A Bunch Of Plonkers…

I don't remember who told me this, so apologies for the lack of attribution. But apparently, back in the day Soros would kick off his meetings by reminding the team that they were a bunch of plonkers who were prone to major errors in judgment and execution, himself included. And the fact that they knew this about themselves was one of their greatest strengths.

I love that.

When was going through the hiring process at Bridgewater. I had to watch a number of internal videos. They record every meeting Big Brother-style so anybody at the firm can tune in, all in the spirit of radical transparency.

One of these recordings was of the top investment team. There was maybe 20-something people in the meeting, including Ray Dalio.

The firm had just closed out one of its most profitable years. It was a self-congraluatory vibe in the room. They'd all just made their clients and *themselves* a lot of money and were feeling pretty good about it. A number of execs gave doting speeches, talking about how well the team executed throughout the year and how great their firm is, etc.

But Ray just sat there in the corner stone-faced. And finally after the 4th or 5th speech he abruptly stood up, cut someone off who was talking, and started tearing into the group.

His contention was that they, as a firm, did <u>nothing</u> special that year. Their "specialness" was not why the fund put up great numbers. The fund had a great year because of the particular market conditions. And their results were well within the normal expected distribution of returns according to the hard coded investment process they run. A process that they'd been developing for decades.

So being self congratulatory was like patting themselves on the back for it being a sunny day. It was ridiculous… They ran the exact same process the year prior and their returns were meh. Neither year's performance had anything to do with their work during those specific periods. But… the fund's performance over *years* and *decades…* now, *that* was due to the firm's skill in developing and executing on a solid process.

I don't respect Ray as much as I used to. His weird CCP apologist's schtick doesn't sit well with me. But I did like his take. Similar to Soros, Dalio is acutely aware of our innate human tendency towards misattribution — misattribution of cause and effect, predictive accuracy, skill, and so on.

I don't know where I'm really going with this, as I'm kinda just jotting down some random thoughts.

Something I've been working on over the past few months and which I hope to complete and share with the group before the end of the year. Is the quantitative sectioning of market regimes.

Kind of like how we use the SQN for swing trades. I'm working on building a Trifecta system. One that uses price action, market internals, macro, and sentiment/positioning to quantify the probability distribution for expected forward returns and characteristics of those returns over a multi-month period.

The idea is that by doing this, we will have a tool that can give us a probable distribution from which we can adjust our portfolio risk, position sizing, and our approach. We can then develop and backtest various strategies for each of these regimes.

Just like a chef has a particular blade for each job, whether he's cutting sashimi or chopping through bone. He has a specific knife for each task. So we'll have our own tools for the broad market regimes that play out.

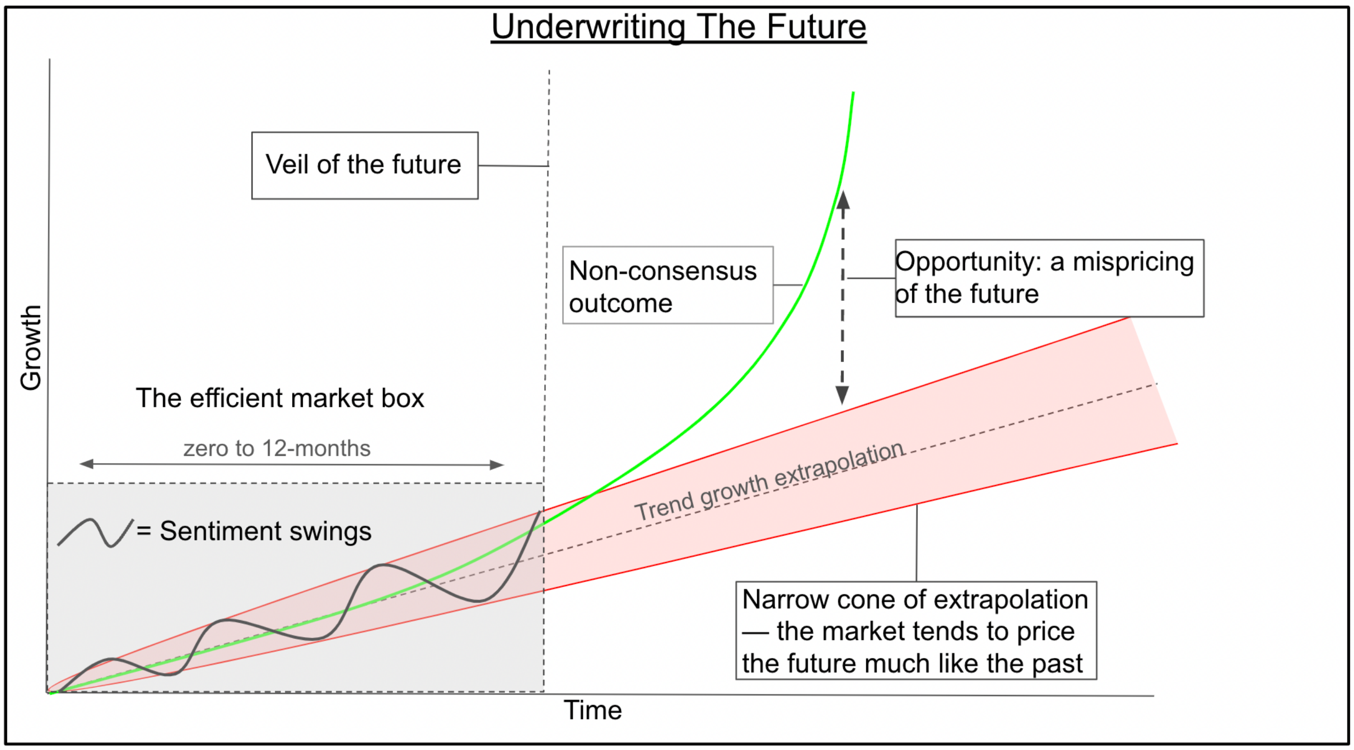
This tool won't give us certainty. That's impossible. But it will, *hopefully*, give us a little edge. And just as importantly, it will reduce our cognitive load. Allowing us to focus more on the areas where we can personally provide additional edges. While also helping to reduce biases in our decision-making, helping to prevent us from falling into common narrative and sentiment traps, and reducing our error rate in execution.

A while back, I shared this graph which illustrates how I think about single stock bets. The market is usually — though not always — efficient over the near term (ie, 0-12 months). That's because the near future often looks very much like the near past. And most participants simply play the game of extrapolation, which is usually the correct move. Though there's little edge or alpha in playing that game.

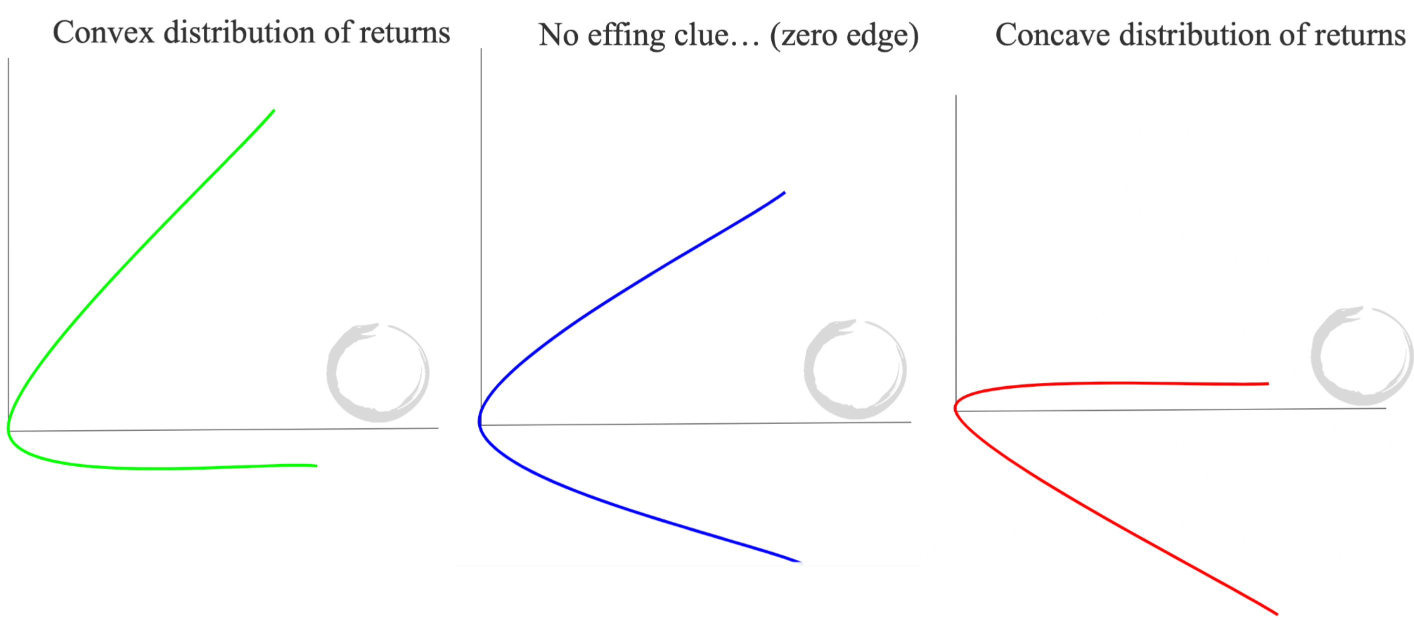
The alpha comes from being able to peer further, to pierce the veil of the future, and find bets where you can develop reasonable confidence that the future 18-36 months will look very different from what's being priced today.

To quote Druckenmiller "Too many investors look at the present, the present is already in the price. You have to think out of the box and sort of visualize 18 to 24 months from now what the world is going to look like and what securities might trade at.. "

The two PMs I know who've worked with the Chandler brothers have told me they would take a 3-year view on nearly all their investments. That's the timeframe they try to build confidence in when analyzing a bet.



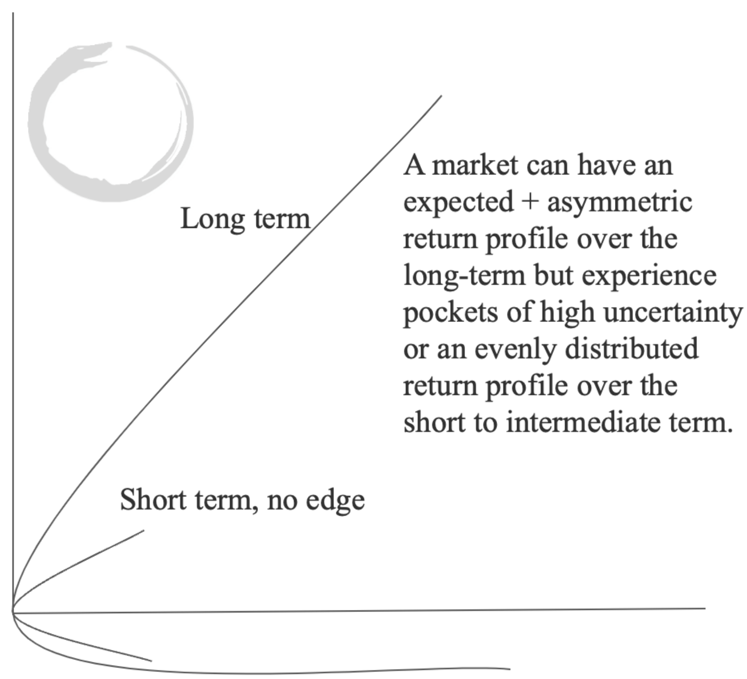
Similarly, when asessing the broader market or a larger macro bet. I'm always thinking in terms of the distribution of returns or the [cone of probabilities](). It looks something like the graph below. Each distribution, or regime, whichever you choose to call it. Has it's own characteristics (daily volatility, drift tendency, momentum, etc…). These characteristics mean each regime has its own optimal strategy, portfolio structure, risk levels, position sizing, and so on...



Every timeframe has its own distribution profile. An asset can have a long-term positively skewed cone. But, over the short term, it could be evenly distributed or negatively skewed.

So we need to apply this thinking across multiple timeframes. I'm always looking at short-term (days to a few weeks), intermediate-term (weeks to a few months), and long-term (months to a few years).

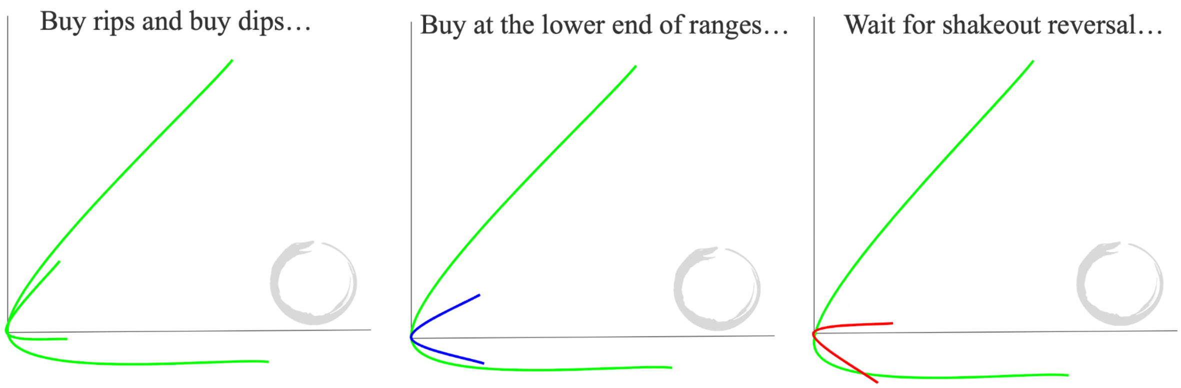
A common analytical trap is to get so focused on a particular timeframe that you stop assessing the distribution for the other timeframes that matter just as importantly to your trade management. And this leads to costly errors in judgment and execution.



A recent example we've talked about is copper which I wrote up in [The Game Has Changed...](#) Long-term, we, like many others, are quite bullish on the copper market. The dearth of CAPEX means supply will be constrained for years. Ambitious carbon zero targets means a LOT more electrification of everything, which means a significant and sustaining boost to copper demand in the decade(s) ahead.

However, the mistake many made is that they anchored too much on the long-term. By doing so they blinded themselves to the large developments impacting the short-to-intermediate terms, where there were totally different drivers at work.

And there we've been bearish; because of technicals, because China is slowing and their housing market is collapsing, and because the Fed is tightening, which is causing global growth to stall, etc…



The best trades. The ones we want to really size up on. Are the ones where the cones are consistent across all three time frames. Those are the [Big Bets] where we want to back up the truck, bet the ranch, stuff the goose, you get the point.

This framework can seem laborious, but through practice it becomes second nature. And you soon find yourself thinking in this way about most things in life.

One of the other major benefits, is that it instills a level of detachment. It forces you out of the common practice of thinking in absolutes and instead thinking in probabilities. Nothing in markets is a sure thing. It's always just a distribution of potential.

There's no irreparable right or wrong. No ego. Just you, your process, and your continuous stacking of conditional edges. That's the game...

We don't need to predict the future. We just need a framework that allows us to effectively understand what's going on now and what that means for the future. This framework is comprised of tested quantitative and qualitative tools. These tools give us guideposts from which to orient. And it's through this orientation that we find out, within a certain level of confidence, where we are and where we're headed… It's like the market is always dropping bread crumbs and we simply need to follow the trail.

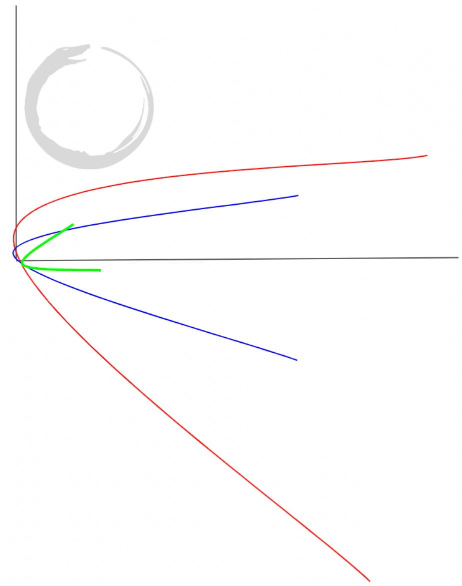
> *What makes a decision great is not that it has a great outcome. A great decision is the result of a good process, and that process must include an attempt to accurately represent our own*

state of knowledge. That state of knowledge, in turn, is some variation of "I'm not sure. ~ Annie Duke via "Thinking in Bets"

"Probability is not a mere computation of odds on the dice or more complicated variants; it is the acceptance of the lack of certainty in our knowledge and the development of methods for dealing with our ignorance." ~ Nassim Nicholas Taleb, "Fooled by Randomness"

The market's current distribution…

This is how I think the market's current distribution profile looks: bearish over next 1-2 years, neutral over next few months, and slightly skewed positive over the next few weeks.



Because of the embedded uncertainty of this environment… the known unknowns (policy response, inflation path, Ukraine war, etc…) coupled with the fact that there is just no great historical analog for all that we're experiencing today. I hold low confidence in each of these profiles.

Practically speaking, this means I'm not anchoring to anything and won't lean too heavily in any direction from an opinion, positioning, and portfolio risk standpoint. It means that I have to acutely focus on the guideposts, listen to what the market and data are saying and adjust fire accordingly.

Let's walk through the current guideposts for each timeframe, starting with the long-term.

We recently pointed out how our preferred recessionary indicator, BBG's 12 and 24-month probit model, is now assigning 30% and 100% odds of a recession, respectively. This aligns with what we're seeing in our other key data points that track the housing and labor markets, financial stress, and growth leads.

I've been writing all year about how a 22' recession was unlikely. This was despite the fact that calling for one has been a consensus point for much of the year.

Yes, the data was and still is softening. But my main points for being constructive, which are still very much true, are (1) the labor market remains strong, UR is making new lows and jobless claims are trending back down (2) we don't have the typical financial imbalances that cause a credit driven recession (à la 08') and (3) it's impossible to quantify exactly how much *but*… a good portion of the slowing we've see is due to the Great Convergence between spend on durable goods and services.

Just head to an airport. They're packed. The consumer is still strong.

Okay… so near-term growth remains above levels that typically precede a recession over the next 3-6 months. But it is slowing and we expect it to continue to slow, and potentially dramatically so, as we head into 23' and the Fed keeps tightening the thumbscrews.

The big known unknown here is inflation and its future path. I know, I know, surprise surprise… What shocker will I throw out next… Unfortunately truth is truth and this is one of the most important variables as it'll drive policy, which will drive financial conditions, which drives investor preferences, which drives the market.

Have you heard the story about the king and his meteorologist?

A king wanted to go fishing and asked the royal forecaster what the weather looked like for that afternoon. He assured the king there was no chance of rain that day.

So the king departed to go fish. On his way, he met a man with a fishing pole riding on a donkey, and the king asked the man how the fish were biting.

The man replied, "Your Majesty, you should return to the palace! In just a short time, I expect a huge rain storm."

The king said: "I hold the royal forecaster in high regard. He is an educated and experienced man. Besides, I pay him very high wages and he gave me a very different forecast. I trust him."

So the king continued on his way. However, a short time later, a torrential rainstorm began, and the king became soaked.

Furious, he returned to the palace and gave the order to fire his forecaster. Then he summoned the fisherman and offered him the prestigious position of royal forecaster.

The fisherman said, "Your Majesty, I don't know anything about forecasting. I obtain my information from my donkey. If I see my donkey's ears drooping, it means with certainty that it will rain."

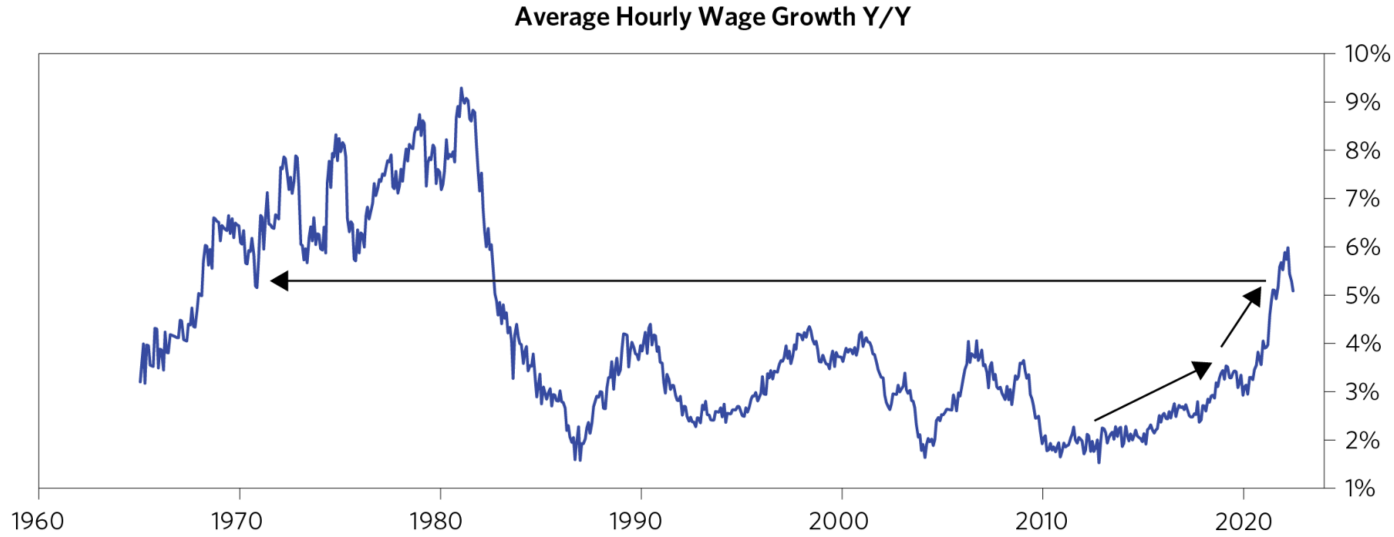
So the king hired the donkey.

And thus began the practice of hiring dumbasses to work in influential positions of government.

Forecasting inflation is hard. But this doesn't stop plenty of donkeys from trying.

Personally, I'm not interested in trying to predict where inflation will be in 2-years time. I find it more useful to track what the dominant narratives are around inflation. How these are being priced into markets. And how this stacks up against the incoming inputs, which typically lead CPI.

One of these inputs is wage growth. And this is where there are some troubling signs. BBG's wage data only goes back so far, so here's a longer-term chart showing average hourly wage growth Y/Y via Bridgewater.



Data estimated through June 2022. Estimates based on Bridgewater analysis.

In that same piece, which is worth reading in full (link here). Bridgewater's Bob Prince lays out why the above chart is concerning (emphasis by me).

> *Income growth establishes the base level of nominal spending. This is because spending produces income, and then that income gets spent, producing an income-spending flywheel that has inertia and thus tends to be self-sustaining…Policy tightening is likely to slow inflation from where it has been, but whether it brings inflation down to what is discounted (2.5%) and to what the Fed expects and is targeting (2%) depends on how deep the contraction is and how long it lasts. It needs to be deep and long-lasting because **there is inertia in the system in the form of wage growth that is much higher than what would be required for 2.5% inflation.***

> *A big near-term decline in wages is unlikely because labor markets are now tight. The unemployment rate is near its lows, job offers are plentiful, and the cost of living is giving people reason to ask for more.* ***Thus, the degree and duration of the tightening must be strong enough and long-lasting enough to bring credit growth down by enough (roughly by half)*** *for long enough—to bring spending down by enough for long enough—to weaken labor markets by enough—to bring wages down by enough—that NGDP growth falls by enough and stays there—to bring inflation down to 2.5%.*

This is why Fed officials are taking a more aggressive stance. They've been studying the inflationary 70s. Back then, strong wage pressures de-anchored expectations which created an inflationary spiral.

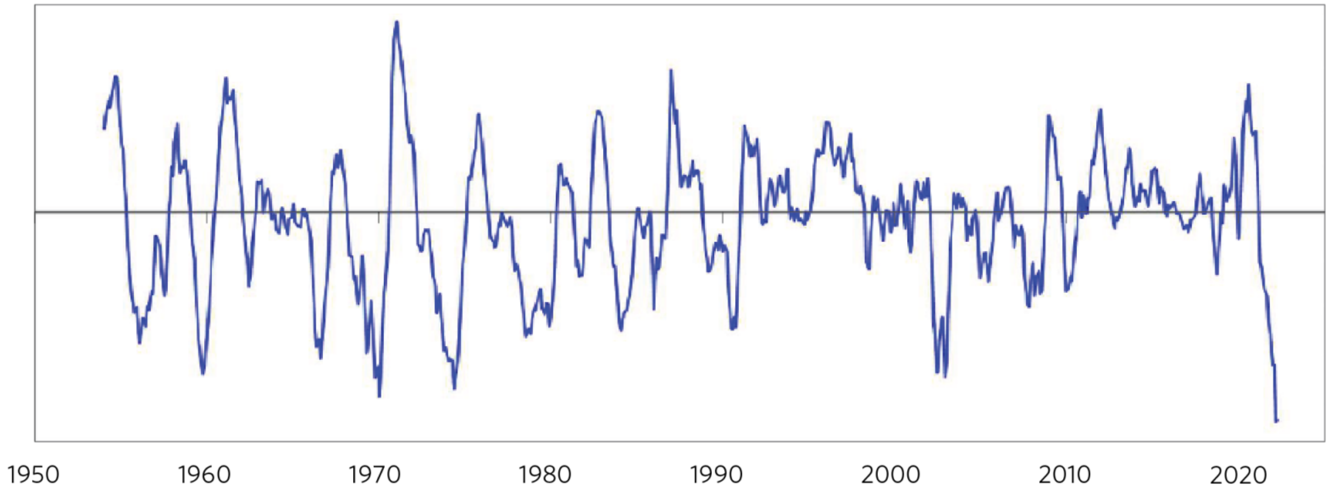
Now, I don't believe we're at risk of this happening at all. FULL STOP. Today is a very different environment from back then. But, it doesn't matter what I think… The Fed seems to believe this is a real risk. And this scares them. Powell doesn't want to be remembered as another Arthur Burns (which if you read Burns' journal entries and study the economic history of that time, you find that he gets unfairly pinned with too much of the blame, but I digress…). So I think it's safe to take the Fed at their word and assume they will keep tightening until inflation is at target for a good length of time.

And when it comes to thinking about the long-term distribution profile for the market, this is really all that matters. Household allocation to equities is still near historic highs. A quick path to a 3.5%+ Fed Funds rate in a low real growth world changes a lot of the math behind those preferences. Not to mention, it opens up the possibility for large liquidity-driven dislocations.

To return again to the Bridgewater piece. Bob points out why this matters, writing:

> *By our measures, even though the actual rise in short-term interest rates has not been much, the substantial discounting of the tightening with its knock-on effects through the markets, combined with the shift from QE to quantitative tightening (QT),* ***suggests one of the most extreme downward pressures on money and credit of the past decades.*** *In other words, we're very likely to get a reduction in nominal spending in the near term.*

Pressures on the Change in Credit Growth



Data estimated through June 2022. Estimates based on Bridgewater analysis.

So for us to turn more constructive on the long-term outlook for equities, we need to be able to reasonably believe that the Fed will aggressively turn policy within the next 6-months. For us to believe that we need to see wage growth significantly slow and inflation move closer to target. These are our long-term guideposts.

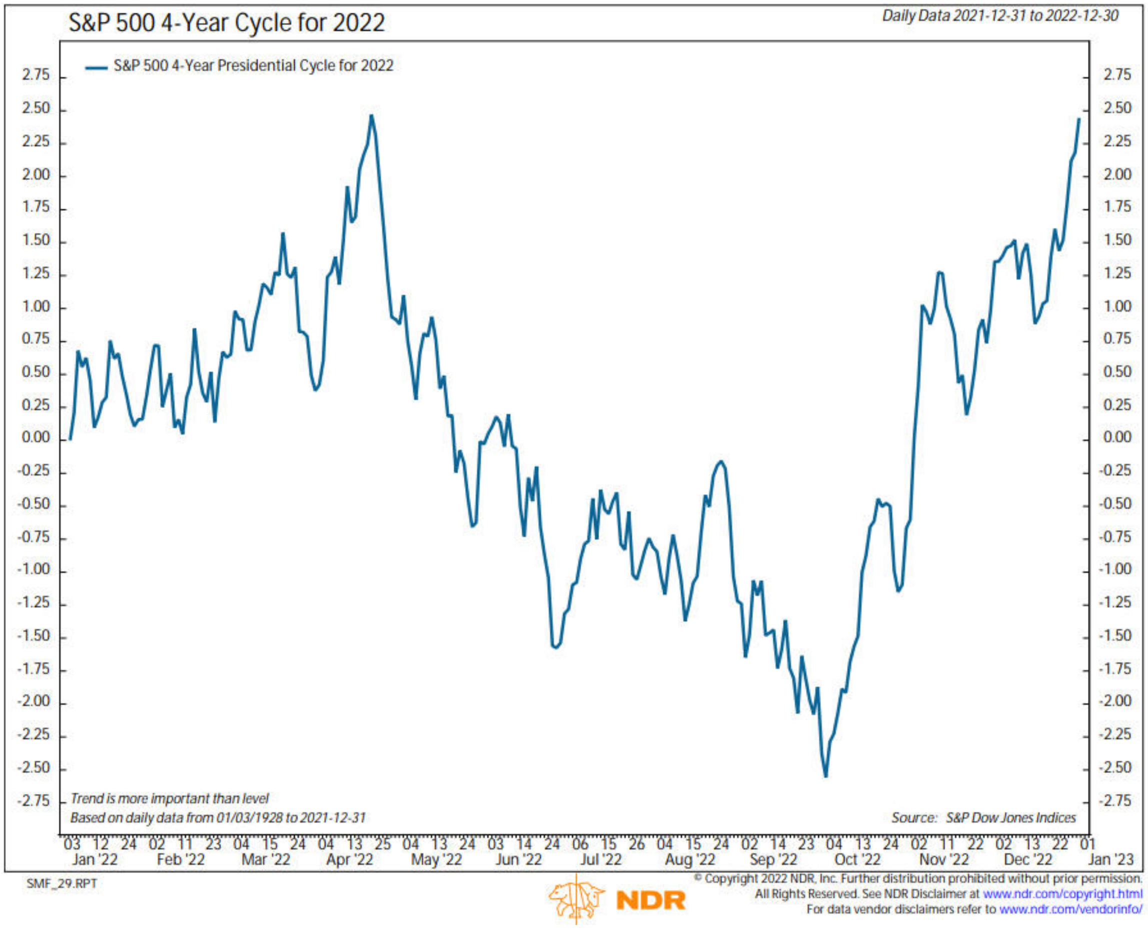
The intermediate-term outlook (next few months)…

I don't feel like I have an analytical edge in this timeframe right now. My base case remains the same as it's been all year; expect lots of sideways chop and volatility with increasing risks to the downside.

Here are a few of the key guideposts I'm tracking in trying to get a feel for this timeframe.

One is seasonality.

Check out the following Four Year Cycle/Midterm chart via NDR.

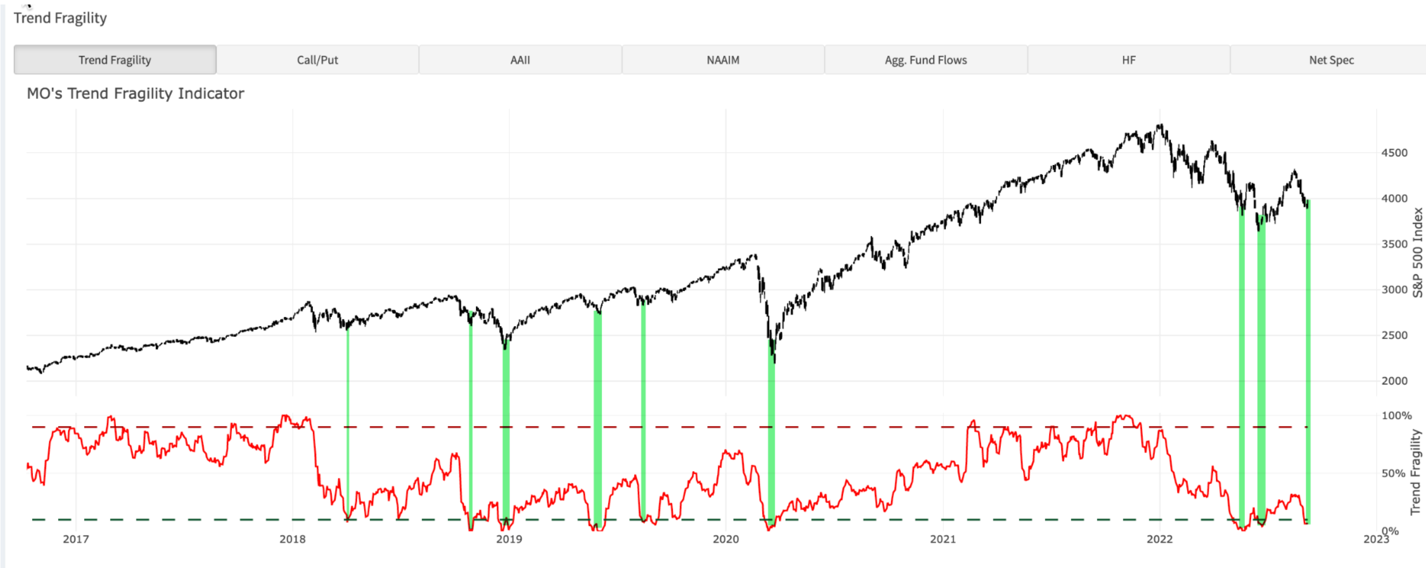


We've been in the weakest period of seasonality on the past month or so. But in a few week's we'll enter the most positive period of seasonality, which runs into year's end.

Now, seasonality is hardly a sure thing. Any year can be wildly anomalous, and seasonality periods can shift. Again, we're not looking for sure things, just for contextual edges, and this is one of those.

So this input makes me a little more open to the bull side over the intermediate term. Maybe a run-up closer to the highs at the start of the year. I wouldn't say this is likely, but it's certainly possible. This is why we need to stay open to it.

Another point for the bull side is the one-sided positioning and sentiment. There's still a clear bearish consensus. Our Trend Fragility indicator from the HUD (link here) is back below its 10th percentile. A level that historically leads to positive returns over the following 1-3 months. We got a similar signal at the start of July, which is one reason I wrote a multi-week rally was odds on at the time.



The reasons to be bearish are the ones I laid out for the long-term. The higher timeframes always exert influence on the lower ones (sorry, I know, I'm stating the obvious here). You can think of the long-term as the ocean tide going in and out, intermediate as the waves coming and going, and the short-term as the ripples.

So this is why I don't have a strong directional bias for the next few months. We will continue to play the tape as it unfolds. Watch financial conditions closely. See where credit spreads trend. Keep our risks balanced and not get overly bearish or bullish until the data says to do so.

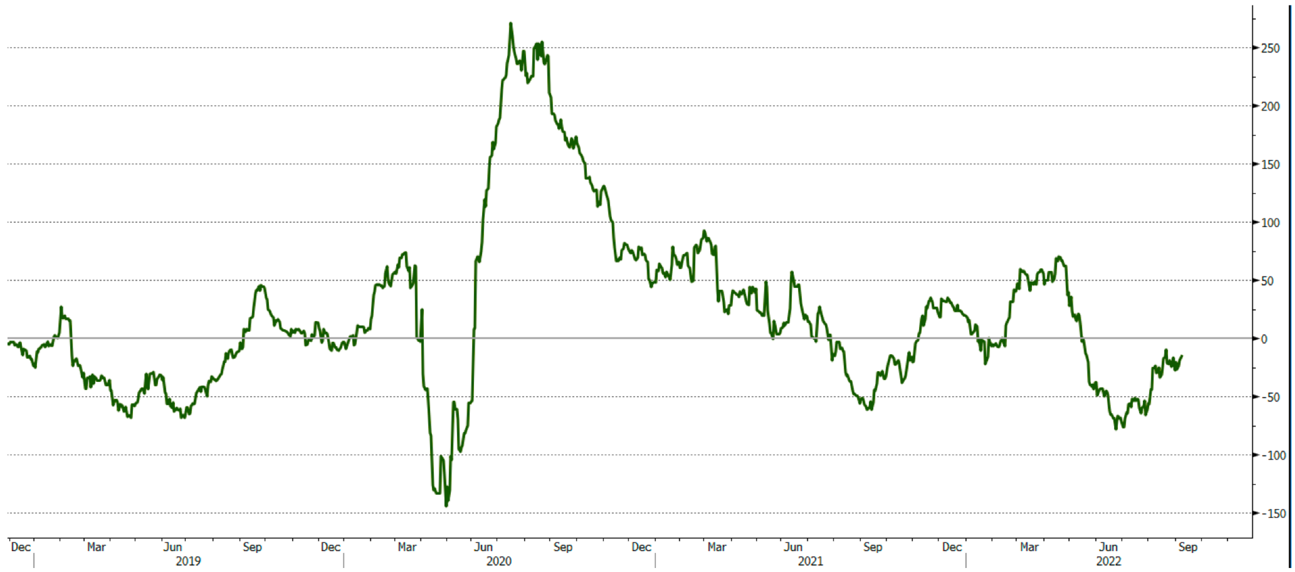
The short-term outlook (days to weeks)...

I just shifted to bullish over the next few weeks. Here's why.

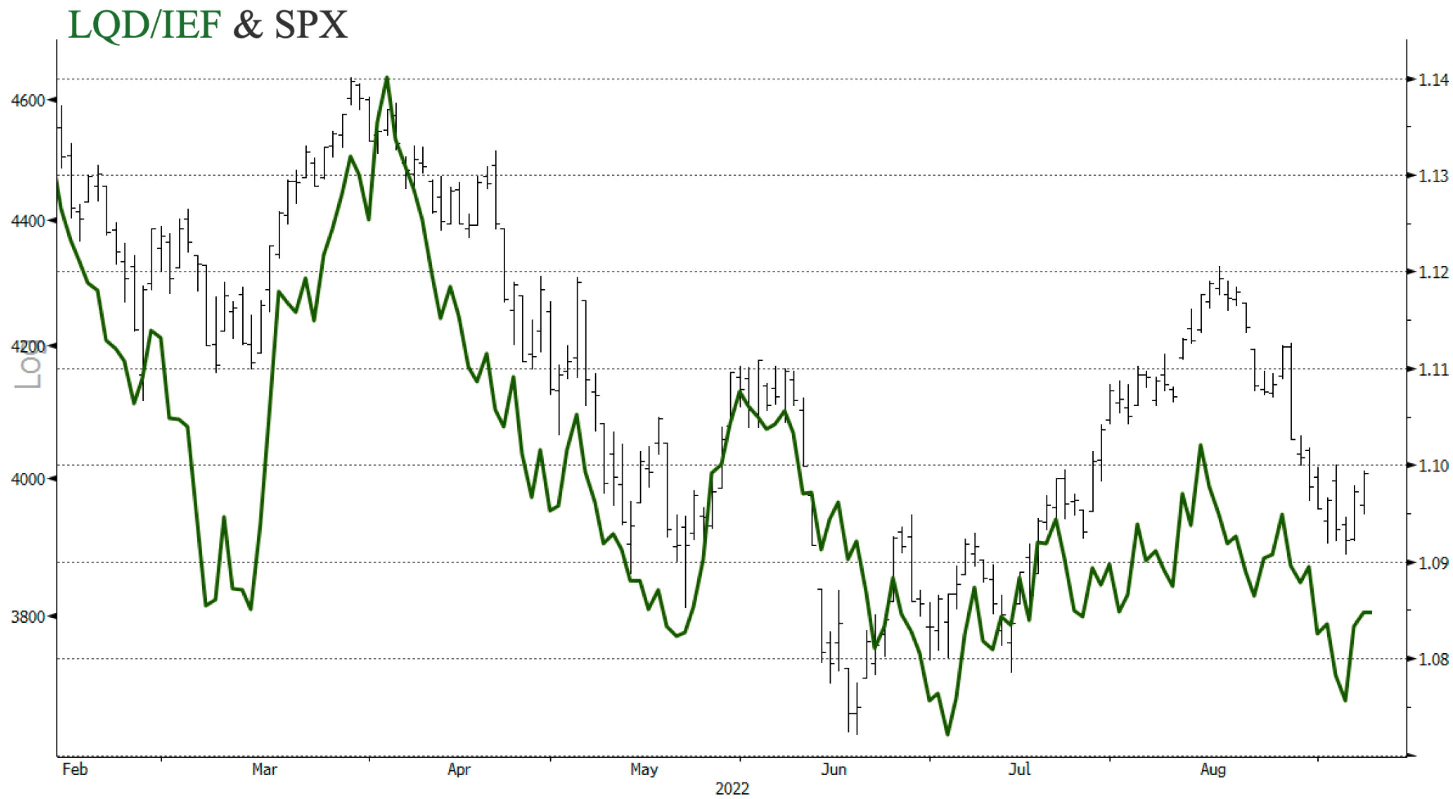
One, like I said, sentiment and positioning are just too one sided. It *feels* as though that narrative has outrun the data over the very near term. And when this is the case it doesn't take much for participants to over interpret incoming data as bullish and begin to spin a new bullish narrative that reverses price.

CESI is trending up and so we may start to see data being surprising to the upside shortly (readings above 0. I wouldn't be surprised if we soon see punters start talking about a *soft landing* and other nonsense.

Citi Economic Surprise Index - US



Credit is so far playing ball. We'll of course have to watch this to see if it continues.



And yields are holding steady, for now, at least. I keep saying this but yields are the linchpin here. If bonds can hold their recent level while stocks climb, **that'll be a sign we can up our risk exposure**. If not, we'll ride our stops tight on any tactical longs and look for a turn to add some shorts.

We added Desktop Metal (DM) yesterday as I like the chart for a tactical long, but I also like the company as a play on the secular reshoring and regionaliization thematic (more on that soon).

But there are a number of good looking technical setups, specially within the beaten down growth/tech space. A few of my favorites (that we don't already own), where I like both the fundies and techs, are: ESTC, TEAM, EPAM, PWSC, TTD, AFM:TSX, BTU, SMR, and UBER.

This SPX chart I shared two weeks ago (link here) still feels like a good fit. We got the down move and now we've put in a bottom. From here we head higher for a few weeks. And since there's a lot of managers who are underperforming the market on the year and are dramatically underweight risk, there's potential for a self-reinforcing run. As these guys face career risk which drives them to chase the market higher.

These are just some lines I put on a chart. So they're meaningless. Just my weakly held base case for the path going into the end of the year. Take with much salt.

That's it for now.

I do want to apologize for getting this note out much later than I had hoped to. Not to bore you with health stuff. But I've been treating mercury poisoning for the past few years. I fell into a puddle of the stuff while on on of my overseas combat escapades and it nearly killed me (I may write more about my story with this some day).

Anyways, the treatment often feels worse than the illness but I've made significant improvements over the past year and think I'm finally getting close to being a normal healthy person (knock on wood).

But, after my meditation retreat I was feeling so good that I thought it'd be a smart idea to not listen to my doctors and double up my treatment as I'm eager to be done with this nonsense (I chelate which slowly pulls the mercury out of my cells).

This was a bad idea. A bad idea I've done a few times now. Each time with the same predictable results. I crashed my adrenals which flatlines my endocrine system, which makes putting my thoughts into words a near herculean task. And this typically takes at least a couple weeks to recover from.

So that's it. Still no excuse as I hate to not produce and deliver on my word. So, again I apologize gang. Luckily, this phase is nearly behind me. And my girlfriend has taken control of my chelation so I won't be allowed to shoot myself in the foot again.

In my next note I'll be sharing the most important and interesting chart in the world. Gold is included in that chart, so for those of you who've been asking my take on PMs, just stand by for a couple more days.

I hope everybody enjoys their weekends and stays frosty.

Your Macro Operator,

Alexander