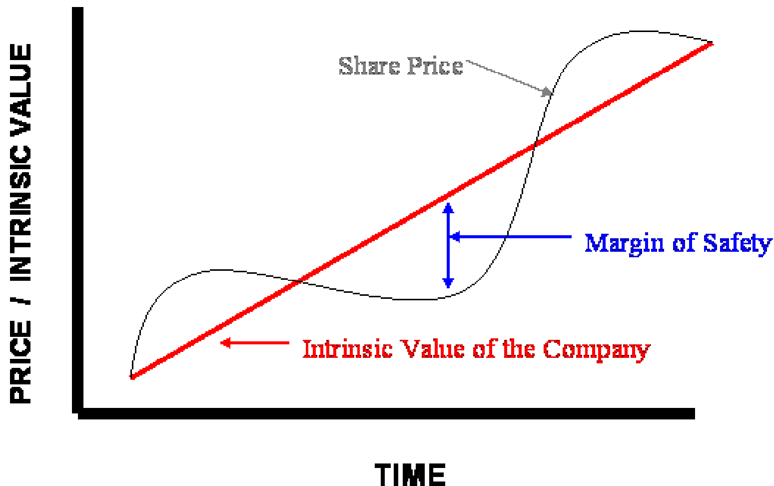
MACRO INTELLIGENCE REPORT

February 4th, 2017

Market Overview: Margin Of Spread



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Some investors, desperate for better yield, have been reaching not for a new Wall Street product but for a very old one–common stocks. Finding the yield on cash unacceptably low, people who have invested conservatively for years are beginning to throw money into stocks, despite the obvious high valuation of the market, its historically low dividend yield and the serious economic downturn currently under way.

How many times have we heard in recent months that stocks have always outperformed bonds in the long run? Funny, but we never hear that argument at market bottoms. In my view, it is only a matter of time before today's yield pigs are led to the slaughter house. The shares of good companies and bad companies alike are vulnerable to sharp declines. Moreover, many junk bonds that have rallied will tumble again, and a number of today's investment-grade issues will be downgraded to junk status if the economy doesn't begin to recover soon.

What if you depend on a higher return on your money and can't live on the income from 4% interest rates? In that case, I would advise people to ignore conventional wisdom and consume some principal for a while, if necessary, rather than to reach for yield and incur the risk of major capital loss. Stick to short-term U.S. government securities, federally insured bank CDs, or money market funds that hold only U.S. government securities.

> *Better to end the year with 98% of your principal intact than to risk your capital roofing around for incremental yield that is simply not attainable.*
>
> *I would also counsel conservative income-oriented investors to get out of most stocks and bonds now, while the gettin is good. Caution has not been a profitable investment tactic for a long time now. I strongly believe it is about to make a comeback.*

The above is from a Forbes article written by legendary value investor and hedge fund manager Seth Klarman.

In the article, Klarman excoriates common investors for being "yield pigs" blindly piling into common stock. Low yields having driven them into a frenzy for return… as they hoof their way to the slaughterhouse to be ground into some expensive breakfast sausage.

Hopefully some of you more astute readers caught this line, *"What if you depend on a higher return on your money and can't live on the income from **4% interest rates**?"*.

4% rates isn't a typo. This article sounds like it could've been written today (it's actually a lot more applicable now), but Klarman wrote it all the way back in 92'.

Klarman made some good points. Back in 92' stocks <u>were</u> overvalued on a historical basis and investors <u>were</u> chasing yield.

What Klarman got wrong was the timing… he was 8 years too early to be exact.

The "yield pigs" got to enjoy a 269% return in the S&P and a not too shabby 840+% run in the Nasdaq before they were led to the "slaughterhouse".

Not to pick on Klarman — despite his error in 92' he's managed to do just fine (massive understatement) — but he fell victim to a common misunderstanding of how to assess valuations and future returns from a macro perspective.

At this point you may be thinking to yourself, *"Jesus, Alex… just how full of yourself are you to think that you can teach Seth Klarman something about valuation?"*

Yeah, yeah. I get it. That's a more than reasonable response and I wouldn't blame you if you're somewhat skeptical of my sanity (you're hardly alone). But just hear me out. Keep an open mind and come to your own conclusions.

What I'm going to show you is that valuations matter a lot but not in the way that most people use them. To do this, we'll discuss the following theory that's central to how we at Macro Ops determine macro valuations:

- **Relativity Theory:** Valuations can't be looked at in a vacuum but only relative to other asset classes

Afterwards, we'll look at where relative valuations are today and how we want to be positioned going forward.

Back in 1992…

Let's start at the beginning and go back in time to 1992 when Seth Klarman warned readers about the impending "stock market disaster".

It was a contentious presidential election year between the incumbent George H.W. Bush and his opponent Bill Clinton.

The US military had ended the Gulf war a year earlier and the economy had just come out of a mild recession in the middle of 91'.

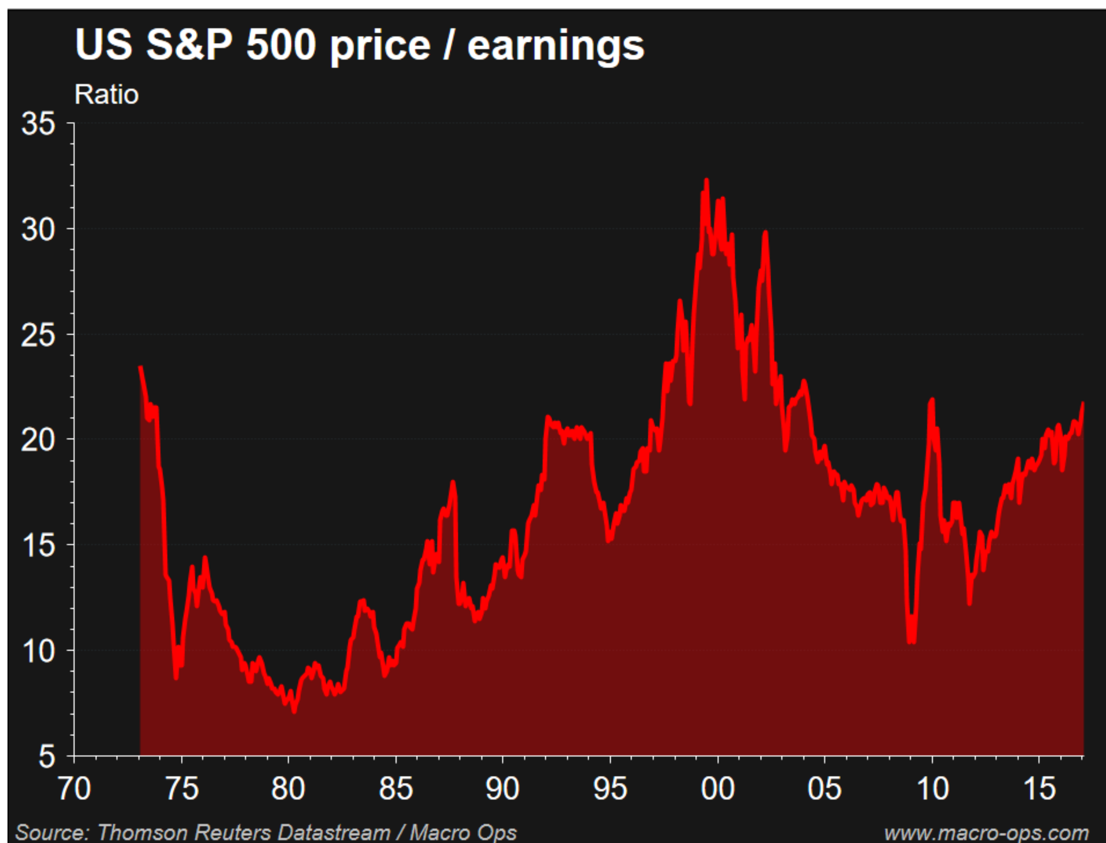
US GDP growth was hovering around 4%. Inflation was at just over 3% and the 10-year was yielding a whopping 7.25%. (Can you imagine getting over 7% on a government bond? Must have been nice.)

If one were to open the *NYT* they would see articles such as:

- MARKET WATCH; A Clinton Win: Good for Stocks, Bad for Bonds?
- Next It May Be Economy Up, Stocks Down
- Stocks Surge, And Wall Street Is Surprised

Newspapers were filled with concerns over stock market valuations, debt levels, a coming boost in fiscal stimulus driving up inflation, and political risks from a new presidential administration. Just a lot of dour pessimistic views on the economy in general — sounds somewhat familiar, huh?

The S&P had a PE ratio of 25.93 (today it's at 25.56) and a cyclically-adjusted price-earnings (CAPE) ratio of 19 (today it's 28).



Valuations were high (average historical PE is 15 and CAPE is 16), debt levels were high, we'd just come out of a war, and like today there were a lot of things to be worried about.

Under these circumstances it was very *reasonable* to be if not bearish, then at least pragmatic about future stock market returns.

Seth Klarman probably sounded pretty smart and responsible admonishing those yield chasing pigs who were destined to pay for their investing gluttony.

And yet… 92' happened to mark the *very* beginning of the longest economic expansion and greatest equity bull market in US history — one that would last for 3,452 days…

The S&P's CAPE went from 19 to a high of 44 and its price-to-earnings climbed from 25 to the nosebleed levels of 34 (and those pale in comparison to the multiples on the Nasdaq which were at 175).

So *why* did this happen?

How were extremely talented value investors like Klarman and Buffet left sidelined and befuddled by market valuations that seemed to go from stupid to "*you gotta be kidding me"* levels*?*

The most common explanation comes from Nobel Laureate economist Robert Shiller — the market entered a period of "irrational exuberance". Basically… we all lost our marbles and entered a collective hysteria culminating in a massive stock buying orgy.

Okay, that's kinda like what ole' Keynes said about how the market can stay irrational longer than the investor can stay solvent.

Now it's true our animal spirits may certainly account for some of the 90's bull market, especially the latter part. But it can't account for the first half where market skepticism was prevalent and investors were far from exuberant.

To solve this puzzle, let's unpack valuation multiples real quick. Since the price/earnings (PE) ratio is the most commonly used, we'll deal with that, though what we're going to talk about applies to all valuation multiples.

The PE ratio has just two variables: price, which is the numerator, and earnings per share, which is the denominator. The valuation multiple is comprised of the ratio of the price paid for an amount of earnings, or price divided by earnings.

So there are two ways to affect the PE multiple (1) adjust the price paid up or down or (2) grow or shrink the amount of earnings. Higher earnings, all else equal, means a declining PE multiple and vice-versa.

Basic stuff.

Well we know that earnings are driven by the business cycle and the resulting profit margin expansion/contraction. But what really drives the change in valuation multiples is the numerator; the price investors are willing to pay for a certain amount of earnings.

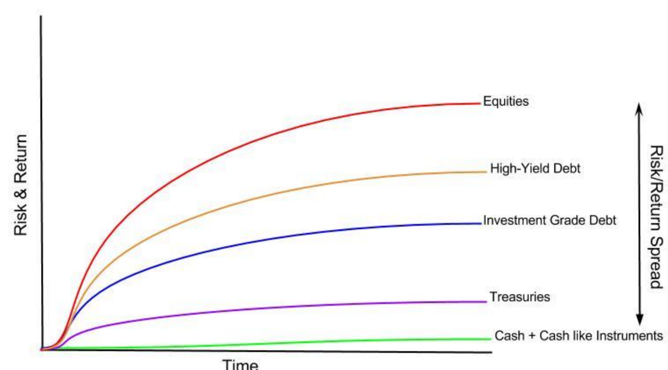
The common misperception is that this "price" is determined solely by investor risk appetite and expectations for future growth. If that were true, then why were stock multiples so high in 92'? And why did they continue to scream higher when there were so many *logical* reasons to be bearish?

The answer is the Relative Risk-Premium Spread (RRPS).

Here's a quick explanation of RRPS:

1. The cyclic nature of markets and the economy is transmitted through financial spreads, beginning with the cost of money. The central bank controls the cost of money; in which EVERYTHING is valued off of. The *relative* changes over time to the cost of money transmit through these financial spreads, creating large bull and bear markets in different assets. Nothing is valued in a vacuum. Everything is relative and reflexive.

2. Spreads start with the cost of money. The next spread up is the closest asset in terms of risk/return (ie, short dated treasuries). After that comes longer dated treasuries. And then you get investment grade corporates. Then there's high-yield and finally, equities. It could look something like the diagram to the right.



3. The difference (spread) between all of these assets is called risk premia. Risk premia is the risk (volatility)

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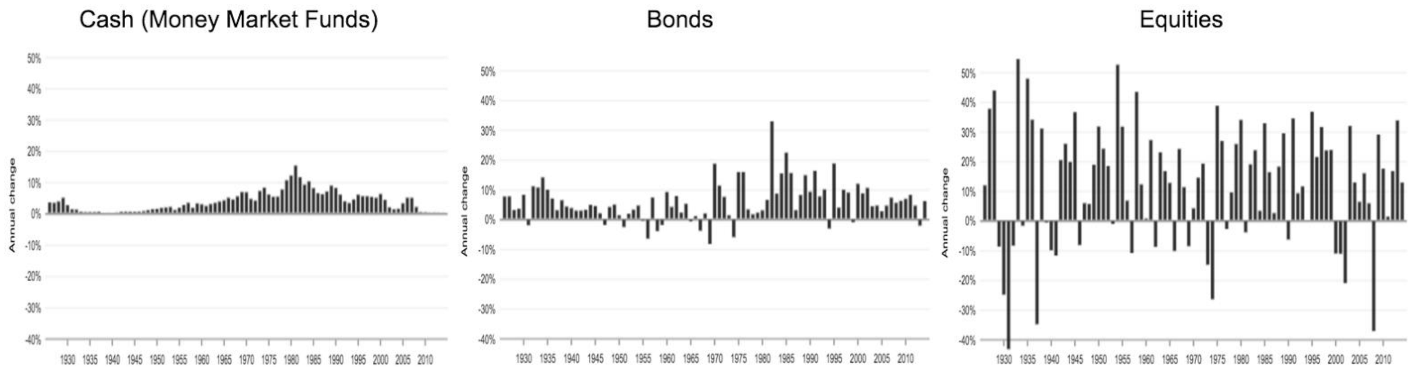
and average return function of each asset. The asset classes with lower risk premia (i.e., higher on the capital structure and less volatile) offer a lower average return. While assets like equities, which have much higher volatility and payout a higher average return over time, have a higher risk premia.

Here's a little snapshot that shows this volatility/return relationship of the big three asset classes over the last 80 years.



4. Risk premia exists because people need to be compensated for lending their money (exchanging cash for stock) and assuming risk. Or else why the hell would anybody change their fungible safe dollars for a more illiquid and risky asset? They wouldn't. It would be illogical.

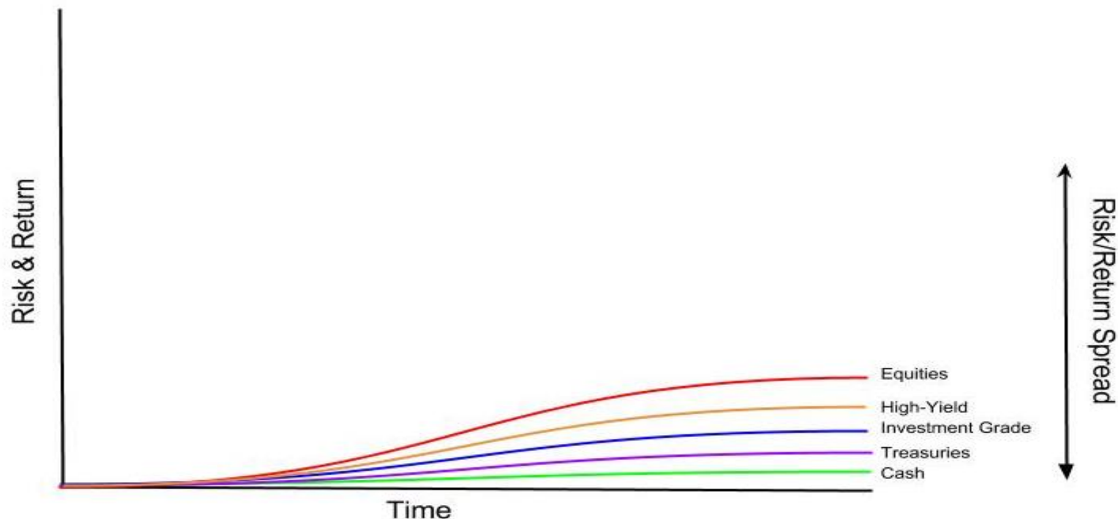
It all starts with the Fed's policy tools. The overnight rate, open market operations, and reserve requirements are the tools the Fed uses to set the cost of money.

When they lower the cost of money, it transmits through the yield curve of treasury bonds, bringing down both the short and long end — pulling the premia of cash + cash like instruments and bonds lower. As bonds get pulled lower the spread between them and stocks widen. The larger risk premia means that investors get compensated more for assuming risk relative to that of cash and bonds.

As a result, stocks get bid up. And the higher their multiples go, the more the premia spread between them and bonds turns around and contracts. As this happens, the future return on stocks actually *goes down*. This is because future returns have been pulled forward and enjoyed today.

In typical cycles, the spread on risk premia gets pulled closer and closer to that of cash and bonds. This goes on until it can't get any tighter. You can take rates negative… you can make

the return on cash negative… and you can eke out a bit more in the return spread between risk-free and risky assets… but eventually that spread gets bid tight and looks something like this:



Now, here's the thing. When the risk premia spread is pulled as tight as it can go, not only does the future return on those assets drop, but the risk, or volatility distribution, actually widens and becomes increasingly asymmetric with a fat negative tail.

Say what? Sorry… this time in English. When there is little difference in risk premia (expected return) between cash and risk assets (equities), risk assets becomes drastically more risky. That's because when stocks have high multiples and tight spreads, there's little upside in holding them (future return has been brought forward to today) but there's lots of downside due to their equity valuations tendency to mean revert.

When there's no difference between the expected return on that of equities over cash, then why would anybody want to hold equities?

That's a good question.

Now you may be saying, *"that's all very interesting Alex but how do you know what the risk-premium spread is on stocks?"*

Well, let's make a generalization and say that an investor can put his cash into either stocks or bonds or some mix of the two.

US treasuries are the closest thing an investor can get to a free lunch (risk-free return).

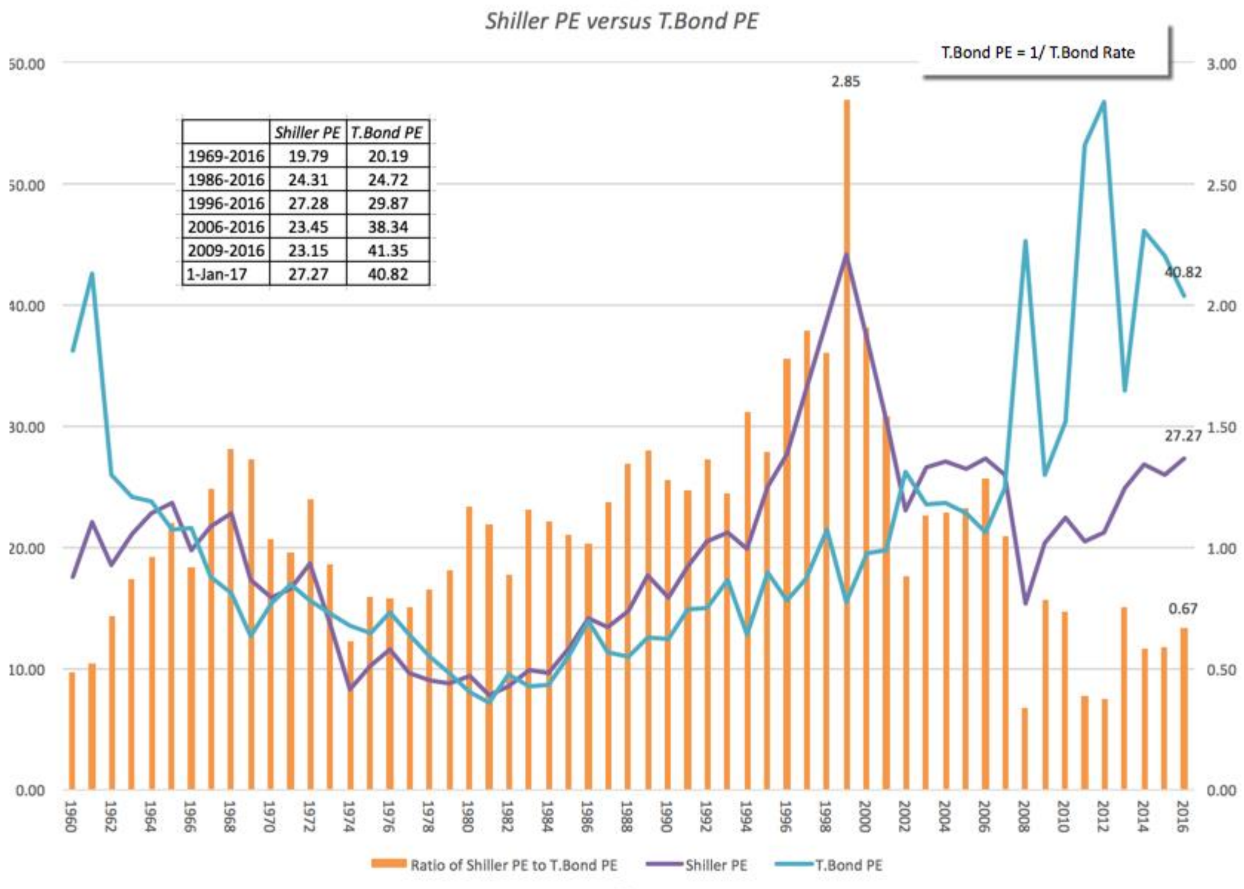
To figure out what the relative risk-premium is on stocks we have to know what the equivalent PE ratio is for bonds. We can construct a bond PE ratio by dividing 1 by the 10-year rate.

Bond PE = 1/10-year UST rate

If you purchased a bond in 92’ you would have effectively paid 14 times earnings because 1/.0720 = 13.8

Now that we have our bond PE ratio of 14, we can compare it to the stock PE ratio of 25 and get an idea of what the risk premium for equities was.

The following chart is from NYU finance professor Aswath Damodaran. In this, he charts the PE of bonds (blue line), the Shiller PE for stocks (purple line), and the ratio or spread between the two (orange bars). The lower the orange bars, the greater the risk-premium spread between bonds and stocks; meaning the more attractive (cheap) stocks are relative to bonds or cash.



	Shiller PE	*T.Bond PE*
1969-2016	19.79	20.19
1986-2016	24.31	24.72
1996-2016	27.28	29.87
2006-2016	23.45	38.34
2009-2016	23.15	41.35
1-Jan-17	27.27	40.82

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In the early 90's we can see that stocks benefited from falling yields (higher bond prices) which drove up the PE multiple for bonds and made stocks relatively more attractive in comparison.

Secularly falling bond yields acted as a magnet over the 90's, pulling stock multiples higher and higher.

Falling interest rates not only boost the numerator in multiples but they also increase the denominator (earnings).

Lower yields increases borrowing and lowers debt servicing costs, pushing up consumption. This boost in demand widens profit margins and fuels the business cycle.

The driving force behind the extended boom in the 90's is the loose Fed governor Alan Greenspan who kept interest rates too low for too long, leading to the tech bubble.

So it's not enough to say that stocks are overvalued because such and such multiple is at X, like Klarman did at the start of the 90's bull market.

Valuations cannot be looked at in a vacuum. Investors have to put their money somewhere and that somewhere is always based off their considerations of risk/preservation and return/growth across a range of assets.

In its most simple form, this choice is deciding the right mix between stocks and bonds. As a result, it's the relative valuation between the two choices that matter because it's the relative risk-premium spread that drives much of investors decision making (whether they're conscious of it or not).

A Slimming Margin of Spread

Now that I've explained financial relativity theory we can apply that to where markets are today.

Going back to our premium spread chart we can see that the shiller PE to Bond PE ratio is still near record lows, despite earnings multiples being near record highs.

Similar to Klarman in 92', we've had many smart financial pundits and market players calling for market chaos over the last four years because of these "high" valuations. And just like in 92', stocks have risen, multiples have expanded, and valuation bears have continued to be wrong.

All this is because real interest rates have been between negative and 50bps for the last seven years (the real 10-year rate is only 46bps and real rates on the 5-years are zero).

Low nominal and real interest rates on bonds mean a wider risk-premium spread on stocks and a cheaper relative valuation.

So does that mean we're at a point in time similar to 92' and we're about to go on a large secular bull market expansion?

No. No. No...

The 90's benefited from the tailwinds of a long-term debt cycle where interest rates trended lower from historical highs. And the consumer had a relatively strong balance sheet (reasonable debt to income).

But now we're going through a turning point of the long-term debt cycle and moving into the deleveraging phase. Interest rates can't fall any further and the balance sheets of consumers and companies alike are maxed out with leverage. What were tailwinds in the 80's and 90's will be headwinds over the next 10 years.

With that said, the relative value of US equities is still attractive at the moment. The equity risk premia spread is only at 0.62. This spread has a ways to tighten before equities' relative valuation starts to look less attractive (it's when the stock/bond PE ratio is closer to 1 that investors should start to worry).

The biggest risk to premia spreads right now are either collapsing earnings or much higher rates.

Barring any politically induced blow ups (which both figuratively and literally look more and more possible) we should see sustained earnings growth over the coming year. Earnings growth is continuing to benefit from low hurdle (comparables) relative to the year before. We talked about these base effects in a previous MIR which you can read here.

Q4 EARNINGS SEASON REPORT - USD

Identifier	Earnings Summary			
	% Reported	% Beat	% Met	% Missed
All Economic Sectors (3193)	29%	63%	11%	26%
Energy (255)	16%	45%	5%	50%
Basic Materials (156)	33%	59%	12%	29%
Industrials (414)	33%	61%	13%	25%
Consumer Cyclicals (444)	19%	57%	6%	37%
Consumer Non-Cyclicals (134)	28%	62%	11%	27%
Financials (763)	50%	60%	15%	25%
Healthcare (498)	11%	69%	9%	22%
Technology (408)	32%	83%	6%	11%
Telecommunications Services (4...	17%	14%	14%	71%
Utilities (80)	20%	63%	13%	25%

The primary risk is that the rise in interest rates greatly exceeds the growth in earnings. This could happen under an environment where growth and/or inflation starts picking up and the Fed moves more aggressively to raise rates.

This type of scenario is plausible if the Trump administration is successful in pushing through its tax and regulation reforms and in carrying out its expansionary fiscal policy.

I see the 3.25 - 3.5% level as being the critical point on the 10-year note where we'll likely see the end of the bull market in US equities — risk premium spreads would be completely collapsed at that point and holding stocks would offer the same return as cash but with a lot more volatility.

And just as lower interest rates can boost earnings and drive the business cycle upward, higher rates can turn the business cycle lower and put the earnings trend in reverse.

When this happens (all business cycles eventually do come to an end) we'll be left with double valuation headwinds: falling earnings forcing high valuation multiples higher and higher stock/bond relative PE ratios.

It's in market environments like this when conventional valuations of just plain PE ratios begin to matter. That's because the power of mean-reversion takes effect, with higher multiples generally equating to larger falls.

The following two charts via Pension Capital and Star Capital, respectively, demonstrate the markets tendency towards this mean-reversion of valuations. Meaning, higher valuations equate to lower future returns.

US stocks are currently in the top valuation percentile. The average future returns from these levels as the graphs clearly show are not good.

		S&P 500 Average Forward Maximum Loss (1928 - 2016)									
Valuation Percentile	CAPE Ratio	1-Yr	2-Yr	3-Yr	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year
0-10%	5.57 to 9.68	-4.1%	-4.5%	-4.5%	-4.5%	-4.5%	-4.5%	-4.5%	-4.5%	-4.5%	-4.5%
10-20%	9.69 to 11.22	-3.6%	-3.6%	-3.7%	-3.7%	-3.7%	-3.7%	-3.7%	-3.7%	-3.7%	-3.7%
20-30%	11.23 to 12.67	-3.7%	-4.6%	-4.7%	-4.8%	-4.8%	-4.8%	-4.8%	-4.8%	-4.8%	-4.8%
30-40%	12.68 to 14.98	-6.5%	-8.3%	-9.1%	-9.5%	-9.7%	-9.7%	-9.7%	-9.9%	-9.9%	-9.9%
40-50%	14.99 to 17.03	-12.7%	-15.5%	-17.4%	-18.9%	-18.9%	-18.9%	-18.9%	-19.9%	-19.7%	-19.7%
50-60%	17.04 to 18.84	-6.0%	-11.1%	-13.7%	-15.0%	-15.2%	-15.2%	-15.2%	-15.6%	-15.6%	-15.6%
60-70%	18.85 to 21.03	-4.8%	-7.3%	-8.2%	-9.4%	-10.2%	-10.7%	-11.2%	-11.6%	-10.9%	-10.9%
70-80%	21.03 to 22.21	-8.1%	-13.0%	-16.0%	-19.0%	-20.8%	-21.9%	-23.0%	-23.0%	-22.2%	-22.2%
80-90%	22.22 to 26.40	-5.4%	-9.2%	-15.6%	-22.3%	-24.4%	-26.1%	-26.3%	-26.3%	-25.9%	-23.9%
90-100%	26.41 to 44.20	-9.0%	-18.9%	-26.8%	-30.3%	-32.8%	-33.3%	-33.3%	-33.3%	-33.3%	-32.4%

So we find ourselves in an environment where classic earnings multiples are historically stretched. And these valuations are typically followed by large drawdowns.

But relative risk premiums still favor stocks over bonds. Interest rates will also only go higher from here, which will compress that premium spread further, leaving us with high valuations in a rising rate environment. Meaning, by holding US stocks investors will be carrying a lot more risk than they think. Mean reversion hasn't disappeared from markets.

This fits in with our US market outlook that we've been writing about for the last six months: we believe we have entered a period similar to 98' - 99'. US stocks should continue to move higher but with those gains come increasingly dangerous drawdown risks.

This is also inline with the sentiment I'm seeing around the market. I've noticed signs of growing exuberance from other fund managers and private equity guys about the next few

years. But I haven't seen the level of frothiness or excitement that's indicative of a market top… though I think we'll get there fairly quickly if it looks as though the Trump administration will be successful in carrying out its economic agenda.

If I was an asset allocator and not a trader, I would start allocating more and more of my money into lower valued foreign stocks and bonds. The following table *via Meb Faber* shows the lowest valued markets around the world.

MSCI Investable Market Indices

	CAPE	CAPD	CAPCF	CAPB	Average Rank	Dev or Emerging	Real Drawdown %
Czech Republic	8.9	11.6	4.2	1.2	4	E	-44.83
Portugal	11.4	16.3	3.9	1.1	4	D	-59.13
Russia	5.9	31.2	3.8	0.8	6	E	-73.76
Italy	12.8	21	4.3	0.9	6	D	-47.12
Poland	10.1	21.5	4.8	1.2	6	E	-42.77
Brazil	9.9	20.5	6.2	1.2	7	E	-44.43
Spain	11.8	17.9	5.7	1.4	8	D	-25.4
Turkey	9.1	31	6.8	1.3	10	E	-52.93
Singapore	11.4	24.7	8.8	1.3	11	D	-22.71
Greece	-16.9	4.8	1.2	0.2	12	E	-96.95
Norway	12.8	28.4	6.4	1.6	13	D	-11.23
Austria	14.4	36.2	5.8	1	14	D	-48.11
China	11.5	35.3	7.8	1.6	16	E	-41.27
Chile	14.6	33	8.5	1.5	18	E	-38.18
Hungary	12.6	49.6	6	1.5	18	E	-29.47
U.K.	14.3	29.6	8.9	2	19	D	0
Hong Kong	14.3	33	10.8	1.3	19	D	-19.2
Egypt	15.5	30.9	8.9	1.9	19	E	-48.24
Israel	13.7	33.3	9.5	1.6	19	D	-22.64
Korea	13	75.1	7.2	1.3	20	D	-9.87
Colombia	15.8	28.3	11.3	1.4	20	E	-35
Taiwan	18.7	29.2	9.1	1.9	22	E	-20.76
Malaysia	15.5	34.2	10.4	1.8	23	E	-12.1
Australia	16.9	22.9	11.6	2	23	D	-4.12
Finland	18.2	27.5	10.4	2.2	23	D	-52.37
France	18.3	34.3	9.4	1.7	23	D	-3.44

At Macro Ops we'll continue to play the US market to the long side until we see the bond/stock spread go over 1. Then it'll be time to start testing the market to the short side.

Around The World

Eurozone: An Obvious Ending

Seeing events unfold in the Eurozone is like watching a blaringly obvious scary movie. You find yourself shouting at the screen, *"Don't go in there!"*, and yet they proceed anyway. The result ends up being exactly what you'd expect.

2016 year-end data out of Italy showed that 12% of the workforce is now unemployed. That's up .4% from the year earlier, making Italy the only European country where unemployment actually rose year over year.

What's most concerning is that the unemployment rate is rising fastest among those under the age of the 25. This is occurring when 40% of young people in Italy are *already* unemployed. The trend is going the wrong way.

Italy's economic reality is bad news for the presiding Democratic party. As we explained in previous MIRs, Italy holds its general elections this year. And populist parties like the 5 Star Movement (M5S) are quickly gaining steam. This is especially true among the most economically vulnerable populations. Check out the graph to the right. The latest polls show that M5S

has gained a 20-30 point lead among the unemployed, self-employed, students, and those in low-paying occupations. They're also close to taking over the blue-collar worker segments.

The worse the economy gets, the more Italians shift to the 5 Star Movement. And as we've previously written, nationalist parties like M5S gaining power will exacerbate the tensions between Italy and Germany, especially with the Italian banking crisis in play. The friction will eventually splinter the European Union.

Recently, two Italian members of the European Parliament (both from populist parties) sent a letter to the ECB asking how a country's balances would be settled if it decided to leave the Eurozone. This is the first time members of parliament have asked this question. And Mario Draghi *actually* responded, marking one of the first times a European authority acknowledged a country potentially leaving.

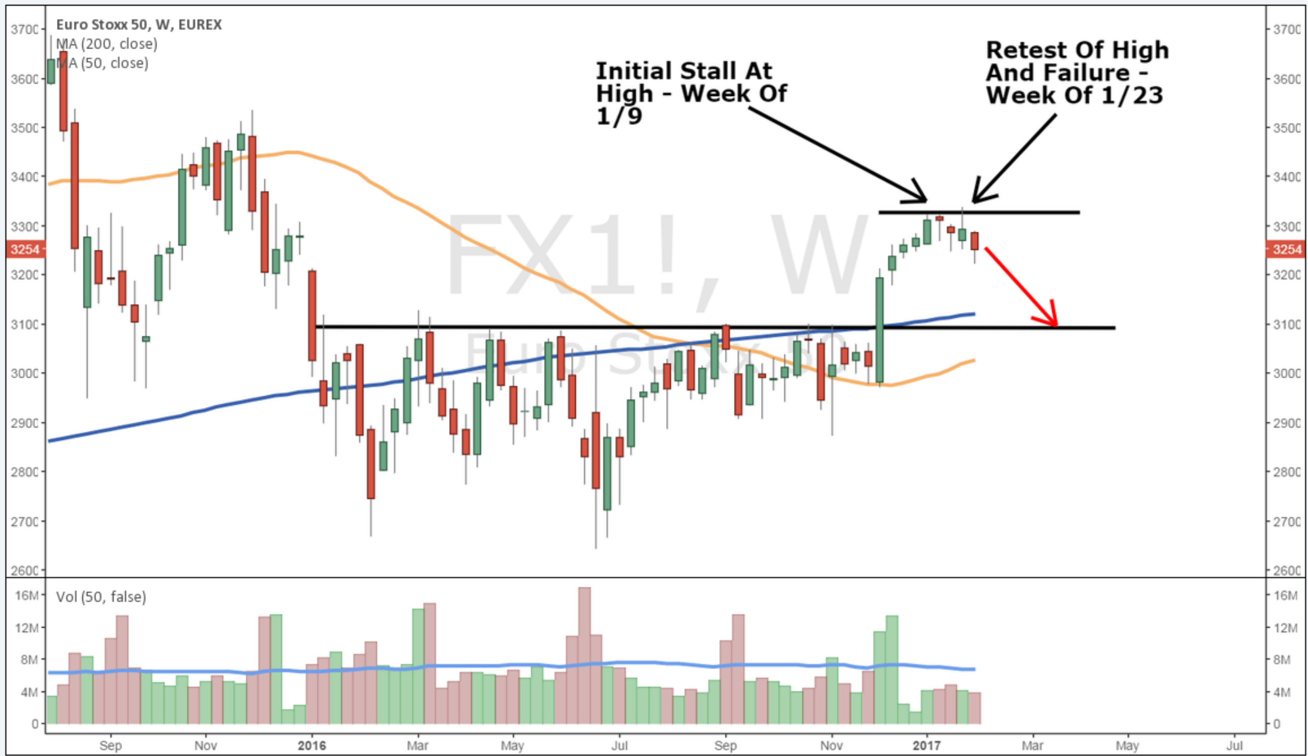
Both sides understand that Italy's membership in the EU will be hotly debated in this year's elections. And it looks like both sides are already preparing for a potential exit.

Considering the deteriorating situation, it's becoming difficult for the recent European equity rally to hold.

Healthy economic data from the Eurozone over the last few months created a sentiment rally as investors adjusted their bearish bias. This data continues to be constructive, with the most recent 4th quarter GDP numbers showing an expansion of .5%, beating analyst expectations. Inflation rose too. It jumped 1.8% in January, up from 1.1% in December. January also saw the manufacturing sector come in strong according to a variety of business surveys. PMI for the Eurozone was 55.2, higher than initial estimates. (Any number above 50 signals an expansion.) As Chris Williamson from IHS Markit explains:

> *Eurozone manufacturing is off to a strong start to the year, enjoying its fastest rate of expansion for almost six years in January.*
>
> *Rates of growth of new orders, exports and employment have all hit multi-year highs, with the depreciation of the euro playing a key role in helping drive new sales in export markets.*

But as we said, even with positive data, it looks like the sentiment rally has begun to fail. You can see a number of the indices we've been tracking stalling, including the Euro Stoxx 50 (FX) and Greek equity ETF (GREK).


MacroOps published on TradingView.com, February 03, 2017 10:26 EST
EUREX:FX1!, W 3254 +5 (+0.15%) O:3289 H:3291 L:3223 C:3254
Euro Stoxx 50, W, EUREX
MA (200, close)
MA (50, close)
Initial Stall At High - Week Of 1/9
Retest Of High And Failure - Week Of 1/23
Vol (50, false)

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BATS:GREK, W 7.81 +0.08 (+1.03%) O:7.70 H:7.87 L:7.52 C:7.81
GLOBAL X MSCI GREECE ETF, W, BATS
MA (200, close)
MA (50, close)
After An Initial Breakout, Price Quickly Stalled
A Return To Lows?
Vol (50, false)

The reason for this is two-fold. One, the Italian Banking Crisis keeps chugging along, and with elections coming closer, the potential of gray swan Italian Exit is increasing. And two, with all this positive economic data, the ECB could start taking their foot off the easing pedal. This would put a quick stop to the equity rally.

As we explained in last week's Market Brief (exclusive to Hub members) we're looking to take advantage of a potential rate hike by shorting Euro-Bund futures. Europe is behind the US in its hiking cycle and the spread between the countries' 10yr rates is at historical all-time highs.

There's a huge potential payout if European rates can close that spread. We're planning to short Euro-Bund futures (GG) should price action complete its 12-month H&S top.

Britain: Brexit? Sounds good!

Sentiment has quickly shifted around the idea of a "hard" Brexit. What was previously thought of as an unequivocal disaster is now being seen as a positive development.

Prime Minister Theresa May secured a crushing victory in the latest parliament vote on triggering Article 50 (the EU exit clause) this past week. The motion passed 498 votes to 114, revealing a marked shift in the number of MPs now *supporting* a Brexit. Most analysts believe May should have no problem getting through future parliamentary stages considering the extent of her recent victory. With Brexit looking to be well on its way, the government also released a 77-page white paper explaining the specifics of how it would take place.

A big reason fears around Brexit have subsided is due to strong economic data. The disaster everyone was calling for didn't happen. In fact, the opposite occurred as the economy continued to grow.

This week the Bank of England (BOE) kept interest rates steady at 0.25% while dramatically increasing their growth expectations for 2017. Their latest forecast shows the economy growing 2% this year, up from 1.4% forecasted in November, and the dismal .8% forecasted in August. As the BOE explained:

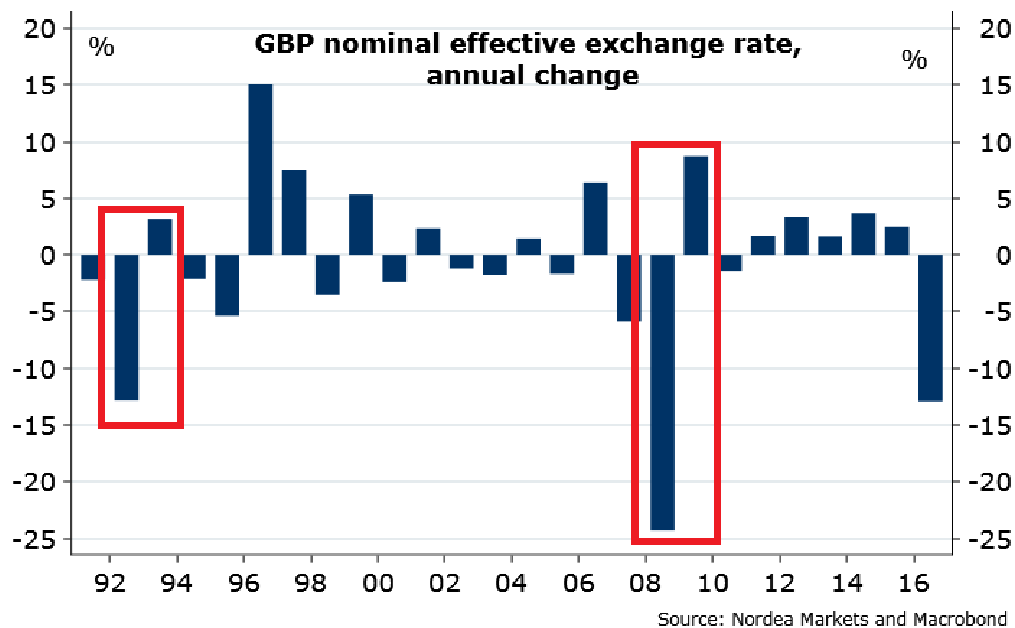
> *Domestic demand has been stronger than expected in the past few months, and there have been relatively few signs of the slowdown in consumer spending that the committee had anticipated following the referendum.*

No one expected growth to be this strong after the Brexit vote. And it was particularly surprising how robust consumer spending and borrowing continued to be. Household savings in the UK is now set to fall to its lowest level since 1963, boosting both spending and inflation. The inflation numbers are now slowly approaching the BOE's limit. We can expect them to start tightening soon, especially because they tend to follow the Fed which has already been turning more hawkish.

The best way to take advantage of the Brexit sentiment shift is by going long the pound.

GBPUSD recently established a textbook double bottom pattern. The secondary bottom completed itself on a huge price reversal. Price originally broke to new lows on 1/17, but quickly shot higher. This reversal was made on news that PM May was planning to move up the date for a hard-Brexit, which was previously thought of as a negative. Strong positive price action on that announcement was a clear signal that sentiment had changed.

Considering the positive economic data and the BOE possibly tightening in the future, the pound should continue to strengthen. The currency is also due for a mean-reversion rally after being crushed in 2016 post-referendum. It lost nearly 13%, one of its three largest annual falls in 30 years. Previous drops were at least partially reversed the next year. We should see the same type of rally take place in 2017.



And of course, should the U.S. dollar correction hold, we'll see the pound get an extra boost higher.

We currently have a long pound trade on our books. But last week's market action was not as constructive as we would have liked. We'll be quick to cut our position if the pound continues to fall next week.

Russia: Warming Up

Putin is pretty happy about his best bud Trump becoming president. The two had an hour-long phone call the other week where they promised to improve relations between their two countries. Discussions ranged from terrorism to restoring economic ties, but of course both sides said the issue of lifting sanctions never came up. Either way, the conversation was described as "warm" and the Trump Administration released a statement explaining that "*the positive call was a significant start to improving the relationship between the United States and Russia that is in need of repair*".

As we've discussed in previous MIRs, there's a strong likelihood of sanctions being lifted on Russia. Trump has already said he'd be willing to do it (much to his party's dismay) and with Russia being the EU's largest trading partner, it's in their benefit to lift sanctions as well. We should see Russian equities get another boost should this occur.

The Russian economy also looks to be returning to growth. Recent GDP data showed that the economy only contracted 0.2% in 2016, beating expectations of a 0.5% contraction. The latest number implies that 4th quarter growth came in at a positive 1% yoy. Citigroup economists are even predicting that GDP could rise by 2% in 2017.

The current recovery is being led by the manufacturing sector which rose 1.4% in 2016. Recent PMI numbers came in at 54.7 for January, an improvement over last month's reading of 53.7. Russian firms saw their strongest manufacturing upturn since March 2011, with backlogs accumulating at their sharpest pace in almost 10.5 years.

Considering the sanctions situation and an improving economy, we expect the Russian equity rally to continue.

The Russian equity ETF (RSX) broken past both its breakout line and its 200-week moving average. The confluence of both support levels creates a great low-risk entry point. Our target is the 27 level.

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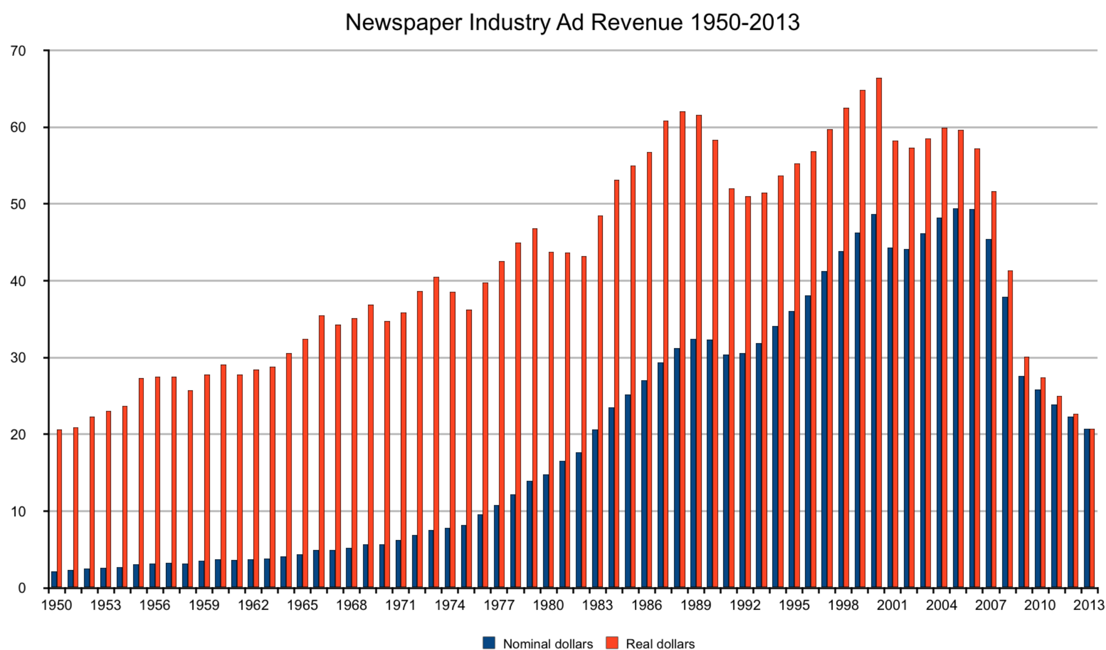
Russian miner (MTL) has more than doubled since we first covered it. It recently had a huge breakout on outsized volume and is now making a tight retrace to its 50-day moving average on declining volume. This is very constructive price action. An entry at these levels is low-risk with the 50 dma providing solid support. We expect price to make a big bounce here.

The risk here is still oil prices. Should they turn lower once again, the entire Russian picture will quickly morph. But if the current dollar retrace holds, we'll likely see oil prices stay elevated. Russian equities should benefit over the intermediate term.

Deep Dive: New Media Investment Group



> *Print media is going the way of the dinosaurs!*
>
> *It can't compete with online / digital / social / mobile… you name it. Advertisers are fleeing, black and white rags in mass.*

That's the market narrative that has been dominating traditional print media stocks over the better part of the last decade.

And if one looks at the shift in ad-spend dollars from print to digital, they would have to conclude that the "Print Media Is Dying" narrative is justified. Newspapers on a whole have been taking quite a shellacking by the shift in news consumption from print to digital.

So with all that said, I'm looking to go long a newspaper stock.

It may sound like I'm being a contrarian for the sake of being a contrarian and that maybe I'm too smart by half. And sometimes you'd be right to think that. I do instinctively like to go against the consensus and that results in me sometimes getting burned… but I don't think that's the case here.

Let me explain.

I do fully accept that the digital age has brought a paradigm shift to the way we consume media. That's not debatable.

I also accept that newspapers were slow to adapt and have lost a lot of advertisement market share to their new digital overlords. There's simply a lot more competition chasing after the same ad-spend pie.

But I do think the turbulence from this initial shift is beginning to settle down.

Those companies that have been unable to successfully make the transition have either gone or will soon go out of business.

Those that remain will continue to consolidate and grow their readership.

And as this process continues to unfold, I think the market will begin to reassess the future earnings prospects for the survivors. They may still be classified as print media but many have evolved into multi-medium news distribution platforms… and in the case of the stock I'm looking at today, something even more than that.

I believe that we're at somewhat of an inflection point in the news distribution space. That makes it an exciting time for us as investors to dig in and see if there are any potential phoenix's that look set to rise from the ashes.

My pick to play this resurgence is New Media Investment Group (NEWM).

Here's the following from a *WSJ* article written last April *(emphasis mine):*

> *The U.S. newspaper industry is dominated by 11 big players including Gannett Co., Tribune Publishing Co., Wall Street Journal owner News Corp and New York Times Co.* ***But 45% of the 41 million papers sold every day are titles owned by 200 smaller companies,*** *according to the Alliance for Audited Media.*
>
> *A move to roll them up is under way, driven by a sharp decline in prices. Last year, 70 daily newspapers changed hands in 27 transactions for $827 million, the highest total for the industry since the 2008 economic crisis, according to data compiled by merger-and-acquisition adviser Dirks, Van Essen & Murray.*
>
> *New Media, a low-profile outfit managed by private-equity firm Fortress Investment Group LLC, has surfaced as one of the most aggressive consolidators, alongside USA Today owner Gannett and Warren Buffett's Berkshire Hathaway Media Group.*

> *New Media emerged in 2014 out of the bankruptcy of GateHouse Media and has quietly acquired more than 100 newspapers for $637.5 million during the past two years, bringing its total portfolio to 575 titles.*

NEWM now has a portfolio of media assets that spans across approximately 565 markets over 35 states. These include roughly 600 community print publications and around 550 websites.

If you live in a small town or city and like to read your local paper, there's a good chance NEWM owns it.

I particularly like this company's niche. It focuses on the "hyper local" newspaper market. They own small town papers like *The Colonial Voice* in Petersburg, Virginia and the *Cape Cod Times* in Hyannis, Massachusetts.

Many of these papers provide award winning local journalism and have a long and storied history; some are near 200 years old.

National and global news has become commoditized. But readers from small towns and cities can't get quality local news from the larger players. And people still very much want the local dope…

By buying up and consolidating these small-town papers NEWM will be able to bring about some very profitable changes.

One issue with old newspaper businesses, even at the local level, is a bloated cost structure. Many of these papers have been around for a 100 years and have enjoyed somewhat of a monopoly on readership and therefore local advertising dollars.

But nowadays they're competing with Yelp, Facebook, Google, and the blogger who lives down the street in his parent's basement.

While these local papers can offer readers and advertisers something other large digital players can't (a long-standing respectable local brand name and quality community knowledge and reporting) they still have to pare down their back offices. The need to become lean and nimble to survive and compete in today's market.

That's what NEWM is doing when purchasing these papers.

Its business model is to buy up small, high-quality local newspapers, never paying more than 4.5 times LTM EBITDA.

They're able to get such a good value on these papers because as one NEWM exec said, *"This has only become possible because the industry is so hated and so out of favor".* (Like I said, this is a big contrarian play.)

The company has deployed $100 million on such deals just this last year alone.

Once NEWM acquires a paper it's able to significantly cut costs by combining and centralizing back office work such as copy editing, advertising, sales, human resources, and finance operations.

This cost cutting, though painful because it's often mostly personnel, is absolutely essential for the survival of these papers.

But cost cutting only gets you so far. It's not what excites me about the business NEWM is putting together.

I want growth potential and lots of it! It's here where I think NEWM could be a real diamond in the rough.

Here's the following from CEO Mike Reed in the latest earnings call:

> *And what are the leverageable assets we have as a consolidated company? Number one, real scale. We operate in over 525 markets across 36 states and can touch nearly 3 million small businesses in our markets and more importantly those small business owners know us.*
>
> *Number two; we have over 1,300 local sales reps in markets where in most cases we have the largest local sales force. And three, we have a incredibly strong and fast growing digital businesses with Propel being the primary one that we can leverage across our expansive national footprint.*

All those leverageable assets excite me, but it's the third one, NEWM's digital business, that really makes me think there's a massive mispricing here.

As of right now, the company's print advertising accounts for 47% of total revenues. Subscription income is 34%. And digital accounts for 19%. Digital is expected to grow to 25% of total revenue this year.

In addition to running over 500 websites for local newspapers, the digital business is also comprised of Propel business services.

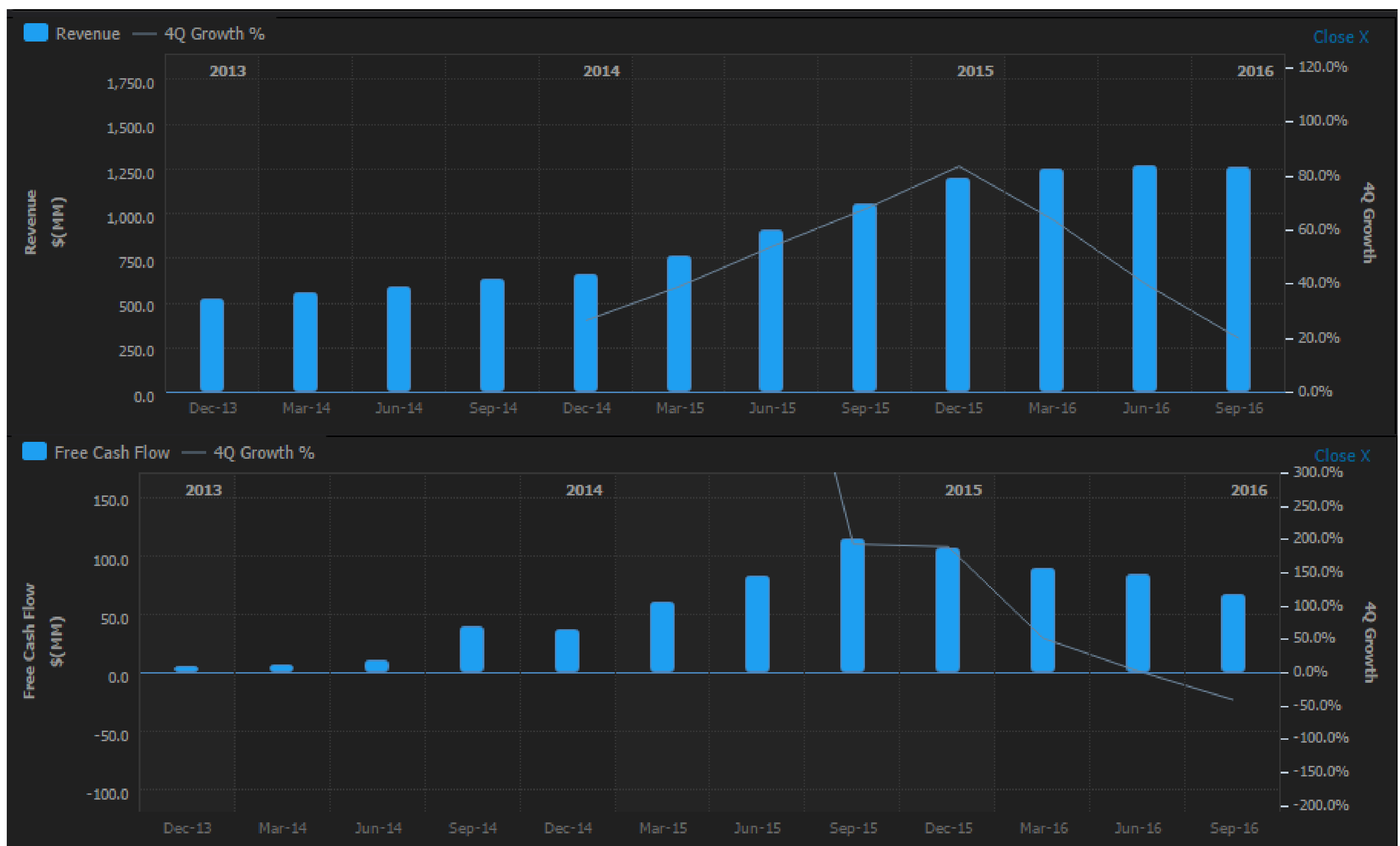
Propel is the company's new digital marketing services platform that generated $14.6 million in revenue in the third quarter. This was a 77% increase over the year prior and a 22.5% increase sequentially over the prior quarter.

One of Propel's offerings is ThriveHive which is a low-priced software as a service (SAAS) platform geared towards the types of small local businesses that NEWM's papers and websites advertise for. This platform was ranked #1 in customer satisfaction last year by G2 Crowd (a leading business software review website).

Currently, Propel only accounts for 5% of total revenues for the company. But management expects it to grow to become a significant driver of its top and bottom line growth.

Which reminds me, we should get into the numbers real quick.

NEWM currently has a market cap of $830M. It trades at a LTM price to earnings of 9, a price to sales of 0.6, a book value of 1.1 times, and has a free cash flow yield of 8.4%.



It has been steadily increasing its dividend over the last three years and currently yields 8.8%.

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Over the last three quarters, NEWM saw revenues increase 7% to $921.8M while net income grew 53% to 17.1M.

The stock is cheap.

It's cheap because the market is pricing it as a value trap — a cheap stock that's going to get a lot cheaper because it's a boring business in a dying industry.

But that's definitely not the case with NEWM. And it's just a matter of time before the market wakes up to this fact.

NEWM is going to the one of the largest players in the small local news market. It has a catalogue of old and respected publications. These brands have strong relationships with their community which NEWM can leverage within its digital marketing and SAAS platform.

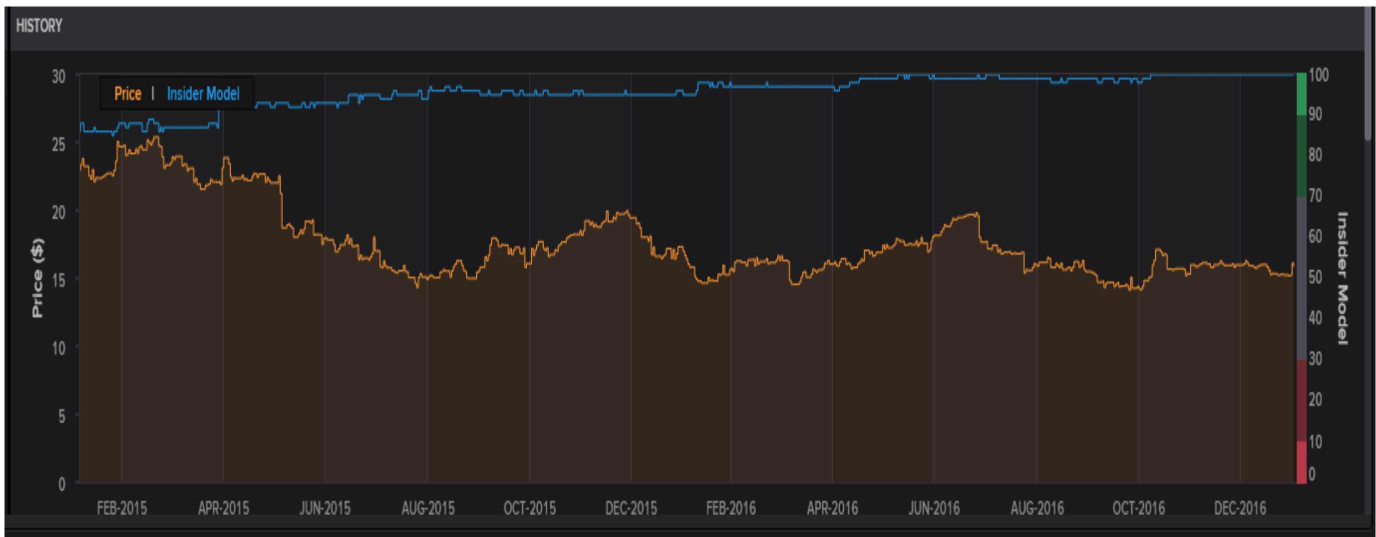
This puts NEWM in the very unique position of controlling the entire marketing and advertising vertical at the small city/town level across much of the US.

Listen to some of their earnings calls and you can hear the conviction in the CEO Mike Reed's voice when he talks about the opportunity that NEWM is taking advantage of.

I normally like the management of the stocks I own to focus on their work and not discuss or cheerlead the stock price. Unless of course they're putting their money where their mouth is and buying a ton of the shares. This is exactly the case here.

Over the last year, Mike Reed, along with other executives, have been buying the stock hand over fist. Reed alone has purchased over $2 million worth of shares in the last 12 months alone.

Our insider buying model currently gives it the highest reading of 100 and ranks it in the top decile for insider purchasers, not just in the media and publishing sector, but against consumer cyclicals as a whole.



When you see strong insider buying like you do here, along with a stock price that has done a whole lot of nothing over the last few years, it behooves you to pay attention and try and figure out what the insiders know that you don't.

In this case, it's a matter of a slow narrative shift and overly bearish sentiment that has plagued the industry for a number of years. Investors are blinded to the amazing opportunities at hand here.

And out of all the cases of the baby getting thrown out with the publishing bathwater, NEWM offers a substantial opportunity.

It's an undervalued stock that's establishing a sizable moat in its high-quality and longstanding local journalism publications. It has the real potential for strong growth by leveraging its verticals to grow its digital SAAS and marketing business.

I believe NEWM will be trading north of $25 within a year, an increase of over 60% from where it trades now.

The stock has formed a textbook two-year coiling triangle. The large jump it's seen in volume over the last six months suggest a budding interest and some large accumulation in the stock.

A good entry could be on a breakout of the pattern or a weekly close above its 200-day moving average.

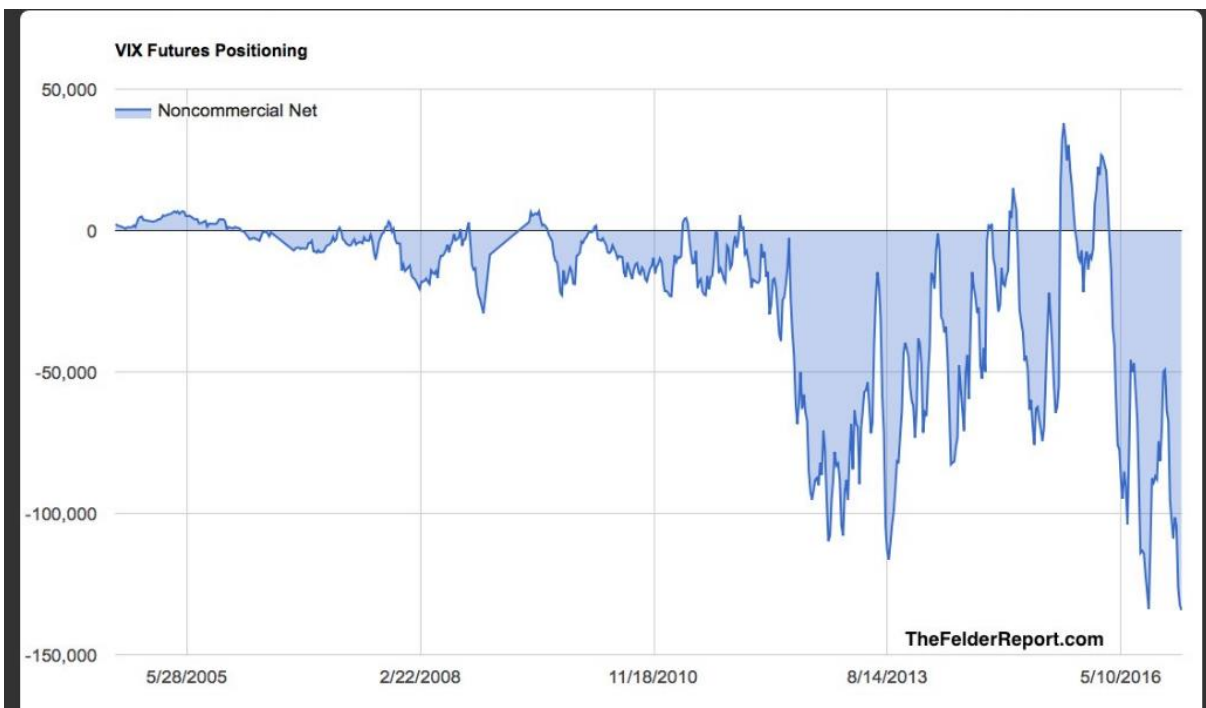
New Media embodies its name. It's taking the best of the old small town journalism that's invaluable to communities and integrating it into a vehicle that will carry it into the "new media" age. Investors that jump on board are likely to enjoy the ride.

Quant

VIX Views

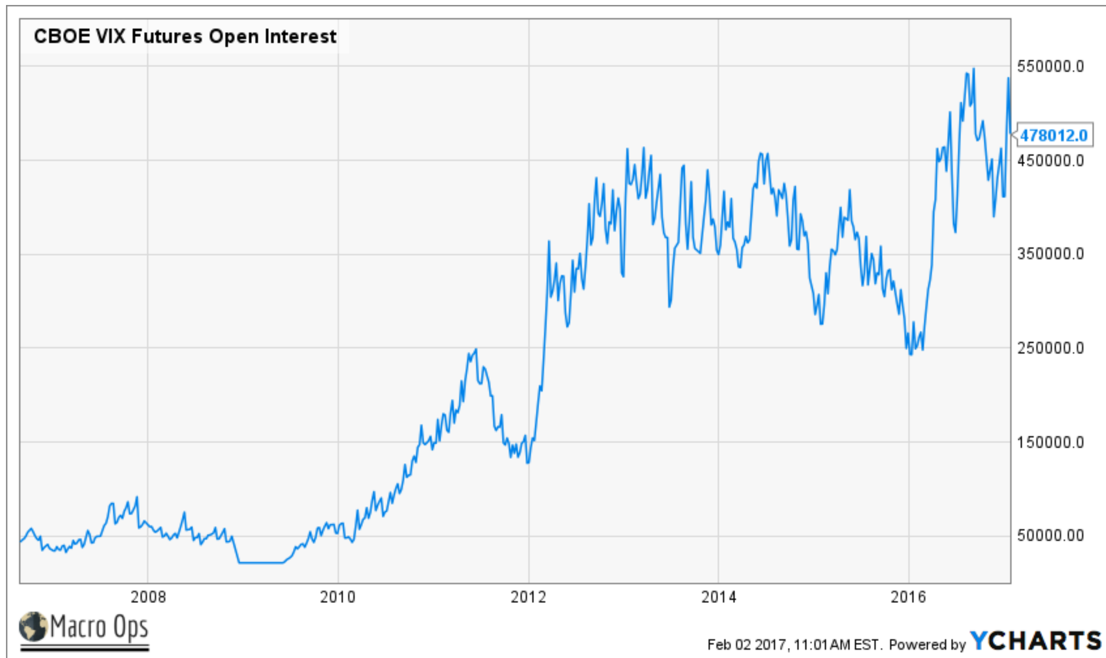
The trading community has been yapping away about the VIX trading sub-11 and the extreme number of speculative shorts involved. They're saying it's *gotta* burst higher.

Their proclamations are presented with a chart like the one below which measures net nominal non-commercial positioning.



But these positioning charts are misleading. They fail to account for the growth in open interest.

The VIX futures in particular become heavily distorted because open interest and volumes have increased 10x since they first started trading in 2004.



Net nominal numbers therefore mean nothing. Yes, the total amount of net shorts is higher than it's ever been, but that's because more people are trading VIX futures than ever before.

It's easier to see why this is true with a simplified example.

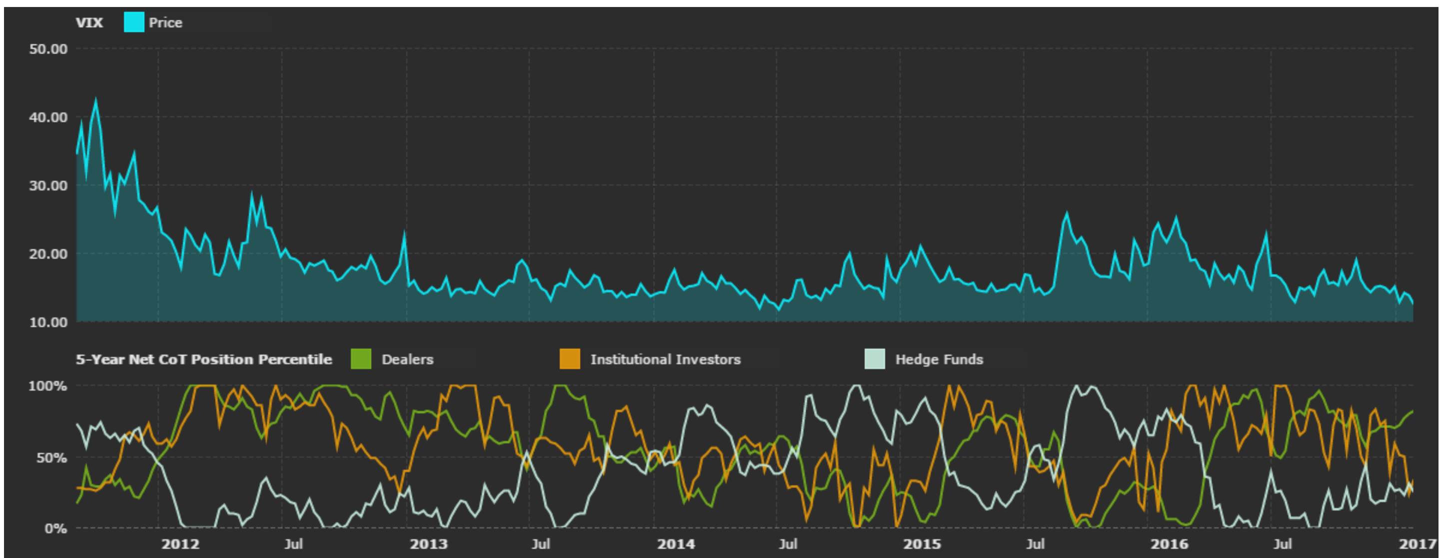
Say they're 100 open contracts and specs are short 99 contracts. Well obviously that's a crowded trade. If the specs race to cover, price will squeeze hard. Specs are short 99% of the open interest.

Now let's say activity grows and there's 1,000 open contracts. Of these, specs are short 600, or 60% of the open interest. Compared to the prior reading, net short 600 looks a lot bigger than net short 99. But in reality the first situation has a more concentrated spec position. Participants previously were short 99% of open interest instead of 60% of open interest now.

That's why you need to make sure you're accounting for open interest.

We know a number of you visit freeCOTdata.com to look at positioning. We emailed the site owner Adam to ask if he was accounting for changes in open interest or not. As of now he is **not** accounting for them. But he's rolling out an update soon to reflect the changes. After that update, the charts should give us a better idea of whether or not we're at a true speculative extreme.

It's worth noting that even without the update the 5-year percentile in VIX futures is not at an extreme. All the fuss on twitter was for nothing…



Given that positioning isn't at an extreme (money managers are *way* too afraid to short vol in the Trump era), we're in agreement with Goldman on what these low VIX readings mean. The data shows that low vol begets low vol, not high vol. Goldman conducted a study going back to 1990 to find out what happens to VIX and the market after VIX crosses below 11. The specifics of the study are shown below:

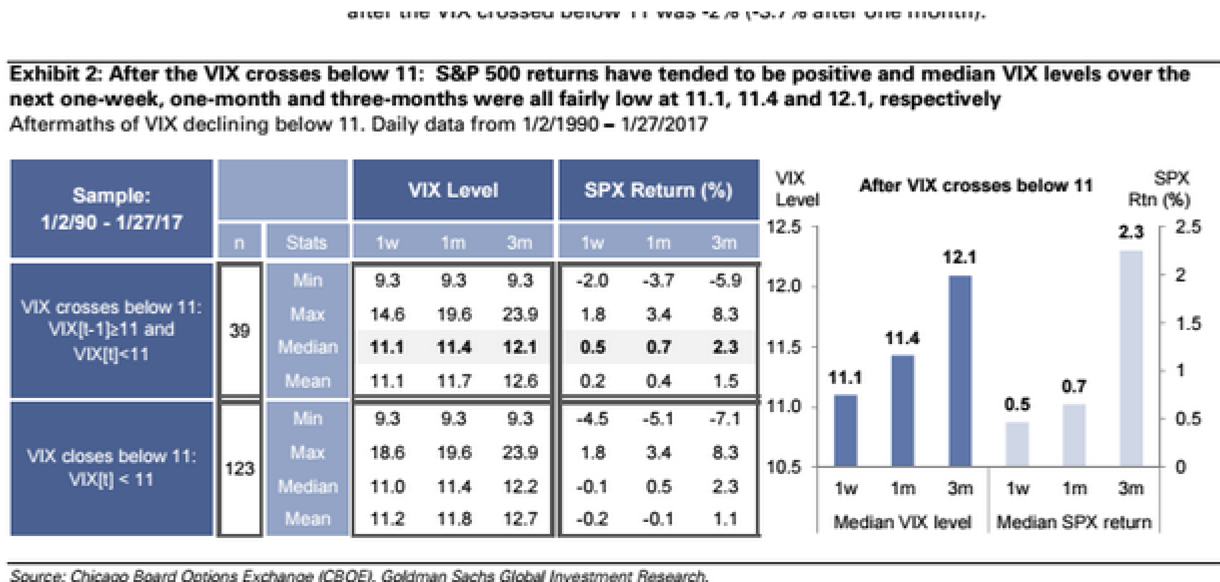


Exhibit 2: After the VIX crosses below 11: S&P 500 returns have tended to be positive and median VIX levels over the next one-week, one-month and three-months were all fairly low at 11.1, 11.4 and 12.1, respectively
Aftermaths of VIX declining below 11. Daily data from 1/2/1990 – 1/27/2017

Sample: 1/2/90 - 1/27/17	n	Stats	VIX Level 1w	VIX Level 1m	VIX Level 3m	SPX Return (%) 1w	SPX Return (%) 1m	SPX Return (%) 3m
VIX crosses below 11: VIX[t-1]≥11 and VIX[t]<11	39	Min	9.3	9.3	9.3	-2.0	-3.7	-5.9
		Max	14.6	19.6	23.9	1.8	3.4	8.3
		Median	**11.1**	**11.4**	**12.1**	**0.5**	**0.7**	**2.3**
		Mean	11.1	11.7	12.6	0.2	0.4	1.5
VIX closes below 11: VIX[t] < 11	123	Min	9.3	9.3	9.3	-4.5	-5.1	-7.1
		Max	18.6	19.6	23.9	1.8	3.4	8.3
		Median	11.0	11.4	12.2	-0.1	0.5	2.3
		Mean	11.2	11.8	12.7	-0.2	-0.1	1.1

Source: Chicago Board Options Exchange (CBOE). Goldman Sachs Global Investment Research.

The median VIX level is only 11.4 one month after VIX crosses below 11. And 3 months after it's only 12.1.

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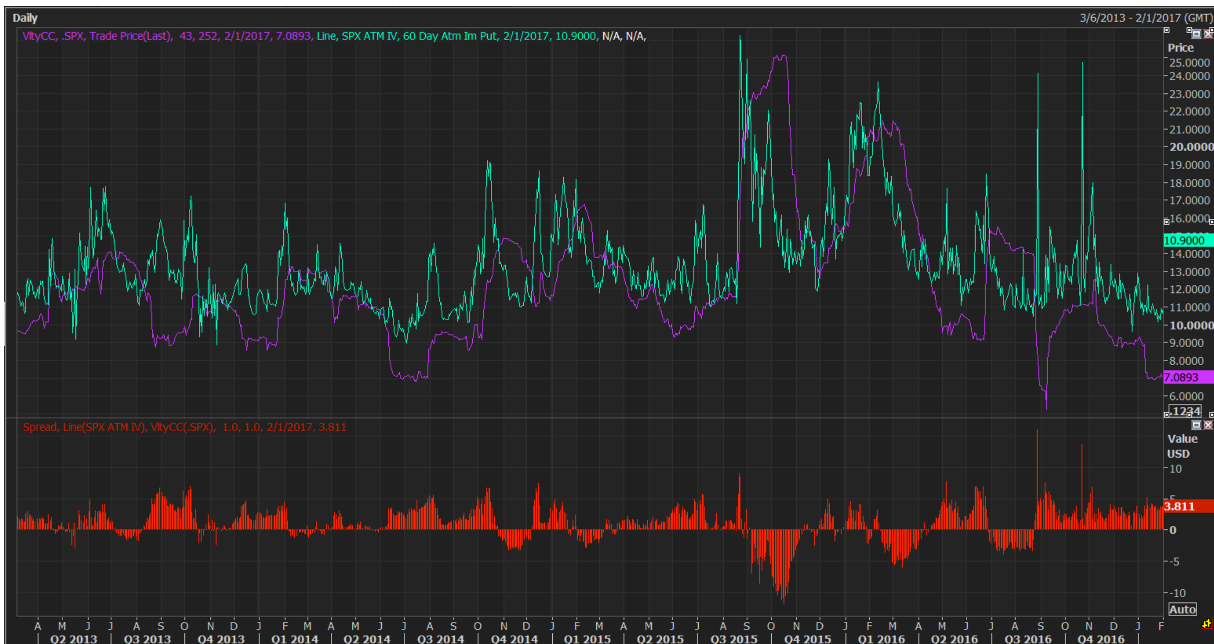
SPX tends to have positive median returns over the same period. The return for SPX is 0.7% after one month and 2.3% after 3 months. The worst observation showed a loss of only 5.9%.

Respecting these stats requires us to play for a continued grind higher in US equities and a low VIX. Resist the attempt to buy vol just because the VIX is low. This is a bad trade to make, especially when there are no foreseeable macro events in the coming month.

On top of the Goldman stats, implied volatility is currently trading at a high premium to the actual market. Look at the chart below of 60-day ATM implied vol (in green) plotted against 60-day realized volatility (in purple). The red histogram below the chart plots the spread between the two. A positive spread means equity index options are pricing in more volatility than what's actually occurring. A negative spread means options are underpricing market moves.



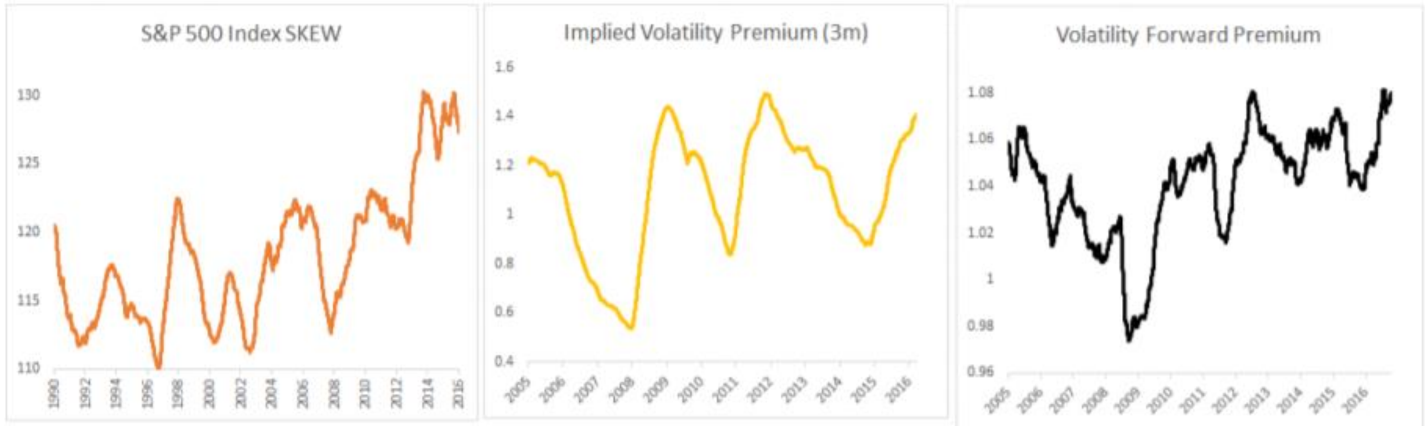
Right now implied vol is trading at 10.9% which is low. But realized vol of SPX is only 7.08%, even lower! Option sellers are charging a hefty price for long volatility exposure in relative terms.

This is what makes long vol trades so hard to execute profitably. The volatility risk premium (the spread) also tends to be even larger when the VIX is at low levels. The result is a strong negative carry that's almost impossible to overcome.

And the election of President Trump has only exacerbated this negative carry problem. Chris Cole at Artemis Capital put it perfectly:

Trump is a protectionist bull in a china shop. *Trump will keep the price of uncertainty high, and high uncertainty is very good for the business of dynamic volatility trading, but oddly poses a challenge for traditional hedging and tail risk funds.*

In anticipation of a volatile U.S. presidential term, investors have drove the cost of hedging to historic highs. You can measure this by skew, implied volatility premium, and volatility forward premium.



Charts by Artemis Capital

Out of these three graphs, the CBOE SKEW Index is the most interesting. For those of you unfamiliar with SKEW, it's a measure of how much perceived tail risk there is in the market. High readings mean far out-of-the-money puts are rich and investors are pouring money into tail hedges. Low readings are the opposite — investors are complacent and not worried about an outlier event.

Plotted to the right is the 1-Yr moving average of the SKEW Index. Usually it oscillates in a well-defined range. But since 2008, the SKEW Index has trended straight upward.

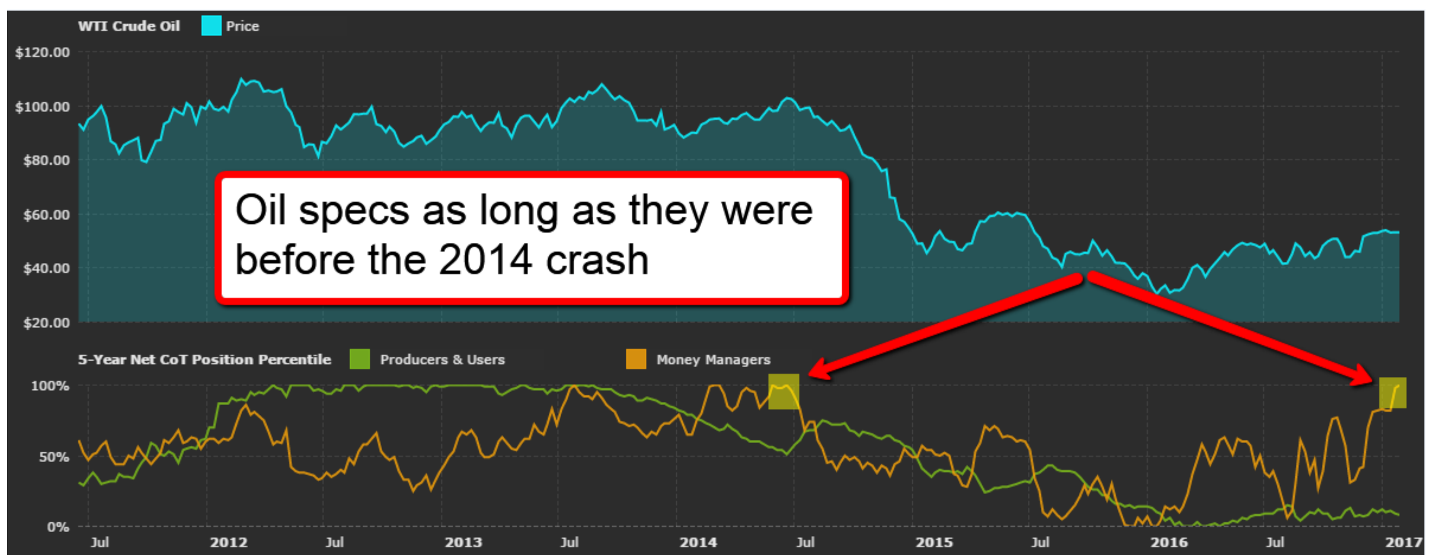
Maybe investors are still having nightmares about the 2008 crisis. Or perhaps Taleb's black swan theory has become so mainstream that everyone's protecting against the "fat tail." We're not sure why we're seeing this mean-reverting

oscillator break down and start to trend, but this change in investor behavior is interesting. Hedging a stock portfolio is now more expensive than ever before.

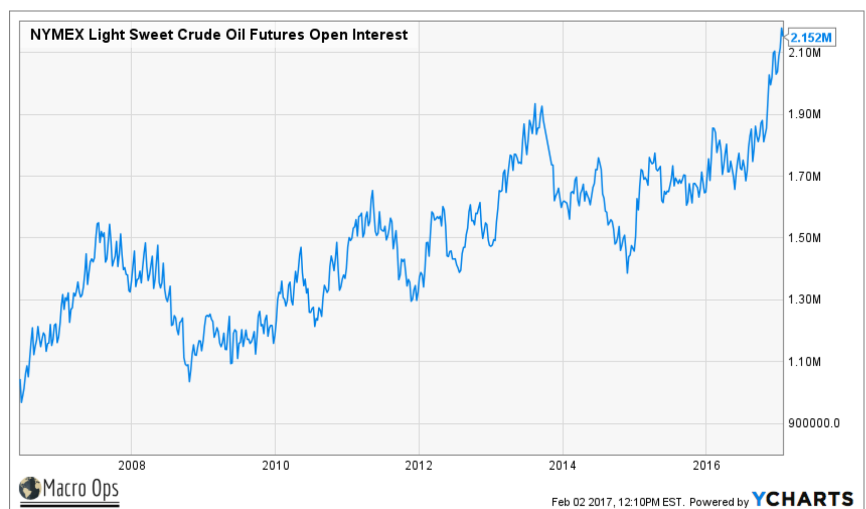
We'll likely continue to climb the "wall of worry" until institutions get sick of losing so much money hedging their equity downside. We're staying clear from tail hedging for the time being. Insurance ain't cheap today.

Crude Oil Primed For a Move

WTI Crude Oil popped back up on our radar due to an extreme COT reading.



This reading is more believable than the VIX reading because crude oil contracts have been around longer. They don't have the growth in participation that VIX futures have. Crude futures OI has only increased around 43% since 2008. This shouldn't have that big of an impact on the net nominal spec position.



Given the COT profile, we can entertain the idea that the long side is crowded. This sets the stage for a sharp move lower.

And what sweetens the short further is realized volatility. Check out the chart below:

Plotted below the price chart is the 30-day realized volatility of crude. When realized vol is extremely high, it's best to fade the recent move and play for mean reversion. When the realized vol is low, it's best to bet on a continuation of a trend by buying or selling a breakout/breakdown.

In the 2015 bullish retrace you can see how realized vol fell as price compressed into a tight range. When the market finally broke from this range the next leg of the downtrend began. A similar setup is underway. Realized vol has fallen to an extreme and crude oil retraced into a bullish compressed range. The best play is shorting a breakdown to profit from the trend continuing lower.

When structuring this trade we can't help but remember John Bender's interview in [Stock Market Wizards]. John Bender was a genius options trader Soros himself invested in. If you haven't read that interview, check it out. It's fantastic. The story of Bender's [eventual death in 2010] also makes for a good murder mystery if you're into that sort of thing.

Anyway, read the selection from *Stock Market Wizards* below and see if it sounds similar to the situation in Texas Tea.

> *The best example I can think of involves the gold market rather than stocks. Back in 1993, after a thirteen-year slide, gold rebounded above the psychologically critical $400*

level. A lot of the commodity trading advisors [money managers in the futures markets, called CTAs for short], who are mostly trend followers, jumped in on long side of gold, assuming that the long-term downtrend had been reversed. Most of these people use models that will stop out or reverse their long positions if prices go down by a certain amount. Because of the large number of CTAs in this trade and their stop-loss style of trading, I felt that a price decline could trigger a domino-effect selling wave. I knew from following these traders in the past that their stops were largely a function of market volatility. My perception was that if the market went back down to about the $390 level, their stops would start to get triggered, beginning a chain reaction.

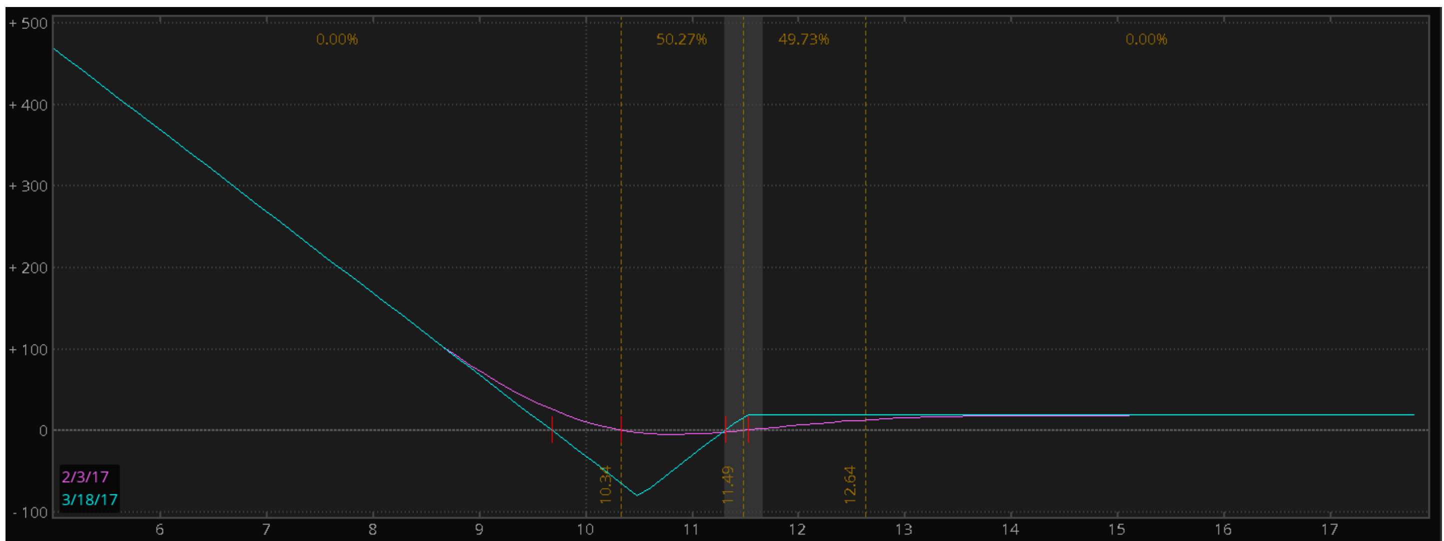
I didn't want to sell the market at $405, which is where it was at the time, because there was still support at $400. I did, however, feel reasonably sure that there was almost no chance the market would trade down to $385 without setting off a huge calamity. Why? Because if the market traded to $385, you could be sure that the stops would have started to be triggered. And once the process was under way, it wasn't going to stop at $385. Therefore, you could afford to put on an option position that lost money if gold slowly traded down to $385-$390 and just sat there because it wasn't going to happen. Based on these expectations, I implemented a strategy that would lose if gold declined moderately and stayed there, but would make a lot of money if gold went down huge, and a little bit of money if gold prices held steady or went higher. As it turned out, Russia announced they were going to sell gold, and the market traded down gradually to $390 and then went almost immediately to $350 as each stop order kicked off the next stop order.

The Black-Scholes model doesn't make these types of distinctions. If gold is trading at $405, it assumes that the probability that it will be trading at $360 a month from now is tremendously smaller than the probability that it will be trading at $385. What I'm saying is that under the right circumstances, it might actually be more likely that gold will be trading at $360 than at $385. If my expectations, which assume nonrandom price behavior, are correct, it will imply profit opportunities because the market is pricing options on the assumption that price movements will be random.

- Crude above a psychological level? Check. It’s right above $50.00.
- CTAs fully loaded? Check. We know that from the COT report.
- Near-term support preventing a decline? Check.

The option position Bender is talking about is called a back spread. It’s when you sell 1 at-the-money put and buy two out-of-the-money puts. You can put this trade on for a small credit. If oil rallies, you win a little. If oil declines a little, you lose. And if oil declines a lot, you’ll win big.

The USO 11.5/10.5 put back spread in March looks interesting. The trade can be put on for a net credit of around $0.19. Here's what the payoff graph looks like:



We're thinking about executing the following back spread:

Sell 1 March 17th 11.5 put in USO

and

Buy 2 March 17th 10.5 puts in USO

If the John Bender situation plays out this will pay out handsomely.

Copper/Gold Ratio – A Subtle Tell

Finally, we're keeping close tabs on the copper/gold ratio pictured below:

Copper/gold gauges the health of the economy well. When copper rises relative to gold it's a sign the global economy is accelerating. The opposite occurs when investors become fearful of an economic contraction or stagflation. Right now the short-term trend is clearly higher, but if it stalls at that down trending line, we'll have to re-examine the bull case in equities once again.

But until then, keep those equity bids stacked!

Systemic Risks

Yuan Devaluation

As we recently explained, China's banks are sitting on trillions of bad debt.

Their strategy to deal with it? Roll their bad loans over by adding new debt — real smart.

Now eventually this will come to an end. The banks will go bust and then need to be recapitalized, requiring the money presses to print full time. And the yuan will take a nosedive as a result.

This is one of the events we're waiting for to kick off a rapid currency devaluation.

But it looks like we'll have to keep waiting… because if there's one thing China's good at, it's kicking the can down the road. Their latest scheme involves using debt-for-equity swaps to roll bad corporate debts into the equity market.

Much of the Chinese banking system's non-performing loans (NPLs) come from the corporate sector, including state-owned enterprises (SOEs). In October the Bank for International Settlements (BIS) reported China's corporate debt at 121 trillion yuan. That's equivalent to 169% of the country's GDP. This debt has continued to grow from the 2008 crisis while corporate profits have steadily declined, exacerbating the leverage ratio. The IMF estimates that total NPLs are now above 5%, with 15.5% of all corporate sector loans at risk of default. This a very serious problem.

To deal with it, the CCP published guidelines to debt-for-equity swaps last October. Now according to the CCP, these swaps would only be used for companies facing "temporary difficulties" and that still had "long-term potential". There would be no zombie enterprises allowed and the whole program would be governed "under market principles".

Yea right…

This last month the Industrial and Commercial Bank of China (ICBC), the world's largest bank, reached deals with seven SOEs to convert $8.7 billion worth of unpaid loans into equity shares. Now if these swaps are truly governed "under market principles", then there should be some decent corporates involved. But this doesn't look to the be case.

Two companies that recently completed a swap, BBMG and Taiyuan Iron & Steel, both had terrible 2016's. Any positives in their reports were due to an overheated property market that's now cooling off, making their future prospects look even worse. They are in no way good investments. So clearly there aren't any "market principles" at work here. It's just more government intervention.

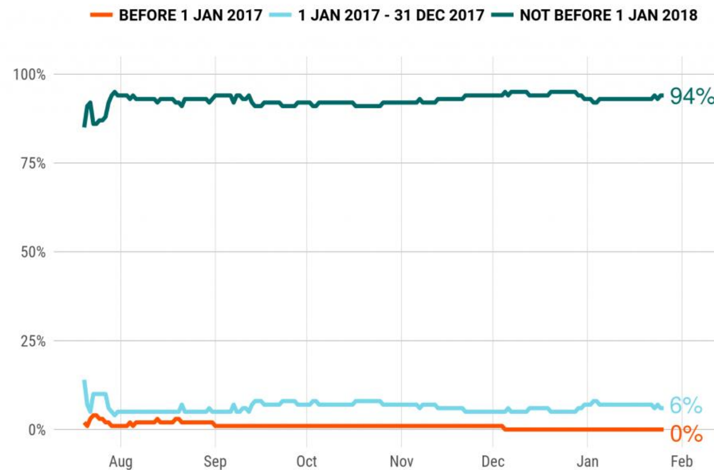
But this is what needs to happen for Xi Jinping is to continue consolidating his power. Letting these SOEs fail would hurt the CCP's credibility and cause unrest in the country, which is exactly what Xi wants to avoid ahead of the 19th Party Congress later this year. He rather continue to shuffle debt around the system for as long as he can. The end result will be the same, but the shuffling gives China more time. And that means more time we'll have to wait before the devaluation picks up speed.

Mosul Dam

Even though most people, including our policy makers, pay no attention to the situation progressing at the Mosul Dam, it's no less dangerous.

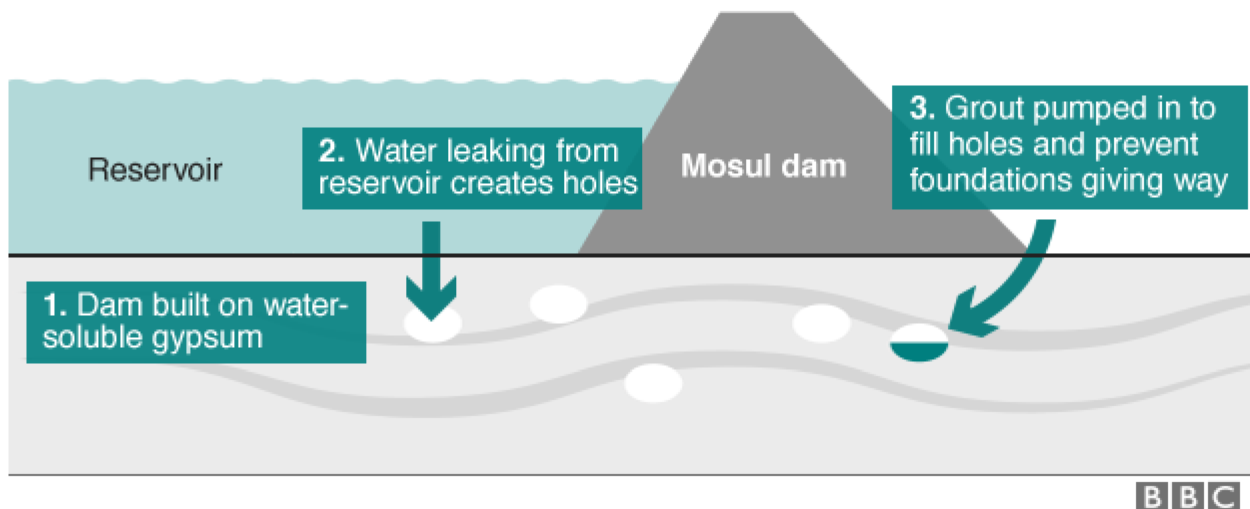
Analysts estimate that the number of people that would be dead and displaced from a dam collapse would easily exceed 1.5 million. And that's just the lower bound. Nearly 7 million people are at risk when considering all the Iraqi cities along the Tigris that are also in danger. With flood waters come disease, corpses, and washed up bombs. To say it would be a giant mess is an understatement.

The Superforecasters are putting the probability of the dam bursting in 2017 around 6%.



This percentage may seem small to you, but considering the outsized impact a dam failure would have, it's not something to be ignored. This is especially true when considering the unpredictability of ISIS. These percentages can swing at any time based on their actions.

Even the Italian company currently working to repair the dam is only a temporary fix. The only solution is to build another dam where the rock beneath it isn't soluble. Until that happens, the Mosul Dam will remain a huge global risk factor. We'll continue to monitor it going forward, along with its potential impact on oil prices.



Trump Trade War

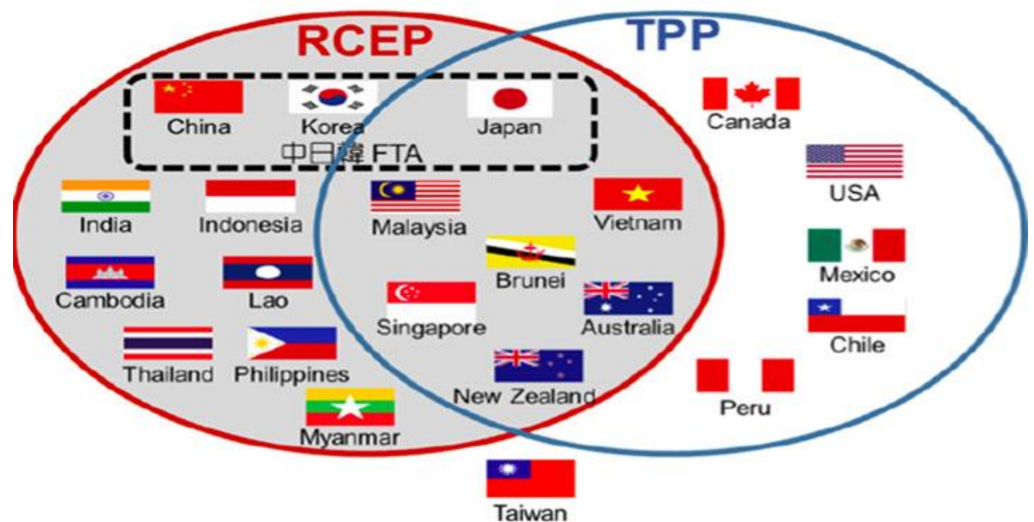
Mexico, China, Japan, Germany… and everyone else too. When Trump said he would be a wrecking ball he meant it.

It's difficult to know exactly what the impact of Trump's trade negotiations will be. Will something like a 20% Mexican border tax actually benefit Americans? Considering the negative effect tariffs will have on consumer good companies' supply chains, there's a good chance domestic goods will just become more expensive for American consumers. The cost increases may stunt consumption while at the same time increasing inflation. And with the Fed on inflation watch, they could easily hike rates and send the American economy back into the doldrums. At that point there wouldn't be any jobs for Trump's America to hold onto.

But the potential negative cost effects of a trade war need to be balanced with Trump's goals to reduce US corporate tax rates. Will those cost savings be enough to make up for the more expensive goods? That's once again tough to say because we don't know exactly what Trump will be able to accomplish on either side.

What's also worrisome is the long-term geopolitical effects a trade war may have. Actions like pulling out of the Trans-Pacific Partnership (TPP) will strengthen the economic, political, and military ties between other countries. If the US decides against playing the same role it has since WWII, foreign countries will instead rally around a different leader.

That leader could possibly be China. Just the other week the first direct freight train from China to London made its inaugural trip. This is a small example, but it shows how new trade routes will open with China gaining a significant influence. Free trade agreements like the Regional Comprehensive Partnership may become a reality as the US shuts its doors.



Source: ASEAN Trade Union Council

Macro Ops
Target. Deploy. Profit.

Again, we'll have to keep a close eye on the actual *results* of Trump's negotiations before we can make more accurate predictions. We'll continue to closely watch events as they unfold.

Thanks for reading this month's MIR. Trade em' well!

For questions about the Market Overview, Deep Dive, or Asset Allocation Model, contact alex@macro-ops.com

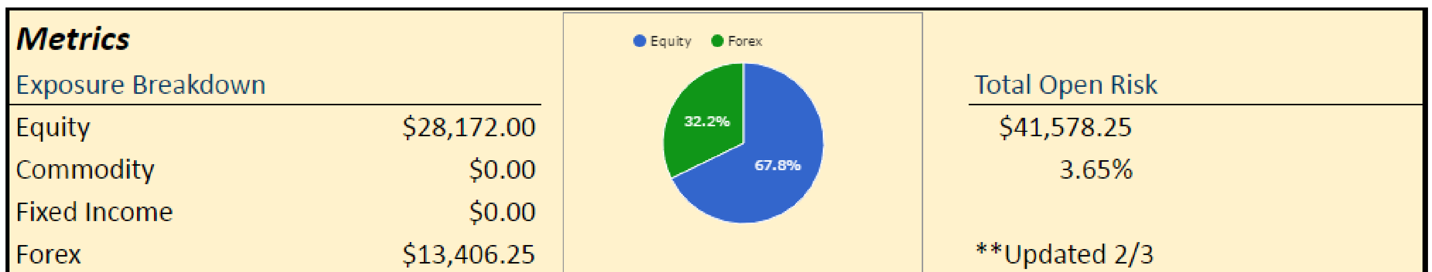
For questions about Around The World or Systemic Risks, contact anish@macro-ops.com

For questions about the Quant Overview, contact tyler@macro-ops.com

Portfolio Snapshot

Strategic Ops

NAV	$1,138,065						
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	$6,450
Equity	Whiting Petroleum WLL	1,000	$10.41	$8.10	$2,310.00	$16.42	$11,910
Equity	Century Aluminum CENX	1,700	$11.11	$7.55	$6,052.00	$16.55	$25,625
Equity	Navios Partners NMM	5,000	$1.65	$1.49	$800.00	$4.00	$8,000
Equity	Navios Holdings NM	15,000	$1.75	$1.55	$3,000.00	$4.10	$30,750
Equity	Intrepid Potash IPI	5,000	$2.34	$1.74	$3,000.00	$4.20	$10,800
Equity	AV Homes AVHI	3,200	$17.92	$16.12	$5,760.00	$29.35	$60,480
Equity	Uranium Res URRE	6,000	$2.56	$1.58	$5,880.00	$9.00	$14,280
Forex	Pound (GBPH7)	5	$1.2569	$1.21	$13,406.25	$1.38	$470,925



Metrics

Exposure Breakdown	
Equity	$28,172.00
Commodity	$0.00
Fixed Income	$0.00
Forex	$13,406.25

Total Open Risk
$41,578.25
3.65%

**Updated 2/3

Volatility Ops

NAV	$1,164,124			
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 2/3

Asset Allocation Weightings

Asset Allocation Weightings	Underweight	Neutral	Overweight
EQUITIES			
Large Cap Growth		x	
Large Cap Value			x
Small Cap			x
Mid-Cap			x
International Equity			x
Emerging Market Equity			x
Cyclical			
Materials			x
Gold		x	
Commodities			x
Consumer Discretionary			x
Financial Services			x
Real Estate, Domestic		x	
Real Estate, Global		x	
Sensitive			
Energy		x	
Industrials			x
Technology		x	
Telecom		x	
Defensive			
Consumer Staples	x		
Healthcare		x	
Biotech	x		
Utilities	x		
FIXED INCOME			
Preferreds		x	
Government Bonds	x		
Corporates	x		
Munis	x		
Long Duration	x		
Intermediate Duration		x	
Short Duration		x	
High Yield	x		
TIPS			x
Emerging Credit			x

For more information about real time portfolio updates please email alex@macro-ops.com