Control The Rules, Rule The Game

“If you wait by the river long enough, the bodies of your enemies will float by.”

“He will win who knows when to fight and when not to fight.”

“If a battle cannot be won do not fight it.” ~ Sun Tzu

The Art of War by Sun Tzu dates from 6th century B.C and is the oldest known manual on military strategy.

I first read it in my early teens and was captivated by the weight of the wisdom packed into such a short book. It’s not just a treatise on war but a deeper philosophical look at the underpinnings of how nature works, and more importantly, how we should operate within it.

It’s one of the few books that I revisit every few years and still manage to come away with new insights each time.

Sun Tzu birthed the concept of guerilla warfare. Guerilla warfare enables a small force to defeat a significantly larger and more well equipped one. It accomplishes this through extreme patience, knowledge of thyself and thy enemy, and a superior strategy that shapes the rules of the game to one’s advantage.

The key is in the "shaping of the rules". That's what the patience, knowledge, and strategy all aim to achieve. It's easy to win a game in which you've made the rules.

A conventional army has to play by conventional rules. These rules are dictated by its size, the resources needed to sustain it while deployed, and the politics needed to support a large campaign.

In a conventional war, armies fight for a binary outcome; they either win or lose. To win is to combat the enemy to a point where it loses its will to fight.

In a war that involves a non-conventional force, such as an insurgency that uses guerilla tactics, the rules are quite different.

The conventional force still fights for a binary outcome where success is dictated by breaking the enemy's will. But the smaller unconventional force often has the advantage because it can establish a broader definition of what winning is. It can more easily set the rules of the game it plays.

An unconventional force can win by just *not losing*. Being less dependent on large political support, it can use extreme patience to exploit a temporal advantage over its larger opponent. Because of its size it can utilize its mobility and speed to better dictate the points of engagement. It can control the operational tempo of the battlefield.

Like Sun Tzu says "Speed is the essence of war. Take advantage of the enemy's unpreparedness; travel by unexpected routes and strike him where he's taken no precautions. Swift as the wind. Quiet as the forest. Conquer like the fire. Steady as the mountain."

The conventional force is compelled to rush because of the natural constraints that come with its size and deployment. For it to win, it needs to maintain financial and political support. This support declines the longer the campaign continues. Essentially, the conventional force is exposed to Theta decay that accelerates with the passage of time.

In my past life, when I worked as a Marine Scout Sniper, I always exploited the benefit of being part of a small and unconventional force.

Operating in Iraq during the early 2000's, we fought an enemy that used basic guerrilla tactics with some brutal success. We counteracted the insurgency by leveraging our conventional assets (air and superior firepower) in combination with our guerrilla warfare operational capability.

We'd deploy in small teams (2-4 guys) that could stalk unseen into a busy city at night and set up shop deep within an enemy controlled area.

We'd create a time advantage by being patient and selective in our targeting. This enabled us to be in places the enemy didn't think we were, which meant they'd become unguarded and complacent. High valued targets would end up coming to us.

A Prussian officer said of the Spanish guerrillas during the Peninsular War, "Wherever we arrived, they disappeared, whenever we left, they arrived — they were everywhere and nowhere, they had no tangible center which could be attacked."

Like the Spanish guerrillas, we operated in accordance with the teachings of Sun Tzu. We practiced the scout sniper motto of "Suffer Patiently, Patiently Suffer". We used this to set the rules of the game in our favor. This allowed us to only play when we wanted to.

Those who control the rules, control the game.

As traders, we can utilize the same principles to set the rules and tilt the game in our favor.

I think of the market as our competitor, our enemy. It's a conventional force that has vastly superior numbers with combined cognitive power that establishes its pricing. This makes it highly efficient and difficult to beat. 99% of actively managed US equity funds have underperformed the market over the last decade (link here).

And it's in the news this week that Buffett is a sure lock to win his bet against the fund of funds manager. Buffett bet that the fund manager's selection of a handful of hedge funds couldn't beat a Vanguard S&P index fund over the last decade (the handful of funds the guy picked have performed pathetically).

Now there are many reasons for this, many of which are centered around plain mediocrity. But I believe one significant reason is that fund managers are fighting a vastly superior conventional force by using conventional tactics. They keep most of their capital fully invested and diversified. This gives the market a temporal advantage over them and exposes them to inevitably poor human decision making.

They're playing the same game that everybody else is. They aren't controlling the rules.

So how do we control the rules of the game?

Let's turn to Warren Buffett. He controls the rules of the game that he's playing better than any other investor.

And most of this rule setting advantage is centered around his patience and willingness to "sit on his hands…" and do nothing, as Livermore would say.

Buffett is highly selective. He only has to fight battles when and where he wants. He does so by spending the majority of his time studying and learning about the enemy and very little time actually engaging with it.

This is his whole punch card idea, where he said:

> *I could improve your ultimate financial welfare by giving you a ticket with only twenty slots in it so that you had twenty punches - representing all the investments that you got to make in a lifetime. And once you'd punched through the card, you couldn't make any*

> *more investments at all. Under those rules, you'd really think carefully about what you did, and you'd be forced to load up on what you'd really thought about. So you'd do so much better.*

This doesn't only apply to investors, but traders as well. The average trader (myself included) consistently takes suboptimal trades.

If you're putting on a handful of trades a month, then you're probably taking suboptimal trades too. And taking suboptimal trades means we're playing the markets game, not our own, and assuming unnecessary risk.

As traders we seek out highly asymmetrical opportunities. This translates to large market mispricings. But since the market is mostly efficient, these large mispricings are rare (in my experience they occur less than a handful of times a year).

PTJ said, "First of all, never play macho man with the market. Second, never overtrade." But as we all know, not trading is something that's easier said than done. There's few things worse than almost pulling the trigger on a trade but then deciding not to, only to see it take off for the races. Fear of missing out (FOMO) is one of the strongest impulses that we as professional speculators have to learn to control.

By practicing infinite patience and being highly selective of the instances we engage the market and put our capital at risk, we start to set the rules and control the game a little more. This is a form of **guerilla speculation**. We use our small size and mobility to set the operational tempo and dictate the rules of engagement. This puts the odds in our favor and gives us a chance of beating a more powerful conventional force.

We can continue to put the odds in our favor by leveraging our guerrilla speculation strategy onto a beta capturing strategy that seeks to piggyback off the prevailing trends in the broader indexes.

This is a mutli-strat approach and something we've been spending a lot of time developing. Currently we have the Volatility portfolio and our Strategic portfolio. And in the next few months we'll be rolling out a Core asset allocation strategy that's a trend following system with a macro overlay.

We'll be able to capture multiple beta and alpha streams through a diversified approach. The Strategic portfolio can then be used to play higher conviction macro trades, using leverage when appropriate.

A multi-factor approach not only helps smooth an equity curve but also helps fight the impulse to overtrade. The effects of FOMO are dampened because you always have a strategy at work for you. This allows you to stalk slowly and purposefully for your next high value target. It also gives you the dry powder and clarity of mind to strike when the moment is ripe.

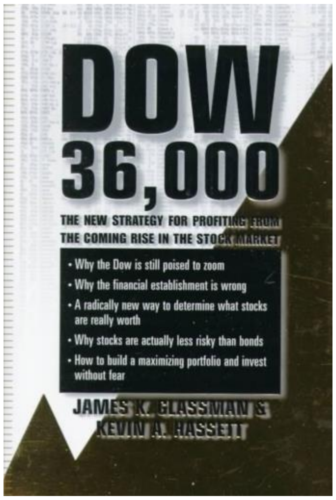
Like Sun Tzu said, If we wait by the river long enough, asymmetric trades will float by. So practice suffering silently. Study the enemy (market). And start to control the rules of the games you play.

> *The good fighters of old first put themselves beyond the possibility of defeat, and then waited for an opportunity of defeating the enemy.* ~ Sun Tzu

Macro: Credit Impulse Gone Limp

Let's start off with some quick and interesting bullet points:

- The S&P has now gone over 48 days without a 1%+ intraday move, making it the most peaceful market in history.
- Volatility persistence is at 88 year lows.
- The DJIA has closed at new ATH 11 days in a row now. A streak of superlatives not seen since 1987. And according to Urban Carmel, the streak has only extended to 12-13 days twice since 1900.
- The percentage of bullish newsletter writers from Investor's Intelligence Survey is at record highs last seen in January of 1987.
- Kevin Hassett, the economist most infamously known for authoring the book *Dow 36,000* just months before the dot-com bubble burst, was just named Chairman of the White House Council of Economic Advisers.



At Macro Ops we feel more and more comfortable with the call we made last year that we're entering a period similar to 98'-99'. We don't see mass euphoria yet, and think this market still has a ways to run, but expect this party to get even more frothy in the coming months.

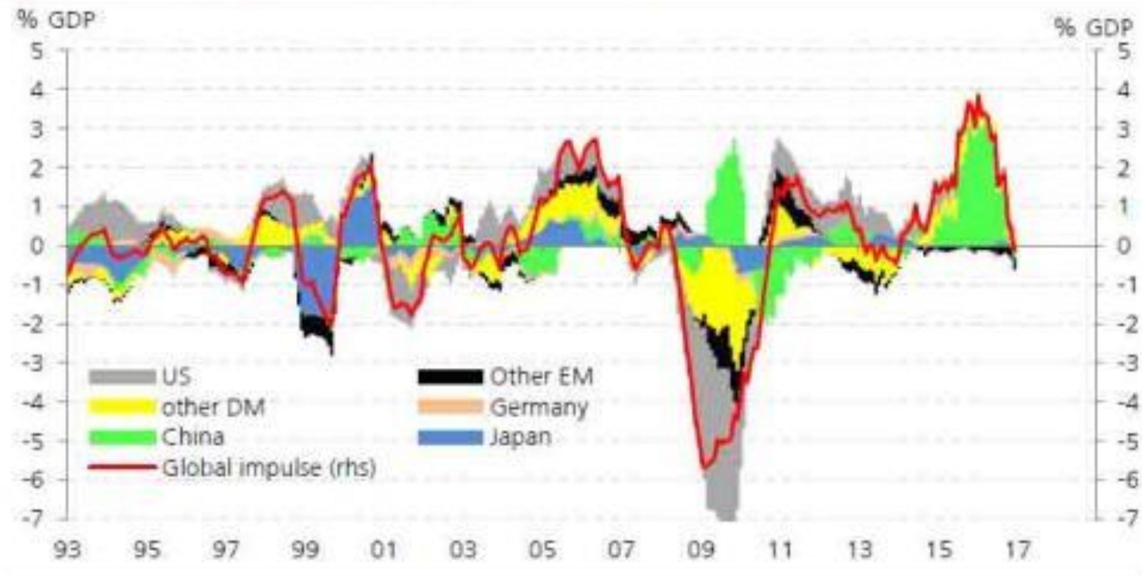
To cite Urban Carmel again, of the last 14 similar streaks in the Dow, the index closed higher 1 and 3 months later, 79% of the time. And it closed higher 6 or 12 months later, 79% of the time. Basically, momentum is a powerful thing and this trend is building some sizable momentum.

And this is interesting because as we've been talking about, this will only further drive price away from any sustainable narrative. This will result in a hangover that will be *that* more nauseating.

As is typical in the latter stages of the credit cycle, we're seeing the trend in the bullish narrative increase while the underlying fundamentals begin to turn over.

Recent data in the global credit space are an example of this. Look at the following chart from UBS showing the global credit impulse.

Figure 1: Global Credit Impulse falls back to zero



Source: Haver, UBS estimates

A credit impulse is just a derivative that denotes the rate of change of credit creation. And as we know, credit creation/destruction is at the very heart of the short-term debt cycle (business cycle).

The chart shows that the global credit impulse has collapsed recently and has begun to turn negative. This is largely being driven by the turning over of credit growth in China, following their large credit injections at the beginning of last year.

And across developed markets we're seeing a tightening of lending standards and a slowdown in lending growth as well. Wells Fargo noted the following in a recent note:

> *On the supply side, lending standards for CRE loans continued to tighten across the board in the fourth quarter, marking the sixth-consecutive quarter of net tightening (bottom chart). The Fed survey noted particularly "significant" tightening for loans secured by multifamily properties and construction land development loans, with a net 33.3 percent and 25.0 percent of firms, respectively, tightening standards. Meanwhile, a more moderate 13 percent of banks reported tightening standards for nonfarm nonresidential property loans.* ***The survey data suggest that bank lenders are proving themselves more cautious/selective, consistent with indications that the sector is at a mature stage in the current cycle.***

This slowdown in credit growth (which means a slowdown in future demand) is also coinciding with an end to the base effects we've been enjoying for the last few quarters. Here's the following from a BofA note *via Macronomy:*

> *WTI oil prices have more than doubled since reaching the low close of $26.21 a year ago on 2/11/2016 (Figure 1). This means that, if oil prices remain stable, headline inflation is peaking (at least locally) today. However, because economic data is reported on a delayed basis – and only monthly, not daily – we should*

continue to see oil prices driving up headline inflation numbers above core when reported for January (next week) and February.

This means that we should see lower growth and lower inflation over the next few months. This could be affected by the short-term movements in the dollar (a USD selloff would be supportive of both) but that would likely be transient.

Either way, it's going to make for an interesting year ahead.

Here are the key events for the week ahead:

- US Durable Goods and US Pending Home Sales come out Monday
- Eurozone CPI, China and Japan PMI's, US GDP and trade balance, US Chicago PMI and Consumer Confidence hit the tape Tuesday
- Trump is speaking to Congress on Tuesday and is supposed to reveal his "Big League" tax plan. I suspect that the market could use this as a reason to run (but maybe not if it includes a BAT)
- US auto sales and Fed Beige book come out on Wednesday
- Thursday a lot of European PMI's, Flash CPI, and US unemployment claims
- Yellen speaks on Friday

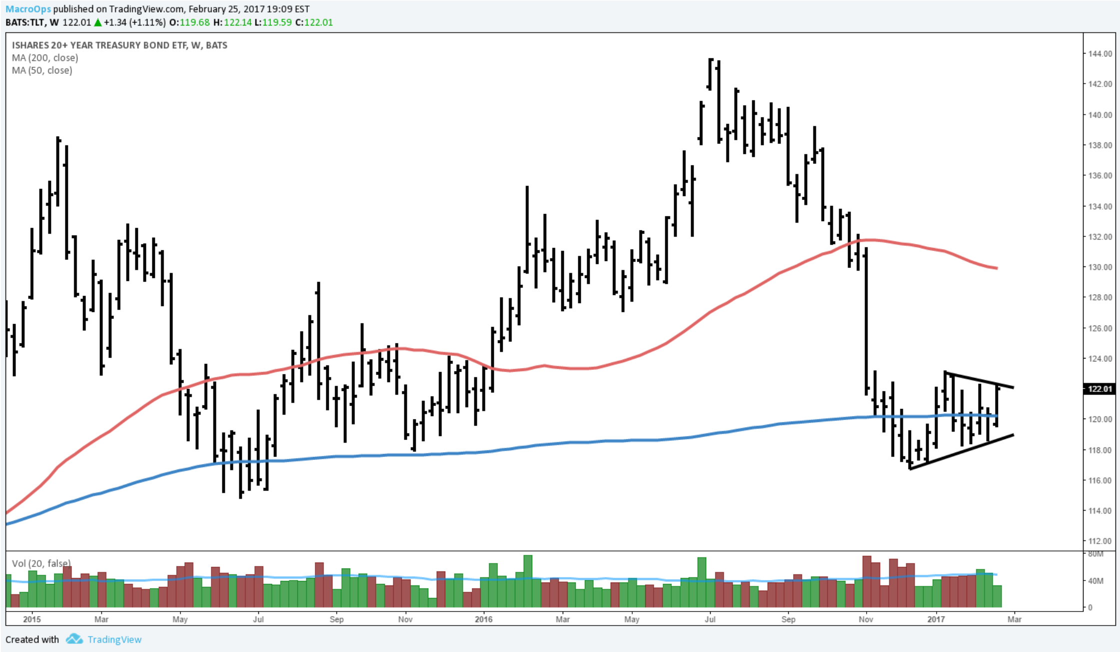
Finally, Snapchat is going to IPO this week and apparently, the issue is hot and oversubscribed.

Tactical: Ain't Nothin Coming…

I still don't see any great trades at the moment. I'm waiting for the currencies to do something, but they continue to frustrate and disappoint anybody who tries to call a breakout. Perhaps after Trump's speech and maybe some color on potential for BAT or import tariffs we'll see some action in the dollar… but I'm not holding my breath.

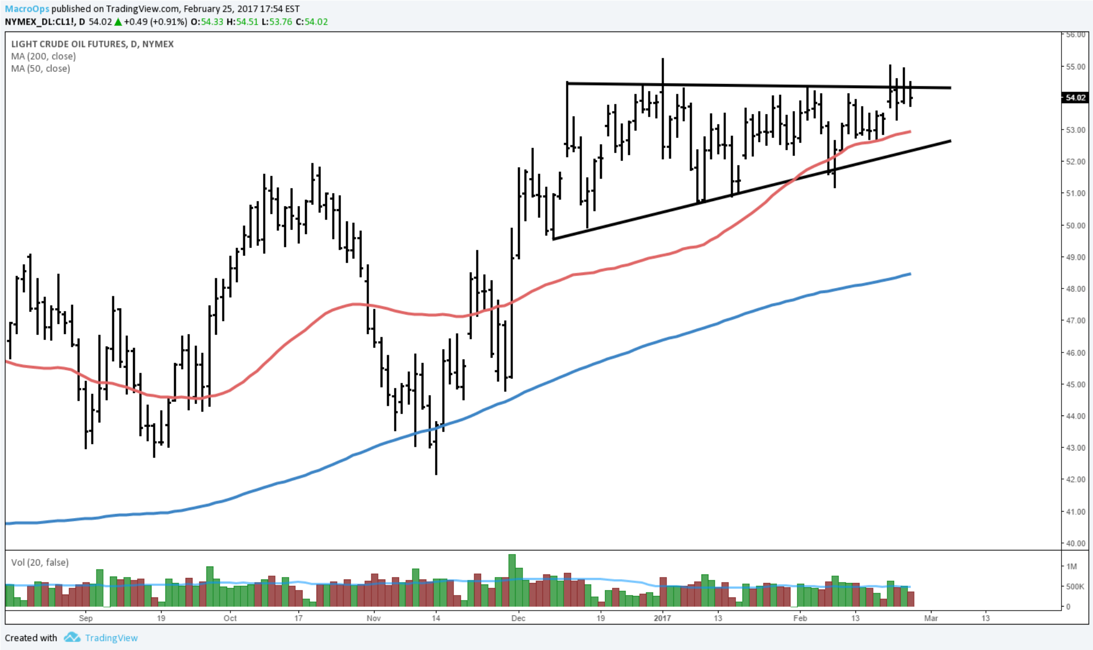
Market breadth weakened a little bit last week but not enough to signal a large selloff yet. We'll keep the community posted if we see that change.

The US 10-year closed near the high of its wedge last week (chart below).



I'm willing to take a swing trade to the long side here if the equity market looks like it's going to turn over.

Oil, like currencies, continues to burn the hand of anybody who tries to play a breakout. Welcome to the new world of algo dominated trading. You should expect to see more and more pattern failure and false breakouts where fading classical chart pattern breakouts might be the go to move.



I think oil will eventually move to the upside but I don't think it'll have much in the way of legs. I'd rather play the bull trap scenario, wait for a turnaround, and play the reversal to the short side. Again, it all depends on where the dollar is headed.

That's all I've got this week. These markets are sleepy and it's a good time to focus on process and study. Let me know if you guys are seeing something I'm not and let's continue our guerrilla warfare on the market ;)

Cheers,

Alex

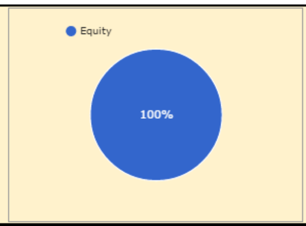
Portfolio Snapshot

Strategic Ops

NAV	$1,128,258						
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	400	$11.11	$7.55	$1,424.00	$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	Uranium Res URRE	3,000	$2.56	$1.58	$2,940.00	$9.00	$6,300

Metrics

Exposure Breakdown	
Equity	$11,844.00
Commodity	$0.00
Fixed Income	$0.00
Forex	$0.00



Total Open Risk
$11,844.00
1.05%

**Updated 2/26

Volatility Ops

NAV	$1,163,761			
Asset Class	Position	Size	Cost Basis	Notional
Volatility	April VIX Future	-17	15.697	-$259,248

Scenario Analysis/Stress Tests

1-Day VAR	-$34,531

**Updated on 2/26