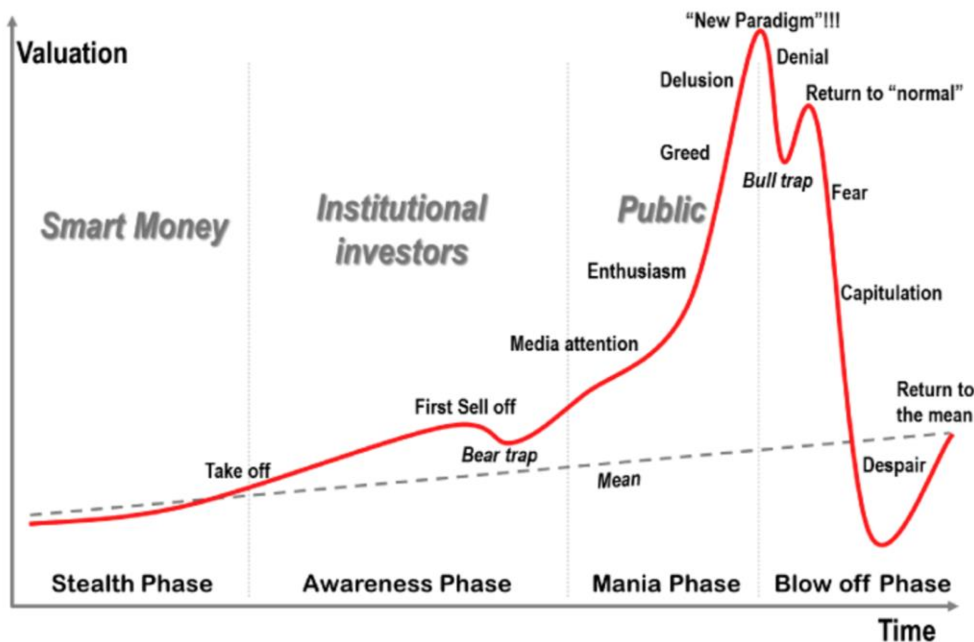
A Self-Fulfilling Prophecy



> ***There is always a divergence between prevailing expectations and the actual course of events. Financial success depends on the ability to anticipate prevailing expectations and not real-world developments.*** *But, as we have seen, my approach rarely produces firm predictions even about the future course of financial markets; it is only a framework for understanding the course of events as they unfold. If it has any validity it is because the theoretical framework corresponds to the way that financial markets operate. That means that the markets themselves can be viewed as formulating hypotheses about the future and then submitting them to the test of the actual course of events.* ***The hypotheses that survive the test are reinforced; those that fail are discarded.*** *The main difference between me and the markets is that the markets seem to engage in a process of trial and error without the participants fully understanding what is going on, while I do it consciously. Presumably that is why I can do better than the market.* ~ George Soros, *The Alchemy of Finance*

I came across this passage while going through my old *Alchemy of Finance* notes this weekend (I'm writing up the *Ops Notes* for it now) and thought it pertinent to what we're seeing in markets today.

In this passage, Soros gives us a more developed take on Keynes' "markets as a beauty contest" analogy… It's not how beautiful the economic future will be, but how beautiful the average market participant thinks it'll be etc...

Our job as macro traders is not to try and predict future market outcomes. Our job is to anticipate prevailing expectations.

This is at the heart of Soros' edge. As he says, "The main difference between me and the markets is that the markets seem to engage in a process of trial and error without the participants fully understanding what is going on, while **I do it consciously. Presumably that is why I can do better than the market.**"

The current market narrative (prevailing expectation) is predicated on the Trump reflation theme, a topic we've covered extensively since the election.

The heart of the narrative is that the Trump administration will be successful in executing large scale deregulation, tax reform, and the passing of a substantial infrastructure spending plan.

The logic is simple. These proposals are positive for growth and therefore the economy should improve along with stock prices.

The narrative benefits from the positive momentum that comes with an 8-year bull market and central bank suppressed volatility. This supports market sentiment and eases the adoption of the reflation theme.

Using the *Soros Cycle* model we discussed in our December MIR, we can consider the market to currently be in an "established regime". The narrative has become accepted fact (a point reflected in all the soft econ surveys, not to mention stock market prices).

The *Soros Cycle* plays out like this:

An **established regime** exists and is comprised of a few dominant narratives —>

Narrative drift begins as information starts to challenge accepted fact, which leads to data cherry picking and growing cognitive dissonance —>

Narrative crisis hits because reality has diverged too far from the dominant narrative for the regime to be sustained (narratives always lag shifts in reality) —>

Narrative revolution finally happens when reality forces the majority of people who were reluctant to admit they were wrong to adopt a new narrative —>

Regime change occurs when a new narrative becomes dominant and accepted by the majority of market participants. It's reinforced by reality which eventually brings us full circle back to the established regime.

And since we know what the narrative is, we know what its drivers and expectations are. This allows us to surmise what the "tests" will be that will either reinforce it or cause a narrative "crisis and revolution". Put another way, we know what data to watch, enabling us to better anticipate shifts in market narrative.

Currently, one of the more important tests to this narrative is Trump's ability to pass healthcare reform. His "deal making" abilities are central to the narrative and passing his healthcare bill is the first real test of this. It's also the first major hurdle he has to clear before moving on to tax reform.

If successful, the narrative will be reinforced. If not, it'll be weakened.

The further the narrative diverges (stock market runs without positive narrative confirmation) from our current reality, the more unstable the trend becomes. It becomes more vulnerable to shocks and failed narrative tests.

To pull another quote from Soros, "Typically, the trend appears to be sound when it is first established and the flaws become apparent only when the trend is already well advanced.

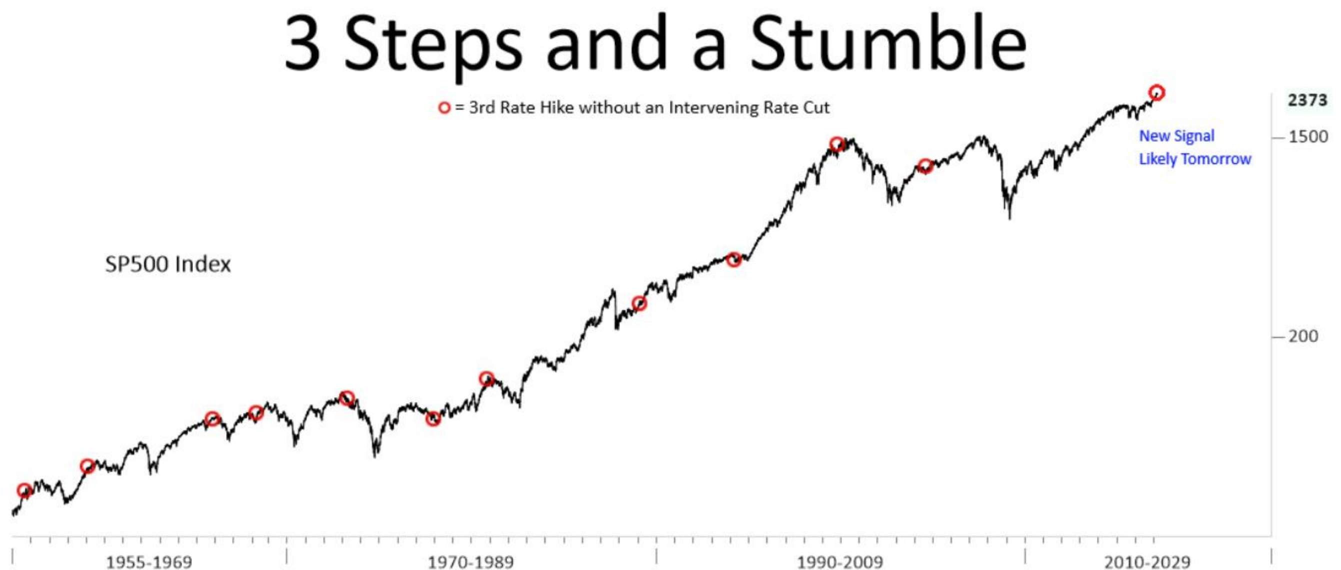
There is a twilight period during which the participants grow increasingly leery and reluctant, and the trend loses momentum. Eventually, the realization that the trend is unsound and unsustainable comes crashing in. **The prophecy is self-fulfilling and the trend is reversed, often with catastrophic consequences.**"

Macro: A Dovish Hike and a Third Step Before a Stumble?

The Fed hiked on Wednesday as expected, bringing the Fed Funds rate to a whopping 1%. The market, with its rose-colored glasses in full effect, interpreted the hike as dovish.

In reality the meeting was neither overly dovish or hawkish. The Fed stuck to its playbook of hiking rates and then muting expectations going forward. Their infamous dots still project two more planned hikes this year and three more the year following.

Nautilus Research published the following chart noting market action following the third rate hike in a tightening cycle.



The "3 steps and a stumble" theory was put forth by late trader and market guru Marty Zweig (he wrote a book worth reading titled *Winning on Wall Street*). Zweig noticed that the market has a tendency to considerably underperform following the third rate hike in a hiking cycle. Here's the following from Nautilus.

> *The SP500 has endured significantly below average results from 1 to 12 months after 3rd rate hikes in 11 events back to 1955. Note that 6 (more than half) of those hikes occurred within a year of a major cyclical top for stocks (1955, 1965, 1968, 1973, 1980, 1999). However, the market defied that relationship on the last occurrence in 2004 by rallying for 3 more years... When looking at all hikes - note that hikes are generally bad for stocks, somewhat bad for the US Dollar, and bullish for 10yr yields and commodities.*

Yale economics professor Robert Shiller, of CAPE ratio and "Irrational Exuberance" fame, noted the similarities in sentiment between the current market and that of the late tech bubble (an analog we've discussed quite a bit).

In a recent Bloomberg article Shiller said, “They’re both revolutionary eras, in the tech boom it was a new era of prosperity brought on by the internet now it’s a ‘Great Leader’ has appeared. The idea is, everything is different.” But no matter how you cut it, Shiller says “The market is way over-priced… It’s not as intellectual as people would think, or as economists would have you believe.”

Going off of the chart at the top of the Brief, it’s a safe bet to say we’re transitioning from the greed to euphoria stage. Take a look at magazine covers and article headlines and it’s easy to see that the market is entering a new level of optimism and complacency.

BofA's Banks Says S&P 500 Could Reach 2,600 Before Pullback

The Future for U.S. Stocks has never been so bright

S&P 500 Weekly Update: Fed Raises Rates, The Market Reaction Is Positive - New Highs Ahead For The S&P

As we progress further into the latter innings of this cycle, and as expectations become more and more dependent on a narrowly defined and exceedingly optimistic future, it pays to remember the following from the book Ubiquity: Why Catastrophes Happen (bolding is mine):

> *In this simplified setting of the sandpile, the power law also points to something else: the surprising conclusion that even the greatest of events have no special or exceptional causes.* ***After all, every avalanche large or small starts out the same way, when a single grain falls and makes the pile just slightly too steep at one point.*** *What makes one avalanche much larger than another has nothing to do with its original cause, and nothing to do with some special situation in the pile just before it starts.* ***Rather, it has to do with the perpetually unstable organization of the critical state, which makes it always possible for the next grain to trigger an avalanche of any size****.*

(Note: There will be eleven(!!) Fed members speaking this week. Who knows what kind of tone they’ll take, but it should make for an interesting week).

Oil

Oil is teetering on its 200-day moving average. The next two weeks will decide whether we see a v-bottom move back above the $50bbl level or a continuation lower.

The daily chart shows crude is forming a bear flag. Combine this price action with the still overwhelmingly bullish positioning by large speculators and I'm biased oil moves lower.

If so, it's going to have considerable implications for the bigger macro picture.

For one, the oil price is inextricably linked to the junk credit market because of the leveraged E&P players.

Here's the following from David Riley, head of credit strategy at Bluebay Asset management, "Credit spreads continue to imply $55 a barrel at the end of the year… A sustained fall below $50 will likely prove a catalyst for a meaningful re-pricing of energy credit."

Sustained sub $50 oil will also drag down inflation and likely slow the Fed's hand once again. So we'll need to keep a close eye on where price goes over the following weeks.

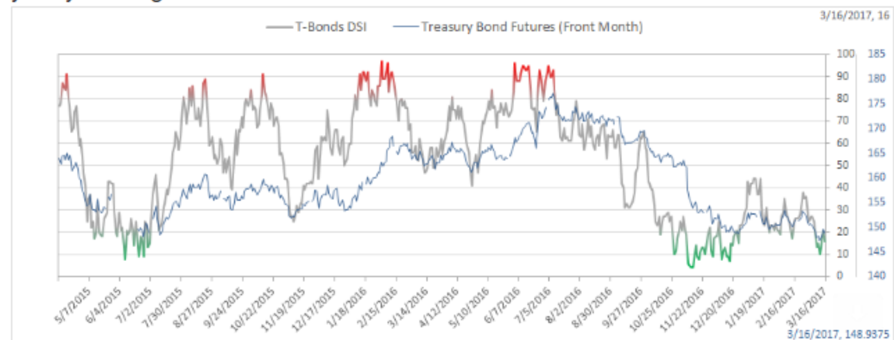
We already have direct exposure to short oil in Vol Ops through put options. But sub $50 crude should work in favor of our long bonds in Strat as well.

Lower oil and diminishing base effects mean that inflation and inflation expectations are extremely susceptible to a turnaround.

This is typically what happens towards the end of a hiking cycle so we wouldn't be surprised to see it happen soon.

This hit to the reflation narrative combined with the overly bearish bond sentiment as noted in the chart to the right via Tommy Thorton provide us with the the setting for a sizable run in long bonds.

Bond bullish sentiment continues to drag at 16%. People are set up very short bonds and squeeze potential is ripe. I like bonds long with a 2.15% downside 10 year yield target.



This is of course barring any major progress by the administration on taxes and infrastructure (which I'm not expecting over the coming month).

Europe

We shared the following chart of the MSCI Ishares Spanish ETF back in August. We noted how the chart displayed a textbook double bottom. The ETF is now up 20% and looks to be picking up momentum.

The charts in Europe are looking strong.

Europe is benefiting from low relative valuations and a shift in sentiment from strongly bearish to more positive — though little has changed to brighten the fundamental outlook.

And with global credit conditions loose, there's still a lot of hot money flows in search of returns, looking to diversify the clearly overvalued US market.

Hedge Fund manager David Tepper is one of these Europe bulls. He's done a number of recent appearances on TV touting his long European stock position combined with shorting European credit.

If the euro starts to move higher then it could accelerate the flow into European equities, driving their prices higher relative to the US.

We don't believe this will be a long sustained rally, but it's more likely a Soros-style false trend. Nevertheless, false trends can be just as profitable and we'll continue to watch closely. We may put on a position either through the currency or a small basket of stocks.

India

Finally, as we pointed out a few weeks ago, the Indian charts are looking the strongest and unlike Europe, India has much more favorable fundamentals as tailwinds.

We'll be entering starter position in VDTH this week which we wrote about [here](#).

There are a number of other stocks we're digging into in our search to find the few remaining asymmetric plays that have little to no correlation to the broader market as a whole.

We'll continue to update the group with what we find.

Vol Ops

Our volatility portfolio made new equity highs last week. We had the successful short vol FOMC day trade on Wednesday followed by a continual sell off in VIX futures into the end of the week. The "dovish" hike was the catalyst for this flow.

Vol term premium (the difference in price between spot VIX and the far out futures) continues to stay elevated. The chart from Bloomberg below shows this. The spread favors shorts as future vol is priced much higher than what is actually occurring in the market.

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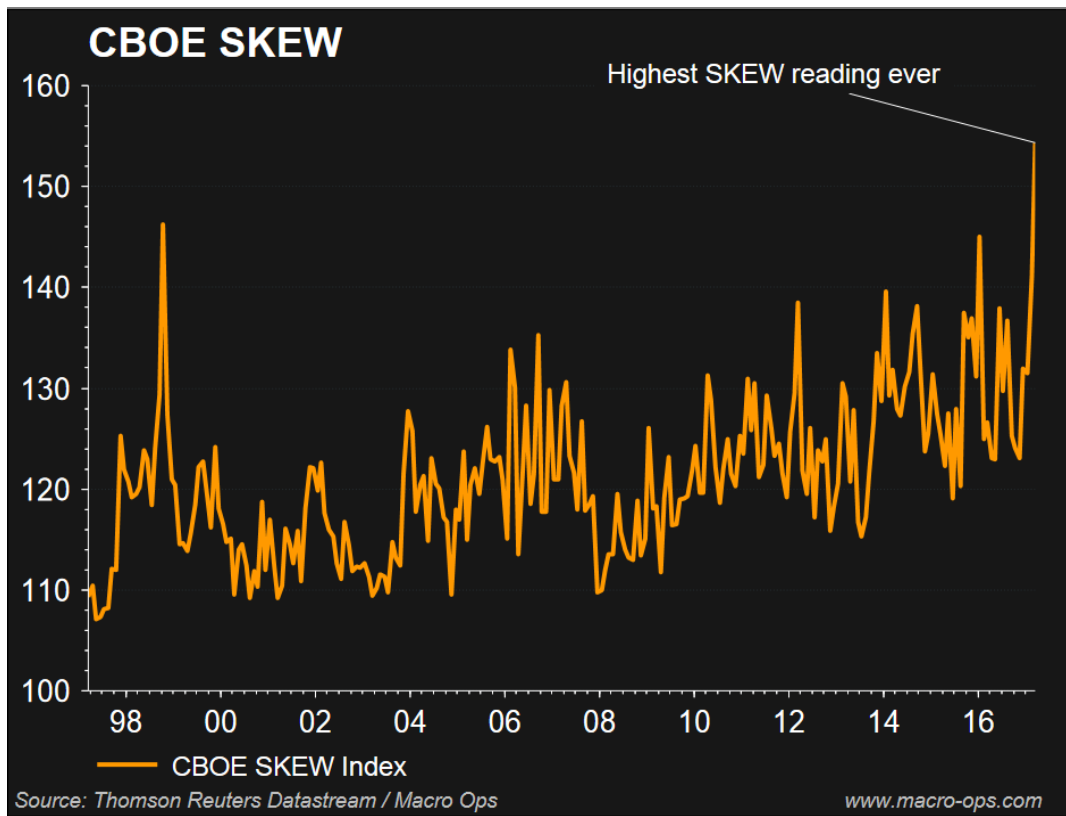
Bloomberg ®Charts 1 - 1

Investors are also paying a hefty price to hedge their portfolios with out-of-the-money put options. You can see in the graph below the CBOE SKEW index has hit a lifetime high.



Investors are extremely long the market, fully bought into the Trump narrative. But they are willing to pay a hefty premium to cut off the left tail event. You can see a similar spike occurred in 1999 during the blow off top. Yet another confirmation of our '98-'99 analog.

Have a great week,

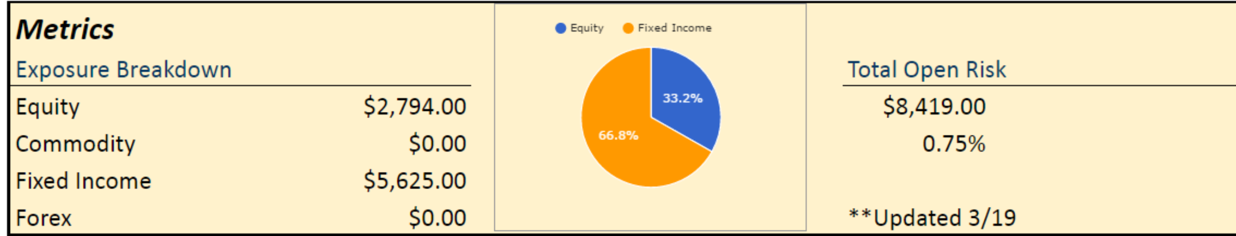
- Alex

Portfolio Snapshot

Strategic Ops

NAV $1,129,434

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	Century Aluminum CENX	400	$11.11	$7.55	$1,424.00	$16.55	$26,860
Fixed Income	30 Yr-Bond Futures (ZBM7)	6	$146.69	$145.75	$5,625.00	$153.00	$890,952



Metrics

Exposure Breakdown	
Equity	$2,794.00
Commodity	$0.00
Fixed Income	$5,625.00
Forex	$0.00

Total Open Risk
$8,419.00
0.75%

**Updated 3/19

Volatility Ops

NAV $1,206,801

Asset Class	Position	Size	Cost Basis	Notional
Volatility	April 19th VIX Future	-17	$15.70	-$259,248
Commodity	Crude Oil May 2017 48.5 P	11	$1.06	~

Scenario Analysis/Stress Tests

1-Day VAR -$34,531

**Updated on 3/19