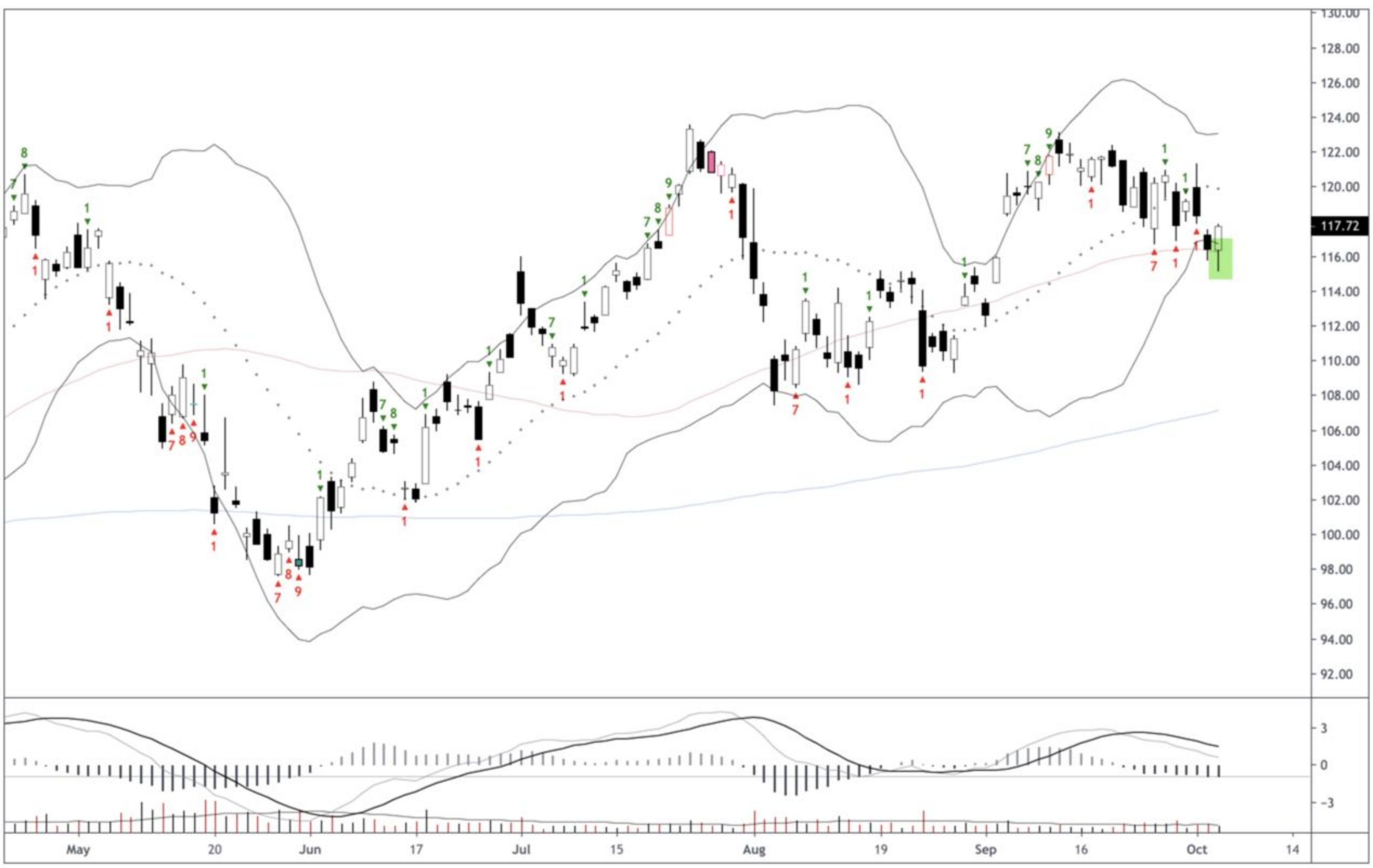
Operators,

The continuation of the selloff we talked about [over the weekend]() has kicked off in earnest. Here's my updated thoughts on where I think we are and where we're headed over the next couple of weeks. Plus, I've included an ongoing discussion about our recent portfolio changes with another Collective member that provides some additional color on the topic.

First off, markets... We've likely hit a short-term bottom and I'm now expecting a bounce over the next few days. I think this bounce is going to be short-lived and will lead to another — likely more powerful — down leg. We'll want to use this bounce to sell into and/or further hedge our long exposure.

Let's go through the charts that say a short-term bottom is in and then I'll show you why I think we have another leg lower ahead.

Semis (SMH) have hit their lower BB + 50dma and reversed.

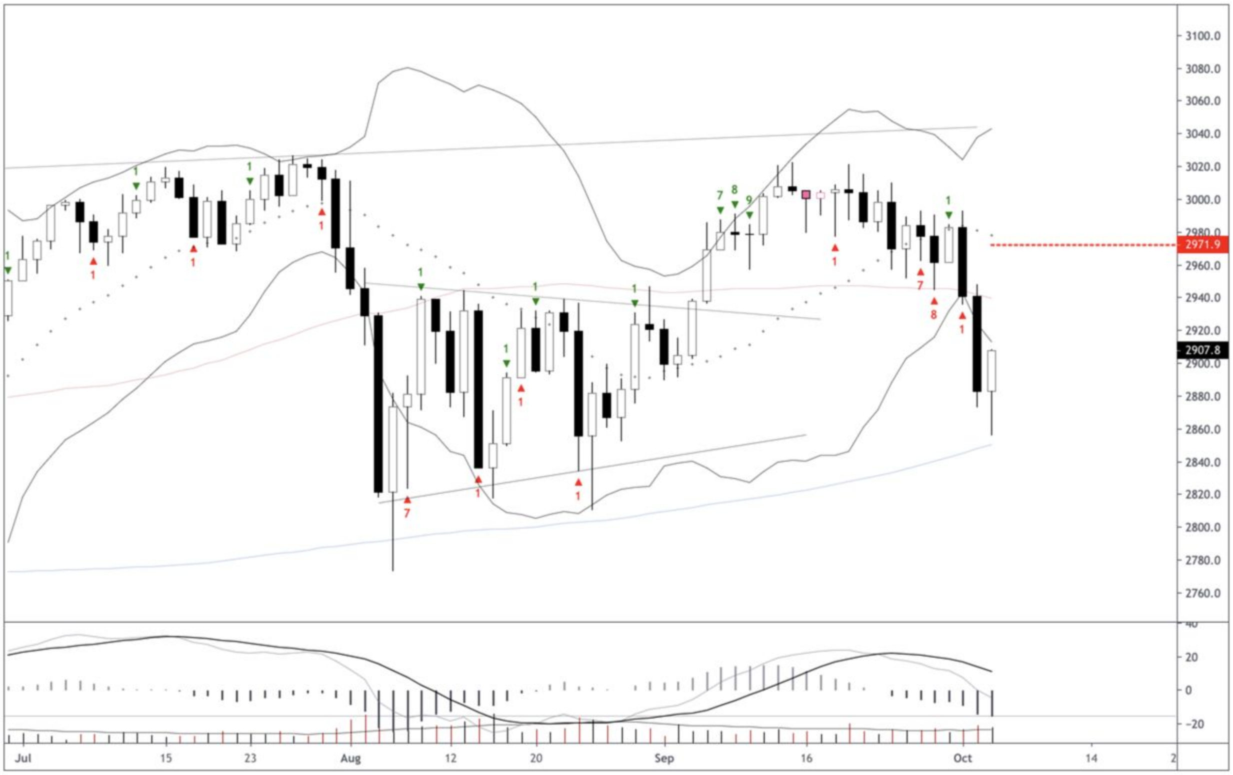


High-yield debt (JNK) is also at its lower BB and bouncing off its 200-day moving average.

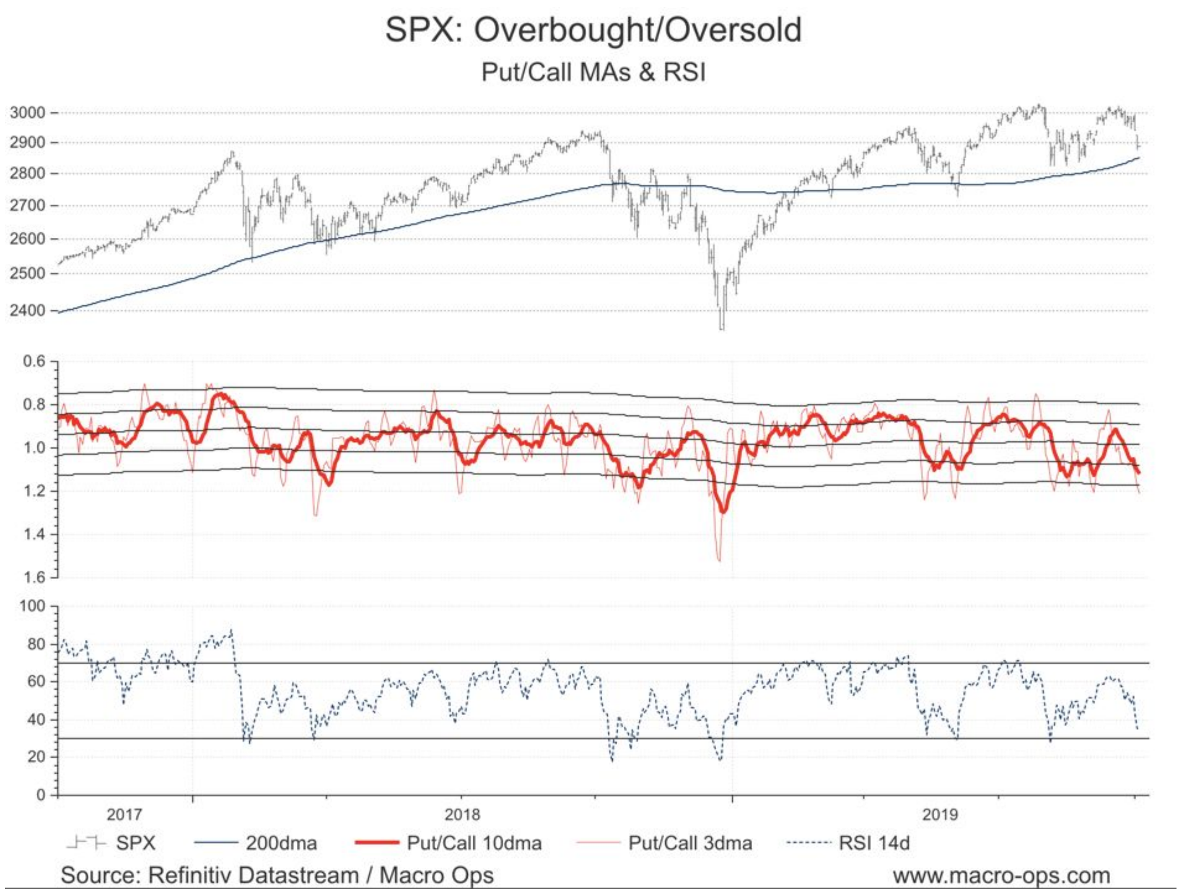
Same with small-caps (IWM).

Crude oil (CL_F) is bouncing off its lower daily and weekly BB.

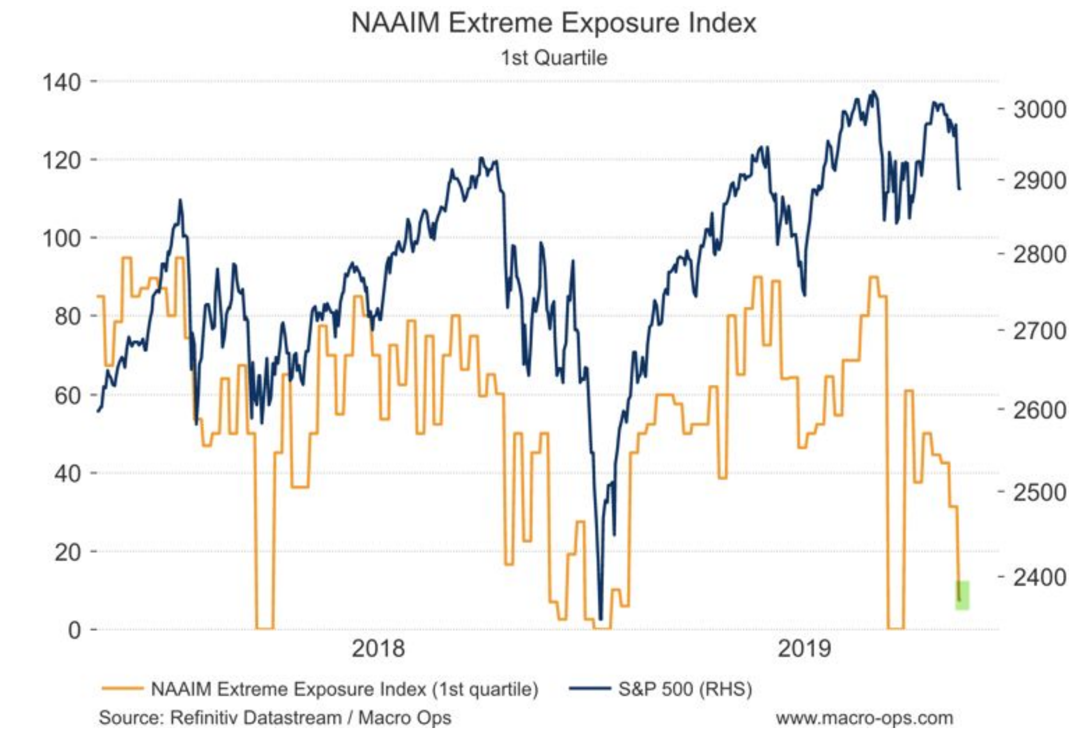
As of right now, I'm looking for a run back up to the 2,970 level in the S&P which would put it near the mid-line of its BB but there's a chance it gets cut short before that by its 50-day moving average like it did during the August chop.



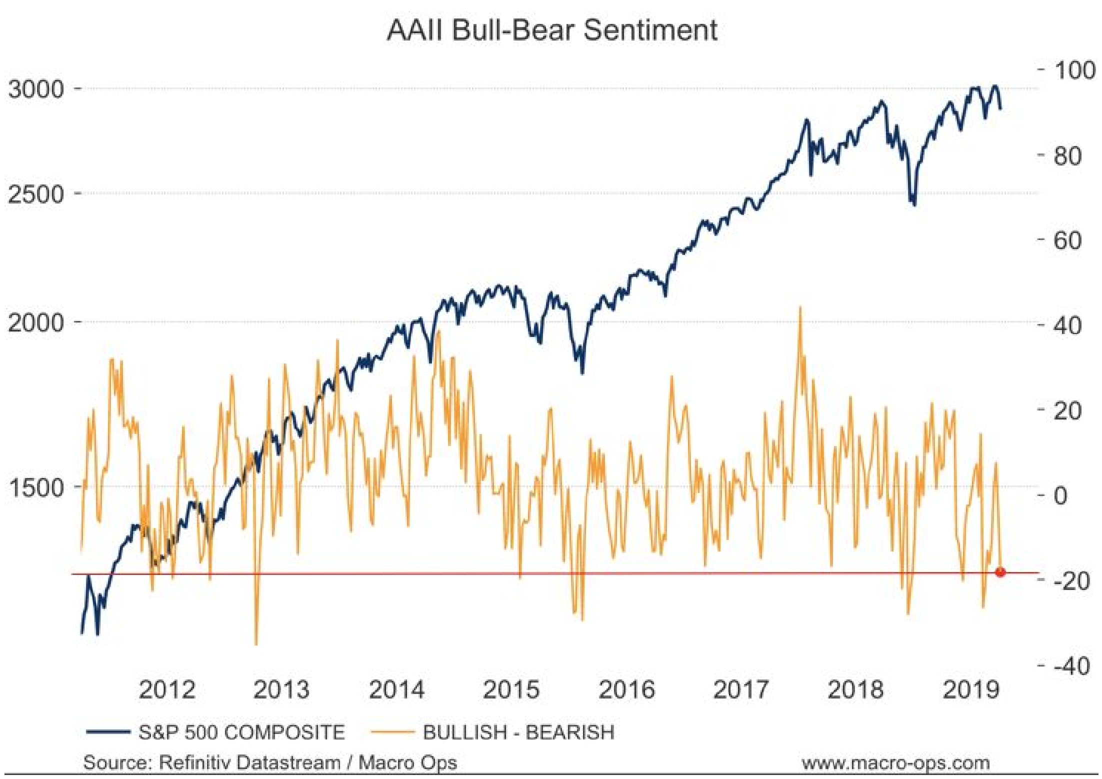
Total Put/Call 10&5-day moving averages (one of the main reasons we turned cautious a few weeks back) has completely reversed and triggered an official buy signal this morning. We'll want to watch this indicator closely to see how quickly the market switches back to bullish positioning on this bounce.



The stretched sentiment levels that I've been noting have for the most part been worked off. Our NAAIM Extreme Exposure Index is back near zero (indicating flat leveraged long positioning). It should hit zero in the next week or two which will give a good indication that a more durable bottom is in.

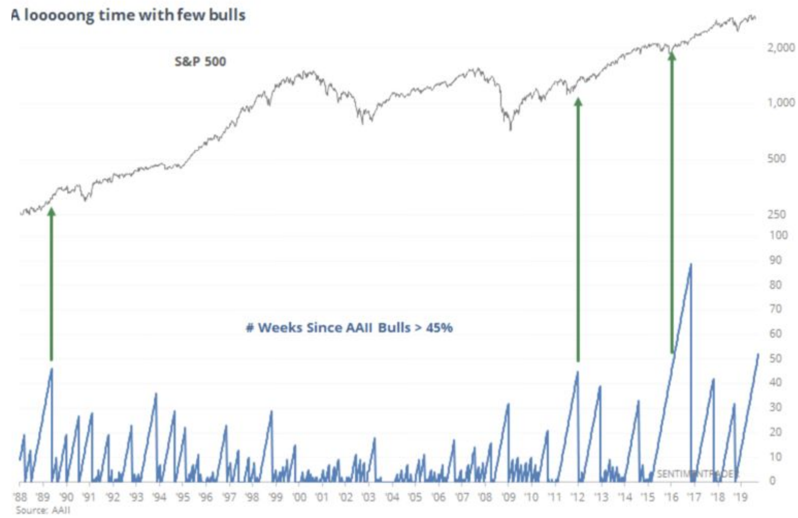


The AAII Bull-Bear spread has reversed and is back near negative extremes.

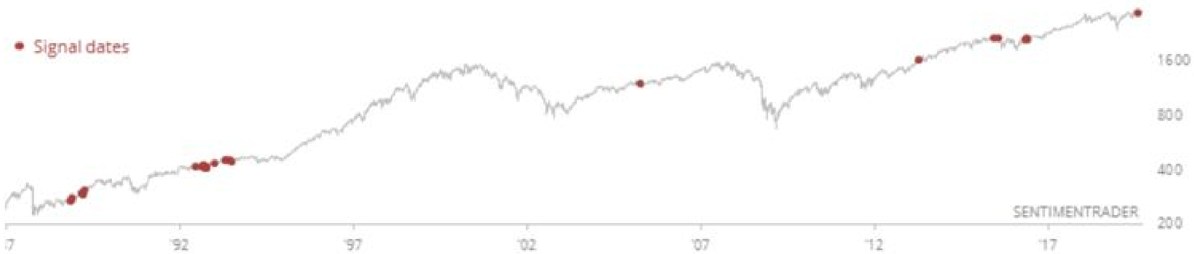


Here’s a great chart from SentimentTrader noting how extreme the pervasive bearish sentiment has been. The chart below shows the number of weeks that AAII bulls have measured less than 45%. This is the second-longest streak in the survey’s 30+yr history.

Historically, this has preceded strong returns in the S&P over the following months.



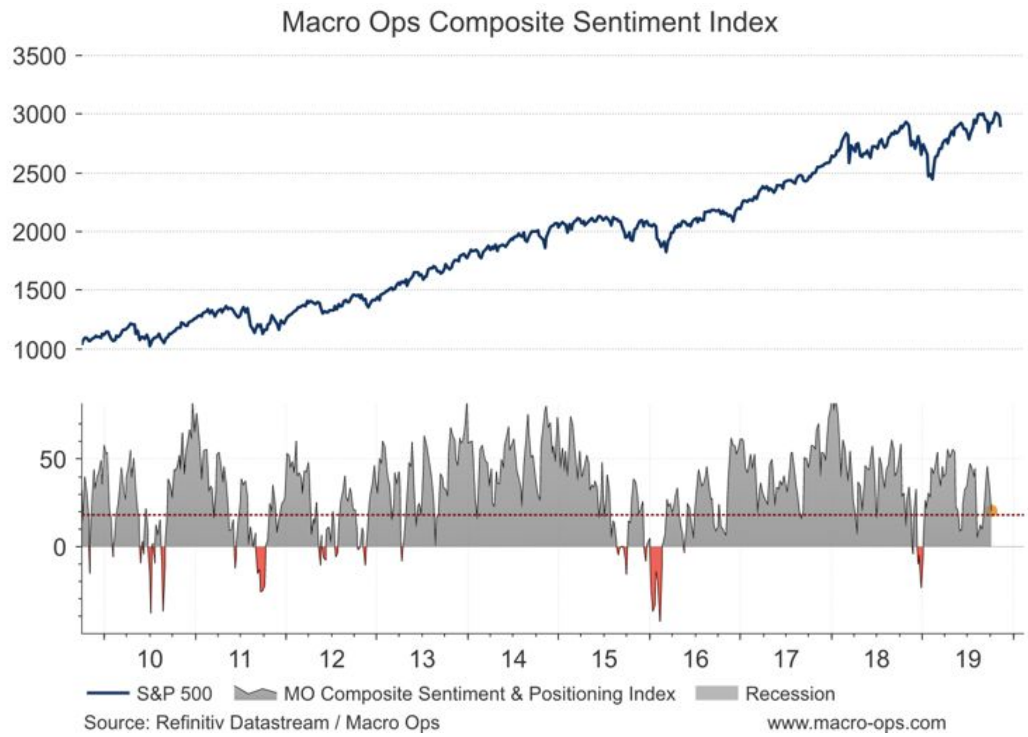
S&P 500 w/in 5% of 52-week high and AAII bulls < 22% (1987-2019)



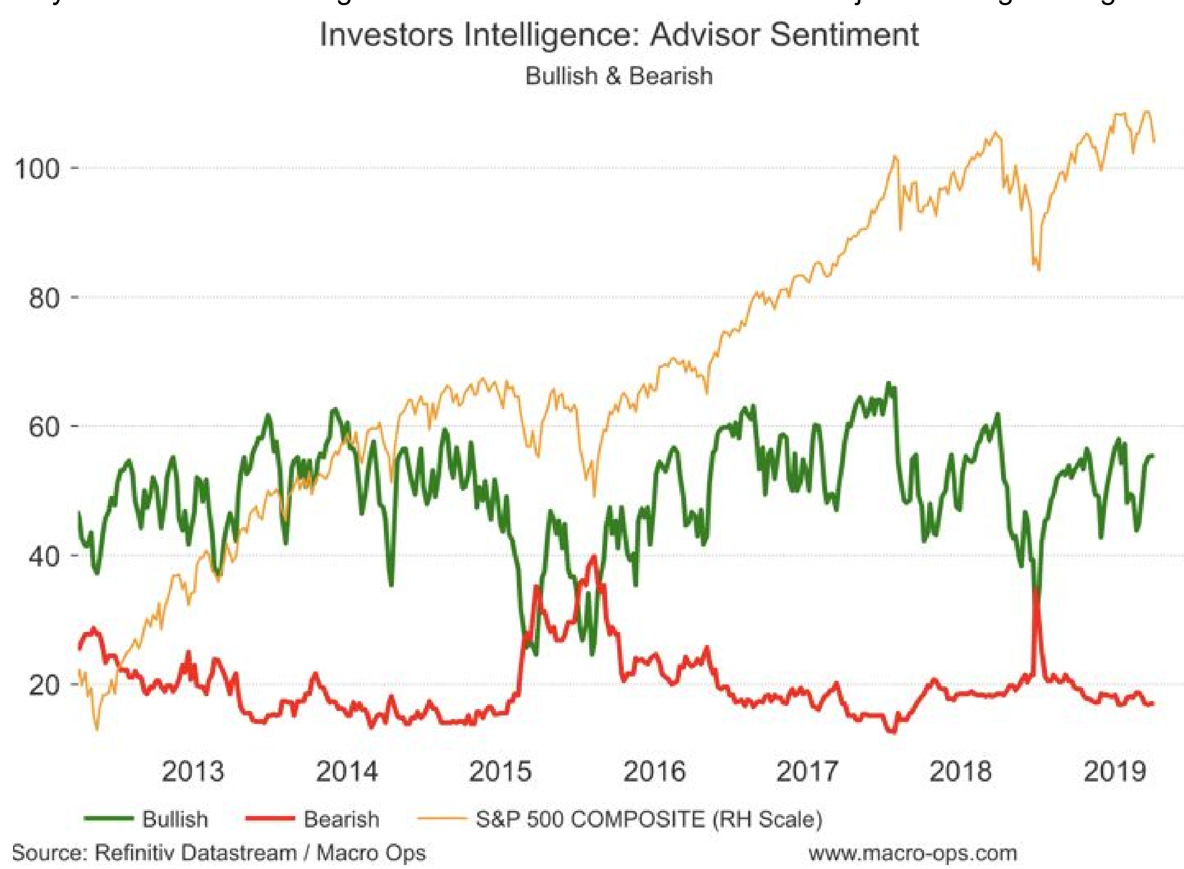
Signals	1 Week	2 Weeks	1 Month	2 Months	3 Months	6 Months	1 Year
1988-11-23	1.3	2.8	3.3	7.5	6.7	18.7	27.1
1988-11-30	1.6	0.6	1.5	8.7	5.9	17.6	25.5
1988-12-07	-1.0	-0.3	1.0	7.7	5.7	17.5	25.3
1989-03-08	0.9	-1.2	1.0	4.1	11.2	18.8	14.6
1989-03-29	1.3	2.3	5.9	10.0	12.3	17.8	16.8
1989-04-19	-0.1	0.3	3.5	4.8	9.3	11.1	10.9
1992-07-01	0.3	1.1	2.7	0.3	1.2	6.3	9.1
1992-09-02	0.5	0.5	-1.8	1.1	2.8	7.0	10.8
1992-09-16	-0.6	-0.5	-2.5	0.6	3.0	6.8	9.9
1992-10-07	1.3	2.8	3.5	7.7	6.6	9.5	14.0
1992-10-14	1.5	2.6	3.3	5.7	6.5	9.5	12.7
1992-10-21	1.1	0.3	1.9	6.0	4.8	5.7	12.1
1993-01-06	-0.3	-0.3	3.5	4.6	1.5	1.9	7.4
1993-05-05	0.1	0.7	1.2	-0.7	0.9	5.4	1.6
1993-05-12	0.6	1.9	0.6	0.7	1.3	3.5	-0.7
1993-05-19	1.3	1.1	-0.9	-0.1	1.9	4.3	1.4
1993-06-30	-0.4	-0.3	-0.5	2.5	2.1	4.5	-0.6
1993-07-07	1.6	1.0	1.2	4.2	4.1	5.4	0.7
2005-04-13	-3.1	-1.5	-1.2	2.3	4.2	0.9	9.7
2013-04-10	-2.2	-0.6	2.5	3.5	4.1	4.3	17.9
2015-06-10	-0.2	0.2	-1.4	0.0	-7.8	-2.0	0.5
2015-07-29	-0.4	-1.1	-5.7	-10.8	-2.0	-10.2	2.9
2016-05-11	-0.8	1.3	1.5	4.2	5.4	3.6	16.0
2016-05-18	2.1	2.8	1.2	5.7	6.6	6.5	15.5
2016-05-25	0.7	1.2	-2.5	3.8	4.1	5.4	15.5
2019-08-07	-1.5	1.4	3.3				
2019-10-02							
Median	**0.4**	**0.6**	**1.2**	**4.1**	**4.1**	**5.7**	**10.9**
% Positive	**58%**	**69%**	**69%**	**84%**	**92%**	**92%**	**92%**
Risk	-0.7	-0.9	-1.2	-1.4	-1.4	-1.4	-1.7
Reward	0.7	1.4	2.1	4.6	5.0	7.0	13.0
Z-Score	0.9	1.2	1.0	3.1	2.5	1.1	1.3

 Numbers are % return after signal; Risk = avg max loss; Reward = avg max gain; Z-Score +/- 2 suggests significance.

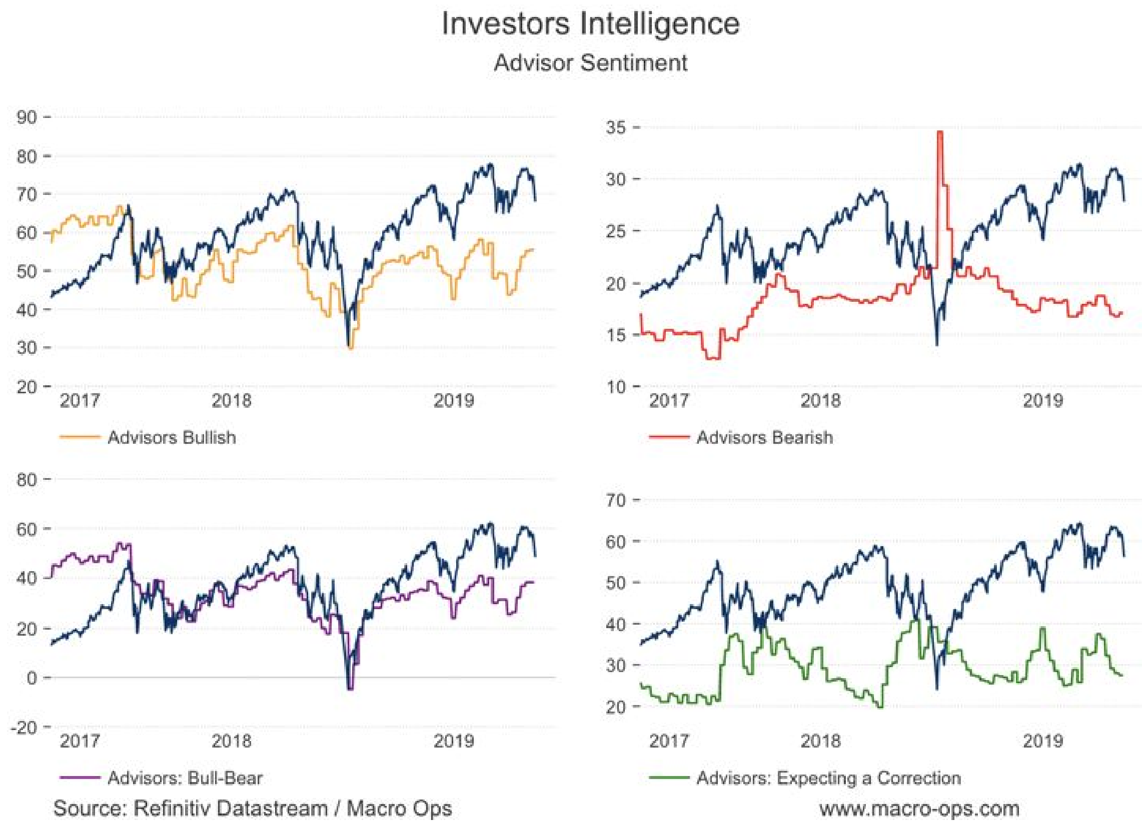
Our sentiment and positioning index has come off some but is still too high to mark a significant bottom.



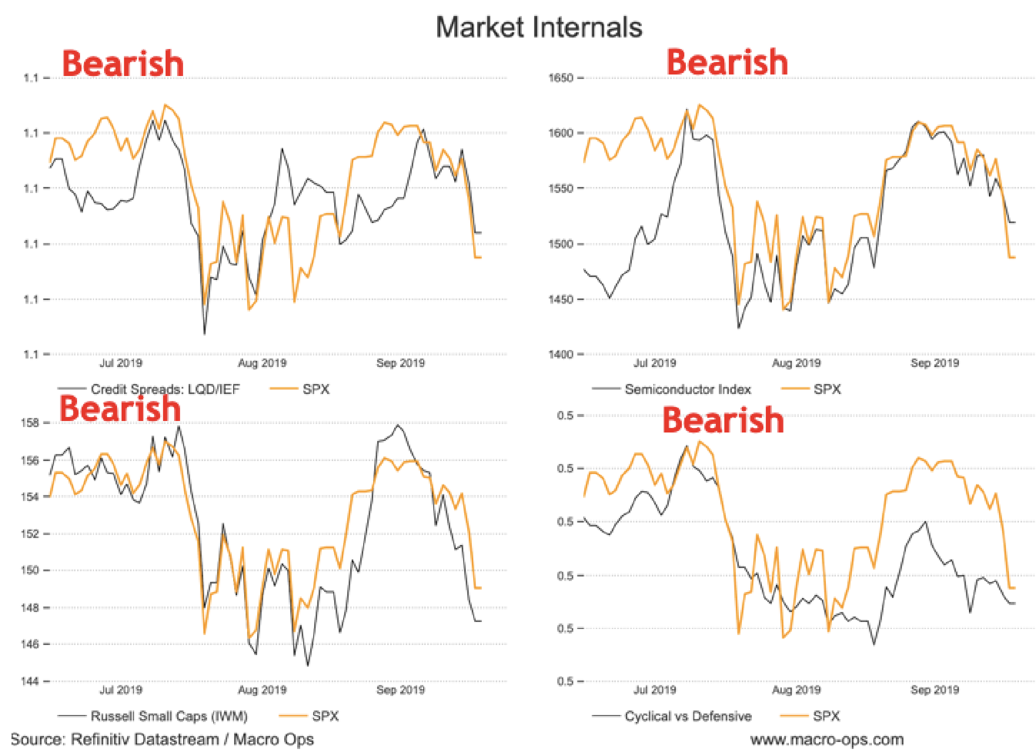
Investors Intelligence, which is one of my favorite longer-term measures of sentiment, is still showing too much complacency. This is one of the big reasons I believe we have another major down leg coming.



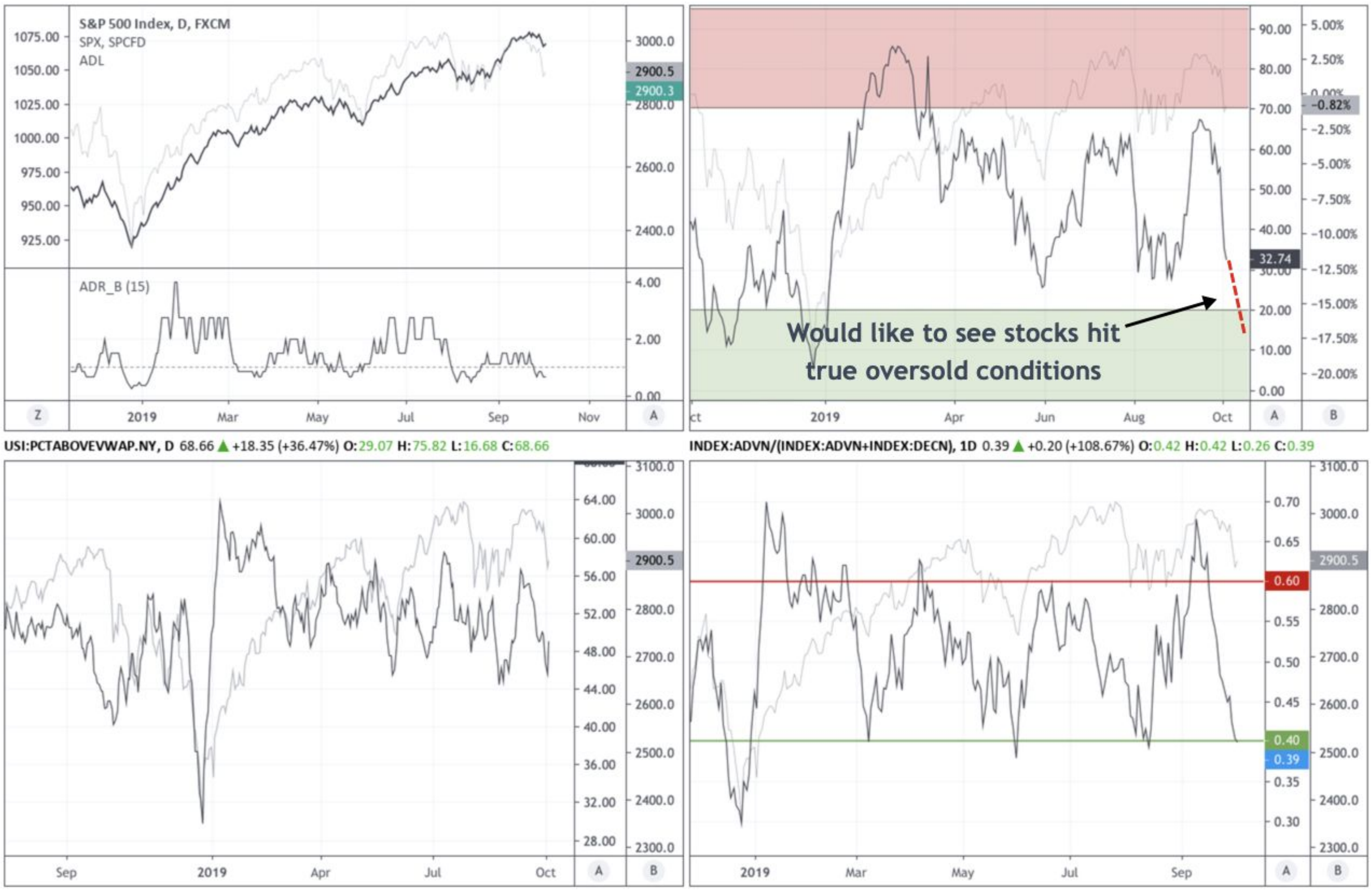
Here's all the sub-components of the survey. We want to see bullishness fall below 50 and preferably 40 to mark a significant bottom. And we want the percentage of advisors expecting a correction to pop well above 30.



Internals are still bearish for the most part and our McClellan indicators (summation index and oscillator) are still in downtrends.

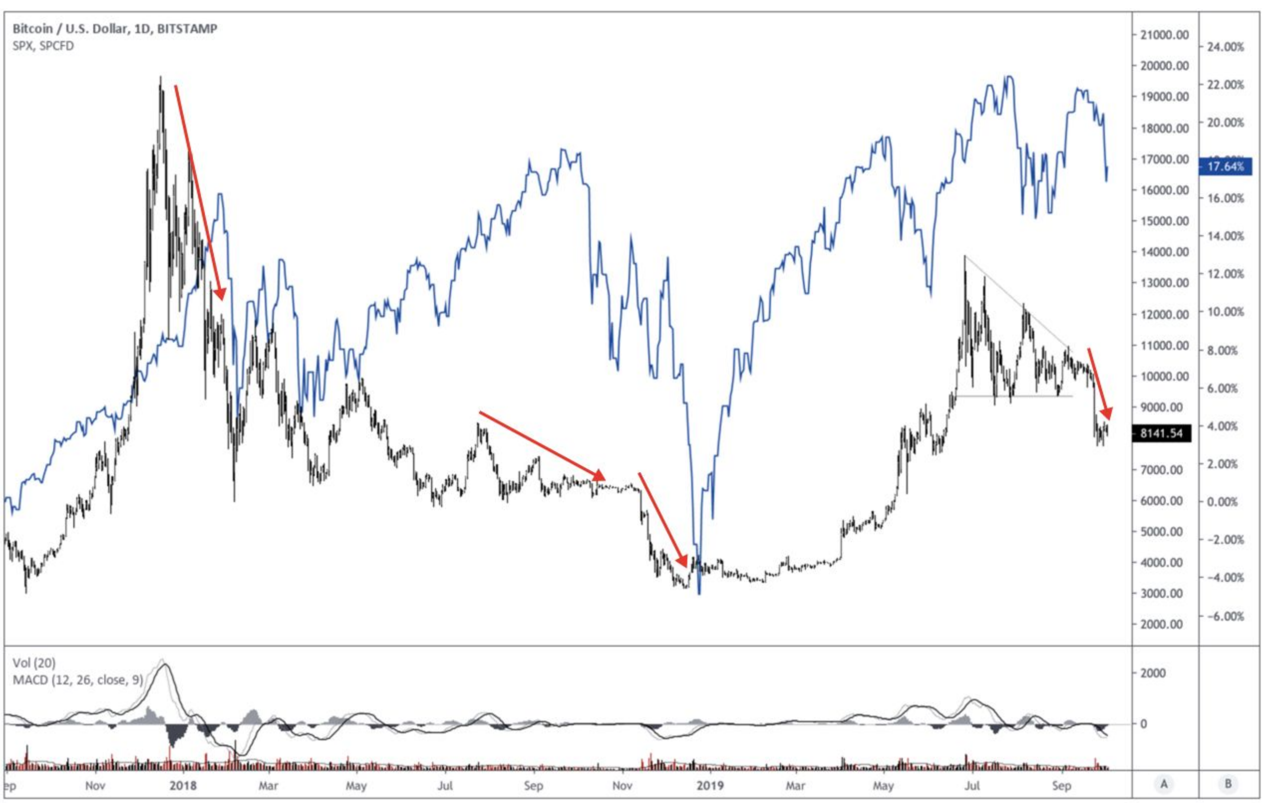


Ideally, I'd like to see stocks hit true oversold conditions to mark broad-based panic selling. One measure of that would be for the percentage of stocks trading above their 50-day MAs to drop below 20% (green shaded area in top-right chart).



Finally, another key thing I think we should be watching is bitcoin. My bet is that it's headed for another leg lower. See the daily chart below. It's hugging the underside of its 200-day moving average, likely consolidating before the next thrust down.

The crypto market seems to be acting as a good barometer of major sentiment shifts lately. See the chart below showing BTC and the S&P over the last 2-years. Major drops in the price of Bitcoin have preceded the last few big selloffs in the market.



We'll be using this bounce to completely hedge out our equity exposure and probably even go net short. I'll be sending out updates when we do so. Bottom line is, the next three weeks are some of the weakest and most volatile of the year, historically (as I outlined in the last Brief). This selloff has done a lot to bring down sentiment but there's still more work to be done.

The weak ISM is bringing the recession narrative back in vogue. This is good as we want a tall wall of worry for the market to climb. I'll be writing up a longer report over the weekend outlining why I think its odds on that we're nearing the lows of this global manufacturing recession. Anecdotally, I'm still not seeing the broad-based fear and front-page headlines talking about a bear market and recession yet. I think we'll get this on the next sell-off. Until then, we want to play defense.

Portfolio Discussion

Matt, a fellow Collective member (@MattJ in the CC), shot me an email in response to my "Four Pillars Portfolio" write-up with some great observations and questions. He gave me the okay to share the email in full here. I included my responses to his Qs below.

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Thanks very much for sending this note. It is uncannily similar to something I have been exploring and thinking about for several months so I thought I'd share my thoughts. I've given some background that you can of course skim but please do have a more detailed look at the information at the bottom. I'd be very interested to know what you think. I'd, of course, be delighted to continue this conversation by email or to speak in person. Ultimately if the message, once refined, was one you thought useful for the collective I'd be happy to share it there too.

I have been gravitating towards putting ~80% of my portfolio in a systematic multi-asset portfolio and keep 10% in two buckets to take controlled risk but large bets (i.e. a lot of options) on macro and micro themes/ideas. I'll spare you a full history but in brief - I've spent the best part of 30 years in finance, largely in London, in every asset class and their derivs (including crypto briefly) and I have been both salesman and trader in banks and asset managers. As of 2012, I was no longer either at a bank or risk-taking so was in a position to be much freer in managing my own finances.

My investment style is what I would call macro thematic. I very happily concentrate risk in to scenarios such as, in order, 2012-13 long US equity and short gamma/vol through over and underwriting, 2014/15 Abenomics (long Japanese equity, USDJPY and long WETF as the icing on the cake), lower for longer rates 2015/16 in US and EU, and 2017 for EU via Eurodollar and Euribor calls and futures and overwritten futures. Throughout almost all of this period one running theme as been long new finance (I've owned/own unlisted shares in ETF firms and fintech) vs short old finance (listed big banks and asset managers). No surprise I had a very good run compounding up my wealth with Sharpe ratios that I'm frankly amazed at and too modest to share.

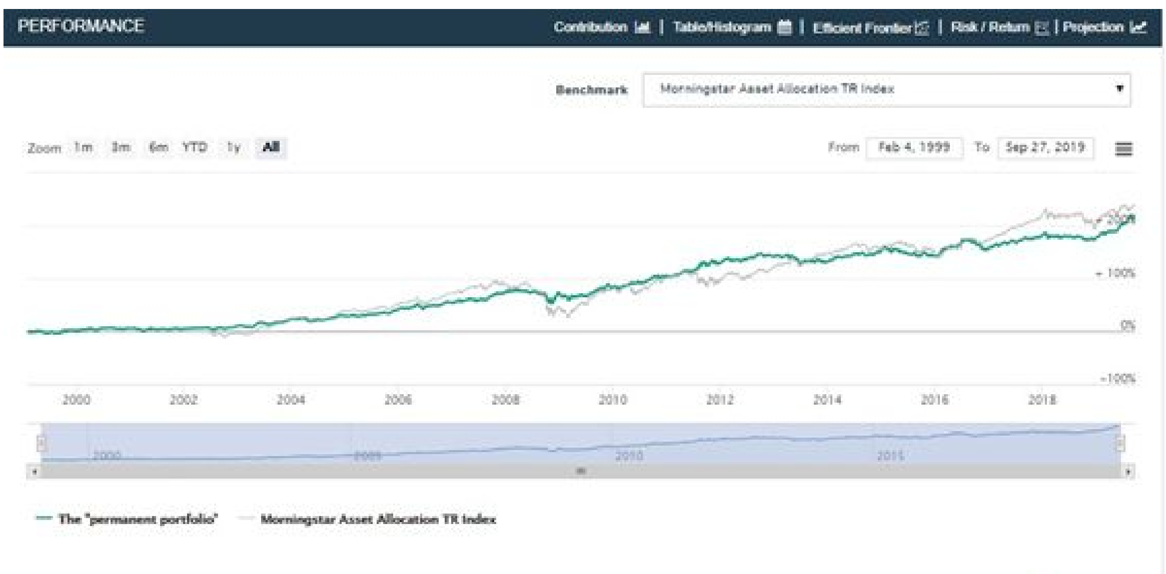
However, as of early 2018 something changed. I still managed to be on the right side of the VIX blow-up (but annoyingly not long XIV puts!), the Italian debt issue in May of that year and the Q4 equity sell-off. However, the whippiness of the markets resulted in me being way too slow to book profits and I finished the year only up single digits. This year has been worse and despite getting on the gold and rates move through the spring/summer I was again too slow to book these winners and blead on many other losers (basically getting value/growth wrong). The result is year to date I'm down single digits.
~~~~~~

I've thought a lot about this and with help from friends in all sorts of roles but most notably in terms of new info from those who consult in different banks on their algo activities I have come to the conclusion that market structure means I now need to rethink my operating style.

I think the electronic price takers/makers make short term entries very difficult to borderline counter intuitive and they also make position management a nightmare. For an example of the latter look at AUDJPY just last night printing just above recent highs as the rate cut news came out and then the cross 'correctly' tanks. I sense you have had just this problem in FX with your recent USD views. I also conclude this electronic activity has also increased over time in equity pushing value/growth to their extremes simply because they are able to force out/in (respectively) other positions with only the odd quant crash being their risk. I think we saw the first of these in 2007, then again in 2015 and again quite recently. The most recent one hurt more as I think quant funds at asset managers and funds had also got involved but earlier episodes like 2015 despite their violence didn't even last 2 days so showed who was playing. I don't mean this to read as a woe is me diatribe but rather just examples of what has forced my rethink. I'd be very interested to know if you have seen/thought/concluded the same as it would help me move to my new regime.

My current role is at a small, but backed by a large player and with major clients, fin-tech that has some good quant kit. So here is hopefully where the email gets interesting for you.

Here is how your permanent (I historically know it as the cockroach as it survives everything) portfolio looks with fixed weights rebalancing quarterly. I have included a 5b.p. transaction cost and 40b.p. portfolio fee to make it realistic.



PERFORMANCE METRICS

Diversification ratio | Drawdown | Volatility | Scenarios

Show benchmark performance metrics

Since Inception | Custom Range

	YTD	3M	6M	1Y	3Y	5Y	Since Inception
Returns (Actual / Annual)	13.77%	3.82%	8.88%	13.27%	16.17%	28.85%	215.23%
Volatility (Risk) (An.)	5.03%	6.46%	5.47%	5.13%	4.80%	5.26%	6.63%
Return / Risk Ratio (An.)	3.82	2.60	3.46	2.60	1.07	0.99	0.86
Max Drawdown	-2.55%	-2.55%	-2.55%	-2.55%	-6.43%	-7.59%	-14.80%

However, I was thinking of something a little more sophisticated. A maximum diversification logic running on a few large US-listed ETFs giving access to 3 points on the treasury curve, corps, TIPS, gold, property and different global equities (10 in total). Here is how it compares, with the same fee/cost assumptions:

PERFORMANCE METRICS

All metrics based on USD timeseries
Comparable history since 21/06/2002

3M | 6M | YTD | 1Y | 3Y | 5Y | All | Custom

Name	Actual Return	Annual Return	Volatility	Maximum Drawdown	Return / Risk Ratio	Daily VaR 95%	Daily VaR 99%
ALPIMA MASTR - Global Multi-Asset Strategy	242.20%	7.38%	5.84%	-11.68%	1.26	-0.57%	-1.06%
Morningstar Asset Allocation TR Index	237.03%	7.29%	8.87%	-35.78%	0.82	-0.87%	-1.68%
The "permanent portfolio"	194.43%	6.45%	6.59%	-14.80%	0.98	-0.65%	-1.11%

Here is how it has allocated (I think you'll be able to guess the tickers despite some being back build to give a longer history).

You can see for a lot of the ‘history’ several of these assets/ETFs have simply not added any diversification so have not been ‘bought’.

Did you consider something more sophisticated than the permanent portfolio? And if you decided against it I’d be very interested to know why.

So to wrap up:

1) As I’ve not said it before -thanks for all of your work, it is always a good read.
2) Please let me know if this mirrors any of the rational/thoughts on why you are making the shift to the permanent portfolio but in light of the negative tone you felt it was better to go with the apt fog of war point
3) Also please let me know if you consider more complex 'base' portfolio and if so why they were dropped.
4) Lastly, let me know if you'd like more info on any all of this and if you think the collective would benefit from it.

Regards,
Matt

~~~~

A “maximum diversification logic” for those of you not familiar with the idea is an allocation that’s based on the weighted average of volatilities divided by the total volatility of the portfolio. Their look-backs generally range from a few quarters to a few years and most are quite active in rebalancing, which you can see in the graph above.

The logic aims to solve for this point on the efficient frontier (image via Matt).
~~~~

MDP = Most diversified portfolio

I like this approach and I'd be interested to see how it tests out over a longer timeframe, though that may be tough finding the data to see how it does in a higher cross-asset vol market, such as the late 60s and 70s.

I'm not sure if there's a single best answer to the broader question we're both trying to solve for. And I think it really comes down to one's objectives and trading style. The reason I decided to go with an extremely simplified approach, like the permanent portfolio, is because I plan to be more active in using the futures market to increase/decrease my exposure to each of the individual pillars. Having a more simplified allocation makes it easier for me to hedge out whatever I want to hedge out or leverage whatever I want to leverage.

The approach doesn't require me to rebalance as often. There's little difference in whether I rebalance quarterly or annually. I'm leaning towards doing it ever two quarters just for ease. I really like at it as a way to solve for my cash problem (I have a tendency to carry too much cash on my books) and allows me to have a stable diversified allocation (that's proven across different secular regimes) without having to worry too much about it.

But if you're optimizing 80% of your portfolio for allocation and then will be using the remaining 20% for more asymmetric type bets, in a less active approach. Then I think using something like the logic above would be superior.

To answer Matt's second question about why I'm making this change: His reasons are very similar to my own. The market structure has certainly changed, increasingly so over just the last few years. Smooth trends and clean technical breakouts are a lot less prevalent now. The reason being, as Matt rightly points out, is the rise of algos that are driving short-term price moves — and are extremely efficient at hunting out concentrated risk points in the market.

Stanley Druckenmiller commented on this change in his Real Vision interview from last year (link here to my notes). Here's a clip from that talk.

> "These algos have taken all the rhythm out of the market and have become extremely confusing to me. And when you take away price action versus news from someone who's used price action news as their major disciplinary tool for 35 years, it's tough, and it's become very tough. I don't know where this is all going. If it continues, I'm not going to return to 30% a year any time soon, not that I think I might not anyway, but one can always dream when the free money ends, we'll go back to a normal macro trading environment.
>
> The challenge for me is these groups that used to send me signals, it doesn't mean anything anymore. I gave one example this year. So the pharmaceuticals, which you would think are the most predictable

> earning streams out there– so there shouldn't be a lot of movement one way or the other– from January to May, they were massive underperformers. In the old days, I'd look at that relative strength and I'll go, this group is a disaster. OK. Trump's making some noises about drug price in the background.
>
> But they clearly had chart patterns and relative patterns that suggest this group's a real problem. They were the worst group of any I follow from January to May, and with no change in news and with no change in Trump's narrative, and, if anything, an acceleration in the US economy, which should put them more toward the back of the bus than the front of the bus because they don't need a strong economy.
>
> They have now been about the best group from May until now. And I could give you 15 other examples. And that's the kind of stuff that didn't used to happen. And that's the major challenge of the algos for me, not what you're talking about.
>
> Well, I'll just, again, tell you why it's so challenging for me. A lot of my style is you build a thesis, hopefully one that no one else has built; you sort of put some positions on; and then when the thesis starts to evolve, and people get on and you see the momentum start to change in your favor, then you really go for it. You pile into the trade. It's what my former partner George Soros was so good at. We call it– if you follow baseball, it's a slugging percentage, as opposed to batting average.
>
> **Well, a lot of these algos apparently are based on standard deviation models. So just when you would think you're supposed to pile on and lift off, their models must tell them, because you're three standard deviations from where you're supposed to be, they come in with these massive programs that go against the beginning of the trend.** And if you really believe in yourself, it's an opportunity. But if you're a guy that uses price signals and price action versus news, it makes you question your scenario."

The markets are always changing so this is nothing new. It just means that we have to adapt. There are plenty of ways we can do so, having a stable diversified asset allocation as your base is one of these ways. It allows you to keep your exposure on while not getting whipsawed by the constant rose thorns of this new market regime. The diversification hedges out your downside and gives you peace of mind to wait for fat-pitch setups.

If you've got any questions or comments, please don't hesitate to shoot them my way or post them to slack. I'm super fascinated by this topic and am always looking to learn more on the subject.

Your Macro Operator,

Alex