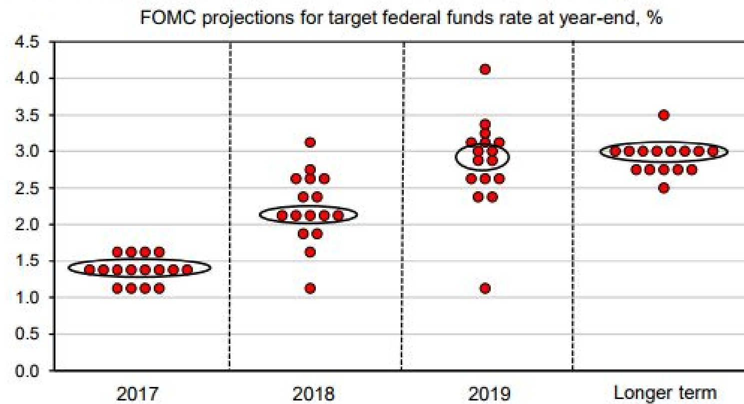
MARKET BRIEF

Macro Ops Collective

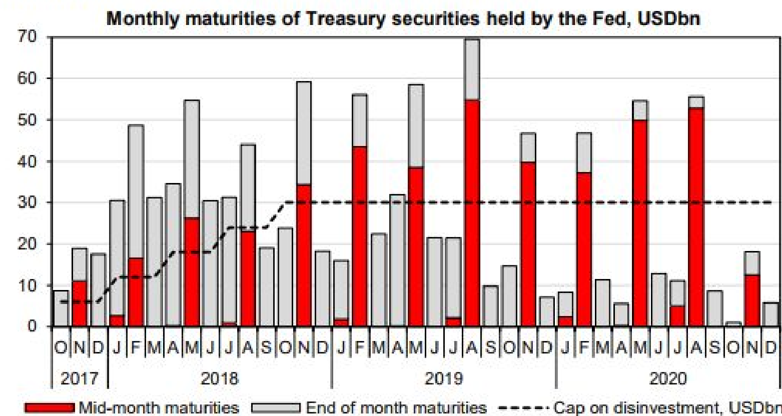
It's All About The Dots



The FOMC meeting is now underway. They'll be making their announcement on interest rates, balance sheet reduction, and forward guidance tomorrow at 2pm EST. Yellen will then speak at 2:30.

This is an important meeting.

The Fed should — at least this is what they've signalled and is what the market is expecting — keep interest rates on hold but start the process of reducing its enormous balance sheet.



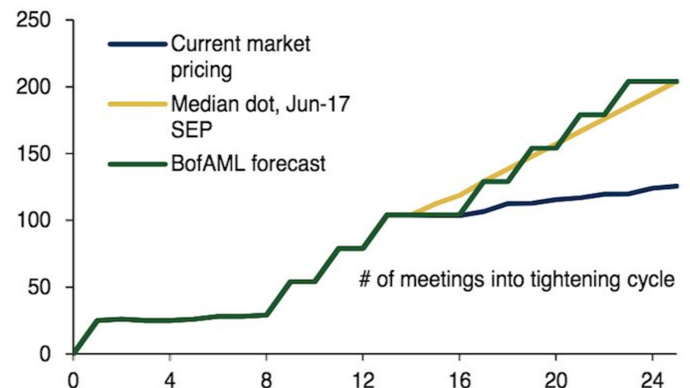
The start of its balance sheet reduction is likely to have little impact on markets.

The Fed is moving gingerly, as they're the first central bank to attempt this, so the amount of treasuries and agency mortgage backed securities that it'll be running off into the end of the year is small.

Here's a breakdown of how it's going to work.

Going forward, the principal payments on the Fed's holding will only be reinvested according to set caps.

Starting off, the Fed will begin letting $6B in treasuries and $4B in agency MBS run off. And every three months these caps will be raised by another $6B and $4B, respectively. This will continue until the runoff reaches $30B and $20B next October.



By then, balance sheet reduction will begin to matter as it essentially amounts to $50B+ in monthly demand being pulled from the treasury and MBS market. Definitely not a bullish catalyst for bonds.

The most important thing to watch for at this meeting though will be the Fed's dots (chart above).

The dots represent the FOMC members expectations for forward interest rates (ie, their planned rate hiking path).

According to their last meeting, the median FOMC expectations were for another rate hike before the end of the year, likely at the December meeting.

The market disagrees and has consistently been pricing the rate path, lower.

This is reflected in the Fed Funds futures, which aren't pricing in another hike until June of next year.

Since the economy is already at full employment, this disagreement between the market and the FOMC is all about inflation. Both current and expected inflation.

We're in the camp that the market is completely offsides on the inflation trade.

The market has bought tooth and nail into the lower inflation for longer narrative. While we believe higher inflation is around the corner, driven by a weaker dollar and the “overheat” phase dynamics of where we are in the economic cycle.

The FOMC is somewhere in the middle.

This meeting, and the FOMC’s dots are so important because it should hopefully gives us an idea as to which the camp our Game Masters are leaning.

If they move their dots lower, closer towards the market’s, then that will cause stocks to rally and the dollar to plunge — it’ll be great for our long oil trade and also good for gold stocks.

If they move it higher (this is unlikely), then the dollar will rally and the stock market will get jittery.

I expect they’ll stick to their running script. This means they’ll start reducing their balance sheet but they’ll keep rates on hold and their dots level, signalling a December hike.

But… they may come out with a dovish tone and reaffirm they’re flexible and data dependent.

I would love it if this happens. And here’s why I think it will.

Recent speeches by FOMC members Dudley, Kashkari, Brainard etc… suggest that members are buying more and more into the secular low inflation narrative where technological change is now a much stronger deflationary force that it used to be.

There’s a lot of truth to this. And this has been the case for the last few years but as we pointed out in the MIR, cyclical pressures are building that will bring higher, albeit transitory, inflation.

The market wants to read dovish. If the Fed gives them any dovish signal then the market will run with it. This would mean another (possible washout) move lower in the dollar and a jump higher in risk assets.

This would only put the Fed and the market more on the wrong side of the coming inflation trade — which is why I really want it to happen.

Another move lower in the dollar would also increase inflationary pressures. And the Fed has a habit of ALWAYS being on the wrong side of everything, so it wouldn’t surprise me.

The CPI numbers ticked up last week but I think the Fed could write it off as a result of the hurricanes knocking out supply and thus lead to them taking a dovish tone here.

But of course, they also care about financial stability and inflating asset prices. So we'll just have to watch the dots and parse through their statement to see which way they're leaning.

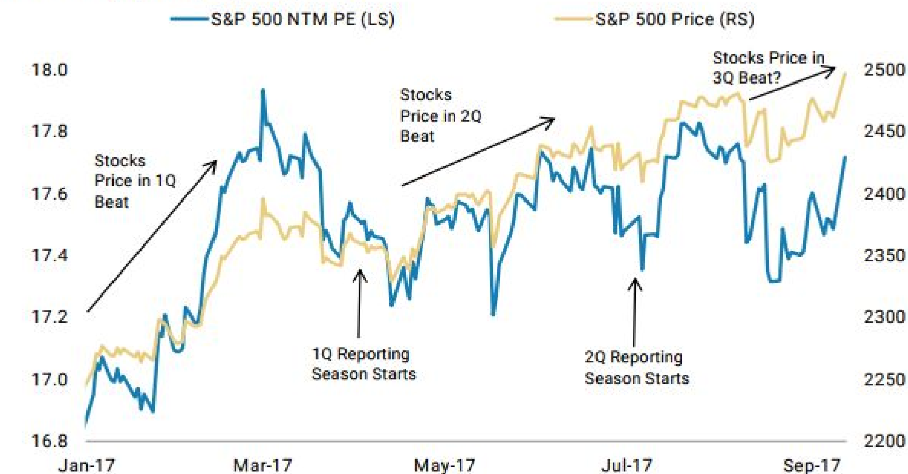
Morgan Stanley recently put out a report with some great charts in it that I want to show you (you can find the full report, along with other IB research hung up in the Comm Center).

The report suggests we'll see continued earnings growth and estimate beats going forward.

The chart below shows S&P earnings revisions breadth (number of earnings forecast being revised up versus down) trending higher, which is a positive signal.

Their leading earnings indicator is projecting much higher EPS growth over the next 12-months.

They also note an interesting trend going on in markets. And that's that the market appears to be consistently front running the earnings season. It's pricing in EPS growth before earnings releases and then settling and consolidating following reporting.



They're not sure why this is and I don't know either.

I wonder if it has something to do with the accelerating arms race in the short-term earnings forecasting game.

I know of a number of sophisticated hedge funds that are using things like satellite monitoring of store parking lots and the buying of esoteric private email store receipt data, to get a better read on a company's business in real-time.

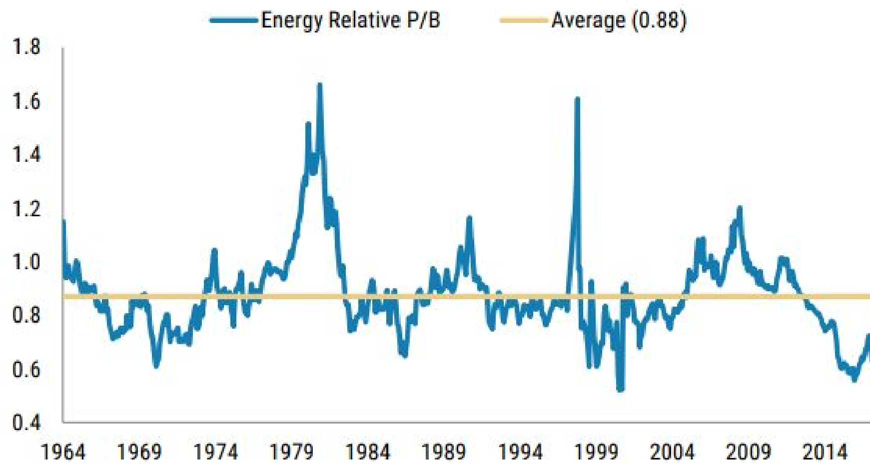
Just more reason for us smaller fish to focus on playing the long game.

Our Long Energy Theme

MS also had some great fodder on our long energy trade. Here's a snippet of what they said (emphasis is mine).

> ***Further supporting our view that last year's low was indeed an important longer term low is the observation that energy stocks traded at their all time low relative Price/Book ratio at that time.***

Exhibit 7: Energy P/B Relative to the S&P 500



Source: Factset, Morgan Stanley Research. As of Aug. 31, 2017. Monthly Data.

In short,energy stocks have never offered such value relative to the broader market on a Price/Book basis. Finally, "real" oil prices, measured by the ratio of oil/gold, also reached all-time low at last year's nadir with today's price not much higher.

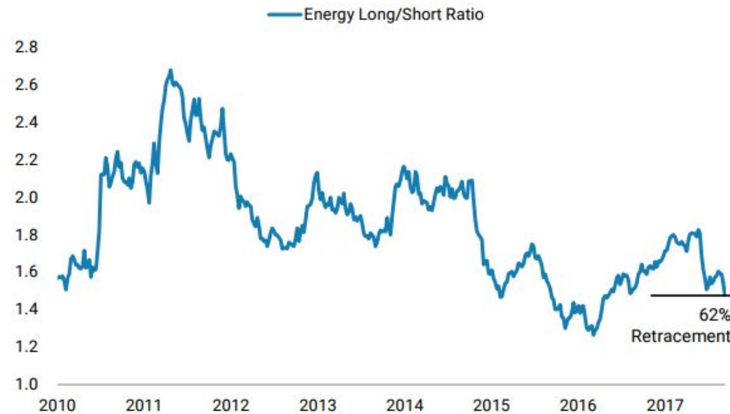
Exhibit 8: Oil vs. Gold

Source: Bloomberg, Morgan Stanley Research. As of Sept 15, 2017.

Like all commodities, low price drives greater demand and with a weaker USD, these prices are even lower for international buyers/users of crudes, especially inefficient energy consumers in the emerging markets.

Indeed, global energy demand has surprised even the most bullish forecasts year to date and that is expected to continue given the synchronous global economic recovery.

Finally, our Prime Brokerage team tells us that long/ short equity manager exposure to energy stocks has rarely been lower. *The ratio of longs to shorts is in the bottom decile of the past seven years.*



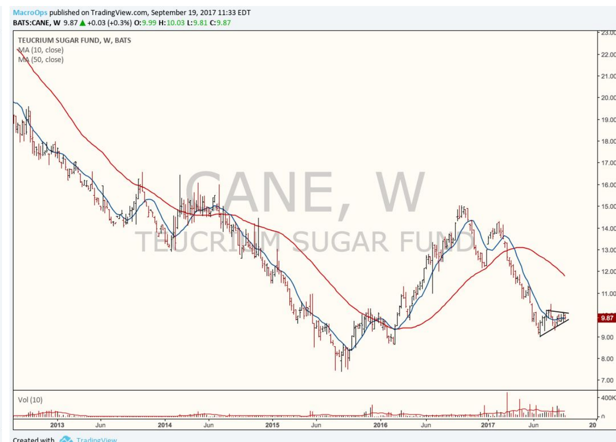
Looks like Morgan Stanley is on the long energy train with us. Hopefully the trade gets a boost and not a whip from the Fed tomorrow.

Some other areas of interest are sugar and cocoa.

Peter Brandt noted the other day how stretched COT positioning is, saying " Seldom in history have Commercials been net long Sugar and Cocoa, such as is the present case. Thus, I believe both markets are poised for strong bull runs."

You can check out the unusual COT profile for both at the site Free CoT Data (link here).

The charts on both look solid. There's a decent trade here should price break to the upside out of both its consolidation patterns.



You can play these through the futures market or the above ETF's.

A few trades other that I'm currently digging into are JD.com (JD) which is the Chinese equivalent to Amazon, a Chinese lithium battery maker called Highpower International (HPJ), and then twitter (TWTR).

I'll put out our findings on these shortly.

Portfolio Review

I like the way our book is positioned and it's making money for us so I'm not looking to make a lot of changes in the near term.

I remain bullish on the market as a whole but it's stretched and vulnerable to a pullback in the near-term. I prefer to be patient and wait for a selloff before adding any new positions or increasing current ones.

A number of our holdings are closing at new 52-week highs.

Interactive Brokers (IBKR), one of my favorite trades on our book, is at 52-week highs and within spitting distance of new all-time-highs.

PGAL, the Portugal ETF, has also moved to new 52-week highs. The country's bonds were recently upgraded to Investment Grade as the eurozone as a whole benefits from a cyclical recovery.

Hudson Technologies, another holding that I really like, is on the move again and is set to close at 20yr highs. This is one of the trades that I'd like add another layer to once we see a pullback in the market.

Intrepid Potash (IPI), which continues to be one of our best performing trades is at new 52-week highs. The potash sector in general looks to have found a bottom and is moving higher. If we get some strong sector tailwinds going then IPI could really rocket higher.

The retail basket consisting of GNC and TUES that we added on Monday isn't off to a great start. But that's why sized our position small and gave them wide stops. If this starter position gets knocked out then worst case scenario is we lose 70bps (that's 0.7% of total capital) and we'll move on.

Bottoming processes are always volatile as there's a lot of supply overhang and negative sentiment that the stock needs to work through. But if it's successful then there's the potential for outsized returns. So we'll see.

I'll put out a follow up note after the Fed meeting tomorrow.

If you've got any questions just shoot me an email or hit me up in the CC.

Have a great trading week!

Your Macro Operator,

Alex