The Curve of Destiny

Operators,

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

We start off discussing the huge tectonic shift in the macro sphere that practically nobody is talking about…

It'll have an enormous impact on markets over the coming decade. (Hint: Demographics + Wealth = Economic and Market Destiny.) We explain how this shift will affect prices and how to position for it.

In This Issue:

Our Deep Dive for this month covers one of the most hated sectors in global markets, agriculture, which we believe is set to rise with our long oil theme.

And then we take a look at the cheapest volatility trade in the market.

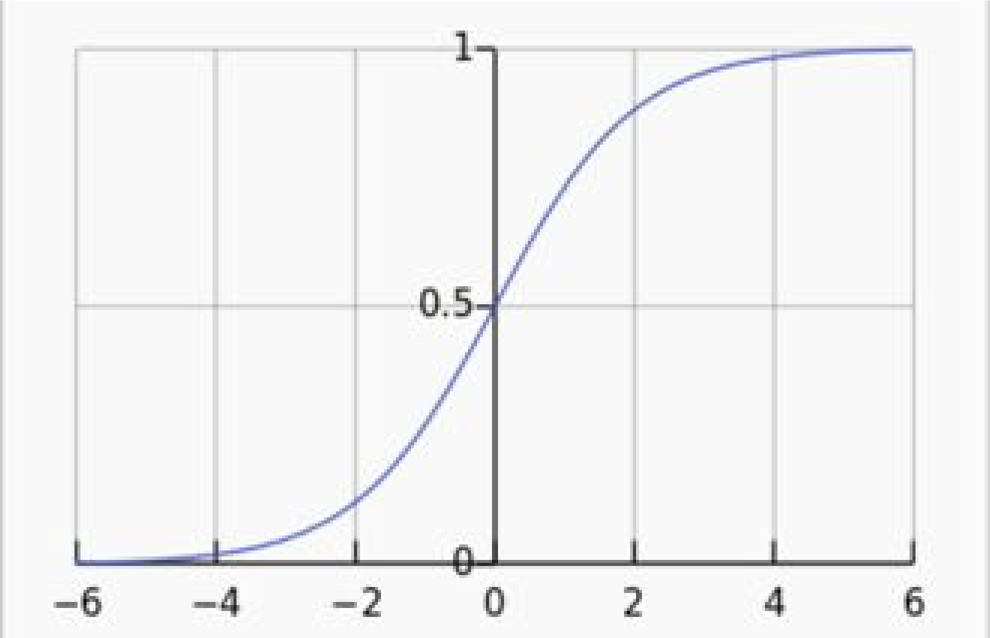
I hope you enjoy it and I'm excited to hear your thoughts.

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

Your Macro Operator,

Alex

Macro: The Curve of Destiny



Standard logistic sigmoid function i.e. $k = 1, x_0 = 0$

The graph above shows a logistic function that maps out a sigmoid curve… otherwise known as an S-curve.

This function was popularized by mid-19th century scientist Pierre Francois Verhulst who applied it in his study of population growth.

Verhulst found that population growth follows a certain S-curve. It grows at a steady state until it hits a certain point where it grows exponentially. This exponential growth sustains until the system hits a saturation point where it slows and eventually stops.

The S-curve is one of those strange universal laws that shows up all over the place. Similar to how power laws, as put forth by Pareto, dominate nature and the law of entropy permeates the universe, so to does the S-curve show up time after time in natural systems.

The S-curve has been successfully used in projecting growth in new technology adoption (we used it to analyze Apple's business and iphone adoption rates), to biological systems, nonlinear geoscience relationships, economics, demography and the list goes on.

You're probably wondering why I'm talking about some 19th century Belgian scientist, logistic functions, S-curves… and all this jazz.

Fair question.

Here's the reason:

The S-curve lies at the foundation of what I think will be one of the largest macroeconomic forces driving markets over the next decade.

We're about to begin seeing its effects very soon.

Put simply, **THIS WILL BE BIG.**

Let me explain.

French philosopher Auguste Comte, rightly said that "demography is destiny".

He was referring to national power. But, if you take demography and combine it with rising wealth, then you have economic and market destiny as well.

The IMF wrote recently that, "History has shown that as countries become richer, their commodity consumption rises at an increasing rate before eventually stabilizing at much higher levels."

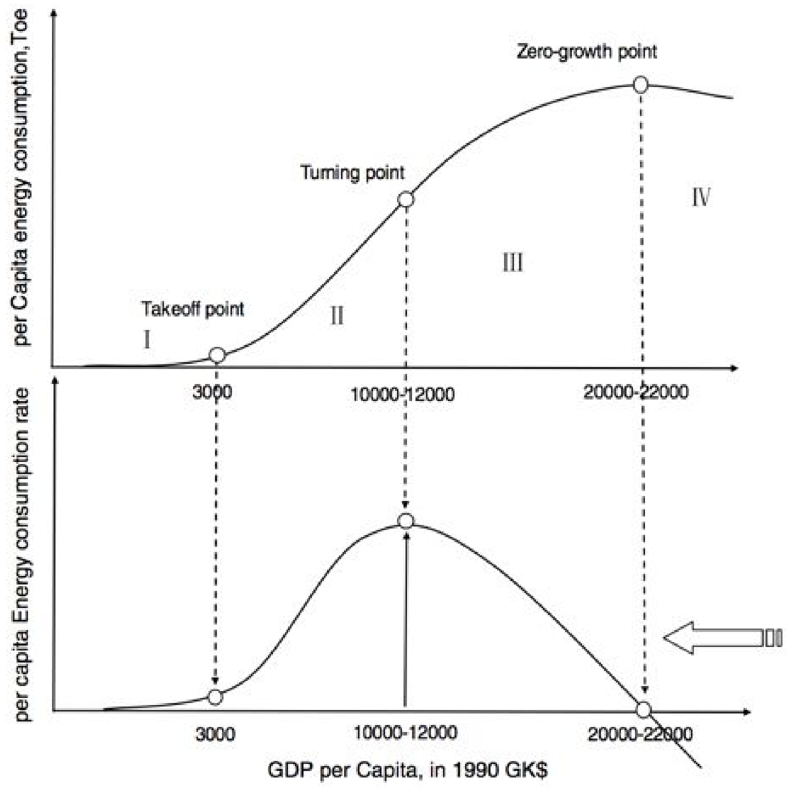
The more wealth people have, the more nonessential goods people buy, and the more commodities they consume.

There's a very interesting and well documented relationship between rising GDP (as noted by GDP per capita) and commodity intensive consumption. In other words, once a country hits a certain level of GDP per capita (ie, wealth) they begin to consume a lot more oil, gas, wheat, copper, livestock etc… This consumption grows exponentially.

Can you guess what type of shape this gdp/commodity consumption relationship takes?

That's right, an **S-curve**.

The chart below shows the S-curve (on top) and per capita energy consumption on the bottom.



When a country's GDP per capita hits the 'Tipping point', energy consumption begins to rise at an exponential rate.

The same S-curve dynamics occur in agricultural consumption too.

Once a country passes the GDP per capita tipping point, they begin to eat significantly more protein.

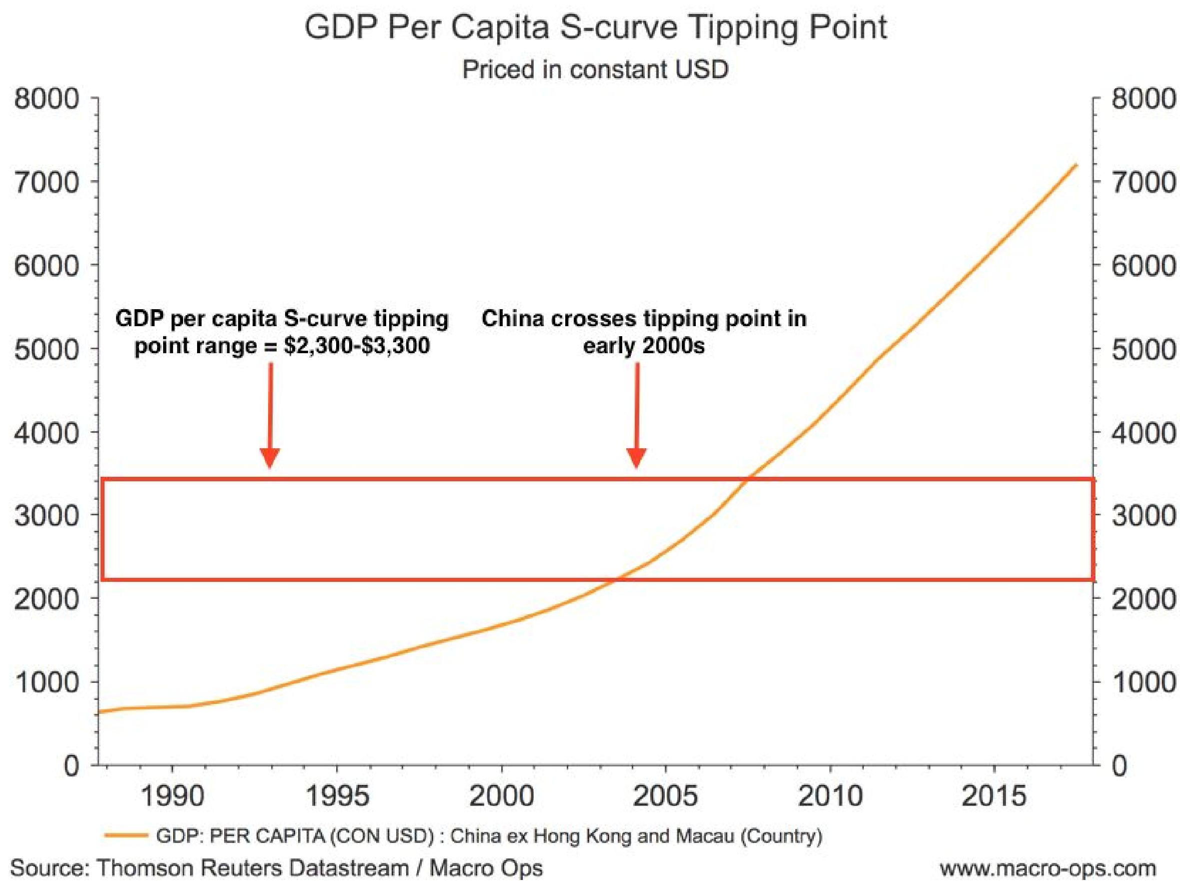
Raising livestock is over <u>seven times</u> more grain-intensive than producing for a simple plant based diet. The resulting impact on the agriculture sector is significant.

Keeping track of where the world's population sits on the GDP per capita S-curve, or let's call it the wealth S-curve, is important.

If a large portion of the global population is transitioning from the turning point to the zero-growth point (refer to the chart above), or tipping point to turning point, it would have far reaching impacts on not just commodities but global markets as a whole.

For example, one of the largest drivers of the last secular commodity bull market which started in the early 2000s and ended in 2011 was the rise of China.

China, the most populous country in the world with 1.4 billion people, crossed the tipping point of the wealth S-curve in around the early 2000s.



From research we know the tipping point on the wealth S-curve that signals more intensive commodity consumption is in the range of $2,300 to $3,300.

Once a country crosses this point its commodity consumption begins to rise exponentially over the following decades.

Goehring & Rozencwajg Associates (GRA), a commodity fund, explained in their latest quarterly letter how this commodity intensive growth works. Excerpt below:

> *The average Chinese citizen in 2001 consumed 1.4 barrels of oil over the course of the full year. Total vehicle sales in 2001 averaged 2.2 vehicles per thousand Chinese citizens, while the airlines carried approximately 57 out of every thousand Chinese*

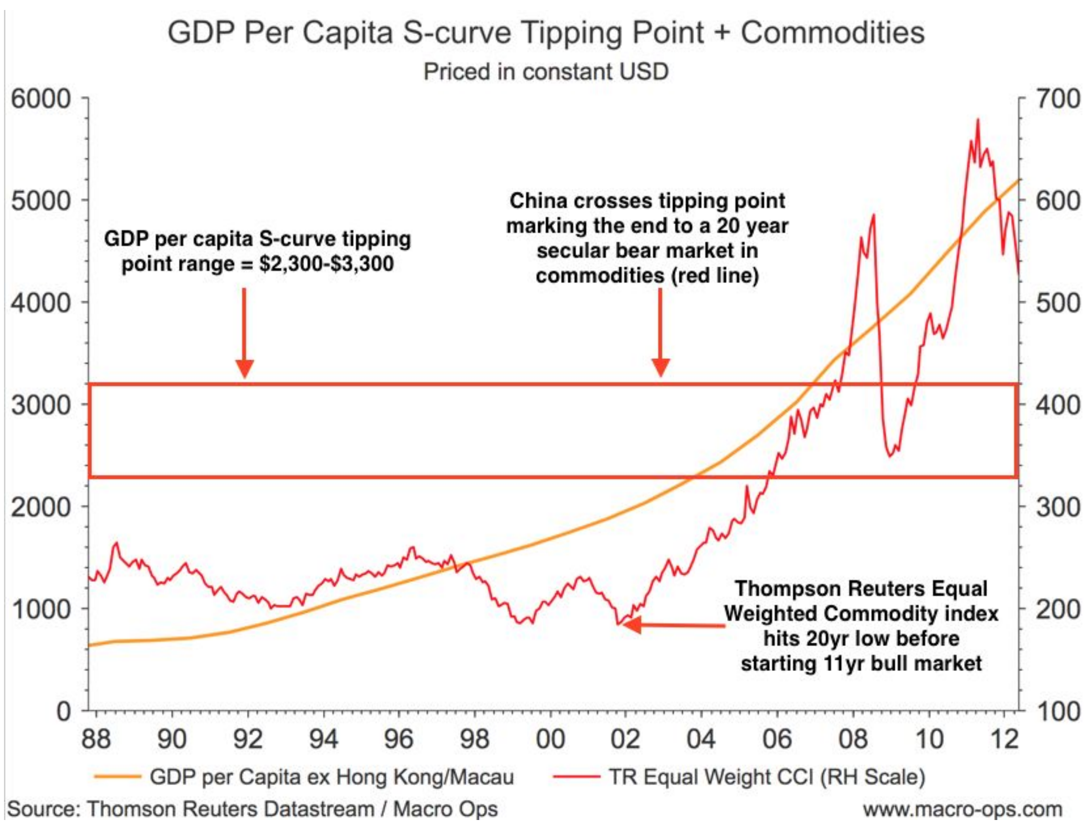
citizens. In many respects, 2001 was a typical year for Chinese per capita oil demand growth: it grew by 0.02 barrels per person that year, very much in line with the average rate it had grown over the prior 25 years of 0.03 barrels per person per year.

But shortly after it hit its "tipping point" in the S-curve….

The average Chinese citizen consumed 2.2 barrels of oil over the course of the year. Instead of two vehicles being sold per thousand citizens, by 2008 this figure reached nearly nine vehicles. Similarly, total passengers carried by airlines increased from 57 per 1,000 Chinese citizens to nearly 100. Before most analysts realized what had happened, Chinese oil demand growth had quadrupled from 0.03 barrels per person per year to 0.12 barrels per person per year in only seven years.

We can see the S-curve dynamic play out on the chart below.

A 20-year bear market in the Thomson Reuters equal weighted commodity index bottomed in 02' and began a 11 year secular bull market right as China and its billion plus people crossed the tipping point.



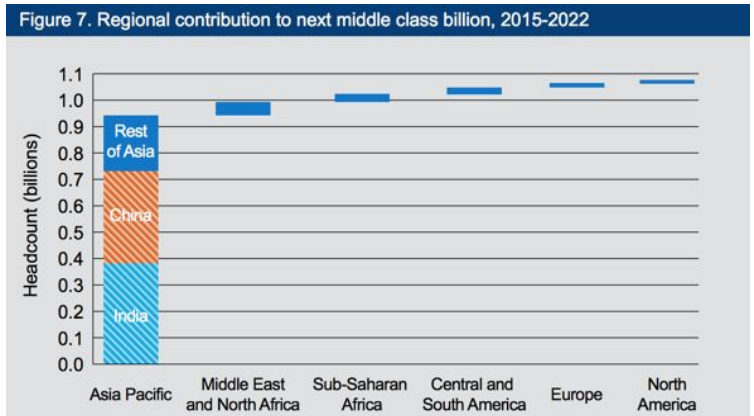
If you bought the commodity index in 2000, right as the tech bubble was bursting, you would have compounded your money at over 20% annually over the following decade.

Wealth + demographics = market and economic destiny.

Now that you know the massive impact shifting populations along this curve can have on global markets, here are some excerpts from a recent — and widely unnoticed — research paper put out by the Brookings Institute. It's titled *The Unprecedented Expansion of the Global Middle Class (emphasis mine)*.

> *There were about 3.2 billion people in the middle class at the end of 2016. This implies that in two to three years there might be a tipping point where a majority of the world's population, for the first time ever, will live in middle-class or rich households.*
>
> ***The rate of increase of the middle class, in absolute numbers, is approaching its all-time peak.*** *Already, about 140 million are joining the middle class annually and this number could rise to 170 million in five years' time.*
>
> *An overwhelming majority of new entrants into the middle class—by my calculations 88 percent of the next billion—will live in Asia.*
>
> *The implications are stark.* ***By 2022, the middle class could be consuming about $10 trillion more than in 2016;*** *$8 trillion of this incremental spending will be in Asia.*
>
> *By 2030, global middle-class consumption could be* *$29 trillion more than in 2015**. Only $1 trillion of that will come from more spending in advanced economies.* ***Today's lower middle-income countries, including India, Indonesia, and Vietnam, will have middle-class markets that are $15 trillion bigger than today.***
>
> ***We are witnessing the most rapid expansion of the middle class, at a global level, that the world has ever seen. And, as Figure 7 makes clear, the vast majority— almost 90 percent—of the next billion entrants into the global middle class will be in Asia: 380 million Indians, 350 million Chinese, and 210 million other Asians.***

Figure 7. Regional contribution to next middle class billion, 2015-2022

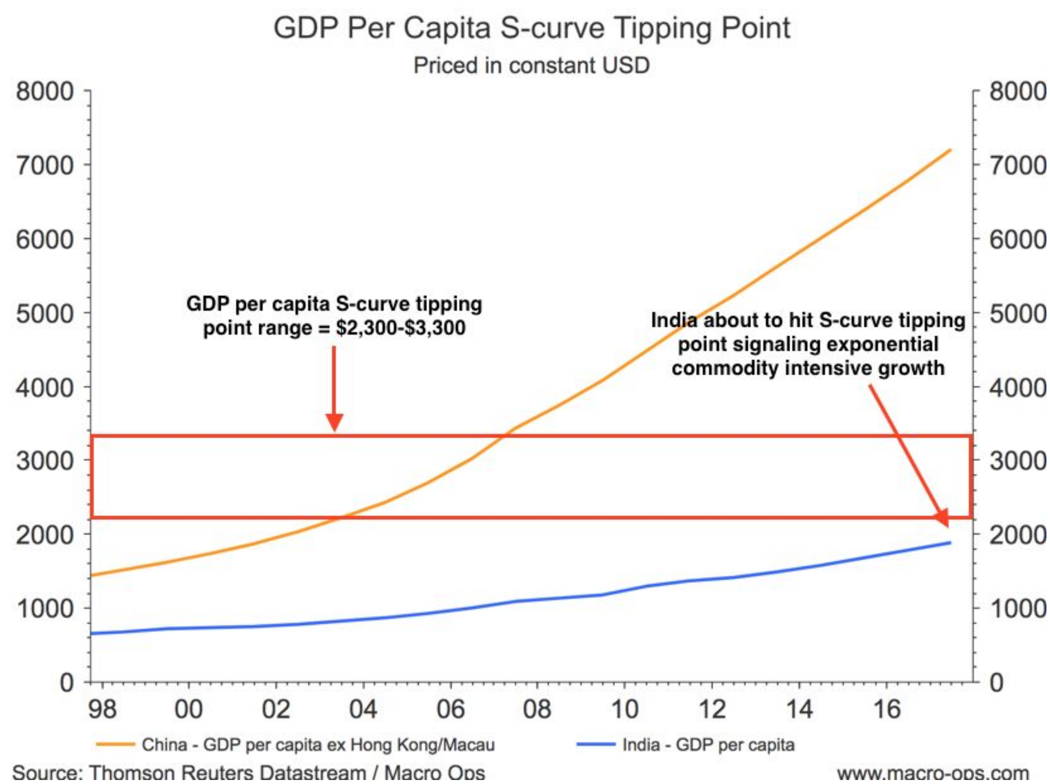


Source: Author's calculations

Brooking's definition of global middle class income is approximately the same as our wealth S-curve tipping point. And as the chart above shows…

The new S-curve driver of this commodity intensive growth trend is going to be India.

India is nearing the tipping point on the wealth S-curve. It's GDP per capita is exactly where China's was in 2001, right before the last commodity bull market began. India has a population of over 1.3 billion people. Just 60 million shy of China's.

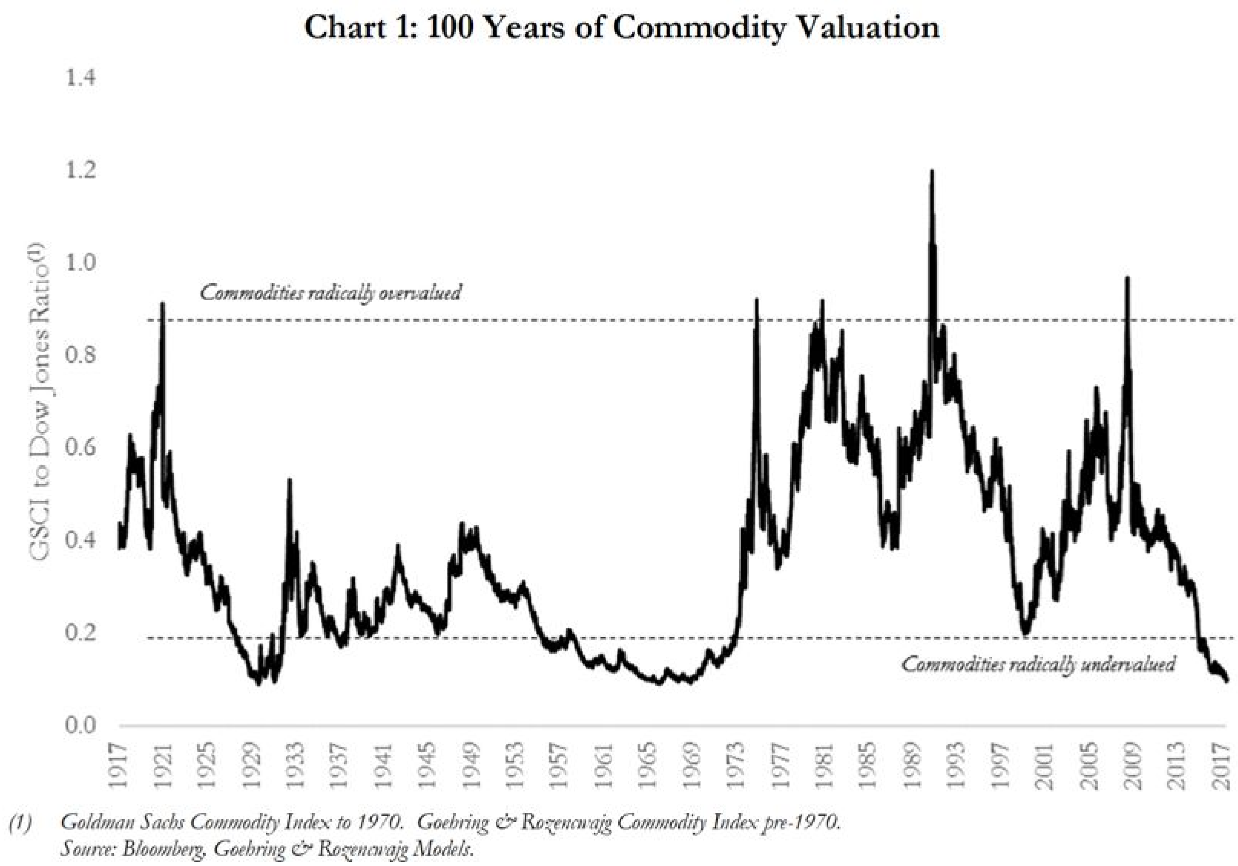


GRA also shared the following in its quarterly letter (emphasis mine).

> *From 1970 to 2000, the average number of people going through the S-Curve tipping point globally was relatively stable at approximately 700 million.* ***If we are correct, then we are on the verge of having four billion people globally all going through the S-Curve tipping point together. Simply put, we are potentially entering the largest period of commodity demand growth the global economy has ever experienced.***

And as we're about to enter the **largest period of commodity demand growth the global economy has ever experienced**, how exactly are commodities fairing?

Commodities have only been priced this low, relative to financial assets (as represented by the Dow), two other times in the last 100 years.



This is one of those things that makes you go "hmm…."

Right?

The market is clearly not seeing the forest from the trees in the commodity market and it's about to be caught offsides.

And remember our discussion from last month's *MIR* about how we're in the third phase of the *Investment Clock* cycle, otherwise known as the overheat phase, where commodities are the best performing asset?

Here's a quick refresher from that report.

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")

> ***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 and cyclical value the best equity sector.***

We have MASSIVE secular tailwinds lining up with third phase drivers plus commodities at 100-year lows relative to the stock market.

Am I missing anything?

Oh, yeah, there's sentiment. It's negative…

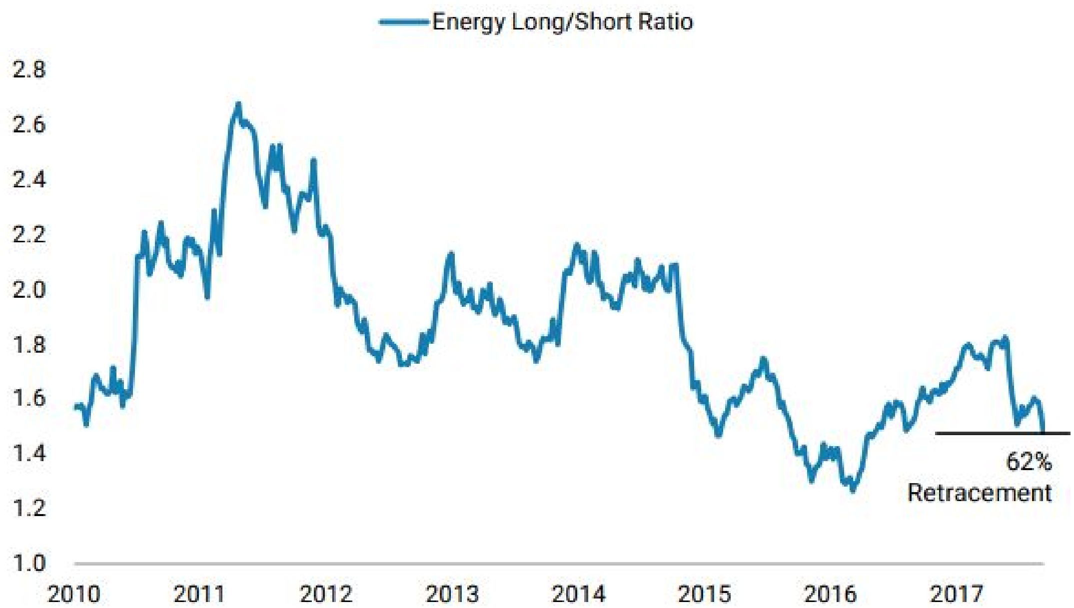
Not surprising given the horrid price action in commodities over the last five years. The BofA fund manager survey has hedge funds holding very low levels of commodities relative to historical positioning.

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

Source: BofA Merrill Lynch Global Fund Manager Survey

Morgan Stanley recently shared that the long/short equity managers they broker for have rarely had lower exposure to energy stocks than they do now. And the ratio of longs to shorts is in the bottom decile of the past seven years!

Exhibit 9: Long/Short Exposure to Energy Is Very Low



Source: Morgan Stanley Prime Brokerage as of September 8, 2017.

As a contrarian, I love situations like this.

Finding and executing great trades is about peeling back the curtains of time and peering into the future and putting the pieces of the puzzle together better and faster than the market.

This is one of those times, where the market's narrative has been carried to an extreme and is based off a past that's no longer relevant and differs completely from the coming future.

Famed investor and former Soros compatriot, Jim Rogers, said the key to his success was that he "waits until there's money lying in the corner, and then all I have to do is go over there and pick it up."

Well, right now, I see a big pile of commodity backed money lying over in the corner. And all we have to do is start picking it up!

We did this last month, by initiating our long position with an energy basket. In that report we recommended RIG, CRR, and COG. We bought those and also threw in WTI and ESV which our Collective members were notified of.

The basket is off to a good start. **Since the MIR's publication RIG's up 27%, CRR +18%, COG +0.5%, ESV +30%, and WTI +57% (climbing as high as 90% at one point).**

We believe, for the reasons stated above, that this is just the start of the run in the commodity market.

We expect a lot of up and down action in our holdings. This is usual at the start of a new bull market. But we'll hold through the volatility, while respecting our risk points of course. And we'll look to build on our energy plays as well as other commodities we're stalking and which I will talk to you about next.

Summary:

- **The S-curve lies at the foundation of one of the largest macroeconomic forces driving markets over the next decade.**
- **When a country's GDP per capita hits the 'Tipping point' on the S-curve, commodity consumption begins to rise at an exponential rate.**
- **The new S-curve driver of this commodity intensive growth trend is going to be India.**
- **We have MASSIVE secular tailwinds lining up with third phase drivers *(Investment Clock)* plus commodities at 100-year lows relative to the stock market. This will propel a commodity bull market forward.**

Micro: Agricultural Boom & Bust

FACT SHEETS | APRIL 13, 2017

A Looming Crisis on American Farms

by ALICIA HARVIE

Trouble on American Farms: 'We Face a Grim Future'

Mark Koba | @MarkKobaCNBC
Published 10:16 AM ET Mon, 20 May 2013 | Updated 12:21 PM ET Mon, 20 May 2013
CNBC

Google agricultural bust and you'll find article after article with titles like the ones above… all published over the last six years.

Since the last great agriculture boom peaked in 2011, ags, like the rest of the commodities, haven't been able to find a bid.

To those familiar with the capital cycle and how it works ([we've written about it extensively](#)), the farming bust was easy to see coming.

The boom that started in the early 2000s, and which was primarily driven by China crossing the tipping point of the wealth S-curve, drove up prices across the entire agricultural space to new record highs.

High prices led to more competition and more investment. As a result more farmland was cleared and planted.

Just as night follows day, this led to a big increase in farming capacity and more crop (supply) coming to market.

Supply eventually outpaced demand and prices collapsed. And that's how we got to today's drawn out bear market in ags.

It’s a classic boom and bust cycle which farmers have weathered as long as tilling the land for food has existed. I bet 9,000 years ago the farmers of Jericho were dealing with the cyclic rise and fall in the bartering value of their crops.

The six year bear market in ags has been tough medicine to swallow for those in the business. Across the world, marginal high cost producers have been shuttering their doors, unable to keep operations going in this low price market.

The *WSJ* recently noted that “U.S. wheat exports last season were the lowest in almost a half-century”.

Anecdotally, a good friend of mine who lives in the heart of the bread basket, tells me that a number of her farmer friends have sold off their land for commercial development.

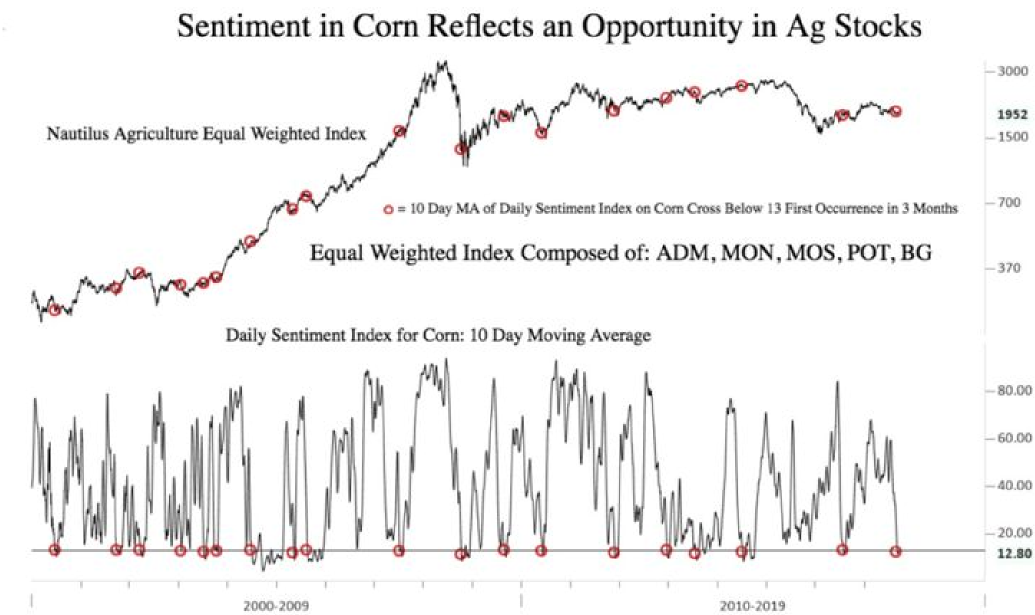
Land once used to produce wheat and sugar will now house “luxury” condos and strip malls. They simply couldn’t afford to stay in business. That story has been playing out all over the country.

Even agriculture focused trading firms are calling it quits, with their tired traders moving onto markets where a bid exists...

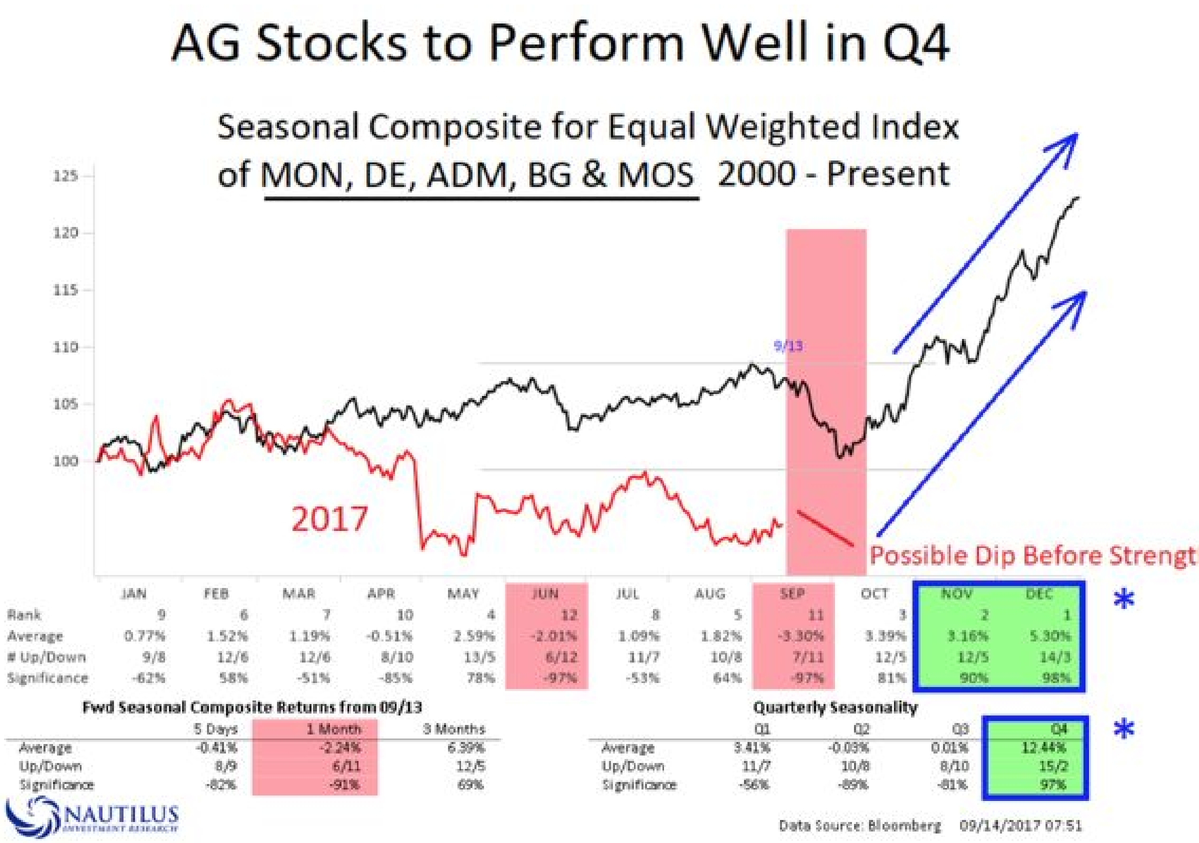
A mass exodus from the ag business is what the bottom of the capital cycle looks like.

Ags are a beaten down sector of the market where sentiment doesn’t reflect the improving future supply/demand landscape.

The chart below *via Nautilus* shows that the Daily Sentiment Index (DSI) is at rock bottom. This is a point that, in the past, has marked a fantastic buying opportunity more times than not.



We are also moving into a period of great seasonality for agricultural stocks. The chart below, again *via Nautilus*, shows how ags tend to dip into mid-October before going on a strong run into the end of the year.



	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC
Rank	9	6	7	10	4	12	8	5	11	3	2	1
Average	0.77%	1.52%	1.19%	-0.51%	2.59%	-2.01%	1.09%	1.82%	-3.30%	3.39%	3.16%	5.30%
# Up/Down	9/8	12/6	12/6	8/10	13/5	6/12	11/7	10/8	7/11	12/5	12/5	14/3
Significance	-62%	58%	-51%	-85%	78%	-97%	-53%	64%	-97%	81%	90%	98%

Fwd Seasonal Composite Returns from 09/13

	5 Days	1 Month	3 Months
Average	-0.41%	-2.24%	6.39%
Up/Down	8/9	6/11	12/5
Significance	-82%	-91%	69%

Quarterly Seasonality

	Q1	Q2	Q3	Q4
Average	3.41%	-0.03%	0.01%	12.44%
Up/Down	11/7	10/8	8/10	15/2
Significance	-56%	-89%	-81%	97%

A strong bull move like this would certainly catch a lot of traders off guard. Trading legend Bruce Kovner would say, and I paraphrase, "look for where the market can hurt the most people and that will typically be a great trade."

Long-time readers of our work know that we like to buy when an opportunity has multiple tailwinds. We also look for a long runway; meaning there's potential to sit on it and let it work for a long time.

We believe buying ag related equities is one of these multiple tailwind opportunities. Let's run down the list:

- **India is passing the tipping point of the wealth S-curve which is bringing the most rapid expansion of the middle class the world has ever seen. This will drive commodity markets over the coming decade.**
- **Cyclically, markets are entering the overheat phase where the GDP gap is tight and both growth and inflation pick up. Commodities are the best performing assets during this phase.**
- **The capital cycle in commodities, and agriculture in particular, looks to have bottomed. This means that low crop prices have knocked off CAPEX which will lead to lower future supplies in the years ahead (at the sametime as future demand grows dramatically).**
- **Crop yields shattered records this last year. Growing conditions (ie, weather) were nothing short of perfect. This is baked into the price now and it's tough to beat "perfect" going forward.**
- **This is a kicker: China has formally announced plans to implement a nationwide 10% ethanol fuel mix by 2020. That's a lot of corn that will be taken off the market and used to make fuel instead of food.**
- **Finally, it's an unloved asset. A lot of investors have been burned trying to call the bottom over the last five years and this is why prices are so depressed. Their despair is now our opportunity. With the positive seasonal kicker going into the end of the year, now seems like a good a time as any to dip our toes in.**

We'll play this like we did our energy trade. By that I mean we're going to spread our bet across a basket of promising ag stocks. In classic Peter Lynch style, we'll cut the laggards and add to the winners as we go.

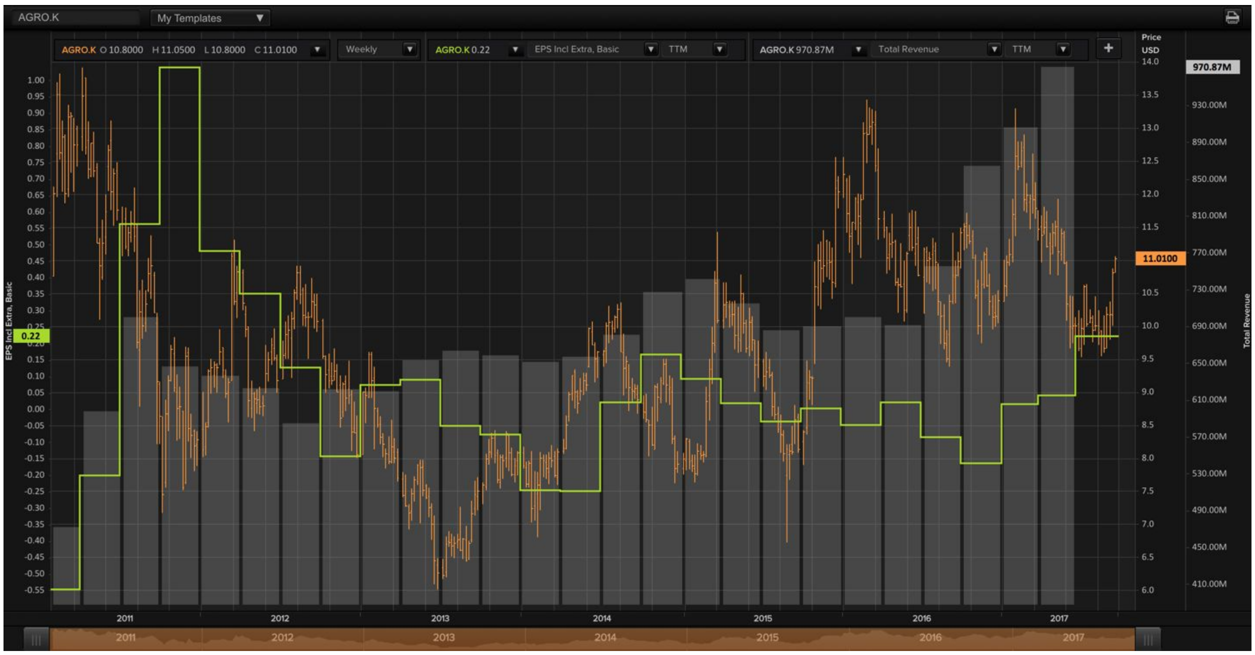
The key will be to start with modest position sizes and wide stops for each.

Large turnaround plays like this tend to be volatile. We want to start small, wait for the market to confirm our thesis (in the form of higher trending prices), and then build on our winners over time.

Here's the basket of three ag stocks we'll be putting on our books.

Adecoagro S.A. (AGRO)

Orange bars = price, Grey columns = TTM revenue, Green line = TTM EPS



AGRO is an agriculture holding company domiciled in Luxembourg but with the majority of its operating assets in South America.

It's diversified across the entire ag space and offers a great vehicle for a recovery in soft commodity prices.

The company farms sugar, soybeans, corn, wheat, and rice. It also has a large dairy operation as well as an ethanol and land transformation business.

The company owns approximately 256,130 hectares, consisting of over 20 farms in Argentina and 10 in Brazil, including a smaller operation in Uruguay.

AGRO has smart and experienced management that's driven to maintain the company's position as the lowest cost agricultural producer globally. This is why they've managed the bear market so well.

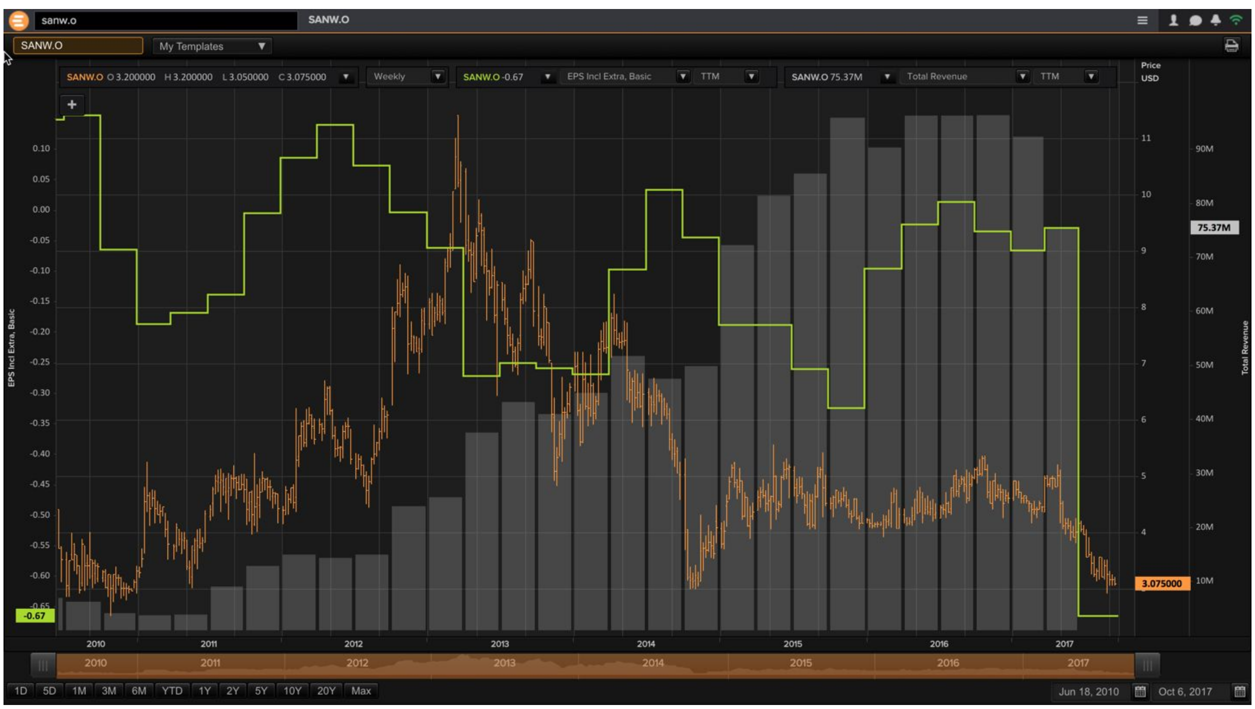
It has a strong balance sheet with little debt and the stock currently trades at just 4x free cash flow and 1.3x revenues which are at TTM all-time highs.

Technically, the stock looks like it put in a bottom and recently closed above its 200-day moving average.

If we're correct in our bullish commodity thesis, then AGRO is well positioned to ride the wave and at minimum double in price.

S&W Seed Company (SANW)

Orange bars = price, Grey columns = TTM revenue, Green line = TTM EPS



SANW is a global agricultural company that focuses on the breeding, production, and sale of specialty seeds such as alfalfa, a hybrid sorghum, and sunflower germplasm.

The stock chart above looks like it's imitating a Jamaican cliff diver with TTM revenues falling over 20% this year and earnings digging a hole and jumping in for cover.

But this isn't because of a systemic problem with the company or its product. Rather, it's due to unforeseen regulations surrounding water use restrictions in Saudi Arabia, which is a big distribution hub for the company's alfalfa seed market.

The issue is currently being worked out and the deferred 2017 shipments that cost SANW revenues are supposed to ship early next year. This will give the company a nice YoY boost to both its top and bottom line once things are resolved and business gets back to normal.

The real reason we like this play is that the company just brought on a new CEO, Mark Wong.

Wong is a serial entrepreneur and 40 year veteran of the agriculture business. He's founded and built several successful seed companies which were then sold off to the likes of Monsanto and Syngenta. Here's a short bio of his accomplishments in Wong's own words, from the company's latest earnings call.

> *For those of you who may not be familiar, I have spent the last 40 years of my career in agriculture. I have developed multiple seed companies which have been sold to the likes of Monsanto and Syngenta. My first company was Agrigenetics, one of the first three founding companies to transform plants in the biotechnology industry with a focus on corn, sorghum in silage and soybeans. Agrigenetics was sold to Lubrizol Corporation for $150 million in 1985. Agrigenetics later was sold to like to Mycogen Seeds and thereafter became part of Dow Chemical.*
>
> *Next I developed and commercialized key technologies with the integration of value added genes into soybeans and other crops for Agracetus. Agracetus was purchased by Monsanto for $250 million in 1992. Then I saw a tremendous opportunity in the agricultural market, international markets and created Emergent Genetics. At Emergent, we operated multiple international seed companies integrating technology into the company seed lines. Emergent Genetics achieved the world's second largest market share of cotton seed and was sold to Monsanto for $325 million in 2005 with a separate vegetable component of our business later sold for $50 million to Syngenta in 2006.*
>
> *Also, I am currently Chairman of American Dairyco, one of the 20 largest dairies in the United States. My previous success in the seed industry has been based on leveraging core assets through the integration of technology and having a more customer centric strategy. Specifically, creating more effective products using a lead germplasm in genes, I see a tremendous opportunity to leverage S&W's existing businesses through the introduction of new traits as well as robust customer support and marketing to enhance S&W's market share going forward.*

That's an impressive resume.

Even though this is a macro trade where company specifics are less important of a driver, it makes things all the better when we can find a standalone value play that fits the macro framework. And since leadership is such a big differentiator between average and great businesses, it pays to take notice when an experienced visionary like Wong takes over a company that's selling on the cheap. For that reason, we really like the long-term prospects of SANW.

Wong says he'll be focusing on unlocking value in the company's three Stevia patents (Stevia is a natural healthy sugar replacement that's gaining in popularity), which he thinks have a lot of potential. If he's successful, there's no reason to doubt that he won't be selling another company to one of the big AgTechs in a few years for a hefty premium.

The company will be doing an issue in the next 1-2 months in order to recap its balance sheet and fund its working capital needs. We don't have guidance on the size or exact timing yet. We'll wait until after the announcement to build into a larger long position.

Intrepid Potash (IPI)

If you've been with us for a while then you should be very familiar with IPI. **It's a low cost and sole US based producer of Potash, which is a fertilizer.**

We first recommended this stock back in November of last year and it has since shot up over 220+%. It's still grossly undervalued.

If the grain market rebounds, like we believe it will, then IPI will be a $12+ stock.

Like we've written in the past, **IPI has the added benefit of being a secret water play that will benefit from a rebounding energy sector.**

The company has the largest private water rights in the state of New Mexico. It sells this water to the frackers in the Permian basin right next door.

The company expects to bring in over $30M next year on just these water sales alone. This is an extremely high margined revenue stream and should put the company back in the black middle of next year, regardless of a rebound in ags.

We plan to continue building this position on viable technical setups through the end of the year.

And another option is to diversify your potash play amongst IPI, POT, and MOS. All of which should perform well in a rebounding Ag market and have recently put in technical bottoms.

Summary:

- **Supply in the agricultural market eventually outpaced demand and prices collapsed.**
- **Current market sentiment isn't reflecting the improving future supply/demand landscape.**
- **There are multiple tailwinds to the coming ag bull market:**
    - **India's tipping point of the wealth S-curve**
    - **The overheat phase which favors commodities.**
    - **A bottom in the commodity capital cycle.**
    - **China moving to a nationwide 10% ethanol fuel mix by 2020.**
- **Our 3 ag equity plays on this theme are:**
    - **<u>Adecoagro S.A. (AGRO)</u> — Diversified across the entire ag space and offers a great vehicle for a recovery in soft commodity prices. Should at minimum double in price.**
    - **<u>S&W Seed Company (SANW)</u> — Effective CEO in newcomer Mark Wong that makes this stock not only a macro play, but a value micro play as well.**
    - **<u>Intrepid Potash (IPI)</u> — A low cost and sole US based producer of Potash with a secrete water play kicker.**

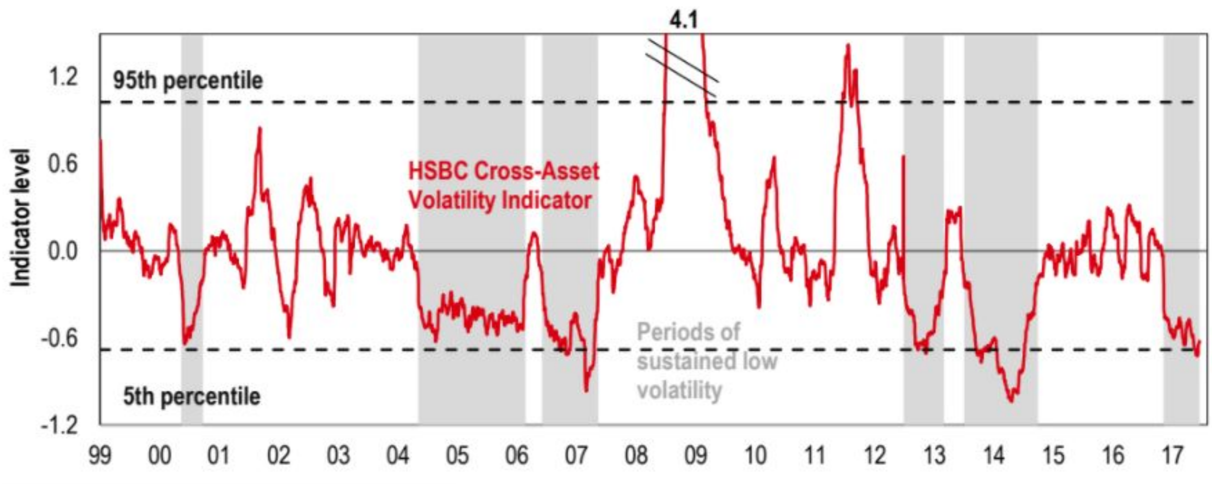
Quant: Bond Vol

Bond Vol Is The Next Best Bet

Back in the beginning of September we thought the U.S. debt ceiling deadline would finally bring back a bout of volatility to financial markets.

But Trump pulled a fast one and struck a short-term deal with the Dems to push that decision back to early December. This surprise agreement gave the market the green light to sell vol into oblivion….

Cross-asset volatility is now below the 5th percentile (chart below). That's low.



Source: MSCI, Bloomberg, Thomson Reuters Datastream, HSBC

Volatility isn't any more complicated than other financial assets. The same conventions apply. We want to buy it when it's cheap, and sell it when it's expensive.

The mean reversion tendencies of volatility are very clear and widely studied. So when vol reaches the 5th percentile, it's cheap and time to start buying.

In last month's MIR we explored buying cheap precious metal volatility. The metal market had all the key characteristics of a good long vol bet. Here they are again:

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**

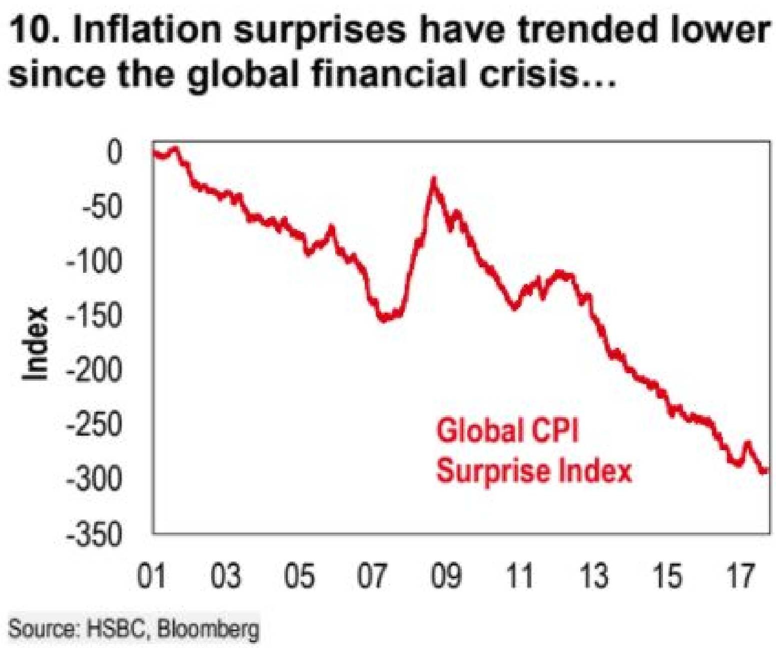
If you don't remember the details of the trade, here's the link here so you can revisit.

The exact same setup we saw in precious metals last month has now developed in the U.S. bond market.

The macro outlook for U.S. treasuries is at a critical inflection point.

One side (the majority) is convinced that we're in the middle of a "muddle through" recovery that will soon end in another deflationary downturn. They're betting on more of the same. Inflation will continue to disappoint to the downside, the Fed will remain cautious, and global recession fears will cause bonds to stay bid.

They're betting that the trend below will continue chugging along.



The other side (the minority) thinks that inflation will actually start to reverse its trend and surprise to the upside. Better than expected growth in an economy with little excess capacity is a recipe for inflation. **We're in this camp,** as we've explained in our Investment Clock framework.

Both of these camps are also trying to wrestle with the implications of QT.

The Fed will begin unwinding the **biggest monetary policy experiment of all time** this month. Everyone has taken their best guess at how this will play out, but it's incredibly hard to handicap. No one really knows the true implications of a Fed balance sheet run off.

And of course, all the major geopolitical concerns are in play as well. If "Rocket Man" keeps toeing the line then we could see a flight to safety and a strong bid for U.S. paper.

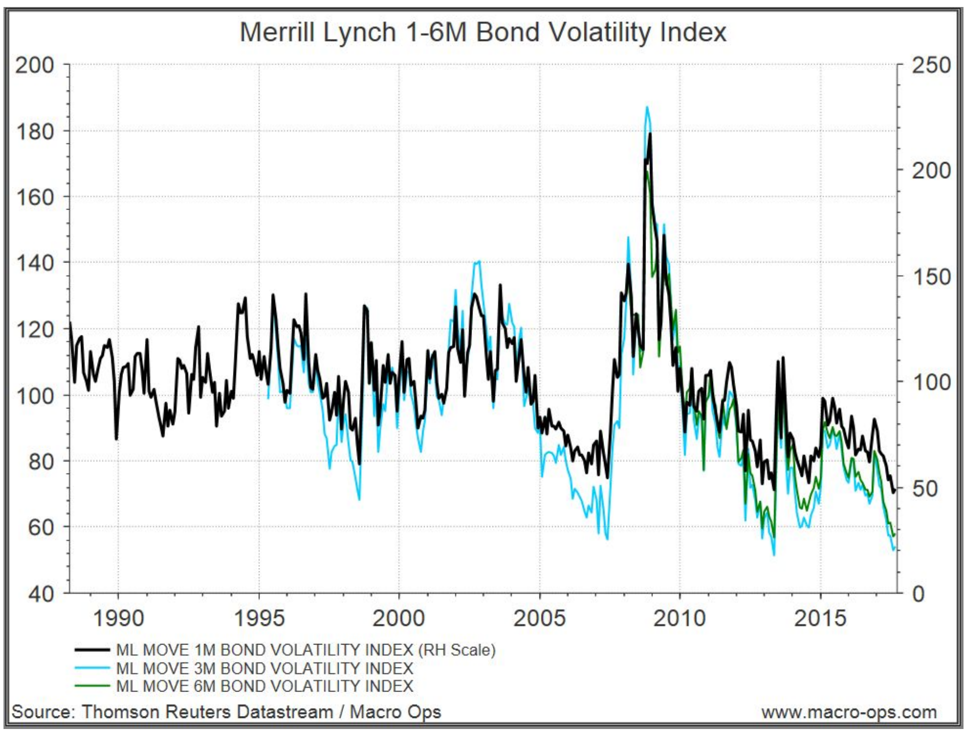
The U.S. bond market has a lot on its plate with an incredibly complex game tree. This cocktail of confusion is what we want to see when buying vol.

Next on that list is cheap implied volatility. (Note: implied vol = the market's estimation of future volatility)

Bond implied volatility has never been cheaper.

We like to track the Merrill Lynch MOVE index to get a gauge on implied vol. It's the oldest bond vol index out there so we can get a good comparison of where vol is today compared to the last 20-years.

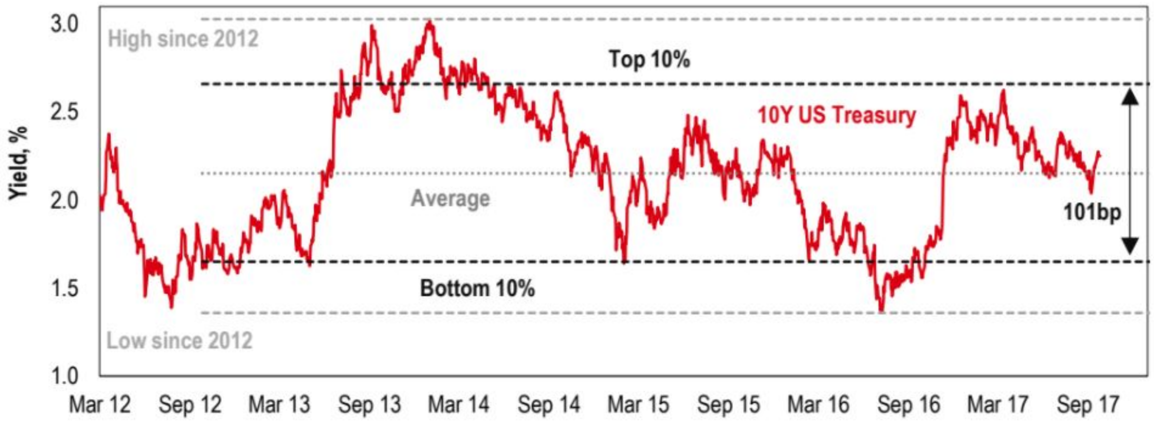
As shown in the chart below, the MOVE index has moved to its lowest levels since inception.



If you buy this chart today you're literally getting ***lifetime low prices.***

On top of low implied vol, the US 10-Yr has been in a range for over 5 years.

17. US Treasuries have been range bound since 2012



Source: Bloomberg, HSBC

A long drawn out range sows the seeds for the next large trend. This is why we always want to buy vol when prices are compressing.

All three components of a great long volatility trade are here. But finding the perfect way to express this trade is a challenge.

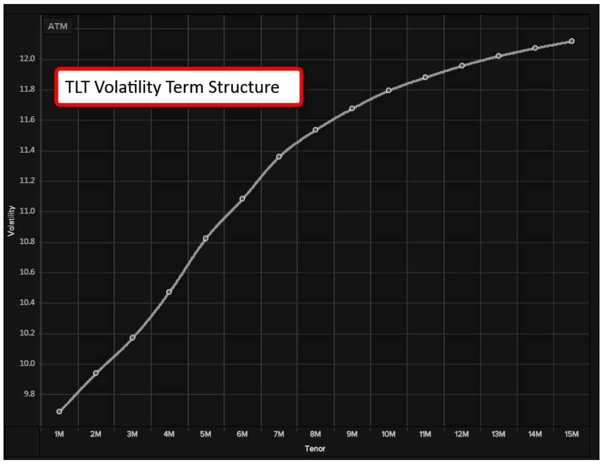
Hedge funds can make elaborate OTC option deals with their prime brokers to bet on interest rate volatility. But as small players we don't have that luxury, so we need to trade something that's on an exchange.

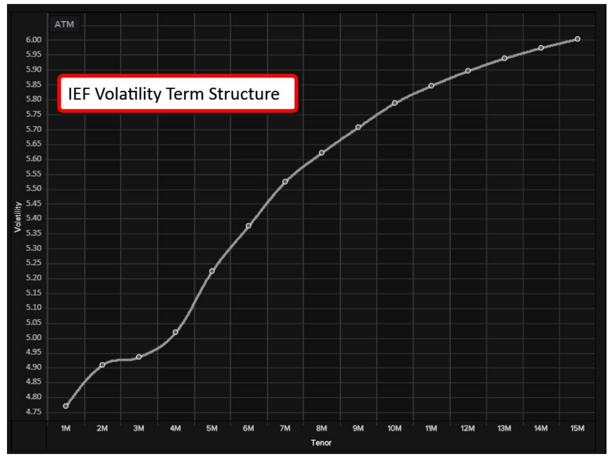
The top two candidates here are the ETF's TLT and IEF. Both have liquid option markets that have expirations into 2019.

TLT holds bonds with 20+ years to maturity, while IEF holds bonds with 7-10 years to maturity.

The target horizon for this option play is around 6-months, so I went ahead and looked at the volatility term structure of each ETF to find the best deal.

Both have upward sloping term structures which is normal. In general, the further out in time we go, the more unknowns, so traders demand more option premium to account for this uncertainty.





We want to pay the least amount of term premium possible, so the ETF with the ***flatter slope*** is what we are looking for.

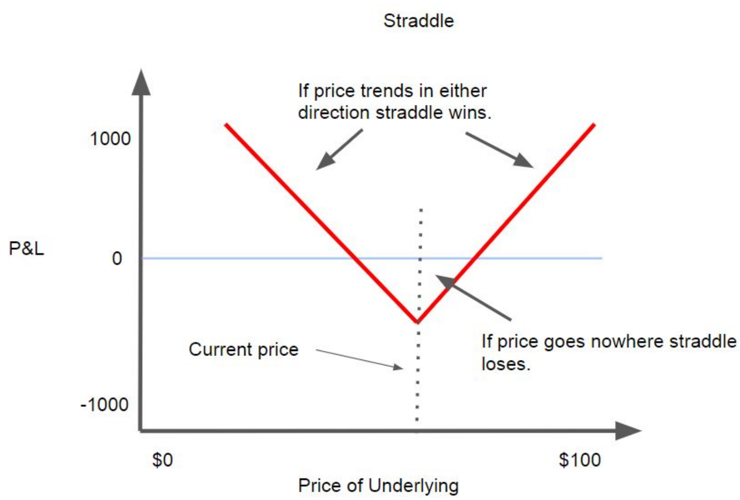
It's hard to see in the graphs, but TLT's term structure is slightly steeper than IEF's which means that **the 6-month options on IEF are the best value.**

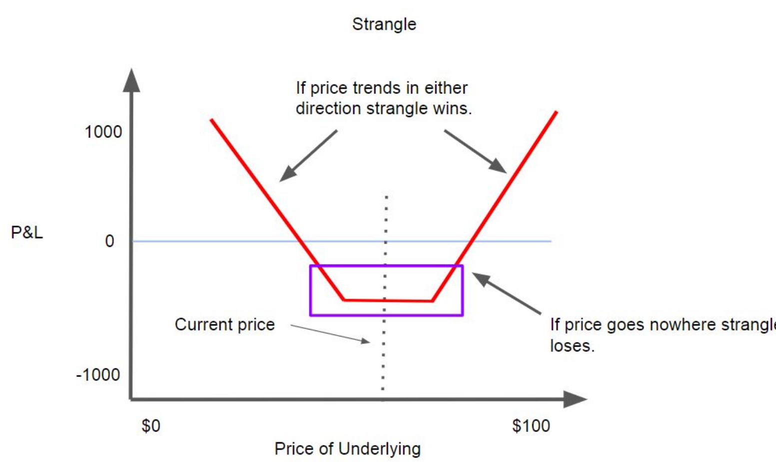
In the past we've gone long vol by purchasing the ATM straddle. That involves buying both the call and put struck at the current price of the underlying.

But for this play we want to try a strangle instead. The only change is that instead of buying two at-the-money options you buy two out-of-the-money options.

The payoff profiles are similar. Both structures win if the underlying trends far away from where it's currently trading. (Charts to the right).

The key difference is that the strangle has a higher probability of max loss. Inside of the purple box you can see an entire range that the underlying can fall into by expiration and cause this max loss.





For a straddle to lose the maximum amount the underlying must expire at exactly the same price it started — a rare occurrence.

So why trade the strangle over the straddle?

Strangles have much more convexity, which means when you do win, you win big.

On a typical straddle trade we're looking for a trend that will cause the price of the straddle to appreciate by about 50-100%. That same trend would cause a strangle to go up by almost 200%!

Strangles = higher risk and higher reward
Straddles = lower risk and lower reward

To express our view we're looking at buying the March 2018 104/109 strangle in IEF.

As of this writing the 104/109 strangle costs $1.25. That means IEF will need to exceed $110.25 to the upside or $102.75 to the downside in order for the strangle to show a profit.

Between now and then we'll have 6 data releases for inflation and another 3 FOMC meetings. If inflation surprises higher like we think it will, IEF should selloff well past our lower boundary.

And if geopolitical risks materialize, such as actual war, then IEF should push through the upper boundary.

Summary

- **Bond volatility is at all time lows.**
- **QT, N. Korea, and an upside inflation surprise all have the potential to shock the bond market.**
- **This makes a long vol trade in U.S. bonds extremely attractive.**
- **We're expressing this view by buying the March 2018 IEF 104/109 strangle.**

Equity Updates

Here's a quick rundown of what's happened with some of our favorite plays from previous MIRs.

GAIA

We've been long-term bulls on Gaia (GAIA) since discovering it back in March of this year. The stock is up about 34% since our entry and we've been sitting on this thing in size in our Strat Ops portfolio. See page 11 in the March MIR for the initial write-up of this company. The high-growth narrative we originally discussed remains intact.

FCAU

Back in May, our attention turned to European stocks that could rocket higher during the post election relief rally. Fiat Chrysler (FIAT) ended up at the top of our list. Mohnish Pabrai, the famous Buffett disciple, also had a large position in this name, which gave us even more confidence. Since we first wrote about this pick it has skyrocketed over 50%. **Pabrai still has an eye-popping 34.45% of his portfolio in this stock, according to the latest 13F filing.**

BBRY

We first took a look at Blackberry in June. It had a strong fundamental story but at the time the chart was stretched to the upside. We took a small stab at it during the overextension but ended up cutting it for a small loss during the deep retrace.

It’s front and center on our radar again after crushing Q2 earnings. The company reported a second-quarter net income of $19 million — vastly surpassing estimates.

The stock ripped on the news and we think this bullish momentum might lead into a potential buyout by the time this bull cycle comes to an end. Right now we’re looking for an optimal technical entry to get back on for the ride.

HDSN

Hudson Technologies (HDSN) has been the "rock in our shoe" since we covered it back in early June. The stock had a nice rip after its August earnings announcement, but the market sold it hard on the following open. Despite a strong broad market, HDSN can't keep it's head above water so we were forced to cut the position and exit for a small loss.

IBKR

One of our newer picks, Interactive Brokers (IBKR), continues to gain upward momentum and is now up over 16% since our entry in August. IBKR benefits from a rising rate environment, so if our base case macro thesis plays out (higher inflation and higher rates) this stock will pay us well. Price action looks great and we are a strong long in this name.

TUES

Back in the June MIR, we wrote how the “Death of Retail” narrative got way ahead of itself. Quality retailers with great balance sheets were getting sold just as hard as the ones struggling to avoid bankruptcy. It was a classic example of “throwing the baby out with the bathwater.”

Tuesday Morning (TUES) was one of these quality retailers on our radar. They had a strong balance sheet and a management hellbent on adapting and changing the business to fit the new landscape. The execs even started buying the stock — a great sign that they have high confidence of success.

Since publication, TUES has climbed 80% higher. We are long this stock and are looking to continue adding to our position.


MacroOps published on TradingView.com, October 02, 2017 11:26 EDT
BATS:TUES, D 3.025000 ▼ −0.180000 (−5.47%) O:3.250000 H:3.300000 L:3.000000 C:3.025000
TUESDAY MORNING CORP, D, BATS
MA (100, close)
Vol (20)
1.372672 (80.39%) 137
June MIR called the low on TUES.
Created with TradingView

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	