A Pound of Flesh

Summary:

- US-China trade talks breakdown
- Market sentiment/positioning still way too complacent
- Expect more volatility and downside risks in coming weeks
- Tape bomb risks make for tough trading environment

The US-China trade talks look to have completely derailed. It seems that Xi may be zeroing in on Trump's obsession with the S&P as a yardstick of his administration's popularity and leveraging that weakness to take a pound of flesh — as Shakespeare's Portia would say — in order to extract a better deal. Read the following clip from a recent *WSJ* article on the ordeal (link here).

> In Beijing, as the talks approached, Chinese officials believed they had some leverage, The Wall Street Journal has previously reported, because they saw Mr. Trump's public criticism of the Federal Reserve and his desire for lower interest rates as a sign that he was worried about the future course of the U.S. economy and therefore may be more eager to do a deal. It was a miscalculation on their part; Mr. Trump has long called for low borrowing costs and also has repeatedly cited the enduring strength of the U.S. economy.
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> President Xi also was encouraged by a pickup in Chinese growth—the result of Beijing's aggressive stimulus policies—and by a perception that the American economy is about to enter a down cycle. "Time is on our side," said a senior official in Beijing. On the home front, Mr. Xi is wary of a potential political backlash as a result of any perception that he is conceding too much to Washington.
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> Chinese officials were therefore caught off guard, three days before the Washington talks were scheduled, when Mr. Trump said on Twitter he would increase tariffs, to 25% from 10%, on the $200 billion in Chinese goods because he saw the Chinese backtracking—the original threat he had set for a March 1 deadline.
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> He also said he would start the legal proceedings necessary to add tariffs to almost everything else the Chinese sold in the U.S., even if it meant the Chinese canceled their Washington visit.

> ...The Chinese side wanted more information from Washington before making the decision. But senior officials knew news of Mr. Trump's tweets would inevitably cause market anxiety. The first order of business Monday morning: China's central bank sped up a plan to release more funds for banks, a stimulus measure aimed at calming jittery investors and businesses.
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> State-backed funds were also instructed to buy what was necessary to prevent a free fall of shares. China's Foreign Ministry spokesman released a statement at Monday's regular press briefing that said only that the Chinese delegation was "preparing to travel to the U.S." The spokesman didn't say when the team would depart or give additional details.
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> The two leaders are expected to meet at the G-20 meeting at the end of June, if they don't meet earlier. After Mr. Liu jetted off back to Beijing, Mr. Lighthizer released a statement saying that on Monday USTR would "begin the process of raising tariffs on essentially all remaining imports from China."

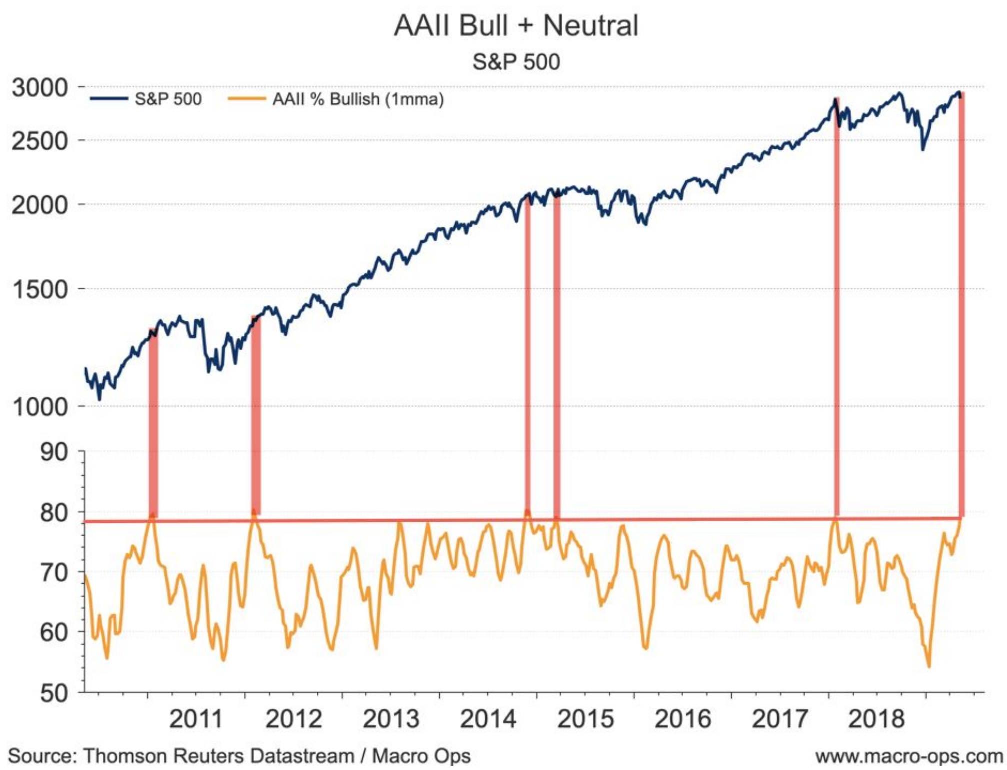
This trade-deal narrative can flip-flop faster than a politician on the campaign trail so it's possible that Trump tweets something or a surprise deal is announced in the coming weeks but the chances of that happening are looking slimmer by the day (at least the surprise deal thing, of course Trump will keep tweeting stuff). It's now likely we won't see many positive developments on this front until we get closer to the G-20 meeting near the end of June.

This, along with deteriorating macro data, should weigh on markets over the coming weeks. In addition, a number of the sentiment data we track has actually become more bullish over the last two weeks despite the selloff in equities. This is not a good sign and indicates we should expect greater downside volatility in the weeks ahead.

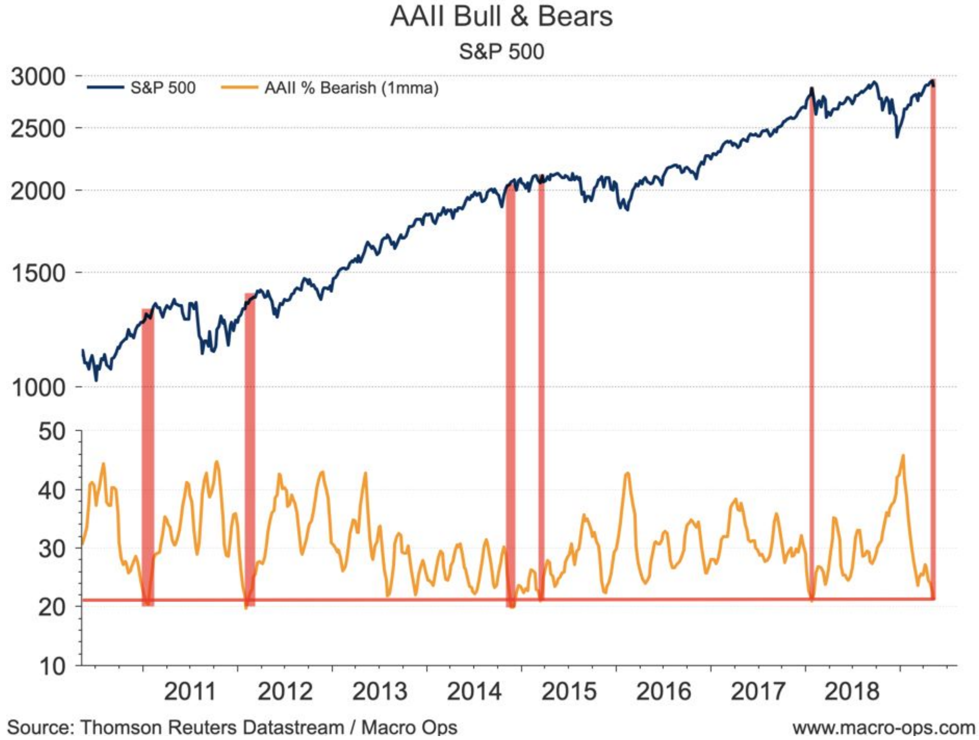
Let's run through some of the indicators we're looking at.

The Nasdaq McClellan Summation Index (NASI) rolled over at the end of last week, giving another sell signal.

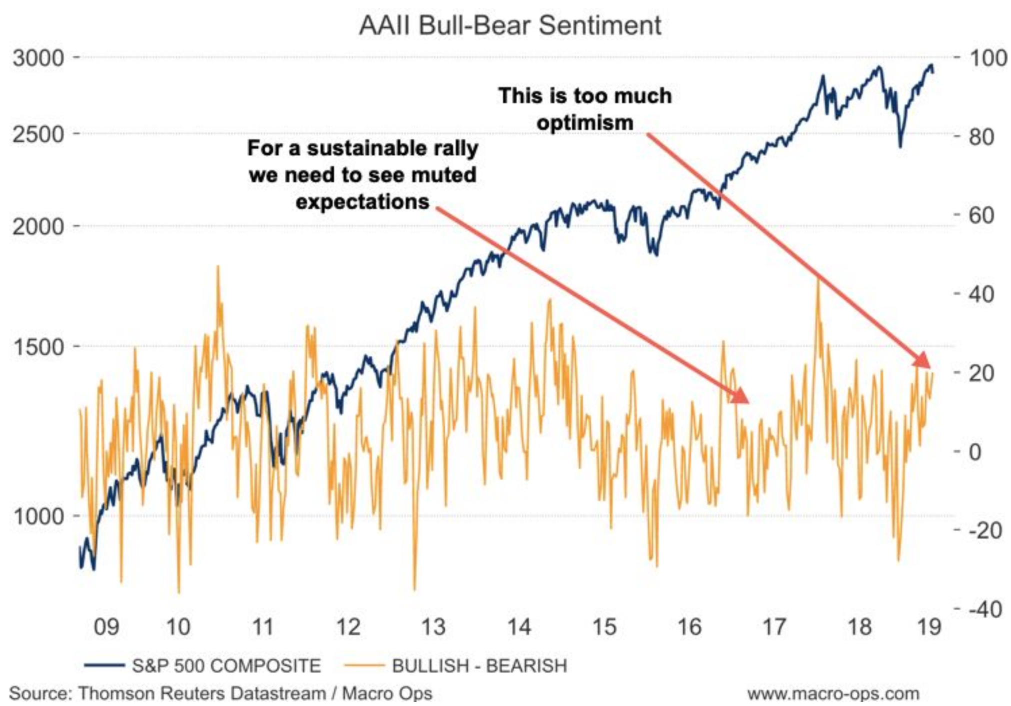
The 1-month moving average of AAII Bullish+Neutral sentiment is extremely elevated and at levels that have marked or directly preceded past major intermediate market tops.



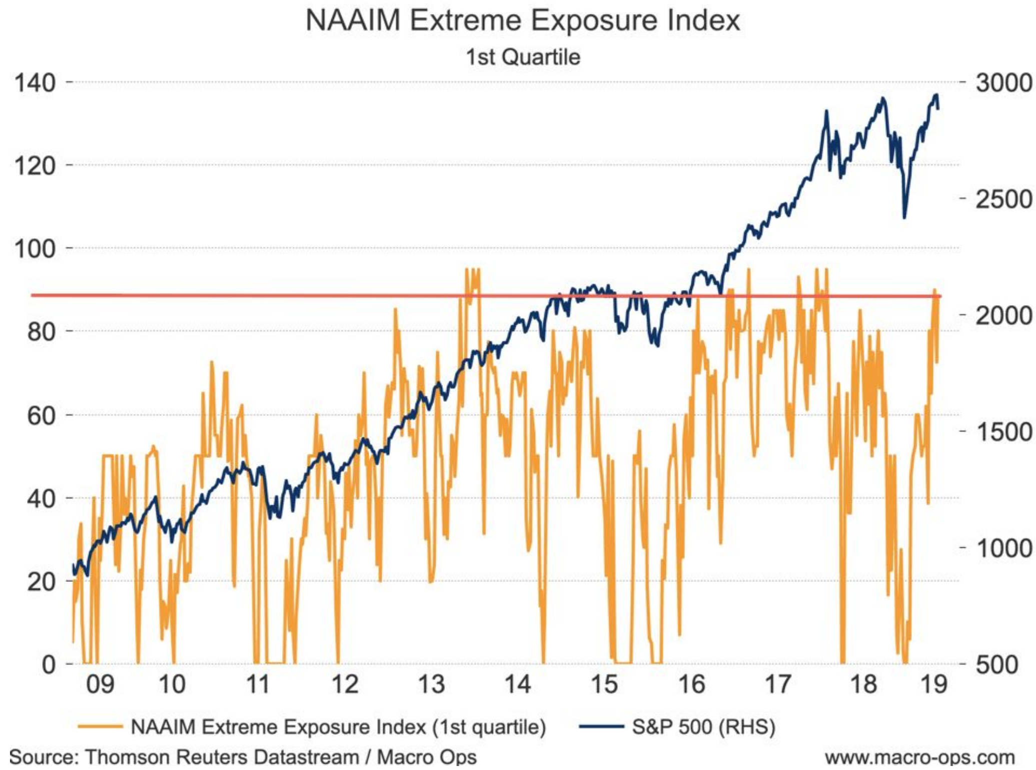
Conversely, the 1-month moving average of AAII Bearish sentiment has collapsed to levels which have historically marked intermediate tops.



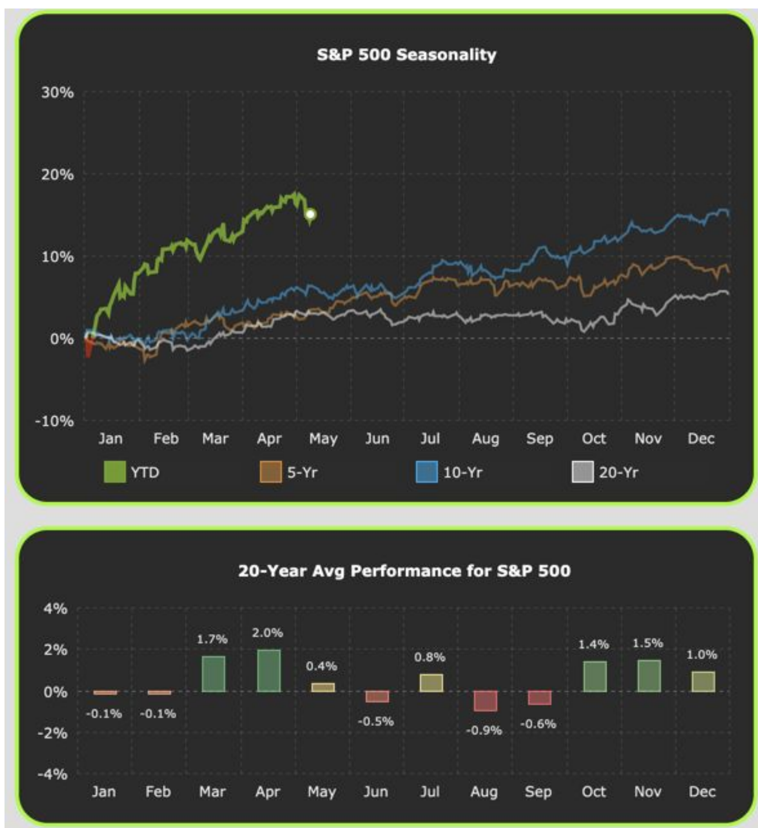
Stocks need a wall of worry to climb. For the market to be able to sustain the trend higher we need to see less complacency and more concern. Here's the 1-month moving average of the AAII Bull/Bear spread.



And again, here's the NAAIM Extreme Exposure Index which shows a number of investors are getting a bit over their skis.



May and June tend to be weak months for S&P returns and considering the year-to-date performance so far, along with the backdrop we just discussed, there's little reason to expect this time around will be much different, if not worse than average (chart via [Commodity Seasonality](#)).

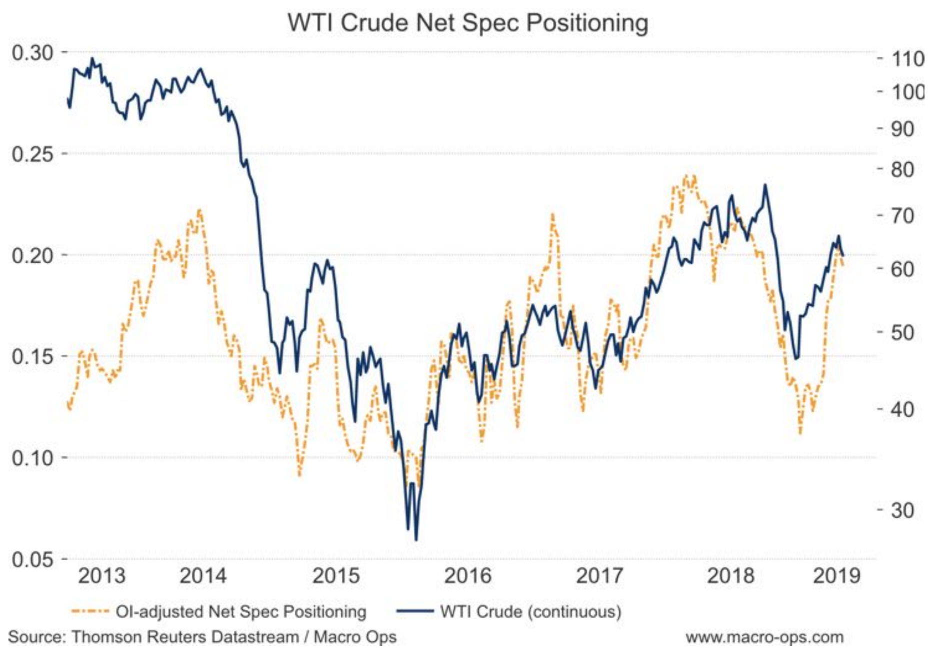


A month or two of volatile markets should be enough to fully reset sentiment and maybe even push the Fed into doing a preemptive cut or announcing a major policy change (they have a big monetary policy conference in June where they'll be discussing how to combat low inflation and it's possible something significant comes out of this).

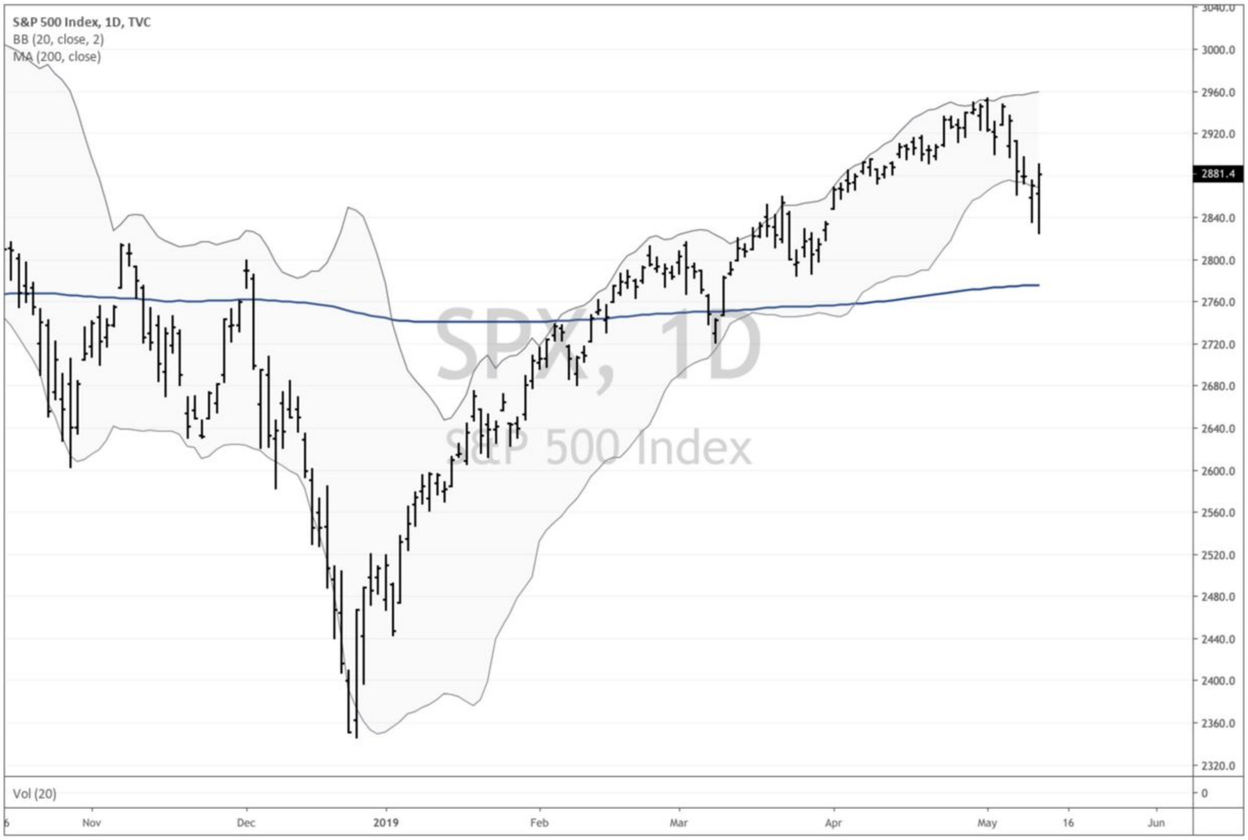
We've already reduced our long book and have considerable short exposure on via our TSLA puts. We may look to put on additional short positions in the coming week in some of the vulnerable higher multiple growth names we talked about in the latest MIR.

The headline risks (i.e., a Trump tweet or positive trade talk chatter) is going to make this a difficult trading environment over the next month. Because of this, we're going to keep our trading light and look to be less active.

One area I'm watching is crude. Spec positioning has become crowded on the longside again and if we move into a risk-off environment we should see crude prices fall and this positioning reset. CL_F is bouncing off support in its 200-day moving average but we'll be looking for signs of technical weakness to probe to the short-side.



The broader stock market is oversold on a short-term basis so we should expect to see a bit of a bounce over the next few days (SPX, IWM, JNK are all bouncing of their daily Bollinger Bands).



This rally should should be used to establish more short exposure.

That’s all I’ve got!

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