A Circular Logic

Trading Wisdom

The following is an excerpt from Ned Davis' excellent book *Being Right or Making Money.*

> I've often wondered why the crowd and popular forecasts are so often wrong. My favorite theory is that crowd psychology and liquidity (potential demand) are inversely related. For another explanation, in the foreword to Charles Mackay's book *Extraordinary Popular Delusions and the Madness of Crowds*, the legendary Bernard Baruch says that "all economic movements by their very nature, are motivated by crowd psychology… Without due recognition of crowd thinking (which often seems crowd-madness) our theories of economics leave much to be desired." But listen to how he views crowd thinking, "Schiller's dictum: Anyone, taken as an individual, is tolerably sensible and reasonable — as a member of a crowd, he at once becomes a blockhead."
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> Baruch, who wrote this forward in October of 1932, prescribes a "potent incantation" to use against crowd thinking:
>
> *I have always thought that if, in the lamentable era of the "New Economics," culminating in 1929, even in the very presence of dizzily spiraling prices, we had all continuously repeated, "two and two still make four," much of the evil might have been averted. Similarly, even in the general moment of gloom in which this foreword is written, when many begin to wonder if declines will never halt, the appropriate abracadabra may be: They always did.*

Another quote I really like that Ned shares in his chapter on psychology and markets is the following from Bennett Goodspeed. It goes, "Man is extremely uncomfortable with uncertainty. To deal with his discomfort, man tends to create a false sense of security by substituting certainty for uncertainty. It becomes the herd instinct."

Data and Events in the week ahead

The big events to watch for this week are the ECB MPC minutes which come out Thursday. The market will be looking for comments about the euro's strength (the ECB may try and talk the euro down), and of course further guidance on its QE unwind. Then Friday the US has CPI and retail sales come out (real retail sales are a great leading recession indicator). The following summary is from the *WSJ* with notes and charts from me.

The ECB MPC minutes are the main event. Traders will be looking for comments about the EUR level, and of course for further QE unwinding guidance.

The second week of 2018 will see inflation data from the U.S. and China, the eurozone's unemployment rate for November, minutes from the European Central Bank's December meeting, and comments on the economic outlook from New York Federal Reserve chief William Dudley.

TUESDAY: *The eurozone economy's surprising strength in 2017 was evident in the jobs market, as unemployment fell more rapidly than most economists had expected. Figures for November are expected to show a pause in that decline, but the jobless numbers have regularly surprised over recent months and another drop could be in the cards.*

WEDNESDAY: *Two inflation readings come out of China on Wednesday (release time is Tuesday evening in the U.S.). Economists expect China's consumer-price index to have climbed 1.9% in December, compared with 1.7% year-over-year growth in November. The country's producer-price index likely rose 4.8% in December, compared with 5.8% in November.*

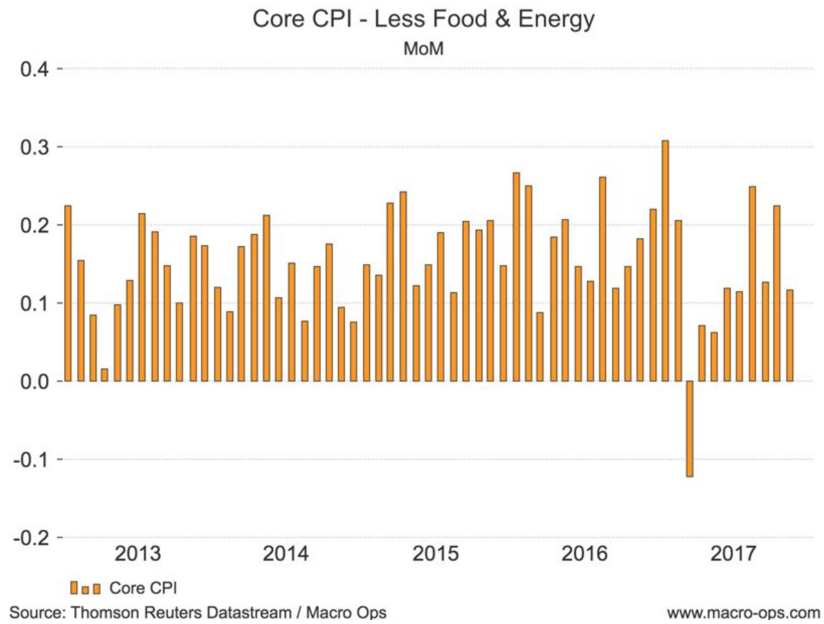
THURSDAY: *Federal Reserve Bank of New York President William Dudley speaks on the U.S. economic outlook for 2018, in which he could offer thoughts on the connection between inflation and employment. Mr. Dudley in a November speech said he still expects that a strong labor market will help push up inflation over time.*

The European Central Bank releases minutes of its Dec. 13-14 policy meeting, when it left interest rates unchanged even as its new economic projections forecast strong growth for the 19-nation eurozone through 2020. Also Thursday, European Union statistical agency Eurostat releases industrial production figures for the eurozone in November. The euro area saw a 0.2% monthly rise in October, and economists expect November's growth to accelerate to 0.6%.

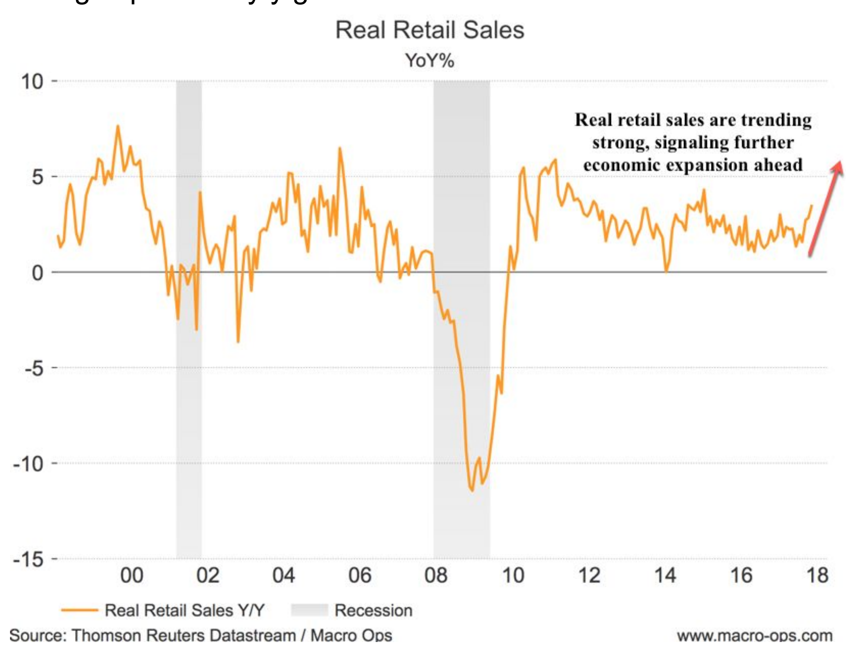
FRIDAY: *The U.S. Labor Department releases December consumer-price index data, the latest look at inflation, which has persistently undershot the Federal Reserve's target. The price index increased 0.4% in November from the prior month. Core prices, which exclude the volatile categories of food and energy, rose a more sluggish 0.1% in November from a month earlier. Economists surveyed by The Wall Street Journal expect the December consumer-price index gained 0.1%.*

The U.S. Commerce Department releases data on December retail sales. Holiday sales were robust in November, with sales at online retailers, brick-and-mortar stores and *restaurants rising 0.8% from a month earlier. Economists surveyed by The Wall Street Journal expect retail sales increased 0.4% in December from a month earlier.*

We should start to see inflation pressures pass through to core from the headline numbers in the months ahead. So I'd expect to see some slightly rising numbers in the next few prints.



Inflation-adjusted retail sales on a year-over-year basis are an excellent indicator of the health of the economy. This chart will turn over and head down well in advance of a recession. And right now, it's showing impressive y/y growth.



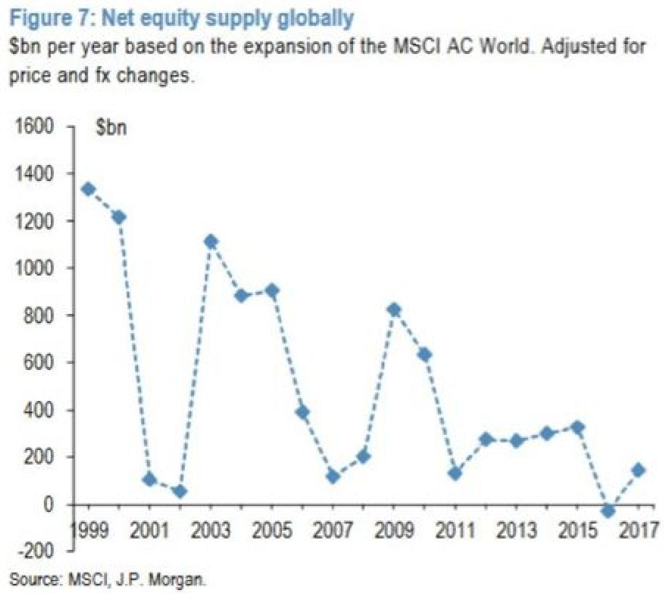
Earnings Releases

A number of financials report earnings this week (JPM, WFC, BLK) which should give us a look into the improving health of bank stocks. We expect the financial sector to be a strong performer this year, bolstered by strengthening economic growth and rising interest rates.

$JPM $LEN $KBH $WFC $SCHN $HELE $BLK $AYI $DAL $FCEL $MSM $SVU $PNC $SNX $WDFC $SJR $SHLM $SMPL $EXFO $SAR $LMNR $SLP $PRGS $NTIC $VOXX $INFY

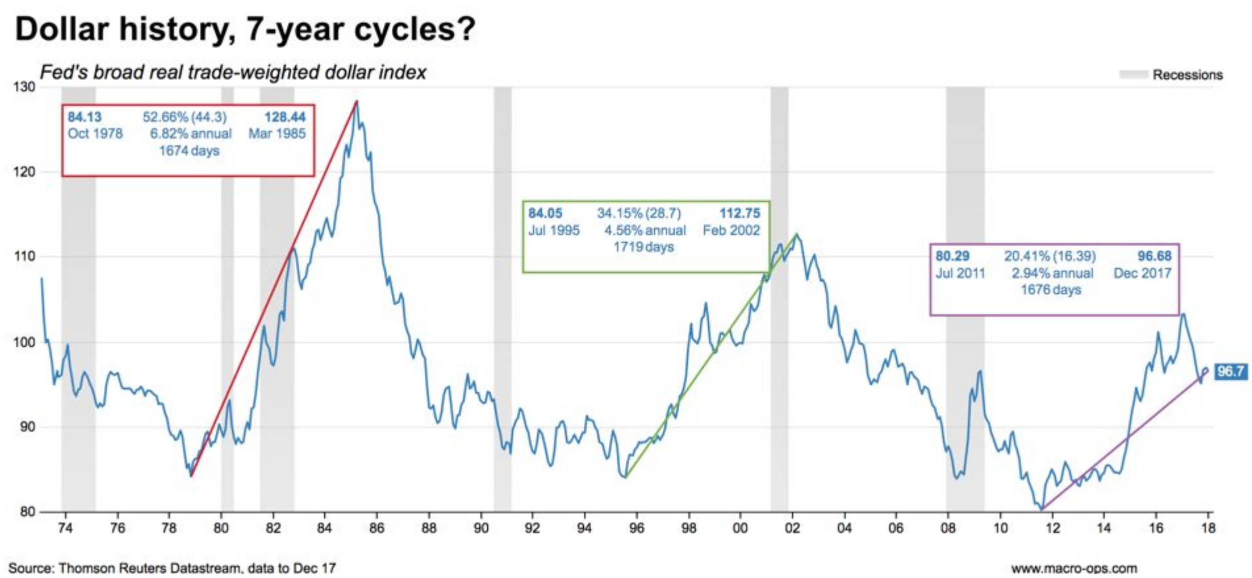
Interesting Charts

This chart was shared by @modestproposal on twitter. It shows the net global supply of equity relative to the expansion of MSCI AC world. The steady decline of relative equity supply over the last 20 years is pretty astonishing. If you're wondering why valuations are so high (and likely headed higher), this is one of the reasons. A classic case of increasing global demand for outstripping available supply. We wrote about this in our August MIR titled *Where's Our Irving Fisher Moment?*



The dollar bearish narrative is close to becoming a consensus take. Nearly every IB report — and I read a lot of 'em — are pontificating on why the dollar bull is over, and it's nothing but lower prices for the greenback.

I'm open to the the dollar bear argument and personally would like to see it as it would be great for our energy positions. But I'm far from being convinced at the moment.



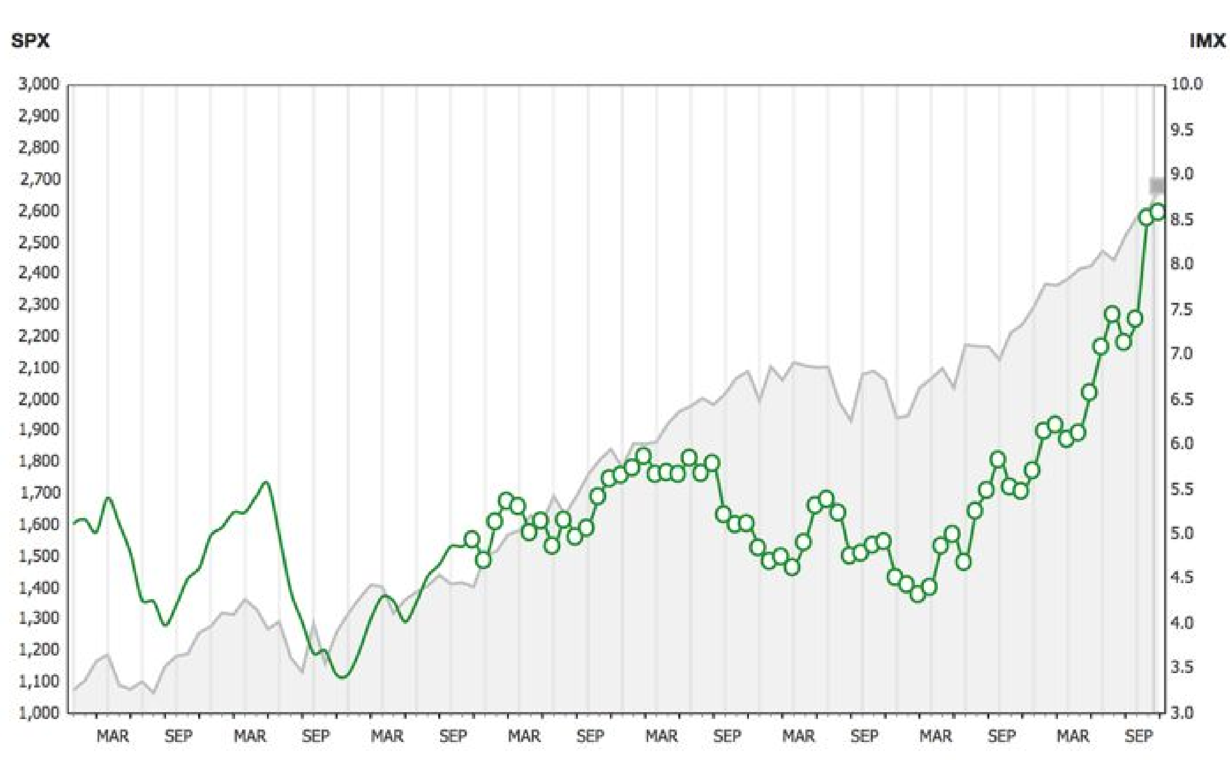
The US dollar has been trading lower on increasing risk-on sentiment, globally. This has pulled capital flows out from the core (the US) and into the periphery (EMs) as investors climb out further on the risk curve in search of return.

What I'm skeptical of is if this trend survives the next bout of volatility.

It's been a while since the market has seen any vol, but it's highly probable that this year won't be as quiet as 17'. And I imagine that after the next inevitable market shock, we'll see these flows reverse. When this happens is anybody's guess. We could stay in melt-up mode over the next few months without seeing any vol. But sentiment and positioning are now at levels that in the past preceded transitions in vol regimes.

Take this chart from Bloomberg. The bears have been slaughtered. Short interest in the S&P 500 is now at the lowest levels of this market cycle. The bears are giving up and throwing in the towel.

TD Ameritrade's Investor Movement Index, which tracks the flows and behavior of their retail clients, shows that retail is aggressively long this market.



This isn't to suggest it's time to be bearish. We don't think it is. Late cycle stages with excessive sentiment and positioning can persist for years. This market still has plenty of gas left in the tank. But these conditions do set the stage for higher volatility. And that's likely to impact the market's perception of risk and perhaps reverse the trend lower in the dollar.

Also, we have to watch this chart closely. It shows the DXY (black line) and US equities relative to the rest of the world (ROW). There's a circular logic to markets and especially currencies where FX is driven by speculative flows which drives relative equity market outperformance, which drives the local currency higher that in turns make that country's equities more attractive — and a positive feedback loop is born.

Well, US equities have been steadily outperforming the ROW for the last four months. If this keeps up, it's likely the dollar (red line) will converge higher and begin the next leg of its bull market.

Target List & Portfolio Review

We're not looking to add any new trades this week. We may cut some positions in the portfolio in order to reallocate risk capital elsewhere. Sugar will likely be cut as it's failed to get going and we're not willing to sit on it. We're also waiting for an entry into TLND, which we covered in the last MIR. And we'll be looking to build on our long energy positions in the coming weeks.

Other than that, the port is off to a really good start for the year. Our positions in IBKR, FCAU, and UIHC are having a great run. And everything else is looking strong.
This week I'm digging into Overstock (OSTK) which is a semi-value play with a deep out of the money option like payoff structure on blockchain technology. Not sure if there's a trade there yet but I will let you guys know what I find.

Housekeeping

Tyler made a bunch of updates and upgrades to our portfolio reporting graphic. We added return metrics, subdivided out the two core strategies, and created a new risk metrics section. Tyler will be coming out with a short video this week explaining these changes in detail. These changes will make our process easier to understand and give us a better idea of our portfolio risk.

Macro Ops Portfolio			YTD	Inception (16')			
NAV	$2,775,114		2.89%	38.13%			
Big Bet Macro							
Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target	Last Price
Equity	Limbach LMB	2,750	$13.66	$12.50	$2,997.50	$18.00	$13.59
Equity	JD	5,867	$44.74	$36.00	$59,843.40	$72.00	$46.20
Equity	Interactive Brokers IBKR	1,800	$41.71	$38.50	$42,696.00	$55.50	$62.22
Equity	W&T Offshore WTI	16,000	$2.18	$2.00	$2,880.00	$4.50	$2.18
Equity	Ensco ESV	3,700	$5.15	$4.30	$10,101.00	$6.50	$7.03
Equity	Transocean RIG	2,900	$9.32	$8.26	$10,208.00	$15.00	$11.78
Equity	Cabot COG	1,350	$26.28	$24.00	$6,763.50	$34.00	$29.01
Equity	Tuesday Morning TUES	7,500	$2.60	$2.00	$7,500.00	$5.00	$3.00
Equity	United Insurance UIHC	13,000	$16.98	$16.30	$25,610.00	$20.00	$18.27
Commodity	Sugar SGG	10,534	$31.23	$28.75	$10,428.66	$55.00	$29.74
Equity	Nikkei Mar 18 Future	6	$23,300	$22,803	$30,810.00	$26,000	$23,830
Equity	CCJ Jan '19 17 Call	236	$0.41	$0.00	$7,080.00	$5.00	$0.30
Equity	FCAU Jan '19 25 Call	108	$0.90	$0.00	$25,920.00	$5.00	$2.40
Equity	JD Jan '19 70 Call	108	$0.92	$0.00	$14,688.00	$7.00	$1.36
Equity	TRIP Jan '19 75 Call	108	$0.89	$0.00	$2,700.00	$7.00	$0.25
Equity	CHK Jan'19 10 Call	750	$0.14	$0.00	$9,750.00	$1.00	$0.13
Equity	Tesla Mar '18 240 Put	28	$8.80	$0.00	$4,564.00	$24.00	$1.63
Equity	MS June '18 65 Call	126	$0.46	$0.00	$3,528.00	$3.00	$0.28
Equity	WMT June '18 120 Call	126	$0.51	$0.00	$8,694.00	$3.00	$0.69
Volatility							
Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target	Last Price
Forex	FXE Jan 2018 104 Put	80	$3.45	$0.00	$0.00	$7.00	$0.00
Rates	IEF March 2018 104/109 Strang	80	$3.45	$0.00	$2,640.00	$7.00	$0.33
Commodity	SLV June 2018 17 Straddle	130	$2.84	$0.00	$23,920.00	$5.00	$1.84
Commodity	GLD Sep 2018 128 Straddle	24	$15.10	$0.00	$23,520.00	$30.00	$9.80

Risk Budget					
	Total Allowed (In Bps)	Total Used	Total Available	Percentage Used	
Big Bet Macro	1250	1033	217	82.67%	
Volatility	1250	180	1070	14.44%	
					**Updated 1/9

Operator Q&A

We’ve been getting a lot of great process questions from you guys. Keep them coming!

Instead of answering individually, we’re posting our answers here so the entire Collective can benefit.

Q1: When you execute a trade and you enter at slightly higher than the planned entry do you adjust your risk point by the same amount? Also, do you have any rules on how

much higher do you still enter the position? When I was doing the CANSLIM stocks I wouldn't enter if it was higher than 5% above the ideal entry.
No, the risk point never changes. If the entry is higher than what we originally planned we will put slightly less size on. This is reflected in the position sizing model. If you enter in a slightly higher price into the entry column with the same risk point you will see that the total share number goes down. (Example below — 125 shares turns into 111 shares).

Account Size	Risk (bps)
$ 100,000.00	100

Position Size Equity		
Direction	Long	Short
Planned Entry	$44.00	$0.00
Planned Risk Point	$36.00	$0.00
Share Count	**125.00**	**ERROR**

Account Size	Risk (bps)
$ 100,000.00	100

Position Size Equity		
Direction	Long	Short
Planned Entry	$45.00	$0.00
Planned Risk Point	$36.00	$0.00
Share Count	**111.11**	**ERROR**

We don't have any set rules for "chasing" entries. Precise entry conditions matter the shorter the holding period. Since we are primarily looking for 2-12 month trends the exact entry price does not have that big of an impact on our trading style.

Q2: This alert came out at 4am (Australia time) and I noticed the ETF is now trading slightly above the entry price. How would you handle this given I am in a different time zone? Obviously the slippage over time could have a dramatic effect on portfolio performance.

Slippage matters a lot for short-term traders but we do not play that game. Our target holding period is from 2-12 months so small one day movements are of little significance to our strategy.

Q3: You currently have an active portfolio and I am only just starting to take trade based on your trade alerts. Given you already have trades setup to mitigate a spike in volatility, how should I handle this given I just started taking trades and have no downside protection setup?

Right now we have no short volatility positions on the portfolio. When we put on short volatility positions we will do so in a way that has protection from sudden VIX spikes.

If you would like to be even more protected you can always buy calls on VIX/VXX/or UVXY to protect against sharp drawdowns in the market. There are a few members in the Collective who actively do this. We prefer to manage our risk with carefully crafted position sizing.

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Have a great week in the markets and see you in the CC!

Your Macro Operator,

Alex