Large Breadth Thrust

Good week everybody!

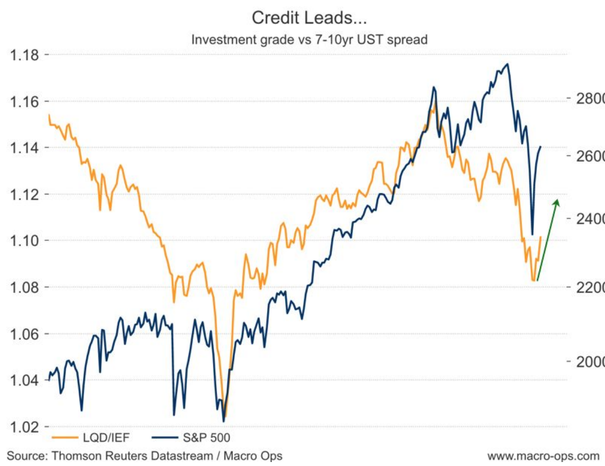
Alex here with a quick note on markets, some data/charts from the latest BofAML Fund Manager Survey, and a look at some trades.

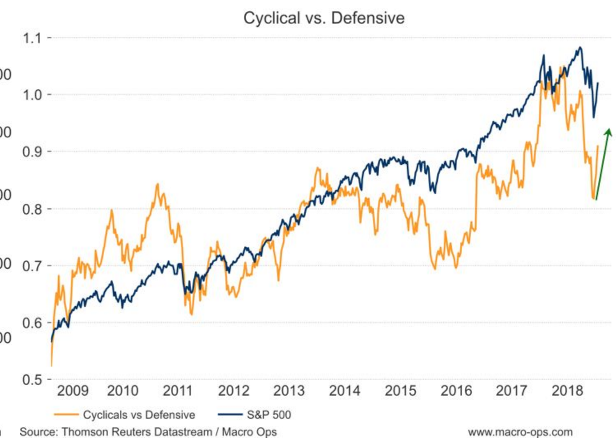
The market is battling through the major supply overhang (red zone) that I pointed out a few weeks ago. I'd expect a selloff from these levels over the next few weeks. This bounce is technically overextended (price is near the upper Bollinger Band) and one more good washout would really set the stage (both from a technical and sentiment point of view) for another major leg higher.

Of course, we don't need to see a selloff. We could see persistent strength and have the market move higher from here. But, I believe it's odds on we see a reversal before the market makes another major move.

In periods of uncertainty like these I just like to maintain a balanced book, be patient and not overtrade, and wait for the market to give a clear signal before moving aggressively in one direction or another.

The market has so far, though, given us a number of things to be optimistic about. Both credit and Cyclical vs Defensives have been confirming this rally; which is just the type of action we need to see in order for a significant bottom to be in place.

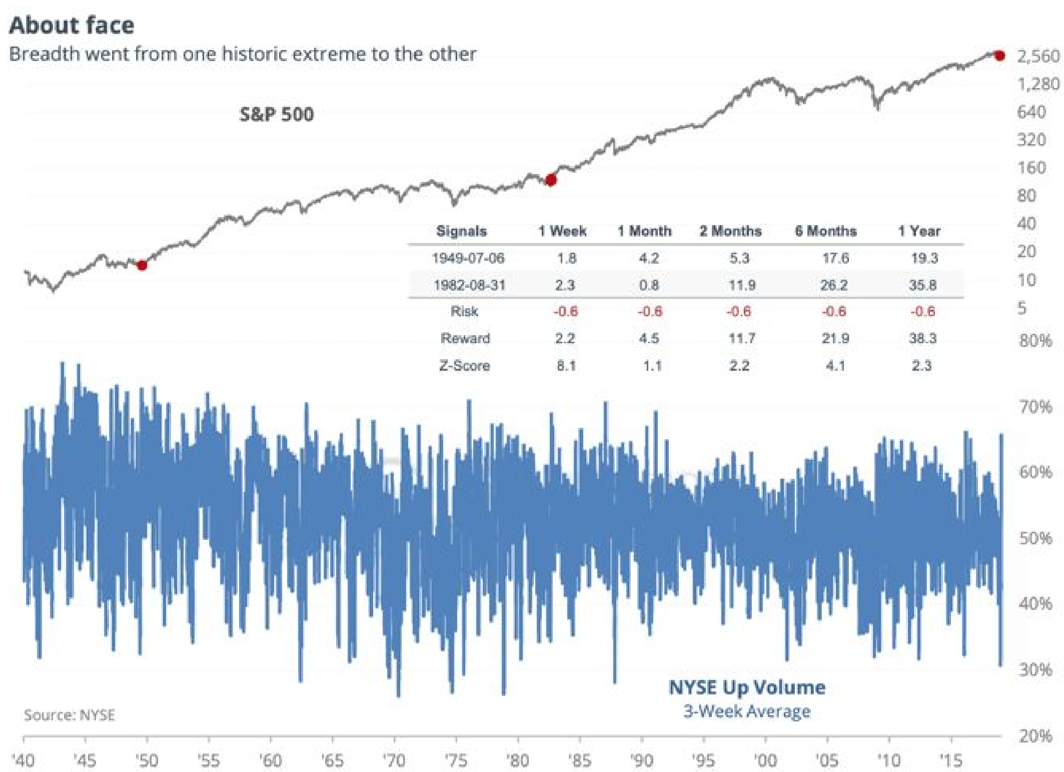




And various breadth indicators are showing extremely large buying pressure coming into the market. My longer-term breadth indicator is moving in the right direction. We need to see it cross above 0.60 (upper black horizontal line) for an official signal.

And then there's this via Sentiment Trader from one of their latest reports (emphasis by me).

> Starting on January 4, we've spent quite a bit of time looking at **the thrust in buying pressure. It was extreme and wide-spread…and hasn't stopped.** From several different viewpoints, **the cluster of up days over the past three weeks has been extraordinary.** There is always the risk that this time is different due to changes in market structure, a concern that will probably never go away. If we take the readings we're seeing at face value, though, **then the past three weeks have been truly historic.**
>
> The 3-week average of the Up Volume Ratio has gone from below 35% to above 65% in less than a month. Going back to 1940, this has only happened twice before, shown in the chart below. Both of the others triggered after approximately two-year declines of just under 30%, so quite a bit more extended than our current one. W**hat's remarkable is that both also kicked off major bull markets that went essentially straight up for the next 6 months, at least.** As stocks continue to ignore any short-term signs of exhaustion here, these two precedents should at least be considered.



Signals	1 Week	1 Month	2 Months	6 Months	1 Year
1949-07-06	1.8	4.2	5.3	17.6	19.3
1982-08-31	2.3	0.8	11.9	26.2	35.8
Risk	-0.6	-0.6	-0.6	-0.6	-0.6
Reward	2.2	4.5	11.7	21.9	38.3
Z-Score	8.1	1.1	2.2	4.1	2.3

This large surge in buying isn't just isolated to equities either. Credit investors have been piling into the high yield market as well. Again, here's Sentiment Trader.

> It's not just stocks that are enjoying a massive amount of buying pressure. Shortly after **sentiment on the high-yield bond market got about as bad as it has gotten in 15 years, that market has taken off to the upside**. Like in stocks, the gains have been abnormally large and broad-based.
>
> Over a three-week period since the low, there has been at least one day when a net 40% of high-yield bonds rose on the same day. And there has not been a single session when more than a net 15% of them declined. **That's a rare display of both firepower and consistency.**

> The history of this data is short and when combined with the explosive nature of the breadth readings, it means the sample size for precedents is tiny.
>
> As much as we can read into a sample size of four, the behavior following these stretches was relatively consistent. Each of them saw the HYG fund pull back over the next 2-4-weeks, and those pullbacks **served as excellent staging areas for the next phase of a longer-last rally.**

HYG after 3 weeks with no breadth < -15% of issues and at least one > 40% (2007-2019)

Signals	1 Week	2 Weeks	1 Month	2 Months	3 Months	6 Months	1 Year
2008-12-29	6.4	1.8	-0.5	-11.6	-8.1	11.3	29.0
2009-04-30	-0.4	-1.1	5.3	6.3	11.8	17.0	28.6
2010-01-01	2.1	1.4	-1.1	0.9	1.8	0.8	11.6
2011-10-27	-1.1	-3.3	-5.9	0.1	2.0	4.6	9.7
2019-01-17							
Median	**0.9**	**0.2**	**-0.8**	**0.5**	**1.9**	**7.9**	**20.1**
% Positive	**50%**	**50%**	**25%**	**75%**	**75%**	**100%**	**100%**
Risk	-0.2	-0.5	-2.6	-6.0	-6.0	-6.0	-6.0
Reward	1.7	1.8	3.7	4.2	4.5	7.9	20.9
Z-Score	0.4	-0.1	-0.5	-0.1	0.1	1.4	2.7

This type of buying pressure NEEDS to be respected. It doesn't guarantee that we'll see a major rally from here but it's one of the data points we NEED to see for a major bottom to form and a subsequent rally to occur. And this type of action is even more significant when weighted against the broader context of overall market sentiment and positioning.

The latest BofAML Fund Manager Survey is out and is hung up in our Slack "Research" channel. Here's a link to the report (link here). The BofAML FMS is one of my favorite summaries of overall market sentiment and most of the data points should be looked at from a contrarian perspective.

Here's the broad takeaway from the recent survey via BofAML.

Top 8 takeaways from BofAML's January Global FMS

Bearish positioning = rally: investors bearish, GDP & EPS optimism has crashed, 10-year high in leverage fear...but investors discounting "secular stagnation" not recession, a steeper yield curve (Exhibit 1), and are adding risk via tech stocks & EM assets.

Macro crash: global GDP & EPS growth expectations plummet toward 2001 & 2009 lows...but just 14% of investors see "recession" in 2019.

Credit fear: investor demand for companies to improve balance sheets highest since Sept'09; investors demand for higher capex the lowest since Oct'09.

Safe US$ haven: long US$ is #1 "crowded trade", US$ seen as most "overvalued" since 2002; #1 tail risk is still "trade war" but fears are way down from Jul'18 peak.

FMS de-risk ends: the good news was inflation expectations plunged allowing investors to discount a new dovish Fed & a bull steepening of yield curve; no surprise that Jan FMS shows de-risking is over.

Cash high as investors nibble: FMS cash levels up slightly to 4.9%, hedge fund gross exposure cut to 8-year low; Jan FMS shows investors adding to tech & EM assets, while cutting exposure to industrials, Japan & European stocks (to 7-year low).

BofAML FMS Rules & Tools: still "defensive" but bulk of the predicted bear moves from the BofAML trading rules (i.e. –70bps in Treasury yields, +230bps move in credit spreads) is now behind us.

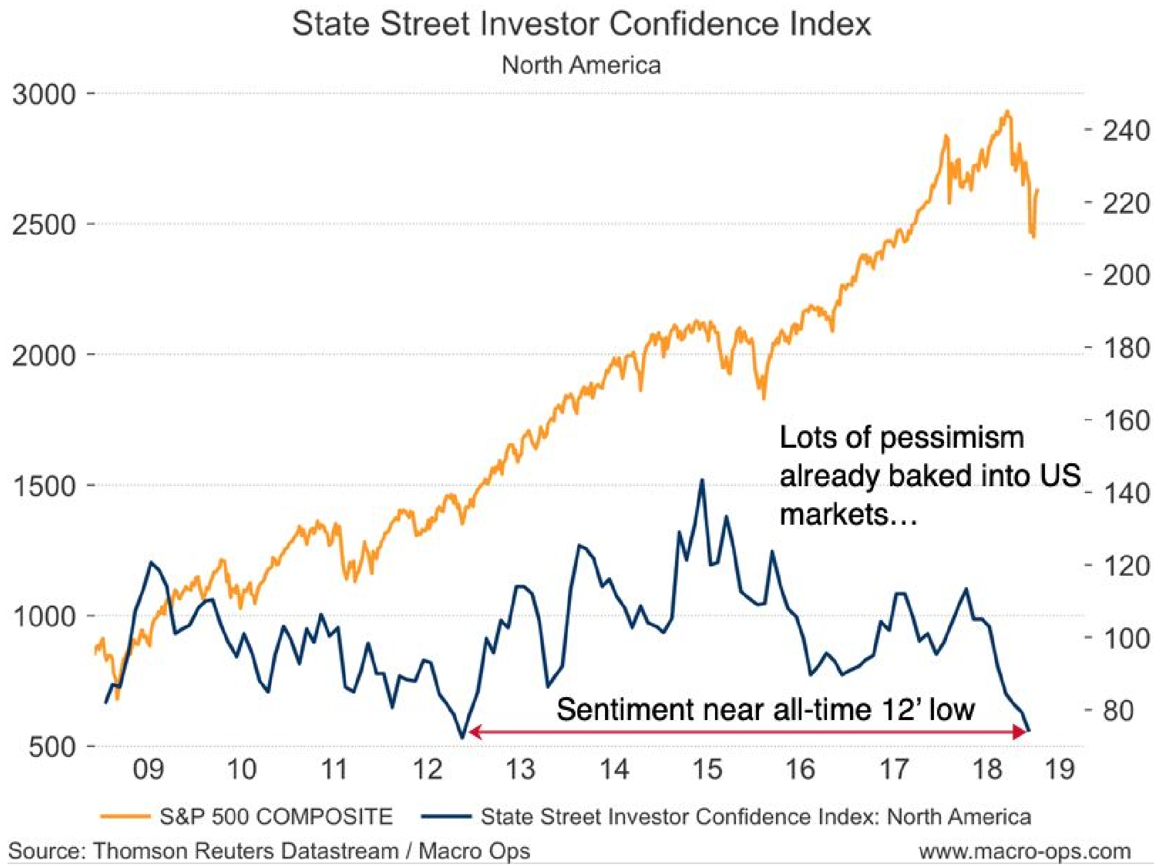
Jan FMS contrarian theme & trades: "cyclical leverage" via risk assets, long EM FX, long US industrials & small cap versus short healthcare, and long European stocks.

Fund managers remain extremely long cash which is bullish. They also still seem to be favoring banks which just blows my mind as financials are an obvious value trap this cycle, imo. And… they keep moving greater allocations into emerging markets, another value trap due to the changing macro regime of slowing China and being BoP constrained.

Exhibit 8: 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 all others

So we have bullish confirming moves from credit and cyclicals… We have historical breadth thrusts in both stocks and bonds… And then we have sentiment and positioning at very bearish levels…



One more leg lower should really cement the bearishness and set the market up for a strong run and a great opportunity to add to our longs. Until then, patience….

Bad Data in Big China

The economic slowdown in China continues to accelerate *sarcastic shocked face*…

Here's some recent headlines from Reuters on the wilting Red Dragon.

> China's crude imports by tanker look set to peak in January, breaking over 10 million barrels per day for the first time, according to Refinitiv data. But that masks signs of slowing demand growth for both transportation and industrial fuels, according to analysts.
>
> China's car sales fell for the first time in more than two decades in 2018, the country's top auto industry association said this month, dropping by 2.8 percent from a year earlier. (Full Story)

Property investment growth in December slowed to the second-slowest rate for 2018. Real estate is a key Chinese economic driver and construction is the source of much of the country's diesel demand. (Full Story)

China National Petroleum Corp this week said it expected diesel demand to fall by 1.1 percent in 2019. That would likely be China's first annual demand decline for a major fuel since its industrial ascent started in 1990. (Full Story)

Some of China's record crude oil imports were used to fill up strategic reserves, including at new storage sites in Jinzhou in the north and Huizhou on China's southern coast, meaning they did not reflect actual end-user demand. (Full Story)

Additionally, independent refiners increased their overseas orders at the end of the year to use up their annual import quotas received from the government for 2018.

But that meant they produced more fuel than even thirsty China can absorb, triggering record exports of refined products as refiners offloaded surplus fuel.

To contain the glut, the government has cut back import quota for independent refiners, while it may further raise fuel export quotas. (Full Story) (Full Story)

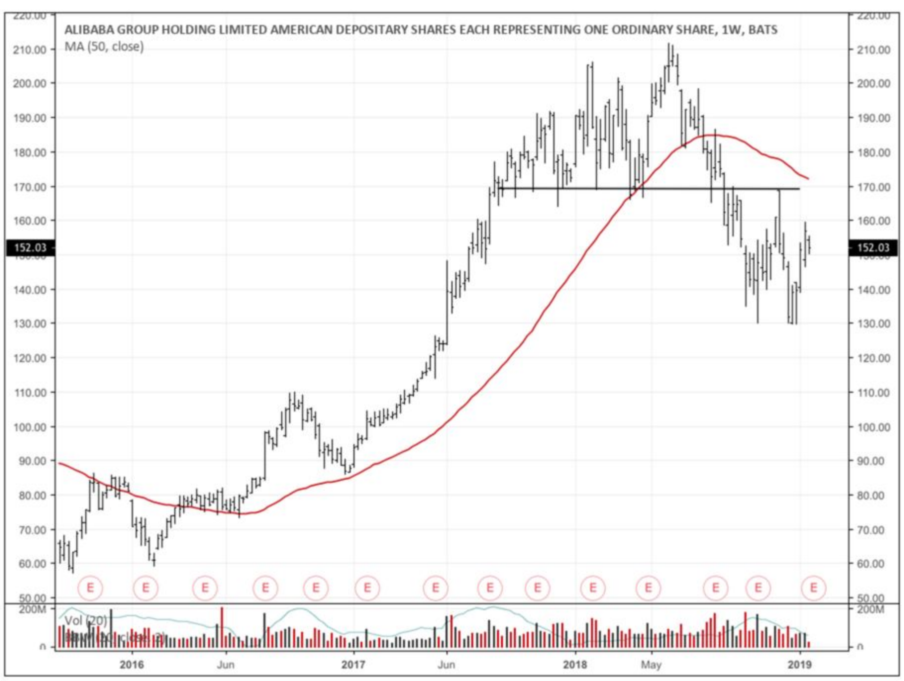
"Fuel exports will hit another record this year," said Seng-Yick Tee, oil analyst with Beijing-based consultancy SIA Energy.

Car sales growth has collapsed to its lowest levels on record. Not a good look for the Chinese consumer.

The country just posted its slowest growth in nearly 30-years and that's only if you believe the official numbers — we don't. They're saying Q4 real GDP came in at 6.4% but the China watchers we talk with say the real number is likely closer to zero or negative.

The data outside of China is confirming this slowdown. Exports across the board in Asia have turned negative for the first time since early 16'.

We're probably going to put on another short BABA position using puts. We'll send out an alert when we do.



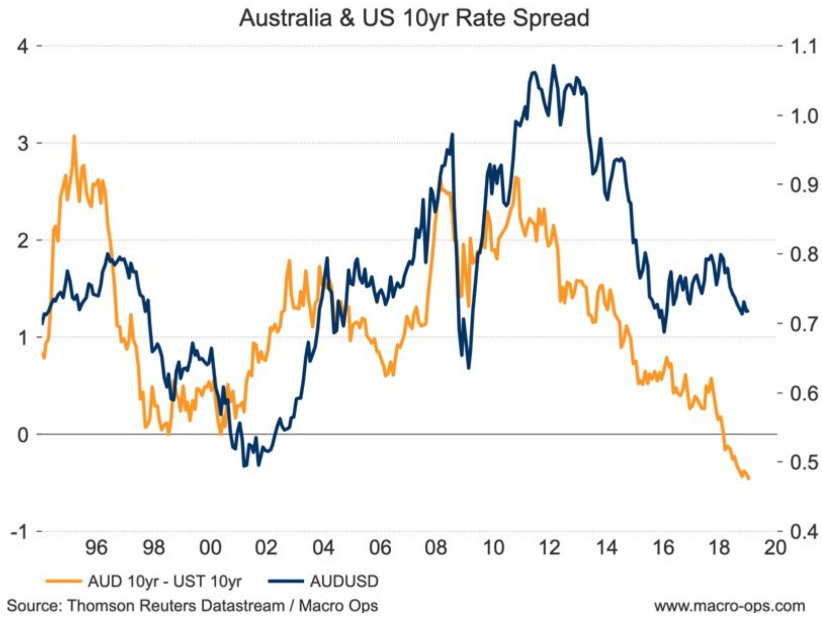
Speaking of China… Elon Musk is probably now regretting that he pinned Tesla's growth narrative on the country. The TSLA bull camp appears to be quickly unraveling and the tape doesn't look good. There's increasing likelihood that we see a shock-event (bankruptcy, DoJ charges…) in the coming quarters in which case our puts should pay out well.

Gold continues to chop around and hang above our $1,280 line of demarcation. I want to see a solid close, preferably weekly, below that level before initiating a short position. Since the dollar (DXY) looks ready for another possible leg lower, we may not get this break for a couple more weeks.

Regarding the dollar, I'm going to be putting out an update on my views soon. I think we're getting very close to a major macro inflection point in both precious metals and dollar pairs. All the pieces seem to be coming together and one more washout in USD would really be the final piece in the macro puzzle that would reset CoT positioning and set us up for another leg higher.

I mean, if you just look at some of the dollar pairs, it absolutely baffles my mind with what some traders are buying against the dollar, with the aussie being perhaps the best example.

Not only are interest rate differentials completely out of whack but there are fewer countries more exposed to a slowing China. Throw in a slowing and overleveraged housing market on top of that and you have the makings for an excellent short opportunity setting up.



This week I've been digging into Criteo (CRTO) with our value guy who must remain nameless for now. I've had this company on my watchlist ever since the stock suffered a major selloff in 2017.

In short, CRTO is a technology company that engages in digital performance marketing. It's based out of France. The stock was kneecapped in 2017 following changes Apple made to its rules over how advertisers could track and use data. Since then, pessimism over CRTO's future has driven the stock down by as much as 65% at one point.

Steven Wood, a very talented value investor and manager of GreenWood Investors, recently established a position in CRTO and discussed why in his latest investors letter (link here).

The company trades at the incredibly low multiple of 4.5x EV/EBITDA. It appears a lot of bad possible outcomes have been baked into the price. But the company has solid management and a viable path forward to not just stable but exceptional growth. We have more digging to do but at first glance CRTO appears to have all the makings for a great asymmetric trade. We'll be putting out our report once we've finished our dig.

That's all I've got for now.

If you've got 10-minutes then give this recent CNBC interview with Dalio out in Davos a watch (link here). He talks about the incredibly difficult policy landscape we're moving into in the next cycle (both politically and monetarily) and what that means for markets.

Oh, and also, we're starting a monthly MO book club. We just created a channel in the slack for it, so make sure to go in there and join the channel. I'm thinking that I'll send out a list of potential books sometime in the next week and we can all vote and pick one for our February read and then discuss in the channel.

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