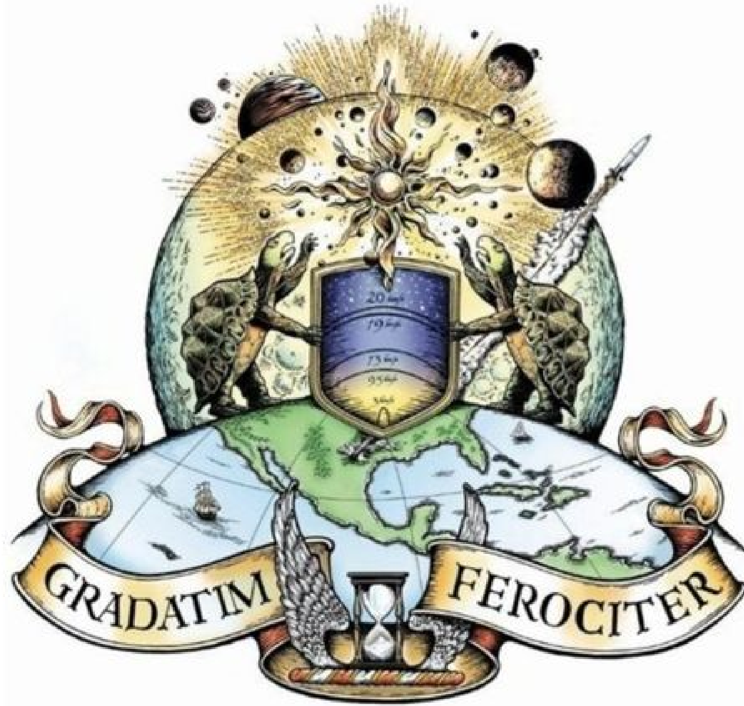
Gradatim Ferociter



This is the coat of arms for Jeff Bezos' space company, Blue Origin.

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I came across it during my daily procrastination session. This time I was watching videos on space flight — time well spent.

I'm a Bezos fanboy and think he's probably the most impressive capitalist since Henry Ford. And I love Blue Origin's motto *Gradatim Ferociter* and wanted to include it in this month's report. The motto is latin for: *Step by Step, Ferociously.*

Here's Bezos discussing the symbology behind the logo *via Geekwire*.

> ***What's Blue Origin's motto?*** *"Gradatim Ferociter" is Latin for "Step by Step, Ferociously." Bezos says that's his approach to spaceflight. "If you're building a flying vehicle, you can't cut any corners. If you do, it's going to be [just] an illusion that it's*

> *going to make it faster. … You have to do it step by step, but you do want to do it ferociously."*
>
> ***Why is there a winged hourglass on Blue Origin's coat of arms?*** *Bezos says that's "a Victorian cemetery symbol which means 'time is fleeting.' We don't have forever."*
>
> ***Why is Blue Origin's mascot a tortoise?*** *The lesson from the fable of the hare and the tortoise is that "slow and steady wins the race." Bezos puts a different twist on the tale: "Slow is smooth, and smooth is fast." The mascot also may be a commentary on other commercial space ventures that leap into aggressive schedules but don't end up meeting them, like the hare in the fable. After each successful New Shepard flight, Blue Origin's team paints a tortoise on the capsule's hatch.*

Step by Step… Ferociously.

There's a lot in here that's applicable to the game of speculation.

Like building rockets, earning alpha is tough. It's fraught with pitfalls for those who move with haste. An example being the tendency to force trades when no trade should be made — a practice no different than attempting to squeeze blood from a stone.

A macro operator must embody infinite patience… move slowly, *Step by Step*… and wait for the trades to come to him. The ancient Chinese warrior philosopher, Sun Tzu, remarked on the importance of such, when he said, "The good fighters of old first put themselves beyond the possibility of defeat, and then waited for an opportunity of defeating the enemy" and "Victorious warriors win first and then go to war, while defeated warriors go to war first and then seek to win."

Preparation over constant action.

Moving *Step by Step* is the macro operator equivalent to maniacally managing your capital, protecting your downside, and waiting for the proverbial fat-pitch. And when that lob comes down the pipe, moving *Ferociously* to capitalize on the opportunity and fully exploit that right tail.

The late great Jesse Livermore put it this way, "There is a time for all things, but I didn't know it. And that is precisely what beats so many men in Wall Street who are very far from being in the main sucker class. There is the plain fool, who does the wrong thing at all times everywhere, but there is the Wall Street fool, who thinks he must trade all the time."

Well said, Jesse…

The correct trade since the start of the year has been to mostly not trade. For all the back and forth, the S&P is currently *unch* on the year.
But global tectonic plates are a' shifting… And the great macro Pangea landmass is about to crack wide open and change the rules to the game we've all been playing these last two years.

And in this brave new world those who move erratically and with haste, risk falling into the abyss. While those who move step by step, ferociously… will have some opportunities to seize Totis Portis.

There are three factors we must focus on going forward. These three drivers (all of which are interconnected) will drive capital flows, price movements, and investor behavior throughout the rest of the year.

These are:

1. China's managed slowdown
2. Inflation/disinflation
3. Core to periphery flows

Let's review each one and discuss how one leads to the other which leads to the other which leads back to the first; creating a Soros style Benign Circle.

We'll then talk about how these changing dynamics will impact markets; driving some assets higher and many much lower.

And then finally go over the what we think will be the most profitable trades in this environment.

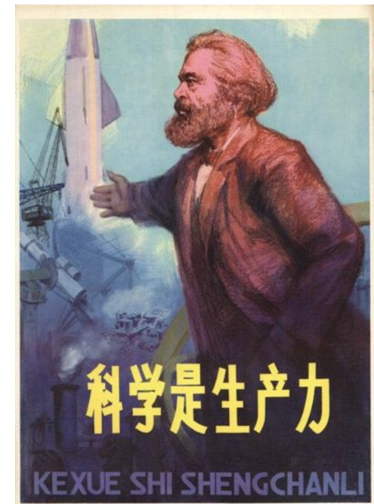
Let's go.

China: Dead Pigs Aren't Afraid of Boiling Water… Redux

> "Confucius say: Baseball lies… man with four balls cannot walk" ~ ancient Chinese proverb

Last July, we laid out the case for why China is *the most* important macro factor this cycle. We talked about why it's a debt riddled neutrino bomb waiting to go boom... *But*… we also noted how the Chinese Communist Party (CCP) had been injecting liquidity into its economy in order to steady the boat during its all-important National Congress last year.

Our pitch was that we were tactically bullish but strategically bearish (which so far looks to have been the right call).



Well, now that the big gathering of Marx lovers is over and Xi Jinping has been anointed the Grand Emperor for life. The CCP has the all-clear to move forward with managing the country's deleveraging and transitioning from an export economy to a consumption based one.

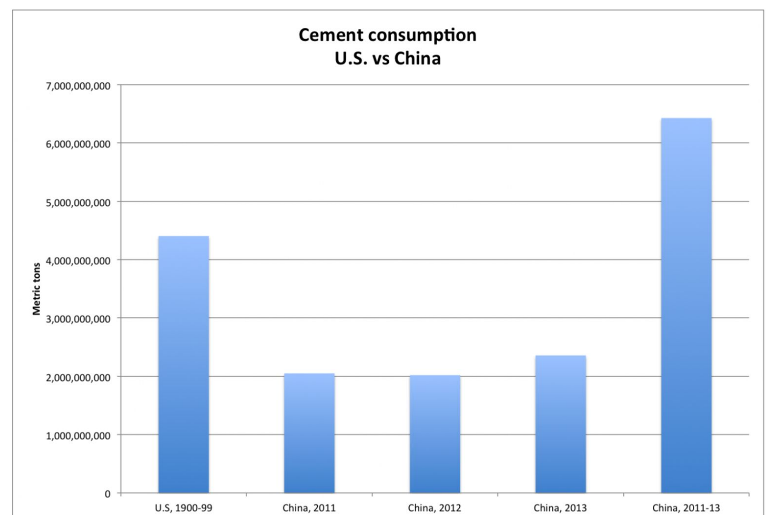
Why does this matter? Why is China so important to global markets?

Well, it's mainly because they are the world's marginal buyer of commodities… by a wide mile. So when China wheezes the rest of the world (and especially emerging markets) catches cholera.

Here's a short summary of just how important the red dragon has become.

It's been said that China builds a new skyscraper roughly every five days.

In the last year alone, the country has built half of the worlds new super skyscrapers (buildings with a minimum height of 656 feet). To put that into perspective, there's only 113 buildings in New York city, total, that are over 600 feet.

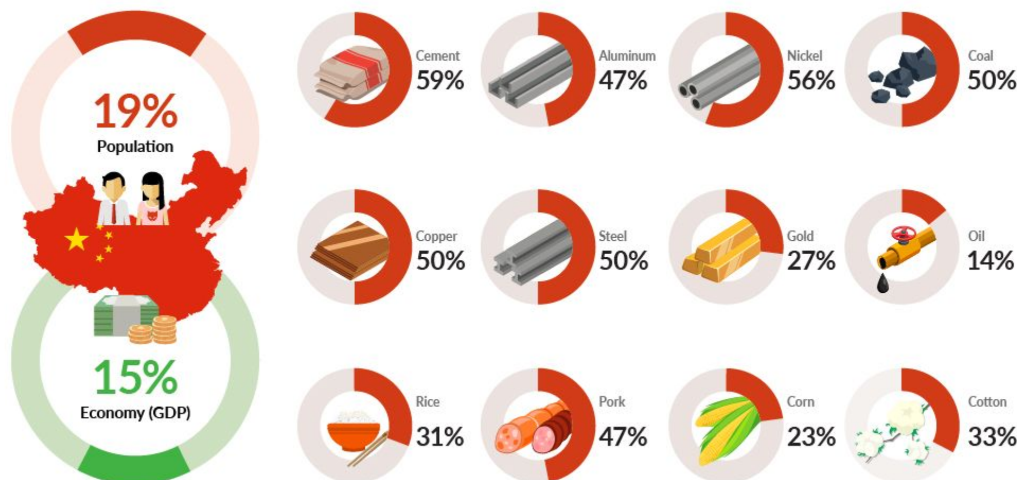


U.S. Geological Survey and International Cement Review

That takes a LOT of steel, copper, cement and other such resources. Another fun fact that I

often like to share is this mind bender: **China consumed more cement from 2011 to 2015 (that's just four years) than the US did in the entire 20th century.**

China dominates global commodity consumption. They consume more than half the world's cement, nickel, coal, copper, and steel every year (image via Visual Capitalist).



Paul Podolsky, a PM at the macro hedge fund Bridgewater, estimates that over **"70 percent of the swings in the global economy are driven by swings in the Chinese economy."**

Famed short-seller and fund manager, Jim Chanos, recounted the following regarding China a while back in an interview with the FT :

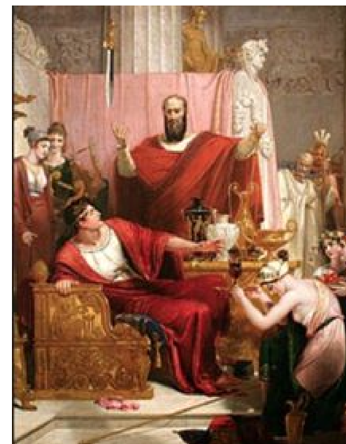
> *This story is internally now one of our great stories.*
>
> *A real estate analyst was addressing the partners and he said: 'Currently there's 5.6 billion square meters of high rises in China under construction. Half residential, half office space.' And I thought for a second and I said: 'No, you've gotten the American, rest of the world metrics wrong. You must mean 5.6 billion square feet. Because 5.6 billion square meters is roughly 60 billion square feet.'*
>
> *And my analyst looked at me sort of terrified. He was a young analyst at the time. He said: 'I know. I double checked. It's 5.6 billion square meters.' And I thought for a second*

> *and I said:* ***'Well if half of that's office space, that's roughly 30 billion square feet of office space. And that's a five foot by five foot office cubicle for every man, woman and child in China!'***
>
> ***And that's when we all looked at each other and our jaws dropped. We realized, wow, this is a once in a lifetime kind of thing,*** *where this whole country is in effect building itself out in a very short period of time.*
>
> *So then we looked at the capital spending of their miners, and we went back and looked at a time series of those that were around from 1990 on, and once again it was just one of these hit your head kind of moments.*
>
> *And with the government's explicit backing to do whatever it takes to keep China growing faster than the rest of the world's major economies.* ***Right now markets believe in two things: central banks have the market's back and China has the global economy's back.***
>
> ***Those are two very, very big pillars and they'd better hold up… because everybody believes them.***

This is important —> ***Right now markets believe in two things: central banks have the market's back and China has the global economy's back****…* One of these beliefs is going to be tested in the coming year.

Before I explain why, let me first layout what exactly makes the CCP and its leader, Xi Jinping, tick. Since they ultimately pull the levers in the country which affect the rest of the world so much.

It can be boiled down to the following: **power and control.**



Xi Jinping, as the leader of the CCP, cares solely about keeping his grip on power. All leaders, especially authoritarian ones, sit under a heavy sword of damocles. Xi is no different. Maintaining power and control are necessary to his survival.

The same goes for the broader party and its members. The CCP fears social unrest more than anything else; lest the people take to the streets and begin to demand a voice in government. Both know that the best way to keep the peace is by keeping the engine of economic progress turning and never letting things regress, too much.

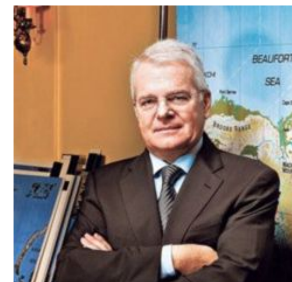
This is one of the *many* reasons why undemocratic systems are inherently fragile. They don't have the shock absorbers that are organic to democracies — we can vote our frustration out.

Question. Do you know why communism is superior to capitalism?

Answer: Because it heroically overcomes problems that do not exist in any other system.

Anyways, so Xi and fam know that they must maintain stability, both economically and politically to ensure their survival. And since their government is filled with very bright technocrats, they know that they have to deal with their debt problem. They can't afford to keep kicking that can down the road, anymore.

In addition, communism is all about outward appearance. Dog and pony shows are extremely important in reminding the people that the communist system is really the best. Which is why the CCP's coming centenary anniversary in 2021 is such a big deal. They need to celebrate 100 years of ~~The Great Chinese Famine~~, ~~Tiananmen Square~~, ~~wide scale oppression~~, economic progress.



It's very important that the Chinese economy is strong like dragon for the centenary in just three years time. The technocrats know this. And they know that if they want a strong economy in 2021 then they need to slow it down, now. This was the theory first put forth by macro hedge fund manager Felix Zulauf, which I wrote about here.

Here's Felix's updated thinking on this hypothesis from a recent interview he did with Real Vision (emphasis mine).

> *2021 is the 100th anniversary of the Communist Party... So I assume that the current president, who is now president for a lifetime, wants to have a good economy in 2021. If he wants to have a good economy then, he's no dummy, and his experts aren't either*

> *because I think, actually, the Chinese government has the best experts of all the governments in the world.* ***So they have to slow down the pace of the economy in '18-'19, and reduce some of the risks they have built up****. And I think you are seeing that already.*
>
> ***And I think the Chinese think that the fiscal stimulus in the US could take up some of the slack.*** *And I think it is timed that way that when the US pushes their economy a little bit further through the fiscal stimulus, that they could retreat some and it would be balanced.* ***Of course, it will not be balanced because China's effect and impact on the world economy today is much bigger than the US economy.***
>
> ***So I think the Chinese will most likely overdeliver in their restructuring efforts over the next two years, compared to what the world expects.*** *If that is true, then we will have a stronger dollar for longer, and will have weaker commodities for longer. But once the world then gets disappointed in '19 or whenever they figure that out-- the Chinese are beginning to kick start their economy from 2020 onwards.* ***So I think there are many cycles within these long cycle that we are in. And the mini cycle, I think, <u>is topping.</u>***

The theory sounds solid doesn't it?

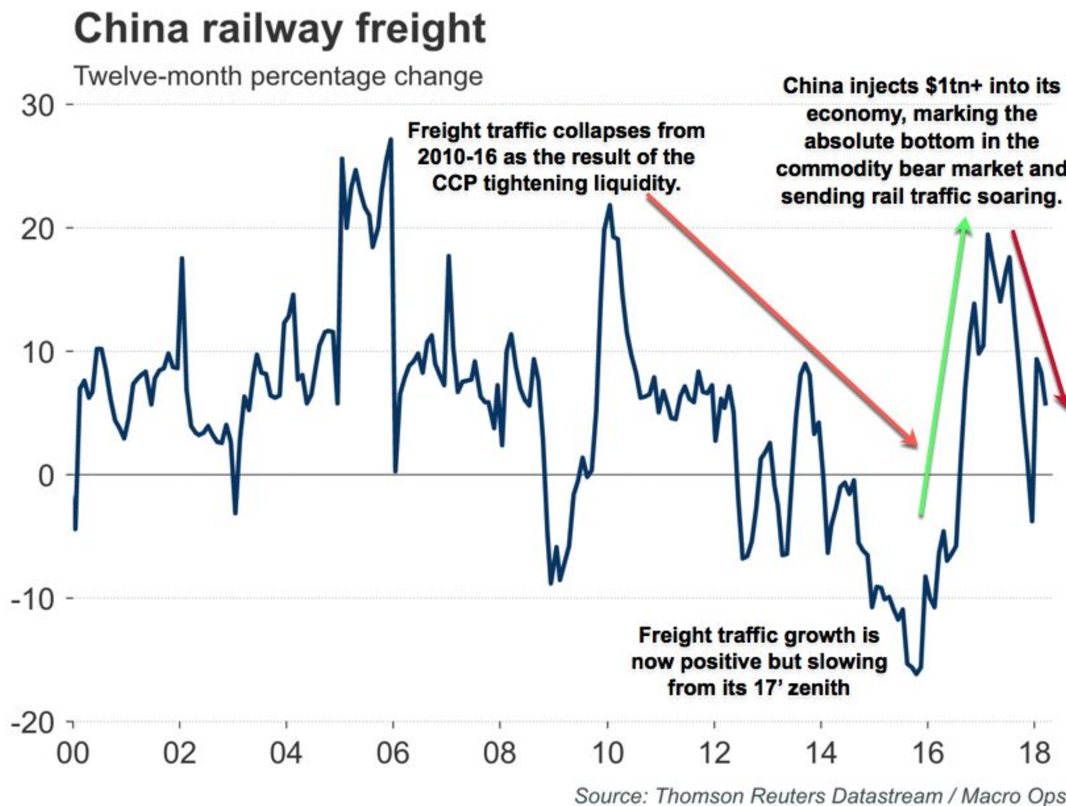
I mean, we know the Chinese government is worried about its excessive leverage. And we know that political anniversaries and pageantry are important in their culture. *And*… it would be wise — and China's technocrats are wise, if not sometimes hamstrung — for China to move aggressively in deleveraging while the US (its counterpart engine for global growth) is firing on all cylinders, with unemployment sittings at 17-year lows and capital expenditures trending towards generational highs...

But a theory is just an opinion if we can't back it up with numbers. And as macro operators, we need to be like the late W. Edwards Deming where, "In God we trust; but all others must bring data."

So let's peruse the data. And since China likes to fudge the more popular datasets, we'll look at a dashboard of more esoteric stuff that tends to fly under the radar, unmolested.

Here's one of my favorites.

It's the YoY change of railway freight. Remember, in last week's article, we talked about why it's best to view data at the second derivative level. Because the rate-of-change reveals important trend changes in velocity. Well, we can see that in the chart below.



Growth in railway freight slowed, then turned negative, from 2010-14' when China was doing its stealth tightening.

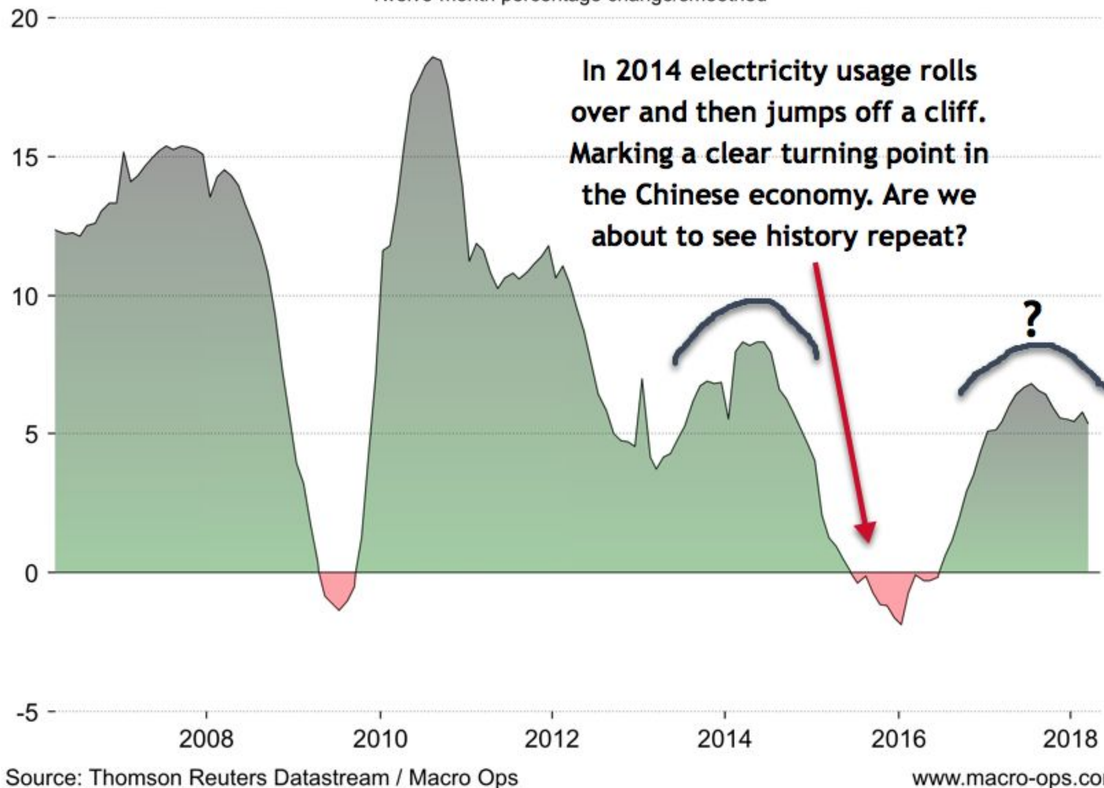
Looking at this chart alone would have tipped you off to something being amiss. You could have triangulated this with price action in commodity and emerging markets to either help you to side-step or go outright short into what became a nasty bear market.

And then in early 16', this chart reflected the massive credit injection by the PBoC (China's central bank) by hockey sticking upwards, which subsequently marked the nadir of the commodity/EM bear market.

Now, while growth in freight traffic is still positive. It's slowed dramatically since its 17' peak and looks to be decelerating further. Something we'll have to keep a close eye on.

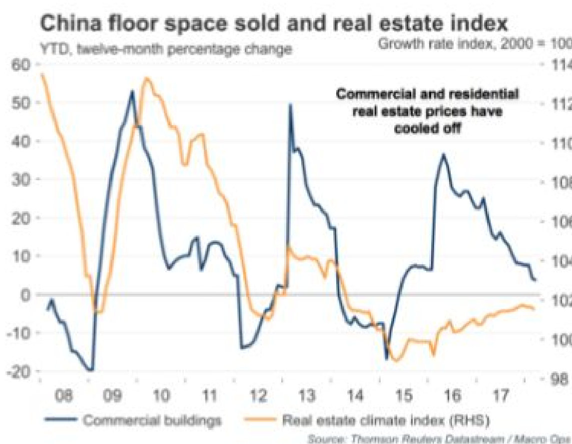
Now onto the second derivative of another favorite of mine… year over year Industrial Production Electricity Usage... Fun!

This one is sketching out the same pattern as railfreight traffic. Growth is clearly decelerating from its high-water mark hit last year.



Real estate, both commercial and residential, are telling a similar story.

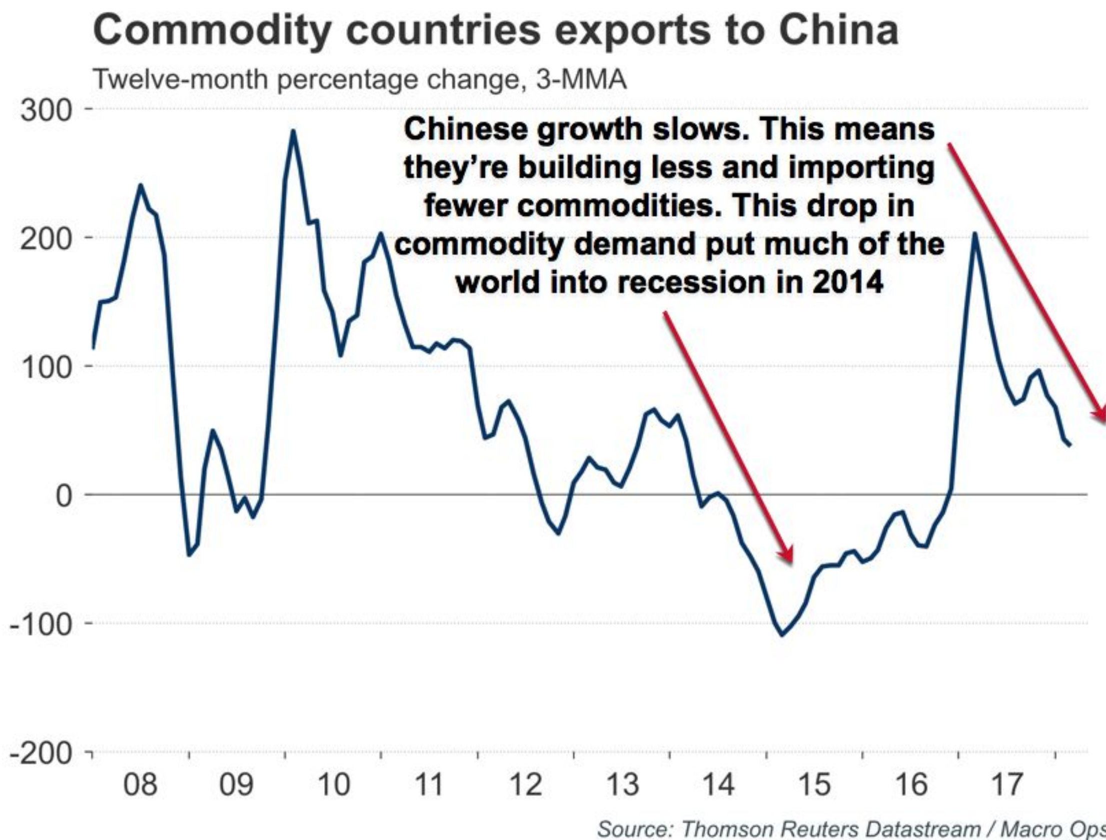
Home prices in China's two hottest cities, Beijing and Shanghai, are falling. And the growth in the amount of commercial floor space sold is about to turn **negative for the first time in over 3-years.**



Real estate plays an important role in the Chinese consumer psyche. If this trend continues it'll make the economy's transition to a consumption based one, that much more difficult.

Since China is such a dominant source of global commodity demand, I've found that tracking their imports from commodity producing countries to be a fantastic bellwether for what's really going on in the country.

Below is a chart showing the year-over-year changes in exports to China from the countries largest commodity trading partners.



This chart, like the others, paints a picture of decelerating growth.

Our theory now looks less and less like an "opinion" and more like the word of God, doesn't it?

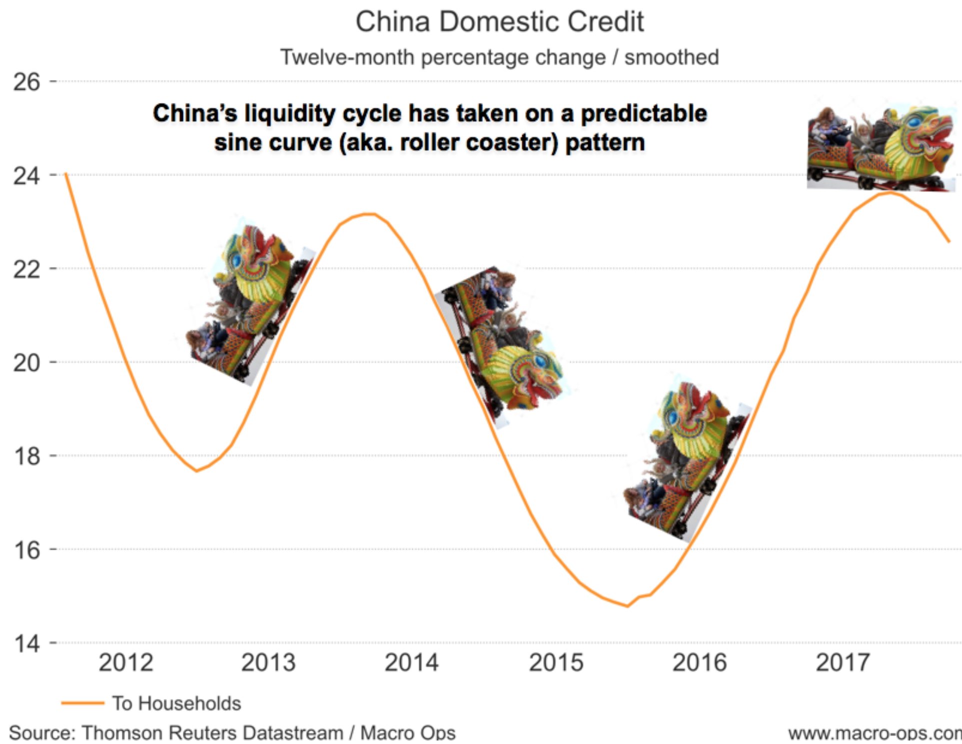
But, we can go even further. Let's look at the source of this deceleration. The supply of money (liquidity), itself.

China's M1 money supply (narrow money) growth turned negative following its large upswing in 16'-17'. Here it is, charted along with the year-over-year change in industrial metal spot price index. Notice any correlations? Perhaps any leading correlations?

Hopefully, the puzzle pieces are beginning to come together for you.

China is the dominant source of global commodity demand. And liquidity (ie, money supply) drives demand. So ceteris paribus, collapsing Chinese liquidity leads to falling commodity prices.

So this chart and the next one should have us somewhat concerned; because they clearly show that liquidity in China is rolling over.



People have been wondering why emerging market debt and currencies have dived into a hole, recently. Well, the above is why. China is deleveraging and the rest of the world is just starting to feel the affects.

Does all this mean that we should sell all our positions, convert to cash, and join a friendly prepping community?

No, not exactly…

I'm no curmudgeon or China doomsdayer. I think China will manage things just fine. But growth there is clearly decelerating. And the CCP's actions give weight to our "slowdown into 2021" theory. So, as long as the data continues to confirm our theory, that's the one we'll base our assumptions off of.

I'm guessing the CCP learned its lessons from the painful economic slowdown in 14'-16' and will proceed with more caution this time around. Taking one step back for every two forward in their move to deleverage — or crossing the debt river by feeling the stones, as Deng Xiaoping would say.

Lucky for them, the US economy is booming and will help soften the blow to the global economy. Which is why we're not predicting fire and brimstone, just yet.

But… this will have a dramatic change on the macro landscape, and thus, markets. So let's talk about that. Let's discuss what these changes will be and how we can capitalize on them.

Soros' Benign Circle

I've written about the Core/Periphery and dollar smile models that make up Soros' Benign Circle regimes, a bunch, ane recently too. You can find them here, here, and here.

And I don't want to bore everybody with another in depth explanation of them. But they are some of the core mental models we use in analyzing the macro-sphere. And just in case some of you are new, here's a very brief explanation.

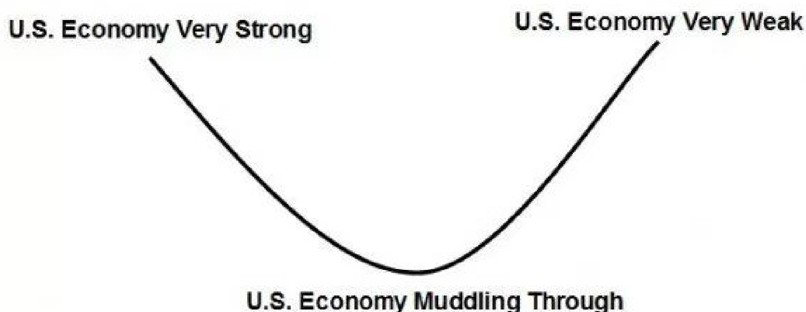
Core/periphery model: Global capital sloshes around the world in search of the highest total return. Total return is comprised of three things:

(1) exchange rate differentials
(2) interest rate differentials and
(3) local currency capital appreciation (ie, how much the stock market goes up).

When the US dollar (the world's reserve currency) appreciates due to the sum of the above three factors, more capital is attracted to the US, and thus into US dollars. The US is the core. When opportunities outside of the US (the periphery) appreciate more, on a relative basis, then

capital flows out of the core and into those markets. **Core driven bull markets last longer than periphery driven bull markets.**

Dollar smile theory: The dollar outperforms when the US economy is very strong (on the left side of the smile) or when it's very weak (right side). And it does poorly when it's just muddling through (middle of the smile). This is because the US trades at a "safety premium" relative to other countries.



Soro's Benign Circles: Is essentially a combination of the two models above. A benign circle is when capital is flowing to the core, causing the dollar to appreciate. And since the US dollar is the world's reserve currency and all commodities and trade is done in US dollars, a stronger dollar = a disinflationary force. And lower inflation = less aggressive central banks which = looser liquidity conditions for longer which = better conditions for risk assets (stocks) to run higher.

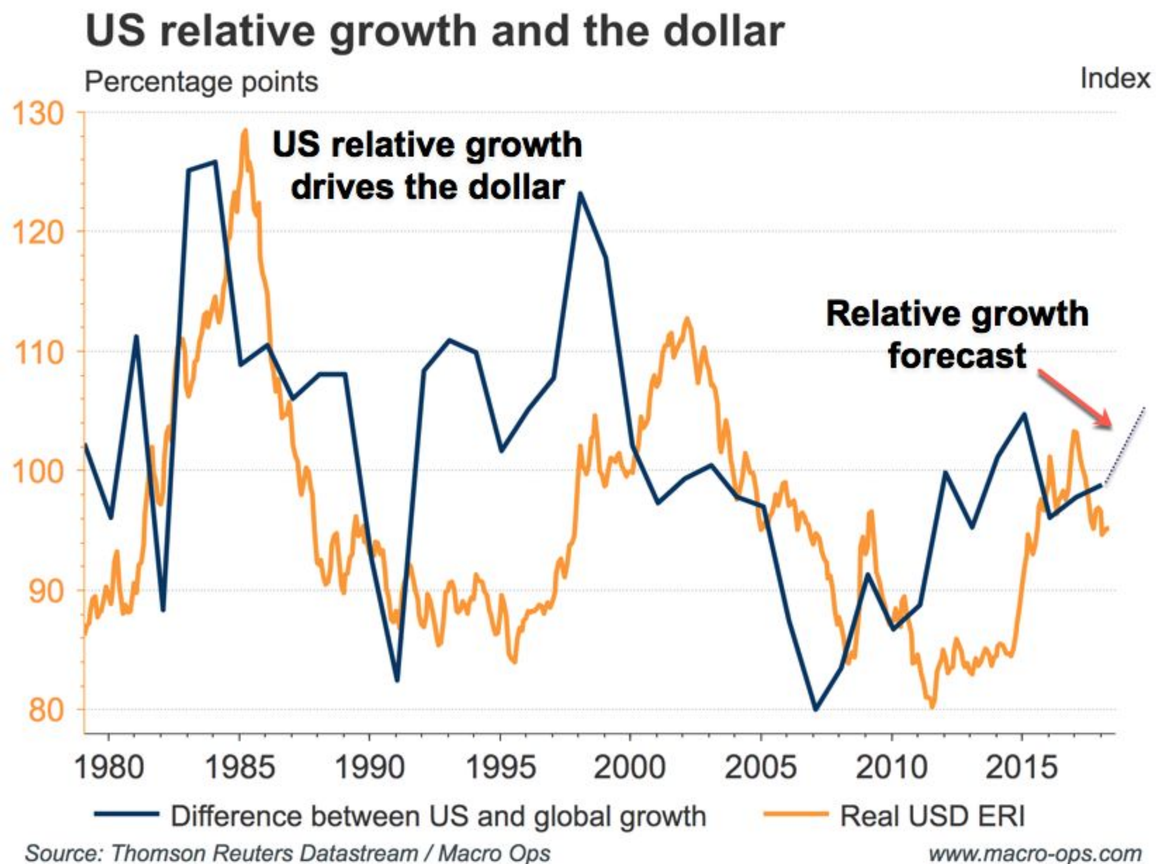
The opposite of this, is what Soros refers to as a vicious circle. This is essentially a periphery driven rally where the dollar is in a bear market and US stocks underperform the rest of the world (ROW). It's vicious, because a falling dollar = higher inflation and higher inflation = more aggressive tightening by central banks which = higher volatility and a shorter cycle.

Clear as mud?

Great…

Now that we're all on the same page. I can show you this chart. It's one of the most important charts in the game right now, in my humble opinion.

It shows that US growth is picking up relative to the ROW. It also shows how this relative growth clearly leads the US dollar. And we've spent the last 10+ pages talking about why the ROW is likely to see growth decelerate (because of CHINA… just in case some of you've forgotten) while the US economy is picking up steam.



An important point I should make here is that most of the movement in the trade-weighted dollar (DXY) is due to the euro. The euro has the largest weighting in the dollar trade-weighted basket (over 60%).

And if you dissect Europe's growth, you find that <u>well over half</u> of it is directly or indirectly tied to exports to China. So a slowing China = significantly slower growth in Europe which = an easier hurdle for the US to clear on a relative growth basis which = a stronger dollar!

And a rising dollar can very easily trip powerful reflexive feedback loops into gear.

This is where a stronger dollar attracts flows back from the periphery to the core. Those capital flows drive relative US stock market outperformance which attracts even greater flows to the core. Driving up the dollar even more.

A stronger dollar that's fleeing the periphery depresses commodity prices, which hurts emerging markets, and tightens global liquidity. Tighter liquidity leads to higher volatility which drives investors to reprice higher risk which leads to them bringing more of their money back to the core, where it's safe.

This is the benign circle as Soros described it:

> ***The longer a benign circle lasts, the more attractive it is to hold financial assets in the appreciating currency and the more important the exchange rate becomes in calculating total return.*** *Those who are inclined to fight the trend are progressively eliminated and in the end only trend followers survive as active participants. As speculation gains in importance, other factors lose their influence.* ***There is nothing to guide speculators but the market itself, and the market is dominated by trend followers.***

So now we have our fully laid out working thesis. Supported by data and the tape. It's the following:

- ➔ China is carrying out a managed slowdown/deleveraging in order to set its economy up for a strong rebound going into its 2021 centenary anniversary
- ➔ Since China is the largest source of global commodity demand, this slowdown will hurt select commodities, emerging markets, and Europe; who derives over half its growth from exports to China
- ➔ This deceleration in the ROW contrasts starkly with the US where thanks to tax cuts, fiscal stimulus, and the world's largest consumer market — making it less dependent on global trade — is firing on all cylinders
- ➔ This relative growth differential, in favor of the US, is attracting capital flows back from the periphery to the core. This is strengthening the dollar and sucking liquidity from the rest of the world
- ➔ A strengthening dollar coupled with slowing demand from China will put a ceiling on inflation, thus keeping the Fed steady in its projected low and slow rate hiking path
- ➔ A low and slow Fed is bullish for US risk assets and will further widen the outperformance of the US versus the ROW. This will attract more capital inflows to the core, driving the dollar even higher, putting more strain on the ROW. Thus creating a powerful feedback loop of US outperformance -> stronger dollar -> lower inflation -> low and slow Fed -> greater US outperformance and so on.
- ➔ All of this equals strong outperformance by US stocks and the dollar. And it means this cycle will be extended and last longer than what most everybody expects.

Now contrast our thesis with the current popular narrative of the market:

- ➔ The US market is overvalued versus the rest of the world and so it's prudent to be overweight EU and EM assets and underweight US stocks
- ➔ Due to a tight labor market, inflation is coming back to the US and US Treasuries should continue in their bear market
- ➔ The US dollar is overvalued and has already started what will be a multi-year bear market. This is supportive of non-US assets

➔ We are very late in the cycle and recession in the US is right around the corner

This isn't hyperbole, either. We can see how investors are positioned. Speculators hold record short positions against US bonds. And they're record long the euro and short the dollar.

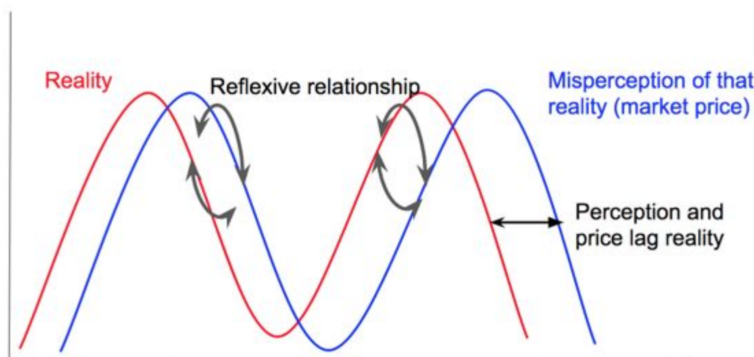
Look at the two graph below via BofA's most recent Fund Manager Survey.

They show investors hold large amounts (relative to the survey's history) of EM and Eurozone stocks. While they are drastically underweight US stocks, the dollar, and bonds.

Also, notice the extremely large cash position. That means there's still tons of fear in this market. Everyone thinks we're nearer to the end of this cycle than the middle. While we just laid out the case why that won't be true.

You see, investors are working off the old paradigm.

Their perception lags reality which is why they always miss the turns. They're extrapolating the past, while we're anticipating the future… and looking for the market to then confirm that future. Well, with the recent action in the dollar and all the charts we ran through above, I think we have our confirmation!



Trading legend, Bruce Kovner, once remarked that **"one of the traders I know does very well in the stock index markets by trying to figure out how the stock market can hurt the most traders. It seems to work for him"** and **"What I am really looking for is a consensus the market is not confirming. I like to know that there are a lot of people who are going to be wrong."**

Here we have a strong consensus. Both in accepted wisdom and actual positioning. But the market is not confirming either. This means there are A LOT of people who are going to be wrong. Just not us...

How to play it: The Race to $1 Trillion

Since this is going to be a core driven rally, we want to be long US stocks. But which stocks?

Using history as our guide, and considering the current positioning and relative trend directions. I believe large US tech stocks, particularly the FAAMGs (Facebook, Apple, Amazon, Microsoft, and Google) and other growth/momentum names will continue to outperform — by a lot.

I know, this isn't too original and probably appears to be too obvious a play. But this game can be funny like that. Howard Marks once said, **"The thing I find most interesting about investing is how paradoxical it is: how often the things that seem most obvious — on which everyone agrees — turn out not to be true."**

So, let me explain.

Momentum and growth are often the best performing factors in the latter stages of a bull market. Jeremy Grantham of GMO recently laid out why this is.

> *Concentration is the essence of an escalating euphoria. By late-stage cycles, many buyers are fixating on "winners" with the purchase motive being further stock gains, rather than any logic of long-term value. Thus, as the market soars, attention is increasingly focused on those with the largest earnings and stock price gains, and interest in the B players falls away. (This concentration effect naturally favors larger companies, perhaps because they can better absorb a rising demand.)*
>
> *In previous great bubbles we have ended with sensational gains, both in speed and extent, from a decreasing number of favorites.*

Robert Prechter, founder of Socionomics, calls this phenomenon the "Law of Patterned Herding", or LPH for short.

LPH posits that "aggregate investor thought is not conscious reason but unconscious impulsion. The herding impulse is an instrument designed, however improperly for some settings, to reduce risk" and "straying from the group induces feelings of safety and well being. Therefore, investors in the aggregate — whether they are buying in uptrends or selling in downtrends — are always acting unconsciously to reduce risk, thanks to the emotionally satisfying impulse to herd."

Momentum is one of the best predictors of future performance. This fact, completely befuddles economists. Because, in their EMH world, it simply shouldn't exist. But to us traders, it makes perfect sense. We understand reflexivity and know that price affects perception which affects price — LPH is a real thing.

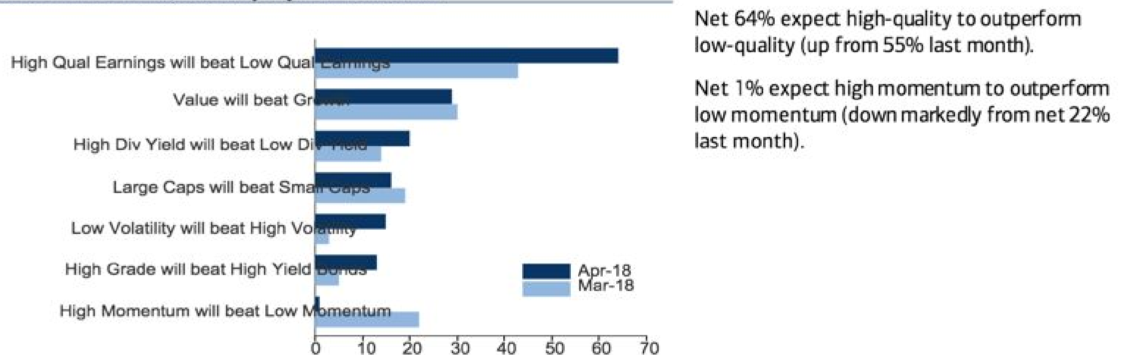
The normalized factor return graph below (via KoyFin) shows momentum and growth factors leading year-to-date by a healthy margin.

And here's a momentum factor ETF (MTUM) relative to the S&P since the start of 2017. It's been in a steady trend of outperformance.

In addition to momentum factor outperformance, it seems the market doesn't believe this trend will continue.

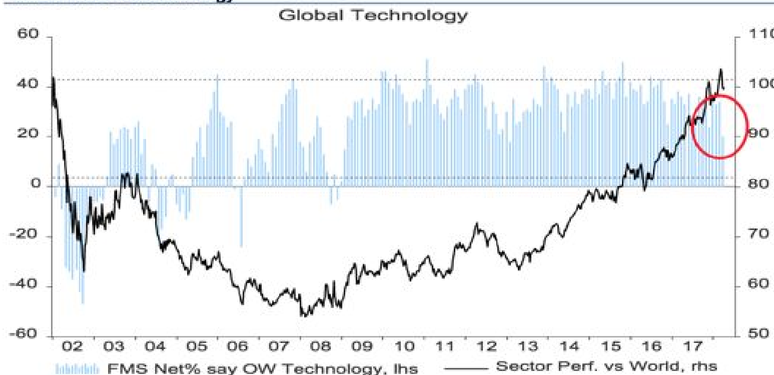
Positioning and sentiment data show that despite momentum and FAAMG's gangbuster performance over the last two years, the market is skeptical — which is great, because the greatest trends climb a wall of worry.

Check out this chart, again via BofA's recent Fund Manager Survey. The text from the report was a little screwy but hopefully you can read it. It shows that only **"1% expect high momentum to outperform low momentum (down markedly from net 22% last month)".**



And **investor's allocation to technology stocks has fallen to its lowest readings since Feb 2013** — 0.2 standard deviations below its long-term average.

Exhibit 37: Global Technology



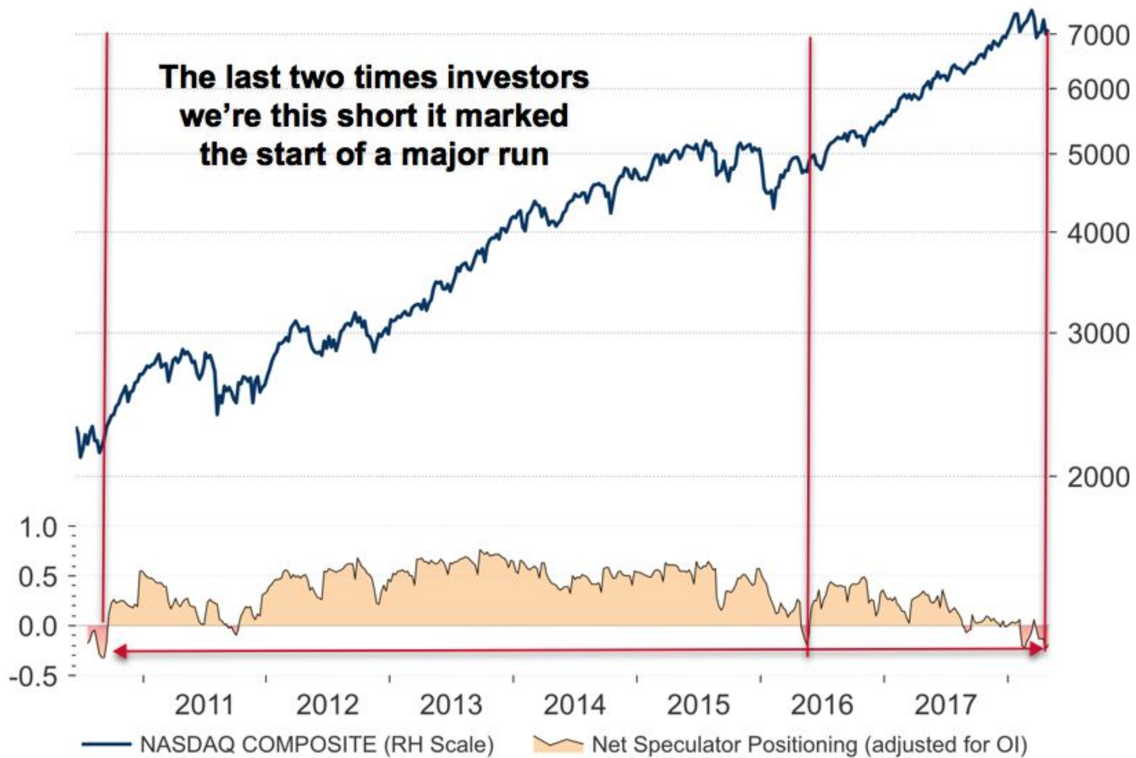
Source: BofA Merrill Lynch Global Fund Manager Survey

Allocation to technology fell 14% to net 20% overweight in April, the lowest since Feb 2013.

Current reading is 0.2 stdev below its long-term average.

And the CoT data shows speculators hold their largest net short position against the Nasdaq since 2010. The last three times net positioning was short against the index, it marked the start of a major run higher.

Nasdaq Net Speculator Positioning



This level of pessimism and short-positioning is surprising given the confluence of strong drivers behind momentum tech names. I mean, they've absolutely been crushing it.

modest proposal @modestproposal1 · May 2
Interesting to try and normalize for business models and look at GP$ and growth of the big 5 in most recent Q:

AAPL - $23.4B +13.6%
AMZN - $20.3B +52.6%
GOOGL - $17.7B +18.4%
MSFT - $17.5B +15.8%
FB - $10.1B +46%

this type growth at this scale is just incredible

This brings us back to Marks' comment about the sometimes paradoxical nature of markets.

I mean, everyone knows that everyone knows that the FAAMG companies are crushing. So everybody knows that everybody knows that going long FAAMG stocks at this point is chasing an old trend and a crowded trade.

But these are just common knowledge beliefs. The important question is: are they true?

I don't think so.

I think one of the main reasons behind this popular misconception is that humans are naturally linear thinkers, while the market operates on non-linear exponential dynamics. We have a tendency to underestimate the power of compounding and exponential growth that's the result of these company's powerful network effects.

It's hard for us to get long FAAMG stocks because they are already so large, so dominant, and their trends have run on for so long.

Trees don't grow to the sky, we tell ourselves. The natural power laws of scaling eventually kick in. And this is certainly true. But, the thing is, we don't know where the sky is for these FAAMG stocks. We don't know when scaling laws will begin to inhibit their growth. All we know is that we clearly haven't hit that limit, yet.

The common retort from investors is "what about their crazy valuations!". But again, is this consensus assumption even true?

MacroMan had a good post where they dissected the valuations of different country/sectors (link here). And they found that on a relative basis, US tech stocks are trading at pretty reasonable, if not outright cheap, multiple, considering their growth. He wrote:

> *Sticking with the MSCI indices, Tech's market cap is over 24% of total US market cap versus 16.2% for MSCI World. For EM, that's only 7.1%.* ***Given gangbusters growth, it's pretty reasonable for US Tech to trade at a healthy forward multiple, 17.31x next 12 months' earnings.*** *But wait: MSCI World Tech trades richer than that, at 17.53x! If you want to pay really exorbitant prices for forward earnings in Tech, head across the pond* ***where the MSCI Europe Tech sector trades 20.6x next 12 months' earnings****. EM Tech is valued at a similar level.* ***So the US is expensive in aggregate, but its biggest sector actually looks pretty cheap!***

On an individual level, the FAAMG stocks look like bargain-bin discounts versus the rest of the market. This sounds crazy, I know. But it's true... They are cheap when you account for their growth. And they're really really cheap when you factor in the defensibility of their MOATs.

Stanley Druckenmiller — perhaps the greatest trader to have ever walked the earth — talked a few months ago about what the market is getting wrong when valuing the FAAMG stocks.

He argued that investors shouldn't be focusing on earnings multiples. But, instead, focus on free-cash flows and future earnings potential; because these companies have been under-earning intentionally.

They have been reinvesting their operating profits back into expanding their businesses, thus widening their MOATs.

He gives Amazon and Facebook as the perfect examples. Amazon trades at only 4x sales, which is cheap when compared to its growth rate and market dominance. And Facebook trades at a PEG (price-to-earnings growth) rate of less than 1.

Druck backs up this talk too. Here's his fund's top 10 holdings as of last quarter.

Top 10 Stock Holdings			total 65.09%
GOOGL	10.27	PCLN	6.17
MSFT	9.85	BABA	6.11
FB	8.42	EA	3.83
CRM	6.49	JD	3.8
AMZN	6.38	WDAY	3.77

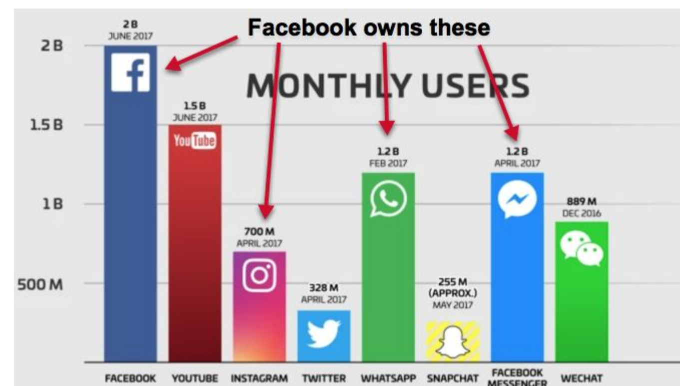
Google is a perfect example of the large discount these dominant growth/momentum stocks are trading at. *FT's Alphaville* team recently broke down and valued Google's many different operating businesses to arrive at a sum of the parts valuation. Here's what they found (link here).

Google Search			
2017 Ad Revenue ($m)	$	95,375	10-K
2018 Revenue Growth		20%	Bloomberg
2018 Revenue Est. ($m)	$	114,450	
YouTube Revenues ($m)	$	22,516	UBS
Advertising ex-YouTube ($m)	$	91,934	
TAC Cost % Revenues		24%	10-K
Revenue ex-TAC ($m)	$	69,870	
COGS ex-TAC % Ad Revenues 17		22%	10-K
Adj. Advertising COGS %		11%	
Advertising Gross Profit ($)	$	59,757	
Operating Costs % Ad Revenues 17		33%	10-K
Adj. Advertising Share %		20%	
Advertising Op Profit ($)	$	41,554	
Google Tax Rate (7 year)		24%	FT
Net Income	$	31,581	
Per Share ($)		44.89	
AA Share Price	$	742.61	
AA Adj. P/E Ratio		**16.54**	
*AA - Alphaville Adjusted			

They concluded:

> ***So for Google's core advertising business, investors are paying an Alphaville-adjusted 16.5 times forward earnings. With the current price-to-earnings ratio of the S&P 500 at 24 times, one might be forgiven for calling Google cheap.***
>
> *We have not even accounted for Google's famed 'Other Bets' line -- a collection of misfit, moonshot investments including self-driving software Waymo, health-data laboratory Verily Sciences and Alphaville favourite, smart-city planner SideWalk Labs.*

16.5 times forward earnings… for a company that Charlie Munger said "has a huge moat. In fact, I've probably never seen such a wide moat." And which is growing revenues and earnings in the high double digits, year after year…



Don't even get me started on Facebook which owns nearly all of the world's most popular social networking platforms. This gives them a total combined user base that's more than half of the world's total population. And they've barely even begun to monetize the other platforms outside of Facebook.
The last pillar of the bearish narrative then against these tech behemoths is the threat of regulatory

action. “Surely, Congress is going to come down hard on them and break up their business…”

Not likely… not anytime soon, at least.

Study history and you find that government only tends to enact regulation on the private sector following a painful bear market and long recession. In the midst of a strong bull market, the political will just isn’t there to do such things — no one dares upset the apple cart.

On top of this. The US and China are locked in a battle for AI supremacy. Governments from both countries have stated how important it is for them to win the AI race. Our own Department of Defense has said that general AI will represent a full phase shift in modern warfare and so it’s imperative the US leads.

And Google, Microsoft, Amazon, and Facebook are the world leaders in this race. You think Congress wants to Tonya Harding these companies when the Chinese are breathing down our necks? Yeah, me neither...

So government may continue to bicker and moan and stage theatrics but these powerhouses of American capitalism are safe from the vice grip of overregulation until at least the next recession.

What’s the best way to play this US led tech/momentum rally?

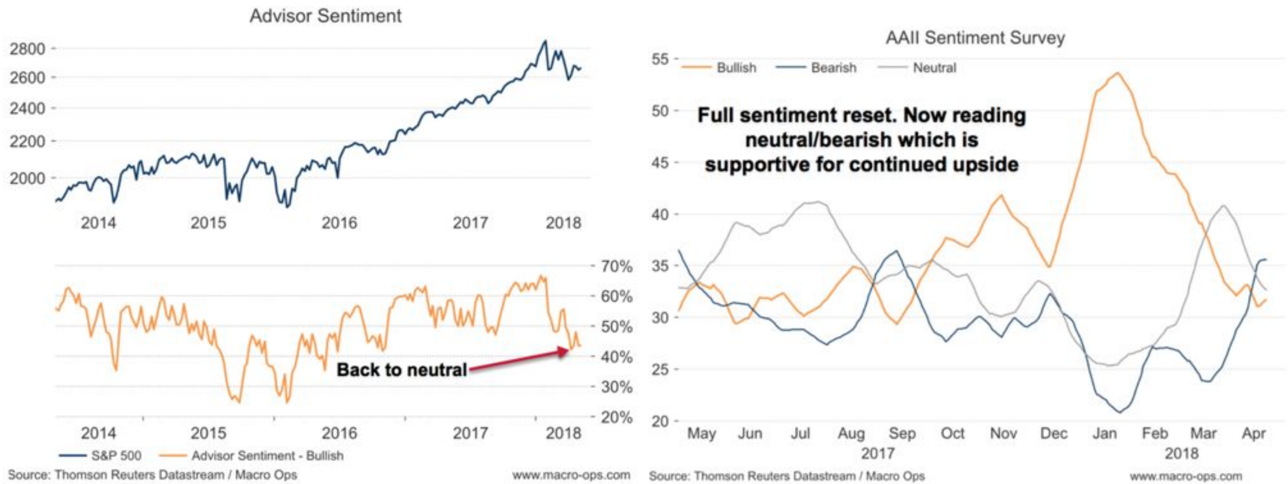
We can play the momentum ETF (MTUM) directly or putting together a similar basket to Druckenmiller’s listed above, would be a good start. I even think JD and BABA (two Chinese tech stocks) will continue to do really well, despite their country’s slowing growth. They may even dramatically outperform if the government looks to try and juice its equity market like it did in 14’, the last time it deleveraged.

Out of the US tech names my favorites are Google, Amazon, and Facebook. In that order. Our DOTM call strategy is a great way to play these themes. Here are our favorite DOTM options for those three stocks.

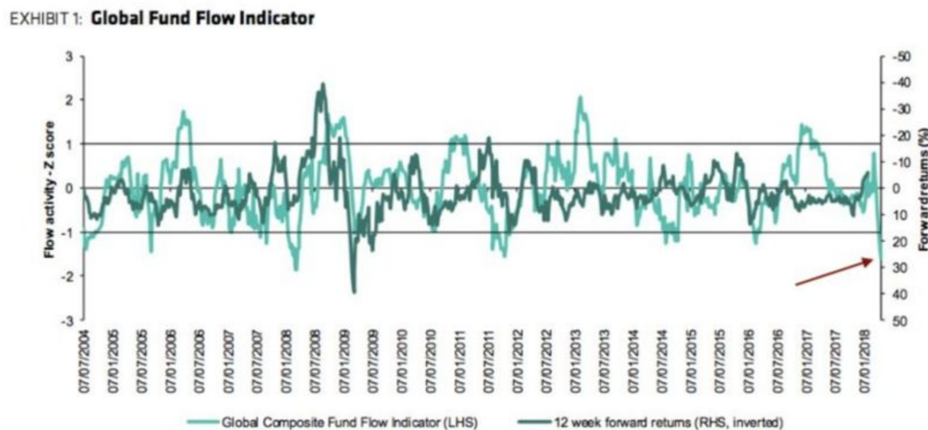
- ➢ **GOOGL Jan 2020 Calls Struck at 1660 for $14.00**
- ➢ **AMZN Jan 2020 Calls Struck at 2355 for $72.10**
- ➢ **FB Jan 2020 Calls Struck at 280 for $4.05**

Final thoughts on the market: Setting up for a run

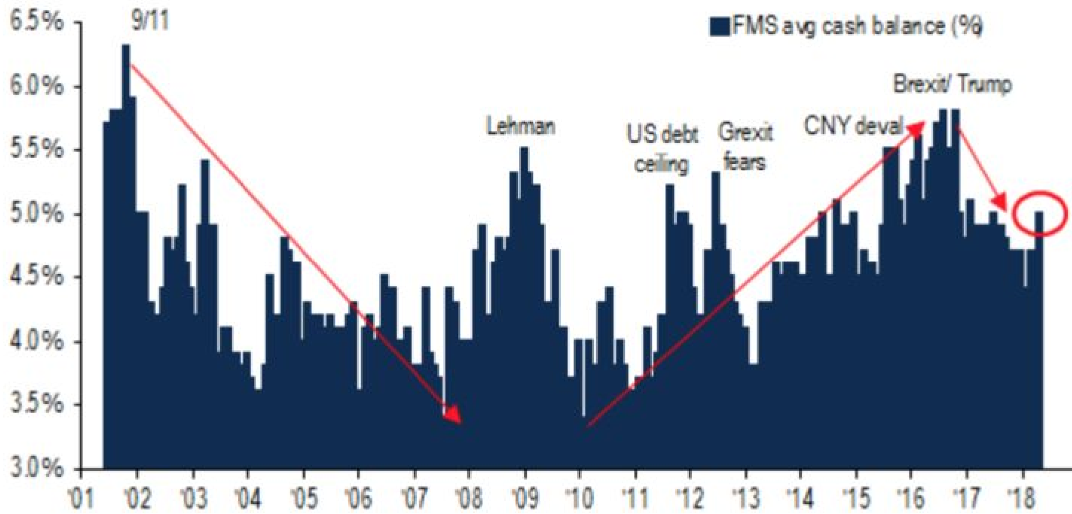
The market appears to be nearly finished resetting the euphoric sentiment reached in the beginning of the year. Sentiment and positioning are now at levels that can act as a floor for stock's next leg higher. Interest rates have also settled somewhat, which is good for stocks.



Bernstein's global fund flow indicator also shows signs of extremely bearish sentiment / positioning. Regarding current levels, Bernstein wrote that "We have found historically that when our indicator flags sentiment at such pessimistic levels that the market tends to respond positively over the following 12-week period."



And finally, let's not forget how much cash there is that's just sitting on the sidelines. Manager's cash positions are still at recession like levels. This is a lot of demand that I think is going to come flooding into the market over the next two years. That's very very bullish…



The tape for the broader market and FAAMGs, in particular, recently firmed up. And now looks ready for a breakout run higher.

My favorite Shakespeare line is from Julius Caesar. It goes:

There is a tide in the affairs of men,
Which, taken at the flood, leads on to fortune;
Omitted, all the voyage of their life
Is bound in shallows and in miseries.
On such a full sea are we now afloat,
And we must take the current when it serves
Or lose our ventures.

Shakespeare must have dabbled in the markets.

The macro tides are turning, and we must try to catch the current. So let us set sail into this new sea, *Step by Step*… and be prepared to move *Ferociously* when the flood comes….

That's it 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

P.S. I (Alex) am travelling to Tel Aviv and Vienna next week for a short 10-day trip. I've never visited either so I'm really excited for the visit. If any of you would like to meet up or have suggestions for things to do or places see, please shoot me a note.