Perpetually Unstable Organization

Summary:

- Selloff: What to expect
  - Odds favor more downside/chop ahead
  - What to look for to indicate a bottom
  - Covid-19 update
- Fattened equity risk premium
- Portfolio Update

> *In this simplified setting of the sandpile, the power law also points to something else: the surprising conclusion that even the greatest of events have no special or exceptional causes.* ***After all, every avalanche large or small starts out the same way, when a single grain falls and makes the pile just slightly too steep at one point.*** *What makes one avalanche much larger than another has nothing to do with its original cause, and nothing to do with some special situation in the pile just before it starts.* ***Rather, it has to do with the perpetually unstable organization of the critical state, which makes it always possible for the next grain to trigger an avalanche of any size****.*
> ~ Mark Buchana, "Ubiquity: Why Catastrophes *Happen"*

Markets have been in a "perpetually unstable organization of the critical state" for the last few weeks, as I've pointed out here and here.

Decade high valuations, overzealous sentiment/positioning, and stretched technicals made a move like this inevitable. Though the fact that Covid-19 — an impossible to model global pandemic — is the catalyst, certainly throws some extra fuel on the fire.

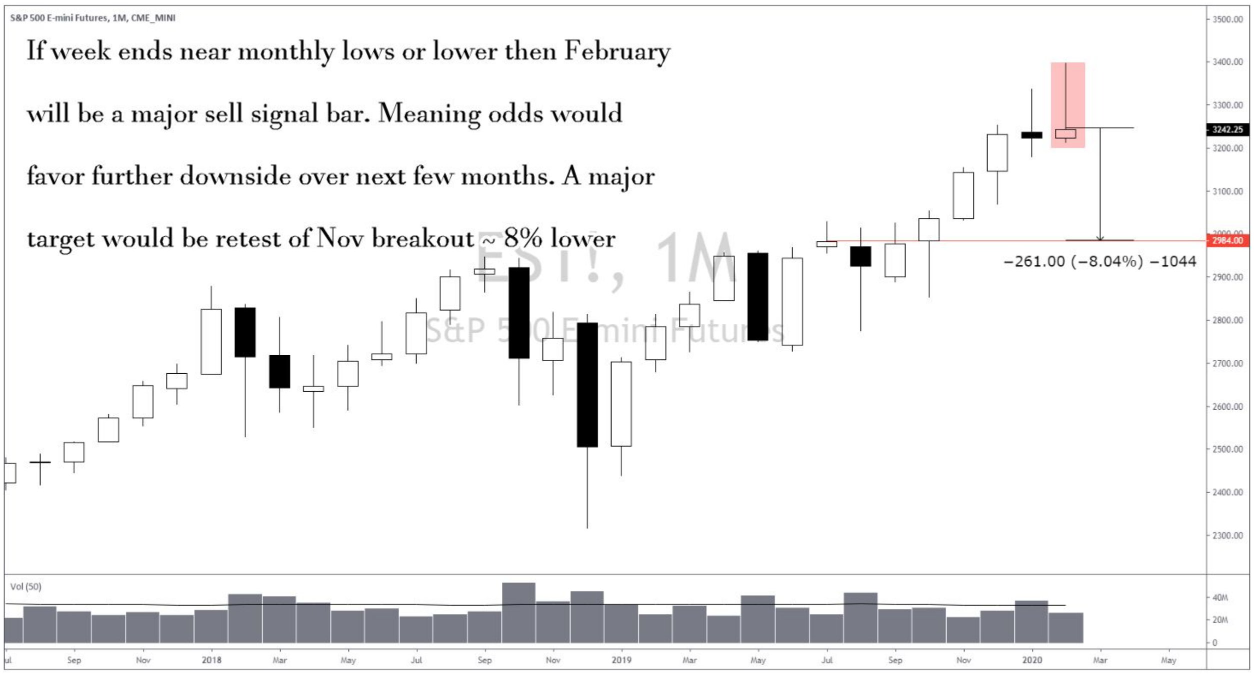
While the SPX's year-to-date gains were all wiped out today. Our large (200% of NAV) long bond position, our 25% allocation to gold, and our large cash position kept our portfolio more than buoyant.

My base case is for further chop and downside ahead. I'll be using rallies to further reduce risk by taking partial profits on some of our positions while we wait out the chop for some greater technical clarity.

Here are the technicals I'm looking at for the SPX.

This is the final trading week of the month (monthly bars below). If the SPX closes below its open then it'll complete a bearish reversal bar for February. This would put the odds in favor of further downside follow-through in the months ahead.

The next major support level would be a retest of the Oct/Nov breakout level near the 3,000 range — roughly 8% lower than current prices.



On a daily timeframe, the market has completed three large surprise bear bars. This means there's a lot of trapped bulls who will be selling into any rally. So rallies will likely be short-lived and odds favor at least one more leg down. A measured move target from the base of the current trading range would put us near 3,030 — 6%+ lower from current prices.

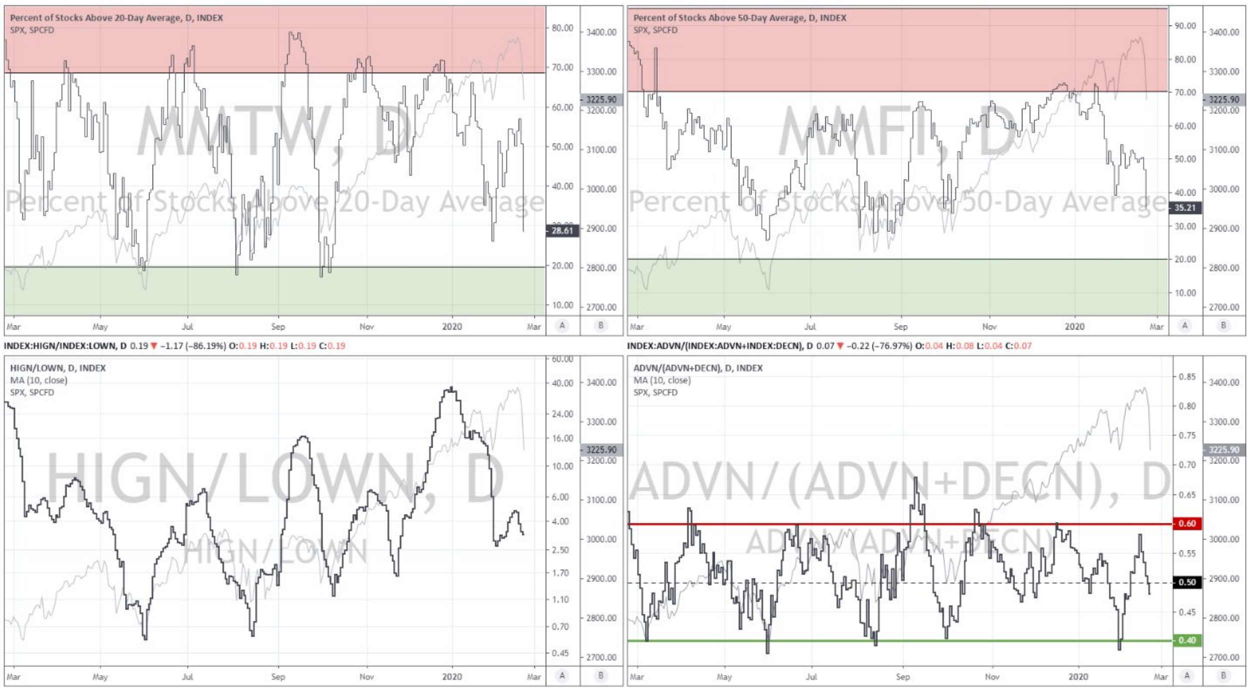
But… the SPX is at support in its lower Bollinger Band and short-term double-bottom so there's a chance we see a slight bounce here as bears cover their initial shorts.

Look for fear and capitulation to mark a bottom.

We've been in a 4-month long buy climax where a lot of crowded positioning was built up. There's quite a bit of length that needs to be unwound. This is going to take some time and some volatility.

Take the 20-day moving average of the Put/Call ratio for example. It fell to its third-lowest point in five years. We want to see this move back above 1 before an all-clear can be declared.

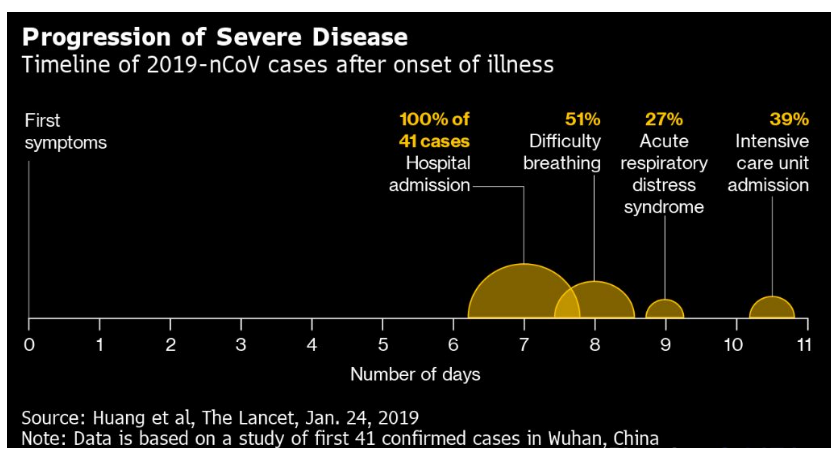
And ideally, we want to see oversold conditions in the percent of stocks trading above their 20-day moving average (top left) and even better if we can get there on the 50-day as well (top right). Our Zweig Thrust indicator (bottom right) also has a good track record of marking bottoms when it crosses its lower green line.



Covid-19

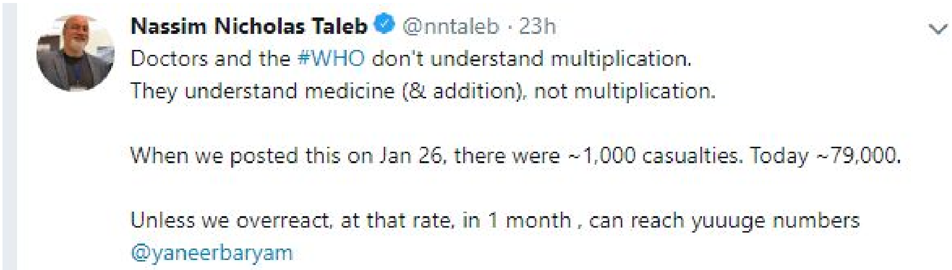
Clusters of the virus are now firmly entrenched and spreading rapidly in China, South Korea, Japan, Italy, and Iran. With the number of cases topping 80,000.

The insidiousness of this virus — the extended lag-time between when one becomes infectious to the time they develop symptoms — nearly ensures that this virus will become a widespread pandemic.



I noted in last week's Musings that while it's impossible for anybody to know exactly how bad things will get. We do know that it's already surpassed the point in which it'll cause lasting supply chain disruptions — potentially critical disruptions — into the end of the year.

And Nassim Taleb today pointed out another major rub (you can find the paper he's referring to [here](#)).



Nassim Nicholas Taleb @nntaleb · 23h

Doctors and the #WHO don't understand multiplication.
They understand medicine (& addition), not multiplication.

When we posted this on Jan 26, there were ~1,000 casualties. Today ~79,000.

Unless we overreact, at that rate, in 1 month , can reach yuuuge numbers @yaneerbaryam

We have to "overreact" if we want to have any chance of quickly containing the spread of this virus. This means following China's example of widescale lockdowns and quarantines in cluster areas.

Doing this will have dire short-term economic impacts. But the alternative, only doing half-measures in order to minimize economic disruption, would nearly ensure much greater pain down the road.

Tim Duy, an economist, and author of the blog Fed Watch commented in a recent post [(link here](#)) on the economic catch-22 we now find ourselves in, saying:

> **The extended and rolling nature of containment efforts appears to be the greatest concern of market participants**. That concern was likely the proximate cause of Monday's market action. I think we should keep in mind though that, at some point, the economic and social costs of containment become too much to bear. **There is only so long authorities will be able to hold the global economy hostage for a virus that can no longer be contained and has a potentially fairly low death rate. At some point, the focus shifts from containment to mitigation, supply chains come back to life, and the inventory correction begins.**
>
> **If containment is still possible, but takes longer than expected, then the V-recovery becomes a U-recovery.** The longer it takes to shift from containment to mitigation, the wider the base of the "U" and the higher the chance that the bottom of the "U" is a recession. In any scenario, I would expect persistent weakness in travel and tourism activity. It seems reasonable to expect international travel, particularly to Asia, to be depressed until people become more familiar with the nature of the virus (I am still assuming it is out in the wild).

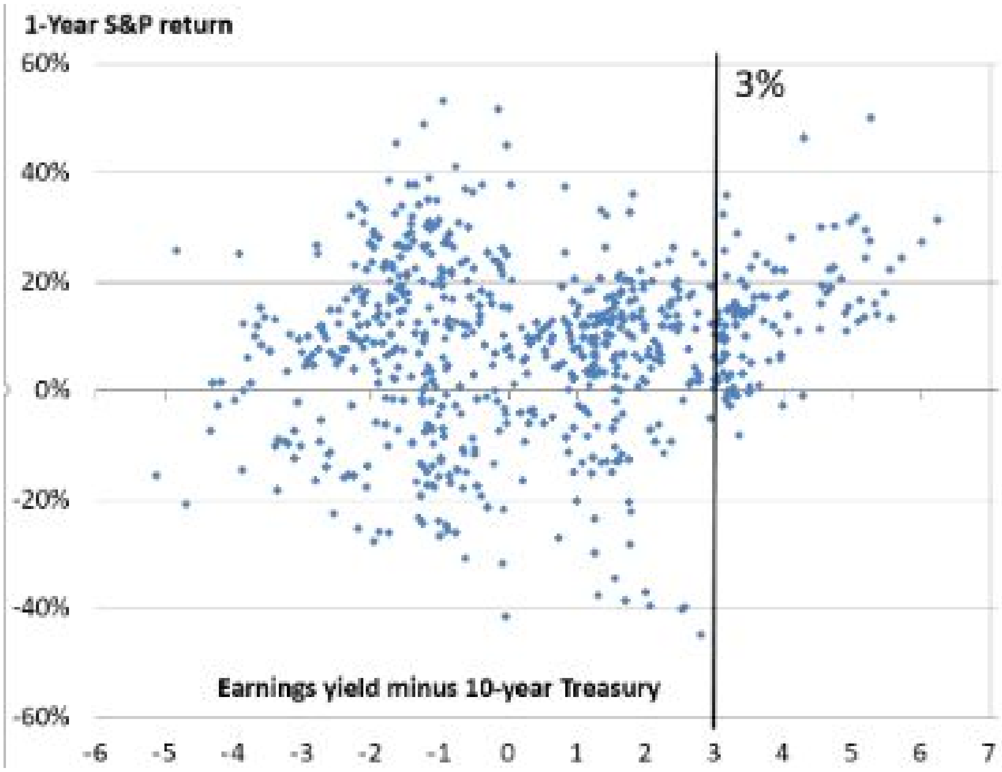
As traders and investors there's not much else we can do other than to ruthlessly manage our risk to cap our downside and play the market in front of us — which is what we do anyway.

Just… maybe now, we play a bit more defensive as we accept that the probability cone of potential future outcomes has widened dramatically.

Widening Risk Premium

Just so we're not all bearish here. There are still a few reasons to expect that the high is not yet in on this market. Take the equity risk premium for example. With the recent fall in the 10-year yield, the SPX's risk premium is back up to 3.3% (earnings yield - bond yield).

Bloomberg points out that "Historically, when the equity risk premium climbs above three percentage points, the S&P 500 is **all but guaranteed to post a positive return in the next 12-months**".



If this virus doesn't become the Spanish Flu and knock out a large chunk of the global population then there'll be some incredible market opportunities — shipping and energy come to mind.

Until then, we're in wait and see mode until the fog of uncertainty lifts a bit. We'll be more tactical than strategic in our trading (ie, more short-term and technical based).

Portfolio Updates

I reduced our Core equity allocation to zero. So for now, we're sitting in 25% bills, 175% long bonds, and 25% gold in our Core positioning.

I also took off our long Mexican peso trade. Price is above our risk-point but the virus likely kills this trade for the time being. The peso goes back up on our watchlist as I think it'll be a monster trade someday.
've moved up all stops on our positions to breakeven or better. I'm also cutting our small starter position in VEEV.

We'll look to add back to these names once this move looks to be over. *** The remainder of the report for Collective members only***