MARKET BRIEF

The Quality/Price Paradox

The fifth and last wave of market cycles (which we believe we're in now) are dominated by steep angled trends and shallow drawdowns. Positive sentiment becomes palpable and crowd psychology drives areas of the market viewed as "sure bets" to stretched valuations. These "sure bets" are the market leaders — the Generals that lead the cycle's advance. Where these Generals go, the broader market follows.

In the 2003-2007 bull market, the market Generals were steel, potash, and financial stocks. This cycle the Generals are tech stocks; specifically the FAAMGs (FB, AAPL, AMZN, MSFT, GOOGL). Generals tend to get stupid acronyms — a sign of the exuberance and one sided narratives driving their advances. The "Nifty-50" were an example of this. They were the darlings of every institutional investor and hedge fund during the bull markets of the 60's and 70's. They were known as "one-decision" stocks because it was taken as a matter of accepted fact that investors should just buy and hold them forever, regardless of price.

Those who bought to hold the Nifty-50 committed an investing mortal sin, they forgot that there are two sides to every investment: Quality and Price. Hedge Fund Manager Howard Marks lays out this often overlooked paradox here (emphasis mine):

> *When everyone believes something is risky, their unwillingness to buy usually reduces its price to the point where it's not risky at all. Broadly negative opinion can make it the least risky thing, since all optimism has been driven out of its price. And, of course,* ***as demonstrated by the experience of Nifty Fifty investors, when everyone believes something embodies no risk, they usually bid it up to the point where it's enormously risky****. No risk is feared, and thus no reward for risk bearing—no 'risk premium'—is demanded or provided.* ***That can make the thing that's most esteemed the riskiest. This paradox exists because most investors think quality, as opposed to price, is the determinant of whether something's risky.*** *But high quality assets can be risky, and low quality assets can be safe. It's just a matter of the price paid for them... Elevated popular opinion, then, isn't just the source of low return potential, but also of high risk.*

Market pricing is always a function of embedded expectations versus probable outcomes. The higher the value placed on something (ie, the greater multiple applied to its cash flow and earnings) the higher the probability the market has assigned to the company fulfilling its lofty expectations. But as enthusiasm builds around the quality of the company, the risk these high expectations go unmet increases as well.

There's quality and then there's price. The intersection of the two is value. As Buffett says, "Price is what you pay, value is what you get."

Though we're not buy and hold investors, the concept of expectations vs outcomes and quality vs price is important to know. It helps us understand where increasing risk and fragility are building in the system.

The market Generals of today, the FAAMGs, are a good study in this.

Like the Nifty-50, the FAAMGs are quality companies with strong revenues and earnings growth. They have impressive competitive advantages and wide defensible moats. The narrative for owning them is convincing and widely adopted — they're the largest positions in most institutional portfolios and have become popular hedge fund hotels.

Because of these reasons, FAAMG stocks have risen over 30% this year-to-date. Collectively, they've added over $600 billion in market cap in just the last six months which is incredible considering that that's equal to the GDP of South Africa and Hong Kong combined.

As a result, these five stocks have accounted for over one-third of all of the S&P's year-to-date gains. According to UBS analyst Julian Emanuel, this level of extreme clustering (ie, large amount of index returns attributable to five stocks) has only happened four other times over the last 25yrs: 93', 99', 05', 07'.

The broader sentiment around the tech sector as a whole has driven a steady ramp higher in prices bringing in more and more performance and momentum chasers — leading the Nasdaq index to a ytd gain of 18% just before Friday's dump. In fact, a sign of how squirrely things are getting is this tidbit from an Analyst at Jones Trading, "The Nasdaq 100 index has closed higher in 70% of its sessions this year… The closest it had previously come to this relentless pace was in 1998, 1999, and 2007, when the percentage of "up" days reached 60%."

With this level of sentiment and positioning, Friday's selloff in the FAAMGs on no news shouldn't come as a surprise. The chart below shows the ytd performance of the FAAMG stocks and their Friday selloff, which went as low as 6.8% at one point.

Steep and low volatility trends accumulate weak holders who dump at the slightest sign of adverse price action — an example of Nassim Taleb's premise on how stability breeds fragility. Also, the selloff happened for technical reasons; both AMZN and GOOGL are bumping up against the $1,000 price per share mark. Large round numbers like these tend to attract sellers and act as points of resistance.

Since these are our Generals for this cycle we should be intensely interested in where they may be headed from here. The war (bull market) won't end until the Generals are killed off. So figuring out if this is the start of a major trend change or just a small breather before another leg higher is important to us.

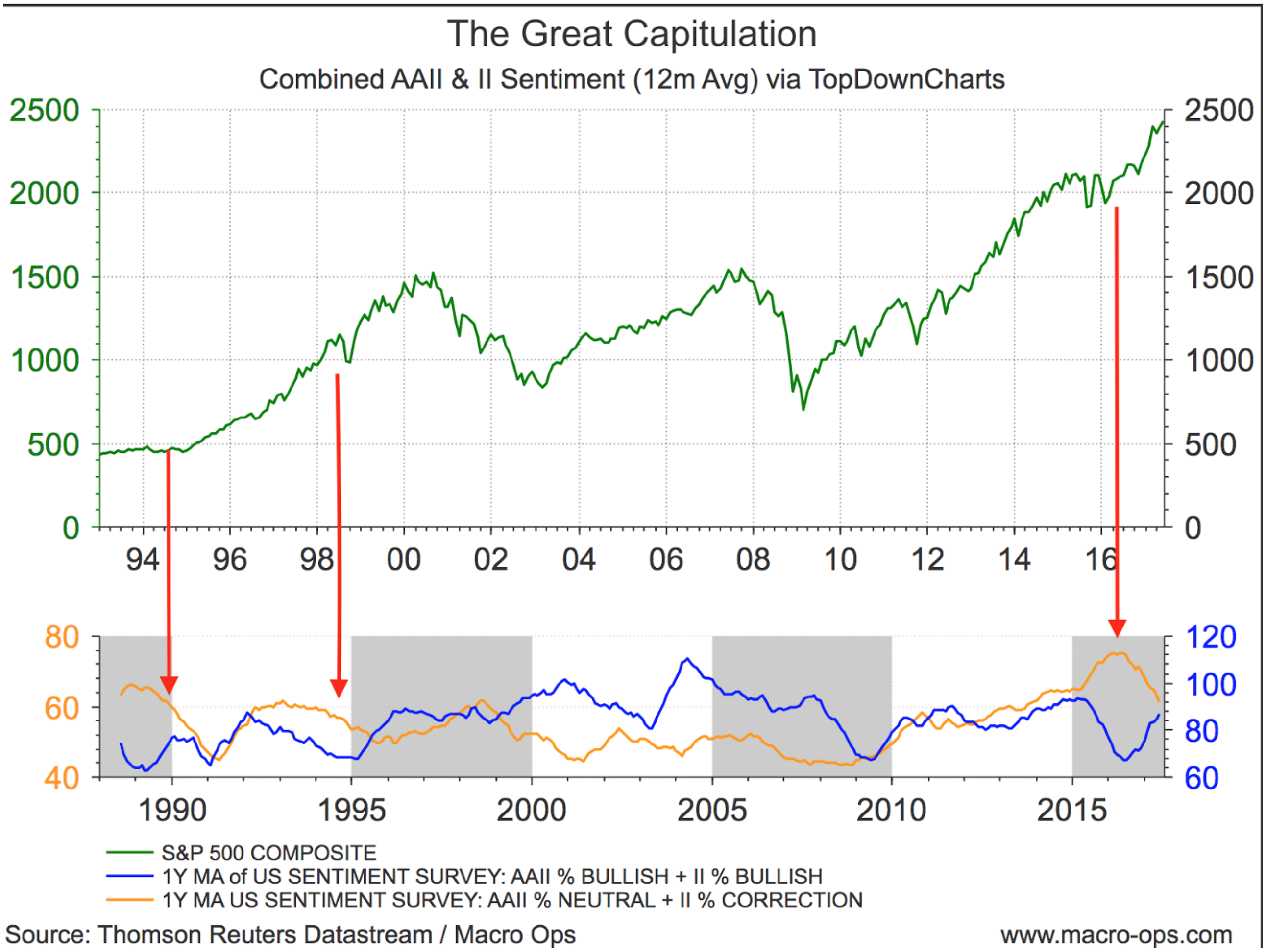
To understand this we need to look at the macro, sentiment, and technicals.

We've talked about the macro picture a lot lately. Though we're entering a period of weak seasonality during the summer months where equities have a tendency to underperform, the broader macro picture is still very supportive of higher equity prices.

Real inflation adjusted OECD interest rates remain near secular lows. Credit, as measured by BofA's high yield spread index, remains near cyclical lows, indicating credit investors are risk on and liquidity is loose. Other indicators we track such as Yardeni's equity and boom and bust index, the LEI, and the unemployment MA crossover all indicate that the coast is clear for this bull market to continue higher over the next six months or so.

There's a number of things I like to look at for big picture sentiment. But one of my favorite charts I've come across and which I think perfectly encapsulates this latest rally is below (h/t to Callum Thomas for the chart).

The green line on the top is the S&P. And the blue and orange line below are composite sentiment scores. The blue line shows the cumulative bullish % sentiment of both the AAII and Investors Intelligence Polls while the orange line shows the cumulative percentage of those neutral.

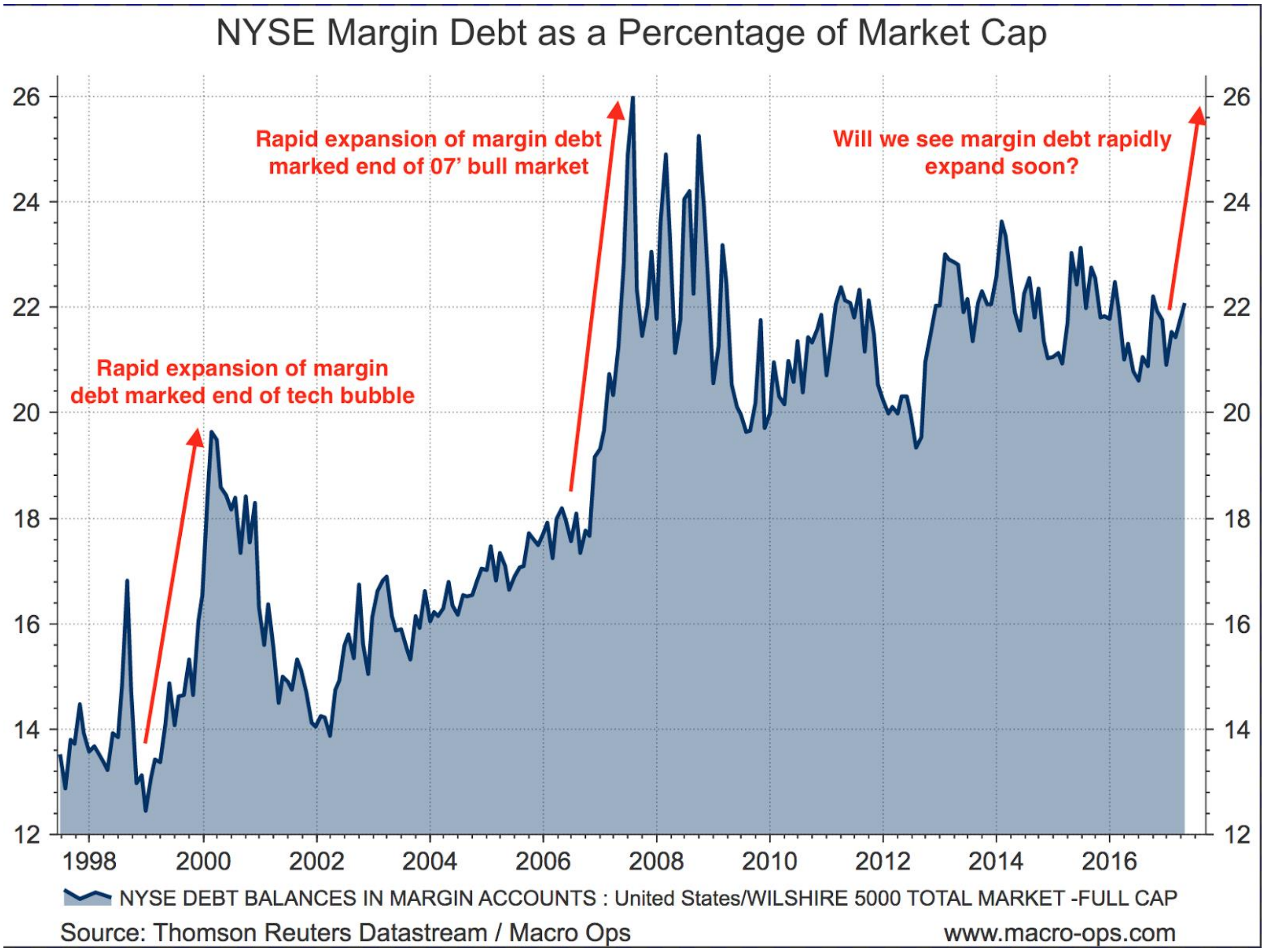


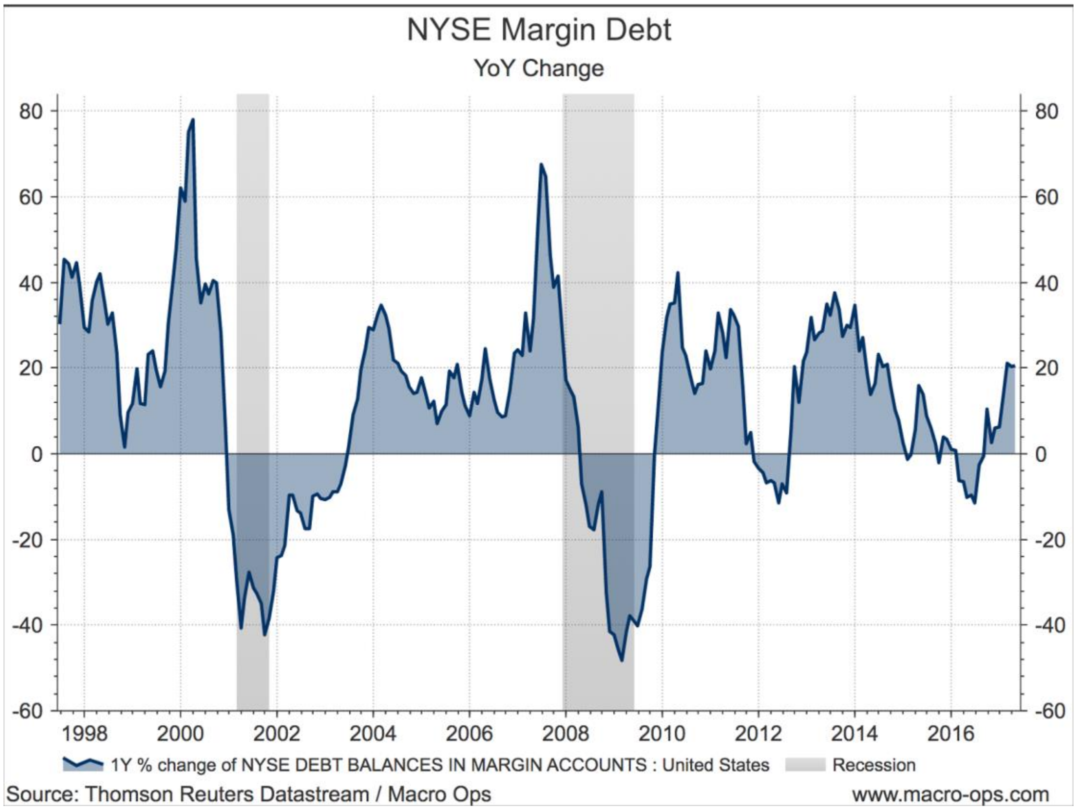
The chart is aptly titled "The Great Capitulation" because as the red arrows show, the recent rally beginning in 16' has been marked by strong pessimism. The other two red arrows show that the last time there was this level of neutral (non-bearish) sentiment was in 95' and 99'. All three rebounds in bullish sentiment (blue line) coincided with major advances in the broader market.

The bull market won't end until this high level of pessimism has been erased (ie, the orange line is well below the blue line). Tyler, AK, and I have long joked that this bull market die until the perma bears of the likes of Jesse Felder and Raoul Paul start growing horns.

Another great way to gauge broader market sentiment is to look at the change in margin debt. This is the amount that investors are willing to borrow to buy into positions. It's easy to assume that if investors start borrowing money quickly and in mass, then it may be a good sign that sentiment is reaching extremes.

Many traders wrongly look at NYSE margin debt on an absolute basis, but this is wrong. It's the change in the amount of margin debt relative to market cap that matters. That's what the chart below shows.





Another way we can look at this is by charting the YoY change of margin debt. Look at that chart on the right and you can see a clear rapid expansion in the amount investors are borrowing to buy stocks which directly marked the tops of the last two bull markets.

The YoY change in margin debt has been picking up since the middle of last year. I would not be surprised to see this chart trend higher over the next 6-12 months.

Both the macro and sentiment pictures indicate that the path of least resistance remains higher over the next six months.

Now for the technicals.

For a look at the technical health of our Generals, let's focus on AMZN since that company more than any other seems to drive the current belief in total tech dominance.

The chart below shows AMZN on a weekly basis. On Friday the stock fell as much as 8.5% but then regained some to close down 3.5% for the day.

On this chart we have the 200-week (thick blue), 50-week (red), and 13-week (light blue) moving averages.

Moving averages are useful tools in trend following and trade management. William O'Neil of *IBD* uses the 10-week MA (or 50-day) as a guide for noting trend direction and in setting stop losses and entries. Jesse Stine, author of Insider Buy Superstocks and a fan of O'Neil, likes to use the 13-week (65-day) moving average but talked about how stocks each seem to react specifically to a certain moving average. He calls these the stock's "magic lines".

We have also found that strong trending stocks typically adhere to a particular moving average (magic line) which tends to act as a point of support and resistance to price. For AMZN, its magic line is clearly its 13-week moving average. The orange dots mark the seven times over the last 18-months in which the stock has touched that moving average and then quickly reversed and bounced higher. Friday's lows were marked at exactly its magic line before rebounding higher.

And the two red dots on the chart show the last two times where the stock broke below the 13-week MA on a weekly basis. The first time led to a selloff of 31% and the second a selloff of 16%. Both selloffs lasted approximated six weeks.

It's impossible to say if AMZN's latest retrace quickly rebounds to new highs or if we'll see a larger selloff in the range of the last two — which would mean 13-28% more downside and which still wouldn't necessarily mean a trend change. A move below its 13-week MA would indicate there's likely further pain to come though which would also be in line with the seasonality weakness but we'll have to wait and see.

Either way, the broader macro, sentiment, and technical picture all remain supportive of AMZN and the rest of the Generals (FAAMG stocks) of this market — which is a good sign for the market as a whole.

But over the long run, even though these companies represent quality and their prices will likely go higher over from here, I don't find much "value" in them for those looking to buy and hold. But for trend followers they could still be a great trade.

Even though the Nasdaq is up over 14% ytd, depending on investor's enthusiasm it could run much higher. The index rose over 85% from 99' to 00' from already lofty valuations. It then followed that up by another 40% run at the start of the following year before finally rolling over. I don't expect to see that type of run as the secular tailwinds are nowhere near as strong today as they were in the late 90's. But a run of another 10% this year wouldn't surprise me.

<u>Macro</u>

The FOMC is meeting this week and will come out with their decision on Wednesday. They're fully expected to hike and the market is pricing this in. The real question is how much of a hawkish or dovish tone they take in their forward guidance.

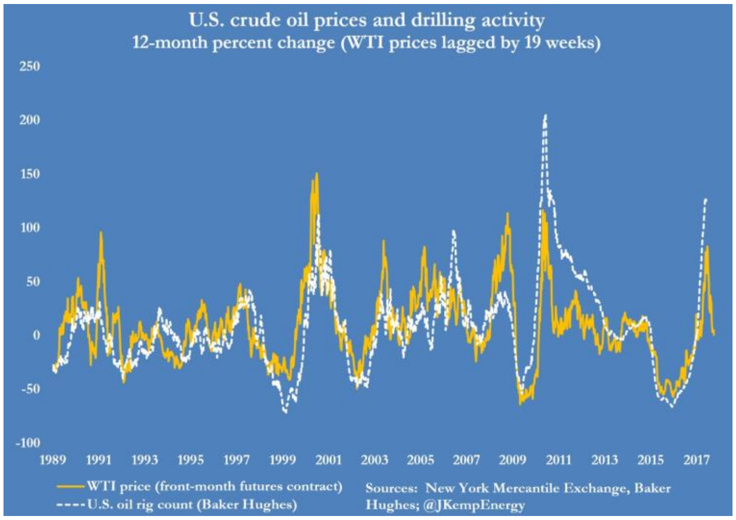
There's a chance the FOMC comes out overly hawkish to get the market more in line with its thinking, since it's currently underpricing the Fed's ability to carry out its planned hikes. I don't have an opinion either way but it pays to be aware of the possibilities.

And as we noted in the MIR, the last three times the Fed has raised rates, stocks have sold off and bonds have gone up (yields lower). There's a chance we see a repeat of that this week and that the tech selloff is just the beginning of that move.

Oil had a terrible week last week, selling off more than 6% at one point down to $45/bbl. I continue to be agnostic on where oil is headed over the next few months. I think it stays range bound between $35 and $55bbl. I'm using the end of the last commodity super cycle (98'-01') as a macro analog and I wouldn't be surprised to see the end of this super cycle follow a similar pattern.

John Kemp of *Reuters* published the chart below which shows YoY change in US crude oil prices and drilling activity. There's a strong correlation, as you'd expect, with drilling activity lagging the change in the price of crude by 19-weeks on average.

The yellow line which represents WTI crude has turned lower so we should expect drilling activity to significantly drop as a result. This means lower revenues and profits for US E&Ps in the near term.



Longer term, the oil picture is muddled. Saudi Arabia is supposedly listing Saudi Aramco sometime next year and they desperately need a large valuation as their state coffers are running dry. The recent Saudi led blockade of Qatar is partly, I believe, an attempt to stir things up in the Middle East with the hope of raising the risk-premium assigned to future oil prices. I would not put it beyond them to escalate the situation in order to drive oil higher. I plan on writing a more indepth oil piece that discusses this scenario along with the market's overall future supply/demand balance sometime soon.

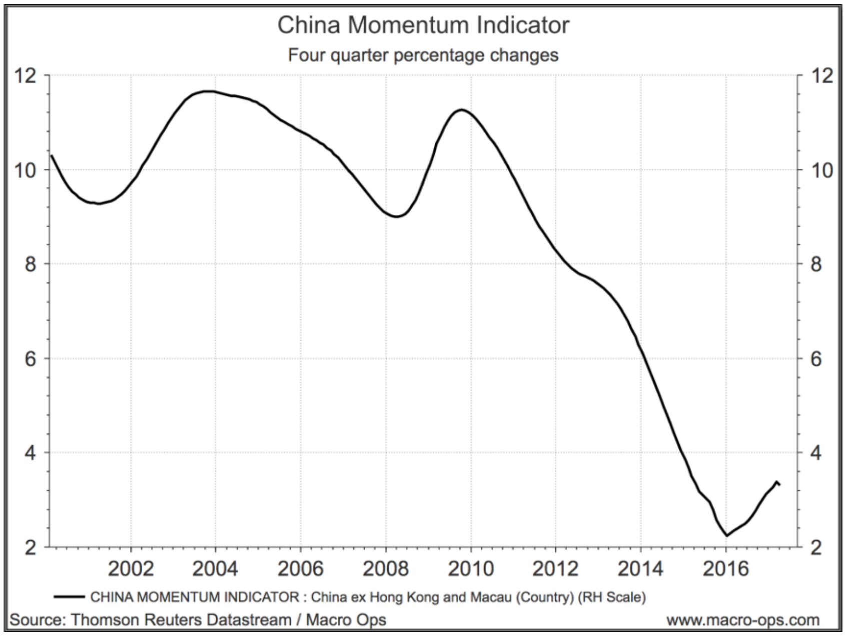
As I noted in last week's Macro Musings, China A-Shares have broken out of at tight 18-month consolidation zone.

We discussed in the last Brief why this breakout might be the result of an end to the Chinese government's current tightening cycle (ie, they've reached their economic pain threshold) and are about to start an easing cycle to keep things running smoothly into their important November congress. Here's the chart again via *Nautilus* showing that China might've hit a near term bottom.

forward returns after 5 events 7/13/2009 - 5/18/2017

	MBIO62DA MBUL	MXEF/MXWD	MATR/SPX	FCX (Freeport)	DE (Deere)	PCAR (Paccar)	STLD (Steel Dyn.)	IBOV Index
Event Dates	3Mo	3Mo	3Mo	3Mo	3Mo	3Mo	3Mo	3Mo
07/12/2010	18.88%	4.10%	7.18%	51.09%	31.09%	20.97%	0.76%	12.47%
10/27/2011	13.70%	1.30%	2.23%	7.84%	12.44%	0.66%	20.42%	5.90%
08/29/2012	32.80%	2.51%	2.34%	9.64%	13.09%	10.71%	5.47%	1.45%
04/01/2015	12.32%	-2.11%	-1.44%	-3.00%	9.81%	3.96%	5.46%	0.38%
12/07/2015	48.54%	1.73%	0.80%	26.56%	4.98%	6.53%	22.05%	8.06%
Avg after Signals	25.25%	1.51%	2.22%	18.42%	14.28%	8.56%	10.83%	5.65%
Average All Periods	1.34%	-1.11%	-0.72%	0.77%	3.67%	2.78%	3.94%	1.04%
T-Statistic	3.48	2.54	2.07	1.87	2.39	1.64	1.58	2.07
# Events Up/Down	5 / 0	4 / 1	4 / 1	4 / 1	5 / 0	5 / 0	5 / 0	5 / 0
Significance	99%	97%	95%	94%	97%	92%	91%	95%

Since you can’t believe the economic numbers that come from China since many of them are sugar coated by the CCP, I’ve gone ahead and created my own index to measure their economic growth.



The index is to the right and is meant to show the momentum in Chinese economic growth.

It's a composite of electricity production, rail freight volume, and credit growth in China and so should more accurately reflect what's really going on on the ground there. The indicator has collapsed over the last five years which makes +6.5% gdp growth suspect. But it has bottomed, temporarily at least, and remains in an uptrend.

Another area of the market I'm looking at is financials which haven't gone anywhere this year. According to Thomas Lee at Fundstrat Global Advisors, "Never in the last 28 years have energy, banks, and telecoms been bottom three at the same time" in regards to relative performance.

The chart below of the financials ETF XLF over SPY looks like it's forming an extremely bullish setup. This suggests that perhaps the time of relative underperformance from financials is coming to an end.

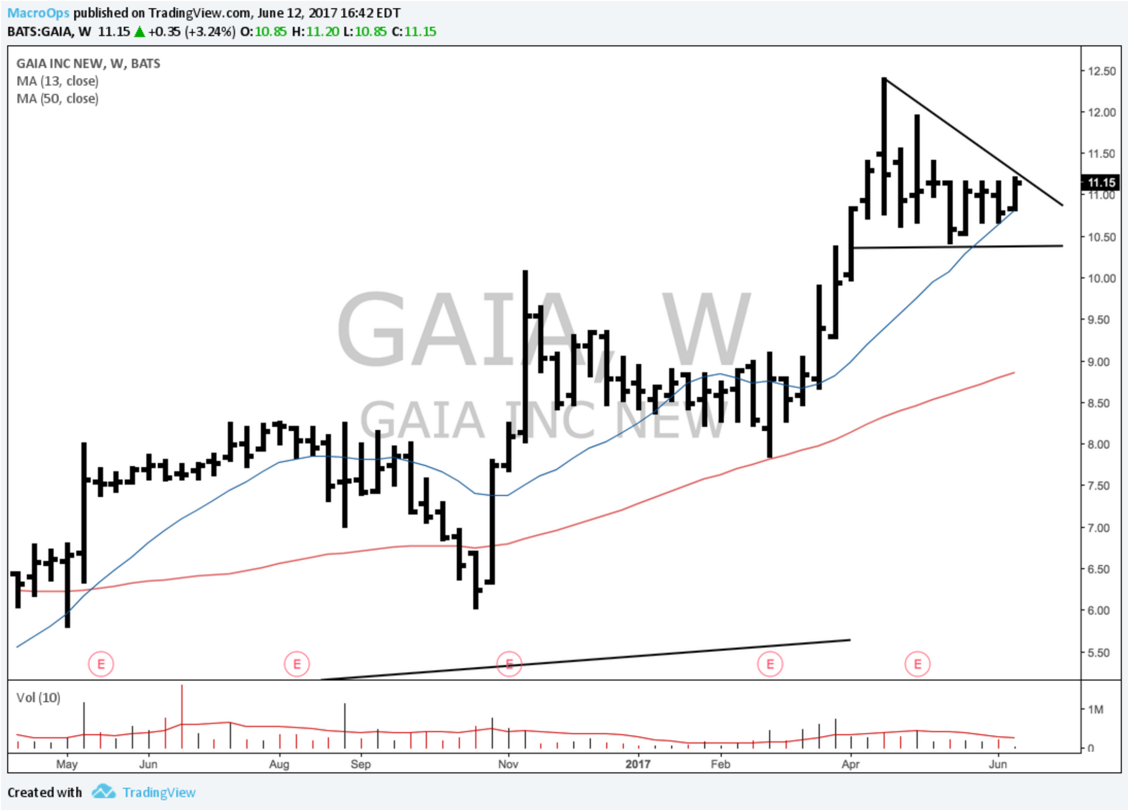
The failed H&S topping pattern in XLF is supportive of this possibility. Failed H&S are powerful continuation patterns. Also, with the Fed hiking rates which will raise bank's NIMs (net-interest margins) and the likelihood for soon to be announce deregulation there's no lack of bullish catalyst for the sector.

Strat Portfolio Update

Goldfield (GV)
Entry Date: ***11/15/16***
Entry Price: **$3.10**
P&L: ***($284)***
Prior Coverage
Trade Updates

Nothing new to report on GV. It remains a very small position in our portfolio and we're waiting till they report earnings at the end of this month before we assess whether we want to build onto it or cut.

Gaia (GAIA)
Entry Date: ***3/23/17***
Entry Price: ***$9.74***
P&L: ***$9,442***
Prior Coverage
Trade Updates



GAIA continues to form a solid consolidation zone. The chart above is a weekly and shows GAIA is nearing 10 weeks of tighter and tighter consolidation. This is the kind of price action I like to see in areas of consolidation for my growth stocks. It shows the stock is being held by steady hands which can be seen by the lack of large selling pressure. We're just waiting for a breakout from this consolidation zone on strong volume and we'll consider adding to our position.

<u>Videocon (VDTH)</u>
Entry Date: ***3/23/17***
Entry Price: ***$11.27***
P&L: ***($4,483)***
[Prior Coverage]
[Trade Updates]

Now contrast GAIA's solid looking price action with that of VDTH's, which is not what we want to see. VDTH has retraced its entire gain since its breakout. I think the reason for this is because of its coming merger with Dish India TV and the uncertainty that's always prevalent with these events. I'm guessing also a number of holders have decided to just dump their shares because they don't want to take receipt of the new global deposit receipts (GDRs) they'll receive which will trade on the Luxembourg exchange once the merger is complete.

Now we may get stopped out of our trade, our risk point is at $9.26, but after the merger this might be a trade worth revisiting as the secondary receipts that result from these mergers often are abandoned and passed over by investors, thus creating huge value for those willing to look into the matter. Hedge fund manager Joel Greenblatt made a ton of money off such trades and even wrote a whole book on the subject. So this might be one we revisit down the road.

Portugal ETF (PGAL)
Original Entry Date: ***4/25/17***
Entry Price: **$10.57**
P&L: ***$6,710***
[Prior Coverage]
[Trade Updates]

PGAL is extended and will likely continue to correct over the coming weeks. This is healthy and we'll be looking for opportunities to add to our position. I think PGAL moves much, much higher from here over the coming year.

Stratasys (SSYS)
Entry Date: ***4/25/17***
Entry Price: ***$24.45***
P&L: ***$3,087***
Trade Updates

Similar to PGAL, SSYS is just going through a healthy retrace after a strong move. Should another positive R/R entry present itself then we'll look to add to our position.

Trivago (TRVG)
Entry Date: ***5/15/2017***
Entry Price: ***$21.16***
P&L: ***($4,686)***
Prior Coverage
Trade Updates

TRVG is in the same boat as PGAL and SSYS and is experiencing a retrace after a strong move upwards. I took a sloppy entry on this stock which I shouldn't have done. As a result, I will probably get knocked out of the trade.

Colombia ETF (GXG)
Entry Date: ***5/15/2017***
Entry Price: ***$10.18***
P&L: ***($1,889)***
Prior Coverage
Trade Updates

GXG continues to consolidate above its breakout. This trade is essentially a synthetic long oil trade and since I don't have strong conviction on the near-term direction of oil, I'm going to move the stop up on this trade to $9.80.

BlackBerry (BBRY)
Entry Date: ***5/15/2017***
Entry Price: ***$9.70***
P&L: ***$2,561***
Prior Coverage
Trade Updates

BBRY is also overextended over the short-term and likely to continue its pullback. I really like this trade and think it has a lot of potential upside. The company faces many challenges and it's path to success is far from guaranteed (Chintan, who's from our Operator community and who is my go-to for tech info, lays out many of these challenges in the Comm Center). But the potential upside to the stock should BBRY's CEO John Chen succeed make the "pot odds" compelling for the trade. I will be patient but am looking for price action setups to add to this position.

Hudson Tech (HDSN)
Entry Date: ***5/15/2017***
Entry Price: ***$8.09***
P&L: ***$1,446***
Prior Coverage
Trade Updates

Nothing new to report on this one.

30Yr Bond Futures (ZBU7)
Entry Date: ***5/17/2017***
Entry Price: ***$153.81***
P&L: ***$9,721***
Trade Updates

As I showed above, bonds have performed very well following the last three Fed rate hikes. This time could of course be different and it all depends on what the Fed comes out with regarding its forward guidance.

IAMGOLD Corp (IAG)
Entry Date: ***6/06/2017***
Entry Price: ***$4.97***
P&L: ***$1,188***
Trade Updates

I'm actually surprised this position has performed as well as it has. It's one of the few miners that are up since gold's false breakout. When I put on the trade I didn't notice that gold was breaking out of a multi-year trendline. Had I know I wouldn't have put on the trade. Large trendline breakouts like the one in gold tend to attract a lot of retail traders. As a result, more often than not, it tends to be more profitable to fade these breakouts than participate in them. But we just got lucky here. I'm moving our stop up to breakeven at $4.92 as a result.

That's it for this week. We've got a number of new recurring pieces that we'll be rolling out to the group in the coming weeks. We want to further structure our macro framework and more frequently share the data and tools we have at our disposal with you guys as a whole. So we'll be putting out regular liquidity, Sentiment, and Currency pieces to just name a few. Please shoot us feedback as we'll be adjusting fire and making changes as we move.

Have a killer week and expect some trade updates from me over the coming days.

You're Macro Operator,

Alex

Portfolio Snapshot

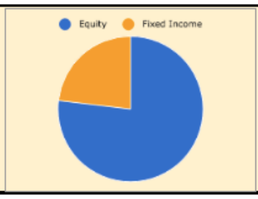
Strategic Ops

NAV $1,162,833

Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target	Notional	Beta
Equity	Goldfield GV	1,000	$3.89	$2.52	$1,370.00	$4.50	$5,250	1.0694
Equity	GAIA	7,600	$9.88	$8.50	$10,488.00	$13.75	$79,040	0.4497
Equity	Videocon VDTH	2,900	$11.27	$9.26	$5,829.00	$17.45	$32,335	0.7855
Equity	Portugal ETF PGAL	8,000	$10.57	$9.98	$4,720.00	$11.75	$85,040	1.0467
Equity	BlackBerry BBRY	2,600	$9.70	$7.50	$5,720.00	$18.00	$25,038	1.084
Equity	Colombia GXG	10,350	$10.17	$9.62	$5,692.50	$12.75	$105,104	0.6661
Equity	Hudson Tech HDSN	5,300	$8.08	$6.98	$5,830.00	$11.50	$43,142	0.8107
Equity	Trivago TRVG	1,750	$21.16	$17.70	$6,055.00	$30.00	$35,245	-4.961
Equity	SSYS	1,546	$24.45	$21.44	$4,653.46	$31.50	$40,528	1.4414
Equity	IAMGOLD Corp IAG	12,500	$4.97	$4.50	$5,875.00	$6.00	$65,000	-0.2194
Fixed Income	30 Yr Bond Futures	9	$153.44	$151.56	$16,920.00	$161.62	$1,381,716	-0.582

Metrics

Exposure Breakdown	
Equity	$56,232.96
Commodity	$0.00
Fixed Income	$16,920.00
Forex	$0.00



Total Open Risk

$73,152.96

6.29%

**Updated 6/12