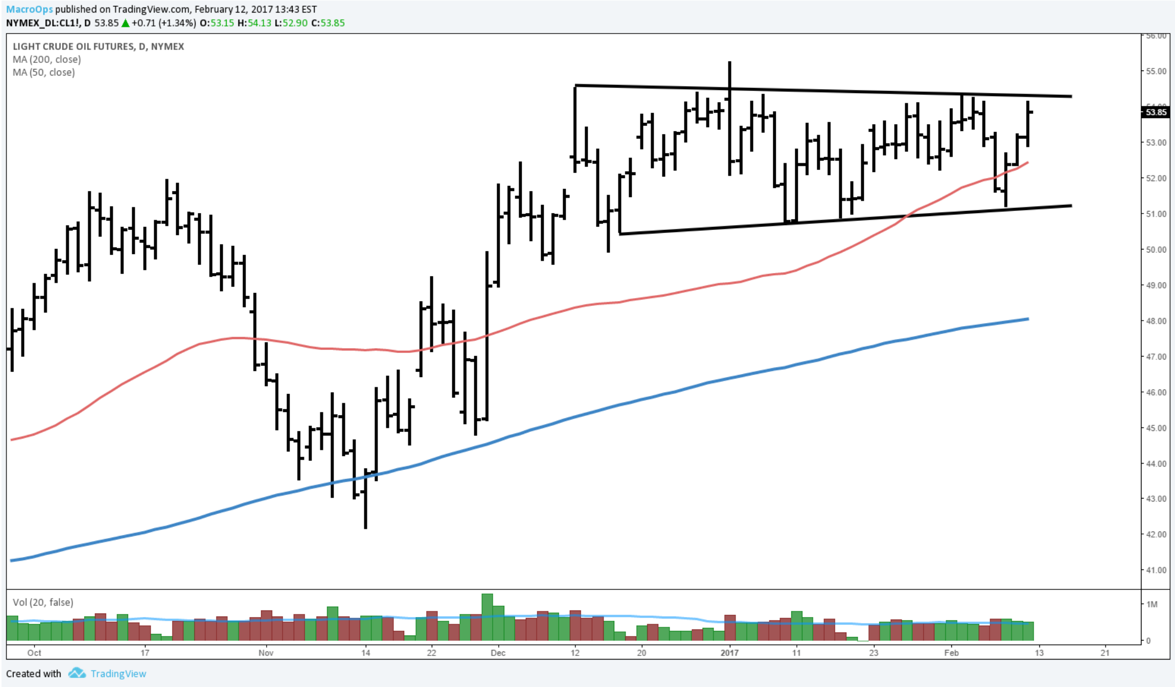
The chart below on the left shows the 50-day moving average (red line) of NYSE new highs over new lows. It confirms the trend upward in the SPX (black line). The chart on the right shows the weekly breakout to the upside of the percentage of stocks trading above their 200-day moving averages.



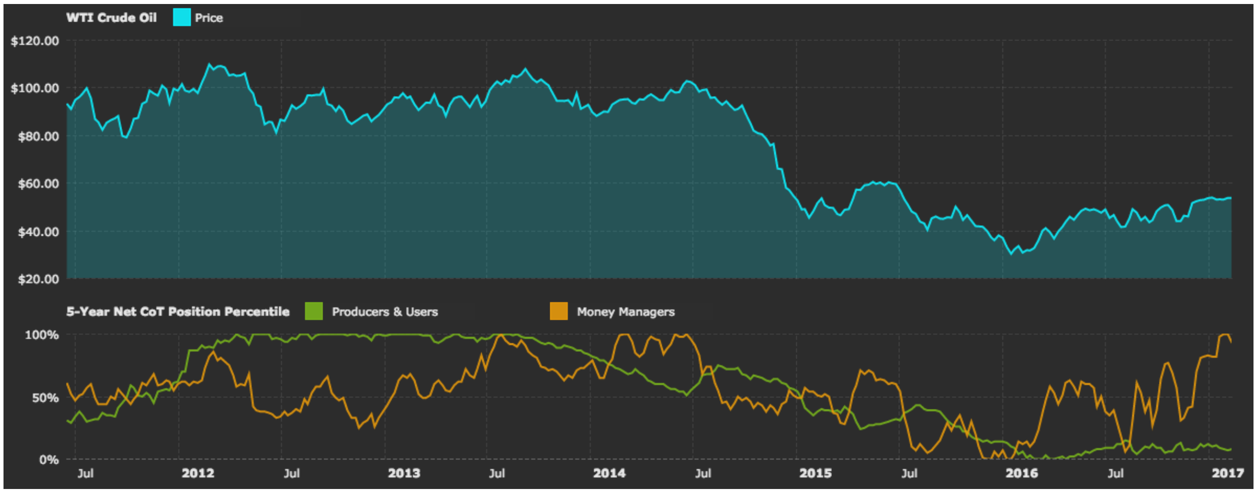


With a March rate hike seemingly off the table for now, I expect the trend higher in US equities to accelerate as the virtuous fear of missing out (FOMO) cycle that we've talked about in past Briefs picks up momentum.

Oil continues to trade in its range between roughly $51.50 and $54 bbl. We'll likely see a breakout in one direction or the other in the next week or two.



As we noted in last week’s MIR, speculators are currently holding record long positions in oil according to the COT data. Typically these divergences in positioning are resolved in the direction of producers (in this case, that would mean oil moving lower).

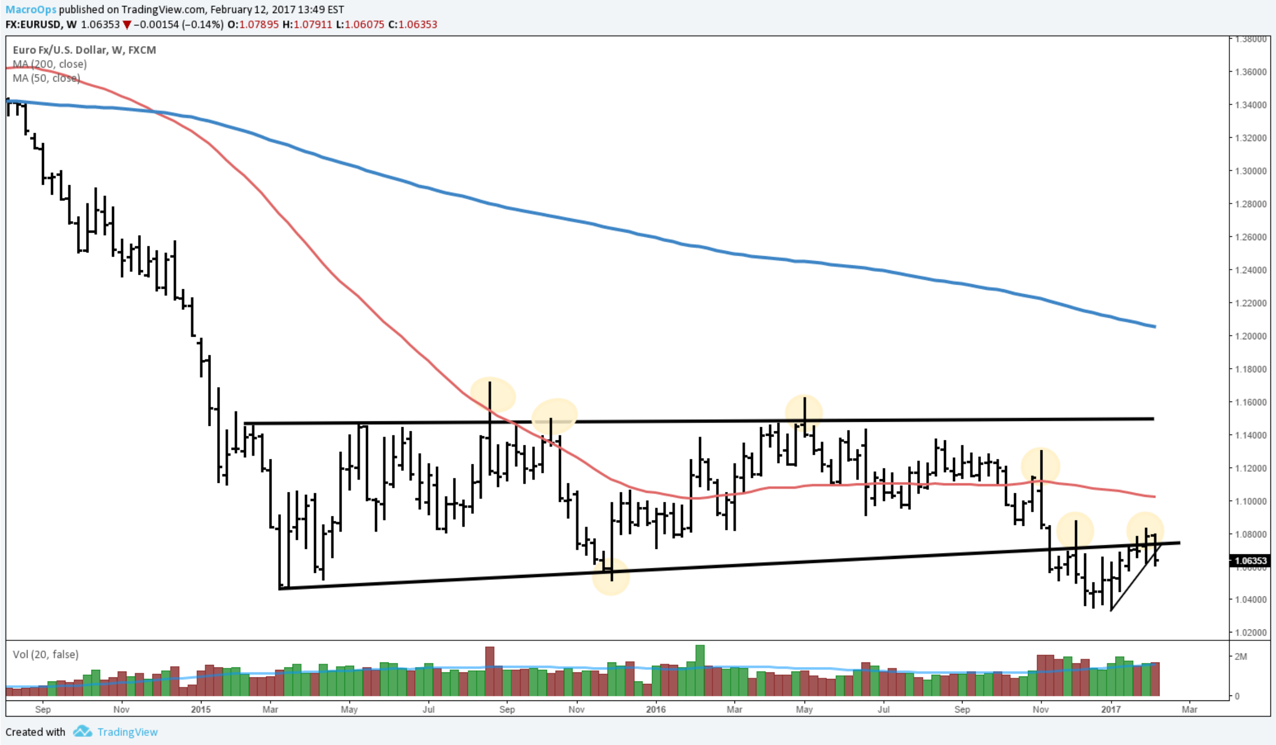


Due to the capacity issues we talked about earlier and the record level of speculative long positions in the COT data, my bias is that oil falls lower. But because of the way markets have been moving lately I would not be surprised to see a breakout to the upside only to reverse downward again in the near future.

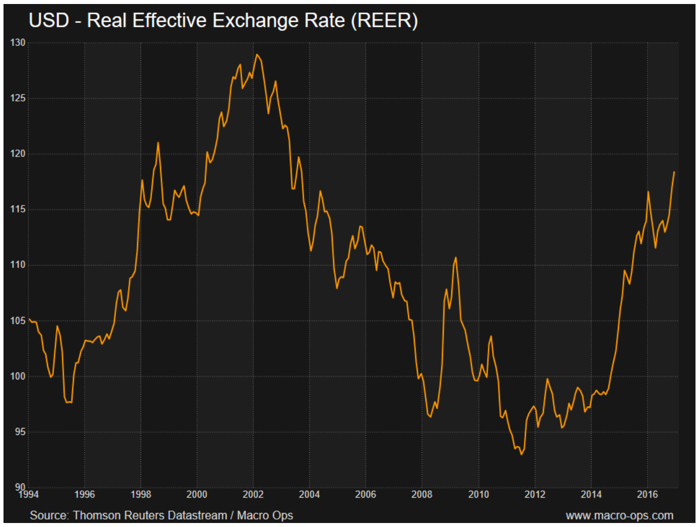
For me to put on an actual short position in oil I’d need to see a move lower confirmed by a significant move higher in the dollar.

Currencies continue to be a churn and burn trade for me. I got stopped out of my long GBP position this past week after moving my stops up to my initial entry price. Due to the rise in algorithmic trading it has become increasingly difficult to trade range bound currencies over the last few years.

Take a look at the EURUSD pair below and you can see that the chart pattern is riddled with these large wicked reversal weeks and false breakouts where stops are steamrolled.

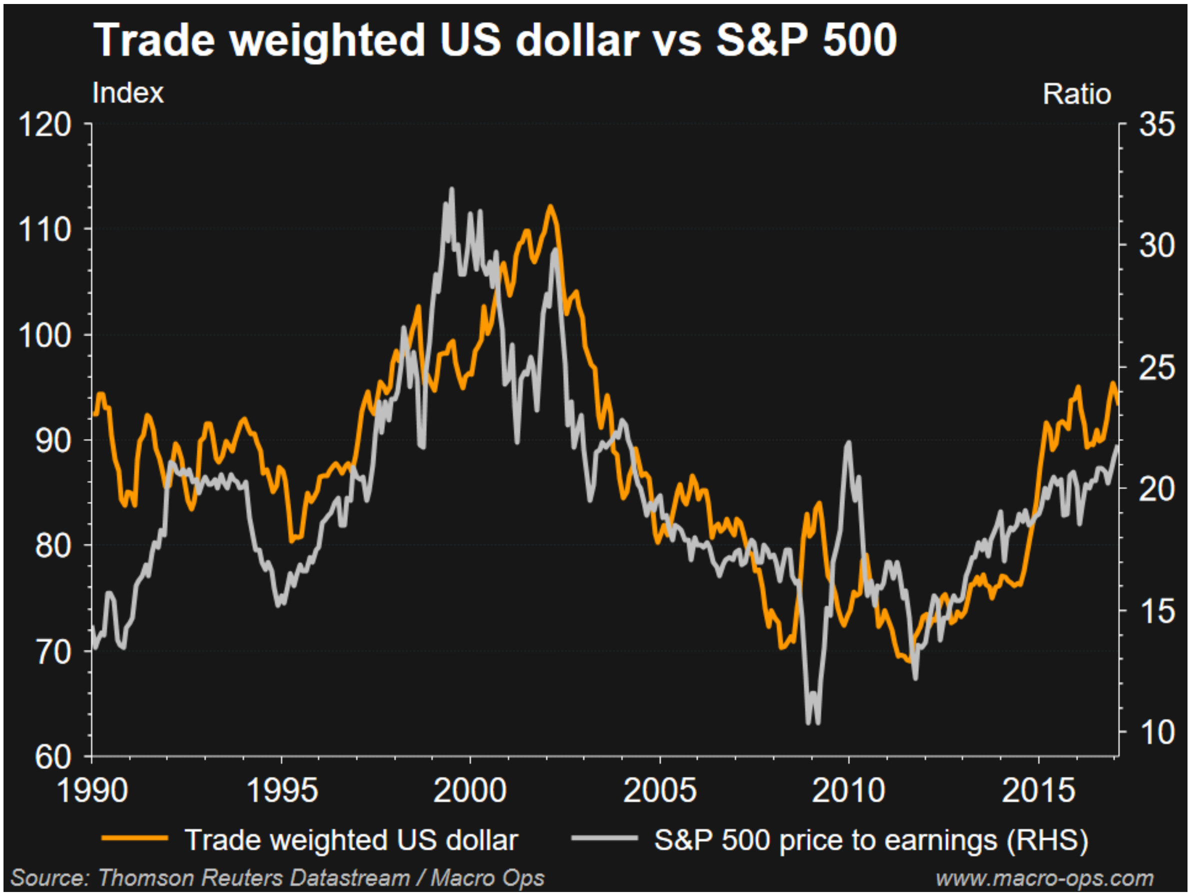


Because of this, we need to wait for signals that the larger trend is resuming before putting on a trade or else size our positions small and keep our stops wide.



The US dollar looks like it's getting started again on its next leg higher. However, I'd like to see clear confirmation from the other currency pairs before I put on a position long.

A big driver for this next leg higher in the dollar is speculative inflows into the US that are being driven by strong total return comparables relative to other global options. That's why relationships like the one charted below of the dollar and S&P earnings multiples exist. As the trend accelerates in the indexes we should see the bullish trend in the dollar pickup as well.



Source: Thomson Reuters Datastream / Macro Ops

Portfolio Review: Pareto's Law and Playing Small

I've been getting knicked up the last two months in the Strat account. There hasn't been great follow through on a number of the trades I've entered and in hindsight I was playing too aggressive following my good run into the end of last year (note: my worse periods always tend to come right after my best periods).

This reminds me of what I think is one of the most important things for a trader to keep front of mind. And that is that Pareto's law will always dominate our returns. This means that the majority of our returns for the year will come from just a handful of trades. These trades also tend to group together in periods throughout the year.

That means that the majority of the year we will be either fighting to break even or attempting to keep our losses small. That last point being key. The most important job in trading is to not lose money. Soros had a win rate in the 30% range but he made billions because he kept his losses small and rode his winners for all they were worth.

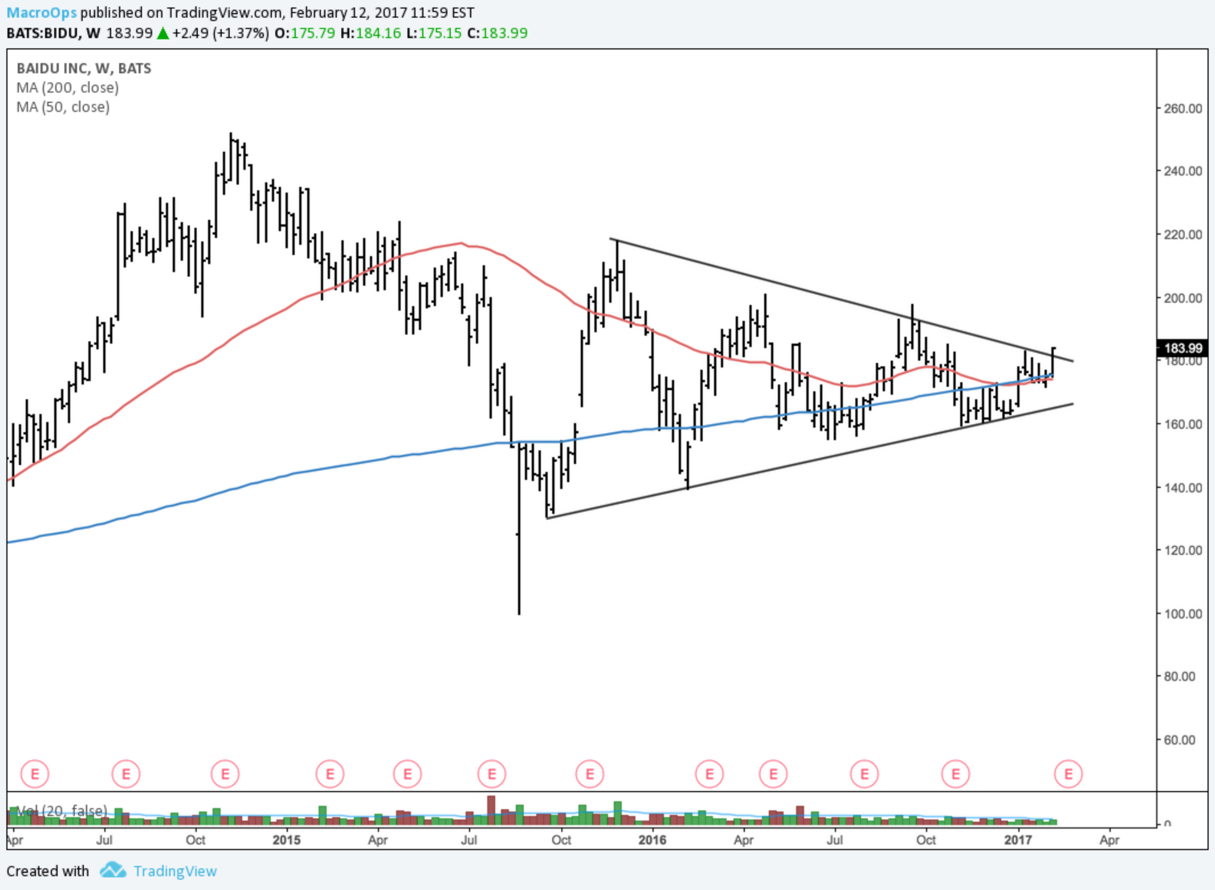
Because of the natural 80/20 or even 90/10 distribution of returns it should be our focus as traders to try and determine when we're in a period that's conducive to profitable trading (ie, when our conviction levels are high) and when we're likely to be chopped up (which will be the majority of the time). Once we know this, we need to adjust our position sizing and trade frequency accordingly.

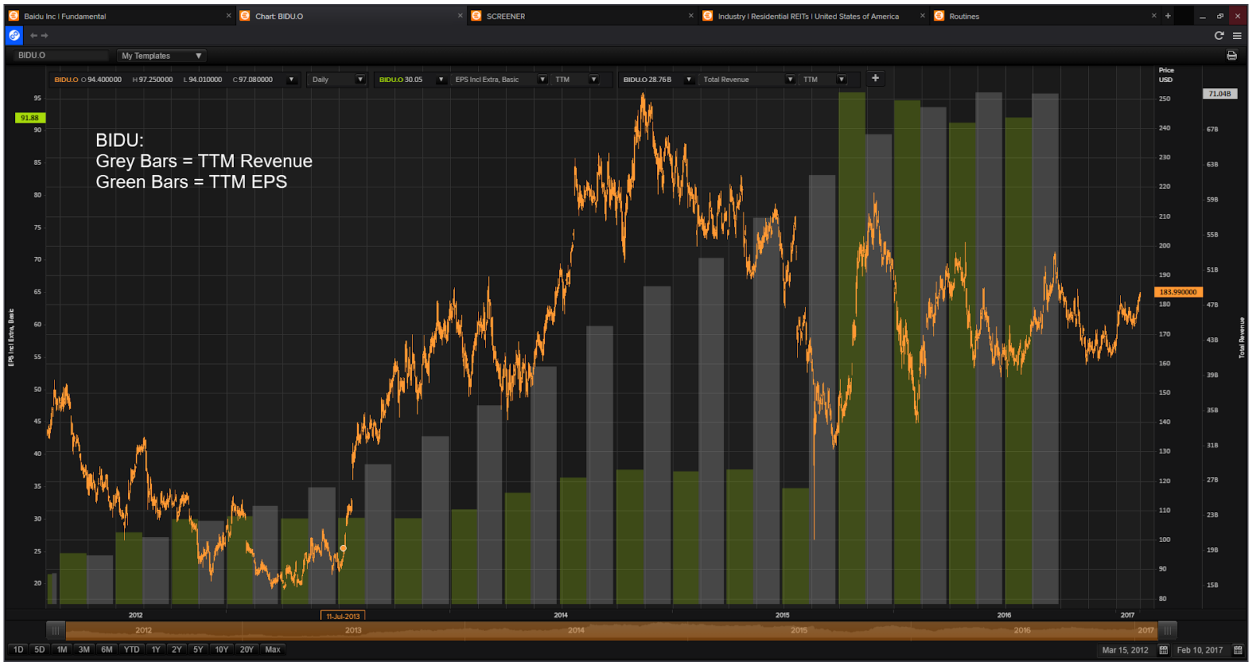
The start of this year has been comprised of mostly range bound, low volatility markets. These are what the old CME floor traders would call “whip and suck” price action. That’s not a profitable environment for my type of trading so I should have pared back even more than I did. This is where we benefit from having a volatility premium portfolio (Vol Ops) that mints money in these mean reversion markets.

With that said, I’ll be cutting most of my book on Monday and moving stops up on remaining positions. I’m going to cut AVHI if there’s not a strong move higher on Monday and I will do the same with WLL. I’ll also jam the stops up to right below last week’s lows on the remainder of the portfolio.

I am considering putting on a position in BIDU which is finally breaking out of its 18-month wedge pattern that we pointed out a few weeks ago. This move is also being confirmed by bullish price action in a number of Asian equities.

Chinese stocks are benefitting from continued easy monetary policy as President Xi seeks to keep the economy smoothly going into the run-up to the November Congress.




Baidu Inc I Fundamental
Chart: BIDU.O
SCREENER
Industry I Residential REITs I United States of America
Routines
BIDU.O
My Templates
BIDU.O O 94.400000 H 97.250000 L 94.010000 C 97.080000
Daily
BIDU.O 30.05
EPS Incl Extra, Basic
TTM
BIDU.O 28.76B
Total Revenue
TTM
Price USD
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55B
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47B
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39B
35B
31B
27B
23B
19B
15B
EPS Incl Extra, Basic
Total Revenue
2012
11-Jul-2013
2014
2015
2016
2017
2013
1D
5D
1M
3M
6M
YTD
1Y
2Y
5Y
10Y
20Y
Max
Mar 15, 2012
Feb 10, 2017

BIDU:
Grey Bars = TTM Revenue
Green Bars = TTM EPS

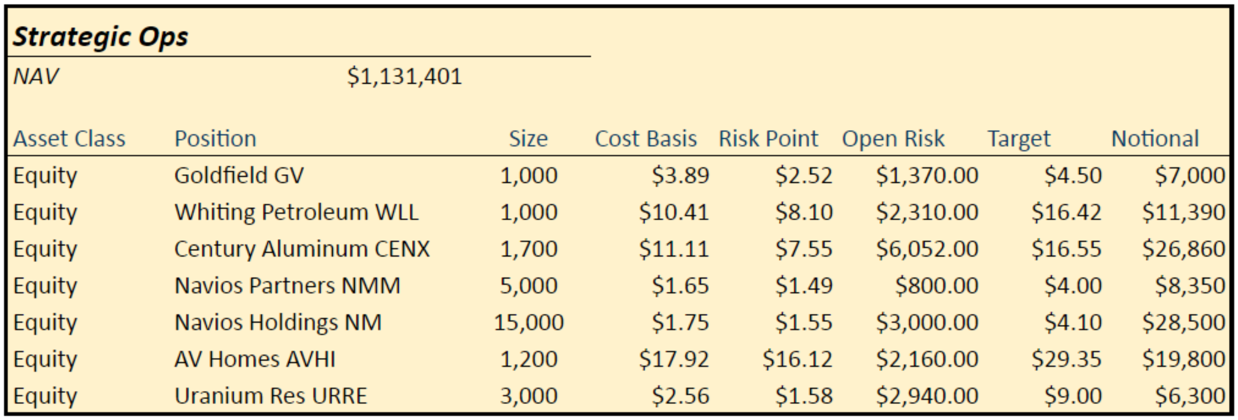
This would be a low conviction trade so I will size it under 35bps and will be quick to cut should price action not follow through.

That's all I've got for this week. We just put up our equity screens in the Hub. We're going to send out an email this week that breaks down each of the three screens and the variables that we use as filters. These screens will be updated weekly.

Hope your weekend is going well and have a great week!

-Alex

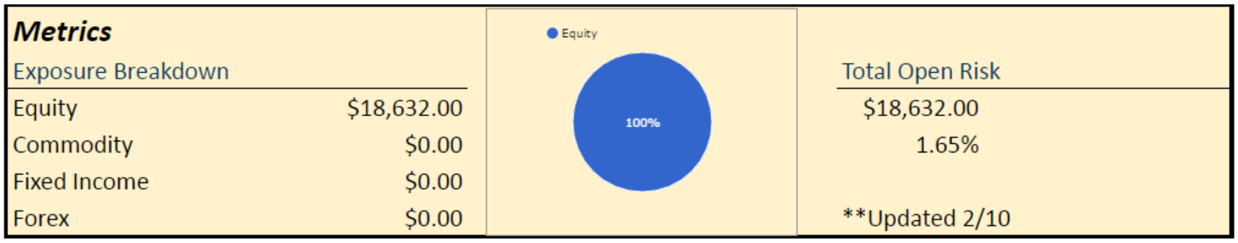
Portfolio Snapshot



Strategic Ops

NAV $1,131,401

Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target	Notional
Equity	Goldfield GV	1,000	$3.89	$2.52	$1,370.00	$4.50	$7,000
Equity	Whiting Petroleum WLL	1,000	$10.41	$8.10	$2,310.00	$16.42	$11,390
Equity	Century Aluminum CENX	1,700	$11.11	$7.55	$6,052.00	$16.55	$26,860
Equity	Navios Partners NMM	5,000	$1.65	$1.49	$800.00	$4.00	$8,350
Equity	Navios Holdings NM	15,000	$1.75	$1.55	$3,000.00	$4.10	$28,500
Equity	AV Homes AVHI	1,200	$17.92	$16.12	$2,160.00	$29.35	$19,800
Equity	Uranium Res URRE	3,000	$2.56	$1.58	$2,940.00	$9.00	$6,300



Metrics

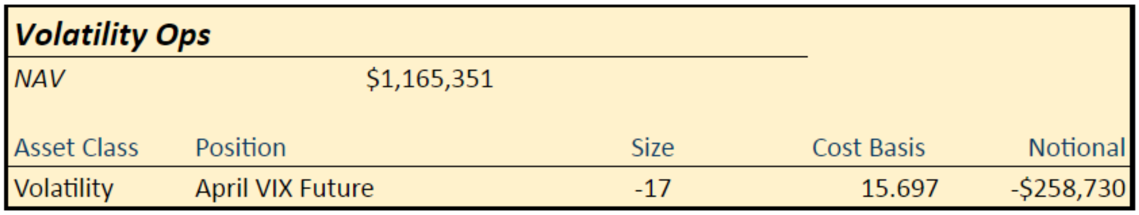
Exposure Breakdown	
Equity	$18,632.00
Commodity	$0.00
Fixed Income	$0.00
Forex	$0.00

Total Open Risk

$18,632.00

1.65%

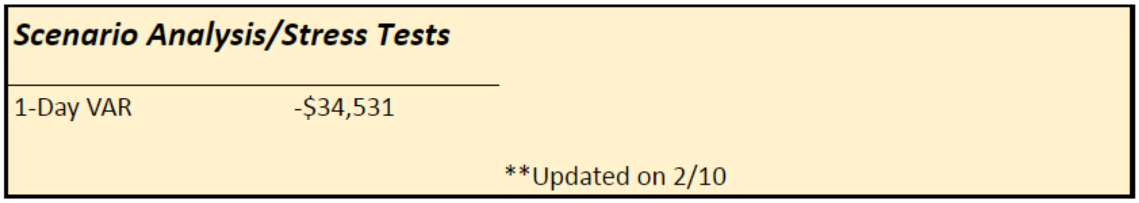
**Updated 2/10



Volatility Ops

NAV $1,165,351

Asset Class	Position	Size	Cost Basis	Notional
Volatility	April VIX Future	-17	15.697	-$258,730



Scenario Analysis/Stress Tests

1-Day VAR -$34,531

**Updated on 2/10