The "Investment Clock" Turns

Operators,

In This Issue:

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

First up we discuss all the "newsworthy" factors that will dominate the market narrative in the weeks ahead.

Then we cover the *phase shift* we're currently seeing in markets. We also give you a new mental model for assessing economic conditions and show you how to utilize this framework to target the best performing asset classes going forward.

We then step down a level to the micro and explore three trade picks to play in what we believe will be the fastest gaining sector going forward.

Next in our Quant section we look at precious metal volatility and a few potential trades in gold and silver.

And finally we cap it off with a review of some prior equity picks along with our asset allocation tilts.

The macro game is starting to move fast. And fast moving markets are money makers for the astute macro trader!

I hope you enjoy and I'm excited to hear your thoughts.

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

Your Macro Operator,

Alex

Macro: The "Investment Clock" Turns

The month of September is shaping up to be an eventful one for markets.

Here's a snapshot of what will dominate price action and news flow over the next 30 days.

- **North Korea's sixth nuclear test and the world's response**
- **Damage assessment and rebuilding following Hurricane Harvey and now Hurricane Irma**
- **FOMC meeting and the possible start to its balance sheet reduction (aka. Quantitative Tightening)**
- **Raising of the debt ceiling (note: this was kicked to December as this issue went to press)**
- **The normalization of the Treasury's cash balances**

Some of these events pose higher risks than others. Some of them are more probable than others. All of them increase market uncertainty and will therefore affect price action in one way or another.

Markets move in cycles of varying types and time scales. Low volatility regimes lead to excessive risk taking and crowded positioning which lead to instability and high volatility regimes and on and on.

The VIX (volatility index) recently had its 4th lowest monthly close in history. 5 out of the 10 all-time lowest VIX closes have occurred in 2017. The S&P hasn't had a down month since October, the longest bullish streak in over 20 years.

Low volatility by itself is not cause for alarm or reason to sell down longs. But it's important context when looking at upcoming market events and adjusting one's risk exposure.

And despite the overhang of these seemingly bearish events, we argue that these are more distraction than market moving. **The really important variable is in the economic *phase shift* we're experiencing and its bullish impulse for markets which we'll soon discuss.**

In this month's MIR we're going to introduce the concept of the "Investment Clock".

Using this model we'll show how higher growth and higher inflation are set to drive markets into the end of the year.

The "Investment Clock"

We use a number of mental models to better understand markets and the world. We've shared many of these models; such as Debt Cycle theory, the Capital and Kuhn "Soros" cycle, and the Five Sentiment Stages of a bull market, amongst others, here in the pages of the MIR.

This month we're going to share another valuable mental model we use, called the "Investment Clock".

We were first introduced to the idea in a research paper put out by Merrill Lynch.

It's a simple yet useful framework for understanding the various stages of a business cycle and which asset classes perform best in each stage. A similar framework is used at Bridgewater Associates, one of the most successful hedge funds of all time.

We'll walk through the concept and then apply it to the current market to see which assets are likely to perform best going forward.

The Investment Clock splits the business cycle into four phases. Each phase is comprised of the direction of growth and inflation relative to their trends. You can see these four phases in the chart below *via Merrill Lynch*.

Table 1: The Four Phases of the Investment Clock

Phase		Growth*	Inflation	Best Asset Class	Best Equity Sectors	Yield Curve Slope
I	"Reflation"	↓	↓	Bonds	Defensive Growth	Bull Steepening
II	"Recovery"	↑	↓	Stocks	Cyclical Growth	-
III	"Overheat"	↑	↑	Commodities	Cyclical Value	Bear Flattening
IV	"Stagflation"	↓	↑	Cash	Defensive Value	-

Source: ML Global Asset Allocation * Growth *relative to trend* (i.e. "output gap")

Here's a breakdown of each phase.

Phase 1 - Reflation phase: Growth is sluggish and inflation is low. This phase occurs during the heart of a bear market. The economy is plagued by excess capacity and falling demand. This keeps commodity prices low and pulls down inflation. The yield curve steepens as the central bank lowers short-term rates in an attempt to stimulate growth and inflation. **Bonds are the best asset class in this phase.**

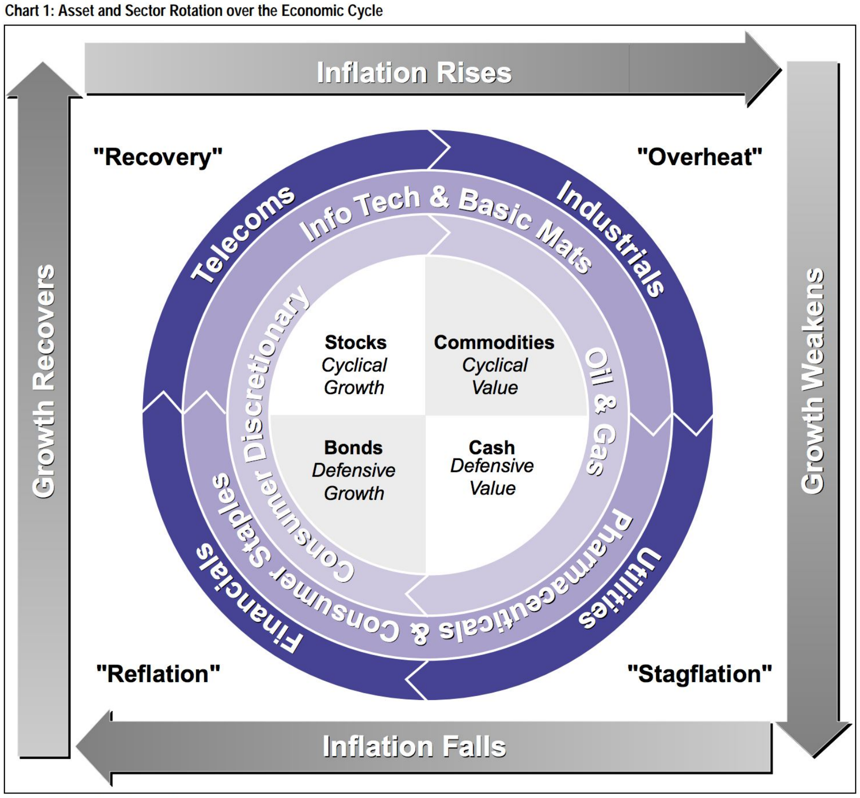
Phase 2 - Recovery phase: The central bank's easing takes effect and begins driving growth to above the trend rate. Though growth picks up, inflation remains low because there's still excess capacity. Rising growth and low inflation is the goldilocks phase of every cycle. **Stocks are the best asset class in this phase.**

Phase 3 - Overheat phase: Productivity growth slows and the GDP gap closes causing the economy to bump up against supply constraints. This causes inflation to rise. Rising inflation spurs the central bank to hikes rates. As a result, the yield curve begins flattening. With high growth and high inflation stocks still perform but not as well as in phase 2. Volatility returns as bond yields rise and stocks compete with higher yields for capital flows. **In this phase, commodities are the best asset class.**

Phase 4 - Stagflation phase: GDP growth slows but inflation remains high (*sidenote: most bear markets are preceded by a 100%+ increase in the price of oil which drives inflation up and causes central banks to tighten*). Productivity dives and a wage-price spiral develops as companies raise prices to protect compressing margins. This goes on until there's a sharp rise in unemployment which breaks the cycle. Central banks keep rates high until they reign in inflation. This causes the yield curve to invert. **During this phase, cash is the best asset.**

Below is a chart that illustrates this process.

Chart 1: Asset and Sector Rotation over the Economic Cycle



Source: ML Global Asset Allocation Team.

The investment clock helps with understanding the progression of the economic cycle. As well as help you think about preferable asset allocation for each relative phase.

Here's the following from Merrill Lynch:

- ***Cyclicality****: When growth is accelerating (North), Stocks and Commodities do well. Cyclical sectors like Tech or Steel out-perform. When growth is slowing (South), Bonds, Cash and defensives outperform.*

- ***Duration:*** *When inflation is falling (West), discount rates drop and financial assets do well. Investors pay up for long duration Growth stocks. When inflation is rising (East), real assets like Commodities and Cash do best. Pricing power is plentiful and short-duration Value stocks outperform.*

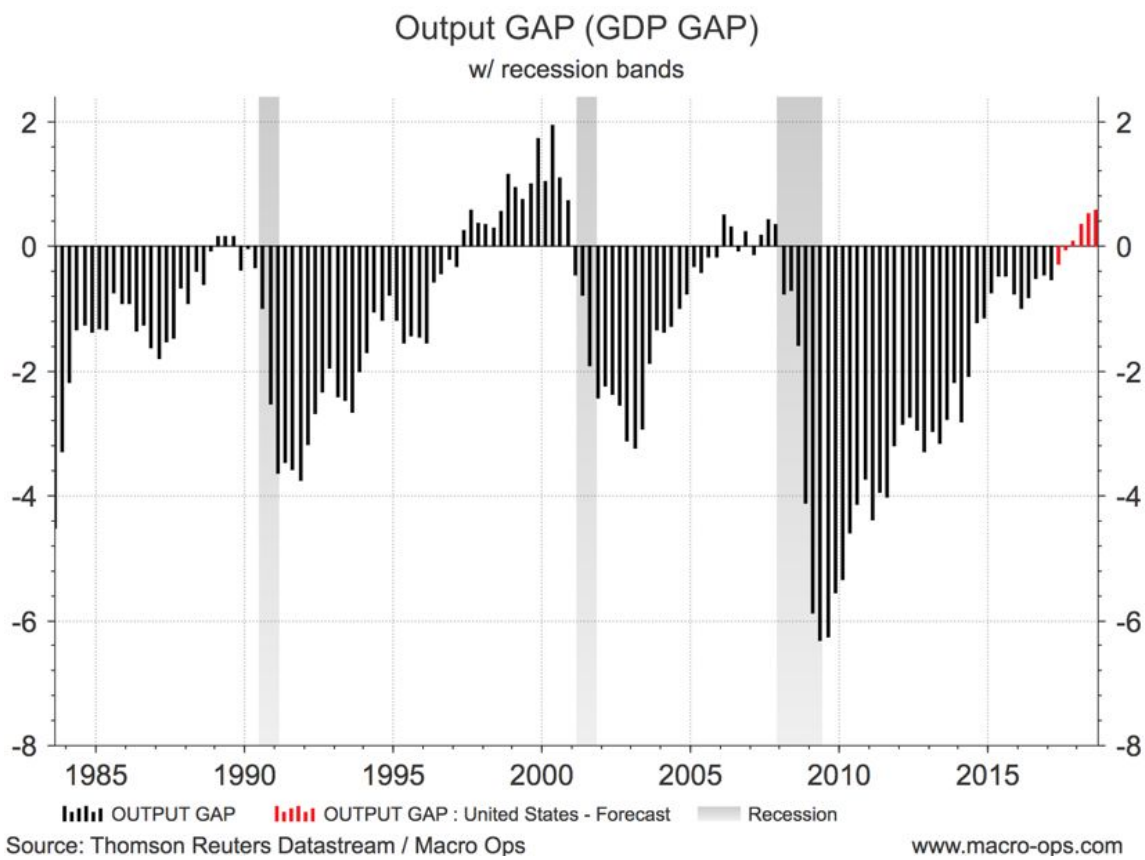
- ***Interest Rate-Sensitives****: Banks and Consumer Discretionary stocks are interest-rate sensitive "early cycle" performers, doing best in Reflation and Recovery when central banks are easing and growth is starting to recover.*

- ***Asset Plays:*** *Some sectors are linked to the performance of an underlying asset. Insurance stocks and Investment Banks are often bond or equity price sensitive, doing well in the Reflation or Recovery phases. Mining stocks are metal price-sensitive, doing well during an Overheat.*

Pretty simple, right?

Now let's apply this framework to where we are today.

A good place to start is by looking at the GDP gap. GDP or "output gap", measures the difference between the economy's *actual* GDP and its *potential*, when producing at full capacity.

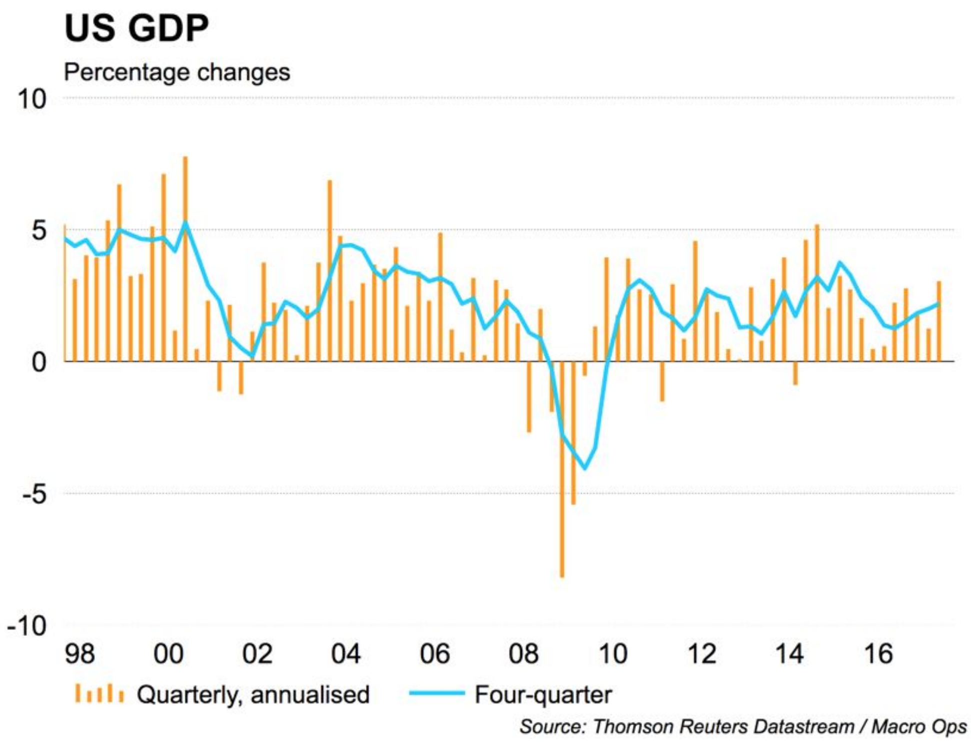


The zero line represents full economic capacity, or a closed GDP gap. When the reading is positive (above the zero line), it means the economy is producing at above trend capacity. This causes inflation to rise and drives the central bank to hike rates. This is why a recession (marked by the vertical grey bands) follows after each subsequent period of above capacity production.

Some guesswork goes into figuring out what the economy's potential gdp is — and actual gdp, for that matter — but we don't need exactness. We're just concerned with the bigger picture. And looking at the chart, **it's reasonable to say that the economy is operating near full capacity, but not yet above it.**

This means we're in the later phases of the cycle but not at the end.

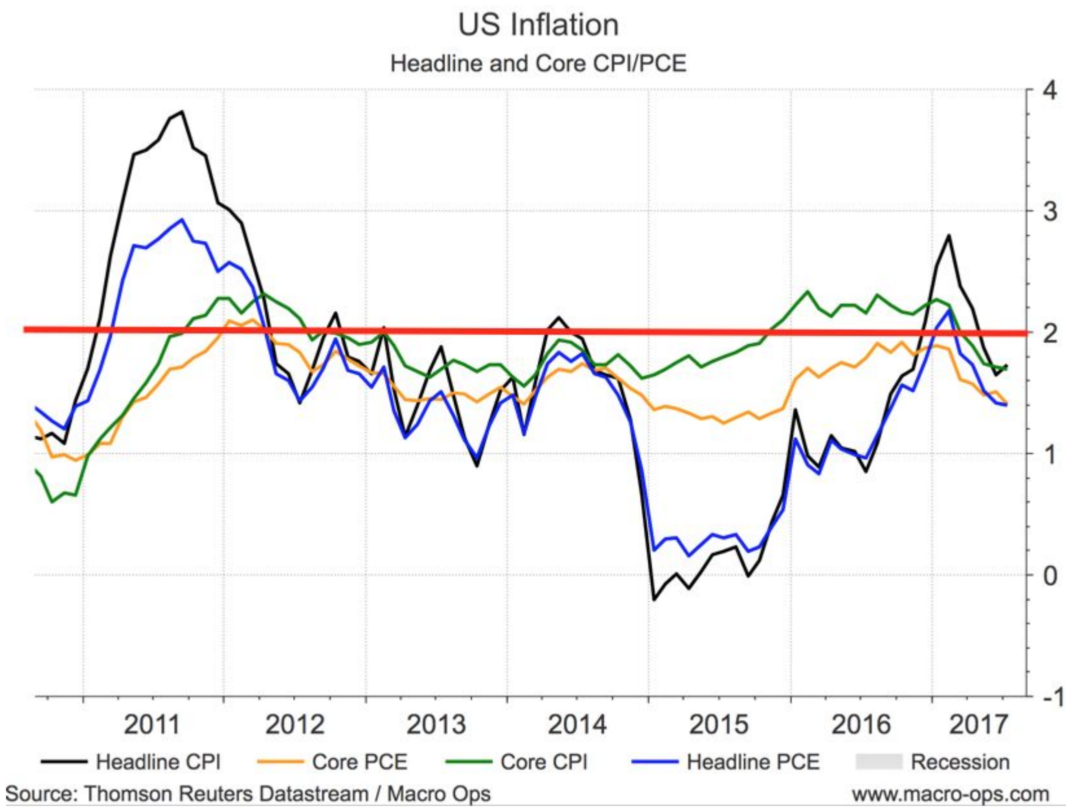
A look at GDP shows that growth remains firm and is trending up.



So we have one part of our equation. We know that growth is <u>trending up and GDP gap is tight</u> but not yet above capacity.

Now we have to figure out the other variable; inflation.

Inflation peaked earlier in the year and has since turned down below the Fed's 2% target. Depending on the measure, inflation is currently between 1.4 and 1.7%.

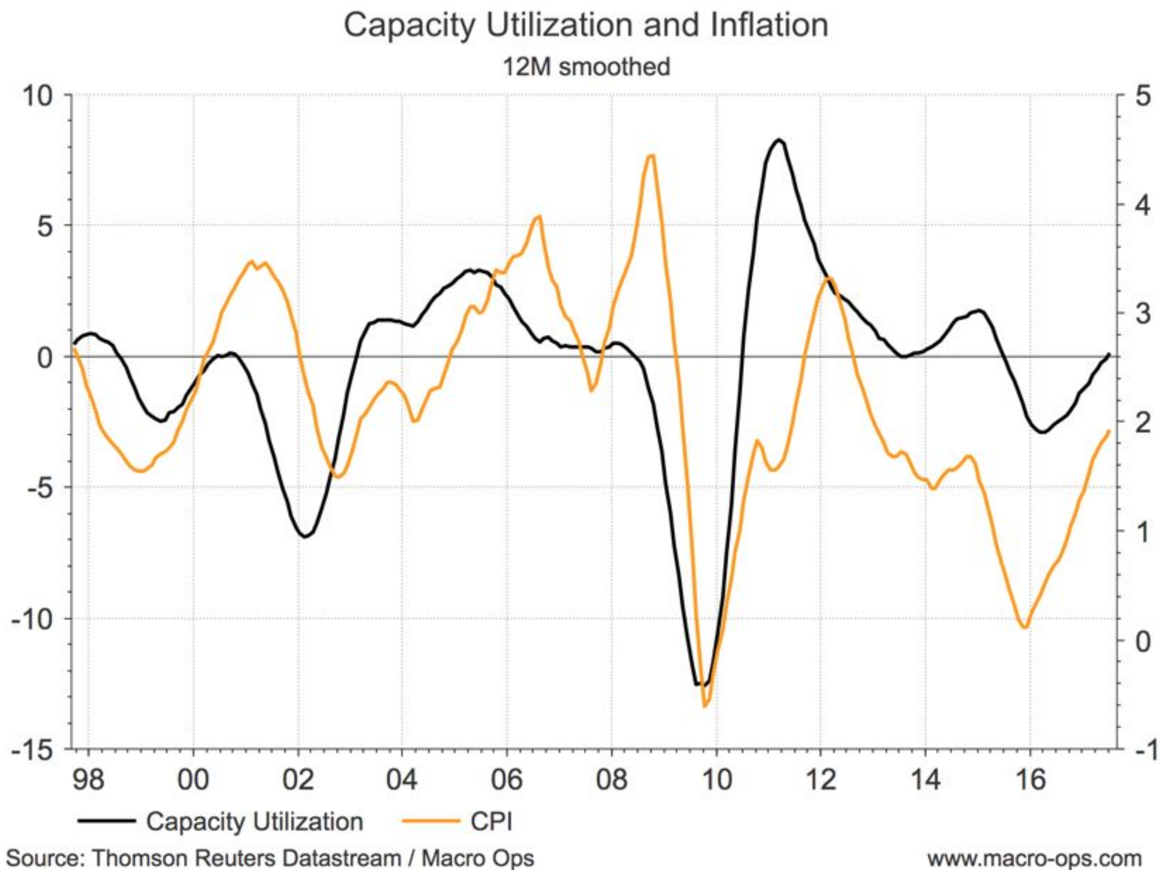


We're less concerned with the absolute value as we are with the trend and where it's headed.

One tool we can use for that is capacity utilization.

Capacity utilization is another way to measure GDP gap. It's useful because when the economy is firing on all cylinders it causes what's called "demand-pull" inflation where demand exceeds supply which causes prices to rise.

The chart below shows the relationship. Both capacity utilization and CPI are smoothed over 12 months to shake out the noise. Capacity utilization leads inflation by 6-12 months.



As the business cycle advances, capacity utilization will continue to rise, pulling inflation up with it.

But inflation is a tricky ephemeral thing so it pays to look at a number of indicators to get a better idea of what's going on.

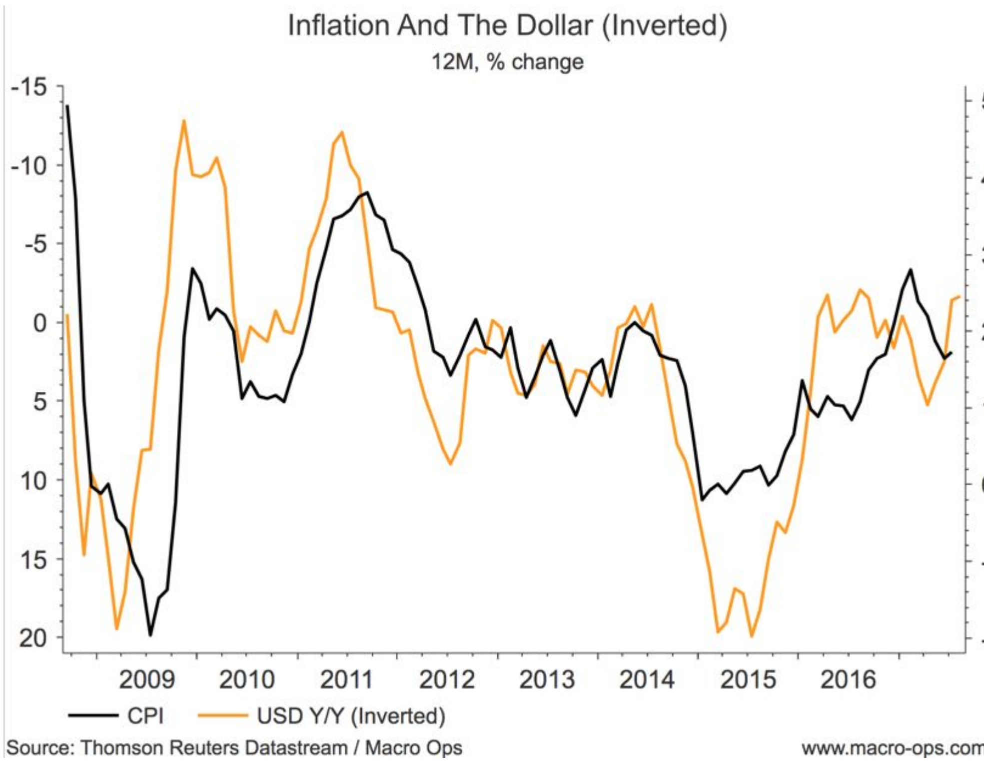
One of the best leading indicators of inflation is the relative change in the dollar. This is because the dollar is the world's reserve currency. Most international trade is done in dollars. And commodities are priced in dollars.

When the US dollar falls it pushes commodities up. It also makes imports more expensive. Both of which drive inflation.

A great way to figure out where inflation is headed is by paying attention to where the dollar has been.

When you run a regression analysis, you'll find that inflation and the dollar have a correlated relationship. Movements in inflation lag the greenback by two months on average.

You can see on the chart below we are due for a pop in inflation on the back of recent dollar weakness.

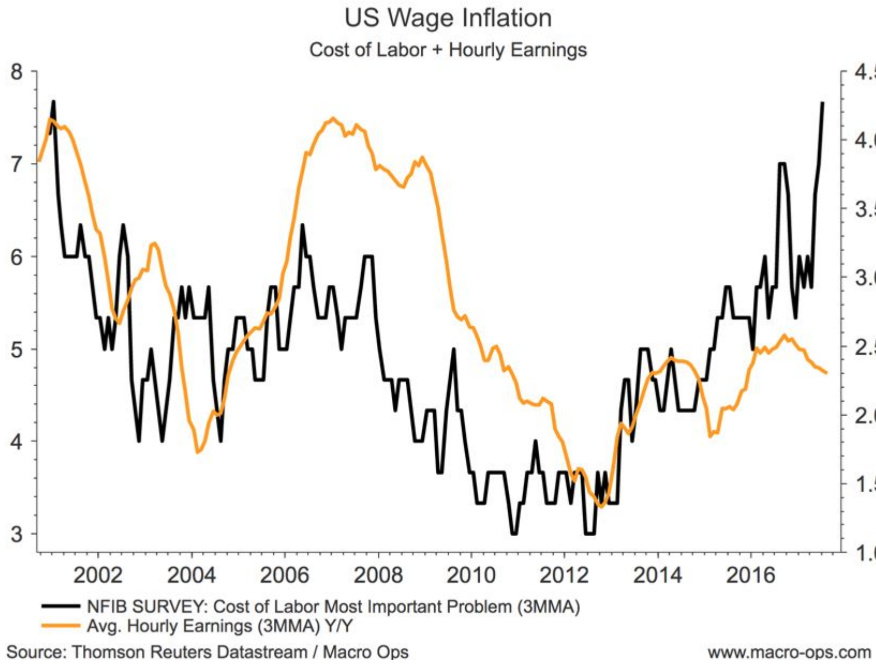


Capacity and the dollar are the largest drivers of inflation outside of extreme supply shocks such as the 73' oil embargo. But we can always look at the wage data which is a lesser, though still important, data set for gaming inflation.

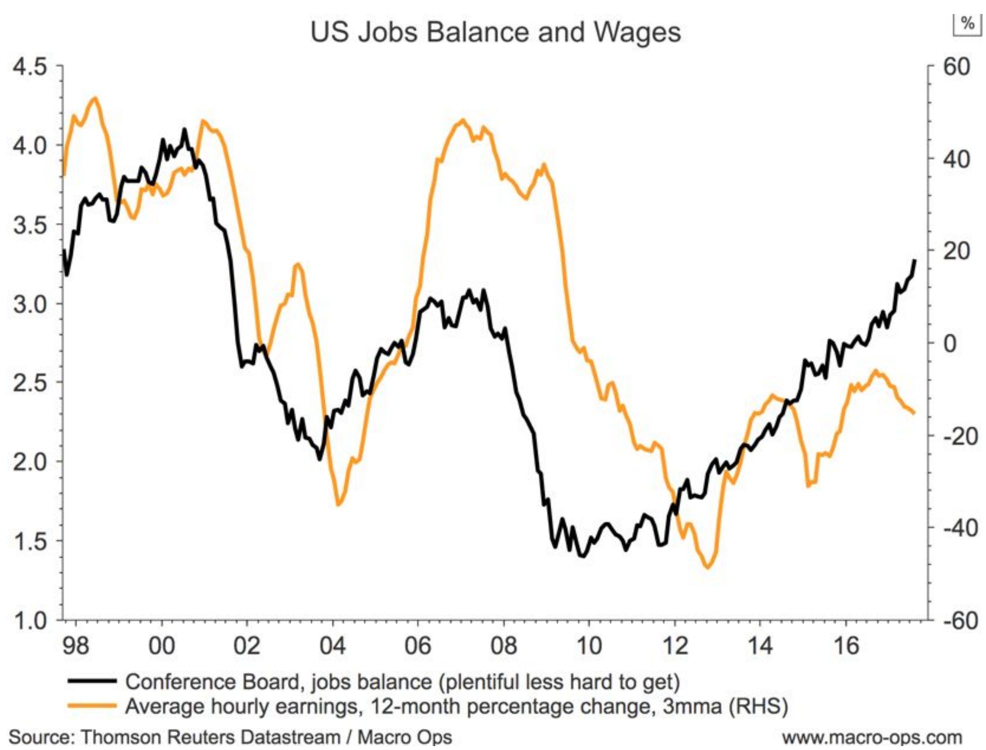
Labor is the largest input into production. Wages tend to be sticky but in the later stages of the cycle, the labor market tightens which drives up labor costs, as employers compete for scarce workers.

Recent wage growth has been disappointing but the data suggests that pressures are building under the surface which should lead to a pickup in wage growth very soon.

THe NFIB survey (NFIB is America's largest small business association) indicates that the rising cost of labor is now, by far, the number one concern of owner/operators.



And the Conference Board's jobs balance indicator has been trending higher too telling us jobs are becoming increasingly easier to get.

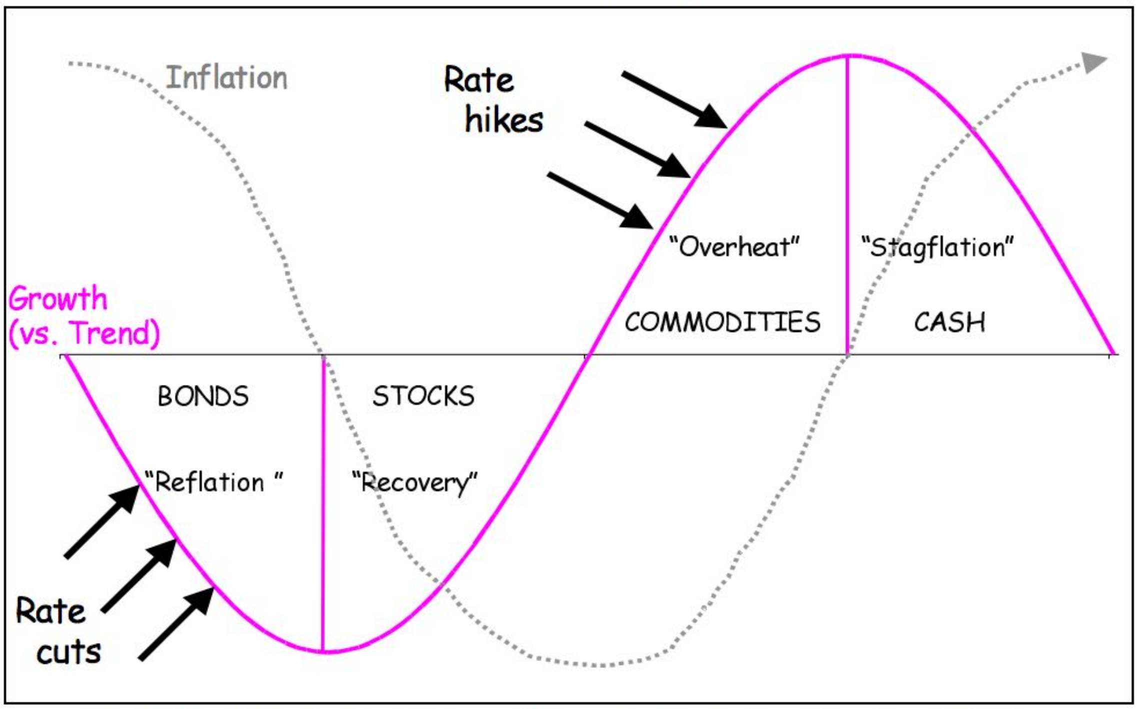


So now we have our second input in the Investment Clock. The economy is nearing full capacity and growth is trending up. <u>Inflationary pressures are building which will pull inflation higher in the months ahead.</u>

Positive growth and positive inflation put us in phase 3 of the cycle.

<u>"The Overheat phase"</u>.

Chart 2: The Theoretical Economic Cycle – Output Gap and Inflation



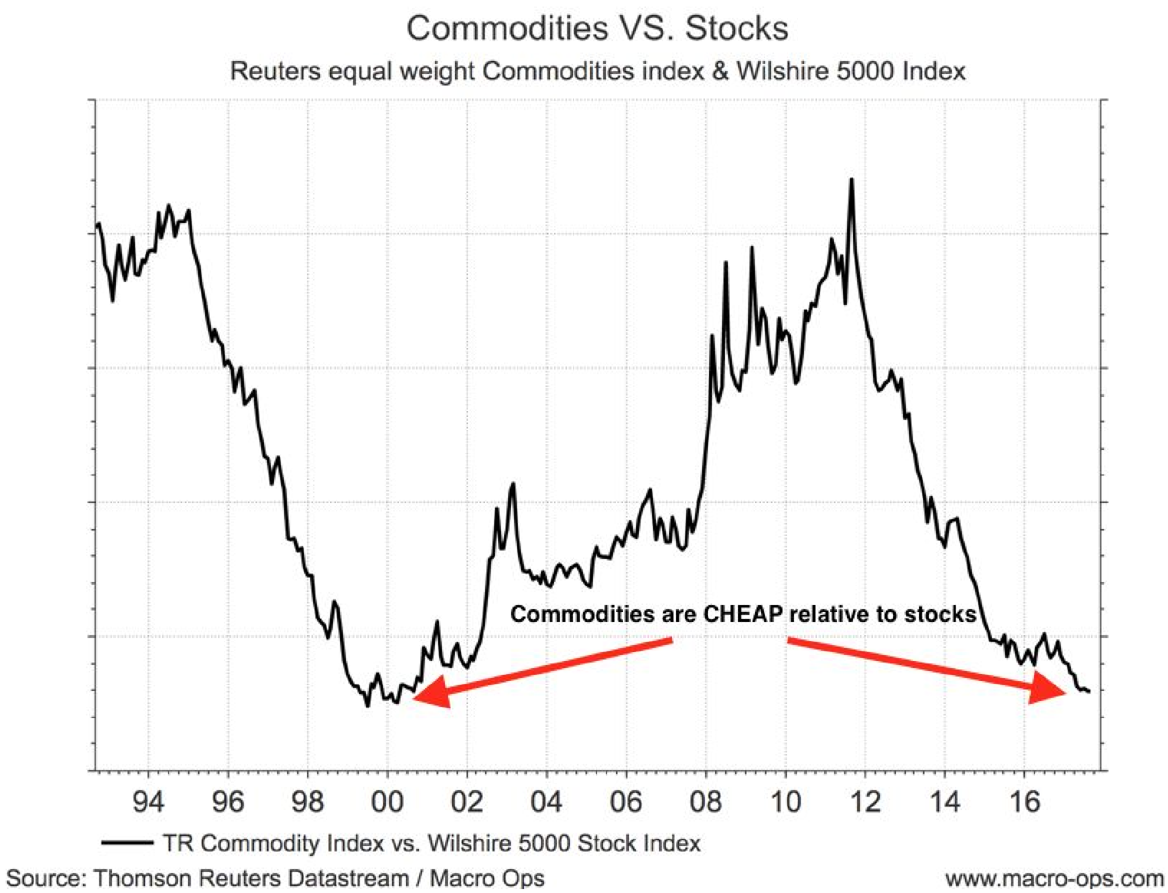
Source: ML Global Asset Allocation Team. The horizontal line represents the "sustainable growth path". Inflation lags growth, starting to rise only once spare capacity has been used up.

To repeat, the overheat phase is where GDP gap closes (which is happening) and the economy bumps up against capacity, causing inflation to rise.

The central bank hikes interest rates and bonds selloff causing the yield curve to flatten (also happening). With high growth and high inflation, stocks still perform but not as well as in phase 2. Volatility increases as higher yielding bonds compete with stocks for capital flows.

In this phase, **<u>commodities are the best performing asset class</u>** and things like basic materials and industrial tend to also do well.

Take a look at the following chart showing commodities relative to stocks.



Commodities relative to stocks are at their lowest levels last seen in 2000. Which also happened to be right before the start of a major bull market in commodities.

As we progress towards phase 4, inflation will continue to pick up and commodities and commodity related stocks, should begin outperforming the broader stock market.

This is what we'll be focusing on this month's deep dive and in research pieces we'll put out in the weeks ahead. We'll be exploring commodity related plays that will benefit in a high growth, high inflation market — think miners, select emerging markets, agriculture and so on.

Conversely, the bond market will hit a rough patch as rates adjust up to the new inflationary environment.

And as this report goes to press, there's been a number of developments that could have far reaching impacts on the market.

Stanley Fischer, the Fed's Vice Chair, abruptly announced that he'll be stepping down immediately. He's one of Yellen's closest associates and has helped balance out the more dovish voices in the FOMC.

President Trump now has three empty Fed chairs to fill. And he's made his desire for a lower US dollar very clear through multiple twitter declarations. So it's unlikely he's going to install a hard money conservative into any of these slots.

Dovish dissent has been growing in recent months among FOMC members, from vocal members such as Kashkari and Brainard.

There's the increasing possibility that the Fed board becomes overweight with policy doves. If so, this will have enormous policy implications for the market and especially the dollar.

It'd also make the bullish case for commodities that more convincing.

Summary:

- **The Investment Clock consist of four phases (Reflation, Recover, Overheat, Stagflation)**
- **These phases are comprised of the trend rate direction in GDP and inflation**
- **The data currently points to an economy operating near full capacity with higher growth on the horizon**
- **It also suggests inflation will soon pick up due to capacity constraints, a weak dollar, and signs of coming wage inflation**
- **This puts us in stage 3 of the Investment Clock, the "Overheat" phase**
- **Commodities are the best asset class in this phase**
- **Commodities are historically very cheap relative to stocks**

Micro: Oil Stocks

All equity trades fall under 3 categories. These are:

1. **Growth/Value**
2. **Special Situations**
3. **Cyclical/Macro**

Knowing which category your trade falls under is important. Each has certain key information you need to understand and track, so you know what truly drives your trade.

Growth/value trades require standard business assessments. The key information here is company-specific and centers around the value of a company's assets and its ability to generate returns. Your success in these trades comes from your ability to discern growth/value better than the market.

Special situations are, well… special. These include a range of scenarios from spin-offs and debt restructurings to merger arbitrage and more. The key information you should focus on will vary greatly from your growth/value trades.

And finally you have your **cyclical/macro trades**. These are trades where the key information is less company-specific and more driven by the macro drivers of the stock's industry.

With these trades, it's less important to study management's competency than it is to understand the macro factors that drive the cyclicality in that industry. Your returns in these plays will depend on the macro more than anything else.

In this month's MIR I'm looking at oil and gas stocks which are classic macro/cyclical plays.

Oil and gas stocks are trading cheap relative to the broad market.

What's equally enticing is that this sector performs best in the Overheat phase of the economic cycle — which I believe we're about to enter.

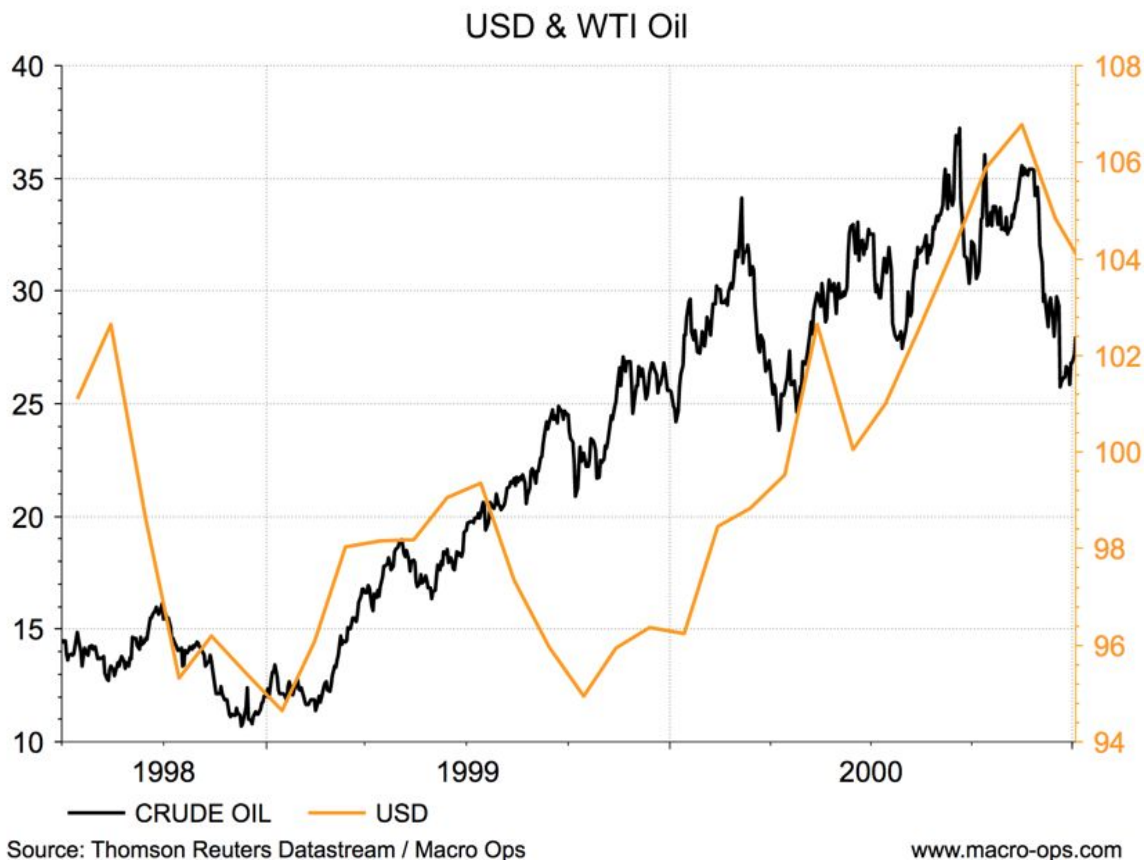
The Macro of Oil

The US dollar is the most important macro driver of oil prices.

In the Overheat phase of the economic cycle, there's high demand for fossil fuels. Oil prices rise. At the same time, interest rates move up, credit spreads widen and the credit cycle begins to turn. These factors are dollar bullish.

But even though the dollar IS the *most* important driver of oil prices - this relationship can completely break down in an Overheat phase.

The 98’-01’ analog serves as a perfect example. Both moved higher into the end of the bull market.

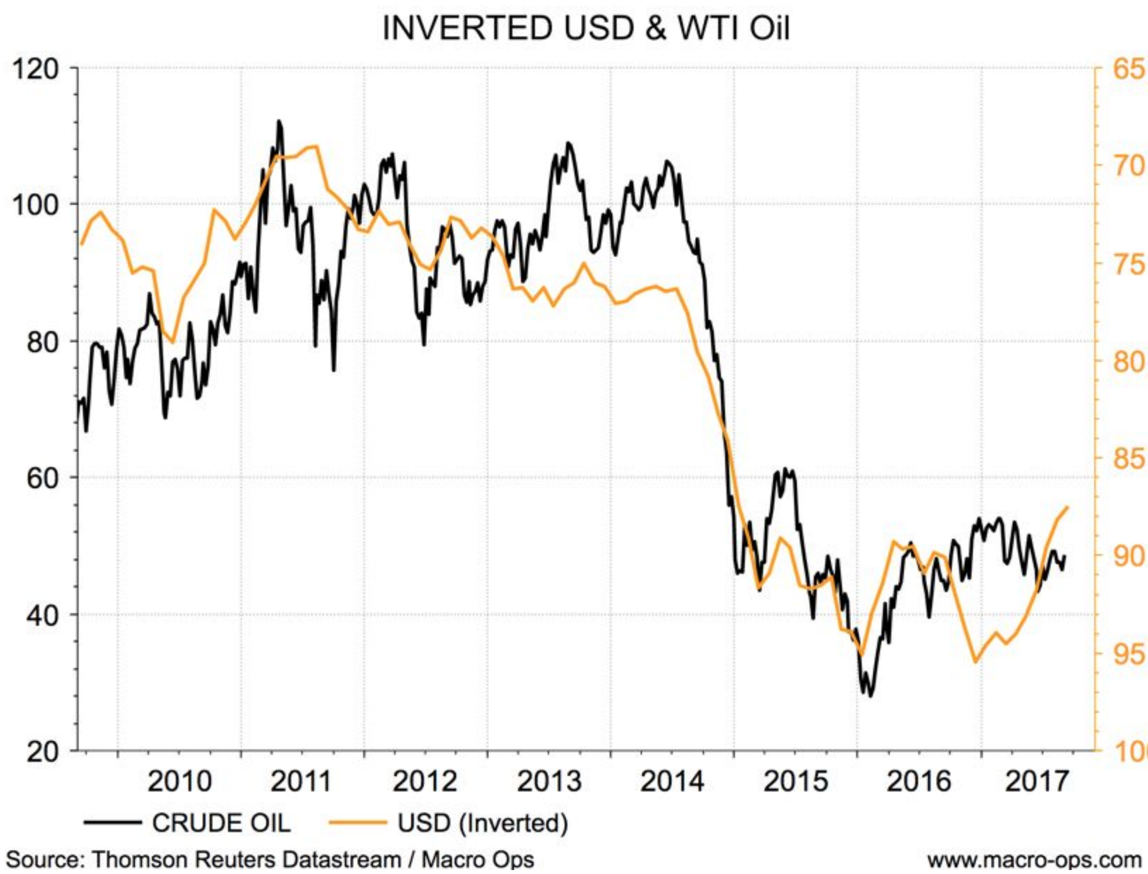


So I’m not too worried about a bull run in the dollar ruining the party in Texas Tea ***IF*** we are in an Overheat phase...

And if the dollar stays in its range then that’s all the better.

This would be extremely bullish for commodities and oil, since dollar weakness is the number one driver of commodity bull markets.

We can see on the chart below that the recent dollar weakness should continue to act as a powerful bullish driver on oil.



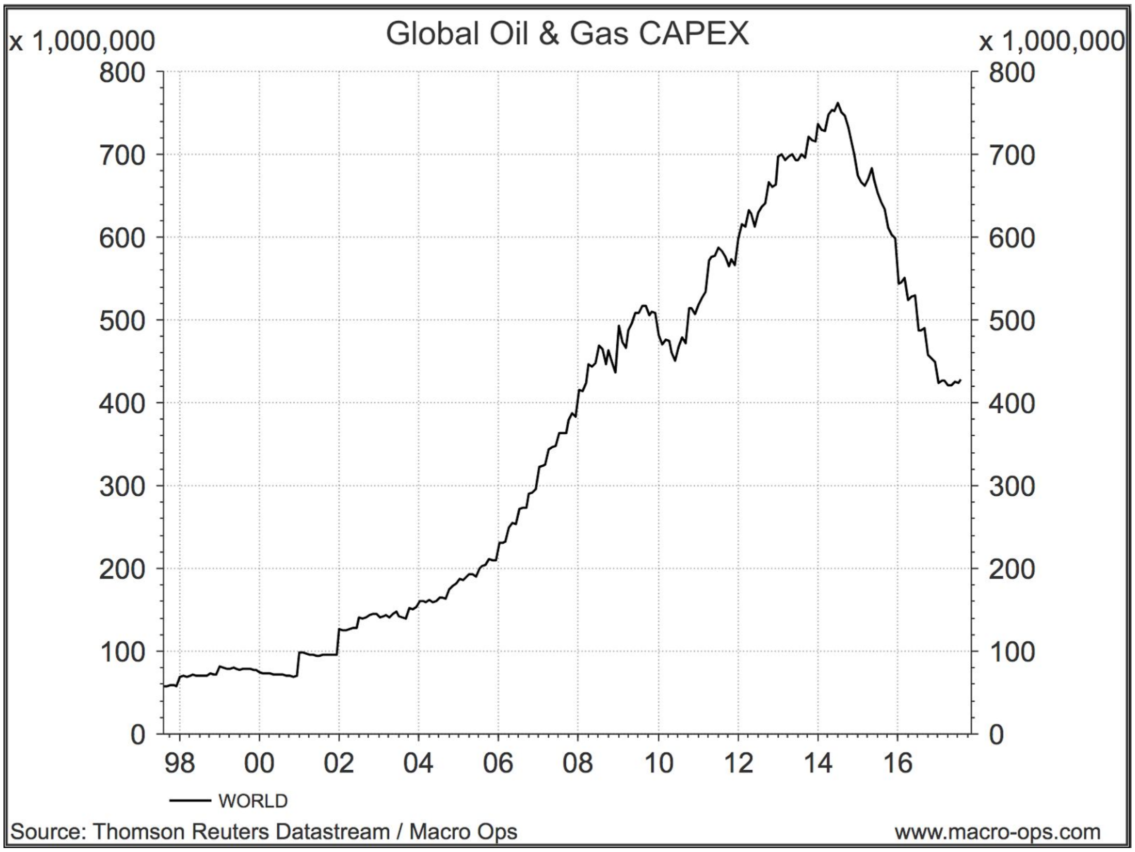
And here's an interesting fact: **<u>There's never been a year in which the dollar has fallen by more than 6% and commodities have finished the year negative</u>. The dollar is currently down 10% and falling while crude is down 8% for the year.**

Something has to give, and if history is any precedent, it will be commodities and oil that rally into the end of the year.

The second large macro driver, for oil is CAPEX.

This is because investment today determines supply tomorrow (and in the future tomorrow, not actually tomorrow, tomorrow). And while oil demand sees fairly constant growth, the supply can fluctuate quite a bit over the cycle.

The chart below shows the massive amount of investment that has been cut in the oil and gas sector, globally, since the price collapsed in 14'.



Compare the recent reduction in CAPEX to the *massive cuts* we saw at the bottom of the last commodity supercycle in 99'. It barely registers when compared to today's, right? That's the point...

Global oil and gas investment, as a percentage of GDP, has fallen from a cycle high of 0.9% in 2014 to only 0.4% today.

This means CAPEX for future capacity is now less than half of what it was only a few years ago.

This is one of the largest CAPEX reductions for oil and gas in HISTORY. Which means that sometime in the next few years, we will enter a *severely* supply constrained market.

The macro landscape favors higher oil prices into the end of the year.

We have an economy that's heating up, a weakening dollar, and a multi-year period of draconian CAPEX cuts sowing the seeds for a supply imbalance.

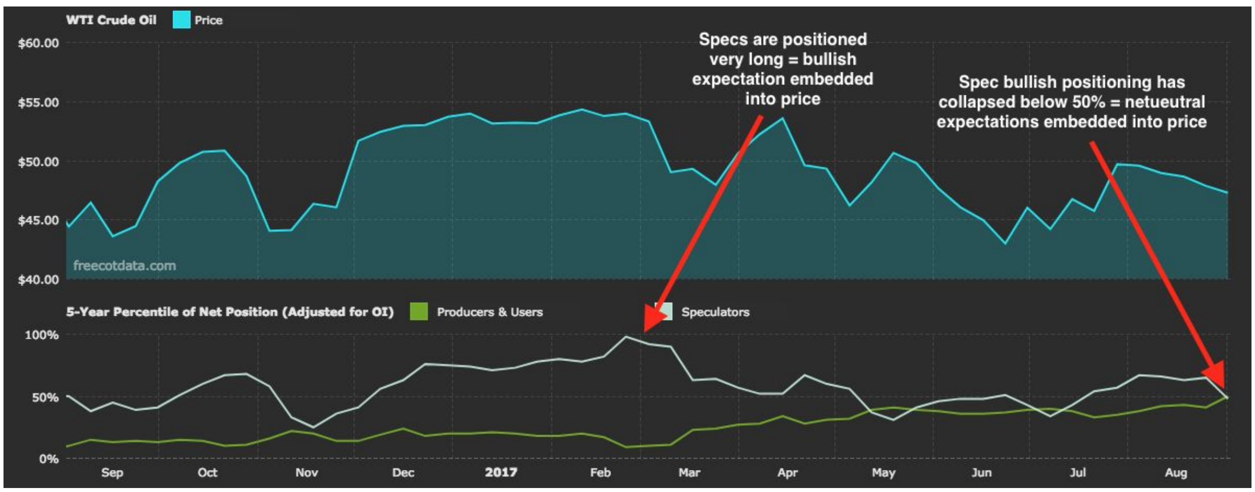
The Sentiment of Oil (Play the Player)

When gauging sentiment in the commodities space I always like to start with futures positioning data in the COT report.

This is invaluable to look at. It allows us to see how speculators are positioned so we can tease out what expectations are embedded into the market.

What we're looking for are extremes. An extreme high or low reading in spec positioning (light blue line below) would indicate a one sided trade and a likely reversal point in the market.

The chart below shows that the bullish positioning earlier in the year has been unwound. Specs are now less than 50% long the oil market. This is good news for us as potential bulls.



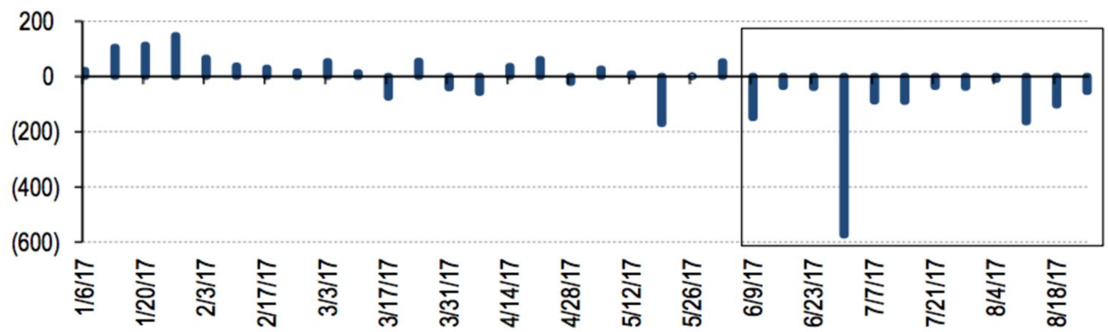
The BofA's Merrill Lynch fund survey gives us an alternative look at sentiment. Again, we're looking for negative sentiment if we're thinking about getting long.

According to BofA's latest report, the energy sector has seen the most consistently sold sectors by retail over the last three months. Chart below shows these outflows.

Chart of the week: Retail flow sentiment most (-) in Energy

Chart 1: Private clients have been net sellers of Energy stocks for the last 12 consecutive weeks

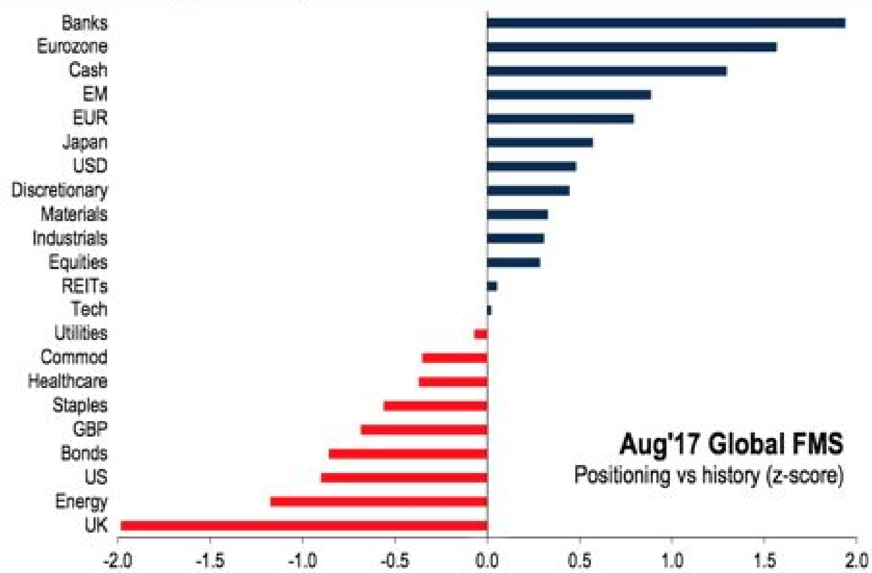
BofAML private clients' net purchases (sales) of Energy stocks ($mn) by week year-to-date



Source: Bank of America Merrill Lynch

And the next chart, also from BofA's fund survey, shows that after the UK, energy is the most underweighted asset within hedge funds. **A solid contrarian signal.**

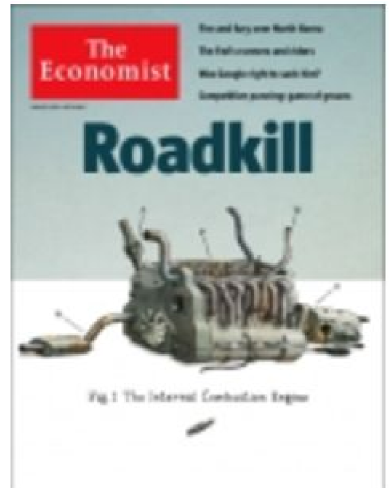
Exhibit 6: The Longs & Shorts, relative to Global FMS history*



Source: BofA Merrill Lynch Global Fund Manager Survey

Meanwhile, longer-term value oriented institutional flows have been positive. They've been buyers of the energy sector in 8 out of the last 9 weeks.

And there's also supportive anecdotal evidence of bearish oil sentiment. The Economist (a bellwether of consensus thinking) declared the death of the internal combustion engine on the cover of one of their recent magazines.



The overall sentiment on the energy sector seems to be bearish/neutral which is what we want to see for a new bull market to ignite.

The Technicals of Oil

The technical picture for crude is currently neutral. It continues to trade within its 18-month range. A weekly close above $52 would suggest a bull run is getting underway.

The more compelling technical chart for oil's bullish case is the dollar, which continues to break support line after support line. (Remember, dollar down = oil up). The recent closes have been under critical long-term support and the 200-weekly MA.

The next technical support for the dollar is 90, which would mean another 2% move lower.

And finally, XES, the oil & gas services ETF, is in the process of putting in a solid technical double bottom. It's also selling at its lowest levels relative to the price of oil since 08'.

Overall, the technical outlook for crude is constructive.

The dollar should continue to weaken in the near-term which will push crude closer to breaking upwards out of its holding pattern.

Our Top 3 Oil Stocks

To diversify risk, we're looking to play this oil theme in multiple beaten down stocks.

These stocks, in order of perceived risk are: Cabot Oil & Gas Corp (COG), Transocean LTD (RIG), and Carbo Ceramics Inc (CRR).

COG is an independent E&P with two primary assets in the Marcellus Shale region in Northeast Pennsylvania and in the Eagle Ford Shale in South Texas.

There's a number of things to like about the company. It has solid free cash flow — which management is using to buy back stock it views as undervalued. And it has impressive sales growth momentum.

Revenues increased 85% over the prior six months. Its return on capital ranks in the top decile of all U.S. E&P companies. And there's a number of key pipelines that will be coming online in the coming year which will serve as a catalyst for further top and bottom line growth.

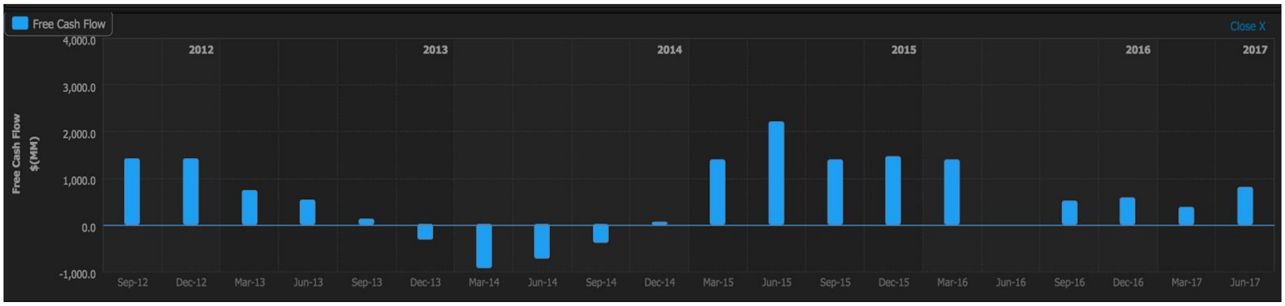
The company also has a strong balance sheet — one of the reasons the stock has held up so well these last two years — with $517mm in cash against only $1.5B in debt

The stock recently broke out of its 18-month consolidation pattern and looks ready to move higher.

RIG is the world's largest provider of offshore drilling services for oil and gas.

The company operates a fleet of 44 mobile offshore drilling units across various drilling provinces. The company's fleet includes 30 high-specification floaters, ultra-deepwater, deepwater and harsh environment drilling rigs.

In their latest quarter, RIG reported an adjusted breakeven EPS versus an estimated -$0.09. It also generated $800M in positive free cash flow on a trailing twelve month basis (chart below).



According to their latest earnings call, the company views the $50/bbl oil price level as a key threshold for deepwater sanctioning. It estimates that fully marked to market deepwater project costs has more than halved in just the last few years.

Management points to this cost reduction as a likely driver for capital to begin shifting “from land to offshore” as onshore well costs continue to rise.

Technically the stock has put in a textbook bottom offering an excellent inflection point for a good risk/reward entry.

CRR is the riskiest of the three trades but also offers the largest return should oil prices move significantly higher from here.

CRR labels itself a technology company that provides products and services to the global oil and gas and industrial markets. It's main source of revenue is in specialized ceramic proppants used in the drilling of oil and gas wells.

Since the collapse in the oil price, the company has been making significant efforts to diversify its revenue streams. And has made some impressive progress building out its industrial facing business.

It has topline management who is doing all the right things in what's a difficult operating environment for the energy services sector.

And there's signs that these changes are working. Revenues increased this last quarter 46% over the year prior and management announced they expect to be positive on an EBITDA basis by next year with oil prices staying at current levels.

The stock is forming a multi-month coiling bottom and is a buy on a breakout to the upside of its current pattern.

Summary:

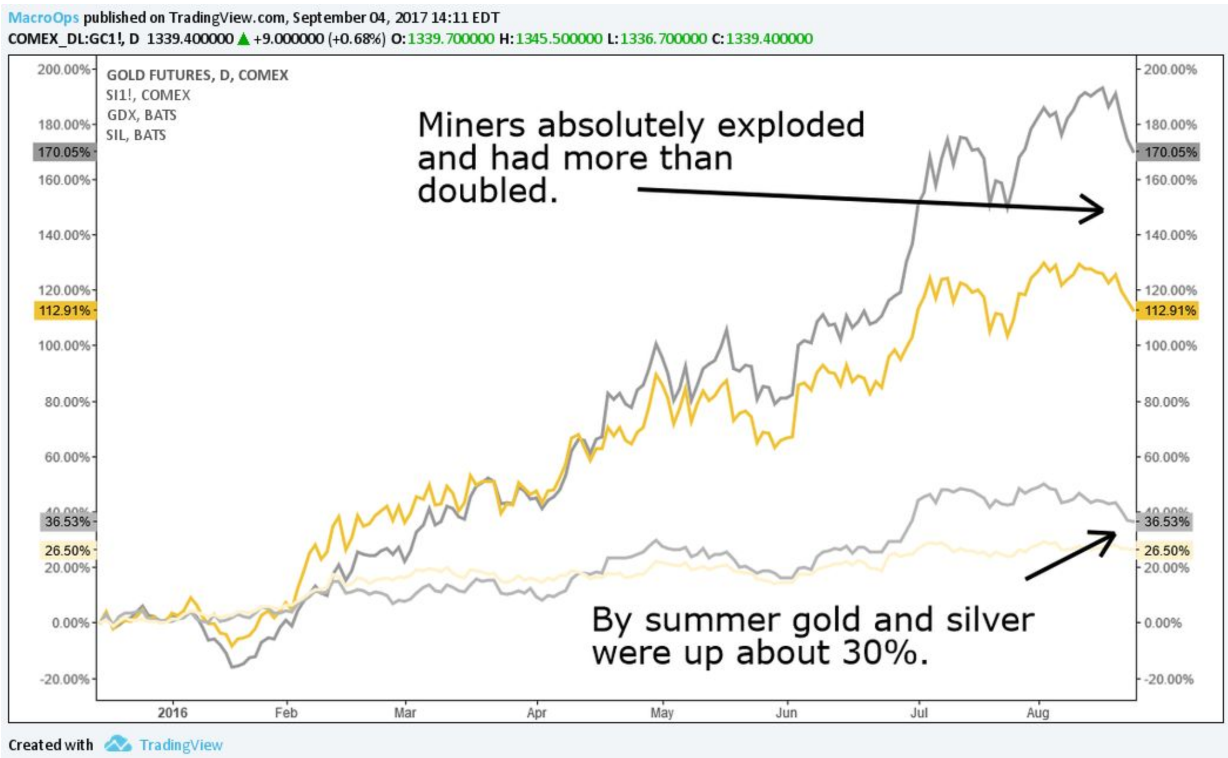
- **Oil prices are set to pick up as we enter into the Overheat phase of the economic cycle**
- **The largest reduction in history for oil and gas CAPEX is going to lead to a severely supply constrained environment; which means higher oil prices**
- **There's never been a year where the dollar has fallen more than 6% and commodities finished negative. The dollar is currently down 10% and commodities are still negative**
- **If history is any precedent, oil should revert higher, especially on further dollar weakness**
- **Oil sentiment remains fairly bearish. Fund managers are underweight it and retail has been dumping it. This is good for us oil bulls**
- **The technical picture is setting up nicely and a weekly close above the $52/bbl in WTI crude would mark the likely beginnings of a long-term advance**
- **We like COG, RIG, and CRR**

Quant: Precious Metal Volatility

Gold and Silver — Volatility On The Cheap

Precious metals have frustrated both bulls and bears the last 4 years.

In the beginning of 2016 gold bugs got excited by the prospect of deflation and more central bank stimulus. This sent gold, silver, and all the miners straight up in what looked like the beginnings of a major trend.



But a majority of this trend reversed by the end of the year after Trump won. Instead of the doom and gloom everyone was playing for — the opposite occurred. Inflation picked up, growth stayed fairly strong, and the "reflation theme" was born.

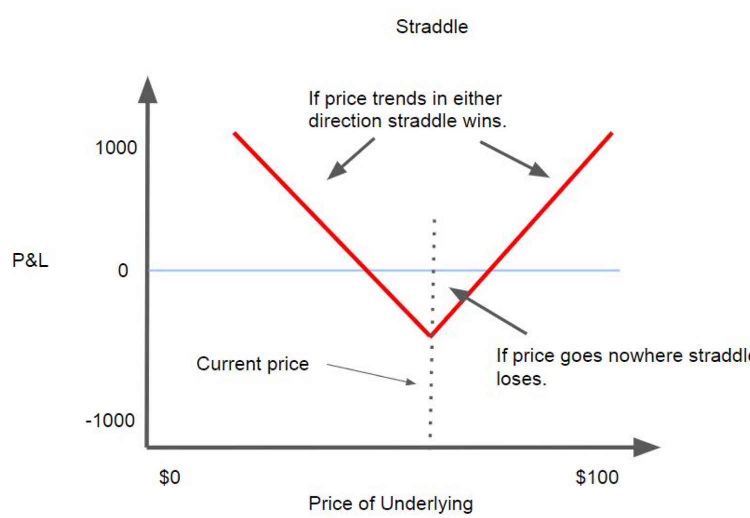
This sent the precious metals complex straight back down.

Ever since, it's been a tug-of-war between buyers hedging against political risks and sellers focused on consistent positive macro data.

This clash between the two makes it hard to call a direction here. *But as traders with a unconstrained approach, we don't have to.*

Instead of betting on an uptrend or downtrend, **we can use options to bet on a trend in *either* direction.**

This is possible through an option structure known as a **straddle**. A straddle involves buying both a put and call at the same strike price. It makes money if price trends either way and benefits from higher volatility.



Now just because you can win on both sides doesn't make this an easy trade…

Straddles are usually so expensive that the time decay in their options normally offsets the trend of the underlying. This means you have to cherry pick only the best situations to make any money with these structures.

Here are 3 things you want to see before purchasing a straddle:

1. **A highly uncertain macro outlook with multiple binary catalysts**
2. **Cheap implied volatility**
3. **A long-term price range that's about to break**

Those of you reading the MIR since early April will remember that the EURUSD straddle we purchased had this same set of conditions:

1. The EUR/USD had a fuzzy macro outlook which was further complicated by a pending binary event (French elections)
2. EUR/USD options were really cheap
3. The Euro was in a huge range and ripe for a break

We bought that straddle before French elections and made big money on the move higher. The call part of the straddle has more than tripled since our entry.

This same set of conditions has aligned in the precious metals market.

The macro outlook for precious metals is extremely complex and muddled.

Valuing precious metals is a tough job. They don't have cash flows or yields, so there's no way to model them.

Investor fear and faith impact their pricing more than anything else.

When people have a lot of faith in the stability of the system (governments/central banks), they sell gold in favor of assets with a real yield. When people fear the government and central banks are losing control, they buy gold.

It's tough to tell what emotions will dominate precious metals by the end of this year. It could go either way.

On the one hand, **if the macro stays strong, the Fed will most likely hike rates as planned. This will cause precious metals to dump.** Faith in the economy will increase.

On the other hand we have risk of war with North Korea along with the looming debt ceiling deadline. If either of these events go south, gold and silver will rocket higher.

Ray Dalio recently published a note about how hard it is to make a good directional call on gold and silver. Below is an excerpt (emphasis mine).

> *Most immediately, during the calm of the August vacation season, we are seeing 1) two confrontational, nationalistic, and militaristic leaders playing chicken with each other, while the world is watching to see which one will be caught bluffing, or if there will be a hellacious war, and 2) the odds of Congress failing to raise the debt ceiling (leading to a technical default, a temporary government shutdown, and increased loss of faith in the effectiveness of our political system) rising.* ***It's hard to bet on such things, one way or another, so the best that one can do is be neutral to such possibilities.***

Dalio has the best and brightest helping him decipher a direction in precious metals and even he's saying they can only be neutral right now.

Gold and silver options have extremely cheap implied volatility.

> *The single best predictor of future increases of volatility is low historical volatility. ~* Jamie Mai, *Hedge Fund Market Wizards*

Any student of volatility can tell you that vol likes to mean revert. Investors overvalue options when things are bad and undervalue them when things are good. This creates a cycle similar to the one we see in stocks — the best option traders buy when vol is cheap, and sell when it's expensive.

Right now 12-month implied volatility (IV) for gold is trading at some of the lowest levels since the 2008 crisis.

The current IV reading of 14% ranks below 95% of all observations since 2008.

We have no idea why IV is so low given all these macro catalysts. It's probably because gold hasn't had a meaningful breakout or trend in the last 4 years.

Silver is the same with decade low volatility readings.

At 23.45%, today's reading is in the bottom 10% of all readings since 2008.

These IV levels mean we can scoop up option straddles at a nice discount.

Gold and silver are both breaking out of long-term ranges.

Good ole' fashioned technical analysis can do wonders when timing a straddle.

Since a long straddle benefits from a trend, it's best to put it on near a technical inflection point. This usually occurs at a break of a long-term range.

One of two things happens at inflection points:

1. Price holds the breakout and starts a new trend
2. Breakout fails and price rapidly turns the other way

A failed breakout is called a "trap". Large players consistently bet on breakouts to continue, but if there's no follow through, they quickly sell to contain losses. **This rapid unwind can fuel a strong trend in the opposite direction.**

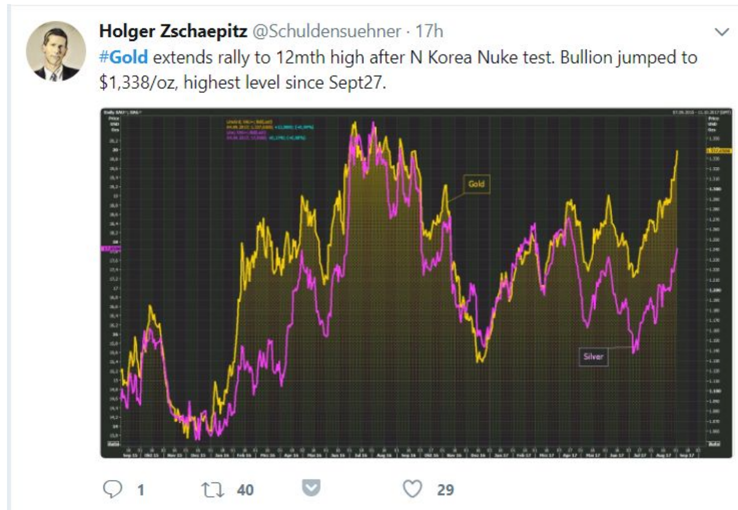
Gold and silver had formed extremely long and compressed ranges since the sell off in 2013.

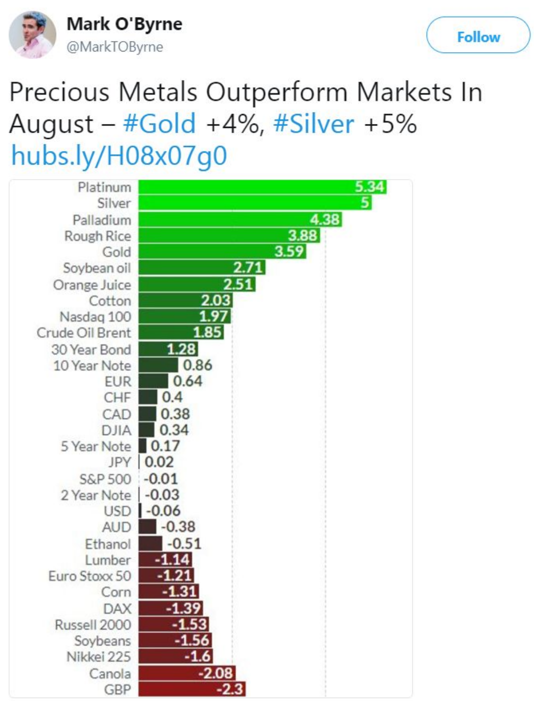

MacroOps published on TradingView.com, September 04, 2017 12:42 EDT
COMEX_DL:GC1!, M 1338.700000 ▲ +8.300000 (+0.62%) O:1326.900000 H:1345.500000 L:1321.400000 C:1338.700000
GOLD FUTURES, M, COMEX
52 bars, 1584d
Gold has gone nowhere in over 1500 days!
Created with TradingView


MacroOps published on TradingView.com, September 04, 2017 12:44 EDT
COMEX_DL:SI1!, M 17.980000 ▲ +0.165000 (+0.92%) O:17.660000 H:18.030000 L:17.505000 C:17.980000
SILVER FUTURES, M, COMEX
Silver has also been in a long-term compressed range.
Created with TradingView

The recent breakouts from these ranges are more visible in the daily charts.

The influx of precious metal Fintwit activity also supports an inflection point here.





This is a good thing. The charts have people interested. We need high interest to kick off a new bull trend or… sow the seeds for an epic bull trap.

The Trade

The last, and arguably hardest step to straddle buying is determining the tenor. The tenor is the time to expiration.

We normally default to longer dated options because the math used to price options breaks down the farther out in time you go. Jamie Mai talked about this in HFMW:

> *Option math works a lot better over short intervals. Once you extend the time horizon, all sorts of exogenous variables are introduced that can throw a wrench into the option-pricing model.* ~ Jamie Mai, *Hedge Fund Market Wizards*

Market makers excel at pricing options in the 1-3 month window. And if there's a pricing error, it's almost always in favor of the option seller. No one wants to hold short options without getting handsomely compensated for it.

But in the long-term there's too much complexity. Many different scenarios and reflexive processes play out over a year's time, making it impossible to determine a "fair price." The Black-Scholes model isn't *that* good.

For this precious metal trade we're looking at options expiring around a year from today.

Gold (GLD) and silver (SLV) both have liquid ETFs with liquid options going all the way out to Jan. 2019.

We want to buy the GLD Sep 21st 2018 Straddle (Call and Put) Struck at 127 for $14.58.

SLV doesn't have a Sep 2018 expiry but the June 2018 will work just fine.

We want to buy the SLV June 29th 2018 Straddle (Call and Put) Struck at 17 for $2.84.

For the gold straddle to go "in the money" by expiry, we only need GLD to clear $141.80 on the upside and $112.04 on the downside.

Remember, we have an *entire year* for this to happen. And if any of the potential catalysts we discussed come to fruition, we'll see GLD clear these boundaries by year end.

SLV needs to clear $19.83 on the upside and $14.14 on the downside by June of next year for the option straddle to show a profit.

Silver will likely follow a similar path to gold. If one wins, we expect the other to win as well.

Summary:

- **The macro outlook for precious metals is complex and muddled**
- **Options on gold and silver are cheap with low implied volatility**
- **Gold and silver are at key technical inflection points**
- **This sets up the perfect opportunity to buy a straddle on GLD and SLV**
- **We're looking at the Sep 2018 straddle in GLD and the June 2018 straddle in SLV**

Equity Updates

Here's a quick update on some of our current positions and past MIR Equity Picks.

In [last month's MIR](https://macro-ops.com) we noted the accelerating levels of planned and actual fixed investment. Because of this, we were looking at industrial metals and related stocks, noting how the price action in Bloomberg's Industrial Metals Index was forming a bullish wedge.

Our timing happened to be spot on. The index jumped roughly 14% in the month since our report was published.

We referenced three related stocks we thought would benefit from the turnaround in miners. Since then, two have run up and one has moved lower. Our favorite of the three, CLF, has gained approximately 13%.

Interactive Brokers (IBKR), last month's equity write up, is currently trading a few hundred basis points above our entry. It's now consolidating for what he hope to be another leg higher.

We hold a sizable position in the stock and believe it has the potential to be a long-term compounding machine.

In our July MIR, [Dead Pigs Aren't Afraid of Boiling Water](), we discussed the probability of a coming China rebound. We were looking at buying China A-shares (ASHR) on the breakout of its long-term bottoming wedge.

This trade is currently up over 10% in the last two months. It's still one of our largest holdings.

We expect it to continue to do well as long as the dollar remains weak and the Chinese government stays loose with its fiscal policy. This is likely to be the case at least until their all-important November Congress concludes.

In the same July MIR, our micro section was centered on casino operator MGM Grand (MGM).

The stock has since climbed over 10%, though it's been a bumpy path.

We don't currently have a position in the stock but continue to track the sector closely. It should do well as long as the China reflation trade remains alive.

In our [June MIR]() we reviewed Hudson Technologies (HDSN).

The company is remains a compelling value case. We added to our position two weeks ago. We believe there's still plenty of upside to the trade (30%+) and we'll look to add on opportunistic technical setups.

GAIA Inc. (GAIA) was covered in our [March report](). The stock currently trades 30% above our original entry price and has climbed as high as 60% since our recommendation.

We've pyramided onto this trade as it's moved higher. It's one of our largest portfolio holdings.

The company is run by one of the best CEOs in the business and we believe it has a long runway for growth. We plan to sit on this one for a while.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BATS:GAIA, D 11.05 ▲ +0.10 (+0.91%) O:11.00 H:11.05 L:10.85 C:11.05
GAIA INC NEW, D, BATS
5.01 (59.15%) 501
2.67 (31.49%) 267
GAIA, D
GAIA INC NEW
March 6th MIR published
Vol (10)
Mar
16
Apr
May
16
Jun
16
Jul
Aug
16
Sep
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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			
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	