Mental Capital

Trading Wisdom

> *What you can't afford to do is throw away your capital on suboptimal trades. If you do, you will be too debilitated to trade when the right position comes along. Even if you put the trade on, it will be relatively small because your capital will have been depleted by the other trades.* ~ Richard Dennis

The pillars of successful trading and investing begin with risk management. You have to create a system that's robust to being wrong and which puts positive compounding in your favor.

Second is trade management. You have to learn to exploit the inherent 80/20 distribution of returns by maximizing your right tail winners while reducing your left tail losers (ie, cutting your losers short and letting your winners run).

And lastly, through experience and study you need to learn the difference between a bad, mediocre, good, and great trade. You do this by expanding your knowledge base over time which allows you to better identify the asymmetry of a trade.

By raising the bar of what constitutes an actionable trade we not only protect our cash but we preserve our mental capital from the strain of managing subpar trades.

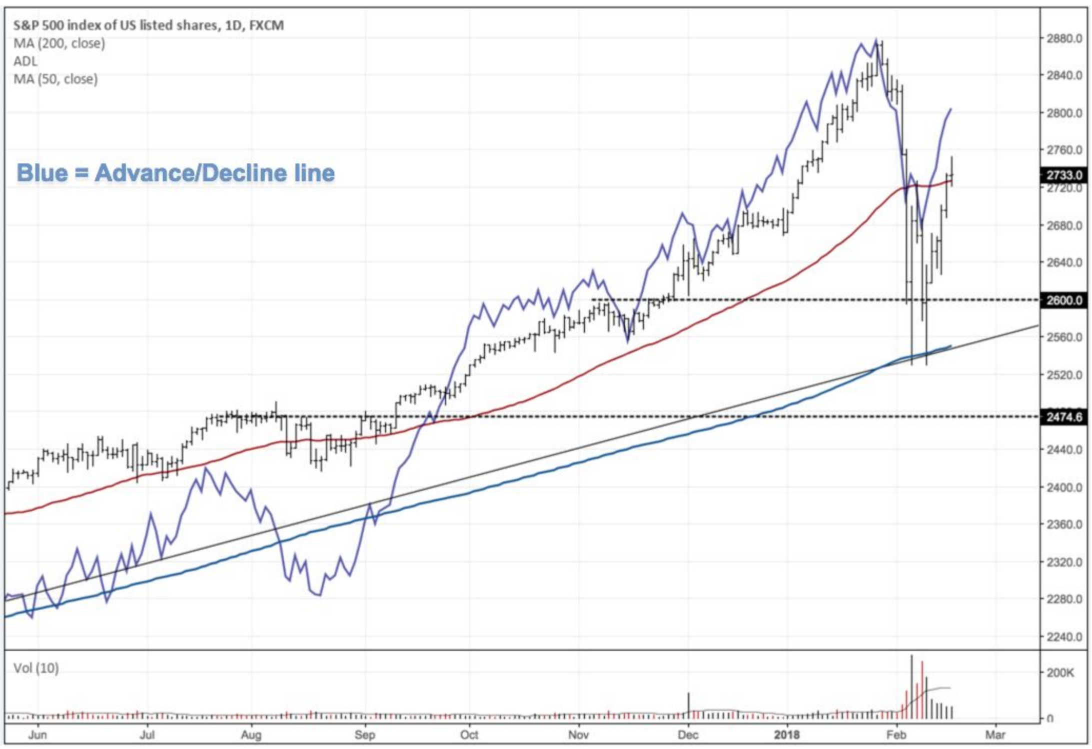
Both are equally important to long-term success in this game.

Markets and Macro

There's a lot I want to cover this week so let's just jump right in.

First, the market (chart below is of the SPX) bounced this week and has now retraced roughly half its previous selloff.

2,750 is the next critical hurdle the SPX needs to pass to signal this rally will have legs. If it can close above that line on a daily basis then the market should move quickly to previous highs.



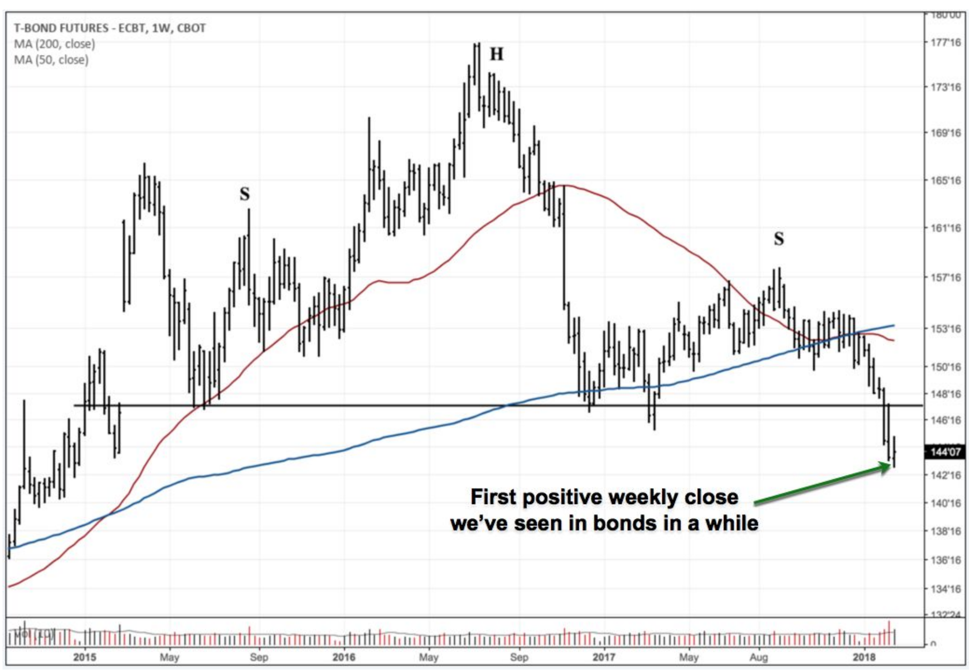
Another positive note is the strong breadth in this bounce. We can see it above in the positive divergence of the A/D line (blue line).

We also saw a strong reversal in junk bonds (JNK) this week. Price retraced the entire previous week's dump and then closed on its high. JNK is always a great indicator of investor risk-appetite and this shows that the buy-the-dip mentality is still alive and well in markets.

We also saw a strong rebound in the percentage of stocks trading above their 200-day. For a rally to be sustainable it needs to be supported by strong breadth like this.

Another sign of market strength is the recovery in NYSE new highs over new lows (black line). This indicator led the market selloff and is now leading its recovery.

And remember how we discussed last week that equities were unlikely to find a floor until bonds stabilized? Well, 10-years had their first positive weekly close in a while. I don't think we've seen the low yet in bonds but it'd be good for equities if they slow their descent somewhat.



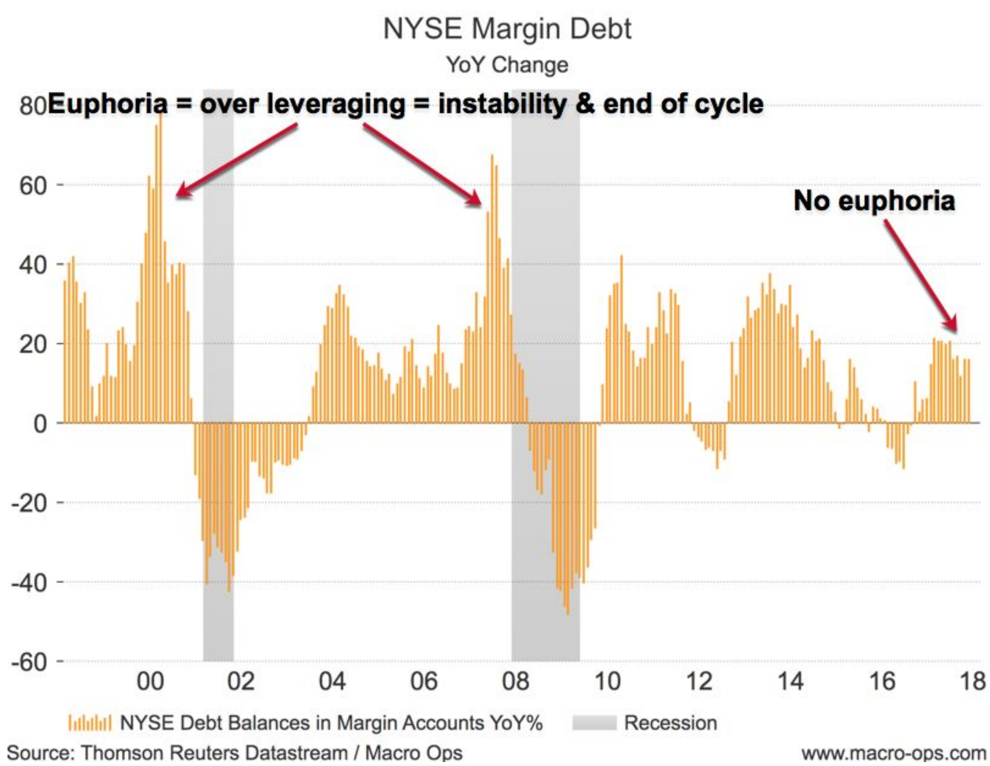
To sum up, the evidence currently tips the scale in favor of the bulls.

We saw strong breadth, a bounce in credit, and finally a bid in bonds. The market's "Generals", the FAANG stocks, had strong closes into the end of the week absent Facebook. Sentiment bellwethers like semis (SMH) and biotechs (IBB) also showed strength going into the end of the week.

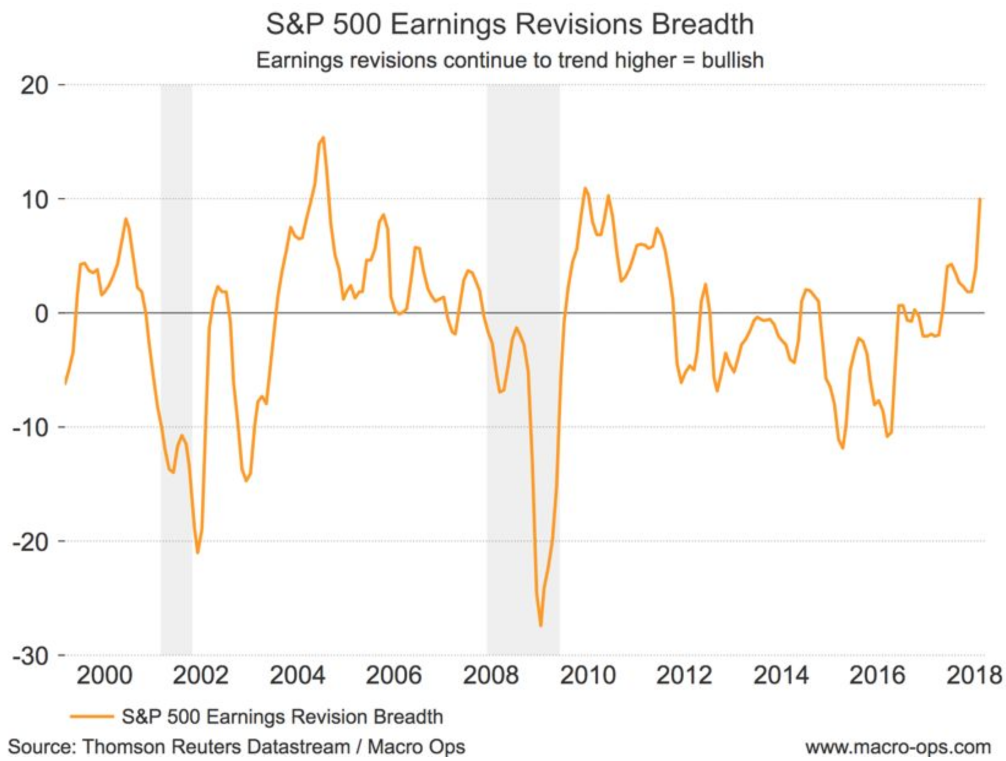
And finally, this is more anecdotal but worth mentioning nonetheless, I was surprised this week by how quickly sentiment turned negative. My twitter feed was full of doom and gloomers and comparisons to the top right before the 1987 crash.

It amazes me how persistent the knee-jerk negative sentiment reaction function has been. Bears are still quick to call a market top after every little down week. This, as much as anything, is reason to stay bullish. Bull markets die on euphoria, not pervasive skepticism.

This negativity shows in the data too. We've yet to seen the leveraging up that typifies the manic buying of market tops.



Equity analysts continue to underestimate the earnings power of this market. S&P 500 earnings revisions breadth is at its highest levels since 2010.



And it looks like corporates are about to ramp up share buybacks to record breaking levels.

CNBC this week noted the following (emphasis mine).

> *Corporate buybacks continue to surge, and are* ***now at year-to-date record of $170.8 billion.*** *The boom, fueled by tax law changes, could help boost stock prices, as companies buy in their shares and the smaller float of outstanding shares helps their already rising earnings. Cisco's $25 billion buyback announcement this week was the largest, followed by Wells Fargo's $22.6 billion.*
>
> *"There's a whole stockpile of cash that just came back. Take Cisco. We know they had $68 billion trapped overseas, and they're going to take $25 billion of that and buy back stock," said Art Hogan, chief market strategist at B. Riley FBR.*
>
> *Birinyi Associates, which has tracked buybacks since the 1980s, said* ***this year's level, from Jan. 1 through Feb. 15, is the most ever****, topping $147.2 billion in the period of 2016, which had been the busiest at this point of the year. During that period of 2016, the market was working its way out of a roughly 14 percent correction.*
>
> *"It acts as a floor, you have a natural buyer in there," said Jeff Rubin, director of research at Birinyi. Rubin said companies have been large buyers for a number of years now, and they have a large amount of cash already available for purchases.*

> *"At the end of the third quarter, **companies had dry powder of over $800 billion,**" he said.*

All of this is **not bearish.**

The large buyback flows could be the source of these quick v-bottom retraces we've been seeing in markets over the last year. I've heard from a number of people that these buybacks are run by algorithms that seek to buy in at the best price over the span of a number of months. So when the market dips by a few points the algos turn on and bid orders flood the market. This should only accelerate throughout the year.

Gold is at a major inflection point. Chart below is a weekly.

It's sitting at the neckline of a 5-year inverse H&S pattern. A strong weekly thrust above this neckline would signal the start of a major bull market in gold. A failure to break above would indicate a further continuation of the bear market in precious metals.

I don't have a strong opinion on gold at the moment. Persuasive arguments can be made for both the bull and bear cases.

The bear thesis is that we're in a rising rate environment globally and gold typically performs poorly when rates are going up.

Also, even though gold has gone up over the last year I'm surprised by how slow its advance has been considering the drop in the US dollar over the same period. The two usually move inversely to one another. Gold's lack of strength in this falling dollar environment isn't exactly inspiring.

The bull case is that we're seeing widening deficits in the US. We may be in the early stages of a cyclical dollar bear market. The US commerce department just fired the first shots of what could become a burgeoning trade war (more on this below). Trade wars are inflationary which is bullish for gold. There's also increasing potential for conflict with North Korea (I expect this narrative to come back to the fore in the second half of this year). And gold performs well in times of conflict and uncertainty.

Plus, the charts for many of the miners look really solid.

Platinum, which often leads gold and silver, looks like it has put in a bottom and is getting ready to rip.

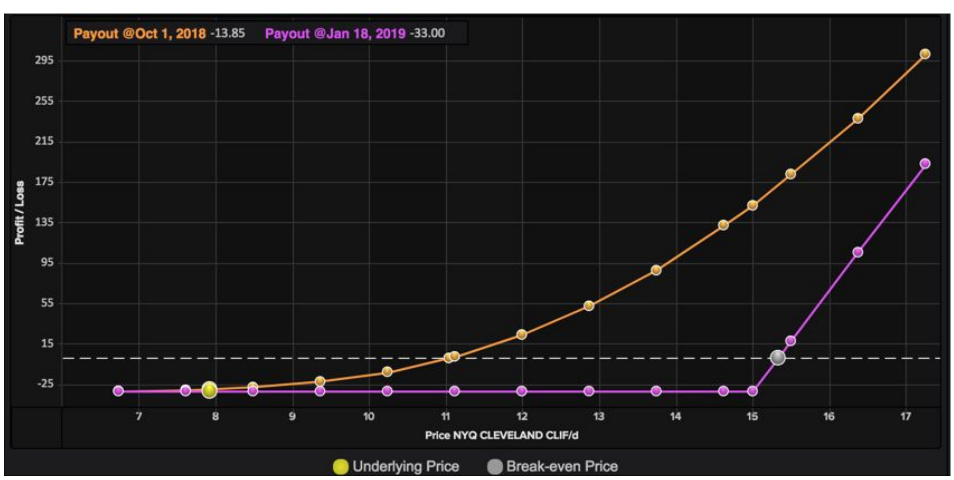
We'll continue to watch the action in precious metals closely. And if price continues to look constructive we'll consider buying some DOTM calls on a gold miner.

Steel stocks shot up this week on news of the recent Commerce Secretary's report ([here's a summary](#)) recommending significant tariffs and quotas on steel and aluminum imports. If this gets passed it would be a big deal and could lead to an all-out trade war. It would also be very bullish for domestic producers.

Because of this, it’s worth taking a serious look at steel related stocks.

Cleveland Cliffs (CLF) is an iron ore producer with improving fundamentals, insider buying, and a solid looking price price setup.

We can buy DOTM calls on CLF that expire in Jan 2019 with a strike of $15 for only $0.33. If CLF were to hit $15 by October these options would be worth $1.50. That’s roughly a return of 4.5x. I’m looking at some other names but we may put this trade on this week.



Portfolio Updates

Tripadvisor (TRIP), one of our larger positions, reported earnings this week and the stock reacted nicely. It's now up 15+% since our entry a few weeks ago. TRIP's strong close this week is also a significant technical achievement as it marks the first time the stock has closed above its 50-week moving average in over two years.

The earnings report was good but not great. TRIP is still going through a difficult business transition. But the value of its assets and its wide competitive moat continue to increase. Here's a few highlights from the latest report.

- User reviews and opinions grew 29% year-over-year and reached 600 million at December 31, 2017, covering approximately 1.2 million hotels, inns, B&Bs and specialty lodging, 750,000 vacation rentals, 4.6 million restaurants and 915,000 attractions, including tours and activities.
- Average monthly unique visitors on TripAdvisor-branded websites and applications grew 17% in Q4 2017 and grew to 455 million* during the 2017 peak summer travel season.
- Average monthly unique hotel shoppers grew 3% in Q4 2017 and grew 7% in the full year 2017.

- Fourth quarter consolidated GAAP net income was negative $84 million, primarily driven by a $73 million income tax charge related to the enactment of the Tax Cuts and Jobs Act of 2017.
- Q4 Hotel segment year-over-year adjusted EBITDA margin was 26%, primarily driven by increased efficiency in Hotel segment marketing investments.
- Full year 2017 Non-Hotel segment adjusted EBITDA was $45 million, and full year 2017 Non-Hotel segment adjusted EBITDA margin was 13%, up from negative 10% in 2016.

TRIP is worth twice as what it's currently trading at. It looks like the market is beginning to slowly realize the mispricing here.

This week we're going to put on a position in Micron Technologies (MU) which we talked about in the latest Macro Musings. I think we'll play it using DOTM calls. We'll send out an alert when we do.

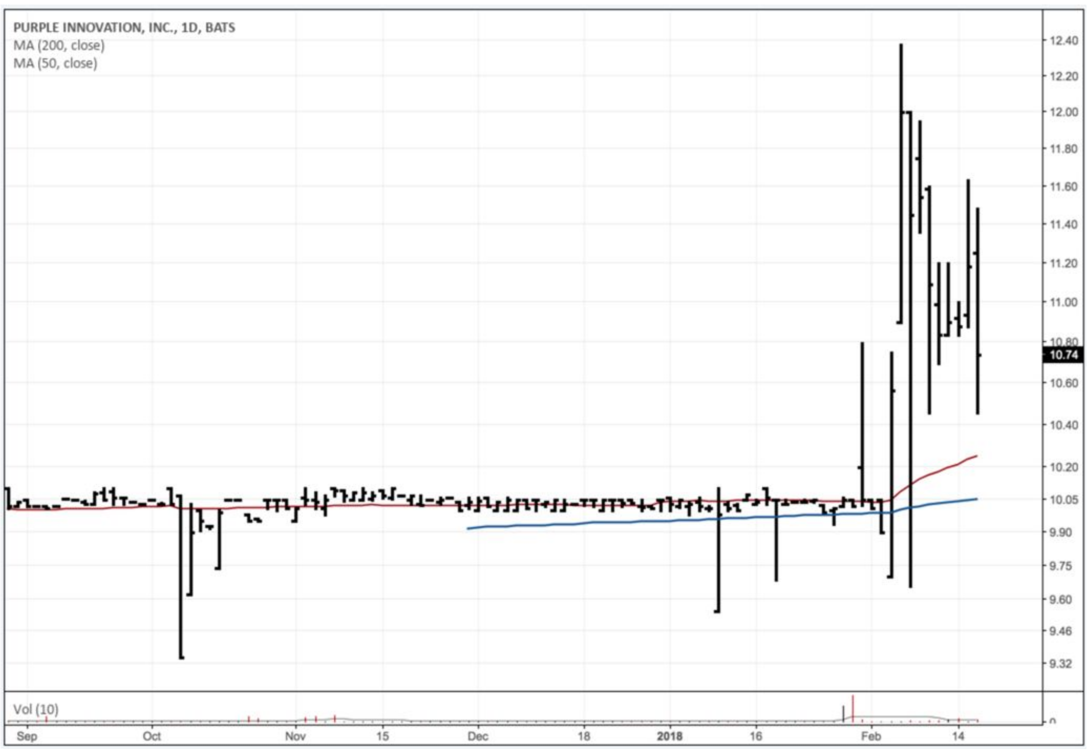
I'm currently digging into two companies that at first glance look promising.

The first one is Fairfax India Holdings, which is a fund based out of Canada that invests in public and private companies in India. It's run by a talented and experienced investment team with local knowledge. It could be a great vehicle to play our India growth theme.

The second company is Purple Innovations (PRPL). You might have seen one of their advertisements which have gone viral on youtube ([here's one of them]). The company makes mattresses, pillows, and such. It's growing like crazy. A number of people I know who use their products swear by them.

The company reminds me of Dollar Shave Club in its early days with its viral marketing campaign and cult like user base. And Dollar Shave Club ended up selling out to Unilever for $1 billion.

PRPL recently came public through a SPAC which is why it's still under the radar and also why there's potentially a major mispricing here.



I'll share my findings with everybody as soon as I'm done digging.

Four of our holdings, UIHC, WMT, CHK, and LMB, have earnings this week. LMB has been a dog so if the release doesn't get this stock moving in the right direction we'll just cut and run.

We'll put out updates in the CC after the releases.

That's all I've got for this week. Hope you're having a good weekend and I'll see you in the CC!

- Alex

Macro Ops Portfolio			YTD	Inception (16')			
NAV	$2,793,881		3.59%	39.07%			
Big Bet Macro							
Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target	Last Price
Equity	Limbach LMB	2,750	$13.66	$12.00	$2,887.50	$18.00	$13.05
Equity	JD	5,867	$44.74	$36.00	$61,134.14	$72.00	$46.42
Equity	Interactive Brokers IBKR	1,800	$41.71	$58.50	$15,966.00	$55.50	$67.37
Equity	W&T Offshore WTI	16,000	$2.18	$3.30	$9,440.00	$4.50	$3.89
Equity	Yatra Online YTRA	39,286	$7.40	$6.45	$39,286.00	$14.00	$7.45
Equity	United Insurance UIHC	13,000	$16.98	$17.00	$23,270.00	$20.00	$18.79
Equity	Trip Advisor TRIP	7,754	$36.46	$33.80	$73,818.08	$50.00	$43.32
Equity	BCS Jan '19 15 Call	574	$0.35	$0.00	$15,498.00	$3.50	$0.27
Equity	DB Jan '19 30 Call	670	$0.30	$0.00	$6,030.00	$3.00	$0.09
Equity	CCJ Jan '19 17 Call	236	$0.41	$0.00	$3,540.00	$5.00	$0.15
Equity	FCAU Jan '19 25 Call	108	$0.90	$0.00	$27,540.00	$5.00	$2.55
Equity	JD Jan '19 70 Call	108	$0.92	$0.00	$15,120.00	$7.00	$1.40
Equity	TRIP Jan '19 75 Call	108	$0.89	$0.00	$9,288.00	$7.00	$0.86
Equity	CHK Jan'19 10 Call	750	$0.14	$0.00	$4,650.00	$1.00	$0.06
Equity	Tesla Mar '18 240 Put	28	$8.80	$0.00	$854.28	$24.00	$0.31
Equity	MS June '18 65 Call	126	$0.46	$0.00	$4,158.00	$3.00	$0.33
Equity	WMT June '18 120 Call	126	$0.51	$0.00	$14,477.40	$3.00	$1.15
Volatility							
Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target	Last Price
Rates	IEF March 2018 104/109 St	150	$1.31	$0.00	$30,450.00	$7.00	$2.03
Commodity	SLV June 2018 17 Straddle	130	$2.84	$0.00	$26,780.00	$5.00	$2.06
Commodity	GLD Sep 2018 128 Straddle	24	$15.10	$0.00	$25,248.00	$30.00	$10.52

Risk Budget

	Total Allowed (In Bps)	Total Used	Total Available	Percentage Used
Master	2500	1,465	1035	58.62%
Big Bet Macro	1250	1170	80	93.62%
Volatility	1250	295	955	23.62%

**Updated 2/18