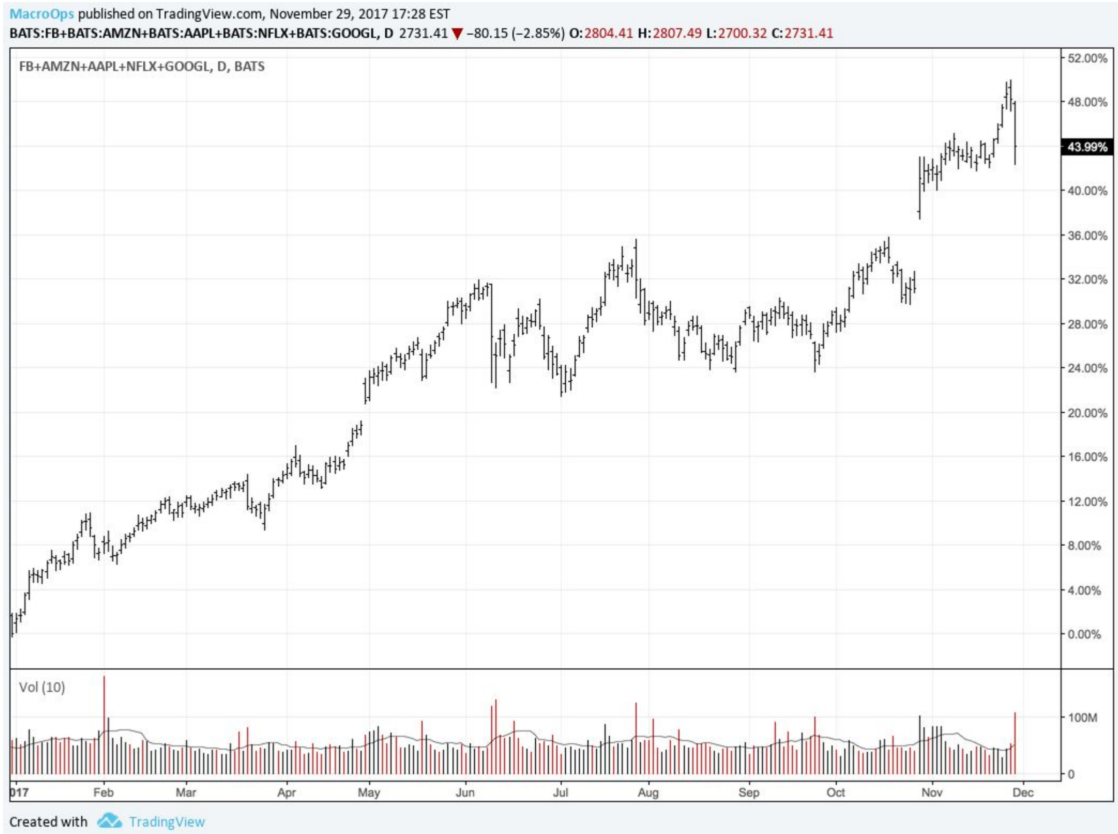
Short Gamma

Hedge fund manager and occasional blogger, Mark Dow, wrote the following a few weeks ago which I think sums up current market sentiment/action well (emphasis mine).

> *But perhaps the trickiest part right now is investors' short-gamma mindset. When you're short an option, the size of your exposure increases as the market moves against you. To hedge or reduce your exposure you are forced to continuously buy if the market goes higher, and continuously sell if the market goes lower. In other words, you're chasing, rather than fading.*
>
> ***The short-gamma mindset happens every year at this time as the final stretch intensifies performance anxiety, but especially so in big up years. If you are lagging–as many are–and the market powers higher, you have to be in. The FOMO is overwhelming**. Some guys will play the laggards, others will want to make sure their end of year balance sheet shows healthy positioning in 2017's winners. Either way, they chase.*
>
> ***But there is only one thing worse than lagging all year and then missing the end of year push higher: lagging all year and loading up for the end of year push just before the market finally corrects.** If this has never happened to you have no idea how mercilessly savage this can be. And since we haven't had a correction in so long, if one were to come it's easy to imagine it being larger than the garden variety sort.*
>
> *In essence, it feels as if traders are short at-the-money straddles and are poised to chase any sharp move that lasts more than a day. Be careful.*

You can find the entire post here.

The Nasdaq, before today's 180bps selloff, is up 32% on the year. Netflix, Facebook, and Amazon are each up over 60% since January. And the FAANG's as a whole are up 44% collectively adding over $900 billion in market cap in the last 11 months. Just so you know, this is not normal.



If you're a portfolio manager and you're not holding large positions in the FAANG stocks going into the end of the year, and you're underperforming, then you're putting your career at risk.

Being heavy in those stocks might not be the 'right' decision from a money and risk management perspective but it's definitely the right one from the "I don't want to lose my job" perspective.

Managing money is a tough biz…

Personally, I don't feel the need to own any of the zeitgeist stocks, at least not absent a further selloff. I'll probably miss out on some upside. That's fine. I just can't bring myself to chase into popular trades like the FAANGs… that's probably a flaw of mine but it's kept me out of trouble when these pop stocks inevitably hit an air pocket.

I prefer to go where others aren't. This usually leads to me being early and underperforming for short periods, especially during crazy markets like these. But this strategy has served me well over the long-term.

Urban Carmel noted yesterday how the recent runup in the market put the S&P over 25% above its bollinger band width, which is rare. Here's an excerpt of his comments and you can find his post here.

> *There have been only 5 similar instances since 2009. None marked an exact short-term top in the market, but all preceded a fairly significant drawdown in the week(s) ahead. Risk-reward over this period was very poor.*
>
> *Between 2003 and 2008, there was only one additional instance similar to those above, in September 2007. SPX chopped sideways for a week, then gained 3% over the next 2 weeks into its October peak from which the market crashed over the next year.*

It seems like the market is getting ahead of itself here. The narrative is all on tax reform (which should pass). I wonder if we'll see a "sell the news" type event where the market finally corrects 5+% following passage of the bill. Frothy sentiment and positioning definitely make that a possibility.

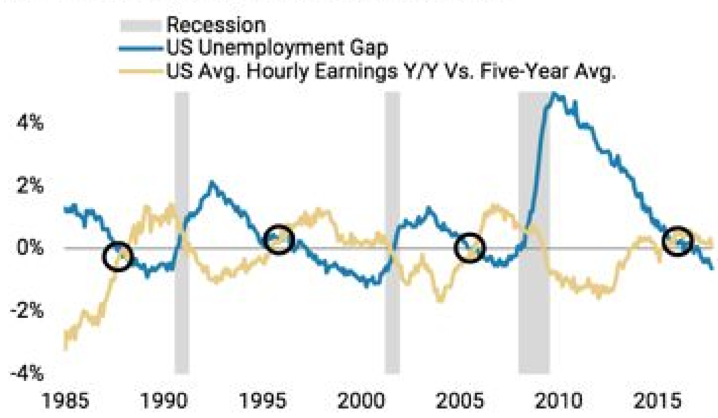
But the broader technicals of the market (ie, breadth, credit, new highs/lows etc…) remain strong. And just today we saw industrials, financials, and transport sectors make new cycle highs (Dow theorist rejoice!). That's not bearish.

At the least we're seeing the start of a large sector rotation happening.

This rotation should pick up as bonds sell off and yields rise in response to the pickup in inflation which should intensify in the coming quarters.

"Rising wage costs" were one of the main talking points on earnings calls this quarter. And as the labor market tightens, wage pressures will continue to build and drive take home pay upwards.

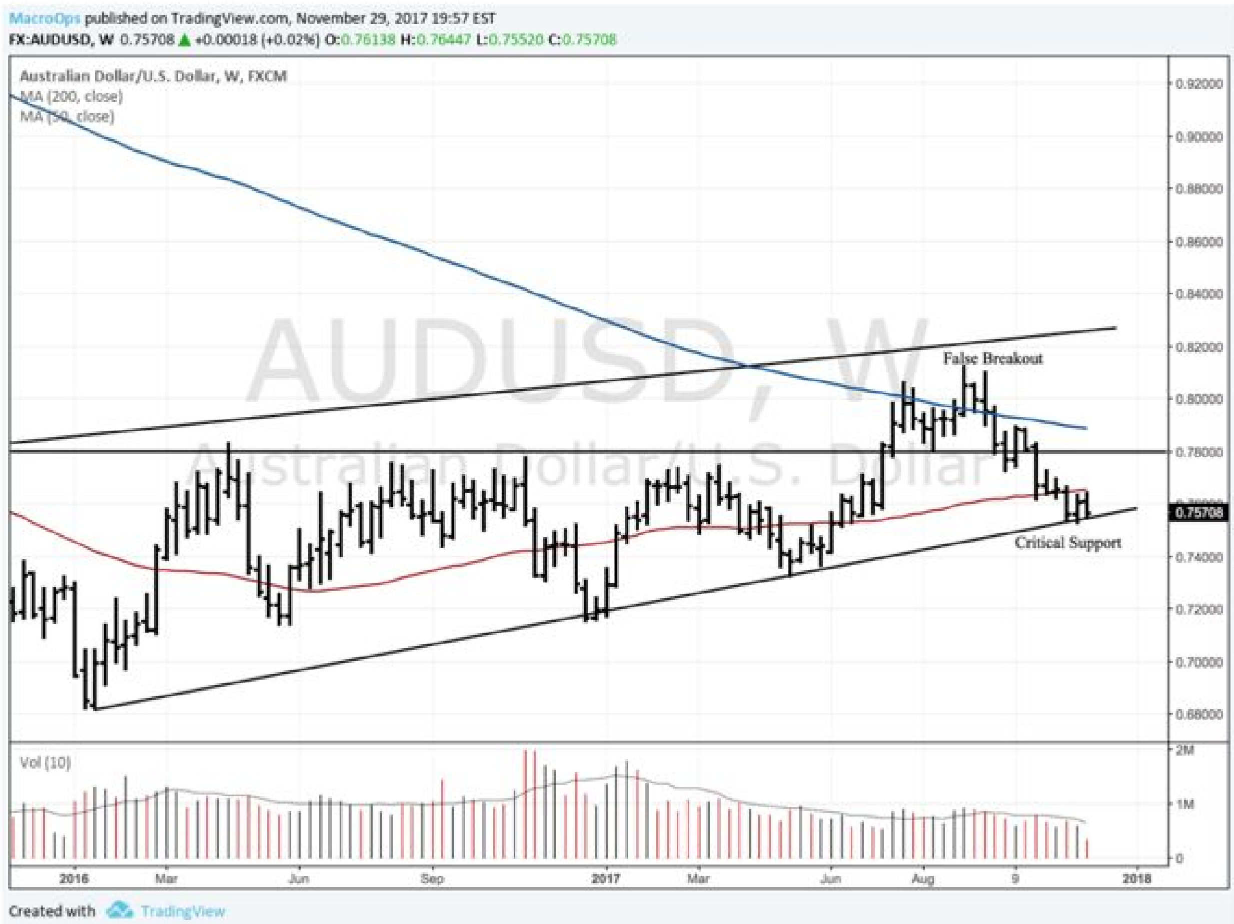
Exhibit 7: Labor Costs Should Accelerate in 2018



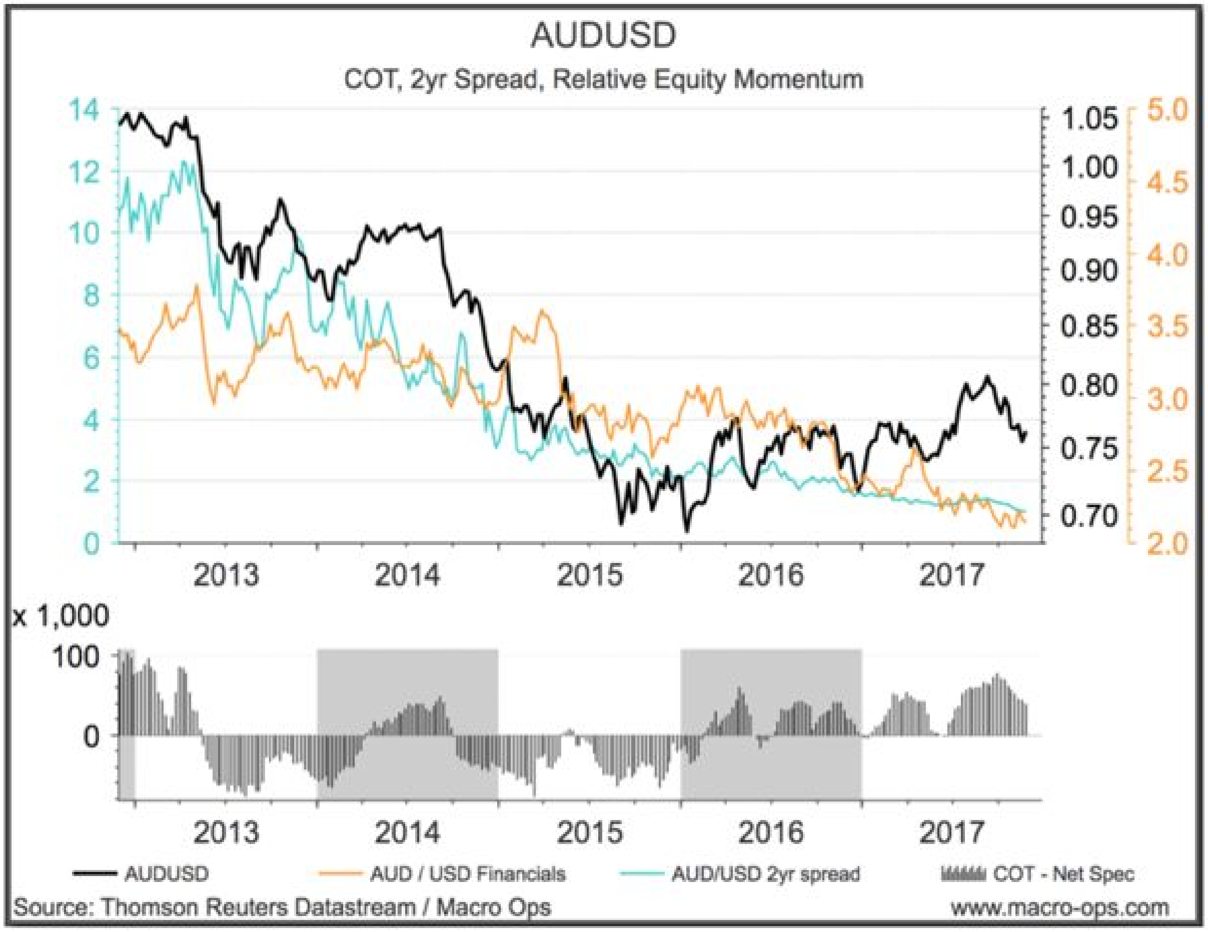
Source: Bloomberg, Haver, Morgan Stanley Research as of October 2017.

The FOMC meeting is in less than two weeks. The Fed is expected to raise rates.

I think the dominos are lining up for another leg in the dollar bull. AUDUSD is setting up nicely (see weekly chart below). We'll be putting on a starter position soon (maybe tomorrow) and adding to it aggressively should price break below its lower support line.



Short AUDUSD is developing into a high conviction trade. Interest rate spreads, equity momentum, and COT positioning all suggest the pair needs to go lower. And technically, the chart is setting up perfectly. We may be a few weeks early still but that's why we'll wait for price action to confirm our thinking.

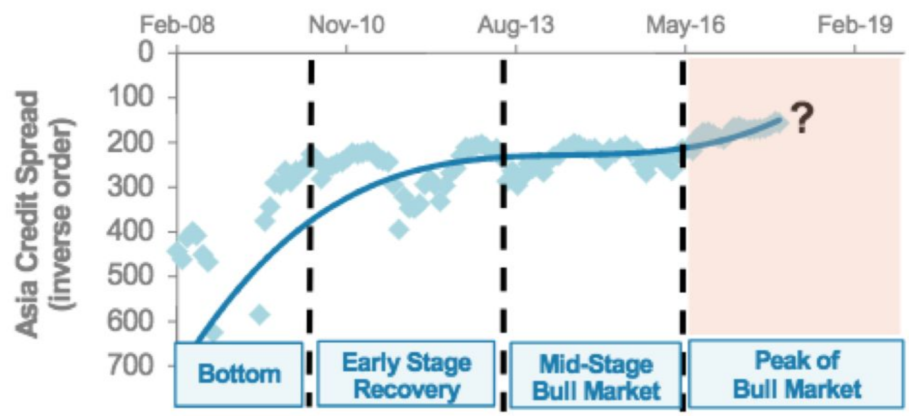


Furthermore, the aussie dollar is sensitive to a slowing China (we'll be covering that in detail next week) as well as rising global interest rates. Morgan Stanley wrote the following in a recent FX note:

> *Our analysis suggests that AUD would be more sensitive to rising global rates, given: i) AUD's sensitivity to the domestic housing sector; and ii) Australia's dependence on foreign funding in the form of its current account deficit. We expect Australian yields to fall below the US as the Fed hikes and the RBA stays on hold for longer, given the lagging labor market dynamics in Australia.*

Australia hasn't had a recession in over 25 years. The country has benefited from the rise of China and its voracious appetite for Australian commodities. But all good things come to an end, and Australia's impressive run is on its last legs. And since Australia rode China's coattails higher it's going to suffer with it as the Asian dragon goes through a painful transitioning over the coming years as the credit cycle in China turns.

Exhibit 1: Market phases for Asia credit



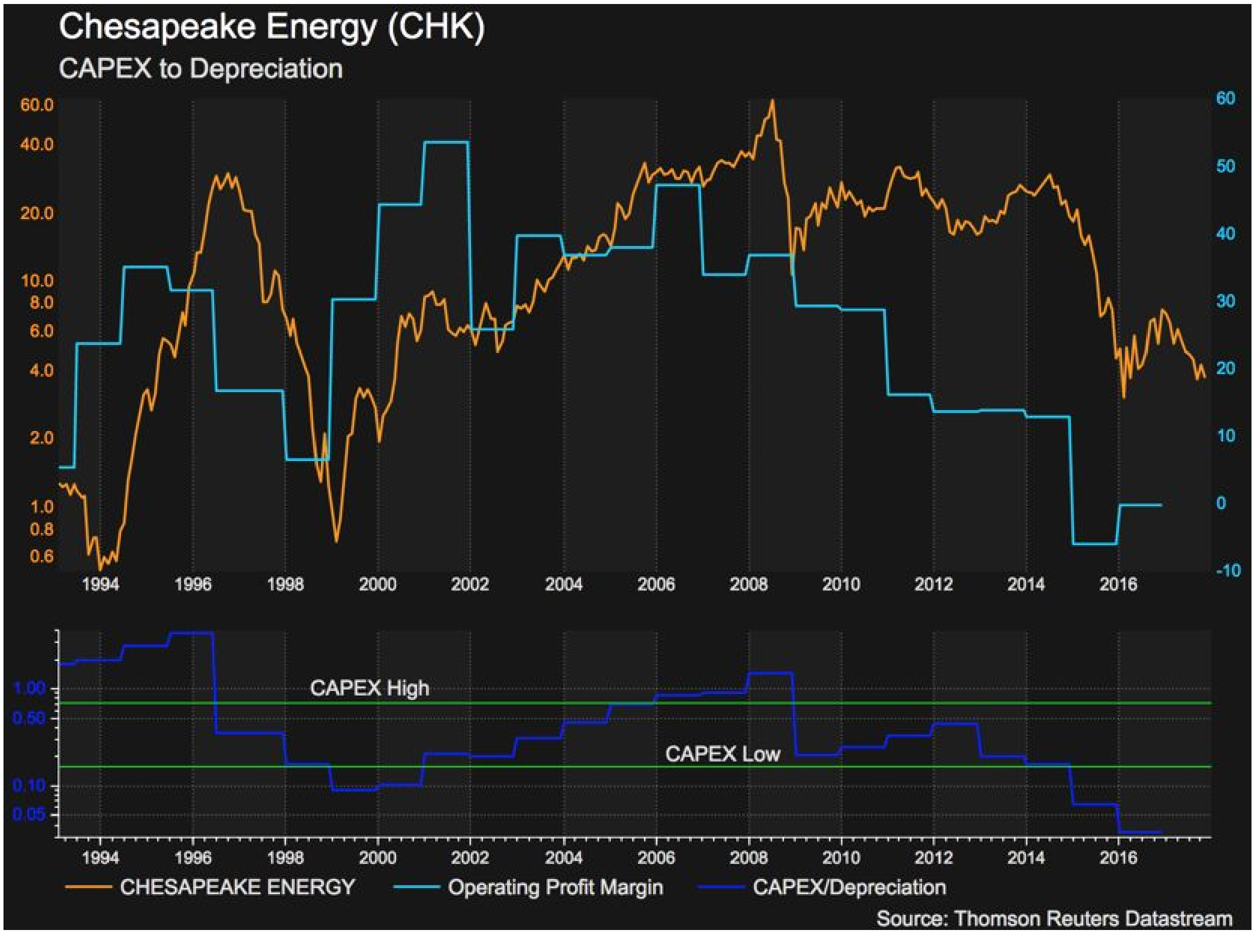
	Bottom	Early Stage Recovery	Mid-Stage Bull Market	Peak of Bull Market
Fundamentals	20% Improving but ignore	30% Solid underlying performance	40% Sweet summer of growth	**20% Optimistic, long duration, projection**
Valuations	20% Attractive, but no takers	50% Abundant bargains	30% Willingness to pay up	**20% Revised models, justify stretching**
Psychology/ Technicals/ Liquidity	60% Exhaustion, disbelief, demoralization	20% Doubt, reflection, conversation	30% Faith, hope, charity	**60% Euphoria, greed, extrapolation**

Source: Adapted from *The Art of Asset Allocation*, Second Edition, by David M. Darst, CFA (McGraw-Hill, 2008), iBoxx, Morgan Stanley Research

I'm also watching natural gas closely and considering going long the futures. The COT profile is neutral and technically the price action looks good. Odds are increasing we'll experience a La Nina this winter which would bring more extreme winter weather to the US.

Looking at CHK (a natural gas producer) levels of CAPEX to depreciation show how far fixed investment into future production has fallen. It's at its lowest levels in the 20+ years for which we have data. The CAPEX picture is similar across the industry.

These low levels of investment into future capacity mean that we're likely headed for a major supply crunch in the near future. And a supply crunch means much higher prices.



We already hold DOTM calls on CHK which is a synthetic long natural gas play. We might double up our position if the data continues to line up favorably for this trade.

And then finally I'm looking into putting on a starter position in AGRO this week. This is the agriculture stock we covered in the October MIR. It dumped after earnings even though the numbers were good. I think this is an instance of some big fish washing out weak hands so they can buy in at lower prices and I bet the stock follows a similar pattern to that of last Fall when the stock went on to rise over 80% in the follow on months.

Here's a shot of the company's revenues, cash flows, and earnings. All trending in the right direction. It's trading at less than 4x free cash flows and only 14x next year's earnings. It's cheap, it's growing, and it has budding macro tailwinds.

I'll finish this week's note with a short excerpt from Joel Tillinghast's excellent book titled *Big Money Thinks Small* which I finished reading a few weeks ago. Considering everything going on in the crypto market I figure it's timely — If you've tried debating with a crypto head on twitter then this will resonate with you.

> *French Polymath Gustave Le Bon wrote The Crowd in 1895 as a rant on French politics, but his observations also describe how stock market manias occur. Under the influence of crowds, individuals act bizarrely, in ways they never would alone. Le Bon's key theme is that crowds are mentally unified at the lowest, most barbaric, common denominator of their collective unconscious -- instincts, passions, and feelings -- never reason. Being unable to reason, crowds can't separate fact from fiction. Crowds are impressed by spectacle, images, and myths. Misinformation and exaggeration become contagious. Prestige attaches to true believers who reaffirm shared beliefs. Crowds will chase a delusion until it is destroyed by experience.*

Paul Tudor Jones said the following about trading in the late stages of a bull market.

> *There is no training — classroom or otherwise — that can prepare for trading the last third of a move, whether it's the end of a bull market or the end of a bear market. There's*

typically no logic to it; irrationality reigns supreme, and no class can teach what to do during that brief, volatile reign.

Both of the above will come in handy next year as we move into the final stages of this rally and all rationality gets thrown out the window and the crowds *chase a delusion until it is destroyed.*

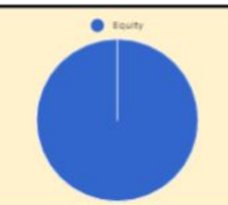
Strategic Ops

NAV $1,249,733

Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target	Notional	Beta
Equity	Limbach LMB	2,750	$13.66	$12.50	$3,190.00	$18.00	$104,703	-0.1902
Equity	Interactive Brokers IBKR	1,800	$41.71	$38.50	$5,778.00	$55.50	$74,628	0.9292
Equity	GAIA	7,600	$9.88	$8.50	$10,488.00	$13.75	$79,040	0.4497
Equity	Portugal ETF PGAL	4,000	$10.57	$9.98	$2,360.00	$11.75	$85,040	1.0467
Equity	China A-Shares ASHR	3,464	$26.69	$25.83	$2,979.04	$31.30	$199,876	1.475
Equity	W&T Offshore WTI	16,000	$2.18	$2.00	$2,880.00	$4.50	$40,800	2.415
Equity	Ensco ESV	3,700	$5.15	$4.30	$3,145.00	$6.50	$18,574	1.667
Equity	Transocean RIG	2,900	$9.32	$8.26	$3,074.00	$15.00	$26,796	1.683
Equity	Cabot COG	1,350	$26.28	$24.00	$3,078.00	$34.00	$36,288	0.4829
Equity	Tuesday Morning TUES	7,500	$2.60	$2.00	$4,500.00	$5.00	$18,000	2.041
Option	CCJ Jan '19 17 Call	236	$0.41	$0.00	$96.76	$5.00	~	1.273
Option	FCAU Jan '19 25 Call	108	$0.90	$0.00	$9,720.00	$5.00	~	2.373
Option	JD Jan '19 70 Call	108	$0.92	$0.00	$9,936.00	$7.00	~	1.3
Option	TRIP Jan '19 75 Call	108	$0.89	$0.00	$9,612.00	$7.00	~	2.378
Option	CHK Jan'19 10 Call	750	$0.14	$0.00	$10,500.00	$1.00	~	2.105
Option	Tesla Mar '18 240 Put	28	$8.80	$0.00	$24,640.00	$24.00	~	1.048

Metrics

Exposure Breakdown	
Equity	$105,976.80
Commodity	$0.00
Fixed Income	$0.00
Forex	$0.00



Total Open Risk
$105,976.80
8.48%

**Updated 11/29