Go-Devil

Operators,

Your December MIR contains everything you need to know about playing the coming bull market in oil.

The energy space is currently providing one of those rare contrarian opportunities where the rest of the market is completely wrong. In the following pages we'll show you exactly why and how you can stay one step ahead of them.

We'll reveal exactly what equities we're using to play this trend.

After that we outline the other themes we're keeping an eye on as the market enters into the final stage of this bull run.

And finally if you're looking for a shorter-term option trade in oil we have an interesting play in the quant section.

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

Be sure to send me an email at alex@macro-ops.com when you're done reading.

Your Macro Operator,

Alex

In This Issue:

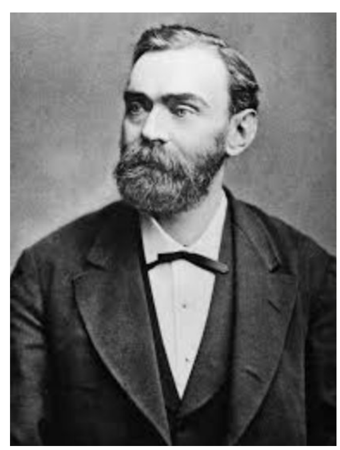
- Oil - Pg. 2
- U.S. Macro Cycle - Pg. 21
- Oil Vol - Pg. 32
- Updates - Pg. 40
- Asset Allo - Pg. 45

Macro Spotlight: Oil

Back in 1862, a former military man turned wildcatter by the name of Colonel Edward A.L. Roberts invented a process of detonating explosives at the bottom of dry holes to unlock oil.

He would pack nitroglycerin — the active ingredient in dynamite — into canisters (he called these things torpedoes) and would then drop them into a dry well and… boom. He found that more boom meant more oil and soon the practice of dropping "torpedoes" into wells became common.

The problem was that this made for some dangerous work. Nitroglycerin is what's known as a 'contact explosive'. It's a liquid that sloshes around and if sloshed too much, turns into a mushroom cloud.



Fun Fact: Nitroglycerin was first commercialized by a Swedish chemist/businessman by the name Alfred P. Nobel, of Nobel prize fame (that's him on the right). He then went on to create dynamite which was able to carry the explosive in a more stable form. The invention *spawned after his nitroglycerin factory along with its workers blew up… on two separate occasions.*

Anyway, before the ironic “lifesaving” invention of dynamite, oil men had to deliver nitroglycerine to their wells in its liquid form, packaged in tin canisters. And since the thinking at the time was that more boom meant more oil, these torpedoes had grown to over 10ft long and carried more than 200 quarts of liquid boom.

This was in the days before paved roads, cars, and rubber tires. So some poor Joe would have to drive a horse drawn wagon, loaded up with tree-sized torpedoes, holding the most unstable powerful liquid explosive of the time, over a dirt road out to wherever the well was, praying to the good Lord that he didn’t hit the wrong bump.

Many successfully made the trip, but some did not. One writer of the time described a torpedo carrier who drove his wagon over a bump “a few inches too high”, saying the fragments that were left of the driver would’ve “fit in a cigar box.”

Torpedo delivery wasn’t even the most dangerous part of the job. That title went to the men known as “Go-Devils”.

These were the guys who had to lower the torpedoes — slowly — into the bottom of the wells and detonate them by dropping a 10-pound cast iron projectile down the hole… and then run… like the devil. Hence the name.

Workplace safety has come a long way since then but being a roughneck in the oil game is still plenty dangerous. And so is trading in the energy space; where maybe we’re safe from being packed away in a “cigar box”, but our capital is exposed to the whips and saws of the volatile oil market nonetheless.

Some ask why play at all?

It’s for the same reason Go-Devils risked life and limb… to strike oil and make it rich! And just as the crude market can taketh, so can it giveth in abundance. That’s why it’s worth playing when the stars align.

The key of course is in knowing how to determine the right time to play. It’s no easy feat. And like all things in markets, there’s no surefire thing.

But as speculators it’s not our job to figure out sure things. We just need to assess the risk and the potential rewards, weigh the probabilities, and place our bets.

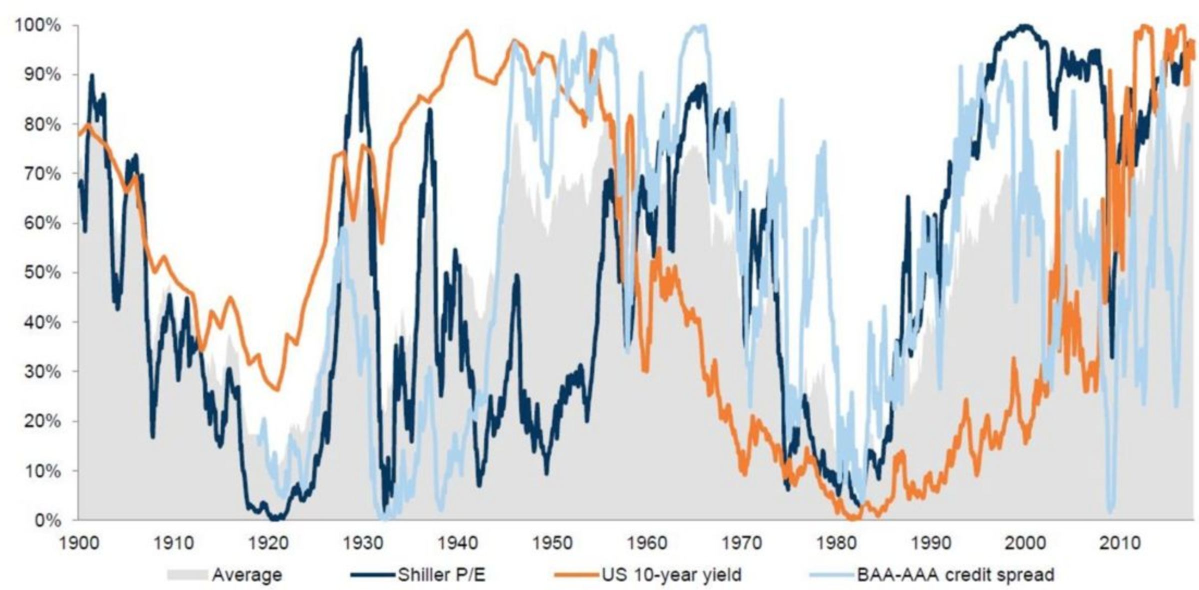
We know if we do this with discipline, that even though we'll take many losses (it's part of our job), in the end we'll come out ahead because we've got asymmetry on our side. Our winners make us way more than our losers lose.

Seeking out asymmetric trades today is a bit tougher than normal because of where we are in the cycle. We're in the latter stages and valuations are high (very high) so upside is somewhat limited on the whole and completely dependent on sentiment.

But it's not late enough in the cycle where it makes sense to start pressing shorts — the trend is still up and could persist for another couple of years.

The large vampire squid (aka, Goldman Sachs) noted recently that the "average valuation percentile across equity, bonds and credit in the U.S. is 90 percent, **an all-time high.**"

Exhibit 12: Valuation frustration - both bonds and equities appear expensive
Valuation percentile (since 1871 for S&P 500 & US 10-year yields, 1919 for BAA spreads)



Source: Shiller, Goldman Sachs Global Investment Research

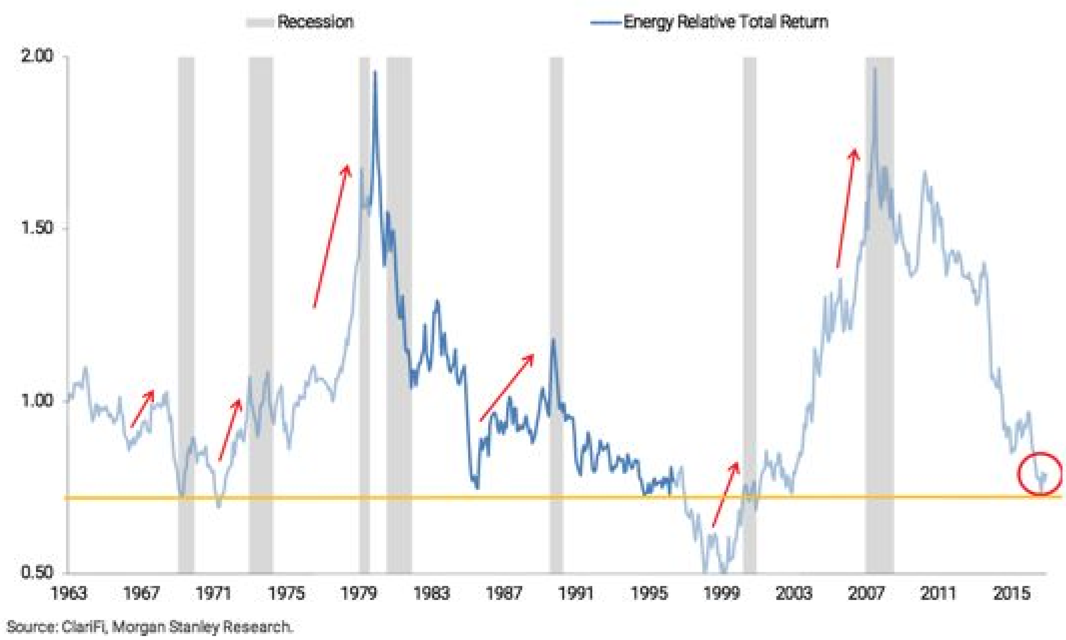
A good approach in environments such as these is to stick with the large trends that are running, but to start toeing the water in the few discarded and unloved assets that have upside asymmetry and a relative margin of safety.

For our team at Macro Ops, the asset that fits the bill is oil.

Back in August we wrote about why we thought the puzzle pieces were coming together for a bullish oil rebound — a veritable "Marcus Trifecta" of macro, sentiment, and technicals signaling major upside asymmetry.

We made the argument that the market was overestimating oil's future supply growth while understating demand. Furthermore, we remarked how the market was headed for a supply constrained environment due to a record level of cuts in CAPEX (ie, reduction in the investment into future supply) to the global oil market over the past few years.

Lastly, we wrote how the bullish case for oil was made even more delectable by the trend rates in GDP growth and inflation. The "Investment Clock" framework has us entering the "Overheat" phase of the business cycle. In this phase, commodities and oil and gas stocks in particular historically perform very well. The chart below shows energy's relative total return outperformance in the final year(s) of a bull market.



This was, and remains, a very contrarian call. And that's all for the better.

Since our August report, WTI crude has climbed from $49/bbl to a high of $59/bbl last week. The basket of three oil and gas stocks (CRR, RIG, COG) that we recommended is up over 12%; roughly double the S&P's return over the same time.

So we're off to a decent start.

But as we've continued to dig into the energy story we've become more convinced that there's incredible asymmetry building in the space. In this month's MIR, we're going to reiterate our bullish call for oil and gas equity outperformance going into 2018 and update the evidence on why it's nearing time to become a Go-Devil and strike it rich.

There Will Be… Bull? — The Coming Oil Bull Market

One of the more difficult, yet important, jobs of a trader is tease out what's likely to happen versus what's already priced in. It's at this intersection of the unfolding path of reality and embedded expectations where trades are born and die.

But getting inside the head of every other market participant and weighing their thinking against the price of the market is tough going for obvious reasons.

A workaround we use is paying attention to the popular stories that market participants are telling. And more importantly, how these stories evolve and react to new information, and then how these reactions get reflected in prices.

Narratives are the human way of trying to make sense of a chaotic, complex, system. The stories we tell ourselves are often wrong, incomplete, and sometimes crazy. But nonetheless our ability to believe in them has been so powerfully ingrained in us because it's helped us thrive as a species.

Author of the book Sapiens, Yuval Harari, notes the following:

> *Sapiens rule the world, because we are the only animal that can cooperate flexibly in large numbers. We can create mass cooperation networks, in which thousands and millions of complete strangers work together towards common goals. One-on-one, even ten-on-ten, we humans are embarrassingly similar to chimpanzees. Any attempt to understand our unique role in the world by studying our brains, our bodies, or our family relations, is doomed to failure.* ***The real difference between us and chimpanzees is the mysterious glue that enables millions of humans to cooperate effectively.***
>
> ***This mysterious glue is made of stories, not genes.*** *We cooperate effectively with strangers because we believe in things like gods, nations, money and human rights. Yet none of these things exists outside the stories that people invent and tell one another. There are no gods in the universe, no nations, no money and no human rights—except in the common imagination of human beings. You can never convince a chimpanzee to give you a banana by promising him that after he dies, he will get limitless bananas in chimpanzee Heaven. Only Sapiens can believe such stories. This is why we rule the world, and chimpanzees are locked up in zoos and research laboratories.*

We are genetically programmed to buy into the popular narratives that are shared by the crowd. That's why it's so damn hard to be a contrarian… it's literally against our biological programming to go against the herd.

Similar to how species react, adapt, and evolve slowly in response to environmental stresses, so too do the popular narratives adjust slowly over time as new information enters the picture that challenges their validity.

This is why popular market narratives always lag the market. And once the market finally acknowledges the faults in the prior narrative, we see violent surges and reversals in price.

We want to identify the popular story that's embedded in prices and look for instances where new information signals a diverging outcome. The more divergent, the more lucrative the trade.

We want to be ahead of this narrative adoption. If we can lead the story then we can make money.

Going back to the oil markets:

The popular story over the last three years of the oil bear market rested on two things (1) that the world is awash in oil thanks to the introduction of fracking and (2) the adoption of electric vehicles was going to soon kill the internal combustion engine, thus clipping off a big source of demand for oil.

But the data doesn't support this narrative.

Like most popular stories, this one was born in some truth.

But that truth, or rather its supporting facts, have evolved. And the popular narrative of the oil market has not yet fully awoken to the new reality.

Once it does we're likely to see $80, even $100/bbl oil in the coming year.

Here's why.

The consensus in oil is predicated on the belief that fracking and the introduction of shale oil has led to a new paradigm of sustainable drilling productivity growth, making the US a major swing producer in the global market.

But recent data isn't backing this up.

Supply forecasts have been predicated on the belief that improvements in fracking technology will continue to increase well productivity at the growth rates we've seen over the last few years. The expectations are that this rate will compound, bringing ever more supply growth online.

The problem is that these forecasters have mistaken the source of that "well productivity growth".

For example, output in the Bakken shale (one of the most productive shale regions in the US) more than tripled from 2012 to 2015. Recent research done by MIT suggests this rise in well productivity was not actually due to improved fracking technology and efficiency gains… but rather because shale companies abandoned their less productive fields following the market slump and instead pumped from their prime acreage.

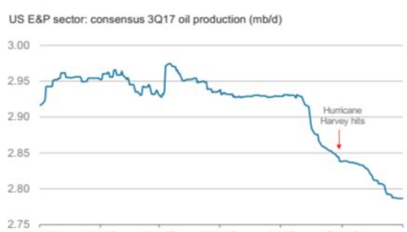
In addition, the E&Ps have been tapping their drilled but uncompleted (DUCs) wells.

The combination of only pulling from Tier 1 fields, along with draining pre-drilled wells, led to forecasters greatly overestimating future supply growth by misattributing the excess supply to technology driven productivity gains.

So while forecasters have been modeling out continuous well productivity growth of roughly 10%, the real number is likely closer to 6% or less. And while that difference may not seem like a lot, when you think about the compounding effect that 40% less growth has over time… it's huge.

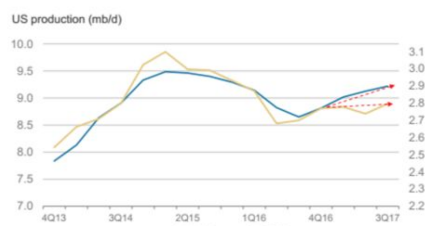
This has led to forecasters continuously overestimating US production over the last year.

Exhibit 10: Production estimates for US E&Ps were downgraded 5% during the quarter, at least half already before Harvey



Note: charts based on the 18 oil-focussed US E&PS that have reported 3Q results so far, i.e. EOG, Oxy, Anadarko, Pioneer, Concho, Devon, Apache, Hess, Noble, Marathon, Newfield, Murphy, Chesapeake, Laredo, SM Energy, Whiting Petroleum, QEP and EP Energy.
Source: Bloomberg, Morgan Stanley Research

Exhibit 11: Since 4Q16, actual production has started to diverge from the EIA's estimate for total US production

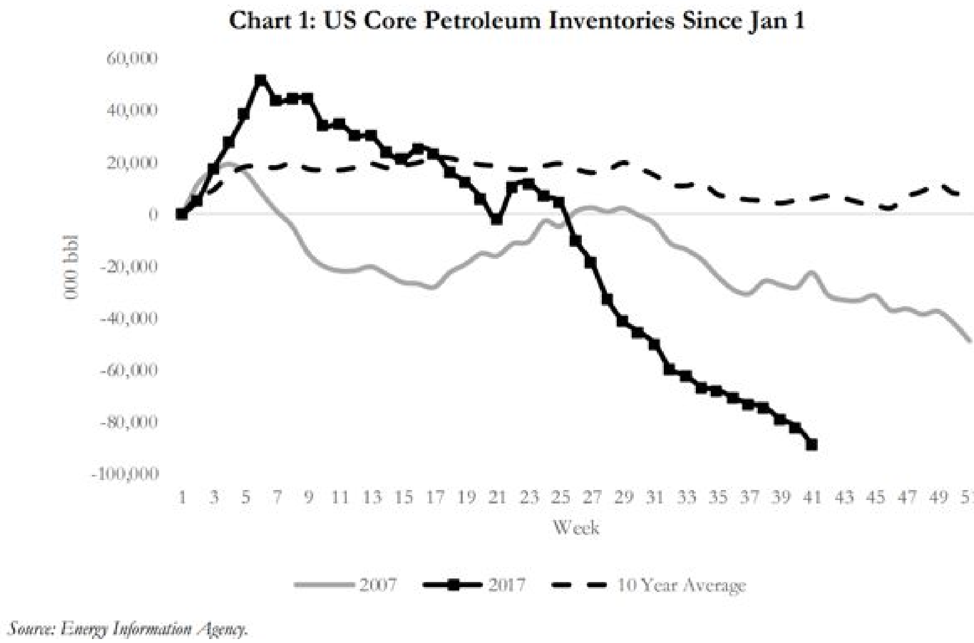


Source: EIA, Company data, Morgan Stanley Research

Commodity Hedge Fund, Goehring & Rozencwajg Associates (GRA), wrote the following in their latest quarterly letter (emphasis mine):

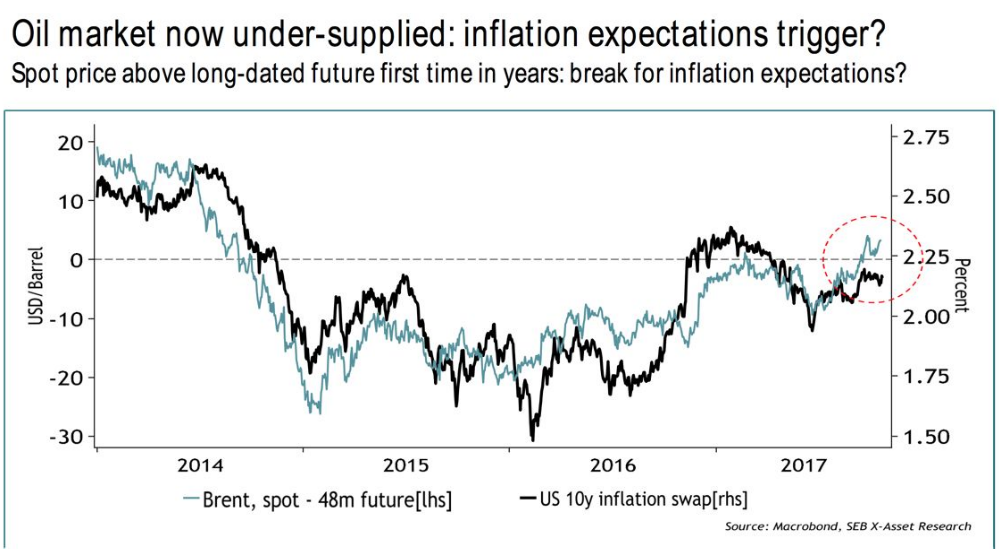
> *Most oil analysts at the start of 2017 believed US crude production would grow by approximately one million barrels per day between January 1st and December 31st. That level of growth would imply full-year 2017 oil production of 9.3 million barrels per day or 450,000 b/d above 2016 levels...* ***Many analysts felt these estimates would ultimately be revised higher.***
>
> *Even with substantial OPEC production cuts,* ***the energy analytic community has vigorously argued that because of strong US shale oil growth, global oil markets would remain in long-term structural surplus...***
>
> *However,* ***data has now emerged suggesting that US crude production growth is rapidly slowing...***
>
> *Between September 2016 and February 2017, US crude production grew by 100,000 barrels per day per month, but since then US production* ***has ground to a near standstill.*** *Between February and July, US production has only grown by 33,000 barrels per day per month –* ***a slowdown of 67%****. Moreover, preliminary weekly data for August and September (adjusted for the impact of Hurricanes Harvey and Irma) suggest that* ***production growth has slowed even more.***
>
> *The slowdown in US onshore production growth is even more puzzling given the huge increase in drilling that took place over that time. The Baker Hughes oil rig count is up 130% since bottoming in May of last year. In spite of a surging rig-count,* ***onshore production growth is now showing signs of significant deceleration.***
>
> *Although it is still early in the production history of the shales, it now appears the growth in US shale production may not be nearly as robust as originally expected. If our observations and analysis are correct,* ***then the oil market will be even more under-supplied that we expected in the 4th Q of the year and incredibly undersupplied into 2018.*** ***<u>The ramifications are going to be huge.</u>***

The deceleration in production growth has led to a large comparative drawdown in inventories.



GRA notes that "inventories have now drawn down to critical points where further inventory reductions will result in **severe upward price pressure**" and, "If our inventory extrapolation is correct and inventories reach these levels (and they should — our modeling has been correct over the past nine months), **then prices have historically surpassed $100 per barrel.**"

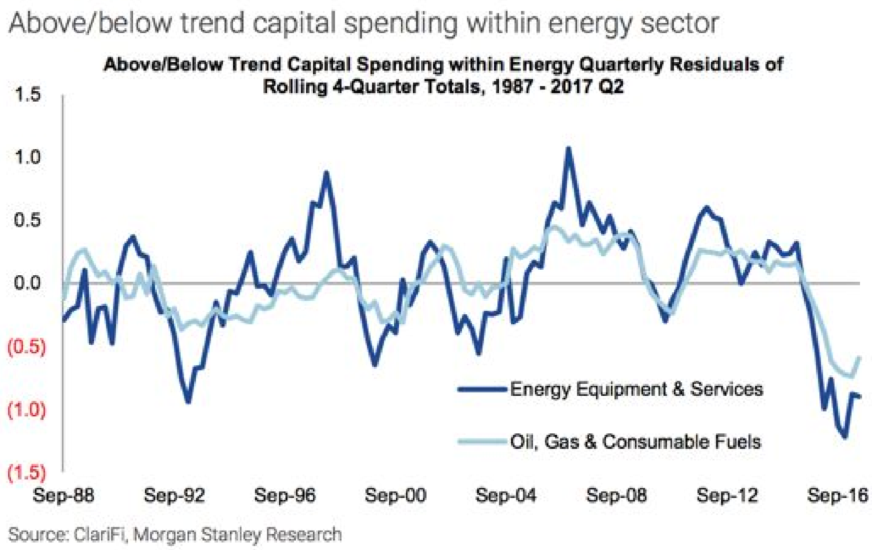
Signs of a tightening supplies are beginning to show in the futures market where the spot price has recently pushed above long dated futures for the first time in years.



Despite this new data indicating a market moving closer to a supply deficit, the market continues to operate under the old narrative and faulty assumptions.

The irony is that these faulty assumptions (wrongly extrapolating shale productivity growth into the future) has driven OPEC to extend their output cuts — where compliance has been strong — for another year.

On top of this, oil companies are beginning to focus more on cash flows and less on production which means even less CAPEX (investing into future production). And this is all following the largest reductions to CAPEX in the history of the oil and gas market over the time for which we have data.



This is setting the market up for a massive repricing sometime in the coming year(s). None of this is priced in.

Despite crude's recent rally, the most bullish piece put out by the Street has come from Goldman Sachs which went out on a caveat filled limb saying they expected WTI to finish the year at a whopping $57.50 (it's trading at $56 right now).

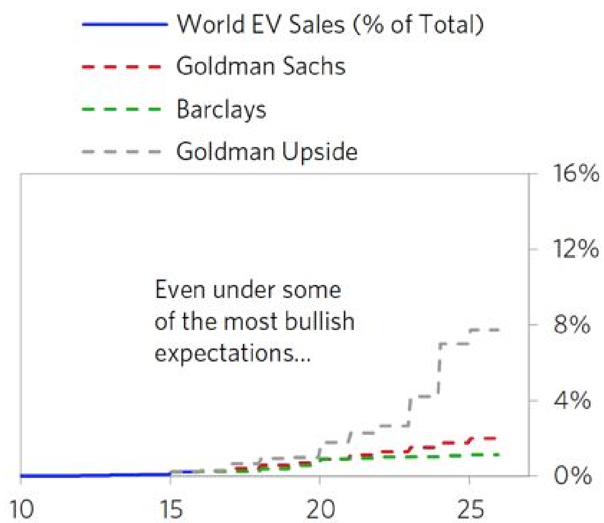
Oil trader and fund manager Pierre Andurand of Andurand Capital (who's fund has returned over 560% since 2008) noted the following in his recent investment pitch in Sohn, London (summary *via marketfolly*):

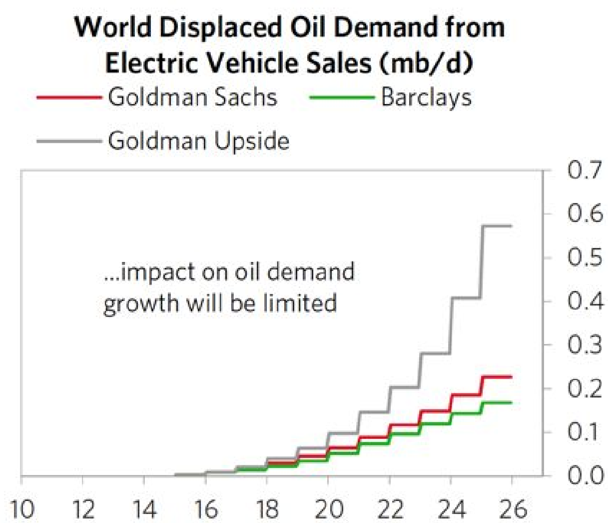
> *Oil prices will go much higher than consensus. In the last 18 months there has been a lot of negative hype about oil prices.* ***The two most discussed factors have been US shale production and electric vehicles. US shale has been called the internet of oil.***

> *Demand for oil has rarely been as strong as it is today.* ***Demand is as high as it was 10 years ago when there was a lot of talk about the super cycle and demand growth. New oil discoveries are at all-time lows.***
>
> *Supply will peak before demand at current oil prices.* ***Oil demand will peak sometime between 2027 and 2035, much later than the consensus view. The supply of electric vehicles will be constrained by a shortage of batteries.***
>
> *Supply will peak in 2020.* ***Oil discoveries peaked in the 1960s. They stabilised in the 1990s making a lower peak with US shale discoveries in the early 2000s but they have been declining since then. We are finding 10x less oil than we were 20 years ago. Global reserves are going down fast. We have a 100bn barrels (or 10% less) of reserves than we had 10 years ago when everyone was worried about peak oil. The largest declines have been in ex-US small oil fields. The rate of decline will quicken and supply will be less than expected.***
>
> ***Nobody wants to invest in oil projects that take 6 years to come to market and 20 years to make a profit. Against expectations,*** *US production is flat this year. Productivity per well will go down. We could need $100 a barrel oil to mitigate the fall in supply.*
>
> ***If OPEC goes back to full production, there would still be a deficit of half a million barrels per day. Inventories are low.***
>
> *OPEC is unlikely to go back to full production leaving a deficit of 1m barrels per day. In this scenario oil could easily reach $80 per barrel.*

While the “Death of the Combustion Engine” narrative sounds compelling, the data again doesn’t support it.

Even under the most bullish adoption estimates, EV’s impact is expected to be limited in the coming decade. Bridgewater notes that “in even the most bullish scenarios, only 0.2-0.3 mb/d of oil are expected to be displaced over the next five years.” (charts below *via BW*)

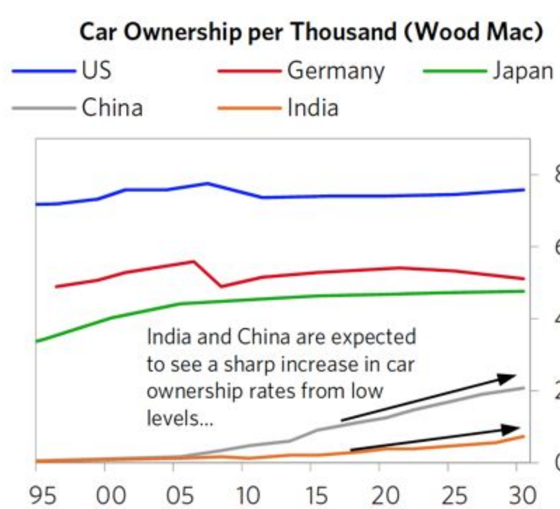


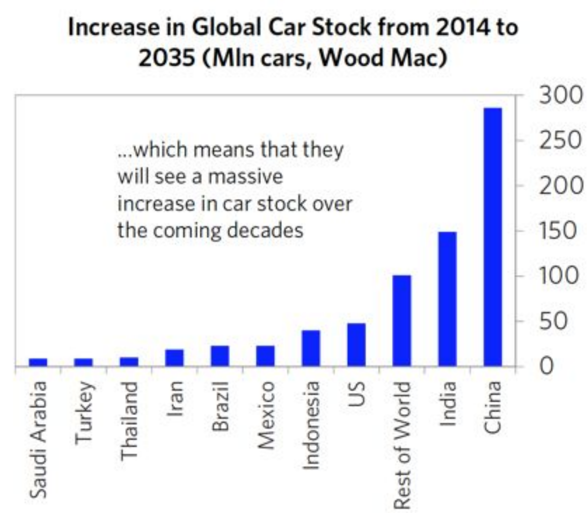


That's a drop in the bucket.

While EV's will undoubtedly change the energy landscape in the distant future, it's not going to have a material impact within the next decade, which is the timeframe we're investing in.

In any case, EV's impact pales into comparison to the growth in the global car stock that we'll see over the next decade. Charts below again *via BW.*





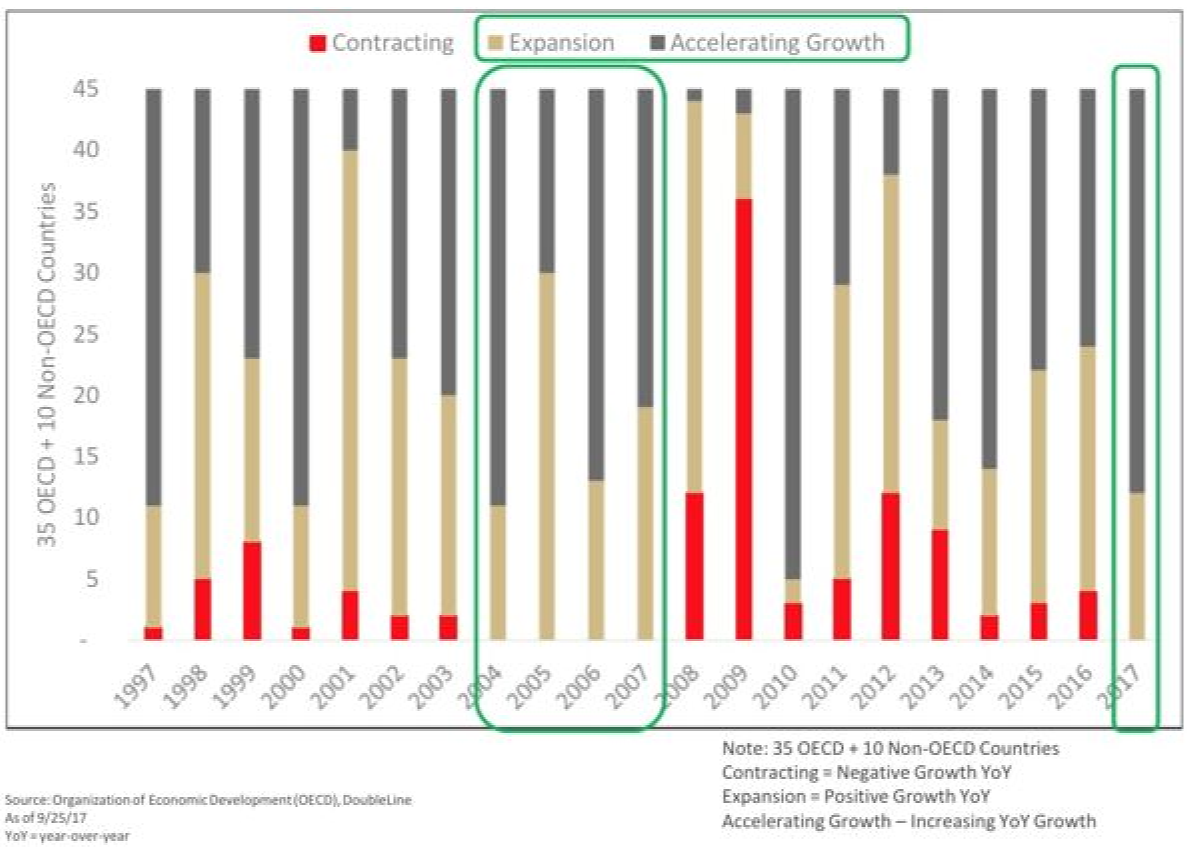
This goes back to the powerful impact of Asia, which led by India, is hitting the wealth S-curve that we talked about in the October MIR.

We're going to see the global middle-class balloon to over 4 billion people in the coming years. This means EXPONENTIAL growth in commodity consumption… and a lot more gas guzzling cars on the road.

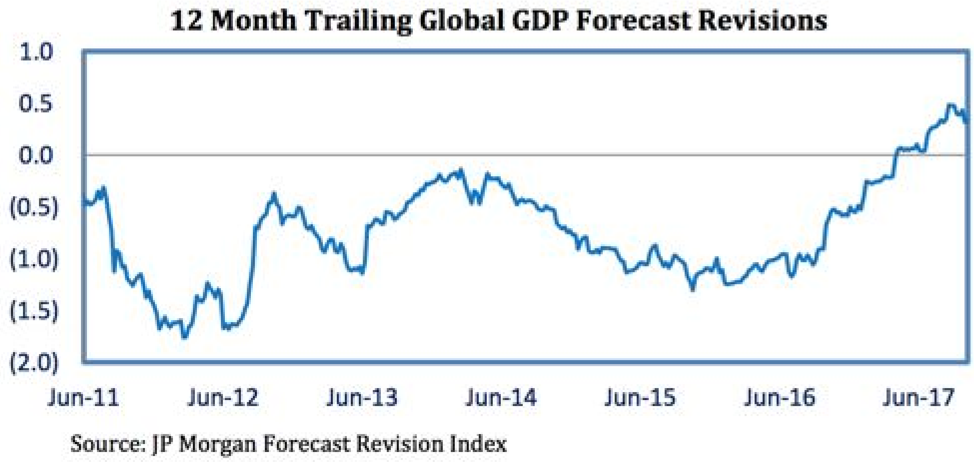
Which brings us to our current cycle.

We are hitting that sweet spot in the global business cycle where the world economic engine is firing on all cylinders.

The OECD Growth Indicator below shows all 35 OECD countries are in growth and/or accelerating expansion mode for the first time since 2007.

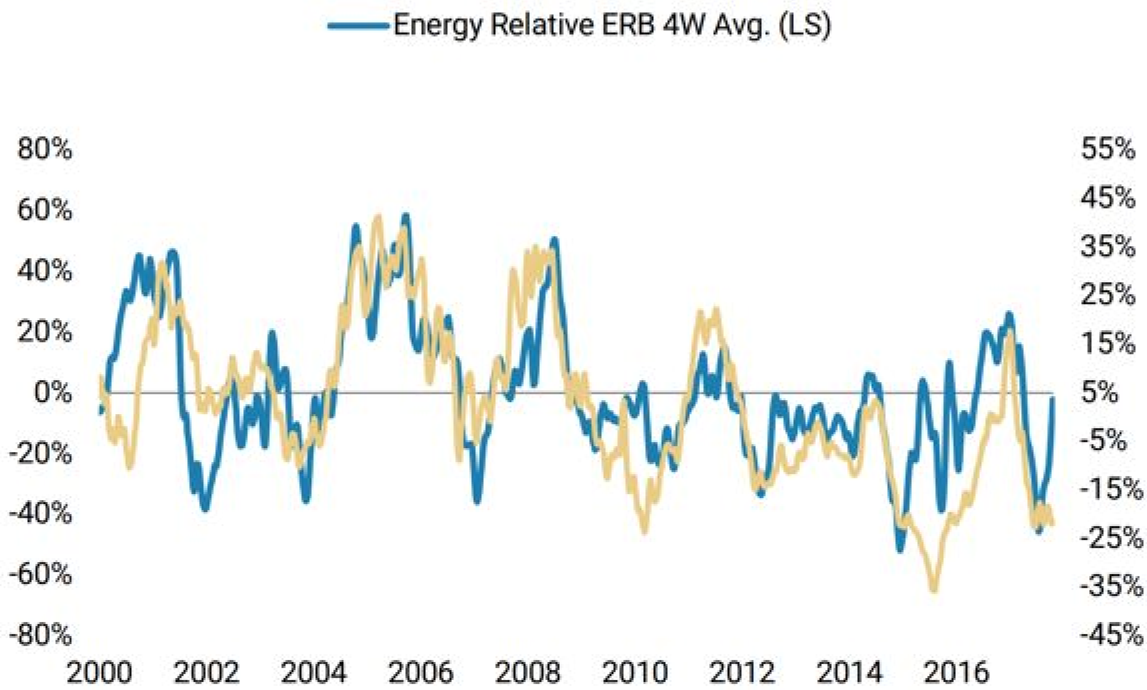


And this has led to GDP forecasts being continuously revised upward.



The demand forecast for oil is also being continuously revised higher.

Exhibit 11: A Rebound Off of Extreme Low Revisions Breadth is Positive for Energy's Relative Performance

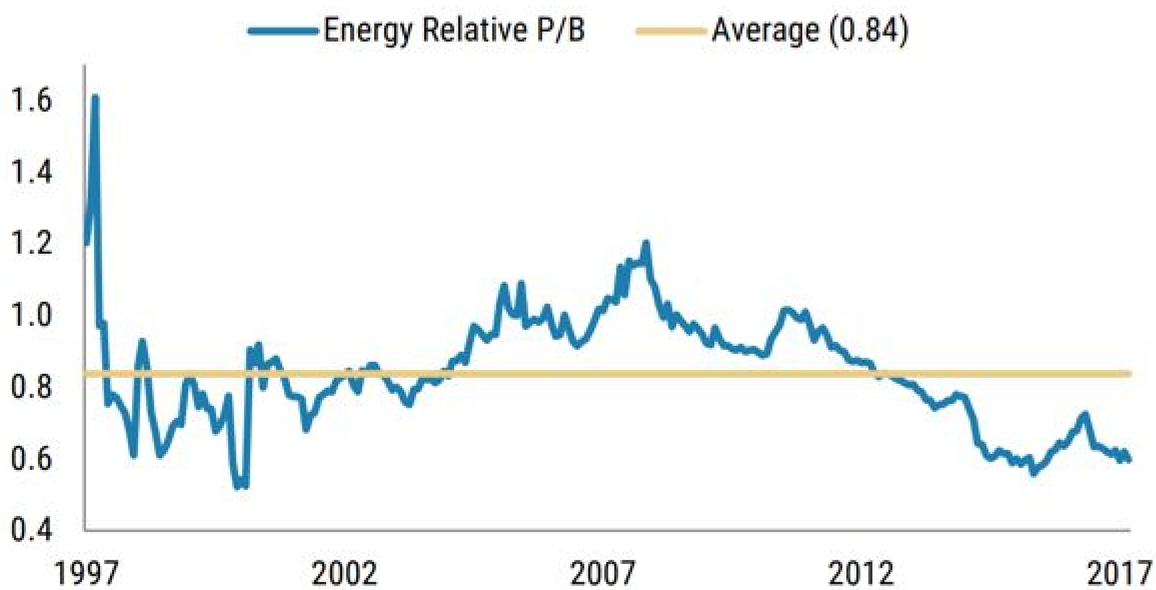


Source: Factset, Morgan Stanley Research.

It's frequent data surprises like these that eventually force new narrative adoption and drive new trends.

Under this backdrop of greater than expected rising demand and significantly lower than expected supplies, we have oil and gas equities priced near secular lows, and completely out of favor with the market.

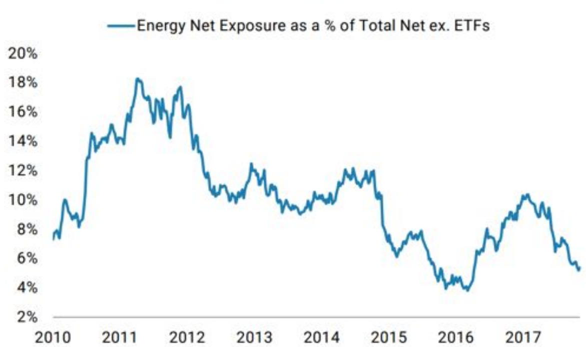
Exhibit 13: Energy P/B Relative to the S&P 500



Source: Factset, Morgan Stanley Research. As of Oct. 31, 2017.

Do you think there may be some asymmetry here?

Exhibit 15: Energy Net Exposure at Depressed Levels



Source: Morgan Stanley Prime Brokerage as of November 3, 2017.

Exhibit 16: Long/Short Exposure to Energy Is Very Low

Source: Morgan Stanley Prime Brokerage as of November 3, 2017.

Now of course, there's potential downsides that may delay our bullish oil thesis.

The big unknown is China. With President Xi having consolidated power there's now talk he's going to make some moves to deleverage the economy. And there's evidence in the data of this effort (look at the recent selloff in metals).

It's unclear how aggressive the communist party will be in cleaning up China's balance sheet. Since the CCP's number one priority is maintaining social order, it's unlikely they'll move too swiftly and risk blowing up the system.

But China remains a black box. All we can do is look at the data available and adjust fire as we go.

Besides, there are numerous potential geopolitical shocks that could light a fire under our bull case.

There's potential war brewing between Saudi Arabia and Iran using Lebanon and Hezbollah as proxies. Not to mention the new Saudi crown prince seriously shaking things up at home. Then there's North Korea always on the brink of war and Venezuela which is quickly becoming a failed state. And the list goes on...

Arguably none of this is priced into the market at the moment.

But there are signs that the popular story is changing… albeit slowly.

This change is being led by the rise in price (as always). And we can bet that sometime next year, a reflexive loop will form where the rise in prices spurs adoption of our bullish oil thesis which further drives prices.

John Percival's quip, "Listen to what the market is saying about others, not what others are saying about the market" applies.

For now we're sitting tight with starter positions in our energy basket of (RIG, WTI, ESV, COG, CHK).

Below is a chart of the basket on a weekly basis. You can see the group is trading in a 2-year channel. Long consolidation patterns like these often form the base for explosive multi-year moves.

Once the group breaks above the channel we'll look to get more aggressive in adding to our positions.

The key is to sit patient and wait for the tape to give the "all clear". Trading turnarounds can be choppy which is why we're sized small and waiting for the trend to develop further. If we're right in our hypothesis then the wait will be worth it, because these beaten down equities could see a repricing in the multiples… making the risk of being an oil trading Go-Devil well worth it.

<u>**Summary**</u>

- **The popular narrative surrounding oil over the last 3 years has been:**
    - **1) Supply is rapidly growing due to fracking driven productivity growth**
    - **2) Electric vehicles are taking away a huge source of demand**
- **But the latest data doesn't support this narrative…**
- **Forecasters have been misattributing increased oil supply to productivity gains when it was really from tapping Tier 1 fields and DUCs.**

- **Drillers have cut production and CAPEX and are now experiencing large drawdowns in inventories.**
- **The most bullish scenario for electric vehicles displaces only a miniscule amount of oil demand over the next decade. Oil demand is actually set to rapidly grow as Asia hits the wealth S-curve**
- **The market is slowly waking up to this reality and there will be a massive repricing once it does. We're sitting with starter positions in RIG, WTI, ESV, COG, CHK.**

The Macro Cycle: Full Steam Ahead

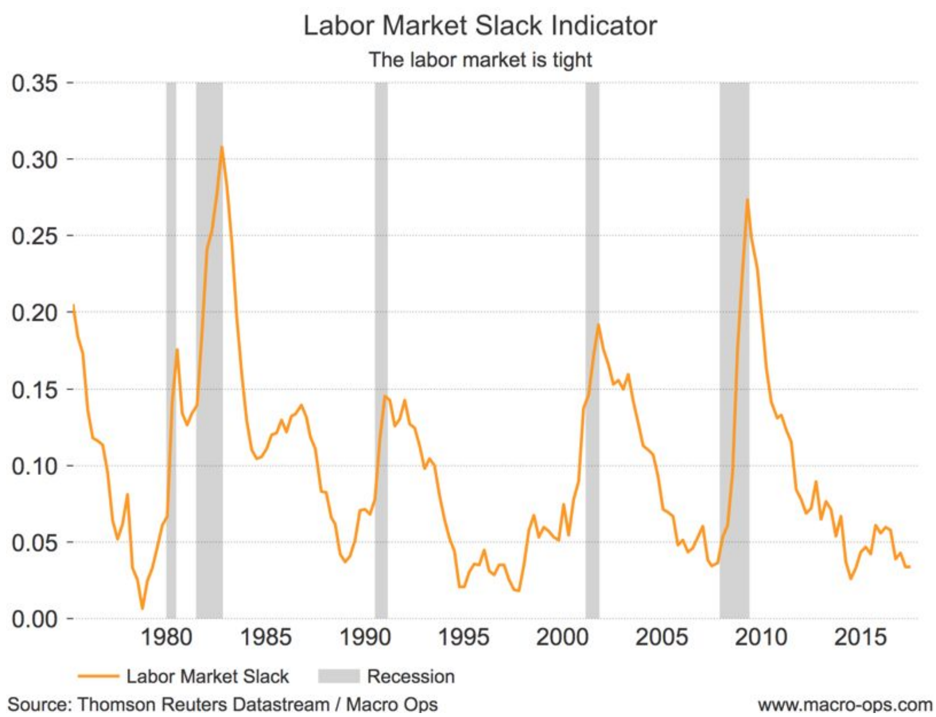
"Without data you're just a person with an opinion." ~ W. Edwards Deming

Let's take a step back and look at the data showing where we are in the cycle. We'll see how much support the market and economy have going into 2018.

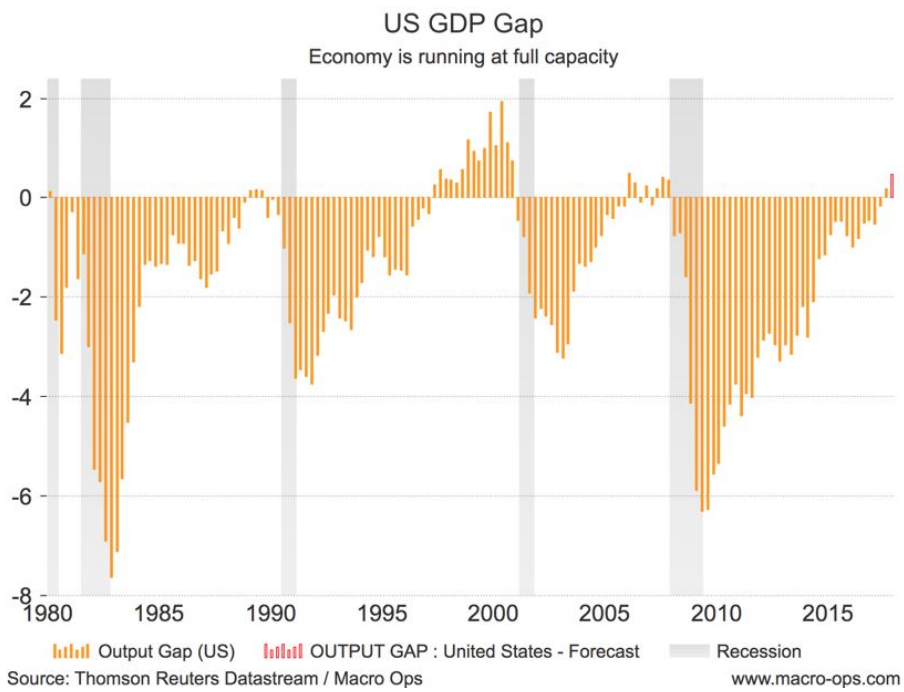
Capacity is tight.

The data shows an economy running at full capacity:

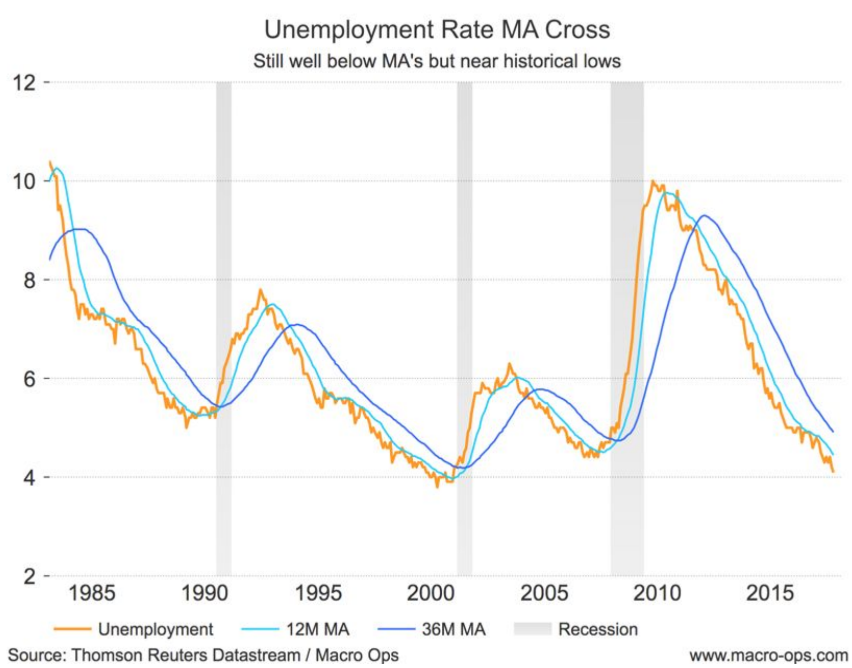
➢ Our labor market slack indicator is near historical lows. (This indicator measures the total available workforce relative to those employed against the total capacity in the economy.) This means the labor market is very tight which will result in greater wage pressures and inflation in the coming year.



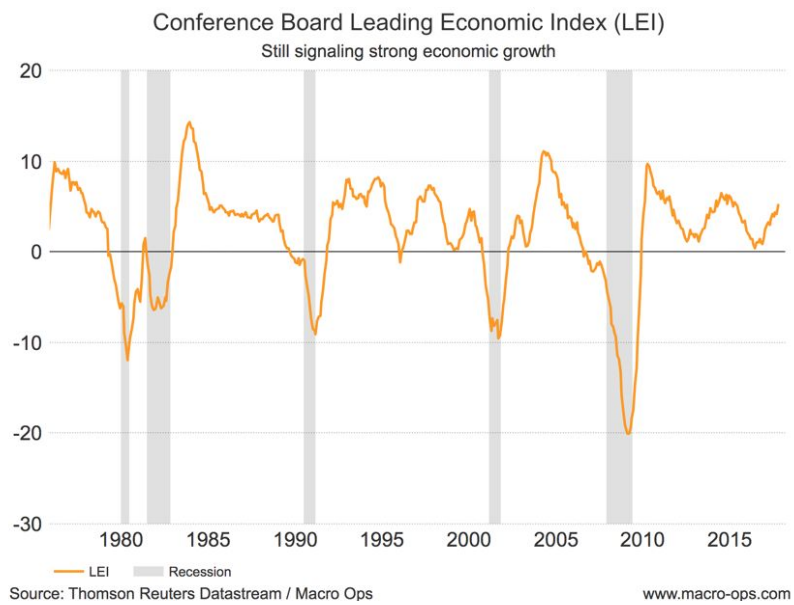
➢ The GDP Gap has completely closed this last quarter, hinting that the economy is running above capacity.



➢ The unemployment rate is trending downwards and near historically low levels. It remains well below its 12 and 36 month moving averages. The rate typically crosses above the 12-month average a year prior to recession which means a recession is unlikely until at 2019 at the earliest.



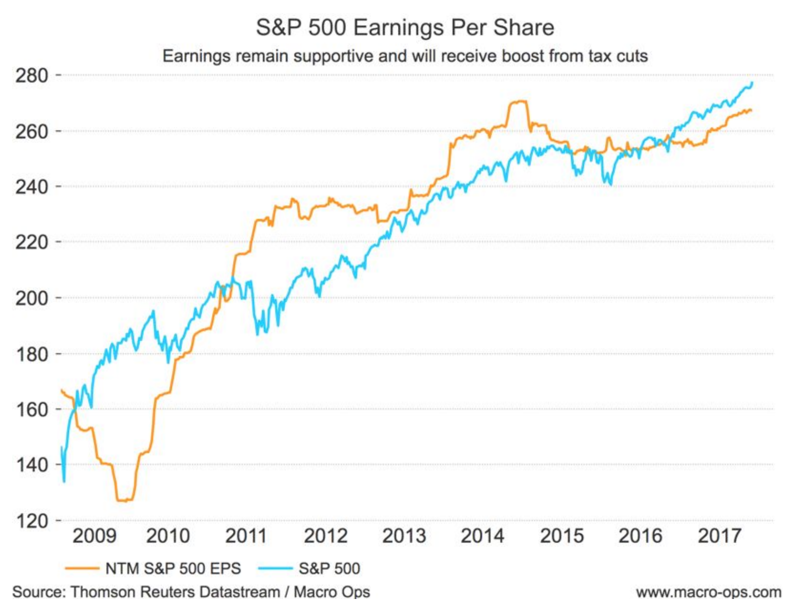
➢ The Conference Board's Leading Economic Index is in a strong uptrend. This suggests continued growth in the months ahead. The LEI will go negative on a yoy basis 12 months prior to a recession.



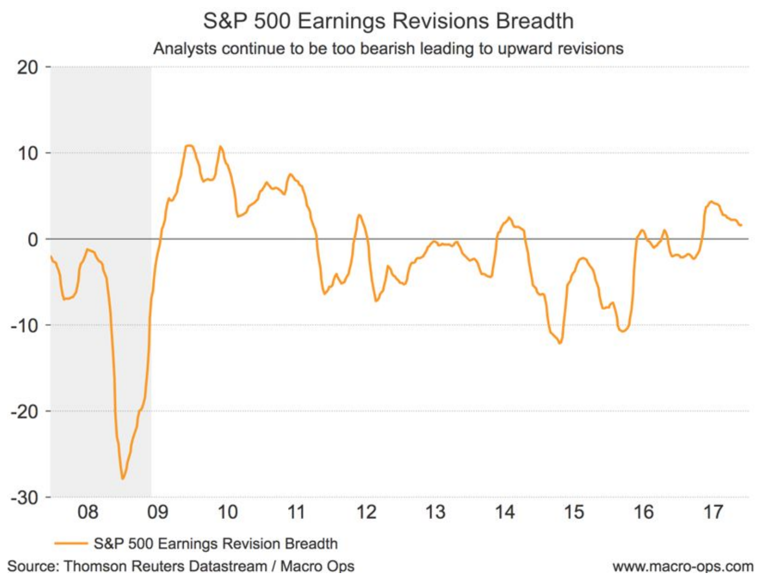
The stock market remains supported by strong earnings.

Earnings growth remains supportive of equity prices:

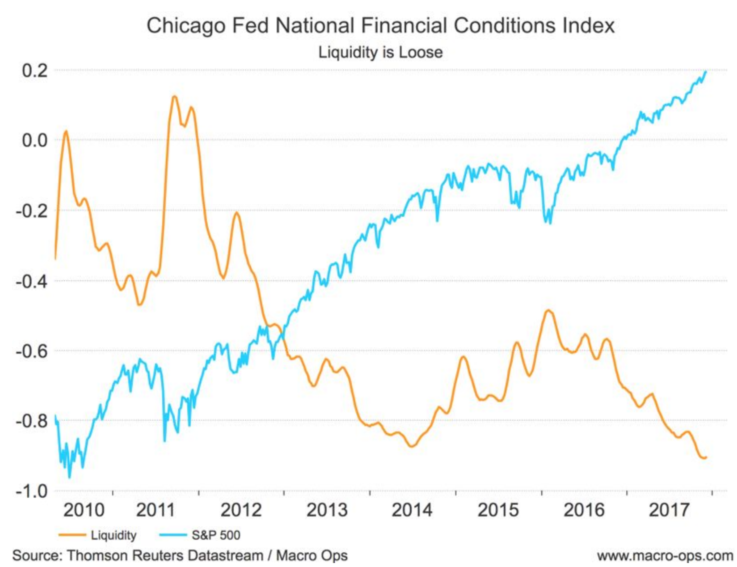
➢ The trend in EPS is up and with probable tax cuts next year we should see this trend accelerate.



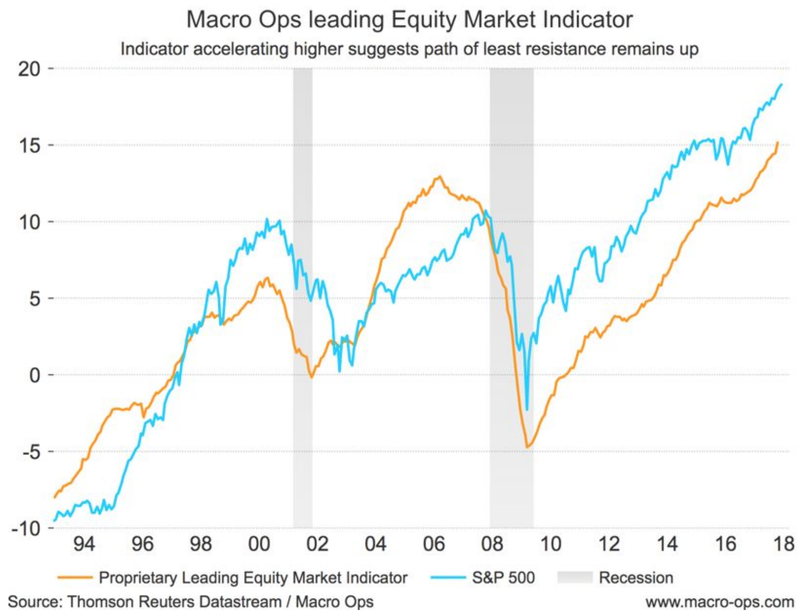
- EPS revisions breadth has been positive the last 12-months. This shows that analysts have been underestimating the strength of the economic recovery, resulting in positive earnings surprises to the upside.



- The Chicago Fed National Conditions Index shows that liquidity is extremely loose which is supportive of equity risk premiums.



- Our Leading Equity Market Indicator is also accelerating higher. This suggests that even though the current rally is stretched, the path of least resistance remains up — at least for now.



Late cycle conditions can last for years and this time should be no different.

The following from Morgan Stanley sums up the current market, well.

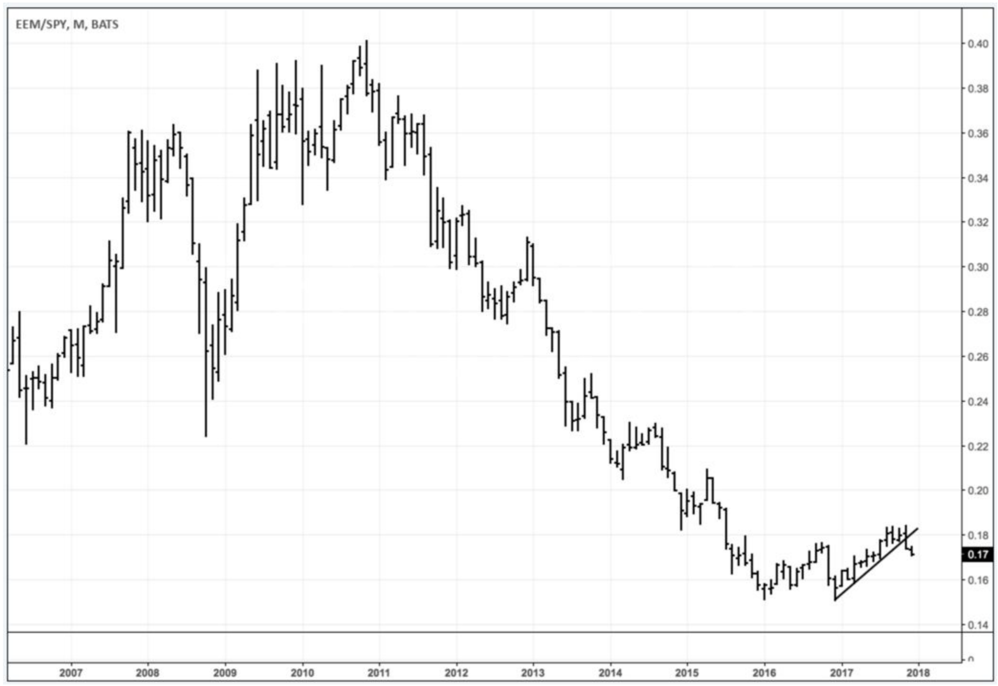
> *We believe the late cycle stage began in late 2016 as animal spirits came to the forefront after the US Presidential election. Given the delays in tax reform and other legislative action, the behavior we typically see on the back of rising animal spirits has been delayed until now. With clarity on tax and other parts of the legislative agenda, the behavior that leads to excess (in capex, more questionable M&A, and frivolous consumer spending is) starting to appear and will likely accelerate in 2018.*

With this macro context in mind we can drill down into relative momentum charts to try and suss out what's setting up to outperform going forward.

The following are the major reversals and developing trends we're tracking on top of our oil thesis.

The U.S. will outperform foreign markets.

The following chart shows emerging markets (EEM) against the US (SPY) on a monthly basis.



We can see that the pair closed on its lows last month and are breaking lower. This means emerging markets are underperforming against the US.

A chart of the US versus the rest of the world also shows US stocks beginning to outperform foreign markets. We expect this trend of US outperformance to continue into the first half of the year. This will reverse capital flows back to the core (US), causing greater volatility in emerging markets, and driving the US dollar higher.

U.S. financials will outperform the broad market.

The chart below shows the financials ETF (XLF) against the S&P.

We expect inflation to surprise to the upside in the coming year. This will move long end treasury yields higher which will propel financial stocks on a period of continued outperformance relative to the S&P index.

We prefer playing the large banks over the smaller regionals as the former will benefit more from rising long end rates. Morgan Stanley (MS) is our favorite of the group and the June 18' DOTM (deep out of the money) calls are good way to play the trend.

Retail stocks will finally stage their comeback.

The following chart shows a reversal at work in retail stocks (XRT) relative to the S&P.

Retail has vastly underperformed the broader market over the last three years but it looks like that's about to change.

Many retail stocks are trading at extremely low valuations. A period of outperformance would be consistent with the Investment Clock model where value stocks tend to outperform in the Overheat phase of the cycle.

Our favorites are Walmart (WMT) and Tuesday Morning Corp (TUES).

WMT has made a number of key acquisitions (most notably Jet) in the tech space, as well as some smart partnerships with companies like Google. The company looks to finally be playing offense against the big disruptor AMZN.

We expect WMT's revenue growth to pick up next year and the stock to continue trending higher. A positive for WMT is that since the company is moving more aggressively into tech, the market seems to be moving its attention from near-term bottom line earnings to top line growth. We should expect to see a multiples expansion closer to its peers, going forward.

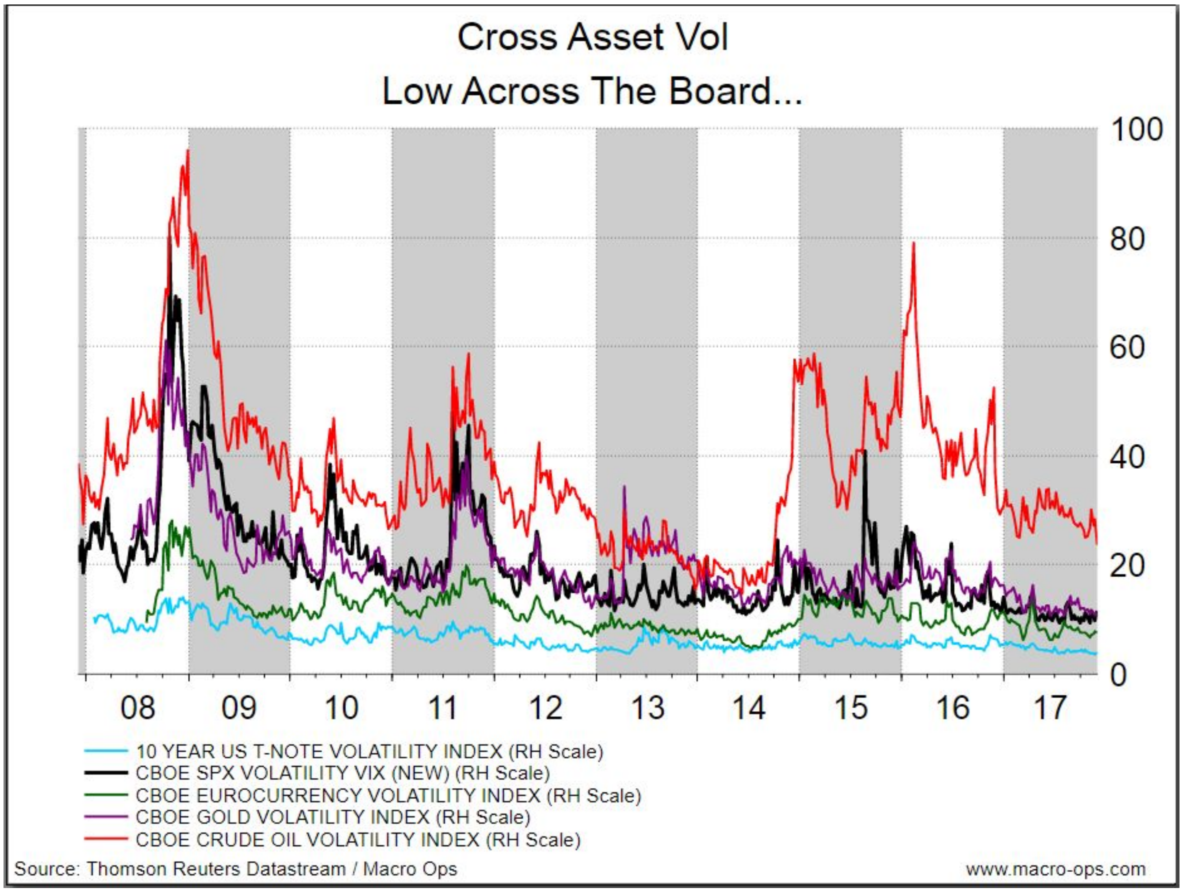
TUES is a discount retailer we covered in the June MIR. It's got solid management that's making the right changes. And these changes are starting to show up in the numbers in improved revenue growth and uptrending positive cash flows. It's also cheap and management is buying back lots of the stock.

Summary

- **The economy is firing on all cylinders.** The labor market is tight, the GDP gap is closed, and growth is accelerating. This is leading to increased wage growth and price pressures building in the economy which will result in stronger than expected inflation in the coming quarters. Stronger inflation will lead to less accommodative central bank policies and higher interest rates.
- **Earnings growth and liquidity continues to support this highly valued market.** Because of stronger sentiment, positioning, and rising interest rates, we expect greater market volatility starting next year. But the dominant trend will remain up going into the first half of 2018.
- **Tax cut clarity paves the way for an extended late cycle run.**
- **The US equity market should continue to outperform foreign markets.** This will lead to a reversal of speculative flows which will drive the dollar higher and increase volatility in emerging markets.
- **US financials look set to outperform the broader market.** Rising interest rates and a strong economy will act as tailwinds for the relatively cheaply valued sector.
- **The period of retail underperformance relative to the broader stock market looks to be over**. There's lots of value in this space but there's also plenty of melting ice cubes so names need to be chosen with care.

Quant: Odd Man Out

In the last three MIRs we've covered long vol trades in the quant section. That's because vol has been hitting post-GFC lows in almost every single asset class. And when vol gets *that* low it's a good time to go bargain hunting for some optionality to play for mean reversion.



But there's one area of macro that we've specifically avoided buying options in — and that's oil.

You can see in the chart above that since 2014 oil vol has had a mind of its own. That's because the energy industry went through a good 'ole fashion economic bust — a rare thing in today's centrally planned economies!

Oil is the one area in the market where vol is actually an attractive sell rather than an attractive buy.

Selling vol after an industry bust is analogous to selling hurricane insurance right after a hurricane. The price of insurance after a huge storm skyrockets as everyone scrambles to get protected. But the *true* probability of that storm occurring hasn't changed. The insurance is just overpriced.

The same thing happens in financial markets. After a bust, investors and traders scramble to buy protection because they don't want to get burned again. But the *true* probability of another crisis occurring isn't any higher than it was pre-crisis. In fact — the probability of another crisis occurring is actually *lower* than before since an economic bust clears out the dangerous leverage and excessive investment.

We're in a "post-hurricane" environment right now in oil. The fundamentals have reset and are now pointing to a turn in the cycle while the option premiums still have plenty of meat on the bone.

If you look at the spread between IV and HV, the "post-hurricane" effect becomes clear. In the chart below we've plotted implied volatility in white against 30, 50, and 75 day realized vol.

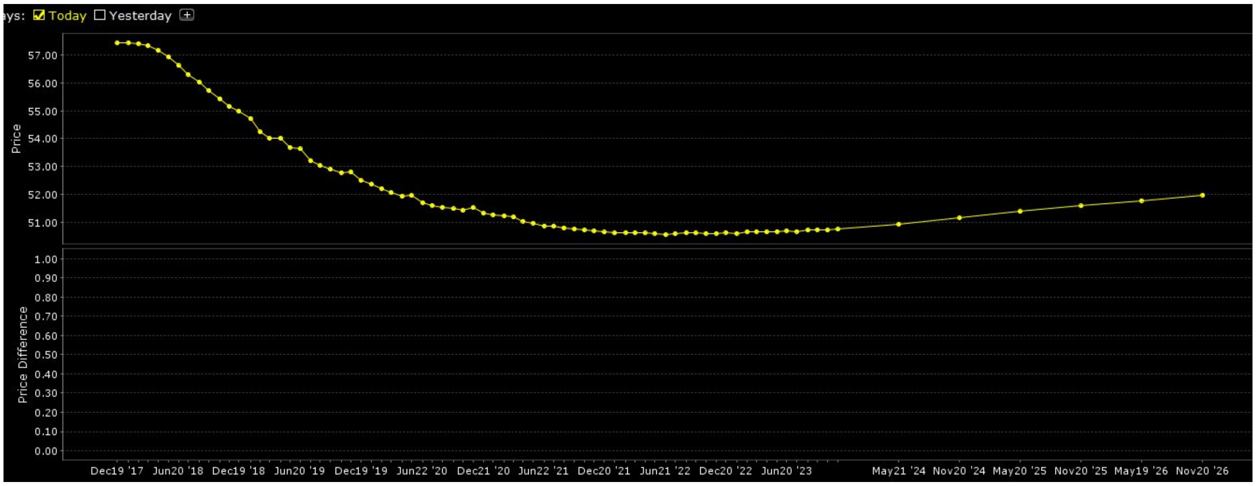
Implied vol has been consistently higher for most of the year which means that options have been too expensive. Traders and hedgers have been expecting moves that never come — just like a classic "post-hurricane" insurance market.

Option buyers are making a bad bet because the oil market has fundamentally changed.

In this quant section we want to highlight the oil futures curve. The shape of the curve is a powerful driver of future returns for anyone trading the oil price.

The WTI crude oil curve has transitioned into backwardation — historically a bullish sign.

This is what backwardation looks like.



Backwardation means futures priced out further in time are cheaper than the price of oil today. You might think that means oil is expected to get cheaper but the effect is exactly the opposite. **In general futures roll up to the spot price — not the other way around.**

The graph below, courtesy of Morgan Stanley, shows how the crude oil curve has evolved over time since the 2014 energy bust. You can see that we have entered an area of backwardation for the first time since the large sell-off.

Exhibit 33: WTI Time Spreads ($/bbl)

Source: Bloomberg

This is a loud signal that the fundamentals of the industry have improved. We're emerging from an oversupplied environment into one where supply is becoming tight. That's why the curve has inverted. Real economic demand is finally outpacing available supply.

A look at the chart shows these bullish dynamics stand out in a clear way.

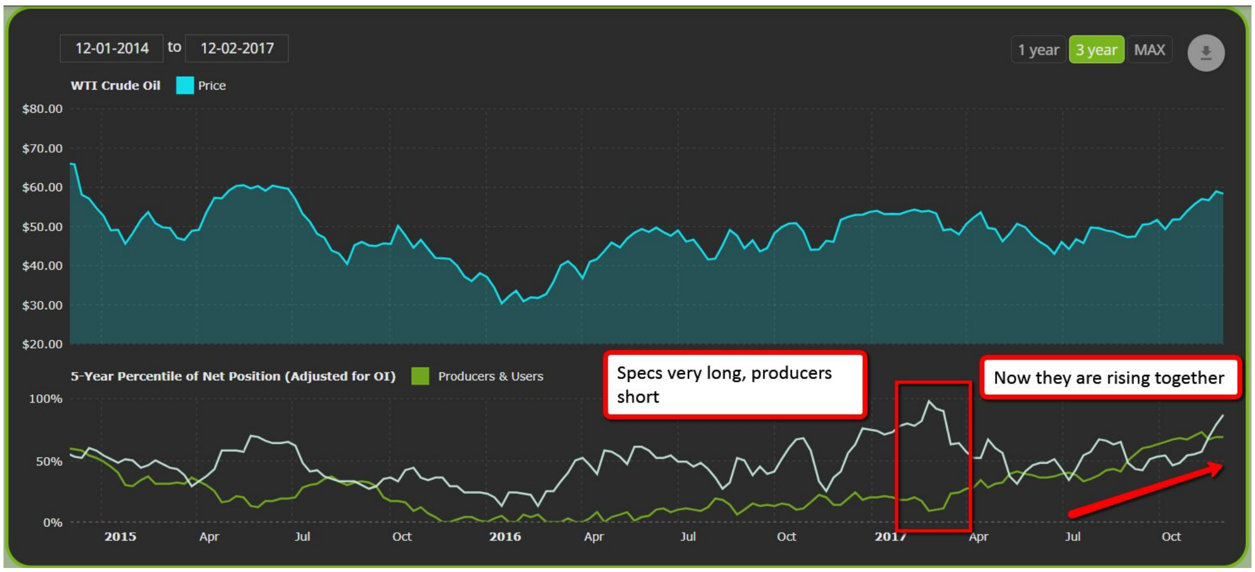
Price has broken out of a long consolidation and has held the move for over a month. The 20-week MA has formed a stable upward slope.

But what about positioning? There were some concerns earlier in the year that specs were building up record long positions in crude oil futures.

Currently, positioning has become stretched to the long side — but with an interesting twist — producers are buying too.

The typical heuristic used with COT data is that you want to fade the speculators and go with the producers. When producers are buying a commodity it's usually for good fundamental reasons. When specs are buying it's usually a "mud at the wall" attempt to hop on a trend. Specs cover quickly when wrong.

In March of this year we had a massive spec long position build up in crude, but the producers were still shorting. In predictable fashion, oil had a big washout as the specs scrambled to derisk once momentum declined.



But now producers have bought this rally along with the specs. **Producers have actually been slowly accumulating long positions all year.**

So from a positioning perspective we don't have to be overly concerned. Yes, specs have started to chase the trend, but producers have joined in as well. There's a lot of support under this move.

The combination of overpriced vol, bullish fundamentals, bullish technicals, and bullish producer positioning create a great opportunity to get short puts in crude oil.

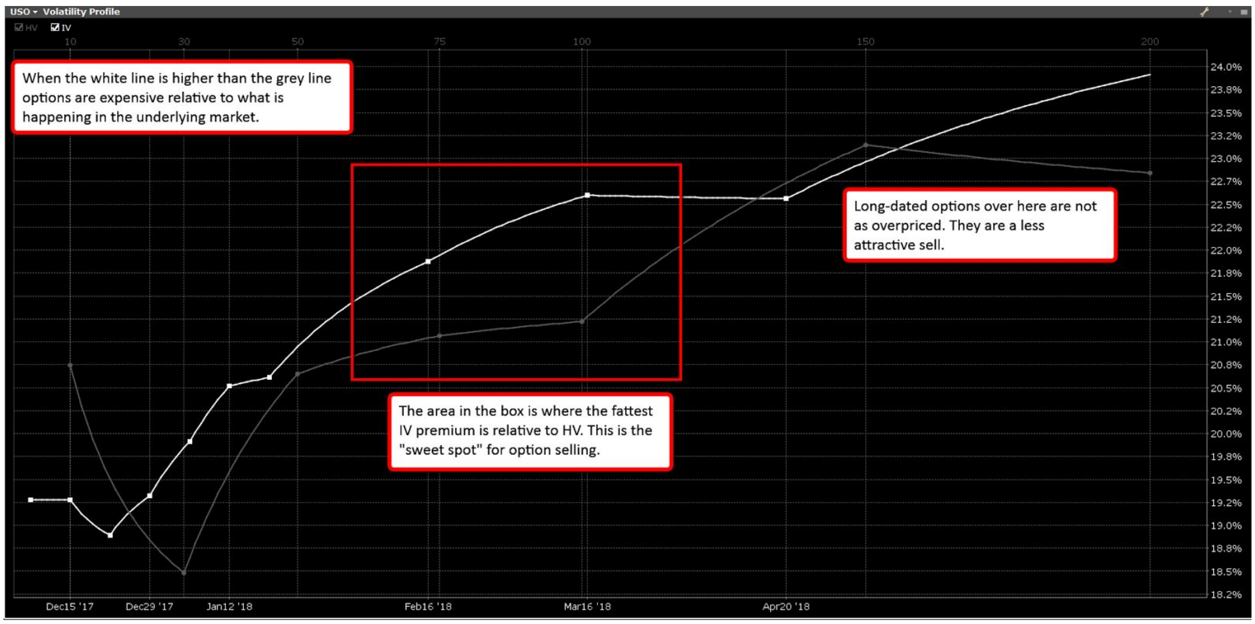
The trick in options trading is figuring out what expiration to sell. The tenor of the option is just as important as the directional bias and the vol level so we need to choose wisely.

The latest option literature out there will tell you to sell mid-term options, specifically those expiring between 30 and 90 days. Our experience would agree with that. Institutions and hedgers almost always use this tenor to hedge exposure which means they are expensive relative to the short-dated and long-dated options.

If you've been with us for a while you know that we like to sell mid-dated options and buy long or short-dated ones.

The term structure of current oil options fits exactly within our rule of thumb.

The chart below shows what IV (in white) and HV (in grey) look like at each expiration. We want to sell areas where the white line is high above the grey line.



The curve dynamics clearly show that we want to be selling options in the 60-90 day timeframe. It's nice when the data confirms the theory!

There are two ways to express this trade. The first is through options on the oil ETF USO. And the other is to directly trade the options on futures.

In USO we like shorting the puts struck at 11 expiring in February. As of this writing they are trading for $.30.

For the futures we like shorting the 55.5 puts that expire with the March crude contract. They are currently trading for a $1.65.

This trade serves as nice way to add positive carry into a portfolio without the swift "washout" risk we face in the equity market.

Summary

- **Crude oil is the one macro asset that does not have low vol.**
- **The oil narrative has completely shifted and now points to higher prices.**
- **Backwardation in the oil curve confirms the narrative shift.**
- **Crude oil futures have a bullish chart formation with positioning support from producers.**
- **These dynamics make selling oil puts set to expire in February an attractive trade.**

Updates

IBKR

Interactive brokers continues to be one of our strongest performing equities since we covered it in the August MIR. It's seen a strong 50% run with little drawdown.

IB releases their brokerage metrics each month so we don't have to wait until an earnings calls to see results. The latest release on December 1st had some good things to say.

- IB hit a new all-time high in customer accounts — 474,000. This is 25% higher than the prior year and 2% higher than last month.
- DARTs (Daily Average Revenue Trades) have risen to 795,000. This is 9% higher than the prior year and 14% higher than the prior month.

Growth remains strong and we expect this to continue.

IB has also started to improve their client facing software. We've never been a fan of their analytical tools, but the recent releases have actually been pretty good. We've gotten a lot of use out of their new "volatility lab."

If you're an option trader check it out!

Finally, there's been a lot of negative discussion around IB for jacking up margin requirements on volatility products. But this is actually a ***good thing*** for shareholders. IB is proactively protecting themselves and clients for when the short vol trade finally turns.

We will continue to hold IB until either the primary trend clearly turns or some new data changes our thesis.

AGRO and SANW

In the October MIR, we talked about a few agriculture stocks that we liked as a play on rising commodity prices. But so far none of these have been able to gather enough momentum to justify an entry. We have a habit of being early and are keeping these trades on our watch list.

AGRO continues to consolidate sideways. We're waiting for a break above $10.50 to look at it again.

And it's the same story with SANW. The stock is stuck in it's bottoming pattern. We aren't really interested in entering until this thing breaks $3.50.

None of these stocks will move higher until the underlying commodities start to gain some upward momentum. And so far the futures have been unable to breakout higher all year.

In summary, we still like the theme over longer-term but it looks like it's going to take some more time to develop.

VIX Hedge

In the quant section of the November MIR we explained how to hedge equity exposure with zero carry by shorting VIX 10.5 puts to finance VIX 16 calls.

Since we debuted the trade it has performed as expected. VIX has rallied since November out of the low 9s and into the 11s.

So although the 16 calls haven't seen any profits, the short 10.5 puts have paid the time decay.

This is great because we've been protected from SPX drawdowns without having to deal with the slow bleed.

This zero-carry protection is still possible for the December expiry.

The December 20th VIX 10.5 puts are trading for $.40. And the December 20th VIX 16 calls are trading for less.

Shorting one of the VIX 10.5 puts will generate enough to premium to buy the 16 calls at 0 cost.

This will cover exposure until the week before Christmas. But beyond that the trade is not nearly as attractive. The Jan VIX 10.5 puts are only trading for $.20. There's just not enough premium there to make this option structure worth it.

Asset Allocation

Asset Allocation Weightings	Underweight	Neutral	Overweight
EQUITIES			
Large Cap Growth			x
Large Cap Value			x
Small Cap			x
Mid-Cap			x
International Equity		x	
Emerging Market Equity		x	
Cyclical			
Materials			x
Gold	x		
Commodities			x
Consumer Discretionary		x	
Financial Services			x
Real Estate, Domestic		x	
Real Estate, Global	x		
Sensitive			
Energy			x
Industrials			x
Technology			x
Telecom	x		
Defensive		x	
Consumer Staples		x	
Healthcare	x		
Biotech		x	
Utilities		x	
FIXED INCOME			
Preferreds		x	
Government Bonds		x	
Corporates		x	
Munis		x	
Long Duration		x	
Intermediate Duration		x	
Short Duration	x		
High Yield	x		
TIPS			x
Emerging Credit		x	