Bullish for Bullion?

Trading Wisdom

The following is a section from Barton Biggs' *Hedgehogging* that may be relevant to market's today (emphasis mine).

> *Gold is a highly durable asset, and thus, as stressed by levhari and Pindyck (1981), it is the demand for the existing stock, as opposed to the new flow, that must be modeled. The willingness to hold the stock of gold depends on the rate of return available assets. We assume the alternative assets are physical capital and bonds. ~ "The Pricing of Durable Exhaustible Resources" The Quarterly Journal of Economics*

Since 1988 the price of gold has had a negative 0.85 coefficient of correlation with the S&P 500 and an R2 of 72%. As things got crazier since 1994, the negative correlation rose to 0.94, with an R2 of 88%. ***In other words, the stock market explains 88% of the weekly price fluctuations of gold over the past eight years.*** *The long-term correlation with Treasury bonds is not as high but still very significant.*

As Peter explains it, ***the so-called problem with gold, which causes its erratic price behavior, is that "the elasticity of a positively sloped investment demand function overwhelms the inelasticity of supply."*** *I didn't understand it either until he explained. You see,* ***only 18% of the gold mined throughout history is held in investment form, or slightly more than $200 billion. The investable capital markets of the world are estimated to be about $60 trillion.*** *In a low return cycle for stocks and bonds, monetary and investment demand for gold turns positive, and there is a dramatic shortage of available metal. This large differential can only be solved by much higher prices.* ***The point is that it is not inflation or deflation that is the principal driver of gold, but the return from other long-term financial assets, particularly equities.*** *Peter's model of this relationship is shown in Figure 19.1. As you can see, in times of bleak returns, gold beats everything else.*

FIGURE 19.1

Expected Real Return Matrix

Capital Markets				*Gold*
10%	–		–	–8%
8%	–		–	–3%
6%	–		–	2%
4%	–	↔	–	7%
2%	–		–	12%
0%	–		–	17%
–2%	–		–	22%

Source: Sun Valley Gold LLC

Macro: Gold, Oil, and Stocks

The so-called barbarous relic is nearing a critical inflection point. Check out this chart of gold on a monthly basis showing a near completed inverted H&S pattern.

I’ve been skeptical of the bullish case for gold. But this is because I’ve been expecting a dollar rebound which has so far failed to materialize. And it’s looking more and more likely that I may be wrong.

I’ve written before about the circular relationship between the dollar and gold, as in how a lower dollar means higher gold prices and vice-versa. And the relationship is circular because for some reason, gold tends to lead the two assets in signalling the start of major moves.

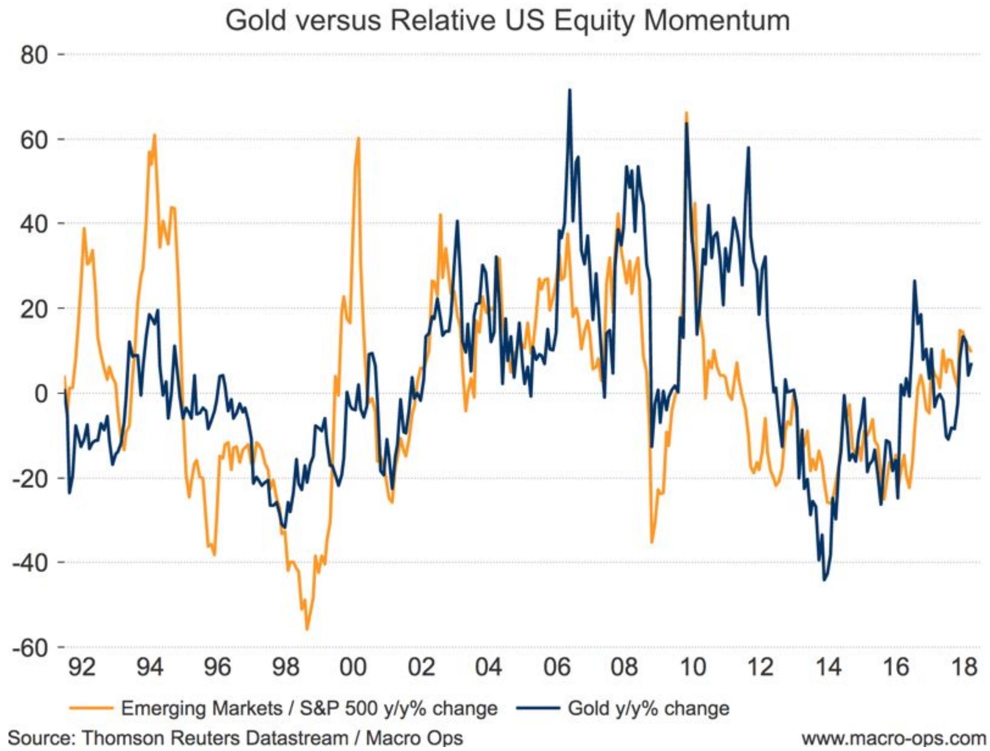
This is why the above chart is so critical to watch. If gold completes this pattern and signals the start of an advance higher, then the dollar is likely headed for another leg down — and that circular feedback loop of lower dollar and higher gold could kick into effect.

As Biggs notes in his book it’s “*not inflation or deflation that is the principal driver of gold, but the return from other long-term financial assets, particularly equities.”*

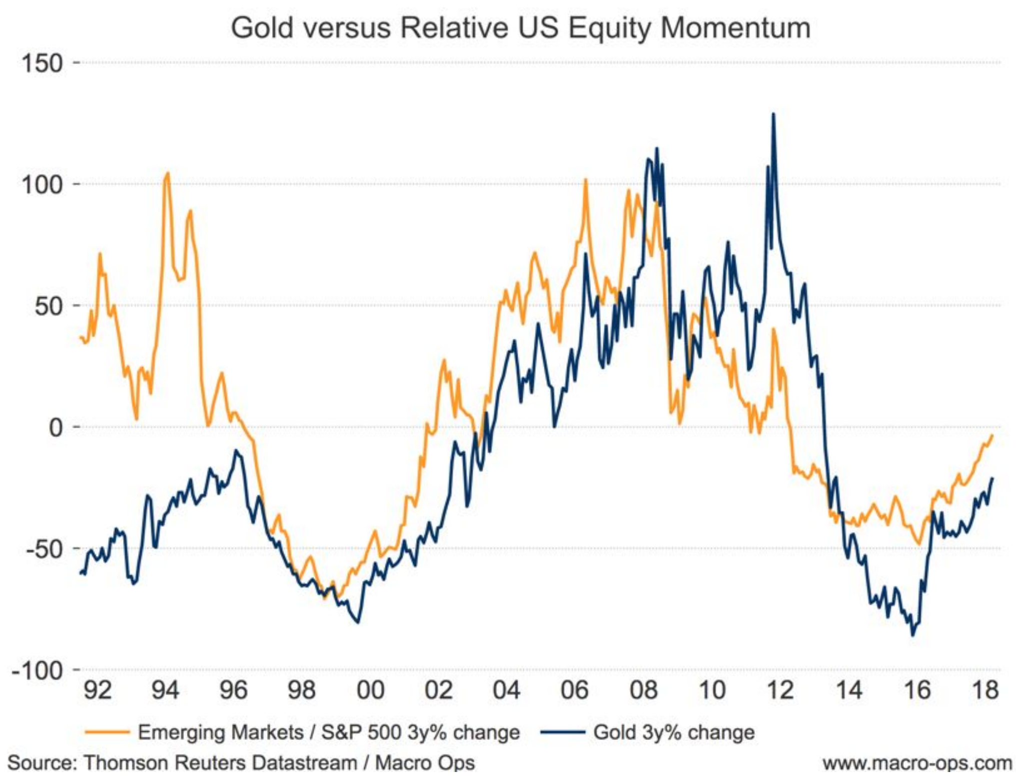
This is not a mainstream concept for what moves gold but it’s one that I have found to be useful. I view gold as being reflective of the fundamental value of $1 of US liquidity. What I mean by that is that gold tends to mirror the global demand for US assets (ie, stocks and bonds) relative to the supply of US dollars (liquidity).

We can see how this relationship plays out in the two following charts.

This chart shows the relative momentum of emerging market equities versus the US and the price of gold on a year over year basis. The correlation is easy to see. When emerging markets outperform US stocks, gold rallies and when the US outperforms (ie, when there’s high demand for US assets) gold goes on offer.



Here's the same charton a 3-year rate of change basis, which makes the relationship even easier to see.

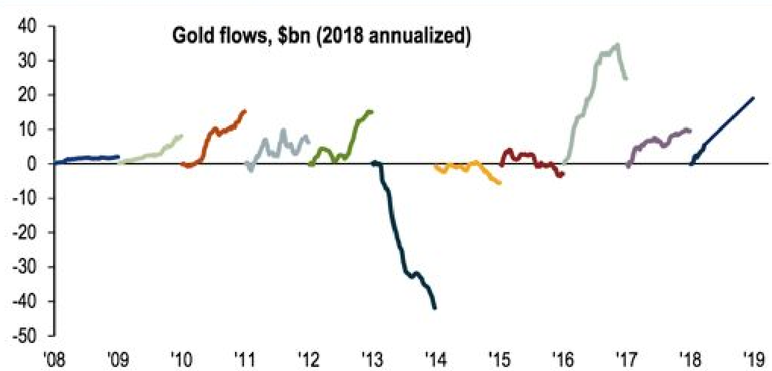


These charts show how relative equity momentum drives the trend-direction of gold.

And the major transition in outperformance between EM and the US equities over the last 2-years looks very similar to the 99'-01' period, which ended up being the start of a major gold bull market. If this analog holds and emerging market stocks continue to outperform the US, then we should see gold begin another bull market soon.

The current flows into gold are so far supportive of this thesis.

Chart 5: Investors return to Gold



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg, EPFR Global

And the charts of many gold miners also look very constructive. Below is South African miner Anglogold Ashanti (AU). One of my preferred vehicles to play a potential gold revival.

We can buy 0.12 delta DOTM calls on AU that expire Jan 19' struck at 17 for $0.20 or even go further out and get calls struck at 20 that expire Jan 20' for $0.45.

I'm not completely convinced that the dollar is now in a cyclical bear market or that gold is about to start a new bull. But... the current macro environment is noisy — there's lots of moving pieces and unknowns — and I want to hedge my uncertainty.

This inflection point in gold gives us an opportunity to allocate some capital to a DOTM trade that would allow us to exploit this move. If gold falters and turns lower then we'll lose only our premium. But if it starts a new bull run then there's tons of asymmetric potential in this unloved asset.

Oil is Running to Our Year End Target

Oil continues to surprise the market with its persistent push higher. Chart below is a weekly.

There's a number of reasons for this strength we're seeing in oil. We've discussed many of them, such as how we're in the 'Overheat' phase of the Investment Clock cycle and how global growth (driven by wealth/demographic trends in Asia) is driving higher than expected demand.

But there's also a number of other drivers and potential catalysts that have entered the picture recently that could drive oil even higher. These are Venezuela and Iran.

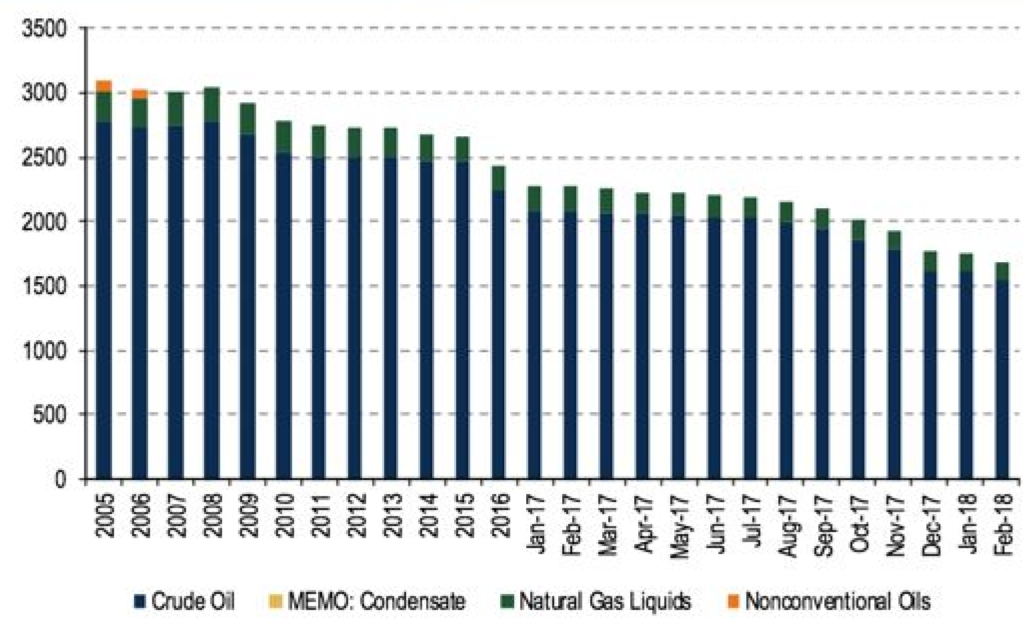
The recent selection of Mr. Bolton to replace McMasters as the new NSC could end up portending significant policy changes coming from the White House. Bolton is as geopolitically hawkish as they come and he's been no fan of the Iran deal that was put in place by Obama.

If he persuades Trump to pull out of the Iran nuclear agreement — a move that Trump already seems to favor — and re-apply sanctions, it could mean a good deal of oil supply coming offline at a time when the market is already getting quite tight.

A drop in Iranian production hitting the market would be significant because due to the success of socialism *sarcastic voice* in Venezuela, the country has seen a whopping 50+% decline in its oil production. Venezuela sits on the world's largest proven oil reserves and yet Maduro and clan have found a way to squander this enormous wealth of natural resources.

Venezuela only produced 1.55mbd last month, which is 25% below its OPEC production cap.

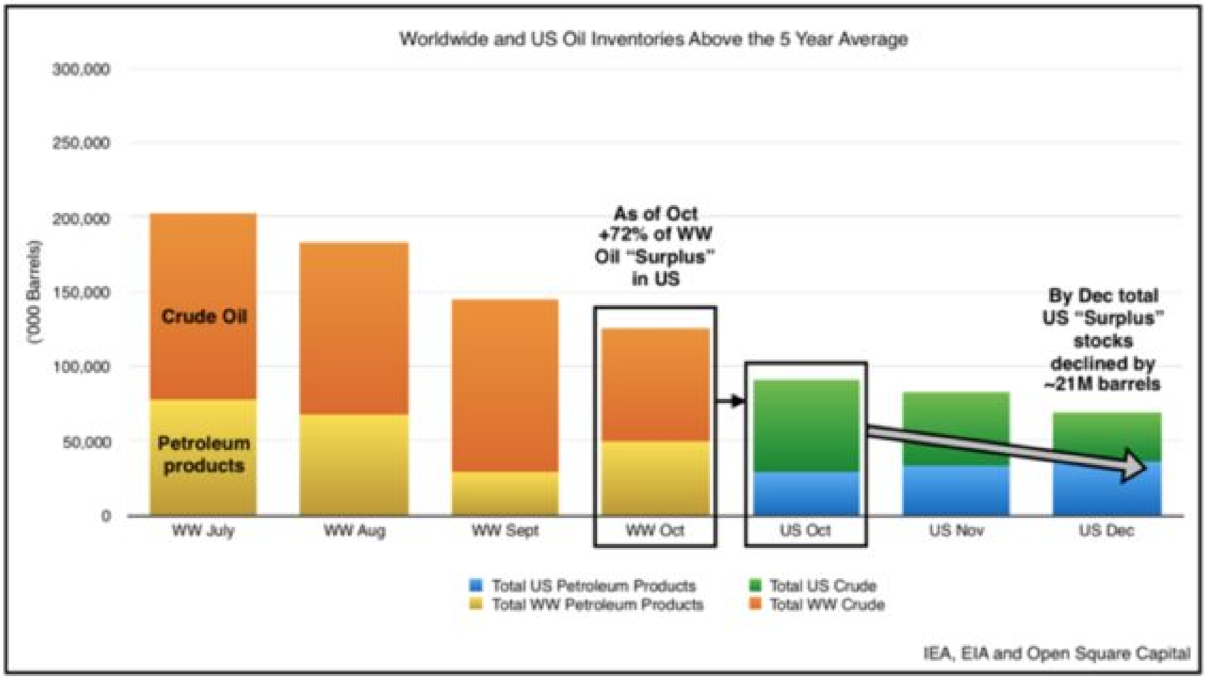
Chart 12: Venezuelan oil production (kbpd)



Source: BofA Merrill Lynch Global Research, IEA data

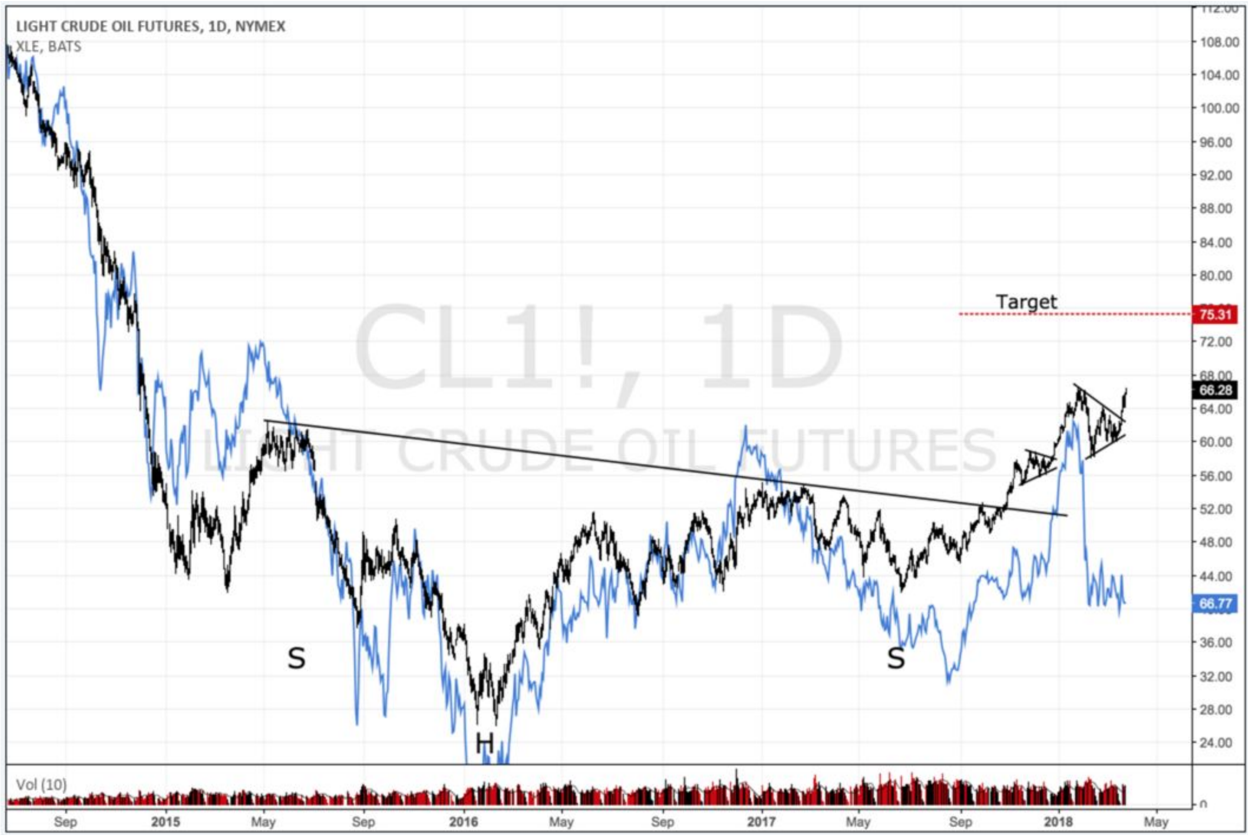
OPEC members Libya, Nigeria, Iraq and Iran have stepped in to fill the gap. But spare capacity for the group is now less than 10%.

If global demand growth continues to surprise to the upside (which I think is very possible) then the oil market will quickly move into deficit. And with global inventories quickly drawing down there's real potential for an oil shock type event that could drive the price of crude up well past our end of year target of $75bbl.



Despite the increasingly bullish fundamentals for the oil market, the equities have failed to rally much.

Below is a chart showing WTI crude and the energy producer etf (XLE) in blue. Energy stocks have been going sideways while crude marches higher. And surveys show that investors are massively underweight the sector.



I'm not completely clear on why this is. It may have something to do with the "rise of the EV" narrative which would mean lower terminal values for energy companies. But from the research we've done, we think this is massively overstating the coming hit to energy demand from electric vehicles — at least over the next decade.

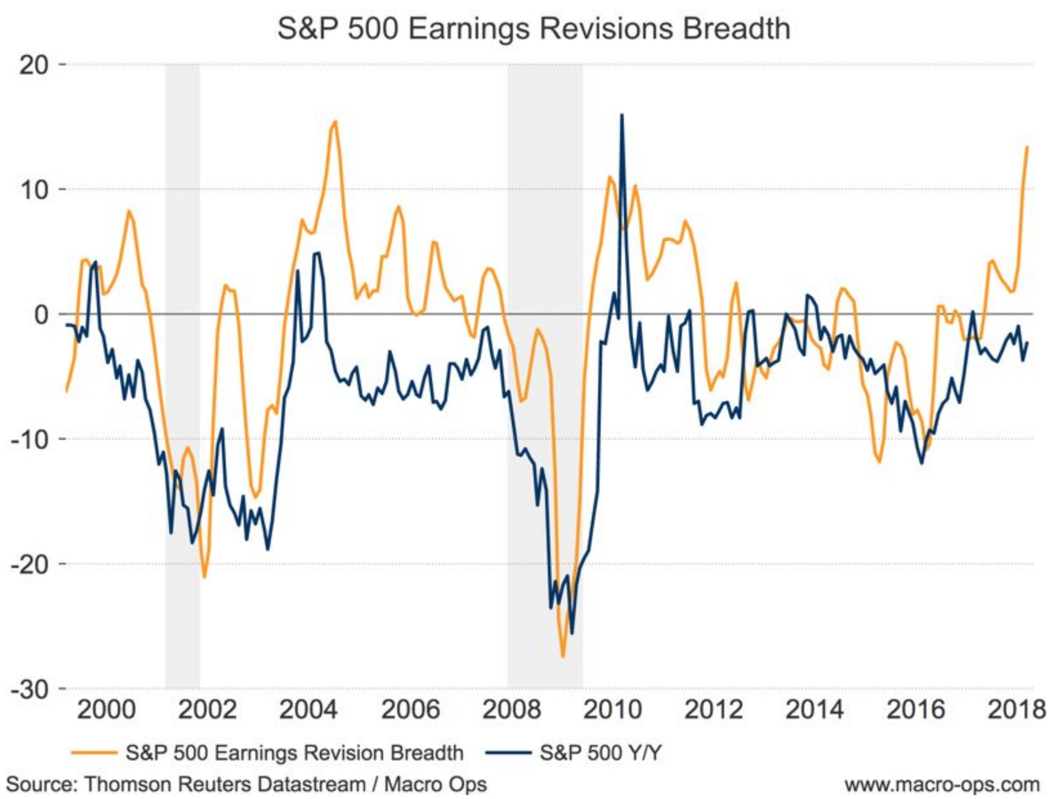
I see a lot of value in E&Ps like Diamond Offshore (DO) that are currently profitable and trading at just 6x FCF. But I don't want to put on more exposure to this sector until we start to see the market begin to change its view. So we'll continue to watch the tape here closely and see what develops.

A Market Shakeout

The S&P is now resting near its technically important 200-day moving average and its 2-year trend-line.

There's a number of narratives being ascribed to this move, such as the threat of rising trade wars, regulations against big tech, and climbing interest rates. There might be some truth to these narratives but it could also just be that we're seeing the return to normal market volatility after a long dry spell of easy markets.

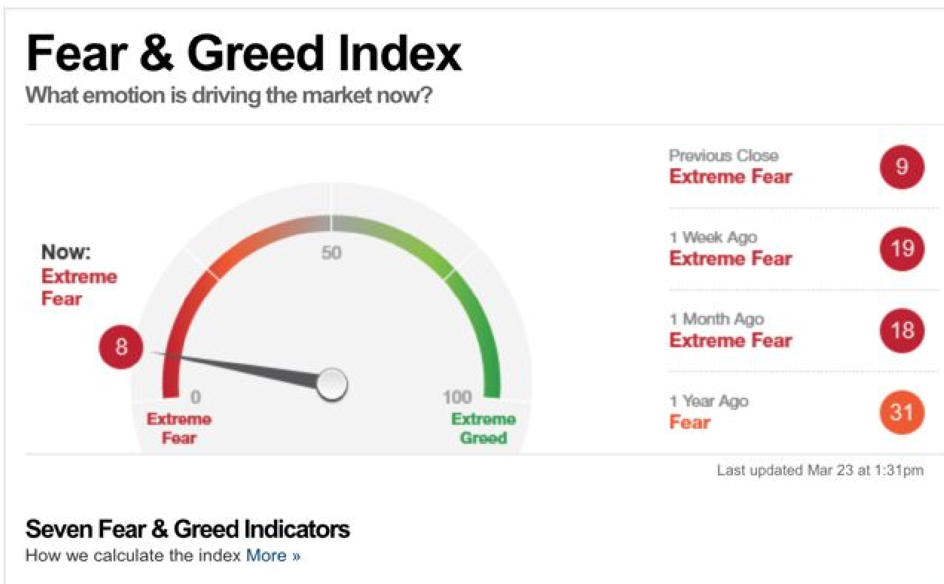
The underlying data is still supportive of risk assets even though spreads are getting tighter which is typical in the later stages of a bull market.



I’m not expecting a market top. But I wouldn’t be surprised to see the S&P dip below its 200-day and its bollinger bands in a large spike down bear trap. We might up our long bond position this week to hedge our book. And we’ll cut any stock positions that hit their risk points, of course.

I think the key here is to just sit on our hands and watch the tape. Let the market signal the next move and not overreact. I’m seeing a lot of bears coming out of the woods screaming that this is the beginning of the end. And I’m not buying it...

CNBC’s Fear & Greed Index is already showing extreme fear. Its this kind of pervasive sentiment that accompanies a near-term bottom.



And BofAML’s Bull & Bear indicator is no longer giving a sell signal. Flows and sentiment have turned more neutral but it still has a ways to go before giving the all-clear.

BofAML Bull & Bear Indicator (B&B)

Our BofAML Bull & Bear Indicator is now at 6.5 (no longer a sell signal).

Chart 14: BofAML B&B Indicator (scale from 0 to 10)

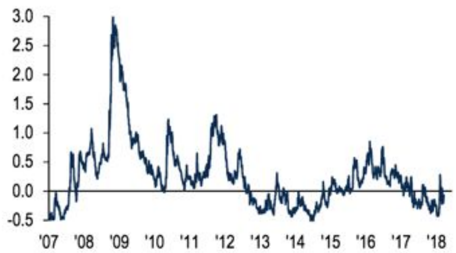
Source: BofA Merrill Lynch Global Investment Strategy

Table 4: Components of BofAML Bull/Bear Indicator

Components	Percentile	Sentiment
HF positioning	91%	V Bullish
Credit market technicals	89%	V Bullish
Equity market breadth	39%	Bearish
Equity flows	81%	V Bullish
Bond flows	4%	V Bearish
LO positioning	77%	Bullish

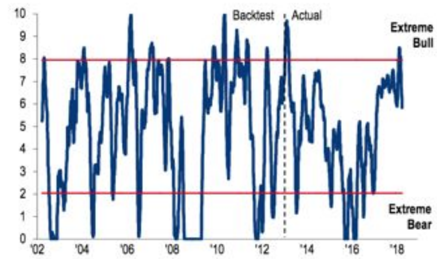
Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg, EPFR Global, Lipper FMI, Global FMS, CFTC, MSCI

Chart 15: BofAML Global Financial Stress Indicator



Source: BofA Merrill Lynch Global Research

Chart 16: BofAML Bull & Bear Indicator history



Source: BofA Merrill Lynch Global Investment Strategy, EPFR Global, FMS, CFTC, MSCI

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

- Alex

Macro Ops Portfolio			YTD	Inception (16')			
NAV	$2,651,504		-1.69%	31.98%			

Big Bet Macro

Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target	Last Price
Equity	Limbach LMB	2,750	$13.66	$11.00	$1,347.50	$18.00	$11.49
Equity	JD	5,867	$44.74	$36.00	$28,572.29	$72.00	$40.87
Equity	Interactive Brokers IBKR	1,800	$41.71	$64.60	$2,898.00	$55.50	$66.21
Equity	W&T Offshore WTI	16,000	$2.18	$3.30	$17,280.00	$4.50	$4.38
Equity	Yatra Online YTRA	39,286	$7.40	$6.45	$6,678.62	$14.00	$6.62
Equity	United Insurance UIHC	13,000	$16.98	$18.00	$17,550.00	$20.00	$19.35
Equity	Trip Advisor TRIP	7,754	$36.46	$35.50	$35,203.16	$50.00	$40.04
Equity	MU Jan '19 70 Call	118	$2.12	$0.00	$58,528.00	$10.50	$4.96
Equity	BCS Jan '19 15 Call	574	$0.35	$0.00	$17,794.00	$3.50	$0.31
Equity	DB Jan '19 30 Call	670	$0.30	$0.00	$9,380.00	$3.00	$0.14
Equity	CCJ Jan '19 17 Call	236	$0.41	$0.00	$4,012.00	$5.00	$0.17
Equity	FCAU Jan '19 25 Call	108	$0.90	$0.00	$14,904.00	$5.00	$1.38
Equity	JD Jan '19 70 Call	108	$0.92	$0.00	$5,400.00	$7.00	$0.50
Equity	TRIP Jan '19 75 Call	108	$0.89	$0.00	$4,320.00	$7.00	$0.40
Equity	CHK Jan'19 10 Call	750	$0.14	$0.00	$3,000.00	$1.00	$0.04
Equity	MS June '18 65 Call	126	$0.46	$0.00	$1,512.00	$3.00	$0.12
Equity	WMT June '18 120 Call	126	$0.51	$0.00	$630.00	$3.00	$0.05
Rates	ZBM8 Bond Futures	14	$144.47	$142.375	$32,690.00	$150.5	$144.71
Forex	6BM8 Pound Futures	-3	$1.4095	$1.4197	$1,912.50	$1.2457	$1.4196
Forex	6EM8 Euro Futures	-2	$1.2417	$1.2575	$3,950.00	$1.0972	$1.2446

Volatility

Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target	Last Price
Volatility	VXX	5,860	$48.48	$25.00	$137,592.80	~	$49.76
Commodity	SLV June 2018 17 Straddle	130	$2.84	$0.00	$22,880.00	$5.00	$1.76
Commodity	GLD Sep 2018 128 Straddle	24	$15.10	$0.00	$20,640.00	$30.00	$8.60

Risk Budget

	Total Allowed (In Bps)	Total Used	Total Available	Percentage Used
Master	2500	1,692	808	67.69%
Big Bet Macro	1750	1009	741	57.66%
Volatility	750	683	67	91.07%

**Updated 3/25