8/18/2021: Despite Their Better Judgement...

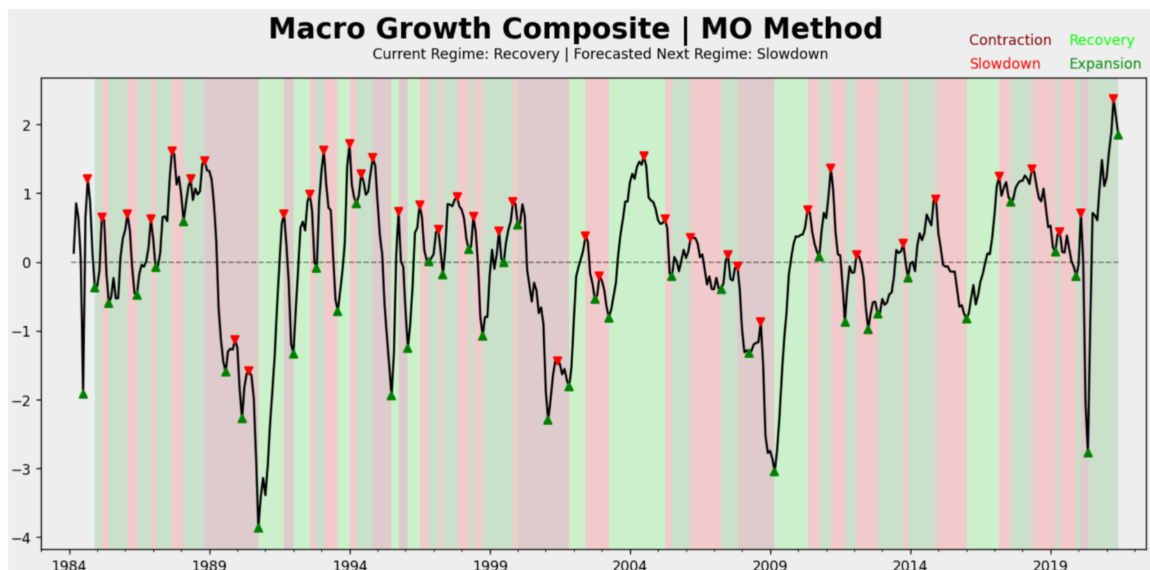
For the last two months, we've been playing for the final leg of this move. There's been consistent high Trend Fragility, marked by crowded positioning and overly bullish sentiment. But the main indices have trudged on to new highs, despite a wide dispersion in performance under the hood.

They've withstood diverging credit and weakening breadth, shrugging off what's historically been a very reliable confluence of bearish signals.

The back and forth of the market internals have been some of the choppiest I've seen.

We've been sitting at roughly 50% net cash for the last two months. This is more cash than we typically like to carry and we've been itching to put it to work. But while there's not a lack of names we'd love to buy or add to here, the noisy data has us staying cautious.

We recently talked about how we're transitioning from a Recovery to what will likely be a back and forth rotation between Slowdown and Expansionary regimes. These regimes carry with them their own particular characteristics of asset performance. And this is partly why we're seeing such a schizo environment… the market is trying to sniff out what's next around the corner.



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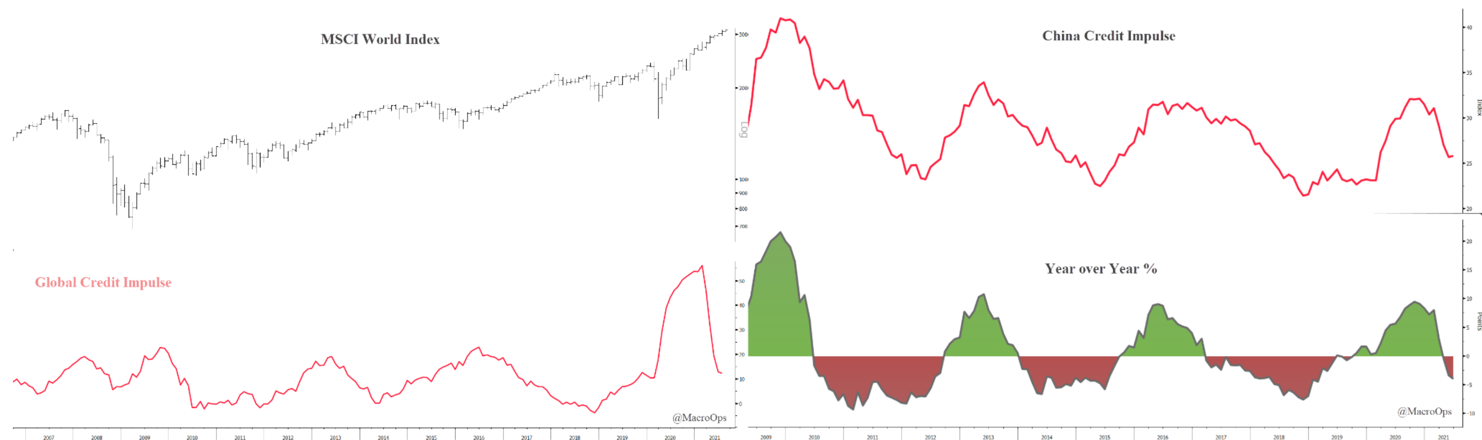
The other two reasons being, of course, the spread of the delta variant and its subsequent economic impact on less vaccinated regions of the world. Along with our transitioning to the backside of the major credit impulses.



Markets swing from feast to famine and back again. The COVID lows to early Spring marked a major feast for easy returns. And ever since, the pickings (trends) have been a little worse for wear. This famine naturally sets the stage for the next feast but for that to happen we need to see expectations and position reset.

We started this week looking for an acceleration of the last leg of the current Buy Climax. A final 2-3 week parabolic run-up, the action which typically marks the turning points of these types of moves.

But the breadth that had so quickly reversed off its lows the week prior, spun a 180 and dipped back down the other day, just as fast.

The longer that breadth (and credit) fail to rebound and hold levels of strength, the heavier the broader indices will trade. And the **greater the gravitational pull becomes for them to <u>catch down</u> to their weaker performing holdings**.

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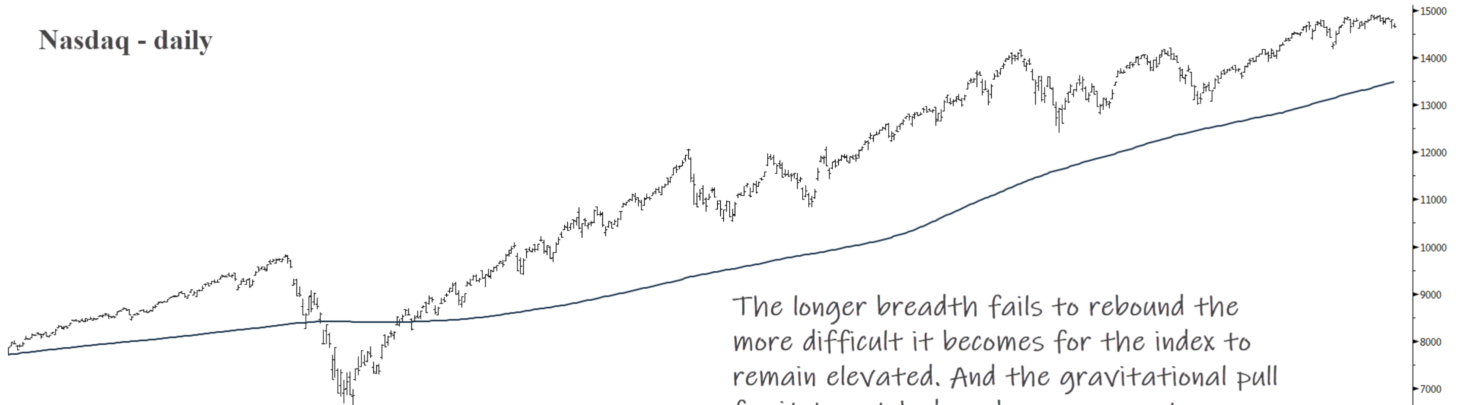

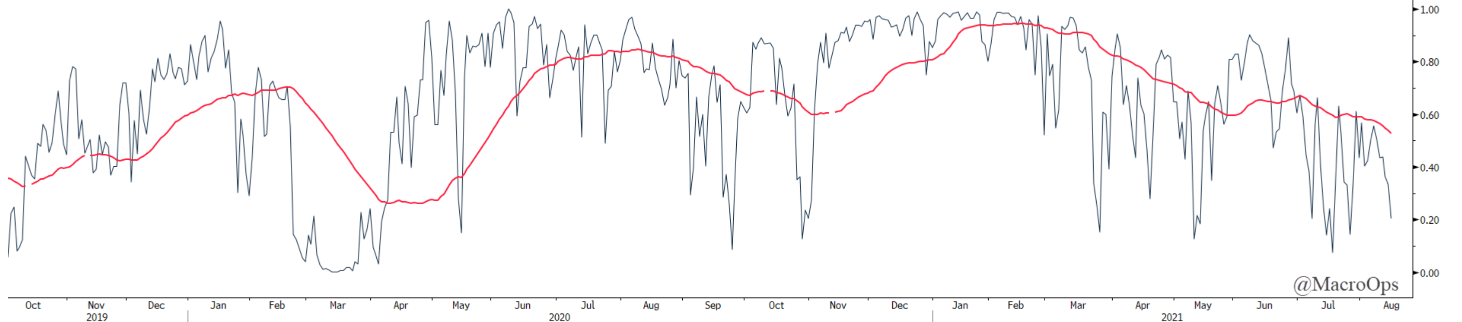

SentimenTrader recently shared a study on historical instances in which Nasdaq breadth and the tape were this wildly diverged. Since this is incredibly rare to see there are only two other occurrences over the last 25-years. It's a small sample set but shows the risk profile skews strongly bearish over the following weeks, as logic suggests it would.

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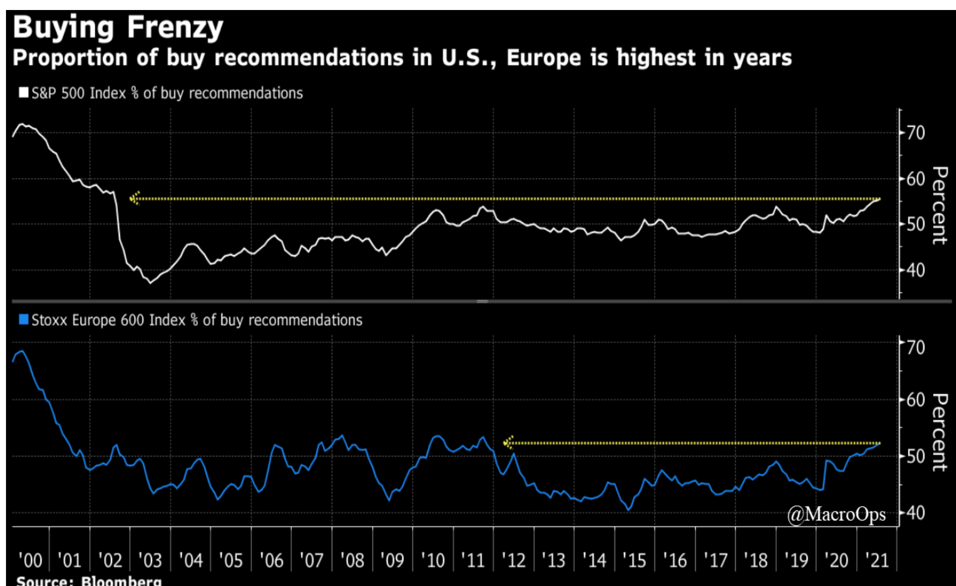
Nasdaq Composite w/in 1% of 52-week high, McSumm < -250 and NH/NL < 40%

Signals (2)	1 Week	2 Weeks	1 Month	2 Months	3 Months	6 Months	1 Year
1999-04-01	4.0	-0.4	1.7	-2.4	8.5	10.1	78.8
2014-09-24	-2.9	-1.9	-2.2	3.5	4.6	6.8	3.9
2021-08-16							
Median	**0.5**	**-1.1**	**-0.3**	**0.5**	**6.6**	**8.5**	**41.4**
% Positive	**50%**	**0%**	**50%**	**50%**	**100%**	**100%**	**100%**
Avg Risk	-1.5	-2.1	-6.7	-6.7	-6.7	-6.7	-6.7
Avg Reward	2.0	2.1	3.2	4.9	6.9	13.1	58.5
% Big Drop	50	0	100	0	0	0	0
% Big Rise	50	50	50	0	0	0	50
Z-Score	0.1	-2.0	-0.6	-0.4	2.0	2.0	0.8

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

This failure to launch is made all the more concerning by the fact that the Street is so bullish it's tripping over itself... According to Bloomberg, "56% of all recommendations on S&P 500 firms are listed as buys, the most since 2002. It's one more data point that shows the extent of the euphoria sweeping markets after a blockbuster earnings season."



This is the group we want to fade as their conviction and groupthink has a habit of being strongest just as the data is turning over, as we're seeing now.

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I think BofAML's latest Global Fund Manager Survey squarely hits the nail on the head. While fund manager expectations have rolled over from exuberant levels, their positioning has yet to follow… because of TINA *(there is no alternative*) and all that. But as the chart at the bottom shows, **their positioning has a history of lagging their better judgment.**

BofA August Global Fund Manager Survey

Bottom line: FMS growth, profit & inflation expectations sink + 84% say taper before year-end = cautious sentiment (BofA Bull & Bear Indicator down to 5.6 from 5.7) = EM, commodity, resources, small cap cut, but TINA means extreme long stocks-short bonds AA intact; "TINA turners"…Fed error, US fiscal fail, China credit, US consumer hits wall.

FMS on macro: expectations for global growth cut to net 27% (lowest since Apr'20), for profits to 41% (lowest since Jul'20), first time since Jul'20 profit margins expected to fall; this despite investors raising size of US infrastructure spend from $1.4tn to $1.7tn.

FMS on rates & risks: 84% expect Fed to signal taper by year-end; but 65% say inflation "transitory", just 4% expect higher CPI in 2022, lift-off for Fed hikes pushed back to '23; Delta variant, asset bubbles, China rising as "tail risks" at expense of inflation/taper; note FMS "geopolitical risk" was ranked low (41% vs historic 52%) before Afghan crisis.

FMS on AA: cash as % AUM up from 4.1% to 4.2%; allocation to commodities cut to lowest since Nov'20; allocation to equities peaking (Chart 1) and lagging lower growth expectations, but zero fear Fed can stomach lower stock prices, and risk aversion/yields too low to raise bond allocations.

FMS on sectors, styles, regions: more defensive…health care #1 sector 1st time since Nov'20; tech #2 (still deemed most "crowded trade"), energy UW 1st time since Feb'21, materials cut, utilities up; large>small @ 10-month high, quality>junk @ 12-month high; long US & EU but capitulation out of Japan & China-fear keeps EM as big UW.

FMS contrarian trades: for "growth scare"…long bonds vs stocks, long staples/utilities vs banks; for "reflation resumption"… long EM & Japan.

Chart 1: Macro expectations have rolled over but equity allocation still to follow
Net % OW equities vs Net % expecting stronger economy

Source: BofA Global Fund Manager Survey
@MacroOps
BofA GLOBAL RESEARCH

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Due to these growing concerns, our continued lack of clarity in market internals, and our TL Score flipping back to -5 today, we're going to add a hedge to our book.

Hedge details:

> Since the forward VIX is still too rich to put on our Conditional 50 Cent hedge, we'll be purchasing the 60dte (20 Oct) VIX calls at a 60 strike (~15delta). This allows us to capture the convexive nature of gamma expansion in the underlying option if the sharp increase in vol is realized, using little capital. We're allocating 75bps to this position.

We've completely closed out our swing long position in the Nasdaq for a scratch and are willing to short should we see a VBO from its current squeeze — or get back in long should the index move to new highs.

Humility, hedging risk, and staying nimble are the keys to getting through the current regime. Perhaps we see some greater signal emerge following Jackson Hole. There's an obvious hangup around taper talk and some indications from Fed officials may help steer the next trend, whether that be up or down. The US Dollar, which is in a major compression regime, seems to be hinging on this as well.

In the meantime, we're being less active and focusing on researching new names and thematics.

We'll be out with more soon. Until then, stay safe and keep your head on a swivel.

Your Macro Operator,

Alex

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