# Prevailing Expectations

## Trading Wisdom

Here's one of my favorite pieces of market wisdom from the Palindrome (George Soros):

> *There is always a divergence between prevailing expectations and the actual course of events.* ***Financial success depends on the ability to anticipate prevailing expectations and not real-world developments.*** *But, as we have seen, my approach rarely produces firm predictions even about the future course of financial markets; it is only a framework for understanding the course of events as they unfold. If it has any validity it is because the theoretical framework corresponds to the way that financial markets operate.* ***That means that the markets themselves can be viewed as formulating hypotheses about the future and then submitting them to the test of the actual course of events.*** *The hypotheses that survive the test are reinforced; those that fail are discarded.* ***The main difference between me and the markets is that the markets seem to engage in a process of trial and error without the participants fully understanding what is going on, while I do it consciously. Presumably that is why I can do better than the market.***

Humans are bad at understanding non-linear systems, such as markets. It just doesn't come natural to us. Because of this, most people approach markets as if they're solving a puzzle with fixed inputs and a set future outcome. They think that if they can just solve for X they'll figure out Y and make money. But the reflexive nature of markets, where participants beliefs affect the inputs, and these inputs then continuously change the outcome in a never ending feedback loop, ensures that the future is not set nor knowable.

This is why Soros says that what his advantage is, is the fact that he is conscious of this reflexive link between investors and the market, while others are not. And this allows him to play a different, higher level, game than others. In this game he's focused on anticipating prevailing expectations and not so much real world developments.

## Markets and Macro

The clowns in Washington have shutdown the government. As of the end of this week, the markets didn't seem too concerned. That could change come Monday but a shutdown isn't a long-term threat to this market. Also, we don't have an edge in predicting when DC will unscrew itself, so we're going to ignore it and focus on the things that matter.

This week I want to talk about interest rates and financial stocks. It appears we're hitting a critical inflection point for both. And there may be some very profitable trades to make on the back of this.

The US 10yr for example, is bumping up against its long-term downward secular trend line (chart below is a monthly). Now I think trendlines are silly and don't hold much significance. They are only worth paying attention to because others pay attention to them. But really they're just a tool for us to try and apply order and meaning to a two-dimensional representation of supply and demand.

The real utility from charts is that price zones help give you a sense of where the supply and demand pressures are, and where they might heading.

The above chart shows that bond supply has been outpacing demand recently and the pressure is currently pushing yields higher (yields move inversely to the price of bonds).

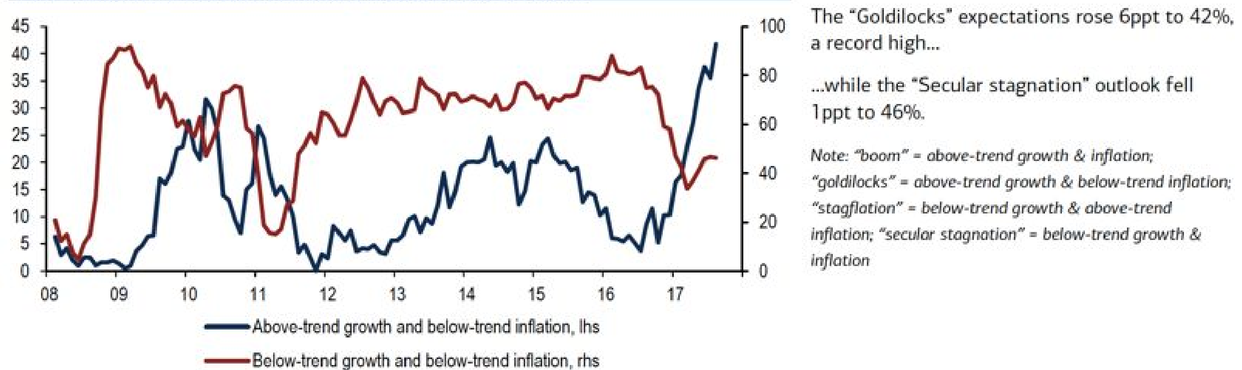
Bonds trade off of expectations over inflation, growth, and risk. If investors expect inflation to remain lower for longer, then bonds become more attractive. If growth expectations are high

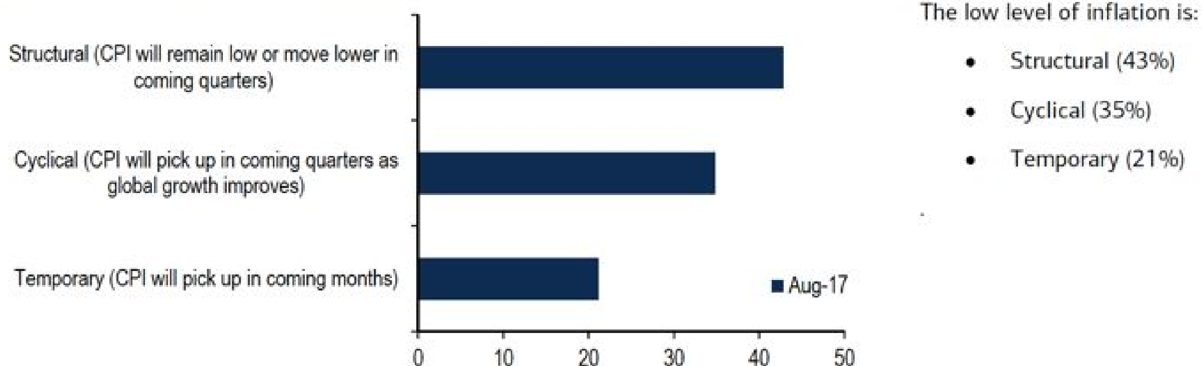
and risk is perceived as being low, then equities attract more capital flows from bonds and bonds sell off.

Back in September we started writing about how we expected growth and inflation to pick up in the coming quarters per our *Investment Clock* framework. We explained how this would be bearish for bonds and bond like instruments while bullish for stocks and commodities.

We also noted how the market was not positioned for this. The market was (and still is) expecting inflation to remain lower for longer.

Here's two charts from the August BofA Fund Manager Survey showing a near consensus over below trend inflation expectations.




The yield on the 10yr has since traded from 2.15% up to 2.64%.

All of the data we track suggests that inflationary pressures are continuing to build which will drive CPI higher from here. And higher inflation and growth will lead to lower bonds and higher yields.

This monthly chart of 10yr bond futures shows a clear trend reversal in progress. This trend is also going to accelerate in the coming quarters as the government deficit widens, due to tax reform (less money coming in) and greater government spending (ie, expected fiscal stimulus).

Both mean that the government is going to have to increase its borrowing, which equals more bond supply coming. And as global synchronized growth accelerates, investors are likely to move more capital out of bonds and into stocks.

The market is slowly being forced to wake up to the changing landscape in rates. Interest rates are going higher. But when a narrative like low rates and low inflation have dominated for so long, it takes a while for a new narrative to supplant the old one.

We're seeing the death of a powerful narrative.

The low inflation / low rate narrative has been so pervasive and widely adopted that it's long become accepted wisdom by the market. It's no longer even questioned.

A lot of capital that has been invested on the back of this narrative.

And when deep rooted structural narratives like these are broken and participants are forced by the evolving reality to adopt a new story, it leads to new large and powerful trends being born.

That's what I think we're about to see.

Like Soros said, the game is about anticipating and trading off shifts in prevailing expectations. And we're about to see a large shift in expectations over interest rates and inflation.

So the next question we need to ask ourselves is, how do we trade this?

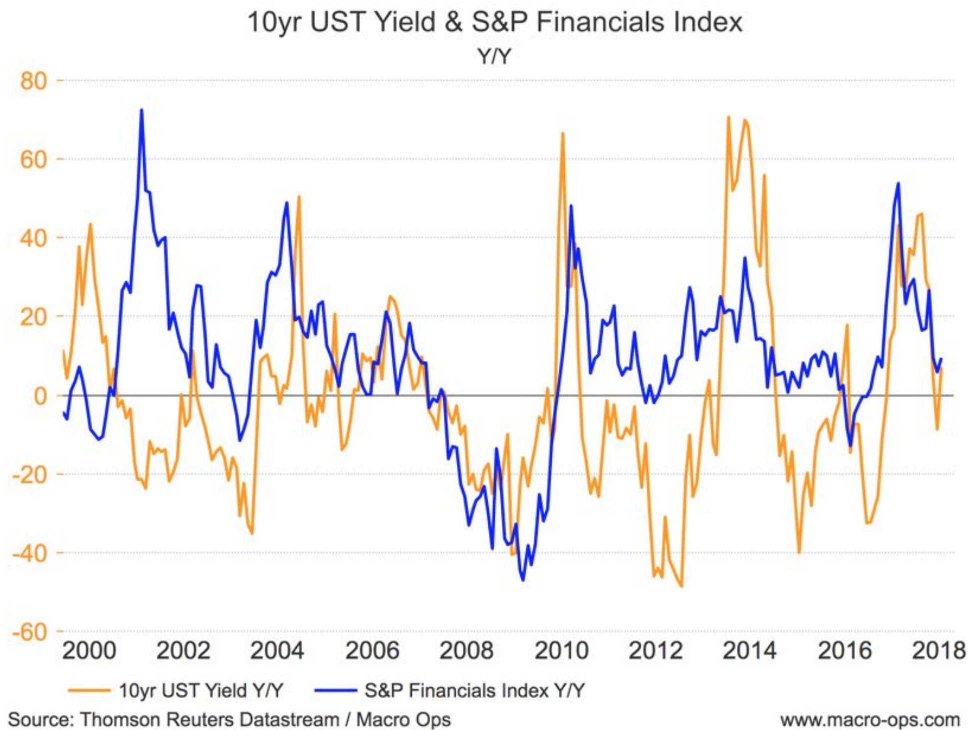
The obvious trade would be to short bonds.

But there's some issues with this. The trade isn't free in that you have to pay a sizable cost of carry. And there isn't a whole lot of asymmetry to it. Bonds will go down, but we don't expect a crash and yields to go to over 4+%.

No, a better trade is to go long financials.

Now let's run through some charts real quick to show you what I look at when assessing financial stocks from a macro perspective.

First, financial stocks mostly trade off expectations around long-term rates. I find the US 10yr to be the best benchmark for this.

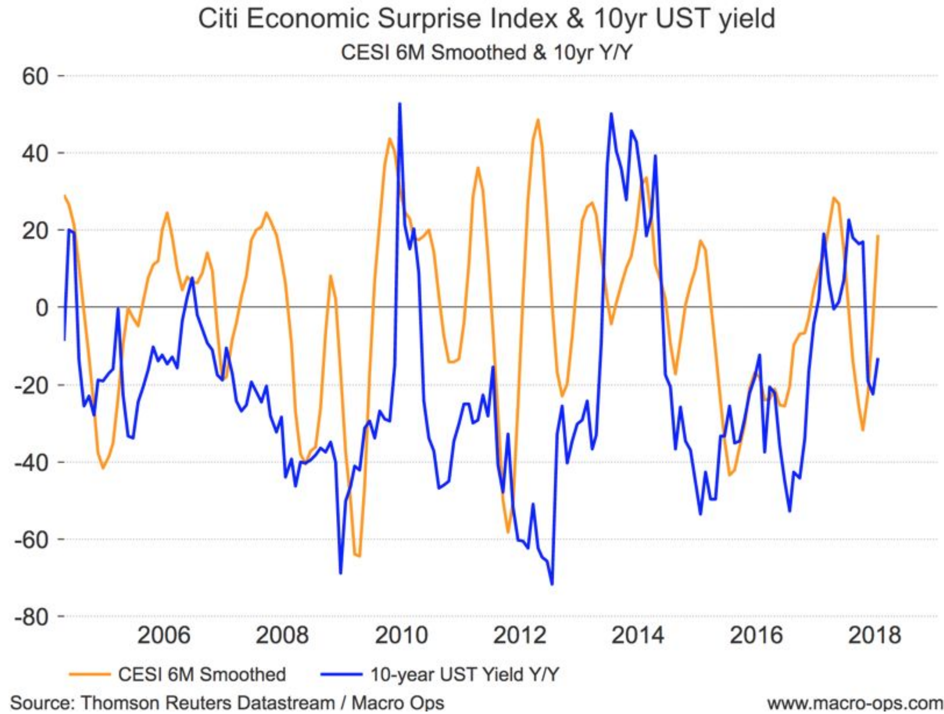



The chart above shows the year over year change in the US 10yr rate (orange line) along with the yoy change in the S&P financials index.

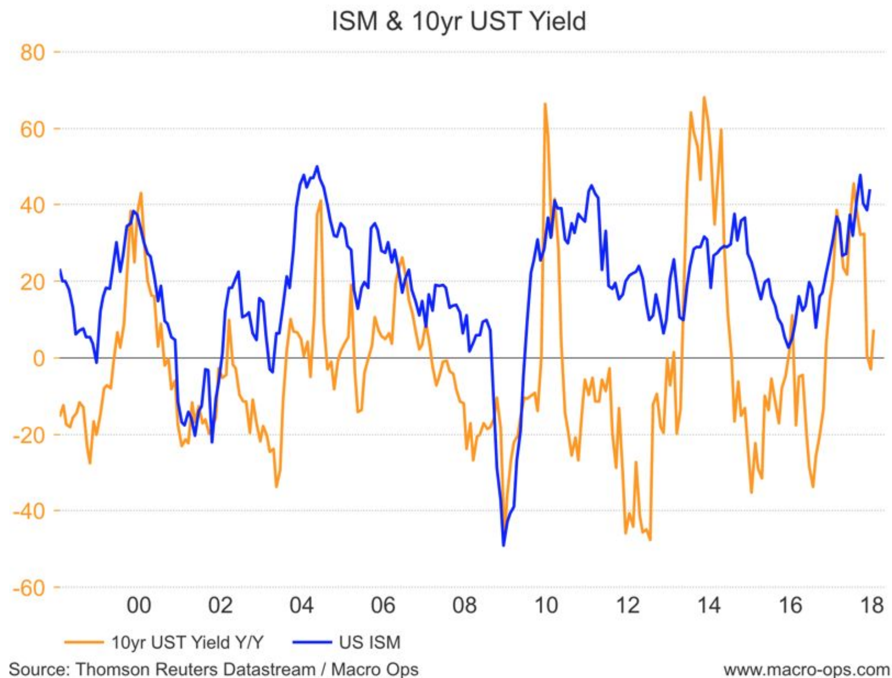
You can see that they track each other fairly well. Improving growth and inflation expectations drive interest rates higher along with financial stocks.

The Citi Economic Surprise Index (CESI), which measures actual data releases versus expectations, also has a high correlation with the change in interest rates. When data surprises to the downside over an extended period of time, interest rates fall as expectations over future growth decline. And vice versa for when data surprises.

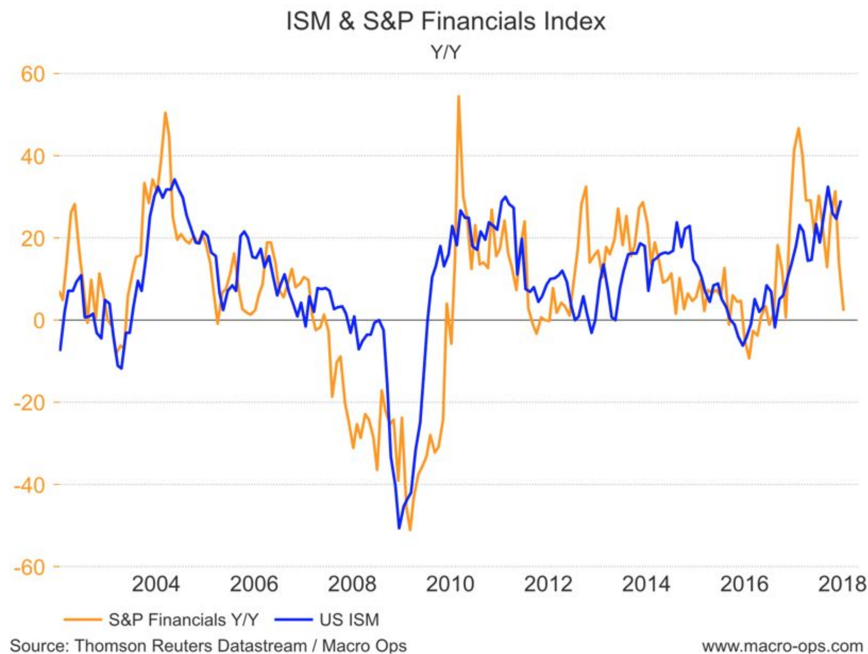
Here’s the CESI smoothed with a 6M moving average (the actual chart is near all time highs) showing that CESI bottomed in 2016 and has been rising since, bringing rates up with it.




Another data point we want to look at is the ISM PMI, which also shows a correlation to 10yr rates. The connection is logical. A rising PMI indicates an improving economy and higher growth tends to lead to higher interest rates.



And here's a chart showing rising ISM (blue line) and S&P financials yoy. Improving growth leads to higher rates which leads to rising financial stocks.




Now look at this chart showing the momentum of financials (XLF) relative to the market (SPY).

We can see the chart coiling tight and it looks ready to break out higher, which could lead to a sustained period of outperformance by financials.

We also have a major catalyst now coming into the picture.

The incoming Fed Chairman, Jerome Powell, is notably more bank friendly than his predecessor. And he has said that he wants to get rid of many of the post financial crisis regulations on banks, which have hindered their profitability. Here's the following from Bloomberg:

> *The Federal Reserve is working to relax a key part of post-crisis demands for drastically increased capital levels at the biggest banks, according to people familiar with the work, a move that could free up billions of dollars for some Wall Street giants.*
>
> *Central bank staffers are rewriting the leverage-ratio rule -- a requirement that U.S. banks maintain a minimum level of capital against all their assets -- to better align with a recent agreement among global regulators, said two people who requested anonymity because the process isn't public. The people said the Fed effort is drawing opposition from the Federal Deposit Insurance Corp., an agency with authority over banking rules that's still led by a Barack Obama appointee.*
>
> *Fed Governor Jerome Powell -- Trump's nominee to replace Chair Janet Yellen -- spoke in support of recalibrating the leverage ratio months before the Basel committee took action, a move he said "could help to reduce the cost that the largest banks face."* ***Even slight changes could have a big impact on firms including Morgan Stanley,*** *and custody banks such as State Street and Bank of New York Mellon.*

This is a huge development and could act as booster to get momentum in financials going.

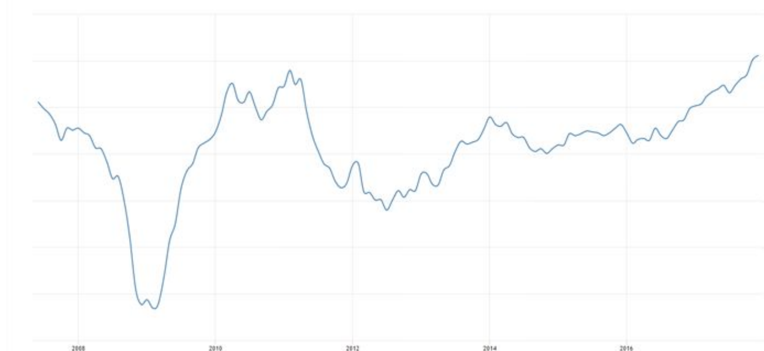
We currently have a position in DOTM calls on Morgan Stanley that are up roughly 60% since we bought them a couple months ago. We are going to add to this position in the coming weeks.

We also like a number of DOTM calls on European financial stocks for the same reason. In Europe, we're not expecting much financial deregulation, so we're missing that catalyst, but interest rates there look set to rise… and probably by a lot.

Right now, there's a huge disparity between where European interest rates are trading and the improving economic backdrop in the eurozone.

The German 10yr is currently trading for a measly 50bps. This is over 200bps lower than comparable US rates. While at the sametime, it can be argued that the economy in Europe is just as good, if not better than the US.

The eurozone PMI recently came in at 60.6. This marks the strongest pace of economic expansion since the series began in 1997. And country specific PMI's printed at all-time highs for Austria, Germany, Ireland, and the Netherlands.



European financials are even more appealing because we can buy long-term DOTM calls on many of their large banks, for very cheap.

The charts for Barclays (BCS), Credit Suisse (CS), Banco Santander (SAN), and Deutsche (DB shown on the chart below) all look very constructive.

We’re going to dig more into the option plays here and we’ll send out an alert this week with what we think is the best value to play this theme.

## Target List & Portfolio Review

We’re sending out an in depth portfolio update/review in the next few days where we’ll talk over each position and update our views and targets.

That’s all I’ve got for now. Expect some trade alerts and research to come your way this week.

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

Your Macro Operator,

Alex

| ***Macro Ops Portfolio*** | | | YTD | Inception (16') | | | |
|---|---|---|---|---|---|---|---|
| *NAV* | $2,803,887 | | 3.96% | 39.57% | | | |
| **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 | $3,492.50 | $18.00 | $13.77 |
| Equity | JD | 5,867 | $44.74 | $36.00 | $57,320.59 | $72.00 | $45.77 |
| Equity | Interactive Brokers IBKR | 1,800 | $41.71 | $54.00 | $14,220.00 | $55.50 | $61.90 |
| Equity | W&T Offshore WTI | 16,000 | $2.18 | $3.30 | $17,760.00 | $4.50 | $4.41 |
| Equity | Ensco ESV | 3,700 | $5.15 | $5.75 | $3,700.00 | $6.50 | $6.75 |
| Equity | Transocean RIG | 2,900 | $9.32 | $10.30 | $2,610.00 | $15.00 | $11.20 |
| Equity | Cabot COG | 1,350 | $26.28 | $24.00 | $4,617.00 | $34.00 | $27.42 |
| Equity | Tuesday Morning TUES | 7,500 | $2.60 | $2.40 | $6,750.00 | $5.00 | $3.30 |
| Equity | United Insurance UIHC | 13,000 | $16.98 | $16.30 | $47,060.00 | $20.00 | $19.92 |
| Equity | Nikkei Mar 18 Future | 6 | $23,300 | $22,803 | $31,110.00 | $26,000 | $23,840 |
| 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 | $36,720.00 | $5.00 | $3.40 |
| Equity | JD Jan '19 70 Call | 108 | $0.92 | $0.00 | $12,960.00 | $7.00 | $1.20 |
| Equity | TRIP Jan '19 75 Call | 108 | $0.89 | $0.00 | $3,240.00 | $7.00 | $0.30 |
| Equity | CHK Jan'19 10 Call | 750 | $0.14 | $0.00 | $8,250.00 | $1.00 | $0.11 |
| Equity | Tesla Mar '18 240 Put | 28 | $8.80 | $0.00 | $3,052.00 | $24.00 | $1.09 |
| Equity | MS June '18 65 Call | 126 | $0.46 | $0.00 | $6,300.00 | $3.00 | $0.50 |
| Equity | WMT June '18 120 Call | 126 | $0.51 | $0.00 | $14,490.00 | $3.00 | $1.15 |
| **Volatility** | | | | | | | |
| Asset Class | Position | Size | Cost Basis | Risk Point | Open Risk | Target | Last Price |
| Volatility | SVXY | 2,257 | $132.60 | $0.00 | $298,646.24 | ~ | $132.32 |
| Forex | FXE Jan 2018 104 Put | 80 | $3.45 | $0.00 | $0.00 | $7.00 | $0.00 |
| Rates | IEF March 2018 104/109 St | 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 |
| **Master** | 2500 | 2,245 | 255 | 89.80% |
| **Big Bet Macro** | 1250 | 1001 | 249 | 80.10% |
| **Volatility** | 1250 | 1244 | 6 | 99.50% |

**Updated 1/19