2018 ~~Predictions~~ Strong Opinions, Weakly Held

Operators,

It's that time again where everyone likes to make their "big calls" for the upcoming year.

But as macro traders we know that these "calls" are nothing more than a probability weighted assessment of what might come. I urge you to take our calls as simple "strong opinions, weakly held" rather than prophecy.

Right now the data says to focus on commodities. Oil and uranium should have a great year ahead of them.

In This Issue:

Outside of that we're really excited about three stocks:
Talend S.A. (TLND), Limbach Holdings (LMB), and JD.com (JD).

Volatility shorts should continue to perform until the latter half of the year. But that timeline could get moved up if one of the major systemic risks trigger earlier than expected. We talk about all of those potential risks in the final section of this MIR.

As the year plays out, data will change, and we'll update our beliefs accordingly.

To strong opinions, weakly held!

Your Macro Operator,

Alex

Macro: The Commodity Bull

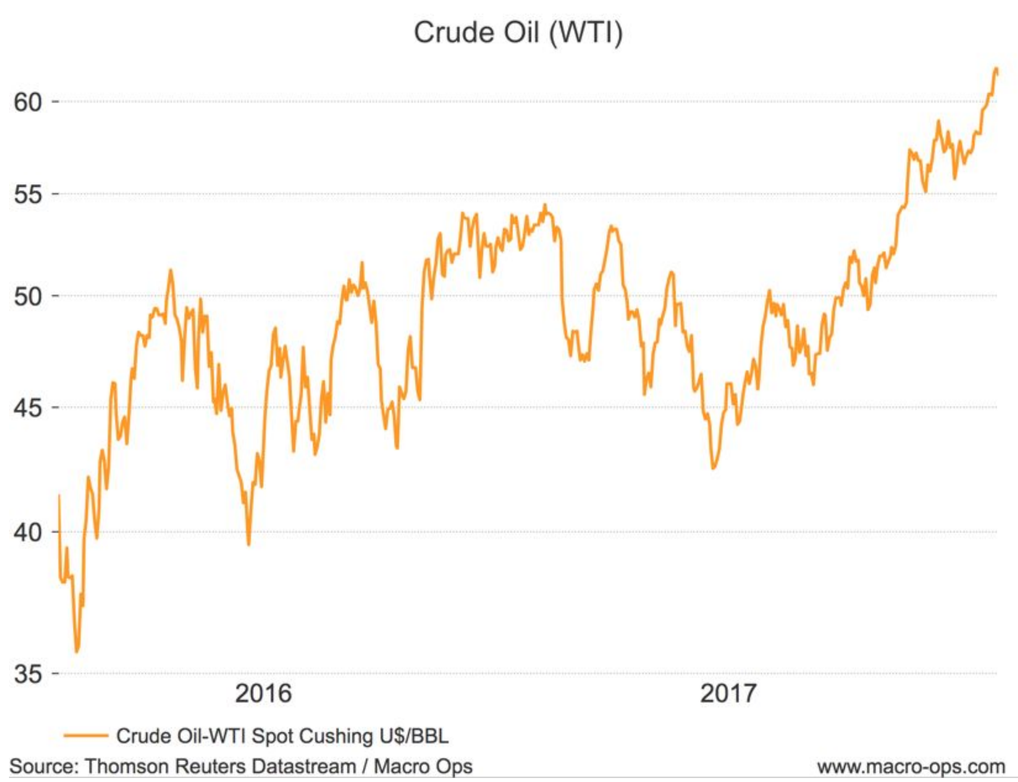
2018 will be the year the commodity bull gets running…

> *When a man makes his play in a commodity market he must not permit himself set opinions. He must have an open mind and flexibility. It is not wise to disregard the message of the tape, no matter what your opinion of crop conditions or of the probable demand may be.* ~ Jesse Livermore

> *The stock market has far more short-term countertrends. After the market has gone up, it always wants to come down. The commodity markets are driven by supply and demand for physical goods; if there is a true shortage, prices will tend to keep trending higher.* ~ Bruce Kovner

In late August we turned outright bullish on crude oil and energy related stocks. At the time this was a deeply unpopular opinion. No sooner than when we published did we start receiving emails giving us a list of reasons why we were wrong. I love this type of response when I take a real contrarian viewpoint. The more derided and unpopular our market stance, the more profitable the trade usually ends up being.

At the time, WTI crude was trading around $46bbl. And most market players were calling for a return to the $30s. Instead, crude went on a run rising over 30% to +$60bbl where it is today.



The energy stocks we've recommended over the last four months have done well.

- WTI is up over 100%
- RIG is up 36%
- CRR is up 70%
- ESV is up near 50%
- COG is up 14%

Despite this run up in oil and energy stocks, we're still hearing primarily bearish takes on the sector with traders looking to call a top after every rise.

Typically after a 30% rise over a short few months, a bullish narrative becomes popularized and widely adopted. But we have yet to see that. This is all the better because the greatest bull runs climb a mountain of disbelief. And that is what we're seeing here.

This negative sentiment just bolsters the bull case. **We think 2018 will be the year of the commodity bull. We expect WTI crude oil to climb over 20% higher and finish the year above $75bbl.** This will drive energy stocks (our basket included) up by multiples, and the energy sector will finish the year as one of the best performing sectors.

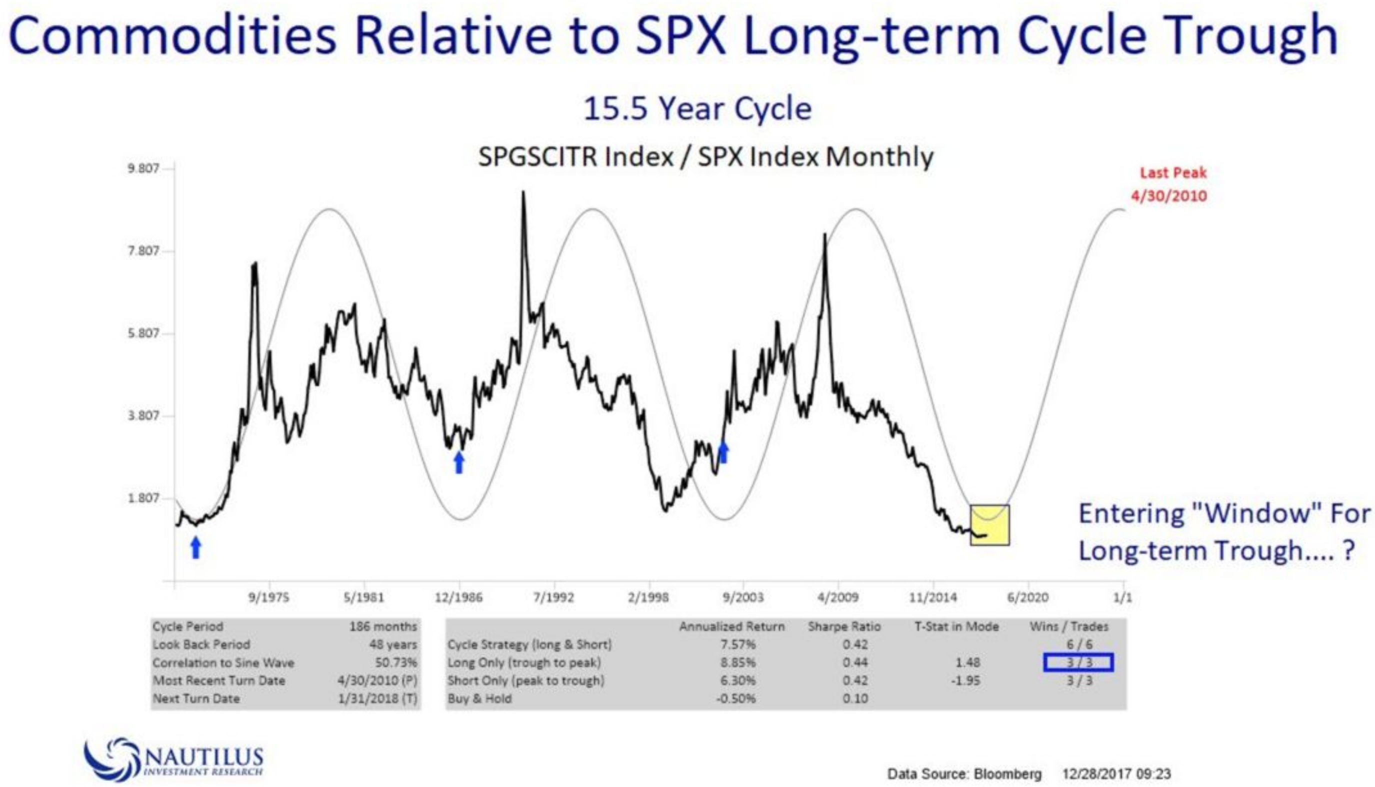
The evidence is increasingly pointing to this potentially being a secular bottom in commodities and energy stocks in particular.

We have commodity valuations relative to stocks at 100 year lows.

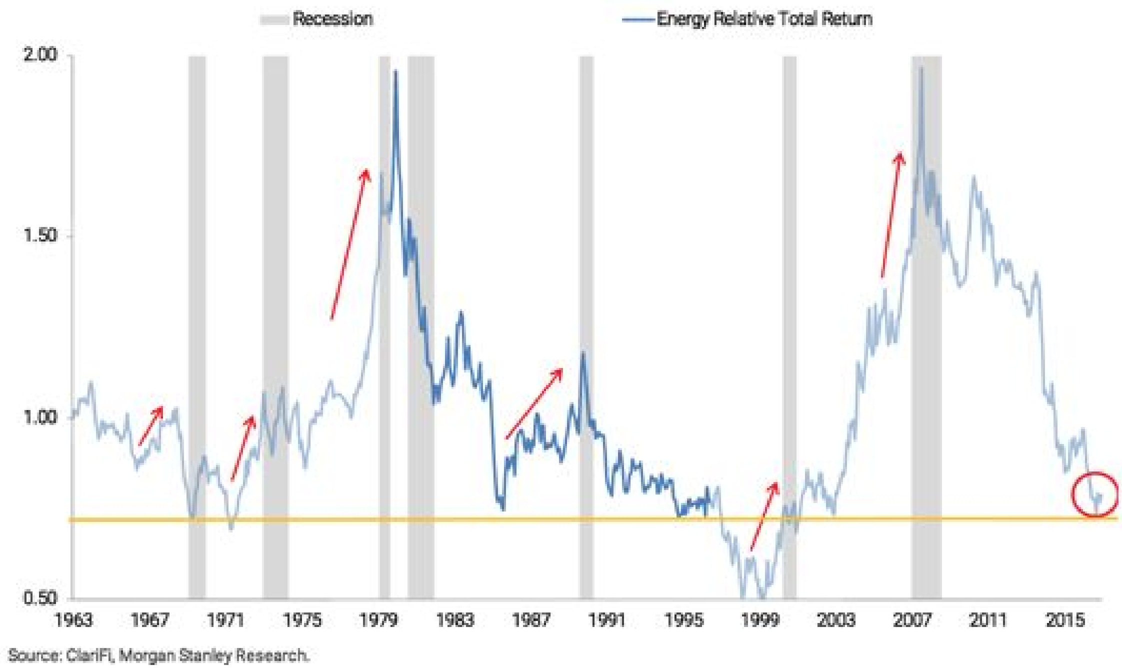
Chart 1: 100 Years of Commodity Valuation

(1) Goldman Sachs Commodity Index to 1970. Goehring & Rozencwajg Commodity Index pre-1970.
Source: Bloomberg, Goehring & Rozencwajg Models.

Commodity pricing relative to stocks tends to follow a full 15.5 year cycle. **We're at the trough of the current cycle — a point that has marked the start of the last three commodity bull markets.**



And energy's relative total returns to stocks is classically a late cycle performer, as we've noted at length in our [September report](#) on where we are in the Investment Clock cycle.



We are at a long-term inflection point for commodities.

Global growth continues to surprise to the upside, which we expect to continue in 2018. And inflationary pressures are starting to build which will become apparent next year (note: we don't expect "bad" as in high rampant inflation, but we expect stronger, around 2% inflation to persist towards the second half of the year). And beaten down commodity/value stocks do well in this environment.

Throw in the potential for a new infrastructure spending bill here in the US, as well as increasing expansionary policies in other parts of the world (ie, India), along with the wealth S-curve, and we have the makings for a large secular bull market in commodities that's ready to get started.

2018 marks the year that uranium and uranium equities complete their secular bottom and more than double in price by the end of the year.

The 2011 Fukushima disaster kicked off a 7-year bear market in uranium and uranium stocks. It's been a steady and painful decline. The sector, shown in the monthly chart above (uranium etf URA), has completed a 2-year triple bottoming pattern. Conditions are now ripe for a major recovery in the industry.

The bullish case for uranium is very simple: nuclear as a base load electricity source is not going away. In fact, it's set to increase and will likely become a central source of clean energy in the decades to come.

But at its current price of around $20 a pound, even the lowest cost producers can't profitably mine the stuff. This is the classic case of 'low prices being the cure for low prices'.

And recently we've seen the catalysts that are set to drive spot uranium above $35 a pound by the end of the year, and miners (which are a leveraged play on the spot market), many multiples higher along.

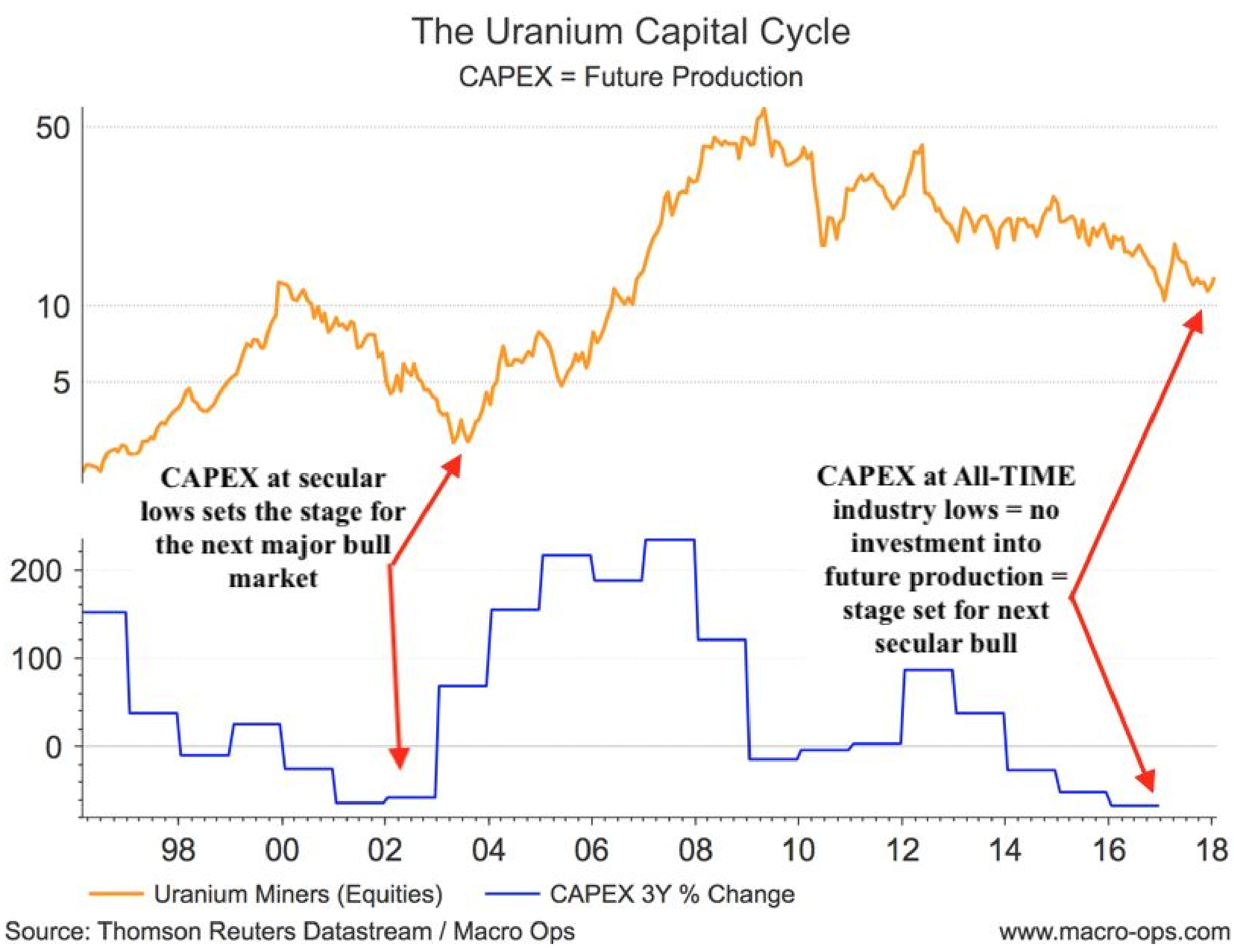
Here are the numbers:

- ❖ Nuclear energy is responsible for over 10% of global electricity production and 20% of electricity in the US.
- ❖ More than a dozen countries get over 25% of their energy from nuclear. And there are approximately 440 nuclear reactors running around the world.
- ❖ 75 new reactors are currently under construction. 168 are in the planning stages of construction and 300 more are being proposed.
- ❖ China alone has 20 reactors under construction and over 115 more that they're planning to build (with the aim of cutting down pollution from their coal burning power plants).
- ❖ India recently pledged to 10x its nuclear capacity over the next decade.
- ❖ This means we are going to see a significant secular rise in uranium demand over the next two decades. As of right now, demand is expected to increase to 190 million pounds per year by 2020 and to 220 million pounds per year by 2030. That's an increase of 20% in just 15 years.
- ❖ Meanwhile, massive cuts to supply are in the works with spot prices so low.
    - ➢ Cameco (the world's largest public uranium miner) recently said it's shutting down production at its massive McArthur River mine in Canada. This mine is responsible for over 10% of global uranium production. **This is equivalent to Saudi Arabia announcing that they are shutting down ALL oil production. It's that significant…**
    - ➢ To top this off, Kazatomprom, the Kazakhstan state uranium producer and largest uranium miner in the world (accounts for over 40% global uranium production), just announced a 20% reduction in production over the next three years.

Like oil, we're seeing a similar capital cycle at work, but on an even more massive scale.

Producers simply can't make money at current prices and so many have been driven out of business. The few who remain have slashed CAPEX and taken production offline.

Just look at the chart below showing uranium miner equities (orange line) and the rolling 3yr change of CAPEX for the industry.



CAPEX is at its lowest levels EVER…

This means we're set to see rising demand for nuclear (due to greater electricity needs from global wealth S-curve effects) at the same time we're entering an extremely tight supply environment due to non-existence investment into future production.

This is what massive secular bull markets are made of.

The last time CAPEX across the industry was anywhere near being this low, it marked the bottom in uranium stocks, many of which went on ridiculous runs of over 1,000% over the following couple of years. We think we're about to see a replay.

Ur-Energy (URE), Uranium Energy Corp (UEC), Cameco (CCJ), and Denison Mines (DNN) are our favorite names to play this trend.

Micro: TLND, LMB, JD

Talend S.A. (TLND) will finish the year above $60 a share, a rise of close to 50%.

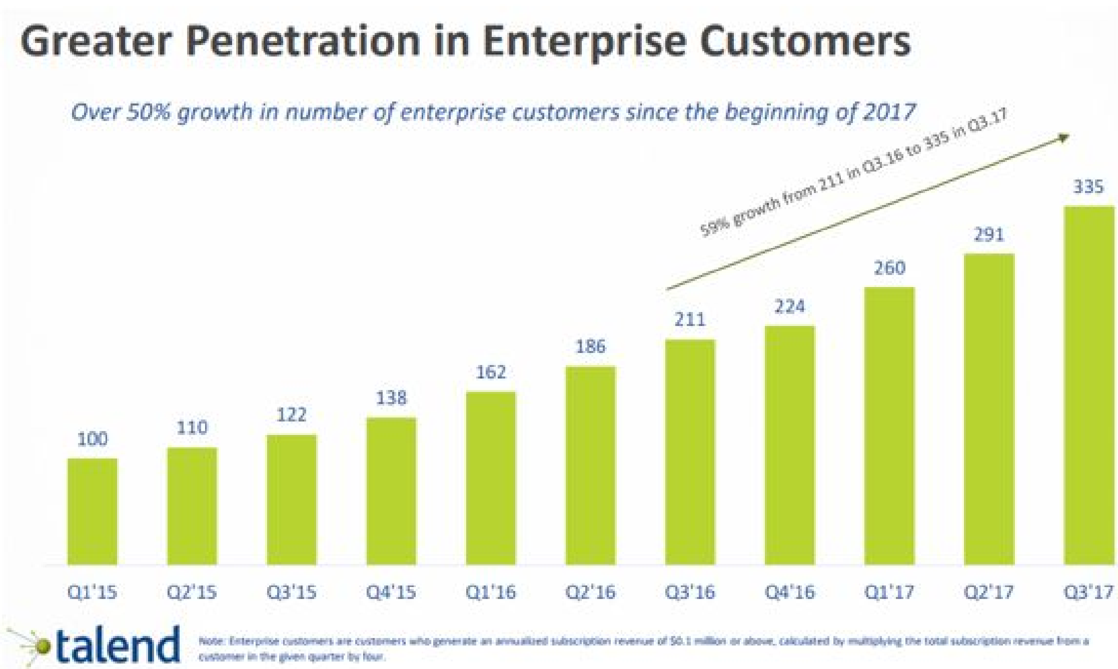
Company Profile: Talend SA (TLND) is a relatively new (IPO'd in 2016) and unknown tech company. Its main product is Talend Data Fabric which works to bring together a variety of enterprise systems and user endpoints into a single environment. Simply put, the company's products help other companies make sense of all their data.

What The Market is Pricing: At first glance, TLND looks far from cheap. It currently trades at 8x revenues, which on a relative basis, isn't super expensive for a high growth tech stock, but it isn't a screaming value either. It's still a relatively small ($1B market cap) and unknown player in the tech landscape. And being based in Europe has helped this stock fly under the radar.

Our Take: It's always important to look beyond the immediate numbers of a stock screen to try and understand the business and its future opportunity set. When you do that with TLND, you find that even an 8x sales multiple is too low for the runway of this company.

Big data is set to dominate our future as the IoT expands into nearly all areas of life. But big data without the proper means to analyze and make sense of it is useless. This is where TLND excels. The company's "data blending" capabilities can source data from multiple spigots and aggregate it all into a consumable format. And the company's tech is one of the best at doing so.

Gartner, the leading software industry analyst, recently named Talend the leader in the data integration tools space. The customer value of Talend's platform is beginning to rapidly spread and this is driving an acceleration in the company's growth. In this last quarter, TLND saw an annual revenue growth rate of 40% and a 60% increase in the number of enterprise customers it serves (these are high value customers).



The company also saw revenues from existing customers increase by 23% y/y, which puts sales growth from existing customers above the 20% mark for the 14th straight quarter. That is impressive and shows the value of Talend's products and the existing operating leverage it has in its subscription based business model.

We expect this operating leverage to accelerate growth *even further* in the coming years. As a result, we expect this company to have a strong run in 2018 and think the stock finishes above our end of year price target of $60 a share.

Limbach Holdings (LMB) will rise over 75% to finish the year at $26 a share.

Company Profile: Limbach (LMB) is a boring company, but boring in a good way. The company is a US based contractor that specializes in installing and servicing non-residential HVAC systems. It focuses on universities, hospitals and large entertainment venues (think stadiums and arenas). LMB has a centralized engineering staff that assists local architects and general contractors with the design of complex builds. This helps lower the design costs while improving win rates. The company has been around for over 100+ years but only went public in 2015 through a SPAC.

What The Market is Pricing: LMB trades at an extremely low valuation — multiples lower than its comparables. The low valuation is because it's an under the radar small-cap (a boring company in a boring industry). There's also a lot of negative stigma around going public through a SPAC. (SPAC's are rife with bad deals for the unwitting investor).

Our Take: LMB is an overlooked deep-value play with a clear path towards continued organic growth and margin expansion. The company has strong and experienced senior management and a healthy expanding business with a backlog that's growing over 30% y/y. The company has multiple avenues for expansion, either through selective acquisitions, expanding geographies, or adding new business lines such as electrical and fire suppression.

On their latest earnings call, LMB guided to the low-end of their original $18-20mn EBITDA guidance for 2017. But this is due to over $2mn in cost overruns on existing projects and $2mn on public company costs that will not recur next year. And it should be noted that LMB management has a history of being overly conservative in their guidance. This means that, at worse, 2017 EBITDA comes in at +7% for the year. But if we back out the one time non-recurring costs, earnings growth comes in at over 30%.

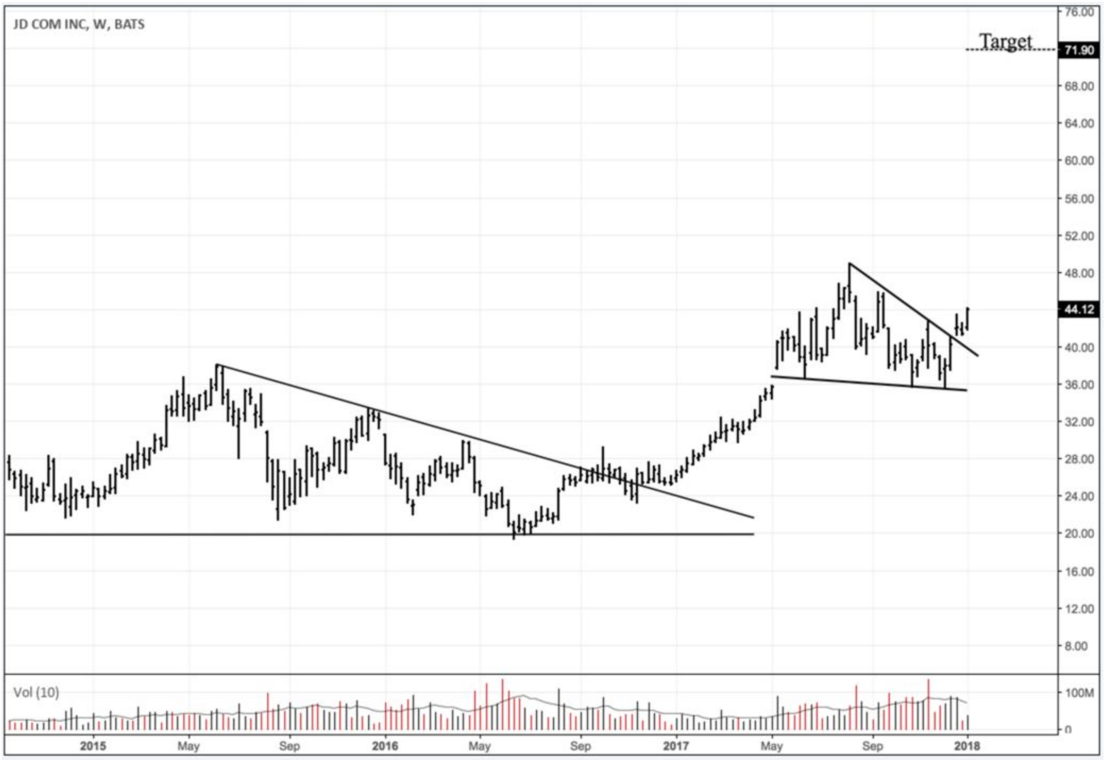
This sets up LMB for a really strong 2018. Backing out the non-recurring costs from 2017 and factoring in further growth (3Q backlog was up 9.4% with a shift towards higher margined services), we should easily see EBITDA come in above $25mn which would equate to 40% y/y EBITDA growth this year. In addition, the company just brought on one of its board members to lead it's search for accretive acquisitions. So it's likely that the company will make one or more acquisitions at under 5x EBITDA, adding around $7mn in earnings, which would put y/y EBITDA growth in the 70-80% range.

The stock is currently trading at just 4x our $25mn 2018 EBITDA estimate. And if LMB grows earnings, even at just our most conservative estimate, then the stock should see its multiple expand significantly. If we assign a still very modest multiple of 8x EBITDA on the lower end of our 2018 EBITDA projections of $23mn, it would mean the stock would be trading at $25 a share, over 80% higher than current levels.

Add in the coming focus on a new infrastructure bill, combined with the late cycle rise in CAPEX spending we're beginning to see, and there's a good chance we see investors' attentions turn back towards construction stocks which will only serve as an added boost on a deeply undervalued play.

One of our favorite small cap value fund managers, Scott Miller, did a writeup on LMB (it's one of his core largest positions). You can find it here.

JD.com (JD) Will go on a tear and finish the year over $70 a share, an increase of 60+%



Company Profile: JD.com (JD) is China's Amazon. It's the third largest online company in the world in terms of revenues — behind only Amazon and Google but ahead of Facebook. The company controls over 18% of the online retail market in China, and more than 30% of the online B2C market.

It's an online direct sales company and unlike AliBaba (BABA), JD owns and operates its entire logistics operation (which is now massive). This includes everything from warehousing, delivery stations, and even "last mile" delivery to customers' doors — which puts it ahead of even AMZN whom is only just beginning to test last-mile delivery.

What The Market is Pricing: JD trades at just 1.2x sales and 16x FCF. BABA, its main competitor, trades at 16x sales and 30x FCF. And AMZN trades at 3.6x sales and 76x FCF.

Why the large valuation gap? Two reasons:

1. Accounting/earnings: JD has been re-investing heavily in its logistics network and future business growth at the cost of current profitability (similar to AMZN's strategy).While

BABA has reported much larger earnings growth, some of the accounting is suspect and the company is likely overstating its true profitability.

2. Low profile: Unlike BABA and its stock promoting founder Jack Ma, JD and its founder/CEO Liu Qiandong have kept a much lower profile. This has resulted in the stock/company getting surprisingly little attention despite it being one of the most sophisticated, large, and fastest growing tech companies in the world.

Our Take: This is a stock you can buy and forget about for 10+ years. JD checks all the boxes of a hallmark long-term compounding machine:

- It's run by a truly visionary Founder/CEO (here's a few interviews with him: link 1 and link 2).
- The company plays the long game and isn't concerned with promoting its stock or boosting its short-term earnings at the cost of long-term growth/profitability.
- Numerous Chinese consumer surveys rank JD as the most popular and "trusted" e-commerce website in China.
- It's a fast growing company in a fast growing market:
  - In the first half of 2017, Chinese e-commerce grew by 29% y/y, versus 16% in the US.
  - Expectations are for JD to grow gross merchandise volume (GMV) 47% this year, to $79.3 billion and third-party GMV at 49%, to $61.6 billion. This is faster than both BABA and AMZN, which have GMV growth in the 30% range.
- It has a number of key partnerships that help it dominate the market:
  - It has a partnership with Tencent Holdings (which owns close to 20% of JD's stock) that allows JD to advertise and sell on Weibo, China's most popular social media site.
  - It also recently partnered with Walmart, who has 400 outlets in China and owns 10% of JD.
  - And it even partnered with Baidu (BIDU), China's leading search engine, which will allow shoppers to purchase JD goods within Baidu's apps.

Company / Ticker	Alibaba Group Holding / BABA	JD.com / JD
Recent Price	$180.53	$38.51
YTD Gain	106%	51%
Market Value	$457 bil.	$55 bil.
Founder	Ma Yun (Jack Ma)	Liu Qiangdong (Richard Liu)
2017E Gross Merchandise Vol.	$708 bil., up 30%*	$141 bil., up 47%*
2017E Revenue	$35.8 bil., up 56%*	$55.1 bil, up 46%*
2017E Net Income	$8.9 bil., up 41%*	$666 mil. vs. loss*

E=Estimate *Year-over-year change BABA estimates for fiscal year ending March 2018 Source: FactSet

So we have a fast growing company in one of the world's fastest growing consumer markets. The company is led by a visionary Founder/CEO who is reinvesting heavily into its future growth and building a massively defensible moat with its logistics network. Yet the stock is trading for just a small fraction of its peers…

I agree with JD's CEO Liu Qiandong, who recently said in an interview with the FT that, "Within five years I'm 100 percent sure we will be the largest B2C [business to consumer] platform in China — we will surpass any competitor." By competitor, Liu is referring to BABA, who's market cap is 9x that of JD's.

Eventually the market is going to wake up to JD's true value. And when it does, its stock will be a multi-bagger.

Quant: Ride The Trend Until It Bends

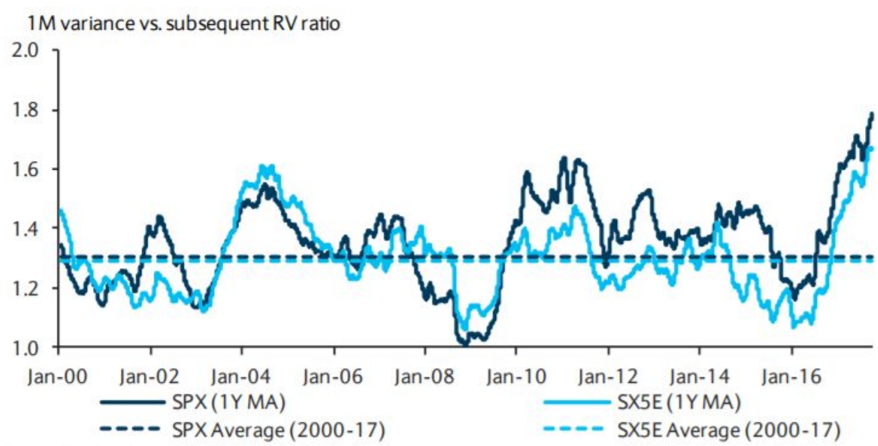
Low volatility will persist throughout the first half of 2018.

In 2017 the VIX dominated financial headlines as it traded down to record lows again and again. But the truly incredible story is that *SPX realized volatility was even lower.*

The spread between [IV (the cost of SPX options) and RV (the actual movement of SPX)] has been trading at extremely high levels. This is a feast fest for anyone harvesting volatility risk premium. So don't be fooled.

Low VIX levels can still be incredibly attractive times to harvest vol premium. **The important variable is the spread between IV and RV, not the absolute levels**. The chart below from Barclays shows just how large current premiums have been.

FIGURE 4
Although low on an absolute basis, implied volatility is trading at a significant premium to realized volatility



Source: Barclays Research, Bloomberg, OptionMetrics

There will be a time when this finally normalizes. The VIX will move higher to its long term mean and that will temporarily impair the short vol carry trade.

Many are betting on this normalization happening soon.

We disagree.

The same 2017 VIX theme will persist throughout the first half of 2018.

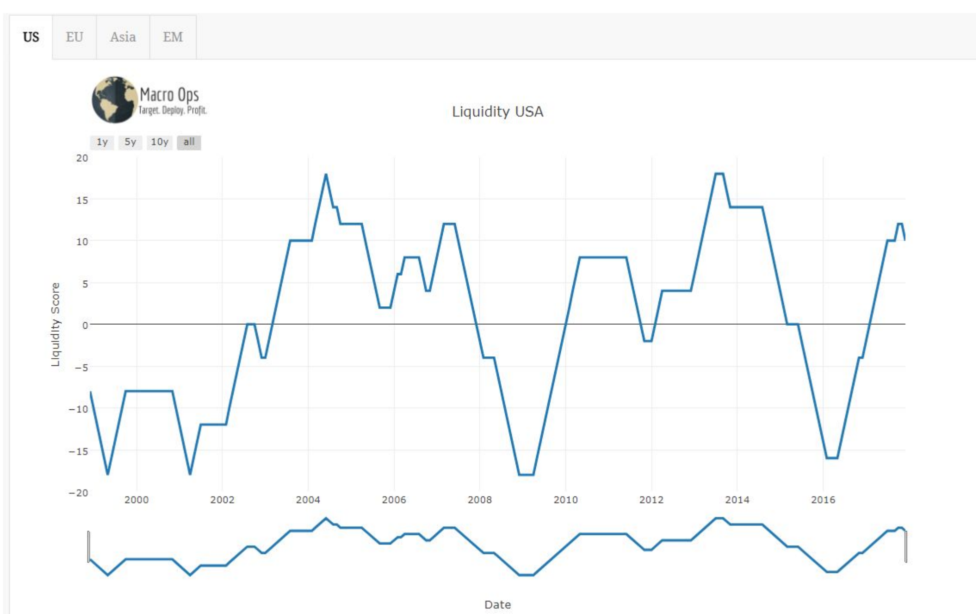
None of the datasets we watch are flashing warning signs for higher volatility and weak equity performance...yet.

Record low VIX levels might not “feel right” with Trump treating a potential nuclear conflict like a school yard pissing contest….

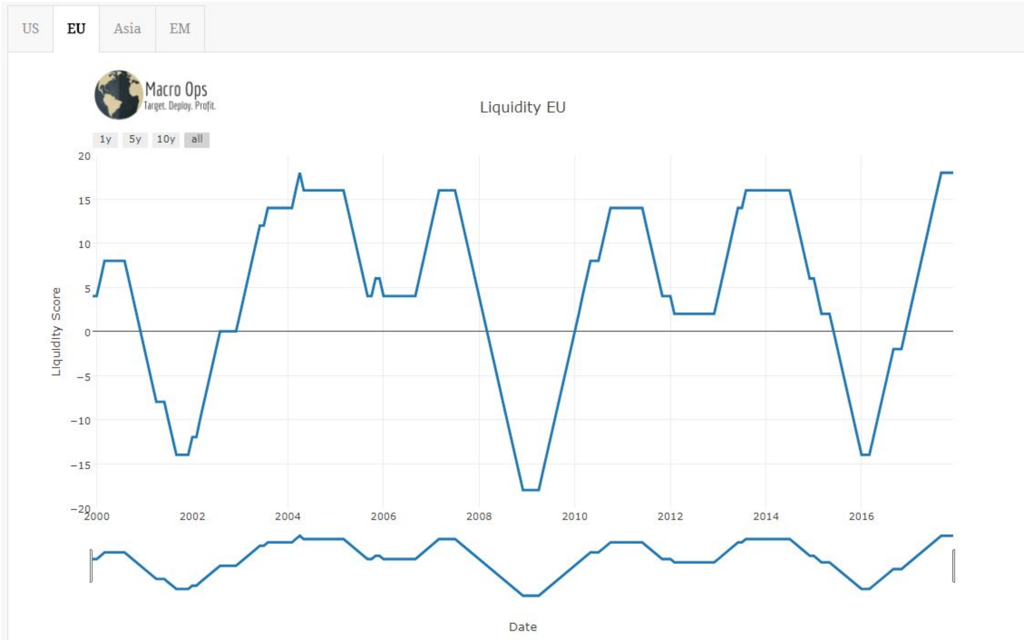
But current VIX levels are justified by the underlying macro fundamentals.

Our liquidity trackers (pictured below) have a high positive score, indicating easy conditions, in every market around the world.

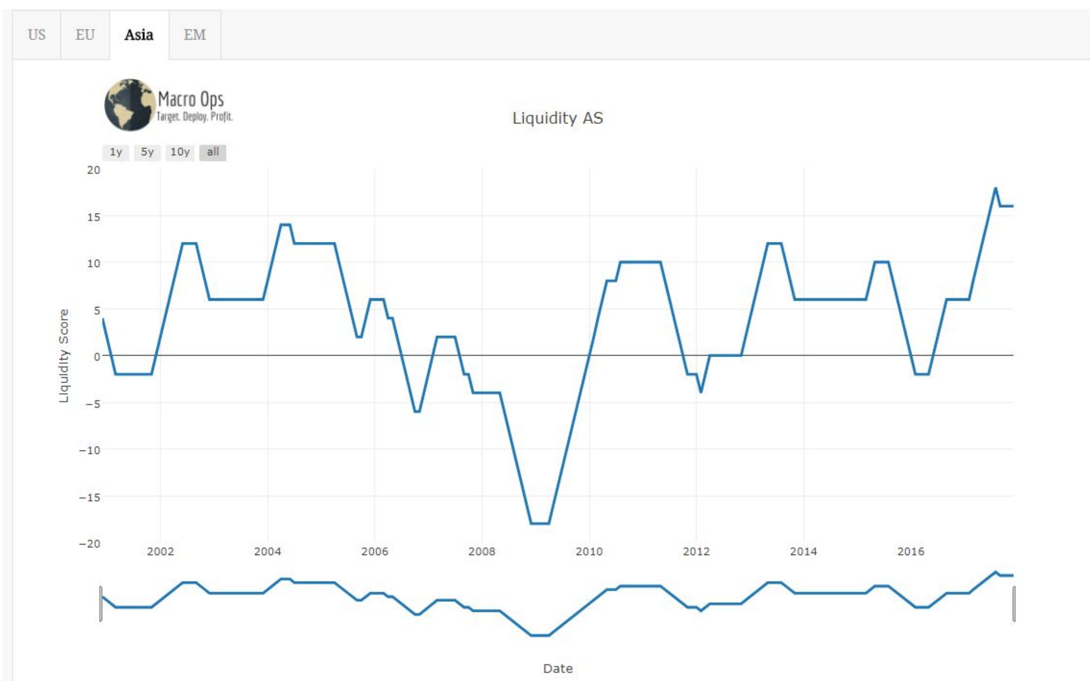
USA



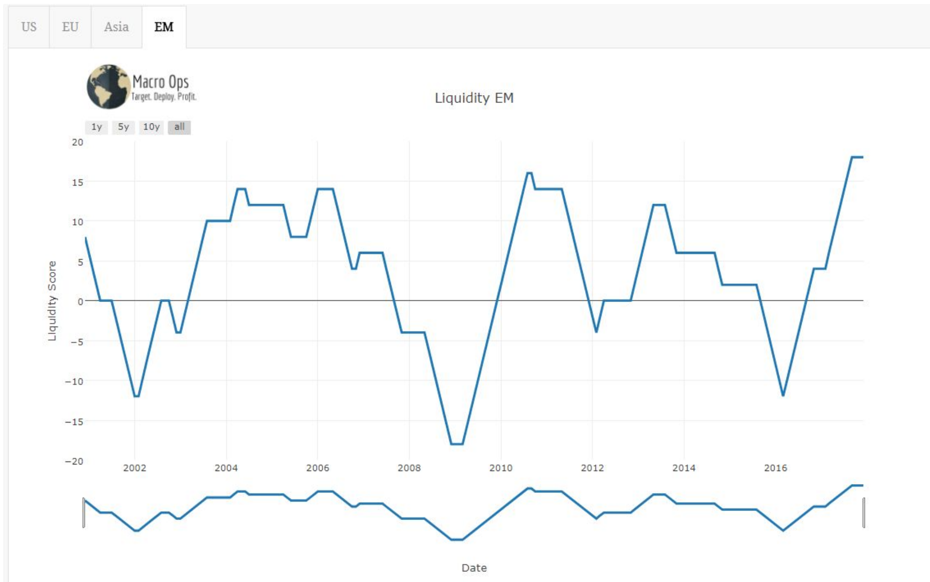
Europe


US
EU
Asia
EM
Macro Ops
Target. Deploy. Profit.
Liquidity EU
1y
5y
10y
all
Liquidity Score
Date

Asia


US
EU
Asia
EM
Macro Ops
Target. Deploy. Profit.
Liquidity AS
1y
5y
10y
all
Liquidity Score
Date

EM

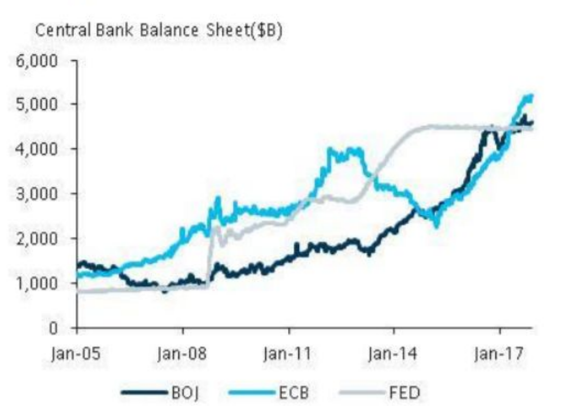


Volatility (and the VIX) is highly correlated to liquidity conditions. So as long as these trackers stay in positive territory there's no meaningful VIX flare up to worry about.

The one thing that could turn the trend in vol is overly hawkish central bank policy — but that isn't likely to happen anytime soon.

The BOE and the BOJ continue to pump money into the system and the Fed has been vocal about gradually tightening.

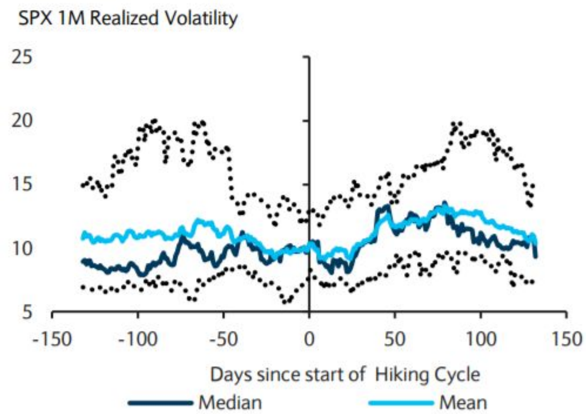
FIGURE 21
Monetary conditions are still quite easy



Source: Barclays Research, Bloomberg, data as of 24 November 2017

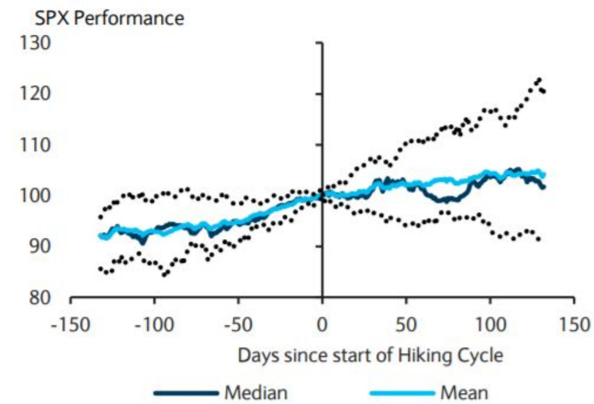
We’re still in the very early stages of a tightening cycle. And even if the BOJ and BOE start to tighten it won’t have a profound effect on volatility or equity momentum in the initial 6-12 months. You can see in the charts below the start of a hiking cycle, on average, has little effect on the subsequent returns of volatility and equities. This make sense as CB’s prefer to tighten into economic strength.

FIGURE 23
Muted volatility increase after past Fed hikes



Note: Statistics calculated by averaging across cycles starting in 1973, 1977, 1980, 1983, 1986, 1994 and 2004 and 2015. Dotted lines are 90th and 10th percentile values. Source: Barclays Research, Bloomberg

FIGURE 24
Since equity rally decreases in magnitude but does not end

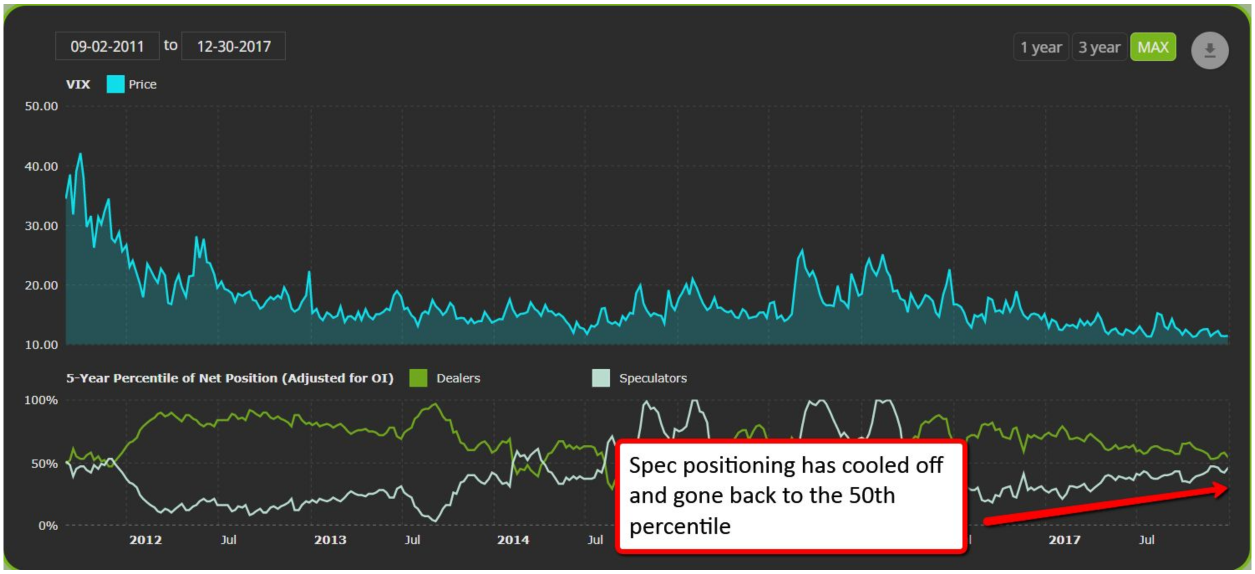


Note: Statistics calculated by averaging across cycles starting in 1973, 1977, 1980, 1983, 1986, 1994 and 2004 and 2015. Dotted lines are 90th and 10th percentile values. Source: Barclays Research, Bloomberg

Tighter financial conditions won’t wreak havoc until much later in the hiking cycle.

Finally, positioning data suggests that the short VIX trade isn’t crowded at all.

You would think that after an incredible short vol run in 2017 that the trade would be extremely crowded. **But in reality short positioning has backed off from extreme levels and positioning is neutral.** The chart below shows the net spec positioning as a percentage of OI for VIX futures. VIX futures are important because popular vol ETFs like XIV, SVXY, VXX, and UVXY all use the futures to build exposure. The current net spec position is at the 50th percentile — a neutral reading.

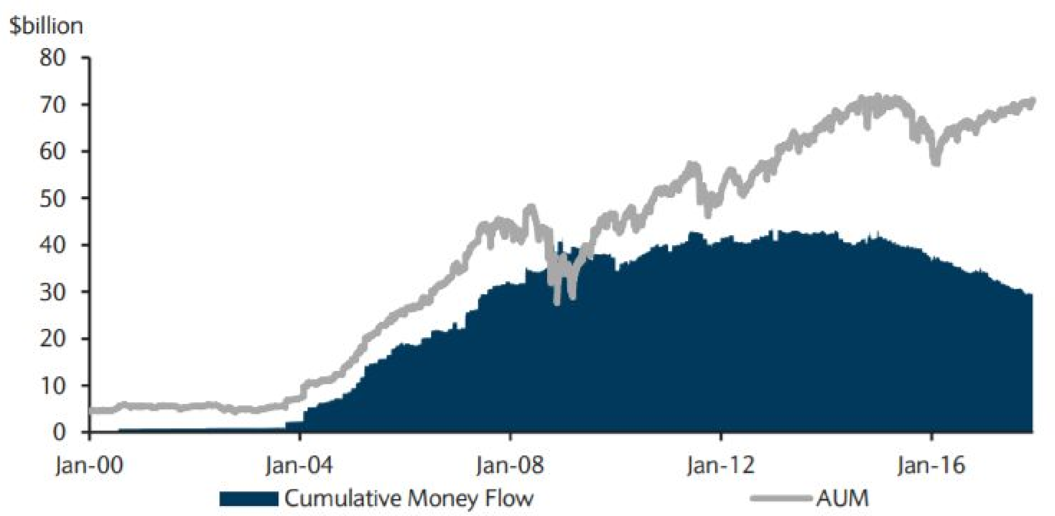


Fear of a market sell-off has kept a steady wall of demand from hedgers in the VIX space. Supply and demand is currently balanced — completely contradicting the "VIX blowup" narrative that has been circulating around the web now for over a year.

In fact, mutual funds that short volatility systematically have actually seen outflows over the past few years.

FIGURE 55

Money flow into listed mutual funds which systematically sell options has been negative over the past few years

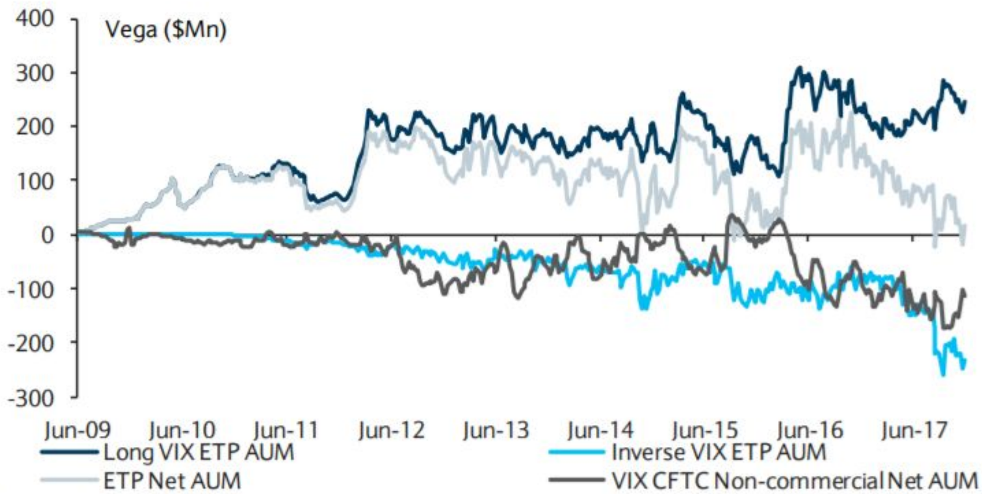


Source: Barclays Research, Bloomberg

And VIX ETP AUM data shows that there is just as much money betting on the long side as there is on the short side (light grey line below).

FIGURE 62

Short volatility positioning via inverse VIX ETPs and short speculator position in VIX futures simply supplying liquidity to demand from long VIX ETPs



Source: Barclays Research, OptionMetrics, CBOE

Note: See *VIX Compass* for details of the VIX ETP universe. Data as of 28 November 2017

We'll continue to monitor and update our views on the positioning data, but for now none of it suggests that there is some large lurking short squeeze on the horizon.

Given the current context we are happy sellers of 1-2 month SPX vol on a moderate up move in the VIX.

Our plan is to establish defined risk short vol positions on the next sign of weakness in the S&P. Defining the risk is key because we are late in the cycle and due for a regime change. Short volatility strategies do the worst when the market transitions from a low volatility state to a high volatility state. It's virtually impossible to time this perfectly so we need to protect capital in advance. The easiest way to execute a defined risk structure is by using an inverse volatility ETP like XIV or SVXY. The chart of XIV is included below.

We'll keep buying dips on this trend in full size until we start to see initial signs of regime change.

If VIX trades and holds above 14.5 that will signal the beginning stages of a volatility regime change.

Keep a close watch the next time VIX trades up there. Vol shorts will be fair game unless the VIX holds above 15 for an extended amount of time. If it rebounds back to the lows the current regime is still in place and we can continue to hold and trade defined risk short volatility positions.

Summary:

- **Low volatility will persist until for the first half of 2018 for the following reasons:**
  - **Liquidity conditions remain favorable**
  - **Central Bankers are reluctant hawks**
  - **Positioning in the volatility space is neutral, not skewed short**
- **We like shorting vol on any modest VIX spike using a defined risk structure**
  - **XIV and SVXY are most favorable**
- **Our stance will change if VIX is able to hold above 15 — that will signal the beginning of a volatility regime change**

Systemic Risks

Here's what we see as the greatest downside risks in 2018.

War with North Korea - This is an increasing risk that the market is not pricing in at all. Old acquaintances of ours in the national security sector tell us that a full scale war with North Korea is no longer a low probability event. The impacts of this would obviously be large. The recent bullish action in gold makes us wonder if increasing "war risks" is the driver behind it, as the gold market has a tendency to sniff these things out well before the rest of the market becomes aware.

Protectionism & Trade War - Now that tax reform is out of the news cycle, Trump's protectionist agenda may come back to the forefront. Some big free trade initiatives are behind schedule or stalled (e.g., the Transatlantic Trade and Investment Partnership). And NAFTA could collapse altogether.

More Aggressive Fed leads to tighter policy, liquidity drain, and higher dollar - The market is not positioned for a hawkish Fed. Data suggests that the market agrees one hike will be delivered in 2018 but it's evenly split about the potential for a second. If we get a hawkish surprise, the dollar will rip, tightening liquidity conditions around the world. This tightening would dramatically cool off the rally in risk assets.

Rising inflation leads to selloff in bonds / higher rates putting the squeeze on high valuation equities - Most analysts today use DCF (discounted cash flow) to value stocks. A key input in this model is the cost of capital. When the cost of capital rises (interest rates go higher) the future cash flows of a stock look less attractive relative to other financial assets — driving valuations down. If rates rally hard, that will put selling pressure on equities as people rotate into fixed income.

Chinese policy misstep: Deleveraging leads to global spillover effects - Deleveraging by its nature is painful. That's why China has been pushing back on the idea for years, which has only served to make its debt problem bigger. If growth slows unexpectedly, debtors will have trouble servicing payments and a liquidity crunch is in the cards. A Chinese liquidity crisis will negatively impact all risk-on assets around the world.

Brexit deal falls through - The U.K. has 10-months to get a deal figured out with Europe. A 'no deal' Brexit would mean recession for the UK in 2019: the pound would fall again, raising inflation and further reducing real incomes. Tariffs and non-tariff barriers would create massive disruption to trade, and investment would also fall as companies moved operations and staff over to the EU.

Populism resurges in Europe - Italian elections will happen sometime in the first half of 2018. If the Five Star Movement (an anti-establishment/anti-euro political party) picks up steam again and actually wins, that will put a huge dampener on European optimism. Volatility around the world would rise and the Euro will see heavy selling pressure.