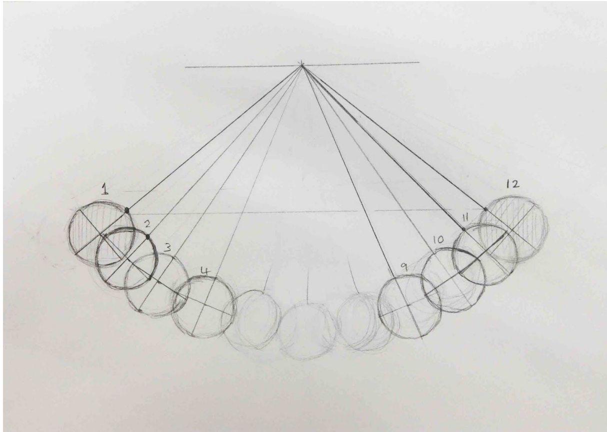
The Known Knowns Don't Matter



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> The pendulum of the mind alternates between sense and nonsense. ~ Carl Jung

> Politics is a pendulum whose swings between anarchy and tyranny are fueled by perennially rejuvenated illusions. ~ Einstein

Stephen Buhner wrote in his book "The Secret Teachings of Plants" the following:

> The physical Universe is an aggregate of frequencies. - Buckminster Fuller

> *All living organisms receive electromagnetic signals all the time. And like the signals received by our radios, many of them contain extremely large amounts of information, which can be used for a great many things. These range from regulating the opening of little doors in cells to let food in and waste out, to healing, to the beating of the heart, to birds orienting themselves to the magnetic lines of the Earth when migrating, to the communication between pollinators and their flowers, to the communications between members of the same family who have bonded with each other — and, of course, a great deal more.*

> *Electromagnetic spectrum signals, like those we know as a particular radio station, can and do contain very large amounts of information… Every time life flows through a frequency in the electromagnetic spectrum, it fractalizes that wave differently, because the flow of life is always nonlinear.* ***What is interesting is that unique information is always embedded or encoded within the way the oscillating sine wave is fractalized.***

Fractalized sine waves seem to be encoded into the very fabric of our reality; like the Golden Ratio and the second law of thermodynamics. They appear throughout the universe on nearly every level of scale and function. It's no surprise then that they underlie the very structure of our market, which is just fractalized sine waves overlaid on fractalized sine waves of various temporal scales.

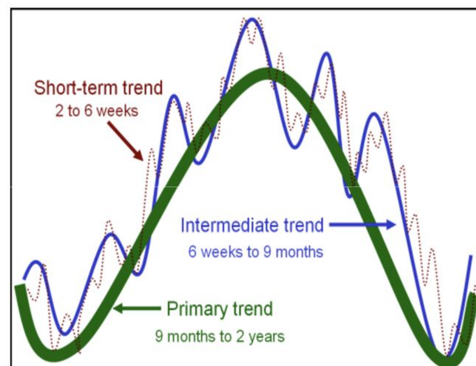
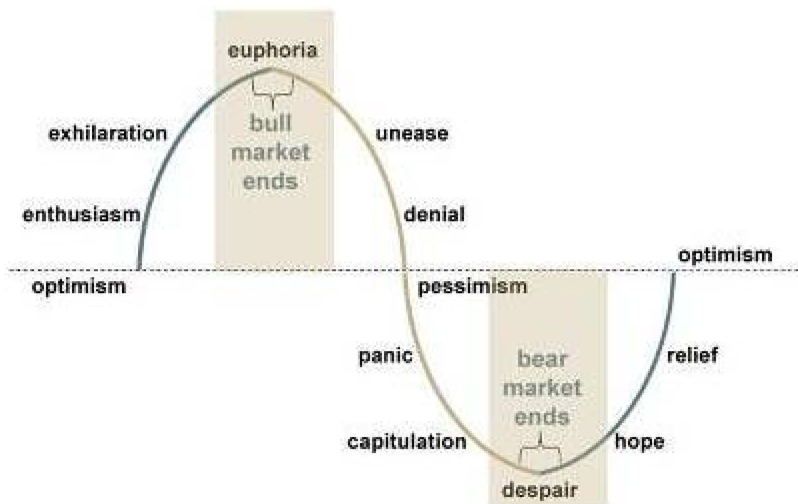


Chart courtesy of Pring.com

This makes intuitive sense because a sine wave is just a continuous pendulum swing. And crowd dynamics naturally follow the path of a pendulum, swinging from one local extreme to another.

The market is in effect a large complex information transmission system. All acting participants make bets using their particular knowledge set which then in aggregate moves the market, providing new information for the actors to incorporate into their decision-making process where they then make new bets. Creating a neverending information feedback loop.



The infinite feedback loops in the structure of the market, not to mention the way group psychology evolves, necessitate this constant back and forth, like that found in every natural system.

Every rally sows the seeds for a reversal and every reversal sows the seeds for a rally. Ad infinitum.

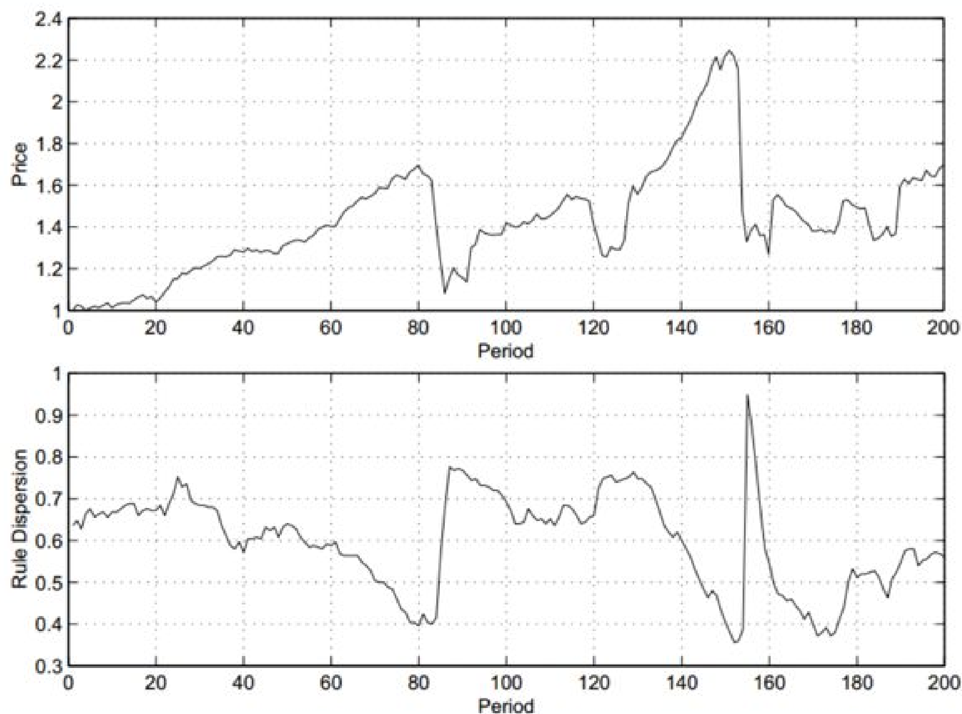
Michael Mauboussin discussed a critical driver behind why this process plays out in his recent paper titled "Who is on the other Side?". In it, he shares work done by economist Blake LeBaron which animates this concept using an agent-based model (here's a link to the original paper).

The model is computer generated and the "agents" are imbued with decision-making rules and objectives similar to those that drive market participants (i.e., make money, try not to lose money, don't underperform the average for long periods, etc…)

Here's a section from the paper (emphasis by me):

> *LeBaron's model replicates many of the empirical features of markets, including clustered volatility, variable trading volumes, and fat tails. For the purpose of this discussion, the crucial observation is that* ***sharp rises in the asset price are preceded by a reduction in the number of rules the traders used*** *(see exhibit 5). LeBaron describes it this way:*
>
> > *During the run-up to a crash, population diversity falls.* ***Agents begin to use very similar trading strategies as their common good performance begins to self-reinforce.*** *This makes the population very brittle, in that a small reduction in the demand for shares could have a strong destabilizing impact on the market. The economic mechanism here is clear.* ***Traders have a hard time finding anyone to sell to in a falling market since everyone else is following very similar strategies.*** *In the Walrasian setup used here, this forces the price to drop by a large magnitude to clear the market. The population homogeneity translates into a reduction in market liquidity.*
> >
> > *Because the traders were using the same rules, diversity dropped and they pushed the asset price into bubble territory. At the same time, the market's fragility rose.*

Exhibit 5: Agent-Based Model of Asset Prices



Source: Blake LeBaron, "Financial Market Efficiency in a Coevolutionary Environment," Proceedings of the Workshop on Simulation of Social Agents: Architectures and Institutions, Argonne National Laboratory and University of Chicago, *October 2000, Argonne 2001, 33-51.*

Mauboussin goes on to note the important lessons this model underscores about our market structure, which can be broken down into three primary points.

1. Falling agent diversity initially leads to agents making more money which creates a feedback loop of higher prices -> agents in the 'herd' make more money -> less agent diversity -> higher prices… This is why fighting trends, even ones based on faulty prepositions, can be so dangerous over a short timescale.
2. A reduction in agent diversity is non-linear. Meaning, as diversity falls, market fragility rises exponentially. This is more often than not initially obscured by rising market prices. But, as Mauboussin points out "crowded trades work until they don't" and eventually an incremental change in diversity will lead to an outsized drop in market price. This is the age-old liquidity problem. When a large portion of the market is using the same buy and sell rules there conversely becomes a disproportionately small population to sell into and the market needs to drop significantly for prices to clear.
3. Lastly, the model highlights the importance of understanding how beliefs propagate across a network. Like a disease, a belief's level of virality is based on its contagiousness (how compelling it is), its degree of interaction (how many

high-density nodes in a network adopt it), and the degree of recovery (how supported is the belief by the unfolding reality).

The Palindrome George Soros was perhaps one of the best at playing the player and identifying these belief-diversity cascades when in his prime. He applied an entirely new vocabulary to financial markets with terms like reflexivity, feedback loops, false trends and so on.

Soros would break down reality into three sub-categories:

1. Things that are true
2. Things that are untrue
3. And things that are reflexive

He said that “Economic history is a never-ending series of episodes based on falsehoods and lies, not truths. It represents the path to big money. The object is to recognize the trend whose premise is false, ride that trend and step off before it is discredited.”

Soros was exceptional at reading where the market was in its pendulum swing (i.e., gauging the level of extremity of consensus narratives and their subsequent positioning) relative to the quality of assumptions in which they are based on (true, untrue, reflexive).

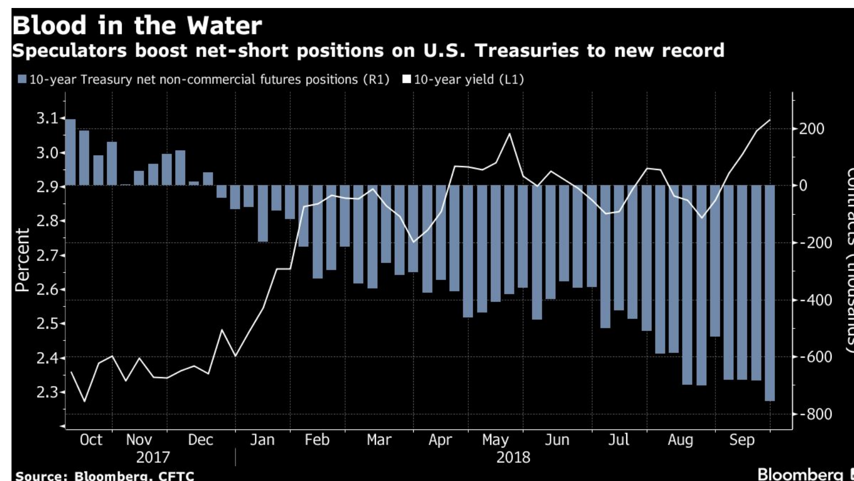
An example of the type of pendulum swing Soros would try to exploit is the clear narrative shift in bonds last year.

Remember back in the middle of 18’ how the popular belief had become that “we’re in a new secular bear market in bonds”.

Both “Bond Kings” we’re shouting about the “game changer” in rates….

Here's a few excerpts from a Bloomberg article in October of last year when the bearish bond narrative reached its pitch — which also happened to be right when yields peaked. The article is aptly named "Bond Bears Popping Champagne Say U.S. Yields Have Room to Rise".

> *Thirty-year Treasury yields pushed above the 3.25 percent level that fixed-income veteran Jeffrey Gundlach identified as a "game changer."*
>
> *"Solid data releases, higher oil prices and a technical backdrop that suggests there are not a lot of obstacles for yields to continue to push higher will have many wondering how far this new push higher can go," said Rodrigo Catril, a Sydney-based strategist at National Australia Bank Ltd.*



Short sellers were already positioned for more pain in the Treasury market. Speculative net short positions on 10-year notes climbed to a record, the most recent Commodity Futures Trading Commission data showed. An update to those figures comes Friday.

"In hindsight, we wish we were even shorter on U.S. rates," said Raymond Lee, a fund manager at Kapstream Capital Pty in Sydney.

"That gradual withdrawal of liquidity is causing yields to rise," Bob Baur, chief global economist at Principal Global Investors, said in an interview with Bloomberg Television in Tokyo Thursday. "We look for 10-year Treasury yields to hit 3.5 percent at some point -- later this year, early next year -- and I think that's going to be a real problem for stock markets."

The famous speculator of the early 20th century, Bernard Baruch, used to say "Something that everyone knows isn't worth anything."

The "Bond Bear" narrative was predicated on a false trend. It wasn't a sustainable move. Our leveraged balance sheets combined with a decelerating China and a responsive Fed ensured it. Crowding in both positioning and narrative combined with a textbook technical breakout in late October made for a perfect buying opportunity — something we pitched in our November MIR at the time.

Not only was the move in bonds not much of a "Game Changer…" but it was also clearly a local extreme on the swing of the pendulum. The narrative was on the front pages of ALL the financial newspapers and shared by nearly ALL the talking heads on CNBC.

And how quickly that narrative pendulum has swung back. It's now accepted wisdom that yields won't and can't rise. The global economy is simply too weak and the Fed too dovish…

Subsequently, investors have been stampeding in droves into bonds since the beginning of the year. More on this in a minute.

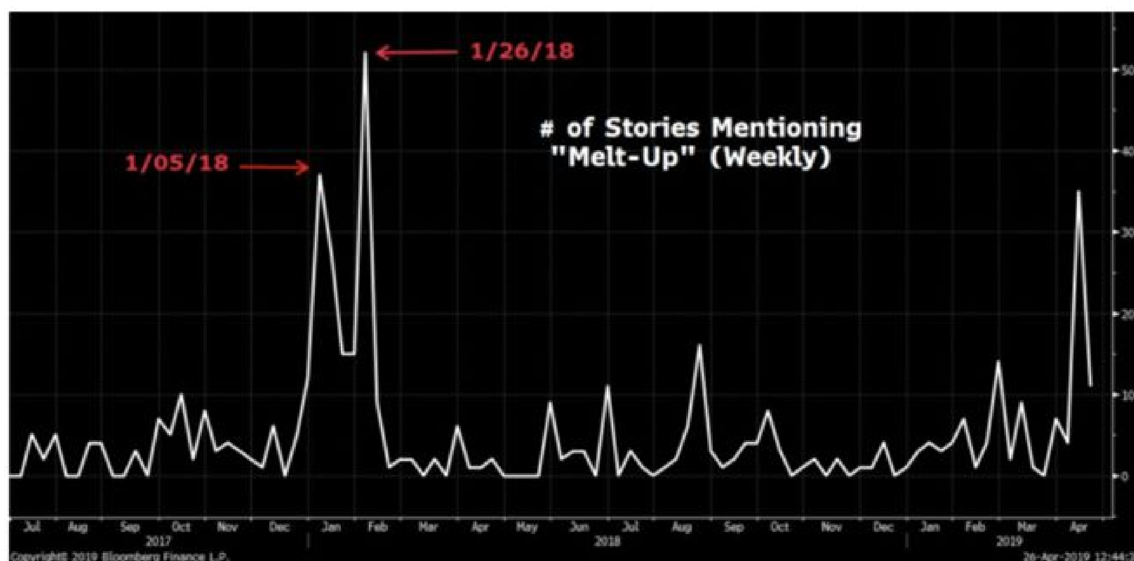
Something that everyone knows isn't worth anything…

Equity markets too, have seen a full swing of the pendulum over the last six months. Back at the end of December when we put out a number of reports explaining why it was an excellent time to buy, the dominant belief was that a vicious bear market had started and a recession was around the corner.

I mean, the Yield Curve had inverted!!!! Everybody was fretting about the yield curve and a recent drop in retail sales…

Five months and a vertical runup in stocks later and there's hardly a whisper of either. Now, the talk is of a Fed Put, a low growth low inflation Goldilocks economy, and a Melt-Up in equities.

Exhibit 1: When People are Talking about it so broadly, Maybe it's already happened?



Source: Bloomberg, Morgan Stanley Research

One more time: *Something that everyone knows isn't worth anything…*

Viewing markets — also history, politics, culture, and on and on — through the lens of a swinging pendulum is a useful heuristic. Look for local extremes and compare it to alternative possible outcomes, ones that aren't being discounted by the market. Then wait for a break in the technicals and you have yourself a trade.

Doing this, you'll find that the market, especially when at pendular extremes, is more often than not suffering from acute myopia. It tends to overly discount what's happening <u>now</u> while not accounting for a <u>future</u> that could look any different than today.

Stanley Druckenmiller (aka The GOAT) put it like this:

> *[My] job for 30 years was to anticipate changes in the economic trends that were not expected by others, and, therefore not yet reflected in security prices.*
>
> *Too many investors look at the present; the present is already in the price. You've got to think out of the box and visualize 18 to 24 months from now what the world is going to be and what (level) securities might trade at… what a company has been earning doesn't mean anything, what you've got to look at is what people think a company's going to earn and if you can see something in 2 years that's going to be entirely different than the conventional wisdom, that's how you make money.*

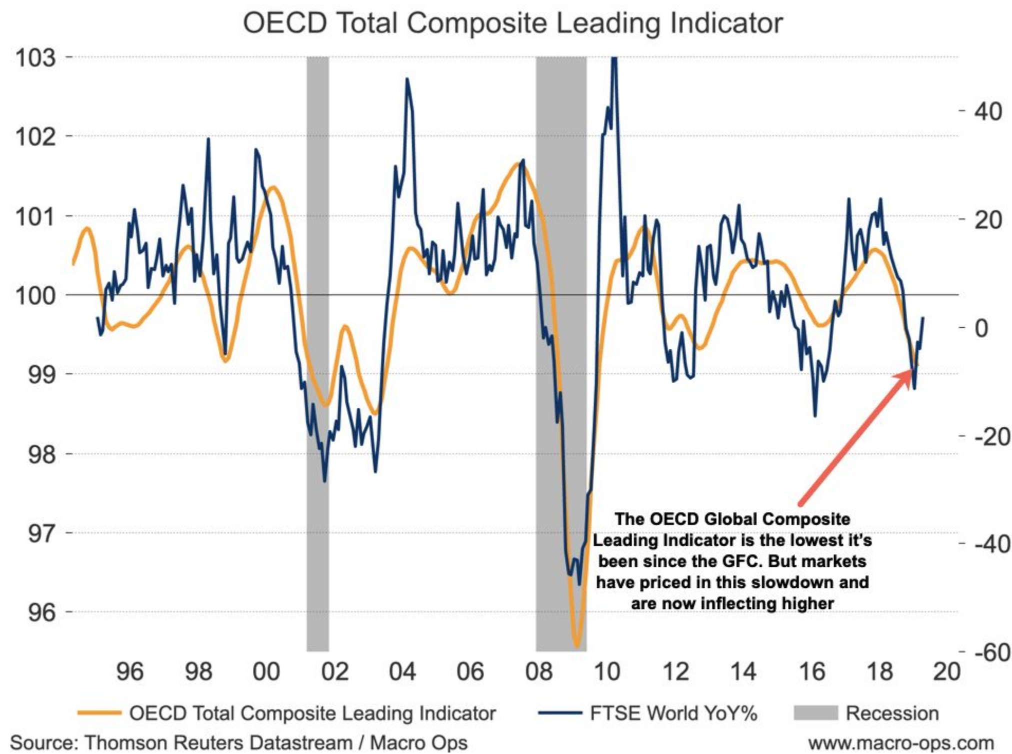
We're going to take the advice of Soros and Druck and peer out into the veiled future and compare some alternative outcomes relative to the popular beliefs being priced in today. I'm going to walk you through where I think the pendulum has swung to local extremes and is gearing up to swing back the other way.

Doing so we'll find the following.

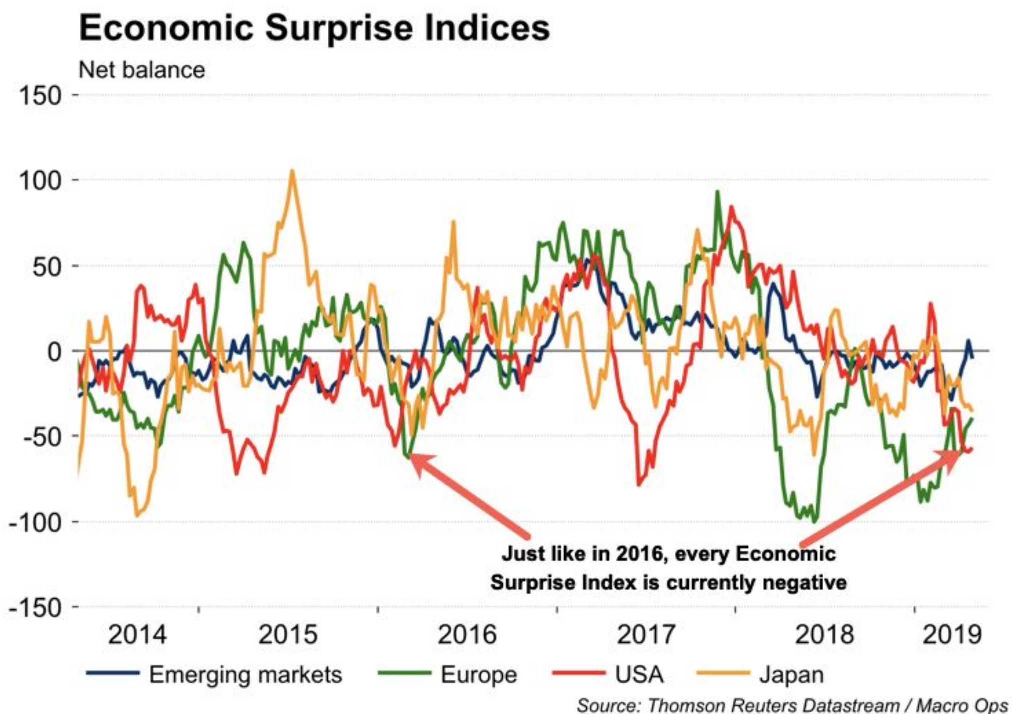
1. The market is overweight slow global economic growth and underweight a pickup in growth
2. The market is overweight the dollar and underweight the euro
3. The market is overweight growth stocks and underweight value

Let's start at the top.

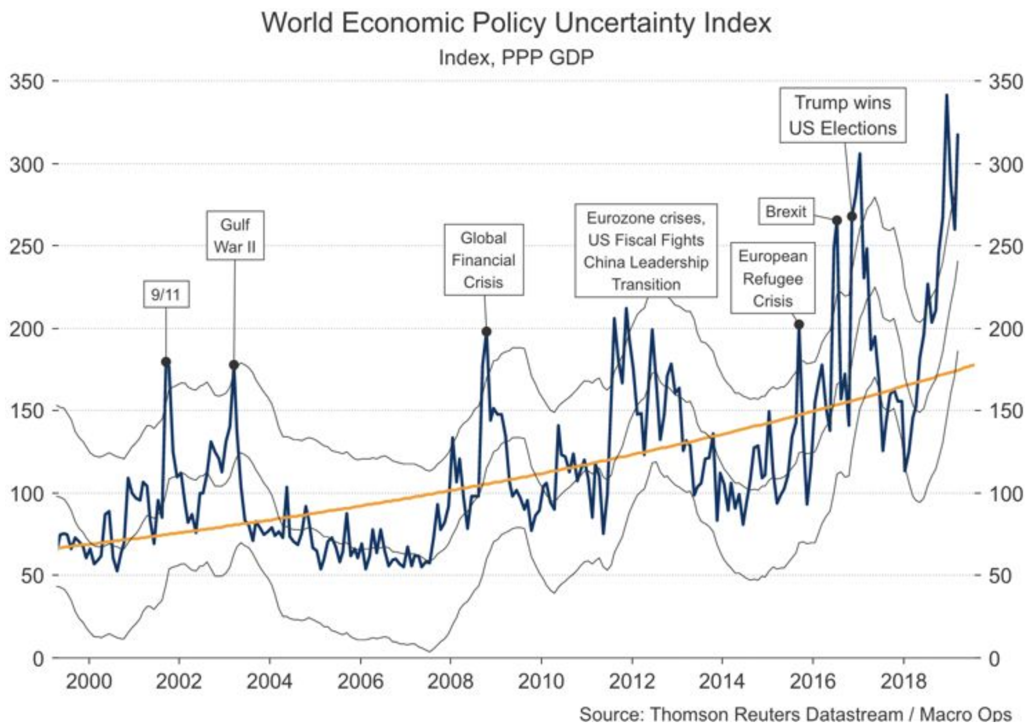
Last year we saw decelerating global growth on the back of rising US interest rates and a deleveraging China. Numerous leading economic indicators, such as the OECD Global Composite Leading Indicator below, fell to extremely depressed levels. Markets reacted in kind and 2018 ended up being one of the few years in history where every major asset class underperformed inflation.



Similar to 2016, this year started out with all major region's economic data surprising to the downside.



And between the trade wars, Brexit, Yellow Vest protests, and opaque Chinese policy, we started the year with measures of global economic uncertainty at record highs.

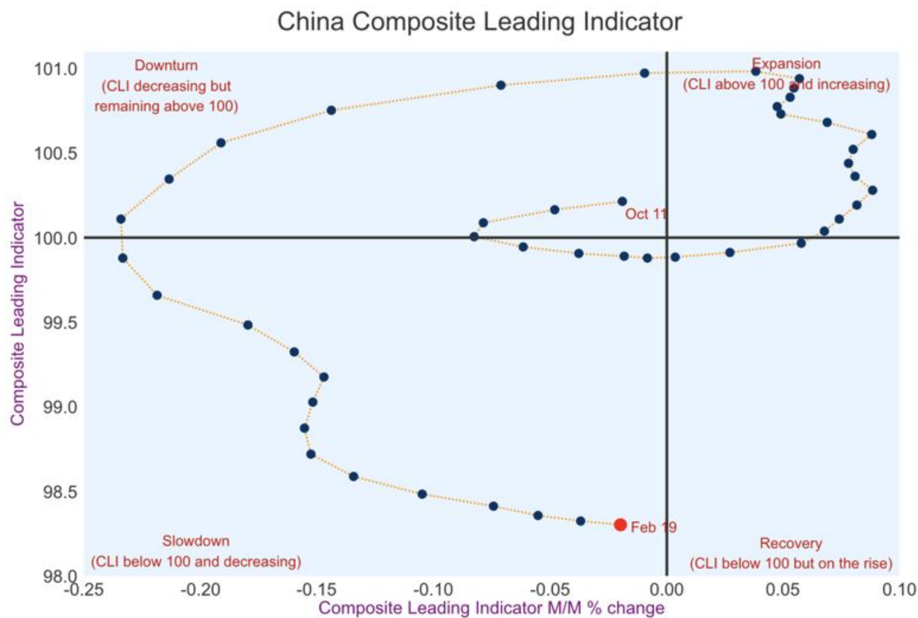


This is the backdrop under which global risk assets, which spent much of 18' in a bear market, began the year. But by January 19', slowing economic growth was something that everyone knew and therefore didn't matter — it was already priced in. So the pendulum swung in the other direction and stocks rallied.

Growth is going to continue to slow in the US. We expect GDP growth to fall over the next two quarters to 1.5%. But the market already knows this as well as the Fed which is why its become much more dovish in recent months.

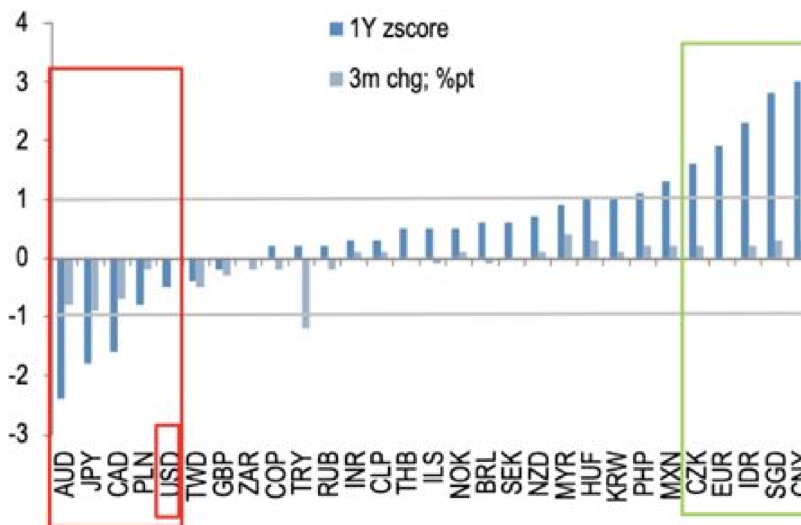
While the US continues to slow there are increasing signs of 'green shoots' in the rest of the world, which looks to be bottoming.

This is in large part due to the injection of Chinese stimulus at the start of the year. The impact of which won't even be fully felt until the second half (credit injections take 6-9 months to hit the real economy). Our Composite Leading Indicator shows that China is moving from the "slowdown" quadrant into the "recovery" one.



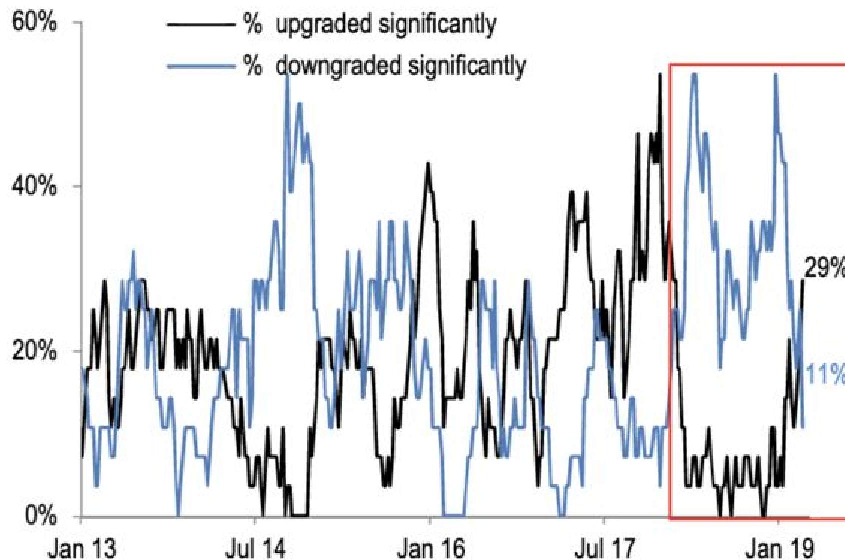
Source: Thomson Reuters Datastream / Macro Ops

While most developed markets are seeing growth downgrades, emerging markets, led by Asia and notably Europe, are leading in positive growth revisions.



Source: J.P. Morgan

J.P. Morgan notes that now "for the first time since US exceptionalism surfaced a year ago, growth forecasts are getting upgraded in more countries than they are getting downgraded in."

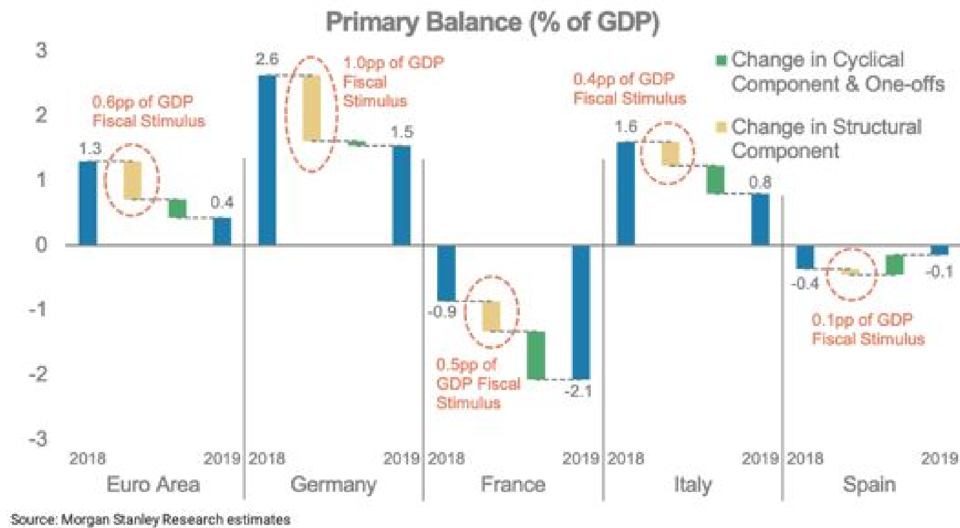


Not only is global growth ex.US improving but there are a number of potential positive catalysts on the horizon that aren't being priced in AT ALL.

For instance, nobody is talking about the fiscal impulse out of Europe. A fact we've been writing about since the start of the year.

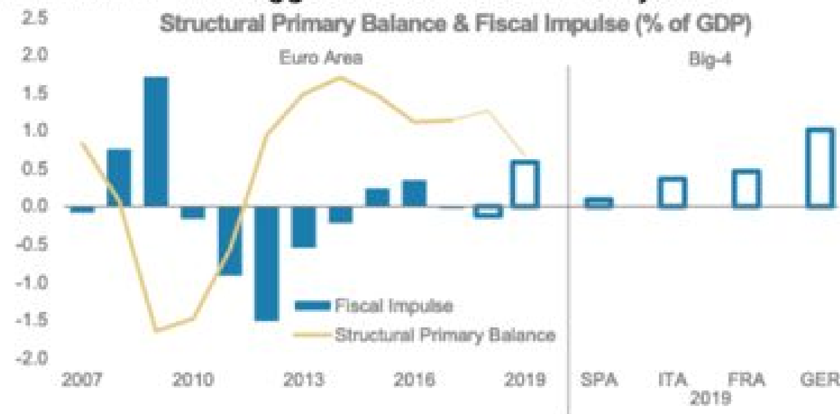
Europe is about to see its biggest fiscal boost in a decade…

Exhibit 5: Loosening the belt across the board



Source: Morgan Stanley Research estimates

Exhibit 1: The biggest fiscal boost in ten years



Source: European Commission, Morgan Stanley Research; Note: Empty bars, thin line = Morgan Stanley forecast; Structural primary balance = cyclically adjusted primary balance ex one-offs; Fiscal boost = change in structural primary budget balance; +/- = fiscal boost/drag.

The debate over fiscal stimulus in Europe, and most importantly in Germany, has changed dramatically over the last year. It's flipped from one of necessary government austerity to one of necessary fiscal stimulus.

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The Case for a Significant German Stimulus Is Now Overwhelming

Blog Post by Brad W. Setser

February 11, 2019

Desmond Lachman

March 11, 2019 9:13 am | AEIdeas

Time for a German fiscal stimulus

Economics, International Economics, Monetary Economics

Editorial Board

Germany's Economy Could Soon Need a Boost

If the slowdown persists, Berlin's fiscal conservatives might have to think the unthinkable.

By Editorial Board

January 13, 2019, 11:30 PM PST

Economics

France's Villeroy Urges Fiscal Stimulus in Germany, Netherlands

By William Horobin

April 2, 2019, 1:30 AM PDT

No doubt the rioters in yellow vests who've been setting Paris ablaze are a driving force of this turn in talk.

There's also been a reinvigorated call in the US for a massive infrastructure bill coming from both sides of the isle.

U.S. Democrats seek up to $2 trillion to invest in aging infrastructure

Susan Cornwell, Richard Cowan

4 MIN READ

And finally there's the Chinese Communist Party (CCP) who is likely to begin further easing in the latter half of this year in an effort to get their economy running strong into the all-important centennial anniversary of the communist party.

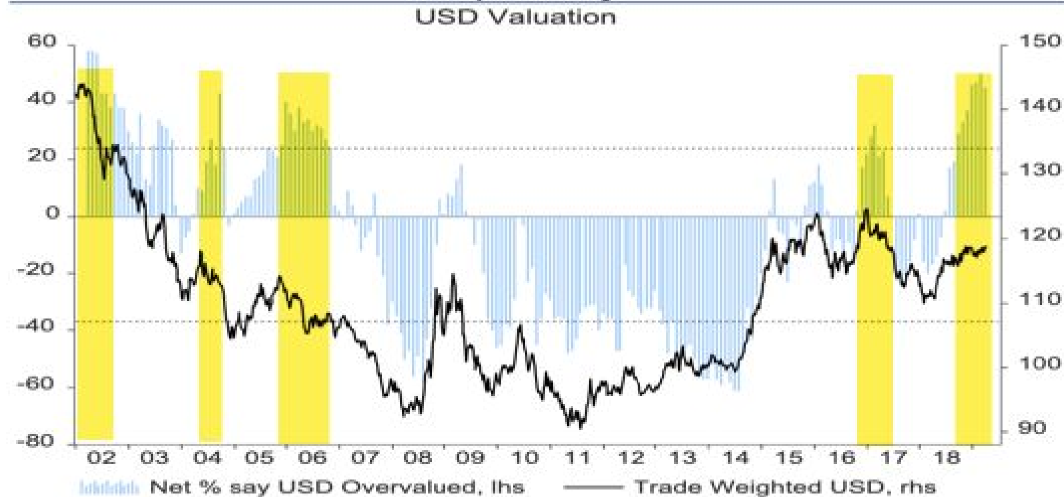
What else could boost the global economy?

A Lower the Dollar

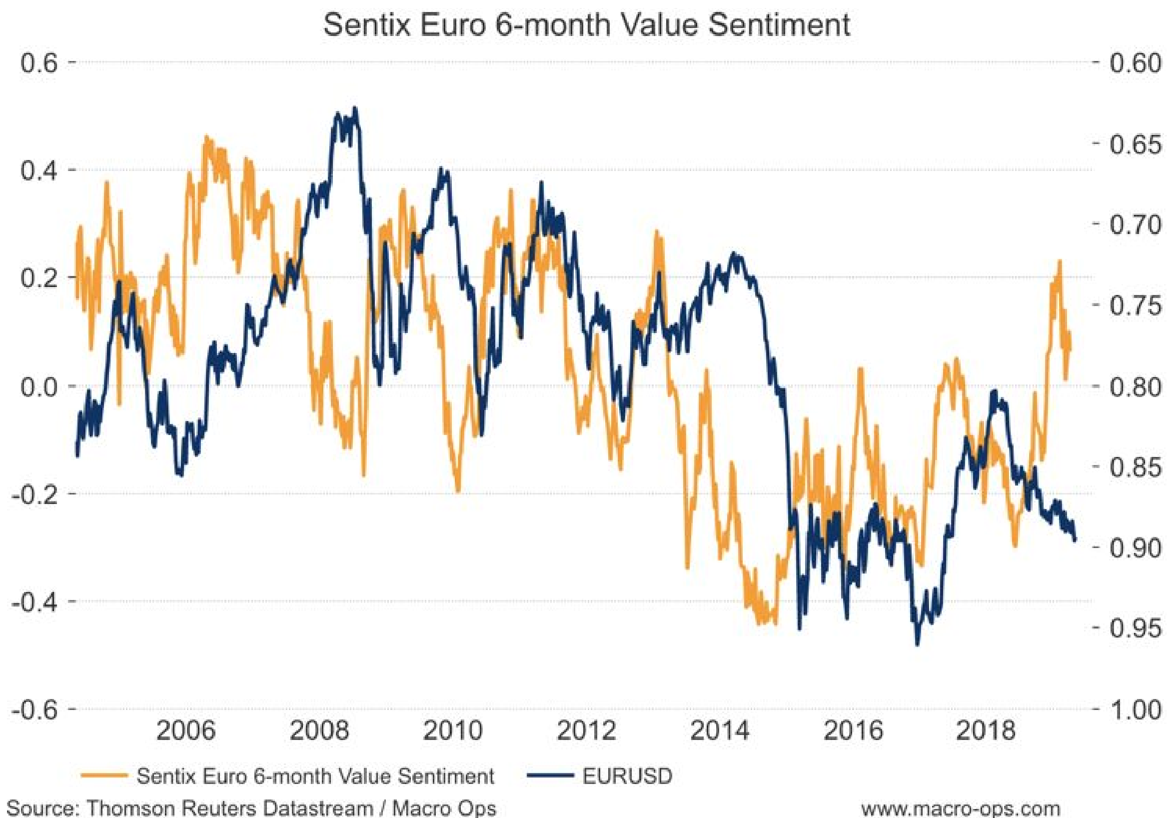
We are currently long the dollar because the technical setup demands it. But I remain highly suspicious of this rally and expect a reversal in the coming weeks.

Here's why.

The dollar (DXY) is overvalued. The BofAML Fund Manager Survey has the highest reading of respondents saying the dollar is overvalued since 2002, right before the dollar embarked on a multi-year bear market. All other instances in the survey have corresponded with significant tops in the dollar.

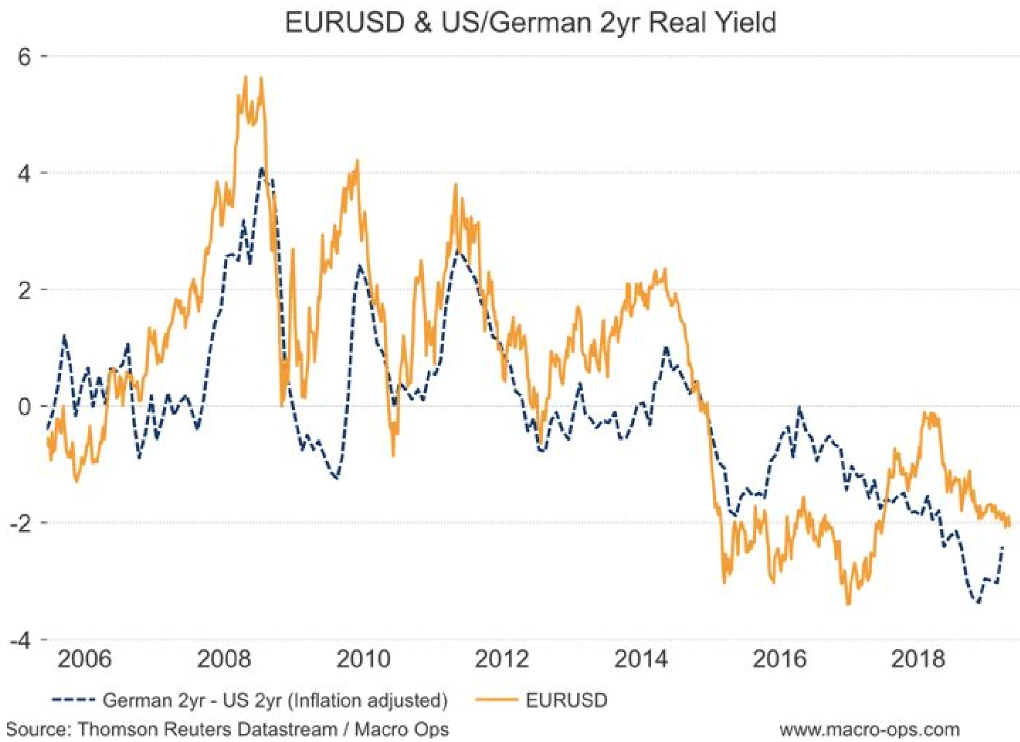


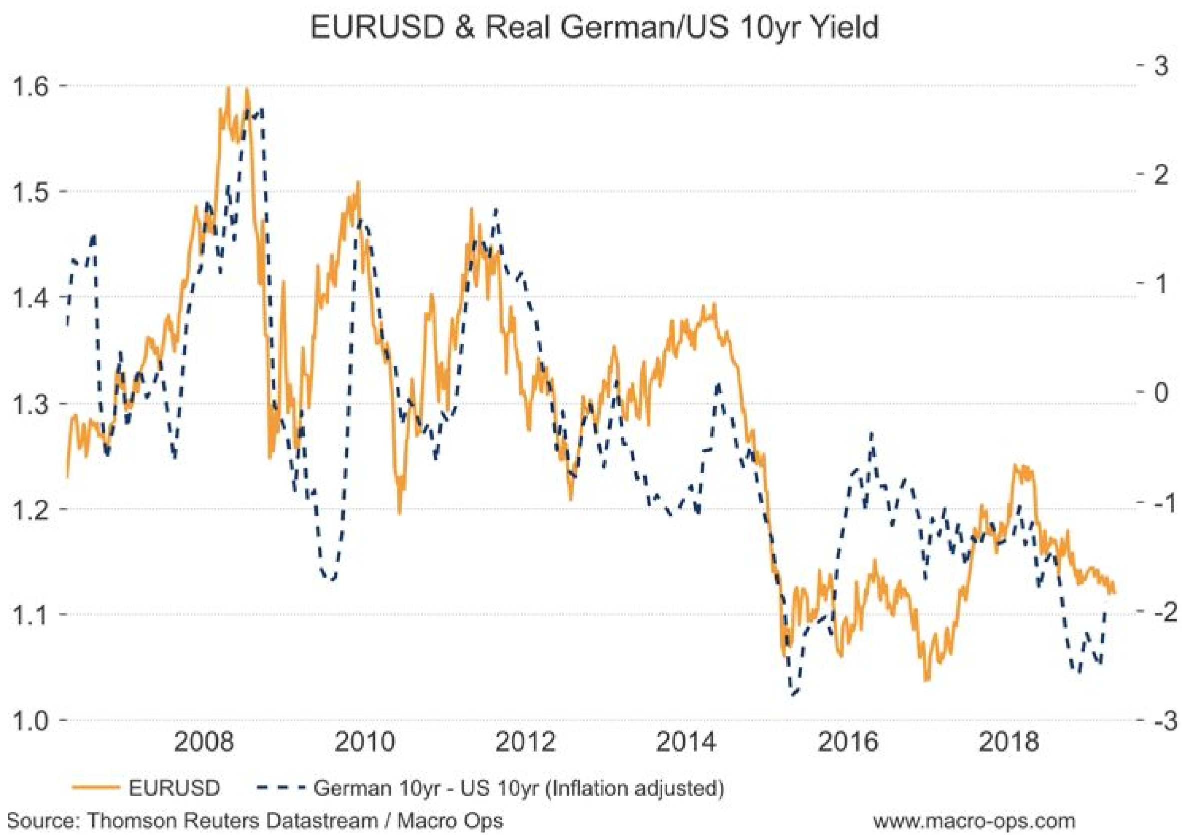
Conversely, according to our Sentix survey data, investors see the euro heading much higher in 6-months time. There's now a wide gap between the euro's current price and its expected future value. You can see in the chart below that this Sentix data has a strong record of leading eventual moves in the EURUSD pair.



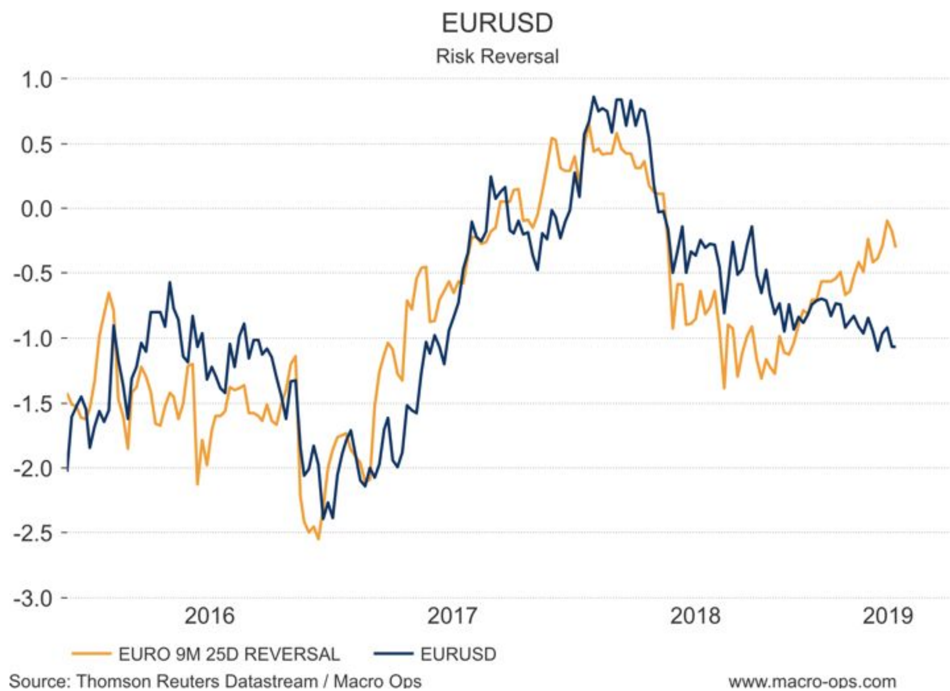
Looking at the euro is important when analyzing the dollar because the euro makes up close to 60% of the dollar trade-weighted basket (DXY).

The real yield differential is inflecting higher along both the front and long end. There's room for this trend to continue as the Fed is near its upper limit while European rates literally can't move lower. Plus the increasing fiscal stimulus could finally lift European rates off the zero bound.

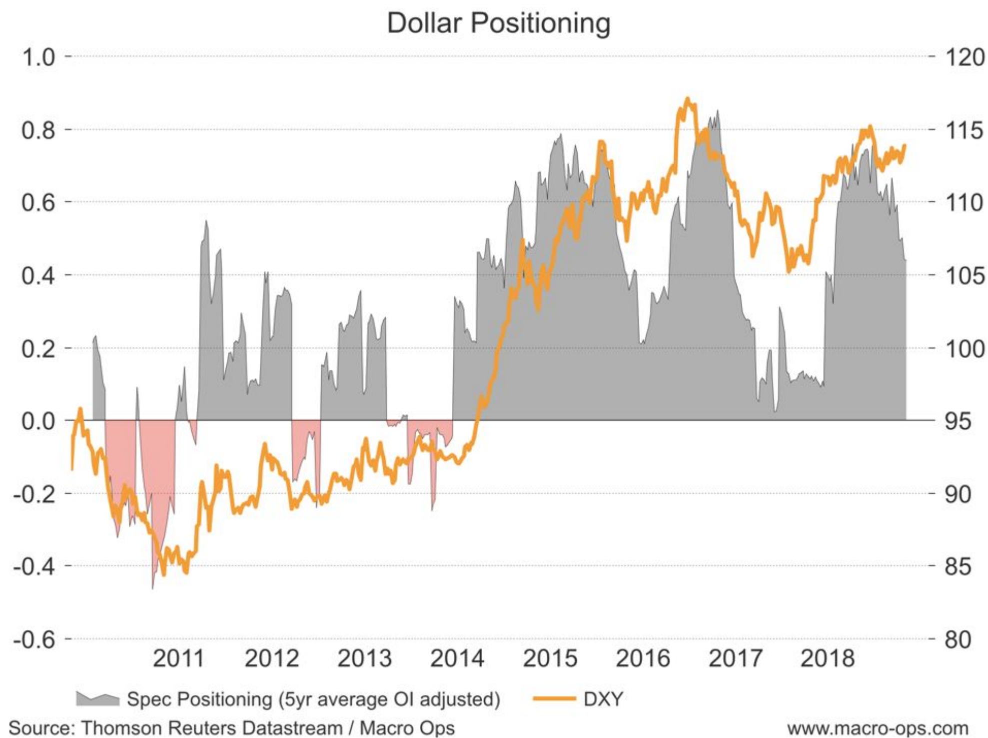

EURUSD & US/German 2yr Real Yield
6
4
2
0
-2
-4
2006
2008
2010
2012
2014
2016
2018
German 2yr - US 2yr (Inflation adjusted)
EURUSD
Source: Thomson Reuters Datastream / Macro Ops
www.macro-ops.com


EURUSD & Real German/US 10yr Yield
1.6
1.5
1.4
1.3
1.2
1.1
1.0
3
2
1
0
-1
-2
-3
2008
2010
2012
2014
2016
2018
EURUSD
German 10yr - US 10yr (Inflation adjusted)
Source: Thomson Reuters Datastream / Macro Ops
www.macro-ops.com

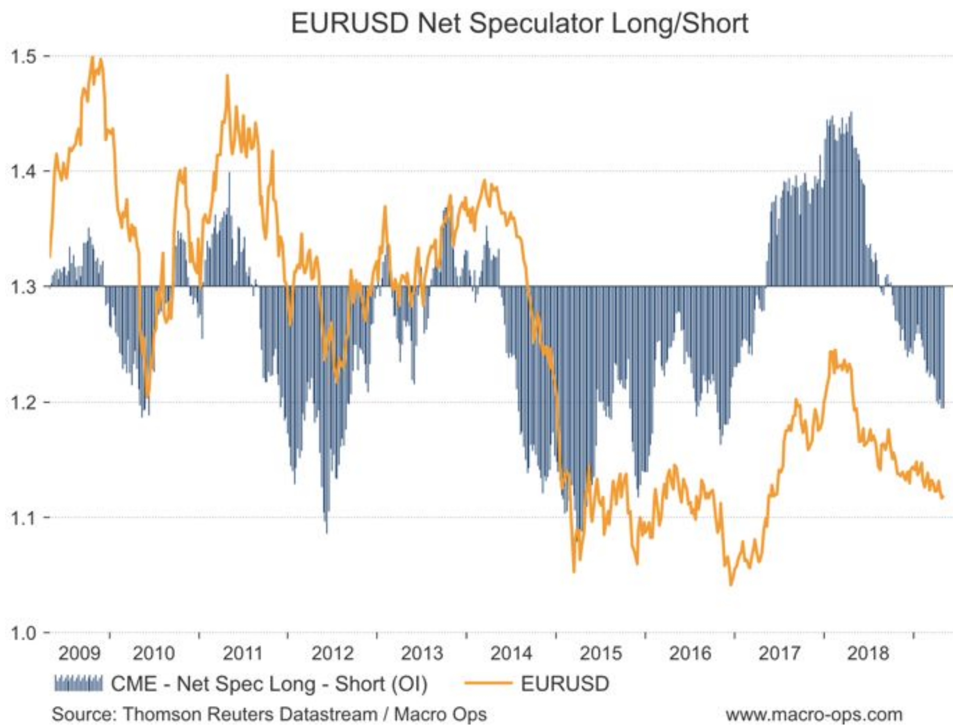
The options market is pricing in a higher euro.



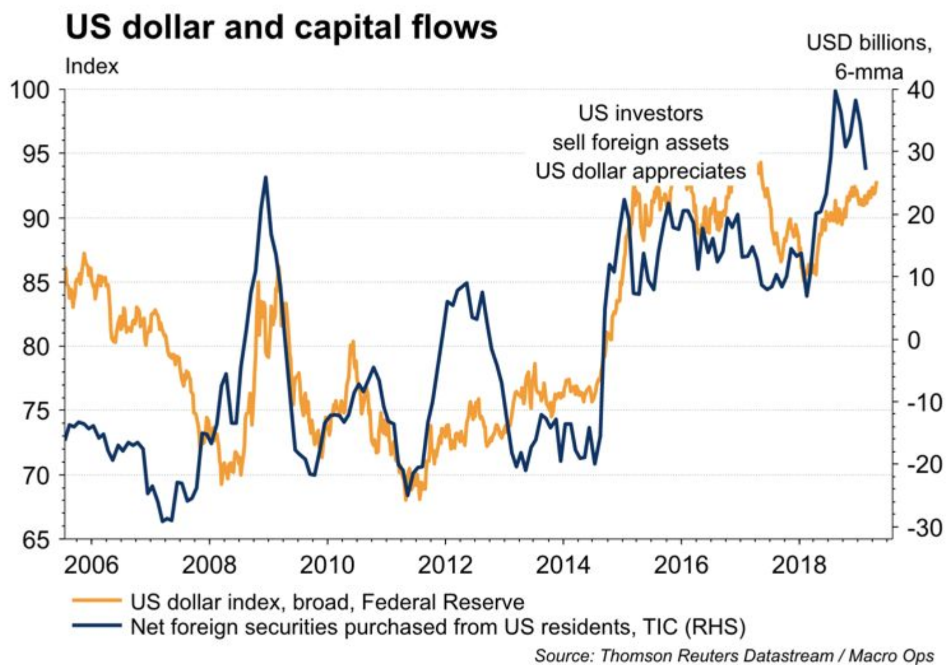
The positioning is crowded in long dollars where spec longs are coming off from near multi-year highs.



And speculators are already pretty short euros.



Finally, US investors have been chasing US outperformance by selling their foreign held securities and concentrating their assets in the US, which is what's driven the dollar higher.



This trend looks to be turning over though. And capital flows out of the US should intensify in the coming months as the US vs. RoW growth differential turns to favor greater international exposure.

What does a falling dollar mean?

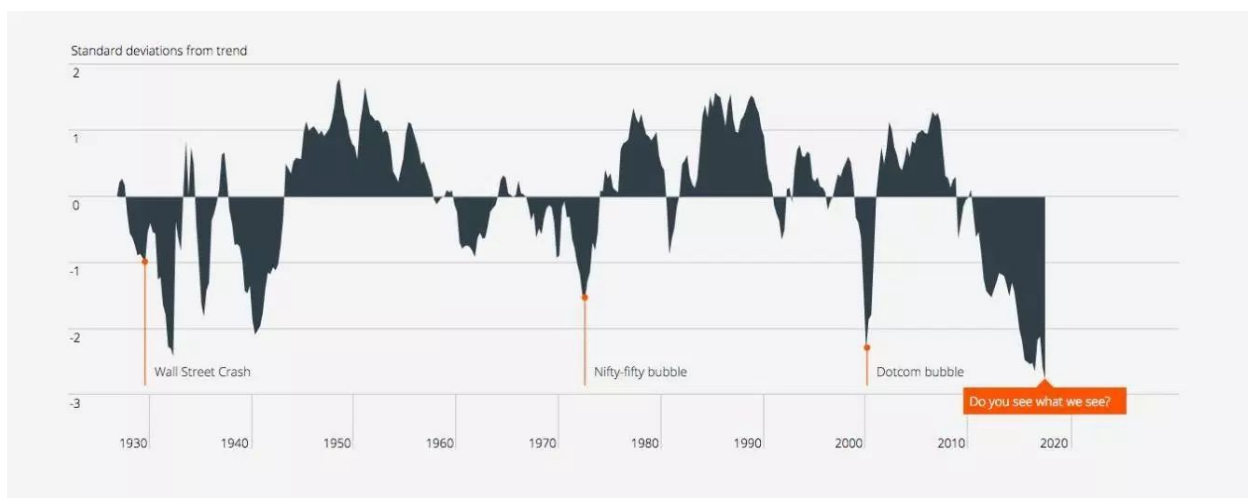
The Death of Growth Stocks and the Rise of Value

Here's an excerpt from a recent BofA note on what they're hearing from clients (emphasis by me).

> *Robots outperforming humans; bullish humans are "frustrated" (have not made enough money), "paranoid" (quick to take profits, see China/EM price action this week),* ***"exhausted" by trying to play contrarian in TIPS, value, Europe, banks****, "clustered" happily more & more in tech & corporate bonds;* ***zeitgeist is era of no inflation, no hikes, no inflows set to continue, still a modest cycle in US & China, but no cycle in Japan or Europe (and trade war to engulf Europe in H2).***

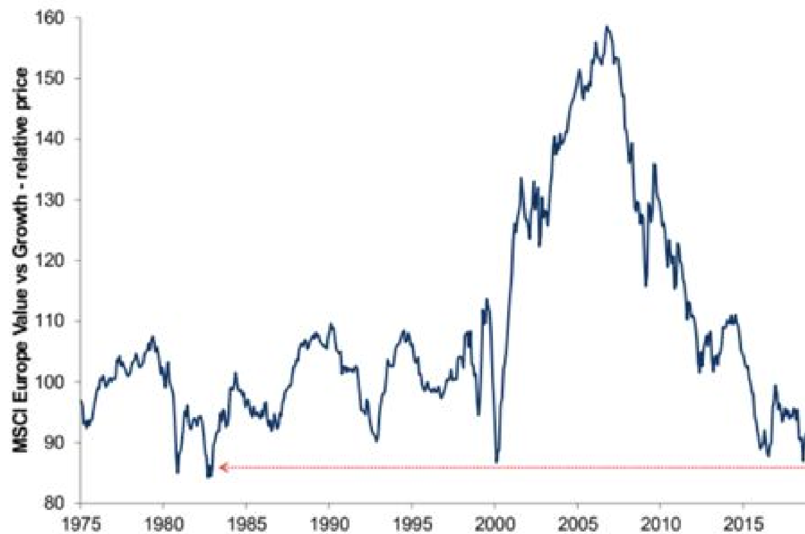
Investors are "exhausted" trying to play in value and European stocks and so have happily "clustered" in tech and corporate bonds.

Okay… I mean, you can't blame them. The performance spread between growth and value stocks is 2.5 standard deviations below the historical average. That's an even wider spread than the point reached at the height of the tech bubble.



In Europe, value's relative performance versus growth is at its lowest levels since the early 1980s.

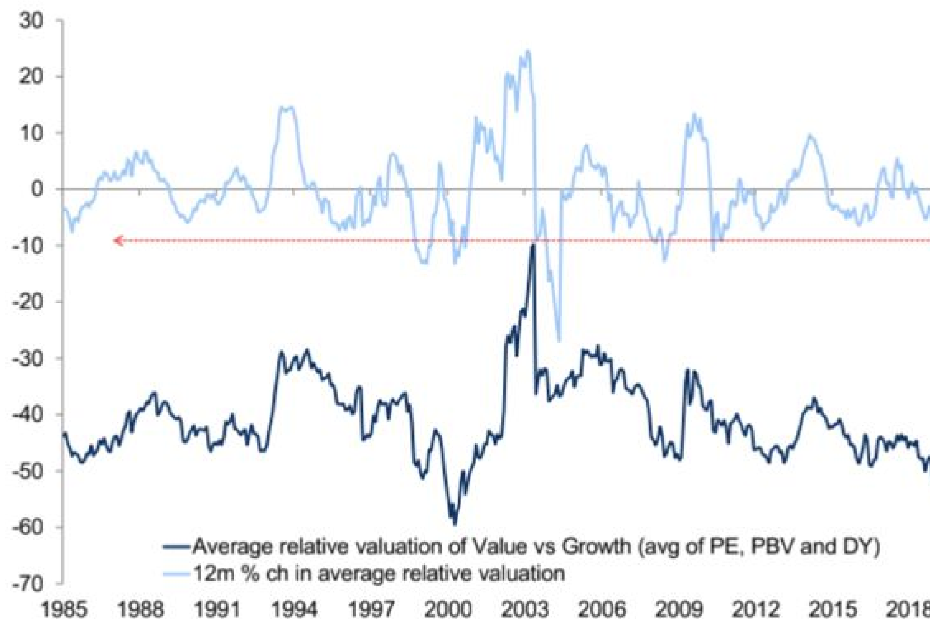
Exhibit 11: Relative performance of MSCI Europe Value vs Growth is at its lowest level since the early 1980s



Source: MSCI, Morgan Stanley Research

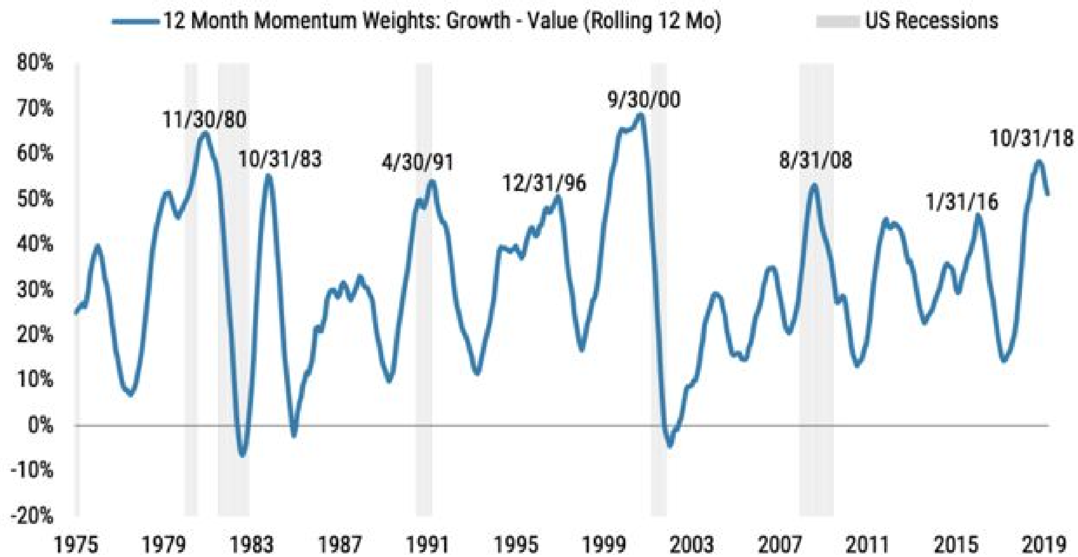
But the relative valuation of value has de-rated recently and this, as Morgan Stanley points out, often precedes a period of relative outperformance.

Exhibit 4: Value has de-rated by c. 8% in last 12m - often indicates a period of Value outperformance ahead

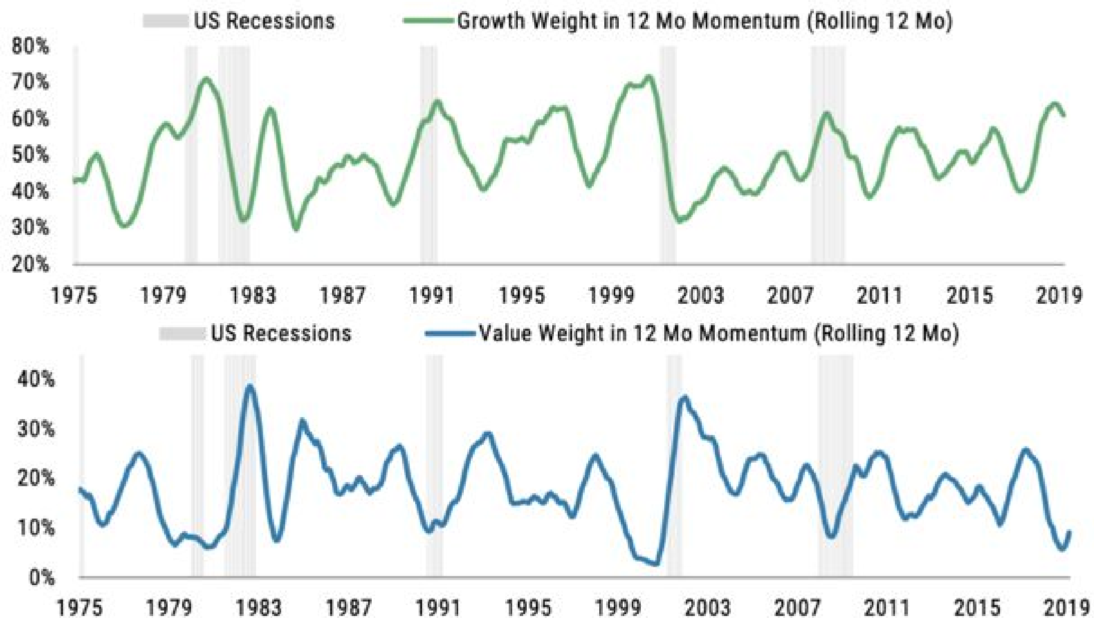


Source: MSCI, IBES, Datastream, Morgan Stanley Research

Growth's weight in momentum is turning over from an extremely high multi-year peak.



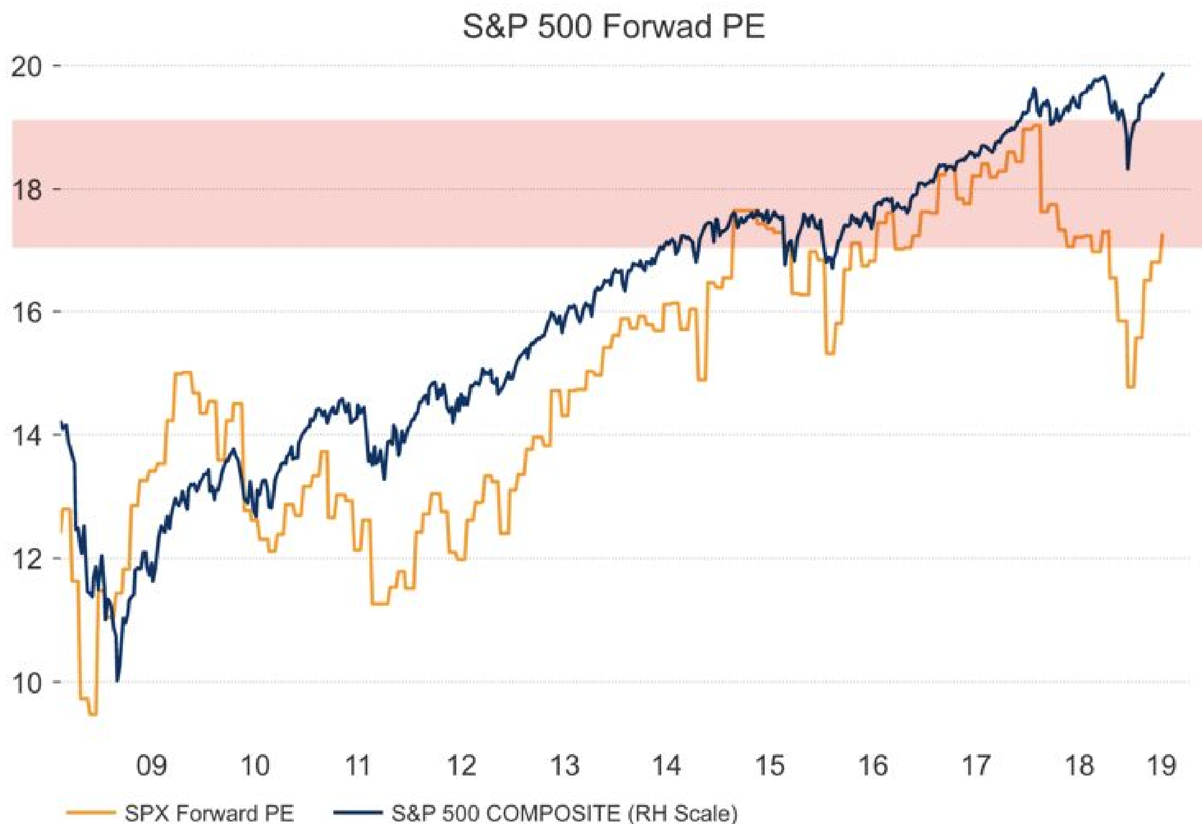
While Value's weight in momentum is turning up from extreme lows.



Morgan Stanley sums up what this likely means (emphasis by me).

> *When such reversals have occurred from such extremes in the past,* ***they have typically persisted until the spread reached extremes on the other side.*** *In other words, the rotation toward Value that began in the 4th quarter (our call) may be the primary trend and the recent rally in Growth relative to value may be counter-trend.* ***This would likely be a major problem for most portfolios which are not positioned for such a move going forward****… We also suspect that the next leg of this rotation could occur during an overall correction in the S&P 500 as Growth stocks go down a lot more than Value given their higher relative valuations much like we saw during the fourth quarter. The difference this time is that we think the correction will be driven more by disappointing earnings growth rather than higher interest rates.*

There's plenty of deep value on offer in the market if you know where to look — more on this in a bit. But the overall market is expensive. The Forward PE ratio of the SPX is back up in the 17+ range. A level which has caused some instability for the market in the past.



The rally off the lows in December has been entirely due to multiple expansion. I'm forecasting basically low to flat earnings growth in the US for the rest of the year. Which means the market

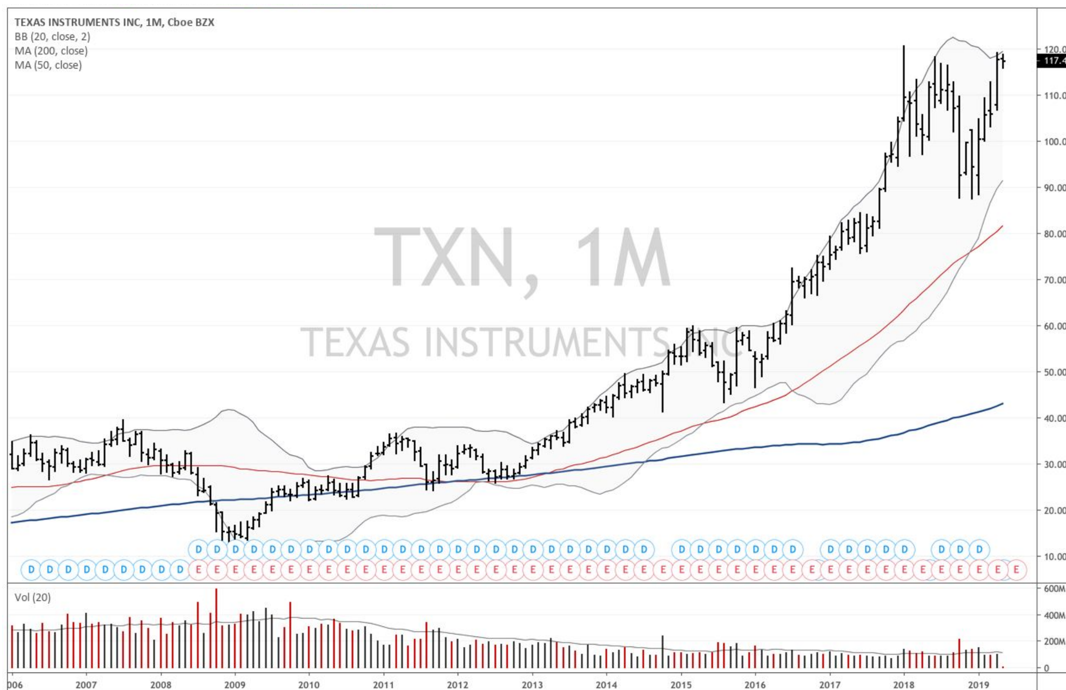
will need some serious animal spirits, perhaps with the help of a preemptively easing Fed, to move the broader stock market significantly higher from these levels.

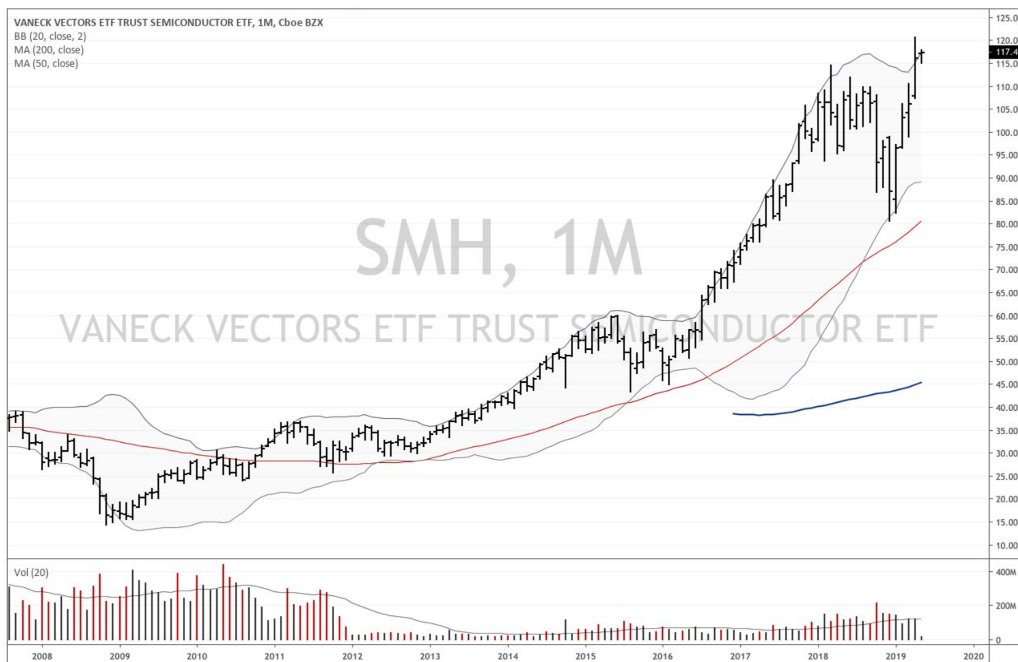
Exhibit 2: P/Es have Expanded More Than We Expected but Hard to justify more from here.

There's a growing list of hot growth stocks who have, or are close to, piercing their upper monthly Bollinger Bands. Here's a few of them below. These will make good short candidates once the market looks ready for a dip but be careful, we need to see some technical weakness first and risk management is key. You never want to fight momentum.

Microsoft Corp., 1M, Cboe BZX
BB (20, close, 2)
MA (200, close)
MA (50, close)
MSFT, 1M
Microsoft Corp.
128.90
Vol (20)

SHOPIFY INC, 1M, Cboe BZX
BB (20, close, 2)
MA (200, close)
MA (50, close)
SHOP, 1M
SHOPIFY INC
264.03
Vol (20)

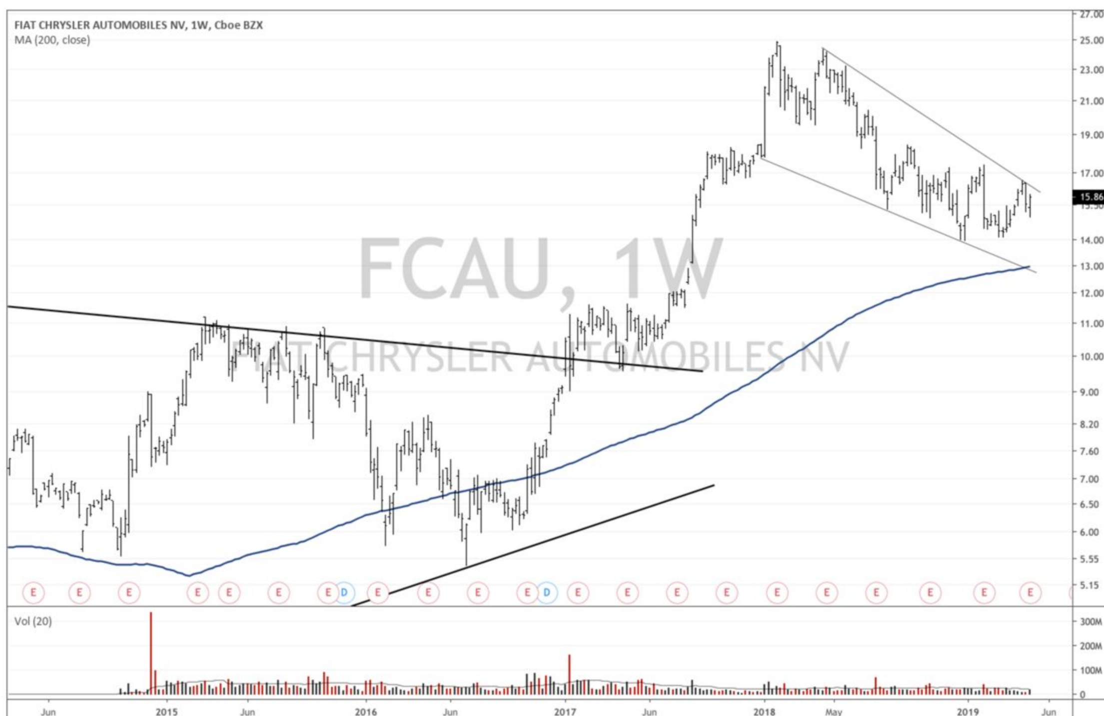




Here's the list of deep value stocks that we're looking to buy or add to.

Graftech International (EAF) put out good earnings last week and bounced off its lower weekly Bollinger Band, forming a possible double bottom. This is a deep value stock with large contracted cash flows. You can find our original writeup here.

Following the next market selloff, we're going to look to increase our position in Fiat Chrysler (FCAU) which continues to trade at a deep discount and is a prime acquisition target. Read our last update on the stock here.



Garrett Motion (GTX) is up 40+% since we initially pitched the stock in November and it's still trading for less than 5x FCF. Here's the writeup.

Construction Partners (ROAD) is up 25+ % since we pitched it in January (link here). Technically the stock looks to be forming a large inverted H&S pattern. This company should benefit from the increasing focus on infrastructure spending. We'll look to add to our position on a break of the neckline.

Target Hospitality (TH) is the under the radar deep value housing and services name that's connected to the energy market. Here's the writeup and we'll look to put on a starter position in the coming weeks.

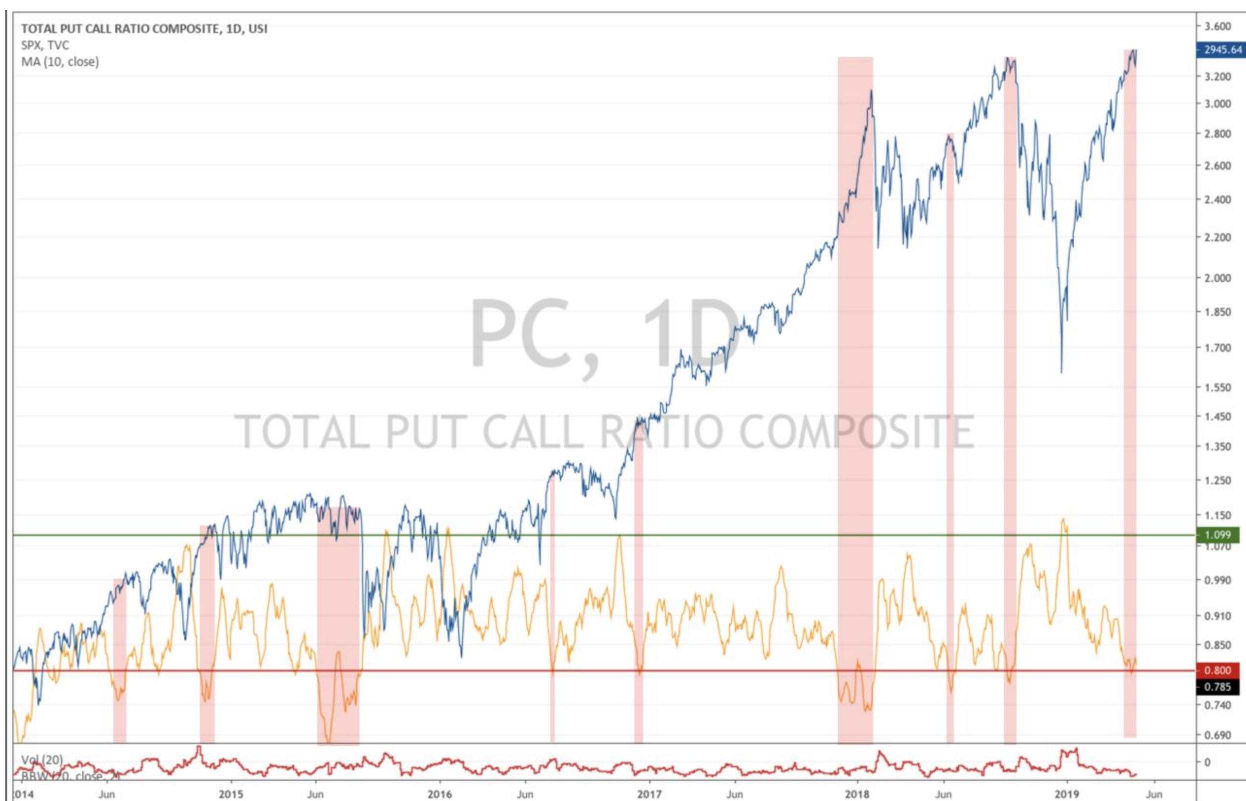
Interactive Broker's (IBKR) chart is setting up nicely. We first pitched IBKR back in early 2017 as a disguised value stock with a long runway for accelerating growth. The stock has been correcting its overbought condition for the last year and a half and now finally looks ready for another run.

And finally, we have shippers which is the most compelling deep value sector of the market, in my opinion. To get caught up on the bullish shipping thesis, read this here. And to read up on our favorite shipping stocks then give this a look.

Summary

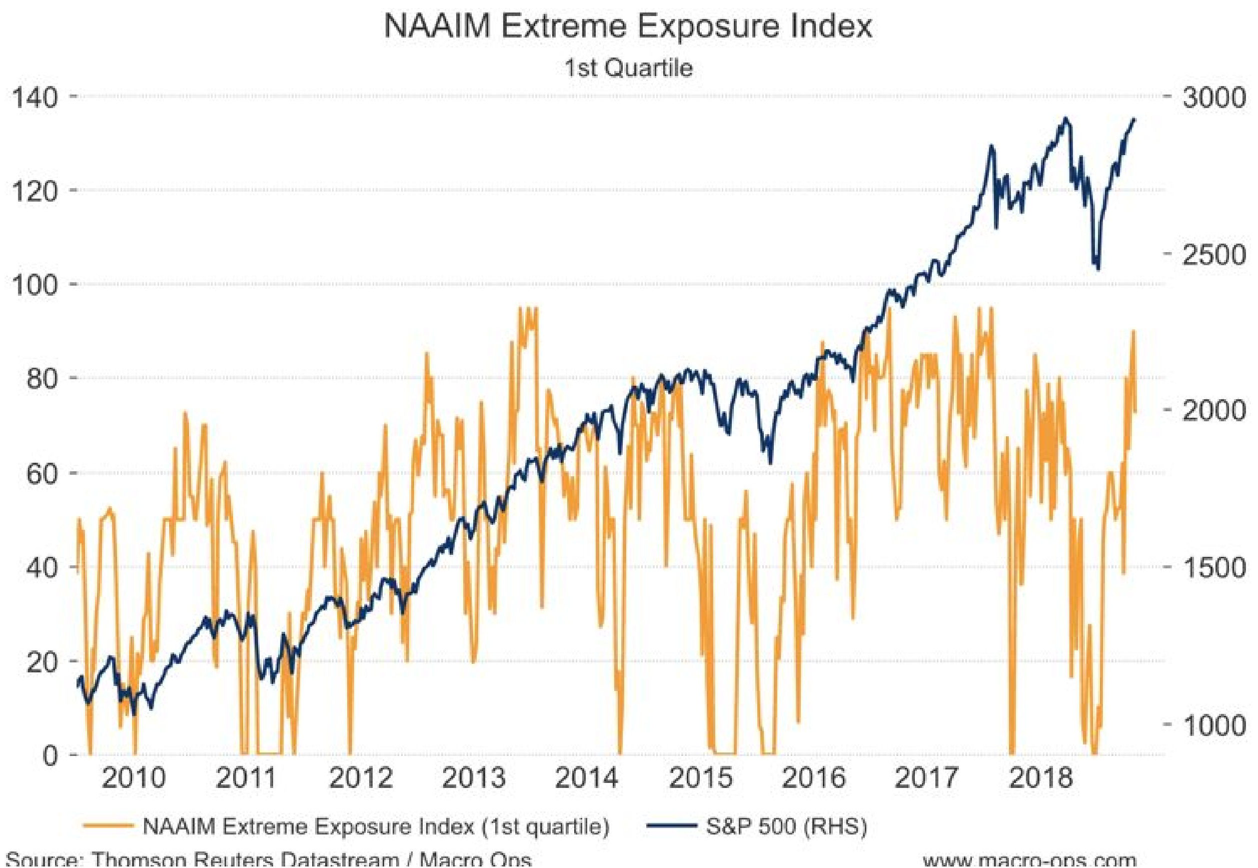
My indicators are telling me that we're headed for a broader market correction in the coming weeks. I'm not expecting this to be a big selloff like the one we experienced in Q4 of last year but it could be significant in some of the individual overstretched names.

But due to the strength in the recent breakout in small-caps (IWM) the market could run a bit more from here first *(sidenote: As this is going to press we're getting word that Trump is upping the tariffs on China. The trade war with China is mostly a red herring but the optics of escalating tensions between the two countries are bearish for the market. I expect the two will do a deal but it may take a market selloff to get the two sides to the table.)* Expect some volatility in the coming weeks. Our Total Put/Call 10dma indicator gave a brief sell signal last week and is likely to turn back over and head lower in the coming weeks.



And while our longer-term indicators of positioning and sentiment show that investors are still very underweighted risk assets. Our shorter-term indicators of positioning/sentiment like the

NAIIM Extreme Exposure Index shows that a section of the market is taking additional risk and is getting complacent.



We've been writing since last December that the majority of the market has been on the outside looking in at this rally and that the time to get defensive will be when those on the sidelines begin giving into FOMO and piling stocks. It looks like that is starting now. Momentum may carry us higher for a bit longer but we'll be taking this time to begin reducing our exposure to some of our more richly valued growth names and allocating more to our value names above.

The coming selloff should give us great entry points to start building positions in our value plays.

That's it for this month's report!

Thanks for reading and shoot any questions you may have to me at alex@macro-ops.com.

Your Macro Operator,

Alex