Where's Our Irving Fisher Moment?

Operators,

We've got a lot of great stuff for you in our August issue of the MIR.

First up we discuss what constitutes a bubble. Then we get into the *real* reasons why valuations are high, along with why they're going higher. And finally we'll talk about how the whole shebang is gonna end.

Then we review the three primary macro drivers of markets and look at the vertical trends in planned and actual US CAPEX... as well as some trades to play it.

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After that we'll dive into one of our favorite trades — a company we're intimately familiar with.

We'll finish up with our Quant section where we look at the relationship between volatility and liquidity.

I'm excited to hear your thoughts on on everything we have to say.

Be sure to send me an email at alex@macro-ops.com with what you think.

Your Macro Operator,

Alex

Intro: Where's Our Irving FIsher Moment?

"Stock prices have reached what looks like a permanently high plateau…"

These were the infamous words spoken by one of the most respected economic authorities of the time — Irving Fisher.


FISHER SEES STOCKS PERMANENTLY HIGH

Yale Economist Tells Purchasing Agents Increased Earnings Justify Rise.

SAYS TRUSTS AID SALES

Finds Special Knowledge, Applied to Diversify Holdings, Shifts Risks for Clients.

Fisher spoke them only a few weeks before the great bull market peaked in 1929 and then crashed.

You could say Fisher's timing was a little off…

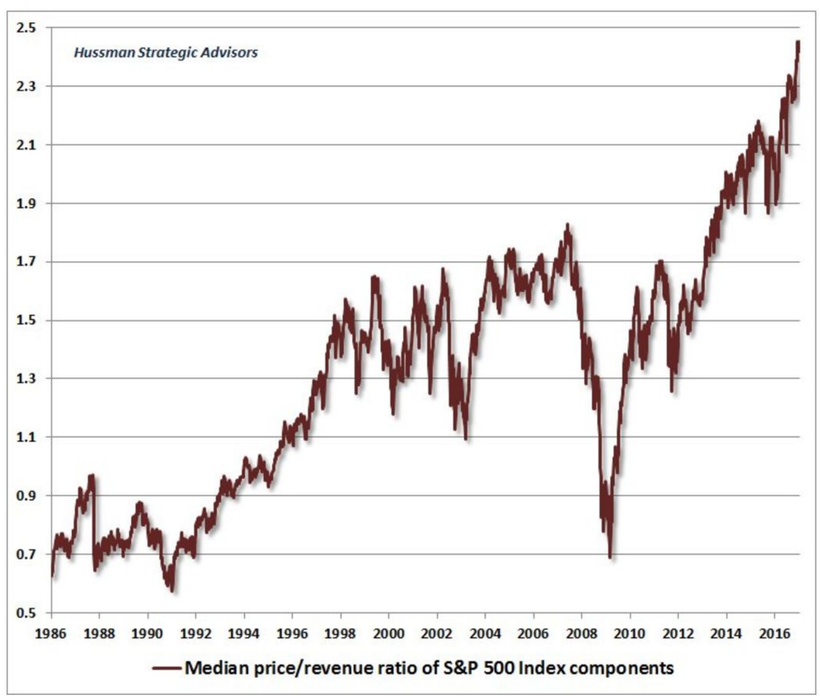
In this month's MIR, we're asking the question, "where's our Irving Fisher moment?"

We'll explore why valuations are so damn high (hint: it's structural changes). And why, counterintuitively, these high valuations have actually *helped* keep this bull running.

Then we'll dive into the macro and quant of the current market as well as some trades we're scoping out.

Let's begin.

You've probably seen charts like the one to the right showing the high valuations US equities are trading at.



Valuations are indeed high by any objective measure and have been for a while… which is why the popular narrative of referring to this market as "The Everything Bubble" spawned in late 2013.

'The Everything Bubble': Why The Coming Collapse Will Be Even Worse Than The Last

by Tyler Durden
May 17, 2017 10:20 PM

735 SHARES

Behold The Everything Bubble

Jared Dillian, Mauldin Economics June 22, 2017

33-Year Fed Veteran: 'The Everything Bubble' Is About To Burst

Jesse Felder
May 13, 2016

Now I only have two market cycles (2000 and 2007) of experience under my belt, but I don't remember such a large group of bubble spotters in either.

It was just the opposite.

You were ridiculed in 2000 if you said tech stocks were in a bubble as well as in 06' if you said home prices could "go down". The majority would look at you with pity for not "getting it", thinking you must be too dense to understand the new world we lived in.

One of my favorite market thinkers is Jeremy Grantham of GMO. We're going to talk about him more in a sec, but he has a solid definition of what a bubble is. He explains it as:

> *Best characterized by a market with excellent fundamentals that are irrationally extrapolated… which leads to euphoric sentiment and the popular belief that 'this time is different'.*

In *The Five Stages of A Bull Market* we wrote how this bull has been one of the *most* hated in history and how its negative sentiment was great for its continuation.

Remember *playing the player*… if a rising market is marked by negative sentiment, it means there's a lot more fuel in the tank to push it higher.

So when you have a large subset of the market claiming it's an "Everything Bubble", there's a good chance it's not…

For a bubble to exist, the majority of the market has to *fervently* believe in it… to the point where the only thing that matters is how much a stock is up over the prior month and how much margin can be borrowed to buy it.

Valuations are always high this late in the cycle. But it takes euphoria to drive margin buying and create a bubble. The leverage *is* the instability.

And this euphoric, blind, FOMO-driven margin buying is something we haven't seen this cycle… though there's signs it may be starting.

This brings us to an important question: what's the "everything bubble" crowd getting wrong? If high valuations are not due to euphoria, then what's causing them?

The answer is simple. It's the thing that always drives price: Supply and Demand.

Grantham recently wrote in his quarterly letter titled *"This Time Seems Very, Very Different"* that the shift to higher valuations over the last 20 years is due to 3 structural changes… changes that are unlikely to be resolved anytime soon.

These are:

1. **Globalization**
2. **Corporatization (monopoly state)**
3. **Low interest rates**

On globalization, he writes:

> *Increased globalization has no doubt increased the value of brands, and the US has much more than its fair share of both the old established brands of the Coca-Cola and J&J variety and the new ones like Apple, Amazon, and Facebook. Even much more modest domestic brands – wakeboard distributors would be a suitable example – have allowed for returns on required capital to handsomely improve by moving the capital intensive production to China and retaining only the brand management in the US. Impending global trade today would decrease the advantages that have accrued to US corporations, but we can readily agree that any setback would be slow and reluctant,*

capitalism being what it is, compared to the steady gains of the last 20 years (particularly noticeable after China joined the WTO)

On the corporatization of America:

Steadily increasing corporate power over the last 40 years has been, I think it's fair to say, the defining feature of the US government and politics in general. This has probably been a slight but growing negative for GDP growth and job creation, but has been good for corporate profit margins. And not evenly so, but skewed toward the larger and more politically savvy corporations. So that as new regulations proliferated, they tended to protect the large, established companies and hinder new entrants… New entrants into the US business world have plummeted since 1970! Increased regulations cost all corporations money, but the very large can better afford to deal with them. Thus regulations, however necessary to the well-being of ordinary people, are in aggregate anti-competitive. They form a protective moat for large, established firms. This produces the irony that the current ripping out of regulations willy-nilly will of course reduce short-term corporate costs and increase profits in the near future (other things being equal), but for the longer run, the corporate establishment's enthusiasm for less regulation is misguided: Stripping out regulations is working to fill in its protective moat.

And finally, on low interest rates:

Stock prices are held up by abnormal profit margins, which in turn are produced mainly by lower real rates, the benefits of which are not competed away because of increased monopoly power, etc. What, we might ask, will it take to break this chain? Any answer, I think, must start with an increase in real rates. Last fall, a hundred other commentators and I offered many reasons for the lower rates. The problem for explaining or predicting future higher rates is that all the influences on rates seem long term or even very long term. One of the most plausible reasons, for example, is the aging of the populations of the developed world and China, which produces more desperate 50-year olds saving for retirement and fewer 30-year-olds spending everything they earn or can borrow. This results, on the margin, in a lowered demand for capital and hence lower real rates. We can probably agree that this reason will take a few decades to fade away, not the usual seven-year average regression period for financial ratios.

These are all solid points. Each has plainly driven profit margins higher and made moats easier to defend, thus leading to higher valuations for stocks.

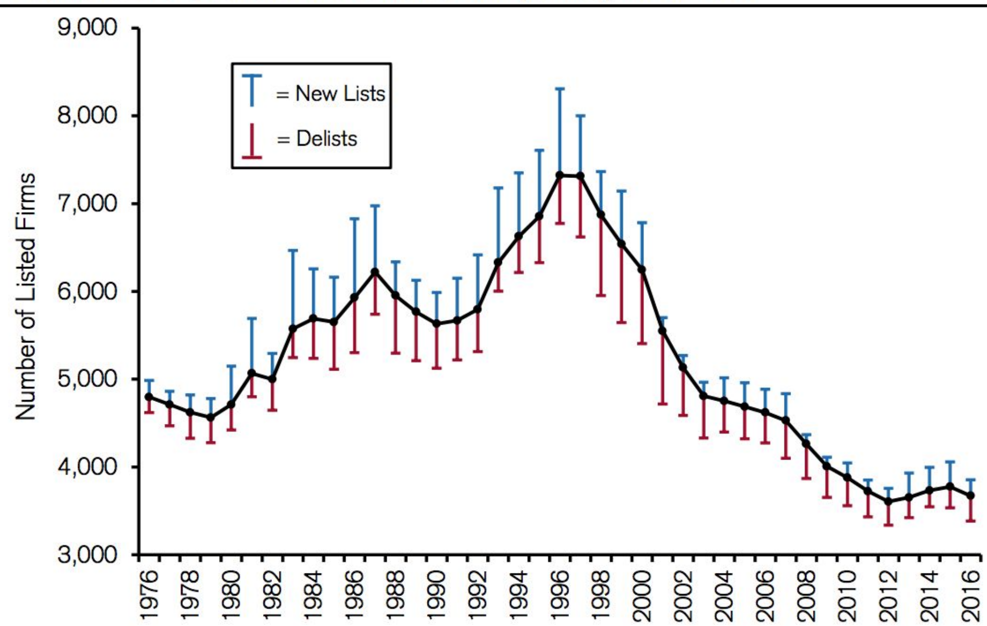
But there's even more to the valuation story.

The following three structural changes, along with those noted by Grantham, have led to a semi-permanent supply/demand imbalance in US stocks which have led to high valuations. These are:

1. **The cannibalization of public markets has led to a decline in single issues and a drop in total equity shares**
2. **Systemic stress in the international banking system outside the US, combined with high USD liquidity sloshing around the globe, has created large structural demand for US assets (ie, stocks and bonds)**
3. **The ETF-ization of the US market has lowered the risk of equity ownership through passive market cap weighted diversification. This brings down the risk-premia (expected relative return over bonds and cash) while also creating a relentless bid thus creating a reflexive low volatility “melt up” in stocks**

Let’s start with the first structural change — the disintegration of US public markets. Take a look at the chart below of the trend in listed public companies in the US.

Exhibit 2: Additions and Subtractions to Listed Companies, 1976-2016



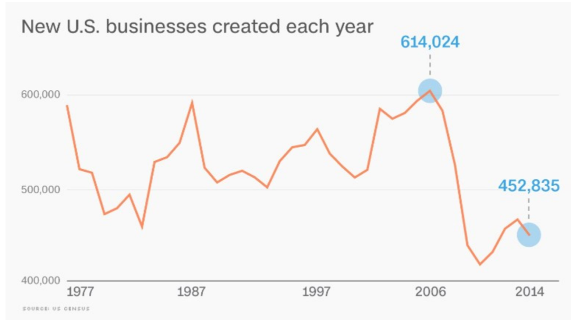
Source: Craig Doidge, G. Andrew Karolyi, René M. Stulz, “The U.S. Listing Gap,” Journal of Financial Economics, *Vol. 123, No. 3, March 2017, 464-487 and Credit Suisse estimates.*

They’ve more than halved since the late 90s.

- In 97’, there were more than 2,500 small caps and nearly 4,000 “microcap” stocks. Now, fewer than 1,200 small caps and less than 1,900 microcaps are left

➢ The number of new companies started each year has fallen from an average of 600,000 in the 1970's to only 450,000 today — a decline of 25%!
➢ The number of people working at companies that are less than 2 years old (both public and private) has more than halved since 1970

Doesn't exactly paint a picture of a thriving entrepreneurial America, does it?



The fall in the number of publicly listed firms is due to fewer initial public offerings (IPOs) and a rise in mergers and acquisitions (M&A).

The rise in M&A comes from two points Grantham noted:

1. Low interest rates means cheap funding for leveraged buyouts.
2. The government-allowed corporatization of America has changed the incentive structure for US executives. It's more profitable, in the short term, to buy growth and boost your stock price than to invest and organically create it.

M&A became popular over the last two decades due to ill-conceived government policies under President Clinton that tied executive compensation to stock prices and secularly low interest rates. It was cheap to borrow and easy for a company to carry debt.

Charlie Munger always says, "incentives are everything".

With cheap credit and executives *incentivized* to focus on short-term stock prices over long-term value creation, it became more profitable to borrow and buy — merge and acquire — versus invest and grow.

The second structural change is the stress in the international funding markets.

This is a complicated topic and it would take pages and pages to describe the mechanisms at work. You would be bored to tears in the process. So instead, here's the gist of it and why it matters.

Many international banks, primarily large European financial institutions, never recovered like their American counterparts following the financial crisis. This has created a structural asset-liability mismatch in the international dollar funding markets. A lot of strange things have happened as a result, such as the breakdown in covered interest parity theory but I digress…

Essentially, this financial stress has caused persistent structural demand for US dollar assets such as US stocks and bonds. When you combine this with the large amount of USD liquidity currently sloshing around the world, you end up with a lot of dollars chasing fewer equity shares.

Again, it's all supply and demand.

The this structural change is the ETF-zation of markets and collapsing risk-premia.

The ETF-ization of US markets is one of the largest and most underappreciated drivers of valuation increases.

Pseudonymous blogger "Jesse Livermore" lays out the reasoning clearly on his blog *Philosophical Economics.*

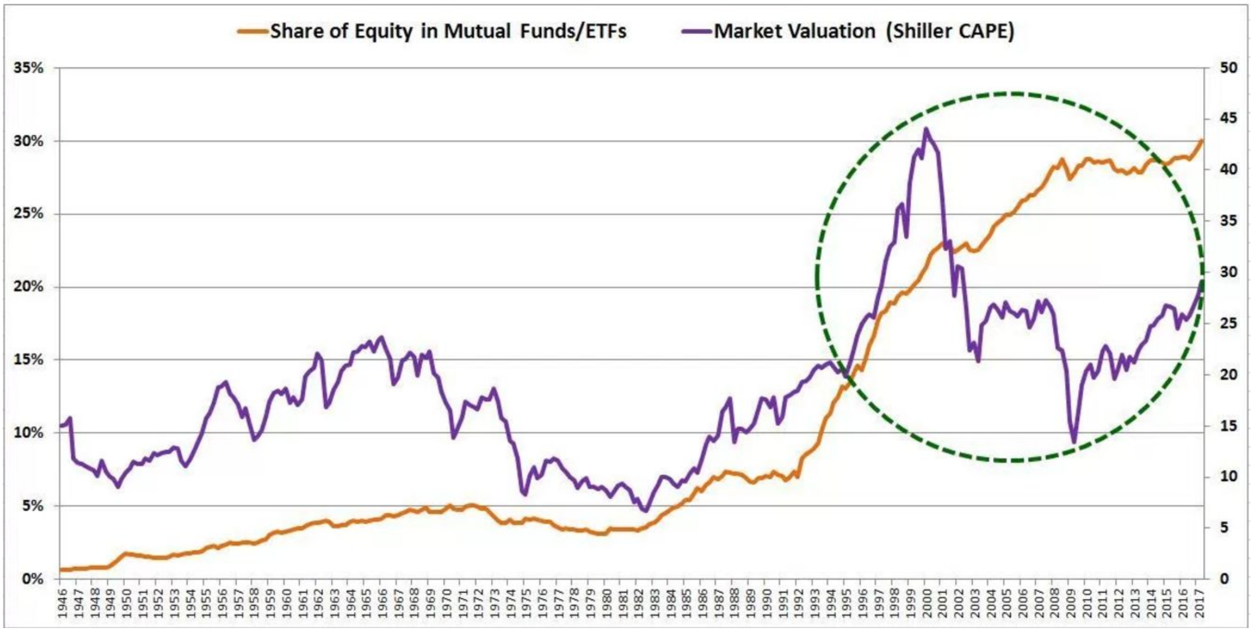
> *The market builds and popularizes increasingly cost-effective mechanisms and methodologies for diversifying away the idiosyncratic risks in risky investments, the price discounts and excess returns that those investments need to offer, in order to compensate for the costs and risks, comes down. Very few would dispute this point in other economic contexts. Most would agree, for example, that the development of efficient methods of securitizing mortgage lending reduces the cost to lenders of diversifying and therefore provides a basis for reduced borrowing costs for homeowners–that's its purpose. But when one tries to make the same argument in the context of stocks–that the development of efficient methods to "securitize" them provides a basis for their valuations to increase–people object.*

The logic is simple. Stock returns are a function of perceived risk. The higher the perceived risk, the higher the expected return needed to compensate for that risk. Risk and expected return balance out so price clears. That's what price discovery is all about.

When you take away single issue risk (ie, accounting fraud, mismanagement, product risk) by automatically buying a basket of stocks, you diversify that risk lower. The passive inflows into ETFs drive the risk-premia spreads (the difference in return of stocks over bonds and cash) on asset classes lower because their risk is lower. Livermore again writes:

> *To summarize: over time, markets have developed an improved understanding of the nature of long-term equity returns. They've evolved increasingly efficient mechanisms and methodologies through which to manage the inherent risks in equities. These improvements provide a basis for average equity valuations to increase, which is something that has clearly been happening.*

This chart makes the point evident.



The rise in the share of equity and mutual funds has pulled market valuations higher. As it should.

So you could kind of sorta say… “This time *is* different”.

- **There’s a lower supply of US equity shares due to M&A and fewer businesses being started and going public.**
- **There’s larger persistent demand due to the structural need for US dollar assets in the international funding market. This means more dollars chasing fewer stocks.**
- **And the securitization of the stock market through the rise in ETFs has pulled the risk-premia lower on stocks. A lower relative risk-premia equals higher valuations.**

And the interesting thing is, these structural changes — especially those due to ETFs — have formed an important reflexive relationship between demand for stocks, volatility, and valuations.

The passive inflows into ETFs tend to tie together the relative values between stocks as money automatically flows into the market. The stocks with the largest public float and market cap all grow relatively in tandem.

This has the effect of dampening volatility, something we’ve seen a lot of. The lower volatility leads to lower perceived risks, as value at risk (VAR) models adjust to the lower vol environment. This leads to larger position taking in the market (ie, more money flows).

A reflexive relationship is born where ETFs' lower volatility increase capital inflows, which leads to even lower volatility.

So combine these points with those offered by Grantham and it's easy to see how valuations have gotten so high while sentiment has been mostly poor, at least until recently.

It's simply a case of a structural supply and demand mismatch and not one of euphoric buying inflating a bubble.

We're in a new value paradigm, but not a permanently high plateau.

How long we stay here, I don't know.

I agree with Grantham that it depends on interest rates. And as a result, the direction of inflation.

He's a little more sanguine on the subject and thinks we don't see full mean reversion for another 20 years. But I believe there's a good chance inflation comes back with a vengeance in the next cycle. Driven by populist policies, trade wars, and a push by the forgotten worker to get his share of the pie back.

So back to the question… are we in a bubble?

Grantham recently said in an interview:

> *I've dedicated my life to financial bubbles, and I don't think it is a bubble… This is the broadest market of all time.... That is not the nature of a bubble. We value investors have bored momentum investors for decades by trotting out the axiom that the four most dangerous words are, 'This time is different.' I would like, however, to add to this warning: Conversely, it can be very dangerous indeed to assume that things are never different.*

Like we talked about in our February Brief *Margin of Spread*; valuations can't be looked at in a vacuum.

All asset prices are relative to one another. It's dangerous to be ideological in this game — as many smart value investors and central bank haters have been the last few years.

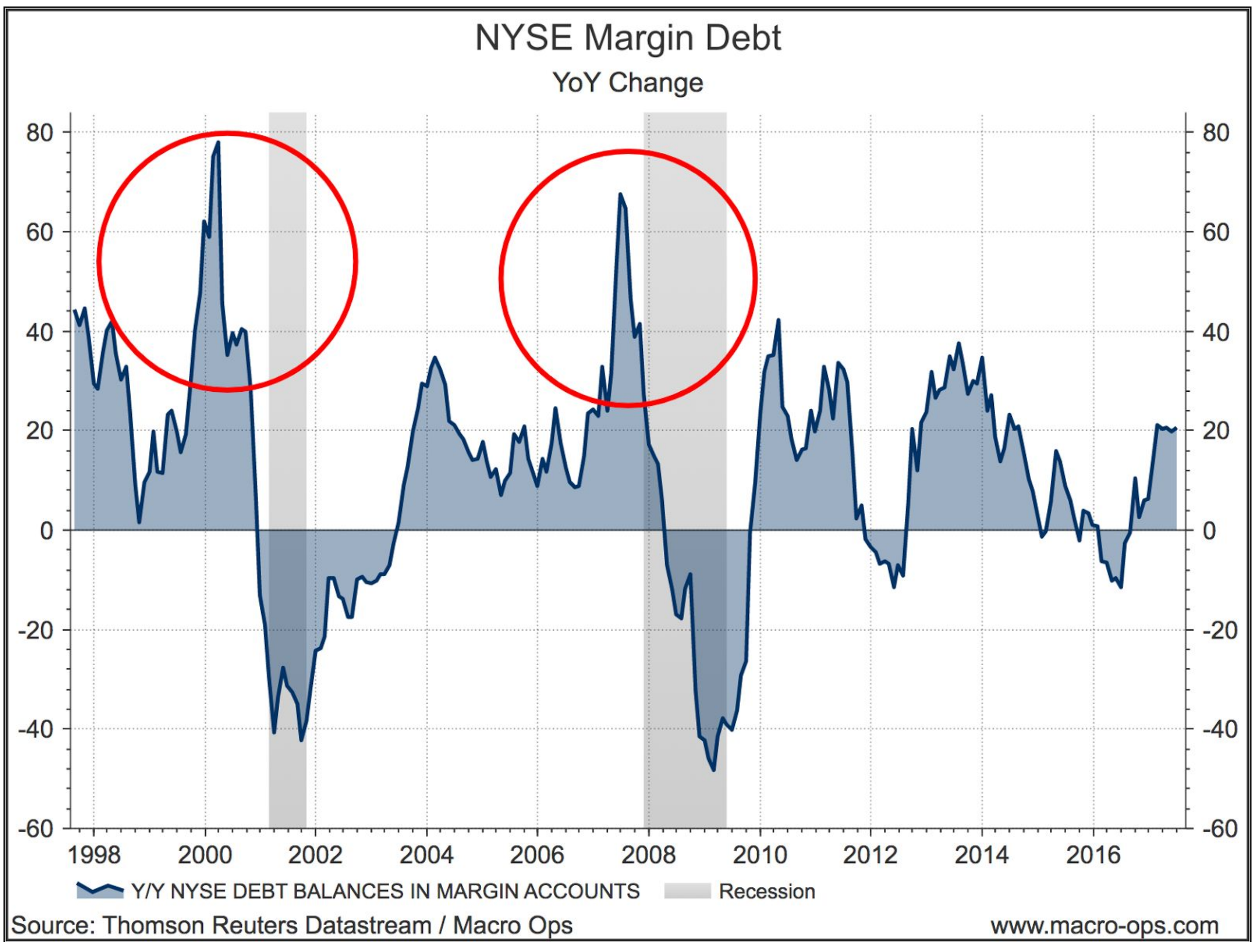
Ideology blinds critical objective judgement. The only thing certain in this game is that it's always changing. Rigid thinkers get competed away.

Valuations are high. But now you know this is due to more structural changes to markets than it is euphoric sentiment.

We'll reach bubble territory once the economy materially picks up and the market begins extrapolating excellent fundamentals irrationally into the future. That's when euphoria will spread through the herd and buyers will begin imprudently leveraging up their books.

There's some signs the euphoric tide is coming in, such as record retail broker accounts opening, low investor cash holdings and high market expectations. This will continue to increase over the next year.

A favorite tool we use to track this is the Y/Y change in NYSE margin debt. It tends to pop in the final innings of a bull market as FOMO drives market participants to leverage up.



Once we see this move higher, then we'll likely have our Irving Fisher moment… where the dominant narrative will be something along the lines of:

"We've reached a permanently high plateau!"

“Dow 30,000 or Pet.com is such a great idea!”

“Home prices never go down!”

Summary:

- **Valuations are high but the bubble spotters have been wrong**
- **Bubbles are caused be the irrational extrapolation of excellent fundamentals which lead to euphoric buying on leverage**
- **Leverage brings instability, not high valuations**
- **This time IS different in that the market has structurally changed over the last 20 years. Valuations and profit margins are higher due to low interest rates, corporatization, and globalization**
- **In addition, there exists a large supply and demand imbalance which has pushed valuations up.**
    - **This is due to the declining number of shares listed in the US from fewer IPOs and an increase in M&A.**
    - **International banking stress since the GFC has created persistent demand for US assets in the international funding markets.**
    - **And the ETF-ization has collapsed the risk-premia on stocks while suppressing volatility which has led to more demand**
- **Late cycle sentiment is now starting to pick up and we’re seeing the beginnings of euphoric buying and leveraging up in markets creating what will likely become an unstable bubble**

Macro: Thanks China

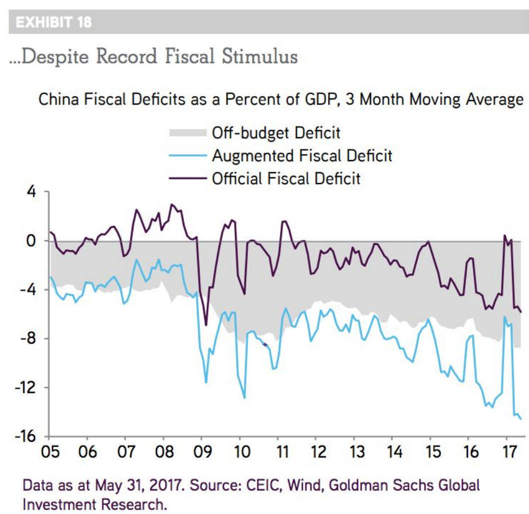
Three things continue to drive the global economy and markets:

1. **Global reflation fueled by Chinese government spending in its run up to their November Congress**
2. **Developing market central banks shifting to tightening cycles while closely coordinating forex policy**
3. **Improving late cycle sentiment driving stocks higher**

Two months ago we began writing about how China was transitioning from a short tightening cycle to an easing one in the lead up to the all important November Congress. We discussed how this would drive not just Chinese markets higher, but also emerging markets and commodities.

So far this scenario has played out to a “T” and it looks set to continue doing so.

Recently we’ve seen evidence which peg China’s budget deficit at over four times their official number of 3% of GDP. This equates to over $1T in government spending reverberating throughout global markets.



And when the Chinese government spends, they like to spend it on large commodity intensive infrastructure products.

This extra liquidity is flowing through global markets showing itself in commodity demand and emerging market dealmaking. It’s been a boon for risk assets and there’s no sign of it abating anytime soon.

Global markets are also benefiting from a falling dollar (lower USD = higher commodities and looser liquidity conditions).

As we talked about in the last MIR, we went short the dollar against countries that benefit from a reflating China, such as Canada and Australia. These short dollar trades have been net bottom liners for our book this year.

Recent actions and speeches given by developed market central bankers suggest they’re closely coordinating with one another on their transition to normalizing interest rates (raising rates).

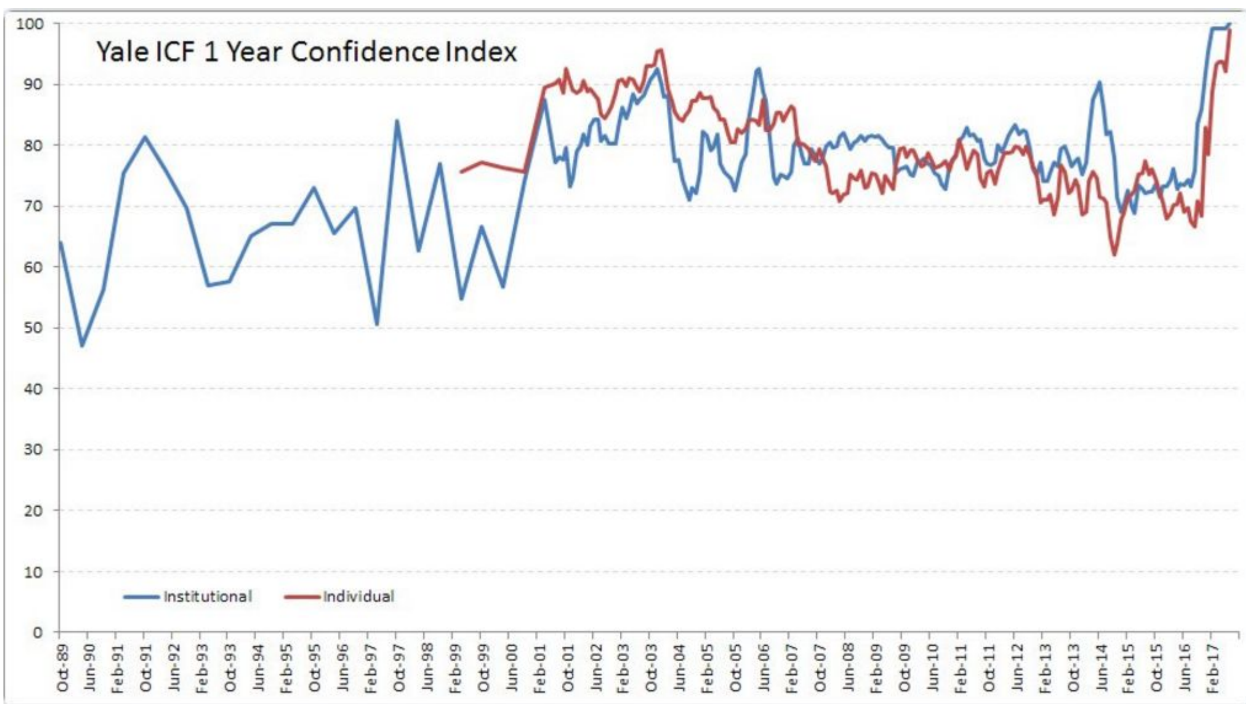
Their concern is that with the Fed leading the pack in moving interest rates higher, without proper coordination, they risk sending the dollar higher. Central bankers don't want a repeat of 15' and what a stronger USD did to commodities and global markets.

This central bank coordination is the driving reason other developed market central banks have surprised hawkish over the last month. It's also why the Fed is holding off until at least December to hike interest rates again. Instead, they're begin let their balance sheet runoff (rate hikes are more dollar bullish than balance sheet reduction).

What central banks are trying to do (which is working maybe *too* well) is stabilize or strengthen their currencies against the dollar while the Fed leads the way in higher rates. The ultimate aim is to stem speculative bubbles without driving the dollar higher, which would lead to global instability.

Against this positive backstop of China easing and the dollar falling, it appears market sentiment has turned a corner and is finally in the beginning stages of developing the euphoria that typifies the last innings of a bull market.

For example, according to the latest numbers of the Yale Confidence Index, 99% of all individual and institutional investors expect higher stock prices one year from now. This reading is the highest in the survey's 18 year existence.



The trifecta of booming liquidity, a lower dollar, and improving sentiment will be boosted by improving economic data that should begin to pick up into the end of the year.

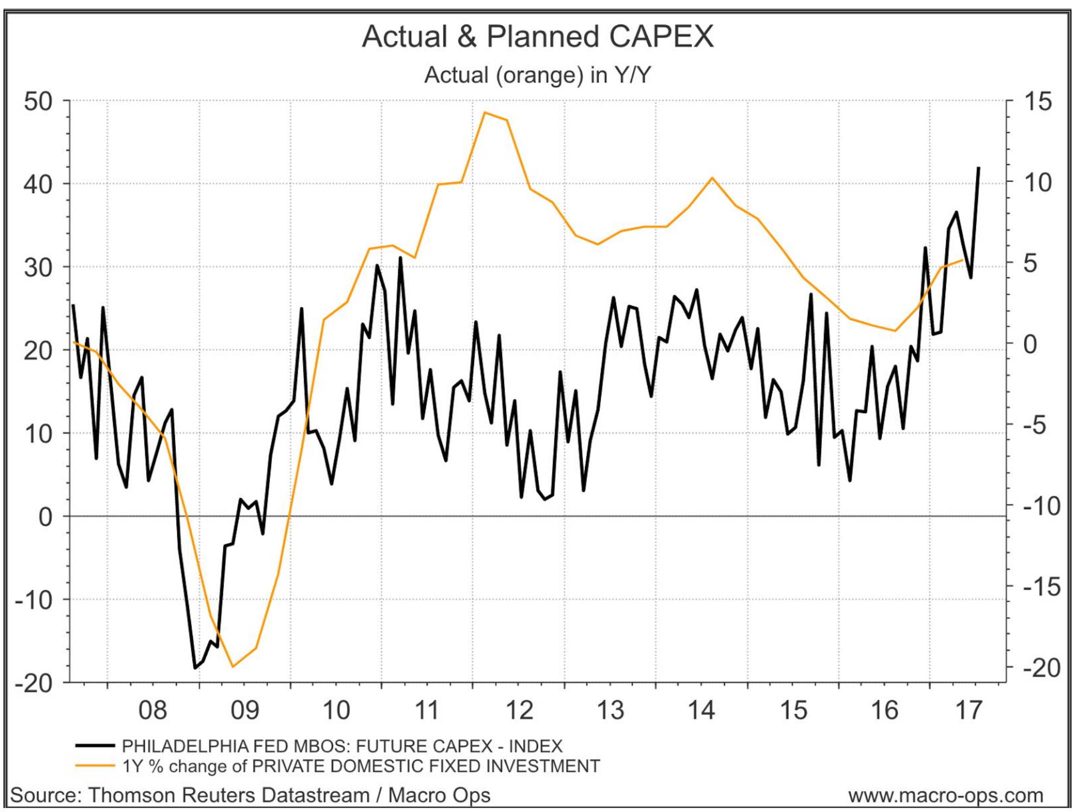
The Atlanta Fed *GDP Now* is currently tracking next quarters GDP at 4%. This number will undoubtedly come down some, but it's a high starting point. Growth is also supported by positive seasonality as we move into the second half of the year

The stage is being set for "excellent fundamentals irrationally extrapolated".

An area of the market we expect to perform strongly in this environment is industrial metals (aluminum, copper, steel, and related stocks).

Typically, in the latter stages of a cycle, when the labor market is tight and the economy is running hot, companies begin upping their CAPEX in order to meet growing demand. This is good for growth and good for the industrial metals that go into the products that comprise a lot of this investment.

The chart below shows planned US CAPEX (black line) and actual private fixed investment on a year-over-year basis.



Planned CAPEX is at its highest point in decades and it leads actual capex by six months on average.

Now look at the chart below showing the Bloomberg Industrial Metals ETN (JJM). The chart is on a monthly basis.

It has put in a major bottom and recently cleared a significant downward trend line and area of resistance. Note how the index bottomed a few months after planned and actual CAPEX bottomed and turned upward.

There's an obvious correlation between the two. Private fixed investment leads industrial metal stocks. And telling from the vertical rise in planned CAPEX, one can assume there's plenty of upside left in this bullish breakout in industrial metal stocks.

You can play this in JJM directly, but it's daily volume is fairly low.

There's also a number of individual stocks setting up nicely. We prefer US based companies for this play because you get the added kicker when the White House starts slapping tariffs on Chinese imports.

Here's our top three US stocks for this theme.

Ticker	CLF [NYSE]		
Company	Cliffs Natural Resources Inc.		
Country	USA		
Industry	Industrial Metals & Minerals		
Market Cap	2.28B	EPS (ttm)	0.27
P/E	27.52	EPS this Y	42.30%
Forward P/E	8.88	EPS next Y	-4.56%
PEG	-	EPS past 5Y	-38.90%
P/S	1.01	EPS next 5Y	-
P/B	-	EPS Q/Q	263.60%
Dividend	-	Sales Q/Q	14.70%
Insider Own	2.10%	Inst Own	70.60%
Insider Trans	3.73%	Inst Trans	2.26%
Short Float	11.21%	Earnings	Jul 27/b
Analyst Recom	2.70	Target Price	7.06
Avg Volume	13.43M	52W Range	4.91 - 12.37

Ticker	ARCH [NYSE]		
Company	Arch Coal, Inc.		
Country	USA		
Industry	Industrial Metals & Minerals		
Market Cap	1.84B	EPS (ttm)	46.09
P/E	1.62	EPS this Y	136.60%
Forward P/E	11.55	EPS next Y	-33.87%
PEG	-	EPS past 5Y	61.20%
P/S	0.81	EPS next 5Y	-
P/B	2.34	EPS Q/Q	117.90%
Dividend	1.88%	Sales Q/Q	30.80%
Insider Own	-	Inst Own	-
Insider Trans	-	Inst Trans	-
Short Float	-	Earnings	Jul 27/b
Analyst Recom	1.80	Target Price	94.25
Avg Volume	448.39K	52W Range	59.05 - 86.47

Ticker	NRP [NYSE]		
Company	Natural Resource Partners L.P.		
Country	USA		
Industry	Industrial Metals & Minerals		
Market Cap	342.59M	EPS (ttm)	5.56
P/E	5.06	EPS this Y	137.70%
Forward P/E	4.56	EPS next Y	21.76%
PEG	-	EPS past 5Y	8.90%
P/S	0.89	EPS next 5Y	0.00%
P/B	2.15	EPS Q/Q	-98.40%
Dividend	6.39%	Sales Q/Q	20.00%
Insider Own	1.30%	Inst Own	23.60%
Insider Trans	0.00%	Inst Trans	-0.17%
Short Float	1.82%	Earnings	Aug 08/b
Analyst Recom	3.00	Target Price	36.00
Avg Volume	31.05K	52W Range	16.59 - 45.60

We expect some market weakness over the next month. The improving late cycle market sentiment is building as an important driver of stocks, but will also serve up higher volatility. And technically, this latest leg is stretched and due for a shakeout. We'll look to be buyers of one or more of these companies on a market pullback and a favorable price action setup.

Summary:

- **Currently, the three primary macro drivers of markets are Chinese liquidity, central bank coordination driving the dollar lower, and improving late cycle sentiment**

- **These drivers plus supportive seasonality will result in improving economic data going into the second half of the year which will work to further boost sentiment**
- **Planned CAPEX survey data is at its highest level in decades. This data leads actual private investment by six months which will be a boon for certain areas of the market**
- **Our preferred trade for this is to play industrial metals and mining related stocks**
- **Technically the market is overbought on a short-term basis and we expect a pullback soon. We view any pullback as a good time to enter into this trade which should perform well as the end of this bull market plays out**

Micro: Interactive Brokers (IBKR)

The online brokerage business is as cutthroat as they come. For the last 10 years, the dominant players have been trying to kill each other off by relentlessly lowering commissions. It's been a brutal "race to the bottom" for everyone… except Interactive Brokers (IBKR).

IB has not only survived the price war, they've *thrived* on it.

IB took a page from Amazon's playbook and focused all their efforts on technology and efficiency.

The result…

IB has commissions well below the industry average.

The table below by Barron's shows just how far ahead of the competition IB is.

Occasional Trader's* Monthly Costs	
Lowest	
Interactive Brokers	$20.00
eOption	$27.00
Merrill Edge ***	$28.90
Lightspeed Trading	$29.94
Just2Trade	$30.00

Frequent Trader's** Monthly Costs	
Lowest	
Interactive Brokers	$847
eOption	$881
Just2Trade	$1,163
Lightspeed Trading	$1,200
SogoTrade	$1,500

Highest	
TradeStation ****	$145.00
TD Ameritrade	$94.92
E*Trade	$94.92
Charles Schwab	$87.06
Scottrade	$81.00
Average (16 brokers)	$63.45

Highest	
TD Ameritrade	$2,967
E*Trade	$2,953
Scottrade	$2,838
Charles Schwab	$2,763
Fidelity	$2,529
Average (16 brokers)	$1,905

The brokerage beats in both cost categories. Occasional swing traders and more frequent day traders save gobs of money by routing trades through IB.

IB makes these prices work by stripping out all the front-end sizzle found at other brokerages. These savings get passed down to the trader in the form of lower commissions.

- They don't have any brick and mortar branches.
- They spend half the money others do on advertising.
- And they don't pour capital into fancy looking front end software.

This business strategy hasn't attracted the *most* customers, but it has attracted the *right* customers.

IB attracts the active traders in the brokerage industry, who are by far the most profitable.

You can see below that even though IB has far fewer client accounts than guys like Schwab and Ameritrade, they generate far more trades per day.

Company	Brokerage Accounts	Trades/Day	Estimated Trades Per Year Per Account	Equity Per Account
Interactive Brokers	344K	607K	513	$205K
Ameritrade	6.8M	463K	19	$105K
ETRADE	3.3M	157K	13	$88K
Schwab	9.9M	278K	8	$260K

The average IB customer trades 60x as often as the average Schwab customer.

IB has focused its entire strategy around these active traders.

Most of them are market professionals who play the game for a living. These customers could care less about a pretty looking frontend.

IB understands this and lures them in with features like attractive margin financing, impressive product breadth, and advanced algorithmic order types.

No one comes close to competing with IB on these offerings.

Their margin financing rates are laughably tiny compared to other big players.

U.S. Margin Loan Rates Comparison

	$25K	$200K	$1.5M	$3.5M
Interactive Brokers[4]	1.86%	1.61%	1.23%	0.97%
E-Trade	7.94%	6.14%	3.89%	3.89%
Fidelity	7.575%	6.575%	3.75%	3.75%
OpitonsXpress	8.25%	7.00%	6.00%	6.00%
Schwab	8.00%	6.875%	6.25%	6.00%
TD Ameritrade	8.75%	7.75%	6.50%	6.50%

And their product offering crushes the competition too. Traders only need one IB account to trade everything imaginable. Stocks, options, futures, forex, bonds, ETF's, CFD's — if it trades on an exchange, you can access it through IB.

Their full suite provides access to over 100+ markets in 24 different countries. No other online brokerage has that kind of product breadth. Interactive Brokers automatically wins anyone looking to take a global approach to markets.

IB also equips its platform with extremely advanced order types. Examples include funari, dark ice, snap to midpoint, and VWAP. Serious traders need this tech to execute complex systematic trading systems. It also lets them trade big while staying undetected.

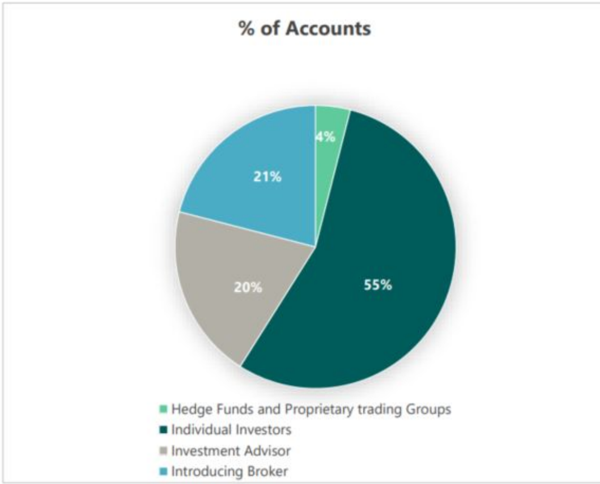
With this combination of financing costs and features, IB has built the perfect brokerage for a sophisticated retail client or a small professional trading shop.

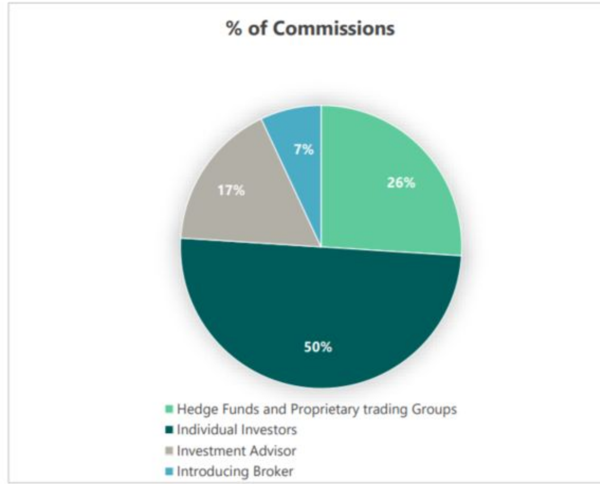
And in many cases they are the *only* option for these guys.

Big Wall Street banks like Goldman, Morgan Stanley, and JP Morgan are starting to impose fees on funds $50 million and below. This is a nice way of saying "you're too small to be worth our time."

IB welcomes these outcasts with open arms.

These hedge funds are the perfect fit for IB's "active trader" focused business strategy. A small number of hedge funds can generate massive commissions as shown below.





Interactive brokers is now a growth story because they've successfully carved out a segment of the market no other player is going after — the guys in the middle.

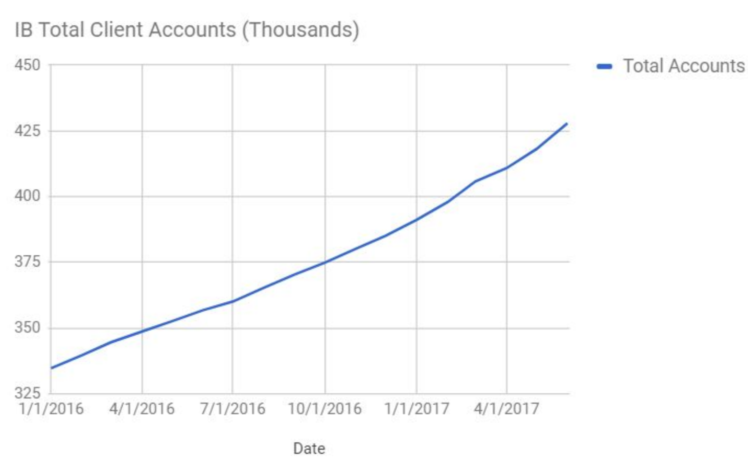
Instead of dabbling retail traders, or billion dollar funds, they capture **all** the $200k - $50 million dollar HNWIs, professional independents, and trading groups.

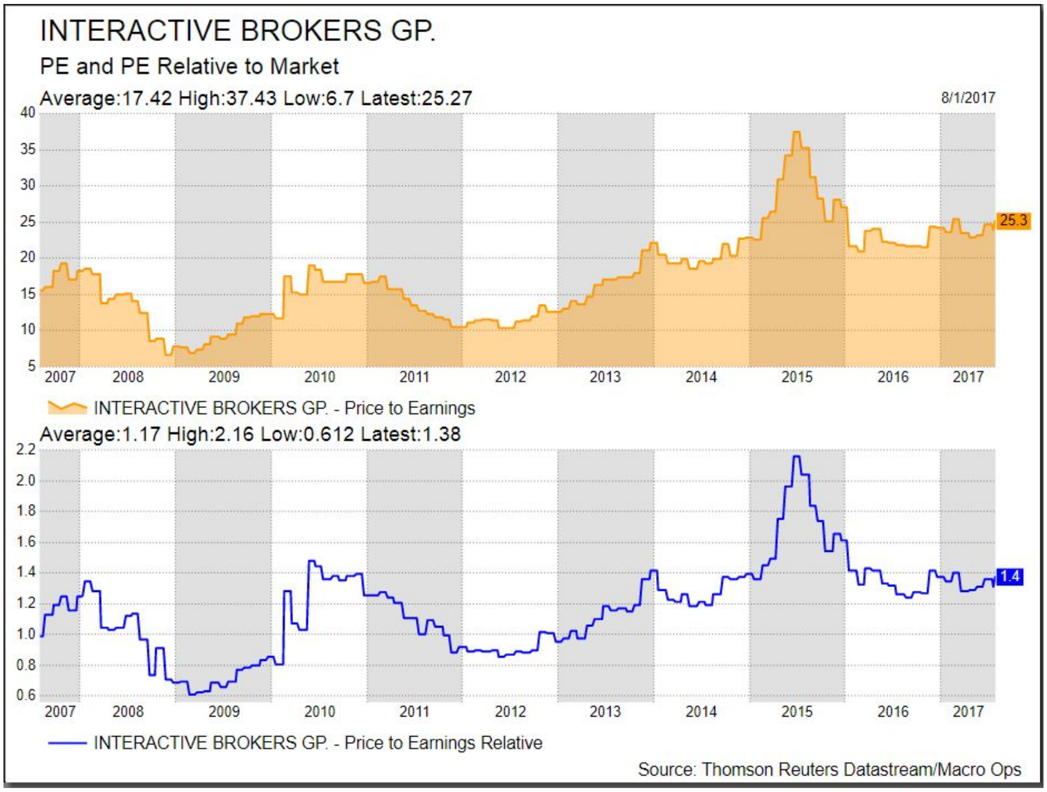
Month after month, year after year, traders that fit the above profile have been closing accounts at their current broker and moving to IB.

This summer IBKR hit a record for total accounts — up 20% from last year.

This growth hasn't gone unnoticed by the market. The stock is up around 130% since mid 2013.

By conventional metrics it's not a cheap stock either. The forward P/E is at 25.3 which is roughly 1.4x more expensive than the market average.





Despite this, the market is still underpricing IB's future growth.

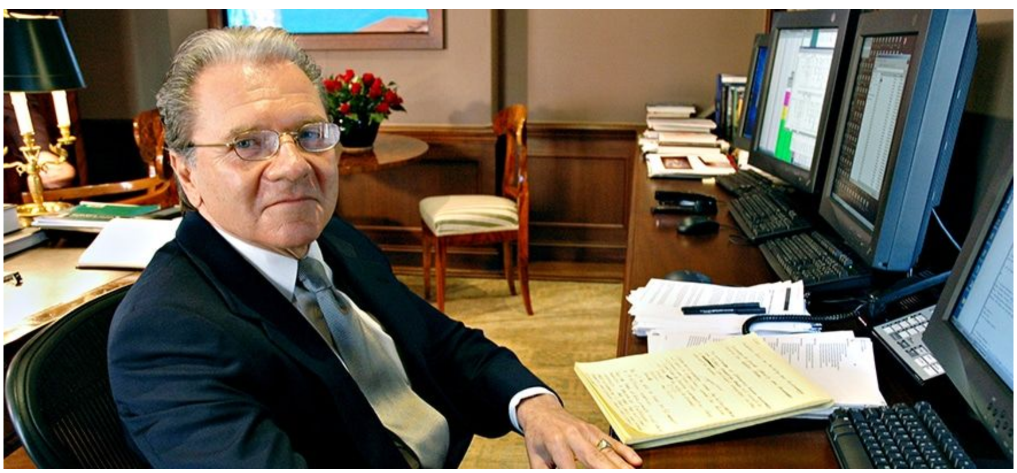
We can *play the player* here by taking advantage of the market's underappreciation of the company's improving competitive advantage. This advantage is leading towards niche market dominance and will provide large pricing power in the future.

To top it all off, IB has what we consider the most important factor of future success — *an all star CEO with a lot of skin in the game.*

When buying a stock you're betting on the jockey just as much as the horse.

In the March MIR we talked about GAIA, ran by all star CEO Jirka Rysavy — a man with a strong track record and a large stake in his own company. It's had a nice run since our report.

The Rysavy equivalent at IB is Thomas Peterffy.



Like Rysavy, Peterffy is an immigrant who came to the US in search of opportunity. And it was in the markets, where he found it.

Peterffy founded Interactive Brokers in 1977. He got his start as a marker maker on the floor of the American Stock Exchange and over time grinded up his business into what it is today.

Before going into trading, Peterffy was a computer programer. This gave him a huge edge in the brokerage and market maker business. While everyone else was using pencil and paper, he was busy automating and coding everything he could. He was one of the first traders to bring handheld computers to the floor back in the 1980’s.

This technology first mindset helped IB consistently beat its competition. Over the years we've seen the rest of the brokerages scramble to add as much tech as possible to their actual trading operations, but they haven't been able to catch up.

> *We have a huge advantage because we've been at this for several decades, right. Building automation, and the automation is not only in the software we give to our clients but also in the software that the company runs on. So that we as I said we have 750k trades per day in 27 different currencies over 100 different exchanges in many countries that we have to clear and settle and account for and corporate actions and custodial functions etc. and we do all that with 1,100 employees. Most firms that do our volume have 10 times as many employees. So with the automation we are able to take the cost out of the business and we are passing the bulk of that on to our customers and that's why we get more and more customers every year.*
>
> *~ Thomas Peterffy*

Peterffy's computer science background allowed IB to flourish in a rapidly changing industry. He navigated the switch from floor to screen trading perfectly.

His ability to stay on the cutting edge has made him a very rich man. He's now worth $13.8 billion dollars. **And a majority of that wealth is concentrated in Interactive Brokers. The guy still owns over 75% of the company!**

At 72, some are concerned that Thomas Peterffy will soon hang up the gloves. But that's not likely. The man is just as excited now as he was in the early days of his business. In a recent earnings call he told investors that he's "*obsessed with trying to grow this to become the largest brokerage in the world. That's the only thing I care about.*"

There are three important boxes you want to check when looking for long equity trades. If you can buy into a company that checks all three, it raises your chances of success exponentially. These are:

1. **Capable proven leadership:** You want companies run by management with a track record of smart capital allocation. That way you can buy the stock and let management do the heavy lifting for you. They'll invest in high ROI opportunities that will compound the value of the company and your shares.
2. **The right incentives:** Incentives are everything and you want to make sure a company's management has the right payout structure. They need a level of ownership in the company that incentivizes them to steward your capital in a way that creates long-term growth.

3. **Competitive advantage:** The company needs to have a discernible and sustainable competitive advantage that warrants them earning returns well over the cost of capital into the future. You want to buy stocks of companies with defensible moats.

IB checks each of these boxes with a thick pencil.

Peterffy is one of those exceedingly rare leaders who lives to grow his business, has a lot of skin in the game, and has a sixth sense for allocating capital and creating long-term value.

Incentives? Peterffy is basically *ALL IN* on his company and has been for some time.

And the moat around IB grows in time through the Amazon strategy of using superior technology allowing them to vastly undercut competitors on pricing which drives more customers to IB thus allowing them to lower cost even more. It's the whole flywheel concept at work.

Throw in the added benefit of the big Wall St. banks no longer catering to smaller hedge funds and high net worth traders due to regulatory changes, and you have a large middle market that IB is quickly becoming the biggest fish in.

This competitive advantage is leading to market dominance which will lead to pricing power and higher earnings in the near future. Our base case has the stock selling for over $53 a share by next, which translates to over a 30% increase from current prices.

From a technical perspective, IBKR has been consolidating for over two years.

But just recently price broke out of this pattern and triggered a strong buy signal.

We love IB not only as investors, but as customers too. All of our trades at Macro Ops go through IB. We're taking a page from Peter Lynch on this one and investing in what we know.

Trade Idea: Long Interactive Brokers - IBKR

Summary:

- **IB has the lowest commissions, best financing rates, widest product depth, and the most sophisticated technology in the online brokerage space.**
- **These features are rapidly attracting active traders which generate the lion's share of commissions for a broker.**
- **New accounts are growing at 20% and at all time highs.**
- **IB is still ran by it's original founder who is a multi billionaire with over 75% ownership in the company.**
- **Technical breakout makes for an attractive entry at these levels.**

Quant: Liquidity & Volatility

Nothing has puzzled the finance community more this year than the VIX.

Traders and pundits haven't stopped harping about why it *should* be higher. We've heard the same reasons over and over:

- North Korea
- Trump's White House in disarray
- A dysfunctional Congress
- Crowded retail vol shorts
- Quantitative Tightening and Hawkish Central Banks

At first glance, all these things *sound* like they would contribute to higher volatility. **But in reality they don't.** The pundits have been wrong in a BIG way.

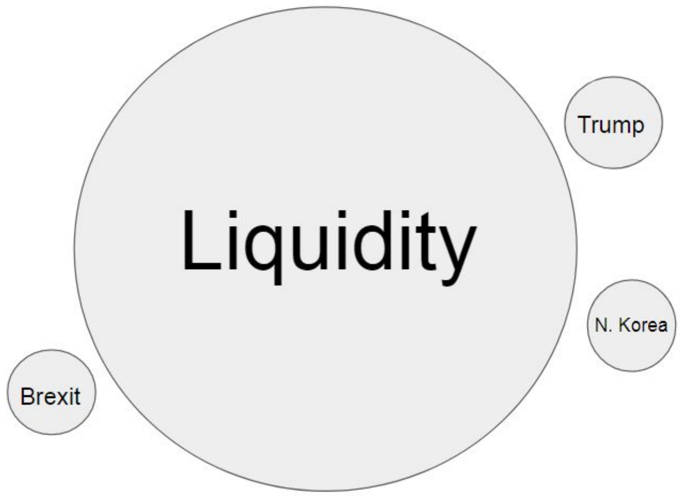
The first half of 2017 has been one of the most peaceful in market history.

VIX actually made a new record low on July 26th…

Pundits and vol tourists have misread the VIX because they're ignoring the most important macro fundamental — liquidity.

It's funny to see them debate how Trump's agenda or Kim Jong-un's latest missile test should send the VIX soaring… but they never even mention liquidity.

The proper way to analyze potential volatility conditions looks something like the picture below.



Current events and macro news come **AFTER** liquidity.

If markets have loose liquidity conditions, no amount of Trump tweets or White House shakeups will cause volatility.

And if liquidity conditions are tight, no amount of good news can save markets from volatility.

This makes intuitive sense when you look at how liquidity impacts market microstructure.

Every market, whether it be FX, bonds, commodities, or stock, has an order book with bids and offers that looks something like this:

	Size	Price
Offers	200	104
	4900	103
	2000	102
	400	101
	500	100
Bids	1000	99
	200	98
	700	97
	1000	96
	900	95

It's just a bunch of buyers and sellers displaying how much they're willing to transact and at what price.

When financial conditions are loose, with high liquidity, everyone has a bunch of cash and credit they need to put to work. All this demand flows into the market and stacks up the order book which compresses prices.

A liquid order book looks something like this:

	Size	Price
Offers	100000	102
	20000	101.5
	40000	100.7
	80000	100.2
	50000	100.1
Bids	70000	100
	40000	99.8
	65000	97.6
	100000	97
	400000	96.5

The difference between the bid and the offer is tight and there's a lot of size at each price level. Price will bounce around in a modest range because the order book can easily absorb any incoming orders.

A liquid market translates into *lower volatility*.

The opposite happens when financial conditions are tight and the system is illiquid. Investors are no longer lined up to buy financial assets. They don't have the cash or credit available.

During illiquid times the order book looks something like this:

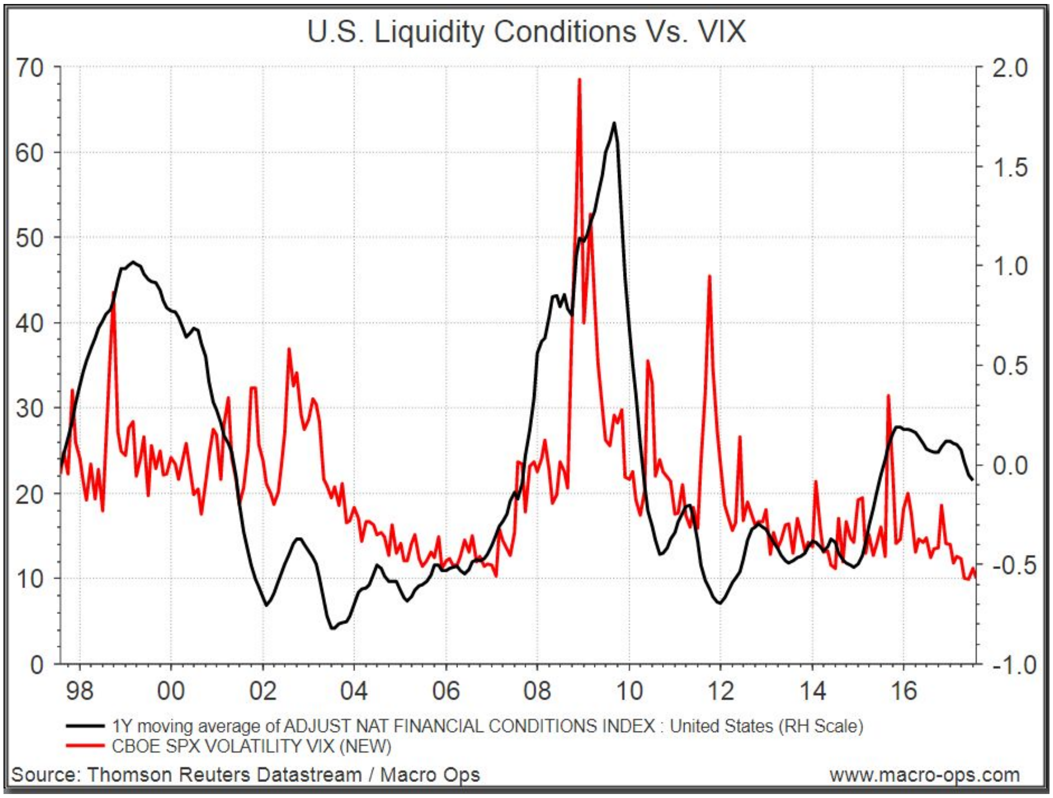
	Size	Price
Offers	30	120
	2000	115
	50	110
	1000	105
	500	101
Bids	70	98
	800	95
	3000	90
	1000	85
	200	80

Notice how much wider the bids and offers are. The best bid is $3 away from the best offer, instead of $0.10 away lik in the last example. Also notice how each price has way less size attached to it.

So not only are buyers and sellers farther apart, they have less to buy and sell. Price will oscillate wildly between all these different values because there's not much here to absorb new orders coming into the market.

An illiquid market translates into *higher volatility*.

This connection between liquidity and market microstructure is why we see moves in volatility follow liquidity so closely.



Higher black line = tighter liquidity conditions.

The last time liquidity conditions tightened was in 2014 and into 2015. During this time the Fed was winding down its QE program — sucking liquidity right out of the system.

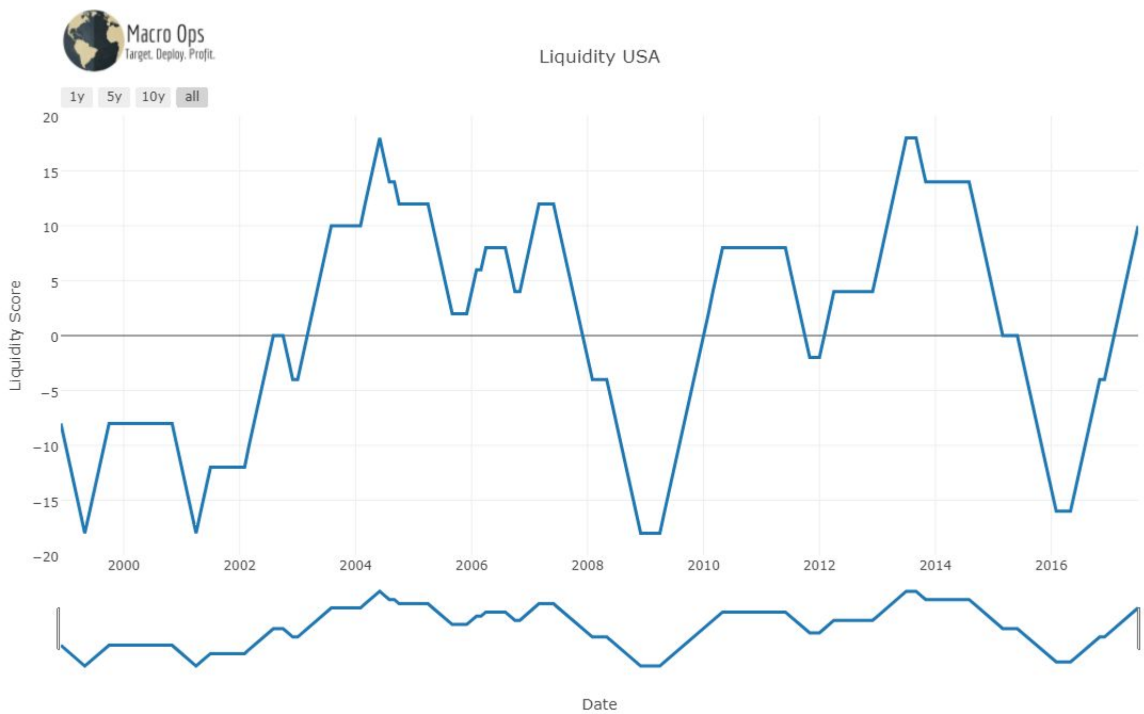
The stock market struggled, the dollar strengthened, commodities dropped, and as you can see in the chart above, the VIX popped. ***It popped primarily due to tightening liquidity conditions***.

Since then the market has adjusted to the absence of the Fed's bond purchases. Liquidity conditions have improve and VIX responded by embarking on a sustained downtrend throughout all of 2016 and now into 2017.

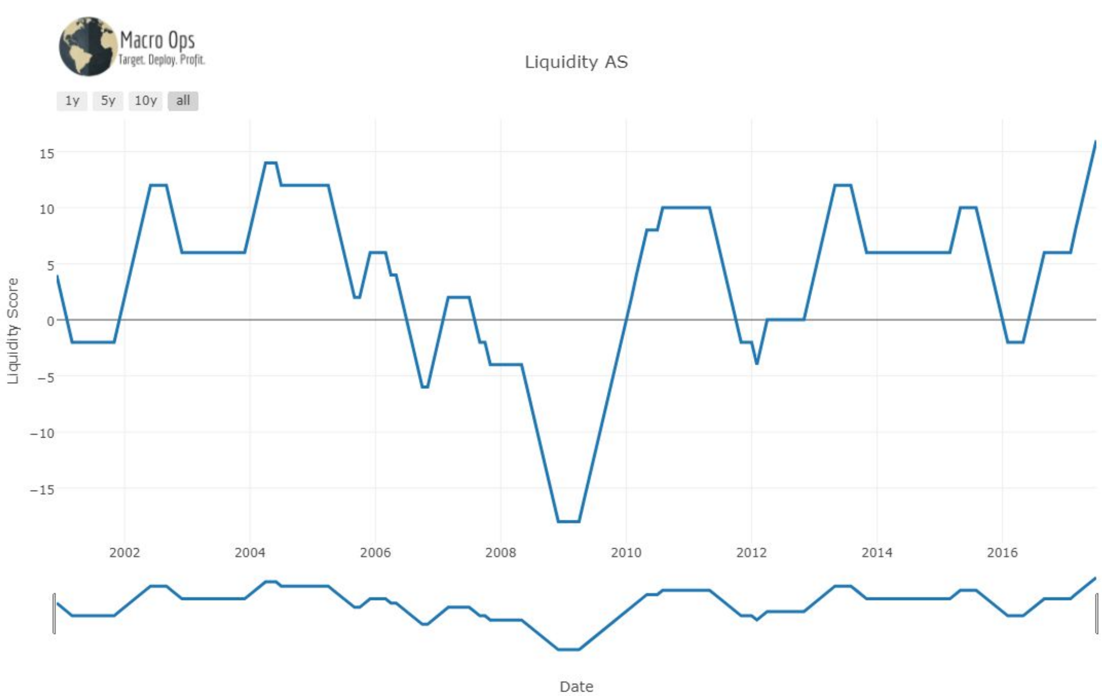
Currently liquidity conditions remain loose.

All the pundits and Fintwit traders can say what they want about VIX being "poised for more upside." But that's just not going to happen until liquidity tightens again.

Our proprietary U.S. liquidity indicator remains in a stable uptrend. We haven't had one downtick in it since the 2016 market low.



And our Asian liquidity indicator is at all time highs!



Given current liquidity conditions it shouldn't surprise anyone that VIX is in the one percentile of observations. The entire global marketplace has loads of money sloshing around that can absorb any aggressive buying and selling.

With the liquidity indicators still in an uptrend, we have to push back our estimations for a structurally higher VIX into late 2017/early 2018.

It might take even longer considering the recent move in the dollar index.

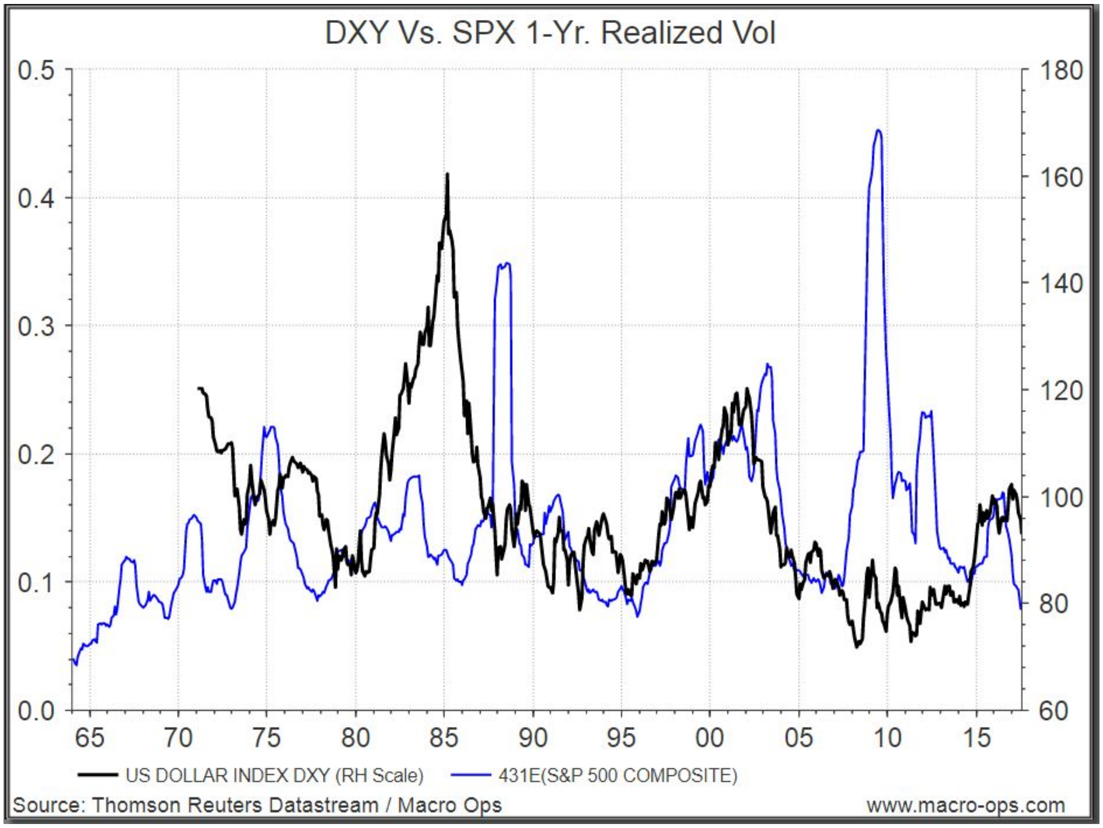
The DXY has sold off by about 10% since the beginning of the year.

A weaker dollar loosens up global liquidity conditions *even more*.

Commodities, priced in USD, get a tailwind, and dollar denominated debt becomes easier to service. Both of these forces increase investor confidence which in turn compresses credit spreads. Tight credit spreads lower the cost of borrowing, companies take on more debt, spend more, and inject even more liquidity into the system. It's one giant feedback loop.

The USD has an important role in global liquidity conditions, which is why we pay such close attention. It's been a good alternative indicator for judging the liquidity landscape.

It's not perfect, but you can see the USD bull run in the mid-90s coincided with an uptrend in SPX volatility.



The same thing happened on this last dollar bull run during 2014. The dollar took off and volatility followed.

What To Do From Here:

The best thing to do is first turn down the volume on all of the media talking about record low VIX.

More often than not you're reading warnings from someone who hasn't ever traded a VIX derivative and has only a cursory understanding of it. They're looking at the wrong variables in order to draw their conclusion.

VIX will stay low for the coming future but it will have some mini spikes along the way.

If you have any long vol positions, make sure to take profits early on these spikes. Do not bet on a sustained trend higher.

Also, use these mini spikes as a shorting opportunity in volatility products or a buying opportunity in SPX.

We’re still in the type of macro environment where the BTFD trade has a good probability to work. Keep hammering away on this edge until liquidity conditions turn.

Summary:

- **The first half of 2017 has been one of the most peaceful markets in history.**
- **Pundits and vol tourists have been wrong about a higher VIX because they’re looking at the wrong factors.**
- **Liquidity matters more to volatility than any other variable.**
- **Highly liquid markets = low volatility**
- **Illiquid markets = high volatility**
- **Currently liquidity conditions are very loose — continue to short VIX spikes and take profits early on any long vol positions.**

Equity Updates

In our June MIR *A Market Salmon*, we profiled the brutality in retailers. We noted four companies we thought were decent, but had been overly punished — a pure contrarian *play the player* trade.

We haven't taken a position in any of these companies yet, but we're continuing to track them for a technical setup. We believe they'll do well into the end of the year.

Let's start with nutritional supplement retailer GNC.

Since our MIR was released on June 2nd, GNC has climbed as high as 47%, but is now trading just over 35% higher.

The company recently reported strong earnings though with slightly declining sales. Management remains optimistic and insiders continue to load up on shares. We almost pulled the trigger on this stock at the end of June, but decided to hang back and see how earnings played out.

The numbers were good enough to put this back on our target list and we'll consider buying on a favorable technical setup above the 200-day moving average (where it's currently consolidating).

Clothing designs and retailer Sequential Brands Group (SQBG) has fallen 10% since June's report.

This is a company in transition. They recently brought on a new CEO before our coverage started — a strong, capable leader — and it's going to take her a few quarters to right the ship. It's early, but she seems to be making all the right moves and we'll continue to track this stock.

Signet Jewelers (SIG) is up over 15%.

The price action and recovering fundamentals continue to look strong. We don't have a position, but are watching how the next few quarters develop closely.

Discount home goods retailer Tuesday Morning Corp (TUES) is up a little over 10%.

I love the price action in this stock. There's very little intraday volatility and low volume. This means there are strong hands in play and the stock is in the process of forming a long-term base. Company insiders continue to backup the truck on this stock

This is my favorite play in the retail group and I'll consider buying on an upside breakout, which may come on the next earnings date.

China's A-shares, which we covered in last month's MIR, continue to do well. We still hold a large position that we established in June.

The index is up over 3% since our July report.

Global casino operator MGM Grand (MGM) immediately ran over 13% higher following our report but has since pulled back. The stock is now up just over 4% since July's release.

We don't currently hold a position in MGM. The technical price action right now doesn't look great and we'd like to see a move back to new highs before jumping in.

Asset Allocation

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			x
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	