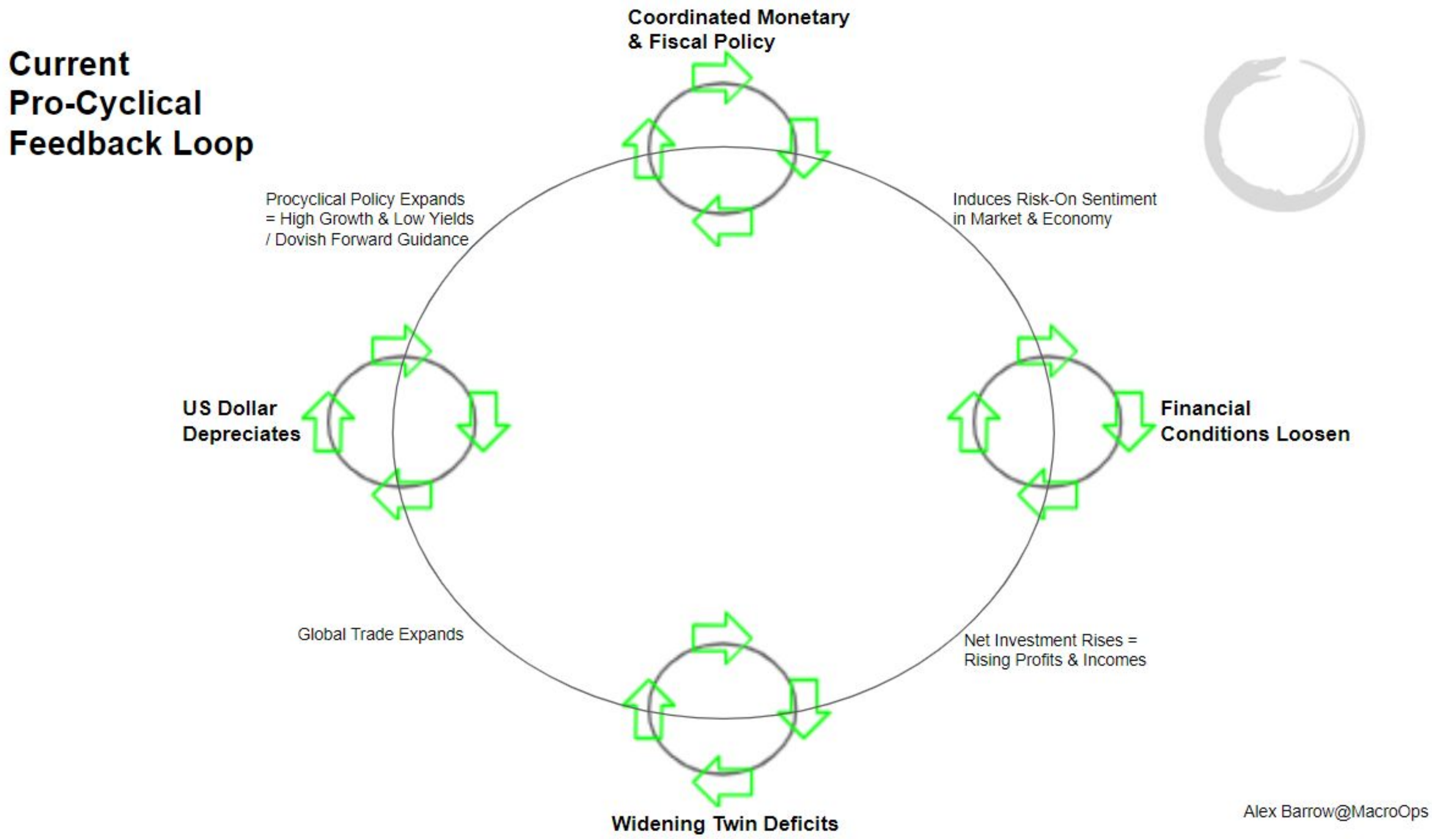
2/1/21: A Fatal Feedback Failure

Below is the current procyclical monetary/fiscal feedback loop at work.



It goes a little something like this…

The Fed and US government coordinate easing and fiscal stimulus →

This policy backdrop sets a psychological floor under the market and economy and thus induces greater risk-taking, causing financial conditions to loosen →

Easy financial conditions and increased risk sentiment cause net investment to go up. This drives both profits and incomes higher as per the Levy-Kalecki equation →

Higher incomes lead to greater consumption which causes the current account to widen and global trade to expand →

The twin deficits along with the improving risk-on sentiment drive speculative outflows, which acts as a depreciating force on the US dollar. →

This boosts global liquidity as well as growth and inflation. But, unlike past cycles, the Fed is *leaning* into the improving growth and inflationary backdrop. This procyclical forward guidance keeps yields low in the face of improving economic fundamentals, which further accelerates the feedback loop.

> *At any moment of time there are myriads of feedback loops at work, some of which are positive, others negative. They interact with each other, producing the irregular price patterns that prevail most of the time; but on the rare occasions that bubbles develop to their full potential, they tend to overshadow all other influences.* ~ Soros

This positive feedback loop has worked incredibly well for the US economy and the world at large, over the last 8 months.

But... the reflexive nature of markets has driven a dramatic repricing of expectations. This has led to a wide-scale discounting of the new policy regime over a *very* short period of time.

We can see this in the sentiment and positioning backdrop across a number of markets that are showing extremes…. Extremes that are higher than those I pointed out in the week leading up to the beginning of the 2020 crash, in late February (link here).

Let me paint you a mental picture… Let's think of the market as a person who for whatever unfortunate reason, needs to traverse back and forth between the top of two skyscrapers.

When expectations are wide, meaning there's little consensus, our guy (or gal) has a large and spacious walkway to meander over between the two buildings.

However… when expectations get *fully* baked in and we approach a consensus… that walkway narrows to the size of a high-wire and our unfortunate walker has to trapeze across a very narrow and wobbly line.

When we have a consensus and extreme levels of positioning, the list of things that *could* derail the trend, rises dramatically. Put another way, the higher the trend-fragility the more potential catalysts there are to tip things over — the shakier the foundation the easier a house blows over.

Trend fragility is created by a crowding of weak hands. These weak hands consist of those who were early and now consider taking profits, those with FOMO who sat on the sidelines for much of the trend only to give in and buy late and in haste, and those who've increasingly leveraged up as doing so has been profitable for some time.

This is how the market works. Trends *trend* until they pull everyone in; when it becomes *too* painful to sit out and not participate in the upside.

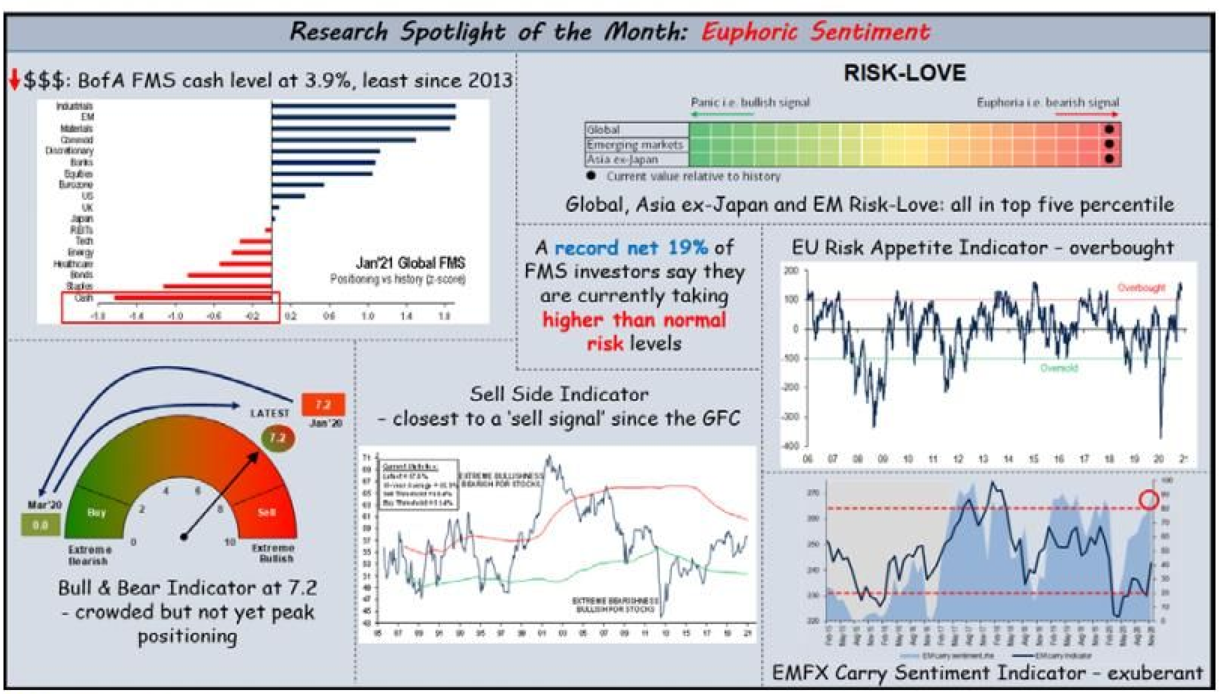
When dips get repeatedly bid it creates widely adopted pavlovian responses amongst participants. These participants then begin to blindly and aggressively buy the dip because that behavior has paid in recent memory. This culminates with participants' concentrating around a singular behavioral response and an eventual leveraging of broader positioning.

That leveraging around common positioning equates to increased market instability (ie, trend fragility).

To reiterate, here's where expectations and positioning currently stand.

- A record net 19% FMS investors assuming **higher than normal risk**
- FMS **cash level of 3.9%** have triggered a 'sell signal'
- Global Risk-Love indicator is in the 97th percentile of history **going back to 1987**
- EU Risk Appetite indicator is in extreme overbought territory
- Asia ex-Japan and Emerging Market Risk-Love Indicators are signaling **euphoria for the first time since 2015**
- The Sell-Side Indicator is at its **closest level to a 'sell signal' since the GFC**
- Investor expectations are at record highs on EPS, inflation, emerging markets, commodities
- Investor expectations for a steepening yield curve are at record highs
- Goldman's Risk Appetite Indicator **has only been higher a few other times in 30+yrs**
- Two-month flows into DM and EM equity funds hit their highest level since Oct 2000, November saw its highest monthly inflow into global equities on record, **three-month inflows hit their highest level on record**

Exhibit 2: Research Spotlight of the month: Euphoric investor sentiment



Source: BofA Global Research

The market is walking a narrow tight rope. But, this is just a condition... Trend fragility can persist for some time. It needs a catalyst for that weakness to become apparent. Catalysts can come in the form of a **narrative shock** or a **significant price movement** that kick-starts a cascade of sell orders.

There are currently two potential known shocks or catalysts to the current intermediate trend.

1. USD Smile dynamics drive the dollar higher
2. COVID mutations and a slow vaccine rollout ding recovery expectations

Let's start with numero uno.

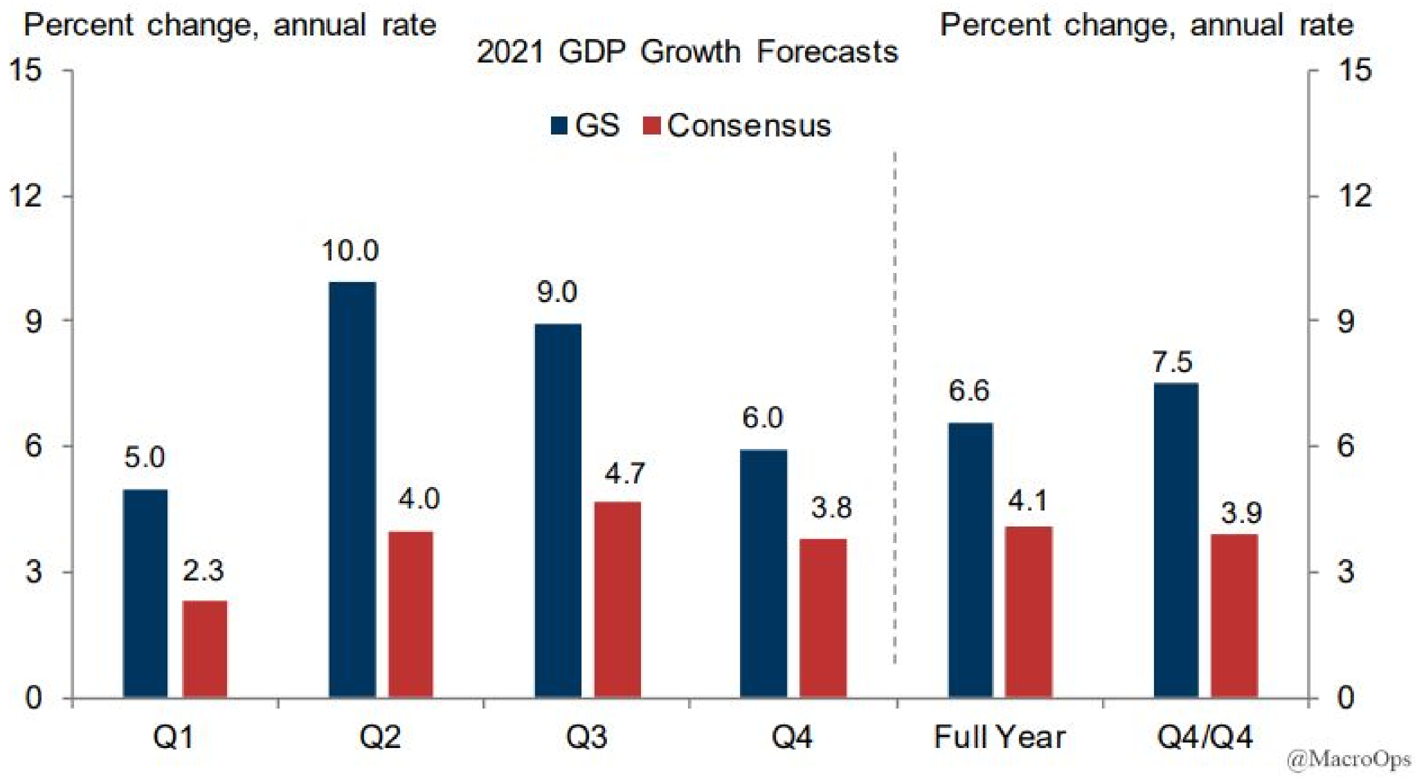
A few things have happened over the past month that have changed the long-term monetary policy outlook.

One being the Dem win in GA, giving them control of the Senate which is critically important for two reasons:

- It means that fiscal is here to stay and will outlive the COVID crisis
- It means that the market has good reason to stop pricing in the "Japanification" scenario where rates and inflation stay at the zero-lower-bound into perpetuity

The second is that this fact is going to introduce some messaging difficulties for Powell and Team later this year.

The reason being is that it's much easier for the market to believe the Fed will *lean* into reflation when nominal growth is sub 3% and inflation well below 2. It's a whole other thing when GDP is expected to climb over 6% and 10-year breakevens are trading above 2%...



> *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. ~ Druckenmiller*

The FOMC needs the market to believe in its forward guidance or else it risks losing its procyclical effect. Similar to the 2013 Taper-Tantrum, the market will front-run the perceived path of policy, causing financial conditions to tighten, thus risking an early termination of its policy feedback loop.

This is going to be a rolling dynamic that will become a significant force at times — as growth and inflation data come in strong — over the coming year(s).

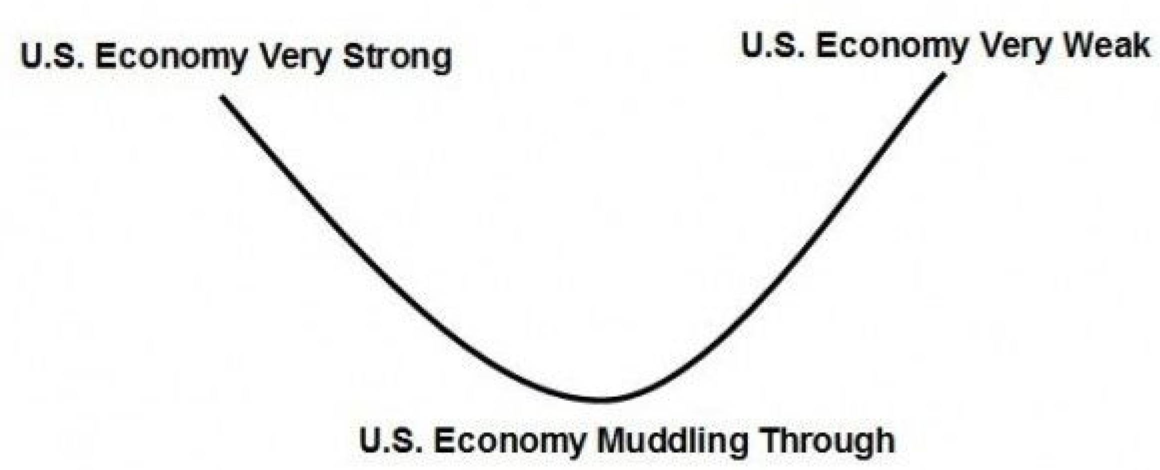
Where this can impact markets right now is in the US dollar weakening bit of our loop.

The depreciation of the US dollar over the last 11-months has been *critical* to easing global financial conditions and facilitating global trade and rebounding growth. The Fed can't admit it but a lower USD is vital to its policy framework working.

Due to the reflexivity of markets though, **everything with a market set price will at some point become the victim of its own success.**

The US dollar may be about to prove this fact, thanks to the 'smile'.

The "dollar smile" is a simple observation put forth by Morgan Stanely analyst, Stephen Jen, years ago. 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.

Some might snarl at that and there's a lot of gold bugs who think the US government's debt blowup is imminent. But the reality is that relative to the rest of the world, the US has one of the most dynamic economies, highly liquid markets, (relatively) stable governments, decent rule of law, and not to mention, the world's reserve currency.

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, that detail matters.

Conversely, 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.

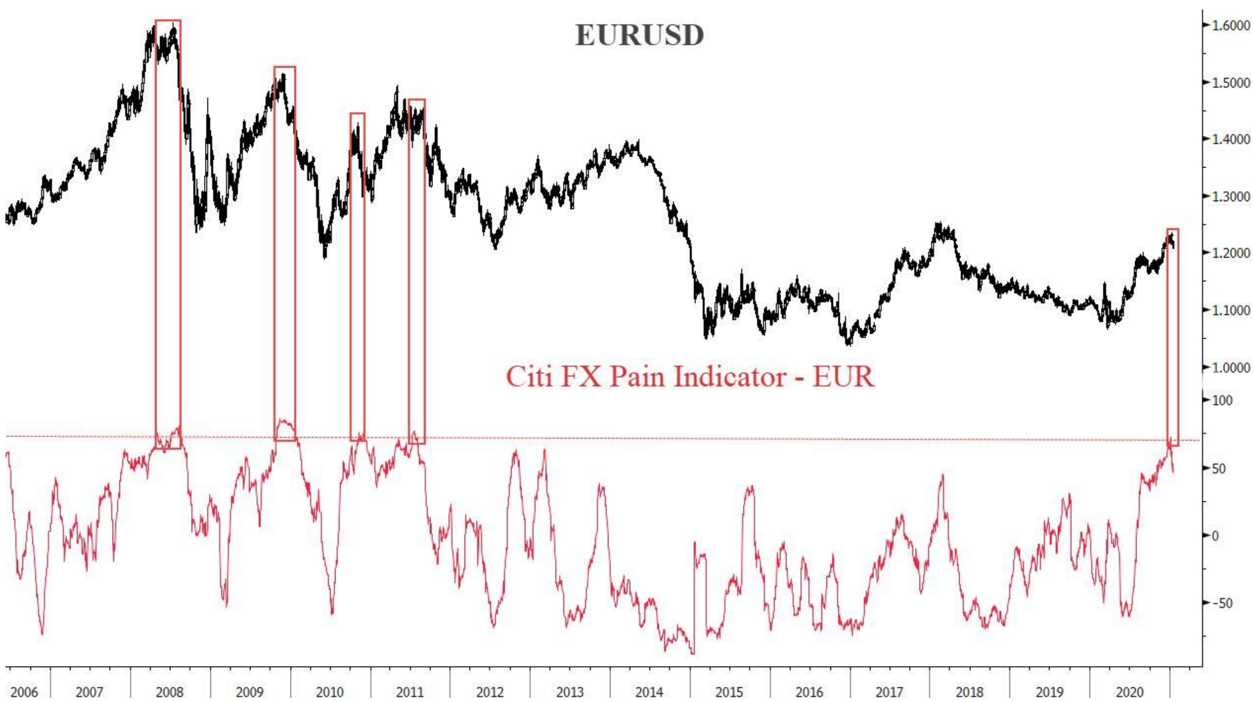
But when the economy is in the middle of the “smile” and just muddling through, the dollar tends to perform poorly.

The primary reason being that mediocre growth and low inflation is bullish for risk assets because it keeps the Fed steady and prevents them from raising rates too quickly (again, reference the Druck quote above).

This dynamic creates a *potential* near-term issue for the dollar and markets at large. The US’s strong relative growth, fueled by its greater fiscal capacity and an aggressive vaccine rollout — we just hit a new milestone with more vaccinated than current cases in the US — puts it *squarely* on the left side of the smile.

Europe and much of the rest of the world (RoW) on the other hand are struggling with their [vaccine rollout] and are starting to see declining growth. This is unlikely to change soon with vaccine supplies projected to remain limited well into 2022.

This widening US v. RoW growth differential is basically an accelerant on the USD smile dynamics. And it’s coming at a time when positioning and sentiment are at or near record levels of bearishness.



Now, of course, the normal caveats apply… This is just a *potential* move... a *probable* catalyst, perhaps... It doesn’t *have* to happen… We remain steadfast cyclical USD bears for the reasons we laid out [here]. We view the current situation as a counter-trend opportunity and will soon look to begin probing the long side in some starter USD positions but will respect the tape if proven wrong.

The USDSEK chart I shared in today's Dirty Dozen looks particularly promising, as does long USDJPY.

If we do get a USD retrace, it would obviously put the cool on the reflation trade for a hot minute.

The reflation trade, like the USD bear, suffers from consensus sentiment and crowded positioning. In addition, it's also going to start feeling the headwinds from a dwindling credit impulse out of China and a rerating of global expectations regarding a return to "normalcy".

This brings me to the second part, and I'll keep this one brief.

There's increasing evidence that new COVID strains could cause reinfections; meaning more people who have had COVID remain susceptible to getting it again which would also mean that our current vaccines will likely need continuously updated boosters to remain effective.

If you're interested in reading more about this and the developments in Manaus, Brazil, that sparked this theory, then I suggest reading this article here.

In addition, it's likely that those of us in the US are about to see a spike in hospitalizations over the coming weeks due to the recent introduction of the UK and South African variants (B.1.351 & B.1.1.7) within our borders. These strains have much higher transmission rates and therefore spread significantly faster.

Back to the market

So to be clear, I'm not calling for a "Market Top" or any nonsense like that. We're still quite bullish on risk-assets over the longer-term. My aim with this piece is to simply explain the increasing vulnerabilities I see looking out over the next month.

Here's what I'm seeing in the short-term chart.

I'm not a big believer in analogs but there *is* an interesting symmetry between where we are now and where we were at the end of January of last year. I think we may see a similar move, with a spike up to new highs before leveling off and finally turning over — though I'm not expecting a selloff anywhere near as dramatic as the one we saw in 2020.

If this happens, it'd give us a complex double top on the monthly (which we also saw in Feb of 2020). And it would likely lead to 1-2 months of down to sideways chop, with a target for the selloff in the 3,500 range, making for a 10-15% retrace.

I'll be out later this week with a note updating my view on precious metals as well as a discussion on some recent uranium developments.

Until then, keep your head on a swivel…

Your Macro Operator,

Alex