Stay The Course

> *Markets are context dependent, their behavior is a function of the particular circumstances that exist and how those circumstances are expected to or do change. The trick is not to predict an unknowable future, but to try to understand the present and the probabilities of the various paths that may evolve from it.* ~ Bill Miller

In This Issue:

We often write that we're not in the business of making predictions. Rather, our job is to gauge the asymmetry of outcomes.

We do this by determining what the consensus beliefs and positioning are by triangulating the macro, sentiment, and technicals. This helps us paint a picture of what expectations are already embedded in the price. Then we just weight these against possible future paths.

The larger the disparity between consensus and potential outcomes, the greater the asymmetry and the more attractive the bet (trade).

There are additional benefits to using this mental model versus the typical one of making predictions.

1. It helps protect you from yourself. **Certainty is a killer in this game**. When we play the prediction game, we put ourselves at risk of becoming champions to a cause and slipping into the pull of our ego driven tribal nature. This distorts our perception of the world and blinds us to new information.
2. Prediction making is linear and bimodal in nature. Markets are non-linear and endlessly dynamic. This fact causes prediction makers to live in friction and disharmony with markets — think the perma bears who've been on the wrong side of the market for years. They become stuck when their view of the world does not match up with how things *actually* are.
3. Focusing on asymmetry of outcomes versus predictions frees the speculator from the psychologically destructive game of trying to be right over wrong. Instead, the speculator lives in a world of various shades of grey (50 shades maybe?) where they're always some mix of both right and wrong. In this way, the objective becomes not to form an opinion and stick with it. But rather, to apply bayesian analysis and continuously update

their views as new information comes in — this puts the focus on making money versus being right.

Bennett Goodspeed put it like this, “Why do investment professionals get such poor marks? The main reason is that they are victims of their own methodology. By making a science out of an art, they are opting to be precisely wrong rather than generally correct.”

This year, we’ve been more generally correct than we’ve been generally wrong. We’ve handedly beaten the market, as a result.

But we can’t rest on our laurels. We must constantly check for holes in our own assumptions. Like a good writer, we must be willing to kill our darlings and be ready to flip our positioning should the triangulation of the macro, sentiment, and technicals tell us to do so.

This is what we’ll be doing in this month’s *MIR*. We’ll assess the developing macro environment and see how it lines up with our current beliefs and positioning. We’ll then talk about what could change our views and whether we should stay the course or make significant changes to our portfolio.

Our Global Macro View

As a refresher, our core macro thesis since the start of the year has been the following:

- **Peak Liquidity and the end of global synchronized growth.** The perfect market conditions we enjoyed last year are over and we should expect a trend towards greater disparity between market/asset returns and higher vol.
- **China is the tail that’s wagging the global dog.** China has been, and continues to be, the most important macro variable. The CCP is attempting to slow the build up of leverage in the Chinese economy in order to set the country up for a strong rebound in 2021 (the communist party’s 100th anniversary). This deceleration in growth will hurt emerging markets the most.
- **The Fed put has been pulled.** Jeremy Powell and the FOMC have made it clear they are no longer concerned about weakness in the economy but instead are now focused on normalizing policy (ie, steadily raising interest rates and letting their balance sheet runoff in quantitative tightening).
- **US outperforms the rest-of-the-world causing capital to flow back to the core.** All of the above is leading to a steady tightening of global liquidity and a repricing of risk assets. Because of this, investors are beginning to pull their money from emerging markets (the periphery) and bring it back to the US (the core). This is driving a strong dollar feedback loop where: flows to the core raise EM volatility leading to greater

outflows which leads to a stronger dollar which tightens liquidity, raises volatility, leading to more outflows etc…

Our core positioning around this macro thesis has been:

- Long the US dollar
- Short gold
- Long select US growth/momentum leaders

Now let's run through and update the data on our core thesis and then we'll reevaluate our positioning and talk about some new trades. Starting with China.

A "Deleveraging" But With Chinese Characteristics

Global synchronized growth last year was driven almost entirely by large scale credit injections and policy loosening done by the Chinese in 2016 — the effects of credit often take 6-18 months to fully work their way into the economy. The deceleration in global growth (sans the US) this year is due to just the opposite; a Chinese styled deleveraging.

We say Chinese style, because their debt stock is still growing; just now more slowly. But when you're economy is built on an Everest sized pile of byzantine shadow banking loans, a deceleration in credit growth can have an outsized impact.

And the evidence suggests that the CCP is serious about tightening the screws — as much as they can without causing a total crisis — this time around, putting an end to what they know to be an unsustainable leveraging path. And with the global economy, bolstered by a strong US that's operating near full capacity, they likely view now as an opportune time to get aggressive in clamping down.

Let's look at the numbers.

Economist.com

Record defaults. China has already set a record for total bond defaults in a year. Even state backed infrastructure companies, once seen as having the eternal backing of the government, have gone into default. According to *The Economist*, Chinese banks have so far written off $780bn in bad loans and have needed to raise nearly 1trn yuan in fresh capital, with plans to raise another 1trn. To give you an idea of the size of this recap, it amounts to roughly three-quarters the size of the US's bank rescue following the GFC which is hardly anything to sneeze at.

It seems the Chinese are no longer practicing their long-held unofficial policy of pretending that a rolling loan gathers no loss…

Even more importantly than these corporate defaults is what their doing in the shadow banking sector.

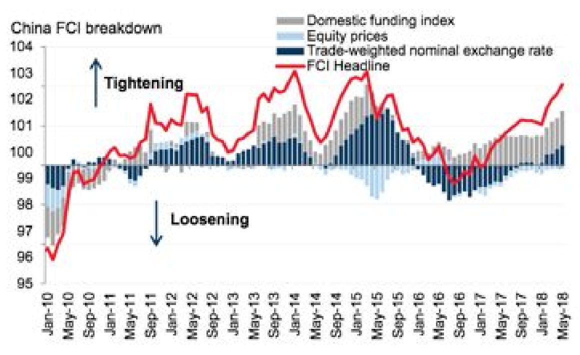
China is shining the light on its shadow banking sector. China's off balance sheet shadow banking sector is vast. Estimates put its assets at anywhere between $8 to $14trn — China's GDP is just over $11trn to give you some perspective.

One of the main conduits for the shadow banking sector has been through wealth management products (WMPs). These are high-yielding investment vehicles offered to Chinese retail customers. Over the last year, **the money flowing into WMPs has stalled out for <u>the first time ever.</u>**

The CCP recently told banks that the government will no longer backstop these off-balance sheet loans. This is a big deal since the whole shadow banking sector was built off the implicit assumption by bankers and investors alike, that if their loans went south the government would bail them out.

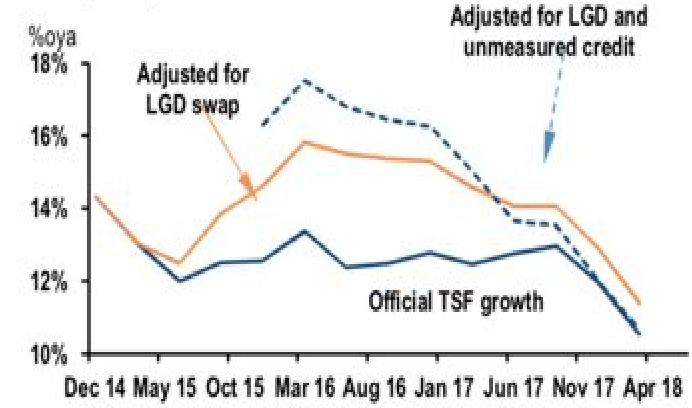
This financial crackdown is showing up in tighter domestic liquidity conditions within China (below left, is Goldman Sachs' China Financial Conditions Index). Goldmans' FCI is now near levels that were last reached in early 15', and eventually put much of the emerging world into a recession. And China's total social financing growth (a measure of domestic private credit) recently hit new cycle lows, as well.

Exhibit 3: Financial conditions have tightened, mainly via slower credit creation



Source: Goldman Sachs Global Investment Research

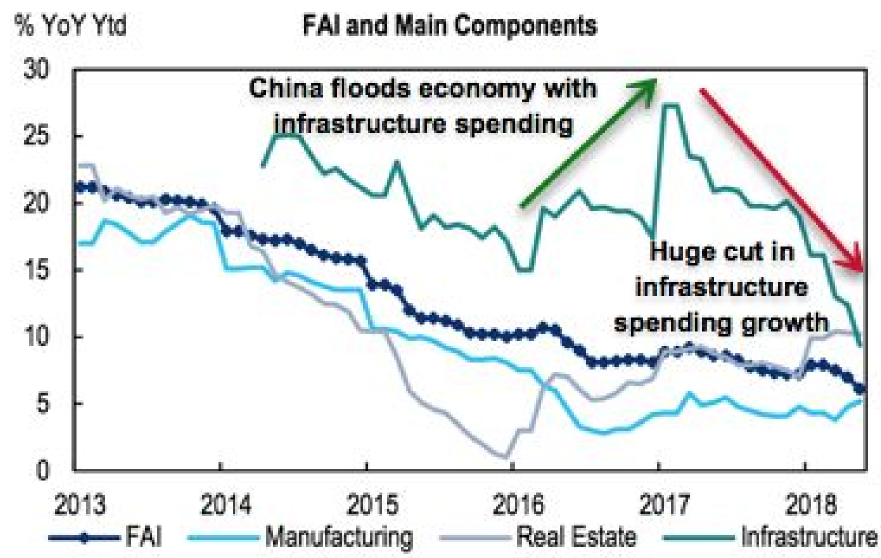
China; TSF growth



Source: NBS; PBOC; J.P. Morgan

A major slowdown in building. One of China's favorite economic levers is infrastructure spending. When the CCP wants to boost growth, they build some new cities and high speed rail lines, which is what they did in 16'. But since the start of last year spending growth on infrastructure has collapsed from over 25% yoy to just above 5% now.

Figure 4. Sharp Infrastructure Investment Slowdown Weighed Overall Investment Growth



Source: CEIC and Citi Research

Infrastructure is obviously commodity intensive and China comprises over half the world's commodity demand. So this huge cut in spending is something we need to keep an eye on.

China's M1 money supply has followed a similar pattern to its infrastructure spending. The chart below shows that China's yoy M1 growth is also near levels last hit in 15'.

We should expect industrial metals to follow suit — copper recently completed a textbook H&S top.

China and EM bulls will point to positive developments like China's recent interest rate cuts and their easing of some lending standards. And this is true, the data isn't entirely terrible.

The CCP is taking a moderate approach to tackling their debt; going after the most pernicious areas of their financial economy, while easing up in other ways.

But when looked at as a whole, it's very clear that the net impact is a big negative for global growth. And I believe we're only beginning to see the impact from this.

The biggest question going forward is just how bad will the CCP let things get before they intervene à la 2016?

Many assume that they'll be quick to open the credit taps at the nearest sign of trouble, but I'm not so sure. I get the sense they're looking to make some concrete progress this time around, so they're set up for a strong centenary. But ultimately, what Xi and his inner circle want is a black box. So we'll just have to react to the data as it comes out.

The Fed is no longer with you…

Stanley Druckenmiller once said that as "an economy reaches a certain level of acceleration… **the Fed is no longer with you… The Fed, instead of trying to get the economy moving, reverts to acting like the central bankers they are and starts worrying about inflation and things getting too hot**. So it tries to cool things off… shrinking liquidity…"

This is where we are now. A classic late cycle environment.

The Fed stated loud and clear that they're happy with where the economy and plan continue on full-steam ahead with rates hikes and quantitative tightening.

This doesn't mean a recession or bear market is around the corner. In fact, we probably have another 12-18m of upside (barring a material escalation of the trade war) here in the US. But it does mean that we should expect the Fed to execute on their projected median rate path and that it's unlikely they'll slow down in response to market volatility.

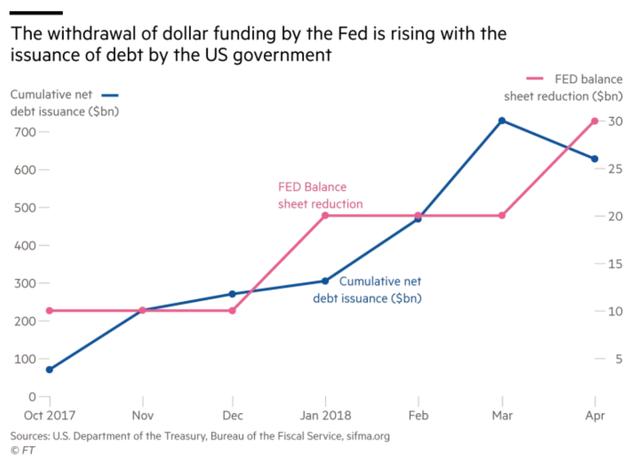
And we should expect more volatility… especially in emerging markets. This is because the Fed is about to start pulling large amounts of global liquidity.

Urjit Patel, India's central bank governor, summed up the coming EM liquidity drain well in a recent op-ed in the *FT*, writing:

Dollar funding of emerging market economies has been in turmoil for months now… ***The upheaval stems from the coincidence of two significant events: the Fed's long-awaited moves to trim its balance sheet and a substantial increase in issuing US Treasuries to pay for tax cuts.*** *Given the rapid rise in the size of the US deficit, the Fed must respond by slowing plans to shrink its balance sheet. If it does not, Treasuries will absorb such a large share of dollar liquidity that a crisis in the rest of the dollar bond markets is inevitable.*

Consider the scale of both events. Starting in October 2017, the Fed began reducing reinvestment of the coupons it receives from debt securities holdings. ***That shrinkage will peak at $50bn a month by October and total $1tn by December 2019. Meanwhile, the US fiscal deficit is projected to be $804bn in 2018 and $981bn in 2019, implying net issuance by the US government of $1.169tn and $1.171tn, respectively, in the two years.***

So, the withdrawal of dollar funding by the Fed, as it reduces its reinvestment of income received, is proceeding at roughly the same pace as that of net issuance of debt by the US government. Over the next few years, the government's net issuance will stabilise, albeit at a high level, whereas the Fed's balance-sheet reduction will keep rising.



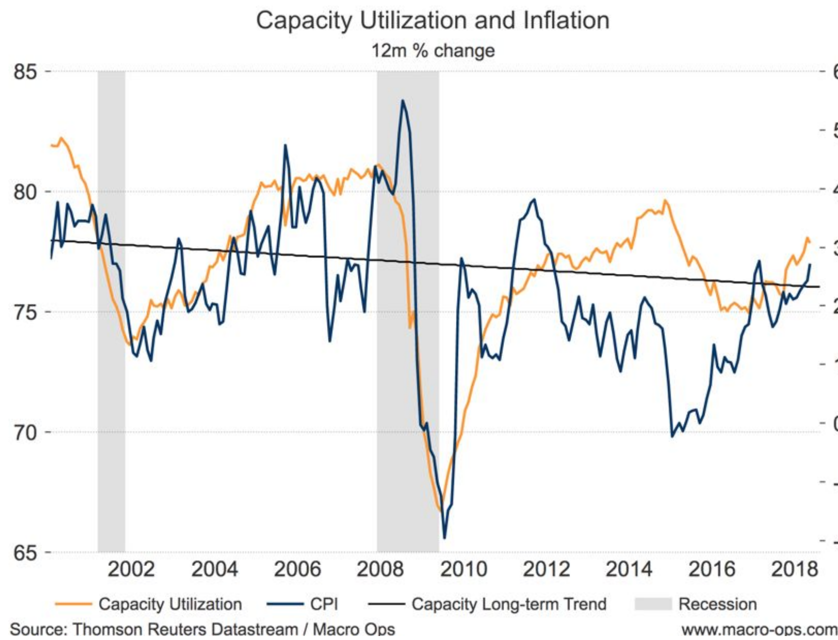
This unintended coincidence has proved to be a "double whammy" for global markets. ***Dollar funding has evaporated, notably from sovereign debt markets. Emerging markets have witnessed a sharp reversal of foreign capital flows over the past six weeks, often exceeding $5bn a week.***

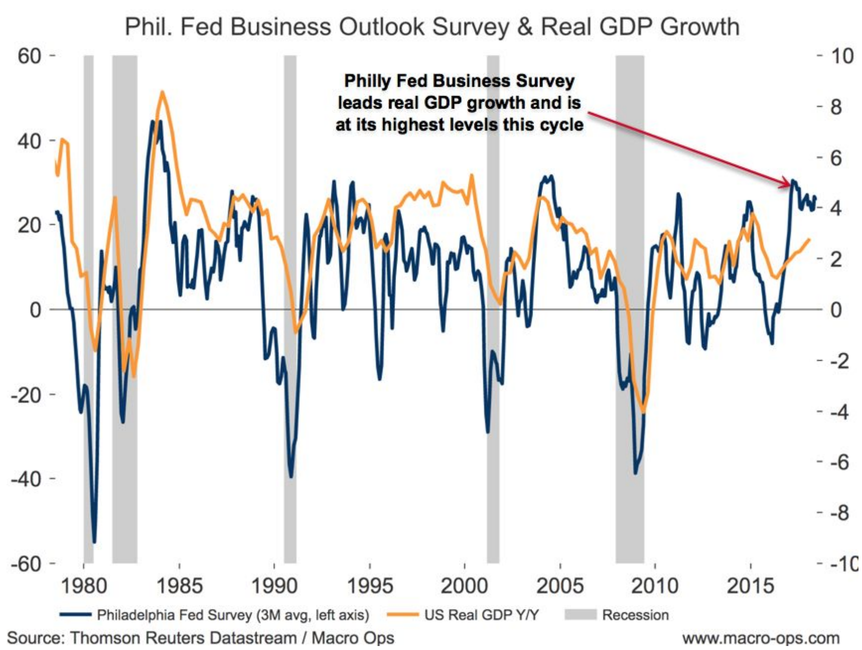
When you combine the Fed's quantitative tightening (QT) with the increased treasury issuance stemming from the rising deficit, you get roughly $2trn in extra treasury supply that's going to have to be absorbed by the market. These dollars will have to come from somewhere and that somewhere, has so far been the USD denominated emerging market debt market.

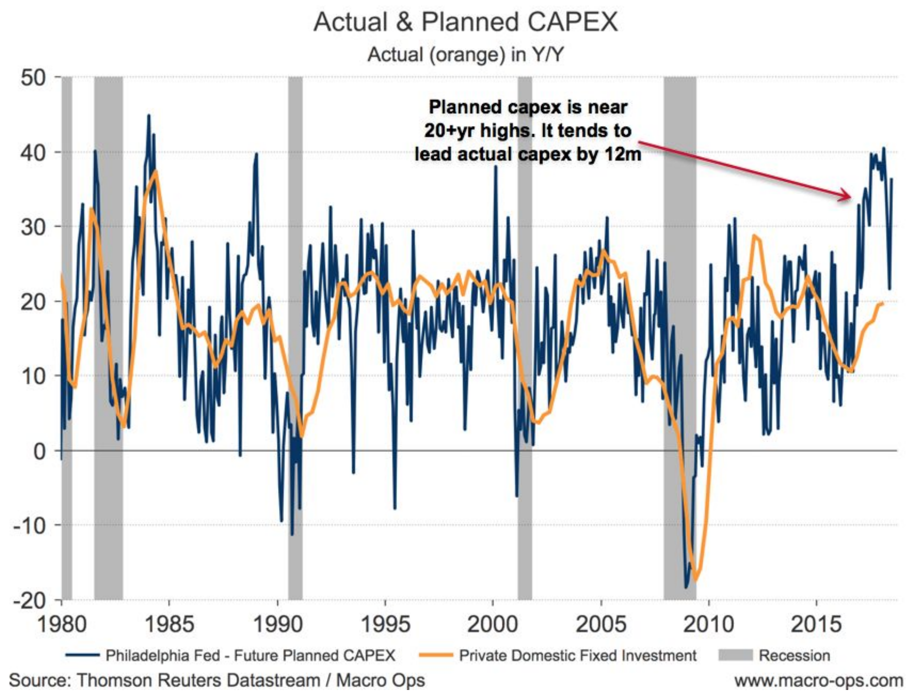
Throw in higher US interest rates and it's tough to see how emerging markets find a way out of this tightening liquidity vice.

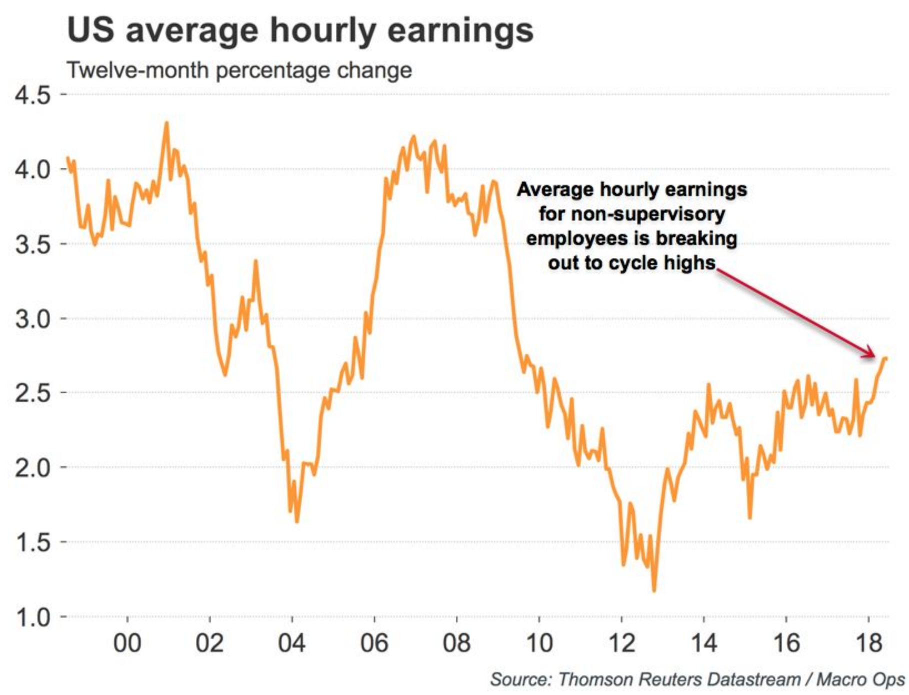
Plus, there's the increasing possibility that the market is underpricing, not overpricing, the steepness of the Fed funds path. We have unemployment at 20-year lows, the economy is operating at full capacity, and the government is hitting the gas with fiscal stimulus.

Our leading indicators suggest we'll see new cycle highs in GDP growth, fixed investment growth, and wage growth in the coming quarters. The risk is now to higher — not lower — inflation surprises and subsequently a steeper rate hiking path.









Considering this, I find myself in agreement with Jurrien Timmer of Fidelity, who tweeted.


Jurrien Timmer @TimmerFidelity · Jun 29
I'm getting the sense the #Fed doesn't feel it can pause tightening efforts like it did a couple of years ago. In 2015-16 we were earlier in the economic cycle, before sub 4% unemployment rate and #fiscal stimulus. The Fed had little opportunity cost in waiting. But not today.

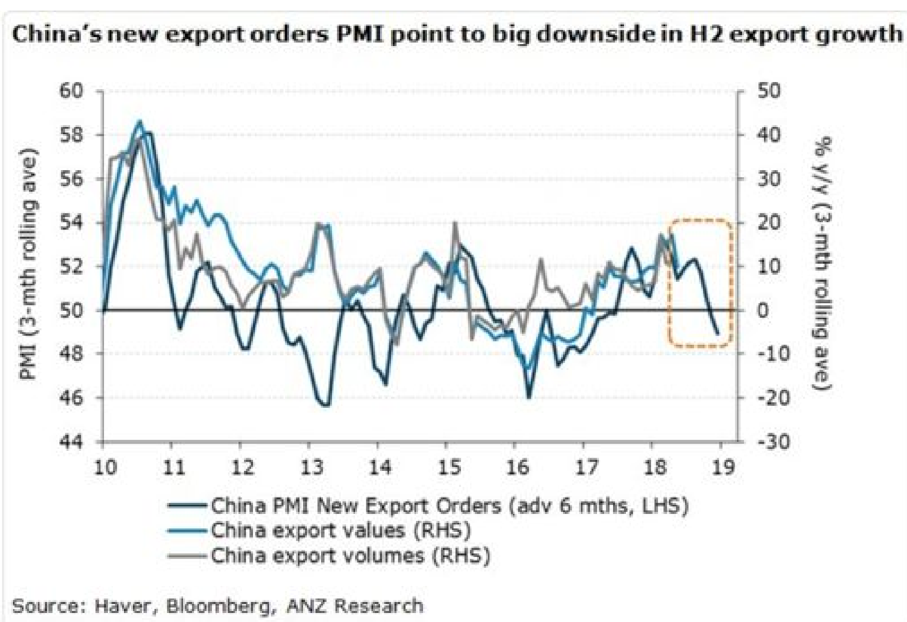
The risk now is that we see more positive surprises to inflation and growth which will lead to higher than expected interest rates. If this ends up being the case, it will only accelerate capital flows back into the US.

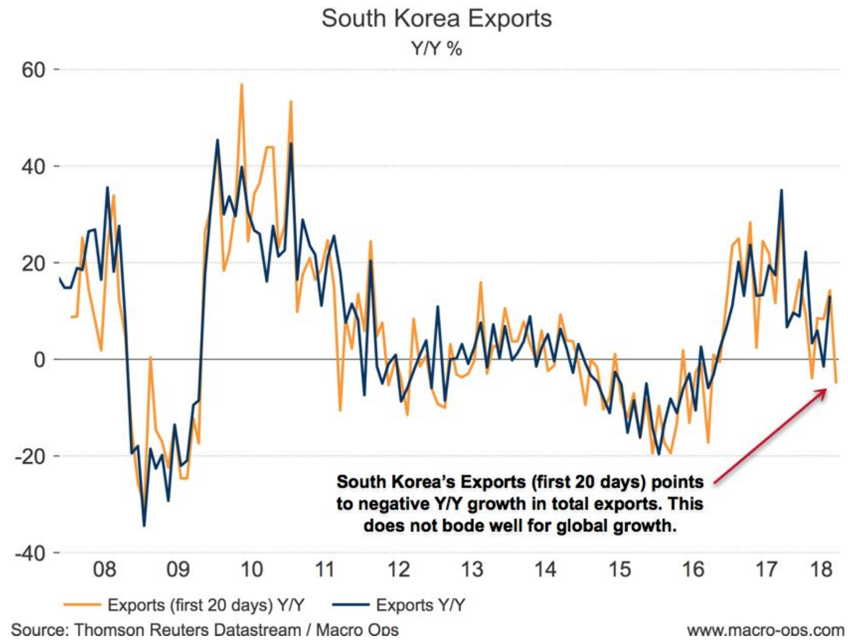
America is the exception…

All the data we look at points to a continued slowdown in global growth with the US being the sole exception.

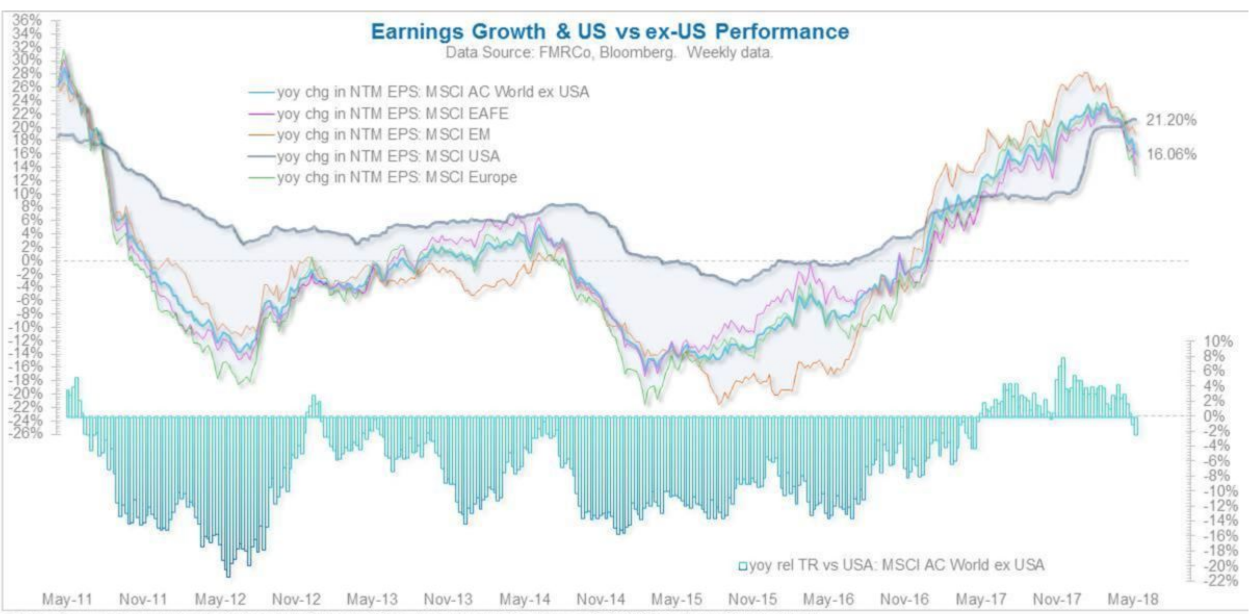
As we've discussed, this slowdown in the rest-of-the-world (ROW) is being driven by a deleveraging China and an increasingly hawkish US Fed — both of which aren't showing signs of reversing course.

Look at the following two charts showing leading indicators for China and South Korean exports (two bellwethers of the global economy). China's PMI export orders, which leads actual exports by 6-months, has turned negative for the first time since 16'. And the first 20-days of South Korean exports is indicating negative YoY growth in exports.





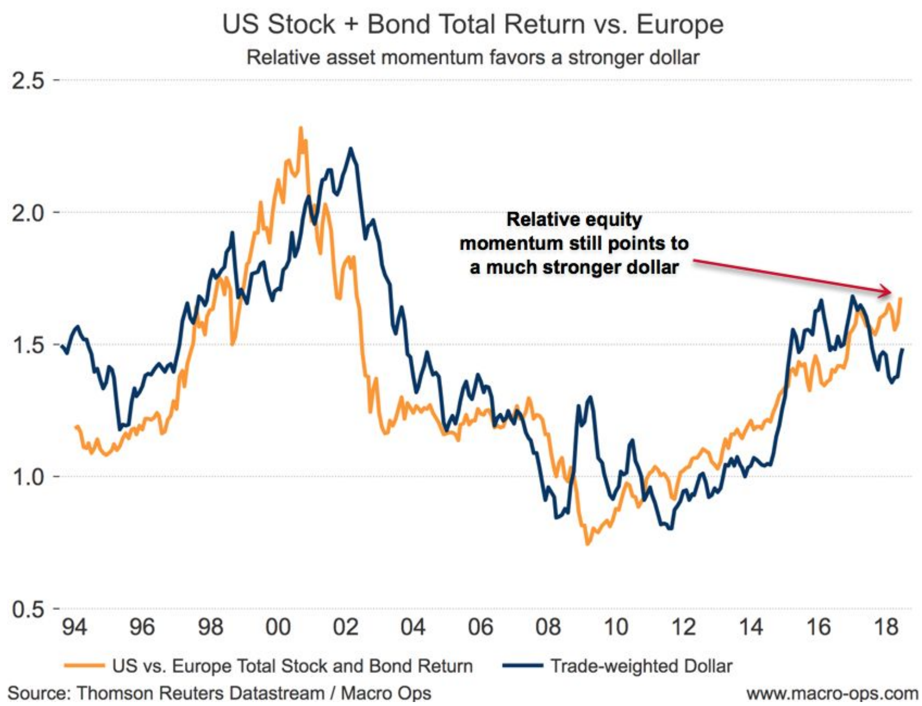
Here's a chart that I really like. It's from @TimmerFidelity and shows relative earnings growth per country and then global ex-US earnings growth on the bottom. You can see that ex-US earnings growth recently turned negative after a year of positive prints.



Remember, capital leaves the safety of US borders in order to chase superior growth. When growth outside the US slows, that capital flows right back home.

We can view these flows in the relative return performance between regions. This is why when analyzing the US dollar we always need to look at relative stock+bond performance between the US and Europe (the euro accounts for over half the dollar trade-weighted basket).

This indicator, which has a strong leading correlation to the dollar, shows there's still lots of upside ahead for the greenback.

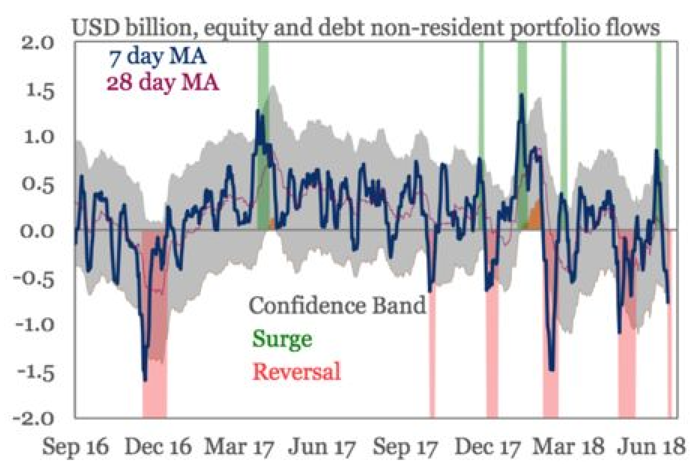


This slowing global growth and strengthening US dollar is leading to increased outflows from emerging markets and kicking off a stronger dollar feedback loop. We can see the EM outflows directly in the chart to the right.

The popular narrative appears to still be to try to call a bottom in EM stocks. We think this is a bad idea…

This brings us to another interesting chart; this one is a quarterly of the emerging market etf (EEM). Price is

Chart 1: Daily non-resident portfolio flows to EMs



**IN, ID, KO, TH, PH, ZA, BR, HU, CN, TW, VN. Partial data through June 19, 2018. Source: National sources, Bloomberg, IIF Flows Alert Report* retesting a significant 9-year support level. If it closes below this level it'll be a big technical breakdown for EM stocks.

A deleveraging China, a tightening Fed, and an outperforming US vs. the ROW are putting the pinch on emerging markets and kicking the bullish dollar flywheel into gear. There's no visible catalysts on the horizon to stop this trend, other than a full policy reversal by China or the Fed; both of which seem unlikely.

Considering all of the above, **we don't think there's anything to do other than stay the course in our original macro thesis and current positioning**. Long the dollar, short gold, short rates, and long a select basket of US growth/momentum leaders appears to be the right thing to do until the data or the market says otherwise.

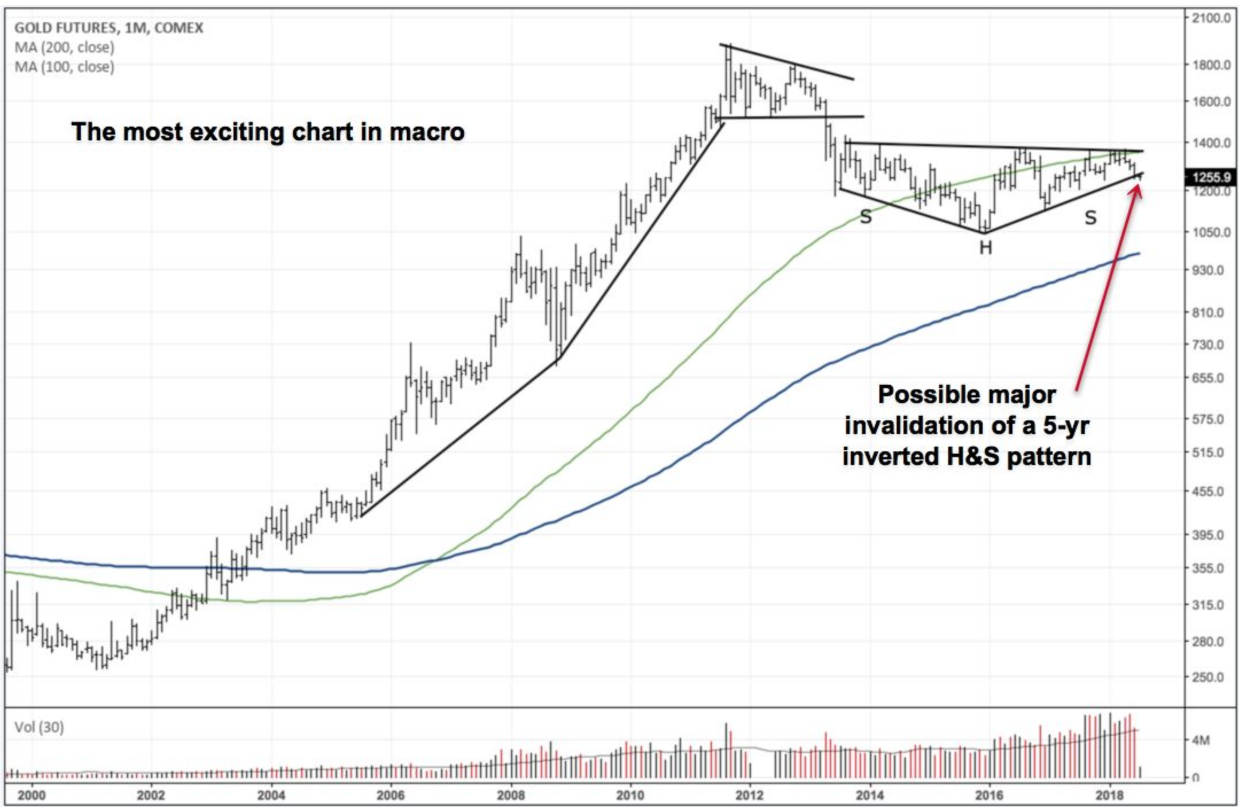
Summary

- ➢ China is clearly carrying out a Chinese-style deleveraging. They're likely to continue into the foreseeable future. This deceleration will start showing up in global growth more and more in the coming months.
- ➢ The Fed is no longer working for us. Late cycle tight capacity, a strengthening US economy, and a tight labor market leave the Fed little room to ease and if anything the risk is now greater we see more hawkish policy surprises.
- ➢ We've hit peak liquidity this cycle. The double whammy of QT + a larger deficit is going to soak up global dollars. These are dollars that won't be going to funding EM debt.
- ➢ Global growth outside the US is slowing and should continue to do so in the coming quarters according to our leading indicators.
- ➢ Everything is setting up for continued US outperformance versus the ROW. This will attract more capital flows and drive the dollar higher, causing more volatility in emerging markets.
- ➢ Considering the above, we need to stay the course in our current positioning until the data suggests otherwise.
- ➢ The primary threat to our macro thesis would be a significant policy reversal by the Chinese. We see this as unlikely in the near-term but will have to keep a close eye on the data just in case.

Update on our short gold trade...

We've been short gold since April and have since added to the position, which has so far worked out well for us.

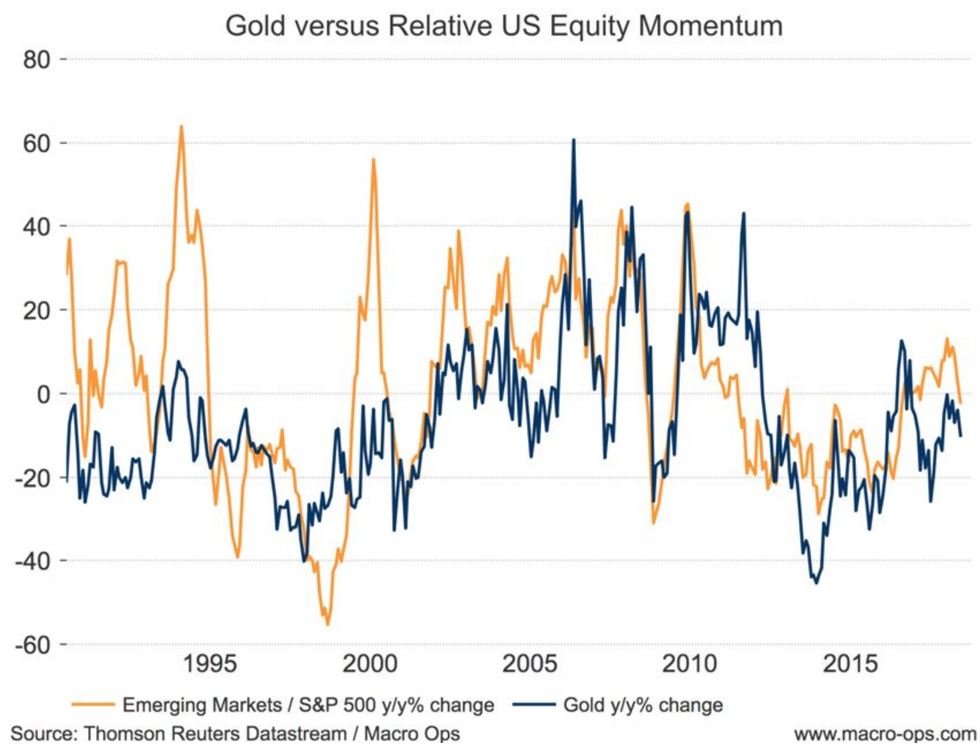
The precious metal is now at a major inflection point. It recently broke below its 5-year inverted H&S pattern (chart below is a monthly). If it doesn't reverse here then that'll spell big technical trouble for the barbarous relic.



I think this is the most exciting chart in macro right now. This is because gold is often a tell for the other major macro instruments; meaning it has a tendency to lead the dollar, rates, and relative US vs. ROW outperformance.

Gold is interesting because it acts as a barometer of global relative demand for $1 USD in earnings. This means that gold rises when investors would rather hold foreign assets relative to US assets and gold does poorly when US investors are willing to pay a higher premium for USD assets.

We can see this relationship in the relative equity momentum between US and EM stocks on the chart below. When US stocks outperform, gold falls. And vice-versa when EM stocks outperform.



You can overlay gold on a cape-shiller PE chart for the S&P and see that they mirror each other. When gold moves lower the cape moves higher. So much of macro goes back to our core/periphery model and gold is no different.

And since we still believe that US markets will outperform EM into the end of the year it then makes sense to be short gold.

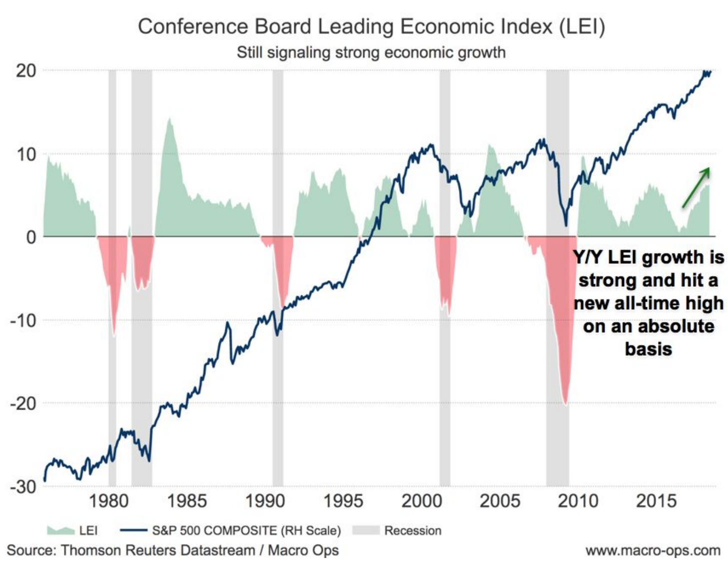
Furthermore, our gold and 5yr inverted TIPs chart that we shared with you a few MIRs back, still shows a giant gap that needs to close — we expect gold to do most of the work.

The next two weeks will be decisive. Either gold reverses hard and we liquidate our position (and perhaps go long) or gold consolidates before another major break lower below its 200-week moving average (blue line). If that happens then it'll probably fall all the way to its next major support at $1,100.

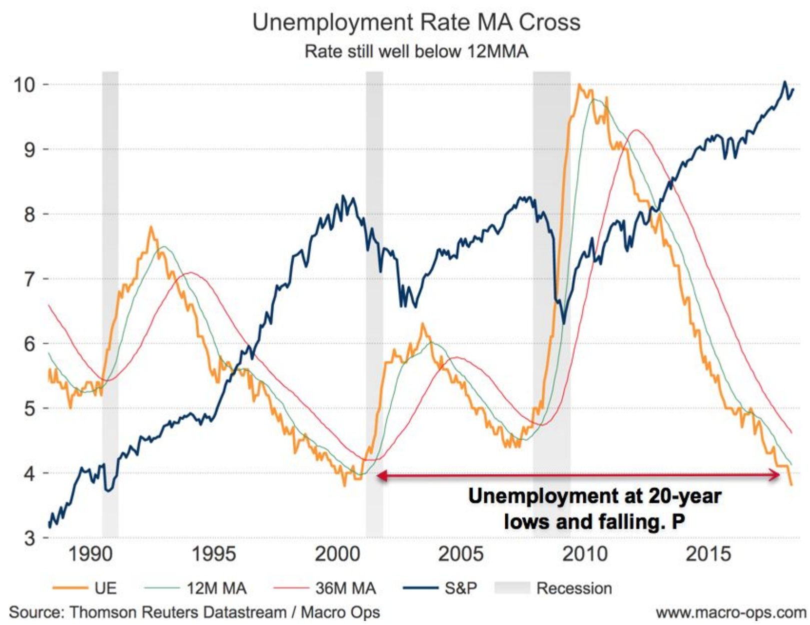
Intermediate US Macro Overview

- **Liquidity:** US liquidity is near cycle highs (meaning, it's extremely loose). This is bullish for US stocks and should prevent emerging markets from going into full-blown crisis mode. This indicator will turn over well before this bull market ends.

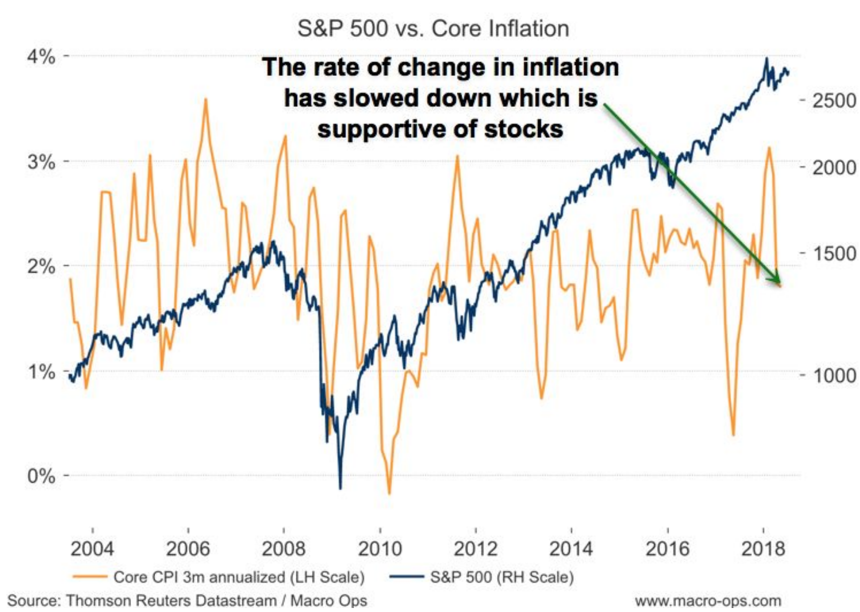
- **LEI:** The Conference Board LEI, which tracks a basket of US economic indicators, is still in a strong uptrend on both an absolute and YoY basis. This indicator will roll over well before we enter a recession.



❖ **Unemployment Rate MA Cross:** The unemployment rate is near a 20-year low and falling. It remains well below both its 12 and 36 month moving averages. It will cross over both before a recession.

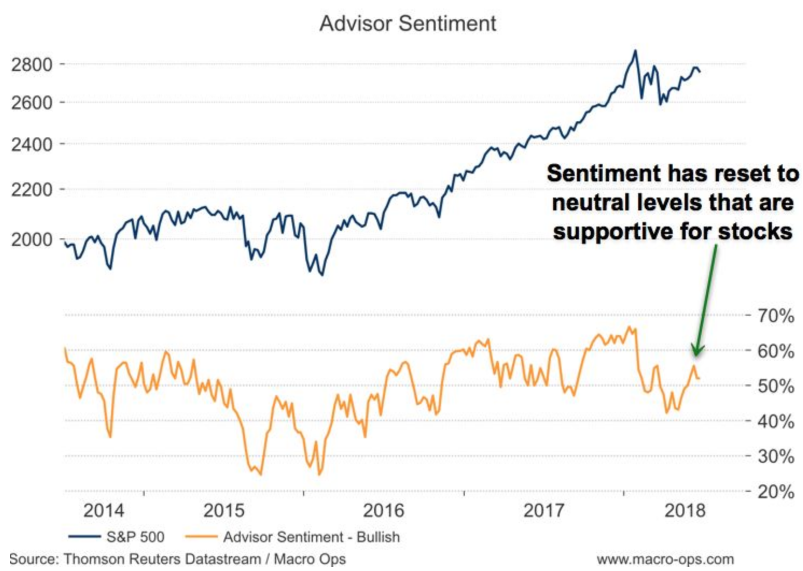


❖ **Inflation ROC:** 3-month annualized core inflation has come down from its Jan/Feb highs which sent interest rates shooting up. A slower change in inflation eases pressure on yields and is supportive of stocks.

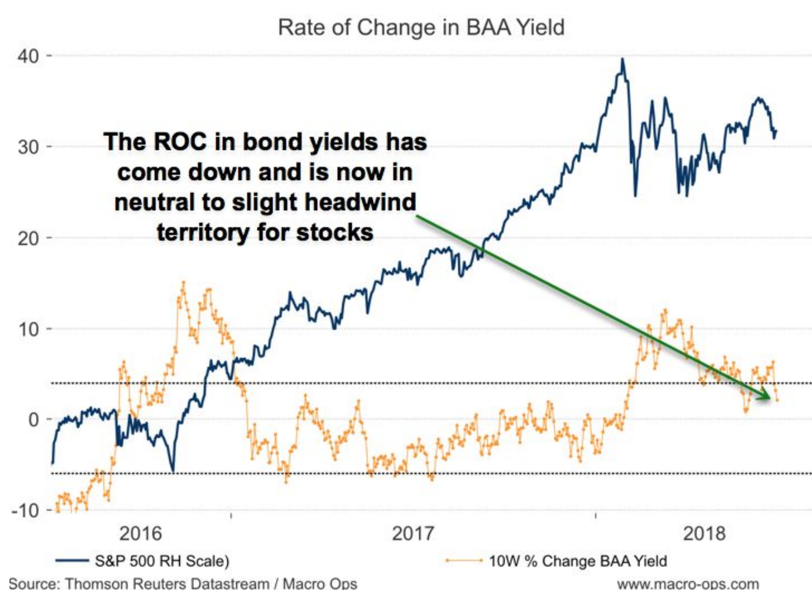


Short-term US Market Overview

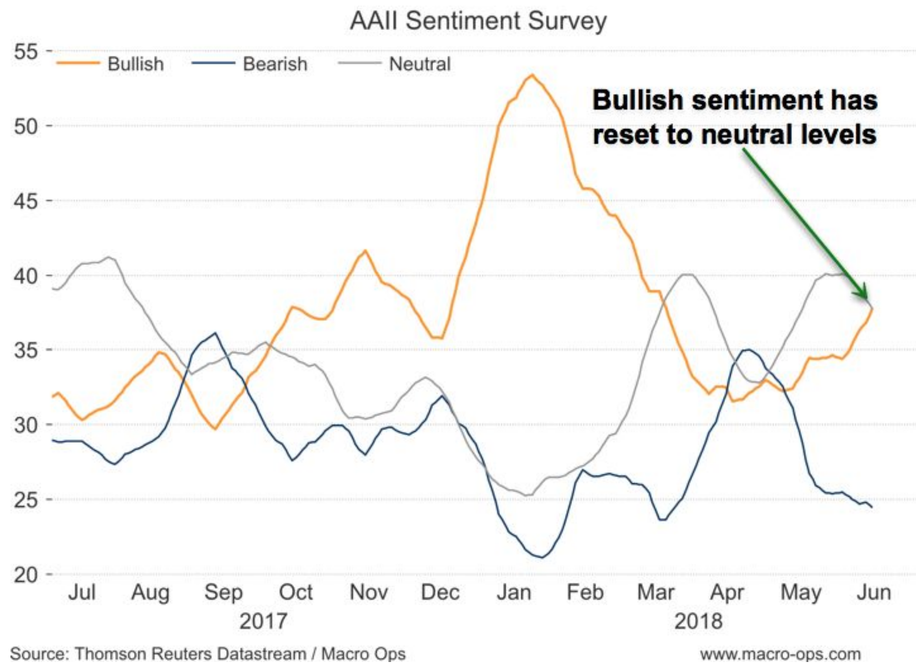
- **Advisor Sentiment:** Advisor sentiment has reset from its excessive bullish Jan/Feb highs and is now neutral. This is supportive of stocks.



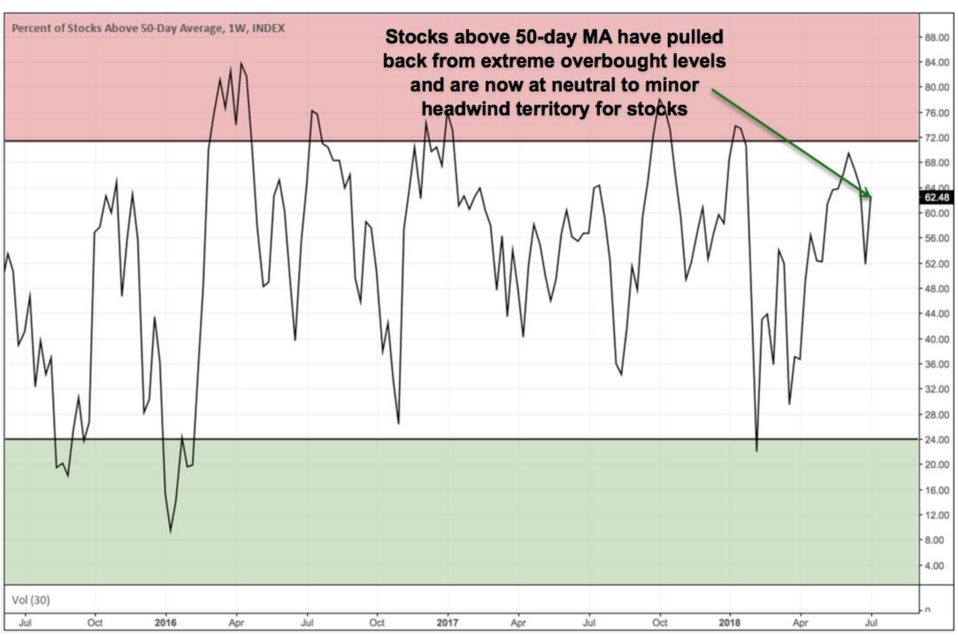
- **BAA Yield ROC:** The rate of change in yields has come down from its highs reached earlier in the year. This indicator is in neutral to slight headwind territory for stocks.



❖ **AAII Sentiment Survey:** AAII Bullish sentiment has completely reset since the beginning of the year and is now supportive of stocks moving higher.



❖ **S&P 50-day MA Spread:** The percentage of stocks above their 50-day moving averages has come down from overbought levels. It's now in neutral to slightly overbought territory and is overall bullish for stocks.



Summary: The US economy is strong and growth is accelerating. All our leading economic indicators are giving positive readings making the odds of a recession in the next 12-months extremely low. Liquidity is flush which is supportive of the broader trend higher in stocks. Market sentiment has reset from its highs reached at the start of the year. The primary trend higher in US stocks is supported by the data.

The developing trade war is currently more newsworthy than anything meaningful to markets. This could change but as of right now it’s best to focus on the hard fundamentals and technicals of the market.

Over the short-term the fundamentals are supportive of a move higher in stocks. The ROC in yields and inflation has come down, plus sentiment has fully reset. The technicals for the US stock market seem to confirm this and we should expect stocks to continue to brush off trade-war fears and run higher from here.

Micro: Stitch Fix (SFIX)

Company Summary: StitchFix (SFIX) is an online subscription fashion retailer that went public last December. The way the service works is you sign up for a delivery frequency of your choosing (usually every 1-3 months) and SFIX sends you a box of five items ranging from shoes to shirts. These items are selected by a stylist who is assisted by SFIX's data analytics which track yours and others trending style preferences. The company is partnered with most of the upper end leading brands from Nike to Nordstrom. The stock has a market cap of $2.5B and trades at 2x sales.

What is the market pricing?: SFIX is still relatively an under the radar tech stock. The biggest concerns over the company's future are centered around their ability to compete with Amazon (AMZN). AMZN recently started a similar service called Amazon Wardrobe and the market is of course latched onto the threat of this.

Our Variant Perception: There's room for multiple players in this space and concerns over the Amazon threat are misplaced. The primary reason is that AMZN and SFIX are going after different markets. AMZN is naturally focused on being the lowest cost competitor while SFIX is targeting higher end, fashion conscious shoppers. SFIX's CEO Katrina Lake noted the difference in a recent interview with Fast Company, saying:

> *You can't underestimate Amazon (AMZN). They've done a lot of amazing things. In retail, and in particular in apparel retail, they're extraordinarily good when you're looking for the cheapest and fastest X or Y. When you look at some of the brands that have been very successful at Amazon—its Essentials brand, Hanes, and Fruit of the Loom—these are categories where people already know what they want and they're looking for the cheapest price. Amazon is amazing at making that transaction happen in the most efficient way.*
>
> *But if you say, "Let me find a yellow dress. I'm going to a wedding in Mexico. I have a vision of myself wearing a flowy, yellow dress that's kind of fitted on the top but looser on the bottom." You can imagine these things that you would want to buy, and the tools that are available to you in e-commerce today—it's very hard to find those things that would be right for you and your body. We're focused on a very different value proposition, which is not, what's the cheapest and fastest? It's, how do I get the things that are right for me and my style and my body?*

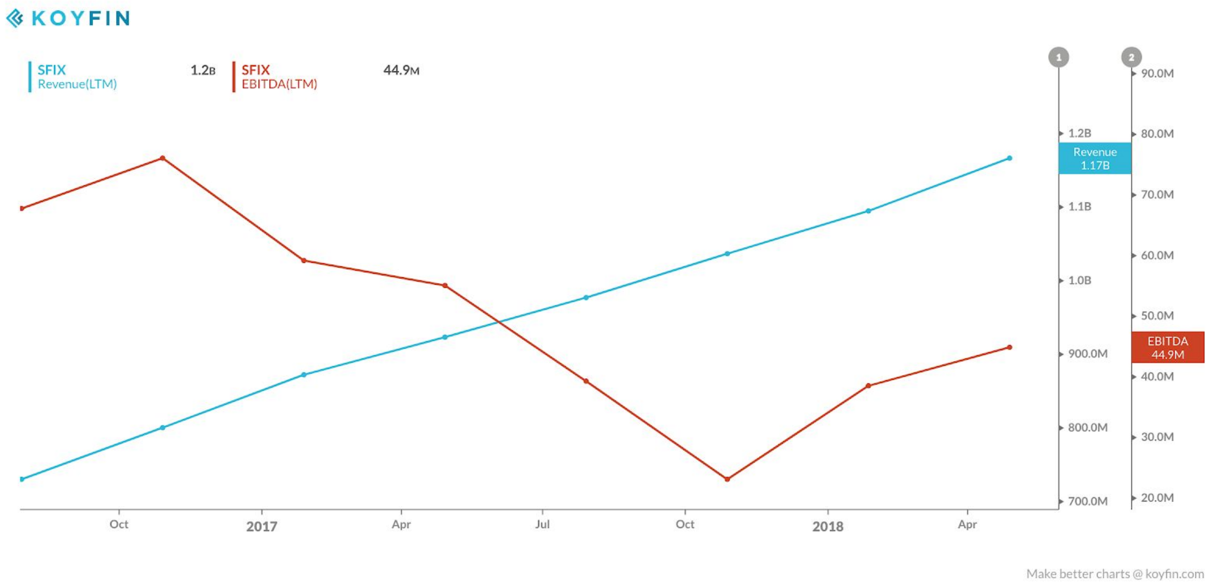
Amazon's service doesn't use personal stylist, the shopper has to go through and select what they want. So it's not a curated shopping experience. It's a "try on at home" shipping service.

My wife started using SFIX at the beginning of the year. She signed up because two of her friends are using it and they're die-hard fans. She then signed me up because I wear clothes from over 10-years ago and refuse to step foot in a mall. And though I have absolutely no interest in fashion, I have to say that I've been impressed with the service. Everything fits perfectly (which isn't easy for me to find) and it's all really high quality comfortable stuff.

This past week I was at a wedding and I went around doing an informal pole to see who else is using it. And I was surprised by the number of people who said either they were signed up, were planning on signing up, or knew people who were really happy with the service — it was probably close to a quarter of the people that I talked to.

This is hardly scientific but I have found this type of intel gathering to be useful, especially when researching retail trends. It's how I came across Crocs shoes (CROX) in 06', which ended up being a great stock (for a while at least).

The numbers seem to add some quantitative backing to our informal survey. SFIX grew revenues at roughly 30% yoy last quarter, bringing in more than $316m. And what's even more impressive is that the company is already profitable, doing over $12m in adjusted EBITDA in the third quarter.



They've been able to reach profitability so early because they limit their ad-spend, relying largely on word of mouth for customer acquisition.

Their active client base reached 2.7m in April, up 30% from the year before. And the company recently rolled out new offerings that should accelerate this growth. Some of these include a new Plus-sized service, as well as a Stitch Fix for Kids.

Returning to the AMZN threat… I put out a bullish pitch on the online arts and crafts retailer Etsy last year when the stock was trading around $13 a share. My inbox was soon flooded with emails telling me how wrong I was and how AMZN — who had recently launched a competing site called Handmade — was going to eat ETSY's lunch and leave nothing in its wake.

Now, these critics may be right one day. I don't know. But I do know that ETSY is up 250% in the 12-months since I put out that call.

Amazon is a great company, but they won't become the entire US economy. Sometimes there's a great advantage for companies that focus on a single niche and do it better than anyone else — even Bezos.

I think SFIX is a similar setup to ETSY. At $32 a share we get a high growth underfollowed tech company with a solid balance sheet for only 2x sales. The company has a loyal and quickly expanding user base — which should accelerate in the coming quarters following the company's expanded offerings.