A Chinese About-Face

It looks like China may be folding…

We've talked all year about how China is *THE* largest driver of markets this cycle and their deleveraging was the force behind the widening performance gap between the US and the rest of the world.

The continuation of this trend has been dependent on China's willingness to stay the course and press on with much needed financial and economic reform. A reversal of policy would be seen as a failure and a direct hit to Xi's credibility.

Cue recent reports indicating the CCP can't take the heat and has decided to ease once again. Here's Bloomberg on China's policy U-turn (emphasis by me).

> *China unveiled a package of policies to boost domestic demand as trade tensions threaten to worsen the nation's economic slowdown, sending stocks higher.*
>
> ***From a tax cut aimed at fostering research spending to special bonds for infrastructure investment****, the measures announced late Monday following a meeting of the State Council in Beijing are intended to form a more flexible response to "external uncertainties" than had been implied by budget tightening already in place for this year.*
>
> ***Fiscal policy should now be "more proactive" and better coordinated with financial policy, according to the statement -- a signal that the finance ministry will step up its contribution to supporting growth alongside the central bank****. The People's Bank of China has cut reserve ratios three times this year and unveiled a range of measures for the private sector and small businesses.*
>
> ***"It is now quite clear that Beijing has fully shifted its policy stance from the original deleveraging towards fiscal stimulus that will be underpinned by monetary and credit easing,"*** *said Lu Ting, chief China economist at Nomura Holdings Inc. in Hong Kong.*

China's State Council plans to raise local government spending by roughly 1.35 trillion yuan (roughly US$200b) to be spent primarily on infrastructure this year.

And the tax cuts aimed at boosting consumer spending are equivalent in size to the tax cuts passed last year in the US — not an insignificant amount.

Why has China decided to backpedal on what was one of Xi's and the Party's top stated goals last year?

It seems there's increasing fear at the top of losing control of the economy and this fear is being exacerbated by the escalating trade war. Chinese State media recently warned that China's judiciary should prepare itself for a possible spike in corporate bankruptcy cases as a result of the trade dispute with the US.

The South China Morning Post (SCMP) recently shared the following (emphasis mine):

> *In an opinion piece published on Wednesday by People's Court Daily, Du Wanhua, deputy director of an advisory committee to the Supreme People's Court, said that courts needed to be aware of the potential harm the tariff row could cause.*
>
> *"It's hard to predict how this trade war will develop and to what extent," he said. "But one thing is sure: if the US imposes tariffs on Chinese imports following an order of US$60 billion yuan, US$200 billion yuan, or even US$500 billion, many Chinese companies will go bankrupt."*
>
> *As Chinese courts have yet to have any involvement in the trade dispute, **the fact that the newspaper of the nation's top court, ran an opinion piece – for a judiciary-only readership – suggests concerns might be rising in Beijing about the possible socioeconomic implications of the row**.*

There's also been a number of reports (so far, unverified) over the last few weeks of serious trouble brewing within the party. Geopolitical Futures recently shared this.

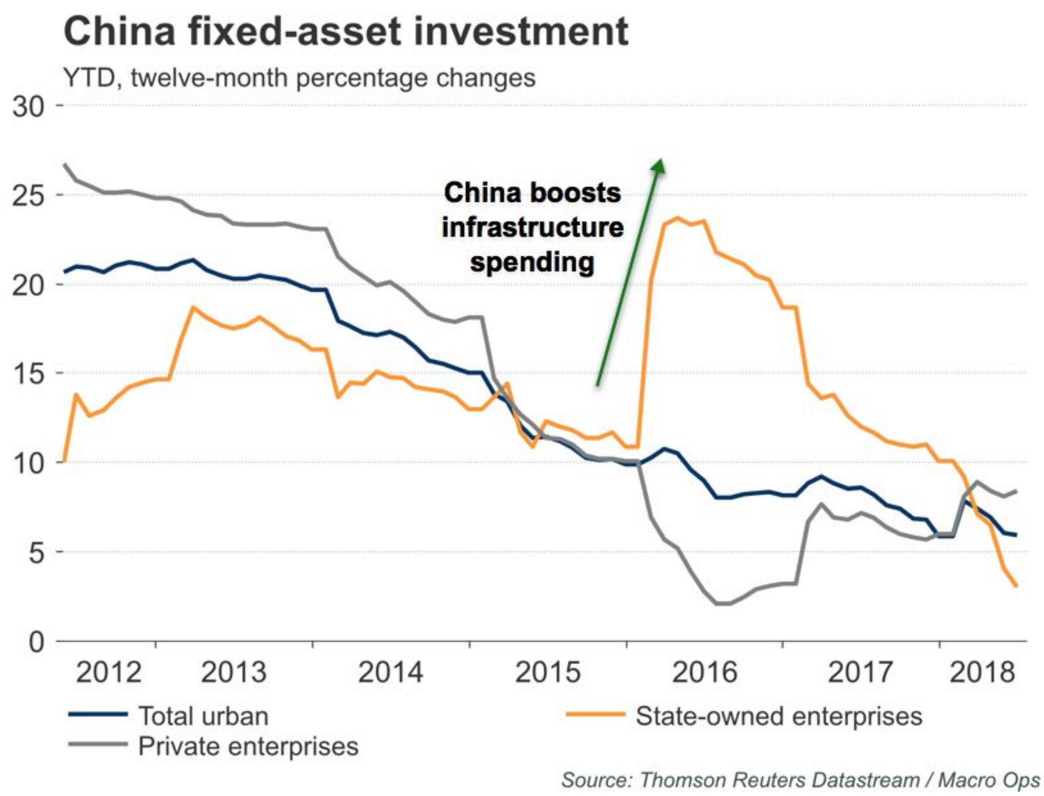
> *Last Friday, online reports indicated that gunfire had been heard for roughly 40 minutes in Beijing near the Second Ring Road. The reports claimed it was a violent spasm by groups that sought to overthrow Chinese President Xi Jinping. The following day, French public radio reported it had heard rumors that former Chinese leaders, including Jiang Zemin and Hu Jintao, had allied with other disgruntled Chinese officials in an attempt to force Xi to step down. A Hong Kong tabloid went so far as to suggest that Wang Yang, chairman of the Chinese People's Political Consultative Conference, might be the compromise leader next in line.*

It's impossible for us to know if there's any truth to these rumors (China keeps a tight lid on these types of things) but just the fact that they're circulating are indication of growing unease with the state of the Chinese economy. And it may be why we're seeing this policy 180 by the CCP.

We also don't know if this easing will be enough to reverse the negative trends kicked into gear by the initial deleveraging nor do we know how long and aggressive the CCP will be in this round of easing. All we know for sure is that however they choose to carry out policy will continue to have an outsized impact on markets and the global economy.

For our part, we just have to keep a close eye on the data and change up our positioning to account for the new uncertainty created by this shift back to easing.

Two important data points we'll want to watch in order to gauge the scale of the current easing response are fixed asset investment (ie, infrastructure spending) and China's M1 money supply (which has a close leading correlation to changes in industrial metal pricing).



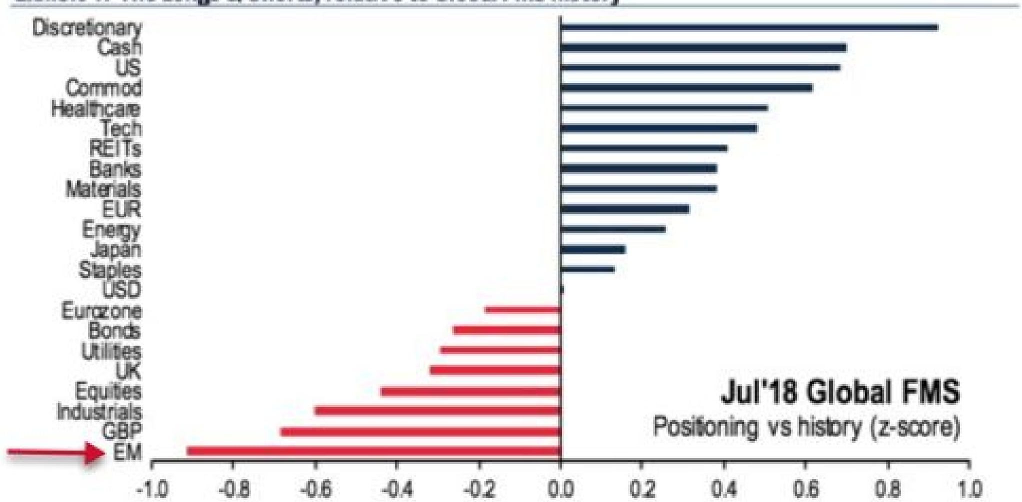
How to trade this?

Last week we talked about how the relative equity momentum between the US and emerging markets had grown overextended in the short-term and that it's now odds on we'll see a period of EM outperformance. Here's that chart again showing the spread between SPY/EEM and the 50dma. The red horizontal lines mark points where the spread has become stretched to the upside.

If the Chinese policy response proves to be significant, which it looks like it is, this should put a strong floor under EM assets which have been hit hard since the start of the year.

On top of that, sentiment and positioning have strongly reversed in EM over the last six months to where buying EM is now a contrarian play. Look at positioning data from BofAML's latest Fund Manager Survey showing that long EM has become an extremely unpopular trade.

Exhibit 1: The Longs & Shorts, relative to Global FMS history*



Source: BofA Merrill Lynch Global Fund Manager Survey. *data since 2006 for commodities & real estate; since 2001 for everything else

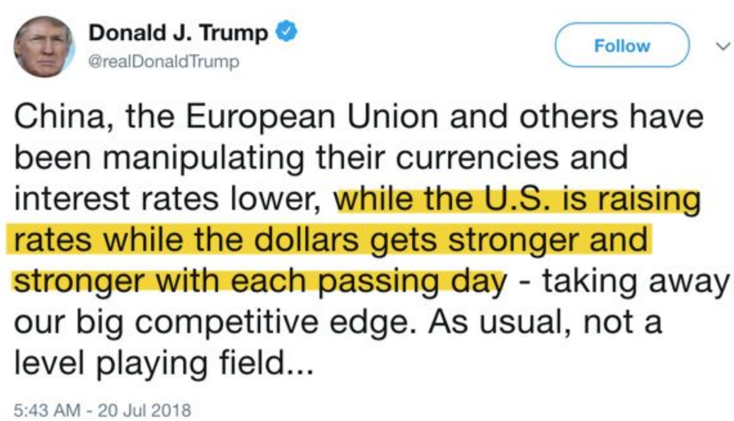
And fund managers are holding their first net short positions in EM stocks since the start of 17'. And we all know how EM performed over the subsequent year.

Our July Fund Manager Survey says...

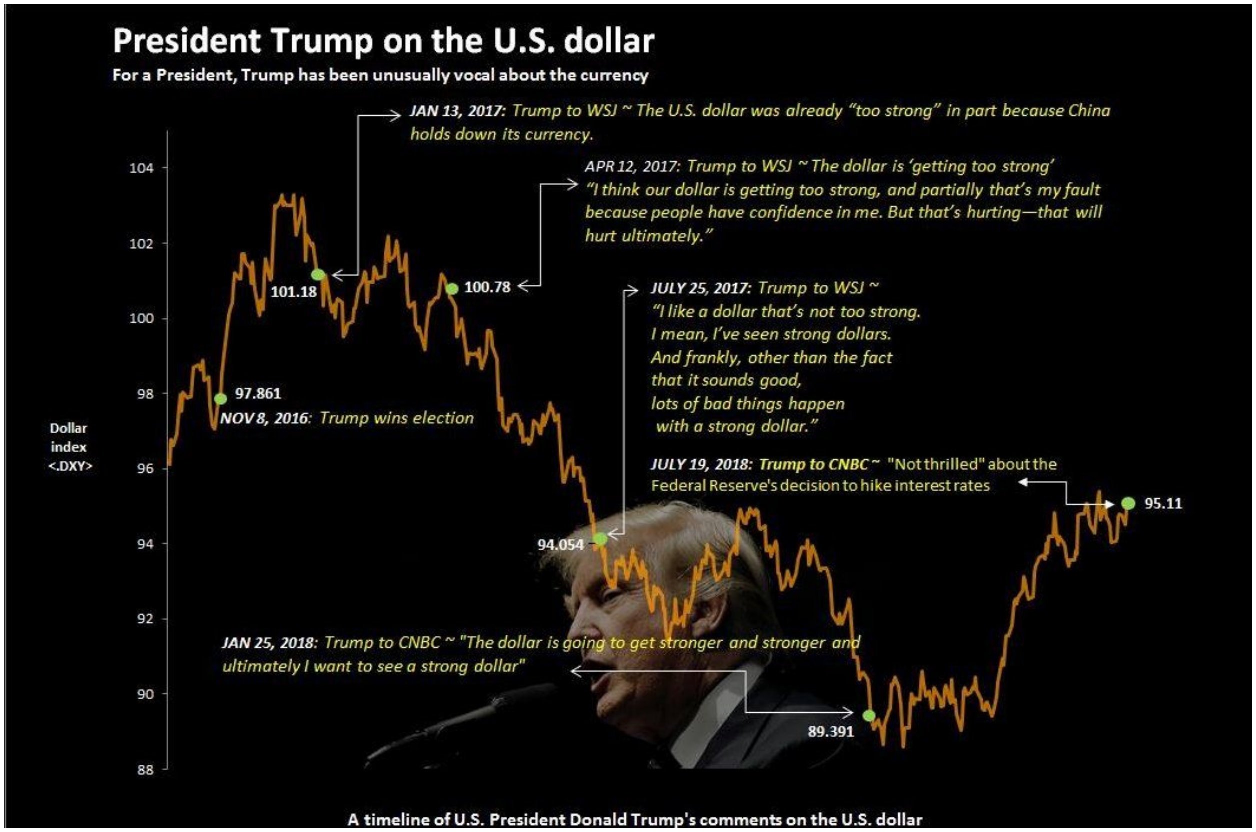
- ..."trade war" now seen as biggest tail risk to markets since 2012 EU debt crisis.
- ...sentiment bearish as growth & profit expectations plunge to Feb'16 lows, equity allocations lowest since Nov'16, forecast of yield curve steepening at 8-year low.
- ...July cash levels dip to 4.7% from 4.8%, still high, leaves BofAML Bull & Bear Indicator @ 2.3, i.e. close to "extreme bearish" contrarian buy signal.
- ...bearish investors ditched "value" theme via their first "short" of EM stocks since Jan'17, smallest Eurozone "long" since Dec'16, and biggest drop in global bank exposure in 2½ years; note FMS demands for corporate deleveraging hit 9-year high.

Investors withdrew a 4-year record amount of capital from world ETFs (excl. US) indicating widespread pessimism.

And for the icing on the cake, last week Trump tweeted that he's not happy with rising interest rates and a stronger dollar.



He then went on CNBC and talked about how he wants the Fed to ease up on hiking interest rates, sparking debate about concerns over the independence of Fed policy. The chart below, shows how Trump's comments on the dollar and Fed policy have coincided with inflection points in the dollar.



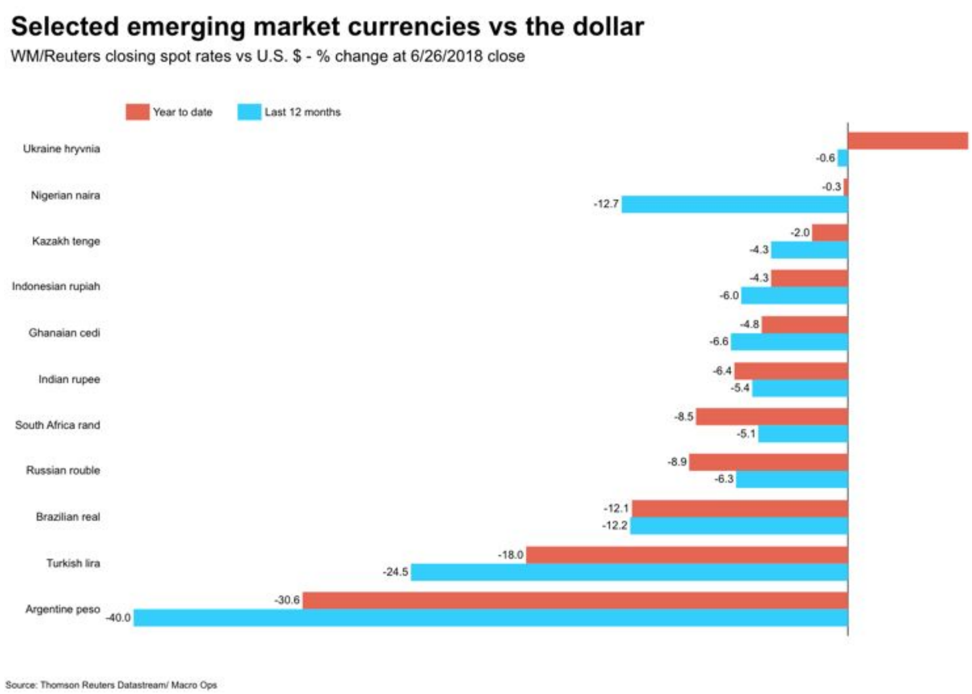
Put it all together and we have:

- ❖ Indications of a major Chinese policy reversal from tightening to easing.
- ❖ Technically stretched US/EM equity outperformance now favoring EM stocks over next few months.
- ❖ Consensus pessimism and positioning in EM assets.
- ❖ President Trump trying to talk down the dollar and putting Fed independence in question.

We want to see more data come in that gives credence to the Chinese policy reversal and which shows its scale before we get too aggressive in positioning to play this theme. But there's a number of attractive stocks that we can start building positions in now and which should do extremely well if we see a sustained bounce in EM equities.

My favorite EM country at the moment is Argentina which has been clobbered since the start of the year. The Global MSCI Argentina etf (ARGT) fell over 30% from its February highs.

Tightening global liquidity driven by China and the Fed caused massive outflows out of EM stocks, which in turn killed their currencies and sparked a short-lived feedback loop.



In response, Argentina had to turn to the IMF for emergency financing which resulted in the IMF giving them a bailout deal worth $50B — the largest in the IMF's history.

But now the country is on much firmer footing. The Argentine President Mauricio Macri remains a pro-business / pro-market force and continues to clean up the mess left after years of mismanagement by his predecessors.

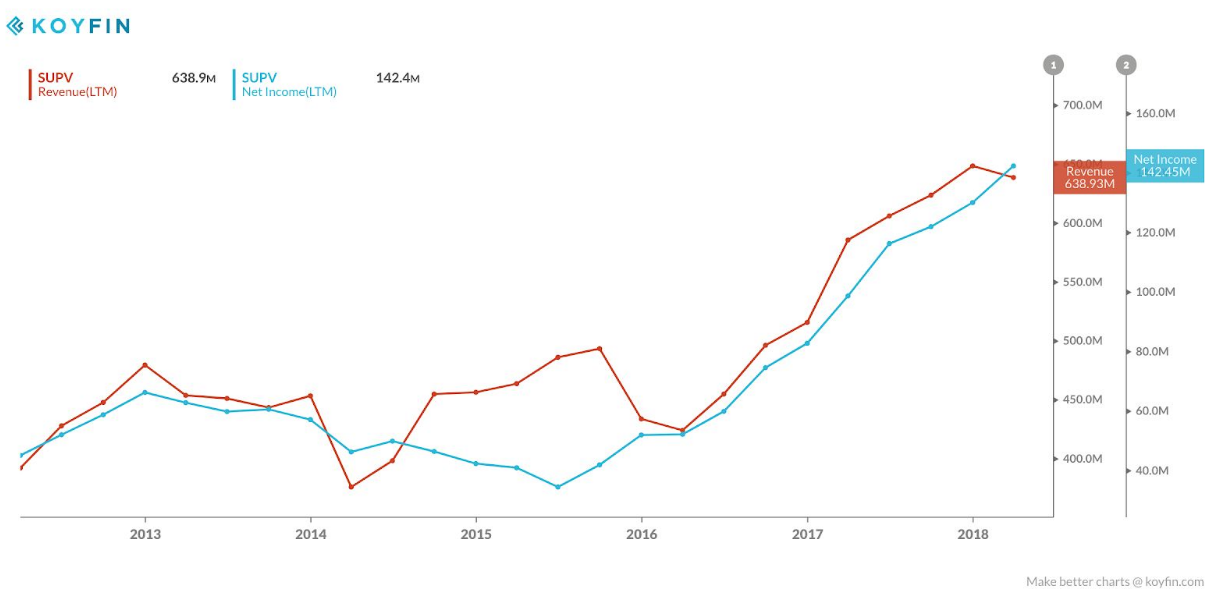
Luis Caputo, previously the finance minister, was recently picked to replace Federico Sturzenegger as head of the country's central bank. Caputo is a former banker and portfolio manager and should help boost investor confidence in the future management of the peso .

Plus, just last month the index provider MSCI promoted Argentina to its flagship emerging market index. In the past, index inclusions like this have led to large equity inflows and a period of outperformance. Morgan Stanley estimates that the MSCI upgrade will lead to $3.4B in net inflows to Argentine stocks, saying "Historically local stocks on average tend to outperform their emerging markets peers by almost 15% during the 12-month period from the inclusion announcement to 6-months after implementation."

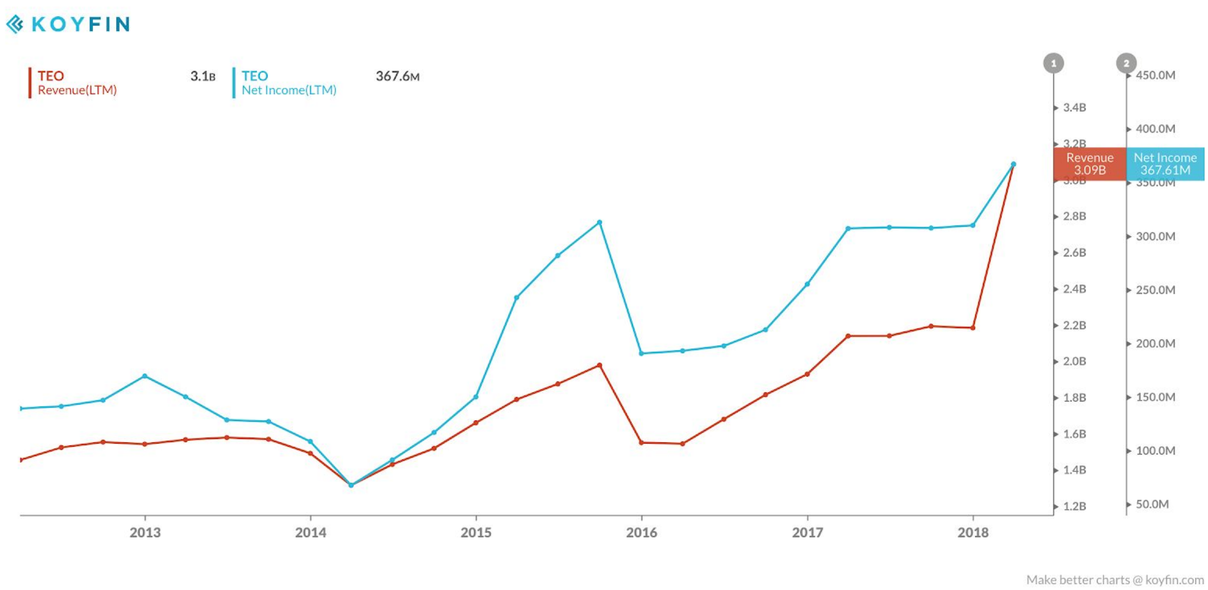
There's a number of Argentine stocks available to trade as ADRs that are selling at discount prices right now. And the technicals look great.

Two of my favorites are Grupo Supervielle S.A. (SUPV) and Telecom Argentina (TEO).

SUPV is a bank that's grown revenues close to 50% over just the last two years and trades at under 6x next year's earnings. The chart looks like it's putting in a textbook bottom.



TEO is a large telecommunications operator in the region. The company has averaged 25% annual revenue growth over the last 5-years and trades at just 13x next year's earnings.



We'll be putting on small starter positions in both stocks this week. And we'll add on further technical strength and data confirmation of Chinese easing.

Portfolio Update

Google (GOOGL) announced earnings yesterday and beat the most positive analyst estimates. The stock is now trading at new all-time highs.

Google continues to be one of my favorite positions and we'll probably soon add some DOTM calls to give it additional leverage.

It continues to surprise me how consensus anti-FANG the market is. If you think Google is a value play you're widely derided for being naive.

Yet, Google has one of the most dominant moats in history (according to Charlie Munger). It has consistently grown revenues over 20% a year since inception. After adjusting for the $103B of cash on the company's balance sheet, as well as the big investments it's making (think Waymo and AI), the stock trades at only 16x next year's earnings… and it's growing its intrinsic value per share in the mid to high teens every year!

That's crazy…

Like we wrote in our [May MIR *Gradatim Ferociter*](), I think most people are scared off by the scale of the company's growth and the length of its bullish trend and just think "no way it can keep going up." Their analysis of the company doesn't get past this bias and so remains extremely superficial. The same with Facebook (FB) which reports earnings later today and which we expect will have similarly impressive results.

Dollar and Gold

In light of the recent macro developments we are moving up our stops on our short gold and long dollar positions.

For gold, we'll look to take profits on the entire position should price close above this week's high.

And we'll take profits on our long dollar futures trade should price break below this consolidation zone. My longer-term bias is to be bullish the dollar and I see a move lower here as being corrective in nature, with the expectations it'll last for a few weeks to a couple of months. We'll retain our dollar DOTM calls.

As for the broader market, the path of least resistance remains up. But we should continue to expect higher volatility and a widening disparity between asset returns (US small caps look vulnerable here). An important thing to watch this week will be the advanced US GDP numbers that come out on Friday. I'm expecting a stronger than consensus print which would impact bonds and the dollar.

That's all I've got for this week. Hit me up in the CC if you've got any questions.

Your Macro Operator,

Alex

Macro Ops Portfolio			YTD	Inception (16')			
NAV	$3,014,603		11.51%	49.72%			
Big Bet Macro							
Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target	Last Price
Equity	JD.com JD	6,187	$39.10	$35.50	$2,908	$70.00	$35.97
Equity	Discovery DISCA	3,450	$28.09	$23.80	$9,039	$60.00	$26.42
Equity	Stitch Fix SFIX	1,750	$32.96	$25.50	$12,863	$60.00	$32.85
Equity	Advanced Micro AMD	14,818	$14.84	$11.50	$73,794	$25.00	$16.48
Equity	United Insurance UIHC	13,000	$16.98	$17.45	$34,060	$20.00	$20.07
Equity	Facebook FB	1,775	$179.99	$165.00	$88,768	$230.00	$215.01
Equity	Google GOOGL	332	$1,073.37	$992.00	$89,969	$1,400.00	$1,262.99
Equity	Disney DIS	5,694	$102.34	$95.00	$94,008	$150.00	$111.51
Equity	Yatra Online YTRA	36,819	$7.24	Investment	~	$15.00	$6.21
Equity	MU Jan '19 70 Call	118	$2.12	$0.00	$35,990	$10.50	$3.05
Equity	FB Jan '19 260 Call	35	$2.59	$0.00	$12,775	$20.00	$3.65
Equity	AMD Jan '19 28 Call	192	$0.40	$0.00	$6,912	$3.90	$0.36
Equity	BCS Jan '19 15 Call	574	$0.35	$0.00	$8,610	$3.50	$0.15
Equity	DB Jan '19 30 Call	670	$0.30	$0.00	$1,340	$3.00	$0.02
Equity	CCJ Jan '19 17 Call	236	$0.41	$0.00	$2,360	$5.00	$0.10
Equity	FCAU Jan '19 25 Call	108	$0.90	$0.00	$7,020	$5.00	$0.65
Equity	JD Jan '19 70 Call	108	$0.92	$0.00	$4,212	$7.00	$0.39
Equity	TRIP Jan '19 75 Call	108	$0.89	$0.00	$21,600	$7.00	$2.00
Equity	CHK Jan'19 10 Call	750	$0.14	$0.00	$14,250	$1.00	$0.19
FX	UUP Jan'19 27 Call	1,230	$0.13	$0.00	$18,450	$1.20	$0.15
Commodity	Sep Crude Oil Futures	-3	$67.17	$71.00	$7,020	$60.00	$68.66
FX	Sep Dollar Futures (DXU8)	20	$94.44	$89.80	$88,000	$96.00	$94.20
Metals	Aug Gold Futures (GCQ8)	-4	$1,300.6	$1,350	$43,000	$1,250	$1,242.50
Metals	Sep Gold Futures (GCU8)	-5	$1,230.4	$1,247.8	$8,200	$1,110	$1,231.40
Volatility							
Asset Class	Position	Size	Cost Basis	Risk Point	Open Risk	Target	Last Price
Commodity	GLD Sep 2018 128 Straddle	24	$15.10	$0.00	$24,432.00	$30.00	$10.18