MARKET BRIEF

Macro Ops Collective

Even Odds…

Hope everyone had a good weekend!

This week looks set to be a busy one in markets.

We have some big earnings reports coming out, including CAT, MMM, APPL, AMD, FB, TSLA, MSFT, BABA, AMZN, V, and XOM.

CAT, MMM, V, UPS, XOM, NUE, and AMD are good economic bellwether stocks. So we'll be sifting through their reports to see if we can tease out any interesting data points on the various trends in global demand.

And on Wednesday, we have the conclusion of the FOMC meeting. I'm not expecting any major surprises from this meeting. The FOMC should leave rates unchanged at 2.25-2.50% and we're likely to see more emphasis on "patience" in the cadence of further policy normalization versus the previous emphasis on a "gradual" rate hiking path…

One thing we'll be looking for is any new discussion on the Fed's balance sheet reduction (aka. QT). The Fed's gradual reduction of its balance sheet has become a hot point for markets and any new talk on possibly slowing or reducing the pace and size of QT would be viewed as extremely bullish by the market.

Fed policymakers have made a concerted effort over the last month to communicate to the market that they are flexible and willing to respond to the data by changing course in policy. Here's a nice summary of quotes from Fed members over the last few weeks via MS (emphasis by me):

Gradual is out, patient is in—recent quotes from Fed policymakers:

December FOMC minutes: Against this backdrop, many participants expressed the view that, especially in an environment of muted inflation pressures, the Committee could afford to be patient about further policy firming.

Kaplan (1/3/19): I would be an advocate of taking no action and, for example, in the first couple of quarters this year, if you asked me my base case, my base case would be take no action at all. That could change if things improve but my own view right now is we should be patient.

Powell (1/4/19): There is no preset path for policy. And particularly, with the muted inflation readings that we've seen coming in, we will be patient as we watch to see how the economy evolves. But we're always prepared to shift the stance of policy and to shift it significantly if necessary.

Bostic (1/9/19): To me, the appropriate response is to be patient in adjusting the stance of policy and to wait for greater clarity about the direction of the economy and the risks to the outlook.

Rosengren (1/9/19): Recent data from China's economy, the potential for increased trade tensions, and heightened volatility all counsel for policy to be both flexible and patient.

Powell (1/10/19): I think we're actually in a good place. I think where that leaves us, particularly with inflation low and under control, is we have the ability to be patient and watch patiently and carefully as we see the economy evolve and figure out which of these two narratives is going to be the story of 2019.

Clarida (1/10/19): With inflation muted, I believe that the Committee can afford to be patient as we see how the data evolve in 2019 and as we assess what monetary policy stance is warranted to sustain strong growth and our dual-mandate objectives.

Kashkari (1/15/19): Have we reached the proverbial soft landing where the economy has achieved maximum employment, stable prices, growth at potential, and monetary policy neutrality? In my view, we are not there just yet. However, we are close and for now, it seems to me that we should proceed with caution and be patient as we approach our destination.

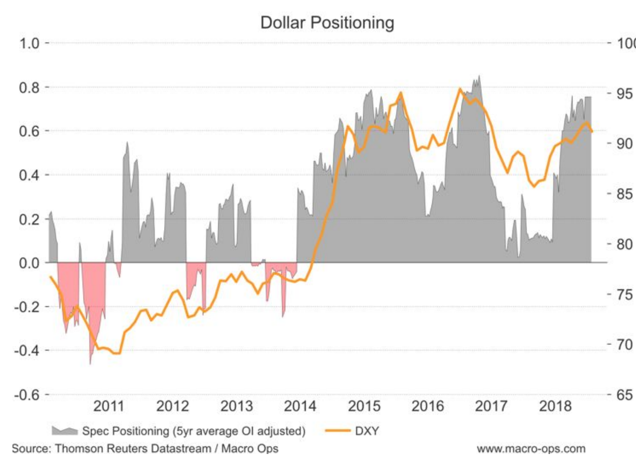
I don't know about you but all that reads as pretty darn dovish to me.

The market has already picked up on this shift in tone though and is currently pricing in zero hikes for the year (see chart below). This is important because as traders we're always looking at **what's likely to happen versus what's already embedded into prices**. And it seems to me that the market might be *over* discounting US economic weakness and the subsequent rate path.

Exhibit 6: Markets may be assuming that the rate-hike cycle is done

Source: Morgan Stanley Research

Regardless, the market appears to want to focus on continued uber-dovishness from the Fed and so the FOMC meeting on Wednesday may be the catalyst to send the dollar lower which would finally wash out its crowded long positioning (see chart to the right).



The dollar (DXY) closed the week below its all-important 200-week moving average (blue line). I can see a selloff driving the dollar down to the spot 94.50 range, near its 50wma and its lower Bollinger Band.

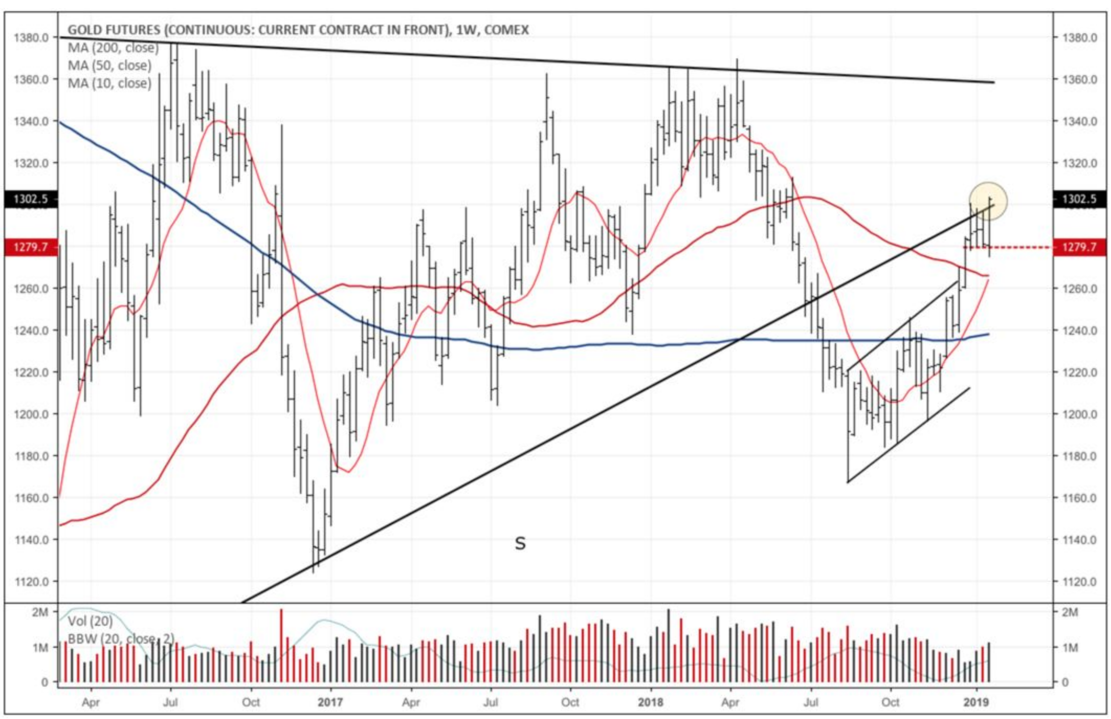
We are still short the dollar through our long EURUSD trade. We may add to this position on strength later this week.

I still view this dollar weakness as a tactical move. I don't expect it'll last much longer than a few weeks. The dollar bull case is supported by structural tailwinds (ie, large global dollar-denominated debt and funding needs + strong US relative growth versus the RoW which should become more pronounced in the coming quarters).

The current weakness is primarily being driven by repositioning speculative flows (investors moving capital into EM stocks following recent US market volatility and the repricing of the Fed Fund path). But, dollar pairs like AUDUSD have some fundamentally high hurdles to convince me this a primary trend change — see this thread on AUD I tweeted yesterday (link here).

I'm looking for AUDUSD to rally up to around the spot 0.7400 level which would put it near its 50wma and the upper Bollinger Band. Currencies often go on large counter-trend moves before the resumption of the primary trend. That's likely what we're about to see and will set us up for a great entry point to get long the dollar.

Gold saw a strong weekly close on Friday, closing above its previous trend-line. I'm going to be honest, I don't understand this move. It doesn't align with the models I use to view gold. Therefore, I'm putting gold in my too-hard bucket for now and will watch to see how price develops.



I will consider getting long if it continues to show persistent strength which would suggest its putting in a large long-term inverted H&S bottom which would be very bullish and have large implications for the rest of the macro space.

Moving onto equities…

The stock market continues to hold up well. **And every bit of continued strength should make us question our primary thesis that we'll see a pullback before a continued leg higher.**

As Chris D. pointed out in his email on Friday, the market is at a critical line in the sand according to his systems. He's still positioned for a bearish retrace but if markets move much higher from here it would likely mean we're "out of the woods" as far as this correction is concerned.

The evidence is building up in support of the bulls. We've had a [Total Sentiment Capitulation] followed by [Large Breadth Thrusts] in both credit and stocks.

The latest BofAML Bull & Bear indicator is still giving a buy signal as the market remains tilted bearish sentiment-wise after this latest up move.

BofAML Bull & Bear Indicator (B&B)

Our BofAML Bull & Bear Indicator rises to 2.8, in "neutral" territory.

Chart 16: BofAML B&B Indicator (scale from 0 to 10)

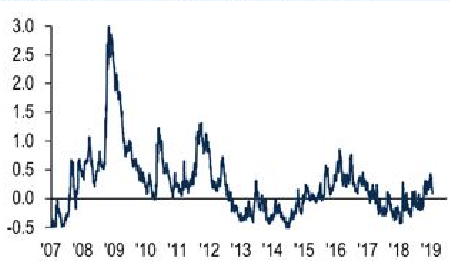
Source: BofA Merrill Lynch Global Investment Strategy

Table 4: Components of BofAML Bull/Bear Indicator

Components	Percentile	Sentiment
HF positioning	80%	Bullish
Credit market technicals	56%	Bullish
Equity market breadth	13%	V Bearish
Equity flows	68%	Bullish
Bond flows	22%	V Bearish
LO positioning	16%	V Bearish

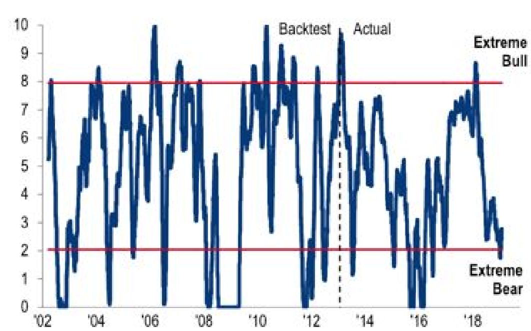
Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg, EPFR Global, Lipper FMI, Global FMS, CFTC, MSCI

Chart 17: BofAML Global Financial Stress Indicator



Source: BofA Merrill Lynch Global Research

Chart 18: BofAML Bull & Bear Indicator history

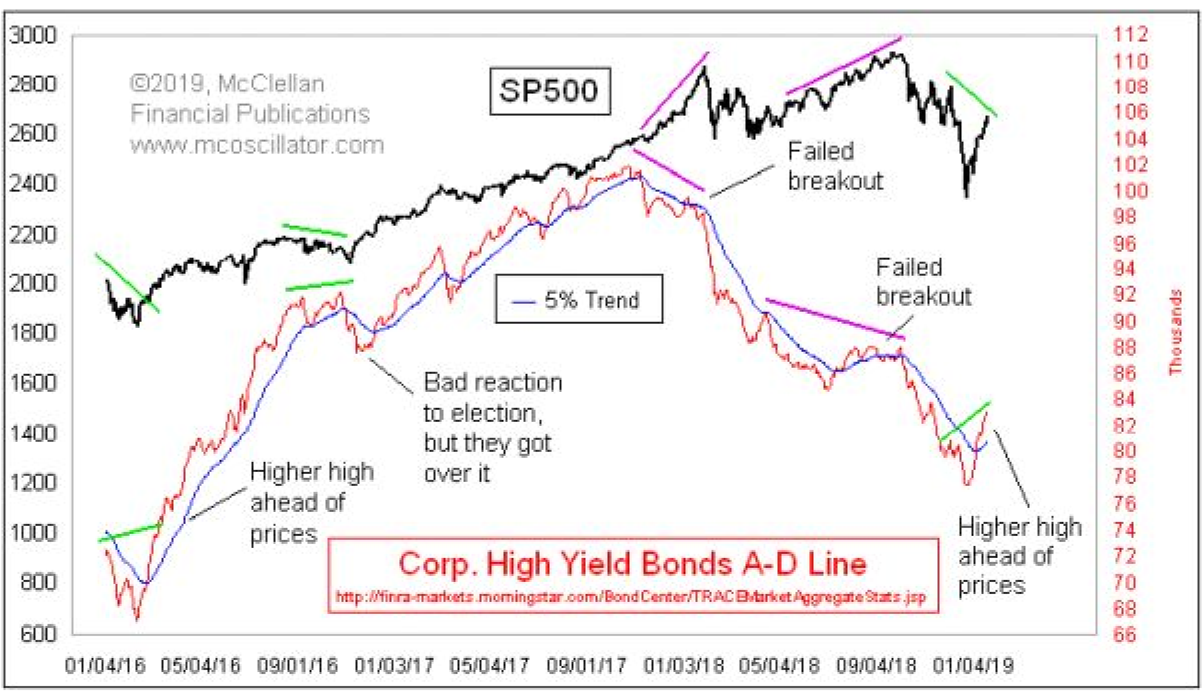


Source: BofA Merrill Lynch Global Investment Strategy, EPFR Global, FMS, CFTC, MSCI

And high-yield credit is showing lots of strength, confirming this rally in stocks.

Chart 2: Credit leading equity higher

Source: BofAML Global Investment Strategy, Bloomberg



Because of this, I want to slowly add to our long book this week. But we'll look to get more aggressive following the FOMC and after seeing how the market reacts to the big earnings reports over the next few days.

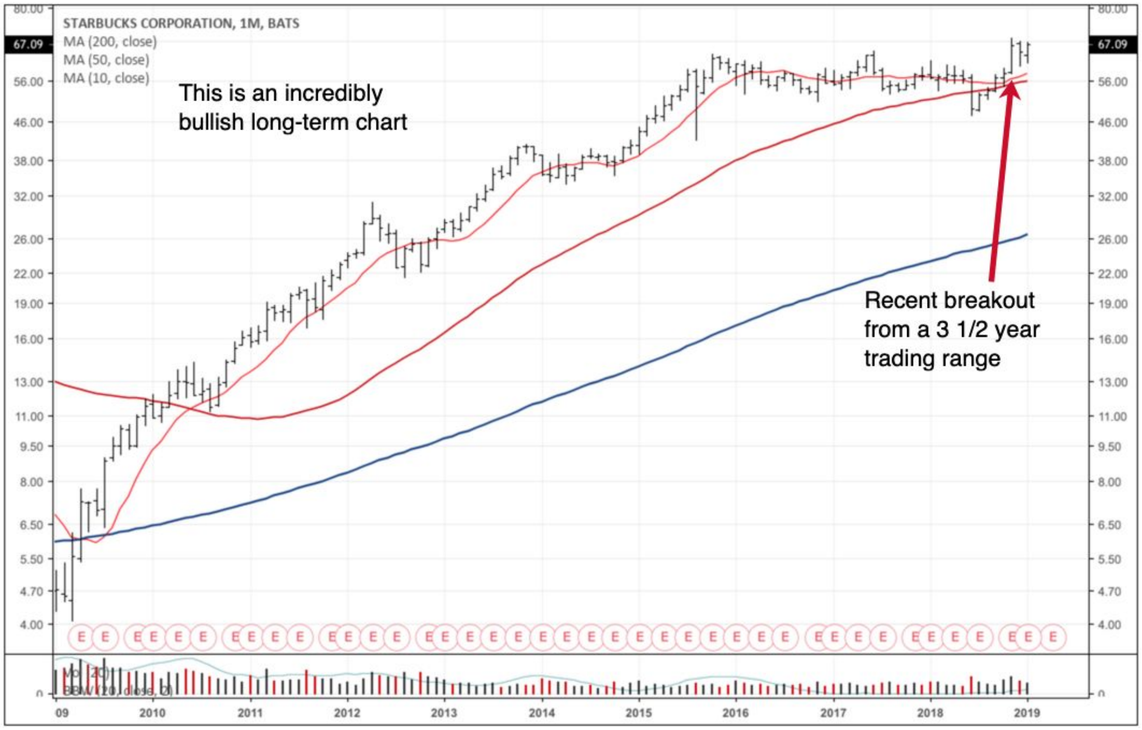
Our Argentinian Bank (GGAL) is now up over 33% from our entry two months ago. It's now bumping up against major resistance in its 200wma (blue line). We'll look to add to this position if it closes on a weekly basis above this line, which it should soon if we see the dollar sell-off.

I also will look to add a bit to our BOX and FCAU holdings. Both of which continue to move nicely.

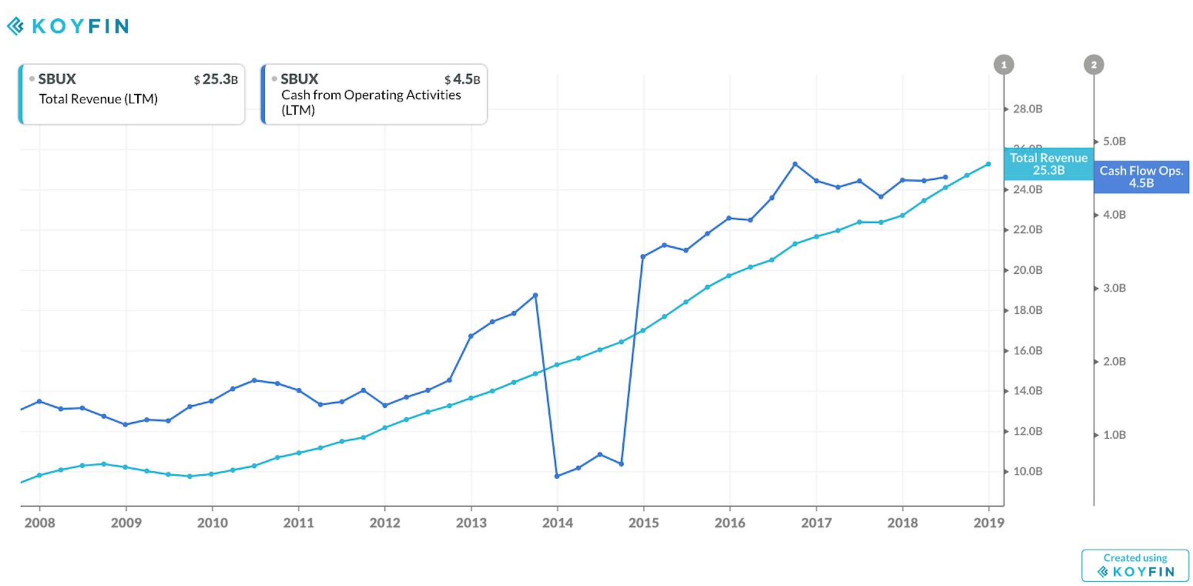
We're also going to put on a DOTM trade in Starbucks (SBUX) this week. We've been tracking SBUX closely for a while now and missed the initial entry point but the stock continues to show unremitting strength and there's a confluence of factors that are aligned to drive it higher.

First, let's take a look at the chart.

Here it is on a monthly basis. This is a great looking tape. SBUX coiled in a tight trading range for nearly 4-years before seeing a bear trap spike lower and a move to new highs. This tells me that there are very strong hands who accumulated in the $52-56 range and now that level should act as a springboard driving the stock upwards.



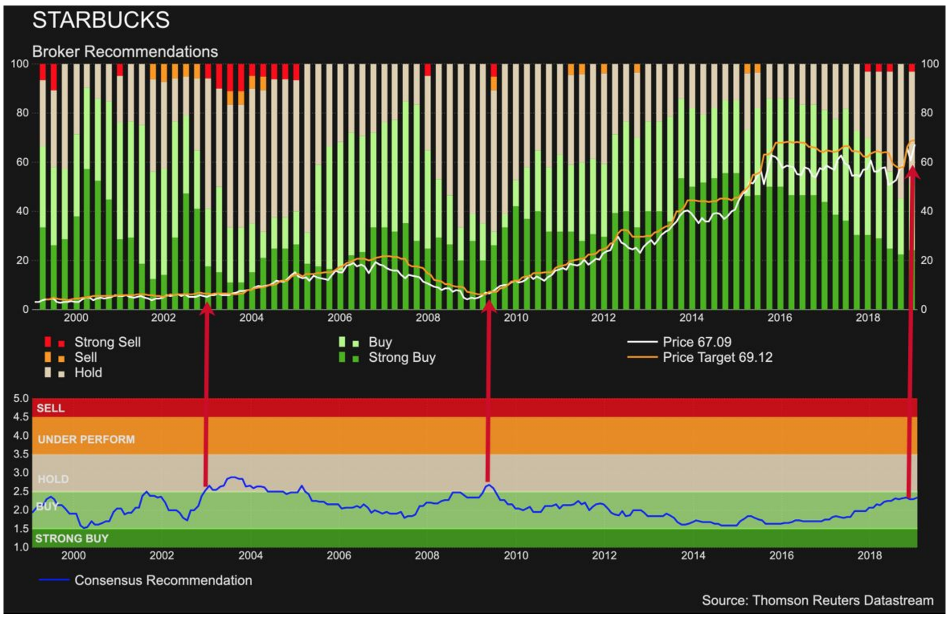
Revenue and cash flows are trending the right direction; up and to the right.



Starbucks still has a very large growth runway as it expands into new markets. They open a new shop in China [every 15-hours](#) where, according to the company, the average consumer drinks less than 1 cup of coffee per year compared to the 300 cups the average American consumers each year. The company is also moving into other parts of Asia, including India.

This expansion and investment back into growth opportunities mean tightening margins and lower earnings over the near-term but with the hope of greater market share and shareholder value created down the road. Much of Wall St. seems to be focused on the former at the exclusion of the latter, as it often does.

The average broker recommendation is the most negative its been on the stock in nearly 9-years. The last time the average recommendation was a hold (near where it is now) happened to coincide with major bottoms in the stock that preceded large runs.



We're also going to put on a starter position this week in Criteo (CRTO).

Here's our working notes on the company (via our value guy). We're going to continue to investigate the company but so far like what we see, especially considering the price that's on offer.

Criteo, Inc. Notes

Elevator Pitch: Massive selling from new ITP Regulations set forth by Apple and European departments have caused share prices of the digital performance advertising company to fall to 4x EV/EBITDA -- well below industry averages. With almost all of the negative news surrounding the new privacy laws baked into the price, one can buy shares of the core operating business for extremely low multiples while getting the ancillary operations (call options) for free. CRTO sports 90%+ customer retention rates, extremely low churn levels and ample ROAC (return on advertising cost) to its clients to the tune of an average of 13x. With over 19,000 customers worldwide and the largest Shopper database in the world, Criteo is priced as if the company will never again achieve top-line revenue growth. Former CEO is back in the saddle, talking to investors, and quickly initiated an $80M share repurchase program. Interests are aligned.

What They Do: Criteo is a digital performance advertising company. Their goal is to help businesses target the right client, with the right product, at the right time. The company achieves this mission through four operating segments: **Criteo Dynamic Retargeting, Criteo Sponsored Products, Criteo Customer Acquisition and Criteo Audience Match.**

- **Criteo Dynamic Retargeting:** Post-click sales by engaging consumers with personalized ads that offer products or services that the customer has already expressed interested in.
- **Criteo Sponsored Products:** Post-click sales by pricing and delivering real-time sponsored product ads to consumers that "demonstrate intent" or have actively searched for a specific product on the website of retailers selling the product.
- **Criteo Customer Acquisition:** Helps clients acquire new customers, engaging with their Shopper dataset to generate personalized advertisements that are offered to the customer based on predictive machine learning models.
- **Criteo Audience Match:** Accurately targets and re-engages existing customers with personalized ads that offer new products or services existing customers haven't purchased before.

Underlying Business Value / Advantages: Largest Customer Dataset, High Retention Rates & Leading Machine Learning Models.

- CRTO has the largest dataset on global shoppers in the industry -- perhaps the world. This dataset gives the company two major advantages versus its competitors. First, the size of the dataset enables Criteo to scale quickly and efficiently along with its customers' growing requests. Secondly, the dataset enables CRTO's machine learning

algorithms to learn quicker, become more intuitive, and generate more predictive ads for its customers.
- Advantages to Shopper Graph: Two-way exchange of data (consent is prioritized on a first-party basis -- no backdoor data gathering), access to 4.5 billion products, largest consumer reach worldwide, 120+ shopping intent signals evaluating per shopper, 100 participating retailers, $760B in annual e-commerce sales.
- High Retention Rates: CRTO sports less than 1% monthly churn rate with 80% of their customers choosing to opt-out of capped budgets for their CRTO campaigns. CRTO has 90% client retention rates, 75% direct relationships with their clients.
    - Company maintains 90% retention rate while consistently adding around 480 new clients a quarter.

Growth Plan: Growing Existing Customer Base, Increasing Value for Existing Clients & In-App Transition
- Growing Existing Customers: Given the under-monetization, CRTO is prioritizing its salesforce growth -- which the company admitted it had issues filling during the latest quarterly report.
    - Growing the sales staff gives CRTO the ability to offer multi-solution packages to its customers -- not just the standard ad campaign.
    - The company expects to continue to grow its customer base by around 480 clients per quarter.
- Increasing Value for Existing Customer Base
    - Leveraging the Criteo Shopper Graph
    - Broaden supply of inventory -- adding different avenues to advertise (i.e., video and streaming).
    - Continue to enhance the CRTO deep learning engine.

Why Apps? : Q3 CRTO completed the acquisition of Manage -- in-store advertising company -- for roughly 5x EBITDA. Manage is already profitable with growing top-line revenues and robust EBITDA margins. 5x EBITDA seems like a fair price (they likely didn't overpay).
- Mobile app usage is growing *very* quickly. CRTO's customers are asking the company for in-app solutions. This makes sense given the inherent advantages of advertising inside an app.
    - The lifespan value of an app customer is much higher than a customer using the web. This makes intuitive sense -- as someone who downloads a specific app would *most likely* have a higher tendency to spend money with that company/service.
    - Apps increase moats for businesses. If a business can get its customer to download its app, its captured more of its customers time and interest at little to no incremental cost to the business.

- Because of this -- delivering in-app advertising at scale to various businesses requires *tremendous* amounts of R&D spending that other advertising companies simply can't afford to spend.
- However, this investment pays handsome dividends once successfully implemented. In-App ads deliver (on average) higher return on app-send to its clients. Since customers spend more time on apps than on the web, it gives CRTO a higher chance at capturing that customer. Also, user identification is easier within apps because apps don't rely on cookies the way web browsers do.
    - This is important if CRTO wants to break free of the decrease in revenues it suffered from the Apple ITP case in late 2017.

<u>Financials</u>

- The company has grown EBITDA margins from 17.5% to 35% over the last five years.
- Gross margins maintained in the high 90% during the same five year period.
- Company maintains high levels of FCF (mid $100M)
- Net cash of close to $456M
- Current EV of $1.24B, trading at 4.3x forward EBITDA with an industry median of 18x EBITDA.
- Trading at 10.60x FCF -- industry average is 26.75.

<u>Valuation</u>

- Given the ITP headwinds -- the company's multiple shrunk from 17x to 4.5x.
- Assuming zero revenue growth from its 3Q 2018 figures:
    - Applying a 10x multiple puts the share price at $33.64.
    - DCF model (which assumes current EBITDA margins, 5% CapEx of revenues) and 34% tax rate) puts fair value range around $21, only 17% lower than current share prices.
- Assuming 5% top-line growth and median multiple expansion of 12x:
    - EBITDA multiple gives us fair value of close to $42.
    - DCF model gives us fair value close to $23.
- **Assuming 10% top-line growth, 11% EBITDA margins and 15x EBITDA multiple:**
    - **EBITDA multiple approach gets us a fair value range of around $65-$68, representing close to 65% upside from current prices.**
    - **DCF model gives us fair value of $29.**

<u>Risks:</u>

- Continued expansion of privacy-related initiatives -- making CRTO's efforts to gather data even harder.
- Cannibalization of returns on ad-spend.
    - FB, for example, has cannibalized returns on its ad spend over the last three years.

    - If Criteo's customers experience lower and lower returns on the same ad-spend it could lead to customers leaving, which would translate to higher churn rates & lower customer retention rates.
- Failure to expand into different areas of advertising (video, streaming, apps).
- GOOG or FB developing similar deep learning/machine learning models and engines to compete with CRTO.
- Plug-ins from various browsers (i.e., Google Chrome Adblock): This is something I use to prevent ads from being shown. Increased usage of ad-blocking plug-ins cause headwinds to businesses like CRTO trying to target predictive customers.

And if you haven't read it yet, here's Steven Wood's (of GreenWood Investors) writeup on the company (link here).

I'm also looking to open a position or two in some more cloud SaaS related names. This space continues to show incredible strength, both fundamentally and technically. Some of the names I like most are CSOD, WDAY, DATA, MIME, ADBE, INTU, and ZUO.

We'll be sending out trade alerts and research notes this week as we make some moves.

That's all I've got for now.

If you've got a few minutes I suggest giving Scott Miller's latest Investor Letter a read. It's good.

He talks about the latest market volatility and how he thinks about it and then he makes the pitch for a couple of his new holdings, including KKR and RADH, which I found interesting. Here's the link.

If you've got any questions for us in the meantime, let us know in the Comm Center. Have a great week!

Your Macro Operator,

Alex

P.S. I just started reading Robert Greene's *The 33 Strategies of War* this week and I'm really enjoying it so far. Greene must have spent A LOT of time doing research for this book. He cites widely and uses a ton of great historical references and examples to tie together what he views to be the 33 first principles of strategy. And these principles apply not just to war but to life and investing and everything else. I'll put out my book notes when I finish.

And on that note, look for an email tomorrow regarding our new MO book club. I'll be sending out a poll to select our first book for the month of November.