MARKET BRIEF

Macro Ops Collective

The Market is Teeing Up…

Summary:

- A Trade War with everybody?
- Regulators coming after Big Tech
- A Macro Breakdown: No recession on the horizon
    - Economy
    - Labor
    - Liquidity
- Trifecta Update: Still waiting on capitulation but getting close to a major bottom
    - Sentiment
    - Earnings outlook
    - Technicals
- Trade Setups
    - Precious metals breaking up
    - US Dollar breaking down
    - Emerging markets holding steady

We're going to cover a lot in this week's report. We've got trade wars, trade wars, and some more trade wars… Regulatory action against tech giants… A look at sentiment and technicals which are setting up for a significant bottom… And finally, we'll walk through the major macro indicators to dispel the nonsense being peddled about an impending recession… Oh, and then we're going to cover some trades that are teeing up…

Pour yourself a fresh cup of joe, strap in, and let's get cracking.

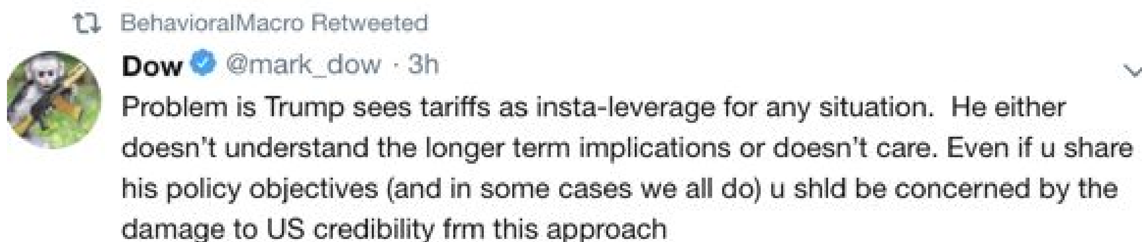
I don't know about you but I want me some of whatever President Trump is smoking. The Donald has been non-stop these last few days.

Growing bored with an escalating trade-war with China he — apparently on a whim — decided to start one up with our Mexican Neighbors in an effort to get them to do something about their porous borders. Despite the fact that we just signed a major trade deal (USMCA or New Nafta) with them last December which took over a year of negotiations to hammer out.

Not wanting to stop there he then decided to remove India's "special trade status" which exempted the country from US tariffs and followed that up with an effort to hit that thieving

Australia with tariffs of their own before being talked back amid fierce opposition from military officials, as well as the State Department.

It looks like Trump has become besotted with the total discretionary authority that tariffs give him. No checks and balances, no going through Congress; he can wield near instantaneous economic force from his smartphone. Macro Hedgie Mark Dow summed up the implications of this well, tweeting:



Goldman Sachs shared their revised expectations of the trade war's impact this weekend, writing:

> *We now expect a 10% tariff rate by July on both the final $300bn of Chinese imports (60% subjective odds) and on all Mexican products (70% odds for the first 5%, and just over 50% odds for the step-up to 10%)." For China, this represents a middle ground between our previous assumption of a delay following the G20 summit in late June and the full 25% across-the-board tariff proposed by the US Trade Representative.*
>
> *Additional tariff rate increases or an across-the-board auto tariff are also possible but not our base case. We still expect deals with China and Mexico to lead to a removal of the tariffs, but not until late 2019/2020.*

We don't have an edge in figuring out what the Trump admin or those on the other side of his trade fury will do. GS's expectations are as good as any. They calculate that this base case will impact inflation, where they see it "climbing from 1.57% in April to 2% in August and to 2.3%-2.4% in early 2020" and dinging GDP growth in the second half by roughly 50bps.

Exhibit 2: This Year's Tariffs Could Dwarf those Implemented in 2018

Source: Goldman Sachs Global Investment Research

Precise numbers aren't that important here, in my opinion. What matters more is how this continues to widen the Cone of Uncertainty, not only for investors but for participants in the real economy. This is where the real risks lie, which are two-fold. These are (1) that this trade war escalates and creates a bear market of unnecessary stupidity which, due to the financialization of the economy, then leads to a recession and/or (2) private fixed investing (capex) collapses due to an inability for businesses to plan which then leads to a profits recession in accordance with the Levy-Kalecki framework.

As an example. Here's some comments included in the recent Dallas Fed Manufacturing Survey (emphasis mine).

Primary Metal Manufacturing

- The possible increases in tariffs related to China will negatively impact our agriculture customers and put further pressure on a segment that is already experiencing cyclical lows.

Nonmetallic Mineral Product Manufacturing

- There are many unknowns due to tariffs.

Machinery Manufacturing

- There has been a sharp decline in orders, and pricing has taken a huge dive as well. Competition has pushed pricing to near-guaranteed losses.
- With all the tariff fees pouring into the U.S. Treasury, when should we expect a tax break?
- We are seeing steady business that should begin to grow again if a China trade deal is reached.
- China tariffs were already causing significant price increases, and the latest escalations will raise our costs even more—probably our prices, too—and make us less competitive on the world stage where we export 70 percent of what we produce.

Computer and Electronic Product Manufacturing

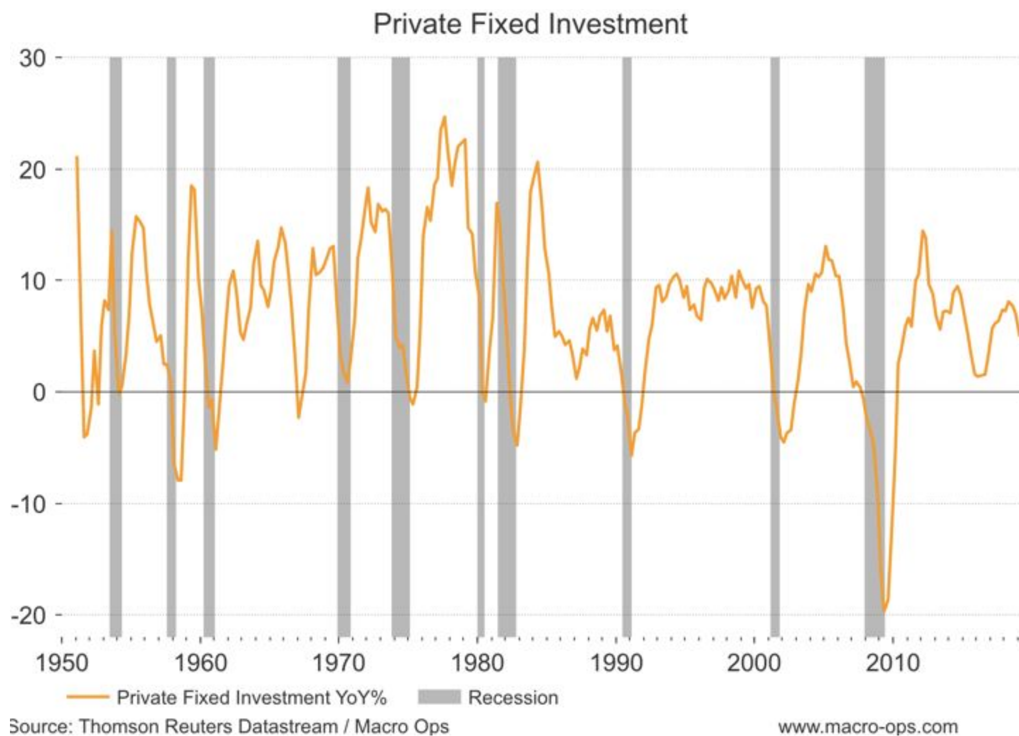
- Trade talks with China could have a longer-term impact but have no impact at this point.

- Growth is robust and would be even stronger without current supply chain and labor constraints, but we aren't complaining.
- With our government's intention to resolve issues with Iran and China and also introducing the "Deal of the Century," it adds warranted risk to our future business that we can't ignore.
- There is significant uncertainty.

Transportation Equipment Manufacturing

- We are changing our business model to increase volume, with pricing based on wholesale margins versus retail margins. This change is to be phased in over six months.
- Our primary customer is the U.S. government. We continue to be concerned regarding the volatility of the decision-making processes at the higher levels.

Net investment is what drives profits over the long-term. Growing regulatory and trade uncertainty makes operators less willing to make long-term investments. Private fixed investment is still growing at a healthy clip of 5% in the most recent quarter. But it's also rolled over from its most recent high reached in Q2 of last year. If the trade war escalates and we see this number continue to fall then we'll maybe want to start battening down the hatches.



The Regulators are Encircling the Tech Giants

Here's a few sections from a recent article by Reuters (link here).

(Reuters Breakingviews) - At some point, antitrust investigations of Google and Amazon.com AMZN.O become a no-brainer. As a step in that direction, the Federal Trade Commission and Justice Department, which police U.S. competition issues, have divvied up responsibility for the tech giants, according to news reports. That could create ammo for future fights. Facebook FB.O ought to worry too.

... Splitting jurisdiction between the FTC and DOJ – which have overlapping remits – is a logical way to clear the decks. It avoids overloading one agency, duplication of work, and bureaucratic infighting. It will also leave each to explore different approaches to big questions like how troves of data on users and suppliers affects competition – something on which regulators worldwide are feeling their way.

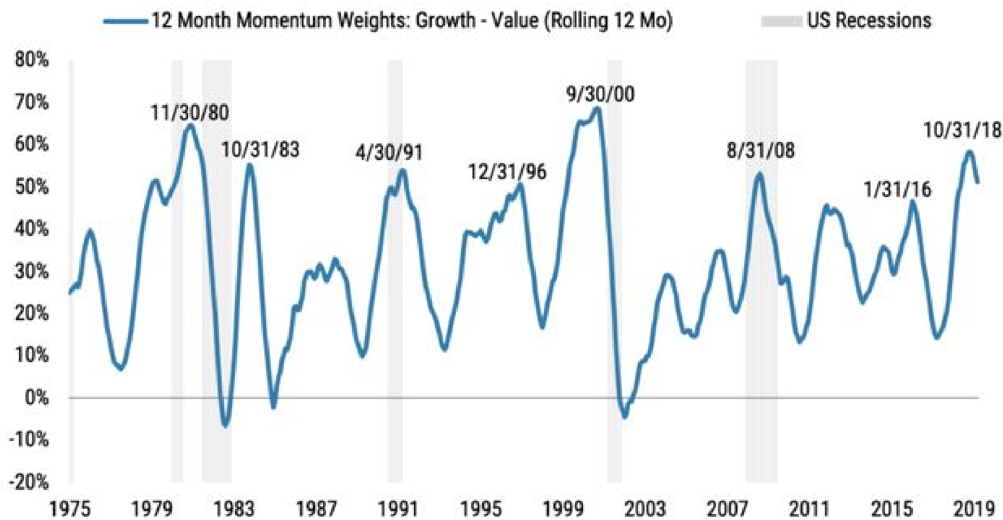
Politics also raises the stakes, notably at the DOJ, which was already scrutinizing social media firms for alleged bias against conservatives after pressure from President Donald Trump. Antitrust scrutiny of Google has been informed partly by competitors' complaints, including those by Oracle ORCL.N, whose Co-Chief Executive Safra Catz served on Trump's transition team.

In the past, U.S. regulators have failed to make a dent on Google and software giant Microsoft MSFT.O, and they may achieve little again. These investigations could, however, establish important precedents that, a few years from now, inform more dramatic skirmishes.

The popular high-growth tech names are getting hammered on this news. This thread does a good job of laying out the implications of this. Basically, high-growth tech/SAAS plays have been the ONLY game in town these last few years. They've become hedge fund hotels where positioning concentration has reached ridiculous levels + when you couple that with the rather low volatility and high momentum we've seen in many of these names, you get a 'fire in a crowded theatre' type scenario where a bunch of weak hands end up clambering for the exit at the same time.

I wrote about the shift that's underway from growth to value in last month's MIR (link here). Here's one of the charts from that report showing the cyclical swing between growth/value on a momentum basis.

Exhibit 5: Growth's Weight In Momentum May Have Hit a Multi-Year Peak



Source: ClariFi, Morgan Stanley Research. As of March 31, 2019.

We'll be looking to put out shorts in a few of these Icarus stocks in the coming weeks.

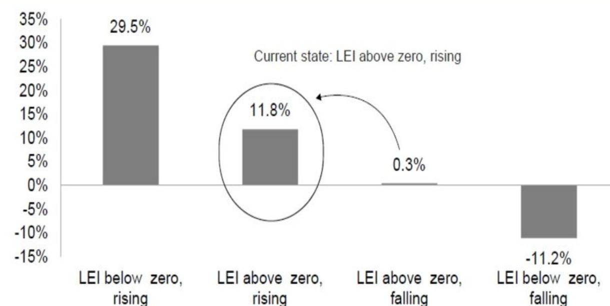
Slowing Growth but NOT a recession…

It's been a few weeks since we've taken a macro fundamental look at the US market. And since I've seen a lot of screaming and hollering about an impending recession I thought I'd dust off a few of our mainstay recession indicators to see if that's a high-probability risk. The short answer is, of course, no.

Let's start with the Conference Board Leading Economic Indicator (LEI). The LEI is a composite of 10 leading economic and market indicators. You can read more about it here.

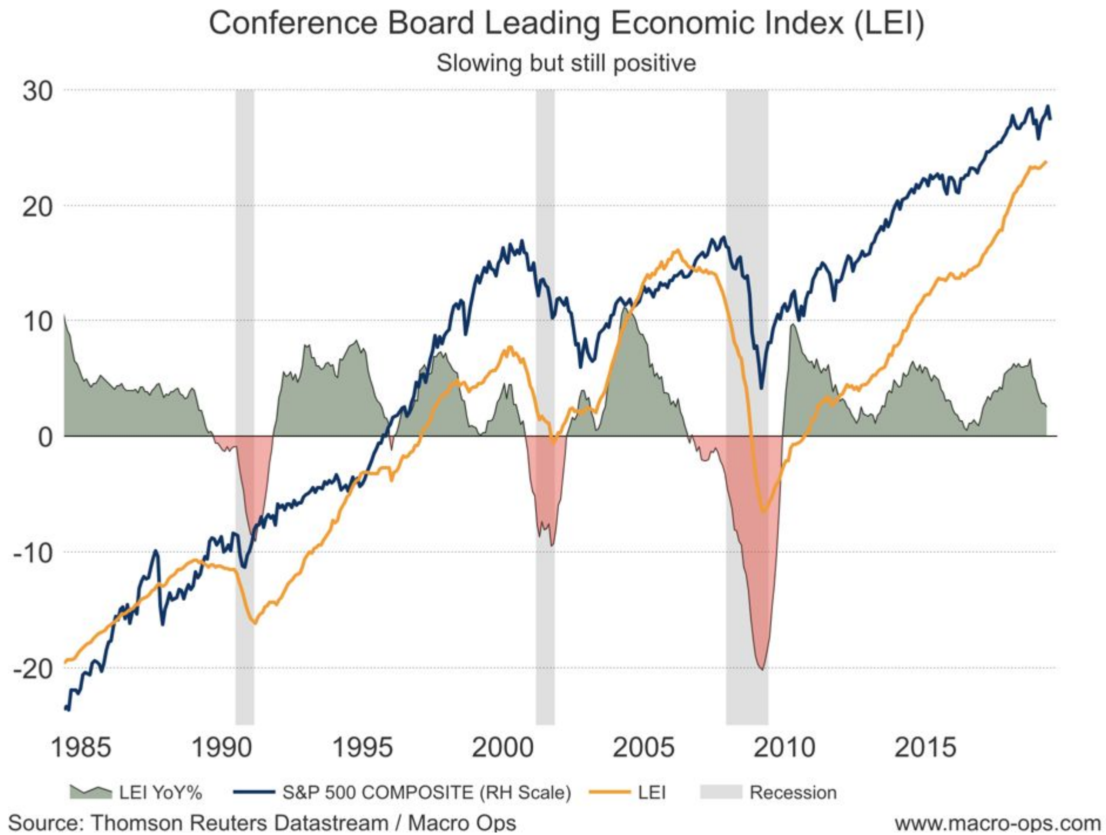
The LEI has given advance signal of all eight recessions since its inception in 1959. It peaks on average of 10.5 months before a recession comes. The graph to the right shows the average returns per state of the LEI.

Exhibit 63: Average annualized equity returns sorted by LEI phase
S&P 500 Index



Note: based on rolling monthly periods back to January 1960. The year-over-year change in the Conference Board Leading Economic Index was used as the basis for above/below zero, and the month-over-month change was used as the basis for rising/falling. Source: Wolfe Trahan & Co., Bloomberg, RBC GAM

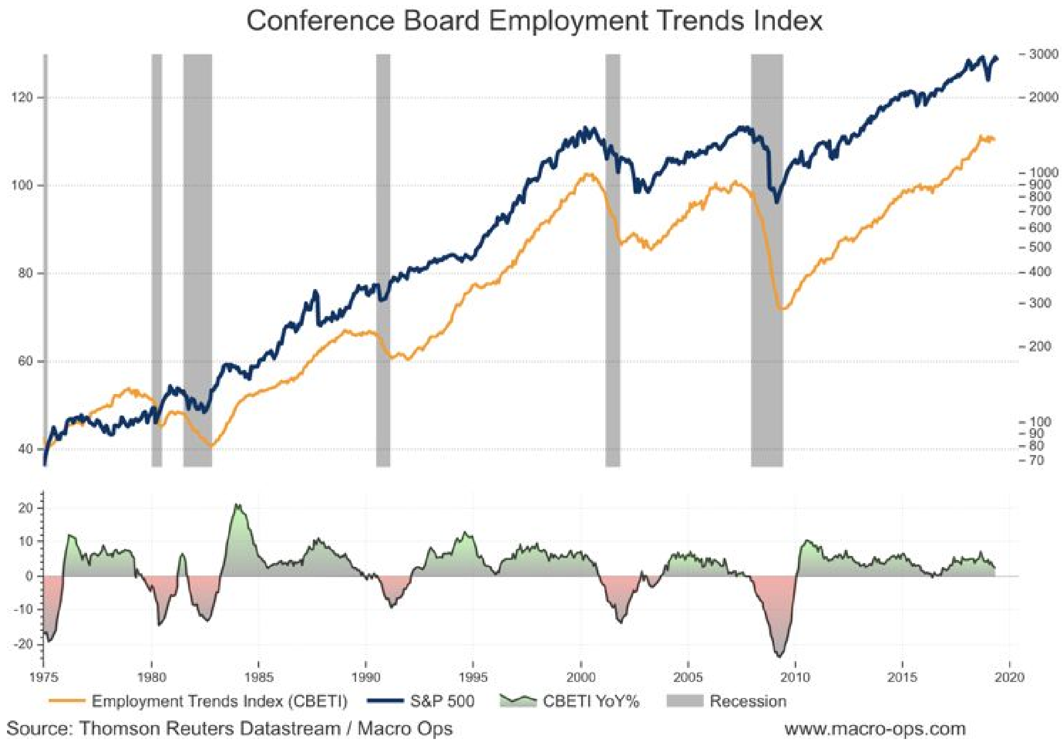
The chart below, which exhibits the LEI on an absolute and YoY basis, shows that the indicator is still heading up and to the right, though at a more muted pace.



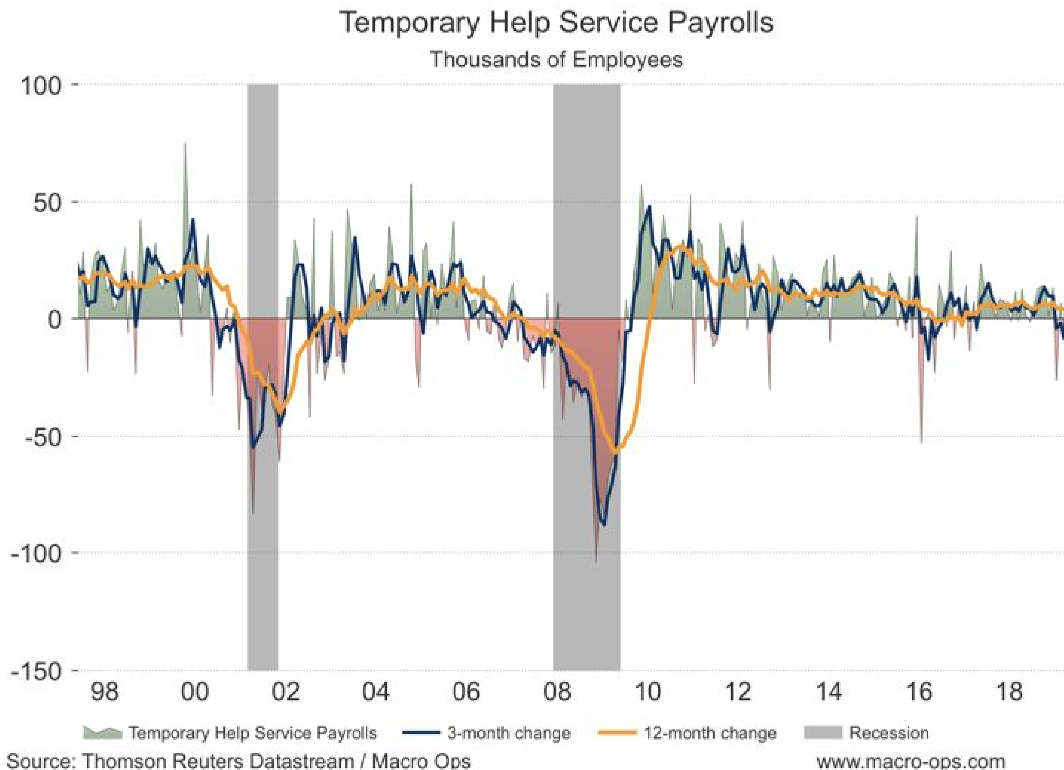
Let's turn now to labor. There's a lot of ways to slice the jobs market but we'll look at two of the stalwarts that I prefer — the other labor indicators I keep an eye on tell the same story.

The first is the Conference Board Employment Trends Index which, like the LEI, is an aggregate of eight labor market indicators (you can read more on it here).

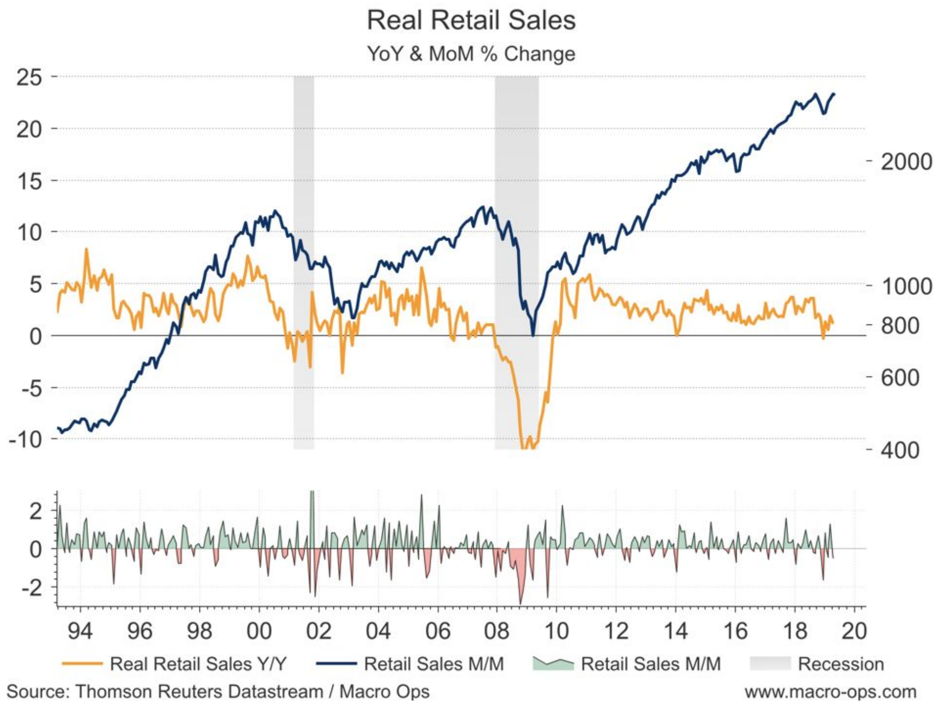
The chart below shows that it peaked on an absolute basis back in August of last year and has flat-lined since but is still positive on a 12-month basis. We shouldn't be worried though until this indicator turns negative.



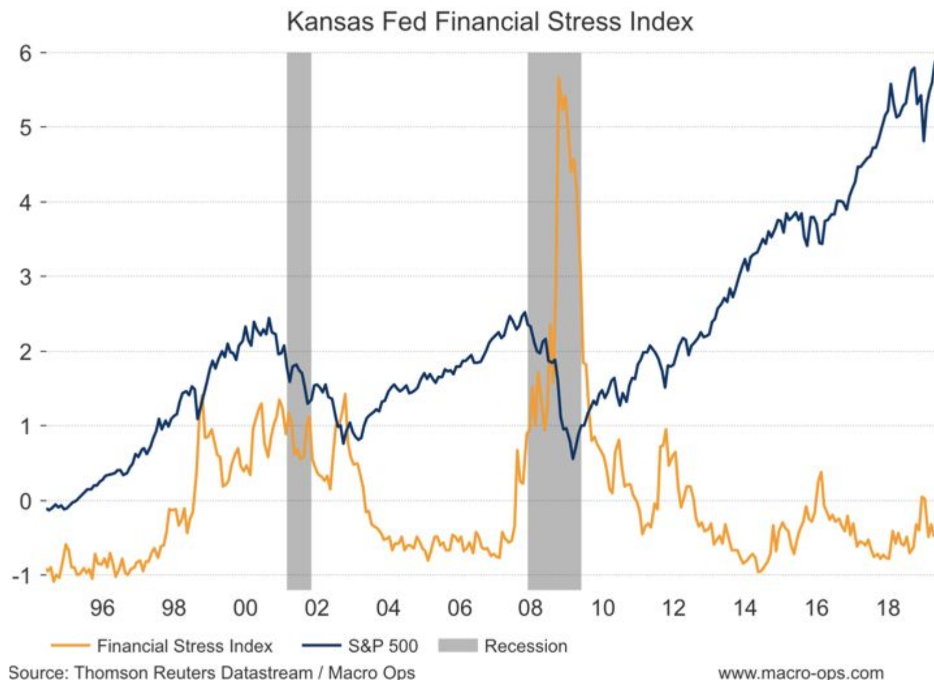
Then we have Temporary Help Service Payrolls on a monthly, quarterly, and yearly basis. After a brief soft-patch at the start of the year, the data is back in the black showing positive growth. This indicator will turn over and begin to bleed a lot of red before a recession rolls around (see 00' and 07').



Inflation-adjusted Retail Sales are another reliable leading indicator for the economy and though growth has slowed it's still positive. If it rolls over and continues lower from here then we'll have to start getting concerned.

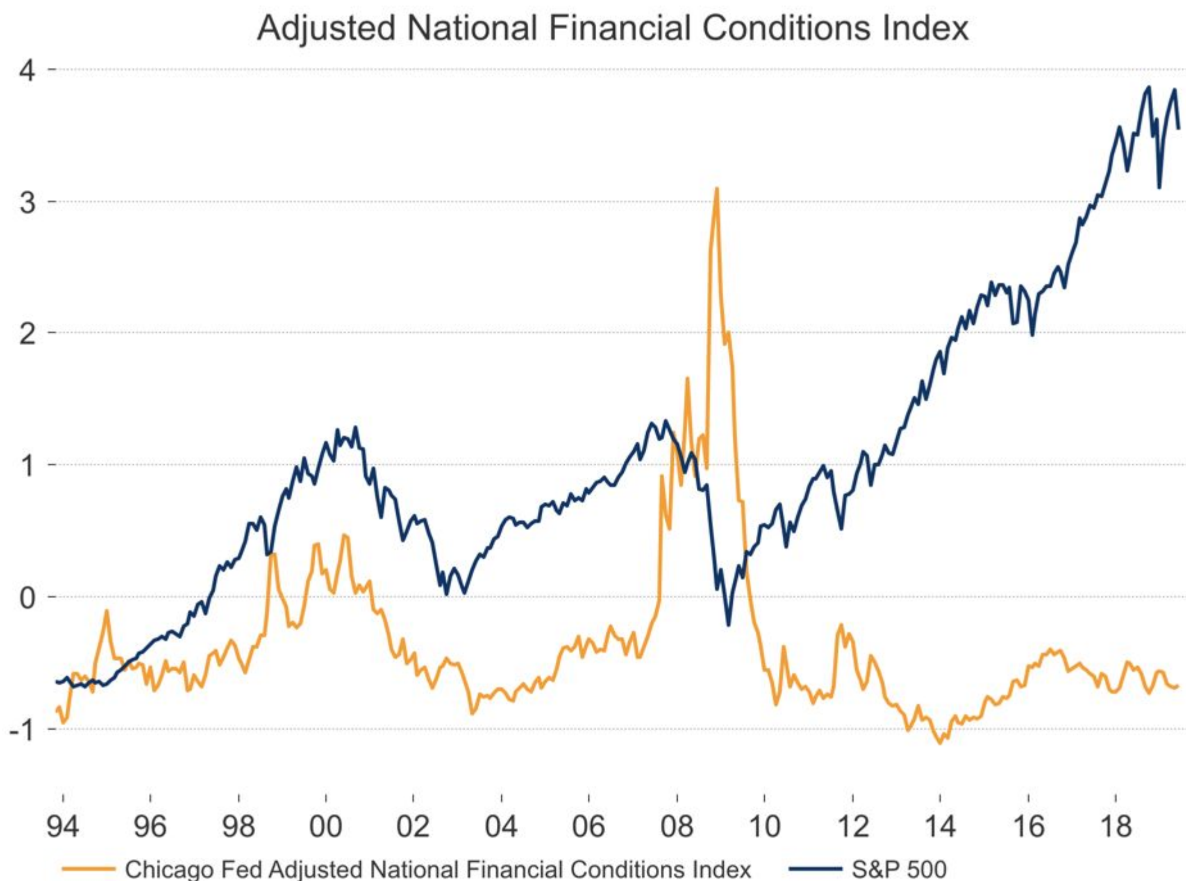


Lastly, let's take a look at financial conditions (aka. liquidity). Like the labor market, there's a lot of ways to gauge liquidity. We'll look at a few of my favorites like this one, the Kansas Fed Financial Stress Index (KFSI) which is comprised of 11 financial market variables (read more here).



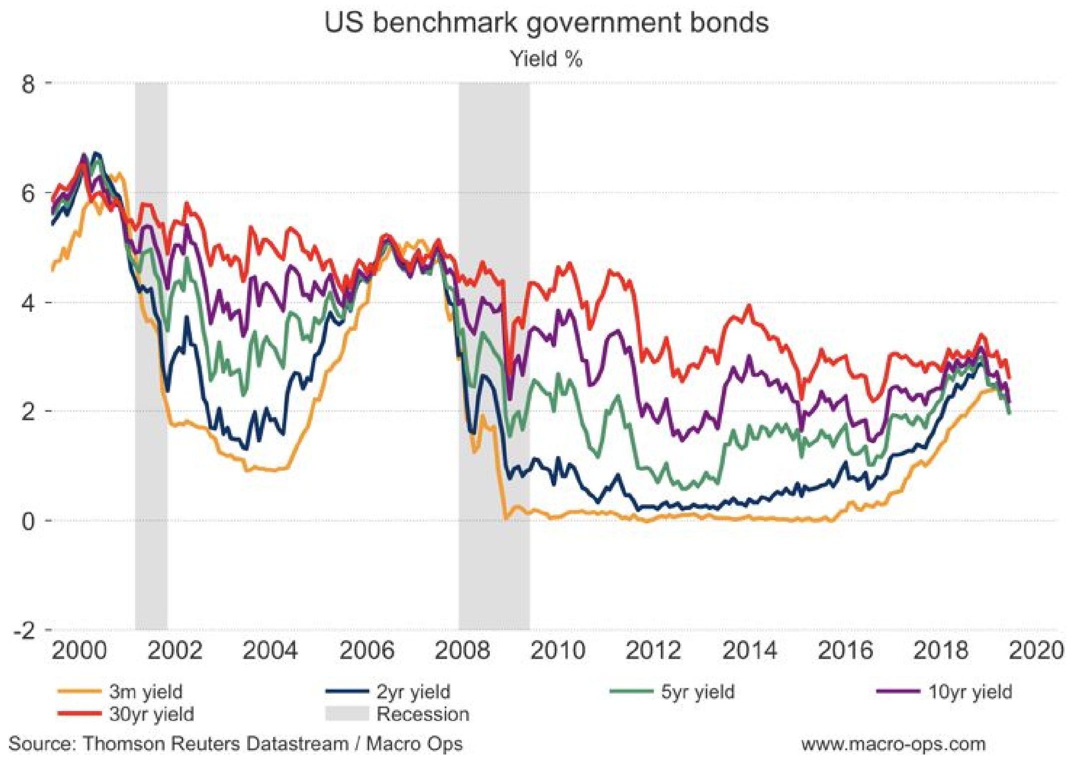
The KFSI is very muted, showing easy financial conditions. This indicator will turn and spike higher in the lead up to a recession, as it did in the summer of 07' and 99'.

The Chicago Fed Adjusted National Financial Conditions Index (ANFCI) summarizes 105 indicators of financial activity (read more here). Like the KFSI, this indicator is trending sideways and near very low levels, showing easy financial conditions despite the recent bout of market volatility.



So we have uptrending LEIs, a strengthening labor market, positive real retail sales, and easy financial conditions. The bears will say "what about the inverted yield curve!?".

A yield curve inversion does have a reliable track record of predicting recessions but my answer to that is three fold (1) an inverted curve should not be dismissed, but we need to look at the evidence in its totality and not just select one data point that confirms our bias (2) the signaling utility of parts of the curve may be somewhat less reliable this cycle, as I've noted here and (3) parts of the curve are still positive, such as my go-to, the 10-2s.



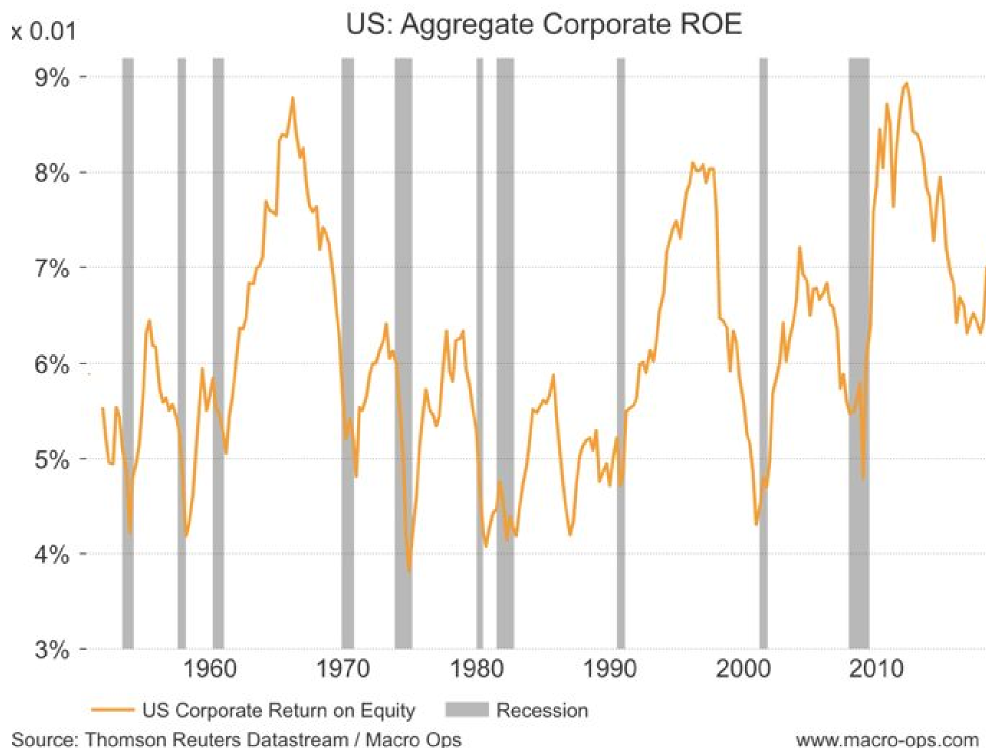
With all that said, our base case is that growth will continue to slow (we predict real GDP growth for the year to come in around 1.5%).

Slowing growth is not a recession and a low growth / low inflation economy is not a bad environment for risk assets as Stanley Druckenmiller has pointed out numerous times.

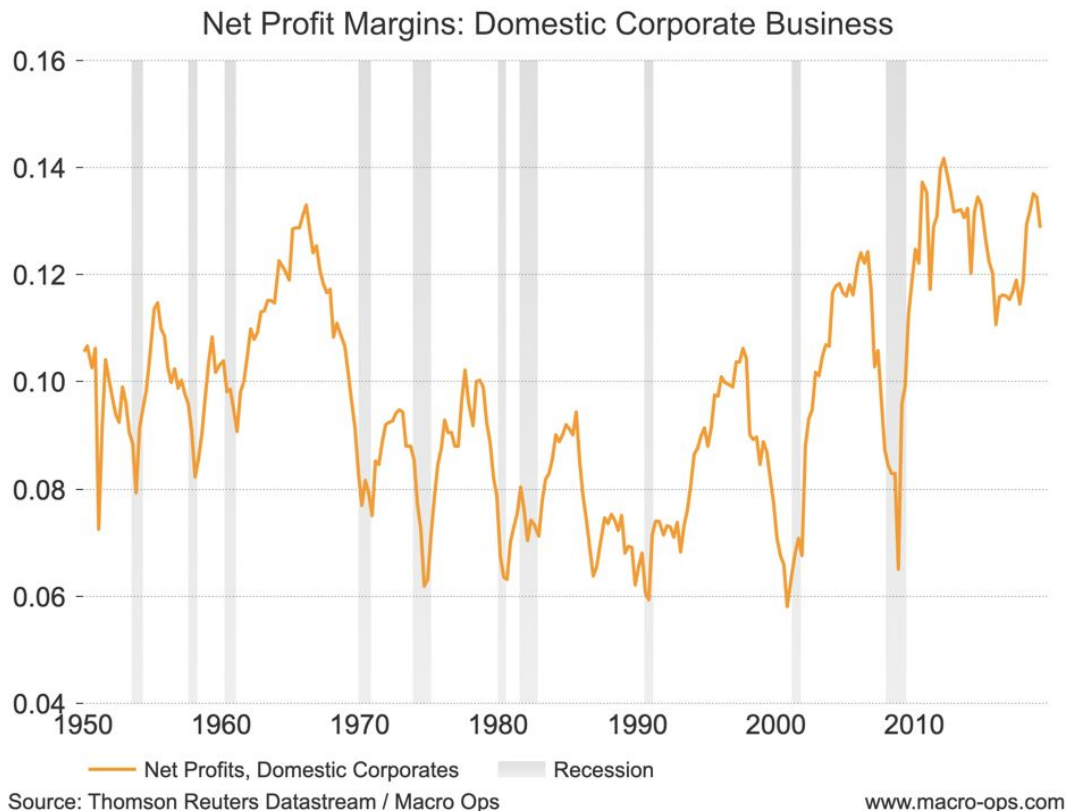
> *The major thing we look at is liquidity, meaning as a combination of an economic overview. Contrary to what a lot of the financial press has stated, looking at the great bull markets of this century,* ***the best environment for stocks is a very dull, slow economy that the Federal Reserve is trying to get going****… Once an economy reaches a certain level of acceleration… the Fed is no longer with you… The Fed, instead of trying to get the economy moving, reverts to acting like the central bankers they are and starts worrying about inflation and things getting too hot. So it tries to cool things off… shrinking liquidity… [While at the same time] The corporations start having to build inventory, which again takes money out of the financial assets… finally, if things get really heated, companies start engaging in capital spending… All three of these things, tend to shrink the overall money available for investing in stocks and stock prices go down…*

Oh… I also want to point out the trend in US Profit Margins and Return on Equity (ROE). Both are important to watch as they directly drive equity valuations.

Starting with ROE, we can see that following an extended contraction that began in 12' it's actually begun to trend back up after bottoming in 17'. ROE will typically compress in the lead up to a recession.



Net US Profit Margins also peaked in 12' but are still holding up pretty well. Like ROE, we will see margins compress in the lead up to a recession.

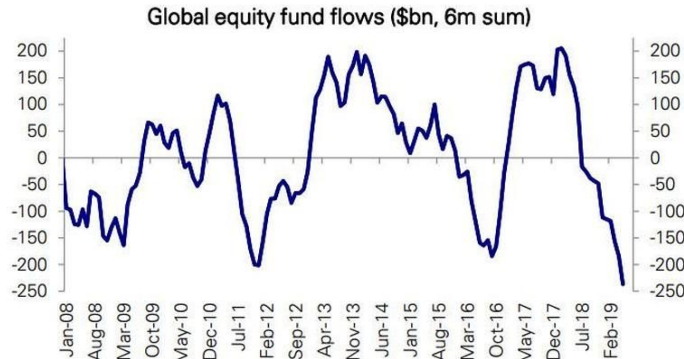


A Trifecta Update:Technicals, Fundamentals, Sentiment

We're still waiting for signs of the capitulation sell-off that I talked about in last week's *Brief: A Roadmap* (link here). But there are a number of indicators suggesting we're getting very close to that point.

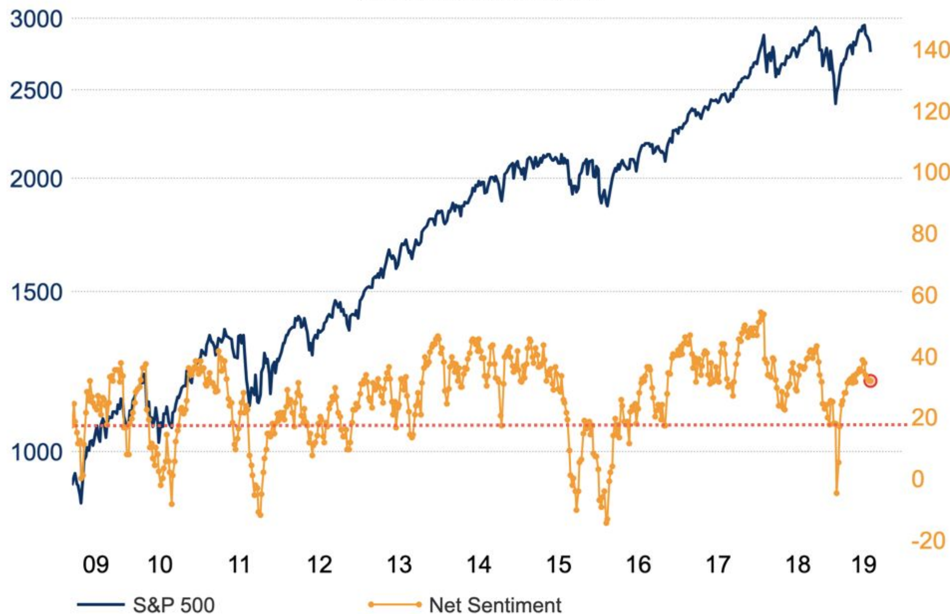
Take outflows for example.

Investors have been pulling their cash out of stocks at a near record pace over the last few months. DB points out that equity funds (ETF + Mutual) have seen over $132bn in capital withdrawn from equities since the beginning of the year. Which, they point out, means that **outflows this year have been larger (in dollar terms) than any 6-month period prior** — and yeah, I know that's in dollar terms and not as a percentage but either way, the outflows have been large substantial.



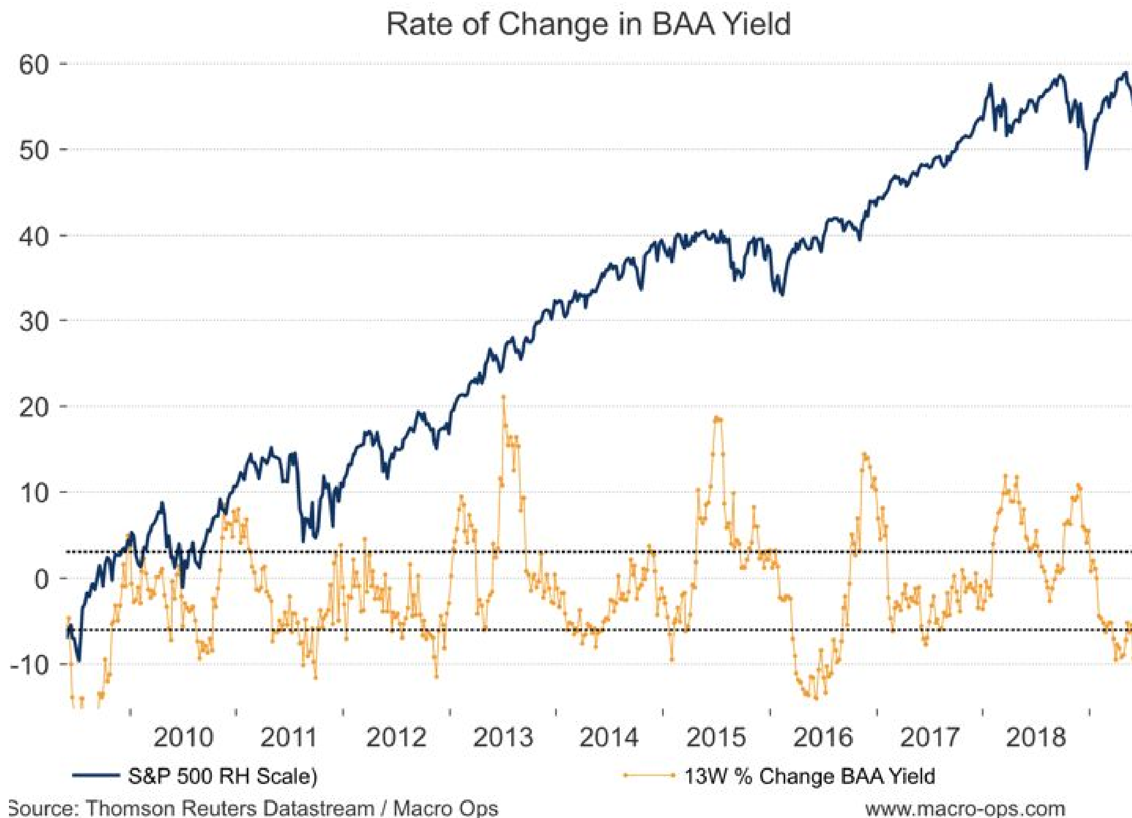
Sentiment Trader backtested the preceding market returns following similar instances of outflows in US market history and found that "when we look at the more appropriate medium-to-long-term returns, they were impressive… Over the next 6-12 months, there was only a single loss, and overall returns were well above random, with **very small risk and very high reward**".

A number of key markets are at or near their lower weekly Bollinger Bands (areas that often work as key support) and many short-term indicators of sentiment are depressed, such as Put/Call (10dma) and AAII Bull/Bear. But, as I pointed out last week, I'd like to see II Bull/Bear capitulate first (fall below 15) along with our Extreme Exposure Index cross below 40.



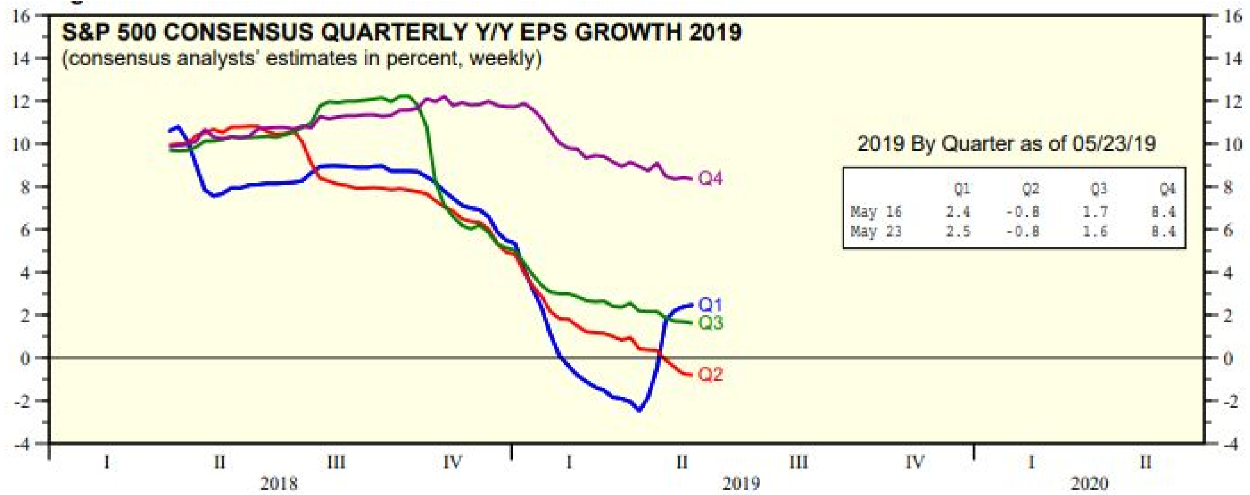
I think we'll see this happen sometime in the next few weeks. We should expect more pain first, since that's what a 'capitulation' entails.

Another additional positive for stocks is that all the capital flowing into bonds since the start of the year have brought yields down to very low levels. Stocks and bonds compete with each other for capital flows and lower bond yields make the risk premia of stocks appear more attractive. The last time the RoC on BAA yields was this low was at the start of 2016.



Moving onto earnings.

A positive of this higher volatility environment is that its dragging consensus earnings estimates lower. I've been writing since the start of the year that estimates were too high looking out past the first quarter. But now, estimates are much more manageable and make for a lower bar to clear.



The consensus earnings for next quarter has fallen to -1% YoY and -0.9% for Q3. Q4 is still too high at 5.5% but those should continue to trend downward.

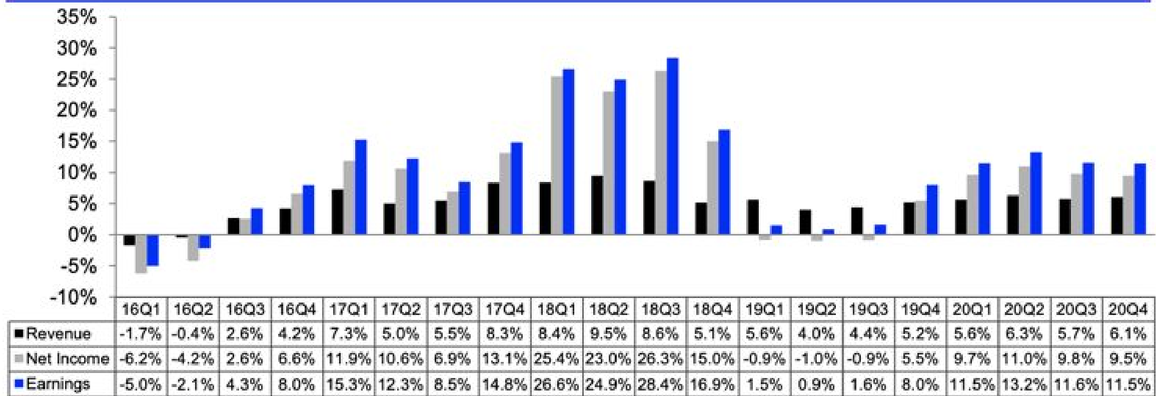
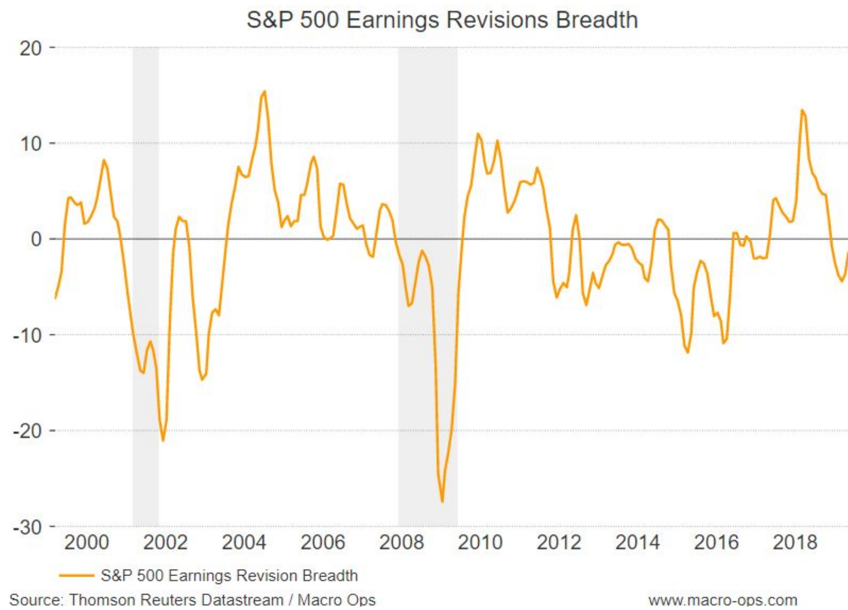


Exhibit 5. S&P 500 YoY Growth Rates

	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%	5.6%	4.0%	4.4%	5.2%	5.6%	6.3%	5.7%	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%	-0.9%	-1.0%	-0.9%	5.5%	9.7%	11.0%	9.8%	9.5%
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%	1.5%	0.9%	1.6%	8.0%	11.5%	13.2%	11.6%	11.5%

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

Earnings revisions are still negative in the US but have turned upward. I expect this indicator to flip positive next quarter as companies find these low estimates an easy bar to clear and analysts subsequently revise their expectations higher.



Keep a close eye on emerging markets (EM). The dollar looks ready to puke — we're going to be reversing our positioning, I'll be putting out a note and alert on that shortly — and a down trending dollar should help drive a bid back into EM. The emerging markets etf (EEM) is bouncing off a significant support level in its 200-day MA and lower weekly Bollinger Band. EM stocks in general have been holding up better than their US counterparts and I expect them to lead on this next leg up.

Precious metals are finally breaking out which is something we've been expecting (read more here). Our trade in gold miner (AU) is already up 20% since we entered the other week.

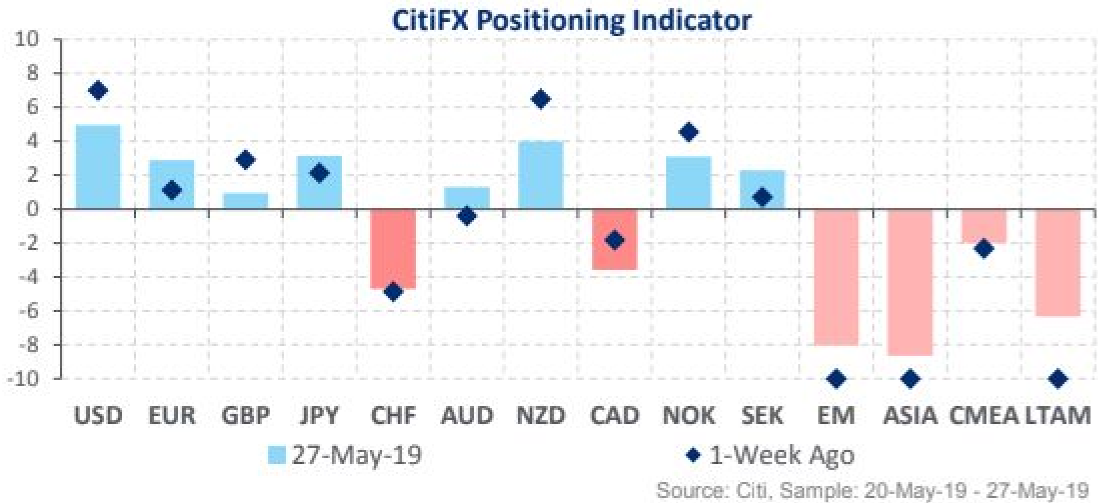
A number of confluent factors are lining up which make me believe gold and silver are about to go on a big run. *Sentiment Trader* noted that 'smart money hedgers' recently went net long silver for only the second time in history. The other instance preceded a 9% spike higher.

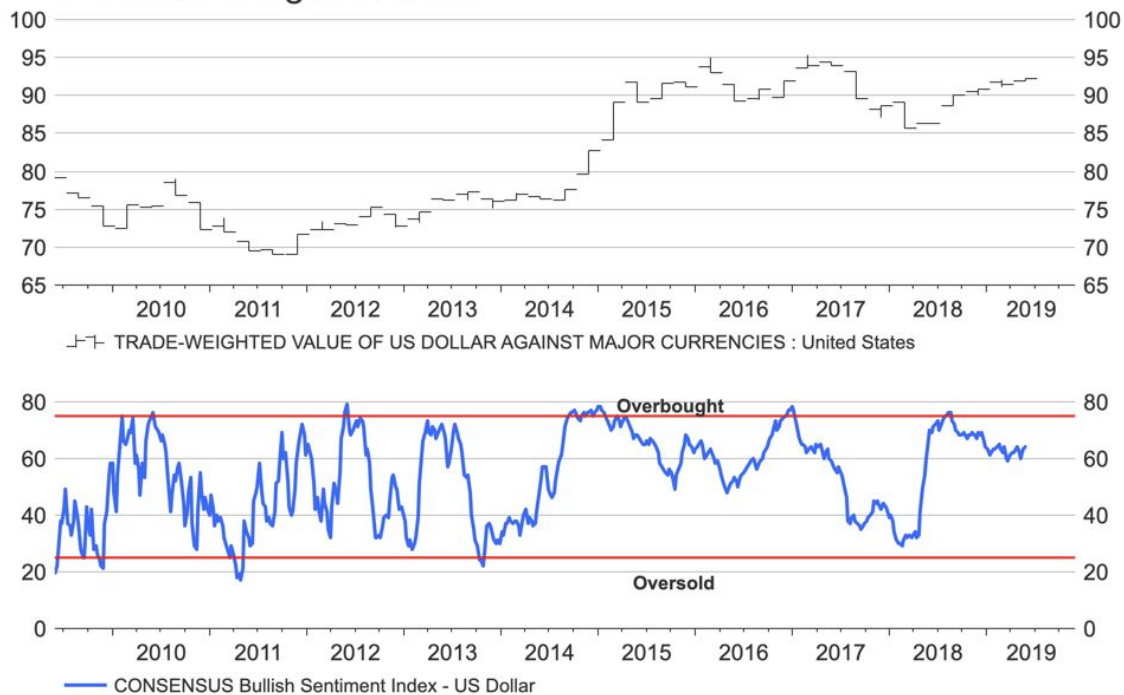
We often talk about how precious metals lead FX at major turning points. Meaning, rising gold usually leads a falling dollar and vice-versa. Considering this, check out the following USD charts.

USDJPY is about to breakdown out of a 2-year triangle (chart is a weekly). We'll likely put on a short position this week.

EURUSD is close to breaking out of its tight coiling wedge.

I've already laid out over the last month the reasons why I think the dollar is headed lower, so I won't go into that much here. But the gist of it is, is that everything comes down to sentiment and positioning. Both are crowded and make the dollar susceptible to an extended selloff.





Summary

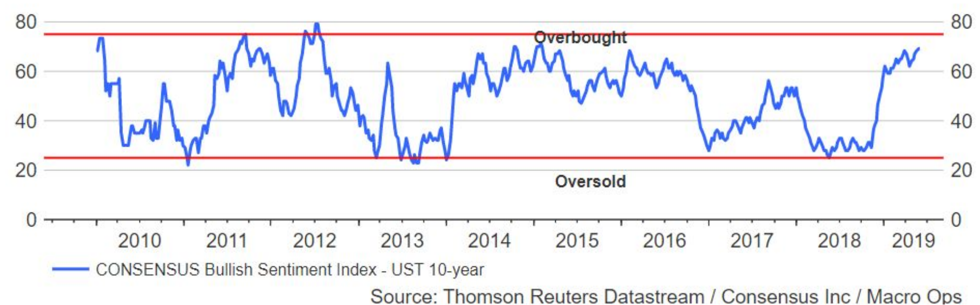
We have macro fundamentals which are slowing but still positive and far from signaling a recession is nigh. Depressed yields fatten the risk premia on offer from risk assets, making stocks appear more attractive. The consensus earnings estimates have been driven down to very manageable levels which should make for easier ‘beats’. Sentiment, positioning, and technicals are all pointing to a significant market bottom in the coming weeks — just waiting on full capitulation first. On top of all this, we have a US dollar that looks like its breaking down. A lower dollar = a tailwind for US earnings and easier financial conditions for EM stocks, not to mention a big positive for commodities.

Back at the end of March I wrote *There’s a Big Macro Move Brewing in Markets* noting the record low asset volatility we were seeing in major dollar pairs and precious metals. I laid out how these compression regimes usually lead to expansionary ones (ie, BIG TRENDS). I think we’re going to see that start very soon.

There are a number of trades setting up that are making me excited. There are energy and shipping names trading at 1x normalized free cash flows and I’m seeing signs that investors are FINALLY starting to allocate money to the sector — I’ll write more about both soon. There are fantastic shorting opportunities lining up in the overvalued tech names. And we have bonds that are in the process of putting in what looks like an intermediate blow-off top.

Consensus Bullish Sentiment

UST 10-year



I'll be putting out a series of notes and trade alerts in the coming weeks to update you on things as they unfold and as we make moves in our portfolio.

There is a tide in the affairs of men,
Which, taken at the flood, leads on to fortune;
Omitted, all the voyage of their life
Is bound in shallows and in miseries.
On such a full sea are we now afloat,
And we must take the current when it serves
Or lose our ventures.
~Shakespeare

Time to take the current…

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

Macro Ops Portfolio — YTD 10.92%

Big Bet Macro

Asset Class	Position	Position Size	Cost Basis	Notional %	Risk Point	Target	Last Price	P&L
Equity	Construction Partners (ROAD)	8,438	$12.25	10.17%	$10.80	$17.00	$13.25	8.16%
Equity	Fiat (FCAU)	2,666	$15.20	3.11%	$13.70	$28.00	$12.82	-15.66%
Equity	Garrett Motion (GTX)	5,630	$15.11	7.78%	$13.80	$25.00	$15.19	0.53%
Equity	Discovery DISCA	1,300	$28.09	3.23%	$26.70	$60.00	$27.32	-2.74%
Equity	Disney DIS	2,146	$102.34	25.86%	$108.50	$150.00	$132.47	29.44%
Equity	Yatra Online YTRA	13,877	$7.24	5.16%	Investment	$15.00	$4.09	-43.51%
Equity	Graftech (EAF)	2,205	$13.59	2.03%	$10.00	$25.00	$10.10	-25.68%
Equity	Frontdoor (FTDR)	1,240	$34.10	4.40%	$28.00	$55.00	$39.02	14.43%
Equity	Anglogold (AU)	5,500	$11.79	7.07%	$10.75	$18.00	$14.13	19.85%
Equity	TSLA Sep '19 175 Put	11	$13.81	2.08%	$0.00	$85.00	$20.80	50.62%
Equity	TSLA Jun '20 100 Put	14	$10.70	1.66%	$0.00	$85.00	$13.00	21.50%
Equity	TSLA Jan '20 150 Put	5	$15.01	0.91%	$0.00	$60.00	$20.00	33.24%
Equity	TSLA Jun '19 220 Put	4	$18.01	1.31%	$0.00	$60.00	$36.00	99.89%
Equity	DIS Jan '20 165 Call	205	$1.11	2.42%	$0.00	$10.50	$1.30	17.12%
FX	June Dollar Futures	5	$98.03	44.44%	$96.95	$102.00	$97.69	-0.35%

**Updated 6/2