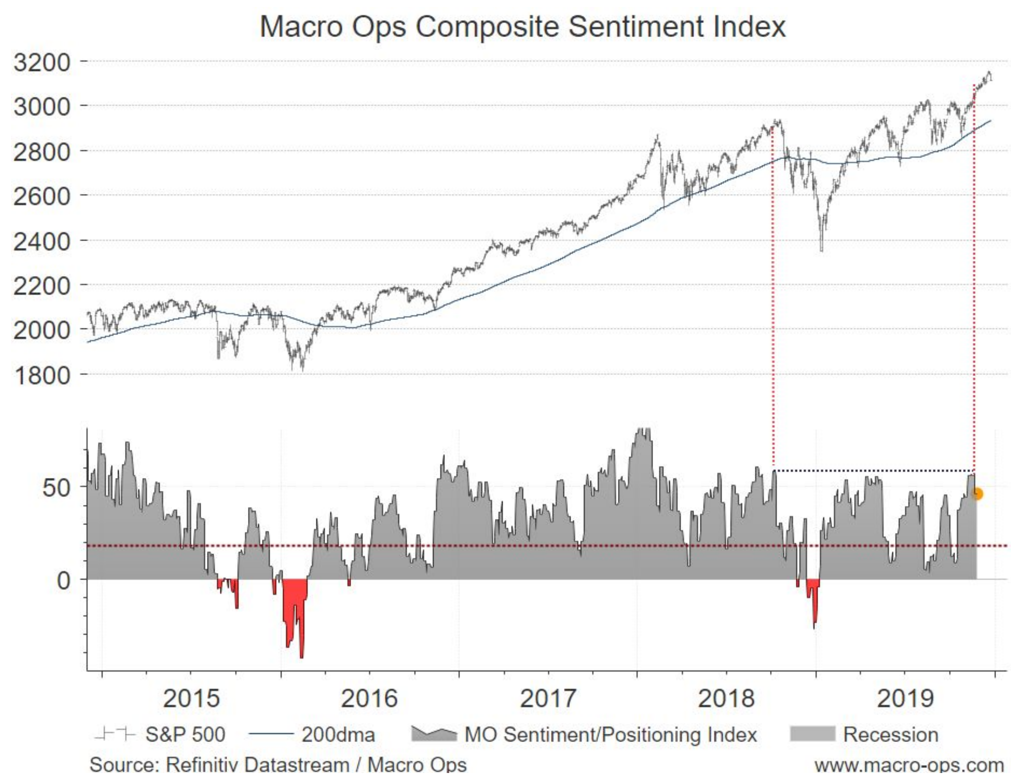
A Vanilla Correction

Summary:

- Overbought and overloved, the SPX has started what is likely to be a multi-week retrace
- The market remains in a solid uptrend. This is a healthy correction allowing the market to work off the excessive positioning and sentiment we noted in the [last Brief](#).
- The logical target for this move is around the 3,000 level in the SPX.
- Liquidity and longer-term technicals point to a continuation of the bullish trend.
- January effect and record tight FX volatility
- Portfolio and Trades
  - Core equity allocation is flat
  - Core bonds allocation doubled to 100%
  - Core gold allocation back to neutral at 25%
  - Holding full Disney (DIS) and Scorpio Tankers (STNG) positions

After a bit of a run since we issued our sell signal in the last brief ([link here](#)) the market has started a much-needed correction to work off its overbought and overloved conditions. Our composite sentiment and positioning index hit its highest levels since October of 18' last week.



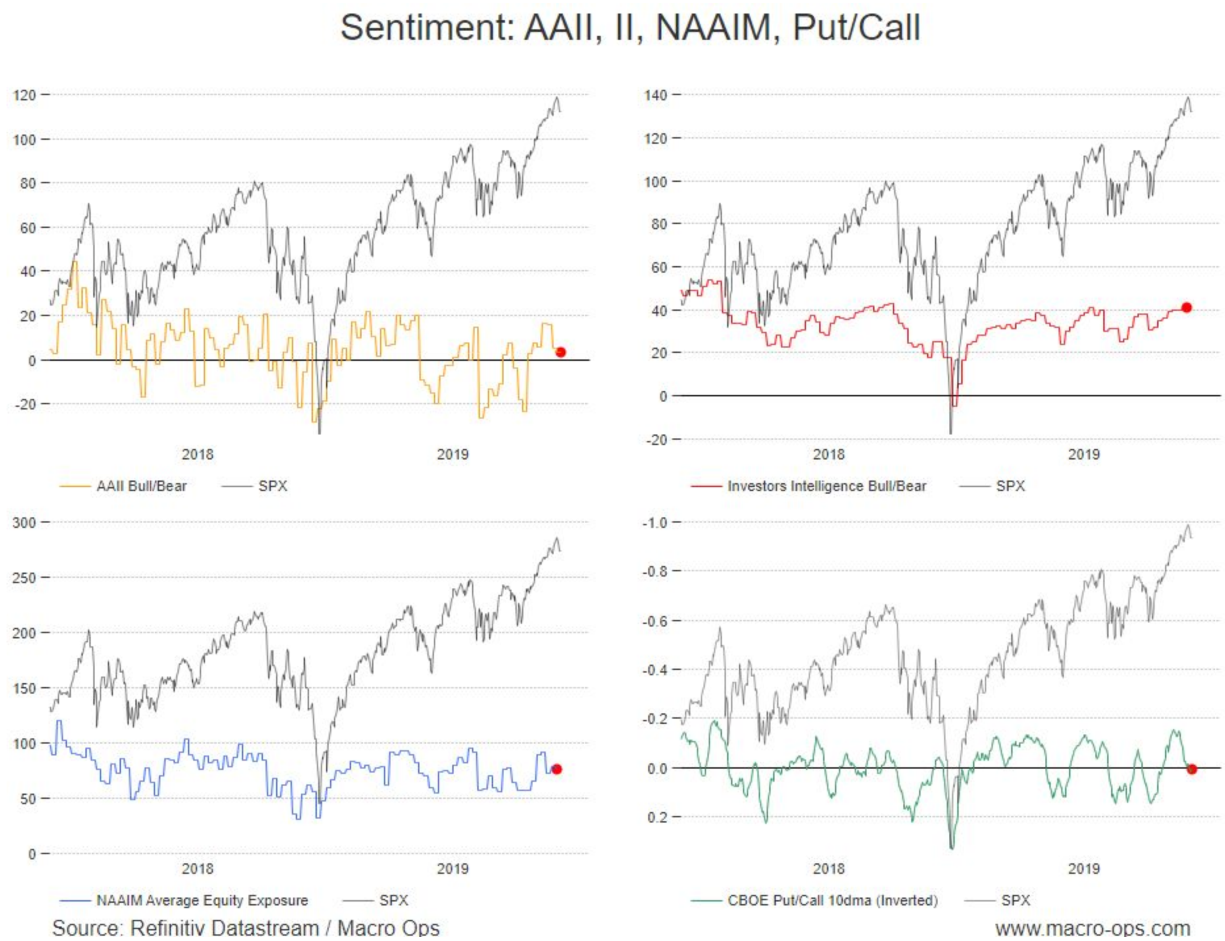
A buying climax drove the SPX above its 6-month bull channel trend line only to quickly reverse, forming a failed breakout.

After rising for nearly 8-straight weeks we should expect at least a multi-week pullback/consolidation as bulls take profits and bears become emboldened. These corrective impulses typically comprise two legs in an ABC pattern.

The 3,000 level (shaded grey area) is the target level for this pullback. This is an area of major support, it’s the middle of the bull channel and a measured move target from its smaller 8-week bull channel.

The play here is to stay defensive until sentiment and positioning suggest a bottom is near and the technicals indicate the corrective wave is over.

This should set up a number of good buying opportunities in late December when positive seasonality (Santa Rally) comes into effect. We’ll be keeping a close eye on shippers and look to add once the selloff has exhausted itself.



Despite all the focus on the negative ISM numbers (which weren't that bad) this week and the political circus that is the US/China trade war, there are a number of positive developments — which the financial news isn't talking about, of course — that bode well for the US stock market heading into the new year.

For example, take liquidity and financial conditions.

The Goldman Sachs Financial Conditions Index continues to trend lower (indicating easing financial conditions) and is now at its lowest levels since April of last year.

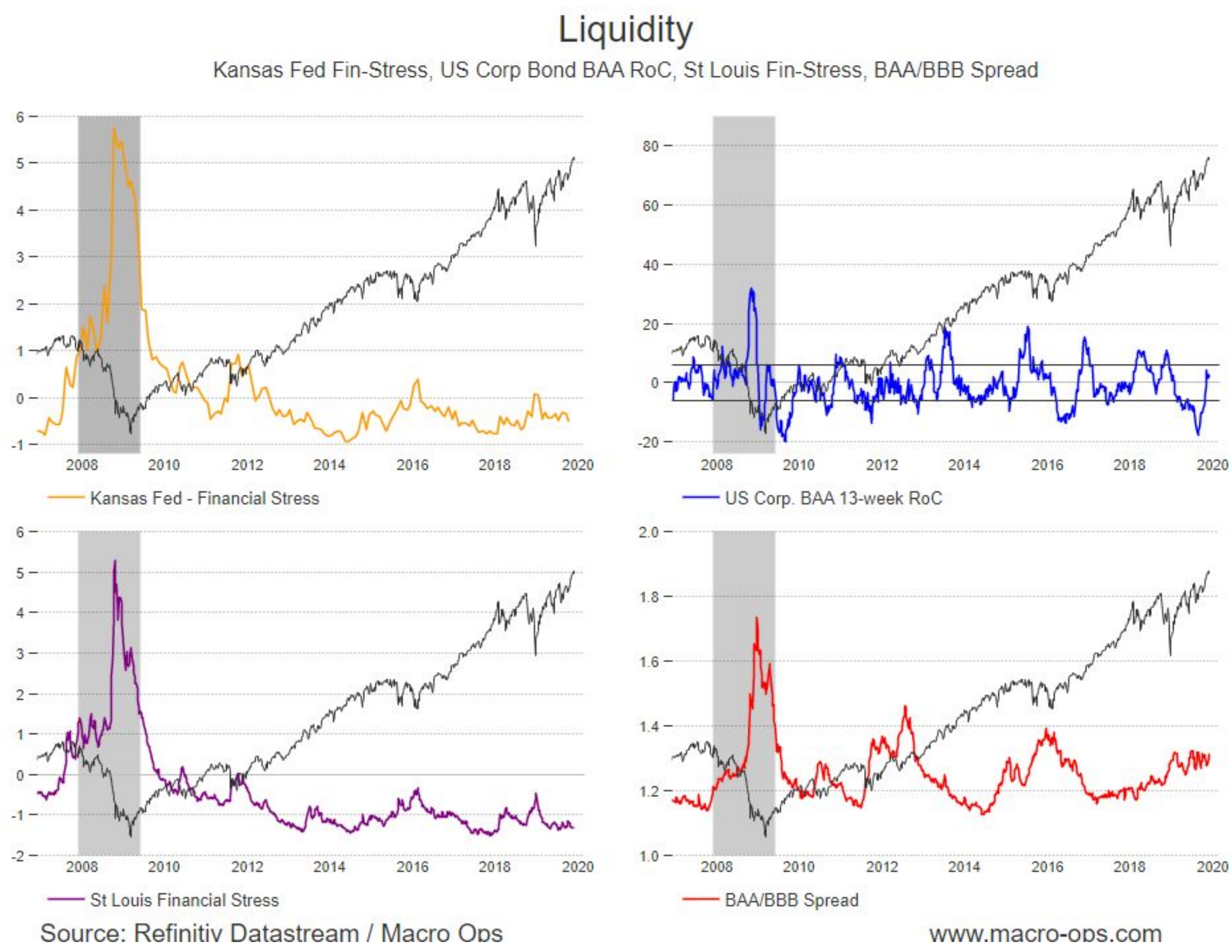
This index tracks changes in credit spreads, exchange rates, equities, and risk-free interest rates.

Sentiment Trader notes that when the GS FCI falls to a 419 day low, as it did last week, the returns over the subsequent 12-months tend to be very strong.

Signals	1 Week	2 Weeks	1 Month	2 Months	3 Months	6 Months	1 Year
1995-06-19	-0.2	0.3	1.1	2.5	6.9	13.0	22.0
2003-06-03	1.4	4.1	2.3	0.9	5.2	10.1	15.8
2006-12-04	0.3	0.9	0.0	2.8	-0.5	5.8	5.4
2010-04-23	-2.5	-8.7	-11.8	-10.3	-9.4	-3.0	9.9
2013-04-11	-3.2	-0.5	2.5	2.1	5.1	4.0	15.0
2017-05-19	1.4	2.3	2.3	3.9	1.8	8.6	14.7
2019-11-27							
Median	0.0	0.6	1.7	2.3	3.5	7.2	14.9
% Positive	50%	67%	83%	83%	67%	83%	100%
Risk	-0.2	-0.3	-0.3	-0.3	-1.6	-1.6	-1.6
Reward	0.7	1.2	2.8	3.8	4.6	9.1	18.9
Z-Score	-0.2	0.2	0.4	0.4	0.6	1.3	2.6

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

And while there's been some tightening in liquidity over the last couple of months, such as a reset in the rate of change of BAA rates (top right blue line) and rising BAA/BBB spreads (bottom right red line). The liquidity picture taken as a whole remains quite supportive of higher equity prices.



Coiled Currencies and the January Effect

I've written before about the "January Effect" in major dollar pairs. For those of you not familiar, the January effect refers to the EURUSD's tendency to establish its annual pivot high or low in the month of January. And since the euro makes up more than half of the trade-weighted dollar's basket, this tends to hold true for other major dollar pairs as well.

Peter Brandt notes that "in 35 of the past 46 years the Euro currency has experienced an annual top or bottom in January (actually, in five of the 25 years the effect occurred during early February). The average subsequent price gain or loss from the January high/low during these years has been 20.1%, not an insignificant amount."

There are fundament reasons for this quirky seasonality such as yearly FX repositioning by central banks and corporates. And like all seasonality, it's far from being an iron-clad law and needs to be looked at in context of the broader technical picture.

But there are a few reasons to suggest that we should be paying very close attention to major USD pairs over the new few months.

The primary one being the historically low volatility regime we're in right now, which I've been noting (link here).

G10 FX annual volatility is at its most compressed level in history this year. Compression regimes lead to expansionary ones (ie, big trends).

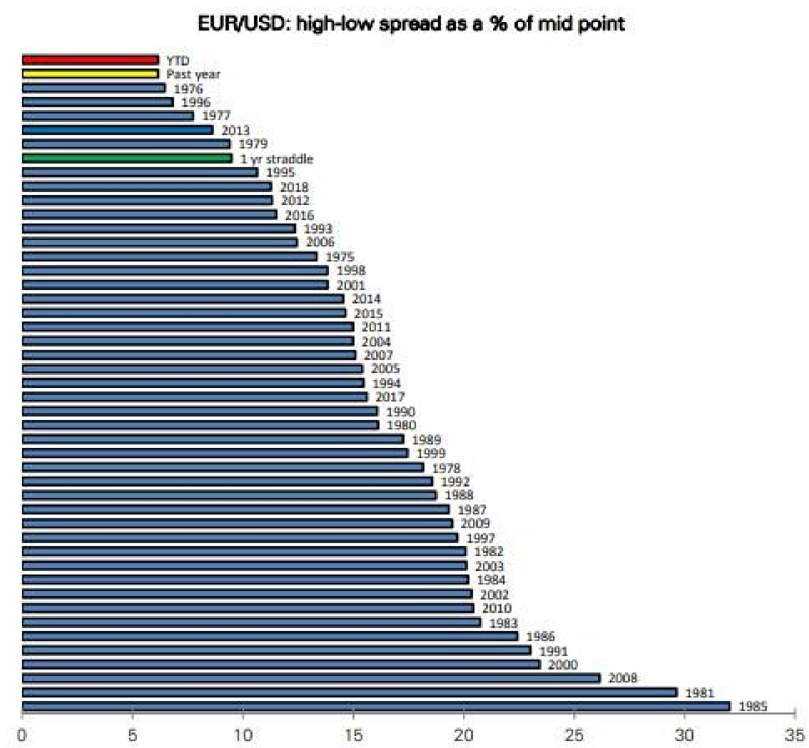
Figure 1: Average of the ranges of actively trade G10 currency pairs including USD/G10

Source :Bloomberg Finance L.P, Deutsche Bank

We talked about a similar setup in gold earlier this year. Pointing out how the compression in precious metals was going to lead to a big rally (link here). Which of course it did. The FX markets looks like it will soon follow in gold's footsteps.

Just look at how unusual the compression is that we're seeing in EURUSD right now. The last two years have experienced the tightest average price range in history.

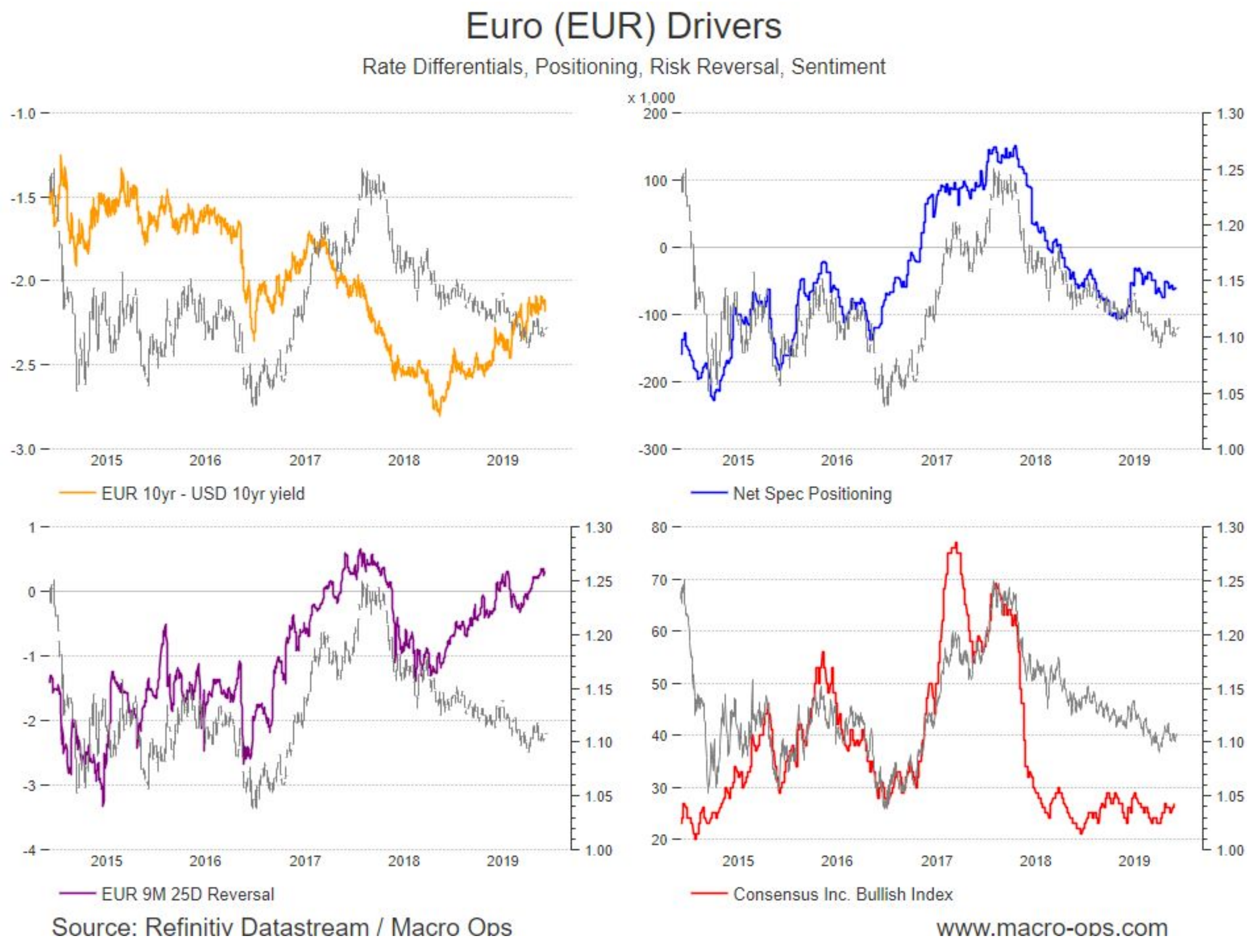
Figure 10:EUR/USD high-low spread as a % of mid point



Source : Bloomberg Finance L.P, Deutsche Bank.

EURUSD is coiling in a 2-year downward sloping wedge. Patterns like these typically precede breakouts to the upside.

The euro's core fundament drivers currently favor the bulls.



But, really, we should be directionally agnostic. The important point is that we're in an extremely compressed FX regime. These regimes birth massive trends. We need to wait and watch closely for the market to tip its hand and then grab the trend with both hands and ride it for all we've got.

Portfolio Update

Our core equity allocation is flattened. We'll look to raise it back to 100% once the technicals suggest this correction is over.

I've doubled our core bond position to 100% of NAV in order to help hedge out our remaining equity exposure in DIS and STNG, which we continue to hold full positions in.

I've also moved our gold positioning back to neutral at a 25% allocation to NAV.

The Four Pillars Portfolio		YTD				
		17.81%				
The Core	Fixed Allocation	Market-Timing		Net Position		
Large Cap Equities (/ES_Z or VOO)	25%	-25%		0%		
Short-term Bills (/ZT_Z or VGSH)	25%	25%		50%		
Long-term Bonds (/ZB_Z or TLT)	25%	25%		50%		
Gold (/GC_Z or GLD)	25%	0%		25%		
Big Bets	Thematic	Cost Basis	At Risk	Notional %	Risk Point	Last Price
Disney (DIS)	Value	$129.37	Above B/E	22%	$130.00	$149.00
Scorpio Tankers (STNG)	Turn in Shipping Cycle	$35.35	Above B/E	21%	$26.50	$33.50
CADUSD (6C Dec' Futures)	FX relative value	0.7565	100bps	70%	0.7467	0.7520

That's all I've got for now.

I'm working on a number of projects that I hope to start getting out to the group by the end of this week. The macro, technicals, and sentiment/positioning picture is setting up in a way that makes me think 2020 is going to be a target-rich environment for us. More on that soon.

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