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# Market Tops and Archimedes' Lever

Whenever I see that recession and market top calling has become the *in vogue* thing, as they have in recent months, I like to reshare this bit of wisdom from the late Justin Mamis' newsletter titled "The Philosophy of Tops" -- which happened to come out a few weeks before the crash of 87'.

He gives the best description of the topping process that I've come across and which rings as true today as when it was written over 30-years ago. Here goes Mamis with emphasis by me...

*The Charts Themselves: Market tops, in chicken and the egg fashion, do not, can not, form without individual charts shaping up as sales, as shorts. Indeed, in the past, and despite tops made while the Dow actually goes on to a marginal new high (see April 81'), many stocks were no longer advancing but were, instead, already in downtrends. **This is a truism that must follow from deteriorating breadth and lagging new highs: by the time the blue-chip average makes its own peak probably a third to a half of all NYSE stocks have already long since seen their highs. Perhaps another third top out as the Dow does; and the rest cave in after the bear market takes hold...***

*Portfolio management requires anticipating: identifying which stocks have already had it. Since it has become virtually impossible to outperform the averages on the upside, it becomes all the more essential to try to do "less bad" during selloffs, by paying attention to not owning vulnerable stocks... rather than being lulled into believing that the ongoing bull market will bail everything out eventually.*

*Long-term forecasts, which once were modest, **suddenly become "the sky's the limit"**. Belief expands, while the place to put money narrows to "the stock market's the only game in town."*

*If you look at every top we've lived through, they each have certain ingredients — **internal market deterioration; rationalizations and lullings; using up buying power even though you used to know better; and waiting and waiting for the bell to go off, which proves in hindsight to be rather more of a little tinkle that you thought you heard but weren't sure enough of to act upon. The one eternal aspect of every market top is that it occurs before we're ready for it.***

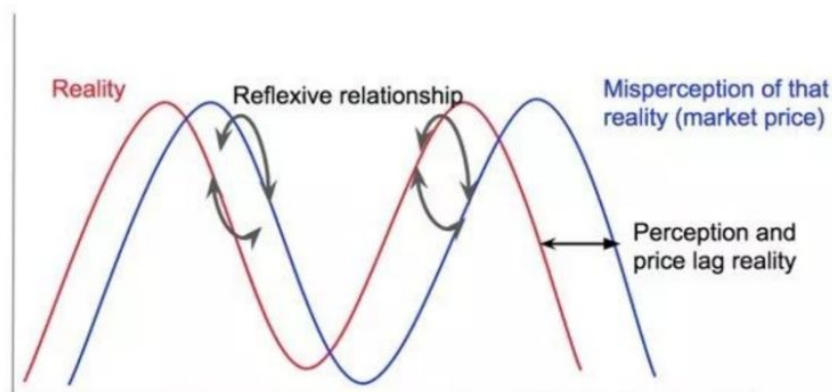
*Other "missing" ingredients: Past tops typically have also seen such factors as public speculation, insider selling, and the end of a new issues boom. The argument goes that we won't get a top of any consequence until these additional factors appear.*

*Tops are not made in a day. Unlike bottoms, which often can abruptly materialize on a climatic panic, with many stocks making their lows at the same time (although still requiring ample subsequent base-building), tops form over a much longer period of time. Also unlike bottoms, which form in anticipation of discernible, albeit unbelievably, change, tops seem to come out of nowhere, indeed, out of a glowing good-news climate. Nevertheless, **there are several repeatedly appearing essential ingredients to tops, the chief of which is, of course, how to fool the most number of people into confidently holding (and even buying) stocks as the bull market ends. The way this is done is often almost by magic. Tops don't look like tops.***

*Everyone kept saying 'a top is not in place yet.' They persistently pointed to the 'normally reached' levels of this or that statistic that were not yet there to reinforce their desire to remain bullish. ... Apart from statistical measures of increasing blindness, this unwillingness to acknowledge what they themselves were already feeling revealed a comfortableness, a confidence, a conviction that whatever was happening – short-term survivable dips – would continue . . . until 'the top,' like a striptease artiste of our youth would, with decorum, appear on stage, bow, and then, accompanied by applause from all the bulls eager to cash in on their excitement, would begin to twirl its statistical tassels in front of everyone.*

*I've gotten so old I can't remember the names of those ladies at the Old Howard, but I can remember that all you got was a flash of this or that, before they waltzed off. Stock market tops are like that. You know it's there somewhere if you squint hard enough, but you never quite see it, so you keep waiting for more. And then, in the end, as the curtain comes down on the bull market you realize that the one rule about tops is not that they provide this or that signal, but that **they come before anyone is ready.***

Markets are counterintuitive by nature. The underlying [reflexive process](#) between the observer (market participants) and the observed (markets) makes it so.



I recall something [Bruce Kovner](#) said once about a successful trader he worked with. Kovner commented that “one of the traders I know does very well in the stock index markets by trying to figure out how the stock market can hurt the most traders.”

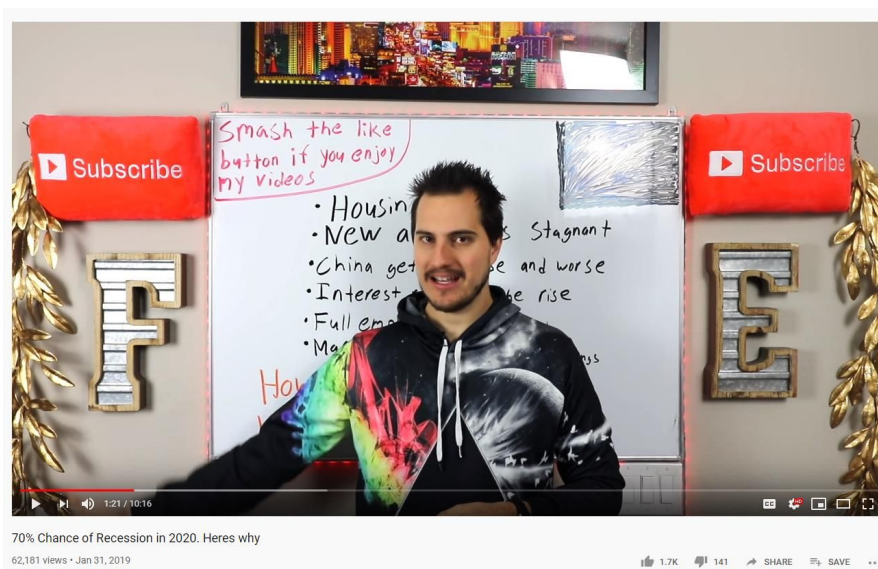
I’ve found that most market participants have a rather difficult time fully grasping this idea of [embedded expectations](#) -- known facts already reflected in the price. You see, the market will always move against the direction of the consensus (ie, hurt the most traders). It has to... The reason being is that’s the path of least resistance because the consensus is already baked into the price -- like I said, counterintuitive.

This is why [playing the player](#), **identifying the collective sentiment and how the majority of the market is positioned is critical**. It pays to know which directional trend “can hurt the most traders.” We’re all playing Keynes’s Beauty Contest after all; most of us on the 1st level but some on the 2nd and a few even higher.

This is why I find it silly that there’s been such a fuss being made about the low ISM print in the US, falling export growth in South Korea (a bellwether) and the likes. I’m not saying that these things aren’t signs of slowing growth. They sure are. But they certainly don’t guarantee a bear market and recession.

I wrote a piece recently about how #Recession2020 has been trending on YouTube for the last few months. Nearly every swinging dick and Mary on there is blabbering on about it. Young millennial social media influencers -- most of whom probably think an e-mini is some new party drug -- are confidently saying a recession is on the way.

No offense to this guy and his sweet threads but I think I’ll go elsewhere for my macro calls.



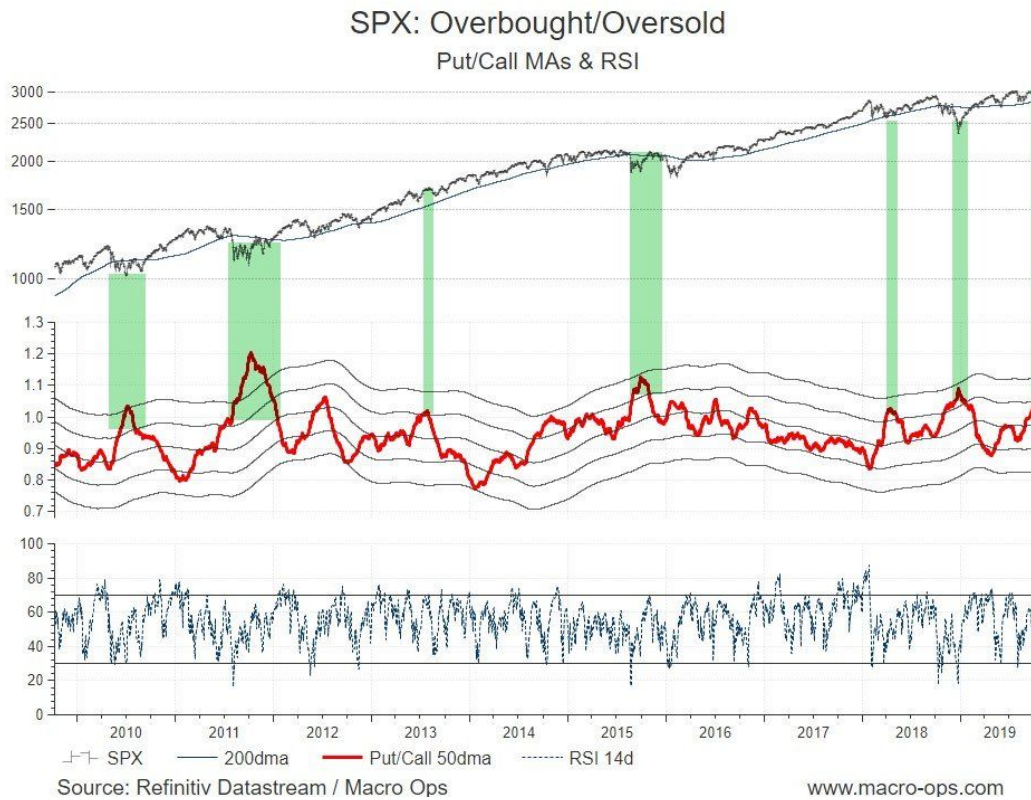
Here's the thing. It's like old' Mammis said, "market tops come before anyone is ready". And everybody just seems too ready right now, don't they?

Yeah, markets don't work like that. They never do.

This isn't my subjective opinion either. We can see this directly in the positioning.

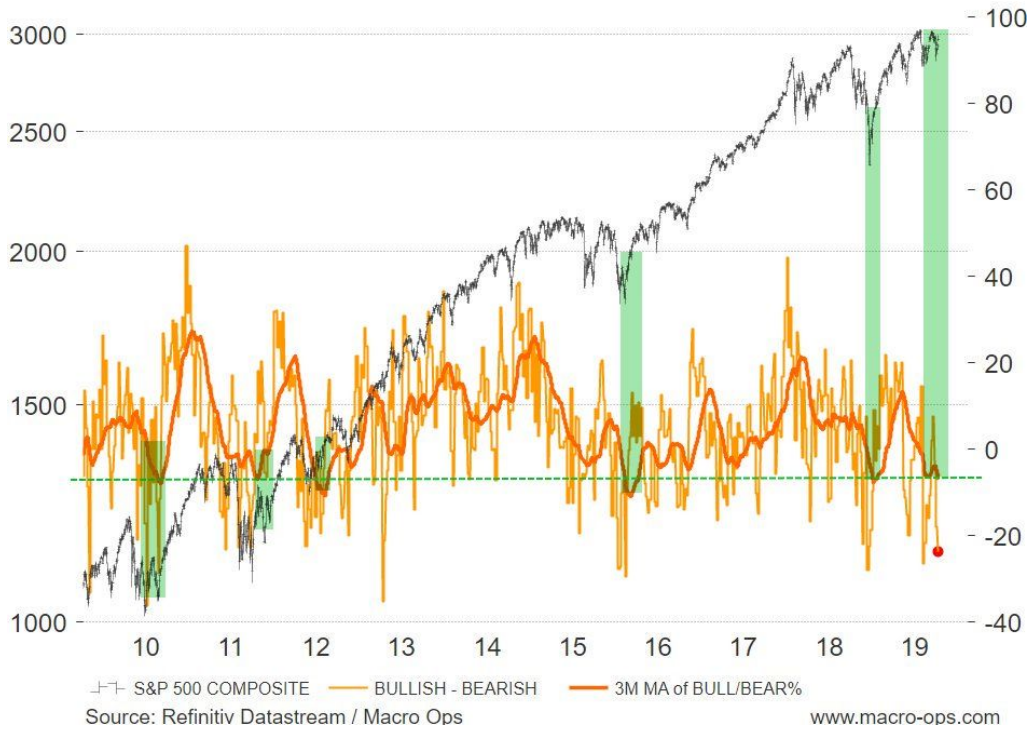
US markets are at or near all-time highs in the history of the world but investors are moping around as if their dog was just run over.

The 50-day moving average of Put/Calls is over its rolling 1-stdev level; meaning investors have been persistently buying downside protection at near-record rates. The latest BofAML Global Fund Manager shows the same, managers have been buying protection against extreme downside moves at the highest rate since the survey began.



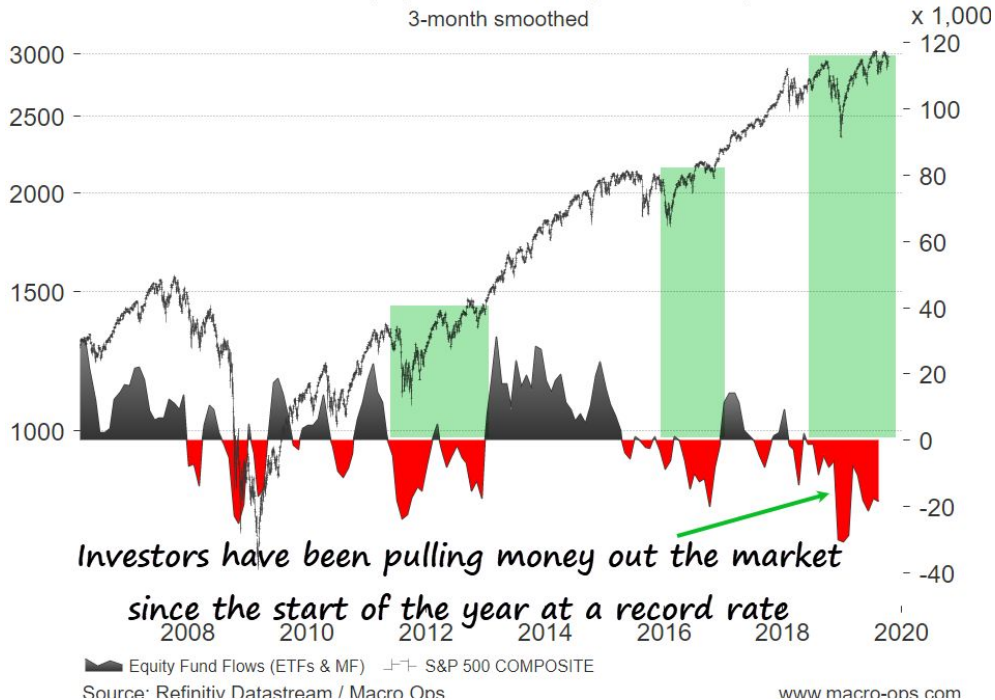
The investors who've been responding to the AAI survey are a bunch of cranks. The quarterly moving average of Bulls-Bears is at cyclical lows (meaning extreme pessimism).

AAll Bull-Bear Sentiment



And investors have been yanking their money out of the market at a record rate since the start of the year.

ICI US Equity Fund Flows (ETFs & MF)



Just to really kick this dead horse. Let me share this excerpt from the legendary technician, Walter Deemer, who wrote in his book “Deemer on Technical Analysis” this about market tops (emphasis by me).

*How Do You Know When the Market Has Topped? How Do You Know When to Sell?*

***First and foremost, gauge market sentiment. When the time comes to sell, you won't want to.***

*At some point, everyone who wants to buy has bought, and prices will stop going up. That is a bull market top.*

*At a bull market top, the market advance usually slows over a lengthy period of time. No one wants to sell. **Everyone is happy. Everyone thinks that the market will keep going higher. The newspapers are full of glowing headlines and reports.** It takes a bit of intestinal fortitude to say that this news is the reason why the market has already gone up, and it, therefore, may be time to back away and do some selling.*

*When everyone who wants to buy has bought, there is usually not much for sale. But unlike, say, commodities, where fear of scarcity causes price spikes, prices tend to remain steadier than seems normal.*

*Market tops usually take a while to form. There is usually time to get out. But always remember: When the time comes to sell, you won't want to; the news is always good — very good — at a top.*

Wise words Deemer, wise words.

Back to the inverted [yield curve](#) and horrid ISM numbers.

These are important data points to watch. They're both an integral part of my process of trying to discern where the macro winds are blowing. The keyword there being “process”. You can't cherry-pick data and look at it in isolation. [Confirmation bias](#) runs deep in all our veins which is why we need to look at things holistically. See where the odds lie and all that.

You can find my primary “Recession” dashboard” below (I recently wrote a piece on it [here](#)). Click on any of the links to see that specific chart.

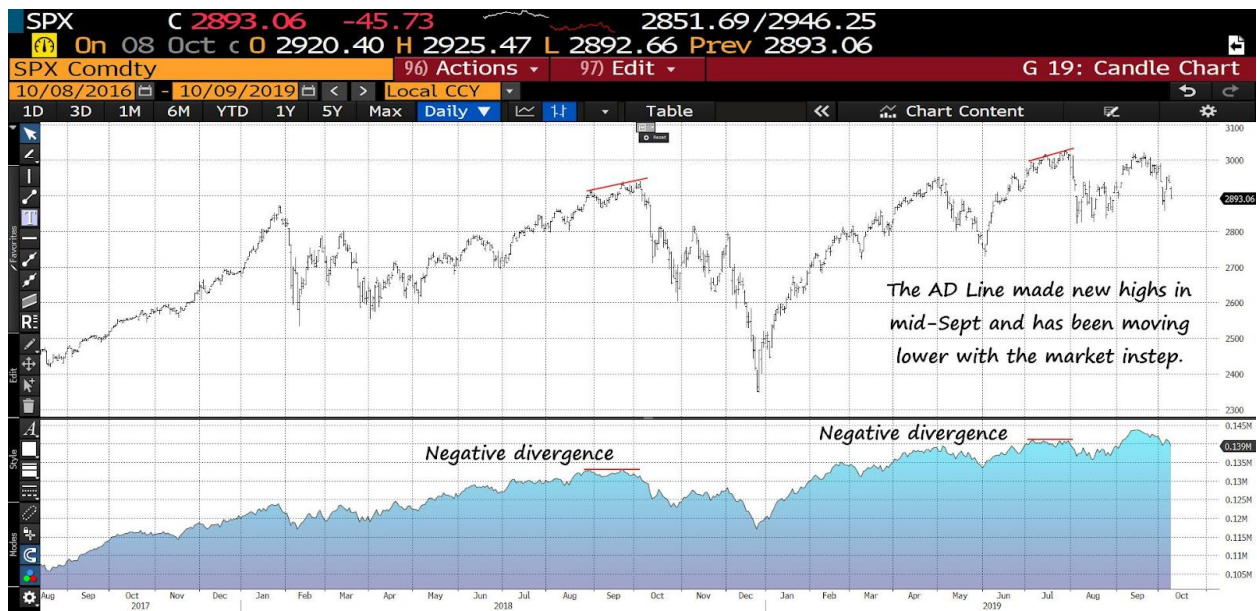
Early U.S. Recession Indicators				
Indicator	Median Lead Time	Current Cycle	Key Recession Level	Current Level
<a href="#">Conference Board LEI Peak</a>	10-months	New cycle high	Negative YoY%	+1.08
<a href="#">Yield Curve Inverts (2s10s)</a>	19-months	2-months	NA	NA
<a href="#">Initial Claims (4wk avg) Trough</a>	8-months	5-months	36-month MA crossover	Well below
<a href="#">SPX Peak</a>	7-months	2-months	Below 50-week MA	Above
<a href="#">New Housing Starts Peak</a>	28-months	New cycle high	NA	NA

Leading/Coincident U.S. Recession Indicators		
Indicator	Key Recession Level	Current Level
<a href="#">Consumer Confidence Index</a>	36-month MA crossover	Above
<a href="#">Breadth of Philly Fed State Leading Indexes</a>	Below 0.7	1.4
<a href="#">ISM Manufacturing Index</a>	Below 44	47.8
<a href="#">ISM Non-Manufacturing Index</a>	Below 51	52.6
<a href="#">Conference Board's Business Confidence Index</a>	Below 43	34
<a href="#">Unemployment Rate</a>	12-month MA crossover	Below
<a href="#">Real Retail Sales YoY%</a>	Negative YoY%	+2.3%
<a href="#">Adjusted National Financial Conditions Index</a>	Above 0	-0.65
<a href="#">Kansas Fed Financial Stress Index</a>	Above 0	-0.35

The data shows there are some increasing signs of economic weakness but the weight of the evidence suggests we're still in the leveraging phase of the [short-term debt cycle](#).

Then there's the market itself, which as [Druckenmiller](#) likes to say is "one of the best predictors of recession". And a close review of the tape and the market's internals show that demand is still outstripping supply, as I recently laid [out here](#).

Leading cyclical sectors in the US are on the rise. The AD Line made new cycle highs last month -- the AD line tends to diverge from the market for months when forming a cyclical top.



Outside of the US, things are a bit different.

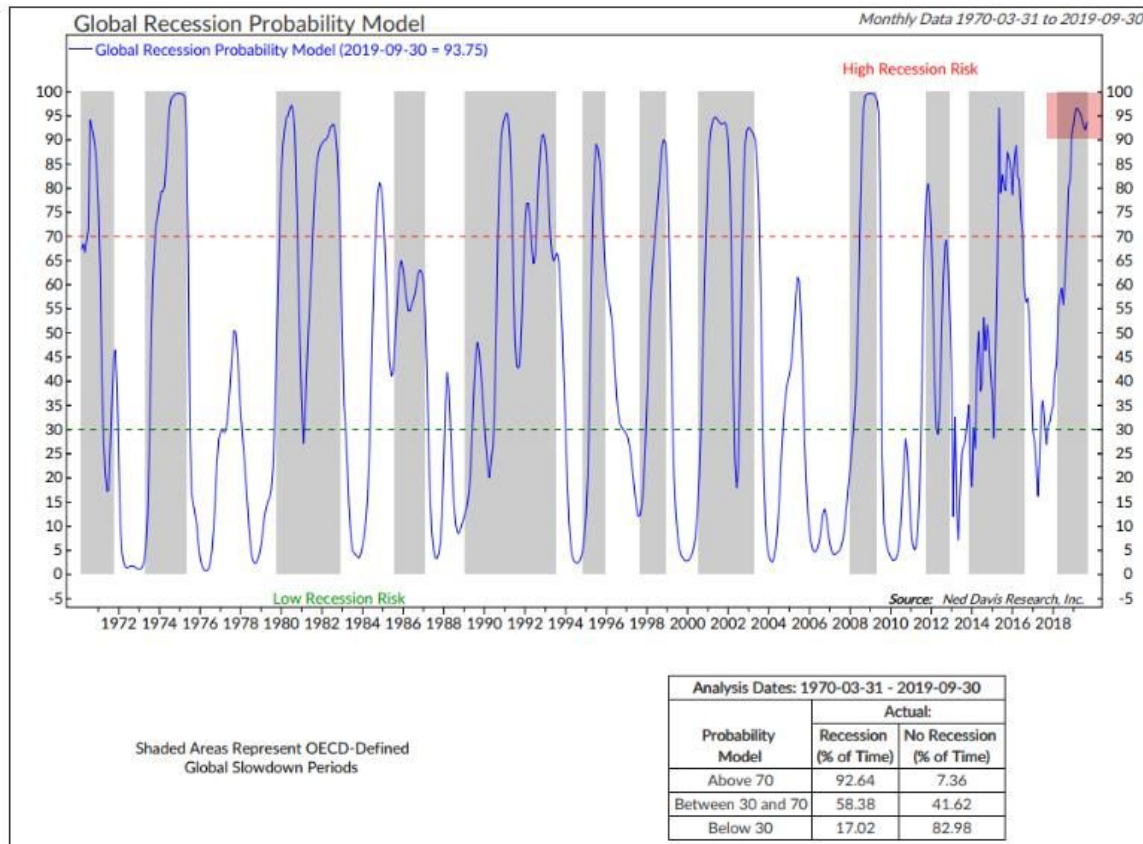
Most global markets have been in an extended bear for the better part of 2-years.



The negative trend in much of the world is due to a poor global economy with many countries experiencing a contraction in growth that began in the middle of last year. NDR's Global Recession Probability Model shows that much of the world is in a technical recession.



Global ex.US recessions last 14-months on average. That would put this one ending sometime near the end of this year.



This global slowdown has been driven by four factors, none of them being the “Trade War”:

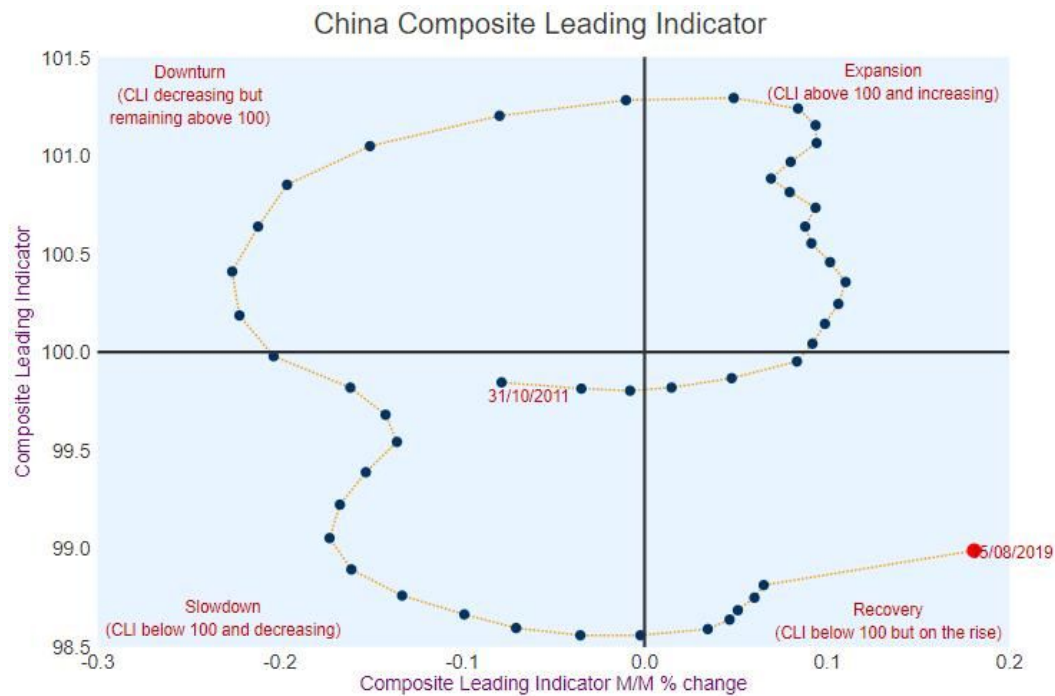
1. This is the BIG one. **A deleveraging China.** We should really call it a “deleveraging with Chinese characteristics” because they haven’t actually deleveraged, just slowed the pace of credit creation. China has become the engine of the world economy so the tightening in the shadow lending market and the subsequent slower global growth is no surprise.
2. **A Fed that ran too tight.** The Fed raised rates too fast last year and now they’re working on reversing that error.
3. The transition to the **backend of the Chinese and US fiscal impulses.** The rate of growth that boosted us on the way up has worked against us on the way down.
4. Newly introduced **Chinese and German 6a emission standards** created a global bear market in auto demand, so much so that the “new passenger car registrations fell more sharply (in absolute terms) than during the global financial crisis” according to *ING*, a bank. This echoed throughout the global supply chain (a lotta steel, copper, plastic,

rubber etc... goes into making vehicles) and intensified the contraction in global manufacturing.

Going back to where we began with understanding what's already embedded into the price. These are all now known knowns. The four factors above have been discounted, hence the 21+ months of sideways action in the NYSE and bear markets in global markets. Even better, most of these factors have reversed, are flattening out, or were one-off events.

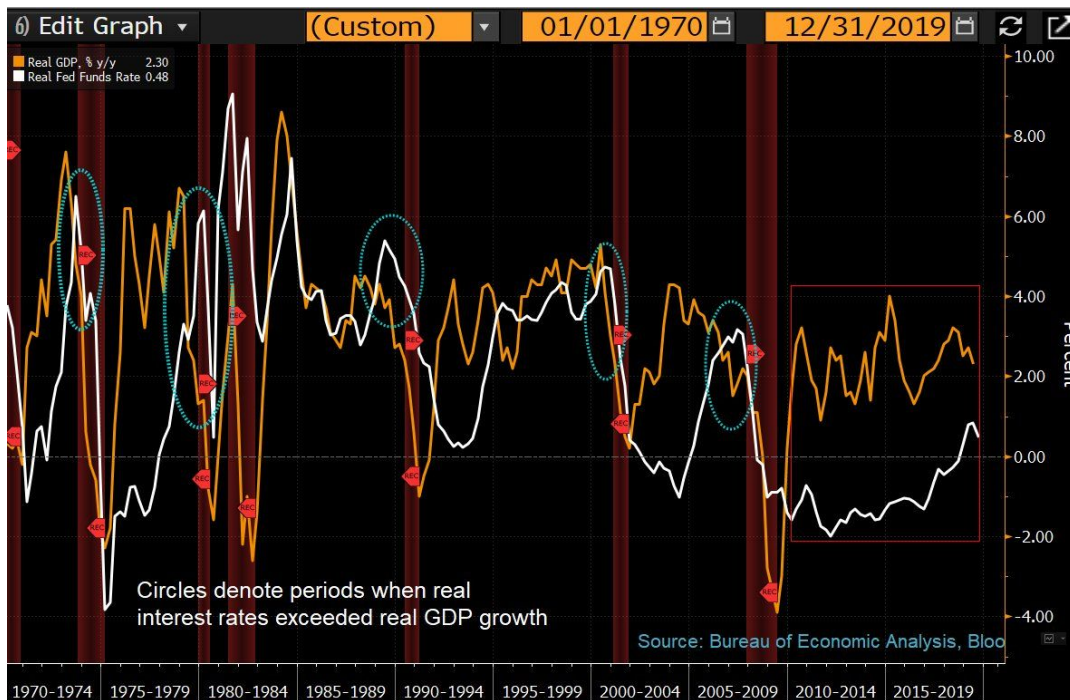
Starting with the top: Chinese deleveraging.

Momentum in the Chinese economy is still weak but it's becoming less so. PMIs have perked up and our China CLI has moved firmly into "recovery" territory.



Source: Refinitiv Datastream / Macro Ops

The too-tight Fed has reverted back to doing the Greenspan Jig; reversing course on their tightening. Plus, real rates remain well below real GDP.



We're moving off the backend of the fiscal impulse into better base effects (the past data in which YoY% is measured against). This means easier hurdle rates going forward.

And finally, auto-demand. It was a one-off event and global demand for car vehicles will improve going forward (the data is already showing this).

So, yeah, spiking [repo rates](#), ISM in free-fall, and [inverted yield curves](#) are scary things. But this is the market; there's always something to fret about. That's what builds the wall in which stocks climb.

**The market is a discounting machine and looking out 6-12 months, things look better than they are today.** China will stabilize, the Fed will stay easy, the global manufacturing recession will soon end. And we'll return to a very low but positive growth world -- which just so happens to be the best type of environment for risk assets.

I know that probably reads as complacent head-in-the-sand thinking to some of you. It's not easy taking this position, which means it's more than likely the correct one. Markets are funny like that.

## A Reversal in Flows: Buy the Despicables

Give me a place to stand,  
and a dollar that's trending,  
and I can move the world  
~ Archimedes

Archimedes, the Greek tinkerer, knew of the US dollar's importance to global macro well over 2,200 years ago, decades before Fed Chair Powell was born. A man ahead of his time.

If you read my work then you know that I refer to the dollar as the world's fulcrum.

This is no exaggeration. The US dollar is that important in global markets.

The deeper you get into the global macro game the more you realize nearly every trade is a derivative of a long or short dollar position.

Long Brazilian equities? You're short the dollar.

Long airliners? You're making a macro call on oil and thus the dollar.

Long volatility? You've got an embedded dollar call there.

Short inflation through duration? Then you're long the dollar.

The dollar is important.

Why is this?

Short answer is the dollar is the world's reserve currency. It's what commodities and goods are priced in for global trade, and it's the dominant global funding currency. The dollar is pervasive and it's everywhere which is why the Fed swings the biggest stick of them all.

If you can figure out the path of the dollar then you're starting from an advantaged point in assessing where the other major macro trades are headed. It's always my starting point when analyzing any market.

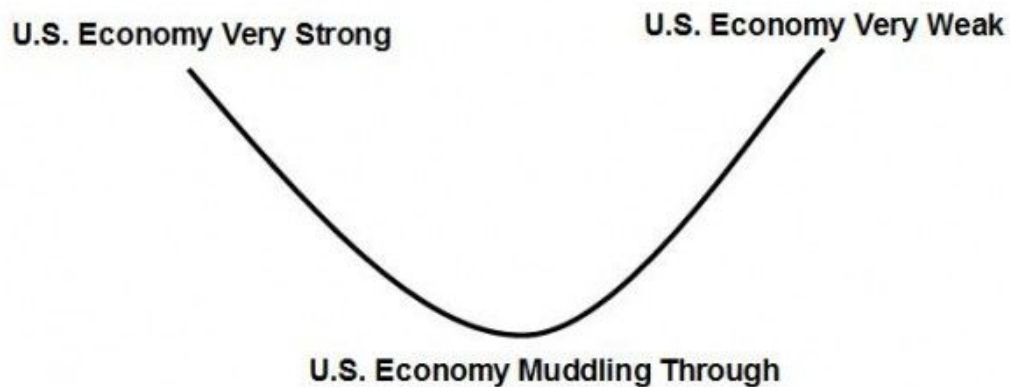
With that, let's walk you through some of the models I use to look at the dollar.

### **Some dollar models.**

I've shared a more in depth piece on the way I think about FX that you can find [here](#). In it, I hash out Soros' arrows and the core/periphery model.

Today we're going to talk about the "dollar smile" concept put forth by Stephen Jen of Morgan Stanley because it's relevant to our conversation.

The theory is simple. It states that the dollar tends to outperform when the US economy is very strong (on the left side of the smile) or very weak (right side). And it does poorly when the US economy is just muddling through (middle of the smile).



Why is this?

Well, the logic is straightforward.

The US trades at a "safety premium" relative to other countries.

When the US economy is performing well, investing in the US is a no brainer. And since well over 80% of the moves in the FX markets are due to speculative flows, this fact matters.

And when the US economy is very weak, the dollar performs well because it gets a safety bid. Money gets pulled back from overseas to within safer borders.

Most international funding is done in USD dollars. And when volatility increases and markets are perceived as riskier, these dollar loans are called back and Brazilian Reals or whichever, get converted into USD to cover the dollar debt thus putting upward pressure on the dollar.

But when the economy is in the middle of the “smile” and just muddling through, the dollar tends to perform poorly... why?

Well, the primary reason is that mediocre growth and low inflation are bullish for risk assets because it keeps the Fed steady and prevents them from raising rates too quickly.

**So a steady [Fed keeps interest rates low](#). These low-interest rates suppress volatility and push investors further out the risk curve in search of returns. They go overseas to high growth emerging markets to play in their fertile fields.**

Low growth and low rates lead to speculative outflows from the US, which drive the dollar down relative to where the capital is flowing to.

There’s a reflexive relationship in these FX flows that starts to dominate.

This is because currencies make up the largest pie of the total return picture when investors put money into foreign markets.

So when speculative capital leaves the US because of low rates and slow growth, and then flows into, say, Latin America. It depreciates the dollar while appreciating the Latin American currencies. This drives up the total return of those investments in these EMs which then attracts more speculative flows (ie, reflexivity).

Here’s a short snippet from [Soros](#) on the mechanism.

*To the extent that exchange rates are dominated by speculative capital transfers, they are purely reflexive: expectations relate to expectations and the prevailing bias can validate itself almost indefinitely... Reflexive processes tend to follow a certain pattern. In the early stages, the trend has to be self-reinforcing, otherwise the process aborts. As the trend extends, it becomes increasingly vulnerable because the fundamentals such as trade and interest payments move against the trend, in accordance with the precepts of classical analysis, and the trend becomes increasingly dependent on the prevailing bias. Eventually a turning point is reached and, in a full-fledged sequence, a self-reinforcing process starts operating in the opposite direction.*

This is why currencies tend to trend for long periods of time once they get going. See the 7-year USD cycle below.

## Dollar history, 7-year cycles?



Strong US growth = outperforming dollar. A very weak US economy = strong US dollar. And a muddling US economy = weak dollar.

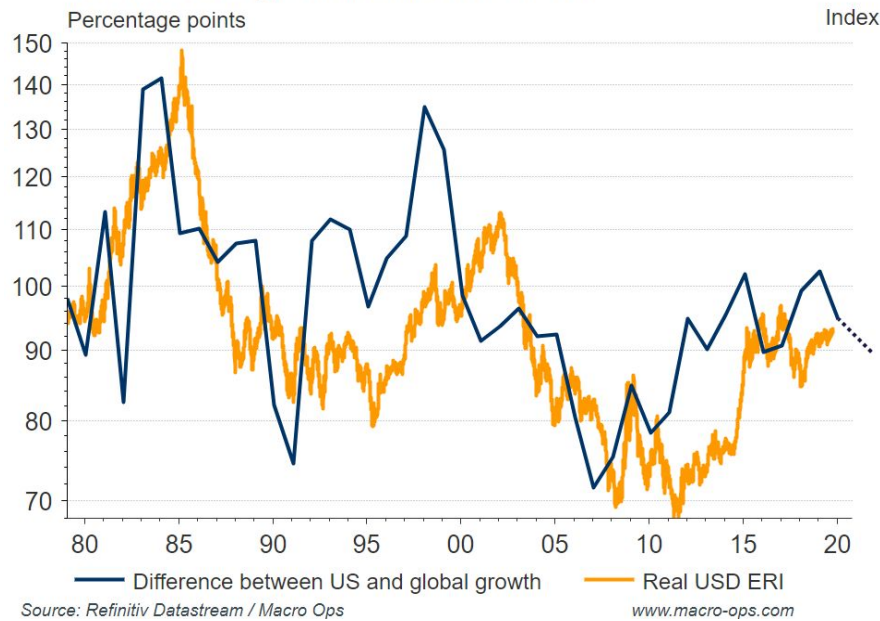
I should point out an important point that I'm not sure Stephen Jen mentioned when he introduced this concept. But all of this is relative. We don't care about the US's economic growth on an absolute basis. **We care about its economic picture *relative* to that of the rest of the world's (ROW).**

If the US is muddling at sub 2% growth but emerging markets are a dumpster fire, like they were following the GFC, then that's still dollar bullish.

The idea is that investors have to perceive risk to be low and the reward to be well above the US's premium, in order for capital to leave our beautiful shores and invest in a Chilean poultry producer or whatever.

The chart below shows this dollar smile relationship at work. Blue line shows the US's growth relative to the rest of the world (ROW) and the orange line is the USD (the dotted blue line is our relative growth forecast).

## US relative growth and the dollar



It works because if growth in the US is strong relative to the ROW's then it means that the Fed is likely leading developed markets in raising interest rates. This makes the US real interest rate spread more attractive. And vice versa when the US is performing well below the ROW.

And as [Soros](#) said, the “expectations relate to expectations” that drive FX trends far from their “fundamental equilibriums”. This is why we always need to be trying to understand the market's expectations around future **relative** growth and rates.

**Once we understand the embedded expectations we can compare them to the likely outcomes and see if there's a divergence between the two.**

**If there is, then we can identify potential catalysts that would reprice these expectations to be more in line with reality. And then we have a trade.**

So what are today's expectations then?

Well, we've already covered where we've been, where we are, and where we're likely headed.

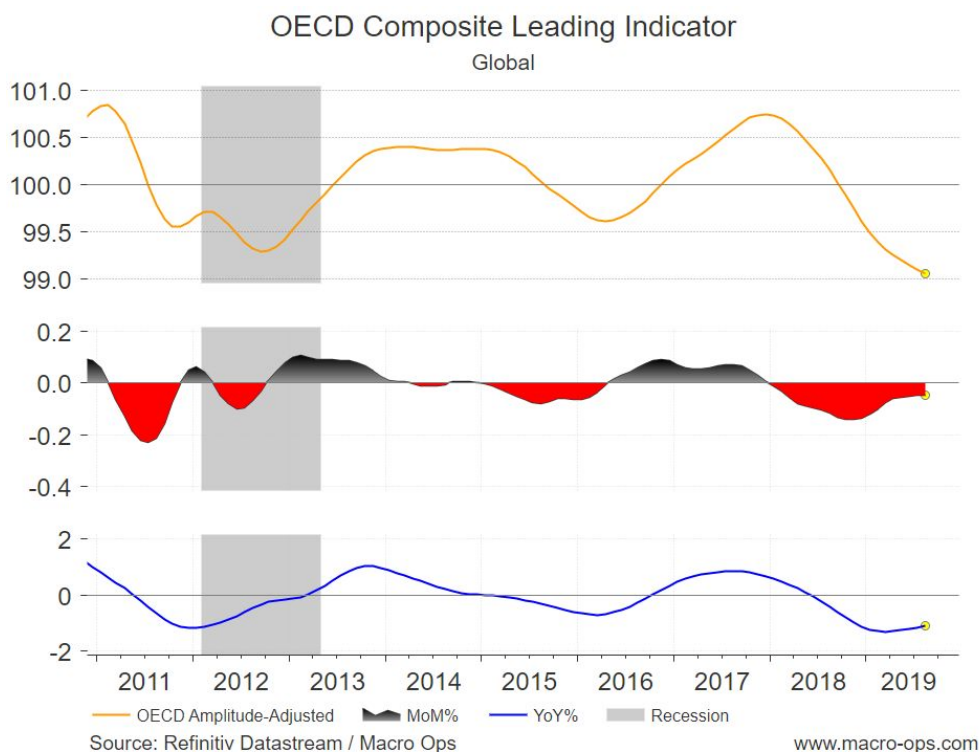
In dollar model terms, we've been in an environment ideal for a stronger dollar over the last 18-months. Emerging markets and the RoW have suffered an extended bear market on the back of a hawkish Fed and slowing Chinese growth. All while the US enjoyed idiosyncratic strong growth due to tax cuts and fiscal stimulus.



Trade wars and real wars have driven policy uncertainty (read: risk-off sentiment) to record levels. It's a wonder the dollar didn't trade much higher than it has -- all told and done the Fed's broad traded dollar index is still below its Dec 16' peak.

That alone should be telling. That, under the above circumstances, all the ole' greenback could muster was a grinding low angle trend higher.

But consider where we are now. There are signs that global growth ex.US is bottoming (see the rate of change in the OECD CLI turning back up) while at the same time our leading indicator has US GDP trending down to sub 2% real growth in the coming quarters.

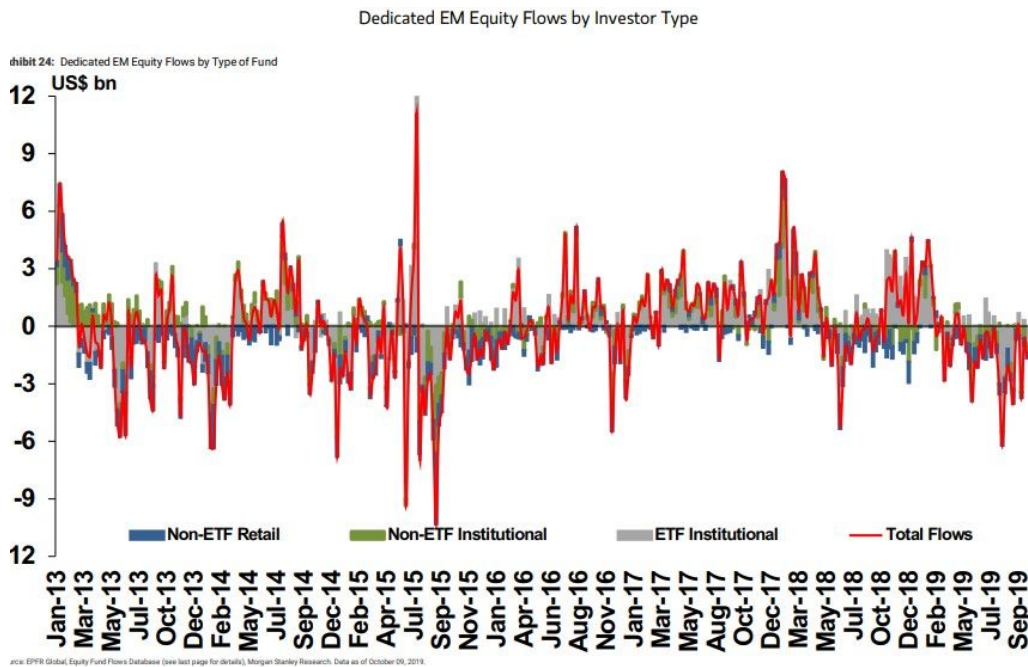


But investors are always playing the past which is why they get burned at the turns. They fail to anticipate! Global fund managers are positioned in US equities over 1 stdev above their long-term average (chart via BofaML).

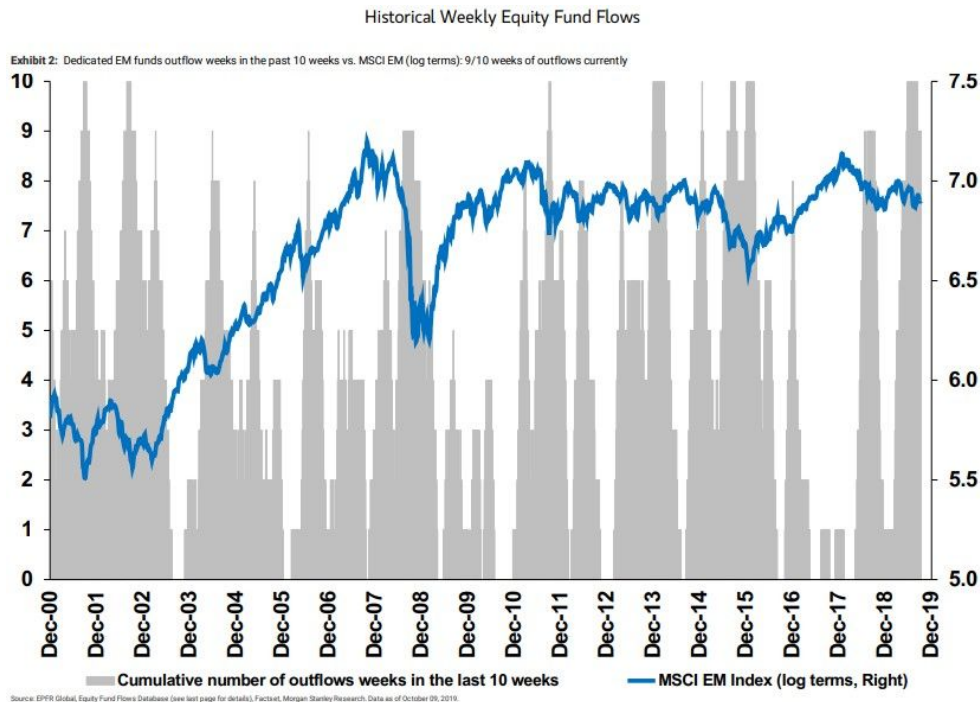


Source: BofA Merrill Lynch Global Fund Manager Survey

While they've been consistently pulling money out of emerging markets over the last year (chart via MS).



This has been some of the most persistent and extended outflows from EM markets over the last 19-years (chart via MS).



This leaves us with converging US/RoW growth on the back of muddling but improving economic conditions globally. **We have high capital concentration in the US and historic outflows from EM markets as well as near-record low positioning in Europe and Japan.** Are you seeing the picture I'm painting here?

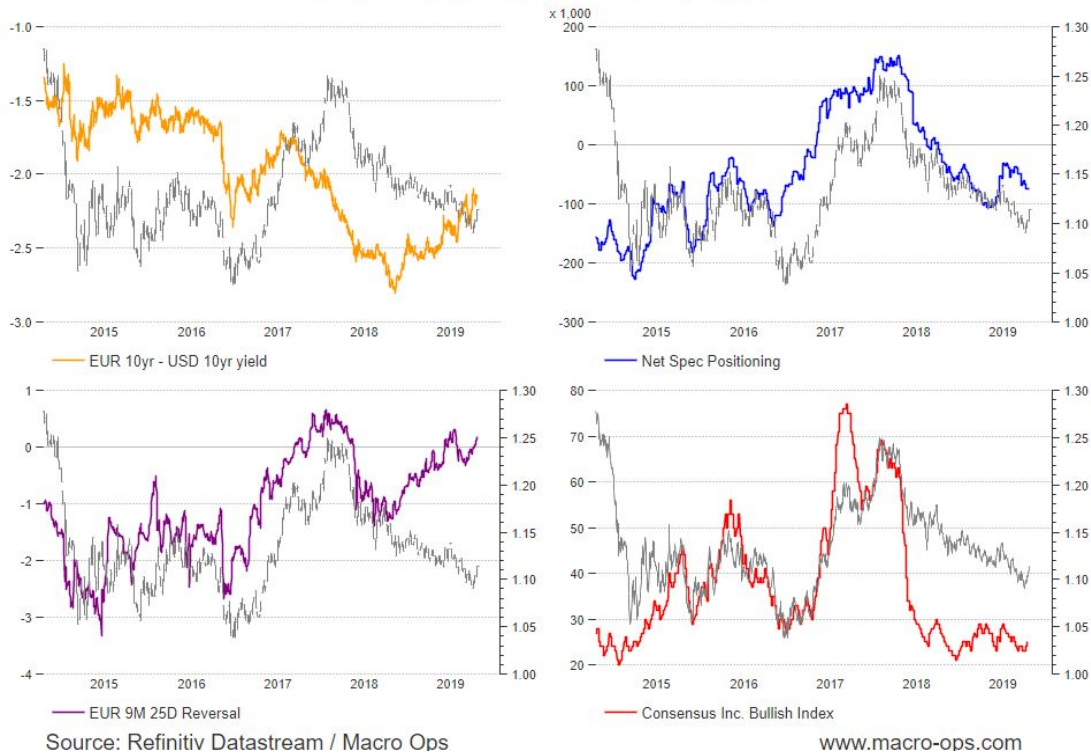
Now, no talk about the dollar would be complete without a review of the euro. After all, the euro makes up roughly 60% of the trade-weighted USD basket.

Let's have a quick look at a few of the euro's core drivers.

1. **Rate differentials:** The German/US 10yr spread bottomed in mid 18' and has been trending up ever since (rate spreads almost always lead currencies on big moves).
2. **Positioning:** Spec positioning has all been reversed from its 17' highs and is now net short.
3. **Risk-reversals:** The options market turned around the same time rates did and have been pricing in a higher euro ever since.
4. **Sentiment:** The Consensus Bullish Index shows max pessimism for the euro's prospects.

### Euro (EUR) Drivers

Rate Differentials, Positioning, Risk Reversal, Sentiment



The tape is the final arbiter of truth and for dollar bears to be able to claim victor then we need to see DXY make a new pivot low. That would be a close below the spot 96 level. The dollar just closed below its 200dma, so it's making progress towards bear territory. I'm short USD through long CADUSD but am positioning gingerly until we see confirmation in the trend.



There's also a few structural changes that could really turn the downtrend into something nasty (read: profitable).

For instance, one thing that not many people are talking about is what's going on with Treasury issuance and how it could impact things.

We're currently running a deficit of roughly 4% of GDP. When you factor in the size of the deficit, the low growth rate of the economy (sub real 2%), and the maturity of our debt profile. In just a few years, we end up with massive debt roll-overs. I'm talking about gross Treasury issuance in the realm of **25% of GDP or higher. Every year.**

Normally, people don't pay much attention to our debt rollovers because there's little reason to. But here's the rub. Foreigners hold a large portion of these IOUs and if you're a foreign investor (1) you've likely been burned, threatened, or strong-armed by our government recently and (2) you're probably looking at the fast-growing pile of Treasuries and thinking about maybe parking your money elsewhere.

The pressure from our rising gross issuance can only be relieved through one of two ways. It can reset through higher interest rates -- unlikely due to the anchoring of low rates globally. Or it comes through on the FX side, in say a lower dollar. A much lower dollar.

My bets on the latter but we'll see. It's a crazy world we live in.

Other than the CAD my favorite way to play a devaluing dollar is the Mexican peso (MXDUSD).

There are many reasons to like the peso but, like everything in this game, we have to start with the chart. And the peso has one of the best looking FX technical setups I've seen in a long while. Here it is on a weekly basis. You can see it coiling tighter and tighter over the last 3-years. Nestling right below its 200-week moving average.



The peso has the highest positive carry of any major currency at the moment.



Rank	Currency	Symbol	Interest Returns (%)
1	Mexican Peso	MXN	8.69
2	South African Rand	ZAR	6.99
3	Brazilian Real	BRL	5.54
4	United States Dollar	USD	2.56
5	New Zealand Dollar	NZD	1.93
6	Canadian Dollar	CAD	1.90
7	Singapore Dollar	SGD	1.82
8	Australian Dollar	AUD	1.77
9	Norwegian Krone	NOK	1.33
10	South Korean Won	KRW	1.27
11	British Pound	GBP	0.84
12	Taiwanese Dollar	TWD	0.65
13	Swedish Krona	SEK	-0.16
14	Japanese Yen	JPY	-0.20
15	Euro	EUR	-0.37
16	Danish Krone	DKK	-0.54
17	Swiss Franc	CHF	-0.71

And then we have a number of large positive shifts on the structural side. The biggest being the US/China trade war. This is a spat that will ebb and flow over the short-term but the conflict between the US and China will only intensify over the long-term.

What this means is that we’re **only seeing the very beginnings of a great move towards deglobalization and the regionalization of major economic spheres**. There will be many winners and losers in this game but one of the surest winners will be Mexico.

Mexico is already seeing big gains from the trade conflict with an increasing number of MNCs looking to relocate and/or expand operations in the US’s southern neighbor. The value of Mexican imports into the US overtook those from China for the first time just this past March.

Finally, there’s been recent positive developments on the USMCA front and it’s looking likely that the Democrats and the Trump admin will wrap things up here shortly. If you’re looking for a positive catalyst to propel the MXN out of its coil, well there you go.

Keep an eye on the tape for “the tape tells all”. It may soon be time to make a run south of the border.

I’ll end things there and leave you with a quote.

‘The market,’ says Mister Johnson, ‘is like a beautiful woman — endlessly fascinating, endlessly complex, always changing, always mystifying. I have been absorbed and immersed since 1924 and I know this is no science. It is an art. Now we have computers and all sorts of statistics, but the market is still the same and understanding the market is still no easier. It is personal intuition, sensing the patterns of behavior. There is always something unknown, undiscerned.’ ~ “Adam Smith”, *The Money Game*

Best of luck in “sensing the patterns of behavior”.