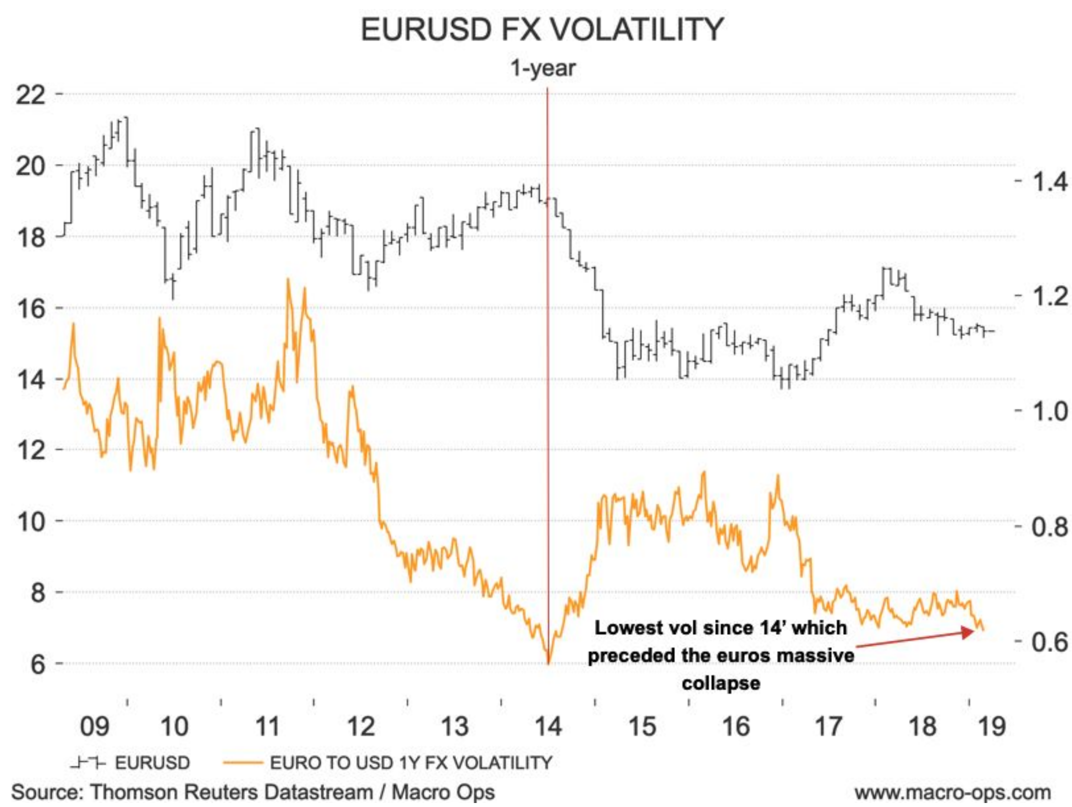
Low Vol to High Vol

Good morning Operators,

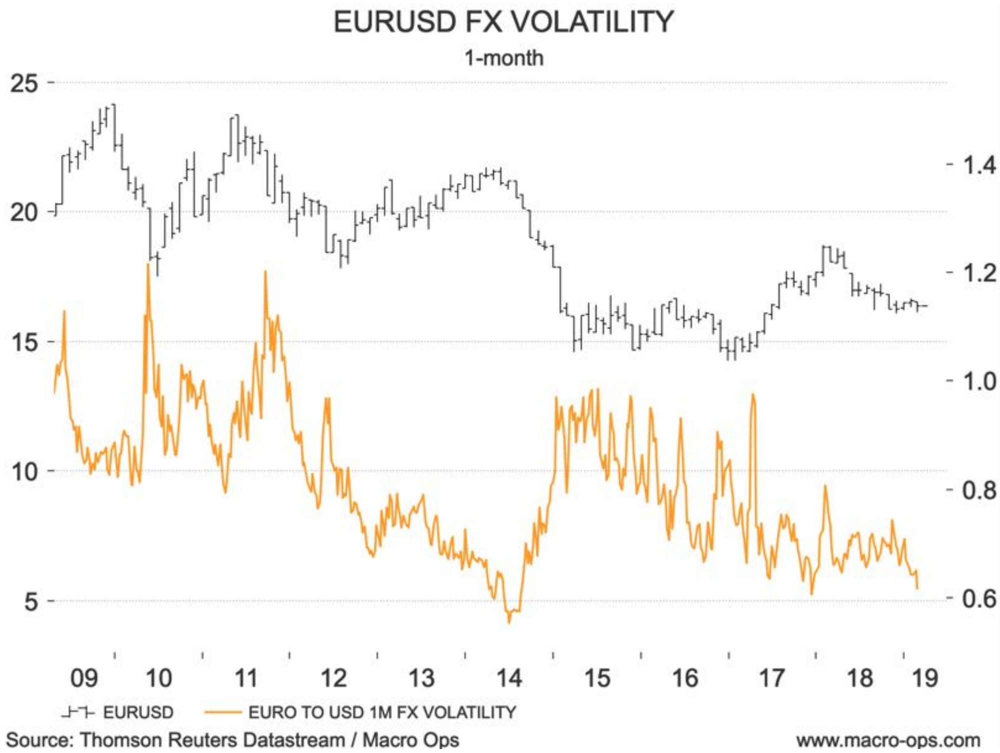
In our most recent podcast ([link here]) Chris D. talks about how the market is telling him a major macro regime change is coming.

One of the reasons is due to the extremely low volatility in the FX market. Low volatility regimes typically precede high vol regimes (ie, explosive trends). There's a number of ways you can measure this. You can look at an asset's Average True Range (ATR), its Bollinger Band Width (BBW), or just observe its price action directly and look for tight extended trading ranges.

The EURUSD is a prime example of the current wound up FX regime. One-year EURUSD volatility is nearing its lowest level in 5-years. You can see on the chart that the last time vol was this subdued it preceded the euro's massive downtrend.



Here's the same chart but looking at vol on a 1-month basis which is also nearing multi-year lows.

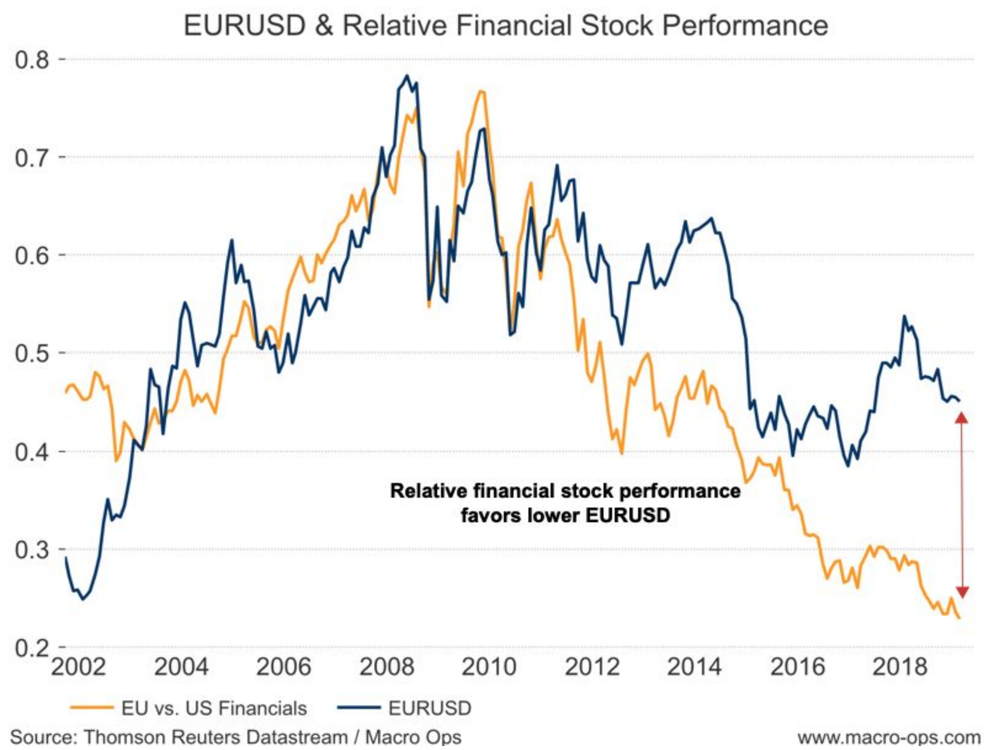


This information alone doesn't give us a probable trend direction. It just tells us that a large move is likely coming in the euro and therefore the dollar (DXY) since euros make up over half of the USD trade weighted basket.

Unfortunately, the weight of the fundamental evidence is mixed and doesn't clearly favor a bullish or bearish trend at the moment.

Let's run through some charts so you can see why.

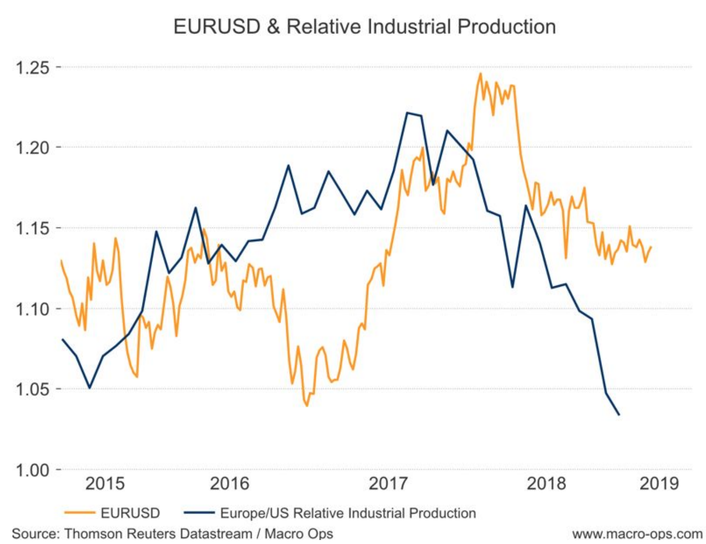
Relative performance between US and EU financial stocks clearly favors a lower EURUSD. This indicator has a good track record of working because bank stocks move off of growth and interest rate expectations (two key inputs in exchange rates) and equity traders tend to be smarter (in the collective sense) than FX traders.

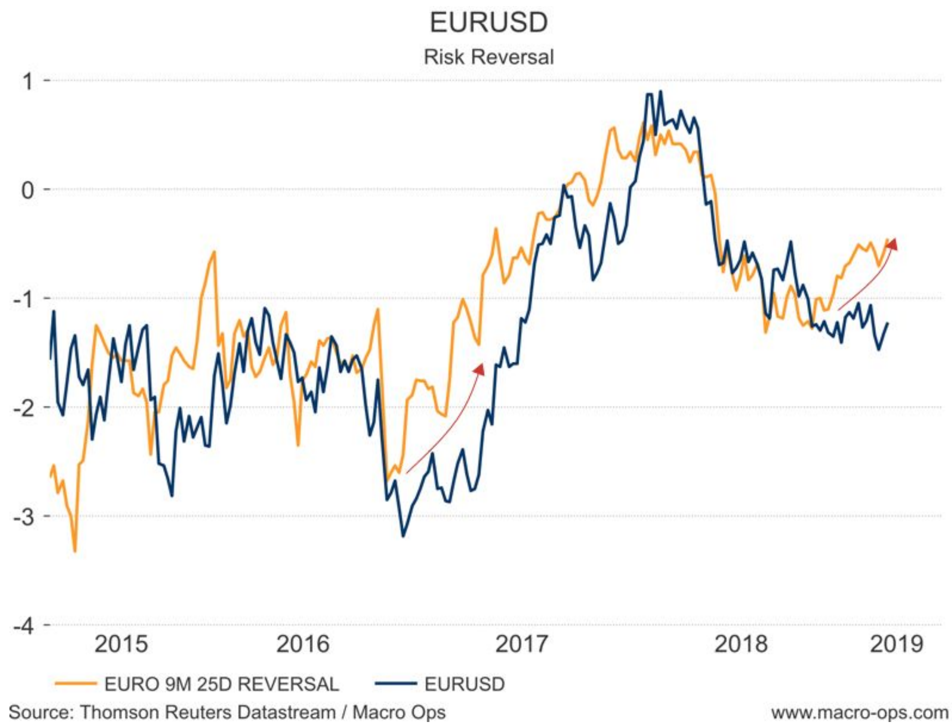


Relative US-EU industrial production also favors a lower euro.

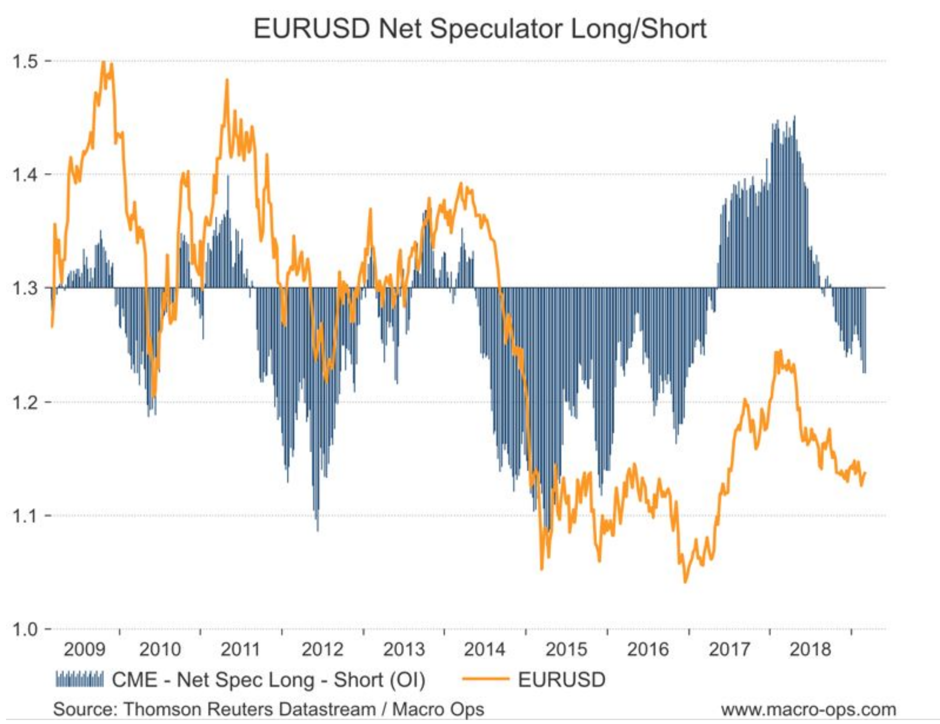
This indicator peaked out in mid and 2017 and preceded the EURUSD top 6-months later.

The euro risk-reversal (risk-reversals measure the difference in the implied vol of similar dated call and put options) favors a move higher. We can see the last time we saw a similar divergence was in 16' when the indicator lead EURUSD upward.



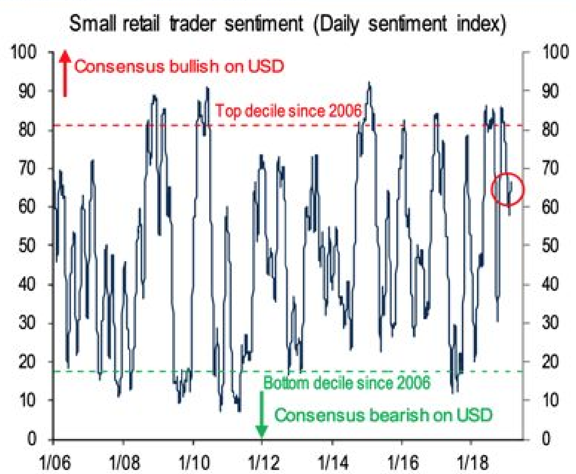


Positioning in EURUSD has now flipped to net-bearish. It's not at extreme levels but is no longer a headwind for the euro and if anything is bullish.



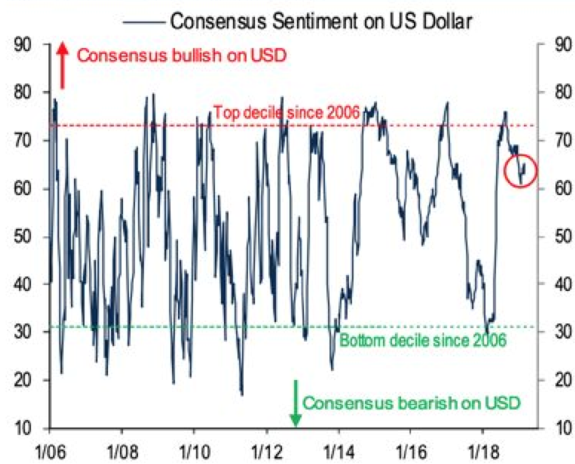
Broader positioning in the dollar (DXY) remains crowded long as well as shorter-term indicators of sentiment.

Figure 17: USD - still too many bulls (I)



Source: Trade Futures

Figure 18: USD - still too many bulls (II)



Source: Consensus Bullish Sentiment

The ECB meets this Thursday and there's a chance that gets the euro trending again. There's also the possibility that we continue to chop sideways a while longer. Because I'm not interested in expending capital (both mental and monetary) getting whipsawed on further sideways action, I'll wait until we see close above spot 1.1400 to buy or below spot 1.1250 to sell.

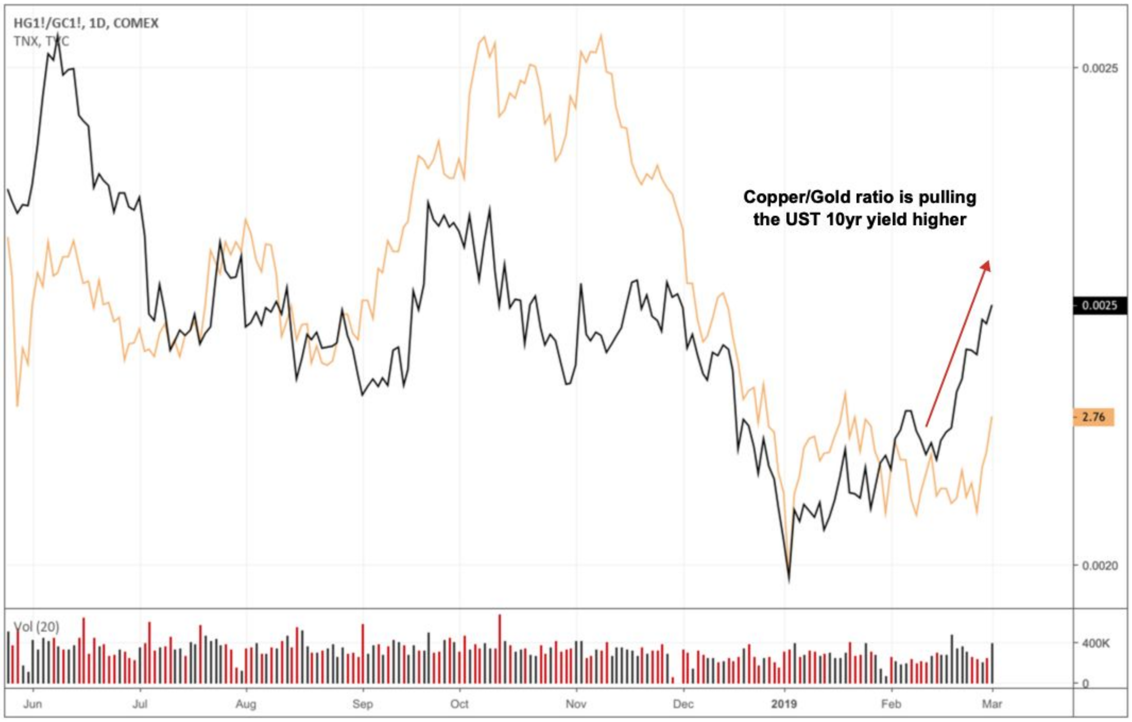
I still have a hunch we'll see risk-assets rally on the announcement of a US-China trade deal ([see latest WSJ article on deal here](#)) which is likely to be announced in the coming week(s). I'd think this would also drive RoW outperformance versus the US which would be dollar bearish in the near-term.

No way to know how long that rally would last, maybe a few days or a few weeks. But, unless China's recent credit impulse begins to show up and meaningfully reverse the weakening global econ data then it's likely that rally would be purely speculative and set the market (both stocks and FX) up for a painful reversal. This would also have the added benefit of potentially resetting positioning in the dollar, which we need if we want to see a sustainable trend higher.

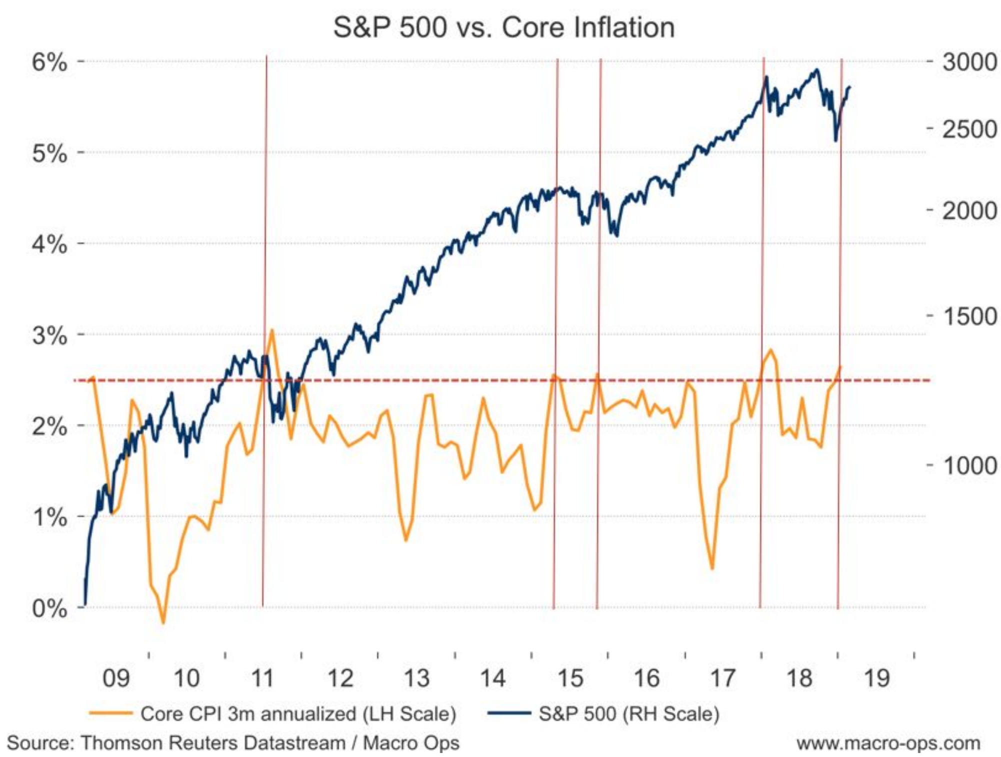
Rates

US bonds recently broke down out of a 2-month coiling wedge.

The metals market hinted this breakdown in bonds was coming. You can see on the chart below that the copper-to-gold ratio has been pulling rates higher (bonds lower).

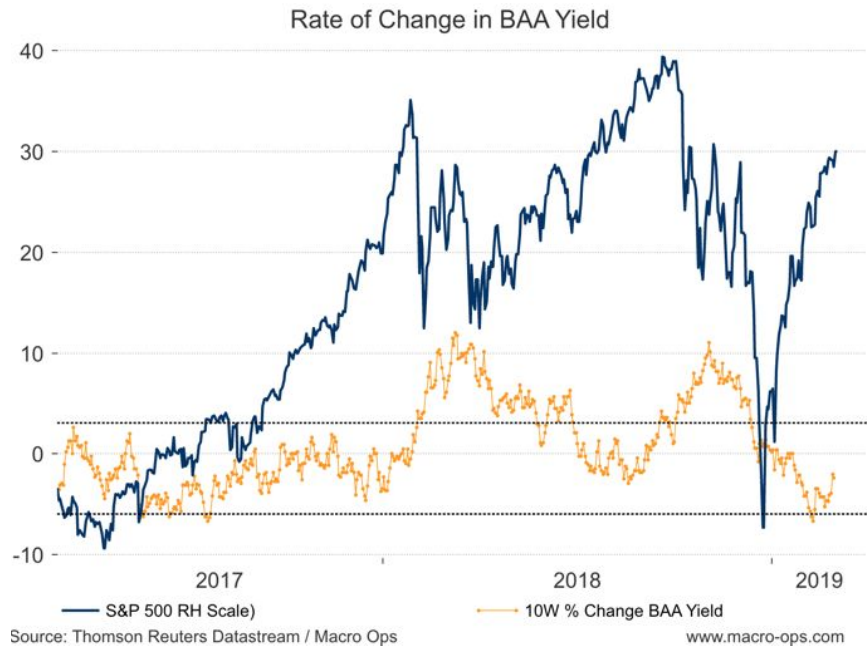


This move in rates is in part being driven by increasing risk-on sentiment as well as the rise in the short-term RoC in inflation.

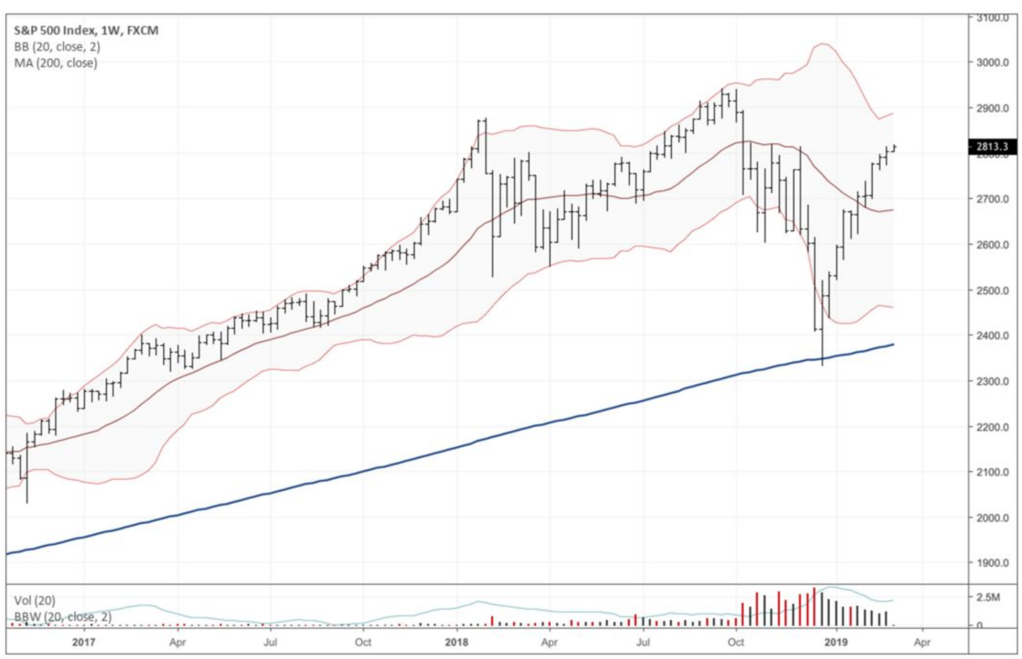


As I wrote in last month's MIR, this pickup in the rate of change in inflation will put pressure on interest rates as long as it stays elevated (above the horizontal red line).

Luckily for stocks, the longer-term RoC in interest rates has dropped quite a bit due to the market rout at the end of the year. This means that rates can rise (bonds sell off) for a while before they begin to exert meaningful pressure on stocks.



Equity Market

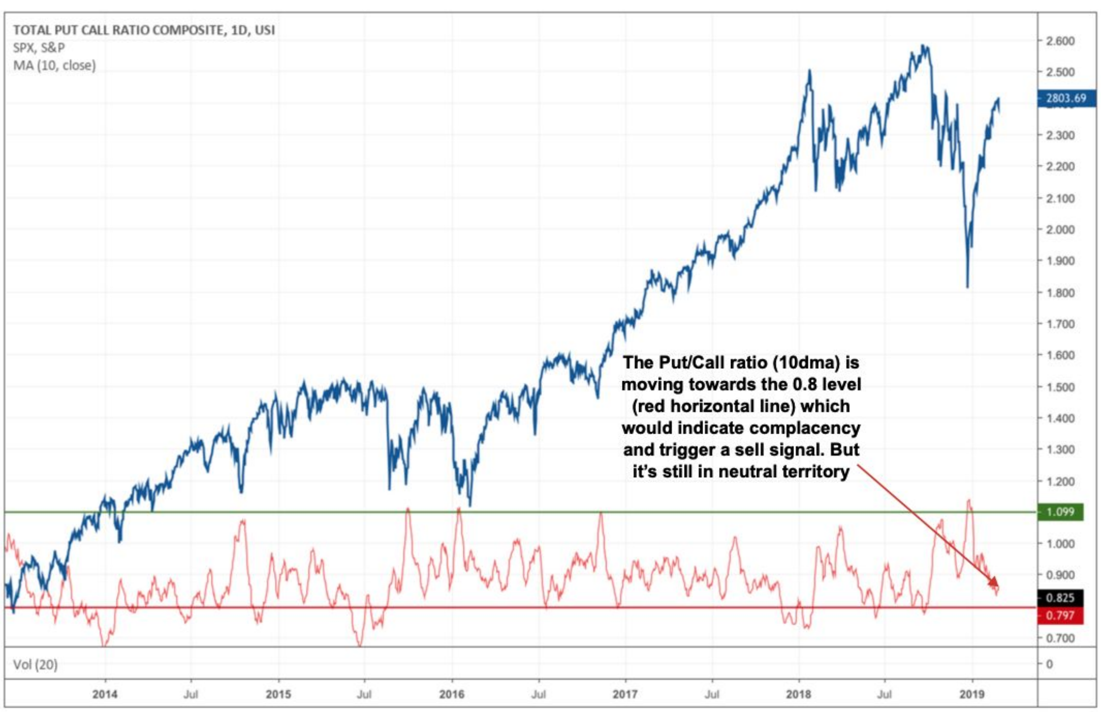


In our most recent MIR we wrote about how the “Trifecta” of data (macro, sentiment, and technicals) broadly supported the primary trend higher in US equities. But… I also pointed out how the short-term trend was becoming extended and we should expect some sideways action or retrace in the coming weeks.

There’s yet to be any tell-tale signs of an impending pullback (ie, weakening credit, breadth, or excessive sentiment). So currently, the odds still favor higher stock prices. It’s possible we see the S&P rally another 2.5%-3% to its upper Bollinger Band around the nice round 2,900 number before retracing.

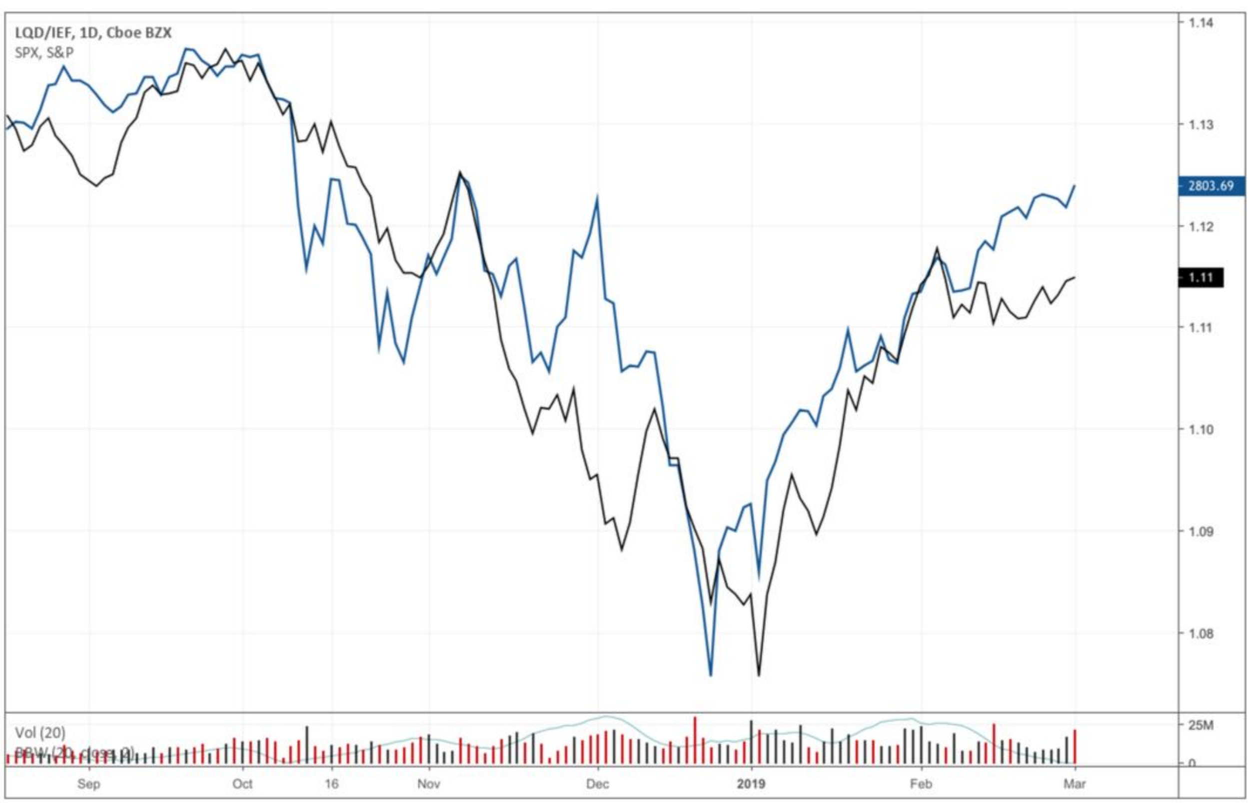
We’ll send out an alert when we start to see our shorter-term indicators weakening.

For instance, the Total Put/Call ratio is still in neutral territory and likely a couple of weeks from triggering a sell signal.

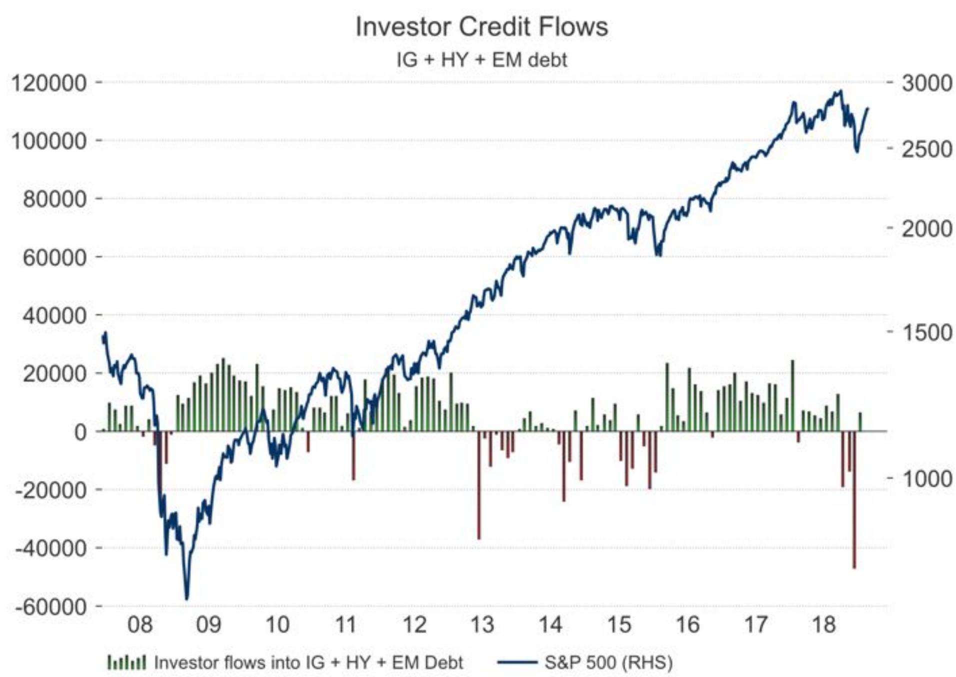


The Nasdaq McClellan Summation Index (NASI) is close to rolling over and triggering a sell signal, though it's not quite there yet. And this indicator typically leads the market by a week or two.

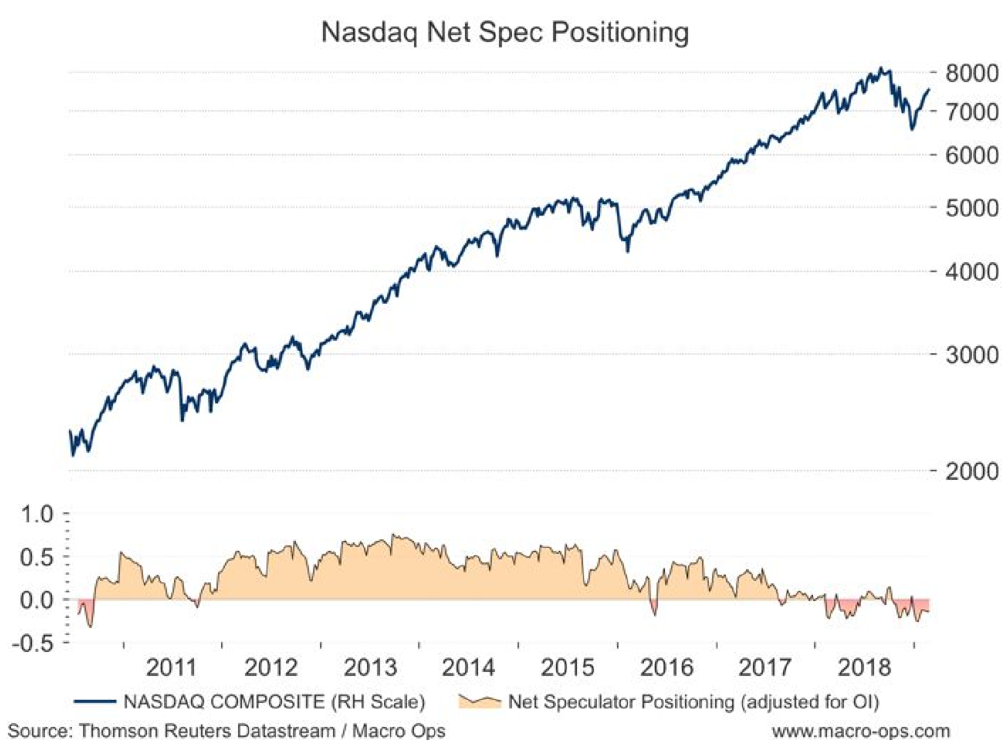
We're seeing a slight divergence between the market (blue line) and credit (LQD/IEF marked by the black line). But credit is still largely in an uptrend and far from triggering a sell signal.



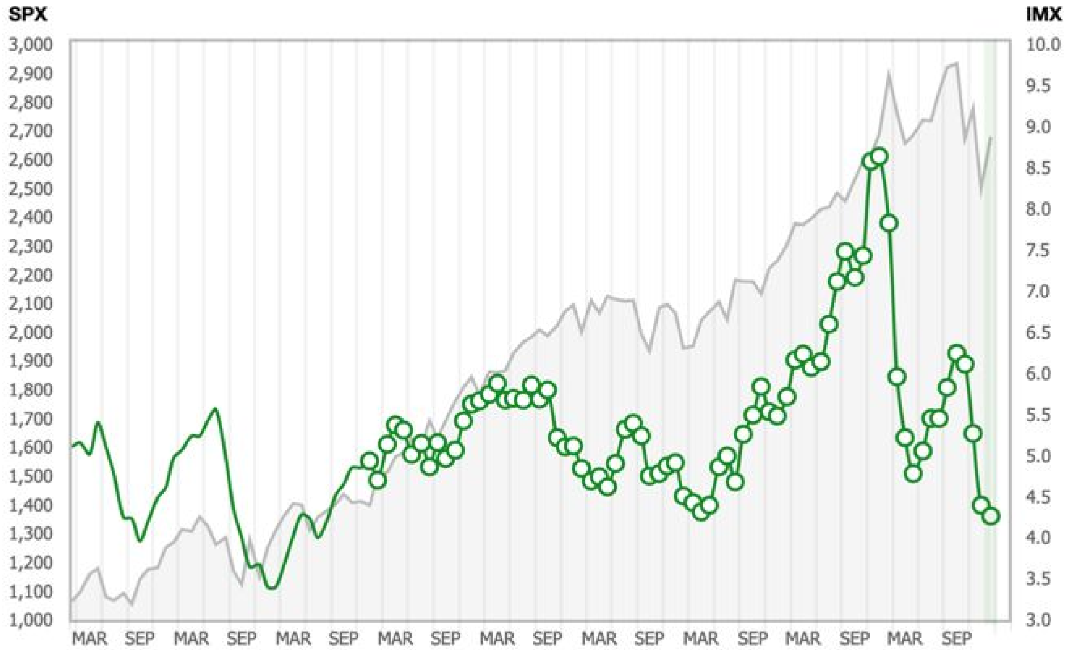
Speaking of credit, our long-term credit flows indicator just triggered with positive inflows for the first time in 3-months. Historically, this is bullish for the broader market, especially after seeing significant outflows like those we saw at the end of last year.



Net speculative positioning in the market is supportive of the trend higher.



The latest numbers for TD Ameritrade's Retail Movement Index (IMX) were just released and the index dropped again for the fourth month in a row in January. This indicates that retail investors, for the most part, have not actively participated in this rally.



All our other indicators of sentiment (II, AAII, BofAML FMS, NAAIM, State Street etc...) show that sentiment remains surprisingly muted, despite the recent run up in US stocks. Our shorter-term indicators of sentiment show bullish sentiment picking up recently, but still below levels that typically mark a turning point.

BofAML's Global equity risk-love indicator, which measures sentiment/positioning in global assets, shows that sentiment is actually more bullish outside the US. The indicator is still at what's considered neutral levels but is close to triggering a "euphoria" bearish signal . A trade deal announcement would likely set off the alarm bells.

Figure 14: Global Risk-Love has bounced off sharply from the panic zone since late December/early January, climbing from 11th percentile to the 73rd percentile of its history since 1987 in two months

Source: BofA Merrill Lynch Global Research, Bloomberg

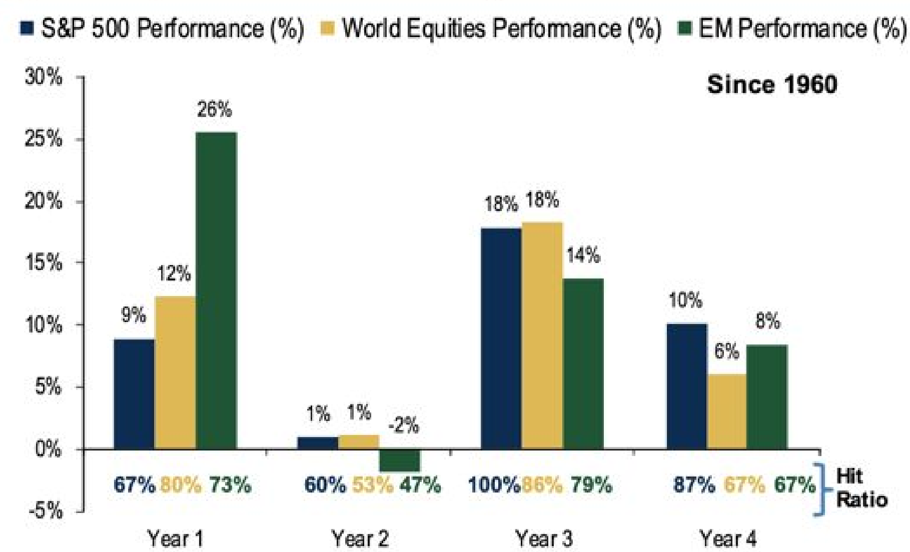
It seems that the majority of investors have been outside looking in at this rally, expecting a resumption of what they thought was the beginning of a cyclical bear market. We're probably getting close to their uncle point, where they won't be able to stand seeing stocks rally any further without them. They'll then throw in the towel and pile in. This will likely be when the market finally reverses a bit.

The key word there being a bit. I'm not expecting a strong reversal. Sentiment and positioning nearly guarantee it'll be a shallow one.

Also, it being the third year of a US Presidential term bodes very well for the stock market going into the rest of the year. Read the following via BofAML:

> ***The third year of the US Presidential cycle – the one preceding the election year (like 2019) - is special****. US equities have risen in ALL 14 "Third Years" since 1960, with the median rise at 18%. EMs were up in 80% of cases in this third year, with the median rise at 14%.*

Figure 12: Third year of US Presidential term is usually the best...



Source: BofA Merrill Lynch Global Research, MSCI, Global Financial Data, Bloomberg, FactSet
Note: Median returns are used for this analysis. For world equities, MSCI AC World is used since Dec 31, 1987. Before that, MSCI Developed Markets are used till Dec 31, 1969. Prior to that, S&P 500 is used as a proxy.

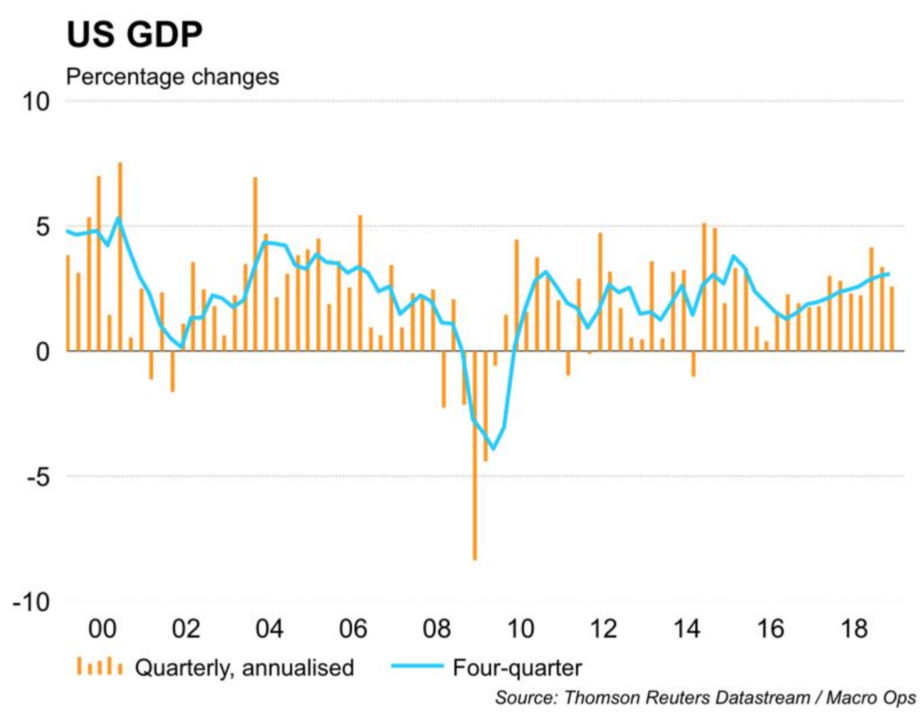
Table 2: Since 1960, about two-thirds of the time, policy is eased during the third year of the US Presidential cycle. US equities were up during ALL these periods with average returns of 18%

			US Policy Stance (S.D.)*			
Episode	Start of 3rd year of Presidential term	End of 3rd year of Presidential term	At the start of 3rd year	At the end of 3rd year	Change during 3rd year	SPX performance
1	11/30/1962	10/31/1963	-0.09	-0.14	-0.05	30.9%
2	11/30/1966	10/31/1967	-0.59	-0.01	0.58	17.1%
3	11/30/1970	10/31/1971	-0.26	0.71	0.97	13.2%
4	11/30/1974	10/31/1975	-0.48	0.43	0.92	20.5%
5	11/30/1978	10/31/1979	0.00	-0.97	-0.96	9.3%
6	11/30/1982	10/31/1983	-0.32	0.19	0.51	22.3%
7	11/30/1986	10/31/1987	0.86	0.02	-0.84	3.2%
8	11/30/1990	10/31/1991	-0.12	-0.21	-0.09	29.1%
9	11/30/1994	10/31/1995	-0.38	-0.30	0.08	23.1%
10	11/30/1998	10/31/1999	-0.59	-0.25	0.34	24.1%
11	11/30/2002	10/31/2003	0.28	0.61	0.33	18.6%
12	11/30/2006	10/31/2007	-0.18	0.18	0.36	12.4%
13	11/30/2010	10/31/2011	0.72	1.13	0.41	5.9%
14	11/30/2014	10/31/2015	0.23	-0.27	-0.50	3.0%
15	11/30/2018	10/31/2019	-0.08	-0.06^		
Likelihood of policy easing during 3rd year of Presidential term					64%	
Median change during 3rd year of Presidential term					0.33	18%
Likelihood of policy easing during other years of Presidential term					36%	

Source: BofA Merrill Lynch Global Research, Bureau of Economic Analysis, Bloomberg, Datastream
Note: *US Policy stance is gauged by the average of real short term rates, real money supply growth, real-effective exchange rate, and the fiscal balance of the government. Green shaded regions denote policy easing during the third year of the Presidential term. ^Data as of January 31, 2019.

Here's a link to the BofAML report on this. It's worth checking out ([link here]).

Oh, and also, just to further squash any serious bearish ideations you may have, here's a chart showing the latest real GDP numbers (note: data was delayed due to gov shutdown).



Real GDP in the US came in at an annualized rate of 2.6% last quarter, well above the 2.2% rate that the consensus expected. And look at the trailing-twelve-month trend (blue line). NOT Bearish…

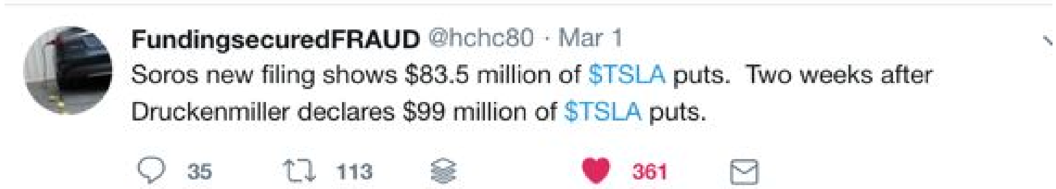
Stocks/Portfolio Holdings

The Tesla (TSLA) saga continues to be mind-blowing. For those of you who haven't been following it, I suggest reading these two short quick blog posts and getting caught up (link 1, link 2).

Elon Musk appears to be desperate to raise cash and is pulling out all of his promotional tricks to do so. But it finally looks like he's losing control of the narrative — which is dangerous, because a stock like TSLA is kept purely afloat by belief.

Both Soros and Druckenmiller have recently taken large positions in TSLA puts. This is really interesting because just last year Druckenmiller was saying how he wouldn't short the stock no matter how bad the fundamentals looked because the hype surround it was just too much.

Looks like something seriously changed his mind.



I’m considering adding to our put position (it’s currently 1.5% of NAV) in the coming weeks.

Our small starter position in Box Inc (BOX) took a hit after earnings came out, giving back most of our profits on the trade.

The earnings reportwasn’t terrible but revenue and billings came in below analyst’s estimates. The stock is still above our entry price of $19.25 but the technical damage from this gap down is significant. And since there’s a lot of other ideas we can put our money in, we’re going to move our stop to breakeven and exit the trade if we see a close below that level.

We have two other holdings reporting this week, GAIA after the close on Monday and SSYS on Thursday. I’m considering reducing our position in SSYS going into earnings seeing as how one of their competitors (DDD) just took a hit after missing expectations.

Other than that, I’m still looking for opportunities to add to CRTO, EAF, ROAD, and GTX. We’ll send out a trade alert when we do.

That's all I've got for now.

I'm currently digging into shipping stocks and hope to get out a report to the group later this week.

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

Macro Ops Portfolio YTD 6.13%

Big Bet Macro

Asset Class	Position	Position Size	Cost Basis	Risk Point	Target	Last Price	P&L
Equity	Construction Partners (ROAD)	4,500	$12.07	$10.80	$17.00	$12.04	-0.25%
Equity	Gaia (GAIA)	4,500	$12.07	$10.80	$20.00	$11.58	-4.06%
Equity	Facebook (FB)	216	$138.00	$119.50	$144.19	$165.99	20.28%
Equity	Fiat (FCAU)	2,666	$15.20	$13.70	$28.00	$14.57	-4.14%
Equity	Box Inc (BOX)	1,095	$19.25	$15.60	$35.00	$19.83	3.01%
Equity	Sharpspring (SHSP)	859	$13.71	$10.80	$20.00	$15.01	9.48%
Equity	Garrett Motion (GTX)	5,630	$15.11	$13.80	$25.00	$16.75	10.85%
Equity	Criteo (CRTO)	3,333	$25.47	$23.00	$45	$27.26	7.03%
Equity	Grupo Financiero (GGAL)	1,536	$26.13	$21.00	$44.00	$29.31	12.17%
Equity	Stratasys (SSYS)	2,335	$24.76	$20.50	$50.00	$27.11	9.49%
Equity	Discovery DISCA	1,300	$28.09	$26.70	$60.00	$29.07	3.49%
Equity	Google GOOGL	195	$1,129.78	$1,100.00	$1,400.00	$1,162.47	2.89%
Equity	Disney DIS	2,146	$102.34	$108.50	$150.00	$113.77	11.17%
Equity	Yatra Online YTRA	13,877	$7.24	Investment	$15.00	$4.08	-43.65%
Equity	TSLA Jan '20 150 Put	5	$15.01	$0.00	$60.00	$11.25	-25.05%
Equity	TSLA Jun '19 220 Put	4	$18.01	$0.00	$60.00	$9.75	-45.86%
Equity	FCAU Mar '19 24 Call	135	$0.25	$0.25	$2.50	$0.00	-100.00%
Equity	SPX Mar '19 3150 Call	7	$8.10	$0.00	$80.00	$0.00	-100.00%
Equity	DIS Jan '20 165 Call	205	$1.11	$0.00	$10.50	$0.25	-77.48%

**Updated 3/3