MACRO INTELLIGENCE REPORT

Macro Ops
Target. Deploy. Profit.

Toight Like A Tiger

Operators,

This month we kick off with a discussion about financial risk premia spreads and how they drive asset prices.

With interest rates on the rise — it's important to understand how cash, bonds, and equities compete for capital flows.

Interest rates are driven by inflation expectations so in the macro section we cover the latest inflation indicators and what they're telling us.

In This Issue:

➢ Risk Premium Spreads - Pg. 2
➢ Inflation Bacon - Pg. 15
➢ DO, FIH.U - Pg. 21
➢ Commodity Corner - Pg. 33
➢ Volatility - Pg. 43

The micro section this month includes two picks; one is a deep value offshore driller and the other is a fund that invests in Indian companies. It's run by one of the best investors you've never heard of...

We also got an interesting long idea in sugar and gold that's worth a look. And finally, we do a short analysis of the volatility space that includes a low risk way to hedge portfolio beta.

Enjoy!

Your Macro Operator,

Alex

Theory: Risk Premium Spreads

Ray Dalio recently wrote the following about where we are in the current cycle and the dynamics at work (emphasis mine).

> *In the "late-cycle" phase of the short-term debt/business cycle, when a) an economy's demand is increasing at a rate that is faster than the capacity for it to produce is increasing and b)* ***the capacity to produce is near its limits, prices of those items that are constrained (like workers and constrained capital goods) go up.***
>
> *At that time, profits also rise for those who own the capacities to produce those items that are in short supply. Then* ***the acceleration of demand into capacity constraints and rise in prices and profits causes interest rates to rise and central banks to tighten monetary policy, which causes stock and other asset prices to fall because all assets are priced as the present value of their future cash flows and interest rates are the discount rate used to calculate present values.***
>
> *That is why it is not unusual to see strong economies accompanied by falling stock and other asset prices, which is curious to people who wonder why stocks go down when the economy is strong and don't understand how this dynamic works.*

We are somewhere in the "late-cycle" phase of the short-term debt cycle. Where exactly, we can't know for sure. The late-cycle typically lasts between 18-30 months. We entered the late-cycle stage sometime last year, as evidenced by capacity utilization, risk premium spreads, and where we are in the Fed rate hiking cycle.

Though we can't know for sure exactly where we are, if we understand the main dynamics at work (ie, what's driving the market action) we'll be more prepared in knowing what to expect going forward and better able to identify the turn when it comes.

In the late stage of the short-term debt cycle the following dynamics begin to play an outsized role in markets.

1. **Risk premium spreads** become tight as valuations are driven up and expected future returns lower (this idea is explained below). Tight risk-premia spreads make risk assets (stocks) more vulnerable to the movement in interest rates.
2. **The cost of money** (interest rates) begins to rise as inflationary pressures build in an economy and the Federal Reserve raises interest rates.
3. **The economy begins to run hot** — it operates at/above capacity — this drives the costs of goods and labor higher, in turn pushing up interest rates and further putting pressure on risk premia spreads.

Clear as mud?

Don't worry, we'll run through each line real quick and break it down Johnny style and then look at the data to see what it's saying.

First up, risk premium spreads.

Investing is a series of decision making and the decisions are made by comparing the expected risk to the expected returns of various assets.

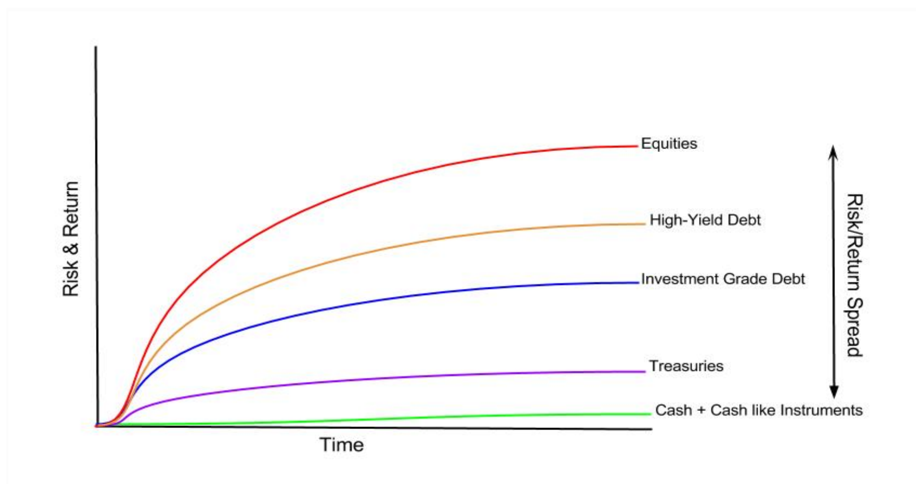
Investors then create a portfolio with a mix of these assets that all have their own expected risk/returns profiles that then hopefully make up the optimal mix of acceptable risk relative to desired returns for that investor.

Risk premium spreads are the difference in expected returns relative to risk between these assets (from cash to bonds to equities). The expected returns are the yield offered on bonds and forecasted earnings yield on stocks. The spread is just the difference.

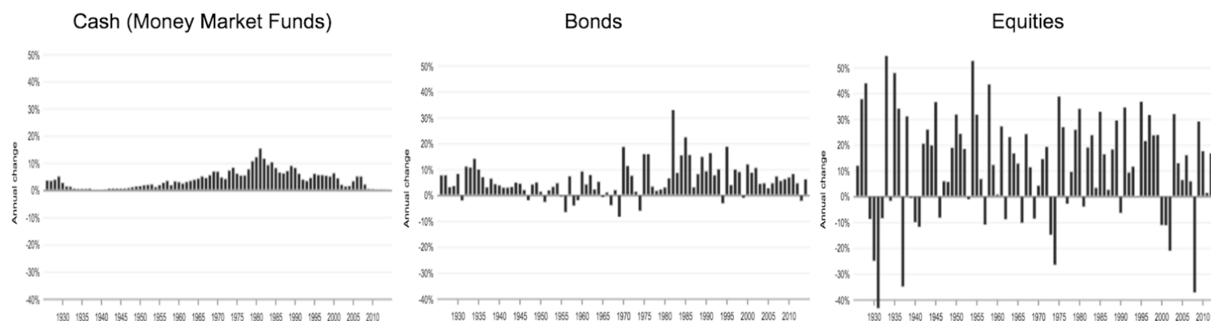
Cash, or the cost of money, sets the foundation for all other risk assets. Everything along the risk curve prices off the cost of money and central banks set the cost of money.

The next asset out the risk curve is the closest asset in terms of risk (average historical volatility), which in this case is short-dated treasuries. Then next we get longer duration bonds. Then investment grade corporates, high-yield, and finally, equities.

Risk premium spreads look something like this:



Here's a snapshot that shows this volatility/return relationship of the major asset classes over the last 80 years.



On average, cash provides the lowest returns but with the lowest volatility. Bonds have higher volatility but also higher expected returns. And then stocks offer the best long-term returns but investors pay up for it in the price of assuming gut wrenching volatility (ie, risk).

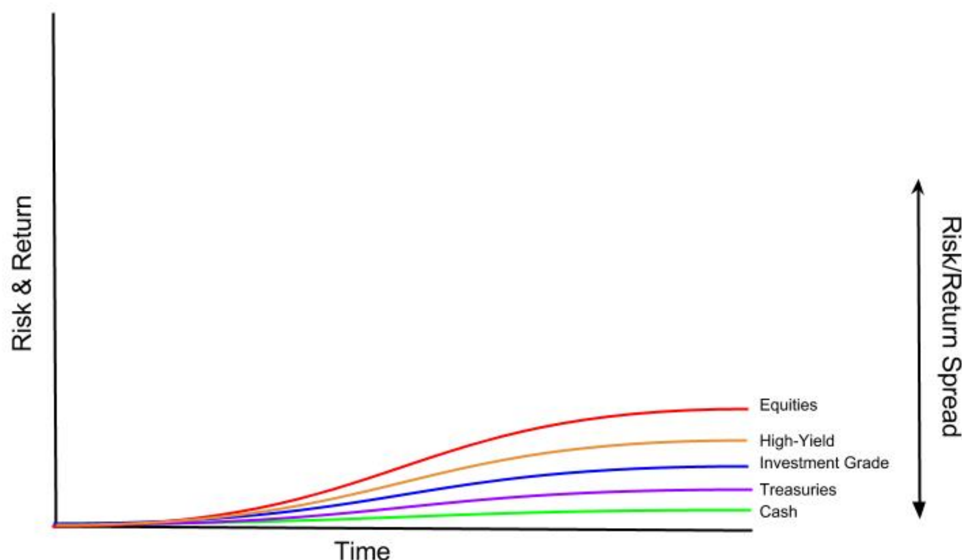
Risk premia exists because people need to be compensated for exchanging their low risk fungible cash for a higher risk asset. **The premium is the price you get paid for assuming greater volatility.**

When the Fed lowers interest rates, the lower cost of money transmits out the risk curve. It lowers the return (yield) on bonds and widens the spread between safer assets like cash and bonds and riskier assets, like high-yield and stocks.

This larger spread means that risk assets become more attractive relative to safe ones. And with a lower return in safe assets, investors need to move out the risk curve to maintain the same desired return profile for their portfolio.

This causes risk assets to get bid up, driving valuations higher. And when the valuations of an asset class increase, its expected future return *actually* goes down.

Ultimately, in a bull market, risk premia spreads get pulled closer and closer to that of cash and bonds. This goes on until they can't get any tighter. Central banks can take rates negative and you can eke out a bit more in spread between risk-free and risky assets… but eventually stock valuations become so high that their expected future returns are about the same as cash and the risk premia spread looks more like this.



It's at this point in the late-cycle phase of the short-term debt cycle where stock valuations are so high that their long-term (5-10 year) expected return is the same as that of cash but with much higher volatility.

Why would anybody hold stocks at that point in the cycle? Well, they don't and that's what causes a bear market as investors reduce their stock holdings and up their allocations to cash and bonds — one of the reasons why the yield curve inverts before a recession.

In the late stages of a bull market the movement in interest rates becomes of key importance. And that's because risk-premium spreads are pulled so taut that there's less room for interest rates to rise before it makes holding overvalued stocks a losing wager.

This is why late market guru Marty Zweig used to say that, "Monetary conditions exert an enormous influence on stock prices. Indeed, the monetary climate — primarily the trend in interest rates and Federal Reserve policy — is the dominant factor in determining the stock market's major direction."

He understood the importance of risk premium spreads.

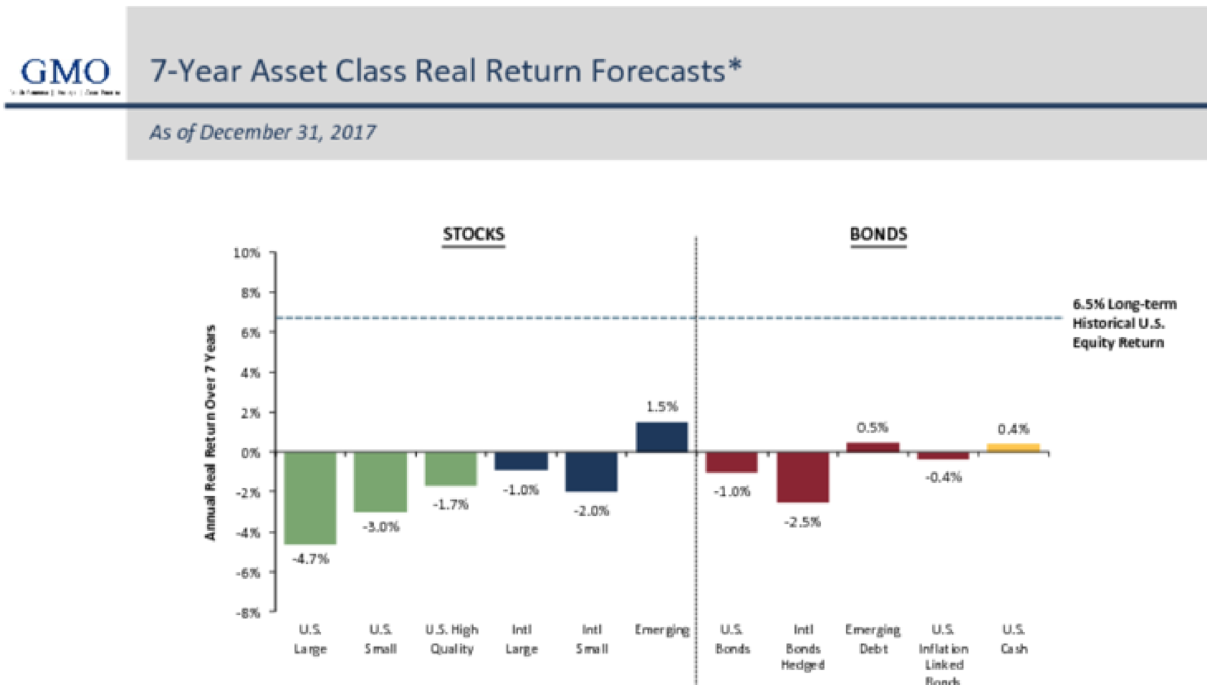
So, where are risk premiums spreads now and how susceptible are they to rising interest rates?

There's a number of ways to measure risk premium. And each way can give us a little different context.

We'll start with a look at GMO's 7-year asset class real return forecast. This looks at current asset valuations using various measures of return on capital relative to earnings multiples and then compares them to their average historical real returns over the following seven year period.

The model currently predicts that US large cap stocks will return -4.7% after inflation over the subsequent 7-years. Bonds will return -1% and cash 0.4%.

Only US cash, emerging market stocks and debt have positive — though very low — expected real returns over the next 7-years.



Source: GMO

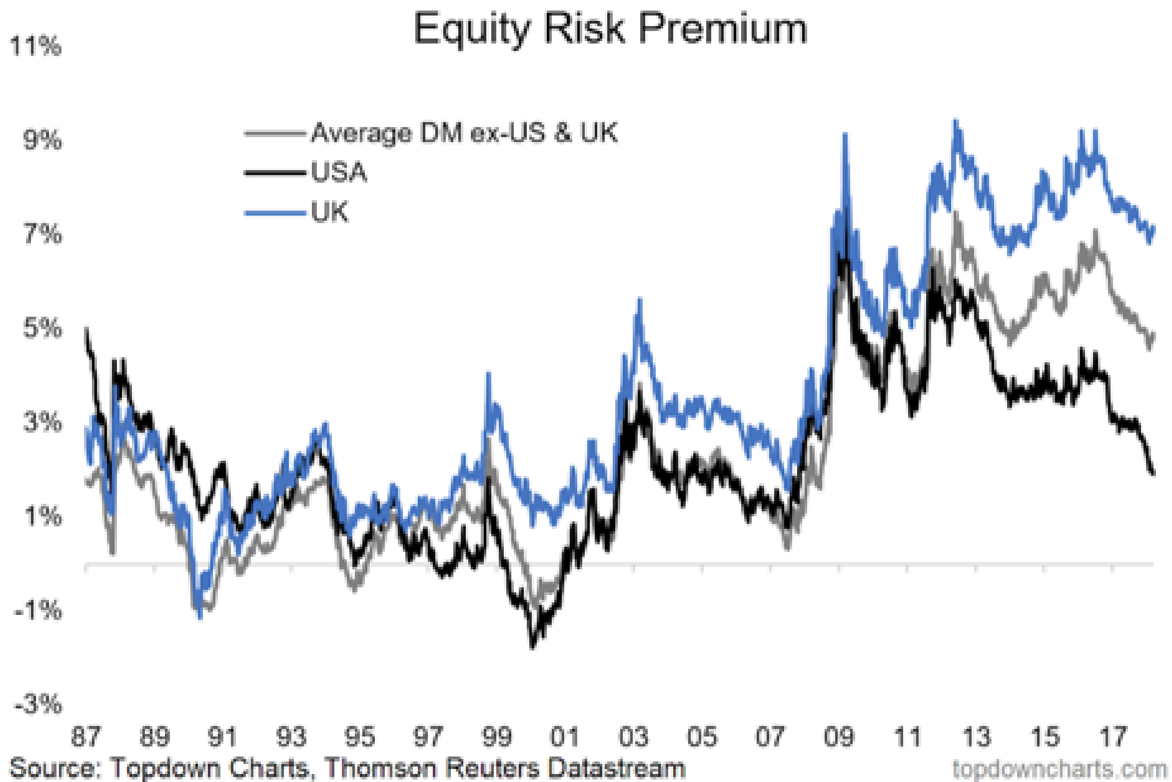
*The chart represents local, real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward-looking statements. U.S. inflation is assumed to mean revert to long-term inflation of 2.2% over 15 years.

Proprietary information – not for distribution. For Institutional Use Only. Copyright © 2018 by GMO LLC. All rights reserved.

This shouldn't be much of a surprise. Valuations according to any long-term metric are at historically high levels, across the globe.

But this is a long-term measure and the next 7-year forecast is only so helpful in giving us the big picture context.

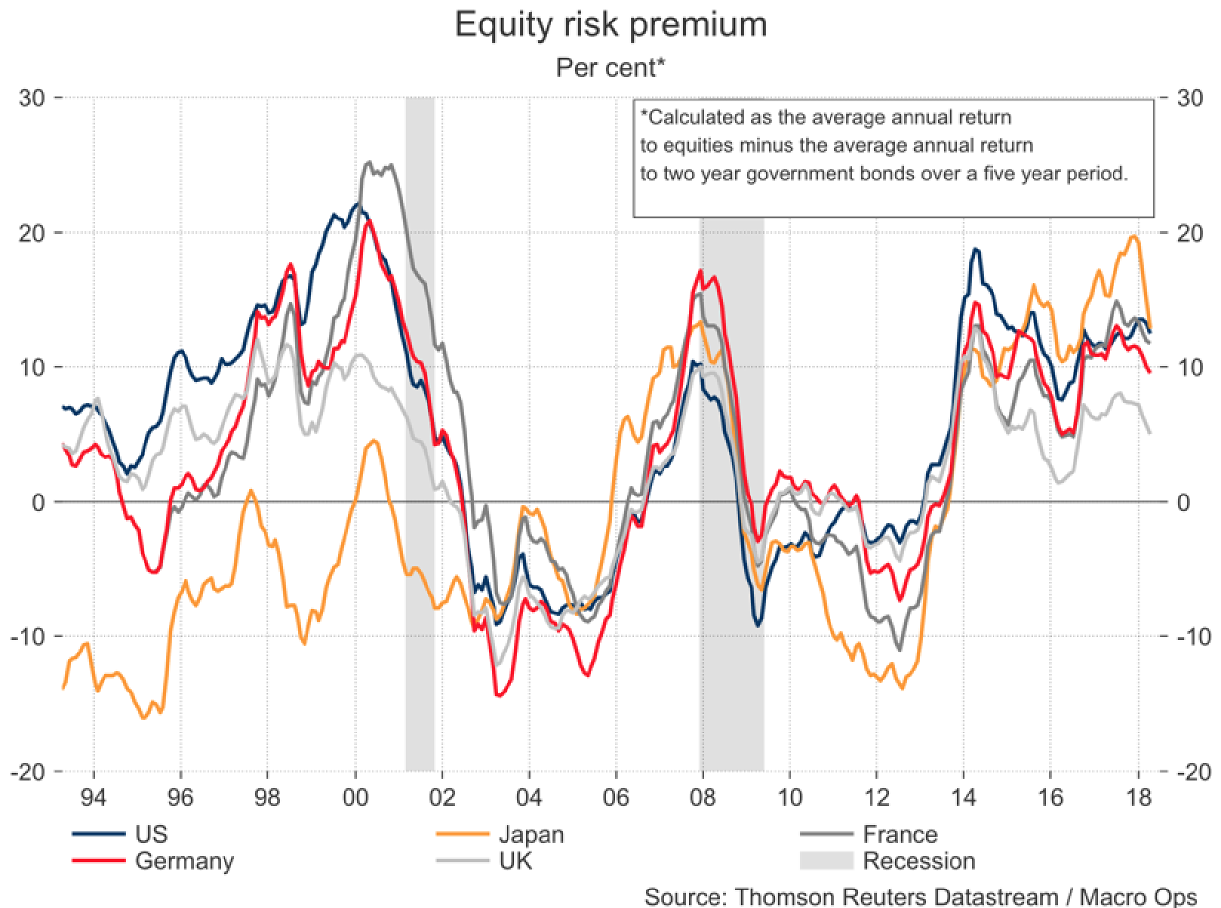
To measure the intermediate-term equity risk premium we like to look at the inverse of the CAPE (earnings yield of the S&P smoothed over the last 10-years) minus the rate on 10-year bonds, adjusted for inflation. (Graph below courtesy of Topdown charts)



The chart shows that though the spread is tightening in the US. It's still 1.5% wider than where it was at the top of the last bull market and over 3% wider than the *negative* levels it reached in 2000.

A slight drop in the earnings yield and a 1% rise in interest rates will put us at levels that have marked the end of bull markets in the past.

Another way to gauge risk-premium is to look at the rolling 5-year average annual return to equities relative to 2-year bonds. Like the measures of risk premium spread above, this is a mean reverting model. But in this chart, the higher the line is, the tighter the spread is.

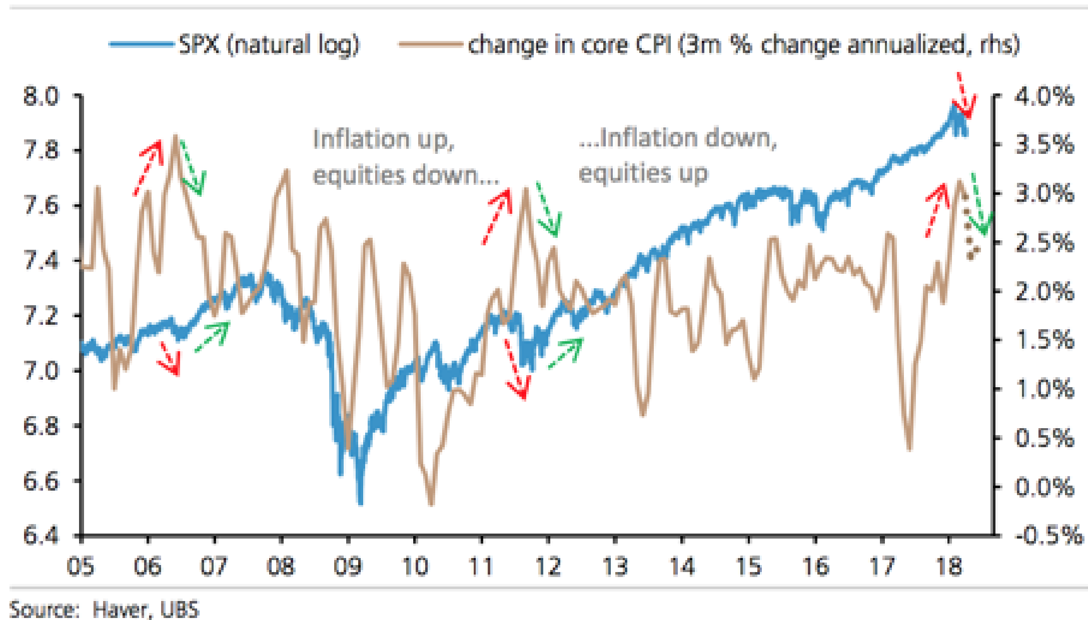


This measure of risk premium shows puts us at similar levels reached at the top of the last two cycles.

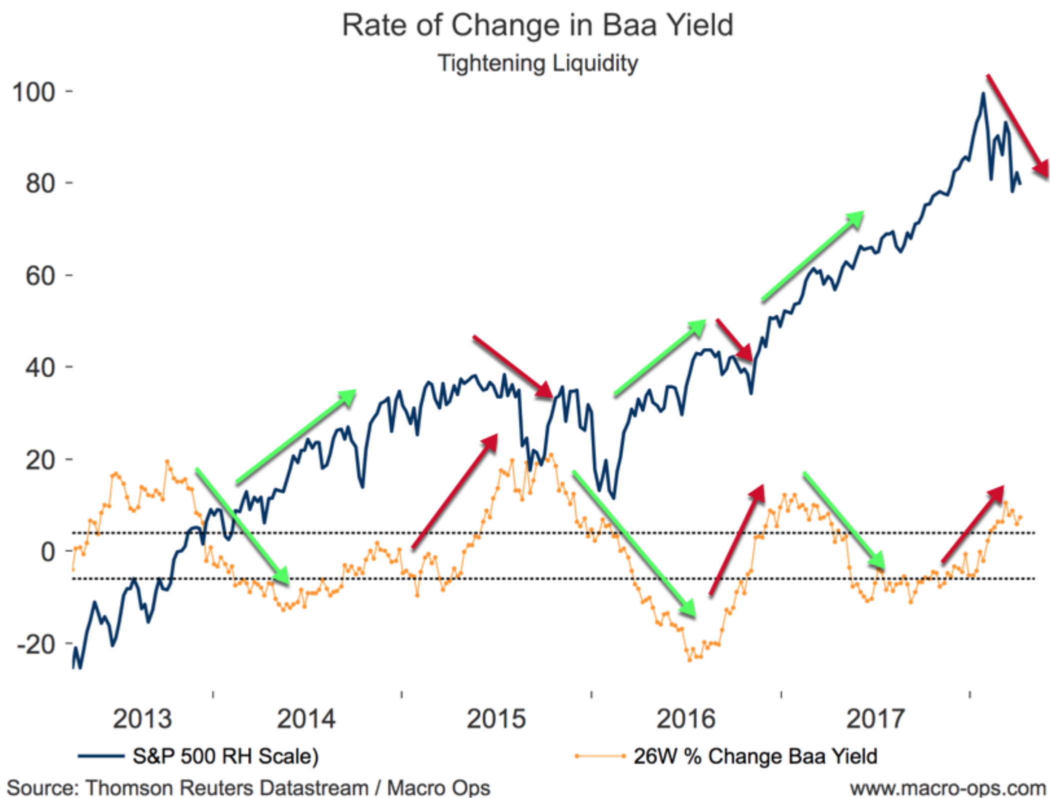
The data clearly shows that we're in the "late-cycle" phase. But within that phase, which typically lasts between 18 to 30 months, we're closer to the middle than the end. <u>This puts the next bear market 12-18 months out.</u>

When risk premia spreads tighten, changes in the inputs (earnings, valuations, interest rates) have a larger impact on equity volatility. This means stocks become extra sensitive to unexpected changes in inflation and interest rates. The market selloff that began at the end of January was the result of rising inflation expectations driving rates up.

The chart below shows the connection between short-term changes in inflation and subsequent moves in the stock market.



We can see this relationship directly in the change of interest rates. When bond yields rise, liquidity tightens which puts pressure on stocks. When yields fall, liquidity loosens and stocks run higher.



This is because stocks and bonds always compete for capital flows.

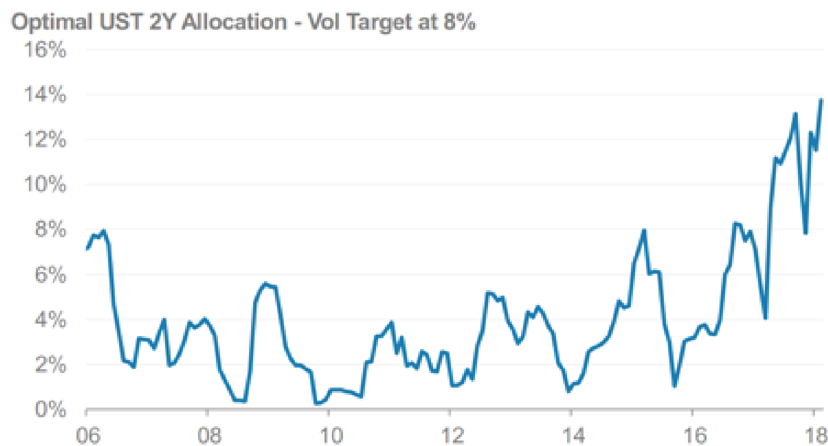
That’s why they move inversely (most of the time) to one another. When yields move higher, they become more attractive to investors and capital flows into them. Money flows in and out as the narrative and expectations around inflation and growth evolve.

This is why market volatility has been higher and will stay high for the remainder of the cycle. Higher interest rates make bonds more attractive on a relative basis. The TINA (there is no alternative to stocks) narrative is becoming less and less compelling as stock valuations become more stretched and bond yields more attractive.

Morgan Stanley, using their expected market return model, recently wrote that the optimal allocation to short-end Treasuries is now at *extremely* high levels (emphasis mine):

> *Short-term rates act as the 'anchor' for the capital allocation line. This 'anchor' is dragging upwards, implying higher allocations to short-end bonds for most investors, regardless of vol targets.* ***In fact, on our calculations, the optimal weight to 2-year USTs is now at 12-year highs.***

Exhibit 1: Optimal allocation to short-end Treasuries has risen and is now at extremes



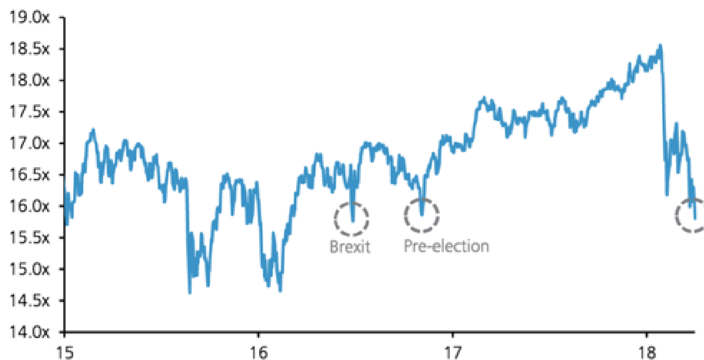
Source: Bloomberg, Morgan Stanley Research; Note: Based on 10Y expected nominal returns, and trailing 10Y realised correlation and vol, with min 0%, max 60% asset class weight constraints, and 8% vol target. 6M smoothed.

Paul Tudor Jones said, “You look at every bear market and they've always basically occurred because of an uptick in inflation and an uptick in interest rates.”

This time will be no different.

The positives are that the recent selloff in the market has **reset valuations back to their 25-year average.** This makes them no longer a near-term headwind. The S&P's forward PE is now only 15.8X

Figure 12: S&P 500 forward price to earnings multiple

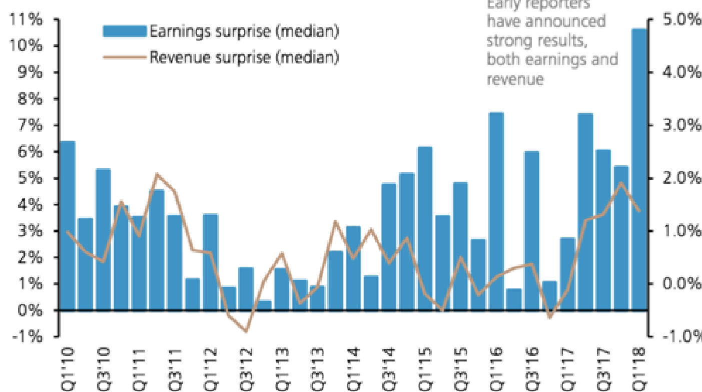


The S&P 500 forward P/E has declined to 15.8x, similar to levels around the post-Brexit and pre-election lows.

Source: FirstCall, FactSet, UBS

In addition, early reports indicate both revenues and earnings are likely to come in extremely strong this quarter. Median results for companies that have already reported thus far are at or near cycle highs for top and bottom line numbers.

Figure 11: S&P 500 early reporters results over time



Early results very positive for the 19 companies that have announced earnings thus far; the median earnings surprise for the same set of companies is at a cycle high as revenue is also near the cycle peak.

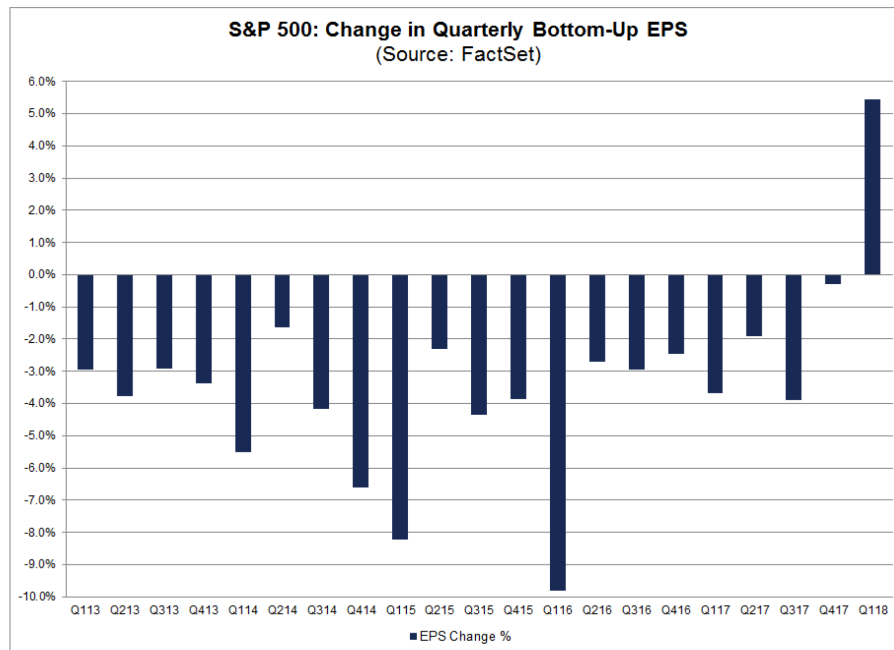
Source: IBES, FactSet, UBS

FactSet is seeing record increases in bottom-up EPS estimates so far this quarter. They write (emphasis mine):

> *On average,* ***the bottom-up EPS estimate usually decreases during a quarter.*** *During the past five years (20 quarters), the bottom-up EPS estimate has recorded an average decline of 3.9% during a quarter. During the past 10 years (40 quarters), the bottom-up EPS estimate has recorded an average decline of 5.5% during a quarter.*

During the past 15 years (60 quarters), the bottom-up EPS estimate has recorded an average decline of 4.1% during a quarter.

In fact, ***the first quarter of 2018 marked the largest increase in the bottom-up EPS estimate during a quarter since FactSet began tracking the quarterly bottom-up EPS estimate in Q2 2002.*** *The previous record for the largest increase in the bottom-up EPS estimate was 4.8%, which occurred in Q2 2004.*



Earnings growth and valuations remain supportive of risk assets. There's still room for risk premia spreads to compress further which is bullish for stocks. This bull market is old but not over...

Summary:

- **We're in the "late-stage" of the short-term debt cycle as indicated by tight risk-premium spreads, capacity utilization rates, and the Fed rate hiking cycle. This phase typically lasts between 18-30 months.**
- **The risk-premium spread is the difference in compensation investors can expect to earn on average for moving further out the risk curve.**
- **The wider the spread (ie, the higher the expected return of equities over bonds) the more attractive risk assets are to investors and vice-versa.**
- **The primary inputs into the risk premium are earnings growth, valuations, and interest rates — with interest rates being the big one.**

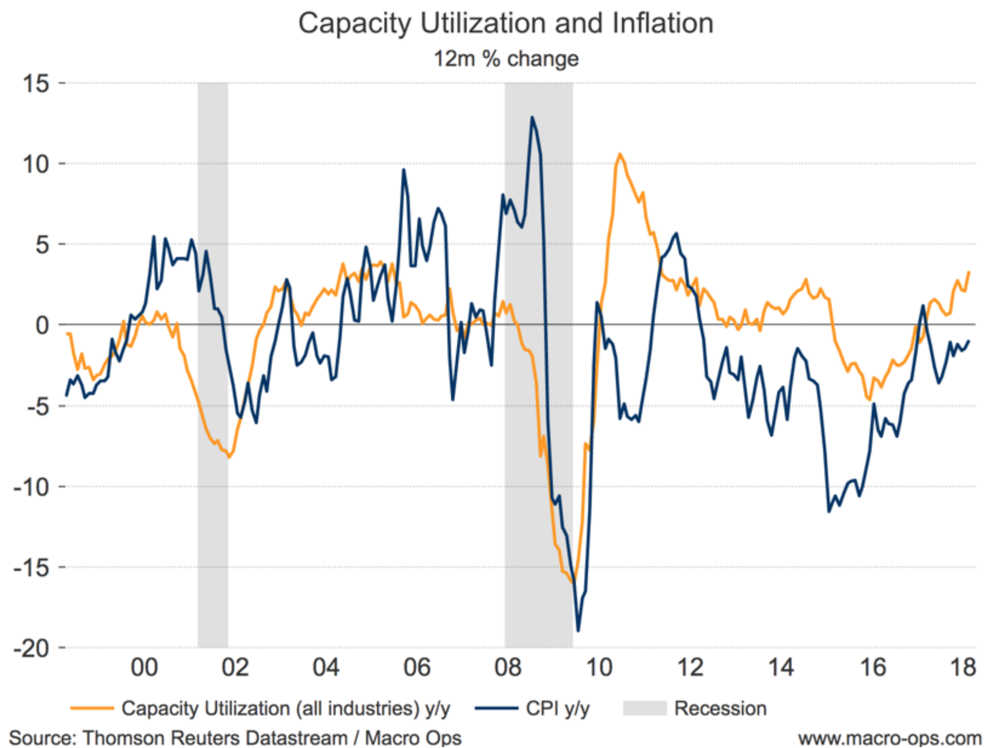
- **The market is currently supported by strong earnings growth and reasonable valuations after the most recent selloff. The biggest risk to equity markets in the near-term is a rise in interest rates. And the primary mover of interest rates is expectations around the path of inflation.**

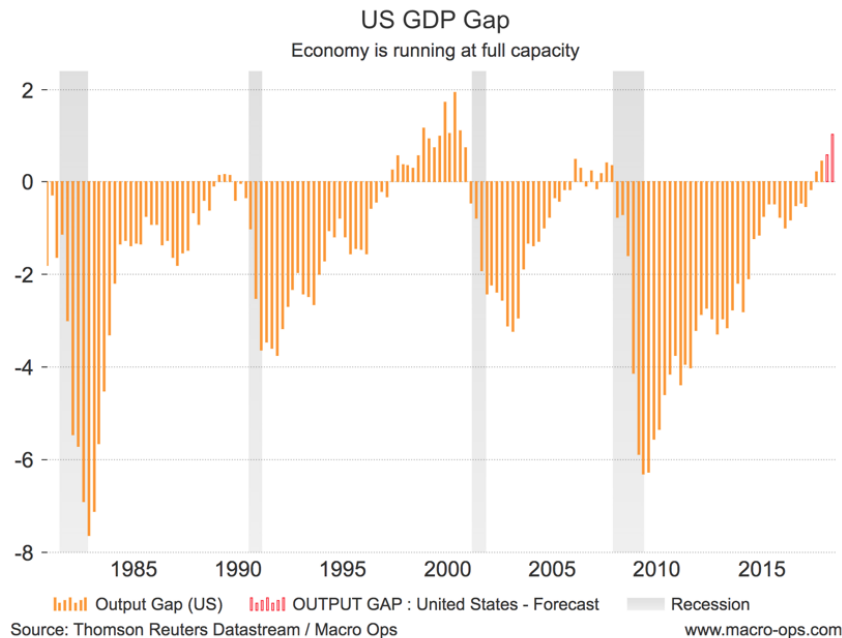
Macro: Inflation Bacon

The potential for trade wars and tech regulation is increasing. And these are real market risks. But so far, it's all talk and speculation. They remain low probability events. We need to closely monitor them but not overweight them in our decision making.

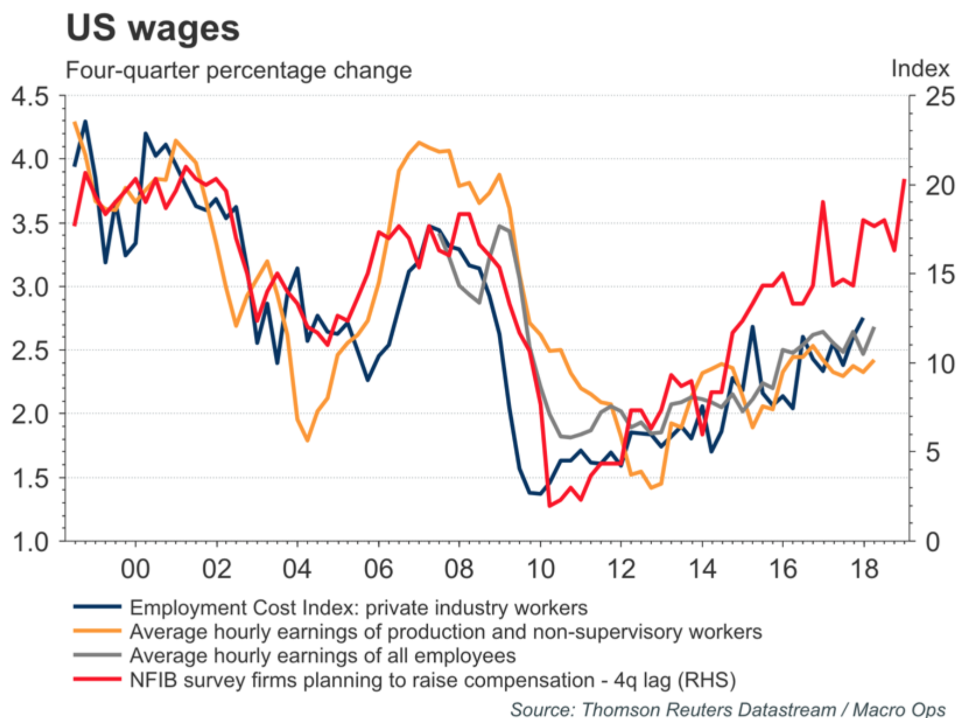
Currently, the key driver of market direction over the near-term is interest rates and thus inflation expectations. This is why we'll need to keep a close eye on inflation indicators in the coming months.

The cyclic environment is currently supportive of building inflationary pressures. The economy is maxed out, as measured by capacity utilization and the GDP gap.



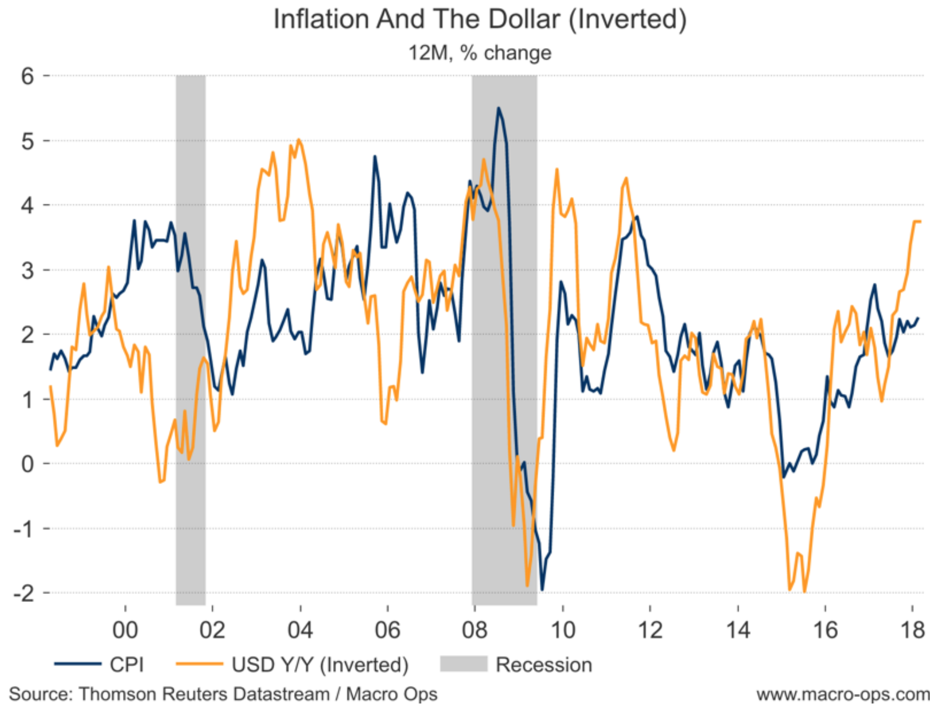


The labor market is tight and this is beginning to drive up wage pressures.

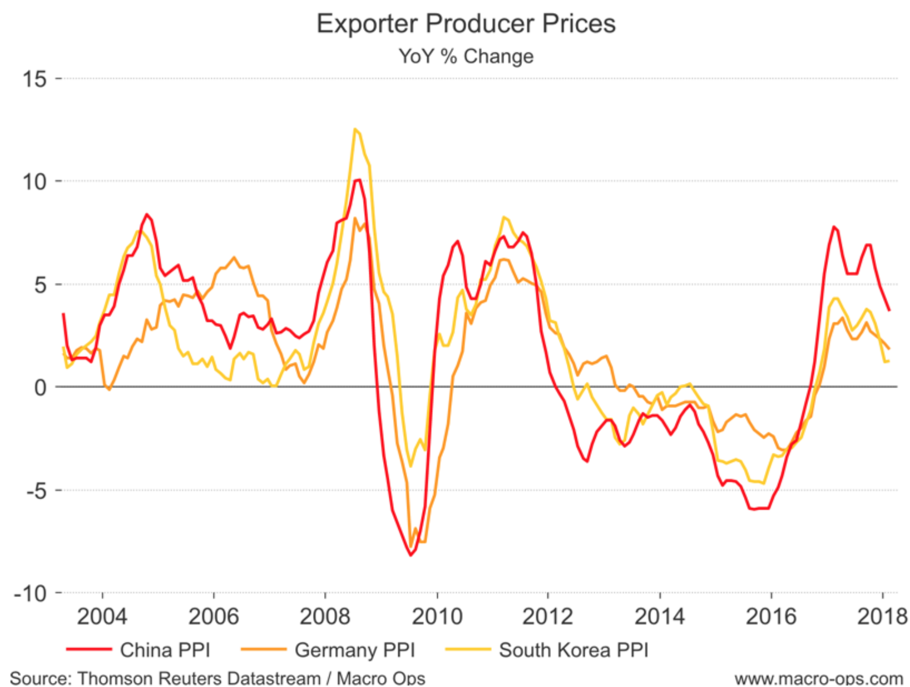


The US dollar, which has shown an increased correlation (or causal link) to inflation these last two cycles, is signalling a jump in inflation over the coming months. Lower dollar = higher

inflationary pressures through the commodity price channel. Dollar is inverted on the chart below.

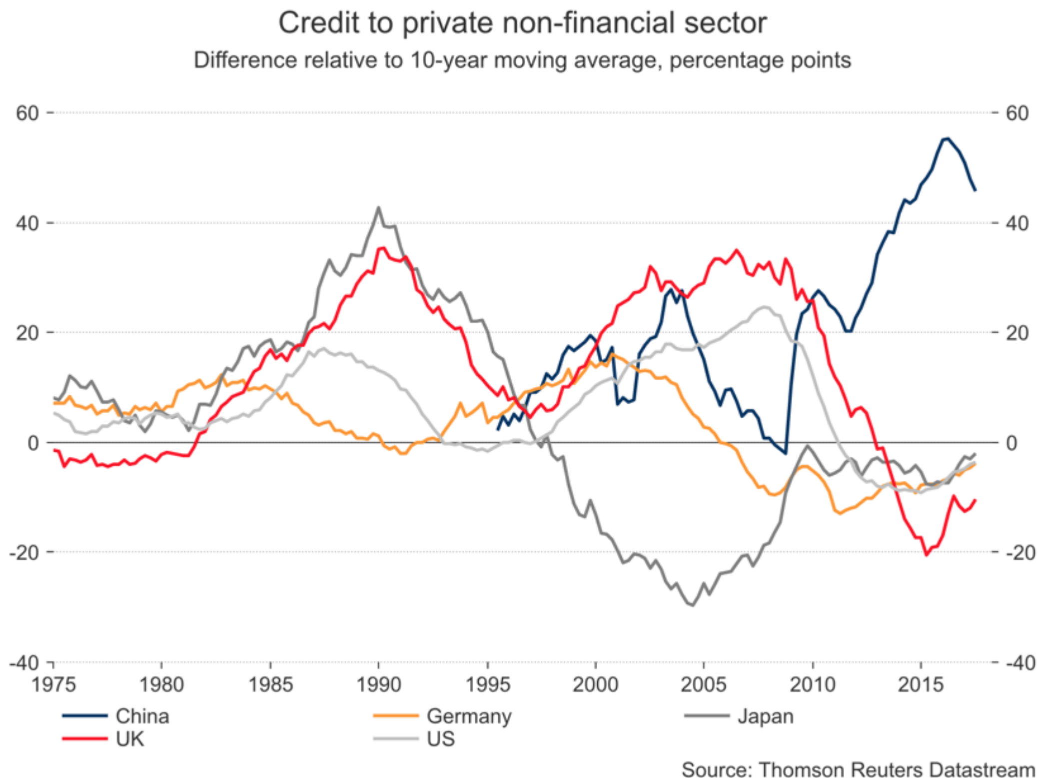


But on the other hand, we have disinflationary pressures coming from a deleveraging China, which is showing in falling exporter producer prices.



There's also still the issue of a world awash in debt. And debt is naturally a deflationary force.

The developed world is only beginning to chew through the massive debt load it accrued over the previous two cycles. This is why developed market credit growth has been so anemic lately.



In my eyes, the inflation picture remains mixed.

Pressures are building in the economy which is typical this late in the cycle. But it's to be seen whether this will be strong enough to counteract the disinflationary pressures of the global debt load and a deleveraging China in any meaningful way.

My base case is that we see inflation continue to rise modestly but not enough to make the Fed ramp up their hawkishness.

Of course, I could be wrong. I think the big tell will be the US dollar which is now at a critical inflection point. If it takes off on another leg lower then we'll see commodities run up, giving a boost to inflation.

This would shorten the last phase of this bull market…

The primary trend in global markets remains up. But we're likely to go through a gestation period while the last vestiges of overly bullish sentiment get washed out. This should result in continued volatile chop for some time (a few weeks to months) while a new base develops from which the market can launch its next leg up.

The key here will be managing our risk and not overtrading. We don't want to get chopped up in the sideways action. We'll be selectively adding starter positions in trades that have a low correlation to the broader market.

Summary:

- **The inflation outlook is a mixed bag. There are inflationary pressures building from an economy that is operating at/above full capacity and an increasingly tight labor market that is slowly pushing wages higher.**
- **But these inflationary pressures are being counteracted by persistently high debt levels in advanced economies and a deleveraging China, that is feeding into lower export/import prices to the rest of the world.**
- **Our base case, which could very well be wrong, is that inflation will continue to firm but only modestly. Not enough to push Powell's Fed to become more aggressive in hiking rates.**
- **The big tell that we'll have to track is the US dollar. The dollar has become highly correlated with inflation over the last two cycles. The recent fall in the dollar should put upward pressure on inflation through the commodity pricing channel. If the dollar embarks on another leg lower, that'd greatly increase the odds of us entering an inflationary regime which would translate into a violent bear market.**
- **Expect equity markets to continue to chop around and go through a gestation period for a while. Overly bullish sentiment needs to be reset. Q1 earning surprises are likely to eventually drive the market on its next leg higher.**

Micro: DO, FIH.U

Diamond Offshore Drilling, DO

Company Profile: This is a stock we've been tracking for a few months, waiting for the right shoulder of the H&S pattern to finish forming. Diamond Offshore Drilling (DO) is an offshore contract drilling service provider with a global footprint. The company operates primarily in the floater market, from ultra deepwater to mid-water, and offers a fleet of offshore drilling rigs, drillships, and semisubmersibles.

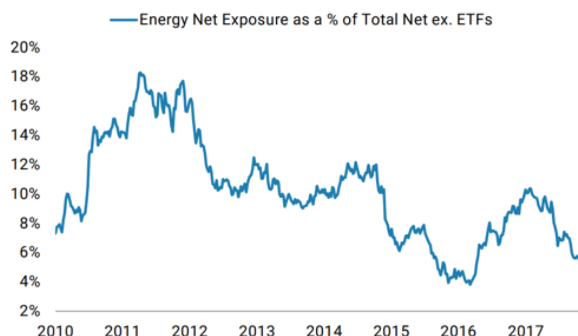
What The Market Is Pricing: Despite the roughly 50% rise in the price of crude oil since last summer, oil and gas related stocks have mostly floundered. This has led to a breakdown in what's typically a strong correlation between the two. We can see this difference in performance on the chart below and the large return gap that has developed over the last year.

What's going on here, why the breakdown?

There's a number of reasons for this bout of relative underperformance in the energy space but the two big drivers come down to (1) Anchoring: investors are still skeptical of energy stocks after getting burned playing the long side over the last 4 years and (2) Narrative: the market has latched onto the "rise of the electric vehicle (EV)" narrative and are now over discounting the terminal value of energy equities.

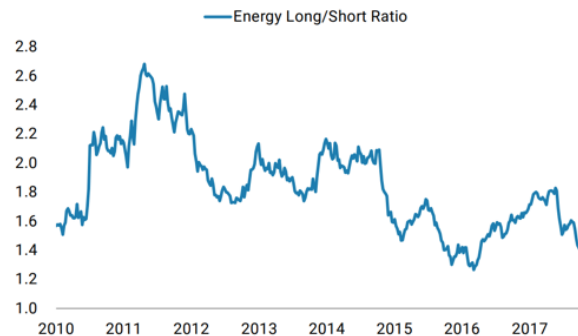
This is why investors currently have record low exposure to the sector.

Exhibit 15: Energy Net Exposure at Depressed Levels



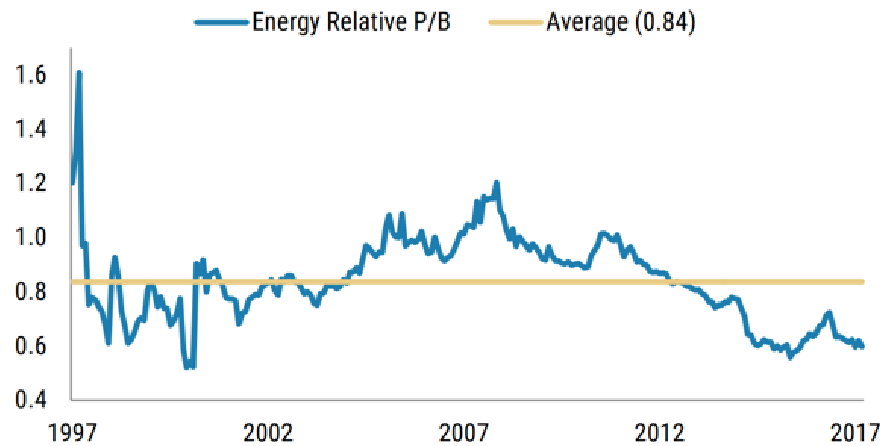
Source: Morgan Stanley Prime Brokerage as of November 3, 2017.

Exhibit 16: Long/Short Exposure to Energy Is Very Low



Source: Morgan Stanley Prime Brokerage as of November 3, 2017.

And valuations are near all-time lows.

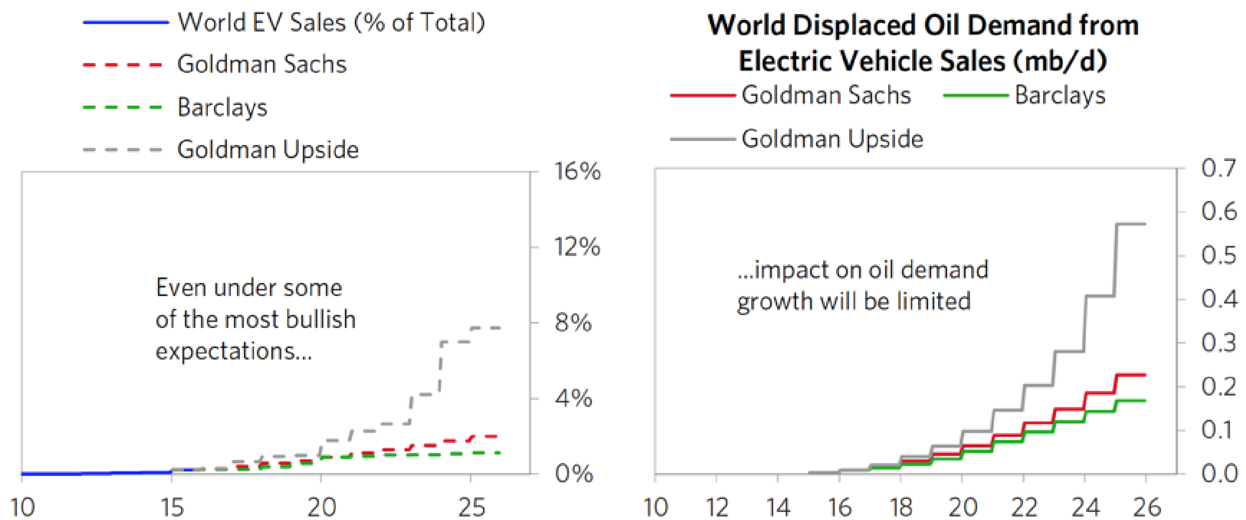


The bottom line is that the market doesn't like energy stocks and this strong aversion to the sector has created some deep value opportunities.

Our Take: We can't know for sure the speed at which electric vehicles will be adopted thus making oil and energy stocks obsolete. All we can do is to gauge the value of the underlying relative to the probabilities of potential outcomes. And in this case, it seems like the market has lost its damn mind.

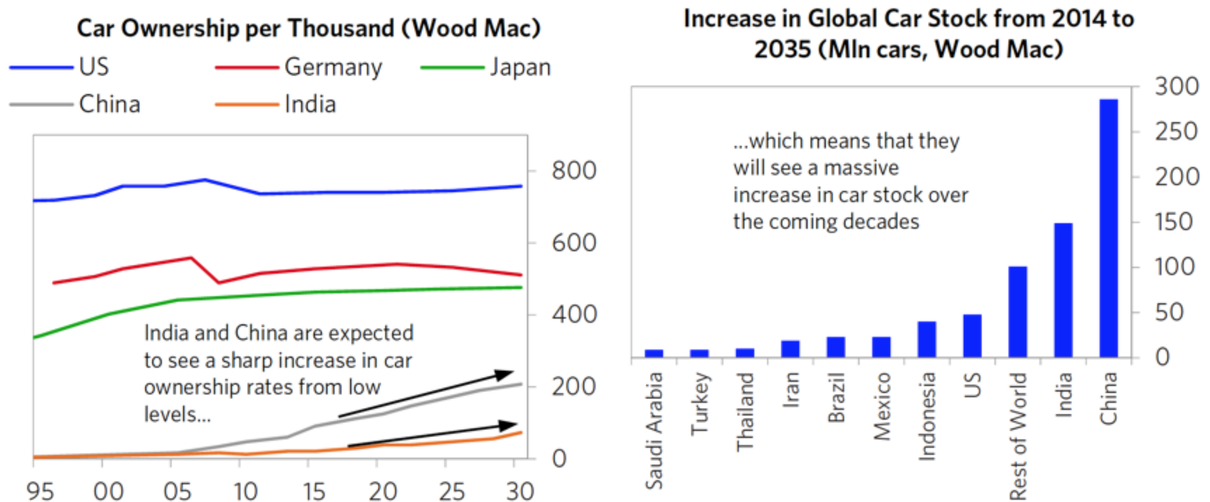
Let's quickly walk through the data.

As we discussed in our December MIR, *Go Devil*, the Rise of the EV narrative is likely overplayed. We shared that macro hedge fund Bridgewater has noted that **"in even the most bullish scenarios, only 0.2-0.3 mb/d of oil are expected to be displaced over the next five years."** (charts below *via BW*)

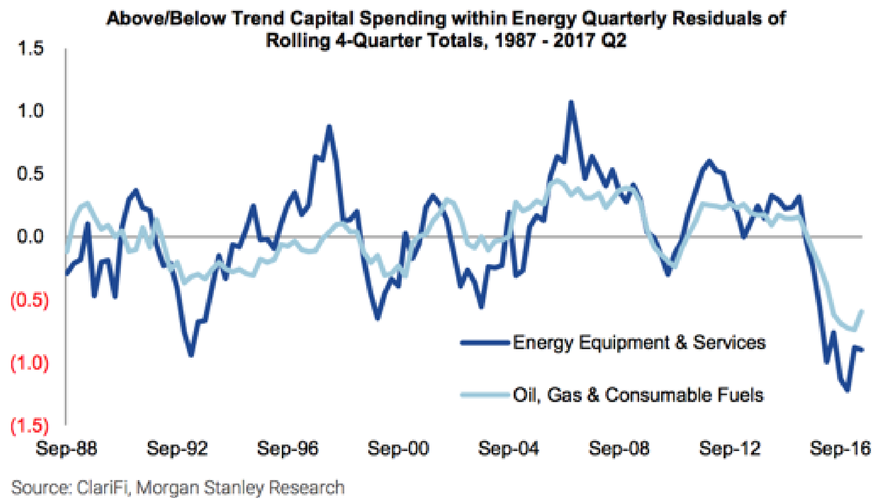


0.2-0.3 mb/d of oil demand displaced a day…. To put that into perspective, the world consumes on average 96mb/d, currently. And with the rise of the middle class in Asia, consumption growth is set to rise exponentially over the coming decades.

This is going to lead to a massive jump in the global car stock. Chart below again *via BW.*



In addition, the global energy space has seen its deepest reduction in CAPEX over the last five years in history. CAPEX = future supply, so lower CAPEX = Lower supply.



So maybe… just maybe… the market is wrong here. Maybe it's being myopic… and maybe this gives us an exceptionally skewed risk-reward opportunity to own a solid company with a strong balance sheet and improving free cash flows (trading at just 4x FCF) that's selling for a deep discount (half of book value).

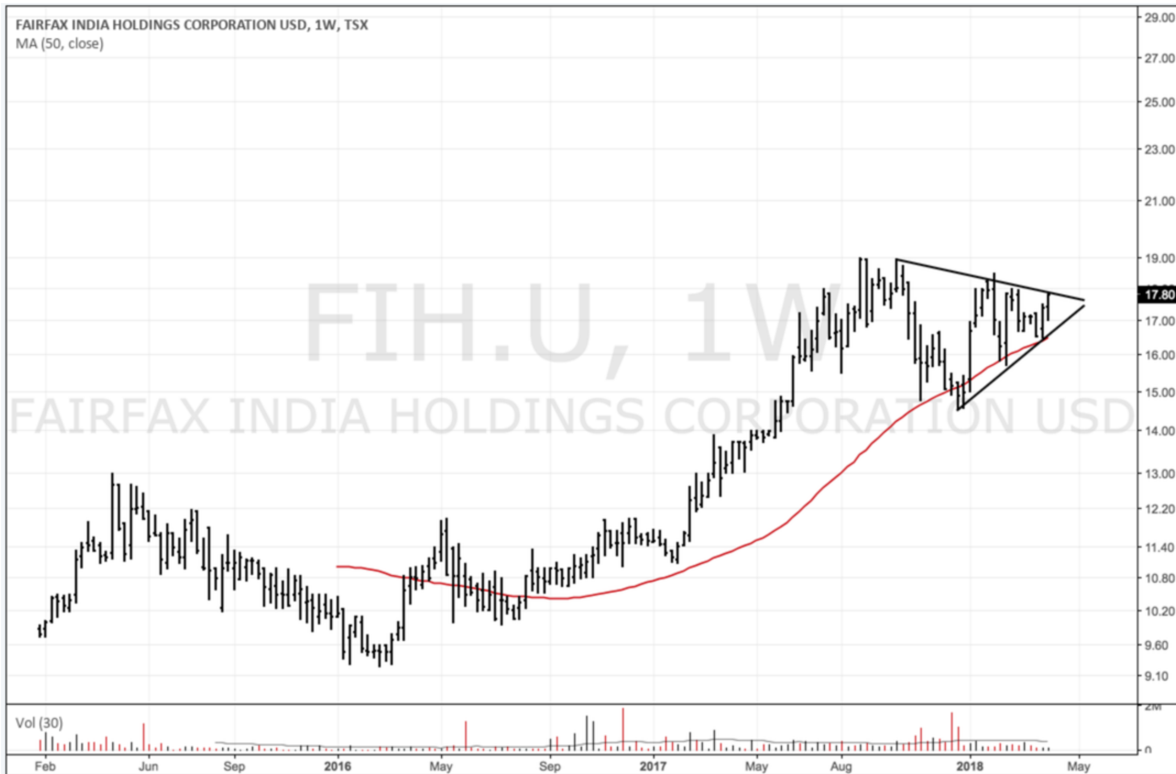
Despite seeing its revenue more than halved since 2009 the company still generates substantial free cash flow, $493M on a TTM basis. This seems to us like a safe option to play any potential rebound in the energy sector.

There's two ways to play DO.

You can wait for the breakout of the head and shoulders base and put on a vanilla long position. Or you can execute a DOTM call strategy and outsource the trade management to the call option.

DO has **January 2020 calls struck at $35 trading for $0.73**. If the thesis plays out over the next 18-months these calls will 10x. You can buy these and file them away without having to worry about stopping out.

Fairfax India Holdings, FIH.U



Company Profile: To start, take a sec and admire this chart… This is a good looking chart. A long 6-month coiling pattern that's teeing right off the 200-day moving average… This sucker looks ready to run.

Alright, the company. Fairfax India Holdings Corp (FIH.U) is a Canada based investment holding company. It's a listed investment company (LIC) that has a ready-made portfolio of extremely attractive Indian based businesses (both private and public) that we could never get access to normally. It trades on the Toronto exchange and is run by Prem Watsa. If you don't know that name, don't worry, more on him below.

The fund currently holds positions in the following companies.

	Date of Investment	Ownership	Amount Invested	Fair Value at December 31, 2017	Return[1]
National Collateral Management Services	Aug. 2015 and Aug. 2017	89.5%	174,318	179,054	1.3%
IIFL Holdings (including 5paisa Capital)	Dec. 2015, Feb. 2017 and Oct. 2017	26.6%	276,734	908,443	93.3%
Fairchem Speciality (formerly Adi Finechem and Privi Organics)	Feb. and Aug. 2016	48.8%	74,384	149,200	59.3%
Sanmar Chemicals Group	Apr. and Sep. 2016	Debentures and 30.0%	300,000	333,728	6.9%
National Stock Exchange of India	Jul. 2016	1.0%	26,783	40,452	39.3%
Saurashtra Freight	Feb. 2017	51.0%	30,018	28,000	(7.6)%
Bangalore International Airport	Mar. and Jul. 2017	48.0%	585,591	608,288	6.4%
Total			1,467,828	2,247,165	

(1) Return calculated using the internal rate of return.

For a full description of each company check out Fairfax's most recent shareholder letter (link here).

This current basket of companies give the fund exposure to nearly every part of India's growing economy; including banking and capital markets, agriculture, food processing, biotech, both freight and pedestrian transport, and industrial chemicals.

What The Market Is Pricing: This is not a well-known stock. It's a relatively new fund that's been listed for only 3-years. It trades on the Toronto exchange and Prem Watsa is not a big name outside of Canada and investing circles. So it's an under the radar stock.

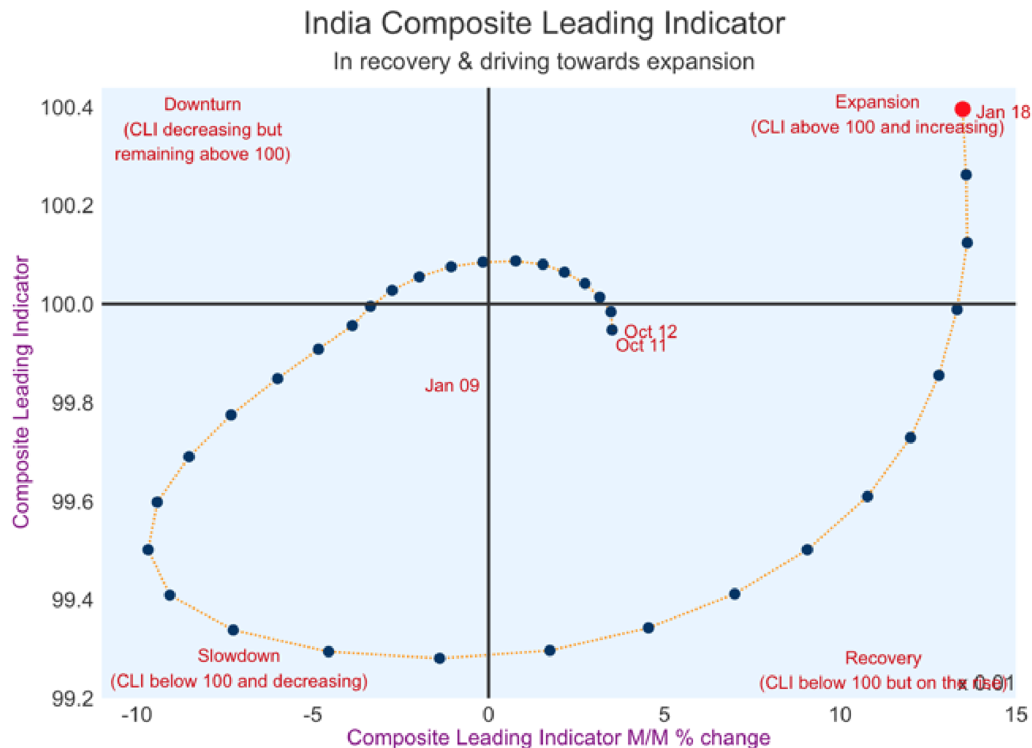
Also, being an LIC, the fund charges fees. And the fees aren't small. Watsa's advisory firm charges Fairfax India a 1.5% management fee with a 20% performance charge that's subject to a 5% hurdle rate. This is no small drag on returns.

In addition to the fees, the stock currently trades at a 25% premium to book value. As a general rule of thumb, you want to buy LICs at a discount to their net asset value (NAV).

Our Take: We are bullish on India. We've written about why here. The 2-second summary is that the country is hitting the knee of the Wealth S-curve where they're about to see an explosion in the middle class which translates to exponential growth. On top of this, they have a transformative leader in Modi who is reshaping a country that has long been plagued by too much bureaucracy and too little infrastructure.

In a world that's awash in debt, saddled with deteriorating demographics, and excessive asset valuations. India, well, India looks pretty darn good…

Not only does India dominate the gdp growth projections over the next decade but their economy is already beginning to expand at an increasing rate.



Source: Thomson Reuters Datastream / Macro Ops

Investing in India now is like investing in China in the early 2000s. The only problem is that their markets are not deep yet and as a foreigner it's difficult to find suitable equities. We have to comb through the short list of stocks with large exposure to India that trade on Western exchanges. We've discussed the Indian based online travel agency Yatra Online (YTRA) in a previous MIR. It remains one of the most exciting investments I've come across in a long time.

While Fairfax India doesn't have the same degree of asymmetry that YTRA has. It does have a higher probability of payout with long-term compounding potential. Here's why.

Let's start with the manager, Prem Watsa.

Prem is known as "The Warren Buffett of Canada". The guy's track record is as good as they come. His other firm, Fairfax Financial, has compounded capital at 20+% a year since the early 80's. That's no easy feat... it's safe to say that Prem knows a thing or two about allocating capital.

If you've been with us for a while then you know we put a big emphasis on the Jockey. When you back th 1%'ers like Thomas Peterffy at IBKR, Rysavy at GAIA, or Marchionne at FCAU your chances for outsized returns increases exponentially. Prem is of the same cut. He's a guy we want to put our money with. It also helps that's he was born in India and has very close connections to the business community there, giving him deal-flow that we could only dream of.

Next, what about paying a premium above NAV, isn't that a big no-no?

In most cases yes. But not here.

Global value investing fund, Peters MacGregor (who holds a large position in the stock), notes how "the current reported NAV significantly undervalues the company's investments." The reality is that Fairfax's NAV is much much higher. Prem commented on this in his most recent shareholder's letter, saying (emphasis mine).

> *While the valuations of the private companies that Fairfax India has invested in remained relatively close to the prices it paid for them, two of the three publicly traded companies in its portfolio (IIFL and Fairchem Specialty) have posted strong mark to market gains.* ***IIFL's share price has appreciated 207% to 670 rupes from our blended cost base of 218 rupees, and Fairchem's share price has appreciated 90%*** *to 500 rupees from our adjusted cost base of 263 rupees,* ***resulting in mark to market gains, since inception, including foreign currency translation gains, of $632 million and $75 million respectively.***
>
> ***While the book value per share of Fairfax India is $14.46, we believe that the underlying intrinsic value is much higher. IIFL, for example, in spite of an average 14% return on equity (ROE) and a 30% annual growth in book value per share over the past ten years,*** *even at its current price of around 700 rupees per share* ***is selling at a price earnings ratio of only 18 times expected earnings*** *and the founder, Nirmal Jain, is an outstanding entrepreneur. All the companies listed above have similar characteristics. The potential for all of them is very significant.*

Instead of paying a 25% premium on book value we're likely buying at a sizable discount when the private investments are taken at their true value and the potential for long-term growth and compounding is factored in. How much exactly, is tough to say because the macro tailwinds are that big and exponential growth of the kind we're going to see in that country over the next decade is tough to model.

But it's safe to say that in buying at current prices we're getting a deal with a satisfying margin of safety.

The fund's performance over its short three years has been impressive. What's even more exciting is that performance is markedly improving as they drawdown their cash position and take advantage of the recent spurt in growth that India is experiencing following the slow down from demonetisation.

They've smashed the Sensex over the same period and that's after fees.

At December 31, 2017	**1-year**	**3-year Annualized[1]**
Fairfax India book value per share:		
– before performance fee	48.7%	15.5%
– after performance fee	41.1%	13.5%
USD S&P BSE Sensex 30	37.9%	5.9%

(1) Fairfax India's 3-year annualized growth in book value per share is calculated based on its IPO price of $10 per share on January 30, 2015.

Just this year, net income was up 320% from $108m the year prior to $453m today. Fully diluted EPS increased 191% to $2.94 and book value per share rose 40+% year over year.

	2017	**2016**	**2015**	**CAGR[1]**
Income	609,670	128,604	65,251	
Net earnings	452,509	107,825	40,939	
Return on equity	28.2%	10.3%	4.0%	14.2%[2]
Total assets	2,672,221	1,303,497	1,025,451	38.9%
Investments	2,635,726	1,095,569	978,569	40.5%
Common shareholders' equity	2,132,464	1,075,446	1,013,329	29.1%
Book value per share – before performance fee	$ 15.24	$ 10.25	$ 9.50	17.1%
Book value per share – net of performance fee	$ 14.46	$ 10.25	$ 9.50	15.0%

(1) Compound annual growth rates are since Fairfax India's inception on January 30, 2015, when it raised net proceeds of $1.03 billion at $10 per share representing an initial book value of $9.62 per share after expenses.

(2) Simple average of the return on equity for each of the three years.

To sum up, with Fairfax India, we get broad market exposure to what will be the fasted growing economy over the coming decade, through a fund run by the "Buffett of Canada" who has a 30+ year track record of remarkable returns and who has top notch private deal flow in the country. But we have to pay a 25% premium to NAV. Though in reality it's likely a large discount to its true value; and the stock is setting up in a textbook long-term coiling pattern that typically precedes an explosive run higher…

Sounds good to me. Am I missing something?

Oh, also Prem has a 30% personal stake in the fund, through his primary fund, Fairfax Financial. So he's got a good deal of skin in the game… even Nassim Taleb would be proud. And, Markel, the large insurer that many value investors refer to as "the mini Berkshire" because of its impressive record for finding hidden value, has taken a large position in the stock which is a good vote of confidence.

This is a coffee can stock. Buy it, stuff it in a coffee can (metaphorically speaking), and don't look at it for another 10 years. You'll be glad you did.

If you'd like to see a short video on the company and India in general, check out this piece by Peters Macgregor (link here).

Commodity Corner: Sugar, Gold

Sugar: Interesting Long Not Beholden To SPX

During times of macro stress it's tough to find a trade that will move independently of SPX. Correlations converge to 1 as cross-asset algos constantly cue off of each other and cause volatility to expand across the board.

But if you look far enough, and get out of your comfort-zone, there's usually *something* out there that can deliver an uncorrelated return stream and some decent diversification.

Sugar fits this bill.

The histogram below the price chart plots the 100 day correlation coefficient with SPX. For 2018 it's been oscillating between -0.25 and -0.5. In other words it couldn't care less what US stocks are doing.

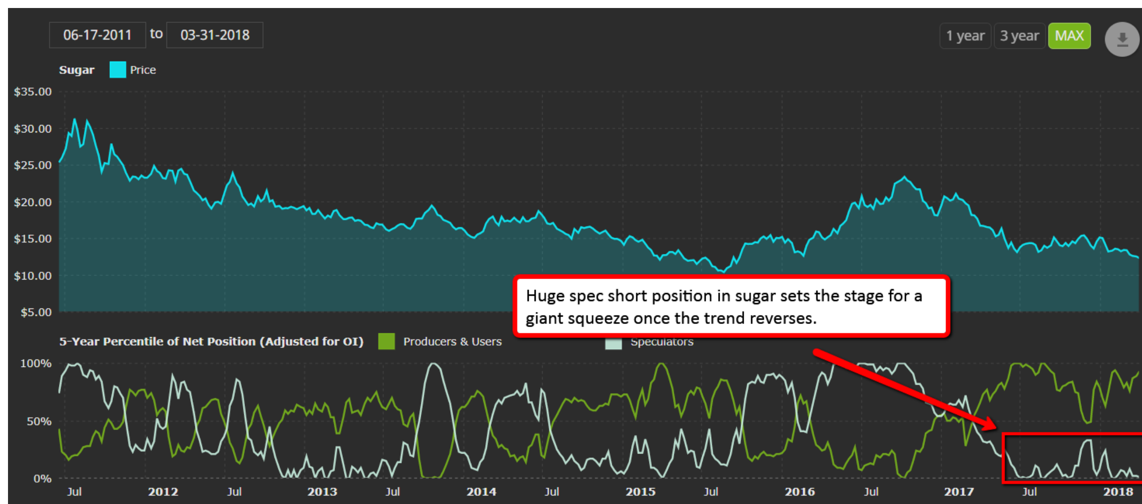
The other interesting thing is that despite volatility rising significantly among all the popular macro instruments, sugar realized volatility has actually been falling.

This commodity's price action has completely divorced from the head spinning whipsaws of the current macro environment.

The long side of sugar here is interesting. Further downside is limited because the current price in the futures market is below the cost of production.

It costs around 15.5 - 17 cents per pound to produce — and with the current price at 12.5 cents, commercial players are operating at a loss. As with all commodity cycles, this will self correct as weaker suppliers exit the market, setting the stage for less supply and higher prices down the road.

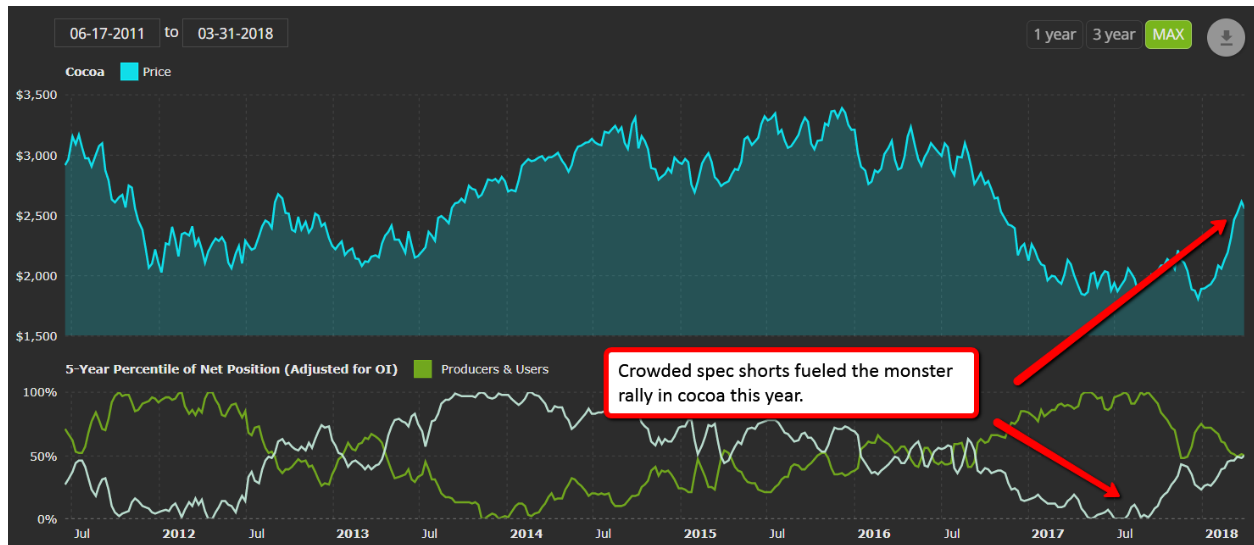
On top of the favorable fundamental backdrop, there's a massive short speculative position that has built up over the last 12-months.



We see crowded positioning like this end badly over and over again. When the price turns eventually turns up all of the trend following CTA's will be forced to cover and a large short squeeze will develop. This creates additional positive asymmetry for bulls.

We think the next 6-months in sugar will play out exactly like cocoa's run earlier this year. Cocoa took off in January and short covering fueled a 33.5% rally over just 3-months. It has been one of the best performing assets this year.

Before it's face ripping rally, cocoa had the same sideways basing price action pattern coupled with the powder keg of crowded shorts.

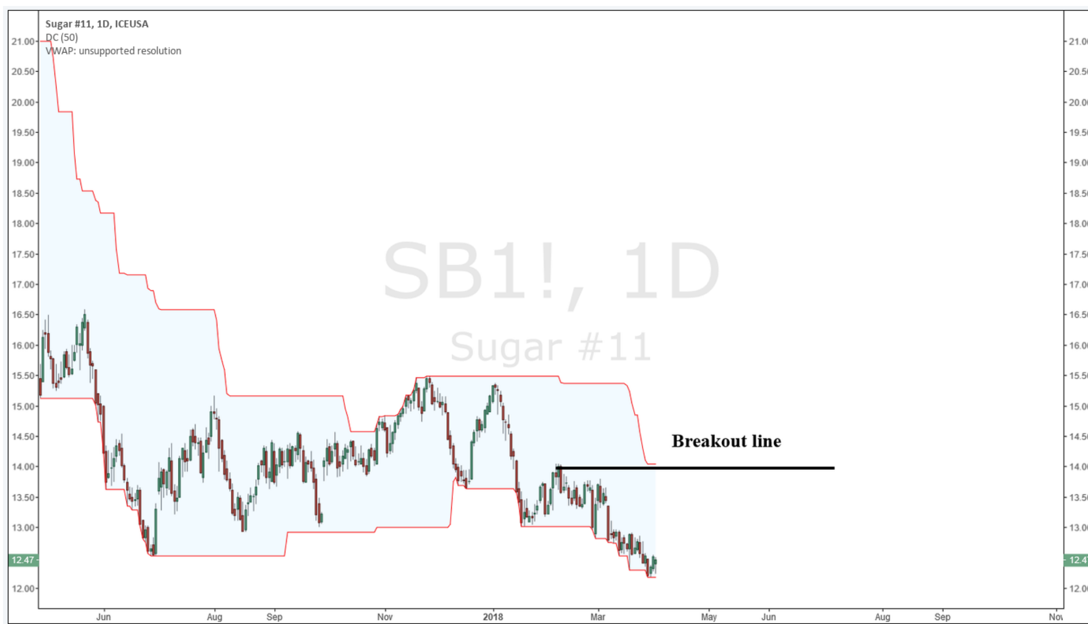


There's two ways to play a setup like this in sugar:

1. Start accumulating long positions with wide stops, plan to hold until the positioning profile reverses
2. Wait for price action confirmation and buy a breakout of base

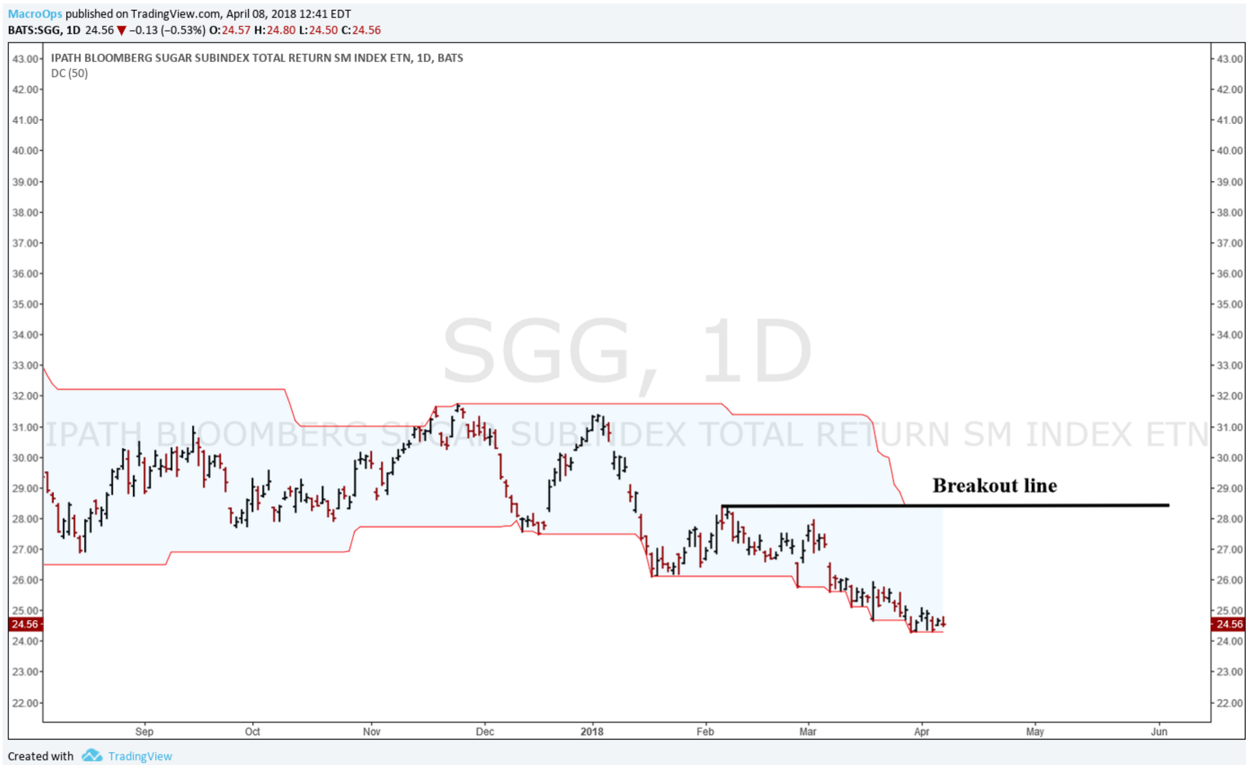
Method 1 has better risk/reward but a lower probability of success. The plan would be to accumulate contracts in this support zone notated below and then hold through the end of the year — rolling exposure at each expiry. Since this option require wide stops, position size must be kept under control.

Method 2, buying a breakout, is the safer bet — but it will also get you in at a higher cost basis so the risk/reward on the trade won't be as great. But the good thing about this entry style is that it will keep you out of a "dead money" trade if sugar decides to chop sideways for longer than we expect.



A good entry would be a break above 14 cents which aligns with sugar's last 50 day high. A breach of this area will trigger many CTA programs to cover their short positions and start the massive unwind of the short spec positioning.

For those of you who can't trade the sugar futures, there is an ETF ticker symbol SGG that has decent liquidity.



Gold: It's Do or Die Time

Gold has failed again and again at the key resistance level of $1360.

This level is not only important for potential gold investors but for dollar watchers as well. Higher gold prices mean a lower dollar. If price breaks out higher we have to expect yet another leg down in the DXY and higher inflation numbers.

Famous investor Barton Biggs has a theory on gold and it goes as follows: "*not inflation or deflation that is the principal driver of gold, but the return from other long-term financial assets, particularly equities.*"

You won't find that relationship in any economic textbook, but as practitioners we've found that mental model to be quite useful. When investors are doing well in instruments that have actual yield like stock and bonds they shun gold. That's why the yellow metal has been in a bear market since the start of 2013. Stocks and bonds have performed well over this time.

So far in 2018 we have the opposite performance profile. Stocks are down 2.5% YTD, bonds have fallen about 2%, and gold is up on the year.

An interesting low risk way to play a potential gold breakout would be to purchase a DOTM (deep out of the money) call on a gold miner.

One of our favorites is South African miner Anglogold Ashanti.

We can buy 9 delta DOTM calls on AU that expire Jan 19' struck at 17 for $0.15 or even go further out and get calls struck at 20 that expire Jan 20' for $0.45.

This expression is nice because you can buy these for super cheap and file them away. If gold happens to break out and follow through this year these calls will 10+x.

And if the bear market in gold continues then your loss will be miniscule. That's the benefit of finding trades with large convexity.

Volatility: Directionless In A Changing Regime

Ever since the vol-pocalypse (Feb 5th.) the vol space has been a dead money trade. A flat volatility term structure has kept the market locked in a stalemate where traders are just swapping back P&L with each other.

This type of back and forth action occurs whenever we're transitioning from a lower vol regime to a higher vol regime. Changing regimes are tough to trade and unfortunately they tend to last for about 3-6 months. We're working our way through month 3 of the current change so we have to keep our minds open to the possibility that this will persist into the summer months.

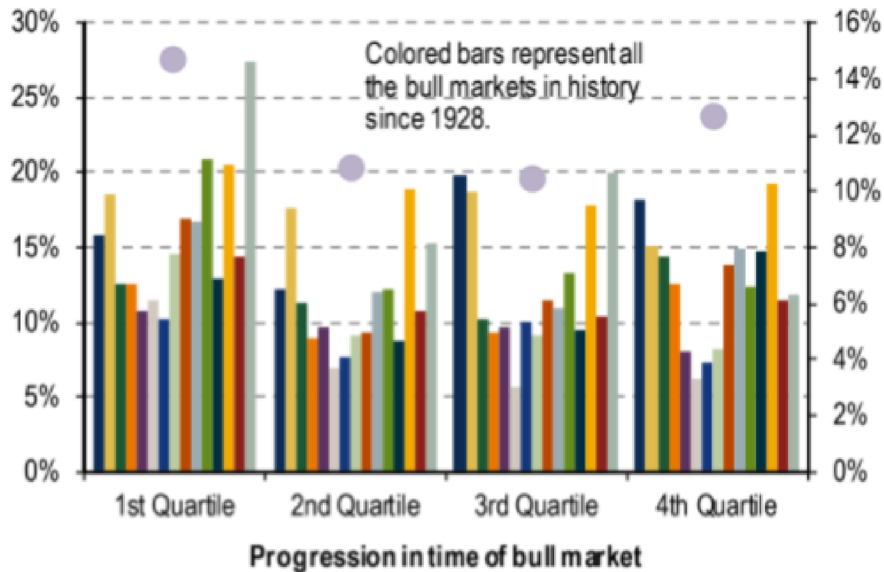
The last time we had a low to high vol regime change was in 2014. That was at the time when the dollar went parabolic and crude oil collapsed. VXX traded sideways for 215 days before resuming its downtrend.

Instead of currency moves driving the regime change, we have rate spikes and a Twitter-happy president injecting uncertainty into the market. This coupled with late stage valuations makes people incredibly skittish.

BofA released an interesting graphic demonstrating the tendency for vol to pick up during the fourth stage of a bull market. We've known this heuristically through guys like Soros and PTJ but it's nice to finally get some data behind the old trader wisdom.

Focus on the grey dots in the graphic below. These represent the median realized vol level per regime. It traces out is a smile. Stage 1 is high vol then stage 2 and 3 go to lower vol and then the topping process brings back another high volatility regime.

Chart 10: Bull markets tend to exhibit a "volatility smile" in which realized volatility is more elevated during the first and fourth "stages" of the bull market compared to the second and third



Source: BofA Merrill Lynch Global Research. Bars depict the average 1m SPX realized vol during each quartile of each bull market period. Dots represent the median realized vol per quartile. Data from 30-Dec-1927 to 21-Mar-2018.

This pattern is again playing out perfectly.

Given this landscape, our strategy is to take "go or no go" breakout shots on the long side of vol if the term structure heavily inverts. We define an inversion by the VIX/VIX3M ratio trading above 1.10.

If this breaks, buy some VXX or front month VIX futures as a portfolio hedge. If the stock market follows through to the downside, the trade will pay out big time as VIX spikes back up to the 45 level.

If it's a fakeout the loss won't be more than a papercut. **When the vol term structure inverts this puts a tailwind behind long volatility positions due to positive carry**. The carry seems irrelevant when compared to the day to day movement but it adds up significantly over time.

Take a look at the linear regression line of the VIX (in purple) since the Feb. 5 blow up.

It's in a clear downtrend — meaning on average spot VIX has been falling over the last two months.

Now take a look at the same linear regression of VXX which includes the effects of the carry.

It's a completely different story. The linear regression is actually *upsloping*. This is all due to the fact that spot VIX has spent a lot of time trading above the futures — hence positive carry for longs.

We've tried this trade a few times already this year. And although we haven't had a home run yet — losses have been extremely small because the carry has been on our side.

Taking advantage of the positive carry when the term structure inverts puts the odds in your favor. You get a low risk way to capitalize on a 2nd leg down in the stock market. Instead of shorting ES futures or buying SPX puts, buy the breakouts in VXX or VIX futures.

—

That's all we've got for this month!

If you've got any questions please shoot them over to me at alex@macro-ops.com or hit us up in the CC if you're a Collective member.

Take care and good luck in the markets,

Alex and Tyler