The Macro Spiral

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The whole universe is based on rhythym. Everything happens in circles, in spirals. ~ John Hartford

In this month's MIR, I'm going to take you on a walk through a Macro Spiral. A Macro Spiral is where we analyze the foundational drivers of economies and markets from a 30,000ft secular view down on to a cyclical one before finally ending with a close up look at where things lie.

And then, of course, finish with some trade ideas…

Our Macro Spiral consists of three concentric circles. Each circle has three points because three is just a good number… also, three points are needed to draw a circle. Our tradeable universe lies in the center.

Through this spiral, I'm going to explain why global growth over the next 100-years is going to look nothing like the growth we saw over the previous 100-years. We'll explore what these trends are and what they mean for markets in the future, as well as today — we'll even dissect a little known tax law that's going to eventually bring on a tsunami of equity supply over the coming decade.

Let's hop in…

The First Circle: Three Ds… Deleveraging, Demographics, Deglobalization

Deleveraging and the turning of the Long-term Debt Cycle

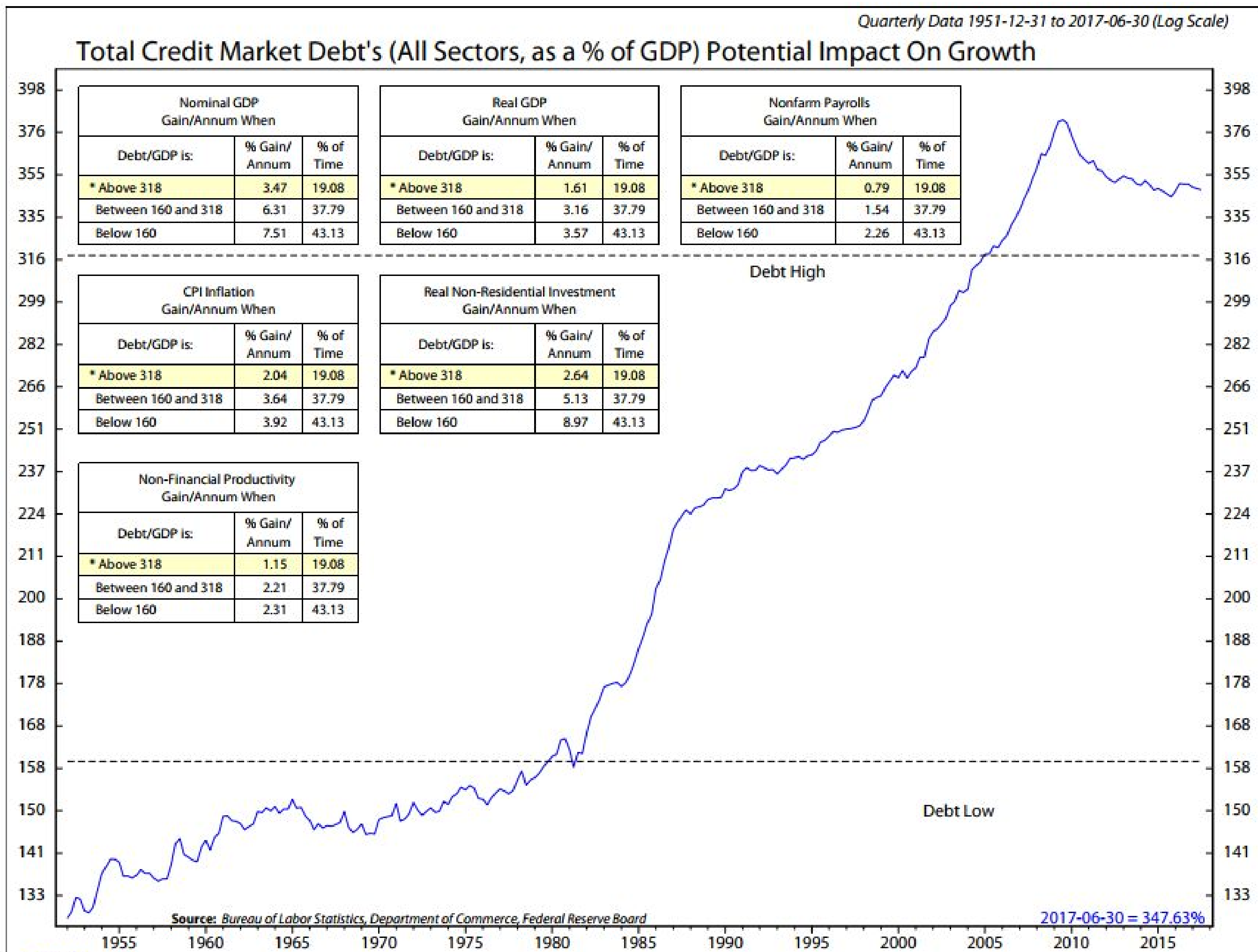
We've written about this one extensively, so I'll just going to give it a short summary here. If you'd like to read up more on how debt cycles work then go and give this a read (link here).

Here's the nitty-gritty.

The world has already begun a long-term deleveraging cycle as per the Bridgewater debt cycle framework. This is going to be a major secular driver of markets and the economy over the next decade.

The chart below from NDR shows total world debt relative to GDP. Global debt to GDP currently sits at approximately 345%, which is roughly $245 TRILLION worth of debt in dollar terms.

The graphs on the left show the average annual change to real and nominal GDP at various debt levels (above 318%, between 160% & 318%, and below 160%). Not surprisingly, when debt is high (above 318%) real and nominal GDP growth drops to less than half its average when the total debt stock is low. As this deleveraging cycle continues, we'll see our average growth fall even further.



High levels of debt constrain an economy in three ways:

1. It inflates asset prices in a reflexive loop (i.e., more debt = higher asset prices = more debt required for people to participate in the economy). The continuous lowering of interest rates (aka: the cost of money) facilitates this game until the zero bound is hit and interest rates can't be lowered any further.

2. It lowers the dynamism of the system while greatly increasing its fragility.

3. Once leverage reaches a saturation point (i.e., the end of the long-term debt cycle where we are now) over-indebted consumers max out their ability to take on more debt. An increasing amount of their incomes go to debt servicing costs, which means less consumption. This lowers economic growth and acts as a drag on inflation.

Demographics: On the other side of a once in human history labor force impulse

One of the most important and yet widely ignored factors in economic growth is demographics.

The French philosopher Auguste Comte, knew what he was talking about when he said: “demography is destiny”. I’m going to show you why this is, what really drove the last 100 years of exceptional global economic growth, and then lay out why the next 100 years is going to look nothing like the last.

We’re then going to talk about how this is already significantly impacting the global economy and markets; from shifting consumer preferences for goods and services to financial assets. And then we’ll finish with a little known tax law that’s going to result in a growing wave of equity supply over the next 10-years.

Let’s start with the basic equation for economic growth.

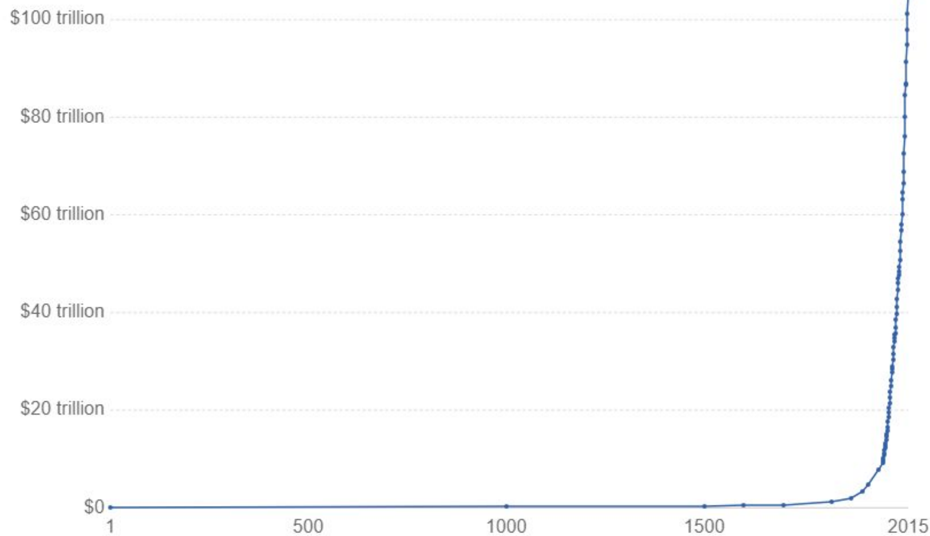
Number of Workers x Total Productivity

That’s it.

Over the very long run, it’s just these two factors that drive all economic growth.

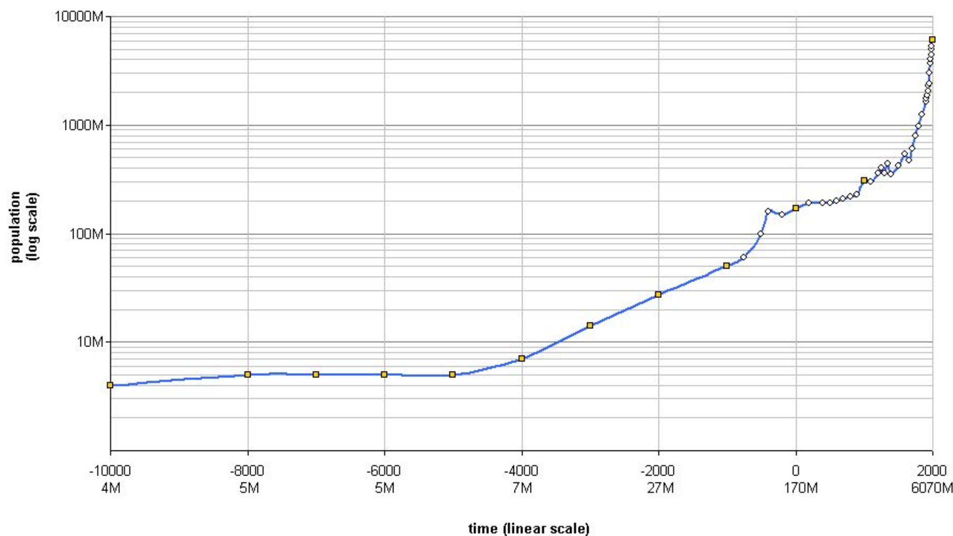
The more workers there are the more creators, makers, service providers there are in an economy. That means more laborers creating value and conversely creating demand. Productivity is essentially the steady build-up of knowledge (advancements in our technology and know how) that drives efficiency gains over time. Combine the two and you have all the ingredients that make up economic growth.

Now take a look at this (ignore the obvious chart crimes being committed for now). The chart shows world GDP over the last two millennia. I’ve seen many point to this parabolic rise as proof that our recent technological advances are driving an explosion in economic growth, one that’s likely to continue. They take Moore’s Law, apply it across the board, and extrapolate into the future.

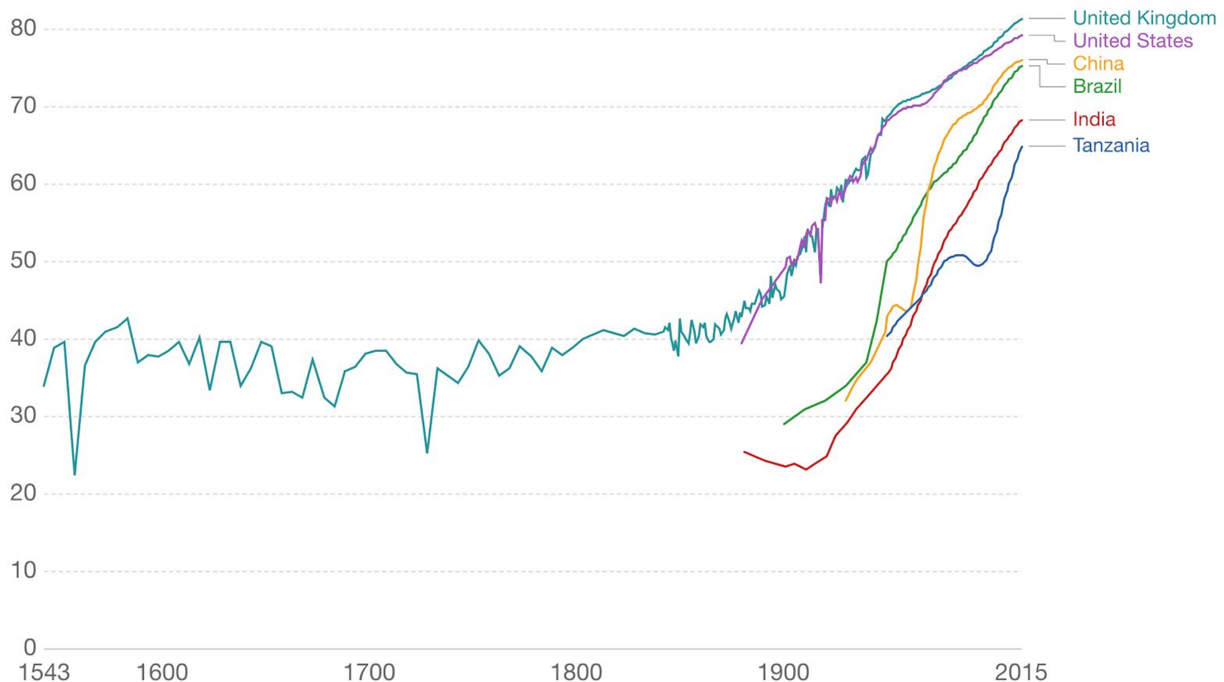


But now let me show you another chart.

This one is of a log scale of the world's population over the last 12,000 years. Notice how something interesting happens around 150-years ago that causes the population to hockey-stick upwards and begin to rise exponentially?



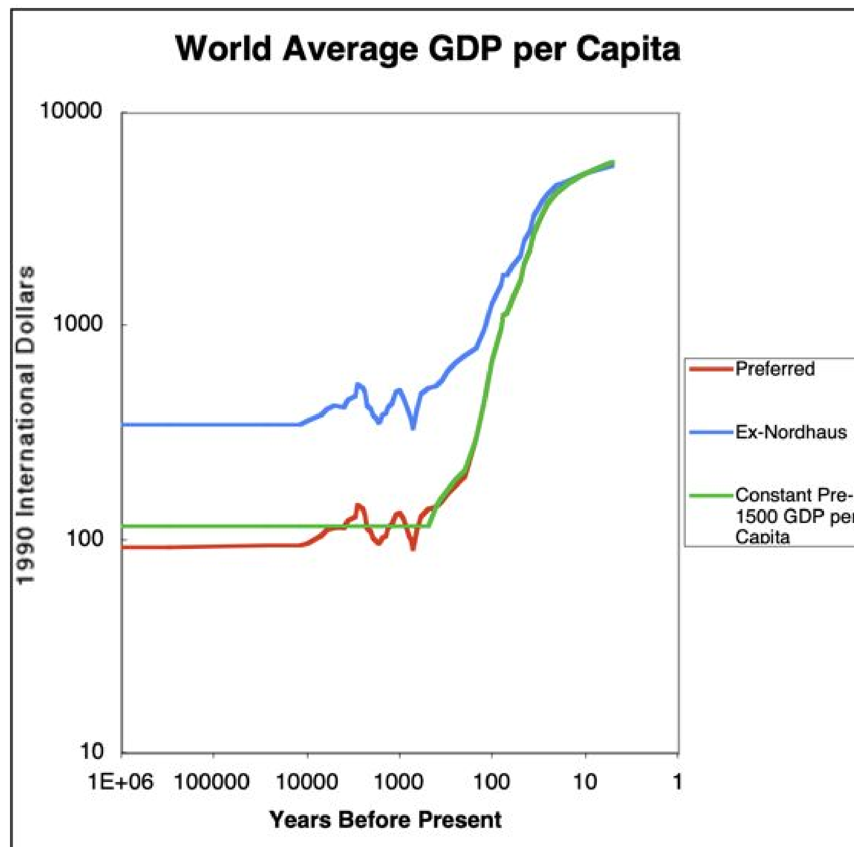
Well, this population “explosion” was driven by two developments (1) The discovery of “Germ Theory” in the late 19th century, which literally led to doctors learning the importance of washing their hands before surgery and (2) the advent of antibiotics in 1928. These two developments drastically lowered the mortality rate which led to global life expectancy quickly doubling for the first time in human history.



Longer lifespans meant more people having more babies. This kicked off the exponential growth in the world’s population that began roughly 150-years ago.

This is exactly around the time that global GDP turned parabolic.

So now take a look at this chart which shows world GDP per capita since the start of human civilization. Unlike the first GDP chart which commits the chart crime of graphing exponential growth on a linear scale. This one is logarithmic and you can more clearly see how economic growth progressed before pivoting straight around the turn of the 20th century and finally tapering off over the last 15-years (more on that in a bit).



This isn't surprising.

We know that demographics are one of the two critical ingredients for economic growth. In 1900 the global labor force (working population age = 15-64) was somewhere in the neighborhood of a billion people. **By 2000, that number had quintupled to 5 billion people.** The explosion in the world's labor force is the primary driver behind why the 20th century saw the most rapid economic growth in human history.

Since we're investors and we don't make money from trading off economic growth that happened in the past, **we have to look to the future and ask ourselves are we likely to repeat this historical outlier of economic growth?**

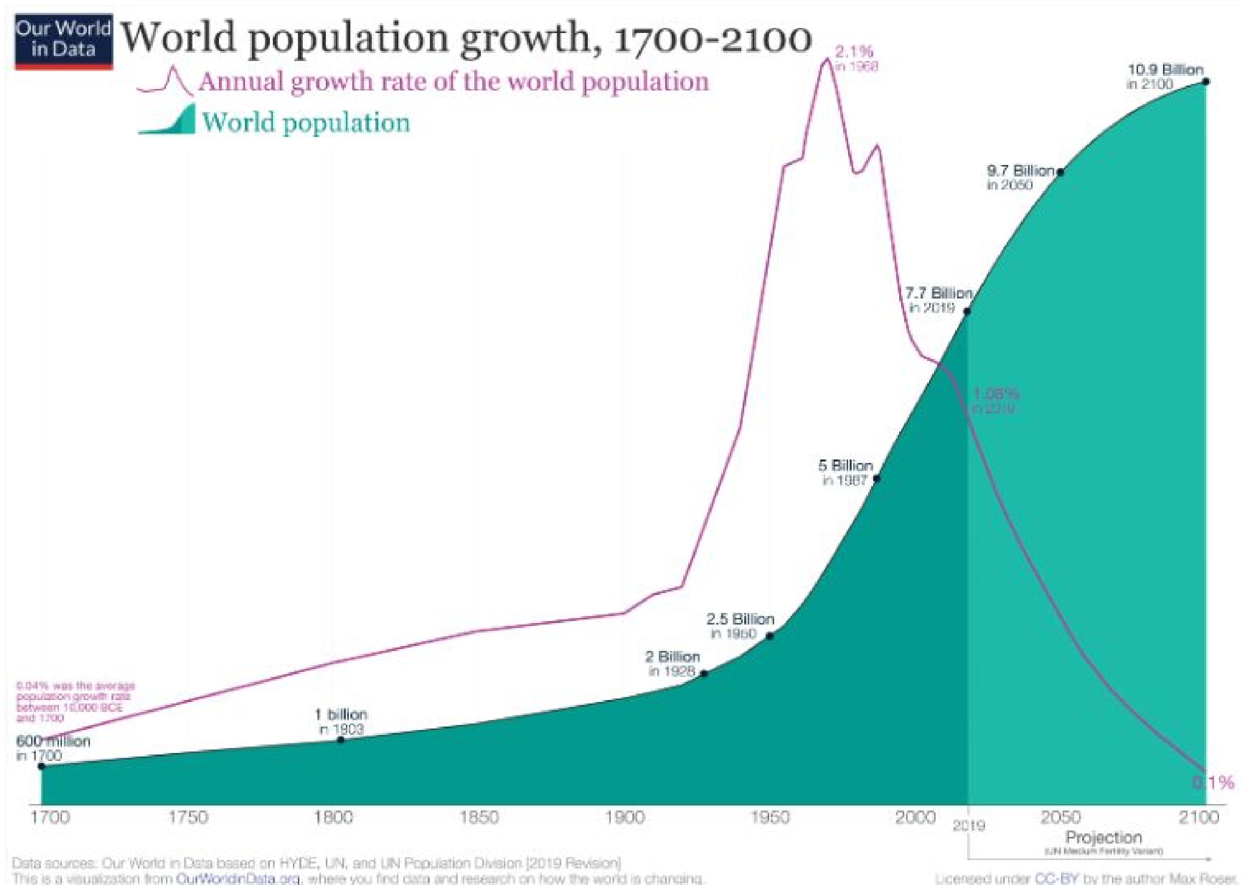
And the short answer to that question is a fat resounding... NO.

Why?

Because the once in human history demographic impulse that was spawned by a sudden drop in the mortality rate has already rolled over and is now falling about as fast as it climbed on the

way up. This means that the force that was such an incredibly powerful economic tailwind for the last 100-years is now all that… but in reverse.

The chart below shows what's taking place. The annual population growth rate peaked at 2.1% in 1968. It's now at 1%. The UN projects it will hit zero — in other words, the global population will peak — in the next 80-years. Also, the UN has consistently *underestimated* the slowdown in global population trends, so there's a good chance growth this forecast is too optimistic.

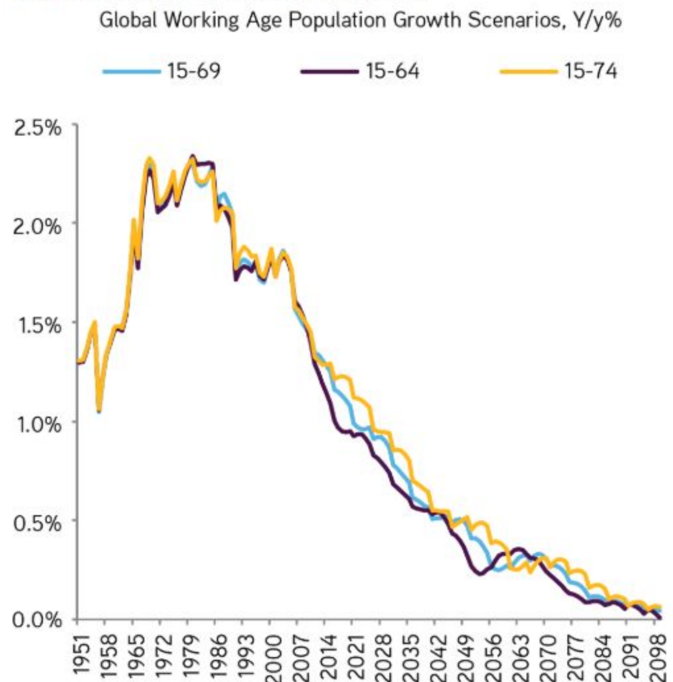


It's important to note that when looking at growth, it's the rate of change and not the absolute number that matters. Yes, the global population will continue to expand for the next 50-100 years. But it will do so at a much slower pace and the demographic makeup of that growth is increasingly comprised of old people living longer rather than new kids being born.

We are already close to 'peak child' which is a term coined by Hans Rosling to mark the first moment in human history at which the number of children in the world stops increasing.

Remember how I pointed out that **in the previous 100-years we saw a quintupling — that's a 500% rise — in the world's labor force? Well, over the next 100-years it's going to climb by a meager 20%.**

Working Age Population Growth Rates Are Declining, Which Has Implications for Economic Growth



Note: The above analysis depicts the growth rate of the global working age population under three definitions: 15-69, 15-64 and 15-74. In all cases, growth in the size of the global working age population will continue to slow in coming decades. Data as at June 23, 2017. Source: United Nations, Haver Analytics.

There are a number of other one-time demographic/Total Factor Productivity impulses that have rolled over as well and will no longer be positively contributing to economic growth.

There a bit wonky so we won't go too much into them here but things like the "Mankiw Extension" which is basically the huge improvement in child education over the last 150-years along with an improved matching function of labor in bringing more women into the workforce (see research by Cesare Marchetti).

All the juice has been squeezed from these positive trends and now we're seeing their benefits to the growth rate fade…

When you understand all this, which I now hope you do, the confusion over all the "Secular Stagnation" talk that everybody is struggling with, suddenly isn't all that confusing. It actually makes perfect sense. Of course, the global economy is trapped in a low growth, low inflation environment. The only factors in the economic equation say that MUST be the case.

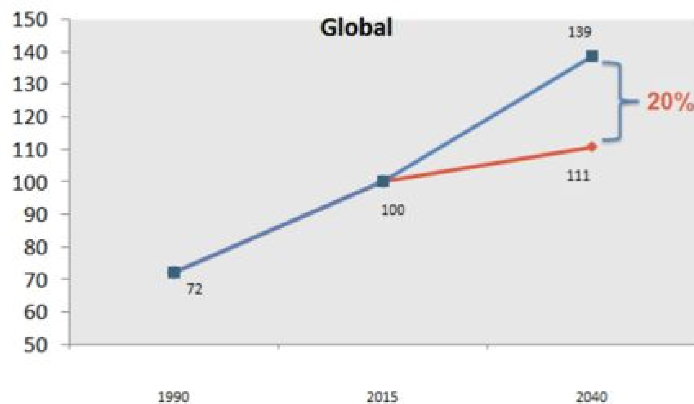
Check out these key findings from a presentation given recently at the Berkley *Forum on Aging and the Global Economy* (emphasis by me).

> *Expansion of the working age population has been a powerful engine of the global economy in recent decades,* ***with the resulting demographic "tailwinds" accounting for 48% of annual economic growth from 1990-2015.*** *These tailwinds will slow, however, as the global population ages 20-64 will grow less than half as fast from 2015-2040 as compared to the prior 25 years, while the age 65+ population will grow five times faster than the working age population.*
>
> ***We predict that slowing population growth and rapid aging of the population in the United States and other leading economies around the globe will cause global demographic tailwinds to be only 31% as strong in the 2015-2040 period as***

compared to 1990-2015. *Tailwinds that added 1.3% per year to global economic growth during 1990-2015 will drop to only 0.4% per year from 2015-2040.*

*...**We find that in 2040 the global economy is projected to be 20% smaller than if we had ignored the upcoming changes in the rate of population growth and aging between 1990-2015**... The most dramatic difference is in China: we project a Chinese economy in 2040 that will **be 41% smaller than under naive backward-looking projections that ignore the effects of China's slowing population growth and rapid aging.***

Figure 5: Difference in Size of Economy under Historical and Projected Population Trends (2015=100)



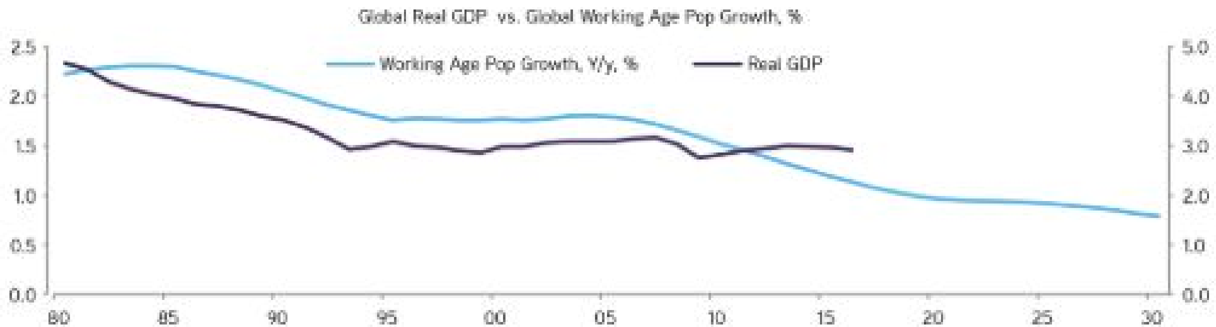
China is so screwed and they don't even know it yet…

Take a look at various global GDP forecasts and they project economic growth to hold steady at around 3.5%+ over the next decade.

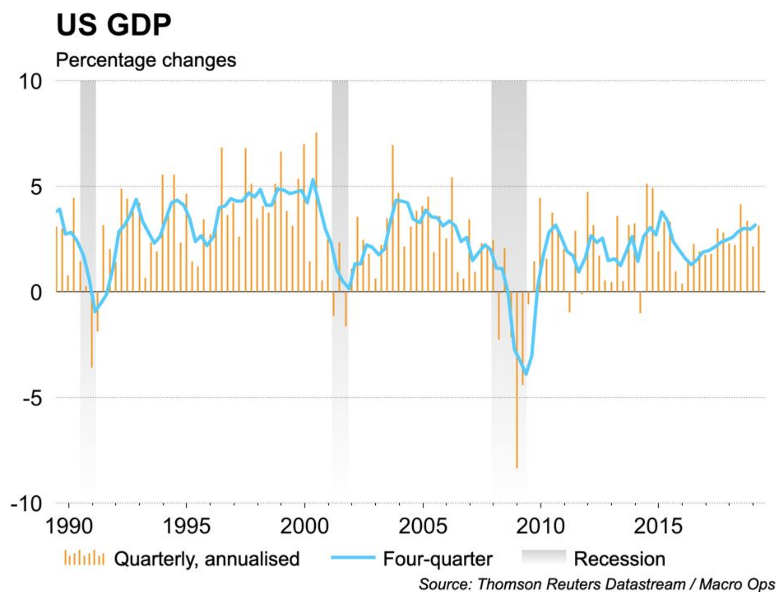
These forecasts are not factoring in at all this massive secular shift that's occurring in our labor force demographics. Barring all other factors such as deleveraging and deglobalization, **this demographic turning point alone will lower the average real global GDP growth rate by close to 2% a year —** 2% doesn't seem like a big deal, but compound that out over just three decades and you get… actually, see for yourself (link).

Aggregate demand is shifting structurally lower. This means real global GDP growth of sub 2% is going to be a part of our new economic reality going forward.

For a system that is predicated on rapid and ongoing economic growth (ie, you NEED the growth to pay off the debt), this change is going to have long-lasting and wide-ranging repercussions… Ones will require a total reorg'ing of how we think about and conduct our economies (chart via KKR).



This growth has been so stubbornly low. Look at the tiny bump we saw in GDP following a trillion dollar tax cut and a $300mn boost in fiscal spending in 17'/18'. Growth jumped a whopping 1.5% and is already rolling over — I project GDP growth to fall even further to around 1.5% within the next 12-months and stay there until the next recession or round of US/China fiscal stimulus.



And again, this is only going to accelerate as more boomers retire and drop out of the labor force. Studies have shown that **retirees consume 35% less than those in their working years.**

Consumption not only decreases but their preferences change dramatically as well. No longer are they in the market for things, especially the big-ticket items that make for a dynamic economy such as bigger houses and new cars. Instead, most of their consumption goes to services. Things like healthcare.

This is a persistent structural deflationary force. **If you think 2% nominal yields on the 10-year are crazy then just wait… Barring an introduction of new major fiscal/monetary policy experiments (which is increasingly possible), we're following right in Japan's footsteps. The zero bound is acting as an irresistible attractive force for the entire yield curve.**

Now I'm going to finish up this section with what I think is one of the most interesting and impactful — from an investing standpoint — developments that is happening right now and which very few are talking about.

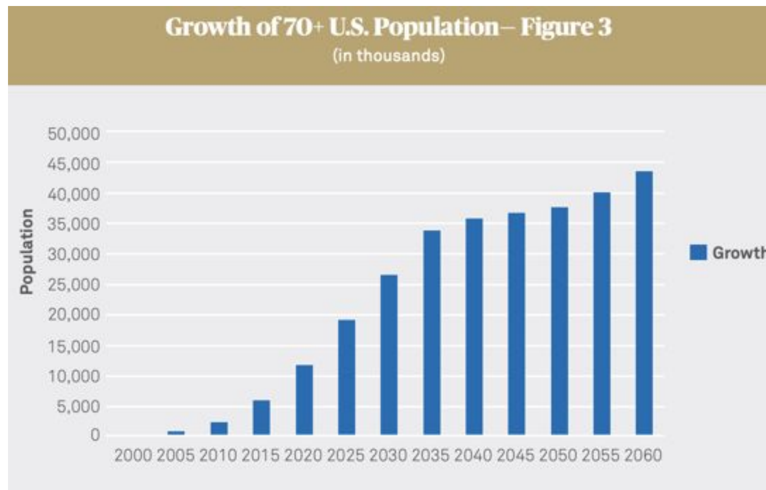
The Required Minimum Distribution (RMD) Law.

Some of this is going to sound dull. But stay with me… RMD is going to be one of the most impactful ongoing forces on markets over the coming decade. I'll keep this discussion easy and just tackle the main points and their eventual effects.

Here's a short summary on RMD from Bank of New York Mellon (full report here).

> *Beginning in 2016, when the first of the baby boomer generation(1) reaches 70½ years of age, a growing share of applicable retirement savings will become subject to RMDs, which is t**he annual minimum amount a retirement plan account owner must withdraw beginning in the year he or she reaches age 70½.***
>
> *As a result, throughout the next 20 years, **billions of dollars annually will be forced from retirement accounts** through distributions that will, in many cases, be taken in the form of a single large annual payment.*

RMDs have been required for many years. But, what makes this time different is the sheer size of the population crossing the critical 70 ½ mark, combined with the amount of savings they have tied up in these retirement vehicles (401K and IRAs) that are subject to RMD.



Source: U.S. Census Bureau

And a few key highlights from the report (emphasis mine):

- *The value of retirement assets for all RMD-eligible plans currently* ***totals an estimated $16.2 trillion****.*
- *The current population of 50-69 year olds who will reach RMD status over the next 20 years will increase by more than 27 million individuals.* ***By 2035, the total number of retirees taking RMDs could swell to 58.7 million individuals according to census projections.***
- *It is estimated that more than 65% of current traditional IRA investors (and their assets) will enter into the RMD strata in the coming 20-year period. If these projections are correct,* ***up to $10 trillion in assets will be subject to mandatory withdrawals over the next two decades****.*
- *A first-year withdrawal, based on the current IRS formula, requires a distribution of 3.65% of eligible assets. What's more, the percentage grows as the retiree ages and jumps to 5.35% for that same individual at age 80. At age 90, the mandated withdrawal percentage leaps to 8.77% of the account holder's balance.*

IRS Uniform Lifetime Table – Figure 1

RMD Age	Distribution Period	% of Balance	RMD Age	Distribution Period	% of Balance
70	27.4	3.65	81	17.9	5.59
71	26.5	3.77	82	17.1	5.85
72	25.6	3.91	83	16.3	6.13
73	24.7	4.05	84	15.5	6.45
74	23.8	4.20	85	14.8	6.76
75	22.9	4.37	86	14.1	7.09
76	22.0	4.55	87	13.4	7.46
77	21.2	4.72	88	12.7	7.87
78	20.3	4.93	89	12.0	8.33
79	19.5	5.13	90	11.4	8.77
80	18.7	5.35			

Source IRS

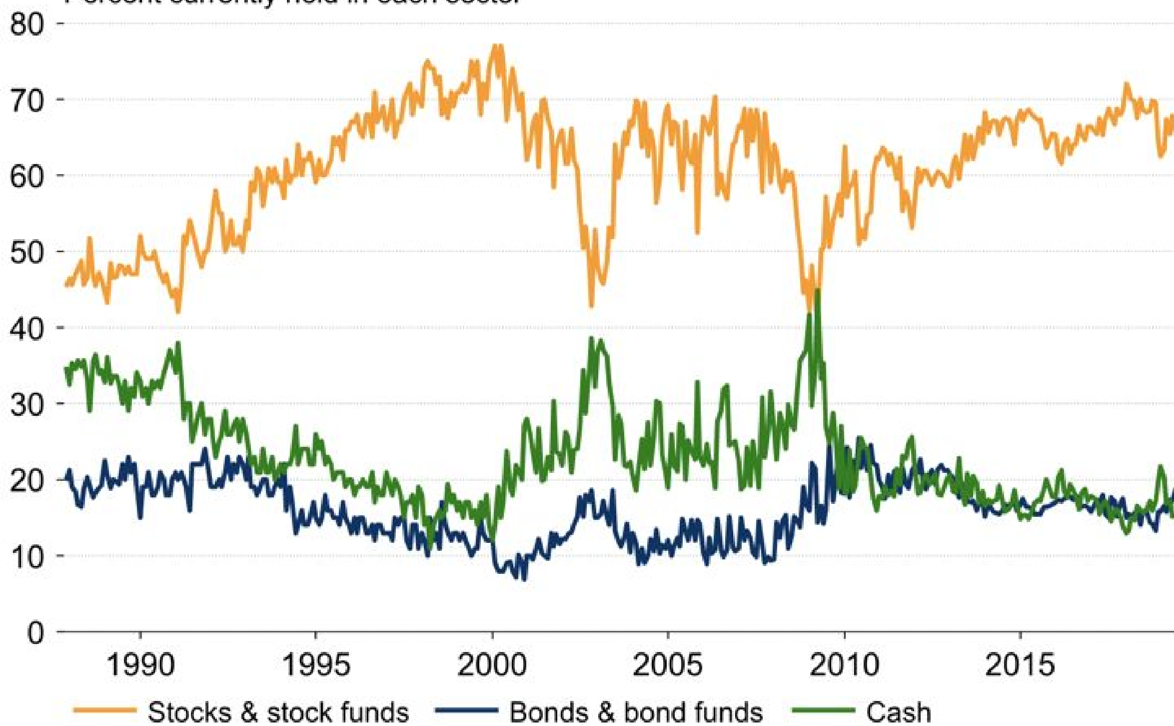
You can see the required distribution percentages in the table to the right.

Let me put this all into perspective, because trillions of dollars is a lot of money.

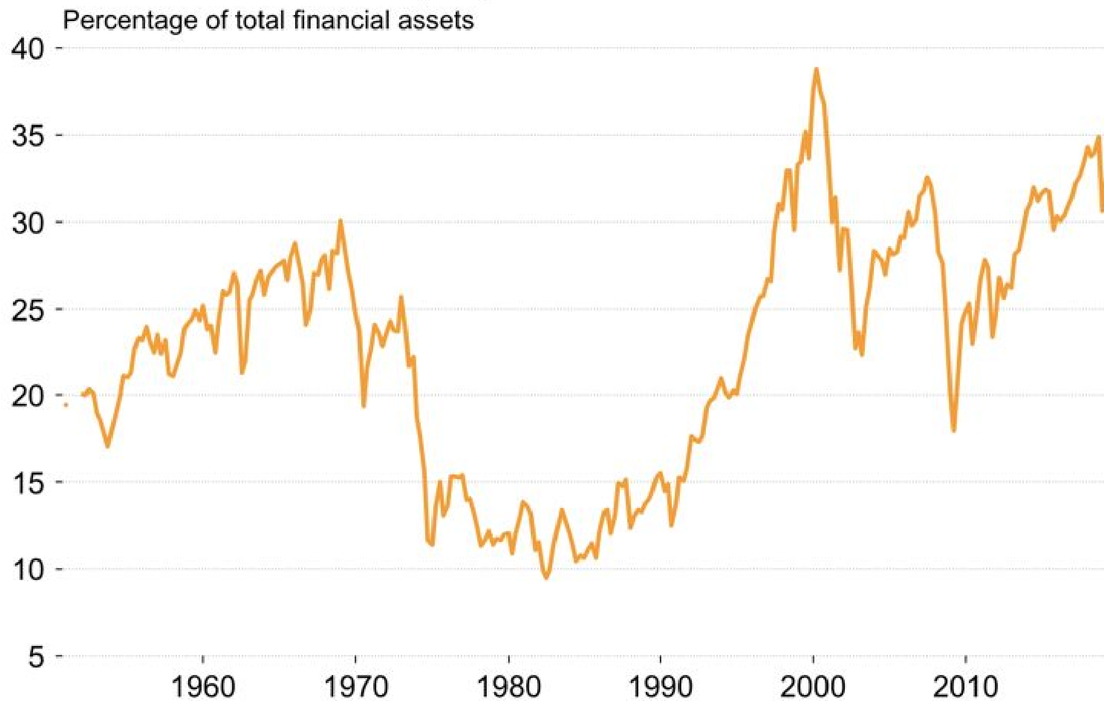
Well, if the above report is anywhere close to being right, and "up to $10 trillion in assets will be subject to mandatory

withdrawals over the next two decades." **Then that is equal to about one-third of the market cap for the ENTIRE US equity universe.** This fundamentally means that the supply of equities (those wanting or needing to sell) is going to structurally rise by a lot over the next decade.

Now, of course, Boomers don't have all their savings in equities. They hold a mix of assets but anyway you cut it, they still hold a SUBSTANTIAL amount of stocks.



Which is why Household's allocation to equities is near the record highs last reached at the top of the TMT bubble in 2000.



It's possible that some of these forced distributions will be reinvested back into the market — especially as long as the trend stays up and overall market volatility relatively low — heck, I could even make the case that RMD will drive an equity bubble as retirees, lulled by a seemingly endless bull market and unappealing alternatives, with yields so low elsewhere, extend their risk-taking and go for broke. It's possible, but long-term this is going to equate to stocks getting sold in mass.

Research by the Investment Company Institute indicates that "41% of withdrawals from retirement accounts are used to pay living expenses in retirement" and "38% of survey respondents… indicated that withdrawals are actually reinvested or saved in other accounts".

But here's the rub… their allocation mix is going to change substantially. This is because stocks are a great asset when your young and have a job (you're functionally long labor). Volatility actually benefits you in the long run by increasing your returns as you're able to deploy capital at lower prices (ie, get more bang for your buck).

This flips completely when you're retired. When you're retired, you're now short labor and long consumption. Volatility is no longer your friend because you're forced to sell more in a downturn in order to raise cash for consumption now. The implications for the stock market over the coming decade should be clear. It's not good…

There are currently two bills in Congress that are trying to raise the age at which RMD kicks in (one extends it to 72, the other to 75). The bills are being pushed hard by the retirement investing industry, which should be no surprise since they're set to lose buttloads in fees if this trend plays out. We'll see if either of them pass but both are just kicking the can of inevitable down the road.

Boomers hold the majority of wealth. They're starting to retire in mass. This is causing a structural shift in consumption habits, aggregate demand, and financial asset preferences.

Over the very short-term (ie, next 1-2 years) this may not matter much. Especially if one of the bills extending the age is passed. Longer-term though, this is going to be a GAME CHANGER for markets.

Deglobalization: Populism and the rise of economic shamans…

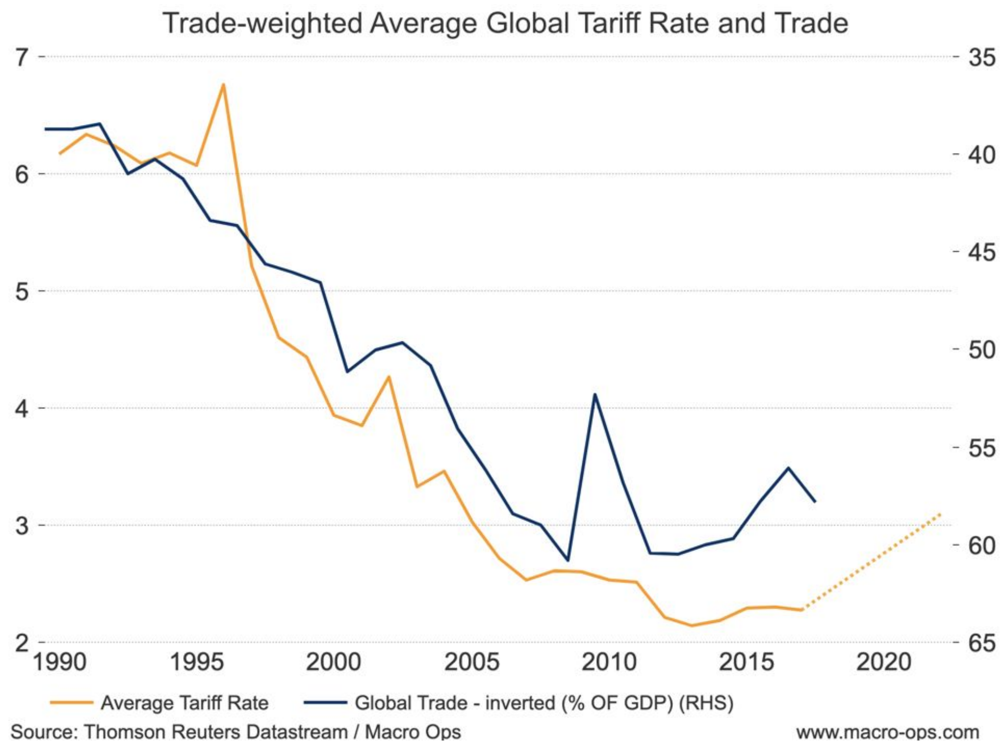
This brings us to our last secular driver: Deglobalization.

It's fitting that deglobalization comes last because it's a byproduct of the first two: deleveraging and demographic collapse.

It's no secret that humans are more cooperative when things are good and perceived as getting better versus when they're not.

Long-term deleveraging and the turn of the demographic boom ensures that economic growth in this century won't be nearly as good as the last (of course, we could create general AI that then exponentially boosts our economic growth but I wouldn't bank on that quite yet).

And because the true drivers of this new slow-growth world are so poorly understood by most, we'll continue to see growing frustration with the political parties, institutions, and the alliances of old as the masses look for someone to blame. This means we're entering a *Brave New World*. A secular cycle of rising populism, less international cooperation, and a reversal of the globalization that has given us a large economic tailwind over the last 30-years.



The Second Circle: Business, Risk, and Profit Cycles

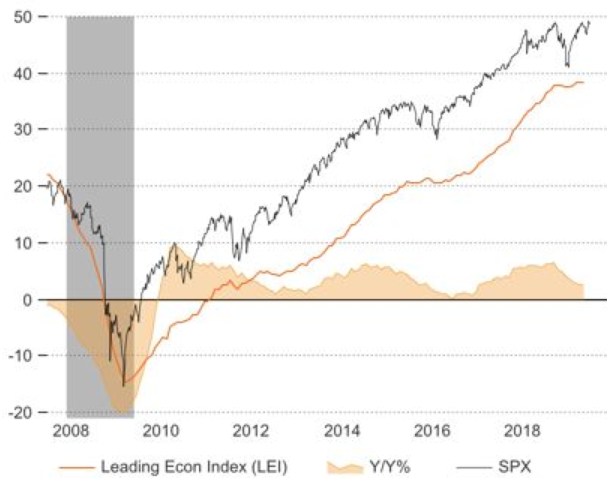
The three points that comprise our Second Ring are:

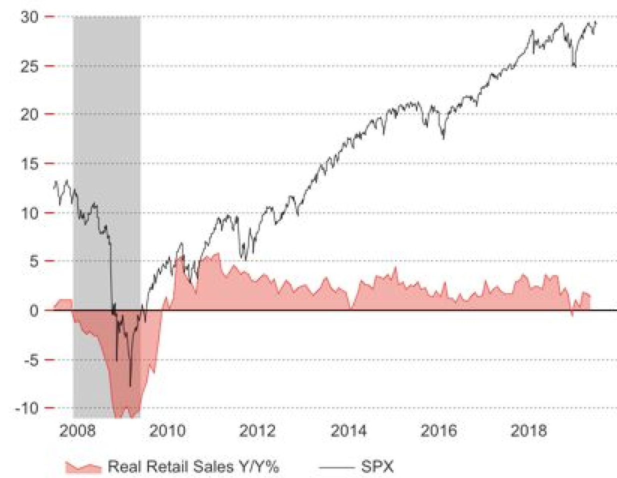
1. Business Cycle
2. Risk Cycle
3. Levy-Kalecki

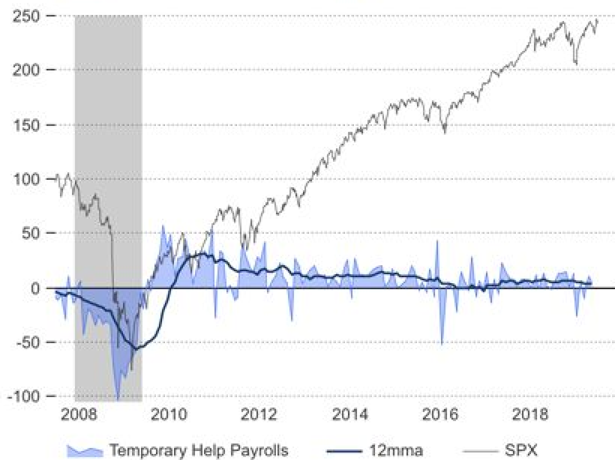
Business cycle: Slowing but still alive and well

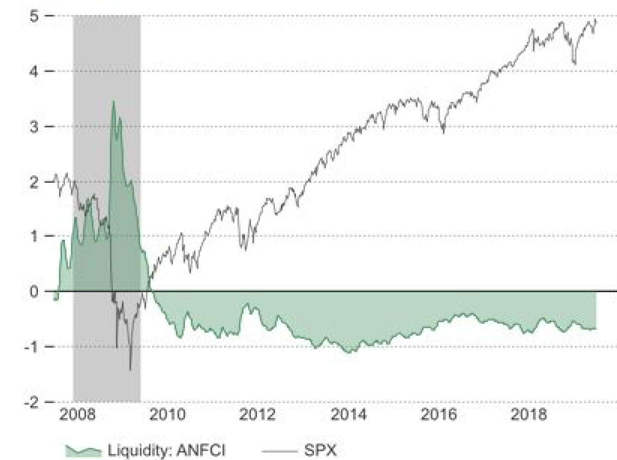
The business cycle in the US is slowing and catching down to the rest of the world. Yet... there are no signs of major financial stress or an impending recession. The three pillars of the economy (Labor, Consumption, Liquidity) are all positive.

US Macro: Labor, Consumption, Liquidity





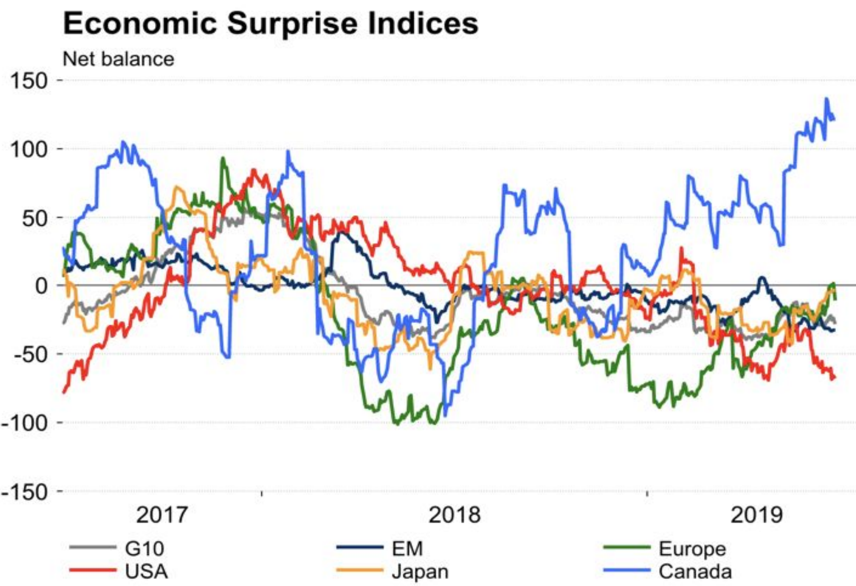




Source: Thomson Reuters Datastream / Macro Ops

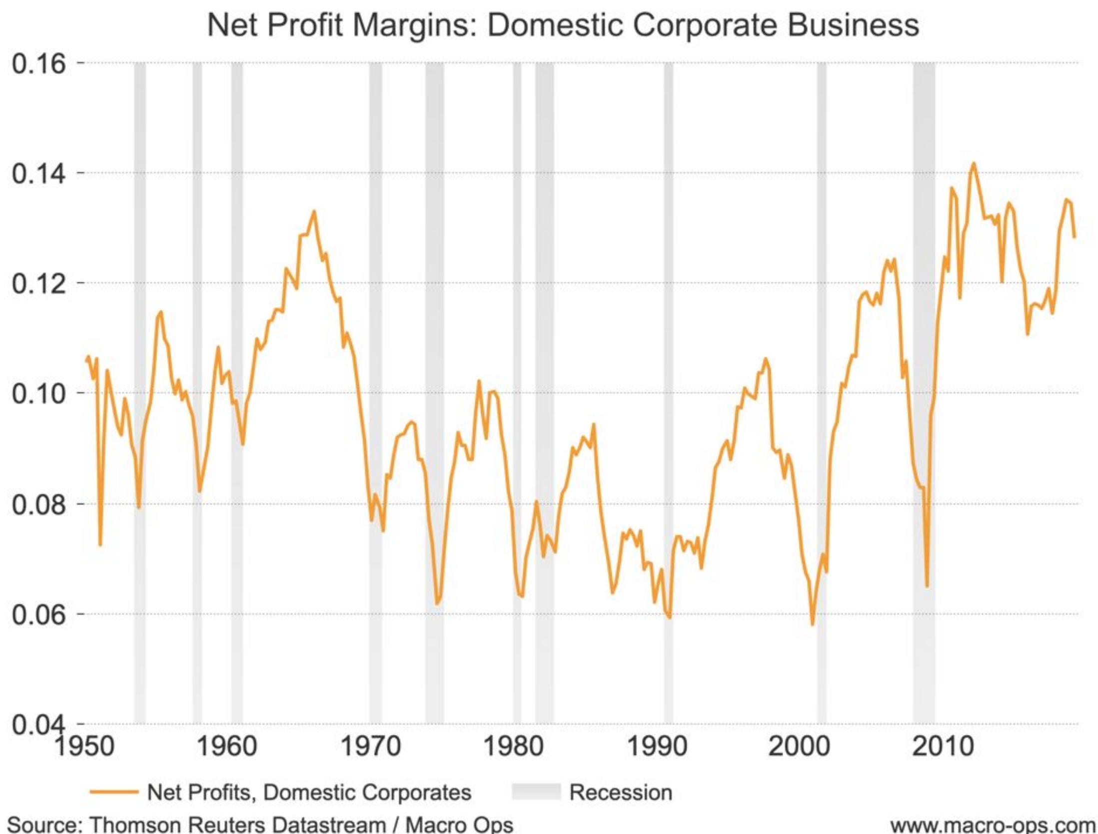
www.macro-ops.com

Economic data in the US is coming in well below expectations. The Citi Economic Surprise Index (CESI) for the US is the lowest in the world. Historically this has been bad for the dollar and good for emerging markets. Expect US data to continue to disappoint but not fall through the floor.



Low and slow growth and inflation is the name of the game along with low odds of a recession in the next 6-months.

Domestic Profit Margins remain within spitting distance of all-time highs. Margins typically contract well before a recession.



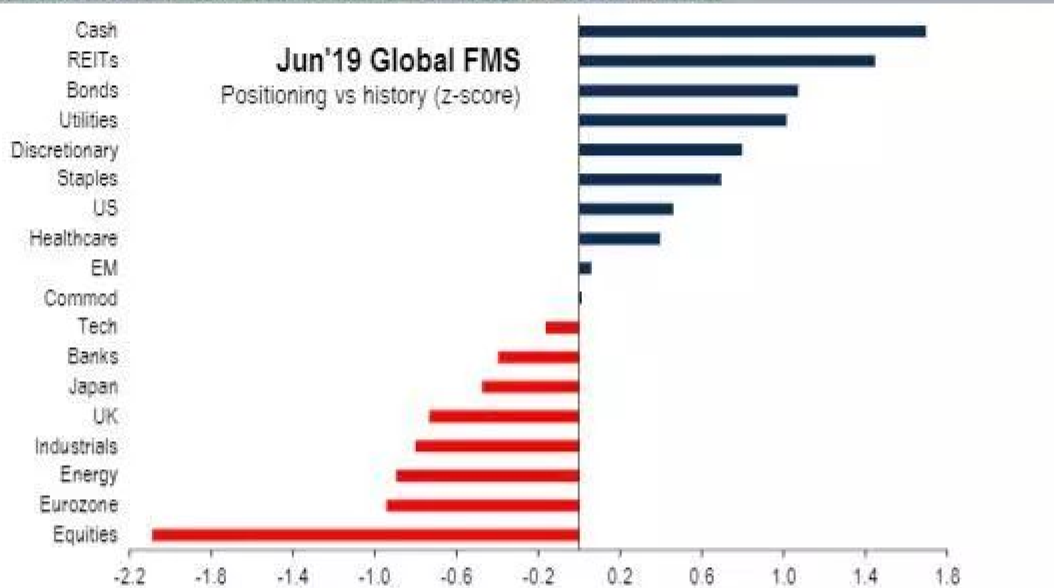
Risk Cycle: Something doesn't make sense here

There are some really interesting things going on from a risk cycle perspective. Going back through the data I can't find a single comparable instance where equity markets were this close to ALL-TIME highs and investor sentiment and positioning were this bearish. It's a total anomaly.

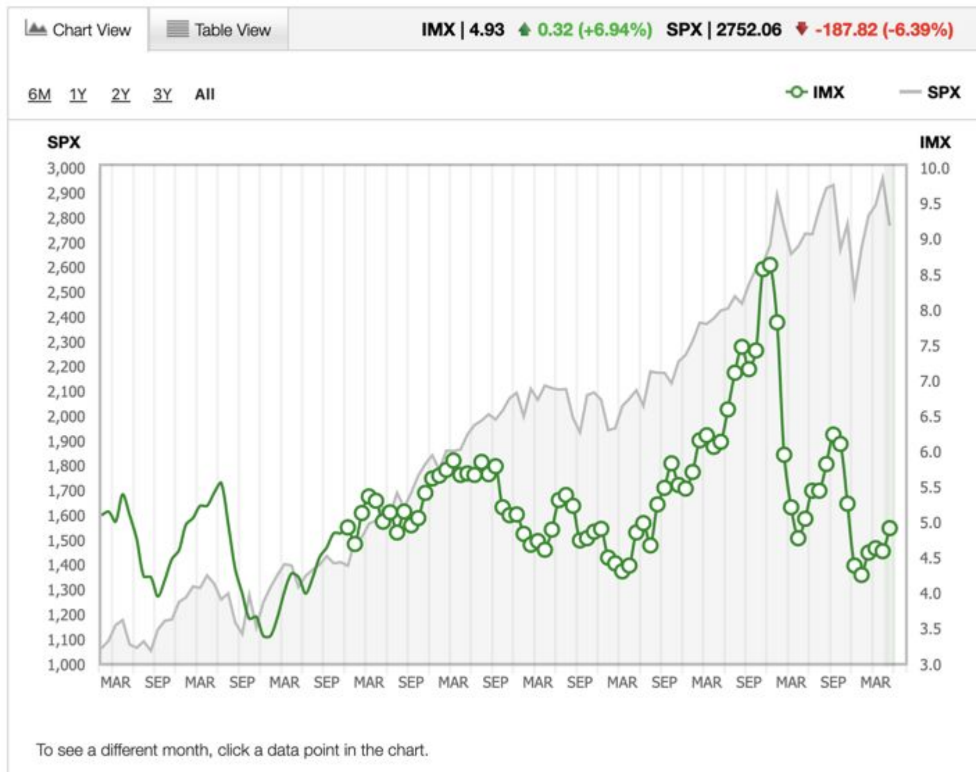
Let's go through some charts real quick.

According to the BofA Fund Manager Survey, fund managers reduced their equity exposure last month by the second largest amount ever (largest occurred in August 11'). They now have their lowest allocation to stocks since March of 09' which is 2.1std below their long-term average.

They LOVE defensives (cash, bonds, utes) and HATE energy, eurozone, and industrial stocks.

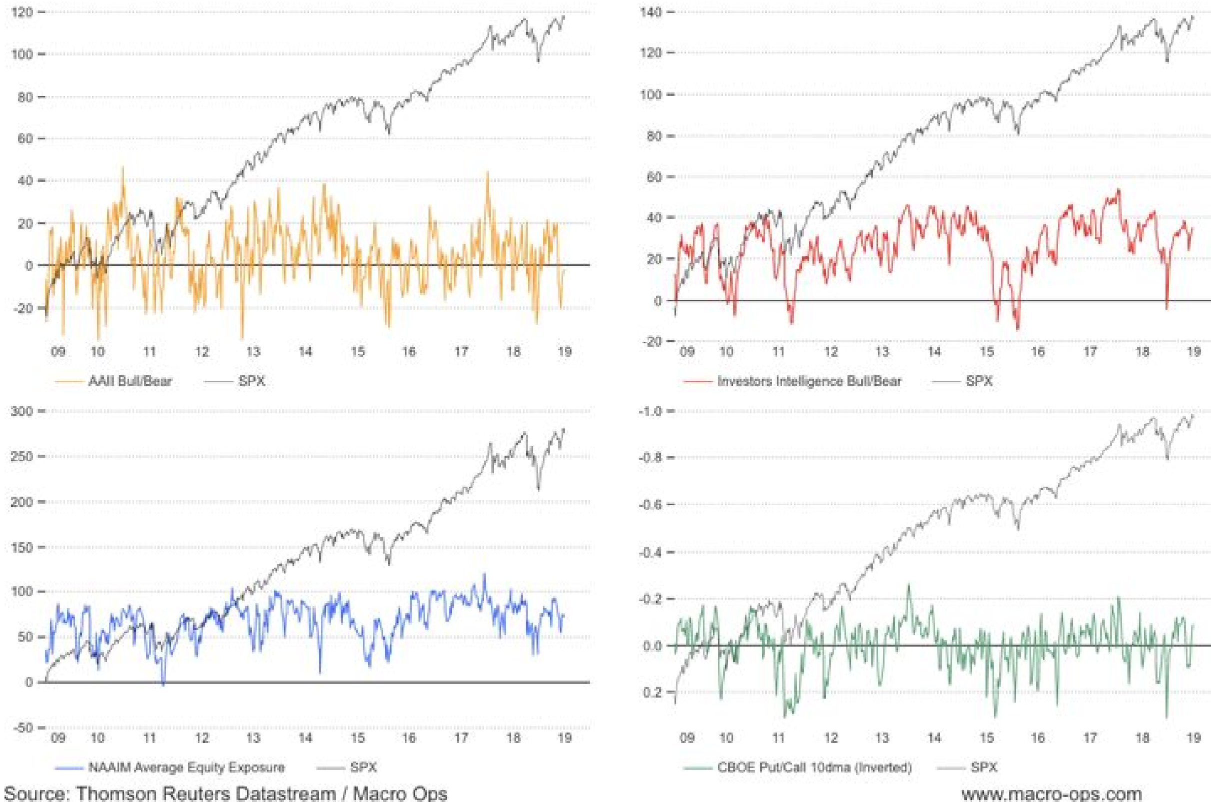


Retail accounts have below cycle average risk exposure according to the TD Ameritrade IMX Index.



And the year-over-year percentage change in NYSE margin debt is the lowest its ever been outside of a bear market and recession.

All our long-term sentiment and positioning indicators are either bearish or neutral.



Consensus earnings expectations continue to drop. Analysts are now estimating just 0.3% and 0.8% earnings growth in Q2/Q3 respectively — which is a mighty low bar to clear.

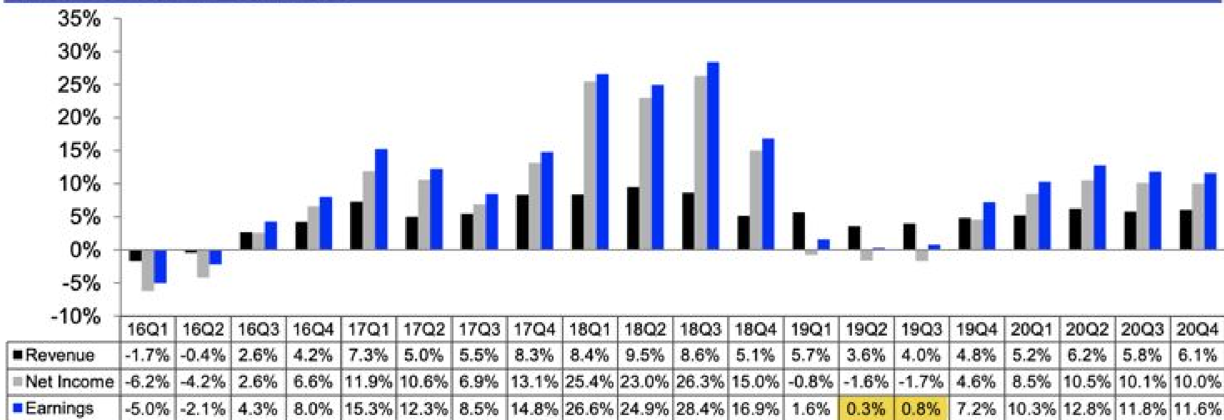
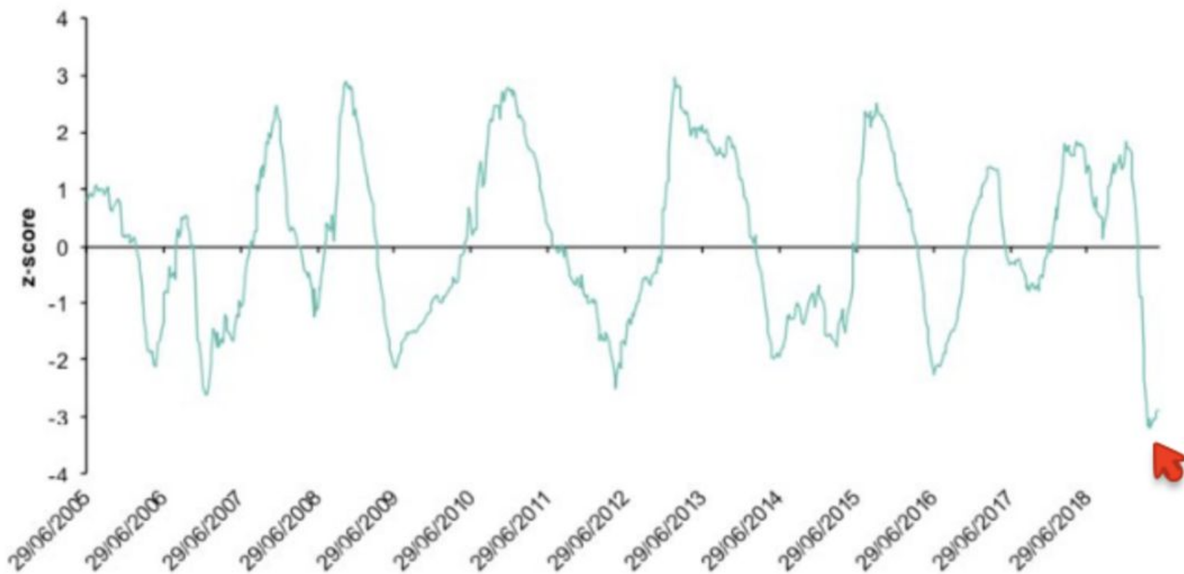


Exhibit 5. S&P 500 YoY Growth Rates

	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4
Revenue	-1.7%	-0.4%	2.6%	4.2%	7.3%	5.0%	5.5%	8.3%	8.4%	9.5%	8.6%	5.1%	5.7%	3.6%	4.0%	4.8%	5.2%	6.2%	5.8%	6.1%
Net Income	-6.2%	-4.2%	2.6%	6.6%	11.9%	10.6%	6.9%	13.1%	25.4%	23.0%	26.3%	15.0%	-0.8%	-1.6%	-1.7%	4.6%	8.5%	10.5%	10.1%	10.0%
Earnings	-5.0%	-2.1%	4.3%	8.0%	15.3%	12.3%	8.5%	14.8%	26.6%	24.9%	28.4%	16.9%	1.6%	0.3%	0.8%	7.2%	10.3%	12.8%	11.8%	11.6%

Source: I/B/E/S data from Refinitiv

The 26-week average z-score of stock versus bond flows recently hit its lowest point on record (chart via Bernstein Research).



What the hell is going on?

It's possible that some of these flows are being driven by RMB and Boomers rotating out of stocks and into bonds. There's also the perpetual global bid for safe assets that I've been writing about. This explains the strong performance of bonds at least.

But doesn't this make you wonder: if everybody is so pessimistic on growth, bearish on the market, and favoring bonds over stocks… then why are stocks near all-time highs?

That's what I've been mulling over, at least. And the only good answer I've found is supply and demand.

I'm not kidding, hear me out. I wrote in our 2018 MIR titled "A Persistent Bid" about the structural supply/demand imbalance that has kept the stock market rising over the last 35-years. Here's a clip from that piece explaining what I mean.

Historically, US corporate share issuance has rarely exceeded 2% and over the last three and a half decades corporates have been actively reducing their share count through buybacks and M&A at an average annual rate of 2%.

While the amount of shares has been falling, the amount of money (cash+credit), has been steadily increasing. Over the last 50 years, the US's money stock has been rising at an average annual rate of 8% a year.

So over the last five decades we've had the supply of equity shares shrinking by an average of 1-2% a year, through buybacks and M&A. And we've had the total money stock increasing at an average rate of 8% a year. Disregarding total market value and investor allocation preferences for a second, this gives us a supply/demand mismatch of roughly 9.5% a year.

Well, guess what the average annual return has been on the stock market over the same period?

That's right...9.5%.

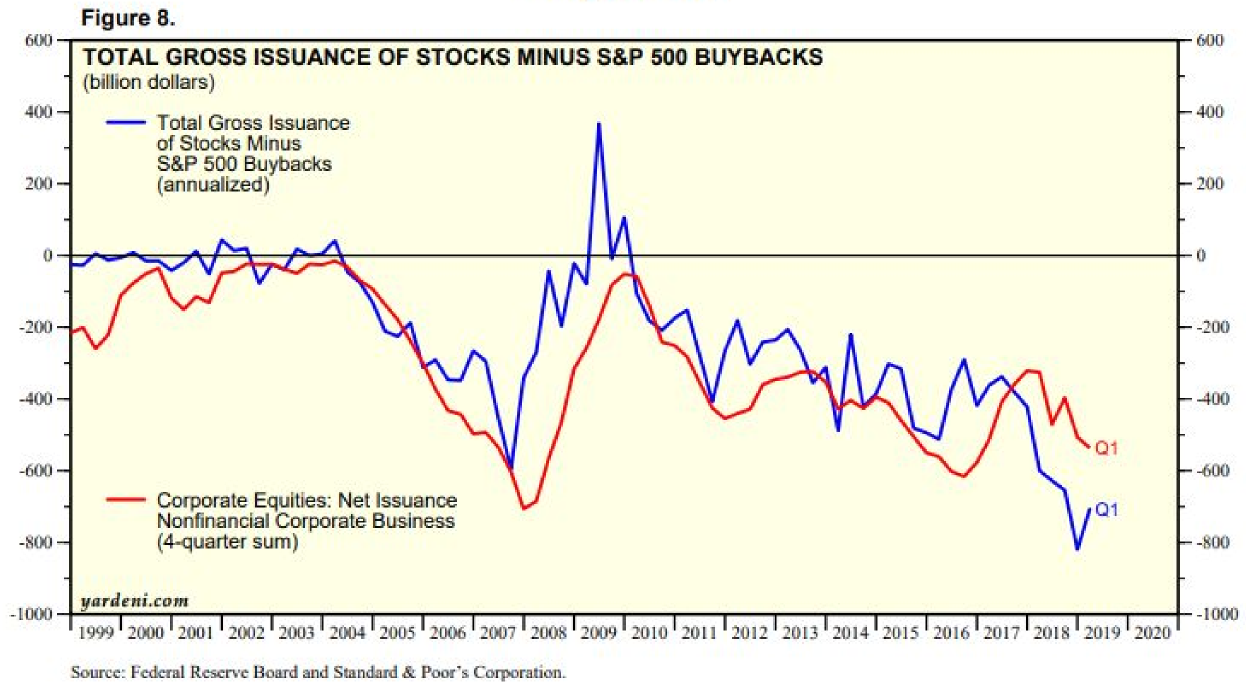
So basically over a long enough time horizon, there are really only three things that drive overall stock market performance. They are:

1. Net share issuance
2. The size of the money stock
3. Investor preferences between equities and bonds

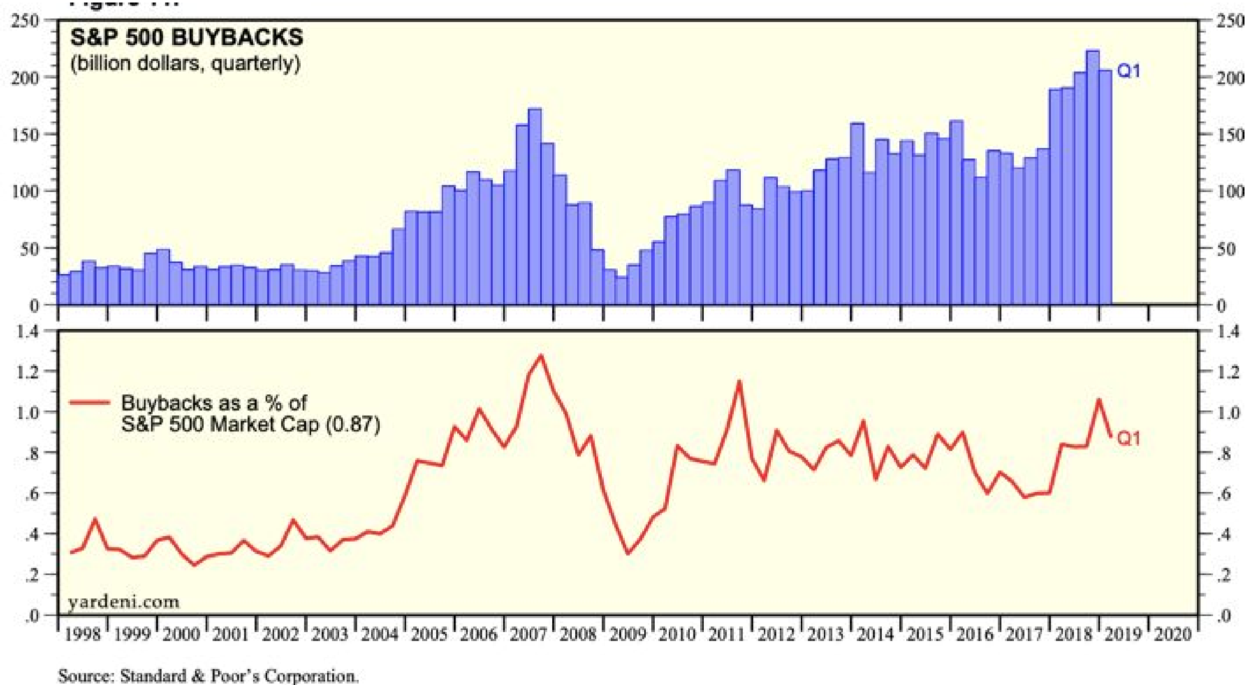
With this information things begin to make a bit more sense.

The overall money stock as measured by M2 is currently growing at about 4%. Despite all the negative sentiment, average US Household allocation to stocks is still high, and **US companies are reducing the supply of their shares on the market at nearly their fastest pace in history** — no doubt being helped by cheap debt.

Buybacks



Source: Federal Reserve Board and Standard & Poor's Corporation.



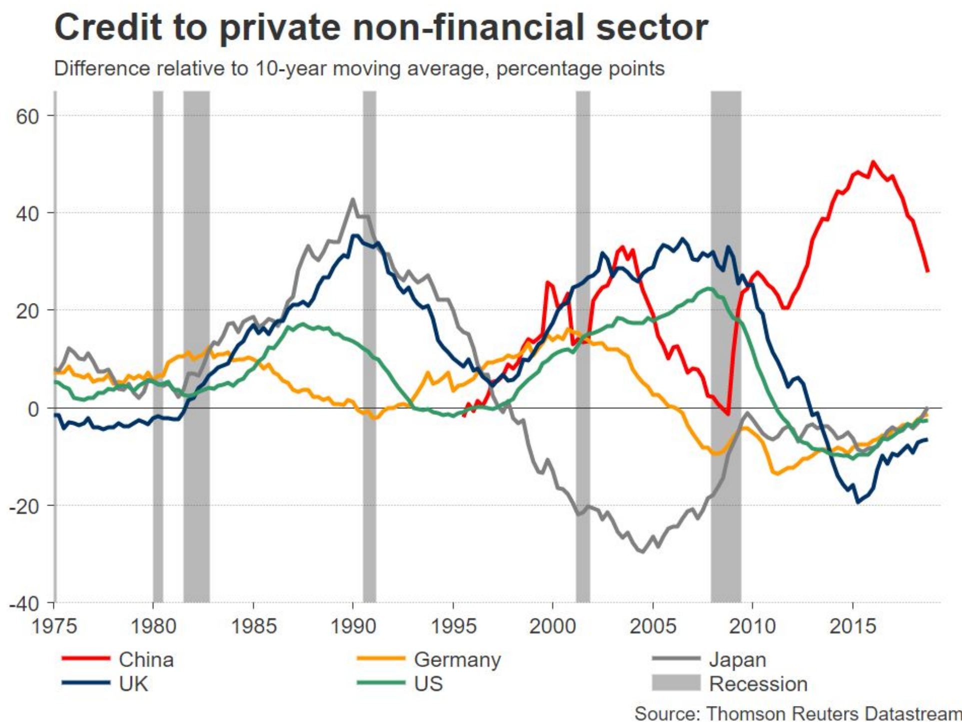
Source: Standard & Poor's Corporation.

Levy/Kalecki: Where will the profits come from next?

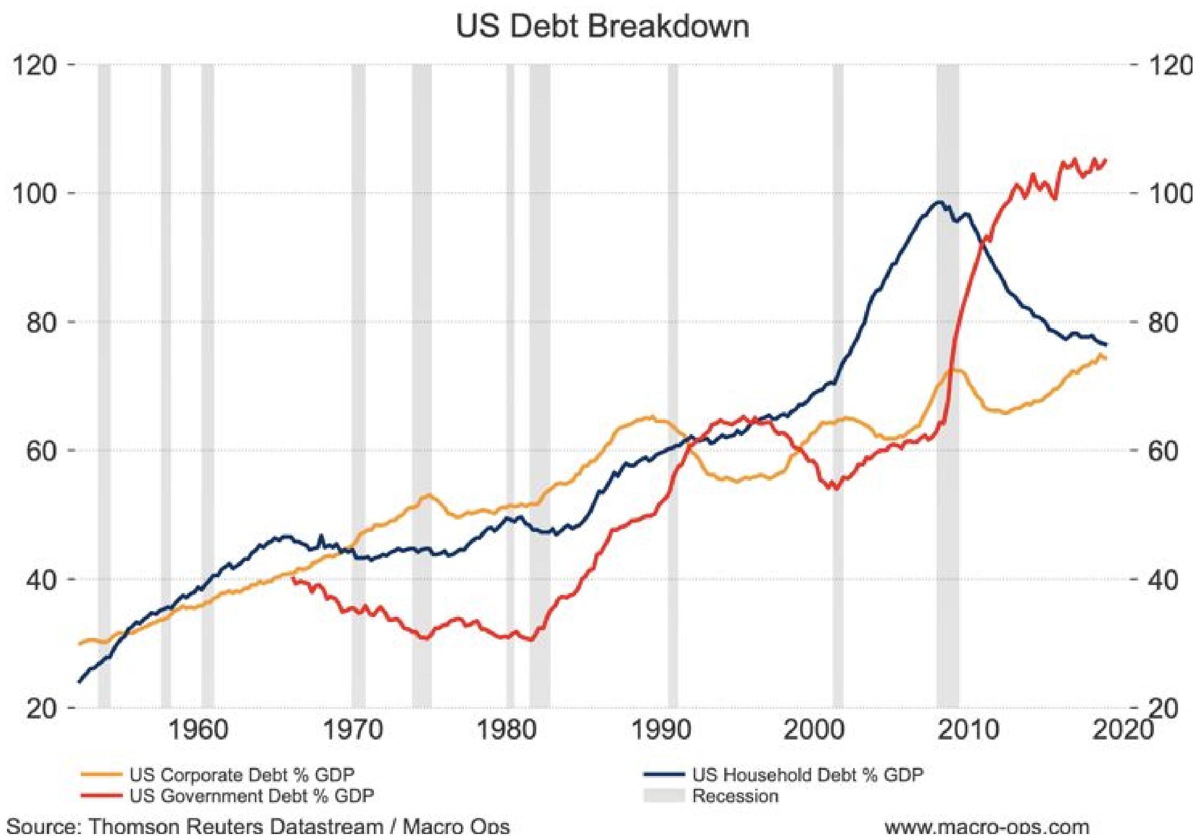
I explained what the Levy/Kalecki Profit Equation is here. In its most basic terms, it's an accounting identity which states that the aggregate profit growth in an economy is dependent on net balance sheet expansion between the three primary sectors (households, private, government).

In a world that suffers from excess capacity and an over-leveraged consumer base. The global economy has needed to rely on governments and central banks expanding their balance sheets in order to keep profits flowing and the business cycle going.

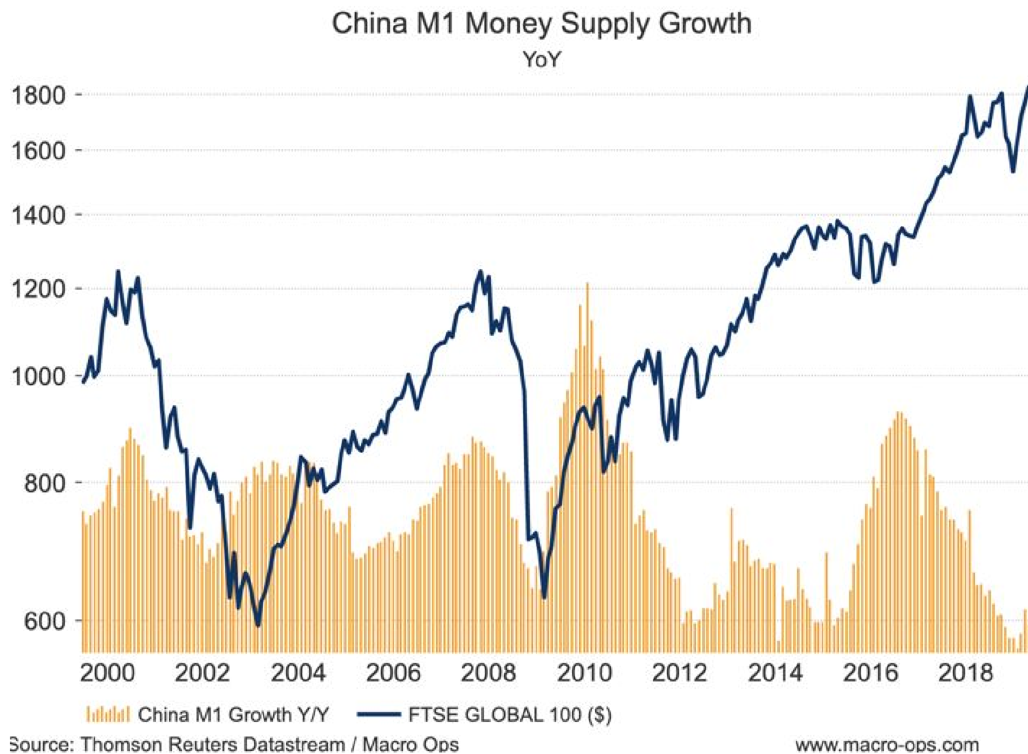
This global cycle has been driven by huge and continuous balance sheet expansions in the Chinese "private sector" (I use quotes because it's really Chinese SOEs).



And also by the US government in the form of a rising fiscal deficit due to tax cuts and increased spending.



We're now on the backside of both of these large fiscal and monetary impulses. This is why global growth has been so anemic over the last 12-months and will continue to be so unless we get further balance sheet expansion; which in the very near term there's only one real candidate that's capable of such and that's China (we are seeing a small but growing fiscal impulse out of Europe).



The China Watchers that I talk to tell me that stimulus at the level that we saw in 2016 is highly unlikely. Over the near-term, we should expect more frequent but comparatively minor boosts to credit like those we saw at the start of this year with the potential for a larger credit injection near the end of 19'. But of course no one really knows, so we'll just have to continue to track the M1 numbers like everyone else.

Until we see some balance sheets expand, expect further anemic but positive global growth. The global recession ex. US which started last year is nearing an end. Leading indicators of global growth are starting to base.

The Third Circle: Marcus' Trifecta - sentiment, technicals, fundamentals

The Three Points that comprise our third circle are:

1. Sentiment
2. Fundamentals
3. Technicals

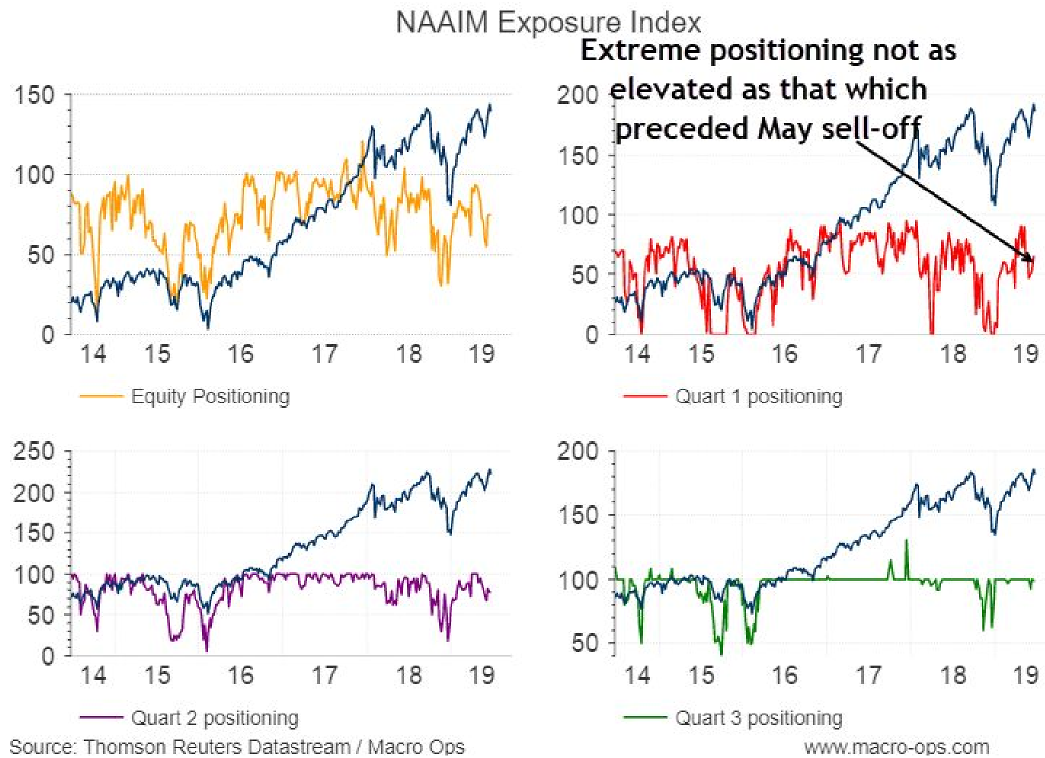
Our technical, fundamental, and sentiment indicators can be separated into short-term (0-4 weeks) and long-term; everything longer than 4-weeks.

Our short-term indicators just triggered a sell-signal today. This signal tends to be fairly reliable and we're expecting a pullback to begin in US markets within the next week.

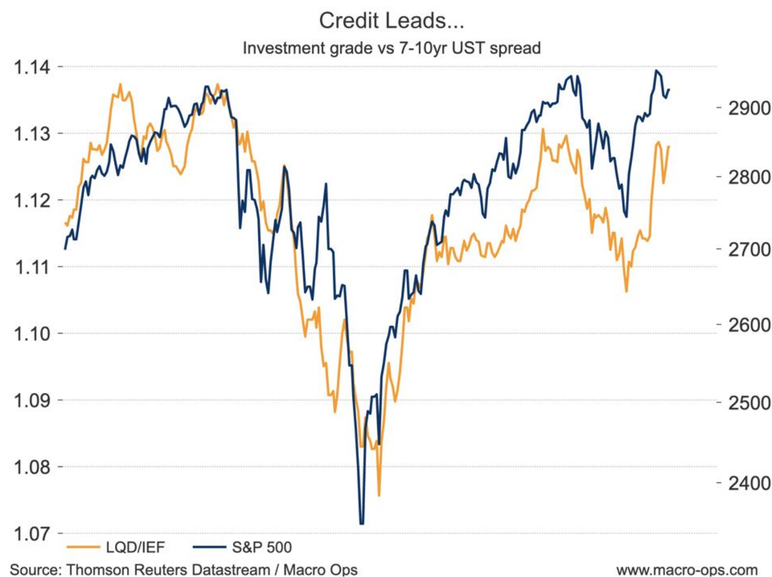
Our Put/Call 10dma indicator has fallen much faster than I expected, even in spite of the downward action in stocks these last few days, which is surprising. When this indicator drops to the horizontal red line below it means market participants are holding less puts relative to calls or to put it another way, **they're becoming complacent.**

The Nasdaq McClellan Summation Index (NASI) has rolled over, crossing below its 5-day moving average (blue line below) today, triggering an official sell signal. This indicator measures the short-term breadth momentum of the heavy tech-weighted index and serves as a solid leading indicator for the broader stock market.

There are a number of reasons to expect not too large of a sell-off though. Overall breadth is strong. Cyclicals are starting to perk up relative to defensive stocks. And sentiment and positioning are widely negative — which is positive.



Plus, we've seen credit spreads (LQD/IEF) tighten significantly over the last week which is something we've been wanting to see in order to confirm the uptrend in stocks.

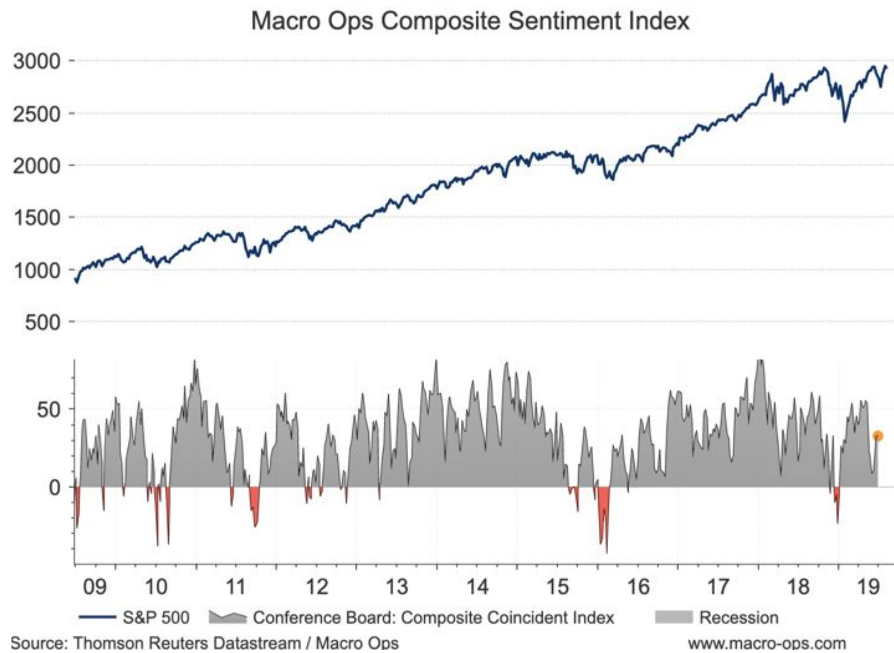


The S&P is reacting to the 2,950 level which has repelled it a number of times in the past. It's likely going to take further consolidation and another pullback before it can break above that level.

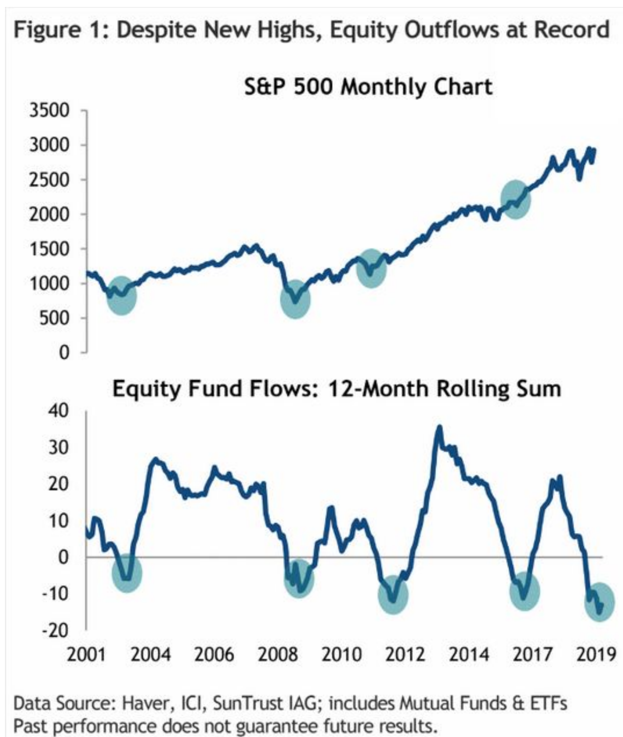
As of right now, I'm looking for a pullback in the S&P to around the 2,850-2,800 level. The big Trump-Xi meeting is expected to take place at the G20 this Fri/Sat and depending on how that goes, we could see a dramatic shift in the narrative for better or worse.

Looking a bit further out, things are much more positive for the market.

Our Composite Sentiment Index shows that aggregate sentiment and positioning are at neutral levels. I expect this to fall back near bearish territory on this upcoming selloff.



Investors have been pulling money out of equities at a record pace. The chart below shows rolling 12-month flows. Every time equity outflows have reached these levels, it's coincided with a major bottom.



We've seen back to back to back Zweig Breadth Thrusts buy signals triggered since the start fo the year.

52-week highs are beginning to spike and cluster again after they went dormant for most of 2018. No matter how you slice the indicators of longer-term market breadth, they show a lot of strength. This is not the type of market internals you want to consistently fade.

Citi's Pulse Monitor Bear Market Checklist, which tracks a score of fundamental data points, shows that the risk of a recession and an extended bear market remain exceedingly low. An "imminent bear market" signal is triggered when amber and red combined readings rise over 50% — current readings are 25% with only one "danger" warning.

Bear Market Checklist

			Last Market Peaks			
	Caution	Danger	1990	2000	2007	NOW
Sentiment						
Average ERP	<2.05	<1.00	2.02	1.83	3.63	5.26
Intrastock correlation	<20.00	<15.00	NA	NA	52.10	31.25
Panic/Euphoria	>0.30	>0.38	-0.05	1.09	0.38	-0.12
Valuation						
S&P 500 Div Yield/10-year Yield	<50%	<40%	38.2%	18.6%	36.8%	94.0%
Normalized Earnings Yield Gap	+1 to +2 stdev	-1 to avg stdev	1.14	1.44	-0.26	-1.53
P/E -trailing	20.0	25.0	15.4	29.9	17.3	18.0
S&P Valuation Composite (seven metrics)	250.0	350.0	176.8	378.9	263.9	278.9
Profitability						
Operating Margins -LTM	16.0%	17.0%	13.3%	15.1%	17.2%	15.98%
ROE -LTM	17.5%	18.0%	14.3%	17.5%	18.0%	17.3%
PV of Flat Earnings into Perpetuity (% of S&P 500)	<65.0%	<50.0%	63.4%	46.6%	73.0%	78.2%
Upward Earnings Revisions %	55.0%	70.0%	NA	57.3%	55.1%	54.8%
Balance Sheet						
Net Debt/Cap -LTM	40.0%	45.0%	45.3%	42.2%	31.4%	34.5%
Capex as % of EBITDA -LTM	30.0%	40.0%	NA	35.0%	29.2%	25.2%
Buybacks % of EBITDA -LTM	30.0%	35.0%	NA	22.3%	37.0%	31.8%
Issuance						
IPO pricing amount as % of SPX Market Cap	0.30%	0.50%	0.35%	0.55%	0.59%	0.21%
Equity Fund Flows as % of US Equity AUM (LTM)	3.0%	5.0%	7.60%	6.80%	3.30%	-0.71%
Macro						
High Yield Credit Spreads	400	500	619	561	371	402
Banks Tightening C&I Loans to Large Firms	10.0%	30.0%	56.9%	10.9%	7.5%	-4.2%
Shape of Yield Curve (10-yr less 2 yr bps)	<30	<0	29	-44	47	29
Industrial Production: % of down industries y/y	30.0%	40.0%	44.4%	33.3%	48.2%	51.9%
SIGNALS						
Caution			5	8	3	4
Danger			6	9	8	1
Total Warnings #			16	19	20	20
Total Warnings %			**69%**	**89%**	**55%**	**25%**

The Inner Circle: Our Target Environment

Now that we've made our way through the three circles of the Macro Spiral, we should have a good grasp of the major fundamental drivers impacting today's economy and markets. Let's sum up all that we've covered so far.

- **The First Circle: Deleveraging, Demographics, and Deglobalization**
    - We're in the early stages of a long-term deleveraging as per the Bridgewater Debt Cycle framework. This is a negative force on both growth and inflation.
    - We've recently transitioned to the other side of a massive 100-year demographic impulse. The growth rate of the global labor force is now contracting at nearly the speed that it rose throughout the 20th century. As per the economic growth equation (number of workers x total productivity) we're now permanently in a structurally low growth, low inflation environment.

- ➢ The aging of the US population is also driving a large shift in consumption patterns, from goods to services.
- ➢ The required minimum distribution (RMD) law is going to cause an increasing wave of equity supply to begin hitting markets in the coming years and will continue to impact equity markets for the next decade. Lawmakers are trying to raise the minimum age at which this starts. If they do, that'll buy us a bit more time. But this shift is inevitable.
- ➢ Deleveraging and demographics are driving the rise of populism — people are frustrated with our new low growth reality and don't understand the forces that are keeping us here. Populism is driving deglobalization. The reversal of the trend over the last 30-years. This will negatively impact overall economic growth even further.

- ❖ **The Second Circle: Business Cycle, Risk Cycle Profit Equation**
  - ➢ On a cyclical basis, the business cycle is alive and well but slowing and there are no immediate signs of a recession in the next 6-months.
  - ➢ The US is "Catching Down" to the rest of the world. Expect GDP growth in the US to fall below 2% within the next 12-months.
  - ➢ The Risk Cycle is not showing any late-cycle behavior. There is no euphoria and no signs of investors over-leveraging themselves.
  - ➢ The fiscal and monetary impulses from China's credit injection and the US's tax cut/spending bill have faded. Any shot in the arm over the near term is going to have to come from China.
- ❖ **The Third Circle: Sentiment, Technicals, Fundamentals**
  - ➢ A short-term sell-signal has triggered. Expect the pullback to last 1-4 weeks and for the S&P to retrace to the 2,800-2,850 range.
  - ➢ Longer-term sentiment, technicals, and fundamentals all support a continued broader trend higher in stocks.
  - ➢ Investors are offsides on this market. They are way over-positioned for a bearish outcome in the near-term. While our entire Marcus Trifecta says otherwise. This makes the odds of a face ripping rally in stocks beginning sometime in the next three months, very high.

Where are the trades in all this?

Let's start with bonds.

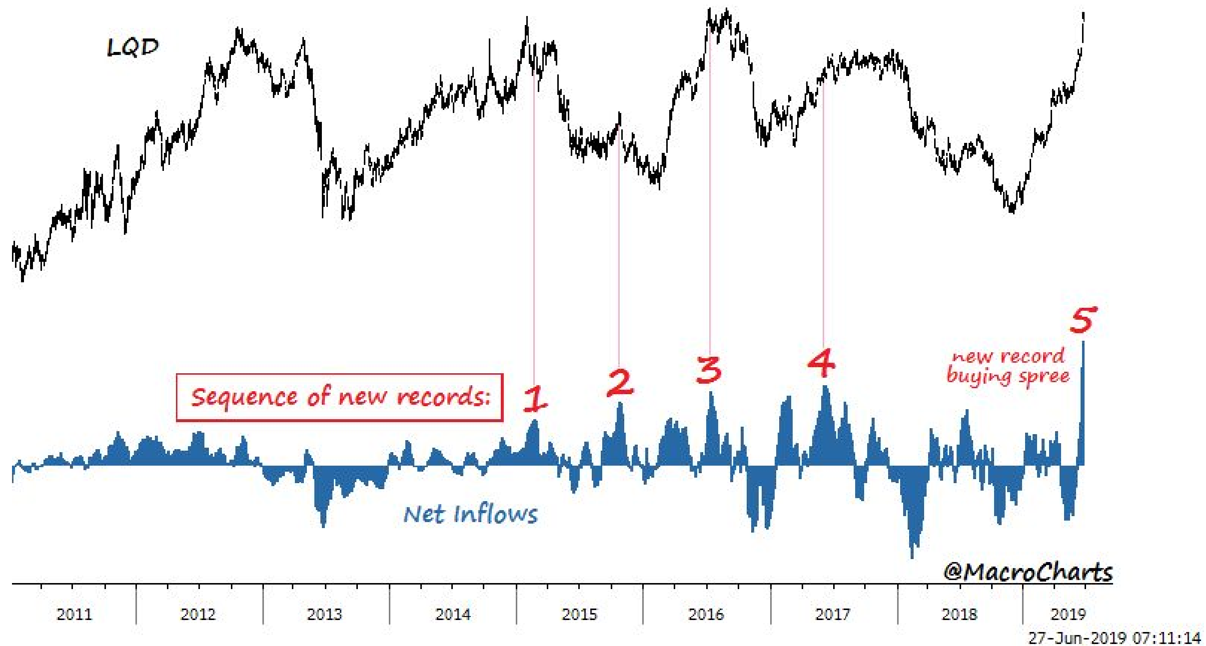
<u>Bonds</u>

US bond yields are eventually heading to zero. And they're going to stay there for a long time… At least until policymakers dream up some new monetary/fiscal regime (ie, MMT on steroids).

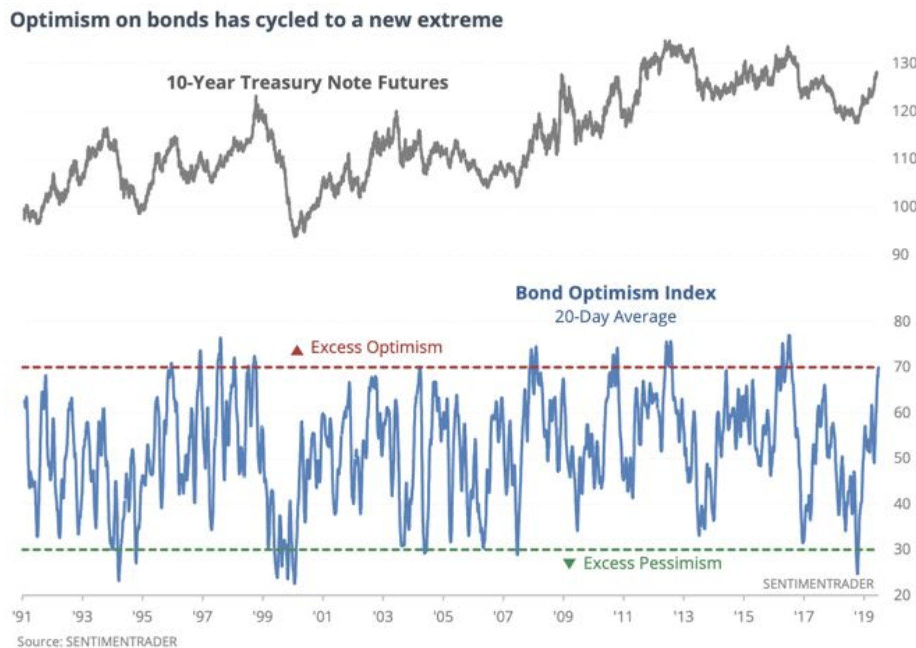
Deleveraging and demographics all but guarantee it.

But, over the near to intermediate term, positioning, technicals, and sentiment are saying we're going to see a pullback soon. Likely once this oncoming selloff in equities completes.

We just saw a record of inflows into bonds (LQD). This type of performance chasing nearly always precedes reversal points.



SentimentTraders Optimism Index (OPTIX) show bond sentiment recently hit a new extreme.



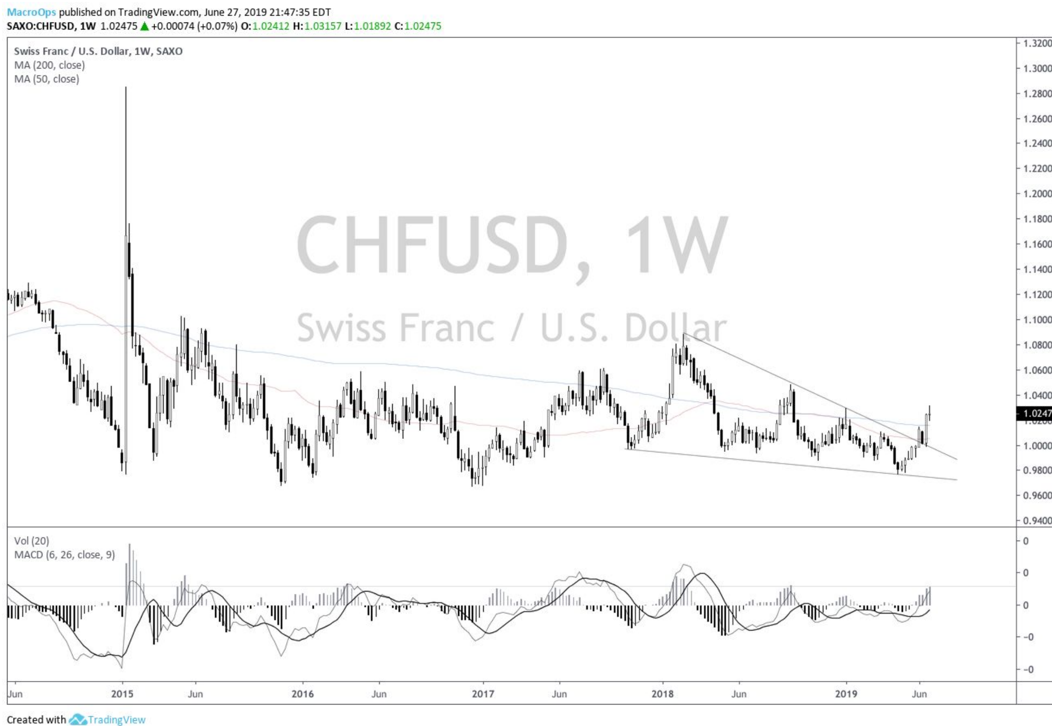
But I think this retracement will be relatively shallow. The low growth, low inflation environment we're in, combined with safe asset shortage flows out of Asia, should continue to drive the primary trend in bond yields down.

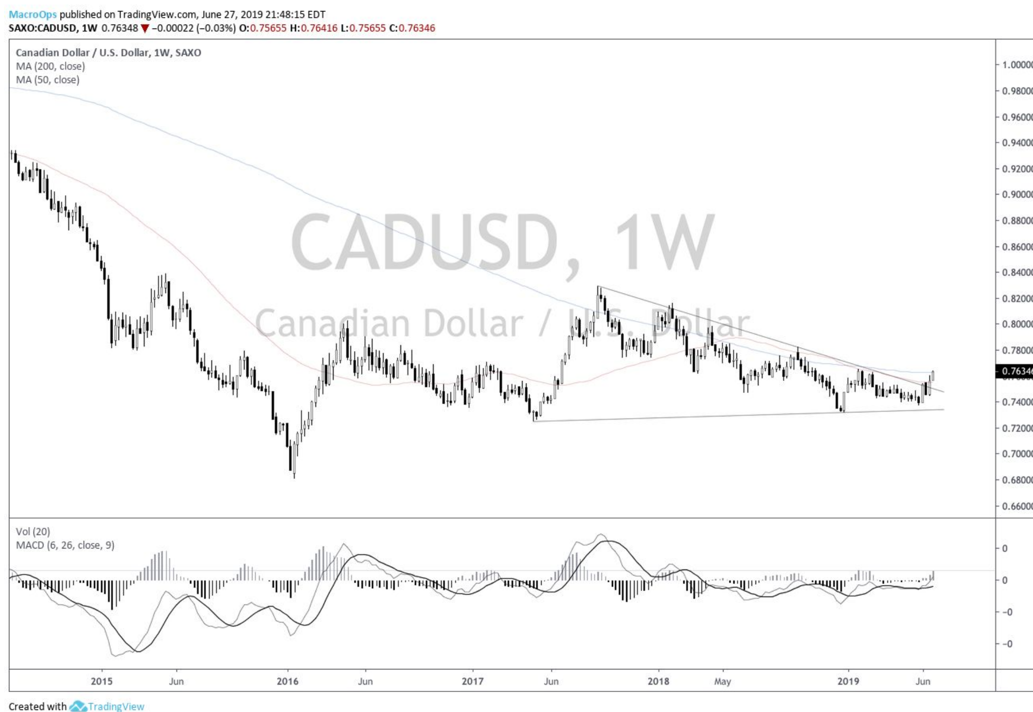
US Dollar

The technical setups occurring right now in short dollar trades are really something to look at.

The following charts are weeklies.

The Swiss franc and Canadian dollar are two of my favorite candidates (we're long both).





Meanwhile, EURUSD swaps and risk-reversals are all pointing to a higher euro relative to the dollar (the euro makes up roughly 60% of the trade-weighted dollar basket).

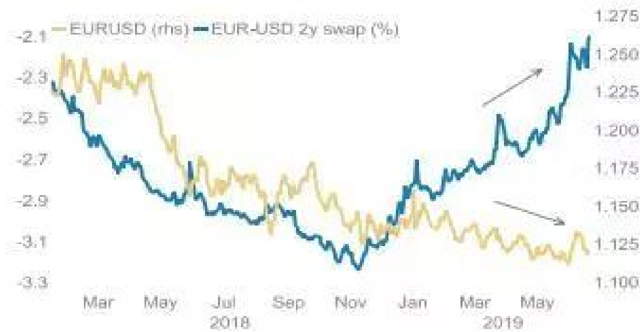


Exhibit 6: EURUSD trades cheap to relative swap rates
EURUSD (rhs)
EUR-USD 2y swap (%)
-2.1
-2.3
-2.5
-2.7
-2.9
-3.1
-3.3
1.275
1.250
1.225
1.200
1.175
1.150
1.125
1.100
Mar
May
Jul
2018
Sep
Nov
Jan
Mar
2019
May
Source: Macrobond, Morgan Stanley Research

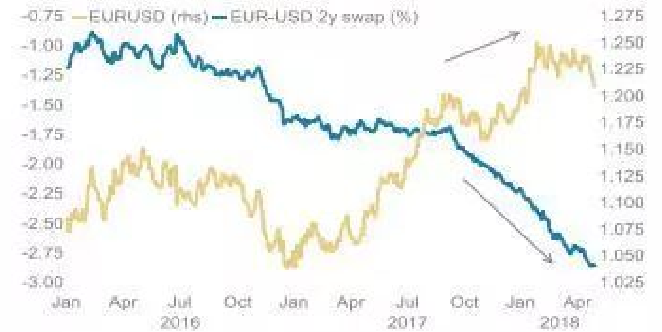


Exhibit 7: In 2017, it diverged the other way around
EURUSD (rhs)
EUR-USD 2y swap (%)
-0.75
-1.00
-1.25
-1.50
-1.75
-2.00
-2.25
-2.50
-2.75
-3.00
1.275
1.250
1.225
1.200
1.175
1.150
1.125
1.100
1.075
1.050
1.025
Jan
Apr
Jul
2016
Oct
Jan
Apr
Jul
2017
Oct
Jan
Apr
2018
Source: Macrobond, Morgan Stanley Research

EURUSD
Risk Reversal
1.0
0.5
0.0
-0.5
-1.0
-1.5
-2.0
-2.5
-3.0
2016
2017
2018
2019
EURO 9M 25D REVERSAL
EURUSD
Source: Thomson Reuters Datastream / Macro Ops
www.macro-ops.com

Expect FX volatility to play catch up with its bond counterpart — driven by a sharp dollar selloff.

Commodities

A falling dollar is a good tailwind for commodities.

It's a bit serendipitous that total commodities positioning recently hit record lows (chart via @macrocharts).

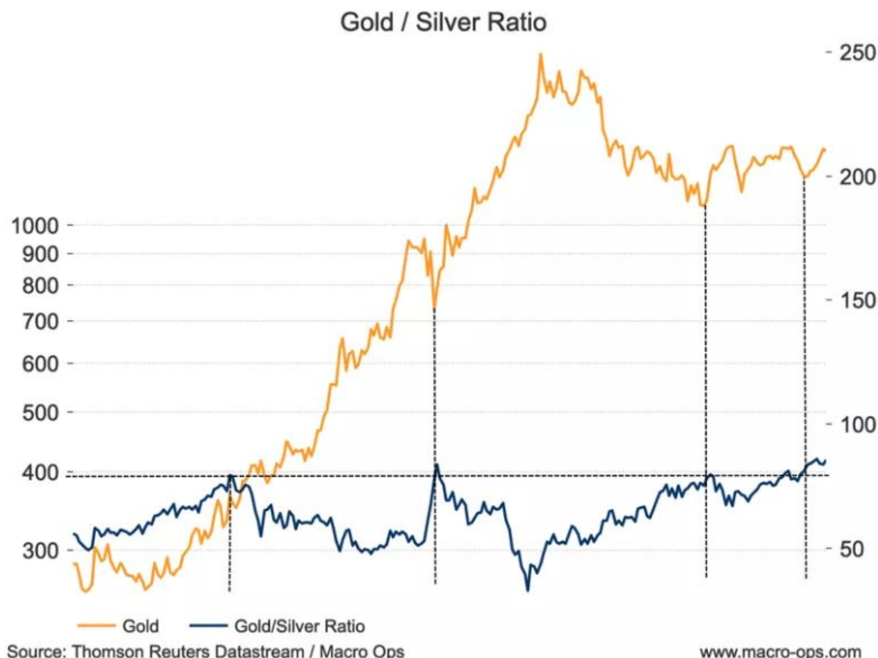
Some BIG trends are about to be born.

Precious Metals

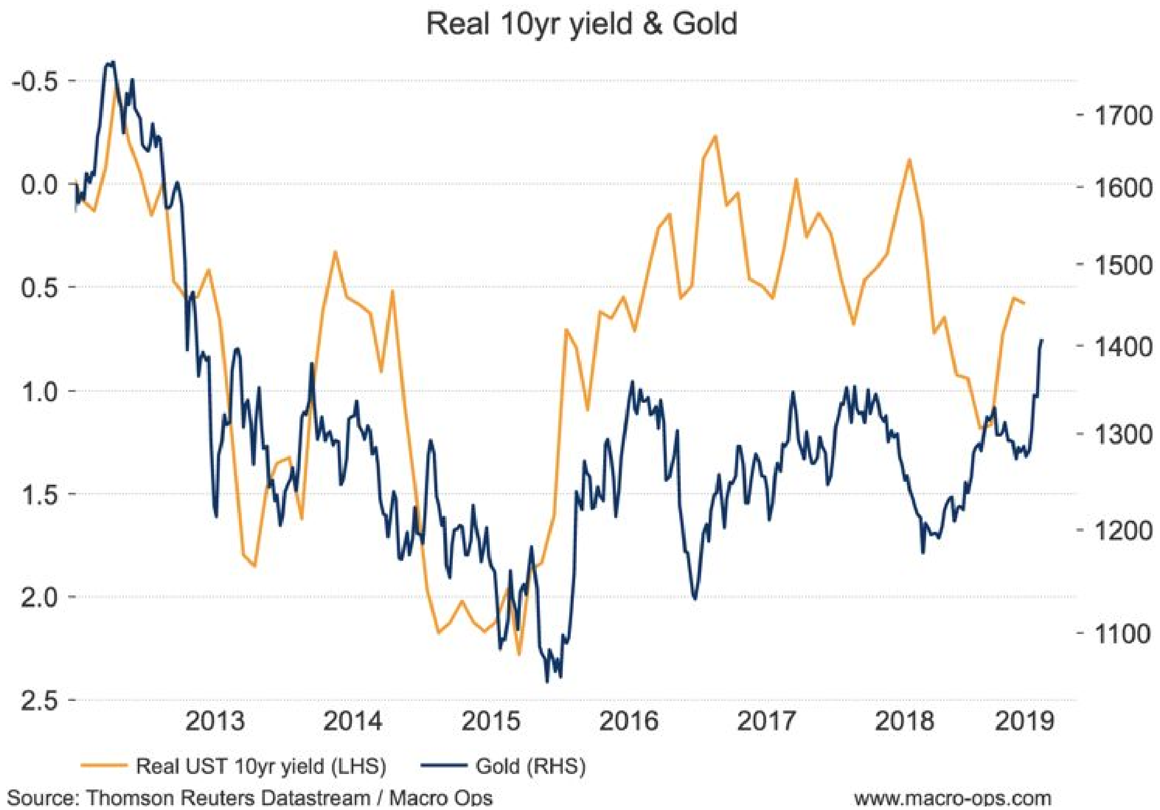
Back in March, we started pointing out the compressed volatility in precious metals and major dollar pairs and noting how this compression regime was signaling that some big macro moves were around the corner. I wrote:

> The last time gold vol was anywhere close to being this contracted was in 2002, right before the yellow metal busted out the gates and ran for a decades-long bull market.
>
> The background timing of the current macro environment tells us something big is coming, something that's not yet fully known or fully discounted by the market…
>
> This means some major trends are on the horizon. And along with major trends come major opportunities to profit.
>
> Gold is just one area I see that's ripe for exploitation.

I shared this ratio chart of gold to silver. It shows that historically when the gold/silver ratio has been this extended it's coincided with a major bottom in gold.



Gold's recent breakout above its multi-year consolidation range is largely being driven by two factors (1) falling real yields, which we expect to continue and (2) growing concerns over the Fed's independence.



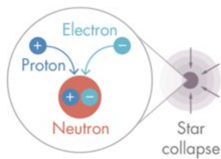
Its technical breakout is a thing of beauty.

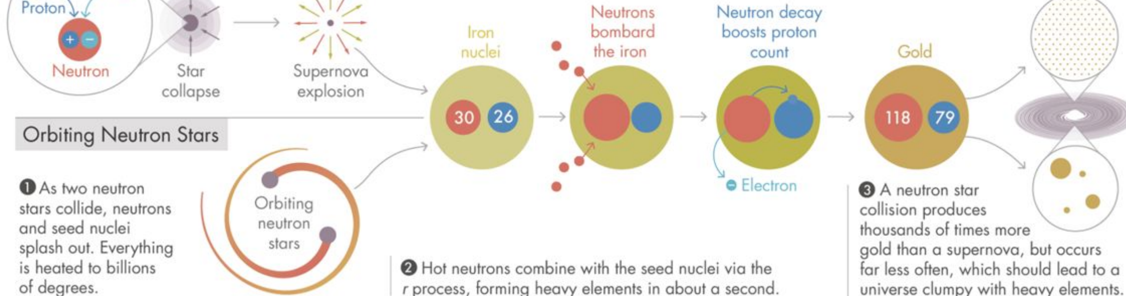
It’s a bit overextended in the short-term. And this move has attracted some hot money flows, so there’s a chance we see some consolidation before the next move higher. Though, sometimes with these types of moves, the price just runs away from ya and never gives you a good pullback to enter on.

I like playing the miners for this trend. We’re currently in South African gold miner, Anglogold Ashanti (AU). We got in at around $11 and some change and are looking to add to the position.

And let me give you a quick aside on how I think about gold.

The true value in gold comes from the fact that it can neither be created or destroyed (it can only be created by supernova explosions or colliding Neutron stars [see image below]), it's acted as a store of value since the dawn of civilization, and it has a strong track record as a hedge against government ineptitude and international crises.





In practical trading terms, gold is the internationalized value of 1 USD of account. This is why gold does poorly when there's strong preference for US assets relative to the RoW and vice-versa. But going back to the hedge against government ineptitude, consider the environment we're now in. Slow growth, low inflation, the causes of which (deleveraging and demographics) are poorly understood. As a result, populism and geopolitical tensions are on the rise.

Gold seems pretty good.

Fast forward a few years and it looks even better. Sustained low growth, greater global dysfunction, and increasing monetary experimentation. I remember reading a Fed paper a while ago where they discussed what the required response would be in a recession environment, with interest rates already so low. And going off their findings, you came to the conclusion that the Fed is going to have to expand its balance sheet by a MUCH larger amount come the next recession.

I think the gold market is already sniffing some of this out.

Energy Stocks

We already know total short positioning in the commodity market is at record lows. But here's an 80-year chart that shows commodity stocks performance relative to the Dow Jones Industrial Average is at all-time lows. This is a trend that's looking a bit overdone (chart via GRA).

Energy stocks, in particular, have been on murderer's row over the last 10-years. The chart below via L.Hamtil and Ken French show that the rolling 60-month returns in oil and gas stocks is at its lowest levels in history.

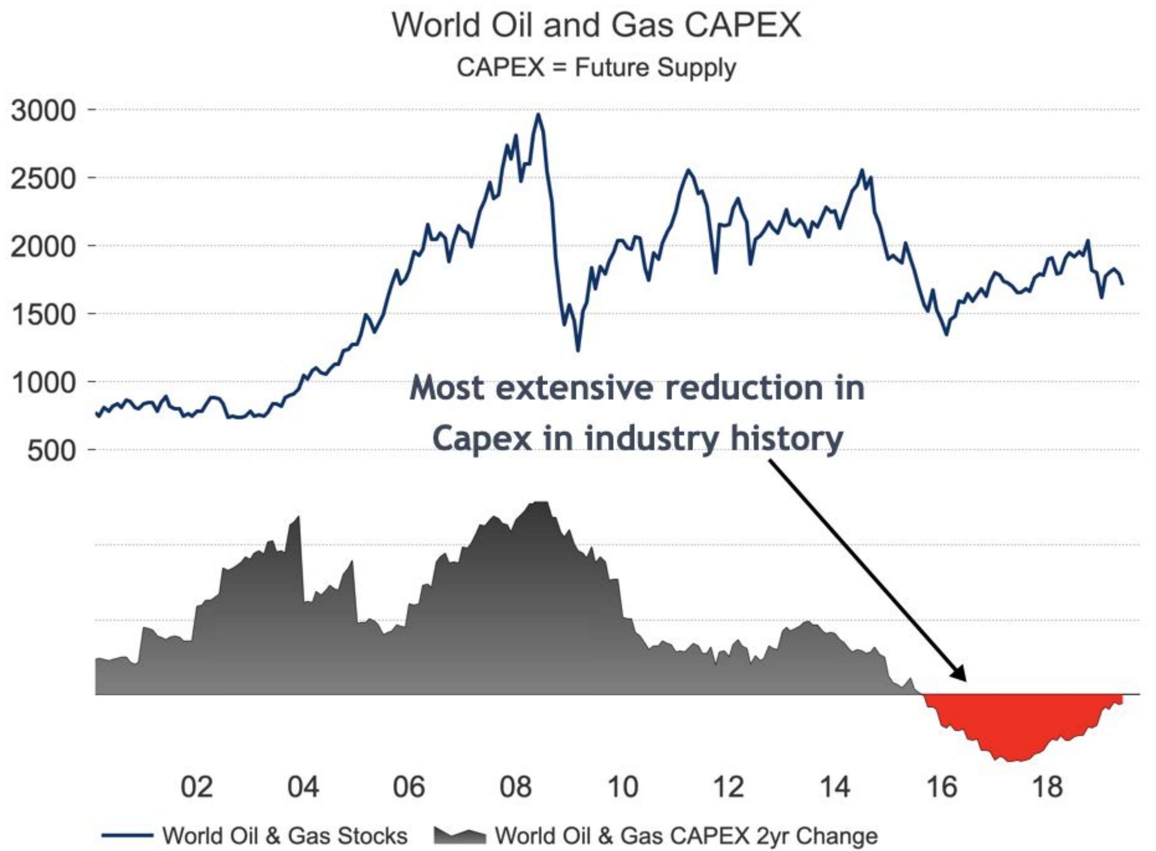
The consensus is that energy consumption is about to slow dramatically. The rise of electric vehicles combined with a slowing China and free-spending frackers are going to keep energy stocks perpetually in the "don't touch" bin. I've written extensively on why I disagree (link here).

Here's a summary of my thoughts.

- ❖ The popular narrative surrounding oil over the last 5 years has been:
  - ➢ 1) Supply is rapidly growing due to fracking driven productivity growth
  - ➢ 2) Electric vehicles are taking away a huge source of demand
- ❖ But the latest data doesn't support this narrative…
- ❖ Forecasters have been misattributing increased oil supply to productivity gains when it was really from tapping Tier 1 fields and DUCs.
- ❖ Drillers have cut production and CAPEX and are now experiencing large drawdowns in inventories.
- ❖ The most bullish scenario for electric vehicles displaces only a minuscule amount of oil demand over the next decade. Oil demand is actually set to rapidly grow as Asia hits the wealth S-curve
- ❖ The market is slowly waking up to this reality and there will be a massive repricing once it does.

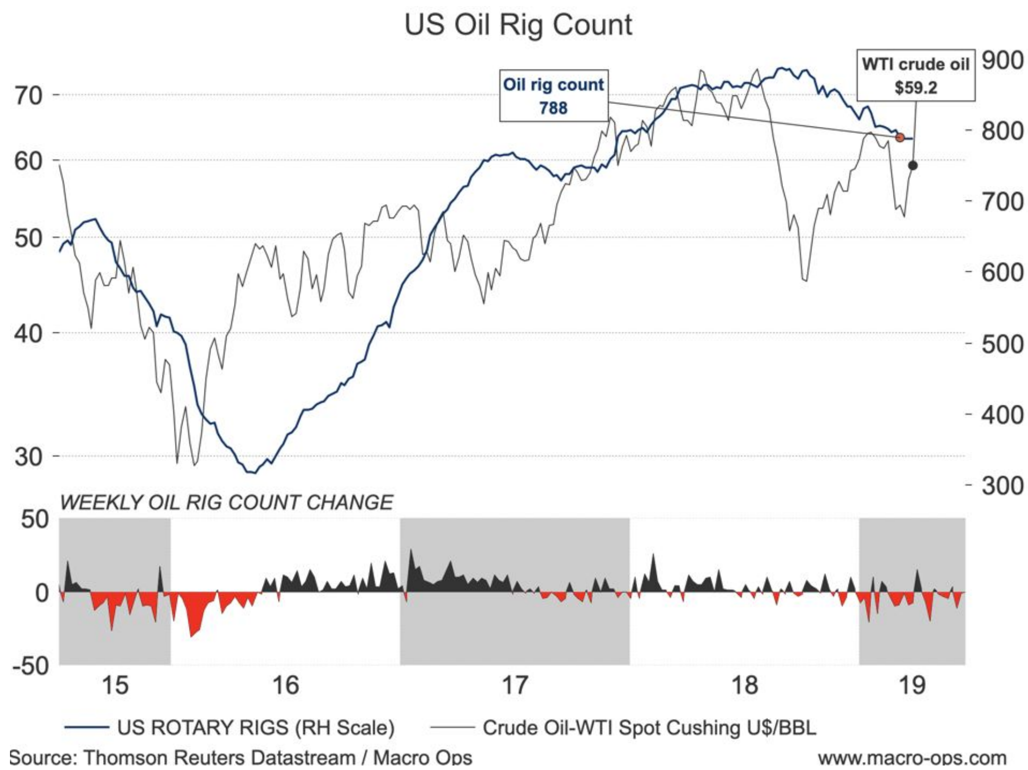
The incoming data isn't supporting the consensus narrative. According to the IEA, we saw "an extraordinary increase in global energy demand in 2018, growing at its fastest pace this decade."

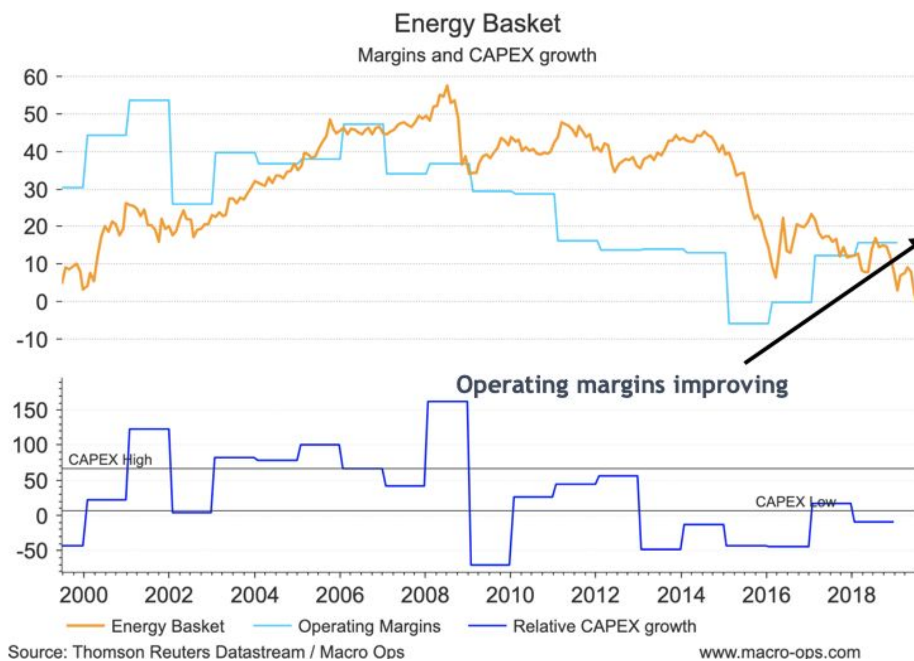
This persistent and "surprising" global demand for oil is occurring at a time when the global oil and gas industry is coming off its longest and most extensive cuts to capex in industry history.



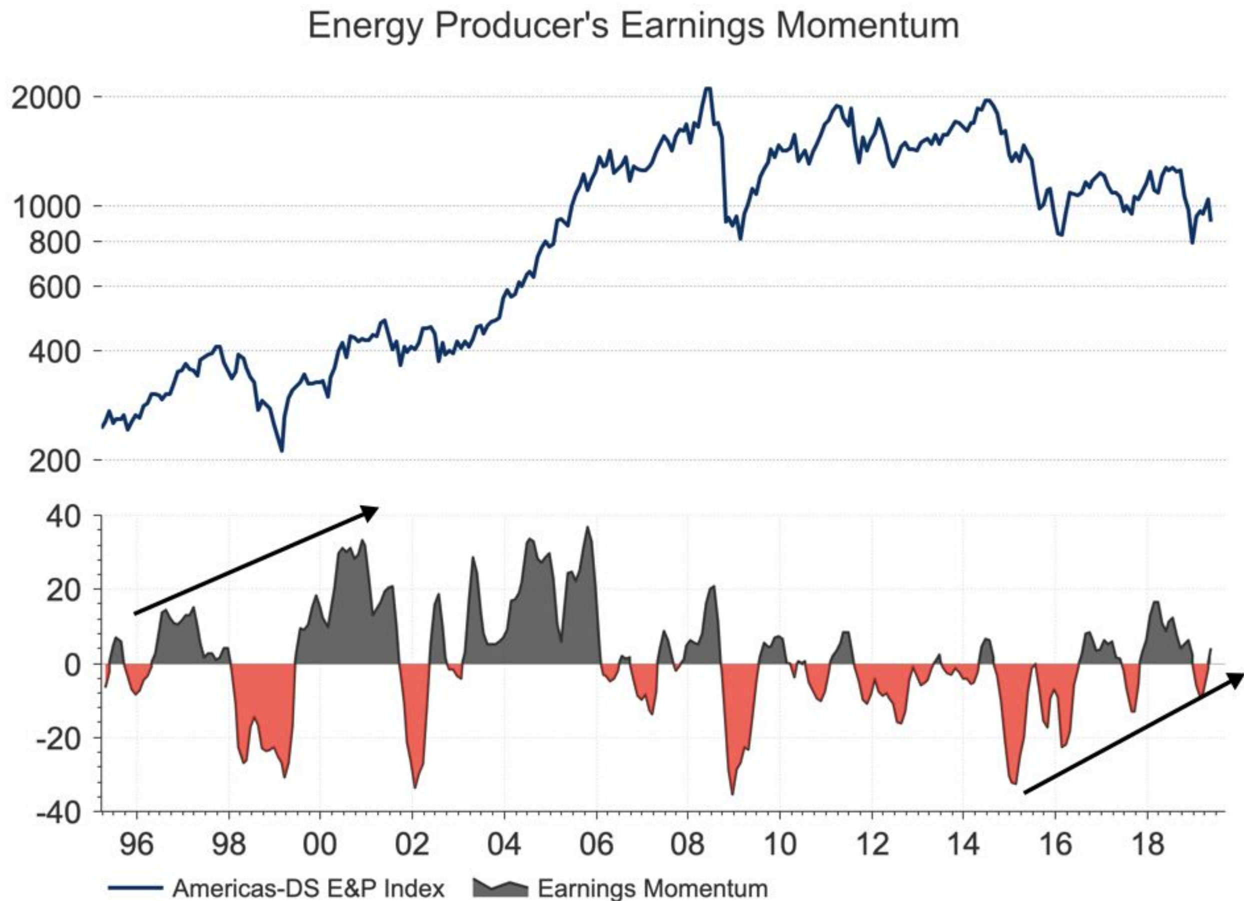
This new focus on capital discipline in the E&P space is going to help keep supply growth low over the coming years while also continue to improve operating margins. The rig count reflects this.

Compare the current change in rigs to the last time in 16' and 17' when the oil price was recovering. The amount of rigs in operation continues to fall despite a recent 15%+ rise in the price of crude. If this keeps up, it'll go a long way in changing the current pessimistic narrative.





The evolving landscape is leading to increasingly positive earnings momentum. Which is the kind of thing you want to see at the start of a new bull market.



We also have the growing threat of a military conflict between the US and Iran. And any armed conflict in the Strait of Hormuz risks escalating into a broader regional conflict including Saudi Arabia, Yemen, the UAE, Iraq, and Syria.

But honestly, almost none of this macro stuff needs to really happen to make money on a number of these E&P names. And that's because the value on offer in the space is ridiculous.

Sure, there's tons of overleveraged garbage that you don't want to buy. But there are also names with solid balance sheets trading at EV to EBITDA multiples in the low single digits. A few of these names can essentially take themselves private with just the FCF produced from their already drilled wells in less than 3-years time. It's nuts.

The names we're currently long are Sandridge (SD), W&T Offshore (WTI), and Ecopetrol SA (EC).

Well… That's all I've got.

It's been a pleasure writing these reports over the last few years. I hope you've got as much out of reading the MIRs as I've got from writing them. Thank you for reading my work.

This is officially the final MIR report, if you haven't already please see our latest email on what is replacing the MIR going forward.

If you've got any questions please shoot them over to me at alex@macro-ops.com or hit us up in the CC if you're a Collective member.

Take care and good luck in the markets,

Alex