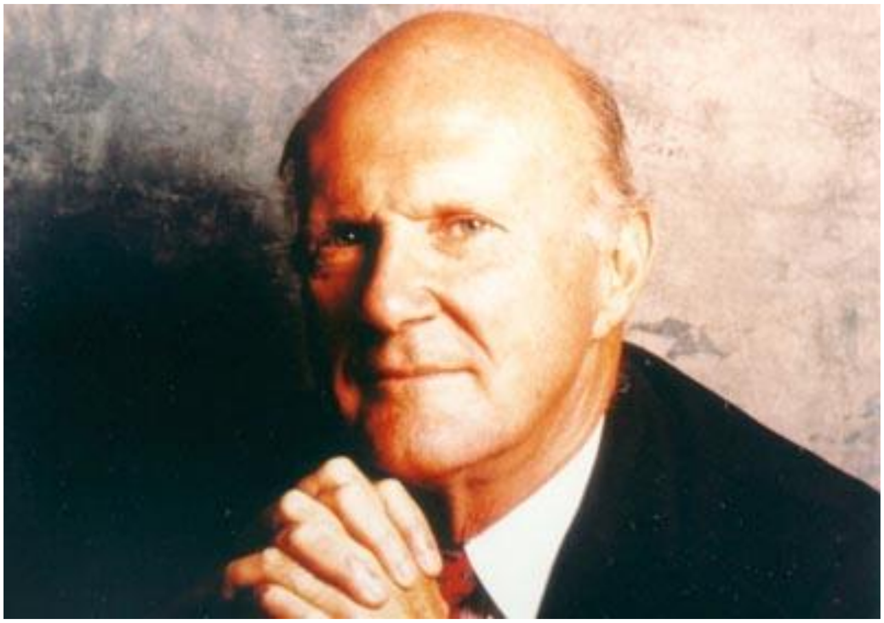
MARKET BRIEF

Grass Or Honey?

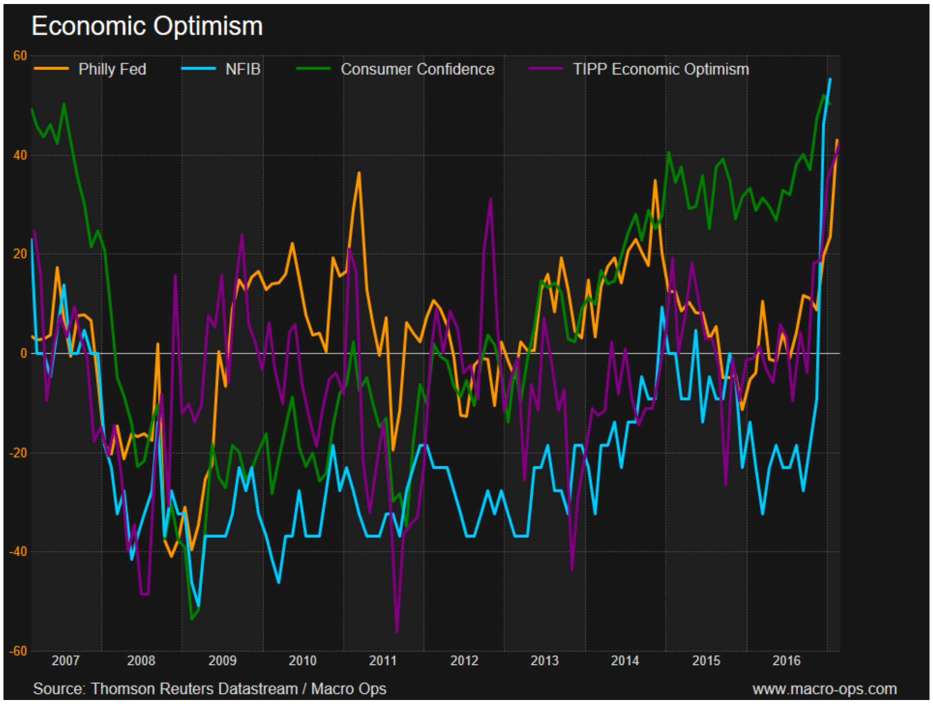


> *“The media, public and analysts, virtually everybody, are so bullish that they could be described as ‘eating grass’, when this happens it may be best to crawl in a log and slurp some honey.”*

Hedge fund legend, Julian Robertson, wrote the above in a letter to his investors describing the excessive optimism he saw in the years leading up to the 87’ crash.

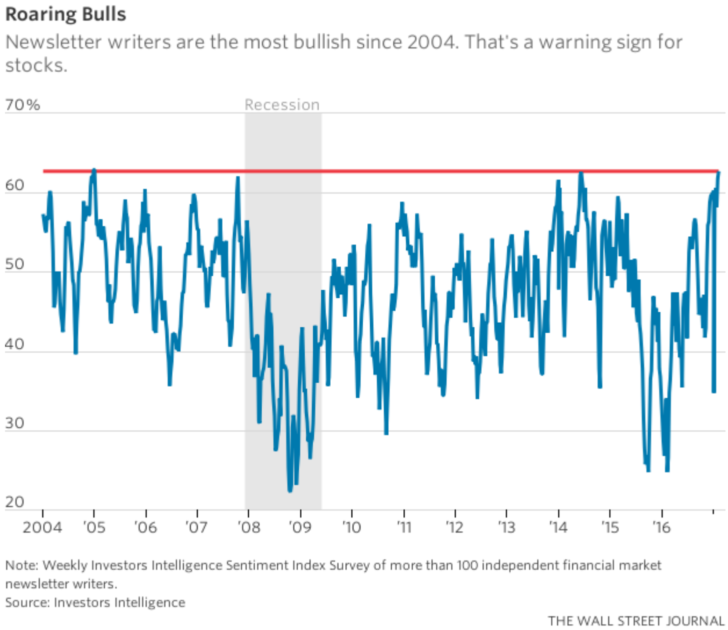
Today, investors aren’t <u>all</u> hoofing grass quite yet but it looks like they’re gearing up to.

Take a look at the survey/expectation data below. All have gone vertical like an Atlas-V rocket since the election, with some surveys seeing their largest positive spike in decades.



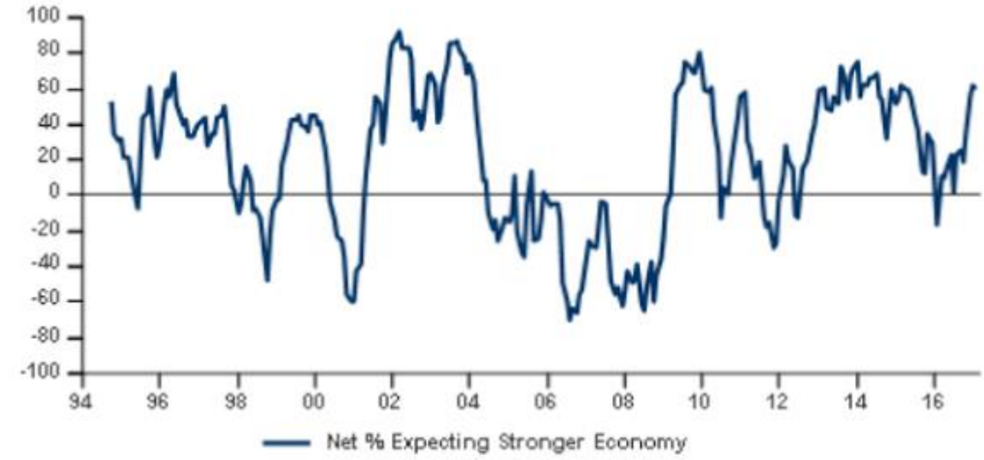
I like the idea of cutting regulations and lowering taxes as much as the next person. That's just plain smart economics. But I wonder if we're (market) getting a little ahead of ourselves here.

Market newsletter writers certainly don't think so. According to the WSJ, *"The share of newsletter writers who are optimistic on the stock market climbed to 62.7% this week, the highest level since 2004."*



According to the latest BofA Fund Manager Survey, it seems that a strong majority of hedge fund managers agree. Over 60% of those surveyed expect a stronger global economy in 12-months time.

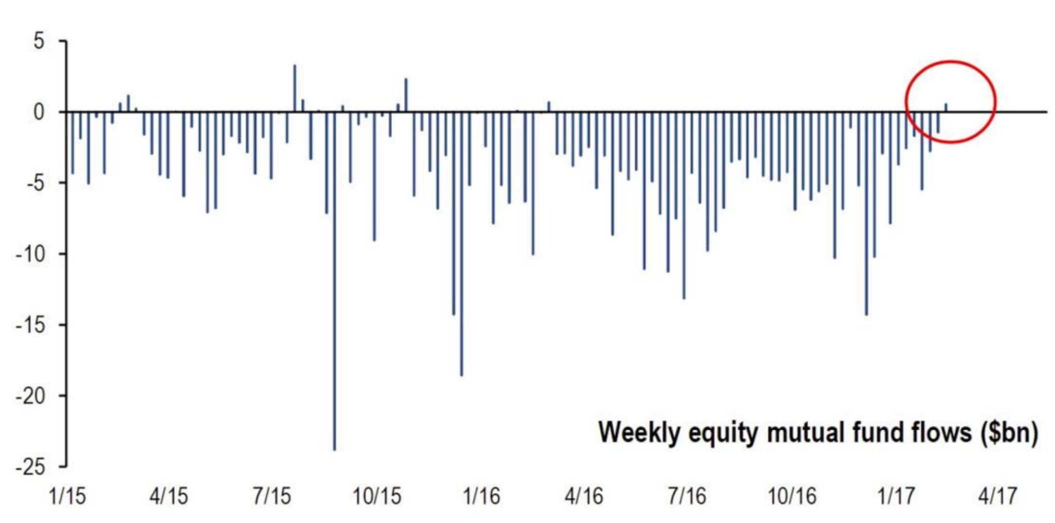
Exhibit 13: How do you think the global real economy will develop over the next 12 months?



Source: BofA Merrill Lynch Global Fund Manager Survey

And retail traders appear to think now is *finally* time to start dipping their toes back into the market with long-only equity mutual funds seeing their first positive weekly inflows in over a year.

Chart 1: First weekly inflows to long-only equity mutual funds in 12 months



Source: BofAML Global Investment Strategy, EPFR Global

When I see across the board consensus like this, the contrarian in me starts to stir like crazy. It makes me want to fade the masses.

Though tempting, it's injurious to one's P&L to run against a herd of stampeding bulls. Late cycle dynamics — like we're in now, similar to 99' — have a momentum that's all their own. Pervasive dip buying brings in more and more aggressive trend followers making the market move in sharp thrusts higher accompanied by quick and violent retraces lower.

And despite the budding bullish consensus over the economy and stock market, there's not a whole lot in the coming weeks that looks likely to derail the enthusiasm.

Let's go down the list.

Q4 EARNINGS SEASON REPORT - USD

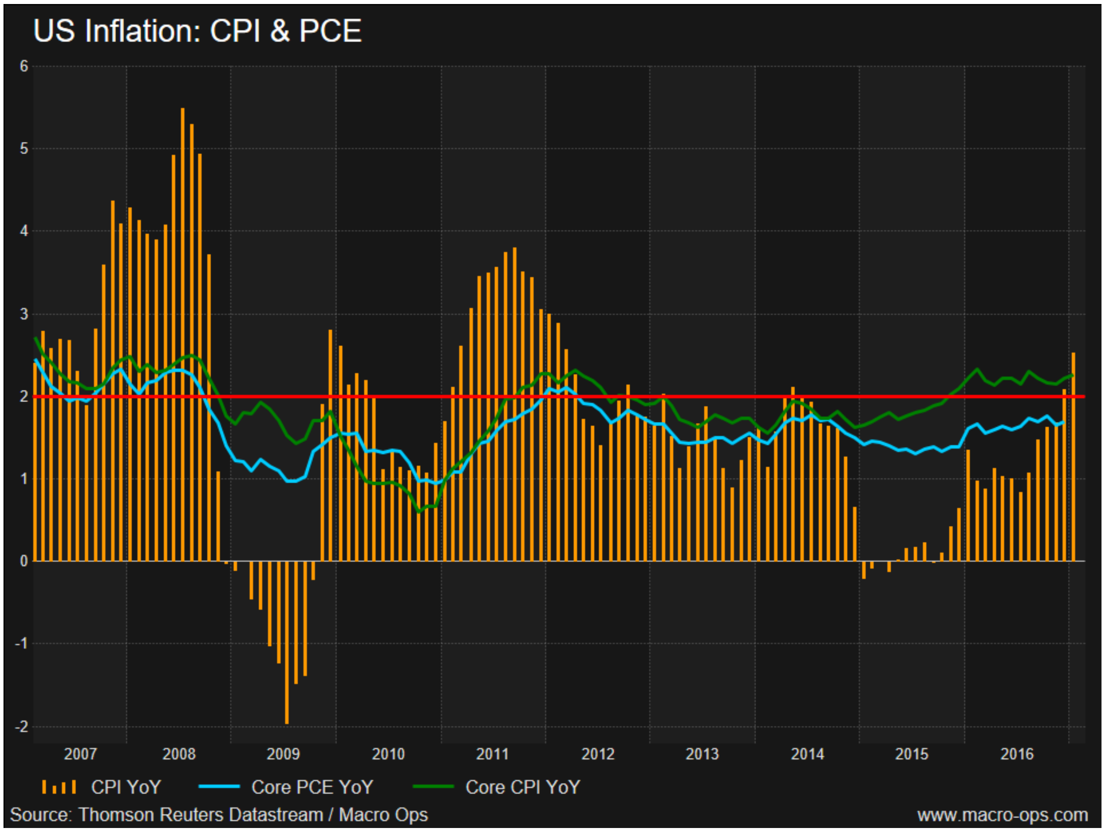
Identifier	Earnings Summary			
	% Reported	% Beat	% Met	% Missed
All Economic Sectors (3200)	53%	61%	11%	28%
Basic Materials (156)	58%	53%	8%	40%
Consumer Cyclicals (442)	43%	62%	8%	30%
Consumer Non-Cyclicals (135)	60%	52%	15%	33%
Energy (257)	39%	50%	5%	45%
Financials (763)	70%	58%	15%	26%
Healthcare (500)	27%	63%	8%	28%
Industrials (415)	59%	60%	11%	29%
Technology (411)	65%	79%	7%	13%
Telecommunications Services (4...	45%	28%	11%	61%
Utilities (81)	40%	44%	16%	41%

So far in the US, 53% of companies have reported 4th quarter earnings. Out of those, 61% beat, 11% met, and 28% missed expectations.

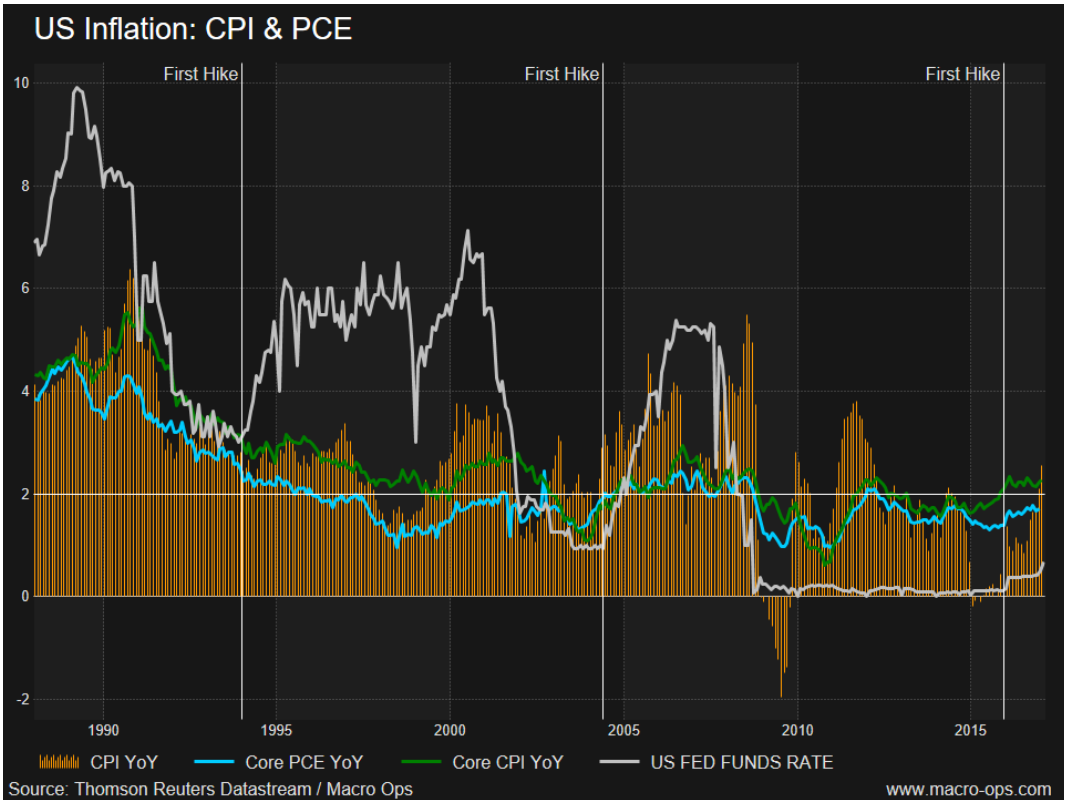
One of my biggest concerns, the Fed, has softened its tone in recent weeks and looks to be playing it extra safe in setting rate expectations. Here's the following from my favorite Fed watcher, Tim Duy, writing in *Bloomberg*:

> *The January employment report, while showing a solid 227,000 gain in nonfarm payrolls, also revealed an uptick in unemployment to 4.8 percent. That is actually good news. It means the Fed is underestimating the rate of labor-force growth. The economy can run hotter for longer than the Fed anticipated and justifies a continued gradual approach.*
>
> *Sure, it's open because there will be a meeting and there will be talking. But market participants are matching the data to the Fed's reaction function and concluding that 1) the Fed isn't behind the curve, 2) if anything, the Fed is in jeopardy of falling short of its forecast, 3) there is no pressing reason for a preemptive move, especially given that 4) the Fed still has plenty of opportunities to raise rates later this year, and 5) the quantity of incoming data between now and the March meeting isn't likely to be sufficient to overturn points 1 through 4.*

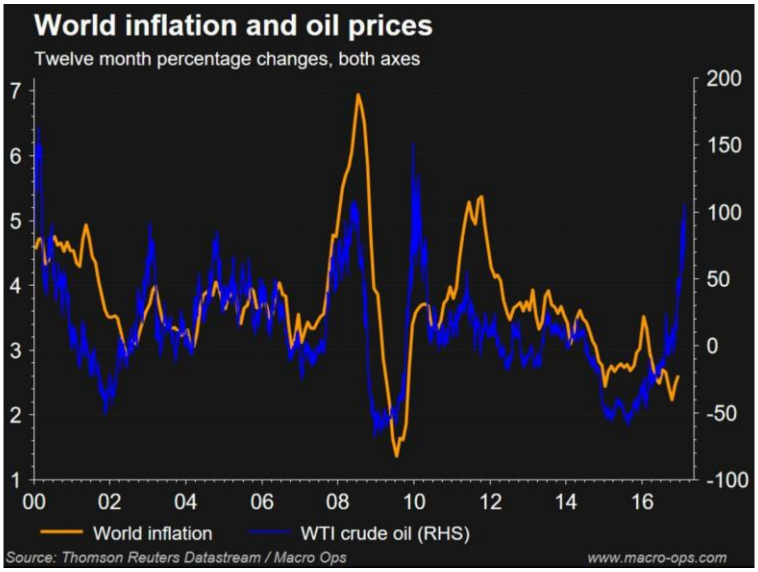
A lot of people are noting the recent rise in inflation as a cause for alarm that the Fed may raise its rate path. The chart below shows that both headline and core CPI are now above the Fed's target of 2%.



However, core PCE, the Fed's preferred measure of inflation, remains safely below 2%. Looking at the last two hiking cycles you can see that in comparison, today's trend in inflation still gives the Fed plenty of cover to play it slow and steady.



But of course this could change quickly. It's possible that in a few months we'll see all the inflation readings well above 2%. In which case, I think the Fed quickly transitions to fearing that it's fallen behind the curve and starts aggressively hiking rates.



One of the most important variables affecting where inflation trends is oil. Changes in energy precede changes in inflation. And that includes core inflation, even though it excludes food and energy prices.

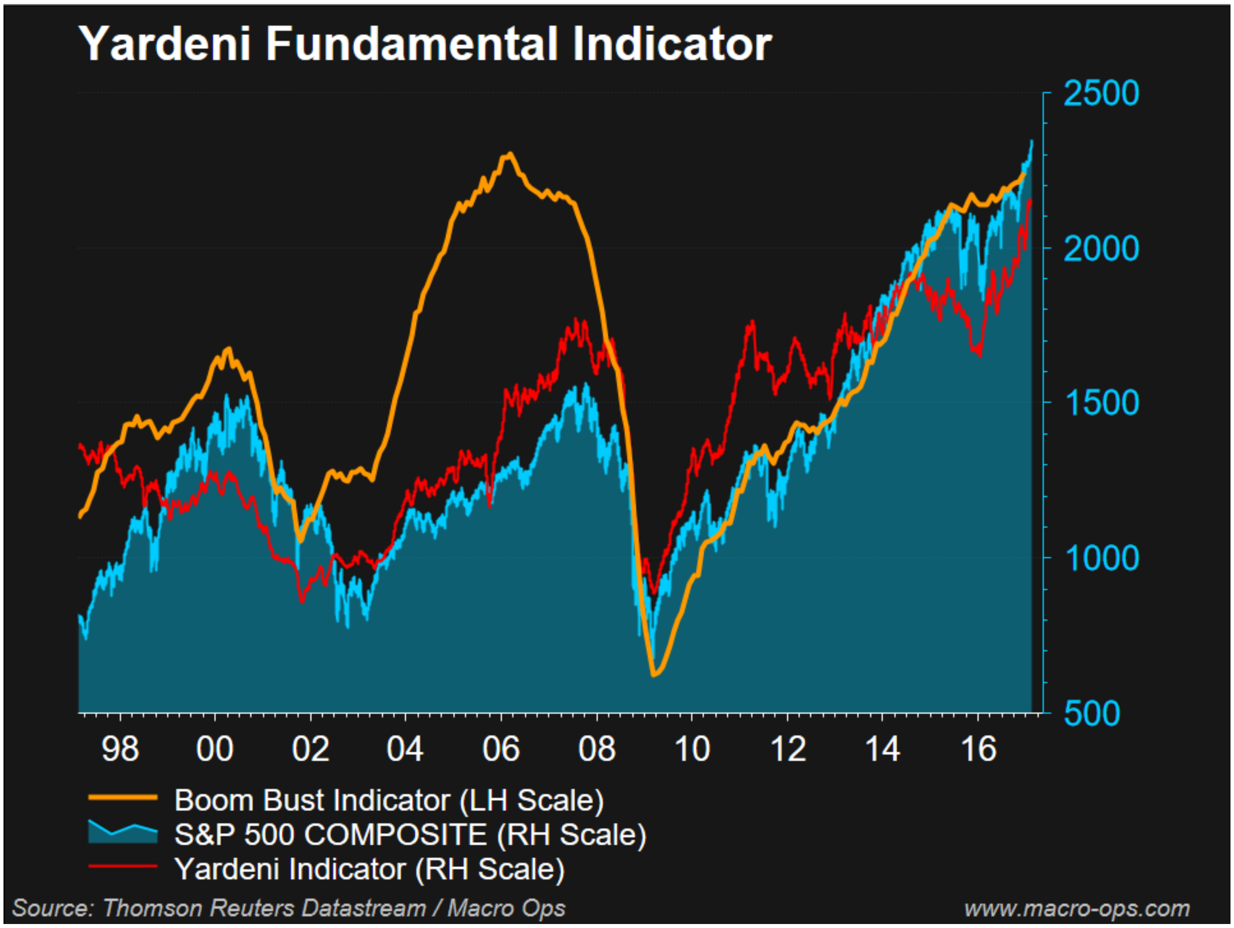
This is because the cost of oil affects production and transportation costs of nearly all other goods. Also, the primary driver in the price of oil is the relative movement of the US dollar. A downtrending dollar raises energy prices as well as the prices of other goods.

All our liquidity and breadth indicators remain supportive of equities over the near-term (ie, next few weeks). Markets hardly ever directly reverse from an uptrend. They typically level off and consolidate first beforehand. It's during these leveling off periods that we'll see liquidity and breadth indicators signal an impending selloff. But as of this writing, the coast remains clear.

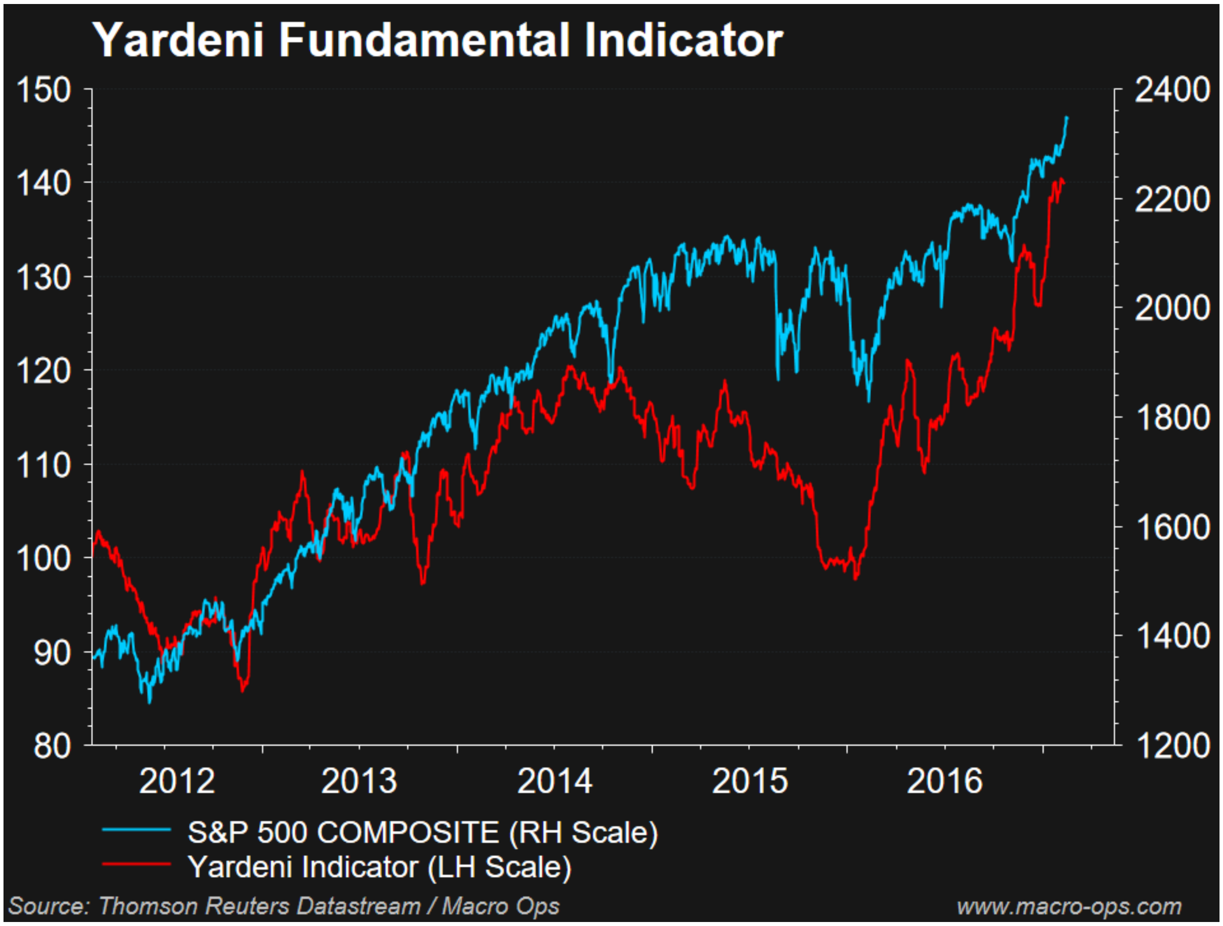
I learned about two useful indicators this week that were created by Dr. Ed Yardeni (h/t to Kevin Muir at Macro Tourist for sending me the indicator breakdown) . His blog is on my weekly reading list and I suggest you read him too if you're not already (here's the link).

The first, which is denoted by the yellow line below, is Yardeni's Boom-Bust Barometer. The barometer is comprised of the monthly average of the CRB raw industrials spot price index divided by weekly initial unemployment claims.

Yardeni's Weekly Leading Index (red line) is a composite of the average Consumer Comfort Index (four week average) with the Boom-Bust Barometer.



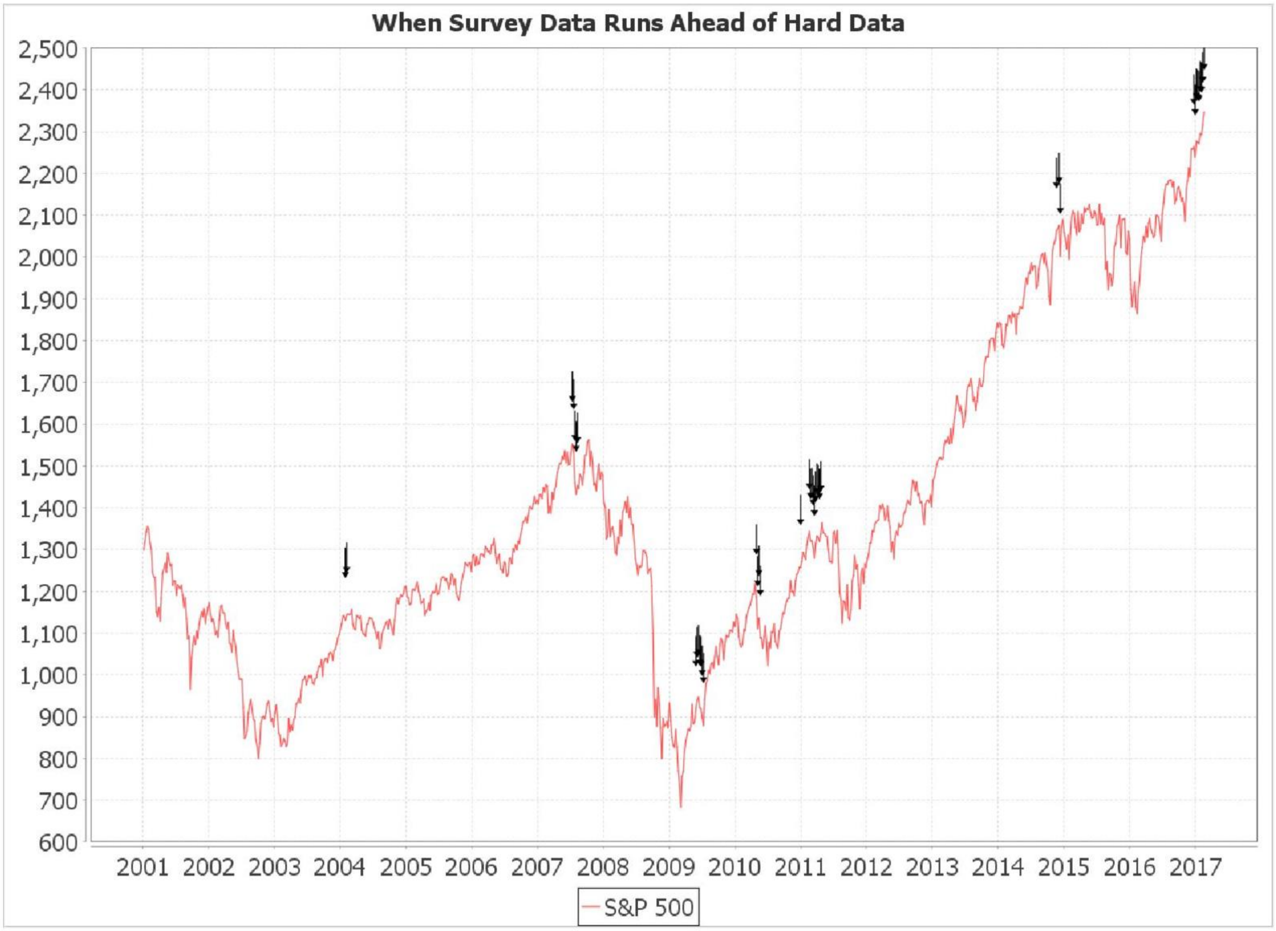
Both indicators have historically worked fairly well as coincident and leading indicators. We'll be adding these to the dashboard in the Hub and notifying you guys of any change in trend. As of right now, the Yardeni indicator is clearly signalling that the path of least resistance remains upward.

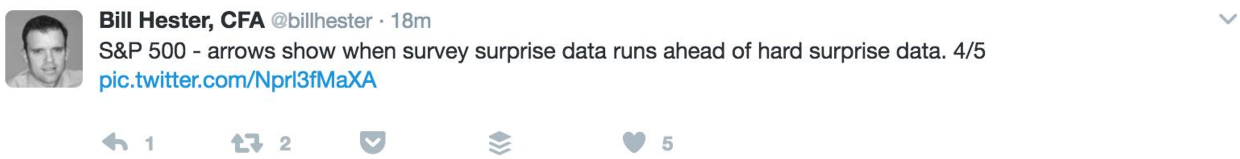


Even though it looks like we're in the clear over the near-term, I think this bullish rise is only going to serve to further exacerbate expectations which by any measure are bordering on unrealistic.

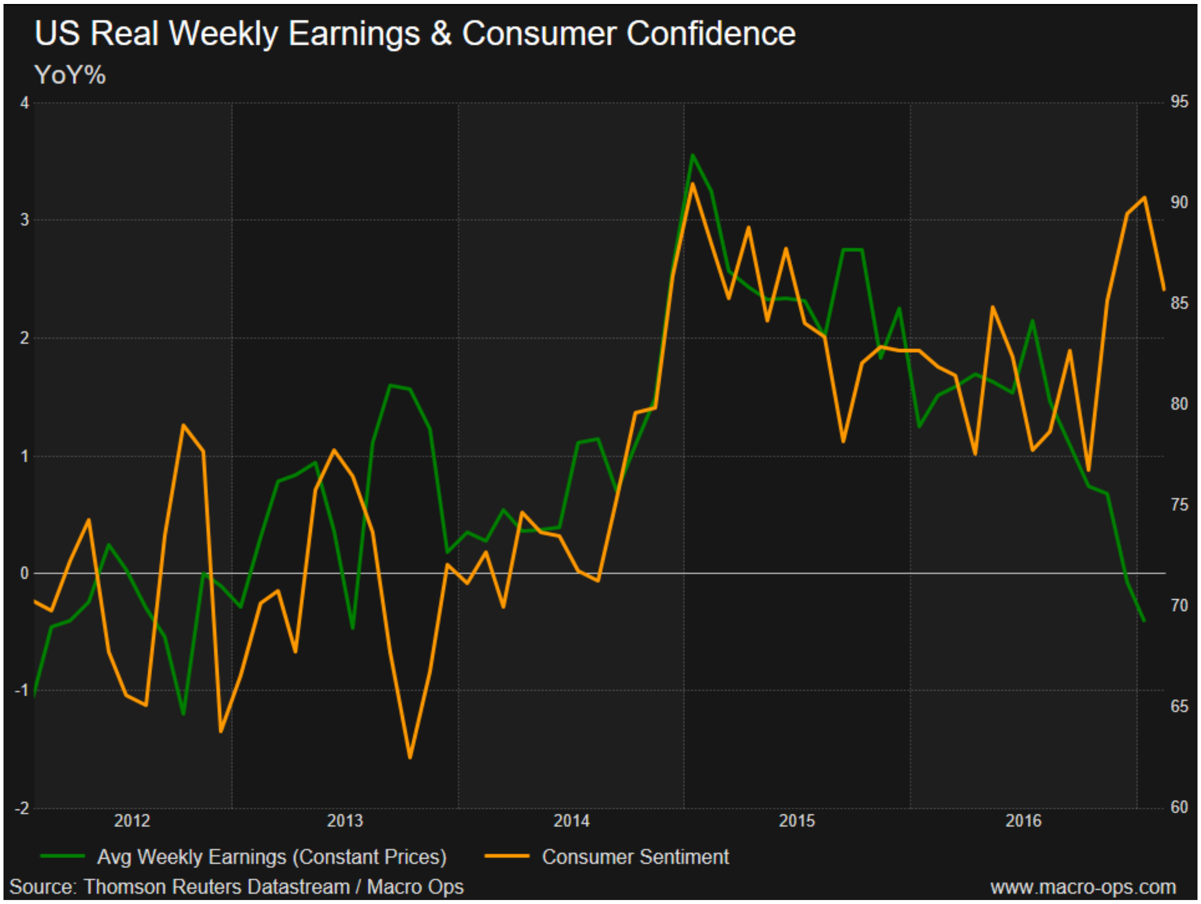
When expectations run far ahead of likely results, it lowers the probability of positive outcomes while drastically raising the likelihood for disappointment. And when markets are already at historically stretched valuations and leverage is high… that is a dangerous thing.

The chart below *via @billhester* shows that when overly optimistic survey data runs ahead of the actual hard data, sizable market selloffs tend to follow.





At the very least, the market is setting a high hurdle for the future. And if we continue to see a growing number of charts look like the one below showing real weekly wages and consumer confidence, then I think we'll see these optimistic expectations begin to snap back.



Trading in late cycle bull markets is tough. It's easy to become tempted to chase, take subpar entries, and up your leverage. You need to do the exact opposite of this.

I'm going to continue to play light and nimble. Capital preservation is much more important than the pull towards performance chasing.

For the last year I have run an extremely light book. I generally have a lot more positions on and a far more diverse exposure. But the current market environment does not present a lot of positive asymmetry so I have to continue to fight the urge to jump in and aggressively trade.

I have a feeling that later this year we will be building a sizable short book; something we haven't done in a long time. But that's maybe 6-12 months out.

Until then, we're going to be cautiously chewing grass while eyeballing the honey.

Technical: Wait and See

I'm not seeing any trades that I love at the moment but there are some that I'm keeping a close eye on.

A lot of people have been talking about going long bonds at these levels. Positioning and sentiment are definitely at extremes on the short-side which make the trade compelling. I'll consider this trade if I start to see a deterioration in stocks. I'd like to see market breadth and junk bonds turnover first. Until then, I'll watch from the sidelines.

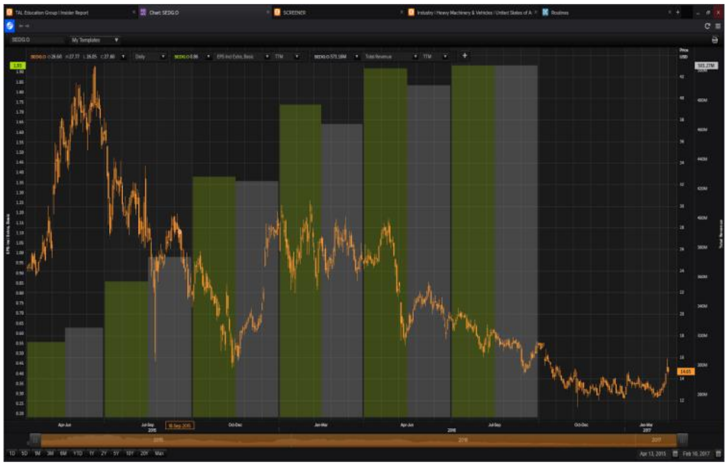
Exhibit 23: Net % AA Say they are OW Bonds

Source: BofA Merrill Lynch Global Fund Manager Survey

The MSCI Israel ETF (EIS) is close to breaking out of a 8-year coiling wedge pattern. Long-term patterns like this tend to lead to large and enduring runs to the upside. If there's a weekly close above the $52 level I'd consider putting on a position in the ETF. I'm also digging into a number of Israeli stocks that trade in the US.

Solaredge (SEDG) is a company I'm looking into. The price action is definitely favorable. Everybody hates the stock on the financial message boards, which is something I always like to see. I'll be putting out a tearsheet this week on the stock.

The left chart is of SEDG on a weekly basis. The right chart shows TTM revenue in grey and TTM EPS in green.



Below is Sapiens International (SPNS), an Israeli based tech company that specializes in providing SAAS to insurance companies. Below is a monthly chart showing the stock in a strong 7+ year trend.

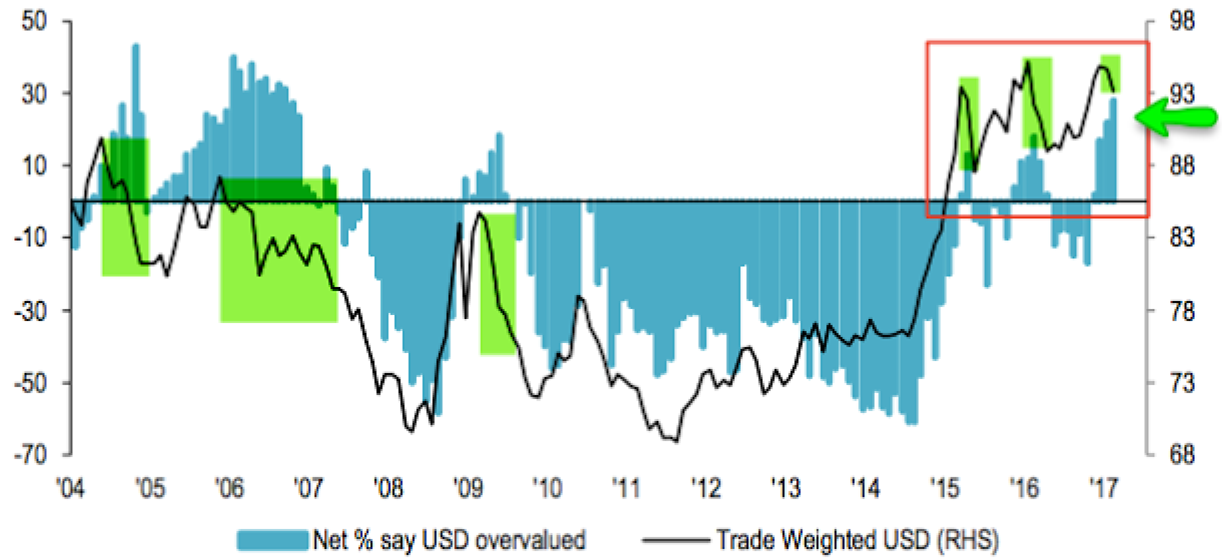
The chart below shows the TTM revenue in grey and TTM EPS in green. The stock continues to see strong growth and with tech leading the way in this market, this could be a decent trade. I'll also be putting out a tear sheet on this company this week.

Finally, the dollar. Currencies remain a tricky trade and after getting continuously burned in the FX market over the last year, I'm being patient and waiting for a clear market signal before entering again.

The chart below of the dollar index (DXY) shows that the greenback may be forming an intermediate H&S top. The EURUSD pair also shows a clear inverse H&S bottom forming.

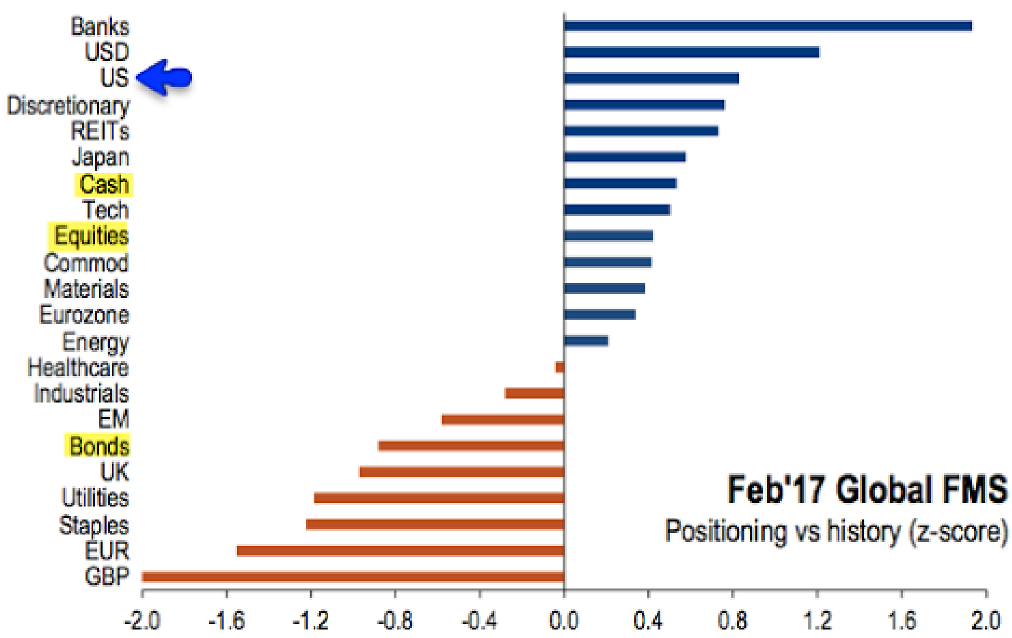
Like bonds, the dollar remains a one-sided trade. Fund managers remain very long US dollars. At the same time, fund managers also think the dollar is overvalued, as shown on the chart below. Both suggest that the dollar is due for a correction and if we see a clear break of that neckline, I'll look to get short the dollar and potentially long some miners for a swing trade.

Exhibit 3: US$ Valuation and Trade weighted index



Source: BofA Merrill Lynch Global Fund Manager Survey

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



Source: BofA Merrill Lynch Global Fund Manager Survey

But I'm not convinced that this would mark the top of the dollar bull market. I think if we see a retrace it'd likely last 1-3 months. And if we do, remember the impact it will have on oil and inflation and then the Fed as a result. Something to keep in mind.

I expect a quiet trading week this week with markets closed on Monday and little econ data coming out.

A big unknown in markets over the coming months is the political situation here in Washington and Europe. In the US, as I've said in the past, I think Trump's erratic governing style is short-term bullish for stocks because it feeds into the Fed's rate decision making. But there is a limit to what the market will accept.

I've been hesitant to comment on US politics because of how charged the environment is. And I know the MO community is pretty evenly divided and passionate on the matter. I, myself, am apolitical. I despise and distrust all politicians and political parties equally.

With that said, I'm afraid I'm going to have to write a piece giving my thoughts on the current administration and where I think things are going. Since I used to work in government and still hang out with many federal employees, I feel I have some useful insight that I can share with the group. However, I expect angry emails from half of you after.

Hope you had a good weekend and see you in the Hub.

Your Macro Operator,

Alex

Portfolio Snapshot

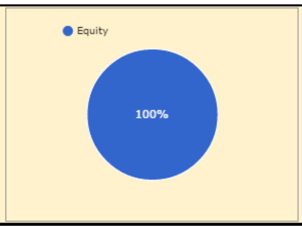
Strategic Ops

NAV	$1,131,579

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	Uranium Res URRE	3,000	$2.56	$1.58	$2,940.00	$9.00	$6,300

Metrics

Exposure Breakdown	
Equity	$16,472.00
Commodity	$0.00
Fixed Income	$0.00
Forex	$0.00



Total Open Risk
$16,472.00
1.46%

**Updated 2/19

Volatility Ops

NAV	$1,179,006

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 2/19