MARKET BRIEF

Macro Ops Collective

Trade War Hype

We've got a lot to cover in this week's Brief so let's just dive right in.

First off: Trade Wars… And then we'll run through some charts and discuss a few trades we're looking at.

We haven't talked much about the budding "trade war" between the US and, well, pretty much everybody else…

There's a simple reason for this, it hasn't been a primary driver of price action and it's unlikely to become one in the next few months. Despite all the hoopla and hysteria of the financial journos who lazily apply the frightening "trade war" narrative to explain market moves they don't understand, it's still the rate of change in interest rates, inflation, a slowing China + a strong US, combined with a resetting of sentiment that is driving price action.

But… this trade war could *eventually* become something that impacts markets. Our thinking with these political developments is that they tend to be slow burning. Meaning, when the narrative first develops the media and talking heads make a big deal out of something that hasn't truly materialized in any meaningful way — **the hype far outweighs the substantive impact.**

Then time passes… the narrative grows stale and the initial excitement fades away as predictions of immediate doom and gloom fail to transpier. The media cycle turns — the media and consumers of it have short attention spans and need new stories to spark their dopamine responses — and focuses on another scary thing while the original narrative continues to develop, just now without much attention.

It is only then that these developments usually become meaningful to markets. **They take so long to develop that when they do, hardly anybody is paying much attention.** As a result, the market fails to discount for them because it's focused on something else. The development comes as a surprise and surprises mean volatile repricings.

This is true whether we're talking about the extremely slooooowwwww dissolution of the European Union, Brexit, or budding trade wars and the general trend towards more closed borders.

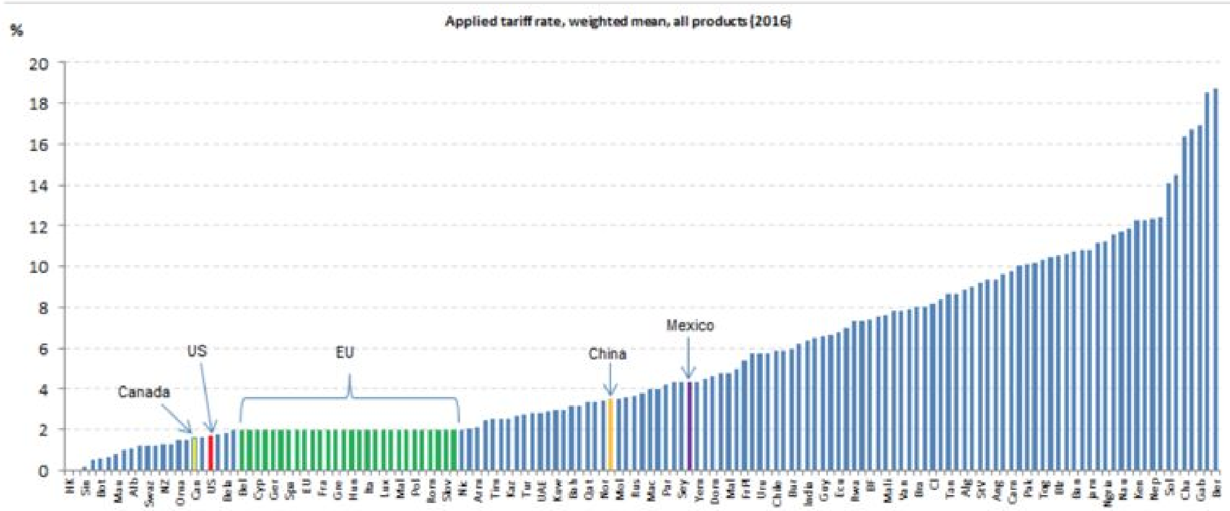
We're still in the hype phase of this trade war narrative cycle.

Our baseline assumption has been that the US is making a lot of noise but will work to make a deal with both China and Europe before things spiral out of control. But this narrative cycle is maturing and some meaningful developments have recently occured which up the probabilities of this trade war becoming a significant driver of price action.
Let’s discuss...

The US has one of the lowest weighted average tariff levels in the world (see chart below). But this can be somewhat misleading when it comes to measuring fair and open trade. This is because tariffs are far from the only tool government’s use to protect domestic industries and the special interest groups that elect them.

There’s also direct government subsidies, favorable tax and regulation policy, and informal rules and practices where the government clearly favors domestic over foreign producers — not to mention outright theft of IP *cough* China *cough*.

Figure 2: Applied tariff rate (weighted mean across all products) – 147 countries



Source: World Bank [Weighted mean applied tariff is the average of effectively applied rates weighted by the product import shares corresponding to each partner country. Data are classified using the Harmonized System of trade at the six- or eight-digit level. Tariff line data were matched to Standard International Trade Classification (SITC) revision 3 codes to define commodity groups and import weights. To the extent possible, specific rates have been converted to their ad valorem equivalent rates and have been included in the calculation of weighted mean tariffs. Import weights were calculated using the United Nations Statistics Division's Commodity Trade (Comtrade) database. Effectively applied tariff rates at the six- and eight-digit product level are averaged for products in each commodity group. When the effectively applied rate is unavailable, the most favored nation rate is used instead.]

For whatever reason, it seems that President Trump is laser focused on the US’s many trade deficits with countries like Germany, China, and Mexico amongst others. Unfortunately this is too simplistic of a take. **Trade deficits aren’t in and of themselves bad**; especially when the country has the world’s reserve currency. More importantly, because of the way national identity accounting works, a trade deficit resolved in one country will just pop up in another.

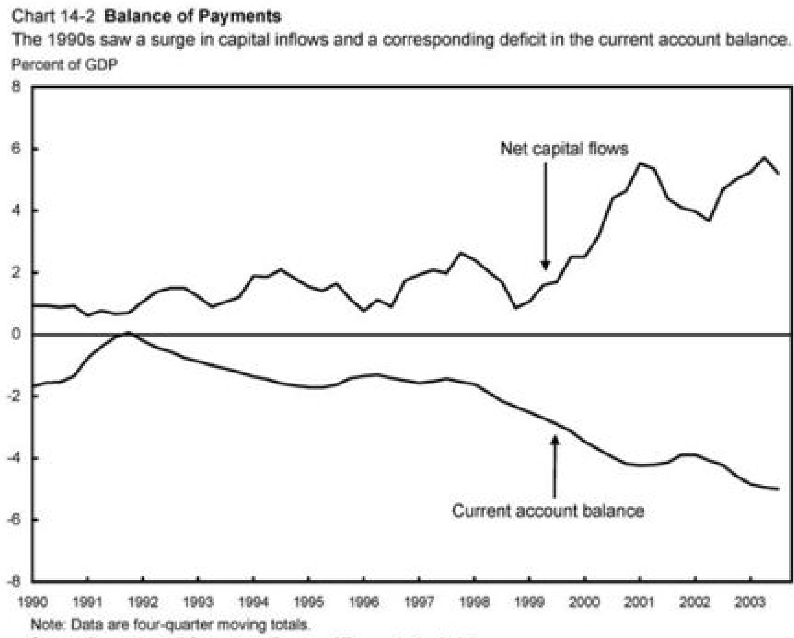
Here’s an excerpt from an article written by economist Michael Pettis where he explains why this is (emphasis by me and you can read the full piece here).

> *China should be able to rebalance its trade relationship with the U.S. relatively quickly by reorienting its purchases of industrial and agricultural commodities, along with some industrial products such as aircraft. As a large importer of commodities, it's easy enough for China simply to shift its buying from one country to another. Unfortunately,* ***any increase in U.S. exports to China will inevitably be matched by a reduction in U.S. exports to other countries.***
>
> *To understand why, we must understand the role of the U.S. in stabilizing global trade and capital imbalances. Under the current global system, the distribution of income in a number of countries — not just China, but also Germany, Japan, South Korea and several others — is distorted in favor of government and businesses rather than households.* ***This is because these economies effectively subsidize manufacturing exports with various hidden transfers from households, including low wages and low deposit rates. The household share of income is consequently too low for domestic demand to absorb everything produced domestically.***
>
> *Such distortions also lead to structurally high savings rates in these countries. Income can be consumed or it can be saved.* ***Households consume most of their income while governments and businesses typically save all or nearly all of theirs.*** *By giving the latter a disproportionately high share of income, and households a disproportionately low share, these countries automatically force up their savings rates.*
>
> ***The global economy, in other words, suffers from excess savings generated by a small group of high-surplus countries. The U.S. plays a stabilizing role by absorbing nearly half of this excess of global savings. That's not because the U.S. has any need for such huge amounts of foreign savings, but because it has completely open, deep and flexible capital markets.***

Hopefully, this isn't too much econo-speak.

All Michael is saying is that the balance of payments — which measures the economic interactions between two countries and is comprised of the current account (ie, trade) and the capital account (ie, financial flows) — has to eventually balance.

So a country like the US who runs a large current account (ie, trade) deficit needs to run an equally large capital account (investment) surplus or vice-versa. This is why the two move inversely to one another.

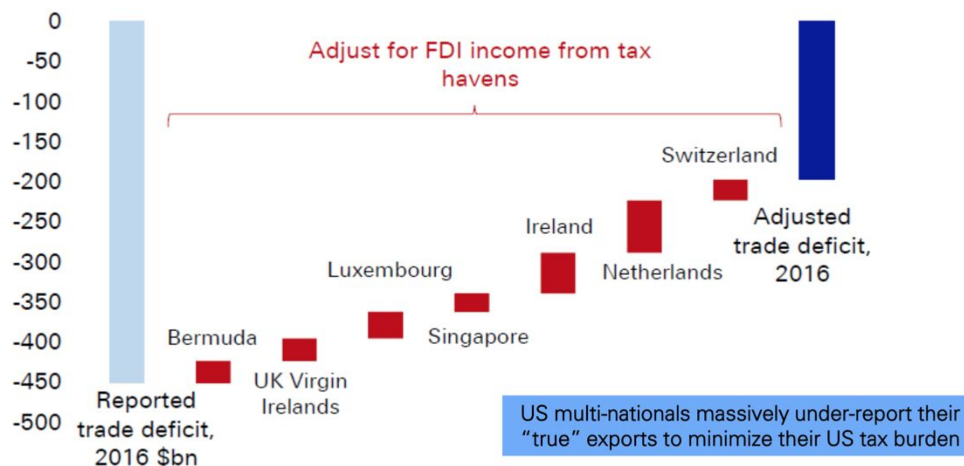


And because a number of countries labeled “exporters”, have high savings rates and **because government and corporations receive a larger share of national income and tend to save more than households —** it means these savings need to flow to a place where they can be invested. Since the US has the world’s deepest financial markets, it acts as natural magnet for these investment flows. And greater investment/capital account surpluses mean a larger corresponding trade deficit.

Make sense? Clear as mud?

Don’t worry if this reads as Swahili to you. Most don’t understand it, even the so-called “experts”. And more importantly, it doesn’t really matter to markets. All that you need to know is that trade deficits aren’t inherently bad and economics is complicated.

In fact, here’s a recent chart from Deutsche bank that shows the US trade deficit isn’t nearly as large as the numbers suggest. The reason being is what they call “tax shopping” which is where US multinationals vastly underreport exports so they can receive better tax treatment. I don’t know how true this is but it’s interesting and probably, at least, somewhat true.



In light of this, it's unfortunate the Trump administration is specifically targeting deficits when there are and have been substantial trade abuses carried out against the US. The worst offender by a wide mile is China.

China has taken advantage of the US, and Western countries in general, for nearly two decades. **And Western government and corporations have let them because they've been driven by myopia, wishful thinking, and greed.**

China's major trade offenses can be boiled down to the following:

1. Aggressive currency manipulation from 2001 to 2008 (the yuan is now actually overvalued).
2. Large scale government coordinated IP theft. It started with them ripping off European high speed rail in the early 2000s and then spread to everything else. Read this piece from the NYT about how China worked to steal IP from Micron Technologies (MU) — it'll make your blood boil.
3. China makes it hard to export into their country. They also make it hard for foreign firms to invest in their country in order to produce and sell locally. And the government uses a myriad of policies and tools to strongly favor Chinese over foreign companies.

The US's response (which has come a decade too late) is so far this, *via Nordea*:

> *The China-US trade war has escalated with the US planning to levy tariffs on USD 200bn of Chinese goods and China vowing retaliation.* ***The sizable impact on Chinese growth and US consumer prices will lead to secondary effects on financial markets.*** *On Tuesday evening local time the US Commerce Department released a list of Chinese goods worth USD 200bn that will be subject to a 10% tariff. It could take*

> *effect after public consultations end on 30 August. **Factoring in the USD 34bn of Chinese goods already subject to a 25% tariff and the USD 16bn expected in late July, that would bring the Chinese goods affected to USD 250bn, about 50% of US imports from China.***

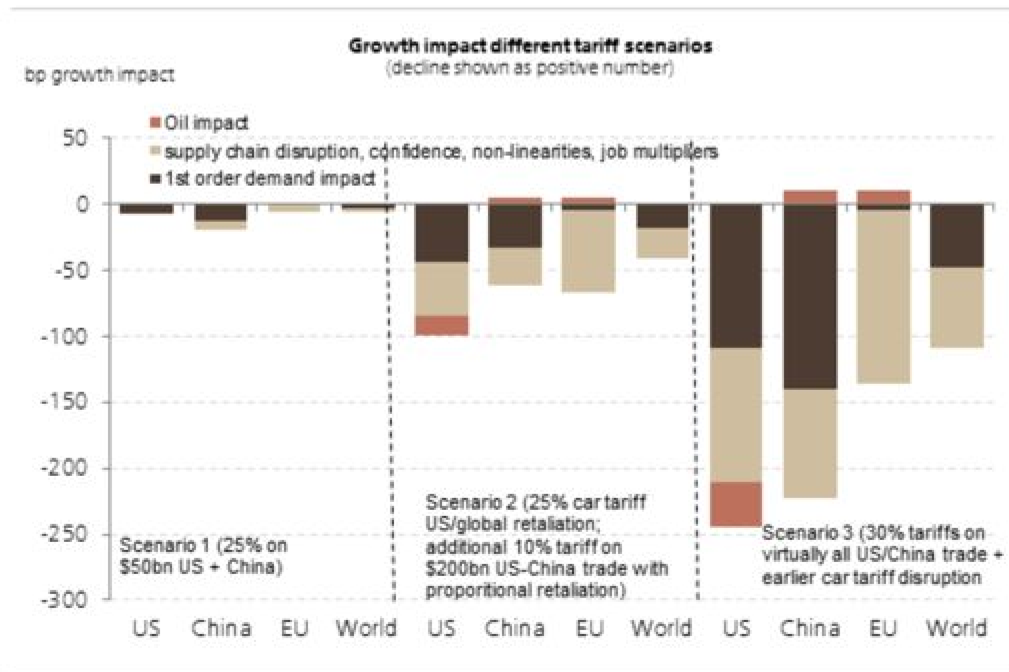
China has of course vowed to retaliate, though they've so far have offered little in the way of specifics.

A key thing to remember in all this is that the US is one of the most self-sufficient economies, meaning exports comprise a very small percentage of our GDP. Because of this, the US should be much more robust to a trade war. China, being a major export economy, is not. **The US would have all of the leverage in this negotiation if we weren't also starting trade wars with all of our other major trading partners; including our closest allies.** This puts us in an incredibly risky spot.

UBS did an in-depth study on potential trade war impacts which you can read here if interested. They conclude the following in the report (emphasis by me):

> *In the event the US-China trade tensions escalate into an all-out trade war—which we define as (i) across the board tariffs of 30% on all Chinese imports (ex-smartphones); (ii) a proportional response by China through a combination of tariff and non-tariff barriers; and (iii) a 25% tariff on US car imports, with retaliation by all its car partners — **global growth could decline by as much as -100bp vs our baseline (essentially a decline from about 4% to 3% growth, a level we have not touched since the depths of the Eurozone crisis).** Growth declines in the US and China are much larger (245bp in the US and 233bp in China) but this is before the effect of any policy response. **That the negative impact on US growth is larger than any other country may be counter-intuitive but it is a function of fighting on many different trade fronts and a large drag coming from much lower oil prices** (Brent oil is assumed to be roughly $25/bbl lower).*

Figure 1: Growth impact of different trade tariff scenarios



Source: UBS

My hopes are that the US administration backs away from its threats of escalating the trade war with our European allies, and in particular Germany. The smart move would be to closely coordinate a strong response against China with Europe — our all in trade restriction difference with them (tariffs+subsidies+policies) is around a 100bps, which is nothing. Unfortunately, it seems President Trump has a particular dislike for Merkel and German autos.

If the US moves too aggressively and is too arrogant in its negotiations with our major trade partners then we risk isolating ourselves and compelling those we're having a trade spat with to coordinate a stronger tit-for-tat response. This would potentially be very bad.

But, like we said at the start, this is a slow burn narrative. It's not at risk of becoming a driving force of markets for the next couple of months at least. And there's a few second order impacts we should keep in mind that may act as governors that'll keep this from hitting markets too hard.

1. **The Trump administration has made it clear that they pay very close attention to the stock market's performance.** They view it as a report card on how they're doing. If the trade war escalates and markets react negatively, it's likely the Trump administration will walk things back. Conversely, if the market continues to shrug off an escalating trade war it may embolden the administration to act more aggressively.
2. How will this impact our Game Masters (the Fed)? It's possible that the Fed will lower its interest rate guidance or adjust QT in order to ease conditions in light of negative

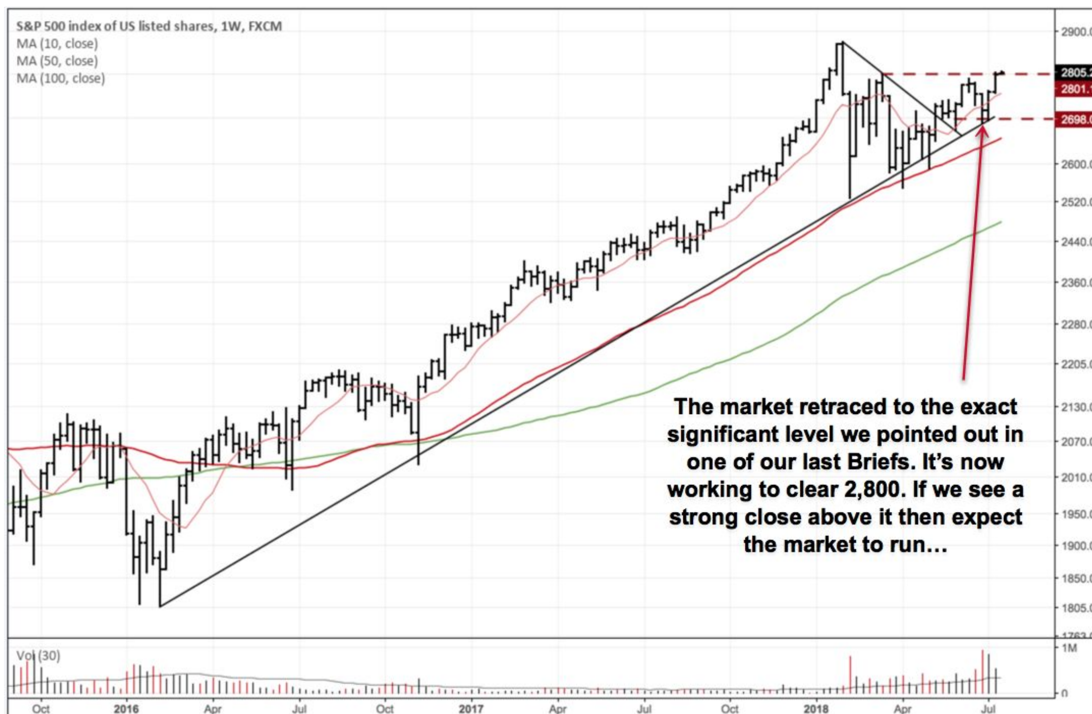
economic impacts from the trade war. This is currently unlikely but possible and could make the trade war bullish for risk assets (temporarily at least) if their response more than offsets the economic impact of tariffs.

3. In a similar vein, it's possible that China will respond to the trade wars negative impact on their economy with more stimulus. This would put a firm floor under EM stocks and commodities. I also view this as improbable but it's a possibility we need to be aware of.

In summary, the trade war is something we should keep abreast of as it could become a significant driver of markets in the future. But we're not there yet and so our primary attention should remain on sentiment, technicals, and the macro fundamentals — all of which point towards a higher market here in the US.

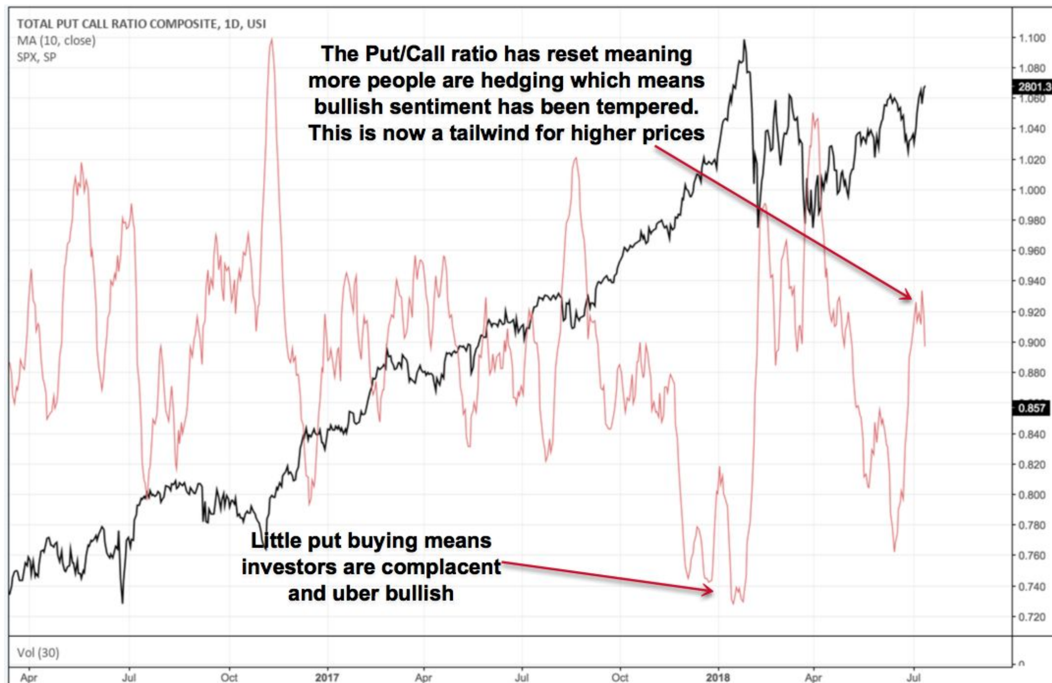
Let's go through some charts.

The SPX is working to clear a significant resistance level in 2,800. The chart looks positively bullish. Once we see a strong close above the round 2,800 number I think we'll see the market run and make new highs. The bullish technical picture is also supported by strong tapes in both the Dow, Russell, and Nasdaq (which made a new weekly closing all-time high on Friday).



The percentage of stocks trading above their 50dma has come down from their stretched readings last month. This is no longer a headwind for the market.

The Put/Call ratio which measures investor hedging (ie, put buying) versus their purchases of calls, has reset to neutral levels. This is a great short-term sentiment gauge; when the ratio (red line below) drops too low it means investors are getting complacent and overly bullish and so it's time to be cautious.



BofAML's Bull & Bear sentiment indicator also shows that sentiment is overly bearish. This is supportive of higher prices in stocks. And just from an anecdotal perspective, I've been blown away by the level of negative takes I see on the market at the moment; especially when one takes into account the bullish technical and fundamental outlooks for the US. It doesn't make any sense!

BofAML Bull & Bear Indicator (B&B)

Our BofAML Bull & Bear Indicator is now at 2.3 (very close to a buy signal).

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

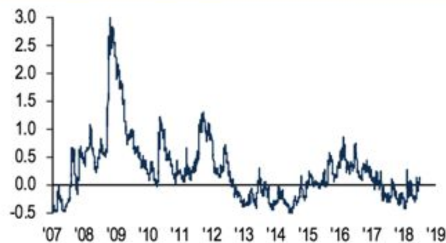
Source: BofA Merrill Lynch Global Investment Strategy

Table 4: Components of BofAML Bull/Bear Indicator

Components	Percentile	Sentiment
HF positioning	65%	Bullish
Credit market technicals	77%	V Bullish
Equity market breadth	14%	V Bearish
Equity flows	20%	Bearish
Bond flows	12%	V Bearish
LO positioning	35%	Bearish

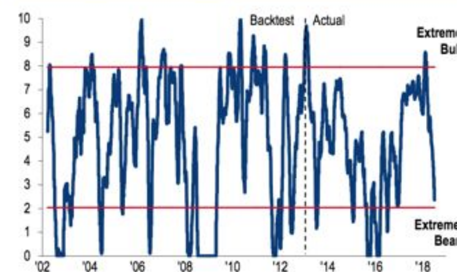
Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg, EPFR Global, Lipper FMI, Global FMS, CFTC, MSCI

Chart 15: BofAML Global Financial Stress Indicator



Source: BofA Merrill Lynch Global Research

Chart 16: BofAML Bull & Bear Indicator history



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

But what's bad for them is good for us, because we're positioned well to capture the upside in US stocks.

Two of our larger positions in Facebook (FB) and Google (GOOGL) made new all-time highs this week. And our largest position, Disney (DIS), is setting up in a perfect textbook coiling wedge.

I think we'll add to our Google and Facebook positions using DOTM calls this week, so we can add some more leverage to those trades.We'll send out an alert if/when we do. And if you're interested in hearing a sound logical argument that makes the case for FB stock to hit $1,000 (it's currently $207) then check out this short video by @hardcorevalue. It's not hyperbole, it's actually very possible.

Our short gold trade continues to play out nicely. It's still wrestling with a major inflection point. If we see a decisive close below its current range then we'll look to press our shorts and plunge hard, as the next significant levels aren't till the $1,100 range.

One thing that makes me nervous about the short-term action in our long dollar and short gold trades is how stretched the SPY vs. EEM (US vs. emerging market equities) outperformance currently is. The chart below shows SPY/EEM and its distance from the 50dma; it's at levels that have typically preceded a snapback reversal in the past.

This doesn't mean US stocks are set to selloff. That's highly unlikely. But it does mean that emerging markets are really oversold and may see a short period of outperformance soon. I'm considering hedging out my ignorance, by going long some EM stocks that have strong fundamentals and great looking charts. This would be a small tactical swing trade.

Jesse Stine (author of Insider Buy Superstocks) put out a market update this week — his work is always worth a read. Here's the link.

He mentions two Brazilian airline stocks that I've been looking at, GOL and AZUL (both ADRs that trade on US exchanges). Both have been killed since the start of the year and both have strong fundamentals. I'll continue to look into this trade and will release a trade alert and more information if we decide to pull the trigger on one or both of them.

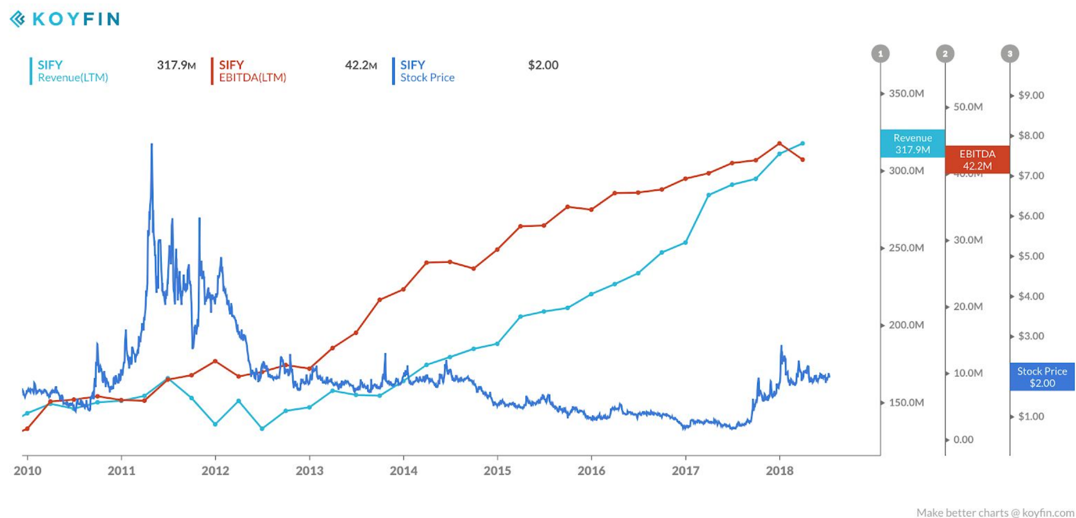
I'm also revisiting SIFY Technologies (SIFY), an Indian tech company that specializes in telecommunications, data centers, and services.

For those of you that remember, I first wrote about SIFY in the Fall of last year when it was trading around $1.45. It quickly ran away from us before we could build a position — at one point climbing up over $3 — but it has since settled back down and has been forming a nice consolidation (chart below is a weekly).

The fundamentals of the company are good and becoming great. Its business continues to benefit from the strong leadership and clear vision of the new CEO, Kamal Nath, that came onboard in late 2012. Kamal has a long history of success and has built and sold a number of tech companies for price tags that ranged in the 100s of millions of dollars.

There's good reason to think he'll continue his history of success with SIFY.

Revenues have doubled and EBITDA has more than 4x'd since he took over. The stock currently trades for an EV/Sales of 1.1x and 8x EV/EBITDA. This is incredibly cheap considering its strong and steady growth over the last five years and it's a downright fire sale when you consider the company's long runway and powerful secular tailwinds…



This stock may be a perfect fit to play our long-term secular theme on the rise of India. I still have more digging to do to catch up on what's changed over the last 9-months since I last looked at the company. But I'm really liking what I'm seeing so far. Long Cast Advisors (a sharp small-cap value focused HF) holds a large position in the stock have a short writeup on the company here.

I'll be sharing my findings with everybody later this week.

Plus, I continue to look into Spotify (SPOT). The chart has set up nicely and I think there's a strong case to be made about the stock's skewed positive asymmetry. But I still have more work to do…

Lastly, the dollar (DXY) continues to battle with its 100-week moving average (green line). Whether or not we see a break higher or a retrace lower first, largely depends on where SPY/EEM trades over the coming weeks.

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	$3,007,888		11.26%	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	$16,767	$70.00	$38.21
Equity	Discovery (DISCA)	3,450	$28.09	$23.80	$12,558	$60.00	$27.44
Equity	Stitch Fix (SFIX)	1,750	$32.96	$25.50	$13,055	$60.00	$32.96
Equity	Advanced Micro AMD	14,818	$14.84	$11.50	$71,126	$25.00	$16.30
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	$75,402	$230.00	$207.48
Equity	Google GOOGL	332	$1,073.37	$992.00	$70,384	$1,400.00	$1,204.00
Equity	Disney DIS	5,694	$102.34	$95.00	$84,328	$150.00	$109.81
Equity	Yatra Online YTRA	36,819	$7.24	Investment	~	$15.00	$6.26
Equity	MU Jan '19 70 Call	118	$2.12	$0.00	$35,990	$10.50	$3.05
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
FX	Sep Dollar Futures (DXU8)	20	$94.44	$89.80	$93,800	$96.00	$94.49
Metals	Aug Gold Futures (GCQ8)	-4	$1,300.6	$1,350	$43,000	$1,250	$1,242.50
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

Risk Budget	Total Allowed (In Bps)	Total Used	Total Available	Percentage Used
Master	2500	2,029	471	81.17%
Big Bet Macro	2250	2089	161	92.84%
Volatility	250	81	169	32.49%

**Updated 7/15